ARS INVESTMENT PARTNERS

THE OUTLOOK

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Why This Is Not Your Parents' Stock And Bond Market

"What is different today is the speed of change driven by technological advances, and the tendency that they will only accelerate...The time it takes poor countries to catch up with pioneering countries' usage of a technology has shortened dramatically. After the spindle was invented in 1779, it took over 100 years for the technology to spread around the world. With the internet the time lag was just 6 years. Society had decades to adapt to the transformations caused by new technologies. Today, we only have a few years."
- Roberto Azevedo, Director General WTO

The global economy has again moved into unchartered territory as important convergences in monetary policy, global politics and trade are creating challenging conditions for stock and bond investors. Technological advances and globalization are reshaping politics, economics and society today, and we would caution market participants from relying too heavily on investment experiences of the past to drive investment decisions moving forward. The combination of these forces is also fostering a return to greater market volatility. Over the next few months, market conditions may be unsettled as these changes are absorbed. While the United States and global economies continue their almost decade-long expansions, the U.S. economy is performing marginally less well than expectations which have been quite high following the tax cuts and budget spending increases. As the economy is in the later stages of one of the longest expansionary periods in history, the transition underway will require investors to think differently than they have previously as the current environment is unlike any seen in the past.

Investors should remain focused on their long-term objectives and not allow short-term volatility to cause them to deviate from the path to building and preserving capital. At the same time, investors need to be flexible as the changes occurring in the system will require course adjustments in portfolios to reflect shifting economic realities. Given current uncertainties, the backdrop for investing is somewhat more challenging than when the year began. This Outlook will frame the conditions we expect to be prevalent in the coming quarters and their implications for portfolio strategy. History shows that the two quarters preceding mid-term elections have proved challenging for investors, and we are generally holding higher than normal cash levels to take advantage of the opportunities being created. Importantly, we would remind our readers that the secular drivers for the global economy remain firmly in place and our focus remains squarely on navigating the risks and capturing the opportunities created during this transition. This is to say that those companies benefiting from the secular trends will be the ultimate

ARS Investment Partners, LLC
500 Fifth Avenue, 14th Floor
New York, NY 10110
212.687.9800

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drivers of capital appreciation, notwithstanding shorter-term pullbacks in their share prices. An important consequence of the changes in the global economy is to anticipate that there could well be fewer winning companies in 2018.

What's different about this period for stock and bond investors?

The strong equity markets of the past few years have been driven by a synchronized global expansion, strong corporate earnings growth and virtually zero interest rates. Now however, the market is adjusting to a less accommodative Federal Reserve policy, increases in employment and in core inflation as well as potential changes in the terms of global trade. While corporate profits should continue to be robust and grow over the next few quarters, subtle changes in expectations for higher interest and inflation rates could lead to a contraction of P/E (price/earnings) multiples creating greater differentiation in stock market valuations and pressure on bond prices. Following a prolonged period of declining unemployment rates, the large labor pool is now disappearing and creating labor shortages in some industries thereby fostering wage inflation. As the Federal Reserve continues its transition from its zero-interest rate policy to a more normalized rate structure, higher interest rates will create new pressures on highly indebted companies as they will face increasing debt servicing costs. Furthermore, attempts by the Trump Administration to improve what it considers to be highly unfair trade practices have the potential to push up the cost of imports for certain companies, including many that are unable pass these costs along to consumers in the form of higher prices. These circumstances suggest that some companies that previously had been considered safe investments in difficult markets may not provide the same protection that they might have in the past. In this environment, those companies without strong balance sheets to continue to invest and/or meet debt servicing obligations, as well as those lacking the ability to increase prices, improve margins or market share, will be penalized. To offset P/E contraction, companies must be able to grow revenues and earnings, while increasing free cash flow to be able to reinvest for the future of their businesses.

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For bond market participants, the situation could well be even more challenging. The bull market in bonds that started over 35 years ago may well have come to an end. To provide some perspective as to how the rate structure has changed, we remind investors that in 1981 the prime lending rate reached 20.5%, money market rates 21%, and the 10-year treasury yielded 15.5%. Today those numbers are 4.75% for the prime rate, 1.5% for money markets and the 10-year is around 2.80%. Presently, the Federal Reserve is targeting 3-4 increases annually for 2018 and 2019 in the Federal Funds rate, while contracting its balance sheet which has grown from $925

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billion to $4.5 trillion over the past decade. This is the first time in history that rate increases and balance sheet contraction have occurred simultaneously. Based on these conditions, investors in bond funds may experience losses not consistent with the return experience of the past. Clearly, the risk dynamics of the market are shifting given the changes in the environment. Strategies that worked in the past decade will be unlikely to produce the same results going forward. Investors should be flexible in their approach to portfolio strategy as subtle changes may result in bigger risks as well as bigger opportunities.

Why are politics today so different?

"Not only have we failed to sell globalization well, we also didn't take care of those who have been affected in the transition to a more global economy. There are many people who have been affected by technological change and globalization who don't have a clear way to reinvent themselves. So there are tragic cases in many parts of the world - people in broad sections of society who are not able to find a job. So even though I don't doubt the benefits of globalization, in implementing the liberalization process, we didn't pay enough attention to these negative side effects of globalization. And now, they're hounding us."

- Agustin Carstens, General Manager, Bank of International Settlements

Social and economic issues are creating a more divisive and polarized political environment in Europe and at home. The populist movement is also encouraging a disquieting rise of autocratic leaders

Technological advances and globalization have contributed significantly to the populist movement as shifting fortunes have left many in the developed world worse off than before, while almost 3 billion people in the developing economies have seen living standards rise. The rise of populism has established political parties losing elections to anti-establishment parties or individuals whose main appeal is that they are not the incumbents. The result of these and other concerns has been a less stable geopolitical situation. Social and economic issues are creating a more divisive and polarized political environment in Europe and at home. The populist movement is also encouraging a disquieting rise of autocratic leaders as shown by the recent election of nationalist Viktor Orban as President of Hungary. Since this trend is not limited to just one NATO member, it could have important implications down the road. In addition, the U.S. voter base is more divided than it has been for some time. With big money supporting both parties, the upcoming mid-term elections will create added uncertainty. Perhaps the best example of today's political climate is in the United States with the election of President Trump. Whether you like him or not, President Trump's understanding of the frustrations of many Americans who felt victimized by globalization helped galvanize his voter base. So far, his policy initiatives on foreign policy, immigration, taxes and trade have closely followed his campaign platform and investors should expect that to continue. President Trump's "America First" policy platform and unorthodox approach to governance have kept both allies and enemies off balance. It will be fascinating to watch how efforts to denuclearize North Korea unfold, but the Administration's approach has

created a move to negotiations as the effects of harsh sanctions have taken hold. At the same time that America is stepping back from its role on the global stage, China's President Xi is aggressively expanding China's role as a global economic and military power. China has been the biggest contributor to global GDP growth for over a decade and is now exerting its economic and military strength in Asia and beyond by offering developing nations a model for growth that is different than the Western model of democracy and market economics. China is also providing other countries significant investment capital to modernize infrastructure through its "One Belt, One Road" initiative. The contrast in political and economic approaches has the potential to create an even more divisive geopolitical world order. It is not hard to envision a less stable world unless the U.S. and China find a way to lead by partnering going forward. One can also imagine a win-win from the political perspective for both President Trump and President Xi whereby each saves face, but where China's most significant unfair trade practices would have been successfully addressed. Investors should not lose sight of the fact that China has embarked on a long-term, multi-decade economic and scientific transformation that will not be derailed by trade negotiations with the United States or anyone else.

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Why are the terms of trade changing?

"We support free trade, but it needs to be fair and it needs to be reciprocal because in the end unfair trade undermines us all. The United States will no longer turn a blind eye to unfair economic practices including massive intellectual property theft, industrial subsidies, and pervasive state-led economic planning. These and other predatory behaviors are distorting the global markets and harming businesses and workers not just in the U.S. but around the globe. Just like we expect the leaders of other countries to protect their interests, as president of the United States, I will always protect the interests of our country, our companies, and our workers."
- President Trump, excerpts from his speech at the World Economic Forum in Davos

Tariffs, trade negotiations and protectionism have been major topics in the media and on Twitter. As the rate of change continues to accelerate, governments need to be more proactive to maintain global competitiveness and address the needs of those affected more so than they have been in the past. In his Davos comments, President Trump was sending a strong message about the unwillingness of the U.S. to accept unfair trade practices from any nation. The Administration started with discussions with Mexico and Canada on the fairness of NAFTA terms and followed with proposed tariffs to address long-term concerns relating to the steel and aluminum industries. However, the underlying issue regarding trade is the battle for future technology supremacy between the United States and China. President Trump's comments were a direct shot at China's "Made in China 2025" plan whereby the government is supporting strategically vital and important

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industries with low-cost loans and other subsidies. As we have written about for years, data is the new global currency and those that own the intellectual property in technology will have a significant competitive advantage especially with the introduction of the newest technologies such as AI, robotics, blockchain and 5G. As negotiations get underway, both governments are stating that they are complying with the World Trade Organization's (WTO) trade practices, that neither wants a trade war, and that each will defend its rights.

Global supply chains are a reflection of the interconnectivity and interdependencies of the global economy as well as the cost effectiveness of the global trading system

Technological advances have been reducing the cost of doing business among nations while helping companies set up global value chains with suppliers in many countries. For example, Boeing, the largest U.S. exporter, employs more than 140,000 people in more than 65 countries. In addition, it leverages the talents of skilled people working for Boeing suppliers worldwide, including 1.3 million people at 13,600 U.S. companies. And this is just one company. What would the figures be for all U.S. companies? Global supply chains are a reflection of the interconnectivity and interdependencies of the global economy as well as the cost effectiveness of the global trading system. Therefore the risks of policy missteps with respect to global trade are causing concern among investors. While we do not expect negotiations to escalate into a trade war, the changes in terms of trade will impact industries and businesses differently with some benefiting, some losing and some experiencing minimal impact.

What are the investment implications?

We encourage investors to recognize that what worked in the past may not work going forward as this environment is unlike any other. Fewer companies will benefit, and the market will react to support those companies at the expense of the rest of the broader market. Those that benefit from the conditions highlighted above should be rewarded with premium valuations. Capital has been flowing to the defense, technology and healthcare companies, and we expect those flows to continue, if not accelerate. Interestingly, companies attempting to fight pricing and margin pressures will likely increase their technology spend in an effort to counter those pressures. Despite the likelihood of increasing government regulation, taxation from Europe and scrutiny, technology companies should continue to benefit as increased spending is virtually a requirement for companies to maintain competitiveness as the Internet of Things (IoT) becomes more widely adopted and the industry moves closer to the introduction of 5G. Our emphasis remains on selecting companies benefiting from disruptive technologies, rising defense spending, changes in the financial and healthcare industries, increasing U.S. consumer spending and the shift to a more service-oriented global economy led by China and India. Unlike in the past, energy companies in the exploration and production area have demonstrated greater financial discipline and have become more attuned to purchasing reserves at a discount to market value by using their free cash

flow to buy back shares. As a result, we have increased our energy exposure this year. Companies with strong balance sheets that can aggressively invest in the future growth of their businesses should be more highly rewarded as will those with the ability to repatriate large overseas cash balances. U.S. small capitalization companies, which in some cases are more insulated from changes in trade, also stand to be significant beneficiaries of tax reform, strong consumer spending and increases in capital expenditures. We continue to remain cautious on fixed income investments given the risk/reward dynamics and would suggest that investors consider reducing their allocations and shortening their maturities to reduce the risk of capital losses.

As we look at the risks and opportunities stemming from these changes, we anticipate that the second and third quarters will see increased volatility and a narrowing of investment opportunities

At the start of the year, investor sentiment was positive as the global expansion was intact, the outlook for corporate profits remained strong with expectations for interest and inflation rates to rise modestly. As the second quarter begins, the shifts in monetary policy, global politics and trade are creating different conditions for stock and bond investors. Looking at the risks and opportunities stemming from these changes, we anticipate that the second and third quarters will see increased volatility and a narrowing of investment opportunities. With respect to monetary policy, it is expected that the Federal Reserve will maintain its plan to raise rates two or three more times this year and up to four times next year, while also reducing its balance sheet. The mid-term elections in the U.S. may weigh on market sentiment and increase volatility. While it is too soon to determine the outcome of trade discussions with Mexico, Canada and China, changes in the terms of trade could impact global supply chains which may upset the synchronized economic expansion that has been helping drive equity markets. In the near term, changes in terms of trade may lead to higher import costs which would be a negative for the consumer-driven U.S. economy. The nation imports approximately $600 billion more goods and services than it exports each year. Industries that are targets of these changes could undergo a retrenchment as excess capacity may be shut down and short-term supply challenges may result which could drive up prices in this adjustment phase. Since the U.S. has many of the world's largest companies with sophisticated global supply-chain networks, these companies could experience near-term disruptions in their businesses.

M&A and buyback activity continue to favorably change the supply and demand dynamics for equity ownership

Two other prominent features of the global stock markets have been the surge in Mergers & Acquisitions and the $800 billion in buybacks estimated to occur this year compared to $500 billion in 2017. M&A and buybacks are reducing the number of publicly traded companies and the outstanding shares available to public market investors. This continues to favorably change the supply and demand dynamics for equity ownership. In the past two months, we have been adjusting portfolios to reflect the changes in the environment as we were trimming some holdings, eliminating others, and investing the proceeds in companies with lower P/E multiples as these should perform better during a period of multiple contraction. Importantly, we

would remind our readers that the secular drivers for the global economy remain firmly in place, and our focus remains squarely on navigating the risks and capturing the opportunities. For our regular readers, we have not changed our fundamental views on the economy but recognize that important shifts are occurring, and therefore it is a time to be more selective and opportunistic in portfolio construction and asset allocation.

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Brian Barry, Stephen Burke, Sean Lawless, Jared Levin, Michael Schaenen, Andrew Schmeidler, Arnold Schmeidler, P. Ross Taylor.

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ARS Investment Partners, LLC
500 Fifth Avenue, 14th Floor
New York, NY 10110
212.687.9800