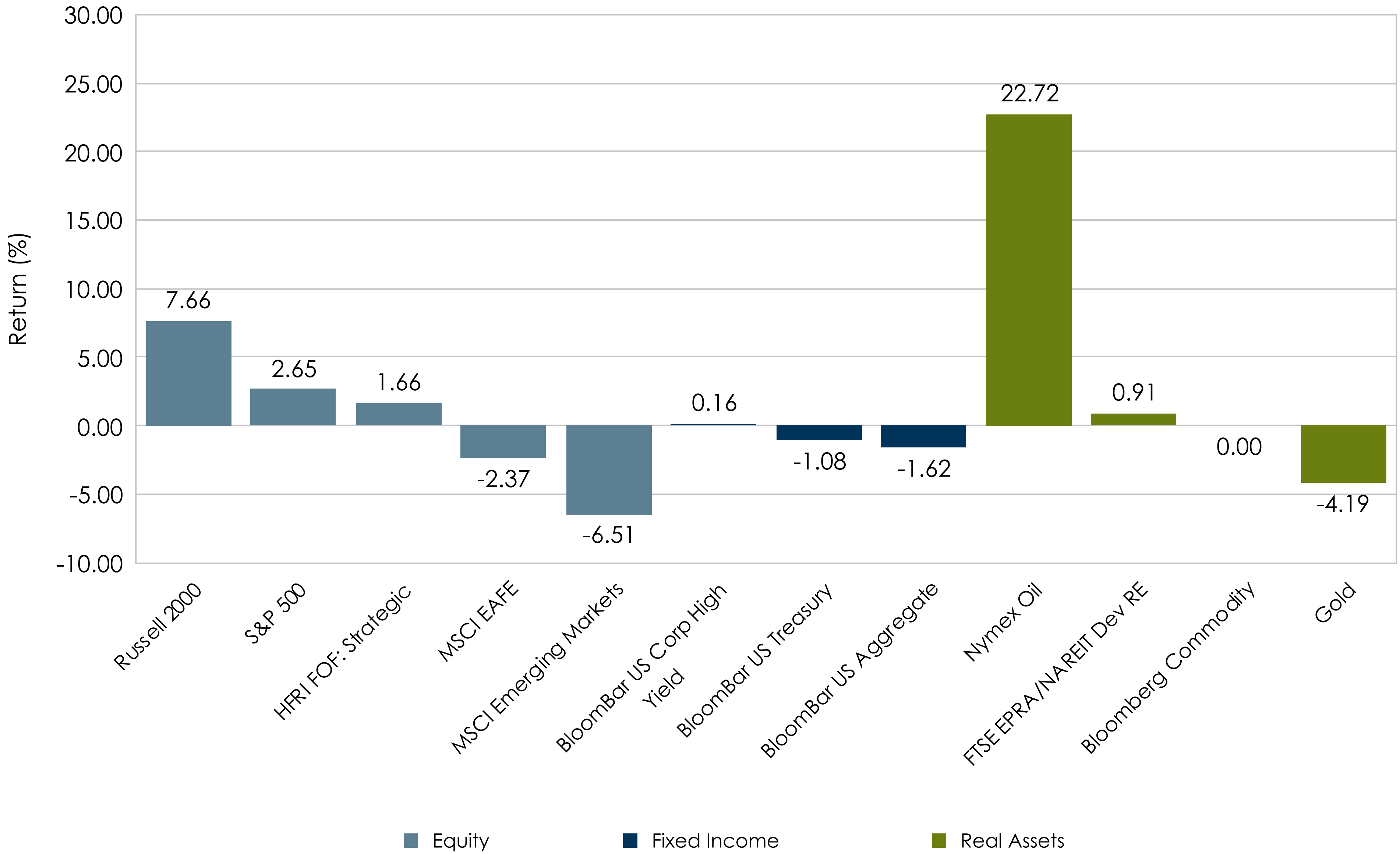
Global Economic Update

Third Quarter 2018

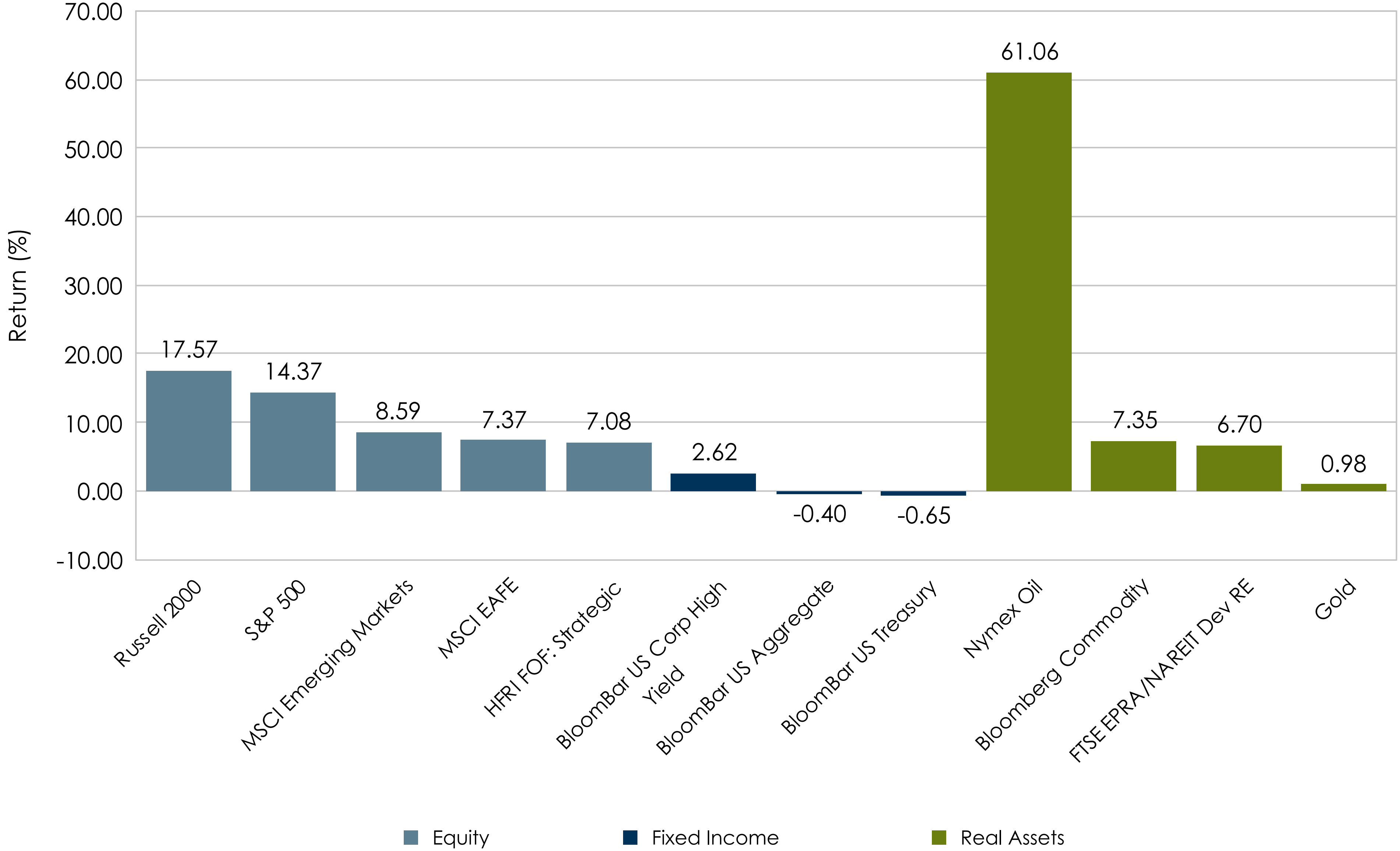
Market Returns

For the YTD Period Ending June 30, 2018



Market Returns

For the 1 Year Period Ending June 30, 2018



US

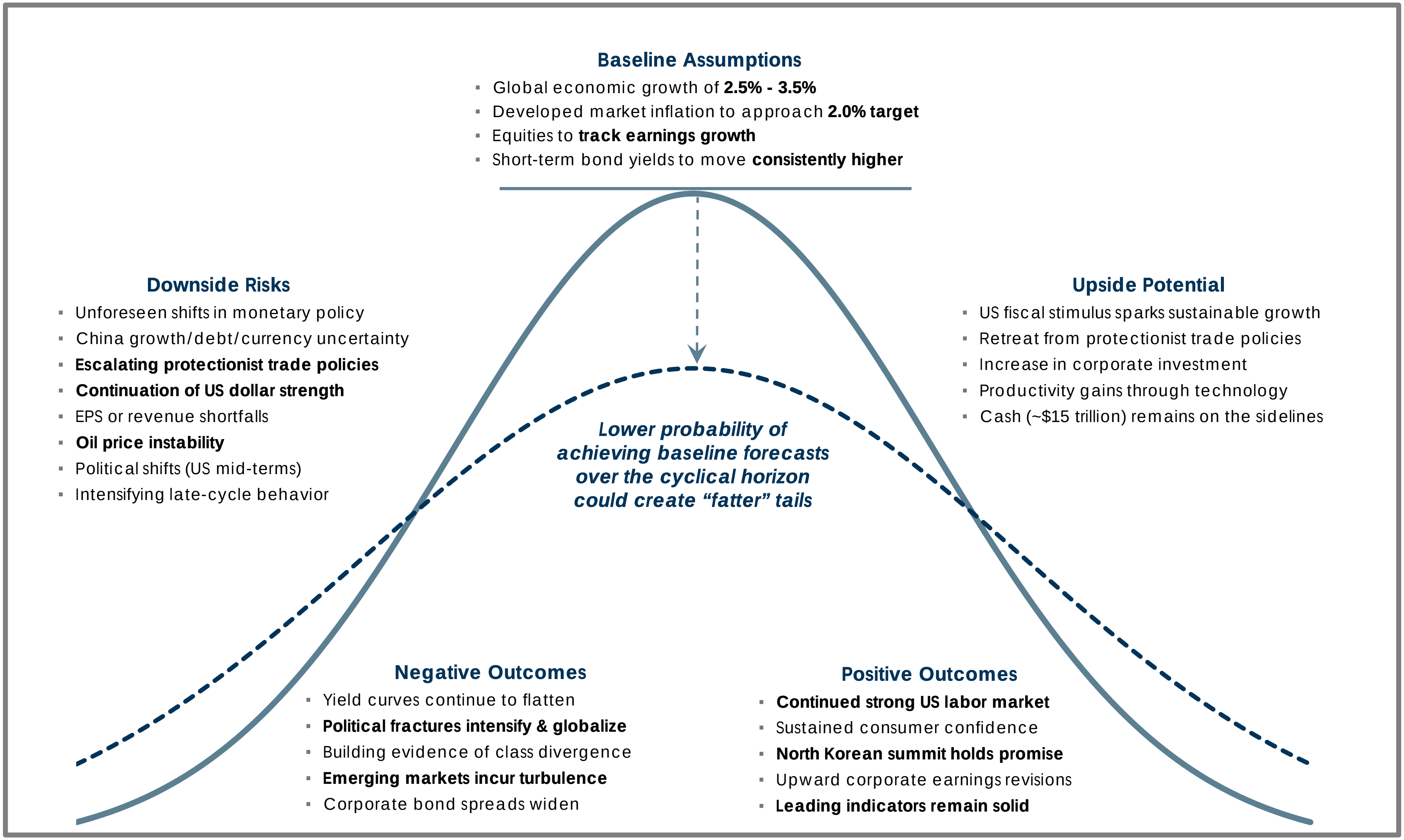
- Although 1st quarter GDP was revised down to 2.0%, the US economy is growing at one of its fastest clips in years. **Projections for 2nd quarter GDP exceed 3.5%**, with solid readings for consumer and business sentiment.
- Labor conditions remain robust, with the **unemployment rate matching a low that dates back to the 1960's** before settling at 4.0%. Most economists, including those at the Fed, are forecasting continued hiring demand.
- Both the manufacturing and service sectors continue to run at a healthy pace, which should support **strong corporate earnings growth over the coming 12-months**. That said, with the increasingly lofty expectations of economists and analysts, the "surprise" index has been on the decline.
- As expected, the Fed **increased short-term interest rates in June**, to a targeted range of 1.75% to 2.00%. The overall tone of the message was slightly more "hawkish," with the unofficial dot-plot **projecting five more increases by the end of 2019**. Core PCE remains fairly well-contained, but has finally achieved the stated objective of 2.00%.

Global/Non-US

- **Momentum for the broader global economy has moderated** somewhat, with Europe experiencing a notable slowdown and the disparate **emerging economies feeling the impact of a stronger US dollar.**
- **Escalating and broadening tariffs** initiated by the Trump administration have spurred retaliatory threats/actions from China and much criticism from long-term allies of the US. **Well-entrenched globalization trends are unlikely to be reversed, but protectionism could weigh on growth.**
- The **ECB provided a "dovish" outline for reduced policy accommodation over the next 12-months**. The BoJ lags further behind the Fed's established normalization path, with rate differentials impacting capital flows.
- Beyond the trade issues noted above, **international political tensions remain mixed**. The impacts of Brexit appear to be isolated to the UK and the meetings involving North Korea may hold promise. That said, anti-EU sentiment has built in Italy and tensions in the Middle East have increased.

Current Issues

- Keeping Score: Evaluating the Facts on the Ground
- Late Cycle Investing: Does it Ever Make Sense to Try to Time the Market?
- Global Divergence: Causation and Implications of a Stronger US Dollar?
- Expectations Matter: Is Growth Sustainable with Less Policy Support?


Baseline Assumptions
Global economic growth of 2.5% - 3.5%
Developed market inflation to approach 2.0% target
Equities to track earnings growth
Short-term bond yields to move consistently higher
Downside Risks
Unforeseen shifts in monetary policy
China growth/debt/currency uncertainty
Escalating protectionist trade policies
Continuation of US dollar strength
EPS or revenue shortfalls
Oil price instability
Political shifts (US mid-terms)
Intensifying late-cycle behavior
Upside Potential
US fiscal stimulus sparks sustainable growth
Retreat from protectionist trade policies
Increase in corporate investment
Productivity gains through technology
Cash (~$15 trillion) remains on the sidelines
Lower probability of achieving baseline forecasts over the cyclical horizon could create "fatter" tails
Negative Outcomes
Yield curves continue to flatten
Political fractures intensify & globalize
Building evidence of class divergence
Emerging markets incur turbulence
Corporate bond spreads widen
Positive Outcomes
Continued strong US labor market
Sustained consumer confidence
North Korean summit holds promise
Upward corporate earnings revisions
Leading indicators remain solid

Market View:

- **An inverted yield curve and increasing unemployment have traditionally been good recession predictors,** with both strongly trending toward precarious levels.
- It's hard to identify a dislocation or "bubble" in the current economy, but **markets anticipate, and valuations appear elevated across various asset categories.**
- **Behavioral finance will play a key role in future market direction,** with investors skeptical about policy-suppressed bond yields alongside policy-supported EPS.

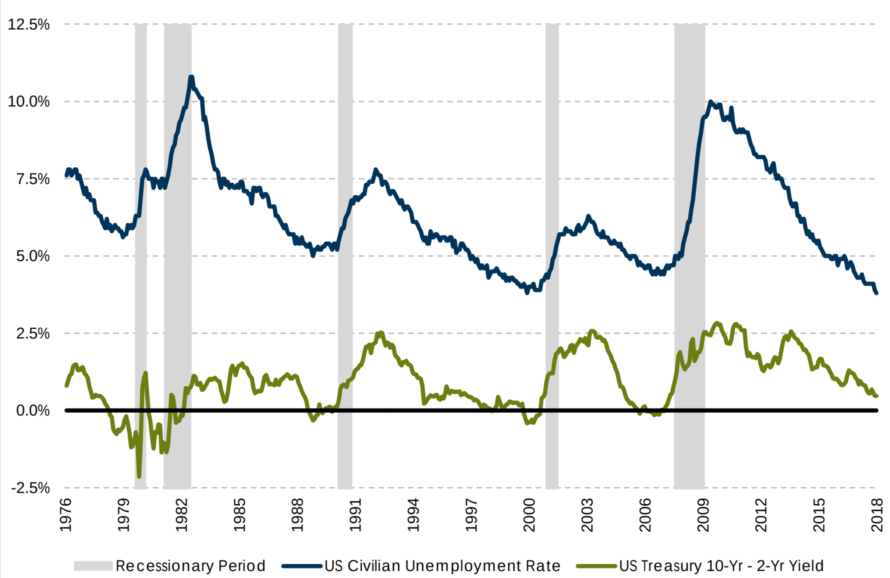
ACG Position:

- While correlated, it's important to understand that **economic and market cycles do not always move together**, and peaks are difficult to identify in real time.
- **Levels of anxiety have rightfully increased** since we are now a decade into the post-crisis recovery, and consequently one year closer to recession.
- Active managers welcome the opportunity to take advantage of market dispersion, so **volatility may not be all bad.**

Portfolio Implications:

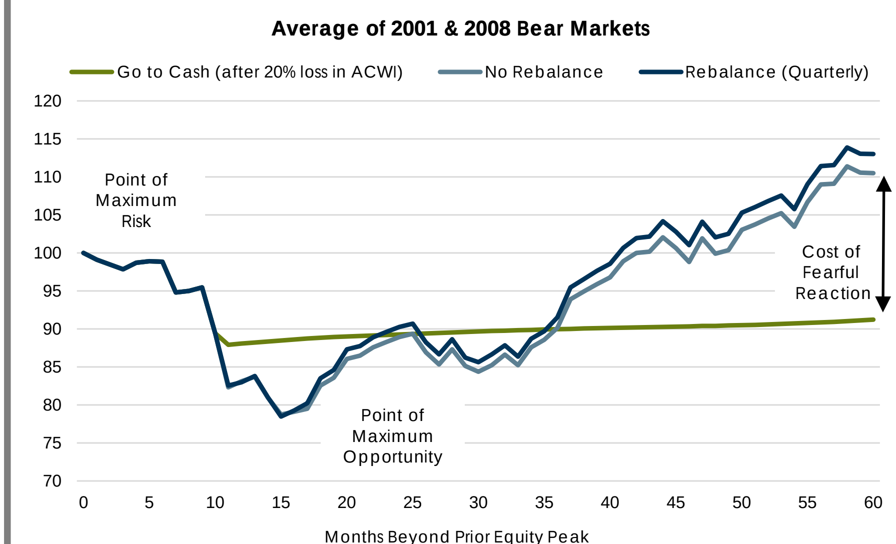
- Closely monitor overall portfolio allocations relative to strategic objectives, **minimizing asset allocation drift** with thoughtful rebalancing and cash flow decisions.
- **Incorporate diversified hedging strategies,** including both absolute return fixed income and long/short equity, to enhance downside protection.
- Take into account long-term relationships when establishing portfolio strategy, ideally **preserving upside exposure while avoiding the temptation to chase returns.**

Historically Consistent Indicators of Economic Recession



Source: ACG Research, Bloomberg, Bureau of Labor Statistics (BLS), St. Louis Federal Reserve (FRED)

Investors Penalized for Getting & Staying Too Risk-Adverse



Diversified portfolio consists of 60% MSCI ACWI, 30% BloomBar Aggregate US Bond, 10% NCREIF Property

Source: ACG Research, Bloomberg

Market View:

- With **US economic momentum recently pacing well ahead of develop market peers**, the US dollar (as measured by DXY) reversed its five-quarter losing streak.
- A relatively active Federal Reserve has **driven interest rate differentials to a 20-year high**, with foreign central banks facing a somewhat surprising slowdown.
- Trade frictions contributed to a nearly 10% decline in emerging market currencies, as **nervous periods of “risk-off” cause investors to seek haven in the US dollar**.

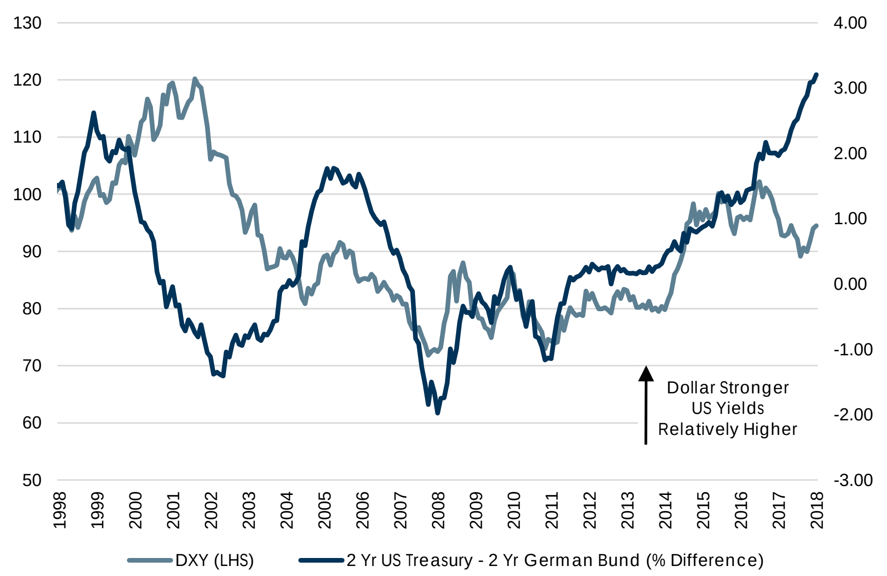
ACG Position:

- Forecasting currency performance can be extremely difficult in the short-term, and **foreign exchange is considered a zero-sum game in the long run**.
- Valuations are typically **driven by respective country conditions (interest rates & growth), but are subject to technical factors** such as capital flows and sentiment.
- **A persistently strong US dollar leads to tighter financial conditions** domestically, while also acting as a headwind for US investors’ returns from international assets.

Portfolio Implications:

- Earnings for large multi-national firms are adversely impacted by US dollar strength, potentially favoring **more domestically oriented small caps**.
- More attractive relative valuations, along with economic cycle and currency diversification, support the **ongoing case for international equities**.
- Employ **active managers** with niche strategies and/or the flexibility to respond to dislocations or heightened volatility across the currency landscape.

Front-End Yield Differentials Supporting the US Dollar



Source: ACG Research, Bloomberg

International Valuations Appear Relatively Attractive

Source: ACG Research, Bloomberg

Market View:

- Benefitting from positive consumer confidence, the recent “Tax Cuts and Jobs Act,” and regulatory rollback, **corporate fundamentals appear relatively strong**.
- Despite **profit margins already residing in the top-decile relative to history**, current analyst estimates suggest nearly 28% EPS growth in the coming 12 months.
- Wage pressures remain surprisingly contained, and **the Federal Reserve’s policy adjustments should be “gradual”** absent a broad-based inflation shock.

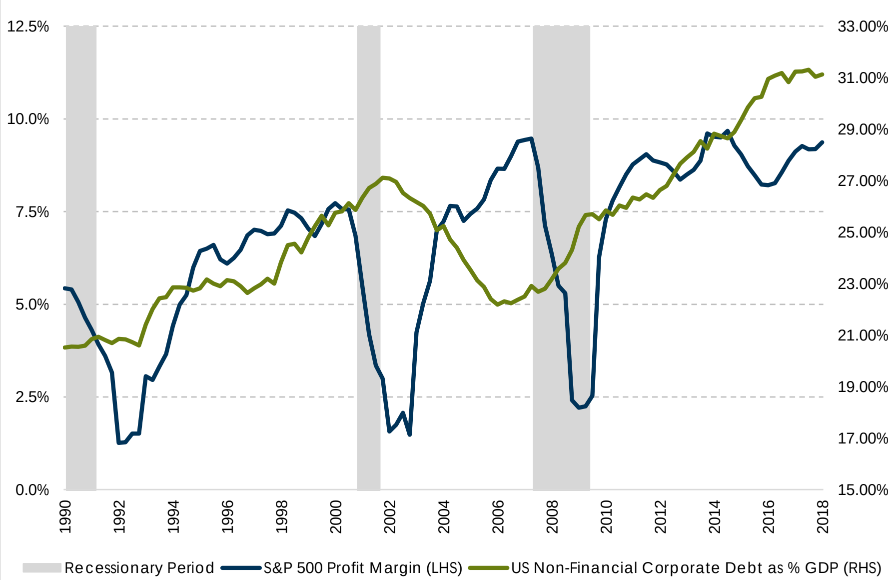
ACG Position:

- Although household balance sheets have improved, the **low rates experienced since the financial crisis have encouraged record borrowing by companies.**
- With **cash stockpiles often deployed for M&A or share buybacks**, the refinancing of maturing debt may coincide with higher interest rates.
- Even if robust near-term earnings expectations are achieved, **maintaining momentum becomes increasingly difficult** as policy support recedes.

Portfolio Implications:

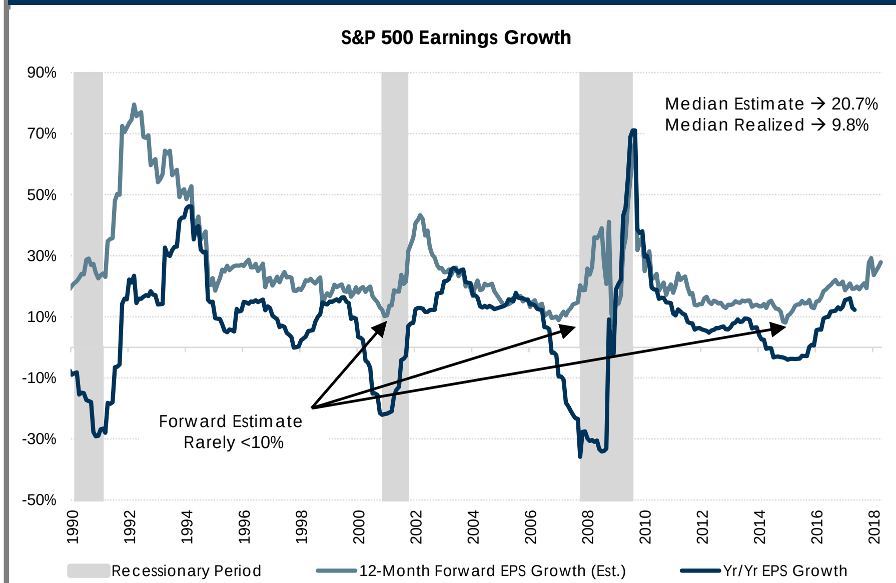
- Consider equity strategies focused on **“quality” companies with relatively strong balance sheets**, and move higher in the capital structure where possible.
- Incorporate hedged strategies for volatility reduction, and **acknowledge that Federal Reserve activity has reduced the penalty of holding cash.**
- **Accept the illiquidity premium offered by private investments** as these strategies offer differentiated results and can mitigate short-term turbulence.

Amid Low Rates, Debt has Supported Corporate Margins



Source: ACG Research, Bloomberg, Bureau of Economic Analysis (BEA), St. Louis Federal Reserve (FRED)

Wall Street is Persistently Bullish on Earnings



Source: ACG Research, Bloomberg

Investment Themes (3-5 Years)

Theme	Rationale	Implementation Strategy
Geopolitical & Policy Uncertainty	▪ Disparate global fiscal/monetary policies ▪ Unknown impact of protectionism ▪ Long term constraint from high government debt ▪ Political polarization and rising inequality ▪ Immigration, nuclear threats, territorial disputes, climate change, social media impact, cyber attacks, terrorist activity	▪ Maintain global diversification; including meaningful non-US exposure ▪ Increase risk-reducing and private strategies ▪ Maintain disciplined rebalancing strategy ▪ Consider enhancing liquidity to exploit dislocations
Maturing Growth Cycle	▪ Ongoing post-crisis recovery globally, driving economic conditions and corporate profitability ▪ Improving metrics necessarily precede "peak growth" ▪ Dependence on monetary policy stimulus to be tested ▪ China transitioning to consumer-driven economy, reduced government spending/lending ▪ Productivity and population trends remain challenging	▪ Still emphasize equities over fixed income ▪ Focus on actively managed, opportunistic strategies in less efficient asset classes (e.g. US Small Cap, Non-US, EM, fixed income) ▪ Allocate to specialized/differentiated managers ▪ Consider strategies with a high-quality orientation
Fixed Income to Remain Challenging	▪ Initial conditions slowly improving, but longer-term yields remain relatively low and spreads are tight ▪ Central bank policy normalization to influence supply/demand dynamics ▪ Inflation expectations driving yield volatility ▪ Later stage of economic/credit cycle ▪ Liquidity challenges may increase volatility	▪ Retain high-quality fixed income allocation for diversification and portfolio ballast ▪ Favor credit and securitized over sovereign debt, but consider shorter-dated maturities ▪ Opportunistically include exposure to private debt or other yield enhancing strategies (e.g. HY, EM debt) ▪ Incorporate absolute return oriented strategies
Global Inflation Conundrum	▪ Unprecedented global stimulus and tightening labor markets support building wage pressure ▪ Difficult to gauge the influence of technology, global market efficiency, and secular demographic trends ▪ Rising consumer spending driving demand ▪ Energy prices normalizing/stabilizing in higher range ▪ Trade policy uncertainty – inflationary/deflationary?	▪ Retain meaningful equity exposure given re-pricing ability for corporate goods and services ▪ Retain core real estate (RE) exposures ▪ Employ active managers with niche strategies
Muted Return Expectations	▪ Relatively high valuations across asset classes, with policy stimulus acting to "pull forward" returns ▪ Potential for increased market volatility would likely result in a period of mean reversion ▪ Global economic growth remains positive but tepid ▪ Longer-term challenges of demographics/debt levels ▪ Yields and inflation advancing from historic lows	▪ Revisit/confirm investment objectives, constraints and strategic allocation ▪ Remain diligent with rebalancing discipline ▪ Implement private equity and/or debt strategies ▪ Consider active strategies with enhanced flexibility ▪ Employ risk-reducing/hedged strategies

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