Strategy Quarterly

Fourth Quarter 2017

Executive Summary

- The market has benefited from two main positive forces: strong corporate profits growth and very favorable financial conditions. These two factors have driven stocks well above their historical levels. Since 1970 through September 2017, the S&P 500 Index has generated an average compound return of about 10% with a volatility of about 16%. Since the market bottom of March 2009, the S&P 500 has produced an annualized return of about 18% with a volatility of only about 13%.
- The Federal Reserve's ("the Fed") zero-interest-rate policy and quantitative easing have likely inflated the valuation of financial assets by suppressing the term premium. As the Fed continues to implement its normalization policy, it is reasonable to assume that term premium will start to rise over time and put pressure on the valuation of equities.
- Normalization of monetary policy against the backdrop of a maturing business cycle represents a risk to the stock market. A measured pace of policy normalization will be the key factor to avoiding an economic contraction with associated market correction. With slack labor markets and muted inflation, we anticipate the shift toward monetary policy normalization to remain gradual.
- However, with a maturing business cycle, potentially increasing interest rates and full market valuations, we believe the only factor that can keep this market going is corporate earnings growth. Current earnings-per-share ("EPS") growth estimates appear quite aggressive in our opinion and the price-to-earnings ("P/E") ratios are certainly not very attractive in relation to historical averages.
- Alpha Quant Advisors offers an array of equity strategies with different sensitivity to economic conditions and appropriate for distinct risk profiles. Each strategy is driven by a distinct set of alpha-factors: fundamentals and valuation metrics that have a demonstrated consistent ability to predict excess returns.

AlphaQuant
Engineered for Alpha

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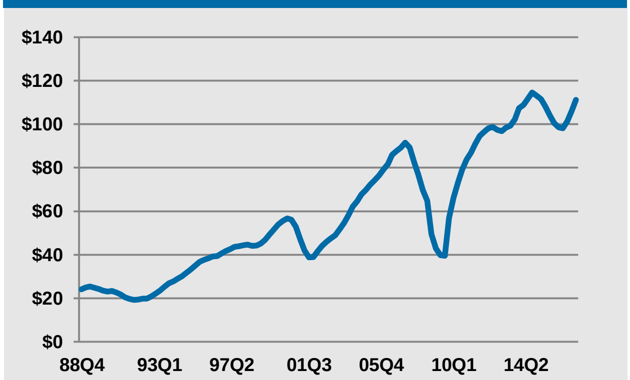
Economic Outlook

The market has benefited from two main positive forces: corporate profits have been rebounding sharply and financial conditions have eased.

Figure 1 depicts the aggregate operating EPS of the S&P 500 companies since 1988. EPS bottomed and rebounded sharply in the first quarter of 2009. Since then, they have been growing at an annual average of about 10%, supported by margins expansion and decent top-line growth.

Figure 1: S&P 500 Earnings Per Share



Source: S&P, Dow Jones

Despite the recent Fed rate hikes, overall financial conditions remain extremely favorable as indicated by the National Financial Conditions Index ("NFCI") in Figure 2. The NFCI measures risk, liquidity and leverage in money markets, debt and equity markets, and in the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

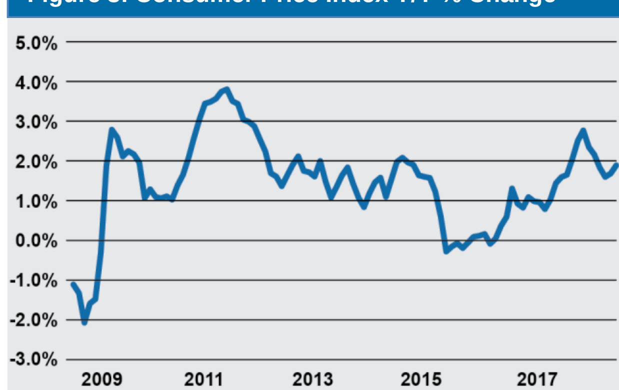
As of the most recent data point of September 2017, the NFCI was at one of the lowest points in its history, signaling exceptionally favorable conditions. Thus, robust earnings growth and favorable liquidity conditions have underpinned this bull market. To put into historical context the recent market advance, investors should consider that since 1970 through September 2017, the S&P 500 Index has generated an average compound return of about 10% with a volatility of about 16%. Since the market bottom of March 2009, the S&P 500 has produced an annualized return of about 18% with a volatility of approximately 13%. And, in the last three years ended September 2017, the S&P 500 returned 10% with a volatility of just 10%.

But what is the market outlook over the next year and beyond? As the business cycle matures and the Fed continues along its path of policy normalization, will those same forces that have underpinned the market reverse course? The normalization of monetary policy within a backdrop of a maturing business cycle represents a risk to the stock market. A measured pace of policy normalization may be a key factor to avoid an economic contraction with associated market correction. With slack labor markets and muted inflation (see Figure 3), we expect the shift toward monetary policy normalization to remain gradual. As long as inflation remains subdued and wages do not increase sharply, the Fed may not be in a hurry to increase rates and the economy might be able to continue moving into the late phase of the business-cycle expansion.

Figure 2: Financial Condition Index

Source: Federal Reserve Bank of Chicago

Figure 3: Consumer Price Index Y/Y % Change

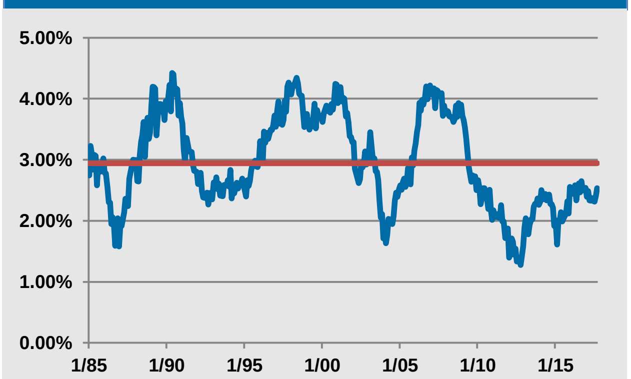


Source: Federal Reserve Bank of St. Louis

Business Cycle Analysis

Historically, wage inflation has been a key development in the context of the business cycle. Typically, wages tend to accelerate well into the expansion phase and prompt the Fed to raise interest rates in an attempt to counter the pervasive inflationary pressure of rising wages. In the current business cycle, apparently tighter labor markets have yet to spur a greater rise in employee wages. Nominal wage growth since the recovery, which officially began in mid-2009, has been low and flat (see Figure 4). This is likely due to a weak labor market placing enormous downward pressure

Figure 4: Hourly Average Earnings



Source: Federal Reserve Bank of St. Louis

on wages. But why has wage growth been so restrained during the current recovery? The 2008 global financial crisis and deep U.S. recession hit labor markets in the goods-producing sectors particularly hard.

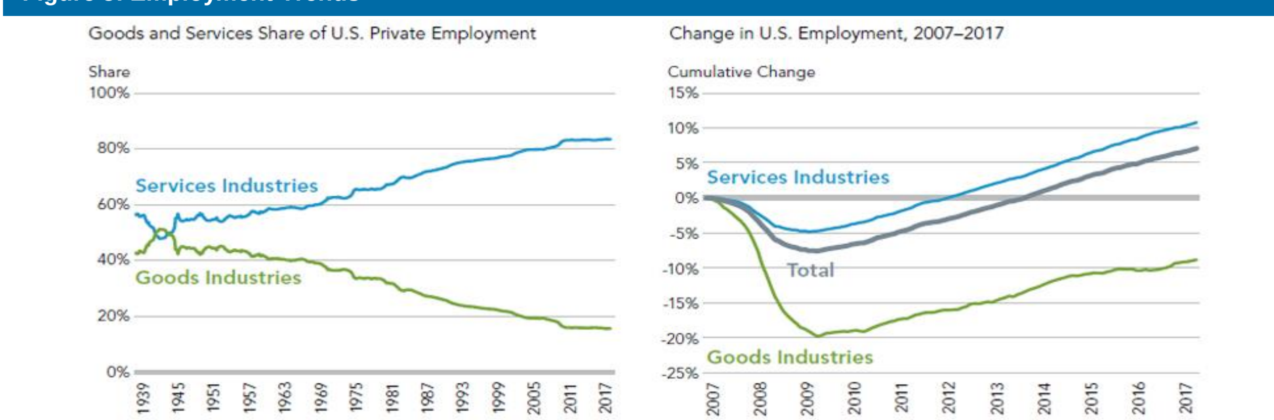
The U.S. economy shed nearly 9 million jobs and the unemployment rate rose to more than 10%, with goods-producing sectors (Manufacturing, Construction, Mining) dropping 20% of their workers. While service-sector employment recovered to prerecession levels by 2012, the number of jobs in goods-producing sectors is still 10% lower than it was in December 2007.

And since goods-producing workers on average have a higher level of income than employees in the service industries, aggregate U.S. wage growth has been further depressed as the share of goods producers has decreased sharply in the overall labor market. This has further accelerated the long-term mix shift of lower-paid service jobs accounting for a larger share of the overall job market, depressing aggregate wage growth (see Figure 5).

Regardless of the reasons of low wage growth, the key point is that as the slack in the labor markets diminishes even more, we should finally see an acceleration of wage growth. Consistent wage growth of more than 4% may also allow the labor share of corporate-sector income – the share of corporate income received by workers in the form of wages and benefits – to begin making up its recent losses.

Usually, the labor share rises late in the expansion as labor markets tighten and workers regain the bargaining power necessary to secure wage increases. This may translate into higher income and, therefore, higher demand of goods and services to support the current expansion.

Figure 5: Employment Trends



Source: Fidelity

Against a backdrop of a maturing business cycle, potentially increasing interest rates and full market valuation, the only factor that might keep this market going is corporate earnings growth.

Figure 6 shows the P/E ratio and projected growth of the S&P 500 Index and sectors based on estimated 2017 operating EPS. Growth estimates appear quite aggressive in our opinion and the P/E ratios are certainly not very attractive in relation to historical averages. Further expansion of market multiples are increasingly unlikely given the Fed's tightening bias.

The global expansion remains relatively steady and synchronized across major economies, but it seems unlikely that the driver of the next advance of corporate earnings will be internal, given that the U.S. economy is firmly in the late stage of the expansion phase. The eurozone is not as far along as the U.S. in the cycle, although it continues to benefit from improving sentiment and credit conditions. China's activity has rebounded to multiyear highs, but strong credit growth comes with rising downside risks to medium-term growth.

On the upside, the cyclical rebound could be stronger and more sustained in Europe, where political risk has diminished. On the downside, rich market valuations and very low volatility in an environment of high policy uncertainty raise the likelihood of a market correction, which could dampen growth and confidence. Monetary policy normalization in some advanced economies, notably the U.S., could trigger a faster-than-anticipated tightening in global financial markets.

Figure 6: Based on 2017 EPS Estimates

	P/E Ratio	Proj. Annual Growth
S&P 500 Index	19.8	12.4
Consumer Discretionary	20.7	18.9
Consumer Staples	20.5	8.9
Energy	36.2	21.3
Financials	15.3	9.7
Health Care	19.2	10.7
Industrials	19.5	10.4
Information Technology	20.7	13.6
Materials	19.5	13.2
Real Estate	37.9	8.4
Telecommunication Services	14.2	3.3
Utilities	18.6	5.5

Source: S&P, Dow Jones

Alpha Quant Strategies

Alpha Quant Advisors offers an array of equity strategies with different sensitivity to economic conditions and appropriate for distinct risk profiles.

The next page depicts the range of Alpha Quant Equity Strategies – what we call the Equity Strategy Spectrum.

The strategies on the far left are built to be less sensitive to economic conditions (or "defensive"). As you move to the right, both volatility and the strategies' sensitivity to market conditions increases.

Each strategy has a well-defined sector composition and is driven by a distinct set of "alpha-factors" – fundamentals and valuation metrics that have historically been associated with future excess returns.

Investors with a long-term investment horizon and an aggressive risk profile could benefit from exposure to our Cyclical Growth and Cyclical Value Equity Strategies. Risk-averse investors should stick with more conservative equity strategies such as our Dividend and Defensive Equity Strategies. For investors seeking a solid core allocation to be maintained throughout various market conditions, we believe our Core Equity strategy is appropriate.

Less Sensitive — **Equity Market Sensitivity** — ***More Sensitive***

Defensive Value	Defensive Growth	Dividend	Quality	Core	Value	Cyclical Growth	Cyclical Value
Focused strategy of 30 non-cyclical stocks with attractive valuations	Focused strategy of 30 non-cyclical stocks with above-average earnings momentum	Focused portfolio of 30 stocks with strong dividend persistence, broadly diversified across sectors	Focused portfolio of 30 high-quality large- to mid-cap stocks with strong profitability and lower leverage at reasonable valuations	Diversified portfolio of 50 to 60 stocks across Quality and Value strategies	Focused portfolio of 30 attractively valued large- and mid-cap stocks with high free cash flow, lower leverage and lower valuations	Focused strategy of 30 cyclical stocks with above-average earnings momentum	Focused strategy of 30 cyclical stocks with attractive valuations
Aims to outperform the market during periods of economic contraction and recession		Aims for high risk-adjusted returns by emphasizing dividend growth potential	Aims to outperform over a full market cycle	Aims for a more consistent return pattern	Aims to exploit investors' short-term biases and under-appreciation of cash flow trends	Aims to outperform the market during periods of economic recovery and expansion	
Composite Inception Date							
8/1/2013	8/1/2013	1/1/2012	1/1/2012	1/1/2012	1/1/2012	2/1/2015	2/1/2015
SmartALPHA® Index Start Date*							
7/1/2012	7/1/2012	—	—	—	—	7/1/2012	7/1/2012

Massimo Santicchia is a co-founder and chief investment officer of Alpha Quant Advisors, LLC. Mr. Santicchia develops and manages equity strategies and funds and oversees all aspects of Alpha Quant's investment process. Previously, he also served as chief investment officer of Cypress Capital Group and Cypress Trust Co. He has more than 18 years of investment experience, including at S&P Investment Advisory Services LLC as developer and portfolio manager of the four JNL/S&P funds. He also co-managed the JNL/S&P Managed and Disciplined funds. Prior positions include: consultant with the investment banking divisions of Goldman Sachs and Credit Suisse First Boston and international equity analyst at Nicholas-Applegate Capital Management. Mr. Santicchia holds a B.A. in Economics and Political Science from the University of Perugia, Italy; an MBA from the U.S. International University, San Diego; and an M.S., Investment Management, from Pace University, New York.

Important Notes

The analysis, tables and charts presented herein are based on the most recent data available as of October 2017.

Any opinions herein, including forecasts, reflect our judgment as of the reporting period and are subject to change. The Alpha Quant strategies and each client's portfolio composition will change depending on economic and market conditions. This report is not a complete analysis of market conditions and therefore, should not be relied upon as investment advice. Although information has been compiled from reliable sources, Alpha Quant Advisors, LLC makes no representation as to the completeness or accuracy of the statements contained herein.