We at Sterling Capital Management are engaged in three key support areas for you and your clients: providing custom asset allocation frameworks, selecting high quality investment managers, and constructing well diversified portfolios. Importantly, of course, we remain engaged every day in the ongoing monitoring & periodic rebalancing of those portfolios over time.

Today, we are pleased to provide a review of global financial markets during the first quarter of 2018, to reflect on changes we made to our portfolios during the quarter, and to update our current positioning and outlook.

EQUITY MARKET REVIEW

Beginning with equity markets, global equity market volatility returned in the first quarter of 2018 as rising interest rates, inflation concerns and trade policy uncertainty played a role in the Russell Global Index's 0.89% decline. While U.S. tax reform optimism helped drive equities higher in January, markets endured several fluctuations in February and March, which ultimately resulted in the Russell Global's first quarterly decline since the third quarter of 2015.

U.S. equities outperformed international equities during the quarter, though emerging markets equities were once again the best performing geographic segment outpacing both U.S. and international developed market equities and providing positive returns for the quarter.

In the US, the broad equity market, as defined by the Russell 3000 Index, fell 0.64% in the first quarter, which ended a streak of nine consecutive quarters of positive returns. U.S. equities began the year in a similar manner to 2017 as equities produced above-average returns while experiencing low levels of volatility throughout most of January. In fact, the S&P 500 Index's 5.73% gain in January represented the highest January return since 1997, driven by tax reform euphoria and rising earnings expectations. Positive results in January extended the S&P 500 Index's streak of consecutive positive months to 15, which matched the longest streak on record set between March 1958 and May 1959. However, market conditions worsened rapidly in late January and early February, triggered by rising interest rates and higher-than-expected wage growth and other inflation indicators, which in turn led to investor fears of the Fed potentially accelerating its tightening cycle. These concerns helped cause the CBOE Volatility Index (VIX), to suffer its largest one-day increase in history on February 5th. In addition, this uptick in market volatility resulted in the first market correction, a 10% decline from a market peak, since early 2016. A brief market recovery in the back half of February was derailed in March as the announcement of U.S. tariffs on imported steel and aluminum, as well as plans to implement tariffs on additional imported Chinese goods, triggered trade war fears. Further, a Facebook user data scandal in the final weeks of the first quarter produced additional weakness in the broader equity market as multiple companies in the technology sector, which makes up almost a quarter of the Russell 3000 Index, also experienced a pullback due to the potential for higher levels of user data privacy regulation.

On a positive note, despite increased levels of equity market volatility, earnings growth trends were favorable during the quarter. For example, Q4'17 S&P 500 earnings growth of 14.8% represented the highest level of growth in roughly six years. According to Factset, 73% of companies in the S&P 500 Index reported 4Q'17 earnings that exceeded consensus estimates, which represented the highest level of positive earnings surprises since Factset began tracking this metric in 2008. Earnings growth expectations for 2018 also increased significantly during the first quarter.

Moving outside the U.S., International equities fell 1% during the quarter. Emerging markets posted positive returns, rising 1 ¼% in Q1, while international developed markets, declined 1.8%. Growth outperformed value and small-caps outperformed large-caps in international developed markets, while value and large-caps outperformed in emerging markets. China, Brazil and Japan were among the top-performing international equity markets during the quarter, while the U.K, Canada and India were among the worst performers. Similar to U.S. equities, information technology was the best-performing international equity sector during the quarter, rising 1.8%. The utilities sector was the only other international equity sector to post a positive return in Q1, while telecom services, materials and consumer staples companies underperformed the broader international markets. International economic and earnings growth data was generally favorable during the quarter, and ongoing Brexit negotiations, trade war concerns, and European Central Bank and Bank of Japan monetary policy guidance were among key overseas developments.

PORTFOLIO POSITIONING

In terms of portfolio positioning, we made multiple changes to the equity portion of portfolios during the quarter. First, emerging markets exposure was reduced to a net-of-benchmark underweight as a result of 2017 relative outperformance that resulted in stretched valuation metrics when compared to developed markets. An overweight to international developed markets relative to U.S. equities was also removed as our analytics suggested little relative value opportunity between these two segments at the beginning of 2018 after international developed markets outperformed in 2017. These changes resulted in net-of-benchmark overweights in both the U.S. and international developed segments, and a corresponding underweight to emerging markets as of March 31, 2018. A number of additional changes were made which included instituting overweights to U.S. large-cap value and international developed market small-cap, as well as mildly increasing the underweight to U.S. mid-cap value.

BOND MARKETS

Now, turning to bond markets, the Bloomberg Barclays Aggregate Bond Index, a proxy for overall fixed income performance, posted a negative 1 ½% return for the quarter.

Similar to the pickup in equity market volatility, interest rate volatility also increased with the MOVE index, which measures volatility in the Treasury market, up over 50% this year. The yield curve flattened and the yield on the 10-year Treasury increased from 2.4% to 2.74% during Q1.

The move higher in rates was a key reason the Aggregate Bond Index generated a negative return for the first three months of 2018.

Under the leadership of new Fed Chairman Jerome Powell, the Fed upgraded both its economic & inflation outlooks in Q1 & continued on its path of rate normalization, hiking rates once again at the March meeting. Although the median projection remains for three rate hikes this year, the Fed expects slightly faster rate hikes in 2019 and 2020.

Notably, while monetary policy is tightening (although still very accommodative by historical standards), fiscal policy is easing, mostly through the $1.5 trillion in tax cuts and $300 billion in new government spending.

Looking at different segments of fixed income markets, corporate credit spreads widened during the quarter with both investment grade and high yield posting negative returns.

Within the structured space, Agency mortgage-backed securities lagged duration-matched Treasuries for the quarter and the Fed's continued exit put pressure on the market.

Foreign developed bonds were the top-performing asset class within our opportunity set as rates abroad, especially on the front-end of the curve, were stable relative to the U.S.

During the first quarter, no changes were made to our Core Fixed Income portfolio & positioning remains similar to last quarter. Our taxable core fixed income portfolio remains short duration relative to its benchmark. It also maintains an overweight to credit, both corporate and structured, and an underweight to government related securities, specifically Treasuries. Yield curve positioning remains a focus.

Our Municipal Bond portfolio also remains slightly short duration and maintains an overweight to essential service revenue bonds and an underweight to general obligation bonds.

FIRST-QUARTER REVIEW

For the first quarter overall, our balanced portfolio posted a slight decline of 0.57% but compared favorably to the blended benchmark's decline of 0.97%. Asset allocation detracted slightly from relative returns in Q1 while manager selection decisions contributed positively.

Leading contributors on the equity side for Q1 included our large-cap value & international developed market large-cap growth managers who outperformed their benchmarks by 2 ¼% & 2 ½% respectively for the quarter. Our global unconstrained equity manager posted a positive 5 ½% return in Q1, outperforming its benchmark by more than 6%. On the fixed income side, all managers outperformed their respective benchmarks for Q1.

Overall, we're pleased with Q1 relative results and the way our portfolios have weathered the increased volatility in both equity & fixed income markets thus far in 2018. We remain confident that we're well positioned for markets ahead.

Thank you very much as always for your interest, trust and support, and we look forward to a continued strong and successful partnership.
