Rocaton

INSIGHTS

2017 Capital Market Outlook

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Executive Summary

At the end of 2015, we published our first capital market outlook (link). The second installment of this publication provides a look ahead to 2017 and a review of our themes from this past year. As you will notice, many of our themes are influenced by the recent U.S. election results. The impact of our themes for next year will vary by portfolio, but may impact investors of all types.

Rocaton's 2017 Themes

Figure 1:

Rocaton's 2017 Themes, Key Takeaways and Portfolio Strategies

Theme	Key Takeaway	Portfolio Strategy
Political uncertainty	We believe political uncertainty will increase market volatility	In our view, municipal bonds currently present a compelling investment case for taxable investors
Improving global growth prospects	We believe faster economic growth in the U.S. could be a tailwind for the rest of the global economy	We would encourage investors to remain diversified and not stretch for yield or return in ways inconsistent with long-term objectives or risk tolerance
Renewed focus on inflation	Market participants are expecting higher inflation, but we believe actual inflation will remain modest	We would not suggest increasing allocations to U.S. TIPS or other inflation sensitive assets
Equity market uncertainty	Although U.S. equity market valuations remain elevated, we see the potential for further upside next year	For investors with underweight positions in U.S. equities (relative to target weights), we would suggest covering the underweight
Financials	In our opinion, higher interest rates and the potential for de-regulation will be tailwinds for the financial sector	We believe equity investors should consider investments in financials while fixed income investors, both taxable and tax-exempt, should consider preferred securities

Political Uncertainty May Create Additional Volatility

Surprising results in the U.S. election and the 'Brexit' referendum are emblematic of the volatility caused by political events around the globe. Further political uncertainty could weigh on markets during 2017. U.S. President-elect Donald Trump's transition will be followed closely to track which of his election campaign promises will be enacted once in office and what his Cabinet will look like. Protectionist policies have the potential to cause sell-offs in emerging markets and changes to personal income tax rates may negatively impact municipal bonds. There is the potential for upside as infrastructure spending and de-regulation of the financial industry appear to be supportive of growth. Outside the U.S., investors may focus on upcoming 2017 elections in France and Germany where the political atmosphere appears to have become more polarized. Regardless of the outcome of these elections, we believe Europe will continue to maintain easy monetary policy and there is the potential for further weakness in the Euro and Pound.

Key Takeaways: Political uncertainty may increase volatility and present market dislocations, leading to potential opportunities for investors.

Portfolio Impact: There is disruption potential for a number of asset classes. Notably, regions within the emerging markets may be impacted by protectionist policies and municipal bonds may be negatively impacted by tax reform.

Political Uncertainty May Create Additional Volatility - continued

Portfolio Strategy: Although headwinds are possible, municipal bonds, particularly below investment grade bonds, currently present a compelling investment case for taxable investors. Investment grade and below investment grade municipal yields have risen sharply and remain favorable on a tax-adjusted basis relative to taxable fixed income investments. For equity investors, emerging market equities continue to have attractive valuations relative to developed market equities.

Improving Global Growth Prospects

While the world remains mired in slow growth, the prospects for stronger economic growth are improving. As we have already pointed out, there are reasons to be optimistic about structural reforms being enacted in the U.S. Growth could pick up in advance of these reforms as expectations of these changes could drive confidence higher for both companies and consumers. The U.S. consumer also seems to be relatively healthy and, despite the recent increase in mortgage rates, the U.S. housing sector continues to show signs of improvement. Admittedly, growth in other parts of the developed world (Europe, Japan) remains slow. Japan has just concluded another year of its quantitative easing experiment without much improvement. In particular, the yen has appreciated relative to the U.S. dollar thus far in 2016 and growth remains weak. In Europe, the U.K. seems to be feeling minimal effects of the Brexit decision and concerns about the stability of the Euro have abated. Elsewhere, China remains relatively calm as it continues to transition from a manufacturing to a service-based economy. In Latin America, there appear to be political tailwinds, particularly in countries such as Argentina and Brazil, and the region has shown signs of stabilization after enduring a lengthy cyclical downturn.

Key Takeaways: We believe faster economic growth in the U.S. could be a tailwind for the rest of the global economy. Additionally, investors have low economic growth expectations for non-U.S. developed economies such as Japan and parts of Europe, while there is optimism in Latin America.

Portfolio Impact: An actual increase in growth or simply a change in perception of global growth would likely push risk assets higher in the short-term. Interest rates globally could also move higher, particularly at the long end of the curve.

Portfolio Strategy: We would encourage investors to remain diversified and not stretch for yield or return in ways inconsistent with long-term objectives or risk tolerance. While U.S. equity and fixed income markets have performed remarkably well in recent years and can move higher in the short-term, we believe valuations will be the primary driver of long-term returns. For investors with a long enough time horizon, we continue to suggest tilting towards non-U.S. markets where valuations seem to be pricing in low growth for many years to come.

Renewed Focus on Inflation

Global inflation has remained low for many years, despite the quantitative easing efforts of many central banks. Recently, many market participants have started to forecast higher inflation in the coming years. Breakeven inflation, a gauge of the market's expectations for future inflation, increased to almost 2% in late-November, a level not seen since 2014. Additionally, Treasury Inflation Protected Securities ("TIPS") strategies experienced sizable inflows for most of 2016. While markets are anticipating higher inflation, we remain skeptical. Realized inflation has remained low and quantitative easing programs across the globe have yet to deliver any material increases in inflation. Further, a stronger U.S. dollar could keep inflation in check over the short-term. A potential offset is fiscal stimulus which could drive inflation higher. We will be watching for signs of inflation picking up as this will have important ramifications for many asset classes. If inflation shows up and economic growth increases concurrently, then the preconditions for major changes in Fed policy are in place. However, a more active Fed would likely be a positive for the dollar, putting some constraints on the ability of the Fed to increase rates further.

Key Takeaways: The level of inflation will influence interest rates at the long end of the yield curve and will likely have an impact on central bank actions. Although markets are anticipating higher inflation, realized inflation remains at low levels to-date.

Portfolio Impact: Increasing inflation may result in higher interest rates at the long end of the yield curve. The impact of higher inflation on equity markets is less clear as some companies may be able to pass along higher costs while others will experience earnings deterioration.

Portfolio Strategy: At this point, we would not suggest increasing allocations to U.S. TIPS or other inflation sensitive assets. While higher inflation may materialize, a rise in real interest rates would likely more than offset the gains produced by inflation given the longer duration of the asset class. Higher rates of inflation have important implications for fixed income investors as it could lead to higher interest rates in the future. Investors looking to hedge long duration liabilities should consider adhering to plans and not waiting for rates to go higher before hedging liabilities unless this was part an established plan. For longer term investors, higher rates, on balance, should help deliver higher fixed income returns in the future.

Equity Market Uncertainty

In our view, the U.S. election result increases the potential range of outcomes for U.S. equity markets. U.S. equity market valuations remain elevated and earnings have been weak for the last two years. However, U.S. equity markets may climb higher as there is scope for significant structural policy change. At this stage of the transition, a wide range of fiscal reform policies may be adopted. Any fiscal stimulus, such as lower taxes or an increase in public spending/investment, could serve to grow the U.S. economy, which is moving into later stages of the business cycle. However, many of Trump's campaign proposals, such as tariff increases or other restrictions on trade, could also serve as a drag on growth if enacted. At this juncture of the transition, it is difficult to be confident about the

Equity Market Uncertainty - continued

trajectory of the political, economic, and financial market landscape. We can envision both positive and adverse outcomes depending on the specific policy changes that are adopted and the degree of cooperation between Congress and the Executive branch.

Key Takeaways: U.S. equity market valuations remain elevated, but fiscal stimulus may provide a boost to equity markets.

Portfolio Impact: Fiscal stimulus, supported by a steepening yield curve and higher interest rates, is positive for industrial-/commodity-driven sectors, financials, some healthcare subsectors and value stocks broadly. U.S. equities, especially companies driven by domestic growth, may perform well and possibly better than non-U.S. equities, despite the relatively high valuation levels of U.S. equities.

Portfolio Strategy: For clients with underweight positions in U.S. equities (relative to target weights), we would suggest covering the underweight and at least being neutral until there is more clarity on fiscal stimulus. Clients who can take sectoral bets may want to consider emphasizing some of the sectors that could benefit from changes in Washington. For clients with global equity portfolios, we would encourage maintaining a global stance as other regions of the developed and developing world have more attractive valuations and should eventually benefit from stronger U.S. growth, if it materializes.

Potential Tailwinds For The Financial Sector

We believe the financial sector may benefit from Trump's victory and the early signal from the market supports this view as U.S. financial equities were up over 12% in the two weeks following the election. Higher interest rates, a steepening yield curve, and potential changes to regulation may be favorable for the financial sector. Post-financial crisis, regulatory changes, including Dodd-Frank, forced many banks to improve their balance sheets and exit riskier but potentially more profitable business lines. In Europe, new Basel III standards were developed in 2013 and European banks have until 2019 to fully comply with these new standards. This has resulted in banks which have levels of capital 2-3x greater than what they were in 2006.

Key Takeaways: The financial sector may benefit significantly from higher interest rates and a more benign regulatory environment.

Portfolio Impact: While investors likely remember the challenging environment for financials during the 2008 market downturn, balance sheets for many of the banks are in far better shape today and a downturn in the financial sector seems unlikely in our opinion.

Portfolio Strategy: Equity investors who can take sector bets may want to consider investments in financials. Actively managed value equity strategies also tend to overweight the financial sector. Fixed income investors, both taxable and tax-exempt, might want to consider preferred securities which have higher exposure to insurers and financial services.

APPENDIX: Review of Rocaton's 2016 Themes

Figure 2:

Review of Rocaton's 2016 Themes

Rocaton Theme for 2016	2016 Key Takeaway	End of 2016 Update	Result
Global Growth	Global growth will be a key determinant of asset class returns in 2016	• Fears of a recession in January and February pushed asset prices significant lower during the first quarter of 2016. • Subsequently, world growth remained modest resulting in positive returns across almost all major asset classes.	Results were mixed as global growth was a partial driver of returns
Europe	Political risk is rising in Europe due to a lack of action and reform	• The 'Brexit' vote increased market volatility, put downward pressure on the British pound and significantly lowered interest rates in Europe, the U.S. and Japan. • Italian referendum, which would have potentially brought reform to Italy, was rejected.	Theme materialized as we expected
Fed Rate Hike(s)	Expect continued downward pressure on the long-end of the yield curve in 2016	• 10-year Treasury yields reached an all-time low in July. • Despite the recent increase, U.S. Treasury yields are mostly unchanged for year-end 2015 levels.	Results were mixed as rates fell significantly before rebounding
Search for Return	Asset class valuations are still elevated and there are few markets that appear attractive	• Valuations across most risk-assets became further elevated in 2016 and, apart from a brief sell-off in the first quarter, market volatility remained low. • Notably, U.S. equities and high yield fixed income performed remarkably well during the year.	Results were mixed as valuations became further elevated
Energy Market Uncertainty	The fundamental backdrop for energy prices remains challenging as global supply remains robust	• Crude oil prices were mostly range bound, trading within a $12 range from April through November. • U.S. energy production remained resilient and OPEC waited until November to reach a production cut agreement. • Oil/energy prices seem on track for a meaningful recovery from their lows earlier in 2016.	Results were mixed as oil supply remained high, but prices rallied
Bond Market Liquidity	Bond market liquidity continues to be an important issue for investors	• New capital and leverage rules resulted in the continued decline in dealer balance sheets. • Risk off sentiment coupled with poor liquidity allowed us to identify several attractive fixed income opportunities including midstream energy debt and CLO debt.	Theme materialized as we expected

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