As Markets Rise, So Do Risks

As we look toward the second half of the year, we continue to find reasons for optimism, but also for increased scrutiny of risks. Similar to the heightened expectations of the U.S. economic outlook at the beginning of the year, the equity market entered 2017 amid widespread investor optimism and some of the largest equity inflows since the beginning of the bull market in 2009. However, in contrast to some disappointing domestic economic data in recent months, the stock market has rewarded optimism with steady gains in the first two quarters of the year.

Signs of late-cycle excesses are beginning to emerge, including hyperbolic moves in highly speculative assets, tight risk premiums, record high margin debt, and growing corporate leverage. Yet, few signs of deteriorating credit market health are evident and global growth momentum continues to improve. As a result, a moderately bullish outlook remains justified until some convincing evidence emerges that the recent uptick in the global growth outlook is reversing. In our view, the long and growing list of potential risks we will outline in this outlook warrants close monitoring in the coming months, but the odds still favor the bull market remaining intact at least into 2018.

Global Economy

Choppy U.S. Growth Continues in the First Half of the Year

One of the characteristics of the current expansion has been the tendency for economic data to reverse course shortly after seeming to establish a trend. The first half of 2017 has seen a continuation of this choppy economic environment, with U.S. GDP growing a disappointing 1.2% in Q1, but on track to rebound to 2.9% growth in Q2. This, according to the June 16, 2017 forecast of the Atlanta Fed’s GDPNow model is shown in Exhibit 1. Similarly, the latest Wall Street Journal survey of economists projects 3.0% Q2 growth.

Exhibit 1. Evolution of Atlanta Fed GDPNow real GDP Forecast for Q2 2017

Source: Federal Reserve Bank of Atlanta (6/16/2017)
Global Growth Surprisingly Strong

So far, in 2017 although economic growth in the U.S. has been somewhat disappointing relative to very high post-election expectations, global growth has broadened and European growth, in particular, has consistently exceeded expectations. This positive momentum for the eurozone is evident in the Citigroup Economic Surprise Index, as seen in Exhibit 2, which shows European economic data consistently exceeding expectations since the middle of 2016, a welcome development after several years of generally challenging economic conditions for the region. The JPMorgan Global Manufacturing & Services PMI and the OECD Composite Leading Indicator also continue to point to firming global growth in the coming months.

Exhibit 2. Citi Economic Surprise Index - Eurozone

Despite Some Concerns, Recession Risk Remains Low

Low interest rates and below-average inflation measures have historically tended to be supportive of equity valuations, except in cases where the economy was slipping into recession. Therefore, when assessing the outlook for equities over the remainder of the year, we believe the most critical question is whether a recent drop in Treasury yields and inflation data reflects a weakening economic backdrop and growing recession risk. There are some very early warnings signs that the eight-year-old economic expansion may potentially be entering a higher risk period. For example, a recent uptick in early stage delinquencies for some categories of consumer debt may signal upcoming weakness in spending. The charts in Exhibit 3 show the small increase in delinquency rates for consumer loans, credit cards, and other consumer debt.
That said, in our view, the weight of the evidence still does not point to an elevated risk of recession over the next twelve months. First, recent data suggests job growth has moderated, but the labor market outlook remains robust. For example, as shown in Exhibit 4, the Job Openings and Labor Turnover Survey (JOLTS) data from the Bureau of Labor Statistics showed a record number of job openings in its latest update. As a result, the number of unemployed persons per job opening recently hit a new cycle low.

Similarly, weekly initial unemployment claims remain near multi-decade lows and have yet to show any signs of trending upward. This suggests the recently somewhat disappointing headline numbers for job growth are likely partially explained by an already low unemployment rate and a mismatch of skills – a problem that is making it difficult for some firms to fill job openings with qualified candidates. Aside from employment, broad credit market metrics also remain reasonably healthy, and leading economic indicators are signaling an improving, though moderate, outlook for growth.
Exhibit 5 below shows the recent performance of several major equity indices. As of June 15th, the S&P 500 was up 3.6% in the second quarter and 9.9% year-to-date. Gains in international equities have been even more impressive, with developed markets up 15.1% and emerging markets up 18.5% in U.S. dollar terms, year-to-date. Weakness in the U.S. dollar, which very few analysts were predicting earlier in the year, has aided the return of foreign assets to domestic investments. In contrast to 2016, gains in the U.S. markets have been led by large cap growth stocks, with value and smallcap stocks notably lagging. The relative performance of the different segments of the equity markets in the first half of the year reflects a sharp reversal of the trends that prevailed in the immediate aftermath of November’s election, as high expectations for forthcoming economic stimulus have met political reality.

Exhibit 5. Equity Market Performance (as of 6/14/2017)

<table>
<thead>
<tr>
<th></th>
<th>Q2 %</th>
<th>YTD %</th>
<th>TTM %</th>
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<tr>
<td>MSCI EAFE Index</td>
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<td>15.1</td>
<td>24.2</td>
</tr>
<tr>
<td>MSCI Emerging Market Index</td>
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<tr>
<td>MSCI All Country World Index</td>
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<tr>
<td>Russell 2000 Index (U.S. Small Cap)</td>
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<td>5.1</td>
<td>25.3</td>
</tr>
<tr>
<td>S&amp;P 500 Index (U.S. Large Cap)</td>
<td>3.6</td>
<td>9.9</td>
<td>20.0</td>
</tr>
</tbody>
</table>

Source: Morningstar; as of 6/15/2017
Valuations Remain Primary Concern

There are many ways of looking at stock market valuations, which at times can send conflicting signals. However, a variety of valuation techniques appear to be sending a consistent message that U.S. equities are at least fully valued at current levels, if not moderately overvalued. The table in Exhibit 6 tracks five common valuation metrics for the S&P 500: price-to-earnings (P/E) using unadjusted GAAP earnings, operating P/E adjusted for one-time items, price-to-average 10-year earnings, the median P/E ratio, and the capitalization-adjusted P/E ratio. At this point, all five of these metrics show U.S. equity valuations above historical averages. Several of these metrics have only reached significantly higher levels during the stock bubble of the late 1990s.

Exhibit 6. S&P 500 Valuation Metrics

Source: Ned Davis Research (data through 05/31/2017)
Despite our growing valuation concerns, which are most acute for U.S. stocks, we continue to recommend a healthy allocation to equities. Clearly, the high valuations of U.S. stocks have not yet posed much headwind to robust market gains. We believe these returns reflect recent strong year-over-year earnings growth, a low inflation and interest rate environment, generally improving global economic data, continuing highly accommodative global monetary policy, and continuing optimism that corporate tax reform would be imminent. Should the solid macro foundation provided by these factors begin to erode, the risk versus reward outlook for equities would become far less favorable.

The likelihood that some of these positive factors will begin to fade before year-end supports our outlook that the ongoing bull market will be accompanied by rising risks. In particular, year-over-year comparisons for earnings will soon become more challenging at the same time expectations have risen to potentially excessive levels. This dynamic is most apparent in forecasted earnings for the fourth quarter of 2017. According to FactSet Research Systems, analyst project growth of 12.4%, an estimate that has actually increased in recent months. Given global economic activity was already reasonably robust at the end of 2016, these optimistic year-over-year growth forecasts may prove challenging to meet; a decrease in Q4 earnings estimates could lead to some market volatility in the second half of the year.

Exhibit 7. DJIA (top clip) versus monetary & fiscal policy (bottom clip) during presidential cycles

Source: Ned Davis Research (03/28/2017)
Typically, the outlook for economic stimulus from monetary and fiscal policy is not particularly encouraging during the first 18 months of the presidential cycle, as shown in Exhibit 7. Since 1964, on average, this period has tended to see stimulus recede. This suggests legislative efforts to cut taxes and increase infrastructure spending may continue to muddle along until the reality of an upcoming mid-term election becomes imminent in 2018. With the GOP in control of Congress, it remains likely, in our opinion, that some form of corporate tax legislation will be enacted by the middle of next year. However, potential disappointment over the timing or details of the ultimate legislation could also lead to increased market volatility.

Further tightening from the U.S. Federal Reserve and some indications that the European Central Bank will begin tapering its massive asset purchases could also somewhat erode the support provided by monetary policy. However, aggregate global monetary conditions are likely to remain accommodative for at least the next twelve months. This accommodation is exemplified by global central banks in aggregate purchasing $1.5 trillion in assets over the first five months of the year and remaining on pace to buy a record $3.6 trillion over the course of 2017, according to data compiled by BofA Merrill Lynch and shown below in Exhibit 8.

**Exhibit 8. Central banks aggressively expanding balance sheets**

![Chart showing central bank balance sheets]


(As of 06/09/2017)

**Fixed Income Markets**

As we hit the mid-point of 2017, the Federal Open Market Committee (FOMC) is ahead of pace to raise short-term interest rates three times this year. The FOMC raised rates by 0.25% in both March and June, setting the target range at 1.00% to 1.25%. While short-term rates have been increasing, long-term bond yields have been falling, flattening the yield curve. The 10-year Treasury yield started the second quarter at 2.40% and has since fallen as low as 2.10%, before rebounding slightly. Bond prices move inversely with bond yields, so bond prices rallied, and the Bloomberg Barclays U.S. Aggregate Bond Index rose roughly 2% this quarter. The chart in Exhibit 9 illustrates how the yield curve has flattened, with longer duration Treasurys yielding less, while shorter-term Treasurys are yielding more. While the flattening is less intuitive given the Fed policy, it may suggest that central bank officials maintain a brighter outlook on economic conditions than does the market.
The June FOMC rate hike was widely anticipated by the market, with near certain odds. The question many investors had was whether the committee would comment on when they would start unwinding the Fed’s large balance sheet, which stands around $4.5 trillion. As a reminder, the Fed bought trillions of dollars of mostly government bonds and mortgage backed securities during the financial crisis through its quantitative easing (QE) programs. Through QE, the central bank was able to lower long-term interest rates and increase the money supply, which can be simulative for the economy.
Although the Fed has not been buying bonds to grow its balance sheet assets, it has been reinvesting the principal payments it receives from these securities. Investors have been waiting to hear how the Fed will approach reducing their balance sheet, since doing so will likely increase the supply of bonds in the market and cause yields to rise. In the June FOMC press release, the committee expressed its continued plans to implement a “balance sheet normalization program” this year, provided the economy stays on a positive path, as broadly anticipated. So, while they plan to move forward with this normalization, they have given themselves margin for error in case the economic recovery stalls. As anticipated, investors received more detail regarding the normalization process. The committee stated it would reinvest only to the extent that the maturing principal payments exceed gradually rising caps. The initial cap for Treasury securities will be $6 billion per month and will increase in steps of $6 billion at three-month intervals over twelve months until it reaches $30 billion per month. The cap for mortgage-backed securities (“MBS”) will be $4 billion, increased by that amount each quarter until it reaches $20 billion per month.

Once the normalization process, which will take twelve months, is fully underway, the Federal Reserve balance sheet will shrink by $50 billion per month. In comparison, the Federal Reserve was adding $85 billion per month as part of its latest quantitative easing program.

Following a recent fall in yields, we expect yields to trend higher over the course of the year. At the beginning of the year, we had expected the yield on the 10-year Treasury to finish 2017 between 2.75% to 3.25%. With the recent fall in rates and weaker inflation numbers, we expect to finish closer to the lower end of this range now, with 10-year yields possibly staying below 3% for 2017. As we have seen, a rise in yields is not a straight path up, and there is volatility as more economic data comes in. As such, we continue to recommend diversifying within fixed income, not having too much exposure to any one risk factor such as duration, credit quality or a specific sector. We recommend being underweight duration-sensitive bonds, such as mortgages and Treasurys, since the reward or yield is low relative to the risk or duration of these bonds. However, we still recommend having an allocation to these higher-grade bonds as they can buffer against equity volatility.

We still recommend an overweight to credit-sensitive bonds, such as investment-grade corporate bonds, high-yield bonds and bank loans as an improving economy, coupled with low borrowing costs, can be supportive for these bonds. We do caution against too much of an overweight, though, as credit spreads have narrowed and these bonds are not as attractively priced as they were in 2016. These bonds can also correlate with equities in times of equity volatility. Building a diversified fixed income portfolio is important as the Fed becomes less accommodative and the bull market for equities enters its ninth year. In addition, while we see no immediate signs of recession in the near term, there is a risk that Fed tightening or normalization and a slower than expected pace of deregulation and income tax reform may lead to softer economic conditions. This may also contribute to volatility in credit-sensitive bonds and is one more reason we feel that a tilt to less risky bonds could be prudent.

Municipal bonds fared well for the quarter as rates trended lower. The muni market also was largely unaffected by the announcement that the Puerto Rican Financial Oversight Board filed for bankruptcy protection in May. Bonds issued by the commonwealth have largely been classified as high yield and, as a result, are less frequently held by investment grade managers; as prices have declined, their impact on the overall market is lower. With the Puerto Rico news largely in the rear mirror, our outlook for municipal bonds remains positive. Improving employment and economic conditions support a recovering tax base, and the supply of new bonds issued this year is lower than the issuance observed in 2016. We should note that income tax reform might be a risk for this sector, especially if high tax brackets are significantly lowered or the Alternative Minimum Tax (AMT) is repealed. However, given the slow pace of reforms from the current administration and general political gridlock, we believe the likelihood of significant tax reform is now lower than it was at the beginning of the year.

**Risks to Our Outlook**

Markets were unflappable throughout the first half of the year, with the Chicago Board Options Exchange Volatility Index (VIX), a measure of the S&P 500 30-day implied volatility, hovering at historically low levels. All the while, major equity indices advanced past previous records, and when they retreated, they held support levels before ascending once again. The global economy has improved over the past year, and domestic earnings had their best quarter since the third quarter of 2011. However, potential risks discussed previously are still present. Thus, we recommend proceeding with caution and an eye on valuation, as both equity and bond markets are more expensive and complacent than before.
In prior commentaries, we pointed out that the extraordinary surge in consumer and business surveys (“soft data”) following the election would not necessarily equate to elevated economic output (“hard data”), even though equity markets increased substantially. In actuality, economic output disappointed with Q1 GDP at 1.2%¹, well below consensus estimates of 3.0%. The shortfall was largely attributable to nearly flat loan growth at U.S. commercial banks—as well as a slowdown in monthly payroll gains, supporting concerns that equity markets might be getting ahead of themselves.

In surveys, figures are retreating from peak highs, showing signs that momentum in the economy could possibly be slowing. For instance, the ISM manufacturing Purchasing Managers Index rose from 52.0 in October 2016 to a high of 57.7 in February 2017. The reading for June now stands at 54.9, marginally lower, but still indicating economic expansion.

One of the more marked contrasts, as shown in Exhibit 11, comes from the Q2 2017 Duke University Fuqua School of Business/CFO Magazine Global Business Outlook, where business leaders walked back their optimism in the U.S. economy to 41.8% in 2Q 2017 from 62.0% in 4Q of 2016 and 64.1% in Q1 2017. Of their top ten concerns, government policies ranked second, and economic uncertainty came in fourth. If confidence is lost, the positive trajectory of the economy could revert, creating a more difficult environment for capital markets.

**Exhibit 11. Duke University/CFO Magazine Global Business Outlook**

Fed tightening remains a focal point in the coming months in determining possible hurdles for capital markets. As history has shown, accurately achieving the appropriate pace, trajectory, and timing of Fed hikes can be as much art as science. The Fed needs to balance the state of the economy, as well as market participants’ expectations, so as not to stall economic activity. Thus far, the Fed has successfully managed the process of coming out of the zero-bound range, though, as policy begins to normalize further, the stakes grow higher. Financial strain on markets

¹ The Bureau of Economic Analysis, 5/26/17. This is the second of three estimates, with the final figure expected on June 29th. BEA releases three vintages of the current quarterly estimate for GDP: “Advance” estimates are released near the end of the first month following the end of the quarter and are based on source data that are incomplete or subject to further revision by the source agency; “second” and “third” estimates are released near the end of the second and third months, respectively, and are based on more detailed and more comprehensive data as they become available.
and on those with adjustable rate credit will materialize as we move forward. It remains to be seen how capital market and consumer behaviors may change if rates increase meaningfully. In addition, should the economy slow and the Fed continue on its current tightening course, recession risks would grow as well.

Political uncertainty continues to be elevated due to policy and geopolitical struggles. Entering office, the current administration had a large undertaking in tackling tax reform, enacting an infrastructure spending bill, and overhauling the Affordable Care Act. Accomplishing their objectives has become increasingly difficult in the midst of Congressional investigations surrounding the administration’s possible involvement with the Russians. Prospects of these pro-growth incentives had lifted markets and expectation for growth in early 2017, though without significant progress. The World Bank estimated that if both corporate and personal income tax reform were passed together, domestic GDP could increase from 2.2% to 2.5% in 2017 and from 2.5% to 2.9% in 2018. It remains to be seen if all the distractions will prove too great for Washington. Additionally, uncertainty around the globe regarding security and policy could possibly reduce confidence and slow the recovering global economy. When firms do not have a clear understanding of policy, it affects their willingness to invest. Economists estimate a 10% increase in global policy uncertainty can cause as much as a 0.2% reduction in trade growth.

**Investment Implications**

At the mid-year point in 2017, several important themes have relevance in portfolio construction. The U.S. has led the global markets for the past several years, but there are signs of the symbolic baton being handed off to other regions. Further, the “Trump trade” that started after the election based on reflation forecasts has reversed. However, the overall low-volatility environment that has been the norm for the past several years has continued, as has the market’s steady climb to new all-time highs.

Domestic economic growth, while positive, has been more anemic in 2017 than we had forecasted. Similar to last year, this has led to growth continuing to outperform value, a theme we believe will persist throughout the year. We would continue to be wary of the more interest rate sensitive sectors such as utilities, staples and telecom. As we expected, economic growth has picked up overseas. International developed and emerging markets have outperformed U.S. equities for the first time in a number of years. We still see attractive valuations in Europe, Japan, and emerging markets. While we would be mindful of the impact of currency, valuation and longer-term mean reversion, opportunities still exist and we continue to recommend a globally diversified portfolio.

While volatility has been unusually low, political uncertainty remains elevated, and the market is developing immunity to political shocks. At the same time, there are signs of sentiment getting overly optimistic. These conditions, coupled with a valuation that is getting a bit expensive, lead us to believe that there might be a return of volatility this year, especially if the prospects of tax reform begin to subside. We would recommend using active managers with flexible mandates, as well as the use of alternatives, within portfolios to enhance the risk management benefits of diversification.

On the fixed income side, despite two recent rate hikes by the Federal Reserve, we have actually seen the much watched 10-year Treasury yield fall about 50bps to about 2.15% year-to-date. In the short-term, we do not see many factors that would move rates materially higher or lower. Longer term, we believe there is more upside risk to rates and would not expect it to breach 2%. Even in the wake of moderately higher rates, we still believe bonds serve a valuable role in a portfolio. We would recommend shorter-than-benchmark duration for the fixed income portion. We also favor inflation-protected bonds as a substitute for a portion of target Treasury exposure. With a steady economic backdrop, we favor an overweight to credit, and we continue to see good risk/reward opportunities in high yield and floating-rate bonds given the modest equity outlook.

All of this translates into a backdrop where we see positive equity performance, but with measured gains below historical averages. We would not recommend drastic deviations from long-term stock/bond targets.
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A High Yield Fund yield is high due, in part, to the volatility and risk of the high securities market. High yield funds are also known as “junk bonds.”

Investors should consider the investment objectives, risks and charges, and expenses of the fund carefully before investing. The prospectus contains this and other important information about the fund. Contact your registered representative or the issuing company to obtain a prospectus, which should be read carefully before investing or sending money.

GLOSSARY

The Bloomberg Barclays Capital U.S. Aggregate Bond Index, which was originally called the Lehman Aggregate Bond Index, is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government–related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody’s and BBB- by S&P. Taxable municipals, including Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings has a fluctuating average life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.

The Bloomberg Barclays U.S. Municipal Bond Index is an unmanaged, market-value-weighted index of investment-grade municipal bonds with maturities of one year or more.

The Bloomberg Barclays U.S. Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government-related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supra-nationals and local authorities. The US Credit Index was called the US Corporate Index until July 2000, when it was renamed to reflect its inclusion of both corporate and non-corporate issuers. The US Credit Index is a subset of the US Government/Credit Index and US Aggregate Index. Index history is available back to 1973.

The Bloomberg Barclays U.S. Corporate High Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

The Bloomberg Barclays U.S. Treasury: U.S. TIPS Index includes all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity, are rated investment grade, and have $250 million or more of outstanding face value.

The Bloomberg U.S. Treasury Floating Rate Bond Index is a rules-based, market value-weighted index engineered to measure the performance of floating rate U.S. Treasury bonds. The index inception date is January 31, 2014—the first month-end following the U.S. Treasury’s issuance of a floating rate bond. Historical performance and characteristics are available from January 31, 2014, when floating rate notes were offered and first traded, the first new Treasury security since the introduction of Treasury-Inflation-Protected Securities (TIPS) in 1997.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Introduced in 1993, the VIX Index has been considered by many to be the world’s premier barometer of investor sentiment and market volatility.
**Citigroup U.S. Economic Surprise Index** measures the reaction to US economic news by comparing how much actual economic data deviates from the expectations of economists. Expectations are measured through a Bloomberg survey of economists which takes place before the release of the economic data and the median value of the survey results are calculated.

The **MSCI EAFE** is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted.

**MSCI Emerging Markets** is designed to measure equity market performance in global emerging markets. It is a float-adjusted market capitalization index.

The **MSCI ACWI Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The SMCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The developed country indexes include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indexes included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

**The MSCI World Index** is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and MSCI World benchmark does not offer exposure to emerging markets.

The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The **S&P 500** is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. Constituent companies within this float-adjusted market cap weighted index must have a market cap of $6.1B or greater.

The **U.S. Dollar Index** is a weighted geometric mean that provides a value measure of the United States dollar relative to a basket of major foreign currencies. The index, often carrying a USDX or DXY moniker, started in March 1973, beginning with a value of the U.S. Dollar Index at 100.000. It has since reached a February 1985 high of 164.720, and has been as low as 70.698 in March 2008.