2018 Capital Markets Forecast

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EXECUTIVE SUMMARY

Long-Term Forecast

Syntrinsic's updates to long-term capital market assumptions are modest this year, with a few upward changes on the margins. We found 2017 highly encouraging in many ways, mostly for improvements in the near-term cyclical environment. We see less support for a meaningfully improved long-term secular outlook over the next full market cycle. The long-term forecast is designed to create a useful and well-grounded starting point for portfolio construction that investors can use to balance themselves against the constant barrage of near-term issues in the market.

- Our ten-year global equity return forecast remains 6.7% - 7.7%, with expectations for Foreign Developed ("EAFE") equity to slightly outperform US equities. Emerging Markets ("EM") stock assumptions slightly improved from last year to 8.8% -10.8%, but not enough to move the dial on the global index.
- Even with the slight improvement in yield expectations over last year, we anticipate low global aggregate fixed income returns over the next decade. We project that the majority of those improvements will come later in the forecast period. Global aggregate fixed income return projections are 1.5% - 2.5%, with higher US fixed income returns relative to lower yielding foreign fixed income issuers. US short-term fixed income expectations have improved with yields rising last year. High yield and EM fixed income expectations are less attractive following declines in yields over the last year.
- Improvements in real estate yields and cash returns have aided our long-term return outlook for listed real estate and hedge fund strategies, respectively. A more balanced supply-demand dynamic keeps our return assumption for commodities the same as last year and just above that of inflation.

Near-Term Sentiment

Syntrinsic's sentiment over the next three years has improved based on encouraging signs from the cyclical upswing that began over a year ago which has only broadened and strengthened. However, our optimism is tempered by elevated valuations across all asset classes, central banks in US and Europe being at an inflection point, and political risk.

- We maintain our neutral near-term sentiment in the US. The economic cycle, while aging, remains healthy. We also remain neutral in the Foreign Developed region, with economic improvements in Europe offset to some degree by a downgrade in the UK and stable Japan. Mid-2017, we had upgraded EM to neutral because an improving global growth picture combined with improving local conditions within EM. We maintain that outlook.
- Relative to other asset classes, we remain positive on global equities. We are not currently recommending an active weighting different from the global index, but are watching several key developments this year that could support a higher conviction recommendation.

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- We recognize the well-documented near-term challenges to fixed income, but do not expect them to be severe. We continue to recognize the benefit of fixed income's role as a diversifier and source of liquidity.
- Our near-term sentiment on listed real estate and hedge fund strategies has improved modestly. The underlying supply/demand fundamentals for real estate remain strong, driving near-term earnings growth. Alpha opportunities are improving for hedge fund strategies.

FORECASTING LONG-TERM RETURNS AND NEAR-TERM CONDITIONS

Syntrinsic evaluates expected returns, volatility, and correlations across global capital markets in order to better understand the investment tools available that may help our clients meet their objectives. Long-term forecasting (10+ years) of capital market returns serves as the foundation of the portfolio construction process, informing high level asset class decisions across portfolios.

Near-term performance will seldom reflect long-term forecasts and for this reason, we also assess market and economic issues that may present opportunities or threats over three year periods. We seek to add value within a market cycle by tactically adding exposure to areas we think will outperform and reducing areas that have a strong likelihood to underperform.

When using forecasts for planning purposes, it is essential to recognize that returns are not guaranteed and are vulnerable to periods of significant deviation from the forecast and even loss. We expect diversification to help reduce the size and duration of these underperforming periods, but recognize that such periods are not always avoidable. The value of long-term forecasting is only significant if investors have the patience to allow long-term fundamentals to play out.

LONG-TERM RETURNS FORECAST

Global Equity Forecast

Syntrinsic bases the global equity forecast on regional expectations for real growth, inflation, and yield. We also take into account foreign economic exposure to regional equity markets. While the factors that inform these numbers are dynamic and can change from year to year, the size of such changes normally will be small. In our near-term sentiment, we account for more cyclical factors such as expectations for changes in profitability and valuations.

Exhibit 1: Syntrinsic Economic Growth Assumptions

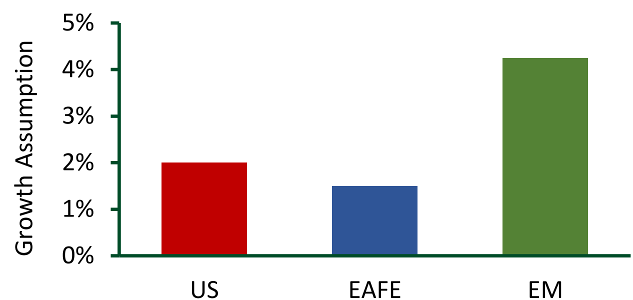

Exhibit 1 outlines Syntrinsic's real growth assumptions for the US, EAFE economies, and EM. Consistent with consensus expectations, we expect

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modest long-term real growth potential based on slowing global trends across demographics, growth, and productivity. EM received a very modest increase based on better signs of stability, following what we feel was an overly negative view last year.

Exhibit 2: Syntrinsic Inflation Assumptions

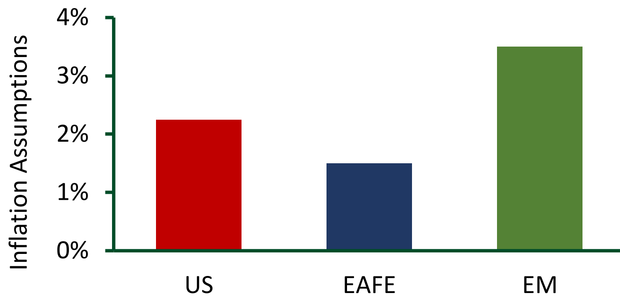
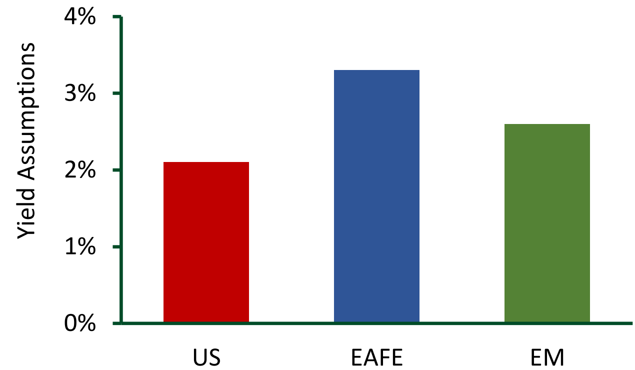


Exhibit 2 outlines Syntrinsic's inflation assumptions. Our expectations are unchanged from last year, which had already assumed a recovery from the recent extreme lows. Our assumptions continue to be at a slight discount to higher longer-term historical inflation averages. Despite potential for a cyclical uptick in inflation in the near term, we believe various factors will continue to anchor inflation on a secular, longer-term basis. These include global aging demographics, increased technological innovation and adoption, and continued globalization.

Exhibit 3: Syntrinsic Dividend Yield Assumptions



In Exhibit 3, we illustrate our expectations for equity dividend yields, which are consistent with last year across the major regions. Without a strong reason to expect material changes to corporate behavior on dividend distributions, we continue to use current equity yields as a guide.

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Asset Class	Segment	Long-Term Forecast (10 Years)	Rationale
GLOBAL EQUITY FORECAST	Global Equity	6.7% - 7.7%	Syntrinsic estimates global equities should have an average annual return from 6.7% to 7.7%. The forecast range assumes a market weight to the MSCI ACWI Index to equities based on the global market capitalization as well as adjustments to account for global trade. The potential for alpha through active security selection is not accounted for in the forecast.
	United States (52% of global equity market)	6.3% - 7.3%	We expect real domestic growth and inflation to be lower than historical and longer-term averages, respectively. Factors such as aging demographics, reduced labor participation levels, and reduced productivity growth partially drive this expectation. We see equity valuations and profitability of companies at levels expected in healthy markets and do not anticipate that these will either add or detract from potential returns. We also assume that dividend yields will be consistent with recent levels.
	Foreign Developed (36%)	6.6% - 7.6%	The economies within the EAFE region are more mature, which keeps our growth and inflation expectations low relative to the US. However, EAFE revenue exposure to both the US and EM economies, and a persistent dividend advantage support net return assumptions that are higher than the US. We expect inflation to improve from current levels but not to reach historic levels. We assume an unchanged dividend yield.
	Emerging Markets (12%)	8.8% - 10.8%	We anticipate growth to be higher in the EM than developed markets but to continue to decelerate from previous levels as the economies mature. Inflation within EM has been moderating and we expect inflation to be lower than recent averages. We estimate that dividend yields will remain unchanged from current levels. Decelerating growth and inflation has led to return assumptions that have been modestly slowing in recent years. However, we are encouraged by what appears to be positive signs of more sustainable growth, thereby improving returns slightly from last year's forecast.

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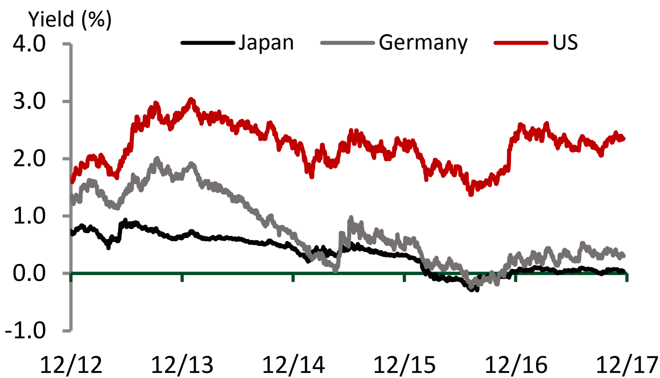
Fixed Income Forecast

The forecast for fixed income begins with the current yield environment for each segment and Syntrinsic's understanding of global economic factors and fixed income markets. We utilize a forward looking scenario analysis framework to model what we believe are a reasonable range of assumptions for the future path of interest rates, regional economies, and credit fundamentals. We explore a broad range of outcomes to help understand an array of possible returns within each segment, but bias our expectations towards our highest conviction base case scenarios. This process helps to create useful and well-grounded assumptions during the portfolio development process.

Exhibit 4: Ten-Year Sovereign Bond Yields

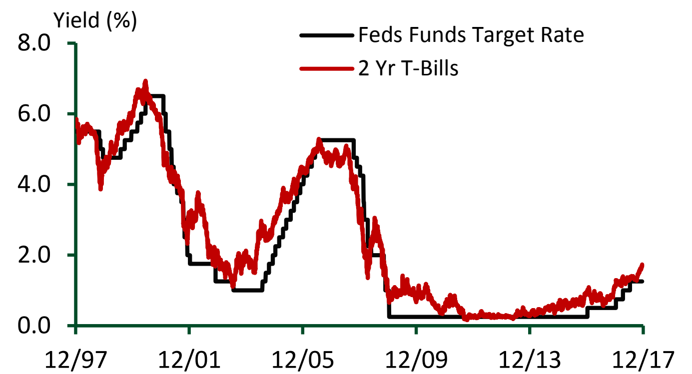


Source: Bloomberg

Exhibit 4 shows that US fixed income rates continue to look more competitive than other large developed economies, but with some narrowing of the gap over last year.

US short-term fixed income yields have risen in close relation to target rate hikes from the US Federal Reserve ("Fed"). This increase is consistent with our expectations and pictured in Exhibit 5. We expect a continuation of rate hikes over the next few years and thus higher short-term yields earlier in the forecast period. Our scenarios include the Fed successfully reaching their short-term and long-term interest rate targets; however, we also explore different scenarios of faster and slower actions than currently expected.

Exhibit 5: Federal Funds Target Rate v. 2 Yr. US T-Bill Yield



Source: Bloomberg

Despite the Fed's action to lift short-term rates, yields of intermediate and longer dated bonds in the US modestly declined over the last year, causing the yield curve to flatten. In conjunction with further credit spread tightening, opportunities to find meaningful yield remains challenging. Our intermediate yield assumptions call for modestly higher rates based on our outlook for growth and inflation. However, the competing pressures listed below create a reasonable degree of uncertainty in our expectations.

- Fed rate hikes
- Fed balance sheet runoff
- Growing US deficit
- Need/demand for high quality bonds
- Automation/globalization
- Aging demographics
- Relatively attractive US rates

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Asset Class	Segment	Long-Term Forecast (10 Years)	Rationale
GLOBAL FIXED INCOME FORECAST	Global Fixed Income	1.5%-2.5%	The class level return is based on the Bloomberg Barclays Global Aggregate Index, which is biased towards low yielding sovereign bonds from developed countries. Similar to last year's process, we are accounting for a gradual rise in US rates earlier in the forecast period. Improvements overseas created a small upgrade to foreign developed returns this year. Similar to the US, those returns are biased towards later in the period.
	US Short–Term	2.5%-3.0%	The yield on US short-term fixed income has risen with Fed actions last year. We increased our forecast because of the higher yields and assume the Fed will continue to tighten policy over the near-term toward the neutral rate.
	US Core	2.5%-3.5%	We expect a gradual and limited rise in intermediate fixed income rates and have forecasted slightly higher returns accordingly. This rise in yields should increase returns in the later portion of the forecast period. The small increase in forecast this year is because of the rise in yields at the end of 2016.
	US Core Plus	3.0-4.0%	We have reduced the core plus fixed income forecast slightly as steady spread tightening throughout the year reduced yield opportunities. We still expect some additional value (with risk) over US Core through a greater opportunity set of issuer quality, structure, and yield.
	Foreign Developed	0.8%-1.3%	Yields remain low, as major sovereign issuers have engaged in significant stimulus measures. We are taking a conservative approach with a forecast only slightly above yield. Progress in Europe's recovery has driven a small upward change from last year when we assumed only current yield.
	Emerging Markets	4.3%-6.3%	Differentiation of credit quality, interest rate policy, and yields among EM fixed income issuers is significant. Yields remain well above developed market averages, but have fallen over the last year. The current yield, however, remains a reasonable base case for return assumptions given the potential geopolitical, currency and interest rate risks.

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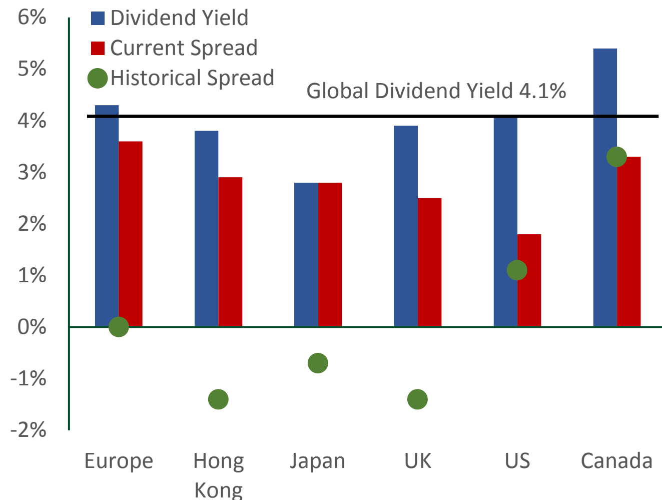
Real Assets Forecast

Our starting place for evaluating listed real estate, similar to global equities, is current global yields (Exhibit 6). Yields have slightly improved over the course of the year, increasing from 3.7% to 4.1%.

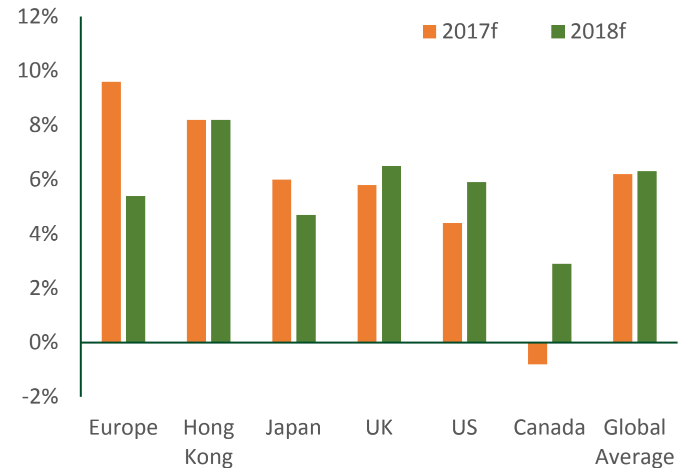
Exhibit 6: Global Real Estate Dividend Yields



Source: CBRE Clarion, FactSet and Bloomberg as of 9/30/17

From there, we evaluate underlying real estate supply and demand fundamentals, as well as earnings growth forecasts. In the near-term, earnings forecasts are expected to be closer to 6%, given the continuing lack of new real estate supply in the marketplace (Exhibit 7). However, when evaluating over a long-term period, we expect growth to moderate and revert to historic levels of 2% - 3%.

Exhibit 7: Global Real Estate Earnings Growth Forecasts



Source: CBRE Clarion as of 9/30/17

Hedge Fund Strategies Forecast

In forecasting hedge fund strategies (i.e. equity hedge, relative value, event driven, and macro) our core building blocks are equity and fixed income beta with additional support from cash returns.

To determine the appropriate beta for the different hedge fund strategies, we analyze the historic beta and correlations to global equity markets, fixed income markets, and the Hedge Fund of Fund universe. We then apply those beta estimates to our long-term return forecasts for equity and fixed income to establish a return forecast for the different hedge fund strategies. The cash component evaluates short rebate and interest earned on cash for hedged strategies.

Finally, we assess historic alpha trends to estimate an alpha adjustment to our projected hedge fund strategies returns. The alpha adjustment is based not only on historic trends but also our overall view of hedge fund strategies and market conditions. We believe market conditions for alpha have improved slightly from last year.

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Asset Class	Segment	Long-Term Forecast (10 Years)	Rationale
REAL ASSETS AND HEDGE FUND STRATEGIES FORECAST	Listed Real Estate	6.0% - 7.0%	Our return assumption increased slightly as current global yields on publically traded real estate have increased to just above 4% (Exhibit 6). Forecasted Funds from Operations ("FFO") growth has moderated somewhat but remains attractive for the near-term. We estimate yields will remain in the 3.0% to 5.0% range and FFO growth to continue to gradually decline to historic levels. Despite a lowered outlook for global growth, the lack of new real estate construction is supportive of the asset class. Valuations are not significantly different from long-term averages, leading to our assumption that multiples will not experience significant net change over the ten-year time horizon.
	Commodities	2.0% - 3.0%	Commodity prices have returned to a more stable price environment as many commodities have transitioned towards a more balanced supply-demand dynamic. Prices should be range-bound around the inflation of the marginal cost of production, which we expect to come in between 1.8% and 2.8%. We believe that positive changes in valuations are limited in the current supply / demand environment, thus limiting return potential to not much beyond inflation.
	Hedge Fund Strategies	2.3% - 5.5%	Increased divergence of performance within and across other asset classes will provide opportunities for hedge fund strategies to add modest alpha over the long-term. We expect the elevated competition for alpha to subside over the forecast horizon as competition drives managers from the space while also lowering fees to the benefit of investors. Varying degrees of beta exposure across hedged strategies also could be a source of limited return, which we estimate will range from 0.0% to 3.0%. Additionally, the cash return component for hedged strategies—including short rebate and interest earned on cash—improved from last year, reflecting higher rates due to Fed action. We believe this component of return will continue to improve as the Fed tightens policy toward their neutral rate, further supporting the asset class.

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Forecasting Near-Term Sentiment

The near-term sentiment process seeks to identify opportunities and risks that are likely to affect performance over a three-year horizon. We base our near-term outlook on a global assessment of economies health and momentum, balanced with our outlook for market fundamentals, technicals, and sentiment.

We begin with crafting our economic sentiment of the three major equity regions, the United States, foreign developed ("EAFE"), and emerging markets ("EM"), with an emphasis on the most relevant EM economies. We seek to balance opportunities and risks to determine the general health and direction of these regions. We seek to understand the drivers of growth and inflation in these economies to build a fair and balanced outlook.

To develop our investment sentiment, we strive to take advantage of the markets' shorter-term considerations that can significantly impact performance of asset classes over the next three years. Central bank policies, factors driving earnings and profitability, valuations, corporate quality, currencies, and investor behavior are just a few of the issues that can materially alter asset class or segment attractiveness.

We consider both our economic sentiment and our investment sentiment for the three major equity regions to inform our allocation sentiment for equities, fixed income, real assets, and hedge fund strategies. Given the nature of near-term volatility and "noise" in the marketplace, Syntrinsic's sentiment is expressed across a qualitative range from positive to negative.

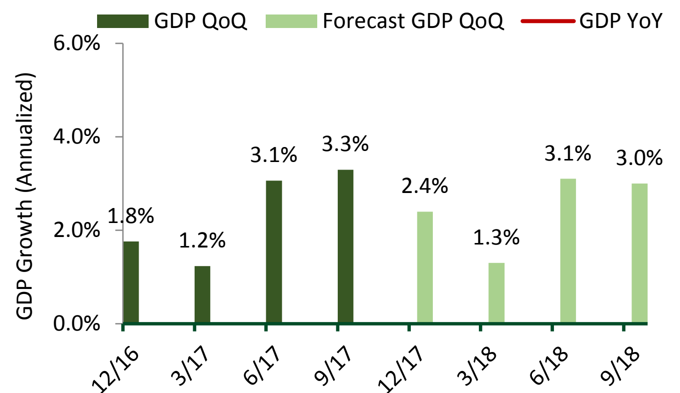
Near-Term Sentiment Forecast

United States

Economic Sentiment
NEUTRAL

The Fed is seeking to gradually remove monetary accommodation as labor markets have tightened. Despite this, wage inflation continues to lag for this stage of the cycle, potentially slowing the pace of further rate hikes. GDP growth (Exhibit 8) has modestly improved from last year but remains low by historical standards. Continued growth along with strong labor markets likely will build inflationary pressures eventually. We continue to believe a strengthening US economy can withstand a gradual rise in rates. However, there is a risk that the Fed continues on the path of gradual rate hikes in the face of low inflation, causing monetary conditions to tighten. Conversely, a stronger-than-expected pickup in inflation could cause the Fed to react with faster rate hikes that could accelerate the cycle.

Exhibit 8: Realized & Forecasted US GDP Growth



Source: Bloomberg

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In evaluating the US economy, we analyze the positives, risks, and outlook for two major growth drivers, the US consumer and US corporations.

US Consumer

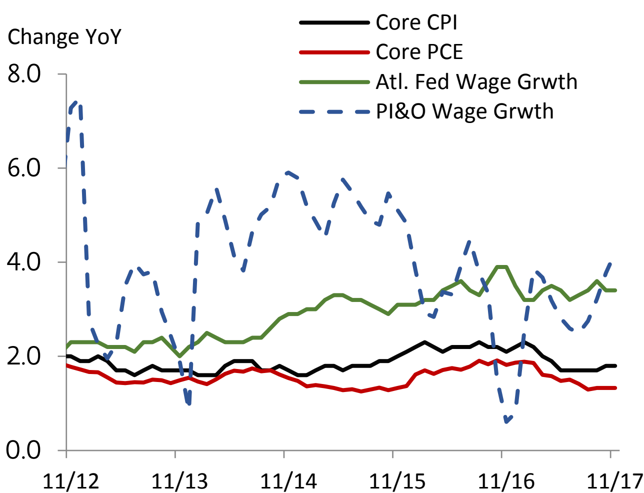
Various factors point to a healthy consumer that can support continued growth in the US:

- Tightening labor markets
- Rising consumer confidence
- Strong balance sheets
- Improving housing prices

We are currently watching for pockets of significant stress and while there has been an uptick in auto loan defaults, there does not appear to be any major risks for the consumer at this time.

In the near term, the US tax reform bill will likely boost consumer spending and economic growth by a small degree. However, the increased spending could also act to accelerate the cycle by creating inflationary pressures and causing a quickened pace of Fed hikes. We will continue to monitor spending and inflation closely.

Exhibit 9: US inflation Measures



Source: Bloomberg

US Corporations

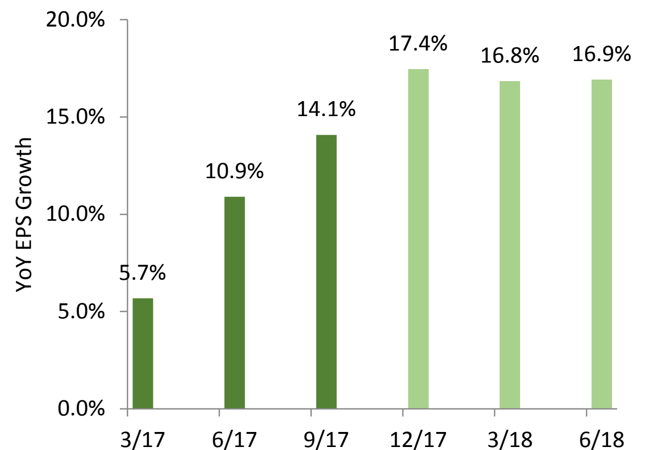
The US Corporate picture looks stable and we anticipate continued growth for the following reasons:

- Strong earnings growth, aided by stable oil prices and improving global demand
- Low debt service ratios, buffered by low interest rates
- Low corporate default rates
- Tax reductions

As we evaluate the different industries, the retail sector is struggling more than other sectors but does not currently change our stable outlook.

In the near term, we could potentially see some pressure on historically strong margins because of rising labor and borrowing costs. However, lower taxes from the tax reform bill could offset this pressure and provide a boost to margins. In addition, we anticipate that stable domestic demand and improved international demand can support revenue growth, offsetting some of the headwinds from rising labor and borrowing costs.

Exhibit 10: S&P 500 Trailing & Forward Estimated EPS



Source: Bloomberg

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Foreign Developed

Economic Sentiment
NEUTRAL

Our aggregate sentiment for the EAFE regions remains neutral. Improvements in Europe's economy are offset by developing uncertainty in the United Kingdom (UK) and modest growth in Japan.

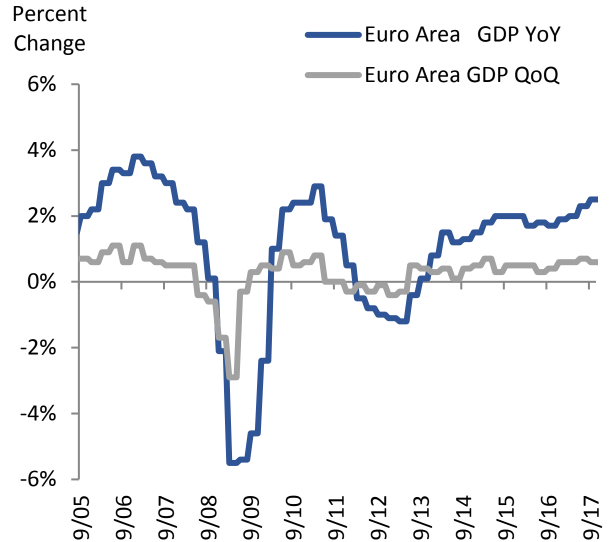
Exhibit 11: EAFE GDP and CPI Estimates

Key Economic Figures	2016	Est. 2017	Est. 2018
Eurozone GDP YoY%	1.8%	2.3%	2.1%
Eurozone CPI YoY%	0.2%	1.5%	1.5%
UK GDP YoY%	1.8%	1.7%	1.3%
UK CPI YoY%	0.7%	2.7%	2.5%
Japan GDP YoY%	0.9%	1.7%	1.3%
Japan CPI YoY%	-0.1%	0.5%	0.8%

Source: Bloomberg

We have been encouraged by the recent improvements in Europe, as evidenced by GDP growth (Exhibit 11 and 12), and continue to expect modest economic acceleration over the next few years. Improvements have been steady, seen broadly across most countries, and no longer supported by just a few areas. Local conditions in Europe have supported multi-year highs in consumer and corporate sentiment, indicating room for further gains as better consumption should eventually be realized. Consumer sentiment is the highest in 17 years, aided by unemployment declining to an eight-year low. Business activity has also picked up to relatively strong levels. The European Central Bank (ECB) will remain supportive during this early recovery period, but will reduce their pace of bond purchases through 2018. We expect ECB policy change to be gradual and reflective of economic conditions. Major political concerns have eased in Europe following several key elections in favor of pro-EU candidates, but tail-risks remain.

Exhibit 12: Eurozone GDP



Source: Bloomberg

We expect the UK to maintain low positive growth over the next few years, but with downside risk due to Brexit uncertainty and much further to go on Brexit negotiations. We reduced our outlook for the UK following the 2016 vote and feel it was justified given the negative impact to local consumption and reduced confidence. Higher inflation due to depreciation in the pound will limit real spending power over the near-term as higher prices and lower confidence impact purchases. Assuming a reasonably productive path towards Brexit, we see positive support from healthy labor markets, a more competitive currency for exporters, and resilient business activity surveys. The Bank of England should remain supportive as they balance temporary inflation with slower activity.

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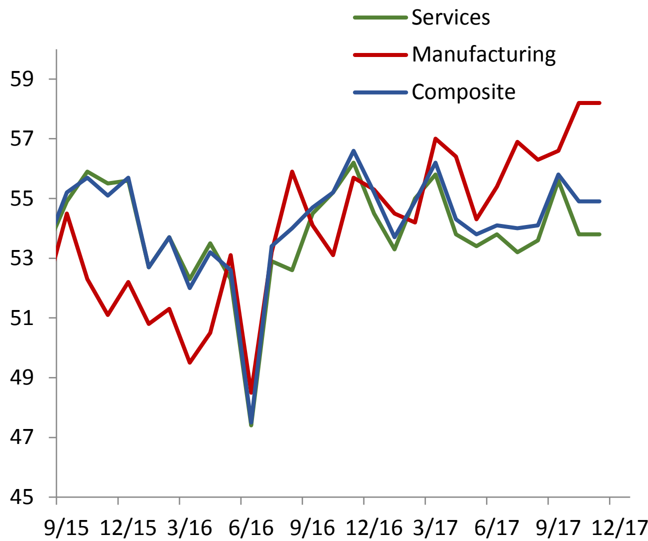
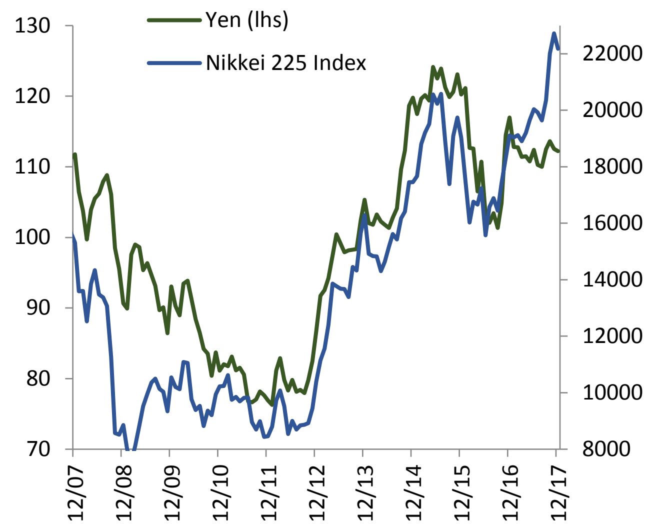
Exhibit 13: UK Purchasing Managers Index



Source: Bloomberg

Exhibit 14: Nikkei 225 and Yen



Source: Bloomberg

In Japan, we expect modest growth with ongoing dedication to extraordinary stimulus and reform efforts. There has been insufficient evidence that inflation will soon meet the Bank of Japan's (BoJ) target and thus the central bank will continue supportive measures. A convincing win for Abe in the Lower House may pave the way for better progress on reforms, but has yet to be seen in earnest. Japan should continue to benefit from healthy global demand with increased business activity and encouraging signs profits are decoupling from dependence on yen weakness. However, limited progress on wages will cap local consumption potential.

EMERGING MARKETS

Economic Sentiment
NEUTRAL

We upgraded our sentiment mid-year 2017 to neutral and continue to expect EM growth, while stable, to outpace developed markets. Our thesis remains intact with continued mild deceleration in China balanced by improvements in other regions. EM may be vulnerable to headwinds from higher US interest rates, but we do not expect this to be a significant headwind at this time. Commodity prices and the US dollar are not expected to repeat challenges seen in past years and should be range bound for the near-term. Geopolitical concerns remain in several regions but appear to be tail-risks with a low probability of occurring or meaningfully impacting markets. Better stability in EM and added support from broad global growth is encouraging. However, the large and fast rise in debt within China remains a material concern.

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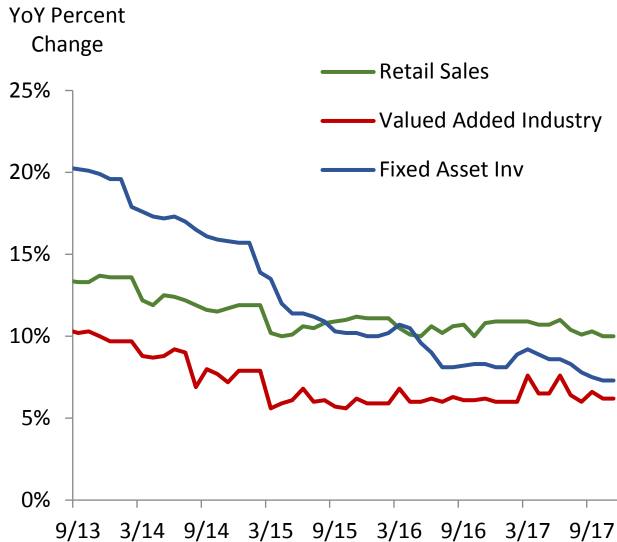
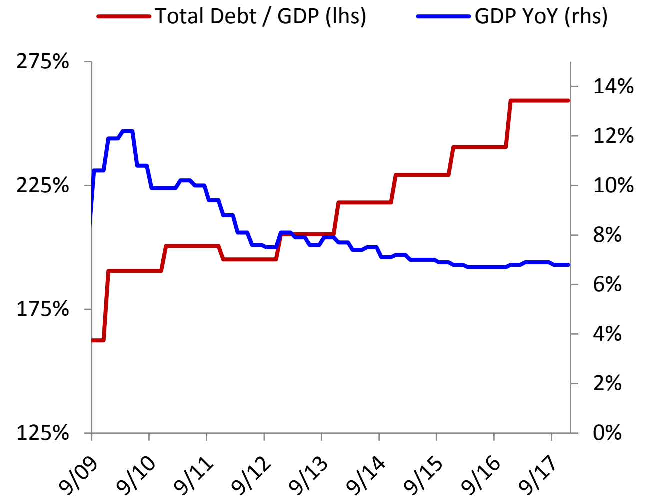
Exhibit 15: China's Economic Indicators



Source: Bloomberg

China remains the largest and most important economic and market region within EM and the largest expected single contributor to near-term global growth. We expect a continuation of the current soft landing path, but with potential for bumps along the way. The transition towards a consumption driven economy is well under way and remains a powerful long-term story locally and globally. The actions of the government and central bank to balance growth and quality will continue to be central to a successful transition. The large middle class and progress towards greater levels of urbanization should continue with spending growth more resilient and taking over leadership from more capital intensive and cyclical heavy industry components. Our largest concern is the rapid rise in debt of Chinese companies and a more recent growing consumer balance sheet. Policy missteps in past years appear to have been addressed, but steering such a large ship will remain a delicate task.

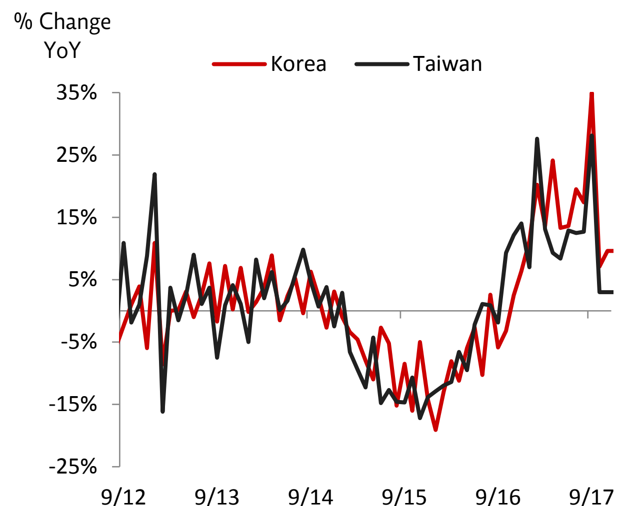
Exhibit 16: China Debt to GDP



Source: Bloomberg

Outside of China, we expect other regions in Asia to be generally healthy and supported by firmer local data as well as continued global growth. Taiwan and South Korea should see positive effects to exports and business activity. In Latin America, Brazil is significant and appears to be on a soft path of positive growth and early recovery.

Exhibit 17: Exports: Korea and Taiwan



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NEAR-TERM ASSET CLASS SENTIMENT

Our Near-Term investment sentiment for the three major equity regions is crafted by first developing a near-term outlook for equity performance in each region based on drivers of revenue, profitability, earnings, valuations, currencies, and other factors.

Then, on a relative basis, we determine our Allocation Sentiment by considering both our Economic and Investment Sentiments. This process is nuanced and based on qualitative factors as, over time, economic and investment factors can vary in importance.

UNITED STATES EQUITY

Economic Sentiment	+	Investment Sentiment	=	Allocation Sentiment
NEUTRAL		NEUTRAL		NEUTRAL

Earnings growth has strengthened in the US as a weaker dollar and strong international demand along with stable domestic spending are supportive of earnings. US tax legislation could further boost growth and earnings in the near-term but the effects in the intermediate to long-term remain uncertain.

Profit margins remain elevated compared to history; however, the potential for rising employee compensation costs as well as rising borrowing costs could eventually become a headwind. A pickup in productivity through increased investment has the potential to offset higher wage costs to a degree.

Valuations have continued to grind higher, reflecting an optimistic economic outlook. Although valuations are on the expensive side, they do not appear overly excessive for the current stage of the cycle. Corrections are always possible and impossible to predict but an identifiable catalyst currently remains elusive.

FOREIGN DEVELOPED EQUITY

Economic Sentiment	+	Investment Sentiment	=	Allocation Sentiment
NEUTRAL		NEUTRAL		NEUTRAL

Earnings expectations are positive across the three major regions with Europe likely to outpace Japan and the UK. We expect Europe and Japan to benefit from improving local conditions while the UK may face continued headwinds to local consumption. Many foreign developed regional companies derive a meaningful portion of revenues from overseas sales and should benefit from the positive global environment. The UK especially receives a high portion of revenues, over 75%, from foreign trade partners.

Most foreign developed regions are earlier not only in their economic cycle but also in their market cycle, with earnings and profitability measures still depressed relative to past cycles with room to improve. Market prices already reflect a positive outlook with valuations elevated in most regions relative to their own recent past. While still cheaper than US equities, rising valuations are not part of our core thesis for the near-term return sentiment. Also encouraging, the average quality of foreign developed equities has been improving over recent years with a reduction in debt and increasing cash levels.

For an upgrade to our investment sentiment, we would like to see continued progress in Europe, better clarity on the future of the Brexit, and more meaningful progress in Japan with local conditions as well as corporate profitability and efficiency.

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Emerging Markets Equity

Economic Sentiment	+	Investment Sentiment	=	Allocation Sentiment
NEUTRAL		NEUTRAL		NEUTRAL

Following a mid-year upgrade to our investment sentiment and allocation sentiment, we remain neutral on EM equities. Broad local improvements combined with reduced expectations for external headwinds from currencies and commodities support a full allocation to EM.

We expect the trend of improvements to sales and earnings growth, which has coincided with improving global conditions, to continue based on what we believe is a sustainable path. Our view is consistent with consensus earnings expectations of low double-digit growth over the next few years, but we recognize the higher expected risk as cause to be closer to neutral than overweight.

While the average EM index forward P/E valuation is well below developed markets at this time, it has risen above recent averages and has wide dispersion skewing the figures downward. Many of the most well-know and fastest growing companies, particularly Asian technology and consumer names, are trading well above developed markets due to the widely known optimistic outlook for these names. The rapid rise in corporate debt, particularly in China, is concerning as well and tempering our sentiment to neutral.

Short-term Fixed Income

Return Sentiment	+	Risk Sentiment	=	Allocation Sentiment
NEUTRAL		NEUTRAL/ POSITIVE		NEUTRAL/ POSITIVE

For conservative investors, a low duration strategy seems more prudent than extending maturities and accepting larger potential interest rate risk and more sensitivity to credit risk. We expect a modest pace of rate hikes with a high correlation to short-term rates as seen in past cycles. While this will create near-term headwinds to prices, our concerns are limited because of the gradual expected pace. Short-term fixed income funds should be able to weather rising rates with a lower duration and faster reinvestment at higher rates. The yield curve has seen some flattening over the last year, making short-term fixed income more attractive compared to last year. For more growth-orientated portfolios, we recommend intermediate fixed income with better expected diversification potential (higher duration) to offset equity risk.

Core Fixed Income

Return Sentiment	+	Risk Sentiment	=	Allocation Sentiment
NEUTRAL		NEUTRAL		NEUTRAL

Investment grade credit spreads have tightened while net corporate leverage is rising. Neither is sufficient to cause a change in our sentiment, but a focus on quality and caution seems prudent given the limited opportunity for capital appreciation. Investment grade balance sheets appear healthy, earnings are strong, and yields still offer a premium over government bonds, just less so than in past years of the recovery.

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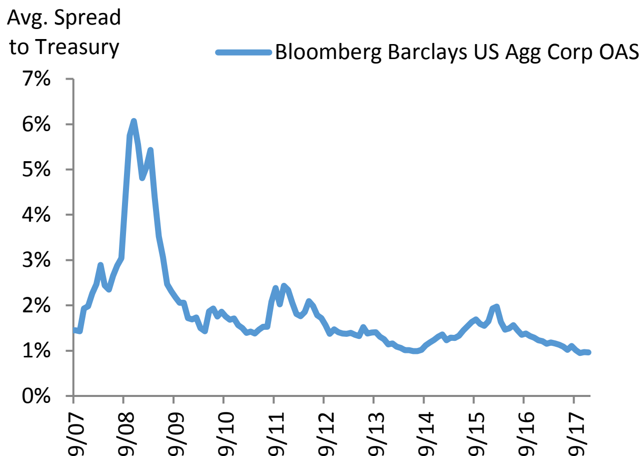
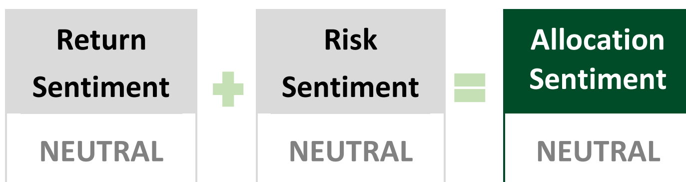
As mentioned earlier, US Core fixed income yields are attractive relative to other foreign options. Given that US issued bonds only represent around a third of the $100 trillion dollar global bond market, it is reasonable to expect some buyers of the large foreign developed market to continue migrating towards more attractive US yields. Also supporting our neutral sentiment on core fixed income is the diversification benefit from high quality bonds as equity valuations are elevated and the business cycle in the US appears mature.

Exhibit 18: Bloomberg Barclays US Aggregate Option Adjusted Spread



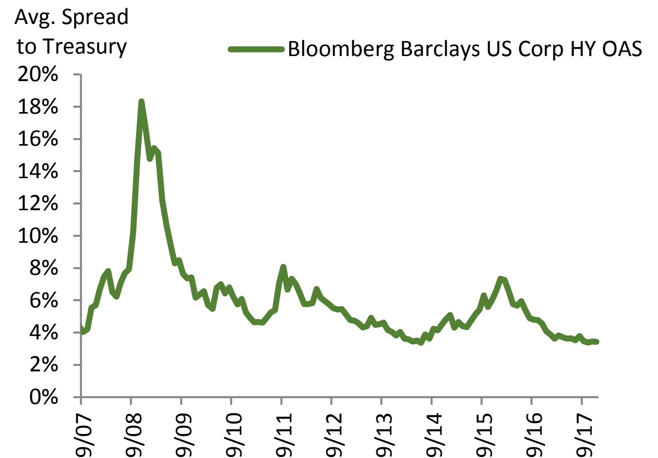
Source: Bloomberg

CORE PLUS FIXED INCOME



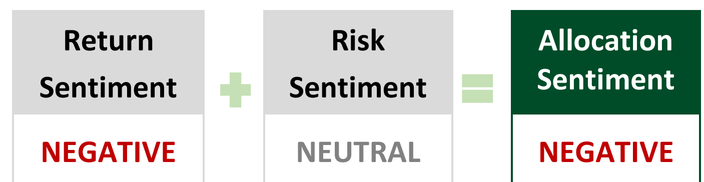
While the general environment for risk taking should be supported by fundamentals, the continuation of fixed income spread tightening in lower quality bonds keeps us cautious as the opportunity to add value is shrinking while volatility potential remains. Given the diverse universe of core plus fixed income and still positive fundamentals, we remain neutral in our sentiment and see value in having a larger opportunity set. However, our approach to core plus fixed income evolved several years ago and we continue to believe now more than ever that access to this space should be through an opportunistic manager with the flexibility on quality and not a dedicated high yield or structured fund as valuations are expensive.

Exhibit 19: Bloomberg Barclays US High Yield Corporate Option Adjusted Spread



Source: Bloomberg

FOREIGN DEVELOPED FIXED INCOME



International yields continue to be very low and negative in some places. While foreign central banks are expected to maintain supportive policies for the next few years, the Euro area appears much better than recent years. Even ignoring the potential for faster policy tightening than expected, rates are low to negative and unappealing in any reasonable scenario.

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EMERGING MARKETS FIXED INCOME

Return Sentiment	+	Risk Sentiment	=	Allocation Sentiment
NEUTRAL		NEUTRAL		NEUTRAL

EM bond yields have declined over the last year, but still offer an attractive premium over US Treasuries. However, higher yields comes with additional credit risks, liquidity risks, and currency risks. A more stable economic backdrop in local EM regions along with less intense expected currency pressure and stable commodities should support the environment over the near-term. US rate increases remain a modest concern at this time.

LISTED REAL ESTATE

Opportunity Set	+	Relative Attractiveness	=	Allocation Sentiment
NEUTRAL/ POSITIVE		NEUTRAL		NEUTRAL/ POSITIVE

Strong labor market conditions globally continue to support demand for real estate. Some regions appear late cycle, limiting potential for improvements from here, but robust demand for properties could sustain the cycle for some time. New supply in most markets and in most sectors continues to lag demand, which should continue to support low vacancy rates and growth in rents. Earnings growth is expected to slightly improve in 2018 over 2017.

Valuations have improved due to recent underperformance as most regions trade at a discount to NAV while cap spreads are wider than historic averages in most regions. P/FFO metrics also appear fair to slightly elevated in the US. Meanwhile, quality of listed real estate continues to improve as leverage has trended lower.

We also continue to be attracted to Real Estate's inflation hedging qualities. In an environment in which inflation will likely pick up in the near term, we like the diversification effects that an investment linked to a physical real asset will have for the overall portfolio. Although, we do not anticipate a strong pickup in inflation, if this were to unexpectedly occur, Real Estate's strong pricing power will likely provide better inflation protection that other assets.

COMMODITIES

Opportunity Set	+	Relative Attractiveness	=	Allocation Sentiment
NEUTRAL		NEGATIVE		NEGATIVE

Our negative sentiment is based on expectations for range bound prices as a result of balanced supply and demand fundamentals across major energy and industrial metal commodities. The previous decade of investment and efficiency gains in production has created robust supply potential. Near-term demand may see tailwinds from recent improvements to global growth. But offsetting these tailwinds are maturing emerging economies, especially China's ongoing transition to a slower and less resource intensive service economy, which will likely limit incremental demand growth. Increased adoption of resource saving technologies such as automation and alternative fuel vehicles should provide further downward pressure on demand growth.

While commodities have historically provided an inflation hedge to portfolios, our near-term outlook for inflation is for only modest acceleration. In addition, our range bound outlook does not change the historically elevated volatility of commodity prices, which we think will continue.

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HEDGE FUND STRATEGIES

Opportunity Set	+	Relative Attractiveness	=	Allocation Sentiment
NEUTRAL/ POSITIVE		**NEUTRAL/ POSITIVE**		**NEUTRAL/ POSITIVE**

The opportunity set for hedged fund strategies remains attractive as correlations between assets have been decreasing, opening opportunity for talented managers to add alpha. Meanwhile, dispersion of returns across managers has been increasing but remains at subdues levels, while volatility remains near record lows, somewhat limiting alpha potential from identified opportunities.

We continue to view Hedge Fund Strategies as attractive lower volatility compliments to equity as bonds, the traditional portfolio risk reducer, only offer low return potential.

In addition, we continue to see value in a diversified source of returns that cannot be accessed through traditional stocks and bonds. We specifically seek portfolio diversifying, lower risk hedged strategies as opposed to risk enhancing hedged strategies. We expect the relative attractiveness of these diversifying hedged strategies to decrease with a corresponding rise in bond yields, however, and will adjust our sentiment in response to market conditions.

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DEFINITIONS

Alpha	The excess risk-adjusted return relative to the risk-adjusted return of the benchmark.
Beta	A measure of the volatility, or systemic risk, of an investment in comparison to a specific market.
Brexit	A term used to describe the potential or actual departure of the United Kingdom from the European Union.
Correlation	The relationship or connection between two things such as an economic event and a market's reaction. The relationship may or may not reflect causation.
Diversification	A portfolio risk management technique that varies investment exposures to varied asset classes, economic factors, or other criteria.
Inflation	A sustained increase in the general prices for goods and/or services, generally across a sector or region.
Volatility	A measure of the historic or anticipated changes in value of an economic factor, frequently used to reflect the price uncertainty inherent in a portfolio.

DISCLOSURES

The information in this document is not intended as a recommendation to invest in any particular asset class or strategy or as a promise of future performance.

Given the complex nature of risk-reward trade-offs involved in portfolio construction, we advise clients to consult with financial professionals on specific investment-related decisions. References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. In addition, past performance is not a guarantee of future results.

Assumptions, opinions and estimates are provided for illustrative purposes only and are subject to significant limitations. Expected return estimates are subject to uncertainty and error. Expected returns for each asset class can be conditional on economic scenarios to which actual returns could be significantly higher or lower than forecasted. They should not be solely relied upon as recommendations to buy or sell securities.

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