

CHINA BEARS AND INFLATION SCARES

NEPC Q3 2021 MARKET OUTLOOK

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SPEAKERS



Phillip Nelson, CFA

Partner, Director of
Asset Allocation



Jennifer Appel, CFA

Research Consultant

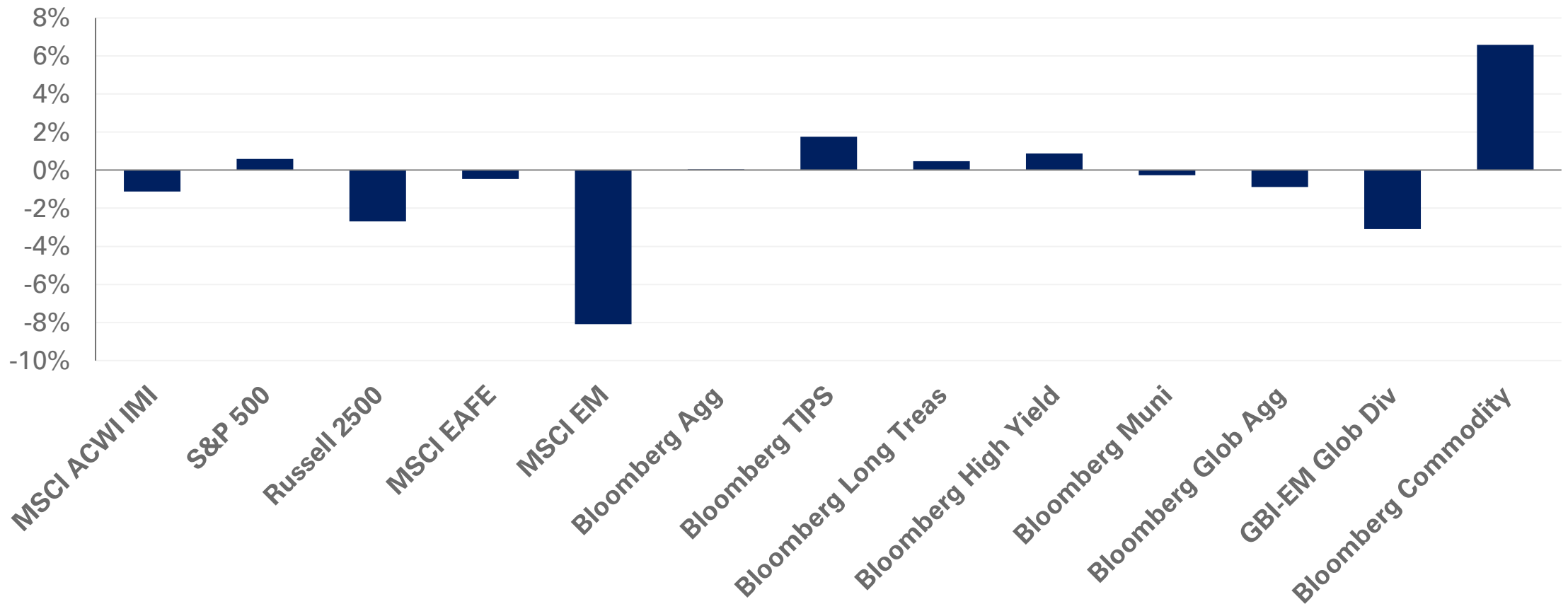
MARKETS IN REVIEW



PROPRIETARY & CONFIDENTIAL

EMERGING MARKETS UNDERPERFORMED

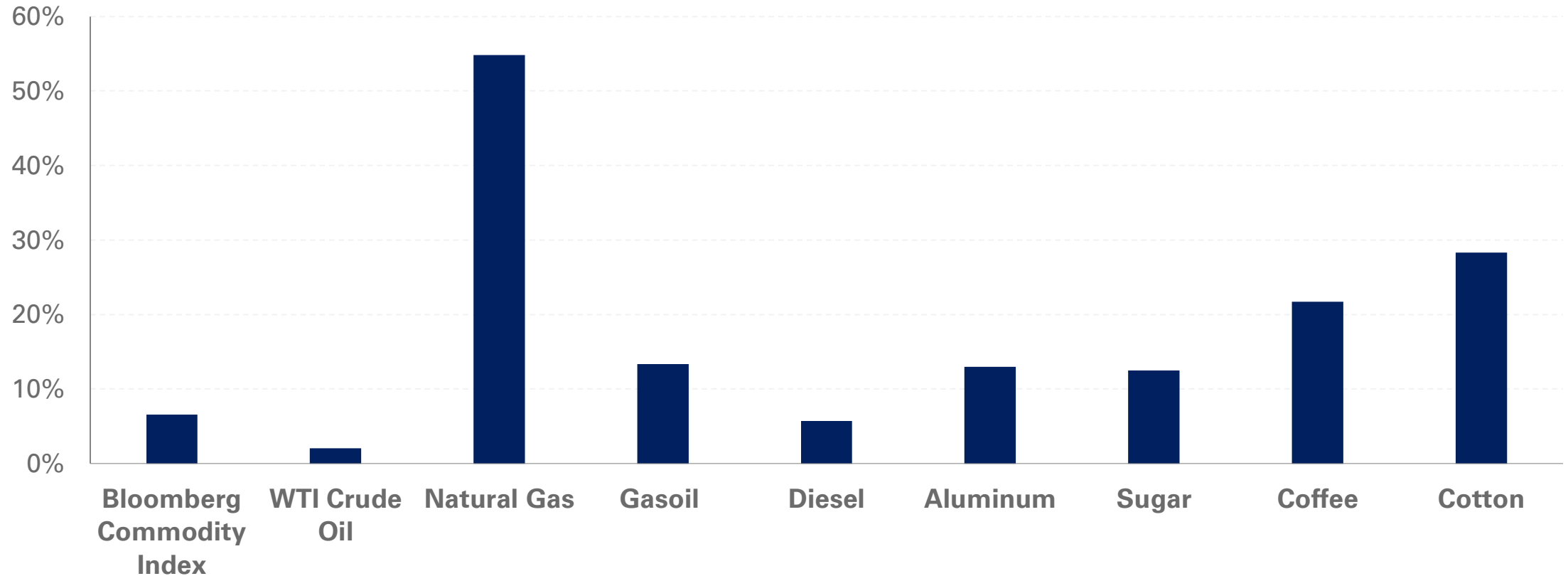
Q3 2021 QUARTERLY TOTAL RETURNS



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

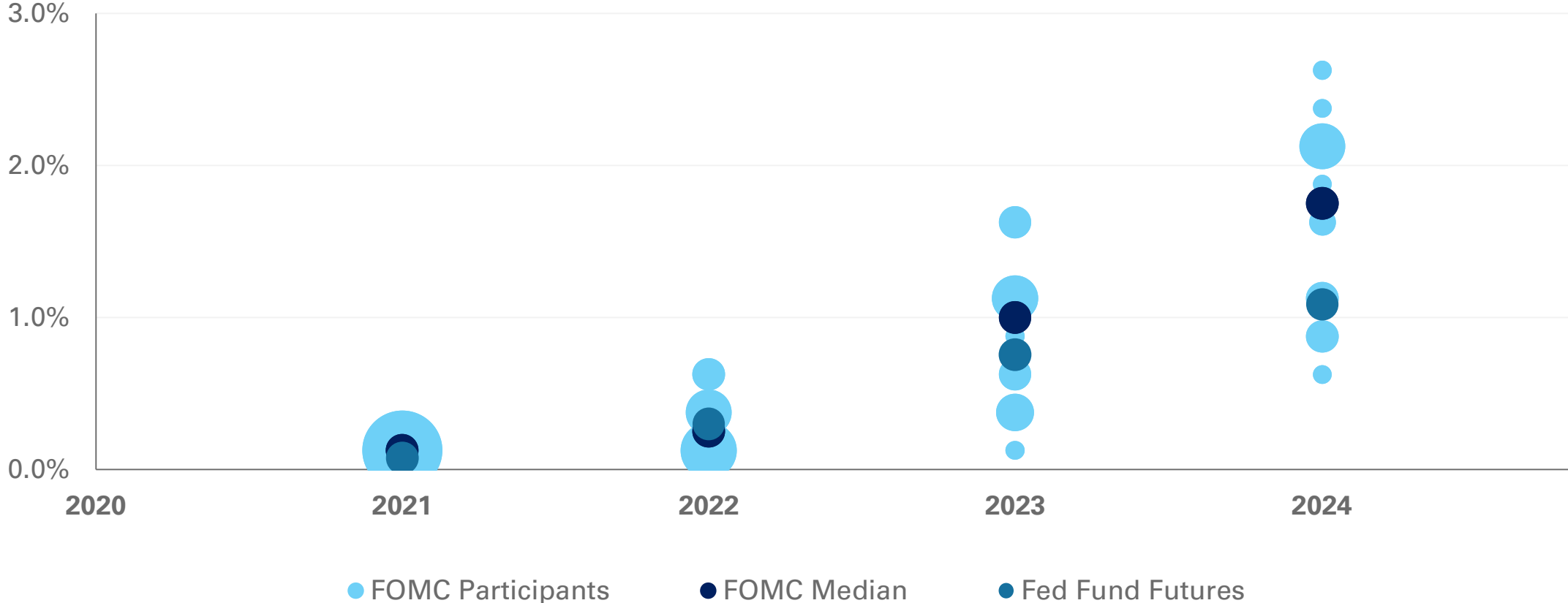
COMMODITY PRICES INCREASED

QUARTERLY CHANGES IN COMMODITY SPOT PRICE



FED PROJECTING THREE RATE HIKES IN 2023

FED DOT PLOT VERSUS FED FUND FUTURES



FOMC Participant dot size reflects the number of policymakers forecasts of federal fund rate at the end of each calendar year
Source: FOMC, FactSet

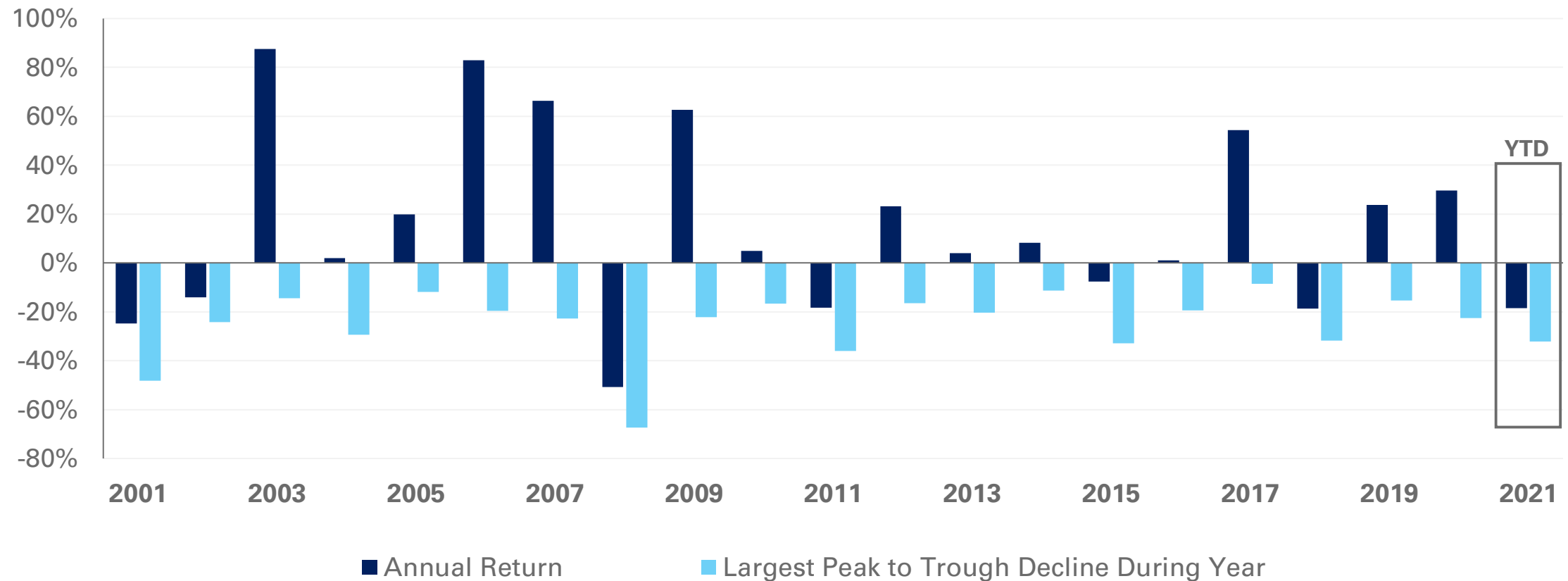
CHINESE EQUITIES HAVE WEIGHED ON MARKETS

YEAR-TO-DATE CUMULATIVE INDEX RETURNS



CHINESE EQUITIES HAVE BEEN VOLATILE

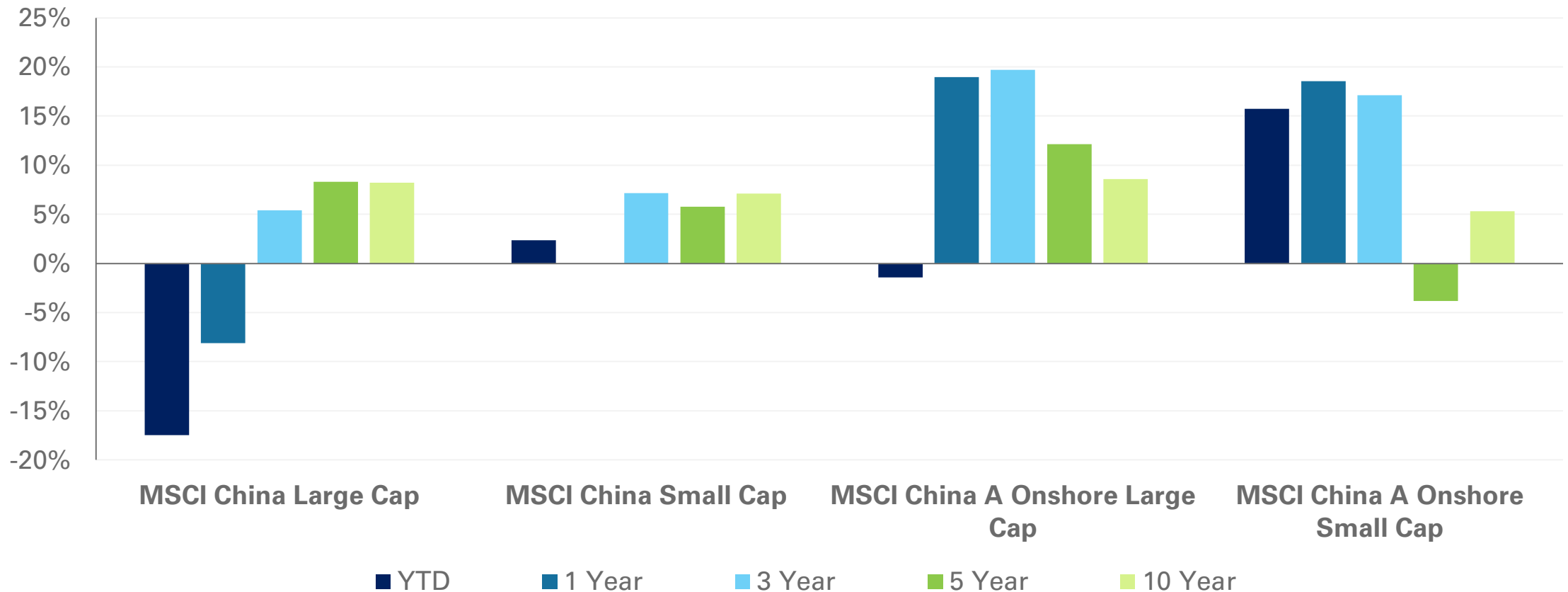
HISTORICALLY HAVE BEEN COMPENSATED FOR THE VOLATILITY



Notes: Represents annual percentage returns of the MSCI China Index; 2021 reflects pricing through 09/30/2021
Source: MSCI, FactSet, NEPC

THE SELL-OFF HAS BEEN TARGETED

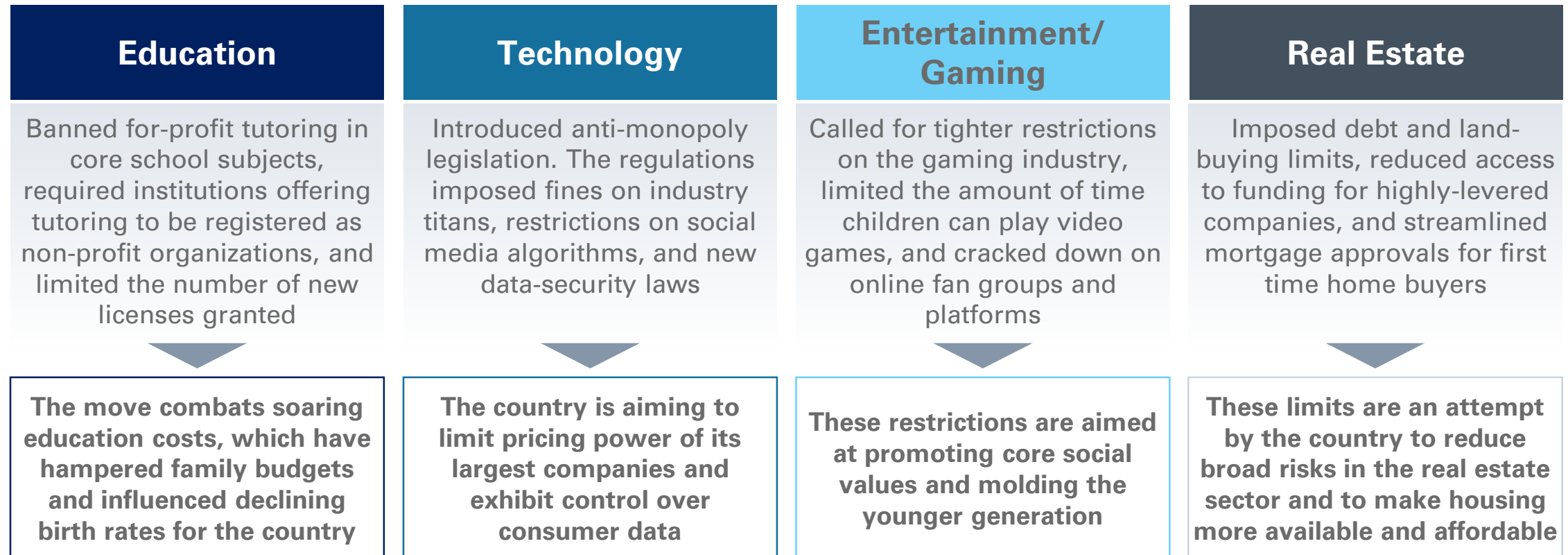
LOCAL MARKETS HAVE BEEN RESILIENT



Source: MSCI, FactSet, NEPC

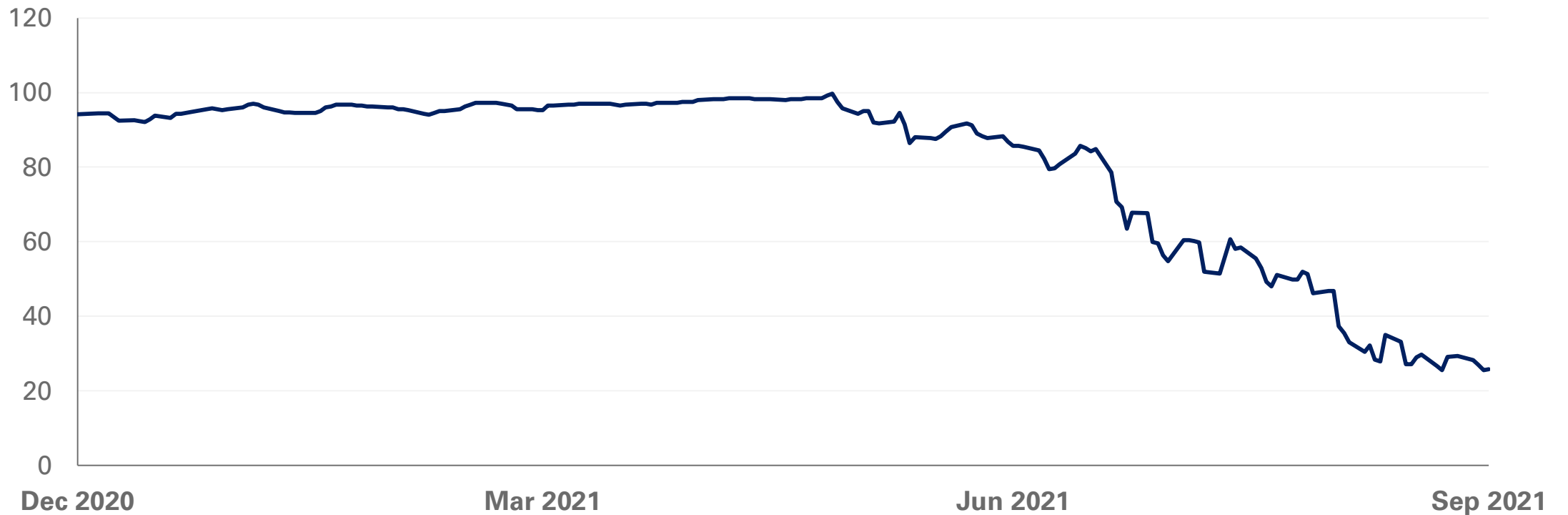
CHINA'S REGULATORY RESET

- China introduced a wave of new regulations, implementing anti-monopoly, industry-specific, and consumer protection regulations



EVERGRANDE BOND PRICES PLUNGED

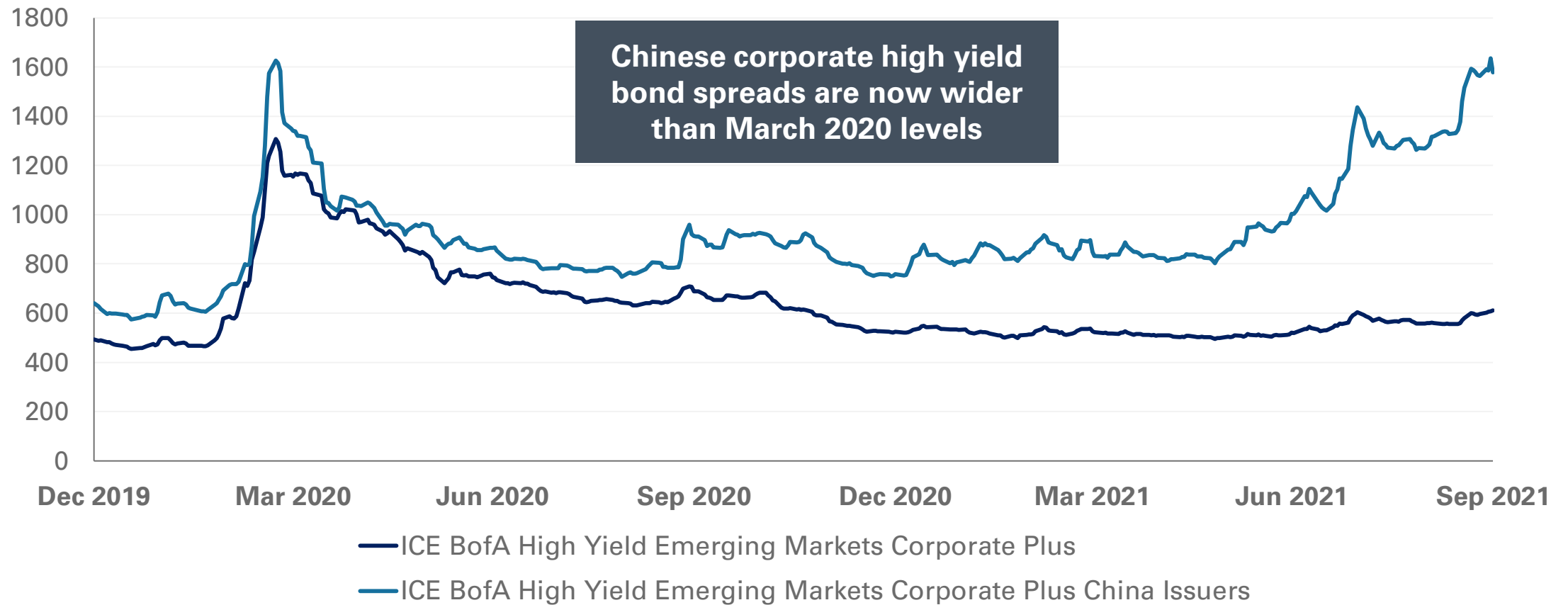
CHINA EVERGRANDE GROUP MARCH 2022 BOND PRICE



Source: FactSet

CHINA HIGH YIELD SPREADS WIDENED

OPTION ADJUSTED SPREAD



STRATEGIC ASSET ALLOCATION OUTLOOK

NEPC's Key Market Theme of Permanent Interventions **sustains positive risk asset sentiment** and elevated valuation levels for equity

Consider **higher strategic equity targets** as the long-term forward return differential relative to fixed income remains elevated

We continue to support a **strategic overweight to emerging market equities** relative to MSCI ACWI IMI, but expect a volatile path

Be mindful of adding public real assets, as inflation-sensitivity and portfolio objectives inform an investor's strategic allocation

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

INFLATION OUTLOOK

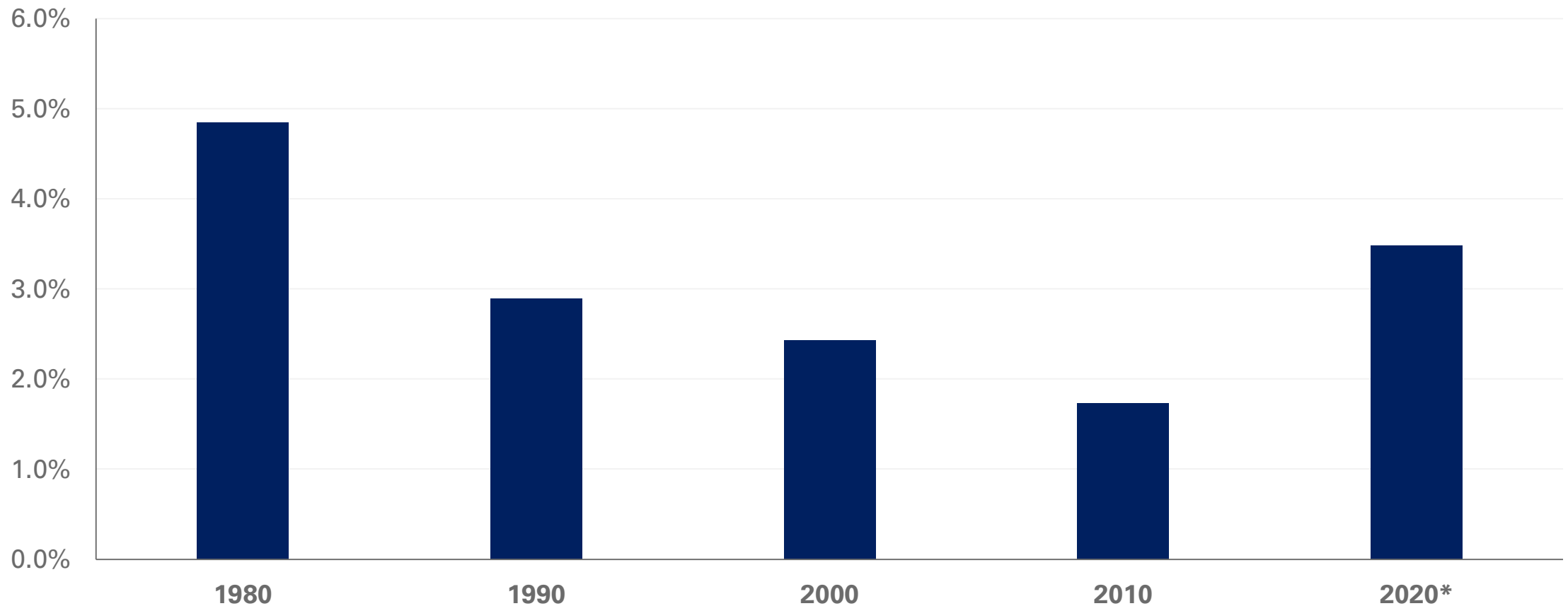


INFLATION OVERVIEW

- **Several factors are contributing to “stickier” inflation levels including continued supply shocks and the potential for elevated shelter costs**
- **NEPC’s expectation for inflation has increased over the near-term (1-5 years), but the long-term inflation view (year 10 inflation) is unchanged**
- **We believe that deflationary pressures, such as demographics and technology, will overwhelm inflationary pressures in the long-run**
- **We expect the 5%+ inflation prints are transitory, but have an increased conviction that ~3% inflation could persist over the next 3 years**
 - Current market pricing and break-even inflation expectations do not reflect the potential for ~3% inflation and this can be a source of disruption for equities and real interest rates

REFRAMING INFLATION EXPECTATIONS

ANNUALIZED INFLATION BY DECADE

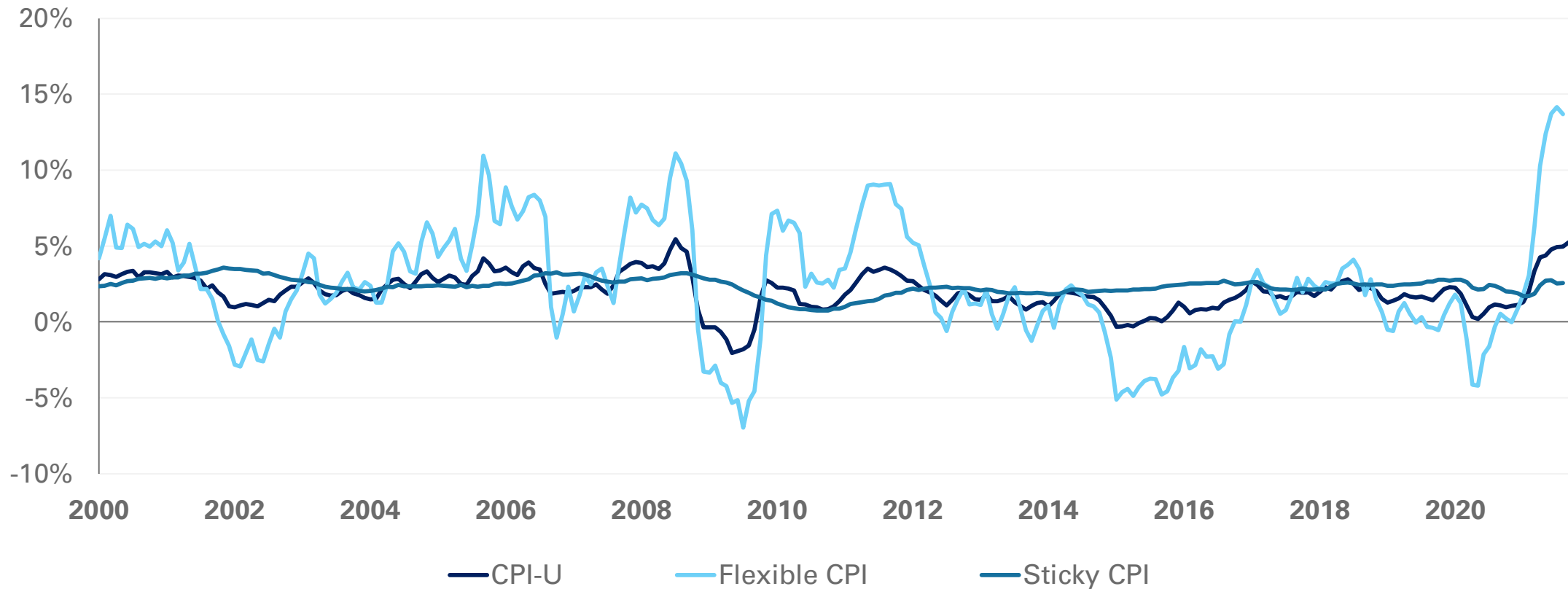


Notes: *2020 reflects returns through September 30, 2021
Source: Bureau of Labor Statistics, FactSet, NEPC



U.S. CPI IS ELEVATED FROM FLEXIBLE FACTORS

TRAILING 12-MONTH CPI METRICS

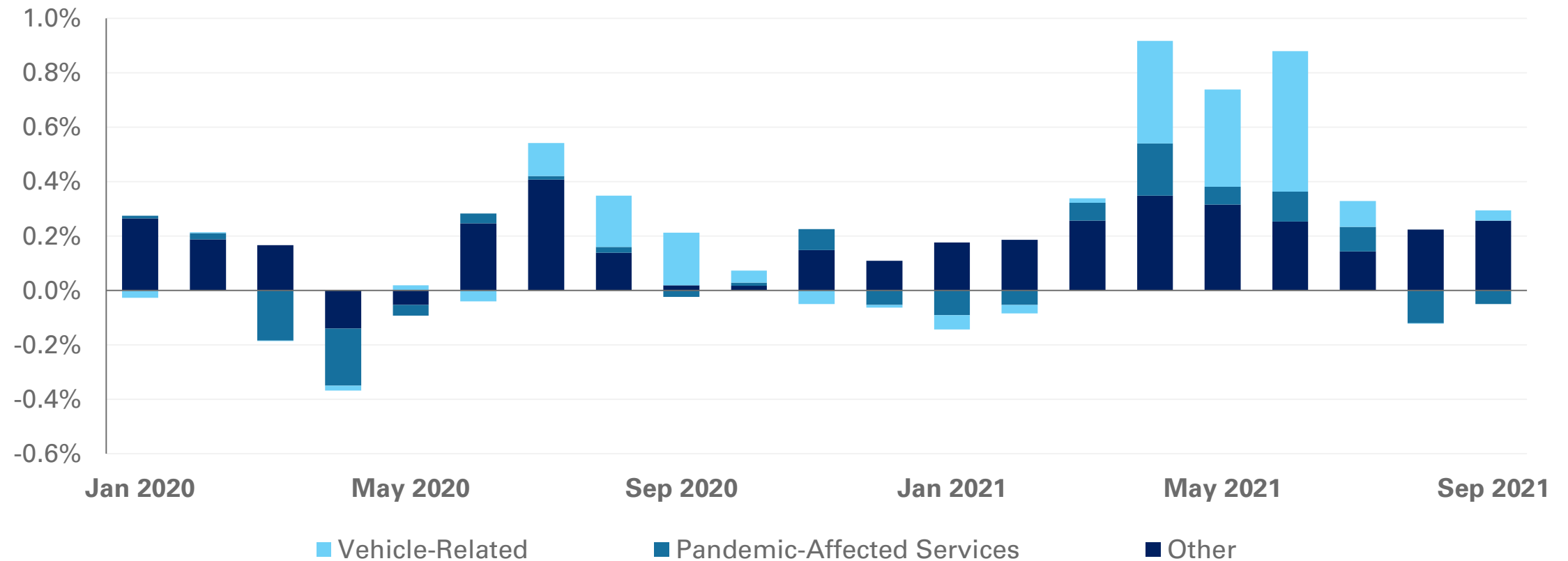


Notes: Flexible CPI represents a weighted basket of items that change price relatively frequently. Sticky CPI represents a weighted basket of items that change price relatively slowly. Data as of 09/30/2021.

Sources: Atlanta Fed, Bureau of Labor Statistics, FactSet

TRANSITORY FACTORS HAVE WANED...

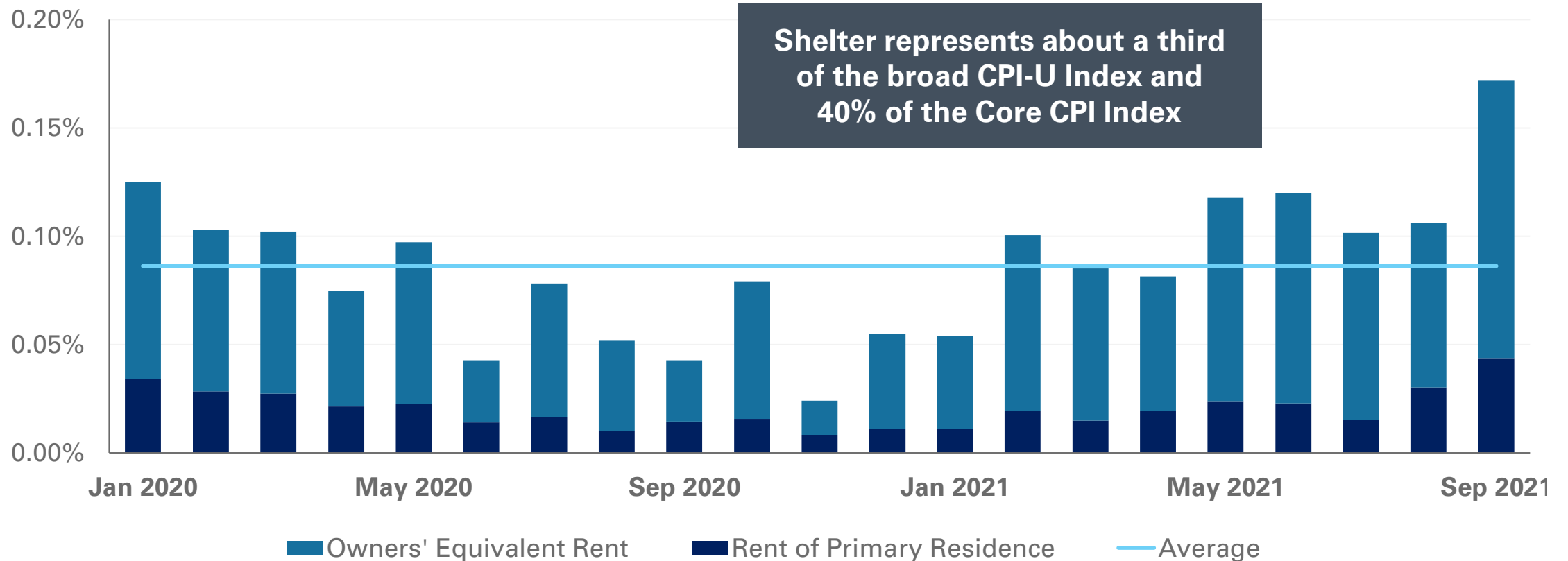
CONTRIBUTION TO MONTHLY CORE CPI-U



Notes: Vehicle-Related includes New Vehicles, Used Cars & Trucks, and Motor Vehicle Parts. Pandemic-Affected Services includes Airfare, Hotels, and Admissions to Events.
Source: Bureau of Labor Statistics, FactSet, NEPC

...STICKIER FACTORS MAY BE ON THE RISE

CONTRIBUTION OF SHELTER TO MONTHLY CORE CPI-U



Notes: Average calculated 01/31/2019-09/30/2021
Sources: Bureau of Labor Statistics, FactSet, NEPC



PORTFOLIO POSITIONING



PORTFOLIO POSITIONING THOUGHTS

Look to severely **underweight lower quality credit** exposure as credit spread levels approach historical lows

We **recommend reducing lower quality credit** and shifting the exposure equally to U.S. equity and safe-haven fixed income

Add U.S. large-cap value exposure to mitigate the price disruption to equities should inflation levels normalize above market expectations

Reduce TIPS exposure as TIPS may respond poorly to “stickier” inflation levels due to tighter Fed policy and changes in real rates

NEPC CURRENT OPPORTUNITIES

RATIONALE

IMPLEMENTATION VIEW

Reduce Lower Quality Credit Exposure

Shift exposure equally to U.S. equity and safe-haven fixed income

- Credit spreads, particularly in the lower-quality space, are near cyclical lows

Return-Seeking Credit Portfolio Tilt:

Shift exposure to U.S. equity/safe-haven FI

Opportunity Cost:

Bloomberg U.S. High Yield

Reduce U.S. TIPS Exposure

Disperse TIPS proceeds to safe-haven fixed income and/or the portfolio

- We are concerned TIPS will be negatively impacted relative to nominal Treasuries should real rates increase due to a surprise in the speed the Fed tightens monetary policy

Safe-Haven Fixed Income Portfolio Tilt:

75% Treasury and 25% TIPS

Opportunity Cost:

50% TIPS and 50% Treasury

Add U.S. Large-Cap Value Exposure

Add large-cap value exposure to U.S. equity, while maintaining overall equity exposure

- U.S. large-cap value exposure can help mitigate the portfolio impact relative to the S&P 500 of heightened inflation levels normalizing above market expectations and interest rates rising

U.S. Large Cap Equity Portfolio Tilt:

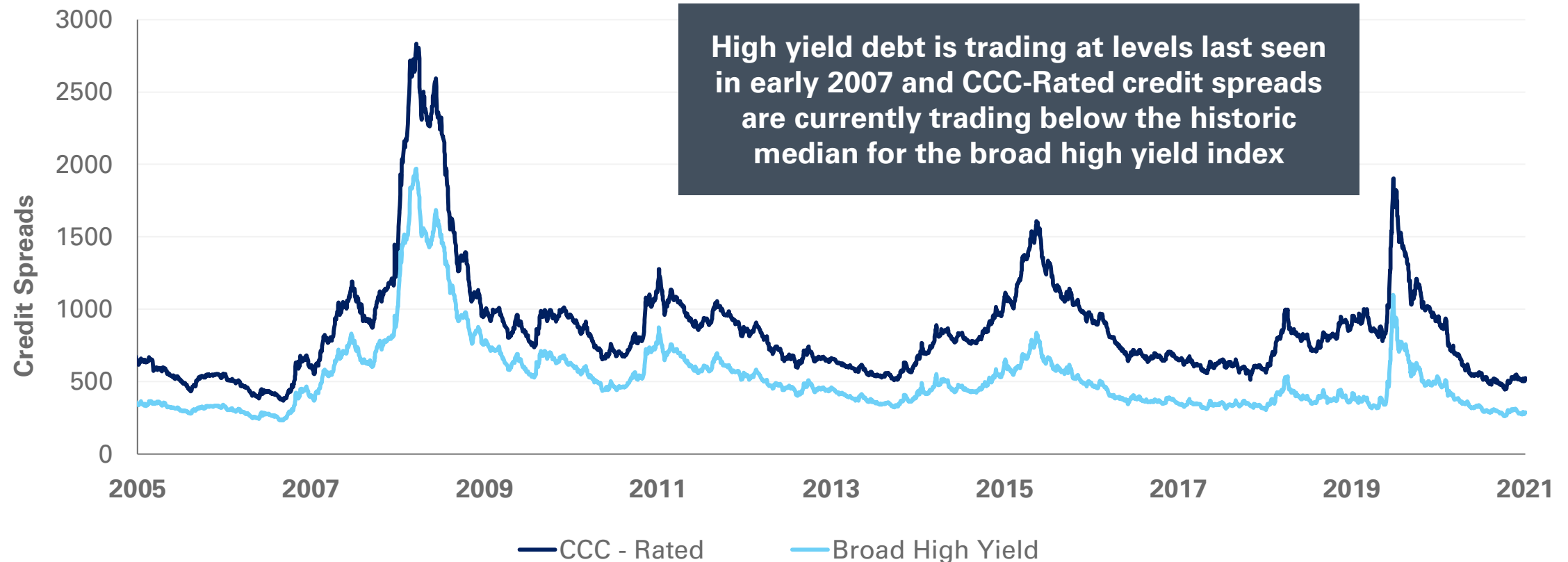
70% S&P 500,
30% Russell 1000 Value

Opportunity Cost:

S&P 500

CCC-RATED CREDIT SPREADS ARE CONCERNING

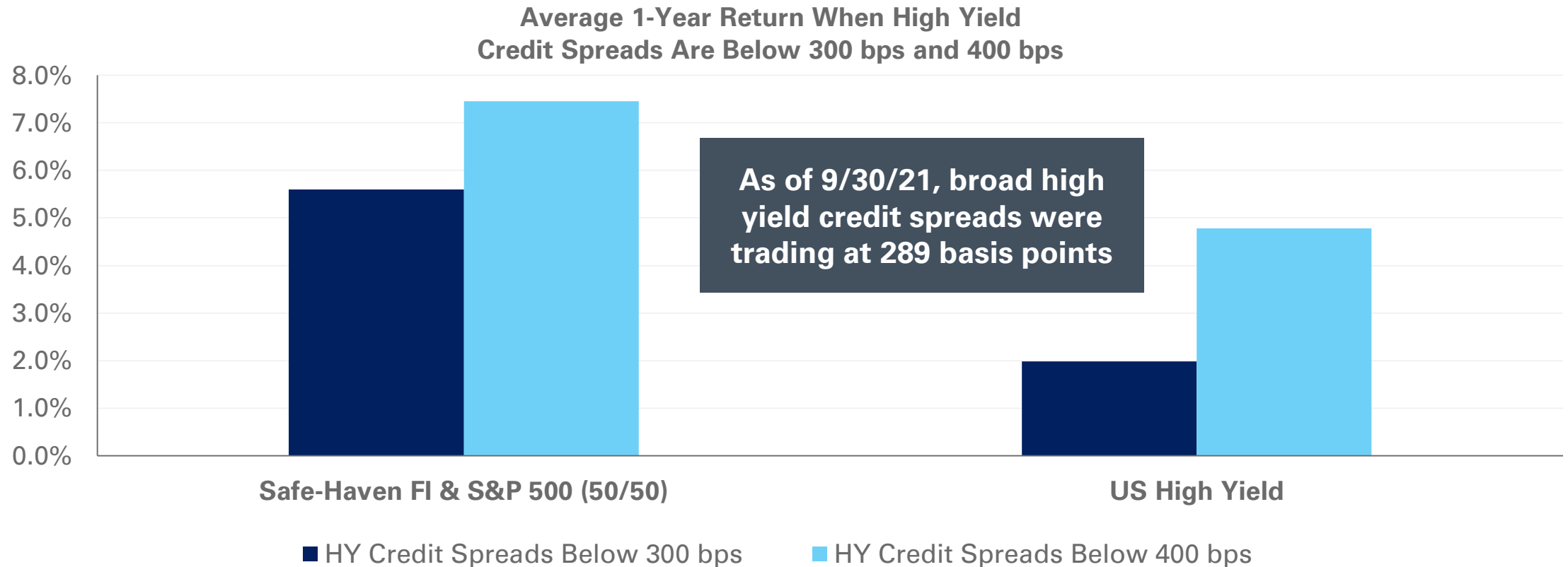
RETURN POTENTIAL FOR LOWER QUALITY CREDIT IS LIMITED



Source: Bloomberg, FactSet

NEPC OUTLOOK: REDUCE LOWER QUALITY CREDIT

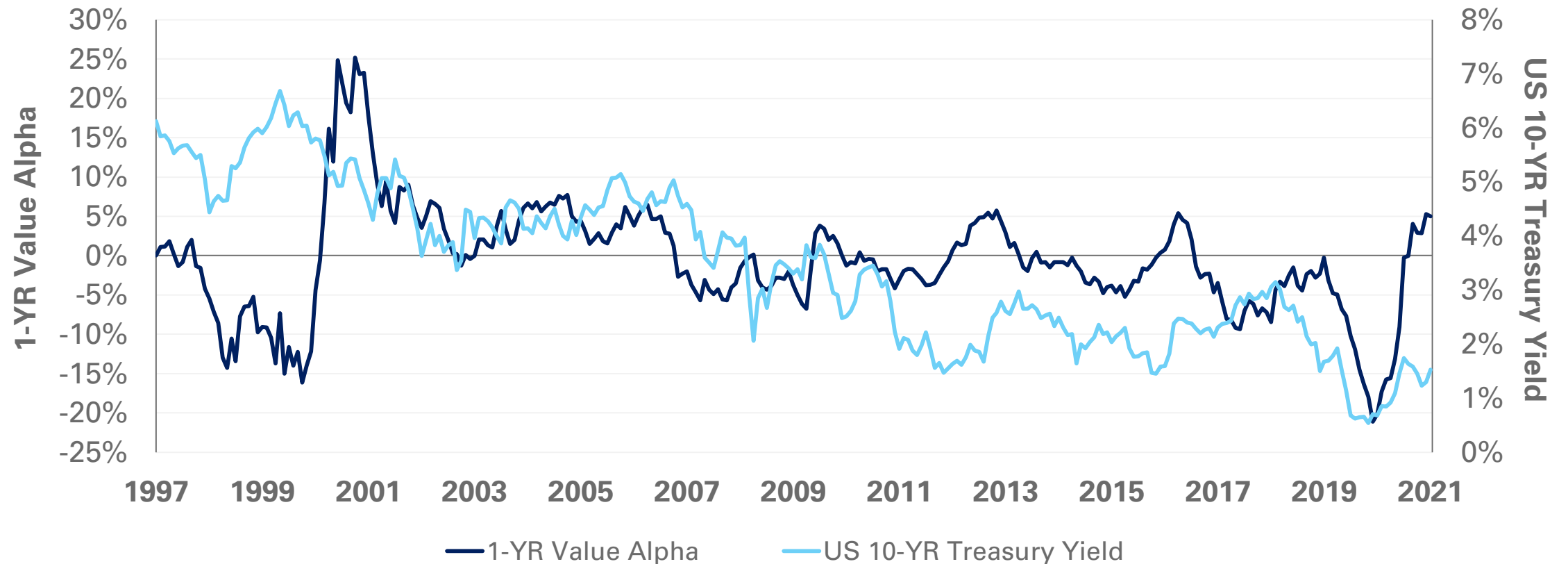
LOOK TO HOLD PUBLIC EQUITY OVER HIGH YIELD



Notes: Safe-Haven FI & S&P 500 represents 25% US Treasuries, 25% US TIPS, and 50% S&P 500. Data reflects last 20 years.
Source: NEPC, Bloomberg, FactSet

INTEREST RATE SHIFTS IMPACT EQUITY TRENDS

LARGE-CAP VALUE MAY BENEFIT FROM RISING INTEREST RATES



Notes: Value Alpha is defined as Russell 1000 Value vs S&P 500
Source: NEPC, Bloomberg, FactSet

NEPC OUTLOOK: U.S. STOCKS AND INFLATION

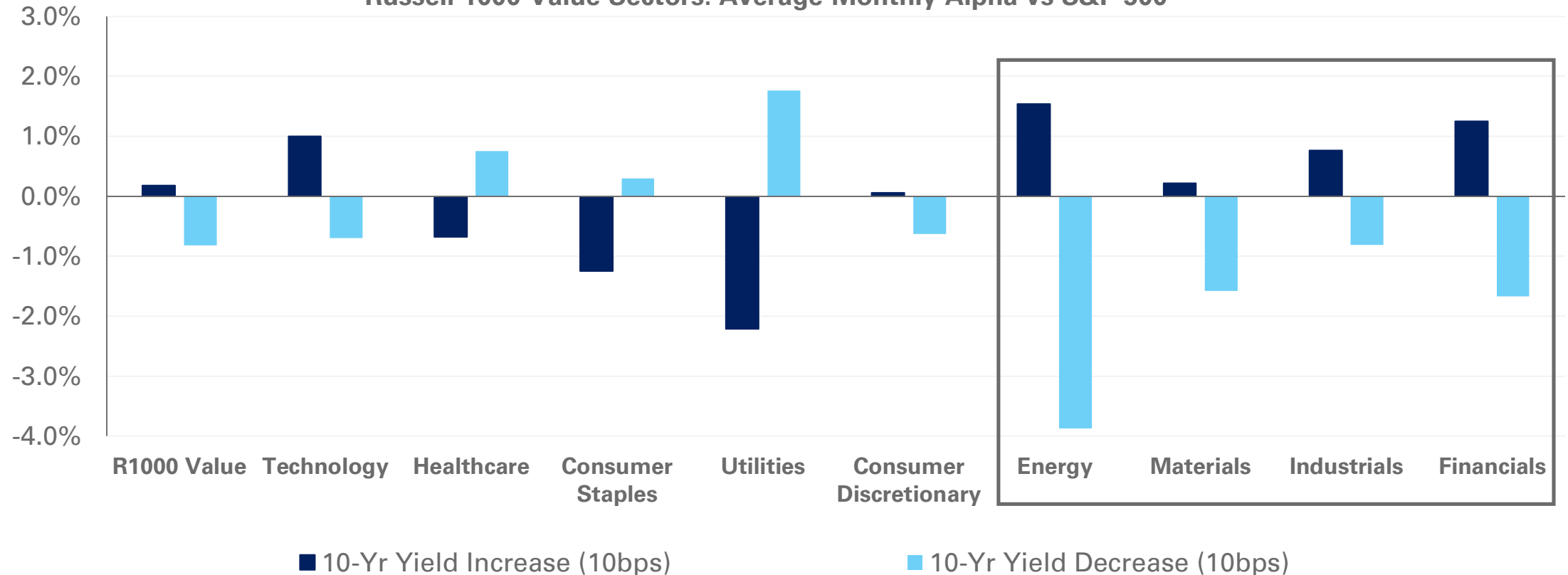
LOOK TO ADD U.S. LARGE CAP VALUE EXPOSURE

- **Should we see “stickier” inflation and higher interest rate levels, we are concerned U.S. equities and the portfolio could see price disruptions**
 - We are looking to implement a solution to address potential portfolio risks, while also maintaining overall portfolio equity exposure
- **U.S. large-cap value exposure is the simplest implementation options to address the portfolio impact of rising interest rates and inflation**
 - The associated repricing of risk premia in both Treasury and equity markets constrains the implementation tools to mitigate the potential price disruption
- **We encourage adding U.S. large-cap value exposure to mitigate the portfolio impact of inflation normalizing above market expectations**
 - Within U.S. large-cap equity exposure, we recommend replicating a target exposure of 70% S&P 500 and 30% Russell 1000 Value
 - The sizing of large-cap value exposure and portfolio tracking error tolerance must be heavily considered relative to strategic asset allocation objectives

INTEREST RATES INFLUENCE STOCKS UNEQUALLY

SECTOR MAKEUP OF VALUE EXPOSURE MAY OFFER BENEFITS

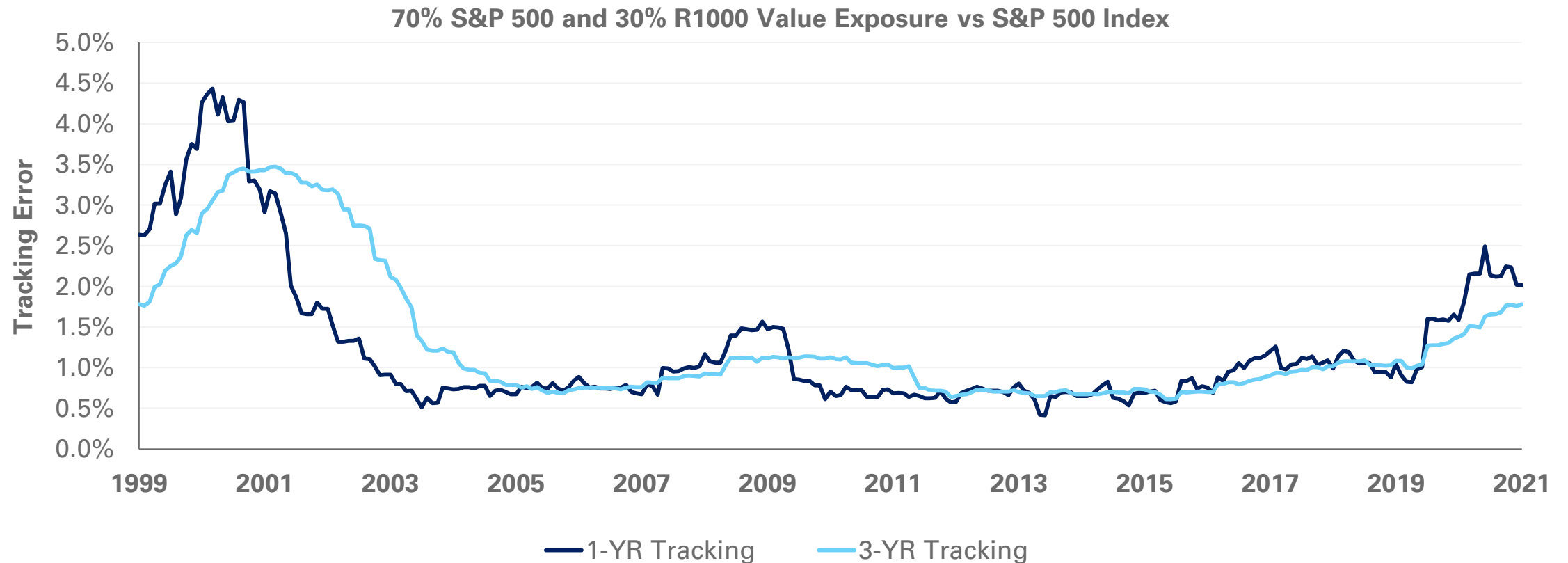
Russell 1000 Value Sectors: Average Monthly Alpha vs S&P 500



Notes: Average Monthly Alpha is defined as Russell 1000 Value and Sectors vs S&P 500 over the last 10 years
 Source: NEPC, Bloomberg, FactSet

BRACE FOR TRACKING ERROR SPIKES VS S&P 500

TRACKING ERROR RISK TOLERANCE MUST BE CONSIDERED

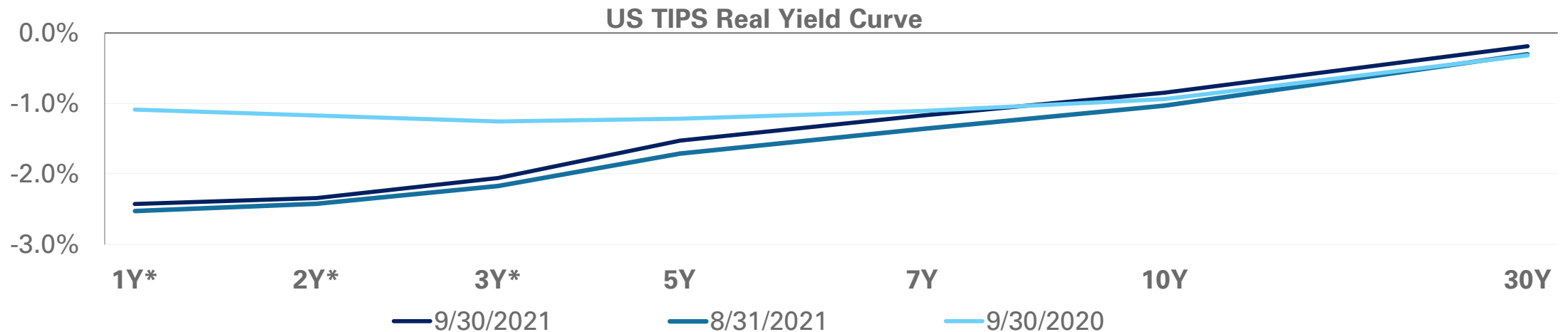


Notes: Tracking Error of 70% S&P 500 and 30% Russell 1000 Value Exposure vs S&P 500
Source: NEPC, Bloomberg, FactSet

NEPC OUTLOOK: U.S. TIPS AND INFLATION

REDUCE TIPS VS STRATEGIC TARGETS BY MORE THAN 50%

- **TIPS have significantly outperformed Treasuries over the last 2 years**
 - TIPS have been a NEPC recommendation since 2016 and we have seen strong excess returns relative to both Treasury and Core Bonds
- **Current market conditions have caused us to question whether TIPS will respond positively should we see “stickier” elevated inflation levels**
 - We are concerned TIPS will be negatively impacted relative to nominal Treasuries as real rates increase due to surprises in Fed policy tightening



Source: FactSet, NEPC

QUESTIONS?



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