Midyear 2017 Investment Views

EXECUTIVE SUMMARY

We continue to see the glass as half full with respect to traditionally riskier asset classes as we turn to the second half of 2017. Tepid, yet growing, corporate earnings, subdued inflation, central banks erring on the side of promoting growth, and global economic growth showing modest progress all contribute to this optimistic view. Global stocks, high yield bonds, private equity, real estate and other growth-related asset classes and strategies continue strong performance from 2016. Further, with the exception of the energy market, major asset classes and categories have experienced only modest declines in delivering this result. With few exceptions outside of specific country considerations, like the United Kingdom and Brazil, broad stock measures, major currencies and bonds have had a significant calm about them for 2017, in some cases registering the lowest volatility readings in over a decade.

The natural question is, what could change our optimistic forward view? We see policy risk as the biggest area that could shift our narrative. In the United States, the new administration's healthcare and tax agendas could surprise in either direction, but we think a lack of substantive legislation in either area could cause investor concerns. Because corporate earnings and global growth have been positive (and the administration is still very new), early policy shortfalls have been less of a concern. Monetary policy, which centers on using the level of interest rates to calibrate inflation or deflation concerns, is also a potential risk. We see the U.S. economy as still being fragile, even eight years since major domestic stock indices began their recovery from the 2008-2009 recession. Should the U.S. Federal Reserve (Fed) move interest rates higher before the economy is ready, or should the European Central Bank (ECB) and the Bank of Japan (BOJ) follow suit, this could raise borrowing costs for consumers and businesses and adversely impact growth prospects. Geopolitical risks are always a concern, including North Korea, and tensions among energy-dependent countries and China's twice-a-decade power transfer this fall could all drive potentially adverse outcomes.

With those risks noted, we also need to respect the possibility of growth accelerating faster, despite the recovery's length to date. With Europe and Japan showing signs of more sustainable growth, Chinese and emerging markets continuing to contribute to global growth, and the potential for pro-growth policies from the new U.S. administration taking shape, market participants could drive asset prices even higher. Should these developments unfold while inflation remains in check or the Fed seeks to deliver inflation in excess of its stated 2 percent target, the U.S. growth trajectory could accelerate beyond our current expectations.

GLOBAL ECONOMIC VIEWS

Global economic growth remains in a synchronized upswing, with positive year-over-year growth seen in all major world economies, with the sole exception of Brazil. In the United States, growth remains modestly positive, though below historical levels as the Fed continues its measured pace of interest rate hikes and delays persist in implementing the Trump administration's domestic policy agenda. Conditions in Europe and Japan continue to improve, with monetary policy (changes in interest rates that help calibrate borrowing costs) remaining extremely accommodative, meaning central banks that set monetary policy currently have a pro-growth mindset. With China on pace to achieve economic growth targets for 2017, policy has shifted toward modest tightening of credit conditions in order to curb potentially excessive growth in credit.

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United States: Risks to our U.S. outlook for modest, positive growth are balanced and primarily related to monetary and fiscal (changes to spending or taxation) policies. The Fed, which conducts domestic monetary policy, usually increases interest rates if they anticipate rising inflationary pressure. If expectations for a re-acceleration in inflation are not realized, additional increases in interest rates could be premature and could adversely impact consumer spending habits, as well as companies' plans to expand hiring or business build-out plans. However, expectations for most policy action outside of gradual interest rate increases are low at this time, and any positive movement in the legislative or regulatory agenda would likely lift business and consumer sentiment, providing a potential upside to our outlook.

- The solid jobs market remains a stalwart for modest economic growth. Business spending has remained cautious amid policy uncertainty, but could improve with pro-growth legislation. Loan growth at U.S. commercial banks has recovered from lower levels registered in March and potential regulatory reforms could provide additional economic support.
- Inflation is positive but remains below the Fed's stated 2 percent target despite a tight labor market, modest housing inventories and more stable commodity prices. We believe that wage growth will ultimately drive inflation toward the Fed target and support continued, measured increases in the policy rate.

Europe and Japan: In Europe, Dutch and French election risks failed to materialize and economic growth has continued to improve. Sentiment remains strong across manufacturing, construction and service industries and unemployment continues to fall. Political risk has shifted to the United Kingdom, where Prime Minister Theresa May's Conservative Party lost its parliamentary majority and uncertainty remains surrounding the Brexit negotiations. Growth in Japan has also been improving, reflective of accommodative monetary policy and the ongoing benefits of structural reforms.

China: 2017 appears to be another year of moderating growth in China. Policy actions have shifted from accommodative to restrictive, with a goal of managing financial system risks while still providing stable economic growth ahead of this fall's 19th National Congress of the Communist Party of China. We believe authorities have sufficient tools in the near term to manage economic risks of high debt levels and risks from currency outflows. The fall Party meeting will be an important determinant in the future pace of growth and reforms.

In aggregate, global economic growth is progressing, providing a reasonable backdrop for asset prices, but we continue to watch for any signs of weakening momentum or policy risks to alter our outlook on the current landscape.

EQUITY MARKETS

Our overall outlook for equities remains favorable amid a global scenario of positive economic growth across all major economies (except Brazil), restrained but positive inflation, relatively low interest rates and broadly accommodative monetary policies. Event risk has shifted from domestic politics to geopolitics, with tensions elevated between the United States and North Korea over that country's nuclear and ballistic missile programs.

Domestic equities: We expect U.S. equities to continue to trend higher in the second half of 2017, bolstered by rising earnings and a not-too-hot, not-too-cold economic environment.

- The S&P 500 and Dow Jones Industrial Average are beginning the second half of 2017 near all-time highs, with nine of 11 S&P 500 sectors posting positive returns, led by Information Technology, Healthcare and Consumer Discretionary.
- While elevated, broad market valuations are supported by modest economic growth, relatively low interest rates, restrained inflation and rising earnings. As of midyear, revenue and earnings growth for the S&P 500 are projected to increase roughly 6 percent and 11 percent, respectively, according to Bloomberg.

- Risks to our near-term outlook include valuations that are well above historical averages, recent softness in consumer spending and a continuation of domestic policy "paralysis." In addition, many sectors and companies appear to be technically extended while seasonal trends have typically pointed to lackluster performance during the summer months.

We retain a growth-oriented bias because we believe these sectors should continue to benefit from accelerating earnings growth, restrained inflation, lessening regulatory scrutiny and potentially lower taxes.

- Information Technology is the best performing sector year-to-date as of midyear, up nearly 16 percent. While there are concerns that select Technology companies have become a "crowded trade," we continue to like the sector based on favorable growth and valuation metrics.
- In the Consumer Discretionary sector, disruptive technologies are impacting investor sentiment and equity prices, particularly among apparel and grocery companies. Companies that are likely to succeed, in our view, are those with business models that require in-store traffic, have a digital presence or are not rendered obsolete by the Internet, and rank high in experiential factors among customers.
- The Financials sector has been among the most volatile since the November election, with its fortunes highly correlated to policy sentiment regarding potential legislative and regulatory changes. Given the pullback leading into midyear, we view the sector as increasingly attractive, with potential upside performance levers being regulatory relief, accelerating loan growth, and/or improved net interest margins associated with rising interest rates.

International equities: Foreign developed equity markets performed extremely well in the first half of 2017. We continue to have a positive outlook for the remainder of 2017 and favor both Japan and continental Europe over the United Kingdom due to modest reflation, firming and broadening economic growth, ongoing earnings improvement and a reduction in political event risk.

- The party of president-elect Emmanuel Macron secured a majority in the French parliamentary election, paving the way for pro-growth, structural reforms in the eurozone's second largest economy.
- Meanwhile, U.K. Prime Minister Theresa May's Conservative Party lost its parliamentary majority just as Brexit negotiations with the European Union have begun, creating an overhang to business sentiment in the United Kingdom.
- The economic picture continues to improve in continental Europe, where sentiment across manufacturing, construction and services businesses remains very strong and the unemployment rate across the region continues to fall.
- While deflationary fears have abated, inflation remains well below targets in Japan and the eurozone. We expect monetary policy in these regions to remain extremely accommodative throughout 2017, which should continue to be conducive for risk assets.

Emerging market equities posted strong gains in the first half of 2017. We remain cautiously optimistic and continue to view opportunities and risks in emerging markets as fairly balanced over the remainder of 2017. We prefer "thematic" approaches to emerging markets that focus on China's maturing economy (healthcare, environment, empire building) and the emerging market middle class.

- China remains on pace to achieve the government's economic growth target in 2017. However, the growth "impulse" from China may have peaked, with authorities engaged in tightening credit conditions in order to reduce financial system risk.
- An alleged bribery scandal involving Brazil's president Michel Temer has reduced investor confidence that sweeping reforms intended to pull the country out of a deep recession and rein in the country's chronic budget deficit will be implemented.
- The emerging middle class remains alive and well. China surpassed the United States in 2016 to become the world's largest retail market. Meanwhile, India has added 270 million bank accounts since the election of Prime Minister Modi in 2014.

FIXED INCOME MARKETS

We anticipate fixed income returns over the next few quarters are likely to be subdued relative to recent history and likely less than current quoted bond yields. Factors driving higher bond yields (and consequently lower bond returns in the near term) include positive global growth, rebounding inflation and the Fed's likely gradual increase in interest rates. The primary risk to our view is that rates could remain low if inflation continues to disappoint relative to Fed expectations.

Key interest rate drivers: Several areas we continue to monitor include:

- Inflation: This has generally been disappointing relative to the Fed's target of 2 percent in recent months, putting downward pressure on interest rates. Given the tight labor market, we think wages should resume their longer-term trend higher, which should contribute to higher inflation and interest rates in the back half of the year.
- Fed policy: We expect one more Fed rate hike in the second half of 2017, with two to three hikes in 2018 if the economy and inflation remain healthy. The Fed should begin to allow its balance sheet, or its accumulated securities purchased to hold down interest rates/borrowing costs, to decline before year-end 2017. While the near-term impact on rates are likely to be modest, it may drive interest rates higher next year.
- Secular theme – global population aging: Global demand for cash flow and income streams is strong and growing relative to supply, partially resulting from low yields across asset classes and an increasing population of retirees. This trend is unlikely to reverse in the coming years, which should keep rate increases moderate.

Corporate credit: This is our preferred way of accessing the fixed income market, reflecting solid performance expectations based on a strong economic backdrop and our expectation for low near-term defaults. However, spreads — defined as a bond's current yield less the Treasury bond yield of a similar maturity — are narrow, leaving little cushion for investors should risk appetites falter.

- We prefer active managers for low quality credits, reflecting a need for caution. For qualified investors, as appropriate, private debt vehicles may be a focus to potentially capture attractive illiquidity premiums.

Municipal debt: Limited supply and persistent demand may lead to continued outperformance in the near term, although municipal debt remains expensive by historical standards. Investor tax status continues to drive the degree of relative value versus corporate credit. Material changes to tax policy appear less likely compared to recent months, reducing a potential source of future volatility.

- The steep municipal curve — meaning bonds with longer maturities appear to provide higher than normal yields relative to bonds maturing sooner — may offer taxable investors attractive incremental compensation for extending duration. At the short end of the curve, investors in low-tax states should carefully assess corporate bonds relative to municipals, which may provide better value depending on tax rates.
- We encourage a focus on higher quality credits since problems in Puerto Rico and Illinois may trigger renewed scrutiny of other weak credits. We encourage using an active approach to manage risks from individual credits.

Emerging market debt: For investors with a higher-than-average risk tolerance, emerging market debt is becoming more attractive. Economic fundamentals in many areas are improving and yields appear fair as opposed to rich.

- Incurring currency risk is unlikely to result in adequate compensation for the volatility, thus we prefer U.S. dollar-denominated emerging market debt over local currency and emphasize active managers over passive.

REAL ESTATE MARKETS

We believe the best of times for the commercial real estate (CRE) market are likely behind us. Fundamental underpinnings for the CRE market are likely to soften from here. Vacancy rates appear to have bottomed and net operating income (NOI, which is a measure of cash flow post expenses) growth is slowing. Additionally, the

potential for rising interest rates could challenge current valuation levels. If safer investment options reflect higher interest rates, other asset classes are subject to moving down in price and therefore up in yield to “compete” with higher prevailing interest rates. To that end, we are likely in the later stage of the real estate cycle, which means property prices may need to adjust lower. However, current cash flow yields are fair relative to the low interest rate environment and positive overall economic environment. We expect total returns to be driven by current cash flow, with a limited contribution from price appreciation due to slowing NOI growth.

Across the major property types, vacancy rates are ticking up and NOI growth is slowing. In the multi-family sector, this is being driven by supply. Multi-family construction is at a four-decade high while the household formation rate remains near a 50-year low. In the retail sector, the phenomenon is being driven by the unprecedented pace of store closures. The closures are creating pressure on malls, with reports predicting 20 percent to 25 percent of malls may close or be repurposed, reflecting changing consumer tastes. In the office space market, there is a general lack of demand in a slow growth economy. The secular shift to telework is likely to further depress office demand over time.

The one bright spot is industrial property. Vacancy rates continue to trend lower and rent growth is still accelerating. This activity is being driven by the revival in U.S. manufacturing, as well as the consumer shift to online shopping.

COMMODITIES MARKETS

Commodity prices generally remain at the low end of the historical range, pressured by strong supply and modest economic growth. We believe prices are likely to remain constrained into next year by these soft fundamentals. Investors may wish to consider investments that potentially benefit from low commodity prices or cash flow-oriented commodity investments.

- Oil markets continue to struggle to bring supply and demand into balance, despite OPEC supply cuts into the first quarter of 2018. Ramping U.S. production and disappointing global demand growth are likely to remain headwinds into the fall.
- Low U.S. interest rates and softer inflation have supported gold despite Fed rate increases. Over the latter half of the year, we believe headwinds from Fed policy and a recovery in inflation are likely to pressure gold prices.

ALTERNATIVE INVESTMENT STRATEGIES

Slow growth and uncertainty about the future can lead investors to seek companies that exhibit strong fundamentals and to avoid weaker firms. We believe this may create potential opportunity for many alternative investment strategies. We see indications of wider performance dispersion in public markets, which is a positive for hedge funds that can benefit from both buying and selling securities. In private markets, the outlook for debt funds remains positive in the near term since they have become the lender of choice over banks and are able to charge attractive rates. Private equity strategies are relatively less attractive at current valuation levels. However, successful private equity funds may profit by using strong value-creation strategies and by focusing on high growth sectors and industries.

Hedged equity: We expect fundamental long/short equity managers to continue to struggle versus passive and quantitative strategies and favor event-driven and activist funds because systematic trading is less of a threat to success. With volatility low, we favor hedging extreme market events. European markets also represent an opportunity to capitalize on market mispricing due to Brexit-related volatility.

- June’s “Tech Tantrum” downturn in prominent Technology sector stocks (Facebook, Amazon, Apple, Microsoft and Google’s parent company, Alphabet) highlighted the potential for rapid sell-off when quantitative trading strategies that follow momentum trends receive a sell signal. Prior to the sell-off, these five stocks drove 30 percent of the S&P 500’s year-to-date gains, carrying significant momentum.
- Continued low volatility has driven down the cost of hedging equities with options at the same time major equity markets are at or near all-time highs. Many hedge funds are taking advantage of this attractive low-cost opportunity for gains in the event of an equity market sell-off.

- The European markets are becoming more attractive due to increased volatility associated with Brexit and other tensions within the region, such as monetary and fiscal policies and protecting its citizens.

Hedged fixed income: Amid slow global growth and persistently low interest rates in developed markets, we still see opportunities for strategies with long exposure to credit. However, it is expensive to hedge against further expected rate increases so we favor trading oriented active long/short credit strategies that may benefit from deep credit research and analysis on specific companies.

Funds that focus on B and CCC-rated securities should find opportunities that are less impacted by interest rates but more so by credit quality. The days of cheap capital may be waning, allowing the markets to reward firms that can manage their capital wisely. The dispersion between "quality" and "junk" high yield companies is widening, which presents opportunities for those who can discern one from the other.

Private equity: Strong fundraising in the private equity markets, combined with the availability of low-cost credit, has resulted in fierce competition for deals leading to valuations that are generally unattractive. Investors have taken a "business as usual" approach in the absence of major policy changes by the new administration. Therefore, we favor strategies with strong focus on value creation through buy-and-build or operational initiatives, niche strategies focused on growth sectors and investing in companies that show valuation resilience. The slowdown in European deal activity post-Brexit also presents unique opportunities for private equity.

- Strategies focused on acquisitions and/or operational initiatives to generate growth or cost efficiencies are expected to create value across market cycles and should be well positioned in the event of an overall flat-to-declining macro environment in the years ahead.
- Healthcare, education, consumer, and business and financial services are the sectors that continue to show promise for growth given the transformative mega-trends within those sectors.
- Companies that show valuation strength in the face of volatility or market contraction, such as those with high recurring revenue streams, sticky consumer contracts and highly visible cash flows present unique opportunities for managers.

Private debt: In 2017, private debt markets have generally remained stable and robust despite unexpected geopolitical events. While spreads have compressed in first lien debt, we still see opportunities in the middle market and niche sector strategies where access and specialized asset valuation knowledge provides an edge, and in second lien debt where spreads remain attractive.

Managers are looking to lend to resilient companies in niche markets that are protected by high barriers to entry and able to offer premium products or services. Also, attractive yields remain to be found in certain debt deals, especially club-style first lien executions, lower middle market investments, and companies within healthcare, financial services and sub-segments of the Information Technology sector.

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