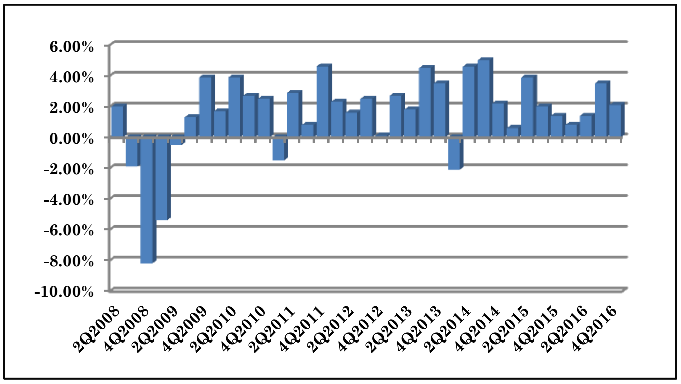
Quarterly Commentary

WEALTH MANAGEMENT

US Economy

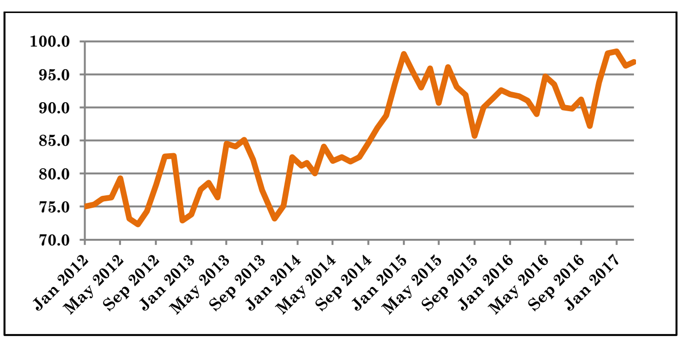
Improvements in the economy continued in the first quarter of 2017.

U.S. GDP Growth Rate



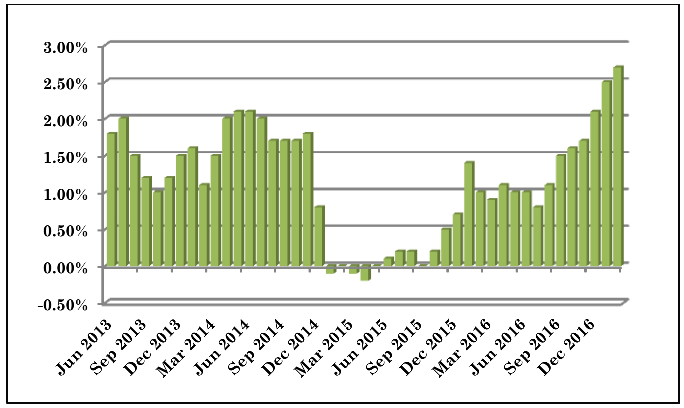
Both consumer and business sentiment remain good, but spending lags those feelings. Many have expressed concerns that the economy is in its eighth year of expansion and is vulnerable to recession. Business debt climbed to 72% of GDP in 2016. This eclipsed the prior peak of 70% set in 2009 and explains why some companies are curbing expenditures.

Consumer Sentiment



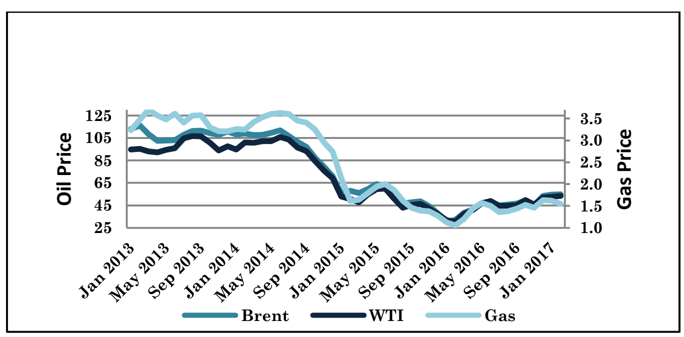
Tighter labor markets spurred wage inflation, while infrastructure optimism bolstered commodities. This combination resulted in the largest CPI increase in over five years.

12 Month Change in CPI



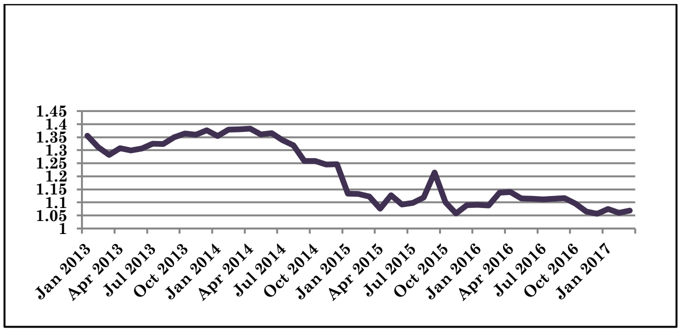
Oil and gas prices firmed on a November OPEC production agreement which seems to be holding. Admittedly, markets were cynical at first as this was the first production cut in eight years, and prior attempts to reduce supply were only marginally effective. Crude prices are hovering near the magical $50 per barrel mark, which allows most domestic drillers to make a profit.

Oil and Gas Spot Prices



The Fed's March interest rate hike marginally strengthened the dollar because it was so anticipated, and European economies started to show some life of their own. Hints at further hikes are being met with some degree of skepticism even though Chairman Yellen is getting some rare backing from President Trump.

Euro vs. U.S. Dollar



Housing prices rose again in the first quarter. While they have recovered all of the losses from the financial meltdown, they are still considerably behind their long-term appreciation trendline.

Global Stocks

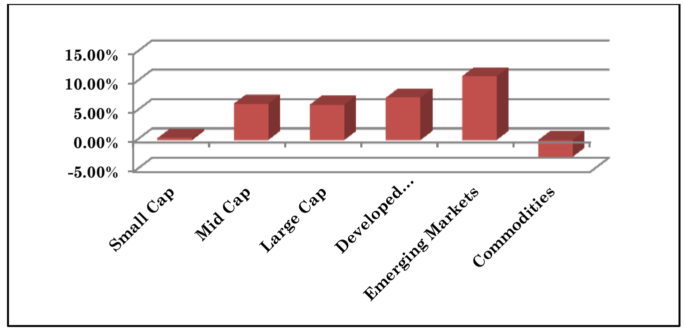
The stocks of most countries rose in the first quarter on the strength of the global economic recovery. US equities continued the Trump Rally albeit with different sectors leading versus last quarter. European companies enjoyed their best quarter since 2013 and Emerging Markets did even better. Chinese stocks had their best quarter in ten years.

Developed International

The United Kingdom (UK) is preparing to leave the European Union (EU) following its vote to trigger Article 50 of the Treaty of Lisbon. They are now on a two-year track to separate themselves from the other 27 EU member nations. This will require the renegotiation of countless trade agreements over which member has veto power. Obviously this will be a momumental task because the EU wants to make an example of the UK to discourage others from following suit.

On the continent, anti-Euro candidate Geert Wilders lost in the Netherlands, but Marine Le Pen looks like a possible winner in France. Her victory would put the EU in jeopardy and unravel years of cooperation. Unfortunately these elections come as the European Central Bank's Quantitative Easing finally begins to have the desired effect.

Asset Class Performance



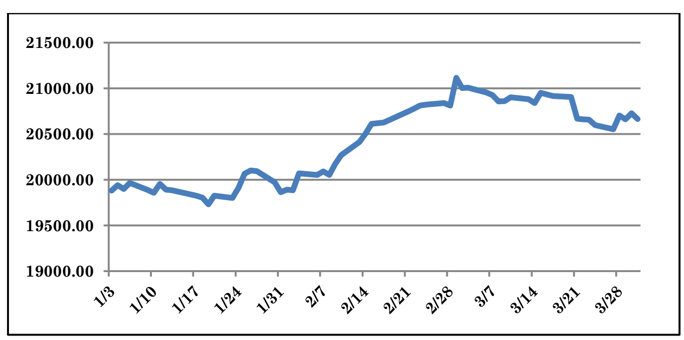
Emerging Markets

The global recovery in Developed Markets is spilling over into the Emerging Markets. Asian markets in particular saw huge inflows. Fears of a Chinese "hard landing" are abating and this is reflected in its neighbors' stocks and currencies. Even Russia saw analysts raise their corporate earnings estimates.

US Markets

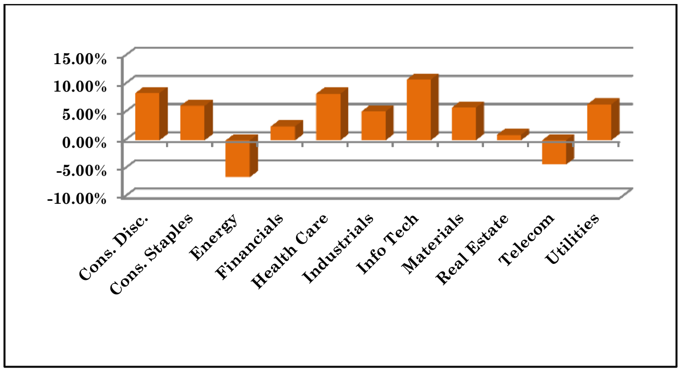
Domestic stocks enjoyed a buying spree in the first quarter based on improving revenues and earnings forecasts. Volatility remained surprisingly low despite numerous political set-backs and the possible delay of several key campaign promises.

DJIA



Sectors saw some investor rotation from the fourth quarter but most stocks remain priced to perfection. Information Technology, Health Care and Consumer Discretion lead the rally while Materials, Telecom and Energy lagged.

Sector Performance



Outlook/Strategy

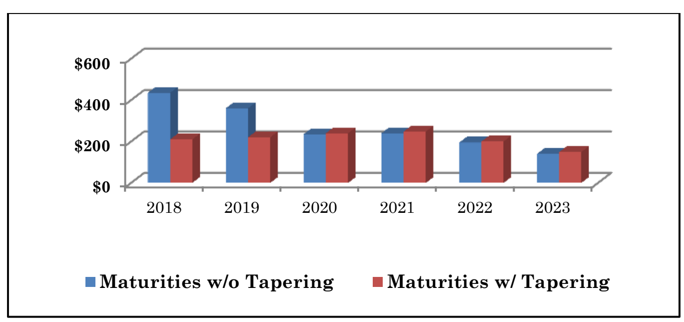
Stocks are currently priced on the optimism of the Trump Agenda and the hope that it will be enacted with the expediency he promised during the campaign. Key factors in the Make America Great Again pledge are: 1) Tax Reform, 2) Obamacare Repeal and Reform, 3) De-regulation, 4) Trade Agreement Renegotiation and 5) Infrastrucure/Wall Spending. Of those five initiatives, deregulation is the only one on schedule. Tax Reform could have the greatest effect but it is being subordinated to the repeal of Obamacare. With the infighting between the conservative and moderate flanks of the GOP, that seems unlikely anytime soon. The Infrastrucure/Wall Spending is also unlikely in the near term. "Shovel-ready" projects have not been identified nor have funds been set aside for them. This leaves the market in the precarious position of being set up for disappointment.

Fixed Income Markets

When the Federal Reserve embarked on Quantitative Easing (QE) after the financial crisis of 2007-2008, investors became focused on the Fed's balance sheet. The Fed had reduced the Fed Funds rate (inter-depository institution lending rate) dramatically, so it turned to another method to help keep rates low. In an effort to stimulate spending and economic growth, the Fed began purchasing large amounts of government supported, mortgage-backed securities and U.S. Treasuries (QE) which expanded its balance sheet. There is no real limit to how large the Federal Reserve's balance sheet can get, and at the height of the financial crisis, we saw their balance sheet expand to over $4 trillion. Expanding or contracting its balance sheet is an unconventional way of implementing monetary policy, and with the unprecedented chain of events during this time, the Fed was using all extraordinary means to get the economy back on track.

In late 2014, the Fed Chair announced the end of the bond-buying program (QE), but due to reinvestment of principal payments and maturing securities, the balance sheet still sits at $4.5 trillion. As economic conditions and the labor markets have improved, the need to hold large positions of bonds to help keep interest rates low may no longer be valid. The most recent comments coming from the FOMC imply a growing optimistic view of the economic outlook, both domestic and globally. As a result, a more aggressive Fed is emerging. The minutes from the March FOMC meeting confirmed that a reduction in the balance sheet had support and could possibly begin before year end. Although this was not a huge surprise to the markets, the method of reduction comes into question.

Fed's Bond Maturity Schedule



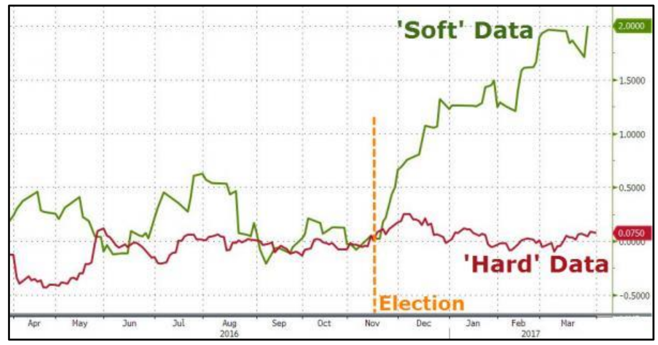
Should the Fed decide to sell securities, it could potentially put pressure on interest rates, and yields could rise rapidly as supply floods the bond market. If the assets mature, the markets will still experience a huge amount of supply rolling off, without being reinvested, also causing rates to rise. This type of volatility is not the objective of the Fed and the concern appears more immediate due to the large amount to mature in 2018 and 2019. The most likely outcome is for the Fed to taper the program as opposed to letting in completely end. The objective would be to allow interest rates to rise gradually, as inflation expectations and growth moves forward, and by reinvesting some of the maturing securities it will ease into the transition, thus easing the rise in bond yields.

After the November election, bond yields rose, on the anticipation of tax cuts, infrastructure spending and reduced regulation. The 10-year Treasury reached 2.63% on March 14, but has retreated 19 basis points since the last FOMC meeting. The question remains, is the bond market ignoring the Fed, or is the pullback in yields merely coinciding with a reset of expectations? Divisions within the Republican Party, and the failure to get the first attempt at health care reform passed, left the markets rethinking the administration's ability to carry out its agenda successfully.

Aside from the fact that yields have trended lower since the March rate hike, the Fed has restated its optimism on the economy and has suggested more rate hikes are on the table before year end. It would seem the bond market has reduced its shorter term expectations for a bump in economic growth and is waiting for some clarity in policy. The short end of the yield curve is reacting more to political implications than a continued shift in monetary policy.

There also seems to be a disconnect between the markets' reactions and certain economic data. The divergence between "soft data" (i.e. consumer and business sentiment) and "hard data" (i.e. wages and GDP) is approaching all-time highs. Business owners report feeling more optimistic, but election promises for tax cuts and deregulation have yet to materialize, and increases in capital expenditures are spotty. The administration's proposed agenda is ambitious to say the least and the effects of implemented policies showing up in the "hard data" will take time. The markets have seemed to take it all in stride, with both the equity and bond markets posting positive returns. The markets, however, are not always patient. For expenditures to become reality, government policies will need to be more detailed sooner rather than later.

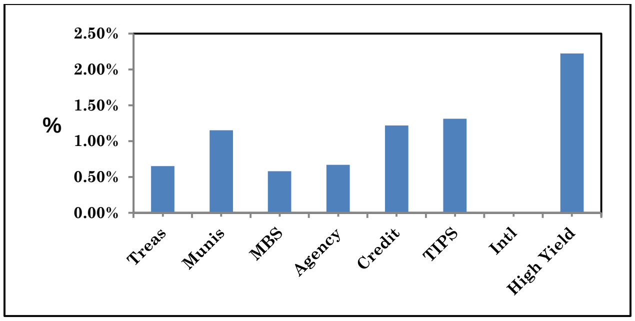
Economic Data Divergence



Fixed Income Performance

All fixed income categories registered positive returns for the first quarter, with high yield leading the way. Yield spreads for emerging market debt and below-investment-grade corporate debt narrowed, making these sectors expensive relative to the rest of the bond market. Investment grade corporate bonds have performed well and are expected to continue doing so. Corporate tax cuts could increase corporate cash flow and make it easier to service debt, thus improving relative attractiveness. Mortgage- backed securities may experience some downturn due in part to increased issuance and the potential surrounding the Fed balance sheet maturity schedule.

Fixed Income Sector Performance



Fixed income strategies going forward will still benefit from broad diversification across all classes. Due to the current slope of the yield curves, it appears to be prudent to keep a portfolio's duration (measurement of interest rate sensitivity) in the 5 to 7 year range, taking advantage of potentially higher interest rates at the end of the year. Of course, all will depend upon economic growth, fiscal policies and inflation expectations.

Municipal Bond Market

With new issuance lower than expectations, the municipal bond market posted a positive quarter, outperforming U.S. Treasuries. In spite of the past four quarters of positive return, the potential for a decline in individual tax rates continues to weigh on the market. However, the muni market seems prepared for lower rates, and current yields seem to be pricing in policy change. Even if lower tax rates diminish the value of the tax-exempt status, the elimination still seems unlikely. Demand continues to be steady as investors seek low volatility, high quality and tax free income assets. Pension liabilities still plague various states and county governments, and the potential for rating downgrades does exist. We focus on high-quality general obligation and essential services debt, and a duration target that is neutral to shorter than the benchmarks, in order to maintain flexibility in a changing interest rate and policy environment.

Outlook/Strategy

The biggest issues that will drive the bond market- tax reform, infrastructure spending and trade policies- are still greatly unknown. At this time, the bond market appears to be in a wait-and- see mode. Rates moved lower at the end of the quarter, as post-election confidence faded somewhat. With inflation and GDP remaining within the Fed's range, and wage growth stabilizing in the 2.5% range, pressure on rates to move higher is minimal. The yield curve has historically been an accurate indicator of future economic activity and growth. The flattening that has taken place (short rates moving higher and longer term rates moving lower or stable) can signal a more aggressive Fed. Regardless of the pace of future rate hikes, we are still advocates of fixed income investments. Markets do not like uncertainty, and these are the times to remain steadfast to one's investment strategy. For the buy and hold investor, with a properly structured portfolio, a rise in interest rates will have minimal effect on the cash flow, income, and face value returned at maturity. An appropriate portion of a portfolio allocated to bonds can provide consistent levels of income, diversification from the equity markets, and help reduce overall portfolio volatility.

Richard L. Ware, CFA & Beth D. Swartz

March 31, 2017

www.chesapeakewealth.com

References

1. U.S. GDP Growth Rates

U.S. Department of Commerce, Bureau of Economic Analysis: Quarterly growth of Real Gross Domestic Product on a seasonly adjusted basis.

2. Consumer Sentiment

University of Michigan, Survey of Consumers:
Based on 500 phone calls in the continental US normalized to a value of 100 in December of 1964.

3. 12 Month Change in CPI

U.S. Department of Labor, Bureau of Labor Statistics: 12 month change in the Consumer Price Index for all urban consumers on a seasonally adjusted basis.

4. Oil and Gas Spot Prices

U.S. Energy Informantion Administration: Average spot price over each calendar month.

5. Euro vs U.S. Dollar

International Monetary Fund: Representing the amount of U.S. dollars it takes to purchase one Euro.

6. Asset Class Performance

Morningstar:: Small Cap – Russell 2000 Index, Mid Cap-CRSP Mid Cap Index, Large Cap-S&P 500, Dev, Int'l-EAFE Index, Em Mkts-FTSE Em. Mkt Index.

7. DJIA

Dow Jones Industrial Average: Price weighted index of 30 U.S. large cap stocks.

8. Sector Performance

Morningstar: Sector performance of the 11 S&P 500 sectors on a quarterly basis.

9. Fed's Bond Maturity Schedule

Federal Reserve Economic Data

10. Economic Data Divergence

Bloomberg.

11. Fixed Income Sector Performance

Bloomberg Barclays Indices.

Disclaimer