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EXECUTIVE DIGEST

INVESTMENT STRATEGIES IN A POST-MONETARY WORLD ORDER

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In this article, we approach the monetary policy discussion from the angle of the Post-Monetarism theory — and present a more nuanced view of some inherent challenges in the current policy environment, including interaction between U.S. bank capital regulations and the Fed's current monetary policy stance.

Read the entire white paper

We remain in a difficult market to forecast, particularly regarding the complex interactions between what we see as the weak fundamental backdrop and how current monetary policy might affect the dollar, interest rates, and investor risk preferences.

Stocks and bonds are expensive relative to history, growth remains sluggish, and corporate earnings have been unable to gather sustainable momentum. Conversely, many investors are still being compelled into equities by the extreme monetary policy environment. These opposing dynamics make it difficult to be decidedly too bullish or too bearish over the shorter term, in our view.

From an investment perspective, growth across Europe is still slow but has remained largely in line with expectations to date.

Regarding equities, we continue to believe that average annual equity returns are likely to be well below what investors have come to expect as average. This view is purely valuation-based and therefore longer term.

Turning to fixed income, we continue to recommend below-benchmark duration positioning in fixed income portfolios. Yields and duration are inversely related, making bond prices more sensitive to moves in interest rates when interest rates are low.

We think this is an important concept to understand, since the price sensitivity in bond portfolios is certainly elevated with interest rates at such low levels; in our view, rates do not need to increase all that much to see a significant decline in prices.

High-yield bonds have had excellent performance so far in 2016 despite our cautious view toward the asset class. We believe performance has been mainly driven by a reach for yield amid speculation the Fed would continue to delay any additional interest rate increases. We think high-yield bonds are at risk of a swift reversal in capital flows if the probability of a Fed interest rate hike rises materially.

On the international front, the fallout from Brexit is starting to filter through some U.K. economic data. Thus far, however, the data are not quite as grim, nor the impact as pervasive, as many investors had feared, causing some to moderate their pessimistic growth forecasts. Still, our view is that England may undergo a significant slowdown, if not recession, and the extreme dip in PMI survey data in July is still a potential warning sign. For now, the Bank of England has aggressively stepped in to dull any Brexit-induced economic pain, and the rest of Europe appears largely insulated.

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