

Late-Year Selloff Snowballs on Uncertainty

Quarterly Snapshot

- › The final quarter of 2018 hosted precipitous declines in stock markets around the globe, which settled into full-year losses.
- › Government bonds led fixed-income performance in the three-month period, while riskier segments like high-yield bonds had the sharpest descent, consistent with a flight-to-safety environment.
- › As painful as 2018 was for risk assets, their gyrations were not outside the norm. We see another important risk-on opportunity developing in equities and elsewhere.

Economic Backdrop

The final quarter of 2018 hosted precipitous declines in stock markets around the globe, exceeding corrections of the first quarter and erasing recoveries that followed during the second and third quarters in some parts of the world, settling into full-year losses. The three-month period began with swift and sharp selloffs, followed by a comparatively flat November overall in most regions; the final month of the quarter saw many markets hit with losses that were more severe than those experienced in October.

Government bonds led fixed-income performance, while riskier segments like high-yield bonds had the sharpest losses, consistent with a flight-to-safety environment. Sovereign yields fell in the U.K. and Europe during the fourth quarter, while the U.S. Treasury yield curve continued to flatten as short-term rates increased and longer-term rates fell; intermediate-term segments of the U.S. yield curve inverted at the beginning of December and broadened through the end of the year. Commodity prices generally tumbled during the fourth quarter, with West-Texas Intermediate crude-oil prices falling by 38%.

U.S. elections in early November produced a partial shift in power away from Republicans and toward Democrats in Congress and statehouses across the country. The new balance of authority in Congress should substantially limit the ability of President Donald Trump and Republicans to pass meaningful legislation; it also enhances the investigatory powers available to Democrats, thereby adding to political risk for the Trump administration. The U.S.-China trade relationship began the fourth quarter on a downbeat, with Trump threatening to expand tariffs to essentially all of China's imports. The situation improved after the countries' leaders conducted a trade-focused meeting on the sidelines of the early-December G20 summit, agreeing to delay punitive actions and producing a three-month roadmap toward more substantive progress.

EU leaders agreed to terms of the U.K.'s divorce in November, establishing a set of domestic challenges for Prime Minister Theresa May given the absence of parliamentary majority support. December was an especially eventful month, with the European Court of Justice ruling the U.K.

Key Measures: Q4 2018

EQUITY	
Dow Jones Industrial Average	-11.31% ↓
S&P 500 Index	-13.52% ↓
NASDAQ Composite Index	-17.29% ↓
MSCI ACWI Index (Net)	-12.75% ↓
BOND	
Bloomberg Barclays Global Aggregate Index	1.20% ↑
VOLATILITY	
Chicago Board Options Exchange Volatility Index	25.42 ↑
PRIOR QUARTER: 12.12	
OIL	
WTI Cushing crude oil prices	\$45.41 ↓
PRIOR QUARTER: \$73.25	
CURRENCIES	
Sterling vs. U.S. dollar	\$1.28 ↓
Euro vs. U.S. dollar	\$1.13 ↓
U.S. dollar vs. yen	¥113.55 ↓

Sources: Bloomberg, FactSet, Lipper

could unilaterally halt Brexit by revoking Article 50; May surviving a no-confidence vote that was brought about by a subset of her Conservative colleagues (in part by promising to stand down before the next election scheduled for 2022); and a growing chorus of politicians calling for a second referendum. Details of contingency plans for a no-deal Brexit also began to trickle out on both sides of the English Channel near year-end that addressed a range of subjects, including travel, trade and financial services.

Elsewhere, German Chancellor Angela Merkel did not seek re-election as leader of the Christian Democratic Union (CDU) party in December after poor turnout in regional elections, leaving Annegret Kramp-Karrenbauer (who was installed as the party's general secretary by Merkel in early 2018) to win the leadership in a vote for continuity. This outcome means that Merkel may be able to serve the remainder of her term as head of government through 2021. France was stricken by anti-establishment riots during most of the fourth quarter that were seemingly triggered by the perceived injustice of President Emmanuel Macron's tax policy; the French president attempted to appease protesters in December with concessions that included cutting taxes for pensioners, increasing wages for underprivileged workers and reversing planned fuel-tax hikes. The Italian coalition government passed a budget at the end of December that retained some promised working-class relief after initial drafts were rejected by the EU for unacceptably large deficits.

The Federal Open Market Committee increased the federal-funds rate in mid-December—the fourth time in 2018—while softening its projections for future rate increases. The European Central Bank (ECB) unsurprisingly announced and issued the final net purchase of bonds as part of its quantitative-easing program in mid-December. Guidance reassured that benchmark rates will remain unchanged as long as needed to achieve the ECB's inflation goal, and that its expanded balance sheet will not begin to shrink until after it begins raising rates. The Bank of England and Bank of Japan's respective monetary policy groups each convened twice during the quarter, and neither introduced new policy actions.

U.S. manufacturing growth eased considerably, yet still ended 2018 at solid levels. Services sector growth was unchanged, remaining in expansion territory at the end of the year. U.K. services growth re-accelerated slightly in December after coming perilously close to contractionary conditions in November; manufacturing activity followed a similar pattern, but at relatively healthier levels. Eurozone business activity softened into year-end, with the services sector slowing toward no-growth territory in December and slow-growth manufacturing conditions holding firm.

Portfolio Review

The fourth quarter's huge increase in volatility weighed heavily on U.S. stocks, particularly smaller companies. Our large-cap strategy was challenged by exposure to volatile stocks in a flight-to-quality environment, although an overweight to value was beneficial. Positioning within

utilities, real estate, energy and financials detracted, but was helpful in information technology and healthcare. Within our small-cap strategy, an overweight to stable, lower-volatility stocks contributed, but was offset by an unfavorable overweight to momentum. Positioning within industrials, financials, and consumer discretionary detracted, while exposures to materials and energy helped. Our international developed-market strategy struggled due primarily to an overweight to and selection in the energy sector, an underweight to and selection in consumer staples, and selection in financials. From a regional standpoint, positioning in most of Asia contributed, while exposures to Europe, North America, Australia and Hong Kong detracted. Within emerging markets, consumer discretionary exposure was beneficial, but was more than offset by weak positioning within information technology, real estate and communication services. Regionally, positioning contributed in Brazil and detracted in Asia.

U.S. investment-grade non-government fixed-income sectors trailed top-performing U.S. Treasuries amid the risk-off environment that defined the fourth quarter. Our core fixed-income strategy slightly trailed the benchmark as a result, but still generated positive absolute returns. A modestly long-duration profile was beneficial as yields declined during the full quarter; our yield-curve positioning contributed as well. An allocation to non-agency mortgage-backed securities (MBS) enhanced returns, while overweights to corporate financials, commercial MBS, and asset-backed securities detracted. Bond-market trouble was most concentrated in the high-yield space; our strategy was challenged during the fourth quarter primarily by credit-quality positioning, namely an underweight to BB rated bonds and overweights to B and CCC rated bonds. From a sector standpoint, overweights to collateralized loan obligations (CLOs), selection within technology, and an overweight to and selection within industrials (primarily leisure) enhanced returns. Selection within media, energy and basic industry detracted. Our emerging-market debt strategy

Major Index Performance in Q4 2018 (Percent Return)



Sources: FactSet, Lipper

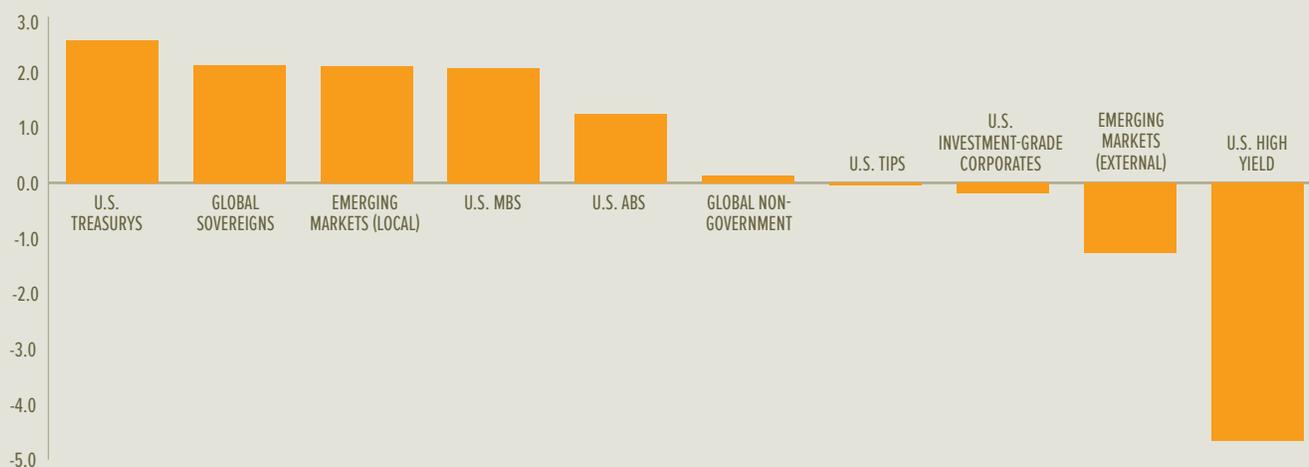
Our deep underweight to hard-currency debt was slightly reduced due to opportunities created by the fourth-quarter selloff.

struggled during the fourth quarter as selection decisions more than offset the benefits of top-level allocation. An underweight to hard-currency-denominated bonds helped, but positioning within Mexico and Egypt detracted. An overweight to emerging-market currencies was beneficial, but local-currency bond selection within Brazil and Mexico pressured relative returns. An allocation to hard-currency corporates contributed as their flat performance outpaced the selloffs in sovereign bonds.

Manager Positioning and Opportunities

Our U.S. large-cap strategy remained underweight the largest companies given increased active-management opportunities within stocks that are not as widely followed and researched. We were overweight financials due to attractive valuations and the sector’s propensity to benefit from rising short-term rates. We also held an underweight to information technology on valuation grounds. Within small caps, we were overweight stability, which we view as particularly attractive at this point in the market cycle given recent volatility. We maintained an overweight to value (the valuation spread between growth and value is near historical extremes), as well as an underweight to real estate (higher-yielding equity sectors tend to underperform in rising-rate environments). An overweight to consumer staples was also retained, consistent with our value strategies and natural defensive properties. We reduced our overweight to consumer discretionary given the sector’s economic sensitivity, while we lessened our underweight to financials as part of our increased value exposure. Overseas, our international developed-market equity strategy augmented an underweight to Europe—primarily by exiting positions in Sweden, Switzerland and Italy. We continued to hold a substantial overweight to Asia given the abundance of attractive opportunities in the region, particularly among information technology companies. We retained our largest regional underweight to Japan on structural and demographic grounds,

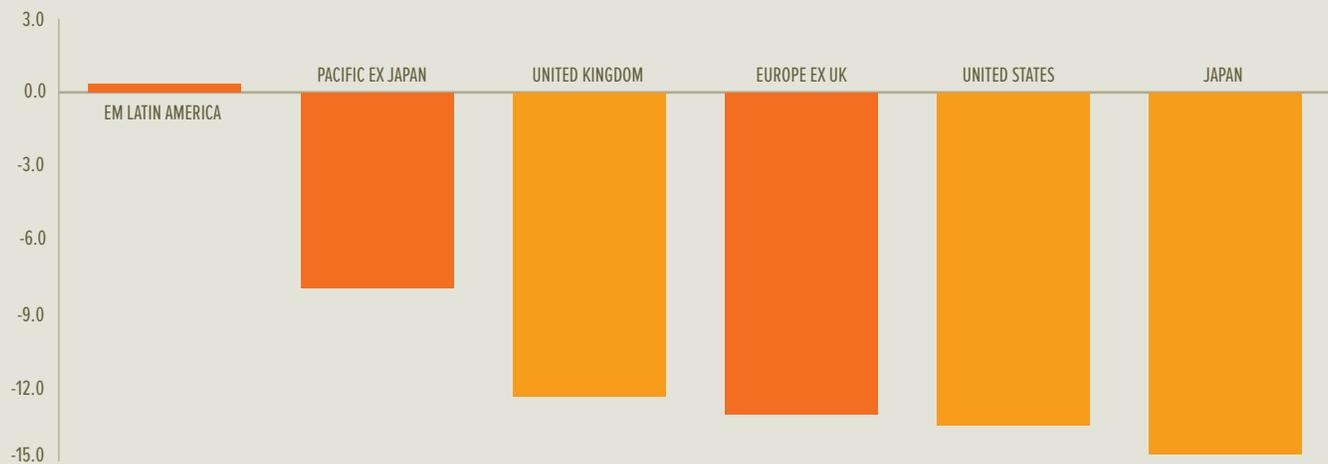
Fixed-Income Performance in Q4 2018 (Percent Return)



Sources: FactSet, Lipper. See “Corresponding Indexes for Fixed-Income Performance Exhibit” in the Index Descriptions section for more information.

Regional Equity Performance in Q4 2018 (Percent Return)

■ COUNTRIES ■ REGIONS



Sources: FactSet, Lipper. See "Corresponding Indexes for Regional Equity Performance Exhibit" in the Index Descriptions section for more information.

and maintained a significant underweight to Australia (which is largely concentrated in financials). Within our emerging-market equity strategy, we increased our exposure to Brazil on a diversified set of opportunities there; this drove an overweight to Latin America. We remained strategically underweight Asia (where our under-exposure is concentrated in the larger economies) and overweight European stocks. From a sector standpoint, we decreased an overweight to energy stocks by exiting positions in Taiwan and India.

Our core fixed-income strategy was overweight duration and remained overweight banks on risk-adjusted valuation grounds. We retained an off-benchmark allocation to non-agency MBS (given their attractive spreads) as well as an overweight to agency MBS (which we view as a high-quality substitute for Treasuries). Within high yield, CLOs remained our strategy's largest allocation; we continued to underweight energy as yields in the sector had not widened enough to compensate investors for the weak outlook. We were underweight financials as lower-rated companies have a cost-of-funding disadvantage, and we moved from underweighting healthcare to overweighting the sector given its defensive characteristics and favorable backdrop for deals. We decreased an overweight to media, but remain constructive on its relatively stable recurring cash flows and positive deal catalysts. We increased our allocation to local-currency emerging-market debt from neutral to overweight, as emerging-market currency valuations appeared attractive. Our deep underweight to hard-currency debt was slightly reduced due to opportunities created by the fourth-quarter selloff. Our emerging-market debt strategy re-allocated responsibilities at the end of October, with the addition of two investment managers and a refined focus for two existing managers. We believe this realignment should better capitalize on the managers' respective skillsets.

Our View

As painful as 2018 was for risk assets, their gyrations were not outside the norm. Rather, given our views that the global economy will continue to grow and that market participants are overreacting to the concerns of the day, we see another important risk-on opportunity developing in equities and other risk assets. We believe a rebalancing of assets back toward undervalued equity classes is an appropriate and timely response.

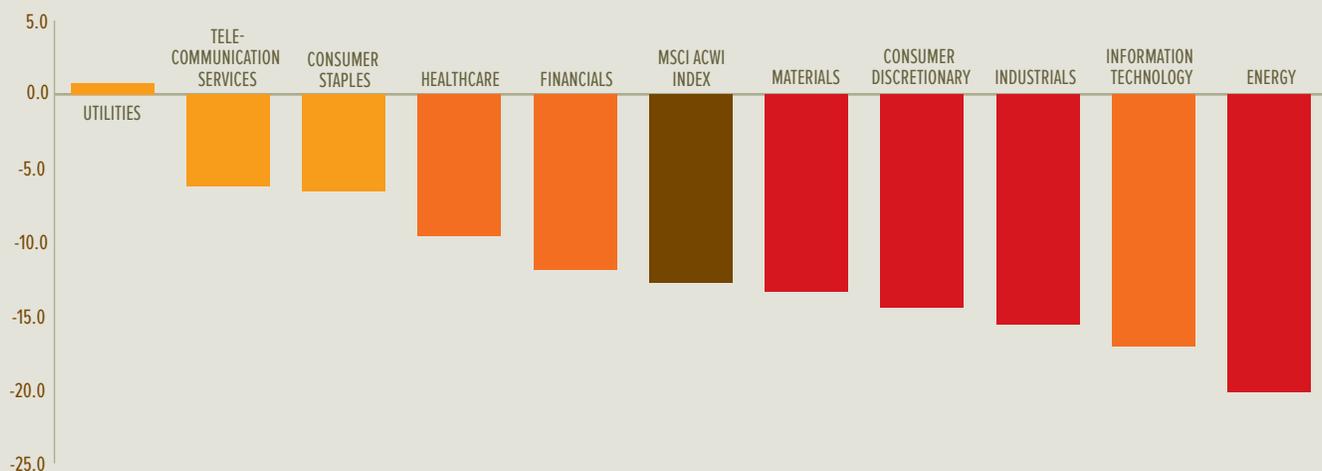
In our view, the U.S. economic position remains fairly solid. Points of strength include the improving economic position of U.S. households as labor markets tighten and real wage growth accelerates, while increased government spending has also helped. With Democrats controlling the House of Representatives and Republicans holding power in Senate, any fiscal-policy agreement made during a period of political gridlock will likely mean slightly more federal-government spending—not less.

The decline in energy prices is especially good news for the broader economy since it reduces concerns about inflation accelerating beyond the Federal Reserve's (Fed) comfort zone anytime soon. It also lowers costs for consumers and businesses on a broad range of petroleum-based products.

Some Fed officials, including Chairman Jerome Powell himself, explicitly acknowledge that the federal-funds rate now is near a level that can be considered neither stimulative nor deflationary. We are penciling in just one rate increase in 2019, and perhaps one in 2020—but these are just guesses. The important thing to remember is that the central bank is adopting a wait-and-see approach to monetary policy and has ended the nearly automatic quarterly rate increases of 2017 and 2018.

Global Equity Sector Performance in Q4 2018 (Percent Return)

DEFENSIVES BLENDS CYCLICALS



Sources: FactSet, Lipper. MSCI ACWI Index Components (as defined by SEI).

We think the odds favor a strong rebound in U.S. equity prices for the following reasons:

- › The U.S. economy should continue to grow, and corporate earnings per share are expected to post a mid-to-high single-digit gain in 2019.
- › Valuations for the S&P 500 Index have declined from almost 19 times one-year forward earnings per share to an attractive level of almost 14 times following the decline in share prices.
- › U.S. bond yields remain rather low and have moved down again in late 2018, bolstering the case for riskier assets.
- › Investor risk aversion has increased, and we think much of the bad news of recent months is reflected in current stock prices—creating space for potential upside surprises on trade wars, the Fed’s policy path, Brexit, corporate profits and elsewhere.
- › Fiscal policy will not be the strong catalyst for growth in the U.S. that it was in 2018, but the impact of political gridlock should still be mildly expansionary.

As for Brexit, we believe it’s unlikely that the U.K. will fall out of the EU without some sort of deal in place. A no-deal divorce would deliver a mighty blow to the economy. In our view, the real choice now is between May’s Brexit deal or no Brexit at all. A no-Brexit-at-all scenario could take one of two forms. The U.K. government could unilaterally revoke Article 50, basically calling off the divorce from the EU. The second alternative is to go back to voters and hold a second referendum. Although the legality would be disputed, we think this is the far more likely scenario. The financial markets probably would respond quite positively to this decision, yet the next few months can still be volatile as the late-March Brexit date nears.

Although the European banking system is in better shape than it was in the immediate aftermath of the global financial crisis, it is still vulnerable at a time when the ECB is in a holding pattern, policy-wise, and possesses only a few options in the event of a financial emergency. A lack of enthusiasm for Europe’s economic prospects is reflected in its equity-market valuations: the MSCI European Economic and Monetary Union (EMU) Index price-to-earnings ratio has sunk to less than 12 times from nearly 15 times at the start of the year. Note that European equities outperformed U.S. equities in fourth quarter 2018.

We are leaning on the optimistic side for emerging markets in 2019. The valuation piece is already in place, in our opinion, with the price-to-forward-earnings ratio collapsing from 13 times at the end of January to 10.5 by year-end. But what could be the catalyst for a turnaround? Big debt expansions in China typically lead to big gains in emerging-market equities. The question is whether the Chinese government has the will to go back to the debt well one more time.

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During periods of market volatility like the one we've been going through, we make sure to remind investors about the importance of sticking with a strategic and disciplined approach to investing that is consistent with personal goals and risk tolerances.

It surely would be a big positive for the country if the threat of tariffs was negotiated away, but we're not holding our breath. On the contrary, the U.S.-China economic relationship will likely continue to deteriorate as the Trump administration seeks to level the playing field—even if it means a less efficient global trading system. When push comes to shove, the Chinese government will probably get even more aggressive in easing lending constraints if the situation warrants.

Commodity prices and the earnings of emerging-market companies are closely correlated in inverse fashion with the movements of the U.S. dollar. For most of 2018, the dollar gained against other currencies, putting downward pressure on commodity prices and the earnings of energy and materials companies that are a large part of the MSCI Emerging Markets Index. In 2017, the opposite conditions held.

We are looking for another change in the dollar's trend in 2019. In our view, U.S. economic and corporate-earnings performance will move toward that of other developed countries. If there are positive developments in some of the pressure-point issues that have roiled markets, investment capital could flow away from the U.S. and back into the world—thereby removing an important source of support for the U.S. currency and a big headwind from the rest of the world. This potential for a reversal in investment flows could accelerate if Fed policy becomes more dovish than currently projected by the central bank.

The awful performance of risk assets in the fourth quarter can certainly prey on investors' emotions. But the global economy is not exactly in dire straits. Yes, there are an unusually large number of uncertainties and concerns, some of which could have a material impact on growth if the worst comes to pass. However, even in an extraordinarily unfavorable economic scenario in which the tariff wars with China and other countries deepen and the Fed raises interest rates too far and too fast, we doubt that the U.S. economy would experience anything worse than a garden-variety recession by 2021. The economic and credit excesses that usually precede a deeper recession simply aren't to be found.

During periods of market volatility like the one we've been going through, we make sure to remind investors about the importance of sticking with a strategic and disciplined approach to investing that is consistent with personal goals and risk tolerances. Diversification is the key to that approach, and the construction of portfolios is consistent with our long-term capital market assumptions.

Ultimately, the value of our assumptions is not in their accuracy as point estimates, but in their ability to capture relevant relationships—as well as changes in those relationships as a function of economic and market influences.

Glossary of Financial Terms

Dovish: Dovish refers to the views of a policy advisor (for example, at the Bank of England) who has a positive view of inflation and its economic impact and thus tends to favor lower interest rates.

Federal-funds rate: The federal-funds rate is the interest rate at which a depository institution lends immediately available funds (balances at the Federal Reserve) to another depository institution overnight in the U.S.

Price-to-earnings ratio: The price-to-earnings ratio is the ratio of a company's share price to its earnings over the past 12 months, which can be used to help determine whether a stock is undervalued or overvalued.

Quantitative easing: Quantitative easing refers to expansionary efforts by central banks to help increase the supply of money in the economy.

Yield curve: The yield curve represents differences in yields across a range of maturities of bonds of the same issuer or credit rating (likelihood of default). A steeper yield curve represents a greater difference between the yields. A flatter yield curve indicates the yields are closer together.

Index Descriptions

All indexes are quoted in gross performance unless otherwise indicated.

The Bloomberg Barclays 1-10 Year U.S. TIPS Index measures the performance of inflation-protected public obligations of the U.S. Treasury that have a remaining maturity of 1 to 10 years.

The Bloomberg Barclays U.S. Asset Backed Securities (ABS) Index measures the performance of ABS with the following collateral types: credit and charge card, auto and utility loans. All securities have an average life of at least one year.

The Bloomberg Barclays Global Aggregate Bond Index (formerly Lehman Brothers Global Aggregate Index), an unmanaged market-capitalization-weighted benchmark, tracks the performance of investment-grade fixed-income securities denominated in 13 currencies. The Index reflects reinvestment of all distributions and changes in market prices.

The Bloomberg Barclays Global Aggregate ex-Treasury Index is an unmanaged market index representative of the total-return performance of ex-Treasury major world bond markets.

The Bloomberg Barclays Global Treasury Bond Index is composed of those securities included in the Bloomberg Barclays Global Aggregate Bond Index that are Treasury securities.

The Bloomberg Barclays U.S. Corporate Investment Grade Index is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index measures the performance of investment-grade, fixed-rate, mortgage-backed, pass-through securities of Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA) and Freddie Mac (FHLMC).

The Bloomberg Barclays U.S. Treasury Index is an unmanaged index composed of U.S. Treasuries.

The BofA Merrill Lynch U.S. High Yield Constrained Index contains all securities in The BofA Merrill Lynch U.S. High Yield Index but caps exposure to individual issuers at 2%.

The BofA Merrill Lynch U.S. High Yield Index tracks the performance of below-investment-grade, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Chicago Board Options Exchange Volatility Index (VIX) tracks the expected volatility in the S&P 500 Index over the next 30 days. A higher number indicates greater volatility.

The Dow Jones Industrial Average is a widely followed market indicator based on a price-weighted average of 30 blue-chip New York Stock Exchange stocks that are selected by editors of *The Wall Street Journal*.

The FTSE All-Share Index represents 98% to 99% of U.K. equity market capitalization. The Index aggregates the FTSE 100, FTSE 250 and FTSE Small Cap Indexes.

The JPMorgan EMBI Global Diversified Index tracks the performance of external debt instruments (including U.S. dollar-denominated and other external-currency-denominated Brady bonds, loans, eurobonds and local-market instruments) in the emerging markets.

JPMorgan GBI-EM Global Diversified Index tracks the performance of debt instruments issued in domestic currencies by emerging-market governments.

The MSCI ACWI Index is a market-capitalization-weighted index composed of over 2,000 companies, representing the market structure of 48 developed- and emerging-market countries in North and South America, Europe, Africa and the Pacific Rim. The Index is calculated with net dividends reinvested in U.S. dollars.

The MSCI ACWI ex-USA Index includes both developed- and emerging-market countries, excluding the U.S.

The MSCI Emerging Markets Index is a free float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging-market equities.

The MSCI Emerging Markets Latin America Index captures large- and mid-cap representation across five emerging-market countries in Latin America.

The MSCI EMU (European Economic and Monetary Union) Index: The MSCI EMU Index captures large- and mid-cap representation across the developed-market countries in the EMU. The Index consists of the following 10 developed-market country indexes: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal and Spain.

The MSCI Europe ex-UK Index is a free float-adjusted market-capitalization-weighted index that captures large- and mid-cap representation across 14 developed market countries in Europe (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and Switzerland). The Index covers approximately 85% of the free float-adjusted market capitalization across European developed markets, excluding the U.K.

The MSCI Pacific ex Japan Index captures large- and mid-cap representation across four of five developed-market countries in the Pacific region (excluding Japan).

The MSCI Japan Index is designed to measure the performance of the large- and mid-cap stocks in Japan.

The MSCI World Index is a free float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets. The Index consists of the following 23 developed-market country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K. and the U.S.

The NASDAQ Composite Index is a market-value-weighted index of all common stocks listed on the National Association of Securities Dealers Automated Quotations (NASDAQ) system.

The S&P 500 Index is a capitalization-weighted index made up of 500 widely held U.S. large-cap companies.

The TOPIX, also known as the Tokyo Stock Price Index, is a capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The Index is supplemented by the subindexes of the 33 industry sectors. The Index calculation excludes temporary issues and preferred stocks, and has a base value of 100 as of January 4, 1968.

Corresponding Indexes for Fixed-Income Performance Exhibit

U.S. High Yield	BofA Merrill Lynch U.S. High Yield Master II Constrained Index
Global Sovereigns	Bloomberg Barclays Global Treasury Bond Index
Global Non-Government	Bloomberg Barclays Global Aggregate ex-Treasury Index
Emerging Markets (Local)	JPMorgan GBI-EM Global Diversified Index
Emerging Markets (External)	JPMorgan EMBI Global Diversified Index
U.S. Mortgage-Backed Securities (MBS)	Bloomberg Barclays U.S. Mortgage Backed Securities Index
U.S. Asset-Backed Securities (ABS)	Bloomberg Barclays U.S. Asset-Backed Securities Index
U.S. Treasuries	Bloomberg Barclays U.S. Treasury Index
U.S. Treasury Inflation-Protected Securities (TIPS)	Bloomberg Barclays 1-10 Year U.S. TIPS Index
U.S. Investment-Grade Corporates	Bloomberg Barclays U.S. Corporate Investment Grade Index

Corresponding Indexes for Regional Equity Performance Exhibit

United States	S&P 500 Index
United Kingdom	FTSE All-Share Index
Pacific ex Japan	MSCI Pacific ex Japan Index (Net)
Japan	TOPIX, also known as the Tokyo Stock Price Index
Europe ex UK	MSCI Europe ex UK Index (Net)
EM Latin America	MSCI Emerging Markets Latin America Index (Net)

Disclosures

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