NEWS & INVESTMENT INSIGHTS

INVESTOR LETTER | JANUARY 22, 2018

- The Theme of 2018: Coordinated Global Growth
- New Tax Law Likely to Boost Corporate Earnings
- A New Fed Chair Inherits a Flattening Yield Curve
- Cryptocurrencies Take Off
- Key Risks that May Hinder Global Growth

SUMMARY OF MARKET INDEX RETURNS AS OF DECEMBER 31, 2017

FIXED INCOME	QTD	1-YEAR	3-YEAR	5-YEAR
Barclays Global Aggregate	1.1%	7.4%	2.0%	0.8%
Barclays U.S. Aggregate	0.4%	3.5%	2.2%	2.1%
Barclays Corporate High Yield	0.5%	7.5%	6.4%	5.8%
S&P/LSTA U.S. Leveraged Loan Index	1.1%	4.1%	4.4%	4.0%

EQUITIES	QTD	1-YEAR	3-YEAR	5-YEAR
S&P 500 (Large Cap)	6.6%	21.8%	11.4%	15.8%
S&P Small Cap 600	4.0%	13.2%	12.0%	16.0%
MSCI EAFE Index (International)	4.2%	25.0%	7.8%	7.9%
MSCI Emerging Markets Index	7.4%	37.3%	9.1%	4.4%

OTHER	QTD	1-YEAR	3-YEAR	5-YEAR
HFRI Fund of Funds Diversified Index	1.9%	6.7%	2.3%	3.8%
HFRI Fund of Funds Composite Index	2.0%	7.7%	2.6%	4.0%
Bloomberg Commodity Index	4.7%	1.7%	-5.0%	-8.5%

Source: Morningstar, Bloomberg. Returns for periods longer than one year are annualized.

THE THEME OF 2018: COORDINATED GLOBAL GROWTH

2017 was a banner year for virtually all risk assets, with most fixed income, equity, and real asset classes experiencing substantial positive performance. The Dow Jones Industrial Average recently put an exclamation point on the year by crossing over the 25,000-point barrier for the first time on January 4, 2018. With corporate tax cuts signed into law in the US, the Eurozone continuing its quantitative easing-supported recovery from its 2011 debt crisis and continued growth from emerging markets including China, 2018 is shaping up to be another year of coordinated growth across the globe, albeit not as strong as 2017. **Thus, investors should consider a more fully invested, less defensive portfolio posture.**

NEW TAX LAW LIKELY TO BOOST CORPORATE EARNINGS

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act into law. This bill represents the largest change to taxation in the US in the last 30 years, permanently lowering the corporate tax rate to 21% (from 35%) and putting in place a temporary tax break for individuals. Proponents of the new tax law argue that the lower corporate tax rate will make the US more competitive and will encourage businesses to hire more workers and raise wages. Detractors of the new law argue that it does not go far enough in providing immediate, direct relief to middle- and

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lower-class citizens and that the projected increase in the deficit could hamper future GDP growth.

The short-term benefit of the new tax law to corporations is immediately clear: a substantially lower tax rate. This change is almost immediately accretive to corporate bottom lines and will cause earnings to be higher than they would have otherwise been with a higher tax rate. In this regard:

- UBS's head of US equity strategy predicts that corporate earnings will be 7% higher in 2018 than they would have been under the old regime, resulting in S&P 500 earnings per share of $141.35.
- KKR estimates that 2018 aggregate earnings per share for the S&P 500 will be $153.90, a 16.5% increase from estimated 2017 S&P 500 earnings per share of $132.10. KKR attributes $13.80 of its estimated $153.90/share to the increased corporate tax rate (9%).
- Factset reports that analysts increased their 2018 S&P 500 EPS estimates from December 11, 2017, to January 11, 2018, by the largest amount over that period since Factset began tracking this data in 1996. President Trump signed the tax bill during that interval.

While this higher earnings outlook should provide a significant tailwind to US equity prices in the short- to medium-term and likely improves the risk/return profile for domestic equities, market optimism is tempered by the following factors:

- Relatively high current valuations; Factset estimates that the forward S&P 500 P/E ratio is 18.4, above the 10-year average of 14.2.
- Operating margins may peak due to higher labor and input costs.
- The domestic economy is likely running at or near full employment, which may lead to wage inflation pressure and higher long-term yields (although wage inflation has been largely absent since the 2009 global financial crisis).
- Potentially unsustainable levels of low volatility in public equity and bond markets.

With an estimated 2018 S&P 500 earnings per share range of approximately $140-$155, the implied value of the S&P 500 at its current forward P/E ratio (18.4) is 2,576-2,852; as of January 16, 2018, the S&P 500 Index value was 2,770, above that range's midpoint of 2,714, but below the high end.

We therefore revise our outlook on both large- and small-cap US equities from neutral/underweight to neutral as corporate earnings growth is likely to support peak valuations in the current low interest rate environment. Due to elevated valuations, we will likely not recommend a neutral/overweight or overweight posture until valuations appear more reasonable. Furthermore, we carry a bias for quality and value, as certain segments of the equity market appear to be overvalued and ripe for dislocation. For example, as illustrated below, the relative valuation premium for the Russell 1000 Growth Index over the Russell 1000 Value Index is at its largest since the "dot com" bubble burst in the early 2000s.

Source: Bloomberg.

For individuals, the tax bill reduces the top tax rate from 39.6% to 37%, doubles the standard deduction, caps state and local tax ("SALT") deductions at $10,000 (as opposed to the previous rules which allowed all SALT to be deductible), and limits mortgage interest deductions to mortgages up to $750K, down from $1M. Important to high net worth families, the bill increases the exemption amount subject to the estate tax to $11.2M from $5.6M. **While Delegate cannot provide tax advice, this piece from Keiter summarizing the changes may be helpful, and we strongly recommend discussing the new tax regime with your tax advisor in order to properly prepare and account for 2018 and beyond.**

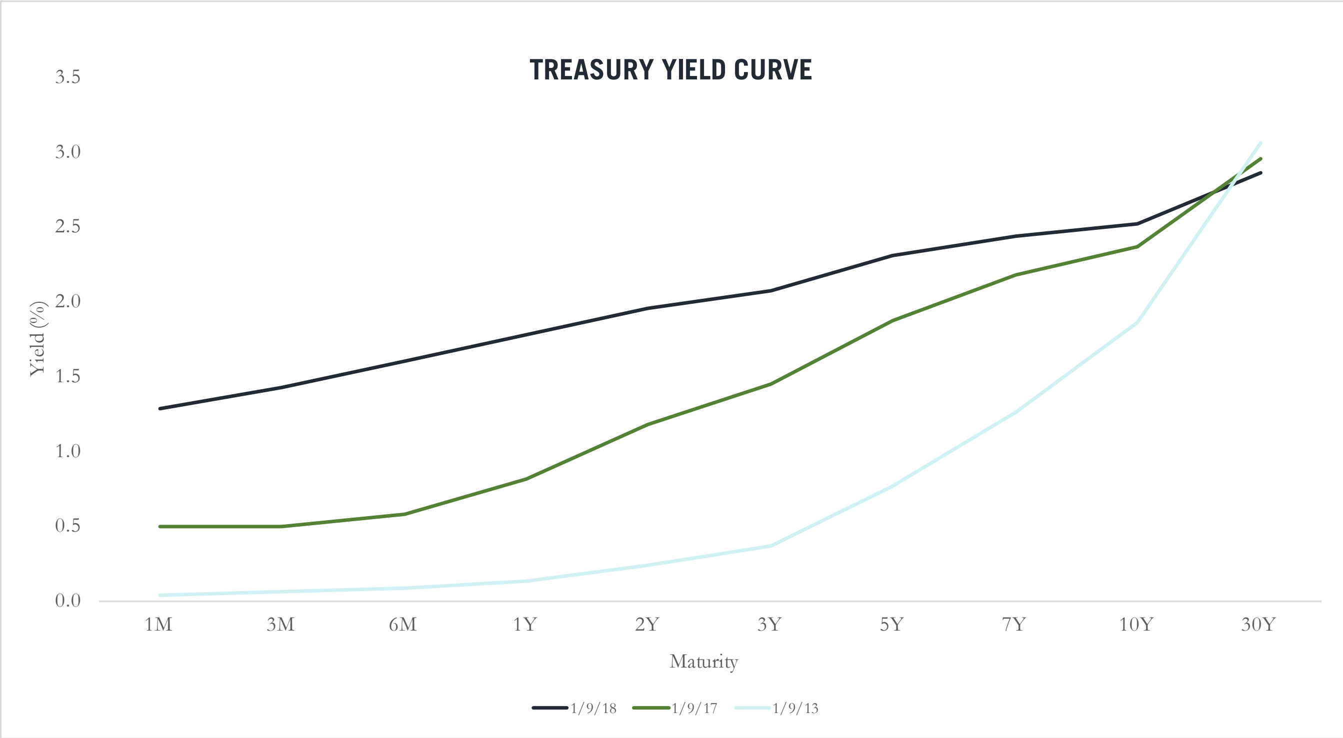
While the short-term implications of the new tax regime benefits corporations and many individuals as noted above, the long-term implications are unknown. On the one hand, the reduction in the corporate tax rate may lead to job, wage and, ultimately, higher GDP growth. On the other hand, the increase in the budget deficit caused by the reduction in national revenue may not be offset by expected increased GDP growth, serving as a headwind to the domestic economy in the decades to come.

A NEW FED CHAIR INHERITS A FLATTENING YIELD CURVE

On November 2, 2017, President Trump announced that Jerome "Jay" Powell will replace Janet Yellen as the Federal Reserve Chair starting in February 2018. According to sources, five candidates including Powell and Yellen were considered in the running for the job. The end of Yellen's tenure is marked by low unemployment (4.1% for December 2017) and stable, even if lower than targeted, inflation for the duration of Yellen's term.

Jerome Powell, Yellen's replacement, was appointed to the Fed's Board of Governors in 2012 by President Obama. When compared to the other candidates for Chairman, economists believe that Powell's monetary policy views compare most favorably to Yellen's. Additionally, like Yellen and Ben Bernanke before her, Powell is considered a leader who will favor open decision-making rather than centralized power in the Chairman. **Collectively, these similarities lead experts to believe there will be a smooth transition of leadership and that the Fed will remain on its established course of steadily rising interest rates and what markets hope will be a gradual reduction in the Fed's balance sheet.**

The Fed continued on this course in 2017 by announcing a 25 basis point increase in interest rates at its December 13, 2017, meeting, raising the Federal Funds rate target that heavily influences short-term rates to 1.50%. This marks the fifth 25 basis point hike since December 2015, which can be seen below on the short end of the current yield curve when compared to yield curves from one and five years ago. Economists currently expect an additional two-to-three 25 bps raises in 2018.



Source: Bloomberg.

These yield curves show a "flattening" where yields on the short end have increased, while yields on the long end have slightly decreased. Another way to view this flattening is by analyzing the spread between short- and long-term treasuries. As shown below, the spreads between the 2-year and 10-year Treasury and between the 2-year and 30-year Treasury have both declined over the past 5 years.

TREASURY YIELD SPREADS

	2/10 Spread	2/30 Spread
1/9/2013	1.6%	2.8%
1/9/2017	1.2%	1.8%
1/9/2018	0.6%	0.9%

Source: St. Louis Federal Reserve.

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This is largely due to the absence of inflation concerns in the long end, meaning that further tightening by the Fed may not be warranted. An inverted yield curve is never a good sign for the economy. The argument to stay shorter in duration is therefore not supported by risk due to further rising rates. It is supported, however, by the fact that the risk premium for taking longer duration risk is minuscule. **We therefore maintain our neutral/underweight posture on investment grade debt and continue to recommend that investors seek yield through short duration and floating-rate bonds that are less sensitive to interest rates and through exposure to private credit markets that feature generally more favorable risk/return profiles.**

With respect to high yield, current option-adjusted spreads ("OAS") of 340 bps are well below the 20-year historical average of 557 bps and much of the universe is trading above par. Additionally, in Europe, the desire for yield has pushed European high yield spreads to extreme lows, with a year-end OAS of 294 bps versus a historical average of 609 bps. As a result, the yield to worst for the Barclays Pan-European High Yield Index (2.99%) is lower than the dividend yield of on the MSCI Europe Index (3.28%). **Due to tight spreads around the world, we revise our outlook for high yield fixed income from neutral/underweight to underweight.**

CRYPTOCURRENCIES TAKE OFF

Cryptocurrencies (e.g., Bitcoin, Bitcoin Cash, Ethereum, and Litecoin) have taken off this year, dominating headlines in the fourth quarter amid spiking prices and unprecedented volatility. Cryptocurrencies are generally open to both individuals and institutions and are widely unregulated, extremely volatile and not backed by any government or physical asset. Bitcoin, specifically, gained substantial credibility at the end of the year when Bitcoin futures began trading on the CBOE after being approved by the CFTC. Many experts note, however, that cryptocurrencies lack certain characteristics that tend to define currencies. Specifically, their value is unstable, transaction processing can be slow and security is questionable. Additionally, cryptocurrencies lack certain exchange and contract infrastructure that protects all parties in a currency transaction.

While the consensus among economists recently surveyed by the Wall Street Journal has called Bitcoin a speculative bubble, Delegate does not take a view on cryptocurrencies because they are virtually impossible to underwrite. **Furthermore, even if effecting transactions by cryptocurrencies becomes more legitimate and mainstream, they remain currencies (i.e., non-earning stores of value) and thus should not be considered investment assets.**

KEY RISKS THAT MAY HINDER GLOBAL GROWTH

While 2018 is shaping up to be a year of coordinated global growth, key risks that may serve as headwinds to this growth include:

- Brexit: The UK and EU still do not have a plan in place for how the UK will leave the union, and both sides appear to be far apart at the negotiating table.
- Housing in the US: The potential negative impacts of the new tax regime on homeowners (i.e., limits on the deductibility of mortgage interest and state and local taxes, including property taxes) could put

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pressure on home prices, especially in high-cost areas.

- Commercial Real Estate: The growth of e-commerce continues at the expense of traditional retail will likely lead to a glut of unused “brick and mortar” real estate, putting stress on the retail sector of the commercial real estate market.
- Geopolitical Events: The chance of a geopolitical event that could result in a flight to safety appears to be increasing (e.g., armed conflict or trade war).
- Slowdown in China: With Chinese growth expected to be a large contributor to global GDP, the effects of any substantial economic slowdown in China could reverberate around the world.

Below are our asset class perspectives:

⇊ **UNDERWEIGHT** ↓ **NEUTRAL-TO-UNDERWEIGHT** = **NEUTRAL** ↑ **NEUTRAL-TO-OVERWEIGHT** ⇈ **OVERWEIGHT**

ASSET CLASS	VS. POLICY ALLOCATION (AS OF 9/30/17)	VS. POLICY ALLOCATION (AS OF 12/31/17)	NOTES
Cash	⇈	↑	Carries material option value, especially during times of uncertainty and high valuations. With coordinated growth taking hold around the globe, however, investors should move more aggressively into risk assets than in years past.
U.S. Investment Grade Debt	↓	↓	Fails to adequately compensate investors for duration risk on the long end. Investors should seek investment grade exposure through short duration, quality assets as the current risk premium for taking longer duration risk is miniscule.
Global Fixed Income	⇊	⇊	Fails to adequately compensate investors for duration risk. Moreover, elevated currency volatility risk adds an additional level of uncompensated risk.
Bank Loans	=	↓	Remain relatively expensive, and are not immune from spread widening in public credit markets. However, they provide protection from rising rates due to floating rate structures and relatively attractive yields.
U.S. High-Yield Debt	↓	⇊	Carries increased risk due to relatively tight spreads and long duration. Moreover, a surge of fund outflows could cause liquidity issues.
Emerging Market Debt	=	=	Provides relatively high current yield. Moreover, stabilization in commodities markets would aid net exporters.
Private Debt	⇈	⇈	Provides, with a relatively high yield, a compelling illiquidity premium relative to public markets.
U.S. Large Cap Equity	↓	=	Carries risk from elevated valuations, but corporate tax cuts should provide a short-term tailwind for corporate earnings.

ASSET CLASS	VS. POLICY ALLOCATION (AS OF 9/30/17)	VS. POLICY ALLOCATION (AS OF 12/31/17)	NOTES
U.S. Small Cap Equity	↓	=	Carries risk from elevated valuations, but corporate tax cuts should provide a short-term tailwind for corporate earnings. Despite recent stress, MLPs remain attractive due to relatively high yields and long-term growth potential.
EAFE Equity	=	=	Carries risk from elevated valuations that are the result of QE, which the ECB has recently announced plans to reduce. Valuations, however, remain relatively low when compared to domestic equities. Uncertainty regarding Brexit remains a risk for UK-based companies.
Emerging Market Equity	=	=	Carries the possibility of relatively good returns (if purchased during times of weakness) owing to long-term growth potential and low valuations relative to U.S. equities.
Private Equity	⇈	⇈	Offers a compelling illiquidity premium relative to public markets. We favor small and middle market buyout, secondaries and sector specialists.
Hedged Strategies	⇈	⇈	Provide uncorrelated returns, alpha opportunities and a reduction in overall portfolio risk.
Real Assets	=	=	Offer relatively good returns if idiosyncratic and interest rate risks are well-underwritten and undertaken. We favor private real estate over publicly traded options (i.e., REITs) due to the relatively more favorable risk/return profile afforded by the private market illiquidity premium.
Commodities	↓	=	Should experience increased demand as growth picks up around the world, leading to the need for manufacturing inputs.