DUFF & PHELPS INVESTMENT MANAGEMENT CO.
A VIRTUS INVESTMENT PARTNER

The Art Of The Trade Deal?

Domestic and international equity markets were choppy in the first quarter amidst uncertainty on a number of fronts. In the U.S., mid-term election years are typically more volatile, given the potential for a shift in political power. The threat of global tariffs and other concerns such as LIBOR rising, potential FAANG regulation, and a flattening yield curve, have all played a role in recent volatility as well.

As it stands, the path forward for the U.S. economy will most likely see capital expenditure rise, and that should, in turn, drive productivity up and lead to higher wages. There is nothing to fear from stronger growth as long as that growth is used to fund, at least in part, productive projects that support a virtuous economic cycle. There need not be any inherent tradeoff between growth and substantial inflation at this point.

Viewed in this light, the uncertainty around global trade—to the extent that it makes companies nervous and fall back into a wait-and-see mode on capital spending—can be damaging. Increasing trade tensions are clearly a near-term negative for equities, though do not appear to be affecting monetary policy, and probably won't until or unless something definitive happens. Fiscal stimulus should continue to buoy the U.S. economy, and regulatory easing should boost the financial sector. Thus far, surveys of business confidence remain elevated, likely due to expectations of improving corporate profits. That story has assuredly not gone away and, if anything, will get stronger with this spring's earnings announcements.

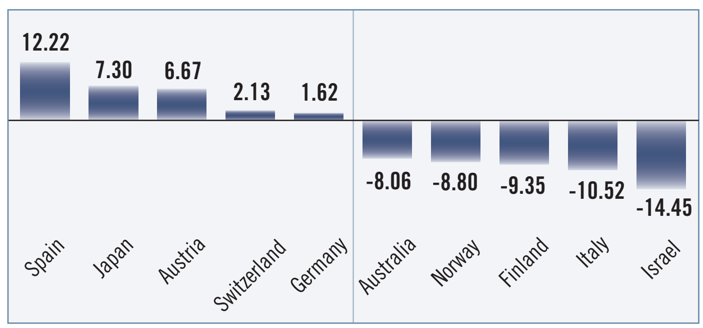
SECTOR HIGHLIGHTS

Global Real Estate – Following a solid 2017, global real estate equities started 2018 on a negative note, with a -4.5% return in the first quarter, as represented by the benchmark FTSE EPRA NAREIT Developed Index (Index), expressed in U.S. dollars. Global real estate also continued to trail global equities, which declined 1.3% as represented by the MSCI World Index, also expressed in U.S. dollars. It should be noted, however, that following positive performance in January, global equities succumbed to rising volatility associated mainly with fears surrounding global trade policies. During this period, global real estate equities proved to be somewhat defensive as they outperformed global equities, reinforcing the benefit of the asset class to portfolio allocation.

Looking at the performance of individual countries represented within the Index, the top performers during the quarter, on a total return basis and measured in U.S. dollars, were Spain, Japan, Austria, Switzerland, and Germany, with all five posting positive returns. Following a robust 2017, Spain continued to shine brightly, driven by a reduction in political noise and very solid economic and real estate fundamentals. Japan also performed well, benefiting from a strong yen currency relative to the U.S. dollar and a mild rebound in Japanese REITs following weak performance in 2017.

The five bottom-performing countries during the quarter were Israel, Italy, Finland, Norway, and Australia. Of these, all but Australia have limited company representation in the Index and their returns in any given quarter are more stock specific. Nonetheless, the weakness in Italy was driven primarily by a rise in risk premiums heading into and following its political elections. The weakness in Finland and Australia was driven primarily by retail real estate companies, which continued to face a tougher fundamental environment given the ongoing dislocation among physical retailers against a backdrop of growing e-commerce retail penetration.

FTSE EPRA NAREIT DEVELOPED INDEX
TOP 5 / BOTTOM 5 COUNTRIES (%) – 1Q18



Sources: FTSE, Bloomberg, L.P.

In our view, there is still room for growth in the global real estate rental market cycle. We expect overall demand in the rental market to exceed supply across most property sectors and major cities. Given the significant amount of private real estate equity capital that has been raised but is unspent, we expect M&A activity to continue in 2018. In aggregate, we view a backdrop of low, but positive, global economic growth and manageable new real estate supply as positive fundamental tailwinds for global real estate securities going forward. Combined with the supportive tailwind to real estate asset pricing, our base case remains for another positive total return year for global real estate securities in 2018.

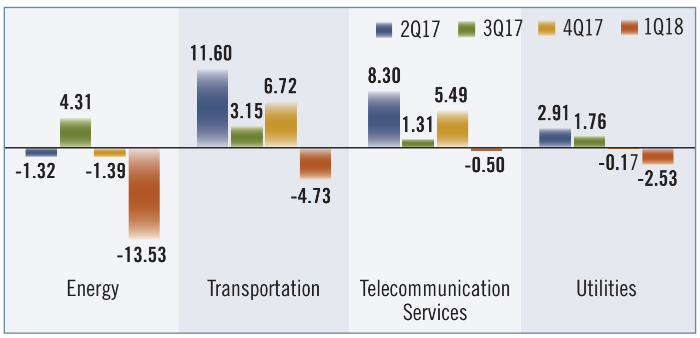
Global Listed Infrastructure – Global listed infrastructure had a challenging quarter, falling 4.6% in the quarter, as measured by the FTSE Developed Core Infrastructure 50/50 Index. All four infrastructure sectors—utilities, communications, transportation, and energy—posted losses.

Communications was the relative winner, falling just 0.5% in the quarter, as a number of the wireless communication tower companies posted gains as they continued to benefit from increasing wireless usage and the ongoing 4G/5G rollout.

The transportation sector declined 4.6% in the quarter. European airports and U.S. railroads followed the market down after a strong start to the year. The railroads were hit by concerns around trade wars, NAFTA, and service issues. Airport traffic growth came in as expected, but the rate of growth is slowing from its quick pace last year.

Utilities finished the quarter down just 2.5%, recovering some of the more significant losses posted early in the quarter due to rising interest rates and the market's general "risk on" attitude. As markets reversed and rates pulled back, the "flight to safety trade" returned, and U.S. utilities segment rallied for the rest of the quarter.

FTSE DEVELOPED CORE INFRASTRUCTURE 50/50 INDEX SECTOR PERFORMANCE (%)

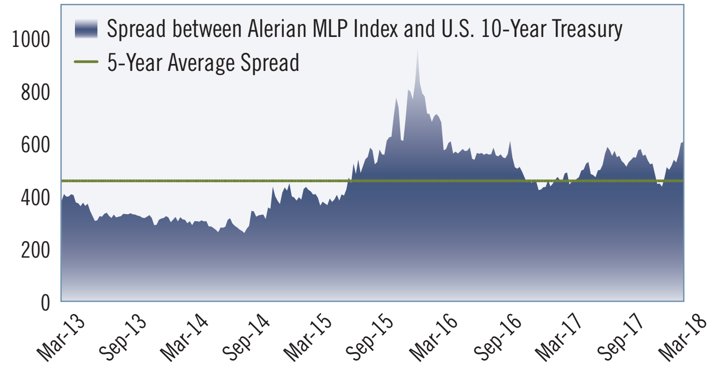


Sources: FTSE, Bloomberg, L.P.

Energy & MLPs – It was another terrible quarter for energy. Most of the midstream sector got off to a very hot start in the quarter. The fundamental backdrop was strong as oil prices continued to climb and U.S. oil and gas production remained robust. Nevertheless, midstream energy companies pulled back with the rest of the market in February, driven not only by the market volatility but also by fears around ongoing MLP restructurings.

On March 15, an unexpected ruling from the Federal Energy Regulatory Commission (FERC) caused the sector to plummet. Essentially, the FERC ruling disallowed certain gas and oil pipelines from using an income tax allowance in their rate calculations. While this materially impacted only a handful of MLPs, it shook the faith of midstream investors. MLPs, as measured by the Alerian Index, finished the quarter down 11.1% while the energy infrastructure benchmark sector fell an even worse 13.5%.

MLP VALUATIONS AT ATTRACTIVE LEVELS



Sources: U.S. Treasury, Bloomberg, L.P.

OUTLOOK

We remain firm believers in the synchronized global growth story, jumpstarted by years' worth of unprecedented fiscal and monetary stimulus. We continue to study market indicators closely to gauge the stability and potential longevity of this trend, and as we look past the current volatility, we see little to shake our conviction. Global manufacturing data continue to look strong, led by the U.S. and eurozone. Labor markets are robust, but wage growth hasn't crossed into inflationary territory. This is at least partly attributable to excess capacity, which has also enabled producers to accommodate surging demand without a litany of supply issues. The bid for investment grade corporate debt remains strong. Yield curves are relatively flat, driven more by technical demand on the back end of the curve rather than recessionary fears. And corporate earnings growth is healthy the world over. These are among the metrics that give us confidence that the risks to continued global growth are to the upside.

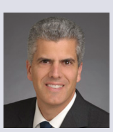
Fears of a full-blown trade war have pervaded market sentiment since President Trump's announced steel and aluminum tariffs. We believe the president is employing "Art of the Deal" tactics, offering an opening gambit in order to create leverage and assist negotiations toward a less audacious, yet still favorable, outcome. The ultimate goal is to cut the U.S. trade deficit with China, and we see this being more realistically achieved by selling the Chinese more of the items their growing economy needs—oil, liquefied natural gas, food stuffs, autos, airplanes, etc. We see trade negotiations taking a turn in that direction. After all, too much is at stake politically.

For the Republicans to have the best odds of maintaining control of the House in November, and for Trump to be reelected in 2020, the economy needs to continue growing and the stock market remain on track. An all-out trade war would impede growth, and as such we are heavily discounting his tariff rhetoric.

continued

So, what then, keeps us up at night? The "great unknown" is—and has been for some time—how markets will ultimately react when a decade of globally coordinated central bank stimulus is removed. Unprecedented efforts to keep interest rates near zero, coupled with asset purchase programs, served to pump liquidity into markets and keep private sector borrowing costs at historically low levels. Now central banks are in the process of choreographing an exit from the risk mitigation business by paring back their balance sheets and raising rates. As we move into this next phase, we are excited about the return of a market environment where companies with strong balance sheets, durable earnings profiles, and excellent stewardship of capital distinguish themselves once again.

Authored by:



John L. Creswell
Executive Managing Director
Duff & Phelps Investment Management Co.

Duff & Phelps Investment Management offers specialty investment strategies that strive to enhance outcomes for clients. The product mix, which includes Global Listed Infrastructure, Global Real Estate, Energy & MLPs, and International Equity, developed from the in-depth fundamental research expertise in income-producing securities that the firm first established back in 1932.

FTSE EPRA NAREIT Developed Index (net): A free-float market capitalization-weighted index measuring publicly traded equity REITs and listed property companies from developed markets, which meet minimum size and liquidity requirements. FTSE Developed Core Infrastructure 50/50 Index: A free float-adjusted market capitalization weighted index that gives participants an industry-defined interpretation of developed market infrastructure companies and adjusts the exposure to certain infrastructure subsectors. Constituent weights: 50% Utilities, 30% Transportation (including capping 7.5% for railroads/railways), and a 20% mix of other sectors including pipelines, satellites, and telecommunication towers. Alerian MLP Index (AMZ): A composite of the 50 most prominent energy MLPs, which is calculated using a float-adjusted, capitalization-weighted methodology. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.