FUNDAMENTALS VS. FEARS

TRANSAMERICA 2018 MID-YEAR MARKET OUTLOOK

TRANSAMERICA®

ABOUT THE AUTHOR

Tom is responsible for overseeing the investment and mutual fund product development functions and sub-adviser selection process. He also actively publicizes Transamerica's investment thought leadership and products to advisors, clients, and the media. Tom has more than 25 years of investment experience and has managed large mutual funds and sub-advised separate account portfolios. Tom holds a bachelor's degree in political science from Tulane University and an MBA in finance from the Wharton School at the University of Pennsylvania. He has earned the right to use the Chartered Financial Analyst (CFA) designation.

TOM WALD, CFA®

Chief Investment Officer,
Transamerica Asset
Management, Inc.

MID-YEAR 2018: WHERE WE STAND

- At the mid-year point the U.S. economy is exhibiting the characteristics of a potential breakout year for growth. With unemployment at an 18-year low, the prospects of higher wages, consumer spending, and business investment appear positioned to drive annual GDP growth to levels not seen in more than a decade. The implementation of U.S.-initiated tariffs and their future impact on international trade poses the most identifiable risk to this momentum.

- We continue to believe U.S. stocks are set up well for the year ahead. Since late January valuations have compressed amid an environment of better-than-expected corporate profits and rising earnings estimates. As we conclude perhaps the best year for earnings growth since 2010, we consider current valuations to be reasonable, and with the tailwind of an improving economy, stocks should be capable of double-digit total returns in the year ahead. Corrections like the one experienced this year will likely occur more regularly.

- The first half of 2018 finally bared witness to the long-awaited spike in long term interest rates as seen in the 10-year Treasury Yield's increase of more than .40%. As we look forward, we believe upward pressure on short and long term rates will continue based not only the strengthening economy and future Federal Reserve tightening but also a steepening of the yield curve, fed balance sheet normalization, and reduced monetary accommodation internationally.

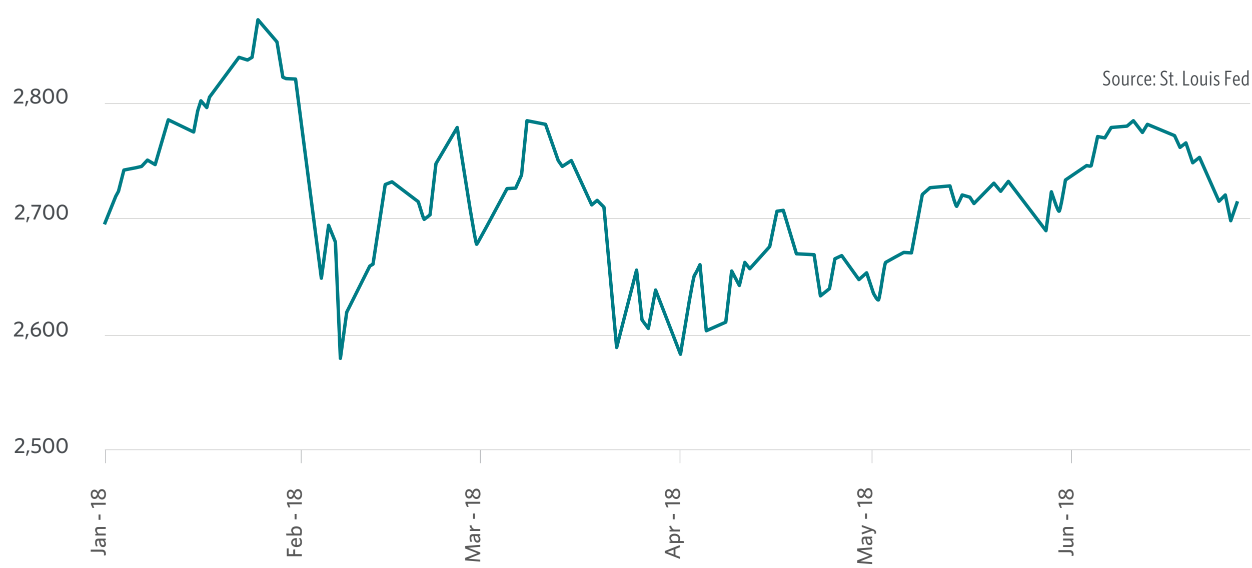
- While the credit markets in our opinion remain fundamentally strong, we believe fixed income investors will need to recognize the new environment they are facing. With interest rates no longer a tailwind it will be crucial that bond investors lean toward lower duration portfolios and focus on stable or improving credit opportunities capable of benefiting from a strengthening economy.

- Prospects in the international markets remain favorable. However sentiment was negatively impacted in 1H18 by slower 1Q growth in Europe and Japan as well as heightened concerns of trade disruptions, rising interest rates, and a rising dollar. Nonetheless, we believe the overall outlook for global growth is still stronger than in recent years and that international developed and emerging market equities are well positioned for long term investors.

- While we believe the current environment continues to favor equity and credit investors, the markets are not without risks for the remainder of 2018 and beyond. Our short list of these would include international trade, growth in Europe and Japan, central bank divergences, political uncertainty, and rising federal deficits.

S&P 500

January 1, 2018 – June 30, 2018

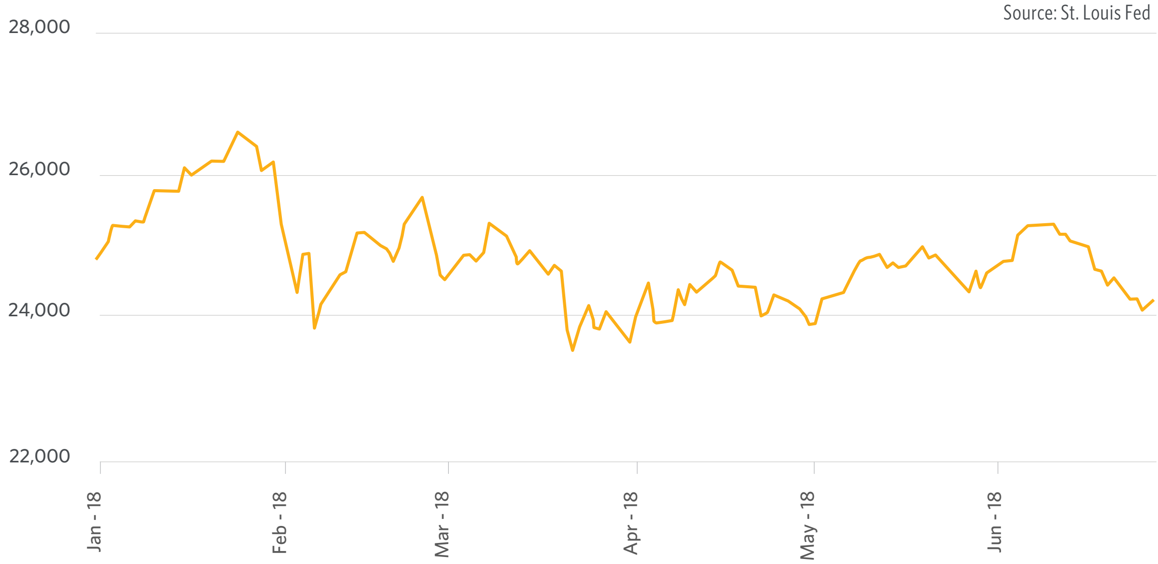


NASDAQ COMPOSITE

January 1, 2018 – June 30, 2018

DOW JONES INDUSTRIAL AVERAGE

January 1, 2018 – June 30, 2018

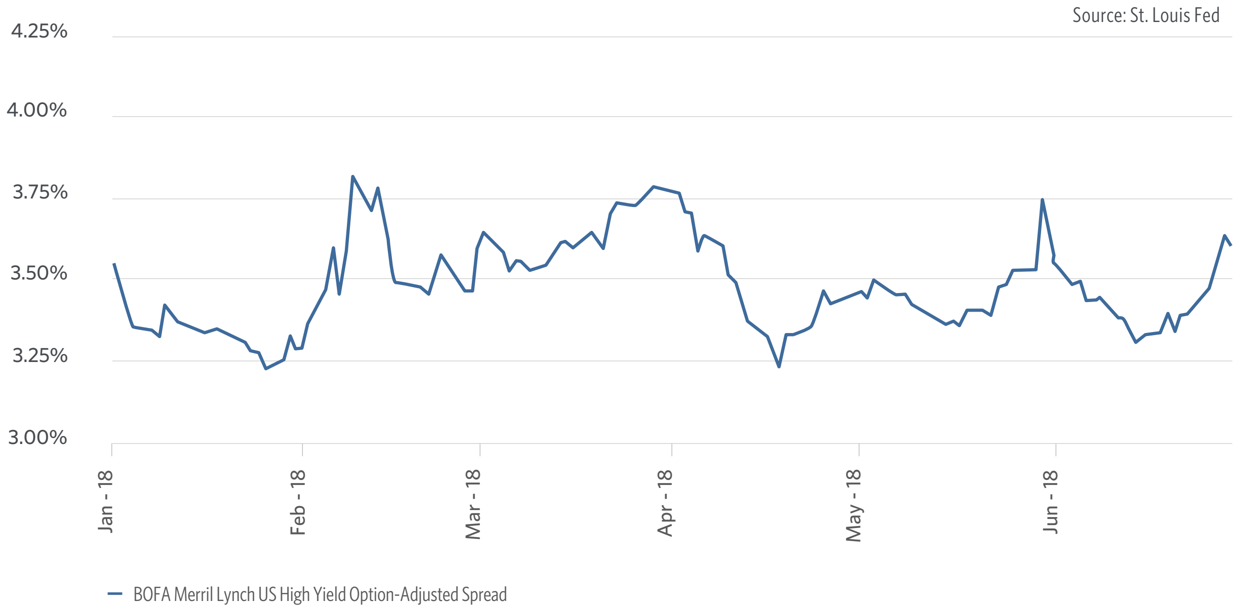


10-YEAR U.S. TREASURY YIELD

January 1, 2018 – June 30, 2018

HIGH YIELD CREDIT SPREADS

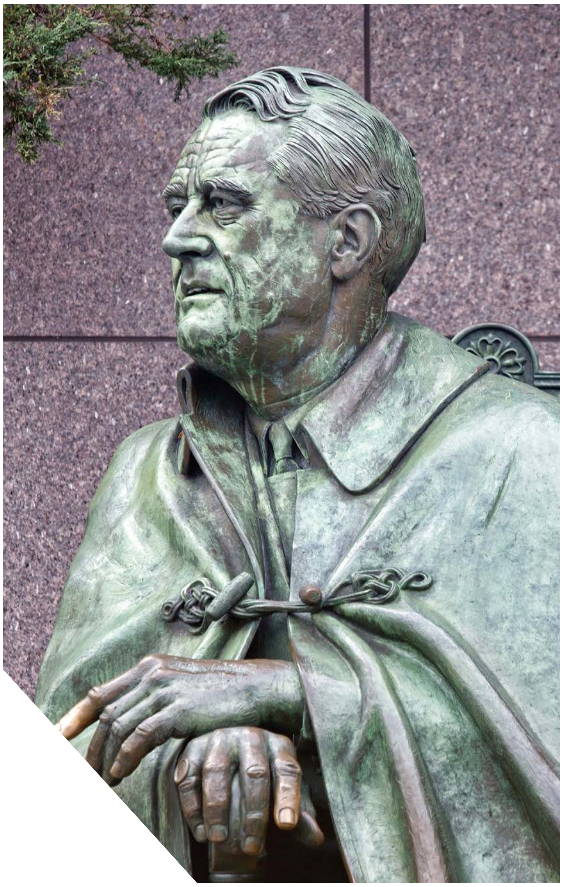
January 1, 2018 – June 30, 2018



FUNDAMENTALS AND FEARS

In his inaugural address in March of 1933 Franklin D. Roosevelt invoked perhaps the most iconic words ever uttered by an incoming President when he declared before a downtrodden nation, "The only thing we have to fear, is fear itself."

With the benefit of more than eight decades of hindsight, I'm not so sure that was really the case. Unemployment at the time FDR proclaimed these words was 25% and stocks had incurred a brutal 80% decline from just prior to the market crash of 1929. Banks were closing in record numbers and many people who were never in the market lost their life's savings. For anyone who bought stocks on that day of Roosevelt's address, they would have close to tripled their money in less than five years, then lost all of those gains in the next five as World War II engulfed the globe. So despite FDR's courage and leadership at that moment, a rational investor might still have been best served to be fearful.



Fears play an important role in the markets for a variety of reasons. They allow investors to take perspective on current market conditions and assess the likelihood they will continue. They serve as a focal point of risk profiles and the free will to change course based on one's willingness and ability to accept the probability of certain outcomes.

They even provide for market liquidity as one investor's fear might be viewed as another's opportunity. Whoever said fear doesn't have a place in the markets probably never saw pictures of the crowd FDR was inspiring on that day 85 years ago.

However, fears must also be evaluated in the present context of the actual results being achieved within an economy, market, or individual companies, and the prospect such results can be repeated or improved upon in the future. This of course is what we often refer to as the fundamentals. So fears, sometimes rational and sometimes not, are always subject to the current market fundamentals and therein resides one of great foundations of what truly makes markets tick.

And as of the midpoint of 2018 they have ticked quite a bit.

THE MARKET COMBATANTS

Investor fears have been far more prevalent this year as opposed to last and at the top of these concerns have been a potential international trade war, rising inflation, excessive stock valuations, the return of market volatility, and fed tightening that could choke off recent economic growth. Perhaps close behind this first tier would be an inverted yield curve, widening credit spreads, and global growth that may have already peaked. Yes, 2018 so far has had no shortage of fears.

However the fundamentals have been extremely strong, in fact far stronger than we have seen in recent years. We have the highest pace of corporate earnings growth in almost a decade and potential levels of U.S. economic expansion unseen since the mid-2000s. Global growth, despite the concerns of those bracing for escalated trade hostilities, could also see its highest annualized rate since 2011. Inflation is guilty of no more than hitting the Fed's long-awaited target and the higher interest rates so far this year are for the most part the direct result of an improving economy. Contrary to popular belief, stock valuations, when taking into account earnings growth and still historically low interest rates, do not actually seem expensive. In fact they appear reasonable to attractive.

So we have an economy and markets that by pretty much all accounts are experiencing strong and improving fundamentals yet there are varying degrees of intensifying investor fears within them. Who wins this battle? Or do these two market combatants actually work together in unison, involuntarily of course, to allow investors to move forward more rationally. Time will tell of course, but here is our take on where these intersecting roads stand right now.

THE FEARS

A litany of fears gripped the markets in 1H18 and for the most part have yet to subside. Among the most prevalent of these have included:

- Potential trade war
- Market volatility
- Higher inflation
- Rising interest rates
- Excessive stock valuations

POTENTIAL TRADE WAR

Of all the fears that have recently plagued the markets, concerns of an international trade war and its future repercussions has seemed to stir the greatest emotion and create the most market volatility. For example, during the middle weeks of March, immediately following two announcements by the White House that the U.S. planned to implement tariffs on approximately $100 to $150 billion of Chinese steel, aluminum and other goods, the S&P 500 dropped more than 7%.

Since that time, which has included the actual implementation of those tariffs in mid-June, the market has seemed to bob and weave whenever tariffs or trade relations are in the headlines. And this has been exacerbated as the White House further decided to apply steel and aluminum tariffs on North American allies Canada and Mexico. In late June, as rhetoric with China continued to heat up, the White House announced consideration of an additional $200 billion of tariffs on goods outside of steel and aluminum. When included with some previous incremental announcements, this took the total market estimate of potential U.S. imposed tariffs to about $450 billion.

In our opinion it has been these concerns of pending trade hostilities that has accounted for the bulk of this year's ongoing market volatility.

MARKET VOLATILITY

Following the enjoyable vacation that was 2017, investors have been reminded in recent months that, yes, equity volatility still exists. After what was more than a year of the CBOE Volatility Index (VIX) averaging daily levels about one-third below long term historical norms, this measure spiked in early February by almost three times (from approximately 11 to 29). As of the end of 2Q18, it has booked a year to date daily average of just over 16, which is more in line with its long term historical average of about 19 or so. Also relevant is the fact that after settling down from its run to 30 in February, the months of March and April saw spikes to the 25 range as trade war concerns further rattled the market. So as we stated back in January, the re-emergence of market volatility was clearly a risk and we have now seen that risk come to fruition.

THE CBOE VOLATILITY INDEX ("VIX")

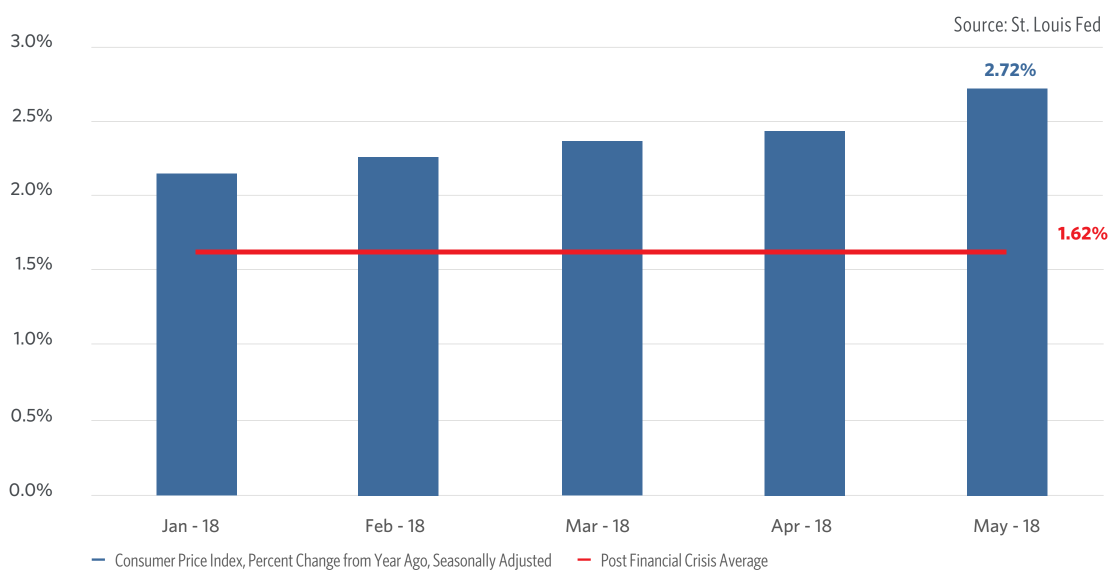
January 1, 2018 – June 30, 2018

INFLATION

Investors awoke to renewed market volatility in early February when the Bureau of Labor announced that monthly average hourly incomes rose by an unexpectedly high annualized rate of 2.9% (later revised to 2.8%), representing its highest level since 2009. This sent warning bells throughout the markets and concerns that a traditional wage-price inflationary spiral might be in the making, potentially sabotaging corporate profit margins and consumer buying power. Within a week the equity markets had fallen into correction territory. Since that time, broader inflation measures such as the Consumer Price Index (CPI) and the Fed's preferred metric, Personal Consumption Expenditures (PCE), have moved higher.

INFLATION: THE CONSUMER PRICE INDEX

January 2018 – May 2018

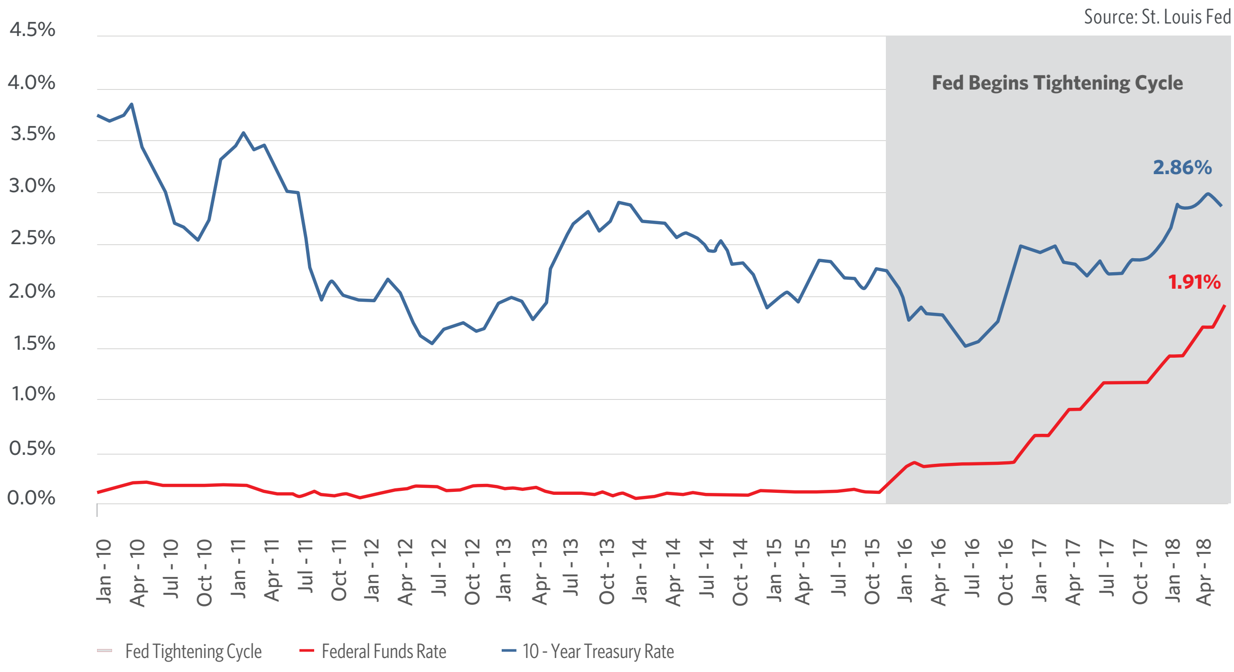


INTEREST RATES

Even prior to the inflationary scare of February, longer term interest rates had begun rising as the 10-year Treasury Yield increased almost .40% by early February and for the most part never looked back. It topped 3% by late April and 3.11% by mid-May before finishing 2Q18 at 2.86%. As we cited in our January Market Outlook, there were several criteria supporting why we thought rates would rise in 2018, including a strengthening economy and the Fed's balance sheet reduction program. So while the upward move in rates was very much expected from our viewpoint, it nonetheless has stoked concerns as to how the equity and credit markets will fair in a higher rate environment.

FED FUNDS RATE VS. 10-YEAR TREASURY RATE

January 2010 – May 2018



STOCK VALUATIONS

Perhaps the most widely used bearish argument against stocks over the past year has been that of excessive valuation. Here it has been often cited that stock price-earnings multiples are well above historical averages and a continued downward repricing of equities is inevitable. This argument reached its loudest decibel in late January when the S&P 500 rose to about 20x latest 12 month operating earnings and 18x forward operating earnings estimates. Since that time stocks have declined while both reported and estimated earnings have increased. By the completion of 2Q18, the S&P 500 was trading at 19x trailing 12 month earnings and 16x forward earnings, however some continue to argue such valuations remain too expensive.

THE FUNDAMENTALS

These concerns need to be weighed against what has been, in our opinion, markedly improving fundamentals throughout the economy, equity, and credit markets. Among the most important of which include:

The U.S. economy could be poised for its best year of Gross Domestic Product (GDP) growth in more than a decade.

This is likely to be driven by a labor market with its lowest unemployment rate since the turn of the millennium, higher overall wages, continued strength in consumer spending, and rising trends of business investment. We believe a key component of this recent momentum has been the fiscal stimulus of the recently implemented tax reform, which is in the process of increasing corporate profitability and returning capital previously parked overseas back to the U.S. Not since 2005 has the U.S. posted calendar year GDP growth of 3% or better, however we believe there is a solid probability that level could be achieved or exceeded this year.

Corporate earnings growth continues to be nothing less than stellar. Following a terrific year in 2017 in which S&P 500 underlying earnings growth topped 16%, 1Q18 profits for these companies surpassed even the most bullish of forecasts, coming in north of 24% growth. While there clearly was an advantage to the lower corporate tax rates, this still represented the highest individual quarter of S&P 500 earnings growth since 2010. We also believe that the remaining three quarters of this year's earnings reports will likely continue to be strong ones with perhaps overall results averaging in the high teens or better. This exceptional environment for earnings has evoked whispers of the "T" word, as in 20-percent growth for 2018, a level that has not been achieved since the early days of the post-2009 economic recovery.

The high yield bond market continues to send favorable signals. One of the more interesting developments so far this year has been the stability of the high yield bond market as compared to its higher volatility equity counterparts. As stock market volatility picked up considerably beginning in February, high yield credit spreads remained within fairly narrow ranges and well below historical averages. This was seen in High Yield (ICE BofAML US High Yield Master II Option-Adjusted Spread), which closed out 1H18 with a composite spread of 3.64% above comparable maturity Treasury bonds. These spreads were close to in line with where they started the year and well below 20-year historical averages of 5.7%. We believe this stability in the high yield market reflects the anticipation of lower default rates, better interest expense coverage, and ongoing balance sheet improvement.

So there you have it, fears throwing punches a lot harder than we have seen in recent years and the fundamentals doing their best to dodge them and return fire. We expect this fight to continue throughout the rest of 2018 and with it investors will likely see continued volatility. Amid this battle we still see strong and attractive opportunities for investors.

The U.S. Economy appears to be setting up for its best year of growth in more than a decade and this should continue to prove favorable for equity and credit markets.

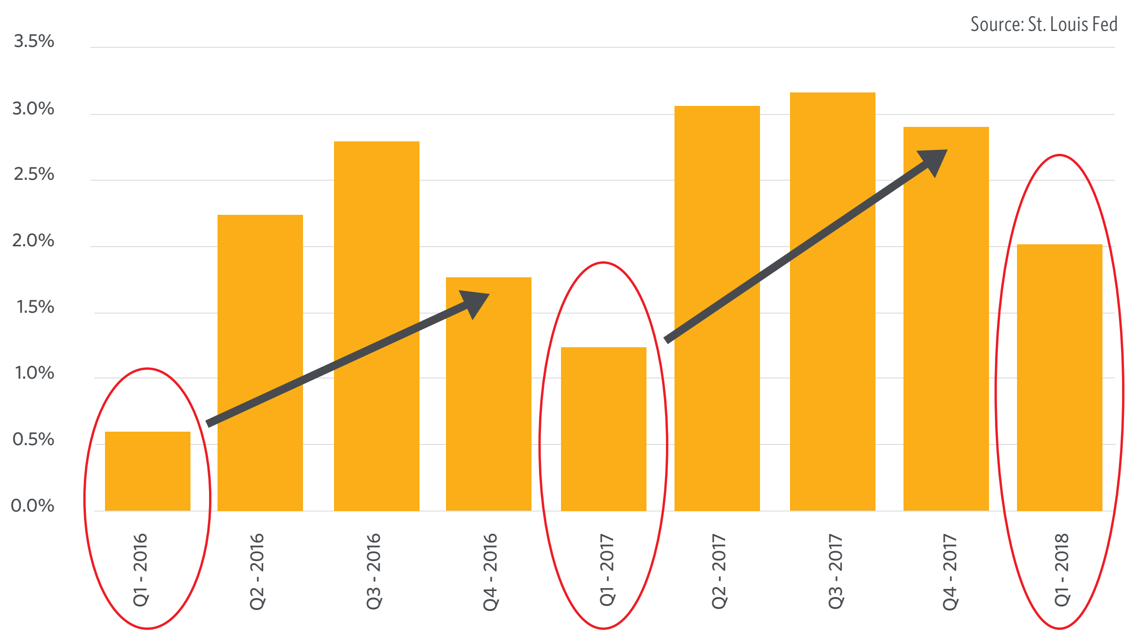
As we mentioned back in January, the U.S. economy entered 2018 with high expectations and so far it seems to be delivering. The year began with the debate in full swing as to whether or not this could be the first year in more than a decade that the U.S. economy could achieve 3% calendar year GDP growth. At this juncture we view that achievement as increasingly likely.

While 1Q18 GDP growth came in at just 2.0%, which was below the previous three quarters average of 3.1% from 2Q17 to 4Q17, we actually believe this first quarter result is an encouraging harbinger for the rest of the year. This is because in recent years it appears as though seasonal adjustments to 1Q calculations and consumer behavior in the early winter months provides evidence of systemically lower GDP growth in the first quarter than in the three quarters to follow.

This has been the case in three of the past four calendar years. In 2014, first quarter growth was -0.9% followed by three quarters averaging 3.9%. In 2016 first quarter growth was 0.6% followed by three quarters averaging 2.3%. Last year the first quarter came in at 1.2% with a following three quarter average of 3.0%. In doing the math in these three calendar years, quarters Q2 through Q4 averaged 2.8% higher than Q1. Even when adjusting for the negative growth in 1Q14 and just looking at the past two calendar years, the incremental difference was 1.75%. So when taking this recent history of first quarter seasonality into account, one might say 2.0% never looked quite so good.

REAL GDP GROWTH FIRST QUARTER SEASONALITY

Q1 2016 – Q1 2018



APPROACHING FULL EMPLOYMENT

At the forefront of our optimism is a labor market where unemployment has crossed below 4% for the first time since the turn of the millennium and done so with a reasonable level of wage growth. Consumer spending and business investment trends are also quite favorable and could accelerate further.

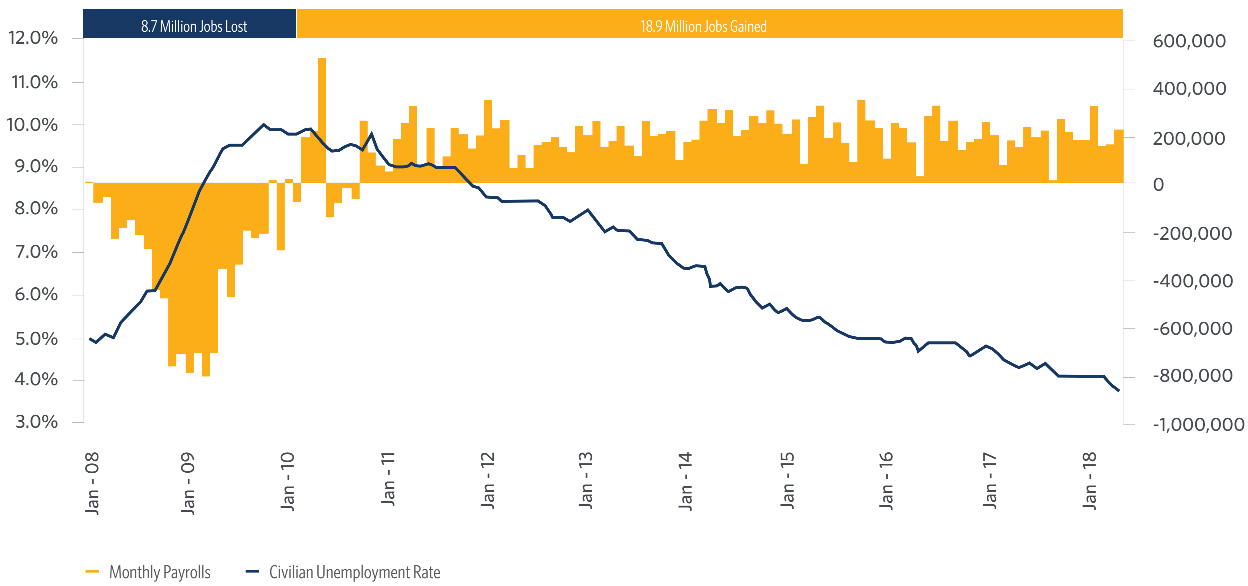
Now nine years into the official economic recovery following the financial crisis and Great Recession of 2008 to 2009, the U.S. economy has regained more than twice the 9 million jobs it lost during that painful downturn. Unemployment has also declined from more than 10% in 2009 to 3.8% in this past May's reading. So given this steady march toward full employment, we are believers that upside to recent monthly averages of about 200,000 new jobs a month will be difficult to accomplish. In fact we would say that at this point, monthly job additions keeping up with population growth of about 75,000 per month would be just fine.

With this in mind, the composition of recent job reports have appeared all the more impressive given this dramatic decline in unemployment. For example, the recent May nonfarm payroll number not only reported an additional 223,000 jobs, but that all seven sectors of the economy, as defined by the Bureau of Labor Statistics, had positive job growth, exemplifying broad based employment throughout the economy.

This is also consistent with recent monthly trends that have managed to stay ahead of population growth and have averaged new jobs north of 200,000 so far in 2018 and just a shade below that number over the past two years. At sub-4% unemployment, we find these results encouraging even as the more important impetus of growth looking forward, in our opinion, now surrounds no longer maximizing employment but maximizing the potential consumer activity of those who are employed.

JOB GAINS AND UNEMPLOYMENT RATE

February 2008 – May 2018



Source: St. Louis Fed. Jobs lost period is 2/2008-2/2010. Jobs gained period is 2/2010-5/2018

WAGES AND CONSUMER SPENDING

Along these lines we would view two of the most important elements driving higher levels of economic activity as being wage growth and consumer spending. Both of these continue to display improving trends and should ultimately play a large role in moving U.S. economic growth to a higher plateau in the year ahead.

For this reason we were a bit taken back by the market's adverse reaction in early February to the January average hourly earnings increase, reflecting year-over-year growth of 2.9%. Interpreted as a potential precursor to higher than expected inflation, we believe this number has room above the 3% mark while still contributing favorably to broader economic growth. The backlog of anemic income growth has been long and tiresome as annual rates over the past 10 years have hovered at only 2.2% and the compounded rate has been 2.3%. (This compares to a pre-financial crises annual rate of 3.5% in back in 2007). So far in 2018 average hourly earnings have tracked year-over-year monthly increases of 2.65%. While this pick up may seem incremental in nature, when viewing it on $7 trillion of aggregate wages it could prove to be meaningful.

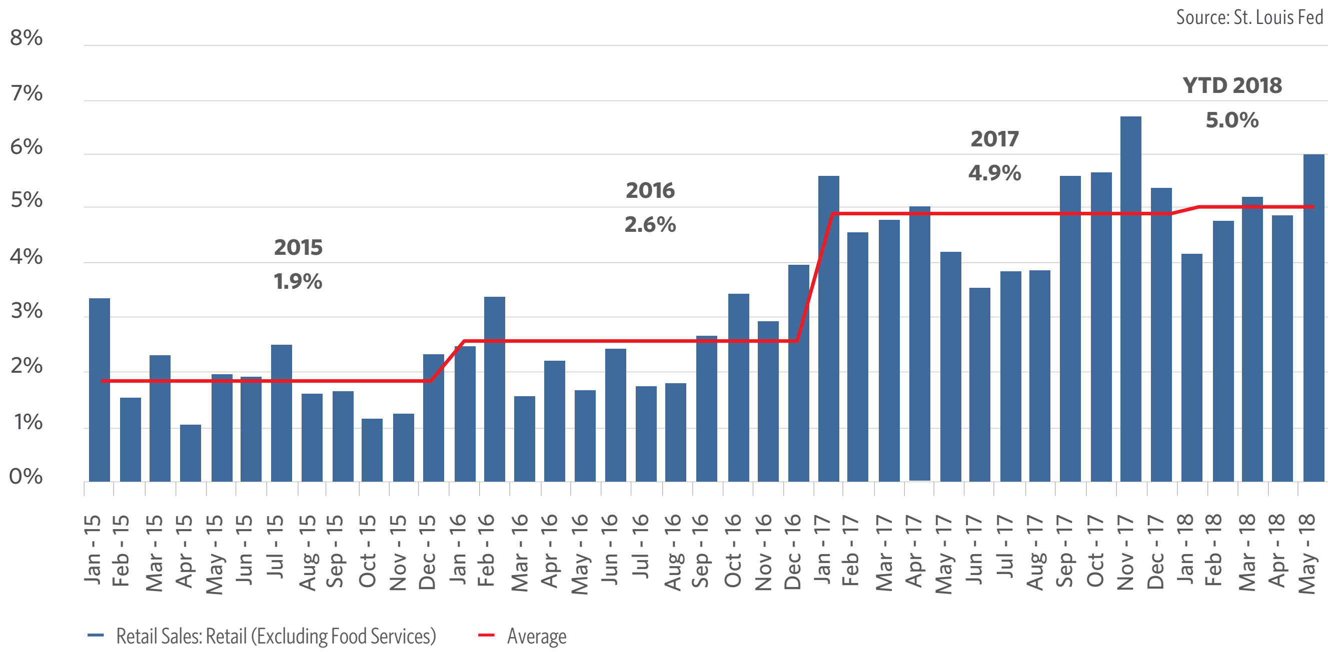
AVERAGE HOURLY EARNINGS (annualized growth)

March 2007 – May 2018

Retail sales, a major component of consumer spending that ultimately drives about two-thirds of overall economic growth, also showed strong momentum as the economy approached the end of 2Q18. Defined as the aggregate purchase of finished goods by consumers and businesses, this metric experienced 0.8% growth in May, which was double consensus expectations, and the April number was revised up to 0.4% from its previous report of 0.2%. On a year-over-year basis, May retail sales came in at 5.9% growth, which was the highest annualized rate since November 2017 and the second highest since 2012. Even when taking out the more volatile components of food, gas, autos, and building materials, the adjusted measure still came in at 0.5% for the month and April was revised higher to 0.6% from 0.4%. This momentum in purchasing behavior, in our opinion, bodes quite well for 2Q18 GDP growth.

RETAIL SALES (annualized growth)

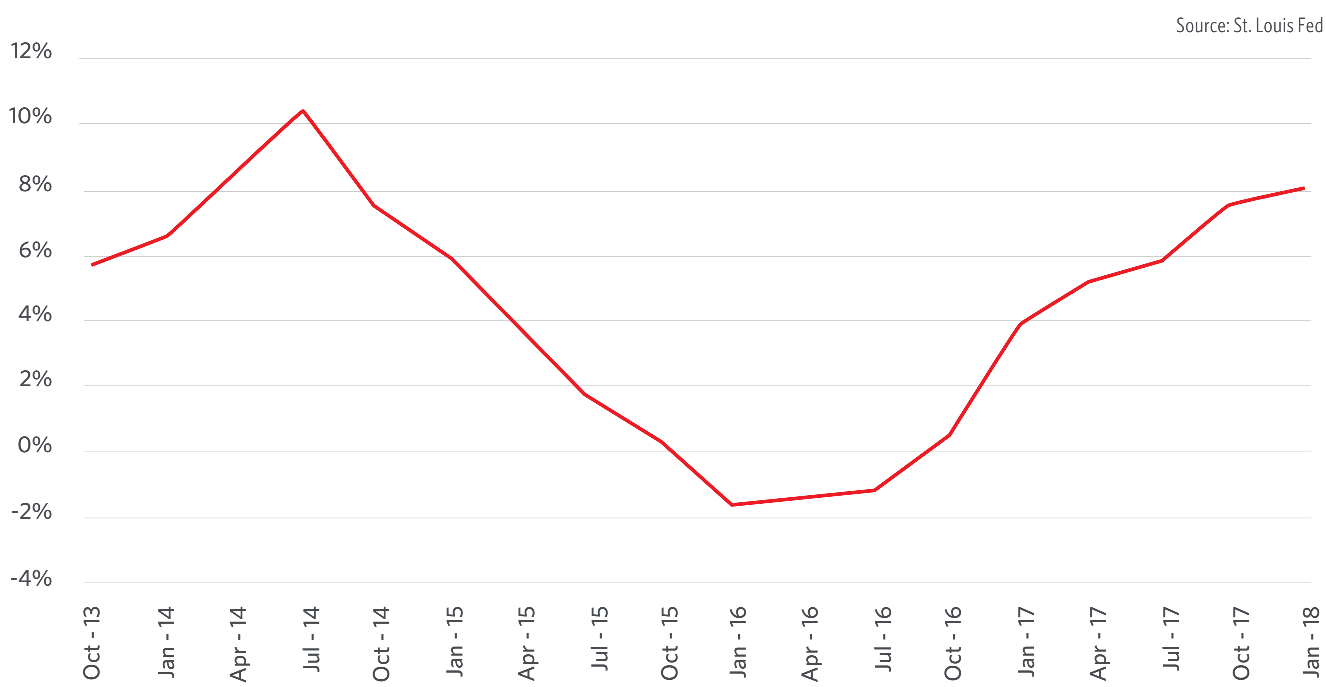
January 2015 – May 2018



We are also beginning to see a noticeable increase in business investment which looks to be settling in at levels well above recent years. This was seen in Private Nonresidential Fixed Investment, (corporate expenditures on commercial real estate, tools, machinery, and factories) which increased 8% year-over-year in 1Q18, its highest level of growth since 2014. This measure has been steadily rising since the second half of 2016 and with the lower corporate tax rates now in effect it could experience higher levels.

BUSINESS SPENDING PRIVATE NON-RESIDENTIAL FIXED INVESTMENT

Q4 2013 – Q1 2018



IMPACT OF TAX REFORM

For those who staked a bullish claim on 2018 U.S. economic growth, that judgment was likely in part predicated on the implementation of the Tax Cuts and Jobs Act ("Tax Reform") passed and signed into law during December of 2017 and implemented during 1Q18. This is our viewpoint as well, as despite the political disagreements behind the legislation itself, we feel that there is and will continue to be tangible fiscal stimulus from this legislation. Specifically, the lower individual brackets should continue to boost consumer spending and the lower corporate brackets should increase business investment. In addition, the ultimate repatriation of approximately $2.5 trillion of overseas corporate cash should also have a strengthening effect on balance sheets, which, all else being equal, will likely increase access to capital.

How companies choose to apply excess cash resulting from lower tax rates or the repatriation of overseas balances is of course a factor not yet fully known. This has also been a subject in the debate regarding Tax Reform's ultimate economic effectiveness. Proponents of tax reform have touted the potential for these corporate savings to be reinvested in jobs, capital expansion, or new facilities all of which could have broader impacts on the economy. Opponents of Tax Reform have argued most of this newly found cash will go directly to immediate shareholder initiatives such as share buybacks, debt pay down, or dividend payments.

Our viewpoint is that it will likely be some combination of the two but more importantly both will prove beneficial to the economy. Obviously capital investment has its favorable implications. However enhanced corporate profitability, balance sheet improvement, and/or increasing returns to shareholders are also actions that can help to generate the flow of capital and investment throughout the economy. So when taking both of these avenues into account, we believe the favorable impact of lower corporate and individual tax rates and the repatriation of overseas cash will continue to be meaningful in the year ahead.

RISKS TO ECONOMIC GROWTH

Of course there are always risks to economic growth and we believe the markets will be watching the following three with perhaps the most attention.

- Potential trade war
- Inflation and the Federal Reserve
- Slope of the yield curve

POTENTIAL TRADE WAR

We believe at this juncture the predominant risk to U.S. and global economic growth is a potential break down of international trade relations as, some are concerned, could result from recent implementation of steel and aluminum tariffs initiated by the U.S. upon China, Mexico, Canada, and the European Union, as well as what might be feared to follow in other countries on a wider category of goods. If there is one dynamic that could potentially disrupt the higher growth path the U.S. economy has recently embarked upon, this would be it.

However we also believe it is important to recognize that this drama has quite a ways to go before we reach that point. There is a chain effect needed to occur before collateral damage becomes high enough to materially threaten economic growth and we are still in the early links. The total market size of the existing and potentially implemented tariffs set in motion so far is approximately $450 billion, which in total represents about 3% of the U.S. economy and 0.6% of the world economy. So at this point there does not seem to be enough at stake to measurably move the needle in the wrong direction.

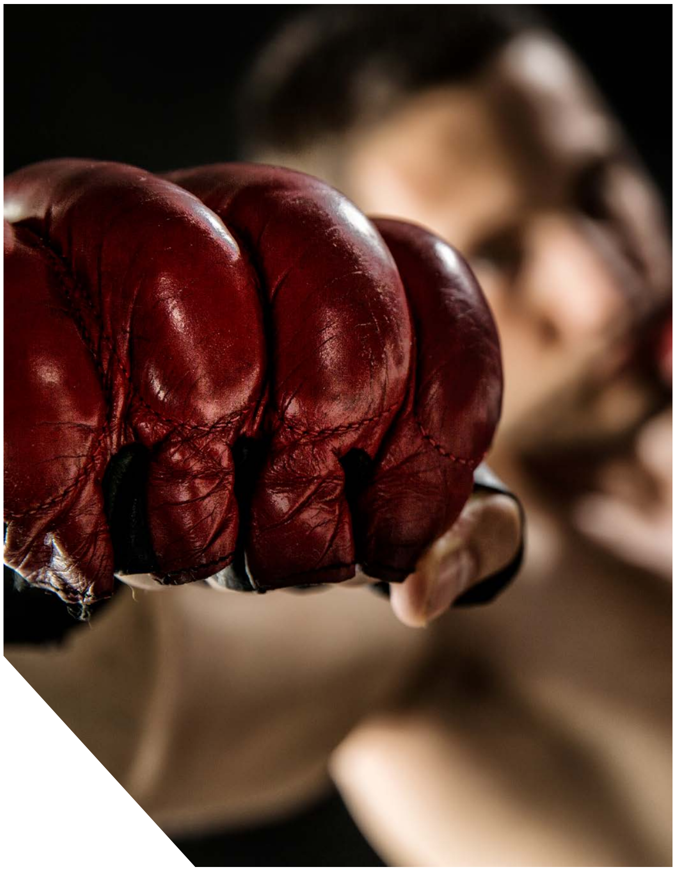
This is not to say a prudent investor shouldn't look down the road to see where this could descend. Trade wars are based on escalation and by its very definition escalation can happen quickly. The fear is that based on these existing tariffs, other trading partners will retaliate with barriers of their own and on a broader classification of goods. As this scenario compounds, former trading allies take on more defensive and hostile postures and a "lose-lose" situation develops as all economies involved operate below potential. Again, in our opinion, we are a good ways from that point.

Another aspect to be considered is the impact tariffs can have on the home country administering them. In the case of U.S. steel and aluminum producers, those businesses would likely benefit from protective relief. However the industries sourcing those metals from them, for example autos, aerospace, construction, food and beverage, would wind up paying higher prices. This could then result in those industries passing on higher costs to consumers or taking haircuts on their profit margins, neither of which is favorable for economic growth.

To reiterate, this is all an extrapolation at the moment. There is of course a school of thought that the newly administered tariffs, even in their implementation stage, are nothing more than bargaining tactics in the ongoing trade negotiations with China and the re-negotiation of the North American Free Trade Agreement with Canada and Mexico. There is also the "cooler heads will prevail" theory that widespread escalation will not occur or that existing tariffs might even be rolled back at some point in order to avoid the longer term risk of their consequences. After all, such was the case with the Cuban Missile Crisis 56 years ago, but of course that involved a far different cast of players.

In summary, we view the current risk here as one of a trade distraction that could evolve into a trade disruption, but at the current time we are a long way from a trade war.

Investors should monitor potential escalation closely, however we believe the U.S. economy's inherent strength currently supersedes the absolute level of this risk.



INFLATION AND THE FEDERAL RESERVE

Another perceived risk regarding the pace of economic growth pertains to concerns that the Federal Reserve will prove to be overly aggressive in tightening monetary policy and raising short term interest rates, perhaps mostly in response to anticipated inflation. So this concern is twofold, that the Fed will overshoot controlling inflation and raise rates too far too fast, hence choking off economic growth just as it begins to really hit its stride. Or that the Fed will not act fast enough and inflation will rise to an economically threatening state on its own. We are less concerned with this risk for a few reasons.

The first is that coming off about eight years of historically anomalous monetary policy and close to zero interest rates from the end of 2008 to the end of 2016, there is still a lot of catching up left to normalize rates. For example, we are believers that 2016 was a lost year for the Fed in which it concluded with only one rate hike in that year's final month, when there probably should have been at least two others prior to that. So in our opinion, higher rates remain overdue.

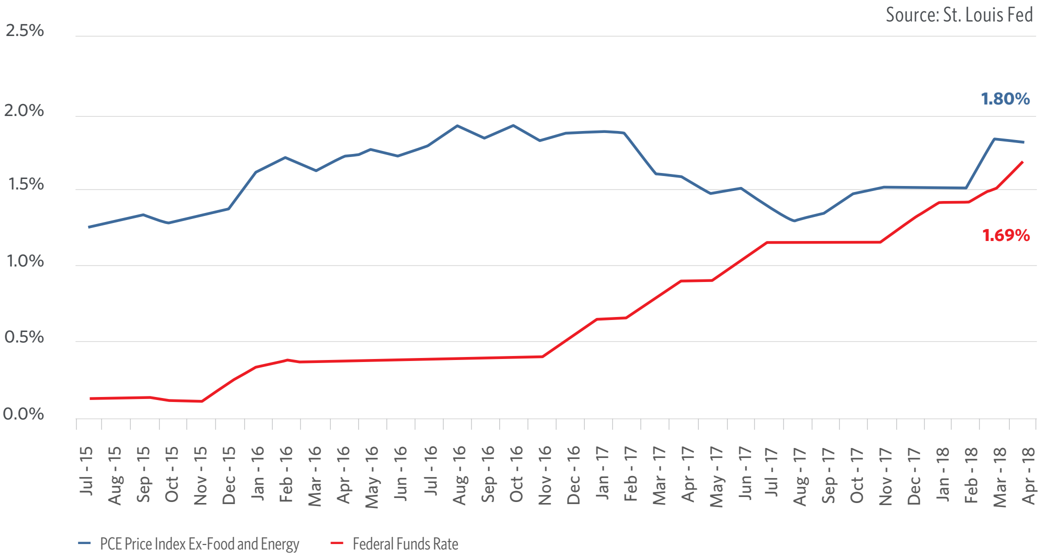
Second, at the current time we don't view inflation as threatening to the economy based in large part that only recently have price levels been approaching the Fed's long term target of 2%. We would even say that following close to a decade of little to no inflation and at times deflation, that another percent or so above this target could still actually be healthy to overall growth. Recent trends in the Fed's preferred measure, Personal Consumption Expenditures (PCE), are just now reaching this 2% threshold, which, by historical standards, is still well below long term inflationary averages of about 3.7% since the end of World War II.

Finally, the Fed has signaled to the market its apparent willingness to be somewhat measured in its actions in the event inflation moves above its 2% target. The key wording being used here is "symmetrical." By using this term the Fed is referring to the concept that the economy operated for a long period of time below its target of 2% inflation, so there should be some license to let it operate above that level if that were to occur.

So the thinking at this point inside the Fed appears to be more along the lines of continued gradual rate hikes, and not a flurry, if and when we do see PCE move above 2%. We believe the markets would likely view such policy implementation as prudent and responsible.

INFLATION AND INTEREST RATES
PCE CORE PRICE INDEX VS. FED FUNDS RATE

July 2015 – April 2018



THE YIELD CURVE

The Treasury yield curve, in this case defined as the difference in yield premium between the 10-year and 2-year bonds, has often been viewed as a potential forecaster of future economic conditions. Probably its greatest predictive capability is believed to be that of projecting a recession or economic slowdown when it becomes inverted, meaning in this case the 10-year bond declining in yield to less than the 2 year.

To be clear, the curve is not presently in this condition, though some fear it is heading in that direction. At the end of 2Q18 the 10-year/2-year curve stood at .33% (10-year yield 2.86% versus 2 year 2.53%). However this spread does stand at its tightest level since 2007 and this has been enough to strike inversion jitters within various corners of the financial community.

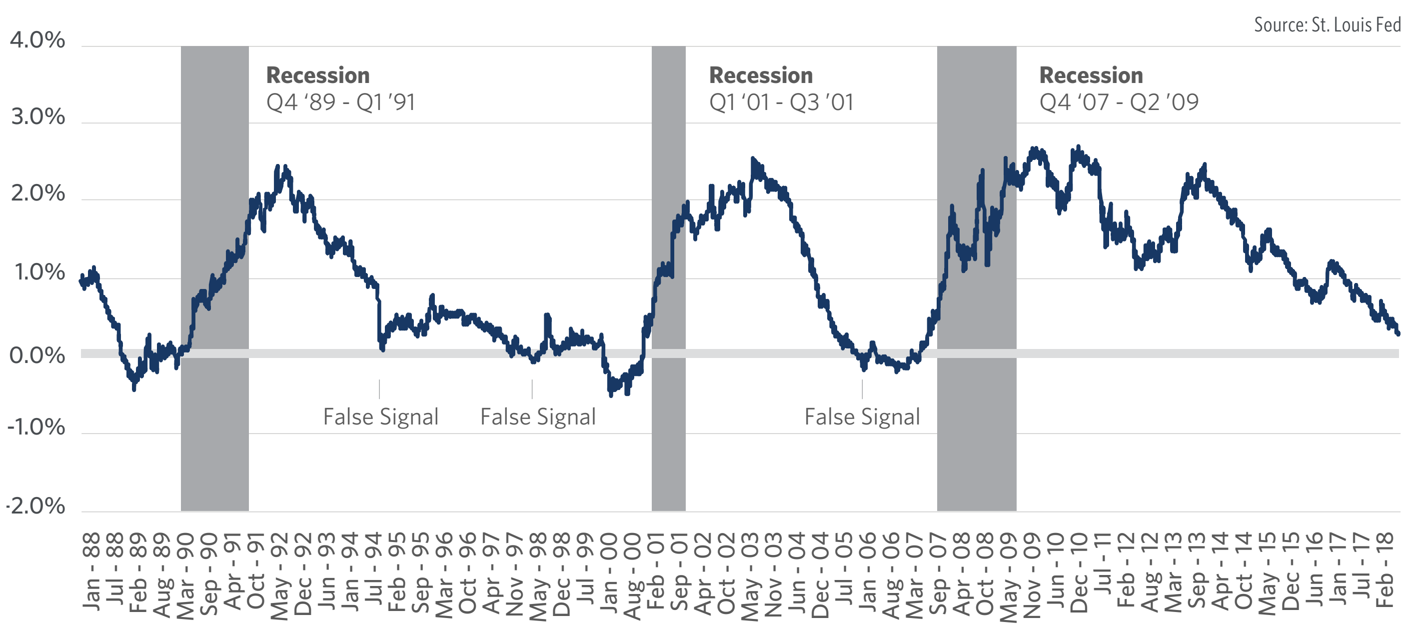
In assessing this risk, we would begin by repeating our perspective from January regarding the accuracy of the yield curve, which is that historically it has proved itself to be a little too accurate. Financial comedians (not an oxymoron) have often joked, "the yield curve has predicted 10 out of the last 5 recessions." So while most recessions have been preceded by inverted yield curves, not all inverted yield curves have been proceeded by recessions. This fact should not be overlooked.

We also believe the U.S. 10-year yield could be unduly suppressed by longstanding accommodative monetary policy in other regions of the world such as Europe and Japan. The European Central Bank (ECB) and Bank of Japan (BOJ) remain mired in negative short term interest rates and this has impacted the longer ends of those curves. So on a comparative basis, lower long term rates overseas might be anchoring the U.S. 10 year somewhat and for reasons unrelated to the economy.

It is our opinion that current economic conditions do not warrant a yield curve this narrow nor one that is at risk of inverting. Nonetheless, it has somehow landed where it is and therefore should be watched closely and interpreted with care.

YIELD CURVES AND RECESSIONS 10-YEAR YIELD MINUS 2-YEAR YIELD

January 1988 – June 2018



All considered, we believe the U.S. economy could be hitting its stride in a manner we have not seen in more than a decade and this should continue to provide a favorable environment for equity and credit based investors.

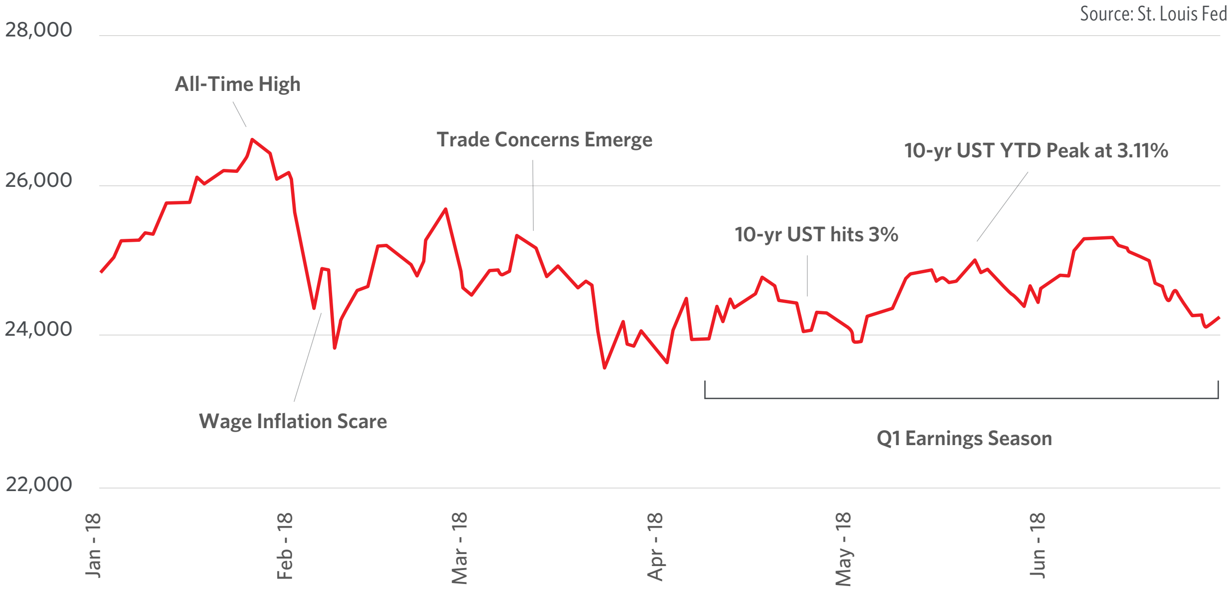
Following a return to volatility and the stock market correction experienced in the equity markets in 1H18, we continue to believe U.S. stocks are set up well for the year ahead.

By all objective accounts, the first half of 2018 should have been an exceptional six months for stocks, However a return to volatility and fears of a global trade war were primary culprits in preventing market averages from reaching levels anywhere close to what underlying fundamentals seemed to be signaling. Corporate earnings growth rose well above even the most optimistic of forecasts at the year's outset. Yet despite that growth, stock multiples compressed and as the economy appeared poised for a breakthrough, daily trading more closely tracked the headlines of tariff talk than bottom line profits.

There is no question that a full blown trade war would not be good for either the U.S. or global equity markets and, as we have stated, current and anticipated tariff activity remains at far distance from this. Nonetheless, a prudent investor should view a trade war as a tail risk to stocks, one of low probability but high consequence. However, in extrapolating the words of John F. Kennedy (when he was of course talking about world problems, not the markets), this is also a tail risk that has been created by humans, therefore humans can solve it. Should humans in fact accomplish this, we think stocks could have a meaningful upward move and one in line with underlying fundamentals.

DOW JONES INDUSTRIAL AVERAGE

January 1, 2018 – June 30, 2018



ADDITIONAL MARKET FEARS

Of course tariffs and a future trade war have not been the only fears plaguing stocks so far this year. Other chief irritants creating nervousness have included:

Inflationary concerns stemming from a rise in wage growth and increasing levels of the CPI that has now shot through the closely watched 2% threshold and appears perhaps on track to exceed 3% in the coming months. Given the abnormally low levels of inflation in recent years and the headwinds it has created for economic growth, we believe consumer prices still have a ways to go before they are detrimental to aggregate stock prices.

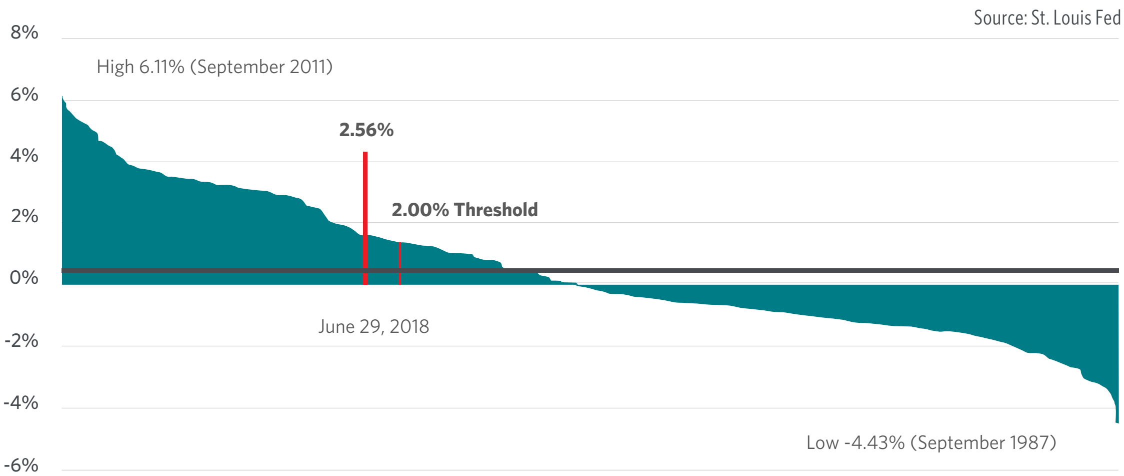
Higher short and long term interest rates that have risen considerably this year as well as since their historical low points of two years ago. Here we would continue to point out that the rise in rates since January, and since July of 2016 when the 10-year Treasury Yield dropped to an all-time low of 1.37%, have been mostly attributable to an improving economy that should ultimately prove favorable for stocks.

Excessive stock valuations, which could portend a longer term downward adjustment in stocks. Here we reiterate that stock valuations should not be evaluated by simple comparisons to past cycles but in the context of the present market environment, which we believe should include potential earnings growth. As of the final week of 2Q18, earnings multiples on the S&P 500 were shaking out at about 18.6x latest 12-month earnings and 16.2x estimated forward 12-month earnings (Factset estimate), which is above longer term averages. Earnings growth, on the other hand, is at and expected to be well above the averages of this time frame with latest 12-month profits rising 16% and forward 12-month earnings growth estimated at 15%. These would represent price-earnings/growth ratios of 1.2 and 1.1 times respectively. We would consider trailing and forward price-earnings/growth ratios close to 1.0 times, when earnings are growing in excess of double digits as reasonable to attractive.

Furthermore, when viewing the S&P 500 on an equity risk premium basis in which the current long term risk free rate (10-year Treasury Yield) is subtracted from the latest 12-month earnings yield (earnings/price), this metric finished 2Q18 at about 2.5%, which is historically above the 50-year average and the 2% threshold that we would categorize as attractive.

HISTORICAL EQUITY RISK PREMIUM

January 1968 – June 2018



Source: FactSet Earnings Insight June 15, 2018
10-year U.S. Treasury Yield from St. Louis Fed. Equity Risk Premium = S&P 500 Earnings Yield – 10-year U.S. Treasury Yield
S&P 500 Est TTM Earnings 146.53 / 2716= 5.40%
10-Year Treasury Yield = 2.84%
Equity Risk Premium = 2.56%

Decelerating earnings growth in 2019. The concern here is that the rate of earnings growth in 2019 and beyond will decline to below that of the past two years, to which we would counter, yes, and pretty much everyone is expecting that. First it is important to recognize that current estimates for 2019 S&P 500 earnings growth is at about 11%. Admittedly, this is a good ways off in the future, hence any forecast will be subject to inaccuracy. (Remember that at the midpoints of 2016 and 2017 forward calendar year estimates for 2017 and 2018 earnings growth proved conservative). Through the first six months of 2018, the S&P 500 has only risen in price 1.7% against a backdrop of better than 20% year-over-year earnings growth. This in our opinion lends credence to the viewpoint that the overall market continues to be well set up for stock appreciation at least in line with earnings growth in the year ahead.

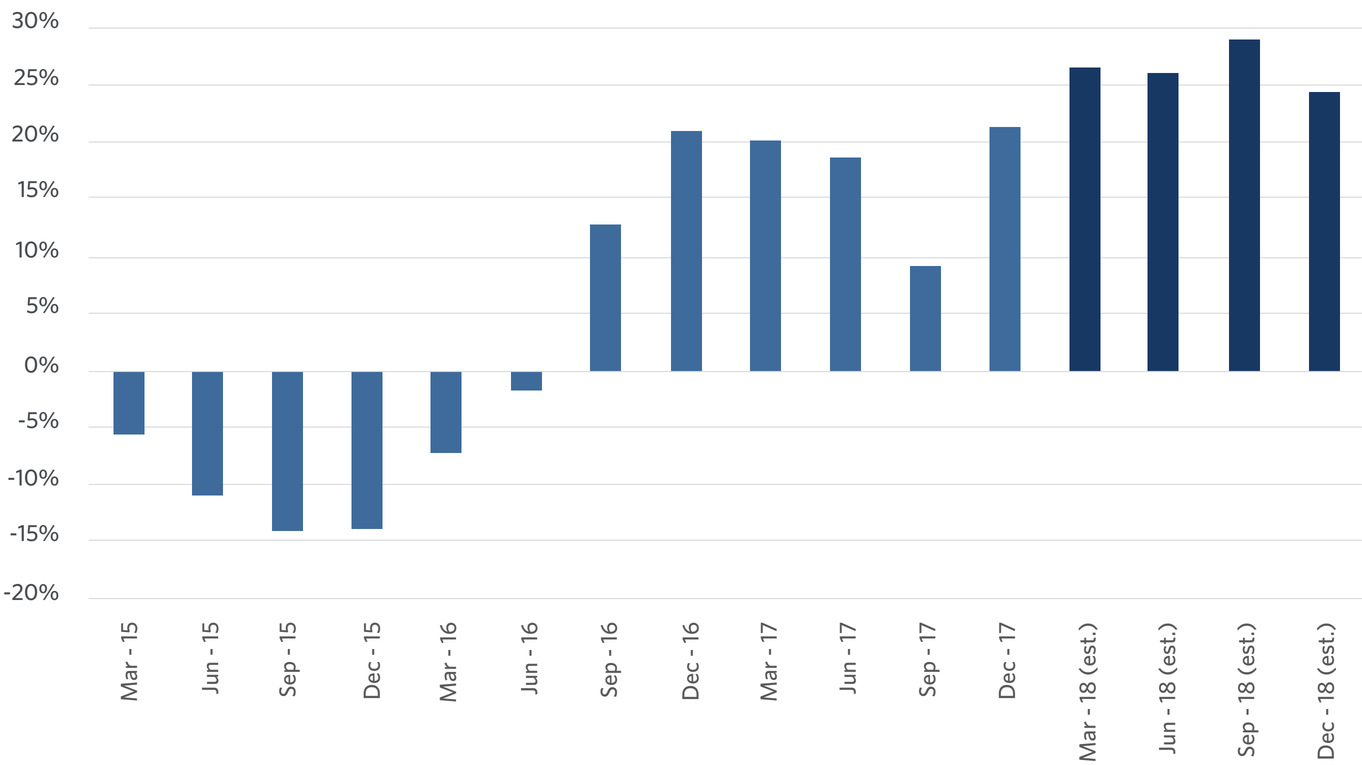
THE FUNDAMENTAL CASE FOR STOCKS

As we said earlier, we believe understanding, interpreting, and at times agreeing with market fears is an important part of equity investing. However, doing so must always be balanced against underlying fundamentals and at the 2018 midpoint we believe overall stock fundamentals are quite strong.

First and foremost on the list of fundamental criteria is exceptional earnings growth for stocks, as evidenced by potential 2018 year-over-year profits growth of S&P 500 companies of approximately 20%. Few people, if any, had such a level in their forecasts even when taking into account the immediate bump to corporate profits received this year from tax reform and the lower rates that have ensued.

S&P 500 OPERATING EARNINGS GROWTH

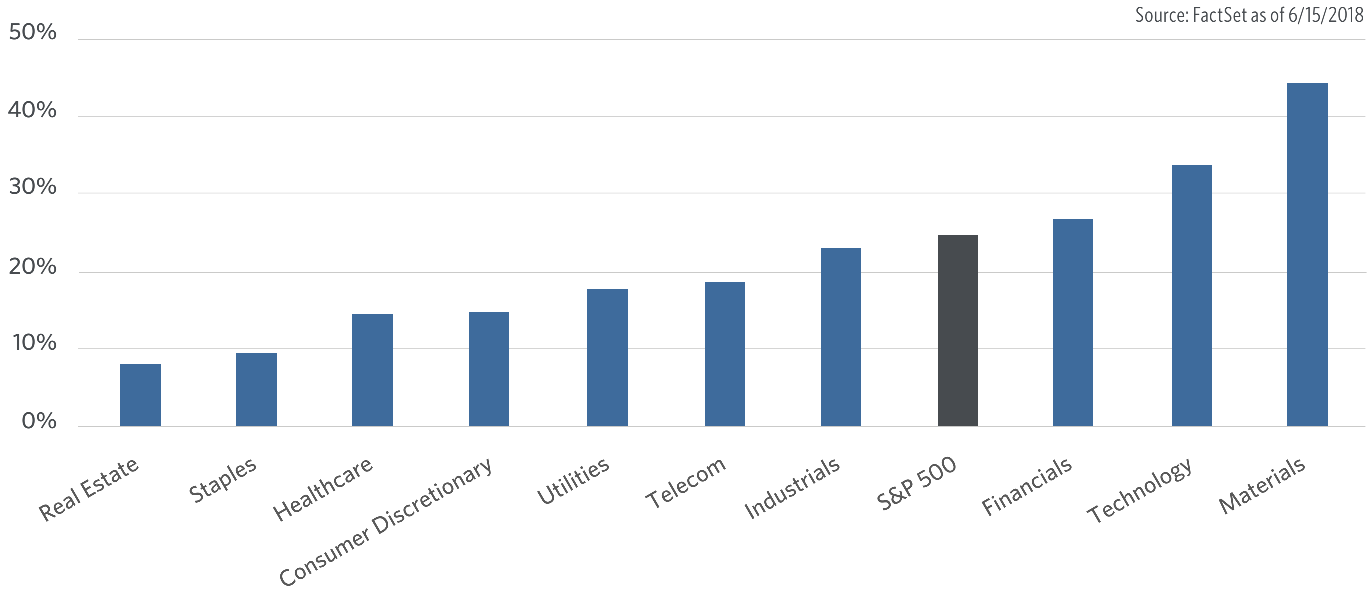
Q1 2015 – Q4 2018 (est.)



Source: DJ Standard & Poor's. Operating earnings measure core business earnings and do not account for non-core activities such as interest, taxes and depreciation. Estimates in dark blue from Capital IQ. As of June 29, 2018, 98.2% of companies have reported for Q1 2018, so still considered an estimate.

S&P 500 SECTOR EARNINGS GROWTH (ex-Energy)

Q1 2018

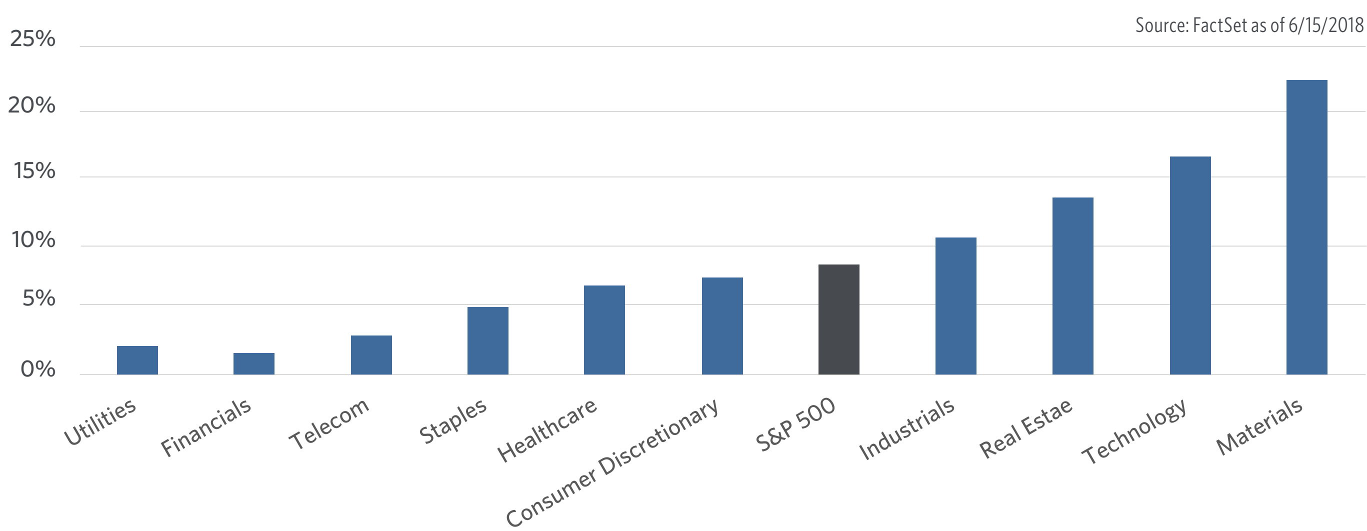


Even when taking out the favorable impact of lower tax rates, organic earnings growth for 2018 still looks as though it will come in around the low to mid-teens, which given where profits were just a couple of years ago (basically flat growth 2014 – 2016) is impressive. Furthermore, while the increase to earnings growth attributable to lower tax rates is one time in nature, the overall foundation of those higher earnings is perpetual (assuming Congress does not repeal tax reform at some point in the future), meaning that future earnings growth will be compounded upon a higher base that has been created by lower tax rates. So while the higher earnings growth may be one time in nature, the higher earnings themselves is ongoing and that is still good for stocks in our opinion.

Moreover, the quality of earnings growth appears to be improving. This can be seen in corporate revenue growth, which is shaping up to potentially reach its highest rate since 2011. For 2Q18, estimates for S&P 500 companies are now at 9%, very encouraging as top line sales growth in our opinion remains the single most important element driving net profits. In addition, this momentum in revenue growth is well diversified, as all 12 sectors of the S&P 500 generated positive revenue growth in 1Q18 and are expected to do so for the full year as well.

S&P 500 REVENUE GROWTH (ex-Energy)

Q1 2018



Corporate profitability is also on the upswing as can be seen in the improvement in net profit margins over the past year. Current margins this past quarter for S&P 500 companies posted an average of 11.6%, a full 1½ percent higher than in 1Q17. We believe this increase is in part attributable to cost management during the previous cycle, during which corporations were forced to tighten their belts under more challenging conditions and now are seeing the benefits of higher operating margins in a better environment.

So the following opportunity remains for stocks in the broader sense. The improving economy, driven by full employment, higher wages, and business investment can result in higher corporate sales growth, which can then flow through to the bottom line at better margins and therefore spur earnings growth well in excess of revenue growth. All else being equal, this should be favorable for stock prices.

SECTORS, STYLES AND MARKET CAPS

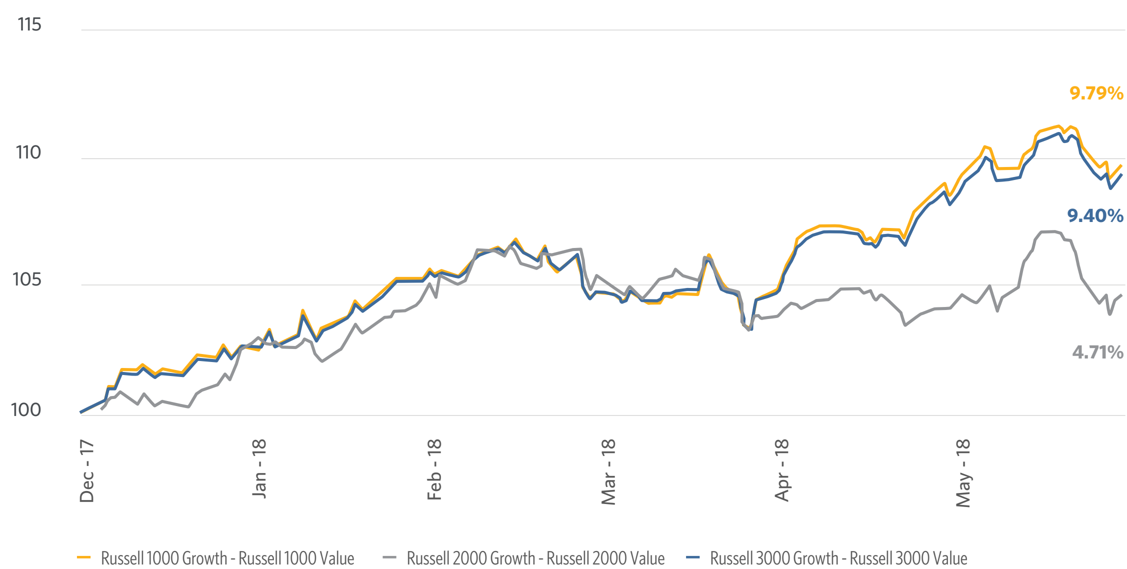
We believe stocks within the more cyclical sectors should continue to be well positioned through 2H18 as growth in the U.S. economy accelerates. This would include the technology, financials, industrials, and consumer discretionary sectors, all of which fit the profile of having upside to current revenue expectations, improving net margins and therefore the potential to exceed anticipated earnings growth.

What is also interesting is that throughout 1H18, growth stocks have continued to lead value and this includes the period since late January when most market indices reached their short term peaks before correcting. This in our opinion clearly represents the market's interpretation that a full recovery of the major indices back to the record highs of January will be driven by a stronger economy and the rising earnings trajectory growth stocks are best equipped to provide. This is evident in the fact that the Russell 1000 Growth Index and Russell 2000 Growth Indexes eclipsed their January highs in mid-June, though they dropped slightly below those levels in the final weeks of the quarter.

Though many see the economy in the latter stages of the cycle and therefore perhaps conducive to a growth into value rotation, we would caution that due to the stimulus of tax reform and the prospect that we are just now breaking into higher levels of GDP, this growth leadership could extend further than most might believe. We also like to provide the reminder that the timing of style-based rotations are notoriously difficult to predict, and that long term investors should still feel comfortable with an equal allocation to growth and value.

GROWTH STOCKS VS. VALUE STOCKS

January 1, 2018 – June 30, 2018



Source: St. Louis Fed. Data series rescaled to begin at 100. Not investable indexes.

Despite the litany of fears and trade concerns that have besieged the markets this year, the historically perceived higher risk NASDAQ and Russell 2000 Indexes also closed out 1H18 close to their late-January levels. This is likely a result not only of the anticipated earnings power within small cap stocks stemming from lower taxes and higher economic growth, but also the market's risk aversion in recent months to companies with larger international exposure that could be susceptible to trade concerns and a rising dollar.

Given all of these factors and the likelihood that the international environment will ebb and flow based not only on global growth prospects but also the rising or falling concerns of trade relations, we believe an allocation of approximately 70% large cap, 20% midcap and 10% small cap would reflect prudent long term diversification.

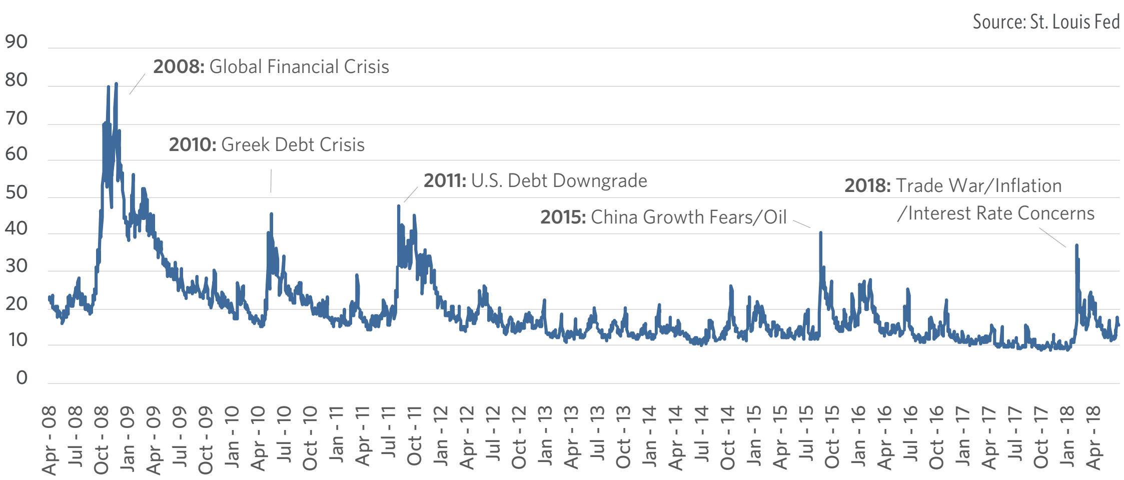
CORRECTIONS PAST AND FUTURE

It is also important to remember that prior to the trade war concerns that have seemed to dominate market sentiment in recent months, stocks incurred a spike in volatility and subsequent double digit selloff during the months of February and March, which was the first broad based market correction in two years. As we wrote in January, we believed a profit taking correction of 10% or more was a strong likelihood during 2018. Looking forward, we expect to see the calendar of such short term selloffs to occur more in line with the historical frequencies of the past half century, which would be about once every year and a half.

In the case of the February correction, the selloff was initially induced by fears of inflation and higher interest rates, concerns that along with international trade are yet to abate. In looking at this correction, one that of course we are yet to fully recover from in terms of the major indexes, we believe it appears no worse than the four others the S&P 500 has experienced since the end of the Great Recession, those being the Euro debt crisis of 2010, U.S. debt downgrade of 2011, Chinese yuan devaluation of 2015, and recessionary scare of 2016. In all of those cases, the market recovered to post at least double-digit gains within a year and a half and in retrospect the fears creating those corrections were more concerning in our opinion than what we appear to be facing today.

MARKET CORRECTIONS AND VIX SINCE 2008

April 1, 2008 – June 30, 2018



There is no question in our minds that after an atypically calm year in 2017, market volatility has returned and that the risk of more corrections like the one experienced this year is now higher. We do not view this as concerning however. In fact we view it as healthy. We believe selloffs of the 10% variety, be it for profit taking, fundamental changes in the markets, or fears of those changes, to be natural occurrences in the long term progression of markets. As I have often reminded others, for the 12 months prior to my birth, the stock market was down more than 10% on concerns of the ongoing Cold War, a modest economic downturn and uncertainty as to who would win the 1960 presidential election. Had you bought stocks the day I was born (which unfortunately my parents did not probably because they had four other young mouths to feed), you would have since made about 240 times your money and that would have included the 38 corrections of 8% or more that occurred along the way.

In summary, despite a far higher level of market nervousness so far this year, we believe stocks continue to be well positioned for total returns in line with earnings growth over the next year, which could prove to be in excess of double digits. So while volatility will likely continue, we believe the equity markets stand to benefit from a favorable earnings environment and an improving economy.

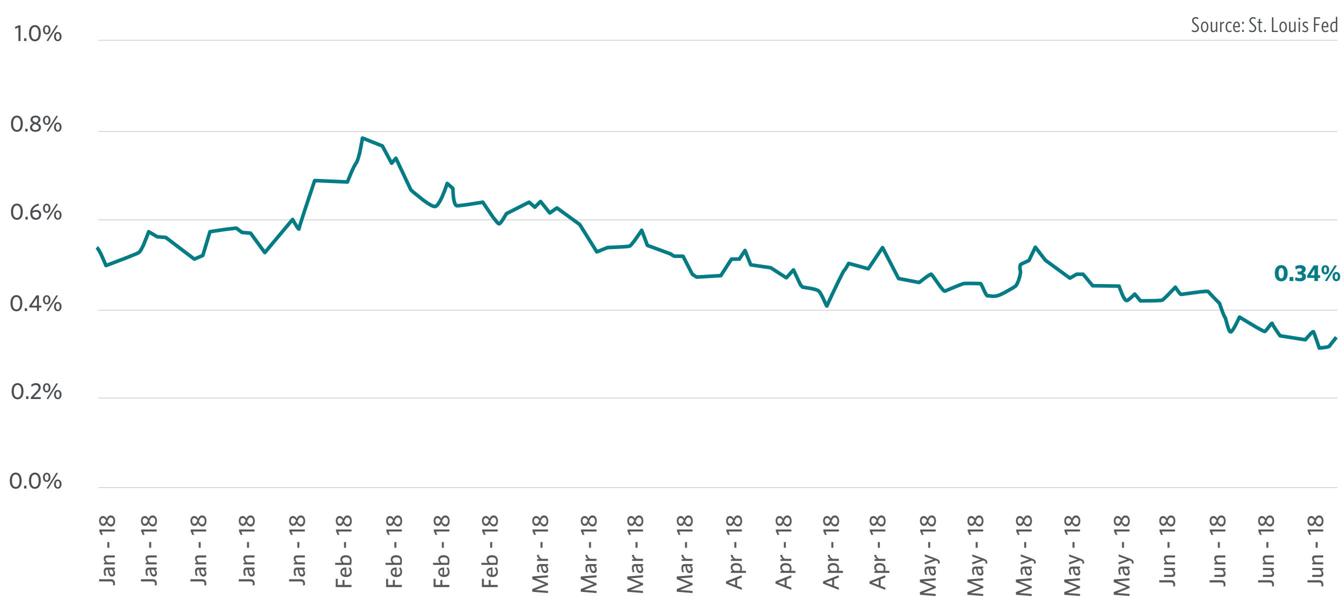
We believe upward pressure will continue for short and long term interest rates in the U.S.

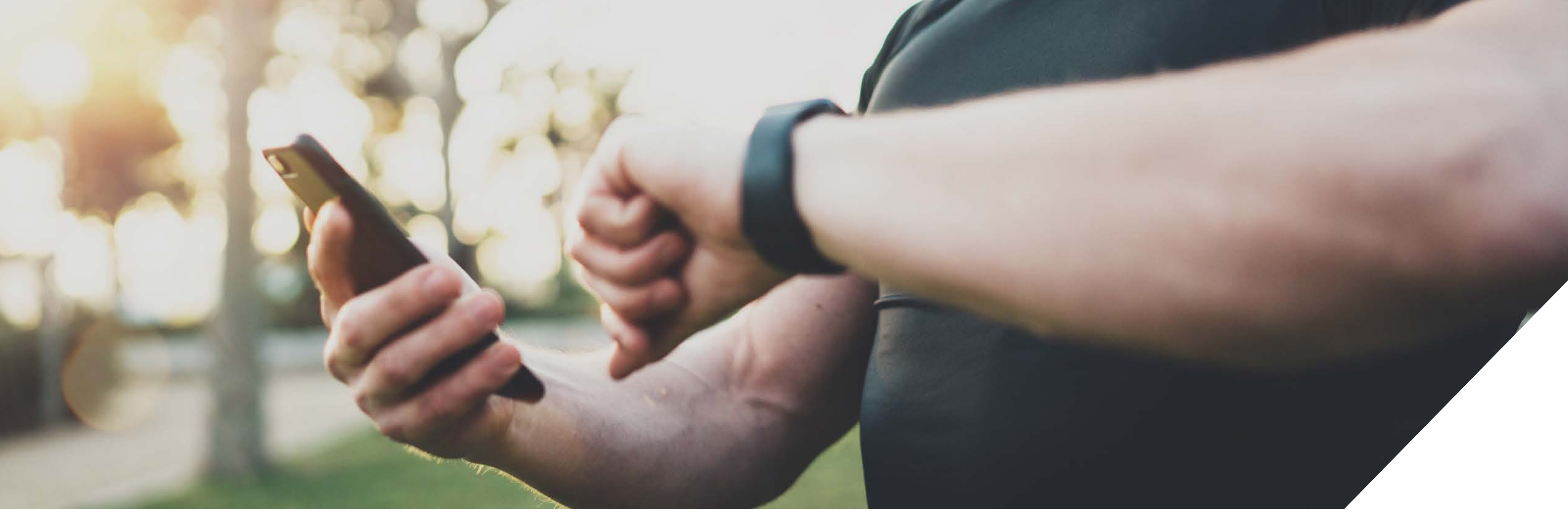
Back in January we expressed our perspective that 2018 would be a year of rising long term interest rates and that the 10-year Treasury Yield could challenge 3%. Now at the midpoint of the year, we have seen those higher rates, as evidenced by the 10-year Treasury Yield's ascent from its beginning-of-the-year level of 2.40% to its 2Q close of 2.86%, which featured a high of 3.11% in mid-May, representing a level it had not experienced since 2011.

Our thesis at the year's outset was based on three primary criteria: 1) A strengthening economy 2) The Federal Reserve's balance sheet reduction program 3) A steepening of the yield curve. In terms of how these criteria have played out so far this year we would quote the famous 1970's recording artist Michael Lee Aday, aka Meat Loaf, who penned "Two out of three ain't bad."

TREASURY YIELD CURVE 10-YEAR YIELD MINUS 2-YEAR YIELD

January 1, 2018 – June 30, 2018

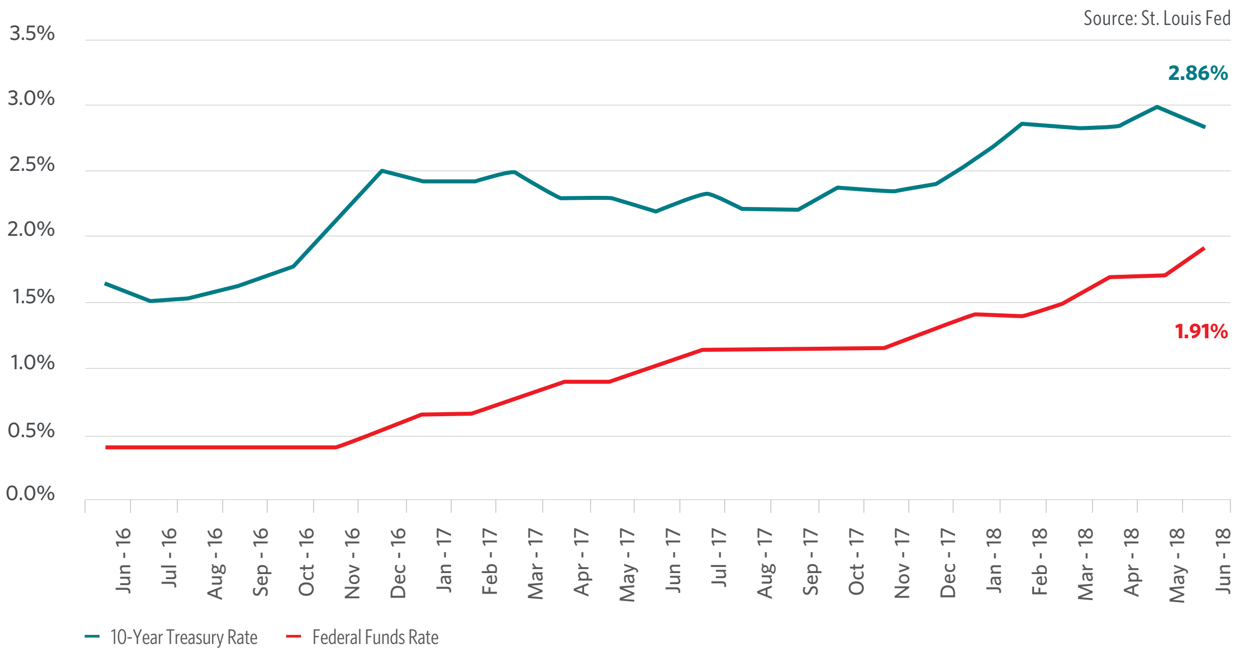




Certainly the economy has strengthened through 1H18 and this has of course played a key role in the Fed's decision to hike the fed funds rate twice, in March and June, to its present target range of 1.75% - 2.00%. Strong employment, business investment, and consumer spending trends combined with the ongoing fiscal stimulus of Tax Reform provided the Fed, in our opinion, with essentially no-brainer decisions to raise rates at the March and June meetings. Barring an unforeseen slowdown, we would expect at least one more hike this year, most likely in either September or December with a strong probability we could see both.

FED FUNDS RATE VS. 10-YEAR U.S. TREASURY YIELD

June 30, 2016 – June 30, 2018



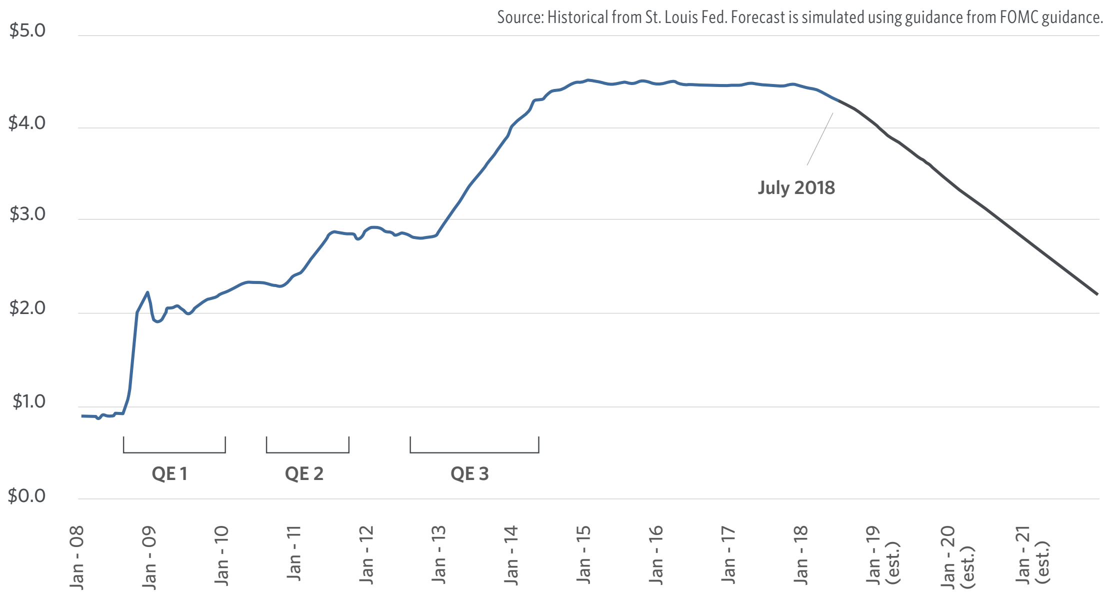
The Federal Reserve's balance sheet reduction or "roll off" continues to roll along with maturing bond principal not being reinvested at a monthly rate of $30 billion. This progression is scheduled to continue up to $50 billion per month by year end, at which point the Fed will likely transition from a net buyer to net liquidator of bonds. Sustained at this monthly level thereafter, the Fed is expected to reduce its overall bond holdings from its present amount of about $4.3 trillion to just over $2 trillion by the end of 2021. As we have stated previously, while there is an argument that the Fed can potentially roll off $2 trillion plus of bonds without pressuring rates higher, it certainly won't be pressuring them lower. Hence this balance sheet reduction is one more dynamic tilting the playing field toward higher long term rates rather than lower ones. That is what has been put in motion this year and is anticipated to remain for the next couple of years.

Which brings us to the yield curve, which amid the strengthening economy has not steepened. In fact, it has continued to flatten. At the year's outset the yield premium between the 10-year Treasury and 2-year Treasury bond yields stood at .51%, which was almost 1.30% below its 10-year average of just under 1.80%. Given the economic conditions, we believed this differential would likely widen in 1H18. However, that is not what we have seen as the spread has further narrowed to .33%.

This continued flattening of the curve may well be the result of major regions such as Europe and Japan maintaining highly accommodative monetary policies. In doing so, they have kept their short term rates negative and 10-year yields abnormally low, as seen in the German 10-year Bund yielding just .30% and the Japanese 10 year at only .03%. When comparing those low overseas rates to the U.S., this could be anchoring the 10-year yield to some degree and therefore preventing a widening of the curve. However, even when taking the international rate environment into account, we continue to believe the yield curve is presently too flat given existing economic conditions and that it will eventually steepen and thus contribute to higher long term rates.

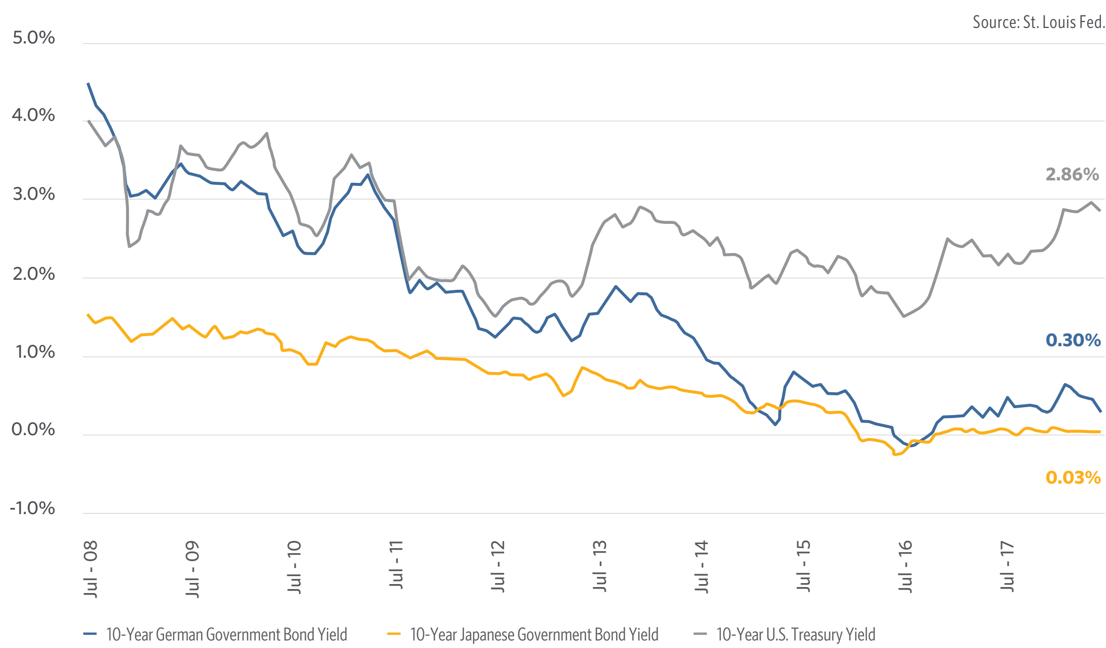
FEDERAL RESERVE BALANCE SHEET AND PLANNED ROLL OFF

January 1, 2008 – December 31, 2021 (est.) ($trillions)



US 10-YEAR YIELD VS. GERMANY AND JAPAN

June 30, 2008 – June 30, 2018



THE FED NORMALIZES ONWARD

In its June meeting, the Federal Reserve raised the fed funds rate by .25% to a target of 1.75% - 2.00%, representing the seventh rate hike we have seen since December 2015. In its statement, the Committee upgraded its view of the overall economy and, in particular, household spending and the labor market. In a post-meeting press conference, which will now follow every meeting, Chairman Jay Powell was more descriptive in stating the view that "the U.S. economy is in great shape" and "strong enough for borrowing costs to rise without choking off economic growth." He also added in referencing the labor market that "most people who want to find jobs are finding them."

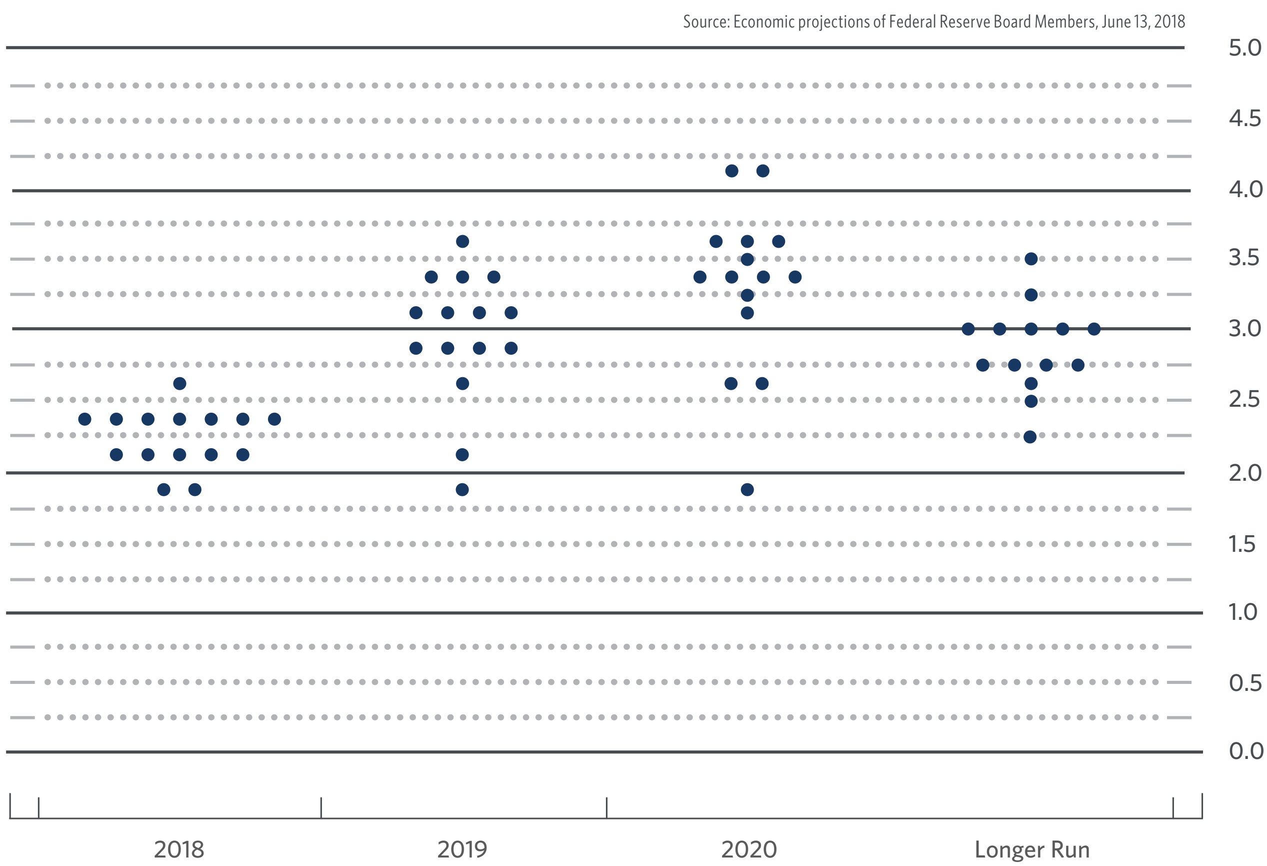
In the statement itself, there were several changes in the language from March, the most notable being the omission of the phrase, "the federal funds rate is likely to remain, for some time, below levels likely to prevail in the longer run." In our opinion this omission can be interpreted as more hawkish in nature and representative of the Fed's willingness to raise rates on a faster schedule. Another conspicuous omission was the famous wording of what history will likely remember as the Janet Yellen data-dependent fed, "However, the actual path of the federal funds rate will be dependent on the economic outlook as informed by incoming data." It now appears that these words may soon be lost to history, which is probably to everyone's benefit.

Along with this rate increase, the Fed relayed guidance through its 15-member survey of expected interest rates, or as it is more widely known, the "Dot Plot," a point in time assessment of where the Committee sees future fed fund levels.

This new plot displayed an upward bias with projected midpoints among the 15 members of about 2.25 – 2.50% for the fed funds rate at the end of 2018, 3.00 – 3.25% by year end 2019 and 3.25 – 3.50% by the end of 2020. On average these midpoints were about 0.25% higher than the previous March survey for the end of 2018 and 2019 and on par with previous expectations for 2020. So this appears as though current Fed thinking tilts toward getting to a neutral rate of 3.00 – 3.25% by 2020, only at a faster trajectory. Based on this new survey, expectations have been set for a total of four rate hikes in 2018, meaning that we would see two more between now and year end, most likely in September and December. However, as the saying goes, "dots were made to be re-plotted," so there is no assurance we will necessarily see this precise pace of rate hikes.

FEDERAL RESERVE POLICY RATE FORECAST ("Dot Plot")

June 13, 2018



Perhaps it is best to take a slightly longer perspective, recognizing the odds favor an additional four or five rate increases between now and the end of 2019 with a probable bias toward sooner rather than later. So if pressed to read a crystal ball or the palm of a Fed Governor, we would probably lean toward two more hikes this year and perhaps three in 2019, assuming of course an unexpected slowdown or higher than anticipated inflation does not ensue.

We previously mentioned that we believe the Fed will likely apply an active but still measured approach to inflation. If this is indeed "symmetrical" in nature as the Fed inferred in the June statement, allowing for some degree of ongoing patience and time above the Committee's 2% inflation target, it is important to note there will still be a directional correlation. So if inflation moves higher over the course of time due to either economic strength or simply a regression to the mean, all else being equal, short term rates will move with it. So even in a world of Fed symmetry, a faster trajectory is still likely unavoidable.

POLICY MOVEMENT IN EUROPE

On the day following the conclusion of the Fed's June meeting, ECB President Mario Draghi announced the scheduled end to the Eurozone's Quantitative Easing policy, which had been in effect since the beginning of 2015. This was no surprise, as since that time the ECB had accumulated approximately 2.4 trillion euros (about $2.8 trillion) of sovereign and corporate bonds on its balance sheet. And with the improvement in the Eurozone economy over the past three years, there was little question in the markets that the ECB would have to begin some rate normalization of its own fairly soon.

However, this did not prevent Mr. Draghi from embarking upon this path with a barrage of baby steps that the market interpreted as dovish versus expectations. Specifically, the wind down of 30 billion euros in monthly asset purchases would not begin until October, at which point it will be reduced to 15 billion and then officially concluded all together by year end. Interest and principal on existing balance sheet holdings will continue to be reinvested and, perhaps of most importance, Mr. Draghi pledged that the ECB's short term deposit rate of -0.40% would stay in effect through at least September of 2019.

So while this measured movement by Mr. Draghi is likely to detract some momentum regarding the rise of longer term rates, the fact that the ECB is at least inching directionally toward higher rates should ultimately add to the levels of international yields.

In assessing the potential path of longer term rates we would begin by recognizing the fed funds rate could reach approximately 3.00 – 3.25% by the end of 2019. Assuming the current spread of approximately .50% between the 2-year bond and the upper target of the fed funds rate, this would infer a 2-year yield of 3.75%. If the 10-year spread were to widen only modestly to perhaps .50% to that 2-year rate, this would infer a 10-year Treasury Yield of about 4.25%. To guard against this scenario or ones similar to it, we would caution fixed income investors to stay in lower duration portfolios.

With interest rates no longer a tailwind, it will be crucial for bond investors to lean toward lower duration portfolios focusing on credit opportunities to achieve total returns.

We believe the underlying fundamentals of the credit markets remain strong and have improved since the year's beginning. In aggregate, bond default rates are declining, interest coverage ratios are rising, and larger cash balances from higher earnings and lower taxes are available to potentially pay down debt. All considered, this is good for most corporations, good for their balance sheets, good for their employees, and good for society.

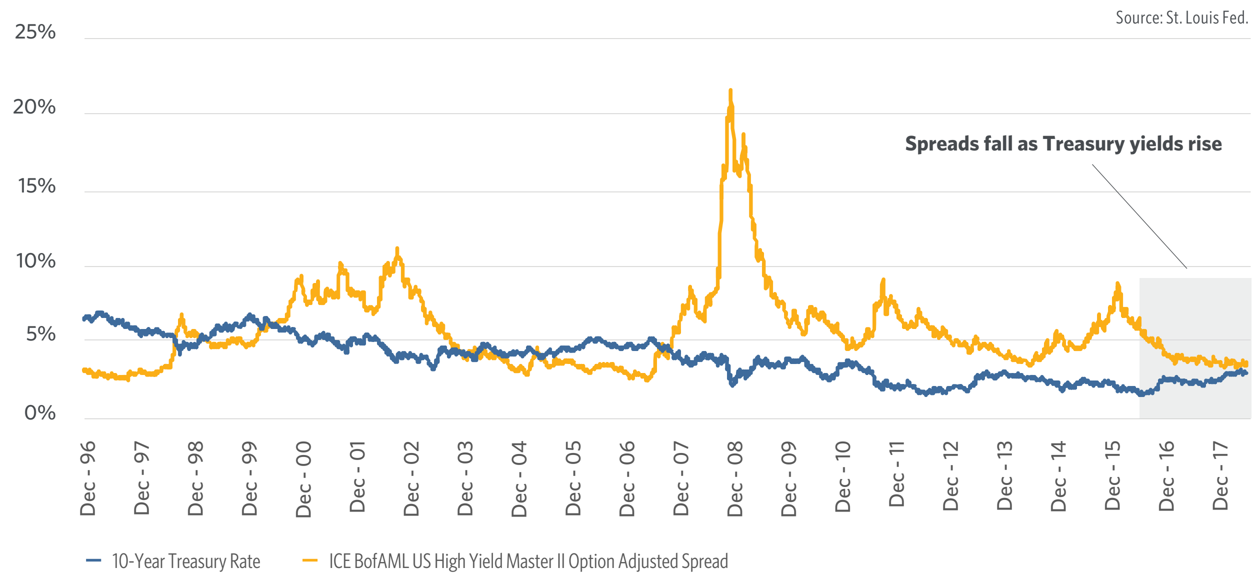
However, it's not necessarily all that great for fixed income investors. This is because current yields and credit spreads reflect these strong conditions and when combined with rising interest rates, this is creating a more challenging environment for bond portfolios to generate total returns in excess of coupon payments.

A look at the past three decades helps to show how unique this environment is at the current time. Since 1987 when high yield bonds first began being measured as an asset class, we have seen rising interest rates and rising credit spreads, falling interest rates and rising spreads, and falling interest rates and falling spreads. But our present state of affairs – rising interest rates and falling spreads – has been quite rare.

So our approach in this environment is a relatively basic one. Bond investors are likely well served by owning lower duration credit oriented portfolios capable of identifying improving situations that will benefit from a stronger economy and corresponding credit catalysts.

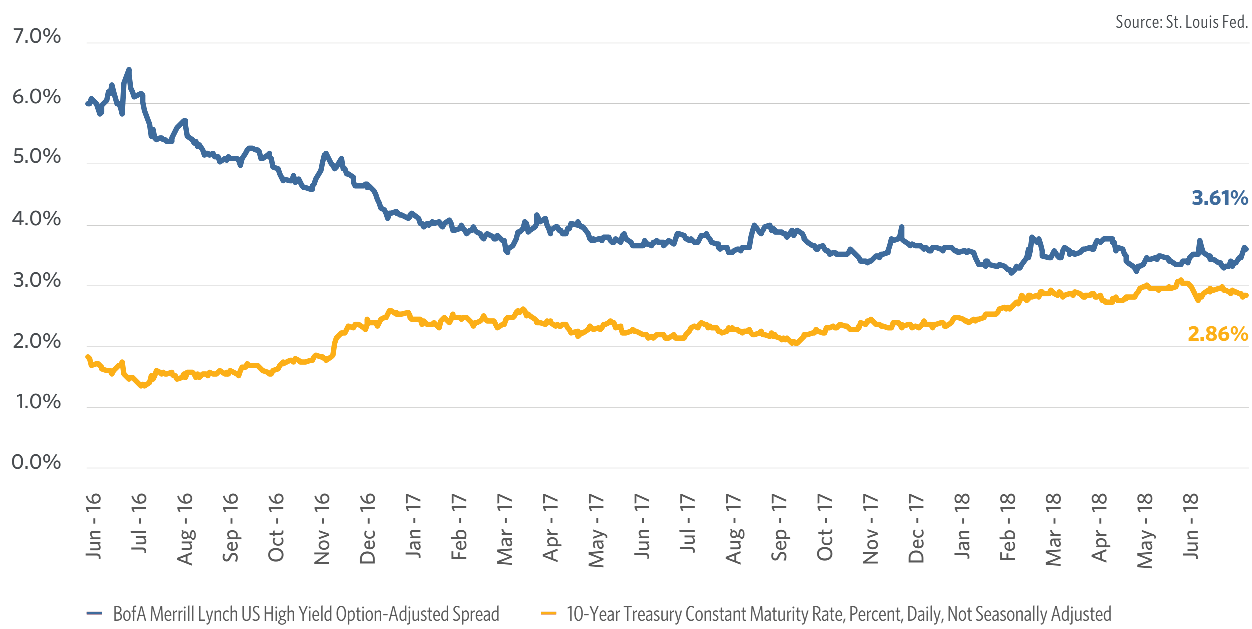
10-YEAR TREASURY YIELD AND HIGH YIELD CREDIT SPREADS

December 31, 1996 – June 30, 2018



10-YEAR TREASURY AND HIGH YIELD CREDIT SPREADS

June 1, 2016 – June 30, 2018

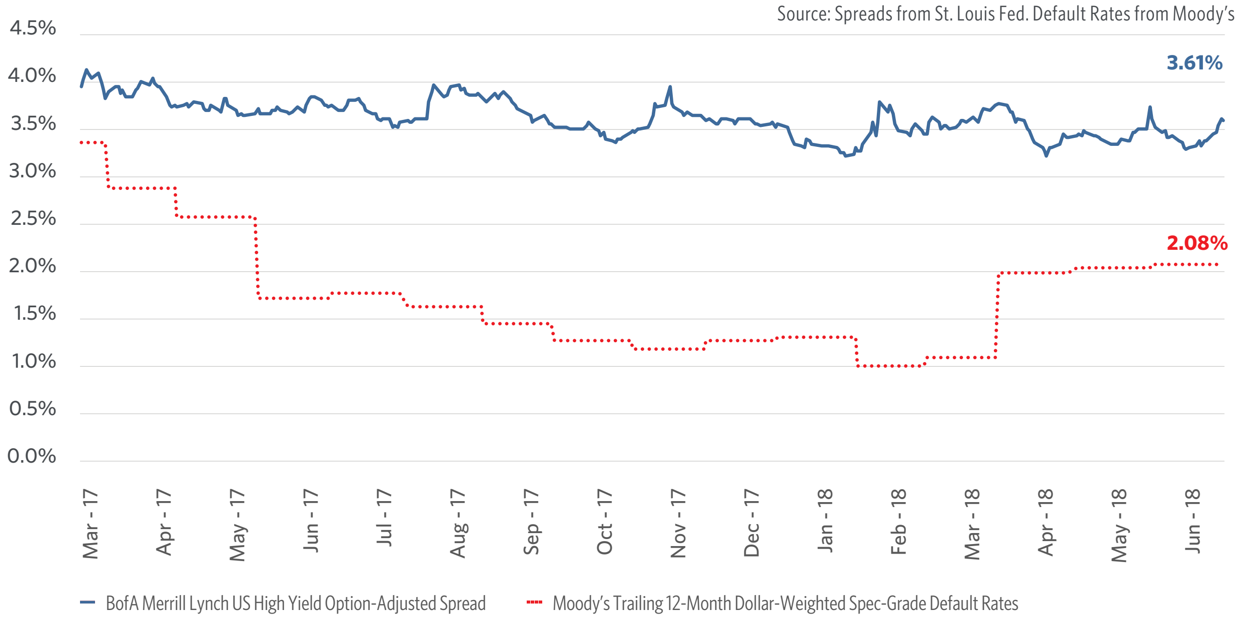


Perhaps the first correlation a bond investor might look toward in this environment is the relationship between default rates and credit spreads. Here we would focus on high yield default trends and the yield differentials between these bonds and comparable maturity Treasury debt.

In doing so the rationality test checks out in our opinion, as default rates for high yield are expected to decline to about 2% by the end of the year, representing their lowest level since before the financial crisis (Moody's Default Rate Research Group). In conjunction with this, high yield credit spreads versus Treasuries (ICE BofAML US High Yield Master II Option-Adjusted Spread) closed out 2Q18 at 3.64% and traded throughout 1H18 between 3.26% – 3.82%, the bottom of this range reflecting their narrowest margins since the summer of 2007. So at first glance, and of course there are many more glances to be considered, this all makes sense.

HIGH YIELD CREDIT SPREADS AND DEFAULT RATES

March 1, 2017 – June 30, 2018



SURVEYING THE RISKS

This is not to say there are not dissenting opinions regarding the ultimate strength of this credit environment, where we are in the cycle, and what could be the risks to its continuance. We feel it is important to look at some of these concerns if for no other reason than the previously referenced low points in default rates and credit spreads occurred, you guessed it, only months before the Armageddon that was 2008, which of course resulted in the highest default rates and credit spreads in a generation. To be clear, we do not see a similar credit downturn, or anything close to it, re-emerging in the foreseeable future. But it does serve as evidence that low default rates and tight credit spreads in and of themselves are not enough to bank stable returns on.

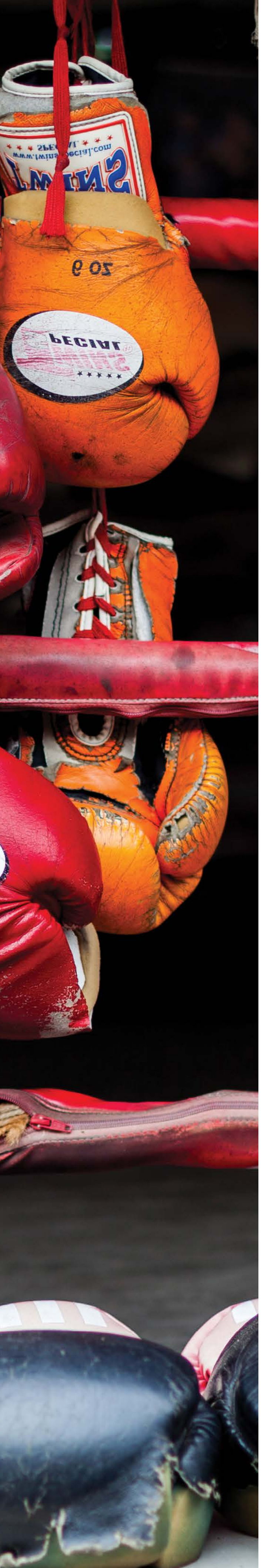
First, there is the debate as to where we currently are in the credit cycle.

This of course is often expressed in the context of a baseball game and the present consensus is that we are somewhere in the sixth or seventh inning, meaning that credit trends look pretty solid for the remainder of 2018 and most of 2019 but will likely hit rough patches starting about 2020. This is based in large part on the broader economic cycle and the recovery that has been in effect since the midpoint of 2009, at least defined by the fact that we have not experienced a recession since then. So when the economy heads south so will credit markets, which historically is a tough argument to take the other side of.

However, we feel there are certain characteristics of the post-2008 recovery that need to be taken into account. Though it has been elongated beyond previous post-recession recoveries, in our opinion it has also been quite muted in its magnitude. With annual GDP growth averaging only slightly above 2% during these past nine years, this overall rate is well below the 1992 – 2000 and 1982 – 1989 post recession recoveries, which averaged GDP growth of 3.9% and 4.5% respectively. Thus with economic growth perhaps just now reaching levels even close to those previous eras, there is a strong case in our opinion that we are closer to middle rather than later innings.

Second, there is the concern that credit spreads and default rates are out of sync with total corporate debt issuance.

This pertains to the notion that as access to credit increases during a favorable cycle, such as the one we are currently experiencing, companies will issue more debt, flooding market supply and becoming overleveraged in the process. This will lead to higher rates and spreads with riskier credit quality, a combination usually leading to a not so happy ending. In regard to current conditions, bond bears like to point to present ratios of aggregate U.S. non-financial corporate debt issuance that has now reached 45% of U.S. nominal GDP (Moody's Analytics, Federal Reserve March 2018). Historically, under previous scenarios when Debt/GDP levels reached the mid-40% threshold, such as in 1990, 2001, and 2009, high yield default rates have spiked and credit spreads have widened. In regard to these three separate years, default rates averaged 10.6%, more than five times higher than current estimates and credit spreads averaged close to 10%, about 6.5% higher than where they closed out 2Q18. No question these numbers are more than a bit harrowing.



When looking at these comparisons though, it is important to consider the cash positions of corporate borrowers and what is referred to as the Net Corporate Debt-to-GDP ratio (Corporate debt less corporate cash/GDP). Over the past year we have seen record corporate earnings with the highest year-over-year growth rates since 2010 and, in conjunction with lower corporate tax rates and the ability to repatriate overseas profits back to American shores, this has resulted in larger cash balances for most companies. When netting out that cash and other liquid financial assets from existing Corporate Debt/GDP ratios, the current level declines to only 33%, which is right in line with the long term average of this ratio dating back to 1986 and corresponding historically with default rates closer to the low single digits. Hence, we believe the risk of over issuance in the corporate bond markets and excessive corporate leverage is far more benign than it may first appear.

Refinancing risk has also been cited as a concern as approximately $4 trillion of corporate debt will be reaching maturity between now and the end of 2020.

This accounts for slightly less than half of the overall corporate market and has therefore elicited some angst regarding the potential impact to the markets in the event companies must refinance at future higher rates. This is a legitimate concern and one worthy of close monitoring as the bulk of this so called "maturity wall" is scheduled to occur in the year 2020. Should rates spike and spreads widen this could result in some problems for issuers and investors.

This is, however, not the first time the corporate debt market has approached heavy refinancing schedules. The most recent of which was 2014 and bond issuers weathered that one pretty well. Though it may sound counterintuitive, the history of most corporate borrowers is to refinance months or even years prior to maturity as market conditions appear advantageous to do so and to avoid the "point in time" risk associated with a particular date in the future. So we would look for corporations to be calling debt between now and the 2020 time frame.

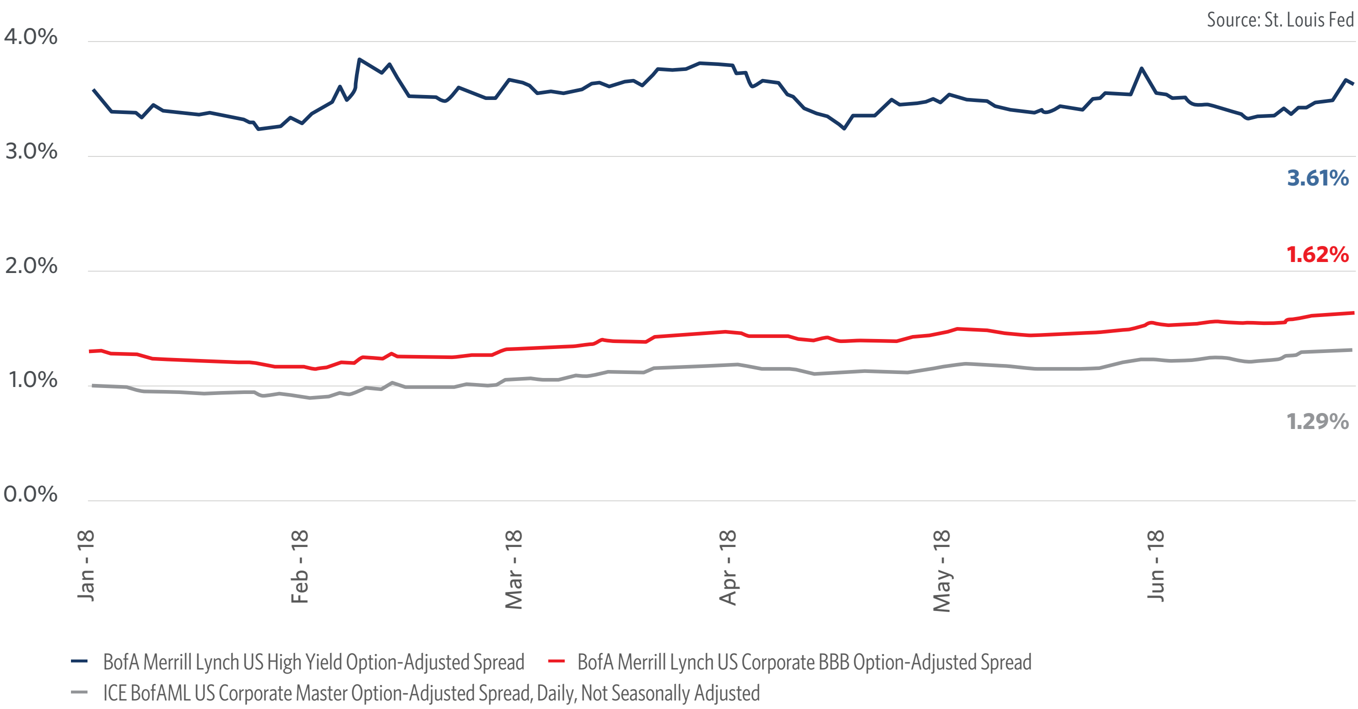
In addition, about ¾ of this $4 trillion pertains to higher quality investment grade bonds that under current and anticipated conditions would likely have little difficulty refinancing given the desire for most bond investors to lock in competitive yields even taking into account a higher rate environment. There is also a decent probability that going into this refinancing calendar more corporations deleverage and pay down debt applying a combination of excess earnings and cash generated from tax savings or repatriated funds from overseas. Nonetheless, we would categorize this as likely the most important risk worth watching in the credit markets over the next couple of years.

INVESTMENT GRADE VERSUS HIGH YIELD

A divergence in credit spreads between high yield and investment grade bonds seemed to emerge during the latter months of 1H18 and while it may wind up being a short term aberration that reconciles itself, we believe it warrants attention through the second half of the year. Specifically, beginning in the final days of March, both the wider investment grade universe (ICE BofAML US Corporate Option-Adjusted Spread) and BBB investment grade bonds (ICE BofAML US Corporate BBB Option-Adjusted Spread) saw their spreads to comparable maturity Treasuries expand by 14 and 18 basis points (from 1.16% - 1.30% on Investment Grade and 1.44% to 1.62% on BBB), while High Yield Bonds (ICE BofAML US High Yield Master II Option-Adjusted Spread) actually declined by about 15 basis points from 3.79% to 3.64%. So the market in these final months of 2Q was expressing a definitive preference toward high yield versus investment grade.

HIGH YIELD VS. INVESTMENT GRADE CREDIT SPREADS

January 1, 2018 – June 30, 2018



We would view this as both a definitive vote of confidence in the U.S. economy by the credit markets regarding the second half of 2018. Also of interest here is that the total market value of "Fallen Angel" bonds, those issues downgraded at earlier points in time from Investment Grade to High Yield (BofAML Global Fallen Angel Index), has declined by almost 30% over the past two years (from $476 to $343 billion) as upgrades within this group have caused the index to lose constituents. More anecdotal evidence in our opinion that the current credit environment remains solid and capable of benefitting alongside the economy.

ICE BOFA MERRILL LYNCH GLOBAL FALLEN ANGELS INDEX

May 2008 – May 2018

THE PATH FORWARD

So the challenge remains as to how bond investors can achieve competitive returns in this new environment of rising rates and tight credit spreads. In addressing this, we believe it is vital to recognize that for about 37 years, since the summer of 1981 when the 10-year Treasury Yield hit 15.75%, declining interest rates have been on the side of fixed income investors and most likely this will no longer be the case for some time. Therefore, if such declining rates will no longer be at the backs of fixed income investors, then those investors will need to find expert credit oriented managers and strategies that can be.

In our opinion this also means there has probably never in the lifetimes of most investors been a more important time for active fixed income management, as passive index strategies are less likely to benefit from the opportunities of current credit markets. So we believe investors should strongly consider lower duration portfolios with the active expertise capable of identifying stable or improving opportunities. This could include high yield, floating rate, and core plus strategies.

We believe the overall outlook for global growth remains favorable and, despite a first quarter slowdown in Europe and Japan, international developed and emerging market equities are positioned well for long term investors.

At the year's outset we described the favorable environment for international equities that was predicated in large part on synchronized global growth, or what can also be thought of as the historically atypical alignment of the economic stars, in which pretty much all regions of the world are growing simultaneously. Under this scenario, global economic growth could potentially last longer because it is better diversified and is at a lower risk of an immediate slowdown since it is less dependent on any one or small group of countries.

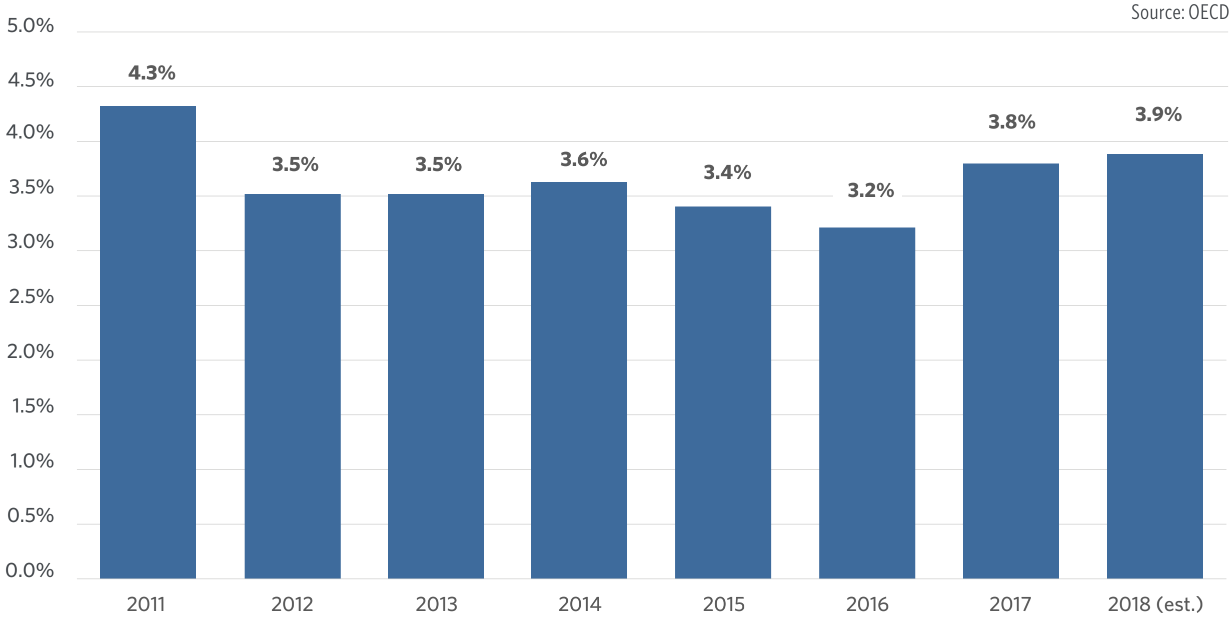
At the year's midpoint we believe the underpinnings of strong and diversified global growth remain in place, though certain events of the past six months have shaken some of the market's confidence in the synchronized global growth concept. At the forefront of these was a first quarter soft patch, mostly attributable to Europe and Japan, and ongoing concerns of international trade wars, fading accommodation from global central banks, a rising U.S. dollar, and the aftermath of higher market volatility. I guess no one ever said synchronized global growth would be easy.

Before turning to some of these newly defined risks now being so widely discussed on the international landscape, let's first take a look at what remains intact and in our opinion are still ongoing catalysts as to why global growth in the year or two ahead should still provide a strong case for international developed and emerging market equities.

Growth estimates remain on the upswing. Since the year's beginning both the International Monetary Fund (IMF) and the Organization of Economic Co-operation and Development (OECD) have upgraded their estimates for 2018 global growth to 3.9%, which if achieved would represent the highest pace since 2011. The IMF also upgraded the forecasts of the two largest economies, the U.S. from 2.7% to 2.9% and China from 6.5% to 6.6%. In the case of the U.S., the world's largest economy, we believe this estimate could still prove conservative.

GLOBAL GDP GROWTH

2011 – 2018 (est.)



Worldwide employment is also displaying historically high levels. This is not only evidenced in the U.S., where the OECD is forecasting a continued decline in unemployment from 3.8% to 3.6% in 2019, but also in Europe, where the current rate of 8.5% is the lowest in 10 years, and in Japan, where it's 2.5% rate is the best it's been since the early 1990's. In all three of these regions the Labor Force Participation Rate, defined as those people either employed or actively seeking employment, has also been rising, which serves to show that not only is unemployment low in these regions but the absolute pace of job creation is increasing.

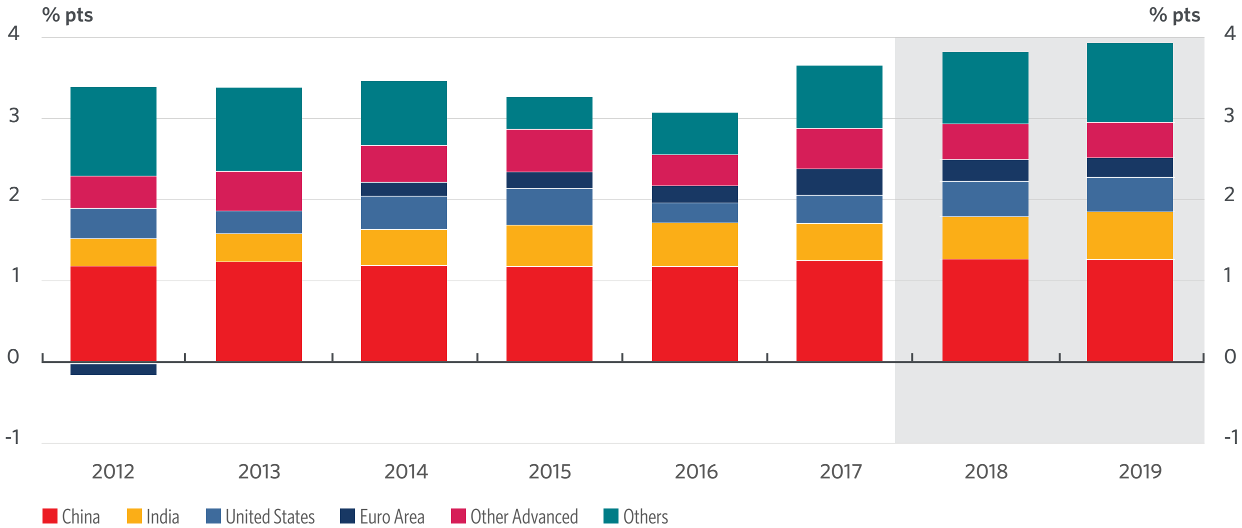
Global wages are rising. After barely keeping pace since 2007, global wages are currently running a full percent above inflation. While at first blush this may not sound like a great accomplishment, given the deflationary forces regions such as Europe and Japan have battled over the past decade, we believe this trend to be meaningful.

Growth in global trade has also been accelerating. Defined as the exchange of goods, services and capital across national borders, global trade has shown sharp increases in growth over the past two years, rising from less than 3% annual growth in 2016 to 5% in 2017 with estimates closely matching that level through 2019. Prior to the international trade concerns that have emerged over the past few months, this trend was viewed as one of the most encouraging of all global growth components.

GLOBAL GDP GROWTH: CONTRIBUTION BY REGION

January 1, 2018 – June 30, 2018

Source: OECD Economic Outlook database.



Despite these favorable developments, international equity markets for the most part have exhibited stagnant to negative returns through the midpoint of 2018 and this is mainly due to new concerns that have emerged over the past several months. These would include:

A first quarter soft patch in growth within Europe and Japan. In Europe, GDP growth was 0.4% for 1Q18 (2.5% year-over-year) as industrial production and manufacturing declined in absolute terms. Japan's economy contracted for the first time in two years with a quarterly GDP decline of 0.2% and year-over-year fall of 0.6%, mostly due to a decline in consumer spending, despite rising household incomes. We believe there remains a good probability the slowdowns in these two regions could prove transitory.

Fears of trade wars. The growing concerns of trade wars that have been a source of angst regarding U.S. stocks can only be magnified when it comes to the international markets. This is because there is of course so many more players and so much of the overall expected growth is dependent upon open markets across borders. This concern, above all others in our opinion, has put future global growth estimates at risk in the eyes of some investors. To reiterate our perspective, we don't believe the current numbers on recently or potentially implemented tariffs are capable of measurably impacting global growth forecasts at this time. For that to occur a large degree of escalation will be necessary, particularly in light of the fact that the current tariffs, in their entirety, only amount to approximately 0.6% (six-tenths of 1%) of the world economy. Nonetheless, given the fact that escalation can happen quickly and the fear of trade wars can impact consumer behavior, this is a risk to keep a watchful eye on.

Rising interest rates and reduced accommodation at central banks. This pertains to the perceived risk that the global economy has been too dependent on monetary policies in recent years. This is perhaps best evidenced by the ECB and BOJ, which for the past three years have not only maintained negative short term rates but provided trillions in euros and yen to purchase sovereign and corporate bonds as part of their Quantitative Easing (QE) programs. Mr. Draghi announced in mid-June the ECB would be closing out its QE by year end and there is speculation that in Japan closed-door meetings are in effect discussing the same prospect. Here we would simply say that historically anomalous monetary accommodation, such as we have seen in Europe and Japan for the past few years, will need to begin a path of reversal at some point and 4% global growth is probably as good a time to start as any.

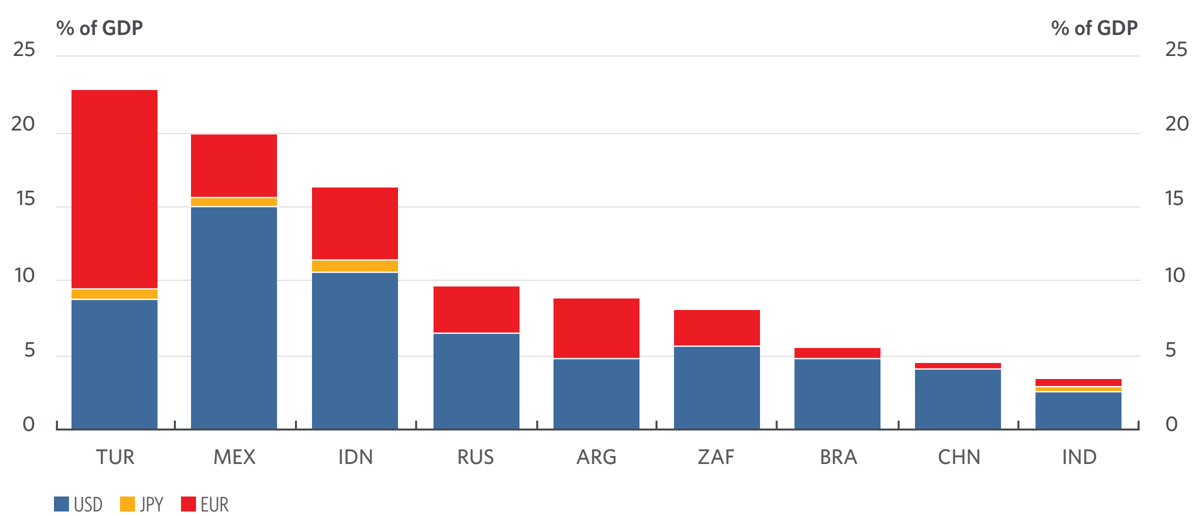
The sharp rise in the dollar. As a result of the recent and anticipated growth in the U.S. economy, as well as the fact that the Fed has been raising rates while other central banks remain hesitant to do so, the U.S. dollar (USD) has seen an increase of 7% since February versus a basket index of developed nation currencies (DXY). The implications of this rise include the many nations whose debt is denominated is USD and therefore could see increases in their borrowing costs. This could affect emerging markets, as nations such as China and India maintain the great bulk of their debt in dollar-denominated loans or securities. In addition, a stronger USD has typically resulted in capital flowing out of emerging markets and negatively impacts the value of local currencies.

TRADE WEIGHTED U.S. DOLLAR INDEX

January 1, 2018 – June 30, 2018

EMERGING MARKETS ECONOMIES: DEBT IN FOREIGN CURRENCY

As of Q4 2017



Note: Debt of non-bank borrowers in the form of bank loans and debt securities domintaed in foreign currencies. Data as of 2017 Q4

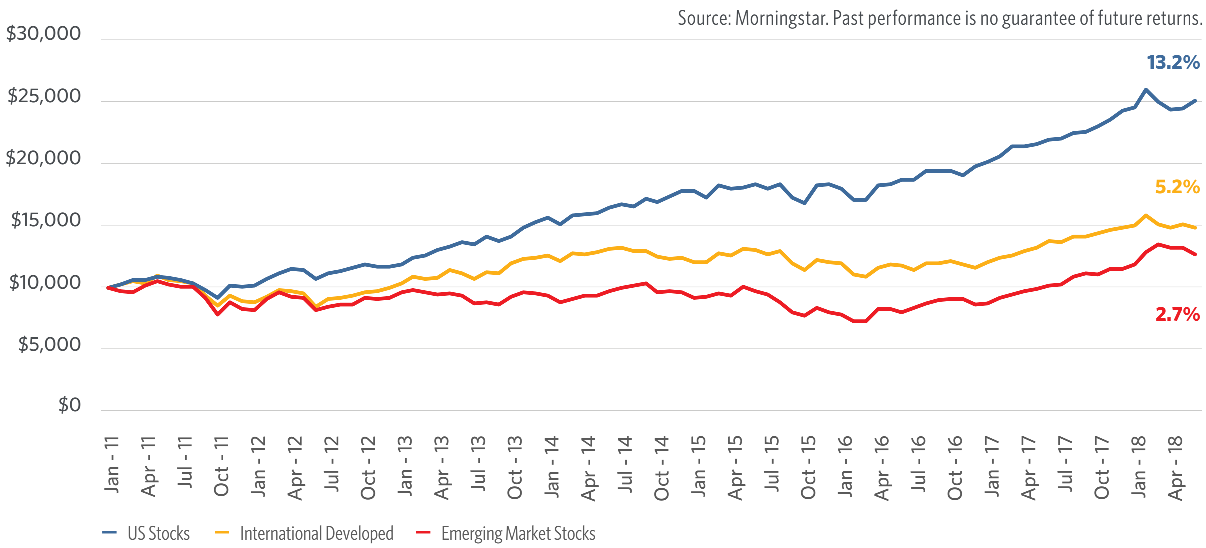
Source: Bank for International Settlements Global Liquidity Indicators database; and OECD calculations.

The correction in emerging market stocks. Since late January, emerging market stocks have declined approximately 17% (MSCI Emerging Markets Index) and this has served as a painful reminder of how volatile this area of international investing can be when certain risks are perceived to be elevated. That having been said, we continue to believe emerging market equities are well positioned longer term based on their premium growth rates, ability to benefit from overall global expansion and the reversion toward U.S. and other developed market stocks that is likely, given the re-acceleration in growth for most emerging market regions over the past couple of years.

Perhaps the international equity markets, more so than any others, presently embody the quandary of sorting out the fears versus fundamentals. In our opinion the foundation of global growth opportunities, though shaken a bit in recent months, remain in place and the risks are less likely to play out in the magnitude many might fear. Hence, we continue to favor long term portfolio positions in both international developed and emerging market equities.

GLOBAL MARKET INVESTMENT PERFORMANCE

January 1, 2011 – June 30, 2018



While we believe the current environment continues on balance to favor equity and credit investors, the markets are not without risks for the remainder of 2018 and beyond. Our short list of these would include international trade, growth in Europe and Japan, central bank divergence, political uncertainty in the U.S., and rising federal deficits.

International Trade – This has in our opinion created more volatility than any other factor so far in 2018 as the fear of a possible trade war between the U.S. and various other nations has sparked angst and concern throughout the markets. At the current time, we would view this risk as one of a trade distraction that could evolve into a trade disruption but a far distance from a full fledge trade war. While we don't view this risk as presently impacting economic growth in the U.S. or globally, sensitivities are high and events can change quickly.

Europe and Japan – As we mentioned earlier we believe global growth is still positioned well for the remainder of the year and into 2019, however it will be important to monitor Europe and Japan, both of which incurred first quarter aberrations in recent momentum. In addition to these two regions, how the emerging market economies weather the stronger dollar and overall concerns of tariffs and their perceived trade impacts will also be of importance.

Return to Volatility – As we cited at the beginning of the year, heightened volatility and a stock market correction would likely be in the cards this year and that is what we have experienced. The good news is the correction is behind us. The not-so-good news is that we believe higher levels of equity volatility will likely be the norm looking forward and market corrections of the 10% variety will probably occur closer to their historical frequency of about once every year and a half.

Divergence between the Fed and other central banks – While the Federal Reserve has clearly embarked upon the path to normalize monetary policy and raise short term interest rates, some central banks in other regions of the world still appear slow to take a similar course. As rates continue to rise in the U.S. while those in Europe and Japan remain negative, this could lead to currency volatility and unhealthy disparity of long term rates throughout the world. This will be an important risk to monitor regarding the international markets.

Higher oil prices and energy costs – The price of oil has risen materially over the past year as West Texas Intermediate (WTI) Crude has jumped from $43 to its 2Q18 close of $74. This level will need to be watched closely to determine if it might further impact inflation trends or create headwinds for consumer spending.

Rising Federal Deficits – As we mentioned back in January, the estimated implementation of Tax Reform could add up to $1.5 trillion to the federal government's budget deficit over the next decade. Therefore it will be imperative that stronger economic growth ensues as a result of this stimulus.

Geo-political developments – While overall circumstances with North Korea seem to have mitigated to some extent in recent months and the June summit between President Trump and Kim Jong-un may wind up yielding progress toward stabilizing future nuclear threats, any revisited concerns of confrontation could certainly create more market volatility.

Dysfunction in Washington – With midterm elections slated for November and disunity between Democrats and Republicans at a generational high, there will likely be no limit to the hostile political rhetoric we will witness in the months ahead. While this usually has a benign impact on the markets, rising and astronomically high animosity between the parties could create a level of dysfunction negatively impacting the markets.

As we said back in January, this year would likely be one in which Old Man Markets would be throwing and landing more punches than he did last year, and that is certainly proving to be the case. With that said, we continue to like the overall market environment heading into the second half of the year and, as we stated at the year's outset, believe there is still more working for investors than against them.

PORTFOLIO POSITIONING

We favor stocks over bonds in asset allocation portfolios as we believe equities will continue to offer more upside potential and better risk-adjusted returns in the year ahead. U.S. stocks are well positioned for potential double-digit total returns in the year ahead based on strong earnings growth at reasonable valuations and a tailwind from the broader economy.

Within U.S. equities, we would diversify between growth and value. This is in recognition of the growth-oriented catalysts that should remain in place through the end of 2018 as the U.S. economy and corporate earnings growth remains strong. However, with continued relative outperformance of growth versus value, we could see value-favored rotation in 2019.

In the bond markets, we would caution to remain short on the curve, as the risk of rising interest rates is likely to continue in the year ahead based on a strengthening economy, yield curve steepening, the Federal Reserve's balance sheet reduction program, and a gradual pace toward normalization of monetary policies in other regions of the world. Unless the yield curve inverts, which we do not believe is likely to occur, we expect both short and long term rates will move meaningfully higher between now and the end of 2019.

We believe fixed income investors could also strongly consider actively managed lower-duration portfolios with the credit expertise capable of identifying stable or improving opportunities. Passive index strategies are less likely to benefit from the opportunities within current credit markets. If declining rates will no longer be at the backs of fixed income investors, then those investors will need to find expert credit-oriented managers and strategies to pursue above-coupon returns.

Despite fits and starts so far this year in the international equity markets and the fears of trade wars, we continue to believe that investors can still benefit long term from allocations to developed and emerging markets. This is based on what we believe could still be a strong case for global growth in the year ahead.

IMPORTANT INFORMATION

Investments are subject to market risk, including the loss of principal. Asset classes or investment strategies described may not be suitable for all investors. Past performance does not guarantee future results.

Fixed income investing is subject to credit rate risk, interest rate risk, and inflation risk. Credit risk is the risk that the issuer of a bond won't meet their payments. Inflation risk is the risk that inflation could outpace a bond's interest income. Interest rate risk is the risk that fluctuations in interest rates will affect the price of a bond. Investing in floating rate loans may be subject to greater volatility and increased risks.

Equities are subject to market risk meaning that stock prices in general may decline over short or extended periods of time.

Investments in global/international markets involve risks not associated with U.S. markets, such as currency fluctuations, adverse social and political developments, and the relatively small size and lesser liquidity of some markets. These risks may be greater in emerging markets.

Alternative investment strategies may include long/short and market neutral strategies; bear market strategies, tactical strategies (such as debt and/or equity: foreign currency trading strategies, global real estate securities, commodities, and other non-traditional investments).

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