CHIEF INVESTMENT OFFICE

Capital Market Outlook

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IN THIS ISSUE

MACRO STRATEGY

Inflection Point for Volatility and Valuation

GWIM Chief Investment Office Macro Strategy Team

In our first Capital Market Outlook for the new year, "*2018 a Year to Watch Inflation*," we focused on the cyclical behavior in equity-market volatility and its relationships to monetary policy and interest rates. As signs that inflation has begun to pick up, we have seen these relationships start to play out.

The surge in volatility in recent weeks reflects the market's need to adjust to anticipated late-cycle turbulence as this expansion becomes the second-longest in U.S. history. Prior to 2018 during this expansion, fears of slow growth and deflation kept market interest rates from accepting the Federal Reserve's (Fed's) desired normalization path as outlined in the "dot plot" released in policy statements from the Federal Open Market Committee. As cycles mature, however, it's normal for Fed policy to progress from maximum accommodation toward a more neutral, less stimulative stance. As that happens, it's typical for the economy to start to get ahead of Fed policy. Gradual removal of accommodation eventually becomes too slow and the market starts to sense the need for faster rate hikes to contain inflation pressures. The recent spike in volatility suggests that this next stage of monetary policy is coming, and an inflection point in volatility and valuations is a natural result. The expectation of higher, more normal interest rates implies less enthusiastic valuations than the January melt-up had suggested.

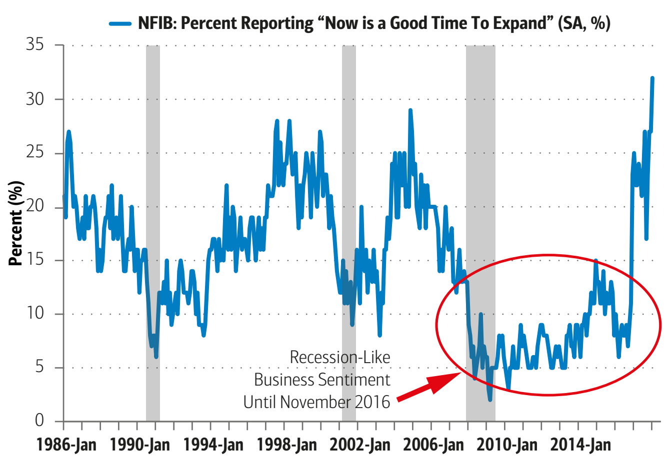
Superimposed on this normal cyclical pattern is a much bigger set of longer-term forces related to the transition out of a secular bull market in bonds and declining nominal growth in gross domestic product (GDP). The "secular stagnation" era encompassed the lowest prolonged growth and inflation combination since before World War II. Nominal GDP growth governs sales, income and corporate revenue growth, which is the basis for servicing the debt in the economy. High debt levels and the weak cash-flow growth implicit in low nominal GDP growth kept the threat of a debt-deflation depression alive during the secular stagnation era.

Monetary policy in the developed economies has been fighting this threat for over a decade, with successive rounds of quantitative easing to bolster zero and negative interest-rate policies aimed at easing the debt burden and stimulating growth. As nominal GDP growth returns to more historically normal levels, these special monetary stimulus measures become inflationary and need to be dialed back.

We think the trick for global central banks is to withdraw this stimulus prudently without prompting a relapse into the deflationary abyss. Risk management dictates that they avoid what we believe to be the greater mistake of not allowing the economy, that is, nominal GDP, to reach "escape velocity," which is close to 5% or 6%. This means central banks should continue to "err on the side of ease," which suggests a period of overheating and rising inflation is likely in the next few years.

Recent fiscal policy actions have cemented the likelihood that "escape velocity" finally happens. The recent fiscal moves, including (1) personal tax cuts, (2) corporate tax cuts, (3) repatriation incentives, (4) increased defense spending and (5) infrastructure spending, have reinforced a wave of animal spirits that was initially set off by the big deregulation push by the new administration. The latest survey of small businesses by the National Federation of Independent Business (NFIB) indicates that the business community has never felt this enthusiastic in the history of its survey. (Exhibit 1).

Exhibit 1: Pro-business policies make many small businesses think that it's never been a better time to expand



Source: National Federation of Independent Business/Haver Analytics
Data as of February 14, 2018

As is usually the case, markets have caught onto this much faster than economists. For the past year and a half, reflation-related beneficiaries of stronger growth have outperformed defensive, deflationary stocks, which were the darlings of the deflationary-threat era of secular stagnation.

In recent months, as the fiscal stimulus has become reality, the consensus view of economists for 2018 GDP growth in the Blue Chip Survey has risen by about a half percentage point, to 2.8% in the early February survey. A breakout in nominal GDP growth, should it persist, would likely force the low interest-rate structure of the secular-stagnation period higher, to more historically normal levels. While this is far from assured, its rising likelihood portends more volatility and less excessive equity valuations. The main point is that the recent market selloff seems to acknowledge that perhaps too much good economic news is too much of a good thing for valuations.

We believe, however, that this is a misinterpretation of the fundamentals, which are clearly still improving, as seen in the latest BofA Merrill Lynch (BofAML) Global Research Global Wave model and particularly in the surge in its earnings revisions-ratio component. As long as central banks withdraw the stimulus of recent years in a responsible way that allows for the "escape velocity" that they have been seeking for over a decade, the economy should continue to reflect the confluence of positive forces that have emerged over the past 18 months.

As always, the main risk as an expansion matures is that inflation surprises to the upside and the Fed decides it needs to be addressed in an aggressive way. We believe the inflation threat, when it finally emerges, deserves to be tolerated for longer than usual. The risks of falling from an "escape velocity" trajectory are much greater than those from flying high for an extended period. Past experience shows that an extended period of strong growth is ultimately bullish for the equity market despite higher interest rates.

As global macro risks shift from deflation, falling interest rates and slower growth to rising inflation, rising interest rates and rising growth, it is natural for the yield curve to steepen as it has in 2018. The key yield spread used in the index of leading economic indicators has widened so far in 2018 and remains near its historical average, consistent with low recession risks in the coming year. We believe this is a sign that the market view is shifting from a Fed policy that is too tight to one that is easy and will need to continue to catch up.

Putting it all together, we believe that ongoing signs of economic strength provide confirmation that reflationary monetary policies are working better in the absence of fiscal policy headwinds. This is reflected in higher business and consumer confidence, as well as accelerating capital spending, which indicate widespread expectations for solid economic performance ahead. In addition, wage gains, bonuses, 401(k) contributions, dividend increases and buybacks have jumped since the tax bill was passed.

In our view, worries that too much of a good thing is bad for equities seem misplaced. Instead, we expect equities to benefit from a strong economy even as interest rates and inflation return to more historically normal levels. Bouts of volatility might temporarily mask these otherwise favorable trends. Ultimately, as in the past, we anticipate the mask will come off to show the favorable underlying fundamentals.

Investing in the World's New "Superpowers"

Joseph P. Quinlan, Head of Market & Thematic Strategy
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Much has been written about the volatile and market-rattling events of the past few weeks, so we take the long view below and outline three "superpowers" in the making: China, Japan and Russia. To be clear right up front, we believe none of these nations are "superpowers" in the traditional post-war, hard-power global sense of the term.

Rather, by "superpower" we mean an activity or capability that is well beyond the global norm or average, or rapidly evolving as a unique and commanding position or platform relative to the rest of the world. In summary, China is rapidly emerging as an innovation "superpower", Japan as a robotics "superpower" and Russia as a cyber "superpower." All three are outlined below, along with attendant investment opportunities.

China as an Innovation Superpower

No country in the world takes the long view like China, in our opinion, with Beijing unrelentingly focused on being a global leader in artificial intelligence, quantum computing, space exploration, life sciences, electric vehicles, supercomputing, semiconductors and 5G wireless devices. There are a number of factors supporting China's bid to become an innovation superpower in the years ahead.

First, spending on research and development (R&D) has risen from 0.9% of gross domestic product (GDP) in 2000 (or $10.9 billion) to 2.1% in 2016 ($232 billion), with strong growth expected to continue thanks, in part, to rising government R&D outlays and increased spending from venture capitalists and private equity investors.[1]

Also, the number of patent filings in China has exploded in the past decade to 2.8 million local patent applications in 2015 versus just 170,000 in 2000.[2] And amid rising concerns of intellectual property (IP) theft, the government has dramatically strengthened its IP rights over the past decade, recognizing that patents, copyrights and trademark protection are the lifeblood of innovation.

Also supportive of China's tech ambitions is its sheer market scale, with over 700 million internet users. This represents just 52% of the population, suggesting there's room for further market expansion.[3]

Now take this vast market and sea of data and mix in generous government incentives for R&D and subsidized capital; blend in a tech ecosystem that encourages and thrives off of risk-taking; add in one of the largest pools of human capital in the world; combine with a large national savings rate and a penchant for techno-nationalism and protectionism, along with a government that thinks in decades, not in days—and it's little wonder China has emerged as a hothouse for innovation. These are the ingredients of an innovation superpower.

Investment summary:

- We think now is the time for U.S. investors to consider building positions in leading Chinese technology companies and startups that are pushing on the frontier of many game-changing technologies.
- Although China's tech giants have posted impressive market gains over the past few years, the innovation boom is just starting and could run for decades.
- The global battle for innovation is shaping up to be a clash between the U.S. and China. We expect the gap between China's tech market cap ($680 billion) and America's ($5.9 trillion) to narrow over the next decade as China leverages and builds off its already formidable strengths.[4]

Japan as a Robo Superpower

Japan is leading the way in a world confronting declining birth rates and aging societies, and the knock-on effects like the decline in the working-age population, acute labor shortages and soaring costs for elderly care. Out of necessity, Japan has been pushing on the robotics frontier for years, and has now reached the stage where the nation ranks as a "robotics superpower."

No other country in the world has strategically embraced robots as much as Japan, with the state's revised Japan Revitalization Strategy seeking to achieve "a new industrial revolution driven by robots." Indeed, industrial robot sales in Japan rose to an estimated 42,000 last year, up from just 13,000 in the recession-year 2009, according to the International Federation of Robotics.

The reach of robots in Japan now extends well beyond the factory floor and has become embedded in schools, hospitals, nursing homes, airports, train stations, space stations and even temples. Pointing to the market upside for robots for nursing-care services, the Japanese government expects the market to expand from 19.1 billion yen ($166 million) in 2015 to 391 billion yen by 2025.

1 "The Fat Tech Dragon, Benchmarking China's Innovation Drive," CSIS, August 2017.
2 Ibid.
3 Internet Live Stats, International Telecommunication Union. December 2017.
4 MSCI Indices. Data as of February 13, 2018.

Investment summary:

- We remain bullish on our global robotics theme, believing that despite elevated valuations in some stocks, the group as a whole remains attractive. We think this powerful secular theme is in the early innings.
- Leading Japanese robotic companies have played a large part in the outperformance of the robotics industry, with the ROBO Japan Index up over 530% since 2009, versus roughly 240% for the S&P 500.[5]
- We recommend investing in leading Japanese robotic manufacturers and service providers, or other leading robotics companies with global exposure.
- Robotics is both a cyclical and secular theme. Because these companies tend to be cyclical in nature, they often provide buying opportunities on weakness in industrial activity.

Russia as a cyber-superpower

A new Cold War has commenced, with Russia emerging as one of the most sophisticated nation-state actors in cyber space. It's a battle without boundaries, pitting nations against nations; non-state actors against states, corporations and individuals; and lone individuals against states, corporations and other individuals.

One of the major factors in Russia's rise to dominance in cyber space has been the investment in and recruitment of talented programmers from universities and the private sector. This contrasts with the substantial shortage of security analysts in other areas of the world, particularly the U.S. and the U.K. Around 209,000 cybersecurity jobs went unfilled in the United States alone in 2015, with the global workforce gap projected to widen to 1.8 million by 2022.[6]

As Russia has been building up its arsenal of cyber capabilities, various cyber-attacks have taken place in its bordering countries over the past decade. Such attacks can cripple a nation's economy, especially in this information age where business, government and banking operations have become increasingly reliant on digital flows.

The upshot from all the above: Global defense and cybersecurity spending has been on a secular upswing. Total enterprise security spending is expected to grow 8% annually through 2021 to reach $126 billion.[7] Corporations are focused on investing in cybersecurity to protect sensitive customer data, safeguard intellectual property and other critical assets, and avoid the outsized costs of a data breach. Ransomware attacks have soared in the past decade, with hackers targeting hospitals, factories, utilities and scores of other activities.

Also, as the number of connected devices grows, cybersecurity is becoming integrated into every aspect of the economy—from banking and healthcare to automobiles and household appliances. Notably, as the push towards greater industrial connectivity continues, there'll be an increasing need to protect critical assets (water, electrical, communications, manufacturing, oil and gas, etc.).

Investment summary:

- Given the primacy of war, increasing digital connectivity and the rising frequency of cyberattacks, we reiterate our overweight for the defense/cybersecurity industry.
- We expect traditional players in the cybersecurity space should benefit from an increase in spending.
- Security of Internet of Things (IoT) devices/endpoint protection is a potential growth opportunity.
- Outside of traditional technology names, we believe defense contractors will be direct beneficiaries of increases in defense and cybersecurity spending, given their expertise and long experience in providing mission-critical or classified cyber protection to U.S. defense organizations.

Exhibit 2: The New Superpowers: Innovation, Robotics, Cybersecurity

	"China: The Innovation Superpower"	"Japan: The Robotics Superpower"	"Russia: The Cyber Superpower"
Macro View	Innovation at the core of the 13th Five-Year Plan (2016-2020). Supporting China's innovation: R&D spending, supportive tech ecosystem, massive market scale, large pools of human capital, high national savings rate.	In response to demographic challenges, Japan is driving a robotics revolution that is expected to transform nearly every aspect of Japanese society—from industrial manufacturing to services.	Russia shaping into cyber superpower after years of building cyber capabilities, investing in technology and recruting talent. Growing number of connected devices point to increase in cybersecurity spending.
Investment Summary	Focus on leading Chinese technology companies and startups that are pushing on the frontier of many game-changing technologies.	Gain exposure through leading Japanese robotics stocks or other leading robotics companies with global exposure.	Gain exposure through traditional technology/ cybersecurity names as well as defense primes.

Sources: GWIM CIO Market & Thematic Strategy Team. As of February 2018.
Past performance is no guarantee of future results.

[5] Measured in USD Net Total Return. Bloomberg data as of February 13, 2018.
[6] "Hacking the Skills Shortage," McAfee, 2016. "Global Information Security Workforce Study," Center for Cyber Safety and Education, 2017.
[7] BofAML Global Research Year Ahead Outlook 2018.

Perspectives on the Global Correction of Risk Assets

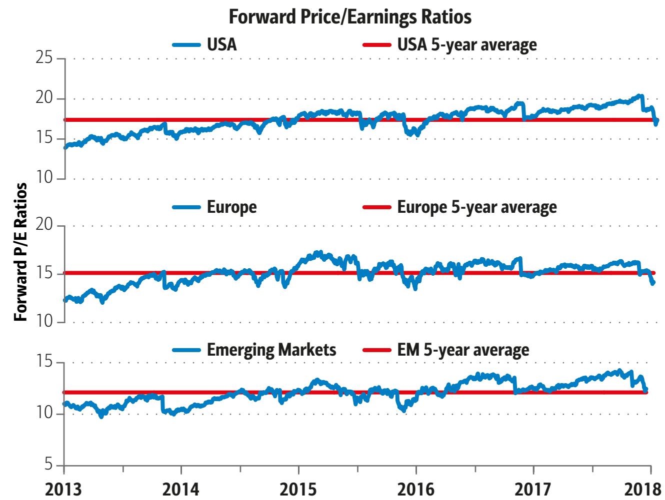
Emmanuel D. (Manos) Hatzakis, Director, Senior Investment Strategist
Kishan Chhatwal, Analyst, Investment Strategist

As time goes on, it becomes clearer in our view that the correction for risk assets since late January is more technical than fundamental. Amid the strongest economy in a decade, it was mainly driven by worries that robust employment and wage growth would cause inflation to overshoot the Federal Reserve's target, and prompt the central bank to become more aggressive in hiking policy rates to more "normal" levels. Bond rates surged, volatility spiked and all of a sudden equity valuations receded to levels that translated to attractive entry points for many who thought they had missed the raging bull market in risk assets.

Current economic data continue to be positive and earnings estimates are being revised upward: 2018 earnings growth estimates for the S&P 500 have risen from 6% at the end of 2017 to 16% as of February 9. That, and the correction, brought down the S&P 500's forward price/earnings (P/E) ratio from 18.75x on January 26 to 16.6x, the lowest level since March 2016. With 83% of the S&P 500 having reported 4th Quarter earnings, earnings per share growth of 15% and sales growth of 8% are the highest since Q3 2011. We continue to recommend equities on solid and improving fundamentals, and especially at the more attractive valuations after the market correction. What is more, positive trends are not confined to the US: In Europe, the forward P/E ratio has declined from 15.3x on January 26 to 14.2x, and in emerging markets it has fallen from 13.7x to 12.5x.

These developments contribute to our view that this is a healthy correction.

Exhibit 3: Rising earnings estimates and the correction have brought down forward price/earnings ratios



Source: Bloomberg. Data as of February 14, 2018.
Past performance is no guarantee of future results.

PORTFOLIO CONSIDERATIONS

- Markets have recovered from their lows and are now back focusing on the fundamentals of above-trend global growth and rising corporate profits.
- We maintain our overweight position in equities relative to fixed income and would use any weakness in the coming weeks as an opportunity to consider adding to equities as we believe the bull market is still intact despite higher rates and higher volatility.

MARKETS IN REVIEW

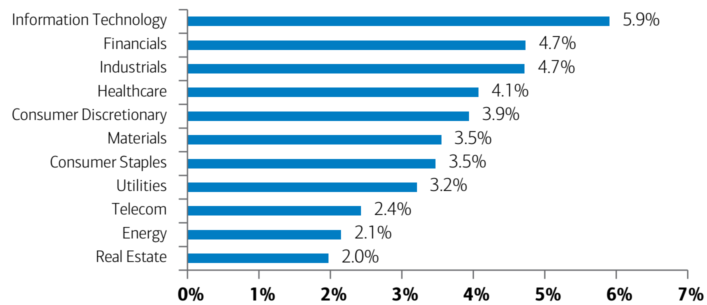
Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	25,219.38	4.4	-3.3	2.4
NASDAQ	7,239.47	5.4	-2.2	5.0
S&P 500	2,732.22	4.4	-3.1	2.5
S&P 400 Mid Cap	1,901.19	4.5	-2.6	0.2
Russell 2000	1,543.55	4.5	-1.9	0.6
MSCI World	2,137.91	4.3	-3.3	1.8
MSCI EAFE	2,075.67	4.3	-3.5	1.4
MSCI Emerging Mkts	1,199.73	5.0	-4.3	3.7

Fixed Income[1]

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
Corporate & Government	3.04	-0.2	-1.1	-2.2
Treasury Bills	1.63	0.0	0.0	0.1
Treasury Notes and Bonds	2.60	-0.3	-0.8	-2.2
Agencies	2.54	-0.2	-0.4	-1.1
Municipals	2.65	-0.1	-0.3	-1.5
U.S. Investment Grade	3.13	-0.2	-1.0	-2.1
International	3.67	-0.2	-1.6	-2.5
High Yield	6.17	0.8	-1.1	-0.5

S&P 500 Sector Returns (For the week ending 2/16/18)



Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	180.39	3.0	-1.7	0.2
WTI Crude $/Barrel[2]	61.68	4.2	-4.7	2.1
Gold Spot $/Ounce[2]	1,347.10	2.4	0.1	3.4
Level	Current	Prior Week End	Prior Month End	2017 Year End
EUR/USD	1.24	1.23	1.24	1.20
USD/JPY	106.21	108.80	109.19	112.69

Source: Bloomberg, Factset. [1] Bloomberg Barclays Indices. [2] Spot price returns. All data as of the 2/16/18 close. **Past performance is no guarantee of future results.**

Asset Class Weightings (as of 2/14/18)

ASSET CLASS	CIO VIEW				
	Negative		Neutral		Positive
Global Equities				●	
U.S. Large Cap Growth				●	
U.S. Large Cap Value				●	
U.S. Small Cap Growth				●	
U.S. Small Cap Value				●	
International Developed				●	
Emerging Markets				●	
Global Fixed Income		●			
U.S. Governments		●			
U.S. Mortgages		●			
U.S. Corporates			●		
High Yield		●			
U.S. IG Tax Exempt			●		
U.S. HY Tax Exempt		●			
International Fixed Income	●				
Alternative Investments*			●		
Hedge Funds			●		
Private Equity			●		
Real Assets			●		
Cash			●		

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Economic and Market Ranges (as of 2/16/18)

	Q1 2017	Q2 2017	Q3 2017	Q4 2017E	2016	2017E	2018E
Real global GDP (% y/y annualized)					3.1	3.5 – 4.0	3.5 – 4.0
Real U.S. GDP (% q/q annualized)	1.2	3.1	3.2	2.6	1.5	2.3	2.5 – 3.5
CPI inflation (% y/y)*	1.6	1.9	2.1	2.1	1.3	2.1	2 – 3
Core CPI inflation (% y/y)*	2.2	2.1	2	1.8	2.2	1.8	2 – 3
Unemployment rate, period average (%)	4.7	4.4	4.3	4.1	4.9	4.4	3.9
Fed funds rate, end period (%) **	0.87	1.12	1.12	1.37	0.62	1.37	1.87 – 2.37
10-year Treasury, end period (%)	2.4	2.31	2.33	2.41	2.45	2.41	2.87 – 3.12
S&P 500, end period	2363	2423	2519	2674	2239	2674	2800-3000
S&P operating earnings ($/share)	31	33	32	38	119	129 – 138	148 – 158
U.S. dollar/euro, end period	1.07	1.14	1.18	1.2	1.05	1.2	1.18 – 1.28
Japanese yen/U.S. dollar, end period	111	112	113	113	117	113	105 – 115
Oil ($/barrel), end period	51	46	52	60	54	60	60 – 70

The average quarterly percent growth for the current calendar year divided by the average quarterly percent growth for the previous calendar year, annualized (unless stated otherwise). E = Estimate.

* Latest 12-month average over previous 12-month average

** Fed funds rate, end period based on market indications.

Past performance is no guarantee of future results. 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.

Source: Global Wealth & Investment Management Investment Strategy Committee.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index.

Indexes are all based in dollars.

Dow Jones Industrial Average is a price-weighted measure of 30 U.S. blue-chip U.S. companies. The index covers all industries except transportation and utilities.

NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

S&P 400 Mid Cap Index is representative of 400 stocks in the mid-range sector of the domestic stock market, representing all major industries.

S&P 500 Index 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 an ideal proxy for the total market.

S&P Small Cap 600 measures the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

MSCI EAFE (Europe, Australasia, and Far East) Index comprises 21 MSCI country indices, representing the Developed Markets outside of North America.

MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 832 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI World Index is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and does not offer exposure to emerging markets.

Important Disclosures

Investing involves risk, including the possible loss of principal. No investment program is risk-free, and a systematic investing plan does not ensure a profit or protect against a loss in declining markets. Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your financial ability to continue purchases.

It is not possible to invest directly in an index.

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.

Past performance is no guarantee of future results.

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).

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.

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.

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