# The Weekly Letter

NOVEMBER 29, 2016

GWIM Chief Investment Office

GWIM Investment Strategy Committee

- **Regime Change:** We believe a major market regime change is underway and that investors should begin repositioning their portfolios accordingly. We think the macro environment is transitioning from secular stagnation to fiscal reflation, and that higher growth and inflation will prompt an equity market rotation from defensives to cyclicals, with value outperforming growth. In addition, we expect a shift toward small capitalization and more domestic-oriented equities, and higher bond yields and steeper curves in the near future.
- **Markets in Review:** Last week, domestic equities rose, with the S&P 500 Index increasing 1.5% while international equities, as represented by the MSCI EAFE Index, gained 1.3%. Within fixed income, the 10-year Treasury yield finished the week at 2.36%, up from 2.35% on Friday of the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, rose 2.4%, with WTI crude increasing 0.8% to $46.10 per barrel. Meanwhile, gold fell by 2.0%, to $1,183.90 per ounce.
- **Looking Ahead:** In the U.S, data reflecting wage growth and inflation headline this week's releases. Hourly wages are expected to be up, while consumer price inflation is forecast to show signs of acceleration. Meanwhile, investors in the Eurozone will focus on Eurostat's report on core consumer price inflation throughout the bloc.

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## Regime Change

*This edition of The Weekly Letter is a condensed version of our **Investment Insights** report published on November 16.*

We believe a major market regime change is underway. Despite many unknowns, we think the macro environment is transitioning from secular stagnation to fiscal reflation as we enter a late-cycle expansionary phase and anticipate a shift toward fiscal stimulus in many corners of the globe.

In our view this shift will have important investment consequences. We expect that higher nominal gross domestic product (GDP) growth and inflation will prompt a significant equity market rotation from defensives to cyclicals, with value outperforming growth. We also see higher bond yields and steeper curves in the near future. This may prompt a slightly faster pace of rate hikes from the Federal Reserve (Fed) in 2017 than the market expects, and leave a broadly stronger dollar.

### The rotation is underway

As the reflation gathers momentum, portfolio repositioning is likely to continue well into 2017. With growth already heading higher from Q3 2016 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 shift toward small capitalization and more domestic-oriented equities due to a stronger dollar, more pro-growth policies and the desire for a hedge against potential retaliatory trade policies from main trading partners.

### Sectors that may benefit

We are moving from a "get paid to wait" core portfolio theme to a more cyclical- and value-oriented theme. 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.

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.

### The benefits of fiscal stimulus

We are also getting more favorable on commodities given expectations for the late-cycle expansion and increasing inflation. Any fiscal stimulus through a potential infrastructure bill would help

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support the rising trend in commodity prices. This trend should not be hampered by the strength in the dollar, which is another core belief for 2017. The dollar should undergo an initial strengthening as growth accelerates, interest rate differentials widen, and the Fed begins to normalize rates earlier than other central banks.

## Rising values for Japan

In typical late-cycle expansions, most cyclical value assets that are leveraged to world growth tend to outperform. Two examples are the Emerging Markets and Japan. We are weighing the positives and negatives for Emerging Market equities and will be assessing our recent tactical overweight in the coming weeks. 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 one out in this late cycle. However, we do expect Japanese equities to rise in value in the coming 12 months given the reflationary policies that have been put in place and may be expanded.

In Europe, we expect upside surprises to growth and economic momentum to continue into 2017. However, we believe the political uncertainty surrounding the December referendum in Italy, as well as elections next year in France, the Netherlands and Germany, should limit upside across the continent relative to the U.S. and Japan.

## 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, particularly for large and small cap equities. For the year ahead, Savita Subramanian, U.S. equity strategist at BofA Merrill Lynch Global Research, has highlighted her bullish case for the S&P 500 to reach 2,300. Asset classes have already started to reflect the initial stages of this cyclical movement into 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.

## Bonds: shorter duration, higher quality

We believe that interest rates bottomed during the summer and yield curves should continue to shift upward, but that the level should stabilize over the next 12 months. 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. If, as we expect, outflows occur due to investor repositioning, longer-duration bonds and lower credits would be more vulnerable. Therefore, we continue to prefer to be shorter duration and higher quality overall.

Given our view of rising inflation expectations, investors should also consider raising allocations to Treasury Inflation-Protected Securities (TIPS) and floating-rate bonds. Although we see a more difficult total return environment for fixed income it remains an important diversifier from equities, adds some protection against higher-volatility asset classes in general, and can help maintain a consistent stream of cash flows that may be required for income.

## Be prepared for higher volatility

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, 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 greater scope to outperform industry benchmarks, which is a break from their recent difficult performance.

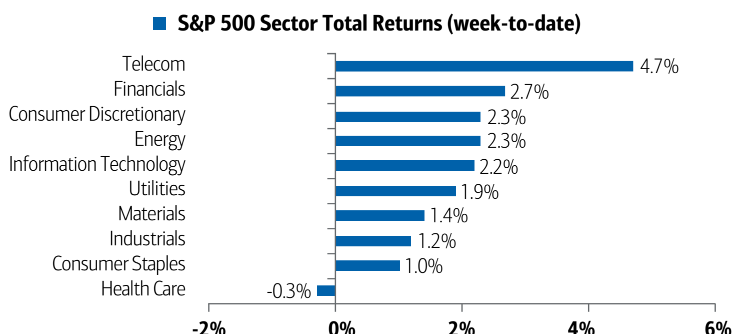
**Portfolio Considerations:** In summary, we anticipate a significant shift to unfold in the next 12 months in order for investors to get better positioned for the expected upswing in nominal growth, economic activity, bond yields and inflation and potential fiscal policy action. Given that a large share of the global investment community has become heavily exposed to defensive, higher-quality, higher-yielding investments as rates globally trended down for years, and to 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 their portfolios accordingly as we head into 2017 in order to better prepare for and take advantage of the events we see unfolding.

# Markets in Review

## Trailing Economic Releases

- The U.S. Census Bureau released its October report on Durable Goods Orders, an important proxy for business investment, which posted a 4.8% month-over-month (MoM) increase. BofAML Global Research had projected MoM growth of 2.5%. Such an increase is an encouraging indicator of stronger corporate spending.
- The U.S. Manufacturing Purchasing Managers Index (PMI) for November was reported by Markit at 53.9, which exceeded the consensus expectation of 53.5. The strong results indicate continued expansion in the sector. After a slowdown throughout 2015, industry has shown signs of reacceleration, according to this indicator.
- In the Eurozone, November's composite PMI came in at 54.1, representing an increase from the prior-month result of 53.3 and exceeding expectations. The strong showing suggests continued, steady growth throughout the bloc.

## S&P 500 Sector Returns (as of last Friday's market close)




## Equities

| | Level | Total Return in USD (%) WTD | MTD | YTD |
|---|---|---|---|---|
| DJIA | 19,152.1 | 1.5 | 5.9 | 12.7 |
| NASDAQ | 5,398.9 | 1.5 | 4.2 | 9.1 |
| S&P 500 | 2,213.4 | 1.5 | 4.3 | 10.5 |
| S&P 400 Mid Cap | 1,640.8 | 2.2 | 8.8 | 19.1 |
| Russell 2000 | 1,347.2 | 2.4 | 13.2 | 20.2 |
| MSCI World | 1,720.8 | 1.4 | 1.9 | 5.5 |
| MSCI EAFE | 1,634.4 | 1.3 | -1.7 | -2.1 |
| MSCI Emerging Mkts | 855.8 | 1.3 | -5.4 | 10.0 |

## Fixed Income

| | Yield (%) | Total Return in USD (%) WTD | MTD | YTD |
|---|---|---|---|---|
| ML US Broad Market | 2.52 | -0.2 | -2.5 | 2.4 |
| ML 10-Year US Treasury | 2.36 | -0.3 | -4.0 | 1.1 |
| ML US Muni Master | 2.51 | -0.5 | -3.0 | 0.0 |
| ML US IG Corp Master | 3.39 | -0.1 | -2.9 | 5.1 |
| ML US HY Corp Master | 6.55 | 0.6 | -0.6 | 14.9 |

## Commodities & Currencies

| | Level | Total Return in USD (%) WTD | MTD | YTD |
|---|---|---|---|---|
| Bloomberg Commodity | 171.8 | 2.4 | 0.2 | 8.5 |
| WTI Crude $/Barrel[1] | 46.1 | 0.8 | -1.7 | 24.4 |
| Gold Spot $/Ounce[1] | 1,183.9 | -2.0 | -7.3 | 11.5 |
| **Level** | **Current** | **Prior Week End** | **Prior Month End** | **2015 Year End** |
| EUR/USD | 1.06 | 1.06 | 1.10 | 1.09 |
| USD/JPY | 113.22 | 110.91 | 104.82 | 120.22 |

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.
**Past performance is no guarantee of future results**.

# Looking Ahead

## Upcoming Economic Releases

- On Wednesday, the U.S Bureau of Economic Analysis releases its October report on Core Personal Consumption Expenditure (PCE), an indicator of consumer price inflation. BofAML Global Research expects MoM growth of 0.1% built upon inflationary pressures within Health Care and rents.
- On Friday, the U.S Bureau of Labor Statistics will report monthly average hourly wage growth for November. BofAML Global Research expects a gain of 0.2%, indicating slower growth of wages from a strong October figure. Wage growth has improved throughout the year but remains a bit below traditional levels.
- In the Eurozone on Wednesday, Eurostat reports Core CPI for November. BofAML Global Research expects year-over-year annualized growth of 0.8%. This represents the final inflation report prior to the December 8th European Central Bank meeting.

## BofA Merrill Lynch Global Research Key Year-End Forecasts

| S&P 500 Outlook | 2016 E |
|---|---|
| Target | 2,100 |
| EPS | $118.50 |
| **Real Gross Domestic Product** | **2016 E** |
| Global | 3.1% |
| U.S. | 1.6% |
| Euro Area | 1.6% |
| Emerging Markets | 4.1% |
| **U.S. Interest Rates** | **2016 E** |
| Fed Funds (eop) | 0.62% |
| 10-Year T-Note (eop) | 2.35% |
| **Commodities** | **2016 E** |
| Gold ($/oz-period average) | $1,301 |
| WTI Crude Oil ($/bbl-eop) | $54.00 |

All data as of last Friday's close.

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