NEPC

MARKET THOUGHTS

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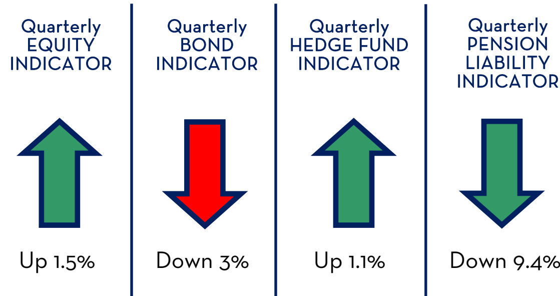

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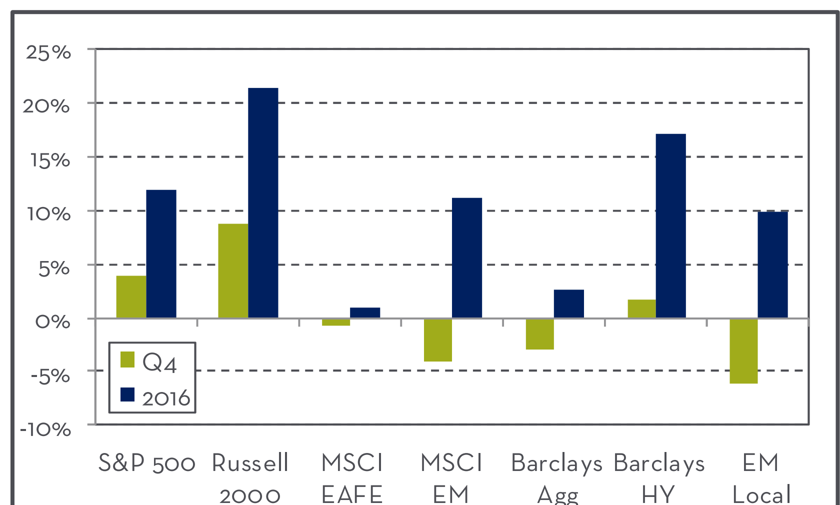
WHAT A DIFFERENCE A YEAR MAKES

A new year is a time for resolutions. It is also a time to take stock and reflect on lessons learned. Our key takeaways from 2016: consensus views are not a forecast but rather an assessment of the facts on hand, and a lot can change in a year.

Case in point: Twelve months ago, investors were fretting over a potential slowdown in the US and Chinese economies. Meanwhile, Donald Trump was vying to clinch the Republican ticket in the US presidential elections among a crowded platform of nominees. Fast-forward to a year later: risky assets forged gains with the S&P 500 Index returning 12%, US high-yield bonds earning over 17%, and emerging market equities reaping 11% in response to a continued economic expansion in the US and an improving outlook for China. The unexpected victory of President Trump in the elections sent domestic small-cap equities surging 9% in the fourth quarter as bond indices slumped amid expectations of higher interest rates and inflation in anticipation of the policies of the new administration (Exhibit 1).

Exhibit 1: Index Returns in 2016



Source: Bloomberg, Barclays, S&P, Russell, MSCI and JPM (As of 12/31/2016)

Now, a new market consensus is taking shape, one that appears to be bullish on domestic stocks while lukewarm on markets outside the United States. Still, as we learned in 2016, a lot can change in 12 months; the coming year, just like the last one, will probably offer up unexpected outcomes differing often from the linear path expected from the market consensus.

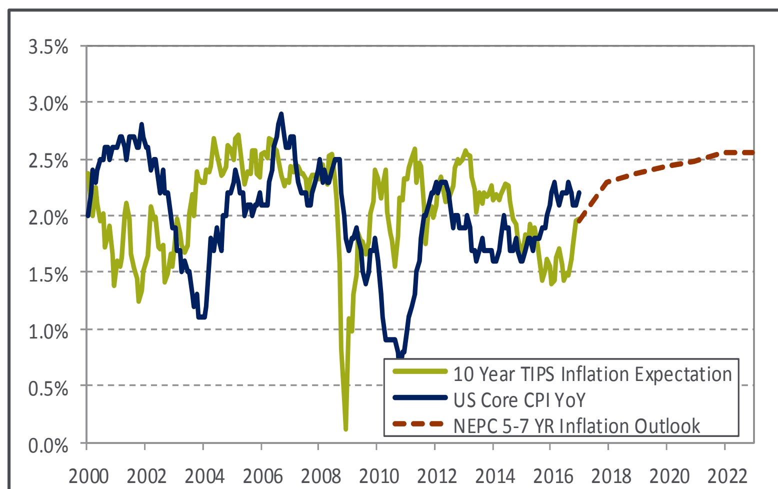
Keeping this in mind, we turn to our annual market outlook. Our views rest on the foundation of these four key themes that we believe will define market dynamics and fuel volatility:

I. The extended expansionary economic cycle in the US, currently entering its ninth year
II. The Federal Reserve's anticipated pace of gradual rate increases
III. China's transition towards an economy more focused on services and innovation than manufacturing
IV. The backlash against globalization and political discontent arising from uneven economic recovery and wage gains

We expand on these themes and their implications in greater detail in our upcoming 2017 Annual Asset Allocation Letter. As we build on this outlook and sift through current investment opportunities, we find several of our views falling outside the prevailing market consensus. To this end, we encourage investors to trim gains in domestic equities. While US stocks

can continue to rally, bolstered by a prolonged economic expansion, corporate earnings growth may be challenged to meet market expectations as the strength of the US dollar pressures corporate profit margins. A more contrarian recommendation for many investors is shifting to an overweight position in non-US developed market equities. As many are aware, non-US developed equities carry material risks amid structural economic challenges in Japan; in Europe, the rise of anti-establishment political parties is jeopardizing the stability of the Eurozone with major elections looming in a number of nations. Despite these concerns, we see tangible catalysts in these markets to drive outperformance as macroeconomic improvements in Europe fuel a recovery in corporate earnings; in Japan, shareholder-friendly actions offer increased dividends and equity buy-backs for investors. Implementation remains critically important with active small-cap equity and broad global equity strategies being preferred approaches. Furthermore, we suggest hedging a portion of non-US developed currency exposure as volatility in these markets may transmit largely through currencies.

Exhibit 2: TIPS Inflation Expectations and Core CPI



Source: Bureau of Labor Statistics, Bloomberg, NEPC

We also believe emerging markets remain attractive despite their strong rebound in 2016. Emerging equities carry below average valuations while local-currency debt offers a compelling total-return opportunity for investors. Although the fundamental profile across local interest rates, currencies and equities suggests an overweight, our excitement is tempered by the heightened volatility and unknown ramifications of President Trump's global trade policy. Within the domestic fixed-income universe, duration is an important input for asset allocation but we believe expectations of higher inflation favor Treasury inflation-protected securities over nominal bonds (Exhibit 2). In addition, we encourage investors to replace high-yield strategies with, for instance, bank loans or dynamic credit approaches, as credit spreads have declined materially.

Rounding out our list of current opportunities for investors, we recommend adding global macro hedge funds, specifically systematic strategies. These approaches tend to exhibit low correlation to equities and offer strong diversification within a total portfolio.

While we hold conviction in each of these current opportunities, their suitability depends on each client's unique objectives and constraints. As such, our market outlook reflects a positive view for risk assets. We remain unwavering in our commitment to a diversified investment program positioned to weather uncertainty as markets deviate from investors' consensus views.

Equity Index Returns as of 12/31/2016				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI World	1.5%	5.3%	1.8%	8.2%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	3.8%	12.0%	8.9%	14.7%
Dow Jones Industrial Average	7.9%	13.4%	6.0%	10.1%
NASDAQ Composite	1.3%	7.5%	8.8%	15.6%
Russell 1000 Growth	1.0%	7.1%	8.6%	14.5%
Russell 1000 Value	6.7%	17.3%	8.6%	14.8%
Russell 2000	8.8%	21.3%	6.7%	14.5%
Russell 2000 Growth	3.6%	11.3%	5.1%	13.7%
Russell 2000 Value	14.1%	31.7%	8.3%	15.1%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	-0.7%	1.0%	-1.6%	6.5%
MSCI Emerging Markets	-4.2%	11.2%	-2.6%	1.3%
MSCI Europe	-0.4%	-0.4%	-3.2%	6.3%
MSCI UK	-0.9%	-0.1%	-4.4%	4.0%
MSCI Japan	-0.2%	2.4%	2.5%	8.2%
MSCI Far East	-1.4%	2.3%	2.1%	8.0%

Global Equities

Domestic stocks led the pack in the fourth quarter as concerns around potential changes to US trade policy under President Trump dragged down overseas markets. Small-cap equities bested large-cap securities with the Russell 2000 Index returning 8.8% compared to 3.8% for the S&P 500. Value stocks outshone growth for the quarter and the year.

Outside the US, developed market equities fell 0.7%, according to the MSCI EAFE Index. Rising interest rates in the US and a strong dollar pulled down emerging market stocks, which lost 4.2% in the fourth quarter, according to the MSCI Emerging Markets Index. Still, they ended the year in the black, posting gains of 11.2%.

Global Fixed Income

Domestic fixed-income securities turned in a sol-

id performance in 2016 with the Barclays Aggregate Bond Index up 2.7% and the Barclays High Yield Bond Index returning 17.1%. Risk-takers were rewarded while investors tilting toward safety lagged. This trend was especially prominent in the fourth quarter when risk premiums tightened across sectors, with commodities experiencing the most pronounced spread compression. While the credit cycle could go on for longer, we advise caution as valuations have moved to the tighter end of the band.

Fixed Income Index Returns as of 12/31/2016				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Global Agg	-7.1%	2.1%	-0.2%	0.2%
JPM EMBI Plus	-5.3%	9.6%	5.8%	5.1%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	-3.0%	2.6%	3.0%	2.2%
BC US Agg. Treasury	-3.8%	1.0%	2.3%	1.2%
BC US Credit	-3.0%	5.6%	4.1%	3.8%
BC Mortgage Backed	-2.0%	1.7%	3.1%	2.1%
BC Interm. Gov't/Credit	-2.1%	2.1%	2.1%	1.8%
BC 1-10 Yr TIPS	-1.5%	4.0%	1.5%	0.7%
BC High Yield	1.8%	17.1%	4.7%	7.4%
S&P LSTA Lev. Loan	2.3%	10.2%	3.6%	5.1%
3 Month T-Bills	0.1%	0.3%	0.2%	0.1%
10-Year Bond Yields	**Mar-16**	**Dec-15**	**Mar-15**	**Mar-14**
US	2.4%	1.6%	2.3%	2.2%
Germany	0.2%	-0.1%	0.6%	0.5%
UK	1.2%	0.7%	2.0%	1.8%
Japan	0.0%	-0.1%	0.3%	0.3%

Overseas, emerging market debt was also a strong performer in 2016 with local-currency debt leading for most of the year but faltering in the aftermath of the US elections. It racked up gains of 9.4%, finishing behind emerging market hard-currency issues which returned 10.2% last year. Emerging market debt remains appealing in terms of rates and currencies.

Currency Markets

The US dollar dominated the currency market in the fourth quarter, further strengthening on the heels of the new administration's emphasis on growth and fiscal stimulation. The Japanese yen depreciated versus the dollar as the interest rate differential widened, in part, because of the Bank of Japan's asset-purchase program. Trump's election victory also put pressure on emerging market currencies with many experiencing sharp sell-offs. Heightened volatility in currency markets may persist as the Fed gradually raises rates and the new administration stokes uncertainty around potential protectionist actions.

Commodity Markets

Commodities gained 11.8% in 2016—the first year of positive returns since 2010—according to the Bloomberg Commodity Index. During its period of negative performance, the index racked up cumulative losses of 45.8%.

For the quarter ended December 31, commodities returned 2.7% with 15 out of 22 constituents posting gains. Within the energy sector, WTI, unleaded gasoline and heating oil benefitted from OPEC's decision in November to cut oil production by 1.2 million barrels a day. The Fed's rate hikes negatively affected precious metals which had been a standout performer during the first half of last year. Industrial metals were bolstered by strong manufacturing data from China and promises of infrastructure spending from the new US administration. Live cattle and lean hogs rallied in the fourth quarter, while record harvests in agriculture were partly mitigated by higher demand.

Pension Liability

After watching interest rates fall steadily over the first three quarters of 2016, the last three months saw rates increase by 57 basis points in the Citigroup Pension Liability Index to 4.14% on December 31 from 3.57% on September 30. This is welcome news to plan sponsors, whose plan liabilities are estimated to have decreased by 9.4% in the fourth quarter. However, this quarter's decline did not fully erase the losses from the first three quarters, as liabilities are estimated to have risen 7.9% in 2016.

A strong showing by equities in the fourth quarter boosted some plan assets; however, fixed-income, especially longer-duration, saw negative returns. Clients who have implemented liability-driven investment (LDI) strategies may not have seen much movement this quarter in funded status, as long-duration credit saw negative returns offsetting the gain from the decrease in liabilities.

Hedge Funds

At the start of the quarter, larger hedge funds within the global macro and equity sub-strategies outpaced smaller funds. Gains posted by market-neutral and growth-oriented funds were offset by the decline in energy, technology and healthcare. Despite economic uncertainty and rising bond yields, fixed-income relative-value arbitrage continued to perform and the asset-backed index stayed in the black in the fourth quarter. Event-driven strategies led performance in November and December aided by a fertile environment for activism, continued activity in mergers and acquisitions, robust multi-strategy returns and a turnaround in special situations. Some global macro strategies saw headwinds in this environment, particularly trend-following CTA strategies. Meanwhile, funds with exposure to emerging markets, particularly Latin

America, posted strong gains in the quarter.

Private Markets

Last year saw a lower number of deals but aggregate transaction value remained consistent due to a few large-sized deals. Prices hovered at record highs in developed geographies, fueled by leverage and high valuations. A weaker IPO market slowed exits. Meanwhile, robust fund-raising led to a greater capital overhang.

In the US, lower-middle market and core-middle market lenders are outperforming. The core-middle market is showing attractive risk-adjusted returns, given the stage of the credit cycle. European banks continue to exit the leveraged loan market due to regulatory pressures. The manager universe in Europe has become tiered with stronger managers enjoying superior deal flow and performance. In Asia, dampened valuations and less dry powder are creating a positive environment for private equity. Private equity in this region continues to capitalize on generational and industry transitions.

Hedge Fund Industry Performance Overview as of 12/31/2016				
Composite	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Hedge Fund Composite	1.1%	1.2%	1.5%	4.3%
Relative Value	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Convertible Arbitrage	0.4%	6.6%	1.9%	3.9%
DJCS Fixed Income Arbitrage	1.8%	4.3%	3.1%	4.8%
DJCS Equity Market Neutral	-2.6%	-4.6%	-1.4%	1.1%
DJCS Multi-Strategy	1.2%	4.4%	4.8%	7.3%
Event Driven	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Event Driven	2.3%	2.7%	-0.8%	4.5%
DJCS Event Driven - Distressed	3.6%	6.4%	1.1%	6.0%
DJCS Event Driven - Risk Arbitrage	0.8%	5.9%	1.6%	2.5%
DJCS Event Driven - Multi-Strategy	1.8%	1.3%	-1.5%	3.9%
Equity Hedge	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Long-Short Equity	-0.2%	-3.4%	1.8%	6.1%
DJCS Emerging Markets	-0.3%	4.5%	1.9%	4.9%
DJCS Dedicated Short Bias	1.8%	-16.9%	-7.0%	-13.7%
Tactical	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
DJCS Global Macro	4.6%	3.6%	2.3%	3.1%
DJCS Managed Futures	-5.7%	-6.8%	3.0%	0.7%
Traditional Markets	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	-3.0%	2.6%	3.0%	2.2%
S&P 500	3.8%	12.0%	8.9%	14.7%

In real assets, OPEC's agreement to cut oil production fueled higher asset values in the energy sector. Our highest conviction remains in private equity and credit as these managers appear best-equipped to invest and manage assets in what we believe will be a choppy recovery. We still believe asset selection is critical in energy and are evaluating select opportunities in other areas of real assets. We are becoming more constructive on the mining sector over the mid-to-longer term and are actively seeking infrastructure opportunities given the headlines associated with the new administration. We remain positive on energy, negative on timber, and neutral on agriculture, infrastructure and metals and mining, with a preference for niche opportunities targeting assets in the sectors with a neutral rating.

In the US core property market, fundamentals remain strong although valuations are at record highs and rental growth rates are showing signs of deceleration. A rising interest rate environment will place upward pressure on cap rates which may begin to reset valuations. However, a flight to quality will continue to favor US core real estate, which is why we remain neutral. Within non-core US real estate, we favor cash flow-driven managers that are attentive to duration risk given the current stage of the expansion cycle.

Across the pond, we are focused on inefficiencies in capital markets and pockets of distress in Europe and emerging markets. Select junior-debt opportunities may yield attractive income streams while providing a hedge against property value declines.

Final Thoughts

Our investment outlook in 2017 is generally constructive for global risk assets as economic trends in the United States and China provide support for continued gains. That said, we are very aware that global market dynamics and valuations can rapidly shift amid uncertainties around US trade policy, the political climate in Europe, and Chinese monetary policy. We recommend reducing exposure to assets that have outperformed expectations and encourage a willingness to be contrarian by adding to assets that have underperformed. As such, we suggest investors rebalance or trim US stocks and shift exposure to international equities. Furthermore, we recommend investors reduce allocations to US high-yield bonds, substituting them with bank loans or dynamic credit approaches. We build on these ideas and provide a broader perspective on our outlook in our soon to be published 2017 Annual Asset Allocation Letter available at www.nepc.com.

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