Market Outlook

2019 MID-YEAR ECONOMIC & MARKET REVIEW

New York Life Investments

Key Themes and Investor Takeaways

We think the investment environment over the next 6-12 months will be defined by a few key themes:

Based on our views, we believe the following takeaways are key for investors:

Theme	Stay invested	Begin to de-risk	Increase tactical allocation
Approach	Build income Focus on cash flows Avoid low quality	Diversify exposures Seek lower volatility Shorten duration	Imbed flexibility Take advantage of mispricing as it occurs
Asset class	Yield-focused equities High-quality credits Diversified income sources	Municipal bonds Real estate Infrastructure	Distressed debt Middle market debt Private equity Multi-asset solutions

Learn more about New York Life Investments' Multi-Asset Solutions team, our investment process, and our partnerships on pages 24-25.

Higher Water Brings Rougher Seas

At the beginning of 2019, economic and market conditions aligned for rallies across asset classes. Investor sentiment was foreboding, policy uncertainty was high, and asset prices had fallen sharply – all without a driver from the real economy or company fundamentals.

We expected, correctly, that market sentiment would calm, reverse course, and take asset prices along with it. Those conditions have now played out. The Fed's newly "patient" stance put a floor on economic conditions, goosed global dollar liquidity, and pushed real borrowing costs down. Economic growth continued to perform on the upside through mid-spring, supporting risk assets.

Looking ahead, we are likely to experience setbacks. Valuations have moved higher, forward-looking economic data has grown a bit wobbly, and trade frictions loom large. Markets have backed away from recent highs, volatility has jumped, and continued shifts in the economy could create further crosscurrents. Where rising tides once raised all ships, higher water has brought rougher seas.

We remain hesitantly constructive on the U.S. economy. Inflation is nowhere in sight; wage growth should be made manageable thanks to previous business investment in productivity-enhancing tools and technology. Threats of global monetary tightening and higher bond yields have receded, shedding a potential impediment to growth. When it comes, the next recession is unlikely to be one that justifies extreme investor fear. Instead, it should help reset investor expectations and kickstart new trends toward higher asset prices.

Still, there are economic and geopolitical risks that we cannot ignore. Some of our leading economic indicators are turning over, and trade and other geopolitical conflicts loom large. Timing economic and credit cycles is extremely difficult, and volatility is sure to be present.

For long-term investors, it is appropriate to move gradually toward a more defensive posture, focusing on generating income across a broad range of sources. For investors allocating capital to private markets, understanding the balance between risk and reward becomes perhaps more important. Amid rich valuations, competitive deal flow, and late cycle risks, investment requires the confidence to be bold, but the skill and capital to be disciplined.

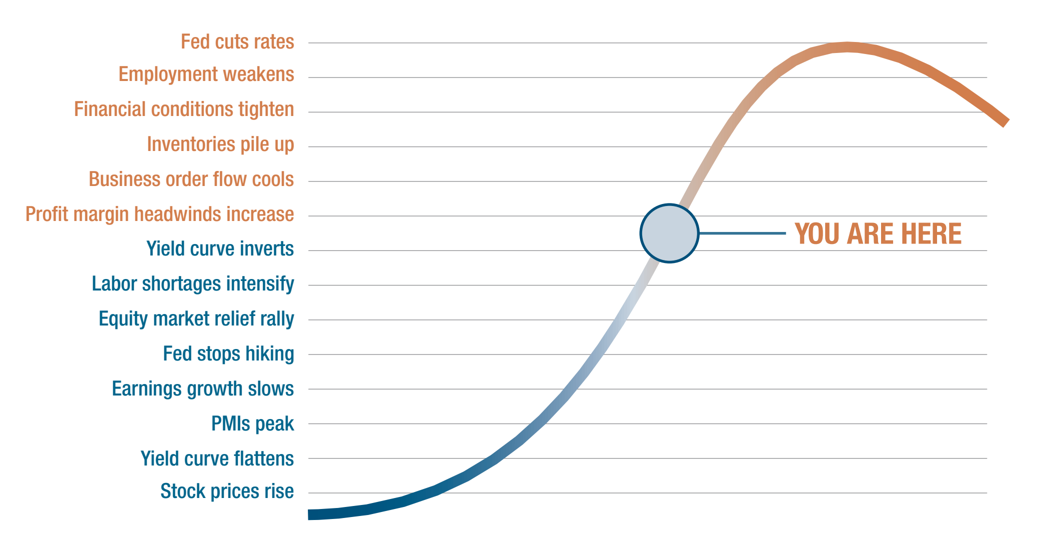
Where Are We in the Economic Cycle?

The U.S. expansion is now the longest in its history. As a result, markets are watching closely for signs of deceleration. We are monitoring a range of economic and market data to determine when the cycle may turn. These signs suggest that it is too early to significantly de-risk our portfolios.

To begin, the U.S. economy is still growing and we are not concerned about a recession in the next 12 months. Full employment, real income growth, and improved household balance sheets underlie a strong consumer sector. Fiscal stimulus at the federal level will uphold stronger government spending into 2020. State and local income tax receipts are also increasing, creating opportunities for additional investment. Capital expenditures have been somewhat disappointing, but business investment in intellectual property and research and development has proven durable.

Expansions do not die of old age, and the Fed's dovish position should put a floor on economic growth, absent a significant exogenous shock. "Lower for longer" – a phrase once applied to interest rate policy – is the new mantra for economic activity. Recessions tend to occur when monetary conditions are tight, which is not currently the case. The Fed is highly aware of economic risks and has expressed that they do not want to disrupt the economic cycle.

Indicators of the Economic Cycle Suggest that Markets Have Some Room Left to Run



Source: New York Life Investments Multi-Asset Solutions, 6/5/19. For illustrative purposes only.

Investing in a mid-cycle slowdown

Investors discuss economic cycles all the time, but cycles are rarely neat circles or eye-comforting wave functions. Instead, cycles are messy. There can be periods of minor accelerations and decelerations in economic growth – not necessarily accompanied by a boom or a bust. Within that context, recessions do not need to be pure business cycle events either. Since the last recession, financial asset inflation overshadowed economic growth. The next recession could begin with financial asset volatility.

Mid-cycle slowdowns make tracking the economic and credit cycles – already a challenging task – even more difficult. We have already experienced two slowdowns in this economic cycle – the eurozone crisis in 2012 and U.S. industrial recession/China slowdown in 2015 – during which leading economic indicators sent mixed signals for a time. Meanwhile, factors such as financial leverage and asset prices have inched broadly higher.

We expect that signals differentiating slowdown from recession will not be clear in real time. This could be another mid-cycle dip. As a result, we are staying invested and looking for attractive entry points.

A deterioration in profit margin will signal the cycle's turn

We are not yet worried about recession, but what factors would make us change our mind? We think headwinds to profit margins will lay the most groundwork for getting there. When margins are elevated, corporations can absorb exogenous shocks to supply or demand, such as wars, oil prices, natural disasters, or trade. Thin margins, however, reduce business enthusiasm and increase vulnerability. As margins decline, companies cut costs, choose share buybacks over new projects, or simply sit on cash. These choices ripple through the economy, slowing overall economic growth.

Profit margins explained

A "profit margin" is the amount of profit a firm makes per dollar of revenue after taxes and other expenses. For example, if something sells for $100 (revenue) and the cost of making, distributing, and advertising it is $90, the firm makes a $10 profit – providing a 10% profit margin.

Expenses that a firm must overcome include:

1) Interest payments on debt

2) Wages paid to workers

3) Input prices

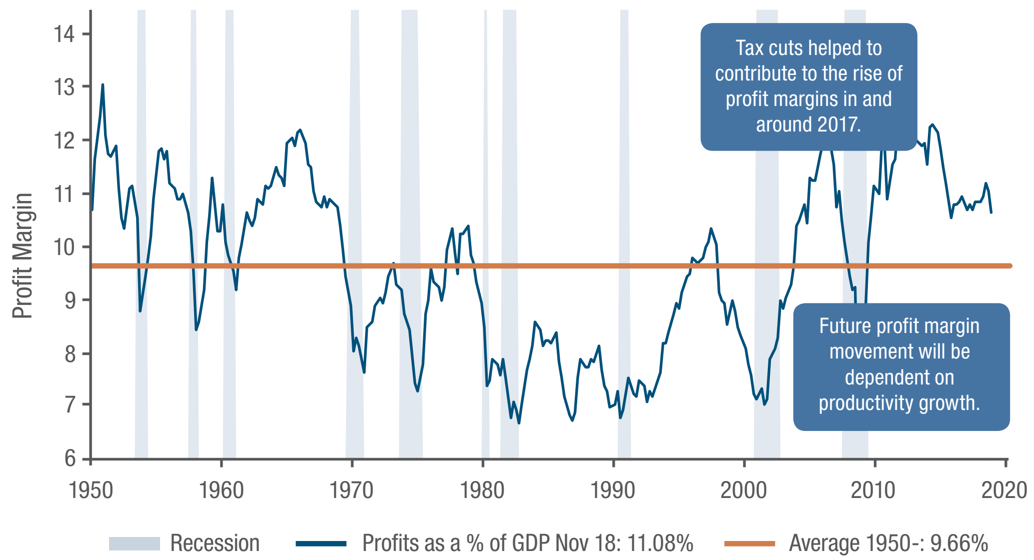
4) Taxes

Up to this point, companies have enjoyed good conditions for growing their bottom lines. Low interest rates minimized borrowing costs, slow wage growth managed labor costs, and a strong dollar made inputs from overseas relatively less expensive. Most recently, corporate tax reform substantially lowered the tax burden on businesses.

Profit margins and share buybacks

Rising margins have been a powerful support for corporate America's bottom line, which has also been aided by a sharp increase in spending on share buybacks. Companies in the S&P 500 Index spent a record $806 billion on their own shares in 2018, which is up almost 56% from the prior year — and well above the previous record set in 2007.

Profit Margins Are a Defining Component of the Business Cycle (1950 – 2018)



Sources: New York Life Investments Multi-Asset Solutions, Bureau of Economic Analysis, Thompson Reuters Datastream, 6/5/19. Past performance is no guarantee of future results, which will vary.

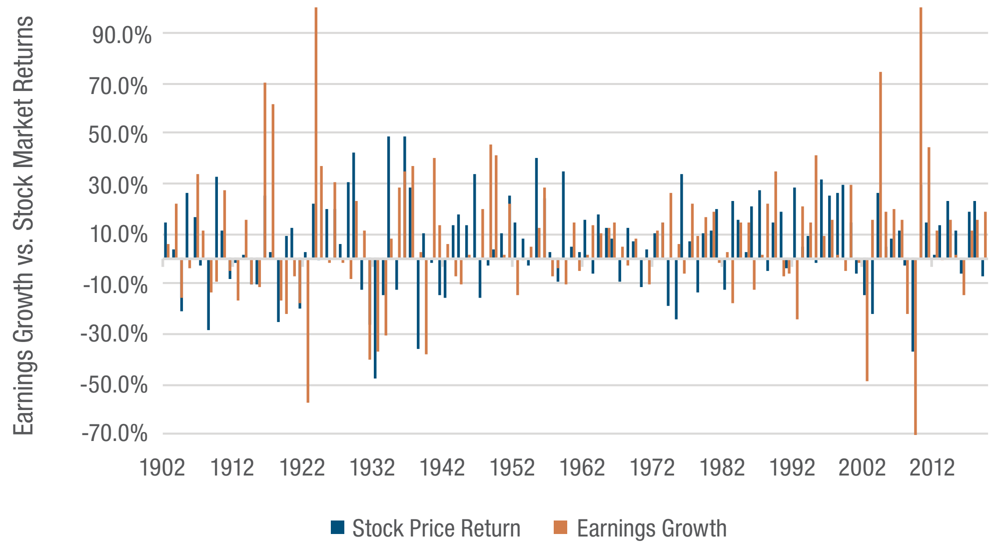
We are reaching the point where costs of production begin to rise. That puts pressure on margins and reduces business confidence for future growth. Demand, though still present, is slowing, and expectations for future demand show early signs of weakness. Costs are climbing as wages and debt levels rise.

Less robust margin growth would have important implications for investment strategy. From a top-down perspective, margins are the core component of profit growth, which is in turn one of the strongest drivers of equity returns. Over time, we find that positive earnings growth tends to lead to positive equity returns. We expect that

relationship to hold, nudging us toward maintaining an equity overweight in our portfolios. If we see companies struggle to sustain cash flows and generate earnings growth, we would expect higher volatility and would consider de-risking.

From a bottom-up perspective, navigating margin headwinds is a major differentiator in company performance and should impact security selection. Investors will benefit from choosing quality companies that are resilient to margin compression. Business strategy fundamentals, such as: pricing power and industry competitiveness come into play here. So, too, does companies' financial health (low leverage and strong balance sheets), revenue diversification, and resilience to external shocks.

Earnings Growth Drives Stock Market Returns



Sources: New York Life Investments Multi-Asset Solutions, S&P, Bloomberg, Shiller, 6/5/19. Stock returns are represented by the S&P 500 Index. Past performance is no guarantee of future results, which will vary. It is not possible to invest in an index. Index definitions can be found at the end of this document.

Productivity will relieve pressure on profit margins and the Fed

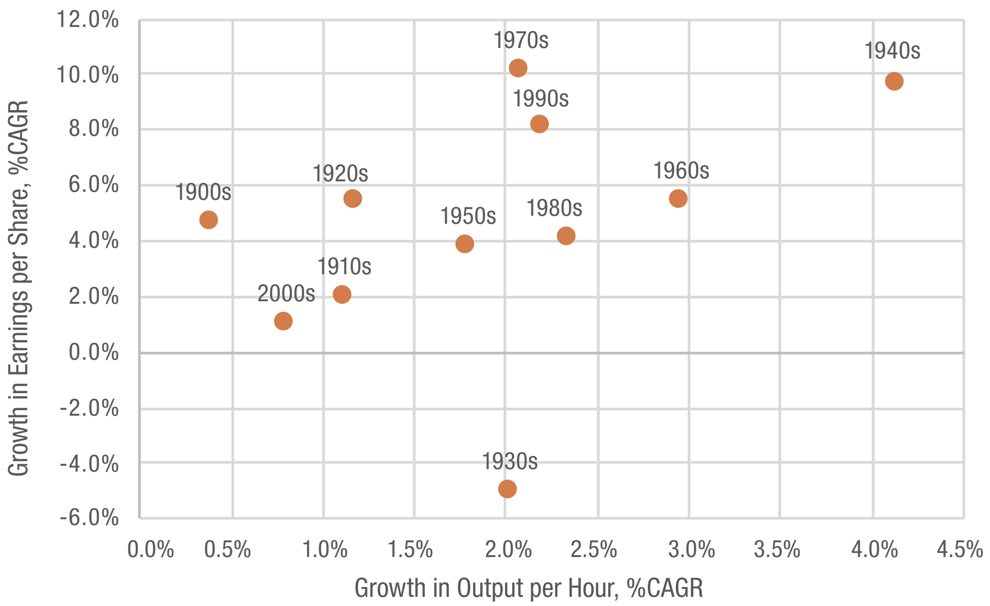
If profit margins are still healthy, how long do we have before a downturn ensues? The answer depends on the careful balance of costs and productivity. Wage growth is already taking hold. Inflation has been perfectly "goldilocks," but the Fed's pause will give inflationary pressures time to take root. These factors could signal an impending end of the cycle. Or, as we believe, they could be held at bay by improving productivity.

Robust productivity growth supports margins by reducing the cost per unit reduced. Wages are a big cost to the firm; offsetting those cost pressures help companies to offset the related margin pressures. Historically, higher productivity has coincided with higher profit margins, and thus more durable expansions, while lower productivity generally drove margins lower and preceded recession.

Despite high levels of innovation in recent decades, productivity growth has been relatively slow. But in 1Q19, U.S. worker productivity increased at its fastest pace since 3Q10. We do not think this is a fluke. After nearly a decade of anemic productivity growth, we believe we may be turning the corner toward higher productivity.

Recent Productivity Growth Lags Historical Periods, Despite High Levels of Innovation

Growth in U.S. Earnings-Per-Share vs. Output-Per-Hour, By Decade, 1900-2010



Sources: New York Life Investments Multi-Asset Solutions; Federal Reserve Bank of Saint Louis; Samuel H. Williamson, "What was the U.S. GDP Then?" MeasuringWorth, 2019; Robert Shiller "Irrational Exuberance" Princeton University Press, 2000, 2005, updated, 6/5/19. Past performance is no guarantee of future results, which will vary.

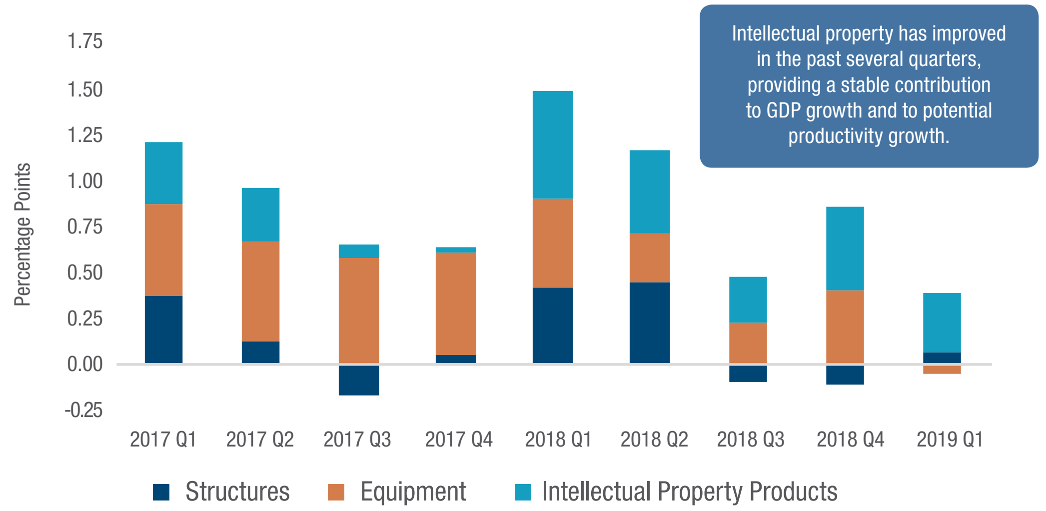
Another key to productivity (and thus the duration of the cycle) is investment. Capital expenditure (CAPEX) has lagged the economic expansion but shows signs of life.

Perhaps more convincingly, less tangible investment is on the rise. CAPEX measures investment in property, plant, and equipment, and thus does not reflect companies' investment in new software, improvements in logistics, or services efficiency. Even in periods when capital expenditure is waning, investment in intellectual property and research and development has thrived.

The resulting innovation technologies are opening the door to further productivity growth. Robotics, energy storage, artificial intelligence, cloud computing, and blockchain technology are likely to change the way the world works. In the meantime, we suspect these technological shifts may be contributing to some confusion whereby understating productivity and overstating inflation.

Investment in the U.S. Economy

Contribution to the Percent Change in Real GDP



Sources: New York Life Investments Multi-Asset Solutions, U.S. Bureau of Economic Analysis, 6/5/19. Past performance is no guarantee of future results, which will vary.

There are risks to our view. Realizing the full benefits of innovation can often take decades, varies tremendously from industry to industry, and often requires complementary 'co-creations' (i.e. business practices, infrastructures, and products) or co-education.

Productivity is also difficult to measure. For instance, the way economists collect and compile data may not reflect the extraordinary increase in computing power for a slightly more expensive mobile device. For these and other reasons, productivity growth has been elusive up to this point. While we expect productivity growth to improve, which would in turn relieve pressure on company margins and on the Fed, we will be watching closely for indications that this view goes sideways.

International markets

Countries outside the U.S. are also experiencing slower — but stabilizing — economic growth. Earnings growth rates are slowing too but should remain in positive territory providing economic growth persists (as we expect) and trade tensions do not escalate further.

Eurozone economies are more sensitive to external conditions, including the recent weakness in global trade. As a result, leading indicators such as industrial production and manufacturing are weakening and even contracting in some cases. While the services sector has proven resilient, services confidence has peaked, suggesting weakness ahead.

There are reasons to be positive on European securities. For example, most countries in the region are earlier in their economic cycles. Having experienced a sovereign debt crisis in 2011, growth only began to improve in 2013, giving it a flatter but potentially longer runway from here. Loan growth to businesses and households, a key contributor to economic activity, is still healthy. Fiscal policy shows signs of turning more supportive. Employment rates are far from their 2006 levels in most countries. Profit margins are not under pressure as labor costs are only slowly increasing.

That said, risks to the eurozone's growth skew to the downside. Potential auto tariffs and Italy's sovereign debt time bomb create drags on business confidence. European Central Bank (ECB) leadership will turn over this year, with the President likely to be more hawkish and less accommodative of Italy. In our view, risk premia do not support prioritizing incremental risk in Europe compared to other economies.

We have a similar view about the prospects for **Japan's economy** in the near term. Companies in Japan have been strengthening their balance sheets and improving profitability in recent years. In addition, an upside in the global trade environment could boost economic activity. But here, too, the risks skew to the downside. For example, the Japanese government plans to increase its value added tax (VAT) in October; previous instances of this policy change have been disruptive.

We remain mildly constructive on **emerging markets**, but our enthusiasm is waning. On the positive side, the pause in the Fed's tightening cycle has removed pressure on emerging markets to follow suit, thus improving financial conditions. In addition, the Chinese government has stepped in with substantial slowdown-battling stimulus, putting a floor on global growth and market sentiment. While we agree with critics of the stimulus, who say that the Chinese government has chosen unsustainable policy tools in the short term, the measures are working.

That said, a stronger dollar, higher U.S. interest rates, and slowing global trade create headwinds for the emerging markets complex. A dramatic increase in the supply of U.S. Treasuries — the result of larger U.S. deficits and a shrinking Fed balance sheet — has also resulted in a diversion of resources away from emerging markets. The outlook should improve with the Fed's dovish turn and any favorable resolution of trade disputes. However, the largest culprit (Treasury issuance) could be disruptive for the foreseeable future.

How Can Investors Lean Into a Volatile Market?

We expect moderate to elevated levels of market volatility throughout the remainder of the U.S. economic cycle. A late cycle environment, geopolitical stress, and greater economic policy uncertainty all point to more turbulent market conditions. A flattened yield curve — like the one we see today — also generally precedes a high volatility index (VIX).

Given our expectation of continued economic growth, we are not transitioning to risk-off portfolio positioning just yet. Instead, we expect investment performance in 2019 will be a function of constructing quality portfolios, managing downside risk, and taking advantage of mispricing when it occurs.

That said, timing market volatility — not to mention an impending credit cycle — is extremely difficult. For some investors, it is likely appropriate to move gradually to a more defensive posture, focusing on generating income across a broad range of sources. If a portfolio can generate the same average annual return as the market (arithmetically), but does so with less volatility, it will end up with a higher annualized return than the market (geometrically) — which means greater wealth for investors over time.

Volatility

Whats going on: There are many potential catalysts for higher market volatility going forward.

Why does it matter: When risk aversion builds and volatility rises (which generally accompanies decelerating profits) investors tend to pay premiums for safety and tend to avoid risk.

How can we monitor: The VIX is a simple measure of anticipated market volatility. There are generally three volatility regimes: low volatility (VIX 15 or Less), medium volatility (VIX 15-25), and high volatility (VIX 25 or more).

Equities tend to perform quite well during periods of low volatility. As shown below, risk assets performed worse with greater levels of volatility – albeit with significantly greater volatility (as defined by standard deviation) in returns. But also noticeable is the clear outperformance of equities versus bonds during low-volatility periods as compared to medium volatility periods.

Looking ahead: The slope of the yield curve has been a good long-lead (3-year) predictor for changes in the VIX. Currently, it suggests that volatility is likely to pick up over the next two years.

Volatility Regime	Agg	S&P
Low Volatiltiy VIX 15 or Less	1.63%	6.32%
Medium Volatiltiy	2.53%	4.44%
High Volatility	3.55%	-0.66%

Sources: New York Life Investments Multi-Asset Solutions, Bloomberg, 6/5/19.

Building income

An income focus in your portfolio can reduce reliance on market sentiment to provide price-related portfolio gains. One thoughtful approach to improving the overall income-generating capacity of your portfolio calls for diversifying sources of yield beyond traditional investment-grade bonds.

Build Income

Fixed Income + **Equity** + **Allocation**

Fixed Income:
- Starting yield
- Coupon
- Spread

Equity:
- Consistency of income, the most stable driver of long-term returns
- Active management, to determine whether a company's payouts can grow
- Lower volatility, which in the end leads to greater wealth for the investor

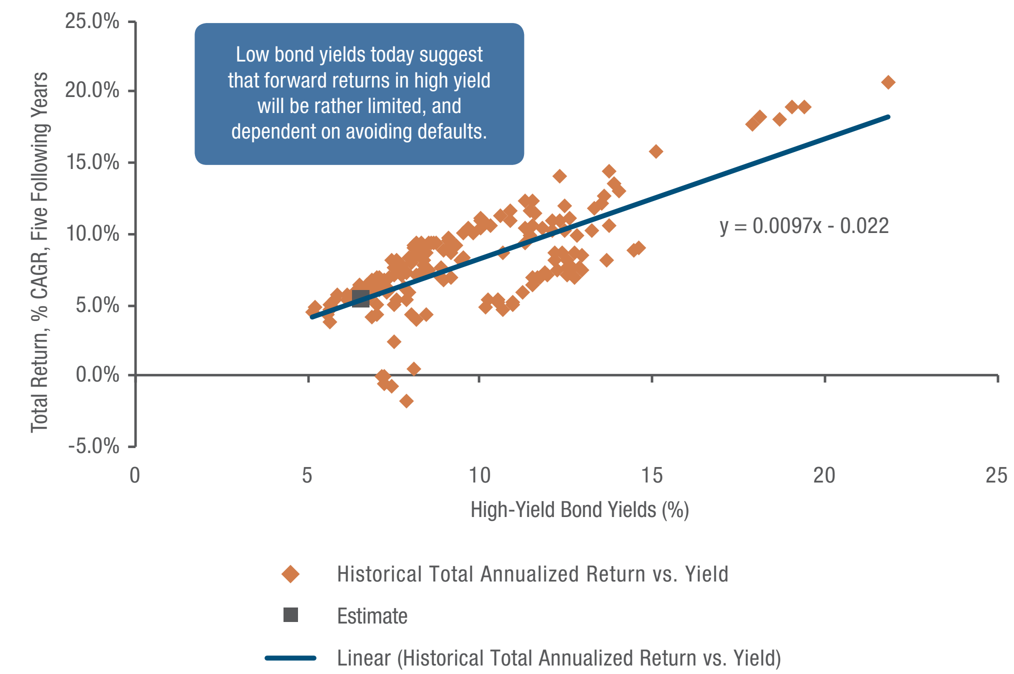
Allocation:
- Mitigate over-exposure to any given geography or sector
- Reduce tracking error

Fixed income. During periods of volatility, dependable return in your fixed-income sleeve requires intensive credit research. The distribution of potential returns on bonds has a negative skew; you generally can't make much more beyond interest payments, but you can lose your principal in the event of a default. The secret to success in beating a benchmark is therefore in avoiding those defaults.

In the next six to nine months, high-yield bonds and bank loans should provide modest returns in a risk-on environment. On the other hand, spreads in investment-grade credit are very tight and do not provide much — if any — cushion for an inflation surprise.

The Return on Fixed Income is Highly Dependent on its Starting Yield

High-Yield Bond Yields and Forward Returns

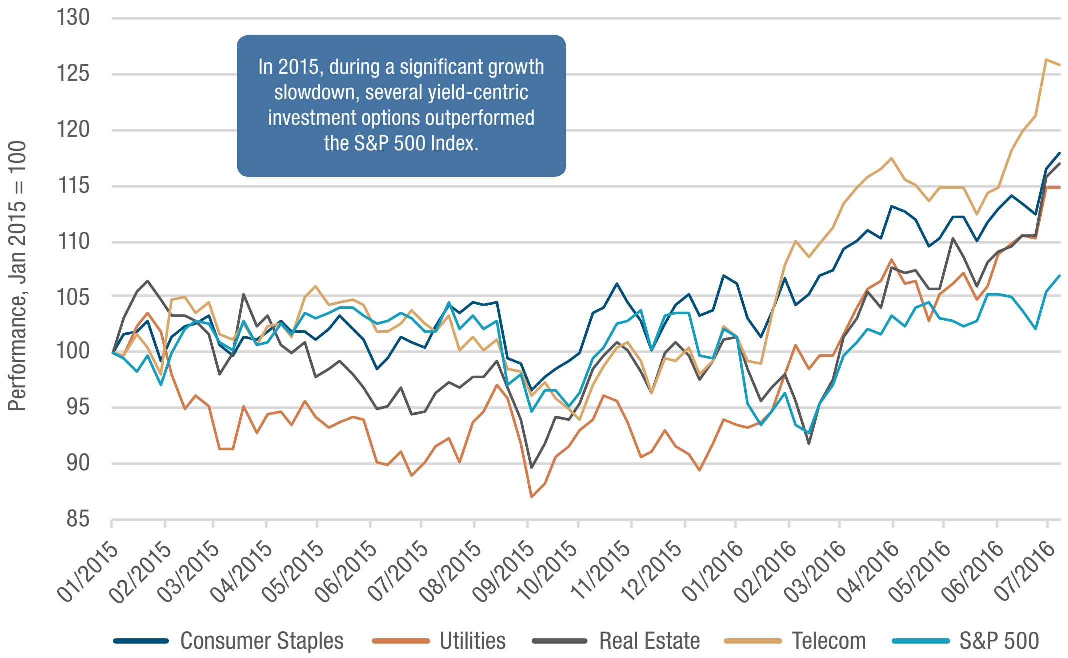


Sources: New York Life Investments Multi-Asset Solutions, Bloomberg, 6/5/19. High-yield bonds are represented by the Bloomberg Barclays U.S. Corporate High Yield Index. Past performance is no guarantee of future results, which will vary. It is not possible to invest in an index. Index definitions can be found at the end of this document.

In the longer term, the risk/return tradeoff in credit becomes less attractive. Healthy corporate profits and limited refinancing risk will keep defaults low by historical standards, but higher overall interest rates and profit margin pressure could cause defaults to rise modestly not too far down the road. As such, we don't see investors in speculative-grade debt as being especially well rewarded for the risk they bear. Adding other sources of income alongside lower quality bonds may be prudent.

Equity. Equity investments, and specifically those relying on shareholder yield, can also contribute to an income-building investment approach. Equity return can be broken into three components: dividends (money paid to shareholders out of profits), earnings growth (new profits), and changes to price multiples (perceived value). The greater the dividends, the less dependent the stock is on strong earnings growth and expansion of price multiples when generating total return. In other words, your equity return is less reliant on investor sentiment or market stability.

Yield-Centric Equity Indices Have Held Up Well During Times of Higher Volatility

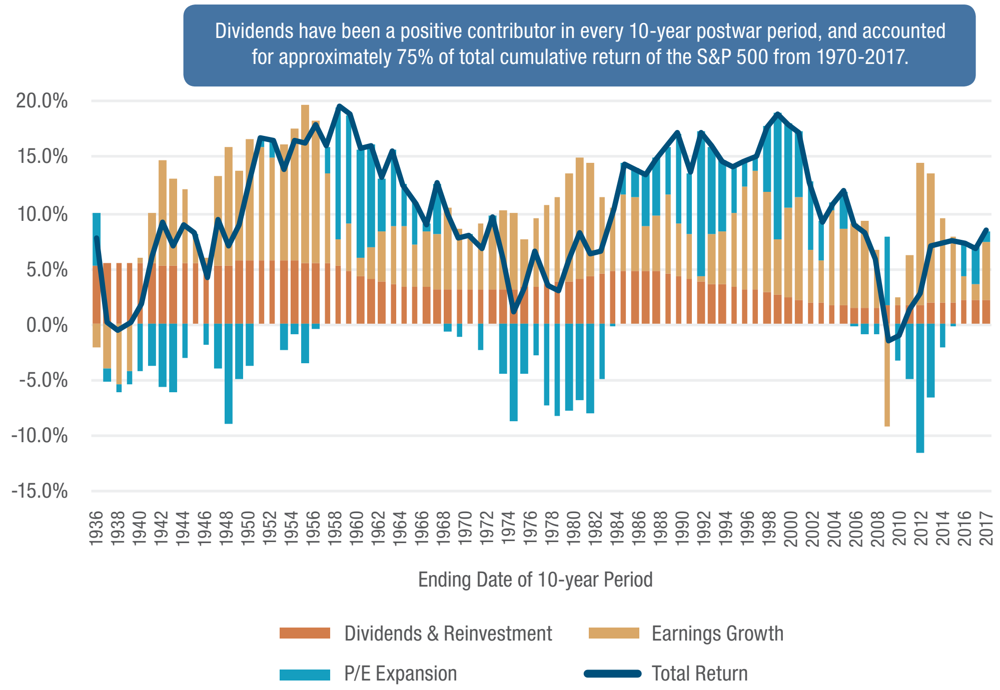


Sources: New York Life Investments Multi-Asset Solutions, S&P, Bloomberg, 6/5/19. Each sector displayed is represented by the respective S&P 500 sector index. Past performance is no guarantee of future results, which will vary. It is not possible to invest in an index. Index definitions can be found at the end of this document.

In times of market volatility, generating reliable income in equity means focusing on companies that consistently generate high levels of free cash flow. These are real businesses generating real sales to deliver real distributable profits. Companies that show promise of growing their cash streams into the future, and that have been good stewards of those profits (in the sense that they find ways of returning it to shareholders) are better positioned to provide stable income for investors through bouts of market volatility.

Consistency of Income Offers a Stable Driver of Long-Term Returns

Components of Compound Annual Total Return for Trailing 10-Year Periods (S&P 500 Composite 1936-2017)



Sources: Epoch Investment Partners Inc., Standard & Poor's, 12/31/18. Note: U.S. historical data is used as a proxy for global markets because similarly detailed data is not available for non-U.S. markets. Past performance is not indicative of future results. An investment cannot be made in an index.

Focusing on free cash flow generation steers the portfolio toward traditionally defensive sectors like consumer staples or utilities that have historically been stable businesses with less volatile stock prices. As such, they have fared relatively well during periods of market stress.

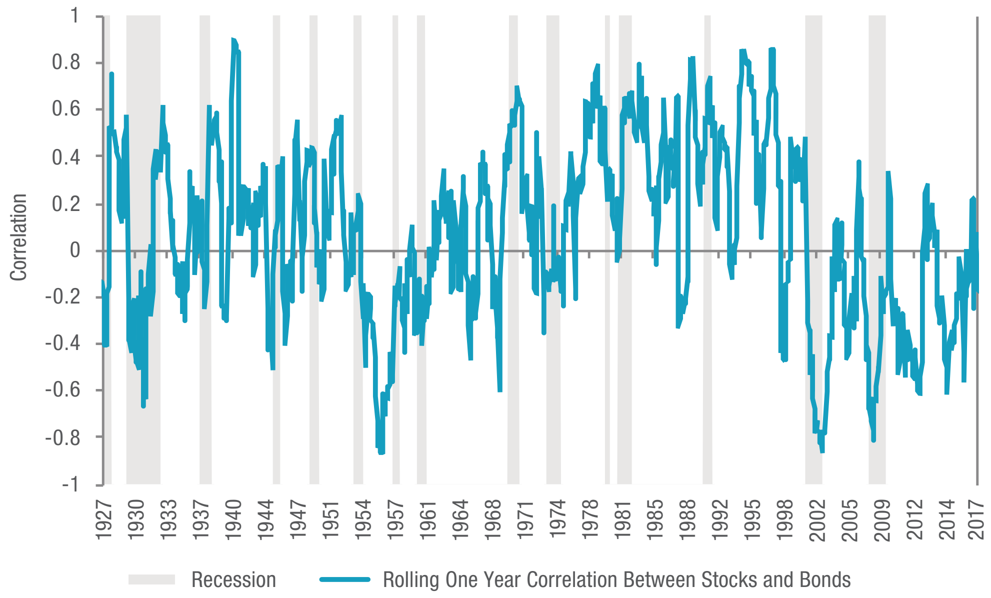
Allocation. Focusing on income in both your equity and fixed income sleeves may over- and under-expose the portfolio to certain geographies and currencies relative to peers or benchmarks. Working with an active or multi-asset manager can help eliminate risk associated with any potentially inappropriate portfolio exposures.

Further diversification

Income-based approaches sound safe and straightforward, but that's not always the case. In a low-growth, low-yield environment, even income-focused stocks and bonds may produce returns below long-term historical averages. Meanwhile, bouts of higher volatility and correlations between asset classes can make it particularly difficult for investors to achieve their objectives. Under these conditions, investors may benefit from investments offering further diversification properties.

Municipal bonds, real estate, and infrastructure investments are three relevant opportunities.

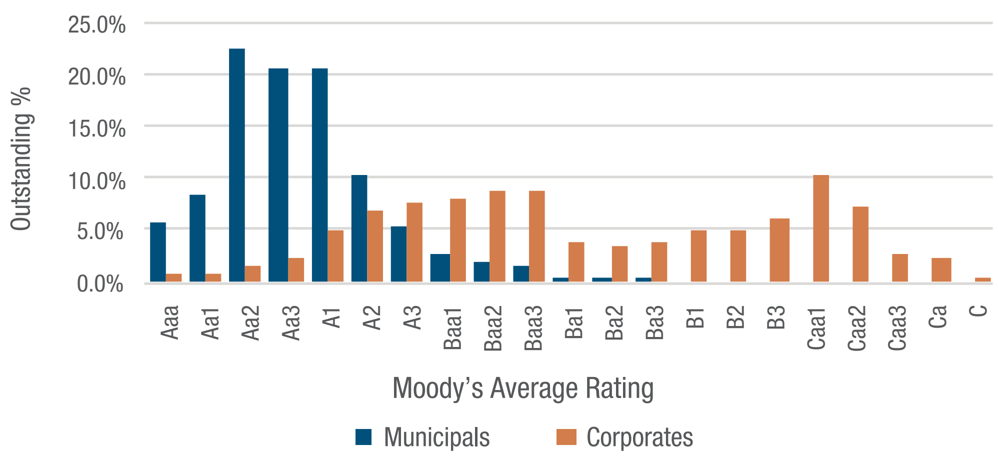
Asset Classes Can Become Correlated at Difficult Times



Sources: New York Life Investments Multi-Asset Solutions, Thompson Reuters Datastream, 6/5/19. Past performance is no guarantee of future results, which will vary. It is not possible to invest in an index. Index definitions can be found at the end of this document.

Municipal bonds. These bonds are higher in credit quality than corporate issues, offering significantly lower historical default rates and higher recovery rates when compared to equivalently rated credits. The after-tax yield can be even more enticing for some investors.

Municipal Bonds Offer Higher Quality and Lower Default Rates



Sources: MacKay Shields Municipal Managers, Moody's, 2017. Municipals are represented by the Bloomberg Barclays Municipal Bond Index. Global Corporates are represented by the Bloomberg Barclays Global Aggregate Bond Index. Moody's rates borrowers on a scale from Aaa through C. Aaa through Baa3 represent investment grade, while Ba1 through C represent non-investment grade. Past performance is no guarantee of future results, which will vary.It is not possible to invest in an index. Index definitions can be found at the end of this document.

Pockets of stress certainly exist in the municipal market and could continue to influence performance dynamics, but we believe municipal bonds present an attractive, relatively low-risk investment option for those looking to substitute away from corporate fixed income.

Real Estate. These securities offer another attractive diversifying strategy. In the short term, real estate benefits from supportive affordability levels, positive near-term demographics, lower interest rates, and a strong consumer. As such, real estate provides a useful income stream for investors while also acting as an inflation hedge.

In the medium term, slowing economic growth and rising inventory could weaken valuations. However, real estate's value tends to have a lower correlation to economic and market forces, allowing it to serve as an important portfolio diversifier even as the economy slows.

How to Invest	What is It?	Opportunity
Real Estate Investment Trusts	REITs are corporations that own or finance income-producing real estate. They typically own a portfolio of real estate within a specific sector and generally pay out 90% of annual profits to investors.	High dividend yield makes these investments attractive, particularly in environments of strong economic fundamentals (high employment, strong household balance sheets, solid wage growth, low delinquencies).
Mortgage-Backed Securities	Mortgage-backed securities (MBS) are investments secured by mortgages, meaning that investors buy the rights to receive the value of a bundle of mortgage payments.	MBS remain a relatively stable high-quality alternative to corporate credit, offering what we believe are attractive spreads and potential returns on a hold-to-maturity basis. They have maintained tight credit standards, offer a steady source of income, and typically outperform credit during early stages of an economic downturn.
Real Estate Limited Partnerships	Real Estate LPs are private investments into a general partnership that own or manage the development and upkeep of a real estate property.	Most Real Estate LPs are private investments, so they lack liquidity and may not be well diversified. But for investors with the appropriate risk tolerance, an investment in an LP can offer an attractive income and return profiles.

Infrastructure. The value of infrastructure investments also shows a low correlation to overall economic and market forces. Given their diversification benefit and the tremendous need for infrastructure investment in the U.S., we believe this investment experience will gain popularity over the next decade.

From an asset class perspective, infrastructure bonds tend to be long-dated and priced at a premium to similarly-rated corporate public bonds. Because cash flows are often contracted or regulated, infrastructure investments benefit from relatively stable and secure income generation.

As in any asset class, investing in infrastructure poses risks. Heavy regulation or unused assets could make cash flows from some infrastructure investments unstable. For infrastructure investors, identifying quality is extremely important.

A Note on investor behavior

During times of volatility, investors tend to run for the hills. Staying invested is often the best option for overcoming short-term market stress. If you're confident in your strategy, maintain your position or even add to it as the market moves lower. Alternatively, if you need capital or decide to shift your allocation in a volatile market, be aware of how market conditions will affect your trade.

Build portfolio resiliency through enhanced allocation

Hypothetical 60/40 Investor Portfolio

Passive Equity Sleeve

50% U.S. Large
25% U.S. Small
20% international
5% EM

17% of domestic equity into Equity Yield

10% of international into Currency Neutral Strategy

Fixed Income Sleeve

75% Agg
25% High Yield

12.5% of investment-grade bonds into Merger Arbitrage Strategy

12.5% of high yield into Short-Term Municipals

5% of high yield into Short Duration HY

Historical Success:
Between January 2006 through March 2009, another late-cycle environment with rising recession risks and fundamental market concerns, a traditional asset allocation portfolio (60/40), enhanced with a satellite portfolio of resilient investment strategies, including shareholder yield, liquid alts, municipal bonds, and shorter duration fixed-income, produced much better risk/return characteristics for investors. While past performance is no guarantee of future results, the inclusion of low volatility strategies to a 60/40 portfolio improved annualized returns by 60 basis points and reduced volatility by 40 basis points, resulting in a higher information ratio and lower drawdown.

Private Markets: Bubble or Opportunity?

The financial crisis of 2008-2009 was not just a recession and a market crash; it was exacerbated by a banking crisis and a housing crisis. It is highly unlikely that the next crisis will be formed in the same way. Banks have shored up their balance sheets globally and particularly in the U.S. Households have deleveraged and credit standards for mortgages have improved.

How, then, might the next crisis emerge? Investors are increasingly concerned about conditions in private capital markets.

Private capital investors

- Private equity
- Private debt
- Leveraged lending

Face challenging conditions

- Growing allocations
- Increased competition
- High valuations
- Record dry powder
- High return assumptions

Investors should screen for four key attributes

- Skill: Manager dispersion is wide.
- Capital: Available capital increases agility in down markets and empowers funds to say "no" to bad deals.
- Access: Strong relationships and reputation help create vital access to the best deals.
- Preparation: Taking advantage of market allocations requires disciplined preparation. In the meantime, avoid value traps.

Why has capital flowed to private markets?

The financial crisis reminded investors of the perils of high leverage, and the Federal Reserve responded by requiring banks to be more disciplined about the leverage on their balance sheets. At the same time, a lower neutral interest rate pushes risk assets' return lower, all else equal.

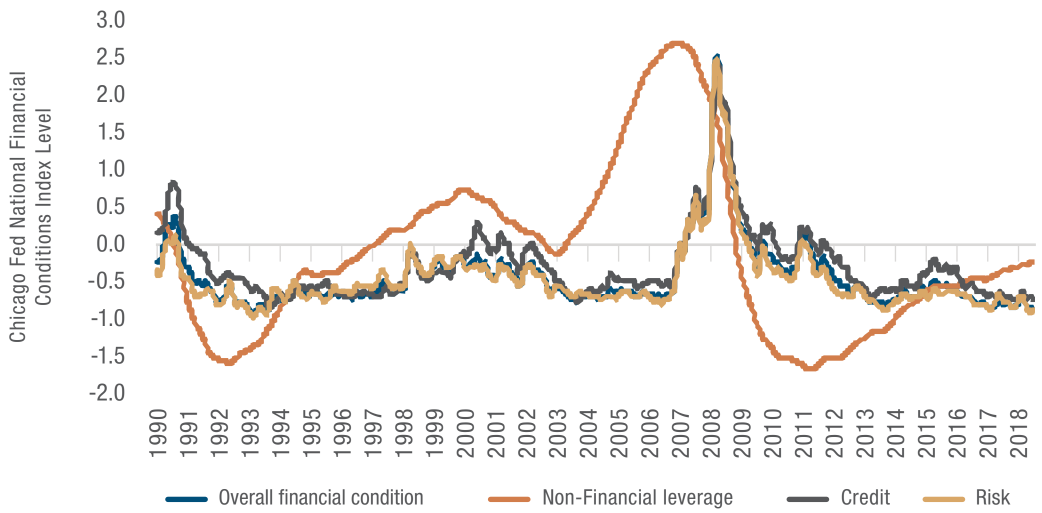
Heavier financial regulations and lower interest rates mean that staggering amounts of capital are searching for yield. An increasing proportion of the investment "pie" is being apportioned to private markets, increasing the overall capital base available to those investors. Even conservative investors have been pushed to look beyond traditional fixed income and equity to meet their investment goals.

On the demand side, the combination of heavier regulations and lower interest rates have pushed more companies into alternative methods of financing their operations. **Private debt** markets, for example, can be an attractive financing option for companies that are too small to enter the bond market, but too big to rely on bank loans alone. **Private equity** can provide attractive terms for growing a company without the scrutiny of public markets' trading and reporting.

What are the risks?

While capital inflows to private markets provide substantial investment opportunities, they also create risks. A bigger share of corporate financing has been brought outside of the regulatory purview, making it harder for regulators to keep tabs on the market. This concern is exacerbated by the presence of leverage; leverage amplifies return as prices rise but can exacerbate uneasiness in the system as valuations or operating performance decline. If an economic downturn occurs and defaults start to rise, capital could dry up, leaving companies nowhere to go for refinancing and triggering even more defaults.

Leverage in Non-Financial Companies is Rising, But Financial Conditions are Still Reasonable



Sources: New York Life Investments Multi-Asset Solutions, Federal Reserve Bank of Chicago, 6/5/19.

Private Markets: Bubble or Opportunity?

Managers in both private debt and private equity markets are witnessing too much cash seeking too few attractive deals. At first glance, this is positive for borrowers who can finance new investments at attractive prices. However, it also allows companies to access private capital much further into their lifecycle, when valuations are already elevated and growth prospects are less robust. Default rates may stay deceptively low as a result, and productivity in the overall economy may be stifled.

Heavy competition for deals also puts pressure on sponsors and general partners to move perhaps too quickly, sacrificing important due diligence in favor of landing an investment. This is particularly worrisome because earnings before interest, taxes, depreciation, and amortization (EBITDA), a measure of operating performance and a focus of private markets' valuation, is mired with accounting tricks requiring careful investigation.

The combination of greater cash and intense competition may result in lower returns and increased risks, especially among new investors who lack the experience, access, and discipline to navigate the best deals outstanding. Moreover, the implications may very well impact public markets. Investors who had hoped for big gains from new initial public offerings (IPOs) may instead be burdened by a more matured company.

Are leveraged loans the next bubble to burst?

What are CLOs? Collateralized lending obligations or CLOs are a structured finance product created by pooling loans to create new securities.

Why all the attention? CLO volume has doubled since the financial crisis to approximately $600 billion, half the size of the overall leveraged loan market. CLO capital structure is organized in tranches, which have differing levels of risk and payout priority. If the business cycle turns and companies in a wide range of industries are downgraded, it would make it harder for the CLO machine to function since they have limits on how many lower-rated loans they can hold.

What might be different? There are reasons to believe that CLOs could be safer than the instruments of crises past. For example, the bulk of CLOs' underlying collateral pool is made up of first-lien, senior-secured bank loans, which means they get paid first in a default. The loans are well-diversified – typically 150-250 companies – making them less susceptible to collateral damage.

What is covenant lite? Loans are being issued with fewer and fewer investor protections. Over 70% of CLOs lack any covenants that allow for monitoring of financial conditions and early intervention to manage problem borrowers. Concerned investors argue that covenant-lite structures can exacerbate the risk of higher losses. If lenders cannot legally react to deteriorating credit quality, then default rates may remain low even as losses pile up.

How should you invest? As with any risk asset, proceed with caution. Work with prudent managers and choose investment tranches appropriate to your risk appetite. Be wary of highly leveraged securities, which can exacerbate losses as valuations or operating performance decline.

Investing in private markets

Dislocation in the private capital markets is likely to contribute to the next recession. The availability of easy money was a primary underlying cause of the 2008 financial crisis and should be a red flag going forward. Even without a change in capital markets conditions, high leverage levels and rising wages increase the risk that companies won't be able to refinance.

But the same dynamic will create opportunities. On the economic front, dislocation would provide needed "creative destruction." Some non-viable companies have been kept afloat by low interest rates and readily available capital. Tightening capital market conditions will cause some of these companies to fail, but will also reduce the drag on productivity.

For investors, market corrections can provide attractively priced entry points to new deals. Dislocation in private markets tends to present a short window of buying opportunity — about six months. To capture this upside, you need skillful managers who can source and access the best deals where newer firms may not see those opportunities. Deep expertise, long-standing relationships with sponsors, and alignment with client interests are essential points of due diligence. If fund managers don't know why deals succeeded or failed, they are unlikely to make the right call during moments of market disruption.

Performance dispersion of private capital firms is wide, particularly in private equity, so selecting the wrong manager can be harmful. For most investors, investments using less leverage, often found in the lower middle market and middle market spaces, are likely prudent. If leverage is desired, apply it to higher-quality, shorter duration credit, and via managers with a proven track record. Unusually high return estimates should be seen with skepticism, particularly late in the economic cycle.

Investment grade… or is it?

Private loans aren't the only area of increasing concern in the post-crisis environment for corporate financing. Publicly traded fixed-income securities may also face rising risks. The share of bonds rated BBB now makes up approximately half of the $5 trillion market for investment-grade corporate debt. As interest rates have fallen, companies have improved their credit ratings across the board. But these BBB-rated bonds sit only one to three notches above "junk" debt. If capital markets or business operating conditions deteriorate, these securities could be downgraded. Conservative investors such as pension funds and insurance companies would then be pressured to sell their holdings, which could seize up the high-yield market and create serious challenges to the broader credit complex.

In short, across all investment types, investors should beware of underlying risks and consider active management for avoiding undue risks in chosen asset classes.

What Keeps Us Up at Night?

There are a few key scenarios that would cause us to reconsider our "risk-on" investment strategy:

Global growth tails off. If we see a faster-than-expected deterioration in leading economic indicators — business confidence declines, housing data deteriorates, services and manufacturing purchasing manager's index (PMIs) roll over and slide below 50 — for key countries, we would likely increase our overall allocation to high-quality fixed income and longer duration assets while reining in equity exposure.

Markets overestimate the Fed. While the Fed's position is dovish, the market is pricing in interest rate expectations even lower than the Fed suggests. This could indicate room for disappointment later. The Fed will be watching for an acceleration in price growth (due to tariffs, price increases forced by margin compression, etc.), several months of stronger wage growth (particularly if not matched with productivity gains), or further increase in the use of leverage by non-financial corporations. Any perceived risk of tighter financial conditions would be unequivocally bad for equities and credit alike.

U.S. debt ceiling debate undermines market trust. On March 2, the debt ceiling was reinstated at $22 trillion. Since that time, the U.S. Treasury Department has been using "extraordinary measures," accounting maneuvers that allow for full government operations to continue until late September or early October. If the U.S. debt ceiling is officially surpassed before a deal is met, then the U.S. would have defaulted on its debt obligations. We see a U.S. default as extremely unlikely, but debt ceiling battles can be extremely partisan. The nature of these political battles could increase the perceived risk of a U.S. rating downgrade, which would prompt substantial market volatility. A default – and again, we see this as highly unlikely – would likely have significant consequences to global markets, prompting interest rates higher and equity prices lower.

Trade war proves durable. We expect trade negotiations with China, Europe, and North America to prompt volatility through the remainder of 2019 and beyond. However, we would need to see more than short-term stress to change in our portfolio positioning. In U.S.-China negotiations, this would mean Round III tariffs (25% tariff on approximately $325 billion of Chinese goods) for six months or more. Signposts in Europe are more complex. Germany is likely to insist upon rapid resolution of any trade war to protect its manufacturing sector. If other European Union (EU) member countries require tradeoffs — such as increased fiscal stimulus or faster movement towards a banking union — that Germany is unable to accept, then market risks would increase.

Oil prices face sustained increase. The U.S. has increased pressure on Iran's oil supply, tensions in the Strait of Hormuz are running high, and Venezuela's crude oil production continues to collapse. Historically, geopolitical disruptions to oil supply have prompted market shocks, increasing energy prices and weakening U.S. consumer purchasing power. However, in the last decade, U.S. shale technology has created additional liquidity in oil markets, allowing new supply to come online more quickly than in previous oil crises. This should limit the likelihood of a sustained oil price increase. We think that oil prices between $40-70 are neutral for the global economy. Prices higher than $70 for more than six months would have real business and economic impacts.

Longer-term risks

While not an immediate concern, we believe these structural risks could shape future market dynamics:

Populism and de-globalization. Globalization creates winners and losers. Since the financial crisis, household losses and low interest rates have contributed to the gap between the two. This matters for economic potential. A 2017 International Monetary Fund (IMF) paper found that at a certain level inequality starts to have a negative impact on economic development, not to mention a negative impact on GDP growth of up to 0.35% per year over 25 years.

This also matters for markets. Greater inequality correlates with more social unrest and higher risk premiums. We are seeing this today across developed markets: Brexit, the election of Donald Trump, increasing popularity of populist parties across Europe.

World trade as a percentage of GDP peaked in 2008. We expect this trend to continue, and for political consequences to contribute to market volatility. How governments go about calming or stoking social unrest will be critical for long-term investment strategy.

Rise of China and digital cold war. The U.S.-China trade war is just one manifestation of conflict between the two countries as China becomes more powerful. China's managed economic model will increasingly challenge the Washington consensus-based principles of reduced economic and financial barriers, privatization, de-regulation, and secure property rights. Companies will have to navigate policy uncertainty and face idiosyncratic risks such as cyber threats with higher frequency.

Shift to managed trade. Sustained focus on one-off trade deals rather than regional deals or global norm-setting would gradually shift the way that multinational organizations consider their supply chains and distribution. Regional trade blocs would become more likely, shifting production closer to home and requiring an even stronger focus on culture and regional preferences. Investment decisions would likely take a stronger regional tilt as well.

Market structure. Changes in market structure since the financial crisis make liquidity disruptions more likely. Lack of market-making and the increasing popularity of passive and quantitative investments reduce market liquidity, creating a feedback loop that precipitates selloffs in times of volatility. Estimates show that the average liquidity in U.S. equity markets during the December 2018 selloff and subsequent recovery were less than one-third of the liquidity in previous episodes — and about half of the worst liquidity drawdowns since the financial crisis. These developments are likely to contribute to the next crisis and could become an attribute of market movements for the foreseeable future.

Why the Multi-Asset Solutions (MAS) team?

We are New York Life Investment's specialists in multi-asset investing, assisting our partners in their persistent pursuit of investment success.

Access

We leverage the depth and breadth of the New York Life Investments platform to support our clients and partners.

Skill

We identify smart investments while providing profitable and secure long-term outcomes.

Navigation

We guide our partners through the rapidly changing investment environment using research and innovation.

Partner with us

Our mission is to build, preserve, and grow financial assets alongside our partners with integrity and respect through quality investments, education, and innovation.

Multi-Asset Strategies

Asset allocation strategies designed to capitalize on market opportunities within a variety of investment objectives.

- Allocation Funds
- Model Delivery

Market Intelligence

Investment services designed to support our partners and our investors.

- Market Insights
- Risk Analysis
- Investment Strategy
- Financial Education

Customized Solutions

Strategic partnerships designed to help meet investment objectives through holistic solutions.

- Global Tactical Allocation
- Risk Modeling
- Income Generation
- Inflation Protection

How we invest

Alpha Metrics, a quantitative tool for holistic portfolio management

The Multi-Asset Solutions team uses a proprietary quantitative portfolio management tool to aid in our analysis of financial markets. Our approach relies in four factor categories, enhancing our research and reducing the emotion associated with financial market analysis.

While often related, no two economies, markets, or financial assets are the same. As a result, we apply a unique blend of indicators within each Alpha Metric category to capture a fully diversified investment portfolio. We enhance this methodology with careful qualitative analysis of related fundamentals. The framework is fully customizable to any benchmark and can be applied to any asset class or risk factor.

Our Alpha Metrics

Economic Cycle

Market performance is punctuated by periods of economic growth and contraction known as the the economic cycle. Each phase of the cycle impacts the challenges and opportunities available to businesses, sectors, and financial assets. We estimate and capture the strength and phase of the cycle using a blend indicator.

Momentum

Investors can capitalize on the continuance of market trends by monitoring momentum. Our framework utilizes mean reversion-adjusted momentum on daily returns of financial assets.

Value

Value is an important driver of returns over long time horizons. Valuations measure the price investors are willing to pay for the future earnings, assets, or interest payments of a business. Economic variables like price inflation and economic growth can warrant higher or lower premiums paid by investors.

Investor Sentiment

Sentiment measures overall attitude of investors toward a financial asset. This variable exhibits predictive power over very short time horizons after reaching extremes – more than one standard deviation above or below it's long-term historical mean.

If you are interested in learning more about our methodology, or in applying these investible ideas to your portfolio, please contact the Multi-Asset Solutions team at: NYLI_MultiAssetSolutions@newyorklife.com

Index Definitions

Bloomberg Barclays Global Aggregate Bond Index is an unmanaged index that is comprised of several other Bloomberg Barclays indexes that measure fixed income performance of regions around the world.

Bloomberg Barclays Municipal Bond Index covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Bloomberg Barclays U.S. Corporate Bond Index measures the investment-grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers.

Bloomberg Barclays U.S. Corporate High Yield Index measures the market of USD-denominated, non-investment-grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging markets debt.

Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments.

S&P 500 Index is widely regarded as the standard for measuring large-cap U.S. stock-market performance.

S&P 500 Consumer Staples Sector Index (S5CONS) is a capitalization-weighted index. This is a GICS Level 1 Sector Group.

S&P 500 Real Estate Investment Trusts Industry Index (S5REITS) is a capitalization-weighted index. This is a GICS Level 3 Industries.

S&P 500 Telecommunications Services Index (S5TELS) is a capitalization-weighted index. This is a GICS Level 1 Sector Group.

S&P 500 Utilities Index comprises those companies included in the S&P 500 that are classified as members of the GICS utilities sector. It is a capitalization-weighted index.

Definitions

Active investing is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continuously monitor their activity to exploit profitable conditions. Active management typically charges higher fees.

Basis points (bp) are a unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent) or 0.0001 in decimal form.

Capital expenditures (CAPEX) are funds used by a company to acquire, upgrade, and maintain physical assets such as property, buildings, an industrial plant, technology, or equipment.

Diversification is a risk management strategy that mixes a wide variety of investments within a portfolio.

A drawdown is a peak-to-trough decline during a specific period for an investment, trading account, or fund.

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock.

EBITDA stands for earnings before interest, taxes, depreciation and amortization. EBITDA is a measure of a company's financial performance and is used as an alternative to earnings or net income in some circumstances.

Information ratio is a measurement of portfolio returns beyond the returns of a benchmark, usually an index, compared to the volatility of those returns.

An initial public offering (IPO) is the process of offering shares in a private corporation to the public for the first time.

Price-to-earnings ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

Private debt is the debt accumulated by individuals or private businesses and can take numerous forms; a personal loan, credit card, corporate bond or business loan for instance.

Private equity is an alternative investment class and consists of capital that is not listed on a public exchange. It is composed of funds and investors that directly invest in private companies, or that engage in buyouts of public companies, resulting in the delisting of public equity.

Risk premia refers to the amount by which the return of a risky asset is expected to outperform the known return on a risk-free asset.

Value-added tax (VAT) is a consumption tax placed on a product whenever value is added at each stage of the supply chain, from production to the point of sale.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

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