Strategic Spotlight - Ten for '15

Investment Strategy Group | Neuberger Berman | January 2015

As the U.S. potentially enters its sixth year of expansion, we are optimistic that its economy can continue on a steady trajectory throughout 2015. Indeed, we believe growth may be strong enough to prompt the U.S. Federal Reserve to raise rates for the first time in nine years. Elsewhere in the world, we believe the outlook is murkier as business cycles appear to be diverging and as many countries remain dependent on government policies for growth. From an investment perspective, we see more attractive opportunity in risk assets versus safe haven assets. However, we would emphasize that diversification and selectivity could become increasingly important, particularly as we expect volatility to rise alongside the Fed's tightening policies. As investors reassess their portfolios for the year ahead, we share our outlook and thoughts on what could be in store for global markets and economies.

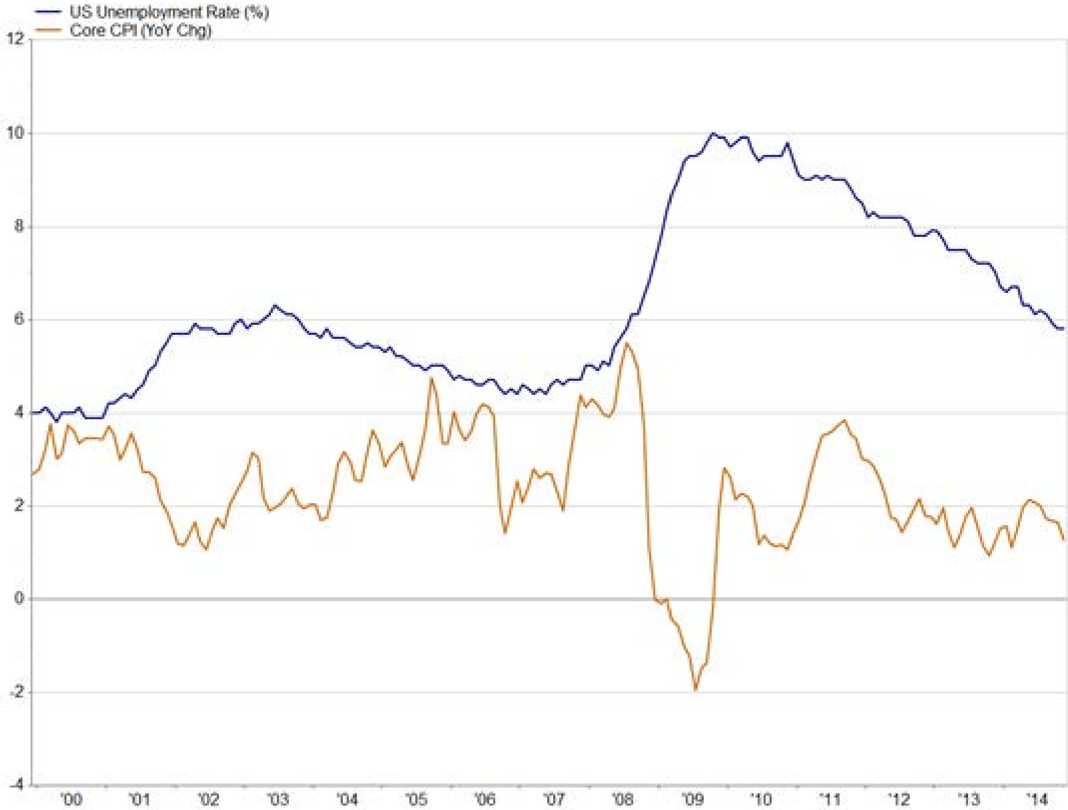
1. STEADY MID-CYCLE GROWTH IN THE U.S.

We expect typical mid-cycle behavior in the U.S. as growth should steady at around 2.5% to 3.0% over the full year. Improving employment rates and rising wages would support consumer confidence and result in stronger credit growth. The corporate sector should also continue expanding at a healthy pace as capital spending and corporate activity are expected to rise. Finally, we are optimistic that Washington, D.C., may find some common ground as declining deficits allows politicians to focus on other pressing matters.

2. BIFURCATING GLOBAL MONETARY POLICIES

As the unemployment rate and core inflation in the U.S. move closer to the Fed's targets, we anticipate that the Fed should hike rates in mid- to late 2015. However, we believe that rate hikes would be gradual as inflation remains fairly benign. Conversely, we expect central banks in Europe and Japan to loosen monetary policy to counter broadly weak growth and deflationary threats. The bifurcation in policy could continue to drive the U.S. dollar higher from here.

Figure 1: Declining unemployment and low inflation bode well for U.S. consumer



Source: FactSet, as of December 19, 2014.

3. NON-U.S. DEVELOPED ECONOMIES STUMBLE FORWARD

As we saw in 2014, growth in developed non-U.S. markets such as Europe and Japan continues to lag that of the U.S. We believe these economies remain highly dependent on stimulative fiscal and monetary policies and have not achieved the "escape velocity" needed to sustain long-term growth. Our base case remains that Europe and Japan will grind higher in 2015 but we are aware that policy missteps, such as a lack of resolve to fight deflation in Europe, could have painful consequences.

4. CONTINUED DIFFERENTIATION IN EMERGING MARKETS

Overall, we think that Asian economies will likely fuel emerging markets performance, while Latin America and Russia could struggle as they weather recessionary conditions. The Chinese government should continue implementing reforms in 2015, which could result in near-term volatility for Chinese equities. In all, we think that the changing dynamics in emerging countries bring both risks and opportunities. In our view, markets with stocks and bonds that are trading at low valuations which can successfully implement reforms could generate strong returns. As in 2014, we believe that selectivity will be crucial.

5. TREASURY YIELDS SHOULD RISE

Despite the decline of market rates in 2014, we believe an interest rate hike by the Fed in 2015 will contribute to an increase in the 10-year Treasury yield from its recent level of around 2% (as of January 5, 2015). Additionally, we believe that some factors that could result in a drop in yields this year (i.e., deflationary fears and a potential recessionary relapse in Europe) could reverse, particularly if the European Central Bank launches a large quantitative easing program, as many investors anticipate. As such, we think that safe haven bonds continue to be unattractively priced and are susceptible to rising volatility.

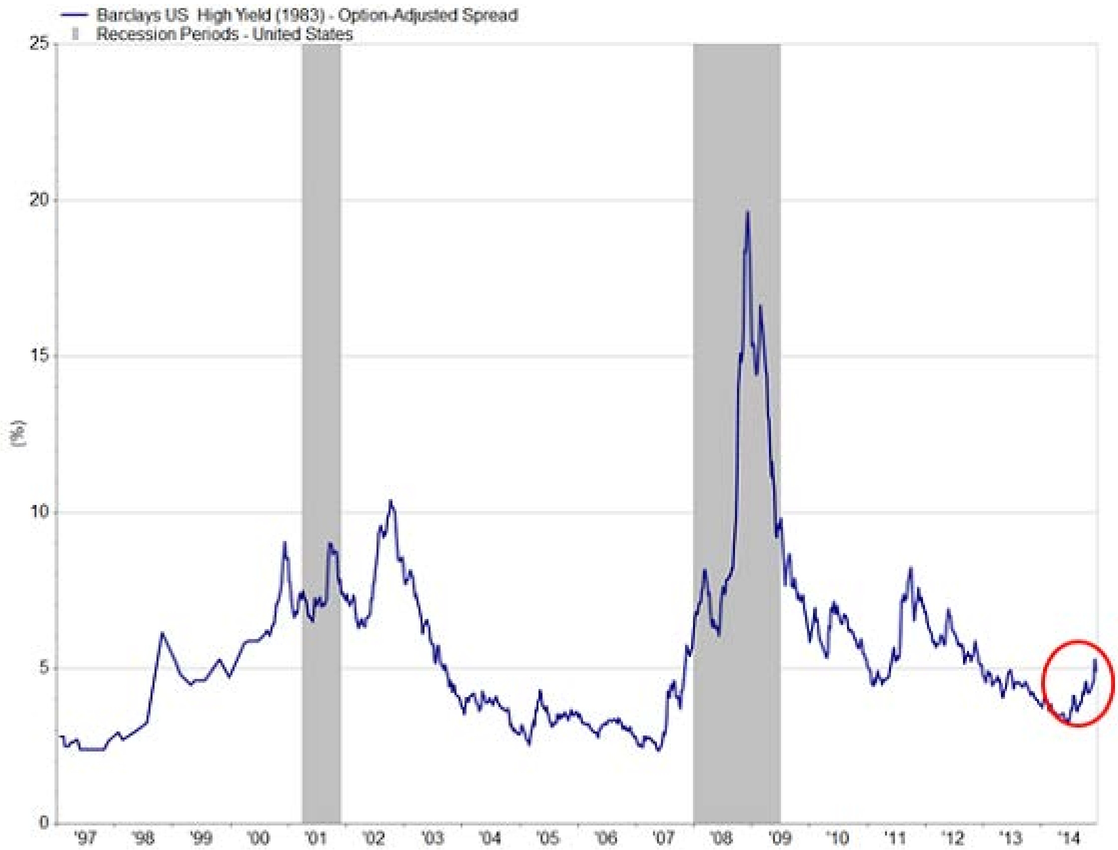
6. POSITIVE BUT MORE MODEST RETURNS FOR U.S. STOCKS

Given the strong appreciation in the S&P 500 over the past few years, U.S. equities appear to be trading closer to longer-term valuation levels. As the U.S. business cycle matures, we believe valuations could drift higher but we are aware that any disappointment in growth expectations might be a drag on returns. Overall, we anticipate earnings growth in the high single digits, but a stronger U.S. dollar could be a headwind. We believe there could be more opportunity in cheaper U.S. cyclical sectors than in defensive stocks should rates rise.

7. CREDIT STILL PRESENTS OPPORTUNITY

The rise in market volatility at the end of 2014 included substantial spread widening in fixed income securities such as high yield bonds and emerging markets debt (EMD). Despite well-founded fears that a sell-off in oil could hurt energy producing corporates and countries, we maintain that high yield and EMD remain resilient and that spreads should contract if default rates stay low. Nevertheless, the sell-off has highlighted the issue of liquidity, which could be a concern in some areas of the market = reinforcing the importance of selectivity in making investment choices.

Figure 2: U.S. High Yield Bond spreads relatively wide compared with mid-cycle lows



Source: FactSet, as of December 19, 2014.

8. EQUITY DIVERSIFICATION WILL MATTER

Over the past five calendar years, the S&P 500 has outperformed the MSCI Emerging Markets and MSCI EAFE three and four times, respectively. While it is tempting to just "ride the winner," we believe diversification continues to be important as valuations in non-U.S. markets remain lower and correlations between markets decline. (The forward P/Es of the MSCI EAFE and MSCI Emerging Markets are about 13.7 versus 16 for the S&P 500 Index.) Moreover, corporate earnings in non-U.S. markets remain well below peak levels compared to those in the U.S. - implying the potential for gains.

9. STABILIZATION IN COMMODITY PRICES

In our view, it is likely that commodities will begin to find a footing over the next several quarters as producers adjust production in response to lower prices. We believe oil in particular will stabilize as global supply/demand dynamics become more favorable and that prices should recover over time from the recent level of around$50 (WTI, January 5, 2015) but stay lower than in past years – which would be overall positive for global growth.

10. MARKETS REMAIN SUSCEPTIBLE TO GLOBAL SHOCKS

Although we are optimistic that the U.S. will continue on a steady growth trajectory, we believe that there are ample risks from abroad that could disrupt our relatively benign outlook of the global economy. Potential "tail events," whether tied to China growth, the Russia-Ukraine crisis, and agitation from North Korea or events in the Middle East, all bear watching. Overall, risk assets are trading at higher valuations and there is more consensus around growth and earnings predictions, making prices more susceptible to shocks.

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