

Cyclicals, Large Caps to Pace Equities Leadership

Compelling investment ideas that turn insight into action

Multi-Asset Strategy Group

Jeffrey Sutton, CFA

Managing Director
Consulting Group

Anusha Rodriguez, CFA

Managing Director
Alternative Investments
Group

Gaal Surugeon, CFA

Senior Director
Asset Allocation

William Zhuang, CFA

Associate Director
Alternative Investments
Group

Michael Chan

Analyst
Asset Allocation

Market Observations

Since the U.S. presidential election on Nov. 8, 2016, there have been numerous references to “animal spirits,” the reflation trade and the “Trump trade.” What do they mean and how do they impact your investments? President Trump was elected largely on the platform of replacing the Affordable Care Act, personal and corporate tax reform, infrastructure spending and reduced regulation. The ensuing market rally was driven largely by proposed tax reform and infrastructure spending, which are expected to “reflate” the economy. The reflation trade has benefited certain sectors over others, especially through the end of February. Whether it’s animal spirits, reflation or the Trump trade, they all pretty much describe the same phenomenon.

Small-cap stocks—in sectors such as financials, industrials and materials—were the biggest beneficiaries. In fixed income, high-yield bonds also rallied on the post-election optimism. Generally, small-cap stocks have less multinational exposure, which gives them an edge over their large-cap peers. Financials saw their share prices rise due to the potential reduction in regulations. Meanwhile, industrials and materials rallied on the potential for increased spending on infrastructure. High-yield credit benefited because below-investment-grade companies would get tailwind of fiscal stimulus. Additionally, due to the reflation trade, the 10-year Treasury yield rallied 0.75% from just before the election to its peak on March 13, 2017.

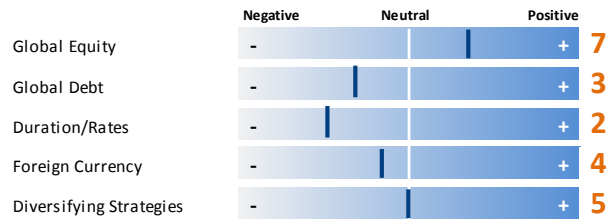
“...small-cap stocks have less multinational exposure, a key characteristic that would give small caps an edge over their large-cap peers.”

Five months into the new year, optimism seems to have waned, changes to health-care reform haven’t been successful, and investors may have concerns that tax reform and infrastructure spending might be watered down. Trade reform may prove to be more moderate than anticipated and enthusiasm over financial industry regulatory overhaul has calmed. The result? The market is dialing back expectations. More recently, U.S. large-cap stocks outperformed small-cap stocks, technology and health care became the top-performing sectors, emerging-market equities outperformed U.S. equities, and Treasury yields settled back down.

As we near the end of first quarter earnings season, a strong showing has supported the lofty valuations in the U.S. equity market. As the market hovers around record highs, the market is priced to perfection, in our opinion. As long as upcoming economic data continues to satisfy, a meaningful pullback could be averted as the Fed continues its path to normalization.

Investment Themes

An aggregation of our cross-asset views, incorporating relative valuations, macroeconomic data and fundamental factors.



Scale: 1-10

Asset Class Detail

Our sector-specific opinions derived from ongoing analysis of valuations, momentum, economics, business cycle, and fund flows.

● MASG View:

■ Negative
 ■ Slightly Negative
 ■ Neutral
 ■ Slightly Positive
 ■ Positive

Global Equity	
U.S. Large Cap	Valuations are expensive relative to long-term average but pro-growth fiscal policy is expected to provide earnings support for cyclical sectors such as industrials, materials, health care and technology. Larger multinationals stand to benefit from any short-term weakness in the U.S. dollar.
U.S. Small Cap	Stretched valuations entering the later stages of the economic cycle typically favor large-cap stocks over higher-beta small caps. Without a clear valuation benefit, the risk/reward payoff for the small-cap universe is negatively skewed.
Non-U.S. Developed	Earnings and growth prospects appear to be improving in Europe on the heels of continued ECB accommodation. However, political risks remain high across a number of core countries. Periods of downside volatility offer additional buying opportunities.
Emerging Markets	Valuations are attractive across much of the region and economic fundamentals are improving overall. However, global central-bank policy divergence, currency fluctuations and commodity price volatility all serve as near-term headwinds.
Global Debt	
Core Bond	Without a sufficient yield cushion in Treasuries, risks from rising rates and inflation do not adequately compensate a U.S. investor. However, we continue to emphasize the importance of maintaining a defensive core allocation in conservative-minded portfolios.
Investment Grade	Valuations have tightened in all U.S. credit segments and high-grade yields remain relatively low, diminishing the embedded yield cushion to offset rising rates. However, credit fundamentals appear to be on a solid footing amid pro-growth political agenda.
High Yield	High-yield spreads are rich, but investor risk appetites may extend the credit cycle further. The sector offers attractive carry and improving default metrics, supporting a slightly positive view. We emphasize the strong risk/reward opportunity in short-duration high yield.
Non-U.S. Developed	Despite elevated valuations, credit markets stand to benefit from continued ECB stimulus, effectively extending the credit cycle relative to the United States. We hold a negative view on low-to-negative yielding sovereign debt in much of Europe and Japan.
Emerging Markets	Emerging markets debt maintains a large yield advantage over developed markets, further supported by improving fundamental growth across Asia and Latin America. The sector has experienced less sensitivity to rising U.S. rates and strength in local currency against the dollar.
Diversifying Strategies	
Real Assets	Positive on MLPs which offer diversification from broader commodity prices. Correlations to crude oil prices have improved substantially since the bottom of the energy market in February 2016. Negative on REITs given their interest-rate sensitivity.
Macro	We have a positive view of fundamental macro strategies that capitalize on current market themes. We have a slightly negative view on managed futures strategies given continued short-term choppiness, which creates headwinds for trend followers.
Other Strategies	Catalyst-focused, event-driven strategies should benefit from continued corporate activity and potential increased cash balances from corporate tax repatriation. Low-net-exposure equity strategies should benefit as intra-asset class correlations are decreasing.

Global Equity



With U.S. equity valuations one standard deviation above their historical average, we maintain a positive, yet cautious, outlook for the asset class. Although future fiscal accommodation should support risk assets in the United States, the strong post-election rally has diminished any valuation cushion against bouts of uncertainty or volatility. While we have a fairly neutral view of U.S. equities, we have a bias towards cyclical-oriented sectors such as technology, financials, and industrials, resulting in a style tilt favoring value. Additionally, we have a more favorable view of large-cap stocks over small-cap stocks in the near term. While U.S. equities are above fair value overall in both segments, we believe that larger-cap multinational companies stand to benefit from the recent decline in the U.S. dollar. In addition, the Trump administration's proposed trade policy has been less aggressive than expected.

Today, we have a positive view of non-U.S. developed equities as we believe improving economic prospects, continued central-bank stimulus and attractive relative valuations should eventually propel risk assets in Europe and Japan. Key risks at this junction are political given the recent populist uprising, upcoming elections, and ongoing Brexit negotiations. We view any increase in volatility as additional buying opportunities.

In emerging-market equities, we maintain a neutral rating based on potentially asymmetric risk/reward opportunities. Valuations are attractive across much of the region and economic fundamentals are improving overall. However, longer-term risks of a stronger U.S. dollar, global central-bank policy divergence and volatility in commodity prices prevents us from holding a positive view on the asset class at this time. Given the rising consumer in many emerging-market economies, along with recent volatility in commodity prices, investments in emerging markets should have an emphasis on domestic consumption rather than commodity exports.

Global Debt



We have a slightly negative view of global debt overall, as the United States leads the charge of global reflation. We favor the U.S. credit market the most because we expect supportive economic data, positive fundamental earnings, rising interest rates and continued consumer optimism. While corporate valuations are expensive relative to long-term averages, high-yield spreads have some room to tighten further, as they are still ahead of the low levels reached in 2014. The segment's higher absolute yields offer enhanced protection against a rise in interest rates, cushioning the impact of price declines.

A potential increase in growth due to fiscal stimulus should spark inflation, and push interest rates higher. In that environment, we favor high-yield credit and high-quality, short-dated asset-backed securities, which offer better risk-adjusted returns than Treasuries. However, we continue to stress the importance of maintaining a core bond allocation in conservative-minded portfolios.

In Europe, central-bank policy remains supportive of credit by providing liquidity through low rates and European Central Bank bond-buying—despite elevated valuations. This supportive climate has established an extended credit cycle relative to the United States. However, there are significant political risks in Europe that may cause near-term volatility in the markets. Sovereign credits in Europe and Japan are unattractive, in our opinion, given the low to negative yields caused by aggressive monetary easing.

Emerging-market debt should continue to benefit from outsized yield advantages over developed economies, with a strong backstop of improving fundamentals and attractive local currency valuations. We strongly recommend active management for this market segment. Despite spreads being attractive on a relative basis, valuations are still fairly tight on an absolute basis and therefore warrant greater attention to fundamentals.

Duration/Rates



Despite a dramatic increase in 10-year yields since the U.S. election, which has now steadied into a trading range, we remain negative on U.S. Treasury bonds. Short-duration biases are recommended across all U.S. market segments as the Federal Reserve is expected to continue its gradual pace of raising interest rates. The relative yield differential between the United States and much of the developed world has led to notable foreign demand for U.S. Treasury bonds—effectively placing downward pressure on the back end of the yield curve. While this pressure may be a near-term boost to longer-dated bonds, a narrowing of the global policy gap could cause the yield curve to steepen.

Foreign Currency



The strength of the U.S. dollar has receded recently relative to most developed and emerging-market currencies as the reflation trade has stalled out. We remain bullish on the U.S. dollar in the face of fiscal and monetary policy reform once the reflation trade continues. Within developed and emerging-market bond exposure, we feel that local currency risk serves as a portfolio diversifier given the recent volatility in foreign exchange markets. Local currencies could be most useful in conservatively positioned portfolios to play the role of diversifier from hard currency fixed income investments.

Diversifying Strategies



Diversifying strategies attempt to provide complementary exposure to equity and bond exposure given the low correlations that exist along with minimal to no market beta. Including diversifying strategies in a portfolio should improve the efficient frontier and create better risk-adjusted returns. With low to no market beta, the return potential is based on the opportunity set that exists

for the specific investment. Given the complementary exposure that diversified strategies provide to a portfolio, we have a slightly positive view.

Overall, our view on real assets is neutral. Within the asset class, we remain positive on the energy sector through Master Limited Partnerships, which offer diversification from broader commodity prices due to their midstream posture and stable revenue business model. Correlations in the sector have improved substantially since the bottom of the energy market in February 2016. We continue to view REITs negatively as they are sensitive to rising interest rates. We have a neutral view on infrastructure, which has favorable tailwinds from fiscal spending but also the headwind of high valuations.

We believe catalyst-focused, event-driven strategies are currently attractive given continued corporate activity and the potential for increased cash balances from corporate tax repatriation. These low-beta strategies allow investors to access corporate equity and credit markets with less valuation risk. Similarly, the opportunity set for low-net-exposure equity strategies, which prioritize alpha over beta, is improving as intra-asset class correlations are decreasing. That leads to increased dispersion between individual stocks.

We have a slightly negative view on managed futures strategies. Continued short-term choppiness within markets creates headwinds for medium- to long-term trend followers. Additionally, many of these managers are currently positioned pro-cyclically, thus diminishing their expected diversification benefits. However, given their ability to quickly reposition and their historical success, we continue to monitor the managed futures space closely.

Within diversifying strategies—given their broad definition—it's also important to keep in mind that underlying manager positioning and performance can vary widely.

Actionable Investment Ideas

Contact your Oppenheimer & Co. Inc. Financial Advisor to determine your suitability and to discuss these recommendations in more detail.

Global Equity

“...we have a bias towards cyclical-oriented sectors such as technology, financials and industrials, resulting in a style tilt favoring value.”

Types of strategies available at Oppenheimer Asset Management to consider:

US Deep Value

Large- and mid-cap deep value strategy that is fully invested with a focused on “analyzable” quality businesses that should earn high returns on invested capital.

US Contrarian Value

Contrarian value approach with meaningful participation across most industries, focused on fundamental valuations with flexibility to raise cash.

US All Cap Core

A high-conviction, highly concentrated portfolio of U.S. stocks representing all market capitalizations that seeks to deliver absolute returns without being tethered to a benchmark.

“We have a positive view of non-U.S. developed equities as we believe improving economic prospects, continued central-bank stimulus and attractive relative valuations should eventually propel risk assets in Europe and Japan.”

Types of strategies available at Oppenheimer Asset Management to consider:

International Growth

A concentrated, unconstrained international growth portfolio leveraging a top-down and bottom-up research process that seeks to neutralize economic and interest-rate sensitivity.

International Value

An international, contrarian value portfolio largely invested in developed markets with flexibility to seek opportunistic emerging-market exposure, all through the lens of in-depth fundamental analysis.

“...the opportunity set for low-net-exposure equity strategies that prioritize alpha over beta is improving as intra-asset class correlations are decreasing, leading to increased dispersion between individual stocks.”

Types of strategies available at Oppenheimer Asset Management to consider:

Sector-Specific Long/Short

Sector-specific long/short equity strategies that are driven by fundamental research that are affected by structural changes within the sectors, without taking significant directional market exposure.

Global Growth

A global long/short growth equity strategy that seeks to generate returns through a diversified portfolio of high- quality, growth-oriented long investments and low- quality, slow-growth alpha short positions.

Global Debt

“A potential increase in growth due to fiscal stimulus should spark inflation, and thus increase interest rates. In that environment, we favor high-yield credit and high-quality, short-dated asset-backed securities that offer better risk-adjusted returns than Treasuries.”

Types of strategies available at Oppenheimer Asset Management to consider:

US Unconstrained Bond

This strategy seeks income and downside protection through top-down sector rotation and bottom-up security selection. Tactical sector weightings drive the fund’s effort to participate in both credit and interest-rate up-cycles by rotating between sectors with historically low correlations.

US Defensive Core Fixed

A flexible multi-sector bond portfolio focusing on capital preservation through fundamental risk management. The portfolio will maintain a large exposure to high quality asset-backed securities and limited corporate credit risk.

“Emerging-market debt should continue to benefit from outsized yield advantages over developed economies, with a strong backstop of improving fundamentals and attractive local currency valuations.”

Types of strategies available at Oppenheimer Asset Management to consider:

Unconstrained Global Bond

An unconstrained global fixed-income strategy that seeks total return through value investing and actively managing duration, yield curve and volatility.

Emerging Market Debt

Predominantly emerging market corporate debt in hard currency (USD) with a large bias towards Latin America.

Unconstrained Global Bond

Focuses on allocating across three risk buckets: duration, currency, and sovereign credit. A majority of risk is currently allocated to foreign currency, with exposure to both developed and emerging market currencies.

Diversifying Strategies

“...we remain positive on the energy sector through MLPs, which offer diversification from broader commodity prices due to their midstream posture and stable-revenue business model.”

Types of strategies available at Oppenheimer Asset Management to consider:

MLP and Energy Infrastructure

Domestic energy infrastructure fund (RIC) with high current income and growth potential from a meaningful General Partner exposure.

“We believe catalyst-focused, event-driven strategies are currently attractive given continued corporate activity and the potential for increased cash balances from corporate tax repatriation.”

Types of strategies available at Oppenheimer Asset Management to consider:

Event Driven

An equity and credit event driven strategy in which returns are driven by a portfolio of global, announced corporate merger situations and distressed European credit investments.

“...the opportunity set for low-net-exposure equity strategies, which prioritize alpha over beta is improving as intra-asset class correlations are decreasing, leading to increased dispersion between individual stocks.”

Types of strategies available at Oppenheimer Asset Management to consider:

Global Equity Market Neutral

A dollar neutral global equity long/short fund using a fundamental value approach in the long book and a quantitative approach in the short book focusing on valuation, earnings growth, momentum, and financial strength.

Equity & Credit Long/Short

An equity and credit deep-value strategy in which returns are driven by opportunistically investing across sectors, geographies and market capitalizations to find securities with substantial mispricing.

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Adopting a fee-based account program may not be suitable for all investors; anticipated annual commission costs should be compared to anticipated annual fees.

Risk Factors

The success of an investment program may be affected by general economic and market conditions, such as interest rates, the availability of credit, inflation rates, economic uncertainty, changes in laws and national and international political circumstances. These factors may affect the level and volatility of securities prices and the liquidity of a portfolio's investments. Unexpected volatility or illiquidity could result in losses.

Investing in securities is speculative and entails risk. There can be no assurance that the investment objectives will be achieved or that an investment strategy will be successful.

Special Risks of Foreign Securities

Investments in foreign securities are affected by risk factors generally not thought to be present in the US. The factors include, but are not limited to, the following: less public information about issuers of foreign securities and less governmental regulation and supervision over the issuance and trading of securities. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Special Risks of Small and Mid Capitalization Companies

Investments in companies with smaller market capitalization are generally riskier than investments in larger, well established companies. Smaller companies often are more recently formed than larger companies and may have limited product lines, distribution channels and financial and managerial resources. These companies may not be well known to the investing public, may not have significant institutional ownership and may have cyclical, static or moderate growth prospects. There is often less publicly available information about these companies than there is for larger, more established issuers, making it more difficult for the Investment Manager to analyze that value of the company. The equity securities of small and mid capitalization companies are often traded over-the-counter or on regional exchanges and may not be traded in the volume typical for securities that are traded on a national securities exchange. Consequently, the Investment Manager may be required to sell these securities over a longer period of time (and potentially at less favorable prices) than would be the case for securities of larger companies. In addition, the prices of the securities of small and mid capitalization companies may be more volatile than those of larger companies.

Special Risks of Fixed Income Securities

For fixed income securities, there is a risk that the price of these securities will go down as interest rates rise. Another risk of fixed income securities is credit risk, which is the risk that an issuer of a bond will not be able to make principal and interest payments on time.

Special Risks of Master Limited Partnerships

Master limited partnerships (MLPs) are publicly listed securities that trade much like a stock, but they are taxed as partnerships. MLPs are typically concentrated investments in assets such as oil, timber, gold and real estate. The risks of MLPs include concentration risk, illiquidity, exposure to potential volatility, tax reporting complexity, fiscal policy and market risk. MLPs are not suitable for all investors.