Rocaton

INSIGHTS

2017 Capital Market Outlook Mid-Year Update

June 2017

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Executive Summary

At the end of 2016, we published our annual market outlook (link) that described several themes which we believed would be important topics for investors in 2017. As we near the halfway point of the year, we thought it would be useful to provide an update on those themes. We also touch on one new theme which we believe will be relevant for the remainder of the year. As always, clients should consider their own specific situation before acting on these outlooks and may want to discuss any potential transactions with their consultant.

Rocaton's 2017 Themes

Figure 1:

Rocaton's 2017 Themes and Mid-Year Update

2017 Theme	Mid-Year Update
Political uncertainty	In our opinion, political stability in Europe will likely be a tailwind for non-U.S. assets
Improving global growth prospects	We expect continued improvement in global economic growth, particularly in Europe and parts of Latin America
Renewed focus on inflation	We remain skeptical about the potential for rising U.S. inflation and would prefer not to increase exposure to TIPS or other inflation sensitive assets
Equity market uncertainty	Investors may want to consider underweighting U.S. equities given continued gains and further increases in valuations during the first half of the year
Financials	We believe that preferred securities should continue to perform well and that financial stocks may regain momentum if meaningful reforms are enacted and/or interest rates move higher
New theme for the remainder of 2017	
Credit market valuations	In our view, tight credit spreads across investment grade and high yield corporate bond markets may lead to weak returns prospectively

Political Uncertainty May Create Additional Volatility

Key Takeaways at Year-end 2016: Political uncertainty may increase volatility and present market dislocations, leading to potential opportunities for investors.

Mid-Year Update: While politics continue to dominate headlines in the U.S., election results in Europe during the first half of 2017 were generally viewed favorably by the market and have been a tailwind for non-U.S. assets. Notably, populist candidates were unable to secure victory in the French and Dutch elections resulting in gains for the euro relative to the U.S. dollar. Admittedly, results from the U.K. election were mixed at best leading to renewed focus on "Brexit" negotiations. In the U.S., political gridlock appears to have returned, dampening the hopes that reforms would get done in a timely manner. Notably, healthcare reform is still hanging in the balance and tax reform appears far from completion. The political focus will remain on Europe for the second half of the year with upcoming elections in Germany scheduled for September. Additionally, Italy will likely hold elections in the next 6-12 months where populist parties appear to have healthy support from voters. Instability in North Korea and Iraq also has the ability to create market volatility and political turmoil.

Portfolio Strategy for the Remainder of 2017: European equities and non-U.S. assets broadly, including emerging markets, may continue to perform well assuming populist sentiment continues to wane. We continue to find value for taxable investors in the municipal market and, periodically, there are opportunities for tax-exempt investors to take advantage of dislocations in the municipal market.

Improving Global Growth Prospects

Key Takeaways at Year-end 2016: 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.

Mid-Year Update: The Eurozone and Japan grew slightly faster than the U.S. in the first quarter. The Eurozone's recovery from its recession is at a much earlier stage than the United States' recovery. As a result, there more pent-up consumer demand. The unemployment rate in the Eurozone is 9.3% while the unemployment rate in the U.S. is 4.3%. Latin America is showing signs of stabilization after a cyclical downturn; however, the ramifications of the latest political crisis in Brazil are unclear.

Portfolio Strategy for the Remainder of 2017: We would encourage investors to remain diversified and not stretch for 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 continue to believe valuations will be the primary driver of long-term returns. For investors with a long time horizon, tilting towards non-U.S. markets, including emerging markets, may be attractive.

Renewed Focus on Inflation

Key Takeaways at Year-end 2016: 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.

Mid-Year Update: Despite market expectations for inflation increasing in early 2017, realized inflation in the U.S. has yet to materialize. In fact, the Consumer Price Index moved lower in March 2017 and is up only modestly (0.6%) for the first four months of 2017. Investors who poured money into Treasury Inflation Protected Securities ("TIPS") strategies in late 2016 and early 2017, have yet to be rewarded. Through early June, the Bloomberg Barclays TIPS Index is up just 1.7% for the year. This performance is among the worst for the major fixed income asset classes as U.S. core fixed income (+2.4% year-to-date), high yield (+4.9%), emerging market debt (+7.0%) and preferred securities (+8.0%) have all delivered superior results through the first half of the year. Furthermore, while we are not confident that we, nor anyone else, can predict oil prices, we see the balance of market forces as being potentially negative for oil prices which could suppress CPI in the next year.

Portfolio Strategy for the Remainder of 2017: We remain skeptical about the potential for rising U.S. inflation as any rise in interest rates would likely cause the dollar to strengthen resulting in downward pressure on inflation. A delay or lack of fiscal stimulus may also lead to more subdued inflation. As a result, we would not be inclined to increase allocations to U.S. TIPS or other inflation sensitive assets.

Equity Market Uncertainty

Key Takeaways at Year-end 2016: U.S. equity market valuations remain elevated, but fiscal stimulus may provide a boost to equity markets.

Mid-Year Update: U.S. equity valuations continued to climb higher during the first half of the year as the S&P 500 gained more than 9% through early June. The cyclically adjusted price/earnings (CAPE) ratio for the S&P 500 climbed to 29.1x as of May 31st, up from 27.9x at year-end 2016. Valuations for U.S. equities have only been higher in two previous instances; 2000-2002 during the tech bubble and 1929 just prior to the Great Depression. It is difficult to say with certainty what might cause the strong performance to reverse. However, the tailwind of fiscal stimulus that seemed likely at year-end 2016 has not materialized thus far.

Portfolio Strategy for the Remainder of 2017: Given the strong performance during the first half of the year, we would prefer that clients take an underweight position in U.S. equities (relative to target weights). For clients with global equity portfolios, we continue to recommend a tilt towards non-U.S. (developed and emerging) equities which continue to have favorable valuations despite strong performance in 2017.

Potential Tailwinds For The Financial Sector

Key Takeaways at Year-end 2016: The financial sector may benefit significantly from higher interest rates and a more benign regulatory environment.

Mid-Year Update: The U.S. financial equity sector has struggled during the first half of 2017, underperforming the broader S&P 500 by more than 6%. Interest rates and the slope of the yield curve, which appeared to be positives for the financial sector, have moderated and help to explain part of the underperformance. Additionally, financial sector reform efforts appear to have stalled although we expect existing regulations will be enforced less stringently.

Portfolio Strategy for the Remainder of 2017: In our view, preferred securities continue to offer relative value in fixed income with less downside risk than similarly-rated fixed income. Through the first half of the year, preferreds have generated significant gains (+8.0% for the BofA Merrill Lynch Fixed Rate Preferred Index) and still appear to offer value. Preferreds are even more advantageous for some taxable investors as part of the income from preferred securities is tax exempt. Financial sector equities may regain momentum if interest rates move higher and/or there is real progress on the regulatory reform front.

New Theme – Credit Market Valuations

Key Takeaways: Credit markets broadly, both investment grade and below investment grade, have performed well since the start of the year and in recent years. Notably, U.S. high yield fixed income gained nearly 5% through early June while emerging market debt hard currency (+7.0% year-to-date) and high yield municipal bonds (+6.6%) has also performed well. As a result of the strong performance, we believe the future return potential for these assets, and other parts of the credit market, is limited. In early June, high yield fixed income (as defined by the Bloomberg Barclays Corporate High Yield Index) had a yield of 5.5%. Investment grade corporate bond yields also remain low, recently trading at 3.2%. Bank loans, while attractive due to their floating rate nature, also have elevated valuations trading with an average price above $98 (based on the S&P/LSTA Leveraged Loan Index).

Portfolio Strategy for the Remainder of 2017: We would prefer that investors maintain flexibility within their “credit/hybrid” allocations which can include exposure to preferred securities, securitized credit, high yield, bank loans, convertibles and emerging market debt, among others. Overvalued asset classes within this group which have generated strong returns, such as high yield, should be exited in favor of more attractively priced exposures such as preferred securities. We suggest investors maintain a target allocation to the asset class group in total and be willing to modify underlying allocations based on market opportunities.

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