Salient®

Potential Opportunities For Income

· Emerging Market Corporate Bonds
· High-Yield Municipal Bonds
· International Real Estate

Weaker Opportunities For Income

· International Sovereign Bonds
· Treasurys

MARKET REVIEW

Emerging Markets Continue to Surge

July was generally a good month for all global markets as the MSCI All Country World Index increased by 2.79% led by the emerging markets (EM), which increased by 5.96%. EM was led by some of the larger economies, including China and India, which increased by 8.89% and 7.70%, respectively. U.S. stocks reached new highs in July as the S&P 500 Index increased by 2.06% and the CBOE Volatility Index reached record lows. From a sector standpoint, it is hard to put a label on July's increase in the S&P 500 as the top sectors were a mix of 2017 favorites, such as technology, and some of 2017 laggards, such as telecom. Europe outperformed the U.S. and increased by 2.99% led by some of the peripheral economies such as Portugal and Ireland, which increased by 5.42% and 4.67%, respectively.

This year, we think it has been important to pick apart performance and review some of the key drivers. Europe's stock rebound has largely been driven by an increase in the euro relative the dollar. For example, the MSCI Europe Index is up 19.53% year-to-date in U.S. dollars, but up a less impressive 6.73% in euros. EM on the other hand is up 25.49% year-to-date in U.S. dollars, but is still up substantially in local currency (18.73% for the year). It is important to note that Europe is mainly benefitting from a strengthening currency while EM, though still benefitting from currency strength, is growing from organic sources, such as increasing earnings.

Bonds also finished a strong month in July as global bonds increased by 1.68% with a yield of 1.59%. International sovereign bonds continue to lead the market, increasing by 2.50% in July. Euro bonds have led the charge among sovereign bonds, increasing by 3.61% for the month, followed by Japanese government bonds, which increased by 1.76% for the month. U.S. high-yield bonds, EM corporate bonds and EM sovereign bonds also posted a strong month, gaining 1.11%, 1.18% and 0.66%, respectively.

Again, we have to peel back the performance. In U.S. dollar terms, euro bonds posted a gain of 10.94% in 2017 and Japanese government bonds gained 5.28% over the same period. Once again, the gains evaporate in local currencies; euro bonds decreased by -0.75% in euros and Japanese government bonds fell -0.34% in yen on the year. While euro bonds may appear to provide a great return for a fixed-income investment, keep in mind that you're only getting a paltry 0.63%, which provides very little cover in the event of rising rates (and rates are currently rising). Additionally, the currency effect dramatically increases the volatility, which is at 9.88% annualized year-to-date. By comparison, the S&P 500 has outperformed euro bonds at an annualized volatility of 8.10%. In other words, stocks may provide better returns and realize better volatility.

STOCKS vs. BONDS

Valuations Continue to Rise

The S&P 500 finished July at 21.33x earnings and we think it is pretty much impossible to find a part of the market that could be called undervalued. Europe finished the month at 22.12x earnings and emerging markets were at 16.21x earnings. Bonds do not offer any better valuations as U.S. high-yield has an option-adjusted spread that is at the lowest level in 20 years. For long-term investors, this situation may be difficult as it is tough to come up with a long-term expected return for stocks that doesn't hover around 2%. We think any new investor to stocks might want to take note of that and make sure that the investment strategy provides some cover if stocks pull back from their current levels.

Shorter term, it might not be such a big deal. One valuation indicator that has worked well since the financial crisis is relative yield of stocks and bonds. At the end of July, the S&P 500, EM and Europe yielded 1.97%, 2.35% and 3.37%, respectively, while global bonds yielded 1.59%.

With stock volatility lower than bond volatility in some cases, it paints a strong picture for stocks. However, we are likely closer to the end of this bull market than the beginning. U.S. aggregate bonds are currently yielding 2.51%, which is higher than the S&P 500—a relatively new phenomenon thanks to rising rates. On the other hand, euro aggregate bonds are yielding 0.59%, which makes a strong case for European stocks over U.S. stocks.

Regardless of valuation, we think there is still a strong case for stocks over bonds, at least in the near term. The NYSE Advance/Decline Indicator achieved a new high on July 25th while the S&P 500 achieved a new high on July 26th. Additionally, NYSE New Highs/Lows is still favoring a bullish condition for stocks. Finally, the JPMorgan Global Manufacturing Purchasing Managers Index is at 53.7, indicating that the global economy is still in expansion. Therefore, for now, we think it still pays to take some risk.

OUTLOOK

Is There a Rotation?

Last month, we discussed the possibility of a rotation toward more defensive asset classes and whether it signaled that investors were starting to rotate to safer parts of the market. At this point, it would be hard to conclusively state this rotation as fact. In July, defensive sectors such as utilities and telecoms were some of the top performers, but so were more growth-oriented sectors such as energy and tech. Additionally, EM stocks, which are typically associated with riskier investors, were the best performing in the market while commodities and commodity-sensitive markets performed well, including Canada and Australia increasing by 3.95% and 4.45%, respectively, outperforming the global stock market. Again, these are the types of positions investors take when they are confident in global economic growth.

On the other hand, the trend for safer bonds has been improving. Our report card shows that investment-grade credit, along with cash, has moved into a higher ranking while high-yield municipal bonds have declined. This movement does appear to be a rotation into safety, but some of the rotation might be associated with improving odds of tax reform, which could change the economics of any type of municipal bond. Other credit-sensitive bond sectors like U.S. high-yield bonds, EM corporate debt and EM sovereign bonds are still ranked near the top in terms of trend and carry.

Given all this, it is safe to say that there isn't a broad-based rotation into safety as the trend still favors the riskier segments of the market and investors usually follow that trend.

FUN FACT

Are We Alone in the Universe?

Scientists at Columbia University published findings that could indicate the discovery of the first exomoon—a moon orbiting a planet orbiting a distant star. This type of structure is believed to be the best place to search for extraterrestrial life. The team reviewed 284 possible candidates searching for a pattern of shadows that could indicate the existence of an exomoon. So far, the data is consistent with the presence of this type of celestial body. On October 29th the team will use the Hubble Space Telescope to see if the moon is really there.

Methodology

To learn more about the methodology visit the Salient Partners blog posting at www.salientpartners.com. You can also follow us on Twitter at @nrowader and @NicMillikan for live updates on the Income Report Card.

Asset Class Key

Bonds

U.S. Treasurys	Bloomberg Barclays U.S. Treasury
U.S. Investment Grade Credit	Bloomberg Barclays U.S. Credit
Municipal Bonds	Bloomberg Barclays Municipal Bond
High-Yield Municipal	Bloomberg Barclays Muni High Yield
U.S. High-Yield Corporate	Bloomberg Barclays U.S. Corp High Yield
Emerging Market Corporate	CS Emerging Markets Corporate Bond
Emerging Market Sovereign	Bloomberg Barclays EM Sovereign
International Sovereign	Bloomberg Barclays Global Treasury ex USD
Mortgages	Bloomberg Barclays U.S. MBS
Short Term Treasurys (Cash Proxy)	Bloomberg Barclays US Treasury 1-3 yr

Stocks

U.S. Stocks	S&P 500 Index
International Stocks	MSCI EAFE
Emerging Market Stocks	MSCI Emerging Markets
U.S. Real Estate	Dow Jones US Real Estate
MLPs	Alerian MLP Infrastructure
Preferred Stocks	BofA Merrill Lynch Fixed Rate Preferred Securities
Utilities	S&P 500 Utilities Sector
International Real Estate	Dow Jones Global Select ex US Real Estate Securities
EM Infrastructure	MSCI EM Infrastructure

AUGUST 2017

Income Report Card: Stocks

Grades: Quintile rankings of asset classes
Downgrade Upgrade No Change

Trend: 12 month momentum
Carry: Current Yield / Current Std. Deviation

Risk: Based on 60-day std. deviation

U.S. Stocks

Yield: 1.97% **Risk:** 7.26%

TREND	CARRY
B	D

There has been little change in U.S. stocks. We continue to see very low volatility, even with a slight increase in rates. U.S. stocks continue to be a good total return option and a good hedge against inflation and rising rates.

International Stocks

Yield: 3.11% **Risk:** 7.87%

TREND	CARRY
A	B

This asset class has benefitted from the global bond sell-off that has continued into July. Coupled with a slowing U.S. dollar relative to the euro and yen, now may be a good time to rotate into international stocks.

Emerging Market Stocks

Yield: 2.38% **Risk:** 9.42%

TREND	CARRY
A	F

Emerging market stocks continue to be one of the lowest yielding asset classes. However, positive trend and valuation, coupled with strong diversification away from U.S. markets, make this asset class attractive.

U.S. Real Estate

Yield: 4.15% **Risk:** 9.51%

TREND	CARRY
D	B

The positive correlation with bonds should be taken seriously in this asset class, especially for any investor with a large position in fixed-rate bonds.

Master Limited Partnerships (MLPs)

Yield: 7.18% **Risk:** 18.48%

TREND	CARRY
C	C

MLPs are still middle of the road in terms of trend and carry, but are likely the only asset class left with a reasonable valuation, plus a 7%+ yield is attractive to income investors. It makes sense to have this asset class as a small position of the overall stock portfolio, but we'd like to see risk come down to indicate an improving trend.

Preferred Stocks

Yield: 5.39% **Risk:** 1.53%

TREND	CARRY
D	A

We see preferred stocks as the asset class to own for safe U.S.-based income. It does have a positive correlation to bonds, but the higher income stream should help protect it from changes in rates. Financial stocks are again moving higher, which should flow through to this asset class.

Utilities

Yield: 3.37% **Risk:** 8.70%

TREND	CARRY
B	C

Utilities continue to be a solid option for an income portfolio. As rising rates continue, we see downgraded carry as earnings multiples and long-term growth prospects continue to be weak in this asset class. We think preferred stocks are a better option for an income portfolio.

International Real Estate

Yield: 3.84% **Risk:** 8.75%

TREND	CARRY
F	A

Volatility has been declining and the carry is looking very attractive at this point. Plus, the asset class has lagged other international assets, so there should be some relative value that could provide some capital appreciation as well.

EM Infrastructure

Yield: 3.07% **Risk:** 9.29%

TREND	CARRY
C	D

If EM stocks are too volatile, we believe this asset class is a great way to access to the economic growth of the emerging markets with some decent income and lower volatility. Additionally, most of these stocks are backed with hard assets and positive cash flow.

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AUGUST 2017

Income Report Card: Bonds

Grades: Quintile rankings of asset classes
Downgrade Upgrade No Change

Trend: 12 month momentum
Carry: Current Yield / Current Std. Deviation

Risk: Based on 60-day std. deviation

U.S. Treasurys

Yield: 1.87% **Risk:** 2.83%

TREND	CARRY
F	F

Treasurys may be the purest way to express an interest rate position. As a result, we think this asset class represents the tip of the spear on the future of interest rates. The recent collapse in trend and carry demonstrates the sharp reversal in fortune for any interest-rate-sensitive asset class. If you must hold Treasurys, we believe short duration/cash-like is best.

U.S. Investment Grade Credit

Yield: 3.04% **Risk:** 3.11%

TREND	CARRY
B	D

A stronger trend grade for this month demonstrates that investors are warming up to the yields available from higher quality bonds. We see this asset class as a great option for investors looking for safety, given the low odds of a recession, but belive that high-yield corporates are still a better bet.

Municipal Bonds

Yield: 2.18% **Risk:** 1.63%

TREND	CARRY
D	C

Muni bonds offer an attractive yield relative to Treasurys. However, the low likelihood of recession favors taking more credit risk. We think you should look to high-yield municipal bonds instead, but keep your ears open regarding tax reform. As that topic heats up, muni bonds might get a bit volatile.

High-Yield Municipal Bonds

Yield: 5.42% **Risk:** 3.18%

TREND	CARRY
C	B

This asset class is riskier than rated muni bonds, but barring a recession (which seems unlikely at this juncture) we believe high-yield municipal bonds are a good alternative to any investment-grade holding. If you are looking for safe cash flow, we think this asset class may provide a good opportunity. Again, we believe you should keep your ears open to possible tax reform.

U.S. High-Yield Corporate Bonds

Yield: 5.41% **Risk:** 1.49%

TREND	CARRY
A	A

Given the stability of the economy and the likelihood of increasing interest rates down the road, U.S. high-yield corporate bonds are one of our favorite asset classes. We expect this asset class to be a relative outperformer for the year.

Emerging Market Corporate Debt

Yield: 6.09% **Risk:** 2.15%

TREND	CARRY
A	A

EM corporate debt is also one of our favorite asset classes for 2017. The low price volatility and high current income make this asset class very attractive. We don't expect this asset class to deliver total return like it has over the past year, but higher income may offset any increased rates.

Emerging Market Sovereign Debt

Yield: 5.03% **Risk:** 3.24%

TREND	CARRY
B	C

If you absolutely need government bonds, we see this asset class as your best bet. However, we prefer emerging market corporate debt instead.

International Sovereign Debt

Yield: 0.76% **Risk:** 7.02%

TREND	CARRY
F	F

International sovereign debt has been a great performer this year, but has volatility similar to stocks and a yield that offers very little cover in the case of rising interest rates, which have been going up. A pullback in currency values could lead to a very sharp decline.

Mortgages

Yield: 2.83% **Risk:** 2.17%

TREND	CARRY
D	D

Mortgages continue to struggle in a rising rate environment. We have seen a downgrade in trend as the course of interest rate increases becomes more visible. Due to this macro trend, mortgages most likely do not belong in an income portfolio.

Short Term Treasurys (Cash Proxy)

Yield: 1.26% **Risk:** 0.61%

TREND	CARRY
C	B

Right now we would prefer credit risk over short duration, but in the event of recessionary environment, cash is looking very attractive.

Investing involves risk, including possible loss of principal. The value of any financial instruments or markets mentioned herein can fall as well as rise. Past performance does not guarantee future results.

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Definition of Terms

Alerian MLP Infrastructure Index is the leading gauge of large- and mid-cap energy master limited partnerships (MLPs). The float-adjusted, capitalization-weighted index includes some of the most prominent companies and captures approximately 75% of available market capitalization.

Bloomberg Barclays EM Sovereign Bond Index is a rules-based market-value weighted index engineered to measure the fixed-rate local currency sovereign bonds issued in emerging markets as identified by Bloomberg.

Bloomberg Barclays Global Treasury ex-USD Index is an unmanaged index composed of those securities included in the Barclays Global Aggregate Bond Index that are Treasury securities, with the US excluded while hedging the currency back to the US dollar.

Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are U.S. domestic, taxable and dollar denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Bloomberg Barclays U.S. Corporate High-Yield Bond Index covers the USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Bloomberg Barclays U.S. Credit Index is an index composed of corporate and non-corporate debt issues that are rated investment grade (Baa3/BBB) or higher.

Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index tracks the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC).

Bloomberg Barclays U.S. Municipal Bond Index covers the USD-denominated, long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

Bloomberg Barclays U.S. Municipal High Yield Index measures the noninvestment-grade and nonrated U.S. dollar-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington D.C., Puerto Rico, Guam and the Virgin Islands).

Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays U.S. Treasury Bond 1-3 Year Term Index is an unmanaged index of public obligations of the U.S. Treasury includes public obligations of the U.S. Treasury with a maturity between 1 and up to (but not including) 3 years.

BofA Merrill Lynch U.S. Core Fixed Rate Preferred Stock Index consists of investment-grade, fixed and fixed-to-floating rate U.S. dollar-denominated preferred securities.

Brexit a term for the potential or hypothetical departure of the United Kingdom from the European Union.

CBOE Volatility Index is a popular measure of market risk and is constructed using the implied volatility of S&P 500 index options.

Consumer price index (CPI) is an index number measuring the average price of consumer goods and services purchased by households. The percentage change in the CPI is a measure of inflation.

Credit Suisse Emerging Market Corporate Bond Index consists of U.S. dollar-denominated fixed-income issues from Latin America, Eastern Europe and Asia.

Dow Jones Global ex-U.S. Select REIT Index measures the performance of equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded globally, excluding the U.S.

Dow Jones U.S. Real Estate Index measures the performance of the real estate industry of the U.S. equity market.

JPMorgan Global Manufacturing Purchasing Managers' Index is a composite index that serves as a global economic indicator by measuring different business conditions in 24 countries, including global manufacturing output, new orders and employment across the global manufacturing sector.

MSCI EAFE (Europe, Australasia and Far East) Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI Emerging Markets Infrastructure Index captures the global opportunity set of companies that are owners or operators of infrastructure assets.

MSCI World Index is a free float-adjusted market capitalization index designed to measure equity market performance in the global developed markets.

Max drawdown is the percentage of loss that an asset incurs from its peak net asset value to its lowest value.

NASDAQ-100 is a modified capitalization-weighted index that includes the largest nonfinancial U.S. and non-U.S. companies listed on the NASDAQ stock market across a variety of industries, such as retail, healthcare, telecommunications, wholesale trade, biotechnology and technology.

NYSE Advance/Decline Indicator is a technical indicator that charts the difference between the number of advancing stocks and declining stocks on the NYSE in a given market on a given day.

NYSE New Highs/Lows is a technical indicator that charts the highest and lowest prices over 52 weeks of NYSE stocks in a given market on a given day.

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index represents approximately 98% of the investable U.S. equity market.

S&P 500 Financials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

Sharpe ratio is a ratio developed by Nobel laureate William F. Sharpe to measure how a fund performs relative to the risk it takes.

Standard deviation measures the degree to which a fund's return varies from its previous returns or from the average of all similar funds.

Valuation is the process of determining the value of an asset or company based on earnings and the market value of assets.

VIX (the ticker symbol for the Chicago Board Options Exchange Volatility Index) is a popular measure of market risk and is constructed using the implied volatility of S&P 500 index options.

Yield is the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost or on the U.S. government's debt obligations.

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