NEWS & INVESTMENT INSIGHTS

INVESTOR LETTER | APRIL 30, 2018

- Trade Wars Brewing
- Canaries in the Coal Mine:
  - Increased Volatility
  - Flattening Yield Curve
  - Ballooning Deficit
- Delegate Asset Class Perspectives

SUMMARY OF MARKET INDEX RETURNS AS OF MARCH 31, 2018

FIXED INCOME	QTD	1-YEAR	3-YEAR	5-YEAR
Barclays Global Aggregate	1.4%	7.0%	3.1%	1.5%
Barclays U.S. Aggregate	-1.5%	1.2%	1.2%	1.8%
Barclays Corporate High Yield	-0.9%	3.8%	5.2%	5.0%
S&P/LSTA U.S. Leveraged Loan Index	1.5%	4.4%	4.2%	3.9%

EQUITIES	QTD	1-YEAR	3-YEAR	5-YEAR
S&P 500 (Large Cap)	-0.8%	14.0%	10.8%	13.3%
S&P Small Cap 600	0.6%	12.7%	10.8%	13.6%
MSCI EAFE Index (International)	-1.5%	14.8%	5.6%	6.5%
MSCI Emerging Markets Index	1.4%	24.9%	8.8%	5.0%

OTHER	QTD	1-YEAR	3-YEAR	5-YEAR
HFRI Fund of Funds Diversified Index	0.6%	5.5%	1.6%	3.3%
HFRI Fund of Funds Composite Index	0.6%	5.9%	2.0%	3.4%
Bloomberg Commodity Index	-0.4%	3.7%	-3.2%	-8.3%

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

In our last quarterly letter, we were somewhat optimistic regarding 2018, noting that we anticipated a modestly positive year due to the continuation of coordinated global growth. We also identified several key risks that may hinder global growth, one of which was a geopolitical event such as a trade war. Over the past quarter, the increased likelihood of this risk causing substantial turbulence has increased. Additionally, several indicators have increased our concern of additional correction: increased volatility, a flattening yield curve, and the ballooning federal deficit (all discussed below). As a result, Delegate is now recommending to clients and investors to be more conservative with respect to risk assets than we have recommended in the past. **We recommend that clients avoid putting additional capital to work in public equities and longer duration and riskier fixed income, taking profits when appropriate and instead building cash positions in anticipation of more attractive entry points.**

TRADE WARS BREWING

On March 1, 2018, President Trump announced via Twitter that "trade wars are good, and easy to win." Soon thereafter, the White House floated the idea of a 25% tariff on all imported steel and 10% on all imported aluminum to disadvantage imports and support the domestic industry. The rationale had three main components, all of which align closely with President Trump's campaign platform:

1335 ENVIRON WAY, CHAPEL HILL, NC 27517 | delegateadvisors.com

- Creating leverage for the US in renegotiating NAFTA;
- Protecting national security; and
- Protecting US metal production jobs.

Economists, government officials and corporate leaders generally disagreed with the President's position and proposal with little hesitation. Their basis was that tariffs would likely be met with retaliation from other nations, which would add more barriers to global free trade (a net negative on the local and global economy). This would likely cause ripple effects throughout the economy, including rising input prices for a variety of goods eventually affecting individual consumers by way of higher prices (i.e., inflation).

President Trump's announcement induced substantial backlash across the globe. Domestically, many US companies, industry associations and trade associations opined that tariffs would negatively affect business. Even some congressional Republicans, usually free market/business friendly advocates, urged Trump to reconsider. The announcement was also at odds with views expressed by the Federal Reserve Chair Jerome Powell, who testified to Congress that free trade is a net positive to the economy. Even Gary Cohn, Trump's top economic advisor, announced his resignation on March 6, allegedly due to his disagreement with the policy. Internationally, the EU, Canada, Mexico and China all quickly responded to the rumors with announcements that they were actively evaluating retaliatory tariffs on US goods.

President Trump ultimately signed a 25% tariff on imported steel and 10% tariff on imported aluminum on March 8, keeping a campaign promise to be more aggressive on trade policy. These tariffs took effect on March 23, 2018. He did walk back the initial announcement somewhat, as Canada and Mexico were exempted. Trump explained that the tariffs were an early step in renegotiating many of the US's trade deals, including NAFTA. Then, on March 22, 2018, President Trump signed an executive memo placing tariffs on goods from China in aggregate of $50B on over 1,300 products. This was done as part of a string of actions against China on the basis that China is stealing American intellectual property. China retaliated by matching the US dollar for dollar by placing $50B in tariffs on 128 products. **An end to this dispute, which has already affected hundreds of companies and will likely affect more, does not appear imminent.**

While it is difficult to predict the potential effects of what appears to be, at the least, increased protectionist policy and, at most, a global trade war, the momentum towards global free trade over the past several decades is subsiding and potentially reversing. Many prominent market strategists believe that this may have negative consequences for the coordinated global growth that the world has recently experienced. Ray Dalio, founder and co-chairman of Bridgewater Associates, recently noted that, due to China's extensive holdings in US government bonds, a trade war could become an "uglier" capital war. Additionally, Jeffrey Gundlach, founder and CEO of DoubleLine, reminded investors in a recent interview that tariffs were one of the primary causes of the Great Depression. **While Delegate does not believe that a depression is in the cards, we are advising our clients to be underweight versus policy targets in most public risk assets, as we believe the downside potential is currently greater than the upside.**

In our last update, we noted that the theme of 2018 was to be coordinated global growth. In the past quarter, however, three indicators have caused us to become more cautious more quickly due to the increased likelihood of a correction or worse: increased volatility, a flattening yield curve and the ballooning federal deficit.

Increased Volatility

Volatility has historically risen near the end of a protracted expansionary cycle and often serves as a warning sign of a bear market. The S&P 500 Index has already experienced daily moves of more than 1% (either positive or negative) than it experienced in all of 2017. At the current pace, 2018 would experience 92 days of these 1% moves. This figure is elevated compared to recent averages and would be the most 1% days in the last several years, as illustrated below.

S&P 500 DAILY CHANGES WITH AN ABSOLUTE VALUE GREATER THAN OR EQUAL TO 1%

	2014	2015	2016	2017	2018 YTD	Total	2014-2017 Avg.
Number of days the S&P 500 gained at least 1%	19	41	26	4	12	102	22.5
Number of days the S&P 500 lost at least 1%	19	31	22	4	11	87	19.0
Total	38	72	48	8	23	189	41.5

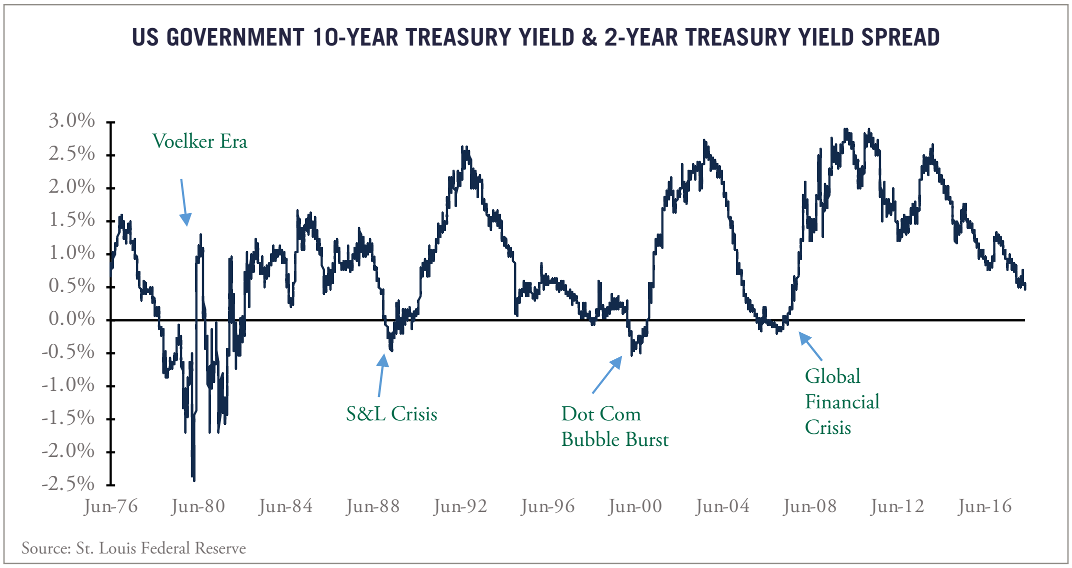
Source: St. Louis Federal Reserve, Delegate Calculations.
Note: 2018 YTD is January 1, 2018 to March 31, 2018. Total column includes January 1, 2014 through the end of March 31, 2018.

As we explained in our 2018 Global Economic Outlook and Asset Class Assumptions presentation (available upon request), market volatility tends to be low during extended expansionary periods of an economic cycle. In the current cycle, January of 2018 marked the 107th month of expansion since the 2009 market bottom, which is almost three times as long as the average duration of 41 months. The recent uptick in volatility may be temporary, but it may also be a **warning sign that post-crisis bull market is coming to an end.**

Flattening Yield Curve

In an expansionary period, the yield curve is usually upward sloping, meaning that yields on the "long end" of the curve (longer maturities) are greater than on the "short end" (shorter maturities). This environment indicates that interest rates are expected to rise as a result of normal inflationary pressures resulting from a growing economy. Recessions, however, are often preceded by a flattening yield curve, when the yield for all maturities is roughly the same, or an inverted yield curve, when yields on the short end are greater than yields on the long end. An inverted yield curve usually indicates that interest rates will likely fall in the future as a result of an economy in contraction or recession, lacking inflationary pressure.

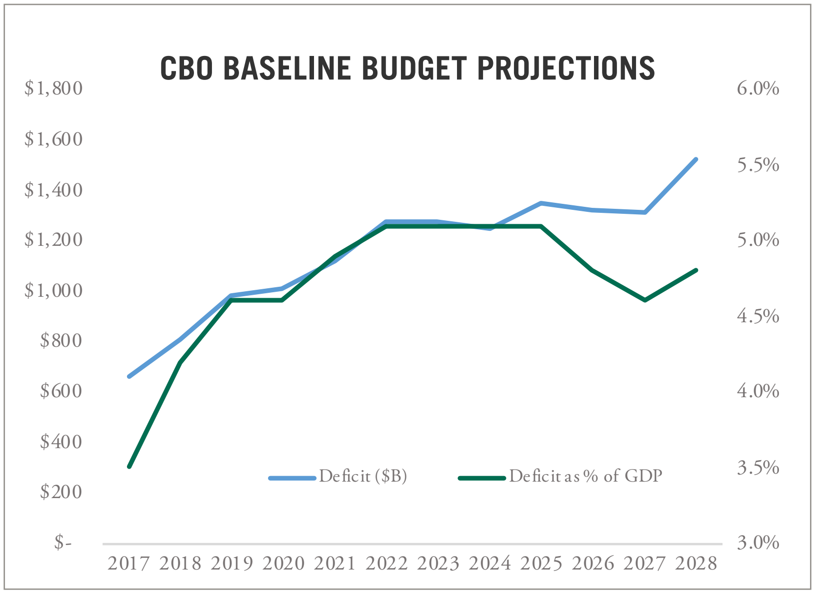
A flattening yield curve can be measured by the difference in yields between 2-year and 10-year US Treasury bond yields (the 2/10 spread). When the difference in the 2/10 spread nears zero, the yield curve is flattening. A negative 2/10 spread is a strong indicator that the yield curve is inverting.



As illustrated above, the 2/10 spread has been declining for some time now and is approaching levels reached in or shortly prior to the bursting of the "dot com" bubble in 2000 and the global financial crisis of 2008. The possibility of an **inverted yield curve, which has historically portended a recession or contraction, is yet another reason to be cautious in the current environment.**

Ballooning Federal Deficit

On April 9, the Congressional Budget Office ("CBO") reported that the federal deficit is projected to be $804 billion in 2018 (a 21% increase from 2017) and that it will top $1 trillion per year by 2020. The CBO noted that a primary reason for the increased deficit is the recent tax cut package pursued and passed by President Trump, which the CBO has calculated will add $1.3 trillion to the deficit through 2028. Supporters of the tax cuts stressed that the simulative effect of the new law on the economy would outweigh the growing deficit. The CBO, however, projected that the bill would not boost domestic GDP as quickly as the deficit will increase. In 2017, the deficit as a percentage of GDP was 3.5%. This number is projected to grow to 5.1% from 2022-2025 and to remain near 5% thereafter.



Source: CBO

While a large and growing deficit might not have an immediate impact on financial markets, the long-term effects could be substantially negative for domestic economic growth. Deficits can metastasize, as larger deficits require larger interest payments, especially in periods of rising interest rates. A larger deficit will eventually have a dampening effect on economic growth as government spending shifts more towards debt service from programs and services that are accretive to domestic GDP.

Below are our asset class perspectives:

↓↓ UNDERWEIGHT ↓ NEUTRAL-TO-UNDERWEIGHT = NEUTRAL ↑ NEUTRAL-TO-OVERWEIGHT ↑↑ OVERWEIGHT

ASSET CLASS	VS. POLICY ALLOCATION (AS OF 12/31/17)	VS. POLICY ALLOCATION (AS OF 3/31/18)	NOTES
Cash	↑	↑↑	Carries material option value, especially during times of uncertainty and high valuations.
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 spreads 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, brewing trade wars and heightened volatility.
U.S. Small Cap Equity	=	↓	Carries risk from elevated valuations, brewing trade wars and heightened volatility. Despite recent stress, MLPs remain attractive due to relatively high yields and long-term growth potential.
EAFE Equity	=	↓	Carries risk from potential trade wars and 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.

1335 ENVIRON WAY, CHAPEL HILL, NC 27517 | delegateadvisors.com

ASSET CLASS	VS. POLICY ALLOCATION (AS OF 12/31/17)	VS. POLICY ALLOCATION (AS OF 3/31/18)	NOTES
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, but are susceptible to risk from negative pressure as a result of trade wars and rising interest rates.
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, if idiosyncratic, returns and if 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	=	↑	Tend to rise during later stages of economic expansion and provide a potential inflation hedge.