Rocaton

INSIGHTS

2019 Capital Market Outlook

December 2018

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Executive Summary

Our annual Capital Market Outlook provides a look ahead to 2019 and provides a review of our themes from this past year (link to 2018 Outlook).

Rocaton's 2019 Themes

Figure 1:

Rocaton's 2019 Themes, Key Takeaways and Portfolio Strategies

Theme	Key Takeaway	Portfolio Strategy
Trade negotiations will materially influence global economic growth	Recent developments in the global political environment, in particular the escalation of trade wars between the U.S. and its trading partners, could result in continued volatility for public markets	Should a concrete trade agreement be reached, we believe equities, particularly emerging market equities, could rally in anticipation
Monetary and fiscal policy may create headwinds	Changes in monetary and fiscal policy may present challenges for economic growth in the coming year, potentially resulting in increased volatility	Given the rise in short-term rates, short duration fixed income may be attractive for some investors. For most investors, we would recommend that investors maintain their current duration posture and stay diversified.
Are equity market valuations still useful indicators for predictions about performance?	Equity market performance over the last ten year for the U.S. versus non-U.S. and emerging markets has confounded performance predictions based on relative valuations	We still believe that fundamentals ultimately drive equity market performance. Investors with a long-term view and the ability to withstand performance deviation from strategic targets may wish to increase non-U.S. equity exposures, recognizing that U.S. equities may continue to outperform in the short term.
Corporate credit quality is deteriorating	BBB-rated corporate bonds have become a larger portion of the investment grade corporate market over the past 10 years. Understanding the drivers and the impact this may have on various markets is important.	In general, corporate defined benefit plans should continue to include BBBs in the opportunity set as part of a broader strategy to diversify credit exposure. Investors should be cognizant of rising fundamental and technical risks in the corporate bond market.
Europe's problems have shifted to the "core"	Europe's political problems appear worse today than they did 12 months ago. Growing risks related to Brexit and budget challenges with Italy grab the headlines but perhaps the most impactful long-term risk is the weakening of Chancellor Merkel and the deterioration in Macron's approval ratings.	Sentiment is too negative on Europe and European equities and other financial assets as well as European currencies seem attractively valued for investors willing to take a long-term view
U.S. housing market stability	Despite the recent slowing of the housing market, long term trends are supportive of stable to rising home prices, on average, nationally	Investment strategies in public and private markets that rely on house price stability to be successful are opportunities worth considering

Trade negotiations will materially influence global economic growth

Recent developments in the global political environment, and, in particular the escalation of trade wars between the U.S. and its trading partners, may continue to create volatility across public markets. We continue to believe that market conditions will be strongly influenced by the outcome of trade negotiations, most notably between China and the U.S. For example, public equity market volatility increased following the G20 Meeting in early December, where President Trump and Xi Jinping agreed to hold further discussions over a 90-day period, thereby postponing the next round of tariffs. This is certainly a positive signal and may provide some relief in the markets from the day-to-day turmoil of trade talks. However, there continues to be a divide between the U.S. and Chinese positions on trade that needs to be reconciled on topics such as forced technology transfer, intellectual property protection, and non-tariff barriers. The hope is that the agreed-upon 90-day period can be used to resolve these differences, find a lasting resolution to trade negotiation, and avoid a full-blown trade war. Further trade tensions have the potential to weigh on investor sentiment and depress GDP globally. Importantly, trade represents a larger portion of GDP for China, the EU and emerging markets than it does for the U.S. and so the negative effect of the trade war are felt disproportionately by the rest of the world.

Key Takeaways: Recent developments in the global political environment, in particular the escalation of trade wars between the U.S. and its trading partners, could constrain global growth and result in continued volatility for public markets.

Trade negotiations will materially influence global economic growth - continued

Portfolio Impact: A continuation or escalation of trade tensions between the U.S. and its trading partners is likely to weigh on investor sentiment, serve as a headwind to economic growth, and may negatively impact risk-assets. A resolution could buoy markets, especially in higher risk assets such as China A-shares and emerging market equities more broadly.

Portfolio Strategy: Should a concrete trade agreement be reached, we believe equities, particularly emerging market equities, could rally in anticipation. However, until there is certainty, we believe investors should expect further public equity market volatility. As such, investors should position their public equity portfolios in line with their risk tolerance and return objectives.

Monetary and fiscal policy may create headwinds

While U.S. economic growth was strong in 2018, we believe monetary and fiscal conditions may present challenges in 2019. From a monetary policy perspective, a less accommodative Federal Reserve may put pressure on the economy broadly as the Fed seems inclined to move forward with additional rate hikes. Balance sheet normalization may also reduce liquidity and is another form of monetary tightening. The impact of fiscal stimulus is also likely to wane in 2019. While tax reform seems to have been a tailwind to corporate earnings in 2018, we see limited new fiscal stimulus emerging next year. As a result, the growth rate in corporate earnings seems likely to slow as year-over-year comparisons become more challenging. Although infrastructure spending is still being considered, very few details have emerged in recent months and it seems, from our perspective, unlikely that legislation will get passed. Beyond monetary and fiscal policy, continued escalation in trade tensions, rising labor and input costs, continued strength in the dollar, and rising interest rates could lead to higher volatility.

Key Takeaways: Changes in monetary and fiscal policy may present challenges for economic growth in the coming year, potentially resulting in increased volatility and headwinds for the equity markets.

Portfolio Impact: We do not see a high risk of recession in the U.S in 2019. However, lack of fiscal stimulus combined with further interest rate hikes may slow the economy and put pressure on risk assets such as public equities.

Portfolio Strategy: Short-term interest rates are at their highest levels since the global financial crisis making short duration fixed income a viable investment consideration for some investors, and in particular, total return investors without liability-hedging considerations. A high quality, floating rate/short duration ABS portfolio yields over 4% currently. However, investors must consider income, diversification benefits, investment objectives and total return potential when determining their duration posture. All else equal, we would recommend that investors maintain their current duration posture and stay diversified. Investors should consider their investment objectives holistically before shortening duration given long duration fixed income can potentially act as a diversifier to risk assets especially as the U.S. economy is expected to slow in 2019.

Are equity market valuations still useful indicators for predictions about performance?

Since the global financial crisis, U.S. equities have significantly outperformed non-U.S. developed and emerging equities. While valuations across all public equities were depressed in early 2009, over the last several years a meaningful valuation disparity has persisted between U.S. and non-U.S. equity markets. Despite this valuation gap, U.S. equity markets have continued to outperform most equity markets across the globe. At the end of 2013, U.S. equities traded at 24.9x (based on the Shiller CAPE ratio) while non-U.S. developed markets traded at 17.1x and emerging markets traded at 13.7x. Over the subsequent ~5-year period (though October 31, 2018), the S&P 500 generated a return of 10.5% annualized while the MSCI EAFE and MSCI Emerging Markets Indexes returned 2.1% and 1.8% annualized (in USD terms), respectively over the same time period. Naturally, investors who positioned their equity portfolios based on valuations likely generated disappointing results.

Key Takeaways: While value investing is generally more appropriate for investors with a long-term time horizon, the last five to ten years have been particularly disappointing for value-oriented investors as U.S. equity markets have continued to outperform non-U.S. equity markets despite lofty starting valuations. It is also noteworthy that within many countries, growth stocks have significantly outperformed value stocks in recent periods.

Portfolio Impact: There are several reasons why U.S. equities might continue to outperform non-U.S. equities including 1) Sustained high earnings growth and/or profit margins for U.S. companies, 2) Meaningfully different sector composition (U.S. has a much larger tech sector than Europe), 3) Different legal systems and rates of innovation that may make the U.S. a more attractive destination for capital, 4) An introduction of additional tariffs which typically harm non-U.S. economies more than they hurt the U.S. economy, and 5) Further strengthening of the U.S. dollar driven by tightening monetary policy. However, as we have pointed out, valuations in U.S. equity markets are far more elevated than valuations in non-U.S. equity markets.

Portfolio Strategy: We continue to believe that investors should tilt towards markets with attractive valuations and away from markets where valuations are elevated. This would suggest that investors should lean into non-U.S. equity markets and away from U.S. equity markets. For investors with the ability to withstand periods underperformance, we believe non-U.S. equities will ultimately outperform U.S. equities in the coming years. However, compared to other relative value decisions our conviction on U.S. versus non-U.S. equities is lower, particularly over a short time horizon. In line with our historical views, we expect there to be a modest structural gap between U.S. P/E ratios and non-U.S. P/E ratios[1].

[1] Rocaton's long-term CAPE ratio assumption for U.S. equities is 20.0x compared to 18.0x and 16.0x for non-U.S. developed and emerging equities, respectively.

Corporate credit quality is deteriorating

BBB-rated corporate credit has steadily increased in absolute and relative terms since the financial crisis, and now comprises approximately 50% of the Bloomberg Barclays Corporate Index, up from less than 35% in June 2008. A meaningful portion of the increase in BBB rated bonds has come from the financial sector. However, over the past ten years, banks have improved their credit profiles meaningfully, partly as a result of regulation intended to reduce systemic risk. More recently, debt-financed M&A has been a cause of the uptick in leverage levels within the industrial sector and partly explains why average credit quality has fallen. While we are not calling for a wave of imminent downgrades, those companies that rely on continued M&A synergies and intend to reduce debt to preserve their ratings may face challenges if the economy were to slow.

Key Takeaways: BBB-rated corporate bonds have become a larger portion of the investment grade corporate market over the past 10 years. Understanding the drivers and the impact this may have on various markets is important.

Portfolio Impact: Credit migration is a risk that investors are exposed to which can create drag on performance and funded status, in the case of defined benefit plans holding large allocations to corporate bonds. This risk may be mitigated by skilled credit managers. Further, if several large BBB-rated issuers were to be downgraded to below investment grade, it could cause the high yield market some indigestion. If downgrades were to occur, several of the largest BBB-rated issuers would be meaningful weights within the $1.2 trillion high yield market. As a result, we would expect market mechanisms for trading fixed income corporate credit to be challenged, leading to higher than expected price volatility.

Portfolio Strategy: We believe that investors should not blindly follow published indices in fixed income portfolios. Specific to corporate defined benefit plans, we believe if controlling average credit quality and/or reducing issuer concentration at the portfolio level is an objective, plans should utilize Treasuries and consider introducing other long duration fixed income sectors. Excluding the BBB-segment from the opportunity set would likely be sub-optimal given that it would likely lead to more issuer concentration. If investors are concerned with investment grade corporate credit, they could consider allocating to other forms of credit (e.g. structured product) that have a greater linkage to the consumer and commercial and residential real estate.

Europe's problems have shifted to the "core"

Europe has been beset by numerous problems in 2018. While the "periphery" had been viewed as being the issue for the last several years, it appears that Europe's problems now lie with the "core". Countries such as Spain, Portugal and Greece, which were once cited as being a drag to the European economy, have improved in recent months. For example, according to the IMF, in the three years from 2015, Spain's GDP rose an average of 3.3% versus 2.4% for the EU as a whole. Elsewhere, Portugal's unemployment rate fell to 6.7%, the lowest in nearly 20 years and well below Italy's unemployment rate of 10.6%. In contrast, countries in the "core"

Europe's problems have shifted to the "core" - continued

which were supposed to propel Europe's growth are now presenting problems. In 2018, Italy was at the center of the European Union's problems leading to higher volatility and lower sentiment. Further, the U.K. faces political headwinds of its own as Brexit is a fluid situation that has the potential to exacerbate volatility. Potentially more impactful for the long-term future of European harmony is the fall from grace of Angela Merkel in Germany. She has been the dominant politician in Europe over the last decade and a strong stabilizing force for the EU. More recently, Emmanuel Macron, another strong pro-EU voice, has seen his popularity decline.

Key Takeaways: Europe's issues now seem to be centered in the "core" and it is difficult to see how conditions improve in the near term given political problems in Italy and the U.K. The modest fall in the euro should help conditions.

Portfolio Impact: There will likely be continued negative sentiment and potential volatility until issues in the U.K. and Italy can be resolved. A "hard Brexit" could result in significant volatility but that is an outcome that all sides seem determined to avoid despite rhetoric to the contrary. The current proposed deal may be the best in a series of bad options, resulting in modest gains across European assets.

Portfolio Strategy: European stocks, currencies and other financial assets cheapened in 2018. Some of this cheapening was justified as a result of weakening fundamentals. It seems to us, however, that sentiment is too negative on Europe and that European equities and other financial assets as well as European currencies may be attractively valued versus U.S. assets. Investors should be aware that there is the potential for further poor performance from European equities in the short-term. Investors wishing to taking advantage of depressed valuations in Europe are likely better served by increasing allocations to non-U.S. developed equities broadly. Investors could also consider an allocation to preferred securities which have exposure to both U.S. and European companies.

U.S. housing market stability

The housing market has shown signs of weakness in 2018 in part due to rising mortgage rates but also due to changes in the deductibility of taxes, enacted as part of the Tax Cuts and Jobs Act of 2017. Despite the recent slowing of the housing market, long-term trends are supportive of stable to rising home prices. The supply of new homes in the US built since 2008 is far lower than long-term averages and the U.S. population is larger by 30 million people since 2008. For example, in the 10-year period from 1996-2006, the U.S. built 1.7 million new homes annually (on average). In the most recent 10-year period, the U.S. has built just 900,000 homes, on average, each year. This lack of supply, combined with millennials engaging in household formation, improved consumer balance sheets, and the increase in population, should be supportive of limited downside in the U.S. housing market in the coming years. We should point out that there are potential headwinds for the U.S. housing market such as rising

U.S. housing market stability - continued

mortgage rates, a potential recession in 2020 (or thereabouts), and issues regarding property tax deductibility.

Key Takeaways: Despite rising mortgage rates and changes to the tax code, fundamentals appear to be supportive for the U.S. housing market. We believe there will be pockets of regional weakness in areas impacted by economic change and/or the change in state income tax deductions.

Portfolio Impact: As the housing crisis of a decade ago is still fresh for many in the economy, there is a perception that rising house prices indicate another housing bubble that may be succeeded by a housing bust. We believe housing and demographic fundamentals suggest this is unlikely. While there can be numerous causes of a recession, we don't believe the housing market will be the primary culprit the next time around.

Portfolio Strategy: The U.S. housing market is unlikely to suffer a bust like the 2008-2011 period for many years. Investment strategies focused on residential home lending in public and private markets that rely on house price stability to be successful should be entertained. Examples of strategies include non-agency mortgage origination strategies and strategies related to the growth in the single-family home rental market.

APPENDIX: Review of Rocaton's 2018 Themes

Figure 2:

Review of Rocaton's 2018 Themes

Rocaton Theme for 2018	2018 Key Takeaway	End of 2018 Update	Result
Markets are expensive globally	Valuations are elevated to varying degrees across all capital markets	• As we outlined, 2018 was a difficult year for investors with a return objective of 7% or higher	Markets appear better valued at the end of 2018 than they did at the end of 2017. This is true in many equity and in fixed income markets.
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	• Public markets across the globe failed to deliver meaningful returns in 2018 • Through late-November, nearly all "major" asset classes (with the exception of bank loans) were flat or negative for the year	Emerging market equities, non-U.S. developed equities and their respective currencies cheapened in 2018 versus U.S. equities. In credit markets, EMD and preferreds offered attractive valuations at the end of 2018.
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	• Global growth appeared to be coordinated in early 2018 • However, thereafter growth across economies diverged meaningfully, particularly between the U.S. and non-U.S. economies	Expectations are that global growth continues to be mixed and that strong U.S. growth tapers in 2019.
"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	• Global equity markets experienced severe declines in January/February and October 2018, largely as a result of unanticipated risks • Despite these declines, the U.S. continued to generate relatively healthy economic growth	This theme aimed to allow for a surprise major negative development that would meaningfully move markets. That did not happen in 2018.
U.S. politics will likely influence market dynamics	Tax reform, infrastructure spending, trade policy and foreign policy will likely influence market outcomes	• Tax reform provided a boost to U.S. equity markets for the first half of 2018 • Trade tension negatively impacted international markets and caused volatility in U.S. equity markets in the second half of 2018.	Politics often grab headlines but in the long-term they do not always move markets meaningfully. In 2018, however, political developments became important forces driving market returns in both directions.
Continued headwinds for inflation	Despite a tight labor market, secular forces are creating headwinds to higher inflation in the U.S.	• Through October, U.S. CPI was up just 2.2% year-over-year • Muted inflation continued even as the U.S. unemployment rate fell to a 48-year low	We expect that the recent downdraft in oil prices will pull CPI even lower at the end of 2018

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