Fiduciary Trust International

PERSPECTIVE

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IN THIS ISSUE

ECONOMIC AND INVESTMENT OUTLOOK

There's Nothing Normal About This Normalization

A roaring start to 2019 saw the S&P gain 7.9% in January, its best start in 32 years. The Dow posted gains for nine consecutive weeks. Include February, and the S&P and Russell 2000 had registered returns of over 11% and 20% respectively. Markets are roaring.

But not so fast. Instead, we prefer to look at the US equity market move in the context of what has been a wild ride since the fourth quarter of 2018. Its heightened twists and turns began in October before culminating in December's troubling swoon. In fact, the market drawdown of 9.2% during December was the worst for that month in nearly ninety years. The fourth quarter, with December's price action the leading contributor, stumbled into year-end returning -14%, the worst fourth quarter performance for the S&P 500 in a decade.

Clearly through this lens, 2019's performance can be viewed as an astonishingly rapid V-shaped recovery. So, what is driving this hasty shift in sentiment? How can voices on financial television be shouting "bear market" one day and "bull market" the next? Who is right?

Policy Crossroads

In our thinking, the way to constructively proceed is to instead think about what is causing the intensified price action. We view investors as forced now to quickly sort through a stack of critical questions on three policy fronts:

- **Monetary Policy**
  A normalization program following a decade of zero interest rates post-Global Financial Crisis, including an asset-purchase program (quantitative easing) that grew the Fed's balance sheet by more than $3 trillion, that had seen the Fed hike interest rates nine times in four years, including four times in 2018.

(continued on next page)

- **Fiscal Policy**
  The most significant tax reform package in decades along with the budget providing for substantial spending increases saw fiscal policy provide an extra gear to an economy already performing well, as well as questions centered on how long the boost to growth would last.

- **Trade Policy**
  The administration remade US trade policy which hadn't been modified for decades, and it did so in dramatic fashion. This stoked fear of a full-blown trade war, as China and Europe were threatened with sweeping tariffs, NAFTA was renegotiated, and the administration embraced a more unilateral approach to negotiations.

All told, the government policy trifecta of trade, fiscal, and monetary individually carry inordinate potential impact on the economy in normal times, let alone times like these that are anything but ordinary. When in combination these policy risks intensify, we have a formula for rapid shifts in market sentiment irrespective of changes in economic fundamentals.

Enacting expansionary tax reform and other stimulative measures late in an extended economic cycle and renegotiating decades-old trade agreements and practices are both undoubtedly complicated. Combine that with dogged progress by the Fed in its attempts to normalize monetary policy and it can quickly get messy, as we just experienced. This level of policy uncertainty is manageable for the market if the economic backdrop remains rosy. However, as we are seeing with global slowdown fears, this intersection of policy risks has forced the market to weigh an ever-higher number of possible outcomes.

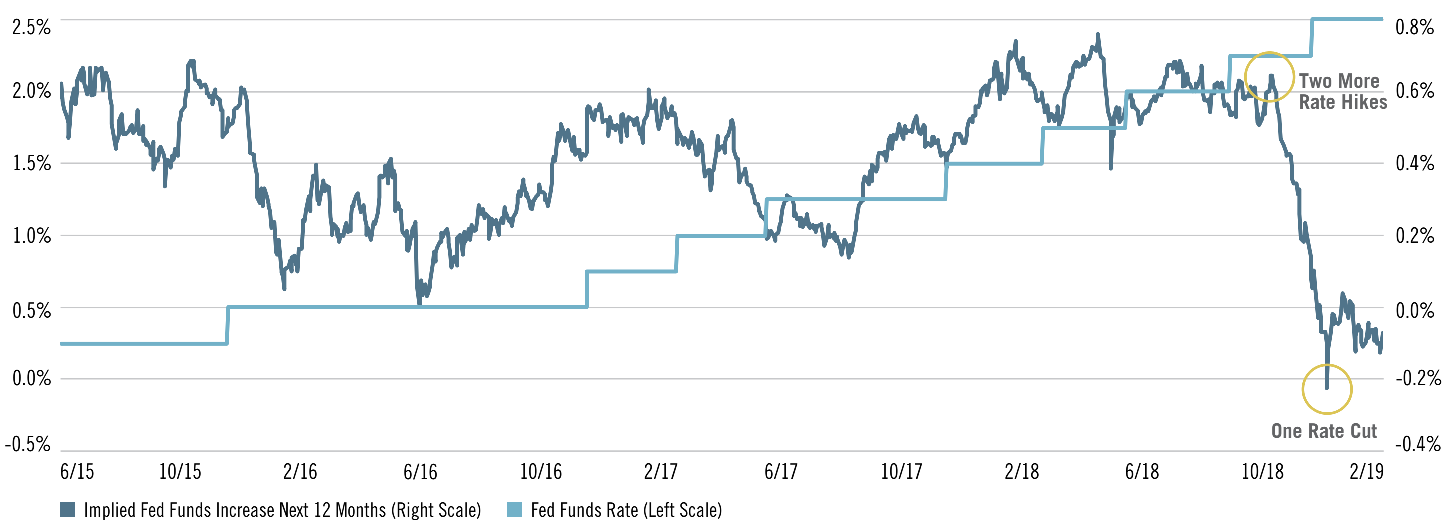
Monetary Policy: Disappointment then Delight

In December, the market evaluated potential outcomes and pivoted to embrace the worst-case scenario. This came on the heels of a Federal Reserve that seemed stubbornly hawkish despite a clear slowdown in the global growth backdrop. The Fed, following through with its fourth rate hike in 2018, further spooked market participants. As we turned the calendar to 2019 and markets rebounded, we didn't have to look far to find a catalyst.

Early in January the Fed clearly shifted its tone and signaled a new stance on monetary policy. This dovish turn was further boosted by stronger domestic economic data, resilient corporate earnings, stimulus in China and a more constructive tone on trade negotiations. Investors began to recalibrate their

CHART 1:

Futures Markets Predict the End of Fed Rate Hikes, Even a Cut
Forward Overnight Index Swaps and the Fed Funds Rate



Source: Bloomberg. Data is as of 2/28/2019.

expectations and quickly priced out the worst-case scenario of the prior month.

Now that the year-to-date V-shaped recovery has propelled the S&P 500 back to within 5% of its all-time highs, we are left to grapple with what caused the wild swings. The answer seems that monetary policy concerns were the common thread in the intense market selloff and despite the questions and concerns regarding fiscal and trade policy, even all these years after the financial crisis, the market remains centered on the Fed. Market sentiment is closely aligned with Fed policy guidance, so how did the Fed and markets fall into disagreement before harmonizing again?

Lights Out: Fed Maneuvers in the Dark

Monetary policy reasserting itself is unsurprising at a time when the Fed is navigating uncharted waters on its journey toward normalization. With no comparable regimes to use as a point of reference, the Fed is essentially working without any historical context, which has kept markets on edge.

Fed chairman Jerome Powell described the situation best when he compared the central bank's challenge to "walking through a room full of furniture" without any lights turned on. Naturally, investors are more cautious than ever about what the Fed might do next.

The Fed Stumbles on the Furniture

As the Fed "feels the furniture" to maneuver through normalization, its guidance has not always been consistent or reassuring for the market.

Specifically, last October Powell suggested the Fed still had a long way to go before reaching a neutral policy rate. This implied that further tightening could be expected and pressured the equity market lower. However, just one month later, he reversed course and suggested the Fed might take a less aggressive approach, sending the market soaring.

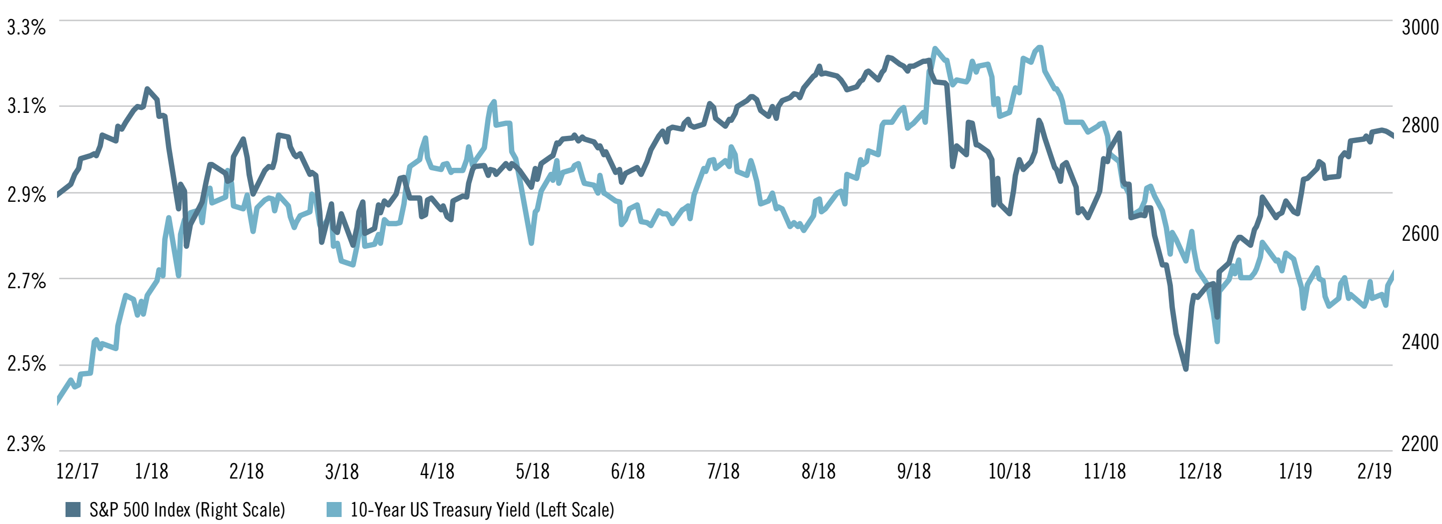
Next, the minutes released after the FOMC's December meeting seemed broadly hawkish, once again heightening concerns about rising rates. To make matters worse, those minutes made no mention of the deteriorating economic condition outside the US, leading some to wonder if the Fed was overlooking the importance of interconnected international markets to US economic growth.

The Fed's lack of clear guidance on policy normalization frustrated investors and culminated in dramatically lower markets which bottomed on December 24th. Investors began to seriously discount the possibility of a Fed policy error, and in turn the potential for a Fed-driven recession. Clear evidence of this was

CHART 2:

Markets Rebound on Heels of Fed Pause

S&P 500 Rallies While the 10-Year US Treasury Yield Remains Rangebound



Source: Bloomberg. Data is as of 2/28/2019.

seen in the pricing of futures contracts, where by the end of December markets were predicting the next Fed rate decision to be a rate cut, not a hike. Only a few weeks prior, investors were expecting two rate hikes in the next 12 months (CHART 1).

The Fed Stops Moving

During the first week of January, Powell acknowledged the market's skittishness. He stated the Fed was "listening sensitively to the message that markets are sending." That set the tone for an onslaught of communications from Fed speakers reinforcing an idea of the Fed hitting the pause button. The path to normalization of interest rate policy would wait.

Markets, buoyed by having the Fed once more on their side, shot higher (CHART 2). The fact remains that despite their best intentions to get back to normal, the Fed, to a heightened degree, remains at the center of the story.

What Happens Next?

As the dust settles, it's clear that investors have struggled to find the correct level for equity prices in an environment of slowing global growth and turbo-charged policy. As we wrap up February, the market is not far from its September 2018 all-time highs. While our low-single-digit return forecast for 2018 was ultimately off the mark, incorporating January and February gives a 14-month return of 6.3% for the S&P 500. Admittedly, this is an unconventional timeframe, but the thought exercise is useful and paints a picture that reconciles to our expectations of modest market returns and reasonable economic and corporate fundamentals.

Accordingly, the lesson is not to overreact to wild price swings during periods of heightened volatility. The pause in Fed tightening and some positive developments around trade negotiations with China has led investors to feel a sense of comfort around valuations. The silver lining with the recent volatility is that it has perhaps led policymakers to reassess the unconventional tactics they've used in trade negotiations thus far, creating another sort of policy "pause" in addition to the Fed.

After this reset, we expect further price appreciation to be modest, but the extremes like in December look to be behind us. Risks appear to be more accurately priced into markets. We acknowledge our place in the advanced stages of this economic and business cycle and recognize the threat from slowing global growth potentially spilling over into the US. However, we continue to see counterbalancing forces from the consumer with continued strength in labor markets and the potential for second order effects of tax reform via increases in capital expenditures.

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March 1, 2019

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ASSET ALLOCATION UPDATE

Growth Moderates, But Fundamentals Remain Supportive

Recently, market sentiment and prices have swung to extremes during this late stage of the economic growth cycle.

While leading economic indicators clearly softened last year, we believe both economic and corporate fundamentals remain strong enough to support our constructive outlook and slight overweight recommendation for equities. We also remain underweight fixed income and have increased our cash holdings to take advantage of market dislocations.

Equities: Patches of Opportunity

In the US, we remain overweight mid- and small-cap equities, which are benefitting from tax reform, deregulation and other stimulative policy measures. They are typically less sensitive to trade tensions than large-caps and considered attractive targets for larger companies as M&A activity ramps up.

Within international developed markets, Japan is showing signs that long-term structural reforms are benefiting certain sectors and stocks. We remain cautious about the prospects of continued Yen weakness, despite indications that the Bank of Japan might consider easing. Moderating global growth hit the eurozone especially hard, but with rates already at historically low levels, EU policymakers may have limited tools available to stimulate growth.

Our neutral view of emerging markets also remains in place. EM equities were dragged down by a stronger dollar and rising US interest rates last year, and the Fed's pause appears to be priced into current valuations. Our outlook for China has improved slightly as stimulus measures percolate through the real economy and credit conditions begin to improve.

Fixed Income: The Fed Pauses

Indications that the Fed is taking a cautious approach to rate hikes helped stabilize Treasury yields and prices in early 2019. We are watching the Fed carefully for hints of its next rate move, as well as any indications of possible changes to their balance sheet policy.

Within the US, we prefer investment-grade credit over government bonds. Despite the Fed's pause, we are also maintaining a shorter average duration than our benchmark to guard against interest rate risk. Rates remain low by historical standards, which means opportunities for total return are limited.

In the municipal bond market, we continue to see tax-favored income potential for high earners. As the market adjusts to reduced supply and weaker demand, we are taking a highly selective approach, generally favoring higher credit quality, liquidity and revenue bonds over general obligation bonds.

Alternatives: Managing Risk

When market volatility escalates, liquid alternatives can provide valuable downside protection. Therefore, we typically recommend a portfolio allocation of 5% to 10% for our clients. In addition, we are actively helping investors find attractive entry points in the private equity market, focusing on deals that add value rather than relying on a rising market or financial engineering for returns.

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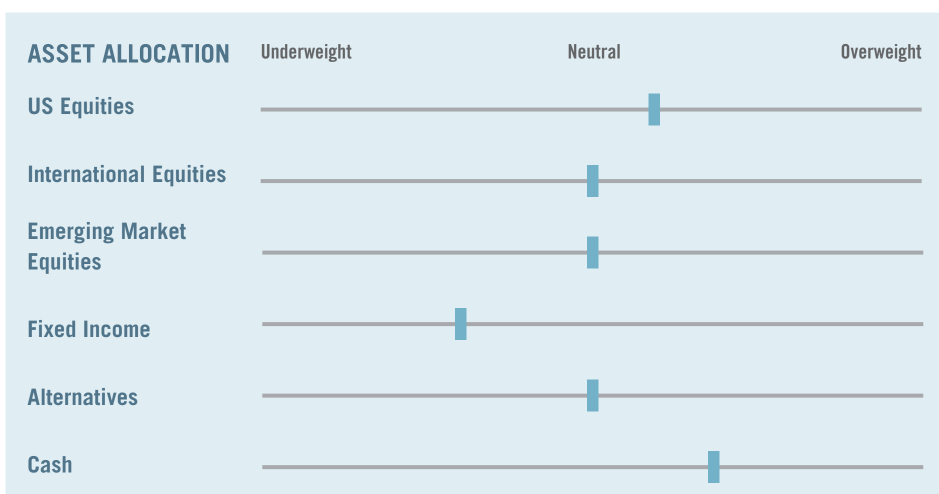
Head of Asset Allocation



FIDUCIARY TRUST FORUM

Hitting the Bull's Eye: How to Invest for Success by Keeping Your Targets in Sight

Your goals are important. So is the investment strategy that helps you achieve them. In this Q&A, Director of Financial Planning and Trust Counsel, Bryan Kirk, and Head of Asset Allocation, Viraj Patel, discuss how "goals-based" investing brings the two closer together to help you preserve and grow your wealth.

Q: What does it mean to insert the words "goals-based" before "investing"?

BRYAN: Your goals should guide everything you do. Why do something if it isn't aimed at getting you somewhere you want to be? In terms of investing, the same concept should apply. By saying your investing is "goals-based," it's simply emphasizing and making explicit what should always be your focus. Our starting point is always understanding your goals because without that we can't effectively frame anything we might do, whether it involves investing, helping with your estate plan or even serving as a trustee or executor.

RAJ: To me, "goals-based investing" is an acknowledgment that your investment strategy must always be personalized, starting with your desired objectives. The information we gather about your financial life serves as the foundation of your Investment Policy Statement (IPS), which is a document we create for every investment management client in the earliest stages of our relationship.

An IPS is designed to synthetize your circumstances into the objective criteria around your time horizon, liquidity needs, tax status and special considerations that provide the basis for your investment objective and asset allocation, balancing your ability to take risk and expected return. It provides your portfolio manager with guidance in the investment decision-making process and tells you exactly how Fiduciary Trust will manage your portfolio.

BRYAN: And that investment objective then leads us back to your goals. Your goals and circumstances shape your investment strategy because your investment strategy needs to be targeted to fulfill your goals.

For example, if you are funding a trust designed to pay for the education expenses of your children and grandchildren, we consider the expected time horizon and liquidity needs of the trust, determine the appropriate investment strategy and show you how that strategy will fulfill the goal of the trust based on current expectations.

RAJ: Using simulations and other modeling techniques, we can calculate the probability of success for different investment strategies, and display that information for you in a way that is easy to understand.

Q: When you link goals and investing, what type of goals are you talking about?

BRYAN: These are financial goals, which typically change over the course of your life. They might include buying your first home, paying off debt, maintaining an adequate level of liquidity, living comfortably in retirement, funding a grandchild's college education or leaving behind a charitable legacy for many generations to come.

As we achieve financial success and security, we tend to lose focus on financial goals like these. That's in part because, as our resources grow, our goals tend to multiply as well. By articulating your goals, you are validating them and setting priorities.

We can also help you build upon something that is more of a concern and turn it into a concrete goal that can be directly acted on. For example, if you are concerned about maintaining peace in the family, we can help you provide for the disposition of your assets at death in a manner that treats your children equally but acknowledges the special circumstances of a particular child.

Q: Assuming I've identified my goals, then what do I do?

RAJ: After you've identified your goals, the next step is to identify all the relevant circumstances. Depending on the nature of your goals, this could be a broad or narrow universe. But in either case, there are certain facts you'll need to share. For example, if we are being asked to create an investment strategy for a $10 million portfolio, as part of understanding your goals we'll need to determine the expected levels of contributions and distributions from the portfolio. We'll need to know the time horizon for the funds, which could be tied to your goals in terms of a specific purchase or payment. Or it could be tied to your estate plan and gifting strategy.

Ideally, we'll also know where the portfolio fits into your overall balance sheet, so we can complement the handling of your other assets and any goals you may be seeking to achieve outside of the portfolio. And last, we want to know your tax status and any special considerations, which could involve preferences around environmental, social or governance concerns, tax considerations or life events you may be anticipating.

Those are the basic considerations when crafting any investment strategy, all driven by your overriding goals. Again, depending on your goals, you may cast a net over a broader range of circumstances or drill down in greater detail on the circumstances I just mentioned.

Q: My goals are way off in the future. How do I monitor my progress?

BRYAN: At the beginning of a relationship with you we establish your strategy. We continually evaluate your strategies along the way and adjust if your financial life evolves over time.

These changes may involve actual changes to your circumstances or your goals themselves, or it may simply be the possibility of change or uncertainty. Our job is to help you understand how and when events in your life influence your financial affairs and how you can best plan to deal with uncertainty.

RAJ: It's also important to note that focusing on your goals doesn't mean ignoring your investment performance. It simply means reorienting performance in the right direction. Quality results are always our objective—not only in terms of reaching your goals, but also in terms of each component of our services that contribute to your achievement. We also aim to keep your Investment Policy Statement up-to-date by including it in your quarterly account statements and having your portfolio manager review it with you at least once a year.

On the other hand, a goals-based approach measures success by tracking your progress toward each of your goals. If you are on course and meeting the timeline you put in place, our asset allocation recommendations are validated. And If you fall short of expectations, we can quickly detect any areas of weakness and make any necessary adjustments to your asset allocation strategy.

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Video Series: CEO John Dowd's Advice for the Next Generation

A Q&A series to help young adults make educated financial decisions

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Fiduciary Trust is a wealth management firm founded in 1931 by families for families, with a singular focus on growing and protecting your wealth through generations. We work closely with individuals, families and foundations to build and manage personalized investment portfolios, and to develop estate plans that extend wealth to future generations.

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