IndexIQ's 2018 ETF Top Trends and Insights

International investments, event-driven opportunities and continued growth in ETF industry assets are all likely to make waves in 2018. Here are IndexIQ's top ETF-focused trends and insights:

1

Tax reform and other legislative priorities may provide fuel for U.S. equity performance

Tax reform can be a large positive factor and could propel both large cap and small cap stocks higher. A reduction in taxes paid on repatriated profits could entice offshore cash to return to the US. The reduction of the domestic tax rate would also benefit companies that generate most of their revenues domestically. While most equities would benefit, those that are well managed may be in the best position. Using a disciplined approach to identify these companies can potentially further improve returns.

2

The strong pace of M&A will continue, providing a way for investors to dampen portfolio volatility

Despite an uncertain political environment, the merger and acquisition market has remained resilient. With continued low interest rates, the possibility of a deal on foreign tax repatriation, and large cash reserves on corporate balance sheets, companies continue to look to the M&A market for deals. Over the last year we've seen more deals that can be thought of as transformational (e.g. Amazon/Whole Foods), where the combined entity is seeking to dramatically alter the competitive balance within an industry. These types of deals are likely to increase in frequency as deregulation changes the playing field and technology becomes ever more disruptive. Regardless of the type of deal, merger arbitrage investing is likely going to be an important tool in helping to dampen portfolio volatility.

3

International equities may deliver strong returns, but currencies will be as difficult as ever to predict

With an expected growth rate of near 2%, the U.S. can continue to perform well but may lag other regions with higher forecasted growth. Factoring in the outperformance gap of the U.S. over the last 8 years with lower valuations, higher dividend yields and more accommodative monetary policies for non-U.S. equities might lead to better return prospects for equity markets outside of the U.S. As we saw in 2017, currencies continue to be difficult to predict and we expect the world will remain as unpredictable in 2018. The consensus expectation was for a strong dollar trend to continue in 2017; however, that was not the case. Investors seeking potentially higher returns outside of the U.S. should consider the possible currency impact for their portfolios and look to hedge some of this currency risk.

4

Fixed income investing may become more difficult as it faces dual headwinds

The spread of U.S. corporate high yield bonds over 10 year U.S. Treasuries is hovering near 3%. While not at a record low level, the spread is below its long term average and is at a level that has historically preceded sharp moves higher. Previously, the spread has been near 3% before the TMT crash of the early 2000s, from 2005-2007 just before the Credit Crisis of 2008, and in late 2014 prior to the sharp drop in oil prices in 2015.[1] As seen historically, the spread can continue to remain low for several years (although not likely to go much lower from these levels) but is exposed to a potentially sharp rise should there be an unforeseen shock to the economy. Further, with the FOMC on a path to continue raising short term interest rates at a measured rate, the monetary backdrop remains accommodative. Adding pro-growth fiscal policies including lower taxes and decreased regulations could cause longer term rates to also rise. Investors may want to consider owning lower volatility bonds for credit risk mitigation as well as more dynamic fixed income strategies to navigate the interest rate environment.

5

The ETF industry will continue to see strong flows as well as further strategy innovation

According to Bloomberg, year-to-date inflows in U.S. listed ETFs are over $339B, which represents almost 11% of assets. Passive ETFs are still dominating active ETFs, however active ETFs are growing at a faster rate with inflows over 38% of assets, albeit from a much smaller base.[1] The changing regulatory landscape also continues to provide a supportive backdrop for ETF asset growth. Specifically, the impending rollout of the European Union's (EU) updated Markets in Financial Instruments Directive II (MiFID II) and the US Department of Labor's (DOL) Fiduciary Rule (despite the delay of many provisions announced in summer 2017) will drive investments towards the transparent and lower fee platforms that the ETF structure provides. However, regulatory tailwinds and increased investor education are not the only drivers of this continued growth. Importantly, we continue to see innovation in the types of active ETFs that are coming to market. This is a trend we expect to continue.

1. Bloomberg, as of 9/30/17.

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Credit Crisis of 2008 began with a crisis in the subprime mortgage market in the U.S., and developed into a full-blown international banking crisis with the collapse of the investment bank Lehman Brothers on September 15, 2008. Excessive risk-taking by banks such as Lehman Brothers helped to magnify the financial impact globally. Massive bail-outs of financial institutions and other palliative monetary and fiscal policies were employed to prevent a possible collapse of the world financial system. The crisis was nonetheless followed by a global economic downturn, the Great Recession.

Credit spread is the spread between Treasury securities and non-Treasury securities that are identical in all respects except for quality rating.

Pass-through rate is the net interest the issuer of a mortgage-backed security pays investors after all other costs and fees are settled. The amount forwarded to investors passes from the payments on the underlying mortgages, through the pay agent, and ultimately to the investor.

Technology, media and telecom (TMT) crash was a historic economic bubble and period of excessive speculation that occurred roughly from 1997 to 2001, a period of extreme growth in the usage and adaptation of the Internet by businesses and consumers. During this period, many Internet-based companies, commonly referred to as dot-coms, were founded, many of which failed. During 2000–2002, the bubble collapsed. Some companies failed completely and shut down.

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