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

Historic Year for Stocks

With 2017 behind us, let's look back at this remarkable year. Global stocks finished with a gain of 23.92% with foreign markets leading the way thanks in part to a weak U.S. dollar. The emerging markets (EM) represent the biggest winners globally, gaining 37.90% in U.S. dollar terms and 30.55% in local currency. Japan and Europe also posted strong gains with Japanese stocks gaining 23.76% and European stocks gaining 26.62%. In this case, the weaker dollar played an even more meaningful role as European stocks only gained 13.06% in local currency and Japanese stocks gained 19.75% in yen. U.S. stocks were not left behind, finishing the year with a gain of 21.27%. Small-cap U.S. stocks finished the year with a gain of 14.14%. The gains were certainly impressive, but when we look behind the curtain we learn some very interesting facts, most notably that U.S. stocks have gone 282 days without a 3% correction—the longest period in history. Additionally, 42 of the 44 stock markets followed by MSCI posted gains as well as nine of the 11 sectors. The most unusual sector was energy, which posted a decline for the year despite the rise in oil prices, marking the first time in 15 years energy declined while oil rose. Energy also posted the biggest sector swing in year-over-year earnings ever besides financials during the 2008-2009 financial crisis, which we believe is likely a positive sign for energy stocks going into 2018.

Not to be outdone, bonds also had a very strange year. Global bonds increased by 7.65%, yet much of the gain can be attributed to currency effect as the local currency version of the index only increased by 3.04%. This number placed global bonds in a very similar position as U.S. bonds, which increased by 3.80% for the year. Once again, EM bonds were the winner with corporate bonds rising 9.50% and sovereign bonds rising 10.28%. Domestic credit investors were also rewarded for the year with U.S. corporate high-yield bonds rising 7.52% and high-yield muni bonds rising 9.95%. It is notable, however, that the volatility of most bond asset classes was unusually high in 2017, which is in direct contrast to stocks, which spent most of the year hugging all-time lows in terms of volatility. This notable fact will be discussed further in the outlook.

STOCKS vs. BONDS

The Case for Cash

At the beginning of 2017, the 10-year Treasury was yielding 2.46% following a rapid increase that began in the summer of 2016. At the beginning of 2018, the 10-year Treasury is yielding… wait for it… 2.46%. This information might come as a surprise since the U.S. Federal Reserve (Fed) has been increasing the fed funds rate while the financial media discusses the impact of increased interest rates. However, beneath the headline interest rates have been a few interesting changes. First, the volatility of rates has been unusually high. The 10-year Treasury reached a high of 2.62% before the end of the first quarter and fell to a low of 2.05% in September. That level of volatility was largely driven by the expectation of increased inflation and increased economic growth that was to be the byproduct of tax reform and infrastructure spending. As "repeal and replace" floundered in Congress, so did the expectation for large-scale pro-business legislation that was expected from the new administration, which drove rates lower. The strength of tax reform later in the year, however, rekindled the hopes of stronger economic growth and with it, higher rates. Currently, other legislative items, such as infrastructure spending, don't seem as likely as they did in early 2017, but nonetheless, there are signs of inflation emerging, specifically in the tight labor market. These factors should continue to push rates higher.

The second issue emerging in the cogs of the bond market is the flattening of the yield curve. At the beginning of 2017, the 2-year Treasury had a yield of 1.27% and at the beginning of 2018, it was yielding 1.92%. Many short duration bond options are now yielding more than 2%, but have a duration of less than one year. The current tight labor market should push the Federal Reserve to continue to increase rates, which will push the short end of the curve higher. As a result, if a correction should emerge from stocks, many investors will potentially flee to the safety of very short-duration bonds to avoid the interest rate risk of core bond portfolios. We believe this shift would potentially push the yield curve back into a normal slope and provide short-duration bond investors some capital gains—a very unusual situation. While we believe this outcome is likely, the markets are still in favor of stocks and the strength of the economy favors credit. However, a correction seems to be on the horizon, and this trade offers a compelling opportunity.

OUTLOOK

More Stocks, More Credit

The case for stocks in general is tame for 2018 and it appears that most pundits are planning for a 7%–10% gain in global stocks. The same pundits agree that all markets will experience higher volatility and are calling for a correction of roughly 10%. This assessment seems reasonable; markets should increase since the global economy remains strong and earnings should continue to grow, and a correction seems likely given the historically prolonged period since a correction in any of the major stock markets. Earnings seem like the most obvious cap on stock growth. The year-over-year earnings growth for global stocks is at 20.8% while the consensus forecast for earnings in 2018 is a 12-month growth of 11.6%. While growth seems likely, it will just be slower than it was in 2017 and thus less of a catalyst for massive stock gains. Another factor is the likely muted gains from the tax reform bill passed at the end of the year. Since this shift is occurring at the height of the business cycle, the ability to push earnings much higher is going to be limited. One positive for stocks is that most surveys of allocators are indicating expectations of global stock returns in the 3% range, which indicates that overall enthusiasm for stock returns may not be at an elevated level of euphoria.

We expect to overweight stocks in 2018 with a preference for foreign stocks, especially emerging markets. According to current metrics, the best value of any market is in Europe and the emerging markets; if the dollar remains weak, then these are the potential winners for the year. Another positive to be gleaned from allocator surveys is that it appears that by and large, most allocators are expecting to increase their exposure to foreign markets this year, which should prove to be a boon for the asset class.

The picture for bonds is less rosy. The value of the 10-year Treasury is basically a combination of inflation expectations, short-term rates and the premium paid for the term of the bond. When we look at cash rates and expected inflation, it leaves very little for term premium. In fact, at the end of 2017, the term premium for the 10-year Treasury sat at roughly -0.5%—possibly the lowest in history. To get the term premium back to 0%, the 10-year Treasury would need to rise to roughly 2.9%, or 0.50% higher than it ended the year. This estimation, of course, could be wrong if we have a period of deflation or at least very slow inflation, which seems unlikely given the strength of the labor market and the boost from tax reform. We think it is reasonable to prepare for a bond bear market in 2018.

Given the strength of the global economy and the potential for rapidly increasing rates (or volatile rates, at the very least), we expect to be overweight credit again in 2018. Our preference will be for U.S. corporate high-yield bonds, which could benefit from strength in the energy sector, EM bonds, and high-yield muni bonds. However, we are keeping our cash proxies on the table in the event of a sharp rise in long rates, which could put pressure on stocks and might trigger a flight to quality that would be very beneficial for short-term bonds. This could end up being the big trade for 2018.

FUN FACT

Super Bowl Sunday

The 2009 Super Bowl was the most watched U.S. TV broadcast in history, breaking a 20-year record held by the TV show MASH. In 2017, the broadcast averaged approximately 112 million viewers who ate an estimated 28 million pounds of chips, 1.25 billion chicken wings and 8 million pounds of guacamole. In fact, Americans consume more food on Super Bowl Sunday than any other day of the year besides Thanksgiving. TV sales also jump around the Super Bowl with as many as nine million new TVs sold in the weeks leading up to the big game.

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

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: 1.89% **Risk:** 5.70%

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: 3.02% **Risk:** 6.15%

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.

Emerging Market Stocks

Yield: 2.26% **Risk:** 10.07%

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: 4.18% **Risk:** 8.26%

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: 7.76% **Risk:** 19.46%

TREND	CARRY	
F	C	Volatility in MLPs continues to rise. Though there was a brief window where this asset class might have come back into favor, we are still waiting on an improving market for this asset class.

Preferred Stocks

Yield: 5.36% **Risk:** 2.15%

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: 3.45% **Risk:** 10.63%

TREND	CARRY	
B	D	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: 3.89% **Risk:** 6.55%

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: 3.67% **Risk:** 7.60%

TREND	CARRY	
C	C	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.

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: 2.19% **Risk:** 2.73%

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: 3.19% **Risk:** 3.08%

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: 2.36% **Risk:** 2.56%

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: 5.14% **Risk:** 3.36%

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: 5.72% **Risk:** 1.89%

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: 5.92% **Risk:** 1.50%

TREND	CARRY	
B	A	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.

Emerging Market Sovereign Debt

Yield: 4.90% **Risk:** 2.84%

TREND	CARRY	
A	B	This asset class has been a great performer, 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, such as the near 4% drawdown in September.

International Sovereign Debt

Yield: 0.71% **Risk:** 5.11%

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: 2.91% **Risk:** 1.87%

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: 1.89 % **Risk:** 0.54%

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 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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