

RESEARCH REVIEW

SECOND QUARTER 2018

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The slope of the U.S. Treasury yield curve, often used as recessionary early warning signal, flattened to a new cyclical low to round out the second quarter. Key drivers behind this dynamic include the potential full maturity of the economic expansion, continued Fed tightening, and fears of a trade war-induced global growth slowdown. In the second quarter, domestic equities—particularly small cap—generated solid returns while international developed and emerging market equities lost traction. Most fixed income sectors experienced modest performance, with relative outperformance in below-investment grade sectors. In real assets, energy infrastructure experienced a solid rebound following a slump in the first quarter, while REITs also experienced solid gains as domestic economic fundamentals remained strong and interest rate volatility moderated.



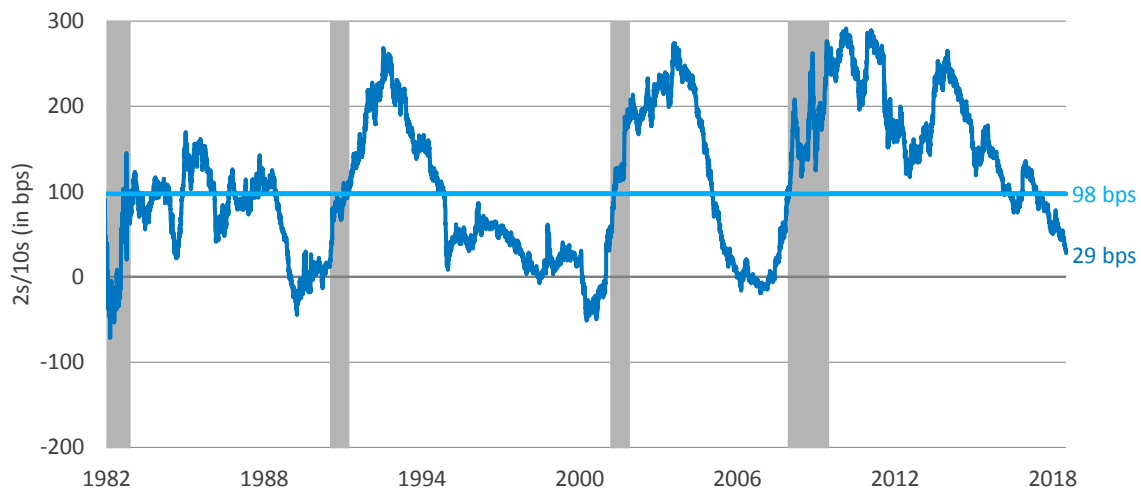
ECONOMIC UPDATE

U.S. Treasury Yield Curve Flattens to Fresh Cycle Low

Business cycle expansions in their later stages are often characterized by a tight labor market, waning economic “slack” (i.e., remaining capacity of resources), bubbling inflationary pressures, and restrictive monetary policy. These competing forces help place pressure on the slope of the Treasury yield curve, with the Federal Reserve's (Fed) interest rate hikes helping to increase Treasury rates on the front end of the curve. This tightening of monetary conditions acts as a counterbalance to late-cycle inflationary pressures. As the long-end portion of the curve exhibits the most sensitivity to inflationary sentiment, these dynamics help create curve “flattening.”

Throughout the second quarter and into early third quarter trading, the slope of the yield curve, as proxied by the differential between the 2-year and the 10-year Treasury notes, tightened meaningfully. Through early July, this spread stood at 29 basis points (bps), the tightest level in the current economic expansion.

U.S. YIELD CURVE AND BUSINESS CYCLES



Data sources: Bloomberg, L.P., NBER; data as of July 6, 2018

Note: Shaded areas represent recessionary periods

A flat/flattening yield curve tends to serve as a headwind to institutions that rely on borrowing in the short-term markets and lending across longer-term maturities, as this becomes a losing proposition when the yield curve is flat-to-negatively sloped. This “net interest margin” is a key profitability gauge for financial institutions like banks. As such, those equity indices that exhibit a material constituent weighting in financials, such as domestic value equity indices, tend to lag their growth counterparts late-cycle (and vice versa).

FEG does not believe investors should become immediately alarmed despite suggestions of an early recessionary warning sign potentially being tripped, as past cycles have shown that the curve can invert one-to-two years ahead of the front end of a recession, a time often ripe with solid total returns. Moreover, the broader subset of business cycle timing tools, such as leading economic indicators growth, high yield spreads, labor market fundamentals, and Purchasing Manager Index gauges, among others, fail to corroborate the recessionary signals emanating from the yield curve, as many of these indicators appear solid.

The U.S. Recession Risk Dashboard, which encompasses a mosaic of business cycle timing indicators, shows that near-term recession risk actually remains quite low. Medium-term (one-to-three years) risk, however, remains moderately elevated. Unforeseen headwinds or tailwinds may alter today's initial set conditions, although the recent implementation of U.S. fiscal stimulus is likely to continue serving as a business cycle tailwind over the near-term horizon.

U.S. RECESSION RISK MONITOR

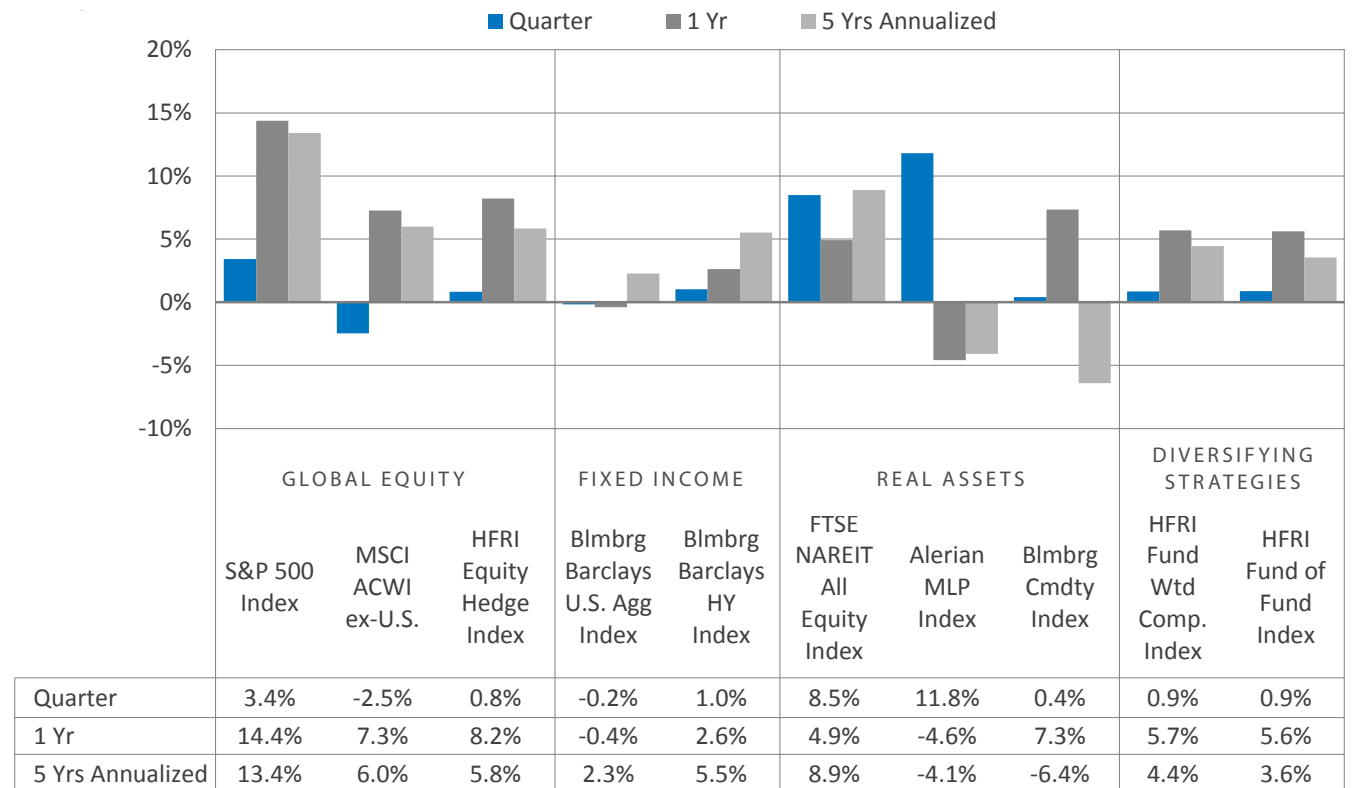
ECONOMIC INDICATOR	CURRENT READING	HISTORICAL AVERAGE	RECESSIONARY SIGNAL	NEAR-TERM RISK	MEDIUM-TERM RISK
Slope of Yield Curve (2s/10s) <small>As of July 6, 2018</small>	29 bps	98 bps	< 0 bp	LOW MODERATE HIGH	LOW MODERATE HIGH
C.B. Leading Economic Indicators Index (YoY) <small>As of May 2018</small>	6.1%	2.0%	< -2.0%	LOW MODERATE HIGH	LOW MODERATE HIGH
Corporate Profits (YoY) <small>As of 1Q 2018</small>	6.8%	7.5%	< 0.0%	LOW MODERATE HIGH	LOW MODERATE HIGH
Industrial Production (YoY) <small>As of May 2018</small>	3.5%	3.8%	< 2.0%	LOW MODERATE HIGH	LOW MODERATE HIGH
Barclays High Yield Spread (OAS) <small>As of July 6, 2018</small>	365 bps	569 bps	> 800 bps	LOW MODERATE HIGH	LOW MODERATE HIGH
ISM Economy-Weighted PMI <small>As of June 2018</small>	59.2	54.2	< 50	LOW MODERATE HIGH	LOW MODERATE HIGH
Unemployment Rate (U-3)* <small>As of June 2018</small>	4.0%	5.8%	Convergence with 3-Year Moving Average	LOW MODERATE HIGH	LOW MODERATE HIGH
C.B. Employment Trends Index (YoY) <small>As of May 2018</small>	3.0%	2.0%	< 2.0%	LOW MODERATE HIGH	LOW MODERATE HIGH
OVERALL RISK <small>As of July 6, 2018</small>	-	-	-	LOW MODERATE HIGH	LOW MODERATE HIGH

*These signals utilize a business cycle perspective, in which cyclical peaks and troughs are taken into account alongside moving average signals
 Data sources: Conference Board, Bureau of Labor Statistics, ISM, Bloomberg, L.P., FEG

To conclude, the ongoing flattening of the Treasury yield curve, the pace of which has accelerated in recent months, is potentially pointing to a business cycle inflection on the horizon. Ongoing Fed rate hikes and a maturing business cycle are likely culprits of this recent dynamic. While recently-enacted tax stimulus may prolong the current expansion, the mosaic of business cycle timing factors points to a moderate risk of a downturn in the medium-term, with near-term risk appearing low at present.

MARKET RETURNS

SECOND QUARTER 2018

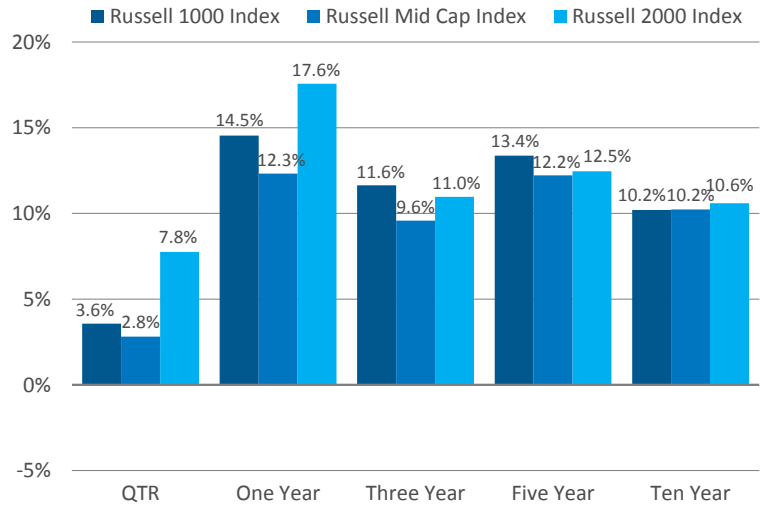


Data sources: Lipper, HedgeFund Research

GLOBAL EQUITY

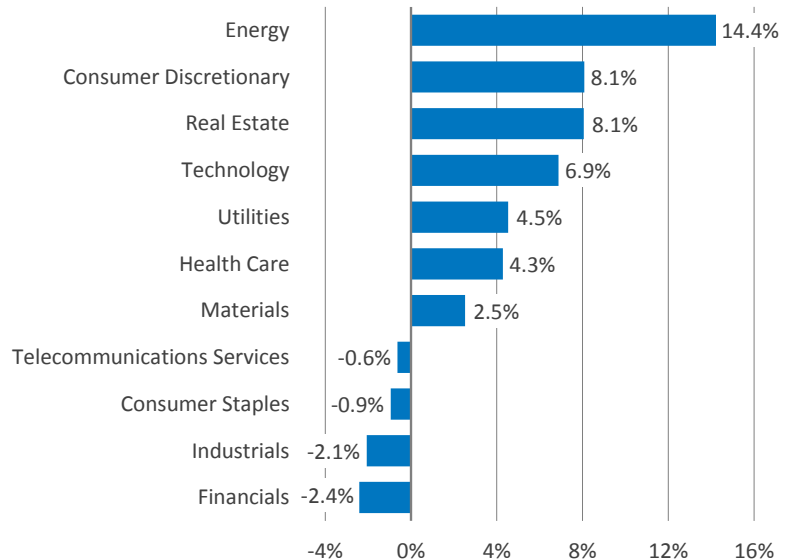
- The U.S. stock market, represented by the S&P 500, posted solid returns during the second quarter on strong reported earnings as well as increased earnings expectations that were supported by positive economic data.
- Rising energy prices placed the energy sector in a position of leadership for the quarter with returns of almost 15% that dwarfed the 8.1% returns of the second-place sectors, real estate and consumer discretionary.
- Growth stocks continued their dominance over value stocks, led by the FAANG stocks' (Facebook, Apple, Amazon, Netflix, and Google) strong performance.
- Small capitalization stocks led over large capitalization stocks for both the quarter and trailing one-year period, with a quarterly performance of over 7%.
- Europe faced headwinds during the quarter including disappointing data releases from the European Union, which included continued low core inflation, and news from the European Central Bank (ECB). The ECB postponed increasing interest rates until the summer of 2019, however, they confirmed that quantitative easing would cease by the end of 2018. Apprehension around Italy's new populist government also likely contributed to volatility.
- The quarter was difficult for emerging markets. The Indian rupee fell to a record low during the quarter, followed by the Chinese yen. Stock in Brazil suffered under political turmoil and a crippling truck-driver strike. China, the largest emerging market economy, suffered a steep decline on trade dispute tensions.
- Currency movements had a significant impact on returns for U.S. investors, as the United States dollar (USD) appreciated approximately 4% against a basket of major currencies.

LARGE, MID, AND SMALL CAP RETURNS



Data source: Russell

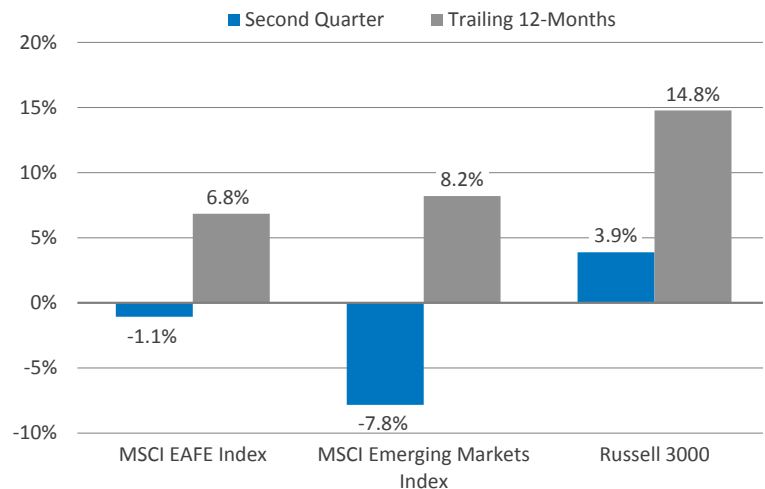
RUSSELL 3000 INDEX SECTOR QUARTERLY RETURNS



Data source: Russell

MCSI AND RUSSELL INDICES PERFORMANCE

Returns in U.S. Dollars



Data source: MCSI

FIXED INCOME

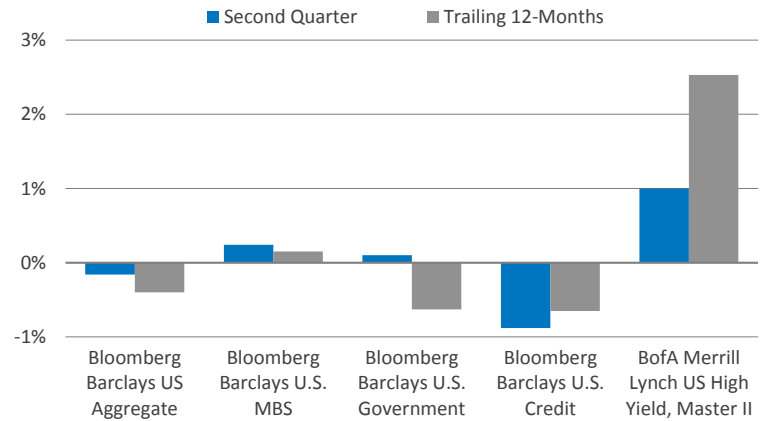
- Bond market sell-offs began during the quarter after healthy retail sales growth was reported in April, causing investor concerns regarding inflation to heighten. The U.S. 10-year Treasury yield briefly topped 3% for the first time in over four years, rising to a high of 3.1% in mid-May. Sell-offs tapered towards the end of May, and the 10-year Treasury yield reverted back to 2.9% to finish the quarter.
- At the June meeting of the Federal Reserve (Fed), the Fed raised rates by 25 bps to a new range of 1.75-2.00%—in line with market expectations—and signaled two additional hikes for the second half of the year, as unemployment continued to fall and inflation overshot the Fed’s target.
- The USD rally throughout the quarter against the euro and most other currencies—particularly the Argentine peso, Turkish lira, and Indian rupee—negatively impacting emerging market debt returns.

REAL ASSETS

REAL ESTATE

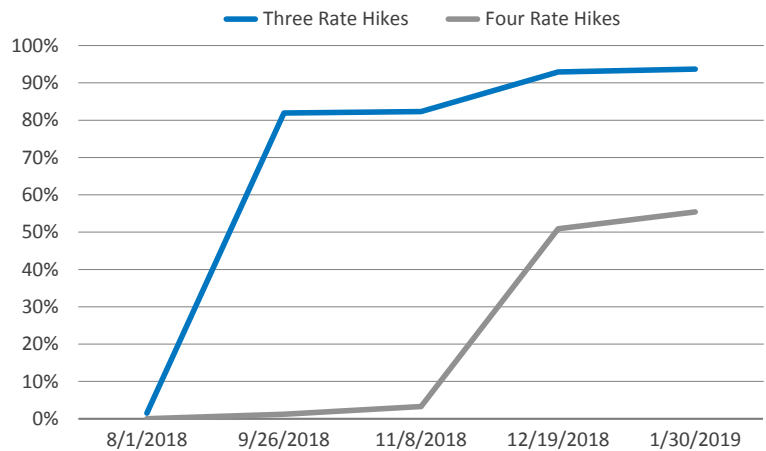
- U.S. REITs returned 8.5% during the second quarter and while yielding more than BBB corporate bonds for the first time in 10 years. Self-storage (15.1%), health care (14.2%), and lodging/resorts (14.1%) were the top performing sectors. Although rising interest rates took a toll on REITs to start the year, rising rates also provided a sign of economic improvement that supported REITs, as property owners raised rents in response to rising rates and inflation.

BOND INDICES PERFORMANCE



Data sources: Bloomberg, L.P., Barclays

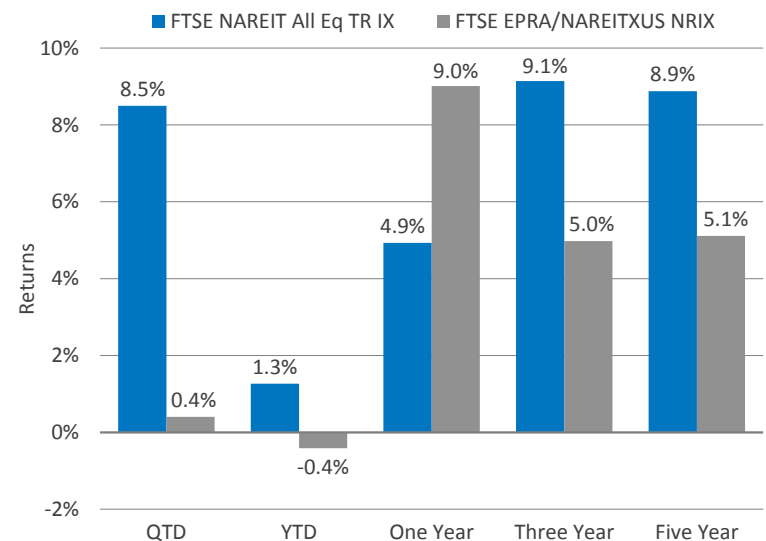
IMPLIED PROBABILITY OF FED RATE HIKES



Data source: CME Group

DOMESTIC vs. INTERNATIONAL REIT RETURNS

As of June 30, 2018



Data source: Bloomberg, L.P.

NATURAL RESOURCES

- Oil prices gained 25% through the first half of 2018. Oil prices hit multi-year highs around \$75 due to a combination of tightening supplies, growing demand, and geopolitical issues while U.S. oil production reached over 10 million barrels per day. The U.S. withdrawal from the Iran nuclear deal and the return of sanctions on Iran has been expected to disrupt oil shipments, with varied estimates ranging from essentially no decline to a reduction of as much as one million barrels per day of Iranian supply.
- Agriculture was negatively affected by soybeans and trade tensions during the quarter, with few signs of a trade resolution. Additionally, corn demand has exceeded supply, which detracted from performance.

MLPs

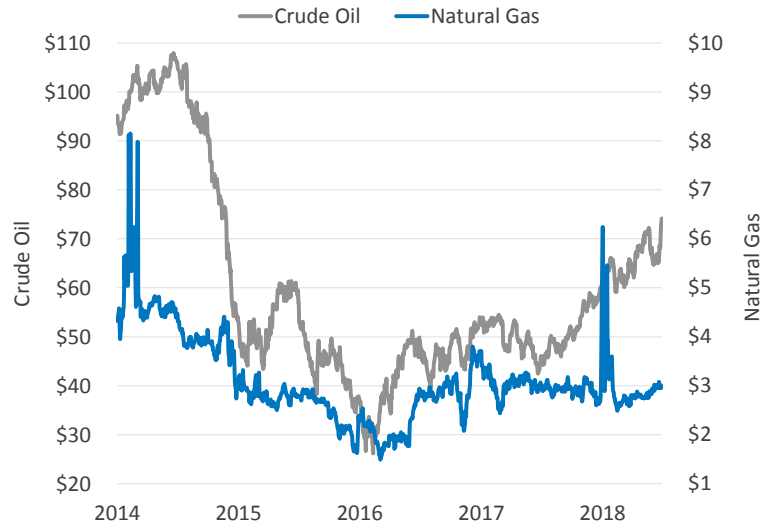
- As measured by the Alerian MLP Index, MLPs gained 11.8% in the second quarter following a similar decline in the first quarter that left MLP performance just slightly negative year-to-date. MLP fundamentals are stable and improving, with the distribution yield on the Alerian MLP index at approximately 8%. Multiple announcements of MLP simplifications and corporate consolidations of MLPs and their corporate sponsors have positively impacted performance in the second quarter.

DIVERSIFYING STRATEGIES

- Macro strategy returns were mixed during the quarter. Discretionary strategies—particularly those focused on developed markets—enjoyed tailwinds from rising interest rates. Emerging markets strategies generally struggled due to trade tensions, political risks, and the strengthening of the U.S. dollar. Challenges for systematic trend followers continued amid choppy markets that contained trend reversals.
- Merger arbitrage strategies rebounded from a challenging first quarter. The strategy benefitted from renewed optimism after the Department of Justice’s blockage of a large merger was overruled.

PRICE OF CRUDE OIL AND NATURAL GAS

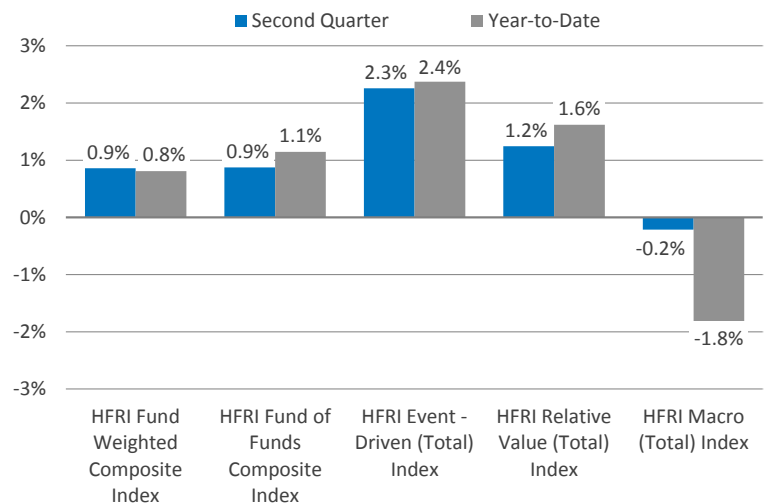
As of June 30, 2018



Data source: Energy Information Agency

HFRI INDICES PERFORMANCE

Returns U.S. Dollars



Data source: HedgeFund Research

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All data is as of June 30, 2018 unless otherwise noted.

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.

Barclays Capital Fixed Income Indices is an index family comprised of the Barclays Capital Aggregate Index, Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, Municipal Index, High-Yield Index, and others designed to represent the broad fixed income markets and sectors within constraints of maturity and minimum outstanding par value. See <https://ecommerce.barcap.com/indices/index.dxml> for more information.

The CBOE Volatility Index (VIX) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time S&P 500 Index option bid/ask quotes. The Index uses nearby and second nearby options with at least 8 days left to expiration and then weights them to yield a constant, 30-day measure of the expected volatility of the S&P 500 Index. FTSE Real Estate Indices (NAREIT Index and EPRA/NAREIT Index) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded real estate securities. Relevant real estate activities are defined as the ownership, disposition, and development of income-producing real estate. See www.ftse.com/Indices for more information.

HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc. (HFX), and are used 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.

J.P. Morgan's Global Index Research group produces proprietary index products that track emerging markets, government debt, and corporate debt asset classes. Some of these indices include the JPMorgan Emerging Market Bond Plus Index, JPMorgan Emerging Market Local Plus Index, JPMorgan Global Bond Non-US Index and JPMorgan Global Bond Non-US Index. See www.jpmorgan.com for more information.

Merrill Lynch high yield indices measure the performance of securities that pay interest in cash and have a credit rating of below investment grade. Merrill Lynch uses a composite of Fitch Ratings, Moody's and Standard and Poor's credit ratings in selecting bonds for these indices. These ratings measure the risk that the bond issuer will fail to pay interest or to repay principal in full. See www.ml.com for more information.

Morgan Stanley Capital International – MSCI is a series of indices constructed by Morgan Stanley to help institutional investors benchmark their returns. There are a wide range of indices created by Morgan Stanley covering a multitude of developed and emerging economies and economic sectors. See www.morganstanley.com for more information.

Russell Investments rank U.S. common stocks from largest to smallest market capitalization at each annual reconstitution period (May 31). The primary Russell Indices are defined as follows: 1) the top 3,000 stocks become the Russell 3000 Index, 2) the largest 1,000 stocks become the Russell 1000 Index, 3) the smallest 800 stocks in the Russell 1000 Index become the Russell Midcap index, 4) the next 2,000 stocks become the Russell 2000 Index, 5) the smallest 1,000 in the Russell 2000 Index plus the next smallest 1,000 comprise the Russell Microcap Index. See www.russell.com for more information.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation, among other factors by the S&P Index Committee, which is a team of analysts and economists at Standard and Poor's. The S&P 500 is a market-value weighted index, which means each stock's weight in the index is proportionate to its market value and is designed to be a leading indicator of U.S. equities, and meant to reflect the risk/return characteristics of the large cap universe. See www.standardandpoors.com for more information.

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

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Research and Investments Team as of date of publication.