CHIEF INVESTMENT OFFICE

Investment Strategy Overview

A Rising Tide Leads to a Great(er) Divide

July 2019

As for the U.S. economy, we expect a soft landing and economic growth at trend, or slightly above, with new highs likely in U.S. equities, and rates that remain low or bottom out, at least for now.

Christopher Hyzy
Chief Investment Office

Listen to the audio cast. with Chris Hyzy addressing commonly asked questions about the investing landscape, including which elements of it are most misunderstood, and identifying appropriate portfolio strategies

Read the transcript

Chris, how would you describe the current economic environment?

According to many market watchers, we are in the late stages of the business cycle with a rising probability of a recession. That view is understandable; after all, more than a decade has passed since the economic collapse of 2008, and, because typical cycles last only five or six years, some economists think it is time. In addition, others point to the slump in manufacturing activity or global trade and suggest growth is deteriorating.

However, rather than one long business cycle, we believe there have been a series of "mini waves," and we are in the early to mid-stages of the fourth mini wave since the Great Recession. Our view is largely based on current economic conditions, many of which are not typical of a cycle's late stages historically.

- Inflation is very low and actually falling, rather than being elevated and rising, as in a late stage.
- The Federal Reserve (Fed) was recently on course to raise interest rates again, as it did last year, but it has been signaling a reversal in policy and is very likely to lower rates instead. This is not typical of a late stage.
- The dollar has been strong for some time; and although we believe it could stabilize or weaken slightly, we believe that would be due more to a strength "overshoot" rather than to the rest of the world's (ROW) closing the growth gap.
- Credit spreads, as a measure of corporate risk, are not flashing late cycle signals.
- The U.S. consumer remains confident.
- Many CEOs of global corporations seem to be growing less confident but this is more about the exposure to economies outside the U.S. Their companies have global exposure and are witnessing weakness in manufacturing and trade, due in part to the U.S trade conflicts and political uncertainty in Europe and elsewhere.
- U.S. economic growth is at or slightly above trend, which is not the case in many other countries.
- We believe there are no major bubbles forming in the U.S., except, perhaps, in private markets, where there are high valuations in specific areas; even so, conditions do not appear "bubbly" enough to be of concern.
- Equity valuations appear constrained—in part by high geopolitical risk and political uncertainty (think trade wars, Brexit, instability in the Middle East, Italy and its future in the European Union (EU))—rather than being overvalued at the end of a cycle.
- There is significant bearishness in investor sentiment, according to the latest BofA Merrill Lynch Fund Manager Survey, rather than the "irrational exuberance" that often signals the end of the cycle.
- The inverted yield curve (another typical indication of recession) is due more to declining inflation expectations and growth expectations, and the weight of negative yields in Europe (including Germany's near-record low 10-year negative yields). If the Fed begins an easing campaign, the short end should begin to turn downward, changing the shape of the overall curve.

How is all this affecting the U.S.'s standing in the world?

We believe the U.S. continues to break away from the ROW, in effect creating (or widening) what we are calling the Great Divide. This is due in part to the Fed hikes in 2018 and the

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U.S.-China trade war, which hurt the ROW more than the U.S. This imbalance occurred largely because the U.S. economy has been relying more heavily on the consumer, small businesses and housing, and has a much healthier banking system, whereas the ROW has been more levered to manufacturing and trade, which have been weakened by the trade war.

As for the U.S. economy, we expect a soft landing and economic growth at trend, or slightly above, with new highs likely in U.S. equities, and rates that remain low or bottom out, at least for now.

What are some of the big cross currents around the world?

We see a number of cross currents that may affect U.S. and global growth in the next year.

The supply chain in East Asia that feeds the manufacturing base in China is being hurt by the tariff war. The tariff war is also affecting China's trading partners, and Germany, for one, is among the largest.

There's the wet blanket of negative rates in the EU, with the 10-year yield in Germany, for example, hovering around a record low, at around minus 36 basis points (bps). Plus, we believe the EU has not yet fully cleaned up its financial system, following the credit crisis from a decade ago, and it has been slow to use fiscal adjustments across the Eurozone.

There are geopolitical tensions, for instance with Iran, as well as lingering concerns over Brexit and Italy's future in the EU. On top of all this, we think the "war" with China is about more than just trade; it's also about superiority in tech, in areas such as 5G telecommunications, judging by ongoing negotiations.

In the U.S., the labor markets are tight, with more job openings than there are people to fill them. Ultimately this could lead to greater use of artificial intelligence (AI), robotics and machine learning, potentially leading to greater efficiencies and yet another productivity cycle. This would help to expand the Great Divide, with the U.S. seeming to have greater leverage to growth than the ROW, helped by the innovation cycle in technology, and by the wealth cycle.

What are some of the primary catalysts that could extend this cycle and what is most important to the growth outlook?

Here are a few of them:

- A change in Fed policy, from hiking rates, to staying on hold, to easing. The Fed is shifting its view mostly due to consistently low inflation, we would argue, rather than to help support financial markets, as some have articulated. At the June Federal Open Market Committee (FOMC) meeting the Fed stated they intend "to act as appropriate to sustain the expansion."

- Consumer confidence remains high and should continue to lead to higher discretionary spending, helping to increase lending velocity.

- Small business confidence remains high, potentially leading to further job growth, which in turn should support a healthy consumer and higher consumer spending.

- Despite the low unemployment rate and the tight labor market, we believe we are still early in the cycle and could see further job growth.

- This should lead to a new capital expenditure (capex) cycle and a productivity or innovation cycle that could last years, not just a few quarters. This view is supported by the fact that companies would need to protect margins against wage growth, in part by automating more and using technology to fill skill gaps.

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What are the big risks that are not being widely discussed?

One is a potential drop in business confidence. This may be due to concerns of weakness in global growth and global trade, which could affect business confidence and delay the capex cycle, leading to lower job growth and, ultimately, lower consumer confidence and spending.

If consumer spending pulls back, then the need for liquidity may rise. We are not there yet, but if we were, any areas with very high exposure to illiquid assets or an excessive need for financing could have liquidity issues.

There is the risk of government regulations on technology, which could result in a domino effect across the corporate world, not just on the tech titans. Also in tech, there could be a risk of essentially a two-world trade zone dynamic, with the U.S. dominating one zone and China the other. Control for and the security of the supply chain and technology/innovations would be at the center of this bifurcation.

There is the risk of the "weight" of deflation. Deflationary risks, in many cases, are more difficult to turn around than inflationary risks. This is where companies have less pricing power, which could lead to anemic financial institutions around the world, a drop in lending velocity, a sharp rise in savings, productive capital exiting the broader economy, and the potential for a negative feedback loop—a self-reinforcing system—so to speak, with these factors potentially driving a further reduction in inflation.

Climate change is a long-term risk. Its destructive aspects may affect labor mobility, with areas of the country that are used to having vibrant workforces seeing the migration of jobs elsewhere. This risk is likely many years away but one we should be mindful of as we close each year.

What are the most misunderstood elements across the investing landscape, in your view?

Fed policy is one. The current Fed mandate is more about price stability and full employment than it is about controlling real gross domestic product (GDP) growth or saving risk assets, in our view. It's important to watch the inflation dynamic as it relates to demographics and structural change, driven by the new economy versus prior cycles.

Central bank balance sheets are another. Traditional economics holds that the expansion of balance sheets is inflationary. Given the high debt levels in most developed markets around the world, including in the U.S., there is a potential that having expanding balance sheets at the central bank level not only keeps rates low, it becomes a feedback loop: lower rates lead to lower inflation expectations; lower inflation expectations lead to lower rates. Versus the opposite view, that expanding balance sheets typically lead to a higher propensity to print money, which leads to a much weaker dollar and higher inflation.

A third is what the real drivers of inflation are in this cycle. It is our view that demographics and innovation, and the fact that debt by default is deflationary, are more likely driving inflation lower today than in prior cycles. It's also important to note that transaction-based inflation—in which consumers spend more because they have a feeling of comfort about their jobs and the belief that higher incomes are coming—typically leads to pricing power, which leads to higher inflation. That's different from asset-based reflation, where you get rising asset prices but not rising transaction prices.

Another misunderstood element is that the U.S. economy and the ROW economy are very different: ROW is manufacturing and trade heavy while the U.S. is much more consumer-, services- and housing-related.

Portfolio construction is often misunderstood. It's important to take advantage of market activity, whether it's up or down, as you rebalance a portfolio. This could allow for greater diversification and the ability to extract more consistent returns over time rather than trying to "time the market" in the short term, which is not a successful endeavor, in our view.

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Which investments do you think are most appropriate to consider in this environment, and over the next few years, as the cycle continues to evolve?

We believe diversification and discipline at the highest levels, across assets, sectors, and factors, are increasingly important. Patience is needed as the fourth mini wave cycle matures, and as the Fed and global trade create volatility waves, in the months and years ahead. The search for appropriate yield (in high-quality dividends, for example, and investment grade credit) continues to make sense. We favor U.S. large caps versus the ROW, and continue to have a mixture of value and growth (value in the long term but growth has the wind at its back in the near term). Emerging markets (EM) could have flashes of strong performance, if concerns over global trade wane; but it could be tough to sustain that view, given geopolitical uncertainties over global trade that continue to present themselves in Europe, China, Japan and elsewhere. Many non-U.S. developed markets are weighed down by Europe's exposure to China's slowing growth, by restrictions that negative rates typically place on the banking system, and by Japan's continuing battle with deflationary forces. We favor shorter-dated yields, given the flat to inverted yield curve. We could take advantage of downswings in the market by deploying cash when warranted, given our constructive view. We believe that active investing is outperforming due to wider dispersion and the uptick in volatility, and we expect this to continue. We favor a hybrid approach, with a mix of active and passive investing across asset classes. Given all of this, especially the seemingly rising tide in the U.S., we believe we are in the early stages of the U.S. breaking away from the ROW, creating a Great(er) Divide.

MACRO OUTLOOK: UNDERNEATH THE SURFACE

What dynamics are shaping the macro environment going forward?

On the surface, markets are preoccupied with fears that a trade war and an inverted yield curve could move the global economy steadily toward recession. Underneath the surface, however, the economic currents are shifting clearly in the direction of a renewed fourth upswing in the decade-old expansion that began in the summer of 2009.

The remixing of global growth currently underway reflects the populist-driven shift of policy from fueling the globalization of markets toward more focus on national interests. This shift is increasingly evident in incoming economic data showing big trade-surplus countries, like China and Germany, slowing more than expected while big trade-deficit countries, like the U.S., perform relatively better as trade-war concerns dampen the growth of international commerce.

This relative outperformance of domestic versus international growth is apparent in the latest business survey data. The National Federation of Independent Business (NFIB) survey of small U.S. businesses has been rebounding since its December low point thanks to the Fed's pivot away from additional tightening. As interest rates have come down, small-business confidence has risen to a new high for the year, with rising plans for capital spending and more optimism that "now is a good time to expand."

In contrast, while still elevated, CEO confidence at big multinational corporations has continued to come off last year's highs as trade concerns weigh on views and global supply chains are increasingly reevaluated and shifted in response to actual and threatened increases in tariffs. As the trade war increasingly focuses on China, it has seen significant slowing and growing interest in moving production elsewhere.

Prior to 2016, confidence at large multinational firms was consistently higher than that of small business owners, which didn't recover to typical expansion levels until 2016. Since then, the gap between big company CEO confidence and small business confidence has closed and this year is moving in favor of the small-business sector, presumably reflecting the differential impact of tariffs on the two sectors (see Exhibit 1).

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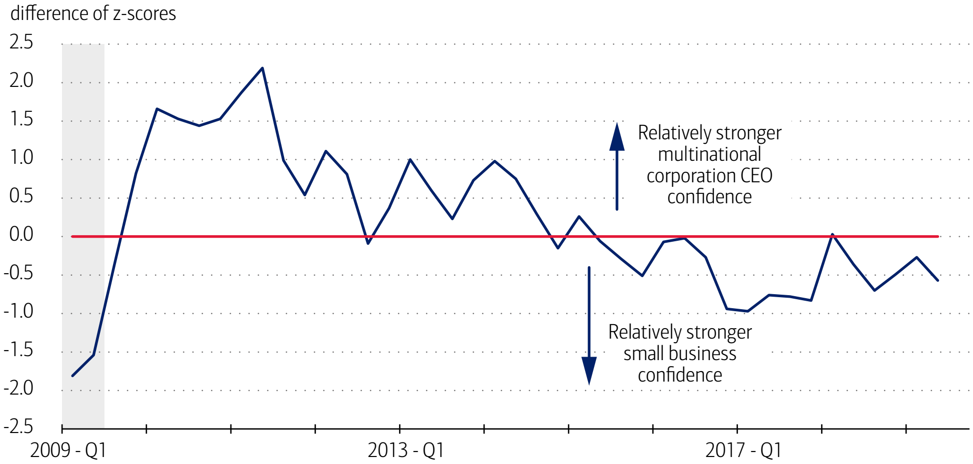
Exhibit 1: Small business confidence has been stronger than CEO confidence since 2016



Source: Business Roundtable CEO Economic Outlook Survey, National Association of Independent Business/Haver Analytics. Data as of June 17, 2019. (A z-score is the number of standard deviations from the mean.)

In sum, there are two distinct dynamics at play: a strengthening U.S. domestic economy and a weakening global economy, especially pronounced in countries with the biggest trade surpluses, like China and Germany, which are most vulnerable to this reset in the global economic order. The mixed messages in the global data are well-encapsulated in the BofA Merrill Lynch Global Wave index. After declining through the second half of 2018 into early 2019, the indicator has flattened out. Some leading indicator components are improving, including the recent earnings revisions ratios, consumer confidence and employment measures. Slowing global trade is offsetting some of these gains by restraining production data. We believe the wave will begin to rise once the Fed begins to ease and the yield curve starts to steepen. U.S. leading indicators have been restrained by the inverted yield curve but other leading components related to housing, employment, equity prices and consumer spending have turned up and should get additional impetus when the Fed takes the brakes off.

The relative strength in the U.S. economy is reflected in the latest retail sales for May, which caused economists to raise their forecasts for real consumer spending enough to boost second-quarter GDP growth forecasts from about 1.5% to over 2%. For example, the Atlanta Fed GDPNow forecast for real personal consumption expenditures was lifted from about 3% to about 4%. Since consumption is about 70% of GDP, this raises the possibility that GDP growth could surprise to the upside again and maintain the 3% trend of the past year.

While the weaker-than-expected May employment report fed fears of a significant slowing underway, the strong consumer spending and other data too suggest otherwise. Labor market indicators from the Jobs Openings and Labor Turnover Survey (JOLTS), initial claims for unemployment compensation and the latest Manpower Survey all show a still red-hot jobs market. This suggests the weaker May employment report was more noise than signal of a slowdown. Vehicle sales remain solid and, importantly, housing is getting a significant boost from the plunge in mortgage rates, which has ignited a flurry of refinancing and new purchase activity. After subtracting from GDP growth the past two years while the Fed was tightening, housing is beginning to add to growth again as rates fall.

Other components of domestic final demand, like business investment, could be supported by the strength in the U.S. consumer sector. Altogether, current leading indicators suggest mid-single digit growth in business fixed-investment well into 2020, helped by an improvement in the nonfinancial corporate financing gap, relatively steady growth in non-investment GDP and much lower interest rates.

Looking at domestic demand as a whole, Applied Global Macro Research found that their leading indicator framework is forecasting "*domestic demand growth of about 3% at the*

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end of 2019 and through Q3 2020. The most recent y/y growth rates have been fluctuating around 3%, so our outlook is basically for more of the same."

Clearly, sustained 3% economic growth is not the consensus, but the 3% trend growth of the past year surprised the consensus. The plunge in interest rates this year also perplexed the consensus as it seems at odds with the strong U.S. economic data that keep rolling in. Coupled with the inversion of the yield curve, the plunge in rates has bolstered the view that the U.S. economy is slowing down and is even vulnerable to a recession next year instead of the solid 3% growth rates suggested by other leading indicators.

To understand the apparent paradox of a strong economy and falling interest rates requires a focus on plunging inflation and inflation expectations. Economists are puzzled by the combination of strong growth and falling inflation because this is inconsistent with the long-held consensus view that strong growth causes inflation. This view has caused the Fed to believe that the fall in inflation is temporary.

We believe the main danger to equity markets is this misperception of the inflation drop, which in our view has instead been caused by excessive tightening in 2018, which engendered much stronger deflationary pressures than the Fed realizes. This was shown last summer when leading indicators of inflation rolled over sharply. Since then, "core" personal consumption expenditure (PCE) inflation has dropped from 2% to about 1.5%. Signs that inflation expectations are becoming unanchored are spreading. The latest University of Michigan survey shows household inflation expectations dropped to the lowest level in the 40-year history of the survey. This plunge in the inflation outlook is global. Inflation in Europe and Japan is even further below central bank targets and falling, as Fed policy tightening hit the rest of the world even harder than the U.S. Fortunately, the Fed pivot this year is allowing other central banks to ease and help ignite a new round of reflation.

Since the Fed had already tightened enough by mid-2018 to impart this deflationary shock, the subsequent hikes exacerbated the situation. The inverted yield curve is screaming that the Fed needs to reverse that excessive tightening, but because it's mainly reflected in falling inflation while growth remains healthy, the Fed has been sanguine about the appropriateness of Fed policy until recently.

Indeed, falling inflation is good for U.S. consumers, making the U.S. economy stronger. Longer-term, however, it could raise the risk that the U.S. economy relapses back to the zero-bound for interest rates. While real growth could remain solid, falling inflation depresses nominal magnitudes like corporate revenues, retail sales, and personal income. In a highly-leveraged economy like the U.S. this makes it harder to service debt and grow at a level to sustain full employment, requiring much lower interest rates. Therefore, strong growth is unlikely to persist unless the Fed gets serious about maintaining its inflation goal. Otherwise, the U.S. could potentially head in the direction of Europe and Japan, where nominal growth is persistently below 2% and interest rates are negative.

Where are we in the trade war and what are its underlying effects?

We believe trade frictions took a greater toll on real economic growth and business confidence in the second quarter, and are likely to remain a tangible headwind to global real GDP growth and earnings over the medium term. U.S.-China trade tensions escalated in the past few months, with both sides digging in for a protracted "cold war" in trade. Asset prices adjusted to this new world, and to the fact that U.S. trade tensions are rising with a number of key trading partners, including Mexico, the European Union and India. We don't expect a full-fledge global trade war to break out; rather, trade tensions are likely to remain a volatile staple of the capital markets for some time in the future.

U.S. multinationals are adjusting to this new era of protectionism and nationalism by rethinking their complex and multi-national supply chains. Where for the past four decades global manufacturing operations of firms were geographically diffuse, with

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plants spread across borders and reliant on a network of international suppliers, future operations will be more local and regional in scope. Think less 'offshoring' of production and a movement to 're-shore' or 'near-shore'.

The United States is hardly the cheapest place in the world to manufacture, but higher relative U.S. labor costs could be offset by increased automation, great supply chain mobility, lower shipping costs and very competitive energy costs thanks to the American energy renaissance. Add in tax reform and other government incentives like job training credits and favorable treatment of capital spending, in addition to a large and wealthy consumer market, and the U.S. could potentially emerge as one of the most attractive places in the world for investment. The main beneficiary from this trend: automation—or advanced robotics, AI, additive manufacturing (3-D printing), digital platforms and related activities that allow firms to suppress costs, boost margins and nimbly reach more demanding consumers.

Uncertainty over trade is likely to weigh on earnings and growth over the near-term, although Fed easing and a confident U.S. consumer should keep the longest economic expansion in U.S. history rolling on. Long-term, the reconfiguration of U.S. global supply chains is bullish for more U.S. productivity-led growth and associated companies and sectors.

EQUITIES

What is your outlook on U.S. stocks? Are earnings going to be a tailwind?

We expect equity markets will continue to be driven largely by the same macro flashpoints which have dominated the first half of the year, namely trade and the trajectory of Fed policy rates. We believe rate cut(s) by the Fed, along with steady increases in corporate profits, signs of more stable global growth and the return of fund flows should lift U.S. stocks in the near-to-intermediate term.

In our view, underlying equity fundamentals remain constructive but fund flows have been tentative as investors, before moving back into risk assets, are seeking more clarity as to how trade developments may unfold and how the Fed might respond to a slowdown in nominal growth. Inversions in some parts of the of the yield curve add another element of concern regarding the economic outlook. Clouds of uncertainty surrounding these issues make investors more hesitant to pay up for earnings, suppressing price/earnings multiples, while earnings themselves also have a large degree of dependency on how the macro issues shake out. This impact has been felt in market trends through the first half of the year, with U.S. equities outpacing international developed stocks and emerging markets lagging both, illustrating a preference for quality. Meanwhile, growth has continued to outperform value.

In January, the U.S. equity market decisively broke away from bear territory when the Fed appeared to engineer what we characterized as a "Dovish Pivot." This pivot coincided with a temporary "trade truce" struck in December, which was extended in February and removed a substantial amount of uncertainty for the time being. With real growth in the U.S. powering along and China adding magnitudes of stimulus, the backdrop was encouraging for investors and equity market multiples expanded. The "risk-on" signal was flashing. However, recent deterioration of global economic data and slower nominal growth reversed the narrative and investors fled risk assets. We believe that some pessimism has been baked into equities, shrinking the "trade peace dividend" and compressing multiples. If trade issues transition down to a simmer and the Fed cuts rates, indicating their support for stronger nominal growth, U.S. stocks should continue their uptrend beyond recent highs, our base case.

Earnings and Valuation: Corporate earnings should provide support for equities as markets move past an extended period of analyst downgrades. A relatively low hurdle has been set for profit expectations and there could be room for equities to "grow into their

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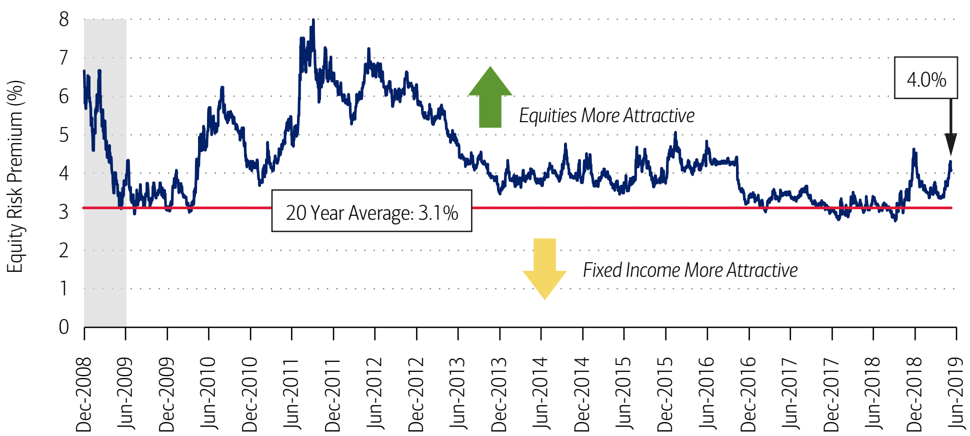
multiples" and rally, as was the case briefly following the upside surprises in Q1 2019. Consensus estimates have markedly tracked down through the year, and now stand at $167 for the S&P 500 (an increase of 3% year-over-year). We are mindful of earnings estimate revisions (ERR), which have recently been mixed, and will need to see evidence of a sustained uptrend before invoking confidence. In the wake of trade frictions, we continue to gauge capital spending and earnings guidance and how corporations are managing rising wages, other input costs and supply chains. Consumer confidence remains buoyant and should provide a tailwind for top-line growth.

We are also monitoring the dollar with the view that a stable or slightly stronger greenback would likely pressure non-U.S. equities, especially those of emerging markets. Finally, lower bond yields further enhance the attractiveness of stocks relative to fixed income (Exhibit 2). Our base case scenario leads us to believe that equity risk is balanced, but favors higher-quality U.S. equities versus international stocks. Given the murky geopolitical environment, quality remains a bedrock theme of our investment strategy as it typically helps portfolios endure volatility while also preserving the potential for upside capture.

Exhibit 2: The equity risk premium has recently picked up



Source: Chief Investment Office, Bloomberg. Data as of June 17, 2019. Equity risk premium illustrated as the spread between the S&P 500's Earnings Yield and the 10-Year Treasury Yield. **Past performance is no guarantee of future results.**

Sentiment and Flows: Less tangible but influential in the short-term are sentiment and market technicals, which point to lingering pessimism. Individual investors have parked funds at a record pace into less risky assets such as Treasurys, now the most crowded trade for the first time in our Fund Manager Survey's history, or high-quality corporate bonds at the expense of equities. In fact, year-to-date inflows into bonds have exceeded $200 billion while equity outflows are nearly $140 billion.

Institutional investors also remain cautious, with the latest report showing over a third of those surveyed having taken out protection against a sharp fall in equity markets in the next three months, the highest level ever. Higher cash levels also indicate buying power on the sidelines, with the latest survey depicting the biggest month-over-month increase in cash balances since the 2011 U.S. debt ceiling crisis. Macro pessimism is on the rise, with 87% of investors perceiving that the global economy is late-cycle, the highest reading in the history of the survey, as expectations for global growth and inflation have moved sharply lower.

On balance, our view is that sentiment is now negative with more bearishness and fear outweighing any semblance of euphoria or greed—which may present an opportunity for a patient, long-term investor.

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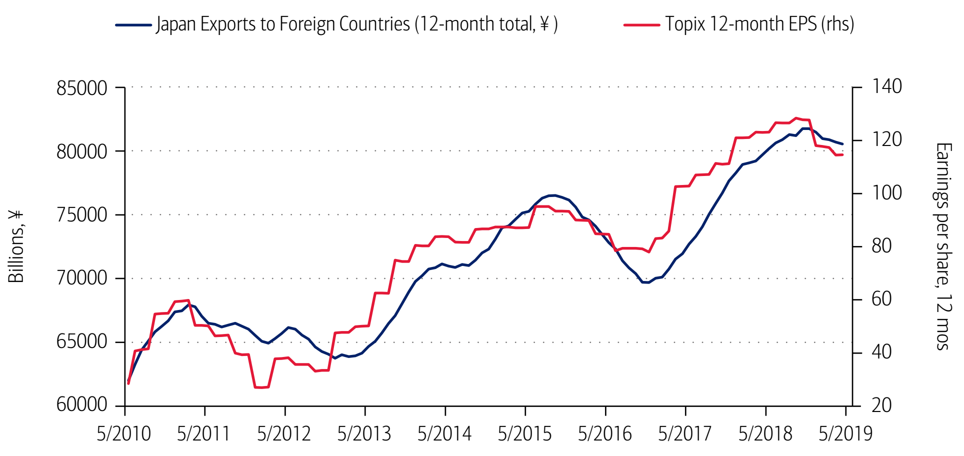
Catalysts: The keys to unlocking the potential for equity upside, in our view, will rest on progress related to the major macro issues directing the markets, such as reduction of trade tensions and enhanced measures of accommodation by the Fed. Corporate profit expectations, in the U.S., have built up a bit of recent momentum but a less cloudy economic outlook and more policy certainty could help to unlock additional investment and productivity gains while supporting the ever-important consumer, ultimately powering nominal GDP higher. This positive feedback loop helps to grow earnings and also rationalizes higher multiples as investors and funds are emboldened to rotate into equities. A steeper yield curve would indicate progress in this regard. Alternatively, we believe further escalation in tariffs and a plunge in business and consumer confidence could stall capital expenditures, restrain productivity growth and increase the likelihood of recession.

What's behind your reduced conviction for international developed market equities?

We believe Europe and Japan are right at the center of concerns over global growth and political risk for this year and next, which was a major reason we recently lowered our allocation to international developed market equities.

The macro outlook for Japan remains less than enticing as economic data broadly continues to surprise to the downside, with business surveys such as the Tankan pointing to further weakness in manufacturing and capital spending while exports have also shown signs of weakening. Despite a historically tight labor market, wage growth remains meager with a number of reports indicating that Japanese companies would much rather utilize automation/robotics in light of labor shortages rather than hike worker pay, dragging consumer confidence lower. Compounding the struggles of slow growth, the yen has strengthened as the destination of capital inflows from rising geopolitical risk, pressuring equities. Corporate earnings are highly leveraged toward external demand, suggesting that weaker global growth is a major downside risk for stocks (Exhibit 3). Much of the outlook for Japan hinges on trade developments as well, particularly from potential U.S. auto tariffs. According to Capital Economics, Japan's auto/transport equipment exports make up 40% of U.S.-bound shipments, and a 25% tariff on imports of Japanese cars could reduce Japanese GDP by 0.5%. Deliberations over the planned October value-added tax hike will be a major catalyst as well, with eyes on the upcoming Upper House elections in July. In anticipation of headwinds for the consumer from the tax as well as a slowing economy, the government has already passed a record budget in March including around 2.03T Yen ($19 billion) in stimulus aimed at supporting domestic demand, so a delay in the tax hike would be an additional tailwind.

Exhibit 3: Japanese corporate earnings mirror exports



Source: Chief Investment Office, Ministry of Finance Japan. Data as of June 17, 2019.

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Europe faces its own headwinds from a macro perspective, especially key economies like Germany and Italy, but the geopolitical challenges for the region in the form of Brexit, European Union Leadership changes and the Italian budget standoff add additional sources of risk.

The results of May's EU Parliamentary elections had little impact on markets but saw the more established centrist parties such as the European People's Party and Socialists & Democrats lose share to more non-traditional, and in some cases Eurosceptic, parties. With the nominations for leadership roles at the European Commission, ECB and European Council now in place, we feel the appointments could signal an increased tolerance for fiscal flexibility, as well as continuity vis-à-vis monetary policy, in Europe. As such, while a number of uncertainties remain on the horizon, political uncertainty in the region seems to have moved slightly lower, for now.

In Italy, the populist government once again found itself at odds with the European Commission (EC) over the size of its deficit. The EC had recently announced that Italy could face disciplinary measures over its rising debt load, and wanted the government to lower its structural deficit by 0.6% of GDP per year. It estimates that the government could bring in revenue of around 1.3% of GDP by raising its value-added tax, which the governing coalition is strongly resisting. Instead, Deputy Prime Minister Matteo Salvini had recently insisted on tax cuts of around 30 billion euro, roughly 1.7% of GDP. Recent reports have indicated that the government has revised its budget plans in order to avoid discipline by the EU, but incoming headlines on the topic will likely be a catalyst for markets.

Add ongoing uncertainty on Brexit, especially given the recent resignation of Prime Minister Theresa May and it's clear that Europe has more than its fair share of challenges as the year goes on.

FIXED INCOME

What is your outlook for fixed income for the rest of the year?

In 2018, markets signaled that the Fed needed to course-correct. After Chairman Powell highlighted that the fed funds rate was a "long way from neutral" and the balance sheet was on "autopilot," the S&P 500 fell almost 20%. The Fed received the message, and communicated that it would be "patient" with further hikes at the next meeting. This backdrop helped fixed income assets have a phenomenal start to the year.

Less than six months later, however, it was déjà vu all over again. Markets again sent an unambiguous signal: a disinflationary wave is washing across global economies. Japan's 10-year expected inflation is 0.25%; Germany's is 0.68%, its 10-year bond yielded -0.37%—the lowest in its history—as this publication went to print. At the May FOMC meeting, however, Powell highlighted that disinflation in the U.S. was "transient." We are approaching the 11th year now where the Fed has missed its inflation target; it has averaged 1.6% over that time period. The only thing that has been transient with U.S. inflation is its ability to stay near the Fed's 2% target. The FOMC promptly fell behind the yield curve, which inverted more than -50 bps from fed funds to the 2-year Treasury.

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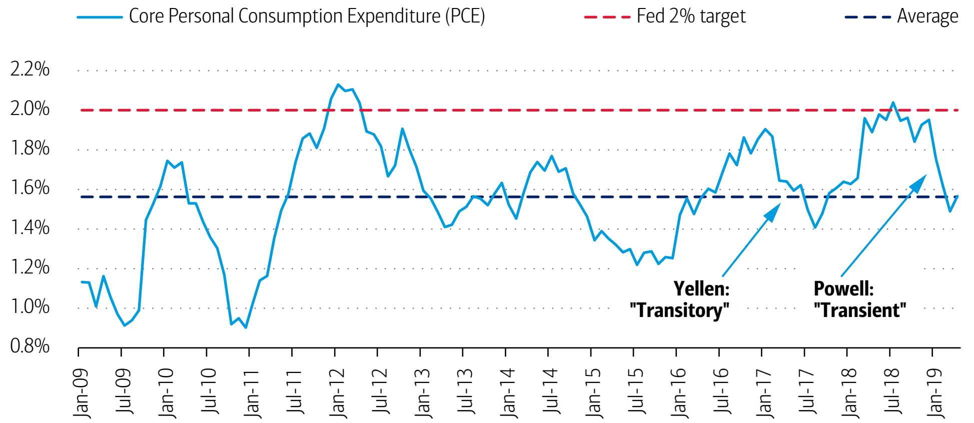
Exhibit 4: Which one is transient? Inflation's decade-long average rate, or its ability to remain at 2%?

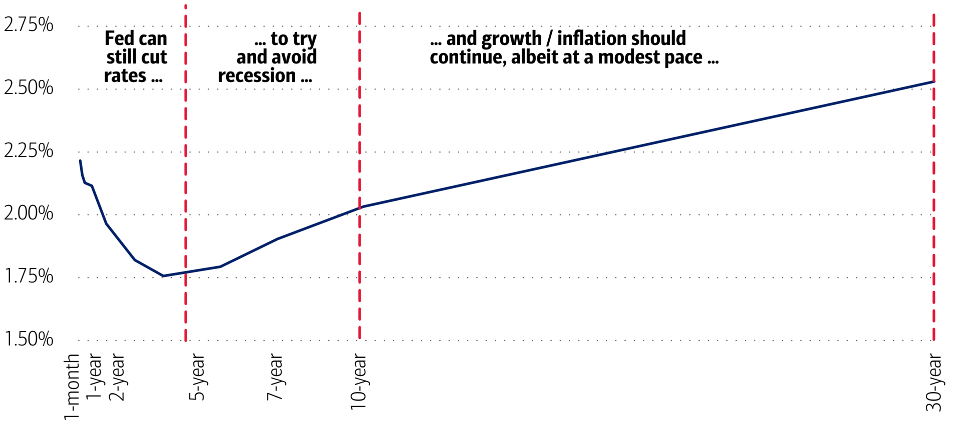


Source: Bloomberg as of June 14, 2019. **Past performance is no guarantee of future results.**

For the second time in less than six months, therefore, this put the Fed in the awkward position of having to do an abrupt about-face. We believe this time markets have priced in that it will do so successfully—presumably as it has accomplished the same feat so recently. As opposed to being down 20%, the S&P 500 has achieved an all-time high. Instead of being near 550 bps, high yield spreads are below 400 bps. Investment grade spreads are 30 bps better than their wides; the municipal market recently hit multi-decade lows in terms of muni-to-Treasury ratios. Paraphrasing Churchill, the market seems to believe that the Fed will do the right thing—but only after trying everything else.

And we believe the market has been correct so far. The Fed used its June meeting to clearly give itself optionality for a rate cut in July. Prior to June's meeting, 10 FOMC participants expected a hike and none expected a cut in 2019. At the June meeting, that flipped: only one expects a hike, and eight now expect a cut. The market actually prices a 25% chance of a 50-bp cut at the July meeting now. Fortunately, the yield curve is signaling that it is not too late and the Fed has time to cut and accomplish a 'soft landing.' The short-end of the curve confirms that an ease is necessary and forthcoming, the intermediate part of the curve signals this should stave off a recession in the next few years and the long end of the curve suggests that the Fed could get to and maintain close to 2% inflation and real growth.

Exhibit 5: The yield curve is signaling that the Fed still has time to prolong the recovery, but the clock is ticking.



Source: Bloomberg as of June 14, 2019. For illustrative purposes only. There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment performance.

While the Fed may change course appropriately—cutting rates at least 0.75% over the next 6 – 9 months—we acknowledge that there is little room for error. The market has

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priced in all of these rate cuts; furthermore lower short-term rates do not necessarily portend lower longer rates if the appropriately more dovish stance leads to economic growth and higher inflation. We therefore recommend investors stay very close to home, being well-diversified across fixed income assets with only minor tilts, and maintain a duration policy as close to neutral as is reasonable. While we believe the current challenges will be navigated successfully, it is by no means a certainty and the binary outcomes make the asymmetries unfavorable for taking on too much risk. For investment grade credit, we are neutral, preferring short duration and financials. For high yield, we maintain a slight underweight due to our overweight equity exposure, and recommend investors are balanced across loans and bonds. For municipals, we are neutral, and acknowledge spreads are tight but may persist until a catalyst appears. For agency mortgage backed securities, we maintain a slight underweight, but valuations are more compelling and closer to neutral.

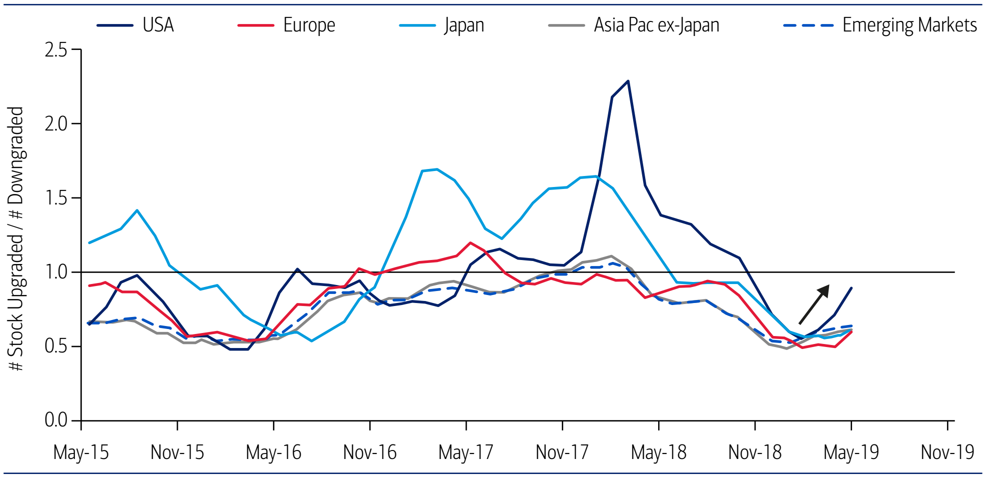
PORTFOLIO STRATEGY

What is your overall portfolio strategy? How are you positioning for uncertainties on the U.S./China trade front?

In our view, the first half of 2019 has been characterized by greater uncertainty regarding global growth, owing in part to geopolitical concerns, and a dovish pivot from central banks attempting to ease financial conditions. Under this backdrop of heightened uncertainty, investors should stay balanced and avoid being overly defensive or aggressive, choosing instead to allocate towards quality and secular sources of opportunity.

Tactically, we recommend a moderately pro-risk tilt in favor of global equities over bonds. In light of our recent strategy changes, we favor a medium-term preference for U.S. equities relative to the rest of the world on the basis of stronger real economic growth as well as higher corporate return on equity, stability of top-line growth fundamentals and better support from share buybacks. Earnings expectations for U.S. equities have dipped this year, and are now expected to slow towards 3% year-over-year for the S&P 500. Profits surpassed consensus expectations in the first quarter and may be poised to do the same in the next couple of quarters. Earnings estimate revisions have recently picked up and in May suggested more upgrades than downgrades (Exhibit 6). A resurgence in higher nominal growth spurred on by productivity gains, housing, consumer spending and the potential easing of trade frictions could further help earnings surprise to the upside. A downside case for earnings and equities could involve the negative impacts from a potentially longer-term "technology cold war" with China that could lead to prolonged uncertainty for the global economy and hurt business and consumer confidence amid supply chain disruptions. We prefer, therefore, exposure to industries with strong earnings streams from long-term secular trends and higher quality exposure from large caps versus small caps.

Exhibit 6: Earnings estimate revisions have recently picked up



Source: BofA Merrill Lynch Global Quantitative Strategy, MSCI, IBES. Data as of May 27, 2019. **Past performance is no guarantee of future results.** Short-term performance shown to illustrate more recent trend.

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Our outlook for emerging markets has shifted slightly negative to reduce risk in the near term amid unresolved U.S.-China trade tensions, a stronger U.S. dollar and declining profit expectations. We recommend maintaining some exposure to emerging markets, however, given their long-term secular growth trends, especially as they relate to the emerging Asian consumer. Structural reform following the European parliamentary elections remains bleak as political fragmentation and the rise of Eurosceptic populist parties present challenges ahead. The limited prospects for stronger economic growth in Europe further leads us to favor the U.S.

In spite of our slightly negative view on fixed income, we continue to believe it is an essential component in most long-term portfolios, providing diversification benefits and a stable source of income. We recommend a neutral to slightly short duration, balancing the potential for lower rates, which may offer a near-term boost for bond prices, and a lower-for-longer fed funds path, which may limit longer-term upside for prices. Our view is neutral on credit with a preference for more short-dated investment-grade corporates. Within high-yield, spreads and yields are back to below-average post-crisis levels, but higher leverage and weaker covenants may portend greater credit risk. Some allocation to leveraged loans, though, may be advisable due to the secured status and minimal yield sacrifice to unsecured bonds. Municipals continue to provide favorable after-tax yield for tax-sensitive investors. Overall, we believe that active management in fixed income can help improve risk-adjusted returns in a volatile yield environment.

ALTERNATIVE INVESTMENTS

What are some opportunities to consider in the alternative investment space?

A cautious stance appears to have helped hedge funds navigate the most recent bout of market volatility. The asset class finished May down 1.5% as proxied by the HFRI Fund Weighted Composite, but returns during the month were buffered by positive alpha generated from managers' short books, a component of active management that may prove particularly helpful during times of stress. (For reference, global stocks[1] were down 5.9% in May). Year-to-date through May, hedge funds were up 5.3% versus 9.4% for global equities, which implies positive alpha[2] of about 2.2%. Importantly, net leverage remains subdued by historical standards here in the U.S. and recent portfolio positioning remains conservative as funds have allocated more heavily to defensive sectors (Consumer Staples, Utilities, Real Estate) over cyclical areas (Consumer Discretionary). Given these dynamics, we continue to expect a wider range of outcomes as alpha becomes an increasingly important differentiator between manager returns (in other words, careful manager selection is of utmost importance). For investors looking to deploy capital to the hedge fund space, we recommend incremental allocations[3] to **equity long/short** and **equity market neutral** strategies as means of capturing differentiated equity exposure.

Our near-term views on private equity have not changed since last quarter. Despite uncertainty and escalations on the tariff front and in the Middle East, specifically Iran, we still believe the backdrop for mergers and acquisitions ("M&A") remains favorable. Financing is currently cheap, with rates having declined nearly 100 bps since hitting cycle highs in November last year. Leveraged loan issuance has dropped 35% year-over-year, but volume remains supportive of a healthy M&A environment. Through mid-June, cash-rich companies and private equity buyers have powered year-to-date M&A activity to roughly $1.3 trillion, which is in-line with the past few years. Purchase price multiples remain elevated (at around 10x) and fundraising and deal sourcing are as competitive as they have been in years. However, given the idiosyncratic nature of private equity

1 **Past performance is no guarantee of future results.** Global stocks are proxied by the MSCI All Country World Index.

2 **Past performance is no guarantee of future results.** Using a long-term beta of 0.33 (HFRI Fund Weighted Composite vs. MSCI All Country World Index).

3 Above long-term recommendations of 30% equity hedge, 30% event driven, 20% macro, 20% relative value. Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

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investing, a strategic mindset and careful manager selection may help overcome headwinds from prevailing market dynamics and should drive investors' experiences over the long term. We continue to look to these investments as return enhancers within the multi-asset construct. For qualified investors who are not yet at strategic private equity targets, we recommend incremental allocations to **special situations** strategies that can help capitalize on pockets of stress and dislocations, and can add potentially counter-cyclical return streams to a strategic private equity pacing plan.

RISK FACTORS

What key risks should investors be watching over the remainder of the year?

We believe the trade tensions between China and the U.S. have been a source of market volatility over the past 6-12 months, and should remain a key risk for investors as we move into the second half of the year. Beyond the potential for further tariff escalation, a prolonged U.S.-China dispute could potentially give way to new non-tariff measures similar to those we have seen imposed on South Korea and Japan in the past. These could potentially include boycotts or new regulatory hurdles for U.S. businesses operating in China, or export controls on critical product shipments such as rare earth metals. This would in turn pose downside risks for business confidence and weigh on the outlook for capital spending and corporate earnings.

We also see developments in the EU as a potential source of risk for markets in the second half of 2019. In the wake of the EU parliamentary elections in May, the potential for more volatility stemming from developments in Italy and the United Kingdom has likely increased. In Italy, fiscal deficit plans for 2020 due to be announced in September could result in another clash between the Italian government and the European Commission as we saw late last year. And market uncertainty could also increase for the UK and Europe in the event of a "no deal" Brexit when the Article 50 extension period expires at the end of October.

Oil markets have also come back into focus with the recent increase in U.S. tensions with Iran. The potential for further unravelling of the nuclear agreement, the risk of escalation in regional proxy wars and the threat of direct disruption to seaborne oil flows each pose upside risks for energy prices that could in turn dampen the outlook for global growth over the months ahead. As a result, developments in the Middle East will also bear close watching alongside those in Europe and Asia.

At the same time, investors should also monitor policy risks in the U.S. during the second half of the year. The technology sector still commands the largest weighting in the U.S. equity market, and calls by lawmakers for new regulatory measures in areas such as data privacy and antitrust could potentially weigh on market valuations. The outlook for Fed policy will also remain a crucial risk factor for investors. Market volatility would likely rise should the Fed disappoint expectations for interest rate cuts over the remainder of 2019.

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Index Definitions

The MSCI All Country World Index captures large and mid-cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,484 constituents, the index covers approximately 85% of the global investable equity opportunity set.

The S&P 500 includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also a proxy for the total market.

The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in U.S. Dollar and have a minimum of $50 Million under management or a twelve month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

Glossary

Alpha is the excess return an investment or a portfolio of investments generates above and beyond a market index or benchmark that represents the market's broader movements.

The **beta** of an investment is a measure of the risk arising from exposure to general market movements as opposed to idiosyncratic factors.

In **active investing** fund managers seek to outperform a strategic benchmark by making tactical allocation and security selection decisions.

In **passive investing** fund managers seek to track their strategic benchmark as closely as possible.

Standard deviation is a measure that is used to quantify the amount of variation or dispersion of a set of data values.

Important Disclosures

Opinions and market data are current as of June 17, 2019 unless otherwise specified.

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Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

All 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. Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

This publication is designed to provide general information about economics, asset classes and strategies. It is for discussion purposes only, since the availability and effectiveness of any strategy are dependent upon each individual's facts and circumstances.

Investments have varying degrees of risk. Some of the risks involved with equity securities 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. Small cap and mid cap companies pose special risks, including possible illiquidity and greater price volatility than funds consisting of larger, more established companies. Bonds are subject to interest rate, inflation and credit risks. Municipal securities can be significantly affected by political changes as well as uncertainties in the municipal market related to taxation, legislative changes, or the rights of municipal security holders. 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. Investing in lower-grade debt securities ("junk" bonds) may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. 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. Mortgage-backed securities are subject to credit risk and the risk that the mortgages will be prepaid, so that portfolio management may be faced with replenishing the portfolio in a possibly disadvantageous interest rate environment. Investments in foreign securities (including ADRs) 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.

Nonfinancial assets, such as loosely-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.

Dividend payments are not guaranteed. The amount of a dividend payment, if any, can vary over time.

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 investor could lose all or a substantial amount of his or her investment. There is no secondary market nor is one expected to develop and there may be restrictions on transferring fund investments. Alternative investments may be leveraged and performance may be volatile. Alternative investments have high fees and expenses that reduce returns and are generally subject to less regulation than the public markets. The information provided does not constitute an offer to purchase any security or investment or any other advice.

Hedge funds are speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment. There is no secondary market nor is one expected to develop for investments in hedge funds and there may be restrictions on transferring fund investments. Hedge funds may be leveraged and performance may be volatile. Hedge funds have high fees and expenses that reduce returns.