SARATOGA CAPITAL MANAGEMENT, LLC

THE ASSET ALLOCATION SPECIALISTS©

MIVI | ABOUT THE ANALYTICAL TOOL

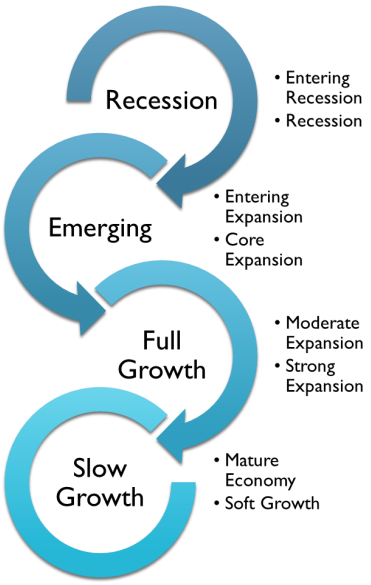
The statistics that comprise MIVI are the foundation of Saratoga Capital Management, LLC's asset allocation research. MIVI is an analytical tool comprised of over 50 macro-economic statistics, and is an acronym for the four main categories these underlying statistics fall into: monetary policy, interest rates, valuations and inflation statistics.

To analyze the capital markets, Saratoga primarily studies the historical and current relationships between economic developments and capital market trends. Our goal is to understand how various asset classes that make up the capital markets (e.g., large capitalization growth, financial services, international equity, etc.) might react in the current economic environment. MIVI helps paint a data-driven picture of current and past economic environments which we can use to shed light on the dynamic between various asset classes. This guides us in our determination for when it is appropriate to adjust our asset allocation strategies. Should the large capitalization growth sector be overweighted versus large capitalization value? Should equity sectors be underweighted versus fixed income sectors, in general? MIVI helps us answer these questions, and more.

GENERAL ECONOMIC OVERVIEW FOR 4Q18

As measured by Real Gross Domestic Product (GDP), the value of the production of goods and services in the United States (US) advanced by an annualized growth rate (AGR) of 3.4% during the third quarter of 2018. This was a decrease from the 4.2% AGR during the second quarter of 2018. The largest component of GDP is Personal Consumption Expenditures (PCE), which helps us to understand how the American consumer is doing; PCE continued its recovery in the third quarter after a rough start to the year. The Durable Goods and Non-Durable Goods segments of PCE both helped to push the Goods portion of PCE above a 4% AGR for the second quarter in a row. The Service sector within PCE is nearly twice the size of the Goods sector, and it makes up the largest portion of PCE. The Service sector had been lagging the other sectors of PCE, but returned to its long-run growth rate of just over 3% during the quarter, a decidedly positive sign for the economy at large. We continue to believe that growth in the domestic economy should be sustainable, though at a moderate pace. The Federal Reserve's restrictive monetary policy over the past several years will most likely slow economic growth in the US, though, for the time-being, we do not believe that the Fed has tightened enough to push the US into a recession over the near-term.

SARATOGA ECONOMIC STAGES



At the December 19, 2018 Federal Reserve Open Market Committee (the Committee) meeting, the Committee released the following statement, in part: "Information received since the Federal Open Market Committee met in November indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has remained low. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year… both overall inflation and inflation for items other than food and energy remain near 2%. Indicators of longer-term inflation expectations are little changed, on balance. The Committee judges that risks to the economic outlook are roughly balanced but will continue to monitor global economic and financial developments and assess their implications for the economic outlook."

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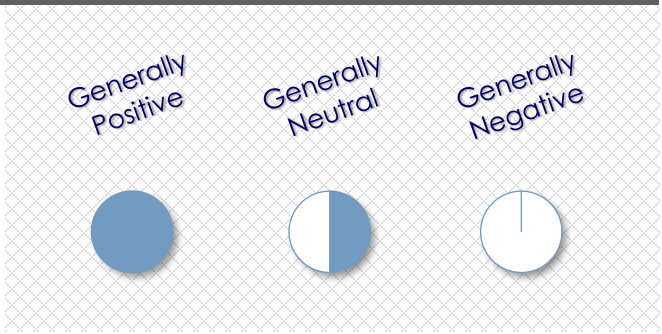

MONETARY POLICY

ASSET CLASS IMPACT	MONETARY POLICY COMMENTARY
STOCKS 	During the period, the Federal Reserve Open Market Committee raised the target range for the federal funds rate to 2.25 - 2.5%. Along with their rate scheme, the Federal Reserve's (Fed) monetary policy has been mostly restrictive over the past several years. The Fed has been draining total reserves of depository institutions at a rate of nearly $20 billion per month since August 2014. The federal funds rate found its last cycle low in January 2014, and has been climbing relatively unabated from that level since March 2014. The Fed announced its plan to increase the Federal Funds rate in December 2015, but the tightening had already begun. The Monetary Base topped at slightly over $4 trillion in August 2014, and as of December 2018 has fallen to just over $3.4 trillion. The growth rates of two money supply measures we use throughout our proprietary economic research, M2 and MZM, have both fallen into historically negative ranges relative to economic growth. We believe the Fed should be very cautious with further reductions in the money supply. Regarding the federal funds rate, we study the rate relative to both inflation and short-term/ intermediate-term interest rates. Our research there indicates that the current federal funds rate should be viewed by the Fed and investors as neutral. In that light, we believe the Fed should slowly increase the fed funds target range only in the face of significant renewed inflation.
BONDS 	

INTEREST RATES

ASSET CLASS IMPACT	INTEREST RATES COMMENTARY
STOCKS 	While most of the interest rate array has been increasing in a stable upward trend, short-term interest rates have been rising more rapidly than long-term rates, which has driven a declining yield curve spread. The monthly yield curve spread, as measured by the 10-year T-Note (10y TN) minus the 1-year T-Bill (1y TB), carved a fresh cycle low at 0.17 at the end of December, its lowest level since the beginning of 2007. It is widely known that an inverted yield curve often portends a negative stock market, so the spread's downward trend has worried many equity investors and economists alike. We don't believe the current spread level tells us much on its own. Other factors help to provide context: the size of the spread decline from its high, additional interest rate trends, and CPI should also be considered. In this context, we believe interest rates at current levels are neutral for stocks; if the yield curve becomes negative, however, and the Fed fails to provide evidence of relief from current tightening, then a sustained market correction is possible. Regarding long-term corporate bonds, the quality spread as measured by Baa bonds minus Aaa bonds has widened. The quality spread has historically been a good predictor of confidence in the corporate bond market; a widening spread could mean trouble for this segment of the market. As of December 2018, its spread was greater than 1.1. A quality spread at that level, along with the state of the yield curve, is likely driving some of the recent market volatility.
BONDS 	

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VALUATIONS

ASSET CLASS IMPACT	EQUITY VALUATIONS COMMENTARY
STOCKS 	As of December 31, 2018, the S&P 500 index sits at 2,506. Our proprietary valuation work uses both fundamental and technical analysis and provides justification for the S&P 500 at roughly 2,670, slightly below last quarter's figure, as corporate earnings continue to be strong, but have undergone some downgrades. In order to create a range of equity market outcomes, we use a valuation tool which we refer to as our Proper PE Valuation™ tool. Among other things, this analysis provides us with a set of ranges above and below which we consider the S&P 500 overvalued or undervalued, respectively. Our valuation tool currently sets an appropriate S&P 500 PE at 19. Additional analysis suggests that an appropriate S&P 500 fair-value range is roughly 2,525 to 2950. To us, fair-value means the stock market should perform within the parameter of its historic mean. The current level and direction of many economic statistics we enter our valuation algorithm indicate that we are likely to stay in fair value range for the near-term. We are watching corporate earnings growth closely, as changes in earnings data has the potential to change valuation levels quickly. Additionally, we are watching our technical indicators for signs that a market breakdown or breakout might be in the cards, as rapid movements in valuations are not unusual at this point in the economic cycle.
BONDS N/A	

INFLATION

ASSET CLASS IMPACT	INFLATION STATISTICS COMMENTARY
STOCKS 	We believe inflation should remain at a moderate rate of growth over the intermediate term. Historically, the employment private service providing sector's (EPSP) weekly earnings 12-month percent change, and its direction, have correlated well with CPI. EPSP has been trending up since May 2015, slightly leading a similar CPI trend. There is moderate and expected consumer demand-side upward pressure on inflation. The growth in the wages complex is building, putting more money in workers' pockets. This would normally concern us, but we see a balance in product and its demand. While the Consumer Price Index (CPI) has reached and surpassed the Fed's initial target of 2.0% and has remained above 2.0% since September 2017, growth has moderated significantly during the current cycle. As of December 2018, CPI is up only 2.18% y-o-y. When there is strong pricing pressure from the manufacturing sector it tends to lift most associated prices, which, in turn, tends to reinforce any extant wage growth, potentially triggering an inflationary cycle. Some previous inflation concerns were being driven by this potential dynamic, as the Producer Price Index (PPI) had exhibited a powerful upward trend at times; PPI, however, has recently been trending down from its upward path. The relatively static trends in both CPI and PPI is further evidence to us that the Fed should be very careful with its policy.
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