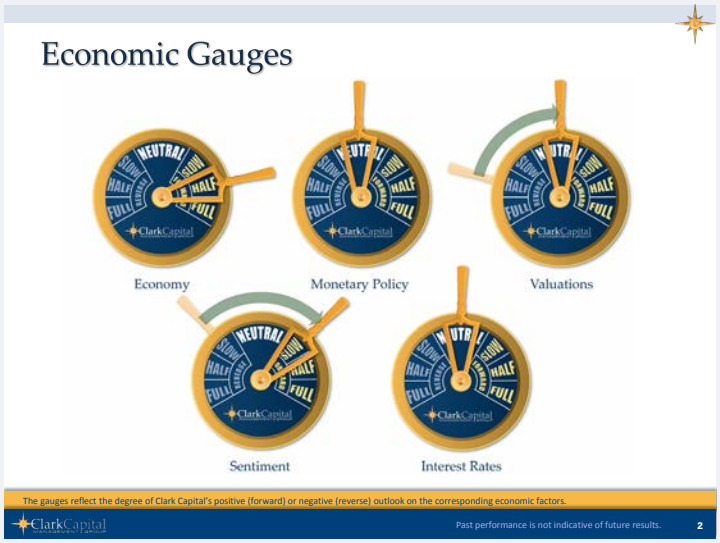
Clark Capital Management Group

Economic Review & Outlook

Video Transcript | First Quarter 2018

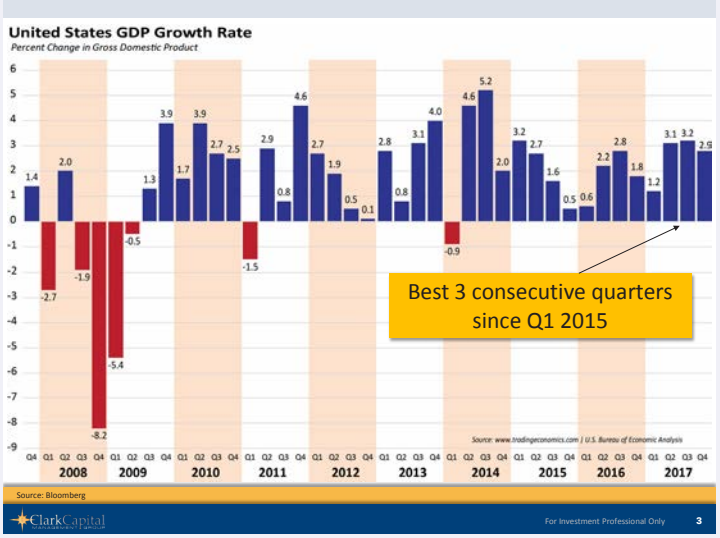
Thanks for joining me for a recap of the latest economic and capital market developments, as well as what we're seeing heading into the second quarter of 2018. So let's begin.



These gauges represent the five major areas that help shape our view for the overall economic environment, which in turn drives our expectations for the stock market. As a reminder, 12:00 is neutral. Anything to the right of 12:00 is positive for stocks, anything to the left of 12:00 is negative for stocks. We made adjustments to two gauges this quarter, improving the valuation gauge by two notches, which brings it to a neutral position and improving the sentiment gauge by two notches as well, moving it into slightly positive territory. The other three gauges remained the same, so we currently have wo gauges that are positive, three are neutral, and none that are negative. Overall, we are generally positive about the environment for stocks as we move into the second quarter of 2018.

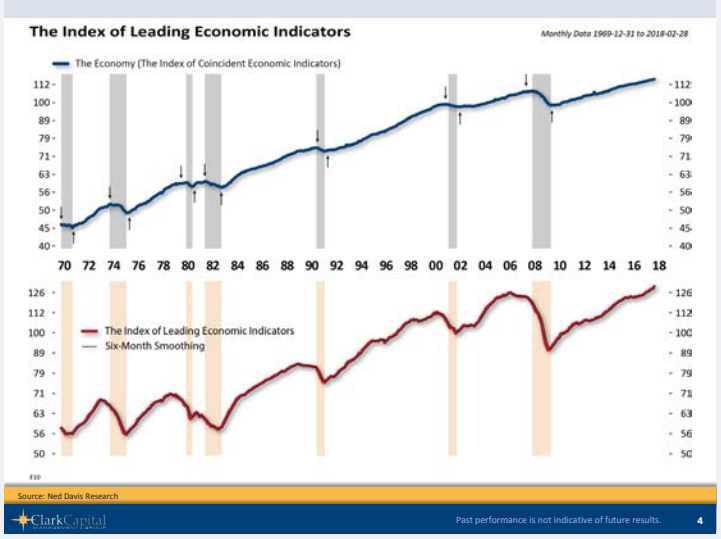
The opinions expressed are those of Clark Capital's Investment Team and are subject to change without notice.

First let's discuss the U.S. economy, which we believe will continue to expand this year and is a key driver providing a positive backdrop for stocks. We have been enjoying the third longest economic expansion in history and it is about to become the second longest historical period of economic growth.

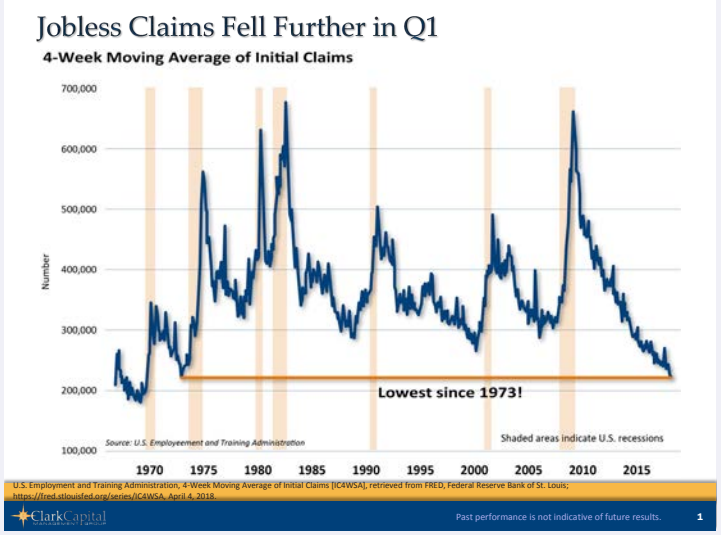


Additionally, the original release of 4th quarter 2017 GDP of 2.6% was disappointing and below the back-to-back quarters of 3-plus percent growth experienced during the second and third quarters of 2017. However, the third update to Q4 GDP, released in late March, was revised upward to 2.9% growth — showing the best three quarters of growth since the first quarter of 2015.

More importantly, economic indicators we look at that help project future economic growth, continue to show strength and are currently indicating no signs of a slowdown on the horizon. Those readings include the Leading Indicators Index, which remains near recent highs.



And Initial Jobless Claims, which are at their lowest (or best) levels since the early 1970s!



Additionally, the slope of the yield curve remains positive – a good sign since the yield curve has become inverted prior to every economic recession since the early 1960s.

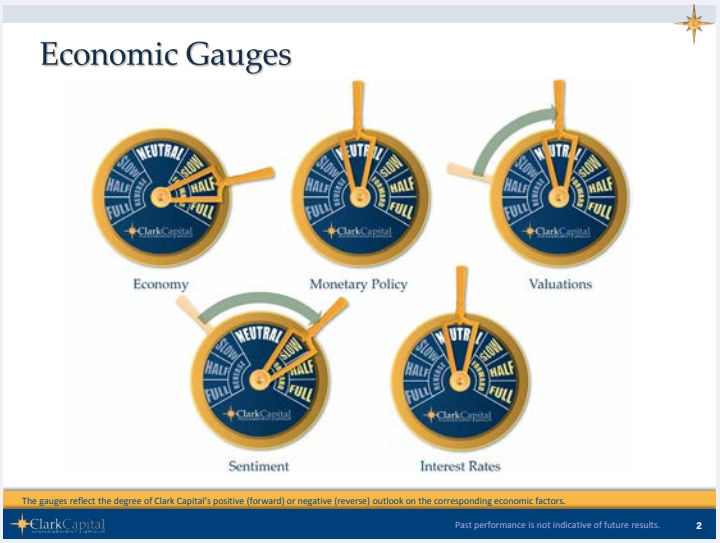
Overall, these important economic indicators indicate ongoing growth for the U.S. economy in 2018 and we believe the odds of a recession this year are very low at this point. This has important implications for our stock outlook, as the economy drives earnings and earnings drive stock prices.

Yield Curve Leading Up to Recessions: 1962 - 2017

	Yield Curve (bps)	
Start of Recession	At Start of Recession	52-Week Low
12/31/1969	-13	-45
11/30/1973	-61	-187
01/31/1980	-87	-208
07/31/1981	-20	-373
07/31/1990	61	-16
04/02/2001	72	-99
12/31/2007	79	-60
Current	101	98

Source: InvesTech Research

Past performance is not indicative of future results. 6



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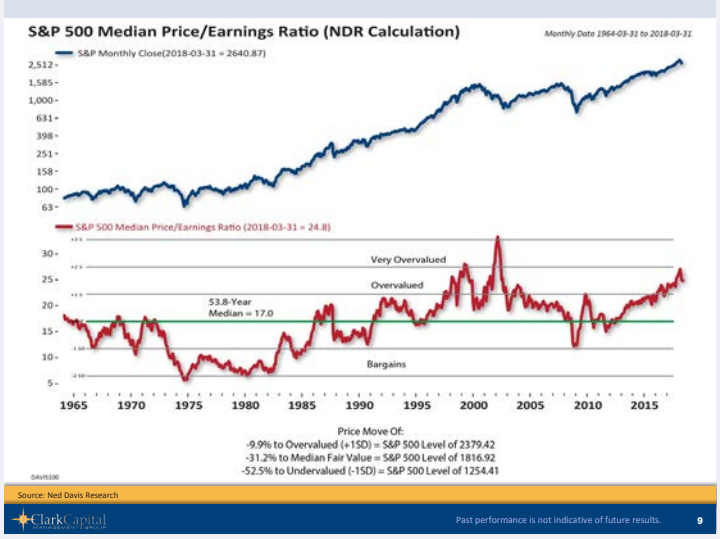
We keep the Monetary Policy gauge in a Neutral position moving into the second quarter. We expect much of the same out of the Federal Reserve (Fed) in 2018 as we have seen over the last couple of years — meaning a slow-paced and measured rate-hike cycle — we think the new leadership of Chairman Powell will be largely similar to that of Janet Yellen.

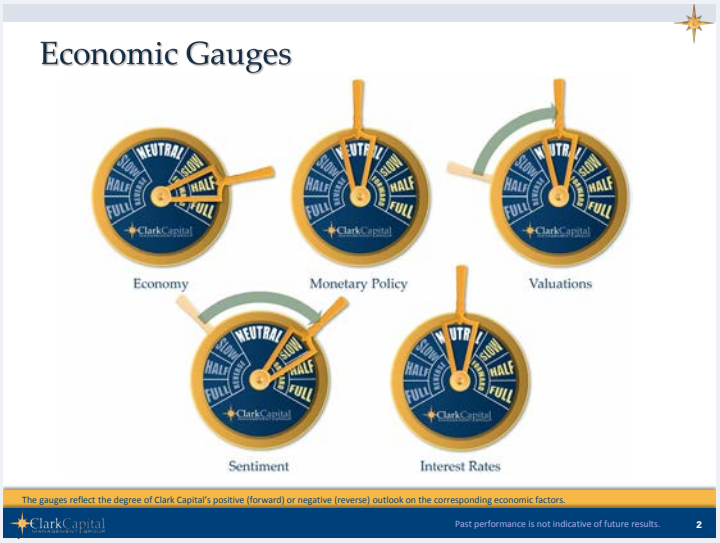
Valuations are next and we made a change to this gauge by bringing it out of negative territory and back to a Neutral posi-

tion for the first time in several quarters. What drove this decision? After this gauge had been in a negative position over the last couple of years due to stocks being expensive on an absolute basis by most fundamental measures, recent market action and strong expected earnings growth have now changed that math.

Higher earnings growth, helped in part by the recent business tax cuts and an improving economic environment, coupled with a stock market that declined during the first quarter, has caused the valuation measure to meaningfully improve.



If we think of a Price to Earnings ratio or a P/E ratio, the P or Price of stocks went down in the 1st quarter but the E or Earnings are expected to grow strongly in 2018. While the market is not necessarily cheap, we think valuations have improved enough to move this gauge back to a Neutral position.



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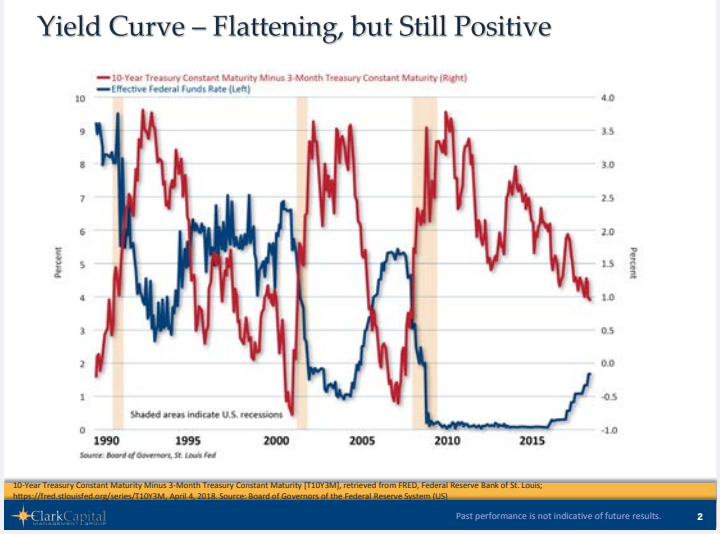
The next gauge is Sentiment, which can be thought of as a measure of speculation. We moved this indicator to a slight positive this quarter because the 10% correction we saw in stocks seemed to dampen some of the recent speculation in stocks, the cryptocurrency craze seems to be receding and some sentiment indicators are near pessimistic extremes. The complacency that seemed to enter the market during the 15 straight months of gains for the S&P 500 since the presidential election in 2016 through January of 2018 abruptly ended as elevated volatility and the first 10% correction in about two years have reintroduced fear to investors, which we think is an overall positive for the equity market environment.

Our final gauge is interest rates, which we leave in a neutral position. We certainly acknowledge that rates rose sharply at the beginning of 2018 with the yield on the 10-year U.S. Treasury hitting its highest level since early 2014 at around 2.95%.

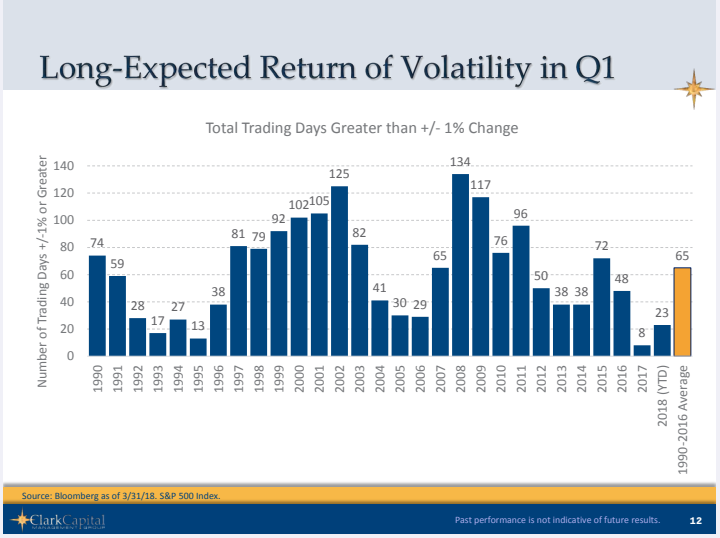
However, rates moved lower over the balance of the quarter and settled a little below 2.75% by quarter's end. This level for interest rates is still historically low, but we believe that interest

rates will continue to move higher over the next several quarters, but at a measured pace. One reason for a more measured increase in rates is the fact that many global interest rates, think Germany or Japan, are still significantly below the U.S. and we believe that will keep a lid on U.S. rates as our sovereign debt looks relatively attractive. At this point, we believe the level of interest rates is having a neutral effect on the U.S. economy and the slope of the yield curve remains positive — a historically good sign.



Moving to the capital markets…the S&P 500 declined over the first three months of 2018, the first quarterly drop for this widely followed index since the 3rd quarter of 2015. Although the quarter started with more record highs in January, February brought about the first 10% correction for the S&P 500 in about two years. While there were several large swings throughout the quarter, the overall decline in stocks was rather muted, with the S&P 500 ending the quarter down less than 1% on a total return basis from the end of 2017. So, although this index was down, the declines for the quarter were modest.

One of the key themes we have been discussing in recent quarters was our belief that volatility would likely return to more normal levels. In 2017, there were only eight days that the S&P 500 either gained or lost 1%. As this chart shows, the historical average from 1990 to 2016 is closer to 65 of those such days, and in the first quarter of 2018, we have already experienced twenty-three 1% days. While more volatile markets and corrections can be unsettling, we believe it is important to focus on business fundamentals and the underlying economy. Again, earnings are expected to grow at a double-digit clip in 2018 and the economy looks poised to continue to grow throughout the year.



Turning to bonds, the move higher in interest rates from the end of 2017 also left most fixed income indices down over the first quarter of 2018. Consistent with our belief that credit exposure is more desirable than interest rate exposure, U.S. Treasuries experienced the largest declines, while high-yield bonds performed better than many other fixed income indices on a relative basis. They also ended the quarter down, but, similar to the S&P 500 they too dropped less than 1% on a total return basis. Fixed income securities were granted a modest reprieve in March as interest rates fell as investors searched for a safe haven from equity volatility.

We continue to expect interest rates to gradually move higher and for the yield curve to flatten. As a result, we continue to favor credit exposure in our bond portfolios over pure interest rate risk. Rising interest rates are usually associated with an improving economy and an improving economy is usually associated with a lower probability of defaults. These conditions should support a stable or narrowing credit spread and help corporates outperform treasuries.

We believe active bond management should also be able to add value over passive, laddered bond portfolios in this type of environment.

Putting this all together, we continue to favor stocks over bonds, and we believe the long-term secular bull market is intact. Our forecast this year for the S&P 500 remains at 2,900, or about an 8.5% increase driven by double digit earnings growth and a modest contraction in multiples. But we continue to expect a more volatile period for markets after coming off a year when volatility was largely absent.

Overall, we believe the recent pullback in equities was a normal correction within a longer-term secular bull market. We believe the choppier recent period for markets are a return to more normal historical levels of volatility, and we think in the long run, fundamentals are what matter.

These are times for investors to stay focused on their long-term goals and objectives. These are also great times to hold review calls with clients, to help them remain committed to their plans and to ensure their investment allocations fall within their risk comfort zones.

Please contact your Investment Consultant to discuss how we can support your client reviews and how we can help you deliver successful outcomes to your clients.

Thanks for watching.

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