

Our Key Themes for 2017

- 1) In spite of significant changes across the geopolitical landscape, we expect many of 2016's themes to continue into 2017.
- 2) The global economy will gain some steam, dragged upward by stronger growth and business confidence in the U.S.
- 3) Global equities will continue to move higher on improving earnings, but upside is limited by valuation while the post-election rally siphons off gains from next year.
- 4) The increase in yields has made high quality bonds "less terrible" going into 2017. TIPS and municipals offer decent relative value.
- 5) Improving growth should bolster credit quality within corporate bond sectors (high yield, bank loans, etc.), but valuation isn't as compelling as it was in 2016.
- 6) The biggest risks to our base case in 2017 include Trump's style/inexperience, a disorderly Brexit, an inflation surprise, and the Chinese debt bubble.
- 7) Less confidence in the outlook: both the upside and downside risks around the base case are growing. Even in a somewhat better growth environment, investors will be tested by market shocks.

2016 Scorecard		Results (return through 12/7/16)
Developed market growth improves (a bit)	✗	Growth in the U.S., Eurozone, and Japan were all slightly lower in the 4 quarters ending Q3:16 than the previous 4 quarters. Only in the U.K. was real GDP growth higher.
Central banks: words louder than actions	✗	Policy announcements from key central banks continued to have an outsized effect on the capital markets
Global equities gain ground, but returns sub-par	✓	MSCI ACWI net in local currency was up 8.1% YTD
Rates dull, but credit lively	—	Both interest rates (later in the year) and credit spreads (earlier in the year) endured significant directional swings
Emerging markets rebound	✓	Emerging market stocks and bonds both had solid-to-strong returns
Risk assets perform better later in the year	—	Most equity indexes performed better in 2 nd half. High yield bonds and commodities did not.
Value outperforms growth	✓	Value trounced growth across the market cap spectrum (Russell 1000 and Russell 2000)
Small/mid-cap beats large-cap	✓	Small and mid-caps handily beat large caps in the U.S.
Credit outperforms quality	✓	Investment grade, high yield, and bank loans generally outperformed sovereigns
Commodities stabilize later in the year	✓	S&P GSCI Index fell and rebounded dramatically in 1 st half. Returns were flattish in 2 nd half.
Dispersion increases with mega-caps underperforming	✓	The Equal-Weight S&P 500 [®] outperformed the cap-weighted S&P 500 [®] by over 4%
Hillary Clinton wins election	✗	Oops. Didn't see that coming.

Similar Trends, More Dispersion

2016 was a year of significant changes around the world, from the Brexit referendum to the midyear turn in interest rates, to the election of Donald Trump in the U.S. At first blush, you'd think this would call for major changes in our economic and capital market outlook. But ironically, most of the trends we've been anticipating have either continued or been confirmed by events in 2016. (See scorecard above.) **Our broadest views for some time now have been that the global economy was slowly gaining traction, that this would lead to modestly higher corporate earnings and stock prices, and put some upward pressure on interest rates, thus detracting from bond returns.** Recent market developments haven't changed these broad themes, but they have reduced the confidence level of our economic and market views. (More on this later.)

The Global Economy Gains Steam

Most developed economies languished with positive but sub-par growth in 2016. We believe 2017 will provide a bit more upside. In the U.S., the Trump administration's trifecta of tax

cuts, infrastructure spending, and deregulation should bolster real GDP from near 2.0% to closer to 3.0%. The combination of tax cuts on personal income and improved confidence should provide a modest upward push to consumption, while an infrastructure program could help reverse the longer trend of weak government spending. Lower corporate tax rates and a reduction in regulatory red tape may also provide a long-awaited return to capital investment. Mitigating factors to stronger U.S. growth include somewhat higher interest rates and the deleterious effects of a stronger U.S. dollar on exports. **On balance, U.S. growth should improve, but not at a break-neck pace.**

Elsewhere, growth across Europe should improve as nascent signs indicate the continent is finally putting its deflation scare in the rear-view mirror. At the margin, the appetite for austerity continues to wane, so we expect a mild uptick in fiscal flexibility. Hurdles certainly remain, but the worst recessionary days for Spain, Portugal, and Greece appear to be behind them. On the downside, **we expect a messy divorce**

for the UK and the EU, but it shouldn't derail the broader, more positive momentum within Europe. While the UK economy has held up well since the referendum, it is likely to feel the brunt of the pain in the Brexit negotiations and may be the downside outlier in terms of growth.

In Asia, we see little change in the trajectory for Japan. Policymakers will continue to toy with the levers of Abenomics, but won't be able to overcome the country's long-term demographic challenges. China remains the wild card. The feared slowdown of 2014–2015 has been arrested (along with a lot of corrupt politicians and businessmen!) but the debt bubble that supports current growth is unsustainable in the long run. There is no way to know if 2017 will be the year it bursts. We expect the Chinese can continue to paper over NPLs in the banking system while slowly chipping away at industrial overcapacity. This, however, is whistling past the graveyard, and the greatest risk scenario to our otherwise modestly positive global outlook.

The stabilization of growth in China has done the same for many EM countries. In addition, commodity prices have regained their footing and are even starting to improve. This should benefit major EMs from Russia to Brazil to Mexico. Supply side headwinds remain, along with country-specific pockets of weakness, but in aggregate, global growth should continue to improve.

Stocks: Overoptimistic Extrapolation

Our forecast for improving global growth should allow the equity bull market that originated in 2009 to continue into 2017. U.S. earnings growth will turn positive after the earnings depression in the energy sector passes. However, bottom-up consensus of nearly 12% earnings growth next year for the S&P 500®, as usual, looks way too optimistic. Trump's likely pro-growth policies have caused us to upgrade our top-down outlook from 3–5% earnings growth (which was already way too high for 2016) to 5–7% for next year. An improvement to be sure, but still far short of consensus.

The ultimate question for equity investors will be whether this growth will be on top of current elevated P/E ratios or whether earnings will simply "grow into" lower valuations. The former (strong earnings X stable-to-rising P/Es) could result in very strong U.S. equity returns. Alas, we're bigger believers in the latter: that elevated P/Es already discount much of the future earnings improvement. While the optimism for stocks may grow, it will likely be bounded by rising inflation and tighter Fed policy, two factors that are unlikely to support higher P/Es. Alongside this is the possibility that the post-election rally has already "stolen" equity returns from 2017. **Bullish investors may be extrapolating gains into the future that have already occurred.** Lastly, the nearly universal prediction of a stronger dollar could also hamper earnings through the export channel. We remain optimistic about solid U.S. equity gains next year, but perhaps not as ebullient as the consensus.

In both non-U.S. developed and emerging markets, we believe growth will improve (as noted above) but perhaps not with the same vigor as the U.S. This should also result in stronger earnings, aided by relatively weaker currencies. Perhaps the biggest difference, however, is in valuation. While far from

compelling, Eurozone and UK stocks still reflect Brexit fears and general growth malaise, and investors still can't get excited about Japan. EM stocks, and their valuations, rallied hard in '16, but remain at levels that are somewhat more attractive. Thus, overseas it is more likely that modestly higher earnings growth will filter into higher stock prices without the heavy blanket of valuation weighing on them. Like U.S. stocks, we believe non-U.S. equities will generate solid but unspectacular returns in 2017.

Bonds: Less Terrible, Less Fabulous

Fears of Trumpflation (growth plus inflation) have sent yields skyrocketing and bond investors into a panic. These basic dynamics seem appropriate as nominal rates rise on the back of both yield components: higher real rates (stronger growth) and higher inflation premiums. But like stocks, the same caveat applies: perhaps much of the Trumpflation has already been priced into the bond market in 2016. Will rising rates pressure high quality/sovereign bond returns in 2017? Probably, but it may not be the disaster that some investors fear. Around the globe, rates are already up dramatically, which is also resulting in somewhat higher starting yields (after plunging to record lows in mid-'16). **Do we still think high quality bonds look relatively unappealing? Yes, but returns should be "less terrible" moving forward.** Within high quality bonds, our preference remains for inflation-protected issues which can mitigate at least one source of pain (higher inflation). For U.S. taxable investors, counterintuitively, proposed lower marginal tax rates have made municipal bonds MORE attractive, not less. Given the post-election underperformance of municipals, the yield differential relative to U.S. Treasuries is now larger, even after factoring in the proposed reduction in the highest tax bracket (from 39.6% to 33.0%).

On the corporate side, our extreme optimism has waned. BBB-rated, high yield, convertibles, and bank loans offered compelling value in our view last year. Many of the same factors persist today, including muted maturity/rollover risk, a low likelihood of recession, and the carry advantage vs. higher quality. However, across the corporate spectrum, tighter credit spreads and higher prices already reflect this rosy scenario. At tighter spreads, corporate issues will incur greater rate sensitivity (less spread tightening as rates rise). So, on a total return basis, we still find the corporate sectors of the bond market more attractive than sovereign, but the gap between the two has closed somewhat. Our "great & hate" view from last year (corporate sectors vs. sovereign/agency) has been downgraded to "not as great & less to hate."

Risk and Uncertainty

A recap of our views reveals only modifications, not wholesale changes, to our investment outlook from 2016. So is 2017 just a "rinse & repeat" of last year in terms of portfolio construction? We don't think so. These views represent our base case scenarios, but the upside and downside dispersion around the base case has widened significantly for several reasons:

1) The Republican clean sweep in the U.S. Congress has allowed the market to price an extreme level of optimism into a Trump presidency. **Markets have largely failed to discount the very real possibility of significant policy or personnel blunders** related to China (tariffs and trade policy), Russia, or

fallout from corporations targeted by the soon-to-be President.

2) A disorderly and destructive Brexit negotiation could drag down both the UK and EU beyond what current consensus believes is possible. It may be overly optimistic to presume the negotiations will proceed rationally and that "they'll work it out."

3) Inflation risks are now significantly higher globally than at any time post-GFC. This in turn raises the risk of a more aggressive Fed fearful of falling behind the inflation curve and/or an uncontrolled ascent of the U.S. dollar. Both could impair growth in the world's largest economy. More broadly, combined with higher growth and fleeing bond investors, interest rates could become untethered in a highly leveraged world – more than offsetting the growth impetus from other factors.

4) With each passing year, debt continues to accumulate in China in nearly every corner of the economy while policymakers fail to institute significant reforms. By controlling both the biggest lenders (banks) and the biggest borrowers (state-owned enterprises), the Chinese can extend and pretend for some time. They cannot, however, repeal the math of credit boom/bust cycles. With each passing day, this risk becomes larger, even if we can't predict the triggering event.

Short on Confidence

In short, **we have (and believe that investors should have) less confidence in almost every economic and market scenario going into 2017.** In classic portfolio optimization terms, our return expectations have changed only modestly.

However, the dispersion around those base case/expected returns has widened dramatically – that is, higher standard deviations (or whatever risk metric you optimize against). In mathematical terms, other things being equal, higher volatilities will push allocations towards lower correlation assets. In layman's terms, **diversification will matter more.** This of course would be muddied by rising correlations in a true flight-to-quality scenario.

Finally, increased volatility often goes hand-in-hand with greater dispersion among assets. The two tend to be highly correlated. In a world of somewhat elevated equity and sovereign bond valuations, the return on beta (broad market exposure) may be less compelling than the return on alpha (idiosyncratic selection among stocks, bonds and asset classes). This may also be a tailwind to active management.

Our somewhat positive base case outlook for 2017 masks the increased potential for major economic and market shocks.

In spite of an improving global economy, we expect investors' patience will be tested in the coming year.

David F. Lafferty, CFA®

Senior Vice President – Chief Market Strategist

David T. Reilly, CFA®

Vice President – Investment Strategist

Investment Strategies Group (ISG)

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