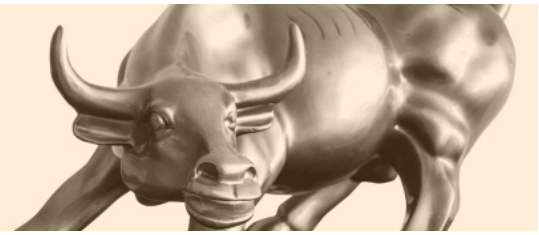
MARKET COMMENTARY

FOURTH QUARTER 2017



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ECONOMIC OVERVIEW

There was an abundance of newsworthy items in 2017, some good, some bad, and some downright frightening. One of the most interesting aspects of 2017, however, was the capacity of most capital markets to calmly absorb the year's unsettling geopolitical landscape—one which some forecasted might frighten investors into panic selling.

Two events in 2017 were most influential in setting the stage for the year to come:

- Passage of tax reform in the U.S., and;
- U.S. Federal Reserve (Fed) activity, including the continuation of rate normalization to the upside and the beginning of balance sheet downsizing.

Near the end of the year, both the U.S. House of Representatives and the U.S. Senate agreed on a tax reform bill that was signed by President Trump on December 22. The new law is expected to provide more than 1% of GDP fiscal stimulus in calendar year 2018. In response, the U.S. stock market roared into the end of the year, with investors anticipating an influx of greater after-tax revenue for companies that could be put toward capital projects, new hires, dividends, and share buybacks.

In mid-December, the Federal Reserve raised the Fed funds rate to a range between 1.25% and 1.5%. They also raised their GDP estimate for 2018 from 2.1% to 2.5%. This falls below recent trend, as the second and third quarters of the year saw GDP growth above 3%, and some forecasts for the fourth quarter also exceed that level.

The end of 2017 brings us to an outlook for 2018 and some of the economic developments that could influence investment markets around the world. This commentary will specifically examine each of the following areas: possible effects of the new tax law, the Fed balance sheet winding down, central bank activity across the globe, corporate earnings, and the flattening yield curve.

TAX REFORM

The recently signed tax reform law is expected to be the second largest cut—in terms of percentage of GDP—in U.S. history. The cut could have a meaningfully positive impact on economic growth, though it is expected to increase the Federal deficit. Importantly, the law takes effect right away—front-loading all of the tax cuts immediately into 2018.

Markets reacted favorably when the tax reform plan's passage became clear, suggesting some of the effect has already been priced into the market. However, there may be follow-on stock market support through share buybacks when companies find themselves with more cash—either due to the lower tax rate or as a result of repatriating profits currently held overseas.

The anticipation of cash influx boosted the markets, but there may be an additional boost when the cash actually arrives and is put to work. Moreover, there are incentives in the new law to encourage investment, such as the immediate ability to expense certain capital expenditures. Although some resulting capital investment seems likely, a large percentage of after-tax cash may be used for stock buybacks, as was the case in 2004. The Center on Budget and Policy Priorities concluded that the 2004 tax holiday did not produce the promised economic benefits because companies mostly bought back

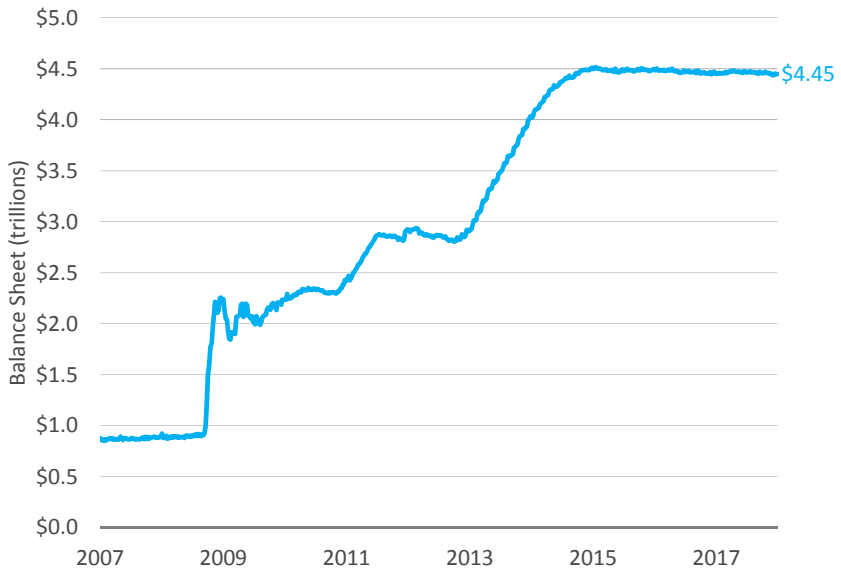
stock rather than investing to grow their businesses.[1] Many questions remain, but we believe there is a strong possibility that the new tax law will act as a positive influence on the U.S. economy and markets; therefore, the impact of the new tax structure will likely remain a meaningful story in 2018.

FEDERAL RESERVE

Connected to tax cuts is the second important driver of economies and markets: the activity of large central banks. As of the end of 2017, the market anticipates the Fed will raise rates three times in 2018, although if the economy gains momentum faster than anticipated and inflation pressures increase, the Fed may be prompted to raise rates more frequently or more fervently.

Additionally, uncertainty surrounds Jerome Powell, who will take over as Fed Chair in February. Since the Fed ended their bond buying quantitative easing program (QE), markets have largely absorbed rising rates without a meaningful pick-up in volatility, in part because the Fed has transparently telegraphed every move. A tighter than expected policy action could halt growth in the stock market—at least for a short time—but it may not derail the market if the reason for the hike is in response to positive domestic economic news.

FEDERAL RESERVE BALANCE SHEET ASSETS



Data sources: Bloomberg, L.P., Federal Reserve; data as of December 31, 2017

Further influencing 2018 is the continued shrinking of the Fed's balance sheet. As shown in the graphic, the size of the Fed's balance ended 2017 virtually unchanged from years prior, even though the tapering program was enacted late in the year. The Fed is expected to allow bonds to run off in an orderly fashion. The initial $4 billion per month is increasing to $8 billion in January, $12 billion in April, and then increasing in stages until reaching a maximum of $20 billion in October. Fed Chair Janet Yellen remarked that the tapering would be about as exciting as watching paint dry.[2] If she is correct and the economy remains strong enough to support the tapering, markets may not be negatively disrupted; however, a policy change by the incoming chair or economic weakness could destabilize markets.

GLOBAL CENTRAL BANKS

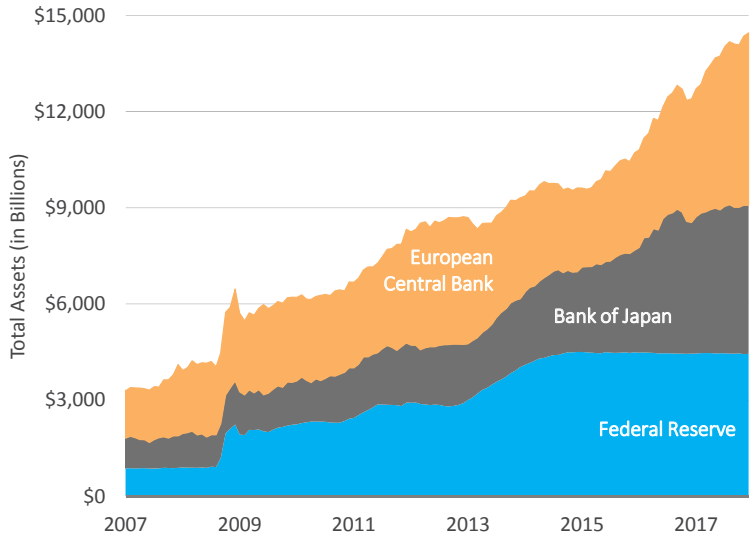
Activities of the European Central Bank (ECB) should also remain in focus. In October, the ECB announced plans to begin tapering their QE program in January, assuring the public that they will deliberately move at a measured pace—not because the economy is weak, but because they have not been able to reach their 2.0% target for inflation. In the latest inflation forecast available at year-end, the ECB predicted that euro zone prices will raise 1.4% in 2018, continuing to rise slowly to 1.5% in 2019 and 1.7% in 2020.[3]

Global central bank activity is important because global stock markets have moved higher for some time, even though the Fed ended QE more than three years ago. Despite the absence of QE in the U.S., the collective balance sheets of central banks globally have continued to expand. For this reason, investors should carefully monitor the reaction of markets when the aggregated balance sheets begin to shrink.

"An ample degree of monetary stimulus... remains necessary for underlying inflation pressures to continue to build up"

—ECB president Mario Draghi, in mid-December

TOTAL ASSETS ON CENTRAL BANK BALANCE SHEETS

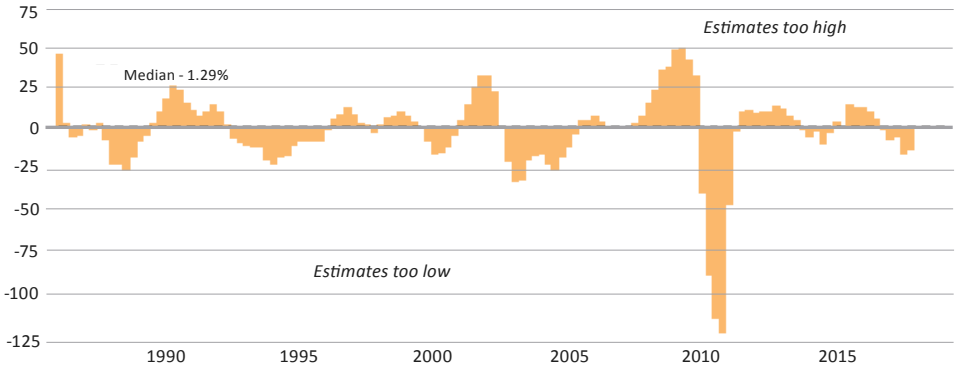


Data source: Strategas; data as of 12/29/2017

EARNINGS

The fourth area of expected intrigue in 2018 is corporate earnings. At the end of an economic cycle, i.e., right before a recession, there is typically an observable difference between bullish estimated earnings growth and more subdued actual earnings growth in conjunction with frothy market sentiment. That phenomenon is illustrated in the graph below from Ned Davis Research when the bars are above the zero line.

ESTIMATED VS. ACTUAL EARNINGS YEAR-OVER-YEAR GROWTH

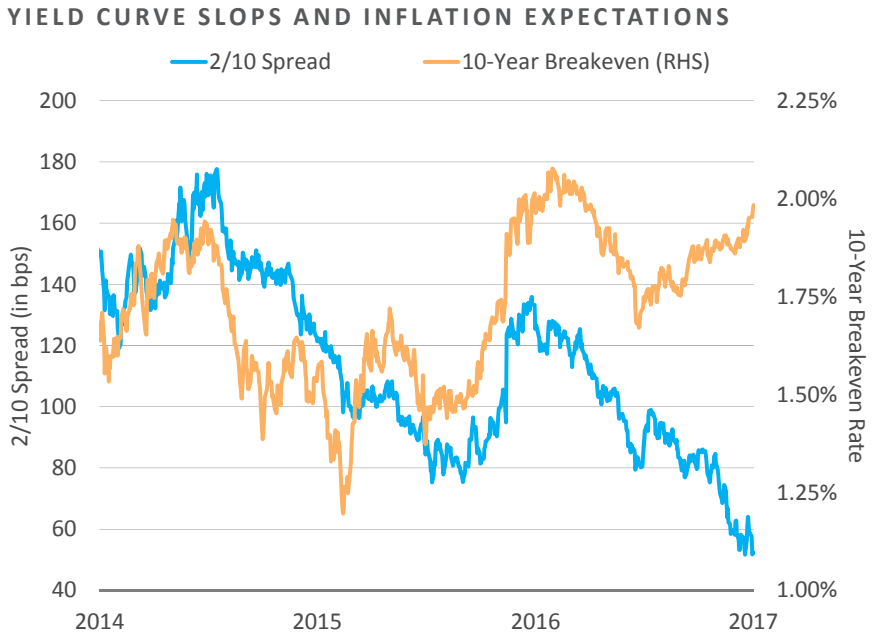


Source: Ned Davis Research

Recently, however, estimates have been coming in too low. In conjunction with a positive trend in earnings, actual earnings have more than kept pace with estimates, which is not reflective of frothy optimism. Moreover, the new tax plan may drive expectations even further below actual. For example, Strategas forecasts that the tax package will increase S&P 500 earnings by over $13 per share, which is more than 10% above the consensus estimates prior to the law's passage.[4]

YIELD CURVE

The fifth and final development worth watching in 2018 is the yield curve. The spread between the two-year U.S. Treasury yield and the 10-year yield has narrowed in recent months, and it may be on a trajectory to the rarely observed inversion in which the two-year yield exceeds the 10-year yield.



Data source: Bloomberg, L.P.; data as of December 14, 2017

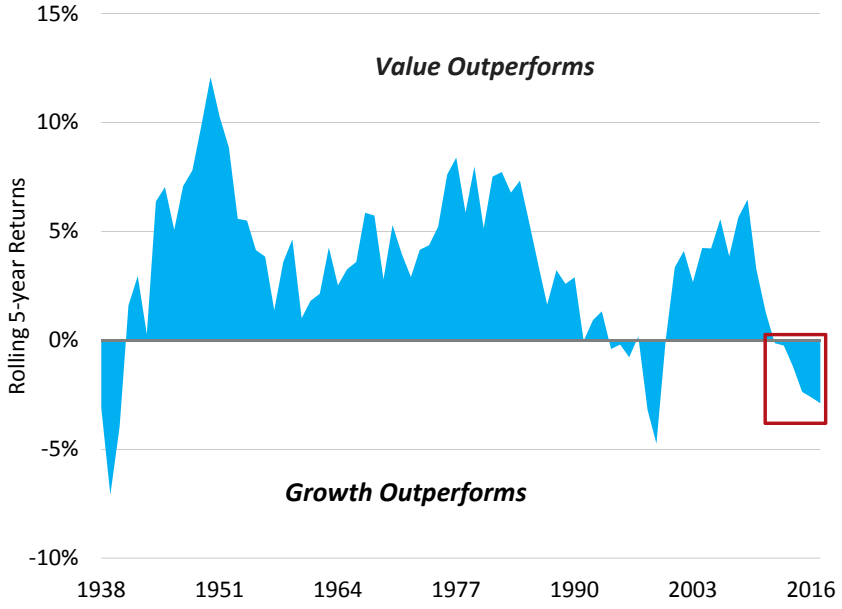
This phenomenon is worth following because recessions have historically preceded by an inverted yield curve, and recessions have had a tendency to correspond with volatile environments for risk assets. That said, the onset of a recession is not a foregone conclusion just because the yield curve inverts. At some points in history, there were several years after inversion before the onset of a recession. Additionally, the validity of a recession-predicting inversion signal comes into question when considering that the long end of the yield curve has been pressed artificially low due to central bank activity.

As always, the economic backdrop for investment portfolios will remain both influential and unknown in 2018. In that environment, investors must remain vigilant observers in relentless pursuit of opportunities to add value and avoid uncompensated risk.

Equity

The value equity style has a deep history of success over long periods of time, as value has historically outperformed growth and by a greater margin. Contrary to most of investment history, however, growth has outperformed value in recent years, dating back to the financial crisis.

LARGE CAP VALUE OUTPERFORMANCE vs. LARGE CAP GROWTH
Rolling Five-Year Returns



Data source: Ibbotson and Russell, through December 2017

One theory that could explain the growth outperformance anomaly is the persistently slow pace of economic expansion during the current recovery. The general thought is that investors are willing to pay a premium for growth when it is scarce. Another factor is the prolific rise of a small group of large, highly disruptive growth companies that have dominated the stock market. The so-called "FANG" stocks—Facebook, Amazon, Netflix, and Google—have enjoyed a significant rise in recent years as they snap up market share, transforming lives across the globe. Include Apple in that group and those five stocks represent just 1% of the number of S&P 500 stocks, yet account for over 10% of the market cap.[5]

However, the tide against value may be turning. Value stocks have gotten a boost lately, as two of the most prominent value subcategories, energy and financials, were big beneficiaries of the new tax law.

According to the MarketWatch corporate tax calculator, the energy sector's median tax rate for the past 11 years was 36.8%, far above the 30% average tax rate for all S&P 500 companies. But another significant item in the tax bill will immediately boost the fortunes of the entire energy sector, which is one of the most capital-intensive sectors. Each year, companies across the sector invest billions of dollars into new projects. Under prior tax law, those expenditures could not be deducted in the year in which they were incurred. The new law, however, allows capital expenditures to be deducted in the year of their occurrence. This change will further lower the tax burden for the energy sector while encouraging more capital spending.[6]

With a lower corporate tax rate, banks will be able to compete with lower-taxed international companies. Investment banking could see a spark of activity if, as expected, the repatriation of profits currently held overseas sparks merger and acquisition activity. The reduction on interest expense could weigh on financials if companies borrow less, but banks' wealth management divisions could benefit if the tax reduction on the wealthy leads to increased investment activity.

Beyond a more favorable tax landscape, energy and financial companies expect a less onerous regulatory environment in the future. Finally, if the tax law jolts economic growth, the high premium paid to own growth stocks–a primary reason for growth's recent dominance—could diminish.

FEG retains a philosophical bias toward value investing, utilizing valuation criteria as the primary driver of any investment decision. While growth has outperformed value of late, the recent fundamental changes previously discussed may set the stage for a return to the more common value style outperformance.

Fixed Income

The market expects the Federal Reserve to raise interest rates three times in 2018, although there is the possibility for more increases if the economy heats up and inflationary pressures begin to mount in earnest. Moreover, there is also precedent for an interest rate jump following a tax break.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 was signed into law on May 28, 2003. At that time, the U.S. 10-year Treasury was yielding 3.4%. Just three months later, the yield had surged to 4.5%. During the same short period, the Bloomberg Barclays Aggregate Bond Index experienced an uncharacteristic 3% decline.

A similar yet less significant increase in yields has occurred more recently. In early September 2017, the U.S. 10-Year Treasury was yielding about 2.1%, yet closed the year over 2.4%. For this reason, investors should pay close attention to the risk that rising rates could place downward pressure on interest-rate sensitive fixed income securities.

Credit-sensitive fixed income—particularly U.S. high yield debt—enjoyed another strong year in 2017. FEG believes yield spreads relative to Treasuries remain tight to a point where the risk of an allocation is not justified by the potential return. We are, however, following high yield prices—which became shaky late in 2017—as a potential harbinger of stock market performance.

Omri Even-Tov of the University of California at Berkley studied 19,518 quarterly earnings announcements of 770 firms from 2005 to 2014. He found:

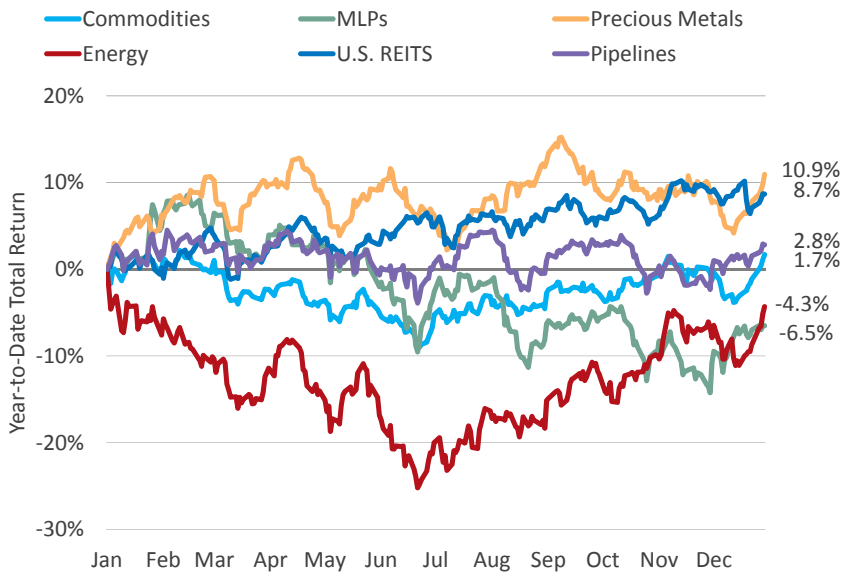
> *The bond price reaction provides incremental explanatory power for post-announcement stock returns over and above the information contained in the earnings surprise (the post-earnings announcement drift), the level of reported accruals (the accruals anomaly), and the immediate stock price reaction to the earnings announcement. This suggests that the sophistication of bond traders relative to stock traders is a driver of the ability of bond returns to predict post-announcement stock returns.*[7]

Valuations, fundamentals, and sentiment contribute to FEG's investment decisions. While certainly not the only or even primary driver that would lead to a portfolio change, cross observations among different asset categories can provide additional insight.

Real Assets

In a year when many different kinds of risk assets enjoyed stellar performance, MLPs fell flat. Worse than flat, in fact, in that they declined 6.5% for the year.

REAL ASSETS 2017 PERFORMANCE



Data source: Bloomberg, L.P.; Data as of 12/14/2017

MLPs had several important things working against them in 2017. First, the price of oil began plunging at the start of the year at a torrid pace. At one point in the summer, the price of oil was down over 20% year-to-date, echoing the oil price decline of early 2016 which significantly hurt MLP performance as well. In 2016, the prevailing thought was that obscenely low oil prices would place such an intense strain on MLPs (with levered balance sheets) that many would fail. Thus, when oil prices dropped in 2017, MLPs followed suit, albeit at a more measured pace. This was exacerbated by continued weakness in natural gas, the other primary commodity to flow through MLP pipelines.

After reaching a low in mid-summer, oil prices began to rally, which would be expected to firm MLPs as well; however, at that point investors had already begun to hear rumors that a new tax law might eliminate the friendliness that MLPs had heretofore enjoyed. From June 30 to November 15, oil prices rallied 20.2% while MLPs dropped 9.3%.

By the fall, MLPs were solidly in negative territory and they began feeling the effects of the third hardship of the year: tax selling. The first few days of 2018 were more favorable, however, as tax selling pressure abated and investors began digesting how MLPs were affected by the new tax law.

A significant benefit of MLPs over C corporations is the lower effective tax rate that applies to MLP income. The new tax law preserves that benefit through 2025. Moreover, the law permanently reduces the corporate tax rate to a flat 21% beginning in 2018, which suggests that the road forward for MLPs is more favorable in 2018 than it was in 2017.

MLP TAXATION

When combined with the maximum 20% tax rate on qualified dividends paid by a C corporation to an individual shareholder, the effective tax rate on income of a C corporation distributed to its shareholders will be 36.8%. The law reduces the maximum individual tax rate to 37% beginning in 2018.

In addition, the law provides a deduction to individual MLP unitholders generally equal to 20% of the MLP's domestic income and 20% of any recaptured income of an MLP unitholder on the sale of an MLP unit.

The wage-based limitation on the 20% deduction that applies to other pass-through entities does not apply to MLPs or REITS.

The combination of the reduced individual tax rate and the 20% deduction lowers the effective tax rate on income of an MLP to 29.6%.[8]

Diversifying Strategies

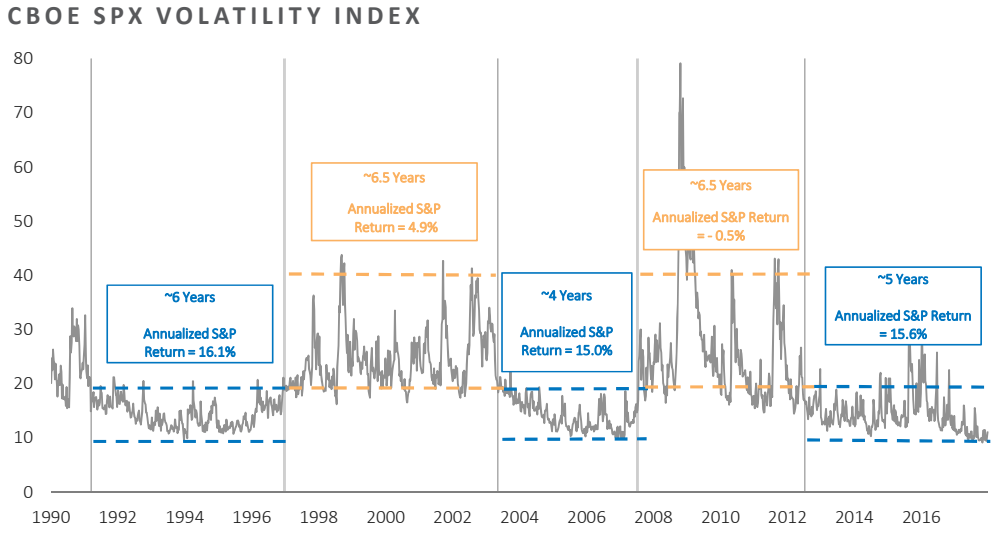
The U.S. stock market in 2017 was less volatile than any year dating back to 1964. With a more recent view, data is readily available on the CBOE Volatility Index (VIX) back to 1990. The lowest reading in that data series occurred November 3 when the VIX reached 9.1 (the average is 19.4).

A low volatility environment can prove difficult for many diversifying strategies (DS). Given that the recently low volatile past has coincided with one of the more challenging environments for DS managers, it is worth asking when might volatility heighten.

One recent report[9] suggested that volatility would return as the result of market stress indicating, "Historically, low volatility as measured by the VIX has preceded a market crash," and adding, "it's rare for markets to stay quiet more than a couple years." While this information sounds intuitively true, the data suggests it is not.

The average level of the VIX throughout all of 2017 was just above 11. Since 1990, levels at 12 or lower have occurred just over 8% of the time, so 2017 was certainly a significantly low volatility year. However, low volatility alone does not necessarily precede the onset of higher volatility. Specifically, the average one-year return of the S&P 500 after the VIX posts a below-12 reading has been 9.9% since 1990, which is higher than the 8.9% average return over that same period.[10]

Looking at the data in a slightly different way, volatility has remained largely in higher or lower regimes for periods of approximately four to six years. The graph indicates that the current low volatility regime has been in place for about five years.



Data source: Strategas; data as of 12/29/2017

Does this mean investors should expect a regime shift to higher volatility soon? Perhaps, but not necessarily. Considering the many reasons for fear globally in 2017, and those which still exist today, it is possible that price volatility is understating actual risk. If volatility moves higher, many DS managers will find a more fertile investment opportunity set. If volatility remains low, many managers will struggle. Regardless, the importance of manager selection in the ultimate success or failure of a DS mandate cannot be understated.

Conclusion

As the calendar turns to 2018, we feel a frigid air of transition. The end of the Federal Reserve's quantitative easing program is certainly more than three years hence, but the impending balance sheet tapering brings new uncertainties, as does the ascension of a new Fed's Chair, Jerome Powell. The European Central Bank's tapering plan is expected to usher in an end to global central bank balance sheet expansion. Taken alone and in the absence of economic expansion, a transition to less accommodative policy could be detrimental to risk assets, but the "Tax Cuts and Jobs Act of 2017" is expected to generate extra cash that companies may use for investment and new hires. Almost certainly, much of the cash will be used for stock buybacks and acquisitions. All of these factors stand to support equity prices, at least in the near term. That said, the impact of subsequent interest rate hikes, cuts on governmental spending, and central bank balance sheet reduction could have tempering influences.

FEG retains a near-term optimism looking forward to the new year, while maintaining a healthy skepticism of the long term. Valuations are stretched, spreads are compressed, and yields have nowhere to go but up.

[1] Matt Egan and Danielle Wiener-Bronner, "The Real Reason Wall Street is Euphoric over the Tax Plan," Money.CNN.com, December 3, 2017.
[2] FederalReserve.gov, "Transcript of Chair Yellen's Press Conference," June 14, 2017.
[3] DW.com, "No Changes to ECCB Monetary Policy," December 14, 2017.
[4] Strategas Research Partners, "Quarterly Review in Charts," January 2, 2018.
[5] Patti Domm, "The Big Influence FANG, Tech have Over Market Could Become a Concern if Volatility Rises," CNBC.com, July 28, 2017.
[6] Robert Rapier, "The Energy Sector Would Be Tax Overhaul's Biggest Winner," Forbes.com, December 18, 2017.
[7] Sid Verma, "How Bond Markets Can Predict Moves in Stocks," Bloomberg.com, July 31, 2017.
[8] BakerBotts.com, "Tax Reform Act – Impact on Master Limited Partnerships," December 20, 2017.
[9] Preeti Varathan, "2017 was the Least Volatile Year in Decades," Quartz Ideas, QZ.com, December 22, 2017.
[10] Data source: Bloomberg, L.P.

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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.

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