The way forward

2017 Global Investment Outlook

presented by Macquarie Asset Management
A decisive close to the post–global financial crisis era, and its lingering effects, may never occur. As 2017 begins, however, many investors feel as if they are reading a new investment roadmap. Last year’s wave of populist politics, and its potential impact on economies and the markets, left a degree of uncertainty. So what turns does the road ahead promise?

Amid change and uncertainty, there is opportunity. And opportunity is among the reasons we’re excited to share our expanded 2017 Global Investment Outlook, which taps into perspectives from more than 20 investment teams across four continents. These insights cover all that Macquarie Asset Management, including Delaware Investments in the United States, has to offer.

In an investment landscape still starved for yield, today’s opportunities for many institutional investors such as plan sponsors and insurance companies typically include a mix of traditional, long-only assets as well as choices from an often complex menu of alternative strategies. These strategies can range from the unconstrained approach of multi-asset portfolios, to infrastructure, real assets, and private equity and debt — and these are among just some of the areas explored in these outlooks.

The year 2017 may well mark the start of a brave new world for investors. But no matter what type of investor you are, we welcome the opportunity to help identify solutions to meet your challenges — and help find the right path on a new roadmap.
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Perspective and outlook

Our investment executives discuss critical issues for 2017, including macroeconomics, risk management in multi-asset strategies, and important research trends.

- Executive roundtable
- Multi-asset strategies
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In many ways, 2016 was a year of the unexpected. It was a time when unprecedented monetary policy did not fulfill the promise of economic stimulus as expected and helped encourage the ongoing hunt for yield… when equities continued their unpredictably long bull market run…and when investments like infrastructure were suddenly thrust in the spotlight as all eyes turned toward fiscal spending. Most of all, it’s been a year of unexpected populist sentiment with the United Kingdom’s Brexit vote to leave the European Union (EU) and the election of Donald Trump as U.S. president.

What do these events and the resulting uncertainty mean for investing in 2017? Five investment leaders from across Macquarie assess the developments and how they could play out, providing insight into potential outcomes as the year unfolds.
How would you characterize the investment climate at the start of 2017?

**Brett Lewthwaite:** Generally, the investment environment can perhaps best be described with one word: “containment.” Since the 2008–2009 global financial crisis, central banks have provided extraordinary support to economies and markets in the form of zero, and even negative, interest rates, as well as unprecedented levels of quantitative easing policies. It seems that any time the economies or financial markets have faltered, central banks have stepped in with monetary policy to try to balance and contain things. This was particularly evident early in 2016.

The markets have become relatively dependent on this monetary policy support, and one outcome has been that global growth rates have continued to be lackluster. Because growth never meaningfully materialized as intended, financial markets have been experiencing significant economic uncertainty, and now they’re also facing rising political uncertainty. As such, 2017 is shaping up to be even more volatile than 2016.

**Roger Early:** What we’re seeing is a balancing act by global markets that has dominated our investment environment since the global financial crisis, and continues into 2017. Meanwhile, macroeconomic structural challenges, as Brett alluded to, are persisting throughout the world. There’s a growing amount of global debt — in fact, debt-to-gross domestic product is at historic levels. Growth, as Brett mentioned, is sluggish at best and might be better said to be in secular stagnation.

**Bob Zenouzi:** From the vantage of investors, the recent environment and prevailing sentiment has become one of complacency. It’s almost as if, in recent years, the central banks have provided a gigantic security blanket, with the feeling that if something were to go wrong, they would help out investors. It’s that sense of containment Brett is talking about. But the upshot from all of this has been relatively constrained risk. Asset prices have really enjoyed this environment as yields drifted lower and lower and, in many cases, into negative territory.

**Is this slowing growth a recent phenomenon?**

**Shawn Lytle:** It isn’t a matter of economies suddenly putting the brakes on growth. For example, if you look at gross domestic product (GDP) growth in the U.S. over the last three decades, you see the actual growth rate meaningfully declining during the expansionary periods of the mid-1980s, the mid-1990s, and the early 2000s. This slowing growth isn’t only in the U.S. — it’s really a global phenomenon of steady deceleration.

If decelerating growth continues, you have to consider the potential effects on the markets. First, anytime we have a sluggish economy, it’s generally considered harmful for the business environment because consumers are less likely to purchase products, and that eventually can have a downstream effect on equity markets. Slowing economies usually affect fixed income markets more directly with yields tending to drop — and, of course, that’s what has happened with yields historically low in 2016 and leading to a global chase for yield.

**Will this chase for yield continue in 2017? What kind of effects might it have on both fixed income and equities?**

**Roger Early:** For the fixed income market, we see 2017 still very much a story of the search for yield. There may be pockets of relative value, such as in the U.S., but we don’t see the yield chase diminishing. This can be troubling for those investors who stretch for yield even to the point of taking risks that may be beyond their normal risk parameters.

**Shawn Lytle:** It certainly seems, as Roger points out, that the chase for yield isn’t over for fixed income in 2017. As a result, it’s entirely possible that we’ll see the continuation of the pattern established in 2016. With global bond yields historically low and global equity dividend yields at more consistent levels, investors tended to turn to dividend-yielding stocks as if they were bonds. This sort of flocking to income-producing equities was viewed as helping to lead to the stretched equity valuations we saw in much of 2016. Going into 2017, those valuations were still somewhat stretched in a macro sense, but the rally late in the year produced a certain level of optimism in the equity markets. We’ll have to see if investors can hold onto that hope of potentially rising earnings in 2017.

**Sharon Hill:** As equity prices rise, the practice of using equities as bond substitutes becomes less feasible. Payout ratios are unlikely to rise given that corporations have been under-investing for many years. Corporations may be more motivated to spend in 2017 given the need to drive growth coupled with potential fiscal incentives. If investors are able to return to bond investments for income as interest rates rise, the valuation disparity that Shawn mentions could normalize.
Equities yield more than bonds

Source: Datastream, MSCI, Citi Research (as of Q3 2016)

Do you see the equity markets taking perhaps a different turn in 2017?

Shawn Lytle: If 2017 is full of ambiguity, one of the big areas of uncertainty could very well be equities. One contributing factor is that we’ve been in a bull market since the end of the global financial crisis in 2009, so there are some views that the equity market may simply be running near the end of its course. We could also see increased equity risks in certain areas like global and emerging markets from that phenomenon of decelerating growth because their economies have become more leveraged.

Sharon Hill: One way to gauge what might be happening with equities is to look at the role fundamentals have played in the recent equity rally. For example, if you look at the U.S. stock market as represented by the S&P 500® Index over the last 15 years, there is a growing gap between how the index is tracking versus earnings-per-share (EPS) and revenue growth of the S&P 500. Despite lacklustre earnings and revenue growth, the S&P 500 has been rising, implying that investors are willing to pay more for the possibility of future earnings. This type of market return, which is driven by valuation expansion, is unsettling because we know that it’s unlikely to be sustainable over full cycles. Over the medium term, however, it may be perfectly rational given the rate environment. Company behavior has also fueled some of this “growthless” rally. Companies have been returning cash to shareholders in the form of dividends and share buybacks. While this does indeed help shareholders in the short run, it too is unsustainable in the long term. We’ll have to see if this trend continues — or if some other factor might upset the containment state we’ve been experiencing.

What could force us out of this containment state?

Brett Lewthwaite: We believe the increased political risk, which has risen recently with the growth of populism in a number of countries, has the capacity to put the contained environment under pressure. We’re wary of movements to depose monetary policy entirely in favor of fiscal policy, or to shift to a de-globalization over globalization. Those would be the opposite of what has served financial markets well since the global financial crisis.

Shawn Lytle: Exactly. Political risk is the potential game changer. It began in 2016 with Brexit and continued through the U.S. election and the referendum in Italy. These hinged on a number of factors, including some trends like income inequality, as well as anti-immigration and anti-globalization sentiments. It’s all been against the backdrop of the important containment balancing act that has been going on — where global economies and markets have looked to central banks to print money, provide liquidity, or support asset prices in any challenging scenario.

Roger Early: Yes, and now that balancing act has become a very fragile balance. Because of the uncertainties and potential new policies that could affect factors ranging from currency valuations to inflation, central banks may very well be pushed to abandon their monetary policy approach. That would upset the fragile balance — and could lead to unintended consequences, such as risk asset valuations declining rather than rising.

What might be the biggest effect of the U.S. election on the global economy?

Brett Lewthwaite: Trump’s election poses a strong test to the environment we’ve been experiencing. As a candidate, Trump talked a lot about a fiscal response — including lower corporate taxes, lower individual taxes, and significant infrastructure spending. That, of course, would be a very welcome situation, if it were to occur, because it could help lift us up out of this lower-growth situation that we’ve been mired in. If those policies were to be enacted, we may get stronger growth and some inflation — although this may all come at the expense of even higher debt levels, which ultimately have negative consequences for growth.

On the flip side, we should factor in another scenario. Many components of Trump’s campaign had strong elements of protectionism — mainly anti-globalization and a strong U.S.-centric bias. Given the long-term structural challenges with high debt, a return to debt reduction and higher growth is far more likely if we were to rely more on global cooperation and trade. So a nationalistic, U.S.-centric policy could lead to less efficient and less effective scenarios that in turn could lead to lower growth.

Market remains disconnected from fundamentals

Source: Standard & Poor’s

Roger Early: The heart of the Trump plan — lower taxes, fiscal infrastructure spending, and some reduction in regulations — could, by and large, bring improved economic growth. But I would agree with Brett that a critical part of the Trump campaign platform has been the anti-globalization aspect. This too is largely still to be determined, but it’s important to note that decisions on the globalization factor have the potential to be the most impactful on the markets and economy.

Shawn Lytle: These are all important concerns, and it is still too early to talk with any degree of certitude which of President Trump’s campaign promises will come about. Our view, however, is...
that the net effect could be positive in the short term — but in the long term, we see the possibility of negative structural implications.

Despite the uncertainties in the wake of the U.S. election, the markets surged, at least initially. What effects do you see through 2017?

Brett Lewthwaite: Financial markets did embrace the election result on the premise that there would be successful delivery of growth-generating policies. That led to excitement about possible better growth, some inflation, and especially some anticipation that the days of extraordinarily low yields for 30-year bonds could be finally coming to an end. However, this thinking is probably a bit premature. Because we’ve been locked into this environment of such support on low rates and building debt burdens, a move to substantially higher yields is probably very difficult. We might see a little spike, but I don’t think yields will move too much.

Roger Early: The key may be the stance on globalization. If Trump stresses an isolationist agenda, that could be troublesome for U.S. growth and certainly not good for global growth. It would be an agenda that could hurt confidence and affect equity markets. We could also see divergent monetary policies, growth could slow down, and by mid-to-late 2017, a growth shock is not out of the question. If that’s the case, given that most risk assets, including credit, are fully priced, markets face a challenge later in the year.

Sharon Hill: We think it’s likely that the Trump administration’s legislative agenda — however moderate or extreme that ends up being — has a relatively good chance of coming to fruition in 2017. That’s because with Republican majorities in both houses of the U.S. Congress, there are few barriers to passing his policies. On the monetary policy side, we’re anticipating rising interest rates, not only from U.S. Federal Reserve action, but from increased Treasury issuance required to fund initiatives such as tax reform. At the same time, we should note that a number of Fed governors could be replaced in 2018, adding to monetary policy uncertainty.

Tell us more about the potential shift to fiscal policy in 2017.

Bob Zenouzi: In some quarters, the highly accommodative monetary policies employed by central banks are seen as close to running their course. So, there’s been some favorable sentiment expressed recently about turning to fiscal policy as a solution, including discussion of fiscal spending such as infrastructure projects. At the same time, during the U.S. election, there was an increased focus on improving deteriorating roads, airports, and other types of infrastructure. As president, Trump has promised to invest billions in infrastructure, with a benefit of this fiscal spending intended to improve the U.S. economy. Of course, it remains to be seen how much infrastructure spending the federal government will actually take on, or how much will be backed by private financing.

Roger Early: It’s true that fiscal stimulus has not been center stage for quite a while. Also, a fiscal program, such as infrastructure spending and tax cuts, could potentially drive economic growth higher more directly than monetary policy, which tends to indirectly affect the economy by driving up asset prices. That’s the potentially positive aspect of fiscal policy, and we expect an uptick in growth if these programs come about.

However, there have been comparisons to the success of past fiscal policy, such as during the administration of U.S. President Ronald Reagan in the 1980s. The Reagan administration pushed through a large fiscal program, which did increase growth. The difference was that, at the time, it was a period of double-digit inflation and extraordinarily high interest rates that then-Fed Chairman Paul Volcker was working to reduce. The current proposed fiscal stimulus may indeed work, but perhaps not to the extent some hope. That’s because half the equation, with the current environment of low growth and low inflation, is quite different from the 1980s.

There has been a lot of talk about inflation heating up. How might this affect markets in 2017?

Bob Zenouzi: Certainly after the U.S. election, there was a sudden renewed expectation, at least domestically, of increased inflation resulting from fiscal spending and other proposals. We do see the possibility of some inflation returning, and a small, measured increase in the current low rate of inflation would be welcome. It’s possible that it could turn into an inflationary scare, or even several of them. An inflationary scare has the potential to create some downside in the market. But it’s also important to remember that there tends to be a self-correcting mechanism at work in these cases. A threat of inflation puts pressure on risk assets and then tends to erase the inflation spike.

Roger Early: We do anticipate the possibility of slightly higher inflation for 2017, in the same way we think that there may be slightly better growth — both outcomes potentially occurring if the core aspects of the Trump plan, lower taxes and higher fiscal spending, come about. However, we can’t forget about the uncertainty regarding the new administration’s plans. Also, Bob brings up an excellent point about how smaller inflation scares sometimes can self-correct naturally in the economy. For example, when we saw in 2015 and early in 2016 indications that the Fed might raise rates, the U.S. dollar reacted by gaining strength, which affected earnings of international companies within the U.S., which in turn helped slow things down domestically. The end result was that inflation expectations backed off. While we would look forward to slightly better growth, and the slight inflation increase that could come with it, much remains in play.

Given that the chase for yield is still on in 2017, what recourse do investors have?

Bob Zenouzi: Investors who traditionally have relied on fixed income certainly face a conundrum. Many institutions, for example, have commitments requiring...
Multi-asset strategies

Managing risk in a world of surprises

Stefan Löwenthal, Multi-Asset Solutions / Vienna

Bob Zenouzi, Income Solutions / Philadelphia

Investors looking to allocate assets in 2017 seem to face pressing issues and surprises at every turn. It’s a world of low-to-negative bond yields undercutting pure fixed income strategies and helping to create more volatility for bonds. Meantime, the seven-year bull equity market has stretched valuations and elevated the risk of a market correction. How do investors meet return expectations that appear suppressed for traditional assets and still balance the risks?

In this light, it’s hardly a surprise that many investors have turned to the risk-balanced allocation strategies that multi-asset portfolios have to offer. These can be unconstrained in the asset classes explored, but — particularly in the context of an uncertain environment likely to continue in 2017 — they should be constrained in terms of risk. These asset managers look at managing multi-asset portfolios in this increasingly complex setting.

No magic bullet, but still opportunities

In the current low-rate environment — likely to continue into 2017 — it’s understandable why investors have been chasing yields and returns on either end of the fixed income-equity spectrum. In 2016, we have seen investors, particularly liability-driven institutions trying to meet commitments that require higher investment returns, resorting to more creative solutions. These include areas like private equity or private real estate, where investors might find the potential for greater returns, but they also need to recognize the higher leverage and illiquidity they can bring.

Let’s be clear: There are no magic bullet solutions to this investing conundrum. However, multi-asset strategies — which typically combine a variety of asset classes in a single offering, securities that could represent many areas of the capital structure and across borders — are diversified yet blended enough to pose a potential solution, especially in a yield-chasing environment.

The trick can be in balancing, as an investment manager, the goal of achieving risk-adjusted returns with what I think of as responsible investing. This comes down to managing risk.

In a multi-asset portfolio, it might be a matter of looking for growth to sustain assets through rising rates or credit spreads, and then combining it with responsible income for downside protection. While there are always attractive opportunities, there also are many issues that can cause that downside: inflation scares, loss of confidence in central bank action, rapidly rising rates with no associated growth, fallout from the change in the U.S. presidential election, and more. These are the kind of issues we look at and take into account in this uncertain environment leading into 2017.

—Bob Zenouzi

Target risk: More prudent for risk budgeting

Asset allocation is considered a universal concept for all investors. For institutional investors, however, particularly on a global stage, asset allocation takes on wholly different sets of complexities, with risk one of the key component. And in the current risk-laden environment, managing risk effectively is more important than ever for the institutional investor.

As a global multi-asset manager using sector experts and quantitative analytics across global sovereigns and credit, emerging markets, commodities,
Two approaches to risk budgeting
Multi-asset strategies for global institutional investors typically take one of two main approaches to risk budgeting. First, in a risk-parity approach, the manager seeks a stable level of portfolio risk over time, leading to a reduction of riskier assets in times of market turmoil and additional downside protection. Risk-parity portfolios derive their name from the way the portfolio is constructed: The manager aims to balance risk exposures evenly across a variety of asset classes.

One shortcoming of this approach is that it tends to generate more negative returns when cross-out correlation is high, particularly in portfolios with static allocations. Another reason we believe risk-parity approaches currently deserve a word of caution is their larger reliance on fixed income. At a point in time when yields have little room to fall and inflation is starting to perk up in the United States and elsewhere, this limits a risk-parity portfolio’s upside return potential.

We believe target-risk funds represent a more prudent approach in the current environment. Compared with risk-parity, target-risk funds use more discretion in portfolio allocations rather than spreading risk evenly among different asset classes. Generally speaking, target-risk funds can increase risk taking during periods of lower volatility and dial it back when volatility runs higher. While the overall level of risk never exceeds the fund’s target amount of risk exposure, there is plenty of leeway on the part of the fund manager to add or subtract exposure based on their views of the market and where risks are increasing or decreasing. That gives managers with high conviction ideas a chance to take advantage of short-term opportunities in a risk-controlled way.

Risks incoming for 2017
When it comes to risks, we see plenty worth monitoring in the coming year. The growth trajectory in the U.S. is one, given the length of the current business cycle and negative corporate earnings trends. Anti-globalization sentiment in the U.S. and Europe could contribute to slower economic activity around the

continues on next page
Asset allocation: Quantitative perspectives

Sharon Hill, Head of Equity Quantitative Research/Philadelphia

From a quantitative perspective, we anticipate continued economic growth during the first half of 2017. While it is difficult to forecast with any degree of certainty the new Trump Administration’s legislative agenda, lower tax rates and increased infrastructure spending appear to be in the cards, providing modest stimulus for the broad economy.

On the basis of Trump campaign statements, investors may rationally expect:

- Increased support for construction, defense, energy, and real estate developers.
- Decreased oversight of agribusiness firms, chemical manufacturers, consumer lenders, pharmaceutical producers, and utilities.

Global equities: Relative valuations

For equity investors, the most attractive markets in terms of valuation are currently China, Russia, and the U.K. One way to assess whether a country or sector looks expensive or cheap by dividing its price-to-earnings ratio by expected medium-term growth in earnings: A lower value suggests that investors are paying relatively less for anticipated future improvement. The table at the right shows consensus numbers for various geographic regions in mid-November 2016.

Among major developed markets, the U.K. looks most attractively valued. Admittedly, there is still considerable uncertainty about the timing of negotiations to leave the EU, but some British companies might benefit from a

Demographics: A shift from investment to savings

One critical driver of the trends of recent years is global demographics and the overall aging of the world’s population. These forces can affect an economy for decades, as seen in the example of Japan. The working age population in Japan began shrinking in the mid-1990s and has continued shrinking since then — aligned with, and a major contributor to Japan’s 20-plus years of prolonged recession.

The effects of aging populations have also been a factor why the extreme monetary policy efforts we’ve seen have not worked to stimulate economies, at least in the consumer segment. Low interest rates would ordinarily be a disincentive to saving, especially among consumers. However, where the population is aging, the inclination of individuals is to save for retirement rather than to spend. While central banks have been trying all forms of monetary policy stimulus with seemingly little effect, individuals are worried about the possibility of increasingly longer retirements.

With populations in many developed countries expected to live longer, with access to better healthcare along with other factors, those consumers tend to save, especially for a longer retirement. This phenomenon can even affect a developing market like China where, because of its past one-child policy, workers have had to make up their saving gaps themselves rather than relying on retirement systems. The shift from consumption to savings in certain swaths of the global economy could merit more examination of the effects of this trend.

Behavioral finance: Will investors’ approach change?

Another aspect that deserves more study is the impact of behavioral finance: How investors act, what expectations they have of the markets, and how they could react in 2017.

For example, while it is common to talk about the current environment as being one with low growth, one can say this is really a matter of perspective. Compared with the past, growth is low, but it is likely to remain low and even trend lower in the future. Global economic growth has been trending downward since the 1970s. There’s been enough noise to disguise this trend, such as the abnormally high 4% to 5% growth of the very late 20th century, for example, but one could argue that the true trend is seen in the approximately 5% global growth in the 1970s, and the fact that it has slipped down to about 2% now. But we may have to ask the question: Is the current low growth genuinely “low”? It could be that we’re actually in a normal growth environment.
Weaker pound, a less onerous regulatory environment, and increased government support due to a shift away from austerity.

By contrast, Japan and the rest of Europe look roughly comparable with the U.S. in terms of this metric. Similarly, among major emerging markets, China and Russia both look somewhat cheaper than Brazil or India. We acknowledge that China and Russia may incur governance risk and macroeconomic risk, but we believe that these may already be fully reflected in their valuations.

Data from FactSet and MSCI as of Nov. 30, 2016; figures are cap-weighted medians of consensus estimates; FY1 price-to-earnings ratio excludes negative estimates.

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<tr>
<th>Region</th>
<th>FY1 Price-to-Earnings Ratio</th>
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<th>P/E to Long-Term Growth</th>
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Life expectancy increasing

If low growth has become the norm, that has implications for investor behavior, both in fixed income and in other asset classes. It’s a matter of investors changing their expectations — for instance, a 5% yield from bonds was once routine, but now it might be only 2%. At present, this has led to a chase for yield as investors are taking on increasing risk in an attempt to cling to the returns they expected in the past. It will be interesting to try to anticipate how investors might adjust to these changing expectations.

One way this new era of differing expectations could have an impact is in potentially reversing the current passive investing trend. In recent years when markets have performed strongly (think of the current bull market for equities, which has run since the end of the global financial crisis in 2009), investors have just wanted to be part of the market, which has led to a flood toward passive investing. But if the “normal” environment is one of lower returns from all asset classes, security selection suddenly becomes more important. For example, if an investor has enjoyed underlying asset class returns of 10%, it doesn’t matter what the specific investments are. But if the returns drop to 3% or 4%, the investor would want to make sure that they buy the few securities that have the potential for the most return. This could lead to a shift back to active management.

**Reaching an inflection point?**

While the global financial crisis continues to cast a long shadow eight years later, the changes and events in 2016 have been so dramatic that they may have brought us to an inflection point. This year could be the beginning of major adjustments or even sea changes in how we invest.

Dean Stewart, Head of Research, Macquarie Asset Management/Sydney
Global equities

Will equity markets continue their strong showing, or will the global challenges ahead present too much headwind? Our equity managers explore the possibilities.

- Equity perspectives
- Global equities
- Small- and mid-cap equities
- Emerging markets
- China and Asian equities
Equity perspectives

After a strong run, equity expectations are muted

Patrick Hodgens, Head of Equities, Australasia/Sydney

Ty Nutt, Large-Cap Value Equities/Philadelphia

Ned A. Gray, Global and International Value Equity/Boston

Equity markets around the globe have seen a strong run because unprecedented monetary policies, while intended to spur economic growth, have not boosted global GDP but have helped strengthen equities. In 2017, our outlook for equities include several themes:

• Donald Trump’s presidency could produce major market reactions — or not — depending on execution of his plan.

• After the stretched valuations in 2016, it’s possible that we’re in for a period of softer returns.

• Because of the economic and political uncertainties, careful security selection will be even more critical.
Uncertainties abound after the U.S. election

Among the developments competing for investors’ attention in 2017, perhaps none is as prominent as Donald Trump’s victory in the U.S. presidential election. The unexpected win carries a high degree of uncertainty across numerous policy fronts, and it could provoke periods of market volatility as his administration attempts to execute on various aspects of its plan.

The new president may pursue policies that could have uneven effects across the equities universe. As a result, we might expect periods of indiscriminate selling, which could also allow equity investors opportunities to find value, particularly if they look past the headlines. This is precisely what we plan as our approach in light of these uncertainties: Paying attention to fundamentals, conducting security-by-security research, and developing informed assumptions about potential outcomes for asset prices.

Are valuations testing their limits?

For several years now, the U.S. Federal Reserve — and its central bank counterparts in Japan, Germany, England, and across the European Union — have used policy tools to suppress interest rates as they tried to reduce market volatility and stoke economic activity. These efforts have provided a powerful lift to global equity markets. In the U.S., for instance, the current secular bull market is the second-longest in American history after the nine-year advance that ended in 2000. As a result of this price support, equity investors in many developed countries are facing stock markets that are fairly valued at best. More likely, these markets are fully valued, and in some cases, they are unmistakably overvalued. In 2017, the challenge will be to identify high quality stocks that are relatively undervalued and that can provide downside protection should markets retreat toward more-normal valuations.

Do equities have more room to run?

During the current bull market that began in the ashes of the global financial crisis, U.S. stocks, as measured by the benchmark Dow Jones Industrial Average, rose about 151% from March 2009 to November 2016. That surge has lifted valuations, whether measured as price-to-sales, price-to-book, or price-to-cash flow. Take, for example, the oft-cited price-to-earnings ratio of the S&P 500 Index based on trailing operating earnings: At about 25 in mid-November 2016, that barometer was more than 50% higher than its long-term historical average of 16.

Security selection more important than ever

As we continue seeking value opportunities, security selection will be more critical than ever, in our opinion. Today’s environment doesn’t easily offer up deeply undervalued securities — those that provide defensiveness at attractive multiples. As a result, our general tendency will be to emphasize sectors that are more defensive in nature while holding underweights in sectors that are more cyclically exposed. In 2017, we are positive on healthcare, consumer staples, and telecommunications stocks. On the flip side, we think it makes sense to scale back in areas like financials and consumer discretionary stocks.

Because of how far the current bull market has run, we are factoring in — indeed, bracing for — the possibility of a period of softer returns. What’s more, the outlook for revenue and earnings growth in developed markets is tepid. There’s been some measurable improvement in the U.S. as of late, but we think it’s more realistic to accept the notion that we are fairly late in the business cycle, which is often a time when revenue and earnings growth compress. High debt levels around the world are putting additional downward pressure on growth opportunities.

There are at least two other significant risks that we are keeping in mind:

- The possibility that inflation could climb more quickly than anticipated. Uncertainties about fiscal policy are on the rise, and some analysts worry that excessive government spending could contribute to an uncomfortable level of inflation.
- The direction of interest rates. Interest rates can be double-edged swords. They could be a potential positive for stocks if they stay where they are, or even if they drift modestly higher. If rates spike or climb faster than anticipated, however, the impact on equities could be problematic.

As we continue seeking value opportunities, security selection will be more critical than ever, in our opinion. Today’s environment doesn’t easily offer up deeply undervalued securities — those that provide defensiveness at attractive multiples.

As a result, our general tendency will be to emphasize sectors that are more defensive in nature while holding underweights in sectors that are more cyclically exposed. In 2017, we are positive on healthcare, consumer staples, and telecommunications stocks. On the flip side, we think it makes sense to scale back in areas like financials and consumer discretionary stocks.

That said, we’re finding attractive relative value in the technology space, and we will continue doing research in that sector. Another sector we’re optimistic about is energy despite its cyclical
nature. There appear to be good value opportunities in specific energy stocks. Furthermore, we expect a three-to-five year recovery in crude oil prices, which could provide some tailwinds within the sector.

Areas to explore in income-generating equities

For global investors looking for an income-generating component within their equity allocations, we think convertible bonds could represent another intriguing area to explore in 2017. Convertible bonds typically do not provide the upside potential that traditional equities can, but they are known to compensate by providing a measure of downside protection. Over the long term, convertible bonds have tended to deliver somewhere between 65% and 75% of the upside of their underlying stocks and only 50% of their collective downside. (Source: Bank of America, Merrill Lynch)

Income-generating equities were a particular focus for investors in 2016, and could be again in 2017. But the rush we’ve witnessed for these kinds of investments as a substitute for bonds leads us to point out the importance of investing in a rational, levelheaded manner. By this, we mean avoiding the urge to chase the highest yield, because such a hunt often entails companies that are more cyclical or more leveraged than we would like. To the degree that an investor is looking for yield, we think it makes sense to settle for what we refer to as responsible yield, because of the emphasis on strong fundamentals. This is more likely to provide enough

Global equities

A tale of two markets: U.S. and the world

On a global basis, developed countries have not been able to keep up with the amplitude of recovery they have generally experienced since World War II. Although the upcycle has endured by global standards, economic gains worldwide recently have been muted. When we look at the performance of global equities since the global financial crisis, we find that two of the most fundamental equity pairings — U.S. versus non-U.S. and growth versus value — have exhibited marked behavior. In short: U.S. stocks have outperformed non-U.S. equities, and growth stocks have outperformed value stocks, both for extended periods.

It’s easy enough for us to observe that these trends may be ripe for reversal, especially as we look at 2017. But the more critical question may be, where will investors find the resulting opportunities? To arrive at an answer, it helps to look at the fundamental causes of the current disparities.

The struggle to recover

The U.S. equity market has recovered more quickly than other developed markets because in general, its underlying economy is aided by more favorable demographic trends and a more business-friendly environment that helped it progress steadily from its 2009 lows. Furthermore, the U.S. Federal Reserve, as the country’s central bank, has been doing some heavy lifting in the form of aggressive quantitative easing measures.

Non-U.S. markets, meanwhile, have had a tougher time since 2009. Consider, for instance, that Japan and Europe have both experienced double-dip recessions. Australia (together with other commodity-exporting countries) suffered when China’s economy slowed and the price of oil plummeted. In 2010–2012, Europe had to deal with the so-called PIIGS malady, in which levels of sovereign debt in Portugal, Italy, Ireland, Greece, and Spain began to look unsustainable. Then in June 2016, the U.K. faced the highly unexpected Brexit vote, which left investors to contemplate the fate of major U.K. producers. Problems like these left the European Central Bank, the Bank of England, and the Bank of Japan a few steps behind their American counterpart in creating monetary stimulus packages.

Where the hot money went

Given the conditions outlined above, it’s easy to see why investors moved into U.S. equities. However, the economic recovery in the U.S. was not exactly robust. This left investors asking, where can we go? Unsurprisingly, they migrated en masse to areas where returns could be found. High-growth stocks in sectors that were insulated from economic malaise, like
On the whole, we expect the best approach to equity investing in 2017 will be to position portfolios with a defensive bias. If and when markets hit rough patches, overpriced stocks will fall and investors should be well served by holding fundamentally sound companies whose shares have been purchased at reasonable valuations.

—Ty Nutt

Global influences on Australian equities

We expect several themes to influence the Australian equity market through 2017:

• In China, commodities should remain well above the lows they reached during the early months of 2016. For certain commodities — coal, for instance — we expect prices to experience some weakness. The outlook for oil remains robust, driven by stable demand and a lower rate of growth on the supply side.

• Equity markets in Australia could see support from reasonably steady consumer spending. Despite weak growth in wages, the Australian consumer continues to benefit from record-low interest rates and a stable unemployment rate.

If the U.S. raises interest rates, the region would likely continue to experience the underperformance of yield-generating assets that began in 2016. Australian banks may find earnings growth harder to come by, with lower credit growth and higher capital requirements posing headwinds.

• Value equities are poised to be more popular than stocks with richer valuations. The latter half of 2016 saw value stocks perform strongly, especially those that generated earnings that were in line with, or eclipsed, market expectations. We expect the trend to continue.

—Patrick Hodgens

technology and pharmaceuticals, were popular destinations. As a result, we now see valuations at historical extremes:

• Based on current valuation, U.S. equities are trading at a 37% premium to non-U.S. equities on a normalized basis, well exceeding the historical normalized premium of 8%. U.S. equities have outperformed non-U.S. equities for 108 months (as of December 2016), longer than any other period since the early 1980s. (Source: MSCI)

• According to index data published by MSCI, growth stocks outperformed value stocks by an annualized 328 basis points over the last 9.5 years through June 2016, also an extraordinary run in terms of duration and magnitude.

In our opinion, this cyclical pattern suggests conditions may be ripe for a reversion. At this point in the cycle, corporate earnings are weakening on a relative basis in the U.S., reflecting ongoing cyclical stress, while they are strengthening overseas. This combination of ample room for cyclical recovery with low valuation in the non-U.S. equity markets sets the stage for a potentially strong relative gain.

Pockets of opportunity: Japan and Europe

As research-driven stock analysts, we don’t view macroeconomic cycles as waves that you aim to get in front of. Instead, we operate under the assumption that cyclical disruptions create opportunities for companies that are fundamentally sound and prepared to compete.

With this perspective in mind, we’re looking for pockets of opportunity in places like Japan, where Prime Minister Shinzo Abe’s reforms are beginning to establish a more growth-friendly environment for equity markets. We’re looking for good values in the telecommunications sector as well as in capital-intensive sectors such as consumer discretionary and industrials, among others.

In Europe, we believe we have identified a number of French companies that are nimble competitors which can thrive in a slow-growth environment. In the U.K., we believe the Brexit fallout won’t be as catastrophic as originally feared. It certainly seems clear that the property sector is at risk — in London especially. But U.K. equities have been doing well in local currency terms, and we wouldn’t hesitate to invest in good companies there, so long as the price is right.

—Ned A. Gray
Small caps still provide reasons for cautious optimism

For most of 2016, the economic environment could easily be described as “moderate” or “meandering.” Despite the ever-present reality of a middling economy, however, a small- and mid-cap rally began in February 2016, allowing smaller companies to outperform large-cap stocks for the first time in several years. Currently, some reasonably good indicators have developed for the U.S. economy, historically considered a barometer for small-cap equities. That gives reason to be cautiously optimistic, especially if there are tailwinds for stock performance from improved economic activity this year.

Dividends, earnings, and capital spending

Another notable development during 2016 was that more small-cap companies began paying dividends. This raised the question of whether the small-cap rally was driven (at least in part) by the yield-seeking behavior that markets have been contending with for some time now. Ultimately, none of us think it was. A more likely explanation was an easing of recession fears that began to set in back in February, putting a wave of optimism to work on behalf of small caps. Overall, the rally drove price-to-earnings (P/E) multiples to what many analysts viewed as fair value (or beyond fair value, in some cases).

The rally was persistent enough to overcome modest expectations for earnings growth, which remained worrisome. This delicate state led many companies to adopt a strategy of buying back shares and paying dividends rather than investing in plants, property, or equipment.

Breaking the GDP ceiling

We’re in general agreement that remarkable innovations exist in the technology and biotechnology sectors, and that advances in the energy sector can also be viewed as impressive. Positive developments exist in other sectors as well, where well-managed companies are anticipating consumer needs and providing the goods and services to address them.

Markets are of course also digesting the prospect of a new presidential administration’s emphasis on infrastructure spending in 2017, and revised regulations within the financial sector. Actions like these can be seen as likely to propel gross domestic product (GDP) growth, perhaps enough that it can be sustained at the sweet spot for small-cap equities — somewhere between 2% and 4% per year. A word of caution here would be that, while an increase in infrastructure spending would likely contribute to economic growth, the economy is still susceptible to underlying structural headwinds, such as excessive debt, falling productivity, wealth inequality, and an aging population, that should not be overlooked.
Where to find growth

Not surprisingly, the technology sector is at the forefront of many of the growth trends our investment teams are following. New technologies that move data faster and more securely are growing dramatically. Data-center companies, which house data and provide services to manage them, are becoming the modern incarnation of utility companies. Not to be left out are innovative software companies that provide services to help organizations manage business-to-business relationships, maintain the security of financial assets, and empower human resources — all while generating a measurable return on investment.

Other areas of notable interest in 2017:

• In the consumer sector, healthy living is a growth trend, potentially offering opportunities via companies that produce high-quality food and beverages (as well as exercise equipment and fitness facilities).

• Brick-and-mortar specialty retailers will also be worth scrutinizing. Despite the dramatic success of online retailers, earthbound stores that deliver value are continuing to execute, achieving solid sales gains with money-saving products like generic foods or services such as do-it-yourself auto repair.

• In healthcare, biotechnology continues to intrigue, because of advances that offer hope of someday curing previously untreatable disease.

• Bank stocks are poised to do well. Loan volume at small banks is exceeding the growth rates of their larger-cap brethren, and balance sheets are generally strong (thanks to better expense control and stricter adherence to underwriting standards). In addition, if interest rates move up in the coming quarters, they will provide a tailwind for net interest margins, which could be a positive for earnings.

• The capital goods sector is another area that we’re finding attractive. During the election campaign, both parties advocated for increased infrastructure spending. This could bode well for companies involved in manufacturing, electrical equipment, engineering services, and construction.

• The energy sector will likely continue to recover, particularly if the price of oil holds steady. Thanks to the hydraulic fracturing revolution, we know there’s a reservoir of oil that can be tapped as economic growth picks up. This will be a boon not only for oil producers, but also for the U.S. trade balance, capital spending, and jobs — and of course for consumers and investors.

Higher rates, inflation on the horizon?

As we face 2017, the U.S. economy is posting reasonably good vital signs, with improvements in key indicators such as employment, wage growth, and even productivity, although we can’t be certain that it has truly achieved sustained growth just yet. Will better economic health lead to an inflationary environment, which could make the Fed comfortable with raising interest rates? If it does, the measured response says it will be a positive as long as it is happening for the right reasons. In other words, if GDP progresses to a range of 2%-to-4% growth, and rates rise as a result of that, small- and mid-cap investors should feel fortunate indeed; better economic activity could potentially create tailwinds for stock performance.
Emerging markets (EM), by nature, are often subject to a variety of forces that can make them dynamic. For EM in 2017, however, it could shape up to be a particularly vibrant year that’s full of developments. Two portfolio managers who specialize in emerging markets look at reasons for optimism and other forces at play in this sector.

As tailwinds bring optimism, security selection is key

Overall in 2017, we see two large forces continuing to influence emerging economies: the transformation of the Chinese economy and the forces of global monetary policy. At the individual country level, we would note substantial differences in terms of key drivers.

China will remain a major focus

China is likely to retain an outsized influence on emerging markets around the world. Its economy continues to undergo a major transformation. In 2016, markets were generally more optimistic about China’s ability to maintain growth and to avoid a hard landing; that sentiment may still hold in 2017, but investors are likely to be sensitive to the slightest change.

Ahead of the 19th National Party Congress in the fall, we expect policymakers to prioritize political and economic stability. We will closely monitor the government’s success at managing issues that include: overcapacity in industrial sectors, high property prices, and capital flight. These are areas that could have repercussions for economic growth, asset quality within the banking sector, and currency fluctuations.

We continue to expect strong secular trends that well-positioned companies will be able to take advantage of, even as overall economic growth trends downward. China has built a robust network of roads, high-speed rail, and high-speed broadband; combined with rising household wealth, this activity has lifted the majority of the population into the modern economy. We therefore expect strong consumption growth for years to come.

Global monetary policy

The outlook for global monetary policy continues to be mixed. We think there will be a renewed focus on the U.S. interest rate cycle, in part because of perceptions that the new Trump administration is likely to result in a faster pace of Fed tightening. Overall, however, we believe the global liquidity environment is likely to remain supportive of emerging markets. Other major central banks are likely to continue providing ample liquidity, with inflation in Europe and Japan continuing well below targets, and the European Central Bank and the Bank of Japan likely to continue their current asset-buying programs for some time.

Key drivers vary by market

Emerging market countries are unique, and so are their respective catalysts for growth. Here are some of the country-level factors we are keeping in mind as we look across the regions we cover.

Asia

- In India, economic recovery has been aided by lower oil prices, easing inflation, and rate reductions, which should continue in 2017. In the short-term there may be some disruption from recent reforms (such as a tax on the sale of goods and services), but longer term, we believe these reforms will help promote growth, along with key initiatives like infrastructure investment. At this writing, Indian stocks are generally expensive; if they stay that way, investing in 2017 will require a selective approach.

- Korea’s economic outlook appears subdued, with exports like automobiles affected by soft demand and fierce competition. A current scandal involving the country’s president means that policy stimulus is unlikely before elections scheduled for late 2017. Valuations are
inexpensive, providing strong stock-specific opportunities.

• Comparatively high dividend yields in Taiwan should be supportive there, while Apple’s next iPhone device will be a key focus for the technology sector. China continues investing in its own technology industry, which may reduce the competitiveness of Taiwanese companies over time.

• Politics will remain at the fore in Thailand, with the crown prince set to ascend the throne and the military government expected to announce general elections.

• In Indonesia, infrastructure investment remains a focus, with the economy on sound footing, but there could be some vulnerability to rising U.S. rates.

• Volatility may increase in the Philippines if U.S. immigration policies affect remittances from overseas foreign workers, and uncertainty around policy has increased.

Emerging Europe, Middle East, and Africa

• Russia is emerging from recession, and continued stability in energy prices will be important to keeping the recovery on track. The potential lifting of international sanctions would be a positive for risk sentiment and for company financing costs. The export sector remains robust, helped by a weaker currency, and the government is experimenting with tax reforms to boost energy sector investment and raise dividend payouts from state enterprises — developments that would likely be viewed favorably by investors.

• Growth in Turkey has slowed as a result of political and security uncertainty, issues that continue to dominate asset price movements. It will be important to monitor the government’s response, in terms of economic stimulus as well as crackdowns on dissent. Further moves toward constitutional reforms aimed at concentrating power in the president’s office will also be critical for markets.

• In South Africa, slowing growth, political struggles, and concerns about a possible ratings downgrade have weighed on stocks. We expect investors to remain focused on these issues while looking for progress on much-needed economic reforms.

Latin America

• In 2016, we have seen inflation in Argentina come down, while sovereign risk continued to lessen. Going forward it is important to monitor whether the government can continue its structural reforms and maintain its positive approval rating. The country will have its midterm election in October 2017, and the results could signal whether the pace of reform can continue.

• In the coming year, Brazil’s monetary and fiscal policies will be important to the country’s economic recovery. Tangible progress on the fiscal front (such as pension reform) can lead to further reduction in long-term interest rates, which would boost the economy. We will also closely watch the government’s progress on infrastructure concessions.

• In 2017, the most uncertain aspect for Mexico will be its relationship with the U.S. and whether its manufacturing sector will be affected by potential changes in the North American Free Trade Agreement. We will also be monitoring how the government executes on its reform plans in the energy and telecommunications sectors.

Focusing on fundamental investing

We remain constructive on the long-term outlook for emerging markets. We believe it remains paramount to maintain a selective, forward-thinking approach to investing, given the important shifts and divergences within the global economic environment. Our process will remain centered on identifying sustainable franchises that we believe can be resilient when faced with fluctuating market conditions and that can gain from supportive secular growth trends.

—Liu-Er Chen
Addressing an EM perception gap

Despite suffering a dip in the wake of the U.S. presidential election, we believe emerging market equities can resume their positive momentum as we move through 2017. There are several key reasons for this.

First, aggregate positioning in emerging markets remains fairly bearish, meaning that the asset class is underweight from a global asset allocation standpoint. This underweight is partly due to overinflated fears that China’s economy is slowing down meaningfully. Indeed, China’s economy has been cooling for some time now, but with a current growth rate approximately between 6% and 7%,* it is well ahead of most other markets and regions around the world.

Given the changing contours of its economy, we think there is reason to view China as a potential source of support for emerging markets equities as an asset class. Some of this economic change is embodied in an increasingly sophisticated and competitive collection of Internet-related businesses; it’s part of a broader, fundamental economic shift that is putting less emphasis on heavy industry and focusing more on domestic consumption. Analysts will be scrutinizing this progression as we move through 2017 and beyond.

**China is not the only story**

Outside China, there are other pockets of opportunity in which prevailing sentiment could be characterized as too pessimistic. In Russia, for instance, coal, energy, and steel stocks are poised in our view to do better than current sentiment would indicate.

More broadly, consensus estimates for corporate earnings are up about 15% for major emerging markets indices, while valuations are close to their longer-term averages and are therefore inexpensive when compared to developed markets — which are generally trading at premiums to historical norms. As we move through 2017, the positive outlook for earnings ought to carry more weight than the noise created by near-term headlines or any amount of bluster about geopolitical events.

In short, there are reasons to be optimistic about 2017. This is not to downplay the risks that investors should observe when investing in emerging markets. However, our positive leanings are based on indicators like earnings that appear likely to grow, and allocations to the asset class that could pick up steam.

— Joseph Devine

*China’s gross domestic product (GDP) was most recently reported at 6.7% in July 2016 by China’s National Bureau of Statistics.
With its complex economy, China is still different

China is different. This is more than a truism when it comes to addressing many of the concerns investors have about the viability of the Chinese economy, off its superheated growth of the last decade but at a 6.7% GDP, still growing faster than most economies. The areas of economic concern include:

- How will China deal with excess capacity in many basic industries like cement and coal?
- Will the government devalue its currency, the renminbi (RNB)?
- Perhaps most urgently, how will the Chinese manage what we estimate to be US$1.74 trillion of non-performing loans in the banking system?

This combination of challenges can read like a recipe for a hard landing or worse. But we spend a lot of time meeting with Chinese officials and studying the risks, asset quality, and potential investment opportunities — and we believe there are key differentiating factors that suggest a better outcome can be achieved. Fundamentally, it appears a resilient China is evolving into a new economy.

QE China style

Differentiating factors that can help offset issues in China include:

- Interest rates in China (and Asia in general) are counter-cyclical. This gives policymakers room to provide liquidity as needed through conventional channels.
- China’s demographics are unlike anything the world has witnessed before. With hundreds of millions of people achieving a middle-class lifestyle for the first time, demand now exists for consumer products and services that can replace manufacturing for export as the basic driver of China’s economy.
- China’s leaders have a range of unconventional tools and mechanisms they can use to gradually neutralize non-performing loans over an extended period of time. Similarly, they should be able to avoid a dramatic currency depreciation, relying on a slow, controlled “dis-appreciation.”

In the new economy, a shift away from heavy industry

Movements in the economy suggest that a rebalancing to a new Chinese economy is well underway. This is particularly apparent in the shift away from state-owned heavy industry and a marked movement toward a service industry, as seen in this chart — a development that has been more typical of other developed markets.

A consumer middle class emerges

We can report first-hand evidence of clues of a burgeoning middle class. In our extensive travels throughout the Asia region, we’ve begun to notice a vast number of mainland Chinese in tour groups or traveling with their families outside China. We notice it when lining up for security and customs, as the queues are getting dramatically longer.

The numbers confirm this impression: There are an estimated 120 million Chinese who travel abroad currently. That number is expected to reach 220 million by 2025. This would be more than four-and-a-half times the size of the U.S. outbound tourist population — a remarkable figure.

As bottom-up stock pickers, we’re finding quite a lot of value at the moment in classic businesses that do well throughout the cycle, such as consumer staples, and food and beverages. In addition, we expect to find value in businesses that provide goods and services for the emerging middle class. These include: airports, duty-free retailers, hospitals, department stores with tax rebates, tour guide operators, overseas education providers, cosmetics, hotels and resorts, and lifestyle brands.

An evolving, new economy

Despite the slowdown in growth in the last few years, China appears to have the tools and capabilities to potentially overcome some significant hurdles — and with an evolving economy that brings the promise of new investment opportunities.

Sam LeCornu, Portfolio Manager/Hong Kong
Britney Lam, Investment Specialist/Hong Kong
Global fixed income

From views on the political events now shaping the landscape, to thoughts on low yields, our fixed income leaders explore issues such as the outlook on credit, the environment for the U.S. municipal bond market, and global currencies.

- Fixed income perspectives
- Credit
- U.S. municipal bonds
- Currency
Fixed income perspectives

Charting new territory with rates still low

Paul Grillo, Co-Head of Total Return Fixed Income/Philadelphia

David Hillmeyer, Portfolio Manager/Philadelphia

Graham McDevitt, Portfolio Manager/London

In recent decades, we’ve witnessed a whole new era of monetary policy, complete with unprecedented balance sheets from central banks around the world. In the more immediate past, globalization and productivity gains have shifted from high gear to a screeching halt. In the year ahead, policymakers and markets will navigate the next steps in this uncharted territory.

Our key outlook for 2017 includes several themes:

• We anticipate a year of coupon-like returns and incremental changes.
• The search for yield will continue.
• Small, incremental steps in monetary policy are possible around the globe, with fiscal policy in the discussion.
• Political upheaval and protectionist trends are the key risks — particularly with the implications of the Brexit vote and the presidential election in the U.S. — although the true economic outcome of such movements remains to be seen.
2016: Setting the stage for another eventful year

The year 2016 was eventful for fixed income markets, including of course the shock of Brexit and the unexpected outcome in the U.S. presidential election. Much of the year was marked by low and negative interest rates around the world, sending investors hunting for yield. Expectations were high early in the year that the U.S. Federal Reserve would undertake a series of rate hikes. However, there were multiple delays in the Fed’s plans in the face of varied uncertainties: plummeting energy prices, a slowdown in China and other emerging markets, pockets of labor market weakness in the U.S., and the rise of protectionist politics in the U.K. and U.S. Treasury yields touched a record low in the year before recovering, yet remain historically low.

Meanwhile, key central banks outside the U.S., including the European Central Bank (ECB) and the Bank of Japan (BoJ), are still in easing mode. A number of central banks have been experimenting with negative rates and other new quantitative easing policies, with mixed success. By year end, markets were starting to question the unintended consequences of negative rates in particular, though the prospect of continued easing outside the U.S. is all but assured.

Low global rates mean high bond prices, but also inflated values for other asset classes, via a lower discount rate. Global demand for yield has only supported that trend. Indeed, the search for yield took on ever-more creative forms in recent years, with bursts of interest in smaller fixed income markets like bank loans, direct lending, and infrastructure debt. We even saw pronounced foreign investor interest in taxable U.S. municipal bonds. The search for yield has led investors, liability-driven institutions especially, further out on the risk spectrum.

Central banks: No sudden moves

Central banks around the world are between a rock and a hard place. Seven-plus years after deploying record-breaking liquidity, central bankers are finding it’s not so easy to claw back. The Fed’s tentative and halted efforts to raise rates, even to a “normalized” zone, are exhibit A. As such, we see the Fed and other major central banks in tweaking mode. Economies do not appear to be ready for traditional monetary policy, according to current GDP and inflation levels, and we don’t expect that to change suddenly in 2017. However, there is political risk to consider, particularly in light of the U.S. presidential election. This, along with the populist movement underlying Brexit, could pose a threat to the delicate balance the central banks have managed to establish in keeping any extreme market reactions to problems like heavy debt and slow growth reasonably contained.

The year 2016 also saw a growing consensus that monetary policy may have found its limits. Quantitative easing can alleviate liquidity problems and provide medium-term support for asset values. But as ECB and BoJ bankers have seen with the lack of effectiveness of negative rates, monetary policy is no magic wand. The central banks’ actions have had limited effect on real GDP growth, increased lending activity, capital expenditures, or the velocity of money (i.e. the turnover of money supply in an economy). What’s more, the consequences of some of the quantitative easing policies — such as creating losses for lending banks — can cause more harm than good.

But with inflation and growth in a fragile state, at least at the start of 2017, policymakers would seem to have little leeway to withdraw support. We expect 2017 to be a year of only small changes, and likely continued low yields. The implication is that the search for yield will continue to be a driving force among investors.

The fundamentals:
Clarity on structural shifts

One of the ideas of post-crisis easing was to provide a stopgap measure until fundamental economic activity — such as growth, inflation, job creation, borrowing activity, and corporate profits — returned to normal levels. But that day still hasn’t come.

In fact, it’s becoming clearer that structural shifts have not taken hold. This may mean that returning to a sustainable level of growth, like that experienced prior to the global financial crisis, will remain elusive for many economies around the globe. Productivity gains have slowed. Global trade activity fell in 2016. And demographics around the world set the stage for more challenges ahead. The global labor market is shrinking as the population ages, changing the ratio of workers to retirees and shifting the landscape of saving and consumption.

10-year Treasurys: New lows in 2016, but headed north

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<th>Yield (%)</th>
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<th>2</th>
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Source: Federal Reserve Bank of St. Louis
Growth is in a positive zone and muddling through. But the prospect of higher growth rates may be a mirage until the structural challenges in many global economies are addressed. One implication is that inflation is likely to remain relatively muted, even if the new U.S. presidential administration does become more aggressive with deficit spending and fiscal policies. There could be a series of inflation scares, but certain self-correcting mechanisms in economies, which put pressure on risk assets when inflation threatens, to “snuff out” these inflation spikes.

Our expectation for 2017 is that these dynamics will persist — growth will muddle along, and inflation will remain moderate. Gains in fundamentals — like profits, job creation, wage growth, and household formation — are likely to be incremental.

Global politics: Fallout and aftermath

The economic developments of the last two market cycles have left a broad swath of the population behind, and global politics seem to be offering up the proof. The Brexit result stunned markets, but turned out to be the opening act for the U.S. election of Donald Trump.

While the pot of economic growth has shrunk, technology gains and global trade patterns have divided the pot. The trend seems to be that opportunities are available only for the most-educated and the lowest-hourly-wage workers, with nothing for the enormous population in between. These trends are not limited to the U.K. and the U.S.

The resulting wave of populist and protectionist politics will likely be a dominant theme of 2017. We anticipate further strength in these movements around the globe, which is potentially destabilizing across trade relations. This is a key risk for the year ahead.

Another issue that comes down to politics is fiscal stimulus. While interest has clearly gone up as seen in the number of media mentions alone (as seen in the chart below), capacity and political will are a different matter. Many emerging market countries have already chosen fiscal stimulus in the form of running budget deficits when commodity prices plummeted. Among developed countries, Germany and perhaps the U.K. are in the strongest positions to add debt and provide fiscal stimulus, but the political will may not be strong enough. China is another country that may have the capacity, and may be more politically able to put it in place.

Our expectation is that major fiscal stimulus is unlikely. As for politics, the result of U.S. and U.K. elections are sure to bring changes, but we believe the true economic impact remains to be seen.

The year ahead

As we look to 2017, we are reminded how much the bond markets can be moved by sentiment and other non-technical factors. The math of coupons and durations is concrete, but the very human developments driving economic activity and politics are infinitely variable.

Still, we can look at the likelihood of changes to yields and spreads, and consider how these three themes — central banks, fundamentals, and politics — are likely to influence market activity. Our expectation is that 2017 will be a year of small steps and careful navigation.

In such an environment, fixed income returns are likely to be coupon-like, rather than being driven by capital appreciation. The debt markets are walking the tightrope of low growth and high anxiety, fertile ground for volatility. In our view, fundamental research and analysis continues to be crucial in choosing investments with true long-term potential.

Spike in mentions of “fiscal stimulus” in the news

Source: Bloomberg News Trends

*Sources: Productivity, various including World Economic Forum; global trade, World Trade Organization.*
**Spotlight: Currency**

**Headwinds for emerging markets; U.S. dollar to gain ground**

Geopolitical friction is fast becoming a dominant theme for financial markets, and currency markets are no exception. The rise of populism, which produced the surprising Brexit vote and helped elect Donald Trump to the U.S. presidency, may create a distinct layer of pressure on international relations.

**Ramifications for the U.S.**
Looking at the United States, let’s separate risks into two categories.

*Domestic:* Within the U.S., monetary easing will likely give way to fiscal easing, given Republican control of the White House and both chambers of Congress. The immediate bias toward reflationary trades in the wake of the election — due to expected infrastructure spending — is likely to be short lived. Any advance in global economic growth will be capped by factors that include higher interest rates from U.S. Federal Reserve hikes, a stronger U.S. dollar, repatriation of dollars parked overseas, and tax cuts.

*International:* By all indications, U.S. foreign policy will concentrate on trade protectionism. Renegotiation of the North American Free Trade Agreement (NAFTA), or a recasting of agreements with Asian nations could generate potential risks for countries in those two regions. Still, we expect little change in the balance of exports and imports, which we believe will ultimately be driven by sustained global growth. Despite strong words during the election campaign, the Trump administration’s global security effort may result only in minor adjustments.

**Putting a finer point on implications for the U.S. dollar**
Our core view is that the dollar will gain ground in 2017. However, the move higher will likely be volatile and capped by its own appreciation, considering that an ascending dollar can have potentially unhelpful effects on corporate earnings, U.S. exports, and inflation.

Although we believe that dollar strength will be limited relative to most growth- and commodity-centric currencies, we do expect to see continued strength against the euro, as the political situation in the euro zone continues to deteriorate. Given that negotiations between the U.K. and the European Union (EU) will probably begin in early 2017, a second nation calling a referendum on their EU membership would produce weakness and instability in the Euro zone. We also maintain that the dollar will have greater strength versus Asian currencies.

**A note on emerging markets**
Throughout 2017, we expect currency markets in the developing world to generally remain range-bound, though violently so. Two points help summarize what we foresee.

- Trade negotiations could have negative consequences for Mexico and Canada (Canada’s economy is often considered more in sync with emerging markets), as well as for China, South Korea, and Taiwan. All of these countries rely significantly on global trade.
- China will face pressure as it attempts a controlled currency depreciation program. This will be coupled with the Trump administration’s threats of painting China as a currency manipulator.

Despite the headwinds noted above, foreign exchange markets across developing nations will likely provide investment opportunities in 2017. But we don’t expect a truly robust positive trend unless the Trump administration’s economic policies prove supportive of global growth, or if Chinese growth returns to its former pace.

**Lloyd Alty,** Head of Currencies / Sydney

**Sean Simmons,** Currency Specialist / Philadelphia
The premium for risk assets continues to be low across the globe, and that’s a key driver of credit today. In the year ahead, we see a continuation of trends that began to take hold in the spring of 2016.

Our expectations for 2017 encompass a number of factors:

- Low spreads are a product of a low risk premium, likely to continue with small but positive growth and foreign central bank monetary easing.
- Credit is at the center of the search for yield.
- A wave of debt refinancing has extended the credit cycle.
- Valuations may overlook real political risk in the year ahead.

Assessing credit markets in 2016
Credit markets saw a lot of volatility at the start of 2016, as energy prices were still looking for a bottom. While this environment pushed some high yield oil and metals-and-mining companies to the brink of insolvency, they ultimately stabilized after commodity prices rebounded. As a result of the turnaround in these industries, companies were able to repair their balance sheets in the form of debt restructuring and/or refinancing. This activity allowed high yield issues to be top performers for the year, while also extending the corporate credit cycle.

U.S. credit markets experienced massive inflows from a diverse set of buyers in 2016. Quantitative easing (QE) programs like the one that allowed the European Central Bank (ECB) to purchase corporate bonds caused near-zero and even negative rates in some regions. With little compensation from local credit markets, European and Asian investors directed dollars to the U.S.

This trend of “crossover investors” has turned the U.S. bond landscape into something of an absolute return, any-yield-will-do environment. As such, foreign buyers have even pursued taxable municipal bonds, historically dominated by U.S.-based investors. We anticipate a continuation of that trend in 2017.

Anticipating smaller shocks in 2017
The 2016 activity in energy and metals and mining sector spreads was extreme in scale and speed. This reaction was a result of a violent exogenous shock in which some commodity prices plummeted more than 60% in less than 12 months.

Today, we see a more stable outlook for commodity prices, without the same kind of exogenous shock on the horizon. If we are correct in anticipating smaller shocks, then we would expect credit market valuations to be more broadly connected to corporate cash flows, defaults, and growth prospects. Healthcare, banking, media, and technology are some of the sectors that could see heightened volatility, however, as the new political regime may affect legislation and the regulatory environment.

Valuations are tight
Since the spring rally in spreads, high yield and investment grade valuations are looking particularly tight. We would argue that they are more in line with what investors would expect with a 2% to 3% GDP growth environment relative to this point in the credit cycle.

These spreads may not price in enough risk, or be dependent on forecasts that are too optimistic — such as $50-plus-per-barrel oil prices. In our view, spreads on an absolute basis are disconnected from fundamentals, but that can persist for long periods given the technical backdrop. Unless the economy goes into recession, we believe that credit spreads could stay flat or even compress slightly further in 2017.

In summary, with valuations as tight as they are, we believe this market warrants discriminating credit research. Relative to historical averages, today’s spread levels imply less upside than downside. So in our view, discerning valuation based on in-depth credit research is paramount to success in this environment.

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<th>Investment grade fundamentals are deteriorating</th>
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<td>Interest coverage</td>
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<td>8% 1996 through 2016</td>
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Source: Morgan Stanley
The surprise election of Donald Trump as U.S. president, along with Republican majorities in both houses of Congress, had an immediate effect on all markets — with the U.S. municipal bond market feeling the impact in particular. The election caused municipal bonds to end 2016 on a decidedly weaker note, due to concerns over Trump’s campaign pledge to increase fiscal spending while cutting taxes. While there were fears this action would add to the federal deficit and accelerate inflation, the bigger concern for municipal bonds would be the double jeopardy of lower taxes, which would render the tax exemption on municipal bonds less valuable. There could be uncertainty and volatility in the municipal market for some time to come. In fact, we believe volatility could be a dominant theme in 2017. However, the change in Washington, D.C., could also mean the opportunity to break long-standing logjams, and could have some positive fiscal outcomes such as infrastructure projects.

The lead-up in 2016 to the election

A correction in the municipal market started well before the November election as new issue supply surged after Labor Day, and demand, as measured by mutual fund flows, moderated. Supply often picks up after the summer but this surge was significant, occurring in September and October ahead of the election and the December interest rate hike by the Federal Reserve. In 2016, the market set an all-time record for new issue supply, with a total supply of $440 billion as of Dec. 15, surpassing the previous high of $433 billion in 2010.

From late August until immediately after the election, the municipal market lost about 4% in return, with more than half of the loss coming since the election. For example, the Bloomberg Barclays Municipal Bond Index had a 1-year return as of Nov. 30, 2016, of -0.92%, after being up 4.54% on Aug. 31. Since the summer, rates have risen, the yield curve has steepened, and credit spreads have widened.

Tax proposals and the muni impact

Presidential election years always seem to bring about talk of tax cuts, tax hikes, and tax reform. This in turn generally leads to some volatility in the municipal bond market over concern about the tax-exemption aspect of the investment. (The higher the tax bracket, the higher the taxable-equivalent yield when compared to taxable securities such as U.S. Treasurys or corporate bonds. The converse is true when tax brackets go lower.)

Trump comes to office with a tax proposal to lower the top individual income tax rate from 39.6% to 33%, and the corporate tax rate from 35% to 15%, as well as eliminate the alternative minimum tax (AMT). Republicans in the House of Representatives have put forth a similar plan, with the exception that they would cut the corporate tax rate only to 20%. Some type of tax cut or tax reform has a higher chance of passing with the GOP holding the majority in the House and Senate as well as the presidency. But while both the House and Trump have discussed capping deductions and exclusions, they have been silent on the treatment of municipal bonds. Previous Obama administration budgets have proposed capping the municipal exemption at 28%, below the top individual tax bracket. This type of cap would most likely hurt municipal bond evaluations and would cause a repricing in the market, unless existing securities were grandfathered.

We have a high degree of confidence that a lower personal tax rate, such as 33%, could pass next year, along with a lower corporate tax rate — one probably closer to the House’s proposed 20% level. Our confidence level is lower on a 28% cap on the municipal bond exclusion. This is because we believe that municipalities will play a significant role in the national discussion on infrastructure, another key campaign promise. That said, we feel that the municipal bond exclusion cap may be on
the table for discussion at some point, and if so, this could cause volatility with valuations. Still, it’s possible that many will reach the conclusion that a 28% cap would serve as somewhat self-defeating for any infrastructure stimulus plan.

Renewed focus on infrastructure

While tax cuts or reform may affect the demand component of the municipal bond market, Trump’s campaign pledge to enact a major infrastructure program has the potential to significantly increase new issue supply in the future. Unlike the tax cut proposals, however, details surrounding the infrastructure plan have been vague.

Infrastructure programs can be funded at federal or local levels, or through public and/or private partnerships. Other, more innovative ideas have been put forth. For example, in a recent paper, Standard & Poor’s suggested repatriation of overseas corporate profits and the creation of an infrastructure fund using a percentage of those profits. There is also always the possibility of resurrecting the Build America Bond (BAB) program, in which state and local governments issued taxable municipal bonds with a portion of the interest costs subsidized by the federal government.

With or without an infrastructure program in the new Trump administration, investment in replacing crumbling roads, bridges, gas and water lines, and many other projects, has become an issue that local municipalities already turned their attention to, with important implications for the municipal bond market. For example, in a 2013 report, the American Society of Civil Engineers set the price tag to fix or replace current infrastructure at $3.6 billion, of which $1.6 billion would need to be raised by local governments. This may already be starting — in 2016, we saw new money issue supply increase to $172 billion as of Dec. 15, representing a 12% increase over 2015. And at the ballot box in November, voters approved approximately $60 billion in new bond issues to address these needs going forward.

While infrastructure needs are likely to continue to add to municipal supply in 2017, refunding issues may start to decline if interest rates become higher, whether a result of fiscal or monetary policy, or a combination of both.

We have a high level of confidence that some type of infrastructure program will be enacted by the federal government, and we are fairly confident that the municipal bond market will play a role in its financing. Some combination of federal, local, and private financing will likely be used to address these problems and stimulate the economy.

We have less confidence in the corporate profit repatriation concept. But we believe some repatriation law can be passed and these returning profits can help stimulate the economy through business investment. We also have a lower confidence level in a resurgence of the BAB program, as in the past Republicans have resisted the subsidy. We would add, however, that there could be a healthy audience for an increase in some type of taxable municipal bond issuance as we have seen strong demand from overseas clients for this asset class.

2017: An interesting year to come

We believe 2017 will be an interesting year as the U.S., after years of gridlock, should be very active on the fiscal side. However, it’s important not to lose sight of the moderate domestic growth and weak global growth that have been driving the lower-for-longer interest rate environment. We are fairly certain that economics and global central banks will steal the spotlight from domestic fiscal policy at times during the year. Regardless of the environment we find ourselves in, we feel that our bottom-up, credit-driven approach to security selection and portfolio construction, will continue to be keys to generating alpha in 2017.
Alternatives and real assets

After years of monetary policy serving as the primary stimulus, there is new focus in 2017 on fiscal policy, and especially infrastructure spending. Against this backdrop, our experts provide perspective on infrastructure and other assets.

- Infrastructure investing perspectives
- Global real estate investment trusts (REITs)
- Commodities
- Agriculture
From the increased focus on deteriorating roads, airports, and other facilities, to growing interest in the asset class for investing or as a fiscal policy solution — infrastructure has taken center stage. We see the global picture for infrastructure in 2017 as including:

- The possibility of significant infrastructure funding, both public and private, as governments increasingly eye fiscal spending as an alternative to monetary policy.
- Opportunities for investments, including infrastructure debt instruments, and vehicles to invest directly in infrastructure assets.
- An emphasis on risk management, particularly in the uncertain macroeconomic environment.
Political landscape: Just one of the catalysts

Among asset classes, few are garnering as much attention as infrastructure in 2017. New U.S. President Donald Trump has promised to invest billions in airports, roads, bridges, and other infrastructure as a means for injecting life into the U.S. economy. Similar sentiments have been expressed across the developed world, where highly accommodative monetary policies are close to tapped out and fiscal spending is seen as a timely substitute.

A supportive political landscape is just one catalyst fueling a rapidly expanding opportunity set for infrastructure investments in 2017. On the supply side, mounting budget deficits are pressuring governments globally to privatize existing assets or turn to private sources to finance new projects. Public and private infrastructure is expiring, inefficient, or underperforming, and by some estimates may require as much as $50 trillion by 2025 just to maintain it. In addition, an estimated $78 trillion is needed by that time to build new infrastructure to address longer-term trends such as urbanization, a growing workforce and environmental mandates. Finally, infrastructure will be critical to a range of current and emerging disruptive technologies, including broadband-hungry cell phones and other devices, bigger and faster trains, and autonomous vehicles.

The investor demand side of the equation appears equally supportive in many ways. Low-to-negative interest rates have compromised the ability of pensions, insurers, and other institutional investors to meet their long-term liabilities, and now they’re seeking higher yielding alternatives that match their time horizons. At the same time, they’re looking for inflation-linked sources of income that protect their future earnings potential. Finally, there’s the appeal of owning an asset not highly correlated with stocks or bonds.

Ways to invest in infrastructure in 2017

Of all of the infrastructure spending on tap around the globe, we anticipate the universe of investable infrastructure projects will represent a smaller but still sizable opportunity set. We believe investors seeking to strengthen their portfolios have several different ways to tap infrastructure investment opportunities in the year ahead: debt or unlisted and listed equity investments.

Infrastructure debt

In addition to governments’ reduced role in financing infrastructure projects, banks are continuing to withdraw from infrastructure debt transactions amid new regulations governing their liquidity and capital ratios. At the same time, the bond-buying spree that some central banks have engaged in recently has limited the supply of government bonds and driven up their prices, making government bonds a less attractive option for many institutional investors. Infrastructure debt strategies may be an attractive income alternative for some investors. Less competition from banks for infrastructure debt has generally pushed their yields higher than corporate bonds. That means, for example, that investors able to buy and hold have the potential to earn a premium across their liabilities and help cover gaps in their pension deficits.

What’s more, default and recovery rates on infrastructure debt have compared favorably with corporate debt as well, especially over longer horizons. The stricter terms that govern most infrastructure debt agreements mean that issuers have far less ability to change the scope of the project and use the capital for something else. The debt burden is further supported by the underlying assets and cash flows, which are contractually obligated, often inflation-linked, and generally uncorrelated with economic activity.

These traits tend to make infrastructure debt an attractive alternative for institutional investors in a year in which many governments could increasingly rely on private financing. In the U.S., it remains to be seen how much infrastructure spending the federal government will actually take on, or how
much will be backed by private financing. One possibility entails using the lure of tax credits and loan guarantees to stimulate private investment. The infrastructure plan put forth by Trump during the U.S. election, for example, called for the use of a “deficit-neutral system” of infrastructure tax credits to help harness market forces and attract new private infrastructure investments. His administration also vows to work with financing authorities, public-private partnerships (generally, private investment in public infrastructure), and other “prudent” funding opportunities.

Regardless of how much U.S. fiscal stimulus spending is on tap for 2017, we expect to see continued strong demand from markets such as the U.K. and Australia that have consistently relied on private financing for new infrastructure projects. We believe energy, in particular, should continue to create demand opportunities in the U.S., Europe, and some key developing markets as strong oil and gas production requires changes in supporting infrastructure and renewable energy penetration onto the grid demands upgrades to electricity transmission networks. In addition, projects sponsored by banks shortly after the credit crisis are now coming off their books through refinancing opportunities.

In addition, the regulations known as Solvency II, designed to create a universal European regulatory system for insurers, have opened up new opportunities for infrastructure. With recent changes to Solvency II establishing infrastructure as potential low-risk investments for insurers, the governing body of the European Insurance and Occupational Pensions Authority (EIOPA) is aiming to provide guidance on how high-quality infrastructure assets may be classified. The result may provide predictable long-term cash flows and transparent, manageable risks for insurers through this asset class.

In contrast to infrastructure debt, equity investments in infrastructure assets may be appropriate for institutions in a position to venture further out on the risk and return spectrum within the asset class. Investors can choose between two approaches: unlisted or listed infrastructure.

Unlisted strategies pool investor capital to make private-equity type of investments in infrastructure projects and assets around the world, while listed strategies spread investor capital among a range of listed equities available on global stock exchanges, and can be established as mutual funds or ETFs investing in infrastructure. For instance,

**Spotlight: Commodities**

**Hard assets feel impact of global change**

Commodities have been in a bear market since 2011. With Donald Trump taking office as U.S. president, there will likely be more political and financial market uncertainty over the long run. However, his economic proposals are largely designed for stronger near-term growth. This could prove to be a catalyst for cyclical growth conditions globally, which is generally a positive backdrop for commodities.

**Energy and oil**

For energy, and oil in particular, we believe the new Trump administration should not have a big impact on fundamentals in the near term. If anything, there could be renewed support for shale producers, such as through less regulation, and thus a continuation of large capital expenditures and advancing technology. This in turn could cause production to ramp up and costs to decline. However, we expect that U.S. shale producers would likely need to make the most cuts in order to rebalance the global oil market. The structural change in oil production will take time, in our view, and limit the upside for oil prices.

**Metals, including copper**

We are much more optimistic on metals. Despite the recent metals rally that has led to euphoria overcoming the markets, it is important to note that the rally started prior to the Trump victory, which means that factors other than stimulus-driven demand must be considered.

The copper market, despite a relatively quiet 2016, has been affected by some supply disruptions recently as a result of strikes in Indonesia, labor disputes in Peru, and bad weather in Australia. However, these disruptions are likely not strong enough to prevent a production rise in copper this year, although they do reduce projected excess supply.

**The China factor**

From a demand perspective, base-metals-linked indicators in China are positive. Although Chinese GDP growth is slowing, the economy is still growing and is fairly strong when considered in absolute terms. As China continues to evolve into a consumer-driven economy, many base metals could benefit from underlying demand growth rates.

In our view, construction and transportation remain key markets, and global auto markets remain solid with cheaper oil potentially encouraging further capital expenditures.
Gold performance

The performance of gold historically is driven mainly by real yields. Therefore, inflation expectations, market views about whether the U.S. Federal Reserve is ahead or behind the curve, as well as idiosyncratic factors in the gold market, all need to be taken into account. The return potential of private infrastructure depends largely on the investments made in the business after it’s acquired. Typically, the goal of unlisted infrastructure investments is to grow the earnings or revenues of the underlying assets, improve their capital structure or service levels, or address management shortcomings before selling the asset or assets for a profit at some point in the future. Even in the midst of the global financial crisis, we’ve observed that many unlisted infrastructure investments still generated positive single-digit returns after expenses and fees, with generally low volatility.

We believe that in 2017 the opportunity set for unlisted infrastructure investments is shaping up to be more diverse than in years past. Utility divestitures in Europe, clean water projects in China, airport privatizations in France and Japan, midstream energy companies in the U.S. and Mexico, and telecommunication providers in Europe and Brazil are among a growing list of interesting opportunities in the unlisted space.

We expect to see continued strong demand from markets such as the U.K. and Australia that have consistently relied on private financing.

Alexandra Schneider,
Portfolio Manager / Vienna

someone looking to invest in toll roads can either invest in a specific project on a private basis (often through an intermediary), or in a public fund that invests in listed toll road operators.

Unlisted infrastructure

Direct investments in unlisted infrastructure generally require long time commitments (for example, 7–10 years) but offer the opportunity to provide attractive returns through greater oversight and future sale of the asset. The return potential of private infrastructure depends largely on the investments made in the business after it’s acquired. Typically, the goal of unlisted infrastructure investments is to grow the earnings or revenues of the underlying assets, improve their capital structure or service levels, or address management shortcomings before selling the asset or assets for a profit at some point in the future. Even in the midst of the global financial crisis, we’ve observed that many unlisted infrastructure investments still generated positive single-digit returns after expenses and fees, with generally low volatility.

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Gold performance

The performance of gold historically is driven mainly by real yields. Therefore, inflation expectations, market views about whether the U.S. Federal Reserve is ahead or behind the curve, as well as idiosyncratic factors in the gold market, all need to be taken into account. Gold could soar if nominal yields rise as long as inflation expectations rise faster, which in turn would keep real interest rates low or even negative. A scenario where a sizable fiscal stimulus boosts growth and real rates higher would mark a game changer and a resulting negative environment for gold. We expect only a gradual rise in inflation in Europe, sluggish growth, and heightened macro uncertainty, and thus room for more upside.

The sharp rise in the gold price this year, supported by strong institutional investor inflows, has hampered consumer demand. According to the World Gold Council (as of the third quarter 2016), demand for gold bars, coins, and jewelry remained weak, and year-to-date consumer demand was down 16%. Looking ahead, we expect physical demand to be stronger in 2017. For example, some consumers, largely in China and India, are still waiting for lower prices before entering the market. We would expect that any further dips in the price will be picked up by a strong consumer response. Combined with the political uncertainty, we still see some tactical upside in gold.

In summary, commodities look increasingly likely to provide diversification going forward. Historically, they have even been negatively correlated with bonds. In our view, the backdrop of central banks’ distorting bond markets, and negative interest rates’ increasing demand for “hard assets,” should be supportive for commodities. U.S. dollar strength is typically a headwind, but this relationship is volatile. Last but not least, we believe that if the current trend toward fiscal stimulus bears out, it would support our constructive view on commodities.

Alexandra Schneider,
Portfolio Manager / Vienna
In some cases, we could very well see governments offering to cover the cost gap to make certain infrastructure projects profitable for private investors. A toll bridge may not be palatable at $100 million, but a cost-sharing project in which the government assumes half the cost and guarantees a minimum toll level is much more likely to incentivize a private direct investment while reducing taxpayers’ burden. Such public-private partnerships could be structured in a variety of ways but seek to benefit both public-sector sponsors and private investors.

Listed infrastructure

By comparison, listed infrastructure funds offer the potential for similar attractive returns, along with the liquidity produced from daily valuation of these vehicles, as well as accompanying short-term volatility, that can come from investment in listed companies. At a time when some investors consider valuations to be stretched across different areas of the global equity markets, valuations for many listed infrastructure companies are still relatively attractive, according to our proprietary valuation methodologies.

We believe a number of factors suggest an attractive outlook for listed infrastructure companies. While there has been growing awareness of infrastructure as an asset class, individual companies in the global infrastructure universe are still not well covered. In addition, we have found that markets often overreact to short-term events despite the very long duration and stable nature of the cash flows that underpin our listed infrastructure universe. Listed infrastructure also offers a way potentially to protect against future inflation through the formulaic revenue adjustment mechanisms present in a number of the concession agreements. Finally, the listed universe is diverse, with companies spread across a broad range of geographies and sectors.

We believe liquid natural gas (LNG) facilities in North America are a good example of the value-driven opportunities that are likely to emerge in 2017. The continent has some of the cheapest and most prolific natural gas in the world, and LNG terminals require substantial capital investment (in the order of tens of billions of dollars) and time to construct. These ports’ financial models have an underpinning of what have historically been highly stable, long-term, take-or-pay agreements that offer attractive underlying internal rates of return. In our view, this confluence of high cost and underappreciated, long duration cash flow has created a number of interesting opportunities in the U.S. market.

Managing infrastructure risks

Of course, a key risk involved with investing in a listed company is its relationship with the broader stock market. Though such companies are frequently seen as defensive plays, they can still be impacted by market price momentum. Historically, listed infrastructure investments have been insulated to some degree from downdrafts, due to their relatively stable cash flows and geographic diversification. And, when prices are generally rising, we have observed that such investment vehicles have tended to be more correlated with the overall market, providing greater upside potential than either unlisted infrastructure or infrastructure debt investments.

In addition, infrastructure investment vehicles share a number of common risks. These are just some of those risks:

- Patronage: One key risk shared by all infrastructure projects is the possibility that they won’t be utilized as expected. In the uncertain macroeconomic environment that we think is likely to dominate 2017, there is greater risk of toll roads, port terminals, airports, and other infrastructure assets being underutilized if growth slows.
- Regulatory/political: Many infrastructure assets are tightly regulated by governments, and as such are subject to the direction of appointed or elected officials.
- Financing: A project sponsor may put too much leverage on an asset, eroding its return potential or exposing investors to refinancing risk.
- Technology: Just as emerging technologies present new infrastructure opportunities, they might also make existing infrastructure less attractive or obsolete.

As these risks can pose significant challenges to the long-term earnings potential of a given infrastructure asset, it’s important for investors to assess their likelihood as part of the due diligence process. In our experience, successful infrastructure investors tend to mitigate these risks by limiting their pursuits to projects with certain characteristics, such as those that have high barriers to entry, provide essential services for the community, enjoy low demand elasticity, and produce sustainable predictable cash flows. Managing these risks takes discipline, particularly for this complex asset class. Investment in infrastructure in 2017 is likely to offer both new opportunities and potentially more risks, making careful asset management decisions a priority.
From the bottom up: Global REITs

After a multiyear advance, will fundamentals hold up?

Bob Zenouzi, Real Estate Securities and Income Solutions / Philadelphia

With interest rates around the world at historically low levels, many investors in search of yield have flocked to global real estate investment trusts (REITs). This rise in popularity has generated strong returns for the asset class over the past five years — though it’s also pushed valuations to high levels, raising questions about how global REITs will be able to extend this performance.

- Many listed real estate companies have significantly less leverage than in the past (particularly during the financial crisis), which could help mute the effect of any potential rise in interest rates.

As long as the supply of real estate continues to grow at a responsible pace, and capital remains available, we believe that commercial real estate stands a good chance of performing well. Should fundamental factors weaken, we think it’s important to keep in mind that REITs historically have tended to have more reliable and stable cash flows than many other asset classes, lending them a degree of defensiveness.

When rates move, so does sentiment

Ultimately, the performance of global REITs in 2017 will largely hinge on the direction of interest rates. Low rates are beneficial to the asset class for two reasons. First, low rates enable REITs to reduce the cost of their raw material — capital — which we’ve already seen happening across Europe, Japan, and the U.S. Second, low rates raise the attractiveness of higher yielding REITs relative to other income-generating assets. A spike in interest rates, therefore, would prove troublesome to REITs because it could prompt yield-chasers to turn elsewhere, and REITs could be faced with a higher cost of capital.

Despite our cautionary view on interest rates, we believe global REITs should continue their trend in 2017. If rates stabilize or increase modestly as expected, they should help provide a supportive environment, one in which we could expect modest returns, composed of (1) dividend yield, and (2) an additional 1-to-3 percentage points in price appreciation.

Fundamentally speaking

On the whole, we think global REITs could be subject to occasional periods of volatility, though the backdrop for commercial real estate generally looks positive. Consider these two sources of support:

- For much of the developed world, commercial real estate has not been subject to the overdevelopment that has strained some emerging markets.
Spotlight: Agriculture

A measured forecast for farmland investments

The case for long-term investing in farmland can be, in our view, a compelling one, based on the world’s current supply and demand factors. As incomes rise and populations become more urbanized, they move toward more protein-rich diets, placing upward pressure on demand for grain and ultimately farmland pricing. With around half the world still at a per capita income of below US$5000, we believe the trend has room to run. Meanwhile, urbanization, pollution, and soil degradation all place downward pressure on the amount of arable land available, and the total amount of available farmland globally actually peaked in 1991, as seen in the chart below.

For institutions seeking relative security of return, agriculture investments offer a hard-asset investment with the potential for diversification and historical volatility generally similar to bonds. But strong guidance in approaching the space can be hard to find. Benchmarks for farmland notoriously vary in quality, and the U.S. government’s subsidization of U.S. farmers creates what is, in our view, a somewhat distorted picture of the market provided by strictly analyzing U.S.-focused farmland indices. As a Sydney-based global manager, we have used detailed data from the Australian Bureau of Agriculture and Resource Economics to construct a benchmark that we believe represents a relatively “clean” view of the asset class, as it generally lacks these distortions.

The correlations table shows the potential diversification benefits achieved by the inclusion of agriculture — especially in equity-heavy portfolios, as equities and agriculture are negatively correlated when using Australian agriculture as a proxy.

Looking ahead

Short-term dynamics in the market are often driven by three factors that impact a farm’s operating environment, and ultimately farm values: operational costs, commodity prices, and interest rates. The year ahead brings potential inflection points in at least two of those areas.

Weather conditions play a significant role in the short term, and yields for oilseeds and grains were above their long-run trend level the last four years running, something that last occurred in the mid-1980s and suggests eventual reversion to the mean. In Australia, grain prices have been less strong than cattle prices lately, but we see the global demand for grains like wheat, corn and barley as being remarkably stable when viewing longer term trends.

Low and downward-trending interest rates in the developed world brings us to a discussion of global monetary policy. The trend for rates in the U.S. currently appears to be upward, and we’ll be watching global monetary policy regimes carefully. However, we generally think that the trend globally over coming decades is toward lower rates. Historically lower discount rates make for a higher net present value and push the price multiples for farmland higher, a trend we’ve seen benefit our markets in recent years.

Elizabeth O’Leary, Head of Agriculture, Macquarie Infrastructure and Real Assets / Sydney

<table>
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<tr>
<th>Correlations</th>
<th>Equities</th>
<th>Bonds</th>
<th>Real estate</th>
<th>Infrastructure</th>
<th>Australian agriculture</th>
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Source: Macquarie

Note: Correlations are global and calculated using these indices: MSCI World Index for equities; Bloomberg Barclays Global Bond Composite Index for bonds; NCREIF Property Index for real estate; Dow Jones Brookfield Global Infrastructure Index for infrastructure.
Adjusting to the unexpected in 2017 continued from page 8

7% returns, and yet they’re operating within an environment of Treasury yields around 2%. That means they have to be more creative, and we’re seeing that in areas from private equity to infrastructure debt. We’re also seeing a lot of yield-chasing. As a manager with exposure to income-generating securities — REITs or multi-asset strategies — trying to understand how these assets can help us achieve good risk-adjusted returns is difficult. There really is no single solution, in my opinion. The low-yield environment makes returns in the high single digits less likely unless you go further out on the risk spectrum, and that presents issues with higher leverage and less liquidity for certain investors.

Roger Early: Here we are today running at around 2% yields in higher-quality portfolios in the U.S., and negative yields in many parts of the world. So the question is: Can fixed income portfolios still provide that downside protection and ample income? It’s a completely different world we live in. But even with all of the uncertainty, when we’re looking for higher-quality assets generating a decent yield, it points us to investment grade credit as the most attractive fixed income option for 2017, in our view. In particular, the U.S. corporate bond market offers relative value.

Brett Lewthwaite: This market demands discipline. When new political regimes could upset the balance and have significant consequences for investors, we need to assume only a sustainable amount of risk. We cannot be panic buyers or sellers but instead need to position our portfolios with discipline.

Shawn Lytle: Discipline, yes, and also to be very aware of possible increased market risks, and quite possibly increased volatility, as we make our way through 2017. Increased risks don’t necessarily mean there won’t be opportunities — but they do likely call for more careful security selection. With the uncertainties we face, there’s all the more reason for a well-informed, bottom-up, fundamental style of active management.

Bob Zenouzi: Those are key points. It can also be prudent to take a responsible level of risk and reward in investing. Responsible investing is what could provide the growth to get through market turmoil or changes. If you consider that, I believe you have more of an opportunity of potentially embedded downside support to help weather developments from rising rates to a market turn.

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Macquarie Asset Management offers investment capabilities spanning the global capital markets. As the investment management business of Macquarie Group, our goal is to provide solutions for institutions, advisors and individuals in public and private markets. Our independent teams construct actively managed portfolios guided by specialist expertise and strong client alignment. We are fundamental, research-driven investors whose hands-on, high conviction approach allows insight and knowledge — informed by experience — to help guide client outcomes.

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