Investment Strategy Overview—Executive Summary

GLOBAL INSTITUTIONAL CONSULTING

Chief Investment Office

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Year Ahead 2019: Powerful Waves of Change

There are Powerful Waves of Change occurring all around the world at the macroeconomic, geopolitical, corporate, demographic and investor psychology levels. The "waves" did not all arise at once, rather they have been building primarily since the Federal Reserve (Fed) began to normalize monetary policy and the U.S. economy broke free from the rest of the world with the help of tax reform and deregulation. This added a boost to rising business and consumer confidence, supported a corporate profits boom led by healthy capital equipment and consumer spending trends, spurred job growth to levels in which there are more job openings than available people to fill them at present, and eventually led to the largest economy in the world, the U.S., growing consistently above trend.

The result of this shift was a powerful wave of change from many years of economic stagnation to a more reflationary environment. This was a break from the most recent past in which deflation worries were an annual discussion. An environment that pivoted from low growth, low inflation, record low rates and low asset price volatility to an economic regime characterized by higher growth, higher secular inflation and rates, and a rise in volatility back to more "normal" levels. We view this as a secular change. One that can take years to ultimately play out, but also a shift that sparks volatility across asset classes.

The global equity market performance in 2017 discounted much of the positive nature of this secular change and drove the U.S. equity markets to record highs in 2018. The "market" led the economy in the U.S. as the rest of the world struggled throughout much of 2018, primarily as the strength of the U.S. dollar applied downward pressure to non-U.S. economic growth and global trade concerns spread throughout the summer months. Are the non-U.S. market corrections indicating a much slower growing U.S. economy is on its way? This is the second major wave of change that drove the market activity we experienced in October and November.

Headline and event risk is high in 2019, which is likely to lead to muted returns in equities. But equities, including dividends, as well as cash are still expected to outperform fixed income over the course of the year.

Christopher Hyzy
Chief Investment Officer

In addition to the secular movement from stagnation to fiscal reflation, there is another more cyclical wave occurring that is currently gripping the markets—a shorter term re-pricing of risk and valuation led by a change in investor sentiment. Contrary to fears of an overheated economy—not too long ago—investors are now more concerned about a "growth scare or economic hard landing." They point to the secondary effects of rising rates on the level of growth in the broader economy and on corporate profits, Europe's fiscal inflexibility, Italy's budget woes, the potential for higher costs from an extended trade and tariff war between the U.S. and China, the significant uncertainty over Brexit, the Fed raising rates too far and the uncertainty over a divided Congress. Most of these obvious concerns make sense to us and, yes, growth is set to slow next year globally and in the U.S. However, we do not expect a hard landing or the economy to grow significantly below trend. The market needs time to adjust to both the long- and short-term realities. This is why investors should expect a wave back to normalcy in many respects. More normal monetary policy and asset price volatility and lower equity returns versus what has been produced since the global financial crisis all require portfolio changes to be made. Coming into the fourth quarter of 2018, investors who were still overexposed to high valuation growth and momentum segments of the equity market as well as areas that were

considered low-quality (companies with high debt loads, more volatile earnings, and/or firms in need of financing) were forced to re-balance portfolios to a more diversified mix. The same holds true, in our view, for fixed income investors who are coming to grips with a flatter yield curve and short-term yields that are more competitive with the dividend yield of the S&P 500. Regime shifts and re-pricing of valuation create week-to-week asset price volatility (at times very sharp) and also create opportunities for the patient investor who takes a long-term approach as markets overshoot. In terms of our portfolio positioning we aim for high levels of diversification across all risk profiles and look to use re-balancing opportunities where markets overshoot to the upside and downside.

This leads us to our final wave of change—a changing political landscape around the globe centered around Germany's post-Merkel era mixed with the ultimate exit of the United Kingdom (U.K.) from the European Union (EU), and despite a short-term truce, the trade uncertainty between the countries with the two largest economies, the U.S and China. The geopolitical "triangle" has the potential to upset the global supply chain of trade that has been well-entrenched for years. Without a transparent agreement multinational corporations will likely begin a wave of adjustments in order to protect margins and maintain global distribution systems. Initially this could lead to higher costs, and potentially lower business confidence, but eventually we expect new manufacturing centers to develop and mix with automation and other technological advancements such as robotics to kick-start a new supply chain cycle in the years ahead.

On the back of the much-welcomed "short-term trade truce" coming out of the G-20 it is still far too difficult to imagine a long-term trade agreement with China anytime soon. However, we do expect the two super powers to protect their own primary interests, which is "the advancement of growth," and, at the same time, keep their home "base" from growing too frustrated. Therefore, over the next 90 days, we expect talks to center on the tariffs that China imposed, increased buying of agricultural and technology components, and potentially a stay on U.S. tariff increases. Growth-friendly initiatives are especially important in the U.S. given the fact that the 2020 presidential election is right around the corner. These negotiations are likely to keep us all guessing during the next three months, but for now this band-aid solution is needed.

As equity market volatility continues to jog its way back to higher, more "normal" levels, it is common to overshoot to the downside. We experienced this type of downdraft the past three months of this year. A slower-growth environment is also likely to confirm this trend and keep investor sentiment from turning positive as quickly as it turned negative. However, the two events that we have recently discussed that can help stabilize the markets (both equity and credit), in our view, are: (1) a pause by the Fed on the back of the more dovish comments from Chairman Powell in late November; and (2) some kind of trade agreement between the U.S. and China. If these events do not occur, we expect a longer period of consolidation with higher volatility in the markets and therefore caution would be warranted. We would then position portfolios in a more defensive posture.

WHAT IS THE YIELD CURVE TELLING US?

As we close out 2018, the most important question to answer, in our view, is whether or not real growth is going to hold up in 2019? It seems like a simple question since the economic data, primarily led by strong consumer spending given the healthy jobs market, is still positive and the leading indicators are not suggesting that we are heading for an economic hard landing. However, the yield curve is perhaps telling us something different. Parts of the yield curve inverted recently and many market participants are concerned that the probability of a recession is on the rise. Are the credit markets signaling something we are not expecting or are they simply saying that "real growth" is fine but the Fed needs to pause given the fact that cyclical inflation has already started to roll over? If this is the case then even if nominal growth comes down as the impact of higher interest rates filters through, the level of real growth can still be at or above trend, which could be positive for equities. This could be the surprise for 2019 - that economic growth actually is slightly above trend. In this case, earnings growth of around 5-6% for corporate America is achievable, which could translate into reasonable equity returns during next year given the most recent S&P 500 level of around 2700 in early December. The debate between the yield curve, the Fed and the level of real growth will likely come to a head early on in 2019. The Fed can help answer that question with a pause. The yield curve believes the Fed has already done their job with inflation. When has the yield curve been wrong?

WHAT ARE THE KEY TRENDS FOR 2019?

- real economic growth stays at or above trend at 2.5% or higher; no economic hard landing
- cyclical inflation rolls over further and is contained below the Fed's target rate of around 2%
- unemployment rate continues to head lower as job growth remains healthy

- a "heavy" equity market environment that contains multiple headwinds produces returns that track earnings growth around 5% or slightly higher
- long term interest rates slowly grind slightly higher; fixed income returns are muted
- market activity further drives portfolio re-positioning (investors overexposed to specific areas use market strength to diversify), which keeps the price-to-earnings multiple flat
- U.S. dollar weakens
- geopolitical and U.S. political landscapes remain volatile and uncertain; market volatility is episodic (driven by trade, debt ceiling, Fed meeting related headlines) and rises to more normalized levels
- non-U.S. growth remains a mixed bag with Europe the least attractive
- emerging markets (EMs) dependent on U.S.-China trade negotiations in the near term and on China's growth and the yuan's direction in the medium term
- WTI oil prices rise back toward $60 per barrel on average over the course of the year

WHAT ARE THE POTENTIAL SURPRISES FOR 2019?

- productivity picks up and U.S. gross domestic product (GDP) growth surprises to upside
- the Fed pauses early in the year as inflation rolls over further
- U.S. dollar weakens considerably
- a U.S.-China trade deal is signed
- a U.S. infrastructure bill is drafted
- emerging market equities outperform global markets as dollar weakens
- the debt ceiling debate gets contentious and a temporary government shutdown occurs
- China's growth falls further due to additional tariff impacts or significant escalation in the trade war
- the credit backdrop deteriorates as a negative growth shock develops
- Italy's budget battle creates a broader, long-term Euro bloc concern
- Brexit negotiations turn further negative and the U.K. is left in limbo

The bottom line: Headline and event risk is high in 2019 creating a "binary outcome" environment, which is likely to lead to muted returns in equities. But equities, including dividends, as well as cash are still expected to outperform fixed income over the course of the year.

WHAT SHOULD INVESTORS CONSIDER IN 2019 AS THE GROWTH SCARE REMAINS THE PRIMARY CONCERN?

Although we continue to believe the U.S. economy should grow at trend levels (approximately 2.5%) or higher in 2019 and expect earnings growth to stay positive at 5-6% over 2018, we recognize that investor sentiment continues to be affected by Fed policy in 2019, Italy's budget battle with the European Commission, Brexit, oil price signals and the uncertain trade relationship with China. The "growth scare" has re-gathered steam as we close 2018, suggesting that an economic hard landing could be around the corner and price-to-earnings multiples are still too high. We don't agree with that assessment at this point.

We recognize the strong headwinds but are not proponents of market timing, particularly as it relates to individuals and long-term institutional investors. Our view would change in this regard if we felt we were headed toward a recession in the near term. Market timing requires a decision at exactly the right moment twice—the timing of the exit from the "market" and the eventual move back in. This is extremely difficult and also involves many decisions not to mention tax implications and potential additional costs and could significantly alter long-term investment returns.

In addition, given our view that we are still in a very long multi-decade bull market that involves many cycles and a few re-sets (corrections and recessions) we prefer to maintain a strategically diversified core allocation across equities, fixed income, alternatives and cash, where appropriate. This is imperative in order to meet your long-term objectives through various business cycles, economic transitions and emotionally driven volatile market periods.

We will continue to weigh all the short-term concerns with the more favorable long-term global demographics and structural growth trends when making near-term adjustments to our overall view and portfolio positioning. At this point we believe we are in a sharp consolidation period that is close to ending (an almost 20% valuation correction in equities since the September 2018 highs). Although caution is warranted and keeping risk balanced is important during more volatile times, we maintain our slight equity overweight. Further downside risks are certainly possible, particularly given the Fed's view on still nudging rates higher, but we would expect the Fed to capitulate and pause its hiking cycle if growth slows too aggressively or if it begins to focus on the latest inflation readings. This, in our view, would stabilize investor sentiment and wipe away a major concern.

PORTFOLIO CONSIDERATIONS

- Keep portfolios appropriately diversified across multiple asset classes. Higher volatility will require greater discipline. Consider re-balancing equity positions back to original plans if markets overshoot and a hard landing does not materialize.
- Don't completely abandon exposure to international investments (particularly if the U.S. dollar weakens) as they possess attractive attributes for long-term patient investors—cheaper valuations, disliked, weak fund flows. However, we are not favorable on Europe.
- Move up higher in quality across portfolios
- The growth versus value decision is not clear cut given the later stage of the cycle. Value is gaining momentum. Maintain a more balanced view.
- One of the better environments for income generation—cash and short-term fixed income yields, dividend growth—in a while.

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Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

All sector and asset allocation recommendations must be considered in the context of an individual investor's goals, time horizon, liquidity needs and risk tolerance. Not all recommendations will be suitable for all investors.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments.

Asset allocation, diversification, dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets. Dollar cost averaging involves continual investment in securities regardless of fluctuating price levels; you should consider your willingness to continue purchasing during periods of high or low price levels.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. While the interest income is tax-exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the Federal Alternative Minimum Tax (AMT).

Tax-exempt investing offers current tax-exempt income, but it also involves special risks. Single-state municipal bonds pose additional risks due to limited geographical diversification. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes and, if applicable, the alternative minimum tax. Any capital gains distributed are taxable to the investor.

Investments in high-yield bonds (sometimes referred to as "junk bonds") offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer's ability to make principal and interest payments.

International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments.

Global investing poses special risks, including foreign taxation, currency fluctuation, risk associated with possible differences in financial standards and other monetary and political risks.

Investments focused in a certain industry may pose additional risks due to lack of diversification, industry volatility, economic turmoil, susceptibility to economic, political or regulatory risks and other sector concentration risks.

Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility.

Stocks of small and mid cap companies pose special risks, including possible illiquidity and greater price volatility than stocks of larger, more established companies.

There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. Tangible assets can fluctuate with supply and demand, such as commodities, which are liquid investments unlike most other tangible investments.

Nonfinancial assets, such as losely-held businesses, real estate, oil, gas and mineral properties, and timber, farm and ranch land, are complex in nature and involve risks including total loss of value. Special risk considerations include natural events (for example, earthquakes or fires), complex tax considerations, and lack of liquidity. Nonfinancial assets are not suitable for all investors. Always consult with your independent attorney, tax advisor, investment manager, and insurance agent for final recommendations and before changing or implementing any financial, tax, or estate planning strategy.

Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties, such as rental defaults.

Alternative investments are intended for qualified and suitable investors only. Alternative investments such as derivatives, hedge funds, private equity funds, and funds of funds can result in higher return potential but also higher loss potential. Changes in economic conditions or other circumstances may adversely affect your investments. Before you invest in alternative investments, you should consider your overall financial situation, how much money you have to invest, your need for liquidity, and your tolerance for risk. Alternative investments are speculative and involve a high degree of risk.

An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund. Hedge funds are speculative and involve a high degree of risk.

Treasury bills are less volatile than longer-term fixed income securities and are guaranteed as to timely payment of principal and interest by the U.S. government. Dividend payments are not guaranteed. The amount of a dividend payment, if any, can vary over time.

Diversification does not ensure a profit or protect against loss in declining markets.

The investments discussed have varying degrees of risk. Some of the risks involved with equities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Bonds are subject to interest rate, inflation and credit risks. Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories.

Investments in foreign securities involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in a certain industry or sector may pose additional risk due to lack of diversification and sector concentration. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risk related to renting properties, such as rental defaults. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the federal alternative minimum tax (AMT).

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