Quarterly Strategy Letter

1st Quarter 2018

THE RETURN OF VOLATILITY

State of the Markets Address

Volatility, the word that strikes fear into the minds of nervous investors, returned in the first quarter of 2018. After a strong start to the year, stock markets experienced sharp swings when volatility made its palpable comeback. Global stock markets ended the quarter down 0.92 percent, according to MSCI data, despite being up over 7 percent around the end of January. Domestic markets followed the same path before relinquishing any gains for the year, with the S&P 500 Index losing 0.76 percent in the first quarter.

A few different bouts of shakiness occurred during the quarter with the first seemingly the most jarring. Investor fears flared in late January over a strong employment number combined with a surprising jump in rates. That selloff appeared to be a harbinger of more to come as geopolitical concerns over international trade reared their heads and prices pulled back. International developed stocks lagged most other regions, losing 1.58 percent and over 4 percent in local currency terms as a weakening dollar aided some U.S. investors. Emerging markets were able to stem their decline after a resilient January, with the MSCI Emerging Markets Index gaining 1.24 percent for the quarter.

Fixed income markets were no exception to the deterioration felt across various financial markets. The Barclays U.S. Universal Bond Index lost 1.41 percent for the quarter as yields soared in the first several weeks of the year. The 10-year Treasury yield went from 2.41 percent at the start of 2018 to a high of 2.95 percent in just under two months – a startling move considering the rate hadn't really exceeded 2.6 percent since early 2014. Investment-grade corporate bonds led the declines for the period, losing 2.32 percent compared to a loss of 0.86 percent for their high-yield counterparts, according to Bloomberg data. Treasuries and mortgage-backed securities also performed relatively well compared to the broader index.

It seemed that almost nowhere was safe during the first quarter as many alternative investments also lost value. Broad commodity prices were almost unchanged for the period, but ended down 0.79 percent, according to the Bloomberg Commodity Index. Gains of over 20 percent in some base metals like nickel and zinc and a resurgence in crude oil pricing were not enough to offset the losses in the three main laggards of the index: natural gas, sugar, and coffee. The MSCI World Real Estate Index fluctuated between gains and losses for much of the quarter before settling down 3.75 percent due to rate and growth expectations. Hedge fund managers did not fare any better despite the increased volatility and, therefore to some degree, opportunity. The HFRX Global Hedge Fund Index lost 1.02 percent in the first quarter. Of the index's eight major subcomponents, only the relative value category was able to eke out a positive return of 0.02 percent.

Who Wants a Trade War?

Most of the instability in financial markets over the last few months arose from the potential for a trade war between the U.S. and China. As with many policy clashes, the initial movements toward a policy battle started small and some time ago. As President Trump took office, he directed the Department of Commerce to investigate imports on foreign steel in April 2017, and months later internally probed China's trade practices. The first open act of the potential trade war occurred in January of this year when the president enacted tariffs of up to 30 percent on imported solar panels and washing machines. Shortly after, the U.S. Commerce Department concluded its almost year-long study that resulted in a recommendation to employ tariffs or quotas on steel and aluminum in the interest of national security. While China was not even a top-10 supplier for U.S. steel imports in 2017, according to the Commerce Department, it is by far the largest steel producer and exporter. According to the World Steel Association, China made up almost half of the world's steel production in 2017. The trade dispute truly escalated when both countries announced tit-for-tat plans for $50 billion in import levies, followed by President Trump upping the ante by declaring potential

tariffs on an additional $100 billion of Chinese goods.

Conflict between the world's two largest economies will likely not bode well for trade or financial markets. Tensions and unease dominated stocks as they swung day to day on announcements from each side of the dispute. While the economic impact may be surprisingly muted – figures from Oxford Economics and Reuters showed that a full blown trade war would only shave 1.0 percent from gross domestic product between both the U.S. and China – ancillary policy moves like potentially restricting China from investing in certain U.S. technologies may have a more profound impact. One additional aspect that the administration is surely keeping in mind is that China is the largest foreign holder of U.S. Treasuries, with $1.2 trillion as of January 2018, according to the U.S. Treasury. That leverage, and how the yuan is pegged, supplies China with the capability to keep its exports competitively priced. Those holdings and their substantial trade flows improve China's negotiating power considerably.

It's plain to see that the tariffs are a key effort by the U.S. to curb the alleged stealing of intellectual property and trade practices that are generally perceived as unfair to companies operating in China. Officials in China have also made it clear they do not want a trade war, but are willing to protect their own interests. If it continues, the U.S. may be going down a rabbit hole from which it will be very difficult to return.

High Flying Profits

Despite the ebb and flow of company stock prices, earnings for S&P 500 companies have seen a dramatic increase as tax cuts hit balance sheets. Even though the Tax Cuts and Jobs Act was controversial in its tone toward individuals, particularly regarding the disparity in savings between upper and lower earners, the benefits to companies are already being seen. The first quarter earnings season, which lasts from February 16 through May 15, may be one of the best for company earnings since the Great Recession. Analyst expectations have been set aggressively higher: operating earnings expectations for S&P 500 companies jumped from under 13 percent to over 17 percent just before this season. Information from FactSet also estimates that earnings growth will top 17 percent, which would be the highest growth rate since 2011. Only a small portion of companies have reported so far, but earnings growth is currently over 31 percent.

Still, it's important to remember the difference between expectations and growth. As Bloomberg stated in an article earlier this year, "Even in the fourth quarter of 2008, when the world was falling apart and the S&P 500 reported its worst quarterly loss ever, 58 percent of companies still beat expectations!" Our team believes that the increased expectation for company profits is warranted, but overly aggressive forecasts may cause additional volatility especially in the cases of disappointment.

Earnings have continued to be a bright spot within financial markets and have helped to buoy stock prices even in the current environment. Double-digit profits and relatively strong sales numbers have shined over the past quarters and have been a source for some of the most recent legs upward in stocks. These data, along with numerous other factors like central bank policy and the synchronized global economic recovery, contributed to an extended period of ultra-low volatility. The CBOE SPX Volatility Index, also known as the "VIX" and the most common measure for U.S. stock market volatility, averaged just under 15 over the last six years, according to our own analysis. The assessment also showed the gauge has only exceeded 25 on eight separate occasions, and only two of those exceeded the 35 level over the same time period. These occurred back in August 2015 during a flash crash over a hard landing in China and changes in Fed policy, and in February of this year over a rapid jump in bond yields and, again, Fed policy concerns. Going forward, investors need to be mindful that the mechanisms that had held volatility at more subdued levels may be fading away, including an extremely accommodative Fed.

Powell's Precarious Position

Jerome Powell may have taken on more than he bargained for when he officially took office as head of the Federal Reserve in February. His predecessor, Janet Yellen, was fortunate enough to preside over a steadily improving economy and what could end up being the second half of one of the longest stock bull markets in history. However, all good things come to an end. Historically, tightening policy from the Fed has been a precursor to an economic slowdown and an increase in financial market volatility. It may make sense for the Fed to tighten policy in order to pump the breaks on the economy and protect it from overheating – where inflation may run rampant – but it seems hard to avoid the pullback in growth that comes

along with the policy change. This same scenario may play out in the coming years.

Over the years, our team has repeatedly written that fiscal policy would eventually overtake monetary policy as the main policy-related growth stimulus. Based on the tax cuts that occurred late last year and the continuing potential for fiscal stimulus via infrastructure spending, we believe that we called that dynamic correctly. However, the addition of fiscal stimulus after an already lengthy period of extremely accommodative monetary policy may result in further imbalances instead of a faster economic growth rate.

When reviewing economic data, particularly employment, it seems that the U.S. economy may have already peaked and that the addition of fiscal policies may not have added much to its momentum. Inflation seems to have been picking up in recent months, especially as an odd phenomenon in wireless phone pricing in March of last year drops off the rolling one-year data. Powell and the Fed will need to walk a tight rope between improving economic data and the potential for raising rates too quickly, which could cause real issues within financial markets and the economy. While this already drawn-out and maturing business cycle continues over the next months or even years, the possibility of a recession could rise along with the Fed's rates.

Where We Are

Geopolitics, particularly the rising tensions with Russia and the potential for a trade war with China, will likely dominate headlines. Accordingly, the Global Investment Management team continues to view these factors as the primary risk to financial markets over the near term. However, we do believe that most of the current trade conflict is simply positioning in preparation for trade negotiations, and that hopefully, an agreement will be made between the U.S. and China. While we haven't reached the point of a full-blown trade war, the rapid escalation has taken its toll on investor psychology. Our team believes market fundamentals remain fairly strong, that valuations, specifically domestically, have improved over the last few months as prices have normalized, and that the trade war will more than likely simply end up as a mild skirmish.

The surge that has been seen in earnings expectations will likely be supportive of a push higher in stock prices, but underwhelming results may have an opposite effect if forecasts are too aggressive. Despite the equity market's loss in the first quarter, the Global Investment Management team maintains our view that global stock markets will achieve modestly positive gains for the year. Over the shorter term, the main risks to this view involve the aforementioned geopolitics and a chance of earnings disappointments. However, over the medium term, we are looking closely at the Federal Reserve's pace of rate hikes and how economic data will change, or possibly turn over that time period.

For now, our strategies remain slightly overweight to equities as we expect stocks to outperform bonds on a risk-adjusted basis. It may not feel like it, but stocks did outperform bonds over the first quarter. Within that portion of the portfolio, we are favoring large capitalization stocks domestically, along with international developed markets, and are holding fairly neutral on emerging market companies. Bonds continue to be an asset class in flux, and our strategies are slightly underweighted to them based on our expectation for a slow but consistent rise in rates as economic growth solidifies. Our baseline scenario for rate increases holds at three hikes for 2018, but it may be forced to four if inflation and the Fed end up in a fight.

Alternative investments remain a key part of our portfolio construction, not only as a diversifier, but also for a separate stream of return from the traditional asset classes. Our team is looking to expand our allocations to alternatives over the coming years. While we are comfortable with our positioning in the current environment, our team is thoughtfully observing markets for any potential opportunities and will adjust our strategies accordingly.

Glossary

Alternative investments are investments that are not one of the three traditional asset types (stocks, bonds and cash).

Barclays U.S. Universal Bond Index is an unmanaged index comprising US dollar-denominated, taxable bonds that are rated investment grade or below investment grade.

Bloomberg is a major global provider of 24-hour financial news and information including real-time and historic price data, financials data, trading news and analyst coverage, as well as general news.

Bloomberg Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The Index is composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME).

Brexit is an abbreviation of "British exit", which refers to the June 23, 2016 referendum by British voters to exit the European Union. The referendum roiled global markets, including currencies, causing the British pound to fall to its lowest level in decades.

CBOE Volatility Index (VIX) is the Chicago Board Options Exchange Volatility Index reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes. 1st & 2nd month expirations are used until 8 days from expiration, then the 2nd and 3rd are used.

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Sometimes referred to as "headline inflation."

Corporate bonds are debt obligations issued by corporations. An investment in corporate bonds is subject to a variety of risks including credit and default risk, market risk, event risk, call risk, interest rate risk, foreign risk, and sector risk.

Dow Jones Average (DOW) is a composite of the price movement of 65 stocks, including 30 industrials, 20 transportation, and 15 utilities.

Emerging Market countries have economies that are progressing towards becoming advanced, as shown by some liquidity in local debt and equity markets and the existence of some form of market exchange and regulatory body.

European Central Bank (ECB) is the central bank responsible for the monetary system of the European Union (EU) and the euro currency.

European Union (EU) is a group of European countries that participates in the world economy as one economic unit and operates under one official currency, the euro. The EU's goal is to create a barrier-free trade zone and to enhance economic wealth by creating more efficiency within its marketplace.

Federal funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis. Institutions with surplus balances in their accounts lend those balances to institutions in need of larger balances.

Federal Reserve (Fed) is the federal banking authority in the U.S. that performs the functions of a central bank and is used to implement the country's monetary policy, providing a national system of reserve cash available to banks.

Frontier Markets are less advanced capital markets from the developing world. Frontier markets are countries with investable stock markets that are less established than those in the emerging markets. They are also known as "pre-emerging markets".

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. Real Gross Domestic Product is an inflation-adjusted measure that reflects the value of all goods and services produced in a given year, expressed in base-year prices. Often referred to as "constant-price," "inflation-corrected" GDP or "constant dollar GDP". Real GDP can account for changes in the price level, and provide a more accurate figure.

Hedge Fund Research, Inc. is a hedge fund industry provider of hedge fund index information. HFR produces over 150 indices of hedge fund performance ranging from industry-aggregate levels down to specific, niche areas of sub-strategy and regional investment focus. HFR also provides visibility into funds via databases and reports on managers.

High yield bonds are high paying bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Based on the two main credit rating agencies, high-yield bonds carry a rating below 'BBB' from S&P, and below 'Baa' from Moody's. Bonds with ratings at or above these levels are considered investment grade. Credit ratings can be as low as 'D' (currently in default), and most bonds with 'C' ratings or lower carry a high risk of default; to compensate for this risk, yields will typically be very high.

Institute of Supply Management (ISM) Manufacturing Index is a monthly index that tracks the amount of manufacturing activity that occurred in the previous month.

Investment-grade (IG) is typically used in reference to fixed income securities that possess relatively high credit quality and have credit ratings in the upper ranges of those provided by credit rating services. Using Standard & Poor's ratings as the benchmark, investment-grade securities are those rated from AAA at the highest end to BBB- at the lowest. To earn these ratings, securities, in the judgement of the rating agency, are projected to have relatively low default risk.

MSCI All Country World Index (ACWI) is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed by Morgan Stanley International to measure the equity market performance of the developed markets in Europe.

MSCI World Real Estate Index is a free-float adjusted market capitalization index that consists of large and mid-cap equity REITs across 23 Developed Markets countries, which generate a majority of their revenue and income from real estate rental and leasing operations.

Municipal bonds are debt obligations issued by states, cities, counties, and other public entities that use the loans to fund public projects. The interest income from municipal bonds is generally exempt from federal taxes and may be exempt from state and local taxes. Municipal bonds are subject to a number of risks such as interest rate risk, call risk, inflation risk, credit and default risk, and tax risks.

Price-Earnings Ratio (P/E Ratio) is a valuation ratio of a company's current share price compared to its per-share earnings.

Tax Cuts and Jobs Act is a bill that was passed into law by President Trump on December 22, 2017. The statute is based on tax reform advocated by congressional Republicans and the Trump administration. The law includes major elements in reducing tax rates for businesses and individuals.

The S&P 500 Index is a capitalization-weighted index of 500 stocks traded on the NYSE, AMEX and OTC exchanges, and is comprised of industrial, financial, transportation and utility companies.

Treasuries are debt obligations issued and backed by the full faith and credit of the U.S. government. Treasuries are subject to interest rate risk, call risk, and inflation risk. As Treasuries are backed by the full faith and credit of the federal government, they have low credit or default risk. As a result they generally offer lower yields relative to other bonds.

One cannot invest directly in an index.

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Investing involves risk, including the possible loss of principal and fluctuation in value.

Among other risks, fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Alternative investments contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors.

International securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

Diversification and asset allocation does not ensure a profit or guarantee against loss.

Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

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