CHEVY CHASE TRUST
INVESTMENT ADVISORS

Investment Update—April 2017

This is a quarterly update of economic conditions and investment strategy.

During the first quarter of 2017, the S&P 500 Index generated a total return of 6.07%. Almost all of the gain, 5.36%, occurred between early February and early March. Since the election, the S&P has returned slightly over 10%. While the prospect of market-friendly policies has contributed, we believe most of the move is underpinned by strength in economic data.

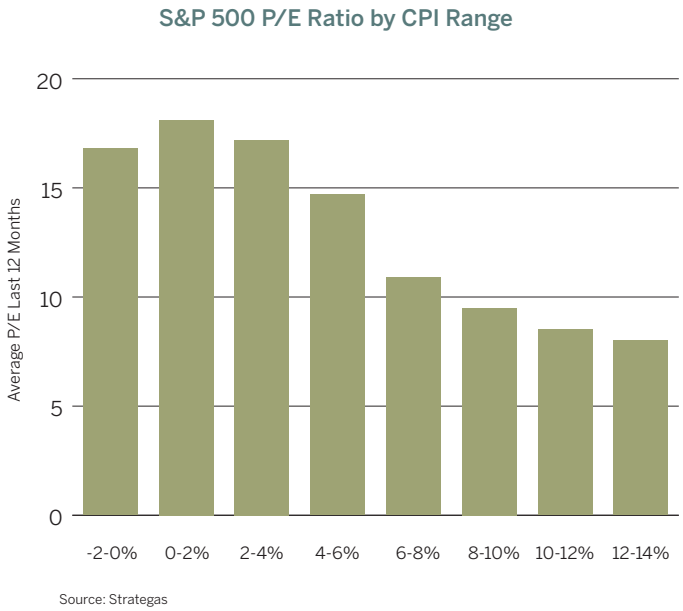
As it stands now, we are in the second longest bull market since 1928. It is logical to think about how and when it will end. The challenge for bears is that there are few signs of speculative excess that normally accompany the start of a bear market. Further, there is a real risk of exiting too early. On average, the final two years of a bull market have represented over 40% of the total return for the cycle. Over the last 80 years, the smallest equity return in the final two years of a bull market was 30%, with median returns of 45%. While we are not expecting returns of this magnitude, we think equities will outperform most other asset classes in 2017.

The Economy and Inflation

We generally agree with Fed Chair Janet Yellen's assessment of the economy. During the most recent Federal Open Market Committee press conference in mid-March, she said that, "the simple message is the economy is doing well." Indeed, the moderate pace of growth that has prevailed since the beginning of the recovery means that the typical imbalances and pressure points that accumulate in the advanced stages of a business cycle are, so far, still absent.

Inflation has remained low, which has frustrated some, but we believe is beneficial for financial markets. Inflation-driven growth often feels good in the short term. Paychecks rise and debt becomes easier to repay. However, over longer periods of time, higher inflation tends to lead to tighter monetary policies and, eventually, recessions. For people on a fixed income, like retirees, even moderate levels of inflation can be problematic.

As illustrated in this chart, equity market price-earnings multiples begin to compress when inflation rises above 4%.



From an investment perspective, we are encouraged by the muted increase in U.S. wage growth. In March, the Fed revised its estimate of full employment to 4.7% from 4.8%. This may seem minor, but it suggests that policymakers believe the labor market has not yet tightened enough to push wage inflation higher. We would not be surprised to see the Federal Open Market Committee continue to trim its forecast for the structural unemployment rate in the coming quarters. We think it could fall as low as 4.2%-4.3% before

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we see inflationary pressure. This is critical because cycles typically peak when unemployment falls below NAIRU (the non-accelerating inflation rate of unemployment). We are not there yet.

Investments

Although inflation can feel like a "quick fix," the only true way to raise standards of living and increase durable, aggregate, real wealth is through productivity growth. Productivity growth is difficult to engineer and almost impossible to engineer quickly. It usually requires years of capital investment and technological breakthroughs. As thematic investors, we spend most of our time researching innovations that can influence productivity growth and impact the economy.

- **The $100 Genome** – The first successful sequencing of the whole human genome concluded in 2003. It took over a decade and cost approximately $3 billion. In January 2017, Illumina announced a new genomic sequencer that will have the capacity to sequence an entire human genome in less than an hour for about $100. Although the cost of genomic sequencing has been falling steadily and precipitously, many oncologists and industry experts we talk to say it is this latest breakthrough that has the potential to spur far greater market penetration and to radically change the course of treatment for certain cancers. Today it can take days or even weeks for doctors to receive comprehensive sequencing results for a tumor. In cases where cancer has metastasized, this relatively short period of time can be too long to wait to start treatment. The oncologist must prescribe medication and/or procedures without a complete genomic analysis. If the doctor could get statistically significant results in hours, rather than days, the calculus changes. We expect a significant increase in the number of genetic tests, and more important, an improvement in cancer treatment as a result of this breakthrough.

  Thematic Investment - Chevy Chase Trust has invested in the global leader in DNA sequencing technologies and the leading provider of comprehensive genomic testing. The latter identifies the molecular alterations in a patient's cancer and matches them with relevant targeted therapies, immunotherapies and clinical trials. We also invest in pharmaceutical companies with promising immune-oncology drugs currently on the market and in clinical trials. Because deciphering genetic information is extremely data intensive, several of our technology holdings will be direct beneficiaries of these developments.

- **Just Walk Out Shopping** – Anyone who has tried to "run into a store to pick up a few things" and ended up waiting in line too long will be pleased that very soon lines may disappear. Last December, Amazon opened an Amazon Go store. There are no cashiers, no lines, and no waiting for the chip reader to chirp "Please Remove Your Card." Walk in, pick up what you need and walk out. The purchases are posted to your Amazon account as you leave the store. Amazon has not revealed the technical details behind the Go stores. A combination of artificial intelligence, machine vision, RFID (Radio Frequency Identification) and sensor technologies make Amazon's "just walk out shopping" possible and importantly, replicable. Amazon plans to expand Go stores later this year. Productivity innovations often come with some adverse consequences. Currently, cashiers are the second largest job category in the U.S.

  Thematic Investment - Chevy Chase Trust owns Amazon in most client portfolios. As the leader in this initiative, it will clearly have a first-mover advantage. However, Amazon is likely not the only or biggest beneficiary from this technological breakthrough. With Amazon's annual revenue projected to be $165 billion this year, it is unlikely that the Go stores will be a large contributor to revenue or significantly influence the stock price. However, Amazon's effort may further erode market share from some already struggling traditional retailers. Avoiding companies in the bullseye of creative disruption is a core element of thematic investing. On the other hand, enablers of the technology will benefit. We currently own the global leader in machine vision systems as well as a leading manufacturer of scanning systems. Both will likely see sales rise as competitors upgrade or fully replace their own check out systems to try to compete.

- **The U.S. as an Energy Exporter** - One of the least discussed, but extremely consequential goals of the new Administration is to accelerate the transformation of the U.S. into an energy exporter. The Administration is on track to restart several dozen energy projects that

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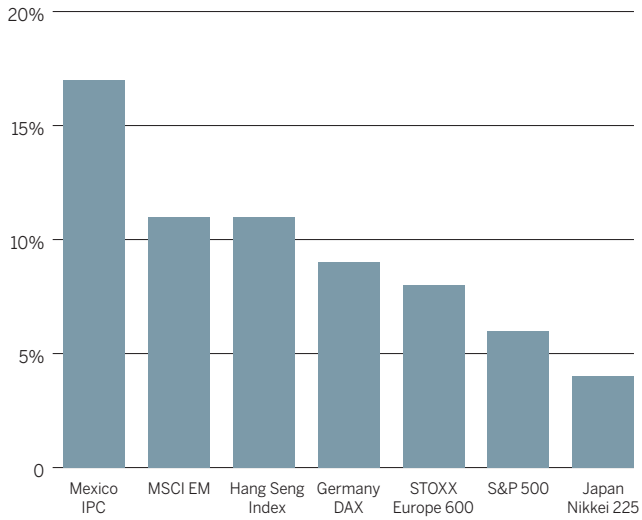
were either canceled or mothballed by legislation and regulation during the prior administration. If the U.S. meets this goal, it will be a political achievement that will be further enabled by technology. Technological advances in oil extraction have led to a huge increase in productivity, shifting the global cost curve downward. In the Permian basin, for example, oil production-per-rig increased by 350% in the last few years, lowering the break-even points for U.S. shale operators. This progress has led to a boost in production, while supporting profitability in a lower-price environment. The economic and geopolitical consequences of reducing U.S. dependency on foreign oil and potentially even becoming an energy exporter could be game changing.

Thematic Investment - Chevy Chase Trust is market weight the energy sector as a whole and underweight oil. Counterintuitively, increased investment in a sector more often than not leads to lower future returns. Although technological breakthroughs lower break-even costs for producers, in this situation we think they will also lead to more competition. We favor investment in companies that are among the lowest cost producers and have superior geological assets. These companies will likely fare best in this more competitive environment. Relatively low energy prices also support our longer-term benign inflation outlook and should provide a boost to our favored consumer-related holdings as money previously spent on energy will be redirected elsewhere.

Portfolio Positioning

In the latter half of 2016, we increased our non-U.S. holdings, particularly in developed markets such as Europe and Japan. We expect to continue to increase our non-U.S. equity exposure as we find companies domiciled abroad that benefit from our themes. Global economic growth has been accelerating in most geographies around the world. In fact, Europe's GDP growth rate was faster than the U.S.'s last year and economic performance in the region continued to be relatively strong in the first quarter of 2017. After several years of underperformance, many non-U.S. equity markets have outperformed the S&P year-to-date. We expect this to continue, due in part to lower valuations and more room for margin expansion.

Q1 Total Returns (US Dollars)



Fixed Income

After spiking higher late last year, long-term yields traded in a relatively narrow range during the first quarter of 2017. The 10-year Treasury bond began the year at a yield of 2.44% and ended the first quarter only five basis points lower at 2.39%, with a high for the quarter of 2.63% and a low of 2.30%. Similar to equity investors, bond investors will be attuned to inflation expectations. If inflation rises sooner and higher (not our current expectation), yields across the curve would rise at an accelerating pace and bond prices would decline. If inflation remains subdued, mid- and long-term bond yields may increase slightly, but not significantly.

As expected, at its most recent meeting the Fed increased the Fed Funds rate by 25 basis points to a range of 0.75%-1.00%. This is only the third rate hike in 15 months, a historically slow pace. Both the written and verbal commentary suggest that the Fed remains committed to a very gradual rate of increase. In fact, Chairwoman Yellen used the word "gradual" (or "gradually") 21 times during her press conference. Since the meeting, some Fed Governors have indicated that they anticipate three or four more 25 basis point rate increases this year. Even this pace feels slightly aggressive to us. Unless we see a significant pick-up in economic growth and/or inflation, we think there may be fewer rate hikes. A slower rate of increases is bullish for both equity and fixed income investors.