Great Expectations

Introduction

In last year's first-quarter 2016 Strategy Insights, *Year of the Monkey*, we asked whether 2016 could represent a paradigm shift in U.S. politics. Our answer was (and still is) a resounding yes.

Thus far the results of the 2016 election have unleashed widespread economic and financial market optimism as investors anticipate increasing political clarity on a number of fronts. The key, of course, will be the evolution from campaign rhetoric and posturing to detailed architecture, design, and policy implementation.

For now, the fundamental backdrop still poses some distinct challenges—valuations are elevated, significant credit expansion appears unlikely, global growth has yet to show signs of a meaningful acceleration, and productivity gains have been rather poor. That said, optimism can be a powerful force in the markets, and we believe positive "animal spirits" may be the biggest wildcard during first-half 2017, with investors digesting and interpreting policy changes and beginning to predict winners and losers.

Ultimately, we expect fiscal stimulus to take the reins from increasingly impotent monetary policy, creating an environment that is likely to prove more fundamentally supportive than what we have seen in recent years. But there is still a long list of worries.

The Economy

To summarize our view for the U.S. economy in 2017 relative to 2016—better, but current expectations are setting the bar high. PNC Economics forecasts GDP growth of 2.4% in 2017, with two additional interest rate hikes of 0.25% each. We also believe we will continue to see some upward pressure on inflation, and the dollar will likely stay strong as interest rate differentials expand between the United States and other large global economies. Oil prices are currently hovering around $50 per barrel (a 100% year-over-year price increase), and average hourly earnings continue to trend steadily higher. Both factors should support higher inflation in 2017. Deflationary pressures from abroad will slow the rate of inflation, however, so we are only expecting a moderate increase. China will likely continue to export deflation to the rest of the world because of the yuan's persistent depreciation, even with domestic inflation in China rising.8 To quote our 2016 outlook, "…another year of tepid global growth," but now with the hope of fiscal policy stimulus laying the groundwork for some fundamental improvement and growth re-acceleration.

Public Equities

Our outlook for domestic equities in 2017 is one of cautious optimism. We believe prices can still move higher even from their current rather lofty levels, but current upward momentum is mostly a function of the potential for an acceleration in growth on the heels of any policy changes the new administration might begin to implement next year. Higher asset prices are not likely to be a function of a significant improvement in underlying fundamentals. That said, the chance of recession still remains quite low in our view (our proprietary recession probability model does not forecast a recession in 2017), inflation is accelerating but at a manageable pace, and additional interest rate increases should still be rather methodical and data-dependent; therefore, we think equity risks are somewhat balanced between the upside and downside as we enter 2017. Recently, markets have shrugged off a number of potential stumbling blocks, choosing to focus instead on the positives and largely ignore the negatives. The question is, will that continue?

Investors should remain selective, focusing on themes that are likely to persist through 2017, such as domestic revenue/earnings exposure, the consumer, housing, financials, energy, and dividend growth stories, broadly speaking. Although we like the infrastructure theme on a very long-term basis, infrastructure stocks have already re-rated in anticipation of the potential near-term benefits from a new infrastructure spending package/bill. Our valuation work suggests large and mid-cap domestic equities are relatively more attractive than small caps, particularly following the massive moves small cap equities have experienced just since November 2016. That said, neither large nor mid-cap equities are outright “cheap” relative to history either, and small-cap companies may enjoy an outsized benefit from changes in tax policy and regulation while also being more insulated from risks associated with a stronger dollar.

Low-volatility shares that led the market in first-half 2016 (that is, Utilities, Telecommunication Services, REITs) have struggled more recently and may continue to do so if real yields continue to rise. As yield remains rather scarce in the current environment, dividend growth looks more attractive to us—companies with sustainable free cash flow generation and the ability to raise payouts over time without harming their balance sheets.

More Attractive:

- U.S. equities;
- Financials, Health Care, and Consumer Discretionary sectors;
- Value;
- Mid and large caps; and
- High domestic exposure, dividend growth, operating leverage, and tax cut beneficiaries.

Less Attractive:

- China and emerging markets;
- Consumer Staples, Telecommunication Services, and Materials sectors;
- Growth;
- Small caps; and
- Interest rate sensitive companies and/or those with large near-term debt maturities, and high emerging markets exposure.

Private Equity/Private Investments

Over the last 10 years, our capital market projections have largely been in a declining trend (that is, for both equities and fixed income), with much of this decline concentrated in the past five to six years. Indeed, our expected returns for equities and fixed income have fallen by approximately 150 basis points (bps) and 100 bps, respectively, over this period.

At a time when the expected returns on traditional (that is, publicly traded) asset classes are likely to be below historical norms, it has become increasingly important to consider the role of private equity in investment portfolios. When carefully selected, we believe private equity has the potential to add incremental return in an otherwise low-return environment, in addition to improving the overall risk profile of portfolios through the diversification benefits offered by certain strategies. For a more detailed review of private equity and other private investments, including definitions, illiquidity effects, mechanics, access, and so on, please see our *Primer/Reference Guide Going Private: A Guide to Private Investments*, published in December 2016.

Fixed Income

Yield Curve and Duration

After taking advantage of the postelection increase in yields to move from short to neutral duration in our strategic portfolios, we expect to maintain neutral duration positioning throughout 2017. Our view is that benchmark neutral duration in fixed income portfolios best balances our belief that although interest rates are likely to gradually move higher over time, the visibility for growth and inflation is even more unclear and may somewhat temper the rise in yields.

Central Banks

After the Federal Reserve’s (Fed’s) latest 25 bps increase in December, the market seems even more convinced of the continuation of a moderate tightening trajectory. We expect the European Central Bank and the Bank of Japan to remain firmly in easing mode throughout all of 2017, promoting a continuation of the spread divergence between interest rates in the United States and those regions (another potential headwind for longer-term U.S. rates). For example, the spread between the 10-year U.S. Treasury bond and the 10-year German bund has averaged about 150 bps over the past few years. Today, that spread has widened to about 230 bps, and we think this elevated spread differential is likely to persist.

We think the level and sustainability of the interest rate differentials between the United States and regions such as Europe and Japan are critical factors for the strength of the U.S. dollar. The wider the rate differential, the more upward momentum likely in the dollar. We identify a rising dollar as an important risk to the global economy since it helps serve to tighten overall global financial conditions. It also may be a governor on how fast the Fed is able to normalize monetary policy.

High Yield

Ultimately, we do not believe 2017 will mark the end of the business cycle, but growth is likely to remain somewhat sluggish, and credit fundamentals support our view that we are closer to the end of the credit cycle than the beginning. That said, given our expectations for a continuation of modest economic growth in 2017, we view the overall environment as generally supportive of high yield credit. Currently, we see a number of cross currents in the high yield marketplace.

- We expect the U.S. dollar to continue to strengthen throughout 2017, likely pressuring the economy and corporate earnings at some point during the year.
- Rising interest rates are an obvious headwind across all of fixed income, but one we view as a particular concern in certain areas of the high yield market.
- Headline default rates are likely to fall as energy-related high yield stabilizes. Our view is that investors are likely to see this relative improvement versus last year and become increasingly confident about the fundamentals of the asset class.
- High yield valuations are still a concern for us, with the market experiencing a great deal of spread tightening throughout 2016.
- Spreads are currently in the mid to high 400 bps range, below the historical average; however, spreads tend to bottom in the low 300 bps range, so further tightening from current levels is possible.

Our current conviction regarding high yield is not pound-the-table positive or negative. We are coming off an extremely good year for high yield, so we believe returns are likely to moderate some in 2017. That said, conditions are in place for the asset class to generate respectable returns. Often highly taxable investors are best served in the municipal universe, and we do not believe the current value in the high yield market makes a compelling case to the contrary.

Municipals

Looking to 2017, our view is that municipals are in a favorable position compared to other fixed income sectors, especially since current prices reflect many worst-case outcomes for the asset class. From a duration perspective, we believe that the intermediate part of the curve likely performs best. Our view on the municipal credit landscape remains constructive, consistent with our overall credit view. Corporate default rates have started to flatten in coordination with the stabilization in oil prices, and municipal credit spreads often lag spreads in the corporate market.

Energy

We believe energy headwinds will fade into the background in 2017 as prices begin to stabilize at higher levels. Even so, challenges will likely remain for companies whose revenues are tied directly to oil, with prices remaining quite low compared to the post-financial-crisis average, in our view.

Our base case for oil prices in 2017 is a further stabilization of prices in the $55–65 per barrel range. In November 2016, OPEC and other large non-OPEC oil producers, namely Russia, surprised the market by finally reaching a deal to cut production; the first such deal since 2008. We believe the execution of this agreement and the level of compliance with stated output reductions will be the primary drivers of oil price movements in first-half 2017.

Master Limited Partnerships

We believe that the potential for higher oil prices will be a positive for MLPs in 2017. Along with general asset class sentiment, a stability in energy prices helps relieve much of the concerns related to cash distributions, debt, and coverage ratios. In our view, cash distributions are critical, and the resumption of more widespread distribution growth would likely give a meaningful boost to the sector. Compared to other yield-oriented securities such as REITs, utilities, and corporate bonds, MLP valuations are not nearly as stretched. Specifically when compared to REITs and utilities, MLPs are less often thought of as traditional "bond proxies." For this reason, we think MLPs could outperform these asset classes in 2017.

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