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Time for a Market Rotation?

Compelling investment ideas that turn insight into action

Multi-Asset Strategy Group

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Market Observations

Equity markets continued their advance globally during the third quarter. In our opinion, improved corporate earnings, fairly good economic data and low interest rates have continued to support high—and growing—equity multiples around the world. Despite hurricanes and the war of words between the United States and North Korea, market volatility remained within a low, fairly tight range during the quarter.

Growth-oriented stocks, which became the momentum trade early in the year, led the market higher during the third quarter. However, value stocks overtook growth stocks in September, which could mark the beginning of a rotation. The value indices were driven by the energy sector, which was the best-performing segment globally in September as the price of crude rose from a low in the second quarter and hit bull-market territory in the third quarter.

Similarly, international and emerging-market stocks led the equity advance for the quarter as the MSCI EAFE index returned 5.4% and the MSCI EM index returned 7.9%, outpacing the S&P 500 index return of 4.5%. However, September favored U.S. stocks, a reversal of what had occurred year-to-date through August. Additionally, in the United States, we saw small- and mid-cap stocks outperform large-cap stocks.

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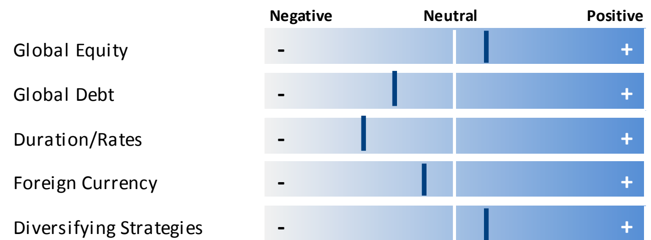
The 10-year Treasury finished the month yielding 2.33% after beginning the quarter yielding 2.30%. The yield got as low as 2.06% on Sept. 8 before bouncing back on anticipation that inflation could pick up. Additionally, the U.S. dollar's slide, which is down 8.9% year-to-date as per the U.S. Dollar Index, stalled in September. Instead, the U.S. Dollar Index rose 0.4% in the month of September, indicating that the dollar was strengthening. The weakening dollar throughout the year was due to concerns about continued slow growth and the lack of fiscal policy coming out of Washington D.C.

The rotations taking place within the equity markets in September seem to have been driven by a reemergence of the reflation trade. An increase in the probability of another Federal Reserve rate hike in December, the unwinding of the Fed's balance sheet and Congress beginning work on a potential tax overhaul could signal the beginning of a rotation to new market leadership. The prospects for an upcoming rate hike helped to increase Treasury yields and strengthen the U.S. dollar. Potential for corporate tax reform and increasing rates have boosted the financial sector, which stands to benefit from a steeper yield curve. Small-cap stocks could benefit most from a corporate tax cut. These events are similar to the reflation trade that began to take shape following the November presidential election. That reflation trade, however, ended up being short-lived as the Trump administration and Congress encountered gridlock when trying to enact legislation.

If the Trump administration and Congress have success implementing tax reform, and if there is enough economic growth to spur inflation and further Fed rate hikes, the reflation trade could have legs this time around.

Investment Themes

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



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 – Valuations are expensive relative to the long-term average but pro-growth fiscal policy is expected to provide earnings support for cyclical sectors such as industrials, materials, health care, financials and technology. Larger multinationals should benefit from dollar weakness.

U.S. Small Cap – Stretched valuations entering the later stages of the economic cycle typically favor large-cap stocks over higher-beta small caps. However, if federal tax reform takes hold it could benefit small-cap stocks.

Non-U.S. Developed – Earnings and economic growth have gained momentum in Europe. Therefore, the BoE and ECB are expected to become less accommodative, likely resulting in upward momentum for the pound and euro. Additionally, major political risks have largely abated in Europe; however, we continue to monitor Brexit negotiations and upcoming elections in Italy. Small-cap exposure 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, protectionist U.S. policies, 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 political agenda.

High Yield – High-yield spreads are near historically tight levels, despite investor risk appetites continuing to extend the credit cycle further. While the sector offers attractive carry and improving default metrics, we move to 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
Albeit highly attractive in absolute terms, the emerging-market debt yield advantage over developed markets has begun to weaken. 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 continue to occur within crude oil's trading range, we believe that supply/demand dynamics will shift toward reduced supply with continued demand growth. Negative on REITs and U.S. infrastructure due to 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 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 one standard deviation above their historical average[3], we maintain a positive, yet increasingly cautious, outlook for the asset class. Although future fiscal accommodation should support risk assets in the United States, the strong rally through the first three quarters has reduced the valuation cushion left to protect against bouts of uncertainty or volatility. While we have a fairly neutral view of U.S. equities, we have a bias toward cyclical-oriented sectors such as technology, financials and industrials, resulting in a barbell-style positioning favoring both value and growth.

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 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 initially expected. Nonetheless, if tax reform is implemented, then it could benefit small-cap stocks most given that they tend to have a higher effective tax rate than larger-cap stocks. Given high market valuations, we also have a positive outlook on long/short equity strategies that provide corporate equity exposure with 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-cap exposure given the idiosyncratic aspects of the market segment. We view any increase in volatility as additional buying opportunities.

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. 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, continued demand for yield could extend the credit cycle into extra innings. The segment's higher absolute yields offer enhanced protection against a rise in interest rates, cushioning the impact of price declines in response to planned Fed tightening.

In theory, a potential increase in 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. 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—although reduced—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

The 10-year Treasury yield may continue to rise if the reflation trade takes hold. 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 raising rates and shrinking its balance sheet. 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 limiting the steepening of the yield curve. There is the potential risk, however, that a narrowing of the global policy gap or sudden bout of inflation pressure could cause the yield curve to sharply steepen.

Foreign Currency

After depreciating for much of the year relative to most developed and emerging-market currencies the U.S. dollar seems to have stabilized with the potential reemergence of the reflation trade. The central bank synchronization theme discussed last quarter may be replaced with an appreciating U.S. dollar if the Fed continues on its pace of three rate hikes this year and three more rate hikes in 2018 along with a fiscal policy kicker of a tax overhaul or tax cuts. If the U.S. reflation trade has legs, then the local currency risk embedded within developed and emerging-market bond exposure may not be ideal. However, the scope of the reflation trade is not a certainty at this point and 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. 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 master limited partnerships 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 towards 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.

"…the scope of the reflation trade is not a certainty at this point and local currencies could be most useful in conservatively positioned portfolios to play the role of diversifier from hard currency fixed income investments."

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 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.

NOTES:

[1] *Source: FactSet. Data as of 9/30/2017.*
[2] *Source: FactSet. Data as of 9/30/2017.*
[3] *Source: FactSet. Data reflects 10-year period ending 9/11/2017.*
[4] *"Hitting the sweet spot: The growth of the middle class in emerging markets" Ernst & Young 2013*
[5] *"Shifting Tides: Correlations and Multi-Asset Investing" Oppenheimer Asset Management April 2017*

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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. OAM101717CM6