Sit Investment Associates

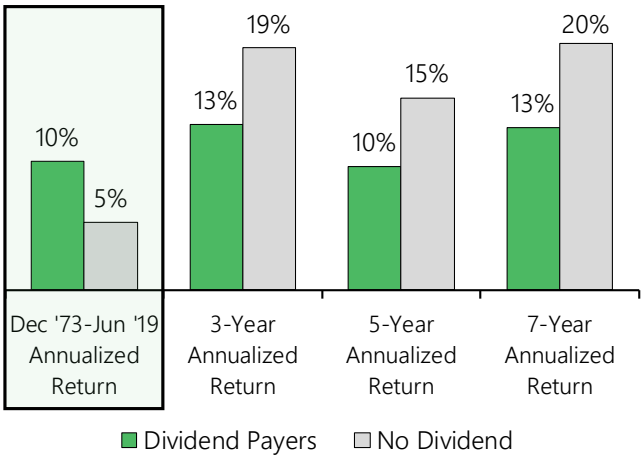
July 2019

GLOBAL INVESTMENT OUTLOOK AND STRATEGY

- **Special Topic: Dividend Growth Stocks Should Come Back in Favor**
- **U.S. Macro Strength Vulnerable to Lasting Trade Policy Uncertainty**
- **China's Growth Slowing, But Credit Impulse Points to Stabilization**
- **Increasingly Dovish Fed Policy May Fall Short of Market Predictions**
- **Stock Picking Key in Progressively Volatile and Discriminate Markets**

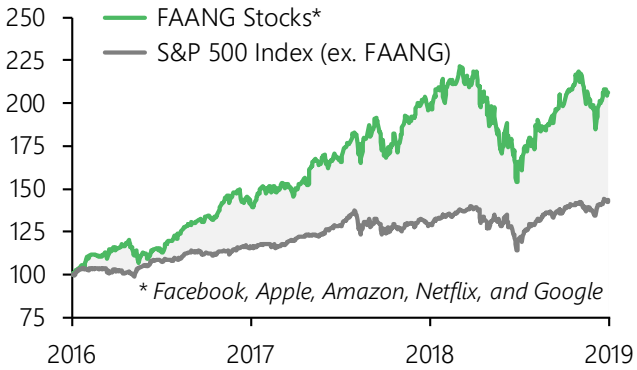
Now is the Time to Own High Quality Growth Stocks with Attractive Dividend Yields

Dividend Stocks Have Lagged the Market



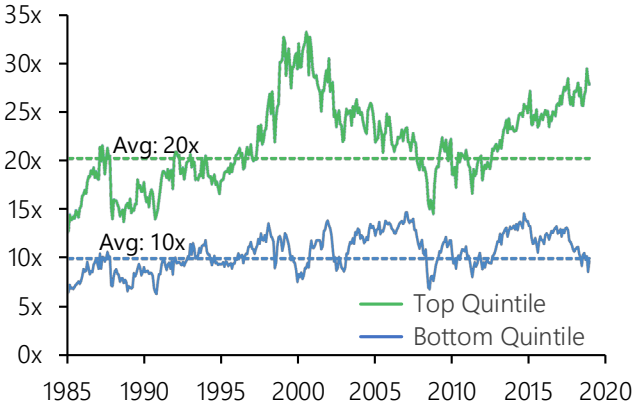
Market Led Higher by Momentum Stocks

Performance of FAANG Stocks vs S&P 500 (ex. FAANG)
Indexed



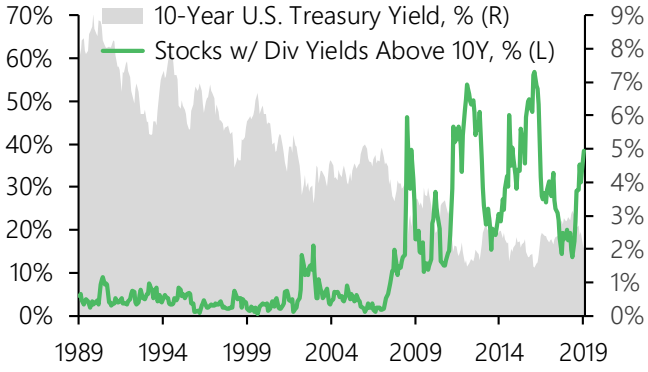
Momentum Expensive, Value Elsewhere

Forward PE of S&P 500 Top & Bottom Valuation Quintiles



Many Stocks w/ Div. Yields > 10Y Treasury

% of Stocks w/ Dividend Yields Above 10Y Treasury Yield
500 Largest Companies by Market Cap



Source: Goldman Sachs, Ned Davis Research, Wolfe Research, FactSet, Sit Investment Associates, 6/30/19

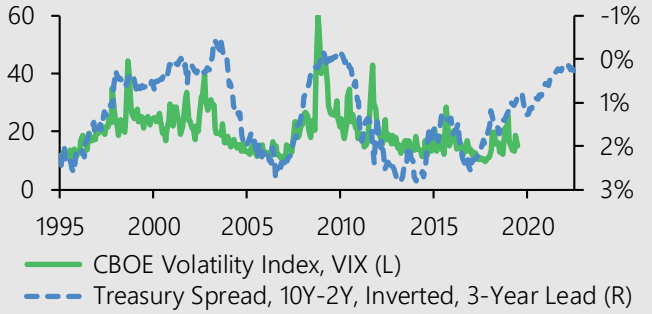
Special Topic: Dividends Underappreciated

The chronic underperformance of dividend payers in recent years has been surprising, as modest GDP growth and low inflation have historically been a favorable backdrop for this investment style. Still, based on a combination of top-down and bottom-up factors, we believe now is the time for investors to own high quality, dividend-paying growth stocks.

We believe investors will increasingly seek exposure to dividend-paying stocks for several reasons. First, due to lagging performance, numerous high-quality dividend-payers now trade at compelling valuations. Second, we believe the U.S. yield curve is distorted by deeply negative term premium and rock bottom rates outside the U.S. and does not signal a looming recession. However, it does reflect an expansion in its later stages and that volatility will rise, adding to the appeal of dividend-paying stocks which tend to perform relatively well in volatile financial markets.

Yield Curve Leads Volatility

CBOE Volatility Index vs U.S. Treasury Spread



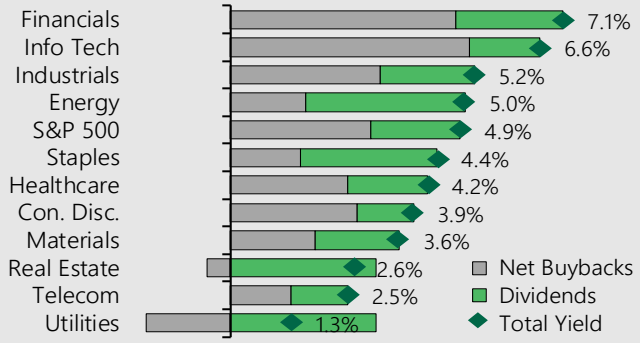
Source: FactSet, 6/30/19

Third, with corporate debt levels at cycle highs and free cash flow growth moderating, investors will increasingly focus on dividends, as buyback activity appears to be peaking. Since valuations for stocks are now at "fair" levels against a backdrop of sluggish corporate EPS growth, incremental returns through dividends will take on greater importance as future stock market gains will likely moderate.

Not all dividend-paying stocks have performed poorly of late, as the most defensive areas of the market (e.g., staples & utilities) have surged, which is typically the case when interest rates fall on rising economic growth worries. Elevated valuations for these "bond proxies" tend to be unsustainable, as an inevitable policy response to growth concerns reverses sentiment and drives down valuations for these stocks. The lagged effect from falling interest rates, Chinese stimulus, and a "pause" in the trade war will tend to favor more growth and cyclical companies within the dividend-paying universe.

We believe there are many compelling investment opportunities in dividend growth stocks across a wide range of industries: financial stocks continue to raise dividends and buy back shares at valuations below market averages; industrial and technology shares should get a boost from a de-escalation in trade tensions; and energy companies are showing increasing restraint on production relative to capital returns. These four sectors currently have solid total yields (dividends plus share repurchases) and, importantly, have significant growth potential.

Total Capital Return Yields by Sector



Source: FactSet, 6/30/19

The appeal of dividend strategies is not confined to large cap U.S. stocks, as many smaller companies also offer attractive growth prospects, with yields significantly above that of the Russell 2000 Index. We believe a "lower risk" strategy is prudent within a small cap universe that is showing increasing signs of speculation – nearly 20 percent of the Index's capitalization is now comprised of companies with negative earnings, with another 28 percent valued at P/E ratios greater than 30 times. Outside the U.S., dividend yields are generally higher and particularly attractive relative to $12 trillion in bonds trading at negative interest yields. Higher yields, undemanding valuations, and the opportunity to gain exposure to fast growing emerging markets, are key reasons for investing in international dividend growth stocks.

A diversified portfolio of quality, growth-oriented dividend-paying companies can provide investors with an opportunity to participate in market gains, but also provide some downside protection if market fundamentals deteriorate.

GLOBAL MACRO DEVELOPMENTS

The United States

Trade policy uncertainty risks undermining the current "Goldilocks" expansion. Fed easing should be supportive, but increased liquidity has its limits against trade fallout.

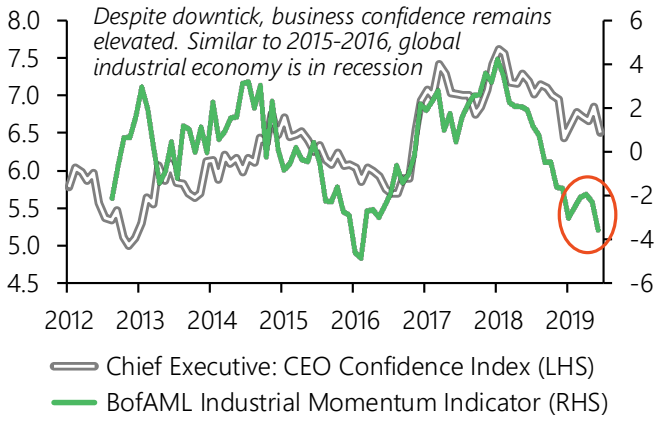
Underlying Macro Strength Threatened by Persistent Trade Policy Uncertainty

Higher-than-expected 1Q19 real GDP growth of +3.1 percent, driven largely by gains in two of its more volatile components, inventories and net exports, combined with strong year-to-date stock market returns, likely emboldened President Trump to take a hard line with China. However, the breakdown in U.S.-China trade negotiations in early May and resumption of earlier-postponed tariff hikes have contributed to a notable downtick in industrial activity and business confidence (Exhibit 1). Reassuringly, consumer spending has stayed resilient, with a dip in mortgage rates giving a near-term boost to home sales. Still, measures of current economic activity signify a downshift in GDP growth in 2Q19, albeit against a difficult 1Q19 compare. Whereas the economic consensus is now +1.8 percent on a quarter-over-quarter annualized basis, down from +2.5 percent on May 1, the Atlanta Fed's *GDPNow* model infers growth of +1.3 percent in 2Q19. Dominated by binary events and chronic policy uncertainties, the near-term outlook is skewed to the downside, with our 2019 real GDP growth forecast of +2.5 percent at risk if confidence continues to falter. However, there is a clear, though narrowing, path to a soft landing and growth reacceleration based on a trade conflict resolution and looming Fed easing.

Despite Accumulating Headwinds, There Are Reasons for Optimism

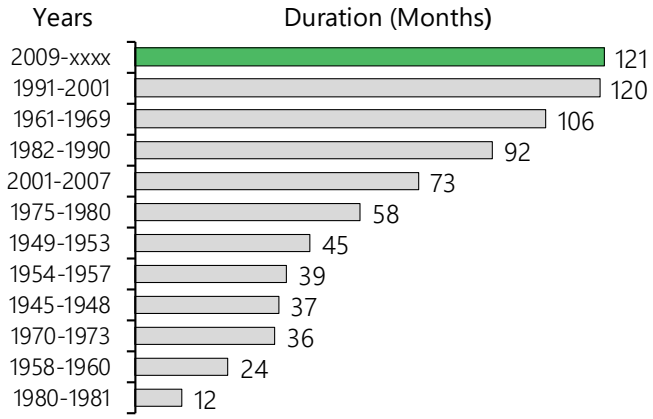
U.S. economic growth continues to moderate from difficult year-over-year compares due in large part to fading fiscal stimulus, lagged effects of monetary tightening, and dogged trade policy uncertainty. Moreover, while it is true that economic expansions do not die of old age, a maturing cycle can contribute to self-fulfilling fears that recession is lurking around the corner. The fact that the current expansion will officially become the longest on record this month, at 121 months in length, has not gone unnoticed (Exhibit 2). On top of this, a continuing global industrial recession, appreciating U.S. dollar, rising debt, looming federal budget standoff, spiraling U.S.-Iran tensions, and decelerating corporate profit growth threaten to dampen confidence further. Despite mounting headwinds, the economy currently remains in solid shape and there are reasons to believe the expansion

Exhibit 1: Confidence & Industrial Momentum



Source: Chief Executive Magazine, BofAML, 6/30/19

Exhibit 2: Duration of U.S. Postwar Expansions



Source: National Bureau of Economic Research, 7/1/19

has more room to run based on enduring benefits from tax cuts and deregulation, rising productivity, accelerating wage growth, solid job growth, recovering retail sales growth, easing financial conditions, and growing global stimulus.

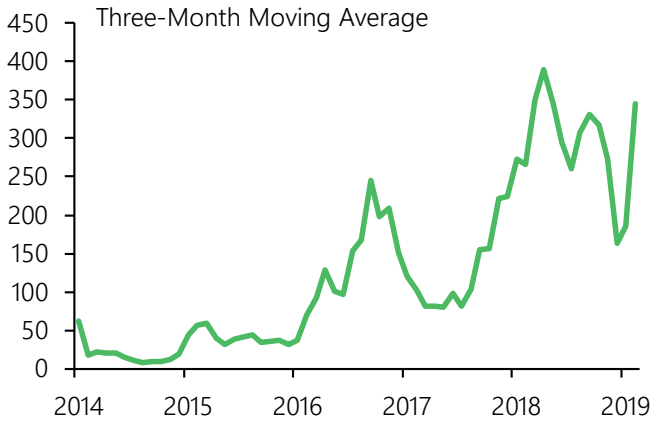
Trade Truce Reduces Overhang, But Also the Likelihood a Deal is Imminent

The U.S.-China trade fight ceasefire announced post the recent Trump-Xi meeting at the G20 Summit removes, at least for now, the economic overhang of an escalating conflict. However, it may also reduce China's urgency to forge a trade deal. While the 25 percent tariff on $250 billion in Chinese imports implemented May 10 will remain in place, the threat of tariffs on an additional $300 billion in imports has been removed indefinitely. Furthermore, in exchange for China increasing purchases of U.S. agricultural products by an undisclosed amount, Huawei will again have access to certain U.S. technologies. The terms of the truce may imply 1) some bargaining power has shifted to China as President Trump may be reluctant to risk additional harm to the U.S. economy (notably the rural economy) ahead of an election year and 2) neither side believes a trade deal in imminent. An eventual trade deal remains our base case as we believe neither side can withstand the economic pain of a long-term conflict. Still, persistent trade policy uncertainty continues to weigh on business investment and raises the odds of a global downturn (Exhibit 3).

Fed Easing May Steady Confidence; Ability to Counter Trade Fallout Unclear

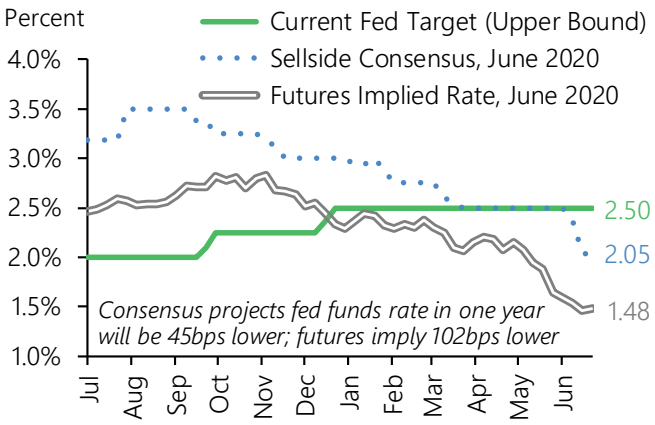
While the Federal Reserve (Fed) strives to be above political influence, it has shown time and again it will bend to the will of financial markets. First dubbed the "Greenspan put" in the 1990s (after the Fed's chair at the time), investors are now conditioned to expect the Fed to intervene at times of market stress. As a result, expectations for interest rate cuts have continued to rise post the 4Q18 stock market correction and in conjunction with the recent collapse in U.S. Treasury yields, with fed fund futures now implying rates will be over 100 basis points lower within the next year (Exhibit 4). On cue, over the past nine months the Fed has incrementally swung from autopilot on interest rate hikes and balance sheet reduction to standby for imminent rate cuts. While legitimate risks to the macro outlook have accumulated, the Fed aspires to short-circuit a negative feedback loop triggered by sinking confidence. There are several past instances in which so-called "insurance" rate cuts helped sooth jittery markets and elongate economic expansions. Thus, we expect the Fed to appease investors near term and cut rates by 25 basis points this month. However, given still solid U.S. macro conditions, there is a risk the Fed will look through global macro uncertainties, thus tempering its policy response beyond July.

Exhibit 3: U.S. Trade Policy Uncertainty



Source: Baker, Bloom, and Davis, 6/30/19

Exhibit 4: U.S. Fed Funds Rate

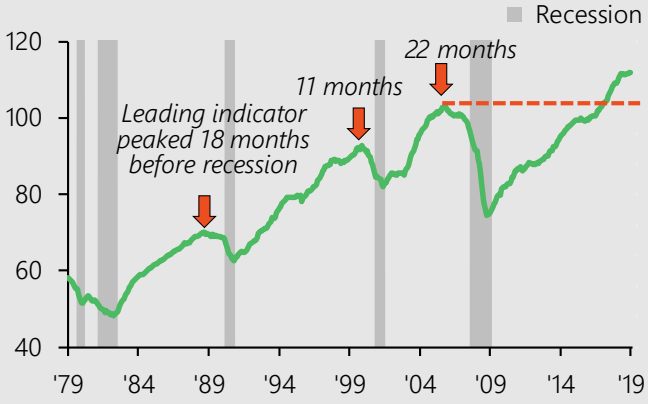


Source: Federal Reserve, FactSet, Bloomberg, 7/3/19

United States: Notable Data Points

Leading Indicator Rising, Albeit at Slower Pace

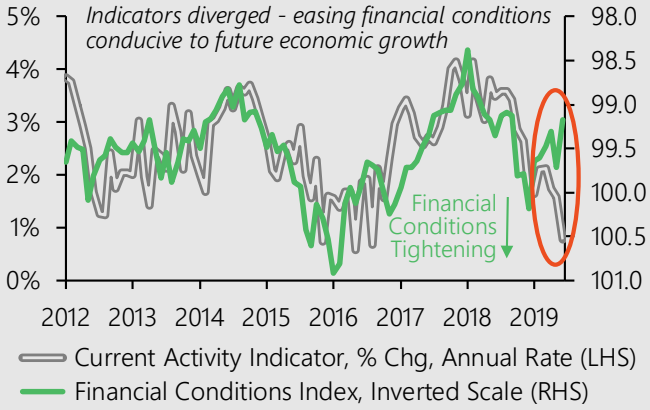
U.S. Composite Index of 10 Leading Indicators
2010 = 100



Source: Conference Board, 6/30/19

Easing Financial Conditions a Notable Positive

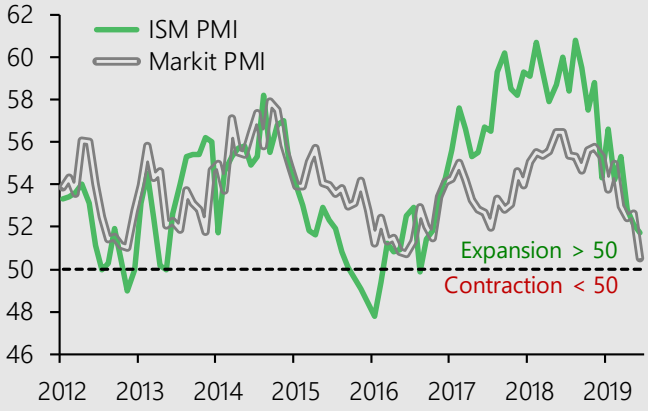
U.S. Current Economic Activity vs Financial Conditions



Source: Goldman Sachs, 7/3/19

Slowing Manufacturing PMI Still Expansionary

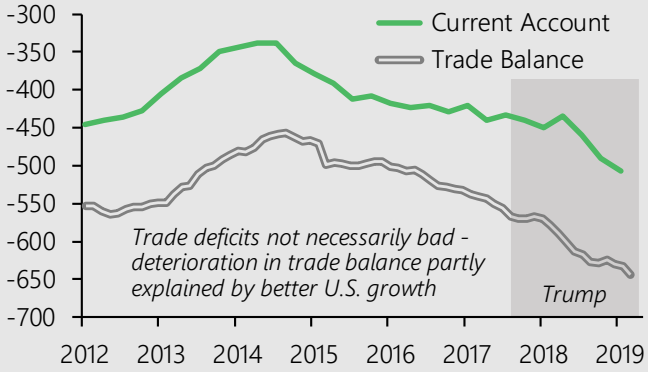
U.S. Manufacturing Purchasing Managers' Index



Source: Institute for Supply Management, Markit, 7/3/19

U.S. Trade Balance Continues to Deteriorate

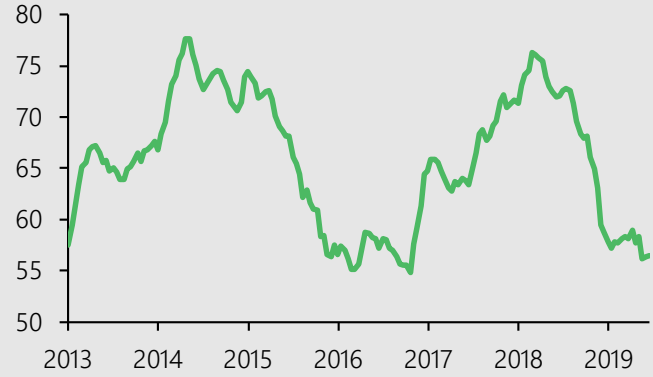
U.S. Current Account and Trade Balances
Last Twelve Months, Billions of U.S. Dollars



Source: U.S. Census, Bureau of Economic Analysis, 6/30/19

Shippers' Survey Foreshadows Stabilization

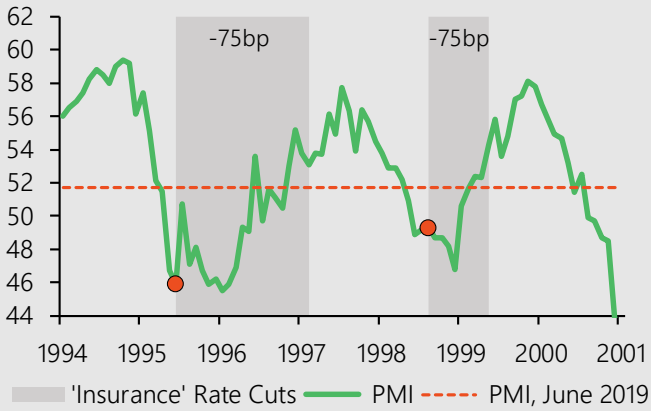
U.S. Shippers' Outlook for Freight Demand
6-12 Months Forward, Diffusion Index



Source: BofAML, 7/3/19

July Cut Would Come Earlier Than Those in '90s

U.S. Manufacturing PMI vs Prior Fed "Insurance" Cuts



Source: Institute for Supply Management, FactSet, 7/3/19

Europe

The Euro Area is at the mercy of external forces, with resilient domestic demand mitigated by lingering trade issues and a global industrial recession. Still little clarity on Brexit path.

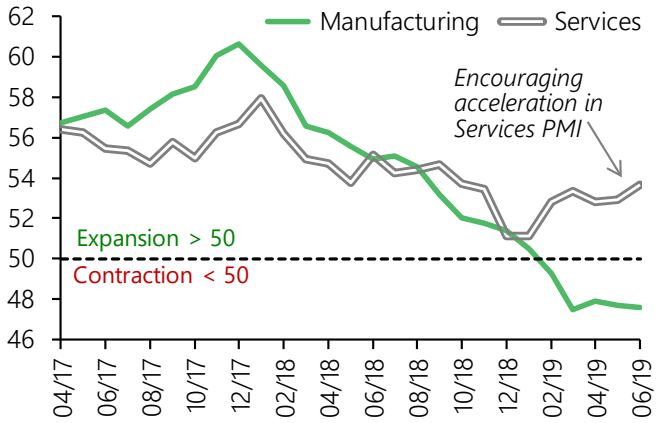
High Trade Openness Has Come to Haunt the Euro Area in the Trump Era

As extra-area exports are about 45 percent of GDP, the Euro Area is disproportionately suffering the fallout from trade policy uncertainty and associated dip in global trade, with manufacturing contracting since February per the Markit PMI survey (Exhibit 5). Earlier green shoots implying a possible bottom in manufacturing activity have since withered with the breakdown in U.S.-China trade talks in May. In contrast, relative strength in the services and construction sectors remains underpinned by a virtuous cycle of improving labor conditions and resilient domestic demand. While growth is further supported by a combination of favorable fiscal and monetary policies, elevated trade-, Italy- and Brexit-related uncertainty infer downside risk to our below-trendline 2019 real GDP forecast of +1.2 percent. Concerned possible rate cuts by an increasingly dovish Fed that may put upward pressure on the euro, further crimping growth, European Central Bank (ECB) President Mario Draghi recently hinted at additional easing. However, it is unclear if the risk of opening a Pandora's box of negative policy rates is worth the potential reward or if the ECB's new president come November will even take up the gauntlet.

Political Polarization May Be Putting the UK on a Self-Destructive Path

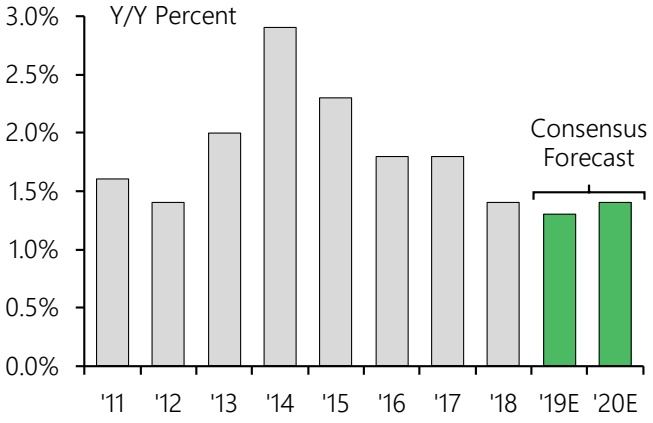
After several failed attempts by parliament to ratify PM Theresa May's Brexit agreement, the European Union (EU) gave the UK until April 12, later extended to October 31, to back the plan or risk a hard Brexit. The contest to succeed Theresa May, subsequent her resignation, is down to Boris Johnson (hard Brexiter) and Jeremey Hunt (soft Brexiter), with a July 21 party vote to select the next prime minister. Both candidates have vowed to extract further concessions, which may prove fruitless as the EU has stated it is done negotiating. As Boris Johnson is favored to win, there is now a greater probability of a no-agreement exit, possibly plunging the UK economy into chaos. Given the absence of Tory consensus, however, such a scenario may lead to a preemptive confidence vote and, possibly, an early general election or second EU referendum. For now, the deceleration in economic growth led by unrelenting Brexit uncertainty has diminished somewhat due to inventory stockpiling, with the composite Purchasing Managers' Index stabilizing at levels indicative of modest real GDP growth of +1.0 to +1.5 percent in 2019 (Exhibit 6).

Exhibit 5: Euro Area PMI Survey



Source: IHS Markit, 7/3/19

Exhibit 6: United Kingdom GDP Growth

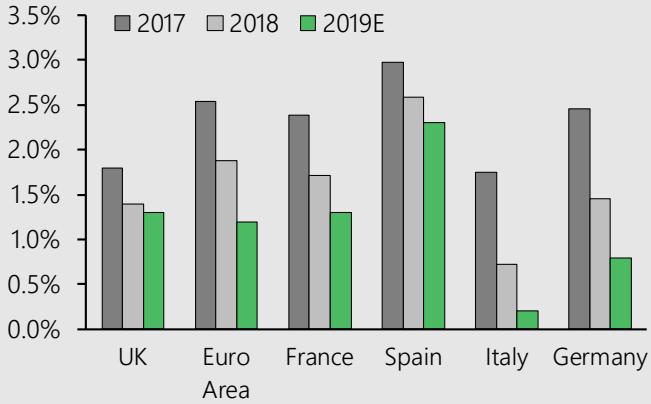


Source: FactSet, 6/30/19

Europe: Notable Data Points

GDP Growth Moderating Across Europe

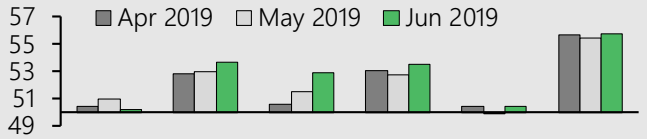
Real GDP, Y/Y Percent



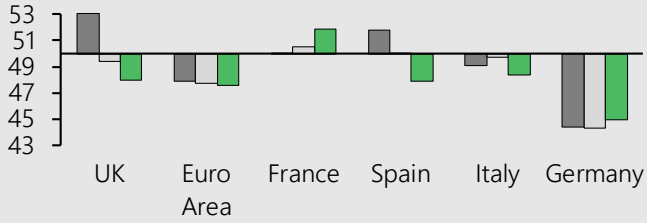
Source: FactSet, 6/30/19

Services Sector Remains Expansionary

Services Purchasing Managers' Index



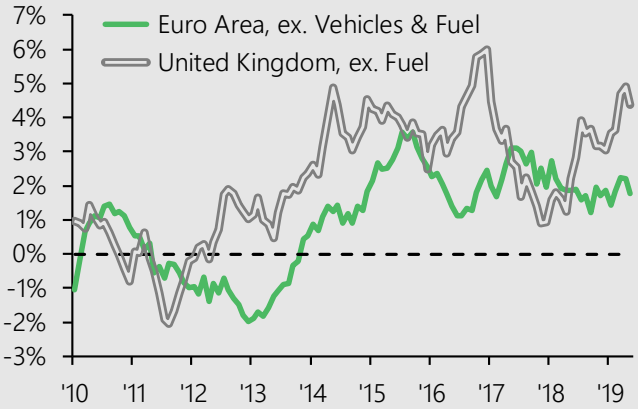
Manufacturing Purchasing Managers' Index



Source: IHS Markit, 7/3/19

Growth Buoyed by Solid Consumer Demand

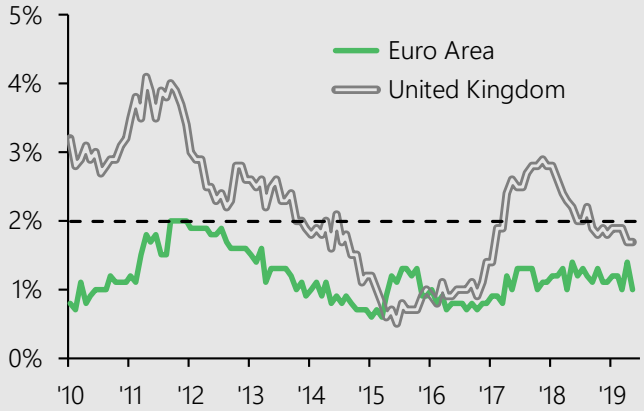
Retail Sales, Y/Y Percent



Source: Eurostat, UK Office for National Statistics, 6/30/19

Benign Inflation Provides Monetary Flexibility

Consumer Price Index, Core Inflation, Y/Y Percent

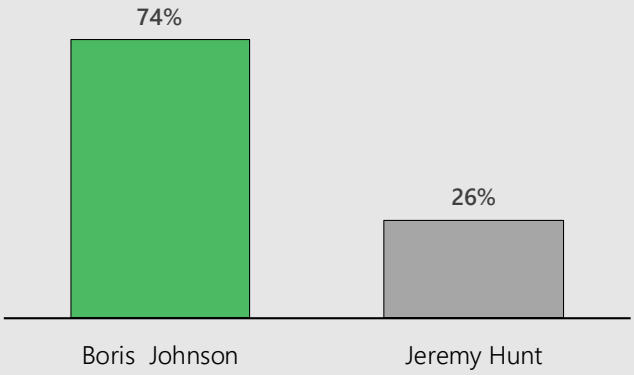


Source: Eurostat, UK Office for National Statistics, 6/30/19

Johnson Poised to Become UK Prime Minister

Conservative Party Member Voting Intentions, N = 1,076

Ex. those who don't know, would not vote, or are not eligible to vote



Source: YouGov UK, 7/6/19

Which Raises the Probability of a No-Deal Exit

Which best reflects your view?

% = Agree, 1,119 Conservative Party Members

Source: YouGov UK, 7/6/19

Japan

Limited monetary easing options add to the growing list of headwinds for Japan. Slowing activity abroad and a coming consumption tax hike already pose challenges.

We continue to expect Japan's GDP to grow a meager +0.5 percent in calendar 2019, with the coming consumption tax hike a near-term risk. A policy rethink at the Fed and other central banks amid emerging signs of flagging growth may soon force the Bank of Japan (BoJ) to follow suit or risk tighter financial conditions domestically. However, the effectiveness of further monetary easing is dubious following six years of increasingly aggressive measures. Unlike elsewhere, the BoJ has been unable to let up and recharge its easing options. This leaves pushing existing policies further, which has drawbacks. Dropping targeted rate levels further into negative territory risks additional pressure on domestic bank profitability, a growing side-effect the BoJ itself has flagged. Upping Japanese government bond (JGB) purchases, which are already below targeted levels, would run counter to the BoJ's ambition for policy sustainability and could revive JGB liquidity concerns. Increasing domestic ETF purchases is feasible, though further concentrates the BoJ's near 5 percent ownership of market capitalization and would have muted benefits given narrow household equity ownership. With monetary policy options becoming limited, fiscal policy may take on increased importance.

Emerging Markets

Chinese policy support dulling blow from trade conflict; Modi reelection clears path for more pro-growth reform in India; Mexico's economy slowing; and Brazil stuck in low gear.

Renewed Macro Weakness in China Amid Measured Policy & Trade Uncertainty

While green shoots of an emerging recovery began to sprout in 1Q19, recent macro data has largely surprised to the downside and implies renewed economic weakness. Chinese policymakers backed off stimulus efforts in late April following stronger-than-expected March macro data. Moreover, as the re-escalation of U.S.-China trade tensions also starts to show up in the economy, real GDP growth will likely moderate to +6.2 percent in 2Q19 versus +6.4 percent in 1Q19. In response to reemerging downward pressures, policymakers recently announced measures to relax auto purchase restrictions and support infrastructure investment. However, incremental stimulus efforts have been relatively modest and unlikely to offset fully the negative impact from trade. With trade solutions still undetermined, economic uncertainty is high in the near term. On May 10, the U.S. raised tariffs on $200 billion of Chinese imports from 10 percent to 25 percent. Assuming the U.S. refrains from placing a 25 percent tariff on the remaining $300 billion of imports as threatened, we project real GDP growth of +6.2 percent in 2019 and +6.0 percent in 2020. While investment and trade are likely to remain a drag on the economy, consumption, though moderating, is expected to be relatively stable.

A U.S.-China Deal Should Eventually Materialize

Since the Trump Administration put Huawei Technologies on its blacklist and restricted its access to U.S. technology in mid-May, the relationship between the U.S. and China has deteriorated significantly. The White House has since added more Chinese firms to the blacklist. In retaliation, China has also begun its own "unreliable entity" list. While the possibility is still low, the risk of decoupling of the world's two largest economies is increasing. Nevertheless, as both sides would suffer great economic pain under an all-out trade war, which neither side wants and there is room for better outcomes, our base case remains that some sort of deal will eventually be made. Given the complexity of

the trade issues and the differences between the two sides remain far apart, we would not be surprised to see more back and forth before a final deal materializes - Exhibit 7 illustrates three potential trade talk scenarios. While only a trade truce was reached with no major breakthrough at G20, the meeting of Trump and Xi, in and of itself, should be viewed positively, as it shows the willingness of both sides to negotiate.

Modi's Reelection Clears Path for More Pro-Growth Reform in India

Prime Minister Modi's National Democratic Alliance, a coalition of right-leaning political parties, secured a larger-than-expected number of seats (352 of 542) in recent elections for the lower house of Parliament, with his Bharatiya Janata Party (BJP) increasing its existing majority to 303 seats from 282. Modi now has a clear mandate to continue pro-growth economic reform in his second term (Exhibit 8), which is needed if the BJP-led government is to deliver anything close to the five-year annualized real GDP growth rate of +7.2 percent implied in its pre-election manifesto. Although the ill-effects of election uncertainty will dissipate, rural stress, liquidity issues in the non-banking finance sector, lingering impact of Goods and Services Tax, and weak global trade continue to dampen economic growth. Real GDP decelerated to its slowest year-over-year pace in five years, rising +5.8 percent in fiscal 4Q19 versus +6.6, +7.0, and +8.0 percent in the prior three quarters. However, supported by monetary stimulus and favorable fiscal policies, growth is poised to improve in the second half of fiscal 2020 against easier compares. We now project real GDP growth of +7.0 percent in FY20 versus +6.8 percent in FY19.

Exhibit 7: Possible U.S.-China Trade Negotiation Paths – Policy Response and Economic Impact

	Path 1	Path 2	Path 3
	Working Towards a Deal	*Uncertain Pause*	*Escalation*
Description	**Tariff situation:** No further tariff and non-tariff escalatory actions, while existing tariffs stay in place Trade talks resume. A high-level agreement on critical issues is reached soon, enabling a deal to be signed. **Timeframe:** Resolution of trade tensions is achieved in 2-3 months	**Tariff situation:** No further tariff and non-tariff escalatory actions, while existing tariffs stay in place Trade talks resume. No clarity as yet on key issues, but discussions continue and both parties try to work towards a deal **Timeframe:** Lingering uncertainty over trade tensions continue for 3-4 months following G20 summit	**Tariff situation:** 25% tariffs applied to added US$300b of imports from China, countermeasures from China Trade talks break down **Timeframe:** Measures stay in place for 4-6 months after imposition
China's Policy Response	Fiscal stimulus of 1.75% of GDP Broad credit growth to reach 12.0%-12.5% Y/Y by end of 2019 (from 11.3% Y/Y currently)	Fiscal stimulus of 2.25% of GDP Broad credit growth to reach 12.5%-13.0% Y/Y by end of 2019	Fiscal stimulus of 3.5% of GDP Broad credit growth to reach 14%-15% Y/Y by end of 2019
China Impact	Growth: 4Q19 growth stays flat at +6.4% Y/Y	Growth: 4Q19 growth slows to +6.2% Y/Y	Growth: 4Q19 growth slows to +5.7% Y/Y
Global Impact	Global growth stagnates and stays at sub-par trend of 3.2% Y/Y in 2019 before recovering	Lingering uncertainty leads global growth to decelerate from 3.2% Y/Y in 1Q19 to 2.9% Y/Y in 4Q19	Global economy enters into recession by 1Q20

Source: Morgan Stanley, 6/30/19

Exhibit 8: India's Economic Reform Agenda (Partial List)

In Progress Reforms	Difficulty
• Liberalize/deregulate telecom auctions and diesel prices	Medium
• Extend business license and cut red tape	Medium
• Refine bankruptcy code	Medium
• Clean Ganga River	Medium
• Create jobs in manufacturing and tourism	Medium-high
• Reform farm & agriculture sector, double farm income by 2022	Medium-high
• Build more homes, especially affordable housing	Medium-high
• Infrastructure - high speed trains, gas grids, optical fiber networks, advanced satellite project, roads, airports, renewable energy	Medium-high
• Lower tax rate (NEW)	Medium-high
• Recapitalize banks, grow credit	High
• India Assurance Health Insurance	High
• Enhance public spending on education to 6% of GDP	High
• Develop India as knowledge powerhouse	High
• Enhance competitiveness of SME sector	High

Stalled Reforms	Difficulty
• Draft Uniform civil code	High
• Land reforms	High
• Labor market reforms	High

Reforms Completed in First Term
• Adopted Goods & Services Tax
• Demonetized currency
• Implemented rice price stability
• Opened up construction and mining sectors for foreign investment
• Swachh Bharat (Nationwide pollution clean-up in India)
• Contained cross-border terrorism
• Improved foreign relations with Southeast Asia and global nations

Source: Center for Strategic & International Studies, Sit Investment Associates, 6/30/19

Mexico Is Stuck Between a Rock and the United States

President Trump threatened in late May to impose a 5 percent tariff on Mexican imports, potentially rising to 25 percent, if Mexico did not do more to stem the tide of refugees to the U.S. border. With around 80 percent of exports and 40 percent of GDP tied to the U.S., Mexico subsequently averted a major blow to its economy by acceding to President Trump's key migration-related demands. However, trade policy uncertainty could linger into early 2020 or beyond, as a divided U.S. Congress is a key hurdle to the ratification of USMCA (aka, NAFTA 2.0). We project below-trend real GDP growth of +1.5 percent in 2019, driven by elevated policy uncertainty, moderating global/U.S. economic growth, tightening financial conditions, and fiscal restraint. New manufacturing orders recently moved into contraction territory and other leading economic indicators are decelerating. Due to the deteriorating credit profile of Petróleos Mexicanos (state-owned oil company) and weakening macro outlook, Fitch also recently downgraded Mexico's sovereign debt rating to BBB from BBB+. While inflation now at the high end of the Bank of Mexico's target range of +2.0 to +4.0 percent may limit monetary stimulus near term, underlying deflationary pressures may provide flexibility to cut interest rates heading into 2020.

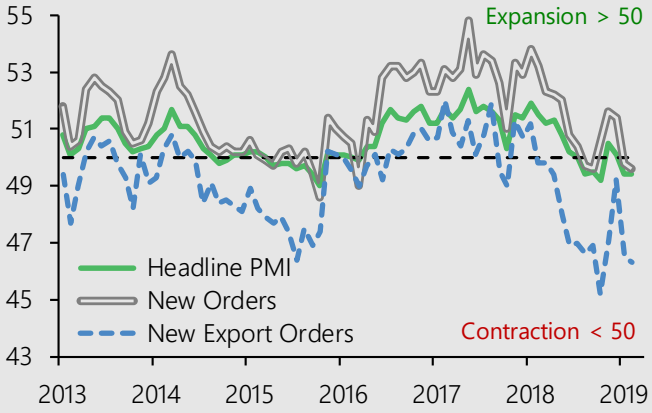
Brazil – The Weakest Recovery on Record Has Followed the Deepest Recession

Encumbered by elevated political uncertainty, fiscal austerity, and above-target inflation, Brazil's economic recovery has failed to gain steam post its deepest recession on record, with the year-over-year pace of real GDP growth decelerating to +0.5 percent in the first quarter of 2019 from a quarterly average of +1.1 percent in 2018. We now project 2019 GDP growth of +1.2 percent, down from our earlier estimate of +2.0 percent, due to weaker-than-anticipated consumer spending and industrial production in the first half of the year. High unemployment is limiting income growth, while policy uncertainty, excess capacity, and slowing global growth have stymied capital spending. However, impending pension reform should be a positive economic catalyst, bolstering Brazil's fiscal position and providing clarity for business investment. While reform is now expected to produce savings of about 900 billion reais in 10 years versus the initial proposal of 1.24 trillion, it is a vital step in curbing Brazil's high government debt-to-GDP ratio of over 75 percent. Brazil's central bank also recently slashed its 2019 inflation forecast to +3.6 percent from +4.1 percent, raising the prospect of interest rate cuts to stimulate the fragile economy.

Emerging Markets: Notable Data Points

China Manufacturing PMI Back in Contraction

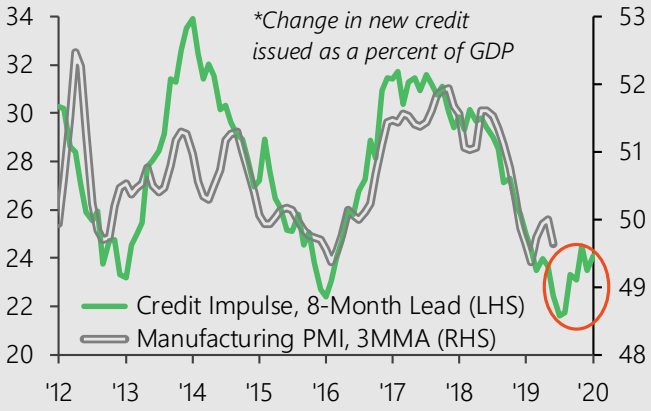
China Manufacturing Purchasing Managers' Index



Source: National Bureau of Statistics, 7/3/19

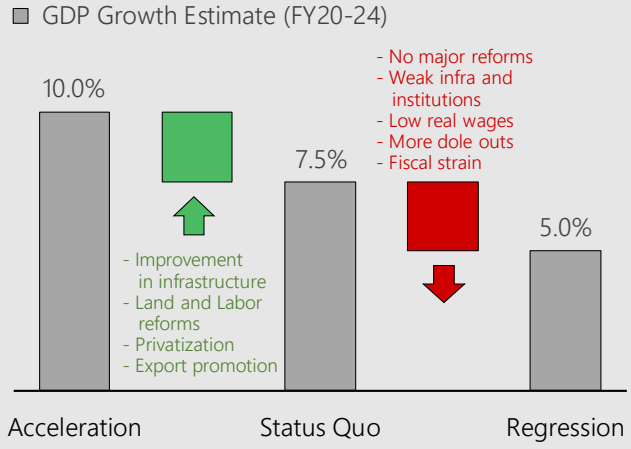
But Credit Impulse Implies Improvement Ahead

China Credit Impulse* vs China Manufacturing PMI



Source: National Bureau of Statistics, Bloomberg, 7/3/19

Potential Upside to India's GDP From Reform



Source: Goldman Sachs, 5/20/19

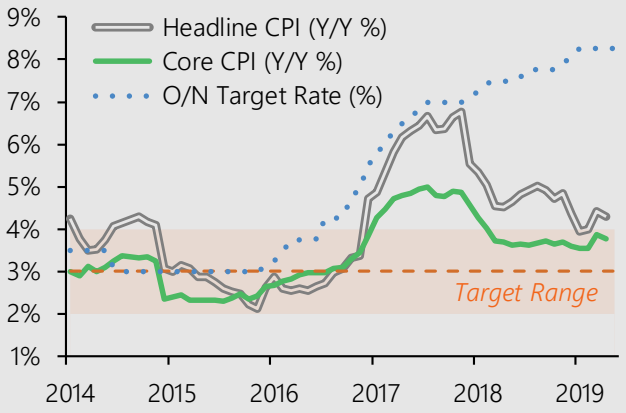
South Korea Sensitive to Trade Conditions

	Percent of GDP				
	Household Spending	Govt Spending	Capital Formation	▼ Exports	Imports
Euro Area	55%	21%	21%	44%	40%
S. Korea	**49%**	**15%**	**29%**	**42%**	**35%**
Mexico	66%	12%	24%	37%	39%
Canada	58%	21%	23%	31%	34%
UK	66%	19%	17%	28%	30%
China	39%	14%	44%	20%	17%
India	59%	10%	30%	19%	21%
Australia	58%	19%	25%	19%	22%
Japan	56%	20%	24%	16%	15%
U.S.	69%	14%	20%	12%	15%

Source: The World Bank, 6/30/19

Inflation Restricts Monetary Easing in Mexico

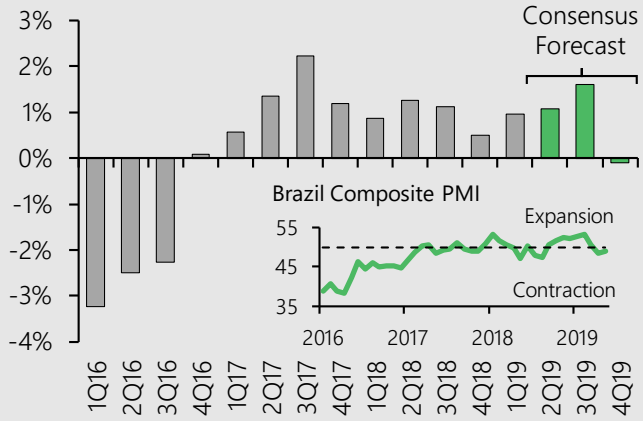
Mexico Consumer Price Index vs Monetary Policy Rate



Source: Bank of Mexico, 6/30/19

Brazil's Economic Recovery Stuck in Low Gear

Brazil Real GDP Growth, Y/Y Percent



Source: Brazilian Institute of Geography & Statistics, IHS Markit, 7/3/19

Taxable Bonds

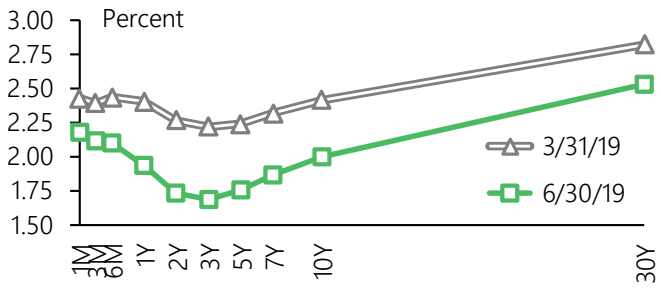
Policy Rate Cuts on the Horizon

Interest rates continued to decline in 2Q19 as the Fed signaled further monetary policy accommodation. The decline in yields was led by the 2-year Treasury, down 53 basis points to +1.73 percent, with subsequent maturities declining by lessening degrees with the 30-year down 30 basis points, to +2.53 percent (Exhibit 9). The discussion at the Fed has shifted dramatically from early December's projected interest rate hikes to a cut expected at the July meeting. Our base case forecast is for 2-3 rate cuts to the fed funds rate over the next 12 months with a 25-basis point cut in July being the only one with any certainty. As future cuts seem tied to the outcome of trade negotiations, cuts would be off the table in the unlikely scenario of a grand resolution with China. Nevertheless, there is some market speculation of a 50-basis point cut in July. Although this is not our base case, it does offer insight into how aggressively some investors are projecting policy change (Exhibit 10). The argument for the larger rate cut is to provide strategic insurance to sustain the expansion. With the low level of rates, the effectiveness of a smaller rate cut may not be enough to prevent global economic deterioration from distorting the domestic economy, as it would do little to resolve supply chain problems caused by tariffs. Some economists argue that a 50-basis point cut simply moves the fed funds rate to the new "neutral" rate, which the Fed has noted is a moving target.

Domestic Strength versus Global Weakness

The call for interest rate cuts is to guard against global growth risks, trade tensions, and protracted weakness in inflation metrics, more so than domestic economic concerns, as has been the traditional rationale for reducing interest rates by the Fed. The domestic economy has moderately slowed but remains healthy. However, global economic data has been weakening. Europe is stumbling through Brexit negotiations and the European Central Bank is poised to add stimulus if necessary. With interest rates low globally, it is difficult for domestic interest rates and inflation to reach escape velocity. In addition, the escalation of trade conflicts and tariffs with China has introduced a meaningful amount of uncertainty. As production shifts away from China, the restructuring of supply chains is causing disruptions to global growth. However, the drag from this transition could be temporary and potentially beneficial for global trade in the long term.

Exhibit 9: U.S. Treasury Yield Curve

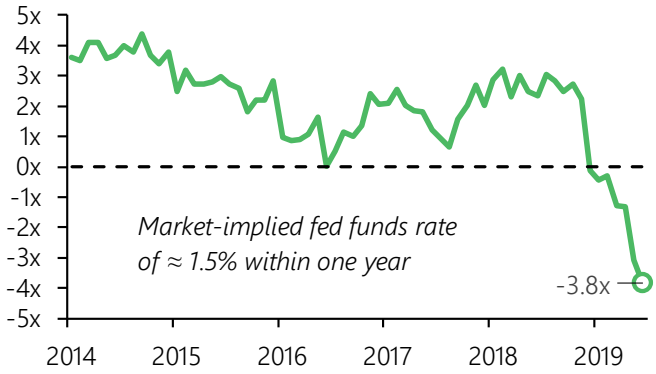


	1M	3M	6M	1Y	2Y	3Y	5Y	7Y	10Y	30Y
3/31	2.43	2.39	2.43	2.40	2.27	2.22	2.24	2.32	2.42	2.82
6/30	2.18	2.12	2.10	1.94	1.73	1.69	1.75	1.87	2.00	2.53
	-0.25	-0.28	-0.34	-0.47	-0.53	-0.53	-0.49	-0.45	-0.42	-0.30

Source: FactSet, 6/30/19

Exhibit 10: Market-Implied Chg. in Fed Funds

Number of 25bp Hikes (Cuts) Over Next Twelve Months



Source: Bloomberg, 6/30/19

Taxable Fixed Income Outlook and Strategy

We have extended durations as the expected cuts from the Fed will keep rates low and spreads tightening in the intermediate term. We do not see any recession risk from trade issues and are optimistic that some production shifts to domestic manufacturing will boost economic data in coming months. With domestic economic activity remaining healthy, we have added to weightings in lower quality investment grade bonds where appropriate. Driven by the decline in interest rates and added volatility, current coupon production mortgages have struggled to keep pace with the spread tightening seen on corporate bonds. Our high-coupon agency mortgages have performed well as they exhibit less prepayment sensitivity to changes in interest rates. We continue to avoid the inverted 3- to 5-year part of the yield curve, as we believe the curve will return to an upward sloping shape as economic strength continues at a moderate pace.

Municipal Bonds

Municipal Bond Yields Fell Across the Board

Tax-exempt municipal bond yields declined significantly across the board during 2Q19, as shown in Exhibit 11. The Municipal Market Data (MMD) AAA General Obligation (GO) curve experienced a parallel downward shift that maintained the upward slope of the municipal yield curve intact (Exhibit 12). Yields on 10-year and 30-year bonds fell by 23 basis points and 29 basis points, respectively, to +1.63 percent and +2.31 percent. Similar movement was seen on the short end, as the 2-year MMD AAA GO yield fell by 24 basis points to +1.25 percent, and the 5-year MMD AAA GO yield by 26 basis points to +1.31 percent. This downward parallel shift was like that which occurred in 1Q19, although the magnitude of the fall in yields was not quite as great. At the end of 2018, the 30-year MMD AAA GO yield was +3.02 percent, and the 10-year was +2.28 percent. Over the entire first half of 2019, these have fallen by 71 and 65 basis points, respectively. The 2-year and the 5-year MMD AAA GO yields have fallen by 53 and 63 basis points, respectively. The Bond Buyer 40 yield fell by 16 basis points to +3.70 percent in 2Q19, and by 39 basis points in 1H19.

Still Better to be Long and Lower Rated

As shown in Exhibit 13, the Bloomberg Barclays Municipal Bond Index posted a strong +2.14 percent total return for 2Q19, bringing the year-to-date return up to a robust +5.09 percent. The Municipal Index quarterly returns were still not quite as much as the Treasury or Corporate Indices, although ahead of Mortgage-Backed Securities. For this quarter, as well as in the first half, it has paid to be long in duration. Long municipal bonds (22+ year maturities) recorded a +2.89 percent return for the quarter; 10-year bonds +2.15 percent; and 3-year bonds +1.11 percent. Lower-rated investment grade bonds outperformed high grade bonds, as the Baa rated Municipal sub-index posted a +2.94 percent return versus the +1.83 percent for Aaa bonds. This pattern continued from the first quarter into the second. Municipal credit sectors that are more credit sensitive also appeared to reflect this trend, as Tobacco, Insured Bonds, Hospitals, Leasing, and IDRs were better performing.

Municipal Bond Technical Outlook Positive

The technical outlook remains quite strong for municipal bonds. Spurred by tax law changes that raised many income tax rates, inflows into municipal bond funds have surged to new records for the start of a year (Exhibit 14). The aggregate of $21.3 billion inflows in 2Q19 almost matched the $22.5 billion inflows in 1Q19. Meanwhile, as shown in Exhibit 15, new issue supply of $88.7 billion in 2Q19 was -11 percent below

the same quarter of 2018. Year-to-date issuance is flat versus the first half of 2018. Both years remain well below prior years' volume, partially due to the elimination of tax-exempt advance refunding issuance. Looking ahead, the third quarter will include the months of heaviest redemptions; this may intensify a net supply deficit.

Tax-Exempt Fixed Income Outlook and Strategy

Market expectations of Federal Reserve interest rate cuts have been largely factored into the market, suggesting that second half performance is unlikely to exceed that of the first half. Technical factors remain supportive for municipals, particularly as we enter the third quarter. Moreover, the municipal market does not typically keep pace with Treasury market rallies, often needing time to catch up. Thus, municipal yield ratios to Treasury yields may be pulled back down over the next few months if volatility declines. We continue to favor high quality medium- to long term- housing bond issues and other municipals possessing short call provisions and intermediate duration. Our strategy remains focused on providing meaningful income, which has been the primary driver of total return over a full market cycle.

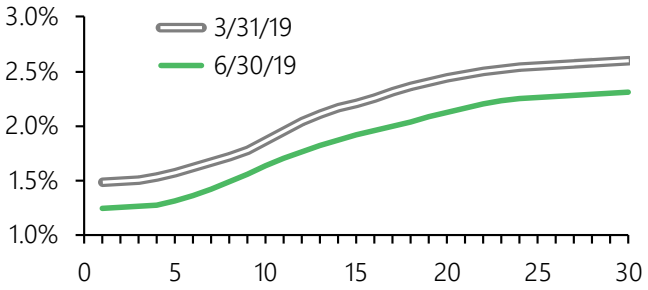
Exhibit 11: Municipal Yields and Spreads

Yields	3/31/19	6/30/19	Chg. (bp)
2-Yr MMD AAA GO	1.49	1.25	-0.24
5-Yr MMD AAA GO	1.57	1.31	-0.26
10-Yr MMD AAA GO	1.86	1.63	-0.23
30-Yr MMD AAA GO	2.60	2.31	-0.29
2-10 MMD Spread	0.37	0.38	
10-30 MMD Spread	0.74	0.68	
2-30 MMD Spread	1.11	1.06	
Bond Buyer 40 YTM	3.86	3.70	-0.16

Source: Thomson Reuters, The Bond Buyer, 7/1/2019

Exhibit 12: Municipal GO Yield Curve

Municipal Market Data (MMD) AAA GO Yield Curve



Source: Thomson Reuters, 7/1/2019

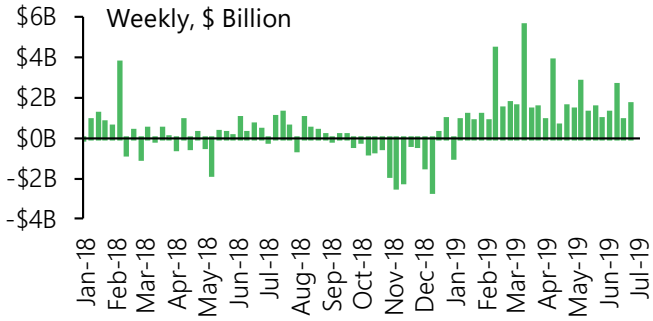
Exhibit 13: Municipal Bond Index Returns

Bloomberg Barclays, Percent

	2Q19		2Q19
Muni Bond Index	2.14	GO Bond Index	2.06
3-Year	1.11	Revenue Bond Index	2.25
5-Year	1.66	Electric	2.04
7-Year	1.96	Hospital	2.49
10-Year	2.15	Housing	2.15
Long	2.89	IDR/PCR	2.52
		Tranportation	2.18
AAA	1.83	Education	2.30
AA	2.01	Water & Sewer	2.08
A	2.31	Resource Recovery	1.25
BAA	2.94	Leasing	2.45
		Special Tax	2.15
		Tobacco Index	2.65
		Insured Bond Index	2.81

Source: Bloomberg, 7/1/19

Exhibit 14: Municipal Bond Fund Flows



Source: Lipper, 7/1/2019

Exhibit 15: Municipal Bond Issuance, $ Million

	2017	2018	2019
April 2019	$30,711	$31,516	$26,801
May 2019	$38,710	$35,147	$28,739
June 2019	$39,301	$33,388	$33,190
2Q Total	$108,723	$100,050	$88,730

Source: The Bond Buyer, 7/1/2019

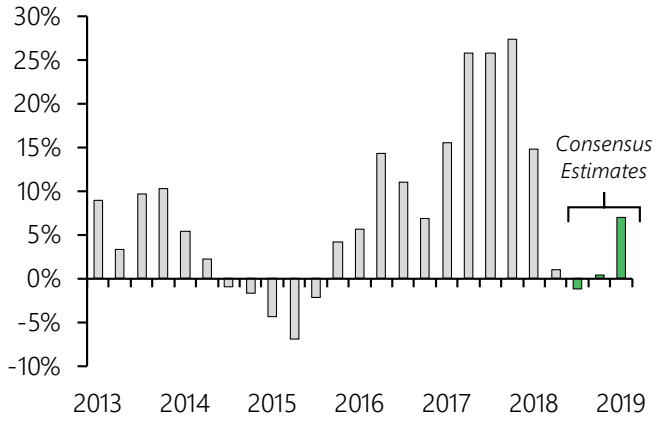
A Full Easing Cycle Could Propel Risk Assets, But Expect Investors to Be Selective

The S&P 500 Index generated a total return of +18.5 percent for the first six of 2019, the strongest first half performance since 1997. Nonetheless, the year-to-date rally comes on the heels of a sharp correction in the final quarter of 2018. For all intents and purposes, the S&P 500 Index has been stuck in a trading range for the last 18 months, not unlike earlier periods of decelerating economic growth during the current expansion. Equity investors continue to assess if the U.S. economy has the underlying momentum and wherewithal, given an adequate policy response, to execute another soft landing and growth reacceleration this cycle. While equities have advanced higher year to date amid accumulating headwinds, in seeming contrast to cautious bond markets, sector and style leadership trends imply a fair amount of angst as evidence continues to mount that trade tensions will have a lasting negative impact on global growth prospects. Equity investor enthusiasm is based on, in large part, the hope that Fed easing will not only extend the U.S expansion, but also compel global central banks to respond in kind, further driving down interest rates. The combination of meager or, in many cases, negative bond yields and rising liquidity will push investors to risk assets to achieve adequate returns (via the TINA, or there is no alternative, effect), possibly resulting in a "melt up" in equities.

Second Quarter Corporate Earnings Reports May Test Equity Markets

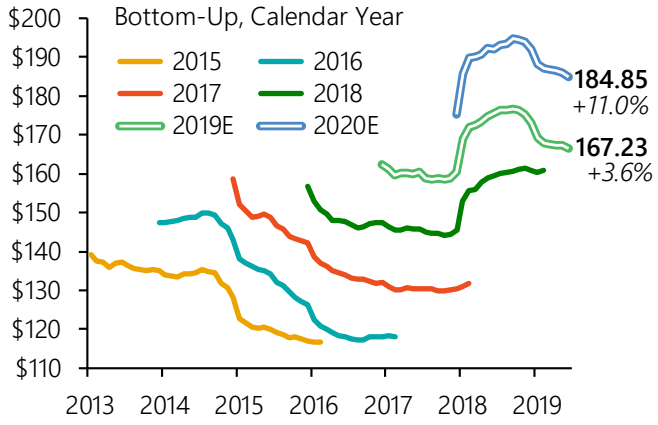
Consensus bottom-up earnings estimate for the S&P 500 Index suggests year-over-year growth of -0.7 percent in 2Q19, down from the corporate tax cut-boosted +25.8 percent in the year ago period (Exhibit 16). Whereas forward EPS forecasts were progressively increased throughout 2018, estimates are once again being revised downward as the year progresses (Exhibit 17). Of the 114 S&P 500 companies that offered EPS guidance for 2Q19, 88 (or 77 percent) guided earnings down. The tone of a broad number of firms we follow has also become increasingly cautious after the breakdown in U.S.-China trade negotiations in May, which dovetails with measures of current activity that imply weaker 2Q19 GDP growth. However, if it appears the Fed will proceed with expected rate cuts and China ramps up stimulus, investors may look through any earnings disappointments in anticipation of a growth reacceleration. In fact, we are in an environment once again where any bad news that compels the Fed to ease is interpreted positively and vice versa – with another setback in trade negotiations a probable exception.

Exhibit 16: S&P 500 Bottom-Up EPS Growth



Source: FactSet, 6/30/19

Exhibit 17: S&P 500, Consensus EPS Estimates



Source: FactSet, 6/30/19

Stock Picking is Key in Increasingly Volatile and Discriminate Markets

We are generally constructive on U.S. equities given solid underlying growth prospects and supportive policy. However, elevated relative valuation, lingering macro uncertainty, Fed policy ambiguity, and rising geopolitical risks (i.e., U.S.-China trade deal, Iran, North Korea, etc.) highlight the importance of diversified portfolios focused on quality growth stocks that provide both upside opportunity and downside protection. We continue to balance investments in pro-cyclical growth stocks that provide compelling risk-reward opportunities with more predictable, secular growth stocks based on the likelihood that "end of cycle" fears will result in continued bouts of equity market volatility. While we believe a barbell-approach continues to provide a balanced risk-reward profile, portfolio composition has been shifted toward more stable, visible earnings growth investments. Thus, we reduced exposure to the industrial and transport sectors given fair valuations against a weakening backdrop. We have also reduced our holdings in select technology services stocks that offer less-compelling valuations. Cash levels have also been raised slightly ahead of anticipated volatility into second quarter corporate earnings reports. Finally, we have added to select investments in healthcare and consumer staples and favor exposure to P&C insurance within the financial sector due an improved pricing environment and attractive valuation. As we highlighted in the *Special Topic* on the inside cover, dividend-paying growth stocks also provide particularly compelling opportunities.

Within international equity mandates we are overweight Europe, while in global-oriented portfolios we are underweight the region as the U.S. economy is on relatively stronger footing. We believe weakening economic data, trade policy uncertainty, Brexit concerns, increased political tensions, and fiscal issues will create continued uncertainty, leading us to favor a barbell approach. Much like our domestic strategy, one side of the barbell is comprised of pro-growth and cyclical companies that have the potential to benefit from macro improvement driven by increasing global stimulus, while the other side consists of traditional growth stocks that possess visible earnings. The Euro Area generally offers more attractive investment prospects, as Brexit is likely to have a much larger impact on the UK economy. Within the Euro Area, we have become more positive on industrial companies, notably German industrials, as they will benefit notably from a U.S.-China trade resolution and are trading at compelling valuations. We also prefer companies that generate a larger percentage of their growth from the United States.

Despite elevated U.S.-China trade tensions, we are sticking with our overweight position in China as we expect its economy to muddle through with the assistance of government stimulus. While there may be additional downside risk to corporate earnings near term, valuations for Chinese equities generally remain attractive. Moreover, sentiment remains cautious given recent weak macro data and investor positioning is light, suggesting equity upside as economic prospects stabilize. Amid heightened trade talk uncertainty, we take a balanced investment approach, while favoring domestic demand-oriented stocks. We continue to overweight "new economy" names, as they are more exposed to domestic consumption and the industrial digital upgrade, both of which should be less impacted by trade issues. Investments in consumer staples and utility stocks offer stable earnings and downside protection. We prefer investments in quality companies with attractive secular growth drivers, strong balance sheets, and reasonable valuations.

We also remain positive on Indian and South Korean equities. In his second term, Prime Minister Modi will focus on policy continuity, better implementation of laws, and GDP growth. Therefore, we prefer economically-sensitive sectors such as consumer, energy,

Sector Thoughts: Healthcare

Healthcare sector performance has recently been impacted by multiple policy initiatives including the introduction of H.R.1384 (i.e., Medicare for All Act), which establishes a national health insurance program for all citizens modeled on the Medicare program. The bill, which has 112 co-sponsors in the House, would eliminate the private health insurance system and transition payments to physicians, hospitals and other health care providers to the Medicare fee schedule that pays much less than current reimbursement for procedures and services.

While H.R.1384 is popular with a subset of the American population, we believe that it is unlikely to become law. Most providers would lose money if the Medicare fee schedule became the sole payment mechanism for procedures and services, as Medicare generally pays less than actual costs for services rendered. We predict that the resulting disruption to the American health care system coming from facility closures and provider exits would be unacceptable to most American citizens. Consequently, we believe that the underperformance that has been experienced by health care services stocks should be a temporary phenomenon that reverses once the implications of Medicare for All and other health policy initiatives are better understood

With both parties in favor of drug pricing reform, experts believe that meaningful reform is more likely now than in recent history. However, the lack of an agreement on the structure of any reform between the Administration and Congress leaves details up in the air. Not surprisingly, the U.S. drug pricing issue is more complicated than typical soundbites. For example, list prices (the prices typically quoted by opponents of U.S. pricing) in the U.S. are 3.8x higher than in the EU, but 2.6x higher on a net basis for patented drugs. That still leaves of lot of room for pricing criticism, but it is important to note that US generic drug utilization is 89 percent by volume, far exceeding the average of 47 percent in the developed world. This nuance, among others, leaves any reform open to unintended outcomes. We are, therefore, avoiding at-risk sectors, such as distributors, and weighing portfolios more toward medtech and life science tools. Our pharma and biotech names have been chosen for their unique products and potential cost-saving treatments.

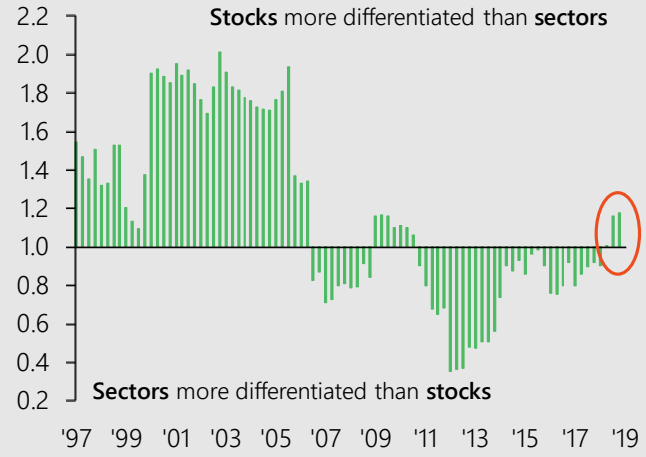
Drug Pricing Reform: Likelihood of New Policies Passing

Policy Recommendation	Likelihood	Rationale
HHS Rebate Rule - Manufacturer rebate will be passed at the point-of-sale to patients	High	Administration is expected to finalize the rule 60 days post-comment period (in June). CMS guidance is for plans to bid in-line with previous pricing/benefit designs for the 2020 open enrollment period
The International Pricing Index (IPI) Model	High	Potential for HHS to move forward under an accelerated timeline, which could surprise markets if a rule is implemented as early as 2020.
Requiring companies to include the price of their prescription medicines in television ads	High	Progress is being made, but how prices will be disclosed, including estimates out of pocket payments, remain to be seen.
Give Medicare Part D and MA plans option to limit coverage of drugs in six categories known as "protected classes"	Medium	Office of Management and Budget (OMB) is in progress of reviewing the final rule. This rule may not require legislation to be implemented, and could be a follow-up step aimed at lowering spend once rebate rule is implemented.
Allow Medicare to negotiate drug prices	Low	Medicare Part D has a non-interference clause which currently precludes the government from negotiating directly on drug prices. Likely won't pass in a Republican-led Senate
Strip monopolies from drug companies if their prices were above the average price in other wealthy countries	Low	At odds with existing patent and exclusivity laws; we would expect this bill to face pushback from both moderate Democrats and Republicans

Source: Morgan Stanley, May 9, 2019

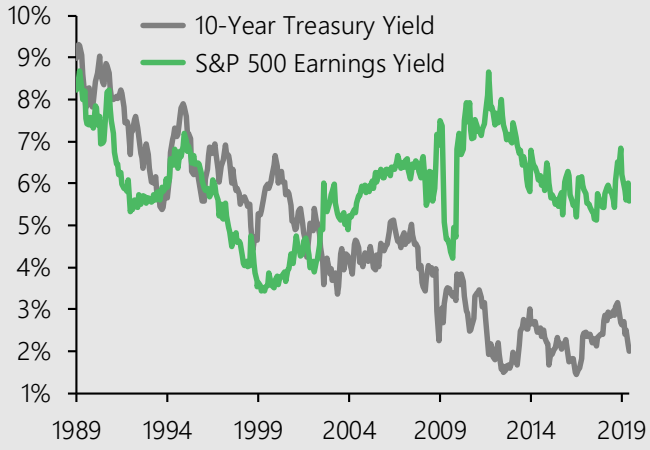
Global Equities: Notable Data Points

A Stock Pickers' Market; Fundamentals Matter



Source: BofAML, 7/3/19

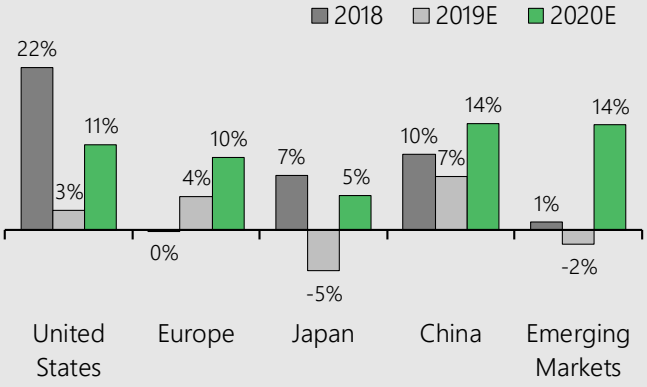
U.S. Equities Attractive Relative to Treasuries



Source: FactSet, 6/30/19

Tough 2019 Y/Y Compares Turn Easy in 2020

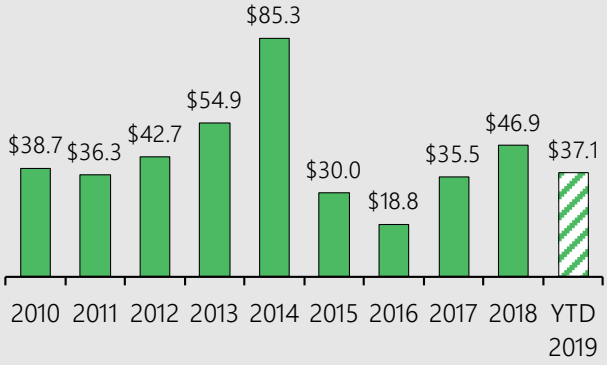
Bottom-Up EPS Estimates for MSCI Indices
Y/Y Percent Change



Source: FactSet, 6/30/19

IPO Proceeds Up +30% Y/Y in First Half 2019

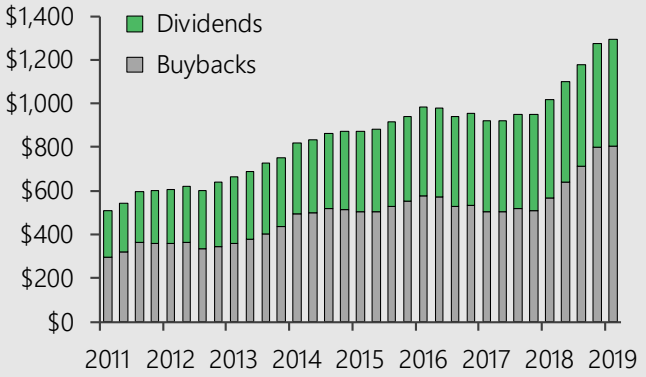
U.S. Initial Public Offerings
Total Proceeds, $ Billion



Source: Renaissance Capital, 7/5/19

Dividends and Shares Buybacks Increasing

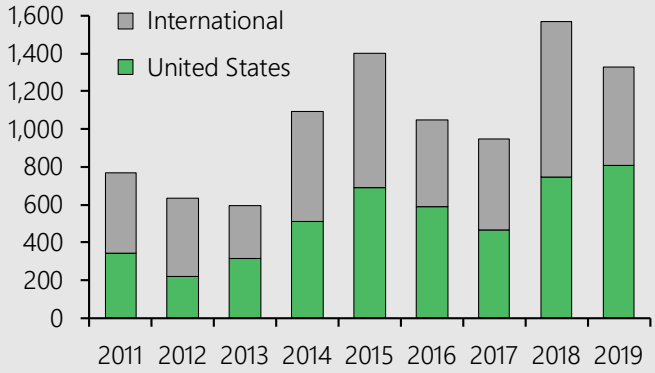
S&P 500 Share Buybacks and Dividends
Billions of U.S. Dollar, Four-Quarter Sum



Source: FactSet, 6/30/19

M&A Activity Supportive of Valuations

M&A Transactions, First Half
Total Deal Value, $ Billion



Source: MergerMetrics, 7/3/19

financials, information services, and industrials, which will benefit from stronger growth. Indian equity valuations are also attractive relative to growth prospects, with the MSCI India Index trading at a 2019 price-to-earnings ratio of 17.8 times. In South Korea, its market is cheap, with the MSCI Korea Index trading at a 2019 price-to-earnings ratio of about 11.3 times. Importantly, earnings should rebound +20 percent in 2020 based on improvements in the technology, consumer, materials and industrials sectors. As South Korea's economy is largely trade-related, the outlook for South Korean stocks remains dependent on a U.S.-China trade deal. Consequently, we own a balanced portfolio of stocks in technology, financial, consumer, pharmaceutical, and materials.

We continue to underweight Japanese equities but see opportunities within the lagging market. Our caution remains centered on Japan's muted long-term growth outlook given an aging population and elevated central government indebtedness. Moderating growth, a coming consumption tax hike, and limited monetary easing options warrant further caution in the near term. The market incorporates these challenges as Japanese equities have continued to lag other developed markets this year. This creates select opportunities in our view, particularly among more cyclical names which could benefit should trade concerns ease. Our preference in Japan continues to be for overseas-exposed exporters and multinationals with links to faster growing areas of the globe. We remain cognizant of specific trade-related risks within this group, seeking to avoid names that could become entangled in the U.S.-China trade dispute. We balance this exposure with a mix of defensive domestic consumption-focused holdings that should perform relatively well in a challenging growth environment.

In Latin America, we remain underweight Brazil due to subpar economic growth, which will continue if the passage of pension reform is delayed. Regarding investment strategy, we prefer the consumer and financial sectors, which are benefiting from better retail sales and robust bank credit growth. At a 2019 price-to-earnings ratio of 13.4 times, a +13 percent premium to its 10-year average on depressed EPS, the MSCI Brazil Index is trading at a reasonable valuation. We also remain underweight Mexico given softer global growth prospects and a weak domestic economy. Mexico's GDP growth will be negatively impacted by President Andrés Manuel López Obrador's decision to reduce federal government salaries and infrastructure spending as well as the slow roll-out of social programs. Our strategy for Mexico remains largely defensive, with investments in domestic consumer staples and in companies with less tariff risk. In terms of valuation, Mexico's market multiple is inexpensive, with the MSCI Mexico Index trading at a 2019 price-to-earnings ratio of 12.8 times, a -20 percent discount to its 10-year average. However, earnings revisions have been negative over the past three months.