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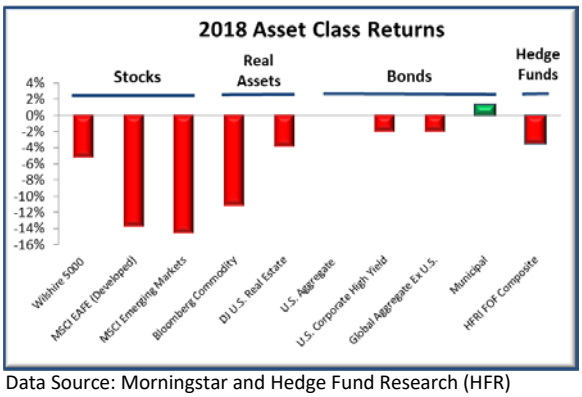
EXECUTIVE SUMMARY

Virtually all asset classes generated negative returns in 2018. Many investments experienced the worst drawdowns since the financial crisis ten years ago. For much of the year, global stock markets and other risk assets seemed out of step with fundamentals as economic growth and corporate earnings remained strong. Only the U.S. stock market, propelled by 25% earnings gains and perceived stability versus Europe and emerging countries, rallied. By year end, global stock markets seemed prescient as signs of a global slowdown emerged and reported corporate earnings painted a mixed picture of the business environment.

Although the rise in stock market volatility concerned investors, the magnitude of recent swings in stock prices is not unusual historically. Given the wide range of potential market shocks–rising interest rates, trade wars, political unrest, tumbling corporate earnings, stressed liquidity–spikes in volatility should be expected in the months ahead.

Even as the stock markets fell, rising interest rates and historically low yields created a dismal environment for fixed income investors. For much of the year credit risk was rewarded with high yield and emerging market debt posting the highest returns. The fortunes of the riskier segments of the bond market abruptly reversed course in December. Assets flowed out of funds focused on bank loans and high yield debt that had attracted investors seeking higher yields. Most fixed income sectors have experienced growing debt and higher leverage. One other indicator of credit



Data Source: Morningstar and Hedge Fund Research (HFR)
Bond indexes from Bloomberg Barclays.

deterioration is the substantial increase in high yield bond default rates.

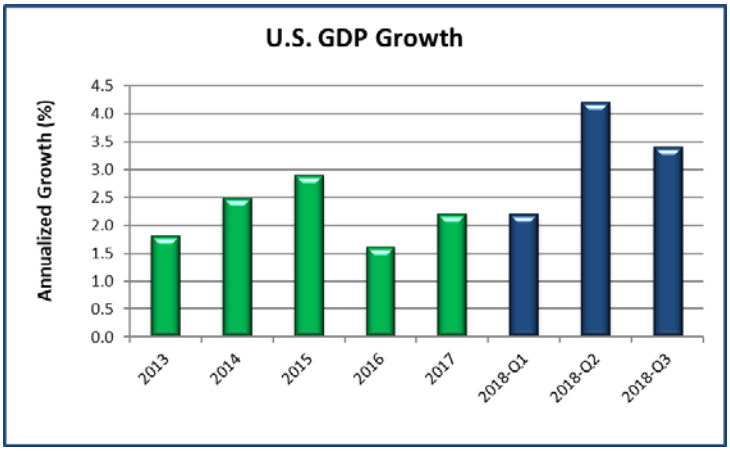
In 2018, the U.S. Dollar reversed course as higher interest rates and strong relative growth drove the Dollar higher versus other currencies. Going forward, the large fiscal and trade deficits and a slower pace of rate hikes may be a headwind for the U.S. Dollar.

The volatility that rocked the stock markets in 2018 has magnified the opportunity to exploit valuation imbalances. The dominance of large cap growth stocks over value and smaller stocks has been exceptional. Emerging stock markets are also undervalued versus their historical average as well as other regions.

Investors that diversified across defensive and growth assets were well positioned in 2018. During periods of market euphoria, high flying technology and energy stocks generated stellar gains. During market declines, high quality bonds and alternative strategies put a floor on portfolio losses. Diversification, in conjunction with a long-term focus, is the best way to pursue investment objectives.

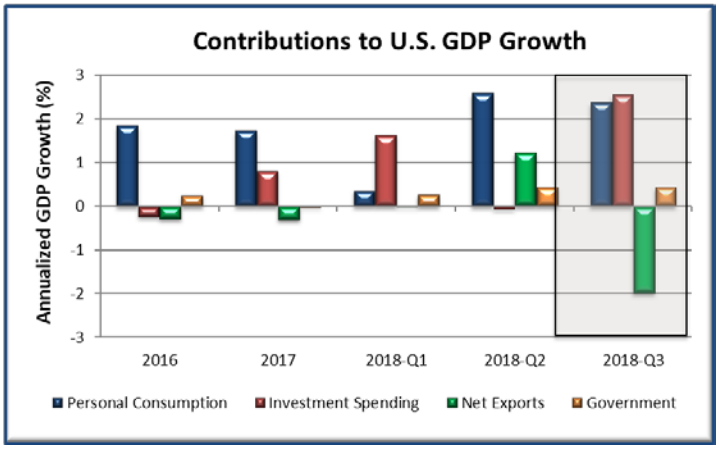
ECONOMIC REVIEW AND OUTLOOK

Key Economic Fundamentals



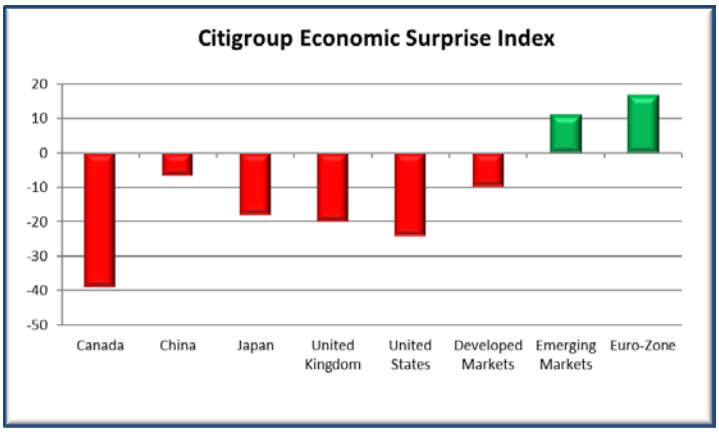
Data Source: U.S. Department of Commerce

Fiscal stimulus from tax cuts and higher government spending prompted an uptick in U.S. economic growth in 2018. 3Q U.S. GDP growth was a healthy 3.4%, driven by consumer spending and inventories. The Atlanta Fed's latest "GDPNow" estimate for 4Q growth is 2.7%. Although a flatter yield curve triggered recession fears, most signs point to a modest slowdown in 2019.



Data Source: U.S. Department of Commerce

After an anemic start, consumer spending rebounded to drive solid economic growth in 2018. Expanding inventories propelled investment spending in the face of slowing housing and weak business spending. U.S. businesses accelerated export shipments in 2Q, fearing retaliatory tariffs from China. Following the resultant sharp drop in 3Q, net exports are expected to rebound.



Data Source: Citigroup
As of December 7, 2018.

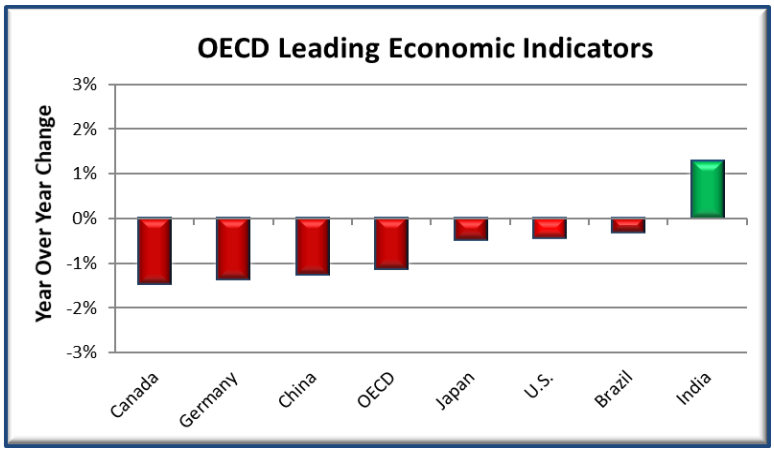
Economic data relative to expectations was disappointing in the U.S. and developed countries overall. The emerging markets and Europe, two regions hardest hit by negative sentiment in 2018, defied the downward trend with results surprising on the upside. Strong stock market returns tend to follow unexpectedly favorable economic results.

Global Growth Rates (%)

	2016	2017	2018	2019	2020
Advanced	**1.7**	**2.3**	**2.4**	**2.1**	**1.7**
Euro	1.9	2.4	2.0	1.9	1.7
U.S.	1.6	2.2	2.9	2.5	1.8
Japan	1.0	1.7	1.1	0.9	0.3
U.K.	1.8	1.7	1.4	1.5	1.5
Canada	1.4	3.0	2.1	2.0	1.8
Emerging	**4.4**	**4.7**	**4.7**	**4.7**	**4.9**
China	6.7	6.9	6.6	6.2	6.2
India	7.1	6.7	7.3	7.4	7.7
Russia	-0.2	1.5	1.7	1.8	1.8
Brazil	-3.5	1.0	1.4	2.4	2.3
World	**3.3**	**3.7**	**3.7**	**3.7**	**3.7**

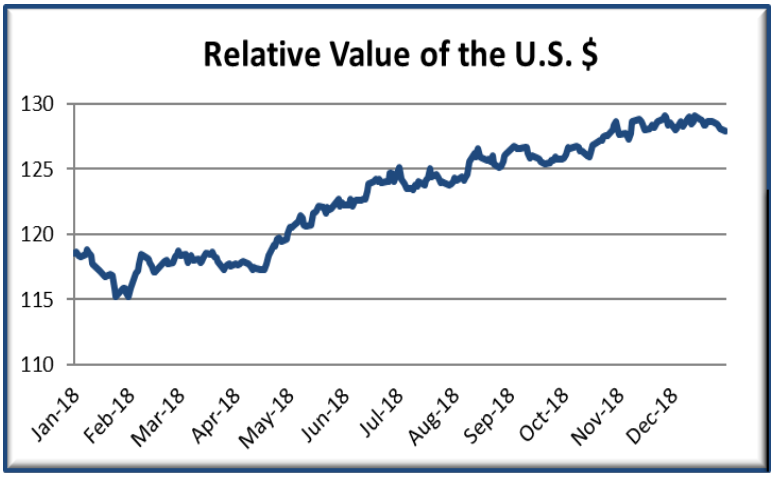
Data Source: International Monetary Fund
2016 and 2017 are actual; 2018, 2019 and 2020 are forecasts.

Global growth forecasts for developed countries moderated after disappointing results in Europe and Japan earlier in the year and the onset of trade tensions between the U.S. and China. In the U.S., the stimulus from tax reform is expected to wane. Emerging countries such as China and Inda have the highest potential for robust growth rates. Energy exporters such as Russia have benefited from a rebound in energy prices. Policy risks are high, calling for a cautious outlook for global growth.



Data Source: Organization for Economic Cooperation and Development
As of November 2018.

Leading economic indicators (LEI), designed to identify inflection points in economic growth, declined for most countries in 2018. The deterioration in many large economies such as the U.S. and Japan, was modest. China's LEI seems to have stabilzed. India, which has strong support from government spending, was the only country with a materially postive LEI. European countries, notably those in Eastern Europe, have the weakest prospects.

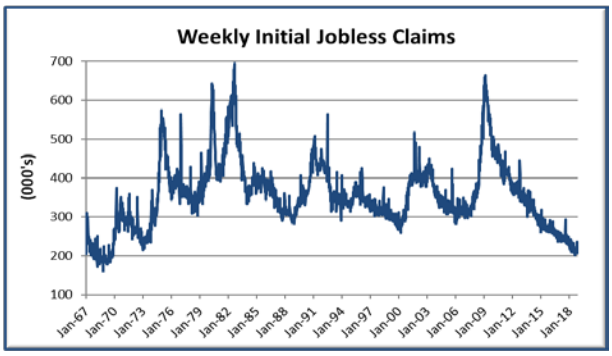


Data Source: U.S. Department of Commerce
U.S. Dollar versus a trade-weighted basket.

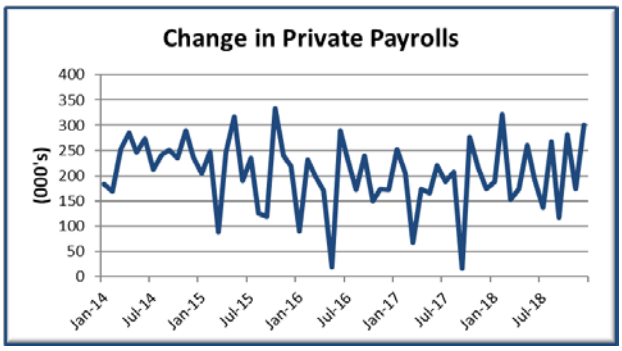
In 2018, the U.S. Dollar rose over 7% versus a trade-weighted basket of other currencies, reversing the downtrend that prevalied the prior year. Emerging currencies were volatile as rising U.S. interest rates bolstered the Dollar. The worst performing currencies, the Argentine Peso and the Turkish Lira, also faced country specific turmoil. The Chinese Renminbi declined 5% as the trade war raged. The Euro stabilized after weakening materially over Brexit concerns and Italy's fiscal problems.

Employment

The U.S. labor market continued to be a pillar of strength for the domestic economy. Jobs were created at a strong pace relative to history for much of 2018. In November, private payroll growth missed consensus expectations and showed signs of slowing, but sharply rebounded with a gain of over 300,000 jobs in December. U.S. employment has now surpassed 150 million jobs for the first time. The number of people receiving unemployment claims is lower than it has been in the past 45 years. The unemployment rate, after dropping to a new cycle low of 3.7% in September, rose to 3.9% at year-end but remains at the lowest level since the 1960s. Average hourly earnings picked up as the year progressed, reaching 3.2% in November. Skilled workers are in short supply in several industries. The Federal Reserve will be closely watching for signs of wage inflation when setting interest rate policy over the coming year.



Data Source: U.S. Department of Labor



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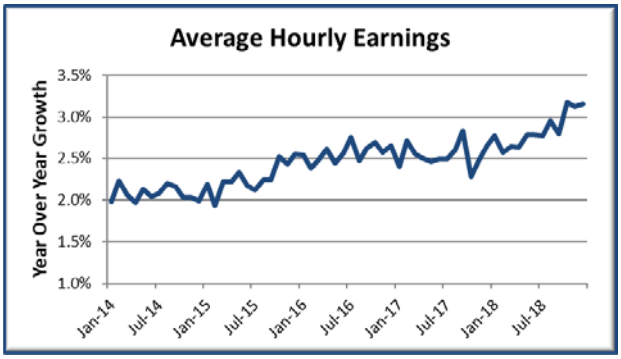

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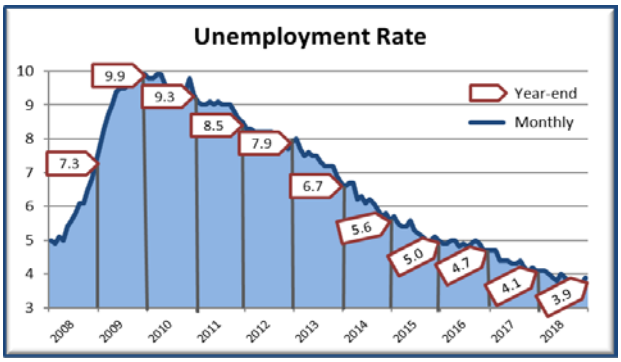
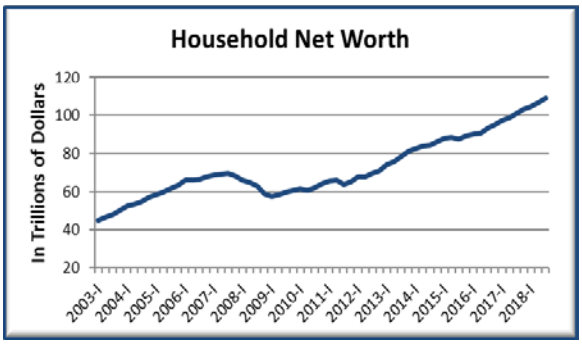


Data Source: U.S. Department of Labor

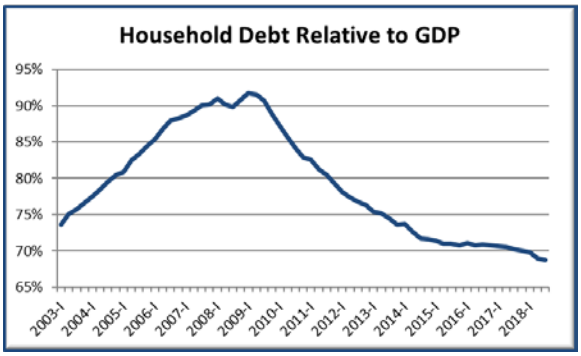
Consumer

U.S. consumers have benefited from historically low unemployment, modestly rising wages and contained inflation. Confidence reached an 18-year high in September, before retreating when consumers became increasing worried about stock market volatility and their job prospects. Retail sales continue to paint a bright picture, up over 4% year over year. Notably strong components include the online, clothing and health care categories. Even cyclical sectors such as auto sales are not flashing warning signs. Household debt relative to U.S. economic output has declined to levels last seen in 2002. On the downside, the personal savings rate has been declining and rising student debt, lower rates of home ownership, and the prospect of higher inflation as the cost of trade tariffs flow through to prices are all risks to consumer well-being.



Data Source: U.S. Federal Reserve

Data Source: The Conference Board



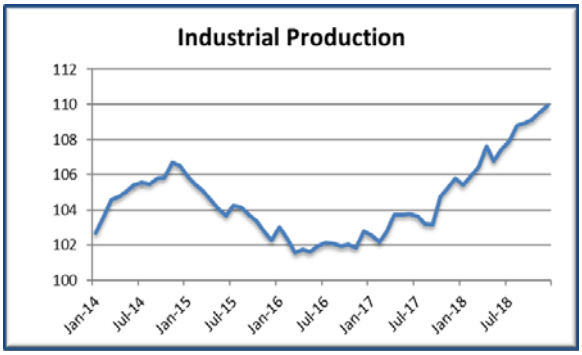
Data Source: U.S. Federal Reserve & Bureau of Economic Analysis

Data Source: U.S. Bureau of Economic Analysis

Business Activity

Both the U.S. service and manufacturing sectors continued to expand in 2018 based on the ISM indexes which use industry surveys to evaluate economic activity. Corroborating the strength seen in the ISM surveys, in September the industrial production index grew at the fastest annual pace since January of 2011. U.S. businesses benefited from tax reform enacted last year, including the reduction in the corporate tax rate from 35% to 21% and lower levies on the repatriation of overseas cash. Global manufacturing PMI has been weak with new orders, production and employment dropping sharply largely due to a slowdown in exports. China's most recent PMI indicates that business activity has contracted despite government support. In December, the U.S. ISM manufacturing index experienced its largest drop since 2008. These markers may indicate temporary weakness, but trends in China and the U.S. bear watching.

Data Source: Institute for Supply Management

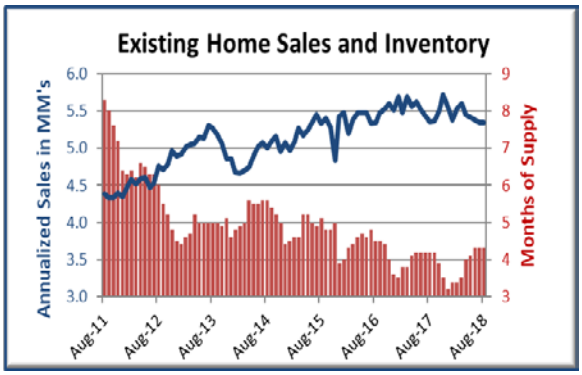


Data Source: U.S. Federal Reserve

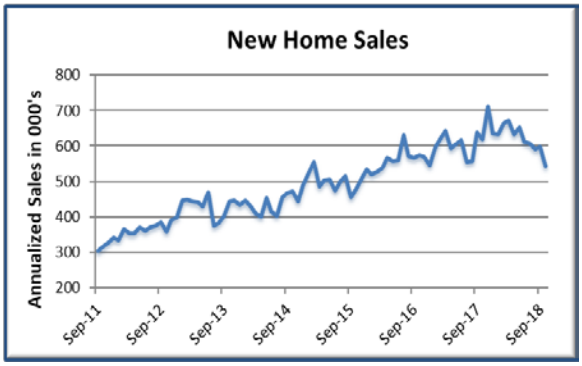
Real Estate

The housing market, an important driver of consumer spending as well as employment in the U.S., lost ground in 2018. Sales activity seems to have reached a cyclical peak. Existing home sales have declined almost 7% over the past year and the supply of inventory remains lackluster. Building activity has fallen from a post-crisis high after trending lower since January and builder confidence has dropped. Home prices continue to rise overall, but at a slower pace, and some market segments have seen material price declines.

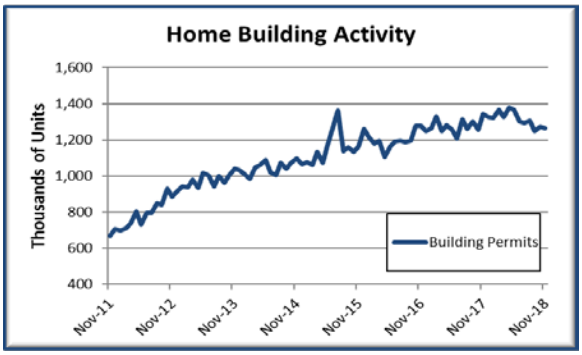
There are signs that the housing market is stabilizing. The negative impact of tax-reform, particularly in high income tax states with elevated property taxes, may have been absorbed. The increase in mortgage rates as interest rates normalized has been a large factor dampening home buyer demand. Mortgage rates have recently moved lower, a welcome development that could support demand going into the Spring selling season.



Data Source: National Association of Realtors



Data Source: U.S. Bureau of the Census, U.S. Department of Housing and Urban Development



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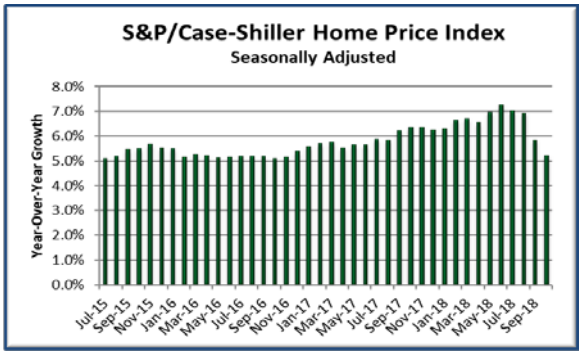


Data Source: S&P/Case Shiller

CAPITAL MARKETS REVIEW

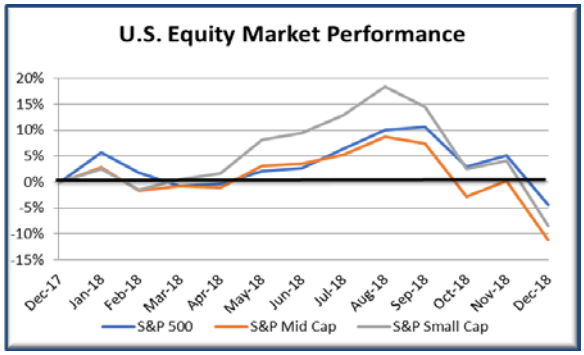
Returns

	4rd Qtr 2018	Full Year 2018
Cash and Fixed Income		
U.S. Treasury Bills	0.6%	1.8%
Bl Barclays U.S. Aggregate Bond	1.6%	0.0%
Bl Barclays Municipal Bond	1.7%	1.3%
Bl Barclays Global Agg. ex. U.S.	0.9%	-2.1%
Hedge Funds and Alternatives		
Bloomberg Commodity	-9.4%	-11.2%
DJ U.S. Real Estate	-6.0%	-4.1%
HFRI FOF Composite	-4.4%	-3.5%

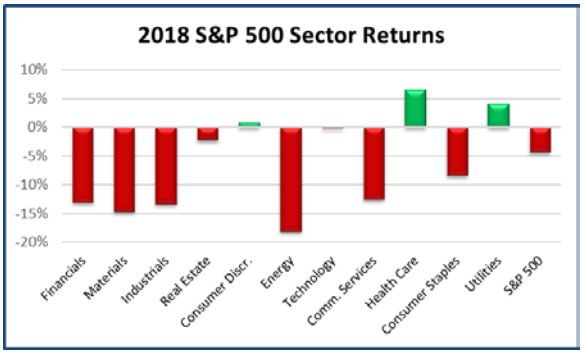
	4rd Qtr 2018	Full Year 2018
U.S. Equity		
Wilshire 5000	-14.3%	-5.3%
S&P 500	-13.5%	-4.4%
Russell 2000	-20.2%	-11.0%
International Equity		
MSCI ACWI ex. U.S.	-11.9%	-14.8%
MSCI EAFE (Developed)	-12.5%	-13.8%
MSCI Emerging Markets	-7.5%	-14.6%

Data Sources: Morningstar & Hedge Fund Research, Inc.

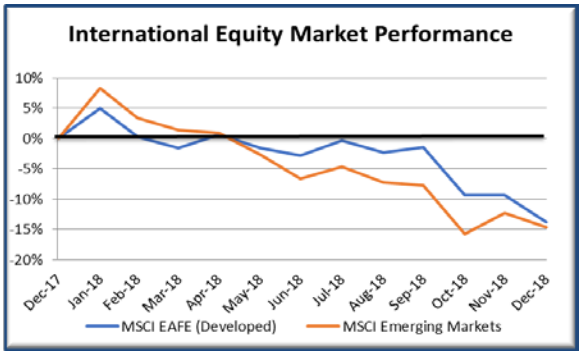
Equity Markets



Data Source: Morningstar



Data Source: JP Morgan



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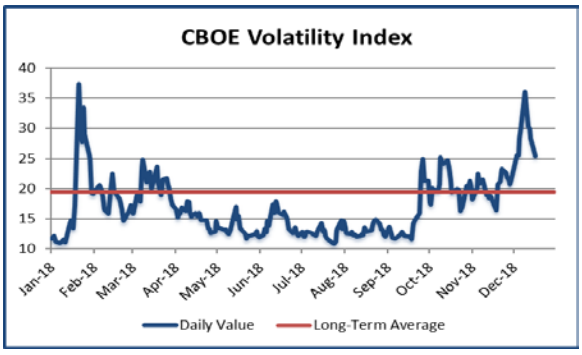
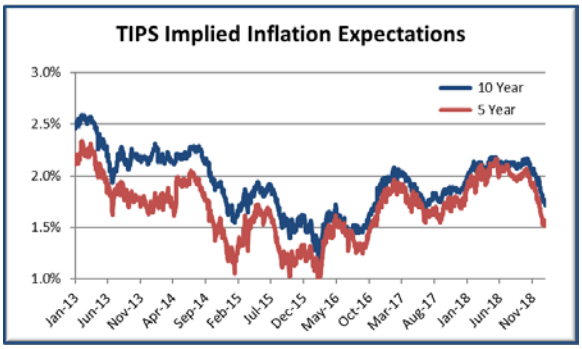
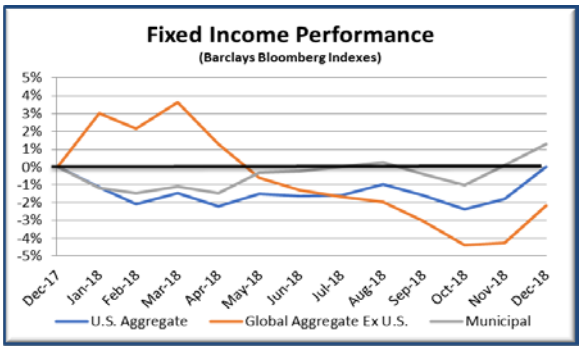


Data Source: Chicago Board Options Exchange

Fixed Income Markets

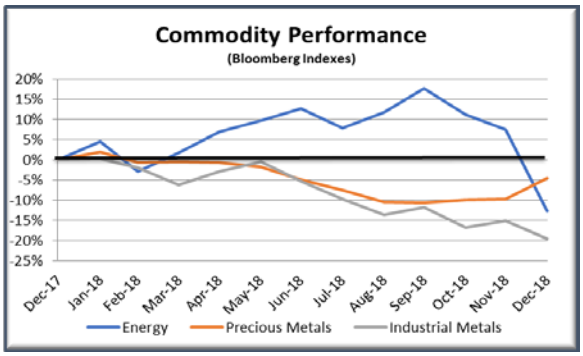


Data Source: U.S. Department of the Treasury



Data Source: Morningstar

Alternatives



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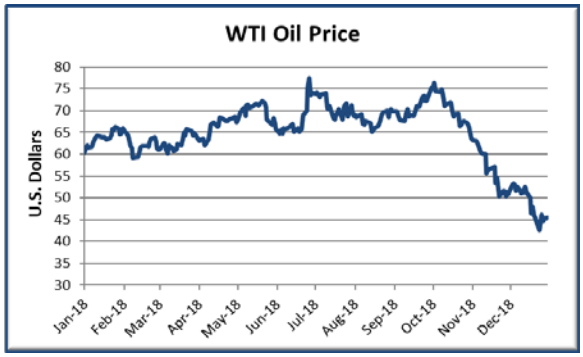

Data Source: U.S. Energy Information Administration

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