Investment Strategy Update

February 2017

Investment Strategy – Proceeding with Caution

U.S. equity markets rallied in the fourth quarter of 2016, on the heels of the surprise election of Donald Trump. Some aspects of the new administration's policy agenda may foster higher economic and earnings growth (regulation and fiscal policy), while other aspects may prove to be prohibitive of growth (immigration and trade). Markets moved quickly to price-in the positive features of President Trump's expected policy actions, with less attention to the potentially negative consequences. Recognizing that there remains significant uncertainty regarding actual policy implementation, our analysis continues to focus on the fundamentals of the macroeconomic landscape, while considering how such fundamentals may change in response to policy actions. Currently, our analysis indicates moderating economic growth and inflation, which informs our view that rates are likely to be low for longer, even in the face of gradual tightening by the Federal Reserve (the "Fed"). We continue to believe that the current economic landscape warrants lower interest rates and lower expected returns across asset classes. In order to adapt to evolving conditions, the Wilshire Funds Management Investment Strategy Committee meets monthly to reassess a variety of factors, including but not limited to economic, fundamental, technical, and risk indicators. Our most recent assessment of global market conditions has resulted in very limited changes in our portfolios, as we remain consistent in our slightly cautious risk posture relative to our strategic asset allocation policy(s), most specifically through an underweight in equity risk in favor of credit risk and alternative investments. Although our views are directly reflected in our portfolios, we have also included a broad review of the changes in our views since October, with a summary of our rationale and supporting exhibits in the proceeding sections. We will continue to keep you apprised of our market perspectives and positioning.

Asset Class	October	Change	January
Fixed Income vs. Equity	Overweight	≈	Overweight
Alternatives vs. Equity	Large Overweight	↓	Overweight
Alternative vs. Fixed Income	Neutral	≈	Neutral
Duration vs. Barclays Cap Agg. Bond Index	Neutral	≈	Neutral
Credit vs. Government	Overweight	≈	Overweight
Investment Grade vs. High Yield	Neutral	≈	Neutral
High Yield vs. Bank Loans	Neutral	↓	Underweight
Non-U.S. vs. U.S. Fixed Income	Large Underweight	≈	Large Underweight
Large Cap vs. Small Cap Equities	Overweight	≈	Overweight
Growth vs. Value Equities	Underweight	≈	Underweight
Global ex-U.S. vs. U.S. Equities	Neutral	≈	Neutral
Emerging Markets vs. Developed Equities	Neutral	≈	Overweight
Global REITS vs. Global Equities	Neutral	≈	Neutral
Commodities vs. Global Equities	Underweight	≈	Neutral

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Asset Class	Change	View	Summary of Rationale
Fixed Income vs. Equity	≈	Overweight	➢ Equities continue to exhibit higher than normal valuations and below average earnings growth. ➢ Economic data is still broadly inconsistent with a significant rise in interest rates, and we expect any move by the Fed to *materially* raise rates in this environment will be met with a more negative response in risk assets. ➢ Our overweight to fixed income is implemented through an overweight to high yield as a substitute for equity risk, with the objective of reducing equity beta while earning additional yield in an environment of lower expected returns.
Alternatives vs. Equity	↓	Overweight	➢ We have reduced our large overweight in alternatives, which is specifically implemented through equity hedge strategies. ➢ This continues to serve the objective of reducing equity beta and introducing more alpha-oriented strategies that can benefit from the additional breadth of short positions.
Alternative vs. Fixed Income	≈	Neutral	➢ We continue to believe that interest rates will be low for longer, given modest levels of inflation and economic growth on a global basis, and we believe that fixed income will continue to serve as one of the best sources of diversification to equity risk.
Duration vs. Bloomberg Barclays Capital Aggregate Bond Index	≈	Neutral	➢ Given our view that the recent move higher in interest rates is overdone and that rates will remain relatively low for the foreseeable future; we remain neutral in our duration exposure.
Credit vs. Government	≈	Overweight	➢ We are mindful of valuations in credit, however we believe that the incremental yield in investment grade bonds provides valuable income in a low return environment.
Investment Grade vs. High Yield	≈	Neutral	➢ Cross-sectional valuations do not warrant a deviation from neutral posture.
High Yield vs. Bank Loans	↓	Underweight	➢ Bank loans offer similar yield spreads relative to high yield, with significantly less volatility.
Large Cap vs. Small Cap Equities	≈	Overweight	➢ Consistent with our relative underweight to equities, large caps exhibit lower equity beta.
Growth vs. Value Equities	≈	Underweight	➢ Although the valuation argument in favor of value equities has diminished, growth equities remain at risk to the degree that earnings disappoint relative to optimistic expectations.
Global ex-U.S. vs. U.S. Equities	≈	Neutral	➢ Foreign equities are more attractive on a valuation basis, but come with material uncertainty due to Brexit, economic headwinds, and downward currency pressure relative to USD.
Emerging Markets vs. Developed Equities	≈	Overweight	➢ Given the underperformance in Q4, valuations are more compelling on a relative basis.
Global REITS vs. Global Equities	≈	Neutral	➢ Cross-sectional valuations do not warrant a deviation from neutral posture.
Commodities vs. Global Equities	≈	Neutral	➢ Although inflationary pressures are limited, we are witnessing technical stability in energy prices (with a trading range), and believe that underweight exposure is no longer prudent.

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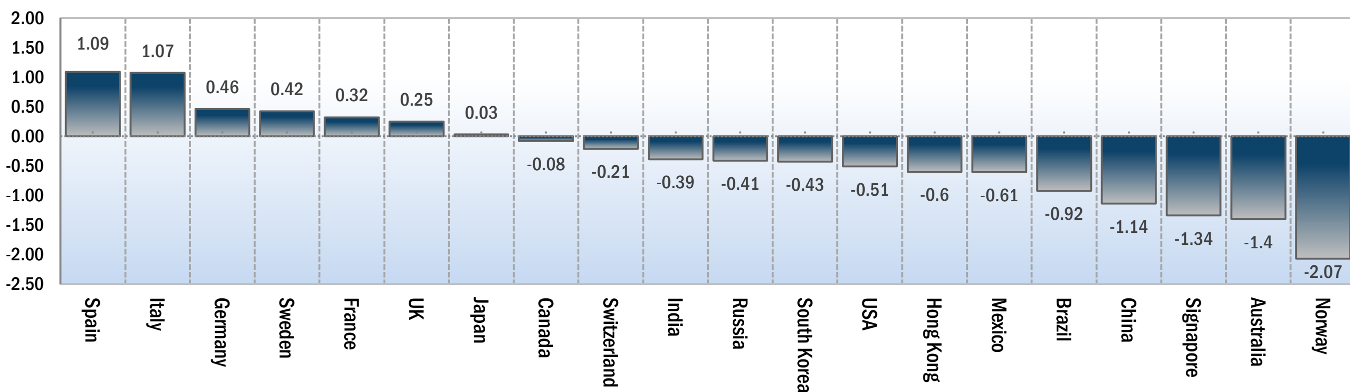
Macroeconomic Outlook

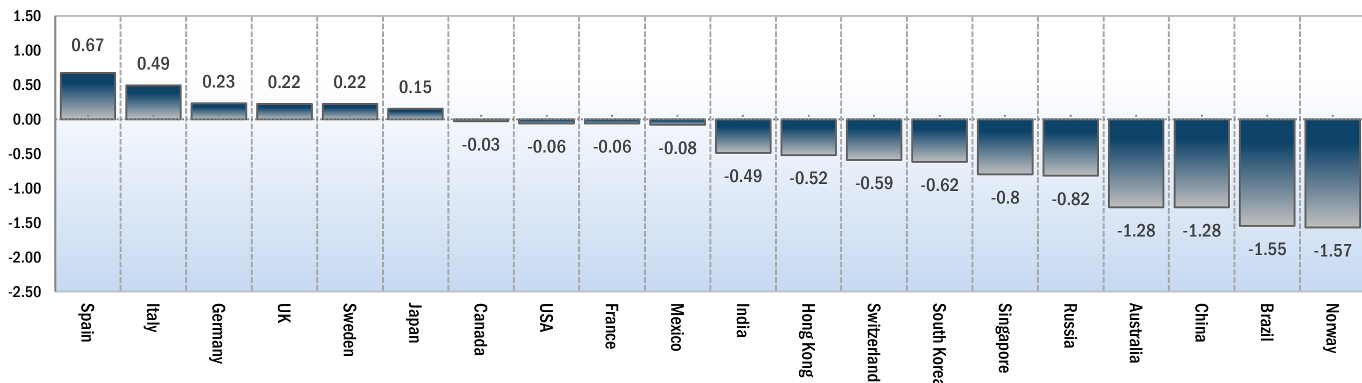
- Our assessment of the macroeconomic landscape indicates moderating economic growth and inflation on a global basis, as shown in Exhibits A and B.
- Developed markets remain relatively stable in terms of GDP growth on a normalized basis, and we are still seeing below average growth in emerging markets, albeit faster than in developed markets.
- On a forward looking basis, we continue to be mindful of the economic uncertainty resulting from "Brexit", in addition to the performance headwinds for foreign equity allocations due to the strength of the U.S. dollar. As a result, we remain neutral in our exposure between U.S. and Non-U.S. equities.
- Although we are witnessing modest levels of inflation on a global basis, we are cognizant of the recent rise in oil prices and the impact on headline inflation.
- Given that central banks are no longer pressing forward with aggressive accommodation in monetary policy, the global economy will be more reliant on fiscal stimulus going forward.

Exhibit A: Country GDP Growth (Normalized, 15 years)



Source: Bloomberg

Exhibit B: Country CPI Growth (Normalized, 15 years)



Source: Bloomberg

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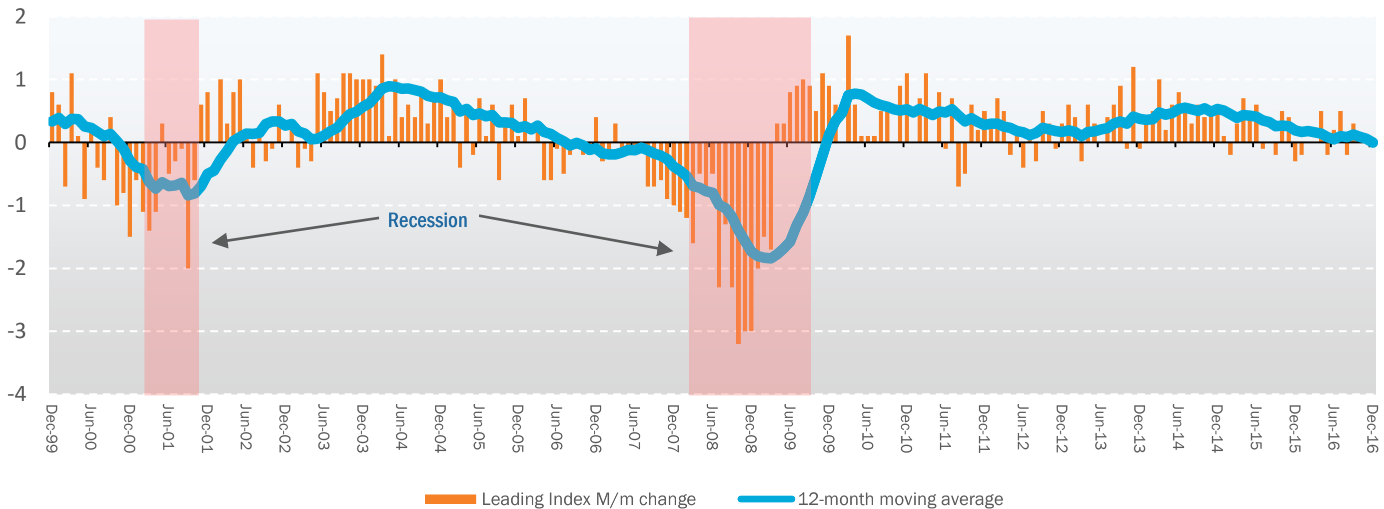
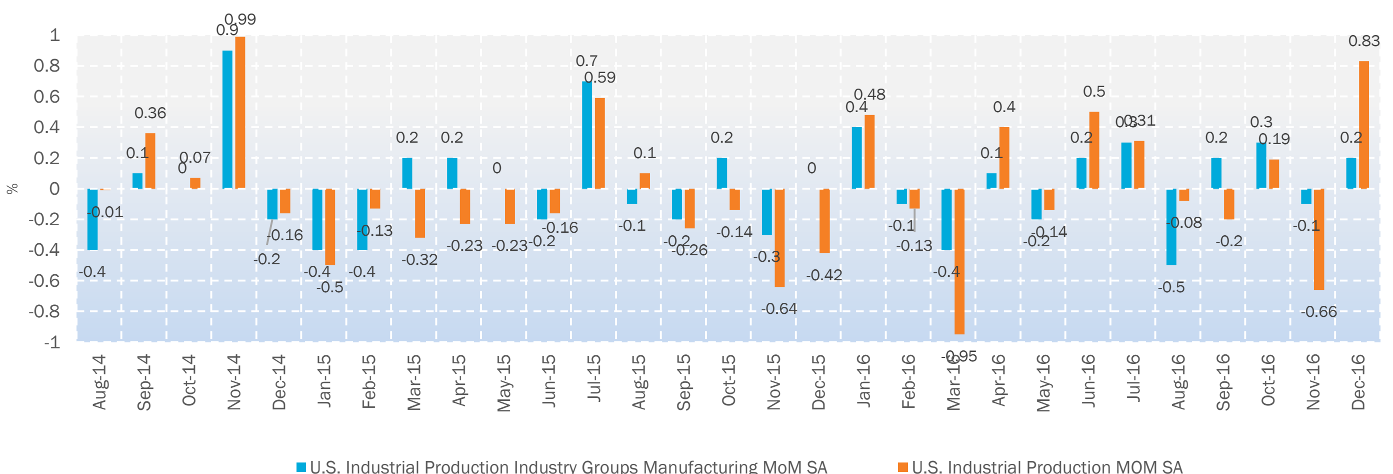
Exhibit C: Conference Board U.S. Leading Economic Index MoM



Source: Bloomberg

- U.S. economic growth continues to disappoint on a year-on-year basis (1.9% in 2016), as we see signs of moderating growth in the U.S.
- Exhibit C shows the Conference Board U.S. Leading Economic Index, which shows a downward trend in leading economic indicators, albeit not yet at levels that are consistent with historic recessions (as denoted by the red shaded areas).
- The most recent readings of U.S. Industrial Production were strong following a weak report in November, and we have more recently seen slower job growth, with the average 12-month change of U.S. Non-farm Payrolls falling slightly below 200,000/month (180,000). Furthermore, persistent dollar strength may continue to weigh on economic growth.

Exhibit D: U.S. Industrial Production MoM



Source: Bloomberg

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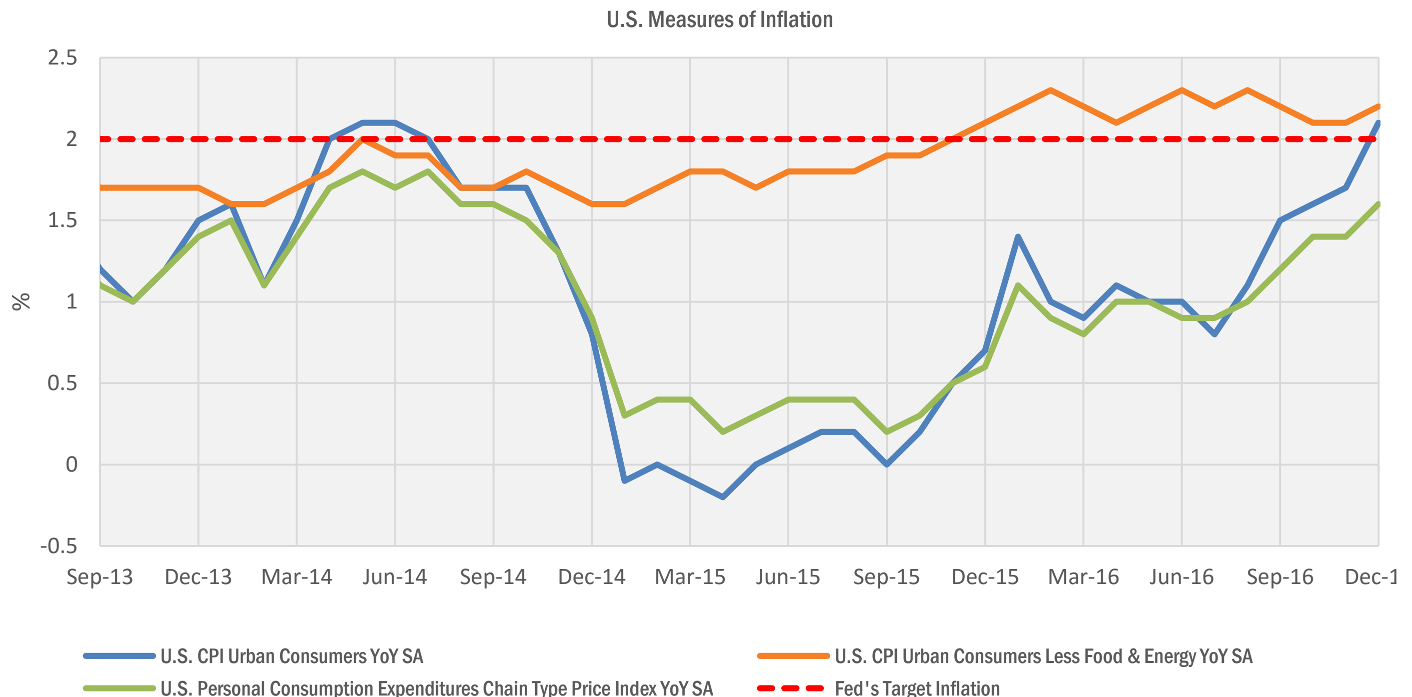
Exhibit E: Inflation Measures



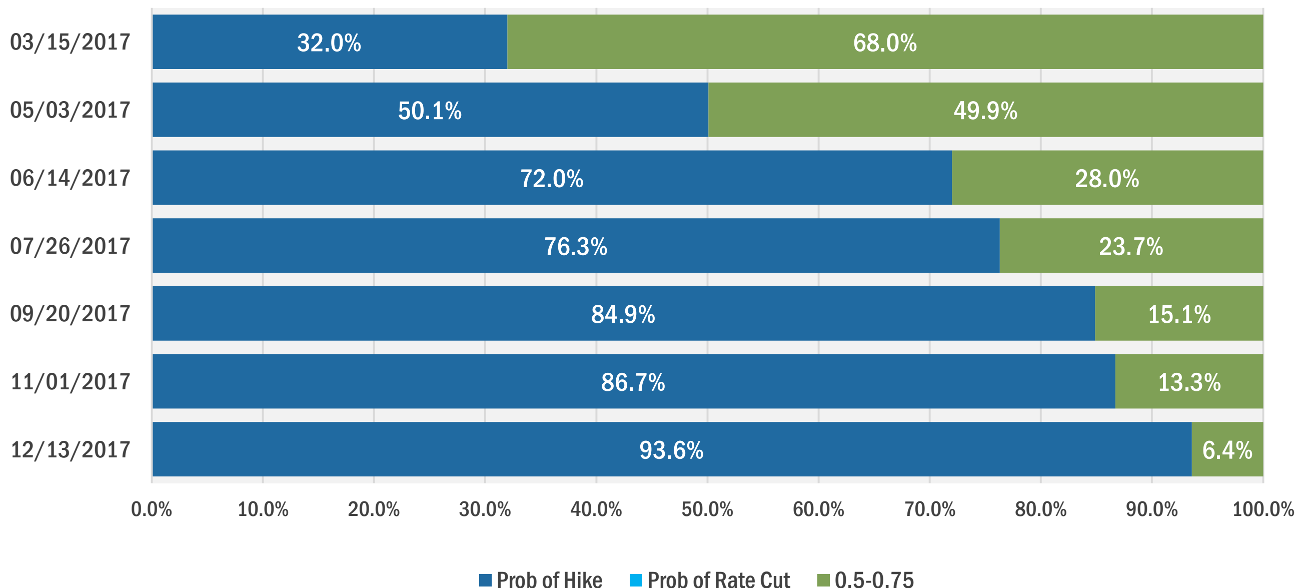
Source: Bloomberg

- We are mindful of the fact that recent readings of core inflation (which strips out volatile fuel and food costs) has risen to above 2% year-on-year.
- U.S. Personal Consumption Expenditures, although rising, also continues to sit below the Fed's 2% target. This represents one of the Fed's most favored measures of inflation, and based on this indicator, we would expect the Fed to be gradual with its tightening policy so as not to stymie healthy inflationary pressure.
- We maintain our view that given the very low bond yields that we continue to witness in developed Europe and Japan (supporting continued global demand for dollars), it is also challenging to envision a material rise in interest rates in the U.S.
- We expect a moderating growth environment in the foreseeable future, and therefore, we continue to believe that the current economic landscape warrants lower interest rates and lower expected returns across asset classes. As a result, we have maintained our more cautious positioning, most specifically in our equity allocations, where we remain underweight.

Fixed Income Outlook

- We remain overweight in fixed income relative to equities, specifically by replacing equity risk with credit risk.
- Given ultra-low foreign developed market bond yields, we favor domestic fixed income over global fixed income, and our concerns that further dollar strength would serve as a headwind for global bonds have continued to materialize.
- From an interest rate risk perspective, we remain duration neutral relative to the Bloomberg U.S. Aggregate Bond Index. We have continued to reiterate our belief that rates will remain low and interest rate sensitivity may still provide a diversification benefit, although more limited, in the event that economic growth and inflation continue to surprise to the downside.
- We continue to believe that the economic data is broadly inconsistent with restrictive monetary policy, and while it is probable that the Fed will raise interest rates further in 2017, we expect any move to significantly raise rates in this environment will likely be met with a more negative response in risk assets (such as equities). Exhibit F below shows that the next likely rate increase implied by Fed Funds Futures is June of 2017.
- With respect to credit markets, we are mindful of higher valuations, however we believe that the incremental yield in investment grade bonds provides valuable income in a low return environment.
- That being said, we believe that allocating to credit as a replacement to equities is prudent, primarily with the goal of reducing equity risk while 'getting paid to wait' in what we expect to be a lower return environment.

Exhibit F: Futures Implied % Probability for 2/2/2017 (Fed Funds Ranges Expressed in 25 basis point increments from 0.0–1.75%)



Source: Bloomberg

Equity Outlook

- Our equity heat map expresses positive and negative signals through green and red indicators, respectively.
- On a cross-sectional basis (Exhibit G), we recognize that U.S. equities remain somewhat more expensive relative to their non-U.S. developed market counterparts, but given the economic uncertainty resulting from "Brexit", in addition to the performance headwinds for foreign equity allocations due to the strength of the U.S. dollar, we believe that maintaining a neutral posture between foreign and U.S. equities is prudent.
- A declining earnings yield in conjunction with higher Treasury yields has led to a considerable decline in the equity risk premium, as shown in Exhibit H. This implies that investors are being compensated meaningfully less for taking equity risk relative to government bonds.
- We have moved past an earnings recession, and earnings forecasts for 2017 are very optimistic—now approximately 11.5% earnings growth for the S&P 500 Index, down from earlier estimates of 13%. As we've discussed in the past, these expectations are largely driven by a recovery in earnings for the Energy sector and imply an average oil price of $54. We continue to see considerable risk to this optimism and forecast.
- While we are encouraged by the market's ability to shrug of geopolitical concerns and moderating economic growth, we believe that ultra-low levels of implied volatility, as measured by the VIX Index, are symptomatic of complacency, particularly in the face of high valuations.
- We believe that maintaining a slight underweight to equity risk while still seeking to harvest returns through our allocation to credit risk is prudent. We will continue to adapt our portfolios to market conditions and promote diversification to dampen the volatility of our client portfolios with the objective of achieving long-term financial objectives.

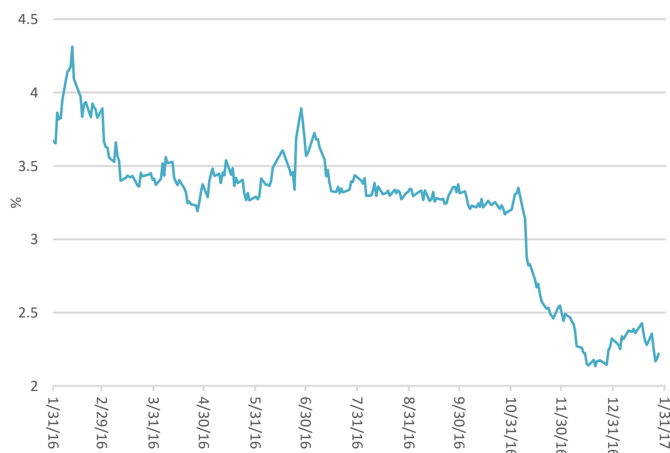
Exhibit G: Cross-Sectional Equity Valuations
(forward P/E, 15 years, normalized)

Forward PE Relative Z-Score Map

	Japan	UK	MSCI Euro	MSCI Europe	ACWIxUS	MSCI Emerging Mkts	MSCI World	MSCI EAFE	S&P 500	Value
Japan		-0.87	-0.81	-0.82	-0.76	-0.48	-0.84	-0.82	-0.83	14.63
UK	0.99		0.23	0.36	0.96	1.12	0.66	0.91	0.49	14.63
MSCI Euro	1.09	-0.29		-0.09	0.70	1.15	0.55	0.84	0.31	14.26
MSCI Europe	1.02	-0.39	0.05		0.97	1.13	0.65	1.01	0.39	14.87
ACWIxUS	0.88	-1.00	-0.77	-0.97		0.91	-0.71	-0.37	-0.66	14.14
MSCI Emerging Mkts	0.47	-1.16	-1.15	-1.14	-0.88		-1.17	-1.03	-1.15	11.86
MSCI World	1.07	-0.69	-0.57	-0.65	0.64	1.20		0.71	-0.40	16.26
MSCI EAFE	1.00	-0.97	-0.84	-0.99	0.30	1.02	-0.73		-0.52	14.89
S&P 500	1.08	-0.51	-0.36	-0.42	0.59	1.21	0.39	0.46		17.10

Source: Bloomberg

Exhibit H: U.S. Equity Risk Premium
(S&P 500 Earnings Yield – 10 year Treasury Yield)



Source: Factset

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