

FIRST QUARTER 2017 – ASSET ALLOCATION

Refocus on Fundamentals and Risk

In our opinion, changing economic, market, and political conditions introduce more uncertainty into markets than in recent years. Essentially ever since the 2007-08 financial crisis, record-low interest rates have forced a single trade on investors—in favor of riskier, higher-yielding assets. But the market environment may now be changing. Given the heightened uncertainty and lack of compelling values in many markets, we are repositioning to our neutral weightings on stocks versus bonds for the first time in years.

Uncertainty the Watchword

Our forecast for economic and market conditions is characterized by a fairly high degree of uncertainty. One key unknown relates to the emergence of populist, anti-globalization politicians in the U.S. and Europe, who threaten potential trade wars and disruption of global supply chains. In addition, the health of economies from Europe to Asia remain in question, with deflation an ongoing concern in many of these countries. As a result, we expect an uneven move higher for the U.S. economy, rates, and inflation.

Neutral on Stocks

After being overweight equities more or less continuously since 2011, we're inclined to take some profits with stocks once again at record highs and return to a neutral allocation. Consider that bond yields are nearly one full percentage point higher today than they were in the immediate aftermath of the Brexit vote, when they hit record lows. As a result, we have been selling into strength in the stock market and buying bonds. This reflects the fact that both our fundamental and technical measures of stocks' attractiveness relative to bonds have deteriorated.

Within U.S. equities, we continue to favor growth over value stocks, in part because we see many value-oriented, dividend-paying stocks as overvalued as a result of the strong investor reach for yield in recent years. We also removed our bias to small stocks because we see their relative advantage in terms of earnings growth and valuations as less compelling relative to large stocks than in the past.

Bond Sell-off Creates Opportunities

The sharp sell-off in the Treasury market in the wake of the election is a reflection of the fact that Trump's pro-growth message means more spending (more bond issuance) and lower taxes (less revenue), leading to larger deficits. Both could result in higher rates and more inflationary pressure. Certainly, we expect more volatility, more uncertainty, and a wider trading range for bonds. Or said differently, we are witnessing a reflation trade. Under those circumstances, we have been adding inflation-adjusted securities, whose yield remain attractive relative to history. We remain underweight Treasuries in favor of corporate securities and select securitized bonds.

Active Management of Risk and Opportunity

Finally, it should be noted that we are firm believers in active portfolio management's ability to produce the desired financial outcomes for shareholders. This is particularly true in multi-asset portfolios, where decisions about risk management and asset allocation over time explain the lion's share of a portfolio's performance. What's more, research indicates that active strategies have historically performed best precisely when uncertainty prevails—when market volatility and dispersion of returns increase. Certainly, the ability to differentiate among individual stocks, industries, and sectors is one of the hallmarks of active management and can be particularly important at times of heightened uncertainty.



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Generally, as interest rates rise, bond values will decline. The opposite is true when interest rates decline.

The opinions expressed are those of Scott Wittman, CFA, CAIA, and are no guarantee of the future performance of any American Century Investments portfolio.

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