Reasons for Optimism and Risks to be Aware Of in the Second Half of 2017

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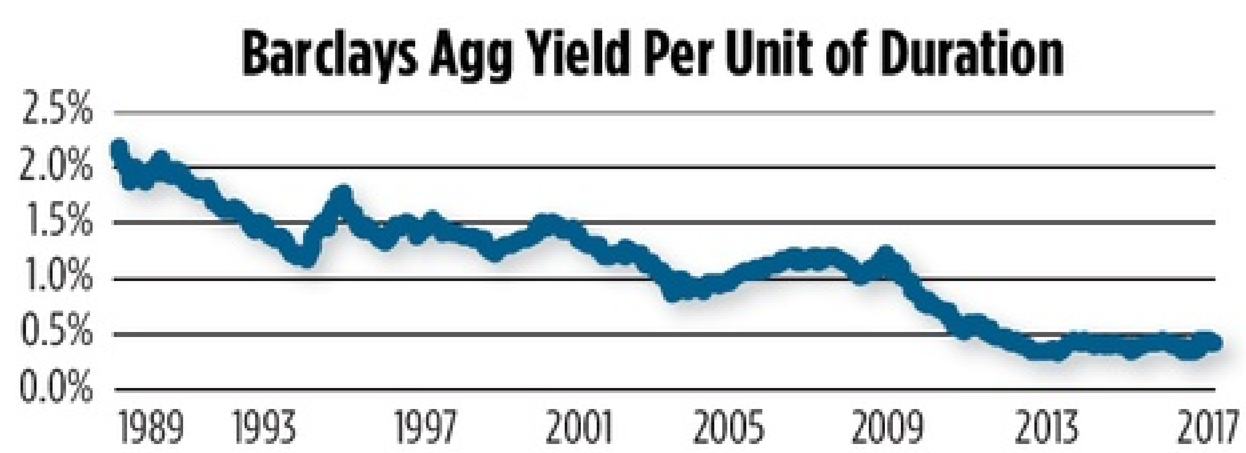
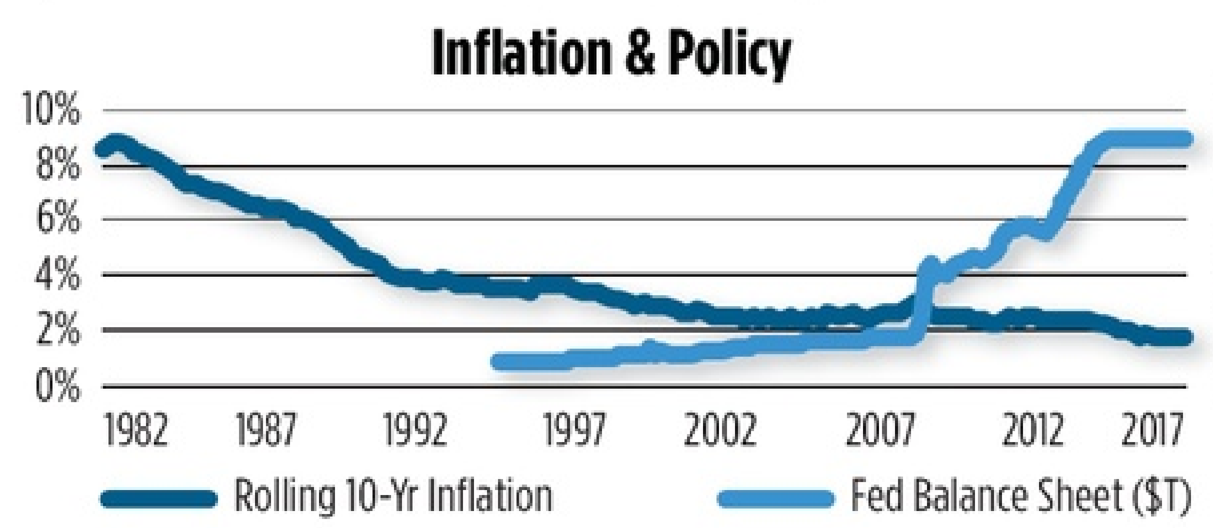
Halfway through 2017, economic and financial conditions in the US paint a mixed picture. Solid equity market returns, low unemployment, a growing economy and low inflation point toward financial and economic health and offer reasons for optimism. Other indicators, however, sit near the high or low end of their longer-term ranges; reversion to their respective means would have significant implications for investors:

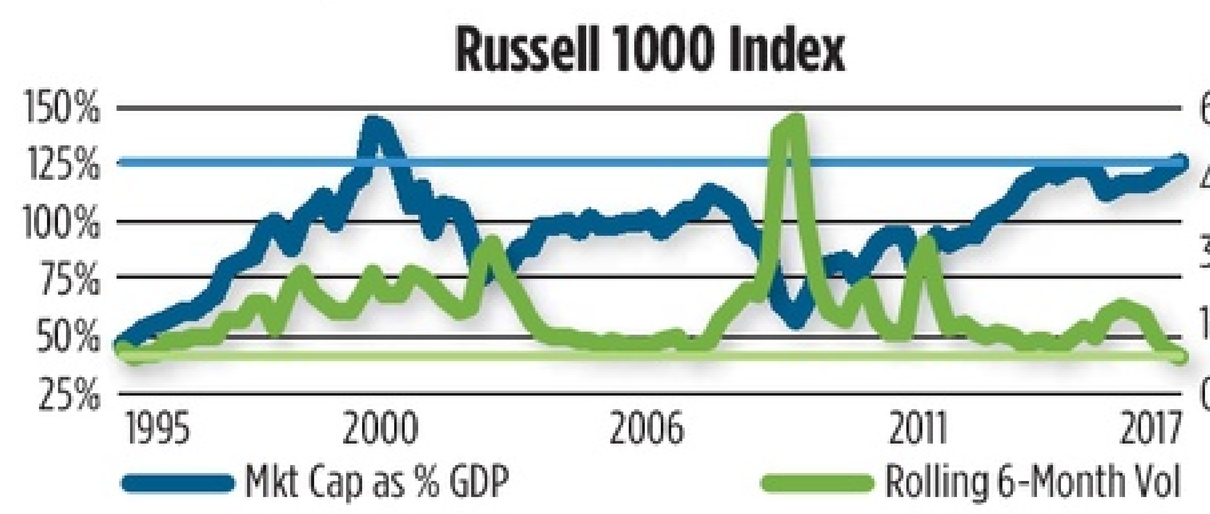
- The yields investors are earning for the interest-rate risk they're taking remain historically low:



- By offering cheap and easy access to money, the Federal Reserve has arguably never been more hospitable to banks, yet inflation has remained stubbornly low:



- Equity market valuations sit at the high end of their range, while volatility hovers at the low end:



We believe these skewed conditions are largely attributable to the extraordinarily accommodative monetary policy of the post-crisis era. In the second half of 2017, all signs point to a measured and deliberate departure from this policy regime. In addition to gradual increases in short-term rates, the Fed has formulated a plan to reduce the size of its balance sheet, both in an effort to tighten policy.

If excessive monetary accommodation has indeed been the source of these skewed financial and economic conditions, then its removal may well be expected to coincide with their return to levels associated with more neutral policy. We believe this has implications investors should be mindful of:

- High levels of interest rate sensitivity would be painful for bond investors as rates revert from historically low levels to historical averages.
- Higher inflation would further diminish bond values and be another source of performance drag for bond investors.
- In carrying out its post-crisis policy, the Fed has also acted as an insurance policy against market losses, stepping in to reassure investors in the midst of market downturns and volatility spikes. This has arguably created a moral hazard risk that has resulted in lower equity market volatility and higher valuations. As the Fed extracts itself from this role as the market's backstop, volatility may well be expected to return and valuations to retreat.

We believe there will continue to be opportunities for investors to earn positive returns, but expect they'll increasingly come with higher volatility and deeper drawdowns. For investors who rely on their assets for income, mitigating volatility and drawdowns is critical to managing sequence-of-returns risk, which in turn is vital to extending portfolio life. In a context such as this, we believe having a plan in place for managing risk remains a cardinal component of managing wealth. ■

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