Global Asset Allocation Viewpoints and Investment Environment

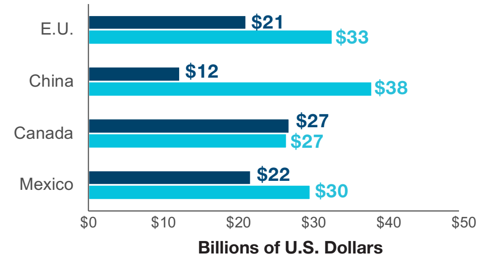
JULY 2018

1 MARKET THEMES As of 30 June 2018

TRADE WARS: CEASE-FIRE OR ARMAGEDDON?

With trade wars escalating, markets are becoming more concerned about when and how it all ends. For now, the U.S. and China appear locked in a tit-for-tat escalation of tariffs, with the European Union and Canada joining the battle by retaliating with targeted tariffs on U.S. goods, and NAFTA undergoing renegotiation. While the U.S. economy is less reliant on trade than most of its trade partners, targeted tariffs could have significant impacts on certain U.S. sectors and companies. For certain, tariffs raise costs, can pressure margins and result in higher prices. While the U.S. may feel it has the upper hand given its trade deficits with China and the EU, tariffs are not the only weapons available—targeted actions on foreign companies, unwinding U.S. treasury holdings and currency manipulation do not seem out of scope. While it is difficult to gauge the impacts on markets given the current dynamics, things could certainly get a lot worse with battles opening on multiple fronts and the choice of weapons expanding.

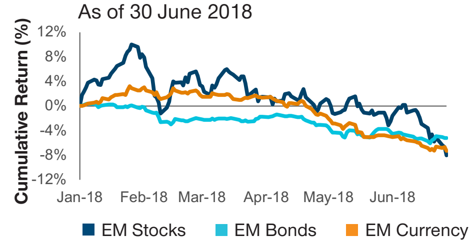
U.S. TRADE BY COUNTRY/REGION
As of 31 May 2018



A SCORCHING SUMMER AHEAD FOR EMS?

Emerging markets debt, equity and currency markets are feeling the heat from a growing list of concerns. With the recent escalation in trade wars, investors are selling emerging markets assets as uncertainty over the outcome grows. Beyond trade wars, liquidity has fallen as developed market central banks—led by the Fed—unwind accomodation, the U.S. dollar has strengthened and interest rates are higher. Some emerging countries are already being forced to raise rates to defend their currencies. With several upcoming key elections, a resilient U.S. Fed and no end in sight on trade wars, it may be a scorching summer for a few emerging markets countries. On the bright side, the broad sell-off seems to have priced in much of the risks and some less vulnerable countries are looking attractive.

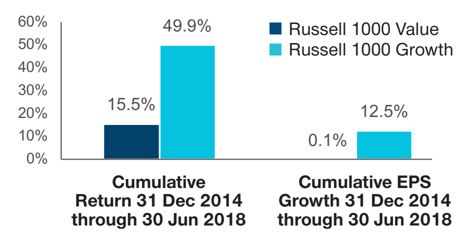
EMERGING MARKETS RETURNS[1]
As of 30 June 2018



WHAT COULD DE-THRONE GROWTH (STOCKS)?

Continued strong relative performance in the technology and consumer discretionary sectors has helped advance a multi-year lead for growth relative to value stocks. Since the end of 2014, growth-oriented stocks in the U.S. are up nearly 50%, more than tripling the return of value stocks. Growth stocks have undoubtedly benefitted from the low growth economic environment where investors sought "durable growers" in lieu of more cyclical sectors, but they have also delivered vastly superior earnings growth. However, the advance has been primarily driven by a narrow list of technology-oriented companies that now hold elevated valuations. Trade wars may cause investors to question these elevated valuations, with technology supply chains vulnerable to escalation of the U.S.-China trade dispute.

U.S. GROWTH VS. VALUE



2 PORTFOLIO POSITIONING

EQUITY

- We increased our underweight to equities as valuations remain elevated against a backdrop of receding global liquidity, higher rates, an aging U.S. economic cycle and rising trade tensions. While valuations are more attractive than levels seen at the start of the year, key factors that supported earnings, including tax reform, a weaker U.S. dollar and higher energy prices will likely be less of a tail-wind going forward.
- We trimmed our overweight to developed markets outside the U.S. amidst signs of moderating growth, rising trade tensions and resurgence in political risk. Valuations outside the U.S. are modestly more attractive and the regions are still supported by monetary policy, however economic growth momentum looks to have peaked near-term.
- We reduced our overweight to value stocks outside the U.S. as catalysts for cyclical sectors to outperform have moderated along with growth expectations. Escalating trade wars, a resurgence in political uncertainty and weakness amongst European financials—a key support for regional growth—all pose headwinds.

FIXED INCOME

- We initiated a modest overweight to long-term U.S. treasuries to mitigate overall risk within our portfolios. Long-duration treasuries can potentially provide efficient downside protection against equity market drawdowns.
- We are underweight to high yield bonds as valuations appear elevated late in the credit cycle amidst high leverage and likely fading support from the recent strong trend in earnings and energy prices.
- We favor floating rate loans relative to high yield bonds. With the Fed expected to continue raising rates this year and possibly into 2019, loans should benefit from their rate reset feature and shorter duration profile.
- We are underweight emerging market-dollar bonds due to risks from rising developed market rates, protectionist trade policies, and increased political uncertainty amongst several key countries.

REAL ASSETS

- We remain underweight real assets equities as we are still cautious on the long-term prospects for energy and commodity prices, given continued advances in productivity growth and fading Chinese demand for industrial metals.
- OPEC's recent agreement with other producers to increase supply by as much as 1 million barrels per day could help moderate supply outages in several countries, including Venezuela and Libya.
- REIT fundamentals are broadly positive, with muted supply growth and healthy levels of occupancy and rental income. However, rising rates may pose a near-term headwind.

Past performance is not a reliable indicator of future returns.
Sources: FactSet Research Systems, All Rights Reserved, J.P. Morgan, [IMF]/Haver Analytics.
[1]Indices used: EM Stocks = MSCI Emerging Markets Index, EM Bonds = JP Morgan EMBI Global Index, EM Currency = JP Morgan EM Currency Index
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3 Regional Backdrop

As of 30 June 2018

	Macro-Economic	Equity Fundamentals	Interest Rates	Currencies
UNITED STATES	▪ In the later stages of the economic cycle, with recession risks low but rising ▪ Pro-cyclical policies of tax reform and deregulation offer near-term support, but late cycle stimulus may result in overheating ▪ Inflation gradually rising amid tighter labor markets, with added pressure from higher oil prices ▪ Aggressive trade policy poses a significant and growing risk, but may ultimately be limited in scope	▪ Valuations above historical averages, with significant bifurcation between winners and losers ▪ Earnings are very strong, but current pace of growth unlikely to be sustainable ▪ Margins could face headwinds from higher rates, wages and input costs ▪ Earnings disappointments are being harshly punished	▪ Short-term rates rising in unison with Fed rate increases, could extend into 2019 ▪ Longer rates volatile, but biased higher over the long term amidst improving growth, rising inflation expectations, expanded budget deficit, and Fed balance sheet unwind	▪ Stabilization of global growth, tighter monetary policy outside the U.S. and valuations are likely headwinds to the medium-term outlook for the dollar ▪ The dollar has continued its strong performance of late, partly driven by softer growth outside of the U.S. Higher relative yields in the U.S. also remain supportive
DEVELOPED EUROPE	▪ Eurozone growth moderating, but expected to stabilize and remain above potential ▪ Rising trade protectionism is a significant risk, most notably for Germany given its export focus ▪ While off their highs, Italian yields remain elevated after the formation of the government, as the market awaits its economic policies	▪ Valuations are modestly attractive relative to the U.S. ▪ Operating leverage provides for further earnings upside potential, with the recent uptrend in earnings expected to continue ▪ European banks showing significant weakness both on an absolute basis and versus other sectors	▪ Sustained growth, recent euro weakness, and further evidence of rising inflation could gradually push rates higher ▪ Recent Italian political events, the lack of progress/acceptance of the Macron reforms to reinforce the Eurozone, and the tension over immigration have re-introduced concerns regarding the sustainability of the E.U.	▪ Political risks, ECB policy, and still lackluster data flow, continue to restrain the euro versus the U.S. dollar ▪ Valuations remain attractive from an exchange rate perspective, and the medium-term economic and ECB policy trajectories remain positive, albiet weakened, drivers
UNITED KINGDOM	▪ Brexit negotiations remain the central issue for growth trajectory ▪ The UK parliament has passed the European Withdrawal Act, which provides for the passage of the UK out of the EU's legal, but not economic or customs, union ▪ UK inflation has declined to its lowest level in a year (2.4%), contributing to higher real wages	▪ UK valuations continue to trade at a discount to other markets ▪ Domestically-driven revenues remain disappointing ▪ Allocations to UK equities by global investors are at extremely low levels	▪ Bank of England signaling support for a rate rise in August, stating that the UK appears to be coming out of its early 2018 weak patch ▪ Over the longer-term, rates will remain dependent on Brexit negotiations and inflation outlook	▪ A slightly more hawkish BOE than expected has supported Sterling versus European counterparts of late, although it has weakend vs. the U.S. dollar ▪ However, despite this and attractive valuations versus history, concerns remain over the long-term political and economic outlook into and out of Brexit
DEVELOPED ASIA & PACIFIC	▪ Trade-driven economies likely to slow as global growth appears to have peaked—though growth remains at healthy levels ▪ Slowdown in Japan continued although some confidence metrics and leading manufacturing indicators are pointing higher ▪ Significant improvement in Prime Minister Abe's approval ratings suggest a stable macro policy outlook for now ▪ Australian economic activity improved from last year with net exports and government spending the main contributors ▪ Easing tensions on the Korean Peninsula may reduce uncertainty in the region	▪ Valuations within the region remain attractive relative to other developed markets, but earnings remain vulnerable to currency and commodity price volatility and a slowdown in global trade ▪ Japanese equities remain supported by better relative valuations, strong earnings growth, and gradually improving corporate governance ▪ Australian equities enjoying a period of strength, driven by mining sector—however, valuations are beginning to appear stretched	▪ A continued rise in global yields could impact long rates in the region ▪ The Bank of Japan continues to reaffirm its accommodative policy, with no change expected in the near-term amid benign inflation ▪ RBA likely to remain on hold with wage growth subdued and inflation below target	▪ Recent risk-off driven strength has moved the yen to the midpoint of its range over the past year ▪ On a medium-term view, the yen remains cheap and external positions are supportive, however U.S. policy and risk sentiment, rather than domestic fundamentals are the current drivers ▪ The Australian dollar has weakened to relatively cheap levels recently due to interest rate differentials and global trade concerns
EMERGING MARKETS	▪ Growth is slowing but not collapsing, likely to stabilize in the latter half of 2018 ▪ Trade protectionism a growing risk, but real impact should be limited as long as the dialogue between U.S. and China continues ▪ Trade war concerns and anticipated economic slowdown should keep Chinese macro policies supportive in the short term. Growth is slowing but remains actively controlled ▪ Idiosyncratic and political risks remain elevated in several key countries— including Mexico, Brazil, Argentina, Venezuela, Malaysia and Turkey	▪ Valuations considerably more attractive, as equities have sold off on trade concerns, U.S. dollar strength, and elevated country-specific risks ▪ Demand for exports is healthy but fading ▪ Earnings growth remains broadly strong, with ROEs broadly improving	▪ Interest rates trending higher as financial conditions tighten in response to rising inflation and higher U.S. rates ▪ Many central banks have shifted from accommodative/neutral to a tightening bias	▪ EM currency valuations have cheapened due to a stronger USD, idiosyncratic factors and notable outflows ▪ U.S. rate policy, global growth, politics and trade will continue to be the major areas of focus for EM

4 Asset Allocation Committee Positioning

As of 30 June 2018

▼ or ▲ Month Over Month Change

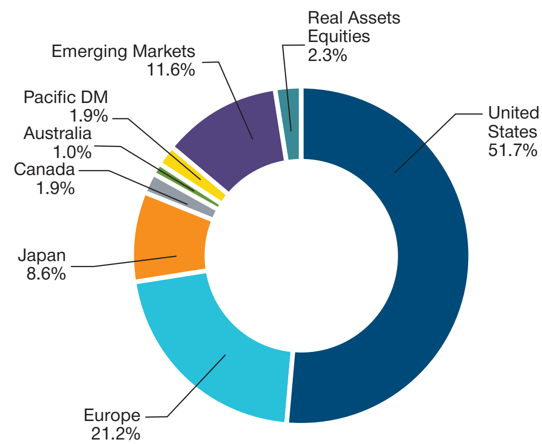
		Change	Underweight	Underweight	Neutral	Overweight	Overweight	These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.
ASSET CLASS	Equities	▼		■				Valuations remain elevated against a backdrop of receding global liquidity, rising rates, an aging economic cycle in the U.S., and rising trade protectionism
ASSET CLASS	Bonds	▲				■		Upward trend in rates may be tempered by demand for yield, still modest growth expectations and increased volatility surrounding trade policies
ASSET CLASS	Cash					■		Yields more attractive as Fed advances rate hikes. Cash can provide a buffer against extended stock and bond valuations
	Regions							
EQUITIES	U.S.	▲		■				Valuations slightly elevated to history, but market leadership has been very narrow. Earnings growth is very strong but likely peaking
EQUITIES	Global Ex-U.S.	▼				■		Attractive valuations relative to U.S., stable economic growth, and positive earnings trends. Increased risks from trade wars and weakness in European financials
EQUITIES	Europe					■		Modestly attractive relative valuations and earnings upside from operating leverage, offset by rising political risks, moderating economic growth, and banking system weakness
EQUITIES	Japan				■			Valuations remain attractive, but dependence on global trade a headwind as global growth momentum has peaked and trade war concerns looming
EQUITIES	Emerging Markets				■			Attractive relative valuations and positive earnings trends are offset by U.S. dollar strength, rising rates, hawkish trade policies, and country-specific risks
	Style							
EQUITIES	U.S. Growth				■			Expect secular growers to continue to benefit in structurally low growth environment, but valuations are elevated, leadership has been narrow with tech supply chains possibly at risk
EQUITIES	U.S. Value				■			Valuations neutral, amidst still modest growth. Tax reform, higher rates, and higher oil prices could be supportive for cyclicals, financials, and energy
EQUITIES	Global Ex-U.S. Growth	▲		■				Relative valuations are above historical averages, particularly within cyclically sensitive areas, most notably industrials
EQUITIES	Global Ex-U.S. Value	▼				■		Relative valuations are attractive, but fundamentals have weakened, most notably within European financials
	Capitalization							
EQUITIES	U.S. Large-Cap			■				Valuations still above historical levels, although less expensive on stronger earnings growth. Tailwind from weaker dollar is fading and trade policy remains a threat
EQUITIES	U.S. Small-Cap					■		Reasonable valuation. Less vulnerable to trade policy and could benefit from tax-related capex spending, and a pick-up in mergers and aquisitions
EQUITIES	Global Ex-U.S. Large-Cap					■		Valuations are attractive relative to small-cap, with earnings upside due to depressed margins. Cautious on trade policy risks and fading global growth
EQUITIES	Global Ex-U.S. Small-Cap			■				Valuations have become more challenging and may be susceptible to fading liquidity, while domestic growth trends are moderating
	Inflation-Sensitive							
EQUITIES	Real Asset Equities		■					Energy supply/demand imbalances and fading Chinese metals demand remain headwinds. REITs valuations and fundamentals are relatively attractive but vulnerable to rising rates
BONDS	U.S. Investment Grade					■		Yields more attractive since start of the year, with risk moderated due to limited upside from growth and infaltion
BONDS	Developed Ex-U.S. IG (Hedged)			■				Expanding short-rate differential between U.S. and other developed markets has made hedged U.S. dollar yields more attractive, but durations remain extended
BONDS	Inflation-Linked					■		Inflation expectations have reset higher, making valuation less compelling. Higher oil prices and tight labor markets are supportive, offset by Fed tightening
BONDS	Global High Yield			■				Limited upside potential from current valuations. Despite late stage of credit cycle, fundamentals remain broadly positive with low near term default expectations
BONDS	Floating Rate Loans					■		Fundamentals supportive and rate-reset feature could offer defense against rising rates. However, loan terms have weakened and strong flows have crowded a less liquid sector
BONDS	EM Dollar Sovereigns			■				Yields are attractive, but offset by tightening monetary policy (both in developed and emerging markets), U.S. dollar strength, and rising country-specific risks
BONDS	EM Local Currency					■		Yields are attractive versus investment grade with potential upside from select currencies. However, volatility is likely to be elevated

5 Portfolio Implementation

As of 30 June 2018

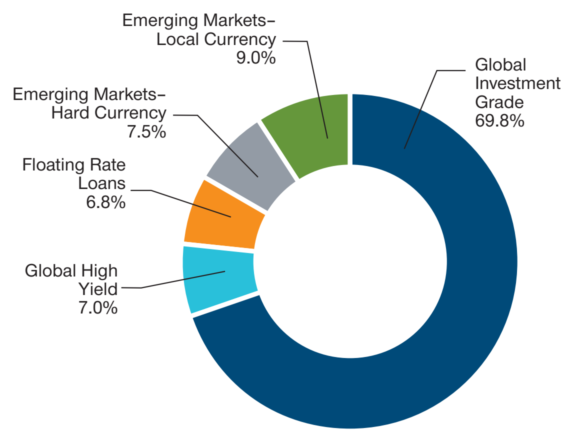
Equity	Neutral Weight	Tactical Weight	Relative Weight
United States	50.9%	51.7%	+0.8%
Europe	19.3%	21.2%	+1.9%
Japan	7.3%	8.6%	+1.3%
Canada	2.8%	1.9%	-1.0%
Australia	2.0%	1.0%	-1.0%
Pacific – Developed Markets	1.6%	1.9%	+0.3%
Emerging Markets	11.2%	11.6%	+0.4%
Real Assets Equities	5.0%	2.3%	-2.8%
Total Equity:	**100.0%**	**100.0%**	

Tactical Allocation Weights



Fixed Income	Neutral Weight	Tactical Weight	Relative Weight
Global Investment Grade (Hedged)	70.0%	69.8%	-0.2%
Global High Yield	10.0%	7.0%	-3.0%
Floating Rate Loans	5.0%	6.8%	+1.8%
Emerging Markets – Hard Currency	9.0%	7.5%	-1.5%
Emerging Markets – Local Currency	6.0%	9.0%	+3.0%
Total Fixed Income:	**100.0%**	**100.0%**	

Tactical Allocation Weights



Source: T. Rowe Price.

Neutral equity portfolio weights broadly representative of MSCI All Country World Index regional weights; includes allocation to real assets equities. Core global fixed Income allocation broadly representative of Bloomberg Barclays Global Aggregate Index regional weights.

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Currency risk – changes in currency exchange rates could reduce investment gains or increase investment losses.
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Emerging markets risk – emerging markets are less established than developed markets and therefore involve higher risks.
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