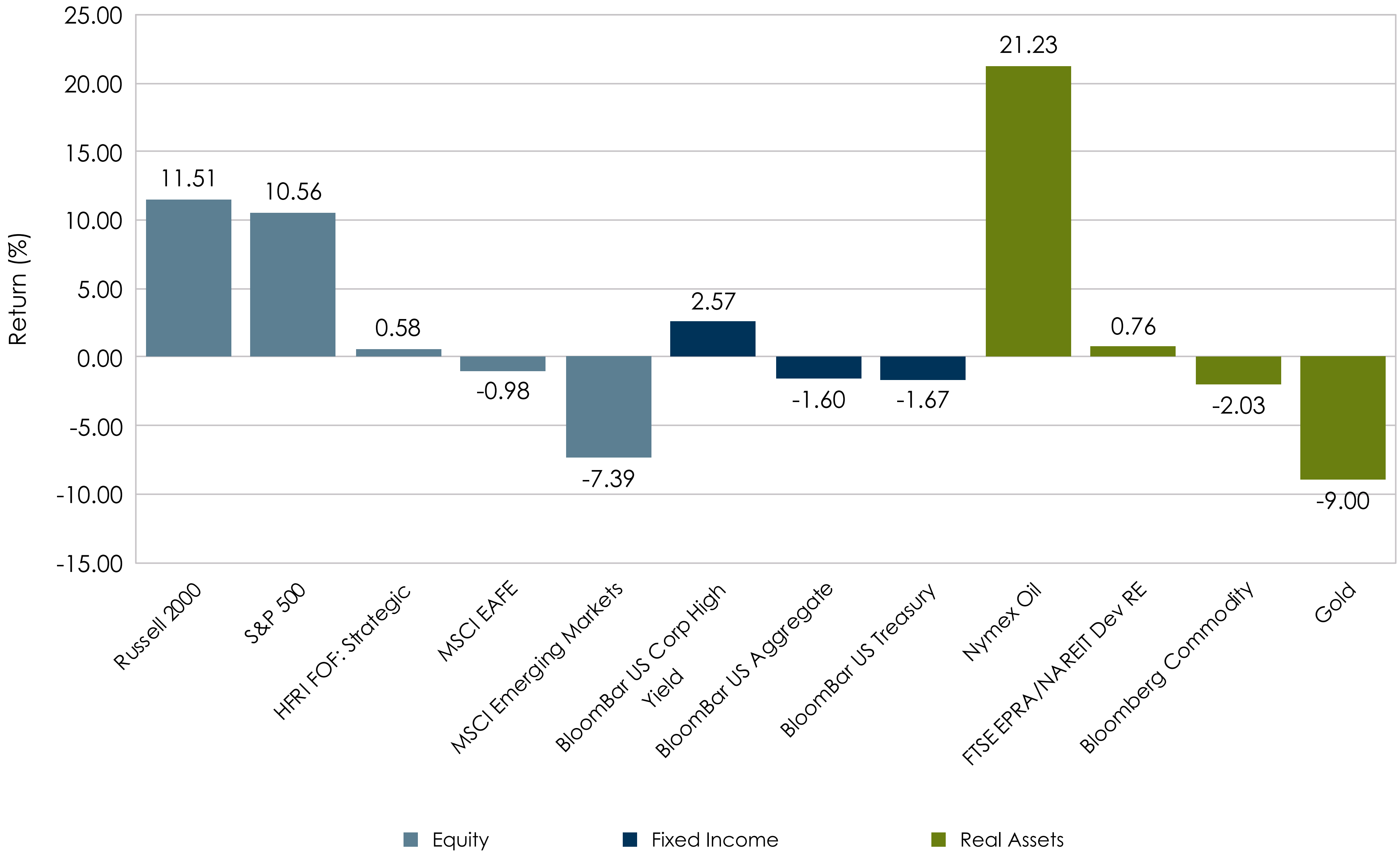
Global Economic Update

Fourth Quarter 2018

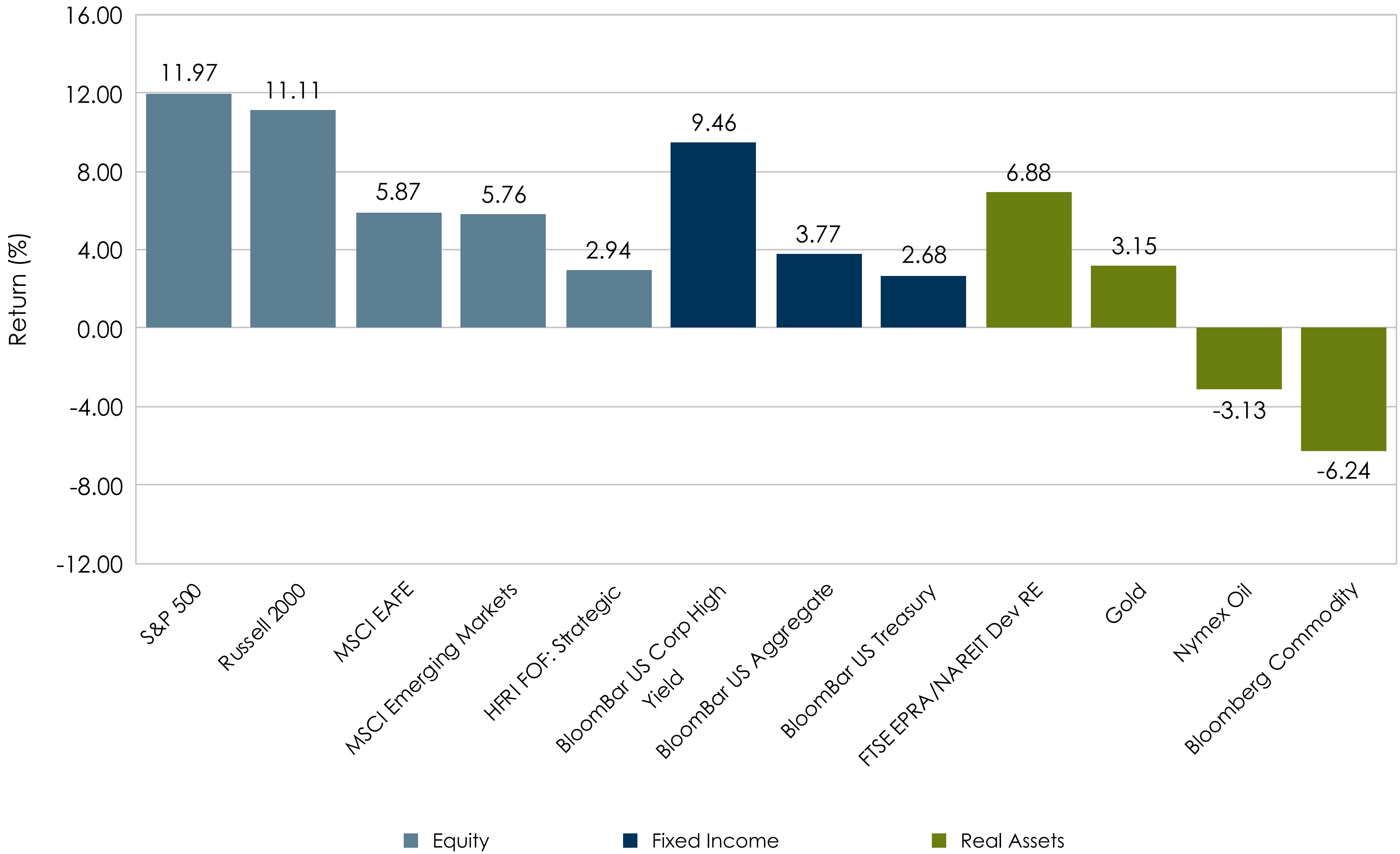
Market Returns

For the YTD Period Ending September 30, 2018



Market Returns

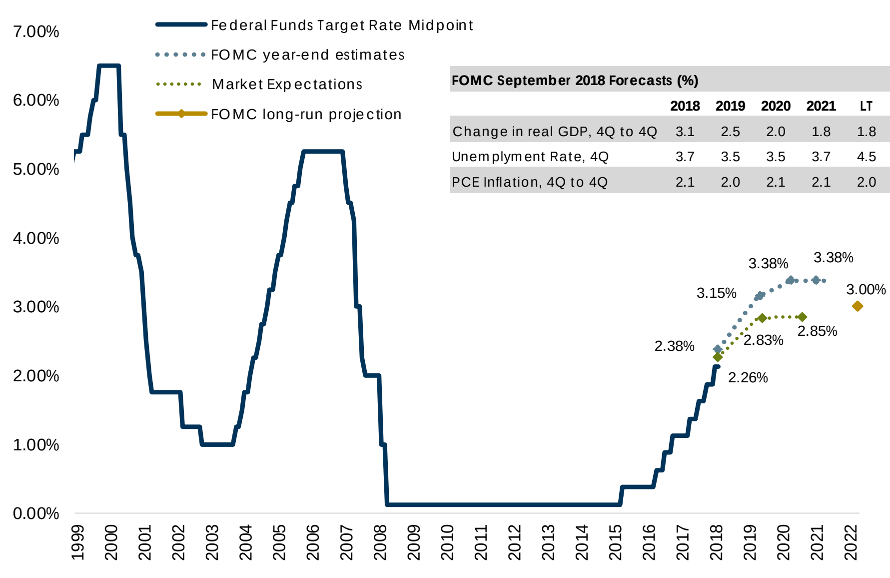
For the 10 Years Period Ending September 30, 2018



US

- 2nd quarter annualized GDP grew at robust 4.2%, the fastest in nearly four years. Consensus **projections for 3rd quarter GDP are between 3.0% and 3.5%**, with continued solid readings for consumer and business sentiment.
- Labor conditions remain robust, with the **3.7% unemployment rate matching a low that dates back to the 1960's**. Although most economists are forecasting continued hiring demand, real wage gains remain subdued after taking inflation expectations into account.
- Both the manufacturing and service sectors continue to run at a healthy pace, providing **support for near-term corporate revenues and earnings.** That said, managing expectations will be critical as policy dynamics begin to make year-over-year comparisons more challenging.
- As expected, the Fed **increased short-term interest rates in September**, to a targeted range of 2.00% to 2.25%. The overall tone of the message was not changed from prior statements, with the unofficial dot-plot **projecting four more increases by the end of 2019**. Core PCE remains fairly well-contained, and has finally achieved the stated objective of 2.00%.

Federal Reserve Actions & Projections



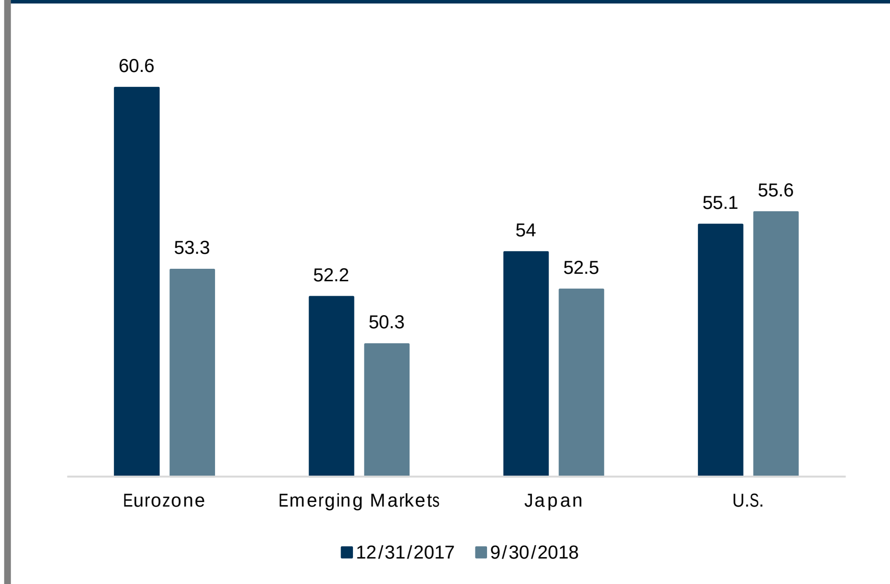
FOMC September 2018 Forecasts (%)	2018	2019	2020	2021	LT
Change in real GDP, 4Q to 4Q	3.1	2.5	2.0	1.8	1.8
Unemplyment Rate, 4Q	3.7	3.5	3.5	3.7	4.5
PCE Inflation, 4Q to 4Q	2.1	2.0	2.1	2.1	2.0

Source: ACG Research, Bloomberg, Federal Reserve

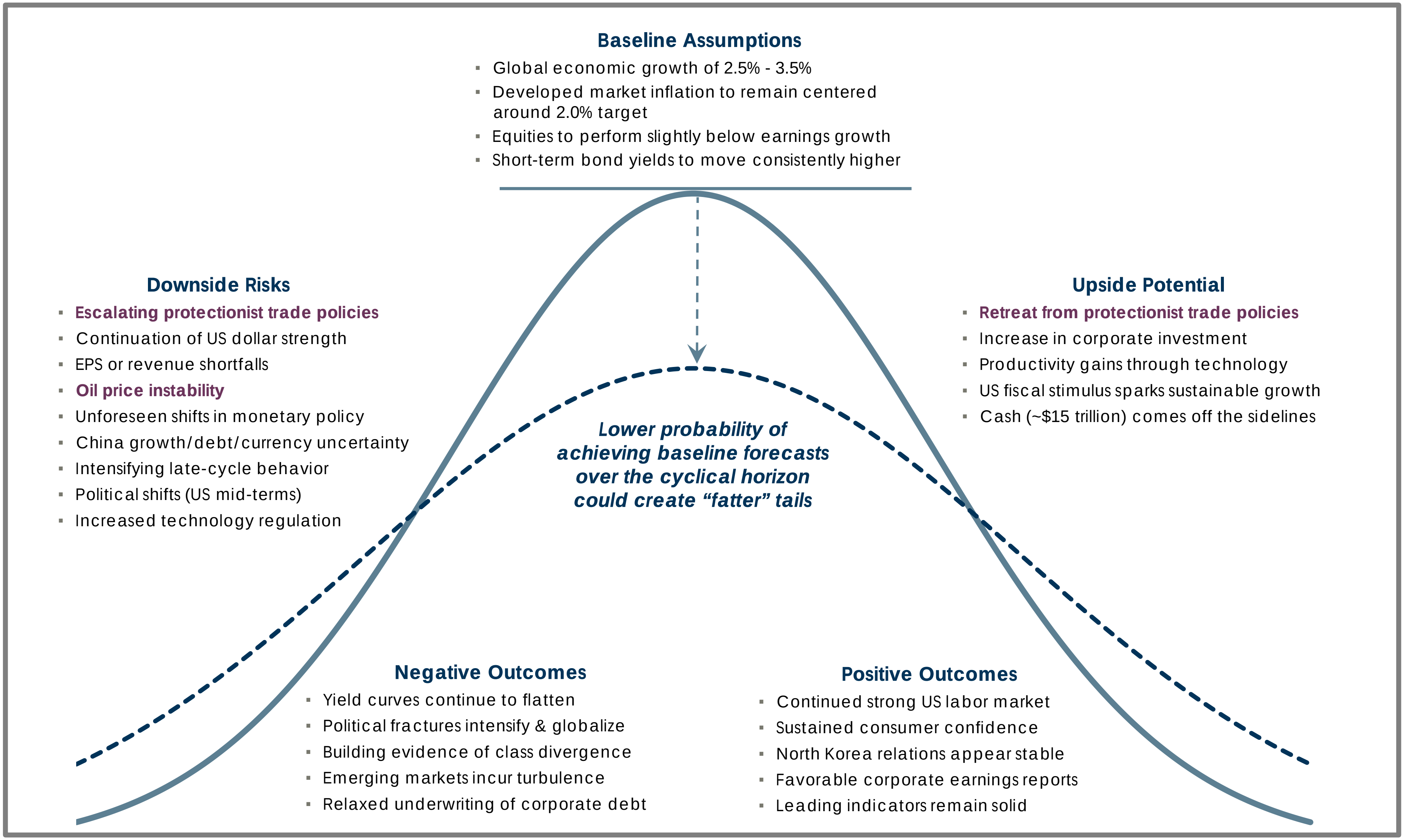
Global/Non-US

- **The trade tariff issue has not gone away,** with continued retaliatory threats/actions from China, amid ongoing occasional formal talks meant to defuse tensions. **Well-entrenched globalization trends are unlikely to be reversed, but protectionism could weigh on growth.**
- The **ECB is expected to end its bond purchase program by the end of the year.** Interest rate increases are on the horizon, although the timing is not at all certain. The BoJ maintained its zero interest rate path and expectation, even as they acknowledge the local economy is doing well.
- **International political tensions are mixed**. With the Brexit deadline looming in the 1st quarter of 2019, the UK has made limited progress in negotiations. Italy's recent budget proposal has renewed concern about EU cohesion. Issues with Russia and North Korea remain, but it's relatively calm currently.
- Country-specific shocks and tightening global financial conditions have **pressured emerging market economies beyond what internal fundamentals might suggest.** Contagion risk appears low, however, as currency volatility has served as the release valve this time around.

Trend in Global Manufacturing PMIs



Source: ACG Research, Bloomberg, Institute for Supply Management


Baseline Assumptions
Global economic growth of 2.5% - 3.5%
Developed market inflation to remain centered around 2.0% target
Equities to perform slightly below earnings growth
Short-term bond yields to move consistently higher
Downside Risks
Escalating protectionist trade policies
Continuation of US dollar strength
EPS or revenue shortfalls
Oil price instability
Unforeseen shifts in monetary policy
China growth/debt/currency uncertainty
Intensifying late-cycle behavior
Political shifts (US mid-terms)
Increased technology regulation
Upside Potential
Retreat from protectionist trade policies
Increase in corporate investment
Productivity gains through technology
US fiscal stimulus sparks sustainable growth
Cash (~$15 trillion) comes off the sidelines
Lower probability of achieving baseline forecasts over the cyclical horizon could create “fatter” tails
Negative Outcomes
Yield curves continue to flatten
Political fractures intensify & globalize
Building evidence of class divergence
Emerging markets incur turbulence
Relaxed underwriting of corporate debt
Positive Outcomes
Continued strong US labor market
Sustained consumer confidence
North Korea relations appear stable
Favorable corporate earnings reports
Leading indicators remain solid

What is the issue?

- An essential part of many countries' economies is trade with other nations.
- All nations will have either a trade surplus (more exports than imports) or a trade deficit (more imports than exports).
- The extent to which countries influence the US trade balance has been a major theme of the Trump administration.
- In particular, there has been a focus on trade with Mexico and Canada (NAFTA) and China.
- Furthermore, specific items (such as steel and aluminum) have been targeted across many countries to favor American workers.
- Protectionist policies, such as tariffs, frequently result in trade war escalation, where each country "ups the ante" in response to the other's behavior.
- It is believed that a trade "war" has an overall negative effect on the global economy, with increased inflation and currency volatility.

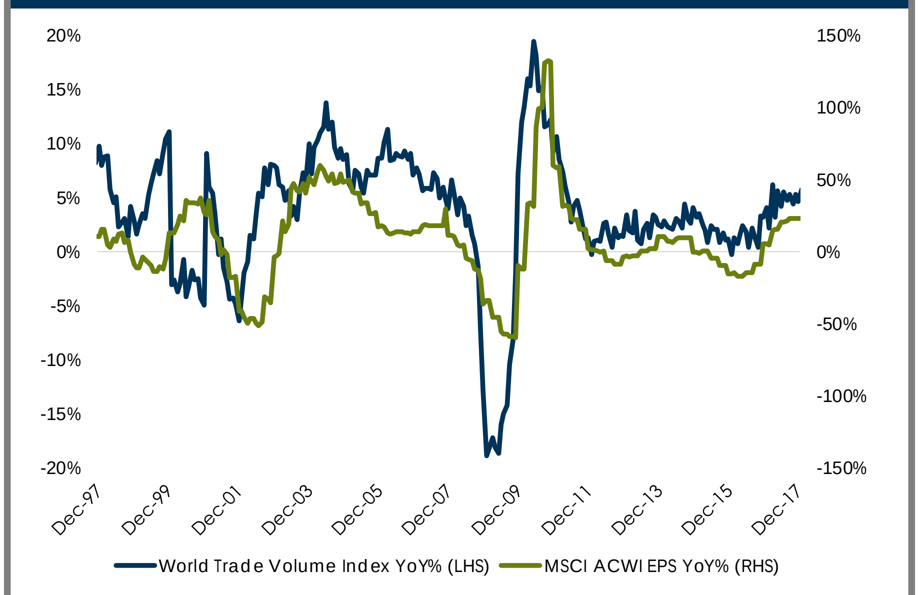
Where do things stand?

- The US, Mexico and Canada recently agreed on a revised NAFTA, now called the United States – Mexico – Canada Agreement (USMCA).
- Discussions continue with China. At times, progress seems to be made. At others, relations are more hostile, with threats of additional tariffs.

Potential Outcomes:

- At one end of the spectrum, the US becomes more competitive in selling its products overseas and reduces its trade deficits. This is positive for the US economy.
- At the other end, the US continues to be an overwhelming net purchaser of foreign goods, inhibiting GDP growth and reducing job growth in the long run.
- China has effectively set tariffs on all US exports. The US has threatened to move toward the same as domestic growth is relatively less affected by global trade.

Global Trade Influences Corporate Profits



Source: ACG Research, Bloomberg

Economic Giants Going Back & Forth on Trade Tariffs

US Action		China's Response
Threatens 25% tariff on $50bn	April	Threatens 25% tariff on $50bn
Finalizes plans for 25% tariff on $50bn	June	Finalizes plans for 25% tariff on $34bn, then add'l $16 bn
Imposes 25% tariff on $34bn, plans for 25% on $16bn and 10% on $200bn	July	Imposes 25% tariff on $34bn
Imposes 25% tariff on $16bn, plans 25% on $200bn	August	Imposes 25% tariff on $16bn, plans 5-25% on $60bn
Imposes 10% (25% as of Jan 1st) tariff on $200bn, threatens add'l $267bn	September	Imposes 5-10% tariff on $60bn

Source: ACG Research, Scarbrough

What is the issue?

- The price of oil, as measured by NYMEX, has risen 21% year-to-date and 42% over the past year.
- US sanctions on Iran are cutting one source of crude oil supply for most of the world.
- Though alternative energy sources are being pursued successfully, oil is still the dominant source of energy in the world.
- As oil prices increase, the cost of doing business increases, and in some cases, fairly dramatically.
- As oil is priced in US dollars, countries that are mainly oil importers are being negatively impacted by a relatively strong US dollar.

Where do things stand?

- The “natural” cap of oil, due to extraction methods that become relevant when prices rise, is likely somewhere in the $100/barrel range.
- Rising oil prices means higher prices in many areas, including at the pump, air travel, and many manufactured goods, due to higher input pricing.
- The cost of shipping goods, either complete or component parts, is also affected by rising oil prices.
- Political uncertainty feeds price levels and volatility, with the current trade war and Iran sanctions playing major roles.

Potential Outcomes:

- Oil prices could continue to climb alongside interest rates and the US dollar. These multiple forms of tightening would be a headwind for equity investments.
- Prices could settle in to a natural supply/demand equilibrium, limiting the impact on inflation and easing pressure on the Federal Reserve to increase rates.

Global Supply/Demand Dynamics in Oil

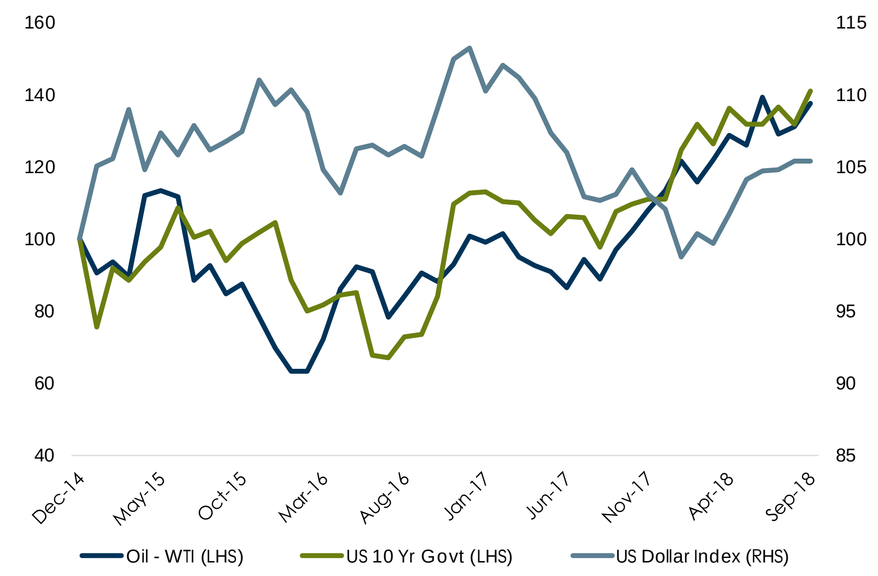
Change in Production and Consumption

Production, consumption, and inventories, millions of barrels per day

Production	2015	2016	2017	2018	2019	Growth since '15
U.S.	15.1	14.8	15.7	17.5	18.8	24.2%
OPEC	38.4	39.4	39.3	39.0	39.0	1.5%
Russia	11.0	11.2	11.2	11.3	11.4	3.6%
Global	**96.6**	**97**	**97.7**	**99.7**	**101.6**	**5.2%**
Consumption						
U.S.	19.5	19.7	20	20.4	20.7	5.9%
China	12.4	12.8	13.3	13.7	14.2	14.8%
Global	**95.5**	**97**	**98.5**	**100.1**	**101.6**	**6.4%**
Inventory Change	**1.1**	**0**	**-0.8**	**-0.4**	**0.1**	

Source: ACG Research, US Energy Information Administration (EIA)

Oil Prices, Rates, and US Dollar Rising in Tandem



Source: ACG Research, Bloomberg

Investment Themes (3-5 Years)

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

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