STANDING AT THE PEAK

2018 Midyear Market Outlook

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Now What?

That's the question investors are muttering to themselves as they stand on the precipice of the second half of 2018. And who can blame them? Many of the catalysts that have been fueling the bull market are fading. And a growing list of investor concerns and some puzzling relationships have taken their place.

As January's market melt-up headlines get more distant in the rearview mirror, the road ahead may be littered with tighter monetary policy, rising interest rates, building inflationary pressures, fragile trade negotiations and geopolitical flare-ups. Simultaneously, and perhaps unluckily, global synchronized growth which was so instrumental in boosting asset prices in the last year is dwindling. Plus, massive US fiscal policy has so far failed to materially change the growth trajectory and corporate profits likely peaked in the first quarter.

Not surprisingly, with very few identifiable catalysts to drive risk assets higher, most assets have just treaded water in the first half of 2018.

The Market's Shifting

For the first time in the post global financial crisis era, the 2-year Treasury yield is more than 30% greater than the S&P 500® Index dividend yield.[1] Add to that modest year-to-date stock returns, falling bond prices, growing risks in the post peak everything environment, increased volatility and an aging bull market and suddenly, for the first time in a long time, the There Is No Alternative (T.I.N.A.) to equities narrative has increased competition for investor's capital from short-term, conservative and sometimes risk-free investments.

Complicating matters further, with rates finally rising instead of precipitously falling, traditional bond allocations may not provide a good hedge against risks to stock portfolios. This challenge comes at a time when traditional defensive stock investments (utilities, consumer staples, telecom and REITs) also have failed to support portfolios. These often highly indebted sectors were used heavily by investors as income substitutes in the T.I.N.A. environment. Defensive sectors have doubly suffered from concerns that rising rates would negatively impact these companies' debt loads while investors now have better choices to generate income.

The Bull Still Seems Ageless

There is still time left in this business cycle. Global synchronized growth and corporate profits may have peaked in the first quarter, but they are still positive. After more than a decade of easy monetary policy, conditions may be tightening but they are doing so gradually. Although the huge US fiscal policy package hasn't boosted growth yet, it likely will later this year. And, while interest rates and inflation are rising, both remain well below historical averages. As a result, global cyclicals are likely to continue to outpace defensive investments in the second half of 2018.

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HOW CAN YOU RE-POSITION PORTFOLIOS?

Position for Later Stages of the Business Cycle

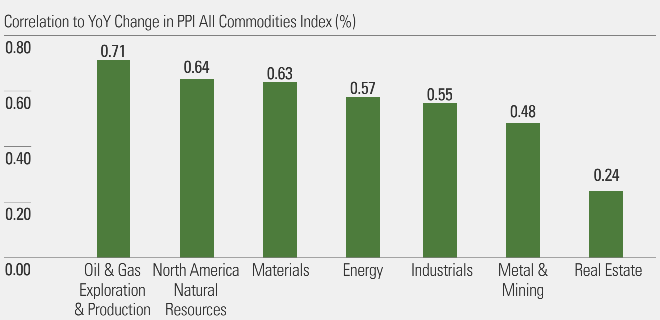
Q1 2018 earnings season will one day be remembered like The Beatles' "Sgt. Pepper's Lonely Hearts Club Band" album — full of hits, hard to replicate and not fully appreciated until well beyond its time. Q1 marked the highest earnings growth since Q3 2010 (34.0%) and the fourth time in the past five quarters that the S&P 500 Index has reported double-digit earnings growth.[2] Plus 78% of companies beat expectations, the highest figure on record — and by the widest margin (+7.5%) since Q4 of 2010.[3]

If this is as good as it gets, get tactical

With Q1 projected to be the high watermark this year, earnings growth has been revised lower for 10 of the 11 GICS® sectors for 2019.[4] The same downward revision trend goes for regions outside the US. Crossing into the second half of the year, a market without an improving fundamental backdrop will lead to uneven price performance, increasing dispersion and creating opportunities for tactical asset allocation.

Meanwhile, fiscal stimulus, protectionist trade policy and geopolitical uncertainties may cause an uptick in US inflation. Peak corporate earnings, post-crisis low credit spreads and increasing interest rates also point to a late cycle economic environment.

Figure 1: Commodities, Materials and Natural Resources Tend to Move in Tandem with Inflation



Source: Bureau of Labor Statistics, FactSet as of 4/30/2018.
Correlation is calculated using 12 month returns of S&P 500 sector indexes and year over year changes in Producer Price All Commodity Index for the period from 06/01/20017 to 04/30/2017.

Consider carving out a portion of equity allocations for exposures which are more sensitive to producer price inflation and higher input prices.

Play the Short Game in Bonds

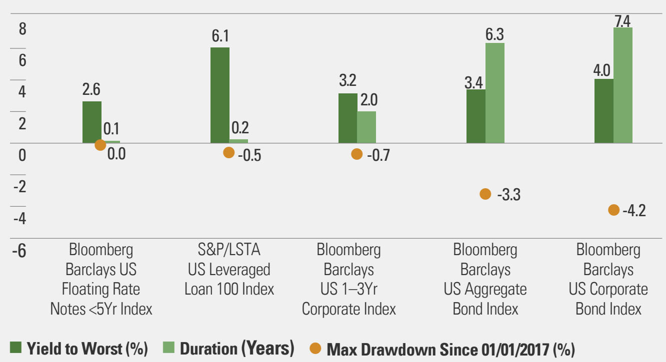
No peaks here. The yield curve has flattened from 96 to 49 basis points (bps) as the US 2-year yield rose 129 bps over the past year, outpacing the 82 bp increase in the US 10-year yield.[5] The trend is even more noticeable further out; the 30-year yield has increased by just 29 bps over the same period.[6] Economists estimate a 40 bp difference between the 10-year and 2-year by the end of 2018.[7]

Cash is cool again

With the Federal Reserve continuing to hike rates, cash and short duration exposures have become attractive sources of income in addition to tempering duration and equity risk. With just 30% of US equities now yielding more than the US 3-Month LIBOR, compared to 66% a year ago,[8] the T.I.N.A. to the equities market narrative has been silenced.

Given bonds' performance since the end of 2016 and their current composure based on yield, duration and credit spread, investors may be well served to focus on their short-term positions, focusing on floating rates (investment grade and senior loans) that have the most optimal yield and duration exposure (yield per unit of duration).

Figure 2: Bond Sector Characteristics Drive Performance in a Changing Rate Environment



Source: Bloomberg Finance L.P., as of 05/18/2018

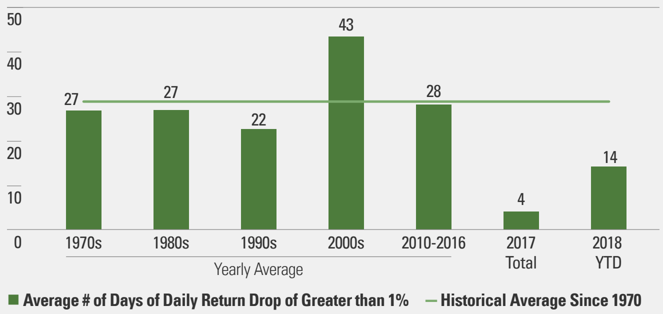
Being selective on bond type, term and sector can help you avoid "Trouble with the Curve."

Prepare For Normal Bouts of Volatility

Forget 2017's extraordinary tranquility. After posting the best January return since 1997, the S&P 500 fell into correction territory in early February and has since struggled in the wake of uncertain trade policy and political tumult.

How normal is the current volatility? Since 1988, the market has dropped by more than 1% an average of 29 days a year, but we saw only four such drops in 2017.[9] So far this year, we have seen 14 days with a 1% or greater drop. Annualize that number and we are only slightly above the long-term average. This back-to-normal volatility has been healthy for capital markets, easing the froth of stretched valuations in the US and curtailing the euphoria that had global stocks trading at the widest margin above their 200-day moving average over the last 10 years.

Figure 3: It's Normal to See Days with a Greater than a 1% Drop



Source: FactSet, as of 04/30/2018.

Discord could thwart growth

As the economic cycle matures, monetary policy becomes tighter and there is less room for growth to exceed expectations. Investors searching for the next leg of growth will also need to contend with erratic geopolitical tensions from North Korea to Iran. Plus, Brexit and a new Eurosceptic regime in Italy will continue to make waves.

In the meantime, President Trump's proclivity for provocation and contentious actions continues. The administration's unpredictable approach to trade negotiations with major US trade partners — China, Canada, Mexico and Europe — likely will heighten economic uncertainty and spark more volatility in risk markets. And the results of November's midterm US elections could also challenge the administration's legislative agenda, potentially increasing already elevated political gridlock.

Seek to counter market uncertainty by diversifying with gold exposure or add a ballast with ultra-short bonds.

1 Bloomberg Finance L.P., as of 05/28/2018.
2 FactSet, as of 05/18/2018.
3 FactSet, as of 05/18/2018.
4 FactSet, as of 05/18/2018.
5 Bloomberg Finance L.P., as of 05/22/2018.
6 Bloomberg Finance L.P., as of 05/22/2018.
7 Bloomberg Finance L.P., as of 05/18/2018.
8 Bloomberg Finance L.P., as of 05/22/2018.
9 Bloomberg Finance L.P., as of 5/18/2018, based on 200-day moving average for the MSCI ACWI Index, reaching a difference of 63.71 on 01/26/2018.

Glossary

Bloomberg Barclays U.S. Aggregate Bond Index A benchmark that provides a measure of the performance of the US dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the US.

Bloomberg Barclays U.S. Convertible Bond > $500MM Index An index designed to represent the market of U.S. convertible securities, such as convertible bonds, with outstanding issue sizes greater than $500 million. Convertible bonds are bonds that can be exchanged, at the option of the holder, for a specific number of shares of the issuer's preferred stock ("Preferred Securities") or common stock.

Bloomberg Barclays US Corporate 1-5 Year Index Designed to measure the performance of US corporate bonds that have a maturity of greater than or equal to 1 year and less than 5 years.

Bloomberg Barclays U.S. Corporate High Yield Bond Index A benchmark that measures the US corporate market of non-investment grade, fixed-rate corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Bloomberg Barclays U.S. Corporate Investment Grade Bond Index A benchmark consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least $250 million par amount outstanding. To qualify, bonds must be SEC-registered.

Bloomberg Barclays U.S. Dollar Floating Rate Note < 5 Years Index A benchmark consisting of debt instruments that pay a variable coupon rate, most based on 3-month LIBOR with a fixed spread. May include US-registered, dollardenominated bonds of non-US corporations, governments and supranational entities.

Bloomberg Barclays U.S. Treasury Index An index that covers the entire U.S. government bond market by containing U.S. Treasuries with maturities ranging from 1 to 30 years.

Credit Spread The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.

GICS, or Global Industry Classification Standard A financial-industry guide for classifying industries that is used by investors around the world.

S&P 500 Index A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

S&P Leveraged Loan Indexes (S&P LL indexes) Capitalization-weighted syndicated loan indexes based upon market weightings, spreads and interest payments. The S&P/LSTA Leveraged Loan Index (LLI) covers the U.S. market back to 1997 and currently calculates on a daily basis.

Yield Curve A line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt.

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Investing in commodities entails significant risk and is not appropriate for all investors.

Diversification does not ensure a profit or guarantee against loss.

International government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

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