FOURTH QUARTER MARKET THOUGHTS

RIGHT ROUND, RIGHT ROUND: A RECORD YEAR FOR US STOCKS

February 2018

Like a record spinning right round, the music played on for US equities in 2017. Hitting new highs, the S&P 500 Index spent its ninth straight year in the black. The flagship US index has posted 14 consecutive months of gains with only one of the last 20 quarters in the red.

While non-US stocks joined the chorus only in 2017, they caught on pretty quickly with developed market equities up 25% in 2017, according to the MSCI EAFE Index. That said, it was emerging market equities that really hit the highest notes last year, with returns of 38%. Not to be left out, high-yield debt and dollar-denominated emerging market bonds outperformed within credit.

It was a banner year for global equities amid optimism around US corporate tax cuts and the continued acceleration of economic growth the world over. However, we would like to hit pause for a moment to remind investors that, at some point, the music will stop. To this end, we advise caution and vigilance. We recommend investors dial up exposure to safe-haven fixed-income assets—core bonds, municipal debt and Treasury Inflation-Protected Securities—back to strategic asset-allocation targets. Furthermore, we suggest reducing assets that have outperformed expectations over a prolonged period, such as US stocks and high-yield bonds, in favor of international equities and TIPS.

WE BELIEVE NON-US EQUITIES OFFER CONTINUED GAINS FOR INVESTORS

We believe non-US equities offer continued gains for investors as they benefit from easy financial conditions, synchronized global growth and a robust outlook for corporate earnings. As such, we recommend investors maintain an overweight position on international equities relative to market-cap benchmark weights.

Within developed markets, we believe a multi-year earnings recovery offers the potential for an elevated return. Preferring non-US small-cap and global equity strategies for implementation, we favor approaches that can exploit improving economic conditions in Europe and the ongoing corporate governance reforms in Japan.

Meanwhile, emerging market equities, despite their strong showing in 2017, offer potentially high total returns for investors. We reinforce our overweight recommendation to this segment as valuations and fundamentals remain compelling. Furthermore, strategies that invest lower in the market-capitalization spectrum relative to a traditional index offer investors a more pure exposure to improving local growth rates.

Shifting to fixed income, we favor TIPS over core bonds. The market-implied pricing of inflationary expectations remains attractive for TIPS, which are likely to benefit relative to core bonds should we see an uptick in inflation. In addition, duration exposure is a core asset-allocation building block and TIPS represent a safe-haven exposure that bolsters a portfolio during periods of market stress.

Across most return-seeking credit sectors, we believe spreads have reached levels that do not adequately compensate investors for risk. This includes high-yield bonds, US bank loans, and dollar-based emerging market debt. We suggest investors reallocate gains from liquid credit markets to other areas of the portfolio, such as equity, private markets, or idiosyncratic credit opportunities paired with safe-haven fixed income. For more tactically-oriented investors, we advocate emerging market local debt, as above average index yields and attractive currency valuations make it an appealing total-return opportunity.

While we currently have a positive outlook on global equities, we encourage investors to look for opportunities to manage portfolio volatility should the music stop. To this end, exposures, such as systematic global macro or long volatility, offer low-to-negative correlations to equity markets and help to mitigate the left-tail of a portfolio return distribution.

GLOBAL EQUITIES

Global equities returned 5.7% in the fourth quarter and 24% for the year. Global stocks saw earnings per share rise nearly 19% in 2017, according to FactSet, the fastest growth since 2011.

The S&P 500 Index was up 6.6% in the fourth quarter, bolstered by the prospect of corporate tax cuts. Maintaining their lead, emerging market equities gained 7.4% in the fourth quarter and ended the year with returns of 37.3%. Healthcare and consumer discretionary dominated sector performance for the quarter, while utilities and telecommunication services lagged. Information technology led in 2017, largely driven by one stock, Chinese internet giant Tencent, which was up 114.3% for the year. Among countries, South Africa, Greece and India led performance, while Malta, Mexico and Pakistan were the stragglers.

Global Equity Market Returns as of 12/31/2017				
Global Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI ACWI	5.7%	24.0%	9.3%	10.8%
US Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
S&P 500	6.6%	21.8%	11.4%	15.8%
Russell 1000 Growth	7.9%	30.2%	13.8%	17.3%
Russell 1000 Value	5.3%	13.7%	8.7%	14.0%
Russell 2000	3.3%	14.6%	10.0%	14.1%
Russell 2000 Growth	4.6%	22.2%	10.3%	15.2%
Russell 2000 Value	2.0%	7.8%	9.5%	13.0%
International Equity	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
MSCI EAFE	4.2%	25.0%	7.8%	7.9%
MSCI EAFE Hedged USD	3.7%	15.2%	8.5%	11.4%
MSCI EAFE Small Cap	6.1%	33.0%	14.2%	12.9%
MSCI Europe	2.2%	25.5%	6.7%	7.4%
MSCI Japan	8.5%	24.0%	11.6%	11.2%
MSCI Emerging Markets	7.4%	37.3%	9.1%	4.3%
MSCI Emerging Markets Small Cap	9.2%	33.8%	8.4%	5.4%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Equity Hedge	3.2%	13.2%	5.7%	6.6%
HFRI Emerging Markets	4.5%	20.1%	7.5%	5.0%
HFRI ED: Activist	-1.9%	3.7%	5.0%	7.4%
HFRI ED: Merger Arbitrage	-0.2%	4.1%	3.7%	3.5%

Within private equity, buyout deal activity fell 2% in 2017, while the number of buyout exits dropped 11%. Fundraising totaled $180 billion last year, up 40% from 2016; mega buyout funds dominated with 11 funds larger than $5 billion accounting for over 60% of the capital raise.

Hedged equity strategies posted strong gains through the fourth quarter with the HFRI Equity Index up 3.2%. Quantitative strategies also drove returns, along with relative-value and other trading strategies, as a result of dispersion in isolated areas of the market. Mergers and acquisitions boosted hedged equity returns, particularly in the technology, healthcare, retail and manufacturing sectors.

GLOBAL FIXED INCOME

Global Fixed Income Market Returns as of 12/31/2017				
Global Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Global Aggregate	1.1%	7.4%	2.0%	0.8%
BC Global Aggregate (USD Hedged)	0.8%	3.0%	2.7%	3.1%
JPM EMBI Plus	-0.3%	8.3%	6.5%	3.3%
JPM GBI-EM Global Diversified	0.8%	15.2%	2.5%	-1.5%
Domestic Fixed Income	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
BC Aggregate Bond	0.4%	3.5%	2.2%	2.1%
BC Municipal Bond	0.7%	5.4%	3.0%	3.0%
BC TIPS	1.3%	3.0%	2.1%	0.1%
BC US Treasury	0.1%	2.3%	1.4%	1.3%
BC US Long Treasury	2.4%	8.5%	2.8%	3.5%
BC MBS	0.2%	2.5%	1.9%	2.0%
BC US Credit	1.0%	6.2%	3.6%	3.2%
BC US Long Credit	3.2%	12.2%	5.7%	5.1%
BC High Yield	0.5%	7.5%	6.4%	5.8%
BC Muni High Yield	1.8%	9.7%	4.8%	4.3%
S&P LSTA Lev. Loan	1.1%	4.1%	4.4%	4.0%
BC T-Bills	0.2%	0.8%	0.4%	0.3%
Alternative	**Quarter**	**1 Year**	**3 Yrs**	**5 Yrs**
HFRI Credit Index	1.5%	6.1%	4.5%	5.0%
HFRI ED: Credit Arbitrage	1.1%	6.5%	4.0%	4.9%
HFRI ED: Distressed/Restructuring	2.3%	7.0%	4.2%	5.0%
HFRI Relative Value	1.2%	5.3%	4.2%	4.7%

Credit also didn’t miss a beat in the fourth quarter. The US yield curve flattened as short rates rose but longer-dated bond yields declined. The Bloomberg Barclays US Aggregate gained 0.4% in the fourth quarter. Long Treasuries and long credit maintained their trajectory, returning 2.4% and 3.2%, respectively, in the quarter. US high yield gained 0.5%, while the S&P Leveraged Loans Index posted a 1.1% return.

Outside of the US, the rally continued within emerging markets. Emerging market currencies were the outperformer, up 2%. Local debt, largely helped by currencies, returned 80 basis points.

Within hedge funds, structured credit remained a strong contributor as collateralized loan obligations (CLOs) posted gains and maintained a healthy pace of issuance. The HFRI Credit Index posted returns of 1.5% in the fourth quarter and 6.1% for the year.

REAL ASSETS

Commodities gained of 4.7% in the fourth quarter to end 2017 in the black, their second straight year of gains, helped by continuing weakness in the US dollar. However, total returns still lagged the appreciation in spot prices due to contango—when the futures price of a commodity is above the expected future spot price—in the index, resulting in negative roll yield. We remain positive on natural resources equities and midstream energy equities (MLPs) with a neutral view on long-only commodities; we believe security selection is critical in this space.

In private real assets, we remain positive on energy-focused private equity and credit opportunities. The recent strength in the underlying commodities has helped buoy asset values, but opportunities remain amid challenges for management teams of publicly-traded companies working through a prolonged recovery. We are also constructive on the mining sector over the mid-to-longer-term.

Within real estate, US core property fundamentals remain healthy but returns will likely trend below historical average as appreciation declines. Rising interest rates will place upward pressure on cap rates, but as capital flows continue to chase yield in the US, we expect positive growth, albeit at lower

Real Asset Returns as of 12/31/2017				
	Quarter	1 Year	3 Yrs	5 Yrs
Bloomberg Commodity	4.7%	1.7%	-5.0%	-8.5%
GSCI Commodity	10.8%	11.1%	1.9%	-7.3%
Gold Spot	1.8%	13.1%	3.2%	-4.9%
WTI Crude Oil Spot	16.9%	12.5%	4.3%	-8.0%
BBG Commodity - Agriculture	-2.0%	-11.0%	-8.5%	-9.8%
BBG Commodity - Energy	8.9%	-4.3%	-12.1%	-15.4%
BBG Commodity - Industrial Metals	10.7%	29.4%	4.3%	-1.8%
BBG Commodity - Precious Metals	2.0%	10.9%	2.5%	-7.0%
S&P Global Natural Resource Equities	8.5%	22.0%	6.6%	1.9%
NAREIT Composite Index	2.3%	9.3%	6.9%	9.7%
NAREIT Global REIT Ex US	2.3%	3.5%	0.8%	-
Alerian MLP	-0.9%	-6.5%	-9.3%	-0.1%

levels. Relative-value opportunities remain within non-core US real estate. We favor demographically-driven property sectors and managers that are attentive to duration risk in the later innings of the expansion cycle.

Outside the US, there are capital market constraints and pockets of distress, for instance, non-performing loans, which are still attractive in Europe and select emerging markets. Subordinate debt opportunities may offer attractive risk-adjusted returns, while providing a hedge against declining property values.

CONCLUSION

As global equities show no signs of slowing down, investors must steer clear of complacency. At the cost of sounding like a broken record, we encourage investors to prepare for the inevitable market disruption by increasing exposure to strategies that help mitigate market drawdowns. While our investment outlook for 2018 is positive for risk assets as global economic growth improves, we believe caution is warranted. We explore these themes in greater detail and offer a broader perspective on our outlook in *Markets Take Flight: NEPC's 2018 Asset Allocation Letter.*

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