Global Economic Update

Second Quarter 2018

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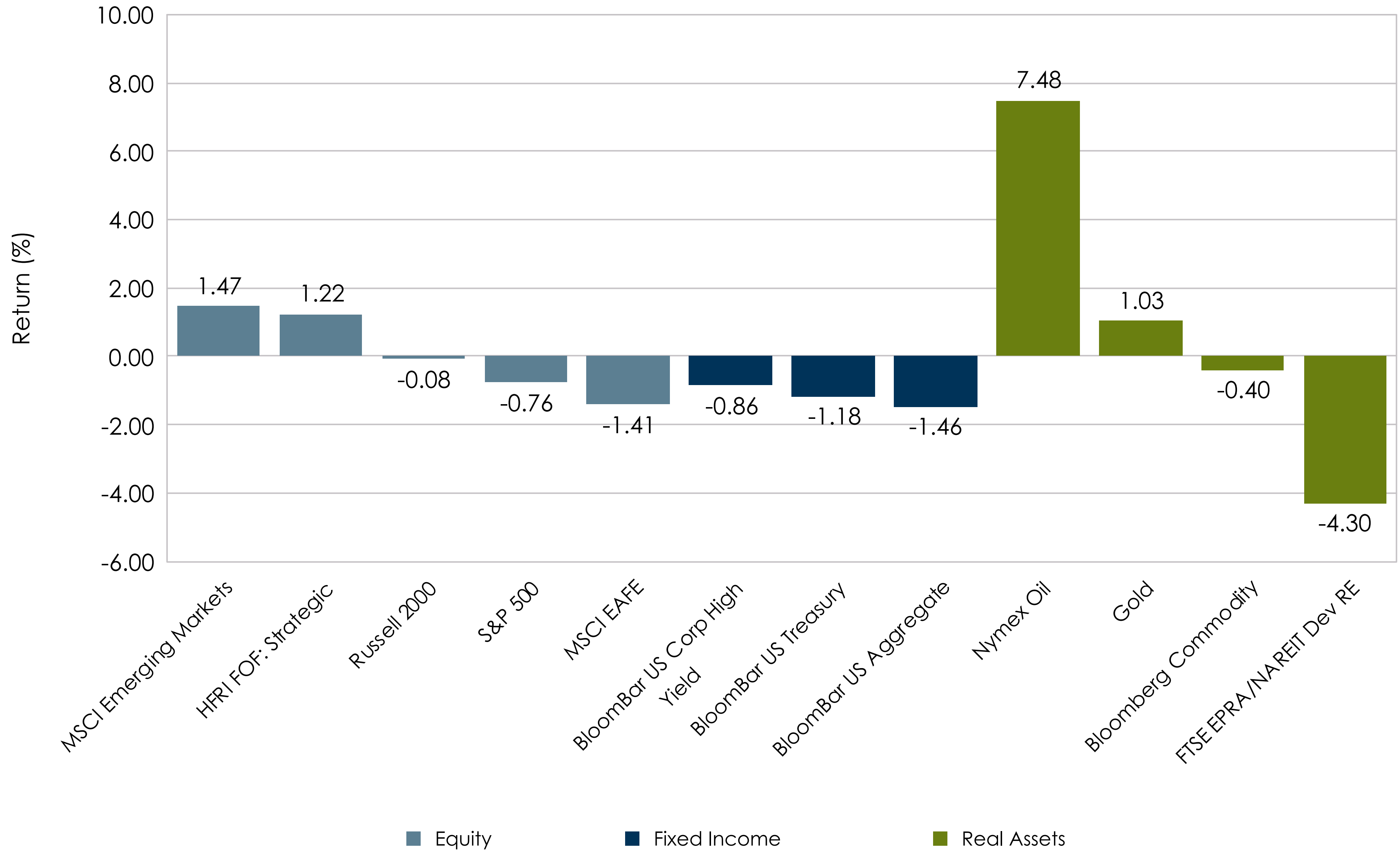
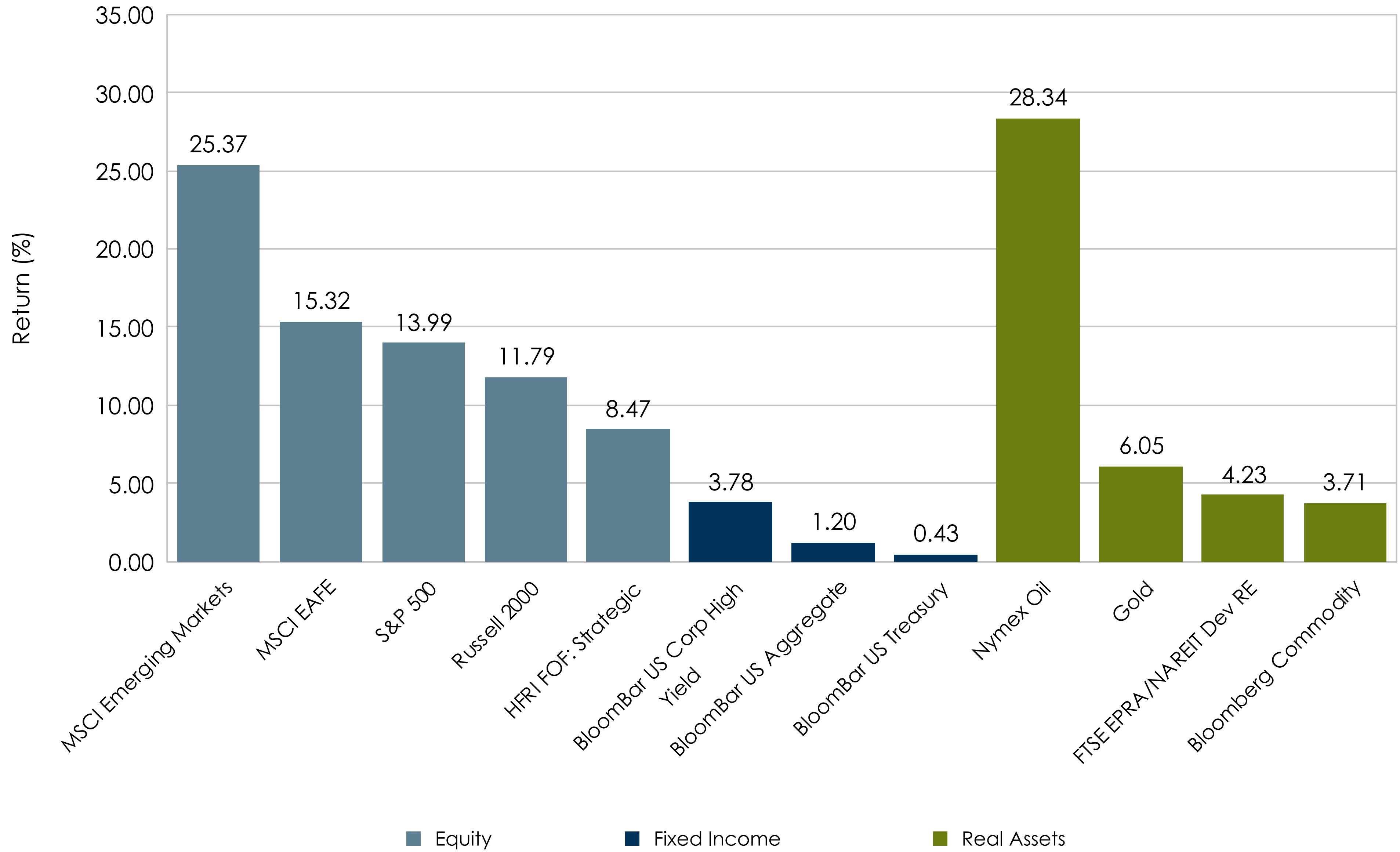
Market Returns

For the YTD Period Ending March 31, 2018



Market Returns

For the 1 Year Period Ending March 31, 2018



US

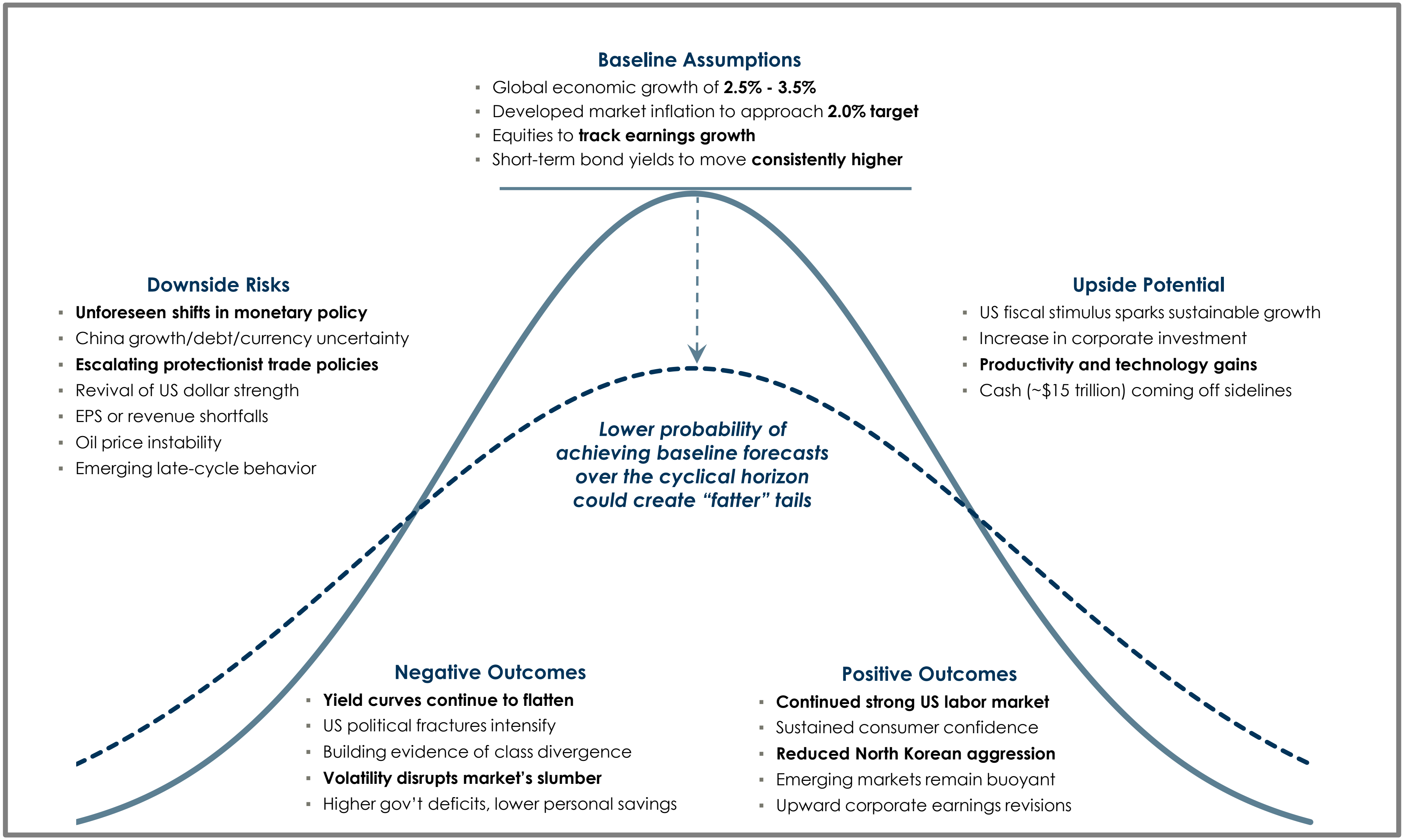
- Economic fundamentals in the US are generally surprising to the upside, with **4th quarter GDP and consumer spending revised upward.**
- Labor conditions remain solid, with the **unemployment rate remaining at 4.1%, a 17-year low.** Most economists, including those at the Fed, are forecasting sub-4% levels on the horizon.
- Industrial activity continues its healthy pace, with the **ISM Manufacturing Index hitting its highest level in 14 years** in February, and the service sector measure also exceeding expectations. These readings support consensus expectations for **strong corporate earnings growth throughout 2018**.
- As expected, The Fed **increased interest rates** in March. Though the tone of the message was more optimistic from a growth perspective, continued moderate inflation has kept the unofficial "dot-plot" at only **two more increases** for the year.

Global/Non-US

- **The Trump administration initiated import tariffs** on steel and aluminum, followed by additional tariffs on Chinese imports. This action spurred retaliatory tariffs from the Chinese and widespread concern about an escalating trade war. **The restructuring of NAFTA is also ongoing.**
- While lagging the Fed's established normalization path, **both the ECB and the BoJ continue to provide indications of moving toward reduced accommodation** over the next 12-months.
- Irrespective of the trade issues noted above, international political tensions have eased with recent and **upcoming meetings between leaders of China, North and South Korea, and the US.**
- **The outlook for world economies remains solid,** as emerging markets are benefiting from above-trend growth in the developed countries. In the UK and Europe, concerns over Brexit have eased somewhat with recent negotiations.

Current Issues

- Keeping Score: Evaluating the Facts on the Ground
- Market Volatility in 2018: Ultra-Sensitive or Appropriately Responsive?
- Trade and Tariffs: A Material(s) Risk?
- Beyond the Fundamentals: Where Do Fund Flows and Other Market Technicals Fit In?


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**
▪ Revival of US dollar strength
▪ EPS or revenue shortfalls
▪ Oil price instability
▪ Emerging late-cycle behavior
Upside Potential
▪ US fiscal stimulus sparks sustainable growth
▪ Increase in corporate investment
▪ **Productivity and technology gains**
▪ Cash (~$15 trillion) coming off sidelines
Lower probability of achieving baseline forecasts over the cyclical horizon could create "fatter" tails
Negative Outcomes
▪ **Yield curves continue to flatten**
▪ US political fractures intensify
▪ Building evidence of class divergence
▪ **Volatility disrupts market's slumber**
▪ Higher gov't deficits, lower personal savings
Positive Outcomes
▪ **Continued strong US labor market**
▪ Sustained consumer confidence
▪ **Reduced North Korean aggression**
▪ Emerging markets remain buoyant
▪ Upward corporate earnings revisions

Market View:

- **In 2017, the market avoided material reaction** to virtually everything, with the S&P 500 recording only eight trading days of at least +/-1%.
- Year-to-date through March, this threshold has been far more attainable, with **stocks experiencing twenty-three such moves (12 increases/11 declines).**
- The **rare and simultaneous decline of both stocks and bonds** also deserves attention, as the fear of rising rates and inflation initially triggered the sell-off.

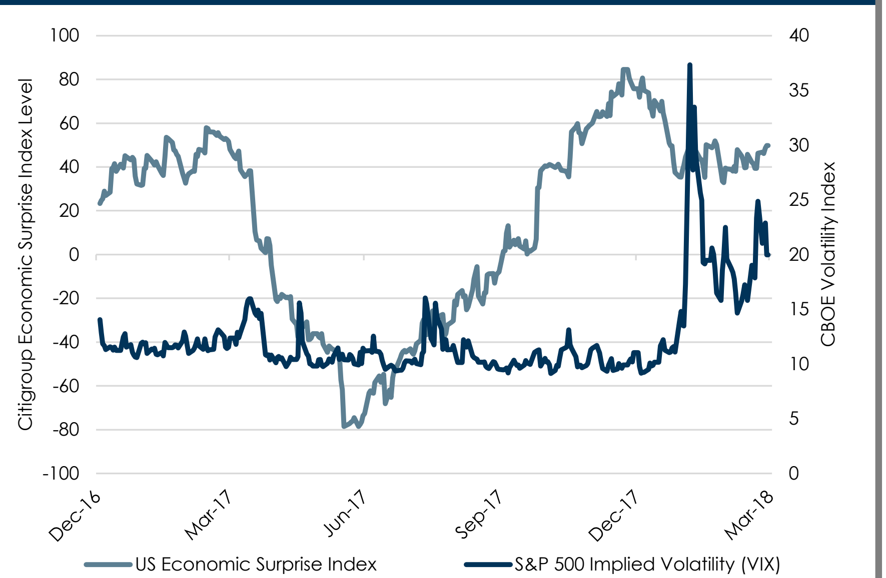
ACG Position:

- **Levels of anxiety have rightfully increased** since we are now a decade into the post-crisis recovery, and consequently one year closer to recession.
- While calm and rising markets supported the "fear of missing out…" mentality in 2017, **recent volatility may challenge the resolve of investors to "buy-the-dips".**
- **Volatility is not a bad thing, in and of itself.** Active managers welcome the opportunity to take advantage of market dispersion and better valuations.

Portfolio Implications:

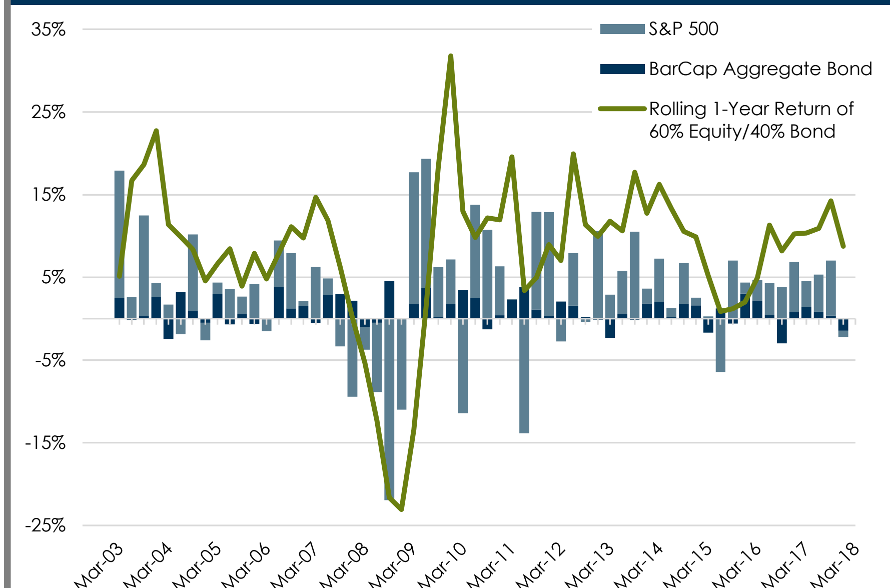
- Maintain investment discipline and **minimize asset allocation drift** through thoughtful rebalancing and cash flow decisions.
- More attractive relative valuations, along with economic cycle and currency diversification, support the **ongoing case for international equities**.
- **Incorporate diversified hedging strategies,** including both absolute return fixed income and long/short equity, to enhance downside protection.

Volatility Awakens in the New Year



Source: ACG Research, Bloomberg, Citigroup, Chicago Board Options Exchange (CBOE)

Stock-to-Bond Diversification Challenged



Source: ACG Research, Bloomberg (bars represent quarterly benchmark returns)

Market View:

- The "America First" agenda of 2017 resulted in tax cuts and deregulation, but **recently announced tariffs raise the level of anxiety regarding a trade war.**
- Past experience with tariffs, and **subsequent retaliatory measures**, have led to periods of reduced global trade, increased inflation, and currency devaluation.
- Taming the trade deficit with China appears paramount, but **vulnerabilities exist as it relates to key exports and their ownership of $1.2 trillion of US Treasuries.**

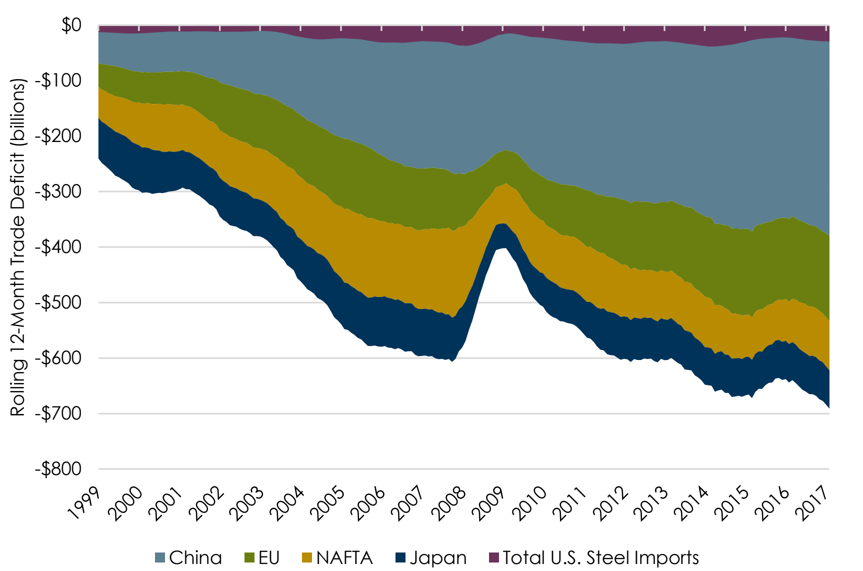
ACG Position:

- President Trump's actions **appealed to his electoral base,** even as US steel imports and the industries "protected" by the new tariffs are relatively small.
- Trade wars have not historically been "good and easy to win" as asserted in a recent Tweet, but **the prospect for diplomacy and negotiation may assuage fears.**
- Given a century of globalization, **a series of more contained tariff skirmishes would not completely disrupt** the world's deeply linked economies.

Portfolio Implications:

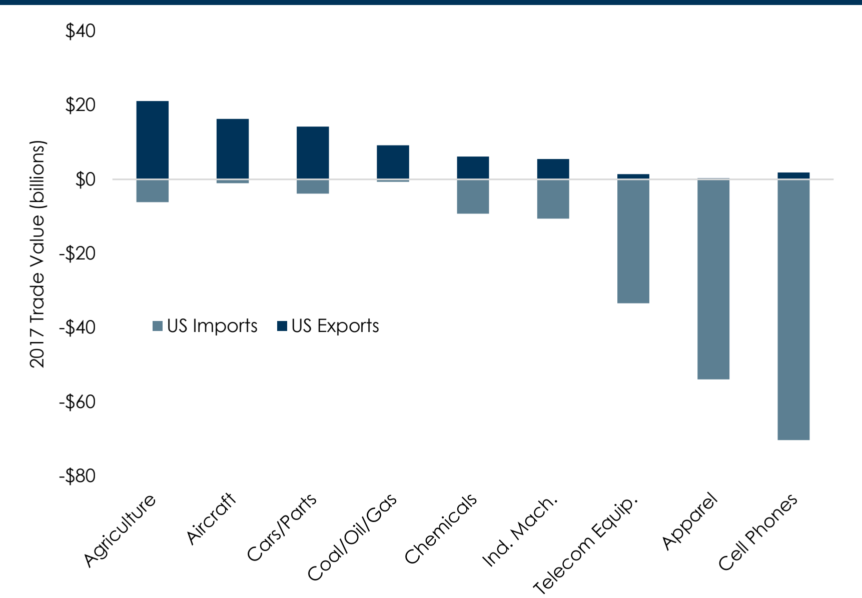
- Employ **active managers** with niche strategies and/or the flexibility to respond to potential opportunities or dislocations across affected sectors/industries.
- **Consider incorporating diversified commodities exposure**, which tends to perform well alongside unexpected bouts of inflation.
- **Accept the illiquidity premium offered by private investments** as these strategies offer differentiated results and can mitigate short-term turbulence.

Record US Trade Deficits With Key Countries



Source: ACG Research, Bloomberg, Census Bureau

Select Contributors to 2017 US-China Trade



Source: ACG Research, Bloomberg, Census Bureau

Market View:

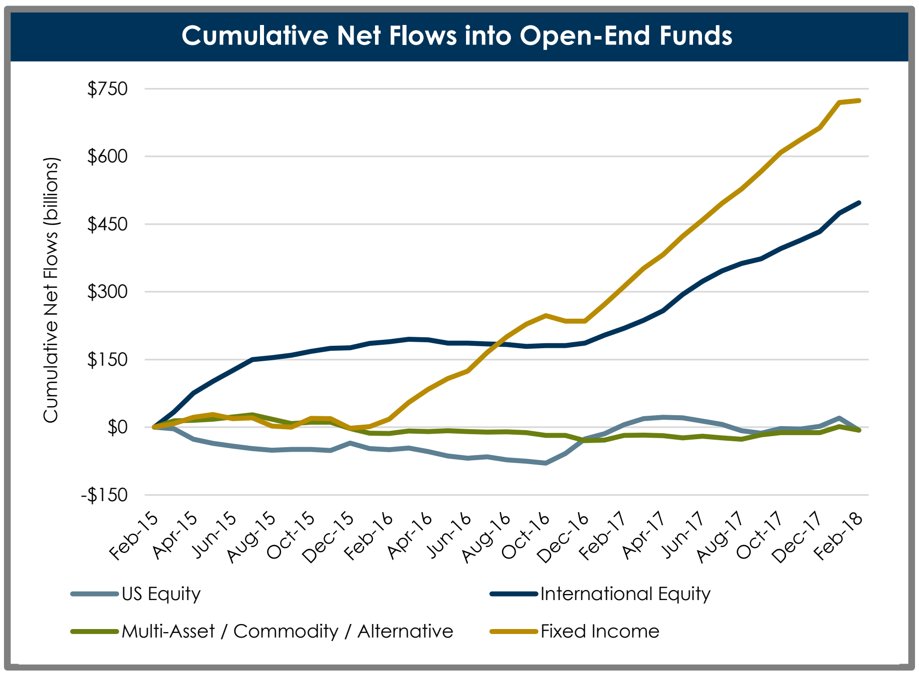
- **Index funds and other passive vehicles are dominating fund flows,** such that ~40% of global equity AUM and ~25% of fixed income AUM is now beta-driven.
- An aging population and persistent **demand for income has influenced the allocation shift toward bonds**, despite potential headwinds.
- Beyond the $2.5 trillion held in retail and institutional money market accounts, **over $1 trillion in "dry powder" exists within private equity funds.**

ACG Position:

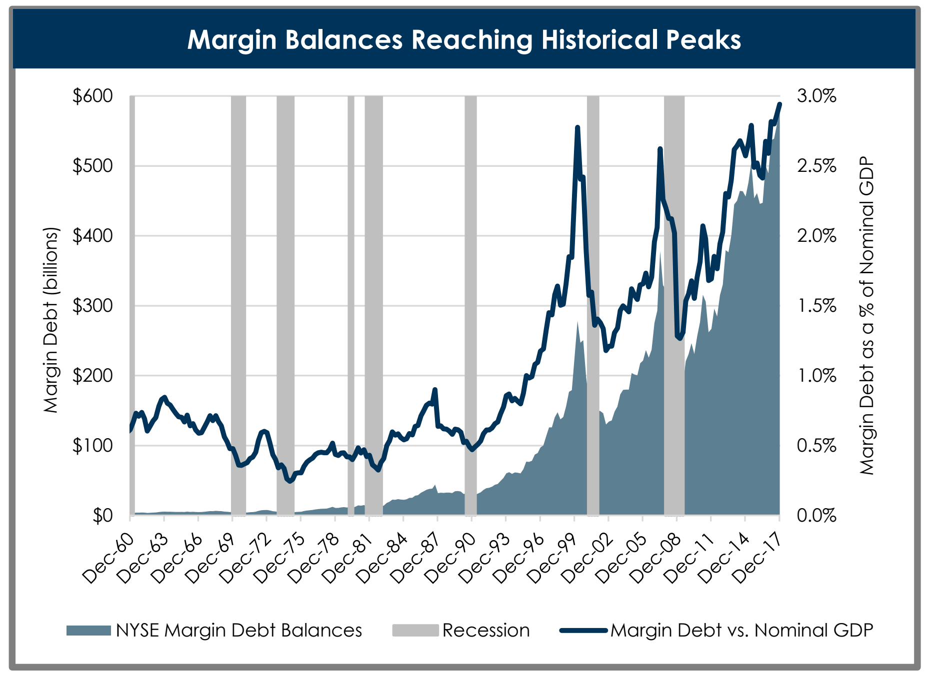
- Passive investing can drive correlations higher among broad asset classes, and there is **likely to be more "herd" momentum at key inflection points.**
- **Sector rotation is also having an impact on the markets,** with Technology (FAANG stocks) and Financials (driven by interest rates) being the most notable.
- The search for return continues to **drive investors toward riskier credit, private assets, and even leverage** at a time when asset prices are relatively full.

Portfolio Implications:

- Closely monitor overall portfolio allocations relative to strategic objectives, **preserving upside exposure without getting over-extended.**
- **Take into account long-term relationships** when establishing portfolio strategy and avoid potential late-cycle traps.
- Incorporate hedged strategies for volatility reduction, and **acknowledge that Federal Reserve activity has reduced the penalty of holding cash.**



Source: ACG Research, Morningstar



Source: ACG Research, Bloomberg, Federal Reserve Bank of St. Louis (FRED)

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 ▪ Terrorism, immigration, nuclear threats, territorial disputes, climate change, social media impact, cyber attacks	▪ Maintain global diversification; meaningful non-US exposure ▪ Increase risk-reducing and private strategies ▪ Maintain disciplined rebalancing strategy
Maturing Growth Cycle	▪ Post-crisis recovery entrenched 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 are generally unattractive, with base yields still relatively low and spreads 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 ▪ 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 ▪ Trade policy uncertainty – inflationary/deflationary?	▪ Retain meaningful equity exposure given re-pricing ability for corporate goods and services ▪ Retain core real estate (RE) exposures ▪ Incorporate diversified commodity exposure ▪ 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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