Investment Strategy Overview

Chief Investment Office

JUNE 2018

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Midyear Outlook: The Journey from the "Unnatural" State

Investors are on a long journey from an "unnatural" market environment to a more normal one. There are concerns that steps taken to normalize financial conditions could lead to instability if they go on too long. We believe the journey will continue for the rest of the year and beyond.

The idea of a "journey from the unnatural state" may suggest a space odyssey, an episode of the Land of the Lost, or some sort of science fiction adventure when one hears about it for the first time. However, we believe it aptly describes the current transition period from the early phase of this business cycle to its latter stages. The unnatural state primarily revolves around the core element of "the cost of funding" (global interest rates), credit market pricing (the supply and demand of credit) and the policies and tools that were developed in the past decade (quantitative easing, balance sheet tapering, yield targets, etc.). In other words, the journey is the bridge period, otherwise known as "normalization."

Many market historians try to utilize traditional methods to assess the implications of the unconventional tools that were implemented by central banks around the world (led by the U.S.). However, this cycle, which is almost a decade long, has a few notable attributes that separate it from past periods and that could make this journey a lot longer than the consensus believes.

Importantly, the "cost of funding" is the anchor, in our view. It establishes both the floor (record-low rates) and, in many cases, the ceiling (investors' search for yield) on global yields. Business and investment decisions at the corporate, government, institutional and retail investor levels are dictated by the cost of funding. This is why the transparency on rates, particularly with the large supply of debt around the world, is vitally important. The central banks understand this, and it is one of the main reasons why overnight rates went to zero in the U.S. and negative in Europe and Japan. The “anchor” helped stabilize the cost of funding and the price of credit, which stimulated asset reflation (rather than price inflation) as real yields remained negative for an extended period of time and economic and profit growth crept higher. Asset reflation (higher asset prices for bonds, stocks, private equity, real estate, etc.) and lower debt-service costs in turn helped to strengthen balance sheets, stabilize the financial system and restore global capital flows.

Basically, the low cost of funding pared down the high cost of debt and deleveraging cleaned up balance sheets. Low interest rates also helped reposition the capital stock of corporations (issue low-cost debt and buyback stock), increased shareholder value (dividend increases, higher margins, higher profits), subsidized higher risk-taking, higher growth areas (venture capital), and helped to monetize investments in disruptive technologies (cloud computing, internet of things, etc). Low-cost funding is not new but its reach, duration, and overall impact have been much greater than in the past. This is why we believe its stabilizing effects could become destabilizing if they persist too long. This normalization “journey” is uncharted territory for investors.

Where do we stand now?

For a few basic reasons, we believe this journey can take longer and be less destabilizing than some of the bears believe. First, the larger global central banks understand how important the cost of funding and the price of credit is, particularly in a highly-leveraged world. Second, global demographics—the aging population—make it difficult to stimulate inflation in a world with a large mountain of debt, which is deflationary in its own right. Third, disintermediation and disruptive technologies, such as automation, robotics, machine learning and artificial intelligence, all contribute to price deflation. Fourth, the dollar remains the world’s anchor currency for the foreseeable future and since U.S. yields are among the highest in the developed world, the flow of funds is likely to still favor dollar assets in the medium term. Moreover, U.S. banks are the best-capitalized in the world, which contributes to higher demand for dollars.[1] A relatively strong dollar helps keep a lid on inflation.

All of this contributes to structural disinflation, which allows global central banks to remain patient in their journey from the unnatural state. They can take longer and be more transparent while nudging short rates back to neutral and paring down their balance sheets. As long as inflation is in check, central banks can allow the bonds they own to mature rather than sell them outright. This is one of the main reasons we expect a longer cycle than many other market strategists and academics anticipate. (Also contributing to our view are technological innovation, global wealth aggregation and vast infrastructure needs). Obviously, none of this is written in stone, and there is always a chance for a policy error that upsets the grand plan (we point to Europe as the area to watch in this regard) or some sort of exogenous shock (geopolitical event).

However, just because we expect a longer, less destabilizing transition period with stronger profit growth than others doesn’t mean we anticipate that asset returns will be above average in the years ahead. In fact, although we remain overweight equities with a focus in the U.S. and slight overweight in emerging markets (EMs), we expect total returns from stocks on average throughout the journey from the “unnatural” state to be around long-term averages. For the U.S., this would indicate equity returns close to nominal gross domestic product (GDP) growth rates (approximately 5% plus 2% for the dividend yield). This is still more favorable than our expectations for fixed income, hence our underweight position in that asset class.

Furthermore, we believe the “journey period” will display ten main characteristics: more normal asset price volatility; a grind higher in rates, but to levels still below historical neutral rates; structural disinflation; patient central banks; a stable dollar; a continued search for yield; fair-to-premium equity valuations; tighter-than-normal credit spreads; continued disruptions from technological innovation, and higher deficits and global debt levels.

For the time being, here are our thoughts on the near term:

- We are still equity bulls, but expect lower returns as the cycle matures.
- Continued tariff and trade disputes plus concerns over Italy’s debt “dance” and emerging-market pressures are dimming the positive views on the broader global economy and profits.
- The U.S. is breaking free from the rest of the world in terms of growth, financial conditions and portfolio flows.
- Capital expenditures (capex) and a strong U.S. consumer are the engines powering the U.S. economy relative to Europe.
- We believe the mid-to-late-cycle environment has further room to run, but we will need earnings to do the heavy lifting between now and year-end for equities to break out above their trading ranges.
- A slow rise in interest rates, limited inflationary pressures, stability in the U.S. dollar and economic growth momentum should continue into 2019. Our upper-end target on the S&P 500 remains at 3000.

[1] Source: Bloomberg. Data as of December 2017.

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- Longer-term, our concern over whether Europe has enough "flexibility" to thwart tighter financial conditions and balance sheet issues remains.
- The end to this almost decade-long bull run is more than likely to be due to restrained growth and balance sheet deterioration in Europe and not the U.S., in our view.
- Yields should remain around current levels and we expect the 10-year Treasury to limit its rise above 3% through year end. The European yield anchor on U.S. rates continues.
- Maintain a positive view on equities and a negative view on fixed income, with an emphasis on the U.S. relative to international developed markets.
- Maintain a high-quality bias across all assets. Diversification across and within asset classes at this stage in the cycle is important, as is a balanced mix of passive and active management.

In the following section we answer the top questions on clients' minds as we transition from the "unnatural" state.

MACRO OUTLOOK

A funny thing happened on the way to interest rate neutrality in the United States. Instead of slower growth in the Federal Reserve's (Fed's) home turf, the impact of rising U.S. rates seems to be causing bigger problems abroad. As Warren Buffett famously put it: "You only find out who is swimming naked when the tide goes out." After 175 basis points of Fed rate hikes since 2015, early indications are starting to expose the weak points in the global economy. Perhaps the most astounding thing is that despite rising rates in the U.S., the domestic economy is still getting stronger while the rest of the world, particularly the Eurozone, appears to be starting to fade.

First, some evidence of the growing difference between U.S. and ROW (rest of world) growth: (1) The earnings revisions ratio (ERR) for U.S. companies remains significantly above 1.00 (more upward than downward revisions to earnings expectations). The only other major economic region with a ratio above one is Japan (1.09 versus 1.38 for the U.S. three-month average ERR); (2) May Purchasing Managers' Indices (PMIs) show the moderate slowdown in growth during the winter may have continued in the second quarter in the Eurozone and Japan while strong momentum resumed in the U.S., where the composite (manufacturing and services) index jumped to 55.7 compared to an 18-month low of 54.8 in the Eurozone, where both composite PMIs for France and Germany "fell quite sharply," according to Capital Economics. (3) One consequence of the much stronger earnings growth in the U.S. is a pronounced jump in capital spending plans; for example, from less than 3% anticipated growth for 2018 back in December to about 10% in May, according to the semi-annual survey conducted by the Institute for Supply Management. The acceleration in capital spending is a major factor behind the acceleration in U.S. growth.

Stronger investment and earnings growth go hand in hand. More precisely, an expectation that more profits will accompany investment spending is critical to the decision to take that chance. The main restraint on U.S. growth after the financial crisis was low business confidence and the associated reluctance to invest. This, in turn, crimped productivity and the wage growth that comes from higher productivity, in the self-reinforcing negative feedback loop behind secular stagnation.

One reason the U.S. economy is not showing signs of slowing despite seven quarter-point hikes in the fed funds rate is the expansive fiscal and regulatory policies that have been implemented to counteract rising rates. This is a major difference between Europe and the U.S. The captains of the Eurozone economy remain adamant in resisting the populist pressure for more pro-growth economic policies. As a result, they are left without any offset to the unwinding of massive monetary accommodation that the U.S. has begun.

It should not, therefore, be surprising that the problems from U.S. tightening are surfacing outside the U.S. This is evident in widening credit spreads in Italy, for example, where the failure of Eurozone policies has propelled anti-establishment parties to power. The refusal to seat the new government's cabinet may further infuriate the voters as the European Union (EU) establishment puts another finger in an increasingly leaky dike holding the Eurozone together.

Fading growth is likely to accelerate the drift toward political instability that is already underway in the Eurozone. Tax and regulatory relief in the U.S. have caused capital to flow back into the domestic economy as lower tax rates and repatriation incentives have not just boosted capital spending plans but also juiced dividends, buybacks, debt paydowns, worker bonuses and wages, and merger and acquisition activity. Consumer confidence is matching sky-high business spirits at multi-decade highs.

The sharp change in the relative attractiveness of the U.S. economy has caused the dollar to strengthen. It makes domestic stocks more attractive compared to those of multi-national companies that get about half their revenues outside

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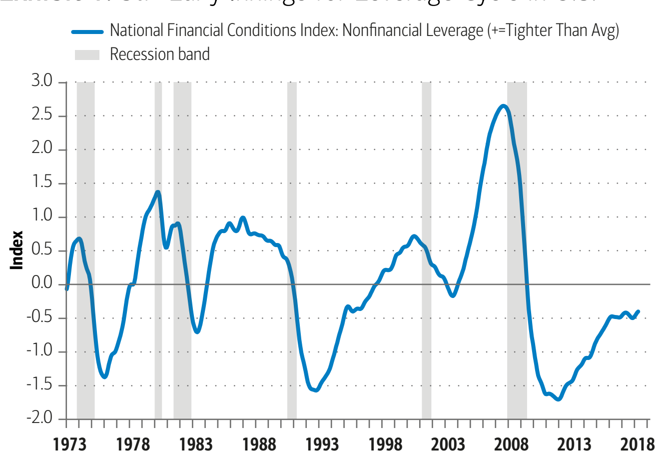
the U.S. As a result, small-cap indices have moved to fresh record highs while the bigger cap-weighted indices have struggled to match their January peaks. Domestic businesses get more benefit from the tax cut than companies that pay other national governments still obsessed with fiscal austerity.

Aside from the extra cushion lower U.S. taxes and regulation provide against the Fed's rate hikes, there is an additional U.S. advantage from the much healthier balance sheets of U.S. banks and households. U.S. businesses are in part using their bolstered cash flows to repay debt and strengthen balance sheets. This means the "swimming naked" are more likely to reside abroad where consumer and business balance sheets are more leveraged. This makes them more vulnerable to the rising-rate tide the U.S. is unleashing. It also means financial conditions may tighten enough to cause external side effects that will dampen inflationary pressures and limit the Fed's ultimate rate trajectory before it causes a U.S. recession. In short, in our view, the next global recession is more likely to come from abroad than the U.S., unlike the Global Financial Crisis that clearly originated in the U.S. financial system.

Since that crisis, U.S. banks have strengthened their balance sheets and reduced leverage to the healthiest levels in memory. U.S. consumers have also deleveraged and debt-service ratios are the lowest in over three decades. While this expansion is old by historical standards and the low unemployment rate is at levels usually only seen at the end of expansions, the overall use of leverage in this cycle remains closer to mid-cycle than late-cycle levels (see Exhibit 1).

Exhibit 1: Still Early Innings for Leverage Cycle in U.S.



Source: Federal Reserve Bank of Chicago/Haver Analytics. Data through April 2018.
Past performance is no guarantee of future results.

Those are all characteristics that imply the U.S. is less sensitive to rising rates than other parts of the world where housing markets and household borrowers are much more extended. Countries with more leveraged household balance sheets include Australia, Canada, Denmark, Hong Kong, Netherlands, New Zealand, Norway, Sweden, Switzerland and the U.K. Europe is also likely to be a swing factor depending on how bad its political problems become. A severe European slowdown combined with the vulnerability of the aforementioned economies to rising rates would put about half of the global economy at risk from rising global interest rates before they slow U.S. growth. The relative insulation of the U.S. from rising rates has caused investors to take a second look at the dollar after a near-universal view at the start of the year that it could only go down.

Discuss your thinking about global financial conditions given the normal rate of central bank policy and the recent strength of the dollar.

The path of least resistance for macro financial conditions is likely to be flat-to-slightly-tighter over the rest of the year and is worth watching. A sharp move higher would be a negative signal for equities and risk assets overall. For now, macro conditions are neutral and support our view that equities will grind higher. This is consistent with our view that Fed policy is also near neutral.

Looking at the components of our U.S.-focused Chief Investment Office (CIO) indicator, the yield curve is likely to remain stable or flatten further as the Fed raises rates, credit spreads are already very tight and could widen if profit margins come under pressure, and international economic uncertainties are showing up in lower bond yields but a stronger dollar (see Exhibit 2). The upside for risk assets (easier macro conditions), is a reacceleration in global growth or an easing of these international growth uncertainties. The downside for risk assets (and tighter macro conditions) is weaker than expected global growth or excessive Fed tightening.

The level of nonfinancial corporate debt as a percentage of GDP is also being flagged as signaling a risk that we could be facing a tightening of credit and liquidity conditions. The credit backdrop has been consistently supportive of macro conditions and risk assets for the last few years. The change in nonfinancial profit margins is the key indicator to watch here as it has a tight link with the change in credit spreads. Given the stage of the business cycle, margin contraction is more likely than margin expansion, another reason to suspect macro conditions could tighten. The offsetting factor in the current environment is stronger nominal growth, which is supportive of topline growth and margins overall.

From a global perspective, global short rates remain broadly accommodative from a GDP-weighted perspective. Nominal

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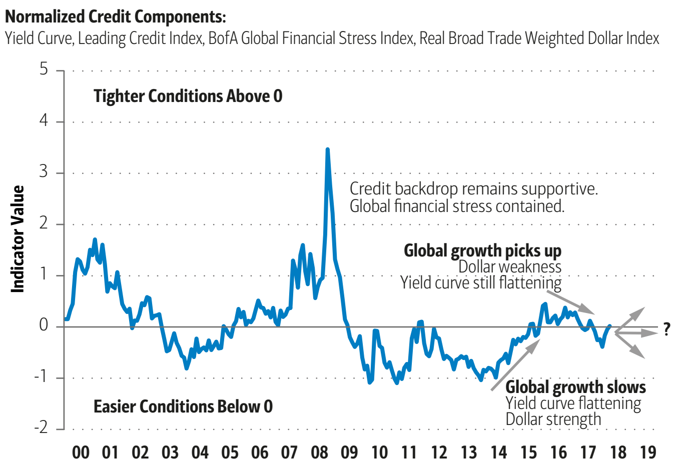
policy rates have moved higher in developed markets (driven by the Fed) while emerging economies have continued to cut rates. Global real short rates are still negative. Importantly, the Fed and other central banks maintain the ability to respond to tighter financial conditions (a stronger dollar, for example, in the Fed's case) by slowing the pace of monetary tightening or even easing policy.

Our base case is that global growth stabilizes around the current pace and the dollar remains mostly stable, leaving room for equities to continue to grind higher. Global financial stress is a bit of a wildcard but remains contained for now.

Exhibit 2: CIO Macro Financial Conditions Indicator



Source: Bloomberg; Chief Investment Office. Data as of June 11, 2018.

Full employment and 2% inflation—What is next for the Fed?

As the unemployment rate drops further below 4.5%, which is the Fed's current best guess of full employment, policy makers will be especially sensitive to signs that inflation pressures are rising persistently above their 2% target. In particular, they will worry that policy is still too easy and needs to be tightened. At the same time, the Federal Open Market Committee (FOMC) realizes that monetary policy works with long and variable lags, so the impact of the seven quarter-point hikes over the past two years will be mainly distributed over the next two years.

A useful gauge of the overall current stance of monetary policy is the yield curve spread between the 10-year Treasury rate and the overnight funds rate set by policymakers. Currently, that spread is about 100 basis points, which is about average over the past century. This suggests the extraordinary monetary accommodation of the past decade has largely been removed and policy is about right.

With policy now more neutral, the Fed will be watching for signs that inflation is still heating up. Such signs would raise inflation expectations and push up longer-term rates, causing the Fed to raise short rates and keep the yield curve in a flatter, less stimulative position. If inflation persists well above the 2% target and appears to be headed higher, the Fed would probably decide to slow the economy with higher rates and an inverted yield curve, which would be a market signal that monetary policy had become tight enough to stop growth and lower inflation. In the absence of signs of overheating inflation, the Fed should be content to let the economy continue growing with low unemployment and inflation near or slightly above the target.

With the U.S jobless rate at a cyclical low, what's the outlook for U.S. wages and the impact on earnings?

Average hourly earnings bottomed on a year-over-year basis in 2012—well below 2%—and have been moving erratically higher to almost 3% in the last 12 months. This is well below the 4%+ pace that characterized past times when the unemployment rate was less than 4%, as it is now.

There are a few reasons why wage growth is slower in this cycle: (1) Inflation has been lower in this cycle than in any other cycle since at least the 1950s, so cost-of-living increases have been lower; (2) Productivity growth has been lower than normal, limiting firms' ability to give real wage increases; and (3) Demographic shifts in the labor force have seen lower-paid younger workers replace an unusually big cohort of higher-paid Baby Boomers, helping to depress the average gain in wages.

While wage growth has been slower to accelerate, it is nevertheless on the rise and sometime in 2020 should reach the 4% threshold that has characterized past cycle peaks ahead of recessions.

Whether this marks the end of the expansion and profits cycle will depend on the mix of wage gains between inflation and productivity. The more productivity accounts for increases in wages, the less inflation and margin pressure on profits. Without productivity growth, 4% wage growth would be associated with inflation above the Fed's target, restrictive monetary policy, and a margin squeeze and profits recession; in short, a potential bear market in equities.

Bottom line: The capex revival that is driving recent stronger growth, rising labor demand, and higher wages will need to boost productivity to keep higher wages from causing inflation and ending the profits expansion and equity bull market. Fortunately, more capital spending is exactly what's needed to boost productivity.

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How does the U.S. dollar movement affect global equity markets?

The U.S. dollar has experienced broad-based strength this year in contrast to the consensus forecast of sustained dollar depreciation caused by rising trade deficits and an increasing government debt burden. Instead, the shift in relative growth toward the U.S., massive corporate cash repatriation, heavy speculative short positions and an oversold market have been consistent with a stronger, rather than a weaker, dollar this year.

The broad trade-weighted dollar index is now back to levels last seen around this time a year ago, with more upside possible. On a real trade-weighted basis, it is hovering around its long-term average. Relatively strong growth and favorable interest rate differentials play important roles in boosting the dollar, so we expect it to stay firm in the near term, with even stronger gains if the global economy loses more strength than expected as the dollar plays a "safe haven" role in times of economic and financial market distress.

Dollar appreciation generally tends to be associated with a loss of momentum in the international manufacturing cycle and global trade growth, adding to the dollar's appeal as a "safe haven" asset. A strengthening dollar index and risk-off investor sentiment typically result in U.S. equity market outperformance. Indeed, despite great expectations for overseas markets given their perceived undervaluation and early-cycle growth potential versus the U.S., both emerging market and European equities have underperformed the U.S. this year.[2]

The negative correlation between changes in the dollar and the global trade and manufacturing cycle raises questions about the risks to global economic growth from rising U.S. interest rates and further dollar appreciation. First, the U.S. monetary policy cycle leads the global economic cycle, and the sensitivity of overseas economies to Fed rate hikes has increased as a result of the rapid increase in dollar bond issuance overseas since the Great Recession. Second, the rise in oil prices along with a broad weakening of foreign currencies against the dollar amplifies the negative effects from rising energy prices on the rest of the world. Third, according to BIS Research, dollar appreciation and the rising cost of the bigger private dollar debt burden tend to hurt domestic investment in the affected countries, weakening economic growth and hurting their domestic profits and equity market performance relative to the U.S. Fourth, while exports tend to benefit from depreciating currencies, the global trade cycle appears to have peaked with the moderation in EU growth from above-trend levels. The loss of momentum in Eurozone business sentiment indicators and appreciation of the dollar also suggest a moderation in the U.S. manufacturing cycle is likely as the year progresses. Fifth, rising interest rates are likely to negatively affect economies with housing and credit bubbles, such as Australia, Canada, Hong Kong, New Zealand, Norway, Sweden, and the U.K. Most of their currencies generally appreciate in an expansion as global export demand fuels domestic growth and encourages their central banks to lift rates. This time around, housing and debt imbalances have made these economies more interest-rate sensitive.

On balance, the surprise dollar and U.S. economic strength in 2018 have made the U.S. equity market relatively more attractive compared to foreign markets.

MARKET STRATEGY

How are the latest global trade tensions changing your outlook on domestic and global GDP growth?

Rising frictions between the U.S. and its trading partners have been a periodic source of market volatility during the first half of 2018. And following the discord at the June G7 meetings, we fully expect trade tensions to persist into the second half of the year. But we see the tariff measures and counter-measures introduced so far as insufficient to have a major impact on the fundamental outlook for global growth in aggregate. Steel and aluminum exports for example account for less than 1% of GDP across major markets such Canada, Mexico and Germany. And similarly, both metals are only a small share of total U.S. goods imports—1.5% in the case of steel and 0.6% for aluminum. Respective tariffs of 25% and 10%, even if fully passed on to domestic purchasers, would therefore be expected to raise U.S. import price levels by just under half of one percentage point overall.

The new tariffs are nonetheless likely to have a greater impact on individual U.S. supply chains, particularly for industries with a high steel and aluminum input intensity such as motor vehicle production, machinery manufacturing and construction. These segments are much more exposed to higher input costs. And to the extent that individual firms in these sectors might choose to absorb the higher prices, profit margins would also be put at risk.

[2] Sources: MSCI, S&P Global. Data as of June 25, 2018.

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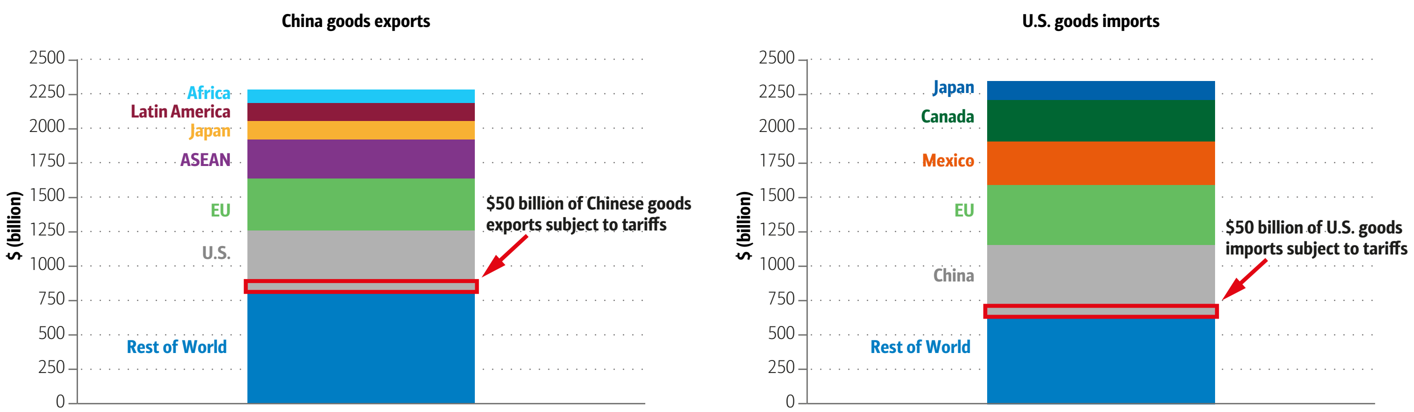
Exhibit 3: Trade tariffs apply to a relatively small share of China exports and U.S. imports



Source: International Monetary Fund, China General Administration of Customs, CEIC. Data as of 2017.

Similarly, the aggregate impact of the restrictions announced between the U.S. and China so far should also be limited. Pledged tariffs on $50 billion of U.S. imports from China represent less than 3% of both total Chinese goods exports and total U.S. goods imports (see Exhibit 3). And despite U.S. threats to respond to any Chinese retaliatory measures, we see clear reasons for each side to be wary of major escalation. For the U.S., China is a large and fast-growing export market for U.S. firms across a range of industries beyond agriculture, which has been the focus for Chinese authorities so far. And though Chinese exports to the U.S. outweigh U.S. exports to China by around four-to-one, local operations of U.S. firms operating in China could also become targets for Chinese counter-measures should trade frictions escalate substantially. At the same time, China may be unwilling to impose major import restrictions on high value-added products from the U.S. such as advanced microprocessors, which it needs for strategic development and would struggle to source elsewhere. A widening of the U.S.-China trade conflict remains a risk, but we would therefore expect the measures ultimately pursued by either side to remain limited.

Despite the lack of progress on renegotiation on the North American Free Trade Agreement, cooperation on NAFTA will also be in the interest of all participants. Exports to the U.S. account for more than one-fifth of GDP in both Mexico and Canada. At the same time, greater trade and investment restrictions between NAFTA members would mean higher input costs and lower profitability for U.S. firms operating in the Mexico border region (particularly in the auto sector).

It is worth noting that global trade has so far remained relatively resilient in the face of the growing frictions between the U.S. and its trading partners. And Asian economies in particular have maintained their commitment to free trade within their own region, as re-stated at the June meeting of the Shanghai Cooperation Organization. Global import volumes have softened over recent months but remain above their cycle average. And without a major escalation in new barriers beyond the restrictions enacted so far, we would expect trade activity to remain a contributor to global growth.

How might the U.S. mid-term elections influence capital markets over the near term?

As experienced so far in 2018, past U.S. Congressional mid-term election years have tended to feature policy-related market volatility and large market corrections. One potential factor could be that lawmakers, seeking to retain Congressional support, introduce measures that have popular support but are viewed unfavorably by investors. Recent examples would include the presidential impeachment in 1998, the Sarbanes-Oxley accounting regulation in 2002 and the Dodd-Frank financial regulation in 2010. Similar developments in the current cycle have included the growing risk of trade protection and calls for technology sector regulation. Over the past 10 presidential cycles, the S&P 500 has experienced peak-to-trough corrections averaging 15% during the mid-term election year, with a rebound over the next 12 months averaging 28% (see Exhibit 4). Historically, the second (current) year of the presidential cycle has been the weakest, while the third year has been the strongest. And just as populist policies may partially explain periods of weakness in past mid-term years, subsequent strength may be associated with expectations for economic stimulus ahead of the next presidential campaign season. Every cycle is of course different, but these historical patterns will be worth keeping in mind ahead of this November's elections and into 2019.

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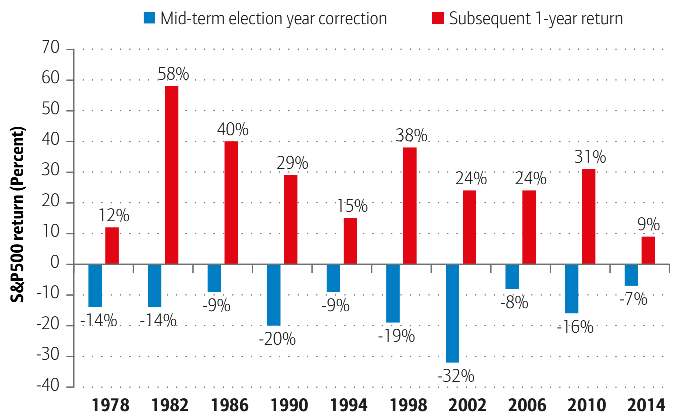
Exhibit 4: Market corrections and rebounds in past mid-term election years



Source: Strategas Research Partners. Data as of 2018. **Past performance is no guarantee of future results.**

EQUITIES

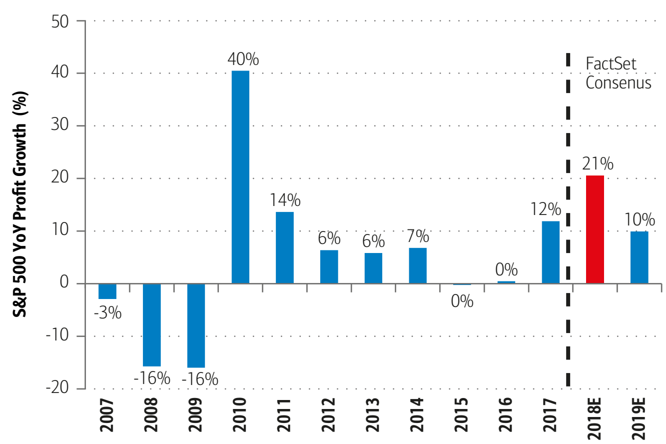
What do you expect to drive U.S. equity markets in the second half of 2018?

We expect more positives for U.S. stocks—such as improving corporate profits, management guidance, and better economic growth and business spending—than negatives such as geopolitical concerns and rising interest rates in the months ahead.

Profit growth should remain the primary driver of U.S. stocks, but we expect additional dynamics to factor in as stocks grind higher towards the upper end of our year-end S&P 500 target range of 2800-3000. Capital expenditures and share buybacks, both forms of cash deployment incentivized via tax reform, should accelerate, and the magnitude of each will have market implications. A pickup in capex may signal management's confidence in future growth and also bolster the outlook for productivity, which could preserve margins in the wake of wage growth. Share buybacks improve the profitability per share of companies and represent a vote of confidence to investors.

Earnings estimations are robust for the remainder of 2018 and growth is a bit more tempered beyond. Consensus earnings per share estimates, as per FactSet, imply S&P 500 profit growth of 21% this year and 10% in 2019 (see Exhibit 5). These estimates, if met, would significantly bolster the denominator of valuation ratios and support our target range of 2800-3000 or higher. As the second-quarter earnings season unfolds, market participants will be keenly focused on forward guidance issued by management along with any clues shedding light on growth in future periods. As supported by the tepid market reaction to an impressive first-quarter earnings season, the markets tend to focus less on recent results but are more rewarding to those companies signaling encouraging growth prospects moving forward.

Exhibit 5: Impressive earnings momentum should power U.S. stocks higher



Source: FactSet, Chief Investment Office. Data as of June 14, 2018. E = Estimate.

The macro backdrop also appears poised to foster a supportive environment for equity markets as U.S. economic growth accelerates towards 3%. Business spending should continue to pick up heading into the second half of the year, the American consumer remains a workhorse and the housing market shows signs of promise. Fiscal stimulus, in the form of tax reform and federal spending, should provide further kindling to growth. With that said, the policy actions and guidance of the Fed will be of critical importance as investors look to project when, or if, the monetary environment may turn more restrictive. We think rising rates by themselves should not be a headwind for stocks if there is a gradual rise in conjunction with improving profit growth and productivity trends.

Finally, the geopolitical calendar is primed to contribute to market angst. Congressional mid-term elections in the U.S., national elections in Mexico and Brazil, a Brexit withdrawal treaty and trade negotiations, most notably with China, all have the potential to move markets, if not for any reason other than the noise and uncertainty they generate. With a host of supportive tailwinds but "grey swans" lurking on the horizon, it seems assured that markets will have a "Wall of Worry" to overcome.

Which sectors are well-positioned in this environment and which are most challenged?

Our expectation for an increase in capital expenditures, an expected gradual rise in interest rates, the effects of

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propitious policy and the longer-term transition to the Digital Era keeps us favorable on the Information Technology and Financials sectors.

The Trump administration's tax reform bill has encouraged an uptick in capex. Among other signals, the first-quarter reporting season for the S&P 500 signaled a boost in spending of more than 20% on a year-over-year basis (YoY). In our view, this trend should favor both Financials, which would see more investable opportunities to deploy funds, and Information Technology, as companies upgrade aged fixed assets to position themselves for an increasingly digitized world.

Focusing exclusively on Information Technology, while some worry that the sector now represents nearly 24% of the S&P 500, the earnings back it up, in our view. Today, the sector accounts for 23% of the earnings per share contribution to the broader S&P 500. The similarity in these levels contrasts with the peak of the 2000 Dotcom Bubble, when the sector constituted nearly 33% of the S&P 500 but only accounted for just over 14% of earnings per share.

In the Financials sector, earnings should be aided by rising interest rates. While conventional wisdom argues that a flattening yield curve may reduce net interest margins and dent profit growth, we believe that these concerns may be misguided, as bank earnings are more levered to shorter-term interest rates. BofA Merrill Lynch Global Research estimates that approximately 70% of bank loans are priced off nearer-term maturities on the yield curve. Additionally, a quicker application of higher interest rates to loans (which create revenues for banks) versus consumer deposits (which create costs) would help maintain profitability. Finally, small and medium-sized banks have recently benefitted from a partial rollback of the Dodd-Frank legislation, reducing their regulatory burden.

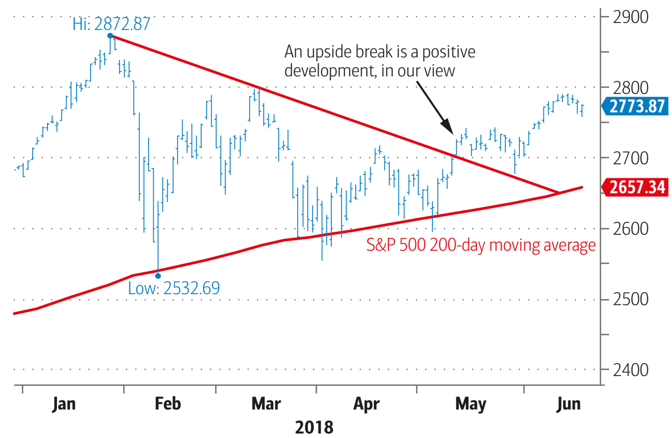
On the other hand, we expect bond proxy sectors, or those sensitive to climbing interest rates, to remain challenged. Within this set, we identify regulated utilities and traditional telecommunications as industries to be pressured by additional structural headwinds, such as falling demand, competition and rising costs.

What are the technicals telling us?

Price momentum, robust market breadth, and a cooling of euphoric sentiment have allowed for positive price action in the S&P 500 and the Russell 2000 indices, representing U.S. large and small cap companies respectively. While these developments suggest a positive equity market outlook, we expect volatility to remain, as global interest rates grind higher. Meanwhile, we are monitoring recent technical developments suggesting a greater potential for U.S. dollar strength and sluggishness in emerging markets.

Recently, the S&P 500 broke out of a "triangle" price pattern to the upside (See exhibit 6). This together with the index's rising 200-day moving average are signs of continued upward momentum. The same can be said for the Russell 2000. Positive price action and momentum can be seen in new all-time highs for this index week after week, alongside its rising 200-day moving average. In sum, the trend remains a friend for U.S. equity investors.

Exhibit 6: A recent break from a triangle price formation higher suggests positive "price action"



Source: Bloomberg. Data as of June 18, 2018. **Past performance is no guarantee of future results.**

Meanwhile, market breadth remains solid. The NYSE cumulative advance/decline line, which is a running total of the number of advancing stocks minus the number of declining stocks trading on the New York Stock Exchange, has recently made new all-time highs. This is at odds with its historical performance nearing the end of bull markets, when fewer participating stocks indicate underlying weakness in an uptrend.

Finally, a famous Wall Street axiom is that "Markets like to climb a wall of worry." In late January, as equities rose sharply, euphoric sentiment suggested that very few buyers were left to sustain the uptrend. This precipitated equity market volatility. Since then, the Bull & Bear indicator, a proprietary sentiment barometer of BofA Merrill Lynch Global Research, has fallen from extreme bullish sentiment readings, indicating rising skepticism. In other words, the "Wall of Worry" is being rebuilt, an encouraging development, in our view. If risks begin to diminish, equity buyers would be available to potentially push markets higher.

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Recent developments in the U.S. dollar and Emerging Market equities have captured our attention. For the U.S. dollar, the 50-day moving average has crossed over the 200-day moving average. This instance is called a "golden cross," a technical signal indicating a potential shift in trend to the upside. Coincidentally, the MSCI Emerging Market equities index has shown the opposite. The 50-day moving average of the index has crossed under the 200-day moving average, indicating potential technical weakness for emerging markets. While we remain overweight Emerging Market equities, we are closely monitoring this development.

Are the fundamentals and technicals indicating the same trends?

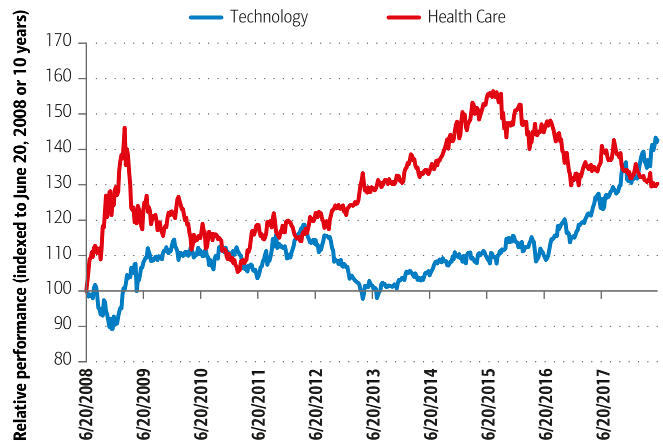
We believe that technology-led innovation, characterizing the Digital Era, and aging populations, underpinning increased demand for health care services, are two trends that will shape the world over the coming decades. The equity market has suggested that these trends are at our doorstep.

Information Technology has been the best-performing sector within the S&P 500 not only year-to-date at 11.1%, but also over the past three and five years (78.8% and 164.1%).[3] The sector's prevalent outperformance demonstrates the capacity for growth in new technologies, such as artificial intelligence, automation, cloud computing and in particular cybersecurity, which sits at a nexus, also benefiting from rising geopolitical tensions. In addition to these structural trends, the Information Technology sector is expected to be a beneficiary of repatriated cash, part of the Trump administration's tax plan, which may be used to fund share buyback programs. Along with this sector, Health Care is one of four S&P 500 sectors gaining year-to-date (1.0%).[4] While its performance has likely been influenced by shifting policy expectations from Washington over the short-term, over the longer term it has largely outperformed the S&P 500 and suggests growth from structural demand spurred by a continuing wave of baby boomer retirements (see Exhibit 7). Finally, adjusting our binoculars and focusing on the nearer-term, regional banks have shown outperformance versus the S&P 500, having hit a new record high. Investors have been anticipating an improved regulatory landscape, while rising interest rates and an expanding U.S. economy should continue to act as sturdy tailwinds for earnings growth.

[3] **S&P 500 Information Technology Sector Total Return Index** seeks to track the performance of U.S. technology companies as defined by the Global Industry Classification Standard (GICS). A total return index tracks both the capital gains of a group of stocks over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index. (Data as of market close, June 26, 2018.)

[4] **S&P 500 Health Care Sector Total Return Index** seeks to track the performance of U.S. Health Sector companies as defined by the Global Industry Classification Standard (GICS). A total return index tracks both the capital gains of a group of stocks over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index. (Data as of market close, June 26, 2018.)

Exhibit 7: Information Technology and Health Care have been long-term winners versus the S&P 500



Source: Chief Investment Office. Date as of June 13, 2018. **Past performance is no guarantee of future results.**

Despite these positive trends, the equity market is also reflecting some negative ones that we are monitoring. Rising interest rates, a strengthening U.S. dollar and trade tensions have fomented uncertainty in the global economic outlook. U.S. small caps, which are more insulated from global trade and are captured by the Russell 2000 index, have been outperforming their large-cap counterparts in the S&P 500, which have a greater share of foreign-based revenues. While earnings growth for small caps has generally been less than that of the S&P 500, their recent outperformance may be reflecting uncertainty regarding future earnings potential for the latter. This has created some conflict between the fundamental and technical picture. Meanwhile, in emerging markets the technical picture may be foreshadowing weakness in the fundamentals. Underperformance by the asset class versus the S&P 500 has started to be reflected in BofA Merrill Lynch Global Research's Global Revision Ratio, which measures the number of analysts raising versus lowering their earnings estimates. This indicator has recently turned lower.

How do you expect companies to deploy their cash stockpiles?

Many U.S. companies are generating record levels of profits and cash thanks to a strong economy, elevated margins and tax cuts.

S&P 500 profits reached a record $303 billion in the first-quarter of 2018, a year-over-year increase of $50 billion, as calculated by Bloomberg. Of these earnings, more than one-third were paid out to shareholders in the form of dividends. The independent research firm Strategas projects $1.7 trillion of unremitted foreign earnings to be repatriated as a result of

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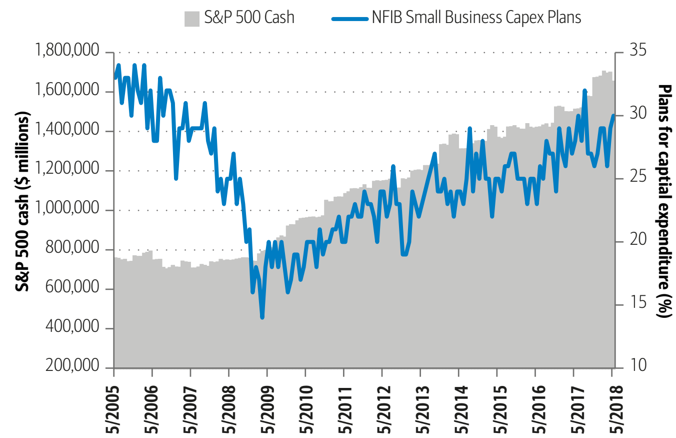
the Tax Cuts and Jobs Act. This supplements the $1.7 trillion of cash already sitting on corporate balance sheets, according to FactSet (see Exhibit 8). Quite simply, companies are flush with capital and the ways in which it is deployed have implications that will shape markets.

To begin the year, companies funneled most of their cash windfall to share buybacks and capital expenditures, and we expect this to continue. In fact, buybacks for the S&P 500 reached a record level in Q1 and could approach $1 trillion for 2018. Share buybacks can indicate management's confidence in the value of their stock, while also benefitting investors by reducing the number of shares outstanding, thus improving earnings per share. Capital expenditures have also accelerated at a record pace, surging more than 20%, totaling almost $160 billion in the first-quarter. We would expect capex levels to continue their elevated pace as surveys suggest strong confidence amongst business leaders, a greater stated intention of businesses to invest and an economic backdrop both rewarding and conducive to greater investment. With the U.S. labor market nearing full capacity, and skilled labor particularly hard to come by, companies will face mounting pressure to share more of their spoils with employees and we have already seen companies announce wage hikes, one-time bonuses, contributions to employee retirement accounts and other measures as incentives.

In addition to cultivating organic growth via capex, some companies find the environment attractive for mergers and acquisitions (M&A). The transaction value of announced U.S. deals has grown in 2018, totaling more than $1 trillion, and is expected to remain robust. Strong M&A activity could be a boon for share prices of smaller companies that may be targets for acquisition. Finally, the war chest of corporate cash may be used for a less flashy purpose—to pay down debt. With corporate debt levels elevated and funding costs grinding higher, it may behoove some companies to alter their capital structure by using cash to retire debt.

Exhibit 8: Record cash prompts corporate plans to invest and expand



Source: FactSet, National Federation of Independent Business, Chief Investment Office. Data as of May 31, 2018.

What are the prospects for international developed market equities?

We have recently lowered our tactical allocation to international developed market stocks in favor of U.S. stocks. The U.S. economy has opened up a considerable lead over its developed market counterparts, such as countries of Europe and Japan, and this growth gap is likely to persist. International developed market equities demonstrate some relative value at current levels. However, the bullish undertones that supported the group heading into the year have been tempered by a series of disappointing economic data reports.

Both Japan and the Eurozone now exhibit multi-year lows in their respective Citi Economic Surprise indices, illustrating soft data as of late (see Exhibit 9). Moreover, earnings per share revision ratios for both regions are in a downtrend, indicating deteriorating corporate profits momentum. With faster growth found elsewhere, higher yields enhancing the relative attractiveness of debt and uncertainty roiling Europe, we find more opportunity outside of international developed markets.

While we do feel a bit more sanguine regarding Japan's recent troubles, Europe is likely to face more challenges going forward. The Eurozone has struggled to overcome the suffocating cloud of political and fiscal uncertainty permeating the region. Recent expectations for corporate profit growth have disappointed, with three-month ERRs tallying 0.86 in May after beginning the year at 0.91. In addition, the eventual tightening of monetary policy by the European Central Bank may cause further divide amongst countries of varying economic circumstances within the bloc. Until progress is demonstrated in enacting structural reforms, we fear that European equities may continue to be discounted by investors.

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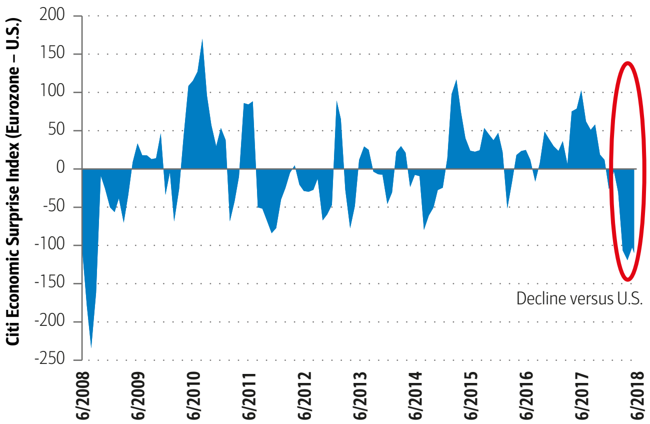
Exhibit 9: Eurozone economic data has disappointed relative to the U.S.



Source: Bloomberg, Chief Investment Office. Data as of June 13, 2018. **Past performance is no guarantee of future results.**

Ultimately, a sustainable recovery in European stocks, where they begin to bridge the performance gap with U.S. markets, will be contingent on the progress of structural reforms. This is looking less likely in the near term given recent political developments in Italy. The new populist coalition government there does not share Brussels' views on fiscal restraint and supply-side reforms, which is likely going to lead to confrontational discussions. And while we don't believe that "Ita-leave" is likely, the risk of an erosion of business and investor confidence remains high.

Conversely, Japan has shown some green shoots, including sharp growth in employment and wages. Expectations for Japanese profit growth did moderate but remain above water, with three-month ERRs falling from 1.63 in January to 1.08 in May. Structurally, Japan enjoys autonomy of its currency and is buttressed by the policy tailwinds of continued fiscal and monetary accommodation, and long-term, Japan remains one of our favorite plays on robotics given the nation's leading embrace of the technology in both manufacturing and services.

What are your current views on emerging markets?

The recent volatility in emerging markets (EMs) has borne some of the hallmarks of past periods of major stress for EM assets: emergency interest rate hikes, declines in foreign exchange reserves and International Monetary Fund intervention, as well as the first period of net portfolio outflows since the panic over protectionism that immediately followed the U.S. election in 2016.

But the extent of the recent weakness in emerging markets has varied across individual countries, with the weakest links concentrated in Latin America and Emerging Europe. For Turkey and Argentina—by far the worst performers this year—a combination of large current account deficits, high ratios of dollar debt to GDP and double-digit inflation has made for particular vulnerability to a stronger U.S. dollar and tightening Fed monetary policy. In the case of Brazil, investor confidence has been undermined by a weak fiscal position, the government's inability to overhaul the pension system, ongoing labor strikes in the transportation sector and declining expectations that a reformist presidential candidate will be elected in October.

However, most important in the current environment of rising rates and dollar appreciation is that the fundamentals for most emerging economies have improved significantly from periods of past crisis. Five years have now passed since the start of the taper scare in 2013, when emerging markets across the board were hit hard by expectations of Federal Reserve balance sheet contraction. But external positions in EM are much stronger this time around. Eight out of 24 countries in the MSCI Emerging Market Index have seen their current account deficits reduced in size since 2013, indicating a reduced reliance on financing for net imports from abroad. Another three have moved from deficit into outright surplus. And there are now only two markets in the index, Turkey and Colombia, that have deficits of more than 3% of GDP. Nine markets fell below this threshold in 2013.[5]

Crucially, we have also begun to see emerging Asia, which remains by far the strongest region on economic fundamentals, begin to decouple from Latin America and emerging Europe. Asia now accounts for close to 75% of the capitalization-weighted emerging market equity index, and its relative resilience has significantly dampened the impact of weakness elsewhere on EM returns overall. And looking forward, absent a full blown trade war, we expect continued leadership to come from the Asia region, with particular support from its high exposure to consumer-linked sectors.

FIXED INCOME

What are the biggest risks that you are watching for fixed income markets for the remainder of 2018?

We highlight three risks to fixed income markets for the rest of the year. The first is that markets are priced for a very favorable outcome; any unexpected negative macroeconomic or geopolitical event may have an outsized impact. The second is that volatility outside the U.S. is increasing while the Fed reduces monetary policy accommodation, which may lead to a

[5] Source: Bloomberg. Data as of Q1 2018.

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dilemma for the Fed. The third is a breakdown in the typically inverse correlation between bond and equity prices, which would reduce the beneficial diversification impact of fixed income in multi-asset class portfolios.

Fixed income market conditions are very favorable. Both investment grade and high yield issuers have had easy access to capital for many years, allowing for debt-financed capital return to shareholders and robust M&A activity. High yield spreads are close to the lowest levels since the financial crisis, and investment grade spreads—while wider on the year—are still well below post-crisis averages. At the same time, debt-to-earnings leverage metrics are very high and above previous cycle peaks. The combination of a market that is almost “priced for perfection” with high debt levels and compressed risk premiums across financial assets is a risk in itself. There are limited “margins of safety” across a broad swath of fixed income assets, so if and when an unexpected event occurs—be it geopolitical, macroeconomic, or a natural or man-made disaster—this might have an outsized, negative price impact on all assets outside of U.S. Treasurys. It would also certainly impair financing conditions, which would have knock-on effects on other markets—including equities—and the economy. While this is a risk that is hard to predict, it is factored into our recommended portfolio positioning. Stay up in quality across fixed income, emphasizing municipals and corporates, and maintain some allocation to Treasurys. Be prudent and underweight high yield, favoring secured leveraged loans in any allocation. While we recommend a slightly short duration to an appropriate benchmark, do not be too short duration as that will limit the diversification benefit in a risk-off environment. While this risk is hard to handicap, this positioning should be relatively helpful in a risk-off environment.

Unemployment is 3.8%—and that is before the economy has realized the full effect of fiscal policy. The last time it was lower was 1969; the narrative is similar for initial unemployment claims, a leading economic indicator. This has emboldened the Fed to accelerate its pace of rate hikes. The Fed now projects two more rate hikes for a total of four this year. As global risks continue to surface—weakness in certain Latin American countries, renewed fears about peripheral European sovereign debt, growth of populism, European banking sector issues—the opportunity for a monetary policy error increases. The Fed’s “dual mandate” is solely U.S.-focused—full employment and stable prices in the U.S.—and it wants rates to rise at this point to prevent the economy from overheating. If the world gets riskier, however, global capital flows to longer-dated U.S. fixed income assets may increase and bring down their yields; they are already at three-decade highs versus Europe, so they are very attractive in a global context—especially in a “risk-off” environment. This could—along with the impacts of U.S. fiscal policy—cause financial conditions to become more accommodative in the U.S., the opposite of the Fed’s intent, or lead to an inversion in the yield curve. While we do not foresee any major systemic global risks at the moment, a significant increase in global volatility that is not mirrored by a weakening U.S. job market and inflation data would present an interesting dilemma for Fed policymakers. They would have to choose between continuing their path of rate hikes and exacerbating market stresses, or slowing the pace and potentially dealing with inflation that is higher than their target. Unless the volatility causes significant stress at home, we would expect the Fed to prioritize its domestic “dual mandate.” We note that, thankfully, the Fed has more tools in its toolbox now to deal with such challenges. It has a significantly larger balance sheet than pre-crisis, so it could sell Treasurys directly to the market if it wanted to impact the supply / demand balance to assert more effective control on long-term rates.

As we transition to a higher-rate environment, we do not want to make any assumptions. Treasurys have diversified equity risk for decades, but that does not make for an immutable law of investing. (No one thought zero rates were a possibility until not so long ago.) Prior to the 1990s, equity and fixed income prices were actually positively correlated. An unwanted acceleration in inflation could conceivably cause significantly higher interest rates and lower price/earnings (P/E) ratios, leading to lower stock prices at the same time bond prices are falling. Such a positive correlation between bond and stock prices would be damaging for many asset allocation models, leading to market dislocations. This remains a niche worry, however. While there were several daily episodes recently when the S&P 500 and Treasury prices moved in the same direction, when push came to shove Treasurys still did their job: The 10-year rallied 15 basis points in one trading session and over 35 basis points over seven trading sessions during the peak of the Italian bond crisis. While this risk is one to watch, it is certainly not one to lose sleep over.

Are municipal valuations too rich right now, given low new issue volume and seasonally heavy redemptions (negative supply) and steady demand from individual investors?

No, they are not too rich, in our view. Ten-year muni-to-Treasury ratios are certainly at the low end of the post-crisis range, but compared to pre-crisis ratio levels they are not out of line. It is true that munis have outperformed many taxable fixed income

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sectors so far this year; we attribute this to strong technicals—extremely low supply and solid demand from individual investors—as well as strong fundamentals, with mostly stable or improving credit metrics. However, we expect these conditions to persist for some time.

Muni supply is down ~22% year-to-date, as tax reform eliminated tax-exempt advance refundings. Furthermore, the expectation of tax reform caused some deals planned for 2018 to be accelerated into 2017. Finally, the decline in issuance has been exacerbated recently by seasonal factors; many municipal bonds mature or become callable in June, July and August, causing negative supply in the summer months. On the demand side, while banks have been reducing their holdings of munis—due to the lowering of tax rates and accounting changes—this has been offset by solid demand from individual investors. This has particularly been the case in high tax states, given the new limits on state and local tax deductions. Fundamentally, muni credit is mostly stable or even improving due to the strong U.S. economy. State and local government tax revenues grew a solid 4.7% in 2017 (9.5% in the 4th quarter alone), budgets are in better shape and Moody's has upgraded more municipal bonds than it has downgraded since 2015.

We expect the strong technical environment for munis to extend at least through the summer, and the strong fundamental environment to extend through this phase of the business cycle. However, we remain cautious on states and local governments with large and growing unfunded pension liabilities and/or structurally unbalanced budgets (such as Illinois, New Jersey and Connecticut), and certain high-yield sectors (like tobacco bonds) that could underperform when the credit cycle finally does turn. Therefore we do not recommend that conservative investors venture down the credit spectrum in search of higher yield.

ALTERNATIVE INVESTMENTS

Why do you believe alternative investments will become increasingly important to portfolios going forward?[6]

Financial conditions have begun to normalize; interest rates are moving higher, inflation is tracking close to the Fed's target, and volatility has returned to the market. In the near-term, despite a largely positive fundamental backdrop for global stocks, we believe risks such as ongoing trade negotiations, a rise in bond yields, political uncertainty and a moderation in investor risk appetite and economic data argue for higher levels of volatility and moderate return expectations. To that end, for qualified and suitable investors, the current environment warrants a look at asset classes that have historically offered lower exposure and correlations to broader markets while providing differentiated sources of return through active management and illiquid securities; these are best characterized as alternative investments (AI).

Periods of heightened volatility have historically coincided with strong AI performance when compared to traditional investments (see February and March equity drawdowns). And intuitively this makes sense; large asset price swings and dislocations tend to widen the opportunity set for strategies that aren't constrained to long-only, market-centric investing. Strategies that are able to take long and short positions as well as invest in complex securities that have less than perfect correlations to markets can help portfolios navigate potentially tough markets. Importantly, each AI asset class brings a unique quality to a multi-asset portfolio. We look to hedge funds as a way of stabilizing the return of the broader portfolio, private equity to help enhance returns and real assets as a means of inflation protection and additional yield. With markets normalizing after an extraordinary nine years for both stocks and bonds, we expect that alternative investments will become increasingly important to multi-asset portfolios and recommend qualified investors consider the asset class as a way of managing risk and return going forward.

Which strategies do you currently favor within the broad alternative investments landscape?

While diversification remains a central tenet of ours when contemplating allocations to alternative investments, we do see compelling opportunities in a number of individual strategies for incremental dollars waiting to be deployed to AI. For qualified investors, we recommend exploring additional allocations to equity long/short, equity market neutral, and merger arbitrage strategies as part of a broader diversified hedge fund portfolio. As we have previously stated, the current environment continues to reward both passive and active strategies. To that end, we believe equity long/short managers will benefit from exposure to a healthy global economic backdrop (beta) and robust active opportunity set (alpha).[7] Stock correlations, dispersion levels and volatility all remain conducive to stock picking. We would look to equity market neutral strategies to capture additional alpha while providing important diversification benefits to multi-asset portfolios by neutralizing market exposure.

6 Alternative investments are intended for qualified and suitable investors only. Please see other important disclosures at the end of this document.

7 See Glossary for investment term definitions.

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A potentially record-setting year in mergers and acquisitions (M&A) has buoyed parts of the event-driven space, specifically merger arbitrage, and we think this trend has room to run given a few near-to-mid-term tailwinds. On top of an already favorable M&A backdrop (low interest rates, positive economic data), a gradual tightening of Fed policy could serve as even greater impetus for companies to close deals while the cost of capital remains low. Additionally, tax reform and repatriation of oversees dollars should continue to power M&A as companies deploy huge cash reserves for dividend increases, stock buy-backs and corporate buyouts. Last, the favorable ruling in the AT&T / Time Warner deal, we believe, could serve as a catalyst for future vertical integrations and deals that were sidelined while awaiting the court's ruling; many will likely use the outcome as precedent to push these transactions through the finish line.

For qualified investors looking to build out their strategic allocation to private equity, we see compelling opportunity in strategies that can complement traditional buyout and venture allocations such as private credit and special situations. Both strategies have benefited from reduced competition in the direct-lending market as large institutions have all but exited the space. Additionally, private credit investments continue to offer between 200 to 300 basis points of premium yield when compared to investments sharing similar risk profiles (such as leveraged loans and high yield bonds). While a growing capital overhang has become a source of concern for buyout investors ($500+ billion in dry powder), once deployed it could, interestingly enough, act as another tailwind for private credit strategies as many private lenders focus predominantly on extending financing to and addressing the capital needs of private equity-backed buyout deals. Further, because most private credit issuance takes the form of floating-rate debt, these strategies could serve as a good hedge, seeing as prevailing interest rates are now on the rise. All that said, it's important to acknowledge that few funds have had their credit selection and deal structuring tested through a full market cycle, and consequently manager selection remains of utmost importance when allocating to this space.

PORTFOLIO MANAGEMENT

What elements of portfolio management are particularly important to keep in mind in mid-to-late-cycle environments? How do you view active risk in portfolios at this stage in the cycle?

As allocators managing discretionary assets, we manage portfolios with a long-term (20-30 year) mindset, while also tracking the medium term market cycle, and monitoring short-term recession risks. Each year, we update our Capital Market Assumptions and Strategic Asset Allocations based on current market conditions. All else equal, higher interest rates lead to higher fixed income allocations, whereas higher stock market valuations lead to lower equity allocations. To avoid an over reliance on our long-term outlook, we assess where in the market cycle regions of the globe are currently. Today, we believe the U.S. is in the latter stages of this market cycle but well supported by other developed economies that are more mid-cycle and emerging markets which we believe are early to mid-cycle. Thus, we are comfortable taking on classic late cycle active risks. As the market cycle matures, we expect our across-the-board implementation of CIO Tactical Asset Allocation guidance to help portfolios negotiate a narrowing set of opportunities and an expanding set of risks. Look at any CIO Tactical Asset Allocation, and compare it to its underlying Strategic Asset Allocation. The differences between the two represent the most important active risk exposures in any CIO portfolio.

Additionally, at this point in the cycle, manager selection in hybrid CIO portfolios remains tilted towards active management. Though there has been some inconsistency related to recent stock market corrections, we have continued to observe elevated cross-sectional volatility along with lower correlations among security returns—characteristics of environments that favor active management. Later-cycle earnings slowdowns are not uniform. Earnings growth persists for some companies even as it slows for others, creating greater return differentiation and better prospects for stock pickers. But, in late cycle, we do start to get concerned about economic recession risks. Currently, as noted elsewhere in this report, shorter-term economic readings do not indicate an elevated level of recession risk in the near term. As such, we have positioned portfolios with an overweight to equities, an underweight to fixed income and a temporary "above market weight" to cash while awaiting normalization of interest rate policy across the globe. Should we get concerned about equity valuations and/or elevated recession risks, we are prepared to tilt portfolios to asset classes with volatility dampening characteristics.

How does that thinking change as rates grind higher and earnings growth slows down heading into 2019?

Higher rates and slower earnings growth would likely temper equity market gains by limiting P/E expansion or even causing some contraction. There would likely be more companies seeing earnings declines and fewer seeing gains. Bond proxies, like utilities, would probably continue to underperform. All these factors suggest the recent advantages of active management would persist as would long-short strategies.

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A key issue would be the reason behind the grind higher in interest rates. Is it reflecting stronger real growth, or higher inflation? The former is positive for growth and profits. The latter is negative. Most likely it would be a mix. We believe the mix includes more growth than inflation, which is on balance positive and suggests that while earnings growth will slow (it's coming down from a one-off, 20% plus tax-cut high), it won't stop completely. We believe positive earnings growth is sufficient to keep a cyclical bull market alive.

If we are wrong and inflation drives long rates higher without a pickup in growth, then earnings are unlikely to grow. An end to the earnings expansion is typically a prelude to recession as companies' mindsets shift from offensive, expansion plans to defensive cutbacks. This high-inflation scenario would also imply that the Fed would be complicit in the slowdown to bring elevated inflation expectations back to the long-term anchor of around 2%.

It's doubtful, in our view, that this stagflation scenario would materialize. We believe the extent of the rate rise over the next year will largely be determined by the magnitude of the growth pickup. Higher rates in this view would be a positive for earnings and the equity market.

How do you view the growing trend of using environmental, social and governance (ESG) factors in investment decision-making?

Interest in and creation of investment strategies that leverage ESG factors continue to show strong growth. In our opinion this is not a fad, but early innings of the adoption of new and material factors. ESG factor analysis reflects company performance regarding issues such as climate change, human capital management, diversity, corporate governance, gender diversity, waste, privacy and data security and product safety, among others.

Changes to our global economy, such as the growth of intangible assets, demographic shifts and the emergence of global sustainability challenges, have introduced new risks and opportunities to company managers and investors. ESG factors and the sustainable business practices behind them can have an impact on revenues, expenses, liabilities and cost of capital. The focus on gender diversity and inclusion provides an example of where social issues are increasingly understood as economic issues. Companies that have not addressed issues of permissive or harassment-prone cultures run the risk of high-profile executive departures and customer losses. Conversely, leaders in inclusion and pay equity may benefit in areas such as recruitment, retention and employee productivity.

Furthermore, data-driven research on ESG factors has blossomed. Historically, empirical evidence showed little difference between the financial performance of impact strategies and their traditional counterparts. Current research has expanded to a broader set of questions. For instance, recently BofA Merrill Lynch Global Research probed the relationship between ESG and traditional factors, and found that ESG would add value to most factor-based strategies and may also provide a differentiated signal uncorrelated with traditional factors.[8] Other research has considered the relationship between ESG and talent management as well as environmental efficiency and the impact of momentum in ESG ratings, each with encouraging results.

Demand for impact strategies continues to grow among both retail and institutional investors. In a recent U.S. Trust study, 40% of high net worth investors reported currently owning or considering using Impact Investments.[9] And 53% agreed that a company's environmental, social, political and governance track record is important to the decision on whether or not to invest. That number jumps to 87% of Millennials—making plan sponsors consider the addition of ESG funds to their offerings. On the institutional front, trustees are becoming more comfortable with the quality and sophistication of impact strategies, many of which are now achieving critical mass in assets and track record. The recent Field Assistance Bulletin from the Department of Labor, while clear in its stance on the need for ESG factors to be "economically relevant," does not change any guidance from the earlier Interpretive Bulletins. We consistently caution that plan sponsors must always act in the best interest of their participants when considering any investment for the plan including ESG-type investments.

[8] Source: BofA Merrill Lynch Global Research. Data as of Q1 2018.

[9] Source: 2018 U.S. Trust Insights on Wealth and Worth®.

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INDEX DEFINITIONS

MSCI Emerging Market 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. EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

Russell 2000 index measures the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

S&P 500 Index, widely regarded as the best single gauge of the U.S. equities market, 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 500 Health Care Sector Total Return Index seeks to track the performance of U.S. Health Sector companies as defined by the Global Industry Classification Standard (GICS). A total return index tracks both the capital gains of a group of stocks over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index.

S&P 500 Information Technology Sector Total Return Index seeks to track the performance of U.S. technology companies as defined by the Global Industry Classification Standard (GICS). A total return index tracks both the capital gains of a group of stocks over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index.

GLOSSARY

Alpha gauges the performance of an investment against a market index or benchmark. The excess return of an investment relative to the return of a benchmark index is the investment's alpha.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

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IMPORTANT DISCLOSURES

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OTHER IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

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.

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.

Please note that short-term performance may not be achieved over longer time periods.

Impact investing and/or Environmental, Social and Governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating.

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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