It's Different This Year: Investors and economists are expressing increasingly divergent opinions about the direction of markets and the economy, as they struggle to evaluate the looming risks of softening growth, rising inflation, and emerging trade conflict. In our last Outlook, we noted that the tax reform plan would clearly increase corporate earnings, but we questioned whether it would have any significant effect on broader economic growth. In January, investors enthusiastically incorporated early information about tax-related earnings increases, driving up U.S. stock prices and elevating valuations. By the end of January, these tax-related earnings boosts were fully incorporated, and investors turned their attention to potential risks. These risks include the expansionary budget bill passed when the economy is already at full employment, and the impact this may have on future inflation and interest rates. In February, softer economic data and international trade tensions intensified these concerns, and stock market volatility moved sharply higher relative to 2017's extraordinary lows. U.S. stock prices fell more than 10% in less than two weeks, then fluctuated through the remainder of the quarter.

Looking forward, we believe investors will increasingly focus on indications of potential inflation and labor market imbalances, while the rapidly approaching mid-term elections will add another layer of uncertainty. As investors seek to weigh hope for positive economic benefits from tax reform against concern about potential inflation overheating and political risks, we believe that the neutral asset class and sector positioning we established several quarters ago remains the appropriate strategy for balancing ongoing risks and opportunities.

Data at High Levels, but Softening: In 2017, a succession of new highs in the Citi Economic Surprise Index led investors to repeatedly elevate their expectations for economic data. This process is inherently unsustainable. As we have described in the past, this index tracks the difference between consensus expectations and reported data. Economic data points remained at a solid level in the first quarter of the year, but failed to accelerate as they had in 2017. Likewise, surveys measuring consumer, business, and investor confidence each softened slightly during the quarter. The much-hyped tax reform plan largely underwhelmed consumers, as only 24% attributed a paycheck increase to the tax reform, according to a Bankrate report. Surveys of business activity, such as the ISM, indicate somewhat softened demand combined with higher prices, at the same time that businesses confront a dearth of available skilled labor in the context of the low unemployment rate. After the announcement of international steel and aluminum tariffs, businesses reported an immediate increase to their input costs, as well as concerns over retaliatory tariffs and their potential to affect demand for U.S. exports. As data points in the first quarter failed to reach the lofty levels of the surprise index, earnings multiples began to contract, and sentiment has retreated to more modest levels.

These trends are all consistent with late-cycle economic headwinds. At the same time, the steady increase in interest rates that the Federal Reserve initiated in 2015 conflicts with the new fiscal stimulus from the budget plan and the deficit-financed tax reform.

Trade Policy Risks: Throughout 2017, financial markets seemed to focus exclusively on the pro-business elements of President Trump's tax and regulatory positions, while discounting the economic risks of his protectionist trade rhetoric. This quarter brought the economic risks to center stage, as Trump launched rhetorical and policy-based attacks on the U.S. trade gap, especially with respect to China.

Our first concern regarding this agenda is the likelihood of a lose-lose outcome. Though Trump has boasted about the ease of winning trade wars, we note that his administration had not yet finalized the terms of its first round of China-specific tariffs by the time China implemented retaliatory tariffs on 128 U.S. products. We see no reason why China would respond differently or less swiftly to future trade threats, and believe that any trade war escalation will be mutually damaging to the U.S. and Chinese economies.

Our second concern on this topic is the distributional effect of politically motivated tariffs. Recent tariffs on steel and aluminum imports offer a targeted benefit to U.S. metal producers and a broad disadvantage to U.S. consumers and to businesses dependent on metals as inputs. In response, the retaliatory tariffs implemented by China target U.S. farmers. The Trump administration has announced that its next tariffs will target China's advanced technology and engineering sectors, attempting to advantage the equivalent U.S. sectors at the expense

of consumers. We believe that a more sustainable policy-based approach to supporting advanced technology industries would emphasize the training and recruitment of skilled labor, especially given that businesses are increasingly struggling to find qualified workers. While recent tensions may ultimately give way to a more considered trade agreement, the intermediate risks to financial markets are real and significant.

First Quarter Performance: In contrast to the strong and steady performance of 2017, financial markets saw significant volatility in the first quarter, and produced broadly negative returns for the first time since 2015. Investors refocused on potential risks, and bounced rapidly between emphasizing cyclical themes and defensive themes. Small capitalization and emerging market stocks were the only segments with positive returns. The S&P 600 Small Cap Index returned +0.55%, and the MSCI Emerging Markets Index returned +1.38%. In contrast, the S&P 500 declined -0.76%, and the MSCI All Country World index excluding the U.S. dropped -1.10% for U.S. investors. Overall, growth themes outperformed value, with the Russell 1000 Growth Index rising +1.41% and the Russell 1000 Value falling -2.83%. Even though West Texas Intermediate oil prices rose by +7.48%, investors appeared skeptical about the persistence of this increase, and the energy sector lost -5.88%. Only the consumer discretionary and technology sectors of the S&P 500 ended the quarter with positive returns.

Bond yields rose during the quarter, especially for shorter duration bonds, as the Federal Reserve raised the Federal Funds rate again in March. Ten-year government bonds ended the quarter with a yield of 2.77%, just 0.48% more than two-year bonds. The Barclays Government/Credit Intermediate Index declined -0.98% over the quarter, while the Barclays Municipal Index ended down -1.11%. Even though bond yields have risen, we believe that bonds offer only limited potential appreciation at this time.

Valuation and Positioning: At the start of the year, most investors seemed to believe that higher earnings would be the primary factor explaining market performance in 2018. While companies did report strong earnings and raised their earnings forecasts by an average of 9.5% during the quarter, the contraction of multiples resulting from data and trade risks overwhelmed these changes. The price-to-earnings ratio of the S&P 500 contracted from 18.2 times next twelve month earnings at the end of 2017 to 16.4 times at the end of the first quarter, eclipsing the positive impact of higher earnings numbers. The cyclically-adjusted P/E ratio, meanwhile, decreased to 32.8, still one standard deviation above the 25-year average. This suggests that stock market returns for the next five years may be below their historical average. The earnings yield of the S&P 500 rose to 5.9% during the quarter, while 10-year TIPS yields increased to 0.7%, predicting that stocks will return approximately 5.2% more than bonds in the next year. Further compression of earnings multiples is possible, even in the context of moderate economic growth. For example, if valuations compressed to a level one standard deviation below the 25-year average, stock prices could fall by as much as 25%, even in the face of continued earnings growth. However, if economic growth continues, we would expect a relatively rapid recovery from this. We believe that our current neutral equity exposure appropriately balances the possibility of continued market growth with the economic and policy risks that have been increasingly affecting markets.

We continue to monitor labor market tension and its potential impact on economic growth. Both existing income levels and early signs of wage inflation are very unevenly distributed. While a number of companies announced that they were distributing bonuses to their employees as result of the tax plan, very few offered sustained wage or salary increases. In contrast, many more companies announced share buybacks and dividend increases, which we expect to filter through to increased CEO pay. Sustainable economic growth, however, requires broadly distributed economic benefits, and we applaud the new and long overdue SEC requirement that companies disclose their CEO's pay as a multiple of their median employee's pay. We expect that this subject, and the unequal distributional effects of tax reform, will receive increasing attention as we approach midterm elections, and may add to investor anxiety about the unstable foundation of continuing economic growth.