April 18, 2018

BCA Q1 Review and Outlook

Russ Allen, CIO

Summary Outlook

- We believe the fundamental backdrop for global equities and credit remains positive. The market's recent volatility isn't all that unusual in the historical context, and may not signal more problems ahead. Most investors are focused on the current above-average stock market valuation, but cheapness alone has never been a driver of the markets. Earnings growth, still-easy policy and reset investor sentiment are more important factors in the market's direction.
- The acceleration in global growth has likely peaked, but economic growth should remain strong this year. Many international stock markets have earnings growth and cheaper valuations, thus we expect renewed international outperformance in coming quarters.
- Volatility is certainly back. The new environment does not necessarily mean "risk" assets will underperform. However, it does mean more flexibility will be needed to take advantage of dislocations and to avoid larger losses.
- We believe global bond yields will move higher over the next 12 months, but will not jump sharply yet, as there is still spare productive capacity in the global economy. Over the long run, yields are going higher and probably higher than the market expects.
- Corporate bonds, bank loans and, to a lesser extent, high yield bonds are more attractive than long term Treasury bonds right now. However, higher corporate debt levels could be a significant problem when the next downturn arrives.
- We are still concerned that significant fiscal stimulus will kick in in 2019, when the economy does not need it. This could be disruptive to financial markets if the Fed must raise rates sharply, boosting the odds of a recession in late 2019 or early 2020.
- If realized, this scenario could be a positive for distressed strategies, which could benefit from dislocation. We plan to make more investments that can capitalize on a market disruption down the road.

Q1 Review

With good reason, investors marveled over 2017's placid markets. The first three months of 2018 couldn't have been a starker contrast. At first, stocks melted up with the S&P 500 posting its best January in 21 years. In February and March, the S&P 500 gave back all of January's gains and more, finishing the quarter down 1.2% in price. Along the way the market entered its first 10% correction since early 2016, which was matched by declines in other markets. Q1 was the first down quarter for the S&P 500 since Q3 2015. After no -2% days in 2017, the S&P logged five in the first three months of 2018.

A few important factors drove the market reversal. Fear of an aggressive Fed was probably the most important, as expectations crystallized for four rate hikes in 2018. There was also a sense that the best market catalysts, for example the significant tax cut bill, are now behind us. This can create a "buy the rumor, sell the news" effect. Concerns over trade protectionism, which have strengthened thus far in April, are another worry.

Bonds fared worse than stocks, as the U.S. Aggregate Bond Index dropped -1.5%. The selloff was sparked by the January jobs report, which showed wage growth rising to 2.9%. Even though spiking 10-year Treasury yields eventually came back in, high quality bonds lost ground this quarter. Berman Capital remains overweight stocks versus bonds and cash in our asset allocation recommendation.

	Total Return	
Index	2017	Q1 2018
S&P 500	21.8%	-0.8%
Russell 1000 Growth	30.2%	1.4%
Russell 1000 Value	13.7%	-2.8%
Russell Midcap	18.5%	-0.5%
Russell Small Cap	14.6%	-0.1%
MSCI EAFE (International)	25.6%	-1.6%
MSCI Europe	26.2%	-1.9%
MSCI Emerging Markets	37.8%	1.3%
MSCI Japan	24.4%	0.3%
US Aggregate Bond	3.5%	-1.5%
High Yield Bonds	7.5%	-0.9%
Gold	13.7%	1.4%
Crude Oil	12.5%	7.5%

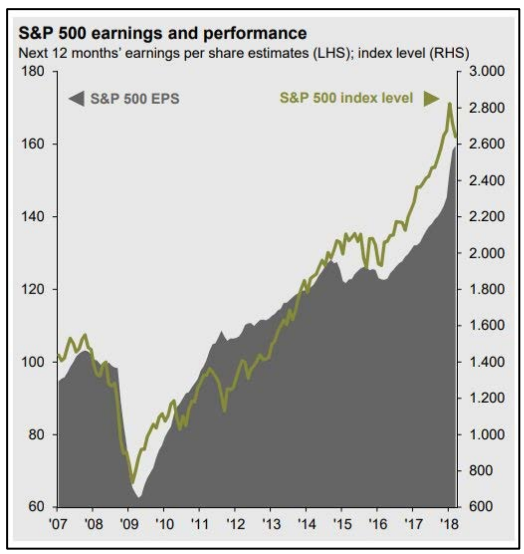
Source: Factset Research

Note: Int'l market returns reported in U.S. Dollars, not local currency

By style, growth outperformed value in Q1, as point to point Technology retained its momentum. Toward the end of the month, smaller cap stocks, energy and financials performed better. Rate sensitive stocks such as Utilities, REITs and Telecom were the worst performers.
The U.S. outpaced other developed markets, thanks to weakness in Europe. Incrementally worse economic news in Europe was the trigger, although underlying trends are healthy.
Helped by higher commodity prices, emerging markets managed to squeeze out a 0.7% total return, beating the U.S., Europe and Japan.

Investment Outlook - Economy

Investors are rightly concerned about high equity prices – although most financial assets today are expensive by historical standards. We think this means lower returns in future years, but that may mean a long sideways period, not a crash. Right now, the short-term outlook is still quite good.



Source: J.P. Morgan

Many factors affect the market in the near term, including political events, economic data and shifting sentiment. Yet, earnings growth and the earnings outlook are the most important factors driving the market over the long term. The rising stock market has been supported by an almost equally sharp rise in earnings. Thanks to the corporate tax cuts and no sign of deteriorating margins, public companies are set to report significant earnings growth again this year. According to FactSet, S&P 500 firms are projected to post growth of 17% in the first quarter from the year-earlier period, putting firms on track for their best results since the first quarter of 2011.

This is underpinned by global economic growth, still-easy (but getting less so) monetary and fiscal policy, and contained inflationary pressure. First, the economy. Measures of global growth remain in expansion territory, although the data from Europe has fallen off somewhat. For example, the global OECD Composite Leading Indicator remains near its highest level in three years and has been above its long-term average for six months, bolstering the outlook for above-trend global growth in 2018. The global composite PMI (services and manufacturing) climbed 0.3 points to 54.8 in February, its best level since August 2014. To generalize, the global economy is growing everywhere but booming nowhere, and that is typically a good setup for equities.

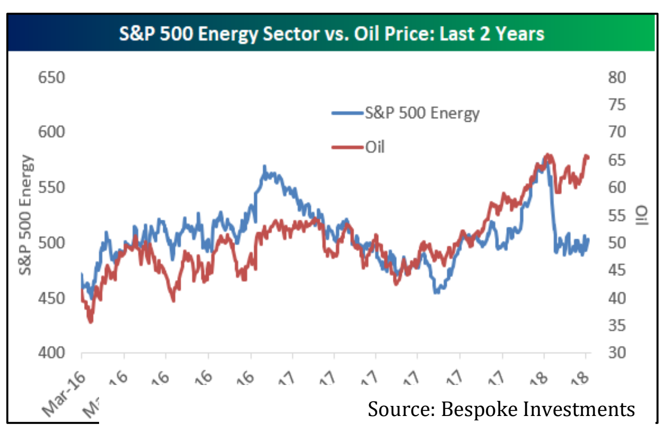
Financial markets are worried about escalating protectionism. President Trump has threatened to hike tariffs on steel and aluminum, go after China for allegedly stealing U.S. intellectual property, and pull out of NAFTA if a more favorable deal isn't reached. Without a doubt, significant trade barriers would raise consumer prices and reduce output, and investors would react very negatively. Most likely, these are just negotiating tactics but nonetheless does represent an important threat.

Investment Outlook – Stocks

Typically, U.S. and broad international markets trade closely together. Yet, beginning in 2011, U.S. markets took off while developed international markets were flat. Recently, international markets have been performing well, too. Thanks to relatively lower valuations, higher dividend yields than U.S. stocks and a falling U.S. dollar, there are good international opportunities. In emerging markets, a rebound in demand for commodities continues to be a positive for Latin America, Canada and Australia. China avoided a "hard landing" after putting the brakes on its housing market. The Chinese market was also helped by the stunning success of its domestic internet companies. Broadly speaking, international stocks haven't yet established a better momentum trend than domestic stocks. Thus, our positioning is about market-weight in both domestic and international, but we anticipate increasing our international exposure, particularly in emerging markets.

In terms of "factor" exposure, in the current environment we like quality stocks. By quality, we mean more stable earnings, low debt and high returns on capital. Quality stocks tend to be fairly evenly distributed across sectors, whereas low volatility stocks can be over-weighted toward interest rate sensitive groups like utilities and consumer staples. We made this change because we anticipate rising interest rates and faster economic growth, which could be negative for those sectors.

We believe renewed volatility will create opportunities, and we plan to invest nimbly across and within asset classes. Although it has been difficult, we believe there are opportunities in energy investing today. Despite the three-year high in oil prices, the Energy sector fell 6.6% in Q1, the third-worst sector performance in the S&P 500 Index. Demand for oil and, especially, natural gas has been rising, but the producers and transporters of these commodities have completely missed the rally. We believe actively



Source: Bespoke Investments

managed exposure to those areas will produce good results, based on fundamental trends and recently improving price momentum.

Investment Outlook - Bonds

Bond investors are worried that faster inflation could force the Fed's hand, but in the current environment, rates are unlikely to rise sharply. Inflation, as measured by the CPI, is low and ticking higher slowly. While CPI inflation appears contained, wage growth is on a firmer footing and the employment market continues to slowly tighten, so the situation requires monitoring. The global economy is clearly improving and the Fed appears determined to return policy to a more normal (higher) rate course. Long-term interest rates remain very low, especially compared to historical averages. So, while the intention is to adjust gradually, the direction of rates seems clear. This back-up in rates should result in weak total returns on Treasuries and high-quality corporate bonds. As defaults are likely to remain low, this suggests that investors will be better rewarded for owning bonds with some credit risk.

The Fed believes the U.S. economy is approaching its long-term unemployment and inflation targets. The decision to increase rates again in March reflected this conclusion, and barring any significant negative shocks, we anticipate the Fed to further raise rates by 0.25% at least two more times in 2018, and possibly three. Remember, the Fed is now reversing quantitative easing, which still could create some uncertainty in the market.

Investment Outlook – Alternative Investments

As we have discussed previously, greater volatility, higher interest rates and less monetary intervention should result in a better backdrop for hedged strategies. We are focused on small and mid-sized managers focused on investments and not asset gathering. For private opportunities, we are looking for less crowded, off-the-beaten-path investments. We are cautious about many traditional private assets given the sheer amount of money that is looking for a return. For example, we are avoiding large buyout funds and are looking to add niche real estate exposures.

As always, thank you for trusting Berman Capital to serve as your advisor. If you have any questions, please do not hesitate to contact us.