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NEWS OR EVENTS THAT MAY AFFECT YOUR INVESTMENTS

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Geopolitical Risk Awakens

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Key takeaways

» *A second U.S. airstrike within a week hit Iranian military personnel in Baghdad on January 2, and Iran has threatened significant retaliation.*

» *On January 3, President Trump said, "We took action to stop a war."(CNN) However, the Pentagon announced Friday that it will send additional troops to the region.*

What it may mean for investors

» *These events have not changed our outlook for U.S. equity earnings growth, which we believe will be in the mid-single digits in 2020. And the events have not changed our oil price targets, which already reflect a reasonable geopolitical risk premium. That said, if tensions escalate, defense stocks may see a new bid higher, and emerging market equities may come under pressure.*

A second U.S. airstrike within a week hit Iranian military personnel in Baghdad on January 2, and Iran has threatened significant retaliation. The Pentagon confirmed the killing of Gen. Qassem Soleimani, the influential Iranian general and the top commander of dozens of Iranian-funded and trained militia groups operating in Lebanon, Syria, and Iraq.

Gen. Soleimani was not only a high-ranking commander—the equivalent rank of U.S. commanding generals in Iraq and Afghanistan—but he was instrumental in organizing, building, and extending Iran's ability to fight anywhere in the Middle East, and even the world, without using formal military forces. In other words, he was the mastermind behind Iran's strategy of waging war with plausible deniability. One of those Iranian-funded militia groups, Kataib Hezbollah, in recent weeks attacked U.S. and allied Iraqi military positions and the U.S. embassy in Baghdad. Its leader is an unconfirmed fatality in the U.S. strike.

Global markets appeared to respond initially by reducing risk appetite. The S&P 500 Index lost 0.7% on January 3 and opened approximately the same amount lower again on January 6. Oil prices rose in the two days following the event. The West Texas Intermediate (WTI) and Brent oil prices rose to $63 and $68, respectively, but remained within our 2020 target ranges.

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Potential political and market implications

We believe there are likely domestic and international political implications for U.S. investors:

Geopolitical implications: Iran has a demonstrated capacity for significant economic disruption. The Trump administration cited U.S. intelligence assessments that officials called evidence of Iranian involvement in the missile attack on the Abqaiq and Khurais oil-processing facilities attacks, which temporarily took down half of Saudi Arabia's oil production, nearly four months ago.[1] As potential economic or market disruptors, we believe Iran could retaliate by directing any of its many paramilitary forces to attack U.S. interests anywhere in the Middle East, including by missile attacks against Saudi Arabia or Israel, by attack boats against oil tankers in the Persian Gulf, and by a variety of means against U.S. military personnel in Afghanistan and Iraq. Support from China and Russia for Iran could blunt U.S. diplomatic efforts to punish Iran.

On January 5, the Iraqi Parliament approved a non-binding resolution directing the government to order U.S. troops out of Iraq. However, it is unclear whether Iraq's caretaker prime minister has authority to carry out the resolution. The *Wall Street Journal* noted in a January 5 article ("Iraqi Parliament Votes in Favor of Expelling U.S. Troops") that Iraq's Sunni and all but one of its Kurdish lawmakers—nearly half the chamber—did not attend the special parliamentary session. This split in Parliament underscores Iraq's persistent sectarian divisions. If Iran's influence over the legislature and the militias in Iraq eventually drives the U.S. out of Iraq, then an additional geopolitical risk is that ISIS may accelerate its resurgence in the vacuum.

Domestic implications: U.S. Defense Secretary Mark Esper in recent weeks made comments suggesting that U.S. forces in the region would begin to shift to other areas (Asia and Europe). However, any such plan appears to be on hold as the Pentagon announced Friday it will deploy additional troops to the region. President Trump's October 2019 order to withdraw U.S. troops from Syria suggests to us the U.S. wants more limited involvement in the Middle East, but we could see more market volatility if Iran pushes U.S. officials to either commit more troops or withdraw. We believe this implies more volatility for markets and probably an increasing international focus on the campaign trail.

Our perspective

We continue to believe that earnings growth will be in the mid-single digits in the U.S. in 2020, but investors may rethink their desired valuation on equities, if geopolitical escalation persists. Additionally, if these tensions escalate further, defense stocks may see a new bid higher. Emerging market equities may come under pressure if risk premia escalate with political uncertainty.

Our $55-$65 WTI and $60-$70 Brent 2020 target ranges already bake-in a $10 geopolitical premium, specifically due to Middle East turmoil, which has been brewing for some time now. We believe Middle East geopolitics are likely to stay tense in the future, but relatively weak oil fundamentals should keep prices from sustaining much higher levels, even as Middle East turmoil ebbs and flows. We remain comfortable with our 2020 WTI and Brent target ranges.

[1] New York Times, "Who Was Behind the Saudi Oil Attack? What the Evidence Shows", September 16, 2019.

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Our 2020 Outlook—A Call for Resilience highlighted ongoing geopolitical risk in 2020 as an ongoing market disruptor. The following reprise our guidance, given the latest events:

1. Focus on quality: For quality, we focus on U.S. based large-cap companies with sizable cash positions, strong balance sheets, and growing dividends or share buybacks. Two equity sectors that share these characteristics are Information Technology and Consumer Discretionary. Within fixed income, we focus on reallocating from low-quality high-yield, in favor of highly rated U.S. corporate bonds.
2. Defense can be a good offense: Hedge fund strategies that can profit in both up and down markets may provide a good alternative late in the economic expansion for qualified investors. Over the next few years, we favor Relative Value and Equity Hedge strategies. In addition, investors can play defense with their equity sector allocations. We favor holding market-weight exposure in the defensive Consumer Staples, Real Estate, and Utilities sectors, and we are unfavorable on the Materials and Communications Services equity sectors, which we expect to underperform in a late-cycle economy.
3. Focus on longer-term diversification as shorter periods are likely to be volatile: Historically, large-cap equities have experienced pullbacks of 5% or greater 3-4 times per year and corrections of 10% or more every year or so. Investors can reduce short-term volatility risk by using cash tactically, focusing on high-quality assets, and positioning into more defensive asset classes and sectors. One of the best long-run approaches has been to diversify across a combination of low-correlated assets and regularly rebalance back to strategic targets.

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Risk Considerations

Forecasts and targets are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Communication services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes; pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. **Consumer Staples** industries can be significantly affected by competitive pricing particularly with respect to the growth of low-cost emerging market production, government regulation, the performance of the overall economy, interest rates, and consumer confidence. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. **Real estate** investments have special risks, including possible illiquidity of the underlying properties, credit risk, interest rate fluctuations, and the impact of varied economic conditions. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

Alternative investments, such as hedge funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

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