December 2018

Voya Multi-Asset Perspectives

Holiday Cheer Wrapped with Trade War Fear

Recent economic and geopolitical developments have given investors reasons to be cautious as we head towards year-end. Plenty of concerns remain and markets will be collecting, weighing and balancing the data, as they always do.

After delivering what investors perceived as hawkish comments in October, Federal Reserve Chairman Jerome Powell and other Fed officials walked backed the notion that interest rate hikes are on autopilot. Speeches by Fed representatives noted the Federal funds rate might be near its neutral level and that the committee will be especially data dependent. While Fed fund futures are still pricing a high probability of a December hike, they have scaled back the likely number of hikes in 2019 to two. Despite October's 3.2% YoY wage growth, the strongest since 2009, core PCE fell to 1.8% from 2.0%.

News flow immediately following the G20 summit insinuated the United States and China were on the cusp of a trade deal. As more details came out, however, it became clear that they had merely agreed to a "truce," a temporary pause in additional tariffs. The reprieve should have provided some semblance of calm, but the false advertising seems to have had the opposite effect, clouding an already highly uncertain market outlook. This does not mean the trade squabble will not be settled eventually; it is in both countries' interest to avoid a full-blown trade war. Given the increasingly misleading statements out of the White House, however, market participants will be sure to discount talk heavily until verifiable progress has been made.

Until then, China's economy will likely continue to suffer the brunt of the pain. Efforts to stimulate the economy conflict with China's currency objectives. Defending the yuan will help stem capital outflows but also limits the capacity for additional monetary easing. Further constraining the ability to add liquidity to the system is the already concerning expansion of credit. China's nonfinancial corporate debt, aka the shadow banking system, has grown to over 164% of GDP,[1] almost twice the value of household and public debt combined.

[1] Source: Bank for International Settlements, as of 9/30/18

Tactical Indicators

Economic Growth (neutral): U.S. and global growth are slowing, but should remain above trend (Figure 1)

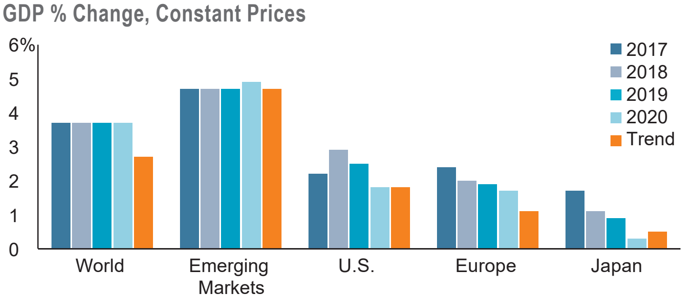
Fundamentals (positive): YoY S&P 500 earnings grew by nearly 30% in 3Q18, but future growth is unlikely to be as strong (Figure 2)

Valuations (positive): Global stock valuations stand near 25-year averages, with the U.S. slightly above and other developed markets and emerging markets slightly below. Japan is the outlier, trading at a forward P/E just above half its long-term average

Sentiment (neutral): Caution seems to be overhanging the market — sentiment indicators have bounced between panic and neutral over the last few months

Figure 1. Global Growth Remains above Trend

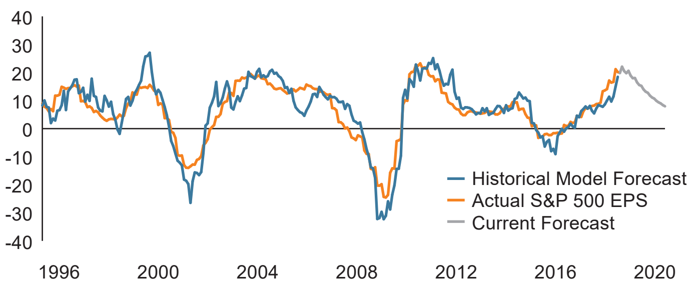
GDP % Change, Constant Prices



Source: International Monetary Fund, JPMorgan, Macroeconomic Advisors and Voya Investment Management, as of 11/30/18

Figure 2. Future Earnings Growth is Likely to Slow

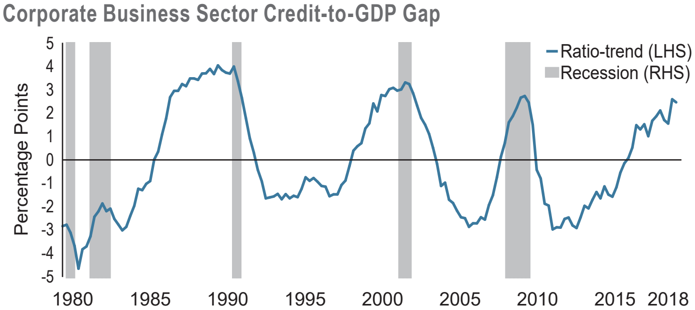
S&P 500 EPS Forecasts



Source: Bloomberg, Voya Investment Management, as of 10/31/18

Figure 3. Corporate Credit Has Accumulated as the Credit Cycle Matures

Corporate Business Sector Credit-to-GDP Gap



Source: Goldman Sachs, Federal Reserve Board staff calculations based on Bureau of Economic Analysis, national income and product accounts and Federal Reserve Board, Statistical Release Z. 1, "Financial Accounts of the United States," as of 11/28/18. **Note:** Calculated using a Hodrick-Prescott filter with lambda = 400,000. Shaded bars represent periods of recession as defined by the National Bureau of Economic Research.

Portfolio Positioning

Equities	●	
U.S. Large Cap	○-○-●	Recent contraction in multiples and robust earnings create relative attractiveness versus fixed income
U.S. Mid Cap	○-●-○	Tax reform is fully incorporated into prices from an after-tax profit standpoint
U.S. Small Cap	●-○-○	Small caps continue to lag as impact from fiscal stimulus fades
International Equities	○-●-○	We expect a stable dollar, continued weak activity in the Eurozone and accommodative monetary policy both there and in Japan
Emerging Market Equities	○-○-●	With less EM currency volatility and more policy support, we expect the growth outlook to brighten and equity performance to begin converging to DM
REITS	●-○-○	Rising interest rates, full valuations and mature real estate cycle have us underweight
Commodities	○-●-○	Positive global growth, still accommodative global monetary policy and increases in inflation should support commodity prices over the medium term
Fixed Income	●	
U.S. Core Fixed Income	○-●-○	Tighter Fed policy and stronger economic growth will push yields higher
Non-Investment Grade	●-○-○	Tight spreads offer little value in the face of rising rates. Income potential and floating rate coupon still make senior loans attractive
International Fixed Income	●-○-○	Low absolute and relative yields lead us to favor U.S. bonds

Underweight ● Neutral ● Overweight ●

Investment Outlook

As year-end approaches and we move into 2019, we expect economic and earnings growth to slow but not stall. By most measures, the economy looks quite strong. Inflation is at the Fed's target, the unemployment rate stands at multi-decade lows, manufacturing activity is robust and consumer spending has been resilient. With this backdrop, a December rate hike is highly probable. This would be the eighth quarter-point increase over the last two years, and would bring the target rate to 2.25–2.50%. With nominal GDP growth running at 5.4% and more hikes projected next year, we think it will be difficult for the economy to find the fuel needed to power higher levels of output.

Similarly, earnings growth are unlikely to increase much, if at all. Third-quarter 2018 earnings for the S&P 500 grew by 28.3%, the third straight quarter of earnings growth in excess of 20%. Margins are razor thin after years of diligent corporate cost cutting. Therefore, incremental gains from here will need to come from the top line, which will be difficult to generate given the limited domestic economic potential. In our opinion, there is more hope that growth abroad can surprise to the upside.

The Eurozone and Japan both disappointed in 2018, but we see signs that activity should remain above trend next year. We expect the European Central Bank to keep monetary conditions very accommodative for at least the first half of 2019, which should help tighten labor markets, allow higher real wages and improve consumer and business confidence. We think Italy will stay with the euro; fallout from Brexit, if it does occur, will be largely contained to the U.K. Japan may have a tougher road ahead after Prime Minister Abe confirmed plans to raise the value added tax (VAT) from 8% to 10% in October. On the other hand, Bank of Japan Governor Kuroda recently stated they are too far from their inflation target to consider raising rates, which should cushion some of the fiscal shock. Should a bull case play out, U.S. multinational corporations could benefit from their overseas sales. If the status quo continues, U.S. multinationals should be more insulated than international equities. As a result, we maintain an overweight to U.S. large cap stocks.

U.S.–Sino trade frictions have severely hindered emerging market activity. With no clear sign that the two countries will resolve their differences anytime soon, EM hopes rest on China's ability to stimulate its economy and on U.S. dollar stability. Any pause in Fed rate hike projections would provide a much-needed lift to local currencies. The International Monetary Fund forecasts EM to move higher by 2020. Because we believe the odds for a flat to weak dollar are better than even and valuations are relatively attractive, our portfolios continue to hold an overweight to the EM equity asset class.

Recently, when the 10-year U.S. Treasury yield was well above 3%, we added back some duration into our fixed income portfolios, to bring our underweight close to neutral. This tactical position contributed to performance during the most recent bout of volatility as long rates declined. On the credit side, we prefer quality given the very narrow spreads currently offered, the build-up in corporate credit (Figure 3) and the mature stage of the credit cycle.

Past performance does not guarantee future results.

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