

October lived up to its reputation as a difficult month for global stock markets. Investor's appetite for risk was depressed due to uncertainty around the election and better-than-expected economic data, which raised the odds the Federal Reserve will increase interest rates in December. Falling oil prices also weighed on stocks as negative sentiment regarding OPEC's failure to commit to production cuts outweighed the supportive impact of declines in U.S. crude inventories. For the month, larger-cap stocks down 1.8% and small-cap stocks were down even further at 4.8%. Interest rate sensitive sectors such as telecom services and REITs were among the biggest decliners.

European stocks declined 3.5% for the month. Investor uneasiness over the extent of future European Central Bank stimulus was one factor driving European stocks lower. Concern over a "hard Brexit," with the United Kingdom losing trading access to the E.U. single market, was another. British Prime Minister Theresa May's tough rhetoric on reducing immigration and reining in the Bank of England's accommodative stance on interest rates ratcheted up these fears. The

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British pound sterling suffered major declines during October, tumbling to a low of \$1.22 versus the dollar by the end of the month. That eclipsed its initial post-Brexit low of \$1.33. Emerging-market stocks performed a little better, finishing the month up 0.3%.

Bonds followed the same trend as stocks, with investment grade bonds down 0.8% for the month. The yield on the U.S. 10-year Treasury jumped by nearly 30 basis points, ending October at 1.84%, up from 1.56% at the

start of the month. Firming economic data and the prospect of rising inflation, both key supports for interest rate increases, prompted the selloff. As we look forward to the rest of the year, below are some thoughts on the election, and our outlook for the floating rate loan and real estate investment trust (REIT) asset classes.

Thoughts on the Election:

Last week's dramatic presidential election result was a shock to the world and global financial markets. The initial reaction overnight led to large declines in Asian markets, the Mexican peso, and U.S. stock market futures as a Trump victory appeared increasingly likely. However, when the results became official a broad selloff never materialized and surprisingly U.S. stocks began to rally strongly. The biggest winners have been in the financial, industrial and healthcare sectors while more conservative sectors like utilities and staples have sold off sharply. As the dust settles from the election investors are turning their focus to the economic impact of the policies President-elect Trump put forward during his campaign. The key Trump proposals that may have the biggest impact on the economy are: substantial fiscal stimulus, tariffs and trade restrictions, and immigration. Below are a few comments on each:

Fiscal stimulus:

The proposed package includes \$400 billion of tax cuts (\$250 bn personal and \$160bn corporate) and large infrastructure spending (over \$100 billion). The spending may be a long-term positive for the U.S. economy, but would increase the budget deficit and debt levels substantially. The proposed tax cuts would likely be highly stimulative to the economy, but also inflationary. The financial markets have been quick to respond to these proposals with interest rates, inflation expectations and the dollar all moving higher.

Trade policy:

Trump has previously promised to withdraw and or renegotiate existing trade agreements such as TPP and NAFTA; and has threatened to impose tariffs of 35% on imports from Mexico and 45% on imports from China. These proposals reflect a shift towards more isolationist and protectionist policies, which would likely reduce efficiency and be a long-term negative for the U.S. and global economy. The worse-case scenario would be both higher inflation and slower economic growth that leads to stagflation. The impact to growth may be muted for developed markets that have

floating exchange rates, but may be a significant negative for some emerging market countries. Financial markets have been quick to respond with some EM currencies dropping sharply and EM stocks selling off as well.

Immigration:

Mr. Trump's immigration proposals are unclear, but are likely to substantially reduce the flow of immigrants into the country. Estimates are that some version of a nationwide "e-verify" system could limit the employment of 2.5 million immigrants. At this time, we don't know how many of his proposed immigration policies he will actually try, and be able, to implement. The answer to this question may have greater significance in social than in economic terms, however we expect any restrictions on immigration to be a net negative for the economy.

In the coming months, we will see how policy proposals from the Trump campaign platform are translated into tangible plans. Until that time we expect continued volatility and uncertainty, giving us greater insight into the long-term impact of policy changes on the economy and our investment decisions. In the near-term, our strategy is to remain disciplined in the execution of our investment process and take advantage of downside volatility to opportunistically purchase assets that have attractive valuations and prospects, and will seek to sell into strength when markets overreact to the upside. In fixed income we have been utilizing strategies that can perform well in a rising rate environment and protect against higher inflation. In equities, we are seeing a rotation into value oriented strategies and positions that will benefit from a stronger economy and higher interest rates, such as the industrial and financial sectors. Areas that warrant some caution in the near-term are bond proxy stocks that may be hurt from rising interest rates and select emerging markets that are negatively impacted by currency and trade shifts.

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Outlook for Floating Rate Loans

The asset class has performed well this year and we view it as a potential hedge against higher interest rates and a good portfolio diversifier. For example, in October they gained 0.8% which was especially strong when compared against investment-grade bonds, Treasuries, and equities, each of which was in negative territory for the month. While opportunity remains, there are risks, but our base case continues to be that floating-rate loans will outperform core bonds over the next five years. Below are the main issues impacting our expected return estimates.

Positives

- Lower-rated issuance has been low this year.
- Continued low-cost refinancing activity is healthy for long-term fundamentals (though this results in a lower yield for the overall asset class).
- There have not been any large leveraged buyouts with high leverage ratios (e.g., 7x) and low cash flow coverage (below 1.5x).
- Investors' near-term demand for loans has been improving (there have been 13 consecutive weeks of inflows), driven by expectations for higher rates and still-low global bond yields.
- Collateralized loan obligation (CLO) issuance is picking up, which is supportive of prices, but it is still down from 2015 levels. (We suspect many issuers are trying to bring new CLO deals to market before new year-end regulations kick in).
- Low default rates are likely to persist given the benign maturity profile through 2018—economic conditions seem supportive of credit. Additionally, the floating-rate loan asset class has relatively little exposure (roughly 4%) to the troubled energy-related sectors, compared to high-yield, which has low-teens percentage exposure to these sectors.
- Higher LIBOR rates incrementally benefit higher-quality BB-rated loans with 75-basis-point floors.

Negatives

- High loan prices have very little room to run (approximately 55% of loans trade above par, a 16-month high). Once more than 50% of loans trade above par, refinancing activity usually picks up.
- Covenant-light loans have made up 60%–65% of year-to-date issuance. That is the highest level since 2010, but it's not necessarily a big negative.
- The number of dividend deals, where issuers take advantage of excess liquidity to pay dividends to equity holders, are increasing.
- Debt-to-trailing 12-month EBITDA ratios are increasing and are now slightly above their eight-year average.
- Aggregate cash flow coverage ratio has been declining of late but remains above its 11-year average.

The Bottom Line

The performance floating rate debt has been strong year-to-date, which slightly reduces our expectations for forward returns. Although we still think returns will outperform those for the core bond index over the next few years in flat- to rising-rate scenarios (or if rates decline moderately). Expectations for returns in the mid-single-digit are reasonable and compare favorably to core bonds. In negative environments we think downside risk can be in the low single digits. We view any exposure to floating rate loans as a complement to core investment grade bonds and not a replacement due to their higher risk profile.

Outlook for REITs

Real estate investment trust (REIT) operating fundamentals continue to look fairly positive. According to Litman/Gregory: demand persists and continues to outstrip supply in many property types with occupancies near peak levels in the low to mid-90% range; core funds from operations have decelerated a bit recently into the mid-single digits but remain healthy; balance sheets in aggregate seem to be in good shape; average payout ratios are in the mid-60% range, below the 72% average; and dividend growth is in the upper single digits. Meanwhile, credit remains available to REITs at historically low interest rates.

However, the valuation of REITs look stretched even after the recent pullback. Forward adjusted funds from operations multiples are near peak levels, dividend yields are well below the historical average, going-in cap rates (returns based on the ratio of the first year of net operating income to the property purchase price) remain at historically low levels in the low 6% range compared to the low 8% average over the modern REIT era that started in the early 1990s. This lower cap rate is not too surprising given today's low interest rate environment. We're seeing investors accept lower yields across several asset classes. In recent years, property values have continued to increase, but they now seem to be slowing. So while fundamentals are generally healthy, many REIT valuations have become pricey relative to historical averages, and we view the asset class as fairly valued to expensive.

The other piece of the puzzle is our concern about rising rates. While we think fundamentals ultimately drive performance, our sense is that REIT valuations have been driven to elevated levels by what we think might be transient capital, given the global search for yield and the perceived safety of the asset class. REITs' interest rate sensitivity in this low-rate environment is a concern. We are holding off making any tactical allocations to REITs at this time, however we would view any significant sell-off as a potential buying opportunity.

--AWM Investment Team (11/16)