ROPES WEALTH ADVISORS

Tactical Asset Allocation Views: Q1 2015

While the global economy has been expanding over the last half-decade since 2008, the pace has been moderate and frustratingly fragile. Deteriorating demographics, slowing productivity, and suboptimal economic policy have all contributed to sub-par growth. In 2014, a further drag was created by special factors such as severe weather in the U.S., extreme fiscal tightening in Japan due to the VAT tax increase, and a major confidence drag in Europe stemming from the crisis in the Ukraine.

Looking to 2015, we predict a somewhat faster pace of global growth, given the lagged benefit of low interest rates, the boon of low energy prices, and the catalysts of monetary and fiscal policy intervention in Europe and structural reform in Japan. Although nominal growth in many EM economies is likely to trend down in 2015, improving current account imbalances and dissipating inflation pressure make for better economic conditions compared to a year ago. In addition, with key EM elections behind us, prospects are high for economic reform to create new growth opportunities and sustainable fiscal policy, as well as policy changes that bring about improvements to corporate governance and cash flow.

Markets in 2015 may be volatile, as we move into a mid-to-late stage part of this economic cycle. Beyond the maturing of the cycle, markets must also deal with likely monetary policy divergence, with the U.S. and UK moving toward tightening, in contrast to the stance of central banks in much of the rest of the world. Geopolitical risks also seem especially high, with declining oil prices keeping Russia on the ropes and risking tensions in the Middle East, Greece poised for another round of electoral tail risk, and ISIS and North Korea providing ongoing terror threats.

While recent investor experience might suggest otherwise, the benefits of diversification are likely to come to the fore in this next phase of the economic cycle as markets mature and leadership shifts. Likewise, a keen focus on investment strategies that perform well over full market cycles should show their worth in the time ahead. Mapping the steps to sustain your time in the markets, not timing the markets, is how we most of all hope to serve.

Equities — Overweight

Global equities are primed to edge higher in 2015 as the economic recovery continues and policy becomes more inspired. We favor equities over fixed income and alternatives, as the total return opportunity is greater than the foreseeable market risks and valuations in many markets are attractive or fair by most measures.

Fixed Income — Underweight

Bond yields globally are at generational lows, and are below fundamental fair value. Slower-than-expected economic growth, low inflation, political turmoil, demographic trends, and the global hunt for yield are all factors holding yields in check. Low default rates and firming economic activity are supportive of bonds with yield spread.

Alternatives — Underweight

Alternatives investment strategies provide differentiated returns; building an allocation, particularly in hedged strategies and hybrid/opportunistic managers, makes sense in mature markets with higher volatility.

Equities

U.S. Large Cap	Neutral	U.S. equities have done exceptionally well since the global financial crisis, and valuations fully reflect improving fundamentals. Above trend U.S. growth supports mid-single digit total return in line with profit growth. Further P/E and margin expansion should be limited.
Non-U.S. Large Cap	Overweight	Our bias for European and Japanese equities is a result of monetary stimulus and given the political and structural changes taking place. While there are risks, most of the bad news is priced in and the performance gap between U.S. and non-U.S. equities could narrow as a result.
U.S. Small-Mid Cap	Overweight	After a significant performance drag in 2014, we favor small and mid-size U.S. stocks based on valuations and given stronger relative sales and earnings growth.
Non-U.S. Small-Mid Cap	Neutral	Non-U.S. small cap equities, more levered to a recovery in domestic consumption, are attractive given our expectation for recovering local economies. We recognize geopolitical concerns offer short-term challenges and prefer to remain neutral for now.
Emerging Markets	Neutral	EM earnings growth rates are being tempered by the slowdown in GDP growth in key economies. That said, EM equities are trading at a 25% discount based on trailing P/E. Much differentiation in outlook exists among the constituent countries.

Fixed Income

Investment Grade	Underweight	Our caution reflects a lack of coupon cushion with spreads at pre-crisis levels and low underlying Treasury bond yields. We anticipate volatility as Fed tightening approaches.
High Yield	Overweight	Low default rates and firming U.S. economic growth continue to be supportive, and after 2H 2014 spread widening, high yield is attractively valued relative to other fixed income instruments. Fixed and floating rate exposure provide balanced opportunity.
Non-U.S. Bonds	Underweight	Broadly speaking, yields globally are lower than those in the U.S., so there is not much benefit to owning non-U.S. debt other than diversification. Some forms of emerging market debt offers attractive fundamentals and valuations, but Fed tapering/tightening may be a short-term headwind for the asset class.

Alternatives

Hedged Strategies	Neutral	The challenging outlook for fixed income markets has created a need for less traditional exposures and an inherent flexibility. Our allocation will seek to deliver enhanced returns relative to cash but with much less risk than traditional bond market exposures.
Hybrid/Opportunistic	Overweight	Hybrid and opportunistic exposures are employed to capture a short-term market opportunity or protect against a short-term challenge. Given a need for yield in this low interest rate environment, we have chosen a hybrid exposure that will deliver income from equity oriented securities.
Real Estate	Underweight	Falling interest rates led to very good performance from REITs in 2014. At current levels, we believe REITS are fully valued and the risks for a correction are high on shifting expectations for interest rates.
Commodities	Underweight	While commodities' portfolio construction benefits are improving (lower volatility and correlations), and we are constructive on oil longer-term, we think the next 3-6 months could be challenging. Gold remains vulnerable to monetary policy shifts.