BRIDGES INVESTMENT MANAGEMENT

Think Forward

Market Comments
July 2, 2016

S&P 500	2099
10 Year yield	1.47%

What are the most important things investors should know at the halfway point of 2016?

1. Capital markets returns for the second quarter, first half of 2016, and the last twelve months are summarized below:

Index	2nd Qtr 2016 %	1st Half 2016 %	Last 12 Months %
S&P 500 Index	2.45	3.82	3.98
S&P MidCap Index	3.99	7.99	1.32
S&P Small Cap Index	3.47	6.20	-0.07
MSCI World Index - ex U.S.	-0.44	-0.71	-9.76
Barclays U.S. Aggregate Bond Index	2.21	5.31	6.00

2. The S&P 500 ended the second quarter at 2099, up slightly from 2060 at the end of the first quarter, and up modestly from 2045 at the end of 2015. Midcap and small cap stocks did a little better than large cap stocks in the first half, buoyed by a sharp recovery in energy and commodity stocks from the stock market's mid-February lows. The small year-to-date gains in U.S. stocks belie significant day-to-day market volatility, first brought on by sharply lower energy prices in the first quarter, and then by a sharp but brief decline triggered by the Brexit vote in the U.K. at the end of the second quarter. We expect continued choppy equity market conditions in the second half of 2016 and into 2017; it would not be a surprise to see either a 15-20% decline or gain, or both, in the S&P 500 over the next twelve months. International equities have declined year-to-date as global economic conditions remain soft relative to the U.S.

3. U.S. stocks remain close to our estimate of "fair value." We believe U.S. stocks are currently priced to provide mid-to-high single digit returns from current levels over the next several years, albeit with increasing levels of interim volatility. If stocks were to decline by 15-20%, we believe they would provide excellent long-term value; we would be inclined to reduce commitments to stocks in the event of a 20% increase in stock prices in the short-term.

4. We currently estimate "fair value" for the S&P 500 at 2200-2250 for year-end 2016 (17-18x estimated earnings of $120-125), and 2300-2400 for year-end 2017 (17-18x estimated earnings of $130-137). Our fair value estimates imply total returns for stocks of 4-7% in the second half of 2016, and 9-15% from current levels through the end of 2017. We define "fair value" for stocks as the valuation level from which long-term future returns will be dependent solely on earnings growth and dividends, with no change in underlying valuation (because valuation, in terms of the price-earnings multiple investors place on stocks, is "fair" – the level at which stocks are neither significantly undervalued nor overvalued relative to a reasonable estimate of their long-term growth in business value). At present, we believe stocks are fairly valued at 17-18x earnings, in line with long-term historical average valuations for U.S. equities. If long-term interest rates remain between 2-3% (the 10-year Treasury is currently is near an all-time low at 1.40%), we believe that a somewhat higher P/E for stocks would be justified (at around 20x). We believe that stock valuations currently discount an eventual return of interest rates to 3.0-4.0%.

5. We believe bonds remain unattractive because current interest rates remain very low on both a nominal and real (nominal yield less inflation) basis. Given the unattractiveness of bonds, we remain both underweighted in bonds relative to other stocks, and defensively postured within bond portfolios. While our relatively defensive posture in fixed income portfolios has cost us some relative performance over the past year, we believe our defensive positioning with respect to bonds is appropriate given the very high valuation at present for bonds. If interest rates rise from current levels (1.5-2.0%) to 3.0-4.0% over the next several years, it is likely that bond returns will be negative. We continue to expect that stocks will outperform bonds over the next three to five years, or until such time as interest rates return to more normal levels.

6. Corporate earnings growth remains the most important variable in our constructive long-term outlook for stocks. Second quarter earnings season will provide us with insight regarding the current strength of the global economy, and the outlook that corporate managements have regarding profits over the intermediate term. We will be closely watching management guidance for earnings for the second half of 2016 and 2017. Aggregate S&P 500 earnings are being slowed by a stronger dollar, lower energy prices, and very low interest rates; these factors have been a drag on earnings over the past six quarters, but may be reaching an inflection point. Aggregate earnings in the current environment are less useful than normal for helping gauge overall market valuation, and we believe over the next several years, company-specific differentiation will be important given an overall economic climate characterized by below-average strength.

7. We are looking for opportunities to increase our exposure to international equities, given their significant lag in performance relative to U.S. stocks. On the one hand, international equities are "cheaper" than U.S. equities, and the strong dollar has increased the attractiveness of non-U.S. stocks, but economic growth outside the U.S. remains sluggish; long-term, we continue to favor U.S. equities over international stocks.

8. We see significant long-term opportunity in sectors and individual companies that have struggled over the past four quarters. Health care stocks in general, and bio-technology stocks specifically, have really struggled over the past year, as earnings growth has slowed (although it remains strong both absolutely, and relative to the broad market) and fears of increased government regulation have increased. Valuations in health care appear to be very attractive over the intermediate to long-term. In a difficult economic environment, we favor companies with demonstrated ability to generate solid business value and free cash flow growth.

Summary

Overall, capital markets returns in the first half of 2016 were modest, but positive. We expect continued equity market volatility, as investors weigh economic risks in Europe, the ongoing impact of a strong dollar, commodity price volatility, the effects of an eventual end of the accommodative Federal Reserve stance, and a Presidential election in the U.S.

In the current challenging capital markets environment, we remain very defensively postured with respect to bonds, and we continue to focus equity investments on those companies with strong and enduring business franchises, demonstrable records of growing shareholder value, growing levels of free cash flow, and attractive long-term valuation characteristics.

Our current capital markets expectations are attached.

Ted Bridges, CFA
President

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Capital Markets Expectations

Current Levels: (06/30/2016) *S&P 500*	2098.86	*Ten Year Treasury*	1.49%	*Inflation:*	1.00%

Long-Term Total Return Expectations:

Asset Class	**Current**	**Historic Range**
Cash	0-1%	2-3%
Treasuries	0-2%	3-5%
Investment Grd Corporates	1-3%	4-6%
High Yield Bonds	4-7%	6-7%
Preferred Stocks	4-6%	6-7%
U.S. Equities	6-9%	9-11%
U.S. Small-Midcap Equities	7-10%	9-12%
EAFE Equities	6-10%	9-11%
Emerging Market Equities	7-11%	9-12%
Alternative Investments	4-8%	4-9%

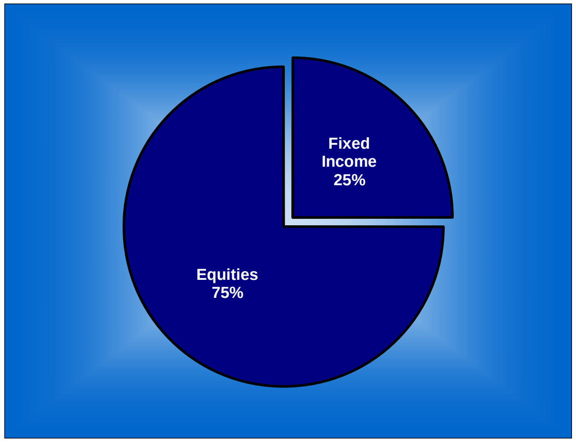
Long-Term Capital Markets Characteristics

	Current	**Historic Range**
U.S. Investment Grade Credit Spread	50-100 bps	50-100 bps
U.S. Equity Risk Premium	4-6%	4-6%
U.S. Equity Dividend Yield	1.5-2.0%	1.5-3.0%
S&P 500 Long-Term Earnings Growth	4-7%	6-7%
Current P/E 2016 (S&P 500)	17.5x	
Current P/E 2017 (S&P 500)	15.8x	
Fair Value P/E	18.0x	15-17x

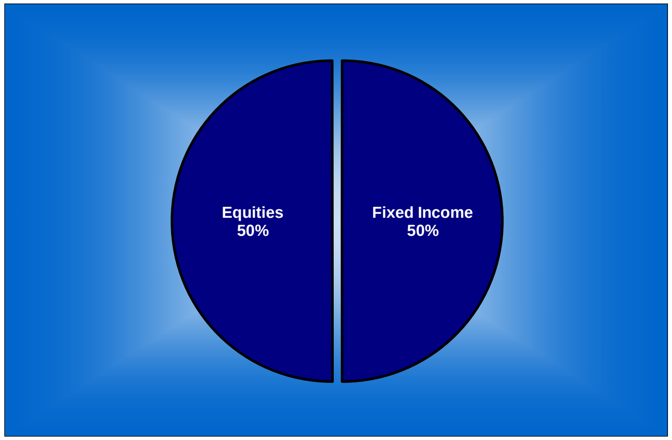
Capital Markets Forecasts 2016-2017

S&P 500 (2016)	Earnings	$115-122	Year-End Fair Value Target	2100-2200
S&P 500 (2017)	Earnings	$130-137	Year-End Fair Value Target	2275-2400
Ten Year Treasury	Range	1.0-3.0%	Year-End Target	2.25%

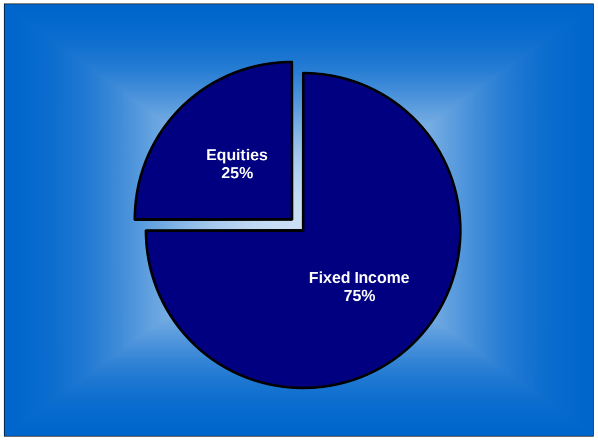
Long-Term Expected Returns by Asset Allocation



6.375% (2.25% yld, 4.125% appreciation)



5.25% (2.5% yld, 2.75% appreciation)



4.125% (2.75% yld, 1.375% appreciation)

Return assumptions for charts: Equities 5.5% appreciation, 2.0% yld; Fixed Income: 3% yld

Key Assumptions:

* U.S. shows GDP growth in 2016-17 at 1.5-2.5% annual rate
* Expect higher interest rates in 2017 as market as Fed begins to tighten
* Corporate profit growth positive but sluggish in 2016-17; weak oil prices, low interest rates, and strong dollar remain headwinds to earnings
* Fixed Income remains less attractive than equities given low nominal and real yields and risk of higher interest rates and inflation
* Domestic equities remain attractive long-term; we expect continued elevated levels of stock price volatility in 2017
* International and emerging market equities are inexpensive, but have greater earnings growth uncertainty due to sluggish international economic conditions.
* We prefer companies with a demonstrated ability to grow revenue, earnings, dividends, and free cash flow in a sluggish economic environment.