A Look Beyond the Business Cycle

Executive summary

We believe that strategic asset allocation is key in helping investors meet long-term investment objectives. A strong case can also be made for tactical adjustments that modify an investment portfolio over time, based on expectations for the economy and markets. One element of our tactical approach focuses on the current outlook for the U.S. business cycle over the next three to five years. We believe it is possible to determine, over that period of time, how those expectations may deviate from long-term assumptions and how to adjust a portfolio accordingly.

In today’s environment, our current tactical view is predicated on an expectation that the U.S. economy will generally continue its pattern of slow economic growth over the next three to five years. We anticipate annual growth in Gross Domestic Product (GDP) of less than 3 percent over that timeframe. Interest rates and inflation should remain low as well, but unemployment will persist at higher-than-desired levels.

While past performance is not a guarantee of future results, when looking at current valuations from a historical perspective, non-U.S. stocks appear to be among the most attractively valued, on average, while bonds in general appear to be expensive. Our enthusiasm for equities is tempered by the reality that they are subject to greater volatility, or risk, than fixed income securities. Our tactical recommendations are made keeping in mind the potential for market, policy and political risks and changing economic trends.

Advantages of business cycle projections

We believe that portfolios may potentially benefit from tactical adjustments made to holdings that have a three-year to five-year investment horizon, the average length of a full business cycle. The potential to capitalize on trends over such an extended time period are, in our view, higher than the prospects of trying to make tactical adjustments by “timing” shorter-term market swings, where changes are far less predictable.

To accomplish our three-year to five-year projections for the markets, we look at two different variables:

1. The outlook for the economy over that business cycle and how history helps guide us in setting expectations for relative asset class performance should those economic trends materialize
2. Asset class valuations, helping us determine where favorable valuations may create the potential for superior future performance

We believe a fair assessment which combines the economic outlook with asset class valuations provides a more precise basis for recommending tactical adjustments to a portfolio.

Our expectation for the U.S. business cycle over the next three to five years is for continued slow growth in the economy. We provide thoughts on:

- How this environment may affect various asset classes
- Why making tactical asset allocation adjustments to portfolios may be appropriate

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A current assessment of the economy and markets

What are our expectations for the economy and different asset classes over the coming three-year to five-year business cycle? Our views are outlined below.

U.S. economic expectations: The U.S. economy has been in “recovery” mode since early 2009 when the last recession ended. The hallmarks of the recession were a dramatic decline in the housing market and a significant upturn in the nation’s unemployment rate. Even today the economy continues to deal with lower levels of housing formation and structurally high unemployment. The new reality of baby boomers beginning a transition into retirement may slow economic growth, which could translate into modest inflation in the years ahead.

Our projection is for real GDP growth in the United States to average around 2.6 percent per year through the next business cycle, with inflation nearing the Federal Reserve’s target rate of 2.3 percent. Given that environment, it seems likely that the Fed will continue its low interest rate policy at least for the foreseeable future.

Asset class valuation perspectives: Asset class returns can fluctuate over short periods of time for various reasons, but over a longer time horizon, valuations often dictate the return prospects for an investment or asset class. One of the biggest drivers of valuations in the current environment is the Federal Reserve’s continued policy of maintaining low interest rates to help stimulate economic growth. It particularly affects fixed income asset classes, where current yields remain low relative to long-term averages, and expectations for rising interest rates further suppress returns. Within fixed income asset classes, high yield debt may offer an advantage over investment grade debt. Overall, however, fixed income returns are likely to be modestly unattractive relative to equities and commodities, but on par with real estate returns.

Among equity asset classes, valuations based on price-to-earnings (P/E) multiples and dividend yields make equities in general an attractive asset class going forward. U.S. equities appear fairly valued from a P/E perspective, but more attractive than fixed income asset classes based on current dividend yields (even though yields on U.S. stocks remain below their historical average). Given our expectation for modest economic growth and low inflation, expectations for U.S. stocks appear fair at best.

The current environment appears to be more favorable for non-U.S. stocks. We anticipate that emerging markets are positioned to outperform developed markets. While valuations are currently more attractive in developed equity markets, this may be offset by the likelihood that economic growth in emerging markets will outpace that of developed markets while inflation levels remain modest. We believe this creates a very favorable environment for emerging market equities.

Real assets, such as commodities, may see performance constrained if inflation levels remain relatively stable. Commodities are modestly better positioned to outperform their historical average than Real Estate Investment Trusts (REITs) if looked at from a valuation perspective. Keep in mind that the commodities market

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includes both current and futures contracts, and we see favorable trends here. Prices for longer-dated futures contracts are lower than those of current contracts, possibly creating a value opportunity for investors who roll from one contract to the next. By contrast, REITs look more expensive from a P/E standpoint than their long-term average, which could limit their near-term potential.

### Strategy implications

Clients considering tactical adjustments to their portfolios may want to consider stocks relative to fixed income, and commodities relative to real estate. Within specific sectors, strategies may include:

- **Fixed income**: when appropriate, consider hedge funds, which may be positioned to add value.

- **Equities**: modestly increase equity positions by reducing allocations in riskier fixed income assets. Based on their more attractive valuations, focus on additional allocations to non-U.S. positions.

- **Real estate/commodities**: maintain existing positions in foreign REITs. Consider reducing weightings in U.S.-based REITs by shifting assets to commodities.

### Conclusion

Making tactical adjustments to a long-term, strategic investment portfolio has the potential to both enhance returns and mitigate the risk of being too heavily invested in overvalued asset classes. Implementing appropriate portfolio changes based on economic and market expectations over a three-year to five-year business cycle is, to our thinking, an appropriate approach to tactical asset allocation.

The expectation for the next business cycle is for continued slow growth in the U.S. economy, with little likelihood of a recession. Inflation should remain relatively tame. In this environment, equities are likely to be more effectively positioned than fixed income investments, with non-U.S. equities being in a more favorable position based on current valuations. Return expectations for fixed income investors remain low, but hedged fixed income strategies may be best positioned to enhance value within that broad asset class.

As always, you should work closely with your Wealth Management Advisor to make certain any changes you consider are appropriate for your circumstances, investment objectives, risk profile and investment time horizon.
Investments are:

| NOT A DEPOSIT | NOT FDIC INSURED | MAY LOSE VALUE | NOT BANK GUARANTEED | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY |

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Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning the construction of portfolios and how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes may be suitable for every portfolio. Hedged investment strategies are typically available via hedge funds which may not be appropriate for all clients due to the speculative nature and high degree of risk involved in these investments.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible difference in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer term debt securities. Investments in lower rated and non rated securities present a greater risk of loss to principal and interest than higher rated securities. Investments in high yield bonds offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer’s ability to make principal and interest payments. The municipal bond market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. Treasury inflation-protected securities (TIPS) offer a lower return compared to other similar investments and the principal value may increase or decrease with the rate of inflation. Gains in principal are taxable in that year, even though not paid out until maturity. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties (such as rental defaults). Hedge funds are speculative and involve a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund.