



# SANDERS MORRIS HARRIS

## Macroeconomic Overview/Asset Class Analysis<sup>1\*</sup>

### Third Quarter 2017

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The following is Tectonic Advisor's ("TA") macroeconomic view and its impact on asset allocation. Before discussing economic trends and our current asset allocation, we will discuss a topical investment theme.

#### I. INVESTMENT THEMES – DO WE EVER LEARN?

Our quarterly investment theme is how similar the current credit expansion (from 2009-present) was to the last one (2001-2007), the cause of it and the impact on investing – both before and after the bubble burst.

**Today.** Central banks across the world have been in an easing mode over the past 10 years (actually, longer if you include the pre-Financial Crisis era of Alan Greenspan). They have lowered short term rates and bought bonds to lower longer-term rates. Given lower rates, US consumers and investors have been encouraged to (again) borrow, spend and speculate. And, they have.

With this daisy chain of borrowing, spending and speculating, asset values of almost every stripe have gone up – albeit unevenly abroad – over the past 9 years.

This abundance of “easy money” has *inflated* asset classes of all stripes, much like an earlier era (which we will address below). We will show how the proliferation of easy money has inflated equity investing, which is typified by the following example comparing a pre-bubble (normal) private equity investment with one made today (higher valuations, or “euphoric”):

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<sup>1</sup> The principal sources used in the preparation of this Report include: *The Wall Street Journal*, *The Financial Times*, *Bloomberg*, and *The New York Times*. Some data included in this Report (including government reports and other data) has been taken from secondary sources (principally those four referenced above) and were not derived from the primary sources.

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**“Normal” 8x Cash Flow Example**

Buyout Target Year 1		Buyout Target Year 5	
Cash Flow:	\$250	Cash Flow (Year 5):	\$375
Price Paid: <b>(8x cash flow)</b>	\$2,000	Interest Carrying Costs:	\$100
Debt:	\$1,400	Debt at End of 5 Years:	\$700
Equity:	\$600	Equity Value (Year 5):*	\$2,300

*\*Assumes 8x CF = \$375\*8=\$3,000 less remaining debt of \$700 = \$2,300.*

*Internal Rate of Return: ~25% (about 20%, net of fees)*

Of late (and during the latter years of the last credit bubble), the dynamic has changed. Private equity firms – armed with cheap capital – have started bidding up prices for companies. This bidding war was fueled by cheap and plentiful credit, which allowed private equity firms to pay ever higher multiples for businesses – as illustrated by the following example:

**“Euphoric” 12x Cash Flow Example**

Buyout Target Year 1		Buyout Target Year 5	
Cash Flow:	\$250	Cash Flow (Year 5):	\$375
Price Paid: <b>(12x cash flow)</b>	\$3,000	Interest Carrying Costs:	\$200
Debt:	\$2,500	Debt at End of 5 Years:	\$2,300
Equity:	\$500	Equity Value (Year 5):*	\$700

*\*Assumes 8x CF = \$375\*8=\$3,000 less remaining debt of \$2,300 = \$700.*

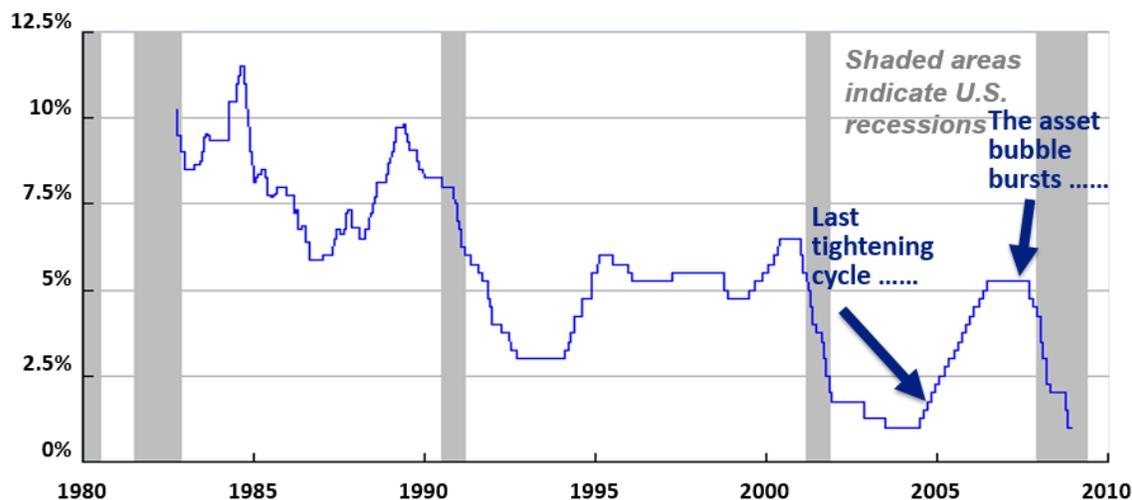
*Internal Rate of Return: 3-5%*

Today, a low double digit return is the “best case” scenario for private equity and assumes that there is no degradation of earnings due to a recession in the next few years – which we view as unlikely. In effect, the private equity firms – the large ones – will be working for the lenders for the next several years, as they try to work out of their mountainous debt loads incurred as a result of “easy money”.

Further, private equity – and the world of public equities – are struggling with the ability to deploy debt capital in a manner that generates a positive return (for the equity) over the cost of carry. This is the so called Minsky moment!

**Parallels to 2001-2007.** This current era bears a close resemblance to the last “easy money” era, which lasted from late 2001 to 2007. After the Tech Crash of 2000-2001 and 9/11, the Federal Reserve lowered rates to an unprecedented 1%, creating the last bubble.

The last bubble started to burst after the Federal Reserve began raising rates in 2005 to stave off inflation (induced by ultra-easy monetary and fiscal policy). There was a lag between policy implementation and the impact of policy, but the first fissures of the credit crisis started to occur in 2006.



Source: Board of Governors of the Federal Reserve System

Housing was hit the earliest and hardest. When the Fed started increasing rates, marginal borrowers could no longer borrow cheap short-term capital to finance, say, a home purchase through a short-term ARM. And, housing prices started declining, particularly in high priced areas. Further, mortgages – particularly subprime mortgages – started declining in value, following (quite logically) the declines in the housing market. Banks – which held troves of these mortgages – started seeing the value of their loan portfolios decline (with “mark to market” accounting) and equity evaporated because each dollar lost on a loan is also a dollar of lost equity. Given that most of these banks were too highly leveraged, they had to sharply contract credit (i.e., curtail lending and actually call loans).

Large investment banks were particularly hard hit thanks to a relaxation of leverage requirements in 2005, which allowed large investment banks to go from 12x leverage to 40x leverage. Of the seven allowed to do this, only two remain independent and solvent today – Morgan Stanley and Goldman. The great de-leveraging cycle had begun – led by banks and followed by the consumer.

The seminal event was the failure of Lehman Bros. in September 2008, which put the world financial system at risk and accelerated the deleveraging cycle and the final pricking of the asset bubble.

When that occurred, people flocked from any asset except for US Treasuries (including cash) and gold, putting selling pressure on assets ranging from relatively safe corporate bonds, municipal bonds to riskier assets such as stocks and speculative debt. Banks – seeing their asset values collapse and unemployment rise – contracted credit further, in an effort to continue repairing their balance sheets. So, after a period of credit euphoria driven by low rates and easy money, credit collapsed and asset values followed. And, investors sold assets to repay debt, driving down asset values further. Many investors – fearful of losing “everything” – sold assets and invested in Treasuries.

The end result was that asset values collapsed, except for the safest and most liquid asset – US Treasuries. Accordingly, the “risk premium” for assets like stocks started rising after years of being too low (due to speculation). And, liquidity became king, with Treasury rates plummeting. *And, the illiquidity premium skyrocketed.*

**Today.** We are now in a tightening cycle, with the Fed eyeing to increase interest rates further over the course of 2017 and possibly into 2018.

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## Federal Reserve Eyes Aggressive Rate Increases

Minutes suggest the Fed could consider raising its benchmark rate as soon as its next policy meeting in March

By **DAVID HARRISON**

Updated Feb. 22, 2017 7:31 p.m. ET

Federal Reserve officials sent the strongest signals yet that they could raise short-term interest rates as early as next month, citing in minutes from their latest policy meeting an improving economy and the possibility of more spending and less taxing by the Trump administration.

While markets largely shrugged after the minutes were released Wednesday afternoon, the language indicated that the central bank could adopt a more aggressive course of

Today's  
Mortgage F  
**3.20**  
APR 15 Year

Without question, our banking and financial system (particularly our largest banks) is far better capitalized. However, our banking system still has significant exposure to real estate, which caused the last Financial Crisis and recession. While we believe that our economy is better positioned to withstand another liquidity crisis, we believe that now is the time to start taking some “risk” off the table.

**Conclusion.** We believe that a modest rotation from equities to quality fixed income is a prudent way to take *some* “risk” off the table. The rotation would reduce equities based on our asset allocation range and increase fixed income. We will explain our asset allocation views in further detail below.

## II. OVERALL THEMES – ASSET ALLOCATION

The factors that influence our asset allocation decisions include: (a) inflation; (b) economic activity; (c) fiscal and trade position; (d) currencies, (e) interest rates (monetary policy) and (f) of course, relative valuations among asset classes. In many cases, the factors are interrelated – e.g., fiscal and trade balances impact inflation, interest rates, currency and relative valuations. We discuss each of these factors in order.

**Inflation.** The following provides an overview of inflation, a key metric that we follow. Inflation erodes purchasing power and is problematic for investing in certain equities and fixed income. Inflation results in higher interest rates over time, which results in lower bond prices. Higher interest rates also put pressure on equities, given that earnings yields on equities would have to rise as well – resulting in lower multiples (which are in an inverse function to earnings yields) and lower equity prices.

The following chart outlines certain inflation metrics:

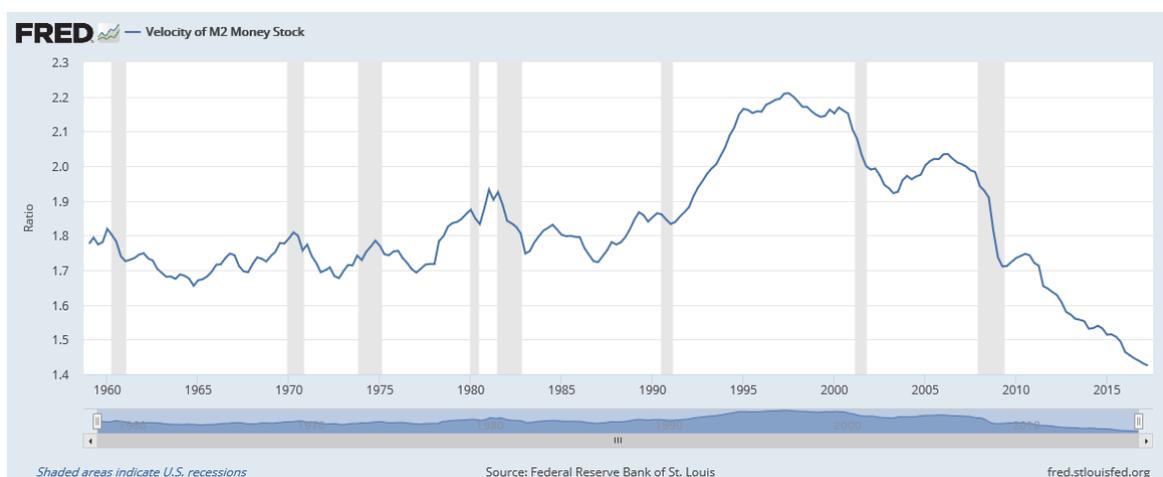
Inflation Indicator	Latest	YOY	Comments
CPI (Core)	<b>0.11</b>	<b>0.13 (-15.38%)</b>	Core prices continue a long track record of low prints
CPI	<b>1.7</b>	<b>0.8 (+112.5%)</b>	CPI has been depressed, given lower energy prices and lack of pricing power of labor.
PPI	<b>1.9</b>	<b>0.3 (+533.33%)</b>	PPI has followed the same trend as CPI.
PCE Deflator	<b>0.9</b>	<b>0.2 (+350%)</b>	Fed's preferred indicator of inflation

Right now, inflation has been less of a problem. Indeed, deflation – which plagued the United States for a considerable period of its history prior to the establishment of the Federal Reserve in 1912 – has been more concerning over the past few years.

Headline consumer price inflation (CPI) has remained subdued for several years now, with “core” inflation (better known as PCE Deflator - the Fed’s preferred measure) remaining below the Fed’s target of 2%. Many statements from Fed governors have indicated that the Fed remains concerned that inflation has not been able to break-out of its depressed state and have expressed concern that raising interest rates in the face of low inflation risks throwing the economy into a recession.

Further, some at the Fed (and elsewhere) believe that there are structural issues holding down inflation. One theory is that wages are being held down because older, higher paid employees are leaving the workforce and being replaced by younger, lower paid people. In addition, there is a lack of aggregate demand growth in the economy and overcapacity. This means that there is little pricing power on the part of producers.

Finally, even though the Fed has eased significantly, capital is not being deployed by businesses and investors, with significant cash still sitting on the sidelines. Thus, even though most monetary measures have increased (M1, M2, etc.), the velocity of money has remained stubbornly lower, negating the impact of increased monetary supply – as evidenced (*in stunning fashion!*) by the following chart:



Despite these concerns, the Fed – absent a downturn in the economy – seems poised to raise rates in 4Q 2017.

In sum, we are not concerned about inflationary pressures, at the moment, impacting our fixed income allocations. Indeed, we believe, if anything, a lack of inflation underscores the need to have an overweight in fixed income at the moment.

**Interest Rates.** Interest rates are a function of the “real” rate of return required by investors to loan money, plus an “inflation” component. Together, both represent the nominal rate of interest charged by lenders to borrowers. The “real” rate of interest is influenced by the “risk” that an investor sees in holding a fixed income instrument, which includes the anticipated default and recovery rates associated with a fixed income instrument and the length of time that the loan is expected to remain outstanding. If investors anticipate higher default rates and lower recovery rates and/or there is uncertainty about inflation in the future, then – by and large – investors will demand a higher “real” interest rate on a particular fixed income instrument. If inflationary expectations are high, then investors will demand a higher rate as well.

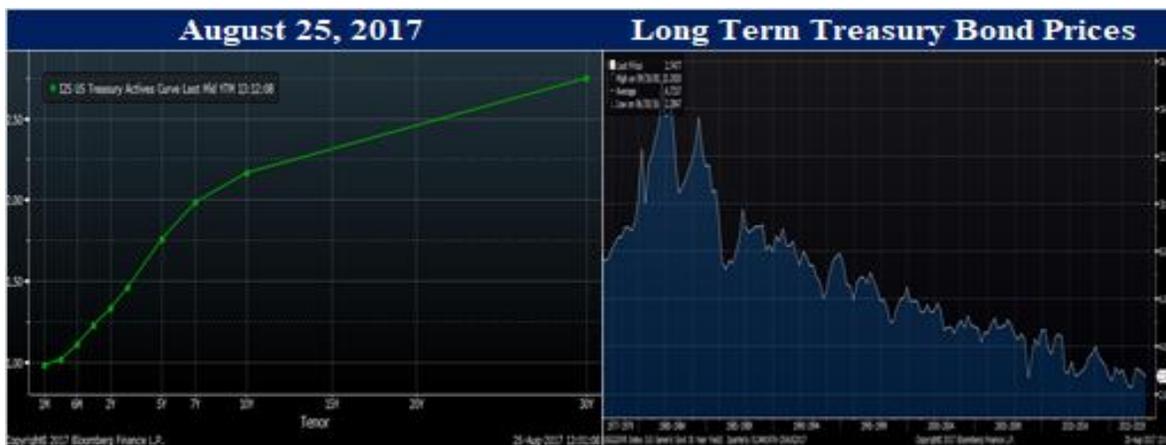
Interest rates across the yield curve are based on the “risk free” rate of return associated with US Treasuries. US Treasuries are significantly influenced – at the short-end of the yield curve – by the Federal Reserve. The Federal Reserve sets short term rates (typically overnight loans) for interbank and direct lending to banks. This influences short-term Treasury rates. As the duration increases, market forces start to drive US Treasury rates, given that the Federal Reserve is typically not involved in making longer dated loans – until relatively recently (i.e., QE1 and QE2).

Indicator	Latest	YOY	Comments
10 Year Treasury Yield	<b>2.211</b>	<b>1.55 (+42.64%)</b>	Treasury yields have been forced lower by “Quantitative Easing”
10 Year TIPS Yield	<b>0.441</b>	<b>0.062 (+611.29%)</b>	TIPS have remained relatively stable
MBA 30Y Fixed Mortgage	<b>3.90</b>	<b>3.45 (+13.04%)</b>	Low by historical standards.

In general, Treasury rates remain very low, but – after the election – experienced significant volatility given investor concerns about potential large deficits due to unfunded tax cuts. This concern has abated, with rates declining from 2.4% to 2.21% (UST 10 Yr).

On the short-end of the curve, Treasury rates have remained low since the Fed lowered them to 0%-.25% on December 16, 2008. However, the Fed began raising rates modestly in December 2015 and has hiked them to their current 1.25% (last increase as June 2017), with the Fed predicting steady growth. As rates on the short end of the curve have steadily increased, the yield curve has flattened.

### US TREASURY YIELD CURVE –



Source: Bloomberg, Barchart.com

Long-term rates have remained low.

Further, foreign central banks have followed the Fed, reducing rates during and after the Financial Crisis. And, each of the largest central banks (except the BOJ) have stopped quantitative easing, and have started increasing short-term rates – with yield curves worldwide flattening.

Right now, we like longer-duration US Treasuries not for their return potential, but as a hedge against a systemic shock.

***Economic Activity.***

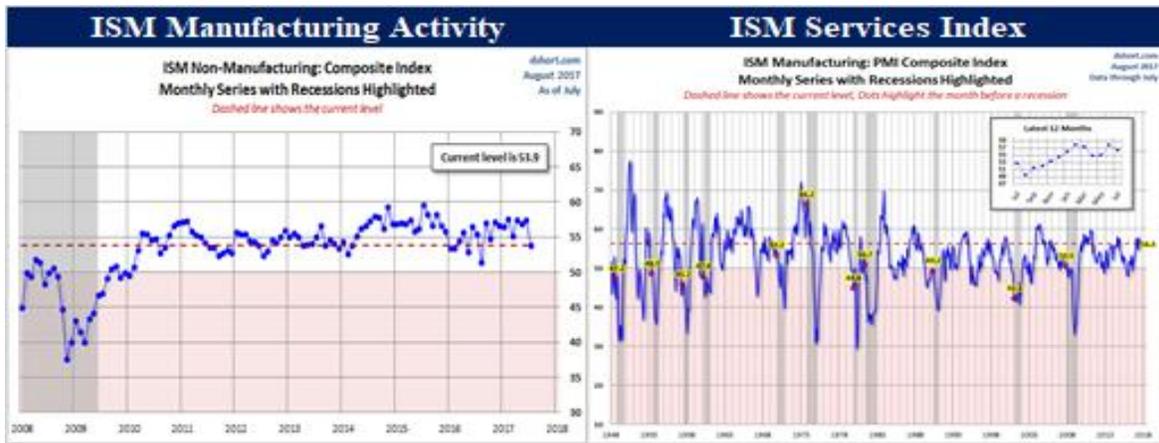
Indicator	2Q17	YOY	Comments
US GDP Growth	<b>3.0%</b>	<b>0.6 (+100%)</b>	US growth remains moderate.
EU GDP Growth	<b>0.5%</b>	<b>0.4 (+25%)</b>	Europe has returned to growth, posting reasonable numbers of late.
JP GDP Growth	<b>1.5%</b>	<b>2.3 (+34.78%)</b>	Much “slack” has been wrung out of the Japanese economy, and exports have improved

For the first time since the Financial Crisis, the world economies appear to be in synchronous growth. US GDP grew at 3% in Q2 with revised growth of 2.7% in 1Q. Growth is expected to be strong in the 3Q as well. This is the strong-its strong pace. Consumer spending (3.3%), fueled by stronger retail sales, led the way, with manufacturing, and trade all up during the quarter. The same largely held true for most of the developed world.

Manufacturing Indicators	Latest	YOY	Comments
US Capacity Utilization	<b>76.7%*</b>	<b>75.87% (+1.09%)</b>	A slowdown in the auto industry has weighed on industrial capacity utilization.
US Industrial Production	<b>.19</b>	<b>.09 (+111.11%)</b>	The US remains in expansion, though auto has weighed.
EU Industrial Production	<b>2.6</b>	<b>0.7(185.71%)</b>	EU has taken over the global expansion, though its last print was a poor one.
JP Industrial Production	<b>5.5</b>	<b>-1.6 (+443.75%)</b>	Led by renewed strength of exports, Japan has seen strengthening of its industrial output.

\*Percent level of utilization.

Manufacturing activity has seen expansion across the world – not strong, but moderate. Several manufacturing surveys have shown nice improvement in the last several months. The Chicago PMI, Empire Fed, and Philly Fed indices all have remained in expansion. Most of these surveys retain readings greater than 50 which still signals expansion.



Source: Advisor Perspectives

The Index of Leading Economic Indicators has now been rising for several years. In the most recent report, strength was recorded in vendor performance, interest rate spreads, real money supply, stock prices, consumer expectations, and building permits.

Employment Indicators	Latest	YOY	Comments
US Unemployment	<b>4.37</b>	<b>(-10.26%)</b>	US payrolls have steadily improved with unemployment at multi-year lows but employment participation lacking.
EU Unemployment	<b>9.17</b>	<b>(-9.47%)</b>	Europe has also seen a steady improvement in unemployment, though it lags the US.
JP Unemployment	<b>2.9</b>	<b>(-8.51%)</b>	Japan's unemployment has been steady and structurally low

Over the past 6 months, the US economy has added, on average, 200,000 jobs per month. This continues a trend that began upon stabilization after the Great Recession. The unemployment rate stood at 4.4% in July 2017, a level not previously seen since 4Q07 (and a significantly recovery since 9.5% in 2009).



Source: Bloomberg, Seeking Alpha

**(e) Relative Valuations - Conclusion.**

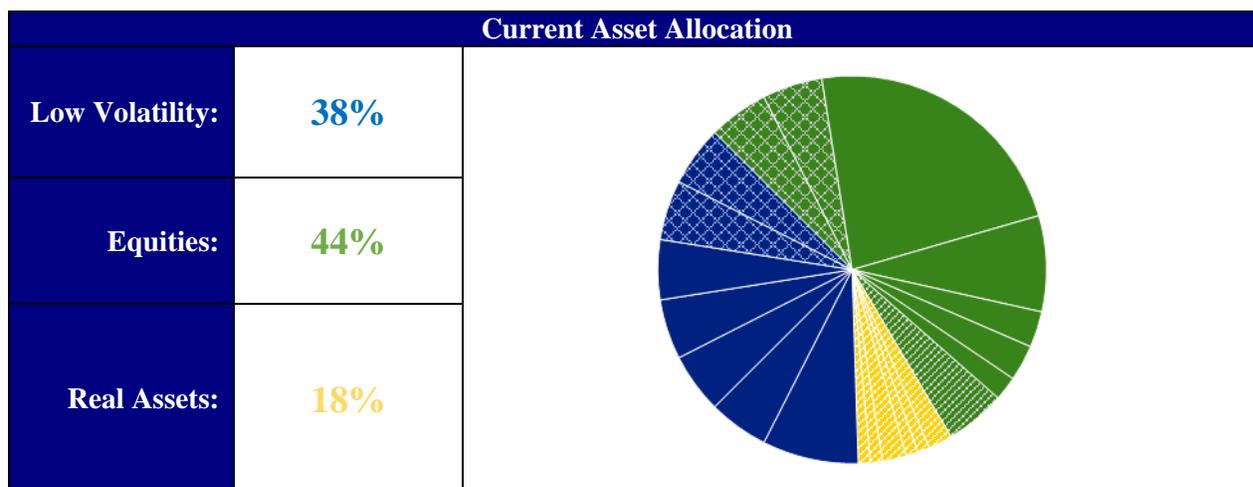
We have been weighted to “risk”, particularly in equities, but are rotating, modestly, into a higher relative position in fixed income.

#### IV. ASSET CLASS BY ASSET CLASS

The following summary provides our views on each asset class.

##### Introduction

We broadly categorize our 9 asset classes into 3 categories: Low Volatility, Equity, and Real Assets. The following graph outlines our current allocation:



In the graph and table above, red indicates underweight, green overweight.

Currently, we are maintaining equal-weight positions to each of our asset classes, though we anticipate building an overweight position to Low Volatility (38%) assets and reducing our allocation to Equities (44%) while maintaining our exposure constant in Real Assets (18%).

##### Low Volatility Strategies

Our low volatility portfolio consists of the following asset classes:

1. Traditional Fixed Income (“investment grade” corporate and government debt); and
2. Enhanced Fixed Income (fixed income investments that are not investment grade)

##### Traditional Fixed Income (Equal-weight; Increasing Exposure)

Index	YTD	TTM	5 Years	Spread
10 Year Treasury	3.7%	-3.6%	1.6%	0.83%(a)
30 Year Treasury	8.3%	-8.4%	2.9%	0.58%(b)
International Government Debt Index	1.39%	8.62%	0.69%	-0.83%(b)
BBB Corporate Debt	5.33%	2.78%	22.55%	1.24%%(b)

(a) Spread over 2 year UST

(b) Spread over 10 year UST.



Source: Bloomberg

The yield curve has flattened, with the 10 year UST trading at less than 100 bps above PCE deflator and the 2 Year UST, reflecting a flat yield curve and also that investors are not being compensated for holding medium duration treasuries except for diversification and panic situations. As you move further out on the curve, the values get a bit better, with the 30 Year UST providing slightly better value and diversification benefits and panic protection.

**Enhanced Fixed Income**

Index	YTD	TTM	5 Years	Spread to UST
Bloomberg USD High Yield	6.18%	8.60%	48.39%	4.88%
Emerging Market Debt Index	7.02%	4.44%	22.67%	4.63%



Source: Bloomberg,

We are moving to an underweight position in high yield. Spreads over comparable duration UST have declined to the point where we believe that the market is not appropriately pricing in default risk and loan loss recoveries consistent with historical norms. However, we believe that emerging markets debt, given dollar weakness and reasonable spreads (though narrowing), represents a better value, and we remain focused on an equal weight. We have the same view of MBSs.

## *Equities*

Our equity asset class consists of:

1. Domestic Equity (investments in US stocks)
2. International Equity (Investments in stocks in developed nations outside the United States)
3. Emerging Markets Equity (Investments in Emerging Markets)

Domestic Equities tend to perform well under the following conditions:

1. **Strong US economic growth.** (our view is that growth will be moderate)
2. **Low to moderate interest rates and inflation.** (our view is that inflation will be quiescent)
3. **Growing corporate profits.** (our view is that they will continue to start slowing)
4. **Perceived lower risk.** (risk aversion is low, but the risk is that it will grow)

*Conclusion: We are equal-weight to US equities, but will start systematically lowering risk and re-allocating to high grade, long duration US Sovereign Debt.*

International Equities tend to perform well under the following conditions:

1. **Strong global economic growth** (our view is that international and emerging growth is strong and growing)
2. **Low to moderate interest rates and inflation** (our view is that we are in an upward trending interest rate environment)
3. **Growing corporate profits** (our view is that global corporate profits will continue to grow)
4. **Perceived lower risk** (risk aversion appears to be diminishing for overseas markets, given better balance sheets and fundamentals)
5. **Declining dollar** (strong theme – tailwind to int'l investing)

*Conclusion: We are equal weighted to International Equities and Emerging Market Equities.*

### Domestic Equity (Equal Weight; Reducing Exposure)

Index	YTD	TTM	5 Years	PE
S&P 500	9.22%	12.56%	73.4%	20.94
Dow Jones Ind. Avg.	10.51%	18.38%	66.94%	18.68
RUSSELL 2000	1.29%	10.85%	68.67%	20.09
NASDAQ Composite	16.42%	20.24%	104.63%	38.50

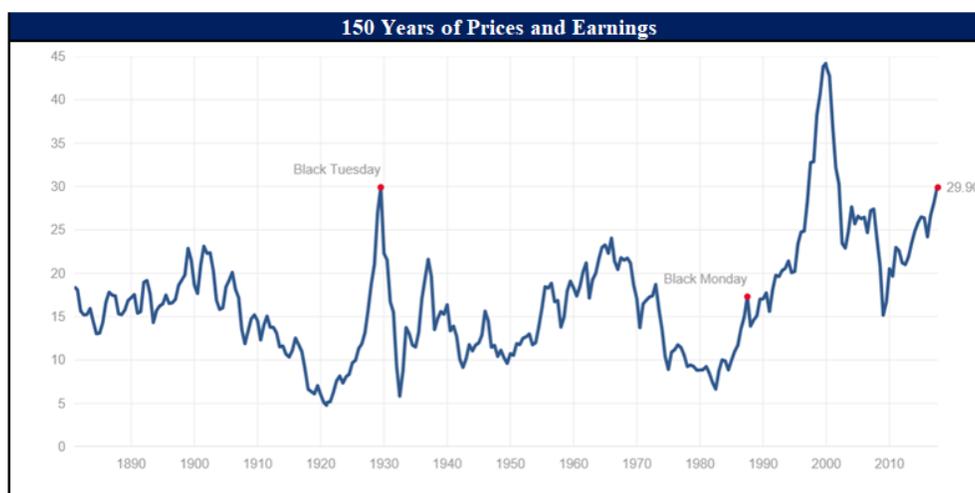
Currently, we are equal weight domestic equity, but are looking to reduce this exposure modestly over time. In addition, we are maintaining our weighting along the spectrum of large, mid and small cap. Our consistent weighting (and overweighting) to US equities versus international has paid off handsomely given that the US markets have been strong over the past four years. However, we believe that valuations are stretched at this point, with valuations on large, mid and small cap stocks ranging from 1 to 2 standard deviations expensive based on P/E ratios.

Despite this overvalued status, domestic equities have continued to surge after the election of Donald J. Trump as President. The market (S&P 500) has surged by 13.01% since Trump's

election on November 9, 2016, including 9.15% thus far in 2017 (through August 24<sup>th</sup>). We believe that this rally has been driven by strong corporate profits and optimism about Trump’s agenda of:

- Deregulation;
- Tax cuts;
- Infrastructure plan;
- Obamacare repeal; and
- Pro business agenda

There are two critical questions at this point. First, what happens if the market loses confidence in Trump’s ability to govern? For the moment, his agenda – except for regulatory reform – has been stalled in Congress. Most market participants, in our opinion, recognize this, yet the market has remained strong. Second, can valuations – which have been driven considerably by multiple expansion – continue their upward ascent? With this rally, valuations are stretched, with PE ratios at 20.93x for the S&P 500. The following chart – by Professor Robert Shiller of Yale – outlines the differential between share prices and earnings over 150 years. As outlined in the chart, the last 20 years have seen a marked increase in stock prices –outstripping earnings growth and resulting in a period of unprecedented multiple expansion. Indeed, the last 20 years have seen multiples soar. Today, the market’s multiple is about the same as Black Tuesday, 1929 (not a great portent!) and more stretched than any point in recent history except for the Tech Bubble. Thereafter, we believe that we may be at the end of multiple expansion and earnings will drive the markets.



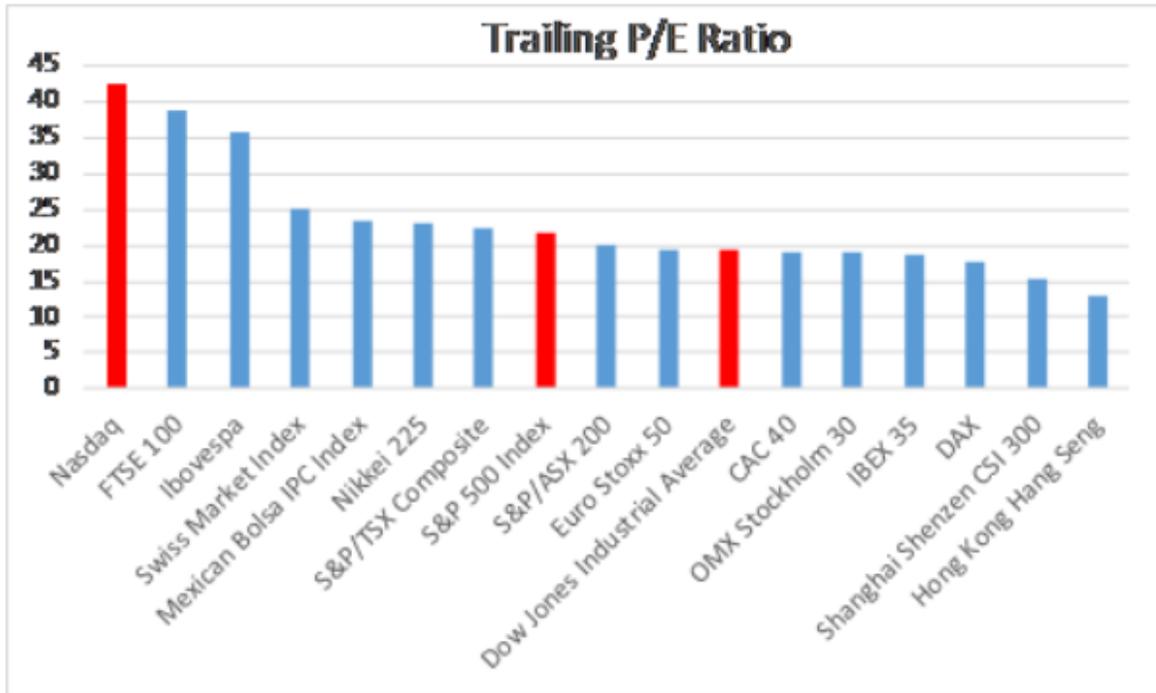
Source: Robert Shiller, Yale University Economics Department

Going forward, our key areas of concern in domestic equity are a loss of confidence in Trump’s ability to implement his agenda and slowing corporate earnings. Given these challenges, we anticipate reducing gradually our exposure to domestic equity to the lower end of our investment range.

**International Equity (Equal-weight; Maintaining Exposure)**

<b>Index</b>	<b>YTD</b>	<b>TTM</b>	<b>5 Years</b>	<b>PE</b>
Europe (Bloomberg Europe)	<b>4.04%</b>	<b>10.11%</b>	<b>36.93%</b>	<b>21.07</b>
Japan (Nikkei 225)	<b>1.77%</b>	<b>17.50%</b>	<b>115.03%</b>	<b>17.58</b>
Brazil (Bovespa Index)	<b>17.93%</b>	<b>23.05%</b>	<b>22.42%</b>	<b>21.80</b>
Russia (RTS Index)	<b>-13.86%</b>	<b>-1.76%</b>	<b>28.33%</b>	<b>7.22</b>
India (Bombay Sensex)	<b>18.66%</b>	<b>13.51%</b>	<b>78.82%</b>	<b>23.27</b>

China (Shanghai Composite)	7.34%	8.58%	61.21%	17.76
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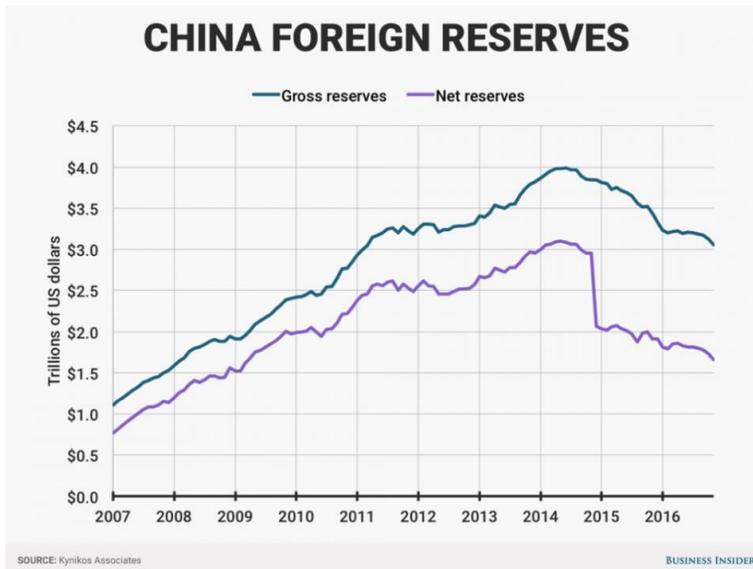
Source: Bloomberg.

The international equity markets (including emerging markets) have lagged the US markets for the past several years. But, they have made up considerable ground over the past year. European equities have been driven by dollar weakness, which has given a lift to bourses and exports. Further, earnings – as in the US – have accelerated, supporting higher valuations without significant multiple expansion. Though European and Japanese stocks appear in line with the US markets, on a forward earnings basis, they are less expensive.

Transitioning to emerging markets, we continue to believe that they also offer a better value than developed markets for the following reasons:

- **Valuations:** Many emerging markets have lagged developed markets over the past several years, and offer compelling valuations relative to developed markets, particularly given growth prospects.
- **Earnings Growth:** Earnings growth tends to outpace developed nations by 10% to 20% and appears more sustainable given that most of the growth is top-line rather than expense reduction driven as in developed countries.
- **Return on Equity:** High return on equity, which can exceed 20% in good years, which is higher than the ROE of the MSCI World Index.
- **Currency Appreciation.** The dollar has been under selling pressure, thus currency gains have fueled some performance in EM shares.
- **Purchasing Power.** The middle class continues to explode, and the rise of consumer purchasing power and domestic demand in emerging markets.
- **Strong Balance Sheets.** Learning the lesson of 1998, many emerging countries have strong balance sheets, which bodes well for currency stability and appreciation. However,

China has seen its foreign currency reserves decline precipitously over the past 3 years, as evidenced by the following chart:



Given the foregoing, we believe that building a slight overweight to European and EM is appropriate. While we believe that there is value in EM, we also have concerns, particularly about China and its eroding foreign reserves.

### Real Assets

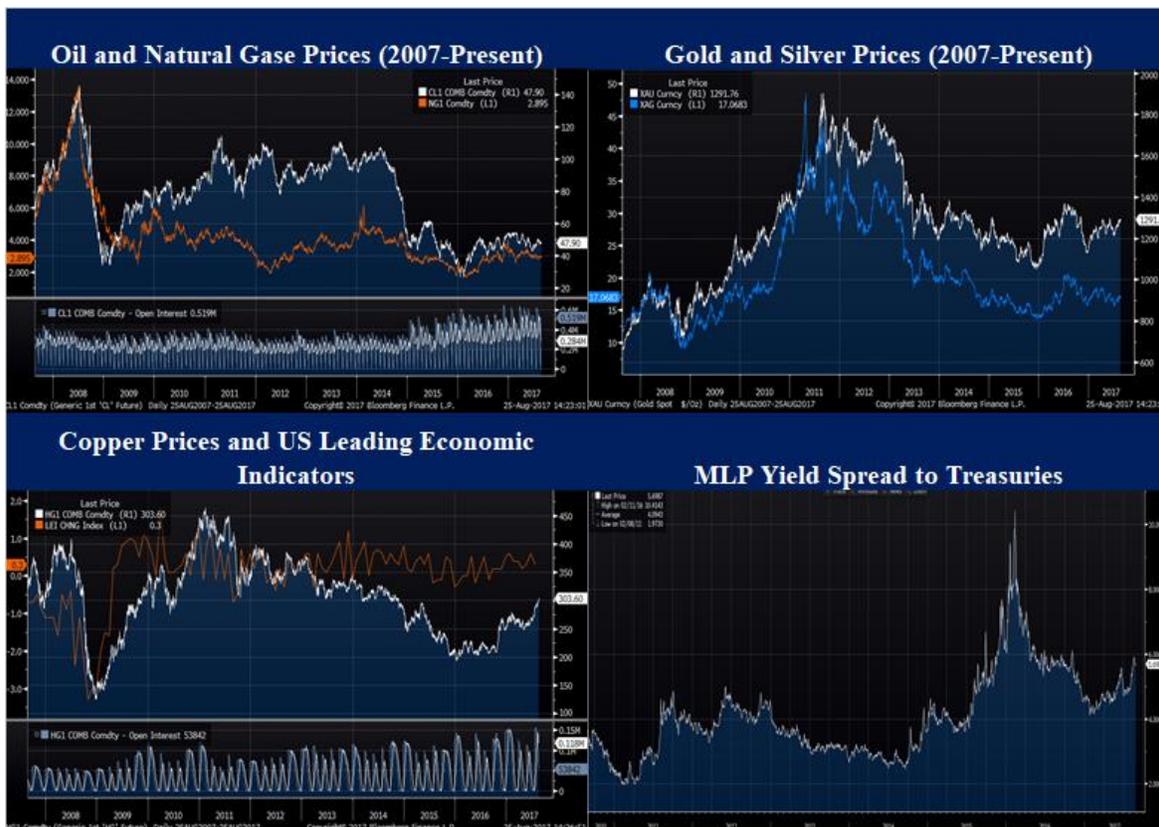
Our real asset portfolio consists of the following asset classes:

1. Natural Resources (energy, precious metals, industrial metals, agriculture and other commodities)
2. Real Estate (public and private real estate, including international)

Real assets tend to provide investors with inflation protection over time, which is why they are included in our portfolio. Generally, real assets also provide a low correlation to other asset classes as periods of high inflation tend to produce poor returns for equities and fixed income investments. Currently, real assets comprise approximately 18% of the portfolio (we typically target approximately 10-25%, which means that Real Assets are an equal weight currently).

Natural Resources (Equal Weight; Maintaining Exposure)

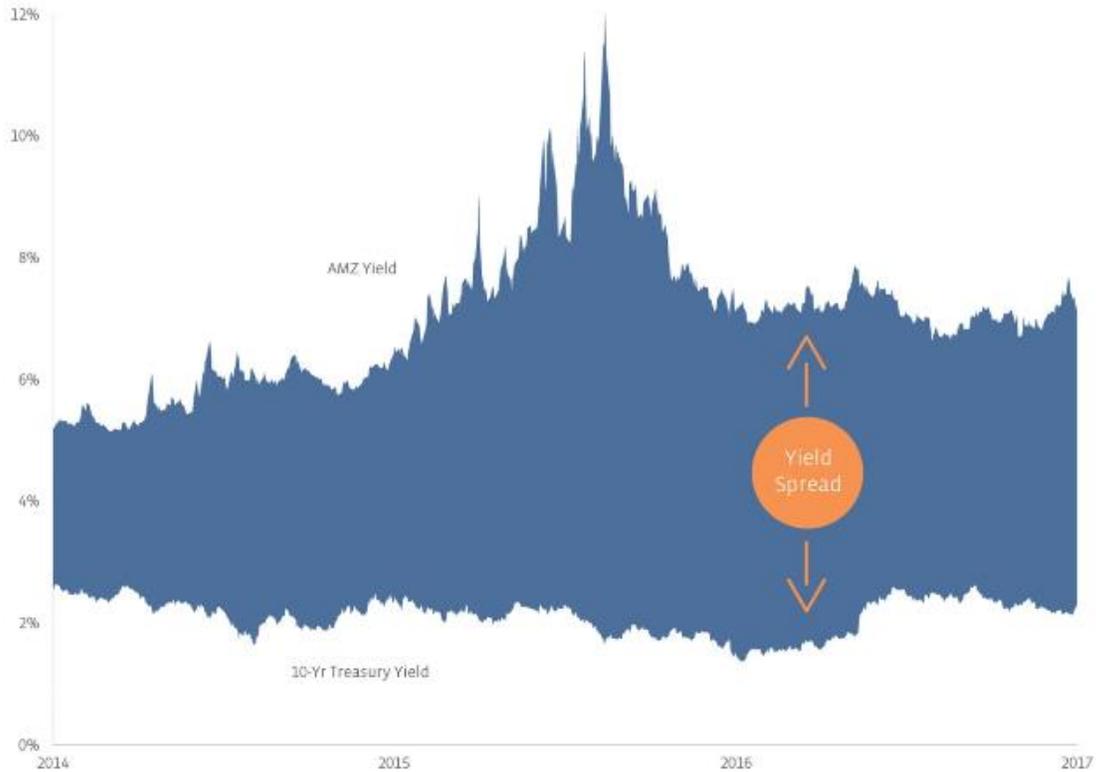
Index	YTD	TTM	5 Years
Oil (Brent)	-8.96%	5.10%	-54.35%
Gold oz.	-0.36%	13.93%	-20.63%
Copper	23.06%	48.14%	-11.56%
Iron Ore	-1.94%	0.06%	-54.63%



Source: Bloomberg.

We believe that we are in a secular bear market in energy, but are more sanguine regarding the rest of the commodity complex. Oil (Brent) has seen its price halved over the last three years, going from \$110 / bbl in mid-2014 to as low as \$28 / bbl in February 2016, but rebounding by 70% since that time to settle above \$50 – as seen in the chart above. We believe that oil will be range-bound for the next year, hovering between the mid-\$40s to the low \$50s, assuming we experience no recession and demand destruction. Beyond 2018, we believe that supply may start to suffer, given the lack of investment in longer lead-time projects, such as deepwater, Arctic, Russian and central Asian projects. But, in the interim, US shale will serve as the “swing producer”, filling the void if price start moving above \$55/bbl and turning off supply when prices dip into the mid \$40s. Thus, we are neutral on oil, as a commodity. As for industrial commodities, we believe that global demand will firm prices and provide profit opportunity. Copper, aluminum, iron ore have all firmed on improved global demand and a weaker US dollar, since global prices tend to be in US dollars.

US Master Limited Partnerships (MLPs) – which tend to be pipelines and transporters oil and natural gas and pay a relatively high yield – have been decimated with the commodity crash. They, however, are an attractive value. MLPs tend to follow oil and gas prices, but to an extent, they are predicated on US oil and gas production, not prices. Given that US production is improving, MLPs should see increased throughput. MLPs, however, are priced as well below historical norms, based on spread to US treasuries.



Source: Alerian,

Accordingly, we are adding to our position in MLPs over time, if this spread continues.

**Real Estate (Equalweight; Maintaining Exposure)**

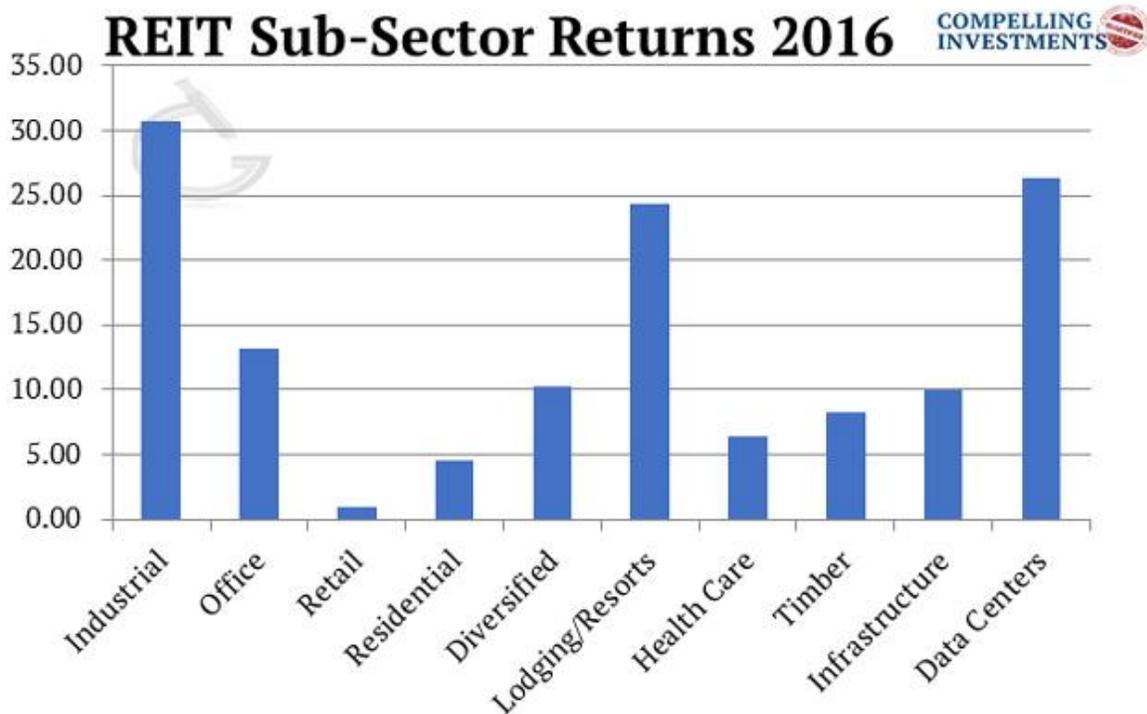
Index	YTD	TTM	5 Years
Public REITs	1.12%	-6.32%	26.00%
Intl REITs	-3.68%	-8.81%	26.04%
Private RE (NAREIT)	5.70%	0.84%	59.49%



Source: MSCI and Bloomberg

REITs are real estate investment trusts. REITs invest in real estate and typically pay 90% of the fund from operations, or earnings, to its holders. REITs have limitations on leverage, which make them moderately risky investments. REITs are typically grouped by the area of real estate in which they invest. There are multi-family REITs, office REITs, retail REITs, etc. As with real estate, different REITs tend to perform well under different circumstances. With the assault of online shopping on retail, retail REITs have suffered over the past few years, though most of them (e.g., Weingarten) tend to have

Public have recovered somewhat from a decent 2016, with the FTSE NAREIT All Equity Index posting a total return of 8.63%. However, as noted above, not all sectors posted great performance. Indeed, industrial, lodging and resorts and data centers lead the way. And, retail, as noted above, lagged. This same theme continued in 2017.



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Source: FTSE & NAREIT

We own both domestic and international REITs. We view both as equal weights. We believe that domestic REITs should generate a current yield in the 5% range, with rent increase / capital appreciation consistent with inflation. Thus, we anticipate a 7% overall total return. Since most of the REITs are moderately leveraged, there is risk to the downside, but manageable.

As for international REITs, we have the same view, but are modestly more constructive given dollar weakness. However, if there is an overweight, it will be modest.

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