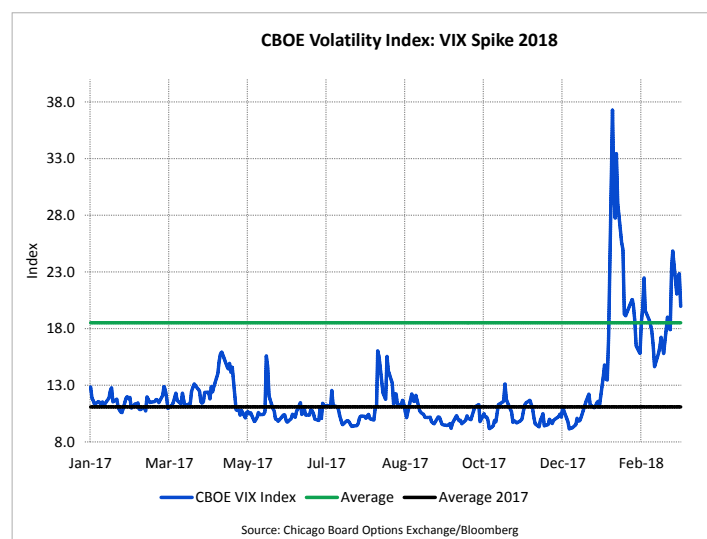


Summary

- In Q1 2018 stock returns were mixed among U.S. large capitalization (-0.75%), international developed (-1.41%), and emerging markets (+1.38%).
- The Barclays U.S. Aggregate Bond Index declined -1.46%, and high yield bonds were down -0.91%.
- The U.S. Dollar declined relative to other major currencies.
- Price and earnings momentum in equities are positive heading into Q2 2018.
- Equity risk premiums are supportive of current valuations while other metrics suggest overvaluation and more potential downside risk. Yield levels have moved up as the Fed has raised the Fed Funds interest rate and has begun quantitative tightening ("QT"). The yield curve has flattened significantly but is still upward sloping. Libor-OIS spreads, a measure of short term funding risks, have widened causing some concern.
- Economic conditions suggest we are in the middle to later stages of a cycle. The fiscal stimulus from the tax reform could extend the cycle.
- Financial conditions have become less supportive, but financial stress indicators remain at low levels.

Review

The first quarter (Jan-Mar) of 2018 was a choppy ride in equity and bond markets. After experiencing perhaps the best start ever to a year, investors subsequently witnessed a resurgence in volatility. The quarter experienced both the largest point drop in the history of the Dow Jones Industrial Average followed by its third largest point gain. After averaging 11.1 in 2017, the VIX index exploded higher to over 37 in early February, dealing a severe blow to certain volatility products. Despite signs of global synchronized growth and benefits to expected earnings from recently enacted tax reform, concerns around inflation and the path of interest rates interrupted early euphoria.



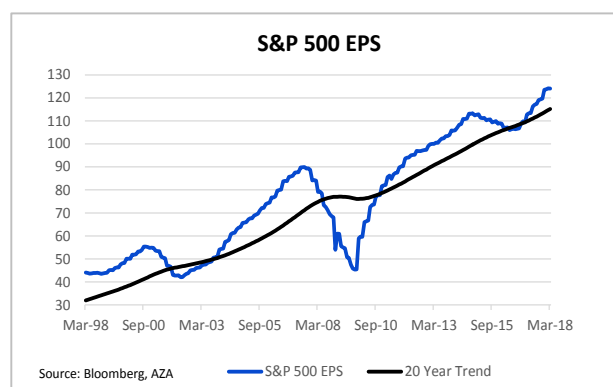
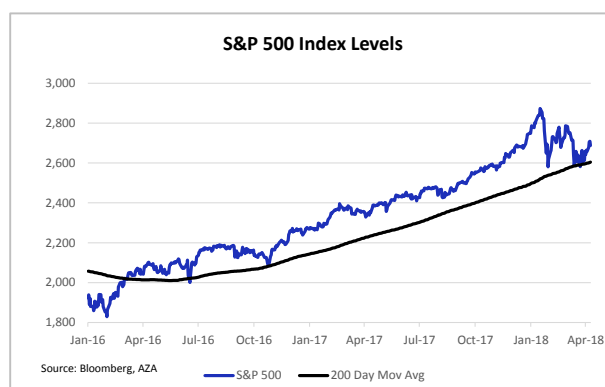
In our opinion, bond markets and technical factors seem to be the primary source of volatility. Interest rates rose and bond prices fell after digesting uncertainties around critical wage inflation data and a combative stance toward inflation from the Federal Reserve Bank. Investors and traders were forced to weigh faster and tighter monetary conditions against positive data that ranges from earnings growth to manufacturing PMI's to stable credit spreads.

During the quarter the Federal Reserve Board installed a new chairperson. In early comments, Chair Powell suggested that the economy and inflation pressures are stronger than the consensus and outlined the Fed's inclination to raise rates quicker than previously expected over the next two years. Adding accelerated rate increases, higher U.S. Treasury issuance to help fund deficits, and a QT balance sheet reduction policy that ramps to a \$600 billion annualized pace could bring tighter monetary conditions. This confluence of events could challenge the current Goldilocks environment of growth, low-to-moderate inflation, and accommodative monetary policy. A change in market expectations was signaled by a flattening yield curve and increased stress in short term funding markets. This translated to equity market uncertainty and ultimately to the stock market volatility witnessed in February and March.

Market Survey

Momentum

Despite the recent pullback in stocks, long-term trends in equity prices remain positive. Corporate earnings appear positive and are supported by corporate tax changes.



Valuation

Valuation measures offer a mixed bag. Earnings multiples and reversion based metrics range from full value to 'bubble' levels. A regime change in U.S. corporate taxation may be clouding the reliability of these metrics as earnings jump and then grow from a new base. Equity risk premiums and yield based approaches are much more supportive to equity returns on a forward looking basis and relative to bonds. Cash repatriation will boost buybacks and lower tax rates will result in higher earnings per share. International developed markets are earlier in the cycle than the U.S. and may provide a more attractive combination of valuation and growth.

Earnings / Valuation Factors

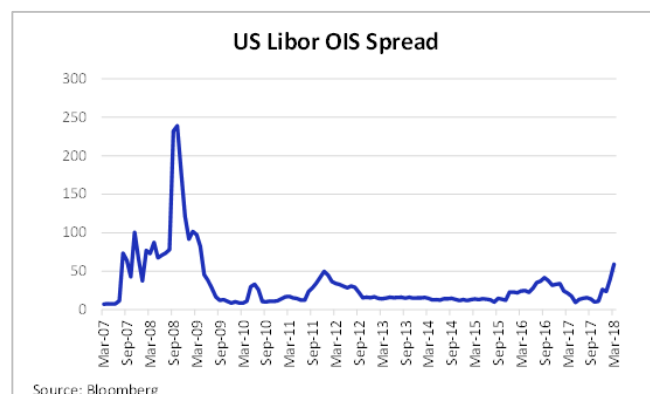
Factor	Notes	Signal / Result
GDP / Earnings Growth	Fiscal expansion via tax cuts combined with global growth are key drivers	SUPPORTIVE
Buybacks	Net issuance remains negative as earnings repatriation drives buyback flows	SUPPORTIVE
Margin Expansion	Margins are off all-time highs but elevated - tax cuts may be beneficial	NEUTRAL
US Dollar	USD continues to weaken	SUPPORTIVE
Multiple Expansion		HEADWIND
P/E, EV/EBITDA, CAPE	These multiples are in ranges that have historically been correlated with lower returns	HEADWIND
ERP, FCF and Div Yields, Forward P/E	These multiples appear near longer term averages	SUPPORTIVE
Overall		NEUTRAL to SUPPORTIVE

Sources: AZA, Bloomberg

Bond Markets

Bond markets are possibly nearing the end of a 35 year bull run, but U.S. 10-Year Treasury rates have yet to sustain levels above 3%. Credit spreads remain tight, which is indicative of a growth cycle. While still upward sloping, the yield curve has flattened significantly, signaling expectations that the economy could be moving into the later stages of a cycle.

Short term funding markets have been showing rate spread conditions that, in the past, proved to be stressful for the financial system. Several possible explanations have been put forward to explain the recent dynamic as a structural change in the market. These include changes in the supply of US Treasuries and corporate repatriation of foreign cash. Additionally, we have heard anecdotal concerns around emerging market debt levels and the quality of underwriting, but this factor has yet to make headlines.



Economic Conditions

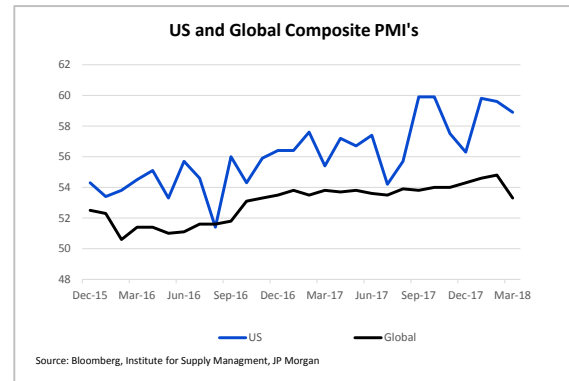
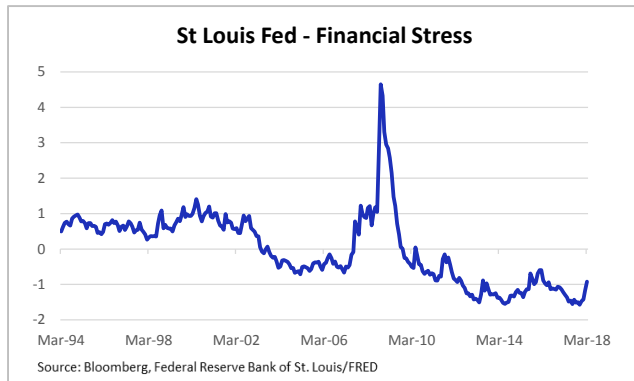
Economic conditions are favorable for growth. Historically the Federal Reserve has attempted to slow the economy and suppress wage inflation via higher rates to slow housing and other investment. The Fed anticipates job market tightening and has entered a cycle of rate increases that have lag effects on the real economy and financial markets.

At this point in the cycle of Fed tightening, markets are beginning to see the effects of tighter financial conditions albeit off of very accommodative levels. Housing starts have decelerated and even had a negative year-over-year print in February. Auto sales have remained at high levels though certain subprime auto lenders are suffering increased defaults. U.S. and Global PMI indexes are indicating growth.

We detail key causes of past recessions and evaluate the current status of each in the table below.

Recession Risk		
Factor	Notes	Signal / Result
Tight Money / Credit Contraction	Federal Reserve Tightening including balance sheet reduction program	MEDIUM to MED HIGH
Housing Starts Decline	Risk of higher rates and prices slowing growth, but Millennials and jobs supportive	LOW
Business Capital Expenditures Decline	Policy uncertainty may slow growth	LOW
Military Demobilization	Low intensity conflicts with higher expected defense budgets	LOW
Overall	External shock from Chinese or European financial sectors could flare	LOW to LOW MED

Note: Four key factors AZA tracks that drive recession risks and may explain most major economic contractions



Conclusion

After experiencing close to euphoric levels in January, equity markets corrected when wage inflation fears and a more hawkish Fed contributed to bond market declines. Volatility briefly surged to levels normally seen during crisis times. Regardless, global synchronized growth seems intact and undergirded by tax reform that will lead to increased earnings and buybacks. As long as the housing cycle moves forward and rates do not move sharply higher, it will be difficult to push the U.S. economy into recession—times when equity markets have historically been most at risk.

Though the expectation that the Federal Reserve would gradually raise rates is being challenged, stronger than expected economic data will be required to support more aggressive rate increases. The Fed's QT program is among the biggest sources of uncertainty and will be in full effect by year end—the outcome could lead to higher bank profitability or more difficult markets.

These outcomes are not certain and the team at AZA will be following events closely.

Strategy Highlights

We are available to discuss your personal investment portfolio in more detail. The following summaries are from select strategies:

DRIV Core

- Guided by our data analysis, this strategy ended the quarter positioned with an allocation of approximately 65% equities and 35% bonds/cash.
- Within the equity portion, we are favoring overweight allocations to large cap value and international developed markets. Within the bond portion, we exited long duration corporate bond exposure in January and now hold a mix of short duration corporates and cash.

Core Equity and Options (CEO)

- As options expire, we continue to shift exposure to select European financials and U.S. technology opportunities. The shift up in volatility has hurt existing options on a mark-to-market basis.
- Volatility has picked up significantly and put premium yields on cash are very good. Currently, we favor put writing over call writing.

Enhanced Income

- The strategy is primarily in a “risk off” mode for most yield asset classes.
- At the end of the quarter, approximately 90% of the portfolio was in a mix of short term and long term U.S. Treasury ETFs, while we estimate an annualized yield of 2.45%.

Global Equity

- We exited positions for gains in January that had hit price targets (XYL and EMR) and our thesis not being met (PM). We used those funds and cash to source investments in European financials and cybersecurity names. We hold approximately 5% cash to deploy in new opportunities.
- We maintain the belief that global markets may offer more attractive returns as they attempt to close the underperformance gap of earnings and capital efficiency versus the United States.

Global Equity & Income

- We exited positions for gains in January that had hit price targets (XYL and EMR) and our thesis not being met (PM). We used those funds and cash to source investments in European financials and cybersecurity names and hold some cash for new opportunities.
- At the end of the quarter, the income portion of the portfolio was in cash equivalents and U.S. Treasury ETFs, while we estimate an annualized yield of 2.45%.

Global Opportunities Hedged

- In February, we shorted volatility (against the long volatility embedded in our hedges) via SVXY and exited the trade in early March for a gain as volatility subsided from its spike
- With cash we added exposures in financials and optical networking tech.

Total Return

- We remain broadly allocated across growth and value as well as large and midcap stocks. International developed markets are a significant exposure, while we have maintained low exposure to small caps.
- At the end of the quarter, the income portion of the portfolio was in cash equivalents and U.S. Treasury ETFs, while we estimate an annualized yield of 2.45%.

Disclosures: The opinions expressed reflect the judgment of the author at the date of publishing and are subject to change. Past performance does not guarantee future results and results may differ over future time periods. There is no guarantee that any investment will achieve its objectives. All investments carry a certain degree of risk and it is important to review investment objectives, risk tolerance, tax liability, and liquidity needs before choosing an iInvestment approach or manager. This publication is provided for informational purposes only and is not to be construed as advice or a recommendation to invest in accordance with a particular strategy or a solicitation for the sale or purchase of any security. The information presented was developed internally and/or obtained from sources believed to be reliable, but not guaranteed.