Summary

At its January 17, 2017 meeting, the Capital One Asset Management (“COAM” or “Firm”) Asset Allocation Committee made several changes to its tactical positioning. We are reducing our underweight to Equities, moving toward a neutral stance. In addition, we are reinstituting allocations to Emerging Market stocks on the Equity side and to Diversified Commodities within the Alternatives asset class. Within Fixed Income, we are eliminating our target exposure to U.S. High Yield.

Guidance

At the outset of a new power structure in both the Legislative and Executive branches of U.S. government, prospects for growth in the short- to intermediate-term appear to be improving. While the path that policies and legislation will take remains uncertain, and Trump’s reform agenda is ambitious, complex and crowded, several of the announced priorities (such as corporate tax reform and regulatory roll-backs) have the potential to accelerate U.S. economic growth this year. With this backdrop, we are reducing our underweight to Equities (despite valuation concerns) while maintaining our bias toward the U.S. Stronger growth may similarly drive demand for commodities, supporting both commodity prices and several emerging economies. We are therefore reinitiating positions in both Emerging Market Equities (though with a bias away from China) and Diversified Commodities.

In the Fixed Income space, credit risk premiums of High Yield bonds have declined to historically low levels and offer little protection against deterioration in credit covenants and underwriting standards. As such, we are eliminating our target allocation until conditions improve.

Discussion

The ascendant presidency of Donald J. Trump and the concurrent Republican majorities in Congress present a particularly challenging environment for investors. While policy objectives have been made clearer over the last several months by both the public pronouncements of elected officials and the selection of nominees for various executive posts, a large number of open questions remain. What will be the highest priorities of the new administration? Where may Congress provide unexpected pitfalls – or support?

As we noted in the December edition of this bulletin – and other past publications – several of the enunciated policies of the new administration could provide significant impetus for economic growth and improved business results especially in the United States. The potential for corporate tax reform, including the possibility of repatriating over $2 trillion in foreign earnings stranded offshore, could conceivably stimulate capital spending, spur a wave of stock buy-backs, while also bolstering the government’s near-term tax collections. The promise of lowered regulatory burdens could offer higher margins and broader opportunities to U.S. businesses. The possibility of improved trade deals could provide a more level playing field for U.S. interests, and the list of other potential sources of support for growth is a long one.
However, this brave new world is not without risks. Trump’s notable penchant for apparently off-the-cuff comments on Twitter introduces several levels of uncertainty. In the days following the election, pharmaceutical stocks pulled back sharply on the basis of aTrump tweet promising to control medical costs. Other tweets have roiled markets on the basis of perceived escalation of international tensions. Meanwhile, the president’s tendency to publicly single out companies for criticism creates heightened individual stock risk. Trump has also installed leading critics of Chinese practices in the trade arena, and concerns remain elevated about the possibility of a trade war. While the growth outlook has improved dramatically with Trump’s election, the risk of policy error has also risen sharply.

Against this backdrop, stocks appear somewhat richly valued compared to historic norms. However, a period of expanding growth could easily push those valuations higher. With the improved clarity of the last few weeks, we feel sufficiently confident that the balance of probabilities has shifted toward an acceleration of short-to intermediate-term growth. Consequently, we are eliminating our Equities underweight and drawing down our current overweight to Domestic Investment Grade Fixed Income. Committee guidance is for Equity allocations to move to neutral by the end of February, or sooner as market opportunities present. As the policy outlook becomes clearer we will continue to evaluate the merits of raising Equity allocations further.

We also continue to monitor our balance of domestic versus international holdings. The bulk of immediate benefits from Trump policies would appear to accrue to U.S. businesses, which should favor our current bias toward U.S. Equities. We have even contemplated increasing the U.S. bias but refrained on the basis of several considerations. The announcement of ongoing stimulus in Europe, for example, may be supportive of stock prices there for the next several months (though it is worth noting that European stocks failed to keep pace with U.S. markets even in the context of European QE last year). Meanwhile, Developed International stocks do look more favorably valued relative to the United States.

Moreover, with oil prices having stabilized and demand for industrial metals on the rise, several emerging market economies could be poised for growth – especially if Trump policies invigorate a period of infrastructure buildout and industrial development in the United States. In addition, several of the economies, such as India and Brazil look to be posed for a period of growth driven by domestic consumption. As such, rather than reduce our overall international exposure, we have elected to divert some of the current allocation away from Developed International Equities and into Emerging Markets Equities.

This move does not signal an end to our previously expressed concerns about the potential for a significant economic pullback in China. We remain concerned about government policies designed to control the over-heated Chinese property markets and deteriorating credit conditions in the country. However, we recognize the Chinese government has several levers with which to delay any eventual reckoning on these fronts with added incentives to continue to support near term growth as this fall the Communist Party of China will vote whether to retain its existing leadership or elevate new leaders. As such, we are re-initiating an Emerging Market Equity holding but remaining underweight the asset class. While not specifically referenced in our asset allocation frameworks, we recommend that Portfolio Managers seek to tilt Emerging Market exposure away from China in selecting investment vehicles for this portion of the portfolio.

As we noted above, we are funding our increased Equity allocations by reducing our overweight in Domestic Fixed Income. We continue to view investment grade bonds (government issues in particular) as important sources of stability in a potentially volatile environment. However, not only has the potential for further gain in the stock market strengthened, the outlook for bond portfolio returns has worsened somewhat given the negative influence stronger growth may have on interest rates. The U.S. Federal Reserve has indicated an intent to raise short-term interest rates more aggressively this year, primarily influencing yields on short/intermediate bonds, while rising inflationary
expectations associated with the stronger growth outlook have negatively impacted longer-dated bonds. As a counterbalance to this, current rates appear to have priced in a strong growth environment and anything short of perfect execution could well lead to some downward drift in longer yields, leading our internal intermediate bond strategies to maintain a neutral to modestly long exposure in recognition of this potential. They are also limiting exposure to investment grade corporate debt and tilting to high quality due to valuation concerns.

We have similar, though more pronounced, concerns about Domestic High Yield bonds. As we have discussed in previous issues of this Bulletin, the past few years have seen an erosion of the protections offered to owners of newly issued high yield bonds. Bond covenants and underwriting standards, which had been dramatically strengthened in the immediate aftermath of the Financial Crisis of 2008, have weakened as income-hungry investors have dominated the high yield space, driving demand and ceding bargaining leverage to issuers. As this trend has progressed, we have reduced our target high yield holdings in phases beginning in 2015 with the guidance for the remaining exposure directed to relatively high-quality, short-duration holdings. In the weeks since the election, the spread, i.e. yield advantage, of high yield bonds over U.S. Treasuries has narrowed below the historically significant 400 basis point level. With challenging valuations, diminished underwriting standards and the potential for unexpected default rates as government policies adjust, we are reducing our U.S. High Yield targets to zero. As with other asset classes we have exited in the past, we will look for an attractive re-entry point.

On that note, the outlook for Diversified Commodities has stabilized sufficiently to prompt us to re-enter the class. When we removed our allocation to Commodities in mid-2015, crude oil was in a price plunge that would see the benchmark West Texas Intermediate benchmark fall below $30 per barrel while concerns about Chinese manufacturing cast a pall over the prospects for industrial metals. In the past few weeks, however, an OPEC-led consortium has reached a broad agreement to cut production. Meanwhile, Chinese industrial metal consumption has ramped up and talks of broad global infrastructure spending are driving prices and apparent future demand. In view of these positive trends and the diversification benefits offered by the class, we are reinstating our Diversified Commodities allocation at 20% of the broader Alternatives category. This allocation will be taken from Diversified Alternatives. However, due to the diversification benefits of Diversified Alternatives, we encourage Portfolio Managers use this as an opportunity to bolster overall Alternatives exposure in cases where particular portfolios may be below our tactical targets for the category.
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Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

This is only an opinion and not a prediction or promise of events to come.

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