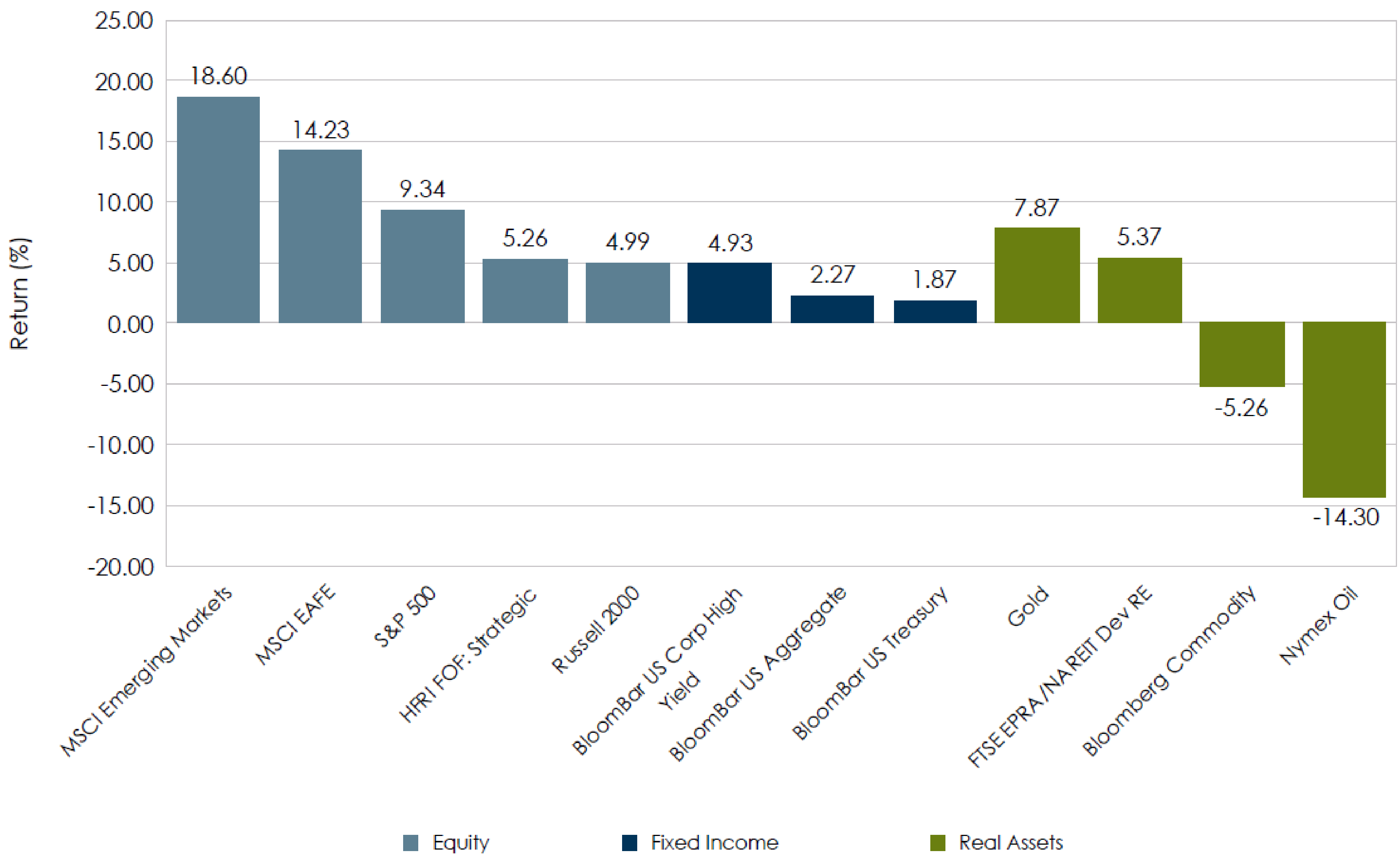
Global Economic Update

Third Quarter 2017

Market Returns

For the YTD Period Ending June 30, 2017



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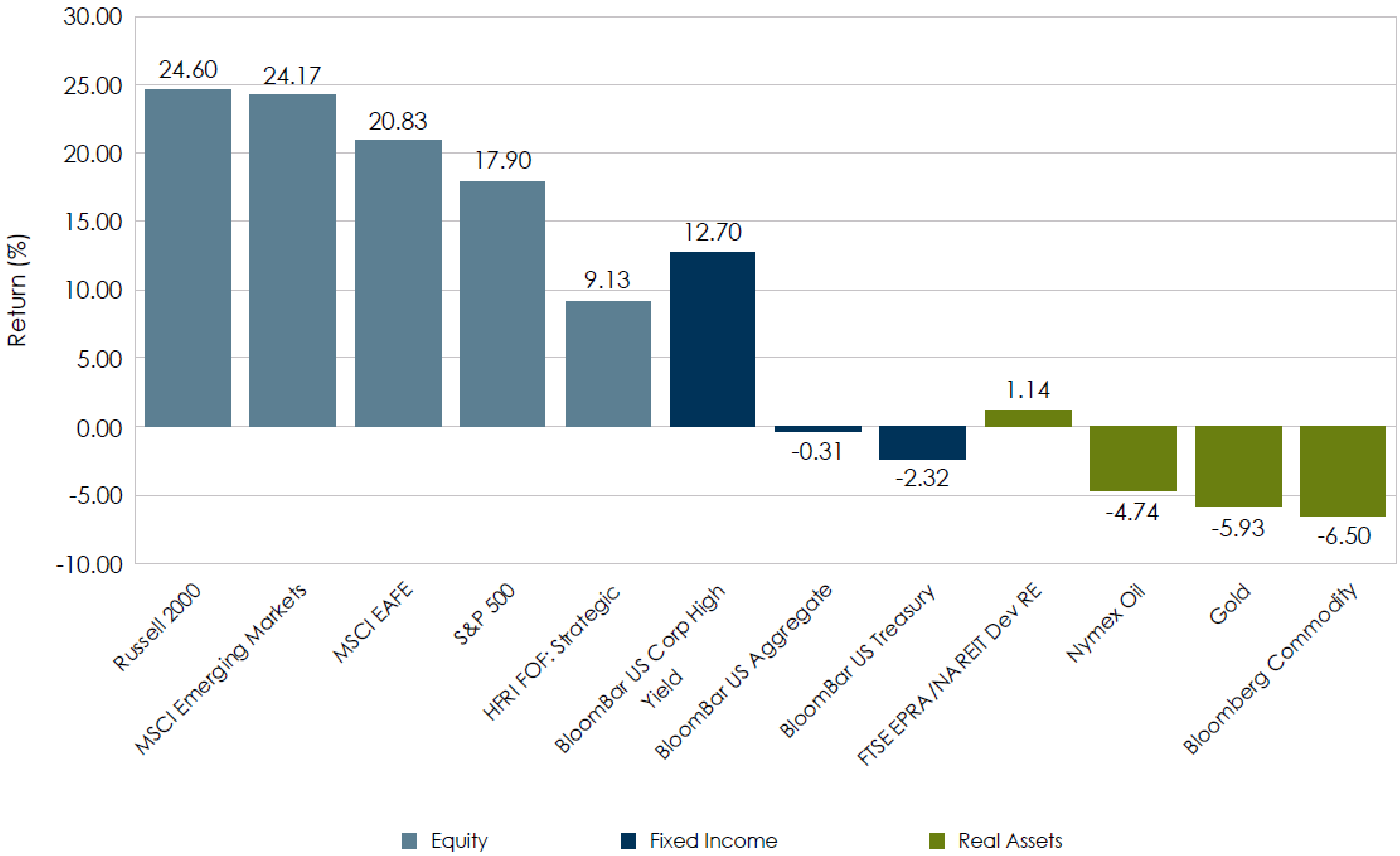


US

- **Mixed signals continue to permeate the US economy.** Even with US unemployment at its lowest rate in years, and below the Fed's estimated "neutral rate," wage growth has lagged expectations. **Recent price indicators do not suggest a meaningful uptick in inflationary conditions. The consensus GDP estimate for 2017 remains modest at 2.3%,** despite projections calling for improvement in the second half of the year.
- Markets appear to have recognized and re-priced the **risk associated with the timing/implementation of the new administration's expansionary policies.** While consumer and business confidence measures remain strong, there have been **declines in the "expectations"** component which could temper any future acceleration in economic growth.
- While **most economists argue that recession probabilities appear low**, certainly over the next 12-months, the odds of contraction grow materially as economies approach full employment (4% often seen as critical level).
- The Fed took further steps **to normalize interest rates** in mid-June. While the market generally maintains the view that **future policy adjustments will occur at a gradual pace,** any perceived eagerness on the part of the Committee would likely prompt an adjustment in asset prices.

Global/Non-US

- Global growth has become more synchronized, with **economic recovery abroad following the lead of the US economy.** Data out of the Eurozone has been surprising to the upside with GDP, manufacturing PMI's, and sentiment all trending higher. Momentum in the region has caused inflation to rise modestly, such that the risk of deflation now seems remote**.**
- Although election outcomes in France and the United Kingdom potentially add stability, the **ECB remains cautious on the sustainability of the recovery**. Given negative market reactions to even the slightest mention of reduced stimulus, Mario Draghi clarified comments and soothed **investors that are relying on monetary policy accommodation.**
- **Japan's economy appears to be on a more sustainable path**, with industrial production recently hitting its highest level since 2008 and unemployment falling to a mere 2.8%. Still, inflation remains stubbornly low, and **the BoJ will likely be the last to roll back aggressive stimulus policies.**
- **Many emerging markets economies are benefitting from healthier global trade dynamics** and improving domestic fundamentals. China's economy continues to operate within the government's 6.5%-7.0% target range for GDP growth. This autumn's Communist Party conference could formalize key reforms, but **Chinese stability is expected near term.**

Current Issues

- Keeping Score: Evaluating the Facts on the Ground
- Which Fundamentals Are Driving the Fed?
- Where are US Equities in the Economic Cycle?
- Do International Equities Remain Attractive?
- Commodities: Are We Near the Bottom?

Keeping Score: Evaluating the Facts on the Ground

Market View:

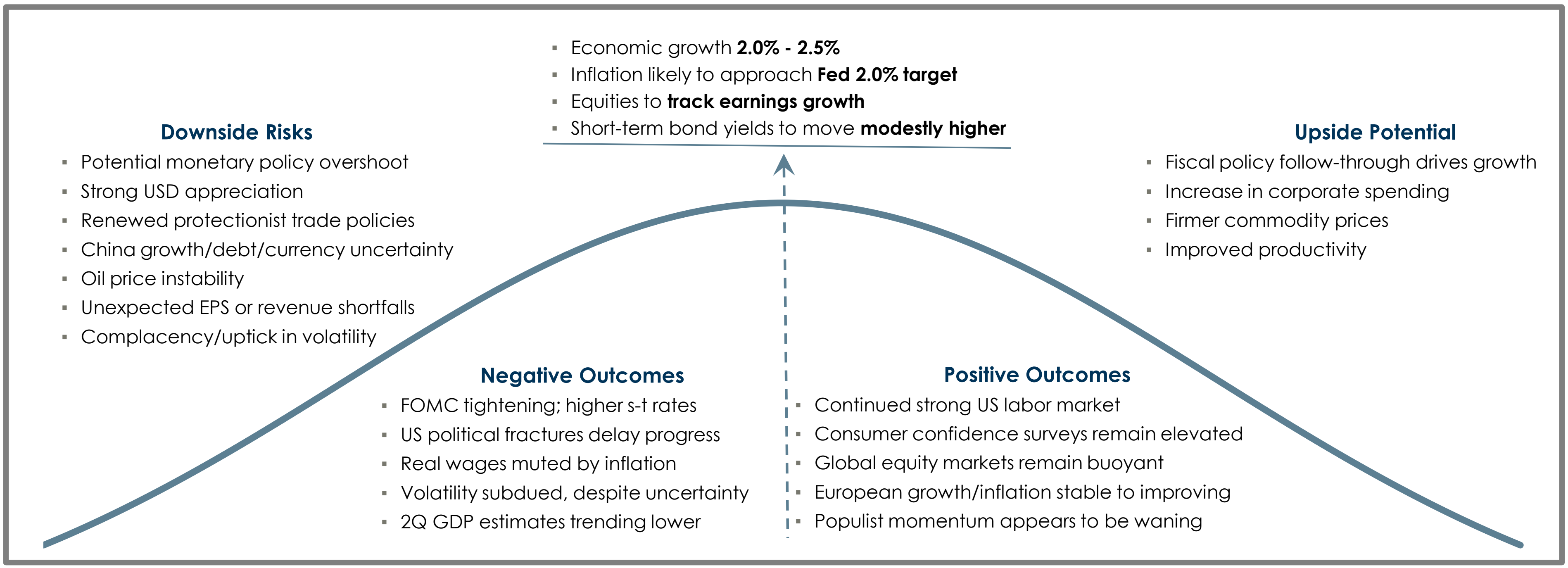
- Global monetary **policy action** will remain a dominant **driver of both volatility and price levels**.
- Even with a potentially **softer approach to Brexit,** forthcoming negotiations may foster **political instability** within Europe.
- China's **slowing growth and growing debts** are a global market concern.
- The suppression of risk premia has **elevated pricing for assets globally** such that they may be **getting ahead of economic fundamentals**.

ACG Position:

- Near-term **monetary policy surprises are unlikely** given the sensitivity and awareness of global central bankers, **but the tail risk cannot be ignored**.
- **Economic and political uncertainties** will affect markets for the foreseeable future.
- Increasing global tensions (most notably North Korea) create **near-term risks and long-term opportunities** for investors.

Portfolio Implications:

- Continue to **favor equities and real assets over fixed income**.
- Employ **actively managed strategies** in less efficient asset classes; utilizing more **opportunistic managers** when appropriate.
- Maintain **hedged strategies** for downside protection and continually **monitor/evaluate portfolio** for compliance with strategic objectives.



Which Fundamentals Are Driving the Fed?

Market View:

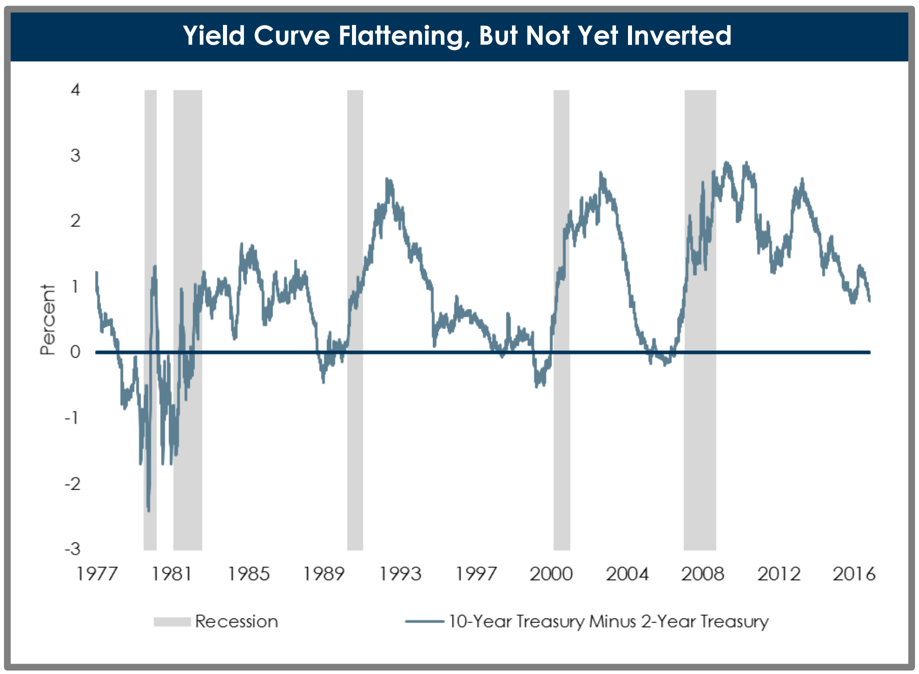
- FOMC rate increase in mid-June was widely expected, but **only 50% believe there will be another adjustment this year.**
- **Price indexes** such as CPI and PCE have moderated in recent months**, trending back below the Fed's 2% objective.**
- The **US Treasury curve has been flattening,** reflecting higher short-term rates, but also reflecting a **pessimistic outlook for growth**.

ACG Position:

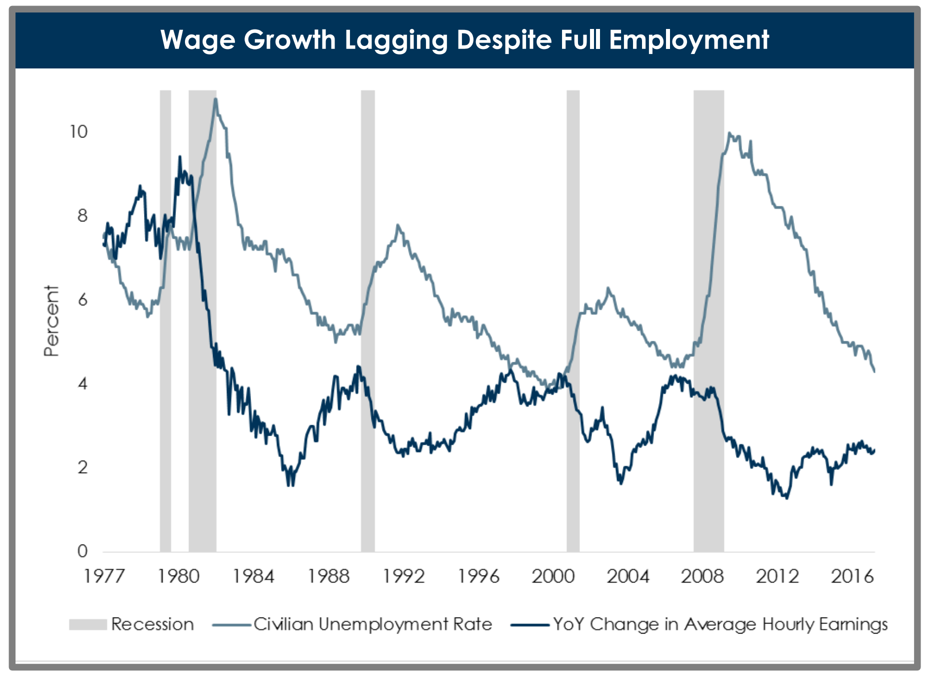
- The Fed's **intentional efforts to be more transparent** helps minimize market reaction to monetary policy actions.
- **The bond market is cautiously discounting the Fed's optimism** as it relates to improvement in growth.
- Continued **slack in the labor market** (falling unemployment, lack of wage pressure) has been the primary factor keeping inflation in check.
- While most economists argue that near-term recession probabilities are low, **the Fed appears eager to continue on with policy tightening.**

Portfolio Implications:

- Amid expectations for higher rates, continue to **moderately underweight duration** in fixed income assets and retain risk factor diversity.
- Maintain targets in large cap US stocks, but **consider reduction in US small cap stocks** given valuations and economic sensitivity.
- **Maintain hedged strategies** for downside protection.



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



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

Where are US Equities in the Economic Cycle?

Market View:

- **US equity valuations are relatively high**, even with solid reports on corporate earnings in Q1 and expectations for further growth.
- Since President Trump's election, **equities have continued to perform even as the potential near-term benefit of fiscal policy changes fade**.
- Investments in credit offering enhanced yield have done well, even as risk-free **US Treasury yields have declined year-to-date.**

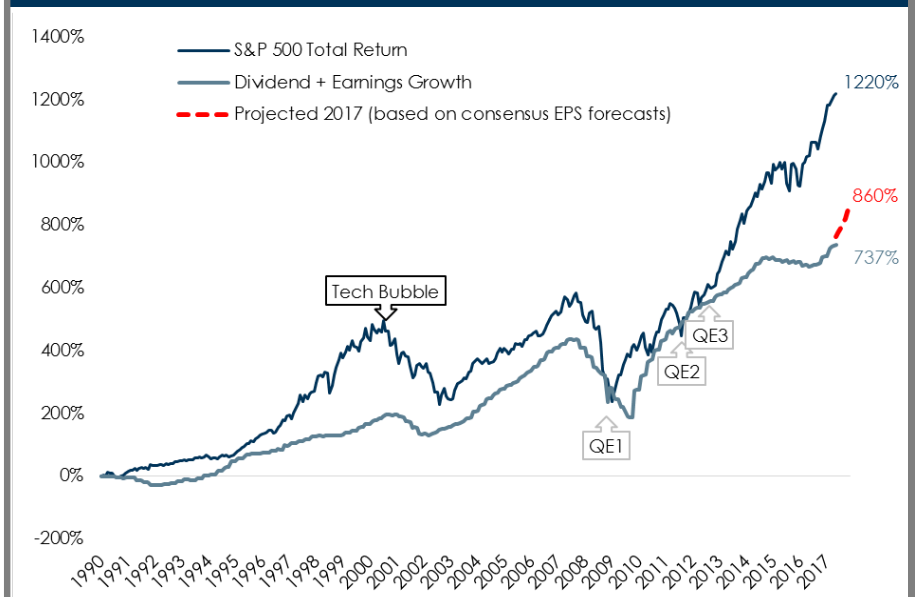
ACG Position:

- Markets have **minimized the likelihood of legislative reform** of any kind in the short-term, but **the need for return is driving risk assets**.
- When compared with cumulative dividends and earning growth since 1990, **US equity returns have outpaced fundamentals and momentum may be tested.**
- **Continued positive earnings surprises will be challenged** by higher market expectations, and potential declines from near-record corporate margins.
- **Volatility is likely to increase** as policy-induced complacency is brought into question with a tighter Fed – both higher rates and unwind of QE's.

Portfolio Implications:

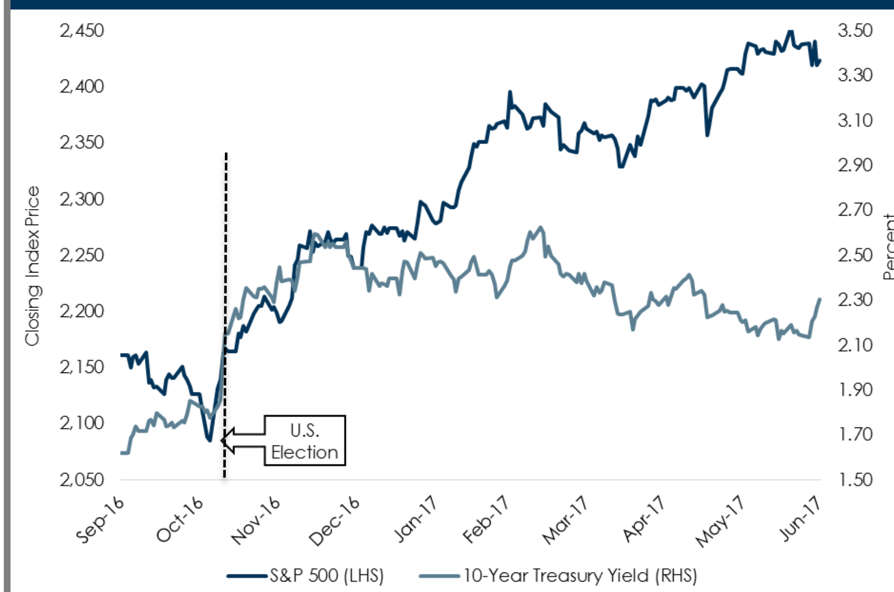
- **Closely monitor portfolio allocations** for US equities relative to strategic objectives, and **rebalance as appropriate**.
- Employ **active managers** that can respond to potential opportunities that may arise.
- Incorporate **volatility dampening** strategies.

S&P 500 Earnings and Dividend Growth vs. Total Return



Source: ACG Research, Standard & Poor's, Bloomberg

Equities vs. Bonds – Seeing the World Differently



Source: ACG Research, Bloomberg

Do International Equities Remain Attractive?

Market View:

- Recent **election outcomes in France and the United Kingdom** have added stability, and serve as headwinds to the global populist movement.
- European growth continues to be solid, **causing some to question the resolve of the ECB** to maintain accommodative monetary policy.
- Emerging market economies are broadly stabilizing, but **periodic disruptions may continue and China remains a risk.**

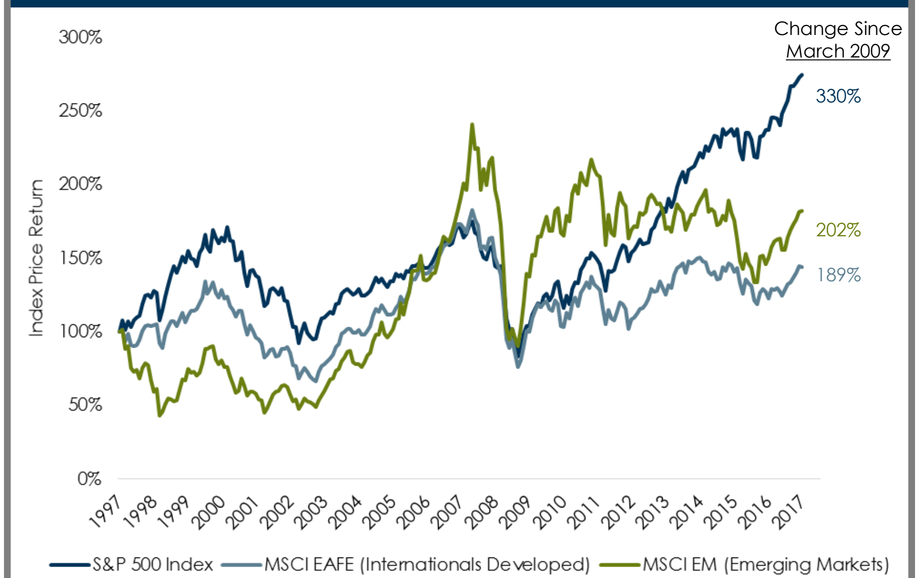
ACG Position:

- Global growth has been more synchronized, but **non-US monetary policy generally lags the Fed**.
- The **dynamic movements of the US dollar** (weaker year-to-date) will have material impacts on exports, non-US corporate earnings, and US investor returns.
- Outperformance by US stocks since the credit crisis has been meaningful, with **relative valuations for non-US drifting well below their historic levels**.

Portfolio Implications:

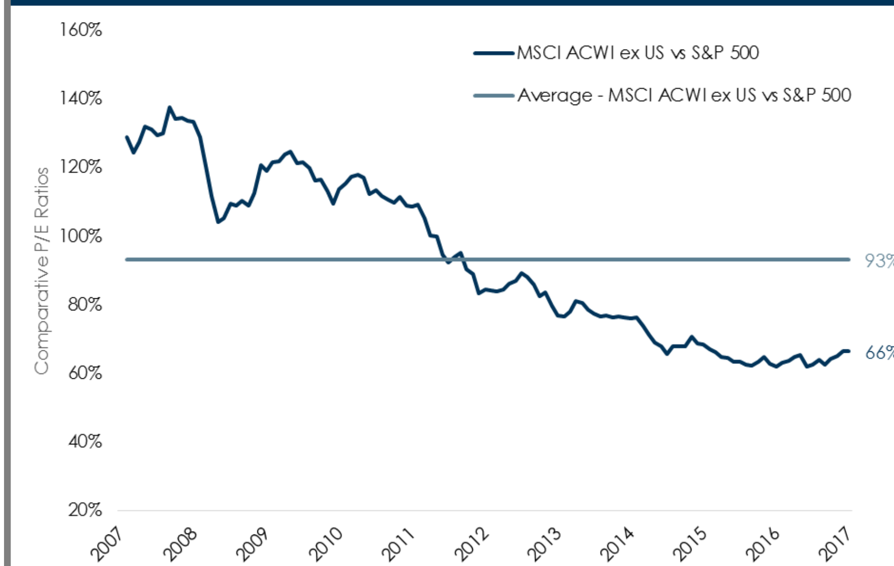
- Maintain non-US equity exposure **at or above target allocations.**
- Employ **active managers** that can respond to potential dislocations that may arise.
- **Maintain hedged strategies** for downside protection.

20-Year Comparative Benchmark Returns



Source: ACG Research, Bloomberg

Relative Valuation – MSCI ACWI ex US vs. S&P 500



*Utilizing historic CAPE values, which is a cyclically adjusted price to earnings ratio.

Source: ACG Research, Robert Shiller

Commodities: Are We Near the Bottom?

Market View:

- After a positive 2016 campaign, **oil and other commodities have declined this year.**
- **OPEC's decision to maintain, as opposed to increasing, production cuts was a disappointment,** especially as their desired impact is being challenged by other low-cost producers (primarily US shale).
- **Equity markets have continued to rally despite the recent drop in oil prices**, reflecting lower input costs for industry and more discretionary income for consumers.

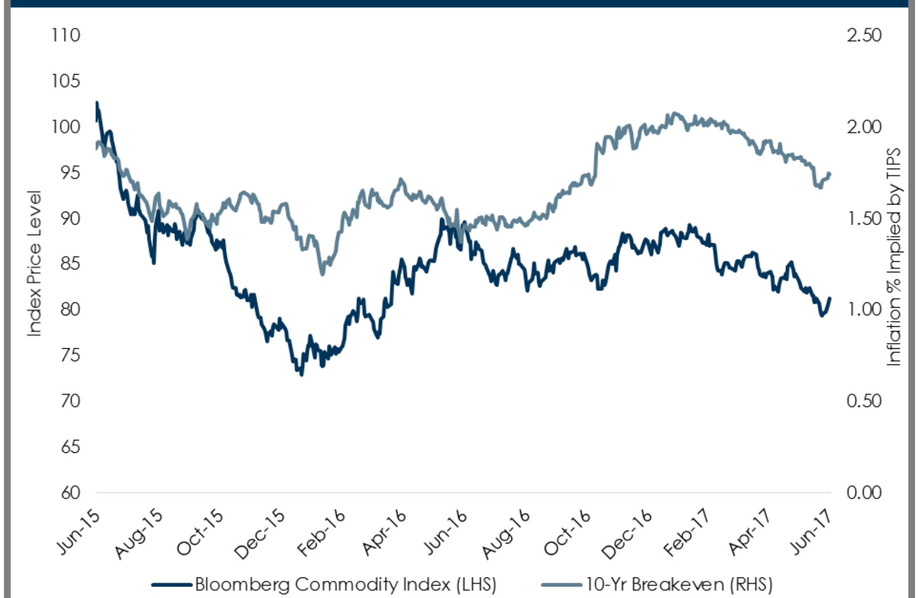
ACG Position:

- **There appears to be a lack of optimism** in energy, absent political upheaval (affecting supply) or significant weather issues (primarily affecting demand).
- Beyond energy and oil, **recent drops in prices for agriculture and certain industrial metals may present buying opportunities.**
- **Precious metals could be a beneficiary of "safe-haven" trading**, if and when global volatility increases.
- **Higher realized growth/inflation** in key developed nations and/or **a continued weaker US dollar** should provide a **tailwind** to increase prices.

Portfolio Implications:

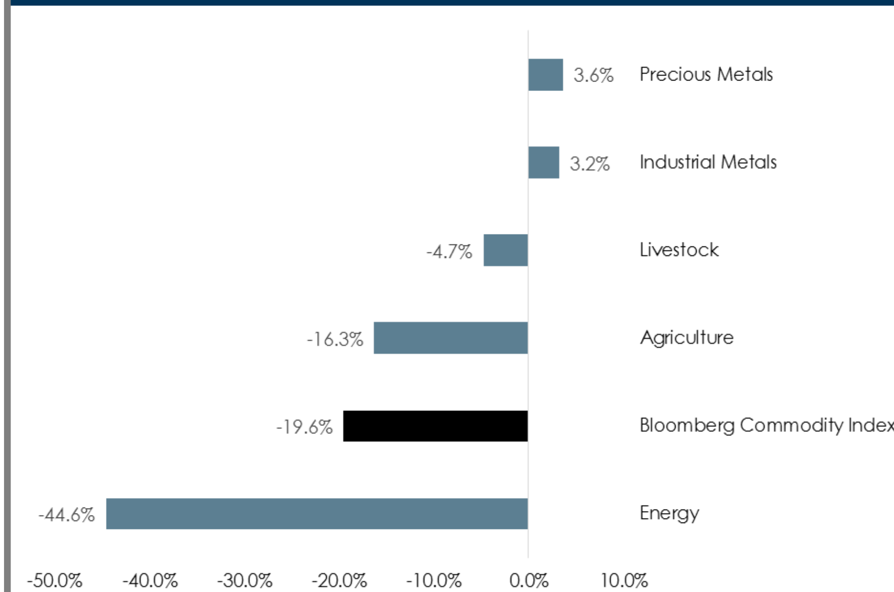
- Given the current outlook, consider **restoring a strategic allocation or establishing a potential tactical allocation to broad-based commodities**.
- There is **often overlap between emerging market investments and commodities,** so understanding the exposures in each can **reduce unwanted correlation.**
- **Return expectations may continue to be muted** for the foreseeable future, but breakouts can occur and diversification benefits exist through time.

Broad Market Commodities vs. Inflation Expectations



Source: ACG Research, Bloomberg

Cumulative Returns Since 6/30/15



Source: ACG Research, Bloomberg

Investment Themes (3-5 Years)

Theme	Rationale	Implementation Strategy
Geopolitical & Policy Uncertainty	▪ Disparate global fiscal/monetary policies ▪ Potential US fiscal stimulus; reduced Euro area austerity ▪ Long term constraint from high government debt ▪ Political polarization – rising in US, declining in Europe ▪ Terrorism concerns, immigration, nuclear issues, territorial disputes, climate change concerns, social media impact	▪ Maintain global diversification; meaningful non-US exposure ▪ Increase risk-reducing and private strategies ▪ Maintain disciplined rebalancing strategy
Improving Global Growth Expectations	▪ Pro-growth policies in the US and abroad ▪ Continued monetary support in Europe/Japan ▪ China transitioning to consumer-driven economy ▪ Improving growth metrics across regions	▪ Prefer equities over fixed income ▪ Focus on actively managed, opportunistic strategies in less efficient asset classes (e.g. US Small Cap, Non-US, EM, Multi-sector fixed income) ▪ Allocate to specialized / differentiated managers ▪ Consider strategies with sustainability orientation
Fixed Income Market Headwinds	▪ Stretched sovereign valuations at low yields ▪ Fed policy normalization ▪ Inflation expectations driving yield volatility ▪ Later stage of economic/credit cycle ▪ Liquidity challenges may increase volatility	▪ Retain fixed income allocation for diversification ▪ Prefer credit and securitized over sovereign debt ▪ Include exposure to private debt or other yield enhancing strategies (e.g. high yield, EM debt) ▪ Incorporate absolute return oriented strategies
Global Inflation Conundrum	▪ Wage pressure building, but still slack in labor market ▪ Rising consumer spending driving demand ▪ Technological efficiencies lowering prices ▪ Energy prices normalizing/stabilizing ▪ Trade policy uncertainty – inflationary/deflationary?	▪ Retain meaningful equity exposure ▪ Retain core real estate (RE) exposures ▪ Incorporate diversified commodity exposure
Muted Return Expectations	▪ Relatively high valuations across asset classes ▪ Shrinking public equity market ▪ Global economic growth remains positive but tepid ▪ Longer-term challenges of demographics/debt levels ▪ Yields and inflation advancing from historic lows	▪ Revisit investment objectives, constraints and strategic allocation ▪ Implement private equity and/or debt strategies ▪ Consider active strategies with enhanced flexibility ▪ Employ risk management solutions

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