INSIGHTS

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ASSET ALLOCATION COMMITTEE SPECIAL REPORT:
A SEA CHANGE IN WASHINGTON—AND ON WALL STREET

In a special intra-quarter meeting to address the implications of the November 8 U.S. elections, the Asset Allocation Committee has shifted its bias toward U.S. equities and away from non-U.S. assets. Very early indications are that a Donald Trump presidency combined with a Republican congress may usher in a pro-growth, pro-inflation environment in which central banks play a less meaningful role in capital market performance and investors demand greater compensation for the risk they bear. That said, given the unconventional nature of the Trump campaign and the relative lack of visibility into his path forward, uncertainty rules the day.

POLICY IMPLICATIONS FAVOR EQUITIES OVER BONDS

While Donald Trump's victory was not the outcome expected by most of the Committee—or the markets—"surprise" may be too strong a term for it given the accelerating anti-establishment and anti-globalization trends we've noted across the developed world in recent months. (See "Up for Debate: The Next President of the U.S." in the 4Q2016 edition of the AAC Committee Outlook.) Though the June Brexit vote was perhaps the most notable pre-Trump example, developed markets in general have witnessed the rise of populist politics and politicians bent on upending the current world order, one in which developed country middle and lower-middle class citizens perceive themselves to be suffering at the expense of the elites and rising emerging countries. And with a slew of European elections and referenda looming over the next six months, we'll soon learn if Trump's ascendency represents the climax of such sentiment or merely an exclamation point within a still-unfolding narrative.

Generally speaking, we view Trump's proposed policy positions as bullish for equities and bearish for bonds, as the incoming administration represents the emergence of a more pro-business environment marked by proposals to lower taxes, reduce regulatory burdens and engage in robust fiscal spending—potentially catalyzing higher inflation expectations and interest rates.

As a result, we have increased our 12-month outlook for U.S. equities across the capitalization spectrum to slightly above normal, as corporations stand to profit from this business-friendly stance; small businesses tethered to U.S. growth, in particular, could thrive, as they may benefit from deregulation without also being punished by the anti-trade rhetoric impacting large multinationals. We also hiked our outlook for master limited partnerships due to increased inflationary pressures and expected lower regulatory restrictions. In contrast, we lowered our outlook on emerging markets equities to perform slightly below normal over the next 12 months; a stronger dollar and higher U.S. interest rates should weigh on the asset class even as the anticipated increase in U.S. infrastructure spending helps support certain markets.

We have reduced our return outlook to below normal for a number of domestic investment grade fixed income sectors on expectations of higher interest rates. We remain neutral on TIPS and high yield debt, and prefer these categories on a relative basis within the fixed income complex. Looking abroad, we reduced our outlook for emerging markets debt to slightly below normal for reasons similar to those driving our downgraded opinion on emerging markets equity; we do prefer hard currency issues to debt denominated in local currency within the EMD space. We maintained a below-normal outlook for global bonds.

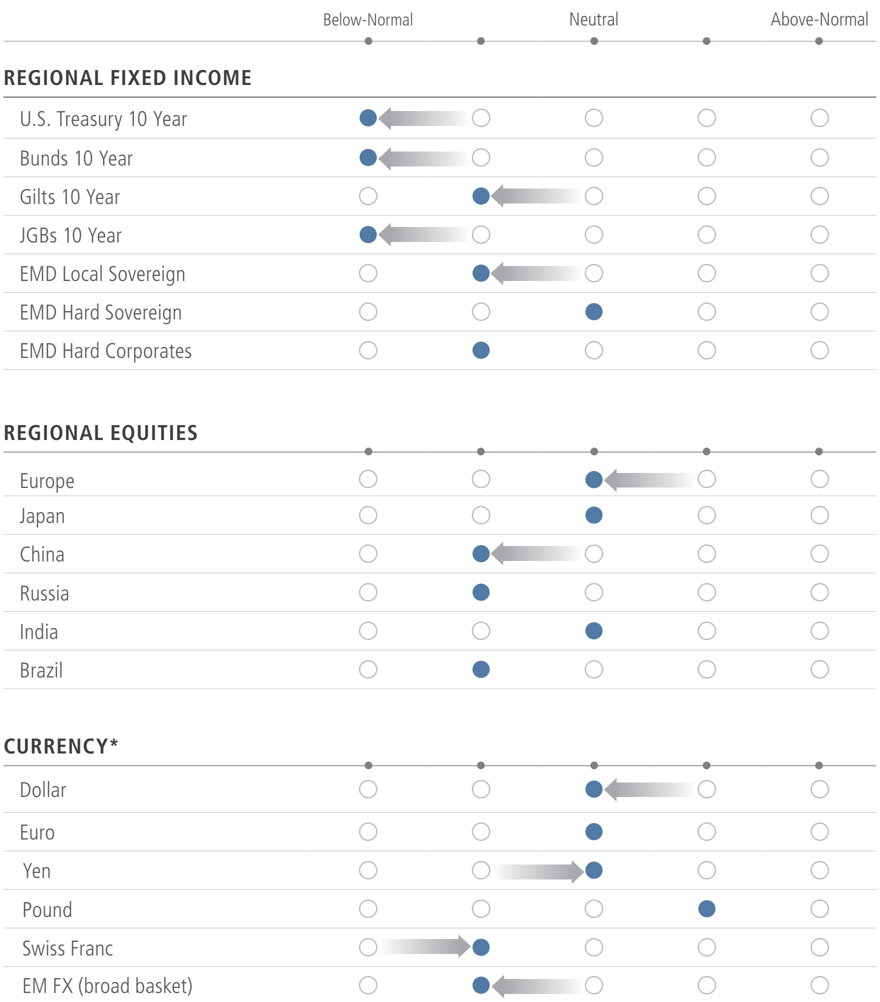
Market Views

Based on 12-Month Outlook for Each Asset Class

As of November 16, 2016. See the additional disclosures at the end of this material for additional information regarding the Asset Allocation Committee and the views expressed.

Regional Focus

Fixed Income, Equities and Currency



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A NEW INVESTMENT ERA BEGINS

That the changes to our asset allocation framework are more or less in line with the market action exhibited since Election Day could raise the question of whether we are merely following a meaningful move in the markets. On the contrary, we believe that Trump's victory heralds a fundamentally changed investment environment, one in which we envision more corporate profitability, more volatility and a higher risk premia for assets.

Key to this updated framework is that we appear to have reached an inflection point with global central banks. (We have anticipated this transition in a number of our CIO Weekly Perspective posts, including the October 30 effort from Brad Tank titled "Populist Fears, Globalist Tears".) The basic mission of central banks historically has been to smooth economic activity: to make sure the highs aren't too high and the lows aren't too low. It could be said that central banks have been "oversmoothing" since the Great Recession, artificially removing risk from the economy and thus incenting greater risk-taking by market participants. Given expectations of greater fiscal stimulus and a more activist approach to economic policymaking, however, we believe volatility is likely to increase, as is the risk premia investors demand. In fact, with central banks becoming less central to investment performance, the whole nature of "risk on" versus "risk off" has fundamentally changed, suggesting the correlations with which the market has grown comfortable over the years need to be reconsidered. For evidence one need only look at the poor post-election performance of emerging markets equities—typically considered a "risk on" beneficiary—in the face of surging U.S. stocks as investors digested the potential negative impact of U.S. policy on these markets.

Real interest rates in the U.S. have headed higher following the election, and we believe that trend is likely to persist over the coming 12 months due to three factors: higher economic growth expectations, higher inflation expectations and an increase in risk premia. For investors, the challenge of anticipating markets going forward will likely rest in attributing the appropriate level of importance to each of these factors. Growth is typically positive for risky assets and higher risk premia are negative, while inflation may be positive if it's driven by "good" reasons like stronger employment.

That said, the gravitational pull of global rates, while diminished, is still powerful and represents a limit to how far U.S. Treasury yields will decouple from the global rate structure. Long-term potential GDP growth is another wildcard for rates, as economies are ultimately constrained by structural limitations. While changes to tax policy and infrastructure spending may introduce an intertemporal increase to potential growth, it is unclear how impactful this can be on worker productivity, which has been on a downward trend since the early 2000s. Productivity tends to revert to the mean over time, in this case positively, but how quickly that will happen in this instance remains to be seen.

RISKS ABOUND

While many markets quickly pivoted from depression to elation following Trump's victory, significant risks are likely to persist moving forward. Economic policy shifting from highly transparent and methodical central banks to legislators and governments that are noisy by nature certainly presents headline risk and potential for spikes in volatility. There's also a good chance over the next 12 months that markets could be profoundly disappointed with Trump actions or policy proclamations. At some point higher interest rates represent a drag on certain sectors of the economy, such as housing; in fact, mortgage applications fell sharply in the most recent reading as rates moved higher. And if growth doesn't materialize as forecast, we may find ourselves facing the worst-case scenario of low growth combined with higher interest rates and higher deficits.

The area of the economy that could be most impacted by the election is trade. Trump's views here diverge from recent Republican free-trade orthodoxy and more closely resemble those of the Reagan administration, which took a combative stance against trade partners like Japan and Germany. China, the U.S.'s second-largest trading partner, might represent this era's version of Reagan's 1980s battles. On the campaign trail Trump vowed to label China a currency manipulator, bring cases against China to the World Trade Organization and potentially slap a tariff as high as 45% on imports from China. Given the president's wide latitude on trade issues, we'll need to watch the new administration's approach closely; while anti-trade policy would obviously affect industries that are dependent on exports, it could be a significant impediment to economic growth and may weigh on foreign investment. Meanwhile, a major trade war likely wouldn't be good for any risk asset.

For hints on where Trump may be headed with regard to trade policy, Brad Tank suggests looking into the book *American Made* by Dan DiMicco, former CEO of Nucor Steel and current trade adviser to Trump, which advocates for the tactical activist approach of the Reagan administration, as characterized by the 1985 Plaza Accord.

THE PATH FORWARD

What should investors focus on between now and Inauguration Day? We suggest keeping an eye on Trump appointments. While selections for certain Cabinet posts and other high-profile administration roles have begun to trickle in, key economic leadership—most notably Treasury secretary—remains unfilled. Judge the quality of Trump's appointments, their backgrounds and the policies they may favor. Once Trump enters office, attention is likely to shift to his legislative agenda, health care and tax reform in particular. A "blueprint" for the latter was released in June by House Republicans proposing a reduction in tax rates for individuals and businesses, as well as an overall simplification of the tax code.

Though investors will likely spend significant time and effort trying to divine what path the Trump administration will take, the reality is that it will be many months before anything really happens. Now is the time to maintain focus on a long-term time horizon. While markets are driven by shifting short-term expectations, we believe the resulting volatility stands to benefit active managers in both equity and fixed income. It could also benefit long-term investors who can exploit their extended time horizons by hedging risks across their portfolio as necessary and taking tactical positions should opportunities arise.

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