Summary

At its July 27, 2017 meeting, the Capital One Wealth & Asset Management (“Firm”) Asset Allocation Committee increased tactical targets for both International Developed Equities and Emerging Market Equities, bringing them to Neutral Weight, drawing from the allocations to U.S. Mid- and Small-Cap Equities, bringing them Underweight. In addition, the Committee re-introduced Emerging Markets Fixed Income into portfolios as a tactical Underweight, drawing from U.S. Investment Grade Fixed Income which was Overweight.

Guidance

We remain Neutral Weight Equities overall, but eliminate our tilt toward domestic equities relative to strategic targets with a preference in the emerging markets space for vehicles that tilt away from China exposure. To accomplish this, we are drawing from U.S. Mid- and Small-Cap equities proportionally to their allocations, leaving our Overweight to U.S. Large Caps intact. We leave unchanged our Underweight to Fixed Income overall and are lowering our exposure to U.S. Investment Grade Fixed Income by diverting sufficient funds to bring Emerging Market Fixed Income back into portfolios at 50% of the strategic target within overall Fixed Income.

Discussion

Global investment valuations reflect a general level of investor complacency. Despite multiple sources of risks – including the daunting task facing central banks considering a return to more “normal” policies, uncertainty around the course of policy in the U.S. executive and legislative branches, and worrying levels of debt in China – market participants have generally enjoyed positive returns so far this year as major stock markets have posted sizeable gains and credit spreads have contracted, helping support corporate bond prices.

There are, of course, good reasons for a measure of complacency or even confidence in the global economy. In the U.S., with about 1/3 of S&P 500 companies having reported second quarter earnings, it appears that we are on track for a fourth consecutive quarter of earnings growth with over 80% of companies that reported having beaten consensus earnings estimates. Forward-looking earnings estimates have also been trending upward with consensus for 2017 S&P earnings forecasting nearly 10% growth for the year and consensus for 2018 well above 11% growth.

This occurs against a backdrop of promising economic data. Headline unemployment is hovering around 4%, an historically low rate and workforce participation appears to have broken a slide that began during the financial crisis of 2008 and has been trending slightly upward since bottoming out in late 2015. Improving labor demand has also inspired acceleration in hourly wages growth, a key measure of worker income, over that period, though it is still well-short of the level of wage inflation we might normally expect in such a robust employment market.

Promising labor data is coupled with positive economic readings. The Institute of Supply Management’s surveys of Manufacturing and Non-Manufacturing activity both show expansion in their respective economic sectors. Significantly, the Manufacturing New Orders sub-index, an important indicator of future activity, recently hit a 3-year high. Meanwhile, capital expenditures are beginning to show signs of life, though still below what we might expect at this later stage in an expansion.

The situation abroad looks even more promising. The IHS Markit PMI™ (a parallel to the ISM surveys in the U.S.) also shows Eurozone Manufacturing and Non-Manufacturing sectors in expansion. Meanwhile, consensus estimates for MSCI EAFE corporate earnings growth are north of 14% and for MSCI EM earnings top the 20% mark (the latter driven partially by recovery in the oil markets).
At the same time, currency trends appear to favor international assets. While the U.S. Federal Reserve has clearly signaled its intentions to continue tightening monetary conditions, the U.S. dollar has shown weakness against a broad basket of international currencies, particularly the Euro. In part, this is attributable to market expectations that the European Central Bank may take a more hawkish stance sooner than previously believed (though Mario Draghi, President of the European Central Bank was quick to remind market participants during a recent speech given in Sinitra, Portugal of the Bank’s willingness to support economic growth following a quick rise in sovereign bond yields and the Euro). In part, too, it is attributable to improving economic conditions in emerging markets economies which are buoyed by much stronger governmental fiscal policies than historically expected. Further weakening of the dollar versus other currencies is possible as the dollar continues to look overvalued compared to historical norms in this backdrop and provides an additional tailwind for U.S. investors in foreign assets.

While the U.S appears to be further along in its economic cycle than much of the rest of the world and economic conditions appear to be strengthening in Europe and the emerging markets, U.S. valuations remain among the richest in the world. As such, we prefer to increase our exposure to international assets, maintaining an exposure to U.S. Large Cap stocks which we believe to be best positioned to benefit from both international economic growth and changes in governmental policy in the U.S., particularly if policy change in the U.S. is slow to materialize.

In the world of bonds, yields remain at low levels around the world. In the U.S., the Fed has enunciated a plan to return to normalcy by both raising its target on the Fed Funds rate and lightening the level of bonds it is holding on its balance sheet. Both these policies forebode headwinds for the domestic bond markets. With corporate earnings health improving, credit spreads have narrowed, leaving little room for further increases in corporate bond pricing. Overall with flattening of the yield curve as a result of both increases in short-term rates and drops in longer-term rates, the market appears pricing in very low inflation for the intermediate- to long-term and some exposure to inflation protected securities like TIPS may be prudent.

In much of the developed world, meanwhile, yields are even lower than the U.S. with nearly half of Developed Market International bonds offering negative yields. In the emerging markets, on the other hand, yields are robust despite overall fiscal health in EM governments, with key indices yielding north of 6%. Even adjusted for more vigorous inflation in EM economies, this provides a compelling case which is strengthened by the likelihood of further dollar deterioration versus EM currencies.

Commodities have suffered so far this year but have two sources of potential strength going forward. First, while the agreement among OPEC and other oil producing nations appears to be suffering from deteriorating compliance (the International Energy Agency estimated only 78% compliance in June), an announcement by Saudi Arabia that it plans to cut exports should be generally supportive. The Kingdom has a strong incentive to support oil prices due to a planned public offering of stock in its public oil company, Saudi Aramco in 2018. Second, Chinese consumption of commodities appears to be stronger than expected, providing particular support to industrial metals.

With traditional asset classes robustly valued and opportunities increasing in commodities, we maintain our overweight to Alternative Assets, though we retain our bias toward Diversified Alternatives.

Overall, our position remains cautiously optimistic. Risk assets like stocks and commodities appear to have room to appreciate from here, while remaining reasonably valued compared to more risk averse assets like U.S. Treasuries. Please reach out to your Capital One Investment Officer if you would like to discuss the impact of these views on your investment portfolio further.
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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.

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