8 Themes for '18

Compelling investment ideas that turn insight into action

Multi-Asset Strategy Group

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Aging Market Cycle Poses Risk and Reward

With U.S. equity valuations one standard deviation above their historical average, we maintain a positive—yet increasingly cautious—outlook for the asset class. Similarly, the credit cycle continues to tread water as corporate bond spreads approach pre-crisis levels. The catalyst for the market advance has shifted from monetary stimulus to a combination of fiscal stimulus and strong corporate earnings. These catalysts should support risk assets in the United States in the near term. However, the strong rally in 2017 has further reduced the valuation cushion left to protect against bouts of uncertainty or volatility in the new year. This could create tailwinds for active managers who have a contrarian view or a short portfolio.

Value to Regain Ground Against Growth

In 2017, the Russell 1000 Growth outperformed the Russell 1000 Value by roughly 17 percentage points (30.2% vs. 13.6%) as the information technology sector rallied close to 40% in the period. This represents a one standard deviation dispersion between the two indices, the largest since the 2001 tech bubble, and marked a reversal from 2016 when the value style was a strong performer. We have a favorable outlook for value, as we believe there are strong upside prospects for certain sectors within the value factor such as financials (32% weighting) amid lower corporate tax rates and a rising rate environment in 2018. However, a favorable view of the value factor in 2018 should not be at the expense of abandoning the growth factor, as active managers who are aware of the factor exposures in their portfolio can manage risk accordingly.

Next-Generation Fed in Focus

Amid strong economic data and limited inflation pressure, the Federal Reserve is signaling another three rate hikes in 2018. Despite the transparent and calculated response of the Fed to this point, uncertainties remain under the new oversight of Jay Powell and a highly modified FOMC. Assuming incoming Chairman Powell attempts to maintain the status quo, our expectations will remain mostly unchanged for the path of monetary policy. As a result, we expect a gradual rise in interest rates heading into next year with the wild card being inflation. If inflation surprises to the upside, then the Fed may need to become more aggressive with rates.

Increased Corporate Activity

According to Fed data, U.S. nonfinancial corporations held a record $2.36 trillion in liquid assets as of the end of the third quarter, up nearly 60% since the recession ended in 2009. A large percentage of these assets are held overseas. With uncertainty over tax reform no longer an issue with the passage of the Tax Cuts and Jobs Act of 2017, we believe companies are likely to capitalize on the favorable interest-rate and tax environment in 2018 with capital investments and repatriation.

Merger arbitrage strategies are expected to benefit from increased corporate deal flow and attractive arbitrage spreads.

Euro-Zone Recovery Intact

Due to a 25% run-up for the MSCI EAFE Index and ongoing geopolitical wrinkles facing the region, we expect moderate upside in 2018. However, continued central-bank accommodation and corporate earnings growth keep the region at the top of our favorites list for next year. Relative to the United States, we believe European equities will better capitalize on an extended global business cycle.

Emerging-Market Momentum

Emerging-market equities outperformed developed markets in 2017 amid healthier economies, improving earnings growth and more attractive valuations relative to U.S. and non-U.S. developed market equities. We expect this momentum to continue into 2018. The biggest risk that could derail this momentum in our view is a threat of rising inflation forcing the Fed to tighten more aggressively than expected.

U.S. Dollar to Shine

After underwhelming performance in 2017, we expect the dollar to be highly favored in the coming year as the global interest rate differential widens. This is likely to propel the dollar against developed market counterparts, such as the euro and yen. However, we favor emerging-market currencies largely on the back of continued global growth.

MLPs to Fuel Energy Renaissance

We remain steadfast in our positive view of the midstream energy space and prospects for a recovery in master limited partnerships. Broadly, MLPs have experienced a declining correlation to oil-price volatility and are trading at cash-flow multiples below historical averages. Fundamentals also continue to show promise, as the Energy Information Administration predicts volumes for crude oil and natural gas to increase considerably in coming years.

Asset Class Detail

The Multi-Strategy Asset Group’s sector-specific opinions are derived from ongoing analysis of valuations, momentum, economics, business cycle and fund flows.

MASG View:
Negative   Slightly Negative   Neutral   Slightly Positive   Positive   ↓ Weakening   ↑ Improving

Global Equity		
Current View		
		U.S. Large Cap – While valuations have become increasingly elevated, we believe the market can continue its rally as long as lofty expectations are met by strong economic data and corporate earnings growth. However, if there are disappointments, or inflation awakens from its slumber, some turbulence among equities could appear. The value style factor is preferred over growth due to more reasonable valuations and tailwinds to the financials and energy sectors.
	↑	**U.S. Small Cap –** Similar to large-cap stocks, valuations are elevated among small-cap equities in the United States. However, there appears to be upside potential embedded in the newly passed tax reform, which could provide a sizable boost to small-cap earnings via reduced corporate tax burden.

Non-U.S. Developed – Relatively attractive valuations, corporate earnings and economic growth should prove supportive of the euro zone in 2018. Additionally, while major political risks have largely abated in Europe, we continue to monitor Brexit developments. Small-cap exposure abroad may provide enhanced alpha generation and added diversification.

Emerging Markets – Valuations are attractive across much of the region and economic fundamentals are improving overall. However, less accommodative global central-bank policy, China growth concerns, currency fluctuations and commodity price volatility all serve as near-term risks.

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 a pro-growth fiscal agenda and tax reform.

High Yield – High-yield spreads are at historically low levels, despite investor risk appetites continuing to extend the credit cycle further. While the sector offers attractive carry and improving default metrics, we hold a neutral view on the basis of unattractive valuations. We emphasize the stronger risk/reward opportunity remaining in short-duration high yield.

Non-U.S. Developed – Elevated valuations and less accommodative monetary policy could put pressure on credit markets. We hold a neutral view on European corporate credit and a negative view on low-to-negative yielding sovereign debt in much of Europe and Japan.

Emerging Markets
Beyond high absolute yields, strong global growth and improving corporate earnings growth offers notable upside price potential not found in most richly valued developed markets. While fundamental growth across Asia and Latin America has improved, volatility could be stirred up by evolving monetary policy among major developed economies.

Diversifying Strategies

↑ **Real Assets –** Positive on MLPs, which offer diversification from broader commodity prices and unique exposure to the energy renaissance. While drawdowns may occur within crude oil's trading range, we believe that supply/demand dynamics will shift toward reduced supply with continued demand growth and gradually push the trading range higher. We are neutral on REITs and U.S. infrastructure as their interest-rate sensitivity may offset any potential gains from fiscal spending and tax reform.

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 potential for short-term choppiness, which creates headwinds for trend followers.

Other Strategies – We hold a positive view on catalyst-focused, event-driven strategies as companies are likely to capitalize on a favorable interest-rate and tax environment through capital investments and repatriation. Low-net-exposure equity strategies and deep value strategies should benefit as intra-asset class correlations are decreasing.

NOTE: No arrow reflects no change in view

Global Equity

With U.S. equity valuations 1.5 standard deviations above their historical average[3], we maintain a positive—yet increasingly cautious—outlook for the asset class. Despite such elevated valuations, the U.S. stock market may continue its rally as long as lofty expectations are met by strong economic data and corporate earnings. However, if there are disappointments, or inflation awakens from its slumber, some turbulence among equities could appear. Although we have a fairly neutral view of U.S. equities, the strong outperformance of growth stocks in 2017 has resulted in a shift to a value style bias as we anticipate outperformance in the financial and energy sectors.

Additionally, we have upgraded our view on small caps slightly heading into 2018. While valuations are expensive in large-cap and small-cap segments alike, smaller companies may stand to benefit most from corporate tax reform. Large multinational companies have plenty to gain from a continued decline in the U.S. dollar and repatriation benefits for offshore cash; however, these may prove to have less of a direct impact on bottom-line earnings growth than for small- to mid-sized companies. Given high market valuations, we also have a positive outlook on long/short equity strategies that provide the ability to dampen volatility during market downturns through alpha short positions and active portfolio management.

"…international small-cap exposure could be a good diversifier to large-cap exposure given the idiosyncratic aspects of the market segment."

We continue to hold a positive view of non-U.S. developed equities as we believe improving earnings growth and economic prospects should continue to propel risk assets in much of Europe and Japan despite increased valuations. Key risks at this junction include protectionary trade policy, less accommodative monetary policy, political instability and uncertainties facing the Brexit negotiations. Given heightened valuations, international small-cap exposure could be a good diversifier to large caps given the idiosyncratic aspects of the market segment. We view any increase in volatility as an additional buying opportunity.

In emerging-market equities, we maintain a neutral rating based on negatively skewed risk/reward opportunities. Valuations are attractive across much of the region and overall economic fundamentals are improving. However, longer-term risks of less accommodative global central bank policy, currency fluctuations, growing pains in China and ongoing commodity-price volatility prevents us from holding a positive view on the asset class at this time. Given the rising middle-class consumer in many emerging-market economies,[4] 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. Within U.S. fixed income, we believe corporate credit could see a continuation of modest positive returns primarily through coupon clipping, as long as fundamentals remain strong and defaults remain subdued. We expect minimal spread compression from this point forward. In theory, a potential increase in economic growth due to fiscal stimulus should spark inflation and push interest rates higher. In that environment, we favor short-duration, 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, elevated valuations and less accommodative monetary policy could put pressure on credit markets in 2018. We hold a neutral view on European corporate credit and a negative view on low-to-negative yielding sovereign debt in much of Europe and Japan. The current climate has become less supportive of credit, but as in the United States, continued demand for yield could extend the credit cycle. 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. While fundamental growth across Asia and Latin America has improved, volatility could be stirred up by evolving monetary policy among major developed economies.

Duration/Rates

Interest-rate movements were largely the product of Fed activity in 2017, as the curve flattening brought the spread between 10-year and 2-year yields to their lowest levels since October 2007. While a flattening or inversion of the yield curve typically signals slower economic growth or recessionary fears, the market appears to be largely discounting these risks at the moment. The primary reason, we believe, is due to the lack of inflationary pressure on economic growth.

Over the past few years, 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 pushing down the long-end of the yield curve. However, a narrowing of the global policy gap or sudden bout of inflation pressure could cause the yield curve to steepen. As a result, we continue to recommend short-duration biases across all U.S. market segments as the Fed is expected to continue its gradual pace of tightening and balance sheet reduction.

Foreign Currency

After depreciating against most developed and emerging-market currencies in 2017, we expect the U.S. dollar to stabilize with the potential reemergence of the reflation trade. A continuation of the Fed's pace of rate hikes in 2018, combined with the fiscal policy kicker of tax reform, could bring about a steeper yield curve. However, the scope of the reflation trade is not a certainty at this point and local currency exposure could be most useful in conservatively positioned portfolios to play the role of diversifier from hard currency fixed income investments. We favor emerging market currencies against the U.S. dollar, but remain more constructive on the greenback over lower-yielding developed market currencies.

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. We believe including diversifying strategies in a portfolio improves the efficient frontier and creates 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. For these reasons, we maintain a slightly positive view on diversifying strategies.

Overall, our view on real assets is neutral. Within the asset class, we remain positive on the energy sector through MLPs as we believe that supply/demand dynamics will shift toward reduced supply with continued demand growth. We continue to view REITs negatively as they are sensitive to rising interest rates. We are leaning toward a negative view on infrastructure. While infrastructure has favorable tailwinds from fiscal spending, valuations are high and some infrastructure investments within utilities could be sensitive to rising rates.

"…event-driven strategies are currently attractive and poised to take advantage of increasing corporate deal flow and a favorable interest-rate and tax environment."

We believe catalyst-focused, event-driven strategies are currently attractive and poised to take advantage of increasing corporate deal flow and a favorable interest-rate and tax environment. 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 and deep-value-oriented strategies, which prioritize alpha over beta, is improving as intra-asset class correlations are decreasing.[5] That often 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, especially within equity markets, thus diminishing their expected diversification benefits. However, we continue to monitor managed futures closely because of their ability to quickly reposition.

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

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 United States. 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 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. 2005264.1