Perspective

ECONOMIC OVERVIEW

Unless otherwise noted, all figures are based in USD.

Independent Perspective | Real-World Solutions

The U.S. Economy

Growth stocks have had a great start to 2017. As the post-election euphoria wore off, the outperformance of value names and other cyclical sectors gave way to renewed investor interest in companies with capacity to generate their own growth in a slow growth world. For investors that remained patient and followed a disciplined approach with a focus on fundamentals, this was a welcomed reversal.

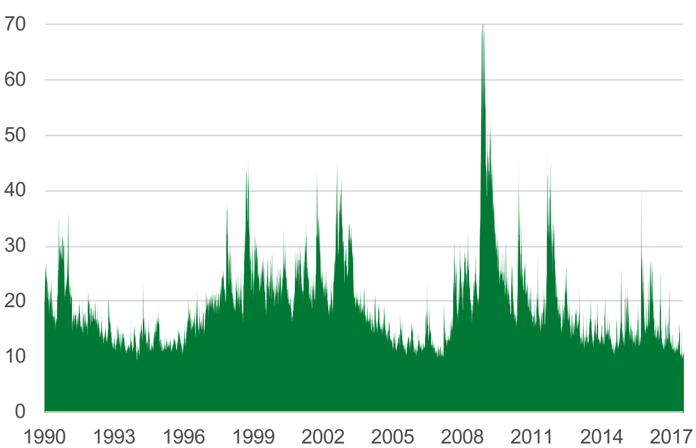
As we've highlighted throughout the year, our slow growth outlook has only slightly changed: we expect growth to remain slow, but there is the potential for marginal improvement. This led us to keep portfolios tilted toward growth, with only marginal increases in exposure to economically sensitive names. As such, we too have welcomed what is seemingly a renewed focus on fundamental value.

As investor optimism pulled back from elevated levels, and as the economic data failed to keep surprising above expectations, U.S. equity markets were little changed. Instead, the stock market became eerily quiet, or in other words, complacency has resurfaced.

There are several different ways to gauge investor complacency. One is by considering the level of market volatility, which is currently hovering near all-time lows. The CBOE Volatility Index (VIX), a popular volatility measure for U.S. equity markets, has already closed below 10 as many times in 2017 as over the first 27 years of its history.

CBOE Volatility Index (VIX) (January 1990 - June 2017)

Source: Thomson Reuters



The Chicago Board Options Exchange (CBOE) is the largest U.S. options exchange. CBOE offers options on over 2,200 companies, 22 stock indices, and 140 exchange-traded funds (ETFs).

Complacency reigns in the fixed income market as well. The Merrill Lynch Option Volatility Estimate (MOVE) Index, which measures volatility of the U.S. Treasury market, is reading at similarly muted levels. Credit spreads, the difference in yield between two bonds of similar maturity but different credit quality, also remain compressed for both investment-grade and high-yield bonds. These tighter credit spreads suggest that bond investors have low risk expectations and are willing to reach for yield.

The return of complacency is in many ways at odds with the economic realities, and something will have to give. Despite low volatility, political uncertainty remains elevated. Recent steps toward passing health care reform are encouraging, though it remains unclear how much political capital must still be spent to achieve success in passing a bill. Tax reform has the potential to be a more meaningful contributor to pro-growth reform, while current and looming challenges such as the Russia investigation and the debt ceiling fight still stand in the way.

From a market cycle perspective, investors must also consider the length of the current bull market, which entered its 9th year in March. This is now one of the longest bull market runs in history, and domestic equities, as represented by the S&P 500, have returned over 300% since their March 2009 bottom. At this point, valuations are stretched, and even though investor optimism has pulled back from recent highs, expectations are perhaps still greater than they should be. At these current valuation levels, there is less upside potential, as elevated valuations equate to lower return potential going forward.

S&P 500 Forward P/E Ratio (June 2007 - June 2017)

Source: Thomson Reuters

Sign up to receive this newsletter electronically by visiting www.manning-napier.com/signup

For these reasons, we believe that maintaining a disciplined investment approach is as important as ever. Periods of low volatility can persist for lengthy periods of time, and investors may be tempted to structurally increase risk amid the complacency. Investors should fight this urge. The combination of high valuations and complacency can be a volatile mix, and as such, risk management will remain key.

For a detailed view of our outlook for the second half of 2017, please download our Semi-Annual Outlook at:

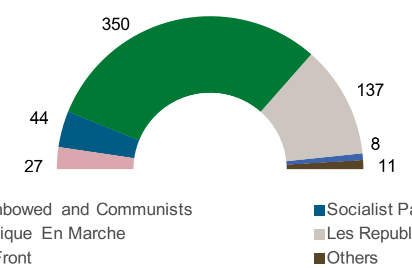
http://go.manning-napier.com/June2017Outlook

Global Economy

Last month, the French held elections to form a new parliament, and they fell into place quite well for President Macron with his brand new En Marche party winning an outright parliamentary majority. Along with a stronger than expected performance for the center-right Republicans, who should also support much of President Macron's economic platform, France is positioned well to actually pass lasting structural reforms. This is a net positive for our improved outlook on Europe.

Macron's Majority

Source: French Interior Ministry



To be sure, there still remain some obstacles. Turnout was disappointing, leading some pundits to suggest that his mandate is less universal than it appears. Further, though the French left and the socialist party suffered a humiliating defeat, powerful, left-leaning French unions will remain formidable, vocal opponents to any kind of rollback of labor protections. The combination of apathy and organized labor imply that street protests and demonstrations may ensue.

Across the channel, election results in Britain were far less convincing. Originally, Prime Minister Theresa May's plan was to capitalize on her Conservative party's popularity by calling for a snap election. The goal was to build a bigger parliamentary majority.

The plan backfired, severely, as the conservatives lost the majority they used to have, calling into question PM May's leadership position as well as the strength of the Brexit mandate. This means that Britain may now take a more conciliatory stance with the European Union, as well as have less negotiating leverage.

Elsewhere, China's rapidly growing domestic stock market was granted emerging status. Technically, this means that Chinese 'A' shares, which are companies listed on mainland stock exchanges, would now be included in MSCI's very popular emerging market index.

MSCI's decision may have long-run implications for increasing the transparency and openness of China's notoriously opaque and abnormal financial system. However, in the short-run, the 'A' shares market is still relatively small, and their inclusion only marginally adds to the existing Chinese weighting.

Our Perspective

Though valuations in the broad U.S. stock market remain elevated, we continue to see few unsustainable excesses that would suggest the U.S. economy is at risk of imminent recession. In this environment, discernment and flexibility are critical.

Given the slow global growth environment, in portfolios geared toward capital growth, we are targeting investments in fundamentally strong businesses that are not reliant upon macroeconomic growth to drive sales and earnings. More specifically, we see value in businesses that have control of their destiny and are taking share in large established markets or are creating new markets on their own. Our goal is to identify companies trading at attractive valuations relative to their growth potential. We have also become incrementally more comfortable with economically sensitive areas of the market based on the slight change in our overview, though selectivity remains key.

Regarding fixed income, our outlook remains constructive toward credit, and although spreads have tightened, they remain relatively attractive on a fundamental basis. Considering these dynamics, we maintain a sizeable allocation to corporate bonds, which consists of investment-grade securities, although some portfolios may contain selective high-yield exposure as well. As we are in the later stages of the economic cycle, credit valuations are not as compelling as they were previously, and we may look to reduce exposure over time if credit spreads tighten further. Portfolios also have a notable allocation to Treasuries—which includes some Treasury Inflation-Protected Securities (TIPS)—and Agency securities, as well as asset-backed Pass-Through securities.

We continue to believe a modest duration remains in clients' best interests. Interest rates are still historically low, and since the excess yield for holding a long-term bond instead of a series of shorter-term bonds also remains low, we maintain our view that investors are not being adequately compensated to hold significant amounts of long-term debt. Should rates gradually move higher over time—as we anticipate—we may incrementally add duration to take advantage of higher levels of income. Conversely, if rates consolidate and prices rise, we may look to reduce duration.

In our view, short-term and income-oriented investors should also explore equities that display stable fundamentals and are trading at attractive valuations. We believe companies that generate strong, stable cash flows and pay an attractive dividend could be compelling options for these types of investors in the current environment.

Sources: Thomson Reuters and French Interior Ministry. Analysis: Manning & Napier Advisors, LLC (Manning & Napier).
Manning & Napier is governed under the Securities and Exchange Commission as an Investment Advisor under the Investment Advisers Act of 1940.
All investments contain risk and may lose value. This material contains the opinions of Manning & Napier, which are subject to change based on evolving market and economic conditions. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.
The S&P 500 Total Return Index is an unmanaged, capitalization-weighted measure of 500 widely held common stocks listed on the New York Stock Exchange, American Stock Exchange, and the Over-the-Counter market. The Index returns assume daily reinvestment of dividends and do not reflect any fees or expenses. S&P Dow Jones Indices LLC, a subsidiary of the McGraw Hill Financial, Inc., is the publisher of various index based data products and services and has licensed certain of its products and services for use by Manning & Napier. Neither S&P Dow Jones Indices LLC, Dow Jones Trademark Holdings LLC, their affiliates nor their third party licensors make any representation or warranty, express or implied, as to the ability of any index to accurately represent the asset class or market sector that it purports to represent and none of these parties shall have any liability for any errors, omissions, or interruptions of any index or the data included therein.
This newsletter may contain factual business information concerning Manning & Napier, Inc. and is not intended for the use of investors or potential investors in Manning & Napier, Inc. It is not an offer to sell securities and it is not soliciting an offer to buy any securities of Manning & Napier, Inc.