

QUARTERLY REPORT

# Vaughan Nelson Investment Perspective

September 30, 2019

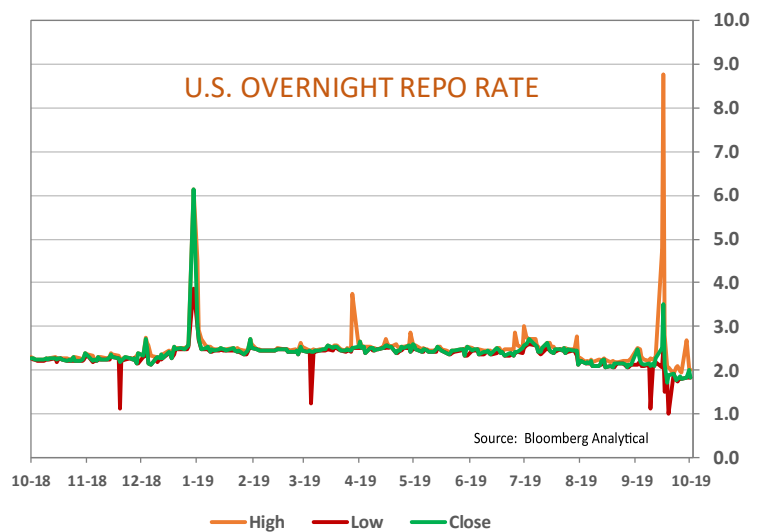
During the third quarter of 2019, equity markets experienced increased volatility as bond yields fell dramatically intra-quarter before recovering modestly in September. The U.S. 10-year Treasury yield declined 34bps in the third quarter (2.00% to 1.66%) and year-to-date has declined over 100bps. The S&P 500 continued to add to year-to-date gains, while small cap indices fell during the quarter. During the quarter, the S&P 500 and Russell 2000 Value returned approximately 1.70% and -0.57%, respectively. The S&P 500 continues to make modest new highs, while small cap indices remain well below highs achieved in 2018.

As we noted in previous quarterly reports, a global U.S. dollar funding shortage would force the Federal Reserve to restart quantitative easing (QE). This U.S. dollar funding shortage became more acute during the third quarter materially interrupting inter-bank lending via spiking general collateral overnight repo rates. This disruption forced the Federal Reserve to provide emergency liquidity during the quarter in order to force overnight rates in line with its policy objectives.

While the global economy continues to experience a manufacturing slowdown/recession driven by China's internal rebalancing and by softening energy industry fundamentals, the biggest threat to risk assets is what we have termed a "liquidity recession". The primary excess during the current 10-year bull market has been liquidity in the form of QE. The excess liquidity that wasn't absorbed in the real economy found its way into risk asset prices. Liquidity began to retreat with the implementation of quantitative tightening by the Federal Reserve and with tightening capital controls by China. We have seen the declining liquidity conditions impact asset prices as global equity index valuations, commodity prices, and global luxury real estate prices have declined. Most recently, the market has repriced the private equity "unicorns" and the IPO market has cooled with several high-profile offerings postponed.

Rising U.S. deficits and slowing private sector fundamentals will further pressure liquidity and ultimately risk assets unless the U.S. Federal Reserve begins to materially and sustainably increase its balance sheet. While central banks globally are beginning to cut interest rates, this will have a minimal impact on liquidity. Low rates are not the problem, the issue is interbank lending and the availability of U.S. dollar funding capacity. We suspect the Federal Reserve will slowly be forced to provide dollar liquidity on a sustainable basis. Should this occur, the Federal Reserve will find itself at a familiar crossroad where it can either choose to control the price of money (i.e. interest rates) or the quantity of money (i.e. U.S. dollar exchange rate/inflation), but not both. We suspect they will choose the former over the latter.

U.S. equity markets continue to price in an earnings recovery beginning in the next two quarters. The leading economic indicators we track show economic activity stabilizing in Europe, but further weakness is expected in Japan, the United States, and China. While Japan is vulnerable to a recession, the United States and China are poised for a further slowdown, but not necessarily a recession. The next three months will be critical in determining whether the increasing stability we are forecasting in Europe can spread to China and the United States or whether the stability is a transitory improvement that presages further economic weakness. For the fourth quarter, we are anticipating further market volatility as weak Q3 earnings reports and modest earnings guidance occurs at a time of liquidity strains in the market. Valuations have risen materially in the first half of 2019 as markets recovered, and we expect markets to remain volatile until we are in an environment of sustained economic growth and have adequate U.S. dollar funding liquidity.



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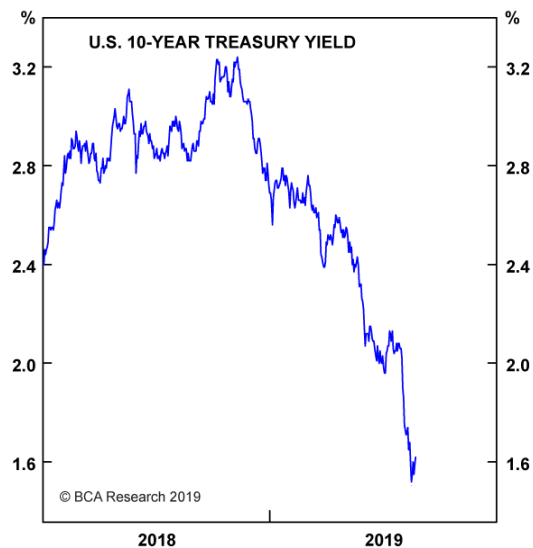
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As mentioned, fixed income markets were volatile during the third quarter as the combination of continuing trade disputes, the surprise attack on Saudi oil production, two Federal Reserve rate cuts, and a Presidential impeachment inquiry had both positive and negative affects on the direction of interest rates. Credit spreads were unchanged in the quarter but remain well below year-end 2018 levels (+120 basis points vs. +159 basis points). We expect the Fed to lower short-term rates one more time this year by another 25bps and we suspect market volatility will remain elevated. With strong demand for investment grade corporate bonds and some slowdown in issuance, we anticipate the credit sector to perform well and therefore will maintain an overweight allocation.



SOURCE: BLOOMBERG BARCLAYS INDICES

Within the municipal markets demand from taxable investors remains strong. The ICE BofAML Intermediate Municipal Index returned 0.73% in the quarter and is up 4.31% year-to-date. Relocations out of higher-tax states into no-tax states such as Texas has been a boon for those states and municipalities. In Texas, personal incomes grew 7.5% in the third quarter, according to a recent Wall Street Journal article. Increasing tax revenue will lead to stronger credit metrics within these states.

Vaughan Nelson is excited to announce that we have expanded our investment team and concurrently added international strategies to our product suite. On October 1, Marco Priani and Kevin Ross joined Vaughan Nelson as Portfolio Managers for the firm's International Small Cap and Emerging Markets SMID Cap strategies. Since 2013, Marco and Kevin have served as Lead Portfolio Managers for both strategies while at Advisory Research Investment Management in Chicago. Marco and Kevin will continue to office in Chicago, which will serve as Vaughan Nelson's second location.

The International Small Cap and Emerging Markets strategies can be accessed via a separate account or mutual fund (ADVIX and ADVMX). Depending on your investment objectives and risk tolerance, these strategies may be appropriate for your portfolio. If that is the case, we look forward to discussing these options with you.

Please note that there is no change in portfolio manager responsibilities related to Vaughan Nelson's domestic equity strategies. Chris Wallis and Stephen Davis continue as portfolio managers on Small Cap Value. Dennis Alff, Chad Fargason, and Chris Wallis remain on Value Opportunity while Scott Weber, and Chris Wallis continue with Select.