NOVEMBER 2016

An Evolving Cycle

We are seeing some tentative evidence of changes to the set of factors driving performance of equities and other asset classes. Since early in the decade, structural shifts in the global economy, helped along by central bank actions, have brought about a decline in real and expected economic growth and inflation, accompanied by a drop in bond yields to record-low levels. In this environment, income-seeking investors have bid up dividend-yielding stocks, e.g., utilities and telecoms, while a relative dearth of earnings growth has favored the growth style over the value style. Low volatility has risen in importance as an equity factor, and has performed well for the same reasons that the traditional defensive sectors did better than cyclicals.

The evolving mix of policy prescriptions around the world, and early signs in economic data are raising expectations for economic growth and inflation and consequently higher nominal, but also real, bond yields. This could mark a turning point from the extraordinary market environment of the last few years to a more "normalized" one.

Central banks are, and are expected to continue, playing an important role in this reversal. In the U.S., Federal Reserve (Fed) officials have signaled their willingness to let inflation overshoot its target, and not slam on the brakes too early in the face of low unemployment rates and the associated upward wage pressures already evident, a stance labeled as "running a 'high-pressure economy'[1]." Speculation about tapering of asset purchases in the European Central Bank's quantitative easing programs could be implying a tighter policy shift. In Japan, the new focus of the central bank is on targeting a 0% yield for the 10-year government bond, when previously the focus was on the quantity of debt purchased.

[1] Inertia in monetary policy is suggested as a sensible course of action when there is great uncertainty as to where the neutral rate of interest lies. For details, see Hamilton, J.D., E.S. Harris, J. Hatzius, and K.D. West. 2015. "The Equilibrium Real Funds Rate: Past, Present and Future," Working paper #16, Hutchins Center on Fiscal & Monetary Policy at Brookings.

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Recent Publications

The Wealth Allocation Framework

LIFE PRIORITIES

The Wealth Allocation Framework helps you put your goals and aspirations at the center of decisions about allocating your financial resources. **Asset categories within the framework include:**

- **Personal:** Individual investors have a desire for safety and personal financial obligations they want to meet regardless of market conditions. To safeguard essential goals, investors can hold lower-risk assets—but they have to accept lower returns in exchange.
- **Market:** When we invest, we strive to capture market growth most efficiently. Today, access to a broadening array of asset classes and types makes diversifying beyond stocks and bonds easier than ever before.
- **Aspirational:** Investors seek significant wealth mobility. To pursue goals that require higher-than-market returns, investors often need to take higher and concentrated risks.

To learn more, read the whitepaper, *Investing in a Transforming World: The Wealth Allocation Framework*

The commentary and actions of these central banks could be an indication of higher yields and steeper curves to come.

Changes in sector and thematic leadership are already reflecting the evolving economic and market landscape. That being said, equities need growth, not just higher inflation, and real growth has to rise faster than prices. There is a limit to how far inflation forecasts can drive risk assets higher. **However, we see select opportunities in cyclical investments** (**i.e. close relationship with growth). As we wrote in our most recent ISC Viewpoint, A Major Pivot at Work, the backdrop of rising cyclical momentum and rising inflation expectations has benefitted cyclical value investments over defensive and yield-driven strategies. We think these trends will continue as we head into early 2017.**

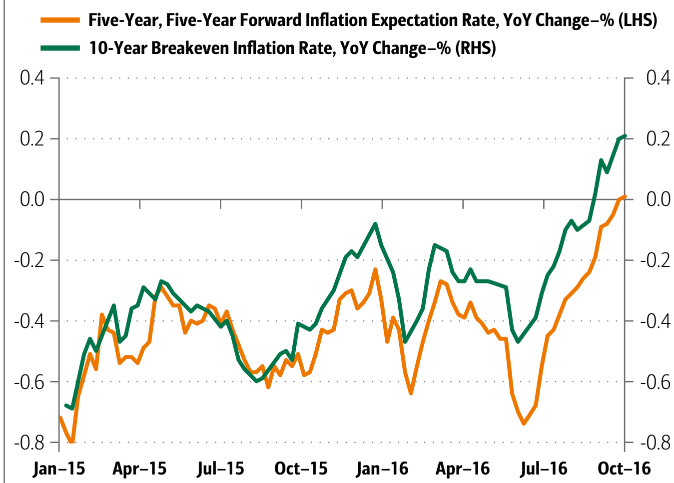
The Pivot

The recent environment has been marked by anemic profit growth (negative in the last few quarters, i.e., an "earnings recession"), driving investors to sectors and companies that offer high quality and predictable streams of earnings. Also, the low rates have diminished income from the traditional yield instruments, prompting income-seeking investors to search for it in higher-dividend equities. Very often, low-volatility stocks offer these attributes in combination. These trends have become evident and played out since 2008, with high-dividend, stable-earnings, lower-volatility stocks being bid up, rewarding investors with handsome total returns.

Recently, as U.S. inflation expectations have picked up and commodity prices have rebounded and stabilized, there has been a clear pivot away from deflation concerns to reflationary traction (see Exhibit 1). Nominal economic data are firming, which helps global earnings growth.

And while the Fed could have looked at all this as supporting evidence that it needs to hasten its pursuit of a tighter monetary policy, recent commentary by some of its highest officials suggests that it is willing to allow modest inflationary biases to build while giving the economy a chance to gain a stronger footing instead of risking a relapse to the recent disinflationary trends by applying the brakes too soon. That, and the expectation of fiscal expansion through a combination of higher government spending and tax cuts, serve as reassurance that the reversal to a new reflationary regime could be credible.

Exhibit 1: A shift from disinflation to reflation



Source: Absolute Strategy Research, FactSet and GWIM Chief Investment Office. Data through October 28, 2016.

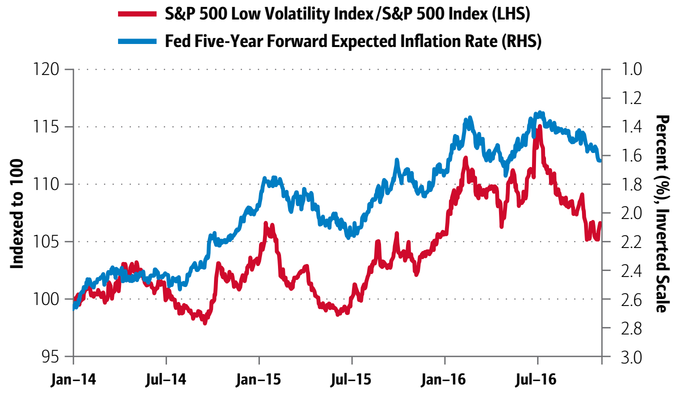
Alongside this pivot, we have seen a rotation in sector and thematic leadership.

We can see the rotation most clearly in early signs of a **reversal** in the outperformance of three themes:

- Low-volatility stocks or minimum-volatility equity strategies versus the market
- Traditional defensive versus cyclical sectors
- The growth versus the value equity style

Outperformance of low-volatility stocks or minimum-volatility equity strategies is receding. Since July, we have seen outflows from low-volatility stocks and minimum-volatility strategies, a portfolio positioning that had been growing in the last few years, and accelerated since August of 2015 (see Exhibit 2). Low volatility had become a crowded theme in an environment of heightened macroeconomic and policy uncertainty, which shifted the focus away from the declining or absent earnings growth to top-line growth. With healthier economic growth prospects, fueled by expectations of fiscal expansion, and low or negative rates a less important policy tool, the focus is swinging back to earnings growth, best embodied in momentum themes and strategies.

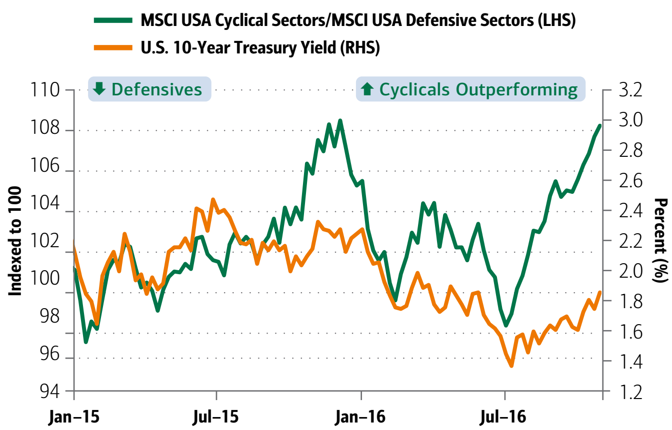
Exhibit 2: Low-volatility indices are tracking expected inflation



Source: Bloomberg and GWIM Chief Investment Office.
Data through October 31, 2016. Please see Appendix for index definitions.
Past performance is no guarantee of future results.

Outperformance of defensive versus cyclical sectors has reversed. Until this summer, defensive sectors had been strongly outperforming cyclical ones. At that time, U.S. Treasury yields started to rise, leading to outperformance of cyclical sectors (see Exhibit 3). The prospect of higher prices has been welcomed by the cyclical parts of the equity market. The cost has been to bond proxies (equities that investors buy mainly for yield), but bank, value and cyclical stocks, as well as the stocks of companies with weaker growth profiles, have been reflated by the turn in inflation expectations. Better pricing power, leading to higher profit margins, is the hope that has driven them higher.

Exhibit 3: Cyclical sectors have started to outperform defensives as growth expectations have improved



Source: FactSet and GWIM Chief Investment Office.
Data through October 28, 2016. Please see Appendix for index definitions.
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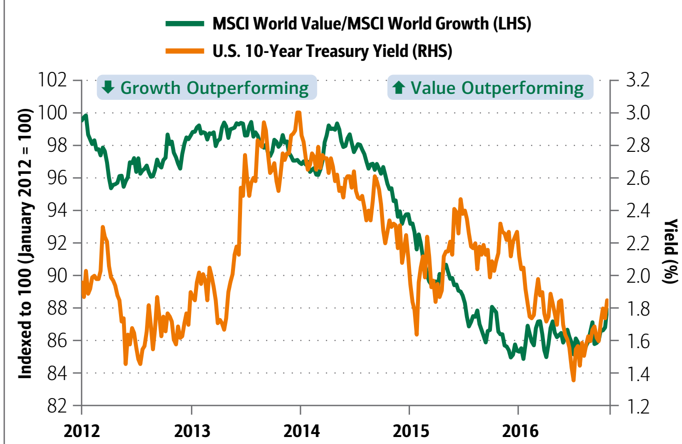
Outperformance of the growth versus value equity style is ending. The reversal of this theme is less pronounced than that of the themes discussed above, and perhaps it is too early to call it. The shift from an environment of meager to more robust earnings growth primarily drives this reversal, as it has typically done in the past. Some of the drivers of the defensive versus cyclical outperformance reversal are also contributing (see Exhibit 4).

Exhibit 4: Previously, there was a scarcity of growth and everyone chased it—this trend has started to reverse



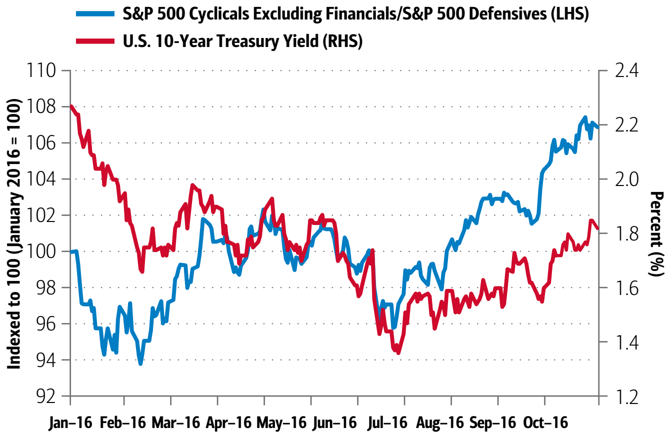
Source: FactSet and GWIM Chief Investment Office.
Data through October 28, 2016. Please see Appendix for index definitions.
Past performance is no guarantee of future results.

What is driving the rotation?

Two of the most significant drivers of the rotation are inflation expectations and rising bond yields. The performance of cyclicals excluding financials seems not strongly linked to bond yields in the U.S., and historically has not closely followed them higher (see Exhibit 5). When looking at the financial sector alone, we find a much stronger relationship with bond yields. U.S. inflation expectations have increased more sharply, and the relative performance of cyclicals excluding financials against defensives has moved closely with the U.S. 10-year breakeven inflation rate (see Exhibit 6).

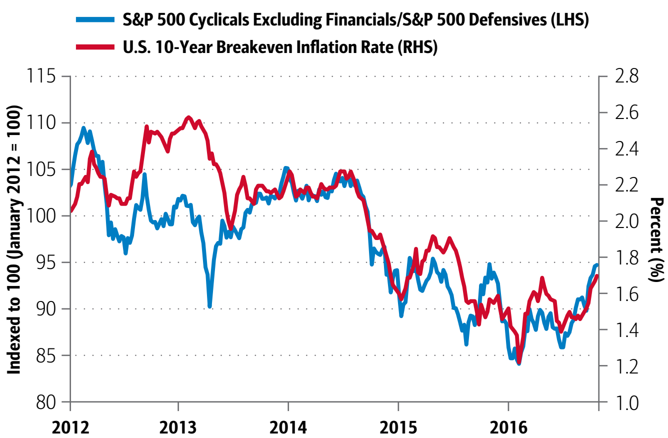
This is intuitive, since a steeper yield curve supports bank profitability by boosting banks' revenue through higher lending (long-term) rates while their cost of capital remains reasonably lower because deposit (short-term) rates do not rise as fast.

Exhibit 5: Cyclical sectors excluding financials are not as bond-sensitive



Source: Absolute Strategy Research, FactSet and GWIM Chief Investment Office. Data through October 31, 2016. Please see Appendix for index definitions.
Past performance is no guarantee of future results.

Exhibit 6: Inflation expectations are driving cyclicals excluding financials versus defensives performance



Source: FactSet and GWIM Chief Investment Office.
Data through October 28, 2016. Please see Appendix for index definitions.
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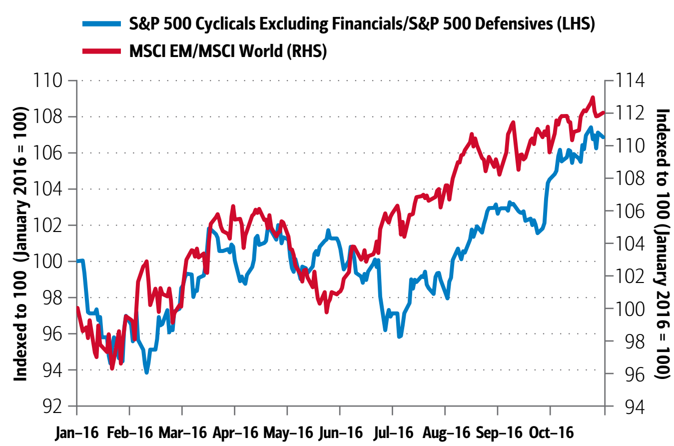
Better macroeconomic data, upward wage pressures in a U.S. economy running close to or at full employment, tighter capacity utilization, and more stable commodity markets are fueling higher inflation expectations and raising probabilities of federal funds rate hikes in upcoming Federal Open Market Committee meetings.

In the new environment, it is legitimate to ask which sectors can benefit the most from higher inflation expectations. It is important to remember that cyclicals are not a homogenous group of assets and their relative performance depends on the type of inflation. Rising commodity prices, rather than wage gains, tend to contribute much more to higher inflation, therefore, when inflation rises, industrial cyclicals tend to perform better than consumer-focused sectors. The latter typically experience rising inflation as higher input costs, which they may be challenged to pass on through raised prices to their customers, possibly putting downward pressure on their margins.

Currently, inflation in the U.S. is being driven by wages. Historically, this leads to consumer-focused sectors outperforming. So, while consumer sectors are getting squeezed by higher wage costs, typically the benefit from greater consumer income and therefore consumer spending outweighs the increase in wage costs. However, resource-related sectors get hit by higher wage costs and need greater commodity price inflation to offset the higher wage expense.

Higher bond yields benefit the profitability of financials and hence their relative returns compared to other cyclicals. Most cyclicals excluding financials get a boost from higher inflation expectations through more robust commodity prices, which in turn are linked to better growth in Emerging Markets (EM) rather than Developed Markets (DM). This becomes evident when looking at the tight relationship between the relative performance of cyclicals excluding financials and defensives, and that of EM versus DM equities (see Exhibit 7).

Exhibit 7: The relationships between U.S. cyclicals excluding financials and defensives, and between EM and DM rotation, have been tight



Source: FactSet and GWIM Chief Investment Office.
Data through October 31, 2016. Please see Appendix for index definitions.
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Portfolio Positioning: In the evolving cycle, we see the trend favoring cyclicals continuing well into 2017. However, we have little expectation that all cyclical sectors will continue performing well in unison, as if they were a single group with the same characteristics. Given the dichotomy in factors driving cyclicals, opportunities will exist but selectivity will be needed. We do have a cyclical bias, with opportunities in cyclical areas that offer solid growth prospects.

Given the heterogeneous characteristics of cyclicals, most opportunities are below the sector level, at the industry level. One sector with the most cyclical opportunity is Technology. The BofA Merrill Lynch Global Research U.S. Equity Strategy team highlights opportunities in the technology hardware and internet software industry groups. The team also highlights opportunities in the industrial conglomerates industry, within the Industrials sector. This is one of the highest-quality sectors within the S&P 500 index, one that has diversified global exposure and historically has benefitted from a rise in commodity prices.

Despite our view that the majority of opportunities are at the industry level, we continue to have a secular sector preference for Technology and Health Care. In our view, both sectors have attractive valuations, as well as higher growth prospects.

We believe that the pivot to cyclical investments will continue as cyclical momentum continues to rise, but we do not advocate a strategy solely focused on cyclical investments. Investors who are underweight cyclicals exposure should consider bringing that weight back to neutral. In our view, it makes sense for investors to maintain the risk-neutral portfolio positioning but with a tilt toward cyclical investments.

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					COMMENTS
	Negative		Neutral		Positive	
Global Equities			●			We are neutral equities. The latter mid-cycle stage of an expansion suggests a more balanced risk/reward spectrum for equities. We prefer U.S. large caps for their high quality and dividend growth opportunities.
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		●				Downside risk to growth and inflation from bank stress and political uncertainty. Major elections in 2017 and negative interest rate policy offset highly accommodative monetary stance and improving global economy.
Emerging Markets				●		Valuations are attractive for long-term investors. Beneficiaries of the pickup in global cyclical momentum. Favor reform-oriented countries and consumer spending.
Global Fixed Income		●				We remain underweight fixed income, as it is less attractive compared to asset classes such as equities. Bonds continue to provide diversification, income and stability within total portfolios.
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 we 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.

* Many products that pursue Alternative Investment strategies, specifically Private Equity and Hedge Funds, are available only to pre-qualified clients.

Appendix

Index Definitions

The **MSCI Emerging Markets Index** captures large- and mid-cap representation across 23 Emerging Markets countries. With 833 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI USA Cyclical Sectors Index** is based on the MSCI USA Index, its parent index, and captures large- and mid-cap segments of the U.S. market. The index is designed to reflect the performance of the opportunity set of global cyclical companies across various Global Industry Classification Standard (GICS®) sectors. All constituent securities from Consumer Discretionary, Financials, Industrials, Information Technology and Materials are included in the index.

The **MSCI USA Defensive Sectors Index** is based on the MSCI USA Index, its parent index, and captures large- and mid-cap segments of the U.S. market. The index is designed to reflect the performance of the opportunity set of global defensive companies across various GICS® sectors. All constituent securities from Consumer Staples, Energy, Health Care, Telecommunication Services and Utilities are included in the index.

The **MSCI World Index**, part of The Modern Index Strategy, is a broad global equity benchmark that represents large- and mid-cap equity performance across 23 Developed Markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and does not offer exposure to Emerging Markets.

The **MSCI World Growth Index** captures large- and mid-cap securities exhibiting overall growth style characteristics across 23 Developed Markets countries. The growth investment style characteristics for index construction are defined using five variables: long-term forward earnings-per-share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend, and long-term historical sales per share growth trend.

The **MSCI World Value Index** captures large- and mid-cap securities exhibiting overall value style characteristics across 23 Developed Markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price, and dividend yield.

The **S&P 500 Index** is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The **S&P 500 Low Volatility Index** is designed to measure the performance of the 100 least volatile stocks of the S&P 500 Index. Volatility is defined as the standard deviation of the security computed using the daily price returns over 252 trading days.

The **S&P 500 Cyclicals Excluding Financials Index** is designed to reflect the performance of the opportunity set of U.S. cyclical companies across various GICS® sectors. All constituent securities from Consumer Discretionary, Industrials, Information Technology and Materials are included in the index.

The **S&P 500 Defensives Index** is designed to reflect the performance of the opportunity set of U.S. cyclical companies across various GICS® sectors. All constituent securities from Consumer Staples, Energy, Healthcare, Telecommunication Services and Utilities are included in the index.

Other Definitions

The **10-Year Treasury** relates the yield on a security to its time to maturity and is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market.

The **U.S. breakeven inflation rates or TIPS** are calculated by subtracting the real yield of the inflation-linked maturity curve from the yield of the closest nominal Treasury maturity. The result is the implied inflation rate for the term of the stated maturity.

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