THE TIMES ARE A-CHANGIN':
NEPC'S 2017 ASSET ALLOCATION LETTER

NEPC's Asset Allocation Committee

In the world of investing, change is the only constant. Sometimes it is slow and gradual, accumulating over years; at other times, change shows up with as much subtlety as a hammer on a nail. As we start a new year with a new US president at the helm, change is certainly in the air. Investing in a changing world can be challenging. It is this challenge that we seek to meet in our annual letter to you by identifying potential opportunities in this shifting landscape.

Looking at the current environment, we see a wide array of possible outcomes due to heightened political uncertainty in Europe related to a number of key elections in the region and policy upheavals at home. These changes carry the potential to disrupt and dislocate markets. To this end, investors should be prepared to act quickly—as they did in early 2016—to exploit this volatility. Prompt action by investors is especially relevant amid the secular backdrop of low returns, as strategic exposure to public market assets offers less support for investors to achieve their target objectives (Exhibit 1).

Before delving into our recommendations on asset classes—ranging from international equities to Treasury Inflation-Protected Securities (TIPS)—that offer the best risk-return characteristics in these times, it is vital to identify the major themes driving change. An informed understanding of the catalysts influencing our themes will help establish a framework for the potential changes in the offing while helping us lay the foundation of a sound investment philosophy.

In setting our annual investment outlook, we distill the macro environment into these four key themes that we believe will define market dynamics in the years to come:

i. The extended economic cycle in the United States, currently entering its ninth year

ii. The Federal Reserve's anticipated pace of

Exhibit 1: Asset Allocation Providing Long-Term Expected Return of 7.5%

Source: NEPC Long-Term Capital Market Assumptions

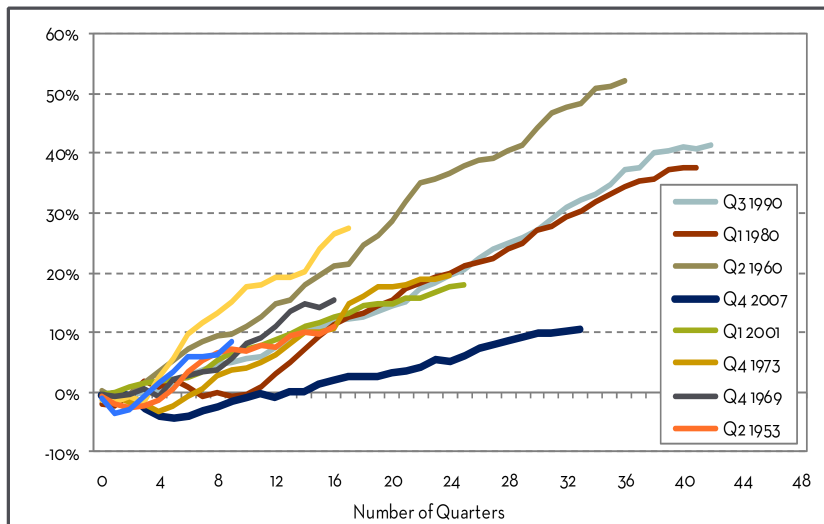
gradual rate increases

iii. China's transition towards an economy emphasizing services and innovation over manufacturing

iv. The backlash against globalization and political discontent arising from uneven economic recovery and wage gains

The pace of change in these themes—be it incremental shifts that compound over time or sudden bursts that upend capital markets—will likely influence the degree of uncertainty and volatility in the global economy. Should the path of change be a moderate one, as we anticipate, our outlook for risky assets is positive domestically and even brighter for international markets. However, we have a less optimistic outlook in the event of rapid and abrupt shifts that force markets to reprice with higher levels of volatility. Investors who are able to synthesize how these themes—discussed in greater detail below—impact their portfolio and prepare for change will be best positioned for success.

Exhibit 2: Cumulative Real GDP Growth Since Prior Expansion Peak



Source: Federal Reserve Bank of St. Louis

(i) Extended US Economic Cycle

The US economy is now in its ninth year of expansion following the financial crisis. But the recovery has fallen short of the growth seen in previous cycles (Exhibit 2). While the after-effects of deleveraging following the financial crisis in 2008 largely explain the subdued growth, we believe there is further room for economic expansion. The extended growth cycle may give pause to some but our concerns of a US recession are muted amid healthy consumer spending. The absence of an economic downturn reduces the potential for volatility in corporate revenue and credit defaults, bolstering equities and credit. Still, a more dramatic change could be in the offing, as the new administration's fiscal policy involving tax cuts and infrastructure spending—even though light on details—positions the economy for modestly higher growth and inflation. That said, we also must consider the possibility of more disruptive changes as a significant departure from current US trade and immigration policies can materially impact economic activity. Given the scant information on hand on domestic policies, investors must prepare for a wider range of outcomes for growth and inflation relative to prior years and accordingly adjust their portfolios.

(ii) Federal Reserve Gradualism

The Fed's anticipated pace of gradual interest-rate increases is very much intertwined with an extended US economic cycle. While headlines may focus on the timing of the next rate hike, the Fed's tempo of raising rates is more important. We believe the Fed will raise rates gradually and steadily over the coming years. A measured approach reinforces the potential for a prolonged economic expansion at home and bolsters sentiment abroad, specifically in emerging markets. From its public communications, it is clear the central bank understands its impact on global markets and is aware that a rapid pace of rate increases is likely to further strengthen the dollar and destabilize global economies with dollar-based debt. Furthermore, the Fed has signaled its willingness to allow expectations for US inflation to trend slightly above its 2% target. While economic cycles do not die of old age, they do suffer from unexpected changes in monetary policy. With this in mind, the transmission of much higher inflation due to potential increases in fiscal spending or import tariffs could significantly alter the Fed's desired course. In addition, uncertainty hovers around its leadership as chairperson Janet Yellen's four-year term ends in February 2018. It

remains to be seen whether President Trump will nominate Yellen for a second term, potentially disrupting nearly 40 years of stable leadership at the Fed (Exhibit 3).

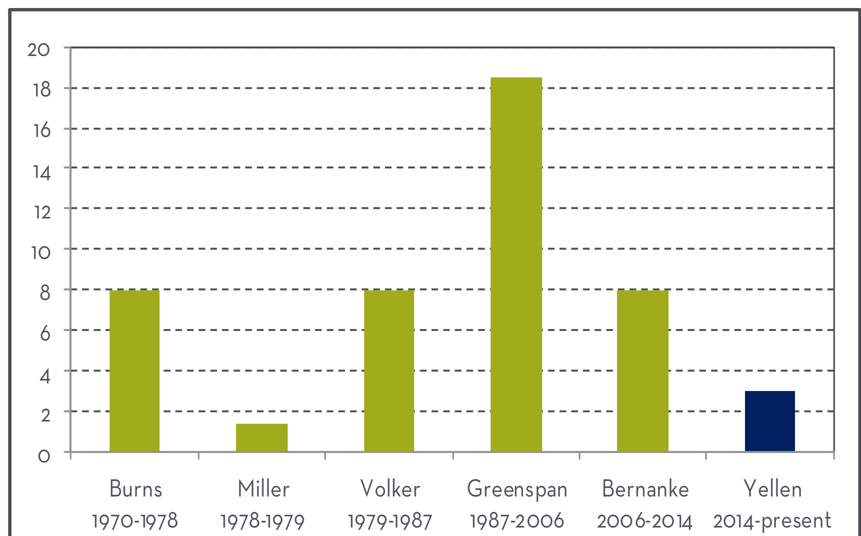
(iii) China's Transition

China's metamorphosis can be traced back to 2001, when it joined the World Trade Organization and began to take its place in the global economy. The Chinese government has exercised careful deliberation as the country shifts to a consumer-focused economy from a manufacturing export-based one in conjunction with opening up its capital markets. Still, this transformation can be unpredictable, potentially jeopardizing global markets, especially given China's heft in the world economic order. For instance, China is expected to account for over 40% of global GDP growth in 2016, according to the IMF — the equivalent of adding a Switzerland to the world economy every year. While China's government has prioritized a gradual approach to mitigate social instability, these transitions are not without volatility as sudden shifts in China's currency management in the recent past have fueled risk aversion and drawdowns in global markets. A disorderly change or decline in the Chinese economy because of its size would have an adverse impact, likely pushing the global economy into a recession.

(iv) Globalization Backlash

This last year will go down in the annals of history as the time when globalization fell out of favor. Starting with the Brexit vote in June and the US presidential elections in November, disaffected voters overlooked by economic progress and saddled with stagnant wage growth thronged the polls, unleashing a wave of populism and nationalism. We believe this theme is broader than a single populist or nationalist movement as decades of resentment related to globalization have festered in the developed world. What remains to be seen is the scope and scale of this change. Europe will take center stage this year with elections in the Netherlands, France, Germany, and, possibly, Italy, which could throw into doubt the fate of the euro and endanger the stability of the European Union. While it is entirely possible this doesn't come to pass, the potential for this type of disruption tempers our positive fundamental view of non-US developed equities. It also informs our thinking on portfolio construction and the strategic benefits of hedging foreign currency exposure in these markets as volatility is likely transmitted through foreign exchange markets.

Exhibit 3: Federal Reserve Chair Tenure (Years)



Source: Federal Reserve

Navigating Key Market Themes

While the key market themes form the foundation of our global outlook, our recommended investment opportunities are assessed on the merit of their fundamentals and reflect their risk-return potential. Our analyses show that allocations that historically provided superior returns in the past may fall short in the future due to expectations of subdued capital market returns. As a result, the asset allocation needed to achieve an expected return of 7.5% has changed over the last 15 years (Exhibit 1), requiring investors to take on more portfolio risk while increasing complexity with exposure to illiquid private market investments. We expand on this dynamic and provide a detailed review of our asset class assumptions in the upcoming paper, The Building Blocks of Asset Class Assumptions.

Broadly, we are cautiously positive about risk assets. In the US, a prolonged economic expansion can sustain a continued rally for domestic equities despite elevated valuations. However, stocks are pricing in strong earnings growth that may remain unrealized as a strong US dollar pressures corpo-

rate profit margins. As such, we suggest **trimming gains in US equities**. Meanwhile, in fixed income, economic dynamics suggest a more pro-inflationary tilt. While interest-rate markets have begun to price this in, we believe inflation may exceed those expectations. This suggests Treasury inflation-protected securities are more attractive than nominal bonds; we recommend investors **allocate to TIPS from core bonds**.

Conversely, investors have largely capitulated in non-US developed equity markets, expecting muted earnings growth in the future. Yet, we see tangible catalysts driving performance as macroeconomic improvements in Europe fuel a recovery in corporate earnings; in Japan, investors are benefitting from shareholder-friendly actions offering higher dividends and equity buy-backs. To this end, we encourage an **overweight in non-US developed market equities.** To counter the potential volatility in these regions, we suggest **hedging a portion of non-US developed currency exposure**.

We believe **emerging markets remain attractive.** While emerging market equities and local-currency debt may carry higher volatility, they offer attractive total-return opportunities to compensate investors for the incremental risk. We expect these strategic asset allocation commitments will be rewarded over time, but they could experience challenges if we see a greater level of disruption in our key market themes, specifically related to the transition underway in China and the backlash against globalization.

It is also vital to look for opportunities for diversification to help manage the range of outcomes that may play out as our key market themes evolve. To this end, we think investors can benefit by **adding global macro hedge fund strategies.**

Conclusion

With the heightened potential for change in 2017 and beyond, we remain vigilant, watching how our key market themes are playing out and evolving. While we see some opportunities today, we expect more meaningful ones to arise in the midst of a shifting investment landscape. We look forward to working with you on these and in helping you meet your long-term investment objectives.

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.

-Not all strategies discussed in this paper are suitable for all clients. Please contact your NEPC consultant for advice that is specific to your investment program. The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

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