GW&K® INVESTMENT MANAGEMENT

QUARTERLY INVESTMENT REVIEW

2Q 2019

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ECONOMIC COMMENTARY

By Harold G. Kotler, CFA

I am having a hard time understanding these calls for the Federal Reserve to lower short-term interest rates. After all, according to key economic indicators, the U.S. economy appears to be doing quite well. We have full employment, low inflation and a stock market near new highs. While this does not feel like a backdrop that requires more stimulus, the two most prevalent arguments for lowering short-term interest rates appear to be the lack of capital expenditures and the tariff war. It seems quite reasonable that businesses would hold off on any major capital expansion given the uncertainty the tariff policy is creating. If that is true, once we have a trade deal with China, companies should gain a clearer picture of how to grow domestically and, of course, globally. So I see this time period as a hiatus in an otherwise very strong economy and wish that the Fed would hold rates where they are.

The U.S.-China trade talks are driving this period of uncertainty. This may well be one of the most complicated negotiations of all time. While the U.S. will get a deal done with China this year, Beijing and Washington need to come to a durable conclusion that both parties can live with. China needs to break away from many old traditions. Chinese reforms have created an economic and social environment that few would have thought possible when former President Nixon opened the door of détente. Their selfish needs are no less important than ours. To change the rules of engagement between two trading partners is not easy, nor should it be. It was always going to take difficult and hard-nosed negotiations for both countries to claim the win they need. Expectations for a quick resolution were far too optimistic. There will eventually be a deal, but let us not get up every morning expecting it to be completed.

Collaboration from both countries is necessary on so many levels. As a new world order unfolds, the U.S. needs to understand that we are now sharing the playing field with China. Whether it be politically, militarily or economically, the Chinese awakening is a game changer.

I see this evolution as an exciting opportunity for global growth and peace. China's central authority is not absolute. They will have massive challenges bringing their country into the 21st century. With a rapidly growing middle class population, all who are looking to live better, healthier lives, it is essential that China address real fundamental needs, be it pollution, the one child family policy or healthcare. My point being, the U.S. and China will learn to live with each other and through this easing of tensions between our two nations, the economies of both countries will continue to flourish.

My frustration with economic pundits is how quickly they turn from one opinion to another. It was not so long ago, as short-term rates were rising, that there was a fear of inflation and an overheated economy. Now there is surprise that there

Continued on next page

INDEX PERFORMANCE — *6/30/19*

	QUARTER	YEAR TO DATE
Bloomberg Barclays 10-Year Municipal Bond Index	2.15%	5.36%
Bloomberg Barclays Aggregate Bond Index	3.08%	6.11%
Bloomberg Barclays High Yield Index	2.50%	9.94%
Dow Jones Industrial Average	3.21%	15.40%
S&P 500 Index	4.30%	18.54%
Russell 2000 Index	2.10%	16.98%
MSCI EAFE Index	3.68%	14.03%
MSCI World Small Cap ex USA Index	1.76%	12.88%
MSCI World Index	4.00%	16.98%
MSCI Emerging Markets Index	0.61%	10.58%

GW&K UPDATE — *6/30/19*

TOTAL ASSETS UNDER MANAGEMENT	$39.4 billion
TOTAL EMPLOYEES	147
TOTAL INVESTMENT PROFESSIONALS	54

NEW EQUITY PROFESSIONAL

Andrea M. Clark, CFA recently joined GW&K as Vice President and Client Portfolio Manager. As a member of our Global Equity Team, Andrea works closely with portfolio managers and analysts to support the firm's client service and business development efforts. This addition reflects the growing interest in our global equity capabilities and our core commitment to maintaining a high level of accessibility to our investment teams and process.

is no inflation. As I have said over the last three decades, inflation will not exist in a global economy with technology constantly changing the way we live. My worry has always been deflation. The growth of smaller global economies will help the more mature economies of the world continue to grow. Patience and a longer-term view would go a long way toward gaining a healthy perspective.

Consider that one of the more beneficial effects of the trade negotiations, besides that it was very necessary and long overdue, is that countries around the world will be the beneficiaries of global companies diversifying their supply chain. Business 101 teaches us to not be dependent on one supplier for a myriad of reasons. Reliance upon one country for sourcing supplies or providing manufacturing is not wise. China will see a loss of business, but the resulting diversification will benefit many countries in Asia, Africa and South America. It also motivates China to work its way up the food chain and have a more value-added economy, which in turn will boost productivity, increase domestic consumption and raise living standards.

With interest rates so low and likely to remain so, the need to have a creative investment portfolio is vital for the long-term health of our financial lives. Do not be discouraged by volatility, bravado or hysteria. World economic growth will overwhelm all the naysayers. Invest, do not speculate, and stay committed to an allocation. Keep cool and enjoy the ride.

Harold G. Kotler, CFA
CEO, Chief Investment Officer

SECOND QUARTER 2019

ECONOMY

- The economy continued to grow in Q2, but at a slower pace. The Atlanta Fed estimates 1.5% GDP for the quarter, down from 3.1% in Q1'19.
- Employment trends remained solid with unemployment at 3.6%, the lowest level in 50 years. Manufacturing activity cooled, although the service sector still showed solid expansion. Consumer and small business confidence stayed elevated, but below recent highs.
- Ongoing tensions regarding tariffs and trade, along with low inflation, ratcheted up concerns over global growth, putting pressure on central banks to act.
- The Fed responded with an accommodative stance at their June meeting leading to a strong rally in both stock and bond markets.

FED ACTION

- While the FOMC left rates unchanged, they removed the prior commitment to "be patient" signaling a willingness to cut rates in the near term. In addition to trade and growth unease, low inflation and a desire to sustain the economic expansion were key factors the Fed noted.
- For their economic projections, the Fed made marginal downward adjustments to unemployment and lowered near-term inflation expectations.
- In the Fed's "dot plot," almost half of the committee members expected to cut rates by a half percentage point by year end. Futures markets are pricing in a slightly more aggressive outcome with over a 50% chance of three cuts in 2019.

BOND MARKETS

- Fixed income markets benefited from a second straight quarter of lower rates and tighter spreads, posting their strongest first-half returns in almost 25 years.
- The Treasury curve experienced a significant bull steepening as investors flocked to safe-haven assets and markets repriced the likelihood of rate cuts.
- The 10-year Treasury yield fell to its lowest level since 2016. More ominously, the 3-month/10-year curve inverted for the second time this year, touching its lowest level since 2007 and lending further support to those arguing a recession is imminent.
- Municipals extended their run of strong performance amid a technical environment that generally remains supportive.

DOMESTIC EQUITY MARKETS

- U.S. equity markets closed higher in Q2 with the S&P 500 rising 4.3%, marking the best first half since 1997. While U.S. equities posted a healthy gain, the quarter was a volatile one and concerns about slowing global growth, reduced corporate earnings expectations and escalating trade tensions whipsawed markets in May. Yet stocks rallied back in June after the Fed signaled monetary policy could ease near term and trade talks progressed.
- Large cap stocks outpaced small caps in the quarter, with the S&P 500 leading the Russell 2000 by 220 basis points.
- Cyclical sectors such as Financials, Materials, Information Technology and Consumer Discretionary led large caps higher. Energy and Health Care exhibited the weakest relative performance.
- Growth outpaced Value, and quality factors were mixed during the period.

GLOBAL EQUITY MARKETS

- Global developed markets rallied into Q2's close after the world's major central banks announced policy measures to offset slowing global growth and the impact of prolonged U.S.-China trade negotiations.
- The MSCI World Index gained 4.0%, led by Europe and the U.S., while Japan turned in more modest performance. Large caps outperformed smaller companies.
- Emerging markets reacted positively to the dovish shift by global central banks. The MSCI Emerging Markets Index recovered after a weak May to end the quarter with a 0.6% gain. The EMEA and Latin American regions outperformed Asia, which is more central to the trade talks.
- As the quarter ended, the U.S. and China announced a trade truce bringing a temporary pause to dueling tariffs. In addition, the U.S. granted Chinese telecom giant Huawei a reprieve in sourcing components from U.S. suppliers.

MUNICIPAL BOND STRATEGIES

INVESTMENT TEAM

Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
Brian T. Moreland, CFA	Partner, Portfolio Manager
Martin R. Tourigny, CFA	Partner, Portfolio Manager
13 Municipal Investment Professionals	**22** Average Years Experience

GW&K MUNICIPAL BOND STRATEGIES

SHORT-TERM MUNICIPAL BOND	Seeks to earn higher after-tax returns than money market funds while managing risk
2–8 YEAR ACTIVE MUNICIPAL BOND	High-quality short to intermediate approach emphasizing research and active management with the goal of preserving income and enhancing capital
MUNICIPAL BOND	High-quality intermediate approach emphasizing research and active management with the goal of preserving income and enhancing capital
MUNICIPAL ENHANCED YIELD	Long-term approach that includes an allocation to higher yielding bonds with a goal to produce high after-tax income

Municipals posted impressive gains in the second quarter, helped along by a powerful rally in Treasuries. Slowing economic activity, unresolved trade tensions and stubbornly low inflation measures all fueled concerns over global growth and pushed investors toward the relative safety of bonds. As the quarter progressed, the Treasury market started flashing an ominous warning sign: the yield on the 10-year note dropped below the rate on short-term bills, an inversion that has preceded every recession for the past 60 years. The Fed came under increasing pressure to act. The White House openly agitated for lower rates while traders in the futures market began pricing in three rate cuts by year end. At the June FOMC meeting, the Fed essentially capitulated, dropping its prior commitment to "be patient" and signaling a willingness to ease policy in the face of increasing threats to an expansion that just became the longest on record. Nearly half of the committee members projected two rate cuts for 2019. By the end of June, the yield on the two-year Treasury had fallen over half a percentage point, its largest quarterly drop since the financial crisis. Yields on longer maturities declined as well, though not by quite the same magnitude, which had the effect of steepening the curve over the quarter.

Municipal bonds started the quarter on a tear, outperforming Treasuries as money continued to pour into the market. Industry mutual funds took in another $20 billion of cash, setting a new record for first half inflows at nearly $44 billion. Meanwhile, supply remained constrained, leading to a scramble for bonds and an almost indiscriminate reach for yield. By mid-May, the 10-year municipal/Treasury ratio had fallen to 71%, within a whisker of its all-time low. But as the Treasury market continued to surge, municipal bonds simply could not keep up. In June, just as rate fatigue started to creep in, new issue volume began to perk up and investors became much more selective with purchases. Deals that would have been heavily oversubscribed earlier in the quarter suddenly saw mixed demand resulting in more leftover balances or dealer concessions to clear the market. By the end of the quarter, ratios had rebounded to more reasonable levels with the 10-year finishing back above 80% and the 30-year again topping 90%.

In most years, when we look ahead to the third quarter, we tend to anticipate a very strong technical environment, where supply decelerates and reinvestment flows spark added demand. And to be sure, there is no reason to believe that will not be the case this year. But as we look back to last November, we cannot ignore the extraordinary run the municipal bond market has just enjoyed. Tax-exempt yields have dropped more than 100 basis points at most major points on the curve, with the sole exception being the two-year (86 basis points). In that same stretch, the curve has flattened while credit spreads and relative value ratios have moved through their historical averages, all of which suggest that further gains will depend much more on the direction of broader rates. The Treasury market has also rallied sharply and, as the quarter came to a close, was still pricing in a relatively dire outlook on global growth and the trade dispute with China. While these risks are real, the narrative could easily be altered by a resolution on trade and/or a regimen of stimulus promised by central banks.

In response to the uncertainty we have moved our portfolios to a more neutral position. Since rates peaked in November, our performance has benefited from a duration overweight first put in place in October of 2018. During the final weeks of the second quarter, however, with rates down over 100 basis points and relative value ratios pushing all-time lows, we decided it was time to lock in gains and reduce portfolio volatility. A historically flat curve, particularly at the front end, gave us the opportunity to shorten duration without a significant yield give-up. In addition, short-term bonds are the most liquid in the market, which will serve us well should rates rise.

"Slowing economic activity, unresolved trade tensions and stubbornly low inflation measures all fueled concerns over global growth and pushed investors toward the relative safety of bonds."

TAXABLE BOND STRATEGIES

INVESTMENT TEAM

Mary F. Kane, CFA	Partner, Portfolio Manager
Nancy G. Angell, CFA	Partner, Co-Director of Fixed Income
John B. Fox, CFA	Partner, Co-Director of Fixed Income
13 Taxable Investment Professionals	**20** Average Years Experience

GW&K TAXABLE BOND STRATEGIES

SHORT-TERM TAXABLE BOND	Through research and diversification, seeks to outperform money market funds while managing portfolio volatility
CORE BOND	A core multi-sector bond strategy that offers a more conservative profile by selecting only investment grade securities
ENHANCED CORE BOND	Offers broad market exposure across multiple bond sectors, including high yield bonds, while seeking to provide strong income
TOTAL RETURN BOND	This multi-sector approach seeks to take advantage of relative valuation among distinct bond sectors and to generate high income and capital gain
CORPORATE BOND OPPORTUNITIES	Seeks to maximize current income and longer-term capital appreciation by focusing on both investment grade and high yield corporate bonds
SHORT-TERM FOCUSED HIGH INCOME	Seeks to achieve a high level of current income while minimizing price volatility by investing in bonds with maturities less than five years and with an average rating of BB

Fixed income markets benefited from a second straight quarter of lower rates and tighter spreads, posting their strongest first-half returns in almost 25 years. Escalating trade rhetoric, decelerating industrial activity, and rising geopolitical tensions stoked concerns of a worldwide recession and drove a global flight to safety. In response, central banks around the world made clear their willingness to move forward with caution—if not provide outright stimulus as conditions warrant. In the U.S., this shift resulted in a massive collapse of the yield curve, driven by the perception that the FOMC had capitulated by removing the word "patient" from its post-meeting statement. This move had the perverse effect of both validating the risk aversion that drove the rally in rates and emboldening investors in risky assets, who promptly sent equities back to record highs.

The Treasury curve experienced a significant bull steepening as investors flocked to safe-haven assets and markets repriced the likelihood of rate cuts. The main driver of sentiment for much of the period was the back-and-forth of tariff threats between the U.S. and China. These worries were compounded by weakness in the manufacturing sector, softening confidence surveys and lackluster payroll data. On top of that, inflation readings continued to disappoint, remaining stubbornly below the Fed's target range. The resulting shift in expectations for cuts was dramatic. At the end of March, futures reflected investor uncertainty that even a single cut would occur in 2019. By the end of June, three full cuts were being priced in. This rerating saw the 10-year Treasury yield fall to its lowest level since 2016. More ominously, the closely watched 3-month/10-year curve inverted for the second time this year, touching its lowest level since 2007 and lending further support to those arguing a recession is imminent.

After an exceptionally strong start to the year, corporate spreads endured a volatile quarter and ended only slightly tighter. First quarter earnings came in ahead of pessimistic expectations, but any lift this provided to sentiment was quickly overwhelmed by a barrage of trade war headlines and recession-auguring economic readings. A selloff was halted only when the Fed signaled its willingness to step in, a move that allayed credit investors' worries about rising financial distress and sweeping ratings downgrades. Mortgage-backed securities underperformed Treasuries as spreads widened to their highest level in more than five years. The sharp decline in interest rates increased the incentive for homeowners to refinance, reducing the attractiveness of the sector as prepayment speeds accelerated.

The tension between market expectations and FOMC guidance continues to build, as is particularly evident in the competing narratives reflected in the bond and stock markets. The rates market is pricing in the gloomier outlook, with significant portions of the yield curve inverted and breakeven rates hovering near multi-year lows. Equities are demonstrating more confidence, sitting at or near record highs and apparently discounting a favorable resolution to the trade talks. Economic data remain essentially sound, and insofar as soft patches have appeared, we believe that an end to the trade war will firm them up. As such, we have maintained duration close to our benchmarks and we continue to be cautious at the long end.

Though our view of the corporate bond market remains broadly constructive, we believe recent strength presents an opportunity to lock in some profits. Spreads at current levels leave a narrower margin of safety, and we see the potential for an increase in volatility if the Fed disappoints expectations by cutting fewer than three times. We continue to see value in the high yield sector, where the default rate is low and corporations enjoy ready access to capital. The investment grade space also offers value against a backdrop of a tight labor market and still positive confidence surveys, especially now that an accommodative Fed lowers the likelihood of end-of-cycle ratings downgrades. Following recent underperformance relative to the rest of the fixed income space, we think the securitized sector has become more attractive. We have been taking advantage of recent volatility by increasing our allocation to mortgage-backed securities, with a particular preference for higher-coupon pools that we believe have better risk profiles than newer pools.

> "Fixed income markets benefited from a second straight quarter of lower rates and tighter spreads, posting their strongest first-half returns in almost 25 years."

DOMESTIC EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Joseph C. Craigen, CFA	Partner, Portfolio Manager
Jeffrey W. Thibault, CFA	Partner, Portfolio Manager
Jeffrey O. Whitney, CFA	Partner, Portfolio Manager
Aaron C. Clark, CFA	Principal, Portfolio Manager
11 Equity Investment Professionals	**22** Average Years Experience

GW&K DOMESTIC EQUITY STRATEGIES

EQUITY DIVIDEND PLUS	Income oriented strategy that invests in companies paying above-average dividends that we believe have the required financial strength to sustain and increase dividend payouts over time
DIVERSIFIED EQUITY	Combines growth & value disciplines and diversifies across large, mid, and small capitalization stocks
SMALL/MID CAP CORE	A core strategy that invests in both small and medium sized companies that we believe offer sustainable earnings growth
SMALL CAP VALUE	Seeks to identify well-managed small cap value companies with attractive valuations and improving fundamentals
SMALL CAP CORE	Focuses on small companies that we believe offer sustainable earnings growth in niche markets with lasting growth potential
SMALL CAP GROWTH	Seeks to identify small companies that we believe have sustainable, above-average earnings growth potential in niche markets

> "Given our expectation of continued earnings growth and low interest rates, our bias is still in favor of a rising stock market."

A quick and violent correction in May was bookended by strong returns in April and June, resulting in positive returns for the quarter across nearly all markets and asset classes. Early quarter returns were driven by signs of improving global growth combined with low inflation, low interest rates and accommodative global monetary policy. However, this reversed in May as fear of a trade war with China, tariff threats with large trading partner Mexico, unending Brexit uncertainty, weaker manufacturing data and an inverted yield curve had investors fleeing stocks. But as expectations of multiple Fed rate cuts and hopeful signals on U.S.-China trade talks once more took hold, stocks rallied strongly to finish the quarter.

The S&P 500 Index posted a respectable gain of 4.3% in the second quarter, boosting first half returns to 18.5%, their best start in over 20 years. All sectors but Energy posted positive returns in the quarter. Performance was driven by the strength of the more cyclical and growth oriented sectors including Financials, Materials, Information Technology and Consumer Discretionary.

The Russell 2000 Index struggled to stay in the black, but solid returns the last few days of the quarter pushed the Index to a modest 2.1% gain. The quarter's performance was led by a rather eclectic mix of sectors, including the more cyclical Industrials and Financials, as well as the more defensive Utilities.

Despite expectations that the strong U.S. dollar and tariffs would hurt the globally oriented large cap stocks, they beat small caps in the quarter by just over 2%, and now lead by 1.5% through the first half. Strong relative performance by the Information Technology and Consumer Discretionary sectors aided large cap relative performance, while small caps' lower earnings growth impacted their relative performance across most economic sectors. Growth stocks continue to lead Value, helped by the strong performance and larger weighting of the Information Technology and Consumer Discretionary sectors, while Value was hurt by its larger weighting in the poorly performing Energy sector.

Global economic trends remain somewhat mixed. While the stock market's continued advance might suggest improving fundamentals, we believe it is more a reflection of accommodative global monetary policy and the relative attractiveness of equities as compared to fixed income alternatives.

The unknowns of trade wars, Brexit and geopolitical uncertainty surely bear watching, especially for their potential impact on earnings and ultimately stock markets should things go awry. Fundamentally, global growth is slowing as corporations delay spending in response to these uncertainties. The inverted yield curve is also worth noting as a reliable, but not perfect, indicator of recession in past cycles. However, while the short end of the yield curve is in fact inverted, the longer end remains positively sloped. Economic data looks particularly sluggish in Manufacturing where numerous global surveys show contraction or at best modest expansion. Housing data also remains suspect with weaker volumes and soft pricing despite the drop in mortgage rates.

Still there are also many positives. The labor market remains robust, with decent wage rate increases, cycle-low unemployment and good job creation. If anything, one could argue the lack of labor availability has been limiting domestic growth. Consumer demand remains solid, although last month's drop in consumer confidence bears watching. The ISM Services Index also continues comfortably in expansion territory. Recall that services is a much bigger component of domestic GDP than manufacturing. With little pricing pressure in the global economy and accommodative central banks, stimulative monetary policy can be maintained without fear of inflation. Taken together, slow but steady GDP growth in the range of 2-3% seems sustainable, while inflation should remain under control and interest rates low.

Given our expectation of continued earnings growth and low interest rates, our bias is still in favor of a rising stock market. Yet the higher market also leaves less room for economic or political disappointment. But it is precisely during these challenging periods where our high quality well-managed companies have proven themselves in navigating through the global economic landscape.

GLOBAL EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Reid T. Galas, CFA	Principal, Portfolio Manager
Karl M. Kyriss, CFA	Principal, Portfolio Manager
7 Equity Investment Professionals	**24** Average Years Experience

“We believe many of the current issues are misunderstood with the U.S.-China conflict not really about trade, the rise in populism driven by demographic changes, and low rates linked to high debt levels.”

GW&K GLOBAL EQUITY STRATEGIES

GLOBAL SMALL CAP STRATEGY	Seeks to invest globally, including the U.S., in quality small cap companies at attractive prices that can grow earnings or recognize value over the long term
INTERNATIONAL SMALL CAP STRATEGY	Seeks to invest internationally outside of the U.S. in quality small cap companies at attractive prices that can grow earnings or recognize value over the long term

After respectable April performance, global developed markets pulled back in May only to rebound in June when global central banks shifted to more accommodative policy and signs of growing optimism for some sort of U.S.-China trade détente. The MSCI World ex USA and MSCI World ex USA Small Cap Indexes finished the quarter up 3.79% and 1.76%, respectively. The modest returns for the quarter belie the strong rally from May’s selloff, with the small cap Index’s June return of 4.54%, its best June performance since 2004. Despite strong performance in the first half of the year, stocks are still in draw down from 2018’s highs. The U.S. dollar has been neutral in 2019, retracing its first quarter strength to end the first half almost exactly where it started the year.

Returns by region were generally positive with Western Europe (+2.79%), North America (+2.31%) and the Middle East (+10.75%) offsetting Asia (–0.04%). By country, Israel (+10.75%), the Netherlands (+8.66%) and Switzerland (+8.38%) performed best, while Hong Kong (–6.28%), Ireland (–4.33%) and Norway (–1.52%) lagged.

Sector returns seemed to follow no particular pattern and were led by Information Technology (+7.70%), Utilities (+3.72%) and Materials (+3.52%), while Energy (–5.32%), Consumer Staples (–2.48%), and Consumer Discretionary (–2.14%) all trailed.

Second quarter market performance mirrored the continuing ambiguity between the strength of the current economic environment and a potential economic slowdown compounded by geopolitical concerns. Wherever you look, you can find data to back a positive or negative view of the global economy.

Politics provides no respite, with the start of the U.S. election cycle, UK prime minister race, Japanese consumption tax increase, European horse trading to appoint heads of the European Commission and ECB, and Brexit. Now that the UK governing party leadership transition process is underway, we could be nearing the end game for Brexit. Current front runner, Boris Johnson, promised to end the deadline extensions and have the UK exit the European Union on October 31, one way or the other.

Due to the shifting narrative surrounding these issues, our focus remains on understanding longer-term trends, both established and emerging, which we believe will be important drivers of future equity returns. For example, the move from global to regional supply chains had already been in progress prior to the recent U.S.-China trade dispute. Time to market, supply chain responsiveness, and total cost to the customer have increased in importance relative to simple labor and manufacturing costs. However, the trade war has elevated supply chain concentration risk, and even the most amicable settlement (which seems unlikely) will not return supply chains to their ex-ante configurations. There will likely be headline grabbing reports of specific disruptions, but the more important potential impact is in broadly lower margins. That is not to say that everyone will be a loser—just imagine the company whose toughest competitor gets caught on the wrong side of a trade barrier. We have been paying attention to weaponization of trade since China used rare earth export restrictions and public sentiment against Japan earlier this decade. Since then the process has become normalized, with actions taken by the U.S., Japan and others. We expect increasing use of economic power in geopolitical disputes to result in both risk and opportunities for investors.

Another, more positive, trend is the gradual but meaningful improvement in Japanese corporate governance towards shareholders. Long-term Japan watchers are right to be skeptical, but improving capital allocation and investor engagement are real and, given the starting point, the potential impact on returns is enormous. Already we have observed a steady increase in dividend payouts and share buybacks—a shareholder demand that had previously been eschewed by corporate Japan.

We believe many of the current issues are misunderstood with the U.S.-China conflict not really about trade, the rise in populism driven by demographic changes, and low rates linked to high debt levels. However, while these topics are of interest, they do not drive our investment process. We invest within the current geopolitical environment, so we work to understand how it might affect global business dynamics. Our objective is not to predict the outcome of world events, but to invest in companies that can deliver throughout the economic cycle.

EMERGING MARKETS EQUITY STRATEGIES

INVESTMENT TEAM

Daniel L. Miller, CFA	Partner, Director of Equities
Nuno Fernandes, CFA	Vice President, Portfolio Manager
Thomas A. Masi, CFA	Vice President, Portfolio Manager
Pablo Salas	Vice President, Portfolio Manager
Bradley J. Miller, CFA	Portfolio Manager
William P. Sterling, Ph.D.	Global Strategist
17 Equity Investment Professionals	**25** Average Years Experience

GW&K EMERGING MARKETS EQUITY STRATEGIES

EMERGING MARKETS EQUITY STRATEGY	Seeks long-term capital appreciation by investing primarily in companies located in emerging market countries
EMERGING WEALTH EQUITY STRATEGY	Seeks long-term capital appreciation by investing primarily in companies located in either developed or emerging markets which are exposed to, and derive revenue or profits from, emerging market countries

Following a strong rally in the first quarter, emerging market equities ended the second quarter with relatively flat performance as tepid economic reports and an escalation of trade tensions were offset by a dovish pivot by the Fed and other central banks. The flat performance for the second quarter masks considerable volatility within the quarter as markets responded negatively to a breakdown in U.S.-China trade negotiations in May. The trade impasse resulted in a tariff hike on $200 billion of China's exports from 10% to 25%, with the threat of more to come. Mexico was also threatened with higher tariffs before a sudden reversal by the Trump administration. Evidence mounted in the second quarter that the trade war was resulting in a significant slowdown in global manufacturing activity as supply chains were disrupted while businesses put capital spending plans on hold. However, emerging market equities were able to recover in June as investors correctly discounted that U.S. and China would agree at the end of the month to postpone further tariff hikes and resume negotiations.

The MSCI Emerging Markets Index increased by a modest 0.6% in the second quarter following a gain of 9.9% in the first quarter. In addition, the Index lagged the 4.0% second quarter gain in developed market equities as measured by the MSCI World Index. That left the emerging markets benchmark up for the year by 10.6% compared to a gain of 17.0% for the developed markets benchmark, with developed markets equities posting their strongest first-half gain since 1998. Not surprisingly, Chinese equities were a notable weak spot for emerging market equities, with the MSCI China Index declining by 4.0% in the second quarter in response to a U.S. tariff hike and tepid economic data. Although China had shown some signs in the first quarter that its economy was reaccelerating, a steady loss of its position in global supply chains has taken its toll on the country's export-oriented manufacturers. Even with the fragile trade truce that was established late in the quarter, it now seems likely that further monetary and fiscal stimulus will be required if China wants to maintain its growth rate close to its target range of 6.0% to 6.5%.

Sector performance for emerging markets in the quarter was mixed, with the main positive performance coming from interest-rate sensitive sectors like Financials, Consumer Staples and Utilities. Notably, all emerging markets sectors were positive in June, led by Consumer Discretionary, Information Technology and Communication Services. Those sectors had been the major underperformers in May when the U.S.-China trade war suddenly escalated. Apparently, market participants welcomed the temporary ceasefire in the trade war even though the major issues between the two superpowers are far from being resolved. Reflecting such uncertainty, it is notable that the flat performance of the emerging markets Information Technology sector for the second quarter was in sharp contrast to the 5.6% gain seen for the developed markets Information Technology sector.

Also demonstrating the key role of Asia-related trade concerns to recent emerging markets performance, the MSCI Emerging Markets Asia Index declined by 1.3% in the second quarter, while the MSCI Latin America and MSCI Europe, Middle East, and Africa (EMEA) Indexes both were up by 3.6% and 6.0%, respectively. As market participants began to price in three rate cuts by the Fed, beginning in July, Latin American and EMEA currencies were boosted against the U.S. dollar, with the lift from currency valuations helping emerging markets stocks in both of those regions to outperform developed markets stocks in the quarter.

The global growth outlook has clearly dimmed over the last quarter with only 39% of countries (16 of 41) with Purchasing Managers Indexes (PMIs) above 50, compared to 68% in April (28 of 41). The fragile trade war truce seems unlikely to reverse the slide in business confidence any time soon, but it still looks likely that global policy easing, supportive credit conditions, and solid consumer spending gains will permit the global expansion to bend but not break due to geopolitical factors. Against that backdrop, emerging markets equities continue to offer excellent relative value, with the MSCI Emerging Markets Index trading at 13.1 times estimated earnings for the next twelve months compared to 17.9 times for the S&P 500 Index.

"The fragile trade war truce seems unlikely to reverse the slide in business confidence any time soon, but it still looks likely that global policy easing, supportive credit conditions, and solid consumer spending gains will permit the global expansion to bend but not break due to geopolitical factors."

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