January 2018

Voya Multi-Asset Perspectives

Seasonality Wins the Day

The U.S. equity market proved to be quite resilient throughout 2017 and December did not prove the exception. U.S. equities, which had been lagging behind their internationally developed market peers, worked to close the gap in 4Q. December helped with a gain of 2%, modestly outperforming the rest of the world. Positive seasonal effects, passage of the U.S. tax legislation and strong economic data propelled equities. Interestingly, U.S. equities posted a perfect pitch year with not one single month of negative returns. It's quite a feat and we would have to go all the way back to 1995 to find another instance of such a persistently strong year.

Bond yields, which had been locked in a range since early October, made a move higher in December. The move was not driven by rising inflation but by the increasing likelihood, with each passing day, of tax reform becoming law. The prospects of bigger budget deficits seem to have been the culprit pushing bond yields closer to 2.5%. High yield and corporate bond indexes were able to shrug off the Treasury market weakness with tighter spreads (Figure 1).

The broad, trade-weighted U.S. dollar looked to be able to break its losing streak in a modest counter-trend rally that faded at the end of December (Figure 2). The positive developments on tax reform gave the currency the lift. Longer term, we are in the U.S. dollar depreciation camp, as the currency has been through a seven-year bull market and bigger budget deficits are a headwind.

We equate the upcoming tax plan to giving a healthy person a shot of adrenalin, and the bond market seems to think so too. Ten-year yields jumped 15 basis points over the course of a week with the passage of the bill. Ten-year U.S. Treasurys ended just about where they started the year, but with a lot of ups and downs touching the bottom of the trading range close to 2.0% and the top 2.6% (Figure 3). With some modicum of near-term faster growth, we expect bond yields to stay near the top end of that range.

Tactical Indicators

Economic Growth (Good):
Global growth is solid among countries and regions

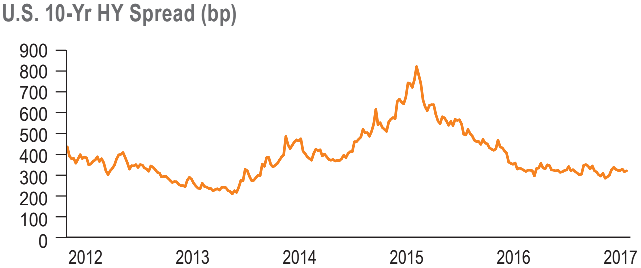
Fundamentals (Good):
December ISM manufacturing and auto sales ahead of expectations

Valuations (Stable):
Equities have become more expensive at 19x forward earnings

Sentiment (Good):
Consensus for upside in stocks based on global growth, strong earnings and U.S. tax cuts

Figure 1. High Yield Bond Spreads Have Tightened Despite Treasury Market Weakness

U.S. 10-Yr HY Spread (bp)



Source: Bloomberg, data as of 12/21/17.

Figure 2. The Trade-Weighted U.S. Dollar Did Not Break Its Losing Streak

Source: Bloomberg, data as of 12/15/17.

Figure 3. The 10-Year U.S. Treasury Yield was Volatile without Much YoY Change

Source: Bloomberg, data as of 12/22/17.

INVESTMENT MANAGEMENT

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Portfolio Positioning

Equities	
U.S. Large Cap	Stronger 2H17 growth and better corporate profits are positive
U.S. Mid Cap	Valuations look somewhat expensive, but should benefit from strong earnings prospects
U.S. Small Cap	Benefit from the decline in corporate tax rates
International Equities	Rising global activity, lower political risks and attractive valuations make us positive, especially in Japan
Emerging Market Equities	Easy financial conditions, solid global growth and attractive valuations are supportive
REITS	Relatively good yields, but full valuations and mature real estate cycle have us neutral
Commodities	Crude oil making a sustained rise over $50/barrel looks durable
Fixed Income	
U.S. Core Fixed Income	U.S. Treasury yields at top end of its trading range, looks to be sustainable with faster growth and larger budget deficits
Non-Investment Grade	High yield spreads near cycle tights, offer less value in the face of rising rates. Income potential and floating rate coupon still make loans attractive
International Fixed Income	Low yields lead us to favor U.S. bonds

Underweight Neutral Overweight

Investment Outlook

A lot of chatter in the markets is focusing on the low levels of volatility that prevailed in 2017 and whether 2018 will be the year that it returns. As usual there are any number of geopolitical or other risks that could cause a temporary sell-off, but we are heartened by the reality of macro fundamentals, which include strong and synchronous global growth. This would put a cap on any weakness in risk assets or rises in volatility.

Equities had a strong run in 2017, driven equally by multiple expansion and earnings growth. They will likely find that earnings will have to do most of the heavy lifting in 2018, however, as equities have become more expensive at 19x forward earnings. It's not a bad thing to have an earnings-driven year for equities; on our models the S&P 500 index should be able to deliver 10% earnings growth. While tax cuts can add more fuel to the earnings fire, they are largely incorporated into equity prices already.

We favored equities all 2017 and continue to do so into 2018. The emerging markets were the darlings of last year, gaining over 30%. Even with a modest setback, lagging behind the U.S. in 4Q17, they are the ultimate beneficiaries of stronger than expected global growth, and at good valuations. Japan has been among our strongest views in the latter part of the year. The continued support from Abenomics and the central bank anchoring bond yields has produced solid growth and even modest inflation.

In the United States, tax reform legislation has cleared the legislative hurdles to become law. We estimate the new policy will boost U.S. GDP growth by 0.3% in 2018 and 2019. The financial markets will have to digest some short- and longer-term consequences. Federal spending will grow more quickly in 2018 than it has for the last three years. With more fiscal stimulus comes larger deficits. Consensus expectations are for the U.S. budget deficit to reach 3.7% in 2018 and 5.0% in 2019. We also expect the Federal Reserve to respond to faster growth to maintain its mandate for a stable labor market. Therefore, we think the Fed will have to raise interests four times in 2018. Raising short-term interest rates will continue to flatten the yield curve (the difference between the yields on two-year and ten-year Treasurys) but the flattening is unlikely to match the speed that it had in 2017. The back end of the curve is unlikely to be as firmly anchored as it was in 2017 as one-off effects of softer inflation and an increase in the global supply of bonds impact the market.

Our portfolio remains positioned for a positive global growth outlook. Our long held constructive view on the emerging markets remains, even in light of some temporary relative weakness. We think economic data are still a positive and not too much of a good thing. While mindful that the cycle may be late in calendar years, we see our economic activity models and earnings projections telling us equities can stay well supported.

Past performance does not guarantee future results.

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