Clarien Investments Limited

2019 Outlook

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Executive Summary

We've entered a more challenging investment environment - geopolitical uncertainty, tighter monetary policy, and a maturing global economic cycle are contributing to more turbulent markets. However, as we detail in the pages that follow, we believe that there are still attractive opportunities around the globe. Before getting into our outlook, one important message we want to convey is that as markets grow more uncertain, ensuring you have a disciplined plan in place to meet your financial goals becomes even more important.

Clarien Wealth Management Approach

The latter stage of an economic cycle is the best time to lay the foundations of an investment plan – before the next downturn. It is always difficult to stick with a plan while in the midst of market declines, and to do so without prior review is nearly impossible. In fact, many investors make their costliest investment mistakes during transition points in the market cycle and markets often reveal the greatest opportunities during times of stress.

At Clarien, our approach to wealth management is based on a careful determination of liquidity requirements, time horizon and risk and return appetite. This framework can help investors plan for their long-term goals, while helping reduce the risk of making emotional decisions in volatile markets. For example, with the equity bull market aging, now is a good time to ensure that there is sufficient **liquidity** in the portfolio to avoid being forced to sell assets at depressed levels.

Our investment approach enables investors to make redemptions and meet spending needs using highly liquid securities such as high quality short duration bonds during typically unforeseen drawdowns in the market. This strategy allows higher risk assets time to recover before having to sell them for any additional redemption requirement.

In addition, **time horizon** is a fundamentally important factor to plan for as well. The risk of investing in equities diminishes significantly with longer time-horizons. The time value of money is one of the most important concepts in investment. Through the power of compounding, small increments in rates of return translate into large increments in future wealth.

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Most investors of course do not like sharp equity declines. But for those investors still accumulating assets, they actually represent important opportunities to invest in growth at a lower price. As a result, if managed properly, market downturns – though emotionally difficult – can increase long-term wealth.

One way of minimizing the risk related to costly emotional behavior is to establish a disciplined investment approach such as rebalancing. While selling top-performing asset classes and buying worse-performing asset classes can be counterintuitive, our analysis shows that establishing a disciplined rebalancing approach within the strategic framework does add value over time.

Our strategic framework isn't a panacea for solving our own emotional biases, but it does provide a concrete structure for decision-making that investors can fall back on during times of market stress. We believe this framework will continue to serve our clients well as the cycle matures.

2019 Outlook

Based on our fundamental analysis of the current economic and capital market environment, we don't currently observe the conditions commonly associated with an imminent recession, though recessions are famously difficult to predict. From our perspective, prospering in this environment will require **selectivity**, **diversification**, as well as a **clear financial plan**.

In 2019, we expect continued volatility: economic growth is slowing globally (most critically in China and in the U.S.), central banks are tightening policy, and numerous political risks all pose challenges. It is worth highlighting that increased volatility is normal this late in a cycle.

However, fundamental indicators around consumption, investment, and employment are not warning of recession. In the U.S. inflation remains low enough for Federal Reserve rate tightening to proceed gradually, and many assets have already moved materially lower to take into account a more uncertain outlook.

The Fed now expects to raise rates two times in 2019, down from three raises previously. The negative market reaction in December seems overdone as the Fed provided evidence it will err on the side of caution to protect growth. In fact, the Fed has articulated recently in January it will be more patient. We are of the view that we are late in the cycle and while the Fed is tightening, financial conditions are not yet sufficient to cause a material economic contraction (such as a recession) over the next six to twelve months.

At this level, we and our external managers still see exciting select opportunities in individual companies globally.

Further, equity valuations have improved in most regions after the sharp decrease in equity markets and earnings growth expectations are not as ambitious as previously expected by analysts. U.S. equity valuations at the broad index level look fully priced and somewhat elevated relative to history.

However, the opportunity set in the equity world looks very different for active managers who are willing to take positions that are significantly different than the broad indices. At this level, we and our external managers still see exciting select opportunities in individual companies globally.

Our focus is to separate the fundamentals from the noise in the news as best we can, and to ensure that client portfolios are positioned appropriately. With so much macro uncertainty we find ourselves going back to basics and focusing on cash flows, the intrinsic value of a company, and good management. It is important to remember that share prices ultimately reflect long-term business results and not the day to day whims of the market.

We favor global diversification within equity holdings, which should also help mitigate volatility. No single region offers a uniquely compelling case and there are select opportunities in all regions.

Certainly, there is a long list of key risks and we highlight a reigniting of the trade war, Brexit, the U.S. government shutdown, the possibility that falling stock and house prices hurt consumer and business sentiment, and China's slowdown. One additional key risk to our view is that the free fall in equities will continue and create its own recession.

The path forward for trade relations is perhaps the biggest known hurdle for markets and the economy in 2019. The tariffs in place and future policy uncertainty is creating headaches for companies that can only be negative to economic activity.

Because the risks are offset by continued conditions for (albeit slower) growth, we recommend investors' portfolios remain **neutral on equities** for now. Until we get more visibility on how the Trump trade demands will play out with China and how China counters, the macro risks and how they get discounted into global equities and credit will remain about as unscientific as it gets.

We are looking to position client portfolios to be overweight equities but acknowledge the uncertainties and would need to observe some positive catalysts around trade talks and confirmation of earnings expectations.

For now, this means rebalancing and adding to equities in the short-term if exposures have fallen lower than strategic allocation targets in the investment plan. There could of course be a new testing of the lows reached in December and this somewhat cautious positioning provides flexibility to respond to specific opportunities or higher volatility.

We believe cash or short-duration high-quality bonds, as well as certain investment strategies that have relatively low reliance on economic growth, such as best of class hedge funds have a warranted place in a diversified portfolio.

Throughout the weeks and months to come, we will endeavor to keep our clients updated on what we think and how we think, as we navigate portfolios through 2019's turning points.

Thank you,

Clarien Investments Limited

Global Economy

Last year, U.S. economic growth was much stronger than growth in the rest of the world (see chart below). It is likely that growth in the U.S. will slow this year: the Federal Reserve's forecast suggests a slowdown in real GDP growth from 3.0% in 2018 to 2.3%.

In the U.S., the consumer remains healthy having reduced their debt most of this cycle. This strength comes from a buoyant job market, accelerating wages and positive consumer confidence. Additionally, though fiscal stimulus will not be as powerful in 2019, the IMF estimates that fiscal policy will add a further half of one percentage point to U.S. GDP growth. This could be further supported by a potentially significant infrastructure project. However, not all indicators are positive and cracks are beginning to appear in the mortgage market, for example.

Global Growth Momentum is Slowing, But Recession Unlikely

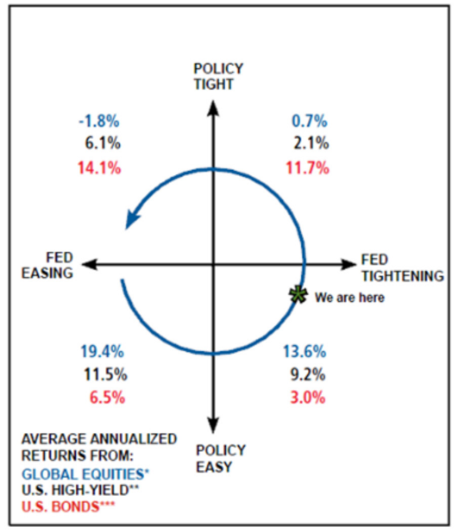
We maintain our view that China will not experience an economic hard landing though it has experienced material slowing. Surprising, to date this slowing has been due to weaker domestic demand rather than the impact of trade wars. Additionally, the soft patch in the Euro area is also likely to give way to better data, aided by recent currency weakness and stronger growth in emerging Asia.

Asset Allocation and Fed Policy

We find the Fed policy cycle produced by one of our research providers, BCA, in the table below to be a useful tool for thinking about probable investment returns from different assets. The best quadrant for risk assets is when the Fed is easing and policy is easy (with the Fed Funds Rate below the neutral rate). Currently we are in the bottom-right quadrant (Fed tightening, but not yet in the tight zone), which also has produced attractive returns for equities and credit.

The Fed is reacting very pragmatically to the evolving circumstances. Chair Jerome Powell emphasized in his post-FOMC press conference in December that "some cross currents have emerged" and that "policy decisions are not on a pre-set course". The FOMC cut its forecast for hikes in 2019 from three to two and lowered its estimate of the terminal rate from 3.0% to 2.8% (currently the fed funds rate is at 2.4%).

The Fed Policy Cycle



* DATA FROM JANUARY 1970 - OCTOBER 2017. SOURCE: MSCI INC (SEE COPYRIGHT DECALRATION).
** DATA FROM JUNE 1983 - OCTOBER 2017. SOURCE: BLOOMBERG BARCLAYS.
*** DATA FROM JANUARY 1976 - OCTOBER 2017. SOURCE: BLOOMBERG BARCLAYS.
NOTE: POLICY IS DEFINED AS TIGHT WHEN REAL FFR IS ABOVE NEUTRAL RATE.

This implies that it will take approximately two more 25 basis point rate hikes before the Fed gets rates back to neutral. As we have often shown, higher risk assets tend to outperform lower risk assets until monetary policy is restrictive. The neutral rate is an academic notion and we admit that it is not a pure science.

Ultimately, it is the level of borrowing rates and availability of credit that determines whether policy is becoming restrictive. On this front, the Fed is still somewhat accommodative based on another indicator: interest rates remain well below nominal GDP growth in the U.S. and all the major economies.

Equities

While it's extremely difficult to forecast one-year returns with any level of accuracy, select developed market equities should benefit in 2019 from slowing but still positive economic and per-share earnings growth and robust U.S. share buybacks.

U.S. equity valuations at the broad index level look fully priced and elevated relative to history even after the recent pull-back. With the business cycle looking long in the tooth, these rich valuations could be a headwind given expectations for further Fed tightening and higher interest rates. Valuations in most other markets are much more reasonable, but ongoing political risks in Europe and trade tensions with the United States could continue to weigh on developed markets outside the U.S.

Despite known headwinds, the outlook for developed markets equities heading into 2019 appears moderately constructive overall. Absent unforeseen developments that affect global equity risk premiums, developed markets equities could generate positive low- to mid-single-digit total returns in 2019 based on expectations for stable dividend yields and slowing, but still respectable earnings growth.

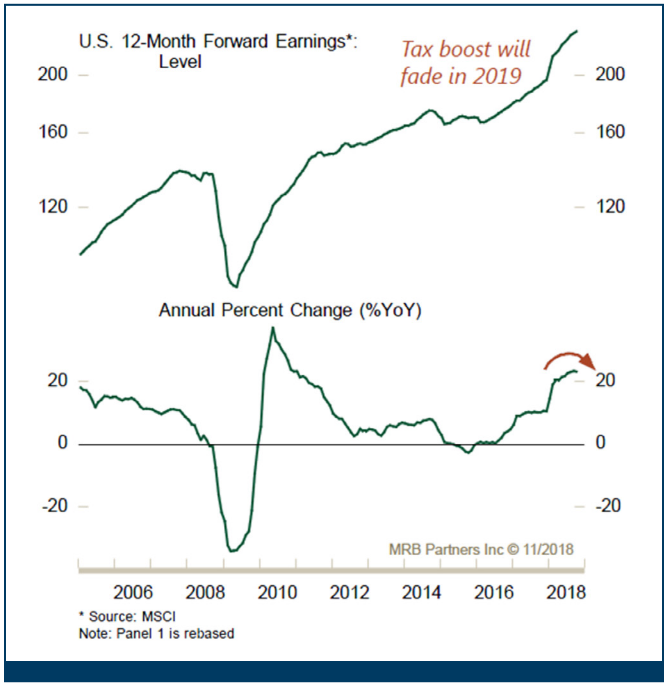
As a base line scenario, we see profit growth in the U.S. market, which comprises more than half of the global equity market, falling off to roughly 4%-8% in 2019 from an eight-year high of 21% in 2018. The one-off boost from corporate tax cuts will not be repeated, and tariffs will begin to have a negative impact.

However, the opportunity set in the equity world looks very different for active managers who are willing to take positions that are significantly different than the broad indices. At this level, we and our external managers still see select opportunities in individual companies globally and are actually quite enthusiastic. Consequently, we do think that the best active managers have an important role going forward and it is now more important than ever to understand what one owns in-depth.

Further, investors who are trading securities for reasons other than a fundamental view of a company's prospects now account for around 85% of trading volume according to a recent report from JP Morgan. This produces short-term volatility but long-term opportunity for skilled investors who focus on the fundamentals.

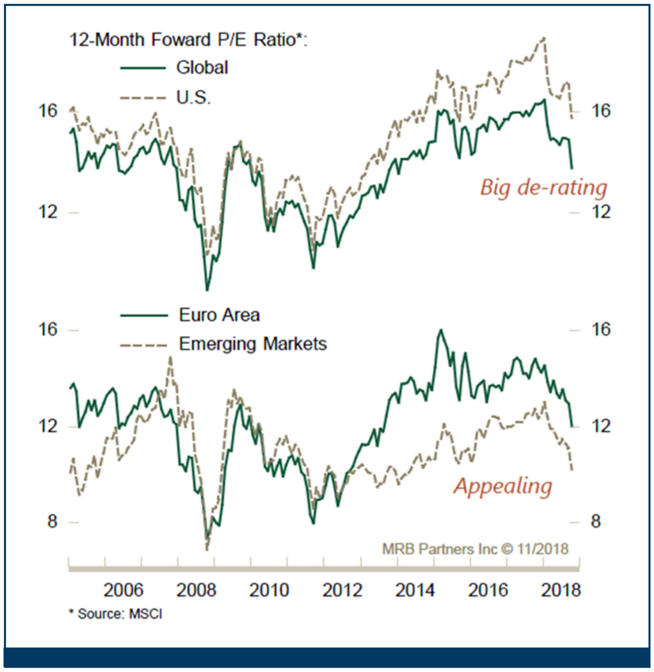
Equity investors should brace for volatility but stay invested. Politics, monetary policy, and incoming economic data will all contribute to higher volatility, but we don't expect a recession, and see global valuations outside the U.S. at a discount to historical averages.

U.S. Earnings Are Slowing, Not Peaking



Valuations are decent again: the forward price-to-earnings for the MSCI All Country World Index (ACWI) is now back to the range it traded at in 2013. The 12-month forward price-to-earnings ratio of around 14x for global equities represents a 10% discount to the three-decade average.

Equity Valuations Are More Appealing



We favor global diversification within equity holdings, which should also help mitigate volatility. No single region offers a uniquely compelling case and there are select opportunities in all regions. The U.S. economy remains strong, but with a price-to- earnings ratio of around 16x, valuations are 15% higher than the global average. Euro-zone and emerging market (EM) stocks have lower valuations, but both regions are more exposed to China's slowdown and other headwinds.

While the U.S. is not immune to developments beyond its borders, the country is better positioned to weather future storms than virtually any other. The U.S. is also sufficiently resilient to absorb uncertainty created from within. The U.S. remains preeminent, and its institutions are stronger than any one president or administration.

Furthermore, we do not believe that the relative cheapness of other developed and emerging market equities is sufficient to prompt a tactical shift but we are looking to add to emerging market companies later this year.

Fixed Income

We expect to stay slightly underweight duration overall, anticipating fairly range bound markets but with the potential for yields to move higher. Even at very low interest rates, we believe bonds can still provide protection to portfolios in the event of a sharp equity decline as they did in the fourth quarter of 2018.

As a result of our view, we like shorter-term dated fixed income including U.S. corporate bonds, U.S. treasuries and securitized fixed income which are offering more attractive yields. Clients should manage their cash holdings more proactively given better interest rates on offer.

Credit spreads have risen despite falling leverage and improving fundamentals, boosting the likelihood of higher returns. We do not expect a crack in the credit cycle but are concerned that 50% of the investment grade fixed income market is now at the lowest level of BBB. We would expect a number of these BBB rated securities to become high yield bonds over the next couple of years.

In U.S. high yield for 2019, we still see opportunity to receive a high level of coupon income but do not expect much in the way of price appreciation. Until we get more visibility on how the Trump trade demands will play out with China and how China counters, the macro risks and how those get discounted into credit will remain.

Alternatives

In order to focus on capital preservation, Clarien will be maintaining its allocation to select funds of absolute return strategies.

Despite recent poor performance, we are still of the opinion hedge funds will provide effective portfolio diversification, and returns continue to compare favorably with other assets in a strategic allocation looking forward. Select hedge funds have outperformed the broad equity and fixed income indices in 2018. Given the need to meet competing objectives of generating returns and reducing risk, we believe that multi-strategy funds remain an important component of the total portfolio in the right size.

Summary of Major Investment Themes for the next six to twelve months

- We've entered a more challenging investment environment - geopolitical uncertainty, tighter monetary policy, and a maturing global economic cycle are contributing to more turbulent markets.
- As markets grow more uncertain, ensuring you have a disciplined plan in place to meet financial goals becomes even more important. From our perspective, prospering in this environment will require selectivity and diversification.
- Our focus is to separate fundamental investment information from the noise in the news as best we can, and to ensure that client portfolios are positioned appropriately.
- In 2019, we expect continued volatility: economic growth is slowing globally (most critically in China and in the U.S.), central banks are tightening policy, and numerous political risks all pose challenges.
- However, fundamental indicators around consumption, investment, and employment are not warning of recession. We are not going underweight equities since global economic growth remains, and corporate earnings will continue to grow though at a slower pace.
- Further, equity valuations have improved in most regions after the sharp decrease in equity markets and earnings growth expectations are not as ambitious as previously expected by analysts. We favor global diversification within equity holdings, which should also help mitigate volatility.
- We are of the view that while we are late in the cycle and while the Fed is tightening, financial conditions are not yet sufficient to cause a material economic contraction (such as a recession) over the next six to twelve months.
- Fiscal stimulus in the form of tax cuts and increased spending has extended this economic cycle even further in our view but is fading. However, this could be reinvigorated if an infrastructure package is passed in the U.S.

- Our active managers are still finding select opportunities. While our view on individual opportunities is slightly positive, this does not mean the coming year will be easy for investors.
- Within fixed income, we prefer shorter dated fixed income and this positioning provides flexibility and allows investors to respond to specific opportunities or higher volatility.
- We continue to like U.S. treasuries as a hedge against unknown risks and a possible recession over the medium term.

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