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 Show No Sign of Stopping

Global stocks had a decent month with the MSCI All Country World Index ending the month of August with a gain of 0.44%. However, nearly all this advance can be attributed to the emerging markets (EM). The MSCI Emerging Markets Index gained 2.23% for the month of August while the S&P 500 Index gained 0.31%, the MSCI Europe Index gained 0.06% and the MSCI Japan Index lost -0.05%. Small-cap stocks continue to have a rough time, as the Russell 2000 Index declined by -1.27% on the month. Because of the strong August performance, the MSCI Emerging Markets is up 28.29% year-to-date, nearly three times the gain of the S&P 500, which is up 11.93% in 2017. Last month, we discussed the impact of currency and that much of the gains in foreign stocks and bonds can be attributed to the rise of the euro and yen relative the dollar. Since this has been a key macro event driving foreign assets, it should be no surprise that August's lackluster returns for foreign stocks was accompanied by a decline in the U.S. Dollar Index, which fell -0.21% for the month.

Bonds had a strong month in August as global bonds increased by 0.99% with a yield of 1.48%. U.S. high-yield municipal bonds led the bond market with a gain of 1.38% and, like EM stocks, emerging market bonds finished strong with an increase of 1.27% for the month of August. However, this alignment didn't apply broadly to credit as U.S. high-yield bonds fell -0.04%. Sovereign bonds also posted a strong month with international sovereign gaining 1.05% and Treasurys gaining 1.08%. International sovereign bonds led the market overall and have posted a gain of 9.31% for the year, outperforming many segments of the stock market. In recent weeks, the yields on many sovereign bonds have fallen as investors seem to prefer the safety of government bonds as we enter the seasonally weak period for stocks. However, these bonds are currently yielding 0.67%, which leaves very little room for error and still makes it one of the most dangerous asset classes for income investors.

STOCKS vs. BONDS

Seasonal Weakness

The S&P 500 hit an all-time high on August 8, then tried and failed to break that high on September 1, which is typically a sign of a potential correction. This event also ushers investors into a seasonally weak period for stocks. Since the S&P 500 began in 1957, the mean monthly return for the index in September—the worst month—is a loss of 0.16%, while October— the second worst month—has exhibited a mean monthly return of 0.08%. While this seems to indicate that a correction is probable, it isn't likely to be a very big one. First, roughly 64% of the index members are trading above their respective 200-day moving averages and the number of new highs minus new lows is trending upward. This data seems to indicate that the overall stock market is still quite strong and any correction over the next two months is probably just a pullback in an ongoing bull market. Therefore, it makes sense that investors stay overweight stocks, but it wouldn't hurt to take some profit off the table.

Bonds are a real puzzle at this point. As expected, the U.S. Federal Reserve has begun to raise rates and, also as expected, the short end of the curve has increased this year from 0.51% to 1.16% for 3-month T-bills. However, long-term rates have continued to slide lower and the curve has flattened substantially. For example, the 10-year U.S. Treasury has decreased this year from 2.44% to 2.19% and doesn't appear to be stopping either. Earlier this year, many investors were focused on government policy as a key component driving market returns. The expectation was a unified White House and Congress would push ahead pro-growth policies such as reduction in taxes and infrastructure spending. This belief drove rates higher in November and December and kept the 10-year Treasury in a tight range of roughly 2.30%-2.60%.

Following the failure of so-called "repeal and replace," investors appeared to pivot away from pro-growth positioning and the 10-year Treasury fell into a new range of roughly 2.15%–2.40%. Further political turmoil has now pushed the rate even lower to nearly 2.00% in early September. The slide in rates is a bit surprising, but it is the flattening of the curve that is unique as cash rates are now closing in higher duration bond rates. Any type of market turbulence could trigger a flight to quality that might favor cash and therefore might even provide some opportunity for some appreciation in cash over long-term bonds. As we mentioned earlier, there doesn't appear to be any meaningful economic risk on the horizon, so this scenario is not immediate, but it is worth noting.

OUTLOOK

Crosscurrents

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

Who can make that straight, which He hath made crooked?*

Scientists at the Oregon Health & Science University have successfully genetically modified a human embryo. Though there are reports of successes in China, this feat is the first successful attempt in the United States. The new technique used a gene-editing tool known as CRISPR, which utilizes a complex arrangement of bacteria and snippets of virus DNA to permanently modify the genes. The experiment was unique in the number of embryos that were modified and the fact that it appears to have corrected defective genes that cause inherited diseases. Furthermore, earlier foreign studies resulted in partial adoption of the modified genes while the U.S. study appears to largely correct this issue.

* Ecclesiastes 7:13

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

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

SEPTEMBER 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: 2.00% **Risk:** 7.83%

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

International Stocks

Yield: 3.15% **Risk:** 7.44%

TREND	CARRY	
A	B	International stocks benefitted from the global bond sell off in June and July. Coupled with a slowing U.S. dollar relative to the euro and yen, now may be a good time to rotate into this asset class.

Emerging Market Stocks

Yield: 2.38% **Risk:** 9.28%

TREND	CARRY	
A	D	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: 4.12% **Risk:** 10.04%

TREND	CARRY	
C	C	The positive correlation of U.S. real estate with bonds should be taken seriously, especially for any investor with a large position in fixed-rate bonds.

Master Limited Partnerships (MLPs)

Yield: 7.65% **Risk:** 19.25%

TREND	CARRY	
F	D	Trend and carry have reversed sharply in the past few months. There is some great value in this asset class, but we are waiting to see volatility come down to signal an improvement in the risk environment.

Preferred Stocks

Yield: 5.40% **Risk:** 1.88%

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 interest rates. Weakness in financial stocks is weighing on this asset class, but it has yet to show up in price volatility.

Utilities

Yield: 3.30% **Risk:** 8.05%

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: 3.89% **Risk:** 8.45%

TREND	CARRY	
D	B	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 good capital appreciation as well.

EM Infrastructure

Yield: 3.57% **Risk:** 6.22%

TREND	CARRY	
C	A	If emerging market 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: 1.77% **Risk:** 2.64%

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 are best.

U.S. Investment Grade Credit

Yield: 2.98% **Risk:** 2.85%

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

Municipal Bonds

Yield: 2.08% **Risk:** 1.41%

TREND	CARRY	
C	D	Muni bonds offer an attractive yield relative Treasurys and the trend does appear to be improving. However, the low likelihood of recession favors taking more credit risk. We think you should look to high-yield municipal bonds instead. But, if you must have a high-safety asset class, we think this asset class is a better bet over Treasurys.

High-Yield Municipal Bonds

Yield: 5.26% **Risk:** 2.65%

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.

U.S. High-Yield Corporate Bonds

Yield: 5.61% **Risk:** 1.77%

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. There is some weakness from the energy sector, but it may be more of a buying opportunity than a risk.

Emerging Market Corporate Debt

Yield: 5.95% **Risk:** 1.34%

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 makes 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: 4.79% **Risk:** 3.15%

TREND	CARRY	
B	C	If you absolutely need government bonds, we see this as your best bet. However, we prefer emerging market corporate debt rather than this asset class.

International Sovereign Debt

Yield: 0.68% **Risk:** 7.29%

TREND	CARRY	
F	F	This asset class 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: 2.70% **Risk:** 1.78%

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: 1.33% **Risk:** 0.55%

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

Source: Bloomberg, Salient Partners, L.P., as of 08/31/2017. 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.

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Definition of Terms

10-year U.S. Treasury is a debt obligation issued by the U.S. Treasury that has a term of more than one year but not more than 10 years.

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 ACWI (All Country World Index) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets.

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 Japan Index is a free float-adjusted market capitalization index that is designed to measure the equity performance of 85% of Japan's large- and mid-cap segments.

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.

U.S. Dollar Index is a measure of the value of the U.S. dollar relative to six major world currencies: the euro, Japanese yen, Canadian dollar, British pound, Swedish krona and Swiss franc.

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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