January 2019

Economic Comment and Market Outlook

Equity markets became reacquainted with volatility in 2018, leaving investors smarting after a weak fourth quarter and an especially sudden decline during the month of December. In fact, from the September peak to the Christmas Eve low, the S&P 500 lost just shy of 20% of its value before rebounding modestly in the last week of the year. The full year total return for the S&P 500 was a loss of (4.4%), a figure that does not fully capture the feeling that many investors experienced toward the end of the year. Experiencing a correction like the market did late in 2018 naturally causes investors to reflect on how the investment environment is changing. Our previous expectations have included rising volatility in the markets as the business cycle ages and financial conditions grow gradually tighter, but we have also drawn comfort from superb corporate profits, a healthy US economy, and reasonable equity valuations. Those factors still remain supportive, and we believe the market can climb the "wall of worry" established in late 2018. Furthermore, we believe the strength of our portfolio companies' balance sheets and cash flows provide financial flexibility and resilience to weather the volatile periods that are a regular part of investing over any long-term period.

In our January 2018 letter, we noted that there were only 8 days in 2017 in which the S&P 500 rose or fell by more than 1%, making that year the calmest investment environment in 50 years. Daily market movements certainly felt more turbulent in 2018, but they really just returned to "normal." Investors experienced 64 days with a price change greater than 1% last year, only slightly above the historical average for the S&P of 59 such days. Growing concerns about global economic growth, US trade policy, the path of monetary policy, and domestic and foreign politics have been weighing on market participants and creating uncertainty. In particular, toward the end of the year, investors grew much more worried about the risk of a recession and began pricing that possibility into the market.

While there is undoubtedly a slowdown in economic growth and the rate of profit increases, we believe there is a disconnect between the recent market action and the reality of the present situation. There are signs of weakness in overseas economies and more cyclical pockets of the US economy. For example, the ISM survey of the manufacturing sector indicates that growth decelerated at the end of 2018 but remained at levels consistent with a growing economy. New order growth decelerated as well but also remained positive, and customer inventory is reported to be too low. Interest rate sensitive sectors like housing and autos have weakened. On the other hand, US consumer net worth sits near an all-time high at an estimated $107 trillion at the end of the year, employment is at record levels, and retail sales during the holiday period registered the best growth in six years. Importantly, the Federal Reserve has taken note of the slowdown as the central bank has communicated a shift from a regular, gradual schedule of interest rate hikes to a

wait-and-see approach. We should not forget the observation of the famous economist Paul Samuelson that "the stock market has forecast 9 of the last 5 recessions." Of course, we will remain vigilant against the threat of recession, but our current expectation is for a slowing but resilient US economy.

Given how infrequent recessions have been for the past generation, investors may have become extra cautious as they eye this slowdown. For a number of reasons, the US economy has experienced much longer expansions in recent decades. In fact, there have only been 3 recessions in the past 35 years. Of course, the most recent one—"The Great Recession"—left many painful memories that continue to influence the behavior of individuals and companies. However, the US has experienced 12 recessions since the end of World War II. Since we invest our clients' funds for longer periods of time, our investment approach must allow for the likelihood that the economy and markets will experience those setbacks with some regularity. In every case of a recession, while the economy and the stock market declined in each one, both subsequently rebounded and went on to establish new highs. We endeavor to construct portfolios that hold investments in financially-strong, industry-leading companies led by skilled managers. Operating from their leadership positions, many of our companies have global scope that dampens the geographic risk of a recession in any one country and enables them to pursue areas with superior growth opportunities. Importantly, we seek companies that are positioned to do more than just survive a recession; we expect our companies to improve their competitive position, make new investments, and plant additional seeds for long-term growth in the midst of a downturn. Every recession is slightly different than the ones that preceded it, but we believe in the often-proven adaptability of our economic system and the experienced management teams of our companies. Therefore, even if we are wrong in our assessment of when the next recession will begin, our view on long-term investing would still remain the same.

With all of the concerns holding stock prices in check during a period of robust profit growth, the valuation of the S&P 500 and our portfolio companies became significantly more attractive during 2018. According to Jonathan Golub at Credit Suisse, the forward price-to-earnings ratio of the S&P registered the third largest decline in more than forty years, contracting almost 4 points to 14.4 times expected earnings. Business fundamentals remained strong as operating earnings per share for the S&P 500 increased approximately 23% during 2018, which helped differentiate US equity returns from the rest of the world. While the S&P 500 provided a negative total return of (4.4%), major international benchmarks fell further. The MSCI EAFE index declined (10.5%) in local currency and (13.4%) when measured in US dollars. The MSCI Emerging Markets Index provided very similar negative returns in local currency and dollars at (9.7%) and (14.2%), respectively. This year of US equity outperformance follows longer 3, 5, and 10-year time periods when US stocks also outperformed their international counterparts handily.

For a typical Sarofim portfolio, earnings growth reached approximately 25% in 2018, ahead of the S&P's strong earnings gain, but in line with our high expectations when the year began. Similar to the dynamic driving the S&P 500's valuation contraction, our typical portfolio saw its forward P/E multiple fall to 15.8 times earnings at the end of 2018, which we believe is an attractive valuation level considering our expectations for growth and low overall rates of inflation and interest rates. We believe our portfolios are positioned to offer faster profit growth of approximately 10% in 2019 versus an estimated gain of 6% for the S&P, and we expect our companies to maintain a growth advantage in future periods as well.

Long-term readers of these letters will recognize a consistent theme: we remain confident in our ability to produce strong long-term results, powered by the superior businesses in our clients' portfolios. We appreciate that many risks exist in the world, including the risk of an economic downturn, but our response to those risks is to ensure that we own a portfolio of investments that offer a combination of return potential and risk protection considering the range of potential outcomes. Given the financial strength, earnings outlook and return of capital of our portfolio companies, we remain confident in the long-term outlook for portfolio returns. As always, we encourage you to contact us if you have any questions, and we thank you for your continued trust and confidence in Fayez Sarofim & Co.

This document is confidential and intended solely for the recipient and may not be published, reproduced or distributed without the express written consent of Fayez Sarofim & Co. ("FS & Co."). This presentation is neither an offer to sell nor a solicitation of any offer to buy any securities, investment product or investment advisory services.

Any projections, market outlooks or estimates expressed herein are forward looking statements and are based on certain assumptions. Such projections, outlooks and assumptions should not be construed to be indicative of the actual events that will occur and do not constitute investment advice. Opinions and information included herein are current opinions and information only as of the date hereof or as of the date indicated, and are subject to change without notice. Additionally, while information contained herein is believed to be accurate and/or derived from sources which the FS & Co. believes to be reliable, FS & Co. disclaims any and all liability as to the completeness or accuracy of the information contained herein.

The indices highlighted herein are presented for comparative purposes only. The volatility of the referenced indices may be materially different from that of FS & Co.'s products, and FS & Co.'s holdings may differ significantly from the securities that comprise the highlighted indices. Products offered by FS & Co. will hold considerably fewer securities than the referenced indices.

As used herein a "Sarofim portfolio(s)" reference FS & Co.'s model portfolio(s) used in connection with certain managed accounts and/or sub advisory arrangements, and the securities comprising such portfolios may differ from those comprising any individual investor's portfolio or managed account. The performance of an investor's account with or managed by FS & Co. may vary from that of a model portfolio due to investment restrictions, management fee arrangements, the timing of capital contributions and withdrawals, and the investor's tax situation.