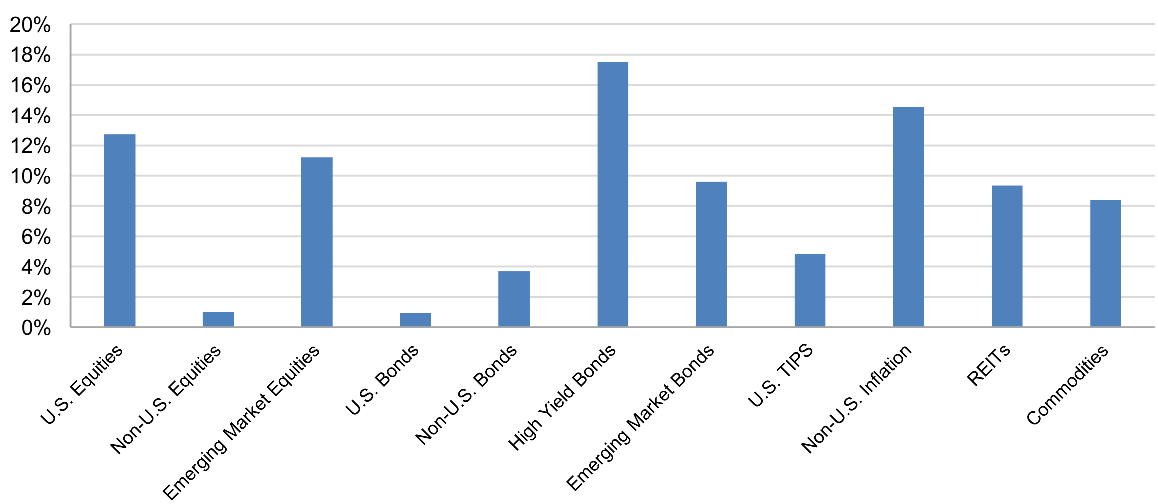
Today's Investment Environment

February 13, 2017

2016 was a year punctuated by outsized market reactions to pivotal political and other events—most notably the oil price shock, the Brexit vote, the U.S. election, and the Fed's decision to raise interest rates. The U.S. election surprised not only in terms of the result, but also in the way markets reacted in the days and weeks that followed. The eventful year included both unidirectional moves, including the 10%+ downdraft in many asset classes in the first six weeks of the year, and significant rotation within and across broad market categories, such as in the fourth quarter when U.S. equities and energy did well, while foreign equity markets, bond markets, REITs and currencies were all down.

The fourth quarter was dominated by the outcome of the U.S. election and the Fed's decision to raise interest rates. Although the rate hike was largely expected, the election results generated bullish economic sentiment which exacerbated the decline in bond prices. For this three-month period, U.S. equities were up 4.2% while Non-U.S. developed market equities were down 0.7% and emerging equities were down 4.2%. U.S. bonds were down 5.5% in the biggest quarterly correction since 1980, and yield sensitive assets such as REITs also reacted negatively, declining 3.0%. Broad asset class returns are show in **Exhibit 1**. G5 currencies declined 2.7% against the dollar and many EM currencies by more than that.

Exhibit 1: Broad Asset Class Returns in Q4 2016*



*Please see the last page for important disclosures regarding the information presented herein.

Today's market environment is best characterized by elevated uncertainty and the extreme divergences that have occurred, not only in 2016, but also over longer time periods. Among the noteworthy facts are:

- Over the nine years since the end of 2007, foreign equities, both developed and emerging markets, have cumulatively posted negative returns;
- The S&P 500 by contrast has returned 7.1% p.a. over this period and has outperformed non-U.S. developed and emerging markets by 7.5% p.a. and 8.8% p.a., respectively, and cumulatively by 89% and 99%, respectively.

As we wrote in our last commentary, while some of the U.S. versus foreign return differential is due to the relatively stronger fundamentals of U.S. firms in these years, much of the gains are also the result of multiple expansion in the pricing of U.S. equities, which today trade at or near record valuations on near peak margins.

Since the U.S. election, the U.S. versus foreign equity market return disparity has widened, and the sectors that have rallied the most are pricing in great optimism—some would say perfection—regarding the success of initiatives being weighed by President Trump and Congress. The banking sector, for example, is up almost 30% post election on the prospects of regulatory relief and higher interest rates. Investors have similarly been bullish about corporate tax reform, evidenced by the shares of companies that pay the most in taxes outperforming low tax rate firms since the election—although that effect has reversed somewhat in 2017. Some markets were particularly negatively impacted, including Mexico whose currency and equity market have fallen sharply. Mexico is but one manifestation of the potential for geopolitical dislocation and realignment.

The reality is that the unknowns today are many and the range of outcomes is especially wide. The upside will absolutely be greater if a new economic vigor can take hold, but the prospect of significant downside risk has also increased. Negative outcomes moreover need not follow from poor economic performance, just from multiple contraction in the face of higher interest rates and fundamentals that do not rise to the high bar that is already priced in.

In recent years, the easy thing in hindsight has been to invest solely within the U.S. and to index to equities and bonds. But it is vastly different today given low bond yields and high market valuations. Betting on smooth sailing in a single market is not what we would advise. Diversification, risk management, and careful manager and security selection make a lot more sense to us, especially when coupled with the patience to wait for and readiness to act in dislocated environments.

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Definitions for Exhibit 1 are as follows:

Asset Class	Index
U.S. Equities	Russell 3000 Index
Non-U.S. Equities	MSCI EAFE Index*
Emerging Market Equities	MSCI Emerging Markets Index*
U.S. Bonds	Merrill Lynch 7-10yr U.S. Treasury Index
Non-U.S. Bonds	JP Morgan Global Government Bond Ex-US Hedged USD Index
High-Yield Bonds	Merrill Lynch High Yield Bond Master II Index*
Emerging Market Bonds	JP Morgan EMBI+ Emerging Market Bond Index
U.S. TIPS	Barclays U.S. Inflation Protected Securities Index
Non-U.S. Inflation	Barclays World Govt. Ex US Inflation-Linked Bonds Hedged USD Index
REITs	NAREIT Real Estate Investment Trust Index
Commodities	S&P GSCI Reduced Energy Total Return Index