

First Quarter 2019 Market Outlook



OUTLOOK SUMMARY

Fueled by mounting concerns over economic growth, an escalation of trade conflicts, worries over central bank decision making, and a myriad of geopolitical alarms, global financial markets closed 2018 with negative returns in most major asset categories. In the U.S., strong corporate earnings and attractive economic growth were not enough to prevent a first for the S&P 500 – finishing down for the year following positive returns in the first three quarters. Entering 2019, evidence suggests that global economic growth is slowing, the U.S. economic expansion persists but is moderating, and trade tensions remain a formidable headwind.

Despite the multitude of current anxieties, we believe the tone in investment markets may be too pessimistic. U.S. GDP growth rates will likely not match the levels reached in 2018, but we do not believe that the end of the current expansion is imminent. Global economic growth also continues to slow, but few signs suggest that a synchronized global recession is on the near horizon. Finally, negative impacts from rising trade protectionism remain a true threat, but major actors in this drama are aware of the potential danger and are strongly incentivized to develop solutions.



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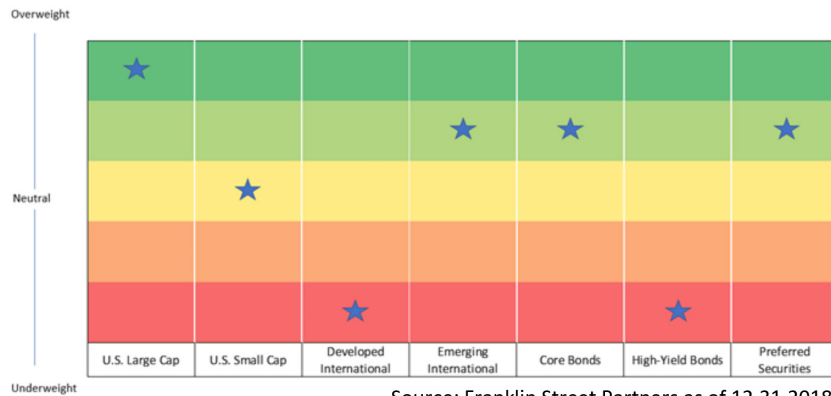


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Franklin Street Partners Current Asset Allocation



Source: Franklin Street Partners as of 12.31.2018

We remain constructive on the investment environment entering 2019 and believe the global rout of risk assets in the fourth quarter of 2018 created opportunities in several areas. In equities, mid-to-high-single-digit corporate earnings growth, combined with attractive, below-average price/earnings multiples, drive our overall optimism. We believe the push and pull of the economic growth narrative, along with global geopolitical risks, provides a real opportunity for active management outperformance. In fixed income, we are focused on shorter-dated (3 years or less to maturity), higher-quality investment grade issues, with a preference for sectors tied to the consumer. We also view both agency and non-agency mortgage-backed securities as attractive and will monitor the high-yield space for favorable entry points given recent spread widening. Finally, we believe preferred stock valuations

appear attractive, as bank balance sheets remain in strong condition.

ECONOMICS

2017 was a year of synchronized global expansion, while 2018 delivered desynchronized growth; U.S. growth ticked higher, while economic growth outside the U.S. cooled. Primary readings suggest the U.S. economy expanded around 3% in 2018, which would represent the highest annual rate of economic progress since 2010. Strong growth was driven by accommodative fiscal policy, the strength of the consumer (supported by 50-year lows in unemployment rates), and business investment in the first half of the year.

Looking ahead, leading indicators of economic activity suggest a low probability of a recession in 2019. However, while indicators do not portend a recession in the near-term, they have likely peaked for this business cycle. The combination of more restrictive monetary policy, tighter financial conditions, slowing consumer and business spending, and trade policy issues all suggest U.S. growth will slow. The median forecast of economists surveyed by Bloomberg is for U.S. growth to remain above trend but for the trajectory of growth to slow to a rate of 2.6% in 2019 and slow further to below 2% in 2020.

Global markets outside the U.S. will likely also face a more challenging environment in 2019, due in part to continued geopolitical uncertainty. After decades of global economic integration, a disintegration of ties between the world's two largest economies (U.S. and China) raises risks to global growth.

In Europe, both survey-based activity data and hard economic data slowed significantly in 2018, driven largely by lower demand for European exports due to slowing global growth, as well as events in Italy and France and self-inflicted confidence shocks created by Brexit. Business cycle indicators currently point to a further deceleration in growth, with current forecasts suggesting that GDP growth will moderate to 1.8% in 2019. Numerous risks continue to hang over European growth, including global trade tensions, Brexit uncertainty, Italy's budget standoff, and unrest in France, as well as newer events including European Union (EU) elections in May and a new European Central Bank (ECB) President.

The U.K. economy has continued to trudge along since voting to leave the EU in 2016; however, little progress has been made during the two-year transition period, which will end on March 31. There appears to be an increased probability of either another general election, and with it potentially a new referendum, or of a 'hard' Brexit where the U.K. leaves the EU without

an agreement. A 'hard' Brexit would likely result in severe disruptions, and the Bank of England has stated its belief that it would result in a significant contraction in economic growth over the 2019-2023 period.

In Japan, consumers are benefiting from a strong labor market and renewed wage growth. Japanese companies are producing near-record profits without excess leverage. The country benefits from a much clearer political situation than other parts of the world. Despite these tailwinds, growth is expected to remain muted, with growth forecast to be just 1% in 2019 and 0.4% in 2020.

Growth in China slowed during the first half of 2018 due to weaker infrastructure spending and the government's attempts to slow credit growth and create a more stable financial system. However, the effects of a trade war with the U.S. and slower global growth meant that the economy cooled more than expected, prompting Chinese authorities to pursue monetary and fiscal stimulus to help support the economy in the second half of the year. There is clearly great uncertainty around the outlook for Chinese growth in the coming year due to trade tensions with the U.S., as well as the challenge of attempting to balance policies to encourage growth and policies which deleverage the economy. We believe China will continue to use both monetary and fiscal stimulus in an

attempt to support growth. Further escalation of trade tensions with the U.S. would likely result in additional currency depreciation.

Emerging markets (EM) economic growth slowed sharply in 2018 due to the headwinds of a stronger U.S. dollar (USD), higher funding rates, and slower global trade. These factors were particularly detrimental to countries with significant current account deficits, external funding requirements, and limited foreign exchange reserves. However, EM valuations appear compelling, particularly when considered in the context of the long-term growth potential.

As we look ahead, concerns about what could cause a sharper slowdown in economic growth can be broadly divided into two categories: those related to the decline in global liquidity, and those related to geopolitical risks.

Historically, investors have observed the level of real rates, credit spreads, and the strength of the USD to gauge global liquidity. An increase in real rates, wider credit spreads and/or a stronger USD are all associated with the removal of liquidity from the financial system. Today, investors need to consider two additional factors: increased U.S. Treasury issuance and the impact of central banks. Over the course of the year, these factors all point to tighter liquidity, which will be met by a return to more normalized levels of volatility than what

the market has experienced in the 2015-2017 period.

Numerous geopolitical risks remain, including the trade tensions between the U.S. and other countries (in particular China), U.S. sanctions on Iran, tensions in the Middle East, Brexit and political unrest in Europe. Among these, we maintain that more restrictive trade policies are the biggest risk to global growth, with the potential to hurt business confidence and investment and to raise prices for manufacturers and consumers. Political tensions in Europe and the uncertainty around Brexit could also undermine business and consumer confidence in that region.

Overall, we expect growth in the U.S. and globally to continue, but at a moderating pace relative to 2018.

EQUITIES:

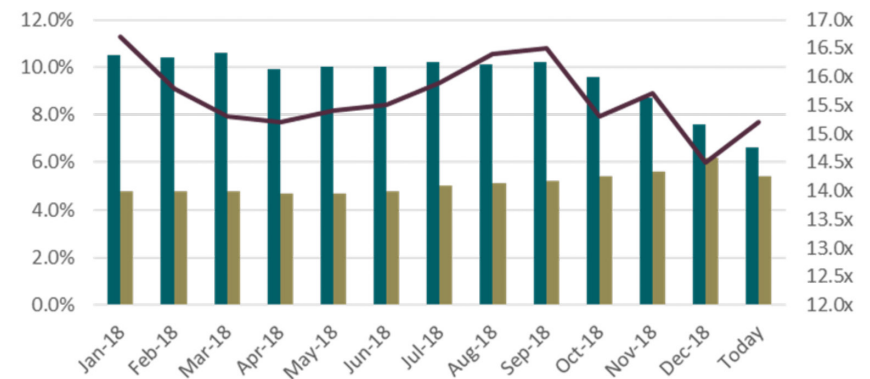
Despite strengthening U.S. GDP growth, tame inflation data, historically solid employment statistics, and corporate sales and earnings growth at the highs of the current economic expansion, U.S. stocks were battered in the fourth quarter, with the S&P 500 recording a total return of -13.5%. The final month of the year was particularly painful, as a -9.2% loss was the worst December performance since 1931 and the depths of the Great Depression. Not surprisingly,

volatility accompanied the poor performance; the Volatility Index (VIX) spiked 110% during the fourth quarter, and the S&P 500 was up or down 1% more times in December (9) than in all of 2017 combined (8). On a sector basis, there were precious few places to hide, as only utilities posted a positive return during the quarter. Notably, a 6.6% rally from the lows of December 24 prevented market performance from being even worse.

For all of 2018, the S&P 500 total return of -4.4% represented the worst performance in a decade and was the first down year on a total return basis since the Great Recession ended. The small cap Russell 2000 Index underperformed larger stocks again, returning -20.2% during the fourth quarter with an overall 2018 total return of -11.0%. Value stocks did hold up better than their growth counterparts during the fourth quarter selloff, as the Russell 1000 Value Index posted a -11.7% total return versus -15.9% for the Growth Index; however, growth handily beat value again for the full year, -1.5% versus -8.3%. Health Care (+6.5%), Utilities (+4.1%), and Consumer Discretionary (+0.8%) were the only sectors to post positive performances for full-year 2018, while the laggards included Energy (-18.1%), Materials (-14.7%), Industrials (-13.3%), and Financials (-13.0%). Both international developed and emerging market equities trailed U.S. counterparts, with particular weakness in China resulting from both

fallout from the ongoing U.S.-China trade conflict as well as slowing growth readings for the domestic economy itself.

2019 S&P Revised Estimates & Valuation



In the face of concerns over decelerating U.S. and global economic growth, worries over rising trade protectionism and conflict, and lingering apprehensions over potential policy mistakes from the Fed, the 2019 setup for equities appears challenged at first glance. Yet, while we remain aware and mindful of the multitude of risks that could shape the stock market environment, we are constructive on the opportunity set and believe that 2019 could prove a solid year for longer-term investors.

U.S. corporate earnings continue to be a source of our optimism regarding equity market attractiveness, despite the popular idea that “2018 could be as good

as it gets.” 2018 was indeed an impressive year for corporate profitability, as S&P 500 earnings are forecast to have grown 20.2% year-over-year, fueled in part by relief from the 2017 Tax Cuts and Jobs Act. However, we believe some investors are incorrectly ignoring or outright dismissing continued fundamental strength. Currently, consensus estimates suggest a 7.4% 2019 growth rate for S&P 500 earnings; perhaps more importantly, estimated revenue growth of 6.0% suggests that tax savings are not the primary fuel for further earnings expansion in 2019. In addition, the growth is well distributed among different business types – all 11 sectors are currently forecast to produce positive earnings and revenue growth.

We also believe that U.S. equities remain supported by valuation, which compressed significantly during the fourth quarter sell-off. Since the start of the fourth quarter, the P/E multiple on consensus 2019 S&P earnings has dropped from 16.5x to 15.1x currently and remains well-below the 25-year average of 16.1x. 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 more than one standard deviation above its long-term average, despite the move higher in Treasury yields to start the fourth quarter.

While earnings growth and valuation form the basis for our constructive viewpoint on equities, we

certainly expect market volatility to remain elevated. Trade and tariff worries are the chief concern entering the year, as the U.S. remains engaged, at one level or another, in trade disputes with our first (China), second (Canada), and third (Mexico) largest trading partners. Negotiations for a deal with China will intensify ahead of a March 2 deadline, after which tariffs on 50% of Chinese exports to the U.S. automatically increase from 10% to 25%. Absent an agreement, the tariff increase could lead to accelerating domestic inflation and the potential for an economic cold war. Also worth monitoring is the progress of passing the U.S.-Mexico-Canada Agreement (USMCA), the successor free-trade agreement to NAFTA; unlike a potential deal with China, the USMCA must gain Congressional approval, which may prove significantly more difficult than investors expect given the current political tenor in Washington. Settling both the China and USMCA trade questions may be the main factor that motivates investors to seek more of a “risk on” investment mindset. We are also monitoring any potential changes in Fed interest rate policy but were heartened by Chairman Powell’s comments in early January that suggested the Fed would carefully monitor conditions and data to avoid policy errors in tightening financial conditions too quickly.

Despite all of the external noise surrounding recent market performance and geopolitical worries, we still believe that the fundamental strength and business advantages (economic, structural, and competitive) of companies owned in client portfolios persist. We remain longer-term investors and view shorter-term market volatility as an opportunity to increase equity exposure and upgrade portfolios with high-quality companies that meet our valuation discipline.

FIXED INCOME

The Federal Open Market Committee (FOMC) raised the target rate for the Federal Funds (Fed Funds) rate to 2.25-2.50% at its December meeting - the fourth rate hike in 2018 and the ninth rate hike since December 2015. However, the FOMC lowered its expectations for the number of rate hikes to two in 2019, as well as its forecast for the expected level of the Fed Funds rate over the longer term. Despite lowering its expectations, the Fed's estimated path for the Fed Funds rate remains well above market expectations. Currently, market pricing suggests investors believe there is a higher likelihood that the Fed will cut rates than raise them over the next two years. Tightening financial conditions, slowing global growth, yield curve inversions, and other corporate pressures all suggest

that the Fed may have to reconsider the future path and pace of the Fed Funds rate. We believe the Fed may be nearing the end of the rate hikes during this business cycle.

The ECB has finally begun to remove some of its post-crisis policy stimulus by ending net asset purchases. However, we think it is going to be very difficult, given the economic backdrop and the point of the business cycle, for the ECB to be able to increase its policy rate. We expect very little – if any – change in the Bank of Japan's (BOJ) policy.

Overall, after a decade of balance sheet expansion, the liquidity spigot, known as Quantitative Easing (QE), has been turned off as the collective size of the Fed, ECB, and BOJ balance sheets peaked in March. The reverse of QE, known as Quantitative Tightening (QT), will decrease market liquidity, resulting in periods of increased price volatility as well as potentially creating less stable correlations between asset classes.

FIXED INCOME SECTOR OUTLOOK

For the first time since the financial crisis, we believe that investors will be more focused on credit risk than interest rate risk in 2019. This view is driven by the confluence of slower growth, stretched credit

valuations, increased financial market volatility, lower liquidity and higher risk-free rates. Over the course of 2018, we constructed portfolios to be more in line with their benchmarks from a duration perspective.

A consistent theme in our portfolio positioning over the past 18 months has been a preference for sectors tied to the consumer rather than corporations. The U.S. consumer has deleveraged considerably over the past decade, with debt-to-income ratios now at the lowest levels in nearly 20 years. In contrast, corporations have taken advantage of lower interest rates to issue debt to fund share repurchases and acquisitions, which has resulted in a sharp increase in corporate debt-to-EBITDA ratios.

We continue to see several headwinds for investment grade credit in 2019, including slower economic and earnings growth, tighter monetary policy, ongoing trade wars, the potential for an increase in credit rating downgrades, and continued merger and acquisition (M&A) activity. As a result, we have been ‘upgrading’ the credit quality of portfolios largely via BBB-rated issues with 3 years or less to maturity and paired these credits with exposure to U.S. Treasury bonds, which offer protection in risk-off events as well as liquidity which could allow us to opportunistically rotate portfolios if needed. In terms of issuer selection, we continue to focus on traditionally defensive sectors

and issuers with higher-quality business models, steady and improving free cash flow, and management teams committed to sound balance sheets.

For the first time in several years, we view agency mortgage-backed securities (MBS) as appealing due to a combination of more attractive valuations, ample liquidity, and most importantly, the sector’s defensive properties to other fixed income sectors. We also like agency commercial mortgage back securities (CMBS) issued through the Freddie Mac ‘K-certificate’ program. These securities are mortgages pools originated through the strict Freddie underwriting process, and we are focused solely on the senior tranches. These securities also offer a more certain maturity profile relative to other types of mortgage-backed securities since the deals include yield maintenance features which will make the investor whole if a borrower decides to prepay. Finally, we continue to believe non-agency mortgages offer one of the most attractive risk-adjusted returns prospects across fixed income.

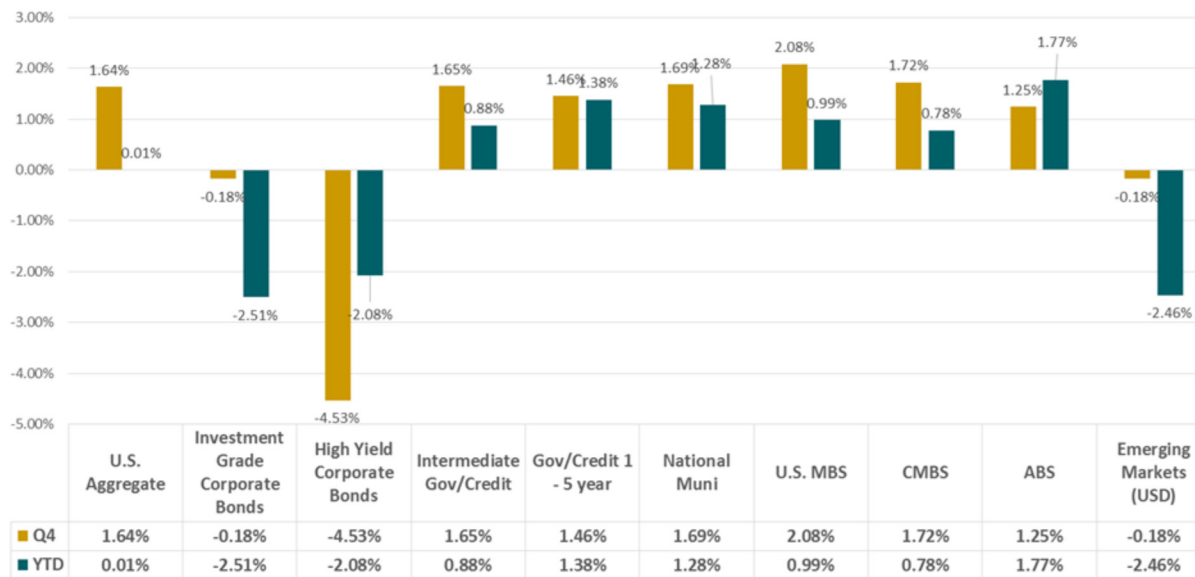
Despite a strong start to last year, high-yield and leveraged loans both sold off sharply in the last two months of 2018. Currently, we don’t see meaningful value in leveraged loans but are monitoring the high-yield space for a potential entry point given year-end spread widening. We do believe preferred valuations

look attractive, as bank balance sheets remain in strong condition and new supply should remain limited.

While the 2017 tax bill created dislocations in the municipal market due to demand shifts away from bank and insurance companies more towards investors

in high tax states, we believe longer dated municipal bonds remain attractive to investors in the highest tax brackets. Importantly, municipals have traditionally outperformed other bond market sectors during prior tightening cycles and when economic growth is slowing.

Fixed Income Sector Performance



Source: Bloomberg as of 12.31.2018

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