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GWIM Chief Investment Office
GWIM CIO Office Team

INVESTMENT STRATEGY COMMITTEE UPDATE

Keeping the angry clown at bay

We maintain our balanced tactical allocation strategy across risk profiles given the latest increase in volatility.

Previously we've written about how we "looked under the bed" and all we saw were some (admittedly suspicious-looking) puppets; despite all the risk and uncertainty globally, none of them presented an imminent risk, in our view. Now the "angry clown" we referred to then has poked its head out from underneath the bed as volatility has picked up across asset classes. In this case, the "angry clown" is the first real understanding that the yield/rate backdrop around the globe is changing as central bank communication in much of the developed world has been adjusted to suggest that perhaps the future will not include an advancement of negative interest rate policies or other forms of monetary accommodation, such as operation twists or buying longer-dated bonds in place of shorter-dated ones.

The most important element here is that there seems to be a dedicated effort to change monetary policy as it has become "tired" and in many cases, ineffective. With this in mind, yields should continue to have an upward bias, particularly in the longer maturities, and the push higher will encourage asset rotation and the unwinding of exposure to bond proxies that became over-owned in portfolios. Complacency is still high in fixed income and we suspect volatility has room to run in the coming weeks and months ahead. This will have ripple effects in equity markets.

With this in mind, we are not making any major tactical asset allocation calls. Rather, we would maintain a risk neutral, balanced approach to portfolio strategy as volatility will likely remain elevated for the following reasons:

Complacency The Brexit vote was a big surprise for the markets but equities moved higher without a significant pullback until the "angry clown" poked its head out.

Positioning Crowded positioning in long-dated bonds, "bond proxy" equities, low-volatility strategies and quantitative strategies like Risk Parity funds, Managed Volatility funds, and CTA funds could lead to an unwinding of these crowded positions if volatility is driven higher by rising interest rates and/or potential adjustments in central bank bond-buying programs.

Seasonality September and October are traditionally high volatility months.

The "angry clown" Concerns over rising rates and potential adjustments from the European Central Bank and Bank of Japan to steepen yield curves.

Global policy uncertainty U.S. election concerns and the European political landscape, for example.

Portfolio strategy and asset allocation

- **We continue to expect equities to outperform fixed income:** Economic indicators suggest that it is too early for a cyclical bear market, and equities should remain on a longer-term uptrend as U.S. and global expansions gradually continue. While valuations are full on an absolute basis, relative valuations versus fixed income, in general, remain attractive. With that said, we believe equity market volatility could remain elevated for the reasons listed above and the S&P 500 is already trading slightly above the full-year 2016 top-end target of 2,100. We would continue our "get paid to wait" strategy—accumulation of cash flows across assets, increase less-correlated investments, and commit to an increased level of tax efficiency and rebalancing. Information technology remains our favored sector for long-term growth.

- **Equities remain at a neutral weight:** We remain neutral on equities as central bank policies such as negative interest rates become less effective and political risks are an overhang. U.S. equity market valuations are full at about 18 times earnings for the S&P 500. Therefore, we believe any further upside from these levels would be borrowing from returns in 2017 or would need an earnings boost for the S&P 500 as the main catalyst. Within equities, we maintain a slight overweight to U.S. large-cap stocks for their high quality, stronger free cash flows and dividend growth. The U.S. equity market is now at the upper end of the range for valuation and index target level.

- **We remain neutral emerging market equities:** Although emerging market equities have some of the most attractive valuation levels, they continue to face a range of challenges, including low commodity prices, gradual normalization of Federal Reserve interest rate policy and the structural downshift in China's growth rate, but given our late mid-cycle view, we believe more cyclical assets, like emerging markets, should gradually continue to attract investment flows. We still view markets such as India—that are less dependent on trade and commodities and have more domestic support from monetary policy and internal reform—as the best-positioned. On a structural basis, we continue to expect strength in demand from the emerging market consumer, as incomes and spending power increase over the longer term.

- **We are maintaining a neutral position in international developed equities versus our strategic allocation, and would approach hedging on a case-by-case basis:** Global financial conditions are currently stable, and the economic backdrop should provide enough tailwinds to support modest growth in Europe. However, elevated headline risks—major elections in 2017, a potential delayed Brexit impact, negative interest rate policies in Europe and Japan—warrant a neutral weight reflecting a more balanced approach. We would approach hedging Japanese and European equities on a case-by-case basis given our more neutral view on the dollar.

- **We remain underweight fixed income, but we still find opportunities selectively in credit:** We recommend that investors maintain a neutral duration in strategies appropriate for their risk tolerance. We continue to prefer credit over Treasuries, with an emphasis on investment-grade corporate bonds, as well as municipals. However, in the current higher-volatility market, some allocation to Treasuries for liquidity and relative safety is advised. We would caution against an over-allocation to long-duration assets given unfavorable risk-reward trade-offs. Given the upward bias of the U.S. dollar, we are generally avoiding non-dollar sovereign bonds. We advocate a neutral weight to municipal and corporate high-yield and leveraged loans. Allocations to high-yield should be in managed solutions that overweight the higher end of the quality spectrum. Valuations and fundamental risks, including the acceleration in default rates, lead us to be cautious on allocations to index-based solutions in high-yield. For all sectors, we recommend an active management approach to improve potential returns in a rising and volatile rate environment. A barbell strategy of owning bonds with both longer and shorter maturities should perform better than a laddered or bulleted strategy in a flattening yield curve environment.

- **We are neutral commodities:** Commodity prices are likely range-bound in the near term, weighed down by global economic policy uncertainty but held up by stable global cyclical momentum. We think oil prices will finish the year in the range of $45 to $55 and move slightly higher next year.

- **We are neutral hedge funds:** We currently emphasize hedge fund strategies that have low to moderate levels of market exposure and those managers that can generate a large portion of their return from asset selection and/or market timing.

- **We are neutral private equity:** We see potential opportunities in special situations/opportunistic and private credit strategies.

- **We remain neutral in real estate as an asset class:** We prefer opportunistic and value sectors.

- **The dollar:** Our base case is that the dollar will likely remain generally stable with some upside potential if, for example, wage growth in the U.S. picks up faster than expected, euro breakup sentiment gains traction or relative emerging market cyclical momentum stalls, further narrowing the growth differential with the U.S.

- **"A Transforming World" investment themes (Earth, people, innovation, markets, government):** We favor themes such as robotics, cloud computing, big data, cybersecurity, agriculture, water scarcity, financial technology, emerging market internet users, alternative energy and defense.

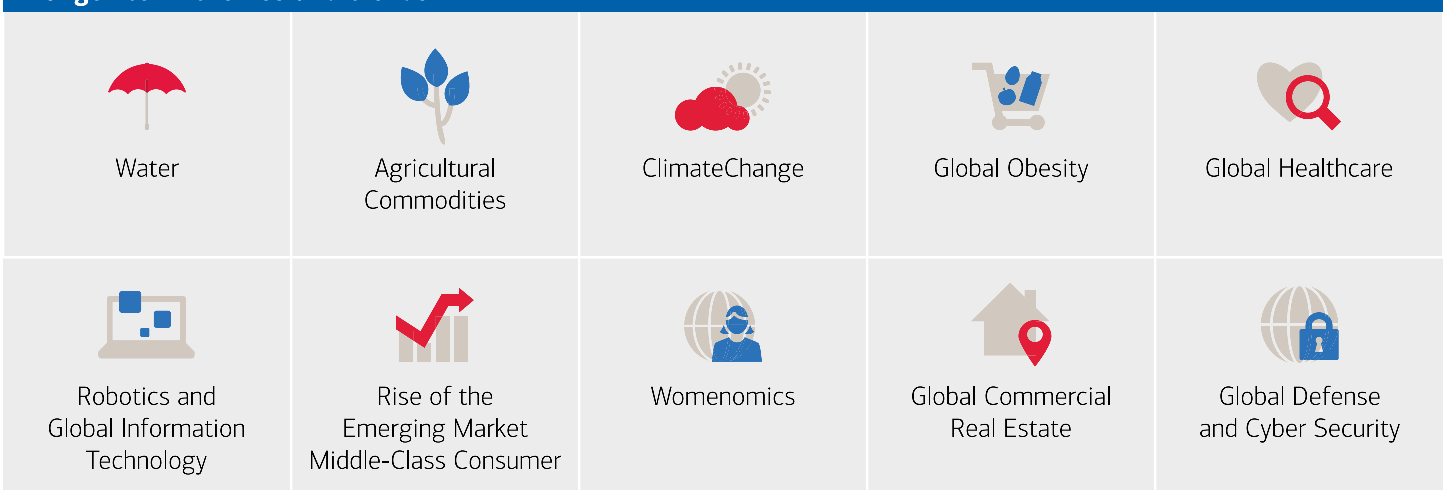
Macro Strategy

- The impact of lower energy prices and a stronger dollar is fading, as evident in first-half corporate profits. Gross domestic product profits show a bottom in the fourth quarter followed by a rebound this year. These are the only official seasonally adjusted statistics, and they are not massaged by companies. Profit growth should return to a low-to-mid single-digit pace.

- A solid jobs market, with unemployment headed toward 4%, and strong real wage gains should keep the U.S. consumer moving forward. With inflation moving gradually higher, we expect the Fed to raise rates by the end of the year. Housing is an important tailwind for the U.S., and residential investment should continue to grow at a double-digit pace.

- The waning global momentum that developed from China's transition, and the negative upfront impact of the stronger dollar and lower oil prices, is now subsiding thanks to the steadier currency and commodity outlook. As these negative effects fade, global cyclical momentum is starting to shift modestly to the upside.

Longer-term themes and trends



When assessing your portfolio in light of our current guidance, consider the tactical positioning around asset allocation in reference to your own individual risk tolerance, time horizon, objectives and liquidity needs. Certain investments may not be appropriate, given your specific circumstances and investment plan. Certain security types, like hedged strategies and private equity investments, are subject to eligibility and suitability criteria. Your financial advisor can help you customize your portfolio in light of your specific circumstances.

ASSET CLASS	CHIEF INVESTMENT OFFICE VIEW Negative Neutral Positive	COMMENTS
Global Equities	• • ● • •	Future returns are likely to be lower than history. Risks are balanced between rising political uncertainty and monetary policy exhaustion versus reasonable valuation compared to bonds and weak investor sentiment.
U.S. Large Cap	• • ● • •	Higher quality preferred given fuller valuations, political uncertainty, improving but subdued economic growth and earnings picture.
U.S. Mid & Small Cap	• • ● • •	Valuation multiples for small caps remain slightly extended; select opportunities within higher-quality can be considered.
International Developed	• • ● • •	Weak organic earnings growth and heightened risk related to central bank policies in Europe and Japan (NIRP) offset improving economic environment.
Emerging Markets	• • ● • •	Valuations are cheap and stability in commodity prices and Chinese economic activity have led to better investor sentiment. However risks remain from a potentially stronger U.S. dollar and heightened volatility.
Global Fixed Income	• ● • • •	Bonds continue to provide diversification, income and stability within total portfolios. Interest rates remaining lower for longer limit total return opportunities in bonds.
U.S. Treasuries	• ● • • •	Current valuations are stretched, especially on longer maturities. Consider Treasury Inflation-Protected Securities as a high-quality alternative.
U.S. Municipals	• • • ● •	Valuations relative to U.S. Treasuries remain attractive, and tax-exempt status is not likely to be threatened in the near term; advise a nationally diversified approach.
U.S. Investment Grade	• • • ● •	Risk of rates rising subsiding. Stable to improving fundamentals expected to attract high-quality foreign investors as yield differentials are supported by divergent monetary policy.
U.S. High Yield	• • ● • •	We remain cautious, as defaults expected to increase; spreads to remain range-bound until further economic growth.
U.S. Collateralized	• • ● • •	Higher rates and Federal Reserve tapering are likely to increase spread volatility. A shortage of new issues should counter the effects of tapering.
Non-U.S. Corporates	• • ● • •	Select opportunities in European credit, including financials; however, any yield pickup likely to be hampered by a stronger dollar.
Non-U.S. Sovereigns	• ● • • •	Yields are unattractive after the current run-up in performance; prefer active management.
Emerging Market Debt	• • ● • •	Vulnerable to less accommodative Federal Reserve policy and lower global liquidity; prefer U.S. dollar-denominated Emerging Market debt. Local Emerging Market debt likely to remain volatile due to foreign exchange component; prefer active management.
Alternatives**	• • ● • •	Select Alternative Investments help broaden the investment toolkit to diversify traditional stock and bond portfolios.
Commodities	• • ● • •	Medium-/long-term potential upside on stabilizing oil prices; near-term opportunities in energy equities/credits.
Hedged Strategies	• • ● • •	We currently emphasize hedge fund strategies that have low to moderate levels of market exposure and those managers that can generate a large portion of their return from asset selection and/or market timing.
Real Estate	• • ● • •	We prefer opportunistic and value sectors.
Private Equity	• • ● • •	We see potential opportunities in special situations/opportunistic and private credit strategies.
U.S. Dollar	• • • ● •	Stronger domestic growth and a less dovish Federal Reserve policy (relative to the monetary policies of other Developed Market central banks) support a stronger dollar going forward.
Cash	• • • ● •	We have a small cash position awaiting deployment when opportunities arise.

* Boxed section, updated since last month.

** Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients. As we continue to converge our guidance across UST and ML, we will no longer provide tactical over-weights or under-weights for Alternatives overall, or for Hedged Strategies, Real Estate, and Private Equity. However, we will continue to highlight areas of opportunity within each of these asset classes through the Navigator, our quarterly outlook for alternative investments.

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