What’s Inside

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Market Outlook</td>
<td>1</td>
</tr>
<tr>
<td>Fixed-Income Market Outlook</td>
<td>3</td>
</tr>
<tr>
<td>Orlando’s Outlook</td>
<td>5</td>
</tr>
<tr>
<td>Where We Stand &amp; Asset Class Views</td>
<td>6</td>
</tr>
</tbody>
</table>

EQUITY MARKET OUTLOOK

Patience is a virtue

As of June 26, 2018

 Highlights

- Don’t let near-term market hiccups spoil your summer
- Trade resolutions may take longer than we first expected
- Strong earnings continue to underpin the equity market

In the meantime, with the consensus also cautious and the fundamental news flow largely positive, we see downside risks as low and continue to recommend an overweight to equities with Technology, Energy, Financials and Industrials favorites at this juncture.

For perspective, consider the following:

- **Earnings to the rescue.** The start of the Q2 earnings season is almost upon us. Although much has been made of the second derivative of earnings growth rolling over—that is, a slower growth rate than last quarter’s phenomenal 26.6% year-over-year (y/y) growth—Q2 is still expected to be very good, with almost 20% y/y growth. That would represent the second-best showing since 2011, surpassed only by this year’s first quarter. In the lead-up to the season, rather than pull back their estimates as they normally do, analysts have been hiking them. That’s a very positive sign. Moreover, some of the biggest y/y increases are expected in the very sectors that have fallen back to their secular uptrend support lines over the last three months, including Energy, Materials and Financials.

- **The long cycle.** Much of the present concern about the market, and the “second derivative of (continued on page 2)
EQUITY MARKET OUTLOOK (continued)

earnings growth,” is rooted in an expectation that we are “late cycle” and that the inevitable recession is just around the corner. We continue to pound against this argument. Most economic indicators we review, especially consumer and business confidence, employment and the ISMs, are at or near cycle highs. Inflation remains in a grind-up mode, with the deflationary forces coming from the digitization of the economy, i.e., robots and iPads, offsetting the inflationary forces coming from the tight labor market and commodity price pressures. Productivity improvements driven by corporate tax reform also are helping and, in reality, are just starting to come into play. As long as growth continues while inflation remains a grind, not a sprint, the expansion should grind on as well ... absent a Fed mistake (see below).

Trade war drag. Despite the coming positive earnings season, it may be difficult for the market to advance much higher in the face of the uncertainty created around the present very public trade-war negotiations. The latest series of salvos signal to us that these talks are going poorly and are likely to be more protracted than we had expected. Although we continue to expect a positive outcome with some reasonable concessions from China, Germany and Mexico/Canada, it may take longer to get there than we’d hoped. In the end, however, we think the president is holding a very strong hand and is likely to get the “freer and fairer” trade he is after. (For example, given the relatively low level of U.S. exports to China, we know it will run out of U.S. goods to slap tariffs on far earlier than the president will! And the idea of China, the European Union and Mexico/Canada forming their own club is interesting as a talking point, but impractical as a way of replacing their massive trade surpluses with the U.S. since all of them would be looking for a partner willing to accept a significant net deficit.) Nevertheless, it will probably take time for the deals to develop and in the meantime uncertainty, never a good thing, will hover over all the key economic players. The tariffs being banded about, if actually implemented, would just be a modest drag on growth. We are more concerned about the impact on growth of all the uncertainty from these very public negotiations. On the other hand, given the otherwise bullish market backdrop, once investors develop a firmer sense of where these trade negotiations are likely to end up—and this could come slowly or very quickly—stocks are likely to break higher.

The Fed: Hawkish or dovish? Markets took Fed Chair Powell’s comments and the accompanying dot plot after June’s policy meeting as relatively hawkish, leading some to conclude the Fed is on a fixed hiking path that is unlikely to end before policymakers throw the economy into a major pullback. We think this is highly unlikely. Powell continued to stress in his news conference the symmetry around the Fed’s inflation target and the data dependence of future rate decisions. Providing inflation data continue to behave well as we expect, the Fed is likely to lean on the side of running the economy too hot rather than too cold. And if the trade war, dollar strength and emerging markets/Italy stresses continue, we’d guess the Fed would see these as doing its job for it and would slow its rate-hike path. Net net, we see the Fed leaning dovish, not bearish.

In sum, if we have to deal with some unpleasantness over the next few weeks and months, so be it. Our longer-term bullish perspective hasn’t changed. In fact, we view potential pullbacks as attractive points to possibly add to positions—at the least, not get out. Our fundamental research continues to indicate that the market should be making significant new highs over the next six to 18 months. So when it comes to any near-term hiccups, let patience be a virtue and try to enjoy the summer.

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FIXED-INCOME MARKET OUTLOOK

Something ... or nothing

As of July 11, 2018

Highlights

- Federated maintaining slight overweight to IG, HY and EM
- Fundamentals fine but trade skirmish muddying the waters
- Will geopolitics get in way of expected December Fed hike?

Depending on one’s perspective, the bond market’s performance in the second quarter was either a warning sign that something is askew in the economic landscape or simply a “nothing burger.”

On the one hand, the market was essentially flat—the Bloomberg Barclays U.S. Aggregate Bond Index returned -0.16% for the three months as Treasury rates as measured by the yield to maturity on the U.S. Treasury Index moved upward by less than 20 basis points. No great shakes there. On the other hand, U.S. and foreign credit spreads (particularly emerging markets) widened in general—unusual for a period of relatively stable rates. Additionally, the yield curve—whose shape often is used as a predictor of possible recession—hit its flattest level since 2007, with the gap between 2- and 10-year Treasury yields narrowing from 54 to 33 basis points. And despite a marginally positive S&P 500 (up nearly 3% in Q2), world equity markets had their weakest quarter since 2010, led by a 10% decline in China’s Shanghai Composite Index.

All of this occurred against a backdrop of a U.S. economy that’s estimated to have grown at an annualized rate above 3% and potentially at its fastest pace in almost four years. Inflation, not surprisingly, also continued to march upward, reaching 2% and higher across virtually every broad metric. This type of environment should have led to relatively positive performance for risk assets (i.e., higher stock prices, tighter spreads, higher Treasury rates and a stable yield curve). However, market activity seemed to be more driven—or at least tempered—by geopolitical events, with escalating trade-war concerns front and center. This made it difficult to get a true “read” on the market.

About that Trump ‘put’

You may recall that last quarter we wrote about the Trump ‘put’—our expectation that the administration was “negotiating” and would pull back from a significant trade war at the appropriate time. While this is still our base case, we must admit to being surprised that if anything, the rhetoric has intensified, not mellowed, and that “the game” seems to be defined more in relative than absolute terms. Indeed, defenders of the tariffs appear to view the U.S. as winning, for now, because its markets are experiencing less pain than others, China in particular.

Hopefully the end goal of the administration’s actions is to eliminate tariffs across the globe, thus optimizing the benefits that free trade can provide. But our concern is it views trade as a one-dimensional “zero sum” game and puts more value on simply reducing the trade deficit, a notion that ignores the concept of comparative advantage in which all sides can benefit by playing to their strengths. Add in the complication of supply chain issues, and tariffs arguably could represent “something.” Oxford Economics estimates tariffs and restrictions already proposed will result in 4% less global trade than otherwise be the case—a significant number on the margin.

When will trade really begin to bite? We already have begun to see signs. The most recent ISM delivery index slowed considerably, not because demand is so strong that suppliers can’t keep up, but because delivery times are being extended on worries supply chains may be vulnerable to negative trade shocks. This represents a potential manifestation of both the start of tariffs and the difficulty U.S. companies are experiencing in finding properly skilled workers. Having said that, June’s employment report displayed more labor slack, with the unemployment rate rising to 4% despite the above-consensus addition of 213,000 nonfarm jobs. Were companies possibly staffing to front-load activity before tariffs really go into effect while delaying capital spending due to longer-term uncertainty? Only time will tell.

Fed in a tough spot

How do Federal Reserve policymakers react to all of this? Minutes from their most recent June meeting spent significant verbiage on the subject of business investment and confidence being affected by the uncertainty of tariffs and how to factor this in going forward. The minutes also showed concern over the flatness of the yield curve—historically a recession indicator but only many months after it actually inverts, with short rate exceeding long rates—and the notion that Fed policy is no longer accommodative. All of this will make for an interesting rate decision not so much in September, when a hike is a near certainty, but rather for a potential December hike, which Chairman Jerome Powell and others had spent a good deal of time previewing over the last few months.

(continued on page 4)
Positioning: Holding steady, for now
For now, we have decided to stay the course. On the rate side, we remain modestly defensive on duration without a major yield curve position on the expectation rates could move up with a resolution, or at least a respite, to the trade skirmish. On the credit side, we continue to be tentatively constructive given the supportive economic backdrop, with small overweights to investment-grade and high-yield corporate bonds, commercial mortgage-backed securities and emerging markets. The EM overweight is based more on value as this sector has been the greatest underperformer year to date, due largely to the strength of the U.S. dollar, which we expect to be more balanced moving forward.

More fundamentally, with the drivers more geopolitical than economic, the investing landscape is challenging. Because of this, our fixed-income portfolios’ risk profiles are about as close to benchmark (i.e., low predicted tracking error) than they have been in some time as we look to manage through the trade skirmish to see what awaits on the other side. We’ll keep you posted.

Municipal outlook solid
Municipal bonds outperformed comparable maturity Treasuries in the second quarter—muni yields were steady to lower, while Treasury yields crept up—and it wouldn’t be surprising if this trend were to continue for basic reasons of supply and demand. On the supply side, the new tax law severely limited the ability of municipal issuers to refinance their tax-exempt debt prior to call dates, causing gross issuance to drop off significantly. At the same time, the new law in some ways encouraged demand from many individual investors who experienced a somewhat modest tax cut overall (the top income tax rate fell from 39.6% to 37%, for example) and are looking for protection from the tax man now that the federal deduction for state and local taxes is capped at $10,000. Muni demand from banks and insurance companies has declined somewhat as a result of the dramatic cut in the headline corporate income tax rate from 35% to 21%, and we have seen some liquidation of their portfolios that have been manageable to the market. Meanwhile, with the U.S. economy relatively robust, the muni credit picture looks good in general, although there are some longer-term issues relating to underfunded pensions and structural imbalances in a few states such as New Jersey and Illinois that ultimately will need to be addressed and currently are causing bonds in those states to trade cheap in the market.

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ORLANDO’S OUTLOOK

Lighten up and lock in some profits

As of June 27, 2018

Highlights
- Trimmed equity overweight as summer storms pass
- Still see likelihood of end-of-year and 2019 rally in stocks
- Potential trade ripples head a growing Wall of Worry

Bottom line
The investment professionals who comprise Federated’s PRISM asset allocation committee decided in late June to lock in some profits by reducing their equity overweight in their moderate growth model portfolio from 8% to 5%, adding the proceeds to cash.

The S&P 500 rallied by more than 9% over a 10-week period (from 2,553 on April 2 to 2,791 on June 13), largely driven by excellent first-quarter profits, in which earnings grew more than 26% year-over-year (y/y). But companies won’t start to report what we believe will be very solid second-quarter results (up an estimated 20% y/y) for another three weeks or so in mid-July. Importantly, amid this earnings vacuum, we’re now concerned that second-quarter management guidance will be soft, as companies share our worries about the global tariff and trade war situation, the risk of a monetary policy error by the Federal Reserve (Fed), the ongoing immigration mess, sharply rising oil prices hurting consumer spending, and the Blue Wave reclaiming Congress in the midterm elections.

So with stocks bumping into overhead resistance for the third time in five months and a host of headwinds ahead of us, stocks appear to be setting up for a 5-8% correction over the summer. As a result, we thought it prudent to lock in some profits now and create a store of dry powder, which we hope to deploy at better prices later this year. We still expect a powerful fourth-quarter and 2019 rally that will eventually drive equities to record highs. Think of this move, then, as strictly short term and tactical, as we continue to believe in the solid, longer-term fundamental underpinnings provided by strong economic and corporate profit growth.

Wall of Worry
There are a host of issues upsetting investors at this time:
- The Fed’s leadership and policy transition is progressing smoothly, as new Fed Chair Jay Powell has already orchestrated two quarter-point rate hikes this year, with at least a third hike to follow later this year. But investors worry that Powell may hike too quickly, pushing the economy into recession.
- Trump-inspired global trade wars and the imposition of tariffs could hurt economic growth. But with the annual U.S. trade deficit at 3% of GDP, if President Trump’s unconventional negotiating tactics generate even modest improvement, then he could boost economic growth here at home, juicing federal revenue generation, reducing the deficit and strengthening jobs and wages.
- Immigration is a hot-button mess at present, with no clear consensus on how to improve border security, reconnect separated families with young children, create a much-needed path to citizenship for DACA, and help to augment cyclical lows in domestic fertility rates with immigrant workers.
- Geopolitical risks include Italy’s political instability, which is out of our control, and nuclear concerns surrounding North Korea and Iran, which are very much in our control.
- Flattening yield curve as a recession signal. But the curve has not yet inverted, and we do not see any signs of recession on the horizon for at least two more years. Historically, once the yield curve does invert, we are typically 20 months away from the start of the recession, during which time the S&P 500 has rallied by an average of 11%.
- Democratic Blue Wave looks less likely to happen in the November midterm elections, due to Trump’s rising poll numbers and improving generic ballots for Republicans, who are now favored to hold onto the Senate.
- Crude oil prices as measured by West Texas Intermediate soared 74% over the past year, from a trough of $42 per barrel in June 2017 to its recent peak of $73 in May 2018, as OPEC production cuts of 1.8 million barrels per day and strong global economic growth helped to bring supply and demand back into balance. Retail gas prices rose by a third over this same period of time, from $2.23 per gallon to $2.97. A penny increase at the pumps cuts $1 billion from discretionary consumption, so that’s a potential GDP hit of 0.37% and counting.
- Feared inflation spike appears to be more of a gradual grind higher, with the core PCE up by 1.8% in each of March and April, which is still below the Fed’s oft-stated 2.0% target. But May is expected to tick up to 1.9%.

(continued on page 8)
WHERE WE **STAND**  (as of June 27, 2018)

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Weight</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large-Cap Growth</td>
<td>Neutral</td>
<td>With summer storms brewing, we decided to take profits in PRISM’s second-largest asset class, dropping the overweight to neutral and putting allocation in cash to await better redeployment opportunities later when the outlook is expected to improve.</td>
</tr>
<tr>
<td>Large-Cap Value</td>
<td>Overweight</td>
<td>Our view on large-cap value stocks is similar to above—we took a tick out of this asset class, too, though it remains overweight on our view that it has added potential to catch up to growth stocks, which have been significantly outperforming value. Value already receives a higher overall allocation in our model because of its historical outperformance relative to growth stocks.</td>
</tr>
<tr>
<td>U.S. Small-Cap Growth</td>
<td>Neutral</td>
<td>We shifted back to neutral from the overweight position we took in spring for essentially the same reasons as we did with large-cap growth, taking profits now and waiting for better opportunities to dive back in once a potential summer rough patch passes.</td>
</tr>
<tr>
<td>U.S. Small-Cap Value</td>
<td>Overweight</td>
<td>As stated above, we think value offers better potential at this point, further buttressed by strong economic fundamentals and domestic earnings growth.</td>
</tr>
<tr>
<td>International Large Cap</td>
<td>Overweight</td>
<td>We think the recent slowdown in Europe is just a hiccup, while Japan is experiencing its first prolonged period of economic growth since 2001. We’re watching Italy but at this juncture don’t see it tipping the apple cart.</td>
</tr>
<tr>
<td>International Small/Mid Cap</td>
<td>Neutral</td>
<td>This asset class is subject to many of the same mix of forces impacting international large cap, but given our broader preference for domestic U.S. equities, we’re playing with the chips in hand and keeping the allocation to this asset class at neutral.</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>Neutral</td>
<td>EM valuations have improved on higher oil and other resource prices and muted reactions to Fed policy moves toward normalization. But pending elections, uncertainty over Nafta and trade generally have us leery of moving above neutral until the clouds clear.</td>
</tr>
<tr>
<td>Fixed Income</td>
<td></td>
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</tr>
<tr>
<td>Treasuries/Agencies</td>
<td>Underweight</td>
<td>Treasury and agency yields have trended higher within a range and offer little value per unit of duration risk, particularly as the Fed continues with policy normalization.</td>
</tr>
<tr>
<td>Mortgage-Backed Securities</td>
<td>Underweight</td>
<td>While recent underperformance has improved valuations, the market is still in search of a new equilibrium spread level. The 10-year Treasury realized volatility declined in June to levels that are average for the past 3 years. However, the Fed continues to reduce its MBS purchase, and REITs are in the capital preservation mode as the yield curve flattens.</td>
</tr>
<tr>
<td>Investment-Grade Corporates</td>
<td>Underweight</td>
<td>Because fixed income is at a maximum underweight in the PRISM stock-bond model, this asset class also is underweight but remains our biggest relative weight within fixed income due to still healthy balance sheets, rising earnings and a robust economy. This underweight in the PRISM model would become larger as we continue to inch closer to neutral allocation within our fixed income space. Less-supportive central banks, higher interest-rate volatility and global trade tensions all pose risks to this credit overweight.</td>
</tr>
<tr>
<td>High Yield</td>
<td>Neutral</td>
<td>With a recession looking unlikely and corporate metrics looking solid, high yield remains attractive for its coupon even as its tight spreads relative to Treasuries limit total return potential.</td>
</tr>
<tr>
<td>International</td>
<td>Underweight</td>
<td>Despite strong U.S. data and subsiding European political risks, global trade uncertainties cloud both investor appetites and global risk premia.</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>Overweight</td>
<td>While spreads are tight, recent volatility and trade tensions have created opportunity. In addition, most EM economies are accelerating, with Latin America expected to reach above-potential GDP growth this year. Counterweights include recent dollar strengthening and rising U.S. yields.</td>
</tr>
<tr>
<td>Alternatives</td>
<td></td>
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</tr>
<tr>
<td>Real Estate</td>
<td>Neutral</td>
<td>Limited supply, recent spread widening and the fundamentals—a growing economy, relatively low vacancy rates and robust rents—are favorable for commercial REITs. But we remain cautious amid still-tight spreads and signs of overbuilding in some markets.</td>
</tr>
<tr>
<td>Commodities</td>
<td>Neutral</td>
<td>After moving sharply higher over the past 12 months, oil prices have pulled back modestly on increased supply but still look to be in an uptrend. Agricultural commodities continue to climb off their winter lows.</td>
</tr>
<tr>
<td>TIPS</td>
<td>Neutral</td>
<td>With the 10-year breakeven inflation rate moving steadily up to near 4-year highs, Treasury Inflation-Protected Securities appear rich, particularly as inflation expectations appear to be moderating.</td>
</tr>
<tr>
<td>Absolute Return</td>
<td>Overweight</td>
<td>We continue to place some of our normal cash allocation into this asset class, which is at a maximum overweight and should outperform very low-yielding cash and possibly bonds, with less downside.</td>
</tr>
<tr>
<td>Cash</td>
<td>Overweight</td>
<td>As noted above, we parked profits from our reductions in our equity allocations into this easy-to-deploy asset class, moving it back to overweight while we await better opportunities to put the cash to work.</td>
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</tbody>
</table>

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**ASSET CLASS VIEWS**

*These views are based on the most recent and prior investment committee meetings. Visit FederatedInvestors.com for the most up-to-date information.*

- ▲ Indicates current meeting position as of 6/27/18
- ▲ Indicates approx. 12 months prior position as of 6/7/17
- ▲ Indicates prior meeting position as of 5/31/18

### Equity and Fixed-Income Balance

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>View</th>
<th>Duration</th>
<th>Treasuries/Agencies</th>
<th>Mortgage-Backed Securities</th>
<th>Investment-Grade Corporates</th>
<th>High-Yield Bonds</th>
<th>International Bonds</th>
<th>Emerging-Markets Bonds</th>
<th>Real Estate</th>
<th>Commodities</th>
<th>TIPS</th>
<th>Absolute Return</th>
<th>Cash</th>
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<tr>
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<td>International Large Cap</td>
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<td>International Small/Mid Cap</td>
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**Note:**
- Positive indicates an increase in assets.
- Negative indicates a decrease in assets.
- Indicates current meeting position as of 6/27/18.
- Indicates approx. 12 months prior position as of 6/7/17.
- Indicates prior meeting position as of 5/31/18.
ORLANDO’S OUTLOOK (continued)

What we did in PRISM

- **Domestic large-cap growth** – Reduced 1%, taking a 1% overweight back down to neutral at a 13% allocation
- **Domestic large-cap value** – Reduced 1%, taking a 4% overweight down to a 3% overweight at an 18% allocation
- **Domestic small-cap growth** – Reduced 1%, taking a 1% overweight back down to neutral at a 3% allocation
- **Cash** – Added 3%, taking a 1% underweight back up to a 2% overweight at a 4% allocation

Where should investors hide this summer in a defensive rotation?
- **Cash**
- **Benchmark 10-year Treasury**

...continued...

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For additional information on PRISM: Effective Asset Allocation®, contact your Federated representative at 1-800-341-7400. PRISM® is a registered mark of FIH Holdings, Inc., a subsidiary of Federated Investors, Inc.

Duration is a measure of a security’s price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Bloomberg Barclays U.S. Aggregate Bond Index: An unmanaged index composed of securities from the Bloomberg Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization.

Bloomberg Barclays U.S. Treasury Bond Index is part of Bloomberg Barclays Capital global family of government bonds indices. The index measures the performance of the U.S. Treasury bond market, using market capitalization weighting and a standard rule based inclusion methodology.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

Shanghai Stock Exchange Composite Index: A capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai stock exchange.

S&P 500 Index: An unmanaged capitalization weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Indexes are unmanaged and investments cannot be made in an index.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

Yield to Maturity (YTM) is used to determine the rate of return an investor would receive if a long-term, interest-bearing investment, such as a bond, is held to its maturity date. It takes into account purchase price, redemption value, time to maturity, coupon yield, and the time between interest payments.

- **Domestic small-cap stocks** have outperformed large caps by nearly 8% over the past five months, a trend that should continue due to stronger U.S. economic growth, a tighter Fed, a stronger dollar, fears of tariffs and trade wars, Trump’s tax cuts and stronger mergers and acquisitions activity from repatriation.

- **Domestic large-cap income-oriented value funds** have underperformed large-cap growth by 27% over the past 18 months, as Treasury yields were rising sharply. That degree of underperformance has occurred only four other times over the past 40 years, followed each time eventually by a sharp reversal in favor of value. Dividend yields for these income-oriented funds are now more than twice that of the 1.9% yield for the S&P 500. With Treasury yields declining at present, we expect income-oriented funds to perform well.

A Few Words About Risk

Past performance is no guarantee of future results.

Investments are subject to risks and fluctuate in value.

Diversification and asset allocation does not assure a profit nor protect against loss.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks and may be more volatile than investment-grade securities. For example, their prices are more volatile, economic downturns and financial setbacks may affect their prices more negatively, and their trading market may be more limited.

International investing involves special risks including currency risk, increased volatility, political risks and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries, and currency risk and political risks are accentuated in emerging markets.

Prices of commodities may rise and fall in response to many factors such as economic, political and regulatory developments.

Investments in real estate involve special risks, such as limited liquidity.

Absolute return investing may outperform broad markets during periods of flat or negative market performance but may not outperform stocks and bonds during market rallies.

The value of some mortgage-backed securities may be particularly sensitive to changes in prevailing interest rates, and although the securities are generally supported by some form of government or private insurance, there is no assurance that private guarantors or insurers will meet their obligations.

Small-company stocks may be less liquid and subject to greater price volatility than large-capitalization stocks.

Value stocks may lag growth stocks in performance, particularly in late stages of a market advance.