US Wealth Management
U.S. Bancorp

Investment views: 4th quarter 2017

Quarterly outlook

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Executive summary

We remain positive on the current investment backdrop as we head into the year's final calendar quarter. Our mantra for this year has been "glass half full," capturing our view that while riskier asset classes have been strong, solid portfolio returns have been justified. The global economy is growing and although below its longer-term potential, momentum has been picking up and growth is more synchronized across major economies than at any other point since the 2008-2009 recession. Contributions from Europe and Japan, ongoing U.S. resilience and an unpredictable, yet expanding, China have helped profit growth. The upcoming holiday season will provide insight into consumer demand.

As 2017 draws to a close, we are mindful that the broad-based recovery could face several risks.

- First, major central banks are looking to unwind pro-growth stimulus plans that helped drive down borrowing costs and pulled forward consumer activity. The execution of the unwind will be a focus for us.
- Second, political tensions surrounding healthcare and tax legislation have yet to impact capital market trends, but with midterm elections a mere 12 months away, the market's seeming indifference may change. International political tensions are also central focal points for us, with North Korea presenting a potential flash point.
- Third, while we do not view asset valuation in and of itself a catalyst, we must respect that while stock and bond prices hover at or near all-time highs, a lot of positive news is already priced into assets. Seeing if reality matches anticipation is always essential, but especially with many asset classes not reflecting a margin for error.

Our job is to provide you with a balanced assessment of the investment and capital market mosaic that we analyze every day on your behalf, and we are thankful for your trust. We hope this commentary helps you understand our thought process and views, but more importantly, it informs you about how

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we are thinking about the capital you have entrusted us to help with. Please do not hesitate to follow up with us if we can help answer any questions or drill deeper into the content herein.

Global economic views

The global economy remains in a broad-based upswing, with positive year-over-year economic growth seen in all of the major world economies. Growth in manufacturing production and trade — indicators of broad global economic health — have accelerated above historical averages. Additionally, crude oil's decline from a range of $80-$120 per barrel earlier in the decade to a range of $40-$60 per barrel has acted as a three-year "global tax cut" for the 88 percent of the world population that lives outside of OPEC and non-OPEC oil-producing countries. We believe the primary risks to our global growth outlook are policy related as central banks look to reverse years of accommodative pro-growth measures, and as geopolitical tensions potentially escalate amid heightened rhetoric between the United States and North Korea.

United States: In the United States, economic growth is modestly positive but still well below historical levels as the domestic central bank, the Federal Reserve (Fed), continues a measured pace of interest rate hikes. Despite ongoing delays in implementing the Trump administration's domestic policy agenda, CEO and small business owner sentiment remains quite positive.

- The solid jobs market supports consumer spending and modest economic growth. Job openings are at record levels and consumer confidence remains high. Despite policy uncertainty, business spending has improved and could improve further with clarity on possible changes to the Affordable Care Act (ACA) and corporate tax rates. Potential regulatory reforms in the Financial and Energy sectors could provide additional economic support.
- Inflation is positive but remains below the Fed's stated 2 percent target, despite a tight labor market, low housing inventories and more stable commodity prices. We believe that eventual wage growth will ultimately drive inflation toward the Fed target and support continued, measured increases in the policy rate.

Risks to our U.S. outlook for modest, positive growth remain balanced and primarily related to monetary and fiscal (changes to spending or taxation) policies. The Fed, which conducts domestic monetary policy, usually increases interest rates if they anticipate rising inflationary pressure. If expectations for a re-acceleration in inflation are not realized, additional increases in interest rates could be premature and could adversely impact consumer spending habits, as well as companies' plans to expand hiring or business build-out plans. However, expectations for most policy action, outside of gradual interest rate increases, are low at this time and any positive movement in the legislative or regulatory agenda would likely lift business and consumer sentiment, providing a potential upside to our outlook.

Europe and Japan: Overall conditions in Europe and Japan continue to improve while monetary policy in those regions (changes in interest rates that help calibrate borrowing costs) continues to be extremely accommodative, meaning central banks that set monetary policy continue to have a pro-growth mindset. Easing political risks in Europe have now turned attention to the economy, where growth is positive and broad-based across the continent, including Greece. Sentiment remains strong across manufacturing, construction and services industries, and unemployment across the region continues to fall. Growth in Japan has also been improving, reflective of accommodative monetary policy and the ongoing benefits of structural reforms.

China: China remains on pace to achieve economic growth targets for 2017 and policy has shifted toward modest tightening of credit conditions in order to curb potentially excessive growth in credit.

2017 appears to be another year of moderating Chinese growth. Policy actions have shifted from accommodative to restrictive, with a goal of managing financial system risks while still providing stable economic growth ahead of this fall's 19th National Congress of the Communist Party of China. We believe authorities have sufficient tools in the near term to manage economic risks of high debt levels and risks from currency outflows. The fall Party meeting will be an important determinant in the future pace of growth and reforms.

In aggregate, global economic growth is progressing, providing a reasonable backdrop for asset prices, but we continue to watch for any signs of weakening momentum or policy risks to alter our outlook on the current landscape.

Equity markets

Our overall outlook for equities remains positive amid a favorable backdrop of corporate profit growth, still accommodative credit conditions, a broad global economic growth base, positive but restrained inflation and ample liquidity. However, equity valuations are elevated and while we believe levels are supported by earnings growth and current economic conditions, they have historically portended below-average nominal returns. Therefore, we retain a pro-risk bias but believe equity investors should temper longer-term return expectations. Also, measures of investor complacency are extremely high, suggesting that high valuations could be at risk from unforeseen policy errors or geopolitical shocks.

Domestic equities: Our outlook is for U.S. equities to drift still higher into year-end and into 2018, supported by positive earnings growth and absent a looming recession or unexpected rise in inflation.

- Equity performance has been remarkably resilient throughout 2017, shrugging off geopolitical tensions and uncertainties regarding the direction of U.S. domestic policy. The S&P 500 is beginning the fourth quarter near all-time highs, with nine of 11 S&P 500 sectors posting positive year-to-date gains.
- Relative to large-cap equities, small companies have surprisingly underperformed year to date by nearly a two-to-one margin. With small companies tending to be more U.S. centric, the lagging performance of the small-cap-oriented Russell 2000 Index can perhaps be attributed to U.S. political uncertainty and associated headwinds for Trump's pro-growth agenda. Conversely, synchronized global growth presents a favorable environment for larger, multinational companies.
- The investor search for yield continues, with equities remaining an attractive alternative with nearly 40 percent of S&P 500 companies beginning the fourth quarter offering dividends yielding above the 10-year Treasury note rate.

Within the U.S. equity market, we believe the current macroeconomic environment presents a favorable backdrop for both growth and defensive sectors.

- Information Technology is leading sector performance based on favorable growth and valuation metrics as well as in anticipation of ramping cap ex spending.
- Consumer Discretionary is a bifurcated sector, with outperformance generally afforded to those companies that have an online presence, a business model that requires in-store traffic and a high experiential rating.
- The Financials sector has been among the most volatile since the November election, with its fortunes closely aligned to the changing landscape in Washington, growth of the broad economy and direction of interest rates. Upside performance levers include regulatory relief, accelerating loan growth and/or improved net interest margins associated with rising interest rates.

International equities: Foreign developed equity markets continued to perform well in the third quarter of 2017. Returns on foreign equities for U.S. investors have been enhanced in 2017 by weakness in the U.S. dollar, which increases the relative value of non-domestic assets. We retain our positive outlook for the remainder of the year and continue to favor both Japan and continental Europe over the United Kingdom due to modest reflation, firming and broadening economic growth, ongoing earnings improvement and a reduction in political event risk.

- President Angela Merkel's re-election as German Chancellor was widely anticipated and completes a European "trifecta" of victories by pro-Euro mainstream parties in three core eurozone economies (Netherlands, France and Germany).
- The economic picture continues to improve in continental Europe, where economic growth is positive and broad based, sentiment remains very strong and the unemployment rate across the region continues to fall.
- In the United Kingdom, the cloudy outlook over a negotiated "Brexit" settlement with the European Union (EU) continues to create an overhang for business and consumer sentiment.
- While deflationary fears have abated, inflation remains well below targets in Japan and the eurozone. We expect monetary policy in these regions to remain extremely accommodative throughout 2017, which should continue to be conducive for risk assets.

Emerging market equities posted double-digit gains in the third quarter of 2017. We remain cautiously optimistic and continue to view opportunities and risks in emerging markets as fairly balanced over the remainder of 2017. We prefer "thematic" approaches to emerging markets that focus on China's maturing economy (healthcare, environment, empire-building) and the emerging market middle class.

- China remains on pace to achieve the government's economic growth target in 2017. However, the growth "impulse" from China may have peaked, with authorities engaged in tightening credit conditions in order to reduce financial system risk.
- Brazil has emerged from a deep economic recession, with economic growth increasing over the prior year for the first time since 2014.
- South Korea completed an abrupt political transition after a scandal resulted in the impeachment of sitting President Park Geun-hye.
- The emerging middle class remains alive and well. In the most recent survey of consumer preferences, China's urban residents' preference to spend continued to increase relative to saving or investing in property or financial assets.

Fixed income markets

While we anticipate that fixed income returns over the next few quarters are likely to be subdued relative to recent history and likely less than current quoted bond yields, investment grade bonds remain a fundamental part of a well-diversified portfolio. Factors driving higher bond yields (and consequently lower bond returns in the near term) include positive global growth, rebounding inflation and the Fed's likely gradual increase in interest rates. The primary risk to our view is that rates could remain low if inflation continues to disappoint.

Key interest rate drivers: We continue to monitor several key areas:

- Inflation: This has generally been disappointing relative to the Fed's target of 2 percent in recent months, putting downward pressure on interest rates. Given the tight labor market, we think wages should resume their longer-term trend higher, which should contribute to higher inflation and interest rates in the coming months.
- Fed policy: We expect one more Fed rate hike in December 2017, with two to three hikes in 2018 if the economy and inflation remain healthy. The Fed will

allow its balance sheet, or its accumulated securities purchased to hold down interest rates/borrowing costs, to decline in the fourth quarter of 2017. While the near-term impact on rates is likely to be modest, the more material event will be when central bank balance sheets begin shrinking in aggregate, which is unlikely to occur until late 2018 or 2019.

- Secular theme – aging global population: Global demand for cash flow is strong and growing relative to supply, partially resulting from low yields across asset classes and an increasing retiree population. This trend is unlikely to reverse in the coming years, which should keep rate increases moderate. Recent flow data indicates that demand for investment grade bonds is strong and accelerating.

Corporate credit: Bonds issued by high-quality corporates is our preferred way of accessing the fixed income market, reflecting solid performance expectations based on a strong economic backdrop and our expectation for low near-term defaults. However, spreads — defined as a bond's current yield less the Treasury bond yield of a similar maturity— are narrow, leaving little cushion for investors should risk appetites falter. Within corporate credit, we prefer higher-quality bonds over riskier high yield bonds. The primary risk in the near term is of repricing, rather than ramping defaults.

- For higher quality credits, we have a strong preference for U.S. over foreign developed bonds. For lower quality credits, we prefer active managers, reflecting the higher risks and diverse nature of the market.

Municipal debt: Limited supply and persistent demand may lead to continued outperformance in the near term. While longer-term municipal debt is attractive versus corporate bonds, munis are quite expensive for shorter maturities. Investors with holdings at the short end of the yield curve who live in low-tax states may want to carefully assess corporate bonds relative to munis, which may provide better value depending on tax rates.

- The steep municipal curve — meaning bonds with longer maturities appear to provide higher than normal yields relative to bonds maturing sooner — may offer taxable investors attractive incremental compensation for extending duration. At the short end of the curve, investors in low-tax states should carefully assess corporate bonds relative to municipals, which may provide better value depending on tax rates.
- We encourage a focus on higher-quality credits since structural problems in Puerto Rico and Illinois persist, and may trigger periodic, renewed scrutiny of other weak credits. We encourage using an active approach to manage risks from individual credits.

Emerging market debt: For investors with a higher-than-average risk tolerance, emerging market debt is becoming more attractive. Economic fundamentals in many areas are improving, justifying higher-than-average valuations.

Real estate markets

We believe the best of times for the commercial real estate (CRE) market are likely behind us. Fundamental underpinnings for the CRE market are likely to soften from here. Vacancy rates appear to have bottomed and net operating income (NOI, a measure of cash flow post expenses) growth is slowing. Additionally, the potential for rising interest rates could challenge current valuation levels. If safer investment options reflect higher interest rates, other asset classes are subject to moving down in price and therefore up in yield to "compete" with higher prevailing interest rates. To that end, we are likely in the later stage of the real estate cycle, which means property prices may need to adjust lower. However, current cash flow yields are fair relative to the low interest rate environment and positive overall economic environment. We expect total returns to be driven by current cash flow with a limited contribution from price appreciation due to slowing NOI growth.

Across the major property types, vacancy rates are ticking up and NOI growth is slowing. In the multi-family sector this is being driven by supply. Multi-family construction is at four-decade highs while the household formation rate remains near 50-year lows. In the Retail sector, the phenomenon is being driven by the unprecedented pace of store closures. The closures are creating pressure on malls, with reports predicting 20 percent to 25 percent of malls may close or be repurposed, reflecting changing consumer tastes. In the office space market, there is just a general lack of demand in a slow-growth economy. The secular shift to telework is likely to further depress office demand over time.

The one bright spot is industrial property. Vacancy rates continue to trend lower and rent growth is still accelerating. This activity is being driven by the revival in U.S. manufacturing, as well as the consumer shift to online shopping.

Commodities markets

Commodity prices generally remain at the low end of the historical range, pressured by strong supply and modest economic growth. We believe prices are likely to remain constrained into next year by these soft fundamentals. Investors may wish to consider investments that potentially benefit from low commodity prices or cash-flow-oriented commodity investments.

- Oil markets continue to struggle with bringing supply and demand into balance as OPEC supply cuts have been met by increased U.S. production. Declining rig counts in the United States, combined with new, increased demand forecasts from the International Energy Agency (IEA), could lead to balance sometime in 2018. However, until those higher-demand forecasts are realized, prices may be capped.
- Precious metals have experienced outsized gains so far this year, particularly gold, with a price increase of double-digit gains. Headwinds from Fed policy in the next quarter or two could put pressure on prices.

Alternative investment strategies

The current environment of positive but below-trend economic growth remains supportive of companies with strong fundamentals that are market leaders in their respective sectors/industries. Persistent divergence between “strong” and “weak” companies continues to provide a breadth of opportunities for alternative strategies. Despite high levels of investor complacency, represented by low volatility in bond and equity prices, hedge fund managers with strong security selection skills can still generate positive returns by exploiting the relative fortunes between the strong and the weak.

In private markets, debt funds continue to successfully raise capital as they fill the gap caused by enhanced regulatory controls on bank lending. The increase in capital flowing into private debt strategies calls into question both the quality of the loans and the quality of borrowers. In addition, private equity strategies are reducing their return assumptions in line with the lower expected equity returns. However, we believe that funds focused on the higher growth sectors such as Technology and Healthcare with unique access can continue to generate outsized returns relative to those funds diversified across many sectors.

Hedged equity: We expect fundamental long/short equity managers focused on the United States and Asia to do well on a risk-adjusted basis relative to their respective long-only benchmarks. Our expectation is that asset prices going forward will be determined more by company fundamentals as the wave of liquidity attributable to a coordinated global monetary policy begins to recede. In the United States and Asia, we believe the sectors with the most potential are Healthcare and Technology. Both regions are early adopters of technology such as robotics. Healthcare companies in industries such as medical devices, biotech and diagnostics benefit from the aging population in the developed countries and the emerging middle class in the developing countries within Asia.

Hedged fixed income: Despite continued below-trend global growth and low interest rates in developed markets, we believe there are still investment opportunities within credit markets, such as lower quality bonds available in the United States and Europe. We favor trading-oriented strategies where managers can perform the required fundamental research yet also understand the "technicals" with how these niche markets (B- and CCC-rated U.S. high yield bonds and European structured credits) trade. Continued access to cheap capital in a low interest rate environment continues to be a challenge when separating "good" from "bad" credits. Therefore, we recommend focusing on strategies that invest in securities less impacted in the event of a rising interest rate environment and a reduction in "cheap" liquidity. However, the tradeoff is that these securities often are less liquid and are of lower credit quality.

Private equity: Private equity funds continue to be oversubscribed and the intense competition for deals is driving up valuations and, therefore, driving down expected returns. Investors don't seem to mind paying lofty valuations as even muted private equity returns remain higher than those expected in the public markets. Nine months into the Trump administration there have been few policy surprises, which provides U.S. investors with a "business as usual" mindset. With that in mind, we continue to favor strategies where fund managers can create value through "buy versus build" operational initiatives and focus on niche strategies that invest in companies with pricing power in growth-oriented sectors. In Europe, uncertainty due to ongoing Brexit negotiations continues to provide opportunities for private equity. Finally, Asian markets have been primarily driven by the sentiment surrounding China's economic fortunes. Going forward, we believe well-positioned managers in Asia can benefit from deploying capital in a more targeted fashion, especially in companies tied to rising domestic consumption.

- Strategies focused on acquisitions and/or operational initiatives that will generate growth or reduce costs are best positioned in case of a prolonged flat to very low-growth economic environment.
- Healthcare, Consumer and Business/Financial Services sectors have more opportunity for growth due to technology innovations that continue at a fast pace with no end in sight. Private equity strategies focused on these sectors are expected to benefit from this trend.
- Investing in Asian opportunities where the differentiator is not just capital but the ability to provide a solution is expected to be favorable. For example, as food safety becomes more important in China, companies are looking for partners who can add value by implementing global best practices.
- Japanese, Korean and Australian markets present opportunities for large-scale corporate carve-outs and operational initiatives to drive growth.

Private debt: Similar to private equity, investor demand for private debt funds is very strong. Subdued bank lending growth is providing private debt funds with ample opportunities. Funds with unique access or specialized knowledge of sectors in middle markets and niche sectors can provide higher yields and total returns than typical bank loans.

To differentiate within private debt, investors should look to funds that lend to companies in niche markets with competitive advantages such as high barriers to entry, pricing power and premium products or services. In addition, the type of deal is as important as determining the yield. While club-style, first lien loans may provide a sense of comfort to investors because other funds are involved, the yield may also be substantially lower. Conversely, funds that invest in lower middle markets' debt issued from companies that operate in sectors that are in the cross-hairs of technology innovation may offer more attractive returns.

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Diversification and asset allocation do not guarantee returns or protect against losses. Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning the construction of portfolios and how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes will be suitable for every portfolio.

Past performance is no guarantee of future results. All performance data, while deemed obtained from reliable sources, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for investment. The **S&P 500 Index** is an unmanaged, capitalization-weighted index of 500 widely traded stocks that are considered to represent the performance of the stock market in general. The **Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index and is representative of the U.S. small capitalization securities market.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. **International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible difference in financial standards and other risks associated with future political and economic developments. Investing in **emerging markets** may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in **fixed income securities** are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in **high yield bonds** offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. The **municipal bond market** is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with an investment in **commodities**, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. Investments in **real estate securities** can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties (such as rental defaults). **Hedge funds** are speculative and involve a high degree of risk. An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem or transfer interests in a fund. **Private debt investments** may be either direct or indirect and are subject to significant risks, including the possibility of default, limited liquidity and the infrequent availability of independent credit ratings for private companies. **Private equity investments** provide investors and funds the potential to invest directly into private companies or participate in buyouts of public companies that result in a delisting of the public equity. Investors considering an investment in private equity must be fully aware that these investments are illiquid by nature, typically represent a long-term binding commitment and are not readily marketable. The valuation procedures for these holdings are often subjective in nature.