# Second Quarter 2018
# Market Outlook

## Outlook Summary

Global financial markets entered this year with tailwinds from a supportive backdrop of largely synchronized economic expansion complemented by mild, growth-friendly inflation data – a nice set up for continued strong performance from most risk assets in 2018. U.S. markets enjoyed an additional boost with the passage of the 2017 Tax Cuts and Jobs Act, which slashed corporate and personal tax rates and provided further stimulus to an already thriving corporate earnings environment. Market activity continued the pattern set in 2017, as equity markets set new highs and interest rates moved upwards with tightening credit spreads. However, this market euphoria changed quickly at the end of January, as investors grew concerned that stronger than expected U.S. wage growth would force inflation higher and push the Federal Reserve to raise rates faster than expected. This factor, along with several unrelated, largely political moves, resulted in a long-awaited return of volatility to both interest rates and risk assets overall. The S&P 500 corrected 10% from the closing high on January 26, 2018, to the lowest level on February 8, 2018, and ended the quarter down 0.76%. Growth stocks outperformed value for the first quarter, but returns across market caps varied. International equities remained positive for the year during the February correction but gave up ground in March. Similar to large cap growth,

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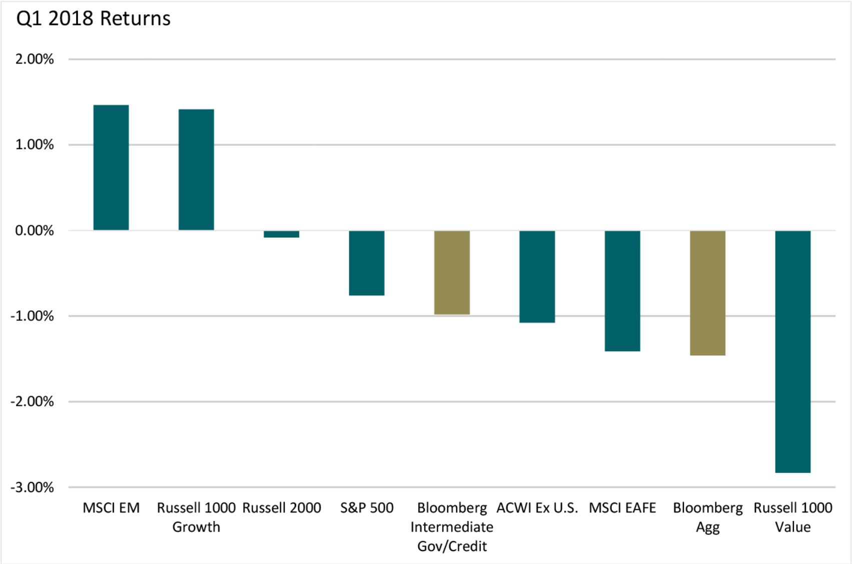
emerging markets remained positive for the quarter. In fixed income, the Bloomberg U.S. Aggregate declined 1.46% for the quarter, as both Treasury yields and credit spreads widened at quarter end.

**What remains in store for investors in 2018?** Despite the return of volatility in the first quarter, we remain optimistic about the global economy and constructive on most risk assets in general. Global macroeconomic data remains largely positive with the U.S. supported by a healthy consumer base, increasing manufacturing activity, and rising levels of confidence. All signs continue to point to the Fed and its new chairman, Jerome Powell, raising interest rates in a well-telegraphed and gradual manner. Corporate earnings growth continues to improve across all sectors, bolstered by attractive sales growth, expanding margins, and the underestimated impact of the tax reform package passed in December. Equity valuations have become more attractive with recent market weakness and currently stand near 25-year averages despite lower than average interest rates and inflation and the aforementioned earnings growth atmosphere. In fixed income, we prefer investment grade issuers with steady cash flow and higher-quality balance sheets, additional Tier 1 securities, and U.S. non-agency mortgages. Additionally, for the first time in a decade, we are seeing some very attractive opportunities for investors in short duration securities, due to the sharp rise in front-end yields. Overall, we continue to believe that investors should expect to own equities in their portfolios for capital appreciation and income, and bonds for income.




*Source: Bloomberg, as of 3.30.2018*

## ECONOMICS

Despite increased volatility in financial markets during the quarter, the overall macroeconomic outlook remains constructive. Global investment and trade are expanding at a firm pace, while purchasing managers indices (PMIs) for both services and manufacturing remain comfortably in expansion territory, despite a softening in recent months. Overall, evidence suggests that all major regions of the world are recording solid and sustainable expansions. However, Inflation in some advanced economies has begun to edge up after a period of surprisingly low readings. These hints of renewed life in inflation, coupled with ongoing labor market tightening, have led central banks to consider the need for policy normalization and, in some cases, have prompted rate hikes. For example, the Federal Reserve, the Bank of Canada, and the Bank of England have already increased short-term rates and are expected to move rates again in the months ahead. We believe such efforts are likely to remain gradual. In emerging market economies, inflation also continues at a subdued pace.

In the U.S., economic activity has become more mixed since the start of the year. First quarter real GDP growth is currently tracking at slightly less than 2%, but softness is expected to prove temporary. Some of the weakness is likely due to pay-back from a disaster relief related surge in demand in the fourth quarter, while some may also reflect the pattern of first quarter weakness that we've seen in three out of the last four years. Looking ahead, the U.S. economy is bolstered by a healthy consumer base and rising capital expenditures. Consumers are supported by buoyant housing and financial markets, as well as high confidence levels. Manufacturing activity has risen, and investment is expected to increase, partially on the back of tax reform and a more business-friendly regulatory landscape. Further, leading indicators suggest the economy should continue to expand at above-trend growth. The March reading of the Bloomberg Survey of Economists showed an expectation for U.S. growth of 2.7% for the full year, despite slower first quarter growth.

With the unemployment rate likely to drop below 4%, we expect some upward pressure on wage growth and consumer price inflation (CPI), with core CPI inflation rising above 2% during the year. The core personal consumption expenditures (PCE) inflation measure, which is the Fed's preferred guide, should rise as well, towards the Fed's target of 2%.

In Europe, economists are forecasting growth rates in the low- to mid-2% range despite lingering political concerns. Germany finally settled on another Merkel-led government, which will have a pro-European agenda broadly aligned with France's agenda under President Macron. However, Italian elections resulted in a strengthening of the anti-establishment parties, making Italy's support for structural reforms in the European Union uncertain. From an economic perspective, the Euro zone appears to be on the strongest growth path since the financial crisis, with business sentiment at multi-year highs and investment spending showing signs of recovery.

Though the U.K.'s growth is slowing relative to accelerating growth elsewhere in Europe, data has consistently surprised to the upside relative to expectations. The progress around the March E.U. summit on a draft "withdrawal treaty" was a positive surprise, following months of a seeming standstill in negotiations. The current draft sets out a 21-month transition period to the end of year 2020, although this is contingent upon ratifying the overall withdrawal agreement, expected to occur in the first quarter of 2019. The perception of progress being made on Brexit negotiations could potentially lead to a reacceleration in growth if consumer and business confidence increases on the back of the progress. Also, following nearly eight years of austerity, the U.K. has the potential to see an increase in government spending.

The Japanese economy has recorded eight straight quarters of GDP growth, albeit at a very modest rate. The country has moved out of deflationary territory, but inflation readings remain well below the Bank of Japan's 2% target. This year's "shunto" spring wage negotiations resulted in average wage increases of 2.16% year-over-year. Although it is an increase over last year's 1.98%, it is still relatively muted, given a

| | 2015 Actual | 2016 Actual | 2017 Actual | 2018-Forecast | 2019-Forecast |
|---|---|---|---|---|---|
| Global | 3.4% | 3.2% | 3.7% | 3.8% | 3.7% |
| U.S. | 2.9% | 1.5% | 2.3% | 2.8% | 2.4% |
| Euro Area | 2.1% | 1.8% | 2.3% | 2.4% | 2.0% |
| UK | 2.3% | 1.9% | 1.4% | 1.5% | 1.5% |
| Japan | 1.4% | 0.9% | 1.7% | 1.3% | 1.0% |
| China | 6.9% | 6.7% | 6.9% | 6.5% | 6.5% |

*Source: Bloomberg, as of 4.03.2018. Forecasted numbers come from the Bloomberg Survey of Economists*

2.5% unemployment rate (the lowest in 25 years), solid corporate earnings and strong government efforts to encourage higher wages. Given the low levels of inflation, the Bank of Japan appears on course to continue to pursue an easy monetary policy. Therefore, the biggest risk to the Japanese economy would appear to be any protectionist policies which may come into place given the heavy export nature of the Japanese economy.

The outlook for emerging markets is generally positive, but with significant variance at the country level. We see growth in general cooling slightly from last year's brisk pace. This is most evident in China, where authorities are seeking to guide the economy to more balanced and sustainable growth. Overall, emerging markets began the year on a solid growth path, reflecting ongoing expansion in developed markets, accommodative domestic policies, and continued support from commodity prices.

While our base case is for a continuation of synchronized global growth over the remainder of the year, we are aware of potential tail risks, most noticeably with respect to trade policy and fiscal policy. The U.S. has recently taken a more aggressive posture on trade policy. First, the Trump Administration announced a set of tariffs on imports of steel and aluminum. These measures were greeted with concern by U.S. trading partners, and in some cases elicited threats of retaliation. More recently, the Administration has also announced intentions to place 25% tariffs on Chinese imports totaling $50 billion, reflecting charges that China has unfairly appropriated U.S. intellectual property. China responded by announcing plans to place reciprocal tariffs on a comparable amount of U.S. imports, which has triggered threats of additional tariffs from President Trump. If trade tensions continue to escalate, with several rounds of retaliatory actions, the implications for global growth would be severe. Given this reality, our expectation is that both sides will ultimately choose more moderate policies, although further flare-ups in rhetoric are likely.

U.S. fiscal policy shifted to a more simulative trajectory with the passage of tax reform in December and, more recently, an agreement to relax spending caps and expand defense spending. These actions will very likely support demand in the near term, leading to an increase in GDP growth over the next year. However, this type of fiscal stimulus typically only results from recessions, rather than at this point in an economic expansion, when the unemployment rate is near all-time lows and inflation readings are already trending upward. If the fiscal stimulus results in an economy which the Fed deems as one which is running "too hot," they may be forced to hike short-term rates faster than expected, which may in turn slow economic growth. Moreover, the financing of the stimulus will cause an increase in supply in the Treasury market at the same time that the Fed is stepping back from asset purchases.

Ultimately, we believe most current risks have their roots in politics. This is true in the United States for fiscal and trade policies and in China as it charts its course toward economic rebalancing. Yet, it is also true in Italy as it seeks to piece together a government after the split election results; in the United Kingdom as it gropes for a cohesive approach to Brexit; and in Mexico and Brazil as economic performance is shaped by presidential elections. In sum, we are optimistic about the outlook for the global economy through the year ahead.

## EQUITIES

U.S. equity markets entered 2018 with an attractive framework: with global developed economies poised for further expansion and strong corporate earnings momentum set to enjoy an additional stimulus by way of the 2017 Tax Cuts and Jobs Act and its potential to unleash renewed business investment, increased share repurchases, dividend growth, and spur mergers and acquisition activity. Stocks continued 2017's strong performance through most of January with similar patterns from the previous year – large caps outpaced small- and mid-caps, and growth equities bested value names with leadership once again from a narrow cluster that included the well-followed FANG (Facebook, Amazon, Netflix, and Goggle) group, as well as technology giants Apple and Microsoft (Fab5 Group) and a few other select names including Boeing and Caterpillar.

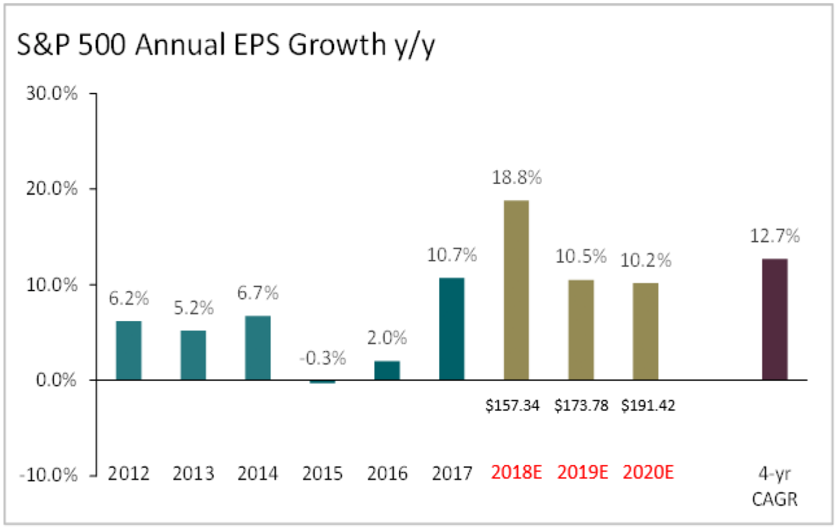
However, a sell-off on January 29, fueled by concerns over increased inflation expectations and the potential for higher interest rates, ended the first part of the first quarter's market pattern. The major market indices peaked on January 26 and, from that date, corrected over 10% from 2018 highs. Market volatility spiked and remained elevated for the rest of the quarter as the S&P 500 saw 23 daily moves of at least 1% compared with a total number of 48 in 2016 and only 8 in 2017.

Several external factors for the correction can be cited, including concerns over a potential trade war following the Trump Administration's announcement of intended tariffs, scrutiny over Facebook's user data handling and privacy issues, and antitrust concerns following a war of words between President Trump and Amazon.

For the overall quarter, the S&P 500's total return was -0.76%, trailing the small-cap Russell 2000's -0.08% return. Growth stocks continued to outperform value counterparts with the Russell 1000 Growth Index posting +1.4% total return versus -2.8% for the Value Index. On a sector basis, only the Technology (+3.5%) and Consumer Discretionary (+3.1%) sectors delivered positive returns for the first quarter; the remaining nine S&P 500 sectors underperformed the broader index with Real Estate (-5.0%), Materials (-5.5%), Energy (-5.9%), Consumer Staples (-7.1%) and Telecom (-7.5%) all down at least 5% during the period. Leaders among technology stocks included Microsoft, Intel, and Adobe rather than 2017 high flyers Apple, Alphabet, and Facebook, while the consumer discretionary returns were dominated by Amazon, Netflix, and Booking Holdings – all technology-driven business models serving consumers' interest for shopping, entertainment, and experiences. Global results were mixed, as international developed stocks trailed U.S. equities, while emerging markets outperformed.

Despite the exogenous factors that largely influenced markets following the January 26 high, the overall backdrop from the beginning of 2018 remains steady or has actually improved. Most economic data suggests that global economies continue to expand, inflation data remains fairly tame, and interest rate increases have largely slowed or reversed, in some cases. Corporate earnings data also improved throughout the quarter. The 2018 S&P 500 EPS estimate increased 7.7% from $146.45 per share at year end to $157.18 as of the end of March - an 18.7% increase over 2017's earnings. Importantly, all eleven S&P 500 sectors are projected to deliver year-over-year growth in both earnings and sales, with aggregate sales growth of 6.7% exceeding the average of the current business cycle. The earnings growth momentum is not limited to 2018, as the 2019 estimate increased significantly as well implying a 10.5% increase in EPS for 2019, to $173.77 a share. On a valuation basis, the S&P 500 ended the quarter with a forward P/E multiple of approximately 16.4x, well within one standard deviation of the 25-year average of 16.0x, and the equity risk premium (defined by the trailing twelve months earnings yield of the S&P 500 minus the 10-year U.S. Treasury yield) remains well above its long term average.

We believe too little attention has been paid to the potential impacts from the tax bill, as we see tax




*Note: 4-year CAGR represents the compound annual growth rate from 2017-2020*

*Source: Factset, as of 3.30.2018*

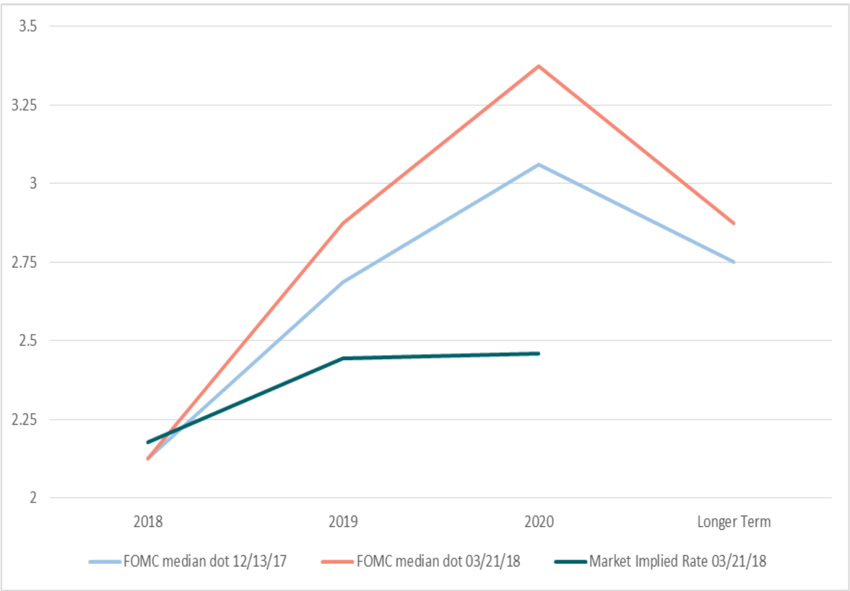
reform benefitting earnings growth and equity returns in three ways: the actual tax savings and increase in cash flow, the ways in which companies deploy the tax savings, and the potential for increased demand and spending. The first and most easily quantified benefit is the direct impact from increased net income due to lower statutory tax rates. Effective tax rates for S&P 500 companies are expected to decline from 25.2% to 19.7% under the new law, resulting in over $160 billion of bottom-line savings, or a 7% boost to earnings. Companies will deploy those savings, as well as repatriated overseas cash, in a variety of ways including increased dividends, share repurchases, and greater merger and acquisition activity. Finally, we believe greater tax savings could lead to increased business and consumer spending; consumers with increased take-home pay should spur greater demand, while businesses use newly increased cash flow on greater capital expenditures and other forms of direct reinvestment to stimulate future growth. Importantly, we believe the impacts from tax reform are not simply a one-year phenomenon and are intended to stimulate GDP growth and extend the current business cycle expansion into 2018 and beyond.

In our view, fundamentals matter most to equity pricing, and accelerating earnings growth and reasonable equity valuations provide investors with an attractive framework. Why does the market remain in correction territory? In our 2018 outlook from early January, we suggested "We are cautious around adverse effects from greater trade protectionism, which could occur via a withdrawal from NAFTA, a showdown with China, or both. Front and center, however, is the potential for a spike in inflation as a result of higher sustainable economic growth, followed by higher interest rates . . . as a result, we expect market volatility to return in 2018." Clearly, some of the volatility triggers that we discussed earlier in the year have materialized. Now, early in the second quarter, we remain in a balancing act of risk on and off for equities. We believe the "noise" currently dominating market headlines will subside, and the impacts from solid fundamental drivers will reemerge as the primary focus. As long-term investors, we view shorter-term market volatility as an opportunity to upgrade portfolios with high-quality companies that meet our valuation discipline. Patience and philosophical consistency are paramount to achieving any portfolio's objectives in all types of market environments. 2018 is set up for alpha generation through disciplined stock picking.

## FIXED INCOME

### Interest Rates:

The gradual path of monetary policy normalization, initiated under Janet Yellen, continues under the Fed's new chairman, Jerome Powell, in his first meeting in charge. As widely expected by the market, the Fed increased the fed funds range by 25 basis points (bps) at its March meeting, citing an improving economy and strong labor market, bringing the target rate range up to 1.50%-1.75%. Federal Open Market Committee (FOMC) participants are now split on whether they will hike interest rates three or four times in 2018. The more interesting aspect of the March FOMC meeting was the change in forecast for the future path of the fed funds rate, as portrayed by the "dot plot." Relative to December, the median path of Fed officials' interest rate forecasts now incorporates two additional interest rate hikes between now and 2020, leaving the policy rate at a projected 3.4% by the end of 2020 – well above the Fed's 2.9% median estimate of the longer-run rate. Market expectations, on the other hand, remain substantially lower: the fed funds futures market indicates that the market is only pricing in 3.5 hikes, or for the funds rate to reach 2.375%, through 2020.




*Source: Bloomberg, as of 4.03.2018*

The main reason for any disconnect between the Fed and market expectations is mixed messages on inflation. On one hand, economic growth is improving and the job market remains very tight; the Fed even raised its forecast for both metrics during its latest meeting. A tight labor market has historically resulted in higher wages and, with it, higher inflation. However, while wages and inflation are trending higher, they are doing so very modestly and have failed to break out despite the labor market tightening.

## Investment Grade:

Investment grade bonds came under pressure during the quarter, as interest rates increased and credit spreads widened. The first quarter saw a large amount of issuance from both the U.S. Treasury as well as corporations. Against the backdrop of higher supply, the investment grade market witnessed a decline in demand, particularly in the short-end of the curve (3 years and less to maturity).

A non-consensus view we have held since tax reform is that cash repatriation may prove to be a negative for the corporate bond market. Prevailing market opinion seems to be that the ability to access overseas cash would eliminate the need for debt issuance for companies with significant of overseas cash, thus leading to a decline in supply and tighter credit spreads. While we acknowledge these companies were likely to issue relatively less debt over the next few years, we also believe this benefit will be more than offset by a decline in their demand for corporate bonds. Corporations have added over $300 billion of corporate bonds over the past 6 years using mostly cash that was "trapped" overseas. This cash can now be repatriated back to the U.S., following the passage of the tax plan, and can be used for purposes other than buying corporate bonds.

While technicals in the market have weakened, strong corporate and macroeconomic fundamentals continue to be supportive of investment grade bonds; therefore, we do not expect spreads to materially widen in the near term. During the first quarter, companies reported strong earnings growth and rising free cash flows in the wake of tax reform. In addition, the outlook for U.S. GDP over the remainder of the year appears solid. We anticipate that these trends will persist in the near term and expect that they should be supportive of spreads.

As we discussed in our first quarter outlook, our top concern this year is corporations increasing balance sheet leverage - in particular, through mergers and acquisitions (M&A). We expect much of the M&A activity to be debt-financed, which generally creates the duel headwind for credit investors of deteriorating fundamentals as well as additional supply. However, event risk - such as M&A - will also create opportunities for adding both absolute and relative value through active management. We intend to use periods of volatility, created by either a general risk-off move in the market or idiosyncratic events, as opportunities to gain exposure to quality credit. However, we are mindful that we are very late in the credit cycle, and at this stage the vast majority of return will come from yield rather than spread tightening. In this environment, we believe avoiding issuers who are most likely to releverage their balance sheets is of the utmost importance, in order to produce strong risk-adjusted returns. Therefore, we are focused on traditionally defensive sectors and issuers with higher-quality business models, steady free cash flow and management teams committed to sound balance sheets.

## Preferreds:

Following very strong performance in 2017, both U.S. and European bank preferreds had a negative return in the first quarter. Performance suffered due to the dual headwinds of higher interest rates in the first six weeks of the quarter and then a sell-off in risk markets in the second six weeks of the quarter. The majority of U.S. banks reported fourth quarter earnings that beat expectations, as companies continue to benefit from improving revenues and expense controls. Capital levels were slightly lower in general due to the one-time effects of the tax bill and higher shareholder payouts. We expect that the multi-year capital build, which banks have undergone since the financial crisis, has likely come to an end, and banks will begin to lower their capital levels, mainly through shareholder returns. However, these lower capital ratios will still be near the highest levels that banks have held since the 1940s.

We continue to select attractive opportunities within the contingent capital (CoCo) securities market. Earnings for European banks was more of a mixed bag, but capital ratios remain very high as financial regulators in Europe remain more conservative than U.S. regulators. One aspect of the CoCo market, which we are aware of and monitor closely, is the increase in correlation with their respective equities, which occurs when markets sell off. Weakness in the CoCo market during these risk-off events is further exacerbated by the fact that CoCos are out of benchmark positions for money managers and, therefore, there is not a natural buyer base for these securities.  Technicals in the preferred market continue to remain positive as the market has a growing investor base, while net new issuance will remain very low both in the U.S. and in Europe as banks have, by and large, filled their additional tier 1 (AT1) regulatory capital buckets. Given the strong performance over the past several years, future performance of U.S. preferreds and CoCos will be driven more by coupon income rather than capital appreciation.

### Municipal Bonds:

Municipal bonds also suffered a loss at an aggregate level with the Bloomberg Barclays Municipal Bond Index losing 1.1% in the first quarter, which was the worst first quarter return for the index since 1996. Despite total new issuance of only $63 billion, a 32% drop vs. the prior year, elevated dealer inventories and steady selling from bank portfolios weighed on the market. Lower corporate tax rates, along with accounting changes, contributed to net selling activity from bank and P&C insurance portfolios. Looking ahead, we believe that the outlook for the municipal bonds is positive as the supply-demand technicals will turn more favorable as negative net supply becomes more pronounced. In addition, higher yields, relative to the beginning of the year, provide a more attractive entry point for investors.

### Other Sectors:

High yield bonds suffered their worst opening quarter of the year since the first quarter of 2008, with the Bloomberg Barclays U.S. High Yield Bond Index down 0.86%.  Tax reform will likely serve as a tailwind for a portion of the high yield market. The reduction in the corporate tax rate from 35 percent to 21 percent is expected to help boost cash flow primarily for smaller, domestically focused companies, given that they typically pay the highest effective tax rates. This description generally applies to BB-rated and B-rated high-yield companies. On the other hand, we are concerned that the inability of borrowers to deduct interest expense above 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) going forward will likely hurt many CCC-rated companies that already pay interest expense above this threshold.

We are cognizant that high yield bonds have been supported for several years by low yields in global developed bond markets, forcing investors to reach down in quality to obtain their yield "bogey." However, with the sharp move higher in interest rates since July 2016 leading to more attractive all-in yields, investors today can move up in the capital structure or into investment grade bonds and potentially reach their yield target. This could lead to less demand for high yield bonds, especially since we are in the later stages of the business cycle. We are also cautious of the high yield market due to the threat of potential tail risks in an environment where high yield credit spreads are tight, the possibility of an economic contraction beginning in two or three years, and deteriorating underwriting standards as we enter the later stages of the credit cycle.

Overall, these factors do not materially impact our positioning in the high-yield market, which has had a lower weighting relative to historical positioning, and has been the case for several quarters now, continues to be focused on the short-duration, high-quality portion of the market.

As in prior quarters, we continue to believe that non-agency mortgages are one of the most attractive sectors within fixed income based upon our positive view on the U.S. housing market and the defensive and diversifying qualities displayed by the asset class. In other areas of structured credit, we like nontraditional asset backed securities (ABS) such as aircraft, container and triple-net lease ABS as oppose to more traditional sectors of the market such as auto, credit card and student loans, where spreads are very tight.