Sit Investment Associates

April 2018

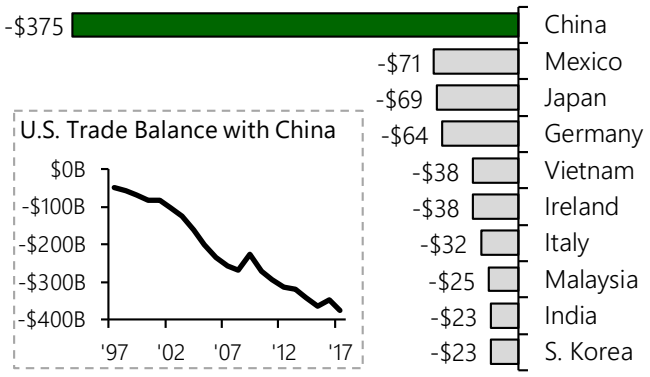
GLOBAL INVESTMENT OUTLOOK AND STRATEGY

- **Special Topic: Are Markets Overreacting to Trade Tensions?**
- **Synchronized Global Growth Led by Improving U.S. Economy**
- **Fed Will Remain Data Dependent as It "Normalizes" Policy**
- **Increased Market Volatility Will Continue Across Asset Classes**
- **Late Cycle Dynamics Bode Well for Quality-Based, Active Investing**

TRADE TENSIONS HAVE LED TO MARKET INEFFICIENCIES, CREATING INVESTMENT OPPORTUNITIES

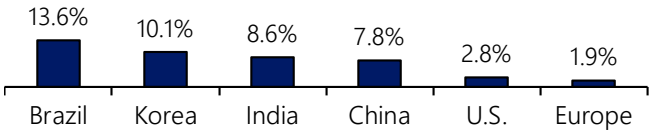
1 U.S. Trade Deficit with China Has Ballooned

Largest U.S. Trade Balance Deficits
Goods, Billions of U.S. Dollars, 2017

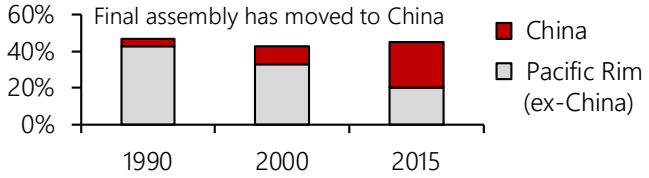


2 Partly Due to China's Trade Practices, but Also Its Role as Final Assembler

Applied Tariff, Simple Mean, All Products

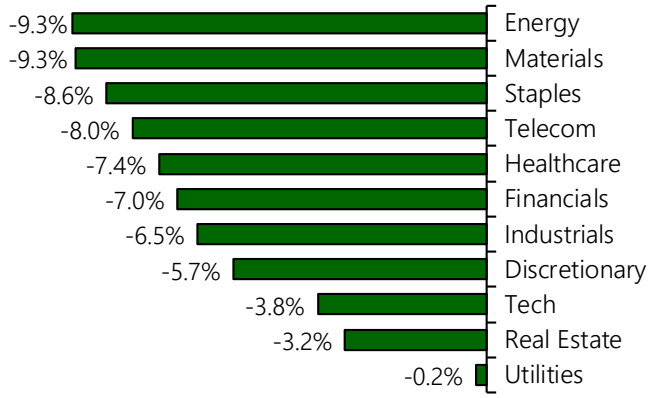


Share of U.S. Manufactured Imports from Asia



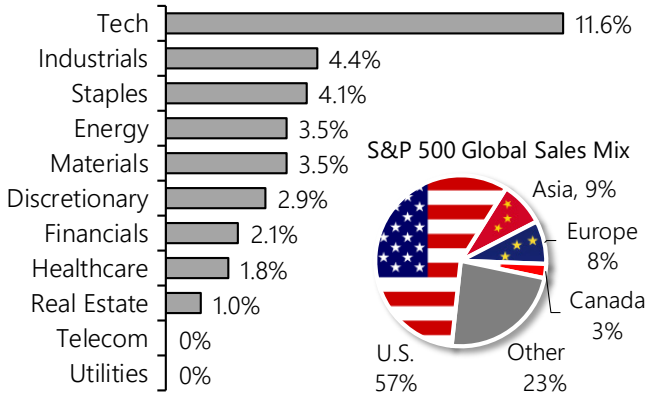
3 U.S. Market Selloff Has Been Broad-Based

Total Returns of S&P 500 Sectors, 1/31/18-3/31/18



4 Although Direct Exposure to China Is Limited

China Revenue (% of Total Sales), by S&P 500 Sector



Source: U.S. Census, World Bank, Carnegie Endowment, FactSet, Sit Investment Associates, 3/31/18

President Trump and Tariffs: Threat to Growth or "Art of the Deal" Part II?

Fears of an escalating trade war have rattled global financial markets in recent weeks, sparking volatility across many different asset classes. It would be a mistake to dismiss the risk of protectionist policies. However, we believe investors have overreacted to recent events, resulting in near-term investment opportunities in a number of sectors and markets.

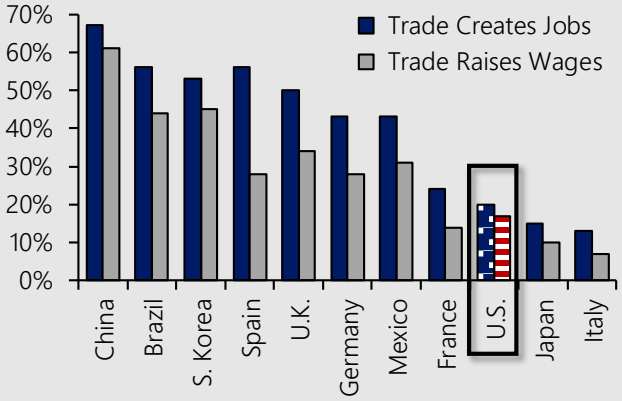
Although a trade war has been a lingering risk since President Trump's election in 2016, investors have been complacent as pro-growth polices took center stage. There has generally been an assumption that the Trump administration would not do anything to undercut its intense focus on economic growth. Unlike his recent predecessors, however, President Trump is a long-standing skeptic of free trade as a driver of economic growth and prosperity. He has often commented that trade deficits are a sign of economic weakness, driven by his perception that other countries are much more protective than the U.S. of their domestic industries. Even though the "math" behind trade deficits is complex and multi-faceted, there is very little dispute that many countries, most notably China, have been reluctant to fully open markets to global competition.

Aside from trade balances and tariffs, there is a widespread view that intellectual property (IP) theft has cost the U.S. economy billions of dollars in revenue and thousands of jobs. Whereas details will emerge in the coming weeks, this is the essence behind the Trump administration's investigation of Chinese technology transfer and IP theft under Section 301 of the Trade Act of 1974. Aside from the President's view, one also cannot dismiss the underlying politics. The simple fact is that, versus the investment community, the average American is decidedly less pro-trade. Additionally, many U.S. officials from both political parties (notably, many Democrats) praised the President's trade actions as necessary and long overdue.

Trade tensions deepened in early March with the Trump administration's announcement of across-the-board tariffs of 25 percent on steel imports and 10 percent on aluminum imports, following a U.S. Commerce Department analysis that concluded reliance on these imports represented a threat to U.S. national security. Importantly, however, many key trade partners have been temporality excluded from tariffs pending negotiations. Thus, retaliatory actions have been limited to this point. While we cannot rule out the risk of trade disputes arising with other countries, it is abundantly clear that the President's focus is squarely on China. With that said, there is increasing optimism that renegotiation of the North American Free Trade Agreement is progressing, and a recently revised trade agreement with South Korea is a clear positive. These could well prove to be models in resolving trade disputes with China, although the path is more complicated and the stakes are higher. Commerce Secretary Wilbur Ross has said the trade renegotiation with South Korea bodes well for potential agreements with other countries. "We're an administration that believes in objectives. We never would have gotten where we are now without tariffs," Ross recently told CNBC.

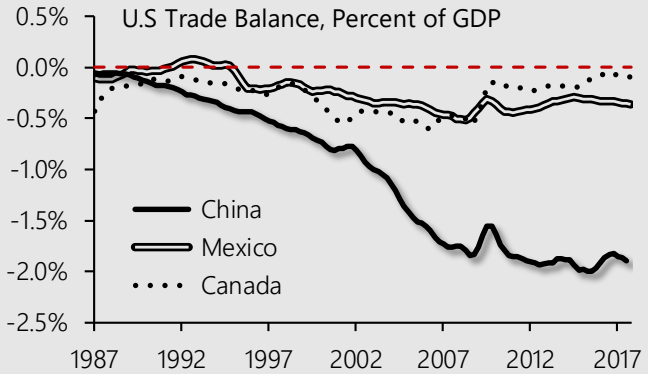
American's Not Immune to Protectionism

Percentage of Respondents Agreeing with Each Statement



Source: BCA Research, Sit Investment Associates, 3/31/18

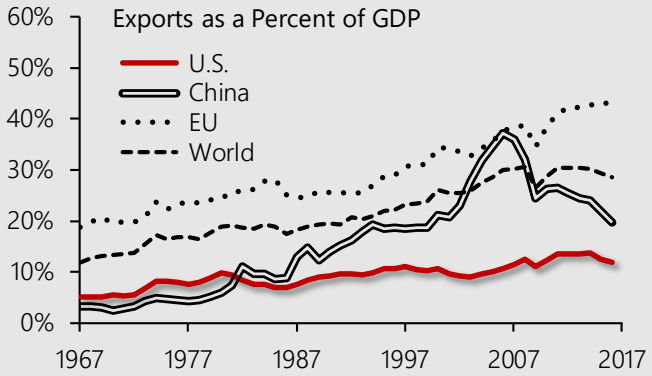
Trump's Sights Set Squarely on China



Source: U.S. Census, BEA, Sit Investment Associates, 3/31/18

President Trump recently stated that "trade wars are good and easy to win." However, we tend to believe his best-selling book from the 1980's, *The Art of the Deal*, may be more relevant to recent events. The President's style has often been to take an extreme view and gradually soften his position. On trade, for example, he made a pre-election vow of placing 35 percent tariffs on our main trading partners (45 percent on China). The Trump administration is betting on simple facts, including 1) U.S. consumption remains critical to global growth and 2) most countries, including China, are much more dependent on trade relative to the U.S.

The U.S. Least Exposed to International Trade



Source: World Bank, Sit Investment Associates, 3/31/18

Trade disputes are rarely resolved easily or quickly and we suspect that US-China negotiations will take time. We believe it would be highly beneficial for the U.S to gain support from European and Asian countries, although it may not be helpful that the President has occasionally alienated key allies based on his comments on trade. Europe has been active in bringing trade cases against China to the World Trade Organization, and the region is an even larger importer of Chinese goods than the U.S.

The Trump administration announced tariffs on $50 billion of Chinese imports and requested that China reduce its trade surplus by $100 billion (from the current $350 billion). However, China may not be able to reduce exports and/or increase imports by this magnitude, particularly in a time of slowing growth in the country. In our view, moderating GDP growth in China, combined with a continued reliance on exports (despite the government's efforts to rebalance the economy), are the key drivers that will lead to trade concessions. While China has recently announced retaliatory measures, our expectation is that it will actively negotiate with the U.S to avoid an escalation that could derail economic growth in each country.

Equity prices have declined in recent weeks as trade war fears have emerged. Markets have historically done a poor job at "pricing in" political risks, and we do not see it as different this time. Our baseline forecast continues to assume trade policy actions will not alter the trajectory of economic growth in 2018. Importantly, the trade disputes are coming at a time when global economic growth has been on the upswing and pro-growth U.S. policies have yet to manifest fully. Although there have been some signs of a slight downshift in Europe, economic growth appears on solid footing in most regions of the world. It is also worth noting that the tariff announcements to date are trivial in the context of the global economy.

One near-term concern relates to negative effects that trade war fears may have on business and consumer confidence. There has been a notable uptick in "animal spirits" since late 2016, pushed along by U.S. pro-growth policies. Given our belief, however, that growth optimism will largely remain in place over the near- to intermediate-term, we have added to positions that have recently been hard hit by global trade fears. Attractive sectors include technology, capital goods, and finance. Volatility has risen in the recent market setting, and we suspect trade talks will be a continued source of market gyrations in the months ahead.

We believe trade concerns are likely to ease somewhat in the coming months, but we cannot rule out a more onerous outcome. The high profile exodus of free-trade advocates (i.e., Gary Cohn) within the Trump administration has raised the odds of a hard line approach. History has shown that trade wars are generally "lose-lose" scenarios, resulting in high costs for affected countries and collateral damage for the rest of the world. Markets have moved in unison with the negative headlines that have dominated the trade discussion in recent weeks, with investors contemplating only downside risks. There is an upside case to be made, however, to both our economy and markets if revised agreements help our workers and corporations gain access to global markets.

The United States

Buoyed by fiscal stimulus, deregulation, and strong confidence, GDP growth projected to accelerate in 2018. However, hawkish policies and increased partisanship are added risks.

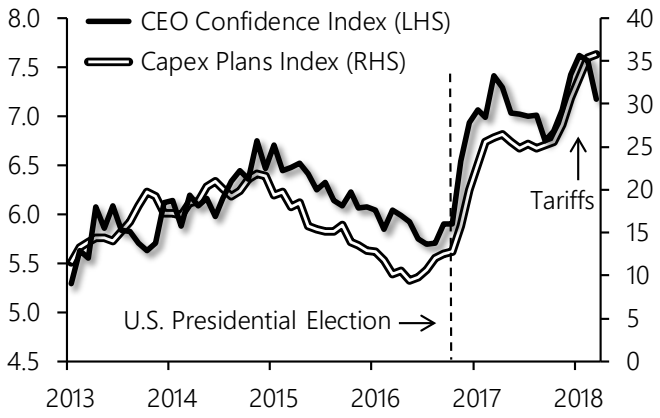
Economic Trends Remain Positive, but Hawkish Policies Add Uncertainty

Business confidence has remained high post the 2016 presidential election as the Trump administration continues to execute a business-friendly agenda including tax reform and deregulation. Combined with better global GDP growth, these policies have contributed to a resurgence in domestic business activity and capital spending (Exhibit 1). The ISM Purchasing Managers' Index, a key indicator of economic strength, recently achieved cycle-highs for both the manufacturing and non-manufacturing sectors, with robust new order growth. Buoyed by fiscal stimulus, we project real GDP growth will accelerate to at least +2.7 percent in 2018 from +2.3 percent in 2017. Corporate earnings will also realize a sizable boost from tax reform, with bottom-up earnings for the S&P 500 Index projected to increase +19 percent year over year in 2018 versus +12 percent in 2017. Certainly, a more hawkish tone on foreign relations and trade may dull "animal spirits." A trade war could push the U.S. economy into recession, while "fairer" trade would be mildly stimulative – the onus is on the Trump administration to proceed wisely.

Modest Core Inflation Growth Lends Itself to Measured Monetary Tightening

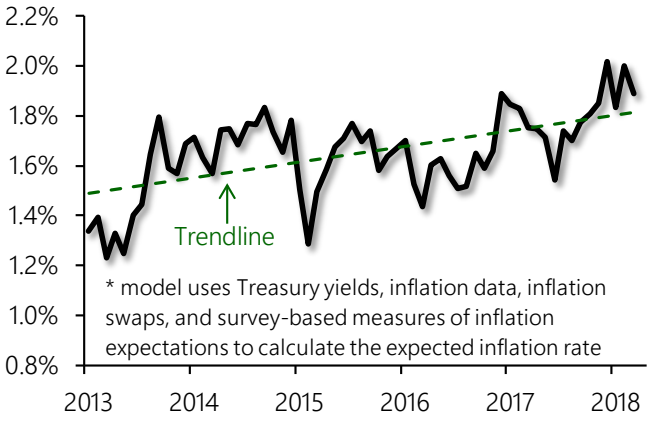
While some inflationary pressures have been accumulating, measures of both current and expected inflation remain below the Federal Reserve's target of +2.0 percent. The PCE Price Index, excluding food and energy, has hovered around +1.5 percent most recently, while the Federal Reserve Bank of Cleveland's inflation expectations model estimates an average inflation rate of +1.9 percent over the next five years (Exhibit 2). Nevertheless, the Federal Reserve recently raised the fed funds rate 25 basis points to a target range of +1.50 to +1.75 percent as it seeks to slowly "normalize" monetary policy. We generally expect two additional 25 basis point interest rate increases in calendar 2018, but believe policy decisions will largely remain data dependent (see page 12 for added commentary on monetary policy). Although "core" inflation is contained, higher energy, food, and import prices will negatively affect consumer spending and the profitability of companies that lack pricing power. For instance, the 20 percent year-over-year increase in gasoline

Exhibit 1: Business Confidence and Capex Plans



Source: Chief Executive, Fed Banks, Sit Investment Associates, 3/31/18

Exhibit 2: Five-Year Expected Inflation*



Source: Cleveland Fed, Sit Investment Associates, 3/31/18

prices, if sustained, would reduce discretionary spending by roughly $20 billion in 2018. The impact of higher raw material and corporate financing costs will be passed through to consumers, where possible, and likely begin to push up core inflation later this year.

The U.S. Dollar Has a Modest Downward Bias Due to "Twin Deficits"

The trade-weighted U.S. dollar has depreciated nearly 10 percent since December 2016, providing a tailwind for exports and multinationals. Still, the Federal Reserve estimates that a 10 percent decline in the dollar translates to roughly a 50 basis point rise in core PCE inflation, with roughly a two-quarter lag. However, there are a multitude of forces affecting both inflation and the value of the dollar. Drivers of dollar strength include U.S. tax reform, potential positive economic surprises, interest rate hikes, and the view that the U.S. remains a relative safe haven in a time of mounting geopolitical uncertainty. Conversely, catalysts for further U.S. dollar weakness include policy uncertainty on issues such as immigration and trade that could have a negative impact on domestic growth. With that said, the "twin deficits" (federal budget and current account) will likely have the largest negative impact on the U.S. dollar, as domestic savings remain low and the annual budget deficit is expected to balloon to over $1 trillion in 2019 and beyond.

Easing of Bank Regulations Should Further Stimulate Economic Growth

The House and Senate have separately passed bills that would ease some elements of the Dodd-Frank Act of 2010, a positive step toward relieving banks of onerous regulation without undermining the stability of the overall financial system (Exhibit 3). Although the Senate bill is more a recalibration than a sweeping overhaul, it is a clear positive for both regional/community banks and loan growth. Notably, the Senate bill would raise the systemically important financial institution (SIFI) regulatory threshold from $50 billion to $250 billion, ease Volker Rule restrictions, simplify capital requirements for small banks, and allow banks to substitute higher levels of capital for costly regulation. These changes would boost profitability, enable capital return, encourage M&A activity, and, most importantly, catalyze lending to small businesses and individuals. If the House and the Senate can reconcile the differences between the two bills, a blended bill can move to the President over the next six-to-eight weeks. After eight years of increased regulation under the Dodd-Frank Act, such changes would not only be a welcome relief for banks, but could also provide an additional tailwind for economic growth.

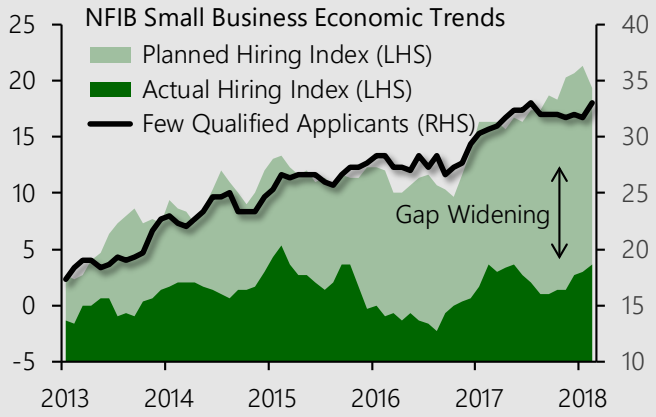
Exhibit 3: The Impact of Financial Deregulation on Banks and the Economy

Regulatory Change	Effect on Banks	Effect on Economy
More transparent stress testing	Higher return on equity; either return excess capital or expand balance sheet	Facilitate loan growth; return capital to shareholders; greater market liquidity
Leverage ratio recalibration	Hold more Treasuries; higher ROE; either return excess capital or expand balance sheet	Facilitate loan growth; return capital to shareholders; greater market liquidity
Volcker rule simplification	Can move into trading businesses they currently avoid; face lower expenses	Shift some financial activities back to banks; greater market liquidity
Regulatory relief for small banks	Reduced compliance costs for small banks, could increase lending	Potentially greater access to loans for small businesses
Burden reduction in resolution planning	Lower liquidity requirements permit moving assets into higher yielding securities and loans	Increase bank profitability

Source: Goldman Sachs, Sit Investment Associates, 3/31/18

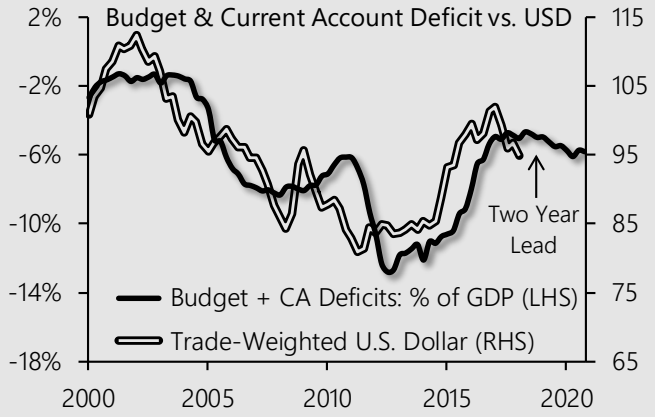
United States: Notable Data Points

Tight Labor Markets Restraining Expansion



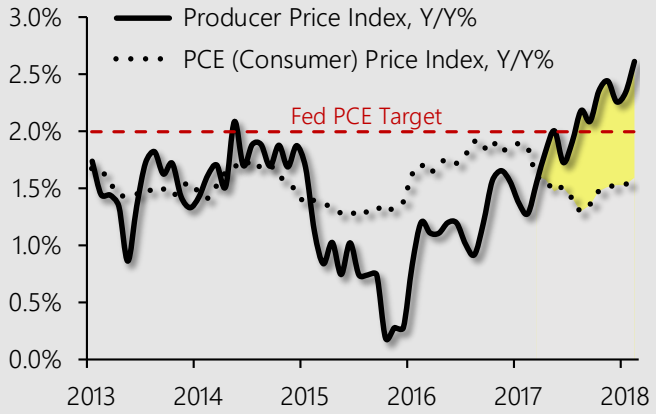
Source: NFIB, Sit Investment Associates, 3/31/18

"Twin Deficits" Herald U.S. Dollar Softness



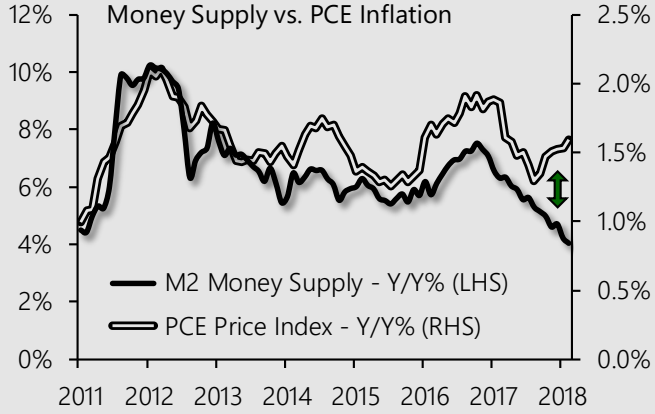
Source: BEA, U.S. Treasury, FRB, Sit Investment Associates, 3/31/18

Producers May Pass Through Higher Prices



Source: BLS, BEA, Sit Investment Associates, 3/31/18

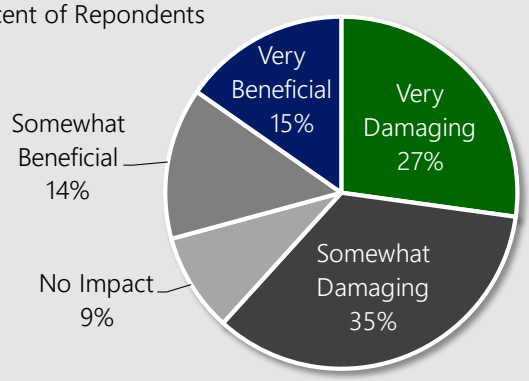
But Money Supply Implies Contained Inflation



Source: Federal Reserve, BEA, Sit Investment Associates, 3/31/18

CEOs Divided on Impact of Proposed Tariffs

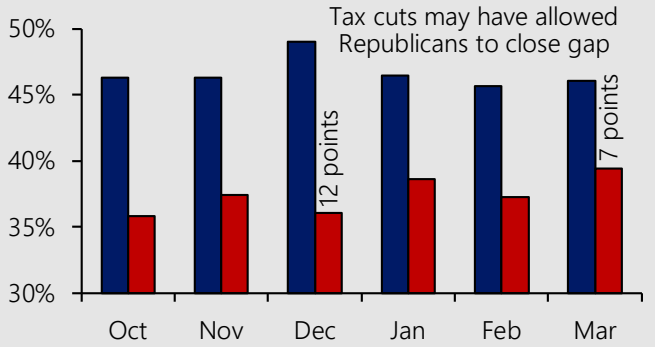
Long-Term Impact of Tariffs on the U.S. Economy
Percent of Repondents



Source: Chief Executive, Sit Investment Associates, 3/18/18

Tax Cuts May Have Dampened "Blue Wave"

2018 Generic Congressional Vote
Voting Intentions if Election Held Today



Source: RealClear Politics, Sit Investment Associates, 3/31/18

Europe

Modest economic growth expected to continue, but export growth moderating as currencies strengthen. The ECB will remain accommodative, with rate hikes not expected until 2019.

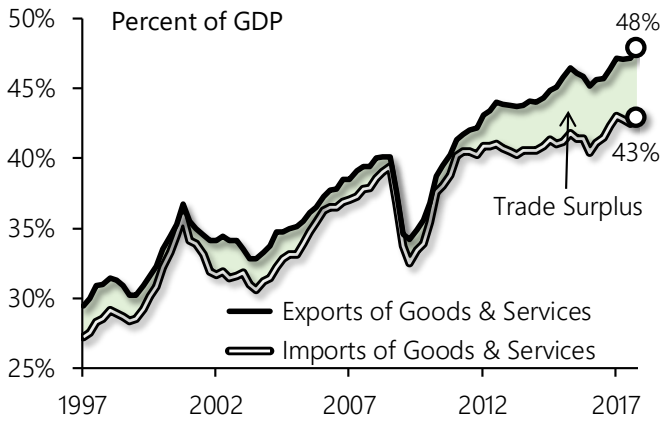
Despite Ebbing Export Tailwinds, Economic Conditions Support Modest Growth

The Euro Area has been a key beneficiary of the synchronized upswing in global growth, with robust export demand contributing to an acceleration in real GDP growth to +2.5 percent in 2017 from +1.8 percent in 2016. While the strengthening euro may pressure export growth henceforth, resilient domestic demand and improving financial conditions should support real GDP growth of +2.0 to +2.5 percent in 2018. As for the United Kingdom, consumer confidence and spending have waned, in part, as higher import prices post the sterling's multi-year depreciation have negatively affected real incomes. Nevertheless, buoyant business activity and easing inflation imply real GDP growth will decelerate only slightly to +1.5 percent in 2018 as export tailwinds abate. Even though central banks have become less dovish, monetary policy will also remain supportive of growth. The European Central Bank intends to increase the size of its balance sheet by an additional €180 billion over the next six months and reinvest principal payments for an extended time thereafter. In addition, the now appreciating sterling should mitigate import inflation and allow the Bank of England to raise interest rates at a measured pace.

The Euro Area is Particularly Vulnerable in a Global Trade War Scenario

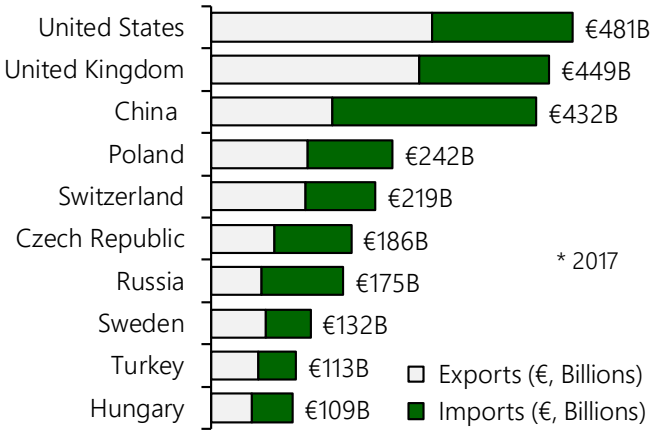
The Euro Area has grown increasingly exposed to global trade, with exports and imports climbing to 48 percent and 43 percent of GDP, respectively (Exhibit 4). In comparison, gross exports as a percent of GDP are 12 percent for the U.S., 20 percent for China, and 29 percent for the World. The U.S. currently accounts for roughly 13 percent of the regions' exports and 10 percent of imports (Exhibit 5). Moreover, the Euro Area's trade surplus with the U.S. has grown to €108 billion in 2017 from $36 billion in 2009. Consequently, the Euro Area is vulnerable to President Trump's "America First" agenda and adoption of protectionist policies. The European Commission quickly condemned the recently proposed U.S. tariffs on steel and aluminum imports and suggested it might implement a retaliatory tariff of 25 percent on a broad range of U.S. goods that have an import value of nearly €3 billion. Although these measures are unlikely to effect trade or economic growth meaningfully, escalation to a broader trade war would likely derail the region's current economic expansion and prove highly inflationary.

Exhibit 4: Euro Area Exports and Imports



Source: Eurostat, Sit Investment Associates, 3/31/18

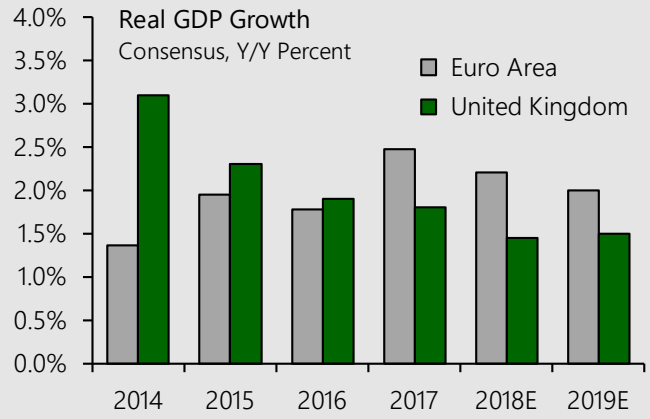
Exhibit 5: Euro Area's Top Trading Partners*



Source: Eurostat, Sit Investment Associates, 3/31/18

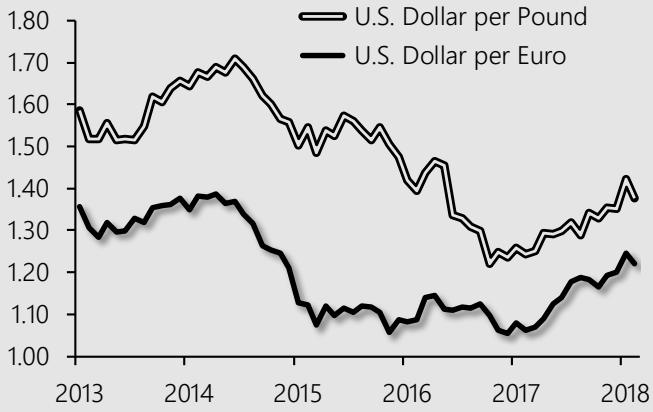
Europe: Notable Data Points

GDP Growth Expected to Moderate Slightly



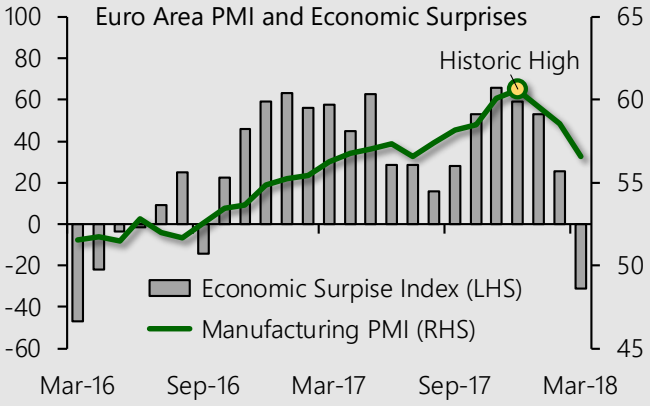
Source: FactSet, Sit Investment Associates, 3/31/18

Strengthening Currency a Modest Headwind



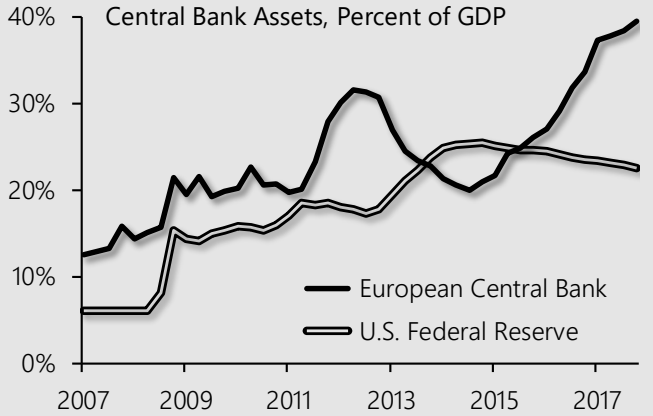
Source: FactSet, Sit Investment Associates, 3/31/18

PMI and Surprises Decelerating from Highs



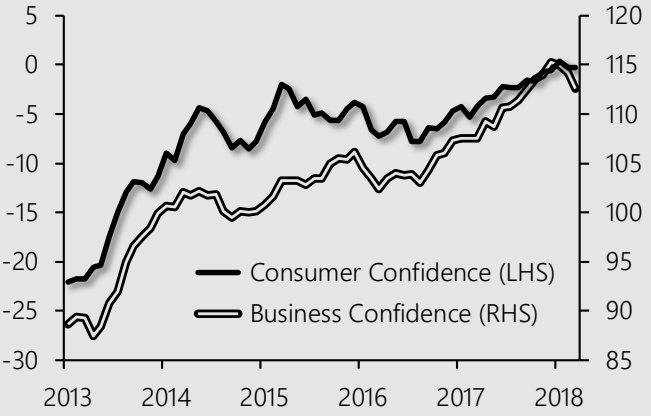
Source: Citi, Markit, Sit Investment Associates, 3/31/18

The ECB Will Remain Accommodative



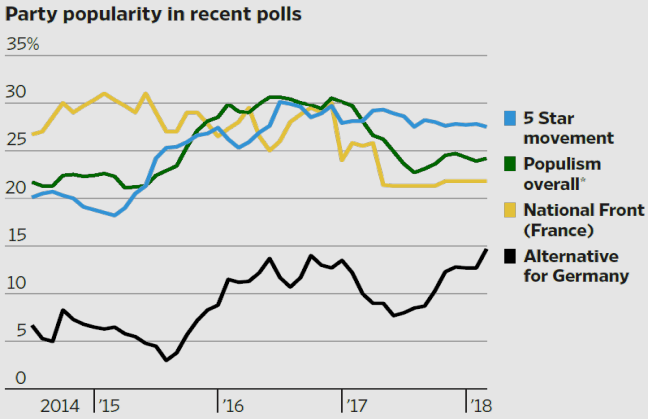
Source: BEA, Federal Reserve, Sit Investment Associates, 3/31/18

Euro Area Confidence Remains Elevated



Source: Eurostat, Sit Investment Associates, 3/31/18

Populism Sweeping Through Europe



Source: The Wall Street Journal, 3/5/2018

Japan

Growth to slow in 2018 as moderating overseas demand tempers exports, a stronger yen and trade tensions present downside risks, and domestic consumption remains sluggish.

We expect GDP growth to slow to +1.3 percent in calendar 2018 from +1.7 in 2017. The broad improvement in the global macroeconomic climate that began 18 months ago has lifted exports and supported a gradual increase in domestic investment. Overseas demand looks to remain favorable, though at a moderating pace, as leading indicators of key trading partners look to have peaked but remain in expansion territory. However, the yen's recent strength, should it hold, will be a headwind. While the impact on Japan from the recent steel and aluminum tariffs imposed by the US is limited, increasing trade tensions creates downside risk. Moreover, domestic consumption continues to develop at a sluggish pace despite elevated confidence levels and low unemployment. Initial indications from the current spring wage negotiations between large employers and labor unions, a barometer for national wage growth, suggest pay gains will remain muted and continue to hold back consumption. The limited spending outlook, in combination with moderating export growth, suggests growth slows in 2018. Against this backdrop, we expect inflation to remain muted and monetary easing to continue.

Emerging Markets

U.S. tariffs announced to date should have limited impact on China's economy, India will grow over +7 percent as policy headwinds fade, S. Korea's export-driven economy remains on solid footing, and, despite political risk, Brazil will continue to recover from recession.

Despite Rising Trade Tensions, the U.S. and China Will Likely Avert a Trade War

China has countered the Trump administration's trade actions thus far, announcing a list of comparable duties on U.S. imports to match the U.S. proposal for tariffs on Chinese goods with an import value of roughly $50 billion. However, China has also called for discussions to resolve the Section 301-related trade dispute. Based on both the Trump administration's softened tone of late and China's willingness to negotiate, our base case scenario would be a deal rather than further escalation of trade tensions. We expect limited impact on the Chinese economy based on the relatively small size of the tariffs announced to date. Therefore, our expectations for a mild moderation in GDP growth to +6.5 percent in 2018 remains unchanged. It is worth noting that increasingly integrated global supply chains make trade deficits difficult to decipher. According to Deutsche Bank, of China's $375 billion trade surplus with the U.S., more one third is due to China's unique position in the global supply chain: China imports parts from countries such as Korea, Taiwan and the U.S., assembles into final products, and then exports them to end-user markets.

China's End of Presidential Term Limits Lends Itself to Policy Continuity

China moved to end a two-term limit on the presidency, paving the way for President Xi Jinping to remain in power beyond 2023. Although the timing is a few years earlier than anticipated, the move was widely expected given that Xi consolidated power in his first term, yet defied tradition and did not nominate an apparent successor at the 19th Party congress last October. Some argue that to prevail against entrenched interests resisting much needed reform, China needs a strong and capable leader such as Xi. On the other hand, critics view this as the end of an orderly transfer of power and warn of dangerous outcomes from unchecked control. From an economic perspective, the news is positive given the expected policy continuity and the potential improvement in implementation.

Moreover, there will likely be many more changes in the future, if the recent massive government shakeup is any guide. Overall, China still runs a well-institutionalized system and we doubt the removal of term limits equates to lifelong tenure. However, in contrast to his predecessors, Xi is clearly moving toward more centralized power and a party-dominated state. Only time will tell if this shift better aligns with the "new era" in China and what the longer-term implications will be.

India's Economy Finally Recovering; Project Strong Growth for Fiscal 2019

India's economy is finally recovering from the negative effects of the demonetization in November 2016 and Goods & Services Tax (GST) in July 2017. India real GDP grew +7.2 percent year over year in the third quarter of fiscal 2018 (its fastest pace in a year), with particular strength from sectors most impacted by the demonetization and GST including agriculture, manufacturing, construction, and real estate. Moreover, industrial production accelerated by +7.5 percent year over year in January 2018 from +7.1 percent in December 2017. We project India real GDP will increase +7.3 percent in fiscal 2019 from +6.7 percent in fiscal 2018, driven by increases in private consumption and infrastructure spending. India's inflation rate has likely peaked, as February CPI of +4.4 percent is down from its December 2017 high of +5.2 percent. Thus, we expect the Reserve Bank of India (RBI) to keep its repo rate at 6.0 percent.

South Korea's GDP Impact from Revised Trade Agreement with the U.S. Limited

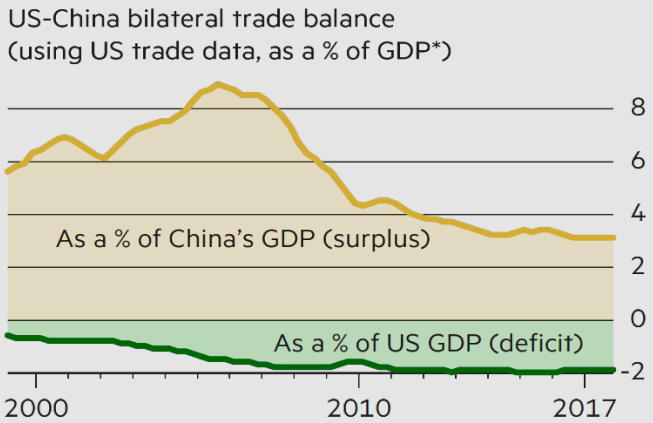
The U.S. and South Korea agreed on March 26 to amend the trade agreement that had been in effect since 2012. The U.S. currently has a $23 billion trade deficit with South Korea, mostly from automobiles and automobile parts. The modified trade agreement includes limiting South Korean steel exports to U.S. to 2.7 million tons; doubling the number of U.S. cars to 50,000 that can be imported without meeting local safety standards; and extending U.S. tariffs imposed on Korean pick-up trucks by 20 years. Nomura Securities estimates that the revised trade agreement would have a maximum impact of -0.07 percentage points on nominal GDP. Accordingly, we forecast GDP growth of +3.0 percent in 2018 versus +3.1 percent in 2017. However, the bigger issue is U.S.-China trade, as 69 percent of Korea's exports to China are for intermediate use. On the political front, there are signs of easing tensions in the Korean Peninsula as President Moon Jae-in has helped arrange a meeting between the U.S. and North Korea in May. This meeting should lower geopolitical risk. However, we are skeptical that North Korea will denuclearize given its history of reneging on agreements.

Brazil Economy Out of Recession; 2018 Presidential Election at Forefront

Brazil's economy is out of recession, having grown real GDP +1.0 percent in 2017. We project the economic recovery will continue in 2018, with growth of +2.5 percent led by household consumption. The economy is benefiting from subdued inflation, declining interest rates, and favorable global growth. Nonetheless, both Standard & Poor's and Fitch downgraded Brazil from BB to BB-, three notches below investment grade, due to a negative fiscal account and the government's failure to approve social security reform. Brazil's presidential election in October 2018 could also add to economic volatility. The most recent poll from Datafolha shows former President Luiz Inacio Lula da Silva (PT party) leading with 34 percent of voter intentions, followed by federal deputy Jair Bolsonaro (PSL party) with 15 percent, and former senator Marina Silva (REDE) with 7 percent. However, Lula may have to withdraw from the election, as a Brazil appeals court has upheld his conviction on bribery and money laundering. Whoever wins the election will face the major problem of resolving pension reform (pension spending is the primary cause of the country's high budget deficit of 9 percent of GDP).

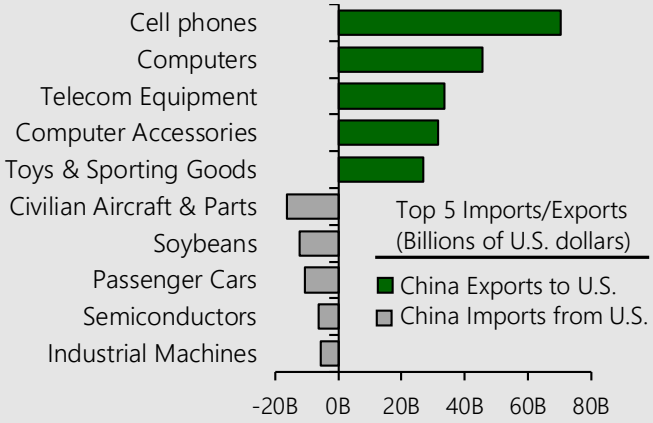
Emerging Markets: Notable Data Points

China Has Become Less Dependent on Exports



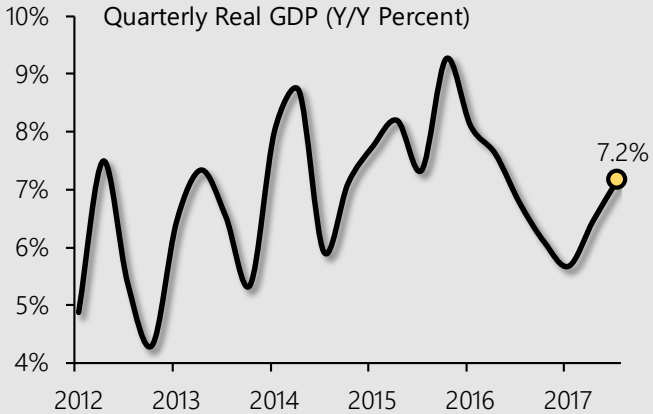
Source: Financial Times, 3/28/18

Top U.S.-China Merchandise Trade



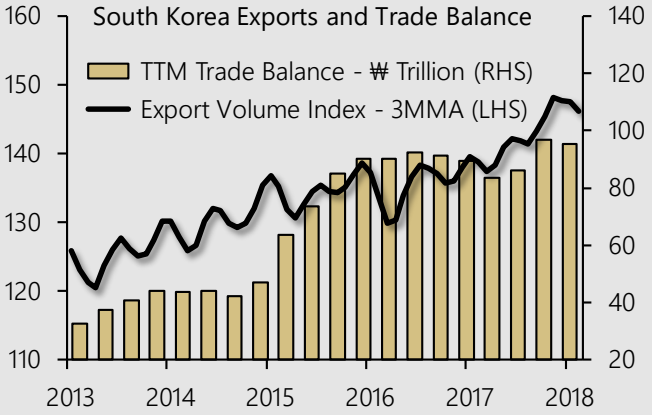
Source: Evercore ISI, Sit Investment Associates, 3/31/18

India GDP Growth Now Above +7 Percent



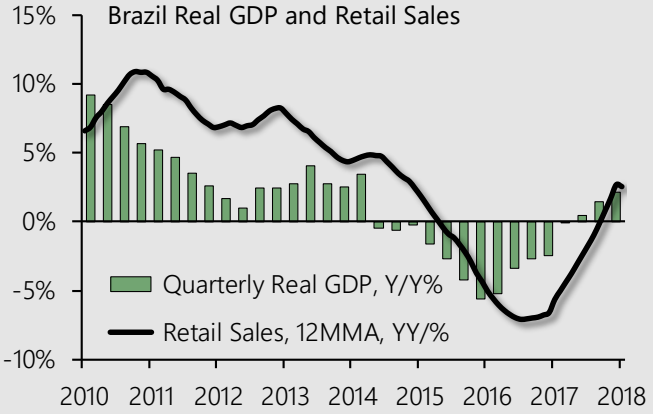
Source: Ministry of Statistics, Sit Investment Associates, 3/31/18

South Korea's Export Volume Remains Strong



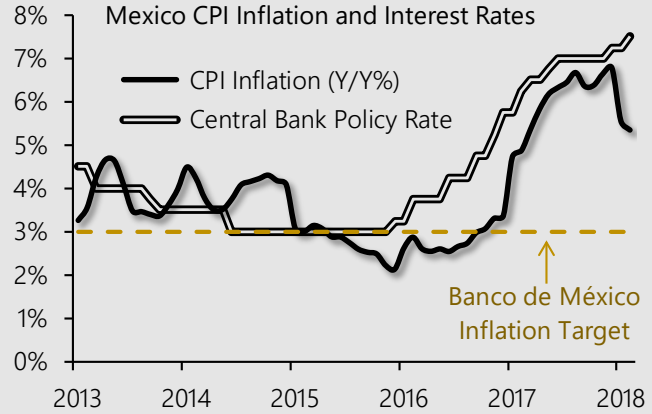
Source: Bank of Korea, KCS, Sit Investment Associates, 3/31/18

Brazil Retail Sales Improving Post Recession



Source: IBGE, Sit Investment Associates, 3/31/18

Mexico Facing Challenging Macro Environment



Source: Bank of Mexico, Sit Investment Associates, 3/31/18

Taxable Bonds

The Fed Has Become Incrementally More Hawkish on Path of Rate Hikes

The first quarter brought a new Federal Reserve (Fed) Chair, an increase in interest rates, and renewed market volatility. Jerome Powell has taken over the reins at the Fed after Janet Yellen's term ended earlier this year. Mr. Powell held his first press conference on March 21, following the Fed's announcement of another 25 basis point increase in the fed funds rate. His calm demeanor and pragmatic approach were generally well received by investors. In concert with the Fed's recent policy statement, the Federal Open Market Committee published outlooks for a variety of economic metrics. It appears Committee members are taking note of increased domestic economy activity and have become incrementally more aggressive on the future path of rate hikes. We believe the Committee will continue to adjust their economic expectations higher as the positive impacts of corporate tax cuts and repatriated foreign profits take hold. However, policy actions will remain data dependent given possible offsets from trade and immigration.

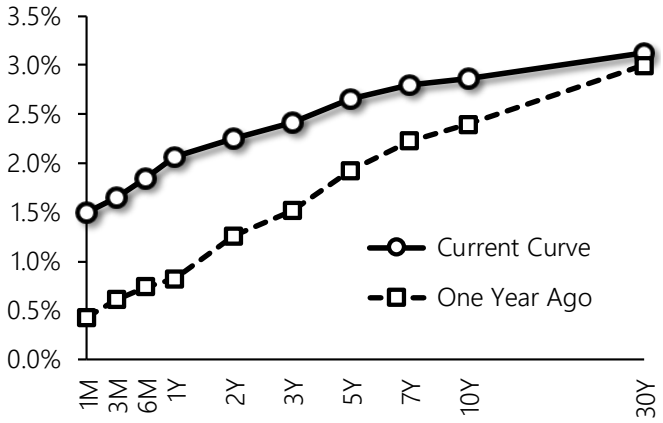
Yields Expected to Increase; Inflation May Limit Magnitude of Flattening

While inflation remained contained during the first quarter, we believe an uptick is likely before year-end. The Fed used the huge amount of surplus cash printed over the last decade to buy bonds, pushing bond prices up and yields down. This in turn depressed financing costs much more significantly than would have been the case at the bottom of a normal interest rate cycle, while making other efficiency-producing projects more economical, both of which served to limit overall inflation. The Fed's balance sheet reduction removes surplus cash from the system, and we expect some of the resulting increase in financing costs to be passed on to consumers. Normally this would cool an overheated economy. However, in the current environment characterized by strong employment and consumers with additional discretionary spending power thanks to recent tax cuts, odds that price increases can be borne by consumers without a meaningfully negative impact on economic growth have grown. While we do not think increasing inflation expectations are a near-term concern, we expect the effects of strengthening economic activity will begin to show up in inflation metrics later this year. We expect rising inflation will put upward pressure on longer-term bond yields.

Taxable Fixed Income Strategy

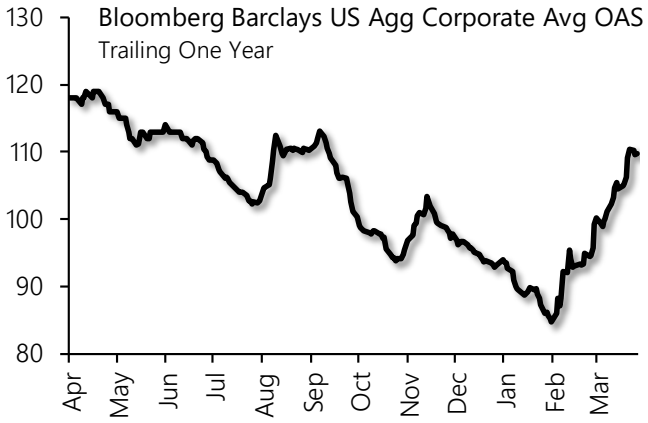
With the continued increase in T-bill issuance as well as the Fed's rate hikes putting upward pressure on the short end of the yield curve (Exhibit 6), we have defensively positioned portfolios to insulate them from rising short-term interest rates. Current coupon mortgages suffered in the first quarter as the Fed reduced purchases of these securities. As the Fed balance sheet continues to shrink at the pre-announced increasing pace, we think agency mortgages will be negatively impacted as the removal of demand will cause spreads to widen. Corporate bonds also had a difficult quarter as we saw the first, relatively sustained, spread widening in years (Exhibit 7). We have a positive bias towards financial institutions debt and taxable municipal securities due to an expected stronger economy and the securities' relatively higher yields. We will be actively increasing the credit quality of the portfolios later in the year, as the benefits of tax reform become fully priced in. As the Fed draws excess reserves out of the financial system, volatility will continue to increase, manifesting itself in additional market corrections. Less government intervention in the capital markets has, and will continue to, provide trading opportunities. We see the return of volatility as a healthy sign.

Exhibit 6: U.S. Treasury Yield Curve



Source: FactSet, Sit Investment Associates, 3/31/18

Exhibit 7: IG Corporate Credit Spreads



Source: Bloomberg, Sit Investment Associates, 3/31/18

Municipal Bonds

Tax-Exempt Yield Curve Steepens

The AAA tax-exempt municipal bond yield curve steepened over the quarter, as short tax-exempt yields increased considerably less than yields on longer tax-exempts. The spread between 2-year and 30-year spot yields increased to 130 basis points at the end of the first quarter from 98 basis points at year-end 2018. In terms of specific spot yields, using the MMD AAA GO for tax-exempts, 2-year yields increased 9 basis points to 1.65 percent, while 30-year yields increased 41 basis points to 2.95 percent. We expect a reversal in this steepening trend as 2018 progresses, with increases in short-term tax-exempt yields leading to a flattening yield curve. The yield on the Bond Buyer 40-Bond Index, generally comprised of longer bonds, was up 11 basis points year-to-date to close at 3.98 percent at the end of the first quarter.

Duration Drove Performance

Shorter tax-exempts outperformed longer tax-exempts with the yield curve steepening during the quarter. The total return for the maturity sub-indices of the Bloomberg Barclays Municipal Bond Index less than 5-years were positive, while the maturity sub-indices 5-years or longer were negative for the quarter (Exhibit 8). Returns generally decreased with longer durations until reaching 10-years, beyond which performance was relatively similar. Revenue bonds and general obligation bonds had similar returns for the quarter. Most sectors in the Bloomberg Barclays Revenue Bond Index exhibited similar performance during the quarter, although housing bonds and industrial development /pollution control bonds did perform modestly better than other sectors. Our strategy continues to emphasize housing bonds, as the incremental yield over comparably rated issues remains attractive. Credit quality was not a meaningful differentiator during the quarter, as returns across the quality sub-indices were not meaningfully different. In terms of geography, the only states and territories with positive performance for the quarter were Puerto Rico and the U.S. Virgin Islands. Bonds from issuers in both locations had sold off markedly during the fourth quarter of 2017 due to continuing fiscal concerns coupled with hurricane damage sustained in the autumn of 2017 and late year tax loss selling. We continue to have little or no exposure to both territories in all portfolios and all remaining holdings in separate accounts possess bond insurance.

Light Municipal Issuance after Heavy Fourth Quarter Supply

Municipal market issuance during the quarter was light on both a sequential and a year-over-year basis after record supply during the month of December. Municipal issuance totaled $64 billion in the first quarter versus $147 billion and $91 billion in the fourth quarter and first quarter of 2017, respectively. We expect issuance to increase in the second quarter, but forecast total municipal issuance for the year will be meaningfully less than 2017. The major factors contributing to this expected decrease in issuance are the elimination of tax-exempt advanced refunding transactions by the Tax Cuts and Jobs Act and private activity bond issuance that was pulled forward to late 2017. Fund flows were modest during the quarter with $6.5 billion of inflows. Looking forward we could experience a seasonal period of outflows in the second quarter as investors use such funds as a source of cash for tax payments.

Tax-Exempt Fixed Income Strategy

We expect tax-exempt interest rates, particularly for shorter maturities, to rise modestly throughout the remainder of 2018 and the tax-exempt yield curve to flatten. That being said, long-term tax exempts are modestly more attractive at the end of the first quarter than they were at the end of the year. Also, technical factors for tax-exempts including mutual fund flows and new issue supply remain positive. As a result, our strategy continues to emphasize a combination of higher quality long-term housing issues and bonds possessing both short call provisions and higher coupons to limit extension risk. Our portfolios continue to provide meaningful current income, which has been shown to be the primary driver of total return over a full market cycle. We expect to maintain most portfolio durations near their current levels and, as always, view diversification as a key tenet in managing portfolio credit risk.

Exhibit 8: U.S. Municipal Fixed Income Index Total Returns

Percent, as of 3/31/18

				Annualized			
Bloomberg Barclays Indices	**3 Months**	**6 Months**	**9 Months**	**1 Year**	**3 Years**	**5 Years**	**10 Years**
Municipal	-1.11 %	-0.37 %	0.69 %	2.66 %	2.25 %	2.73 %	4.40 %
1-Year Municipal	0.38	0.00	0.34	0.61	0.66	0.66	1.34
3-Year Municipal	0.11	-0.66	-0.13	0.40	0.84	0.98	2.15
5-Year Municipal	-0.57	-1.26	-0.59	0.65	1.27	1.54	3.28
7-Year Municipal	-1.20	-1.42	-0.66	1.26	1.62	2.10	4.04
10-Year Municipal	-1.61	-1.10	-0.05	2.31	2.14	2.72	4.66
15-Year Municipal	-1.52	-0.26	1.27	3.74	2.90	3.51	5.24
20-Year Municipal	-1.52	0.24	1.75	4.28	3.05	3.62	5.49
Long (22+ years)	-1.56	0.63	1.87	4.68	3.39	3.96	5.63
Revenue	-1.19	-0.24	0.85	3.06	2.53	3.02	n/a
General Obligation	-1.20	-0.64	0.50	2.31	1.97	2.38	4.17
High Yield	0.58	2.43	3.96	6.03	4.59	4.06	5.61
Muni Aaa	-1.19	-0.69	0.02	1.75	1.64	2.06	3.65
Muni Aa	-1.11	-0.47	0.37	2.26	1.99	2.53	4.21
Muni A	-1.08	-0.20	1.03	3.24	2.82	3.32	4.95
Muni Baa	-1.00	0.40	3.20	5.36	3.44	3.44	4.45

Source: FactSet, Sit Investment Associates, 3/31/18

GLOBAL EQUITIES: ENVIRONMENT AND STRATEGY

Trade Concerns Have Weighed on Global Equities Post Robust January Returns

The robust investor confidence that helped propel equity markets worldwide appreciably higher in calendar 2017 generally carried into the first month of 2018. The MSCI World Index generated a total return of +5.2 percent on a U.S. dollar basis in January, its best start to the year since 1994. The S&P 500 Index also produced an attractive total return of +5.7 percent in January, only to have performance eroded by ensuing trade tensions and fears that inflationary pressures might cause the Federal Reserve to tighten monetary policy at an accelerated pace. By the close of the quarter, the S&P 500 Index reversed its entire January advance and posted a total return of -0.8 percent year to date. Concerns that trade tensions could escalate into a trade war contributed to a reversal in equity performance across the globe, notably in export-sensitive regions such as Europe and Japan. Year to date, the MSCI Europe and MSCI Japan indices generated local returns of -4.2 percent (-1.9 percent in U.S. dollars) and -4.7 percent (+1.0 percent), respectively. The MSCI China Index also gave back much of its substantial January outperformance (+12.5 percent), finishing up only +1.8 percent for the first quarter. The MSCI Brazil Index was a notable outlier, as economic optimism, stronger earnings, and improved prospects for resolving the high budget deficit buoyed stocks (Exhibit 9).

Exhibit 9: Total Returns of U.S. and International Indices

Percent, as of 3/31/18

= Top Quartile Performance within Group

Domestic	YTD 2018	2017	2016	Annualized 3 Years	5 Years	7 Years	10 Years
Russell 2500™ Growth	2.4	24.5	9.7	9.1	13.4	11.8	11.2
Russell 2000® Growth	2.3	22.2	11.3	8.8	12.9	11.3	11.0
Russell MidCap® Growth	2.2	25.3	7.3	9.2	13.3	11.9	10.6
Russell 1000® Growth	1.4	30.2	7.1	12.9	15.5	14.1	11.3
Russell 2000®	-0.1	14.6	21.3	8.4	11.5	10.4	9.8
S&P 500®	-0.8	21.8	12.0	10.8	13.3	12.7	9.5

International	YTD 2018	2017	2016	Annualized 3 Years	5 Years	7 Years	10 Years
MSCI Brazil	12.5	24.5	66.7	17.1	0.1	-3.8	-1.2
MSCI EM Latin America	8.1	24.2	31.5	10.5	-1.6	-2.9	-0.5
MSCI China	1.8	54.3	1.1	10.7	11.6	7.1	6.2
MSCI Emerging Markets	1.5	37.8	11.6	9.2	5.4	2.8	3.4
MSCI Mexico	0.9	16.3	-9.0	-2.2	-4.7	-0.9	0.3
MSCI Japan	1.0	24.4	2.7	8.7	9.3	7.9	4.3
MSCI AC Asia Pacific	0.0	32.0	5.2	8.6	7.8	6.4	5.0
MSCI World Index	-1.2	23.1	8.2	8.6	10.3	9.3	6.5
MSCI EAFE	-1.4	25.6	1.5	6.0	7.0	5.8	3.2
MSCI Europe	-1.9	26.2	0.2	5.4	7.0	5.5	2.7
MSCI India	-7.0	38.8	-1.4	4.3	7.9	2.5	3.0

Source: FactSet, Sit Investment Associates, 3/31/18

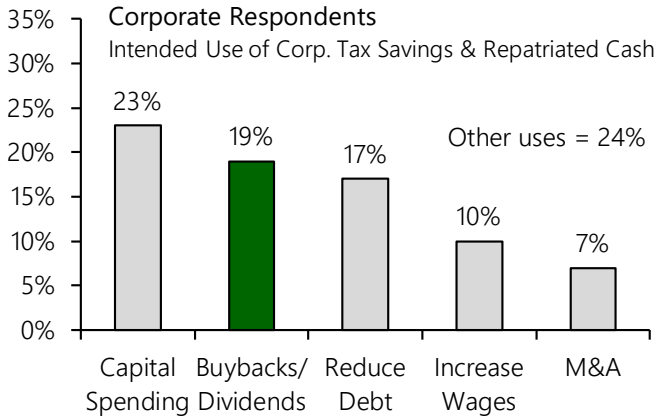
Share Buybacks and M&A Have Surged, But Not Without Political Backlash

Bolstered by tax cuts, bottom-up earnings for the S&P 500 Index are currently projected to increase +19 percent year-over-year in 2018 versus +12 percent in 2017. Companies have stated that they intend to boost capital spending, reduce debt, and increase wages (Exhibit 10). On the other hand, Morgan Stanley analysts project that a preponderance of tax savings and repatriated cash will be used for M&A or returned to shareholders through buybacks and dividends (Exhibit 11), which has been borne out in recent data. The transaction value of U.S.-based M&A deals announced in the first quarter of 2018 was nearly +50 percent above the comparable period average of the last five years. Share buyback announcements have also surged recently, with program value up more than +30 percent year-over-year in the latest three-month period. The particular use of tax savings has notable implications, both in a political context and in terms of the length and magnitude of the U.S. economic expansion. Although M&A and share repurchases will support equity valuations in the near term, such activity has become less politically palatable in light of the recent tax reform and will likely receive added pushback from Washington. In fact, Senator Tammy Baldwin (D, Wisconsin) has recently introduced legislation to rein in share buybacks. Even though the bill will undoubtedly be defeated, companies will likely be sensitive to the political implications of buybacks henceforth.

"Barbell" Strategy across Portfolios Provides a Balanced Risk-Reward Profile

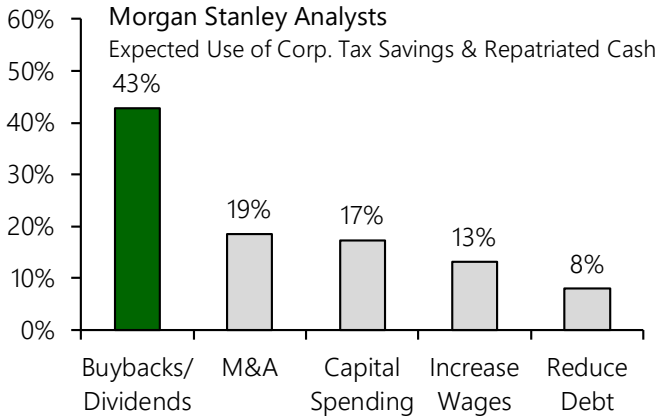
Equity markets may remain volatile as investors fret over a laundry list of risks including tightening global monetary policy, peaking economic momentum, rising global debt, mounting trade tensions, and partisan politics. However, we believe the outlook for U.S. equities remains skewed to the upside given favorable economic conditions, stimulative fiscal policies, and improving corporate earnings. In terms of portfolio positioning, we continue to believe a "barbell" approach provides a balanced risk-reward profile for equity portfolios at this stage of the market cycle. One side of the "barbell" emphasizes pro-growth/Trump policy beneficiaries while the other focuses on secular/traditional growth companies that possess highly visible earnings growth and attractive valuations (Exhibit 12). We continue to refine this strategy and have reduced positions in companies that lack meaningful pricing power in an inflationary backdrop and have added to beneficiaries of increased capex and rising interest rates. The combination of increased market volatility, lower stock correlations, and other late-cycle dynamics bodes well for the relative outperformance of both growth and active strategies.

Exhibit 10: Use of Tax Savings, Corporations



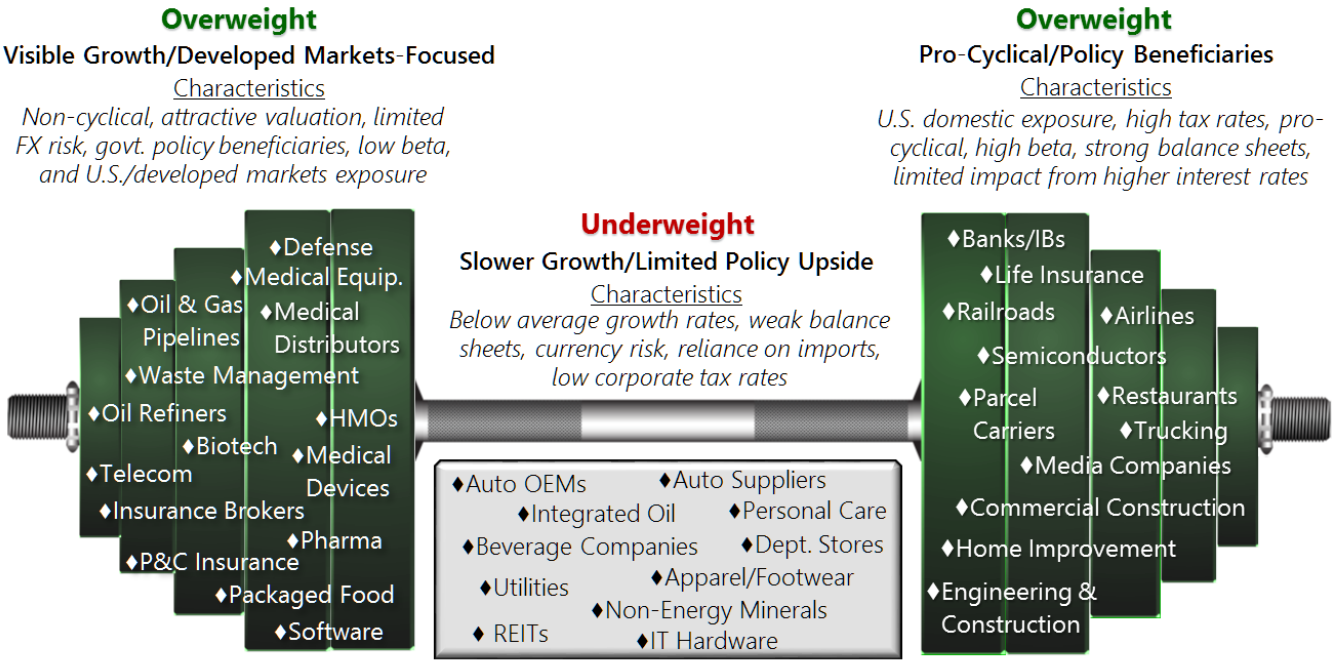
Source: ISI Evercore, Sit Investment Associates, 3/31/18

Exhibit 11: Use of Tax Savings, Analysts



Source: Morgan Stanley, Sit Investment Associates, 3/31/18

Exhibit 12: Components of Sit Investment Associates' U.S. "Barbell" Strategy



Source: Sit Investment Associates, 3/31/18

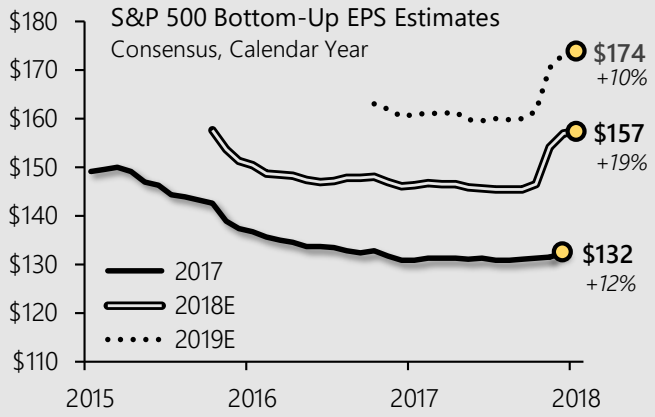
With regard to international mandates, we are overweight Europe and Asia (ex. Japan), while underweight Japan and Latin America. Economic conditions generally remain favorable for European equities, more so for those with continental Europe exposure. We are less positive on UK equities due to the negative impact the sterling's depreciation has had on real incomes and consumer spending. European equity valuations continue to be attractive on an absolute basis and relative to global markets. Moreover, we do not see any major political concerns in 2018, as the next major election will be for the European Parliament in 2019. Our most pressing concern for European equities is a potential trade war. This, however, would not only affect European equities, but emerging markets and other developed markets as well. In this environment, we believe it is prudent to remain diversified and focused on high-quality growth stocks that have secular and/or niche growth drivers. We prefer reflation and Trump policy beneficiaries along with companies with exposure to the U.S. market.

We maintain an overweight position in Chinese equities. While company fundamentals remain solid, equity market volatility has increased due to heightened trade tensions and policy uncertainties. Per Citi research, the direct revenue exposure of companies in the MSCI China Index to overseas and U.S. markets is manageable at 10 percent and 3 percent, respectively. However, the equity risk premium could rise on further negative policy surprises. Our current China holdings focus predominately on domestic demand and "New China" (i.e., internet, consumption). We anticipate that positive earnings surprises will play a bigger role in driving stock outperformance in 2018. As such, we continue to favor names with solid earnings momentum and strong balance sheets.

We remain positive on the Indian and South Korean equity markets on strong economic growth, high earnings growth, and attractive valuations. Growth for the Indian economy and corporate earnings should pick up as the ill effects of demonetization and the Goods

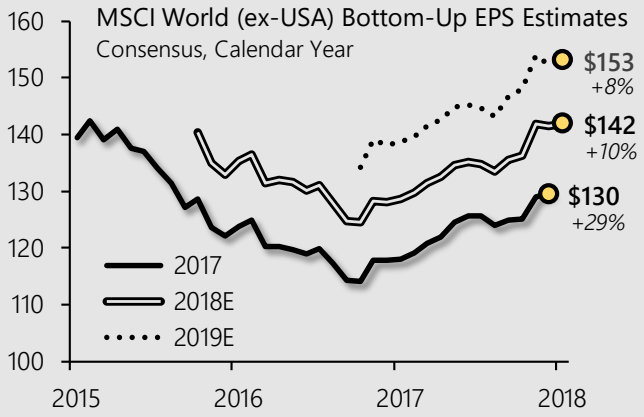
Global Equities: Notable Data Points

Tax Reform Boosting U.S. Corporate Earnings



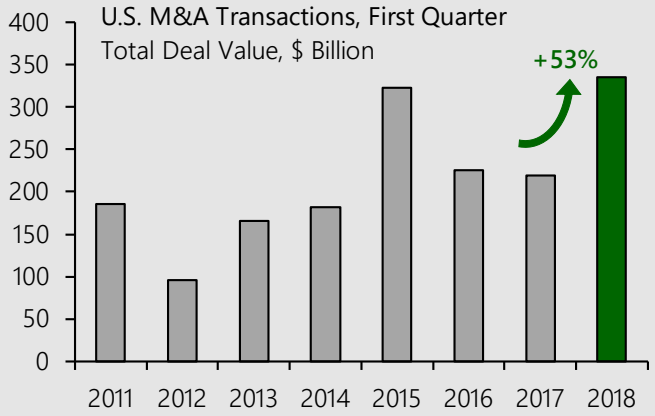
Source: FactSet, Sit Investment Associates, 3/31/18

Global Upward Earnings Revisions Continue



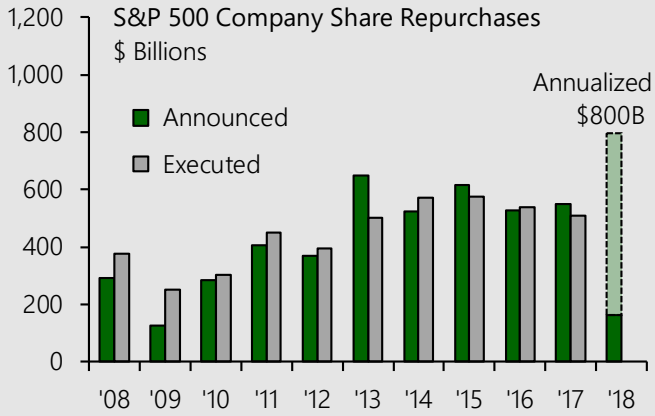
Source: FactSet, Sit Investment Associates, 3/31/18

M&A Activity Has Picked Up Post Tax Reform



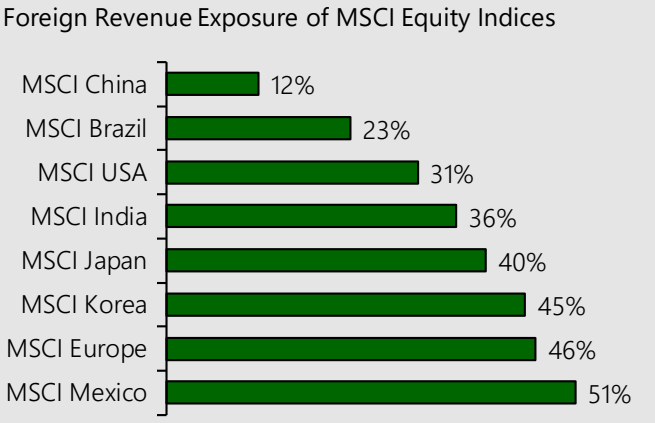
Source: MergerMetrics, Sit Investment Associates, 3/31/18

Buyback Announcements Also Increasing



Source: JP Morgan, Sit Investment Associates, 3/31/18

Equity Indices Are Sensitive to Foreign Trade



Source: FactSet, Sit Investment Associates, 3/31/18

Global Equity Valuations are Reasonable

Source: FactSet, Sit Investment Associates, 3/31/18

and Services Tax fade. The MSCI India Index trades on a 2018 price-to-earnings ratio of 18 times, about a 14 percent premium to its 7-year historical average. Still, we believe this is reasonable given earnings growth forecast of +20 percent in calendar 2018. Our preferred investments are key beneficiaries of the stronger economy including consumer, financials, and information services. Conversely, the MSCI Korea Index trades at a discount to its historical average, with a price-to-earnings multiple of 9 times on earnings growth of +18 percent in 2018. South Korea's export-driven economy should remain intact, as the impact of revised Korea-U.S. Free Trade Agreement was less negative than feared. Consumer spending should also receive a boost from the government's supplementary budget proposal of ₩4 trillion. Core South Korean investments are predominately in the technology, financial, consumer, and pharmaceutical sectors.

We continue to underweight Japanese equities as the country's growth potential remains constrained by its structural challenges. Despite years of stimulative and increasingly aggressive policy measures, the economy managed only modest growth in 2017 against the most favorable global macro backdrop for its export-oriented economy in nearly a decade. Increasingly, we see few options for policymakers to spur growth. The Bank of Japan appears to be running up against the limits of monetary policy experimentation as its asset purchasing operations increasingly dominate the government bond market and impair liquidity. The entrenched government bureaucracy continues to water down structural reform efforts, such as those to overhaul rigid immigration and labor laws, while growing distrust of the Abe administration further limits the potential for productive legislation. With policy options increasingly limited, this leaves the economy hostage to its unfavorable demographic trends. Against this backdrop, we prefer a mix of holdings with either exposure to select faster-growing regions overseas, such as exporters and multinationals, or a focus on domestic defensive consumption end markets.

We also remain underweight Brazilian and Mexican equities. However, we are turning more positive on Brazil as the domestic economy recovers. The valuation of Brazilian stocks appears stretched, with a price-to-earnings multiple of 12.5 times for the MSCI Brazil Index versus its 7-year historical average of 11 times. Year-over-year earnings growth of +30 percent in calendar 2018 and annualized growth of +20 percent between 2017 and 2019 may justify this valuation level. The largest sectors contributing to the 2018 growth are oil, gas and petrochemicals; food and beverage; retail; and banks. We are largely positive on the Brazilian consumer, which should benefit from increased real wages and low interest rates. Consequently, our Brazilian holdings are heavily weighted towards financial and consumer staple stocks. In Mexico, our underweight stems from the uncertainty over North American Free Trade Agreement renegotiation and presidential elections. The price-to-earnings multiple of 16 times for the MSCI Mexico Index is about one standard deviation below its 7-year historical average. Thus, the market does not seem to reflect the possibility of an Andres Manuel Lopez Obrador victory. In addition, earnings growth this year is not high, in the low double-digit range of +12 percent. As a result, we are pursuing a more defensive investment strategy, owning consumer staples in addition to market-leader consumer discretionary stocks.