WILSHIRE FUNDS MANAGEMENT

# Investment Strategy Update

January 2021

Global equities continued to stage a tremendous rally in the fourth quarter, benefiting primarily from optimism regarding the development and distribution of a COVID-19 vaccine. Many investors have called the recovery in equities irrational, with the belief that equity prices appear to be detached from the real economy, but markets often trade ahead of the economy and earnings growth, and the current environment is no exception. The recovery in economic growth and corporate earnings is very much intact. While more recent observations of personal consumption and retail sales have shown some weakness, it is likely temporary due to the recent surge in COVID-19 cases. Fortunately, global manufacturing PMIs have staged a strong recovery, particularly in the U.S. Given the recovery in manufacturing activity and the relatively strong financial health of the U.S. consumer, we will likely witness a reacceleration in personal consumption of both goods and services on the heels of further stimulus, and as COVID-19 cases subside. Investors should be prepared for very strong U.S. GDP growth in 2021, coinciding with higher inflation, higher interest rates, and a turbulent road higher for global equities.

In this quarter’s Investment Strategy Update, we take a deeper dive into the health of the U.S. consumer, the recovery in manufacturing, underlying indications of inflationary pressure, market implied interest rates, and equity valuations and earnings. We also review the historical disparity in the sentiment of CEOs vs. consumers, and discuss what volatility markets are implying about risk in 2021. In summary, we maintain our pro-risk and pro-cyclical views to remain overweight value equities and emerging markets, but given the recent compression in credit spreads, we have moved to a neutral posture in credit vs. government bonds. We also remain underweight to traditional fixed income exposures, and remain relatively cautious in our active risk budget. We provide a summary of our rationale and supporting exhibits in the following sections, and we will continue to keep you apprised of our market perspectives and positioning.

| Asset class | October | Change | January |
|---|---|---|---|
| Fixed Income vs. Equity | Neutral | ≈ | Neutral |
| Alternatives vs. Equity | Neutral | ≈ | Neutral |
| Alternative vs. Fixed Income | Overweight | ≈ | Overweight |
| Duration vs. Barclays Aggregate | Neutral | ≈ | Neutral |
| Credit vs. Government | Overweight | ↓ | Neutral |
| Investment Grade vs. High Yield | Neutral | ≈ | Neutral |
| High Yield vs. Bank Loans | Neutral | ≈ | Neutral |
| Large Cap vs. Small Cap Equities | Neutral | ≈ | Neutral |
| Growth vs. Value Equities | Underweight | ≈ | Underweight |
| Global ex-U.S. vs. U.S. Equities | Neutral | ≈ | Neutral |
| Emerging vs. Developed Equities | Overweight | ≈ | Overweight |
| Emerging vs. U.S. Equities | Neutral | ↑ | Overweight |
| Global REITS vs. Global Equities | Neutral | ≈ | Neutral |
| Commodities vs. Global Equities | Neutral | ≈ | Neutral |

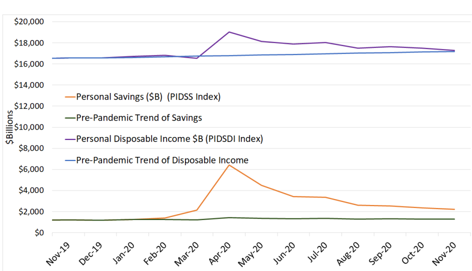
| Asset class | Change | View | Summary of Rationale |
|---|---|---|---|
| Fixed Income vs. Equity | ≈ | Neutral | Despite positive economic outlook, which would normally be expected to benefit equities coming out of a recession, valuations are not materially more attractive in equities vs. fixed income, resulting in a neutral posture. |
| Alternatives vs. Equity | ≈ | Neutral | We maintain a neutral position in alternatives vs. equities, but we may allocate to long-short equity strategies with more beta exposure in lieu of market neutral/equity hedge to facilitate alpha-oriented opportunities that can benefit from the additional breadth of short positions. |
| Alternative vs. Fixed Income | ≈ | Overweight | Given the rich valuations of government bonds and significant compression in credit spreads over the past nine months, we remain underweight in traditional fixed income exposures and are favoring strategies that provide more flexibility and/or potential for differentiated returns. |
| Duration vs. Bloomberg Barclays Capital Aggregate Bond Index | ≈ | Neutral | We believe that there is a negative asymmetric risk/return profile associated with interest rate exposure today, and although we remain neutral in duration, we are expressing this view as an underweight to fixed income, which is expected to result in less interest rate sensitivity in client portfolios. |
| Credit vs. Government | ↓ | Neutral | Given the significant narrowing of credit spreads over the past nine months, we no longer see a significant risk-adjusted return opportunity in credit relative to government bonds and are moving to neutral as a result. |
| Investment Grade vs. High Yield | ≈ | Neutral | We do not see a meaningful valuation opportunity between investment grade and high yield. |
| High Yield vs. Bank Loans | ≈ | Neutral | We do not see a meaningful valuation opportunity between high yield and bank loans. |
| Large Cap vs. Small Cap Equities | ≈ | Neutral | We recognize that small caps are likely to benefit from an economic recovery, however given the dramatic level of outperformance in small cap during the fourth quarter, we are maintaining a neutral posture relative to large caps at this time. |
| Growth vs. Value Equities | ≈ | Underweight | U.S. value equities offer more attractive valuations and are expected to be the primary beneficiaries of a material recovery in earnings in 2021, particularly in Industrials, Materials, and Financials. On the other hand, U.S. growth equities are likely to face relative headwinds from higher nominal and real yields in the future. Therefore, we maintain our overweight view in value equities. |
| Global ex-U.S. vs. U.S. Equities | ≈ | Neutral | Despite attractive relative valuations in non-U.S. developed market equities, the structural headwinds that Europe faces with a unified monetary policy applied to differentiated economies increases the uncertainty regarding its ability to recover from this downturn. Similarly, Japan has already been battling deflationary pressure for decades, and was only recently beginning to gain momentum. Furthermore, earnings recovery expectations are not as strong in foreign developed markets relative to the U.S. Therefore, we are remaining neutral. |
| Emerging Markets vs. Developed Equities & U.S. | ↑ | Overweight | Emerging economies are forecasted to deliver stronger economic growth in 2021 and have historically outperformed coming out of recessions. Emerging markets also offer more attractive valuations relative to the U.S. and foreign developed markets. Therefore, we maintain our overweight view in emerging markets, and are now also sourcing our overweight to emerging markets from U.S. equities. |
| Global REITs vs. Global Equities | ≈ | Neutral | While certain segments of the REIT market may be very challenged in this environment, the market is fragmented in terms of the impact of COVID, and the demand for higher yielding equities such as REITs is likely to increase due to very low government bond yields. Therefore, we remain neutral. |

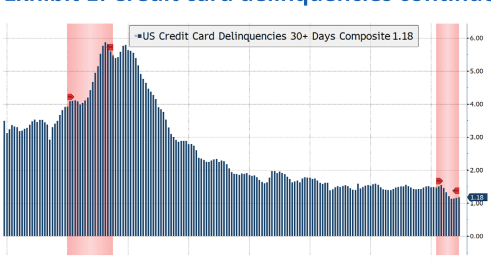
# Macroeconomic Outlook: Temporary Slowing in the Recovery of Personal Consumption

The remarkable economic rebound during the third quarter outpaced expectations, and the V-shaped recovery in personal consumption, particularly Durable Goods, showed the resilience of the U.S. consumer. Unfortunately, more recent observations show signs of slowing in personal consumption and retail sales throughout the quarter (Exhibits A & B). This is likely a temporary result of the recent surge in COVID-19 cases in the U.S. Fortunately, households appear relatively well positioned to manage through this challenging environment, after having accumulated nearly $1 trillion in excess savings relative to the pre-pandemic trend, thanks to the significant increase in disposable income from government stimulus in Q2 of 2020 (Exhibit C). This is also evidenced by the substantial reduction in credit card debt per household, which coincided with the significant jump in disposable income in Q2, as shown in Exhibit D. Unlike the global financial crisis of 2008-2009 when credit card delinquencies surged, leading to an increase in charge-offs (defaults), we are actually observing a decline in delinquencies during this crisis (Exhibit E). This is a likely indication that consumers have the financial capacity to spend when the recent wave of COVID cases subsides and the economy begins to fully reopen. This capacity does not appear to be limited to higher income consumers, as year-on-year credit card spending has recovered across all income groups, and is most elevated for the lowest income segment (Exhibit F)

### Exhibit C: Nearly $1t in excess savings vs. Pre-covid trend[1]

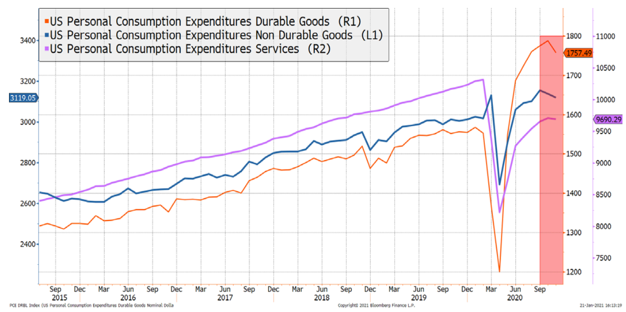



### Exhibit E: Credit card delinquencies continue to fall[1]

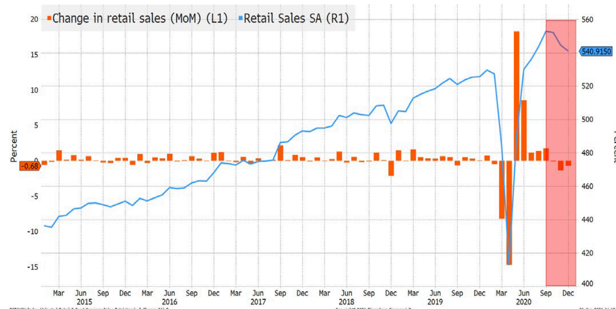



[1]Source: Bloomberg; Bureau of Economic Analysis

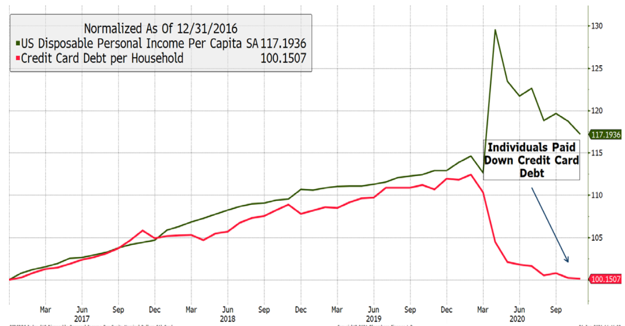
### Exhibit A: Consumption slows following a strong Q3[1]



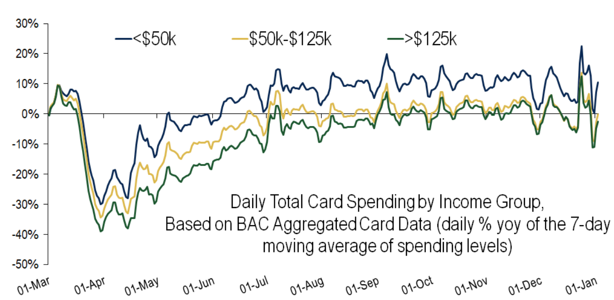

### Exhibit B: Retail sales rolled over in Q[1]




### Exhibit D: Households have reduced credit card debt[1]




### Exhibit F: Card spending recovered across income groups[2]



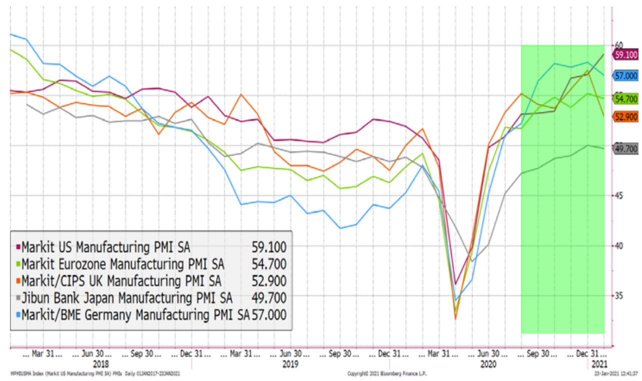

[2]Source: Bank of America Securities

# Macroeconomic Outlook: U.S. Manufacturing Recovery Gaining Momentum

Global manufacturing PMIs have also staged a V-shaped recovery, with most of the developed world still signaling expansion (above 50). While foreign economies are showing some degree of moderation in manufacturing sentiment, the U.S. manufacturing PMI continues to surge higher, and signs of higher export activity and container throughput are further indications of a pick-up in trade activity. Factory orders have also maintained a positive trend (Exhibits G - I). After a substantial jump in demand for durable goods, we are on the cusp of a significant rebuilding cycle of wholesale inventories, particularly for motor vehicles & parts, home furnishings, machinery, equipment, and metals (Exhibit J). The recent increase in inventories in Q4 may contribute positively to economic growth, however higher inventories may also be due to declining consumption activity.

**Exhibit G: Global manufacturing PMIs recover[1]**




Despite recent softening in the labor market, which has been primarily due to job losses in leisure and food & beverage establishments, there are signs of improvement in the demand for professional services, and more notably in manufacturing. As shown in Exhibit K, manufacturing job openings jumped to levels not reached since 2018, and are an indication of a pick-up in manufacturing activity and the potential for further improvement in the overall labor market. Given this recovery in manufacturing activity, in combination with the financial health of the U.S. consumer and a high probability of further stimulus, we will likely experience a reacceleration in personal consumption of both goods and services as COVID-19 cases subside, which should result in very strong U.S. GDP growth in 2021.

**Exhibit H: Higher exports & container throughput[1]**

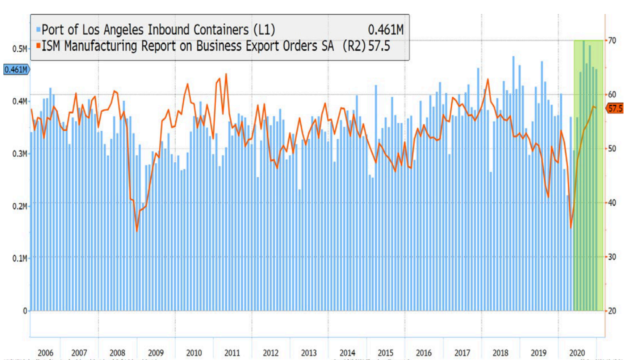



**Exhibit I: U.S. Factory orders continue to recover[1]**

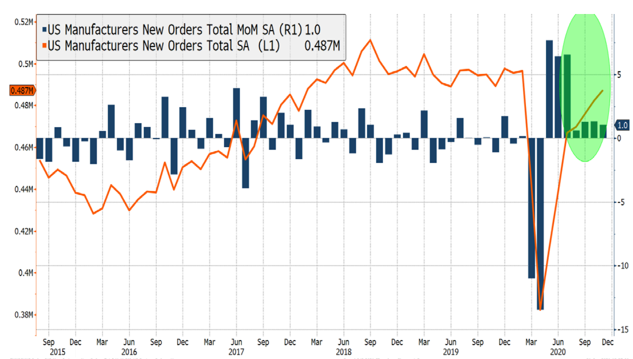



**Exhibit J: Wholesale inventories rebuilding[1]**

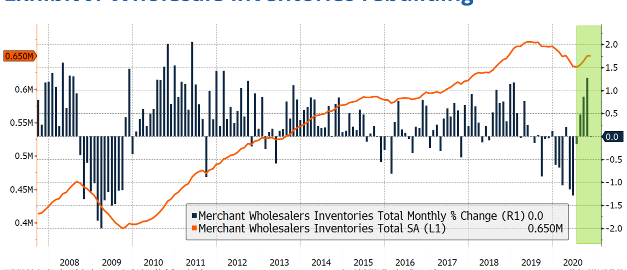
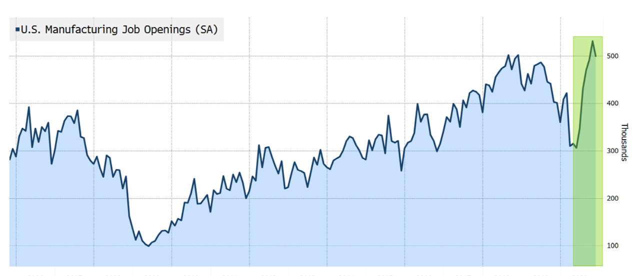



**Exhibit K: U.S. Manufacturing job openings surge higher[1]**




[1]Source: Bloomberg

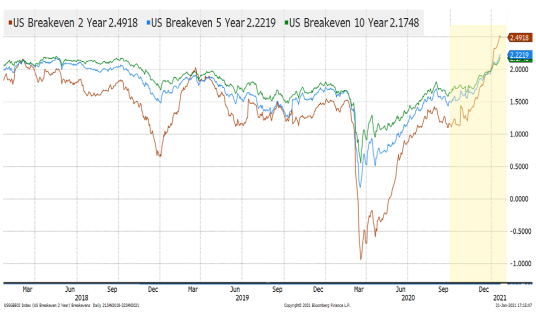
  

# Macroeconomic Outlook: Inflation Risk Should Not Be Overlooked

Inflation has remained somewhat resilient to the temporary shutdown of the U.S. economy, particularly relative to what the market priced-in during the spring of 2020. We never actually experienced anything close to the deflationary pressure implied by the 2-year breakeven inflation rate, which was implying inflation of nearly -1% in March of 2020 (Exhibit L). More recently, the 2-year breakeven reflects inflation expectations of approximately 2.50%, and the 10-year breakeven is now approaching 2.20%. Investors have come to the realization that the economic downturn was not as bad as anticipated, and the combination of a resilient U.S. consumer and extreme levels of government stimulus are likely to spark inflationary pressure not experienced for many years. As shown in Exhibit M, the spike in the prices of Core Commodities, specifically Household Furnishings/Supplies & Used Cars/Trucks, largely offset the weakness in the prices of Services, representing nearly 75% of Core Inflation, which now sits at 1.6% YoY. As the economy reopens, the prices of Services are likely to increase significantly on high demand from consumer spending habits, which are likely to shift to favor experiences such as travel, dining, and entertainment. Furthermore, the low interest rate environment continues to be supportive of the housing market, and the pandemic-fueled demand for home-ownership that is likely to persist for some time. Today, measures of Housing Starts and Existing Home Sales now sit above pre-pandemic highs, and we would need to see a very material rise in interest rates to weigh on housing demand.

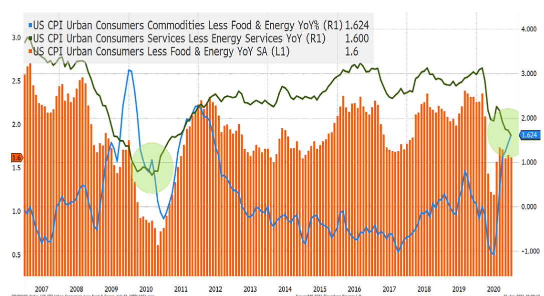
The persistent rise in Wholesale Prices over in the back half of 2020, as shown in Exhibit N, also serves as an indication of pending inflationary pressure, as producer prices are often a precursor to rising consumer prices. The potential for a rise in the velocity of money, in combination with a continued increase in the money supply, is yet another indication of future inflation. Velocity of M2 may have moderated late in 2020, however it is reasonable to expect a rise in the frequency at which money is used to purchase domestically produced goods and services in 2021, thereby fueling inflationary pressure.

**Exhibit L: Breakevens signal rising inflation expectations**



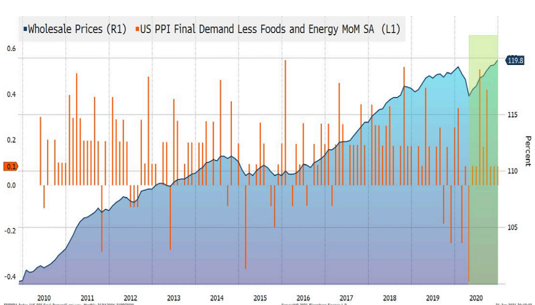

Source: Bloomberg

**Exhibit M: Core commodities spark recovery in core inflation; services prices likely a tailwind as spending habits shift in 2021**



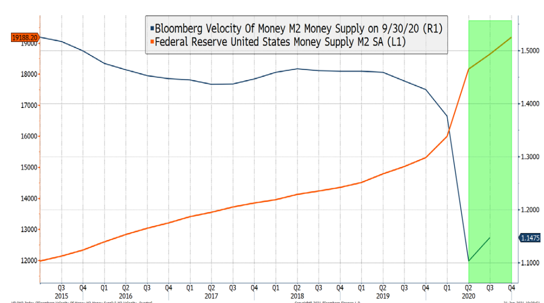

Source: Bloomberg

**Exhibit N: Wholesale prices show healthy recovery**




Source: Bloomberg

**Exhibit O: Rise in velocity of money coinciding with a continued increase in money supply likely to spur inflation**




Source: Bloomberg

# Fixed Income View: Underweight Fixed Income; Now Neutral to Credit vs. Government Bonds

The Fed's communication that it intends to maintain its current policy through 2023 is supporting a high degree of complacency among many investors, as the FOMC Members' Dot Plot Projections have also resulted in the anchoring of Fed Funds Futures to a target rate of approximately 0.0% through 2023 (Exhibit P). In our previous Investment Strategy Update (October 2020), we communicated the following view:

> *"…this anchoring of short-term rates is unlikely to keep long-term rates at current levels. Arguably, the Fed's current interest rate policy is likely to fuel higher economic growth and inflation, leading to an increasingly negative asymmetric risk/reward profile at the long-end of the yield curve."*

Over the past three months, the U.S. 10-year Treasury yield rose approximately 0.30% and touched a near-term high of 1.15%, as nominal yields are only beginning to reflect the upside potential of future growth and inflation. Nevertheless, Exhibit Q shows that the U.S. Real 10-year yield remains near record low levels (-0.99%), indicating that nominal bonds are still priced irrationally relative to the expectations currently reflected in breakeven inflation rates, as discussed on the previous page. Real yields at these levels continue to signal signs of complacency, as investors appear to ignore the recovery in growth and inflation, particularly given the likelihood of additional government stimulus.

**Exhibit P: FED's dot plot implies no change in rates through 2023[1]**

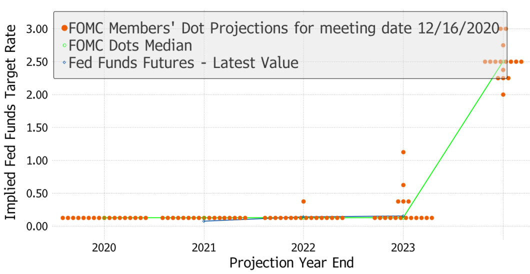



**Exhibit Q: U.S. Real 10-year treasury yield[1]**


There are signs in underlying derivatives markets that some investors are beginning to question the likelihood that the Fed maintains its policy through 2023. For example, there has been a substantial increase in the open interest of Eurodollar put options that imply a Fed Funds Rate of 0.50% or higher by December of 2022 (Exhibit R). While such interest is still at relatively low absolute levels, this recent increase in options demand is a sign that investors may be starting to recognize that there is a rising risk that the Fed pivots its policy stance sooner than what is currently being communicated. We have been keenly aware of interest rate risk, and we continue to promote underweight exposure to core fixed income in favor of more flexible/alternative mandates that exhibit less duration exposure. Given the dramatic narrowing of credit spreads over the past nine months (Exhibit S), we are also now changing our view to neutral in credit vs. government bonds.

**Exhibit R: Open interest in euro$ fut put options rising[1]**

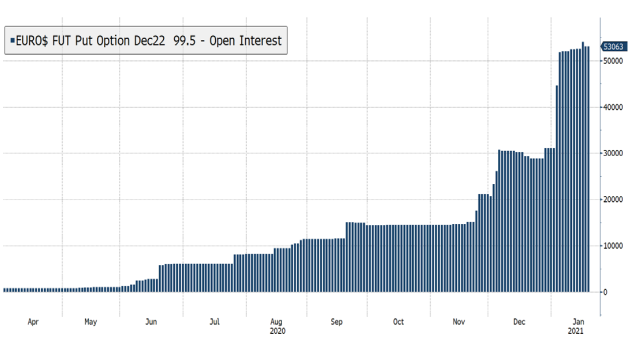
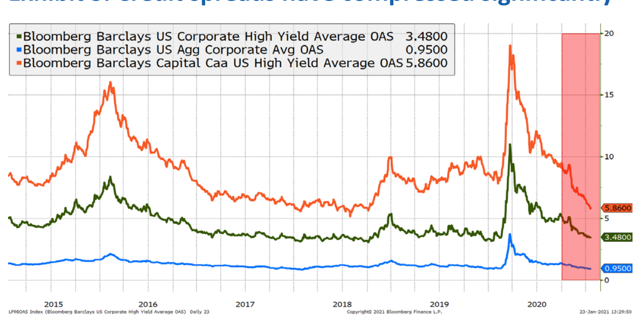



**Exhibit S: Credit spreads have compressed significantly[1]**




[1]Source: Bloomberg

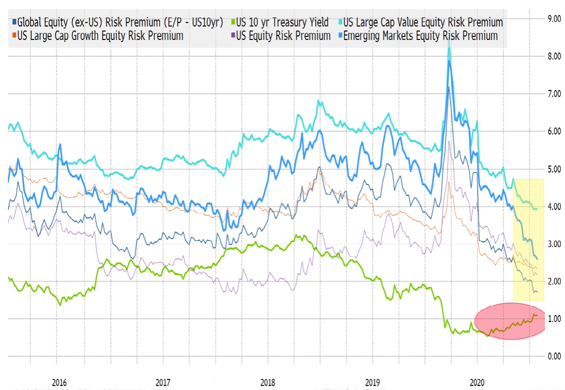
# Equity View: Continuing to Favor Emerging Markets; Underweight U.S. Growth

Global equities continued to stage a tremendous rally in the fourth quarter, benefiting from optimism regarding the distribution of a COVID-19 vaccine. Many investors maintain the view that equity valuations have become detached from the real economy. When gauging the equity risk premium by the difference between the earnings yield of global equities and the U.S. 10-year Treasury yield (Exhibit T), there is valuation compression since the depths of this crisis in March. It is difficult to argue that equity valuations are attractive, even relative to interest rates. Even U.S. Large Cap Value and Emerging Markets, which offer the highest risk premiums and are therefore the most attractively valued, are not necessarily cheap. Therefore, it is hard to expect significant future returns from equities without a material increase in earnings—an outcome that may very well come to fruition.

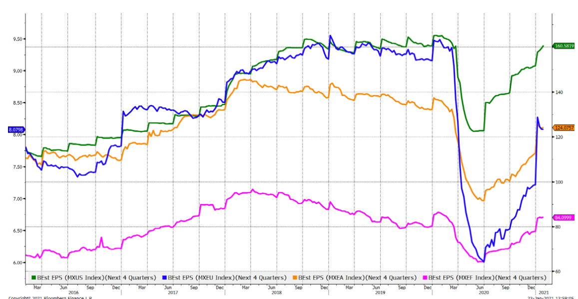
Exhibit U plots the forward earnings expectations (next four quarters) in the U.S. (green), Europe (blue), Non-U.S. Developed Markets (orange), and Emerging Markets (pink). Analysts are expecting a significant recovery in corporate earnings in 2021, with the U.S. and Emerging Markets nearly reaching pre-pandemic levels. While not shown here, the recovery in U.S. earnings is expected to be the highest in the most cyclically sensitive value-oriented parts of the market, such as Industrials, Materials, and Financials. If these earnings expectations prove to be accurate, then perhaps investors are not so exuberant, particularly given the low interest rate environment. Unfortunately, we expect a rise in longer-term nominal and real bond yields, and there has been some resistance in the more expensive segments of the market, such as growth equities. Exhibit V plots the trend in the decline in the U.S. Real 10-year yield next to the spread of Wilshire U.S. Large Cap Value vs. Growth Index levels. This trend, which indicates a clear relationship between the decline in real yields and the underperformance of value vs. growth equities, has consolidated since early September when real yields bottomed and value began to outperform growth. As the economy continues to recover, we expect a material reversion in this trend.

In summary, emerging markets and U.S. value equities offer more attractive valuations and are expected to be the primary beneficiaries of a material recovery in earnings in 2021. Furthermore, emerging markets and value equities are also likely to benefit from a pro-cyclical/post-recessionary environment, while U.S. growth equities are likely to face relative headwinds from high nominal and real yields in the future. Therefore, we maintain our overweight view in value equities and emerging markets, and are now also sourcing our overweight to emerging markets from U.S. equities.

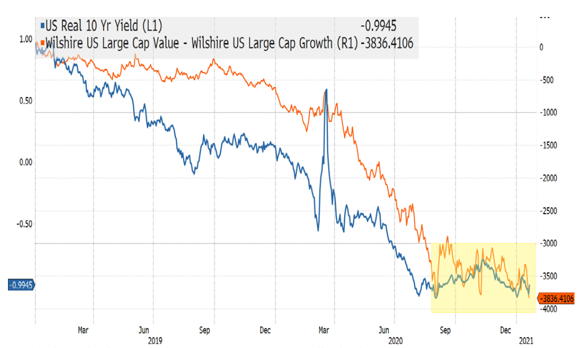
### Exhibit T: Global equity risk premiums compress[1]




### Exhibit U: Recovery in global earnings expectations[1]



### Exhibit V: Negative real yields have been supportive of growth stocks[1]




[1]Source: Bloomberg

# Sentiment, Technicals, and Risk Consumer

Consumer confidence has remained stubbornly low despite the significant recovery in personal consumption and asset valuations. While the COVID-19 pandemic has certainly weighed on sentiment, particularly during this recent surge in cases, history has shown that it takes a considerable amount of time to rebuild consumer confidence. CEO Confidence, on the other hand, has remained relatively elevated and has historically recovered much more quickly, as CEOs tend to be more in tune with the business climate and economic conditions/indicators. CEO Confidence had nearly fully recovered within two years following the depths of the global financial crisis, while Consumer Confidence took nearly eight years to recover, as shown in Exhibit W. Small Business Optimism also remained subdued for an extended period, and has been more directly impacted by the forced closures of food and beverage accommodations, which will likely recover quickly as these establishments reopen. Investors should not infer too much from the current depressed levels of sentiment amongst consumers and small business owners, as it may take longer for these measures to recover.

**Exhibit W: CEOs more confident than customers[1]**

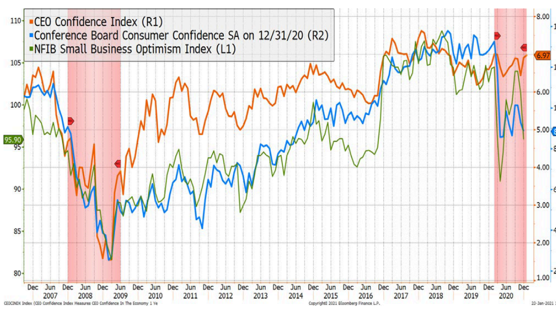


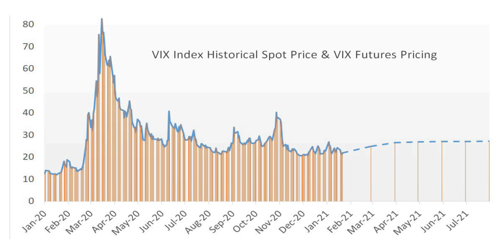

**Exhibit X: Steeper Yield curve (10yr-2yr spread)[1]**


From a technical perspective, there are number of positive indications of both future economic growth and the continued appetite for risk assets. Exhibit X shows the recent steepening of the U.S. yield curve, as measured by the spread between the U.S. 10-year and 2-year Treasury yields. This bullish steepening of the yield curve, characterized by a rise in longer-term bond yields, has been a historically good indicator of future economic growth, as it typically encourages lending and is a reflection of market expectations of growth and inflation. As economic conditions improve and the current health crisis continues to subside, investor sentiment will also continue to improve, thereby driving demand for equities. There is nearly $4.3T still parked in money market assets, well above the peak during the global financial crisis. This “dry powder” will likely serve as a future tailwind to risk assets as sentiment improves and cash continues to come off the sidelines.

There is no doubt that signs of “irrational exuberance” and speculation exist in today’s equity markets—look no further than the meteoric rally in many small-to-mid sized non-profitable tech companies. Make no mistake, these are not low-risk times. Exhibit Z plots the spot price of the CBOE Volatility Index (VIX) since January of 2020 along with the prices of VIX futures contracts. Today, VIX implies near-term volatility of approximately 21% (annualized), which is above average levels and is expected to remain elevated through July of 2021. On a positive note, this indicates that investors are not broadly complacent about equity risk, unlike January of 2020 when VIX implied near-term volatility of only 12% at one point. At the same time, it also implies that investors should be prepared for more elevated volatility ahead. History has shown that markets do not rise in a straight line, and therefore, it is important to maintain effective diversification to manage portfolio volatility through what is likely to be a bumpy road ahead.

**Exhibit Y: Money market assets remain elevated[1]**


**Exhibit Z: Vix futures imply elevated equity volatility ahead[1]**




[1]Source: Bloomberg

# Important Information



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# More information

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