Sit Investment Associates

January 2019

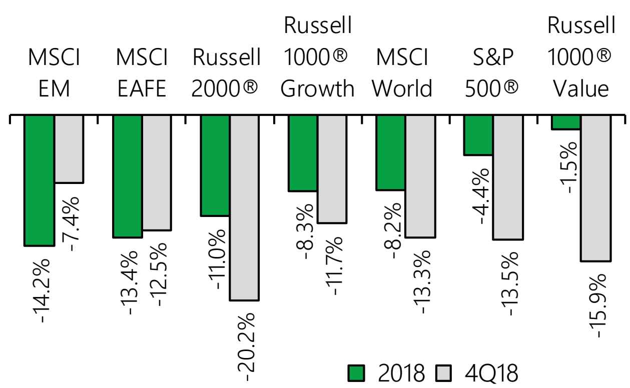
GLOBAL INVESTMENT OUTLOOK AND STRATEGY

- **Special Topic: Have Investors Become Too Pessimistic?**
- **Leading Indicators Imply Slower Growth, but No Recession in 2019**
- **U.S.-China Trade Conflict Negatively Impacting Global GDP Growth**
- **Fed Will Be Data Dependent; Probability of Further Hikes Decreasing**
- **Equity Upside from Stimulus, Trade Deal, Lower Oil, & Weaker US$**

MAGNITUDE OF EQUITY CORRECTION APPEARS UNWARRANTED; UPSIDE CATALYSTS IN 2019

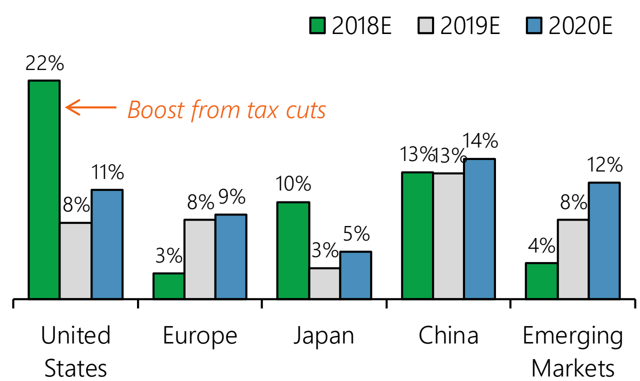
1 Pullback Across Regions and Market Cap

Total Returns, in U.S. Dollars



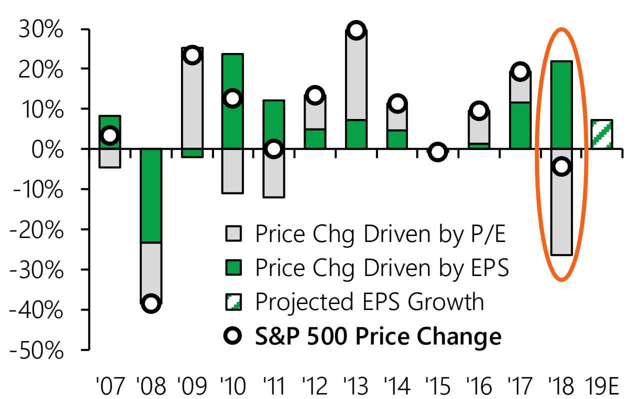
2 Earnings Revised Down, But Still Growing

Bottom-Up EPS Estimates for MSCI Indices
Y/Y Percent Change



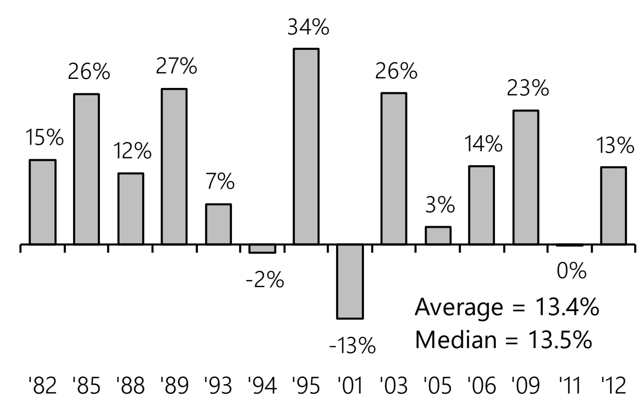
3 Negative Returns Driven by P/E Contraction

S&P 500 Price Returns, Contribution from EPS and PE



4 Solid Returns in Year After Big P/E Decline

S&P 500 Prices Returns in Year After Large P/E Decline



Source: FactSet, Cornerstone Macro, UBS, 12/31/18

Too Much Investor Pessimism

Investors were overwhelmed by several factors in 4Q18 that quickly reversed the positive sentiment that prevailed since late 2016. A pullback in stocks was warranted, but there now appears to be too much investor pessimism based on current market and economic fundamentals.

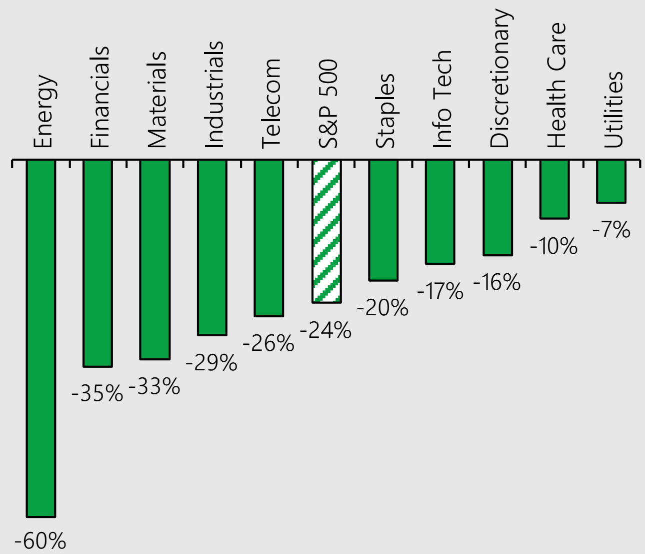
The sharp correction in equities in recent months pushed all major U.S. market indices into negative territory for 2018. We believe tightening financial conditions and escalating trade concerns were the two main reasons for the market retreat, with added pressure exerted from Brexit worries, a partial U.S. government shutdown, and a collapse in oil prices. The cumulative impact of these factors has weighed on global GDP growth, with virtually every major economy decelerating from trends in early 2018. Slowing global growth will take a toll on corporate earnings growth in 2019, with U.S. comparisons particularly difficult due to the tax-fueled gains in 2018. Economic and policy uncertainty naturally lead to bouts of "risk on" and "risk off" swings in markets, but the extremes witnessed in 2018 have been unnerving for investors.

Although difficult to measure precisely, changes in market structure could be exacerbating volatility. According to J.P. Morgan, roughly 85 percent of trading volume is currently generated from passive funds, risk-parity strategies, and high frequency/algorithmic traders. Momentum begets momentum, on the way up and the way down. For fundamental investors, changes in the market/trading landscape have been frustrating, as stock prices may be disconnected from "fair value" (i.e., reflecting discounted cash flows) for long periods. In fact, the greatest opportunities for fundamental active managers to add value are during bouts of volatility and dislocation. However, one may also need to extend time horizons to capture excess returns.

Equity valuations have fallen through most of 2018, with broad-based price-to-earnings multiple compression most evident in cyclical sectors. At the close of 2018, the S&P 500 forward price-to-earnings multiple of 14.7 times was at its lowest point since 2013, falling from 18.4 times at the beginning of the year. Global benchmarks paint a similar picture, with every major region trading at a sharp discount to the United States.

U.S. Equities De-Rated Across Sectors in 2018

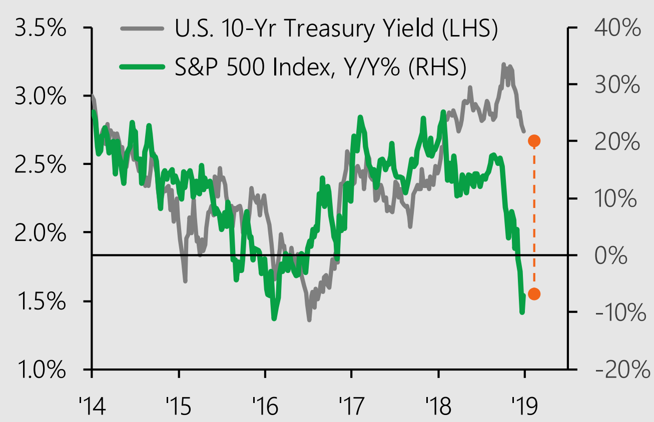
S&P 500 LTM PE, By Sector, % Change Since 12/31/17



Source: FactSet, 12/31/18

Interestingly, while the rise in Treasury yields was a major concern for investors through most of 2018, the sharp drop in yields recently has provided little support for equities. While bond yields may rise from current depressed levels, the combination of slowing Fed rate hikes in a backdrop of subdued inflation should prevent a major move in yields. This will lend support to equity valuations, which we believe are too low.

Absent Recession, Disconnect Unsustainable



Source: FactSet, 12/31/18

Dividends are also becoming a source of support for stocks. As of year-end, 38 percent of the stocks in the S&P 500 Index have had yields exceeding the 10-year Treasury yield. This compares to 15 percent at the end of the previous quarter.

While investors are clearly concerned that earnings forecasts are too high, we believe upcoming fourth quarter earnings reports will be solid enough to soothe investor fears. With bottom-up consensus forecasts still implying low double-digit growth for 2019 (ex-Energy), we expect estimates to come down modestly, but not materially enough to change our view that valuations are attractive. This "earnings reset" is largely discounted in equity valuations, although we expect significant volatility during the January 2019 reporting season.

Historically, sustained market downturns are almost always accompanied by recession. The financial crisis in 2008 still weighs heavily on investors, so an overreaction to slowing growth is understandable, particularly ten years into an expansion. Currently, the preponderance of data points to a slowdown, not an imminent contraction. U.S. consumer and business confidence are still high, the labor market is healthy, capital spending and manufacturing are growing, and there are no clear signs of "excesses" that tend to precede recession. As research from ISI Evercore highlights, there have been numerous market sell-offs that were not harbingers of economic downturn.

Major Market Corrections Without Recession

Year	S&P 500 Correction	Central Bank Action
1984	-14%	Fed funds cut
1987	-34%	Fed funds cut
1998	-19%	Fed funds cut
2010	-16%	PBoC eased
2011	-19%	Operation Twist
2016	-13%	Fed paused
Average	-19%	

Source: ISI Evercore, 12/23/18

While recession in 2019 is unlikely, we view the current backdrop of slowing global growth (notably in China), falling commodity prices, and a surging U.S. dollar are strikingly reminiscent of the late 2015-early 2016 period. To some extent, a slowing of the U.S. economy is welcome news in that it should result in a more dovish Federal Reserve and, therefore, take pressure off the surging U.S. dollar, which has also negatively impacted a number of emerging markets. The Fed has recently signaled a move away from regular quarterly hikes, shifting to a "data dependent" stance. In terms of trade, investors have seemingly ignored recent positive signs that the U.S. and China are finding common ground. We believe macro/market weakness has increased a sense of urgency for an agreement, even one that may be less than satisfactory for both countries. Combined with fiscal stimulus, we expect a trade agreement will boost the ailing Chinese economy, with a positive "second order" impact on global growth (particularly in emerging economies).

As to investment strategy, we believe that many pro-cyclical groups have been deeply oversold and offer compelling risk-reward opportunities. They include a diverse group of industries, including aerospace, semiconductors, oil refiners, chemicals, airlines, life insurance, and investment banks. Many stocks within these sectors are trading at single-digit price/earnings multiples, despite healthy dividends and earnings growth prospects. However, based on the likelihood that "end of cycle" fears will result in continued volatility, we believe it is prudent to balance cyclical stocks with defensive and more stable growth stocks. Attractive groups in this category include pharma/biotech, medical devices, HMOs, telecom, P&C insurance, and select technology stocks. Within technology, we continue to believe that the outsized performance of "momentum" stocks (including the "FAANGs") has largely run its course, and investors will be more discriminating and sensitive to valuations against a backdrop of moderating growth and increasing regulatory risks. Regardless of sector, we believe investors will focus on companies with healthy dividends to provide incremental return and a source of stability if market volatility persists, which we also expect. Internationally, the same catalysts impacting U.S. stocks should be even more supportive of depressed emerging markets. We continue to favor Asia (excluding Japan), but are incrementally more cautious on Europe due to elevated political/policy risks.

"Markets hate uncertainty" is perhaps the most overused phrase in the investment business. There is always uncertainty. Yet, we believe compelling investment opportunities occur when investors are overly focused on risk, not reward. With catalysts in place, we expect a solid year for investors in 2019.

The United States

U.S. leading economic indicators imply a moderation in GDP growth as the impact of fiscal stimulus wanes and financial conditions tighten, but no recession in the next 18 months.

Recession Unlikely in 2019, but Market Turmoil Risks Spilling Over to Economy

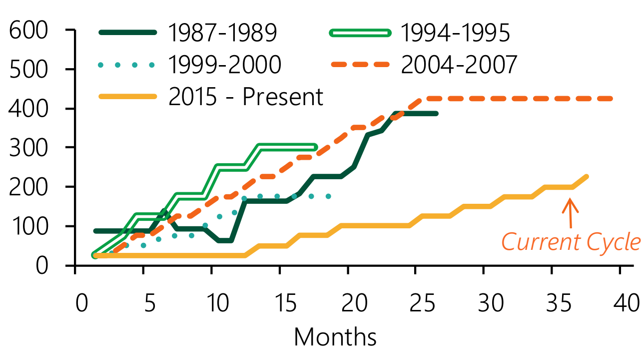
Elevated financial market unease notwithstanding, leading economic indicators generally remain favorable and do not imply recession is imminent within the next 18-24 months. However, real GDP growth will likely decelerate towards +2.0 percent in 2019 from a projected +3.0 percent in 2018 as the direct impacts of fiscal stimulus diminish, financial conditions tighten, and partisan conflicts intensify. We are optimistic a U.S.-China trade deal will begin to take shape in coming months, albeit progress will be subject to fits and starts, and that the Federal Reserve will be data dependent as it normalizes interest rates and its balance sheet concurrently (Exhibits 1 & 2). Moreover, rising incomes, higher tax refunds, and healthy household balance sheets underpin sustained resilience in consumer outlays. Risk assets, nonetheless, have been beset by fears that a possible monetary policy error, trade war, credit crisis, peak in corporate profitability, or combination thereof will lead to recession. Market turmoil risks spilling over to the real economy via the "wealth effect," confidence, and financial conditions if investor angst is left to fester. However, barring exogenous shocks, U.S. economic growth should remain above trend in 2019.

The Federal Reserve Will Disengage Autopilot and Be Data Dependent

Investors have been progressively conditioned to expect central banks to intervene or, at least, modify policy accordingly during periods of financial market stress (also known as the central bank put). Relative to previous Chairs of the Federal Reserve (Fed), Jerome Powell is less swayed by short-term financial market volatility than by "hard" measures of economic health. Moreover, while widely considered a pragmatist and policy centrist, Powell has made some regrettable communication blunders since becoming Fed Chair in January 2018. Notably, his comments during an early October PBS interview in which he stated the fed funds rate was "a long way from neutral" (implying the Fed would hike rates well above market expectation) helped spark the fourth quarter selloff in risk assets. Powell walked back his statement the following month, but numerous market pundits had by then declared the death of the "Fed put" – an important psychological backstop

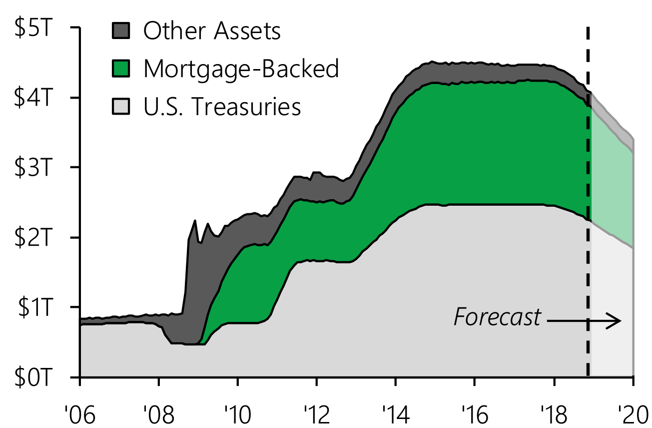
Exhibit 1: Pace of Fed Funds Rate Increases

Pace of Previous U.S. Monetary Tightening Cycles
Increase in Fed Funds Rate, Basis Points



Source: U.S. Federal Reserve, 12/31/18

Exhibit 2: U.S. Federal Reserve Assets, $ Trillion



Source: U.S. Federal Reserve, Sit Investment Associates, 12/31/18 for financial markets. Given heightened scrutiny, the Fed is unlikely to hike interest rates until there are at least two sequential increases in reported core inflation. Market stress and benign inflation will temper policy, but a trade deal would likely embolden the Fed.

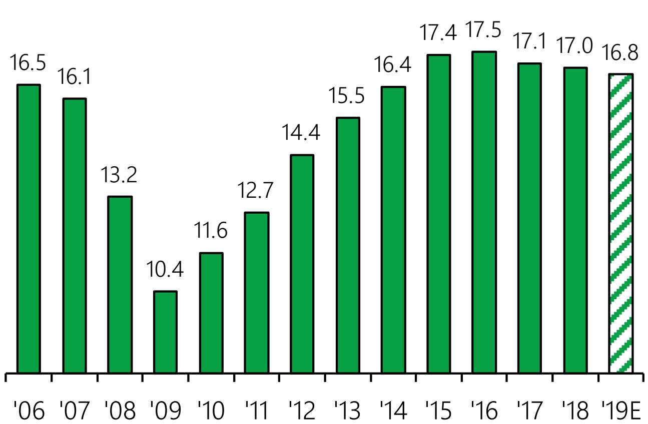
A U.S.-China Trade Deal Will Materialize, as Leaders Are Increasingly Motivated

The meeting between Donald Trump and Xi Jinping at the G20 summit on December 1 provided much-needed forward momentum in the, otherwise stalled, U.S.-China trade negotiations. While the 90-day timeline set forth to finalize a trade agreement will likely prove unrealistic, we are optimistic sufficient progress will be made to delay further application of increased tariffs on Chinese imports beyond the current March 1 deadline. Both leaders are increasingly motivated by decelerating economic growth and deepening political pressures to secure a trade deal sooner rather than later, albeit President Trump is still negotiating from a position of relative strength in our opinion. Nonetheless, post a shift in control of the House of Representatives (widely viewed as a rebuke of Trump), government shutdown, and market correction, the President likely seeks a political win. Still, we are careful not to underestimate the cultural (i.e., "Century of Humiliation") and demographic (i.e., rapidly aging population) forces at play in China that may make major structural reform challenging near term. While heightened tensions will persist as China challenges U.S. hegemony, we believe a trade deal will materialize in coming quarters.

Consumer Outlays Remain Resilient, but Rate-Sensitive Sectors Under Pressure

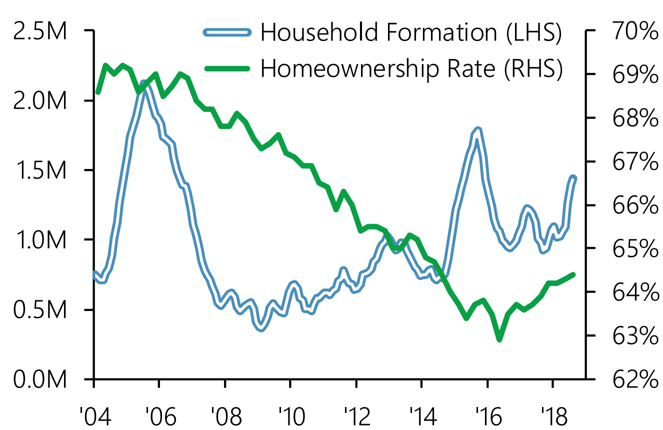
Buoyed by elevated confidence, an extra shopping day, and lower gasoline prices, holiday retail sales topped an already optimistic consensus forecast for +4.8 percent growth year over year, as consumers seemingly shrugged off financial market turmoil. According to data from Mastercard, U.S. retail sales increased +5.1 percent between November 1 and December 24 from a year earlier, representing the strongest growth in the last six years. In addition, U.S. households are now expected to receive a lift of $40-$60 billion from tax refunds in 2019, which bodes well for ongoing resilience in consumer spending. However, further stock market declines risk dampening outlays via the "wealth effect" and rising interest rates are having a negative impact on demand for housing and other big-ticket items. After plateauing at a resilient annual pace of over 17 million units since 2015, tightening credit standards and declining affordability portend softer light vehicle sales in 2019 (Exhibit 3). While rising mortgage rates and unfavorable tax policy changes have taken a toll, we expect a soft landing in housing as sales are supported by pent-up demand and accelerating household formation (Exhibit 4).

Exhibit 3: U.S. Light Vehicle Unit Sales (Million)



Source: National Automobile Dealers Association, 12/13/18

Exhibit 4: Household Formation vs Ownership

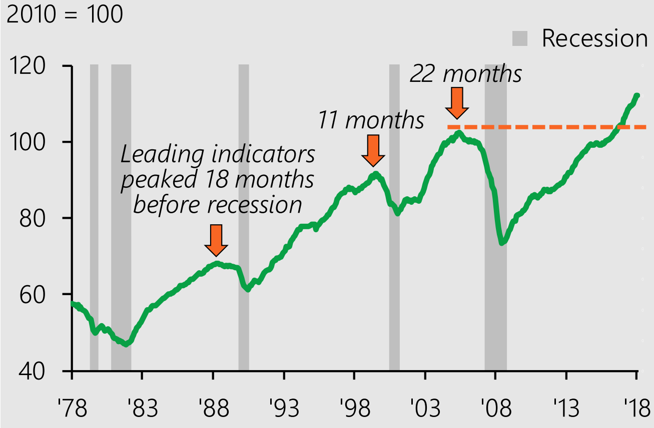


Source: U.S. Census Bureau, 12/31/18

United States: Notable Data Points

Index of Leading Indicators Continues to Rise

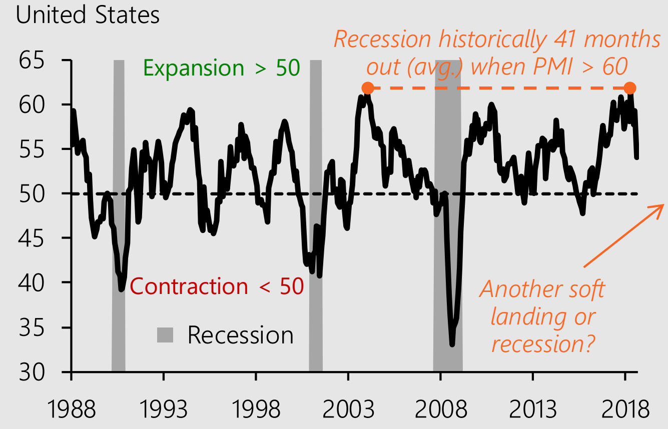
U.S. Composite Index of 10 Leading Indicators
2010 = 100



Source: Conference Board, 12/31/18

ISM Manufacturing PMI Normalized from High

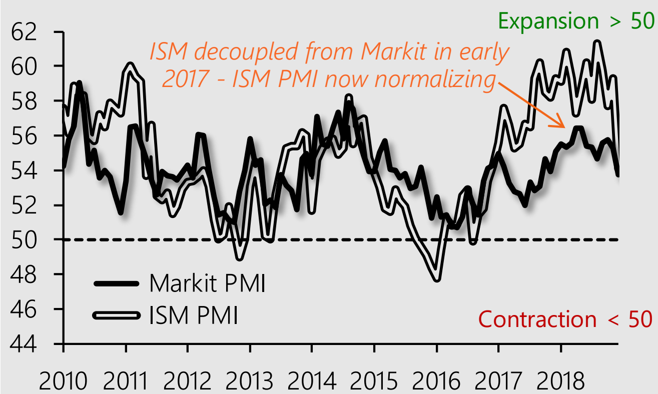
ISM Report on Business: Manufacturing
United States



Source: Institute for Supply Management, 1/3/19

Disconnect Between Two U.S. PMI Measures

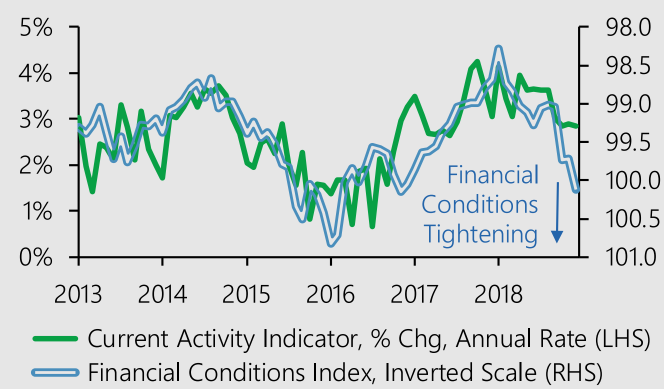
Manufacturing Purchasing Managers' Index
United States



Source: Institute for Supply Management, IHS Markit, 1/4/19

U.S. Financial Conditions Tightening Modestly

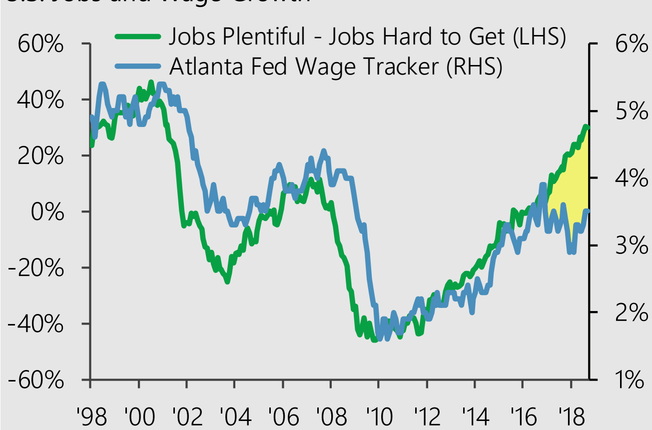
Current Economic Activity vs Financial Conditions
United States



Source: Goldman Sachs, 1/4/19

Wage Growth Poised to Accelerate in 2019

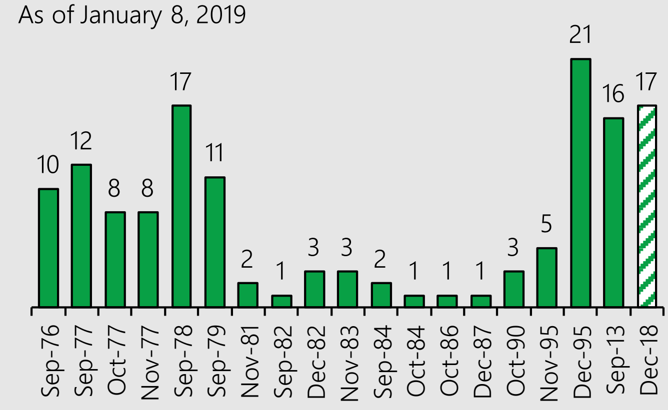
U.S. Jobs and Wage Growth



Source: Federal Reserve Bank of Atlanta, Conference Board, 12/31/18

Sustained Shutdown Could Dampen 1Q19 GDP

Appropriations Funding Gaps Since Fiscal 1977
As of January 8, 2019



Source: Congressional Research Service, 1/7/19

Europe

Growth negatively impacted by Brexit-related uncertainty and trade tensions. However, fiscal stimulus, a U.S.-China trade agreement, and a Brexit deal provide upside potential in 2019.

Trade Tensions Have Taken a Toll on Euro Area's Export-Driven Economy

Decoupled global growth, increased trade tensions, and a stronger euro have contributed to diminished prospects for the Euro Area's trade-sensitive economy, with GDP growth projected to moderate to +1.9 percent in 2018 and +1.5 percent in 2019 (compared to +2.5 percent in 2017). Domestic demand has been buoyed by a tightening labor market, improving wage growth, and elevated consumer confidence. However, elevated policy uncertainty and weaker exports are dampening business optimism and capital spending. Despite benign inflation and slowing growth, the European Central Bank (ECB) recently ended net asset purchases under its quantitative easing program. Reassuringly, it intends to reinvest principal payments from maturing securities for an extended period past the date at which it begins hiking interest rates. Although the appointment of a new central bank president in October 2019 presents some policy risk, interest rates will likely remain unchanged in 2019. Moreover, the Euro Area is poised to benefit from China's stimulus measures and a U.S.-China trade deal through improving export demand. Nonetheless, Brexit-related and European Parliament election uncertainties are near-term headwinds.

UK Economy Hobbled by Brexit Uncertainty and Slowing Export Demand

Brexit-related uncertainty, along with moderating global economic growth and elevated trade tensions, continued to take a toll on the UK economy. Real GDP is projected to dwindle to +1.3 percent in 2018 from +1.8 percent in 2017, and the outlook for 2019 is contingent on a Brexit deal. Leading indicators imply further moderation of growth in coming quarters, but do not yet indicate recession is looming. Even in the event of a no-deal Brexit, counter-cyclical stimulus is expected to sustain economic growth. While the Bank of England recently lowered its near-term GDP growth estimates, it also projects CPI inflation will be below its +2.0 percent target in coming months, providing some flexibility in terms of any additional interest rate hikes. Moreover, the Manufacturing PMI recently improved to 54.3 in December from a low of 51.1 in October (a reading above 50 is expansionary), albeit some of the strength is likely attributable to stockpiling ahead of the Brexit vote. However, much like the Euro Area, UK business confidence and investment have suffered from policy uncertainty and softer export demand. Once a Brexit deal is finalized, UK GDP could very well snap back to above-trend growth.

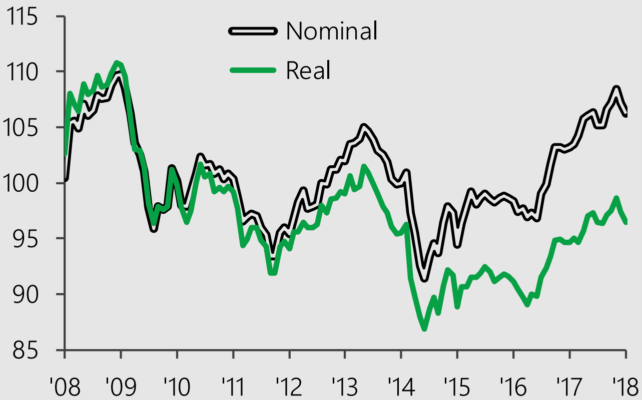
UK Parliament Reluctant to Act, but a Brexit Deal Will Remove a Key Overhang

Facing possible defeat, Prime Minister Theresa May postponed a parliamentary vote on a Brexit deal as she sought further assurances from the EU to bolster her political support. Parliament is now set to vote on the Withdrawal Agreement in the week of January 14. If the deal is rejected, the UK will be forced to leave the EU on March 29, 2019. However, the UK and EU will likely seek to avoid this outcome, possibly resulting in a conditional delay if Parliament requests more time to debate. If passed, a two-year transition period will begin until the agreed-upon terms of withdrawal go into full effect. With its back against the wall, given a no-deal Brexit could prove ruinous to the UK economy and a second EU referendum is viewed as politically unpalatable, we believe Parliament will ultimately approve the deal. While Prime Minister May recently survived a confidence vote, failure to secure a Brexit deal could force her resignation and trigger a General Election/change in leadership – there is an outside chance this may buy more time to (re)negotiate a deal with the EU.

Europe: Notable Data Points

Strong Currency a Headwind for the Euro Area

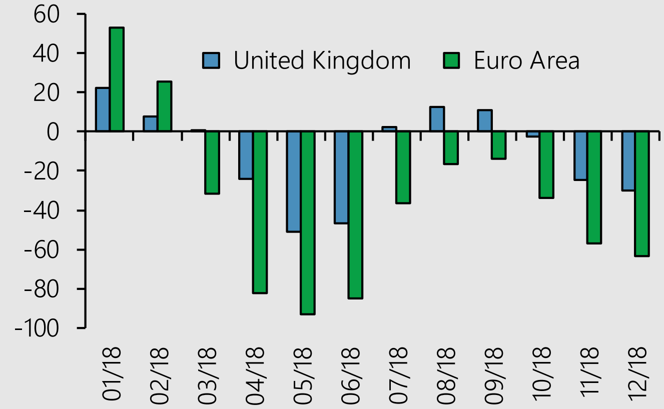
Euro Effective Exchange Rate Index



Source: Bank for International Settlements, 12/31/18

Negative Economic Surprises Increasing

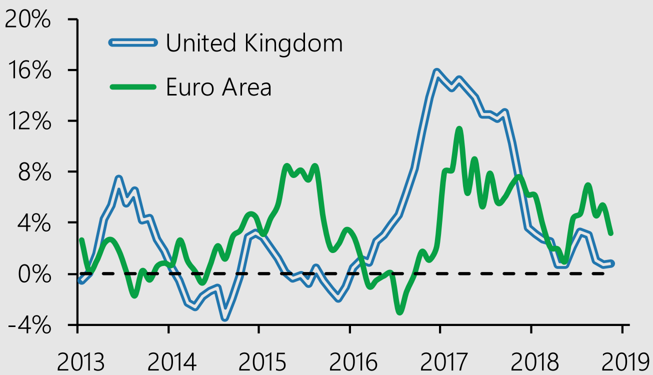
Citi Economic Surprise Index



Source: Citi Research, 1/4/19

Export Growth Hit by Elevated Trade Tensions

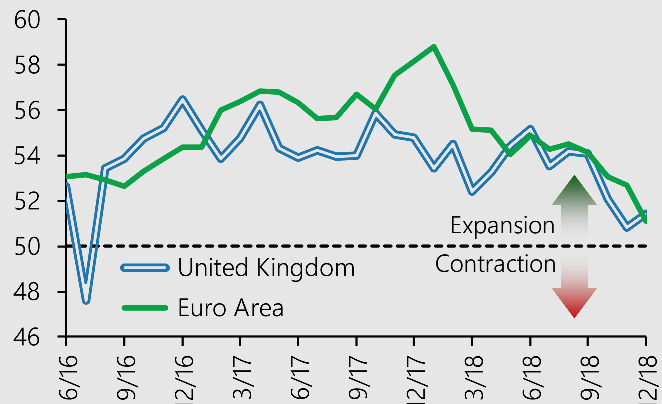
Export Growth
Y/Y Percent, 3MMA



Source: UK Office for National Statistics, Eurostat, 12/31/18

PMI Still Expansionary, But Moderating

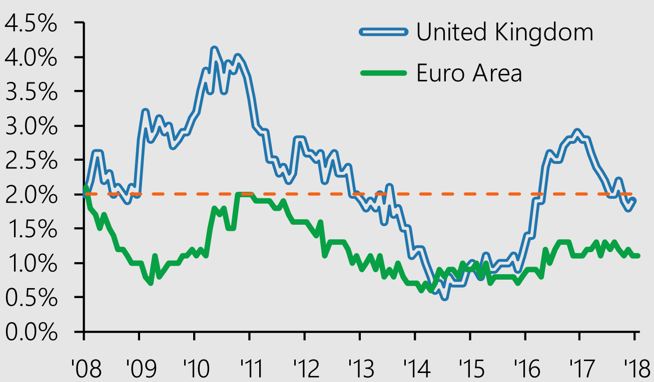
Composite Purchasing Managers' Index



Source: IHS Markit, CIPS, 1/4/2019

Inflationary Pressures Have Been Easing

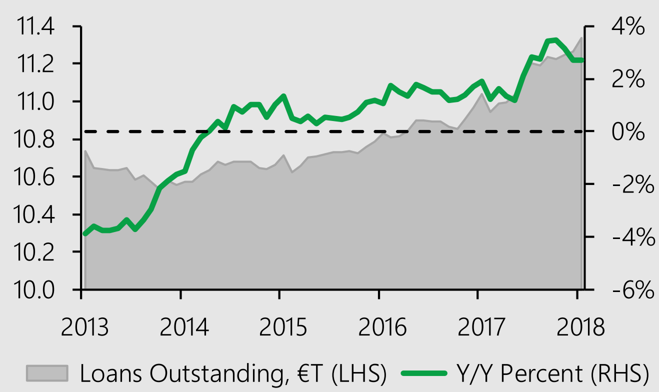
Consumer Price Index, Core Inflation
Y/Y Percent



Source: UK Office for National Statistics, Eurostat, 12/31/18

Euro Area Loan Growth Recovering

Euro Area MFI Loans Outstanding
€ Trillion



Source: European Central Bank, 12/31/18

Japan

Moderating growth abroad, subdued domestic demand, and a looming consumption tax hike in October 2019 point to a clouded outlook for Japan.

Japan faces a more challenging economic backdrop in 2019, especially as slowing growth abroad and heightened trade tensions threaten its main growth engine – exports. The favorable global growth environment over the past 18 months has benefited Japan as strengthening growth overseas buoyed demand for big-ticket exports, such as machinery and autos, and lifted corporate profits. However, some indicators, including moderating export data and purchasing managers' surveys, suggest difficulties abroad are beginning to weigh on the economy (Exhibit 5). An amicable trade outcome between the U.S. and China, Japan's two largest trade partners, would considerably improve the outlook. Meanwhile, domestic demand is firming, albeit at a subdued pace. While a looming consumption tax hike in October presents a significant risk, it is needed to strengthen the fiscal situation having already been twice delayed. Previous tax hikes have triggered meaningful slowdowns, although a package of offsetting spending measures this time should soften the impact (Exhibit 6). Even so, the economy has limited room to cope with any headwinds to growth, struggling to stay outside deflationary territory.

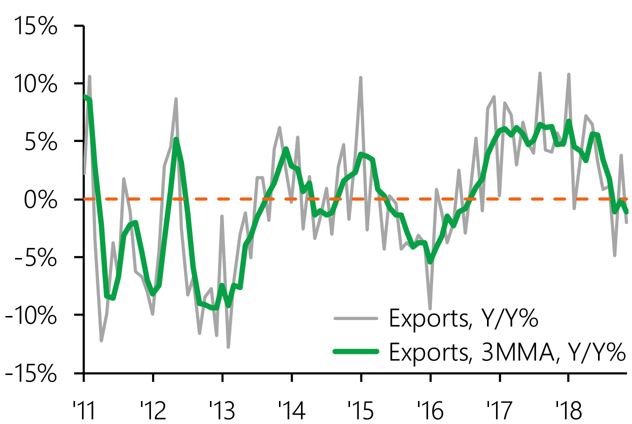
Emerging Markets

Escalating trade tensions, slowing global economic growth, higher interest rates, stronger U.S. dollar, and rising foreign currency debt remain overhangs to emerging markets. The Chinese government is expected to introduce more stimulus and policy support for the slowing economy amid uncertainties on the trade front.

China's Growth Slowed More Than Expected, But More Stimulus Forthcoming

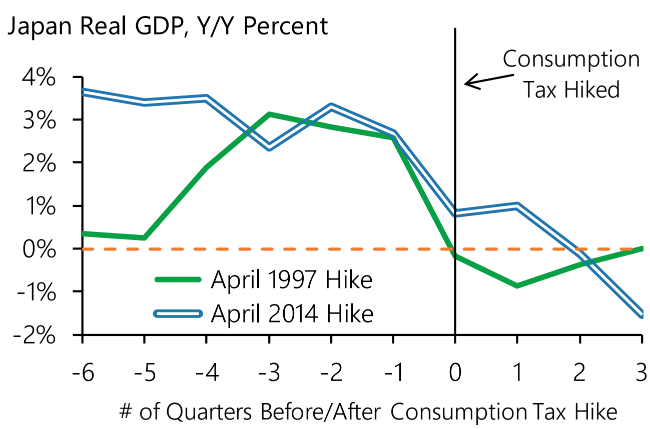
Downward pressure on China's GDP growth will likely continue as the lagging effects of deleveraging efforts and trade tensions increasingly impact the real economy (Exhibit 7). Stimulus so far has largely been defensive and targeted, focusing on fiscal policy and the private sector rather than reopening the credit spigot. Looking ahead, fiscal policy will be more proactive, involving further tax cuts and a meaningful rise in local government bond issuances (Exhibit 8). Monetary policy will also remain accommodative, with more cuts to the reserve requirement ratio anticipated. While the consensus view is that GDP growth will stabilize in 2Q19, we believe timing is difficult to predict given both credit

Exhibit 5: Japan Export Volume Growth



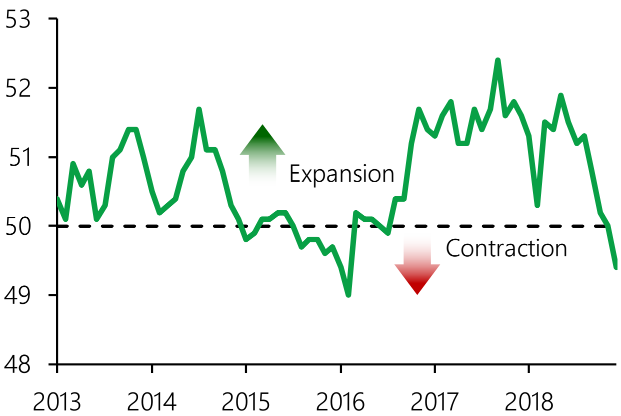
Source: Japan Customs, 12/31/18

Exhibit 6: GDP Impact of Past Tax Increases



Source: Japan Cabinet Office, 12/31/18

Exhibit 7: China Manufacturing PMI



Source: National Bureau of Statistics, 1/4/19

Exhibit 8: China Tax Reduction Actions

Date	Policy Action
May 2018	The rate of value-added tax (VAT) reduced by 1 percentage point
Oct 2018	Threshold for taxable individual income raised to ¥5,000 from ¥3,500 per/mo
Sep & Nov 2018	Tax refund ratio for exports raised.
Jan 2019	New law for Individual Income Tax will be effective, with more deductible items.
Further actions expected/discussed in the market	Streamline VAT rate structure, from 3-tier to 2-tier rates; Further reduction of VAT rates.

Source: Bloomberg, 12/18/18

recovery and trade negotiation uncertainty. As a result, we lowered our 2019 real GDP growth forecast slightly to +6.2 percent from +6.3 percent but keep our 2018 projection of +6.5 percent unchanged. While counter-cyclical policies may help stabilize growth near term, only structural and market reform can bring sustainable growth in the mid- to long-term. We believe recent discussions about more support for private firms and competitive neutrality is a step in the right direction.

More Than Just Rhetoric from China?

We are encouraged by China's efforts to de-escalate trade tensions following the Trump-Xi meeting at the recent G20 summit. Consensus expectation is for tariffs to increase to 25 percent on March 1 and limited, if any, progress on intellectual property protections and industrial policy. However, we are cautiously optimistic that China's response could be more than just cosmetic and think financial markets could be underestimating the potential for a trade deal. Forty years after the launch of economic reform, China is now facing unprecedented domestic challenges. With a rapidly aging population, years of property development, and high debt levels, traditional macro stimulus measures are no longer as effective. It is in China's own interest to reconfirm its commitment to much-needed pro-market reforms to reinvigorate growth. Pressure for reform is also high on the external front, as being tougher on China is one policy for which there is bipartisan support in Washington. In addition, the global business community has become more vocal about its frustration with China's industrial policies and market restrictions. We are confident policymakers in China fully recognize the need for more than just words to address these concerns. We see the West's demands are largely consistent with China's domestic reform agenda, although the plan's implementation remains sticky so far.

India's GDP Growth Slower, But Economy Helped by Lower Inflation

Supported by robust credit growth, consumption, and industrial production, we project India's real GDP will expand +7.2 percent in fiscal 2019 and +7.3 percent in fiscal 2020. Notably, bank credit growth is at a 5-year high and industrial production growth is at an 11-month high (Exhibit 9). Risks from high inflation and a widening current account deficit have also diminished, as the inflation rate has fallen on lower oil and food prices. However, the upcoming 2019 general election is a key risk. In the recent state assembly elections, Prime Minister Narendra Modi's Bhartiya Janata Party was trounced, losing more than 100 of the 678 total seats across five states, and three key Hindi states.

Nonetheless, we think Modi has the support to win the general election and continue his policy agenda of promoting GDP growth, foreign investment, and a more business-friendly environment.

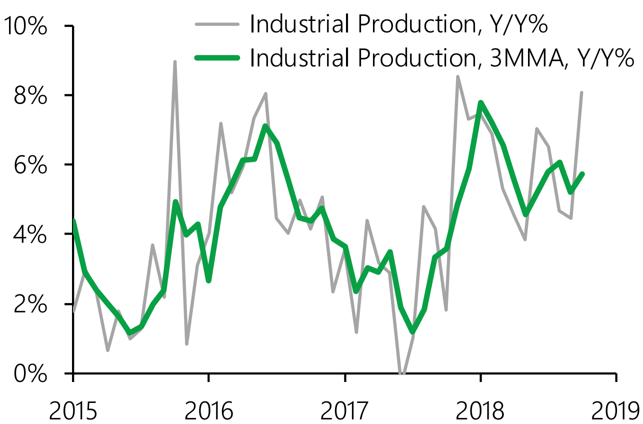
U.S.-North Korea Talks Stalled; Expect Slower GDP Growth in South Korea

Denuclearization talks have stalled, as the U.S. has continued to escalate sanctions and its human rights campaign against North Korea. We believe talks over denuclearization will take time and are optimistic for a peaceful resolution. As for South Korea, GDP growth moderated to +2.0 percent in the third quarter on weaker investment and consumption. Exports, by value, slowed to +4.5 percent year over year in November, with exports to China dropping -2.5 percent. Trade tensions with China could further negatively impact South Korea's exports, as 27 percent of total exports go to China and close to 70 percent of those are categorized as intermediate goods. Although we expect consumption and a positive trade resolution will support growth, we lowered our 2018 GDP growth forecast to +2.7 percent from +2.9 percent and expect 2019 growth of +2.6 percent. Despite a November inflation rate of +2.0 percent year over year that was in-line with its target, the Bank of Korea raised its policy rate +25 basis points to 1.75 percent. However, we believe the Bank could reverse course to stimulate the economy if needed.

Reform Uncertainty in Brazil; Socialist Policies Foreshadowed in Mexico

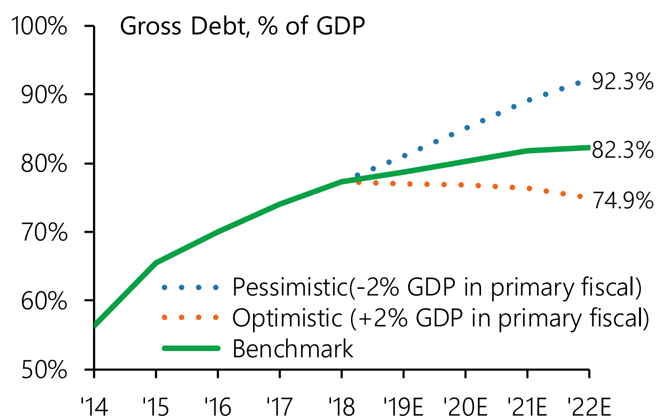
In Brazil, the newly-elected, far-right president (Jair Bolsonaro) faces the dual challenges of high public debt and sluggish growth (Exhibit 10). Brazil's economic recovery is dependent upon passage of reforms that will stabilize the debt. However, given that Bolsonaro's support in Congress is limited, he may not be able to pass the requisite legislation. As a result, we expect continued slow economic growth of +1.3 percent in 2018 and +2.2 percent in 2019, led by consumption. In Mexico, leftist President Andres Manuel Lopez Obrador (AMLO) canceled further construction of the $13.3 billion Mexico City airport after it was one-third completed. His socialist agenda will increase fiscal spending, raise public debt, and discourage foreign investment. We forecast Mexico's economy will grow +2.1 percent in 2018 and +2.0 percent in 2019, as domestic demand continues to moderate. In addition, a slower growing U.S. economy could weigh on Mexico's growth. Mexico's inflation rate of +4.7 percent year over year in November is ahead of the central bank's target of +3 percent, which resulted in Banco de Mexico increasing interest rates +25 basis points to 8.25 percent in December.

Exhibit 9: India Industrial Production



Source: CEIC, 12/31/18

Exhibit 10: Brazil Gross Public Debt (% of GDP)

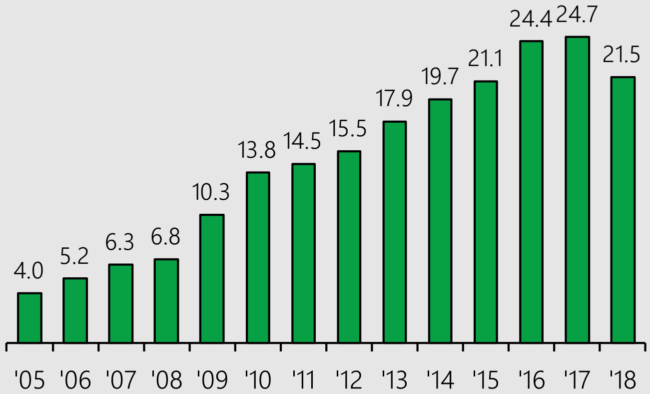


Source: Citi Research, 12/11/18

Emerging Markets: Notable Data Points

First China Car Sales Decline in Two Decades

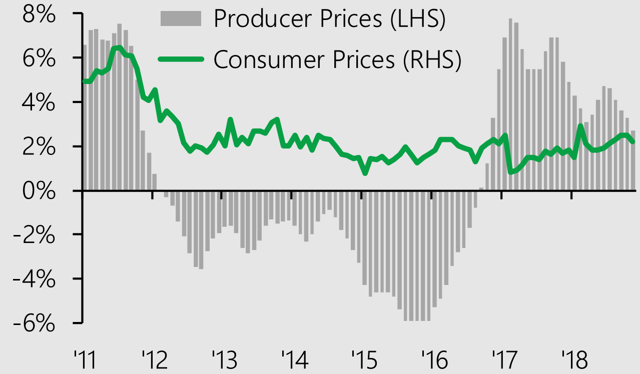
China Auto Unit Sales
Millions



Source: Bloomberg, 12/31/18

China Inflation Confirms Weakening Demand

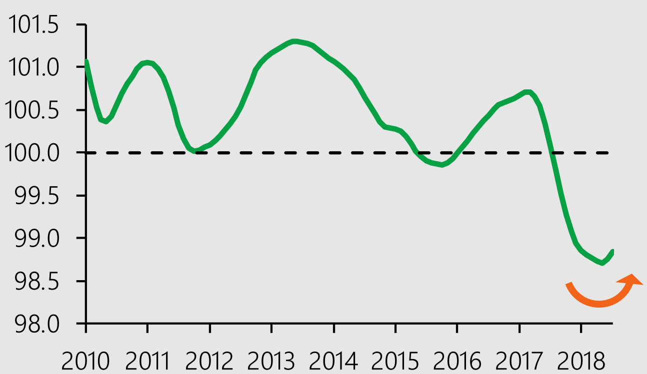
China Inflation Indices
Y/Y Percent



Source: National Bureau of Statistics, 12/31/18

China LEI Suggests Potential Recovery Ahead

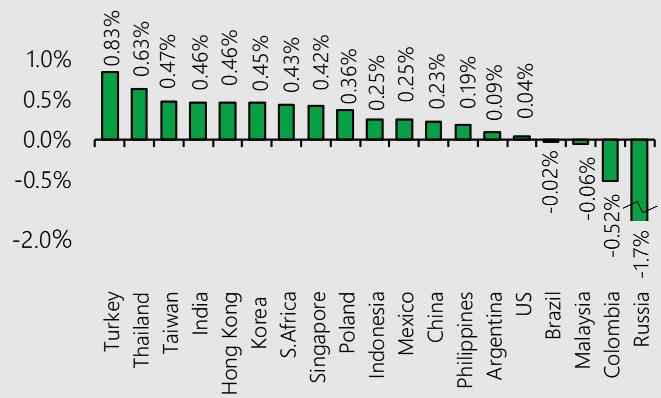
China Composite Leading Indicator
Amplitude-Adjusted, Long-Term Average = 100



Source: OECD, 12/31/18

Falling Oil Prices Are a Tailwind for Many EMs

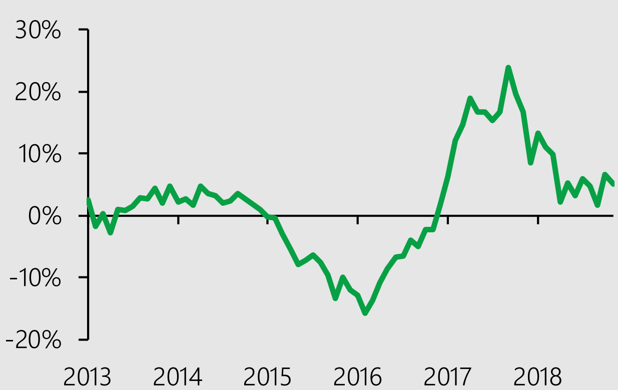
Impact of US$10 Oil Price Decrease on Current
Account Balance as Percent of GDP



Source: Morgan Stanley, 12/12/18

South Korean Exports Continue to Weaken

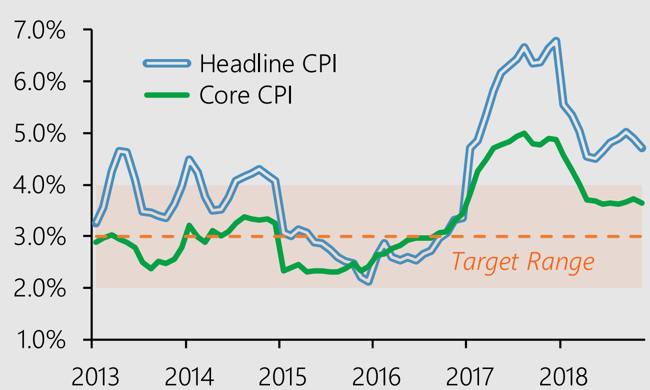
South Korea Exports
Three-Month Moving Average, Y/Y Percent



Source: Ministry of Trade, Industry and Energy, 12/31/18

Mexico's Headline Inflation Remains Elevated

Mexico Consumer Price Index
Y/Y Percent



Source: Bank of Mexico, 12/31/18

Taxable Bonds

Struggling Asset Prices versus Healthy Economic Activity

We are currently experiencing a disconnect between financial markets and economic data, Wall Street versus Main Street. The recent sharp decline in equity markets, collapse in oil prices, yield curve inversion, and elevated policy uncertainty are all flashing warning signals for potential recession. However, actual underlying economic activity remains healthy, albeit moderating from a near-record pace. The unemployment rate is at an historic low, wages are increasing, and holiday retail sales were exceptionally strong. What is causing this dislocation? Recall the financial crisis and implementation of the asset purchase program known as Quantitative Easing. From 2009 to 2014 the Federal Reserve (Fed) grew its balance sheet to over $4 trillion via printing money to buy bonds. Cash flooded the financial system and asset prices soared. From 2014 to 2017, the Fed maintained the size of its balance sheet of bonds by reinvesting cash flows. Finally, in October 2017, the Fed began reducing its bond holdings by not reinvesting cashflows by $10 billion a month (no outright sales yet), increasing quarterly to the current maximum level of $50 billion a month. This was, and still is, an unprecedented monetary policy experiment. When the purchase program began almost a decade ago, the market was rightfully concerned about the eventual exit strategy and its effect on asset prices.

Supply-Demand Imbalance = Lower Liquidity and Higher Yields

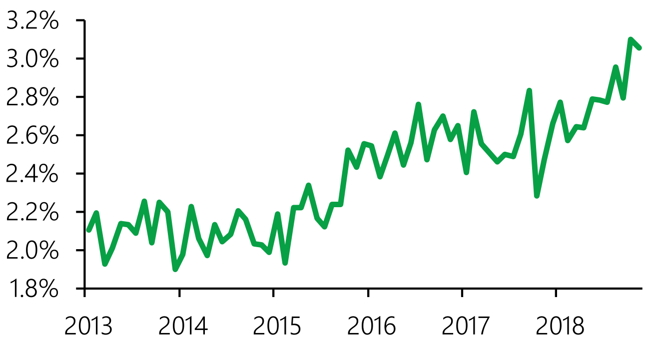
The reduction of the Fed's balance sheet is absolutely necessary and we fully support its pursuit of normalizing monetary conditions. Underlying economic data is robust and the economy should be able to support itself. These conditions are generally when a reduction in stimulus would be warranted. The result is the current phenomenon of a correction of asset prices despite strong underlying economic growth. Combine this reduction in demand for bonds with the increased issuance of Treasuries to cover the growing fiscal deficit and we are left with a large supply-demand imbalance running at $125 billion per month. This supply-demand imbalance is pulling cash from other areas of the market (high-yield bonds, etc.) and is independent of the underlying economy. In conclusion, markets are going through a healthy adjustment of financial asset prices that does not imply the U.S. economy is headed for recession.

Inflation Data Will Be the Key to Future Rate Increases

The Federal Reserve's path for interest rates in 2018 was programmatic, with 25 basis point increases every quarter (conveniently coinciding with scheduled press conferences). The path for 2019 will be different. Each of the eight Fed meetings in 2019 will be "live" and followed by a press conference. The emphasis on data dependency versus predictability of rate increases will drive monetary policy going forward. We believe the Fed will not raise rates until there is clear evidence of rising inflation, characterized by 2 consecutive (month over month) increases in PCE (or CPI) inflation. The consensus forecast for inflation in 2019 is higher than 2018, so we anticipate a period in which we will see inflation increase and expectations rise accordingly. The timing could be sooner rather than later due to high holiday sales and less pressure for retailers to discount combined with rising wage costs. Wages are rising more than +3 percent annually and core PPI is +2.4 percent (Exhibit 11). Labor and materials are the two primary cost inputs for prices, therefore it is difficult to envision a scenario in which core PCE does not rise from its current level of 1.9 percent.

Exhibit 11: U.S. Average Hourly Earnings

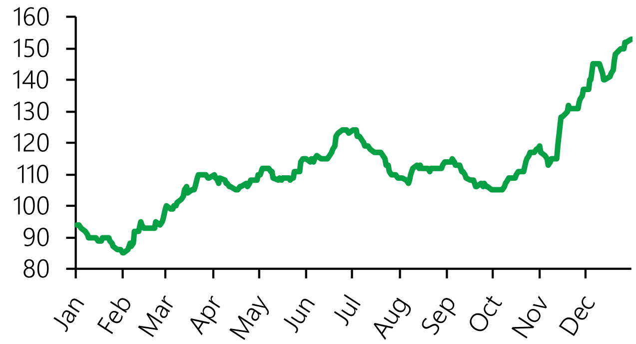
All Employees, Total Private
Nominal, Year-over-Year Percent



Source: U.S. Department of Labor, 12/31/18

Exhibit 12: Investment Grade Credit Spreads

Bloomberg Barclays U.S. Aggregate Corporate IG OAS
Basis Points



Source: Bloomberg, 12/31/18

Taxable Fixed Income Outlook and Strategy

We continue to position portfolios defensively against rising short-term interest rates and anticipate further inversion of the yield curve in 2019. Reduced central bank demand for bonds, combined with an additional trillion dollars of new supply of Treasuries to fund deficits over the next year, will require higher yields to entice investors to fill the void. Those investors are coming from riskier asset classes. This will continue to put upward pressure on the short end of the yield curve and widen spreads for non-government bonds. To a lesser extent, we anticipate longer-term yields to rise due to increased inflation expectations as wage and price increases become more evident in economic data. A potential tailwind of larger than expected tax refunds may continue to support economic activity well into 2019. We continue to favor higher quality credits where appropriate for 2019, as the normalization process continues to put pressure on spreads for lower-rated bonds (Exhibit 12).

Municipal Bonds

Tax-Exempt Yields Decreased Throughout the Curve

Tax-exempt municipal bond yields, as measured by the MMD AAA GO curve, ended the fourth quarter lower, with intermediate maturities experiencing the largest decrease. For the full year 2018, yields increased across the curve, with longer maturities increasing the most. During the quarter, the spread between 2-year and 10-year municipals tightened to 50 basis points from 61 basis points, while the spread between 10-year and 30-year municipals widened to 74 basis points from 61 basis points. Overall, the spread between 2-year and 30-year spot yields was little changed during the quarter, ending with a spread of 124 basis points versus 122 basis points at the end of September, both of which steepened from the spread of 98 basis points at the end of 2017. In terms of specific spot yields, the 2-year AAA GO spot yield ended the quarter at 1.78 percent, a decrease of 19 basis points in the fourth quarter and an increase of 22 basis points for the year. The 30-year spot yield ended the year at 3.02 percent, a decrease of 17 basis points for the quarter and an increase of 48 basis points for the year. The Bond-Buyer 40-Bond Index, predominantly consisting of longer bonds, peaked at 4.34 percent in November before ending the year at 4.09 percent, a decrease of 3 basis points for the quarter but still an increase of 22 basis points for the year.

Intermediate Maturities Fared Best

Structure was the most significant driver of performance during the quarter with intermediate bonds in the 7- to 15-year range outperforming both shorter and longer maturities versus full year performance, where 3- to 5-year maturities did best (Exhibit 13). Credit quality also contributed to performance during the quarter, with higher credit quality issues outperforming lower credit quality issues, reversing the full year trend of lower quality bonds outperforming higher quality bonds. Housing bonds, a significant weighting in Sit client portfolios, were the strongest performing industry for both the quarter and the year.

Decreased Issuance and Mostly Negative Fund Flows

Municipal market issuance decreased to $86 billion in the fourth quarter from $87 billion in the third quarter and $155 billion in the fourth quarter of 2017. For the year, total municipal issuance was $339 billion versus $449 billion in 2017 (Exhibit 14). 2017 issuance, particularly in the fourth quarter, was unusually high due to concerns about the potential impacts from tax reform. Municipal market strategists generally expect municipal issuance to increase by approximately 10 percent over 2018 in 2019. Fund flows were largely negative during the quarter; however, the last two weeks of the year posted inflows after twelve consecutive weeks of outflows that had begun in mid-September.

Tax-Exempt Fixed Income Outlook and Strategy

We expect tax-exempt interest rates may rise modestly during the first half of 2019, somewhat correlated with movements in U.S. Treasury bonds. Our strategy continues to emphasize a combination of higher quality long-term housing issues and bonds possessing both short call provisions and higher coupons to limit extension risk. Our portfolios continue to provide meaningful current income, which has been shown to be the primary driver of total return over a full market cycle. We expect to maintain most portfolio durations near their current levels and, as always, view diversification as a key tenet in managing portfolio credit risk.

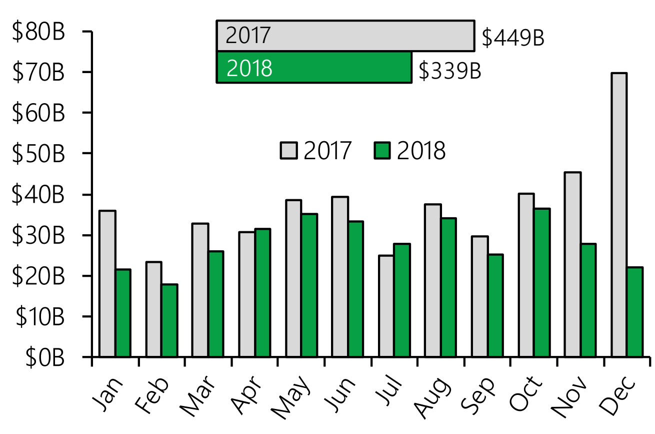
Exhibit 13: Municipal Bond Yields and Spreads

Yields	12/31/17	3/31/18	6/30/18	9/30/18	12/31/18
2-Yr MMD AAA GO	1.56	1.65	1.64	1.97	1.78
5-Yr MMD AAA GO	1.68	2.04	1.99	2.20	1.94
10-Yr MMD AAA GO	1.98	2.42	2.46	2.58	2.28
30-Yr MMD AAA GO	2.54	2.95	2.94	3.19	3.02
Bond Buyer 40 YTM	3.87	3.98	3.98	4.12	4.09

Spreads	12/31/17	3/31/18	6/30/18	9/30/18	12/31/18
2-10 MMD Spread	0.42	0.77	0.82	0.61	0.50
10-30 MMD Spread	0.56	0.53	0.48	0.61	0.74
2-30 MMD Spread	0.98	1.30	1.30	1.22	1.24

Source: Thomson Reuters, The Bond Buyer, 12/31/18

Exhibit 14: U.S. Municipal Bond Issuance



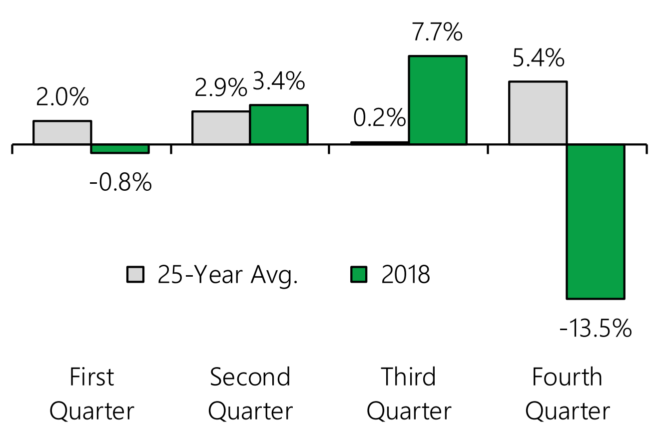
Source: The Bond Buyer, 1/3/19

2018 – The Year Without a Santa Claus [Rally]

Just a month after becoming the longest bull market in U.S. history, the S&P 500 Index sold off sharply, dropping -19.8 percent between September 20 and December 24 – just 21 basis points shy of the "official" definition of a bear market. The U.S. equity market skipped its typical fourth quarter rally and Santa was a definite no-show (Exhibit 15). Consequently, there have now been six bull market corrections of 10 percent or more in the S&P 500 Index since the end of the "Great Recession," with an average pullback of -14.9 percent. In terms of our macro outlook, not enough has changed to reconcile the magnitude and abruptness of the selloff. Nonetheless, investor sentiment went from euphoric to panic (Exhibit 16) with a flip of the switch as hawkish Fed comments, U.S. Treasury yield curve inversion, weak Chinese economic data, a supply-driven collapse in oil prices, a couple of high-profile earnings disappointments, and government shutdown spooked financial markets. Investors had simply become too complacent and a "reset" was needed to realign expectations with the reality of slowing economic growth (without a recession) and lower federal stimulus. While compelling investment opportunities have resulted, there is a risk the selloff could become self-fulfilling if continued market stress results in significantly tighter financial conditions and reduced confidence/spending.

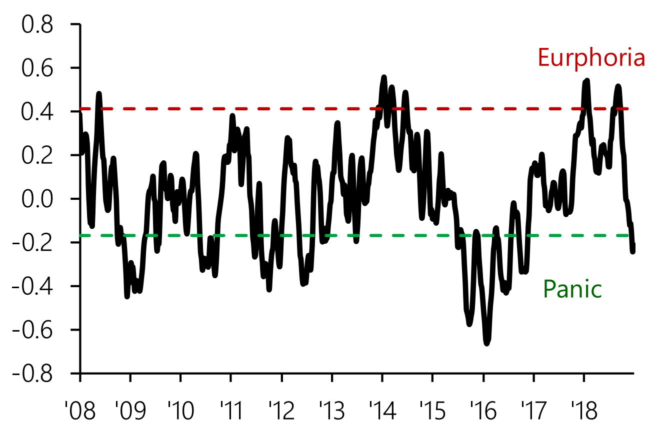
Emerging market stocks were battered through much of 2018 as deteriorating PMI data, stronger U.S. dollar, increasing oil prices, tightening financial conditions, and expanding current account deficits had investors running for the exits. While emerging markets were not immune to the fourth quarter selloff, the MSCI EM Index performed better (or less poorly) than most developed market indices into yearend as declining oil prices and attractive valuation provided a modest tailwind. In U.S. dollars, the MSCI EM Index produced a total return of -7.4 percent in the fourth quarter and -14.2 percent for the full year compared to the MSCI World Index at -13.3 percent and -8.2 percent, respectively. With the region weighed down by slowing export demand and rising policy uncertainty, the MSCI Europe Index delivered a return of -14.3 percent in 2018. The MSCI Japan Index did not fare much better, returning -12.6 percent for the full year. Despite the correction, U.S. equities have still meaningfully outperformed most international peers over the last decade, with the S&P 500 Index producing an annualized return of +13.1 percent from December 31, 2008 to December 31, 2018.

Exhibit 15: S&P 500 Total Returns, by Quarter



Source: FactSet, 12/31/18

Exhibit 16: Citi Panic-Euphoria Model



Source: Citi Research, 1/3/19

"Barbell" Strategy Provides Balanced Risk-Reward Profile

Given evolving macro uncertainties, combined with several potential upside/downside catalysts, we believe a "barbell" investment strategy continues to provide a balanced risk-reward profile for equity portfolios. Holdings in cyclical sectors largely levered to capital spending, reflation, and the Trump administration's pro-growth policies comprise one side of the "barbell," while the other side consists of secular/traditional growth companies with highly visible earnings growth, strong balance sheets, and compelling valuations. We recently trimmed some deeper cyclical stocks, predominantly within the energy sector, and favor insurance and healthcare stocks for defensive exposure over expensively-valued bond proxies. We are constructive on healthcare as demographic trends continue to favor high medical product/service consumption across geographies. The healthcare sector's valuation also appears cheap relative to its growth prospects. Property casualty insurance has sold off with interest rate sensitive financials but does not face the headwinds from sluggish loan growth, flattening yield curve, and potentially higher credit provisions. Cyclical stocks, including transports, refiners, chemicals, and investment banks, also offer compelling investment opportunities as many are currently trading at valuations that discount a much weaker macro environment than we are anticipating.

From a global perspective, we are underweight European, Japanese, and Latin American equities as we prefer exposure to the U.S. and Asia (ex-Japan). While we see modest gains in European economies, we believe the political and monetary headwinds will likely keep equities contained. We prefer mainland companies in Europe versus UK stocks as Brexit uncertainty could loom well into 2019. From a valuation perspective, European equity markets remain attractive relative to many global and U.S. peers. However, we believe exposure to the aforementioned risks may cause funds to flow elsewhere, specifically the United States. Given that we are in a period of evolving uncertainty, we believe it is best to maintain diversified portfolios and invest in high-quality growth stocks that have both secular and/or niche growth drivers. With the recent downturn in global equity markets, we are opportunistically increasing exposure to securities where we believe the correction has been overdone. We are hopeful that a trade agreement between the U.S. and China will be positive for all equity markets and believe Asian and U.S. equities will benefit most from an agreement.

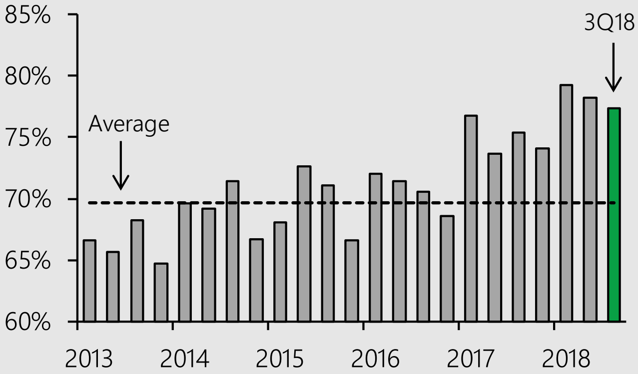
We remain cautious on Chinese stocks given ongoing economic and policy uncertainty. Despite recent positive developments, U.S.-China trade negotiations remain a significant risk. Moreover, whereas valuation is currently at the lower end of the historical range, earnings revisions remain negative. Therefore, we remain positive on stocks levered to the "new economy," where fundamentals are solid. The pharmaceutical sector has been negatively impacted by pricing-related regulations. However, following the recent sharp decline in stock prices, the sector is more appealing given attractive valuation and still strong fundamentals. We are also positive on gas utilities given the industry's resilient growth profile, and neutral to slightly positive on the financial sector.

We remain positive on Indian and South Korean equities. Though corporate earnings for India and South Korea have been revised down because of slower economic growth, forecasts for 2019 earnings are still reasonable at mid-teens for India and flat for South Korea (earnings were impacted by a high base in 2018). India's economic growth will be sustained by stronger consumption, credit, and industrial production. Valuations for India's market remain attractive, with the MSCI India Index trading at a 2019 forward price-to-earnings ratio of 17.8 times, a +13 percent premium to its 15-year average, but

Global Equites: Notable Data Points

U.S. Corporate EPS Reports Have Been Solid

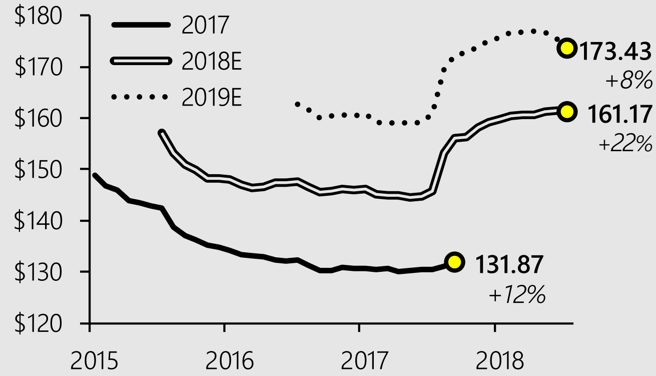
Positive EPS Surprises
S&P 500 Index



Source: FactSet, 12/31/18

EPS Will Normalize Post '18 Tax-Related Boost

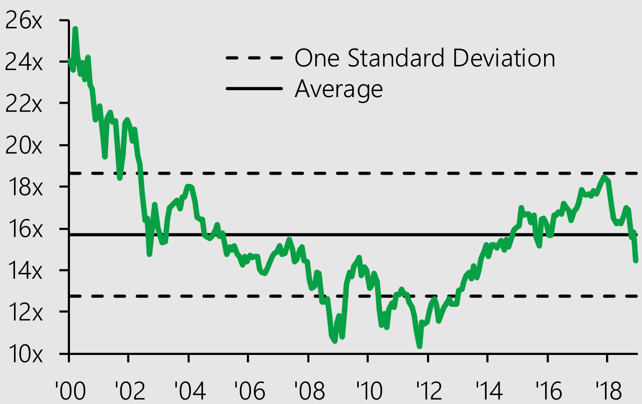
S&P 500 Consensus EPS Estimates
Bottom-Up, Calendar Year



Source: FactSet, 12/31/18

S&P 500 Trading Below Historical Average

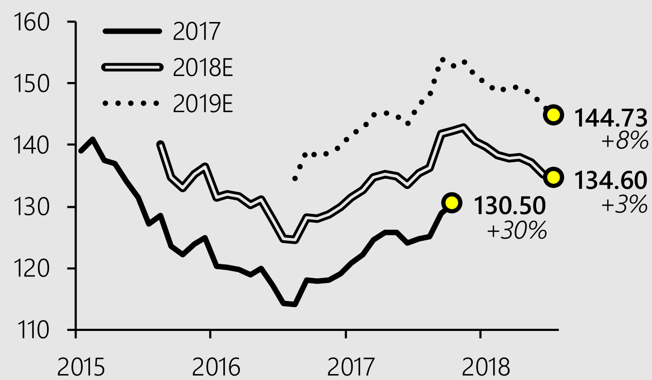
S&P 500 NTM Price-to-Earnings Ratio



Source: FactSet, 12/31/18

Global EPS Projections Achievable Post Cuts

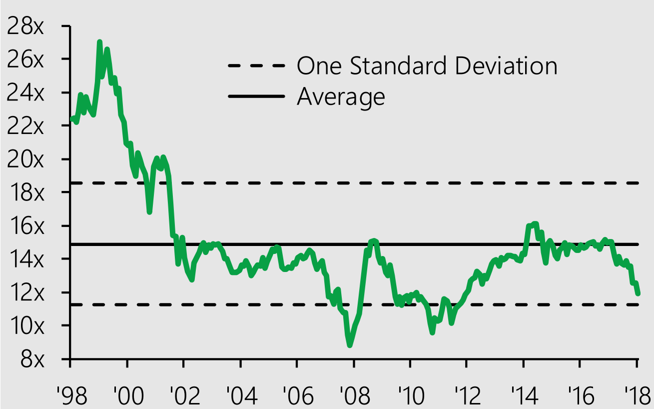
MSCI World (ex. USA) Consensus EPS Estimates
Bottom-Up, Calendar Year



Source: FactSet, 12/31/18

Global Equities Approaching Trough Valuation

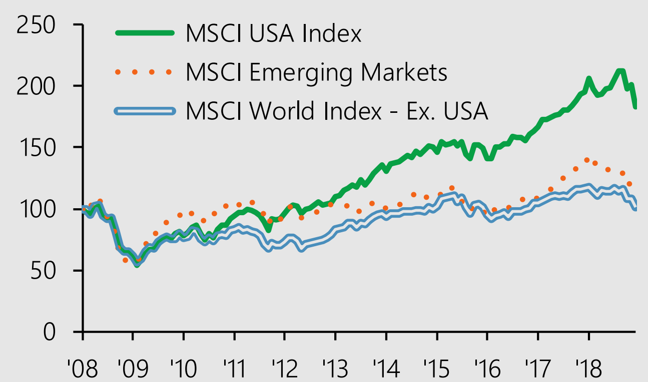
MSCI World (ex. USA) NTM Price-to-Earnings Ratio



Source: FactSet, 12/31/18

U.S. Equities Have Outperformed in This Cycle

U.S. Equity vs. ROW Equity Performance
Price Returns, Index Rebased, in U.S. Dollars



Source: FactSet, 12/31/18

down from its peak premium of +26 percent. Our investments in India are in sectors that are economic beneficiaries, such as consumer, financials, information services, and energy. In South Korea, valuations are attractive, with the MSCI South Korea price-to-earnings ratio of 8.2 times, a -13 percent discount to its 15-year average. As export growth has slowed, we are less optimistic on exporters and favor domestic consumer and secular growth themes. Our South Korean investments are primarily in the technology, financial, consumer, pharmaceutical, and materials sectors.

We anticipate a continued challenging environment for Japanese equities as the growth backdrop becomes more uncertain overseas and the coming consumption tax hike presents notable risks to already sluggish domestic demand. Within Japan, we prefer a mix of overseas-exposed names and defensive domestic consumption holdings in this setting. For our overseas-focused names, we concentrate on companies operating in select faster growing areas such as the US, exposed to secular growth drivers, or possessing an advantaged market position. However, some opportunities may be emerging among cyclical and trade-sensitive areas, such as factory automation equipment providers, which also possess favorable long-term growth prospects. These could perform better should trade tensions ease. Meanwhile, a mix of domestic-focused defensive consumption names, such as those in healthcare and consumer staples, should perform better in a challenging domestic growth environment.

In Latin America, we remain underweight in both the Brazilian and Mexican markets. Both countries' economic growth has been slower-than-expected and there are political risks from the new presidents' referendums. As economic growth in Brazil is soft, we believe the consumer sector will be one of the first to see improvement via higher incomes from lower inflation. We are also positive on the financial sector, as bank earnings will improve as interest rates move upwards to the benefit of profitability. The MSCI Brazil Index trades on a 2019 forward price-to-earnings ratio of 11.3 times, an +11 percent premium to its 15-year average, on earnings growth of +18 percent. In Mexico, President Andres Manuel Lopez Obrador's scrapping of the Mexico City $13.3 billion airport shook investor confidence. The stock market retreated, bond yields soared +42 basis points to 9.27 percent, and the peso hit its weakest level in 5-months. We are cautious on the future impact of AMLO's policies on financial markets, especially on foreign investments. Hence, we prefer a more defensive investment strategy. We like consumer stocks, especially since the +16 percent increase in the minimum wage will help spending. Market valuations are attractive for Mexico, as the MSCI Mexico Index trades at a price-to-earnings ratio of 12.6 times (on EPS growth of +18 percent), a -15 percent discount to its 15-year average.