Second Quarter 2019

General Market Assessment

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Executive Summary

In our 2019 Investment Outlook we emphasized the need to focus on the long-term investment horizon and to not panic during periods of stress in the market. Indeed, the December equity sell-off and subsequent strong market rally has showed investors why it pays not to panic.

In our view, investors should not be making major changes in portfolios at this stage, and should stay invested. Historically investors have not been rewarded for being to defensive if they didn't have a high conviction that a recession would be coming in the next 6 to 12 months. We are of the view, that while the economy is late in the economic cycle, financial conditions are not yet sufficient to cause a recession. The good news is that the economy can be late in the cycle for a long time.

The single largest major change in capital markets so far in 2019 was that the Federal Reserve added additional economic insurance through easing future monetary policy and becoming more dovish. Further, other major central banks have also abandoned any tightening steps, leaving overall global monetary conditions supportive of the economy which should continue to be a tailwind for risk assets.

U.S. economic growth is showing resilience, and we are observing the first "green shoots" of an economic pickup in growth outside the U.S. One example of a "green shoot" is the increase in Chinese manufacturing in March. The economic direction of China continues to play a key role in defining the global macroeconomic picture and we are monitoring Chinese economic indicators closely as the message is currently mixed.

Overall, we remain constructive about the global economic outlook and are cautiously optimistic toward select equities and credit over the next 6 to 12 months. However, investors should expect only modest multi-asset portfolio returns over the next 6 to 12 months with plenty of bumps in the road.

We think the potential upside to equities is a fraction of what we have experienced recently. Equities require a catalyst to move higher such as a positive surprise in earnings, or a U.S.-China trade deal, and in the short-term a pull-back is to be expected. The sailing will not be smooth for equities.

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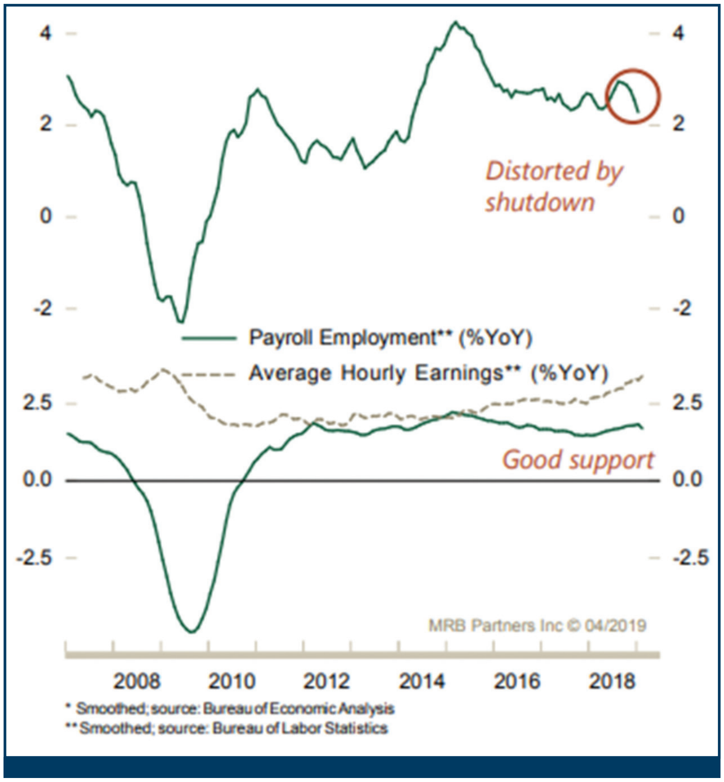
Largely fueled by more accommodative support by global central banks, the first quarter produced the strongest returns for a balanced portfolio since early-2010 as both global equities and bonds rallied. The returns have certainly surpassed our expectations at the beginning of the year. However, similar to when we counselled to stay invested and not panic in December, we now counsel to not get overly excited with the markets' recent positive gains.

Until a number of uncertainties are cleared up (trade, Brexit, earnings) we do not advocate increasing risk in portfolios at this time. Against this uncertain backdrop we recommend only a moderately risk-on allocation. Investors can be assured that their portfolios are in good shape in case worse scenarios materialize through Clarien's care, risk management, and diversification.

Global Economy

While U.S. growth has slowed recently, it remains more robust than in the cyclical economies of Europe and the emerging markets. U.S. growth seems to be stabilizing at a decent level after signs of weakness late last year caused by tighter financial conditions, a slowdown elsewhere in the world, and the six-week government shutdown.

U.S.: Real Consumer Spending* (%YoY)



In the U.S., the consumer will remain solid financially. This strength comes from a buoyant job market, accelerating wages and positive consumer confidence. Further, the manufacturing and services sector indicators are still healthy and capital expenditure remains solid. Most notably, interest-rate sensitive areas of the economy that were under pressure last year, especially housing, are showing signs of stabilizing.

As can be seen in the chart here earnings growth momentum closely correlates with manufacturing activity as represented by the U.S. manufacturing index.

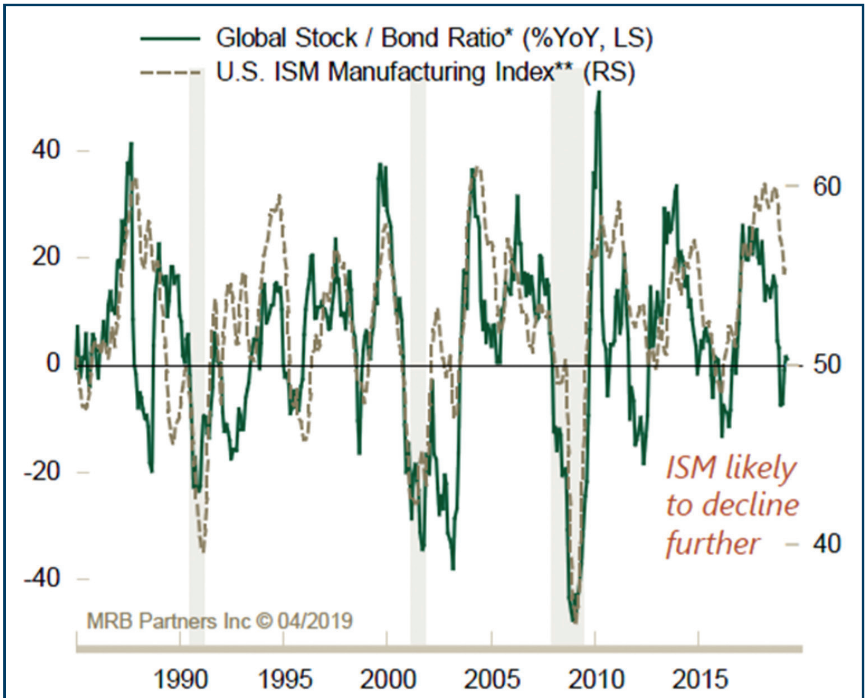
Global Growth Momentum is Slowing, But Recession Unlikely

The European economy continues to slow, driven by weak exports to emerging markets, troubles in the banking sector, and political uncertainty. European manufacturing remains a weak spot within the economy, but the regional service sector is expanding at a healthy pace and businesses in Germany are confident that overall conditions are set to improve.

The economic strength of China continues to play a key role in defining the global macroeconomic picture. We are monitoring Chinese economic indicators closely as the data and message is currently mixed.

The Chinese government's deleveraging efforts has dragged down confidence and investment around the world and particularly in emerging economies. However, we are beginning to see "green shoots" in the Chinese economy as fiscal stimulus has been increased and the government has slowed the deleveraging of debt which had previously dampened capital spending.

"Green shoots" such as an increase in Chinese manufacturing in March show recent signs that the U.S. and China are making progress on trade talks adds to the constructive outlook. However, domestic demand in China remains weak as the consumer is cautious and the housing market is subdued. If the Chinese economy further stabilizes, we will see a buying opportunity in European and emerging market equities going forward.



* Global MSCI stock market total return index divided by G7 10-year government bond total return index; sources: MSCI and Bloomberg
** Source: Institute For Supply Management
Note: Shaded for NBER-designated recessions

Equities

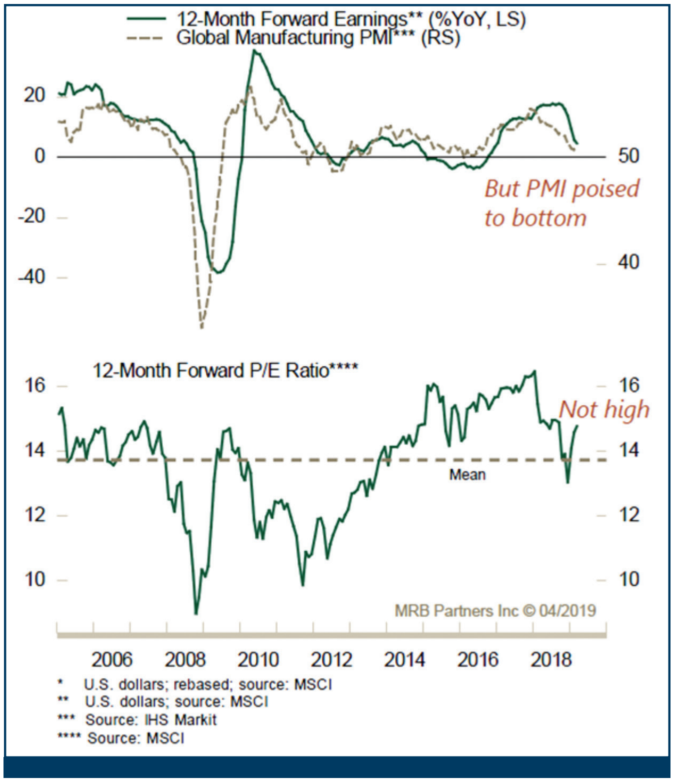
The rebound in global equities since the December sell-off has been driven completely by higher valuations and not earnings growth. In fact, earnings growth expectations have been revised downward. As a base case scenario equities should continue to benefit from improving global growth expectations going forward and the overall level of earnings is not yet peaking.

Global equity valuations are not at extremely high levels. The global 12-month forward P/E ratio (Price-to-earnings) is only modestly above the lows during the 2015-2016 growth and deflation scare, so the ratio is not elevated. The P/E ratio is slightly above the post-2005 average (i.e. after the bubble-year valuations were unwound) but is undemanding if the economic expansion is sustained.

U.S. Earnings Are Slowing, Not Peaking

We favor global diversification within equity holdings, which should help mitigate volatility. No single region offers a uniquely compelling case in terms of offering superior risk-adjusted returns and there are select opportunities in all regions.

We do not believe that the relative cheapness of other developed and emerging market equities is sufficient to prompt a tactical shift, however we are looking to add to emerging market equities later this year if China and the global economic slowdown stabilizes.



Fixed Income

We plan to stay slightly underweight duration overall, anticipating fairly range bound markets but with the potential for yields to move higher if global economic conditions improve as we expect. 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.

Economic growth should remain broadly supportive of interest rate spread products such as corporate bonds, enabling corporate bonds to outperform similar-duration government bonds. However, absolute returns will be unimpressive going forward.

However, with the U.S. 10-year Treasury yielding 2.5%, a modest 30 basis points rise in the yield over the next year will generate a negative total return. German Bunds are at risk of a significant capital loss if the German and Euro area economies firm, which is our base-case scenario.

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 than they have in years due to a combination of Fed rate hikes, accompanied by wider Libor and credit spreads. Clients should manage their cash holdings more proactively given better interest rates on offer.

Within the U.S. high yield asset class for 2019, we still see opportunities in coupon income and the ability to find cheap relative values by sector, though 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 they get discounted into credit will remain.

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

- Overall, Clarien's Economic Outlook remains constructive and we are cautiously optimistic toward select equities and credit over the next 6 to 12 months.
- The Fed added additional economic insurance thereby reducing the probability of a recession through easing monetary policy and becoming more dovish.
- U.S. economic growth is showing resilience, and we see the first "green shoots" of a cyclical pickup in growth outside the U.S. One example is the increase in Chinese manufacturing in March which is encouraging.
- Fundamental indicators regarding consumption, investment, and employment are not warning of recession.
- We are not going underweight equities in our model portfolio since global economic growth remains, and corporate earnings will continue to grow though at a slower pace.
- We are of the view that while the economy is late in the economic cycle, financial conditions are not yet sufficient to cause a material economic contraction (such as a recession).
- Investors should stay invested. Historically, it doesn't pay to get too defensive if investors don't have a high conviction that a recession is coming in the next six months.
- Investors should expect only modest multi-asset portfolio returns over the next 6-12 months with plenty of bumps in the road. We think the upside to equity price appreciation is a fraction of what we have experienced recently.
- Equities require a catalyst to move higher such as a positive surprise in earnings, or a U.S.-China trade deal and in the short-term a pull-back is to be expected. The sailing will not be smooth for equities.
- The economic direction of China continues to play a key role in defining the global macroeconomic picture and we are monitoring Chinese economic indicators closely as the message is currently mixed.
- Our active managers are still finding decent select investment opportunities. While our view on select investment opportunities is slightly positive, this does not mean the coming year will be easy for investors.

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