Rocaton

INSIGHTS

2018 Capital Market Outlook Mid-Year Update

June 2018

203.621.1700 | **rocaton.com**

Executive Summary

At the end of 2017, we published our annual market outlook (link) that described several themes which we believed would be important topics for investors in 2018. 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 that 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 investment decisions with their consultant.

Rocaton's 2018 Themes

Figure 1:

Rocaton's 2018 Themes and Mid-Year Update

2018 Theme	Mid-Year Update
Markets are expensive globally	Given higher interest rates, we believe a variety of fixed income asset classes offer improved return expectations.
Lack of compelling public market opportunities	Investors with the ability to accept illiquidity or add more esoteric exposures may want to take advantage of some of the limited niche opportunities that exist.
Global growth is becoming more coordinated	Slowing growth across parts of the developed and emerging markets may put pressure on risk assets.
"Unknown Unknowns"	We believe investors should stand ready to take advantage of dislocations by adjusting target allocations as opportunities arise.
U.S. politics will likely influence market dynamics	Continued political uncertainty has the potential to push up volatility in both fixed income and equity markets.
Continued headwinds for inflation	We believe traditional inflation protection asset classes may have difficulty outpacing inflation.
New theme for the remainder of 2018	
The U.S. yield curve is flat	We believe it is important for investors to weigh the total portfolio risk/return implications of the duration exposure in their fixed income allocations. Each investor's specific goals and objectives will be an important consideration when evaluating the tradeoffs.

Markets are expensive globally

Key Takeaways at Year-end 2017: Valuations are elevated across nearly all capital markets. In our opinion, many asset classes appear to be overvalued or, in limited cases, fairly valued.

Mid-Year Update: Despite a modest increase in market volatility during the first half of the year, valuations across most public asset classes remain elevated. Notably, the S&P 500 had a cyclically adjusted P/E ratio of 31.3x at the end of May, only slightly lower than the level recorded at year-end 2017 (32.1x) and still well above the long-term average of 16.0x. Credit market valuations were also largely unchanged from year-end 2017 levels with investment grade corporate bond spreads at 1.15% (22 basis points higher year-to-date) and high yield corporate bond spreads at 3.35% (8 basis points lower year-to-date). Perhaps the one market with improved valuations is high quality fixed income. As interest rates have risen in the U.S., particularly at the short-end of the yield curve, high quality fixed income, such as U.S. Treasuries, is more attractive on a relative basis. As of June 12th, the U.S. 10-Year Treasury was yielding 2.95%, after briefly moving above 3% earlier in the year, and the U.S. 2-Year Treasury was yielding 2.53%, the highest level since July 2008.

Portfolio Strategy for the Remainder of 2018: After many years of low interest rates, the case for owning certain fixed income exposures is more compelling than it has been since the 2008/2009 financial crisis. While U.S. interest rates are still low relative to long-term history, we are currently in an environment where risk assets, such as public equities and some credit fixed income markets, have high valuations. At the same time, U.S. interest rates have risen to more attractive levels. Given elevated valuations across most risk assets and higher interest rates, we believe investors might want to consider increasing allocations to parts of the fixed income market, such as emerging market debt (both local and hard currency) and preferred securities. Total return investors may also want to consider increasing high quality fixed income exposures or shortening duration given the flatness of the yield curve. We believe it is appropriate for pension plans to maintain a strategic liability hedge ratio target, but also consider adjusting yield curve exposure to improve the range of expected return outcomes for their LDI allocations.

Lack of compelling opportunities

Key Takeaways at Year-end 2017: 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.

Mid-Year Update: A brief increase in public equity market volatility during the middle of the first quarter did not result in many compelling opportunities as most public markets are flat to slightly higher for the year. After years of outsized returns, a more material fall in equity and credit markets is needed to create compelling entry points. Across the private markets, significant amounts of capital continue to be raised for traditional illiquid strategies such as leveraged buyouts and core real estate. This has created a difficult environment for investors who need to generate high rates of return.

Portfolio Strategy for the Remainder of 2018: Investors with the ability to accept illiquidity or add more esoteric exposures may want to take advantage of some of the limited, niche opportunities that exist. For example, a continued recovery in non-traditional credit markets post financial crisis and ongoing challenges for new loan growth in certain consumer and commercial markets due to continuing stringent regulation are leading to attractive opportunities in the private markets. In the public markets, we believe midstream energy equities (including master limited partnerships) present a compelling opportunity which can be included alongside other public equity exposure while noting that midstream energy equities are prone to long periods of heightened volatility. Beyond these opportunities, we believe investors will benefit from maintaining a broadly diversified portfolio at a risk level that is appropriate for their objectives and time horizon.

Global growth is becoming more coordinated

Key Takeaways at Year-end 2017: 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.

Mid-Year Update: After a promising end to 2017, economic growth across the globe now appears to be more mixed. Notably, after eight consecutive quarters of growth, recent data showed that the Japanese economy contracted in the first quarter, driven in part by weak private consumption. Elsewhere, European growth slowed sharply in the first quarter due to trade tensions, a stronger currency and capacity constraints. In the emerging markets, rising oil prices and falling currencies threaten to derail growth. While the U.S. economy appears to be on more stable ground, higher interest rates may put pressure on the consumer and housing sectors.

Portfolio Strategy for the Remainder of 2018: Slowing economic growth in parts of the developed and emerging world may put pressure on risk assets. While economic growth in Europe, Japan and the emerging markets appears to be less stable than in the U.S., valuations in these markets are pricing in relatively pessimistic growth scenarios. On this basis, we continue to maintain a preference for non-U.S. and emerging market equities. That said, there is the potential for drawdowns across all public equity markets in the event of a material or perceived decline in economic growth. With short-term interest rates at more appealing levels, investors may wish to substitute some of their equity risk for a more conservative risk profile.

"Unknown unknowns" have the potential to disrupt markets

Key Takeaways at Year-end 2017: U.S. equity market valuations remain elevated, but fiscal stimulus may provide a boost to equity markets.

Mid-Year Update: This list of issues that have the potential to derail markets has only increased since year-end. Late last year we cited North Korea, tensions in the Middle East and U.S. political uncertainty as "known unknowns" which could potentially cause a decline in markets. Rising oil prices, concerns in several emerging market countries, political turmoil in the European periphery and slowing global economic growth can all be added to the list of unquantifiable risks that are known to exist. However, we remain concerned about "unknown unknowns", or risks that cannot be anticipated. We frequently hear market pundits proclaim that a recession is unlikely this year or next year. While we have no reason to counter this sentiment, we are also mindful that economists and other market pundits rarely predict economic recessions in advance. Further, while not a guarantee, rising oil prices and a flat (or, perhaps eventually, inverted) yield curve have all been signs which have typically preceded recessions.

Portfolio Strategy for the Remainder of 2018: The first quarter of 2018 reminded investors that markets can fall quickly in a short span of time. While the decline earlier this year was short lived and there were few attractive opportunities, we believe a sustained market drawdown will likely create attractive opportunities for investors. Market volatility might present investors with opportunities if they stand ready to take advantage of those dislocations by modifying target allocations in a timely manner. Further, rising interest rates at the short-end of the yield curve has led to an environment where the opportunity cost is not as significant for investors to lower portfolio risk and wait for more attractive entry opportunities.

U.S. politics will likely influence market dynamics

Key Takeaways at Year-end 2017: 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.

Mid-Year Update: Heading in to 2018, we cited tax reform, a potential infrastructure initiative and trade/foreign policy as the primary political agenda items that would influence markets. Through mid-year, we believe a repricing in the equity market due to tax reform has already occurred and little-to-no progress has been made on infrastructure. Despite trade and foreign policy being in the headlines for much of 2018, it does not appear that these areas have moved markets in a material and sustained manner. To be fair, worries over a "trade war" in March did lead to a brief increase in equity market volatility. Importantly, however, we would also argue that the direct effects of the tariffs on the U.S. economy are likely to be small, absent any retaliation from U.S. trade partners. Lastly, ongoing dialogue surrounding North Korea, Iran and Israel has not meaningfully influenced market outcomes thus far but has the potential to do so.

Portfolio Strategy for the Remainder of 2018: While U.S. equity market earnings have remained strong, any further equity market upside from tax reform appears to have faded. As such, we believe stretched U.S. equity market valuations continue to suggest that investors might improve their portfolio risk/return characteristics by reducing exposure to U.S. equity markets either by redeploying capital to international equity markets or by reducing outright equity market exposure.

Secular headwinds to inflation

Key Takeaways at Year-end 2017: 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.

Mid-Year Update: An increase in inflation during the first half of the year is partially responsible for an increase in long-term interest rates. As of April 30th (the most recent data available), U.S. headline inflation had increased 2.4% year-over-year. This compares to inflation of 2.1% for 2017. While the pick up in inflation has been modest, interest rates have moved up materially with 10-year and 30-year U.S. Treasury yields increasing 55 and 35 basis points, respectively, year-to-date through June 12th. Perhaps more notable is the fact that 10-year interest rates had their largest one-day increase in 2018 on the same day (February 2nd) that data showed that wages rose at their fastest pace since June 2009. The material increase in interest rates has led to poor performance for nearly all fixed income markets. Notably, the Bloomberg Barclays U.S. Aggregate was down more than 2% year-to-date through mid-June and was in the midst of the third-worst drawdown for the Aggregate post-financial crisis.[1]

Portfolio Strategy for the Remainder of 2018: Although inflation has picked up a bit this year, traditional inflation protection strategies have largely provided underwhelming results with U.S. TIPS down 0.9%, U.S. REITs down 1.2% and commodity futures up 2.8%.[2] We believe investors looking to protect against inflation will be better served considering diversified multi-asset strategies which have an explicit target of exceeding inflation. These strategies have the potential to provide more consistent results with less volatility and less drawdown risk. Alternatively, yield/income-oriented strategies can also provide a meaningful return (i.e., spread) above inflation while also limiting downside risk.

[1] The 2013 Taper Tantrum (-4.9%) and the 2016 post-U.S. election rise in yields (-4.4%) were the two worst drawdowns for the Bloomberg Barclays Aggregate post-financial crisis.

[2] Represented by the Bloomberg Barclays U.S. TIPS Index, MSCI U.S. REIT Index and Bloomberg Commodity Index through June 12, 2018.

New Theme – The U.S. yield curve is flattening

Key Takeaways: While the U.S. yield curve has been gradually flattening for the last several years we are now at a point in which the potential for an inverted yield curve is higher. As of mid-June, the spread between the 10- and 2-year U.S. Treasury yields was just 0.42%, the lowest level since 2007, just prior to the global financial crisis. The flattening yield curve has been driven in part by a continued increase in short-term rates by the Federal Reserve. With more rate hikes expected, a further decline in the spread between the 10- and 2-year yields seems likely.

Portfolio Strategy for the Remainder of 2018: All of the recent recessions have included an inverted yield curve at some point. However, there have been points in which the curve has inverted and a recession did not occur, so we do not view this indicator as necessarily perfectly predictive of a recession. A flat yield curve does have significant implications for fixed income investors, many of which we cannot cover in detail in this publication. However, we would strongly suggest that investors with market duration fixed income (i.e. Bloomberg Barclays Aggregate), consider the trade-offs of reducing duration as yield can be roughly maintained with lower interest rate risk. For example, an investor holding the Bloomberg Barclays Aggregate (3.4% yield, 6.1 year duration) can get 82% of the yield with only 32% of the duration by moving to the Bloomberg Barclays 1-3 Year Aggregate (2.7% yield, 2.0 year duration). Taxable investors holding municipal bonds can also experience similar benefits by moving to shorter duration exposures, but may want to consider any tax implications from liquidating existing holdings. For long duration investors, such as pension plans, a broader conversation is likely needed to understand the trade-offs between return potential and interest rate hedging but even these investors could consider targeting duration at different points on the yield curve. Regardless of the investor type, we believe understanding the implications of moving to shorter duration fixed income is critical given the shape of the yield curve including the potential diversification benefits of duration and the total portfolio impact of the duration position of fixed income allocations.

Rocaton

2018 Capital Market Outlook Mid-Year Update

203.621.1700 | **rocaton.com**