Rocaton

INSIGHTS

2018 Capital Market Outlook

December 2017

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Executive Summary

Our annual Capital Market Outlook provides a look ahead to 2018 and provides a review of our themes from this past year (link to 2017 Outlook). As you will notice, many of our themes this year reference the elevated valuations across most capital markets.

Rocaton's 2018 Themes

Figure 1:

Rocaton's 2018 Themes, Key Takeaways and Portfolio Strategies

Theme	Key Takeaway	Portfolio Strategy
Markets are expensive globally	Valuations are elevated to varying degrees across all capital markets	In our view, investors should ensure that the risk profile in their portfolio is consistent with their objectives
Lack of compelling public market opportunities	There is a lack of compelling investment ideas with high return potential in the public markets as there have been limited market dislocations	From our perspective, sectors of the illiquid market continue to offer relatively high return potential with an element of downside protection
Global growth is becoming more coordinated	Potential fiscal reform/stimulus and continuing accommodative monetary policy could result in another year of positive economic global growth	We continue to maintain a preference for non-U.S. equities where valuations are more favorable on a relative basis
"Unknown Unknowns"	From our perspective, the next recession or equity market correction will likely be the result of risks that are not yet known or fully understood	We believe investors should stand ready to take advantage of the next market dislocation by holding high quality, liquid fixed income
U.S. politics will likely influence market dynamics	Tax reform, infrastructure spending, trade policy and foreign policy will likely influence market outcomes	Investors should look for dislocations in fixed income markets that may result from any proposed legislation or policy changes
Continued headwinds for inflation	Despite a tight labor market, secular forces are creating headwinds to higher inflation in the U.S.	We believe investors should avoid inflation protection through traditional means

Markets are expensive globally

2017 turned out to be another strong year for capital markets globally with public equities delivering 23.1% (proxied by the MSCI ACWI Index in USD terms) and fixed income markets gaining 6.9% (Bloomberg Barclays Global Aggregate in USD terms) through December 15th. As a result, capital markets across the globe have elevated valuations. As of November 30, 2017, the S&P 500 had a cyclically adjusted P/E ratio of 31.4x, the highest level since 2001 and well above the long-term average of 16.0x. Credit fixed income markets remain expensive as well with investment grade and high yield bond spreads recently trading at 95 and 350 basis points, respectively (proxied by the Bloomberg Barclays indexes). These levels are inside long-term averages of 133 and 525 basis points, respectively. In some cases, credit market valuations are more elevated outside the U.S. as the European BB High Yield index recently had a yield-to-worst of 2.0%, below the yield on 5-year U.S. Treasury bonds. Even the few attractive markets that existed at the end of last year, such as non-U.S. developed equities (+22.9% year-to-date return for MSCI EAFE) and emerging equities (+32.7% return for MSCI EM), have delivered strong results leading to less attractive valuations today. Perhaps surprisingly, markets have performed well in 2017 despite any meaningful fiscal reform or stimulus in the U.S. While valuations remain elevated, it is not outside the realm of possibility for markets to continue moving higher as valuations can remain stretched for many years. Further, the "central bank put" (i.e. willingness of central banks to prop up markets in times of volatility) may limit downside outcomes.

Key Takeaways: Valuations are elevated across nearly all capital markets. In our opinion, many asset classes appear to be overvalued or, in limited cases, fairly valued.

Markets are expensive globally - continued

Portfolio Impact: We believe it will be difficult for investors to generate high single-digit returns for their total portfolios in the coming years from publicly traded asset classes. As a result, investors with return objectives of 7% or higher may find it difficult to meet this hurdle in the next three to five years.

Portfolio Strategy: We believe investors should become more cautious anytime they are impressed with strong multi-year portfolio returns. At times of elevated valuations, we believe setting an appropriate target risk level for a portfolio is more prudent than seeking out a specific return target. Within return seeking portfolios, we believe investors should remain diversified globally and possibly seek to reduce risk relative to the broad equity market. Investments in long/short equity, convertible bonds, preferred securities and other investment strategies with similar risk and return profiles may help investors maintain equity-like returns while reducing volatility. Within fixed income markets, we believe investors should seek to create a yield advantage relative to the broad fixed income market without taking on excessive credit risk. For example, in the last few years, there have been attractive opportunities in esoteric investment grade asset backed securities where investors have been able to generate incremental yield without generating significantly higher risk.

Lack of compelling opportunities

We believe there is a lack of actionable and attractive investment ideas in the public markets. The feeling of quiescence in the market place has undoubtedly been exacerbated by the low levels of volatility seen throughout the year, despite a steady stream of news at the macroeconomic level. One might normally expect such events to contribute to market volatility, thereby creating compelling entry points for various asset classes. For example, in recent years we have found opportunities in midstream energy debt, collateralized loan obligations (both debt/equity tranches) and trust-preferred collateralized debt obligations. More broadly, mainstream asset classes such as non-U.S. developed and emerging market equities offered compelling long-term return potential after several years of lean performance. Today, we find there are limited investment opportunities with high return potential across conventional asset classes as well as niche sectors. That such opportunities have not materialized is perhaps attributable to several factors including, low market volatility, a lack of corporate defaults, the continued influence of sentiment, global central bank stimulus and passive flows on market outcomes and rational price discovery. As we express elsewhere, we remain mindful of not conflating the benign environment indicated by a lower level of volatility with a lack of risk. While the illusion of safety is appealing, we remain concerned that increasing amounts of capital are chasing a diminished level of return in risk assets that are fully valued.

Key Takeaways: There is a lack of investment ideas with high return potential in the public markets as there have been limited market dislocations in recent years.

Lack of compelling opportunities - continued

Portfolio Impact: Return expectations for conventional fixed income and public equity markets remain modest and we do not see many compelling investment ideas with high return potential in niche sectors.

Portfolio Strategy: Investors should continue to search for niche investment opportunities which may generate strong returns. For investors who can accept illiquidity, we believe there are some opportunities across the real estate and credit markets. For example, within real estate, strategies with high cashflow and downside protection (such as net lease strategies) remain relatively attractive. We will continue to seek out opportunities for enhancing returns in 2018, but we believe it will become more difficult absent market dislocations. For allocations to liquid assets, we believe investors should, at a minimum, rebalance their portfolios as public equity allocations may be overweight their intended strategic targets.

Global growth is becoming more coordinated

In 2017, year-over-year earnings and revenue growth worldwide has been encouraged by synchronized global growth. The increasing coordination of global growth does not appear to be predicated on a single source of demand, country, or region, but a wide range of factors contributing to the upturn. In fact, for the first time since 2007, the OECD is predicting positive growth rates, driven in part by low interest rates, in each of the 45 economies considered. Additionally, with some countries in the early stage of the business cycle, the risk of the global economy overheating may be limited. All told, improving sentiment and a supportive market backdrop could create a positive feedback loop for higher growth in 2018, supported by fiscal stimulus and continued accommodative monetary policy. The current market environment, if maintained, appears favorable for risk assets to continue generating positive returns. However, it is important to remember that positive economic growth is not always correlated to strong returns from risk assets.

Key Takeaways: The world's major economies are growing simultaneously for the first time in ten years. Accommodative central bank policy, an improving consumer, and the potential for fiscal reform are all tailwinds that could lead to another year of positive global growth.

Portfolio Impact: Despite the potential for another year of positive global growth, we continue to feel that the bull market is long in the tooth. Further, equity market declines typically begin prior to any official contraction in economic growth.

Portfolio Strategy: Continued strong growth may lead to higher interest rates across developed markets if inflation picks up. While rising rates may create short-term performance headwinds, higher rates are needed to generate positive long-term returns. Liability driven investors should seek to add duration if interest rates move higher. Within the public equity markets, we continue to maintain a preference for non-U.S. markets, such as developed and emerging markets equities, where valuations remain favorable relative to U.S. equity markets.

“Unknow unknowns” have the potential to disrupt markets

As we have pointed out, markets appear to be in a state of calm despite a growing list of uncertainties that includes North Korea, tensions in the Middle East, and U.S. political uncertainty. We would characterize these issues as “known unknowns”, a term popularized by Donald Rumsfeld. The term known unknowns is often used to refer to unquantifiable risks that are known to exist, such as the risks previously cited. More concerning to us are the “unknown unknowns”, or risks that cannot be anticipated. These types of risks are sometimes referred to as “black swan events.” In our opinion, severe market declines can be the result of these events and it can be difficult for investors to avoid portfolio losses during such events. We are often reminded that recessionary environments and market declines are rarely predicted ahead of time. We do not claim to have the foresight to do so either, however, given the length of time since the last economic contraction, we believe a recession is more likely than not over the next five years. We would also point out “unknown unknowns” are generally always a risk that investors face. Today we believe that risk is heightened due to elevated market valuations, fully invested portfolios, a lack of volatility in recent years and some fragility in trading markets where illiquidity has increased.

Key Takeaways: As we observe financial market history, it seems that markets are most vulnerable when fear and volatility are low. From our perspective, the next recession or equity market correction will likely be the result of risks that are not yet known and may be difficult or impossible to predict.

Portfolio Impact: As experienced in 2008, market volatility can accelerate in a short period of time. Following nearly nine years of uninterrupted gains and limited volatility, the U.S. equity market should, at some point, experience a pull back. It is difficult to estimate the speed, timing and magnitude of such a decline.

Portfolio Strategy: We do not profess to have the ability to forecast the next recession or market decline. However, we believe we can identify attractively priced assets for investors who have a long-time horizon. As a result, we suggest that investors stand ready to take advantage of the next market dislocation. In our opinion, investment grade fixed income allocations and Treasuries in particular, while unexciting from a total return perspective, should prove to be a store of wealth and a useful source of liquid funds during a market sell-off. Therefore, we believe investors should maintain allocations to high quality investment grade fixed income despite the threat of rising interest rates.

U.S. politics will likely influence market dynamics

We believe markets will be keenly focused on the Trump Administration’s agenda in 2018, particularly as it relates to 1) tax reform, 2) a potential infrastructure initiative, 3) trade policy and 4) foreign policy. While tax reform is the policy initiative that seems most likely to materialize, we believe significant changes to any of the aforementioned areas may impact markets.

U.S. politics will likely influence market dynamics - continued

Tax Reform - Republicans in the House and Senate each passed different versions of the Tax Cuts and Jobs Act and then subsequently the conference committee crafted a unified bill. Both chambers of Congress will vote on the unified bill, likely before year-end. In our view, the likelihood of tax reform passing before year-end is high.

Infrastructure – The Trump administration is likely to release details of an infrastructure program in early 2018. If a large infrastructure program were to pass, which is certainly a challenging task, it would likely create opportunities in the municipal bond and private lending markets for several years. A well designed infrastructure program could also increase growth, productivity, and employment.

Trade and Foreign Policy – President Trump needs less congressional support to impact trade or foreign policy relative to tax reform. Markets will likely be focused on potential changes to NAFTA and the administration's approach to foreign policy in the Middle East and Asia.

Key Takeaways: Corporations with high effective tax rates will likely be beneficiaries of the tax bill. The impact of tax reform on individuals is likely disparate depending on an individual's unique circumstances. It is more challenging to make definitive statements in regards to the short-term impact that an infrastructure bill or changes to trade and foreign policy will have on the market.

Portfolio Impact: The passage of tax reform will likely have wide ranging impact on corporations and the fixed income and currency markets, among others. In our view, most of the benefits of tax reform are likely currently priced into the U.S. equity market. Tax reform and an infrastructure bill will likely have an impact on municipal bond issuance. Material (negative) changes to trade and foreign policy would likely inject volatility into risk-assets.

Portfolio Strategy: We believe markets have been pricing in tax reform across various sectors for the last several months and, as such, we would suggest that investors avoid making large sector bets. We believe investors should remain diversified and consider the long-term impact of certain proposals. We continue to look for dislocations in fixed income markets that may result from any proposed legislation or policy changes. For example, a sell-off in municipal bonds, investment grade or high yield, may present an attractive opportunity for taxable investors.

Secular headwinds to inflation

Given the low U.S. unemployment rate has not translated to higher inflation levels, economists and investors have questioned the efficacy of the Phillips Curve which states that higher employment levels in an economy will correlate with higher rates of inflation. We believe the intersection of technology, globalization and demographics are contributing to low levels of inflation and are likely to keep inflation fairly low, absent a commodity shock. We also believe low inflation keeps a ceiling on the level of interest rates further out on the yield curve. The key secular factors that we see impacting inflation are as follows:

Secular headwinds to inflation - continued

1. Technology – Automation puts pressure on wages by serving as a substitute for certain jobs. Technological advancements have put downward pressures on consumer products. For example, the internet has reduced many traditional barriers to entry and thus has created price competition, which has lowered inflation.
2. Globalization – In a global economy it is likely that cheap labor and lower-cost producers will continue to put downward pressure on inflation, particularly in advanced economies.
3. Demographics – The linkage between demographics and inflation is perhaps less clear, but an argument can be made that aging populations lead to lower growth and less demand for certain types of goods.

Key Takeaways: The level of inflation will likely influence interest rates at the long end of the yield curve and will likely have an impact on central bank actions.

Portfolio Impact: Although continued low inflation is our base case, an increase in inflation would likely 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. If we realize low inflation, as we expect, fixed income investment returns will likely be positive, albeit mediocre. Therefore, we would not recommend decreasing duration in an asset-only framework.

Portfolio Strategy: We believe investors should avoid inflation protection through traditional means. In our view, return prospects for inflation linked bonds are modest, REITs can be vulnerable to periods of high volatility and commodity investments are less compelling when implemented through futures-based strategies which are subject to contango. For defined contribution plans that wish to offer an "inflation-protection" option, we continue to believe that offering a diversified multi-asset strategy which makes use of a wide opportunity set may be more effective at preserving purchasing power than a dedicated TIPS or REITs strategy. While there is no "silver bullet" in investing, these types of strategies target reasonable levels of return, take moderate levels of risk and seek to avoid pronounced drawdowns.

APPENDIX: Review of Rocaton's 2017 Themes

Figure 2:

Review of Rocaton's 2017 Themes

Rocaton Theme for 2017	2017 Key Takeaway	End of 2017 Update	Result
Political uncertainty	We believe political uncertainty will increase market volatility	• Concerns about the Eurozone splintering, and deflation faded following European elections • Despite limited progress on fiscal reform in the U.S., market volatility remained low	Theme did not materialize as expected as market volatility did not increase
Improving global growth prospects	We believe faster economic growth in the U.S. could be a tailwind for the rest of the global economy	• Realized growth in the Eurozone and Japan surprised to the upside for most of the year • U.S. growth remained modest, but was not a significant tailwind for the global economy	Results were mixed as U.S. growth was modest, but other economies grew faster than consensus forecasts
Renewed focus on inflation	Market participants are expecting higher inflation, but we believe actual inflation will remain modest	• Realized inflation in the U.S. remained modest with CPI rising 2.2% year-over-year as of November 30, 2017	Theme materialized as we expected
Equity market uncertainty	Although U.S. equity market valuations remain elevated, we see the potential for further upside next year	• U.S. equity valuations continued to climb higher during the year as the S&P 500 gained more than 21% through mid-December	Theme materialized as we expected
Financials	In our opinion, the potential for higher interest rates and de-regulation will be tailwinds for the financial sector	• Longer dated U.S. interest rates moved sideways for much of the year following a significant increase post-U.S. election • Preferred securities performed well (+10.6% YTD), despite limited bank de-regulation	Results were mixed as financials kept pace with the broad market, but interest rates remained low and there was limited de-regulation
Credit market valuations	In our view, tight credit spreads across investment grade and high yield corporate bond markets may lead to weak returns prospectively	• Credit market valuations became more elevated with investment grade corporate bond spreads below 1% and high yield bond spreads just above 3% • There appears to be limited upside in some credit markets, such as high yield, moving forward	Theme did not materialize as expected as credit markets performed well due to a continued rise in valuations

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