Global Solutions

Heading into an uncertain 2019, diversification must be top-of-mind

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Key takeaways

- The road ahead is expected to be challenging due to a variety of factors: rising global interest rates; increased volatility; diverging global monetary policies; and heightened geopolitical tensions around trade and tariffs.
- Our forecasts for returns are tepid across the major asset classes.
- There remain pockets of opportunities within asset classes.

Heading into 2019, the market's resiliency is likely to be tested by evolving geopolitical tensions and questions regarding the ability of a late stage economy's ability to grow. Volatility is expected to remain elevated as the markets seek additional support for increasing asset prices beyond continued earnings growth and the perceived positive impact of tax cuts.. However, the road ahead will likely be more challenging to navigate. While the economy, as measured by Gross Domestic Product, continues to expand, and US equities are experiencing their second largest expansion in recent history, there are numerous challenges for investors to navigate going forward, including:

- Rising global interest rates
- Increased volatility
- Higher correlations among traditional asset classes
- Diverging global monetary policies
- Heightened geopolitical tensions around trade and tariffs

In short, the landscape for investors is increasingly complex, and our estimates for returns across asset classes remain tepid. In our 2018 Outlook last year, we talked about blind spots, particularly with respect to the benefits of diversification across and within asset classes. This year, we are focusing on how to avoid those blind spots in the uncharted markets ahead. Fortunately, the investment tool kit available to investors has expanded over recent years, particularly for those seeking diversification; ongoing areas of development in the financial marketplace include factor-based strategies, private market investments and multi-asset outcome-oriented solutions.

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Asset Class Forecasts

Our capital market assumptions which reflect ten-year and five-year forecasts for the behavior of asset classes, suggest that return estimates across asset classes remain low. Differences in growth and inflation estimates for major economies are now driving diverging expectations of performance among asset classes globally:

- **Equities**
  Elevated valuations continue to factor into lower long-term return estimates. Reflecting the late-stage business cycle, estimates over nearer-term are even less bullish, with lower US equities return estimates relative to international developed markets. Our near-term view slightly favors emerging market equity, given recent underperformance, although emerging market equities tend to face headwinds in many of the above-mentioned market challenges. Within US equities, CMAs reflect a better outlook for the small- and mid-cap equities, given recent underperformance.

- **Fixed Income**
  With higher expected inflation, rising short-term interest rates and narrowing credit spreads, a diversified bond exposure appears more attractive relative to pure credit exposure or long duration. Our outlook for credit is cautious given the historically narrow credit spreads and vulnerabilities of lower-rated credit in late-stages of the business cycle. Our outlook also favors investment grade over high-yield and floating rate bonds.

- **Commodities**
  Our view is for higher returns from commodities buoyed by higher cash rates and rising inflation expectations.

In summary, we see attractive relative value opportunities in emerging markets vs. developed, Europe vs the US, shorter duration investment grade versus longer duration government, and investment grade vs. high-yield.

The Key: Stay Focused on Diversification
In an environment where returns are compressed, volatility is expected to be higher and correlations across asset classes are higher. It is very important to be well-diversified.

We also remain optimistic that innovation within alternatives may enhance the potential for diversification beyond increasingly-correlated traditional assets. Particularly with considerable macroeconomic and geopolitical headwinds poised to challenge the market's resilience and increase its overall volatility, we believe investors should consider turning to alternative investments to seek enhanced risk-adjusted returns and diversification benefits.

- **Non-directional diversifying alternatives** struggled early in the fourth quarter due to leverage, momentum factors and interest rate exposure. While recent performance has disappointed investors, our view remains that the potential diversification benefits and downside mitigation provided by non-directional alternatives during a volatile prolonged downturn secure their place in a diversified portfolio.

- **Multi-factor alternative strategies** are an increasingly mainstream tool for portfolio diversification, as different factors are expected to outperform or underperform in different market environments. In highly volatile markets where risky assets are underperforming, for example, we would expect low volatility and quality to outperform and momentum to underperform. When equities rise rapidly, we might instead expect value and momentum to outperform and low volatility to underperform. We view systematic harvesting of risk premiums from long/short factor investments as an effective potential diversification approach that may also capture consistent risk premiums across market cycles.

- **Private market investments** are attractive on an uncorrelated, risk-adjusted return basis, in our view; while investors should be mindful of their corresponding potential complexities, risks, and liquidity considerations, we expect that private market investments will play an important role in incrementally capturing growth and income while providing diversification beyond traditional asset classes.

The good news is that while we are cautious of the market environment heading into 2019, we are also confident that these challenges will continue to drive new areas of innovation and opportunity that have the potential to help investors meet their financial goals.

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