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Q & A

WITH BAILARD'S CHIEF ECONOMIST & INVESTMENT STRATEGIST



A View of the Market and Economy Ahead

Arthur A. Micheletti, CFA reflects on the volatile 2018 year and shares his perspective on the potential positive and negative turns for 2019.

Last year was a volatile year, with wild swings in global equity markets that mostly ended down for the year. Why the change from 2017's strong year for equities?

Every year there is a list of causes to worry. Typically, the market can often climb this "wall of worry." However, in 2018 that list of potential problems was longer than usual, including international concerns about Brexit, Italian deficits and the "yellow vest" protests in France. Further, Chinese growth came under downward pressure from the continued trade war and Japanese growth turned negative. The global picture has become more uncertain, with the U.S. showing signs of a slowdown but doing relatively well compared to international economies. Nonetheless, it appears that we are in a synchronized global slowdown.

We have been in a slow growth environment since the Great Financial Crisis; what's different now?

The biggest factor is that the world's central banks have changed their behavior. The Federal Reserve (the Fed) continued to raise the Fed Funds rate and is allowing maturing debt to roll off its balance sheet. As of January 1, 2019, the European Central Bank (ECB), while not yet raising rates, is no longer buying securities, effectively removing that excess liquidity from the financial markets. Central banks, in general, have gone from quantitative easing (QE) to quantitative tightening (QT) programs. Historically, central bank quantitative easing provided a strong tailwind to markets by lowering rates toward zero and allowing all financial assets to climb. The unsustainable central bank demand for financial assets created false

pricing of interest rates and provided a major support for the market. If QE provided unsustainable demand, QT then suggests that the supply of bond issuance along with rising deficits, should keep upward pressure on interest rates, turning the tailwind for markets into a headwind.

We are hearing more talk about a recession and the term is trending higher on internet searches. What is the risk of recession?

Recessions typically occur after the yield curve inverts and liquidity slows. The U.S. Treasury yield curve (the difference between long and short-dated Treasuries) is very close to inverting, where short rates become higher than long rates. Despite this, the Fed is still in a tightening mode and plans to raise rates another two more times in 2019. One path to recession is the typical path: overtightening by the Fed. Another path is a major market or financial accident. Rising interest rates in a heavily indebted environment pose the risk of financial crisis. An additional risk comes from the strong U.S. dollar, which makes paying back dollar-denominated debt more expensive and more difficult.

So what could go right?

First, the Fed could see the error of its ways and acknowledge the growth slowdown and ease the tightening. Both the Fed and the Trump Administration seem to be overly optimistic about the economic outlook: painting a rosy picture and ignoring signs to the contrary. Around the world, growth is slowing and expectations are coming down. Given how trends can be amplified by high frequency computer trading and passive investing, this lowering of expectations could trigger another flurry of buying in the equity markets.

The second positive possibility is that China and the U.S. reach a trade accommodation. Much progress has been made but the tough issue of intellectual property rights still needs to be addressed. With the tariffs clearly negatively impacting both the U.S. and Chinese economies, there is incentive to resolve the trade tensions. The question remains whether we are at the point of “peak posturing.”

Finally, while the outcome of the 2018 midterm election fosters further resistance, infrastructure spending is one area where the Republicans and Democrats could agree. Through a public/private partnership on infrastructure, the economy may be able to build on tax cuts, reduced regulation and

smaller government. The danger is a repeat of the last infrastructure program that couldn't find enough “shovel-ready projects;” instead, the spending went to nonproductive projects and debt exploded. A public/private initiative would help ensure projects that could enhance productivity, as the private sector is likely to only support projects that are profit driven. Easier Fed policy, an end to the trade war and a sensible infrastructure program could keep the economy from slipping into recession and lead to another leg up in the market.

How are you positioned for the new year?

We are going into 2019 in a strongly defensive position. With the equity market declines in 2018, the S&P 500 Index ended the year just shy of the 20% decline threshold that defines a bear market. As a result, stocks have begun to look more attractive from a valuation perspective but—as in a bull market when valuations tend to become stretched to the upside—in a bear market, valuations often become stretched to the downside. In order to become more optimistic, we would look for the market to bottom out and for some of the risk factors to ease.

U.S. ECONOMY

A Roller Coaster of Expectations

2018 began with the anticipation of stronger economic growth based on expected benefits from rebuilding from 2017's severe hurricane season and a temporary boost from tax cuts. We expected the economy to peak in the second half of 2018, then begin to slow as rising rates weakened the interest rate sensitive auto and housing sectors. In fact, economic activity appears to have peaked in the second quarter of 2018, at a 4.2% annualized growth rate for Gross Domestic Product (GDP). Growth further slowed in the third quarter to 3.4%, led primarily by the consumer sector that contributed a healthy 2.4% to GDP growth. Most every other sector of the economy, including residential investment, was a detractor. Net exports were particularly disappointing, stripping the economy of 2.0% growth, reflecting the ongoing trade war as well as strength in the U.S. dollar.

Areas of Potential Concern

In addition to net exports, two other sectors were of rising concern. First, inventories accumulated at a rapid pace in the third quarter. An inventory build is not necessarily bad but, when it occurs in tandem with declining sales, it is considered involuntary. The second concern was the failure of capital spending to surge with all the corporate funds repatriated back to the U.S. Non-residential investment increased only 1.1%, with the bulk of the repatriation used to fund share buybacks.

S&P 500 companies set a record in the third quarter, with share repurchases of \$203.8 billion, surpassing the \$200 billion mark for the first time in history. The buyback frenzy was supported by after-tax corporate incomes that had surged due to the Tax Cuts and Jobs Act of 2017 (TCJA) and provided more free cash flow. In addition, corporations took advantage of low interest rates, tacking on more debt. The corporate debt-to-GDP ratio rose to a record 46.5% in the third quarter, higher than in both 2000 and 2008.

Unfortunately, corporations did not use repatriation, higher cash flows or increased debt for capital investment. Nonfinancial corporate capital spending increased a paltry 1.1% year-over-year as of the third quarter; the ratio of capital expenditure relative to

The corporate debt-to-GDP ratio rose to a record 46.5%, higher than in both 2000 and 2008.

GDP also shrank. The lack of either capital investment or rising productivity diminishes the long-term prospects for organic growth. Corporations have been growing their earnings via share buybacks and the temporary boost from the reduction in corporate tax rates, not top line growth.

It appears that the "Trump Bump" in confidence is over with recent manufacturing surveys slipping, consumer buying plans for both homes and autos trending lower, small business confidence peaking and the CFO Survey seeing slower growth in sales and earnings. The best confidence indicator, the performance of the broad S&P 500 Index, ended the year in a steep decline.

Can Consumers Save the Day?

Importantly, the slow growth outlook rests on the consumer. If the consumer continues to do what it does best (spend), it may be enough to offset economic weaknesses elsewhere. While employment growth disappointed in November, trend employment growth rose at a 1.6% year-over-year pace and average weekly pay rose at a 2.8% rate. Together, these suggest nominal consumption growth of approximately 4.4%. Factoring in inflation, real consumption growth comes in around 2.5%. This is still decent growth. If the consumer continues to take on debt or save less, real consumption could remain above 3.0%.

With the Fed tightening its monetary policy amidst a weakening economy, the strong tailwind of real liquidity is drying up. Eventually, it is expected that the Fed will be forced to reverse course as the economy slows further. Until we see a modicum of stabilization in the financial markets, caution is warranted. For now, we are on a roller coaster of expectations surrounding Fed policy, economic activity, China trade tensions and Washington politics.

INTERNATIONAL ECONOMIES

A Synchronous Global Slowdown

EUROPE

European economic growth has continued to slow, with third-quarter GDP growth falling to a 0.8% annualized rate and the year-over-year pace decreasing to 1.7%. The slowdown was led by Germany, where the growth rate declined 0.2% in the third quarter.

Europe has been in a slow growth phase since 1995 and faces many of the same long-term growth headwinds as the U.S. (including debt, deficits and pension underfunding) but with even greater financial risk. Brexit remains an issue and the European Union (EU) seems determined to make the UK an object lesson for other countries thinking about exiting the EU. Case in point is the political struggle in Italy, where anti-Brussels and anti-euro sentiment are both rising. The UK and Italian situations both create uncertainty and are likely to keep markets uneasy until the issues are resolved.

European banks have continued to trend lower as growth was downgraded and core inflation remained stubbornly low. As a result, European banks are sitting on \$900 billion of non-performing loans. According to the Bank for International Settlements, 9% of all large European companies could be considered zombie companies: that is, ones that cannot cover their interest expense with their operating profit. With the ECB bringing its QE to an end, these loans could be in jeopardy and bad debts are likely to rise further. Similar to the U.S., the average European corporate debt quality has been deteriorating. Twenty years ago, 75% of European corporate debt was rated AAA or AA. Now, as of year-end 2018, these two highest ratings comprise less than 10%.

Similar to the U.S., the average European corporate debt quality has been deteriorating.

JAPAN

Japan reported lower-than-expected GDP growth in the third quarter; economic activity contracted 2.5%

annualized, more than the expected 2.0% decrease. Business spending led the decline as capital expenditures fell 2.8%, far worse than the 0.2% initial estimate.

Japanese Prime Minister Shinzo Abe's much-touted Abenomics program (that began in 2012 to stimulate the economy and boost inflation) has failed miserably, with growth averaging only 1%, the same as it had since 1995. Abe has tried raising the sales tax in the past and recently announced another increase from 8% to 10% set for October, 2019.

Jobs, industrial production, retail sales and trade all point to slower growth in Japan. Another fiscal stimulus plan is in the works and Japan has indicated monetary policy will remain accommodative. In other words, Japanese authorities are once again trying to prop up an economy staggering around 1% growth.

CHINA

Rounding out the synchronous global slowdown, China has also been showing economic weakness. Retail sales, industrial production and capital investment are all slowing more than expected and their growth rates have been in steady decline since 2010. China's Purchasing Managers' Index fell to 50 in the fourth quarter, reflecting reduced growth expectations. Although growth is still strong by global standards—rising 6.4% annualized in the third quarter—it is well below the peaks of over 10% China enjoyed following the Great Financial Crisis.

Putting the economic data aside, the trade war with the U.S. likely stands as the most pressing issue for China given its impact on sentiment. Despite a wringing of hands after the G-20 meeting in Argentina, Chinese President Xi has delivered on everything he promised President Trump and more: auto tariffs were cut from 40% back to 15%, China is taking in more U.S. soybeans and rice after drastically cutting back on U.S. imports and it has cut tariffs on over 700 U.S. goods. China is also negotiating for more U.S. imports of natural gas. The remaining sticking point lies in the protection of intellectual property rights, which begs the question, “Can they make inroads over the next 90 days or is there more posturing to be done?”

FIXED INCOME

Growth Likely to Slow and Keep a Cap on Interest Rates

Interest rate volatility increased in 2018. Yields on the 10-Year U.S. Treasury reached a seven-year high of 3.24% in early November before descending back to pre-peak levels. As the Fed raised the Federal Funds rate in 2018, the 2-Year Treasury rates rose in tandem. Longer-maturity interest rates, like 10-Year Treasuries, are more correlated to the level of general economic growth and inflation than to the Funds rate. The current gap between yields on short- and longer-term Treasuries has narrowed to an eleven-year low. This slim spread reflects investors' expectations that the economy will grow slowly, or perhaps move closer to a recession, and that inflation would remain moderate.

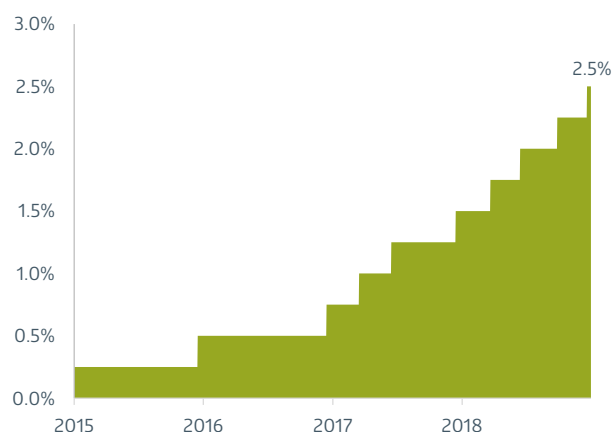
The Barclay's U.S. Aggregate Bond Index (a broadly-diversified index that includes U.S. Treasuries, agencies, corporates and mortgage-backed securities) posted a 0.01% return in 2018 as price declines almost exactly offset bond income. The Index had been posting negative total returns earlier in the year until dramatic rate declines enabled a 1.64% gain in the fourth quarter. Corporates lagged other bond sectors as investors ratcheted down expectations regarding corporate profits. The BofA Merrill Lynch 1-10 Year U.S. Corporate Index returned 0.01% for the quarter, bringing year-to-date returns to -0.17%. Municipals were one of the strongest bond sectors in 2018, enabling the Barclay's 1-15 Year Municipal Blend Index to gain 1.71% for the quarter and 1.58% for the year ending December 31, 2018.

Federal Reserve Monetary Policy

The Fed plans to continue to raise rates; however, many bond investors expect one or more increases

Investors are anticipating slowing growth as financial conditions tighten, global demand slows and fiscal stimulus fades.

Tightening Financial Conditions: Federal Funds Rate Increases, 2015-2018



Source: Board of Governors of the Federal Reserve System (US)

in the first half of 2019, and then a corresponding decrease at the end of the year. Investors are anticipating slowing growth as financial conditions tighten, global demand slows and fiscal stimulus fades.

A yield curve inversion that includes longer-maturity bonds has preceded most recessions, so investors and the Fed are closely watching the behavior of the curve. Notably, by year-end 2018, the Treasury yield curve inverted slightly for short-maturity bonds.

The Fed is continuing to re-normalize, or decrease, its massive balance sheet of Treasury and mortgage-backed debt. The Fed reduced its original \$4.5 trillion balance sheet by \$420 billion in 2018, and is scheduled to reduce it another \$600 billion in 2019. Although less demand for bonds by the Fed may result in higher intermediate and long-term interest rates, so far demand has remained high with investors seeking bonds as a safe haven amongst stock price declines. With the Fed moving to more normal monetary policy, fundamentals should have greater influence. Financial markets in countries outside the U.S. will likely exhibit lower correlation to the U.S. than they have in the recent past, as most are behind the U.S. in normalizing their monetary policies.

Bond Market Recap

Investors are reducing their expectations of corporate earnings. Higher costs of labor and imported materials are expected to take a toll on earnings, but another major factor is the fading impact of the Tax Cuts and Jobs Act of 2017. Analysts have cut profit expectations on more than half of the companies that comprise the S&P 500 Index. With reduced optimism on the level of corporate profits, corporate bond spreads (or the interest rate spread between corporates and Treasuries) have been increasing. Analysts are expecting corporate earnings to grow by less than 8% in 2019, compared to 22% in 2018.

After nearly four years, the European Central Bank has halted its quantitative easing and plans to leave interest rates unchanged through at least the summer of 2019. Further, the ECB intends to hold its balance sheet of security holdings and reinvest proceeds from maturing securities in an effort to keep interest rates low. Economic growth in the region remains low and unemployment is double that of the U.S. Policy makers are expecting the eurozone economy to at least be strong enough to withstand the phase-out of bond purchases amidst the risk of U.S. trade tariffs, geopolitical concerns and increased protectionism.

Bond Market Outlook

Although the Fed remains committed to raising the Funds rate, global growth will likely slow in 2019 due to tightening financial conditions, fading fiscal stimulus and slower growth in China and elsewhere, keeping a cap on interest rates. The year-end flight out of stocks and into bonds has driven interest rates to new lows. If stocks stabilize, yields may move back to levels seen at the end of last year. However, if the stock market continues to decline, rates could decrease even further. With central banks around the world moving from current stimulative policies to more normal monetary policy, rates may also come under some pressure to rise moderately.

As this edition goes to print, the U.S. is in a partial government shutdown: the longest shutdown on record. The shutdown has affected operations at nine departments, including Homeland Security, Justice, State and Treasury, and several agencies including the Environmental Protection Agency and NASA. Many government workers are now working without pay and more simply furloughed. Social Security,

Medicare, Medicaid and veterans benefits, however, are not currently impacted as they received their funding in September, 2018.

Should the shutdown continue into early March, when the debt ceiling expires, the government should still be able to function until the summer using “extraordinary measures.” Even so, a shutdown of such an extreme length would likely cause significant market distress and volatility.

DOMESTIC EQUITIES

Predicting the Unpredictable

Prior to the fourth quarter, U.S. stocks in aggregate appeared overvalued. Rather sharp price declines at the end of the year addressed much of that overvaluation. The S&P 500 Index fell 13.5% for the quarter, the ninth worst decline over the past 50 years and, as a result, ended the year down 4.4%. From its peak on September 20th to its trough on December 24th, the S&P 500 Index dropped 19.8%, just short of the 20% decline threshold used to mark the end of a bull market.* As far as the S&P 500 is concerned, the almost ten-year-old bull market is still (barely) intact. Other indices were not so fortunate.

The S&P North American Technology Index fell 17.9% for the quarter, negating most of its gains earlier in the year but still finishing up 2.9% for all of 2018. From peak to trough, the Index was down 24.1%.* The CRSP U.S. Small Cap Value Index dropped 17.5% for the quarter, leaving it down a disappointing 12.3% for 2018; from peak to trough, the Index declined 21.1%.*

Revisiting 2018's Predictions

Exactly one year ago in this very newsletter, we made several predictions regarding what might transpire in 2018. In the interest of full disclosure, it is only fair that we revisit those predictions to see how they fared:

1. *The decline of traditional retailers will accelerate.* In hindsight, this was the least bold of our predictions, as the trend had been previously established. Nonetheless, it did continue and appears to have accelerated with Sears, Kmart, Toys R Us, Lowes, Macy's, Orchard Supply, Foot Locker, Brookstone, Mattress Firm, Bon Ton, GNC, Victoria's Secret, Ascena (Ann Taylor, Dress Barn, etc.), GAP and Banana Republic all announcing substantial—or total—store closures.
2. *Social media will face a backlash.* This was a bolder prediction, though there were hints at the time. With some heated congressional testimony, and Facebook stock down almost 26% for the year (and down 39% at year-end from its

mid-summer high), we believe it is safe to say a backlash certainly occurred.*

3. *There will be some reversal of stock market leaders and laggards, but perhaps not as much as people expect.* The details of this prediction referred to tech stocks eventually stumbling but avoiding a complete reversal of fortune, and small cap value stocks having a better year relative to the overall market in 2018 than in 2017 but not delivering a performance miracle. Let's call this prediction at least half right. The tech stock portion seems spot on, as it did stumble but still outperformed almost everything else for the year. As predicted, small stocks did relatively better versus the S&P 500 than the year before but still lost both relatively and absolutely.

A prediction that would warm a fortune teller's heart: vague enough to warrant almost any interpretation, while still appearing to possess some foresight.

4. *The stock market will surprise many investors in 2018, as it does almost every year.* Admittedly this was a prediction that would warm a fortune teller's heart: vague enough to warrant almost any interpretation while still making the prognosticator appear to possess some foresight. That said, after two straight years of rising steadily with record low volatility, the market did throw a few unexpected curves in 2018. Early volatility in January and February reverted back to a low volatility, steady climb from March through September, only to have renewed volatility and generally declining prices through the remainder of the year. Were many investors surprised

* Price change only.

by these results? We would argue that they were, but admit that the prediction was rigged to a degree.

Overall, not a bad prediction track record for a team that believes that the future is largely uncertain and generally unknowable. While it would be nice to go out on top and retire from the forecasting business, newsletters require a prediction or two to keep readers engaged, so here we go.

Have we farther down to go, or was the fourth quarter's steep correction enough to wring the valuation excesses from the stock market?

It depends upon several factors. If the economy slows and enters a recession, corporate profits will decline. Declining profits are usually accompanied by declining valuations. One problem with recessions is that we only know that we are in one after the fact; by the time a recession is officially declared, we are usually at least one or two quarters into it. Another problem with recessions is that the stock market is a leading economic indicator, so one of the best ways to determine if a recession is coming is to monitor stock prices. This is helpful if you are an economist, but less useful for those of us trying to determine the future direction of the stock market. For what it is worth, most respected economists—including Bailard's own—are not currently predicting a recession. If we avoid a recession and profits stabilize or grow from here, then the recent correction may have been sufficient. If we enter a recession, it is likely that it would be accompanied by another leg down in the market.

Another element that may determine the market's direction is the Fed's interest rate policy. The Fed has been gradually raising rates and has repeatedly stated its inclination to continue. Yet, in January of this year and in what may signify a temporary halt to rate hikes, Fed Chairman Jerome Powell declared the Fed "will be patient" regarding interest rates, and is "listening very carefully" to the market. Higher interest rates tend to compress valuation multiples, so the Fed's hesitation in raising rates in the near term should ease downward pressure on the stock market, provided that earnings hold up.

Two additional factors likely to shape the market's fate in the near term are volatility and sentiment. Share price volatility tends to shorten investment time horizons and sour investor sentiment. Should volatility remain high, investors may not find the recent market

correction adequate and they may demand lower valuations and higher return potential to compensate for what they perceive as an increased level of risk.

A Simple Prediction for 2019

To be fair, the preceding paragraphs look a lot more like descriptions of possible scenarios than actual predictions. The reality is no one knows for sure if a recession is imminent, or whether the Fed will deftly thread the policy needle or overshoot as it has done so often in the past. Investor sentiment is perpetually fickle and incredibly difficult to forecast. The stock market may still be overvalued or it may have corrected sufficiently to lead to another rally; our prediction for 2019 is simply that stocks, in the short run, are unpredictable.

INTERNATIONAL EQUITIES*

A Down Year in 2018 Potentially Provides a Turning Point

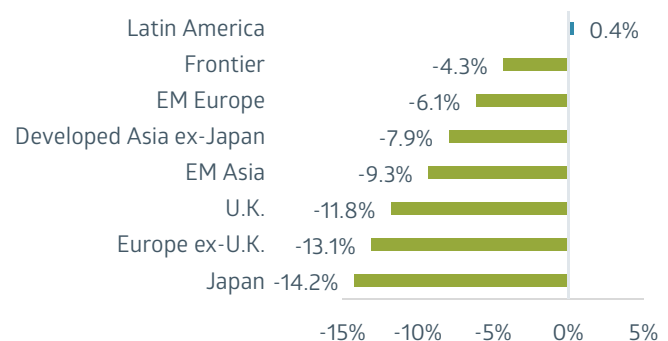
Global stocks were hammered in the fourth quarter, capping a year that began with high expectations but ended on a decidedly sour note. Non-U.S. stocks began 2018 in what appeared to be good condition, poised to continue the outperformance (relative to U.S. equities) that emerging market stocks enjoyed the previous two years and developed market stocks had in 2017. Foreign shares were relatively cheap: their earnings in 2017 had been strong and they were enjoying a currency tailwind. Yet, after a stellar January to start 2018, foreign stocks ground lower for the rest of the year. Returns for developed markets, as measured by the MSCI EAFE Index were down 12.5% for the fourth quarter and 13.8% for the year. The MSCI Emerging Markets Index trailed only slightly for the year, falling 14.6%, and performed demonstrably better than developed shares for the quarter, declining 7.5%.

By any measure, 2018 ended with a volatile quarter but one in which non-U.S. shares provided some downside protection relative to domestic shares. The only major non-U.S. region to underperform domestic stocks was Japan, where stocks fell 14.2% on a U.S. dollar basis. The strongest results came from emerging market regions, notably Eastern Europe, down 6.1%, and Latin America that rose 0.4%. No developed market rose during the fourth quarter, while seven of MSCI's 24 emerging countries eked out positive returns, led by Brazil, up 13.4%.

Developed Markets

Monetary policy has been a prime focus for investors since the beginning of the Fed's QE in 2008 and, by many accounts, a catalyst for the ten-year global equity run. Asset purchases under QE and ultra-low, short-term interest rates from the Fed, the ECB, the Bank of Japan and the Bank of England led to an interest rate environment where equities became the preferred asset of individuals and institutional money managers alike. Since late 2015, the U.S. has led the way in hiking short-term rates. But it is no longer alone; currently half of the G-10 markets have started their hiking cycles. Beyond what this means for economic growth

Total Returns for Selected MSCI International Stock Indices, Fourth Quarter 2018



Source: Bloomberg. **Past performance is no indication of future results.**
All investments have the risk of loss.

in these markets, it is likely to lead to a change in the relative attractiveness of U.S. versus international assets. The Fed's leadership here has led to U.S. dollar strength for much of the past three years. Foreign central banks becoming more active relative to the Fed may point to prospects for a weaker dollar ahead.

Europe ends 2018 facing a similar array of challenges it did a year ago. Although economic growth will likely decline next year, the overall financial health of the Continent is much stronger than it was during the 2012 to 2013 period. European financial stocks have been challenged of late, but banks in particular have been a pain point for investors in 2018. A toxic brew of a challenging yield curve environment, weak lending, Brexit fears, Italian rumblings, prospects for weakening economic growth and exposure to Turkish debt produced an environment where profits were scarce. The market has reacted in kind, pricing all sixteen of the major banks from the largest European markets below book value. While there are no ready solutions to the issues enumerated here, at some point investors could find the values irresistible.

Italy faces a raft of challenges in 2019. The initial budget laid out by Italy's coalition government, with an expected deficit of 2.4%, was roundly denounced by the EU as unacceptable. The final budget will likely

come in closer to a 2.0% deficit but does little to promote the expensive promises of the disparate coalition government, ranging from corporate tax cuts and a version of universal income to a lower retirement age.

In December, Angela Merkel, Germany's chancellor, stepped down as head of the Christian Democrats (CDU), the political party she has led for 18 years. Merkel's preferred successor won as the party's new leader, bolstering Merkel's position to lead the nation through the end of her term in 2021. Given Merkel's history, this isn't likely to be a lame-duck three years but one in which she tries to further put her stamp on Europe's future, working to build the institutions the EU has lacked to make it credible for the long run.

The Brexit clock runs out at the end of March and the prospects for an agreement that satisfies the staunch Brexiteers would likely rend the current UK power structure, leading to a Labour government. Anything short of this—either a no-deal Brexit or a highly-watered down one—only produces a further 21-month transition period, similar to the past 2½ years. For investors, the damage has already been done; in the same vein that tariffs inhibit a willingness to ink deals (and therefore slow capital spending), Brexit has put a wrench in the works across a number of industries in both services and manufacturing. It is currently hard to envision a near-term resolution that is positive for corporations or will be hailed by the markets.

While the U.S. continues its strong-arm approach to world trade, other nations are moving closer together. As discussed in previous 9:05 newsletters, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (the successor to the Trans-Pacific Partnership) was signed early in 2018 and went into effect at the end of December. Also in the last month of 2018, the European Parliament and Japan finalized terms on the largest trade deal in the EU's history. It establishes the world's largest free trade zone, eliminating nearly all tariffs between the EU and Japan and enriching a market that represents 600 million people and one-third of the world's economy.

Emerging Markets

After causing investor pain in the second quarter, emerging markets (EM) beat developed ones in the second half of 2018 and traded broadly in line with U.S. large cap stocks. In the fourth quarter, the comparison was even more vivid: emerging market stocks outperformed the S&P 500 Index by more than 6%.

EM currencies actually strengthened during the period, adding 0.75% to total returns. Excluding China (which fell more than 10% on the quarter), emerging markets as a whole declined less than 6%, better than all developed markets, save Hong Kong.

Could this be a turning point for emerging markets? We have spoken for a long time about the deep discount investors have placed on emerging market shares versus the U.S.; while this differential has narrowed as of year end, it remains large relative to its history. With the exception of China's economic slowdown—along with its trade war with the U.S.—much of the negative sentiment from last spring has been removed from a broad swath of emerging markets. Indonesia's presidential election in April, which had the potential to destabilize the region, is now looking to lead to a solid win by incumbent, Joko Widodo. The fourth quarter's dramatic decline in energy prices (both crude oil and natural gas) is a boon for many emerging markets, notably, Asian net importers including India, Indonesia, Thailand, China, Korea and the Philippines. Turkey imports almost all of its crude; the decline to below \$50 per barrel on West Texas Intermediate takes a lot of pressure off the nation's central bank.

Investors are coming to terms with the new leaders of the two largest states in Latin America. Mexico's President Andrés Manuel López Obrador is a leftist nationalist; Brazil's Jair Bolsonaro is a right-wing nationalist. Bolsonaro represents a change in a system in which the litany of recent left-wing leaders each appears to have fed more at the trough than worked to strengthen weak institutions. Bolsonaro seems set on a very different agenda; its nativist and, at times racist, elements may not play well at home but the general house cleaning has the potential to reengage foreign investors in a market whose perennial potential is underserved by poor leadership and institutions.

With EMs out of the limelight regarding current trade tensions and the kinds of issues Europe is facing, they may benefit as "the cleanest dirty shirt." Beyond perceptions (and, again, with the exception of China), economic growth is not expected to decline as much in the emerging markets as it may in the developed world. Earnings growth is currently expected to reach high single digits in 2019. In combination with a relatively rich dividend yield of 2.9%, as measured by the MSCI Emerging Markets Index, EMs may provide some protection in a likely rather volatile year.

* Unless otherwise indicated, the equity returns cited in this section of the 9:05 are based on their respective MSCI region or country indices. The returns of these indices along with those of the MSCI EAFE and the MSCI Emerging Markets indices are presented in U.S. dollar terms on a total return basis (with net dividends reinvested).

REAL ESTATE

Is There Opportunity in Opportunity Zones?

Opportunity Zones (OZs) have been generating much debate and discussion lately. Created as part of the Tax Cuts and Jobs Act of 2017, OZs are federally-designated areas where real estate investors can get significant tax breaks by developing/re-developing properties. The Treasury Department issued interim guidelines in October, 2018 to help investors navigate the maze, but there are still many areas of uncertainty and a number of unanswered questions. The idea of providing incentives to accelerate investment into disadvantaged areas (approximately 8,700 designated census tracts) to create jobs is certainly laudable, but the over-arching question for Bailard and its clients is: “Is there opportunity in Opportunity Zone investment?” The simple answer is that it’s still too early to tell.

The basics of the OZ program are straightforward. Investors who reinvest realized capital gains in a Qualified OZ Fund (QOF) can initially defer the tax burden on those gains and then, at five-year and seven-year milestones, reduce those capital gains. Ultimately, if the investment is held for more than ten years, investors can eliminate the tax liability on the OZ investment altogether (though 85% of the original capital gain an investor contributed into the QOF would still be taxable and payable in 2027).

If an investor picks the right QOF sponsor that makes astute investments, the OZ investment has the potential to be quite profitable above and beyond the tax benefits. As mentioned above, many of the OZs are distressed areas in desperate need of investment. So investors have an opportunity for a win-win-win: “doing well by doing good”... and doing so with tax advantages, to boot. Unfortunately, as with many tax-incentive programs, the devil is in the details.

Investments must be made through a QOF, which means that no existing fund vehicles may be used. This is unfortunate because there are already a multitude of private funds (closed-end and open-end partnerships and corporations) with tens of billions of dollars of investable capital whose investment strategies would potentially make them ideal investors into OZs.

A Flow of Dollars, along with Sponsors Chasing Them

However, there’s no shortage of promoters interested in forming new vehicles to tap into the flow of capital eager to take advantage of the OZ program. In fact, CoStar Group recently tallied the number of announced funds aimed at the OZ opportunity and the results are stunning. In total, the list tops \$18 billion in estimated fund-raising and includes 30+ funds targeting \$50 to \$99 million; 50+ funds targeting \$100 to \$500 million; and 10+ funds targeting at least \$500 million (including a \$3 billion fund sponsored by SkyBridge.) As expected, the pool of sponsors is a disparate group: some with track records, discernable real estate investment skills and solid reputations for fair dealing, integrity and transparency, along with some that exhibit, well, none of those qualities. Like many well-intentioned (and even well-designed) government programs, the opportunity for a quick buck attracts too many individuals and groups with questionable motivations.

More than 100 funds seeking to raise

\$18 billion

The upshot is that there will be enormous amounts of new money (some of it disciplined and responsible, and some of it not) chasing a finite number of investment opportunities with real merit in a market already characterized by too much capital chasing too few really worthy deals. Interestingly, while most tracts designated as OZs are in secondary and tertiary markets yearning for investment, many of the OZ tracts are adjacent to Central Business Districts (CBDs), including San Francisco, Seattle, Portland, Denver, Los Angeles and Manhattan. For the past five to seven years, the latter had already been undergoing

tremendous transformation because of their proximity to those hot and expensive CBDs. Investment capital was pouring into many previously blighted areas prior to the creation of the OZ program and some of those areas were already over-heating—not good for either the OZ program or QOF investors.

In an ironic twist on this same theme, the city council of Boulder, Colorado (yes, Boulder, one of the wealthiest enclaves in the United States) voted to put a moratorium on most new development in the city's opportunity zone. Apparently, there were concerns about the potential flood of new money into development projects that would amplify the gentrification and displacement of residents already occurring in the zone. Presenters at the public hearing in Boulder that preceded the city council's vote indicated that communities in Oregon and California were considering similar measures.

Equally concerning, as referenced above, there are still a number of details in the law and regulations surrounding the program that lack clarity. For example, it is not clear whether gains realized in OZ investments prior to the five, seven and ten-year milestones can be rolled into other OZ investments and preserve the original "clock," or does a new clock get tolled. Also, there is uncertainty about the role of land value in the equation used to determine the amount of capital that must be invested to improve an existing or develop a new property. Finally, the terms "original use" and "substantially improved"—the definitions of which are critically important for investors to know for certainty on time frames, quantum of investment, qualification and, ultimately, tax treatment—are still the subject of interpretation. Sophisticated investors will need answers to these and other opportunity-specific questions before they will feel comfortable making an investment. Conversely, some of the less disciplined and/or less experienced investors may jump-in imprudently and soil the program's reputation.

In Conclusion

The Opportunity Zone program emanating from the TCJA has the potential to funnel significant investment into many areas of the country that badly need it. Broadly speaking, it will provide incentives for taxable investors to make those investments in exchange for deferrals, breaks and even tax elimination in some cases. Unfortunately, in many ways, the program is not quite "ready for prime time" and suffers from some

design flaws that may delay the salutary benefits it was envisioned to catalyze.

Beyond that, most institutional investors (including Bailard) would not make any investment purely based upon tax incentives. Bailard would not pursue any real estate investment unless there was an opportunity for significant income and capital appreciation, regardless of tax implications. Moreover, we all know that "What the government giveth, the government can taketh away." So best not to put too much faith in the benefits of a program that might not be around when the opportunity ultimately ripens. Finally, with the apparent flood of money into OZ funds, it would stand to reason that pricing on many OZ opportunities will likely increase, diminishing the attractiveness of those opportunities for investors seeking good relative value. Bailard is going to take a wait-and-see posture on the OZ opportunity for the foreseeable future. However, Bailard will continue to monitor the OZ program and keep its ear to the ground for any and all attractive investment opportunities whether they be in an OZ or not. And, if the landscape evolves such that creation of a QOF makes sense for Bailard's clients, Bailard will look to move quickly to diligently and prudently exploit the opportunity.

BAILARD INVESTMENT STRATEGY

An Overview of Our Strategic and Tactical Asset Allocation

U.S. Bonds

With stocks in decline, bond yields have fallen as investors have searched for safe havens. While bond valuations were becoming more attractive as yields rose earlier in 2018, the recent decline in yields has made bonds even more overvalued. With the Fed in tightening mode, the Fed balance sheet being unwound and government deficits ballooning again, the pressure on interest rates should be to the upside. We remain underweight bonds from a strategic perspective.

U.S. Stocks

U.S. stocks ended the year in a steep slide and many valuation metrics were approaching fair value. However, valuations have rarely stopped at fair value in a bear market. Valuation metrics help identify risk and opportunity in the long run but, in the short run, valuation metrics are not very good timing tools. From a long-run perspective, stocks were close to fairly valued at year end. But in the short run, investor psychology is more important than fundamental stock analysis. With the market still trending sharply lower it is too early to take on more equity risk.

International Stocks

International stocks have been undervalued for some time relative to the U.S., but are now rather inexpensive on an absolute basis. After developed markets rose 25% and emerging markets increased 37% in 2017, both fell in 2018, ending the year down by nearly 14% and 15%, respectively (as measured by the MSCI EAFE and MSCI Emerging Markets indices). International stocks are a good example of how long an asset can be cheap and still get cheaper. We are maintaining our strategic allocation to international equities at a neutral weight.

Real Estate*

Real estate continued to rise in the fourth quarter, performing its role as a portfolio diversifier as equities suffered. Real estate has been strong and has moved steadily higher since the end of the Great Financial Crisis. Capitalization rates (the ratio of a property's net operating income relative to its market value) have remained high relative to interest rates. But as rates have risen, this advantage has narrowed. Going forward, we continue to believe real estate will likely provide competitive returns and help stabilize the overall portfolio if the bear market in stocks continues.

Alternative Investment Strategies*

We believe that, for appropriate investors, some types of long/short strategies have the potential to provide important defensive diversification in scenarios where more traditional asset classes experience declines. In our opinion, the economic and financial uncertainty in the current environment underscores the important role such strategies can play.

Tactical Asset Allocation Strategy (TAA)

TAA tends to hold four of thirteen major asset classes and is designed to be both opportunistic and defensive in response to the investment markets on a short-term basis.

**Real estate and alternative investment strategies have significant risks and are not appropriate for all investors.*

12/31/18

MARKET PERFORMANCE

U.S. Interest Rates	3/31/2018	6/30/2018	9/30/2018	12/31/2018
Cash Equivalents				
90-Day Treasury Bills	1.71%	1.92%	2.20%	2.36%
Federal Funds Target	1.75%	2.00%	2.25%	2.50%
Bank Prime Rate	4.75%	5.00%	5.25%	5.50%
Money Market Funds	1.68%	2.03%	2.13%	2.42%
Bonds				
30-Year U.S. Treasury	2.97%	2.99%	3.21%	3.02%
20-Year AA Municipal	3.47%	3.42%	3.65%	3.66%

Source: Bloomberg, L.P.

Global Bond Market Total Returns (US\$) through 12/31/18	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Bonds				
BofA Merrill Lynch U.S. Treasury Index	2.61%	1.93%	0.80%	0.80%
BofA Merrill Lynch Agency Index	1.96%	1.94%	1.37%	1.37%
BofA Merrill Lynch Corporate Index	-0.04%	0.91%	-2.25%	-2.25%
BofA Merrill Lynch Municipal Index	1.58%	1.32%	1.04%	1.04%
International Bonds				
Citigroup non-US\$ World Government Bond Index, fully hedged	2.29%	1.73%	3.49%	3.49%

Sources: Bloomberg, L.P. and Morningstar Direct

Global Stock Market Total Returns (US\$) through 12/31/18	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Stocks				
Dow Jones Industrial Average Index	-11.31%	-2.77%	-3.49%	-3.49%
S&P 500 Index	-13.52%	-6.85%	-4.38%	-4.38%
NASDAQ 100 Index	-16.76%	-9.59%	0.03%	0.03%
Morningstar Small Value Index	-19.19%	-17.69%	-16.61%	-16.61%
International Stocks				
MSCI Japan Index, net dividends	-14.23%	-11.08%	-12.88%	-12.88%
MSCI Europe Index (includes UK), net dividends	-12.72%	-12.02%	-14.86%	-14.86%
MSCI EAFE (Europe, Australasia, Far East) Index, net dividends	-12.54%	-11.35%	-13.79%	-13.79%

Sources: Bloomberg, L.P. and Morningstar Direct

Real Estate Total Returns (US\$) through 12/31/18 (estimated)	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
NFI-ODCE Index*	2.09%	4.22%	8.70%	8.70%

Source: The National Council of Real Estate Investment Fiduciaries

*Since the fourth quarter 2018 NFI-ODCE index return is not yet available, we have estimated it by using the previous quarter's return. This estimate is used for all time periods presented.

Past performance is no indication of future results. All investments have the risk of loss.

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the 9:05 is produced by the Asset Management Group of Bailard, Inc. The information in this publication is based primarily on data available as of December 31, 2018 and has been obtained from sources believed to be reliable, but its accuracy, completeness and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.

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ABOUT THE 9:05

Since 1978, we've held a weekly company wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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