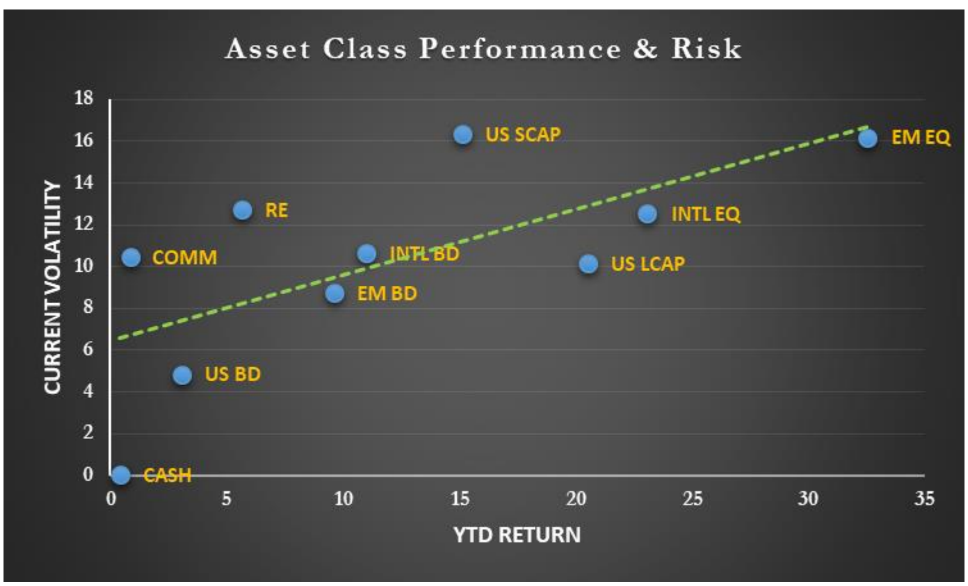
INSIGHT FINANCIAL STRATEGISTS

Monthly Capital Market Perspectives – December 2017

2017 has certainly turned out to be a good year for investors. Stock markets around the world have sprinted ahead and have delivered returns much higher than historical averages while also exhibiting very little volatility.

Bond markets have not been as generous to investors this year but given the year-ago almost universal predictions for rising interest rates, fixed income investors must be breathing a sigh of relief that returns while below historical norms are still in positive territory. Like the stock market, fixed income markets have also been unusually quiet this year.

In general, asset class performance has correlated with measures of risk. This year, risk has been handsomely rewarded in the capital markets. Equity strategies such as emerging markets have done exceedingly well. International approaches have out-performed. Stocks have out-performed bonds. Being safe has come at a high price this year!



Emerging markets have had quite a resurgence this year

The lower US dollar has benefitted international equity and bond strategies

Interest rate sensitive assets have lagged this year

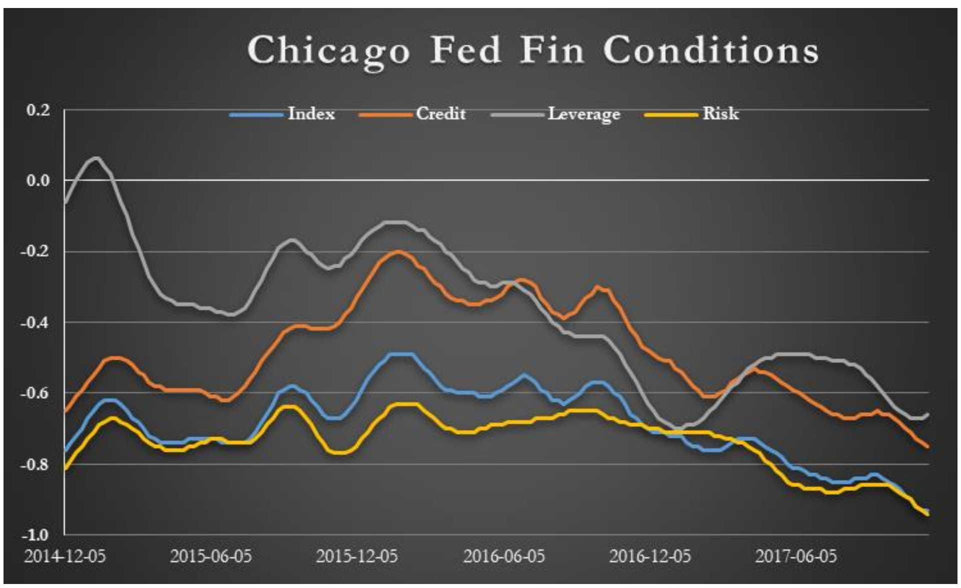
Source: iShares, Insight Financial Strategists, December 2017

Things do not always work out this well for risk takers. The most amazing thing is that all this wonderful performance has taken place within the context of historically low levels of capital market volatility. Normally, higher risk asset classes command higher returns (as we have seen this year) but the ride is often bumpy. This year the ride has been up and steady.

So how does one explain the low volatility of the capital markets with the political turmoil out of Washington?

Can this perceived anomaly be explained by the prospect of tax reform? Or, are investors more in tune with the solid yet unspectacular growth of the economy?

We believe that the ongoing solid global economic recovery from the depths of the Financial Crisis (2008-2009) has created an environment where investors do not foresee any major economic disasters within the next couple of years. Data from the Chicago Federal Reserve corroborates this view as according to their index all categories of financial stress have been trending down.



Lower numbers indicate diminishing economic worries

While economic growth has been below long-term trends there have been few hiccups in the last few years

Few concerns have emerged even as political turmoil has been the norm

Source: Federal Reserve Bank of Chicago, December 2017

Nothing in this summary measure of financial conditions hints at trouble. While our rear view mirror provides comfort that capital markets remain robust we do, however, see some reasons for caution in the road ahead.

What are our primary concerns?

Equity market valuations are cited by many as extreme and indicative of doom and gloom. While valuation metrics such as price/earnings ratios are stretched by historical standards we do not see high valuations as the catalyst that spoils the party. Our view is that as long as interest rates remain low and economic growth continues in 2018 we should expect global equity markets to deliver reasonable yet below average returns next year.

On the economic front we believe that the current global expansion will continue. The vast majority of indicators point to yet another year of 2% + growth in the US. The only cloud on the horizon is the shrinking spread between 10 and 2 year US Treasury yields which typically has been a portend for lower future growth. At the moment we see more noise than signal in this metric.

Our bigger concerns for the coming year involve rising interest rates potentially caused by a less than perfect de-levering of the Federal Reserve balance sheet and/or a spike in inflationary pressures. Both are connected and would surely waken up the bear that has been conveniently dormant.

What happens if interest rates do spike up?

First, fixed income investors accustomed to a 30 year decline in interest rates will quickly discover that they can actually lose money in bonds. The perceived safety of bonds will come into question.

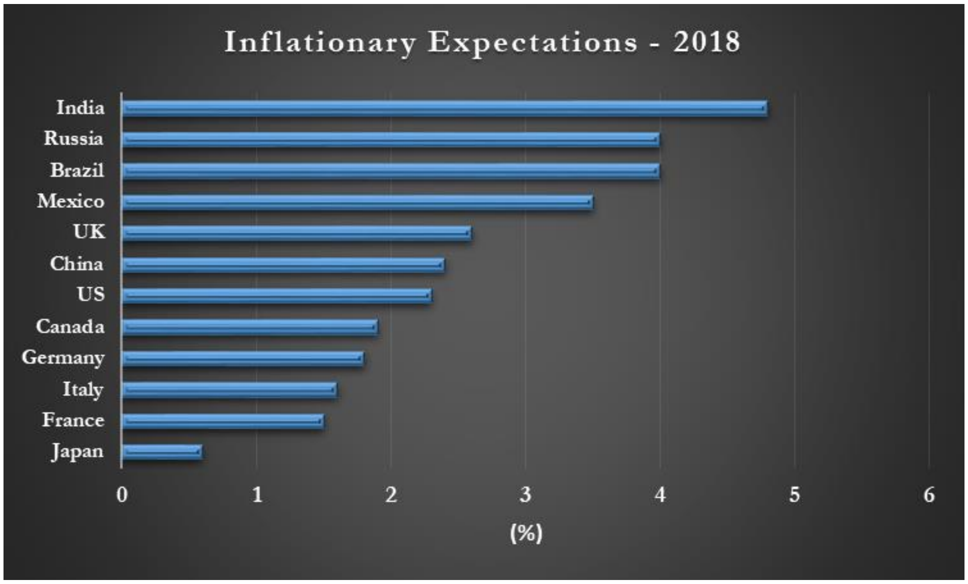
While bonds do not suffer from the same drawdowns compared to stocks (you never lose as much), investors will likely further lighten up their allocations to longer maturity bonds and seek yield in other asset classes. This adjustment has been going on for years but luckily we have not seen a permanent spike up in interest rates or any other significant stress in the bond market in a while.

A spike up in interest rates would also have the derivative effect of increasing investor risk aversion. Nothing wakes people up more than a lot of red and minuses in their statements. We continue to believe that a flexible risk managed approach to multi-asset investing will help investors navigate through the inevitable periods of market turbulence once interest rates significantly turn up.

So what has prevented interest rates from rising sharply?

Two things according to our research. Benevolent global monetary authorities and a lack of visible inflation. The global stimulus party does seem to be disbanding as the US Federal Reserve was the first to leave the party and has already raised rates three times this year. The Europeans and Japanese are, however, still enjoying the punch bowl. For now, the party continues providing ample support for low global interest rates.

Low levels of global inflation are also keeping interest rates in check. US inflation is hovering around 2 percent. The consensus among strategists is for only slightly higher inflation in 2018. The latest IMF projections depicted below point to a subdued inflationary environment. We subscribe to this outlook but worry about the likely reaction of global investors should we experience a bout of higher inflation.



Even typically high inflation countries are not seeing significant inflationary pressures

Monetary policy in emerging markets has been a lot more subdued compared to developed markets

The scare of potential deflationary pressures seems to have dissipated

Source: International Monetary Fund, December 2017

Is it all going to be chocolates and roses?

We wish, but we have been around long enough to expect the unexpected in capital markets. Sure bets never turn out quite as expected and often when investors have thrown in the towel things turn for the better. Best to be prepared for surprises by adopting a flexible approach to portfolio construction.

In this era of low interest rates and high equity valuations there is no place for complacency. There is an inadequate compensation for interest and purchasing power risk in the bond market. Expensive equity valuations put a lid on future expected returns. Few strategies provide truly superior diversification potential.

Hiding from risky assets such as equities is a risky strategy itself especially when viewed within the context of a long-term financial plan often extending 30 years or more.

Keeping up with inflation and growing your portfolio will necessitate a flexible multi-asset approach to investing that captures near and far off opportunities while maintaining portfolio risk at a level consistent with the goals, needs and risk profile of the individual.

What do we expect in the short-term from capital markets?

From a very high level view, our various proprietary asset class models point in the following direction:

- **A preference for stocks over bonds despite their higher levels of risk**
- **A preference for international over US equity** based on valuation differentials and a depreciating US dollar – we especially like emerging market stocks
- Within the fixed income market, **we favor credit exposure** as we believe that economic conditions will remain robust and default risk will be contained

- **Small allocations to alternative asset classes** such as real estate and commodities – these will come in handy should there be an inflation spike
- **Minimal allocations to cash** – the opportunity cost of holding large sums of low yielding cash is high especially for investors with a multi-year horizon
- **Market volatility will revert to episodes of risk on/off** – this will surely stress investors without a firm plan for navigating market turbulence but will provide opportunities for fundamentally oriented strategies

What about the prospects of capital markets over longer horizons such as ten years?

Here it gets a bit tricky and the news is sobering for investors accustomed to the above average returns we have seen since 2009. Wishing for a high rate of return devoid of an analysis of market fundamentals is not a high probability strategy. Best to know what is coming and be prepared!

What are these fundamentals? Conceptually, every asset class has three sources of potential returns – the income (yield) generated by the investment, future profits (growth), and finally the price (valuation) that market participants are willing to pay for the asset in the future.

Where are these fundamentals at the moment? Given the very low levels of interest rates and high starting equity valuations we are forecasting for all major asset classes below average rates of return over the next decade. The below chart depicts our current ten-year ahead expectations for asset class risk and return.

Despite high valuations we expect stocks to outperform bonds over the next decade

We are expecting moderate interest rate increases

All major asset classes are expected to deliver below-average returns

Source: Insight Financial Strategists, December 2017

We expect profit growth to be close to historical norms, but insufficient to offset the negative effects from valuation losses and low levels of available income. We have not yet accounted for the boost to US companies from a lower corporate tax rate – we are waiting for the final legislation, but the effect will be unambiguously positive for equity holders.

What do lower future capital market returns mean for investors? For one, the need to evaluate one's goals, risk attitude, spending patterns and investment strategy will be important. Capital markets are not static and neither are personal situations.

A long-term orientation and tactical flexibility will be a necessity of investors as they navigate what we think will be difficult market conditions over the next decade. Such an approach will be especially important for individuals near or already in retirement. The sequence-of-returns-risk is especially important to manage in the years surrounding retirement when the individual will start drawing down savings.

Our approach at Insight Financial Strategists explicitly deals with this type of sequence-of-returns-risk by building the individual's portfolio around the concept of goal-oriented buckets. Each bucket has a distinct goal and risk profile.

The short-term bucket, for example, while customized for each individual, has the overriding goal of providing a steady stream of cash flow to the individual.

The goal of the intermediate-term bucket is different – this part of the portfolio is designed to grow the purchasing power of the individual in a risk-controlled manner. A sometimes bumpier ride is the price of growth for this bucket but the rewards should be more than commensurate with the additional risk taken.

Finally, the long-term bucket is designed to maximize the long-term appreciation of this portion of the portfolio. This bucket will be the most volatile over the short term and is suitable for individuals with time horizons exceeding ten years and able and willing to withstand the inevitable periods of capital market stress.

Eric J. Weigel

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Guide to Indices referenced: “US Large Cap” represented by the S&P 500 Index.

“US Small Cap” represented by the Russell 2000 Index.

“International Equities” represented by the MSCI Europe, Australasia, Far East (EAFE) Net Return Index.

“Emerging Market Equities” represented by the MSCI Emerging Markets Net Return Index.

“US Bonds” represented by the Barclays US Aggregate Bond Index.

“International Bonds” represented by the Barclays Non-US Aggregate Bond Index.

“Emerging Market Debt” represented by the JP Morgan GBI-EM Global Core Index

“REIT” represented by the MSCI US REIT Index.

“Commodities” represented by the Bloomberg Total Return Commodity Index.

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