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

Historic Year for Stocks

Global stocks finished at a gain of 5.64% in the month of January, just slightly off their all-time high. Emerging market (EM) stocks led the way once again with a gain of 8.33%. Europe and Japan also marked strong gains for the month with an increase of 5.40% and 4.58%, respectively. However, much of these gains (greater than half) can be attributed to appreciation of the local currency. While appreciation of EM currency relative to other major currencies did push prices, these markets would have still outperformed all developed markets. This distinction is crucial since the performance of EM stocks appears to be organic while other foreign markets are largely a function of appreciating currencies, a dynamic that may or may not persist over time. U.S. stocks fared well in January with a gain of 5.73% while small-cap U.S. stocks increased by 2.61%. There has been a notable improvement in the performance of energy stocks following a weak 2017. Strength in this part of the market could help keep the overall stock market rising.

Global bonds did well in January with a gain of 1.19%; however, the entire gain can be attributed to increases in foreign currencies as the local currency version of the index fell -0.71%, which makes sense as global rates have increased over the month. In fact, the 10-year Treasury rate increased from 2.40% to 2.72%, resulting in a decline for U.S. bonds, which fell -1.15% in January. Credit held up nicely during the month with high-yield bonds and EM corporate bonds increasing by 0.60% and 0.66%, respectively.

STOCKS vs. BONDS

The Bond Story Unfolds

As this is being written at the beginning of February, the Dow Jones Industrial Average is posting its worst decline in terms of points in history while nearly every major global market has declined by 4% or more. Additionally, the implied volatility (VIX) of the S&P 500 Index has increased by the largest margin ever. However, this rise is likely just a temporary condition, as there is very little reason for the market to shift into a bear market at this point. In fact, by the time this report is published, the stock drawdown might be a thing of the past. However, the sharp increase in stock volatility has masked a deeper problem. By February 5th, U.S. bonds experienced their worst drawdown in more than 20 years and, at times, were positively correlated with stocks, meaning that few asset classes provided any respite from the decline. Cash was the only safe harbor. This exact scenario was outlined in our January report card and investors should take note of this unusual situation. Investors can use this period as a blueprint for when the stock market really does change into a full-blown bear, but, as mentioned previously, we don't believe that is the case right now. That can change, however, and it would be wise to keep an eye on cash as a type of exit door should the market start to sour.

OUTLOOK

Keeping Volatility in Perspective

Up until the last part of January and early February, the S&P 500 had reached its longest period in history without a 5% correction. This drought, combined with elevated levels of investor optimism, makes the market more vulnerable to a correction. When coupled with historically low volatility, the correction is likely to be quite unpredictable, especially by comparison to the relative quiet markets that preceded the drawdown. Despite this type of correction, it doesn't necessarily mean a bear market is imminent. Typically bear markets are associated with weakening economic conditions, which is not the case today. Goldman Sachs recently published a study on this very topic and noted that corrections within a bull market can have a drawdown of 10%-20%, but typically last no more than four months. By comparison, bear markets historically have led to drawdowns of approximately 30% over a 13-month period. The good news: the global economy is strong, a bear market appears unlikely and the 10% pullback in the S&P 500 is in line with an average correction within a bull market.

The JPMorgan Global Purchasing Managers' Index for January came in at 54.4 and has been rising since June of last year. Readings above 50 indicate a period of economic expansion. Additionally, more than 66% of global markets are trading above their 200-day moving average even after the February drawdown. As indexes reached new highs in January, there was strong breadth in most major markets. In short, we believe the recent pullback is likely a buying opportunity rather than the beginning of a bear market.

FUN FACT

Elephants and Bees

It turns out that elephants are very scared of bees. When they hear a beehive, they instinctually stomp their feet, flap their ears and kick up dirt. A single bee poses no risk to elephants, but bees can be dangerous when they swarm and attack soft spots around their trunk, eyes and mouth. Scientists are using this knowledge to help protect the endangered animal by having farmers put up beehives to ward off the large mammals. The method appears to be successful in warding off roughly 80% of elephants that wander onto farmland looking for a snack. As a result, there are less deadly confrontations between farmers and elephants.

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 Bond
Municipal Bonds	Bloomberg Barclays U.S. Municipal Bond
High-Yield Municipal Bonds	Bloomberg Barclays U.S. Municipal High Yield
U.S. High-Yield Corporate Bonds	Bloomberg Barclays U.S. Corporate High-Yield Bond
Emerging Market Corporate Debt	CS Emerging Markets Corporate Bond
Emerging Market Sovereign Debt	Bloomberg Barclays EM Sovereign Bond
International Sovereign Debt	Bloomberg Barclays Global Treasury ex-USD
Mortgages	Bloomberg Barclays U.S. MBS
Short-Term Treasurys (Cash Proxy)	Bloomberg Barclays U.S. Treasury Bond 1-3 Year Term
Global Bonds	Bloomberg Barclays Global Aggregate Bonds

Stocks	
U.S. Stocks	S&P 500 Index
International Stocks	MSCI EAFE
Emerging Market Stocks	MSCI Emerging Markets
U.S. Real Estate	Dow Jones U.S. Real Estate
MLPs	Alerian MLP Infrastructure
Preferred Stocks	BofA Merrill Lynch Core Fixed Rate Preferred Securities
Utilities	S&P 500 Utilities Sector
International Real Estate	Dow Jones Global ex-U.S. Select Real Estate
EM Infrastructure	MSCI EM Infrastructure
Japan	MSCI Japan
Europe	MSCI Europe
Small Cap Stocks	Russell 2000
Global Stocks	MSCI All Country World Index

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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: 1.80% **Risk:** 7.41%

TREND	CARRY	
B	D	U.S. stocks continue to outperform, eroding the income we are looking for. U.S. stocks remain one of the worst absolute level of income in our stock universe. We see U.S. stocks as a solid total return option and can be used as a good hedge against inflation and rising rates with continued regulatory changes.

International Stocks

Yield: 2.98% **Risk:** 7.23%

TREND	CARRY	
A	B	Developed foreign markets have benefitted greatly by the slowdown in bond purchases by the European Central Bank and Bank of Japan. Additionally, the U.S. dollar has seen a further decline relative to the euro and yen, significantly benefitting this asset class. Caution might be in order as the U.S. dollar is extremely oversold.

Emerging Market Stocks

Yield: 2.17% **Risk:** 11.31%

TREND	CARRY	
A	F	Emerging market stocks still produce low income, but the asset class offers strong diversification away from the U.S. economic environment. The strong trend, valuation and possible change in the long-term cycle all favor this asset class.

U.S. Real Estate

Yield: 4.15% **Risk:** 11.33%

TREND	CARRY	
D	C	The positive correlation with bonds should be taken seriously, especially for any investor with a large position in fixed-rate bonds. This holding is probably a good speculative position on the basis of a rebound off the recent lows, but not a good long-term core position for now.

Master Limited Partnerships (MLPs)

Yield: 7.30% **Risk:** 20.04%

TREND	CARRY	
F	C	Volatility has declined somewhat, which could present a buying opportunity. Keep an eye on further declines in risk.

Preferred Stocks

Yield: 5.57% **Risk:** 3.30%

TREND	CARRY	
D	A	We see preferred stocks as the asset class to own for safe U.S.-based income. The asset class does have a positive correlation to bonds, but the higher income stream should help protect it from changes in rates. The recent resurgence in bank stocks could find its way to preferred stocks in the near term.

Utilities

Yield: 3.56% **Risk:** 12.15%

TREND	CARRY	
C	D	Like real estate, utilities sold off as investors weighed the impact from rising rates. January saw the largest rise in the 10-year Treasury note since November 2016. An upward monthly move that large has only happened eight times in the last 10 years. The earning multiples of this space and long-term growth prospects are fairly weak signals. We believe investors should look at preferred stocks instead of utilities.

International Real Estate

Yield: 3.91% **Risk:** 7.33%

TREND	CARRY	
C	A	Volatility has been declining in international real estate and the carry is looking very attractive at this point. The asset class has also lagged other international assets, so there should be some relative value that could provide some capital appreciation as well.

EM Infrastructure

Yield: 3.49% **Risk:** 8.20%

TREND	CARRY	
B	B	The most recent volatility in EM stocks has highlighted the attractiveness of this asset class. Emerging market infrastructure provides a great way to access emerging markets with decent income and reduced volatility compared to broad EM stocks.

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: 2.47% **Risk:** 2.74%

TREND	CARRY	
F	F	Treasurys may be the purest way to express an interest rate position. As a result, this asset class represents the tip of the spear on the future of interest rates. If you must hold Treasurys, we believe short duration/cash-like or muni bonds are best.

U.S. Investment Grade Credit

Yield: 3.39% **Risk:** 3.23%

TREND	CARRY	
C	D	There has been an uptick in buying of investment-grade credit; however, the strong economy still favors more credit risk, so we prefer high-yield over investment-grade.

Municipal Bonds

Yield: 2.57% **Risk:** 2.66%

TREND	CARRY	
D	D	Muni bonds offer an attractive yield relative Treasurys. However, the low likelihood of recession favors taking more credit risk. Look to high-yield municipal bonds instead. If you must have a high-safety asset class, we think this asset class is a good bet over Treasurys.

High-Yield Municipal Bonds

Yield: 5.25% **Risk:** 3.71%

TREND	CARRY	
B	C	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 is likely the best opportunity.

U.S. High-Yield Corporate Bonds

Yield: 5.78% **Risk:** 2.16%

TREND	CARRY	
C	B	The spread on high-yield is very tight and investors have a right to be cautious. This asset class is still a good source for current income given the strength of the economy, but if you have to choose, EM corporate debt appears stronger.

Emerging Market Corporate Debt

Yield: 5.98% **Risk:** 1.51%

TREND	CARRY	
B	A	EM corporate debt has also been one of our favorite asset classes for 2018. The low price volatility and high current income makes this asset class very attractive. We don't expect this asset class to deliver total return like it did last year, but higher income may offset any increase in rates.

Emerging Market Sovereign Debt

Yield: 5.08% **Risk:** 2.58%

TREND	CARRY	
A	B	If you absolutely need government bonds, we see this as your best bet. However, spreads are now at pre-crisis levels and the great returns from this asset class might not warrant the risk. Again, we'd suggest credit over sovereign bonds.

International Sovereign Debt

Yield: 0.80% **Risk:** 5.12%

TREND	CARRY	
A	F	This asset class has been a great performer this year, but its volatility is similar to stocks and it has 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, such as the near 4% drawdown in September.

Mortgages

Yield: 3.20% **Risk:** 1.94%

TREND	CARRY	
D	C	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: 2.14% **Risk:** 0.53%

TREND	CARRY	
F	A	Right now we would prefer credit risk over short duration, but in the event of recessionary environment, cash is starting to look 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.

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 Industrial Average (DIJA) is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry and are listed on the New York Stock Exchange.

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

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

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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