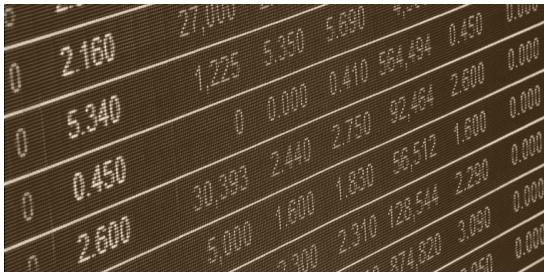
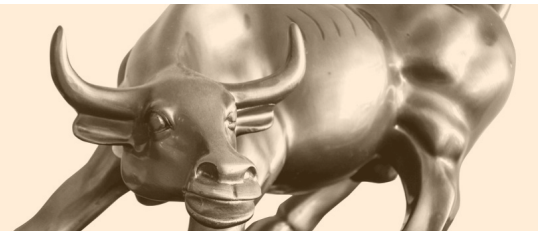
MARKET COMMENTARY

THIRD QUARTER 2018





After nine years in the current economic expansion—the second longest on record, according to the National Bureau of Economic Research—many investors have begun to question whether this upward trajectory can continue. Perhaps at the expense of key trading partners, domestic economic conditions further strengthened during the third quarter and likely supported recent increases in inflation, with incrementally tighter Federal Reserve (Fed) policy serving as a partial counterbalance. Abroad, growing trade war concerns, geopolitical tensions, and a seemingly synchronized return to monetary normality helped drive an increase in volatility, particularly among emerging and frontier market economies.

F·E·G®
investment advisors

A strong tailwind behind domestic macroeconomic fundamentals supported healthy returns across domestic equities, including the strongest quarterly total return for the Russell 1000 Index since fourth quarter 2013. Conversely, international developed and emerging market equities struggled amid an increasingly tenuous global trade backdrop, incrementally tighter Fed policy, and rising U.S. interest rates.

The robust U.S. economy and increasing cost pressures helped drive a broad-based increase in Treasury interest rates, leading to price declines across the higher quality segments of the fixed income market and supporting returns among credit-sensitive areas, such as high yield and bank loans.

In real assets, energy infrastructure posted solid total returns for the second consecutive quarter, with increasing energy prices, elevated domestic crude oil production, and renewed positive investor sentiment underpinning the recent run of impressive returns. REIT returns, however, were essentially flat for the quarter, as modestly positive momentum began to fade in the end of the quarter amid an increase in Treasury rates.

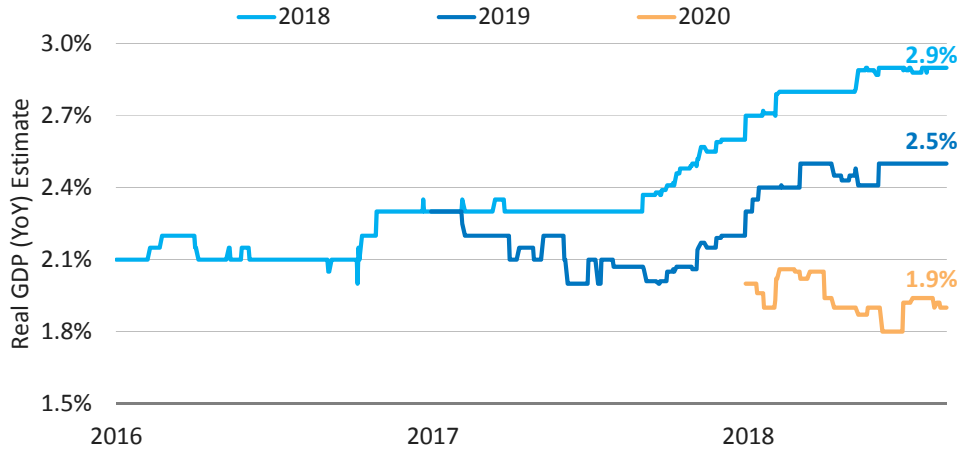
Economic Overview

U.S. ECONOMY: AS GOOD AS IT GETS?

The U.S. economy remained strong and witnessed broad-based improvement throughout the third quarter. Notably, inflation accelerated to a six-year high, the U-3 unemployment rate hit its lowest level since 1969, and both consumer and small business confidence advanced to multi-decade high levels.

With the current business cycle expansion now the second longest since the mid-19th century and many key domestic economic fundamental indicators at or near post-Global Financial Crisis (GFC) highs, asset allocators are likely asking themselves, "Is this as good as it gets?" Most Wall Street economists are skeptical that this pronounced upward momentum will continue, with consensus estimates forecasting the U.S. economy will grow at an inflation-adjusted rate of 2.9% in 2018 before moderating to a 2.5% annualized pace in 2019 and a sub-2% rate in 2020.

U.S. REAL GDP BLOOMBERG CONSENSUS ESTIMATES

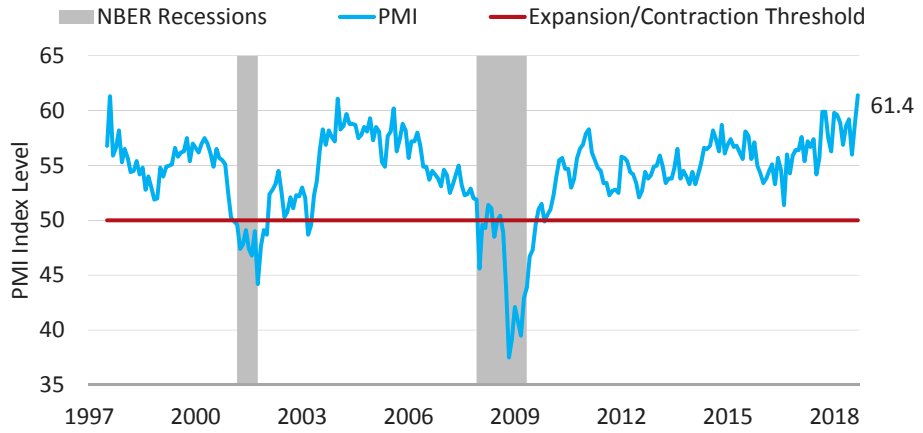


Data source: Bloomberg, L.P. Data as of 9/28/2018. Note: Bloomberg median consensus estimate shown

Like meteorologists, economists have a notoriously poor forecasting track record; however, the pessimistic outlook for near-term growth potential displayed by sell-side economists appears to accurately reflect the short-term "sugar high" effects of the late-2017 tax stimulus package, leaving investors guessing as to what a cycle-extending replacement might look like.

While the economy may indeed slow in the coming years, current conditions remain exceptionally favorable. The Institute for Supply Management (ISM) Economy-Weighted Purchasing Manager Index (PMI), for example, ascended to the highest level on record through September, at more than 11 index points above the critical expansion/contraction level. Furthermore, both the services and manufacturing components of the index registered at or near cyclically high levels.

ISM ECONOMY-WEIGHTED PURCHASING MANAGER INDEX

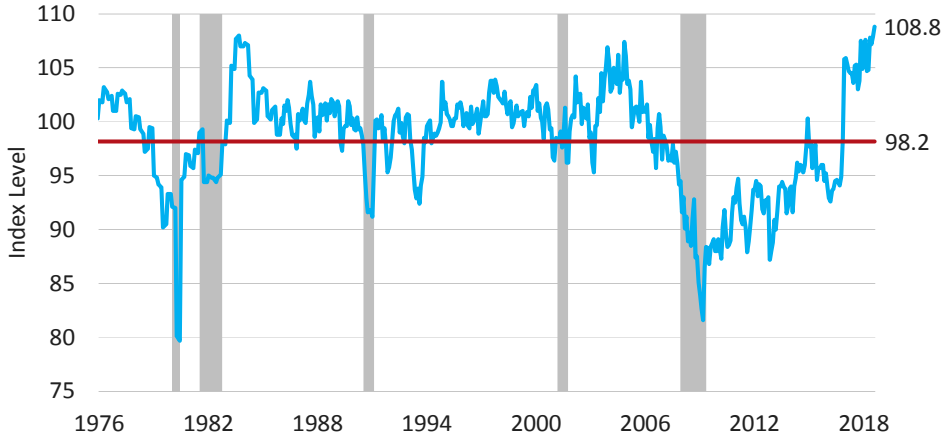


Data sources: ISM, NBER, Bloomberg, L.P. Data as of September 2018.

Not only are purchasing and supply executives upbeat regarding the current state of affairs in the U.S., so are consumers and small business owners. On the consumer front, the Conference Board's Consumer Confidence Index spiked to 138.4 in September, reflecting the highest consumer sentiment since September 2000 and placing the index level in the 95th percentile of all historical observations dating back to 1978.

Small business owners are similarly optimistic, thanks in large part to tax reform, deregulation, and generally solid economic conditions. In fact, the National Federation of Independent Business (NFIB) reported the strongest optimism level for small businesses on record through August.

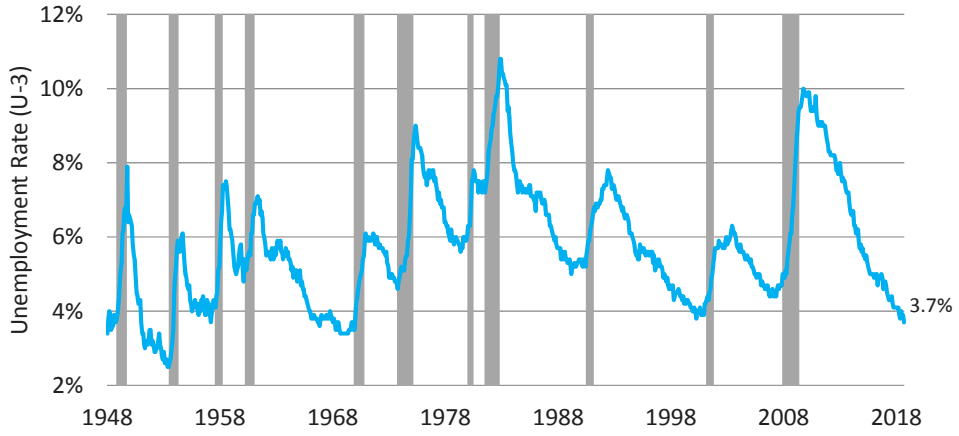
NFIB SMALL BUSINESS OPTIMISM & CYCLES



Data sources: NFIB, NBER, Bloomberg, L.P. Data as of August 2018. Shaded areas represent NBER defined recessions

A robust labor market has underpinned the escalation in confidence levels, which have gathered even more steam in recent quarters. The headline (U-3) unemployment rate improved to 3.7% in September, 40 basis points (bps) lower since the beginning of the year and the lowest rate since December 1969.

U.S. UNEMPLOYMENT RATE & BUSINESS CYCLES



Data sources: BLS, NBER, Bloomberg, L.P. Data as of September 2018. Shaded areas represent NBER-defined recession periods

Of course, stubbornly low participation levels have skewed the unemployment rate in recent years, leaving a sizable number of potential labor force participants unaccounted for. It is difficult to ignore the tailwinds behind the breadth of labor market variables, however, and these positive economic characteristics reflect an economy still in the midst of an uptrend.

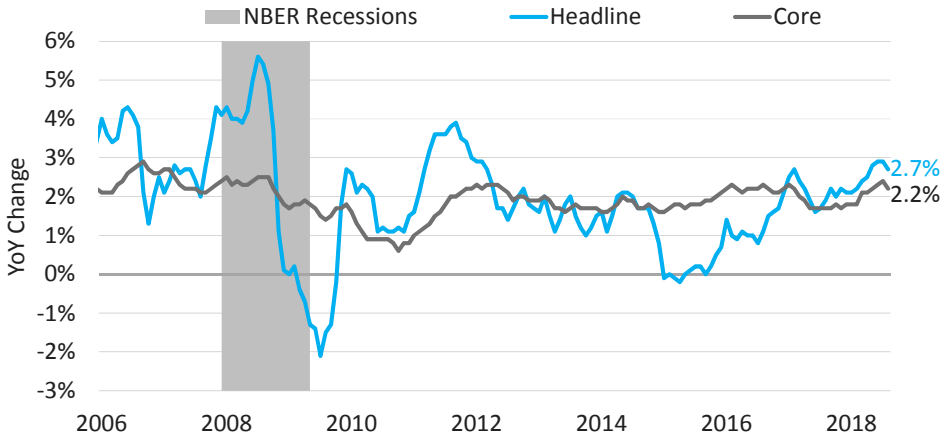
The aforementioned fundamental developments are just a few of the many macro factors that exemplify the robust domestic economic landscape. While the continuing improvement of the economy is encouraging, these signs also lead to the inevitable question, "Is this as good as it gets for the U.S. economy?"

INFLATION (FINALLY) MAKING AN APPEARANCE

Intuitively, economic expansions in their latter stages tend to exhibit a pro-inflationary bias, as rising resource utilization, growing resource constraints, tight labor market conditions, and generally elevated confidence levels help spur wage pressures and consumption growth, all else equal. The U.S. economy currently finds itself in this stage, with fiscal stimulus via tax reform serving as a force multiplier behind classic late-cycle, pro-inflationary forces.

During the quarter, headline Consumer Price Index (CPI) inflation accelerated to 2.9% year-over-year (YoY) in July, before moderating to a 2.7% annualized pace through August. The 2.9% July pace represented the strongest headline inflation rate since late 2011. Core CPI (which excludes the volatile food and energy components) accelerated to 2.4% through July—the strongest inflation rate since September 2008—and settled to a 2.2% annualized pace through August.

U.S. CONSUMER PRICE INDICES (YOY) & CYCLES



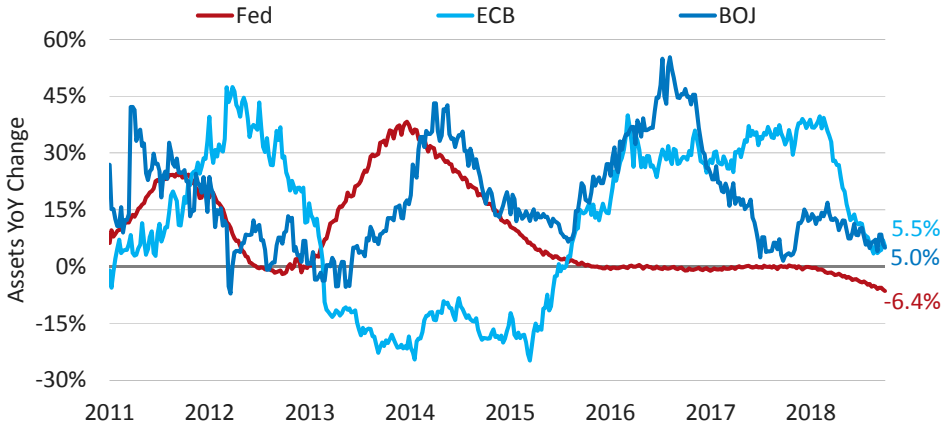
Data sources: BLS, NBER, Bloomberg, L.P. Data as of August 2018.

The revival of realized inflation since 2015, some of which can be attributed to rebounding energy prices, bolsters the case for a return to more "normal" Fed monetary policy; however, this is not without latent negative consequences. Higher inflation rates have helped apply upward pressure to nominal interest rates, in turn potentially reversing the over 30-year downward trend. The implications of such a change are unsettling to ponder given the explosive growth in debt levels throughout this period. The rise in interest rates, particularly real rates, may also serve as a headwind to future discounted corporate cash flows, pressuring already-elevated valuation multiples.

GLOBAL CENTRAL BANK SYNCHRONIZATION

For the first time in the post-GFC era, the Fed, European Central Bank (ECB), and Bank of Japan (BOJ) are each managing a slowdown in their respective balance sheet growth rates. Previously, when one central bank moderated the pace of "flow" of its balance sheet, global investors sought comfort that another major central bank would fill the incremental liquidity void; however, that is no longer the case. Such central bank synchronization creates uncertainty around the movement of exchange rates, interest rates, and asset valuations.

BALANCE SHEET GROWTH RATES

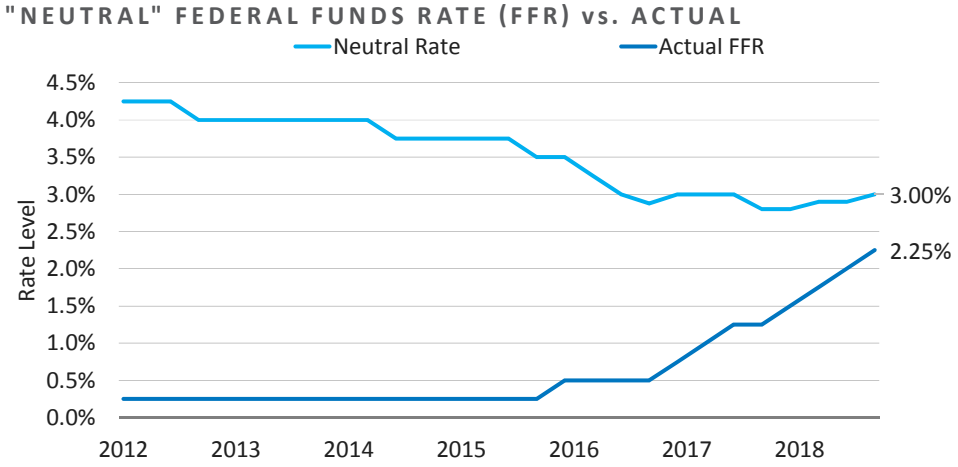


Data sources: Fed, ECB, BOJ, Bloomberg, L.P. Data as of 10/03/2018

The Fed rounded out the third quarter with a 25 bps hike to the federal funds rate (FFR), the third hike of 2018 and the eighth increase to this key policy rate since the Fed began its tightening campaign in December 2015. Through a combination of interest rate hikes and a partial wind down of their balance sheet of more than $4 trillion, the Fed appears committed to removing policy support at a measured pace in order to moderate the hastening pace of economic activity, ensure inflation rates do not drift too far from the 2% inflation goal, and build an ample "cushion" for the next downturn.

Despite the Fed's tightening efforts, the policy backdrop continues to remain somewhat accommodative, albeit incrementally less so. The targeted FFR, with a current upper bound of 2.25%, remains below levels deemed "neutral" by the Federal Open Market Committee. This neutral rate—which is, in theory, neither accommodative nor restrictive—sits 75 bps above the current FFR, implying further rate hikes are in order before Fed policy could be characterized as "restrictive."

Rising inflation could prompt the Fed to push through estimated "neutral" policy rate levels, placing an explicit monetary inhibitor over the economy's growth capacity. Given recent trend momentum in labor market dynamics, interest rates, and Fed policy sentiment, the potential for this to gradually materialize appears greater today than at nearly any other point in the current business cycle.



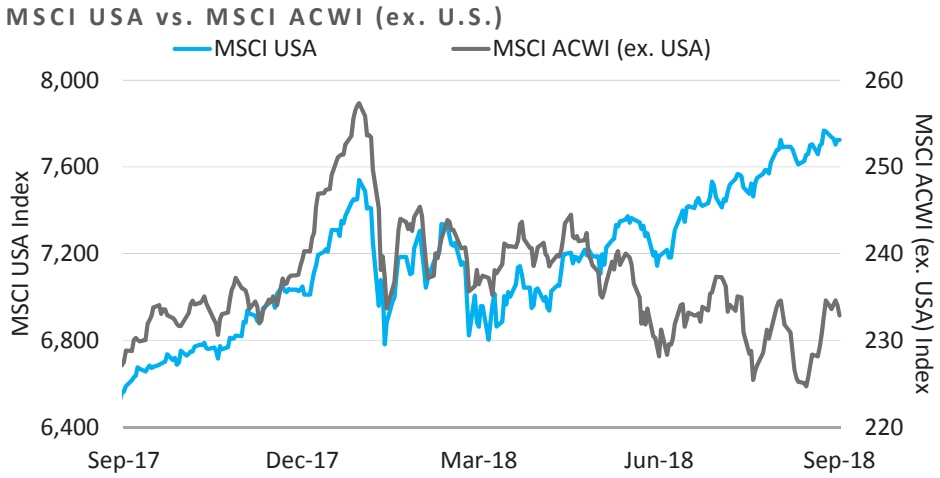
Data sources: Federal Open Market Committee, Bloomberg, L.P. Data as of 9/26/2018. Note: Long-run FOMC median estimates shown for neutral rate.

The U.S. is not the only major developed economy currently experiencing an inflationary renaissance. In the euro zone, an improving labor market is driving wage growth higher, prompting ECB president Mario Draghi to label the inflationary backdrop as "relatively vigorous" during a late-September monetary policy meeting. The recent trend of accelerating cost pressures is expected to support the ECB's plans of concluding its current asset purchase program by year-end, with the first rate hike set to occur in late 2019.

GROWING DIVERGENCE BETWEEN U.S. AND THE REST OF THE WORLD

For an extended period following the GFC, investors rejoiced when incoming macro data disappointed expectations, as weak economic fundamentals often meant increased expectations for looser monetary policy (and vice versa). In a strange twist of events, however, positive economic indicators have once again become good news for risky asset demand. In no marketplace is this more evident than in the U.S.

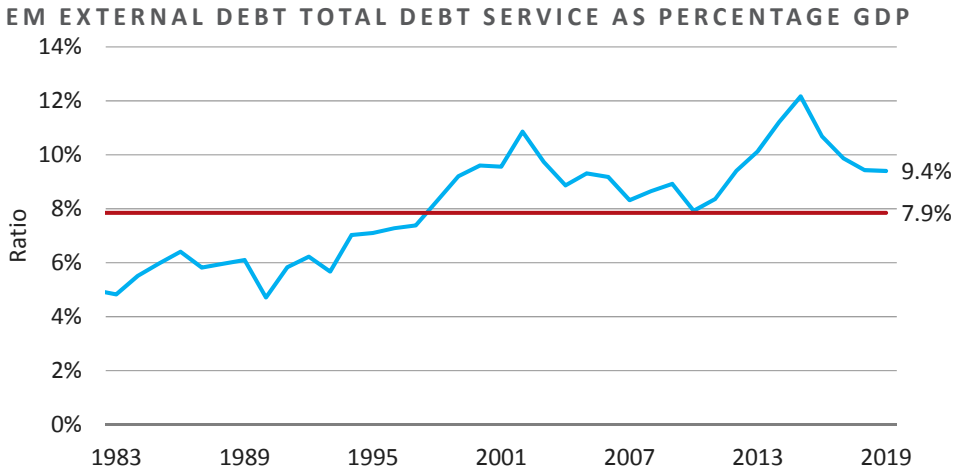
As previously detailed, through the first three quarters of 2018, most domestic economic data releases have reflected a robust fundamental backdrop, whereas pockets of concern have surfaced abroad, particularly within emerging market economies (e.g., Turkey, Argentina, Russia, Venezuela, etc.). As trade war rhetoric began to escalate in June—particularly related to the U.S. and China—the U.S. equity market began to diverge from the rest of the world, leading some to conclude that the U.S. is "winning" the global trade war.



Data sources: MSCI, Bloomberg, L.P. Data as of 9/28/2018. Note: Total return USD Indices used.

Indeed, the spread between U.S. and international equity market returns has widened by more than 13 percentage points and the MSCI USA Index has generated an impressive year-to-date total return of 10.2%, contrasted against the total return loss of 3.1% in U.S. dollar (USD) terms experienced by the MSCI ACWI (ex. USA) Index. Abroad, frontier market economies have borne the brunt of this weakness, though emerging market and, to a lesser extent, international developed economies have experienced their own performance challenges.

Many emerging market economies—particularly those that continue to heavily rely on USD funding for a functioning economy—have struggled in recent quarters amid an appreciating USD, rising U.S. interest rates, and the removal of global central bank liquidity. These factors have increased the cost of capital, resulting in funding pressures and debt sustainability concerns for over-levered economies that cannot depreciate their way out of their respective debt burdens. The International Monetary Fund (IMF) estimates that the cost for emerging market economies to service their debt denominated in external currencies (mainly USD and euro) currently stands at 9.4% of GDP, or 150 bps above long-run average levels.



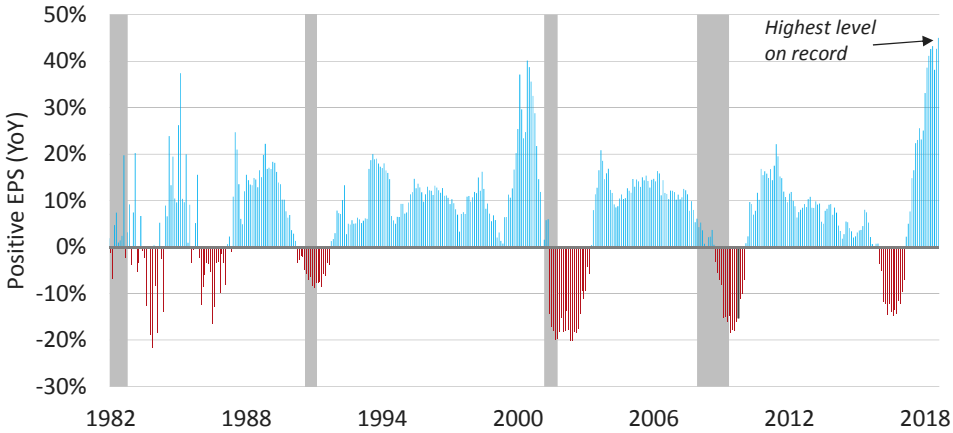
Data sources: IMF, Bloomberg, L.P. Data as of April 2018

Sharp declines in the exchange rate value of emerging market currencies versus the USD have spurred disorderly increases in inflation. In turn, the central banks of several corresponding emerging market economies have scrambled to rapidly tighten policy to prevent the resulting hyperinflation and market contagion, as has been the case in Turkey. Needless to say, elevated currency volatility in either direction presents challenges unique to each emerging market country, the persistence of which could unearth investment opportunities for active managers that thrive in market environments with above-average dispersion.

EQUITY

Many of the primary global equity themes that were present in the second quarter persisted into the third quarter. Geographically, domestic equity market returns outpaced those generated abroad; stylistically, value underperformed growth in the U.S. The solid outperformance of domestic small cap versus domestic large cap in the second quarter reversed course in the third, with the Russell 1000 Index producing a quarterly total return of 7.4% versus a more modest 3.6% return for the Russell 2000. Indeed, domestic small cap's year-to-date outperformance gap had narrowed to just 90 bps by the end of the third quarter, compared to a spread wider than 700 bps in June.

Tax reform and deregulation has supported a meteoric rise in earnings growth for domestic small cap companies. Through September, YoY earnings growth for Russell 2000 positive-earning companies stood just 70 bps below August's record high reading of 45.0%. Positive earnings growth provides a critical support mechanism for valuation levels that remain elevated across the board.



Data sources: Russell, NBER, Bloomberg, L.P. Data as of August 2018. Note: Shaded areas denote NBER-defined recession periods

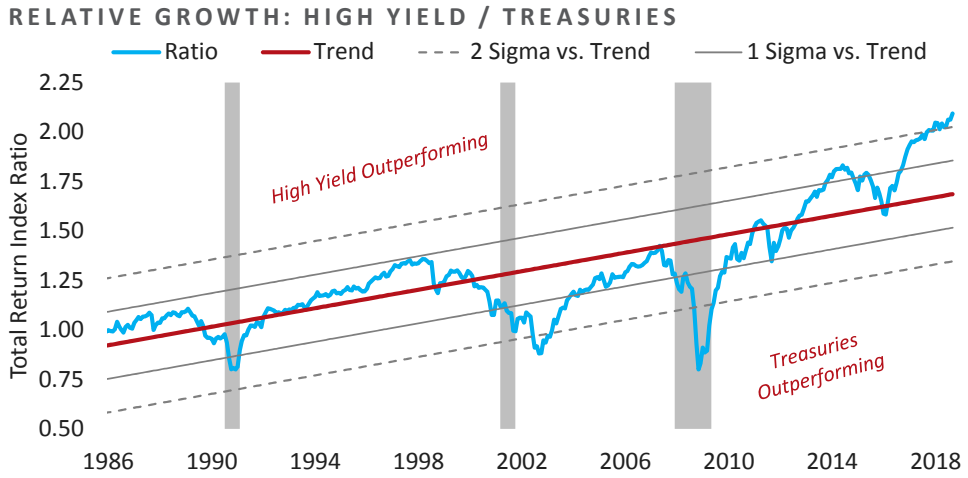
On a look-ahead basis, U.S. earnings estimates—particularly for companies at the smaller end of the capitalization spectrum—may face difficulty keeping pace with forecasted levels as the perceived stimulus of late-2017 tax reform begin to dissipate. Moreover, with inherently more leverage than their larger cap counterparts, small cap companies are likely more exposed to continued increases in interest rates, which appear to be cemented into market expectations for at least the next two years. Continued earnings growth will depend on the degree to which companies are able to successfully invest tax reform stimulus into productive, value-generating endeavors.

Those domestic equity managers that retain the flexibility to invest across market capitalizations, industries, and styles stand to benefit from the anticipated increase in market dispersion generated by an evolving policy and interest rate backdrop, as well as an eventual business cycle inflection.

FIXED INCOME

U.S. Treasury interest rates rose for the fifth consecutive quarter, as the yield on the benchmark 10-Year Treasury Note increased 20 bps quarter-over-quarter, concluding September at 3.06%. This trend appears to have gathered steam in the early trading days of the fourth quarter, with the yield on the 10-Year Treasury Note spiking to 7-year highs. Pressuring nominal interest rates higher in recent quarters are accelerating inflation, a domestic risk-on market environment, increasing policy rates, and broad-based economic improvement.

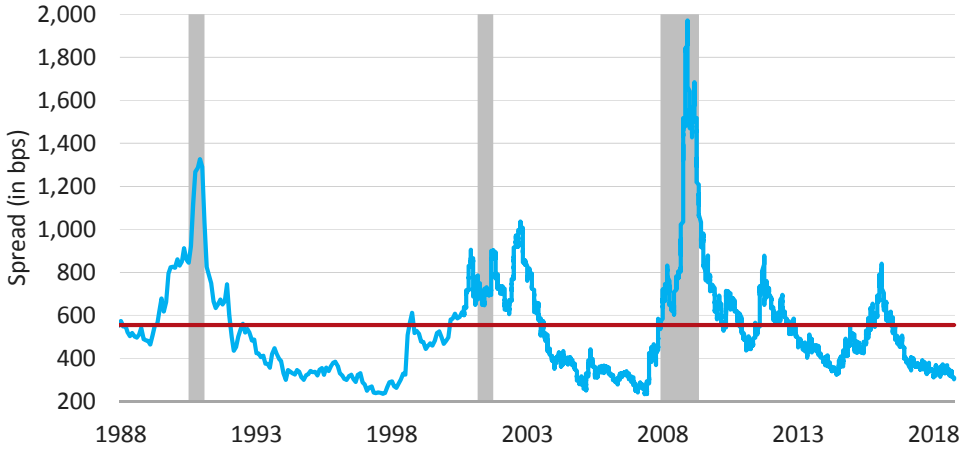
As the higher quality sectors of the fixed income market have suffered in this environment, below-investment-grade credit has exhibited stability. The following visual, which compares the relative total return growth between U.S. High Yield bonds and Treasuries highlights the strong relative uptrend in favor of credit risk, with levels recently moving beyond two standard deviations above trend.



Data sources: Bloomberg, L.P., FEG. Data as of September 2018.

Depicted using more traditional methods, the thirst for credit risk can be viewed simply by looking at option-adjusted spreads (OAS), as the OAS on the Bloomberg Barclays U.S. High Yield Bond Index tightened to a fresh cycle low immediately after the conclusion of the third quarter. This spread, which declined to 303 bps on October 3, is the tightest since July 2007 and just 70 bps above all-time record lows, implying historically low risk compensation versus risk-free Treasuries.

BARCLAYS HIGH YIELD OAS AND BUSINESS CYCLES

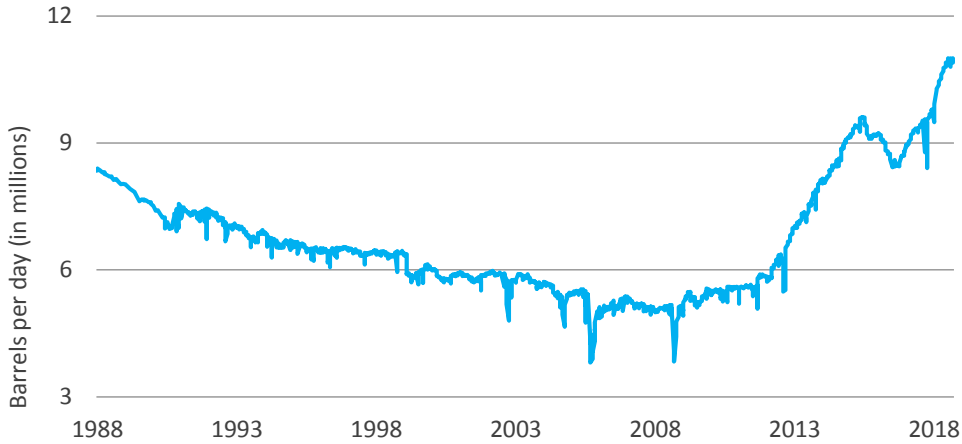


Data sources: Barclays, Bloomberg, L.P., NBER. Data as of 10/3/2018. Note: Monthly yield spread vs. 5-year Treasury used for 1/1987 - 9/2000, daily OAS used thereafter.

REAL ASSETS

Real assets performance was mixed in the third quarter. After rebounding strongly from difficulty in the second quarter, energy infrastructure assets continued to post solid performance. The Alerian MLP Index, for example, followed up second quarter's 11.8% gain with a return of 6.6% in the third quarter. Fundamental improvement across the energy infrastructure complex, including strengthening CAPEX, more simplified funding structures, and a vigorous rebound in domestic crude oil production levels has underpinned the rebound experienced across this asset category. Notably, the U.S. became the single largest producer of crude oil in the world during the quarter, surpassing both Russia and Saudi Arabia by producing 11 million barrels of oil per day.

U.S. CRUDE OIL PRODUCTION



Data sources: U.S. DOE, EIA, Bloomberg, L.P. Data as of 9/28/2018

Real Estate Investment Trusts (REITs), which are often utilized by investors as a bond surrogate due to low yield levels across the fixed income space, witnessed elevated volatility in the quarter amid an increase in both Treasury rates and realized volatility levels. REIT returns were slightly positive for the quarter but have suffered meaningfully in the first handful of fourth quarter trading days. Broad commodity returns have

been unimpressive, particularly for those indices that lack a substantial weighting in energy. For the quarter, the Bloomberg Commodity Index slumped 2.0% with steep declines across both precious and industrial metals prices. Rising real interest rates, an appreciating USD, and a lack of demand for safe haven asset exposure have weighed on precious metals prices throughout 2018.

DIVERSIFYING STRATEGIES

In aggregate, liquid Diversifying Strategies (DS) indices generated flat returns in the third quarter. A risk-on market environment coupled with a lack of persistent volatility served as headwinds for an asset category known for its historically defensive qualities. Managers that emphasize emerging markets struggled, while persistent trends in the USD and select commodities drove gains for trend following strategies.

Event-driven managers, particularly those with large merger and acquisition portfolios, performed well during the quarter amid an increase in deal activity. Volatility arbitrage managers have garnered some interest recently due to muted levels of both implied and realized volatility across most corners of the global investment landscape—with the exception of emerging markets. FEG continues to believe skillful active managers, particularly those with expertise in less liquid markets, stand to benefit from an eventual return to more “normal” levels of volatility.

CONCLUSION

The United States continued to pull away from the rest of the world in the third quarter in both economic fundamentals and market performance, despite some measures reflecting a near-mature business cycle. With many key economic data points at or near cycle highs and others at secularly high levels, this is a prudent time for investors to question the economy’s capacity to continue operating at such robust levels and ask:

- Is this as good as it gets for the U.S., and perhaps global, economy?
- With monetary accommodation in the rearview mirror and the sugar high from tax reform set to potentially wear off by 2020, what could replace fiscal stimulus?
- At what point do equity investors adding incremental capital to the domestic equity asset category care about rising interest rates?
- What effect might a synchronized removal of developed market central bank policy accommodation have on asset valuations, exchange and interest rates, animal spirits, and sentiment levels?

FEG does not profess to have all the answers and remains highly skeptical of anyone making such a claim. Instead, FEG focuses on providing a flexible suite of diversified investment solutions tailored to client missions by emphasizing skillful active managers with proven track records of successfully navigating challenging market environments.

Moreover, through direct negotiations with a vast network of global managers, FEG seeks to continue driving management fees lower with a preference for compensating managers based on market outperformance (i.e., alpha). After all, growing divergent trends detailed throughout this commentary suggest that the market is in the process of increasing dispersion, skewing the cost/benefit proposition in favor of actively managed investment solutions.

DISCLOSURES

This report was prepared by FEG (also known as Fund Evaluation Group, LLC), a federally registered investment adviser under the Investment Advisers Act of 1940, as amended, providing non-discretionary and discretionary investment advice to its clients on an individual basis. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Fund Evaluation Group, LLC, Form ADV Part 2A & 2B can be obtained by written request directed to: Fund Evaluation Group, LLC, 201 East Fifth Street, Suite 1600, Cincinnati, OH 45202 Attention: Compliance Department.

The information herein was obtained from various sources. FEG does not guarantee the accuracy or completeness of such information provided by third parties. The information in this report is given as of the date indicated and believed to be reliable. FEG assumes no obligation to update this information, or to advise on further developments relating to it. FEG, its affiliates, directors, officers, employees, employee benefit programs and client accounts may have a long position in any securities of issuers discussed in this report.

Diversification or Asset Allocation does not assure or guarantee better performance and cannot eliminate the risk of investment loss.

Index performance results do not represent any managed portfolio returns. An investor cannot invest directly in a presented index, as an investment vehicle replicating an index would be required. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown.

Neither the information nor any opinion expressed in this report constitutes an offer, or an invitation to make an offer, to buy or sell any securities.

Any return expectations provided are not intended as, and must not be regarded as, a representation, warranty or predication that the investment will achieve any particular rate of return over any particular time period or that investors will not incur losses.

Past performance is not indicative of future results.

This report is intended for informational purposes only. It does not address specific investment objectives, or the financial situation and the particular needs of any person who may receive this report.

INDICES

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class.

The Bloomberg Barclays Capital Aggregate Bond Index is a benchmark index made up of the Barclays Capital Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc., and are utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund of funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

The MSCI ACWI (All Country World Index) 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 MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The developed market country indexes included are: 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 S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

201 East Fifth Street
Suite 1600
Cincinnati, Ohio 45202

513.977.4400
information@feg.com
www.feg.com

Cincinnati | Dallas | Indianapolis

Subscribe to FEG's communications at www.feg.com/subscribe.