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Investment Strategy

Weekly Guidance From Our Investment Strategy Committee

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Markets at a Crossroads

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Key takeaways

» *We believe that capital markets are at an inflection point that could lead to a move in either direction.*

» *The recent strength in equities amid continued economic uncertainty may reflect some investor complacency. We recently lowered our guidance on select U.S. equity classes to capitalize upon recent equity strength while also aiming to reduce the overall portfolio risk profile.*

What it may mean for investors

» *Capital markets appear to be at a crossroads. We believe investors can position their portfolios to address economic uncertainty by increasing their allocations to Cash Alternatives in line with our tactical allocations, which are currently above our strategic allocations to this asset class.*

» *Investors also can consider aligning their equity exposure with our current tactical guidance on U.S. Large Cap and Mid Cap Equities (neutral or in line with strategic targets) and with our unfavorable guidance on U.S. Small Cap Equities (underweight versus the strategic target).*

We believe that capital markets may be at a crossroads, given the softness in recent economic data and the occurrence of market dislocations, such as when short-term fixed income yields suddenly become higher than longer-term yields (referred to as inversions in the yield curve). So far, the global equity rally has largely dismissed recession fears, but the economic and earnings fundamentals remain uncertain. Such is the nature of retracements after indiscriminate sell-offs like the one we saw late last year. Put another way, we see the global capital markets today at a potential inflection point—a level from which prices could pivot higher or lower. The pivot direction ultimately should depend upon how the economic uncertainties resolve in the coming weeks and months.

Markets at a Crossroads

To us, this disconnect between fundamentals and equity markets may represent some complacency, and we continue to make guidance changes to reflect this fact (as we also seek to capitalize upon the recent market rally). As a reminder, in January, we reduced our U.S. Small Cap Equities guidance and also reduced their allocations. More recently, with the U.S. equity market continuing to grind higher, we took the opportunity to reduce our guidance on U.S. Large Cap Equities and Mid Cap Equities. We also moved capital out of U.S. Large Cap Equities and into Cash Alternatives.

As in January, our focus remains cautious, but it does not imply a negative equity outlook. If the economic data continue to weaken, we may further (and selectively) reduce portfolio exposure to economic risk; alternatively, if the data strengthen, we could favor taking more risk in equities.

We reiterate a critical point that we touched on in the 2019 Outlook report's main theme, "the end of easy." The asset-price trends that advanced easily and without much interruption until 2018 were unusually long, but they may now be over. Looking ahead, we expect muted equity market gains, as political events, and the possibility of rising interest rates, and concerns about the aging economic expansion could disrupt sentiment periodically. Above all, risk and reward are now changing more quickly, and investors may need to adjust portfolio positioning more often.

Given the current level of uncertainty against the backdrop of high equity market valuations, we now view Cash Alternatives as an attractive asset class. We have upgraded Cash Alternatives from neutral to favorable. On a return basis, Cash Alternatives have usually provided a similar yield to U.S. Short Term Taxable Fixed Income (a most favorable asset class), and a yield that is above the comparable total return we foresee for U.S. Long Term Taxable Fixed Income.[1]

Above all, in an environment characterized by uncertainty, volatility, and higher valuations, the reallocation of funds from U.S. Large Cap Equities into Cash Alternatives (now favorably rated) gives us flexibility to potentially reallocate assets back into equity, fixed income, and real asset markets when opportunities arise.

[1] Cash alternatives can include money market funds, short-term CDs, short duration bonds; deposit accounts, Treasury bills; savings accounts. Please see the end of this report for important risk considerations associated with this asset class.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates.

Cash Alternatives: Each type of cash alternatives, such as bank certificates of deposits, Treasury bills, ultra-short bond mutual funds, variable rate demand notes and money market funds, has advantages and disadvantages. They typically offer lower rates of return than longer-term equity or fixed-income securities and may not keep pace with inflation over extended periods of time. While government savings bonds, U.S. Treasury bills, and other U.S. government securities are backed by the full faith and credit of the federal government if held to maturity, other cash alternatives carry higher default risk.

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