

Highlights

The markets have roared back to life following a miserable ending to last year, as both bonds and stocks have posted significantly positive returns thus far in 2019. A significant shift in expectations for Federal Reserve monetary policy has been the primary force spurring asset prices higher. At the same time, excessively pessimistic valuations coming into the year, generally favorable earnings reports and stronger than expected first quarter U.S. economic activity provided fundamental support to the rally. Uncertainty related to Trump's ever changing trade policies hasn't impacted market sentiment negatively despite the general lack of progress to date in this regard. It's been particularly interesting to see appetite for risk assets remain so strong despite the over 100 basis point decline in short term U.S. interest rates experienced since November 2018 highs. While we expect the economy to slow, not collapse into recession, in the year ahead, continued strength in consumer and business sentiment is critical for the rally to continue. Government policy ineffectiveness, political gridlock

and an upcoming election year will provide challenges to confidence. Particularly notable has been the repricing of the future path of interest rates given the Fed's dovish shift which was further confirmed in the Fed's June statement and actions.

While our base case view is that the Fed will cut rates once or twice in the upcoming twelve months, the bond market has already priced in four policy cuts by next June. Traditionally, looser Fed policy has been supportive of risk markets and economic growth. While the U.S. equity markets are reaching all-time highs, we fear that the current easing cycle will not follow a traditional path, and expect a wider range of likely market paths in the year ahead. Asset values already largely reflect much looser monetary policy levels. As prudent investors, we remain wary of worsening economic trends, worrying debt levels, hyperactive investor behavior and less attractive fundamental valuations which typify the current investment environment.

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 YTD ¹
S&P 500 Stocks 15.06%	Taxable Municipal Bonds 20.91%	International Stocks 17.60%	S&P 500 Stocks 32.39%	Taxable Municipal Bonds 16.29%	U.S. MBS 1.51%	High Yield Bonds BB 13.22%	International Stocks 27.41%	U.S. MBS 0.99%	S&P 500 Stocks 10.73%
High Yield Bonds BB 14.93%	U.S. Treasury Bonds 9.79%	S&P 500 Stocks 16.00%	International Stocks 15.59%	S&P 500 Stocks 13.69%	S&P 500 Stocks 1.38%	S&P 500 Stocks 11.96%	S&P 500 Stocks 21.83%	U.S. Treasury Bonds 0.80%	Portfolio Mix 7.80%
International Stocks 12.98%	Inv Grade Corp Bonds 7.51%	High Yield Bonds BB 14.36%	Portfolio Mix 11.84%	Portfolio Mix 9.06%	Taxable Municipal Bonds 0.93%	Portfolio Mix 7.29%	Portfolio Mix 13.36%	Taxable Municipal Bonds 0.33%	High Yield Bonds BB 7.75%
Portfolio Mix 11.08%	U.S. MBS 6.23%	Portfolio Mix 11.74%	High Yield Bonds BB 5.19%	Inv Grade Corp Bonds 7.51%	U.S. Treasury Bonds 0.83%	Inv Grade Corp Bonds 5.96%	Taxable Municipal Bonds 8.37%	Inv Grade Corp Bonds (2.25%)	Taxable Municipal Bonds 7.46%
Inv Grade Corp Bonds 9.52%	High Yield Bonds BB 6.12%	Taxable Municipal Bonds 11.08%	U.S. MBS (1.41%)	U.S. MBS 6.08%	Portfolio Mix 0.20%	Taxable Municipal Bonds 4.97%	High Yield Bonds BB 7.16%	High Yield Bonds BB (2.46%)	International Stocks 7.15%
Taxable Municipal Bonds 7.31%	Portfolio Mix 4.81%	Inv Grade Corp Bonds 10.37%	Inv Grade Corp Bonds (1.46%)	U.S. Treasury Bonds 6.02%	Inv Grade Corp Bonds (0.63%)	International Stocks 4.72%	Inv Grade Corp Bonds 6.48%	Portfolio Mix (3.36%)	Inv Grade Corp Bonds 7.11%
U.S. Treasury Bonds 5.88%	S&P 500 Stocks 2.11%	U.S. MBS 2.59%	U.S. Treasury Bonds (3.35%)	High Yield Bonds BB 5.34%	High Yield Bonds BB (1.04%)	U.S. MBS 1.67%	U.S. MBS 2.47%	S&P 500 Stocks (4.38%)	U.S. Treasury Bonds 4.34%
U.S. MBS 5.37%	International Stocks (14.25%)	U.S. Treasury Bonds 2.16%	Taxable Municipal Bonds (5.42%)	International Stocks (3.39%)	International Stocks (4.29%)	U.S. Treasury Bonds 1.14%	U.S. Treasury Bonds 2.43%	International Stocks (14.62%)	U.S. MBS 3.43%

¹As of 5/31/19

Source: Prudent Man Advisors, LLC, Bloomberg, BAML

Economic Outlook

We expect the pace of U.S. growth to decelerate with an increasing prospect of a potential recession in the years ahead. While the U.S. economy should slow in the future, it's certainly not stalling out and we don't believe a recession is imminent. U.S. real GDP growth rebounded to 3.1% in the 1Q19 despite several headwinds related to the weather and the U.S. government shutdown. While overall growth improved, the numbers belie weaker levels of personal consumption expenditures and business fixed investment. Continued strength in these two measures is essential to our outlook. Equally concerning has been recent declines in business and consumer sentiment measures. Negative sentiment can create negative feedback loops into real economic activity. While current U.S. leading economic indicators remain strong, the trend in these indications has been worsening, specifically in ISM measures, new orders and the shape of the yield curve. We expect policy and geopolitical related technical risks to remain an overhang for sentiment to improve in the year ahead as well.

Leading Economic Indicator	Level	Trend
Leading Economic Index	Strong	Worsening
Average Workweek	Fair	Worsening
Unemployment Claims	Strong	Stable
New Orders: Consumer Goods & Materials	Fair	Worsening
ISM New Orders Index	Strong	Worsening
New Orders: Nondefense Capital Goods excl. Aircraft	Strong	Stable
Building Permits	Fair	Stable
S&P 500	Strong	Improving
Leading Credit Index	Strong	Improving
Yield Curve (10yr Treasury - 30-day T-Bill)	Weak	Worsening
Consumer Expectations for Business Conditions	Fair	Stable

Source: Prudent Man Advisors, LLC, Bloomberg

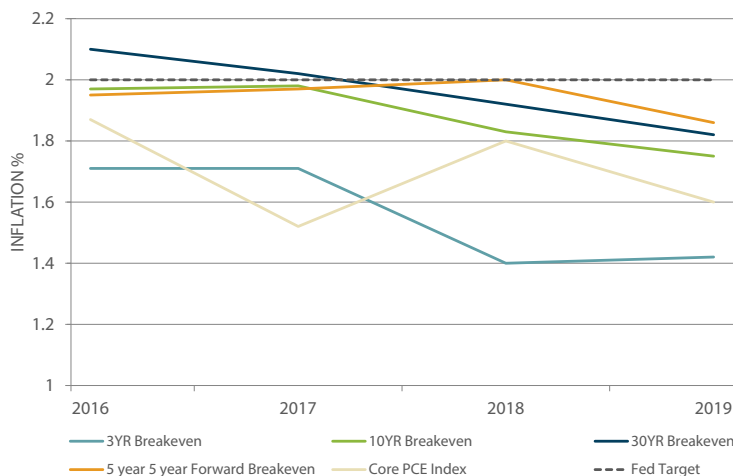
As we learned during the last recession, housing market stability is critical for sustained economic growth. While the housing market isn't an immediate concern and housing prices have continued to grow, housing has been a drag on U.S. GDP growth for 7 of the past 8 quarters, so it certainly bears continued scrutiny. Higher interest rates, until recently, were likely a large factor in the declines due to the strong correlation of interest rates and home prices. Other factors include relatively tight credit conditions and demographic trends such as lower household formation and the aging of the baby boomers. Household formation and housing strength are key pillars to the U.S. economy. Recently, millennials have chosen to rent or live at home longer and start families later while many baby boomers plan to "age in place" instead of moving to smaller homes or assisted living. Together, these factors have resulted in slower home price growth and fewer existing home sales and housing starts. Inventory levels have also been pushed lower due in part to baby boomers that are reluctant or unable to sell. Research indicates the recent change in the tax code, capping property tax deduction at \$10,000

and cutting the mortgage interest deduction in half, effectively increased mortgage rates which reduce the marketability of typical higher end baby boomer properties. Conversely, the recent drop in mortgage rates has been significant, which could boost home prices, housing starts along with new and existing home sales.

Another source of concern is the fiscal challenges that will result from increasing amounts of government debt crowding out private investment. Over the next decade, the Congressional Budget Office (CBO) estimates that interest costs will become the third largest program in the federal budget. If current policy remains in place, interest costs will become the single largest program by 2048. Interest costs benefit current versus future economic growth. The more dollars spent on interest payments the less available for the government to invest in areas that could drive future economic growth. Similar fiscal challenges face the credit markets. The rise in populist modern monetary theory, effectively turning on the printing presses to fund government programs with little regard for potential inflationary risks is gaining momentum. Regardless of who wins the U.S. 2020 election, growing debt levels and associated fiscal challenges are unfortunately here to stay.

This leads us to the puzzle of inflation. Inflation remains the biggest risk to asset prices and economy more generally. Persistently low inflation readings below the Fed's 2% target have reinforced a growing belief that inflation is dead. The culprit in this caper is not easily identifiable and the topic is the subject of much debate outside of the current administration. Certainly, fundamental deflationary pressures have been massive since the crisis and can prove long lasting. (i.e. Japan) While the lack of slack in the labor market has continued to put upward pressure on wages, it hasn't materially impacted headline inflation levels yet.

INFLATION PUZZLE



Source: Prudent Man Advisors, LLC, Bloomberg

Similarly, while the impact from higher tariffs due to President Trump's evolving trade war could pressure inflation higher in the years ahead, current inflation readings and inflation expectations remain well contained. Oil prices have been rising alongside

tensions with Iran and could become an inflationary catalyst should tensions escalate further. The Fed continues to believe the levels are largely transitory in nature.

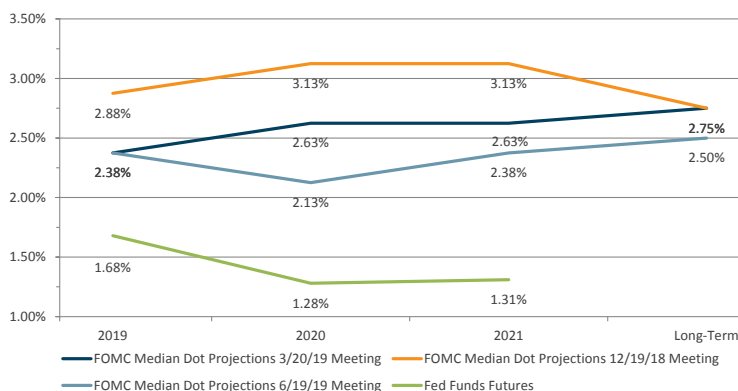
Trouble for the Fed

Existential troubles have continued to mount for the Federal Reserve over the past several years due to various exogenous and self-inflicted blows. While it's debatable if the Federal Reserve has taken the appropriate steps to promote their dual mandate of maximum employment and stable prices following the financial crisis, there is no denying that the pressures accumulating on Chairman Powell and the Fed's board of governors has greatly intensified and appears to be reaching a tipping point. In our opinion, Federal Reserve decisions over the next several months will prove critical to the shape of monetary policy for years to come. In many respects, the Fed has backed themselves into a corner, both in terms of their practices and their policy over recent years. In 2012, the Federal Reserve began the formal practice of publishing forecasts for short term U.S. interest rates as well as the expected timing of changes in policy rates. While in most instances, as prudent investors, we welcome transparency as it can foster a better understanding for investors, in this instance, the practice has limited the Fed's power, influence and their credibility. As older, experienced investment professionals, we long for the time decades ago where investors had to read the tea leaves of Fed Chairman and member comments in an attempt determine potential changes in monetary policy. The lack of transparency enforced discipline on the capital markets as Chairman Volcker and Greenspan typically revealed very little of what the Fed was actually thinking. While certainly an investor's love of being right is best understood in terms of their fear of being wrong, a less transparent Fed historically instilled a healthy amount of fear into investor's minds, in turn keeping the market from quickly moving to extremes. The massive rally that has inverted the yield curve is a current example of more frequent tidal shifts in sentiment. Market outcomes have become more extreme since the crisis, quickly moving toward terminal expectations with corresponding risk on/off behavior more commonplace than the past. To make matters worse, the Fed's forecasting ability has been, safe to say, significantly challenged. Unmasking the Fed has humanized their power as the market has largely ignored their projections for the past several years. The Fed's recent about face, 100bps reduction in their 2020 projection and potential easing this summer only reinforces their fallibilities.

Second, the Federal Reserve's independence, fundamental to the historical strength and stability of the fractional reserve system, as well as the U.S. economy, is being politicized in a manner that puts their credibility fundamentally at risk. Recent interviews and reports regarding President Trump's view on Chairman Powell and appropriate Fed policy have been more than alarming. The same administration that has orchestrated the current trade war that

is threatening the current expansion is now also demanding that the Fed assist in the battle by easing monetary policy. The tension that has been rising from the current administration's apparent desire to co-opt monetary policy to subsidize their political policy decisions should be rightly viewed as a direct attack on central bank independence.

FED FUNDS PROJECTIONS



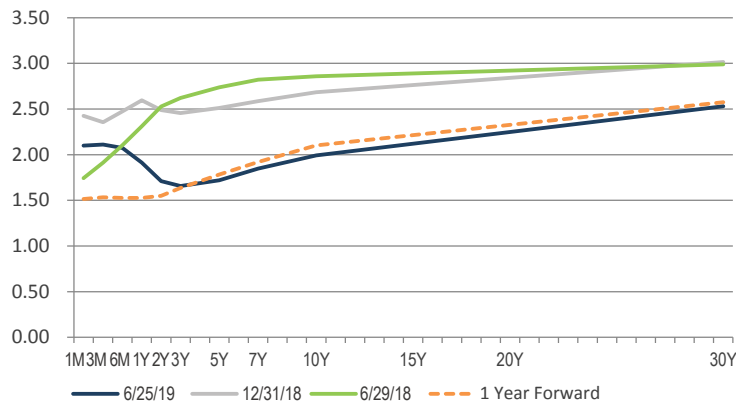
Source: Prudent Man Advisors, LLC, Bloomberg

Despite an economy that boasts full employment and stable inflation expectations, should the Fed decide to lower interest rates in the next several months, the fallout from what could be viewed as a politicized decision could have material ramifications on market expectations and the Fed's reputation more generally. A politicized Fed could quickly erode into larger questions regarding the importance of the Fed and central bank policy more generally. The steeply inverted yield curve has seen increasing chatter for letting the market determine the policy fed funds rate, therein making the Fed expendable. The Fed has placed itself in a troubling predicament and the course they choose is critical to the shape of future monetary policy.

Market Outlook

Given the numerous headwinds facing the market, our outlook suggests continued episodes of market volatility leading to a wider range of potential returns in the year ahead. Recent broad based performance strength, significantly lower interest rates, tight risk premiums and full equity valuations drive our base case expectation for limited positive returns. With economic indicators and earnings growth trending lower, market fundamentals may take a back seat in driving returns versus technical factors such as Fed policy, trade negotiations and political developments. Asset allocation, security selection and risk management will be especially critical during this period. Our outlook coming into the year projected strong returns in 2019, which have largely been achieved. The Fed's decision to pause interest hikes in December not only calmed market fears it provided a catalyst for a massive bull rally in U.S. interest rates over the past several quarters, the likes of which we haven't been seen since the credit crisis in 2008. The belly of the curve (2's-10's) have rallied 100bps (1%) since last fall.

TREASURY CURVE

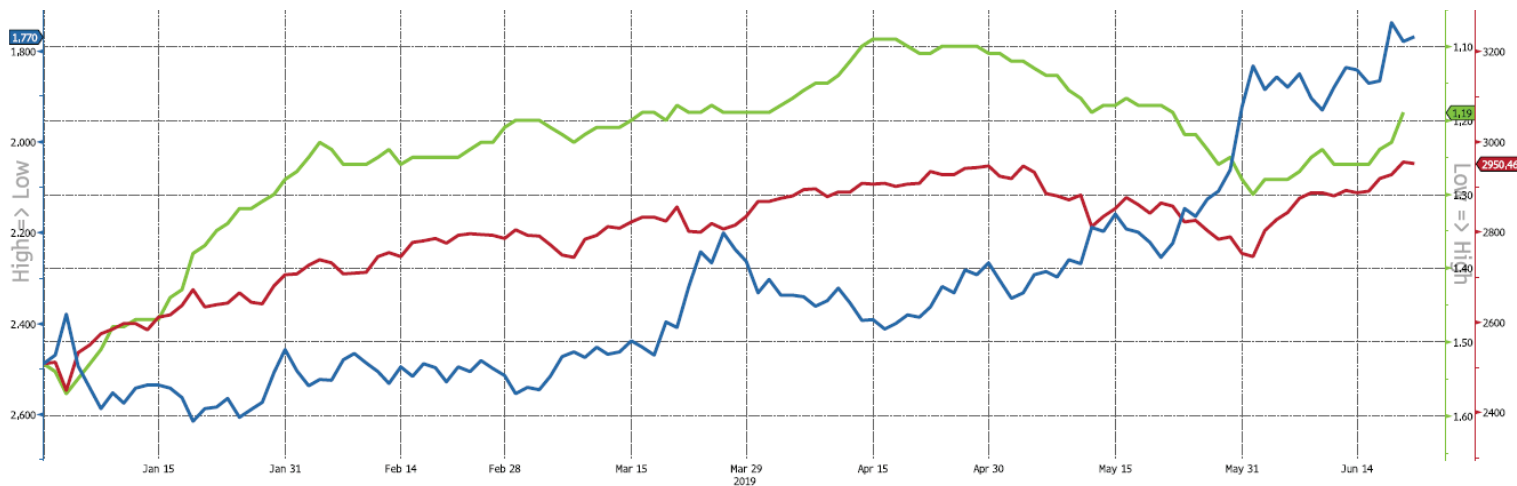


Source: Prudent Man Advisors, LLC, Bloomberg

It's important to remember that short term rates are based on Fed policy and adjoining economic activity. Though the economy performed relatively well versus expectations during the first quarter, worsening trends in economic data and business sentiment caused the yield curve to significantly invert. While the New York Fed President John Williams perhaps accurately stated that an inverted yield curve isn't an oracle to a recession, you wouldn't guess that after looking how the Fed's posture and policy forecasts have done an about face over the past 3 quarters. It's increasingly clear that the Fed is done tightening for this cycle unless the inflation genie magically appears through a policy mistake. Historically, lower interest rates have consistently been good for risk assets since

borrowing gets cheaper for households and businesses alike. As a result, money flows into the system via credit expansion and business activity improves. Lower bond yields make fixed income less attractive versus stocks and the cycle moves on.

However, something seems peculiarly different this time. The pace and breadth at which interest rates have moved lower appears much more like a prelude to a substantial economic recession than it did in previous post-crisis bond rallies during 2011 and 2016. Economic reality is a direct outcome of household and business sentiment, and while a vast number of issues impact sentiment, this relationship has been persistent. And one thing is certain—sentiment is fickle. Markets, news and events change at an increasing rapid pace. While we believe the fixed income market is likely ahead of the Fed, what's more concerning is the impact, or lack thereof, the yield curve has had equity and credit valuations. We can see this relationship quite clearly in the chart below. Here we've spread changes in yields on the 2 year Treasury (blue line; left axis, inverted) versus changes in corporate spreads (green line; right axis, inverted) and U.S. equity values (red line). Traditional correlations are broken, as risk markets have rallied right alongside their US Treasury risk free counterpart. More changes are coming. Ultimately, the relationship between fear and greed will normalize, much as it did in the fourth quarter, and better opportunities will avail themselves to those prudent enough to remain patient.



Source: Bloomberg 6/25/19

Sentiment can shift rapidly, particularly since market headwinds are largely political in nature, as discussed earlier. While global stocks are fundamentally undervalued versus domestic equities, unless economic fundamentals and earnings improve materially, non-US equities lack a clear catalyst to move materially higher. The probability of a hard Brexit has increased, increasing populism in the Eurozone, and weakened prospects for global growth cloud our view. Escalating trade wars will negatively impact all economies, although they could prove most damaging to emerging markets, resulting in a wider path of potential market returns.

CT02 Govt ()
 SPX Index (S&P 500 Index)
 LUACOAS Index (Bloomberg Barclays US Agg Corporate Avg OAS)

Global sovereign interest rates hover near zero and US rates have priced in a recession nearing levels not seen since zero interest rate policies were in effect. This makes income, or carry, all the more attractive to investors. Equity dividend yields out carry the belly the US Treasury curve. With forward multiples close to historical averages, we could very well see dollars flow into the equity market as it remains relatively attractive versus alternatives. We really haven't seen the great rotation in mutual and ETF flows into equities from bonds we typically see at a mature point in the credit cycle.

► PRUDENT MAN ADVISORS MARKET OUTLOOK SUMMER 2019

As a result, equities are expected to outperform once again in the year ahead although with a wider range of potential outcomes.

In credit markets, we strongly favor higher quality credit with tilts toward more defensive and regulated sectors of the market including financials, utilities and consumer staples. With credit priced at significantly tighter levels, along with dramatically lower interest rates more generally, corporations will remain active with shareholder friendly activities including buybacks and merger and acquisition activity. Tight spreads, increasing leverage and higher corporate debt levels argue for continued caution in taking on credit risk.

Rather we prefer to take risk in higher quality, more liquid sectors of the credit markets, particularly in specific agency mortgage sectors that are relatively attractive. High nominal yields provide substantial income relative to their US Treasury risk free counterparts and refinancing risk, while certainly higher given the substantial move lower in 10yr rates, is largely priced into the market. We prefer to position for steepening rates in the years ahead as the Fed ultimately validates the market by easing policy. Here to, while difficult in an inverted yield curve environment, carry will be increasingly important so positioning on the tails of the duration spectrum will

be important. Overall, we expect the equity and credit market to generate positive returns in our base case estimates, but undergo a healthy correction once again this year as economic fundamentals weaken and political risks emerge. A healthy allocation to cash and high quality fixed income will enhance risk adjusted returns for the prudent investor in the year ahead.

Sector	Base Case	Upside	Downside
Cash	2.00%	2.25%	1.75%
US Treasury	2.00%	7.00%	-3.00%
Investment Grade Corps	2.50%	4.50%	-4.00%
US MBS	2.75%	4.00%	-1.00%
US Equities	6.00%	12.00%	-20.00%
Global Equities (non-US)	7.00%	15.00%	-25.00%

Source: Prudent Man Advisors, LLC, Bloomberg



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