ROPES WEALTH ADVISORS

Tactical Asset Allocation Views: Q2 2015

Markets were volatile in the first quarter thanks to central banks and geopolitics. The victory of Prime Minister Alexis Tsipras and his anti-austerity, radical leftist Syriza party created tense negotiations for a Greek bailout, the European Central Bank finally launched quantitative easing, the Federal Reserve danced around the question of when it will begin hiking rates, the Russia and Ukraine crisis continued, and, as always, there was turmoil in the Middle East, this time due to the frightening advance of the militant group ISIS (Islamic State in Iraq and Syria).

The U.S. economy lost some momentum in the first quarter thanks to a combination of bad weather in many parts of the country that disrupted consumer spending and construction, labor unrest at West Coast ports, the strong dollar, and a contraction in energy jobs and production. These conditions will likely prompt the Federal Reserve to delay increasing short-term interest rates until late 2015. Merger-and-acquisition and share buyback activity should remain robust as companies take advantage of low corporate borrowing costs and high earnings yields.

Developed international markets were jolted to life by the fulfillment of European Central Bank President Mario Draghi's promise to do 'whatever it takes' to protect the eurozone from collapse with his announcement of QE. While a sustainable and robust recovery in Europe will require more structural reforms, QE is an important catalyst for consumer and investor confidence. Likewise, the concerted and coordinated efforts monetary and fiscal efforts in Japan show the country making good progress on recovering from a VAT tax-induced economic slide.

Emerging markets remain a varied picture as Brazil and Turkey struggle with high inflation and weak growth, Russia faces a commodity and geopolitically-induced recession, China's growth is recalibrated to the consumer, and India is now the fast-growing of any major economy in the world.

Expect volatility to remain elevated in the near term as investors deal with a shifting global investment landscape related to diverging central bank policies, volatile currencies, disproportionate economic growth, falling energy prices and geopolitical issues. While these concerns may keep the equity market from soaring higher, they should not keep it from grinding to a higher level over the next twelve months, and so we remain biased toward risk assets.

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 are feeling the headwinds of a rising dollar and softening mid-cycle growth. Merger-and-acquisition and share buyback activity should remain robust as companies take advantage of low corporate borrowing costs and high earnings yields. With valuations fair, and perhaps full, we are neutrally positioned.
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 pace. 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 differrentiation 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.