AGENDA SUPPLEMENT (1)

Meeting:	**Investment Sub-Committee**
Place:	**The Lacock Room - County Hall, Trowbridge BA14 8JN**
Date:	**Wednesday 1 March 2017**
Time:	**10.30 am**

The Agenda for the above meeting was published on 21 February 2017. Additional documents are now available and are attached to this Agenda Supplement.

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9 **Investment Themes and Opportunities 2017** *(Pages 3 - 30)*

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HEALTH WEALTH CAREER

ECONOMIC AND MARKET OUTLOOK 2017 AND BEYOND

DECEMBER 2016

MAKE TOMORROW, TODAY

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The global economy is starting to reflate while monetary policy will likely become less supportive for economic activities and financial markets. The changing political landscape adds a new layer of uncertainty

SUMMARY

As we end 2016, there are at last some signs that the global economy is starting to reflate, with slightly stronger growth and higher inflation expected in 2017. Globally, fiscal policy has started to turn more stimulative, while a recovery in emerging economies seems to be taking hold after several years of very weak growth. These reflationary signs, while welcome, will raise monetary policy challenges, with policy becoming less supportive for economic activity and financial markets. The impact of the new administration in Washington DC adds a new layer of uncertainty, with markets focusing on the degree of fiscal stimulus and whether trade restrictions are imposed.

After three years of relatively stable equity markets, 2017 offers the prospect of more material moves in both directions. In US dollar terms, global equity returns have been a little lower than our long-term assumptions over the past three years. In 2017, better real and especially nominal economic growth should at last lead to a recovery in corporate profits. Improved profits and reduced deflationary fears should support equities, although less accommodating monetary policies and any moves by the US to restrict trade with Mexico or China would undermine them. On balance, we see equities generating modest positive returns, although material moves in either direction cannot be ruled out.

While equities have been relatively stable over the past few years, the same cannot be said of bonds. Government bond yields in all developed markets reduced sharply, reaching their lowest yields of all time in mid-2016. Since then we have seen a sharp sell-off, although yields still remain very low. We expect government bond markets to remain weak in 2017, with yields rising further. It remains to be seen whether the signs of reflation emerging will be sustained into 2018 and beyond. Any large sell-off could provide a buying opportunity.

We are becoming more optimistic on emerging market (EM) equities. If their economies continue to recover, then profits could rise for the first time in many years, supporting equities at a time when they are cheap on most measures. The key risk comes from the new US administration, which on the campaign trail promised to impose tariffs on Mexico and China. Such measures would be hugely damaging to the global economy as a whole and to emerging economies such as Mexico in particular.

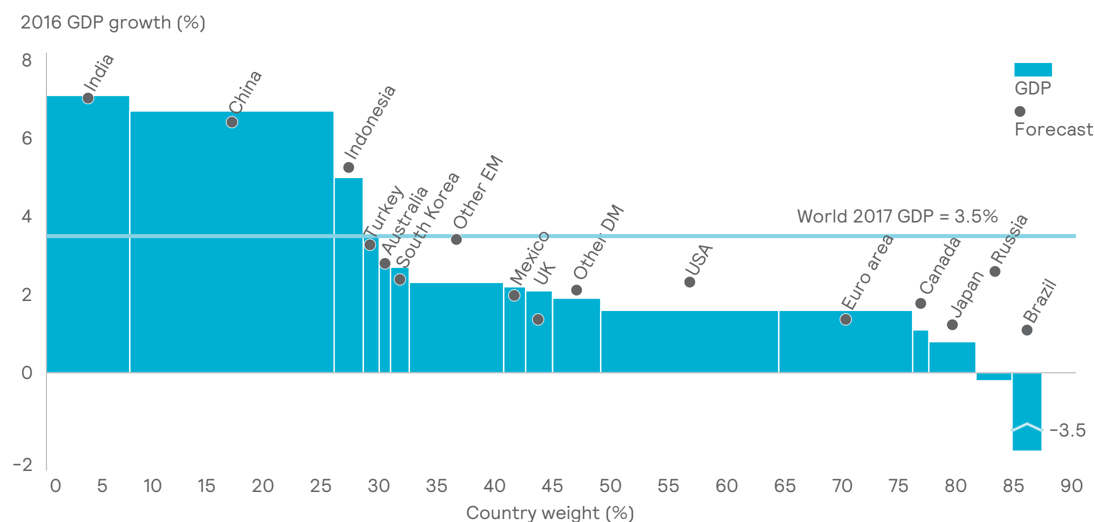
In summary, we think that global growth will pick up modestly in 2017, led by the emerging markets. However, economic growth is unlikely to be strong, with productivity growth remaining soft by historical standards. Higher inflation, on the back of a recovery in commodity prices and stronger labor markets, should support moves by the Federal Reserve (Fed) to raise interest rates at least twice in 2017, while the European Central Bank may start to consider reducing the degree of their accommodation as the year develops.

We expect both bond yields and equity prices to rise in 2017, although any signs that the Fed is behind the curve could undermine both materially. The fundamentals for emerging market equities are positive, although the risk of trade tension with the US is a real, if unquantifiable, risk. The prospect of a material fiscal stimulus plan that would support US growth from 2018 onward should support the US dollar, although in contrast to past governments the new Trump administration is likely to resist significant appreciation. The key risks to this outlook are discussed in depth at the end of the note, but they include more aggressive monetary tightening by the Fed and the increased risk of severe trade tensions.

GLOBAL ECONOMIC OUTLOOK

2016 was another disappointing year for global growth, with a satisfactory performance in the developed world offset by very weak growth in some emerging economies, like Brazil. We expect to see stronger growth in 2017, with EMs stronger (although not strong) and a slightly firmer tone to the developed world, with the notable exception of the UK. This improved performance in the emerging world should push global growth to moderately above the now lower trend, having been a bit below trend for several years. Figure 1 shows the Goldman Sachs economic growth forecast for 2017 relative to 2016, with the size of the blocks being the size of the economy. You can see the EM economies are forecast to be the same or slightly stronger, while the US is a bit better and the UK a bit weaker. We believe these forecasts are reasonable.

FIGURE 1: GLOBAL GROWTH STRENGTHENING A LITTLE IN 2017, LED BY EM



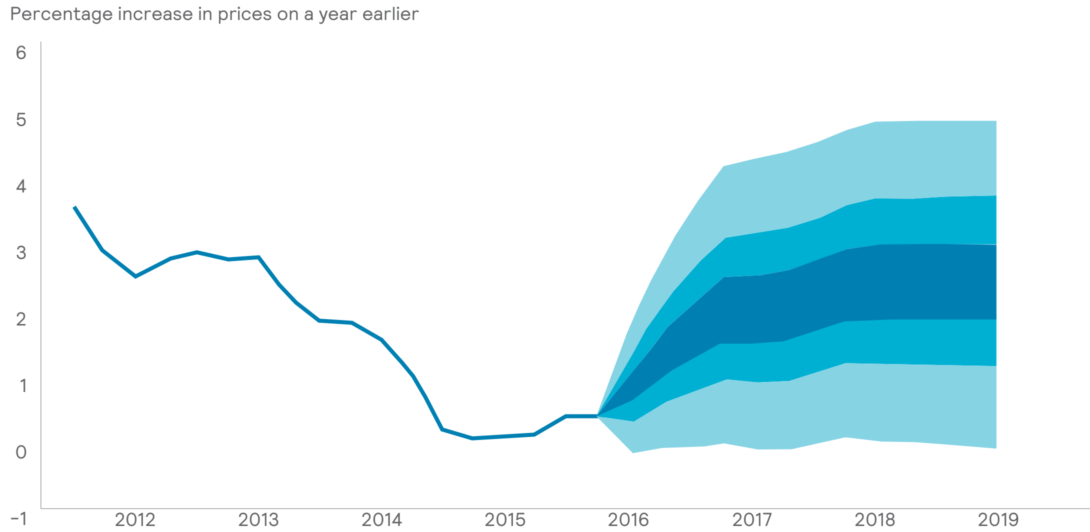
Source: Goldman Sachs

In the US, we expect the economy to grow at or a bit better than the 2% seen in recent years. Possible tax cuts and infrastructure spending by the new Trump administration create some upside risk, although if enacted, these changes are more likely to boost growth in 2018 than 2017. The proposed corporate tax reform, which includes cutting headline corporation tax rates and encouraging companies to bring home funds locked overseas, could lead companies to increase capital expenditure and thereby improve productivity growth. The recent strength in the US dollar, if sustained, will dampen economic activity, while any material escalation in trade tensions (discussed later) would also hurt US growth and raise US inflation.

In the UK, the government's Brexit plans will remain central to the economic outlook, with Article 50 set to be triggered by the end of March 2017. Thus far, Prime Minister May has said that she wants to maintain the closest possible trade relationship while having greater control on immigration. In practice, that rules very little out and very little in. The UK has three primary options: a hard Brexit with the UK trading only using the World Trade Organization (WTO) framework; a comprehensive free trade agreement (FTA); and joining the European Economic Area (EEA), with the EEA either being the final resting point or being used as a stepping stone while a more complete disengagement is negotiated over the subsequent few years. A transitional deal that extends the two-year time frame is also possible for any of the three options. Ultimately, we think the UK will avoid a hard Brexit.

While UK economic growth has held up in 2016, we think it will weaken noticeably in 2017, on the back of weak investment related to Brexit uncertainty, and a sterling related sharp rise in inflation that will hold back household real income. Figure 2 shows the Bank of England expects inflation to rise above 2% and stay there for a few years. Signs that the UK is heading toward a transitional Brexit deal could limit the UK's downturn, while any path that risks a hard Brexit would cause more significant weakness.

FIGURE 2: UK INFLATION LIKELY TO RISE ABOVE TARGET

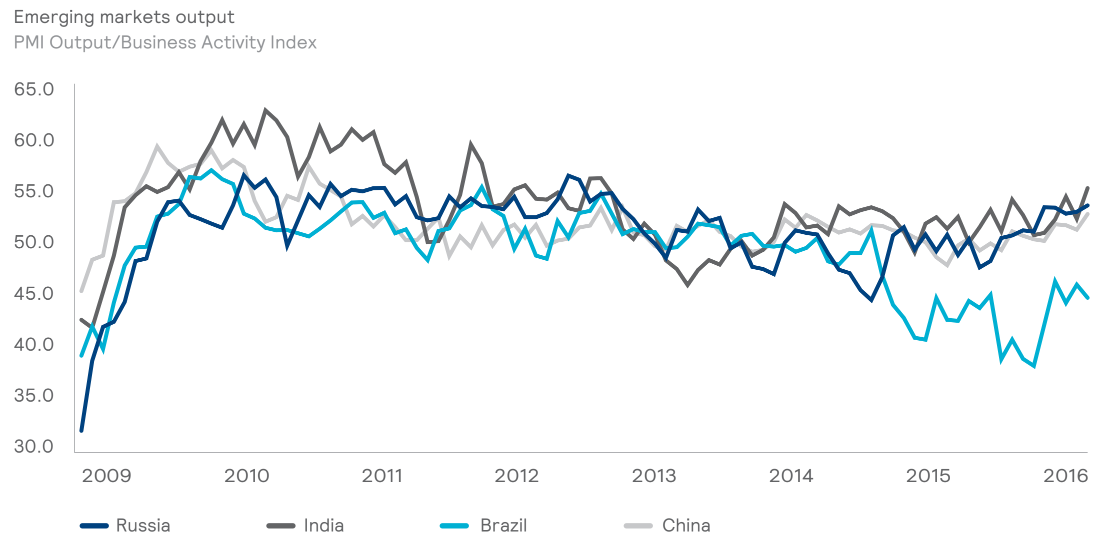


Source: Bank of England

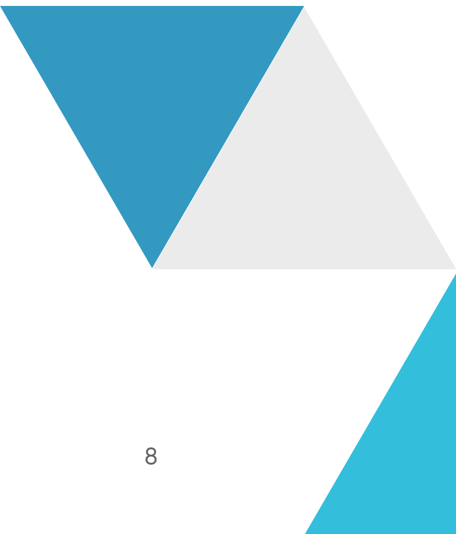
The Eurozone appears to have strengthened in the second half of 2016, supported by stronger consumption and export growth. The ongoing decline in unemployment, the weakness in the euro and the recovery in the global economy should continue to support consumption and investment. The main risks to the Eurozone economy in 2017 are political rather than economic. The fallout from the recent Italian referendum and upcoming elections in Holland, Germany and especially France could undermine confidence in the EU and euro as a whole, triggering a new bout of political uncertainty.

Many emerging economies appear to have stabilized, with most economies strengthening. For some, such as Brazil, that means moving from depression-like conditions to modest growth, while for others it implies stronger growth. Following currency weakness over the past few years, emerging economies are competitive with the developed world, while the recent uptick in commodity prices should support those economies that are big commodity exporters. Figure 3 shows that business confidence, which often closely tracks GDP, has strengthened in recent months in the key EM economies.

FIGURE 3: KEY EM ECONOMIES LOOKING STRONGER

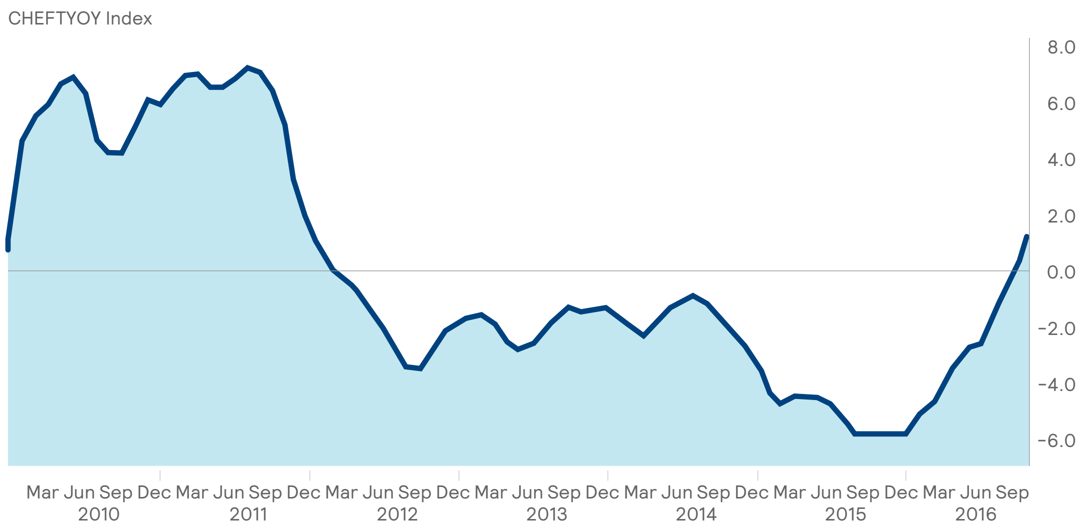


Sources: IHS Markit, Nikkei, Caixin



After weakening at the start of 2016, the Chinese economy strengthened mid-year on the back of increased government spending. On a multiyear view, the Chinese economy is likely to slow further as it moves away from exports and investment and toward consumption. Ahead of key political events in late 2017, we expect fiscal support will remain sufficient to underpin growth of just over 6%. Thereafter, however, if activity were to slow abruptly, the Chinese government would increase its support again. While this fiscal support may be ultimately unsustainable, the Chinese authority's fiscal strength is unlikely to be tested in the near term. In China, while consumer price inflation has been largely stable over recent quarters, producer price inflation (PPI) — figure 4 — has stopped declining after a long period of deflation. This means that China is exporting less or no deflation to the rest of the world.

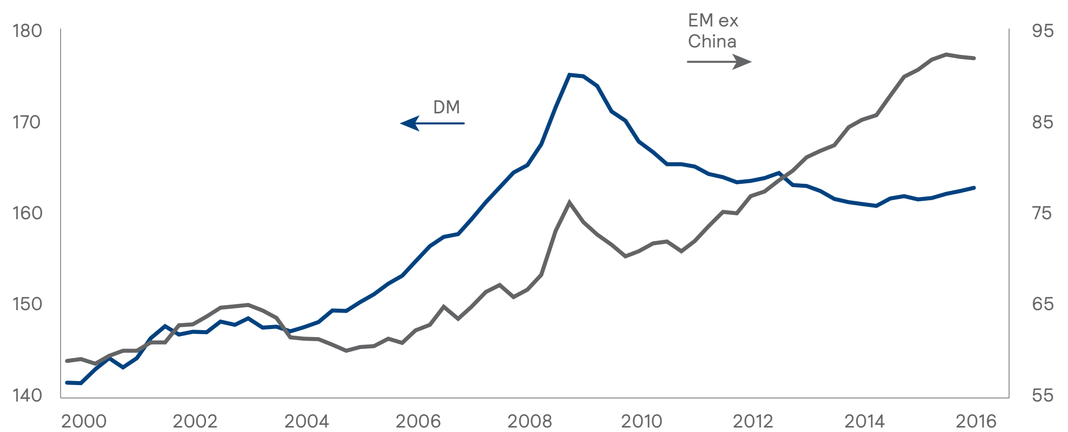
FIGURE 4: CHINESE PPI DEFLATION OVER



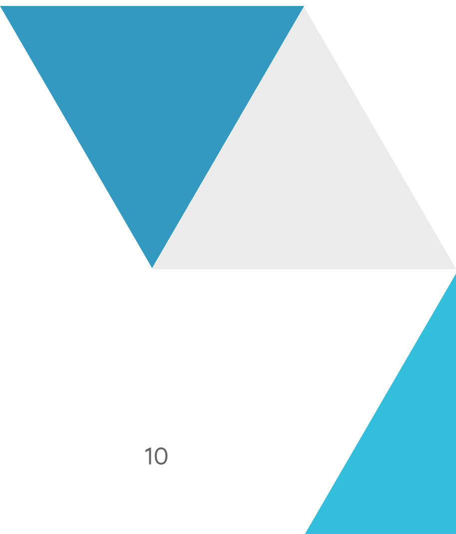
Source: Bloomberg

The introduction of material tariffs against Mexico, China and, possibly, other countries by the new administration represents the biggest risk to EM economies. While, at this stage, events are difficult to predict, we expect President-elect Trump to seek to renegotiate many agreements but stop short of triggering a trade war, because that would ultimately hurt the US. Emerging markets are also vulnerable to a sharp rise in the dollar, should that occur.

FIGURE 5: BROAD PRIVATE NONFINANCIAL CREDIT

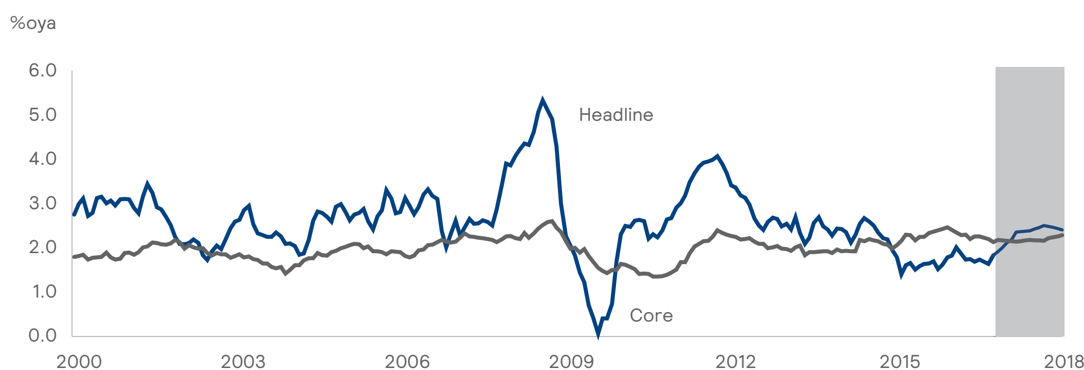


Sources: BIS, central banks, J.P. Morgan



Global inflation is set to move higher as past falls in the price of oil and other commodities drop out of the year-over-year comparisons. Figure 6 shows that global headline inflation could rise from 1.5% in 2016 to almost 2.5% in 2017, in part on the back of oil price movements. If oil stays at its current $50 a barrel, then in year-on-year terms, crude oil in US-dollar terms will be up by over 50% by January 2017. In sterling terms, the price of crude oil will have doubled. This will push inflation in the US and the UK well above their 2% targets, and we should see higher headline inflation in the Eurozone and Japan as well.

FIGURE 6: INFLATION MOVING HIGHER



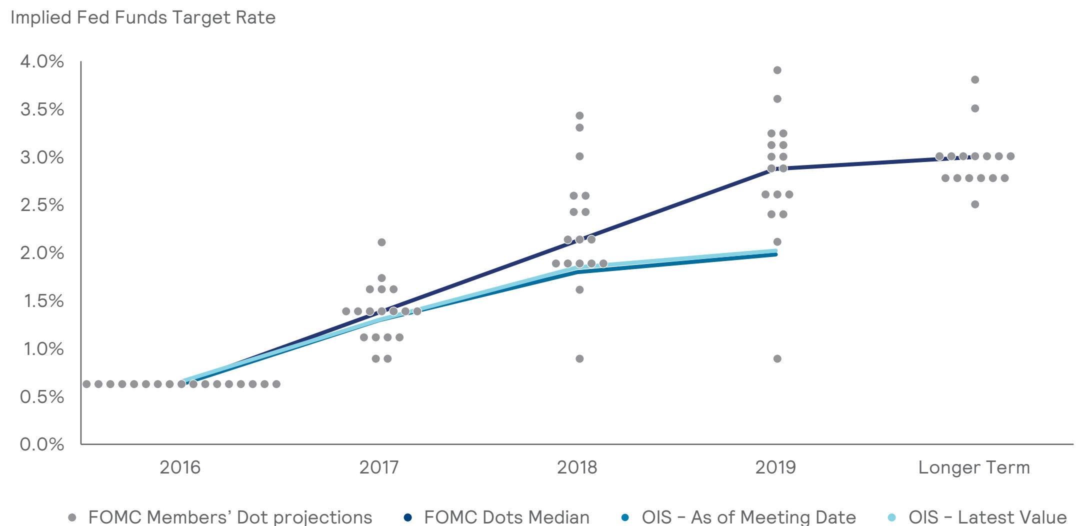
Source: J.P. Morgan

On a core basis — stripping out food and energy prices — inflation is likely to be much more stable, at just above 2% in the US and the UK, but still well below 2% in the Eurozone and Japan. While unemployment rates continue to fall, we have at last started to see signs of wage inflation in the US and to a lesser extent elsewhere. This could push core inflation in the US modestly above target, especially if the new US administration succeeds in pushing a major fiscal expansion plan through Congress. In summary, we think inflation risks in the US are now modestly on the upside, while there is less downside risk in the Eurozone and Japan.

Over the past few years, one of the key concerns of many has been that the global economy could fall into a deflationary spiral, with central banks unable to do much about it. While these risks have not disappeared, they have fallen, in part helped by a slightly stronger global economy, rising commodity prices and the potential for greater use of fiscal policy.

Slightly stronger global growth, lower unemployment rates and rising headline inflation will have implications for monetary policy. In the US, the Fed is likely to raise interest rates with more urgency than in 2015 and 2016, when interest rates were raised only 0.25% in each year. The Fed sees three interest rate increases in 2017 (figure 7), which we think is a reasonable case base. In the Eurozone, the ECB is likely to continue to provide substantial stimulus to ensure the recovery continues. However, by the end of 2017, it is possible that the ECB could start to consider winding down its purchases completely.

FIGURE 7: FED EXPECTS TO RAISE INTEREST RATES OVER NEXT FEW YEARS



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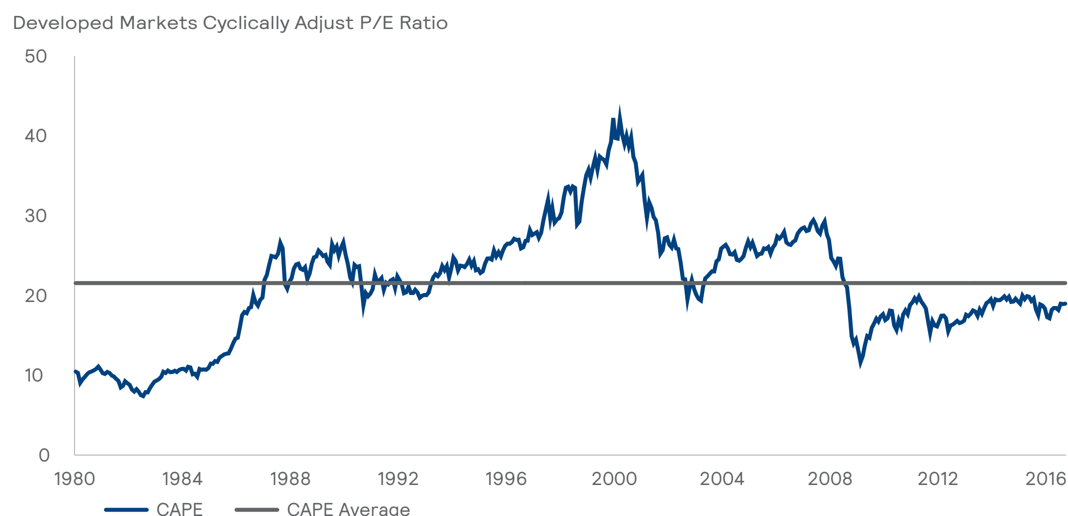
MARKET OUTLOOK

In the short term, if President-elect Trump's policies are taken at their word, the first three to six months of a Trump administration could see a period of policy change and renegotiation, which may trigger a substantial increase in market volatility. This includes both external (trade and foreign relations) and internal (tax and immigration) policy adjustment.

Over the long term, the most important determinant of future equity returns is valuation. We think global equities are fairly valued, expensive in the US but cheaper elsewhere. As a result, this gives non-US equities a bias to slightly outperform US equities, with equities as a whole generating returns in line with historic norms. With valuations in the ballpark of fair value (figure 8), we look to fundamentals to determine whether equities will do well or badly. Here a recovery in corporate profits could be offset by a rise in interest rates. Taking this all together, we expect equities to generate reasonable although not spectacular returns over the next 12 months.

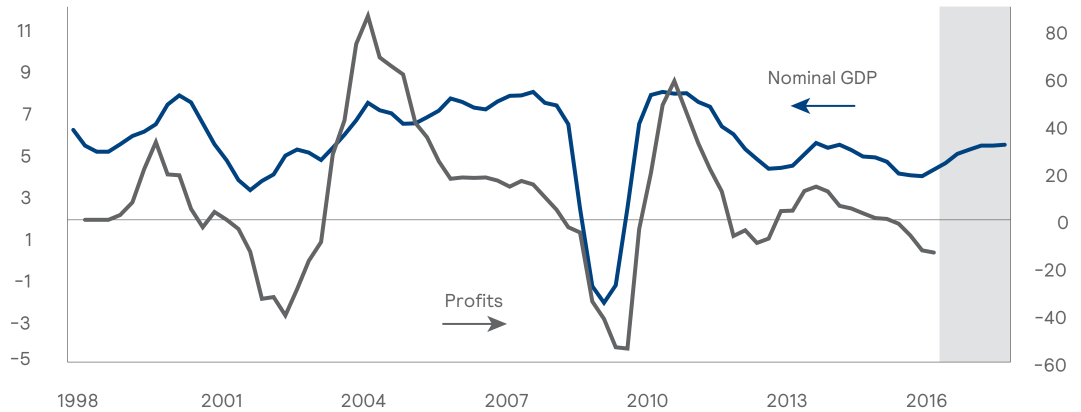
The recovery in both global growth and inflation should support corporate growth — figure 9 shows a strong correlation between nominal GDP growth (real GDP growth + inflation) and corporate profit growth. Corporate profit growth should also be supported by a turnaround in the commodity-linked companies, which should start making profits again on the back of the recovery in commodity prices. Banks could also start to become more profitable again, especially if the new US administration seeks to reduce the level of fines faced by banks for past errors.

FIGURE 8: EQUITIES FAIR VALUE



Source: Thomson Reuters Datastream, IBES

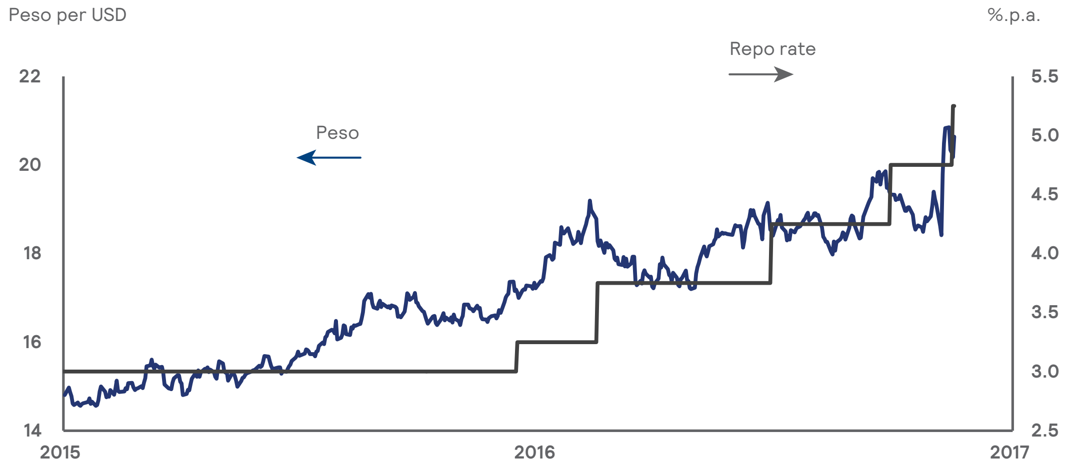
FIGURE 9: PROFITS COULD RISE



Source: J.P. Morgan, MSCI earnings

While stronger profit growth after a number of disappointing years is supportive for global equities, the prospect of higher US interest rates will act as a hindrance. While we doubt US inflation will become uncomfortably high, any sense that the Fed is "behind the curve" would cause economic and especially financial market damage. Any material escalation in trade tensions with either Mexico or China could also undermine both developed and especially EM equities. Even the threat of action has caused the Mexican peso to weaken sharply and forced the Mexican central bank to raise interest rates — see figure 10.

FIGURE 10: MEXICAN PESO WEAKENS SHARPLY



Source: J.P Morgan

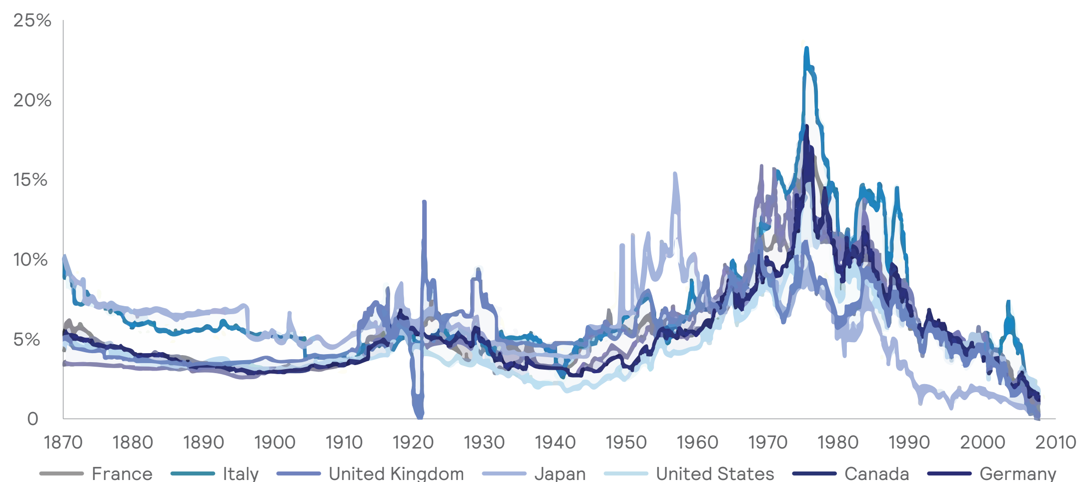
Absent the trade risks for EM equities coming from the new US administration, the outlook for EM equities is the best it has been for some time. Profit growth should start to increase for the first time in several years, while valuations on both the equity and FX side are favorable. As noted earlier, we think President Trump will try to renegotiate various deals, with minor tariffs possible, but will stop short of precipitating a more material trade war. As a result we expect EM equities to do well, although our confidence in that view is held back by uncertainty over what President-elect Trump will do.

We expect small-cap equities to perform broadly in line with developed equities, with support coming from stronger profit growth but with the sector held back by challenging valuations. Low-volatility equities are expected to underperform developed market equities on the back of less favorable valuations and the likely rise in bond yields that could lead to outflows from those who have seen low-volatility equities as an income alternative to low-yielding government bonds.

DEVELOPED MARKET BONDS

After reaching all-time lows in all developed economies in mid-2016, government bond yields have risen sharply over the past few months on signs of economic recovery, rising inflation and fears that President Trump's fiscal stimulus plan could lead the US economy to strengthen at a time when it is already at full capacity. Yields remain at very low levels even after these recent increases. Figure 11 shows that global bond yields are still very low, despite rising 1% in recent months.

FIGURE 11: US YIELDS STILL CLOSE TO ALL-TIME LOW



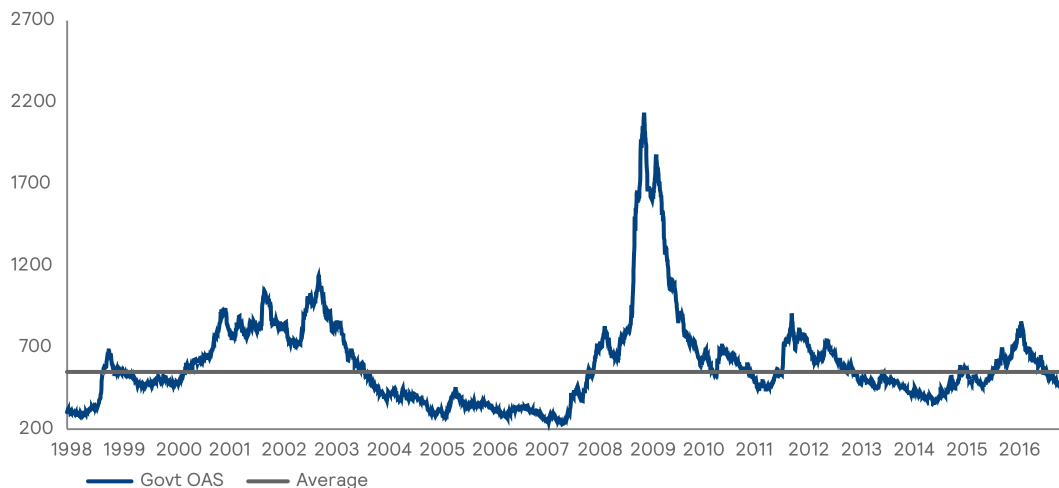
Source: Deutsche Bank, Global Financial Data

We expect global bond yields to rise further in 2017 as the Fed raises interest rates again, the economic recovery continues and headline inflation increases. We expect bond yields in the Eurozone to follow US yields higher as the unemployment rate falls below 10% while inflation risks become more balanced. In the UK, the Bank of England is likely to stay on hold, perhaps with a slight bias to cut rather than hike rates. This could provide some support to shorter-dated bonds, although longer-dated bonds could be hurt by the completion of the Bank of England's bond-buying program and rising global bond yields. In Japan, the Bank of Japan has pledged to buy bonds in unlimited quantities to keep 10-year yields at 0%. We expect they will succeed.

NONGOVERNMENT BONDS

We think nongovernment bonds will modestly outperform government bonds. With the global economy strengthening, we think that defaults outside the commodity sector will remain low, while defaults within the commodity sector will fall on the back of higher commodity prices. However, with spreads at or even lower than the average of the past few decades and commodity gearing increasing, there is little scope for spreads to contract materially. Figure 12 shows global high-yield spreads at a little below the average of the past 30 years.

FIGURE 12: HIGH-YIELD SPREADS NO LONGER HIGH



LOCAL CURRENCY EMERGING MARKET DEBT

The outlook for EMD is closely tied to the outlook for US government bonds and whether the new administration imposes material tariffs or trade restrictions on countries such as Mexico and China. As noted earlier, such restrictions would undermine emerging market economies and currencies.

FOREIGN EXCHANGE

The US dollar has risen sharply over the past few years and again quite sharply since the US election on November 8. The US dollar has been supported by the prospect of higher interest rates, while interest rates in other emerging and developed economies are either on hold or falling. If President Trump's tax plans are enacted, then interest rates could rise by more than is expected, putting further upward pressure on the US dollar. While a stronger dollar against most other developed currencies is our central case, we would caution that the US dollar is already quite expensive, while President Trump may be less supportive of persistent US dollar strength than many of his predecessors. Elsewhere, we think the British pound will strengthen as long as it avoids the hardest of Brexits.

Relative to emerging markets, the US dollar's performance will in large part be the result of the trade policies pursued by the new administration. Emerging market currencies are generally cheap, and we expect economic growth to strengthen, which should both support the sector's currencies. However, aggressive tariffs of some kind could push emerging currencies much weaker. On balance, we expect the new administration to push for a "better deal" but stop short of triggering a damaging trade war.

FIGURE 13: EM CURRENCIES CHEAP

Source: Thomson Reuters, Credit Suisse research

ALTERNATIVES

Hedge funds posted relatively disappointing results over 2016. That said, given current bond and equity market valuations after 8 years of stellar returns, the strategic rationale for alternative strategies is compelling. Looking forward, we expect hedge funds to generate net-of-fee returns well in excess of cash, and we prefer strategies that exhibit low correlation to traditional asset classes. Uncertainty in terms of trade, currency, and central bank policies should create particular opportunities for macro-oriented strategies.

For investors with a tolerance for some illiquidity in their investment portfolios, private market asset classes can offer a range of attractive opportunities. Asset classes like private debt, real assets (e.g., real estate and infrastructure) and private equity are playing an increasingly important role within investors' portfolios. Investors have been seeking exposure to private market asset classes to enhance returns, improve income yield and provide better diversification in their portfolios. We believe the opportunity set for private market investing remains robust, but investors should be aware of the increasing volume of capital being allocated to certain areas of the market and should seek to build their private market exposures over time to diversify risk concentrations.

RISKS

There are always plenty of risks attached to the economic and market outlook every year, and it is almost impossible to know whether these risks, when considered in their totality, are higher or lower than normal. However, as we approach 2017, the risk of the Fed's having to raise interest rates aggressively is higher than it has been for some time, while some political risks also seem elevated. On the positive side, global reflation could lead to a pickup in investment, boosting productivity and greatly diminishing the deflationary fears that have been hanging over the global economy.

Fed raises rates aggressively: The pickup in inflation and growth that we expect to see in the US increases the risk that the Fed starts to raise interest rates much more aggressively than it has so far. The Fed has felt able to move very slowly, with inflation on some measures below their 2% target and unemployment at or near normal levels. In 2017, it is likely that inflation will rise and unemployment will fall, forcing the Fed to move more aggressively.

President Trump starts trade war: Trade war: President-elect Trump has said that he might impose trade tariffs on some countries and pull out of NAFTA. This could lead to a trade war, which would be damaging to the global economy.

European elections: The fallout from the Italian referendum and forthcoming elections in Germany, Holland and especially France could once again raise fears over the existence of the EU and the euro in its current form. Any risk of breakup would have global ramifications. Meanwhile, the UK will enter formal negotiations with the EU on its departure.

Reflation ends deflationary fears: An increase in inflation and a more modest increase in global growth should reduce fears that the world could enter a prolonged period of deflation. This could boost overall confidence, prompting a pickup in global capital investment, and reduce real debt levels, which remain a key vulnerability in some parts of the world.

Productivity picks up: Productivity growth has been very poor in many parts of the world over recent years, and most expect it to remain weak over the next few years. A pickup in global investment as well as the ongoing introduction and spread of new technologies could allow economic growth and profit growth to pick up without leading to higher inflation.

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2017 INVESTMENT THEMES AND OPPORTUNITIES

DECEMBER 2016

MAKE TOMORROW, TODAY MERCER

1 FRAGMENTATION

If 2016 reminded us of anything, it's that forecasting, and especially political forecasting, is challenging. With very few pollsters or commentators having accurately predicted the outcome of either the EU referendum in the UK or the US election, it would be wise to keep an open mind in relation to elections taking place in the Netherlands, France and Germany in 2017. Growing nationalism, fragmentation and what some have dubbed "the death of liberal politics" are likely to remain prominent influences on the political landscape for some time. Indeed, it may be that large parts of the developed world are undergoing a political regime shift on a similar scale to the one ushered in by Margaret Thatcher and Ronald Reagan in the early 1980s.

2 SHIFT FROM MONETARY TO FISCAL STIMULUS

2016 may have witnessed the high point of monetary stimulation, with policymakers increasingly recognizing its limits and unintended consequences. At the same time, increasing calls for fiscal stimulus have been supported by both mainstream economic voices as well as populist politicians. The speed and magnitude of any shift from monetary to fiscal stimulus could have important implications for investors in the years ahead, not least in relation to the potential build-up of inflationary pressures.

3 CAPITAL ABUNDANCE

The sustained period of monetary stimulation by central banks — now entering its ninth year — has created what might euphemistically be described as "a challenging environment" for investors. With real yields below zero in much of the developed world and most asset classes having experienced significant price inflation, generating annual real returns as high as 3%-4% is likely to be difficult over the next 3-5 years. Many investors will therefore need to consider less familiar asset classes and more flexible strategies in order to meet return objectives in the coming years.

4 UNDERSTANDING STRUCTURAL CHANGE

Amid the shorter-term discussion of politics and economics, longer-term structural forces, such as demographic trends, climate change and technological disruption, could also have far-reaching, if less obvious, implications for investors. Identifying some of the broad market outcomes that these structural forces could create will help investors manage risk and return over the long term.

In the sections that follow, we delve into each of the four themes above and consider some of the specific actions that investors can take in response to the evolving economic and market environment.

1 FRAGMENTATION

Taken together, Brexit, the election of Donald Trump, the rise of populism across Europe, and the increasingly nationalist tone of Vladimir Putin and Xi Jinping, suggest a possible fragmentation of the prevailing global political order.[1] These political developments come at a time when global trade and cross-border capital flows (both taken as a proportion of global gross domestic product (GDP)) have been flatlining since the financial crisis. The risk is that isolationism and the introduction of protectionist trade policies send the globalization trend of recent decades into reverse — what has been described as "deglobalization."

While populism and nationalism have been on the rise for some time across Europe, elections in France and Germany in 2017 have the potential to ignite a fundamental crisis within the eurozone given their size and centrality to the European project. Marine Le Pen, leader of the National Front, has already stated that as President she would seek to take France out of the euro and hold a referendum on France's membership of the EU. In Germany, the AfD (Alternative for Germany) has been extremely critical of the eurozone bailouts and has suggested that it would hold a referendum on German membership of the single currency.

The potential implications of political fragmentation and the possibility of deglobalization are far from obvious, not least because there remain many uncertainties around the economic policies that will be pursued by President-elect Trump. In the face of this uncertainty, we would highlight the following actions for investors:

- Given the heightened political risks in this environment (such as trade and currency wars), stress-testing portfolios against large equity, bond and currency movements will be important in assessing portfolio risk exposures. Volatility-sensitive investors may wish to consider approaches to managing their downside risk exposure via "hard" or "soft" hedges.[2]

- Reduced levels of liquidity in markets (driven to a large extent by banking regulations) may exacerbate the magnitude of any sell-off in markets, especially given the increasing volume of assets that respond to spikes in volatility by reducing risk asset exposure (such as risk parity strategies). Periods of market stress may therefore create opportunities for investors who are willing and able to behave in a contrarian manner. This supports the case for flexible and dynamic strategies (and processes) able to capitalize on those opportunities.

- As illustrated by the performance of sterling following the Brexit vote, political surprises create the potential for large currency moves. Protectionism and trade tensions could also lead to currency volatility. This increases the importance of a clear policy on hedging currency risk and may also create opportunities for active currency or global macro managers.

[1] Ian Bremmer, President of Eurasia Group (a geopolitical research firm), has suggested that the world is "at the bottom of a longer-term geopolitical cycle … characterized by a growing vacuum in global governance." *After the G-Zero: Overcoming Fragmentation* (Fall 2016).

[2] "Hard" hedges would include explicit forms of downside protection such as equity options. "Soft" hedges would include a range of strategies that might be expected to reduce the impact of a painful scenario either because of their inherent defensiveness (such as low-volatility equity) or typical performance characteristics in an equity sell-off (for example, trend-following strategies or flight to safety currencies such as the US dollar, Swiss franc or Japanese yen).

2 SHIFT FROM MONETARY TO FISCAL STIMULUS

Over the course of 2016, an increasing number of policymakers and market participants expressed concern about the diminishing effectiveness of monetary policy. Particular attention was focused on the unintended consequences and the detrimental impact on the financial sector of negative interest rates. In response to such considerations, policy discussions have shifted toward the merits of fiscal stimulus, in marked contrast to the insistence on fiscal austerity for much of the post-crisis period. Japan has already taken some tentative steps toward fiscal stimulus, and President-elect Trump is widely expected to propose a fiscal expansion via some combination of tax cuts and infrastructure spending.

The path of inflation over the next few years will be driven, at least to some extent, by the scale and pace of any fiscal stimulus (and the extent to which it is a global phenomenon) as well as actions taken by central banks. As the magnitude of any tilt toward fiscal stimulus becomes clear, we believe the following actions warrant discussion:

- Investors should be clear about the extent to which inflation might pose a risk to the achievement of their objectives. Where inflation is seen as a material risk, investors should consider which parts of their existing portfolio might be exposed and which parts might provide some protection from inflationary scenarios. For portfolios lacking in inflation protection, investors may wish to consider direct inflation hedges or assets providing some inflation sensitivity (such as real assets). Such considerations will necessarily be region and investor-specific.

- A more aggressive shift toward fiscal stimulus will increase upside risk to bond yields (already evident in bond market moves following the US election). Floating rate or short duration credit exposures may therefore be preferable to strategies that are tied to a benchmark that brings structural duration exposure (unless this duration exposure is specifically desired for risk management reasons). It is worth noting in this context that the duration of many fixed income indices will have increased materially as yields have fallen in recent years.[3]

- Regardless of the direction of yields, an increase in bond market volatility due to an increase in uncertainty around monetary and fiscal policy (following a period in which policy has been one-directional) should create a more fertile opportunity set for global macro, absolute return bond and unconstrained fixed income strategies.

- If the monetary policy punchbowl is removed faster than expected and bond yields rise materially, companies that have been supported by ultra-loose policy may face challenges in refinancing their debt. A rise in default rates, while painful for existing credit portfolios, could create opportunities for strategies that are positioned to allocate capital to distressed assets. Long/short credit strategies or more adventurous multi-asset credit strategies may provide some exposure to such assets.

[3] For example, the duration of the Barclays Capital Global Aggregate Index has increased by almost 20% over the past 5 years (from 5.8 years as of November 30, 2011, to 6.9 years as of November 30, 2016).

3 CAPITAL ABUNDANCE

Following 8 years of central bank largesse and low levels of business investment, the world is awash with financial capital seeking yield. The exceptional returns of the past eight years will not be repeated and there is a scarcity of “easy beta” to be harvested. We believe that portfolios dominated by traditional beta (that is, equities, credit and government bonds) offer a relatively unattractive risk/return trade-off on a forward-looking basis. Investors will therefore need to prepare for lower returns or consider less familiar asset classes and more flexible strategies in order to deliver on their return objectives.

An abundance of capital has enabled companies to take on additional leverage and to extend the maturity of their borrowings, and encouraged investors to move up the risk spectrum in search of yield. This clearly brings additional risk and creates the possibility of a reversal of fund flows in stressed markets. In this environment of low yields and low to moderate risk premia, we believe that investors should place a greater emphasis on diversification of return sources and might consider the following areas:

- Continue to seek a contribution to returns from a diversified mix of alpha sources. This can include systematic factor exposures (or “smart beta”) and idiosyncratic alpha (a function of a manager skill) across a range of liquid markets. The search for alpha need not be constrained to hedge funds or traditional long-only active strategies. Indeed, niche strategies in traditional asset classes where much of the return is likely to be driven by manager skill may be attractive diversifiers in the current environment — opportunistic/value-added real estate and activist/engagement strategies in listed equity are two examples.

- While many private markets have seen significant inflows in recent years, opportunities remain for high-quality managers to extract returns from a combination of illiquidity and complexity premia and direct asset management (or “hands-on value creation”). This is especially true for areas of the private markets opportunity set where there continues to be a structural imbalance between the demand and supply of capital — most notably private debt finance for smaller companies that have limited access to the capital markets.

- Less familiar segments of the credit markets (such as asset-backed securities, private lending, trade finance and receivables) offer investors the potential to generate a premium to cash of 2%-4% per annum as compensation for complexity and illiquidity risk. Secured finance strategies provide one potential access route to such assets.

As an aside on capital flows, it is worth noting the significant growth in exchange-traded funds (ETFs) in recent years. This shift has been supported by a gradual but steady multi-year trend from active to passive management (most ETFs provide a passive exposure to some underlying market). We have long argued that market cap-weighted indices are an inefficient means of allocating capital on the grounds that they are biased to past success and often embed unintended risks. An environment of cheap and abundant capital is only likely to have amplified the unintended risks inherent in market cap indices (especially in bond indices). We are wary of these difficult-to-quantify risks and believe this strengthens the case for genuinely unconstrained active management (approaches that are not tied to a benchmark index) from both a risk and return perspective.

4 UNDERSTANDING STRUCTURAL CHANGE

Most economic and market commentary focuses on relatively short-term questions — when the Fed is expected to implement the next rate hike, what the latest employment figures tell us about GDP growth or how China will manage its currency over the next 6 months. As a result, longer-term structural changes are often ignored, despite the fact that they may have important implications for long-term investors.

Three areas of structural change that we believe merit greater attention from investors are climate change, demographic trends and technological developments. As we have discussed frequently in recent years, climate change remains an important issue, both as a physical risk to real assets and as a policy risk to a wide range of carbon-sensitive assets. Demographic trends and technological advance are two of the key drivers of long-term economic growth, affecting the size of the working age population and the rate of productivity growth. Beyond this high-level macroeconomic significance, we believe that a deeper understanding of these trends can provide useful insights to help inform asset allocation decisions.

There is clearly some uncertainty around the future direction of US climate change policy under President-elect Trump. However, climate change remains an issue of global importance, and we continue to believe that investors should review the extent to which portfolios are exposed to carbon-intensive assets as a way of assessing the impact that policy developments (such as carbon pricing or a carbon tax) could have on portfolios. Carbon footprint analysis on listed equity portfolios and recent developments in low-carbon indices can be valuable tools in addressing this source of risk.

The overriding demographic trend is global aging. Fertility rates have fallen across much of the world (especially in Japan and continental Europe), reducing population growth, while advances in health care have led to increases in longevity. As a result, large parts of the world are moving through an inflection point in their dependency ratios — where the ratio of the dependent population (essentially children and retirees) to the working age population is moving from a downward trend over recent decades into an upward trend for the decades ahead.

The investment implications of this shift are far from clear, not least because changes in working patterns (e.g., working long past traditional retirement ages) could mitigate the impact of aging populations thereby halting or reversing any rise in dependency ratios. However, we might venture the following observations:

- While it is not clear what impact an aging population will have on economic growth and corporate profits at an aggregate level, it is clear that some countries will be more challenged by these trends than others (either because their demographic trends are further advanced or because cultural factors mean that they are less likely to be able to adapt in time). This will likely create material divergences in economic outcomes at a regional level.

- As the baby boomers in much of the developed world move into retirement over the coming decades, they are likely to gradually draw down their pools of savings. This is likely to act as an upward force on real yields, albeit one that will play out over a multi-decade horizon.

Technological trends are perhaps even harder

to predict than demographic trends given the somewhat random nature of innovation. However, it is possible to suggest a few of the potential implications for investors.

- Technological disruption clearly creates winners and losers at a corporate level. This should create opportunities for long/short equity investors, perhaps particularly in relation to opportunities on the short side of the book (identifying the losers from technological change may be easier than picking the winners).
- An extension of the point above is that market cap indices may be at particular risk of technological disruption given that these indices hold large weights in the existing incumbents across all sectors.
- The rapid rise in the number of "unicorns" (privately owned companies with a valuation of more than $1 billion) is at least in part driven by the fact that private companies are choosing to stay private longer than they have done in the past. This suggests that investors may need to be willing to allocate to early stage private equity in order to access these sources of future growth. Indeed, some large listed equity managers have started to invest in unlisted securities (where mandate guidelines allow) for precisely this reason.

TAKING ACTION

The ideas outlined in this paper represent our observations on the challenges and opportunities present in the current investment environment. We provide these ideas with the aim of provoking useful discussion, but the appropriate response at an investor-level will be heavily influenced by the specific beliefs, objectives, and constraints of each investor. We look forward to helping investors adapt their strategies as new risks and opportunities arise over the course of 2017.

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