Global asset allocation outlook

October 9, 2014

by Global Asset Allocation Team of Columbia Management

Recent market performance, particularly in September, has been negative across a widespread array of asset classes as we have seen the U.S. dollar exchange rate rise with increasing intensity in recent months. The worst returns, not coincidentally, were delivered by the very assets that have shown historically high sensitivity to dollar strength. This disruption to currency stability in general, and the particular importance of a rise in exchange value for the world's reserve currency, represents an important change in capital market conditions.

It is difficult to say, of course, whether the adjustment in the dollar, and its subsequent effect on asset prices, has run its course. However, we are encouraged that prospects for equity risk remain fairly bright on an intermediate basis, and that the economic data is improving, at least in the United States. The U.S. economy is on a clearly divergent path relative to the rest of the major economies. Growth has accelerated meaningfully since the middle of the year, with indicators such as the purchasing managers index (PMI) hitting record levels not seen since before the financial crisis. Labor markets, credit growth, retail sales and other markers of U.S. economic strength are also showing gradual but steady improvement.

We believe that although U.S. stocks appear fairly valued, they can rise with earnings growth as U.S. corporate fundamentals look solid, supportive of earnings growth. As a result, we continue to recommend that equities stay at the center of return generating strategies. Particularly in light of the recent sell-off, we have moved to a modest overweight in equities from neutral. However, we note that the changes in currency strength over the third quarter argue for a more U.S. centric risk-taking strategy. We have therefore moved from neutral to overweight for U.S. large cap equities.

We remain neutral on overall emerging market (EM) equities, favoring Asia over Latin America and maintaining a small overweight to EMEA which has been adversely affected by the events in Russia but should ultimately benefit from the liquidity in the eurozone. Latin America is slowing down as the bulk of commodity exporting countries are facing multiple challenges from slower global demand, currency headwind from a stronger dollar and deteriorating domestic fundamentals. We continue to underweight Latin America. Aside from China, the rest of Asia is seeing some pickup in growth, especially India and Philippines.

We continue to maintain an underweight to fixed income which faces headwinds as the Fed potentially ends monetary accommodation. U.S. rates are expensive by our measures, and we recommend an underweight to Treasuries. So far this year, global developments have kept a lid on U.S. yields as Treasuries appear attractive to other developed market bond markets, particularly as the dollar appreciates. But we expect rates to rise in response to cyclical improvement in U.S. growth.

We have downgraded some of our non-U.S. overweights, particularly EM debt, which we have moved from an overweight to neutral. Potential Fed policy change is also driving our decision. During last summer's taper tantrum, EM assets were hit hard as a stronger dollar and higher rates increased fears of tightening liquidity. The end of QE could cause temporary dislocation in the EM markets again.

We also downgraded municipal bonds from an overweight to a neutral position on valuation concerns. Our research indicates that muni's underperform in a rising rate environment, but fare better than Treasuries.

We added to investment-grade corporate bonds where valuations are not hugely appealing but provide a better alternative to Treasury bonds which are overvalued. Despite the recent sell-off, we continue to hold a modest overweight to high-yield bonds. Much like the taper scare last year, panic selling in high yield is an opportunity to add to the sector at attractive spread levels as corporate health in the U.S. remains supportive of the sector and default rates remain low. There are no signs of a turn in the credit cycle which typically augurs underperformance in high yield.

We also note that with so many diverse assets proving vulnerable to currency movement, we continue to advocate an overweight to liquid alternatives and absolute return strategies to provide an expanded palate for diversification to investors.

As always, we continue to monitor global economic and markets conditions and will adjust our investment strategy accordingly.

Disclosure

The views expressed are as of 10/6/14, may change as market or other conditions change, and may differ from views expressed by other Columbia Management Investment Advisers, LLC (CMIA) associates or affiliates. Actual investments or investment decisions made by CMIA and its affiliates, whether for its own account or on behalf of clients, will not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not account for individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance. Asset classes described may not be suitable for all investors. Past performance does not guarantee future results and no forecast should be considered a guarantee either. Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that the forecasts are accurate.

This material may contain certain statements that may be deemed forward-looking. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those discussed. There is no guarantee that investment objectives will be achieved or that any particular investment will be profitable.

Investment products are not federally or FDIC-insured, are not deposits or obligations of, or guaranteed by any financial institution, and involve investment risks including possible loss of principal and fluctuation in value.

Securities products offered through Columbia Management Investment Distributors, Inc., member FINRA. Advisory services provided by Columbia Management Investment Advisers, LLC.

1030462