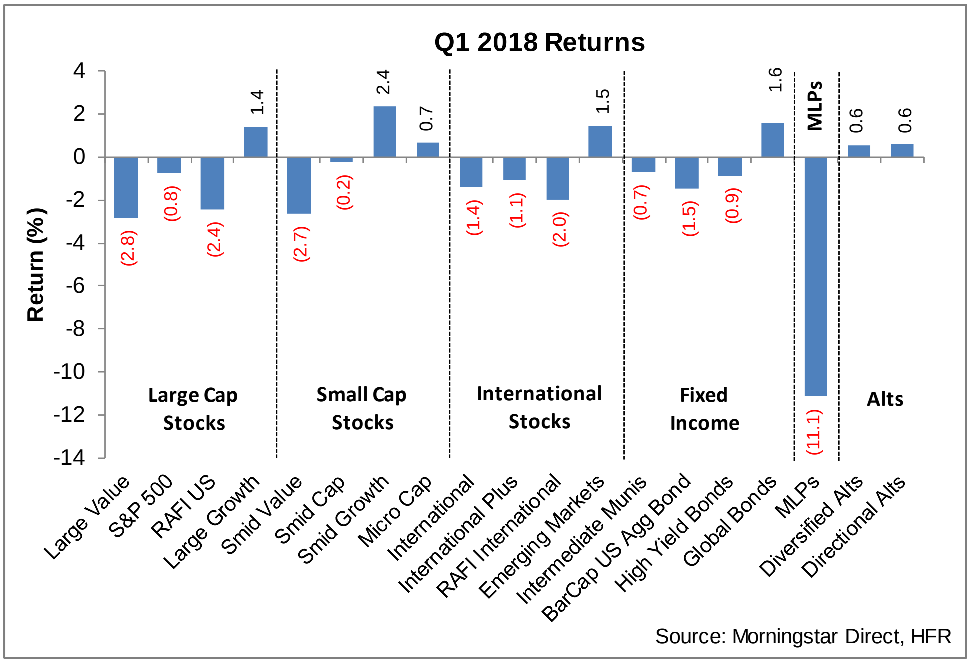
Next Capital Management, LLC
Eleven Times Square, 15th Fl
New York, NY 10036
O: 212.433.1111
F: 212.382.2080
www.nextcapitalmgmt.com

First Quarter 2018 Investment Review & Outlook



EXECUTIVE SUMMARY

Q1 2018 Recap:

- Volatility returned to the markets in the first quarter, triggering the first 10% correction in the S&P 500 in two years
- Both stocks and bonds finished the quarter modestly negative – the first such occurrence since the financial crisis – amid elevated valuations, threat of a trade war, and burgeoning inflation/interest rates
- Alternative investments were slightly positive amid the quarter's market declines, as they mitigated losses and benefited from the increase in volatility

NEXT Outlook:

- Volatility is likely here to stay, but a strong fundamental backdrop and a reset in valuations are supportive of the equity markets
- With little else in the way of legislative "help" for the markets likely coming from this administration, corporate results and economic data will take on greater prominence. Q1 is off to a good start with record earnings beats and the best EPS growth in eight years
- We continue to favor a shorter duration, credit centric approach to fixed income. However, any meaningful increase in intermediate interest rates from here could make longer duration bonds more compelling

To Our Clients and Friends,

After nearly two years without a double-digit pullback, the equity markets finally experienced a long awaited 10% correction in the first quarter. As we noted in our February commentary, such episodes are a normal part of market behavior, typically occurring at least once per year. After 18 months without so much as a 3% decline, it was inevitable that investors would take a pause to re-evaluate whether the market had gotten ahead of itself.

Prior to the market's decline, we saw one final surge higher in January, led by the high-flying tech sector which rose by nearly 8%. With tech comprising nearly 25% of the market (more on this later), the S&P 500 got off to its best start in 22 years. By January 26th, however, the markets finally decided that elevated valuations and threat of a trade war with China were enough to take a breather. US markets fell 10% from their highs while volatility increased substantially; the Dow has moved more than 1% on 30 trading days already this year, three times the number we saw in all of 2017.

The end result was the first negative quarter for the S&P 500 since 2015. It was also only the second quarter since the financial crisis that both equities and fixed income posted losses, as interest rates moved higher amid fears of burgeoning inflation and more restrictive Federal Reserve policy.

Despite this apparent regime shift, we would note that market conditions have remained relatively stable. Credit spreads on junk bonds only widened slightly, while riskier segments like emerging markets and small cap stocks actually outperformed the broad market. Market leadership was also largely unchanged, with tech continuing to lead throughout the broader sell-off. Moreover, markets have also been quick to rebound from any sudden losses, indicative (in our opinion) of the broad base of support that remains entrenched behind them. Investors are not ready to run away from this stock market just yet, particularly when faced with a dearth of other investment options.

Last year we advanced the idea that we may be in the final stages of the bull market, but that such phases often last for multiple years. We noted that these parts of the bull market tend to deliver some of the strongest gains of the market cycle. Since it is also true that the most painful bear markets occur in conjunction with an economic recession – which we believe is simply not imminent based on a wide range of indicators – we remain constructive on equity markets for the immediate future. Valuations have reset to average levels, while the failure of the markets to significantly change leadership in the recent drawdown undermines the notion that the market has fundamentally changed. We should be prepared, however, to continue dealing with significantly more volatility than we've become accustomed as the bull market matures.

The market is always vulnerable to exogenous risks, of course, and President Trump's recent tiff with China regarding trade has caused the market to react negatively on more than one occasion. We would posit that such bluster is straight from Trump's playbook – starting with an extreme position to provide better leverage in negotiations. While there is always the risk that such tactics could spiral out of his control, we tend to believe that Trump's trade barbs are mostly political noise and not something that should affect our long-term (or, frankly, short-term) investment strategy. The market seems to have woken up to this reality, as evidenced by the weakening response to his various tariff announcements.

Exhibit 13: The effect of the ongoing trade spat on the market is becoming dampened over time.

As we move through the remainder of 2018, we believe that actual fundamentals will take on greater prominence for market performance. After the Tax Cut & Jobs Act, it is unlikely that any other major piece of legislation makes it through both houses of Congress, particularly if the GOP loses its majority in the upcoming mid-term elections. With corporate tax reform finalized, it is time to see the impact of the new law flow through the system. Earnings expectations are exceptionally high this year (19.4% growth[1]), so any stumble by the corporate sector would be disruptive – not just to market sentiment, but also valuations that look rather reasonable at 16x forward price-to-earnings. Thus far, corporate America has not disappointed: Q1 earnings growth is topping 23% year-over-year, the highest level in almost eight

[1] Source: FactSet Earnings Insight, April 27, 2018

years, while 79% of companies have surpassed their earnings estimates. While still early in the earnings season, the latter statistic is the highest on record.

Q1 Performance Review

Equity markets were largely negative in the first quarter, although not universally. While the S&P 500 and foreign developed markets suffered declines, the emerging markets delivered positive performance. This was partially due to a very strong January, but emerging markets also held up reasonably well on the downside in February and March.

A big factor was the evolving composition of the emerging markets benchmark. Some may be surprised to learn that the benchmark index, once dominated by commodity cyclicals (i.e., energy and materials stocks), now maintains a 30% weighting to technology. Although this is somewhat concentrated in emerging markets' own version of FANG – BATS, standing for Baidu, Alibaba, Tencent, and Samsung – we believe this will have a transformational effect on the volatility and performance profile of emerging markets going forward.

A similar phenomenon has also taken place in the US. The technology sector hit a peak of 25% of the S&P 500 at the end of January, the highest sector weighting in the benchmark since financials in 2007 and technology in 2000. While this is not a definitive sign of an impending bear market like the tech bubble of 2000, it certainly gives us pause to see a sector dominate the US market to such a degree.

To that end, we raised an eyebrow at the under-the-radar announcement in March that many of the sector's biggest companies will be reclassified into a newly branded "Communication Services" sector. Telecommunications was historically a sleepy, higher yielding part of the market that included wireless carriers like Verizon and AT&T. Later this year, however, stocks including Facebook, Netflix, and Alphabet (parent company of Google) – three of the four FANG names – will be moved to Communication Services, helping reduce the market's technology weighting by more than 5%. We are not sure if we should view this as an obfuscation of risk or further evidence of the transcendence of the technology sector – nonetheless, market risk remains unchanged.

Developed international markets slightly underperformed the US for the quarter, largely due to a technology weighting that pales in comparison to the US (roughly a quarter of the S&P 500's exposure). The Japanese markets led performance, up roughly 1%, while Europe declined approximately 1.9% in the quarter. US investors benefited from dollar weakness, as their US dollar-based return was approximately 2.75% higher than the local currency performance. Europe continues to appear on the upswing, notwithstanding a slight moderation in economic data. Assuming the recovery remains on track, we expect the European Central Bank to ease its bond buying program later this year and potentially begin their own interest rate normalization sometime in 2019.

As we noted in our preamble, fixed income markets sold off during the quarter alongside stocks, an unusual occurrence that has not been seen in nearly a decade. Longer duration bonds were most impacted, as the combination of strong economic data, tax reform, and a new Fed chief stoked concerns that both inflation and Fed policy could push interest rates higher. Credit sectors such as high yield and bank loans outperformed, helped by their higher coupons and lower correlation to Treasuries. Indeed, in recent days the yield on the 10-year Treasury has eclipsed 3.00% for the first time since 2013, underscoring these pressures.

In February, Jerome Powell became the new Chairman of the Federal Reserve, causing some anxiety about how aggressive the Fed would be in unwinding their market-friendly policies. Thus, far, however, Powell has largely stuck to his predecessor's script in both action and language. As expected, the Fed raised short term rates by 0.25% in March, the sixth such hike since December 2015. The result has been a flatter yield curve (the plot of yields across varying bond maturities), offering even less compensation for owning longer maturity bonds. It is important to note that while an inverted yield curve – one whereby shorter maturity bonds have higher yields than longer dated ones – is typically a harbinger of an economic slowdown, a flattening yield curve is not much of an indicator on its own. We will watch this measure closely in the months ahead, but economic data continue to illustrate a burgeoning uptrend that has not yet felt the impact of December's tax reform.

Alternative investment strategies proved additive in the first quarter, protecting capital in February and March and delivering a positive return for the quarter. While difficult to generalize across this category, we saw gains in positions such as short interest rates, long equity volatility, and idiosyncratic credit situations. Despite an environment marked by rapid market whipsaws, we were generally pleased that the asset class lost significantly less money than the broad markets – at an index level, experiencing roughly a quarter of the market's losses in February and March.[2]

As noted here in the past, we favor these solutions in client portfolios because of their diversifying benefits. They provide the opportunity to generate gains less reliant on the traditional stock and bond markets. Although the recent QE-fueled years of strong stock market performance have been a difficult environment for most of these strategies, we continue to believe they serve a role in portfolios as a source of steady, less correlated performance. Should we enter a world where volatility and risk remain elevated for a prolonged period (rather than the quick episodic spikes of the recent market regime), these solutions will take on added importance in portfolios.

Finally, we would note that energy infrastructure assets, or MLPs, had a very challenging first quarter. After a very robust January (up almost 10%), the representative Alerian MLP Index declined by more than 20% in February and March. Thus far in April, the asset class is once again up nearly 10%. This volatility follows a similarly wild pattern in 2015-2016, whereby the asset class vacillated between 25% declines and gains. While we understand most investors are probably quite fatigued by this volatility, we believe robust yields and negative sentiment surrounding the asset class provide the potential for significant upside for those willing to be patient.

Outlook

As we look to the remainder of 2018, we make a few observations:

- The Federal Reserve is expected to hike short term interest rates at least two more times in 2018, pushing the Federal Funds rate to between 2.00 and 2.25% by the end of the year. As noted previously, we are closely watching the impact of these moves on the shape of the yield curve. We continue to believe the most appropriate positioning in fixed income is to maintain a short duration stance, particularly since there is little compensation currently for holding longer maturity bonds. Should intermediate yields move significantly higher, however, we could find longer duration fixed income more compelling for client portfolios.
- The volatility environment for stocks has clearly shifted and we do not expect that to change. Some of this is for technical reasons (largely, the failure of some widely owned investment products designed to bet against S&P 500 volatility), but we are also later in the investment cycle when volatility tends to increase. Investors should be prepared for continued swings in the market.
- The impact of December's tax reform is just beginning to affect corporate earnings. While it is true that some of the benefit has been "priced in" to the markets, we are likely to see fundamental data improve significantly over the next year, creating an environment of positive sentiment for

[2] Source: Hedge Fund Research, Morningstar; Based on HFRI FOF: Diversified vs. S&P 500 Index Total Return.

risk assets. As we noted earlier, first quarter earnings results are already exceeding analyst expectations at a record clip.

- This fall's mid-term elections should come into greater focus in the coming months. With Congress essentially deadlocked on additional legislation, we do not believe the outcome will prove that material for the markets. The 2020 elections may prove a different story, however, particularly if corporate tax reform is threatened.
- With all signs suggesting a recession is not imminent and the Fed proceeding cautiously, we continue to believe the environment is still constructive for stock investors. Certain geopolitical risks remain, of course, that could change the tone of the market quickly. For that reason, we advocate a neutral risk stance rather than being overly aggressive in this market.

We have been encouraged by our clients' calm response to the recent pick up in volatility. Despite double digit losses in the stock market, a diversified portfolio approach has been effective in blunting the impact of this volatility. The inclusion of alternative investments in most client portfolios provided a source of ballast while our short-duration, more credit centric fixed income strategy mitigated the effect of increasing interest rates. While the last two years have been mostly smooth sailing for the markets, February and March were good reminders why we structure diversified, long-term portfolios. We are confident that our investment approach is the right one to help clients navigate an ever-changing market environment.

As always, if you feel your situation has changed or if you would like to revisit your portfolio's risk level, please do not hesitate to call or visit our office at your convenience.

Kindest regards,
Your Investment Team
4/30/2018