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Marketing Material

LAST CHANCE TO DE-RISK?: POSSIBLY SEEK DIVIDEND YIELD WHERE EARNINGS ARE SAFE

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IN A NUTSHELL

- Equities rally on trade-talk hopes (again): Another opportunity to reduce risk
- Tariffs are taxes: but more damaging than the tax revenue suggests
- Fed likely cuts 25bps on September 18: possibly more cuts if October and December tariffs occur
- Possibly seek dividend yield, but make sure the earnings are safe
- Mean-reversion based strategies: no help this cycle, adds to uncertainty

EQUITIES RALLY ON TRADE-TALK HOPES (AGAIN): ANOTHER OPPORTUNITY TO REDUCE RISK

We still believe that a reduction of existing tariffs is extremely unlikely and that more tariffs will likely take effect later this year, despite new talks scheduled in October. In our opinion the main reasons for not expecting tariffs to stop rising are: 1) distrust on both sides; a formal agreement with specific actions and timelines is needed and might require third party involvement (perhaps WTO); 2) many complicated issues beyond trade have entered the negotiations; both sides have concerns within the ranks of their governments and constituents about the long-term compatibility of national interests; 3) preparations and policy adjustments are being made by both to brace their economies for higher and longer lasting tariffs, both may suffer but neither may break; 4) some in the United States think now is the last chance to get China to shift toward western economic and political norms, so maximum pressure must be brought to bear to hasten such change; whereas China resists quick changes, particularly from the west.

TARIFFS ARE TAXES: BUT MORE DAMAGING THAN THE TAX REVENUE SUGGESTS

Some believe that because tariffs are taxes they should not be any more of a shock to the economy than moderate tax hikes would be or the kind of shock that rising oil prices can cause. We think, however, these tariffs present significant near-term and longer-term challenges to the United States and the world economy that greatly exceeds the 100 to 150 billion dollars taken by the U.S. government, which is revenue without a spending or recycling link. While these one-way tariffs are about 0.75% of U.S. gross domestic product (GDP) or 7.5% of S&P 500 after-tax net income, if all was paid by S&P 500 firms (we estimate 35%-50% will be S&P 500 paid), these tariffs exacerbate the pressures already on the weakest parts of the global economy.

The vulnerable parts are commodity-producing and manufacturing industries, which are suffering from excess capacity and the world's regional economies tilted toward such industries, but are also still suffering from their own weak internal recoveries, particularly Europe, Japan and most emerging economies outside Asia. To the extent a weaker Renminbi or price cuts by Chinese exporters mitigates the cost of tariffs to U.S. companies and consumers, it weakens China's ability to afford commodities and foreign capital goods; again, this all puts pressure on the weak industries/regions.

Moreover, more trade tariffs/taxes means less trade, which means less productivity gains. This means that tariffs not only threaten the expansion's longevity, but also weigh on its ability to deliver healthy growth in its remaining years. Furthermore, this trade conflict is closing an important frontier for the S&P 500 to expand. Investors have shifted from asking U.S. multinationals, "what's your growth strategy in China?" to "will you stay in China?" Weak productivity and closed growth frontiers are significant threats to the ability of S&P 500 companies to sustain margins and drive sales growth.

FED LIKELY CUTS 25BPS ON SEPTEMBER 18: POSSIBLY MORE CUTS IF OCTOBER AND DECEMBER TARIFFS OCCUR

The U.S. Federal Reserve (Fed) recognizes it is not in charge of fiscal policy, or other policies like trade or global-geopolitical balance. As such, it must implement optimal

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monetary policy for the conditions it faces; whether those are natural or from policies it agrees with or not. Inflation below target and recent deterioration in incoming economic data make a 25 basis points (bps) federal-funds-rate cut to 1.75-2.0 likely in September. If additional tariffs come, we would expect further cuts, but do not think the Fed cuts below 1.5% unless jobs stall.

Lower interest rates, across the curve, will challenge banks. The collapse in interest rates is how the trade conflict is now spilling into the most domestic of U.S. industries. If the Fed cuts to 1.5% and the curve stays flat or inverted owing to an aging and slowing expansion, S&P 500 Financial-sector earnings growth should be anemic for the rest of the cycle.

POSSIBLY SEEK DIVIDEND YIELD, BUT MAKE SURE THE EARNINGS ARE SAFE

To the extent that lower interest rates are not from rising recession risk, which is always uncertain, the benefit to price-to-earnings ratio (P/E) multiples tends to cascade over time first to defensives stocks, then to secular growth stocks, then lastly (if ever) cyclical stocks.

Currently, we favor pursuing above average dividend-yielding stocks, but only if the earnings are safe and well protected from cyclical/macro risks. We prefer 2% to 3% dividend yields, on high P/E stocks with well protected earnings, than 3%+ dividend yields on cyclical industry stocks, such as Energy, Industrials, Materials and most Financials, Tech hardware. We reiterate over-weights on U.S. Utilities, Real Estate Investment Trusts (REITs), Communications, Health Care. We raise Staples to equal-weight and lower Energy to underweight. We stay underweight Industrials, Materials, and Consumer Discretionary.

MEAN-REVERSION BASED STRATEGIES: NO HELP THIS CYCLE, ADDS TO UNCERTAINTY

Tariffs aside, interest rates remain at the center of investor debate and controversy. What's a normal or fair long-term risk-free interest rate and how should the uncertainty of such affect valuation of income-producing risk assets? Using historical averages of past decades or even centuries has failed. Our skepticism of historical-mean based expectations has intensified. Whether it be interest rates, cycle length, profit margins, value vs. growth, etc. We are humbled by the future's ability to surprise and think every time has its differences. This is a very uncertain point in time: invest accordingly!

GLOSSARY

Basis point
One **basis point** equals 1/100 of a percentage point.

Dividend
A **dividend** is a distribution of a portion of a company's earnings to its shareholders.

Federal funds rate
The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Fiscal policy
Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Gross domestic product (GDP)
The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation
Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy
Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Price-to-earnings (P/E) ratio or multiple
The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Real Estate Investment Trust (REIT)
Real Estate Investment Trusts (REITs) are companies, mostly listed, that own and often operate various types of real estate. They are obliged to pay out a minimum of 90% of earnings.

Recession
A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Renminbi (RMB)
Renminbi (RMB) is the currency of the People's Republic of China.

U.S. dollar (USD)
The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)
The **U.S. Federal Reserve**, often referred to as **"the Fed"**, is the central bank of the United States.

Valuation
Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

World Trade Organization (WTO)
The **World Trade Organization (WTO)** is an international organization based in Switzerland, which regulates commerce between nations through mutually agreed rules.

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