January 2018

2018 Global Asset Allocation Review

Introduction

The Aureus annual asset allocation review evaluates the risks and opportunities available in global financial markets and their potential impact on the investment portfolios of our clients. Our Asset Allocation Policy describes our positioning for the coming year, but may be adjusted as market conditions evolve.

Beyond this annual perspective on global allocation, Aureus also develops a customized investment policy for each client based on their specific goals and objectives.

Summary

The Aureus 2018 global asset allocation review combines critical interpretations of global market factors with a focus on the following:

2018 Analysis			
Market Factors	▪ US Economy ▪ Global Economy ▪ Corporate Profitability ▪ Interest Rates & Inflation ▪ Geopolitics	**Asset Classes**	▪ Cash ▪ Fixed Income ▪ US Equities ▪ International Equities ▪ Alternative Assets

Based on our analysis, we design a 'base case' positioning with four principal asset categories: Cash, Fixed Income, Global Equities, and Alternatives. In turn, equities are further divided into US and International groups, while fixed income is subdivided by quality, and alternatives by directional and absolute return strategies.

Our 2018 asset allocation has relatively modest changes versus 2017, but continues to demonstrate our preference for equities over fixed income, while also moving incrementally more positive on global markets and alternatives.

2018 Asset Allocation Summary

Asset Class	Risk Level	2018 Allocation	Δ vs. 2017	2017 Allocation	2016 Allocation	2015 Allocation
Cash	Low	**5%**	=	**5%**	**4%**	**4%**
Fixed Income		**10%**	↓	**13%**	**14%**	**12%**
High Quality Bonds	Moderate	10%	=	10%	11%	12%
High Yield Bonds	High	0%	↓	3%	3%	0%
Global Equities		**64%**	=	**64%**	**60%**	**58%**
US Equities	High	44%	↓	46%	42%	42%
International Equities	High	20%	↑	18%	18%	16%
Alternatives		**21%**	↑	**18%**	**22%**	**26%**
Directional Strategies	High	9%	↑	8%	12%	12%
Absolute Return	Lower	12%	↑	10%	10%	14%
Total		**100%**		**100%**	**100%**	**100%**

2018 Asset Class Commentary

This year's asset allocation reflects the following adjustments compared to 2017.

Cash: We are maintaining our cash allocation of 5% for 2018. Over the last year, the returns on 6-month Treasury bills have moved from 0.6% to their present level of 1.5%. This is in-line with the four Fed rate increases of 0.25% over the last 13 months. Current expectations are for three additional increases in 2018. We believe that cash could yield between 1.0% to 1.5% this year, which is the highest rate since 2008. Cash provides important protection against market downturns as well as a source of liquid reserves for taking advantage of better price opportunities.

Fixed Income: Although interest rates have moved higher, we are reducing our fixed income allocation from 13% to 10% because the expected returns are less attractive relative to other asset classes. The entire reduction comes from the high yield allocation, which performed well in 2017 and is now fully valued.

Despite the Fed increases to short-term rates, at 2.4% the 10-year US Treasury yield is essentially unchanged from one year ago, having traded between 2.0% and 2.6% during 2017. Last year's allocation piece expressed the opinion that we had seen the lows for the 10-year in July 2016 at 1.36%, which so far has proven correct. Conversely, we had anticipated a rise in the 10-year yield in 2017, which failed to occur. While the US economy continued to expand with GDP growth accelerating above 3% in both Q2 and Q3, inflation remained muted around the 2% level, which kept interest rates in check. In 2018, tax reform will help corporate earnings but could also raise deficit concerns over time.

Global Equities: We are maintaining our 64% allocation to global equities for 2018. However, we are moving the international allocation from 18% to 20% and slightly reducing the US allocation from 46% to 44%. International markets sell for lower earnings multiples than the US and the recovery of international economies has lagged the US. We are more optimistic about the prospects for global GDP growth in 2018 and believe this, combined with valuations, has increased the relative attractiveness of international equities.

The S&P 500 rose 22% in 2017 and has produced an annualized return of 11.4% and 15.8% over the past three and five years, respectively. Improving economic growth, low interest rates, strong earnings growth, and rising profit margins provided support to the domestic market in 2017. We believe that corporate earnings growth will remain strong in 2018 due to the combination of healthy economic growth and tax reform. Our current forecast is for another positive year for US equities, with returns in the mid- to high-single digits. The US market had only one minor 2% correction in 2017 and it has been almost two years since we experienced a 10% correction (January 2016). While we would not be surprised to see a market correction in 2018, based on the factors above, we still think the backdrop for US equities remains attractive.

International equity markets rebounded in 2017 after many years of poor relative performance. For the first time since 2007 most international economies delivered positive GDP growth in 2017. This, combined with a recovery in many commodity markets, helped drive developed markets up 25%, with emerging markets up an even more impressive 37%. We expect international economic growth to continue in 2018.

Alternative Assets: We are moving our allocation to directional strategies from 8% to 9% and absolute return strategies from 10% to 12%. There are three attributes that we believe increase the relative appeal of these alternative strategies in 2018: (1) expectations that interest rates are unlikely to move lower and could move higher (relative negative for fixed income); (2) global equity market valuation multiples are elevated vs. historical averages, with returns more likely to come from earnings growth than multiple expansion; and, (3) market volatility was abnormally low in 2017, setting new records, and we believe it is likely to move higher in 2018 (positive for many alternative strategies).

2017 – Year in Review

The S&P 500's outperformance streak versus international markets came to an end in 2017, with both developed and emerging equity markets outperforming the US, and emerging markets leading all major asset classes. Emerging markets rose 37% with developed markets up 25%. Synchronized global growth, stabilizing oil prices, and a weaker dollar provided an improved backdrop for overseas markets. Among the strongest emerging markets, were China, South Korea, and India. Europe and Japan also benefitted from improving global growth.

US Equities also had an excellent year with a 22% return for 2017, the ninth consecutive year of positive returns. Growth stocks outpaced value stocks, the reverse of 2016. Sector leadership also reversed compared to 2016 with higher-growth sectors (e.g. Information Technology, Consumer Discretionary, and Health Care) providing some of the strongest returns. The Energy and Telecommunications sectors, which led returns in 2016, were materially behind the broader market.

Intermediate US bonds returned 2.3%, as the yield curve noticeably flattened during 2017. Short rates (1 year) moved from 0.9% to 1.8% while longer rates (10 year) were essentially unchanged at 2.4% over the last 12 months. High-yield bonds followed up a strong 2016 with a 7.5% return in 2017 driven by the compression of credit spreads to just 3.5% over Treasuries, the lowest level in 3 years.

The alternative asset class returns were in line with expectations. Higher risk directional strategies had a better year in 2017, but did not keep pace with global equity markets given their lower net market exposure. Lower risk absolute return strategies performed as expected and outpaced bond market returns. Commodity returns were positive at 6% and benefitted from improving energy market dynamics. Gold also had a positive year up 13%.

Investment Return Summary

Asset Class/Index	Asset	Calendar Year 2017	2016	2015	2014	2013	Annualized 3 Year	5 Year	10 Year
Cash									
BofA ML U.S. Treasury Bills	Treasury Bills	0.8	0.4	0.1	0.1	0.1	*0.4*	*0.3*	*0.5*
Fixed Income									
Barclays US Aggregate	US Fixed Income	3.5	2.7	0.6	6.0	-2.0	*2.2*	*2.1*	*4.0*
Barclays US Intermediate Agg.	US Fixed Income	2.3	2.0	1.2	4.1	-1.0	*1.8*	*1.7*	*3.5*
BofA ML High Yield	US High Yield Bonds	7.5	17.5	-4.6	2.5	7.4	*6.4*	*5.8*	*7.9*
Global Equities									
S&P 500	US Large Cap	21.8	12.0	1.4	13.7	32.4	*11.4*	*15.8*	*8.5*
Russell 2000	US Small Cap	14.7	21.3	-4.4	4.9	38.8	*10.0*	*14.1*	*8.7*
MSCI EAFE	Developed International	25.0	1.0	-0.8	-4.9	22.8	*7.8*	*7.9*	*1.9*
MSCI EMF	Emerging International	37.3	11.2	-14.9	-2.2	-2.6	*9.1*	*4.4*	*1.7*
Alternatives									
HFRI Equity Hedge	Equity Hedge Funds	13.2	5.5	-1.0	1.8	14.3	*5.7*	*6.6*	*3.2*
HFRI Fund of Funds Composite	Hedge Funds	7.7	0.5	-0.3	3.4	9.0	*2.6*	*4.0*	*1.1*
S&P GSCI	Commodities	5.8	11.4	-32.9	-33.1	-1.2	*-7.5*	*-12.2*	*-10.2*
S&P GSCI Gold	Gold	12.8	7.8	-10.9	-1.8	-28.7	*2.7*	*-5.4*	*3.8*
Inflation									
CPI-U (Less Food and Energy)	Inflation	1.7	2.2	2.1	1.6	1.7	*2.0*	*1.9*	*1.8*

Best performing   Worst performing

2018 Model Factors

Model Factor 1 - Fundamentals

Key considerations include economic prospects, inflation expectations, and the corporate earnings outlook.

Economic Overview

Tax Reform

In late December 2017, the government passed a major US tax overhaul. The key change was a cut in the stated corporate tax rate to 21% from 35%. While many US companies with foreign operations had found ways of reducing taxes to an effective rate in the mid-20s, most domestically-focused companies paid closer to the former 35% rate. In addition, corporations will pay a one-time tax of up to 15.5% on earnings from foreign operations not previously taxed in the US. After paying this tax, any portion of these foreign earnings held in cash can be repatriated back to the US. Many multi-national companies will take advantage of this provision and certain industries such as information technology and pharmaceuticals have substantial foreign balances. We anticipate large amounts of cash will flow to the US and be used for share repurchase programs, higher dividends, increased employee wages, merger and acquisition activity, and capital investments. The combination of lower tax rates and higher domestic cash availability is a major positive for the earnings and balance sheets of many corporations, and could provide further stimulus to a growing US economy.

For individuals, the tax bill increased standard deductions, lowered marginal tax rates and raised tax bracket ranges, offsetting these by limiting or eliminating many itemized deductions. A key change is the $10,000 limit on the deductibility of state, local, and property taxes. Taxpayers living in high state tax areas with high property values (such as New York Tri-state region, California, and some New England states) may not see much, if any, benefit. Most individuals and particularly those in the highest tax bracket should end up with a tax cut. Generally, tax cuts are most effective when unemployment is high and there is considerable spare capacity in the economy. With unemployment near a record low of 4%, a reduction in Federal taxes may lead to inflation in wages in some industries and higher prices for goods and services in high demand. However, we do not currently see inflation as a major threat because there is still excess capacity overall in the US economy. The downside is an increase to the Federal budget deficit, projected at greater than $1 trillion over the next 10 years. Higher deficits and higher consumer spending may eventually lead to higher interest rates and correspondingly tighter monetary policy on the part of the Federal Reserve.

Global Monetary Policies

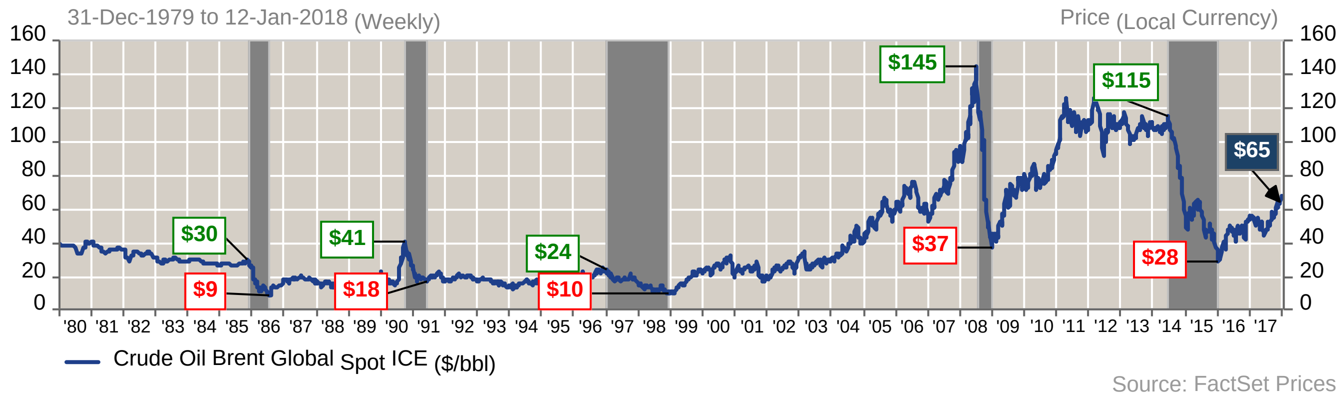
To its credit, the Federal Reserve led the way in counterbalancing the negative effects of the Great Recession (2007 – 2009) by cutting short-term interest rates practically to zero and keeping them there for many years. Additionally, it expanded its balance sheet through the purchase of longer-term mortgages and bonds, keeping long-term rates low. The Fed is currently attempting to normalize its balance sheet and interest rates, with five rate increases now since the first post-crisis target increase in December 2015. With economic growth accelerating, the Fed is expected to implement three or four additional rate hikes in 2018.

Abroad, the central banks of Europe, the UK and Japan were several years behind the Fed’s easing measures. However, the positive effect of those subsequent policies was evident in 2017, with improved global growth, especially in Asia and the emerging markets. In 2018, we believe that all central banks will moderate this easy money stance, thereby pushing interest rates higher. We would expect strong consumer demand across the globe, lower unemployment, and improving GDPs.

Oil Prices

Oil prices rose 20% year over year and prices appear to have stabilized around $60 per barrel. Positives appear to outweigh negatives as global economic growth, OPEC production limits, and falling US inventories offset higher US production.

1980-2017 Crude Oil Prices



Source: FactSet Prices

Interest Rates and Inflation

The major economic conundrums of 2017 were inflation and wages. Wage growth remains stubbornly muted despite a 4.1% unemployment rate while inflation refuses to rise despite a healthy economic backdrop. We will be watching economic metrics closely in 2018 to determine the ultimate impact of the new tax regime and whether it can provide a sustained boost to the economy. Rates are higher year-over-year, but remain low historically and we have yet to see inflation top 2.5%.

Corporate Earnings

While the exact boost to corporate earnings from recent tax reform is uncertain — as companies may choose to reinvest some of their recent windfall in higher wages, capital projects or acquisitions — the near-term net impact to earnings should be positive. Some industries will benefit more than others, but ultimately, tax reform should be a net benefit for the majority of companies. After a year in which the weak dollar helped US exports, we do not see currency being a major factor for corporate profits in 2018.

Economic Growth

United States:
With steady job growth and high consumer confidence, real economic growth could rise from the 3% range in 2017, to over 3% for 2018. It is possible that wage growth, which has been steady at 2-2.5%, will inch up to a 3% annual growth rate. Earnings, aided by lower corporate taxes, should increase more than 10% and dividend increases should follow. However, we expect the Fed to be more aggressive in raising rates.

Factors	Influence
▪ Tax reform benefit to corporations	++
▪ Tax cut for most individuals	+
▪ Continued wage growth and low unemployment	+
▪ Rising interest rates and inflation	–
▪ Increasing federal budget deficits	–
▪ Rhetoric away from global leadership	–

Europe and Japan:
Both Europe and Japan are seeing accelerating growth. This is the first time Japan has grown in decades. The European Central Bank has kept rates low but could change that policy as economic growth continues.

Factors	Influence
▪ Improved economic growth	+
▪ Supportive central banks	+
▪ Political uncertainty in several countries	–
▪ Brexit "Article 50" negotiations	–

Emerging Markets:

Factors	Influence
▪ Improved global growth	+
▪ Reasonable equity valuations	+
▪ Increased government stability in China	+
▪ US trade policy	–

As always, China is the key. With President Xi now firmly ensconced in power, China should demonstrate growth of slightly over 6% this year, despite a national balance sheet which reflects too much emphasis on debt. Rising Chinese consumption should lead to increased commodity demand for South America and Africa, which should benefit both those regions. The rest of Asia will also benefit from Chinese demand, and could result in 2018 being the best year economically for emerging markets in the past decade.

Model Factor 2 - Valuation

Key considerations are valuation and yields, viewed historically, in absolute and relative terms.

Equities

Equity valuations are at the high end of the 10-year range. The price/earnings multiple expanded through the year, and adding in the tax reform gains, the current ratio is 18 times 2018 earnings. As in 2017, interest rates are still too low for bond returns to provide strong competition for equity returns. Valuations would suggest equity returns in the single digits for 2018.

Based on the price/earnings ratio, valuations in Europe and emerging markets are above their 10-year average, with Japan at their 10-year average. This is less expensive than the US on an historic relative basis. Economic growth is improving internationally and earnings growth is expected to follow. Given the valuation advantage of international equities, we believe they will provide similar and perhaps slightly higher returns than the US market.

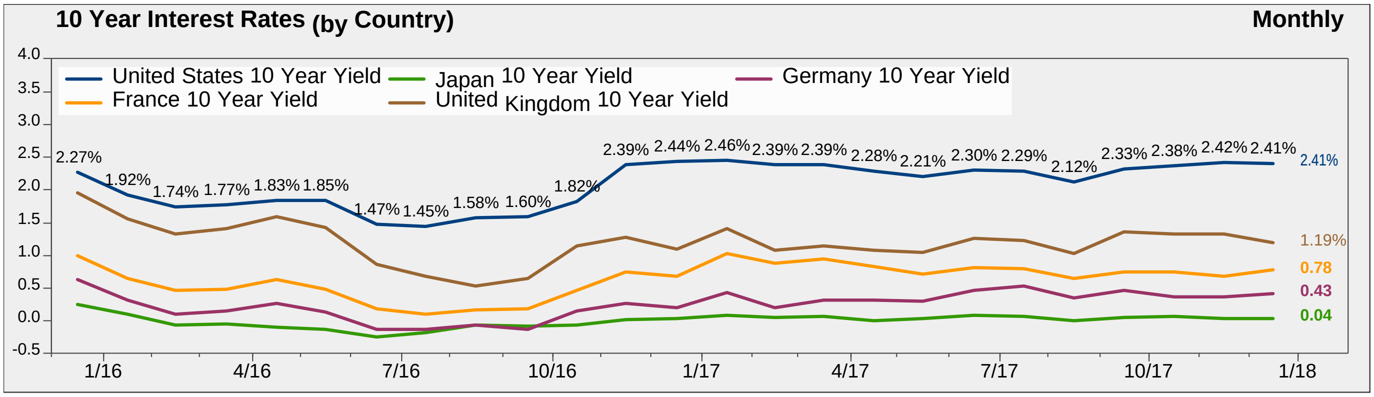
Global Equity Valuation Comparison

	10 Year P/E Ratio			Jan.	Jan.	10 Year Price/Book Ratio			Jan.	Jan.
Country/Region	High	Low	Avg.	2018	2017	High	Low	Avg.	2018	2017
US	19.1	8.8	14.9	18.9	17.6	3.0	1.2	2.2	3.0	2.6
Europe	16.2	6.4	12.3	14.6	14.3	2.0	0.9	1.5	1.7	1.6
Japan	37.3	9.3	15.4	15.4	15.1	1.5	0.8	1.1	1.4	1.2
Emerging Markets	18.9	5.7	12.9	15.2	14.6	2.7	1.0	1.7	2.0	1.8

Source: Factset, January 3, 2018. Forward P/E and P/B ratios.

Bonds

Global interest rates appear to have bottomed in mid-2016. In 2017, shorter maturities (<5 years) moved higher, following the Fed's lead, while longer maturities (>7 years) experienced very little change in yield. The supply of new debt from corporations may decline due to changes in interest deductibility in the new tax law. An improving economy is good for credit quality, but may cause the Fed to adopt a more aggressive stance toward rate increases. Inflation currently remains dormant around 2%, which is likely to keep rates from rising too quickly. We expect the 10-year US Treasury to trade in a range of 2.5% to 3.5% during 2018. High yield bond spreads have narrowed considerably over the last 2 years and, in our opinion, are not attractive at these levels. Developed market bonds outside the US offer essentially the same yield as a year ago and remain well below US yields.



Model Factor 3 - Geopolitical

Key considerations are government and political conditions in specific geographies that may impact economies and investment markets.

United States

Unpredictability within the West Wing will likely keep Congress and the public off guard, waiting for indications of policy tilts on such hot items as Iran, North Korea, and the Middle East. We assume that despite bellicose public statements, the US will not engage in any major military action overseas. The future of NAFTA is a question mark; however, we believe that US corporate interests should prevent major changes in that trade agreement.

Europe

As Britain grapples with Brexit, UK growth will remain somewhat lower than potential, waiting for political compromises which may well not be final until 2019. The Continent, however, is reporting an acceleration in manufacturing as consumer demand throughout the region remains healthy. There are fewer pressures in 2018 from key election struggles, with only the German coalition terms to be settled.

Japan

Prime Minister Abe seems relatively popular, which should aid his program of boosting both inflation and growth.

Emerging Markets

Now that China's very important five-year Party summit has concluded, we expect it to exhibit strong and consistent leadership in Asia. The US withdrawal from the Trans-Pacific Partnership will assist China in that regard. It seems clear that President Trump's withdrawal from foreign initiatives and programs, such as the Paris Climate Accord, leaves the door open for China to fill some global leadership roles formerly held by the United States.

Model Factors – Summary Table:

Region	Economic Fundamentals	Valuation & Risk	Geopolitical
US	▪ Tax reform benefits corporations through lower rates and repatriation of foreign earnings. ▪ Tax reform makes US more attractive for capital investments. ▪ Most consumers receive tax cut in February 2018 paycheck. ▪ Improving year over year GDP growth. ▪ Federal Reserve indicates further rate increases in 2018. ▪ Budget deficit will expand due to tax reform.	▪ Equity valuations at higher end of historic ranges. ▪ Earnings growth remains key to equity performance with limited potential for multiple expansion. ▪ Rising bond yields rising may gradually create some competition for equities. ▪ Equity market has not experienced a correction of >5% in over 650 days. ▪ Big/New tech companies could become a focus of anti-competitive market share.	▪ Mid-term elections create uncertainty for future legislative direction. ▪ Nationalism reduces US influence in global political and economic policies. ▪ Trade agreements yet to be revised under new administration. ▪ Global terrorism and cyberattacks remain a material threat. ▪ North Korea, Iran and Russia are problems for US foreign policy.
Developed Markets	▪ Improving growth prospects following better than expected 2017. ▪ European central banks gradually reducing monetary ease. ▪ Eurozone consumer sentiment at highest level in 17 years. ▪ Brexit "Article 50" terms to be negotiated in 2018.	▪ Equity valuations slightly above historical averages, but reasonable. ▪ Interest rates appear to have reached an important long-term bottom. Bonds are less attractive.	▪ UK political situation tenuous given Brexit implementation. ▪ German political stalemate is troublesome. ▪ Globalization under pressure given resurgence of nationalism. ▪ Revised trade agreements and potential tariffs may change economic relationships over time. ▪ Terrorism poses a threat for most European countries.
Emerging Markets	▪ China growth rate appears to be stabilizing around 6-7%. ▪ Increased global growth should benefit commodity producers. ▪ Many emerging economies a leveraged play on rising global growth.	▪ Equity valuations higher than last year given strong 2017 performance, but still below high end of range. ▪ Apart from China, debt levels appear reasonable, and rates remain low.	▪ China may be moving toward a global leadership position, partially a result of US rhetoric and policies. ▪ US immigration policies remain unresolved. ▪ Trade policies and agreements are uncertain. ▪ Middle East remains a potential source of conflict.

Expected Returns

2018 Asset Allocation: Expected Returns

Asset Class	Expected Nominal Return	2018 Allocation	Expected Nominal Return Attribution
Cash	1.0% – 1.5%	5%	0.1% – 0.1%
Fixed Income	1.5% – 3.0%	10%	0.2% – 0.3%
US Equities	5.5% – 9.0%	44%	2.4% – 4.0%
International Equities	6.0% – 10.0%	20%	1.2% – 2.0%
Directional Alternatives	4.0% – 8.0%	9%	0.4% – 0.7%
Absolute Return Alternatives	3.5% – 6.5%	12%	0.4% – 0.8%
Total Portfolio Nominal Return		100%	**4.6% – 7.8%**
Less Expected Inflation			(2.0%)
Total Portfolio Real Return			**2.6% – 5.8%**

Calculating expected returns is mainly a quantitative exercise to establish a range of returns for both asset classes and an overall "average" portfolio. History has shown that rarely will these asset classes deliver these expected returns during any one calendar year given the cyclicality and volatility of individual asset classes. 2017 provided an example of the difficulty in accurately predicting expected returns, as both US equities and International equities greatly exceeded their expected returns. However, over time and market cycles these expected returns allows us to express our assumptions and their application to a client's portfolio.

For 2018 we expect better returns to come from US equities and International equities. When applied to a diversified portfolio, the expected returns are in the 4.6% to 7.8% range with the overweight to global equities providing the bulk of the return contribution.

As always, we remain diligent in our approach to the financial markets and the management of our clients' investment portfolios. As new information becomes available we update our models and, when market conditions warrant, will adjust our allocations.

We appreciate the opportunity to share our views and welcome your questions and comments.