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

Rising Rates Hit Home

The global stock market declined -4.20% in the month of February, putting an end to the historic run. Overall, global stocks had a maximum drawdown of -9.02% from the January 26th high, but recovered some of that loss through the rest of February. There were few places to hide from the sell-off as European stocks fell 5.88% and Japanese stocks fell -1.51%. However, the impact of currencies was more mixed in February than it has been in past months. The yen declined against the U.S. dollar in February, so local investors realized a loss of -3.71%. European investors, on the other hand, realized a better relative return of -3.69% due to the appreciation of the euro relative the U.S. dollar. U.S. stocks outperformed their foreign counterparts with a loss of -3.69% while small-cap U.S. stocks declined -3.87%. The sell-off took a toll on energy stocks, which were just starting to climb out of their rut in January, declining -10.84% in February, as measured by the S&P 500 Energy Sector.

The real action happened in the bond market as stocks and bonds both declined in February. The global bond market declined by -0.89% and the U.S. bond market declined by -0.95%. The decline in the value of the yen was a big drag on global bonds as U.S. dollar investors lost -0.22% in global bonds. One of the major themes discussed in last month's outlook was the expectation that credit should outperform the general bond market. This theme held up well in February as high-yield corporate bonds declined by -0.85% and emerging market corporate bonds and high-yield muni bonds (two of our noted favorites for income) increased by 0.04% and 0.07%, respectively.

STOCKS vs. BONDS

Cash Is King

One of the themes of this year's outlook was using cash as a hedge against market volatility rather than Treasurys. Since the bear market of 2008–2009, many investors have used long-dated Treasurys to hedge against stock market declines. However, the recent increase in interest rates and volatility in bonds indicated that it wasn't going to be a good strategy in the case of a stock market sell-off. Instead, we suggested in the January 2018 Income Report Card that investors might want to use short-duration bonds as a hedge. This strategy turned out to be quite prescient as the Bloomberg Barclays U.S. Treasury 20+ Year Index fell -3.12% in February while the Bloomberg Barclays Short Treasury Index increased by 0.07%. This theme will probably continue and we believe a portfolio should keep some short-term bond options in their quiver.

The added benefit of keeping cash on hand is the option to utilize it to rotate back into riskier assets once the storm passes. As of now, it doesn't appear that the markets are headed toward a full bear market. The recent sell-off is likely to be a correction within an ongoing bull market based on multiple pieces of evidence, the first being the lack of bad economic news. A bear market is typically concurrent with the start of a recession, but current economic data is quite strong. The JPMorgan Global Composite PMI (a measure of economic demand) is at 54.8, indicating that the economy is currently expanding. Furthermore, the overall health of the stock market remains strong. At the end of February, 68% of global markets in the MSCI All Country World Index were above their 200-day moving average. While the market isn't as healthy as it was in January, it is hard to say that this is a market in decline.

OUTLOOK

Keep Your Powder Dry

If a portfolio has followed a good risk management system, it is likely to be equal to benchmark weights in terms of stocks and bonds at this point. Furthermore, cash should have been a suitable alternative to stocks and, if that is the case, then the portfolio should be well set up for the next stage of this market, in our view. So where are markets heading now? We still see credit as a potential option for income portfolios. The spreads on most credit asset classes have improved and they are less sensitive to changes in interest rates. At this point, we believe an investor's bond portfolio should be a collection of high-yield corporate bonds, muni bonds, emerging market corporate bonds and cash.

From the stock side, emerging markets are still the best value in terms of earnings as nine out of the 10 best valued stock markets are emerging countries. Additionally, the robust performance of emerging markets has not been fueled by the decline of the U.S. dollar, unlike Europe and Japan. Therefore, a rebound in the U.S. dollar should not be an anchor for rising stock prices. Late last year, our outlook posited that energy might be a reliable source of returns given the massive sell-off in 2017 and the break in correlations between stock prices and oil prices. The sector didn't hold up well in the February sell-off, so this indicates that value investors aren't ready to pile back in to these stocks.

FUN FACT

That's a Big Bridal Party

Researchers recently discovered a new super colony of Adélie penguins near Antarctica on the Danger Islands. The study was trying to get an accurate count of breeding pairs for these penguins—one of the few breeds that require ice. It was an enormous find of 1.5 million penguins, which is good news as recent data has shown the breed in decline as the ice shelf in Antarctica recedes. The area falls between two already protected areas and the recent discovery has put the Danger Islands on a high-priority list for protection.

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: 1.88% **Risk:** 17.06%

TREND	CARRY	
B	F	U.S. stocks continue to outperform, eroding the income we are looking for. U.S. stocks continue to offer one of the worst absolute levels 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: 3.08% **Risk:** 12.47%

TREND	CARRY	
A	C	Developed foreign markets have benefitted greatly from 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: 2.35% **Risk:** 14.54%

TREND	CARRY	
A	D	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: 4.47% **Risk:** 16.96%

TREND	CARRY	
C	C	The positive correlation with bonds should be taken seriously, especially for any investor with a large position in fixed-rate bonds. Values need to improve here to provide income justifying a position.

Master Limited Partnerships (MLPs)

Yield: 8.21% **Risk:** 21.03%

TREND	CARRY	
F	A	Volatility remains very high in this asset class and needs to moderate before increasing positions.

Preferred Stocks

Yield: 5.61% **Risk:** 3.57%

TREND	CARRY	
D	A	Preferred stocks are the asset class to own for safe U.S.-based income. They do have a positive correlation to bonds, but the higher income stream should help protect them from changes in rates. Barring a recession, preferred stocks are a good safety asset class.

Utilities

Yield: 3.75% **Risk:** 16.36%

TREND	CARRY	
D	D	Utilities declined sharply along with other rate-sensitive asset classes. This asset class won't provide good exposure if rates continue to rise.

International Real Estate

Yield: 4.13% **Risk:** 12.09%

TREND	CARRY	
B	B	International real estate is still a great asset class for income, but the increased volatility has eaten away at the relative risk per unit of income. However, it will likely rebound as stocks find some better footing.

EM Infrastructure

Yield: 3.66% **Risk:** 11.07%

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.

Source: Bloomberg, Salient Partners, L.P., as of 02/28/18. The performance quoted represents past performance, does not guarantee future results and current performance may be lower or higher than the data quoted. This material is distributed for informational purposes only and should not be considered as investment advice, a recommendation of any particular security, strategy or investment product, or as an offer or solicitation with respect to the purchase or sale of any investment.

Salient®

MARCH 2018

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: 2.61% **Risk:** 3.05%

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 is best..

U.S. Investment Grade Credit

Yield: 3.64% **Risk:** 3.49%

TREND	CARRY
C	D

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

Municipal Bonds

Yield: 2.66% **Risk:** 2.47%

TREND	CARRY
D	D

We no longer see this asset class as a good alternative to Treasurys. Look to high-yield muni bonds, short duration munis or Treasurys, depending on tax needs.

High-Yield Municipal Bonds

Yield: 5.38% **Risk:** 3.47%

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 is likely the best opportunity.

U.S. High-Yield Corporate Bonds

Yield: 6.14% **Risk:** 2.95%

TREND	CARRY
B	B

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: 6.28% **Risk:** 1.97%

TREND	CARRY
A	A

EM corporate debt is one of our favorite asset classes for 2018. The low price volatility and high current income makes this asset class very attractive.

Emerging Market Sovereign Debt

Yield: 5.42% **Risk:** 3.86%

TREND	CARRY
B	C

There are many reasons to like emerging market assets, but this asset class is getting overpriced relative other bonds. Look to EM corporate debt instead.

International Sovereign Debt

Yield: 0.77% **Risk:** 5.68%

TREND	CARRY
A	F

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 interest rates rising, which they have been. A pullback in currency values could lead to a very sharp decline, such as the near 4% drawdown in September.

Mortgages

Yield: 3.36% **Risk:** 2.57%

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: 2.28% **Risk:** 0.70%

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.

Not FDIC Insured | No Bank Guarantee | May Lose Value

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