Greece, China, and Interest Rates: Three Heads of the Volatility Hydra

There are three major clouds on the financial horizon: Greece, China, and U.S. monetary policy. Of the three, the ramifications of higher U.S. interest rates and further weakness in the Chinese financial system are potentially more detrimental to investment portfolios than the exit of Greece from the European Union. We believe that the best way to address these risks is in the context of a carefully constructed saving and investing plan developed in conjunction with a financial professional.

This chart details the difference (Over/Under) between current target weightings and the long-term benchmark strategic allocations as applicable to American Century Investments’ asset allocation strategies.

### Asset Allocation Outlook

<table>
<thead>
<tr>
<th>Segment</th>
<th>Rationale</th>
<th>Degree of Magnitude</th>
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<tbody>
<tr>
<td><strong>Equity vs. Fixed Income</strong></td>
<td>We remain overweight stocks relative to bonds and cash, but by a smaller margin than in the past as bond yields are increasingly attractive.</td>
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<td><strong>Region</strong></td>
<td>Our models continue to favor Europe and Japan over US markets at the margin in terms of positions both hedged and unhedged for currency effects.</td>
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<td><strong>Style</strong></td>
<td>We are moving back to neutral after a long-running overweight to growth, during a period in which growth outperformed value by a wide margin.</td>
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<td><strong>Market Cap</strong></td>
<td>Our latest analysis shows no preference for stocks of a particular market capitalization, so we are neutral here.</td>
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<td><strong>U.S. vs. Non-U.S. Bonds</strong></td>
<td>Our Fixed-Income Macro Strategy Team maintains an overweight to non-dollar bonds, favoring sovereign bonds and European sub-financials.</td>
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<td><strong>Credit Quality</strong></td>
<td>We continue to underweight government bonds in favor of US mortgage-backed securities and high-yield bonds, as well as investment-grade European bonds.</td>
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<td><strong>Inflation hedges</strong></td>
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<tr>
<td>Inflation-Indexed Bonds</td>
<td>Breakeven improved modestly, meaning inflation-adjusted bonds are comparatively more attractive.</td>
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<tr>
<td>Real Estate</td>
<td>We maintain our overweight to REITs versus stocks, bonds, and cash, largely because of REITs’ attractive relative yields.</td>
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<tr>
<td>Currencies</td>
<td>We are underweight the euro and Japanese yen, with overweights in the British pound and South Korean Won, among others.</td>
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Rich Weiss
Senior Vice President and Senior Portfolio Manager
Asset Allocation Strategies
Key Takeaways

Financial markets face significant potential volatility in the form of questions about Greece's ability to remain in the European common currency, economic and financial market difficulties in China, and the likely reversal of years of extraordinarily easy monetary policy by the Federal Reserve (Fed). While we face uncertainty on many fronts, we encourage investors to focus on what they do know—their saving and investing goals, and the balanced financial plan necessary to achieve those financial targets.

• You can view a more in-depth discussion about opportunities our investment teams see at present in global financial markets in the Fixed Income Macro Outlook and Global Equity Outlook on our website.

Fragility, Robustness, and Efficiency

Author Nassim Nicholas Taleb wrote of financial markets: “Fragility is the quality of things that are vulnerable to volatility.” He also famously said that you should never take advice from anyone wearing a tie. So you should probably read the following with the appropriate degree of skepticism.

Fragility and robustness are terms that we should define briefly before using here. Having the characteristic of robustness means that an entity or system is well adapted to withstand internal or external shocks. An organism or system that can be undone by a single shock or event could be said to be fragile. Often, though, the reality is far more complex—a system can be optimized for a specific kind of challenge, but remain vulnerable to unanticipated shocks. In addition, there are often tradeoffs involved in achieving any degree of robustness.

It should be obvious the application of these concepts to investing. If fragility is the quality of things that are vulnerable to volatility, then our goal is to build robust portfolios capable of withstanding unanticipated shocks, expressed as market volatility. But we must be mindful of the tradeoffs involved—it is possible to reduce risk, but often at the expense of return potential. Rather, a robust portfolio is an efficient portfolio—one that maximizes return for the risk taken, or minimizes risk for a given level of expected return. It is our belief that portfolios diversified by asset class, geographic region, currency, and other factor are best able to meet the definition of efficiency and robustness over the
This is important because European growth has actually been better than expected, so removing uncertainty around Greece and the common currency should help economic conditions. Indeed, we are seeing a great many statistics on consumers and businesses show clear improvement across Europe. In addition, there is massive ongoing stimulus, so we believe near term economic prospects remain decent for the eurozone.

Finally, we are encouraged to see the ECB playing a much more active, stronger role in regulatory terms. Generally speaking, banks across the eurozone are much stronger than in the past, while many smaller, weaker financial players have simply gone away. Evidence for the efficacy of these measures can be seen in how muted the market response to the latest round of debt negotiations has been—the euro remained in the same tight trading range it has occupied for some time, even as a potential Greek exit loomed.

China in Focus

We believe the biggest underlying risk to markets at present is poor growth in China, where the central bank is trying step after step to support the economy and having little success. To put the problem in perspective, China accounts for more 16% of global gross domestic product (GDP), and is more than 50 times the size of the Greek economy, for example. When China sneezes, global commodity markets catch cold—it is the slump in China's economy that is wreaking havoc with commodity prices. What's more, now the Chinese stock market is falling sharply. In response, the government has taken a series of steps to support the market, ranging from regulatory changes to direct investment, but all to little avail.

Instead, the economy continues to struggle with significant challenges with respect to overinvestment and a massive buildup in inventories. China's GDP growth has so far managed to stay around the 7% level—thought to be an important threshold for China's ongoing industrialization and development—but
that we see an increasing likelihood that the Fed will raise short-term interest rates before 2015 is out, reflecting the evident improvement in employment, wages, consumer confidence, and financial markets in recent years. Higher rates also connote higher volatility—members of the Federal Reserve Board are on record as saying that they welcome a return of volatility to financial markets and do not target a given level of asset prices. This is a clear signal that investors should not expect the Fed to ride to their rescue if markets sell off while underlying economic conditions continue to improve.

On the other hand, the dollar is gaining momentum again, commodity prices are held down by trouble in China, inflation is essentially flat, and enough uncertainty remains in the global economic and financial system that longer-term U.S. bond yields are unlikely to rise significantly. Will these challenges be sufficient to stay the Federal Reserve’s hand on rates? We think not, but it should be clear that the path ahead is not one of uniformly higher rates and smooth economic sailing. Rather, uncertainty and volatility are likely to remain concerns going forward, even if the economy continues to strengthen. In that sort of environment, we argue for a more robust portfolio, an efficient portfolio built on the proven principles of diversification, and disciplined investing over time.
Commodities—Raw materials or primary agricultural products that can be bought or sold on an exchange or market. Examples include grains such as corn, foods such as coffee, and metals such as copper.

Gross domestic product (GDP)—A measure of the total economic output in goods and services for an economy.

Real estate investment trusts (REITs)—Securities that trade like stocks and invest in real estate through properties or mortgages.

Mortgage-backed securities—A form of securitized debt (defined below) that represents ownership in pools of mortgage loans and their payments.

High-yield bonds—Fixed income securities with lower credit quality and lower credit ratings. High-yield securities are those rated below BBB- by Standard & Poor’s.

International investing involves special risks, such as political instability and currency fluctuations. Investing in emerging markets may accentuate these risks.

Generally, as interest rates rise, bond values will decline. The opposite is true when interest rates decline.

Understanding inherent risks such as interest rate fluctuation, credit risk and economic conditions are important when considering an investment in real estate.

High-yield bonds invest in lower-rated securities, which are subject to greater credit risk, default risk and liquidity risk.

Diversification does not assure a profit nor does it protect against loss of principal.

The opinions expressed are those of Rich Weiss and are no guarantee of the future performance of any American Century Investments fund. This information is for educational purposes only and is not intended as investment advice.

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