Palouse Capital Management, Inc.

Investment Commentary

1Q 2017

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MARKET OVERVIEW

In the January 2017 investment strategy letter, we highlighted several things that could reverse some of the gains we saw in the "Trump rally" that took place after the election. These issues included the dysfunction of Congress leading to potential delays in passing President Trump's growth initiatives as well as potential tests of Trump's leadership by some foreign dictators.

Some of these concerns played out in the first quarter, as an initial attempt at healthcare reform failed, thereby raising concerns over the ability of getting Trump's growth initiatives (tax reform, infrastructure spending, and reduced regulation) passed quickly enough to do any good in 2017. In addition, there have been rising tensions involving North Korea and Syria, as well as concerns regarding trade policies.

However, despite all these issues the Standard & Poor's 500 stock index, as well as other popular indices, generated solid gains in the first quarter. Several factors contributed to this: better economic conditions in the Eurozone as well as other parts of the world; better corporate earnings by US companies; continued suppressed interest rates in Europe and Japan, which encourage inflows into higher yielding US dollar assets; and continued hope that the Trump growth agenda will eventually get through Congress in a recognizable form.

How the stock market behaves from here will depend largely on a continuation of the factors listed above. Another major influence of the stock market is likely to be actions the FED is taking to gradually remove the extraordinary accommodation taken after the financial crisis of 2008. The FED raised rates in December 2016 and again in March. How quickly they increase rates up to levels that appear normal may depend on how the US economy performs, as well as how other financial markets in other parts of the world react to the FED's normalization strategy.

In addition, the latest release of the Federal Open Market Committee minutes showed a discussion ensued in regards to reducing the size of the FED's balance sheet. Before the financial crisis the FED's holdings of government and other securities was over $750 billion. As part of their stimulus plan the FED adopted a Quantitative Easing program in which they purchased government bonds and mortgage backed securities, thereby taking the balance sheet up to about $4.5 trillion. How to reduce the size of the FED's balance sheet while raising interest rates could be a challenging balancing act. A misstep in this process could cause some problems for the stock and bond markets.

Due to the large number of uncertainties and cross currents in the big picture, it appears the stock market could be choppy over the near term. The markets could get a boost if President Trump unveils a tax plan that appears to have a good chance of passage. The stock market may care the most about corporate tax reform, a repatriation tax structure that could encourage companies to bring back cash from overseas, and an infrastructure plan perhaps using the tax revenues from the repatriation tax to fund the infrastructure spending.

Individual tax reform is potentially a later story, especially if the border adjustment tax is part of the package. The border adjustment tax appears to have numerous problems and issues which we may discuss in the future in case this tax is proposed. In the meantime, continued focus upon individual companies' earnings progress may be a more fruitful effort than trying to guess short term movements of the overall market.

STRATEGY FOCUS

Equity & Fixed Income Strategies

Even with global tensions on the rise, the expected rate increase and national political turmoil, the S&P 500® posted a positive 5.21 percent gain for the first quarter of 2017. Within the index, growth far outperformed value during the quarter, with the S&P 500 growth index returning 8.5 percent, compared to the S&P 500 value index up 3.3 percent. Only two sectors were in negative territory for the quarter, energy and telecom services, down 7.30 and 5.06 percent, respectively. All other sectors posted strong returns, with the information technology sector showing a double-digit return of 12.16 percent. Consumer confidence seems to be more positive about the economy, reflected in the consumer discretionary sector posting a strong 8.09 percent for the quarter.

Our Diversified Income Strategy posted strong results for the first quarter of 2017, albeit below the S&P 500 return. The cash weighting, along with no exposure to utilities and our underweight in health care were the main contributors to this underperformance. Our underweight in energy continued to enhance the portfolios.

Our Large Cap Value Total Return Strategy and our Large Cap Value Strategy returned strong gains in the quarter, again due primarily to our under-weight in the energy sector. Stock selection within industrials also contributed to our positive results. Being underweight the telecom sector in the Total Return Strategy, and having no exposure to the telecom sector in our Large Cap Value Strategy, aided in our positive gains.

While posting a positive return for the first quarter of 2017, our Small/Mid Cap Strategy lagged its respective index. Our cash weighting, along with individual stock selections in information technology, financials, and materials, were the primary reasons for trailing the index. We anticipate that our individual stock selection will be the primary driver for positive results as we move further into 2017.

Conference Call and Podcast

Our clients are invited to our weekly podcast and conference call. In each of these programs, Ken Roberts and Bryn Harman discuss market developments and trends that we observe in our week to week research efforts. Please contact Bryn Harman at bharman@palousecap.com for more information.

[1] PCM obtains all financial/performance data cited herein from Bloomberg, S&P Dow Jones Indices, and Russell Investments, as applicable.

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