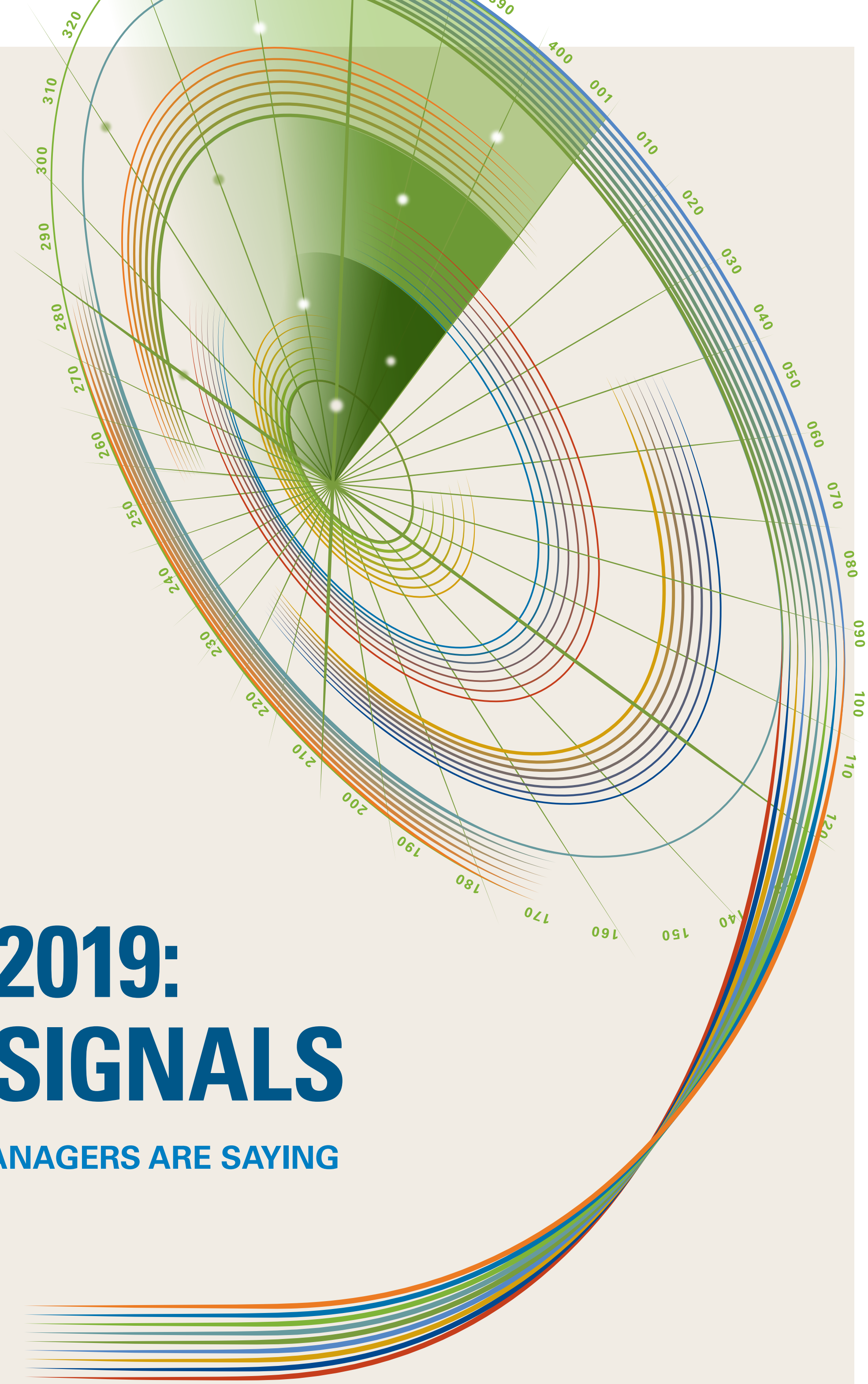


OUTLOOK 2019: SHIFTING SIGNALS

EXPLORE WHAT OUR 9 MANAGERS ARE SAYING ABOUT THE YEAR AHEAD

LEGG MASON
GLOBAL ASSET MANAGEMENT

Brandywine GLOBAL | CLARION PARTNERS | ClearBridge Investments | EnTrustPermal

MARTIN CURRIE | QS Investors | RARE | Royce&Associates | WESTERN ASSET

OUTLOOK 2019: SHIFTING SIGNALS

Economic indicators continue to signal that a strong U.S. economy can continue to drive positive global growth. Yet investors are anxiously eyeing a host of issues that could slow global growth—including trade tensions, Fed policy and political risks.

The resulting uncertainty has roiled asset prices worldwide as markets seek a fresh consensus on the prospects for 2019 and beyond.

Which issues are critical to consider going into the new year? And what could be the consequences for the markets?

GROWTH: HOW MUCH SLOWER?

Western Asset

*"**We think the claims of runaway growth are exaggerated and we will likely see a more modest result in 2019,** along with continued low inflation…if foreign trade and inventories do indeed revert to 2015-2016 trends and either equipment investment or housing sputter, U.S. economic growth could drop to the 2.0%-2.25% range."*

Brandywine GLOBAL

*"**We expect U.S. economic growth to come off its lofty levels.** The supercharged effects of tax cut stimulus should start to wear off in 2019. We have also already started to notice that some important sectors of the U.S. economy looked soft in late 2018; this weakness should extend into 2019."*

VOLATILITY: ALREADY HERE

Royce&Associates

*"We have been arguing for a while now that the market would enter **a period characterized by increased volatility, rising rates and lower overall returns.** All of this, of course, would lead the market back to more historically typical return and volatility patterns."*

QS Investors

*"**We expect that the future will look quite different from the past nine-plus years** of rising equity and bond markets amid low volatility. Several key market indicators are currently at historically high or low levels, suggesting ample potential for mean reversion."*

RATES: RIPPLE EFFECTS

ClearBridge Investments

*"Earnings were the primary determinant of 2018 stock market performance, but **we think liquidity will be the driving factor next year.** Perhaps the most important liquidity driver is credit spreads, which determine the cost of borrowing for consumers and businesses."*

MARTIN CURRIE

*"Higher rates are not going to be good news for some expensive equities, **especially the stocks of companies which have gorged on cheap liquidity for the last decade.** As such, we expect to see volatility persisting in equity markets."*

TRADE: UNCERTAINTY WILL CONTINUE

RARE

***"We don't see the trade war ending any time soon.** There may be "deals" announced with great fanfare on a cease fire from time to time. But an agreement addressing the substantive issues anytime soon seems unlikely to us."*

EnTrustPermal

*"While the Trump-Xi meeting at the G20 Meeting in Buenos Aires offered a respite from trade rhetoric that has negatively impacted markets and global growth, **the risks of further escalation clearly remain and could impact markets over the course of 2019."***

REAL ESTATE: LOCAL STRENGTH

CLARION PARTNERS

*"Going into 2019, the U.S. commercial real estate sector remains attractive to global investors seeking income and low volatility late in this cycle. **Healthy supply/demand fundamentals are likely to continue to benefit from a relatively solid U.S. macroeconomic backdrop."***

MARKET OUTLOOK: GLOBAL FIXED INCOME

FOCUS ON GROWTH

We believe global growth will remain positive in 2019, as U.S. growth moderates slightly and Europe and emerging markets (EM) regain their footing. We also acknowledge four major global risks which may challenge this view. These are a collapse in U.S.-China relations, the Federal Reserve (Fed) overtightening, Italy's governance pulling away from European Union (EU) fiscal norms and the UK separating from the EU via a "hard Brexit." The market, however, is pricing each of these scenarios for extremely negative outcomes. We believe there is room for less pessimism—even some optimism—regarding each of these factors.

United States

Western Asset expects likely slower growth for the U.S. in 2019 as some of the fortuitous factors recently boosting growth begin to fade. While 3%-4% growth in some recent quarters has garnered headlines, average growth for all of 2017-2018 is a more modest 2.8%, albeit still up from 1.9% over 2015-2016. Given the 2017 tax bill's incentives, one would think capital spending would continue to hum, but recent capital goods data has been spotty. Meanwhile, homebuilding looks to have embarked on a downtrend. If foreign trade and inventories do indeed revert to 2015-2016 trends and either equipment investment or housing sputter, economic growth could drop to the 2.0%-2.25% range. We think the claims of runaway growth are exaggerated and that we will likely see more modest performance in 2019, along with continued low inflation.

The Fed's renewed focus on contained inflation, risk management and a lack of certainty about equilibrium or neutral rates suggests a more dovish direction moving forward. What's more, Fed Chair Jerome Powell just declared that the Fed is very near the neutral range (thought to be a fed funds rate of 2.5%-3.5%). We're optimistic that the new tone will prove helpful, but it's too soon to tell. More importantly, monetary policy has been tightening for two years and fiscal stimulus is waning. We think as the Fed comes to face more seriously a moderating growth and inflation outlook, a pause will be both signaled and warranted.

Europe

In hindsight it was the very strong performance of the eurozone economy from mid-2016 to early 2018 that sowed the seeds for the disappointing outcome in 2018. The bar for the eurozone was raised and expectations grew that the strong performance would continue. The slowdown in eurozone economic growth since the start of 2018 stems from a loss of momentum in global activity. Fears over trade wars have led to a weaker global growth impulse and the stronger outcome for the U.S. has not been as supportive of growth for other countries. This global slowdown has been exacerbated by contraction of the German economy in 3Q18, mainly stemming from a large fall in auto production due to new tighter emission tests. Forward-looking surveys have weakened but importantly point to a moderation in growth, not a move toward much weaker growth outcomes.

Looking ahead, we believe that eurozone growth in 2019 (1.8%) will remain above trend (1.25%) and this will foster further falls in unemployment and a gradual rise in wages and core inflation, allowing the European Central Bank to continue down its path toward policy normalization.

Japan

The Japanese economy posted a -1.2% GDP contraction in 3Q18, but we believe that this should be transitory due to a series of natural disasters, such as the severe floods in the western part of Japan and the earthquake in Hokkaido. We believe the economy will continue to grow above potential until 4Q19 when the consumption tax is set to increase from 8% to 10%. Robust capital expenditures and continuing positive investment sentiment and steady growth in exports will also likely drive the economy forward in the coming quarters. Moreover, the administration of Prime Minister Shinzo Abe has started to address demographic challenges with the reform of labor markets including foreign workers in Japan, which should be positive over the longer term.

The greatest downside risk to the economy would be an acceleration in weakening external demand due to increasing trade tension between the U.S. and China. That stated, we believe the Bank of Japan is committed to supporting domestic economic activity via its current monetary policy approach. At this moment, we do not see anything that would push the Japanese economy into a recession.

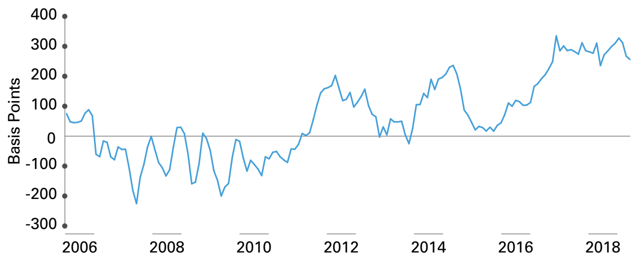
Emerging Markets

We believe EM is the most undervalued asset class. Extreme market pessimism pulled the entire asset class downward in 2018 despite important positives in the sector, such as remarkably subdued inflation and resilient sovereign and corporate balance sheets.

Consider the following statistics: index yield spreads between EM debt and developed market (DM) debt are near 2008 and 2016 levels; currency levels are 35% lower than just five years ago, and the real yield of EM debt is at a 15-year wide versus the real yield of DM debt. While the path to improving risk sentiment may well still be volatile, we believe EM would be the biggest beneficiary of any attenuation of the global risks.

Emerging Markets (EM), the Most Undervalued Asset Class

Real Yield Differential (EM vs DM)



Source: Bloomberg, HSBC as of October 31, 2018. EM real yield is derived from government yields and inflation using the Purchasing Power Parity (PPP)-weighted average of Brazil, China, India, Indonesia, Mexico, Poland, Russia, S. Africa, and Turkey. DM real yield is derived from government yields and inflation using the PPP-weighted average of Germany, Japan, UK, and the U.S. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

MARKET OUTLOOK: GLOBAL FIXED INCOME

THE LIMITS OF U.S. GROWTH

One of the major global macro themes of 2018 centered on robust U.S. economic growth relative to the rest of the world. Supercharged U.S. growth and countertrend dollar strength were the consequences of late-cycle stimulus. We think divergence in relative growth has its limits, and therefore expect these growth rates to converge in 2019. Federal Reserve (Fed) policymaking and relations between the U.S. and China should be the greatest determinants of global economic growth in 2019.

The Fed as hegemon

The Fed remains the hegemon of global monetary policy, thanks in large part to the world's heavy reliance upon dollar funding. A great deal of time was spent analyzing the comments Fed Chair Jerome Powell made during his first year at the helm of the central bank, whether it was about emerging markets being "well placed" to navigate tightening U.S. monetary policy, hawkishness due to the relative strength of the U.S. economy, or the Fed's neutral rate. We expect investors to continue scrutinizing how Powell and the rest of the Federal Open Market Committee (FOMC) regard these factors in 2019. We believe the Fed has two paths to follow in 2019: either hike rates 1-2 times or 3-4 times before taking a pause in its current tightening cycle. We think it would be prudent for the Fed to pause after 1-2 rate hikes in 2019 in order for the lag effects to work their way through the economy. Furthermore, the Fed will continue to normalize its balance sheet behind the scenes in 2019, which implies additional tightening.

The health of the U.S. economy will undoubtedly continue to have the greatest influence on a Powell-led Fed in 2019. At Brandywine Global, we expect U.S. economic growth to come off its lofty levels. The supercharged effects of tax cut stimulus should start to wear off in 2019. We have also already started to notice that some important sectors of the U.S. economy looked soft in late 2018; this weakness should extend into 2019. In the domestic banking system, narrow money growth has slowed, the personal savings rate remains elevated, and household credit has not picked up. Mortgage applications have been off around 20% year-on-year, new home sales have softened, auto sales have been flat-to-down for three years and consumer confidence has softened. We would not be surprised to see a gradual deceleration in U.S. gross domestic product (GDP) growth, which could fall from current levels around 3.5% to something around 2.0-2.5% by the end of 2019.

U.S. corporate profit margins have already been getting squeezed, and another round of tariffs—which are set to be implemented in January 2019—could exacerbate that problem. In 2019, equity and bond investors will be evaluating whether companies can pass on higher input costs vis-à-vis rising wages and tariffs to their customers. The Fed will also be watching rising input costs closely, as this function will impact its neutral rate and tightening schedule. If companies cannot pass these costs along to the customer, then we expect the neutral rate to remain lower and for the Fed to back off additional rate hikes sooner than expected. This scenario could be potentially bullish for the Treasury market, bearish for equity investors, and bearish for the dollar.

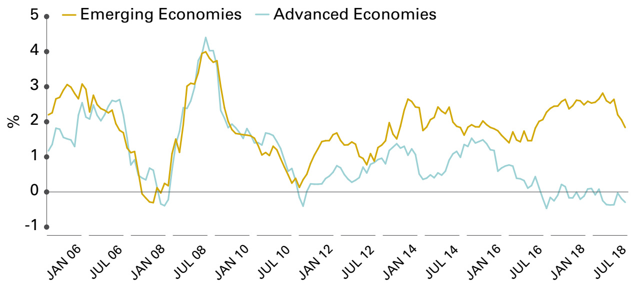
Global trade

The future of U.S.-China relations will continue to impact global trade flows. We expect to see a continued ramping up of stimulus policies in China in 2019, which should offset any drag on trade if the country does not reach a détente with the U.S. The stimulus response in China throughout 2018 has been underwhelming, which leads us to believe that the country's leadership may be storing dry powder if the U.S. enacts additional protectionist measures. We believe the Chinese government and the People's Bank of China have the resources to do whatever it takes in 2019 to accelerate growth. We anticipate that significant policy initiatives in China will be expansionary in 2019, and as a result, economic growth should modestly register above expectations.

The future of trade will also inevitably affect export-centric economies like Japan and the Eurozone. In 2019, we will be looking at the world from the perspective of the G3 versus the G20—much like we did in 2018. While the European Central Bank (ECB) has every intention of sounding more hawkish in 2019, we think this will be ultimately very difficult for President Mario Draghi, as the Eurozone is expected to slow throughout the year. Hawkishness will be even more difficult for the Bank of Japan (BoJ), though the central bank could pull back on yield curve control in 2019. If U.S. economic growth is expected to slow in 2019, then where will we find those pockets of economic activities?

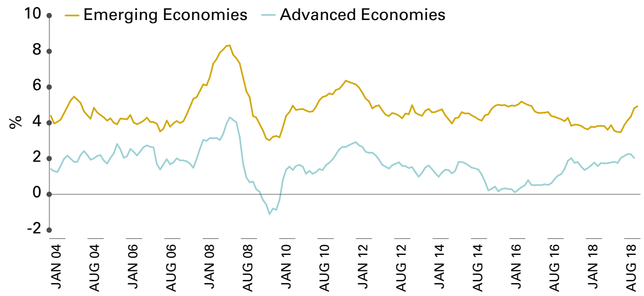
Ultimately, our 2019 outlook will be an extension of our current thinking. There are pockets of the global bond and currency markets that exhibit price dislocations, where asset prices do not reflect actual fundamentals. For example, we believe Swedish krona valuations—particularly relative to the euro—simply do not reflect the strength of the underlying economy. Compared to the ECB, Sweden's Riksbank has turned less dovish, and the data should continue to support its shift in rhetoric. So while we expect G3 growth to moderate, that shouldn't be the case for the broader G20. Looking at the real 10-year government bond yields within emerging and developed markets, these valuation anomalies become clear:

Real 10-Year Government Yields
Emerging Markets versus Developed Markets



Source: Macrobond as of 11/30/18. Reflects GDP-weighted average of the real yields (based on Consumer Price Indexes) for countries in each category. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Global Headline Inflation
Emerging Markets versus Advanced Economies



Source: Haver Analytics as of 8-31-18. Reflects year-over-year % change in CPI for countries in each category, weighted by GDP. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Together, these charts show that the inflation expectations priced into emerging market bonds are just too high relative to actual inflation rates, while expectations for the developed world are low. We think adjusting inflation expectations in 2019 will compress this spread.

There are risks to our scenario. The first downside risk involves the Fed, and if it were to tighten too much, causing something to "break" in the U.S. economy, whether it is increasing corporate borrowing costs, an uptick in default rates, falling corporate profits, a prolonged equity market selloff, or renewed dollar strength. There could be a silver lining in this downside scenario, as some of these indicators could convince Powell and the FOMC to dial down its policy rate increases. The most bearish outcome would be a combination of an overly hawkish Fed along with an escalation from trade tension to an all-out economic Cold War between the U.S. and China. How these issues get resolved over the course of 2019 will be central to global asset market performance and our investment outlook.

MARKET OUTLOOK: GLOBAL EQUITIES
LIQUIDITY IS THE QUESTION

Key Points

- We expect recent market weakness could continue, with stocks testing a low before rallying higher.
- We also believe markets have become too pessimistic on 2019 earnings growth.
- A step down in growth is to be expected given the front-loaded aspects of the 2017 tax cuts.
- Interest rates will continue to climb, though at a somewhat subdued rate, while the Fed will also continue to shrink its balance sheet.Therefore, liquidity will continue to tighten and will remain a key variable to monitor.
- We expect strong cash flows and strong buybacks to support stocks and for quality oriented stocks to outperform in 2019.

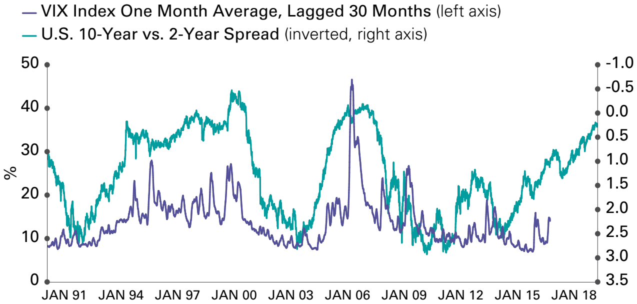
A Key Driver in 2019

Earnings were the primary determinant of 2018 stock market performance, and it's easy to extrapolate that to 2019, but we think liquidity will be the driving factor next year. We look at liquidity in several ways. The strength of the U.S. dollar is one; it has continued to surge, and that's a negative for liquidity. The nominal change in interest rates, which continue to rise as the Fed tightens monetary policy, also impacts liquidity. Perhaps the most important liquidity driver is credit spreads, which determine the cost of borrowing for consumers and businesses. Although spreads have only widened modestly recently, the biggest potential risk in 2019 is a curtailment of liquidity that creates the next bear market.

A widening of spreads should have the effect of separating leveraged companies from those with less leverage. Spread widening should be positive for active management. As we get later in the economic cycle and spreads start to widen, some companies become more sensitive to market drawdowns or weakness. In some cases, you have perfectly good companies with high leverage and fine coverage ratios, but they'll get caught up in a basket of so-called highly leveraged stocks and decline just as much as others. That can create opportunities for active managers to differentiate a quality company with a smarter debt structure that might get sold off indiscriminately.

The return of a more normalized volatility environment, which has been sparked by an increase in Treasury yields and the term premium for bonds, increased worries about China and some high-level earnings disappointments, also creates more opportunities for active investors to make changes. Periods of volatility allow us to ask very productive questions about stocks and whether they should be let go, or if valuations have become attractive enough to warrant buying a stock that we have been researching for some time. A rise in the CBOE Volatility Index (VIX) has historically trailed the flattening of the yield curve by 18 months, meaning we should expect more volatility ahead

Volatility Picks Up Following a Flattening Yield Curve



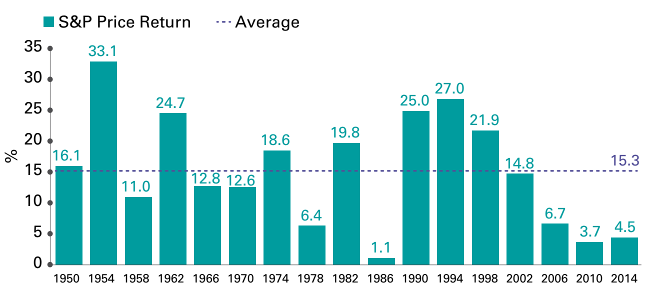
Source: Bloomberg. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Impact of the Political Cycle

The year following midterm elections has historically been positive for equities, with the S&P 500 up an average of 15.3% in the 12 months following midterms going back to 1950. Post-midterm election environments are also positively skewed due to the presidential cycle.

This phenomenon, which closely mirrors the economic cycle, shows that the economy has not seen the start of a recession during the third year of a presidential term in the modern era due to the nature of fiscal stimulus. Specifically, fiscal spending tends to be strongest during the middle of a presidential cycle. For example, consumers will see a $60 billion boost in spending potential in 2019 from tax refunds that reflect the reduced tax rates from the late 2017 tax reform. We could also see additional stimulus as a result of a divided Congress that may not agree on much but could come to a compromise that leads to higher infrastructure spending.

Post-Midterm Election Performance



Source: Factset. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Sector Opportunity: Biotech

The outcome of the midterm elections should create opportunities within specific sectors or sub-sectors. The health care sector has arguably the most to gain or lose. A Congressional split takes drug price controls largely out of the near-term discussion. This should be viewed as positive for pharmaceutical and biotech stocks. Biotech is an interesting long-term opportunity. These stocks have not acted defensively despite what we believe are very reasonable valuations that have gotten cheaper along the way. Yet we find the sector to be among the most attractive across the market. Many biotech companies don't have many financing needs and have good balance sheets. They could also be attractive acquisition candidates for larger pharmaceutical companies flush with repatriated overseas cash.

MARKET OUTLOOK: SMALL-CAP EQUITIES
A SHIFT TOWARD CYCLICALS

The pullback in prices in small-caps since October has been challenging, but from our perspective as selective active managers, the shift is not unexpected, and potentially healthy for investors.

In fact, we have been arguing for a while now that the market would enter a period characterized by increased volatility, rising rates and lower overall returns. All of this, of course, would lead the market back to more historically typical return and volatility patterns.

Yet much of the investment activity that we've been watching recently looks to us as if investors are worried about recessions or sharp declines in growth rates. We therefore want to be very clear that we do not see the likelihood of a recession. Corporate profits are still healthy, and consumer demand and confidence remain high.

Even in light of the still healthy economic environment here in the U.S., however, anomalies still exist within the asset class as a whole. For example, the small-cap index consists of a sizable number of businesses that are not making money —approximately 36% of the companies within the Russell 2000 have no earnings. It's also worth noting that year-to-date through 8/31/18, those non-earning small-caps had higher returns, increasing 22.8% while those with earnings advanced only 12.6%.

Our own small-cap strategies tilt toward cyclical stocks with earnings that are found in sectors such as Industrials, Information Technology, Financials, Consumer Discretionary, and Materials. Over most of the last two years, these areas have lagged (within the highly diverse technology areas, the highest returns have come from more growth-oriented industries such as software).

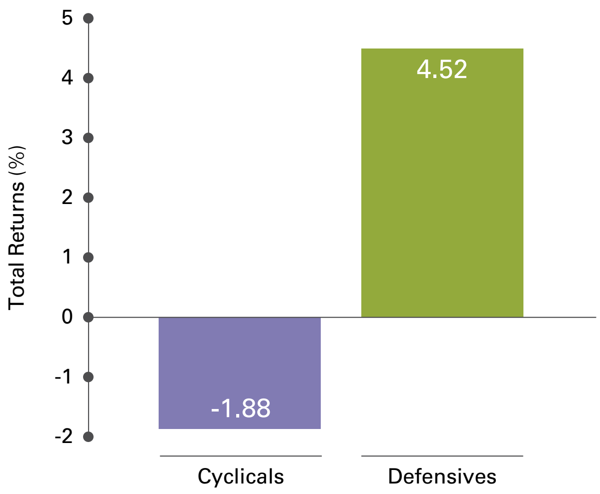
So far this year, this remains the case. However, the recent earnings news for cyclical companies continues to be positive, potentially reversing a relative performance disadvantage that has persisted for longer than we would have thought.

We continue to closely watch one-year trailing operating income growth—a key metric of fundamental strength—especially for important cyclical sectors, which are growing faster than the Russell 2000.

To be sure, one reason that earnings season is so important is that announcements have a way of closing the gap between perception and reality—which often helps us as other investors begin to see the operational and/or financial strengths that first attracted our interest.

Of course, cyclical stock performance has in many cases been blunted in 2018 by concerns over tariffs, trade wars, an economic slowdown, and rising input costs—any one of which could potentially crimp the margin expansion many businesses have been enjoying.

Cyclicals Lag Defensives 2018 YTD
Total Return for Sectors within
Russell 2000 as of 11/12/18



Source: Bloomberg, as of 11/12/18. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

So far this year, then, we are pleased that the negative effects from tariff or trade have not materialized to the degree many seem to have anticipated. And rising input costs have so far been mostly passed through to customers, which is a relatively easier task for smaller companies with established niches and fewer competitors.

Equally, if not more important, the earnings news we've been hearing from companies and the preliminary data that we've examined both show ongoing—and in some cases growing—small-cap earnings strength for key cyclical sectors, including Industrials, Materials, Energy, and Financials.

We continue to believe that the higher volatility and lower returns we're expecting will result in more investors looking for companies with earnings. This shift should make active management approaches that are perennially earnings-driven well positioned to outperform.

MARKET OUTLOOK: GLOBAL EQUITIES
CURRENT VOLATILITY, LONG-TERM OPPORTUNITY

In the coming year, tightening labor markets, rising wages and reasonably strong economic activity in the U.S. will continue to lead the Federal Reserve (Fed) to increase rates. There is, of course, a risk that the Fed will tighten too quickly and that the combined effects of balance-sheet reduction and conventional rate hikes may contract economic growth much earlier than expected in 2019; while this is not our central forecast, it is a risk we remain acutely aware of.

Higher rates are not going to be good news for some expensive equities out there (especially for the stocks of companies which have gorged on cheap liquidity for the last decade), as among other things they mean higher borrowing costs. As such, we expect to see volatility persisting in equity markets for some time to come.

Clearly, there is a risk that the global trade war that came to the fore in 2018 will worsen in 2019, bringing with it the wrong type of inflationary pressure—that is, the regulatory-driven kind. This has the risk of ushering in a sharp slowdown to global activity, while pushing central banks toward more tightening measures—an unpleasant combination for equity markets.

Looking at Europe, uncertainty around Brexit —specifically the shape of the final 'divorce' deal—and Italian sovereign risk will both be a preoccupation for markets. Central bank policies will also remain an important focus, in the context of economic momentum which could be weakening across the European Union, China and the U.S.

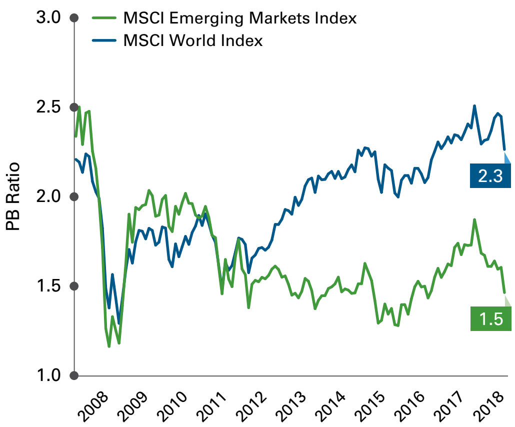
Opportunities for long-term investors in 2019

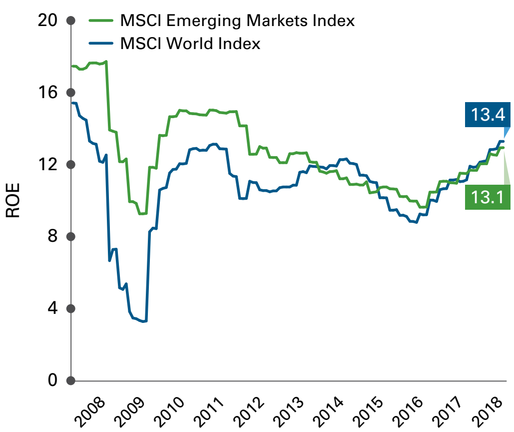
The market is also becoming increasingly anxious about risks of a recession, which is likely to add further volatility in 2019. There is certainly the potential here for investors with a shorter time horizon to be spooked. However, we believe these risks create opportunities for long-term investors such as ourselves; specifically, to initiate holdings in companies that we see as being exposed to long-term secular growth drivers at attractive valuations.

From our standpoint as international equity specialists, we continue to see a huge amount of opportunity for investors looking beyond their domestic markets. For instance, optically, emerging market equities are around their long-term price-to-earnings average. However, we believe the asset class still represents good value in terms of an international equity allocation. Return on equity is fairly synchronized with developed markets, as represented by the MSCI World index. Importantly though, price-to-book and price-to-equity values remain low relative to history and developed markets.

Attractive emerging market valuations

Price to book ratio (PB) and return on equity (ROE)





Source: Bloomberg, as of 10/31/18. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

The ESG perspective in the coming year

Elsewhere, from an Environmental, Social and Governance (ESG) perspective, we are going to see an enhanced level of focus on climate-change reporting in 2019 and beyond. Both investors and companies will need to think more about how they manage and report on systemic issues such as the recommendations from the Task Force on Climate-related Financial Disclosures (TFCD) and the UN Sustainable Development Goals (SDGs), specifically goal number 13—Climate Action. For companies, this is a matter of strategy and sustainable value creation. For investors, particularly like ourselves with longer-term time horizons, these (climate-related) systemic risks will be increasingly reflected in valuation models and incorporated into engagement with company executives and board members.

For some companies, increasing focus from investors on transparency also poses a risk. As we move into 2019, the World Benchmarking Alliance, a body set up with the aim to fill the accountability gap in measuring corporate performance in relation to the SDGs, will start to publish publicly available benchmarks. These will rank companies on their performance and incentivize business action toward achieving the SDGs.

Finally, the issue of plastic waste has generated significant attention in the past year and is therefore likely to feature even more prominently in our thinking in 2019. As global awareness of this problem rapidly increases, the phasing out of single-use plastic will move higher up the agenda for both consumers and investors alike. This is already having significant implications for some consumer goods companies, as well as those within the plastics value chain, so we will be spending considerable time understanding how business models (and ultimately long-term margins) will be changed by a drastic reduction in plastics use.

MARKET OUTLOOK: GLOBAL INFRASTRUCTURE

TIME TO GET DEFENSIVE?

It is an old investment adage that "markets climb a wall of worry." Markets certainly did successfully climb this wall following the Global Financial Crisis (GFC), but had a helping hand. The big global central banks, led by the Fed, through extraordinary loose monetary policy (exemplified by Quantitative Easing), provided a ladder and helpfully propped it against the wall.

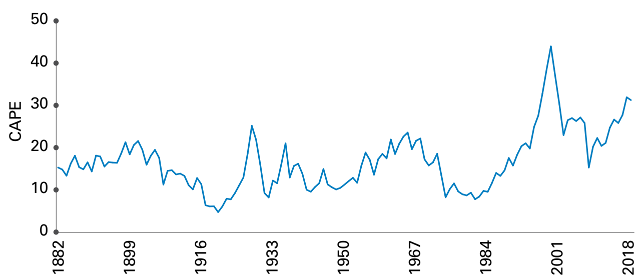
Now, however, the ladder is slowly being pulled away as rates are hiked, and QE turns to QT (Quantitative Tightening). We fear that 2019 may leave markets perched, like Humpty Dumpty, atop the wall. While we hope 2019 doesn't bring a "great fall," hope is not a strategy. We made the call early in 2018 that we were in the late stages of the long bull market that started in March 2009. While we didn't (and aren't) calling an economic recession, we said then that we believed it was prudent to resist the urge to ride the bull right to the inevitable end and to begin moving portfolios to a more defensive posture.

Since then we've seen volatility pick up and, unlike in January, the FAANGs have not reasserted leadership and led a bounce back. We think this provides affirmation of our view that we are seeing a market regime change which is likely to continue to play out in 2019.

The counter-argument to this view (and one we debate internally) is the strength of the U.S. economy. Main Street seems in fine fettle, even if Wall Street seems somewhat out of sorts. None of the key recession indicators we monitor are flashing red (i.e. inverted yield curve, year-on-year fall in the Conference Board's Leading Economic Indicator, unemployment ticking up, fed funds rate greater than equilibrium).

What we point to in response is the vulnerability of the U.S. share market to a correction. Valuations, on any sort of long-term valuation metric such as Cyclically Adjusted PE (CAPE), Tobin's Q, total market cap/GDP, etc. look toppy. As the chart below shows, the only other points in history where the S&P 500's CAPE P/E was higher was on the eve of the 1929 crash that ushered in the Great Depression and at the height of the dot-com bubble in 1999/2000:

Cyclically Adjusted Price/Earnings Ratio (CAPE)



Source: http://www.econ.yale.edu/~shiller/data.htm, RARE Infrastructure. **Past performance is no guarantee of future results.** Indexes are unmanaged and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

It appears Humpty Dumpty is currently sitting atop quite a high wall indeed!

In addition to the withdrawal of central bank largesse—which arguably has suppressed volatility for the last decade—a number of other factors could tip Humpty over. Front and center here is the Sino/U.S. trade war. China is a centrally planned economy. We are sceptical that China will give into U.S. demands to reduce government intervention into the economy. The U.S. position seems just as entrenched. Consider that:

- U.S. Trade Representative Robert Lighthizer has represented the nationalist view on trade within the GOP for three decades, since he led trade negotiations with Japan under Reagan — which resulted in the Japanese voluntarily acquiescing to Washington's demands.

- Donald Trump took out full page newspaper ads in 1987 calling for "taxes" on countries that, he believed, were taking advantage of the U.S. This is one of the few issues he has been consistent on ever since. A "get tough on China" message resonates with the swing voters of the Midwest and rust-belt states that carried him to victory in 2016 but abandoned the GOP in the recent mid-terms. These are the voters that have arguably been the losers from globalization as manufacturing jobs were offshored to China.

Consequently, we expect Trump to continue with his hawkish trade stance in order to appeal to this voter bloc. The failure of the Democratic establishment to grasp the importance of this issue with key constituencies was one of the reasons behind them losing the White House. As a result, there is bipartisan support for containment of China in the mid to long term.

In summary, we don't see the trade war as ending any time soon. There may be "deals", announced with great fanfare, on a cease fire from time to time. But an agreement addressing the substantive issues anytime soon seems unlikely to us. The trade war is impacting on global economic growth. At some point this will begin to impact S&P 500 earnings. Indeed, more recent reporting commentary has seen a sharp pickup in warnings regarding trade and the outlook for corporate profits. At the same time monetary conditions are tightening. We believe that the sugar rush from the Trump tax cuts and fiscal stimulus will start to wear off in 2019.

All in all, it would seem to us this is a recipe for continued volatility in the year to come. But the fact remains that the U.S. economy does have a decent head of steam. There is also a reasonable chance that Trump and the Democrats agree on an infrastructure-centered fiscal stimulus.

It would be premature to reduce equity exposure too drastically at this point. Instead, we think increased defensive equity exposure is in order, and infrastructure stocks are one of the key ways investors can achieve this.

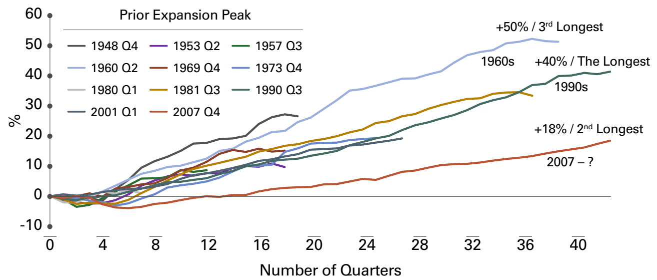
MARKET OUTLOOK: COMMERCIAL REAL ESTATE

AN EXTENDED BUSINESS CYCLE

If the current business cycle continues through July 2019, it will be the longest in modern U.S. history. This naturally begs the question: How much longer can this cycle continue? Bull markets do not die of old age. Rather, they die from excesses that lead to economic shocks, which, if large enough, can lead to a recession.

Despite the U.S. unemployment rate standing at 3.7%, the lowest level in nearly 50 years, the current expansion does not have the makings of a boom and bust cycle. Real GDP has only grown 18% since the prior market peak, compared to the 40% in the 1990s and 50% in the 1960s. Put another way, this cycle's average annual real GDP growth rate is only 2.3%, almost half the 4.2% annual average witnessed during the prior ten cycles.

Cumulative U.S. Real GDP Growth By Expansion Cycle



Source: Bureau of Economic Analysis, Clarion Partners Investment Research, Q3 2018. **Past performance is no guarantee of future results.** The graph above is for illustrative purposes only and is not reflective of an actual investment.

Clarion Partners believes that this slow and steady pace of expansion may in fact prolong the current business cycle. For one, there are no huge imbalances or signs of overheating in the economy. Second, tax reform (Tax Cuts and Jobs Act of 2017) and increased government spending (Bipartisan Budget Act) have significantly strengthened corporate and household spending power. We believe that 2019 U.S. real GDP growth will be in the 2.0-2.5% range, a decent pace but a moderation from 2018. For commercial real estate (CRE) investors, we prefer this slow and steady pace of growth: demand for commercial space is strong but not so robust as to spur excess lending and speculative new development.

Potential risks to our outlook include protectionism, the record level of corporate debt, rising interest rates, the gradual end of monetary stimulus, and global political uncertainties. In particular, a full-blown, prolonged trade war with China would significantly dampen financial market sentiment and lead to slower economic growth in the U.S. and globally. Conversely, a swift resolution and a new trade agreement between the world's two largest economies would boost investor optimism and propel the financial markets even higher.

The Federal Reserve's current dot plot points to three federal funds rate increases in 2019. In our opinion, this interest rate path projection is far from certain due to the recent global slowdown both in developed countries such as Japan and Germany and in emerging countries, especially China. Furthermore, there are soft patches domestically, including auto manufacturing and the for-sale housing market. The Fed might take a pause by mid-2019 after reassessing the U.S. economy's moderating growth trajectory.

Going into 2019, the U.S. commercial real estate sector remains attractive to global investors seeking income and low volatility late in this cycle. Healthy supply/demand fundamentals are likely to continue to benefit from a relatively solid U.S. macroeconomic backdrop, mainly in five ways:

- Steady GDP and job growth: approximately 2.4 million new jobs were added to the economy over the past year amid accelerating wage growth. Property owners should have a greater ability to increase rents
- Strong demographics: over 1.4 million new households were formed over the past 12 months, generating substantial new demand for housing and commercial space
- Higher replacement costs: rising construction materials and labor prices have significantly escalated replacement costs, providing room for additional asset appreciation
- Elevated cross-border capital inflow: high foreign inbound investments have improved capital availability and overall liquidity, thereby creating greater competition for high-quality properties
- A rising interest rate environment: the potential rise in interest rates is generally viewed as a negative for cash and fixed-income bonds, which may prompt investors to rotate more capital into inflation-hedging asset classes including CRE

Clarion Partners expects sustained investor interest in warehouses/e-commerce supply chains, rental housing, creative offices, strategically located retail assets, and health care properties within top employment and retirement hubs. Investment themes in which we see potential include socioeconomic diversity, urbanization, demographic demands, and high-growth industry clusters (e.g. high-tech, new media, and life sciences). Institutional managers generally favor institutional-quality properties and build-to-core strategies. Based on our 2019-2021 outlook, Clarion's near-term strategy favors industrial, urban multifamily, and CBD (Central Business District) office, with a focus on selective value-add opportunities, especially in top secondary markets and premier suburban submarkets outside the major markets.

The global quest for steady and high-yielding financial instruments has driven a long-term shift from conventional investment types to alternative asset classes, of which CRE is the largest category. U.S. institutional-quality real estate cap rates remain attractive on a relative basis to both domestic and international real estate investors. Overall, global investors have been satisfied with CRE performance amid favorable property-level fundamentals and historically low levels of new supply (except for a few markets/submarkets). Both institutional and retail investors have continued to allocate more capital into CRE, with target allocations across portfolios rising steadily. The newly released 2018 Institutional Real Estate Allocations Monitor Survey indicates that the average target portfolio allocation to real estate among global institutional investors continues to rise, up from 10.4% in 2018 to 10.6% in 2019.

Overall, Clarion Partners holds a cautiously optimistic U.S. commercial real estate market outlook for 2019. Pro-growth policies are likely to extend the current business cycle, which is on track to become the longest on record. U.S. property fundamentals are expected to remain healthy as well. CRE same-store net operating income (SS NOI) growth remains strong at 3% year-over-year, well above the long-term average. Attractive total returns will be driven, in our opinion, by stable cap rates, solid NOI growth, and accretive financing. As occupancy rates approach 90-95% in most U.S. markets, we believe there are plenty of opportunities to create value through disciplined, active investment strategies.

MARKET OUTLOOK: GLOBAL ALTERNATIVES

A PLETHORA OF RISKS

We believe that U.S. economic growth and earnings growth are going to decelerate in 2019. Fiscal stimulus is fading, and the impact of tax reform will force earnings growth back to levels more typical of an economy in the later stages of expansion. Normalization does not mean recession; however, it is notable how many downside risks exist today:

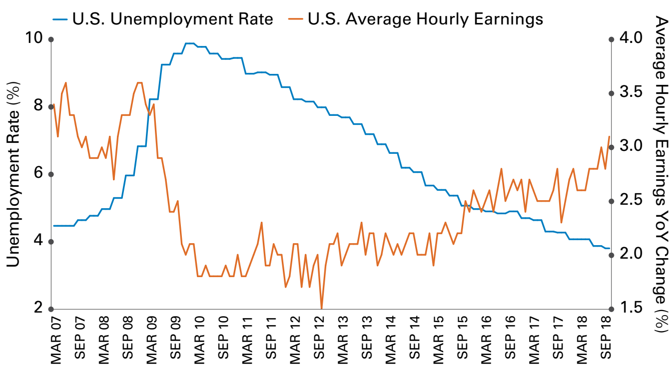
- U.S.-China relationship – Ultimately it is about more than just trade. The U.S. Vice President's speech on October 4th made clear it is strategic in nature, with issues on technology, intellectual property and national security in addition to the trade deficit. While the Trump-Xi meeting at the G20 Meeting in Buenos Aires has offered a respite from the trade rhetoric that has negatively impacted markets and global growth, the risks of further escalation clearly remain and could impact markets over the course of 2019

- Continued monetary tightening – While the U.S. Federal Reserve may be closer to the ephemeral "neutral" level implying a more data dependent approach, the European Central Bank is set to begin to taper their asset purchases and the Bank of Japan may be forced relax its policies around yield curve control to support their banking system. Tighter financial conditions can be a headwind to growth

- Margin compression – Rising costs via wage pressures, higher logistics and materials costs may negatively impact margins. Tax reform was a one-time benefit that will not contribute to earnings growth again in 2019. With the unemployment rate at the lowest level of the expansion, wage pressures are expected to continue. In addition, the impact of tariffs will begin impacting margins

  - After hovering around 2% for much of the post-crisis period, year-over-year wage growth has recently moved above the 3% threshold. As labor markets are set to further tighten, wage growth pressures are likely to increase, dampening corporate profitability

U.S. Unemployment Rate and U.S. Average Hourly Earnings



Source: Bloomberg

- Corporate credit – Widening credit spreads will negatively impact borrowing costs. Low interest rates enabled companies to increase leverage and engage in large share buybacks to support earnings per share (EPS) growth during the expansion

- Middle East geopolitics – Oil prices below $60 per barrel are not sufficient to meet most Middle Eastern economies, budgetary targets. OPEC and Russia may look to cut production to maintain prices, creating further tension with the U.S.

- European politics – Brexit and Italy continue to present potential flashpoints that can negatively impact European growth. The sense of populism is difficult for markets to discount

Factoring in the potential downside risks described above, market volatility is expected to remain elevated. As a result, equity markets will be forced to rely on dividends and earnings growth for much of the gains next year as any increase in equity market valuations are unlikely.

Given the outlook above, we generally:

- Favor Value over Growth strategies in general
- Favor Emerging Markets over Developed Markets
- Expect large caps should outperform small caps
- Believe Quality as a factor should perform well

Lastly, the environment for active management is greatly improved. The shift from quantitative easing to quantitative tightening will impact liquidity, lead to higher risk premiums and impact corporate performance leading to higher dispersion in equity prices.

MARKET OUTLOOK: A MULTI-ASSET VIEW

CHOPPY MARKETS AHEAD

The global economic expansion and equity bull market that followed the Global Financial Crisis ("GFC") is well past the nine-year mark, making it the longest bull-run in U.S. history. While economic fundamentals are still sound in the U.S., and bull markets rarely die of old age, there are important indicators of the frail nature of the current environment. Market volatility in October and November 2018 was a stark reminder of the risks involved in equity investing, a feature that had been all-but-obscured by the long bull-run.

We expect that the future will look quite different from the past nine-plus years of rising equity and bond markets amid low volatility. At this juncture, several key market indicators are currently at historically high or low levels, suggesting ample potential for mean reversion.

- Despite the more recent correction, valuations in U.S. equity markets continue to appear stretched and suggest low potential returns going forward, volatility in equity markets remains at historical lows and there is a wide dispersion between the narrow segments of the market that have led the rally (U.S., China, technology and growth/momentum stocks) and the rest of the market (international, defensive sectors and value stocks), which exhibit more attractive valuations.
- Since March 2009, the U.S. market generated over 400% cumulative returns, outpacing international equities by over 200%; growth has outperformed value in the U.S. by over 100%; and five U.S. stocks have contributed over 50% to S&P 500 Index returns, year-to-date.
- In addition, market volatility is expected to increase as the Federal Reserve and central banks across the globe exit accommodative monetary policies, global growth continues to soften and markets process idiosyncratic events such as Brexit, China-U.S. trade tariffs and others.

All of these features will likely make for choppier markets ahead and a long overdue potential repricing of risk and return.

Repositioning for the Markets Ahead

While financial markets rarely adhere to the Gregorian calendar, the start of the New Year usually offers investors an opportunity to revise their views, rebalance and reposition their portfolios.

Market corrections (declines of 10% of more) typically occur once a year. Over the last 80 years we've had 12 recessions but over 43 greater-than-10% market corrections. While obscured during the most recent narrowly driven bull market, such sell-offs are a reminder of the value of diversification. How much more room for growth in equity markets is there really given current levels?

The secular shift in the relationship between stocks and bonds, coupled with a potential increase in volatility in equity markets, implies that investors may have to look beyond traditional portfolio construction approaches and traditional equity exposure. Many investors have begun looking beyond the traditional 60% stocks/40% bond portfolio—both at the asset allocation level, via exposure to truly uncorrelated return sources within alternatives; and within the equity sleeve making adjustments to address the increased beta and volatility associated with certain factor and sector exposures.

Diversification Beyond Stocks and Bonds

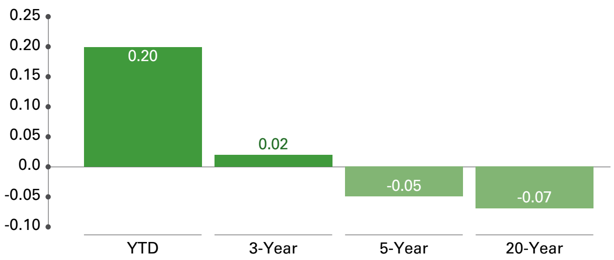
Stocks and bonds have historically realized a negative correlation. However, since the global financial crisis, correlations have gradually climbed, with both asset classes largely rising in tandem. As volatility has started to ripple through markets, stocks and bonds have accrued losses simultaneously—diluting potential diversification benefits.

QS Investors

This leaves investors to consider the portfolio implications as the long-term complementarity between these asset classes begins to fray.

Rising Equity-Bond Correlations:

S&P 500 Index vs Barclays US Bond Aggregate Index



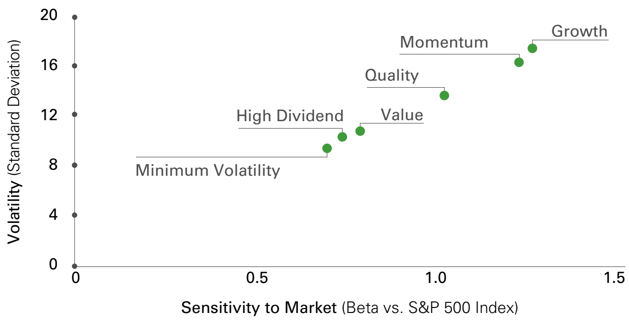
Source: Standard & Poor's, Barclays Indices, eVestment. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

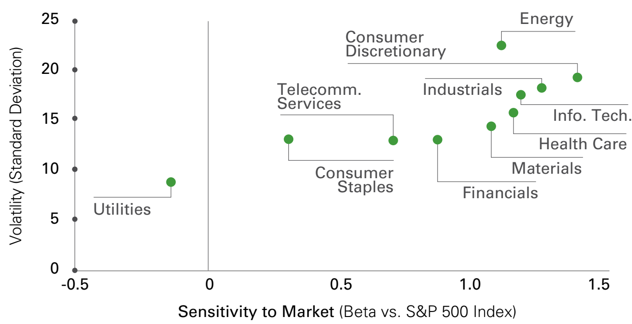
Market environments in which stocks and bonds are positively correlated, such as the 1970-1990 period, require investors to resort to alternative sources of portfolio diversification. Equity market neutral strategies offer this diversification benefit and the opportunity for gains regardless of market direction, making them a compelling option for investors seeking to capitalize on diversification.

Defensive Equity: Equity Exposure with a More Attractive Risk Profile

Amid a trending and narrowly driven market, such as the one experienced post-global financial crisis, many investors may find their portfolios have increased exposure to Growth/Momentum factors and underlying consumer-facing technology companies (housed within Consumer Discretionary, Telecommunication Services and Information Technology sectors). Taking on unintended risks increases a portfolio's vulnerability to pronounced drawdowns as trends reverse. Factors such as High Dividend and Minimum Volatility and sectors such as Utilities and Consumer Staples, which have lagged since the global financial crisis, have exhibited a significantly lower beta to the market and realized a lower standard deviation versus their cyclical counterparts.

Factor and Sector Risks, 2018 year-to-date





Source: Standard & Poor's, eVestment and Bloomberg. Factors represented by equivalent MSCI factor Indices and Sectors represented by S&P 500 Index GICs, Level 1 Classification. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. Figures reflect period of Oct. 1 through Oct. 31. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

An allocation to defensive equity strategies, providing exposure to stocks with lower price volatility, higher dividends and strong earnings/profitability, adds a differentiated return stream with potentially more attractive risk-adjusted returns than the broad equity market.

Definitions:

Beta measures the sensitivity of an investment to the movement of its benchmark. A beta higher than 1.0 indicates the investment has been more volatile than the benchmark and a beta of less than 1.0 indicates that the investment has been less volatile than the benchmark.

Correlation is a statistical measure of the relationship between two sets of data. When asset prices move together, they are described as positively correlated; when they move opposite to each other, the correlation is described as negative or inverse. If price movements have no relationship to each other, they are described as uncorrelated.

The **cyclically adjusted price-to-earnings ratio (CAPE)** is defined as price divided by the average of ten years of earnings, adjusted for inflation.

Market capitalization (market cap) is the total dollar market value of all of a company's (indexes) outstanding shares; it is calculated by multiplying a company's (indexes) shares outstanding by the current market price of one share.

Tobin's Q (Q ratio) is the ratio of the market value of a company's assets (as measured by the market value of its outstanding stock and debt) divided by the replacement cost of the company's assets (book value).

Real yields are calculated by adjusting stated yields to compensate for inflation expectations over the time period during which the yields are expected to be paid.

The **yield curve** is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities. **Inverted yield curve** refers to a market condition when yields for longer-maturity bonds have yields which are lower than shorter-maturity issues.

A **basis point** is one one-hundredth (1/100, or 0.01) of one percent.

The **European Union (EU)** is an economic and political union established in 1993 by members of the European Community. The EU now comprises 28 countries after its expansion to include numerous Central and Eastern European nations.

A **spread** is the difference in yield between two different types of fixed-income securities with similar maturities.

Developed markets refers to countries that have sound, well-established economies and are therefore thought to offer safer, more stable investment opportunities than developing markets.

Emerging markets (EM) are nations with social or business activity in the process of rapid growth and industrialization. These nations are sometimes also referred to as developing or less developed countries.

A **credit spread** is the difference in yield between two different types of fixed-income securities with similar maturities, where the spread is due to a difference in creditworthiness.

A **coverage ratio** is used to determine how easily a company can pay interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) of one period by the company's interest expenses of the same period.

Leverage refers to the amount of debt held by a company or sector of the market. Gross Leverage refers to total debt divided by the last 12 months (LTM) earnings before interest, taxes, depreciation and amortization. Net leverage is net debt (total debt minus the value of cash and other similar liquid assets) divided by the last 12 months (LTM) earnings before interest, taxes, depreciation and amortization.

Gross Domestic Product ("GDP") is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time. **Real GDP** is a nation's total output of goods and services in constant dollar, or inflation-adjusted terms.

G3 refers to the world's top three developed economies: U.S, Europe and Japan.

The **Group of Twenty (also known as the G-20 or G20)** is an international forum for the governments and central bank governors from 20 major economies. The members include 19 individual countries—Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States—along with the European Union (EU). The EU is represented by the European Commission and by the European Central Bank.

"Brexit" is a shorthand term referring to the UK vote to exit the European Union.

Mergers and acquisitions (M&A) is a general term used to refer to the consolidation of companies. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

The **price-to-book (P/B)** ratio is a stock's price divided by the stock's per share book value.

The **price-to-earnings (P/E) ratio** is a stock's price divided by its earnings per share.

Return on Equity (ROE) is the amount of net income returned as a percentage of shareholders' equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. ROE is expressed as a percentage and calculated as: Return on Equity = Net Income/Shareholder's Equity.

Net operating income (NOI) is a calculation used to analyze real estate investments that generate income. NOI equals all revenue from the property minus all reasonably necessary operating expenses.

The **Bank of Japan (BoJ)** is the central bank of Japan and is responsible for the yen currency.

Quantitative easing (QE) refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

The **European Central Bank (ECB)** is responsible for the monetary system of the European Union (EU) and the euro currency.

The **Federal Reserve Board ("Fed")** is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices and a sustainable pattern of international trade and payments.

The **federal funds rate (fed funds rate, fed funds target rate or intended federal funds rate)** is a target interest rate that is set by the FOMC for implementing U.S. monetary policies.
It is the interest rate that banks with excess reserves at a U.S. Federal Reserve district bank charge other banks that need overnight loans.

The **Federal Reserve's dot plot** shows the projections of the 12 members of the Federal Open Market Committee (FOMC) on where they think the fed funds rate should be at the end of the various calendar years shown, as well as in the long run—the peak for the fed funds rate after the Fed has finished tightening or "normalizing" policy from its current levels. The dot plot is published after each Fed meeting.

The **Federal Open Market Committee (FOMC)** is a policy-making body of the Federal Reserve System responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices and a sustainable pattern of international trade and payments.

The **Fed's neutral rate** is the rate that is consistent full employment and capacity utilization and stable prices. It is also called the terminal rate or neutral interest rate.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is an unmanaged index that measures the performance of the investment grade universe of bonds issued in the United States. The index includes institutionally traded U.S. Treasury, government sponsored, mortgage and corporate securities.

The **MSCI Emerging Markets (EM) Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The **MSCI World Index** is an unmanaged index of common stocks of companies representative of the market structure of 22 developed market countries in North America, Europe, and the Asia/Pacific Region. The index is calculated without dividends, with net or with gross dividends reinvested, in both U.S. dollars and local currencies.

The **Chicago Board Options Exchange (CBOE) Volatility Index (VIX)** is a measure of market expectations of near-term volatility as conveyed by S&P 500 stock index option prices.

The **Conference Board's Leading Economic Index** is an American economic leading indicator intended to forecast future economic activity from the values of ten key variables.

The **Organization of the Petroleum Exporting Countries (OPEC)** is a permanent intergovernmental organization of 12 oil-exporting developing nations that coordinates and unifies the petroleum policies of its member countries.

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