CLARIEN

Clarien Wealth Management
2020 Outlook

Executive Summary

What a difference a year makes. 2019 was a reminder that markets often produce strong returns even when they're climbing the wall of worry. The economic backdrop has been volatile and there is little reason to expect this to change in the coming year as we enter the later stages of the economic cycle.

In the year ahead, we will continue to face key questions and uncertainty around political outcomes such as, US-China trade negotiations, central bank policy and how these factors impact the cash flows of companies and the value of assets.

At Clarien Wealth Management, we respond to this uncertainty by staying focused on our clients and how we can help them navigate the challenges they face to meet their goals. **In a time characterized by uncertainty, sound advice is of paramount importance**.

From our perspective, prospering in this challenging investment environment will require **selectivity, diversification, as well as a clear financial plan**.

We remain focused on what we know we can control. At Clarien, this means investing for the long term, remaining disciplined and balanced, working with great partners, and deriving all we can from our growing global group platform with NCB and Portland to help drive value creation regardless of higher market volatility or what's going on politically.

Our portfolio positioning has helped our clients to achieve desirable returns in 2019 and over the past three and five-year periods. We believe our investment framework and active management philosophy was the foundation for these successes and we continue to believe it is the key to responsibly investing our clients' assets.

This abnormally stellar performance across asset classes is unlikely to be repeated in 2020, given the elevated starting point of many financial asset prices but a focus on **selectivity** will be crucial in order to generate positive returns.

Diversification remains central in 2020. As a result, we seek to balance allocations in an effort to guard against the risk of a slowdown or political shocks without giving up the potential for participating in a reacceleration of economic activity and earnings.

We are encouraged by improving leading economic indicators and receding downside risks due to easier financial conditions.....

We are **encouraged by improving leading economic indicators and receding downside risks** due to easier financial conditions, central bank support, moderate fiscal stimulus from China and improving trade talks.

In addition, the US housing and labor markets have performed well, and the yield curve is sloping upward again. Historically, the housing market activity has always weakened going into a recession. Its current upcycle suggests that a US recession remains unlikely over the next 12 months.

However, while we continue to expect a mildly constructive global economic backdrop in 2020, we do not see a major economic growth phase. For example, business confidence has declined over the past three months through November, based on uncertainty about trade and global politics. Further, the data confirming the rebound in global manufacturing remains mixed.

The recovery in economic data is still fragile and risks could reemerge, but we believe the data supports our base case to maintain a constructive view of risk assets such as equities and high yield fixed income and **to not de-risk portfolios**.

However, given the standard investment horizon for our tactical outlook is 6-12 months, the backdrop warrants maintaining a **tight leash on risk exposures**. One of our main tools for maintaining carefully prescribed risk limits in portfolios is through rebalancing.

Rebalancing always reduces risk and in volatile markets can increase returns. Further, we continue to recommend a position in cash to provide flexibility tactically and react to excessive market moves.

In this environment, we seek more **reliable** returns across all classes by focusing on quality and yield, and being invested in the strongest areas of the economy such as US consumer spending, services and US housing.

Our base case, as we enter 2020, is for muted equity market performance for the year, but we note the potential for unexpected outcomes associated with political and policy decisions – to both the up and downsides.

While economic conditions are poised to improve modestly in the year ahead, **limited upside for either valuations or earnings imply modest equity price gains in 2020**. The US equity market has already partly discounted better economic activity and corporate earnings growth through the recent rally which combined with ongoing trade policy and US political uncertainty, warrant staying neutral on equities in a global multi-asset portfolio, for now.

With equities, we also recommend including dividends in a late-cycle, low-yield world.

Our preference is an equity portfolio mix that includes growth and select value exposures that look increasingly interesting to us. Within equities, we also recommend including dividends in a late-cycle, low-yield world. Over the long-term dividends compose a significant part of the total return of equities.

We also advise diversifying globally. Despite being comparatively expensive, US relative earnings will remain well supported if the global growth upturn is modest as we expect. A shift in investment from US equities to international equities would require a confirmation in the data of a pick-up in non-US manufacturing and trade and relative earnings strength from non-US companies. This has not been the case over the medium term.

We cannot look at equity valuations in isolation. Investing is about opportunity cost and the macroeconomic context. Thanks to low yields, equity valuations could be worse. In fact, a number of our active equity managers are enthusiastic about future return prospects as the valuation differences between ‘expensive’ and ’cheap’ equities is abnormally wide.

Looking forward, despite low expected returns, investors should continue to own some high-quality government bonds as their diversification benefits remain valuable. Historically, these assets have been one of the best diversifiers during periods of equity market stress and recession.

We think fixed income exposure to US mortgages and the US consumer are appealing and offer a number of potential benefits, including a low default probability and a way to tap into the relatively healthy US consumer. We also favor high yield given our more positive equity view in order to pick-up yield.

Our modest outlook for equities and fixed income levels over the next decade means we continue to explore opportunities in alternative investments and add to our long history at Clarien of investing in alternatives. In particular, we see a role for strategies that are diversifying and/or risk mitigating within the context of investors’ broader traditional portfolios.

Our focus is to separate the fundamentals from the noise in the news as best we can, and to ensure that your portfolio is positioned appropriately for your goals. The market environment can change quickly and we will continue to monitor our key indicators for changes.

As always, we are happy to explore any of the details of our thinking in more depth.

Thank you,

Robert K. Steinhoff, CFA

Head of Investment Strategy

Political Influence

From the US presidential election to trade negotiations and fiscal policy, political decisions will increasingly influence market returns in 2020.

China

The US-China trade conflict has been among the primary drivers of market volatility over the course of the past year. Although there have been signs of reconciliation between China and the US in 4Q19, investors may start to worry that a re-elected President Trump, no longer facing a future election, could become more adversarial with China. He has already warned that a deal negotiated in his second term would be "far worse." Meanwhile, his political rivals' trade rhetoric suggests that a Democratic president would be unlikely to adopt a more conciliatory approach.

In the lead up to the November Presidential election we think President Donald Trump will likely choose the economy (his greatest strength in the polls) over being tough on China, in a bid to support his reelection campaign. For now, President Trump has done enough to minimize the negative impact on the US economy in an election year. But there remains a possibility that the trade war escalates as a risk during 2020. For example, President Trump may very well get more aggressive on trade talks if he started to slip in the polls.

US Election

US politics is one of the key political risks in 2020 but seems to have calmed down for now. In our view, investors should not position in the hope or expectation of a specific outcome to the presidential election. Instead, we think diversification is key.

President Trump's approval ratings have recently picked up slightly. Should a left-wing candidate win the Democratic primaries and build momentum against President Trump, we think the equity market would be vulnerable. Massachusetts Senator Elizabeth Warren has fallen a little in the polls and in more liberal California she is level with Biden and Sanders in opinion polls.

One of the key policy debates is around taxes. Tax reform under the Trump administration lowered corporate taxes from 35% to 21%, helping boost S&P 500 earnings by close to 10%. If President Trump is reelected we would expect current corporate tax rates to remain the same.

Democratic candidates have put forward various proposals to increase corporate taxes. Debates on this topic could increase volatility in the run-up to the election, but raising taxes would require congressional approval, and passing such a tax hike would only be likely if Democrats secure the White House and a large majority in Congress.

Global Economy

As we look forward to 2020, we are slightly encouraged by improving leading economic indicators and receding downside risks due to easier financial conditions, central bank support, moderate fiscal stimulus from China and improving trade talks.

We focus our attention on indicators that we think lead the Purchasing Managers' Index (PMI) — a measure of economic strength that tends to move together with the equity market. After turning downward for most of 2019, some of the indicators that usually lead the PMI by a few months seem to be bottoming.

Tentative Signs of an Upturn are Emerging

However, overall the data confirming the rebound in manufacturing remains mixed. We will continue to monitor these economic indicators closely.

The US manufacturing economy is stuck in a tug-of-war between easier financial conditions (low interest rates, strong equity markets for example) and the uncertainty of the trade war.

One key driver of economic activity is that global liquidity conditions have eased significantly in 2019. As we already highlighted, the majority of global central banks cutting rates is a positive dynamic for global growth. The markets have reacted positively to these actions.

Further, various growth indicators are sniffing out this positive inflection point in the global economy. For example, the ZEW Indicator of Economic Sentiment, a monthly survey of economists and analysts which assesses the economic conditions of Germany has recently rebounded.

Service Sectors Have Slowed, But Are Still Growing

The service sectors continue to expand across most major economies, although they have slowed noticeably this year. The latest readings across key economies are consistent with our expectation that the global economic expansion will endure through 2020, with momentum picking up modestly compared to recent months.

There is still little sign that the weakness in manufacturing is spilling over into the services and consumption sectors.

Global trade has contracted over the past year, restrained by the US-China trade dispute and slowing domestic demand. Global export orders indicate the worst of the deterioration may have passed, but conditions have not yet turned positive. A muted rebound in trade growth points to a similar outlook for global corporate earnings.

Trade May be Bottoming

In the US, this year's recovery in housing demand has gathered strength in recent months alongside the extended decline in mortgage rates, and is now driving gains in new residential investment, which is poised to add to overall GDP growth for the first time since 2017.

Housing's positive response underscores the overall relative resilience of the US economy, and positive underlying sector fundamentals. Historically, housing market activity has always weakened going into a recession. Its current upcycle suggests that a US recession remains unlikely over the next 12 months.

Emerging markets should benefit from an improving global backdrop and reduced tail risks. In China, targeted stimulus seems to be offsetting the confidence drag from the trade war, and the expansion of the services and consumer side of the economy continues.

We think China's economy will muddle through with some upside potential. While headline data remains weak, underlying data suggests that the cycle has stabilized and a hard landing is not in the cards.

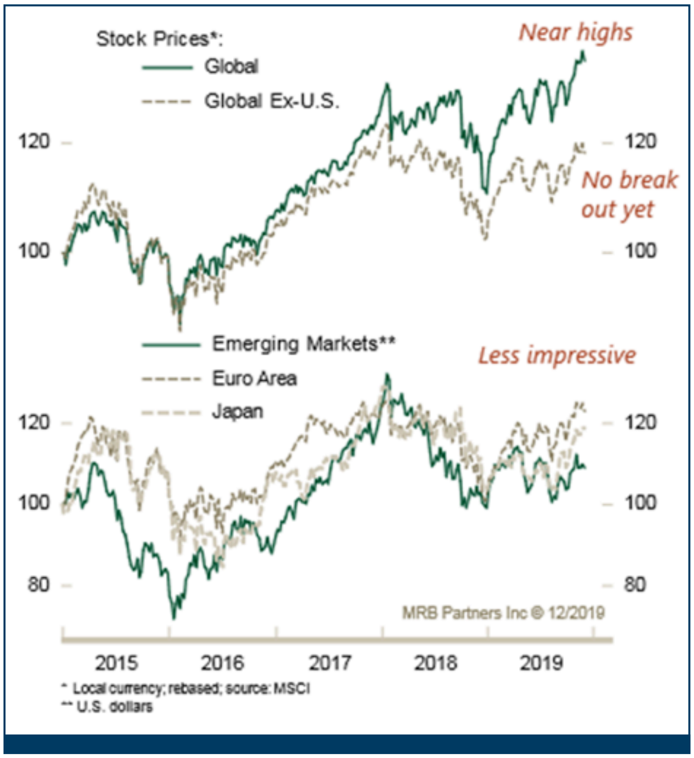
In short, we expect the global economy to gradually reaccelerate next year, but a strong burst of growth is unlikely.

Equities

While economic conditions are poised to improve modestly in the year ahead, **limited upside for either valuations or earnings imply modest equity price gains in 2020**.

While stocks are broadly expensive, bonds are even more so. As a result, if global growth can recover and the US can avoid a recession in 2020 as we expect, earnings will not weaken significantly and stocks should again outperform bonds.

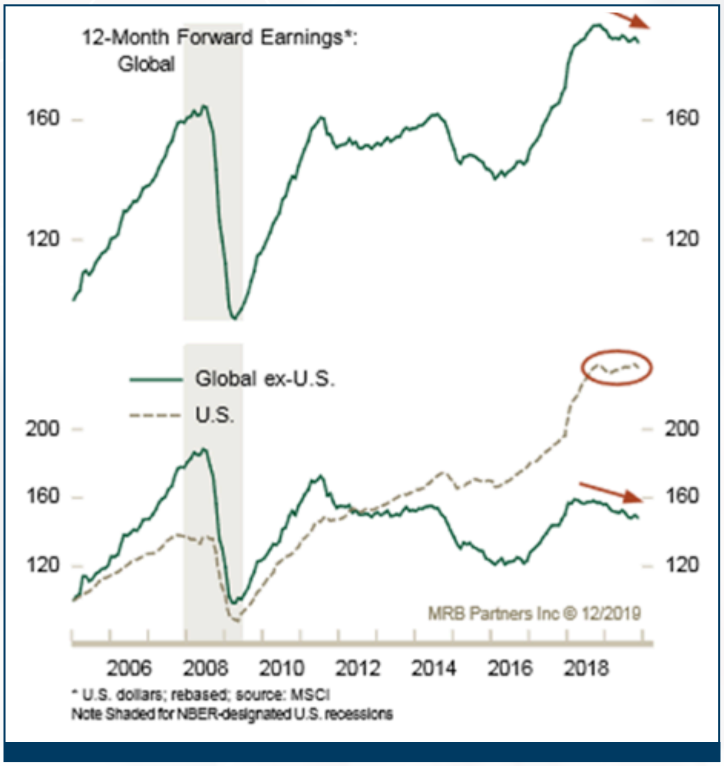
Equity Bull market is US Centric



The performance strength of the global benchmark primarily reflects the robust US index, which has pushed to a series of new highs in recent months. The global ex-US benchmark, by contrast, while rebounding fully from last year's decline, is still below its 2018 high. There are significant divergences across major non-US markets, but most have yet to break out to new highs.

There are structural reasons for why US companies have done so well since 2010: Their return on equity—a measure of how efficient they are at generating profitable investments—has improved, widening the gap relative to firms in Europe, where the return on equity has fallen relative to before the crisis. This suggests that US companies operate in lines of business with more growth potential. A larger part of this has been the rise of the technology sector in the US.

No Sign Yet of an Earnings Turn



Global earnings (shown in US dollars) are still trending lower, primarily because of weakness in the global ex US group.

Indeed, our current neutral stance on equities is consistent with our mildly positive base-case scenario especially given the advanced stage of the investment cycle.

Our neutral stance includes our core holding in US equities in a global equity portfolio. After a brief pullback, US stocks recently resumed outperforming the global ex-US benchmark in common currency terms, supported by rising relative earnings and return on equity.

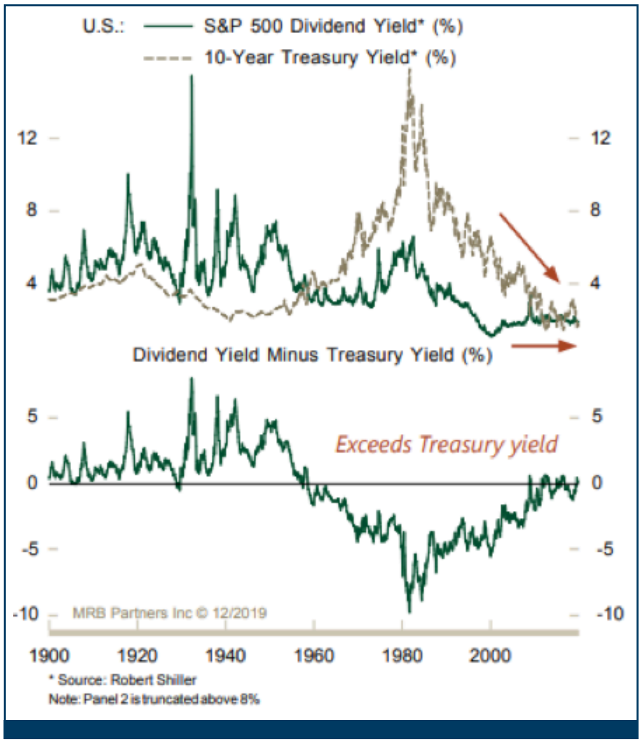
Despite being comparatively expensive, US relative earnings will remain well supported if the global growth upturn is as muted as we expect. Relative tailwinds for our preferred sectors in the technology, health care and financial sectors point toward continued US outperformance.

Europe and Asia are more dependent on trade, and therefore more affected by global economic slowdowns, than the US. A significant and sustained shift in investment flows away from the US awaits a decisive upshift in non-US manufacturing activity and global trade. Currently, we foresee a mild shift in that direction, rather than robust growth, given the ongoing weakness in global capital expenditure and overall business sector uncertainty.

Emerging market equities are more closely linked to China and commodities prices, which are not yet sending strong positive signals. We worry about the excess of debt in emerging markets which remains a structural headwind. However, we remain optimistic about very select exposures in emerging markets and their long-term potential.

Earnings Will Drive Equity Performance

US Dividends are Comparatively Appealing



The combination of rising equity prices and declining earnings has pushed 12-month forward P/E ratios higher. The latter is most notable for the US, where the forward P/E ratio is 18.5x and only marginally below the cyclical peak in early-2018.

The global ex-US forward P/E ratio has also climbed toward the higher end of its 15-year range although it is not high in absolute terms, nor versus the level of bond yields.

Also, since equity multiples have already increased materially (especially within the US market) any further upside will be reliant on stronger actual earnings. Our estimates for earnings growth show an improvement but are more modest than current forward estimates by analysts. In turn, we recommend a mild pro-growth bias, with selective beta bets outside of the US and with some offsets in more defensive equities.

Dividends will account for a significant share of equity total returns in the next year given we expect only modest global earnings growth and limited sustainable upside for P/E ratios. Dividend yields will be appealing relative to low government bond yields in even a sluggish global growth environment. However, the true value of dividends is in their long-term contribution to equity returns, especially if re-invested.

Fixed Income

2019 was a strong year for fixed income returns across the asset class. The dovish pivot by the Fed and another pre-emptive round of reflation from many other central banks drove returns both traditional “safe-havens” and riskier segments of the fixed income market.

Looking forward, high-quality government bonds have limited long-term return prospects, with global yields now back to near record lows.

Fixed income will still play an important diversifying role in portfolios in 2020 but we advise against taking meaningful positions in markets where rates have turned deeply negative. The initial yield on high-quality government bonds is a reliable indicator of future returns over longer investment horizons, but changes in yields drive returns over shorter periods.

Due to our macroeconomic backdrop and the very real possibility of risks, investors should continue to own some high-quality government bonds as their diversification benefits remain valuable. Historically, these assets have been one of the best diversifiers during periods of equity market stress. High-quality global government bonds and US Treasuries should still prove to be an effective portfolio hedge in the event of a recession, despite their low initial yields.

US residential mortgage–backed bonds offer healthy underlying fundamentals, and a way to tap into the relatively healthy US consumer. Spreads are on the tight side now, but given the likelihood of range bound global interest rates, strong demand from overseas, and our base case of no recession over the next 12 months, we think defaults will stay low.

Security selection will become even more important within fixed income as we progress into the later stages of this expansion.

Alternatives

The conservative outlook for many public assets over the next decade will push investors to continue exploring private opportunities, where barriers to entry are higher and more targeted themes can be explored. At Clarien, we are also adding to our long history in alternatives to increase risk-adjusted returns.

In our view, there are several reasons to believe volatility will persist in the period ahead. These reasons include potentially elevated equity valuations, market structure changes, the long-term withdrawal of central bank quantitative easing, and continued geopolitical uncertainty. As we think long-term volatility is likely to continue rising, we believe the opportunity set is increasingly attractive for alternatives strategies.

We believe alternatives are well suited to such an uncertain market given its ability to create value through security selection and tactical changes to their net and gross exposures. In particular, we see a role for strategies that are diversifying and/or risk mitigating within the context of investors' broader traditional portfolios.

CLARIEN

Clarien Bank Limited

Principal Offices and Subsidiaries

Registered Office
25 Reid Street
Hamilton HM 11
Bermuda

Main Branch
19 Reid Street
Hamilton HM 11

Paget Plaza
161 South Road
Paget DV04

Clarien Investments Limited
25 Reid Street
Hamilton HM 11

Clarien Trust Limited
25 Reid Street
Hamilton HM 11

Tel + 441.296.6969 | Fax + 441.294.3165 | www.clarienbank.com