INVESTMENT COMMENTARY
December 2018

Recent Market Backdrop

Equity markets and other risk asset categories have experienced dramatic declines since October as volatility spiked higher. For example, the S&P 500 Index has fallen almost 17% so far in the fourth quarter (as of December 21, 2018) and wiped out all of its 2018 gains. The CBOE Volatility Index, also known as the market's fear gauge, reached its highest level since the February equity rout. Intraday swings in the S&P 500 have averaged 1.2% each day this year—and 2.3% percent this month alone, the most since October 2011.[1]

As evidenced in the table below, most asset categories have experienced negative performance results thus far in 2018. This is in sharp contrast to the unusually low volatility and broad gains of 2017. According to a recent Wall Street Journal article[2], 90% of the 70 asset classes tracked by Deutcshe Bank have posted negative total returns on a year-to-date basis. The previous high was in 1920, when 84% of the 37 asset classes were negative. Last year, just 1% of asset classes delivered negative returns.

Asset Category Performance (As of December 21, 2018)	Year-to-Date 2018	Full Year 2017	Last 5 Years*	Last 10 Years*
Fixed Income				
Cash & Equivalents (Barclays US 1-3 Month Treasury)	+1.8%	+0.8%	+0.6%	+0.3%
Municipal Bonds (Barclays US 1-10 Year Municipal)	+1.5%	+3.5%	+2.4%	+3.3%
Taxable Bonds (Barclays US Aggregate)	-0.4%	+3.5%	+2.4%	+3.5%
Bank Loans (S&P/LSTA US Leveraged Loan)	+0.7%	+4.1%	+3.1%	+8.7%
High Yield Corporate Bonds (Barclays US High Yield)	-2.3%	+7.5%	+3.8%	+11.7%
Equities				
Global Stocks (MSCI All Country World)	-11.6%	+24.0%	+4.0%	+9.6%
US Large Cap Stocks (S&P 500)	-7.9%	+21.8%	+7.9%	+13.1%
US Small Cap Stocks (Russell 2000)	-14.8%	+14.7%	+3.5%	+12.2%
Non-US Developed Markets Stocks (MSCI EAFE)	-14.5%	+25.0%	+0.8%	+6.5%
Emerging Markets Stocks (MSCI Emerging Markets)	-15.5%	+37.3%	+1.6%	+8.2%
Real Assets				
Commodities (Bloomberg Commodity)	-9.0%	+1.7%	-8.6%	-3.0%
Gold (S&P GSCI Gold)	-3.9%	+12.8%	+0.9%	+4.0%
Energy MLPs (Alerian MLP)	-13.0%	-6.5%	-7.0%	+10.1%
Global REITs (S&P Global REIT)	-4.8%	+8.6%	+6.6%	+11.6%

*Note: *Indicates annualized return. Past performance is not indicative of future results. Benchmark definitions are provided at the end of this document.*

There's been no shortage of negative news flow regarding the ongoing trade dispute with China, a lack of progress on the Brexit deal, and now the partial US government shutdown. Market sentiment has clearly turned more negative, reflecting increased uncertainty around the policy outlook and slowing economic growth. Investors have expressed their concerns by withdrawing over $46 billion from US equity mutual funds and exchange-traded funds in the week ending December 12, 2018. This is the biggest one-week outflow on record, according to Lipper. Such strong outflows are typically seen as a contrarian indicator.

The conclusion of the US Federal Reserve (Fed) policy meeting on Wednesday of last week did little to calm financial markets or sooth investors' concerns. Market declines following the Fed's actions illustrate how investors and central bank officials are out of sync on the economic outlook and the impact of recent policy moves. As expected, the Fed raised its benchmark rate by 0.25% to a range between 2.25% and 2.5%, the ninth such increase since December 2015, but didn't strike enough of a "dovish" tone. While several officials lowered the number of rate increases they expect next year, reducing the median to two from three, the Fed didn't substantially downgrade its view that the economy will grow next year at a rate above 2%. The Fed's upbeat forecasts are broadly in line with Wall Street economists, but many market participants are far gloomier, believing the recent market tremors—not just stocks, but also commodities, interest-rate futures and corporate bonds—reflect serious economic weakness.[3]

Macro Outlook

In our view, the US and global economy remain in decent shape, though the pace of growth may have peaked for this cycle. To be sure, 2017's highly synchronized growth has decelerated and become more uneven. And we expect both economic growth and corporate profit growth to slow over the next couple of years given the impact of tightening financial conditions and fading US fiscal stimulus. Yet, our base case assumption is not for a significant deterioration in growth or an outright contraction. Interest-rate sensitive sectors of the economy, notably housing, have weakened—but the overall data seems to mostly point to continued growth. Labor market strength should continue to support consumption as both consumer and business confidence measures remain elevated. For example, The US Leading Economic Index (which weighs unemployment, building permits, stock prices, consumer sentiment and other factors) indicates that growth remains steady, if perhaps a bit slower than in early 2018. Although the Composite Purchasing Managers Indices[4] for the major global economies have generally declined over last several months, the survey data remains above neutral, also consistent with a continued expansion. There will eventually be another recession as they remain a normal part of the business cycle. Yet, we think the odds favor a continuation of the current economic cycle.

As always, both upside scenarios and downside risks exist. For instance, an optimistic case could be made that we haven't yet seen the full benefits of last year's supply-side tax cuts. Incentives exist for business investment and capital expenditures that could boost productivity growth and extend the economic cycle, but uncertainty around trade policy appears to be undermining this activity. Indeed, the downside risks are largely policy related.

- *Trade policy risk:* The ongoing US-China trade dispute and threat of further escalation represents a key threat to the global economy. Both sides have imposed tariffs on billions of dollars' worth of goods. The US has hit $250 billion of Chinese goods with tariffs since July, and China has retaliated by imposing duties on $110 billion of US products. The fear is that keeping existing tariffs in place for a longer period of time, increasing those tariff rates, and imposing new tariffs will drive up prices of imported goods for US consumers and businesses. This would slow investment and consumer spending, harming GDP growth. While signs of consumer inflation from the tariffs has been limited to a few items, businesses are already reporting cost pressures and disruptions from the trade war.

- *Monetary policy risk:* In previous communications and discussions, we've highlighted global monetary policy as a key source of uncertainty. In the aftermath of the 2008 financial crisis, central bankers experimented with a range of unconventional measures (zero interest rate policy, quantitative easing, and forward guidance) aimed to combat deflationary pressures. In addition to creating excess liquidity, central banks' actions helped suppress financial market volatility over the last several years. Therefore, policy normalization (or the exit of these unconventional measures) is likely to lead to higher volatility. The risk also exists that policymakers normalize or raise interest rates too quickly considering the recent economic softening. Yet, historically central banks have erred on the side of raising rates too little too late. With the real or inflation-adjusted fed funds rate only slightly positive at this point, it's hard to argue that US monetary policy is restrictive at this point. The recent tightening of financial conditions, however, signals that the Fed's current policy rate is closing in on the "neutral" level—the rate at which monetary policy neither stimulates nor restricts growth.

Market Outlook & Portfolio Strategy

We continue to believe that the backdrop of positive (albeit slower) economic growth and tame inflation should provide support to corporate profits and equity valuations over the intermediate term. Yet, we also expect market volatility to remain elevated and near more "normal" levels, particularly as global central banks seek to normalize monetary policy and geopolitical risks remain elevated. We acknowledge that recent market conditions have been uncomfortable, but investors should keep in mind that the extremely low volatility over the past several years has been unusual. As we've stated in the past, volatility is an expected byproduct of investing—and unfortunately it tends to pick up in the later stages of the economic cycle.

In our view, developing portfolio strategy isn't based on making predictions about the future, but being prepared for a range of potential outcomes[5]. While we formulate a base case set of assumptions about the future, we recognize the inherent uncertainty involved with investing. Therefore, portfolio construction emphasizes broad diversification and evolves over time based on ongoing assessment of the fundamental backdrop and asset class valuations and risks.

Over last couple of years, we've taken some steps to reduce portfolio risk at the margin. For example, we've trimmed US equities on strength as valuations became a bit stretched. We reduced credit exposure as spreads narrowed to historically tight levels. In addition, we've maintained an elevated cash position as dry powder. Importantly, we also advocated continuing to own high quality, intermediate duration bonds—despite low yields—as a source of stability, liquidity, and diversification of equity market risk. The defensive characteristics of the asset class have been notable over the last several weeks.

Volatility can create attractive investment opportunities, which we'll continue to evaluate. For example, we are considering a slight increase in our tactical allocation to energy MLPs given recent price weakness and asset class fundamentals. However, at this point, we recommend staying the course with current portfolio positioning—a slight overweight to cash/short-term fixed income and a slight underweight position in US equities with an emphasis on large cap, high quality stocks. The table below summarizes our current tactical views.

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Cash					
Cash & Short-Term Bonds				✓	
Fixed Income					
US Investment Grade Bonds		✓			
Non-US Investment Grade Bonds		✓			
Tax-Free Municipal Bonds			✓		
Bank Loans/High Yield			✓		
Equities					
US Large Cap Stocks		✓			
US Small Cap Stocks		✓			
Non-US Developed Markets Stocks			✓		
Emerging Markets Stocks			✓		
Real Assets					
Commodities			✓		
Public Real Estate (Core)	✓				
Flexible/Alternative Strategies					
Directional Hedge			✓		
Less Directional Hedge				✓	

Note: Based on research and opinion provided by Greycourt & Co. Tactical views reflect a three-year investment horizon. Suggested asset class weights are influenced by Greycourt's detailed quarterly tactical analysis and are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investing horizon.

Benchmark Definitions

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships (MLPs). The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated real-time on a price-return basis.

The Barclays Capital US 1-3 Month Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and non-convertible.

The Barclays Capital 1-10 Year Municipal Blend Index is a market value-weighted index which covers the short and intermediate components of the Barclays Municipal Bond Index—an unmanaged, market value-weighted index which covers the U.S. investment-grade tax-exempt bond market. The 1-10 Year Municipal Blend index tracks tax-exempt municipal General Obligation, Revenue, Insured, and Prerefunded bonds with a minimum $5 million par amount outstanding, issued as part of a transaction of at least $50 million, and with a remaining maturity from 1 up to (but not including) 12 years.

The Barclays Capital US Aggregate Index represents securities that are US domestic, taxable, and dollar denominated. The index covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Barclays Capital US Corporate High-Yield Bond Index is composed of fixed-rate, publicly issued, non-investment grade debt.

The Bloomberg Commodity Index is composed of futures contracts on physical commodities. Included in the index family are subindexes representing the major commodity sectors within the broad index: Energy, Petroleum, Precious Metals, Industrial Metals, Grains, Livestock, Softs, and Agriculture.

The MSCI All Country World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of May 27, 2010 the MSCI ACWI consisted of 45 country indices comprising 24 developed and 21 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indices included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The MSCI ACWI REIT Index is a free float-adjusted market capitalization index that captures large and mid-cap representation across 23 Developed and 23 Emerging Markets countries, which generate a majority of their revenue and income from real estate rental and leasing operations. With 71 constituents, it represents about 85% of the global equity REIT universe and all securities are classified in the REIT sector according to the Global Industry Classification Standard (GICS®).

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

The MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The S&P Global REIT Index, a member of the S&P Global Property Index Series, serves as a comprehensive benchmark of publicly traded equity REITs listed in both developed and emerging markets.

The S&P GSCI Gold Index, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark tracking the COMEX gold future. The index is designed to be tradable, readily accessible to market participants, and cost efficient to implement.

The S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market. S&P Leveraged Loan Indexes are capitalization-weighted syndicated loan indexes based upon market weightings, spreads and interest payments. The S&P/LSTA Leveraged Loan Index covers the U.S. market back to 1997 and currently calculates on a daily basis.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of share outstanding), with each stock's weight in the Index proportionate to its market value. The S&P 500 is one of the most widely used benchmarks of US equity performance.

The US Dollar Index is a measure of the value of the United States dollar relative to a basket of foreign currencies. It is a weighted geometric mean of the dollar's value relative to other select currencies, including the Euro, Japanese yen, Pound Sterling, Canadian dollar, Swedish krona, and Swiss franc.

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[1] *Cecile Vannucci and Abhishek Vishnoi, Bloomberg, "Wild Days Return to Stock Market as VIX Surges Like Never Before," December 20, 2018.*
[2] *Akane Otani and Michael Wursthorn, Wall Street Journal, "No Refuge for Investors as 2018 Rout Sends Stocks, Bond, Oil Lower," November 25, 2018.*
[3] *Nick Timiraos, Wall Street Journal, "Investors, Fed Officials Are Out of Sync," December 20, 2018.*
[4] *The Markit Composite PMI Output Index track business trends across both manufacturing and service sectors based on data collected from a representative panel of companies. The index tracks variables such as sales, new order, employment, inventories, and prices. A reading about 50 indicates expansion in business activity while below 50 points to contraction.*
[5] *Ben Carslon discussed "Prediction vs. Preparation" on his "A Wealth of Common Sense" blog on December 16, 2018.*