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TEN PREDICTIONS FOR 2018: 1Q UPDATE

Equity markets on a wild ride to nowhere

WHAT'S INSIDE

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Economic fundamentals remain solid, but risks are rising

INVESTOR SENTIMENT HAS SHIFTED MARKEDLY OVER THE LAST COUPLE OF YEARS. Between 2016 and 2018, the world moved from a profits recession to profits euphoria, from worries about deflation to a strong reflationary backdrop and from an environment of historically low government bond yields to yields moving unevenly higher. Two years ago, we cautioned against taking too negative a stance and thought sentiment was overly pessimistic. Likewise, we thought investor optimism was too high at the beginning of this year. And, indeed, stocks proved themselves to be vulnerable to a sharp correction in early February.

DESPITE HIGHER MARKET VOLATILITY OVER THE PAST FEW MONTHS, ECONOMIC FUNDAMENTALS REMAIN SOUND. True, first quarter gross domestic product (GDP) growth appears to have weakened. Retail sales came in lower than expected, and housing starts took a turn for the worse.[1] Looking ahead, however, we expect the U.S. economy to experience a reacceleration. The consumer sector looks strong: Confidence levels are higher, household net worth is improving, the labor market remains strong and wages are slowly rising. The March University of Michigan Sentiment Index reached its highest level since 2004 in March, while the Current Conditions Index hit an all-time high.[2] Manufacturing data has also been positive, and the corporate sector as a whole appears solid. Outside of the United States, the eurozone's momentum is cooling, but growth should stay firm. China is slowing, but downside risks are limited, and the country should still contribute positively to global growth. Overall, G7 nominal GDP is healthy at slightly more than 4%.[3]

RISING INTEREST RATES AND SLIGHTLY HIGHER INFLATION ARE CREATING CHALLENGES FOR INVESTORS. Real yields are still extremely low, global growth is solid, and monetary policy is slowly tightening. Together, these factors mean that bond yields should likely rise over the coming months and years. The inflation outlook is less clear, but we believe inflation is also moving higher. We are not expecting sudden and dramatic increases in inflation, but tightening labor markets make it reasonable to watch for inflation risks.

TRADE RESTRICTIONS MAY DISRUPT THE ECONOMY AND FINANCIAL MARKETS. Although politics usually matters less to the markets than financial fundamentals, political risks are growing. Trade restrictions in particular have been rattling equity markets. Although tariffs are much in the news, it seems that most of the trade discussion is about political posturing rather than economic reality. The risk is that an actual trade war could be wildly unpredictable, and the outcome could spin out of anyone's control. Such a scenario could present more serious concerns for financial markets.

KEY INDEX PERFORMANCE

TOTAL RETURNS	1Q18
S&P 500 Index	-0.8%
Dow Jones Industrial Average	-2.0%
NASDAQ Composite	2.6%
Russell 2000 Index	-0.1%
Euro Stoxx 50	-1.6%
FTSE 100 (UK)	-3.8%
DAX (Germany)	-4.3%
Nikkei 225 (Japan)	0.6%
Hang Seng Index (Hong Kong)	0.5%
Shanghai Stock Exchange Composite (China)	-0.8%
MSCI World Index (ex U.S.)	-1.9%
MSCI Emerging Markets Index	1.5%
Bloomberg Barclays U.S. Aggregate Bond Index	-1.5%
BofA Merrill Lynch 3-Month Treasury Bill (Cash)	0.4%

Source: Morningstar Direct, Bloomberg and FactSet as of 31 Mar 2018. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indexes are unmanaged and unavailable for direct investment.

Volatility makes a comeback

IN RETROSPECT, INVESTORS HAD GROWN OVERLY COMPLACENT BY EARLY 2018, AND MARKETS MAY HAVE BEEN OVERDUE FOR A CORRECTION. Equity markets began the year as they acted throughout 2017 — moving steadily higher on the back of solid economic data and strong corporate earnings results to set continued record highs. Stock prices peaked on 26 January, when the S&P 500 Index hit 2,873, and from that point suffered a sharp 10% correction to an intraday trough of 2,532 on 8 February.[4]

SINCE EARLY FEBRUARY, STOCKS HAVE REMAINED IN THAT BROAD TRADING RANGE AND HAVE PERIODICALLY EXPERIENCED ADDITIONAL SETBACKS. Importantly, the more recent selloffs featured less negative market technicals compared to the sharp market downturn in early February. Volatility levels were lower, trading volume was less and fewer stocks hit new 52-week lows.[4] We believe all of this means that the worst of the correction may be in the rearview mirror.

DESPITE THE EXTREME MOVES, STOCK PRICES WERE BASICALLY FLAT FOR THE QUARTER. The S&P 500 Index ended the quarter down less than 1%, while small cap stocks (represented by the Russell 2000 Index) were down fractionally.[4] Outside the United States, results were generally mixed, with European markets off a bit more than the U.S., and Asian markets up slightly more. There were no real standout performers, but emerging markets as a whole were a relative bright spot.

THE RELATIVELY FLAT PERFORMANCE, HOWEVER, MASKED SOME SIGNIFICANT DIFFERENCES IN SECTORS AND STYLES AND SHARP INTERNAL MOVEMENTS. The biggest market story may have been the sharp selloff in large multinational technology stocks that occurred toward the end of the quarter. Much of this decline was associated with growing consumer privacy concerns rather than company fundamentals, but the large swings in this sector rattled the broader markets. The tech sector as a whole, however, posted the best results for the quarter. Telecommunications and consumer staples were each down over 7%.[4]

IN OTHER ASSET CLASSES, BOND MARKETS TOOK A HIT DUE TO RISING YIELDS. The 10-year U.S. Treasury yield began the year at 2.40% and spiked to 2.95% in late February before settling at 2.74% to end the quarter.[4] In this environment, bonds (measured by the Bloomberg Barclays U.S. Aggregate Bond Index) fell 1.5%.[4] Cash investments returned a modest 0.4% as short-term rates remain close to historic lows.[4]

EQUITY SECTORS

TOTAL RETURNS	1Q18
Consumer Discretionary	3.1%
Consumer Staples	-7.1%
Energy	-5.9%
Financials	-1.0%
Health Care	-1.2%
Industrials	-1.6%
Information Technology	3.5%
Materials	-5.5%
REITs	-5.0%
Telecommunication Services	-7.5%
Utilities	-3.3%

Source: Morningstar Direct, Bloomberg and FactSet as of 31 Mar 2018. Equity Sectors are classified using the Global Industry Classification Standards (GICS) based on the S&P 500. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indexes are unmanaged and unavailable for direct investment.

TEN PREDICTIONS FOR 2018

SCORECARD *Overall Scoring*	
✓	HEADING IN THE RIGHT DIRECTION
?	TOO EARLY TO CALL
✕	HEADING IN THE WRONG DIRECTION

From nearly perfect to less perfect

Our overall theme for the year is that we expect 2018 to be "less perfect" than last year, as we see continued decent economic growth and corporate earnings, as well as low but rising inflation and yields. We also anticipate more market volatility and less of a tailwind from the political backdrop. It's early, but so far 2018 is generally shaping up as we expected.

1 ?	**U.S. real GDP reaches 3% and nominal GDP 5% for the first time in over a decade.**	First quarter economic growth is looking to be weaker than anticipated at the start of the year, with consensus expectations for real GDP growth declining from the 2.5% to 3% range to 2% to 2.5%.[4] We expect growth to rebound in the second quarter and beyond, especially given the strength in the labor market and a tailwind from additional fiscal stimulus. With inflation climbing modestly, we also believe that nominal growth should climb.
2 ✓	**Despite ongoing protectionism, the global expansion continues with the fewest countries in recession in history.**	Rising trade protectionism is a genuine threat to the global economy. In our view, trade tariffs are effectively taxes and drive a wedge between producers and consumers. So far, however, the world economy has been able to look past these issues as economic growth around the world remains relatively strong.
3 ✓	**Unemployment falls to the lowest level in nearly 50 years as wage growth is the highest since the Great Recession.**	The latest data show that unemployment is down to 4.1% and wage growth is trending at 2.7% year over year.[1] Unemployment is already close to its 50-year low of 3.9%,[1] and we think there is a good chance we'll see that level again in 2018. Likewise, we expect wages to rise to nearly 3% growth by the end of this year.
4 ✓	**The yield curve flattens (but does not invert) as the 10-year Treasury yield reaches 3% for the first time since 2014.**	Yields have moved erratically over the last three months, but have generally trended in the direction we expected. The spread between the 2-year and 10-year Treasury yield narrowed from 52 basis points to 47 over the quarter, and the yield on the 10-year came close to 3% before retreating.[4] We expect both modest flattening and unevenly rising yields to continue as financial market themes.
5 ?	**Stocks enjoy longest bull market in history but experience a 5+% correction after the longest period without one.**	The second half of this prediction came true in February when stocks experienced their first significant correction since 2016.[4] Should equity markets make it to 22 August this year without the bull market ending, the first half of this prediction will come true as well.[5]

"Volatility is likely to remain elevated, but we still expect stock markets to make modest gains. In this environment, we prefer cyclical over defensive sectors and value over growth."

6 ✓	**U.S. equity returns lag earnings growth for the first time in six years, the longest streak in decades.**	So far, this prediction is coming in as we expected. As of the end of the first quarter, estimated 2018 earnings-per-share growth for S&P 500 companies was 19.7% year over year, significantly ahead of equity returns.[5] It would take a massive collapse in earnings and/or a sharp jump in prices for this prediction to move into the "wrong" column.
7 ?	**Equities beat bonds for the seventh consecutive year for the first time in nearly a century.**	As of the end of the first quarter, stocks were down 0.8% and bonds were off 1.5%.[4] Given higher levels of volatility in both markets, we're not comfortable marking this one as heading in the right direction quite yet. We think stock prices will end the year higher, but need to see more clarity before we grow more confident.
8 ✓	**Corporate capital expenditures increase at the expense of share buybacks.**	Capital expenditure levels are picking up, a trend we expect will continue into 2019.[6] Corporate tax cuts have had a positive effect, as have the weaker dollar, still-narrow corporate credit spreads and rising energy prices. Rising protectionism, however, represents a risk to higher cap ex levels. Companies are likely to continue buying back their own shares, but also have many additional options when it comes to spending their cash.
9 ✓	**Telecommunication services, information technology and health care outperform utilities, energy and materials.**	Results are pretty jumbled given market volatility, but this prediction is trending in the right direction so far. A basket of our most-favored sectors is down -1.7%, while a basket of our least-favored is down more at -4.9%.[4]
10 ?	**Republicans lose the House, retain the Senate and further distance themselves from President Trump.**	Absent a significant shift in the political landscape, we expect Democrats will be able to take the House of Representatives in November, although the Senate is less likely to see a leadership shift. We have already seen a number of high-profile Republicans distance themselves from the president, especially on the issue of trade. Now that tax reform has passed, there appears to be less of a political price for GOP members to disagree with President Trump.

As go earnings, so go stocks

EQUITY MARKETS APPEAR TO BE IN THE MIDST OF A CRITICAL INFLECTION POINT. For the past six years, corporate earnings generally rose while price-to-earnings multiples expanded as well. In retrospect, this was a pretty easy time to invest in stocks: Since the value of the market by definition is determined by price multiplied by earnings, if both earnings and multiples are rising, prices will move up.

MARKETS APPEAR TO HAVE SHIFTED AND ARE MORE IN A TUG-OF-WAR. Equities appear generally fully valued, while rising interest rates and inflation are providing a headwind for valuations. Equity valuations at their January highs were nearly full, meaning future price appreciation may need to rely on stronger earnings. At the same time, tightening monetary policy is likely to put upward pressure on market volatility. This implies that the smooth upward ride investors enjoyed through most of the last several years has come to an end.

THE GOOD NEWS IS THAT EARNINGS APPEAR TO BE GROWING NICELY. In the end and over the long term, equity markets almost always move with corporate earnings, and here the outlook is still upbeat. At this point, consensus expectations for S&P 500 companies are for first quarter earnings growth to be up 17%.[4] And expectations remain high for the coming quarters.

NEVERTHELESS, WE ARE MORE NEUTRAL THAN POSITIVE ON STOCKS FOR THE NEAR TERM. Until more clarity emerges around the issues of interest rates and trade policy, we are approaching equity markets cautiously. We would not be surprised to see relatively high levels of volatility continue, and we may not be out of the woods with the current correction. We think investors should remain tactical: seeking buying opportunities if prices drop and bargains appear, and looking for opportunities to take profits when markets become more fully valued.

OVER THE LONGER TERM, HOWEVER, WE RETAIN A RELATIVELY OPTIMISTIC VIEW TOWARD STOCK MARKETS. We do not believe we are approaching an economic recession or an imminent equity bear market. We expect that, over time, stock prices will again be able to climb the wall of worry, and we also believe that stocks will outperform bonds and cash for all of 2018.

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We have a more neutral view toward stocks over the short term, but still retain a constructive long-term outlook.”

Key themes for investors

MATCHING GOALS TO INVESTMENTS

As investors review their portfolios with their financial advisors, we offer the following themes as guideposts:

Maintain an overweight in equities, but be cautious: Equity market volatility is likely to continue, and we are cautious about the near-term outlook for stocks. Longer term, we believe that while this bull market is aging, age alone does not predict the end of a bull market. Solid economic growth and decent corporate earnings should help equity prices rise.

Focus on selectivity: Gains will likely be narrower and more focused on specific companies and investment styles, so selectivity will be crucial. We continue to focus on companies that generate free cash flow and raise dividends. Current preferences include value sectors and cyclical areas of the market.

Selection also matters in fixed income: With low yields and the prospect of modestly rising rates, fixed income investing has become more challenging. Investors may want to rely on active managers with the flexibility to respond to market changes and the investment acumen to remain ahead of their peers in uncertain markets. We think focusing on credit sectors (including high yield) over government-related sectors makes sense, and we also see value in municipal bonds.

Alternatives can play multiple portfolio roles: Alternative assets, including real assets, real estate and other investments, may provide diversified sources of risk, return and/or income. Alternative strategies such as long/short or a market neutral approach may have a low historical correlation to long-only, benchmark-oriented investments.

Characteristics we look for when evaluating companies:

- *Free cash flow can provide flexibility to raise dividends, buy back shares and reinvest in the business.*
- *Companies with the ability to generate unit growth may be advantaged over those that lack pricing power.*
- *Economic sensitivity and above-average secular growth may help insulate against market fluctuations.*

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1 Commerce and Labor Departments
2 University of Michigan
3 MRB Research
4 Bloomberg, FactSet and Morningstar Direct
5 Bank of America Merrill Lynch Research
6 Morgan Stanley Research

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Index definitions

The **S&P 500® Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **Russell 2000® Index** measures the performance of approximately 2,000 small cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. **Euro Stoxx 50** is an index of 50 of the largest and most liquid stocks of companies in the eurozone. **FTSE 100 Index** is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. **Deutsche Borse AG German Stock Index (DAX Index)** is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. **Nikkei 225 Index** is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. **Hong Kong Hang Seng Index** is a free-float capitalization-weighted index of a selection of companies from the Stock Exchange of Hong Kong. **Shanghai Stock Exchange Composite** is a capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The **MSCI World Index ex-U.S.** is a free-float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed markets minus the United States. The **MSCI Emerging Markets Index** is a free-float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. **Bloomberg Barclays U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market. The **BofA Merrill Lynch 3-Month U.S. Treasury Bill Index** is an unmanaged market index of U.S. Treasury securities maturing in 90 days that assumes reinvestment of all income. The **Russell 1000® Value Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The **Russell 1000® Growth Index** measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Risks and other important considerations

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