MARKETS TAKE FLIGHT: NEPC'S 2018 ASSET ALLOCATION LETTER

As markets soar, discipline and asset selection are key to successful investing in 2018

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NEPC's Asset Allocation Committee

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As equities have soared, so have the fortunes of many investors. Still, reaching for the skies in 2018 will involve a more selective and disciplined process. Investors will have to take a measured approach, heeding the words of Daedalus, who cautioned his son, Icarus, to neither fly too high nor too low.

While our intention is not to clip your wings, we do advocate caution while seeking investment opportunities and also suggest scaling back risk exposures where value appears limited. We stand behind equities outside the US, as international stocks are poised to benefit from favorable macro-economic conditions and an improving corporate earnings outlook.

INTERNATIONAL STOCKS ARE POISED TO BENEFIT FROM FAVORABLE MACRO-ECONOMIC CONDITIONS

At the same time, we also see utility in preparing portfolios for the inevitable headwinds by dialing down exposure to US equities and dialing up allocations to safe-haven fixed-income assets, for instance, core bonds, municipal debt and Treasury Inflation-Protected Securities.

We urge investors to review the markets' dizzying performance in 2017 through the lens of NEPC's key market themes. A discussion of the following macro themes not only provides context for the year that was, but also offers insights into the year that will be:

(i) **Extended US Economic Cycle**
The United States is now entering its ninth year of economic expansion following the financial crisis. Measured gains in GDP and robust job growth provided strong underpinnings for domestic equities. The US economy will likely continue to grow, supported by accommodative financial conditions, including tax cuts. At the same time, the excess economic capacity will provide fuel to the ongoing expansion.

(ii) **Federal Reserve Gradualism**
There is no doubt that the Fed's slow pace of raising interest rates has bolstered easy financial conditions. We believe the Fed will remain relatively accommodative, barring a dramatic flare up in inflation. We will be vigilantly following the Fed's moderate unwinding of its balance sheet and the untested impact on capital markets.

Outside the United Sates, gradualism is the policy of choice for other major central banks: The European Central Bank's quantitative easing program continues to expand (now at a slower rate), while the Bank of Japan is carrying on its accommodative monetary policy.

(iii) **China Transitions**

So far, China's move towards an economy emphasizing services and innovation over manufacturing has taken place with minimal disruptions. We expect the country's careful restraint over its monetary and fiscal policies to offer a smooth path for China's massive economic evolution. That said, the world's second largest economy remains a risk to world markets due to its sizable contribution to global growth.

(iv) **Globalization Backlash**

In 2017, political discontent with globalization and an uneven economic recovery fanned concerns around the fate of the euro and the stability of the European Union as the continent faced several key elections. These concerns failed to materialize as mainstream political candidates emerged victorious. Still, we are anxious over US trade policy and political risk in Europe. Populism remains on the rise in Europe, with an anti-establishment political bias a likely longer-term trend; this could fuel potential currency volatility.

(v) **Synchronized Economic Resurgence**

Our belief that the themes mentioned so far provide a foundation for continued market stability gives rise to a new key market theme for 2018: synchronized economic resurgence. It is defined by a landscape of global economic conditions improving in unison, reinforcing gains the world over.

We saw such an environment in 2017. Of the 45 largest economies in the world, 30 exhibited accelerated growth rates for GDP, while the remaining 15 countries grew but at a slower rate. Of greater consequence, we believe this coordinated economic revival extends beyond 2017. The erosion of excess economic capacity across the globe is a catalyst, as the potential for labor reform in Europe, improved workforce participation in Japan, and falling real rates in the emerging markets offer multi-year benefits to economic expansion.

WE BELIEVE THE COORDINATED GLOBAL ECONOMIC REVIVAL EXTENDS BEYOND 2017

When viewed through the prism of each of our key market themes, it is easy to relate to the favorable investment outcomes and the positive investor sentiment of 2017. Carrying NEPC's key market themes into 2018, we now discuss how they will likely shape investment opportunities and performance over the course of this year.

CURRENT OPPORTUNITIES

Our key market themes paint a broadly positive backdrop for risk assets. That said, we caution investors, just as Daedalus did, to not fly too close to the sun. To this end, we suggest investors trim gains in US equities following several years of strong returns. While a prolonged US economic expansion and corporate tax cuts can help sustain the rally for domestic stocks, heightened valuation levels and profit margins give us pause.

We also recommend (with even stronger conviction) reducing return-seeking credit exposure. Formerly attractive credit spreads have now fallen below long-term medians and do not appear to fully compensate investors for the potential risk. Our disenchantment with credit includes not only US high-yield issues, but also bank loans in the US and dollar-denominated emerging market debt.

We encourage investors to reallocate

return-seeking credit exposure to other areas of the portfolio, pairing increases to equities and private markets with additional safe-haven fixed income. Within this safe-haven allocation, we remain steadfast in our belief that duration exposure is a key asset-allocation building block for a diversified portfolio. However, we recommend adjusting this exposure to favor TIPS over nominal bonds. Our outlook for US inflation assumes a gradual uptick in the coming years and exceeds current expectations discounted by fixed-income markets. Our suggested actions on US equities, credit and TIPS help trace a more balanced path, while providing investors the freedom to spread their wings with an overweight position in non-US developed and emerging market equities.

Looking to non-US developed market stocks, the potential of a multi-year earnings recovery, supported by the macro environment outlined in our key themes, offers the opportunity for elevated returns. The catalysts for outperformance are already present with improving economic conditions in Europe and continuing corporate governance reform in Japan. To this end, we believe non-US small-cap and global equity strategies are best equipped to identify valuation discrepancies among stocks across countries and sectors.

Meanwhile, we believe emerging market equities remain attractive even in light of their stellar showing in 2017. They offer the highest total-return potential for investors in public markets with valuations and fundamentals still suggesting an overweight relative to global market-cap weights. Furthermore, the opportunity set for excess returns appears more abundant; we encourage the use of higher tracking-error strategies over benchmark-focused mandates to invest across emerging economies.

At NEPC, we understand that even the best laid plans can go awry, just like the flight of Daedalus and Icarus. With this in mind, we must account for the possibility of an abrupt or rapid shift disrupting a market theme and forcing markets to reprice at higher levels of volatility.

As such, we suggest investors increase exposure to strategies that mitigate market drawdowns. One approach would be adding global-macro hedge funds, specifically systematic global-macro strategies that exhibit low correlation to equity markets and excess performance in longer-term risk-off periods. Another is a more targeted approach, suited to more opportunistic investors: adding dedicated long-volatility exposure in a portfolio. Should the prevailing low levels of volatility in asset classes normalize, exposure to long-volatility may be beneficial, significantly contributing to returns in the event of a sizable market disruption.

ALLOCATING ASSETS NOW REQUIRES CAUTION AND DISCIPLINE

CONCLUSION

With a nine-year rally in equities behind us, it should not be surprising that allocating assets now requires an abundance of caution and discipline. While we expect a low-return environment going forward, it is tempting to look back on the stellar performance so far and get swept into this extended global market rally.

We believe reaching for the skies is appropriate but only as long as it is limited to distinct parts of an investment portfolio, particularly within equity allocations, where we advocate foreign equities over US stocks. While this part of the portfolio can be allowed to soar, we think investors would benefit from greater caution within their fixed-income allocations. To this end, we recommend reducing risk-seeking credit in favor of safer core bonds and TIPS.

While we remain steadfast in the belief that our key market themes will prevail, we urge vigilance. Disruptions in any of these themes will likely cascade across markets in a way not felt by investors in several years. The idea of volatility may now seem as ancient as the cautionary tale of Icarus and Daedalus, but we know market disruptions will return. And when that eventuality occurs, it is best to be flying neither too high nor too low.

DISCLAIMERS AND DISCLOSURES

- Past performance is no guarantee of future results.
- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.
- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
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