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

Foreign Sovereign Bonds Get Their Comeuppance

The global stock market rebounded in April, gaining 1.03% for the month and bringing the year-to-date return to 0.16%. European stocks led the way with a gain of 2.77% in U.S. dollars and 4.75% in euros. Japan increased by 1.37% in USD and 3.58% in yen terms. Emerging markets didn't fare as well as developed markets and declined by -0.31% with very little impact from currency. The U.S. stock market managed a small gain of 0.38% with small-cap stocks gaining 0.86% for the month. Domestic energy stocks were a bright spot, finishing the month with a gain of 9.36% as oil hit new multiyear highs.

Global bonds declined sharply with a loss of -1.61% in USD but -0.37% in local currency, indicating that roughly 1.24% of the loss can be attributed to the decline of the euro and yen relative the U.S. dollar. Credit continues to lead the market with U.S. corporate high-yield bonds and high-yield muni bonds gaining 0.65% and 0.45%, respectively. Investment-grade bonds were a drag on the U.S. bond market with Treasurys declining -0.81% and investment grade credit falling -0.93%. As indicated, currency took a large bite out of foreign sovereign bonds, which fell by -2.46%.

STOCKS vs. BONDS

Despite Volatility, Stocks Continue to Gain

As discussed, foreign bonds fell sharply in April. We have discussed this type of market move in past report cards. Much of the gains in foreign bonds in the past year can be attributed to the appreciation of foreign currency and the fact that rising rates and inflation will eventually undo those gains. The worst is still likely ahead given the low interest rates paid by foreign sovereign bonds, which provide very little cover for these bonds as interest rates increase. Additionally, there appear to be some signs of inflation, which is a punch to the gut for bonds, especially low-yielding bonds.

Despite the increase in volatility, stocks have outperformed bonds this year. Nearly every market has been in a slow sideways-moving churn since the February drawdowns. Last month, we discussed some of the important price points to watch for as indications of renewed bull market strength. Though April clearly continued the sideways churn, the lows are getting higher and the highs are getting lower. As a result, the market appears set up for a big move in some direction. This consolidation will likely resolve itself as more November U.S. midterm election data becomes available.

OUTLOOK

Inflation Picking Up

Any casual observer of the markets might have noticed the increase in commodity prices lately. In fact, it appears that for the first time in several years, commodities are capturing some headline attention. This rise points to increasing inflation risks. Here are a few facts about these inflationary factors:

- Decreasing dollar: The USD is down nearly -9% relative other major currencies according to the DXY Index. As a result, the cost of foreign goods is going up.
- Increased price of finished goods: A component of the ISM Manufacturing Index is forward-looking measure of prices for finished goods (e.g., cars, not car parts). This component has been increasing and had the biggest change since the 2008–2009 financial crisis.
- Wages are increasing, applications are decreasing: Hourly wages are up 2.7% year-over-year while the number of open positions with few or no applicants has been increasing.
- Increased Consumer Price Index (CPI): the CPI is up 2.4% year-over-year, which is high by recent standards and, given the previously noted indicators, could go even higher. This increase is another issue for bonds going forward and, as long as inflation stays contained, is good news for stocks.

FUN FACT

Is Everyone Mad at You?

A recent study published in the Journal of Social and Personal Relationships found that certain people have difficulty identifying neutral facial expressions. Children that grew up in families with lots of conflict find it difficult to identify neutral expressions in adulthood. As a result, these same adults can misidentify neutral expressions as negative and develop a sense that everyone is upset with them. However, it appears to be a treatable phenomenon. Certain therapy tools exist that rely on computer models to help better identify the emotional context around facial expressions.

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. Bonds	Bloomberg Barclays U.S. Aggregate Bond
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

MAY 2018

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: 1.96% **Risk:** 21.84%

TREND	CARRY
A	F

U.S. stocks continue to outperform, eroding income. 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: 3.19% **Risk:** 12.89%

TREND	CARRY
B	C

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: 2.42% **Risk:** 15.91%

TREND	CARRY
A	D

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

U.S. Real Estate

Yield: 4.29% **Risk:** 17.77%

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: 8.76% **Risk:** 24.25%

TREND	CARRY
F	B

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

Preferred Stocks

Yield: 5.66% **Risk:** 3.30%

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: 3.65% **Risk:** 16.87%

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: 4.28% **Risk:** 11.83%

TREND	CARRY
C	A

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: 3.77% **Risk:** 11.75%

TREND	CARRY
B	B

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.

Salient®

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: 2.74% **Risk:** 2.94%

TREND F CARRY 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: 3.68% **Risk:** 3.25%

TREND C CARRY D

Things are looking a bit bleak for this asset class as volatility picked up slightly in February and March. This change just reinforces our belief that high-yield corporates are better in the current environment.

Municipal Bonds

Yield: 2.68% **Risk:** 1.75%

TREND D CARRY C

Muni bonds have improved since last month and look pretty good compared to Treasurys. However, managing duration of this asset class is important as they tend to be longer in duration than Treasurys. Barring a recession, look to high-yield munis instead.

High-Yield Municipal Bonds

Yield: 5.26% **Risk:** 2.90%

TREND A CARRY 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: 6.19% **Risk:** 3.06%

TREND B CARRY 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: 6.42% **Risk:** 1.98%

TREND B CARRY A

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

Emerging Market Sovereign Debt

Yield: 5.50% **Risk:** 4.03%

TREND C CARRY 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: 0.69% **Risk:** 6.13%

TREND A CARRY 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 2017.

Mortgages

Yield: 3.30% **Risk:** 2.78%

TREND F CARRY 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: 2.29% **Risk:** 0.73%

TREND D CARRY A

Right now we would prefer credit risk over short duration, but in the event of a 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.

ISM Manufacturing Index is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management (ISM) and monitors employment, production, inventories, new orders and supplier deliveries.

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

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 (DXY) 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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