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Key Takeaways

- With muted expectations for economic and profit growth in the new year, we recommend a balanced approach with a keen eye toward withstanding swings in investor sentiment and unexpected economic or geopolitical events.

- Consumer spending remains remarkably resilient and is the main reason the bull market has continued well past historical norms. Monitor employment data and the level and direction of interest rates for clues on the future strength of the consumer.

- Earnings growth is becoming scarcer. We believe the market will reward companies that deliver above-consensus results rather than those reliant on an economic expansion or cyclical recovery.

- Despite lingering macroeconomic pressures, the case for emerging market equities remains compelling with attractive valuations and opportunities in individual markets.

- Though we don’t expect a broad recession in the U.S. or globally, narrower segments of the economy could experience recession-like symptoms, creating buying opportunities in out-of-favor sectors and industries.

- Heightened trade tensions, slowing global growth, muted inflation and dovish central banks are positives for U.S. Treasuries, which continue to offer higher relative yields than government securities elsewhere. We have a negative outlook for European sovereigns and credits.

- Despite a challenging 2019 environment for leveraged loans, our Alternatives team believes investors have opportunities among select loans and collateralized loan obligations unduly punished by the flight to quality.

- Responding to heightened interest from investors and positive market feedback, publicly traded companies continue to make material progress in their advances in environmental, social and governance sustainability. Long term, we believe the market will reward these initiatives.
There’s Room to Improve, but Remain Defensive

Just glancing at economic headlines, it would be easy to conclude that not much has changed over the last 12 months. A year ago, slowing economic and profit growth, a looming Brexit deadline and the trade war topped a long list of worries. These issues remain among the biggest concerns hanging over global markets today. But, it’s not Groundhog Day. We’re seeing encouraging differences in the investment landscape heading into 2020.

We entered 2019 coming off a brutal fourth-quarter selloff that dragged the S&P 500® Index into negative territory and made 2018 the decade’s only year with a negative total return.* From that low point, investors quickly found reasons to buy stocks again. The turnaround began with the U.S. Federal Reserve (Fed) adopting a more dovish stance early in the year before cutting rates three times beginning in July. It’s too early to judge the impact, but lower rates, along with progress on trade negotiations support increased business spending and sustained consumer confidence.

On the trade front, negotiators haven’t closed a comprehensive deal, but they were making progress as the year wound down. Adopting a new approach, the U.S. and China appear on track to keep the most punitive measures as part of a limited “phase one” agreement. This phased strategy is unlikely to produce a sweeping bargain that addresses all points of contention at once, but it may deliver incremental gains that help reduce uncertainty. The worst possible outcome also seems to be off the table in Europe. Negotiations, parliamentary maneuvers and the recent election make it less likely the U.K. will leave the European Union (EU) without a deal.

Though we believe these monetary and geopolitical shifts give the global economy room to improve, 2020 remains uncertain. With muted expectations for economic and profit growth, our investment teams continue to think defensively. We are paying greater attention to being able to withstand unexpected downturns.

We recommend our clients remain balanced with a keen eye toward downside risk. Without deviating from their long-term asset allocation policy, we believe investors will benefit from having exposure to proven equity and fixed-income strategies designed to help cushion short-term volatility. We believe this more cautious stance offers the potential to participate in the market’s upside with less exposure to volatility that could accompany swings in investor sentiment or unexpected economic or geopolitical events.

We wish you all the best in the new year. Thank you for investing with us.

* Based on total return of the S&P 500® Index.
GLOBAL MACROECONOMIC OUTLOOK*

Global Economy

U.S. recession risk recedes
The risk of a recession in the next year is fading, but growth may decelerate in the near term. Weaker capital spending and trade policy uncertainties may keep U.S. gross domestic product (GDP) at or slightly below its trend range of 2.0% to 2.5% annualized growth. The U.S. economy likely will remain stronger than the economies of other developed markets.

Slowdown is bottoming in Europe
Despite still-weak manufacturing data in Germany, Europe’s economic slowdown has stabilized. However, we don’t foresee a growth pick-up in 2020, largely due to weak global demand. In the U.K., we expect lingering Brexit and trade negotiations to dampen growth.

Emerging markets are stable
Overall, growth in emerging markets (EM) remains stable and positive. Growth in China, which recently slowed to a nearly 30-year low, should improve due to fiscal stimulus. Although a dovish Fed remains supportive of EM growth, ongoing trade tensions and slow growth in developed markets remain headwinds to developing markets.

Inflation

Weaker inflation remains a risk for the U.S.
Headline and core inflation recently stabilized near 1.8% and 2.3%, respectively. But with core inflation’s rent component recently posting its smallest monthly gain in more than eight years, lower inflation is a growing risk. Meanwhile, longer-term, market-based inflation expectations remain below historical averages.

European inflation is lower
Lower energy prices and a slowdown in industrial production have fueled the recent deceleration in European inflation. Headline inflation fell to 0.7% in October, compared with 2.3% a year earlier. Core inflation has remained near 1.0%. U.K. inflation hovers near the central bank target, supported by a tight labor market and wage growth.

EM inflation falls below target
Inflation remains low and below central bank targets in most EM countries. Notable exceptions include Turkey and Argentina, where significant currency devaluation has caused inflation to spike.

* Outlook as of 11/30/2019.
Monetary Policy

Fed pauses
After delivering three rate cuts during the second half of 2019, the Fed remains on hold to assess the effects of its recent easing moves. Given our expectations for moderating economic growth and muted inflation in the near term, we believe the Fed has room for one more rate cut in 2020.

European Central Bank stimulus stabilizes rates
The European Central Bank (ECB) recently kicked off a new round of quantitative easing (QE), which, combined with the central bank’s new tiered deposit rate, should provide a floor for European rates. We expect QE to continue through most of 2020. We believe the Bank of England, which has appeared more dovish recently, may cut rates in early 2020.

China shows easing bias
The People’s Bank of China continues to step up its monetary policy support amid lingering trade tensions with the U.S. The central bank’s November policy rate cut was the first since 2016, and policymakers could ease further depending on the status of trade negotiations.

Interest Rates

U.S. Treasury yield curve steepens
Despite modest upward moves in longer-maturity Treasury yields, the ongoing risks to global growth and inflation have kept Treasury yields relatively low. As we expected, the Fed’s easing pushed shorter-maturity yields lower and helped restore an upward slope to the previously inverted Treasury yield curve. Although the Fed insists its monetary policy is “in a good place,” the Treasury futures market expects up to two rate cuts in 2020.

Some European rates remain negative
Yield curves across Europe have started steepening due to central bank accommodation and improved global sentiment. Most longer-maturity yields have climbed out of negative territory, but short- and intermediate-maturity yields remain below 0%. U.K. rates remain modestly higher and positive, and the curve has steepened slightly. Rates in Japan remain negative amid ongoing, but reduced, central bank stimulus.

Rate backdrop favors emerging markets
Given the relatively benign interest rate environments in developed markets, we generally favor sovereign securities in select emerging markets. Specifically, we continue to focus on markets where rates are higher and more likely to fall or remain stable, including Mexico, Peru and Indonesia.
Likelihood of Recession Remains Low

Our Disciplined Equity team’s measure of recession risk remains stable and modest, suggesting talk of an impending recession is overblown. Just a few months ago, the market was in an uproar over inversion of the yield curve and uncertainty around economic growth. And while it’s true that manufacturing activity slumped earlier in the year, conditions appear to have stabilized. Given the steady job market, consumer spending and central banks’ stimulus measures worldwide, we don’t foresee a recession anytime soon. Our measure of recession risk shows only about a one-in-four chance of recession over the next 12 months.

Compare our analysis with other widely regarded recession models. The New York Fed’s widely followed recession risk model shows about a 30% chance of recession in the next year. But that’s below what it predicted throughout this past summer. Similarly, American Century Investments’ Fixed Income team, which uses both qualitative and quantitative inputs in its analysis, sees the likelihood of recession as having receded in recent months. Similarly, bottom-up indicators of economic activity also appear to have stabilized or are on the upswing. For example, the outlook for U.S. corporate earnings appears to be improving. The ratio of publicly traded companies providing positive earnings guidance versus those providing negative guidance is now back above the average level since the financial crisis of 2008.

Notable recession models suggest the chances of a recession in the next 12 months are low. However, we recommend a defensive stance with volatility remaining a risk as the economic cycle ages. —Peruvemba Satish

Volatility May Create Security Selection Opportunities

Though immediate worries of a global economic recession have receded, it’s possible for narrower slices of the economy to experience recession-like symptoms that could last months or years. For example, a plunge in crude oil prices began in mid-2014 and continued into early 2016, causing ripples through several sectors. Under those conditions, industrial companies saw revenues and new orders decline while inventory levels rose, and companies paused capital spending. We view such short-term, mini-recessions as opportunities to find what we believe to be higher-quality industrial companies at attractive prices.

More recently, industrial companies have been sensitive to swings in U.S./China trade relations and worries about the potential for a broader economic slowdown. As a result, even high-quality companies have experienced periods of stock price volatility despite having underlying earning power that appears sustainable through a downturn.

We believe a good example is Schneider Electric, a global leader in electrical distribution and automation and control products. The European company has evolved from a medium-sized business making electrical products for discrete automation and commercial buildings into a large global company serving a much broader market. The stock compares favorably to others in the industrial sector, with a strong balance sheet and a history of paying dividends to shareholders. These are key characteristics we seek as value investors.*

Select industrials stocks, in a mid- to late-cycle phase of an economic cycle, could significantly benefit from improvements in trade relations with China and a stronger global economy. —Kevin Toney
Fundamental Pressures on Energy Stocks Could Moderate in 2020

Energy was one of the worst-performing sectors in 2019. Increased U.S. shale production, a slowing global economy and new supply from countries such as Norway, Brazil and Guyana caused fears of crude oil oversupply.

Investors who were underweight the sector most likely benefited from that positioning. No one knows for sure how energy stocks will fare in 2020, but some positive signs indicate the fundamental pressures in the oil patch appear to be moderating. In December, the Organization of the Petroleum Exporting Countries (OPEC), Russia and other oil-producing countries within OPEC’s circle of collaborators elected to maintain their policy of managing supply to keep markets balanced. In 2021 and beyond, shale growth could slow, giving OPEC more leeway in setting oil prices. The demand side of the equation is a bit more uncertain because continued economic growth is necessary for this highly cyclical sector to find its footing.

Barring conditions such as a U.S./global recession, geopolitical conflicts or the return of supply from Iran and/or Venezuela, energy stocks might not suffer from the fundamental pressure they’ve felt recently. We tend to favor higher-quality companies in the energy sector, particularly integrated and oilfield service companies.

After lagging the broad market in 2019, energy stocks could rebound in 2020.
Still, fundamental and macroeconomic threats remain for this cyclical sector.
—Kevin Toney

We Expect Continued Interest in Sustainability

Companies are increasingly aware of sustainability, and many are offering customers more sustainable choices while managing environmental and financial risks. Over the last three years, we’ve seen publicly traded companies make material progress in reporting their advances in environmental, social and governance (ESG) sustainability. Many have established sustainability desks dedicated to engaging with investors on ESG issues. Even companies in carbon-intensive industries are proactively discussing their efforts to use water more efficiently or reduce workplace injuries.

The market is responding positively as evidenced by the amount of investor money flowing into strategies that use sustainable criteria either as a risk factor or as an investing objective. We can argue the merits of each approach, but we believe the increased corporate attention to sustainability is indisputable.

We use the sustainability prism to understand financial risk from an identified ESG issue. We’re just as interested in where the company is going as where it is today. We care about these issues because we’re always interested in what might affect a stream of cash flows or what could make them more variable. We also identify and invest in companies that we believe demonstrate sustainability leadership in their sectors.

We’ve seen heightened interest in sustainable investing by both companies and the investing public. This is reflected in asset flows into investment strategies that consider ESG factors. While we can debate the best approach to integrating sustainability criteria into the investment process, there’s little doubt that corporations will continue to make it a high priority.
—Greg Woodhams

* References to specific securities are for illustrative purposes only and are not intended as recommendations to purchase or sell securities. Opinions and estimates offered constitute our judgment and, along with other portfolio data, are subject to change without notice.

A strategy or emphasis on environmental, social and governance factors (ESG) may limit the investment opportunities available to a portfolio. Therefore, the portfolio may underperform or perform differently than other portfolios that do not have an ESG investment focus. A portfolio’s ESG investment focus may also result in the portfolio investing in securities or industry sectors that perform differently or maintain a different risk profile than the market generally or compared to underlying holdings that are not screened for ESG standards.
Earnings Growth Expected to Weaken Further

Corporate earnings growth weakened in the final quarter of 2019, the third consecutive quarter of decline. Some pockets of strength remain—health care, consumer staples and information technology companies were among those reporting earnings gains. Conversely, materials, energy and most retail companies reported declines. While select companies have surpassed earnings expectations, many have dampened investor enthusiasm by simultaneously lowering forward guidance.

Uncertainty about global trade, already accommodative policies from central banks and concerns about the sustainability of the long-running bull market dampen the outlook for 2020. We expect central banks to remain accommodative, which would benefit local economies and, in turn, corporate earnings. However, we note the Fed chose to "pause" its interest rate-cutting regime. We also wonder how effective further stimulus programs will be in Europe or Japan. Even though rates in many markets are below zero, growth remains sluggish.

As earnings growth becomes scarcer, we believe equity markets will reward companies that deliver above-consensus results and guide analysts and investors toward further growth.

Earnings growth appears to remain pressured into the new year. Consider companies with growth drivers such as innovative new products or processes or those with sustainable earnings streams generated by subscription-based models.

Trade Worries Continue, but Resolution Before U.S. Elections Possible

Investors are suffering from trade war fatigue. After initial optimism for a "first phase" agreement, each side accused the other of failing to make enough concessions. Negotiators announced a limited phase one deal in December, but we expect the back and forth between optimism and fear to continue.

It’s difficult to predict when and how the dispute will resolve. However, the current U.S. administration may prefer to definitively deliver a deal before the presidential election next November. Analyzing individual stocks, we consider how trade pressures may affect the company. For example, we have identified companies with less exposure to global trade and believe opportunities exist for companies that are more locally and regionally focused.

As trade disputes play out, consider domestically or regionally focused companies with less exposure to global trade. Also consider companies experiencing growth despite the effects of tariffs—e.g., manufacturers of luxury goods and high-end spirits, which are benefiting from strong consumer trends in China and emerging markets.

U.K. Elections Lead to Hope for a Brexit Breakthrough

After more than three years of market uncertainty following the referendum to leave the EU, resolution of the Brexit saga may be in sight. Prime Minister Boris Johnson’s Conservative Party is hailing its recent victory in the general election as a mandate to deliver Brexit on or before Jan. 31, 2020, and markets appear to have priced in such a scenario. The British pound and U.K. stocks have rebounded amid optimism for an orderly resolution to this seemingly endless situation.

We agree that the outlook for the U.K. has improved with removal of some of the uncertainty. We further expect U.K. equities would benefit from an orderly Brexit. However, many questions remain about how and when Brexit will occur because the U.K. and EU must still approve a formal trade agreement. We aren’t so sure they can execute an agreement before the end of 2020, as the Conservative party promises. If negotiations for new trade agreements with the EU and other trading partners prove to be as contentious as Brexit negotiations, there remains a danger that the U.K. could leave the EU without a deal. That outcome could undo much of the goodwill U.K. assets have gained since the general election.

Reconsider U.K. holdings now that a resolution is in sight. This may help domestically focused companies that have been pressured along with the U.K. economy amid the recent uncertainty. We recommend evaluating U.K.-domiciled companies with significant business in markets outside the U.K. on company-specific results, not through a broad Brexit lens.
EM Fundamentals Remain Attractive, and We See Opportunities in China Despite Trade Issues

We believe conditions for emerging markets remain attractive because the global outlook is showing signs of improvement and trade dispute activity may be bottoming. Macroeconomic factors have weighed on EM stocks in the short term, but fundamentals for the asset class remain compelling.

It’s important to remember that emerging markets are a diverse group of countries. Correlations between markets are low because each has its own set of economic, fiscal and political characteristics. This allows us to identify opportunities in individual EM markets despite larger macroeconomic trends. We believe certain companies are well positioned to benefit from improving economic conditions in markets such as Brazil and Thailand. We are also finding examples of companies that are growing earnings despite less favorable economic conditions in their home countries.

China remains a focus. We continue to see opportunities despite slower growth and the effects of the trade war, e.g., in real estate and information technology. Some consumer-related companies, including private education providers and sportswear makers, are benefiting from strong consumer activity and aspirational spending.

- The case for EM equities remains compelling. Valuations are attractive, and opportunities exist in individual markets despite lingering macroeconomic pressures. Evaluate each market and company on its own merits. Consider companies focused on local markets and the emerging consumer class.

Resolution of Some Macroeconomic Trends Is Improving EM Outlook

Emerging markets have been under pressure from several macroeconomic trends emanating from developed markets. Trade conflicts, a strong U.S. dollar and Brexit have all weighed on investor sentiment and acted as headwinds for EM equities. We now see changes that may improve the outlook for EM economies.

U.S. dollar strength has weighed on EM stocks for several years. However, after three interest rate cuts in 2019 to support the U.S. economy, the U.S. Fed has held steady. If, as many investors believe, the Fed plans to maintain its “pause” in rate changes, we may see a levelling in the U.S. dollar rally. That would relieve some of the pressure on EM economies and stocks.

Global trade continues to concern investors worldwide. EM economies may have been affected more than some regions because their ties to both the U.S. and China are strong. However, intra-regional trade has improved as a result, lessening some of the effects of the global trade disputes. Some EM companies have benefited from the tariff escalation that has led some U.S. and China companies to seek new suppliers and buyers.

We are finding opportunities in more domestically and regionally focused companies and those less exposed to global trade. Consumer-facing companies and those tied to information technology and 5G infrastructure are attractive. Consumers are demanding increased access to education and financial goods and services, as well as status items.

- Consider domestically focused companies that can take advantage of EM consumers’ increased purchasing power and greater demand for higher standards of living. We are finding opportunities in consumer discretionary, information technology and financials.
We expect year-over-year headline and core inflation to stabilize near the Fed’s 2% target. We don’t foresee a near-term catalyst for higher inflation. Longer-term inflation expectations have modestly increased but remain well below historical averages. At these levels, we believe TIPS remain attractive.

We continue to find value in the U.S. securitized market, which remains less susceptible to the idiosyncratic elements of the corporate bond market. Additionally, we believe securitized bonds provide important downside protection to investors. We generally favor mortgage credit securities, including non-agency commercial mortgage-backed securities (CMBS), over agency MBS. We also believe asset-backed securities (ABS) offer attractive value.

Given the strong year-to-date rally, we believe investment-grade corporate bonds generally appear expensive. We also believe the credit cycle is in its late stages, which means spreads may widen as the cycle matures. Macroeconomic influences, including slowing global growth and trade conflicts, remain concerns, but the Fed cutting interest rates by 75 basis points in 2019 has mitigated those concerns somewhat. We still believe the banking and utilities sectors offer some of the best opportunities. We will closely watch the U.S. presidential campaign because several candidates have far-reaching policy agendas that could lead to significant long-term changes, particularly in the health care sector.

U.S. high-yield fundamentals remain stable. Companies continue to adjust their outlooks downward to reflect a more challenging macroeconomic backdrop. Valuations and spreads remain tight, particularly in the higher-quality tiers of the high-yield market, as investors position more defensively. Against this backdrop, we remain selective and favor higher-quality high-yield bonds with solid fundamentals and spread-tightening catalysts. We are finding the best opportunities in consumer-related sectors, including homebuilding and health care. We remain cautious toward the energy and retail sectors.

Municipal finances nationwide remain stable, and demand for munis, which remains at record levels, continues to outpace supply. Given our outlook for moderating growth, low interest rates and solid credit fundamentals, we have a modest bias toward lower-quality securities (investment-grade municipals and special tax bonds). We continue to favor revenue bonds over general obligation and agency MBS.

Most government bond yields in Germany and France remain in negative territory. However, with open-ended QE and a tiered deposit rate, we believe the ECB has effectively stabilized and put a floor on European rates. The market has retraced its expectations for more rate cuts. We are maintaining our underweight in core European rates. In the U.K., economic data remain weak, so we recently exited our short position in government bonds. Increased government spending may drive longer-maturity yields higher, so we have a slight curve-steepening bias. Elsewhere, we are maintaining an overweight in Norway.

We continue to underweight European credit, largely due to valuation concerns. Credit fundamentals remain benign but subject to ongoing economic concerns. Our underweight is focused on industrial sectors, which are more exposed to economic risks. We believe subordinated financial sector bonds still offer the most value. These securities have strongly outperformed year to date, and we have reduced our exposure to a more neutral position.

We believe benign central bank policy in developed markets, particularly the U.S., will provide a tailwind for EM assets. Given our expectations for a weaker U.S. dollar, we continue to favor local currency debt over external bonds. Our local positioning favors holdings in Russia, Israel and South Africa. Within our external sovereign exposure, we are overweighting holdings in Egypt, the Dominican Republic and Turkey. Among corporate bonds, we favor high yield over investment grade. We believe the oil and gas and technology, media and telecommunications sectors are the most attractive, and we are underweighting the metals and mining and real estate sectors.
Expect Trade and U.S. Politics to be Center Stage in 2020

Positive economic data and progress on trade talks between the U.S. and China have been a tailwind for risk assets. Equity markets are trading at all-time highs and credit spreads have tightened significantly. While the markets still have room for upside, we advise remaining cautious because valuations are stretched, and risks persist.

Trade discussions continue and many more difficult structural issues remain unresolved. Future negotiations will tackle more complex core items, such as technology transfer, intellectual property, industry subsidies and currency. Reaching agreement on all these issues won’t be easy and the back-and-forth negotiations are likely to result in greater volatility for markets.

Another key area of uncertainty is the 2020 U.S. presidential election. So far, equity markets have not been overly concerned about the risk of policy changes. However, as the election nears and front runners emerge, political agendas will likely have more of an impact on the market and specific sectors. For example, we could see additional pressure on the U.S. energy, financials, technology and health care sectors. On the flip side, proposals to break up big tech, could benefit brick-and-mortar retailers. Eliminating student debt and raising wages would help increase consumer spending.

- Given current asset price levels and uncertainties around 2020 trade and election outcomes, we are maintaining a balanced profile. On the long side, we prefer high-quality, income-generating stocks and bonds. On the short side, we’re attempting to generate alpha by shorting overpriced equities and bonds while actively hedging unwanted market risks.

Opportunities Remain Among Leveraged Loans

Credit markets experienced a dramatic shift in 2019. Loans have been particularly stressed. Company-specific events and a pick-up in credit downgrades among lower-quality loans caused investors to be risk averse and spurred a flight to higher quality among loans and collateralized loan obligations (CLOs). Outflows from retail funds also created headwinds.

Despite these stressors, we believe the U.S. economy remains in good shape. Thus, the selloff created relative value opportunities for loans and CLOs that may now offer more attractive yields compared with other asset classes.

From a technical perspective, we may continue to experience periodic stretches of retail outflows that create price volatility. However, we expect the effect to be diminished because retail funds now account for a smaller portion of the loan market. At the same time, CLO investors have become a larger share of the investor base. They tend to buy and hold and haven’t been selling into the recent weakness.

Looking ahead, we think it’s prudent to be wary of the ability of corporate borrowers to service their debt as the credit cycle ages. Technical factors, idiosyncratic credit issues and downgrades may continue to trigger price volatility and inefficiencies. While we expect defaults to rise among weaker credits, we believe the stress is largely contained. CLOs, with their unique structural characteristics, have proven resilient through periods of stress in the past.

- Though a cautious, high-quality orientation is warranted, we believe leveraged loans and CLOs offer attractive yields compared to other asset classes. Further, widespread selling has penalized broad swaths of the lower rated credit market with little regard to the ability of individual issuers to service their debt. We believe this has created upside potential for skilled managers who can identify relative value opportunities for loans and CLOs that have been unduly punished. They could position themselves to benefit if prices rise, risk aversion declines and technical pressures abate.
Running with the Bulls Is Thrilling…and Potentially Dangerous

Academics debate whether the bull market in stocks officially ended in December 2018. We prefer to think of stocks as being on one long—sometimes rocky—road higher since the end of the financial crisis and Great Recession in 2009. Regardless of how you do the math, it’s fair to ask if the bull is on its last legs or if further gains are yet to come.

We see warning signs that indicate caution. First, the market appears to be fairly valued, with some measures suggesting it’s overvalued. Second, economic growth has been slowing for roughly two years in the U.S. and in essentially every major industrialized economy overseas. A factor in the slowdown is the uncertain environment for trade and government policy worldwide, which magnifies the risk of a downturn in growth and complicates any potential policy response. The manufacturing sector in the U.S. has also been up and down—the latest measures of industrial production, factory and durable goods orders declined, while a key manufacturing index recently turned up from a low base. Corporate earnings growth has also been lackluster.

That said, however, one economic driver has remained remarkably resilient—the U.S. consumer. Representing over 70% of U.S. economic activity, consumer spending is arguably the main reason this recovery and bull market have persisted well past historical norms. Most of the retail-related data we see suggest the recovery can carry on a bit longer. The healthy job market is one big support for consumer spending, so we’ll be watching for any slowdown in hiring. Another key factor we’re monitoring is the level and direction of interest rates. The Fed is on hold for now, apparently confident that it has done enough to support growth going forward.

So, we’re not ready to declare the bull dead just yet. But we’re cautious and emphasizing a balanced approach. We remain neutrally positioned in our own multi-asset portfolios. And because these economic and policy tensions won’t likely resolve quickly or cleanly, we encourage individual investors to think carefully about how much volatility they are prepared to tolerate in pursuit of their financial goals.

Asset Class

We explained our qualitative judgements above, arguing for a balanced approach to investor portfolios. Our quantitative models also point toward a neutral allocation to stocks and bonds. The leading argument for stocks at present comes from attractive earnings yields, though our other fundamental measures point toward bonds.

Equity Region

We have moved to an overweight to the U.S. versus non-U.S. developed equities as a result of recent shifts in both our fundamental and technical models. In particular, stronger relative economic conditions and market momentum favor the U.S.

Our model is shifting toward EM equities, reflecting stronger relative returns and economic fundamentals, though these vary widely by country. Nevertheless, enough components of our model—including important measures of interest rates—continue to favor the U.S. though we remain neutral overall.
U.S. Equity Size & Style

The sentiment and fundamental portions of our model point toward large company stocks over small company equities. However, relative valuations favor small caps after having lagged large caps by a wide margin in 2019. Add it all up, and we remain neutral by size.

We remain overweight growth relative to value, but by the slimmest of margins. Our measure of investor sentiment showed a much smaller preference for growth than it has in many months at the time of this writing. Relative valuations favor value stocks, but not by enough to push us off our growth bias.

Fixed Income

We are neutral to slightly long duration in the U.S. and slightly short in many European government bonds. Duration is a measure of bond price sensitivity to interest rate changes. Having a long duration is beneficial when rates fall but hurts when rates rise. We also look to take profits on mortgage-backed and corporate credit trades, looking for more attractive valuations or opportunities to deploy capital.

Alternatives

Real estate investment trusts (REITs) have benefited from the Fed’s rate cuts and low bond yields in 2019, as their relatively high yields make them attractive to income investors. We remain neutral on the asset class, which we believe offers significant portfolio diversification benefits.
GLOSSARY

**Alpha.** Alpha typically represents the value added or subtracted by active investment management strategies. It shows how an actively managed investment portfolio performed compared to the expected portfolio returns produced simply by benchmark volatility (beta) and market changes. A positive alpha shows that an investment manager has been able to capture more of the upside movement in the benchmark while softening the downswings. A negative alpha means that the manager’s strategies have caught more benchmark downside than upside.

**Alternative investments.** Alternative mutual funds that hold a variety of non-traditional investments also often employ more complex trading strategies than traditional mutual funds. These alternative asset classes and investment strategies have unique risks making them more suitable for investors with an above-average tolerance for risk.

**Asset-backed securities (ABS).** A form of securitized debt (defined below) backed by assets that include such items as auto loans, home equity loans, student loans, small business loans, and credit card debt.

**BBB credit rating.** Securities and issuers rated AAA to BBB are considered/perceived “investment-grade”; those rated below BBB are considered/perceived non-investment-grade or more speculative. (See below for more information about credit ratings.)

**Bank loans.** Bank-financed debt for companies with below-investment grade credit ratings.

**Basis points.** Basis points express values carried out to two decimal places (hundredths of a percentage point), particularly ratios, such as yields, fees and returns. Basis points describe values typically on the right side of the decimal point—one basis point equals one one-hundredth of one percentage point (0.01%). So, 25 basis points equals 0.25%. Only when basis points equal or exceed 100 does the value move to the left of the decimal point—e.g., 100 basis points equals 1.00%.

**Beta.** Beta is a standard measurement of potential investment risk and return. It shows how volatile a security’s or an investment portfolio’s returns have been compared with their respective benchmark indices. A benchmark index’s beta always equals one. A security or portfolio with a beta greater than one had returns that fluctuated more, both up and down, than those of its benchmark, while a beta of less than one indicates less fluctuation than the benchmark.

**Break-even inflation rate.** The break-even inflation rate is the difference between the nominal yield (usually the market yield, which includes an inflation premium) on a fixed-income investment and the real yield (with no inflation premium) on an inflation-linked investment of similar maturity and credit quality. If inflation averages more than the break-even rate, the inflation-linked investment will outperform the investment with the nominal yield. Conversely, if inflation averages below the break-even rate, the investment with the nominal yield will outperform the inflation-linked investment.

**Central bank.** Entity responsible for oversight of a nation’s monetary system, including policies and interest rates.

**Collateralized loan obligations (CLOs).** A form of securitized debt (defined below), typically backed by pools of corporate loans and their payments.

**Collateralized mortgage obligations (CMOs).** A form of securitized debt (defined below) derived from mortgage-backed securities (defined below).

**Commercial mortgage-backed securities (CMBS).** Mortgage-backed securities (defined below) that represent ownership in pools of commercial real estate loans used to finance the construction and improvement of income-producing properties, including office buildings, shopping centers, industrial parks, warehouses, hotels, and apartment complexes.

**Commodities.** Raw materials or primary agricultural products that can be bought or sold on an exchange or market. Examples include grains such as corn, foods such as coffee, and metals such as copper.

**Corporate securities.** Debt instruments issued by corporations, as distinct from those issued by governments, government agencies or municipalities. Corporate securities typically have the following features: 1) they are taxable; 2) they tend to have more credit (default) risk than government or municipal securities, so they tend to have higher yields than comparable-maturity securities in those sectors; and 3) they are traded on major exchanges, with prices published in newspapers.

**Correlation.** Correlation measures the relationship between two investments—the higher the correlation, the more likely they are to move in the same direction for a given set of economic or market events.

**Credit quality.** The letter ratings indicate the credit worthiness of the underlying bonds in the portfolio and generally range from AAA (highest) to D (lowest).

**Credit ratings.** Credit ratings are measurements of quality assigned by a Credit Rating Agency (CRA) to issuers of certain types of debt obligations as well as the debt instruments themselves.

**Debt security.** A debt instrument, including bonds, certificates of deposit or preferred stocks.

**Deflation.** The opposite of inflation (see below); considered a highly undesirable economic outcome by economists and policymakers, it describes a decline in prices for goods, assets and services.

**Downside risk.** Downside risk is an estimation of what an investor may stand to lose from a particular investment if market prices decline.

**Duration.** A measure of the price sensitivity of a fixed-income investment to changes in interest rates. The longer the duration, the more a fixed-income investment’s price will change when interest rates change.

**Eurozone.** The eurozone is sometimes referred to as the euro area and represents member states that participate in the economic and monetary union (EMU) with the European Union (EU). The eurozone currently includes Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

**Exchange-traded fund (ETF).** Similar to a mutual fund, an ETF represents a group of securities, but the ETF trades on an exchange like an individual stock. An ETF generally follows the performance of an index, such as the S&P 500 Index.
Federal Open Market Committee (FOMC). This is the committee that sets interest rate and credit policies for the Federal Reserve System, the U.S. central bank. The committee decides whether to increase or decrease interest rates through open-market operations of buying or selling government securities. The committee normally meets about eight times annually.

Federal Reserve (Fed). The Fed is the U.S. central bank responsible for monetary policies affecting the U.S. financial system and the economy.

Fundamentals. In the context of investment analysis, fundamentals are typically those factors used to determine value that are more economic (growth, interest rates, inflation, employment) and/or financial (income, expenses, assets, credit quality) in nature, as opposed to “technicals,” which are based more on market price (into which fundamental factors are considered to have been “priced in”), trend and volume factors (such as supply and demand), and momentum.

Futures contract. A futures contract is an agreement to buy or sell a specific amount of a commodity or financial instrument at a particular price on a stipulated future date. Futures contracts are typically used as a hedging/risk management tool in portfolio management.

Gross domestic product (GDP). A measure of the total economic output in goods and services for an economy.

High-yield bonds. High-yield bonds are fixed-income securities with lower credit quality and lower credit ratings. High-yield securities are those rated below BBB- by Standard & Poor’s.

Inflation. Inflation, sometimes referred to as headline inflation, reflects rising prices for consumer goods and services, or equivalently, a declining value of money. Core inflation excludes food and energy prices, which tend to be volatile. It is the opposite of deflation (see above).

Investment-grade corporate bond or credit. A debt security with a relatively low risk of default issued and sold by a corporation to investors.

Mortgage-backed securities (MBS). A form of securitized debt (defined below) that represents ownership in pools of mortgage loans and their payments.

Municipal bonds. Long-term municipal securities with maturities of 10 years or longer.

Municipal securities. Debt securities typically issued by or on behalf of U.S. state and local governments, their agencies or authorities to raise money for a variety of public purposes, including financing for state and local governments as well as financing for specific projects and public facilities.

Non-agency commercial mortgage-backed securities (CMBS). MBS that represent ownership in pools of commercial real estate loans used to finance the construction and improvement of income-producing properties, including office buildings, shopping centers, industrial parks, warehouses, hotels, and apartment complexes. Typically issued by financial institutions, non-agency CMBS are not guaranteed by the U.S. government or a government-sponsored enterprise.

Preferred stocks. Financial instruments that have characteristics of both debt (fixed dividends) and equity (potential appreciation).

Quality. Nationally recognized statistical rating organizations assign quality ratings to reflect forward-looking opinions on the credit worthiness of loan issuers. Securities from higher-quality issuers carry a lower default risk than securities from lower-quality issuers.

Quantitative easing. A policy in which a central bank buys government securities or other market securities to lower interest rates and increase the money supply.

REITs. Real estate investment trusts (REITs) are securities that trade like stocks and invest in real estate through properties or mortgages.

Short selling. Short selling is a trading strategy intended to capitalize on a falling stock price. In a short sale, a portfolio manager borrows and sells the stock anticipated to decline in price. The manager doesn’t own the stock and must buy back the shares in the future to return them to the original owner. The profit (or loss) from short selling is the difference between the amount for which the manager originally sold the stock and the amount paid to buy it back.

S&P 500® Index. The S&P 500 Index is composed of 500 selected common stocks most of which are listed on the New York Stock Exchange. It is not an investment product available for purchase.

Securitized debt. Securitized debt results from aggregating debt instruments into a pool of similar debts, then issuing new securities backed by the pool.

Sovereign debt. Debt issued by the national government in a foreign currency. Also referred to as government debt.

Spreads, credit spreads. Measured differences between two interest rates or yields that are being compared with each other. Spreads typically are measured between fixed-income securities of the same credit quality, but different maturities (“maturity spreads”), or of the same maturity, but different credit quality (“credit spreads”).

Spread sectors. There are typically non-Treasury securities that usually trade in fixed-income markets at higher yields than same-maturity U.S. Treasury securities. The yield difference between Treasuries and non-Treasuries is the “spread” (defined further above), hence the name “spread sectors” for non-Treasuries.

Treasury note. A treasury note is a debt security issued by the U.S. government with a fixed interest rate and maturity ranging from one to 10 years.

Treasury yield. The yield (defined below) of a Treasury security (most often refers to U.S. Treasury securities issued by the U.S. government).

Upside. Upside refers to investment's potential gains in value.

Yield. The rate of return on bonds and other fixed-income securities.

Yield curve. A line graph showing the yields of fixed-income securities from a single sector from a range of different maturities at a single point in time.
Managing Money, Making An Impact

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International investing involves special risks, such as political instability and currency fluctuations. Investing in emerging markets may accentuate these risks.

Alternative mutual funds that hold a variety of non-traditional investments often employ more complex trading strategies than traditional mutual funds. Each of these different alternative asset classes and investment strategies have unique risks making them more suitable for investors with an above average tolerance for risk.

Investment return and principal value of security investments will fluctuate. The value at the time of redemption may be more or less than the original cost. Past performance is no guarantee of future results.

As with all investments, there are risks of fluctuating prices, uncertainty of dividends, rates of return and yields. Current and future holdings are subject to market risk and will fluctuate in value. Historically, small- and mid-cap stocks have been more volatile than the stocks of larger, more established companies.

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Generally, as interest rates rise, bond values will decline. The opposite is true when interest rates decline.

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