STRETCHING OUT THE CYCLE
Stretching Out The Cycle

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We expect the global economy and equity markets to stretch out what is already an extended cycle, while central banks continue to stretch out the path toward policy normalization.

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   Acceleration to Stability
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The global market has been rising since 2009, led by the US which is now in the midst of the third longest economic expansion and second longest bull market in history. Stock valuations are on the expensive side, but recession risks, which often coincide with bear markets, remain low, and profits should drive equities higher in 2018. The path forward, however, is likely to be bumpier. Within fixed income, we continue to step up our focus on high quality and expect a modest step up in rates.

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Stretching Out The Cycle

2018 Key Themes

Cruise Control
- The global economy is on cruise control, transitioning from acceleration to stability.
- In the US, fiscal stimulus should help lift growth near 3%, matching the fastest pace of this recovery.
- Geopolitical uncertainty is a key risk that could take the global economy off of cruise control; the political pendulum is swinging toward populism and nationalism across the world and important elections lay ahead.

Bullish but Bumpier
- Investors should continue to give the bull market the benefit of the doubt until the weight of the evidence shifts.
- Global equities are set to grind higher, supported by a stable global economy and solid profits.
- Although we anticipate additional gains, we also expect a bumpier path forward. Markets have gone a long time without a pullback, and a fair amount of good news is already priced into stocks.

Step Up
- We continue to step up our focus on high quality within fixed income.
- The 10-year US Treasury yield should see a modest step up in its range to 2.25% to 3.00%, with a bias towards the upside. We anticipate that the Fed will hike rates two or three times in 2018.
- Markets will be adjusting to a new Fed chairman and several new board members. This increases the possibility of an error at a time when the Fed is attempting to normalize policy.

2018 Positioning
- Favor equities relative to fixed income
- Keep a slight US equity bias—but less so than in past years
- Stay constructive on developed international markets, which are earlier in their expansion and are relatively cheap, though geopolitical risks remain prominent
- Stick with emerging markets, as the turn in the equity cycle appears fairly early
- Take advantage of relative opportunity in US mid caps
- Favor economically-sensitive sectors, such as financials and industrials
- Maintain bond allocations at the low end of policy ranges with slightly shorter duration
- Within fixed income, focus on high-quality bonds, given limited upside in credit and a bumpier path for equities
- Keep a modest position in floating-rate bonds as a partial hedge against higher rates
- Use non-traditional strategies to help balance equity risk and a challenging bond environment; these strategies should benefit from a less uniform market
Cruise Control

Over the next year, we expect the global economy to continue to stretch out the business cycle. Global economic growth is on cruise control, transitioning from acceleration to stability, but we are mindful of factors that might cause the economy to downshift.

Acceleration to Stability

The acceleration in global growth seen over the past year is now set to transition to stability. Structural constraints, such as debt and aging demographics, continue to undermine growth and inflation. However, supportive cyclical tailwinds coupled with broadly accommodative policy and limited global imbalances should allow the world economy to maintain cruising speed in 2018 (Figure 1).

Predominant among those cyclical tailwinds is a slower, yet more broadly distributed recovery; all 45 countries followed by the Organization for Economic Cooperation and Development (OECD) are on track to grow in 2017 and expectations for 2018 remain similar.

Developed Economies

Sticking with our cruising motif, the developed bloc economies—such as the US, Japan, and the Eurozone—have considerable economic momentum heading into the new year.

US Recovery Endures

Starting with the US, we expect the world’s largest economy to continue to stretch out the recovery, as the uptick in growth seen over recent quarters carries into 2018.

At almost nine years old, the US is in the midst of its third-longest expansion in history and well past the post-World War II average of roughly five years. Thus, what we are lacking in strength, we are gaining in length (Figure 2).

![Figure 1: Growth Transitioning From Acceleration to Stability](image1)

![Figure 2: Stretching Out the US Economic Cycle](image2)

Data Source: Bloomberg Consensus, SunTrust IAG; f = forecast

Data Source: Haver, SunTrust IAG

Past performance is not indicative of future results
Please see important disclosures for additional information
Importantly, we are not seeing the overheating and excesses that tend to precede recessions. Wage growth is at 2.4%, while it has exceeded 3.8% prior to each of the past seven recessions (Figure 3). Housing starts are headed toward 1.2 million units for 2017, still below the 60-year average of 1.4 million annually.

Fiscal stimulus and a pickup in capital investment as a result of tax reform should help lift US growth for 2018 closer to 3.0%, versus an estimate closer to 2.3% without it. This would match the fastest pace of this recovery (Figure 4).

**Developed International Growth to Remain Firm**

Japan and Europe are also ending 2017 with positive momentum. Europe is on pace for its strongest economic growth in a decade, supported by accommodative monetary policy, the lagged effects of a weak euro, and an uptick in global growth. Some of these tailwinds are set to ebb as we head into 2018, but the growth outlook remains solid. The region remains earlier in its economic cycle relative to the US, and should be aided by improving business confidence, stable credit growth and low interest rates. Manufacturing surveys are also at the highest levels since 2001, and forward indicators of growth are positive.

Similarly, Japan’s economy should push ahead buoyed by aggressive monetary policy and structural reforms. The improvement under Prime Minister Abe appears to be underappreciated. The Japanese economy has registered seven straight quarters of growth, the longest streak since 2001. Rising business confidence, strong profits, and a competitive currency coupled with a strengthening labor force should support the economy in the coming year.

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**Figure 3: Wage Pressures Remain Well Below the 3.8% Level That Preceded Prior Recessions**

<table>
<thead>
<tr>
<th>Year-Over-Year Growth of Average Hourly Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recession</td>
</tr>
<tr>
<td>1965</td>
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<tr>
<td>1971</td>
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<tr>
<td>1978</td>
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<td>1997</td>
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<tr>
<td>2004</td>
</tr>
<tr>
<td>2010</td>
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<tr>
<td>2017</td>
</tr>
</tbody>
</table>

Data Source: Bureau of Labor Statistics. Year-over-year change in average hourly earnings of private production and nonsupervisory employees, seasonally adjusted.

**Figure 4: Fiscal Stimulus Should Lift US Growth Toward 3% in 2018**

<table>
<thead>
<tr>
<th>US Gross Domestic Product &amp; Estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
</tr>
</tbody>
</table>

Data Source: Bureau of Economic Analysis, SunTrust IAG Forecast
Emerging Markets to Remain the Global Growth Engine

Emerging markets (EM) should continue to move at a more rapid pace relative to the developed economies as they reaffirm their position as the world’s principal growth engine. They remain in a better position than in past cycles since most are now more free-market oriented, less commodity-dependent, more consumer-centric, and carry less debt than developed countries.

In 2018, we expect China will continue to balance managing long-term growth with enacting structural reforms. Similarly, India is set to be the fastest growing large economy in the world while the government implements its reform agenda. Brazil should continue to grow, albeit gradually, while economic activity in Argentina, Indonesia, and Poland should help further highlight the improving growth momentum across EM.

Central Banks Still Supportive

Central banks are set to remain supportive of the global economy over the next year, even if policy will be a touch less accommodative than in recent years.

The Federal Reserve (Fed) is shrinking its balance sheet, the European Central Bank (ECB) is slowly pulling back on bond purchases and the Bank of Japan (BOJ) may slightly alter its yield targeting policy. Nonetheless, the current environment allows for a much more gradual path to normalizing global monetary policy.

Indeed, the inflation conundrum—whereby most of the world has struggled with very little price pressure in the decade following the Great Recession—remains, despite the economic recovery. Global nominal yields (10-year sovereign bonds) remain low: under 2.5% in the US, under 2.0% in the UK, under 1.0% in Germany and France, and near 0% in Japan.

Moreover, with the December hike, the Fed has raised rates just five times over the past two years for a combined total of 1.25%. This compares to 17 straight increases from 2004 to 2006 totaling 4.25% (Figure 5).

Importantly, the current federal funds rate is below inflation, which indicates monetary policy is still very loose. A similar backdrop is evident throughout Europe and Japan. Thus, it will be some time before central banks could be considered restrictive.

Figure 5: Federal Reserve Stretching Out the Path to Normalization

![Figure 5: Federal Reserve Stretching Out the Path to Normalization](image)

Data Source: Federal Reserve, SunTrust IAG. Upper bound shown after December 2008.
**Political Pendulum**

While our economic outlook is positive, there are several risks that could take the global economy off *cruise control*.

First, the overall backdrop is more policy-dependent than in previous cycles considering the unprecedented monetary accommodation. Therefore, a more rapid policy change than we currently anticipate would be disruptive.

Next, while geopolitical risks appear to have been overstated in 2017, they appear underrated heading into 2018. The political pendulum is swinging toward populism and nationalism across the globe. Attention will soon shift to the US mid-term elections as well as important elections in Europe (Italy) and Latin America (Mexico and Brazil). The Catalonia movement in Spain and the Brexit saga continue. Tensions abound, remaining elevated with North Korea and rising in the Middle East, while terrorism threats linger (Figure 6).

Lastly, trade protectionism remains a concern. Our base case is for the US to diplomatically maintain current relationships. Outside of specific negotiating tactics, this translates into updating rather than dismantling the North American Free Trade Agreement (NAFTA) with Canada and Mexico, not challenging China on its currency, and strengthening ties in the Pacific, especially with South Korea and Japan.

Although there are several risks to our outlook—as there are every year—the global economy heads into 2018 on a solid footing. This should result in a greater ability to absorb unexpected shocks.

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**Figure 6: Arguably Risks Were Overstated in 2017, but Now Appear Underrated Heading into 2018**

- **US Mid-Term Elections:** The November vote could test the Trump administration, while challenging the country’s policy direction
- **Brexit:** The saga continues with tough negotiations still ahead
- **Elections in Russia and Italy:** Putin to extend Russia’s geopolitical ambitions, while the vote in Italy will test a troubled domestic political landscape, and raise populist risks in the Eurozone
- **Elections in Latin America:** Populism risks are high ahead of presidential races in Mexico and Colombia, while the Brazilian election raises the specter of policy uncertainty, reform stagnation and an ideological political shift to the left
- **Central Bank Leadership Changes:** The Fed, the Bank of Japan, and the People’s Bank of China face potential changes in leadership and policy alterations
- **Geopolitical Pressures:** North Korea’s nuclear ambitions, Iran-Saudi Arabia tensions, and political instability in Turkey are key stress points in 2018
Bullish but Bumpier

In 2018, we expect global equities to grind higher, supported by a stable global economy and solid profit growth. At the same time, we anticipate a bumpier path forward as markets have gone a long time without a normal pullback, and a fair amount of good news is already priced into stocks.

Bullish...

Investors should continue to give the bull market the benefit of the doubt, all the while keeping an eye on signposts which could lead to its demise. A global economy on cruise control with low inflation and relatively accommodative policy should allow stocks to grind higher in 2018.

Over the past year, the most important story for global equities has been a powerful rebound in profits, aided by the broadest global economic recovery in a decade. As the acceleration phase of the economic recovery transitions to one of stability, earnings and stock returns should also moderate.

Global profits are expected to rise 8% to 10% in the coming year, and global equities have tracked earnings closely (Figure 7).

If we take into account this profit outlook but also a backdrop of slightly less global liquidity, a reasonable baseline return assumption is in the 6% to 8% range. That said, we place much greater emphasis on market direction and relative opportunities as opposed to a precise index price target.

Figure 7: Rising Profits Should Help Stocks Grind Higher

Data Source: FactSet, MSCI, SunTrust IAG
On the positive side, strong market years, such as 2017, are typically a healthy sign. Over roughly the past 30 years, there have been seven annual periods where global equity markets rose more than 20%; stocks climbed the following year every time, averaging a gain of about 13%. Although this is a relatively small sample, it reinforces our view that recent market highs are less concerning since these gains are supported by solid fundamentals.

Still, this market cycle is advanced, particularly in the US where valuations are high. The US bull market now ranks as the second-longest in history. With another up year in 2017, the S&P 500 will have increased for nine straight years on a total return basis, tying a record streak from the 1990s.

The good news is that this extended bull market is supported by the third-longest economic expansion. Near-term recession risks are low, which is central to our outlook given bear markets are often associated with economic downturns (Figure 8).

Notably, over the past 50 years, there has never been a US recession with profits up or when the real federal funds rate was negative (short-term rates below inflation), which is the case today.

Furthermore, while valuations suggest that long-term equity returns will be below the historical average, they tell us little about the market’s near-term direction. We are at the stage of the cycle where other factors, such as sentiment and momentum, tend to dominate. Even if we are in the late innings of this bull market, missing the final push could result in a significant lost opportunity. The average gain in the last year of a US bull market has been close to 20% and almost 40% over the final two years.

Figure 8: Bear Markets Often Occur Around Recessions

Data Source: FactSet, SunTrust IAG
...but Bumpier

Although we expect equities to add to gains, we also anticipate a bumpier path forward and more of a two-way market in 2018. A fair amount of good news is already priced into stocks, and there is less room for upside global economic surprises, which have been key drivers of equity gains over the past year.

History also suggests a high probability that markets will see at least one pullback next year, which is normal even during up years. The US market is currently in the midst of the third-longest period in history without as much as a 5% setback.

The deepest pullback so far in 2017 has been 2.8%; 1995 was the only period with a smaller intra-year setback.

Following the 10 calendar years with the shallowest pullbacks, stocks tended to rise the next year but were more volatile, with the S&P 500 averaging an intra-year pullback of 11% (Figure 9). Similarly, over roughly the past 50 years, the shallowest drawdown during mid-term election years was 7%.

Signposts

Despite a bumpier path, investors should stick with the positive trend until the weight of the evidence shifts. Important signposts that could lead us to shift our positioning include a darkening profit outlook, rising recession risks, an aggressive Fed, euphoric investor sentiment, deterioration in credit markets, and weakening market participation.

Positioning

We maintain a slight US bias—though less so than in past years. We see relative value in mid caps, and favor cyclicals, such as financials and industrials. We are constructive on developed international markets, where Japan remains in a sweet spot, and see more upside in EM, where the turn in the cycle appears to be relatively early.

Figure 9: S&P 500 Drawdowns and Returns in Years Following Small Pullbacks

<table>
<thead>
<tr>
<th>Year with Shallow Drawdown</th>
<th>Following Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>Largest Intra-Year Pullback</td>
</tr>
<tr>
<td>1995</td>
<td>-3%</td>
</tr>
<tr>
<td>1964</td>
<td>-4%</td>
</tr>
<tr>
<td>1958</td>
<td>-4%</td>
</tr>
<tr>
<td>1954</td>
<td>-4%</td>
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<td>-6%</td>
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<tr>
<td>1992</td>
<td>-6%</td>
</tr>
<tr>
<td>2017</td>
<td>-3%*</td>
</tr>
<tr>
<td>Average</td>
<td>-5%</td>
</tr>
</tbody>
</table>

*YTD through 12/13/2017
Data Source: FactSet, SunTrust IAG
US Remains Blue Chip Country

US stocks continue to trade at a premium to world markets, buttressed by the status as the world’s blue chip country and heavier growth sector weightings. In 2018, we anticipate the baton to pass from monetary policy to pro-growth fiscal policy, which has tended to be a positive environment for stocks (Figure 10).

Similarly, a solid economic environment with low inflation, consistent with our outlook, has tended to be equity friendly. This backdrop, coupled with an easing regulatory environment, a more competitive dollar and lower corporate tax rates should support corporate profits. Conversely, high investor expectations, a monetary policy error, or lack of traction on fiscal reform are among the greatest near-term risks.

US Mid Caps Attractive

Within the US, we see relative opportunity in mid caps, which are now trading near parity with large caps, down from a premium of over 30% in 2011. These companies should benefit more than large caps from lower taxes, mergers and acquisitions, and positive earnings momentum.

Sectors: Sticking with Cyclicals

Our two favorite sectors currently are industrials and financials. Financials remain attractively valued and should be aided by a step up in interest rates, lower tax rates, and an easing regulatory environment.

We expect industrials to be bolstered by a global economy on cruise control, a pickup in capital expenditures, the likelihood of full and immediate expensing of new equipment, and a more competitive US dollar.

Style Neutral: Warming Up to Value

Solid economic growth and higher interest rates should be supportive of value, which has cheaper valuations than growth. Before advising a value tilt, we would prefer to see an improvement in relative earnings trends, which are still declining, along with stabilization in relative price trends, which are near a cycle low.

Figure 10: Stocks Have Done Well In Periods of Loose Fiscal and Tighter Monetary Policy

S&P 500 Returns During Periods of Loose Fiscal and Tight Monetary Policy

Source: BCA; study defined as periods where the federal funds rate is rising at the same time the budget deficit as % of GDP is rising.
Developed International: Upside Remains

While the US is in its ninth year of recovery, developed international markets are earlier in their expansion, have easier monetary policy, and generally have more attractive valuations after trailing the US by more than 150% since the bull market began. These positives are tempered by geopolitical risks.

Japan in a Sweet Spot

We expect policy consistency in Japan given the recent snap elections that strengthened Prime Minister Abe’s parliamentary majority. The Bank of Japan may slightly alter its monetary policy but is committed to remaining very accommodative.

The stock market is also one of the cheapest among the developed countries. The earnings outlook is bright as corporate management teams are more focused on profitability and shareholder-friendly activities, such as dividends and share buybacks. The Japanese market and GDP have also broken out to the upside of a multi-decade range, a powerful development (Figure 11).

The main risks to our positive Japanese outlook are ongoing tensions with North Korea as well as a weaker-than-expected global economy.

Europe: Marching On Despite Political Theater

After significant underperformance, Europe’s market improved in 2017 on the back of positive economic momentum and double-digit earnings growth. Profits should again rise at a steady clip in the coming year, aided by low interest rates, a stable global economy, and exposure to faster growing emerging markets. Valuations also remain reasonable.

Political risks are likely to stay in the spotlight. Ultimately, a breakup of the European Union appears to be a low probability event as evidenced by the resolve witnessed through a myriad of crises over recent years. Investors should, however, expect to see periodic price spikes driven by political headlines, which would likely be a buying opportunity.

Figure 11: Japanese Market & GDP Breaking Out to the Upside of Multi-Decade Ranges
Emerging Markets: Still Early in the Cycle

Our work suggests an important turn in EM occurred in 2016, when economies and earnings troughed. This turn in EM appears relatively early, as the two prior outperformance cycles lasted seven and nine years, respectively (Figure 12).

Although EM has performed very well over the past year, gains have been driven in large part by earnings, which are up over 20%. Also, the trailing 10-year annualized return for EM is still depressed at less than 2%, which suggests upside remains.

There is also room for valuation expansion in EM, especially with its higher exposure to the technology sector, which is now a 28% index weighting. That is double its exposure from 10 years ago when energy and materials dominated. The stronger economic growth profile for EM is also an attractive characteristic in a lower growth world.

On the risk side, there are several key elections in 2018—most notably in Mexico and Brazil—that are likely to cause periodic bouts of market turbulence.

Furthermore, a more aggressive Fed, a stronger US dollar, or sharp market rotation out of the technology sector would be a headwind. Nevertheless, our overall EM outlook remains positive.

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Figure 12: EM Turn Appears Early

Emerging Markets Relative to Global Equity

![Chart showing EM outperformance]

Data Source: FactSet, MSCI, SunTrust IAG
Step Up

We continue to step up our focus on high quality within fixed income and expect a modest step up in interest rates in 2018. High-quality bonds should provide ballast for portfolios as we expect a bumpier ride in equities, and we see limited upside in credit.

Stepping Up

Rates have been somewhat range-bound over the past year, but have stayed well above the post-Brexit lows of 2016, a period which marked an important inflection point. Looking ahead, we anticipate that the Fed will hike rates two or three times in 2018. The amount of bonds rolling off its balance sheet will also ramp up. The 10-year US Treasury yield should see a modest step up. We expect rates to largely trade within the 2.25% to 3.00% range, with a bias toward the upside (Figure 13).

Supporting our interest rate forecast is a solid global economy, a low US unemployment rate, and less accommodation from the Fed. Oil prices are also well above the lows from last June and coupled with a weaker US dollar should support modestly higher inflation. Finally, there remains a fair degree of investor complacency on the potential for rates to move higher.

Given our rate outlook, we expect the yield curve to continue to flatten slightly but remain positive. Fears that the flattening yield curve foreshadows a recession appear overdone. The current spread between 10- and 2-year Treasuries remains well above zero.

Figure 13: We Expect Rates to Largely Trade in a Higher Range in 2018

![Graph showing 10-Year Treasury Yield: High/Low/Average by Year]
Importantly, following the last three yield curve inversions, it took an average of 15 months before the US tipped into recession (Figure 14). Also, it is not unusual for the curve to stay flat for an extended period of time. For example, the yield curve was nearly zero by the end of 1994, which was a period in which the Fed was raising rates. It stayed relatively flat for almost five years. It did not fall significantly into negative territory until 2000, which was well ahead of the next recession in 2001.

There are certainly risks, though. Markets will be adjusting to a new Fed chairman early in 2018, and there will be several new board members. This increases the possibility of an error at a time when the Fed is attempting to normalize policy. Also, if inflation stays below its target, the Fed risks further flattening of the curve; conversely, if inflation unexpectedly spikes given fiscal stimulus, a low unemployment rate, and higher oil prices, the Fed could need to raise rates more aggressively. Thus, the Fed finds itself in a delicate position.

**Positioning**

We recommend bond allocations remain at the lower end of policy ranges with a focus on high quality. A modest position in floating-rate bank loans still makes sense from a yield and diversification perspective. We retain a slightly short duration.

**Benign but Mature Credit Environment**

Valuations are fairly rich for many fixed income segments. The yield advantage of investment-grade corporate bonds to Treasury bonds is now at its lowest level since before the financial crisis. Spreads could remain in a lower range and even contract a bit—as was the case during the 2004-2006 cycle when the Fed raised rates with a solid economic backdrop. However, opportunities at current levels are limited. Credit spreads for the lowest investment-grade corporate bonds (Baa) have rallied sharply in comparison to bonds rated Aaa to A (Figure 15). Similarly, high yield corporate bonds have only been more expensive than they are today about 20% of the time over the past 20 years.

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**Figure 14: Yield Curve Tends to Invert Well Before Recessions**

Data Source: Haver, SunTrust IAG

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**Figure 15: Lower-Quality Corporate Bond Spreads Have Narrowed Significantly**

Data Source: FactSet; Aaa = Bloomberg Barclays US Corporate (Aaa) Bond Index; Aa = Bloomberg Barclays US Corporate (Aa) Bond Index; A = Bloomberg Barclays US Corporate (A) Bond Index; Baa = Bloomberg Barclays US Corporate (Baa) Bond Index.
While we are primarily focused on high-quality bonds, we still see value in holding a small position in floating-rate bank loans. These securities should provide a hedge against rates rising faster than expected and a source of yield. They are also higher in the capital structure relative to high yield bonds.

**International Bonds**

We are generally avoiding non-US developed market bonds given significantly lower yields in most countries, longer duration, and added currency risk.

Further, higher valuations paired with inherent political and currency risks keep us on the sidelines for EM bonds. Unlike EM equities, they have greater exposure to Latin America, where risk due to upcoming elections is heightened.

**Municipal Bond Opportunities**

We still see value in investment-grade municipal bonds for investors in high tax brackets.

As in the corporate space, we prefer higher-rated credits in municipals since we are later in the economic expansion. We advise an overweight to dedicated revenue streams such as hub airports, toll roads and water and sewer credits over local general obligation (GO) debt. State and local GO bonds will continue to face pressures as federal support is constrained and pension and employee benefit obligations continue to rise.

Uncertainty around the tax exemption for certain types of municipal bonds has weighed on the market over the past few months. Issuers have rushed to the marketplace before year end, and this extra supply, the most in over a decade, has resulted in increased price swings.

In terms of the tax reform bill, the impact on municipal bonds appears to be mixed. Importantly, all proposed bills preserve the tax-exempt status of existing municipal bonds. However, going forward, supply may be reduced as certain issuers could lose their tax exemption. On the other hand, a lower corporate tax rate could diminish demand for municipal bonds from banks and corporations given their lower tax brackets. Ultimately, as the market settles, a reduction in 2018 supply should help to support prices.
Given our outlook for a positive but bumpier path for stocks and headwinds for bonds, non-traditional strategies take on, arguably, heightened importance.

With the stock market and bond yields near record levels, we see value in having exposure to less-correlated assets (Figure 16). We favor an anchor in diversified strategies, which invest in opportunities across the hedge fund spectrum.

At a more granular level, hedged equity strategies should benefit from more of a two-way market in 2018. Although stocks, in aggregate, have had a strong advance over the past year, more than 20% of S&P 500 stocks are down in 2017; thus, the rally has not been uniform. Similarly, market correlations—the degree to which stocks move in the same direction—are at the lowest level since 2000 (Figure 17; next page). This provides a fertile environment for active managers.

Managed futures strategies have faced challenges given the lack of sustained trends in some markets, such as fixed income and energy. However, these strategies have the potential to generate returns in up or down markets, and are unique in that they tend to be less correlated with stocks, bonds, and other non-traditional strategies. Likewise, relative value strategies should be able to take advantage of greater differentiation within and across markets.

Figure 16: Stocks & Bond Yields Near Record Levels

Managed Futures and commodity investing involve a high degree of risk and are not suitable for all investors. Investors could lose a substantial amount of money in a very short period of time. The amount you may lose is potentially unlimited and can exceed the amount you originally deposit with your broker. This is because trading security futures is highly leveraged, with a relatively small amount of money controlling assets having a much greater value. Investors who are uncomfortable with this level of risk should not trade managed futures or commodities.
On the event-driven side, we remain constructive on merger arbitrage strategies as a reasonably consistent return source. A lighter regulatory touch from Washington should encourage deal activity as companies seek to obtain top-line growth with mergers and acquisitions, which would be further enhanced through corporate tax reform.

Consistent with our fixed income theme to step up quality, we are less constructive on credit strategies. Despite a favorable economic growth backdrop, which is generally good for credit, richer valuations and modest yields elevate the risk profile of these strategies. Additionally, the sustained period of low default rates has resulted in reduced opportunities for distressed credit managers.

Figure 17: Equity Correlations at Lowest Level Since 2000

Data Source: FactSet, SunTrust IAG; Chart represents three-month correlation of stocks within the S&P 500.

Hedge fund investing involves substantial risks and may not be suitable for all clients. Hedge funds are intended for sophisticated investors who can bear the economic risks involved. Hedge funds may engage in leveraging and speculative investment practices that may increase the risk of investment loss, can be illiquid, and are not required to provide periodic pricing or valuation information to investors. Hedge funds may involve complex tax structures, have delays in distributing tax information, are not subject to the same regulatory requirements as mutual funds and often charge higher fees.

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Publication Date
December 14, 2017
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Emerging Markets: Investing in the securities of such companies and countries involves certain considerations not usually associated with investing in more established companies.
with investing in developed countries, including unstable political and economic conditions, adverse geopolitical developments, price volatility, lack of liquidity, and fluctuations in currency exchange rates.

Asset classes are represented by the following indexes:

MSCI ACWI Index (Morgan Stanley Capital International All Country World) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices.

S&P 500 Index is comprised of 500 widely-held securities considered to be representative of the stock market in general.

The Nikkei is an abbreviation for Japan’s foremost, best known, and most respected stock index of Japanese companies. Its full name is Nikkei 225 Stock Average. This index is price weighted and made up of the top 225 industry leading companies which investors trade on the Tokyo Stock Exchange.

Investment grade corporate bonds are represented by the Blomberg Barclays US Corporate Investment Grade Bond Index which includes publicly-issued US corporate and specified foreign debentures and secured notes which have at least one year to maturity, have at least $250 million par amount outstanding, are fixed rate, and are rated investment grade.

Aaa Corporate Bonds are represented by the Bloomberg Barclays US Aaa Corporate Bond Index which is the Aaa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

Aa Corporate Bonds are represented by the Bloomberg Barclays US Aa Corporate Bond Index which is the Aa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

A Corporate Bonds are represented by the Bloomberg Barclays US A Corporate Bond Index which is the A component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

Baa Corporate Bonds are represented by the Bloomberg Barclays US Baa Corporate Bond Index which is the Baa component of the Bloomberg Barclays US Corporate Investment Grade Bond Index.

MSCI All-Country World ex-US Index: is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, ex-US equities.

It is not possible to invest directly in an index.

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CN2017-3488EXP12-2020