INVESTMENT ADVISORY GROUP

OUTLOOK 2019

INVESTING AMID A CAROUSEL OF CONCERNS

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OUTLOOK 2019

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Investing Amid A Carousel Of Concerns

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The *Carousel of Concerns*, a mainstay of this bull market, continues to turn. As one worry recedes, another comes to the forefront. In 2019, investors will grapple with concerns including a peak in economic and earnings growth as well as wildcards on trade and monetary policy. The reality is the future is always uncertain; however, investors are now being better compensated for taking on uncertainty as valuations have improved across the capital markets.

The balancing act between risk and reward is magnified as we head into 2019. Given recession risks remain low and profits are set to increase, we anticipate a modestly positive year for financial markets with wide price swings. Importantly, we expect tactical opportunities to present themselves as markets overshoot in both directions, and investors should be prepared to adjust as the evidence shifts.

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Investing Amid a Carousel of Concerns

2019 Key Themes

Moderating Growth

- Global economic growth has likely peaked for the cycle, and regional divergences persist; however, recession risks are low.
- US economic growth should stay above the cycle average, while Europe and Japan muddle along. Trade tensions cloud China's outlook, but its economy is well supported by government stimulus.
- Global monetary policy is shifting to a less accommodative, though not restrictive, stance while global fiscal stimulus should provide a partial offset.

A Balancing Act

- The balancing act between risk and reward is magnified as we enter the year. We expect modestly higher equity prices but also for markets to trade in both a choppy fashion and a wider range.
- There are many wildcards, but the sharp reset in equity valuations and investor expectations suggest some of these risks are already reflected in stock prices.
- Overshoots in either direction should provide tactical opportunities.

Improved Starting Points

- After a sizable step up in interest rates over the last year, the starting points for fixed income investors have improved.
- We believe the Fed funds rate is nearing neutral. As the year progresses, we expect the 10-year US Treasury yield to move slightly higher and fluctuate between the 3.0% to 3.5% range.
- Considering the balancing act in equites and higher yields, the diversifying and income benefits of bonds should be enhanced.

2019 Positioning

- Slight equity tilt relative to fixed income
- Maintain US equity bias
  - Size: Emphasize large- and mid-caps over small
  - Style: Neutral growth/value
  - Sectors: A barbell of offense and defense
- International Markets: Underweight
  - Favor emerging markets over international developed markets
  - Favor Japan relative to Europe
- Bonds: Maintain high quality bias
  - Favor slightly short duration given higher rates and flat yield curve
  - Avoid international bonds
- Non-Traditional Strategies: Favor less directional managers

Past performance is not indicative of future results
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Moderating Growth

2018 looks to have marked the peak in global economic growth during this cycle as regional divergences persist and political risks remain high. However, the threat of recession remains relatively low. The US and China—the world's two largest economies—will remain in focus. Global monetary policy is shifting to a less accommodative, though not restrictive, stance, while global fiscal stimulus should provide a partial offset.

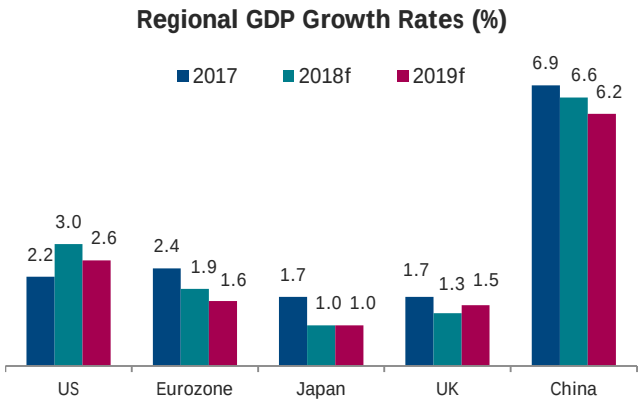
Global gross domestic product (GDP) is currently about $87 trillion, and we anticipate it to grow 3.6% in 2019, slipping slightly from 3.7% during 2018. The US economy should moderate from 2018, though growth will remain above the cycle average. Even with China's continued long-term gradual slowdown, the growth across emerging markets should remain on par with last year, while we expect more of the same from Japan and Europe (Figure 1).

Alas, the *carousel of concerns* continues to spin as trade and tariff uncertainties linger, global monetary accommodation lessens, the US deals with legislative gridlock, and political instability in Europe remains in focus. Nevertheless, we still expect generally stable global economic growth.

United States: Growth above Cycle Average

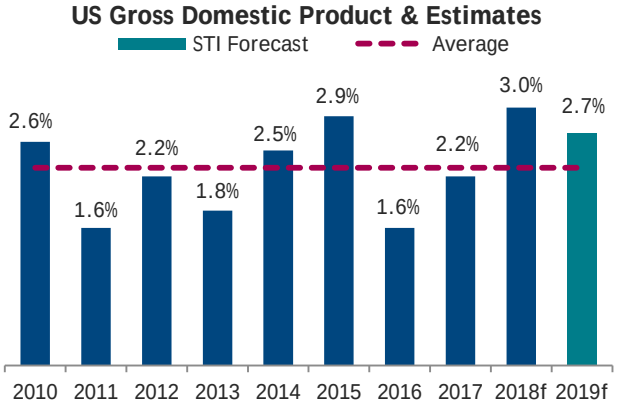
We anticipate the US expansion to surpass 10 years in mid-2019, making it the longest expansion in history. We see overall US growth slipping from 2018's stellar pace near 3% to a pace of 2.6% to 2.8% in 2019, remaining above the average growth rate of 2.3% since 2010 (Figure 2). The extension of the cycle should be driven by a strong consumer, continued business spending due to tax reform incentives and further government spending. This will be partially offset by weaker global trade and tighter financial conditions as a result of higher interest rates.

Figure 1: Global Growth Moderating But Recession Risks Low



Data Source: Bloomberg Consensus, SunTrust IAG; f = forecast

Figure 2: US Growth to Stay Above Cycle Average



Data Source: Bloomberg Consensus, SunTrust IAG; f = forecast

Consumer

Job growth and rising wages—running at a 3% rate for the first time in this recovery—provide strong support for consumer spending, which represents about 70% of the economy.

Moreover, lower personal taxes and receding gasoline prices will more than offset modestly higher interest expenses. In fact, an estimated 57% of the benefit from the lower personal tax rates in 2018 will not be realized until Americans file their taxes in 2019. Additionally, the personal saving rate is almost triple the level prior to the 2007 downturn, which suggests consumer finances are relatively healthy.

Business Spending

The upshift in capital spending should be further supported by companies' ability to write-off 100% of the cost of big ticket items, accommodative lending standards, and an estimated additional $200 billon of repatriated corporate profits in 2019.

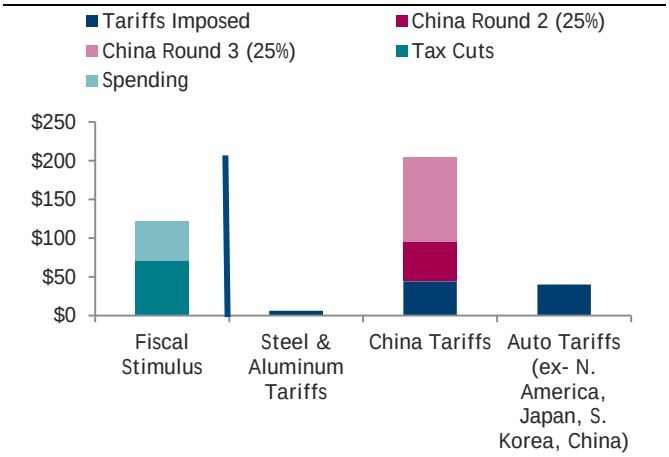
Government Spending

Government spending at the federal, state and local level is set to rise. Most prominent within government spending is the 12% boost in the primary US military budget for the 2019 fiscal year. Including other defense authorizations, total military spending will top $1 trillion, the highest amount ever.

Trade

The tariff spat with China should shave about 0.1% from overall US GDP in 2019. Thus far, there has only been a 25% tariff placed on $50 billion worth of Chinese goods and a 10% tariff placed on another $200B. However, if trade talks falter and the White House pushes forward with additional tariffs, this will more than offset incremental stimulus slated for 2019 from last year's tax bill and government spending packages (Figure 3). Further, tariffs create uncertainty, which could lead to businesses postponing investments and disrupting supply chains.

Figure 3:
2019 Incremental US Fiscal Stimulus vs Potential Tariffs



Data Source: Strategas, SunTrust IAG
Tariffs Imposed = 25% tariff on $50B worth of Chinese goods in place
Round 2: 10% to 25% tariff of $200B of goods identified, but implementation delayed
Round 3: 10% to 25% tariff on $267B goods discussed but not implemented
Assumes equal retaliation from China

Rest of the World: Regional Divergences to Persist

The global synchronization of 2017 transitioned to one of divergence in 2018, which is set to persist over the coming year. Economic activity in Europe and Japan should muddle along, while China's growth slows but remains well supported by government stimulus. Further, G-20 countries beyond China and the US are expected to apply fiscal stimulus in 2019 (Figure 4).

Europe

Over the past year, Eurozone growth was hurt by slower export growth and political instability. As we enter 2019, the Brexit saga and the Italian budget impasse remain. On the positive side, Europe, a large trading partner of China, should benefit from stabilization in China's economy. Monetary policy remains accommodative, and fiscal stimulus is expected in key European countries. Still, until some of the political uncertainties are resolved, growth is likely to remain underwhelming.

Japan

Prime Minister Shinzo Abe's ambitious economic program has boosted nominal growth to a multi-decade high. Japan is also enjoying its longest run of labor force growth since the late 1990s, as more women enter the work force and there has been a gradual increase in foreign workers. In the coming year, the Japanese government is set to undertake a series of massive reconstruction projects along with 2020 Tokyo Olympic-related construction. The main risks to growth stem from a potential consumption tax that could occur later in 2019 and weaker-than-expected global growth and trade.

Emerging Markets

Emerging markets (EM) have been a primary casualty of higher interest rates and a stronger US dollar, which increased the cost to service debt. Consequently, EM central banks raised rates to help support their currencies and stem capital outflows. This further exacerbated the slowdown as business activity surveys took a turn down. Now, however,

Figure 4: Fiscal Stimulus Expanding Globally
Announced & Recently Enacted Global Fiscal Stimulus

China	Expectations for an increase in fiscal spending by >1% of GDP.
France	Announced a minimum wage hike, eliminated taxes on both overtime pay and year-end bonuses.
Italy	Proposed budget with a 2019 deficit of 2.0% of GDP vs. the prior planned deficit of 0.8%, driven by a boost to social spending.
Germany	Plans for additional public expenditures for 2018-2022 equate to 0.34% of GDP annually.
Canada	Announced corporate tax breaks over six years worth $10.5bn ($14bn CAD) and regulatory reform.
Japan	Considering a stimulus package of $17.7bn, and nearly half could be used for infrastructure.

Source: Strategas, SunTrust IAG

many of the larger EM countries' central banks appear to be nearing the end of their monetary policy tightening cycles, and the weaker currencies support exports. Additionally, key headline-grabbing countries within EM, such as Turkey and Argentina, are expected to cut rates as inflation moderates.

We expect China, the world's second largest economy, to maintain growth just above 6%. While trade tensions cloud the outlook, growth should be aided by fiscal stimulus measures starting in early 2019, targeting specific industries. For instance, an income tax cut for low-wage workers will take effect in January 2019 along with other tax cuts worth about 1% of GDP. Local-level governments have also been instructed to accelerate infrastructure spending. Furthermore, the People's Bank of China (PBOC) continues to loosen monetary policy, and it has much more room to cut, if needed. Finally, the currency weakness should help exports (Figure 5).

We also expect positive contributions to EM growth from India, Brazil, South Africa and smaller countries in the Middle East and Africa. There will, however, be growing pains associated with newly-elected and untested regimes in Mexico, Brazil, and Colombia. Furthermore, upcoming elections in India, Indonesia and Argentina also have the potential to further fog outlooks.

Figure 5: China Growth Should Stabilize in First Half

(l) = yuan |(r) = export orders
Data Source: Cornerstone Macro, SunTrust IAG
The China Nominal Trade-Weighted Yuan was advanced 6 months.
Monthly data as of 11/28/2018.

A Balancing Act

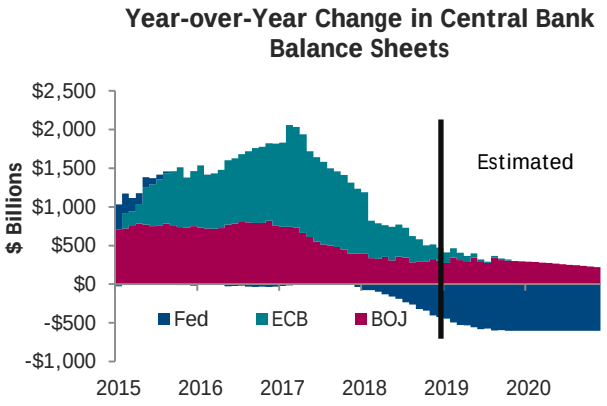
The balancing act between risk and reward is magnified as we head into 2019. We expect modestly higher equity prices but also for markets to remain choppy and trade in a wider range. While there are many wildcards, valuations have contracted significantly, and investors are being better compensated for taking on an uncertain future. We expect to see markets overshoot in both directions, which should provide tactical opportunities. We maintain a US bias, an emphasis on large and mid caps, are neutral growth versus value and advise a barbell sector strategy. We favor emerging markets over international developed markets and Japan relative to Europe.

Entering 2019, investors are grappling with concerns including a peak in economic and earnings growth, less global liquidity (Figure 6) and wildcards on trade and US monetary policy. These concerns are offset by low recession risks and the sharp reset in equity valuations that suggest some of these risks are already reflected in stock prices. From its January 2018 peak, the forward price-to-earnings (P/E) ratio for the global equity market has declined from 17.3x to 13.3x, a more than 20% decline, led by emerging markets (Figure 7).

Our expectation is for equity markets to ultimately trade higher in 2019, but the path forward will be jagged as the aforementioned wildcards on growth and policy unfold. We are likely to see markets overshoot in both directions during the year. This may feel unnerving at times, but should provide tactical opportunities to adjust equity positioning.

Indeed, we expect the market range in 2019 to increase toward the historical norm. Volatility bounced back in 2018, but the gap between the S&P 500's closing high and low price was just under 14% versus an average gap of 27% since 1950 (Figure 8).

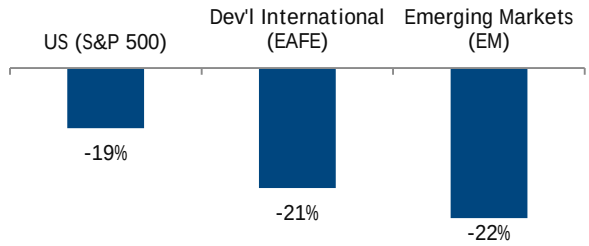
Figure 6: Less Global Liquidity…



Billions of US$ at 11/2018 Exchange Rates
Source: Haver, SunTrust IAG; ECB's QE ending at 2018 yearend; Fed's balance sheet is declining at rate of $600 billion yearly; BOJ's balance sheet expected to grow at slower rate over time.

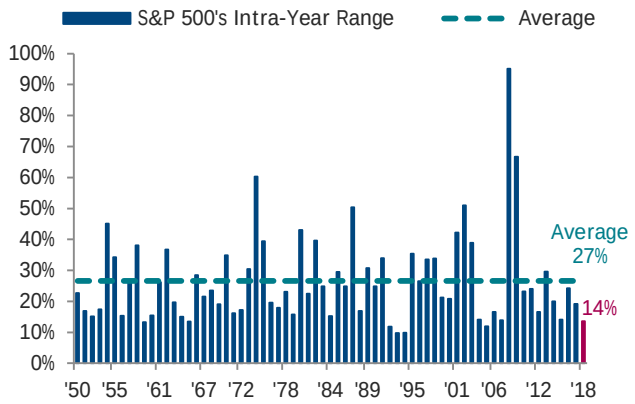
Figure 7: …Offset by a Significant Contraction in Valuations

Decline in Forward P/Es from 2018 Peak			
	Peak	Current	Change
US (S&P 500)	18.5	14.9	-19%
Dev'l International (EAFE)	15.5	12.2	-21%
Emerging Markets (EM)	13.5	10.5	-22%



Data Source: Factset, Haver, MSCI, SunTrust IAG; as of 12/14/18

Figure 8: We Expect the Market Range in 2019 to Increase



Data Source: Bloomberg, SunTrust IAG; as of 12/14/18

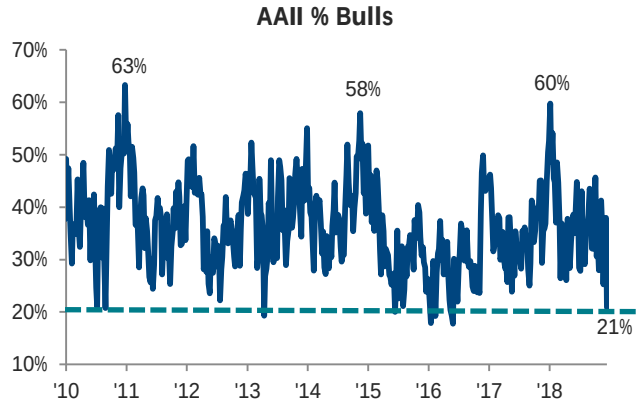
While the risks may appear skewed to the negative side, we see them as balanced, as relief on any of the current concerns provide upside potential. Indeed, the hurdle rate for positive surprises appears much lower heading into 2019 compared to 2018 given depressed investor expectations.

For instance, a recent poll from the American Association of Individual Investors (AAII) shows the percentage of bullish investors has dropped to a multi-year low of 21% (Figure 9). This compares to nearly 60% bulls entering 2018, which was the highest since late December 2010 (which also preceded a flat year in the stock market in 2011). Similarly, the Hulbert Sentiment Index shows that bullish newsletter sentiment is in the bottom 5% of historical readings in contrast to a year ago when it was in the top 5%.

Maintaining US Bias

Although the US outperformed much of the globe, after a record-tying nine straight years of positive returns, the past year proved to be a *bumpy* period. This challenging environment occurred despite a strong rebound in US economic growth and more than 20% earnings growth. The market is forward looking, and this good news was partially priced into markets as evidenced by the strong returns in 2017. Moreover, as the economy improved, interest rates rose, and financial conditions tightened accordingly. This serves as a cautionary note about over-extrapolating seemingly positive or negative news. Investing is not about good or bad on an absolute basis but about what expectations are priced into stocks.

Figure 9: Percentage of Bulls at Multi-Year Lows



Data Source: AAII, SunTrust IAG

An encouraging aspect of the sideways action for stocks over the past year is that we have seen a healthy reset of valuations. Notably, since 1950, there have been 13 years where the S&P 500 saw double-digit earnings growth and P/E contraction. **Similar to 2018, these years proved to be challenging: stocks had an average price return of just 0.2%, despite earnings growth that averaged more than 20%.**

Importantly, in the following year, despite earnings growth that, on average, was cut in half—and in some years, such as 1988 and 2011, where profits were flat—stocks averaged a gain of 11% (14% when excluding the 1973 recessionary period). Returns were driven primarily by earnings and stabilizing P/Es (Figure 10).

We estimate an S&P 500 earnings range for 2019 of $171 to $173, or growth of 5% to 6%—below the consensus of 9%—which tracks closer to our forecast of nominal GDP and includes corporate buybacks.

Notably, earnings tend to rise outside of recessions, and stocks have increased 85% of the time during expansionary periods (Figure 11). We continue to view recession risks as low. Since WWII, there has never been a recession while profits were up. Historically, the administration in power also tends to do whatever it can to stimulate the economy in the year before a presidential election.

Figure 10: Market Statistics Following Double-Digit Earnings Growth Years with P/E Contractions

Year	Price Return	Earnings Growth	P/E Point Contraction	Price Return Next Year	Earnings Growth Next Year	P/E Point Change Next Year
1959	8%	17%	(1.5)	(3%)	(4%)	0.1
1962	(12%)	15%	(5.3)	19%	10%	1.5
1973	(17%)	27%	(6.6)	(30%)	9%	(4.3)
1984	1%	21%	(1.9)	26%	(2%)	2.9
1987	2%	26%	(2.9)	12%	23%	(1.1)
1988	12%	23%	(1.1)	27%	1%	3.0
1993	7%	29%	(3.5)	(2%)	18%	(2.9)
1994	(2%)	18%	(2.9)	34%	19%	1.9
2002	(23%)	19%	(10.4)	26%	19%	1.2
2004	9%	24%	(2.4)	3%	13%	(1.6)
2005	3%	13%	(1.6)	14%	15%	(0.2)
2010	13%	47%	(4.6)	(0%)	15%	(2.0)
2011	(0%)	15%	(2.0)	13%	0%	1.7
***2018**	**(3%)**	**26%**	**(4.9)**	**?**	**?**	**?**
Average	**0%**	**23%**	**(3.6)**	**11%**	**10%**	**0.0**
Average ex-1973 recession	**2%**	**22%**	**(3.3)**	**14%**	**11%**	**0.4**

Study reviewed periods since 1950 with double-digit earnings growth, >1 point of trailing PE contraction. Return and P/E contraction for 2018 based on 12/14/18 close. Data Source: Factset, Standard & Poor's, SunTrust IAG

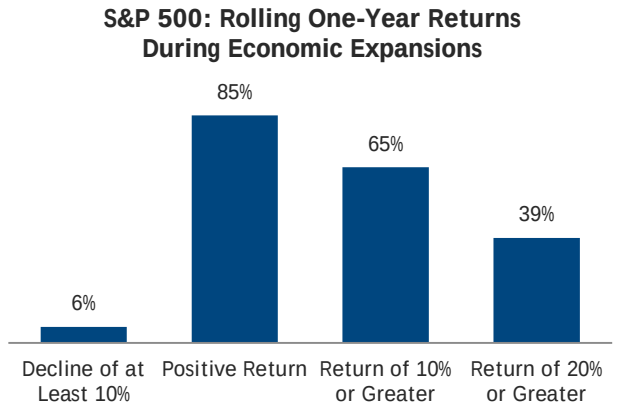
Forecasting exactly where a market will stand on an arbitrary day, such as December 31, or any other random day, is treacherous at best. We place much greater emphasis on, and have greater confidence in, market direction and relative opportunities. That said, we view a reasonable 2019 baseline price return assumption for the S&P 500 in the mid- to high-single digits. This estimate is built upon the premise that the price-to-earnings ratio (P/E), which has already contracted substantially, stabilizes, and investor returns are driven primarily by profits.

Upside/Downside Market Scenarios

An upside to our baseline return assumption would likely be predicated on factors such as a pause in the Federal Reserve's tightening cycle, progress on trade negotiations, and better global growth. In this scenario, we see upside potential for the S&P 500 to a level near 3,000. This represents about 15% upside to the mid-December market level of 2,600. We get there by assuming the P/E on the market expands to 17x, which approximates the average P/E awarded to the market historically in low inflation environments. We apply that valuation to the current 2019 consensus earnings estimate of $177.

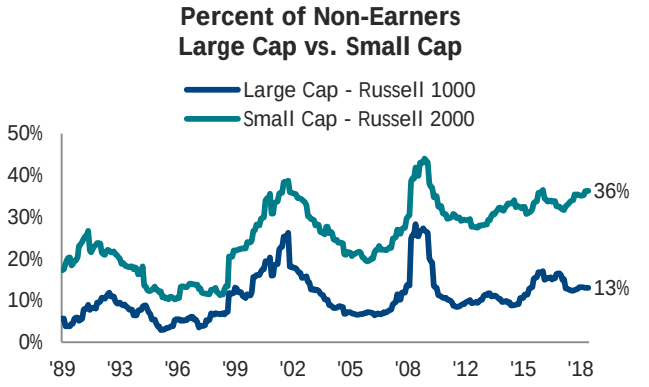
Conversely, a more aggressive Fed, tariff escalation, and weak economic growth could lead to deeper market declines. In this scenario, we estimate that market downside for the S&P 500 should be contained to around 2,350, or roughly 10% below current levels. This approximates a 50% price retracement of the S&P 500 advance from the 2016 price lows to the late 2018 peak. We get there by assuming the S&P 500's P/E contracts to 14x, which is slightly below the valuation level reached in early 2016 surrounding China and global growth concerns. We apply that valuation to a below-consensus earnings number of $168. The gap between the bull/bear cases is in line with the aforementioned average historical average range of 27%.

Figure 11: Market Tends to Rise during Economic Expansions



Data Source: Factset, Haver, SunTrust IAG

Figure 12: 36% of Small Caps Are Not Earning a Profit



Source: Strategas, SunTrust IAG

Positioning Within the US

Emphasize Large and Mid Caps Over Small

We prefer higher quality stocks with an emphasis on large and mid caps at this stage of the cycle. Small cap valuations have improved, but as we move further away from loose monetary policy, it is becoming a more challenging environment for these companies that tend to be more reliant on the debt markets. About 60% of small cap debt is junk-rated versus less than 10% for the S&P 500; 40% of small cap debt is floating and more sensitive to higher short-term rates. Moreover, 36% of the Russell 2000, a benchmark for small cap stocks, did not produce earnings over the past 12 months, and profit trends are deteriorating relative to large caps (Figure 12).

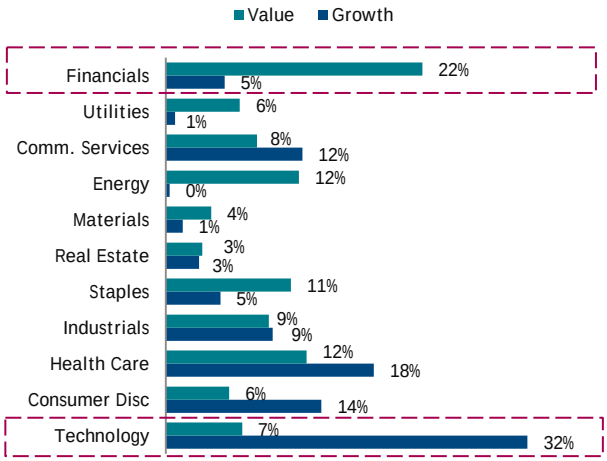
Remain Neutral Growth/Value

We view the relative opportunity between the value and growth styles as neutral. The growth outperformance cycle is extended by historical standards, and, as a result, relative valuations for growth are on the high side. Moreover, the relative performance for value started to improve early in the fourth quarter as a number of growth names, particularly in technology, slumped. The value style also has a higher dividend yield and defensive sector allocation, which should help during volatile market periods. These factors provide a case for the value style.

However, we expect investors will continue paying a premium for companies that can deliver above-average growth against a moderating economic, earnings, and interest rate environment. Notably, differences in style performance have been mainly driven by sector exposure within growth and value (Figure 13). Growth has a large allocation in technology, while value has its largest allocation in financials. Although technology companies are facing headwinds with heightened scrutiny from Washington, financials, such as banks, have also struggled with a flattening yield curve. We expect only a modest rise in interest rates in 2019 and the curve to stay relatively flat. The energy sector is also a much larger weight in the value style and given moderating global growth, oil prices should be constrained.

Thus, while value's improved performance may continue near term, we are not yet convinced that a multi-year outperformance cycle is underway. More likely is that a sustained outperformance cycle for value comes after we have an economic reset—that is, a recession followed by a sharp economic rebound which favors sectors more prominent in the value index.

Figure 13: Large Value/Growth Sector Composition



Data Source: FactSet, SunTrust IAG
Data as of 12/17/2018. Large Cap Value is represented by the S&P 500 Value Index. Large Cap Growth is represented by the S&P 500 Growth Index.

Sector Positioning: A Mix of Offense and Defense

Given our outlook for wide market swings and sharp rotations, we advise a barbell sector approach. On the offensive side, we currently favor technology and industrials. The technology sector, after a sharp pullback in the latter part of 2018, is now only trading at a slight premium to the overall market, while the earnings outlook remains positive. As mentioned, we anticipate investors will pay a premium for growth in a moderating global economic backdrop. Industrials would be among the biggest beneficiaries of progress on the trade front as well as any pickup in capital expenditures. On the defensive side, we favor a combination of healthcare, consumer staples, and REITs. We expect these sectors to hold up well during periods of concerns related to global growth and market turmoil. For example, when the broad-based market corrected about 10% late in the year, the average decline for these sectors was less than 4%.

International Markets: Remain Underweight but Positioning Matters

We remain underweight international markets. Outside the US, we favor emerging markets over developed markets and Japan relative to Europe.

Europe – Remain Underweight

Following another year of underperformance, investor sentiment toward international developed markets and Europe, in particular, remains dour. Consequently, valuations relative to the US have cheapened to the lower end of the historical range. However, we still advise an underweight position to Europe given political headwinds, mixed earnings and economic trends, and high exposure to banks, which are in a weaker position relative to the US.

On the positive side, monetary policy should remain much easier relative to the US, and there is scope for fiscal stimulus initiatives in key nations, such as Germany, France and Italy. Moreover, given depressed investor expectations, progress on the political front, particularly in the United Kingdom or Italy, could set up a situation where a little bit of good news would go a long way. Thus, we expect the political turmoil to create opportunities during the year but remain underweight for now.

Japan – Maintain Tilt but Monitor

Although a focus on long-term issues, such as poor demographics and high public debt, has kept many investors negative on Japan's stock market, a number of positive developments have taken hold in recent years as a cultural shift is underway. Companies have benefitted from lower corporate tax rates and expansive monetary policy, and now place a greater focus on corporate profitability and governance. Consequently, earnings have moved to a record high.

The outlook for profits remains bright, and we expect shareholder-friendly activities, such as dividends and share buybacks, to continue. These developments appear underappreciated, as Japan remains one of the cheapest markets among the developed countries. It is currently trading at a 12x P/E, roughly a 10% discount to the global market versus an average premium of 10% over the past 15 years. The main risks to our outlook are a weaker-than-expected global economy and a potential consumption tax later in 2019 that could dampen economic activity.

Past performance is not indicative of future results
Please see important disclosures for additional information

Emerging Markets: High Risks, High Potential Return

After a very strong 2017, emerging markets (EM) became one of the weakest performers over the past year. It had a peak-to-trough pullback of more than 25% before stabilizing in the fall.

Tighter financial conditions, slowing economic growth, trade friction and a strong US dollar have all weighed on EM, especially China, which represents more than 30% of the EM index. These risks remain as we enter 2019. Indeed, a measure of policy-related economic uncertainty in China has jumped to one of the highest levels in the past twenty years (Figure 14).

There are some mitigating factors, however, as China's government has already injected fiscal and monetary stimulus. Ultimately, we believe that Chinese leadership will do whatever it takes to stabilize the economy.

Importantly, EM valuations are back to early 2016 levels, when China and global growth concerns were in focus (Figure 15). Moreover, EM currencies, which had been under pressure, have stabilized; this is notable as EM's relative underperformance has gone hand in hand with a strong US dollar. From a historical perspective, once the deepest drawdown has occurred for EM during a calendar year, it has averaged a 12-month gain of 32%.

Figure 14: Policy Uncertainty in China Remains Elevated

Data Source: Baker, Bloom, Davis; Economic Policy Uncertainty, SunTrust IAG

Figure 15: Emerging Market Valuations Back to 2016 Lows

Data Source: FactSet, MSCI, SunTrust IAG

Improved Starting Points

After a sizable *step up* in interest rates over the past year, the starting points for fixed income investors have improved. While 2018 was a challenging year for most fixed income asset classes, higher rates set the stage for better performance going forward. We maintain a focus on high quality and prefer a slightly short duration, especially since shorter-term yields are now relatively attractive.

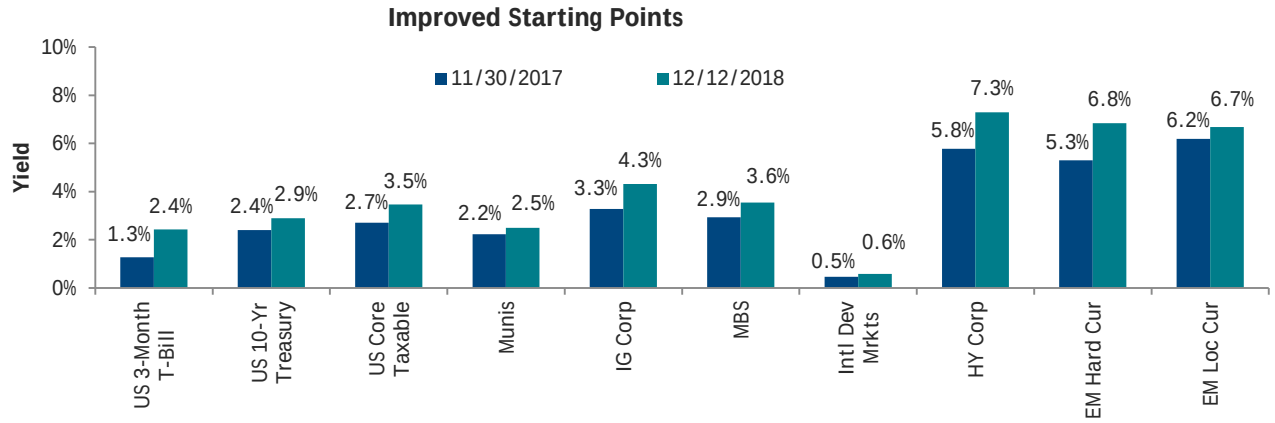
Improved Starting Points

The yield for US core fixed income has almost doubled from the low of 1.8% in July 2016 to 3.5%. In fact, most fixed income asset classes have seen starting points improve (Figure 16). Although we expect higher interest rates in 2019, we believe that the rise will be modest, both for the short and long end of the yield curve.

Over the past three-plus years, the Federal Funds target rate has moved from nearly 0% to over 2%.

Although the pace of normalization started slowly, rate hikes accelerated along with economic growth over the last two years. However, we expect the pace of rate hikes to slow again in 2019 as we believe the Fed is much closer to neutral. While growth and employment continue to be solid, some segments of the economy are already feeling the impact of higher rates, such as autos and housing, while uncertainty on trade lingers. Importantly, inflation—part of the Fed's dual mandate—is easing due to weaker oil prices, the stronger US dollar, and a moderating housing environment.

Figure 16: Improved Yields Across Fixed Income

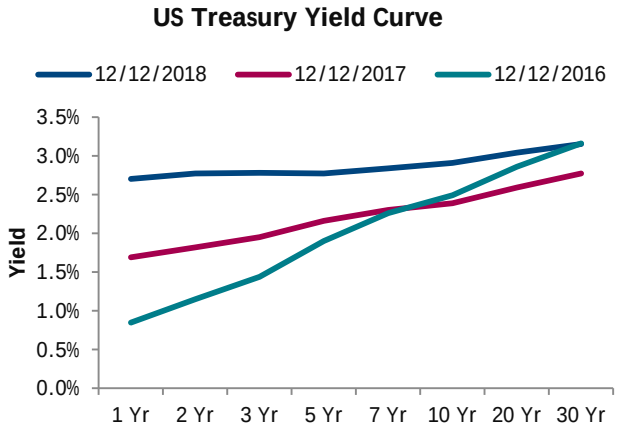


Data Source: FactSet; US Core Taxable = Bloomberg Barclays US Aggregate Bond Index; Munis=Bloomberg Barclays Municipal Bond Blend 1-15 Year; IG Corp=Bloomberg Barclays US Aggregate IG Corporate Bond Index; MBS=loomberg Barclays US MBS Index; Intl Dev Mrkts=ICE BofAML Global Government x the US; HY Corp=ICE BofAML US High Yield Bond Index; EM Hard Currency=JPM EMBI Global Diversified Index; EM Local Currency=JPM GBI-EM Global Diversified Index

We expect the Fed to raise rates twice in 2019, but this will be highly dependent on the path of economic data and the *carousel of concerns*. As the year progresses, we expect the 10-year US Treasury yield to move slightly higher and fluctuate between the 3.0% to 3.5% range. Tighter labor markets, rising US fiscal deficits, Fed rate hikes and balance sheet reduction, as well as less accommodative overseas central banks, support higher rates. However, the magnitude of the rise in rates should be constrained due to moderating global growth, easing inflation and Treasuries' status as a safe haven. Similar to the equity market, rates could overshoot—higher or lower—based on the development of geopolitical events, such as Brexit and the direction of US-China trade negotiations.

With short-term yields rising faster than longer-term yields, the spread between the 2- and 10-year US Treasury yields has narrowed significantly (Figure 17). It is not unusual for the yield curve to stay flat for an extended period of time, as it did during the strong economic environment from 1995 to 2000. This does not necessarily mean that a recession is imminent; even if the yield curve inverts, it generally takes well over a year before the economy tips into recession.

Figure 17: With Flatter Curve, Short-Term Yields Attractive



Data Source: FactSet using US Treasury yields; SunTrust IAG

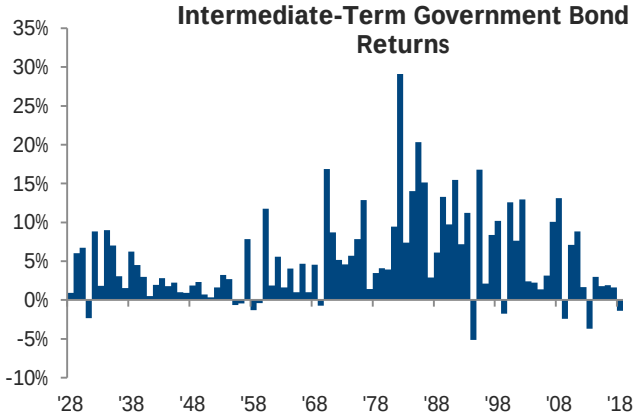
Positioning

Within fixed income, we retain a focus on high quality bonds, a slightly short duration posture, and a position in floating-rate bank loans to start 2019.

High Quality Focus

After the step up in interest rates, high quality bonds should see better performance in 2019. Looking at historical returns back to 1926, intermediate-term government bonds have only had two instances of back-to-back negative annual returns, occurring in the 1950s (Figure 18). Even long-term corporate bonds have rarely had consecutive negative annual returns.

Figure 18: Rare for High Quality Bonds to Have Two Straight Negative Years



Data Source: Morningstar
Intermediate-term government bonds are represented by the IA SBBI US Intermediate-Term Government Bond Index: the index measures the performance of a single issue of outstanding US Treasury note with a maturity term of around 5.5 years. It is calculated by Morningstar and the raw data is from Wall Street Journal.

Moreover, given our expectation for broader equity price swings, high quality fixed income should provide a degree of stability during periods of market turmoil, as was the case in 2018. Indeed, during the 10% equity correction early in the year, the Bloomberg Barclays US Aggregate Bond Index, a measure of high quality bonds, was only down 1%. Further, in the late year double-digit equity setback, it rose about 1%. Finally, we continue to prefer being slightly short duration, especially since shorter-term yields are now relatively more attractive.

Better Year Expected for Credit

In 2018, investment grade corporate bonds had their worst return since 2008. This was driven by two factors—higher rates and credit concerns causing spreads to move to the widest level since the summer of 2016.

The cause for the spread widening includes downgrades for a few large issuers and mergers and acquisition activity. Additionally, BBB-rated companies make up 50% of the investment grade corporate bond universe's market capitalization, up from 43% in 2013. While this represents a risk for the space, BBB-rated companies are still investment grade and fundamentally sound. Moreover, interest coverage ratios, a measure of how many times a company's earnings before interest, taxes, depreciation and amortization can cover interest expense, remain around both shorter- and longer-term averages.

With the *carousel of concerns* expected in 2019, we would not be surprised to see spreads widen modestly on any risk-off event, and we expect investors to be quick to punish the universe for any company-specific troubles—so there is headline risk. Still, barring the economy falling into recession, investment grade corporate bonds should have a better year in 2019.

High yield corporate bonds have benefitted from a strong economic backdrop and lower sensitivity to rising rates over recent years. However, high yield spreads have now widened to their widest level in two years as concerns grow about the stage of the credit cycle. Thus, valuations for high yield bonds have improved but are not yet compelling, and we are sticking with a high quality focus. However, if we see a further improvement in valuations and the economy stays resilient, this is an area we are monitoring for a tactical opportunity.

We continue to see value in holding a modest position in floating-rate bank loans. Their purpose is to provide a hedge against rates rising faster than expected and a source of yield. They are also higher in the capital structure relative to high yield bonds. We are cognizant of the concerns emerging in this asset class, such as the huge amount of issuance, loosening credit standards, and diminishing investor interest, which we are monitoring closely. However, with the late year selloff, valuations have improved.

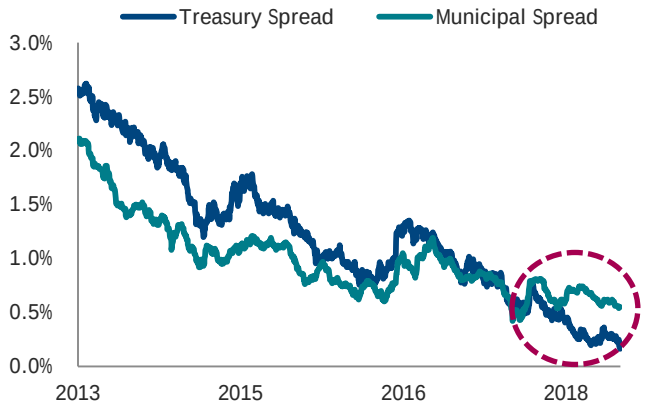
Securities with floating interest rates generally are less sensitive to interest rate changes but may decline in value if their interest rates do not rise as much, or as quickly, as prevailing interest rates. Unlike fixed-rate securities, floating rate securities generally will not increase in value if interest rates decline. Changes in interest rates also will affect the amount of interest income the Fund earns on its floating rate investments. Floating rate securities involve liquidity risk, which may affect the ability of investors to buy and sell them at the desired time or price.

Municipal Bonds Offer Value

Municipal bonds enter 2019 with generally strong credit fundamentals and fair valuations. In contrast to the US Treasury curve, the municipal curve steepened over the past year as many retail investors piled into shorter-term bonds to limit interest rate volatility (Figure 19). As of mid-December, the spread between 2- and 10-year municipal bonds was 0.70% compared to the US Treasury curve difference of just 0.11%. Given this spread, we see value in the 6- to 10-year portion of the municipal curve. We still favor portfolios tilted toward an overall shorter duration, and from a relative value perspective, we advise utilizing both the shorter and middle portions of the curve.

From a credit perspective, we favor remaining up in quality and maintain a focus on essential revenue services, transportation and select healthcare. We are wary of credits that may be negatively affected by tariffs—specifically ports that rely on cargo. This underlines the importance of credit research as an essential part of municipal bond management.

Figure 19: Treasury Curve Has Flattened While Municipal Curve Has Steepened



Data Source: FactSet, SunTrust IAG

International Bonds to Remain Challenged

Dominated by Japan and Europe, representing 85% of the universe, international developed market sovereign bonds had a great deal of headwinds in 2018. While yields were only up slightly, the asset class experienced losses on the currency side, and the outlook does not appear much more favorable for 2019. Given the lower yields, higher sensitivity to rising rates as central banks become slightly less accommodative and exposure to currency risk, we are avoiding this space.

The environment has been even more challenging for emerging markets (EM) bonds. Consequently, yields have become more attractive, especially for hard currency EM bonds. However, given our high quality focus, we remain on the sidelines due to the below-investment-grade rating of the asset class. The universe is about 50% non-investment grade and has exposure to countries with more vulnerable macro fundamentals. Local currency EM bonds do not look as attractive in terms of yields and spreads and are also subject to currency risk; thus, we continue to avoid them as well.

Past performance is not indicative of future results
Please see important disclosures for additional information

NON-TRADITIONAL STRATEGIES

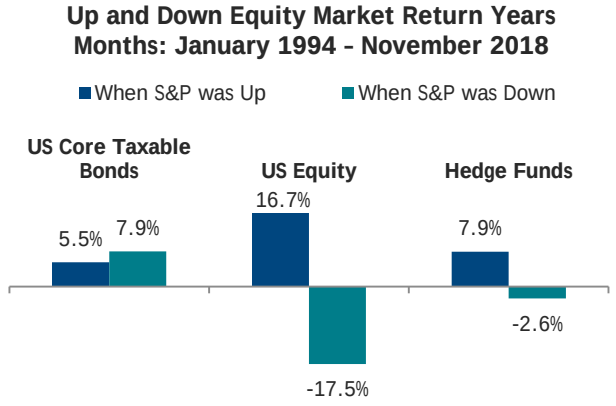
INVESTMENT ADVISORY GROUP

Given our outlook for a choppier path for stocks and a modestly higher range for bond yields, non-traditional strategies provide opportunities for portfolio diversification.

We expect market volatility to persist in 2019 as investors contend with rising global macro uncertainty, geopolitical risks and tighter financial conditions. Against this environment, we see value in holding certain alternative strategies to help balance portfolio risks (Figure 20). Hedge fund manager performance varies significantly, and the importance of manager selection is magnified (Figure 21).

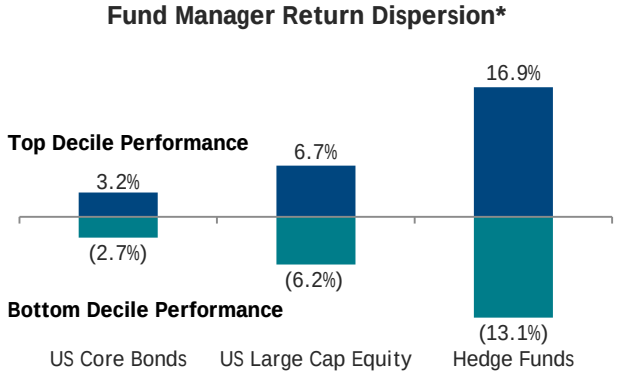
We favor strategies that have less directional biases and prefer an anchor position in diversified strategies. These strategies invest in opportunities across the hedge fund spectrum providing some level of relative performance consistency. Moreover, as we move later in the business cycle and with tighter financial conditions, we see a more fertile environment for some strategies, such as hedged equity, in which managers can take advantage of greater stock dispersion across various market segments.

Figure 20:
Alternatives Provide Potential Diversification Benefits



Data Source: FactSet, SunTrust IAG

Figure 21:
Hedge Fund Manager Selection Is Key



Data Source: FactSet, Haver, Hedge Fund Research, Morningstar, Barclay Hedge, BlackRock, SunTrust IAG

Core taxable bonds represented by the Bloomberg Barclays US Aggregate Bond Index, US equity represented by the Standard & Poor's 500 Index and Hedge Funds represented by the HFRI FOF: Diversified Hedge Fund Index.

Hedge fund investing involves substantial risks and may not be suitable for all clients. Hedge funds are intended for sophisticated investors who can bear the economic risks involved. Hedge funds may engage in leveraging and speculative investment practices that may increase the risk of investment loss, can be illiquid, and are not required to provide periodic pricing or valuation information to investors. Hedge funds may involve complex tax structures, have delays in distributing tax information, are not subject to the same regulatory requirements as mutual funds and often charge higher fees.

Managed Futures and commodity investing involve a high degree of risk and are not suitable for all investors. Investors could lose a substantial amount of money in a very short period of time. The amount you may lose is potentially unlimited and can exceed the amount you originally deposit with your broker. This is because trading security futures is highly leveraged, with a relatively small amount of money controlling assets having a much greater value. Investors who are uncomfortable with this level of risk should not trade managed futures or commodities.

Relative value and global macro strategies should be able to take advantage of differentiation within and across markets and economies. The lack of sustained trends in some markets along with increased volatility in systematic trading strategies is likely to keep returns challenged for managed futures.

On the event-driven side, we remain constructive on merger arbitrage strategies given continued deal activity. Repatriated cash from corporate tax reform and reduced regulatory uncertainty from Washington should further encourage deal activity as companies seek growth through improved synergies.

Consistent with our fixed income preference for higher quality, we are less constructive on credit strategies. Despite continued economic growth, which is generally good for credit, valuations and yields are not yet compelling. However, as the cycle further matures, credit markets tighten and defaults and leverage move higher, we could eventually see better opportunities in hedged credit strategies.

Hedge fund investing involves substantial risks and may not be suitable for all clients. Hedge funds are intended for sophisticated investors who can bear the economic risks involved. Hedge funds may engage in leveraging and speculative investment practices that may increase the risk of investment loss, can be illiquid, and are not required to provide periodic pricing or valuation information to investors. Hedge funds may involve complex tax structures, have delays in distributing tax information, are not subject to the same regulatory requirements as mutual funds and often charge higher fees.

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High Yield Fixed Income Investments, also known as junk bonds, are considered speculative, involve greater risk of default and tend to be more volatile than investment grade fixed income securities.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include potential economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in emerging market countries, since these countries may have relatively unstable governments and less established markets and economies.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations, and illiquidity.

Emerging Markets: Investing in the securities of such companies and countries involves certain considerations not usually associated with investing in developed countries, including unstable political and economic conditions, adverse geopolitical developments, price volatility, lack of liquidity, and fluctuations in currency exchange rates.

Asset classes are represented by the following indexes:

MSCI ACWI index (Morgan Stanley Capital International All Country World) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices.

S&P 500 Index is comprised of 500 widely-held securities considered to be representative of the stock market in general.

The Nikkei is an abbreviation for Japan's foremost, best known, and most respected stock index of Japanese companies. Its full name is Nikkei 225 Stock Average. This index is price weighted and made up of the top 225 industry leading companies which investors trade on the Tokyo Stock Exchange.

Investment grade corporate bonds are represented by the Blomberg Barclays US Corporate Investment Grade Bond Index which includes publicly-issued US corporate and specified foreign debentures and secured notes which have at least one year to maturity, have at least $250 million par amount outstanding, are fixed rate, and are rated investment grade.

Aaa Corporate Bonds are represented by the Bloomberg Barclays US Aaa Corporate Bond Index which is the Aaa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

Aa Corporate Bonds are represented by the Bloomberg Barclays US Aa Corporate Bond Index which is the Aa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

A Corporate Bonds are represented by the Bloomberg Barclays US A Corporate Bond Index which is the A component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

Baa Corporate Bonds are represented by the Bloomberg Barclays US Baa Corporate Bond Index which is the Baa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

HFRI FOF: Diversified Hedge Fund Index. HFRI Fund of Funds Composite: This is an equal-weighted index of 650 hedge funds with at least $50 million in assets and 12-months of returns. Returns are reported in US dollars and are net of fees. HFRI Fund of Funds: Fund of funds invest with multiple hedge fund managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. HFRI may revise index data from time to time, as necessary.

MSCI EAFE index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

MSCI EM index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Russell 2000 Index is comprised of 2000 smaller company stocks and is generally used as a measure of small-cap stock performance.

The Investors Intelligence Sentiment index is a weekly survey of newsletter writers and measures whether participants are bullish on the stock market outlook. At extremes, it is often looked to as a contrarian indicator.

Bloomberg Barclays Municipal Bond Blend 1-15 Year (1-17 Yr) is an unmanaged index of municipal bonds with a minimum credit rating of at least Baa, issued as part of a deal of at least $50 million, that have a maturity value of at least $5 million and a maturity range of 12 to 17 years.

Core Bonds are represented by the Bloomberg Barclays US Aggregate Bond Index which is the broadest measure of the taxable US bond market, including most Treasury, agency, corporate, mortgage-backed, asset-backed, and international dollar-denominated issues, and maturities of one year or more.

JP Morgan GBI-EM Global Diversified Composite is a comprehensive emerging market debt index that tracks local currency bonds issued by Emerging Market governments. It includes only those countries that are directly accessible by most of the international investor base and excludes countries with explicit capital controls, but does not factor in regulatory/tax hurdles in assessing eligibility. The maximum weight to any country in the index is capped at 10%.

BofAML US HY Master index is an index that tracks US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

BofA Merrill Lynch Global Fixed Income Markets Index tracks the performance of developed and emerging market investment grade and sub-investment grade debt publicly issued in the major domestic and eurobond markets.

Leveraged Loans are represented by the Credit Suisse Leveraged Loan index which is a representative index of tradable, senior secured, US dollar denominated non-investment-grade loans.

Bank-loan portfolios primarily invest in floating-rate bank loans and floating-rate investment-grade securities instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London Interbank Offered Rate, or LIBOR.

It is not possible to invest directly in an index.

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