CONGRESS ASSET MANAGEMENT COMPANY

Economic and Market Outlook

First Quarter 2018

The year 2017 should be remembered as the year we left the financial crisis behind. A strengthening domestic economy is now supported by a *synchronized global expansion* – the newest investment phrase meant to capture a mood and secular trend, much as global financial crisis did a decade ago. We ended the year with nearly idyllic investment conditions: negligible inflation, low interest rates, record employment and strong corporate earnings. Hopes for the recently enacted tax reform bill suggest the good times could last.

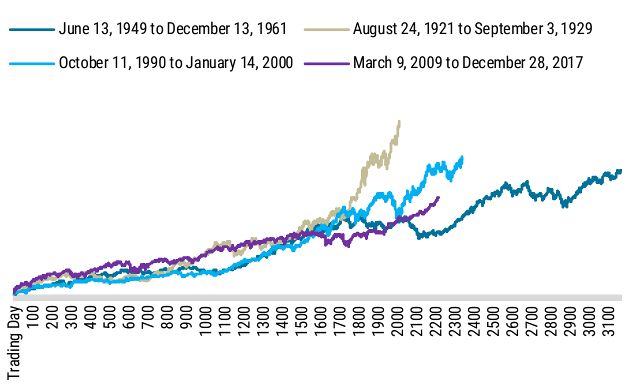
The stock market captured the optimism of the investment community. For the first time ever the S&P 500 increased every month of the year. This gentle market witnessed few meaningful downturns and was accompanied by positive returns in foreign markets as well. The long anticipated rise in market interest rates remained in abeyance, keeping financing costs low and supporting riskier investments. While the absence of significant down trading days is unusual, it is not alarming and does not portend a market collapse.

If exuberance is evident, it may well be in the burgeoning market for crypto-currencies. These digital currencies act more like trading vehicles, not currencies in the traditional meaning of the word. The Wall Street Journal recently reported that there are 31 digital currencies with values over $1 billion. Some forms of digital currencies are likely to survive but their purpose and format as a means of exchange or store of value are unclear. A shakeout is coming and those over-exposed will feel the pain.

Much has been made about the length of the current economic expansion, one of the longest on record, as if time should dictate when it should end. The magnitude of the expansion does not match its longevity, however. A robust expansion typically puts inordinate demands on productive resources, causing inflation or excess speculation. There is little evidence that either is occurring. Employment, an important ingredient for production, has been strong. Unemployment is hovering around 4%. It appears that people are being drawn back into the workforce, alleviating wage pressures that could arise in this strong employment environment.

The Current Bull Market in Perspective

The Three Great Bull Markets of the Past Century & the Current Bull Market



Bull Market defined as no Dow Jones Industrials Average decline of 20% and a minimum length of 6 years

Source: Bloomberg & Dow Jones Industrials

More People are Finding Work

% of individuals outside the labor force who have found jobs on a monthly basis

Line reflects Flows into Employment: "Not in Labor Force to Employed" divided by "Total Number of People Not in the Labor Force"

Source: Bureau of Labor Statistics December 2017

The new tax package supports growth as well. By lowering the corporate tax rate and allowing for immediate expensing of big ticket items, companies should be incentivized to return profits earned elsewhere and invest in productive capacity, meeting anticipated demand in a more cost efficient manner. Many consumers and employees should benefit from tax reform as well. The new tax package will increase the use of the standard deduction, easing the tax burden on 70% of all filers, a number which is anticipated to rise. In addition, many companies, from AT&T to Wells Fargo, have announced bonuses or wage increases as they share the benefits of lower tax rates with employees.

In short, the economy should continue along its growth path. Some secondary measures of future growth indicate that caution is warranted but these readings are inconsistent and probably reflect normal pockets of weaker growth.

The stock market has risen for the better part of the expansion supported by the aforementioned economic growth and low interest rates. As corporate earnings continue to grow, the market should respond in kind. Yet the market is more forward-looking and we see some risks that heretofore the stock market has not registered, largely confined to central bank actions and fiscal policy.

The Federal Reserve has been in a tightening mode for two years. Its adjustments to monetary policy have been gradual and communicated in advance, easing financial markets through the transition. A new chair will take the helm in February and, while he is likely to continue communicating the Fed's intentions, the cumulative effect of changes since 2015 could result in investors adjusting their risk preferences.

Other central banks, notably the European Central Bank and Japanese Central Bank, followed the Fed's aggressive easing steps after the financial crises. Neither of these two important players have begun to tighten, however. When other major central banks do begin tapering investment dollars may be deflected elsewhere, causing the liquidity pool available for stocks to suffer. This tapering may begin as early as 2018, depending on economic circumstances. The U.S. at some point needs to address its fiscal deficits which will likely be exacerbated by the tax cuts. Deficit predictions are imprecise at best but we are running an unusually high deficit for an economy expanding at a 3% clip. This could represent a longer term economic health issue, one to which stocks typically pay little attention until a more acute response is required.

These concerns are notable, but unlikely to weigh materially on stocks in 2018. We expect the upward trending market to continue, albeit with more normal volatility as investors begin to discount growth and inflation levels into 2019 and beyond. Stocks are preferred to bonds as interest rates remain historically low and liquidity high.

Best wishes for a happy and healthy New Year.

Investment Oversight Committee
Daniel A. Lagan, CFA, President

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