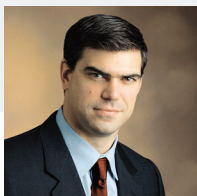




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In-depth analysis and insights
to inform your decision-making.



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*Portfolio Manager, U.S. Large-Cap
Core Equity Strategy*

U.S. Equities

U.S. EQUITIES FLASHING YELLOW AS CHALLENGES MOUNT

KEY POINTS

- The environment for U.S. equities should remain supportive but is likely to become more challenging over the next year.
- The rate of growth in corporate earnings should decelerate to about 8% to 10% from this year's stunning rise.
- Monetary tightening on a global basis may be a bigger concern than just the Federal Reserve raising rates.
- Equity valuations vary widely by sector, but we are likely to see some compression in price/earnings ratios.
- Uncertainty over tariffs and protectionist trade policies pose a significant threat to economic growth and individual companies.

Some of the tailwinds that have thrust U.S. equity markets to record highs in 2018 could become headwinds over the next year or so. While the environment should remain supportive for investing, it could become more challenging.

Corporate earnings have received a substantial boost from lower corporate tax rates, growing at a stunning 18% to 21% this year. However, the rate of growth is expected to decelerate next year to perhaps 8% to 10%. That would still be favorable by historical standards, but this lower rate is probably not being priced into markets now. High profit margins are also likely to face headwinds from higher rates, wages, and input costs.

The U.S. economy, buoyed by tax reform and deregulation policies, is strong. Manufacturing has reached new highs, leading indicators are positive, and small business optimism and consumer confidence are favorable. However, we are in the later stages of this economic cycle with less accommodative monetary

policies, higher interest rates, and inflation and labor costs rising amid tighter labor markets. The uncertainty over tariffs and protectionist trade policies could also have an adverse impact on growth. And the stimulus from the tax cuts will have less impact next year. Recession risks are still moderate but rising.

The Federal Reserve is likely to continue pushing short-term interest rates higher while other central banks in Japan and Europe moderate their very stimulative quantitative easing programs. Monetary tightening on a global basis could be a bigger story for the markets than the Fed raising rates because that global liquidity has been such a huge support in recent years.

Further, with longer-term interest rates fairly stable, the yield curve has been flattening and we could see it invert early next year, with short-term rates exceeding longer-term rates. That's typically been a harbinger for a slower economy and weaker markets.

While investors should probably lower their expectations, markets could continue to perform well if there is resolution on geopolitical issues in general and trade disputes in particular.

Another concern is that tax reform has not led to the boom in capital spending that many expected. Instead, many companies have deployed revenue growth into significant dividend increases and enormous share buyback activity. A stronger capex cycle would be beneficial for earnings.

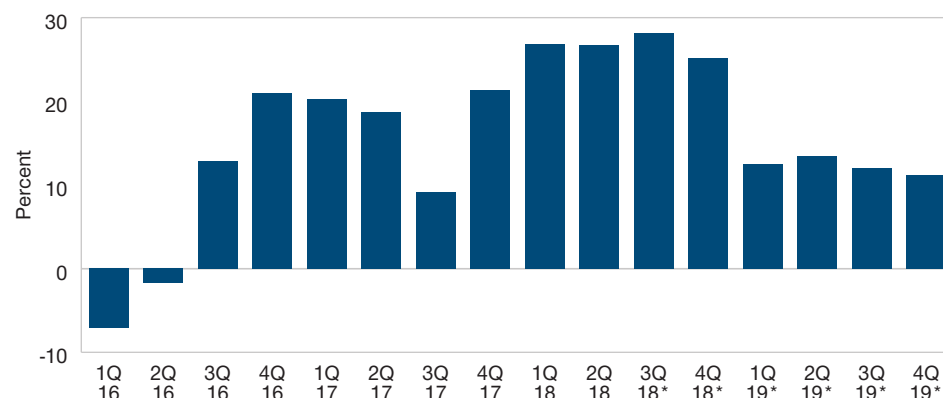
U.S. equity valuations, meanwhile, vary widely by sector but have generally been above historical averages. We are likely to see some compression in price/earnings multiples next year.

Perhaps the biggest threat facing investors is the uncertainty over the trade tensions and tariffs imposed or threatened by the Trump administration as it seeks more favorable trade agreements with other countries. The heavy tariffs on China could end up being very disruptive to the economy and individual companies. As companies incur higher costs in their global supply chains, that leads to margin pressure on goods they manufacture or sell.

For example, we have typically maintained an overweight position in medical technology, which has performed well recently, but we've trimmed that position because the companies are susceptible to retaliatory tariffs imposed by China on their exports to that country.

FIGURE 1: S&P 500 Corporate Earnings Growth

Quarterly operating earnings per share growth, year-over-year as of September 2018



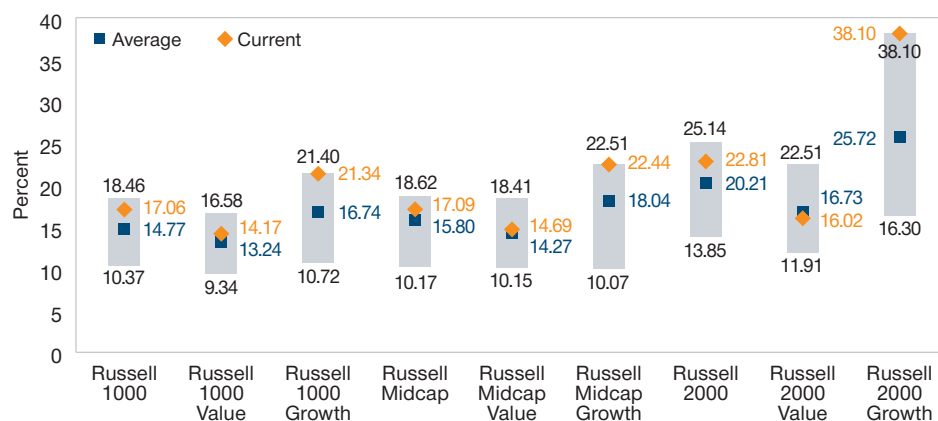
Past performance is not a reliable indicator of future performance.

*Denotes consensus estimated earnings.

Source: S&P Dow Jones.

FIGURE 2: Forward Price-to-Earnings (P/E) Ratios

September 2003 through August 2018



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It is also noteworthy that the current U.S. equity bull market in August became the longest bull market in history—surpassing the run in the 1990s. Since 1958, it has also surpassed all but one other bull market in appreciation.

While investors should probably lower their expectations, markets could continue to perform well if there is resolution on geopolitical issues in general and trade disputes in particular.

INVESTMENT STRATEGY

Our largest sector allocations are information technology, health care, and financials—accounting for almost 60% of portfolio assets as of June 30, 2018. The technology sector, of course, has been dominated by a handful of fast-growing, mega-cap companies able to leverage dominant Internet platforms, such as Apple, Google, Microsoft, and Amazon. I expect these companies

have the potential to remain powerful and continue to grow given their competitive advantages.

However, we trimmed technology holdings this year based on valuation and the regulatory risk stemming from data breaches, which poses our biggest concern for this sector. As a result, technology is actually our biggest underweight, accounting for about 22% of the portfolio compared with 26% for the S&P 500 Stock Index.

We remain optimistic on health care because, over the long term, it provides the best combination of solid fundamentals and acceptable valuations and is secularly driven by the aging population. And health care is becoming more global. China is buying more health care from the U.S. than ever before, in terms of both pharmaceuticals and medical technology.

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We recently began investing in pharmaceutical companies because that sector has materially underperformed, but now valuations are extremely attractive.

In the financials sector, where we are overweight the market, we have owned some of the higher-quality banks, which should benefit from rising rates. We have also had an overweight position in insurance brokers that have attractive business models, modest pricing power, and highly recurring revenue streams.

Also, considering the late stage of the economic cycle, we have invested in utilities. They typically are less volatile than the market and have some attractive secular themes, such as the huge growth in renewable energy in the United States.

We maintain our cautious view of the market overall, but stock selection will be the primary driver of longer-term performance.

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