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The Hills Have Eyes

Although there are still many unknowns, with the transition to a late-cycle phase just beginning and a shift toward fiscal stimulus beginning as early as next year in many corners of the globe, we believe a major market regime change is underway. Our preliminary thoughts are outlined below.

Macro environment:

- From secular stagnation to fiscal reflation

Market regime:

- From a defensive search for yield to extracting value and increasing cyclical exposure

Growth catalysts:

Primary: a move toward the late-cycle phase, fiscal stimulus through tax cuts and a potential infrastructure bill

Secondary: deregulation in healthcare, financial industries and potentially energy

Macro unknowns currently:

- Overall level of growth in the first half of 2017
- Future trade policy tensions
- Size and magnitude of an infrastructure bill
- Degree of future tax cuts for individuals, small business and corporations
- Degree of tax holiday or tax rate on capital repatriation
- Potential unwind of globalization—how far and how fast?
- Durability of Emerging Market recovery given higher bond yields and rising protectionism
- Geopolitical equation
- European elections impact
- Number of Federal Reserve (Fed) rate hikes for 2017

Investment consequences:

- Politics and policy leads to asset class rotation
- Increase in inflation
- Higher nominal gross domestic product (GDP) growth
- Higher bond yields and steeper yield curve
- A bottom in rates
- Potentially quicker central bank response than market expectations
- Value outperforming growth
- Cyclical industries outperform more defensive ones
- Higher commodity prices
- Higher asset price volatility
- Higher deficits and higher debt
- Slightly higher dollar versus developed and Emerging Market currencies
- Longer-duration fixed income is vulnerable to rising yields

Investor positioning

Portfolio repositioning is likely to continue through year-end and well into 2017 as developments unfold and the pro-cyclical environment gathers momentum. With growth already heading higher from Q3 2016 onward and earnings turning positive, investors are like "hills that have eyes." They can see the horizon and have begun increasing cyclicality and exposure to value in portfolios at the expense of more defensive sectors and higher-dividend areas within equities. In addition, we expect a larger shift in emphasis toward small capitalization

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and more domestic-oriented equities due to a stronger dollar, lean, more pro-growth policies and the desire for a hedge against potential retaliatory trade policies from main trading partners. This portfolio shift in positioning is happening at the institutional level and on the part of the individual investor base and portfolio managers globally.

Our investment view

We are moving from a "get paid to wait" core portfolio theme to a more cyclical- and value-oriented theme in multi-asset and all-equity portfolios. However, we still believe exposure to dividend-growth investments versus the "bond proxies" in equities makes sense even as bond yields rise. Dividend-growth mixed with more cyclical value factors is an effective combination in the environment that we are heading into, in our view. Bond proxies or those types of equities and markets that are higher-yielding (think utilities, telecoms, parts of REITs, some consumer staples areas) are likely to come under further pressure as fixed income yields rise in conjunction with higher inflation and rising growth (higher nominal GDP growth). In contrast, we expect more value and cyclical managers to perform better as they allocate more to industries that tend to benefit from the transition to a late-cycle phase, which includes the normalization of interest rates and increasing growth. These industries include banks, energy, materials, parts of the industrials and the technology sector. This late-cycle move should also benefit active managers as stock correlations tend to decline and intra-market dispersion rises.

Commodities and the Dollar

We are also getting more favorable on commodities. This is due more to the late-cycle phase and increasing inflation than the expectations for a large infrastructure bill. However, any fiscal stimulus through a potential infrastructure bill would help support the trend that is already building. The expected rise in commodity prices should not be hampered by the strength in the dollar, which is a core belief for 2017. The dollar should undergo an initial strengthening as growth picks up, interest rate differentials widen, and the Fed begins to normalize rates earlier than others. But the strengthening should turn to stability as growth in Europe and Japan play catch-up heading into 2018.

Non-U.S. Exposure

In typical late-cycle phases, most cyclical value assets that are leveraged to world growth tend to outperform. Two primary examples of cyclical assets as far as economic zones are concerned are the Emerging Markets and Japan. We still expect Japan to undergo a re-rating and rise in value in the coming 12 months given the reflationary policies the Bank of Japan has put in place and may expand. However, with uncertainty surrounding potential trade policy changes, such as tariffs or other measures that could be growth-inhibiting, in combination with a stronger dollar and expected Fed rate hikes, Emerging Markets are likely to be the odd person out in this late cycle. We are weighing the positives and negatives for Emerging Market equities and will be assessing our recent tactical overweight in the coming weeks.

Moreover, even though growth is surprising somewhat in Europe and economic activity is expected to continue to maintain momentum heading into 2017, with the uncertainty surrounding the December referendum in Italy, as well as elections next year in France, the Netherlands and Germany, upside across the continent relative to the U.S. and Japan should be limited, in our opinion.

Still Overweight Equities

Overall, the potential fiscal adjustments starting in the U.S. in mid-2017 should help increase nominal growth materially by the end of next year. This should underpin improved revenue and earnings growth and kick-start various portfolio rebalancing efforts across most investor segments. Asset classes have already started to reflect the initial stages of this cyclical movement into the early stages of a late-cycle phase. But, in our view, this is just the beginning of a broader move that should materialize over the next 12-18 months. We will be assessing our tactical asset allocation policy across all portfolios as we head into the tail end of the year. At present, we continue to have a slight overweight to equities over fixed income (despite equities being close to record highs) and expect the return profile of industry benchmarks to widen versus each other in the medium term.

Fixed Income View

In terms of fixed income, our core belief is that rates bottomed back in June/July, and yield curves should continue to shift upward, but the overall level of rates should not get too

excessive in the next 12 months. With nominal growth rising and potentially reaching close to 6% (as inflation approaches 3%), bond yields, particularly longer-dated ones, should follow suit. We would not be surprised if U.S. 10-year Treasury yields reach 3% or higher next year. With the yield anchor being lifted and investors over-exposed to longer-dated bonds, the asset class is vulnerable to negative price pressures, in our opinion. Investor repositioning of multi-asset portfolios is likely to cause outflows from the asset class in the next 12 months. If this occurs, longer-duration bonds and lower credits would be more vulnerable. Therefore, we continue to prefer to be shorter duration and higher quality overall. This could help the funding status of institutions that are more diversified and have multi-asset mandates. Furthermore, with possible tax cuts and/or tax reform coming next year, municipal bonds are also likely to be vulnerable to price pressures. Lastly, given our view of rising inflation expectations, investors should also consider raising allocations to Treasury Inflation-Protected Securities (TIPS) and floating-rate bonds. For investors who have mandates that allocate to various managers we believe lower-duration strategies that have higher exposures to TIPS, floating-rate bonds and higher-quality credits than their benchmarks makes sense in the unfolding environment. Importantly, however, we would emphasize that although we see a more difficult total return environment for fixed income it still remains an important diversifier from equities, adds some protection against higher-volatility asset classes in general, and can help increase a consistent stream of cash flows that may be required for income and/or for liability matching. While we transition to a new cycle, portfolio rebalancing into higher yields in the next 12-18 months should help improve the level of cash flows from the ultra-low rate environment of the past several years in an overall portfolio.

Higher Volatility, Active Management and Alternative Investments

The pro-cyclical improvement has started to break down the elevated correlation amongst and within asset classes since earlier this year. This adjustment has helped improve some active management scorecards. We expect this adjustment to continue as economic volatility picks up and asset class volatility follows suit. Transitions to late-cycle phases tend to invite a higher level of volatility as inflation rises and central bank policies shift to nudging short rates higher. In addition, with the potential for secular stagnation to shift to higher nominal growth through fiscal stimulus activity, plus uncertainty over global trade policy expected next year, sharp, protracted price swings could develop. In this environment, alternative investments, namely hedge funds, should have a larger opportunity set to outperform industry benchmarks, which is a break from the most recent past of difficult performance.

Asset Class Rotation Is In the Early Stages

In summary, we expect significant investor repositioning to unfold in the next 12 months in order to get better positioned for the expected upswing in nominal growth, economic activity, rising bond yields and inflation and potential fiscal policy action. Given that a large share of the global investment community is heavily exposed to defensive, higher-quality, higher-yielding investments in general (as rates globally have trended down for years) and longer-dated fixed income, a major rotation across and within asset classes could have a material impact on portfolio performance in the coming year. We believe investors should begin repositioning portfolios accordingly as we head into 2017 in order to better prepare for and take advantage of the events we see unfolding.

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