ABBOT DOWNING STRATEGY REPORT

When Bad is Good...Until it Isn’t
# ABBOT DOWNING STRATEGY REPORT — WHEN BAD IS GOOD...UNTIL IT ISN’T

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2 Abbot Downing Strategy Report –When Bad is Good...Until it Isn’t
After a rocky, trade-war fueled couple of weeks of volatile trading in mid-to late-May, markets have rebounded strongly in recent sessions. Much of the optimism seems related to investors’ implied theory that the volatility itself will prompt the fed to lower rates sooner rather than later. Futures markets, for example, have shifted from expecting at least one or more hikes in 2019 (beginning of the year odds) to over 80% odds of at least one .25 bp cut by July and one or two more by year’s end.1

Given the seeming obsession with a cut, each piece of economic news that suggests a slowing economy is cheered by traders. To be honest, we’re a bit baffled relative to why one would applaud a softening economy. The hypothesis seems to be that “bad” news is “good” because it will lead to a rate cut. But this line of thinking ignores several potentially more impactful intermediate and long-term issues that front-line businesses and consumers must grapple with. While there are several—some examples include increased geopolitical tensions and slowing economic growth in China and the EU—we suspect the subject of trade looms largest at present. These factors, more than the day-to-day noise of rate cut prognostication, have the potential to change the course of the economy over a longer time frame, which is why we (and the Fed) are watching them closely.

**Trade**

The trade war is far from settled, even if the short-term scare of Mexican tariffs is off the table. The U.S. Mexico Canada Agreement (USMCA) is unsigned; tensions between the U.S. & China remain elevated with public posturing in front of the G20 meeting later this month; and relations are still open and fractious with Japan and many parts of the EU. Outside of the headline volleys, all of the uncertainty is having fundamental company and sector-specific implications, even if the full impacts have not yet rolled up into readable economic statistics (more on that in a minute). There are numerous recent examples of real life consequences occurring. For example, a recent report from the National Bureau of Economic Research notes: “Overall, using standard economic methods, we find that the full incidence of the tariff falls on domestic consumers, with a reduction in U.S. real income of $1.4 billion per month by the end of 2018. We also see similar patterns for foreign countries who have retaliated against the U.S., which indicates that the trade war also reduced real income for other countries.”2 The Wall Street Journal reported that the U.S. Retail Federation, in looking at projected activity at two of America’s and the globe’s busiest ports—Los Angeles and Long Beach—noted they “handled 48,256 fewer loaded import containers than in the same month [May] last year versus this year” and that “the retail group scaled back its import projection in coming months, saying U.S. ports would see a combined 900,000 fewer inbound containers in June, July and August than had been forecast in May.”3 Further, reports are cropping up with increasing frequency about global supply chains already being altered . And the impact on industries from farming4 to retailing5 are increasingly noticeable.

Somewhat surprisingly, the impact of the trade wars has not seemed to translate broadly into the aggregate economic numbers—yet. Perhaps this has more to do with odd weather in so many parts of the country impacting “seasonal adjustments” as well as the notion that businesses were stockpiling in advance of additional threatened tariffs (which drove activity higher than it otherwise might have been). But the longer matters remain unsettled the more likely it is that the anecdotal evidence...
becomes a solidly entrenched trend. Business optimism or pessimism has often illustrated herd-like, self-reinforcing behavior, exacerbating ebullient or withdrawn states at either end of the pendulum. And structurally, markets will appear to be lapping the strong, tax-cut-fueled numbers of 2018 soon, making comparisons increasingly tough as the year progresses. Any pause or pull back in corporate behavior is likely to be even more noticeable against these tough comparisons.

One final nuance to the trade issues is the reputation of inconsistency that America now potentially has with global trading partners. The presumption that even if both sides negotiate a deal in good faith, either congress can hold up ratification for political purposes, or tariffs can be “weaponized” and threatened in negotiations over unrelated topics like immigration. When both sides use the media to draw hard lines, we suspect it translates into continued uncertainty for business leaders around the globe.

Bringing the discussion back to the Fed: The Fed has said repeatedly it will be data dependent. And we note AGAIN that data has been tough to parse in recent months. As such—and to avoid the appearance of bowing to political or market pressure—we suspect the Fed will err on the side of letting more numbers play out before making their move. As the quote alludes to, we do expect the Fed to be the adult in the room and to be patient and watchful before deploying some of its dry powder. After all, the U.S. Fed is perhaps the only global central bank who has created some maneuvering room for action when the economy truly does turn down. Interest rates and Central Bank Policy rates in much of the rest of the globe are substantially lower than in the U.S. (See Chart 1). The economic numbers—especially on the employment and consumption fronts—have been illustrative of moderate, low inflation growth. Not a scenario that the Fed would need to deploy some of its dry powder on, especially this late in the cycle.

And seriously, when you stop to think about it, the Fed hasn’t been that successful at either getting inflation up to its stated goal of around 2%, or of moving the needle that markedly relative to the pace of banking/lending. With each market and economic contraction over the past few decades, more funding has shifted out of the Fed and the normal banks and into a broader consortium of non-Fed banks, credit unions, private family offices, investment banks, hedge and private capital funds, etc. It’s not as if there will be a big lift of growth resulting from a quarter point cut—borrowers are already noting that credit conditions are ample. From our perspective, Merger & Acquisition (M&A) and Initial Public Offering (IPO) activity are some indications of this.

In bringing it all full circle, we see a reasonably progressing set of fundamentals, but a potentially worrisome whiff of concern emanating from C suites. It’s worth noting that what company leaders say to pollsters versus what they are actually doing can be two very different things (same goes for consumers). Market valuations have popped back and most global markets continue to sport double digit increases for the year meaning valuations are not overwhelmingly cheap. Maybe the Fed’s mantra “patient and data dependent” would be one that all of us would be wise to adopt.
Chart 1: Global Monetary Policy

Benchmark Rates Remain Low but are Rising in the U.S.

Sources: FactSet and Wells Fargo Investment Institute, as of March 31, 2019. Headline central bank policy rates of selected countries.
In a 2017 tweet The House Ways and Means Committee (HWMC) estimated the length of the tax code at over 70,000 pages—unfortunately that’s patently false. This myth was popularized by a 2013 article written by the non-profit Tax Foundation where they summed up the pages in the code plus all the pages of legal case law pertaining to the code. That is kind of like saying Shakespeare’s anthology consists of every work he ever produced plus every scholarly publication ever written about him. The actual code checks in at something just north of 4,000 pages—not exactly the behemoth publication HWMC would have you believe, but not exactly beach reading either. In addition to its length, the other important factor is that unlike Shakespeare’s works, the code evolves and changes every year. This is why, when it comes to taxes, the right advice is so important to seek out, even if you think you already know the answer.

An Ongoing and Important Dialogue

We have discussed our approach to Client Discovery on several occasions. We use this process to uncover a client’s risk tolerance (June 2018 report), determine their time horizon (December 2018 report) and establish the appropriate strategic asset allocation (September 2017 report”). We also use the client discovery process to build a full tax picture; because ultimately what matters most to our clients isn’t what the market returns are, but what portion of those returns they get to keep.

During the discovery process, we gather the current structure of the estate plan, learn the details of the relevant legal and structural entities associated with the family wealth, and get a sense for any future events that could be useful for tax planning. The first reason we do this is to understand the impact of the current structure on the client’s tax picture and the second reason is to create a plan for any future action that could support a more tax-efficient wealth-preservation strategy. This aligns with the two goals we have when helping clients work through tax related issues—allow the client to keep as much of what they have earned each year, and transfer as much as is allowed to the future generations when that time comes.

An example of tax-related value add is the idea of ‘asset location’, meaning locating assets in the account structure that maximizes the after-tax returns. A simple example would be holding income producing assets like bonds and Real Estate Investment trusts (REITs) in a tax-deferred account because the income on those investments is typically taxed at the asset owner’s ordinary income tax rate, which for most of our client’s is the highest rate. Similarly, it makes sense to hold equities—whose capital gains and dividends are often taxed at lower rates than ordinary income rates—in taxable accounts. This is a simple example of placing the right assets in the right ‘location’.

Placing assets in a trust can be another valuable tax planning strategy. Trust structures also highlight an important concept—the tradeoff between control and value. Two common trusts are revocable and irrevocable trusts. The primary difference—not surprisingly—is that in the case of a revocable trust the grantor (person providing the assets being placed into the trust) can change the terms or even fully revoke the trust, tear it up, modify it, anything they choose. Irrevocable trusts generally can’t be changed or terminated by the grantor. Why would a grantor give up control? Because it removes the assets from the grantor’s estate—avoiding estate tax on those assets—which in states with high estate tax rates, when combined with Federal estate tax rates can exceed 50%.
A thoughtful use of tax solutions can also provide value beyond wealth preservation. One of our client families recently established a private foundation, funding it with highly appreciated stock from the family business. In addition to addressing a tax issue—the large capital gains bill that would have been due if the stock were sold—it addressed a few important issues relating to family dynamics. The foundation was set up to support animal welfare. This allowed the family to honor the values of several generations of the family. It also provided several long-term career development opportunities for family members that did not want to continue in the family business. In this particular case, the tax-related value add went well beyond the value of the capital preserved.

Conclusion

An interactive, thoughtful and ongoing Client Discovery process can provide tremendous value to clients. As such, it is important to keep several things in mind when thinking about taxes. First, tax planning and investments aren’t two separate things we do; they are inextricably linked together. Second, don’t let the tax tail wag the investment dog. It is critical to put pen to paper—with your tax, planning and investment professionals working together—to ensure that steps which are taken to add value from a tax perspective are not destroying value on the investment side, and vice versa. Third, tax issues evolve, so that component of the Discovery process that we have stressed so often, that it be an ongoing process, is just as important when it comes to tax planning. According to Twitter, one should also start talking about taxes with the next generation very early in life. Bill Murray tweeted out this advice in 2014 “The best way to teach your kids about taxes is by eating 30% of their ice cream.”
Global equity markets have been on a roller coaster ride since President Trump increased tariffs on $200 billion of Chinese imports from 10% to 25%, with threats of additional levies on another $325 billion of goods. Add into the mix a tariff deadline imposed on all Mexican imports coming into the U.S. (that was subsequently rescinded), and it’s not all that surprising the Dow plunged nearly 2,000 points followed by a rebound of over 1,500 points within a space of about five weeks.

A major problem for investors is the lack of historical precedents or even close examples to determine whether the current situation will ultimately produce permanent tariffs, resulting in lower and less predictable growth—or whether the current negotiating process will eventually lead to fairer trade practices that will ultimately benefit the global economic system.

The future course of Fed policy is another uncertainty facing investors. The May employment report was weaker than expected, with employers adding just 75,000 jobs. Yet, the unemployment rate remained near 50-year lows at 3.6%.

Market gyrations will most likely continue throughout the year, as two potential headwinds will be continuously scrutinized—the extent to which S&P 500 EPS growth decelerates from the unsustainable pace of 20% plus in 2018, and the end result of U.S-China trade negotiations. Behind the broad, swift equity-market slide of 2018 and rebound in early 2019 is an underlying new reality: Roughly 85% of all trading is on autopilot—controlled by machines, arithmetically-driven models, or passive investing formulas (Source: Wall Street Journal). While fundamentals ultimately drive capital markets in the long run, the aforementioned program-trading environment combined with an extended business cycle will likely result in continued volatility in 2019.
Global Trade

After five months of intense negotiations between the U.S. and China, the net result to date has been increased tariffs from both sides with additional levies being threatened over the coming months. The recent last-minute breakdown was allegedly due to what is commonly labeled as “non-starters” in the negotiating business; China has refused to discontinue the practice of supporting and favoring state-owned enterprises (SOEs), while the U.S. will not retreat from utilizing tariffs as a tool in the overall negotiating process. Although expectations remain that a deal will eventually be completed—as the negative consequences could be quite significant if the trade restrictions escalate further, the risks to capital markets are increasing.

Overall, the consensus thinking appears to surmise that the sudden tariff hike by President Trump on May 2nd, followed by China’s immediate response will likely result in further brinksmanship between the two parties; and that the current scenario of tariff escalation after five months of negotiations is not conducive to Chinese concessions—at least in the short term.

Bottom line: The U.S.-China trade conflict will take longer than markets originally anticipated over a month ago. Public commitments from the U.S. regarding the rollback of tariffs, and the same for China with respect to its SOEs would be positive signs that negotiations are moving in the right direction. So far the dominant narrative is that a trade deal will eventually come to fruition. But there is also a growing perception that a long-lasting conflict could extend beyond tariffs to force a rebuilding of the global trade order where institutions such as the WTO brokered disputes, splitting it into U.S. and China spheres of influence—and that there is little sign the markets are pricing in a long-lasting new economic “iron curtain.”

As of this writing, Presidents Trump and Xi Jinping are still planning to meet at this month's G-20 summit in Osaka, Japan on June 28-29.

*Pressure is growing on the U.S. and China to forge a trade deal considering that economic output has slowed in both countries and world trade volumes continue to display weakness.*
Key Market Events  (Continued)

**Domestic Geopolitical Concerns**

Historically, equity markets have corrected in the run-up to midterm elections, but once this uncertainty has been removed following the election, stocks have performed well over the following 12 months—regardless of which party was in charge before or after the election. Looking forward however, the new Democrat Party-controlled House of Representatives could add to market volatility in this rather hostile political environment. Although the new U.S. tax bill with permanently lower corporate tax rates and immediate write-off of capital expenditures for the next five years is currently not in danger of being overturned, issues relating to deficits, regulation, the environment and fiscal spending will likely produce added friction. Case and point, President Trump’s frustration with Congress regarding border security first led to a declaration of national emergency, and then later tariff threats on all Mexican goods entering the U.S.

Although still early in the cycle, investors are beginning to focus more attention on the 2020 presidential election. New proposals focusing on higher taxes and regulations from recently-announced contenders will likely rattle equity markets heading into the primary season.

*Special counsel Robert Mueller’s report concluding that President Trump and his campaign didn’t conspire or coordinate with Russia to interfere with the 2016 election eliminates a potential overhang to equity markets. Nevertheless, both political parties are not satisfied: Democrats are claiming obstruction by the President with several calling for impeachment, while Republicans will investigate potential abuses by the DOJ from two years ago. In addition, Democrats have also promised hearings on President Trump’s tax returns and prior financial dealings.*

**Commodity Prices**

WTI crude oil prices have plunged 22% from $66 to $52 based on the following:

- Record crude oil production of 12.3 million barrels per day (MBPD) in the U.S.
- Higher than expected inventory levels.
- Concerns of a global economic slowdown due to U.S.-China trade tensions.
- Unwinding of long positions in oil futures contracts as prices declined.

It is not surprising that crude oil prices have corrected after a 50% spike earlier this year. Looking ahead however, WTI should find support at these levels, and move higher towards the $65 range due to several factors:

- OPEC members plus Russia and other non-OPEC countries agreement late last year to reduce production by 1.2 MBPD, which is expected to remain in place for the remainder of this year to support oil markets as U.S. production growth remains high in 2019.

- Geopolitics:
  - The Trump administration’s decision last month to end waivers from U.S. sanctions on oil purchases from Iran that had been granted six months ago to China, India, Japan, South Korea, Italy, Greece, Turkey and Taiwan. That means that any country that tries to buy Iranian crude oil could face financial penalties and other possible punishments from the U.S. government.
  - Ongoing crisis in Venezuela; the country’s oil output is projected to reach 1 MBPD (down from 2.5 – 3 MBPD).
  - Escalation of the conflict between rival government forces in Libya.

*Commodities price volatility, especially to the upside, could further stoke investor nerves regarding inflationary pressures.*
Central Bank Meetings—The Fed and The ECB

Although the Fed is forecast to remain on hold at the June meeting, expectations of a rate cut continue to reverberate. As of mid-June, the probability of a cut at the July meeting has risen to 78% and to 94% by the September meeting. In addition to the aforementioned issues regarding trade and economic growth, inflation indicators have been declining; the Fed’s preferred measure “core PCE” was just 1.6% year-over-year through May (1.7% annualized). Chairman Jerome Powell recently stated that the central bank would “act as appropriate to sustain the expansion”—a clear signal that trade war impacts could be included in the Fed’s decision-making process. Finally, the fact that President Trump and National Economic Director Larry Kudlow have called on the Fed to lower rates by a half a percentage point should be included into the overall equation regarding future interest-rate policy.

The Fed announced at the March FOMC meeting its plans to end the balance sheet normalization sooner than expected and also target a much higher normalized balance sheet going forward than has been anticipated. The Fed’s previous monthly balance sheet roll-off target was $30 billion in Treasury securities and $20 billion in mortgage-backed securities (MBS). Beginning last month, the Fed reduced Treasury roll-off by $15 billion—and any principal payments the Fed receives in its agency and MBS portfolio will be invested in Treasury securities. At the end of September, the Fed’s balance sheet reduction will be complete—with any principal payments from its agency and MBS portfolio reinvested in Treasury securities. We estimate that the Fed’s portfolio will stand near $3.75 trillion once this process is complete. (Source: WFII).

Employment cost index releases should continue to spawn market volatility; recent monthly unemployment reports have reached the lowest levels in 50 years and year-over-year wage gains exceeding 3.0% have been the best since 2009. These are likely to be much-watched statistics for the remainder of the year along with their inferred implication for Fed monetary policy decisions.

Acting less than three months after it phased out a 2.6 trillion euro bond-buying program, the ECB introduced surprise plans to stimulate the European economy: (1) Pushing an interest-rate increase into 2020 at the earliest, after previously suggesting one might come this year, (2) Issuing more targeted long-term refinancing operations—TLTROs—to provide cheap funding to European banks until 2023, and (3) Roll over in full maturing bonds acquired under its QE program. In addition, ECB president Mario Draghi opened the door to interest-rate cuts for the Eurozone economy. Inflation in the region is expected to pick up gradually from its current level of 1.2%. The ECB aims to keep inflation close to but below 2% over the medium term.

We feel that markets will remain focused on the progress of inflation and the Fed’s comments surrounding economic health. Statements following the Federal Reserve’s May meeting focused on the fact that both overall inflation—and core inflation, excluding food and energy—have declined. Currently, both are below the Fed’s long-term target of 2%.

Markets will also continue to scrutinize ECB President Mario Draghi’s comments. After unveiling the aforementioned new stimulus plan, Mr. Draghi blamed the Eurozone’s weakness on external factors—protectionism, geopolitical uncertainty and fragility in some emerging economies.
Key Market Events (Continued)

Techlash

After a dismal May, technology stocks posted their best six-day stretch in seven years in June, driven by the end of threatened U.S. tariffs on Mexico, alongside optimism that the Federal Reserve will soon lower interest rates. Nevertheless, the tech sector will likely continue to experience greater volatility relative to other equity sectors. High profile (and continued) hacks, data misuse announcements and global regulators continue to plague many top companies in this sector. Consider the following recent announcements:

• The Justice Department has assumed antitrust oversight for Google and Apple Inc., while the Federal Trade Commission will focus on Facebook, Inc. and Amazon Inc. The Judiciary Committee in Congress is also set to investigate competition in digital markets.

• The tech giants are spending significant sums of money on lobbyists, a combined $55 million in 2018, about double what they spent in 2016.

• China announced repercussions on tech firms that respond too aggressively to U.S. trade restrictions—a direct response to the U.S. move on Huawei.

• There is a rare bipartisanship between Republicans and Democrats regarding anticompetitive behavior by large tech companies.

• Google announced it was dropping its lobbying firm as it faces a number of government investigations into its affairs.

In addition to regulatory issues, tech stocks have come under pressure due to fundamentals; concerns of peak earnings, slowing revenue and high valuations have led to additional volatility for this sector. Indeed, Apple Inc. announced this month that its sales-and-profit slump extended into a second straight quarter—the first time that has happened in more than two years—thanks to falling sales of the iPhone. And Alphabet’s year-over-year quarterly revenue has declined from a peak of 26% last year to 17% in the first quarter of this year, mostly due to increased competition in online advertising.

The European Union is far ahead of the U.S. on this front and has already lodged fines on affected companies from Facebook to Apple. Given the high profile, and growth-valuations that many individual names bear, we expect news flow and market sentiment to continue to buffet the industry on a day to day basis.
**U.S. Economic Data**

According to the U.S. Bureau of Economic Analysis (BEA), GDP rose at a 3.1% annual rate in Q1, the strongest rate of first-quarter growth in four years, and exceeding expectations. Preliminary estimates indicate that Q2 U.S. GDP will advance 1–2% due to inventory and trade, which grew at unsustainable levels in Q1. Overall, U.S. GDP growth is forecast to increase 2.1% in 2019, down from 3.0% in 2018. We believe the latest data inputs support continued growth through 2019: leading economic indicators (LEI), quality corporate bond spreads, and manufacturing surveys are all forecasting solid expansion.

*We believe monitoring incoming data late in a business cycle for signs of acceleration and deceleration is prudent as year 2019 progresses, particularly capital spending by U.S. corporations.*
Non-U.S. Fundamentals

Corporate fundamentals in Europe and Japan have improved, but investors should still be aware of political risks. After British lawmakers refused to endorse Prime Minister Theresa May’s withdrawal package with the EU three times, Nigel Farage’s new Brexit Party subsequently won the European election in the U.K. on a “hard” Brexit platform (leaving the EU without an agreement). Mrs. May was forced to resign, although she will hold office until a successor is picked. Investors face three key issues that weigh heavily on future Brexit negotiations:

1. Conservative Leader Election—There are more than a dozen candidates, who will be narrowed down to two by lawmakers before being voted on by party members in the late summer. Leading the race to succeed Mrs. May as the Conservative leader is Boris Johnson, who says he would threaten to walk away from the EU if Brussels refused to negotiate.

2. U.K. Parliament—Lawmakers are hopelessly divided on Brexit, and can agree on only one thing: They won’t support leaving the EU without a deal.

3. Europe—While the EU can’t stop Britain from walking away, it has repeatedly said it won’t renegotiate the current deal, which has been repeatedly rejected by the U.K. Parliament.

The closer Brexit negotiations reach the deadline for the U.K. to quit the EU without an agreement (October 31st), the more uncertainty it creates for European businesses and capital markets. Another significant risk for investors is a possibility that left-leaning Labor leader Jeremy Corbyn comes to power in the wake of the ongoing Brexit turmoil; Mr. Corbyn is staunchly anti-business and has promised higher taxes.

In the meantime, U.K. firms called on lawmakers to seize on the resignation of Theresa May as an opportunity to break a nearly three-year Brexit impasse.

In France, the “Yellow Vests” have continued to protest every weekend but turnout at the demonstrations has sharply declined. In response to these demonstrations, French President Emmanuel Macron has announced the following:

- Tax-free year-end bonus and a tax exemption on overtime pay
- Pledge to cut income taxes by 5 billion euro
- Plan to boost pensions

Still, Marine Le Pen’s National Front outpolled President Macron’s party and its allies in European elections held in late May—suggesting Mr. Macron continues to face a formidable political challenge from the anti-migrant, euroskeptic party of Ms. Le Pen.

Italy currently has a coalition government formed by two populist parties: Left wing 5 Star movement and the right-wing Lega party, which presents a complicated situation. Indeed, Italy has consistently challenged the EU deficit targets, with the country’s national debt at 132% of gross domestic product—only below Greece and Japan. Moody’s subsequently downgraded Italy’s debt, while Standard and Poors has lowered its “outlook”. The latest plan being floated by Italy’s populist leaders involve paying public-sector suppliers with IOU’s instead of money, a step that Italian euroskeptics have proposed as the starting point for a new currency in case Italy has to leave Europe’s currency union. Nevertheless, the League and 5 Star have stated their desire to keep Italy in the euro and surveys show few Italians support leaving the euro.

The yield on Italy’s 10-year government bond has dropped to 2.4% from 2.9% in 2019, after the country’s economy fell into a technical recession in the last half of 2018 due to a sharp increase in borrowing costs and political uncertainty regarding the standoff with Brussels over its budget plans.

While European governments in general have shifted toward pro-growth policies, investors are keenly aware of intense political divisions within the bloc that could be disruptive. In addition to the aforementioned examples in the U.K., Italy, and France, the leader of Chancellor Merkel’s coalition partner (Andrea Nehles-SPD) resigned citing lack of support in lieu the weak showing in the European elections—prompting speculation that Merkel’s government could fall.
In addition to the trade war with China, which is an economic dispute between the world’s two largest economies, the U.S. is facing several foreign policy tests all at once.

1. In the Middle East, Iran is threatening to ramp up its nuclear program and, according to U.S. intelligence, has prepared to attack American forces. U.S. Secretary of State Mike Pompeo has charged Iran with responsibility for the attack on two oil tankers in the Gulf of Oman.

2. North Korea is again testing short-range missiles, after the failed February summit meeting in Hanoi. U.S. authorities recently seized a North Korean ship they allege Pyongyang used to transport coal in violation of U.S. and international sanctions.

3. In Latin America, Venezuela’s authoritarian regime has steadfastly held onto power, with Russian and Cuban backing. Venezuelan opposition leader Juan Guaido has instructed his political envoy in Washington to immediately open relations with the U.S. military.

4. The mass protests in Hong Kong warrant close monitoring by investors. President Xi has reasserted unbending control over Chinese politics that is being challenged by demonstrators against a proposed extradition bill.

Global “hot spots” with the potential to quickly evolve into a military confrontation could provide additional strains on capital markets and thus require close monitoring.
Notable Observations

Does Deficit Spending Matter?

When the Tax Cuts and Jobs Act tax cut was passed in late 2017, the theory was that increased revenue from growth would offset the cuts to income tax rates, allowing the U.S. deficit to shrink. The most recent read on the deficit, however, showed a 67% increase over the last four years as shown in the chart below. While some appear to be raising this deficit spending as a political issue for next year’s elections, voters have historically shown little concern over budget deficits at the voting booths. Given the trade and geopolitically induced hits to business psyches the mismatch has the potential to widen further.

Chart 1: Congressional Budget Office: Federal Budget Surplus/Deficit 1965 to 2019

Dynamic Allocation Summary

Global Equities Outlook Overview

**U.S. Large Cap Equities**

**Outlook:** Mixed Positive

Macro and fundamental inputs continue to favor U.S. large-cap equities. Valuations have returned to average after the strong rebound in early 2019, and in instances where clients are in need of capital, we would consider taking profits in this asset class, if the client is above target weights. At the same time, if U.S. large-cap stocks were to experience additional volatility, we would consider this a potential opportunity to invest at more attractive prices.

**U.S. Small Cap Equities**

**Outlook:** Neutral

We have a neutral weighting on domestic small cap equities. Valuations are deemed expensive relative to larger companies, and lower profit margins make this equity class more vulnerable later in the cycle when wages tend to increase. Active management is favored to generate alpha in this space.

**Developed Market Equities**

**Outlook:** Neutral

Developed market equities have been downgraded to neutral. Although we are not forecasting a recession, economic growth in Europe is expected to decelerate further in 2019. Rising corporate profits and reasonable valuations warrant a target weight in developed equities.

**Emerging Market Equities**

**Outlook:** Neutral

We have become more optimistic on emerging market equities due to strengthening currencies and stabilizing commodity prices, along with attractive valuations. A potential slowdown in China and future stability of the Yuan are potential risks.

**Outlook Ratings**

The color-coded rating system applies to specific inputs only (Macro, Fundamentals, Valuations, and Market Environment) and represents the current and shorter-term (three to six months) outlook for the specific inputs based on qualitative data and recommendations from the Abbot Downing Asset Allocation Committee. It is intended to provide guidance to the Abbot Downing Portfolio Construction Team. The content does not represent a buy, hold, or sell recommendation for specific asset classes.
Dynamic Allocation Summary

U.S. Investment Grade Fixed Income

**Outlook:** Neutral

We feel that yields of investment-grade bonds (Treasuries, municipals, and corporates) have moved into fair value range, and are supported by expectations that the Fed will continue to be cautious; markets currently anticipate at least one rate cut in 2019.

Non-Investment Grade Fixed Income

**Outlook:** Neutral

We remain constructive on preferred stock securities based on healthy yield premiums versus investment-grade bonds. Valuations have become expensive in the high-yield asset class.

International Fixed Income

**Outlook:** Negative

We believe near zero yields on many developed country sovereign debt issues warrant caution for this sector. Emerging market bond spreads are now near their long-term historical averages.

Real Estate Investment Trusts (REITs)

**Outlook:** Neutral

We have downgraded REITs to neutral, as they have become more sensitive to interest rate moves. REIT fundamentals remain solid and exhibit attractive valuations, but are more vulnerable late in a business cycle. REITs currently sell at a 4.2% premium to underlying real estate holdings.

Master Limited Partnerships (MLPs)

**Outlook:** Positive

MLPs were stable during the recent plunge in oil prices, and year-to-date are outperforming most risk assets. Current MLP yields of near 8% are also attractive on both an absolute and relative basis. Finally, active management is favored in this space due to the recent FERC ruling and risk of C-corp conversion.

Outlook Ratings
Disclosures

Risk Considerations

Past performance does not indicate future results. The value or income associated with a security or an investment may fluctuate. There is always the potential for loss as well as gain. Investments discussed in this report may be unsuitable for some investors depending on their specific investment objectives and financial position.

Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses. Your individual allocation may be different than the strategic long-term allocation above due to your unique individual circumstances but is targeted to be in the allocation ranges detailed. The asset allocation reflected above may fluctuate based on asset values, portfolio decisions, and account needs.

Investing in commodities is not suitable for all investors. Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Convertible securities are subject to the same interest rate, price and credit risks as regular debt securities. Prices tend to be inversely affected by changes in interest rates. In addition, a convertible security is also subject to the risks associated with common stocks. The return and principal value of stocks fluctuate with changes in market conditions.

Alternative investments, such as hedge funds, carry specific investor qualifications which can include high income and net worth requirements as well as relatively high investment minimums. They are complex investment vehicles which generally have high costs and substantial risks. The high expenses often associated with these investments must be offset by trading profits and other income. They tend to be more volatile than other types of investments and present an increased risk of investment loss. There may also be a lack of transparency as to the underlying assets. Alternative investments are subject to fewer regulatory requirements than mutual funds and other registered investment company products and thus may offer investors fewer legal protections than they would have with more traditional investments. Additionally, there may be no secondary market for alternative investment interests and transferability may be limited or even prohibited. Other risks may apply as well, depending on the specific investment product. Please carefully review the prospectus, private placement memorandum or other offering documents for complete information regarding terms, including all applicable fees, as well as risks and other factors you should consider before investing.

Investments in fixed-income securities are subject to interest rate and credit risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond’s price. Credit risk is the risk that an issuer will default on payments of interest and principal. High yield fixed income securities are considered speculative, involve greater risk of default, and tend to be more volatile than investment grade fixed income securities. Municipal bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. They are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Mortgage-related and asset-backed securities are subject to prepayment risks.Changes in prepayments may significantly affect yield, average life and expected maturity.

Currency hedging is a technique used to seek to reduce the risk arising from the change in price of one currency against another. The use of hedging to manage currency exchange rate movements may not be successful and could produce disproportionate gains or losses in a portfolio and may increase volatility and costs.

Investing in foreign securities presents certain risks that may not be present in domestic securities. For example, investments in foreign, emerging and frontier markets present special risks, including currency fluctuation, the potential for diplomatic and potential instability, regulatory and liquidity risks, foreign taxation and differences in auditing and other financial standards.

Master Limited Partnerships (MLPs) involves certain risks which differ from an investment in the securities of a corporation. MLPs may be sensitive to price changes in oil, natural gas, etc., regulatory risk, and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes which would reduce the amount of cash flows distributed by the MLP. Other risks include the volatility associated with the use of leverage; volatility of the commodities markets; market risks; supply and demand; natural and man-made catastrophes; competition; liquidity; market price discount from Net Asset Value and other material risks.

There are special risks associated with investing in preferred securities. Preferred securities are subject to interest rate and credit risks and are generally subordinated to bonds or other debt instruments in an issuer’s capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Private debt has speculative characteristics that include potential default, limited liquidity and the infrequent availability of independent credit ratings for private companies.
Disclosures (Continued)

There are risks associated with investments in private companies. Such companies are not subject to SEC reporting requirements and are not required to maintain effective internal controls over financial reporting. These companies may have limited financial resources; shorter operating histories; more asset concentration risk; narrower product lines and smaller market shares that larger companies. In addition, securities issued by private companies are typically illiquid and there may be no readily available trading market for such securities.

Investing in real estate involves special risks, including the possible illiquidity of the underlying property, credit risk, interest rate fluctuations and the impact of varied economic conditions.

The prices of small cap and mid cap company stocks are generally more volatile than large cap company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Treasury Inflation-Protected Securities (TIPS) are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the “inflation compensation” component of the principal. A holder of TIPS may be required to report this income annually although no income related to “inflation compensation” is received until maturity.

There is no assurance that any of the target prices or other forward-looking statements mentioned will be attained.

Index and Other Definitions

An index is unmanaged and not available for direct investment. Inflation is the change in the Consumer Price Index (CPI). The CPI measures the price of a fixed basket of goods and services purchased by an average consumer.

Core inflation is the change in the core Consumer Price Index (CPI). The core CPI measures the price of a fixed basket of goods and services—excluding the volatile food and energy components—purchased by an average consumer.

Alpha is a coefficient measuring the risk-adjusted performance, considering the risk due to the specific security, rather than the overall market. A large alpha indicates that the stock or mutual fund has performed better than would be predicted given its beta (volatility).

Beta measures a security’s or group of securities’ (portfolio’s) volatility relative to a benchmark. A result greater than 1.0 implies that the security or portfolio is more volatile than the benchmark; a result less than 1.0 suggests that the security or portfolio is less volatile than the benchmark. Betas may change over time.

Conference Board’s Leading Economic Index (LEI) is a composite economic index designed to signal peaks and troughs in the business cycle. The leading economic index is essentially a composite average of several individual leading indicators. They are constructed to summarize and reveal common turning point patterns in economic data in a clearer and more convincing manner than any individual component—primarily because they smooth out some of the volatility of individual components.

Consumer Confidence Index® (CCI) is a barometer of the health of the U.S. economy from the perspective of the consumer. The index is based on consumers’ perceptions of current business and employment conditions, as well as their expectations for six months hence regarding business conditions, employment, and income.

Markit Manufacturing Purchasing Managers Index (PMI) tracks manufacturing and service sector activity in the Eurozone. An index value over 50 indicates expansion; below 50 indicates contraction. The values for the index can be between 0 and 100.

PMI Surveys, such as the Eurozone Manufacturing PMI, track sentiment among purchasing managers at manufacturing, construction and/or services firms. An overall sentiment index is generally calculated from the results of queries on production, orders, inventories, employment, prices, etc.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output.

The Market Volatility Index (VIX) is an index designed to track market volatility as an independent entity. The index is calculated based on option activity and is used as an indicator of investor sentiment, with high values implying pessimism and low values implying optimism.

The Institute of Supply Management (ISM) Manufacturing Index® is a composite index based on the diffusion indexes of five of the indexes with equal weights: New Orders (seasonally adjusted), Production (seasonally adjusted), Employment (seasonally adjusted), Supplier Deliveries (seasonally adjusted), and Inventories. An index values over 50 indicate expansion; below 50 indicates contraction. The values for the index can be between 0 and 100.

The U.S. Dollar Index (USDX, DXY) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners’ currencies.

Real economic growth is the change in the gross domestic product (GDP) adjusted for inflation—that is, the volume of services and goods produced in the United States.
Disclosures

West Texas Intermediate Crude Oil is a light, sweet (i.e., low sulfur) crude oil which is the main type of U.S. crude oil traded in U.S. futures markets.

Brent Crude Oil is a light, sweet crude oil extracted from the North Sea. It serves as a major benchmark price for purchases of oil worldwide.

Bond credit rating. A grade given to bonds that indicates their credit quality. Private independent rating services such as Standard & Poor's, Moody's and Fitch provide these evaluations of a bond issuer's financial strength, or its the ability to pay a bond's principal and interest in a timely fashion. The general meaning of these credit rating opinions are as follows:

AAA—Extremely strong capacity to meet financial commitments. Highest Rating.

AA—Very strong capacity to meet financial commitments.

A—Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.

BBB—Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.

Global Fixed Income Representative Indices

Global Multiverse Fixed Income: Bloomberg Barclays Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index represents the union of the Global Aggregate Index and the Global High-Yield Index and captures investment grade and high yield securities in all eligible currencies. Standalone indices such as the Euro Floating-Rate ABS Index and the Chinese Aggregate Index are excluded. The Multiverse Index family includes a wide range of standard and customized sub-indices by sector, quality, maturity, and country. JP Morgan Global Ex United States Bond Index is a total return, market capitalization weighted index, rebalanced monthly consisting of the following countries:

Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, United Kingdom, Denmark, Netherlands, and France.


U.S. Treasury Bills Fixed Income: Bloomberg Barclays U.S. Treasury Bills includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than three months and more than one month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and non-convertible.

Short, Intermediate and Long Term Fixed Income: Bloomberg Barclays U.S. Aggregate Bond Index is made up of the Bloomberg Barclays U.S. 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.

U.S. Treasury Fixed Income: Bloomberg Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

U.S. Corporate Fixed Income: Bloomberg Barclays U.S. Corporate Bond Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

U.S. Municipal Fixed Income: Bloomberg Barclays U.S. Municipal Bond Index represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, and a remaining maturity of at least one year. The Index excludes taxable municipal bonds, bonds with floating rates, derivatives, and certificates of participation.

U.S. TIPS Fixed Income: Bloomberg Barclays Treasury Inflation Protected Securities (TIPS) Index includes all publicly issued, investment-grade U.S. TIPS with an outstanding face value of more than $250 million and that have at least one year to maturity.

U.S. High Yield Fixed Income: Bloomberg Barclays U.S. High Yield Bond Index is an unmanaged index that tracks the performance of below investment grade U.S.-dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

Developed ex. U.S. Fixed Income: JPMorgan GBI Global ex-U.S. (Unhedged) in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.

Emerging Market Spread: Bloomberg Barclays EM USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set. Country eligibility and classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. This index was previously called the Bloomberg Barclays U.S. EM Index and history is available back to 1993.

Emerging Market Bond (U.S. Dollar): JPMorgan Emerging Markets Bond Index (EMBI Global) currently covers 27 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

Preferred Stock: S&P Preferred Stock is an unmanaged index consisting of U.S.-listed preferred stocks.

U.S. Dollar Index (USDX) measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.
Global Equity Representative Indices

Global Market Equity: MSCI AC World 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 Index consists of 46 country indices comprising 23 developed and 23 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, United Kingdom, and the United States. The emerging market country indices included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

Dow Jones Industrial Average is a price-weighted index of 30 “blue-chip” industrial U.S. stocks.

NASDAQ Composite Index measures the market value of all domestic and foreign common stocks, representing a wide array of more than 5,000 companies, listed on the NASDAQ Stock Market.

Large Cap Equity: S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation, and financial companies.

Large Cap Equity (Growth): Russell 1000® Growth Index measures the performance of those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values.

Large Cap Equity (Value): Russell 1000® Value Index measures the performance of those Russell 1000® companies with lower price-to-book ratios and lower forecasted growth values.

Mid Cap Equity: Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

Small Cap Equity: Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000® Index.

Developed Market ex. U.S. Equity: MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The Index consists of the following 21 developed market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

Emerging Markets: MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: 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.

Frontier Market Equity: MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index consists of the following 24 frontier market country indexes: Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Morocco, Kazakhstan, Mauritius, Nigeria, Oman, Pakistan, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine, and Vietnam. The MSCI Saudi Arabia Index is currently not included in the MSCI Frontier Markets Index but is part of the MSCI Gulf Cooperation Council (GCC) Countries Index. The MSCI Bosnia Herzegovina Index, the MSCI Botswana Index, the MSCI Ghana Index, the MSCI Jamaica Index, the MSCI Palestine IMI, the MSCI Trinidad & Tobago Index, and the MSCI Zimbabwe Index are currently stand-alone country indexes and are not included in the MSCI Frontier Markets Index. The addition of these country indexes to the MSCI Frontier Markets Index is under consideration.
Disclosures (Continued)

Global Real Assets Representative Indices

Global REITs: FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide.

Domestic REITs: FTSE NAREIT U.S. All Equity REITs Index is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

International REITs: FTSE EPRA/NAREIT Developed ex-U.S. Index is designed to track the performance of listed real estate companies in developed countries worldwide other than the United States.

MLPs: Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships (MLPs) that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated real-time on a price-return basis and on a total-return basis.

Commodities (S&P GSCI): S&P Goldman Sachs Commodity Index is a trade-weighted index of commodity sector returns representing unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The index includes futures contracts on 24 physical commodities, of which Energy represents nearly 70%.

Commodities (BCOM): Bloomberg Commodity Index represents futures contracts on 19 physical commodities. No related group of commodities (e.g., energy, precious metals, livestock and grains) may constitute more than 33% of the index as of the annual reweighing of the components. No single commodity may constitute less than 2% of the index.

Commodities (RICI): The Rogers International Commodity Index is a U.S. dollar based index representing the value of a basket of commodities consumed in the global economy. Representing futures contracts on 37 physical commodities, it is designed to track prices of raw materials not just in the U.S. but around the world.

Global Alternative Investments Representative Indices

Global Hedge Funds: HFRI Fund Weighted Composite Index. A global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. Dollars and have a minimum of $50 million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

Relative Value Arbitrage: HFRI Relative Value (Total) Index. Strategy is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative, or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. RV position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

Arbitrage: HFRI RV: Fixed Income Sovereign Index. Includes strategies predicated on realization of a spread between related instruments in which one or multiple components of the spread is a sovereign fixed income instrument. Strategies employ an investment process designed to isolate attractive opportunities between a variety of fixed income instruments, typically realizing an attractive spread between multiple sovereign bonds or between a corporate and risk-free government bond. Fixed Income Sovereign typically employ multiple investment processes including both quantitative and fundamental discretionary approaches and relative to other Relative Value Arbitrage sub-strategies, these have the most significant top-down macro influences, relative to the more idiosyncratic fundamental approaches employed.

Long/Short Credit: HFRI RV: Fixed Income—Corporate Index. Includes strategies predicated on realization of a spread between related instruments in which one or more components of the spread is a corporate fixed-income instrument. Strategies are designed to isolate attractive opportunities between a variety of fixed income instruments, typically realizing an attractive spread between multiple corporate bonds or between a corporate and risk-free government bond. They typically involve arbitrage positions with little or no net credit market exposure, but are predicated on specific, anticipated idiosyncratic developments.
Structured Credit/Asset Backed: HFRI RV: Fixed Income—Asset Backed Index. Includes strategies predicated on realization of a spread between related instruments in which one or multiple components of the spread is a fixed-income instrument backed by physical collateral or other financial obligations (loans, credit cards) other than those of a specific corporation. Strategies are designed to isolate attractive opportunities between a variety of fixed income instruments specifically securitized by collateral commitments, which frequently include loans, pools and portfolios of loans, receivables, real estate, machinery, or other tangible financial commitments. Investment thesis may be predicated on an attractive spread given the nature and quality of the collateral, the liquidity characteristics of the underlying instruments and on issuance and trends in collateralized fixed-income instruments, broadly speaking. In many cases, investment managers hedge, limit, or offset interest-rate exposure in the interest of isolating the risk of the position to strictly the disparity between the yield of the instrument and that of the lower-risk instruments.

Macro: HFRI Macro (Total) Index. Encompass a broad range of strategies predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard-currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches and long- and short-term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments rather than on realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

Systematic Macro: HFRI Macro: Systematic Diversified Index. Diversified strategies employing mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies are designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative processes which focus on statistically robust or technical patterns in the return series of the asset, and they typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean-reverting strategies. Although some strategies seek to employ counter-trend models, strategies benefit most from an environment characterized by persistent, discernible trending behavior. Typically have no greater than 35% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

Discretionary Macro: HFRI Macro: Discretionary Thematic Index. Strategies primarily rely on the evaluation of market data, relationships and influences, as interpreted by individuals who make decisions on portfolio positions; strategies employ an investment process most heavily influenced by top-down analysis of macroeconomic variables. Investment Managers may trade actively in developed and emerging markets, focusing on both absolute and relative levels on equity markets, interest rates/ fixed income markets, currency and commodity markets; they frequently employ spread trades to isolate a differential between instrument identified by the Investment Manager as being inconsistent with expected value. Portfolio positions typically are predicated on the evolution of investment themes the Manager expects to develop over a relevant time frame, which in many cases contain contrarian or volatility-focused components.

Event Driven: HFRI Event Driven (Total) Index. Maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated and frequently involve additional derivative securities. Exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental (as opposed to quantitative) characteristics, with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

Activist: HFRI ED: Activist Index. Strategies may obtain or attempt to obtain representation on the company’s board of directors in an effort to impact the firm’s policies or strategic direction and in some cases, may advocate activities such as division or asset sales, partial or complete corporate divestiture, dividends or share buybacks, and changes in management. Strategies employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies that are currently or prospectively engaged in a corporate transaction, security issuance/ repurchase, asset sales, division spin-off, or another catalyst-oriented situation. These involve both announced transactions and situations in which no formal announcement is expected to occur. Activist strategies would expect to have greater than 50% of the portfolio in activist positions, as described.
Distressed Credit: HFRI ED: Distressed/Restructuring Index. Strategies focus on corporate fixed-income instruments, primarily corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceedings or financial-market perception of near-term proceedings. Managers are typically actively involved with the management of these companies; they are frequently involved on creditors’ committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments that are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.

Merger Arbitrage: HFRI ED: Merger Arbitrage Index. Strategies primarily focus on opportunities in equity and equity-related instruments of companies that are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations in which no formal announcement is expected to occur. Opportunities are frequently presented in cross-border, collared, and international transactions that incorporate multiple geographic regulatory institutions, typically with minimal exposure to corporate credits. Strategies typically have over 75% of positions in announced transactions over a given market cycle.

Equity Hedge: HFRI Equity Hedge (Total) Index. Equity Hedge Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

Directional Equity: HFRX EH: Multi-Strategy Index. Managers maintain positions both long and short in primarily equity and equity-derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios. Managers typically do not maintain more than 50% exposure to any one Equity Hedge sub-strategy.

Equity Market Neutral: HFRI EH: Equity Market Neutral Index. Strategies employ sophisticated quantitative techniques to analyze price data to ascertain information about future price movement and relationships between securities. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies predicated on the systematic analysis of common relationships between securities. In many cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high-frequency techniques may be employed; trading strategies may also be based on technical analysis or designed opportunistically to exploit new information that the investment manager believes has not been fully, completely, or accurately discounted into current security prices. Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.

Cambridge Associates LLC U.S. Private Equity Index® is an end-to-end calculation based on data compiled from 1,152 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2014. Pooled end-to-end return, net of fees, expenses, and carried interest. The latest published returns data are as of September 30, 2014. Note: While the HFRI Indices are frequently used, they have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information hedge fund managers decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.
Citations

7. C-suite gets its name from the titles of top senior staffers, which tend to start with the letter C, for “chief,” as in chief executive officer (CEO), chief financial officer (CFO), chief operating officer (COO), and chief information officer (CIO).
8. Please contact your Abbot Downing Relationship Manager to request a copy of the September 2017 Abbot Downing Strategy Report.

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