# NEPC 2021 MARKET OUTLOOK

## THEMES AND OPPORTUNITIES

January 26, 2021

BOSTON | ATLANTA | CHARLOTTE | CHICAGO | DETROIT | LAS VEGAS | PORTLAND | SAN FRANCISCO

# SPEAKERS

**Michael P. Manning, CFA, CAIA**
Managing Partner

**Phillip Nelson, CFA**
Partner

**Jennifer Appel, CFA**
Research Consultant

# AGENDA

1. NEPC Update
2. Markets in Review
3. Key Market Themes
4. Strategic Outlook
5. Perspectives on Inflation
6. Your Questions

# NEPC UPDATE

# ABOUT NEPC

## OUR GOAL IS TO BE THE "CONSULTANT OF CHOICE"

**328 Employees[1]**

**8 Regional Offices**

**Employees-owned**
**47 Partners[1]**

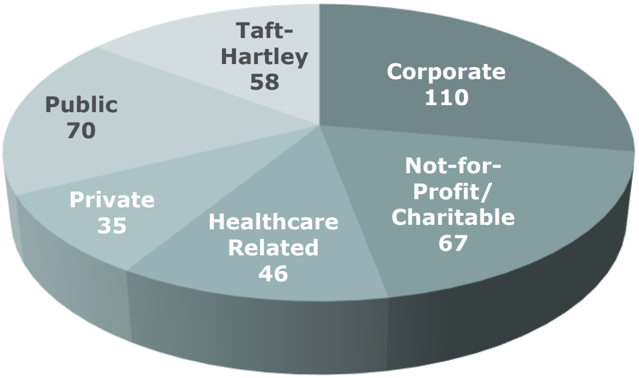
**100% of Revenue**
**advisory and discretionary consulting services**

**7 Practice Groups**
**deliver expertise by client type**

**395 Clients**

**$1.2 trillion**
**assets under advisement**

### Total Clients




[1]As of 1/1/2021. All other stats as of 10/1/2020, including 72 clients with discretionary assets of $39.5 billion.

# WHAT'S NEW FROM LAST YEAR

Client meetings

Manager due diligence

***VIRTUALLY***

**EVERYTHING!**

Client conference

Research connections

# FEEL SMALL BUT BE BIG

## FEEL SMALL

- Be flexible and customized in our partnership with you
- Dedicated segment experts to anticipate your needs
- Identify niche managers and investment ideas

## BE BIG

- Have deep resources at your disposal
- Benefit you by using our size for manager fees and access
- Share learnings and insights from all client segments

# NEPC UPDATE

| 3 NEW PARTNERS | 9 NEW PRINCIPALS | |
|---|---|---|
| Margaret Belmondo<br>Chenae Edwards<br>Judy Murphy | Rick Ciccione<br>Lynda Dennen<br>Will Forde<br>Ellton Thomaj | Scott Harsh<br>Andy Hone<br>Jesse Pricer<br>Alex Rapaport<br>Troy Saharic |

**Focus on enhancing the client experience**

- Negotiating manager fees
- ClientHub portal
- Increased research output – markets and client segments

**Continued efforts to improve DIVERSITY & INCLUSION**

- Increased meetings with diverse-owned managers
- Focus on improving representation and inclusion at NEPC

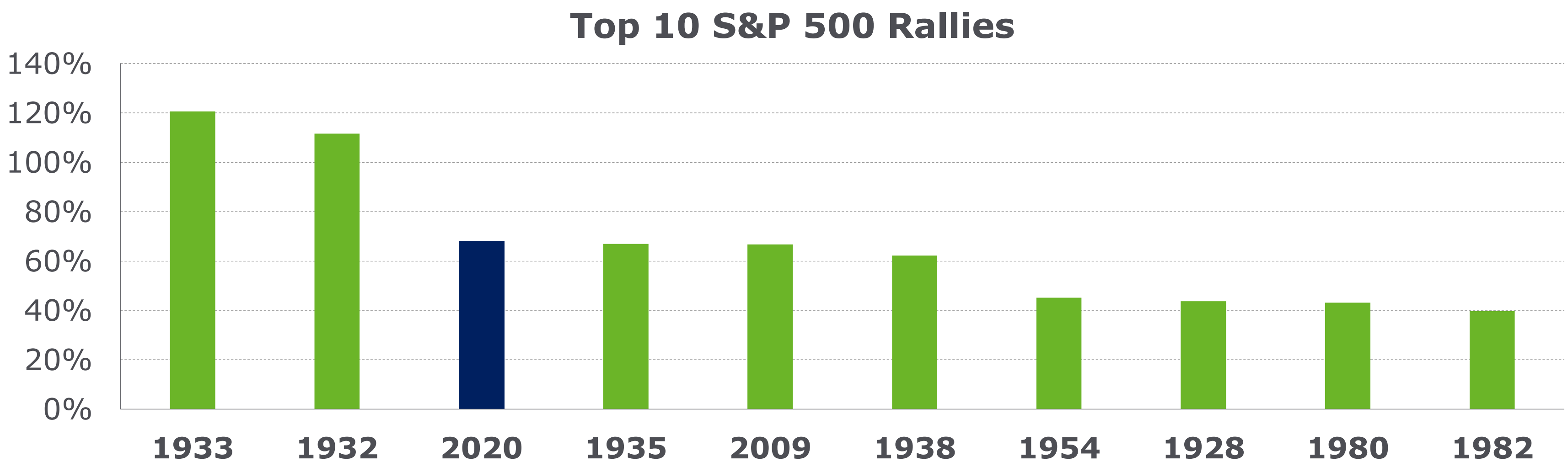
**Seeing increased interest in NEPC for all client segments & services**

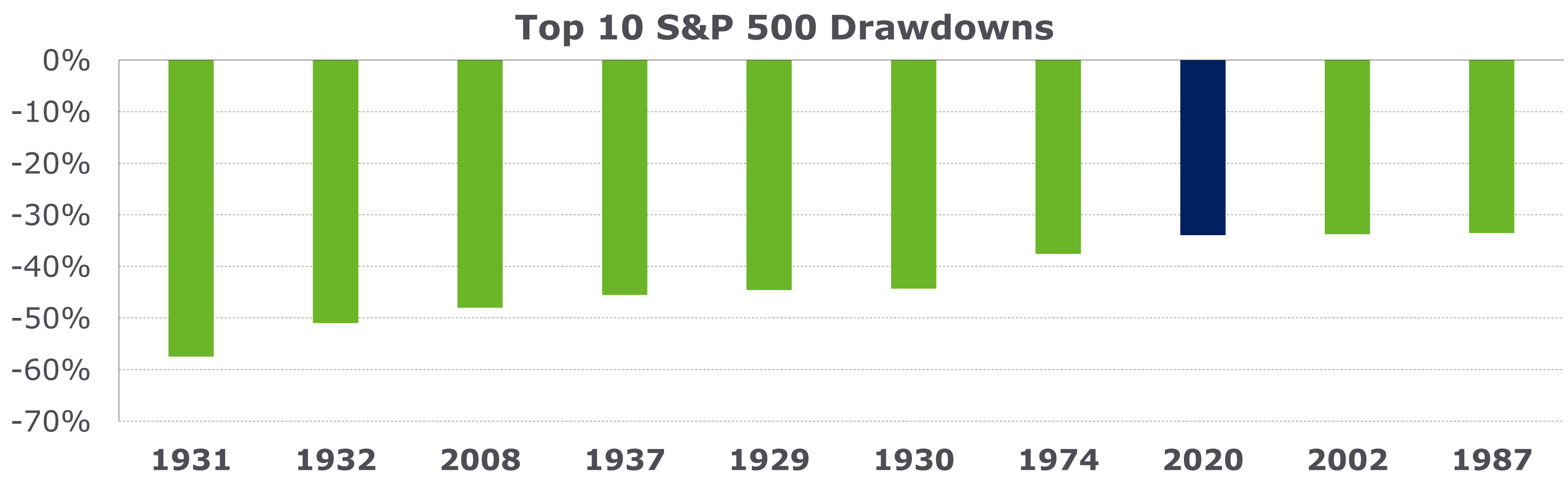
# MARKETS IN REVIEW

# 2020: CLEARLY THIS ISN'T THE FULL PICTURE


Source: S&P, Russell, MSCI, JPM, Bloomberg, FactSet

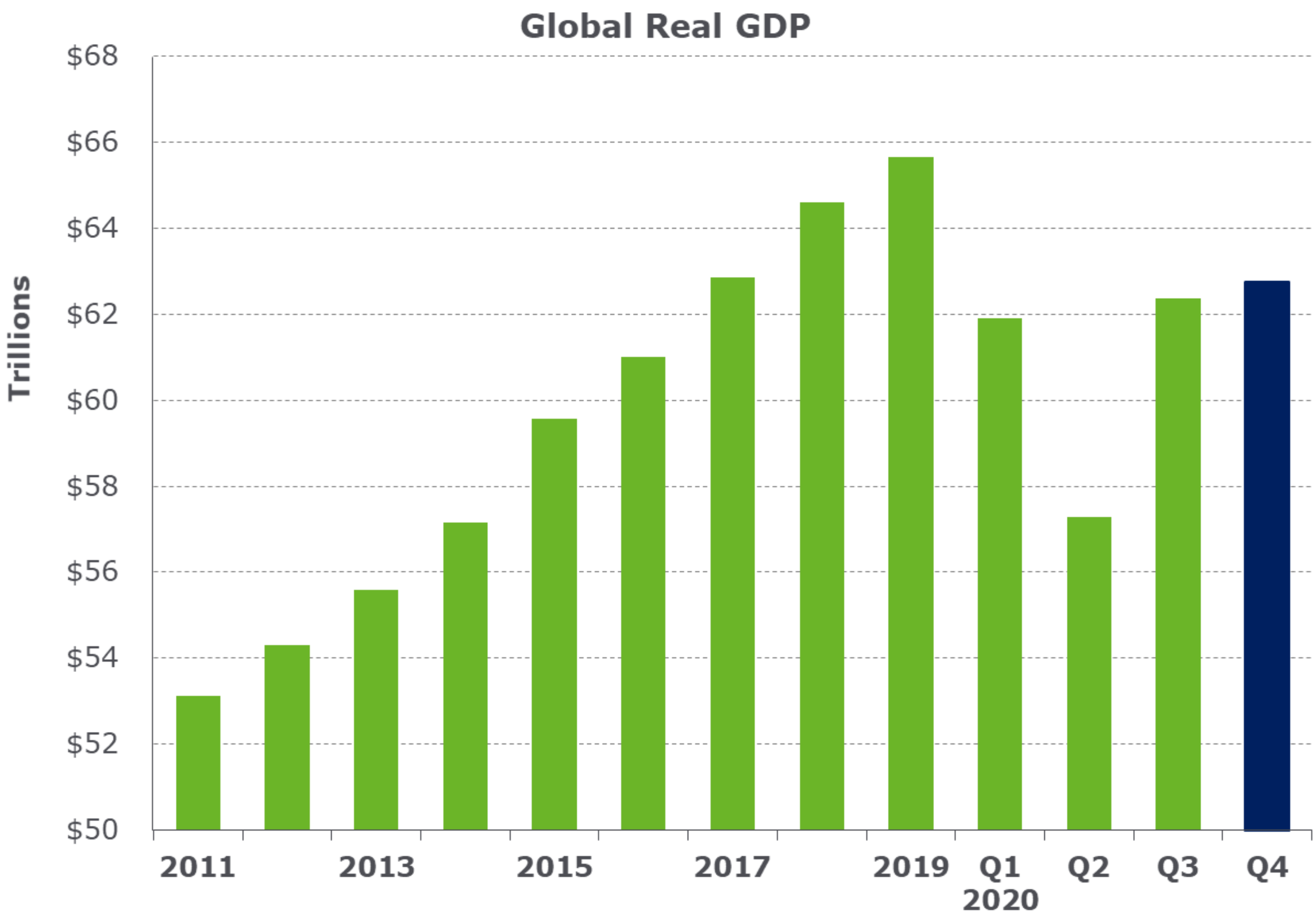
# MOST DRAMATIC EQUITY SWINGS SINCE 1932



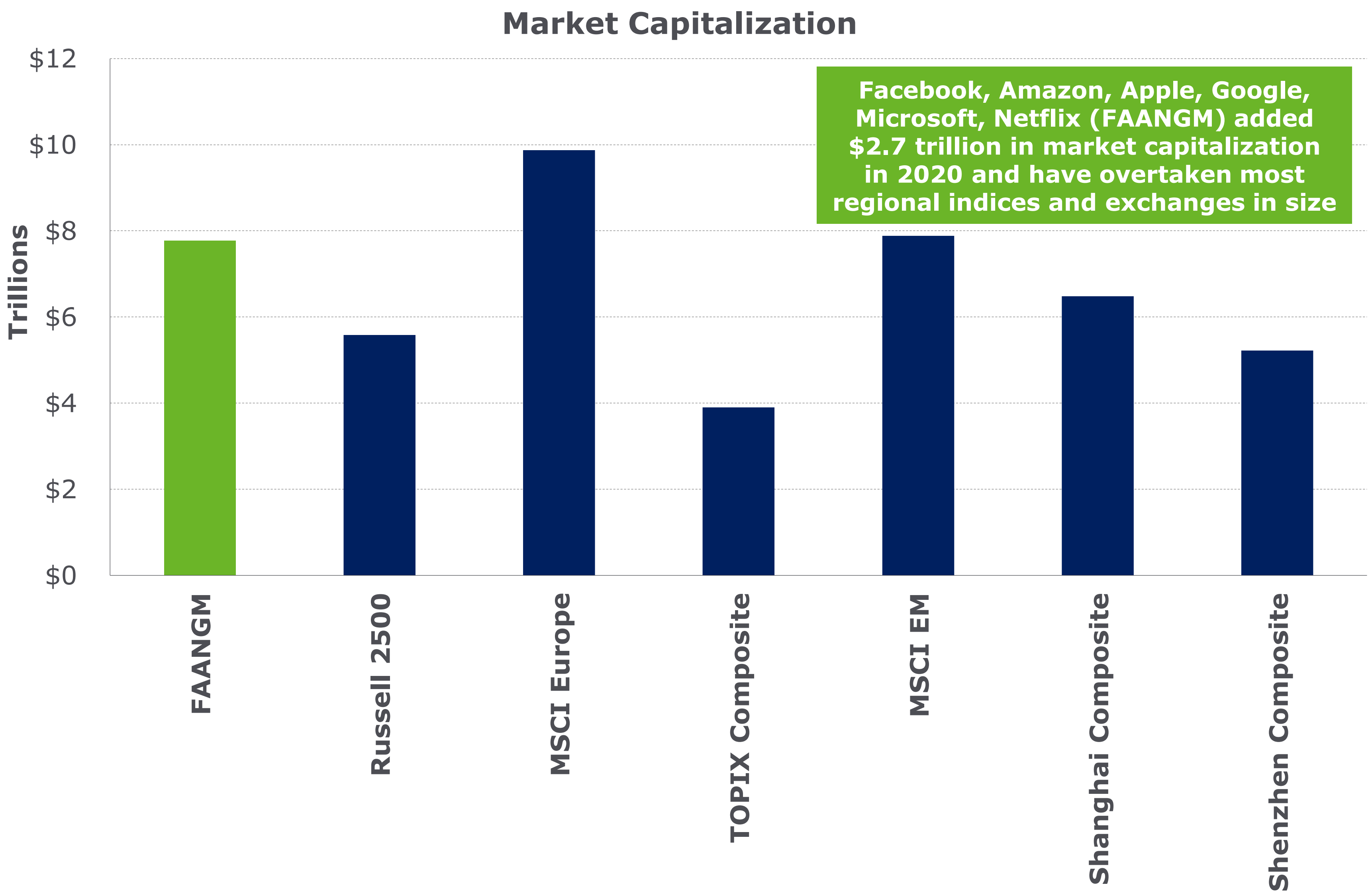

Source: S&P, FactSet
Rallies and drawdowns represent the largest trough-to-peak and peak-to-trough, respectively, within a calendar year

# THE WORLD ECONOMY SHRANK IN 2020




Q4 2020 real GDP figure represents IMF forecast for 2020. GDP figures are seasonally adjusted and chained to 2005 dollars.
Source: IMF, FactSet

# FAANGM IS LARGER THAN MOST INDICES




Source: MSCI, S&P, Russell, FTSE, DAX, CAC, TOPIX, SSE, SZSE, Hang Seng, TAIEX, KOSPI, FactSet

# KEY
# MARKET THEMES

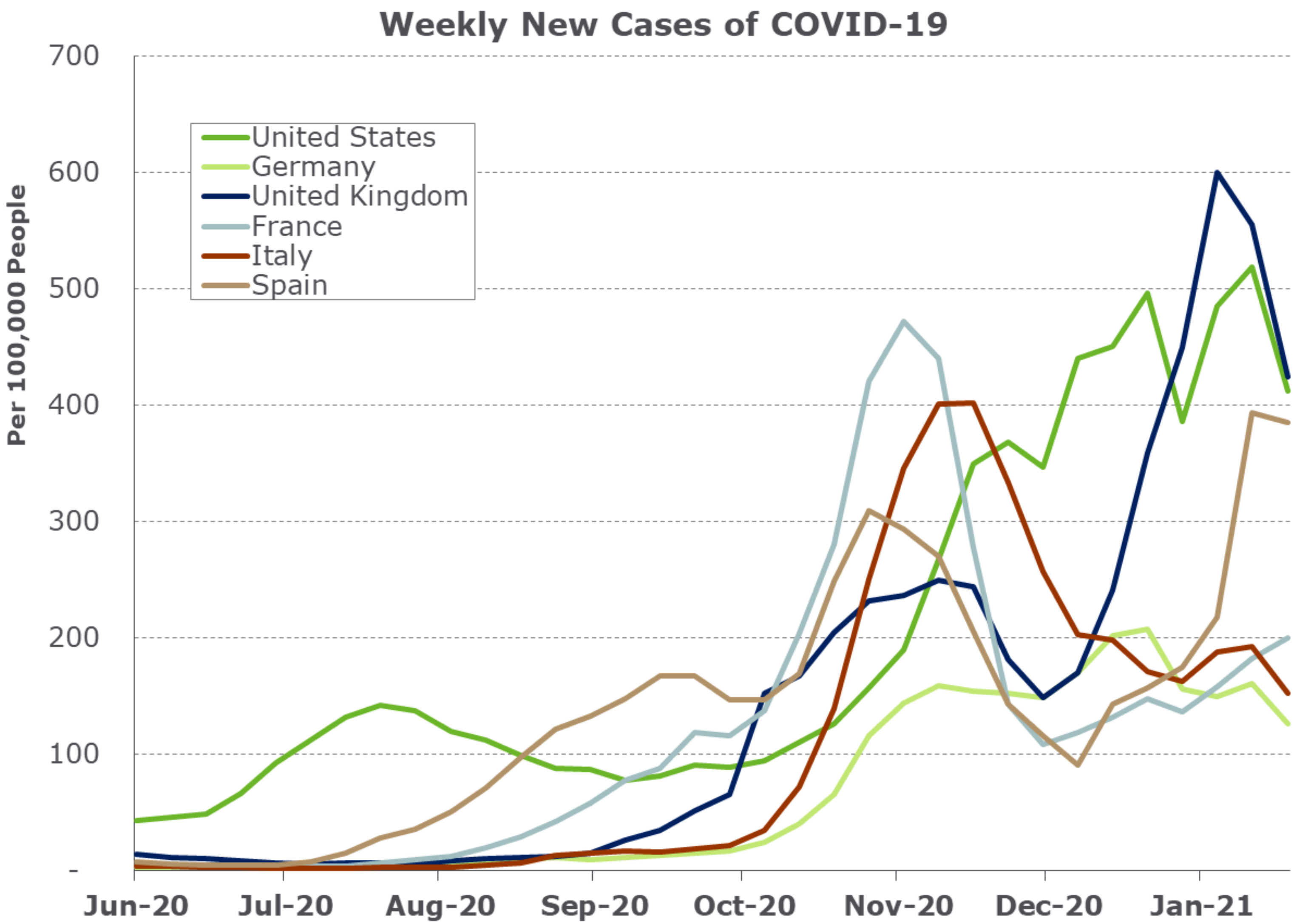
# NEPC KEY MARKET THEMES

- Key Market Themes are factors that influence global markets and remain relevant for an extended period
- Themes may be disrupted and incite market volatility
- The conclusion of a theme may alter market dynamics and NEPC's long-term market outlook
- Our intent is for clients to be aware of these themes and understand their implications for the capital markets

**NEPC currently has four Key Market Themes:**

1. **Virus Trajectory**
2. **Permanent Interventions**
3. **Globalization Backlash**
4. **China Transitions**

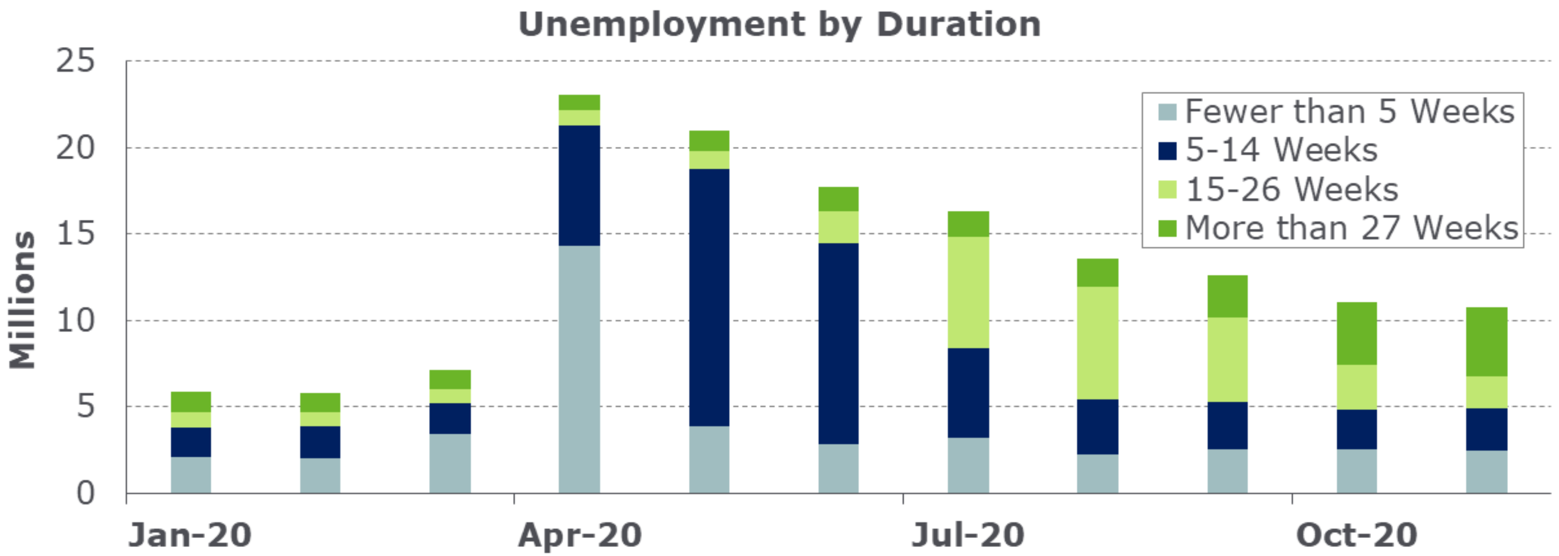
# KEY MARKET THEME: VIRUS TRAJECTORY




Source: World Health Organization, FactSet

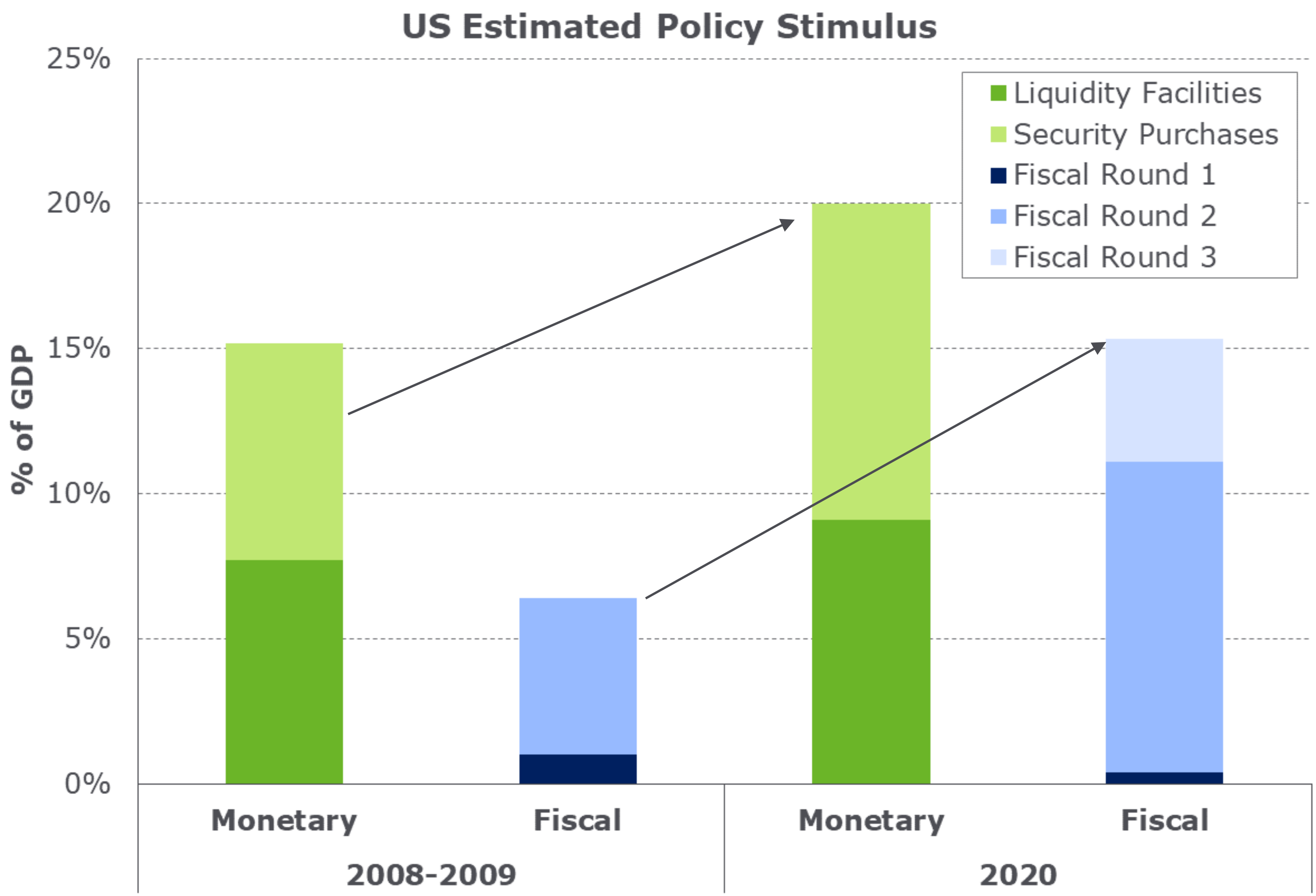
# KEY MARKET THEME: VIRUS TRAJECTORY
## THEMATIC MACROECONOMIC RISKS

- **Economic dislocation from the pandemic is widespread**
  - A rapid vaccine rollout can unleash economic exuberance aiding a rapid recovery and benefiting highly cyclical assets
- **The lasting influence of the pandemic is uncertain as the extent of the economic scars have yet to be fully realized**
  - Despite relative improvement in economic data, recent data points highlight lingering disruptions in businesses and the labor market




Source: Department of Labor, FactSet

# ELEVATED PERMANENT INTERVENTIONS

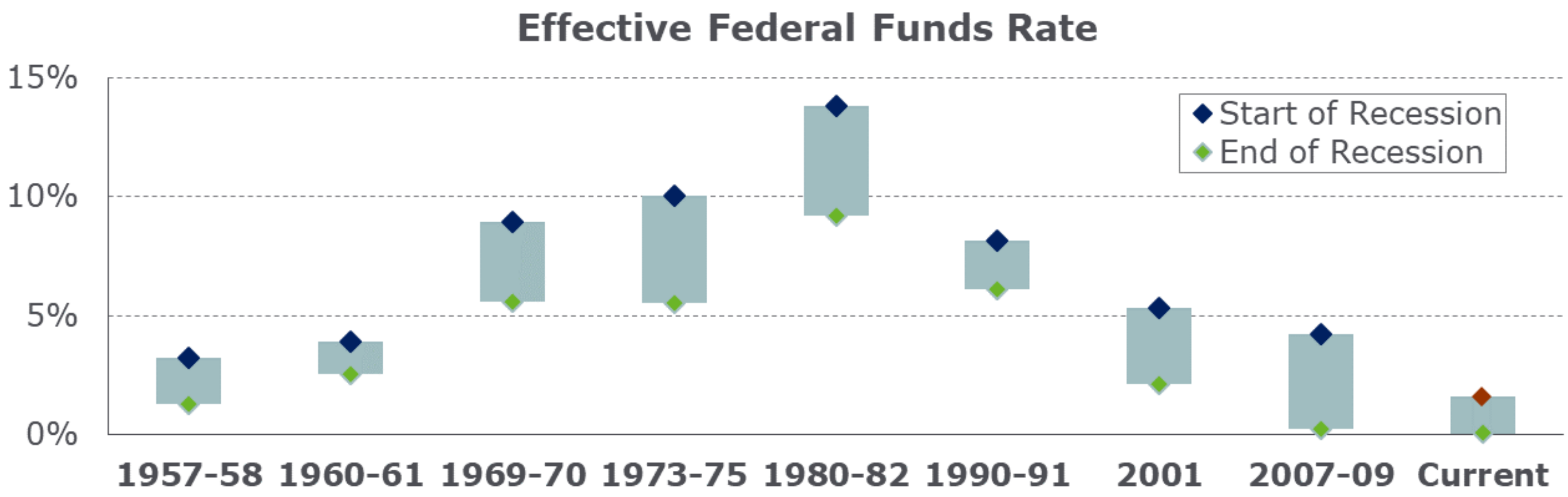



Source: NEPC, Federal Reserve
Fiscal Rd 1: 2008 – Economic Stimulus Act ($152B); 2020 – CPRSA/Families First ($91B); Fiscal Rd 2: 2008 – Am. Recovery & Reinv. Act ($787B); 2020 – CARES Act ($2.3T); Fiscal Rd 3: 2020 – Consolidated Appropriations Act ($900B)

# PERMANENT INTERVENTIONS

## THEMATIC MACROECONOMIC RISKS

- **Market sentiment is now a key central bank policy pillar of equal standing to inflation and employment mandates**
  - Without meaningful inflation pressures, the path of monetary policy does not normalize and an environment of low interest rates persists
- **Permanent Interventions sustains high P/E multiples and equity valuations become a less potent market signal**
  - Permanent Interventions gradually fuels tail-risks as moral hazard is absorbed into the financial system and markets nationalize losses
  - However, proactive tightening of monetary policy damages market sentiment and exposes the fragile nature of market dynamics




Source: FactSet, Federal Reserve

# STRATEGIC OUTLOOK

# ASSET ALLOCATION THOUGHTS AND ACTIONS

- Permanent Interventions **sustains positive risk asset sentiment** and boosts our return outlook

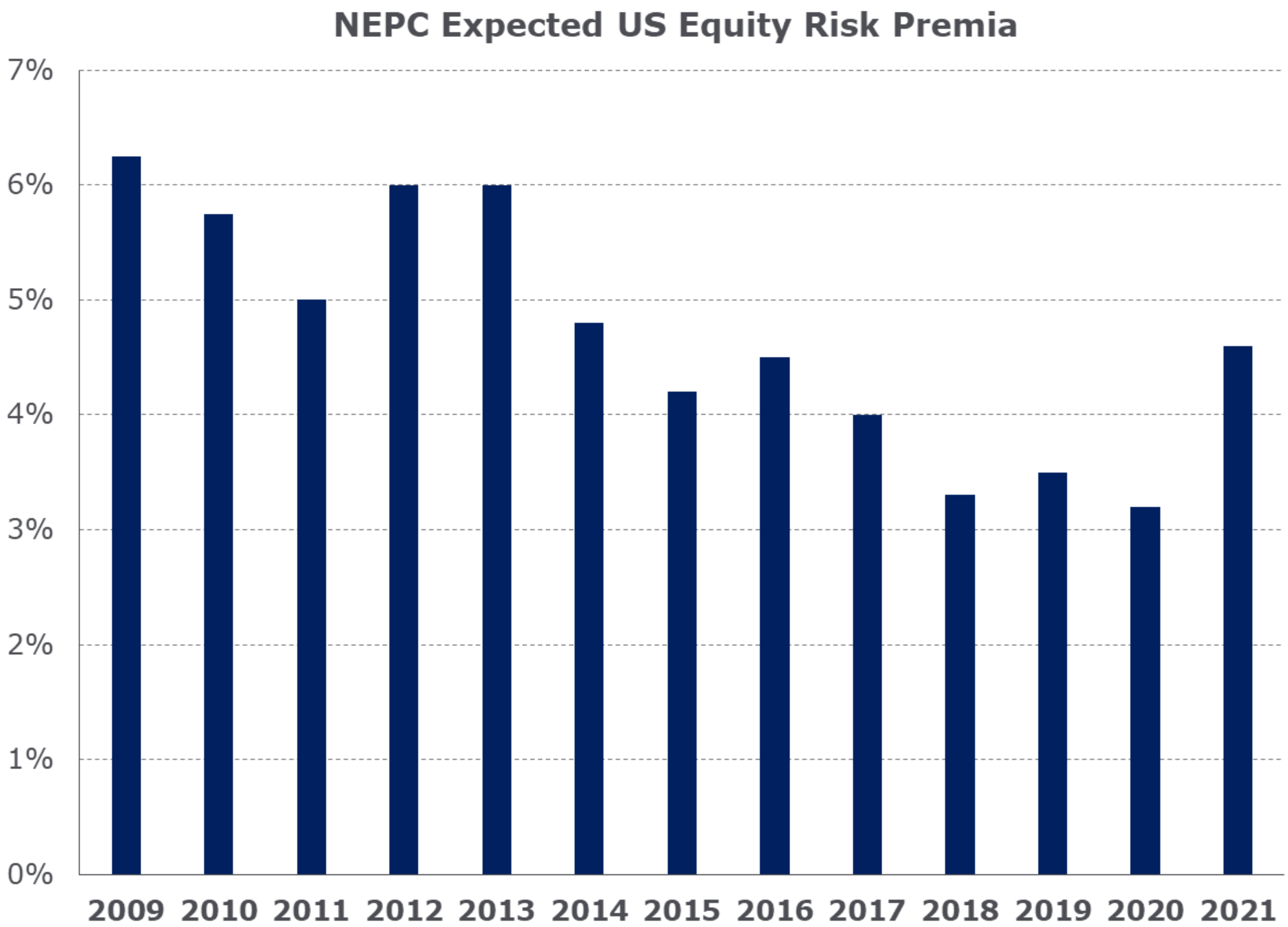
- Consider **higher strategic equity targets** as the long-term return differential relative to fixed income is wide

- **Maintain adequate portfolio liquidity** levels as market stress can inject bouts of illiquidity across public assets

- The **wide range of outcomes** associated with COVID-19 place a greater focus on strategic beliefs

- Maintain a **strategic allocation to Treasuries** to serve as a source of liquidity and to provide downside protection

# CONSIDER HIGHER STRATEGIC EQUITY TARGETS




Source: NEPC
Represents the difference between 10-Year NEPC US Large-Cap and Cash Assumptions
*Prior to 2019, return assumption reflected a 5-7 year time horizon

# PUBLIC MARKET EQUITY
## STRATEGIC VIEWS

- **NEPC recommends US equity exposure be held at a target of 60% relative to overall global equity exposure**

- **We encourage a strategic bias to emerging market equities relative to the MSCI ACWI weight**
  - The strategic overweight is designed to capture higher return expectations and growth potential in emerging Asia

- **EAFE large cap is the recommended funding source for the US and emerging markets overweight**

- **Investor risk-tolerance and illiquidity risk inform the use of active investment strategies and private equity**

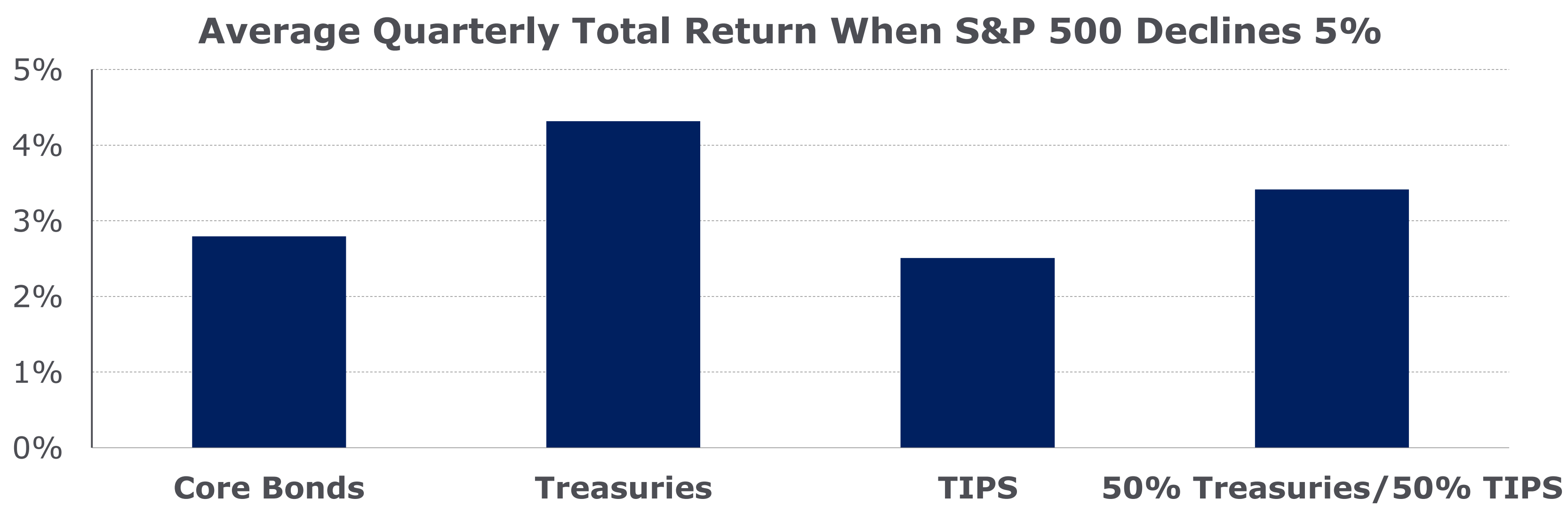
- **NEPC encourages a modest strategic bias to small-cap relative to exposure in the MSCI ACWI IMI**

# SAFE-HAVEN FIXED INCOME

## STRATEGIC VIEWS

- **Safe-haven fixed income exposure is a liquidity source and offers downside protection for the total portfolio**

- **The safe-haven liquidity profile is vital as market stress can impair the portfolio's ability to meet cash flow needs**
  - The inability to service capital calls, support spending needs, or rebalance in times of market stress limit the portfolio's future return
  - Sizing of the safe-haven exposure to support downside protection needs should reflect return objectives and investor risk tolerance

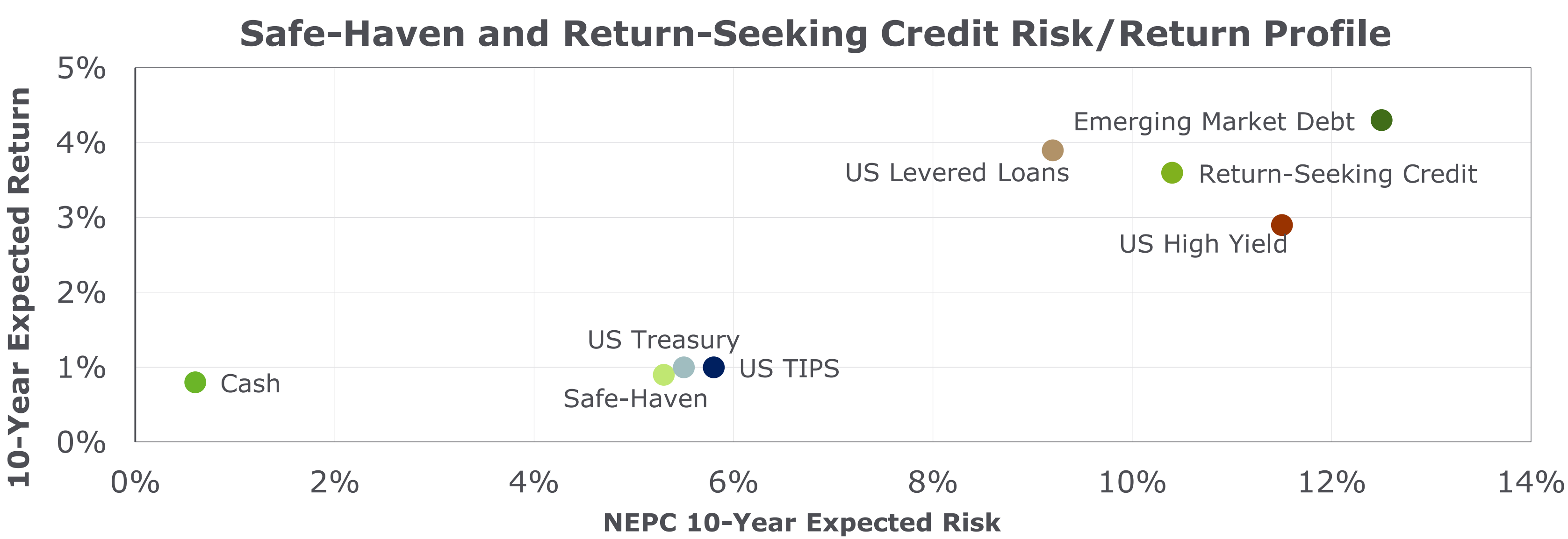



Source: Barclays, FactSet, NEPC

# RETURN-SEEKING CREDIT
## STRATEGIC VIEWS

- **We encourage investors to acknowledge the conflicting objectives of safe-haven vs return-seeking assets**
  - The goal of safety vs return are in conflict and the need for liquidity and downside protection can be overlooked when reaching for yield

- **We recommend investors create distinct strategic targets for safe-haven fixed income and return-seeking credit**
  - Separate strategic targets align the objective and benchmark for each mandate and highlight the role each play in a portfolio



# RETURN-SEEKING CREDIT
## STRATEGIC VIEWS

- **Return-seeking credit investments look to earn income and exploit credit spread changes across credit cycles**
  - Exposure can be adjusted relative to the peaks and troughs of credit spread levels and be an alpha source from active allocation shifts

- **Consider tracking error risk and assess the return opportunity for managers with unique credit expertise**
  - Helps to inform the implementation decision when identifying niche or opportunistic mandates that arise during the credit cycle

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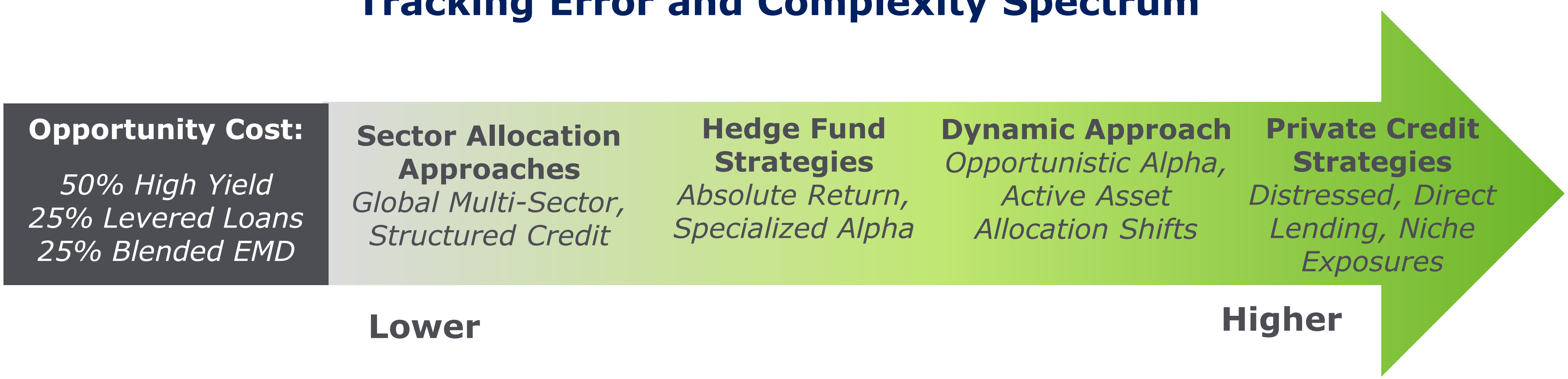
**Return-Seeking Credit**
**Tracking Error and Complexity Spectrum**



# ASSET CLASS ASSUMPTIONS OVERVIEW

**NEPC's capital market assumptions are available each quarter and currently reflect 12/31/20 market data**

- **Asset class returns are lower and reflect a wide range of outcomes related to the pandemic's economic impact**
- **Discounting future earnings with lower interest rates supports higher equity valuation multiples over time**
  - Price-to-earnings and profit margin multiples have been adjusted higher to reflect our Key Market Theme of Permanent Interventions
- **Credit return assumptions are lower as interest rates fall and credit spreads continue to tighten**
- **The strategic outlook for real assets reflect a high level of uncertainty due to subdued inflation expectations**

# ASSET CLASS RETURN ASSUMPTIONS

| | Asset Class | 2021 10-Year | 2020 10-Year | Annual Change |
|---|---|---|---|---|
| | Cash | 0.8% | 1.8% | -1.0% |
| | US Inflation | 2.0% | 2.3% | -0.3% |
| Equity | US Large-Cap Equity | 5.4% | 5.0% | 0.4% |
| | Non-US Developed Equity | 5.9% | 6.0% | -0.1% |
| | Emerging Market Equity | 7.5% | 9.0% | -1.5% |
| | *Global Equity** | *6.2%* | 6.2% | - |
| | *Private Equity** | *9.3%* | *9.4%* | -0.1% |
| Fixed Income | US Treasury Bond | 0.9% | 1.9% | -1.0% |
| | *US Aggregate Bond** | *1.4%* | *2.5%* | -1.1% |
| | US TIPS | 1.0% | 2.2% | -1.2% |
| | US High Yield Corporate Bond | 2.9% | 4.1% | -1.2% |
| | *Private Debt** | *6.1%* | *6.7%* | -0.6% |
| Real Assets | Commodity Futures | 0.9% | 4.0% | -3.1% |
| | Gold | 2.9% | - | - |
| | Core Real Estate | 4.4% | 5.2% | -0.8% |
| | Private Real Assets - Infrastructure | 5.4% | 5.9% | -0.5% |
| Multi-Asset | *60% S&P 500 & 40% US Aggregate* | *4.1%* | *4.3%* | -0.2% |
| | *60% MSCI ACWI & 40% US Aggregate* | *4.3%* | *4.4%* | -0.1% |
| | *Hedge Fund** | *4.0%* | *5.0%* | -1.0% |

*Calculated as a blend of other asset classes

# PERSPECTIVES ON INFLATION

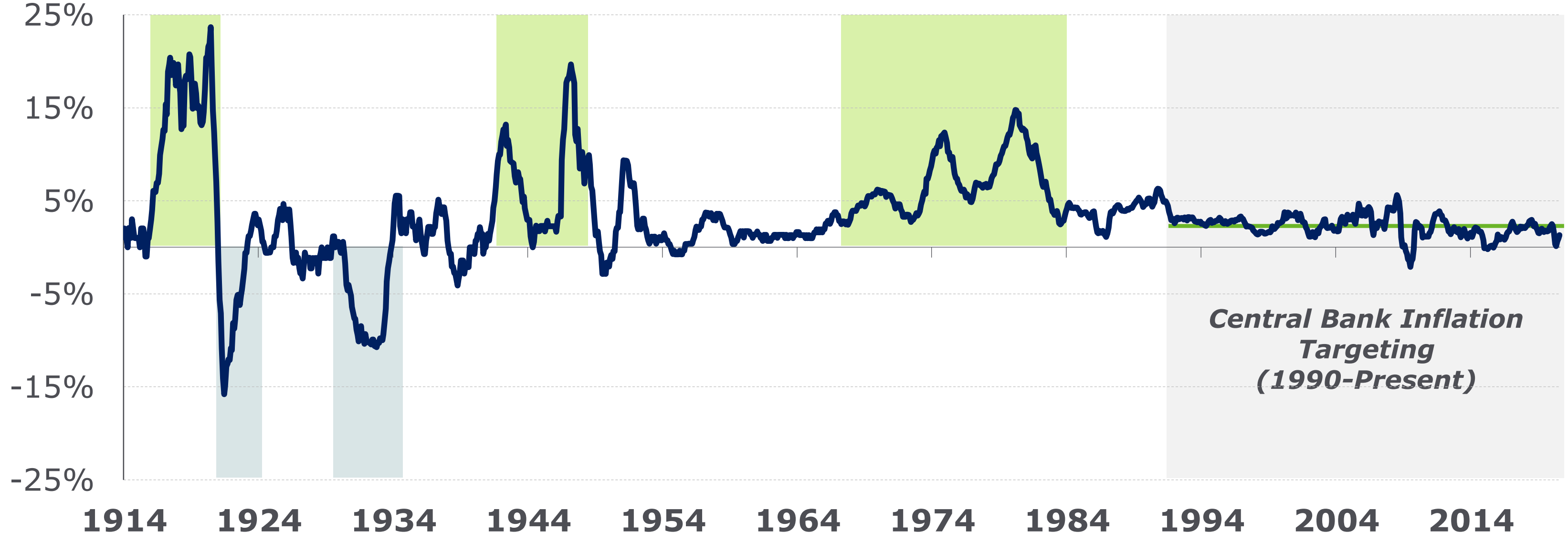
NEPC, LLC

# INFLATION OVERVIEW

- **Inflation is a key risk for investors that can impact progress toward long-term goals and objectives**

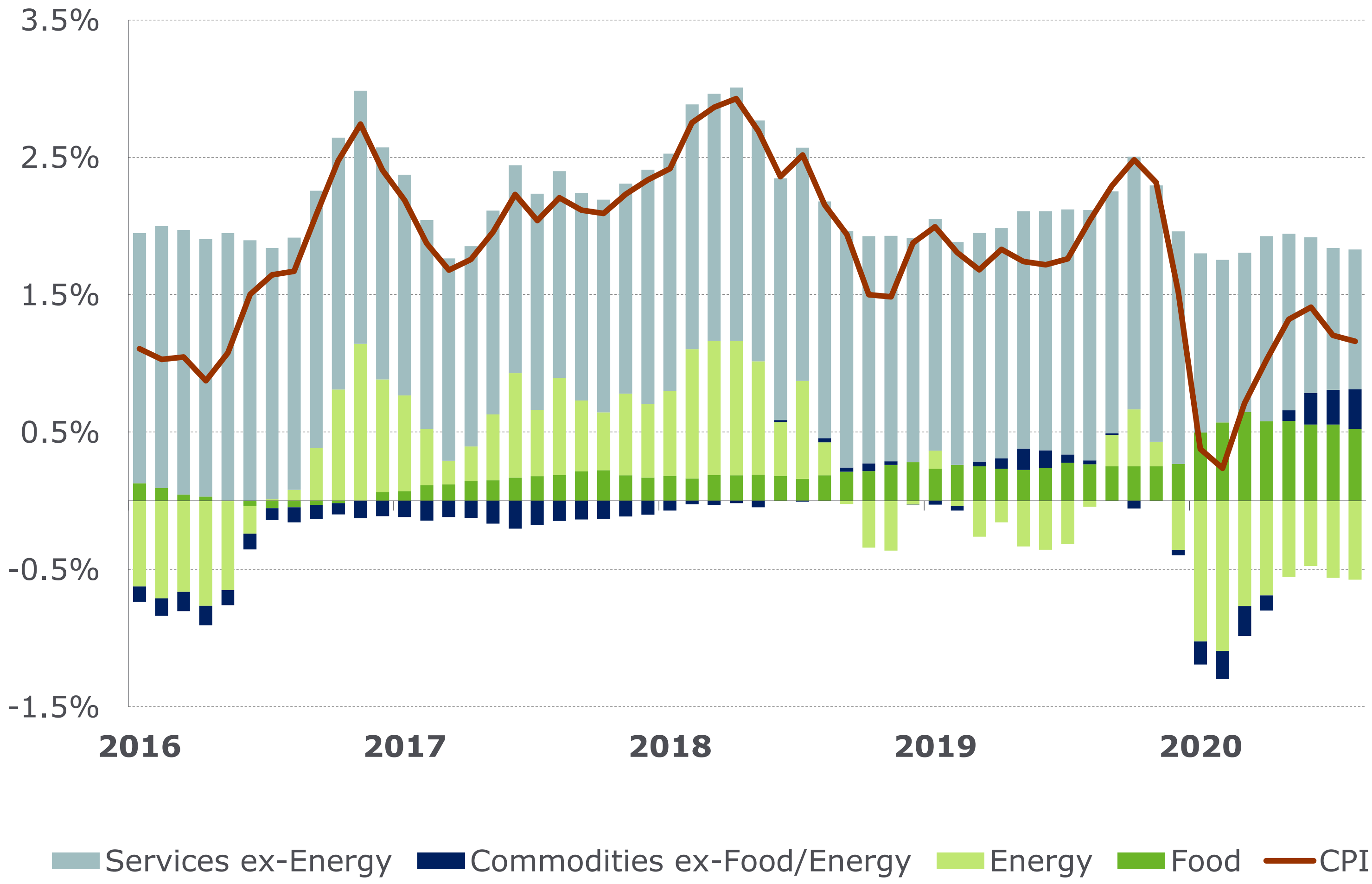
- **Market expectations have anchored to a low inflation environment over the long-term**
  - This dynamic makes an inflation surprise a key risk for asset pricing

**Annual US CPI-U**




Source: Bureau of Labor Statistics, FRED, FactSet, NEPC;
Data through 11/30/2020

# MAJOR COMPONENTS OF THE CPI-U




Source: Bureau of Labor Statistics, FactSet, NEPC; as of 11/30/2020

# WHY DOES INFLATION MATTER?

- Determines Real Savings and Real Returns
- Impacts Borrowing and Lending Dynamics
- Informs Monetary and Fiscal Policy
- Effects Business Competitiveness
- Influences Investment Returns and Expectations

# THEORETICAL CAUSES OF HIGHER INFLATION

**Fiscal and Monetary Stimulus**

**USD Devaluation**

**Vaccine**

**Globalization Backlash**

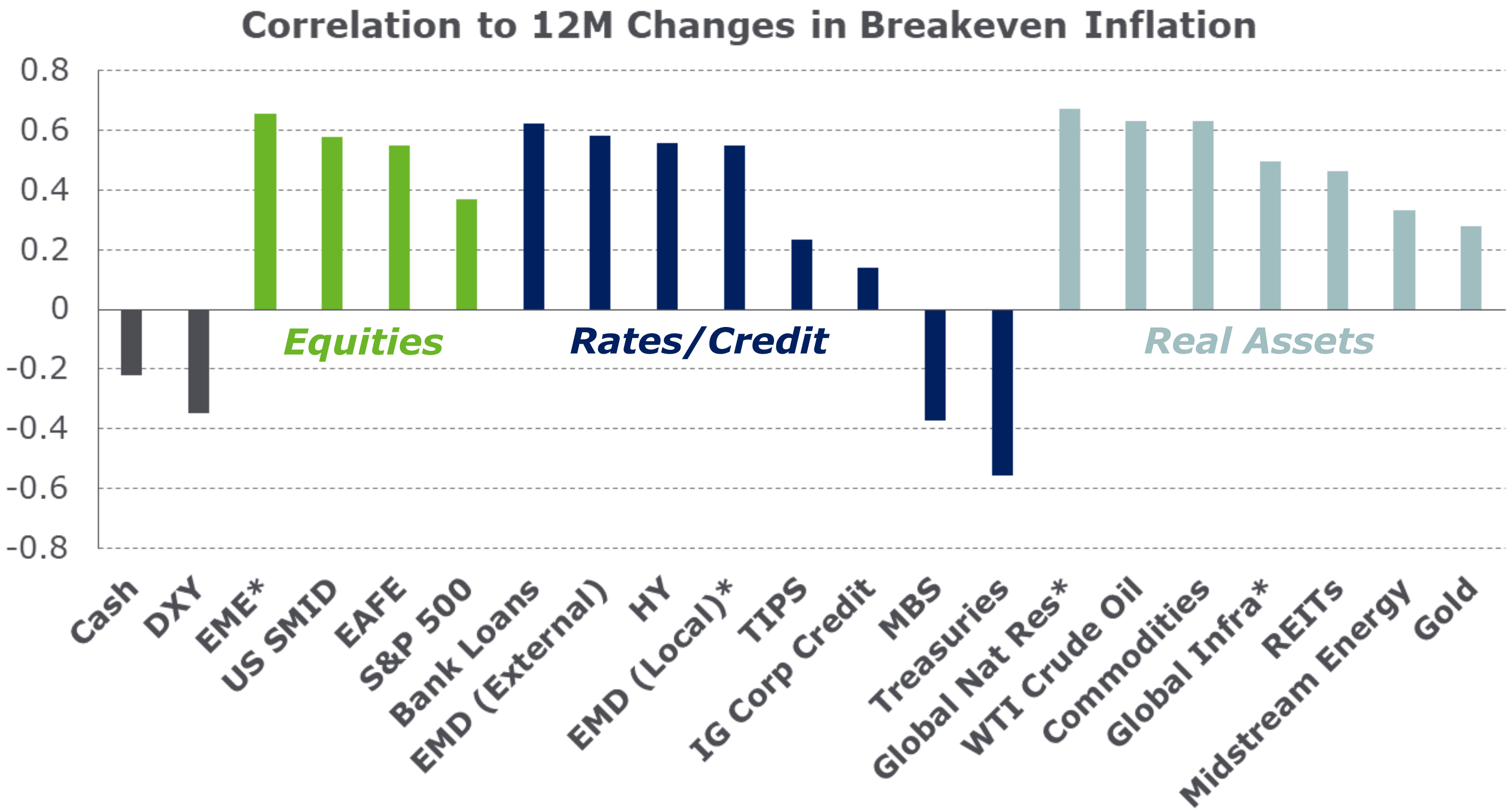
**Energy Price Rally**

**Fed Inflation Framework Adjustment**

**“Healthy” Economic Inflation**

# ASSET CLASS INFLATION SENSITIVITY

- **Most asset classes exhibit some sensitivity to inflation, though the magnitude of the price reaction will vary**
  - Real assets generally exhibit the broadest inflation sensitivity, with positive correlation and positive betas to changes in inflation




Source: S&P, MSCI, JPM, Barclays, Alerian, FactSet, NEPC; correlations calculated 1997-2020
*Denotes shorter time frame for correlation calculation: EME 1999-2020; EMD (Local) 2002-2020; Global Infra 2001-2020; Global Nat Res 2002-2020

# ANALYZING VARIOUS INFLATION REGIMES

- **There is no perfect inflation hedge as the growth, interest rate, and inflation backdrop dictate asset class behavior**
- **Economic regime changes are disruptive and unpredictable**
  - Investors should consider a diversified approach in portfolio construction that balances risks arising from various regimes

| Sharpe Ratios by Regime | US Large Cap | US Treasuries | TIPS | Commodities | Gold |
|---|---|---|---|---|---|
| **Full Data Set (1970)** | 0.374 | 0.430 | 0.505 | 0.135 | 0.160 |
| **Defensive - Falling Inflation** | -0.128 | 0.876 | 0.167 | -0.544 | 0.228 |
| **Defensive - Rising Inflation** | -0.827 | -0.114 | 0.896 | 0.686 | 0.915 |
| **Neutral** | 0.483 | 0.438 | 0.360 | 0.087 | -0.188 |
| **Growth - Falling Inflation** | 1.566 | 1.175 | 0.634 | 0.218 | 0.007 |
| **Growth - Rising Inflation** | 0.616 | -0.272 | 0.448 | 0.515 | 0.280 |

Source: S&P, Barclays, FactSet, NEPC

# INVESTMENT IMPLEMENTATION THOUGHTS

- **NEPC’s inflation path reflects higher inflation relative to market pricing, but does not call for “high” inflation**

- **Inflation exposure should be determined by an investor’s risk tolerance and inflation vulnerability**
  - There is no “perfect” inflation hedge that is suitable for all investors

- **Resilient asset allocation should include exposures to both inflation-hedging assets and safe-haven assets**

- **Inflation can disrupt the Permanent Interventions theme and central bank support**

# QUESTIONS?

# QUESTIONS?

While we answer your questions, we encourage you to read about our upcoming conference

## NEPC'S VIRTUAL INVESTMENT CONFERENCE
## May 4 & 5, 2021

### OUR SPEAKERS

KEYNOTE SPEAKER
**Jean M. Hynes, CFA,**
*Incoming Chief Executive Officer, Wellington Management Company*

**Laurie Santos, Ph.D.,**
*Professor of Psychology at Yale University, Host of The Happiness Lab Podcast*

**Seema Hingorani,**
*Managing Director, Morgan Stanley Investment Management*

As a reminder, this year's Investment Conference will be held virtually. The event will take place on Tuesday, May 4 and Wednesday, May 5. An official 'save the date' email will be delivered in the coming days. We will communicate additional details as they are finalized.

Please reach out to Sarah Winrow: **swinrow@nepc.com** if you have any questions.

Stay up to date on our latest updates and publications at **www.nepc.com/insights.**

# INFORMATION DISCLAIMER

Past performance is no guarantee of future results.

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The goal of this report is to provide a basis for substantiating asset allocation recommendations.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

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