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TIAA
GLOBAL ASSET MANAGEMENT

2017 Economic and Investment Outlook

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Executive summary

- We expect global economic growth to accelerate modestly with stronger consumer spending, rising inflation, and tighter labor markets.
- The rise of political populism may bring a new era in which governments put greater emphasis on fiscal spending to stimulate growth.
- We have raised our forecast for 2017 U.S. GDP growth to 2.6%, a faster pace than in Europe and Japan. In emerging markets, we expect further stimulus from China as it gradually transitions to a more consumer-led economy.
- Improving economic data and a rollout of more growth- and business-friendly public policies should help diversified investors in 2017.
- Expectations for the incoming Trump administration and Republican Congress have already lifted equity markets, interest rates, and the U.S. dollar.
- But while attention will be focused on Washington, D.C., European politics and policy may ultimately have a larger role to play in shaping global market returns.

Asset class preferences

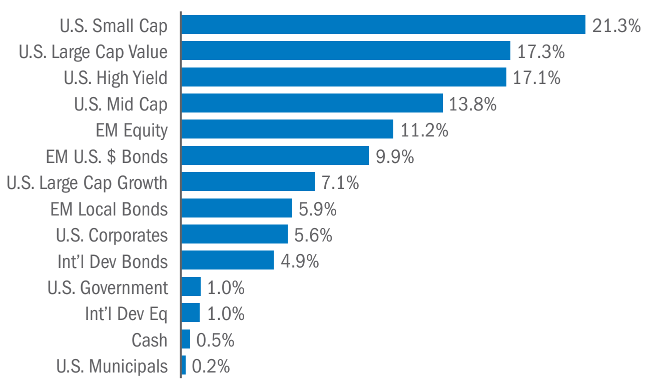
■ **Equities**	■ **Fixed Income**
■ United States	■ Government Debt
■ Large Cap	■ United States
■ Mid Cap	■ Non-U.S. Developed Markets
■ Small Cap	■ Emerging Markets
■ Growth	■ TIPS
■ Value	■ Munis
■ Non-U.S. Developed Markets	■ U.S. Corporate—Investment Grade
■ Emerging Markets	■ U.S. Corporate—High Yield

■ = Most preferred; ■ = Neutral; ■ = Least preferred. TIPS = Treasury Inflation-Protected Securities. Allocations based on an unhedged, U.S.-dollar-denominated portfolio. Please note the forecasts above concern asset classes only and do not reflect the experience of any product or service offered by TIAA. These forecasts are for informational purposes only and should not be considered investment advice or constitute a recommendation to purchase or sell securities. Market forecasts are subject to uncertainty and may change based on varying market conditions, as well as political and economic developments. Past performance is not an indicator of future results.

BUILT TO PERFORM.
CREATED TO SERVE.

2016 Year In Review

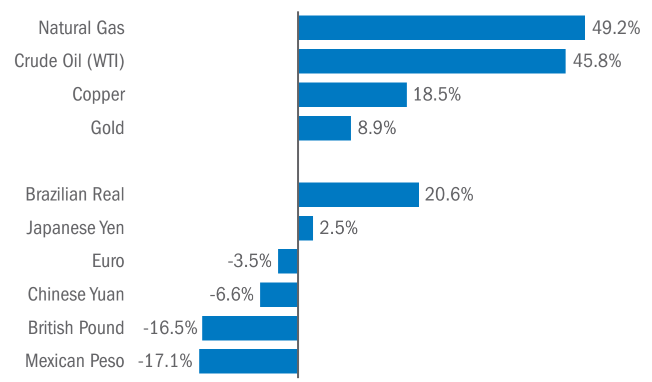
Most asset classes delivered positive returns in 2016



Source: Bloomberg.

- U.S. risk assets (stocks and high-yield bonds) won the year on growth optimism and commodity rebound.
- Fixed-income total returns were generally poor amid low interest rates in the first half of the year and a spike in yields in the second.
- International equities underperformed yet again on U.S. dollar strength and financial risk.

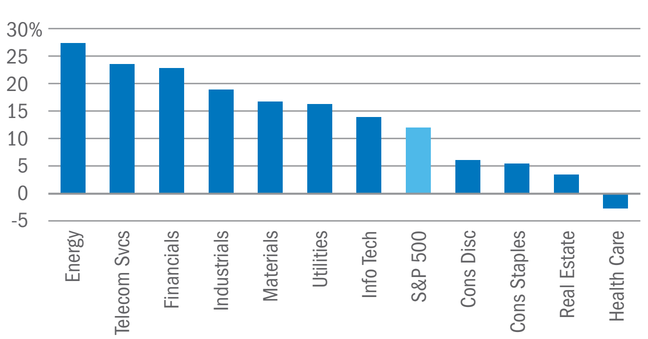
Commodity prices surged despite strong U.S. dollar



Source: Bloomberg.

- Oil prices finished the year above $50/bbl after bottoming near $25.
- U.S. dollar broadly stronger on interest rate outlook.

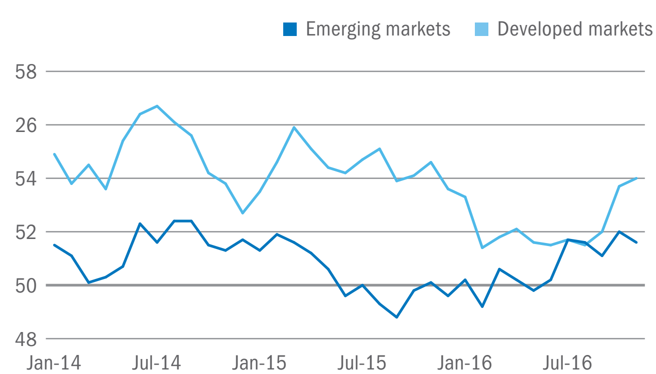
Post-election market reaction swung sector returns



Source: Bloomberg.

- Energy led all sectors with 40%+ rally in oil.
- Financials surged with interest rates after the U.S. election
- Higher-dividend sectors struggled as investors eschewed bonds.

Global economic activity picked up in second half



Source: Bloomberg.

- Emerging market economic activity rebounded broadly in 2016.
- U.S. growth accelerated during year as Europe also shows promising signs.

The populist economy: A shift to stimulus

If establishment politics were an asset class, 2016 would be the deepest bear market in decades, perhaps ever. This is because populism has taken to the main stage in capitals the world over. What arguably started in peripheral Europe a few years after the 2007–2009 financial crisis has grown into a global phenomenon, with new parties and political realities. It's not just that opposition parties now occupy legislative seats in many notable countries. The populist movement has gone much further with the U.K.'s vote to leave the European Union and the U.S. election of Donald Trump, an outspoken anti-establishment candidate, as president.

> Amid rising global populism, the pendulum is swinging toward more fiscal and infrastructure spending to stimulate economic growth.

We believe these stunning developments usher in a new era—one that will focus much more on those who haven't participated in the recovery to date. Although much of this movement is viewed as a pushback against globalization and integration, we believe it's a reaction against sluggish economic growth and the continued lack of an effective government response to the financial crisis. As such, we think governments will begin to shift away from corrective regulation and toward stimulus. This pendulum swing will be far-reaching because it should translate into more fiscal spending, a revival of infrastructure investment, and increased domestic manufacturing. It should also lead to higher wages and inflation, and therefore, to more traditional monetary policy responses as well. But this movement is also a recognition that monetary authorities were ill-equipped to manage the last crisis alone. This suggests the shift toward fiscal rather than monetary responses will occur globally. With this view as a backdrop, Figure 1 shows our growth expectations for several important regions around the world.

Figure 1. GDP growth forecasts (%)*

	Real GDP growth			Forecasted real GDP growth				
	2016	2017	2018	4Q16	1Q17	2Q17	3Q17	4Q17
U.S.	1.6	2.6	3.4	2.3	2.8	2.7	2.4	2.7
China*	6.7	6.6	6.4	6.6	6.5	6.4	6.5	6.8
Eurozone*	1.6	1.7	2.1	1.3	1.4	1.5	1.7	2.1
Japan	1.0	1.1	1.3	0.9	1.0	1.2	0.8	1.4

* Quarterly GDP for China and the Eurozone are reported as year-over-year growth rates, while quarterly GDP for the U.S. and Japan are reported at seasonally adjusted annual rates (SAAR).

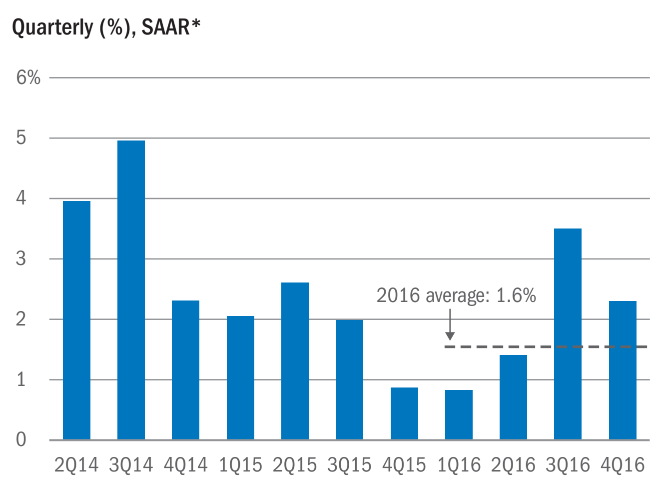
Sources: Haver Analytics, TIAA.

United States

The economy has been operating for over seven years at an average growth rate between 1.75% and 2.25%. Some years, such as 2016, have been slower than average, and some have been marginally better, but the economy has remained remarkably stable in a global environment of policy uncertainty, economic and political volatility, and near-death experiences for the business cycle. We've come to expect continued modest growth; indeed, that was the forecast until recently.

Since mid-2014, a dramatic fall in oil prices devastated capital investment across the economy. At the same time, a strong rise in the dollar deflated corporate profits. Combined, these two forces were enough to slow overall growth. But the corporate sector experienced one more headwind: overproduction. Expecting rising personal incomes, perhaps from lower energy bills, companies produced more than consumers were willing to buy through much of 2014. This glut in inventories ultimately pulled growth forward, and since then, a fierce inventory correction has drained growth. As a consequence, this year GDP will come in close to 1.6% (see Figure 2).

Figure 2. Real U.S. GDP growth



* Seasonally adjusted annual rate. Note: 4Q16 is an estimate.

Sources: Haver Analytics, TIAA.

Fortunately, the rest of the economy has operated at about the same pace since oil prices began falling. Companies continue to hire, nominal wages and incomes are slowly rising, and consumption is holding steady. As 2016 draws to a close, global growth is picking up, consumers are spending more, inflation is on the rise, and labor markets are getting tighter. At the same time, depleted inventories are allowing for increased production again. Thus, growth of roughly 1% through the first half of 2016 has given way to a pace closer to 2.5% in the second half. This most recent acceleration is little more than a return to the average trend for this recovery, but it's also a reminder that conditions remain stable for the economy.

Full employment is one of the Federal Reserve's primary goals. However, unlike in most recoveries, this time labor markets were slow to heal. Even today we see elevated underemployment, low participation rates, and meager wage growth. To date, the U.S. economy has created over 13.5 million jobs since the trough of the recession (after destroying 8 million during it). But a disproportionate number of people still require multiple part-time jobs as real wages remain stagnant. Nor has the return to job growth been uniform across sectors. Construction employment has suffered due to a sharp reduction in home and business investment. Retail employment has lagged because of higher savings rates. Manufacturing jobs—which appeared to reaccelerate shortly after the recession—relapsed into decline compared to the overall economy, a pattern that's been repeated since the 1970s.

Some sectors have seen good job growth and sizable wage gains. Examples include Silicon Valley and technology in general, health care, and select areas within energy and energy-related manufacturing. Thus, people with certain skill sets, and those willing to relocate, have fared better since the recession. But this is a small percentage of the overall labor pool, leaving large segments either out of work, forcibly retired, or in part-time positions.

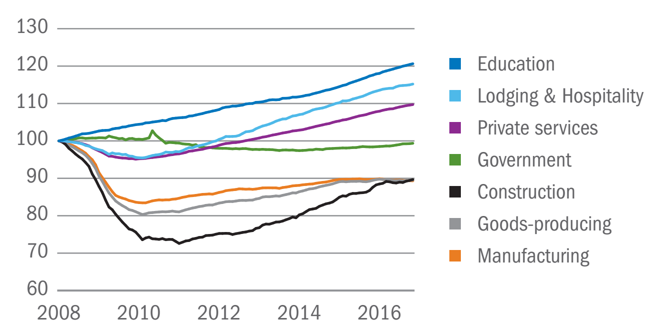
Figure 3 shows that, despite a full recovery in total private jobs, many important, well-paying categories haven't actually recovered from the recession. For example, all goods-producing job types still employ fewer people today than in December 2007, representing about 20% of all private-sector jobs. This group includes manufacturing, energy-related production, and construction. On the service side of the economy, there's been a full recovery, but most of the jobs created are in lower-paying sectors such as retail and restaurants. Higher-paying segments such as financial services have still not recovered, nor have government jobs. Thus, while there has been steady job growth since the depths of the recession, underemployment remains in about 40% of the economy, and sectors that have recovered the most are predominantly lower-paying.

In spite of this long slog, job growth has returned the economy to nearly full employment, simply defined as the equilibrium between demand and supply of labor. In 2017, job opportunities will begin to outstrip available workers in some categories, which will put upward pressure on wages. Experience suggests this will unleash pent-up demand and start a chain reaction of higher incomes, spending, and growth. Full employment is also the typical juncture in the business cycle at which the Fed begins to raise rates in a more sequential pattern to help dampen any inflationary impact.

Stable inflation is the Fed's other primary goal. Inflation had meandered around the 1.5% mark until mid-2014, when falling oil prices and the rising dollar brought the headline rate down to near zero. Since the beginning of 2016, inflation has partially recovered but is not yet showing signs of heading toward the Fed's 2% target (see Figure 4). However, we anticipate that inflation will approach this target by the end of 2017.

Figure 3. Employment indexes by category

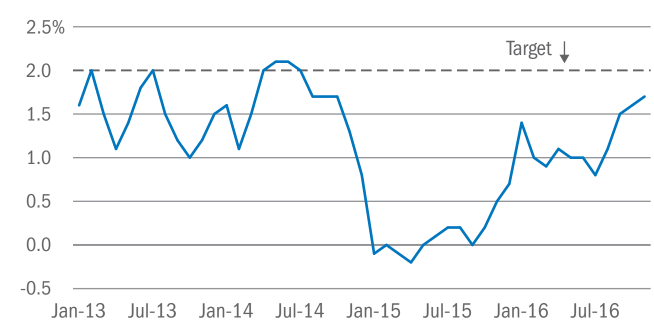
Key sectors have not returned to their 2008 levels



100 = January 2008.
Data as of November 30, 2016. Source: Haver Analytics.

Figure 4. Year-over-year inflation rate

Consumer Price Index, all items, % change from year ago



Data as of November 30, 2016. Source: Haver Analytics.

Overall, the picture the U.S. economy paints is one of slow but stable growth. Unlike Europe, the U.S. has been able to pull slowly away from the gravitational force of recession through sheer time and continued monetary stimulus. But this picture is less one of prosperity and more one of determination. There's been little fiscal aid to the recovery, growth has been inconsistent across sectors, and large swaths of the labor market remain underserved. At the same time, regulatory uncertainty, especially in mortgage and banking markets, has slowed the recovery on the supply side. This is the environment in which the Fed has worked to stabilize growth. Unfortunately, the consequence of having only monetary tools (versus both monetary and fiscal) has been this uneven recovery.

The Trump effect

What had become a remarkably stable forecast changed on November 8 with the election of Donald Trump. While most understood Hillary Clinton's economic program to be in sync with the Obama administration's, the prospect of an outsider who campaigned against the establishment introduced a new level of uncertainty. Suddenly, that populist uprising we saw across Europe entered the White House.

We don't know the full extent of Trump's economic platform, but we do know its intended direction: a reduced regulatory burden, lower tax rates for both the corporate and consumer sectors, and increased fiscal spending with an emphasis on infrastructure. He has also pledged to bring manufacturing jobs back to the U.S. and to renegotiate or change our standing in international trade.

The easiest part of the platform to grasp is the restructuring of the tax system. Trump intends to lower the corporate federal tax rate from 35% to something close to 15% and allow a one-time repatriation tax rate of 10% for corporate earnings kept overseas. On personal income tax, he plans to reduce the number of brackets from seven to three, with a top marginal rate of 33%. Of course, there are many details buried in these proposals, and we won't know the end result until legislation is drafted and passed.

"Wait and see" also applies to many other Trump proposals. The transition team is aiming to overhaul sections of the Dodd-Frank financial regulation put in place after the financial crisis, as well as to reduce certain EPA requirements. Plans are also being developed to increase infrastructure investment, although much of the spending is likely to come from the private sector. Lastly, Trump espouses unconventional strategies such as taxing corporations that move production overseas simply to reimport their goods.

These policies are broadly pro-growth and inflationary. Fiscal spending and tax cuts would add to growth next year, create jobs, and increase wages. They should also increase capital expenditures across the economy, particularly in areas such as construction and manufacturing. However, these policies could also increase the deficit in future years if other spending cuts or revenue streams are not developed.

Some of Trump's policy prescriptions could potentially be dangerous for growth. He promotes a tough trade stance, vowing to renegotiate NAFTA, abandon the Trans-Pacific Partnership (TPP) and strike new trade deals with many other countries. On the surface, these proposals may sound appealing, but they often include threats of higher tariffs. This raises the threat of a potentially damaging trade war.

> Many of Trump's expected policies are pro-growth and inflationary, while others raise the threat of a potentially damaging trade war.

Probably the most striking effect of the election is that we no longer have the perception that growth will be low and slow for a longer period of time. Indeed, until recently, we agreed with the consensus view that weak productivity and job growth were a hallmark of this business cycle, ensuring that economic expansion would continue at a pace below past cycles and forcing low interest rates and weaker inflation to last much longer than they should. Now there is hope that many of the factors holding the economy back can be lifted. Of course, we don't yet know how successful Trump will be in cajoling Congress to accept his prescriptions, or whether he'll be effective in dealing with other nations. And even if he gets everything he's asking for, the legislative process will take time. Still more time will pass before we begin to see the economic impact.

On the other hand, economic activity itself starts with a belief. If Trump can convince people that he is serious about his policies, then it's possible people will begin to act upon them even before any legislation is passed. For example, he's already used this bully pulpit to foster fear in boardrooms of U.S. companies who might be contemplating moving production overseas. It's entirely possible that some of these decisions are already being delayed. Moreover, consumer sentiment since the election has risen dramatically, signaling optimism about future conditions. If Trump acts as though he will follow through on his campaign platform, consumers could begin to spend more in anticipation of better times.

Figure 5 shows how our 2017 and 2018 forecasts have evolved. Before November 8, we called for a modest acceleration toward the recovery's mean economic growth rate of about 2.2%. Post-election, we now anticipate 2017 growth will increase to an average rate of about 2.6%, mostly concentrated in the second half of the year due to lags in implementation. If we assume that most of the pro-growth initiatives are enacted, then 2018 becomes the primary beneficiary, with GDP growth rising to nearly 3.5%.

We believe the Fed will raise rates three times, or a total of 0.75%, in 2017 and as much as 1.25% in 2018, with longer-term rates also moving up.

The Fed

A byproduct of stronger expected growth is the likelihood of more Fed rate hikes. Under the old "lower for longer" scenario, we anticipated two 25-basis-point (0.25%) increases in 2017 to accommodate moderately rising inflation and economic growth. Under the new forecast, we believe the Fed will raise the target federal funds rate three times, for a total of 75 basis points. The rate could also go up by as much as 125 basis points (1.25%) in 2018 as the economy continues to shift into higher gear.

Longer-term interest rates, such as the 10-year U.S. Treasury yield, also stand to increase further, as long as inflation and growth expectations remain on an upward climb. Figure 6 looks at the path of the 10-year yield since early July 2016, when it bottomed at a record-low 1.37% following the Brexit vote. What started as a rebound from very depressed levels became an unmistakable shift toward higher rates after Election Day, when the driver of rate movements changed from technical market factors to fundamental forces expecting much higher inflation and substantially stronger economic growth. History suggests that when these fundamental forces take hold, the yield curve (the difference between short- and long-term rates) steepens quickly. We forecast the 10-year yield to reach 3% or higher in 2017, and it could do so in the first half of the year. This stands in stark contrast to our pre-election view that we had already seen the steepest yield curve during this business cycle, when low inflation dominated the Fed's interest-rate decisions. We now believe the Fed will have to raise rates more than previously thought amid better growth, higher inflation rates, and improved wages.

The dollar

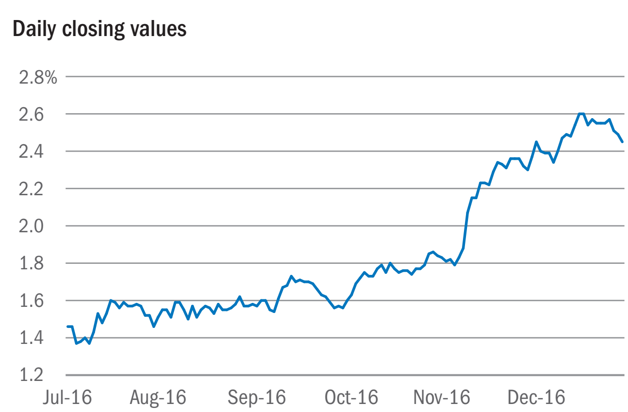
Figure 7 shows expected currency exchange rates through the end of 2017. Along with higher interest rates, it's natural to expect a stronger dollar. Indeed, the dollar has risen since the election. But we are not in the camp that believes the dollar will reach parity with the euro or surge to the level of 130 yen. Like interest rates, exchange rates tend to move in anticipation of future inflation or monetary policy moves, but then typically stabilize once the moves occur. In addition, on December 8 the European Central Bank (ECB) announced that it would reduce the scale of its monthly bond purchase program by 25%, to 60 billion euros ($64 billion) per month, beginning in April, while extending the program to the end of 2017, or beyond, if necessary. We see this is as a hawkish move because, while it doesn't directly call for an end to the program, we now know the ECB is moving in that direction. This will provide support for the euro over the next 12 to 18 months.

Figure 5. Evolving U.S. growth and interest-rate forecasts (%)

	Pre-election		Post-election	
	2017	2018	2017	2018
GDP	2.2	2.3	2.6	3.4
10-year Treasury yield	2.50	3.00	3.20	3.75
Target federal funds rate	1.13	1.88	1.38	2.63

Source: TIAA.

Figure 6. U.S. 10-year Treasury yield (%)



Data as of 12/31/2016. Source: Haver Analytics.

Foreign developed markets

Prominent examples of the rise in populism include the Syriza-led coalition taking power in Greece in 2015, the Brexit vote in June 2016, and, most recently, Italy's vote against constitutional reform that would have handed more power to the prime minister. But these headline events are only the tip of the iceberg. New parties on both the left and right have sprouted up across Europe's major democracies, from Podemos in Spain and the Five Star Movement in Italy to the AfD in Germany and the Free Party in Austria, among others. And it goes beyond Europe. One could argue that Japanese Prime Minister Shinzo Abe rose to power on an anti-establishment ticket in 2012 in a bid to rid that country of two decades of stagnation and deflation. If there's a common thread among all of these movements, it's that each country was significantly hurt by the financial crisis, and in each case the government failed to react swiftly to help those who were most affected.

There will be elections in 13 countries in Europe during 2017, of which those in France and Germany are easily the most important. While votes have yet to be cast, the cry for increased fiscal stimulus and the easing of stringent rules is growing loud. We believe 2017 will be the year that tips politics in the direction of more stimulus and less austerity, either because current sitting governments recognize the need for change or because opposition governments take their place.

Europe's recovery from the last recession was even weaker than in the U.S. In fact, Europe fell back into recession in 2012 and nearly did so again in late 2015, but the ECB's steady hand has finally led to growth of slightly above 1.5%. Whereas the U.S. has managed average growth just north of 2% per year since 2009, the Eurozone has been unable to eke out even half that rate. This has sparked increasing calls for fiscal spending to augment the ECB's lengthy monetary cycle.

Figure 7. Foreign exchange

	Period ending	
	2016	2017
Euro	1.05	1.10
Yen	117	115
Renminbi (yuan)	6.94	7.4
Brazilian real	3.25	3.25

Source: TIAA forecasts.

What will this change in attitude bring to growth across the developed world? In the case of Europe, we expect to see a stronger push toward fiscal stimulus. As in the U.S., this will sow the seeds of rising inflation and allow the ECB to become less accommodative. Meanwhile, growth on the continent should come in just under 2% next year as lending is freed up and consumption begins to rise. The U.K. is an interesting case. The economy remains in relatively good health, but it will need to generate more growth as the Brexit negotiations commence. At the same time, the decline in the value of the British pound has already pushed inflation upward, creating problems for the Bank of England's policy response. These combined forces should help keep the euro close to about 1.10 dollars through 2017 and the pound near 1.30 dollars.

In Europe, as in the U.S., we expect to see a stronger push toward fiscal stimulus, which will sow the seeds of rising inflation and allow the ECB to become less accommodative.

Japan is probably the outlier among developed economies because it still struggles with growth and monetary policy. To combat this, in August 2016 the Bank of Japan (BoJ) announced that it was abandoning its efforts to purchase stated nominal amounts of government bonds each month, and instead switched to a policy of maintaining a roughly zero interest rate on long-term government bonds. This has given the BoJ flexibility in its purchase program, allowing the yield curve to steepen. Moreover, we anticipate further spending plans from Abe in his attempt to shore up growth.

Figure 8. Interest rates begin to retrace 35-year decline

10-year U.S. Treasury yield

Data as of 12/31/2016. Source: Robert Shiller.

Emerging markets

As the developed world faces the prospect of populism, much of the emerging-market (EM) world continued to experience a more traditional economic downturn in 2016. Several EM countries have suffered through commodity price-induced recessions, while others have fallen prey to policy mistakes. The deceleration in global trade since 2011 has also had a strong negative impact on this group's economic fortunes.

Notable examples include Brazil, which ousted its president in 2016, has moved through a deep recession, and is still tackling pervasive corruption at all levels of government. Russia has grappled with the twin headwinds of low oil prices and severe trade sanctions related to its annexation of Crimea. But even in these countries, we see some favorable developments. Oil prices have stabilized, and necessary structural reforms are being enacted in Brazil.

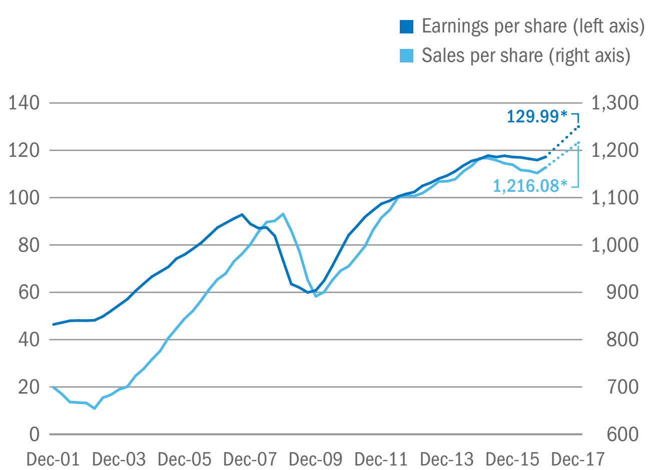
A country that always attracts special attention is China. On the surface, its economy is undergoing a slow and sometimes disruptive transformation, with the goal of becoming less reliant on international trade and more focused on domestic consumption. Below the surface, the waters are murky. The sheer size of China's economy, together with its outmoded communist-style growth plans and targets, complicates efforts for newer, more targeted reforms. In the near term, though, we know 2017 will be an important political transition year. We, therefore, anticipate further stimulus efforts to promote growth stability as the transition continues.

Investment outlook: Shifting into higher gear

With the global economy at an inflection point, global corporate earnings growth is gaining strength, and higher interest rates may be on the way. Investors who are positioned to benefit from these upturns should see good performance in 2017, provided the combination of rising interest rates and political uncertainty does not derail the improving growth outlook. The U.S. has not experienced a prolonged period of rising interest rates since the one that began in the mid-1950s, as Figure 8 shows. That led to a bear market for bonds lasting 30 years—nearly as long as the bull market that followed. Higher interest rates could eventually benefit fixed-income investors, but for the moment they will be a headwind for total returns as bond prices fall.

Corporate profits bottomed in the middle of 2016, allowing equity markets to escape reasonably unscathed from a five-quarter earnings recession brought about by plummeting energy prices. Today's earnings momentum, helped by the rebound in energy prices, may get a further boost from a more market-friendly political environment next year, with Republicans now in full control of the legislative process. But an accelerating economy can be a double-edged sword for corporate profits: sales increase when the economy heats up, but so do costs. Figure 9 shows that 2017 consensus earnings forecasts, which rely largely on a pickup in sales, are already pricing in this renewed optimism.

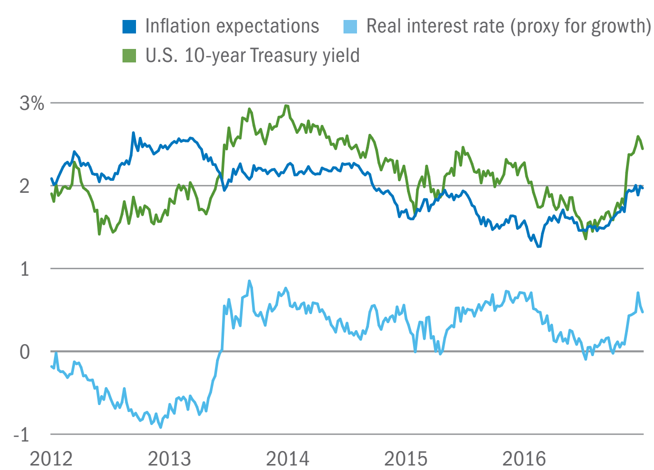
Figure 9. S&P 500 Index sales expected to lead profits higher



* Forecasts represent consensus estimates for sales and earnings over the next 12 months.

Sources: Factset, Institutional Brokers' Estimate System (I/B/E/S), as of 12/31/2016.

Figure 10. Interest rates spike on higher growth and inflation expectations



Source: Bloomberg as of 12/31/2016.

We expect 2017 to be a good—not great—year for diversified investors, much like 2016. Despite the upward move in interest rates since Brexit, fixed income is still priced to deliver below-average returns, while U.S. equity markets, which are anticipating better conditions ahead, have become pricier. If, however, we are correct that the world economy is about to reach “escape velocity”—a noticeable shift from sustained low growth and inflation—there will be opportunities in many of the areas that have underperformed in recent years, including international equity markets and cyclical U.S. stocks, particularly Financials.

The elephants in the room

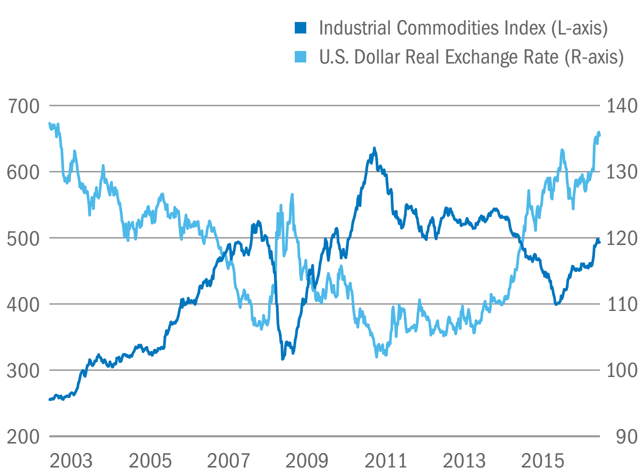
In the years ahead, Donald Trump’s victory and the U.K.’s vote to leave the European Union will come to define 2016. In some ways, the two events were similar for markets, offering a view into what happens when binary outcomes don’t turn out as expected. Unlikely events happen all the time, but they rarely have so broad an impact. Trump’s election, in particular, seems to have reset the chess board in the minds of many investors. So, what if anything can we say about its likely influence on financial markets in 2017?

While the U.S. election did not produce the market chaos many would have predicted, the weeks following the vote featured some significant price action, particularly in the fixed-income and currency markets. If there’s a common thread connecting the various market reactions, it would be that Trump’s policies—to the extent they are known—raise expectations for U.S. growth and inflation. Prices of risk assets such as stocks and commodities have climbed, while the sharp uptick in U.S. interest rates (Figure 10) has hurt bond investors. The most dramatic reaction was in emerging markets (EM)—Mexico in particular, where the collapsing peso and broader credit and equity market selloff derived from concerns about how President-elect Trump’s protectionist campaign rhetoric will translate into policy action.

The post-election reflation trade has not been limited to U.S. stocks and bonds. In a rare moment of positive correlation, both the U.S. dollar and the prices of industrial commodities—oil and copper, among others—have surged together (Figure 11), a sign that markets expect a U.S.-led acceleration in global growth in 2017. This expectation has already created a distinct set of winners and losers among asset classes and, more specifically, within the U.S. equity market.

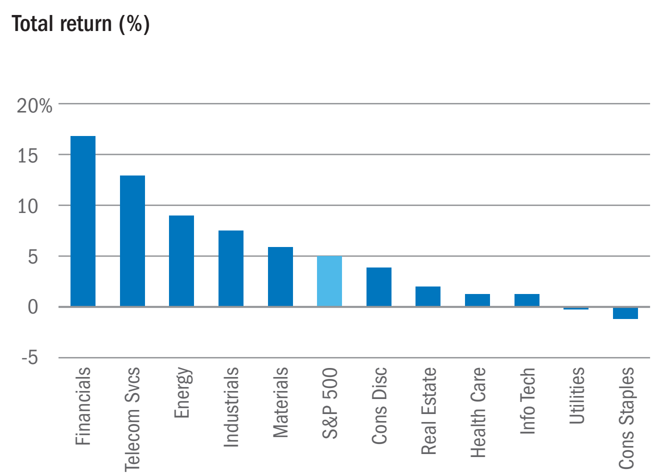
The best-performing stocks in recent years have tended to be those that either a) exhibited strong earnings growth when such growth was hard to find; or b) carried a high dividend yield that made them desirable substitutes for bonds. In the month following the election, however, both of these have been among the worst-performing segments of the market. Instead, formerly lagging sectors like Financials and Industrials have led major equity indexes to all-time highs (Figure 12). Such performance dispersion among sectors, demonstrated in only the first four weeks after the election, would not be unusual to see in a full calendar year.

Figure 11. U.S. dollar and commodity prices surging together on Trump win



Sources: Bloomberg, Barclays, as of 12/31/2016.

Figure 12. Post-election U.S. equity sector performance driven by expected policy changes



Source: Bloomberg, measuring period from 11/9/2016 to 12/31/2016

Are "Great" expectations warranted?

The late 2016 market moves were driven by an expectation that the U.S. economy will soon accelerate out of its so far unremarkable expansion, pushing prices of risk assets up with it. We are seeing signs of this in retail investors' behavior since the election. Based on sentiment indicators and asset flows, we know that investors generally became more cautious throughout most of 2016 but have now turned bullish on stocks again (Figure 13). If this trend holds up, growing investor risk appetite should support stocks and could potentially exacerbate the rise in bond yields over the near term. Keep in mind, however, that retail flows, if anything, have been contrarian leading indicators for equity markets. Increased investor bullishness, for example, has often signaled that a rally is nearly at its end. The key question, therefore, is whether market expectations have become too great.

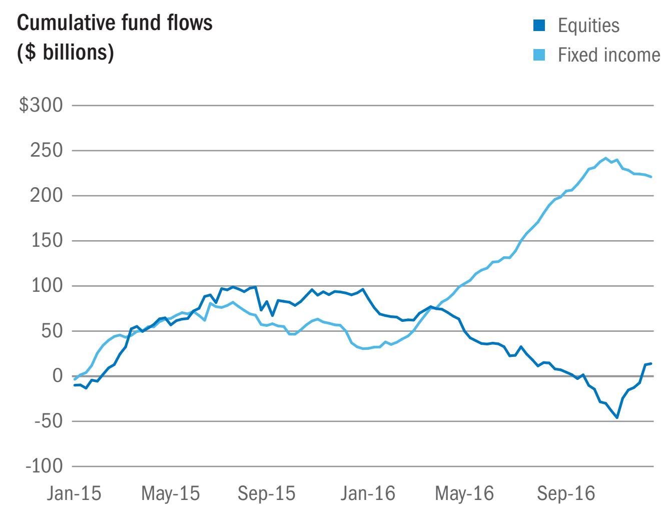
To address this concern, let's consider the current outlook for corporate profits and the likely impact of the election on earnings moving forward. Financial markets are now pricing in a much different legislative slate for 2017 than they had been on Election Day. The agenda seems likely to include individual and corporate tax reforms, broad deregulation of industries, and some form of fiscal stimulus targeted at infrastructure investment. If enacted, this combination justifies the market response since early November, as it presents potential upside compared to the current 2017 consensus estimate of $130 per share for S&P 500 Index earnings. We are therefore comfortable forecasting a further rise in the index to our 2017 year-end target of 2,400, a percentage gain in the mid- to high-single digits above today's level. The two main risk factors that could make our projection too optimistic are policy uncertainty and market valuation.

> Growing investor risk appetite should support stocks and could potentially exacerbate the rise in bond yields over the near term.

Single-party control of Congress would seem to imply more potential for sweeping legislative changes. Indeed, the U.S.-led equity rally reflects optimism that a stimulative policy agenda can be passed and implemented relatively smoothly. But there is no guarantee that a politically inexperienced president will be able to usher multiple complex pieces of legislation through a still-contentious Congress as easily as has been assumed.

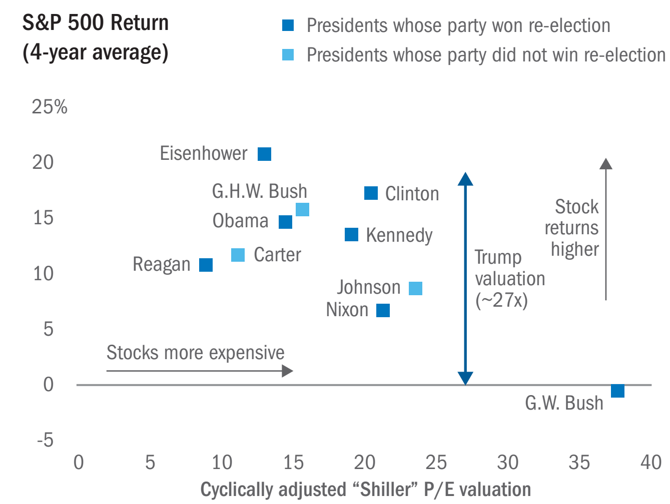
Moreover, the benefits of tax reform and infrastructure spending, even if signed into law, will likely not hit companies' bottom lines until the end of 2017. Markets may continue to "assume the best" about future policies until proven otherwise. But while we do expect stocks and interest rates to rise next year, we don't believe they will do so in a straight line. Investors hoping for muted volatility may be disappointed.

Figure 13. Investors begin to reverse flows from stocks into bonds during Q4



Source: Investment Company Institute as of 12/21/2016.

Figure 14. U.S. presidential re-election depends on more than "market timing"



Sources: Bloomberg, Robert Shiller data from 1/31/1953 to 11/30/2016.

In addition to policy uncertainty, we must consider the fact that the current U.S. equity bull market is about to turn eight years old. Few presidents have entered office at such an advanced stage of a recovery, so it's important to evaluate whether the current level of equity valuations—or the potential for a large correction—threatens the first year of Trump's presidency. Valuation is a poor predictor of shorter-term (6–12 month) returns, but it tells us more about what to expect over a four-year presidential term.

Current U.S. stock valuations point to lackluster—though certainly not disastrous—performance during Trump's presidency. Among modern presidents, Carter, Reagan, and Obama "timed" the market best, entering office with equities at their cheapest. George W. Bush had the misfortune of assuming the presidency during a full-fledged bubble driven by technology stocks, resulting in zero net returns during his first term. Trump will be inaugurated at the second-highest S&P 500 P/E multiple of any president since World War II. Fortunately for him, while valuation is a good predictor of longer-term equity returns, it's a less reliable indicator of re-election results (see Figure 14).

President-elect Trump's prospects for a second term aside, should investors be concerned that U.S. equities are at risk for a severe correction with interest rates on the rise? We don't think so. Higher interest rates can harm corporate earnings and dampen risk appetites under the wrong circumstances, as they did in the late 1970s. During that era, however, rates rose rapidly to very high levels, tightening financial conditions and triggering a series of recessions.

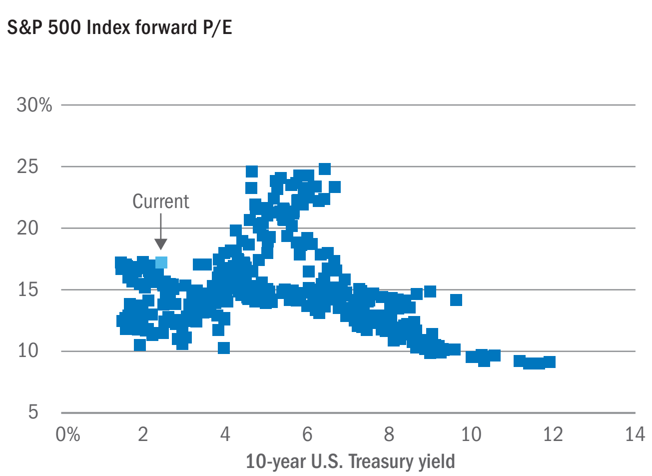
Our 2017 outlook calls for interest rates to move gradually higher on the back of accelerating economic growth. This type of environment is normally associated with strengthening corporate earnings and investor sentiment. Figure 15 shows that S&P 500 valuation—according to its P/E ratio—has historically been depressed when rates are either very low or very high but higher when rates are in a 4%–6% range. Given the prolonged and unusual nature of this cycle, equity valuations have already risen somewhat despite stubbornly low rates. But history does not suggest that valuations need to fall significantly as rates move higher from here.

Risks aside, we don't expect the post-election trends—strong risk appetite, rising interest rates, and pro-cyclical market leadership—to fade in the near term as policy uncertainty remains high but tilted toward optimism. But at least some of the market moves since November 9 have effectively pulled forward the benefit of significant tax reform and an impactful spending bill. So while we believe the recent market winners will continue to lead in the coming quarters, we look beyond the U.S. political picture when evaluating investment opportunities and risks.

Not everything is about Trump

One should resist the assumption that all or even most market fluctuations in 2017 will derive from U.S. politics. One need only look at the past 18 months to see that the biggest market "events" have been neither Brexit nor Trump but market-based growth scares emanating from China and

Figure 15. Equity valuations do not have to fall as rates rise



Sources: Factset, Institutional Brokers' Estimate System (I/B/E/S), data from 1/31/1985 to 12/31/2016.

Figure 16. Market volatility stirred by more than just elections

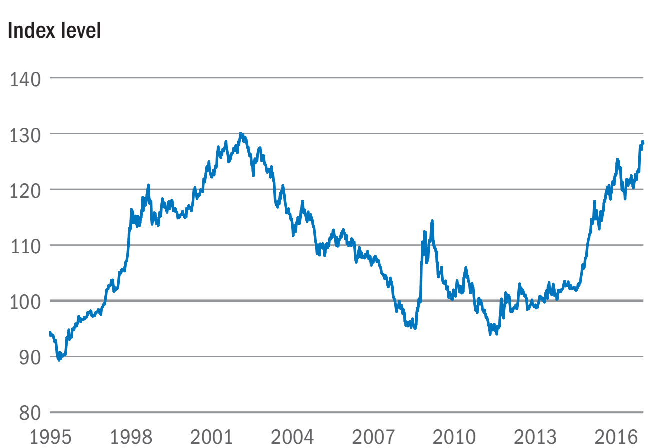
Source: Bloomberg as of 12/31/2016. The VIX level measures market expectations of near-term volatility on the S&P 500 Index, conveyed by stock index option prices. The MOVE (Merrill Lynch Options Volatility Estimate) is a weighted index of implied volatility on 1-month Treasury options across the yield curve.

its handling of exchange rate policy (Figure 16). In both August 2015 and January 2016, equity and interest-rate volatility both increased by more than they did following the pair of surprising political events in the months that followed. A third challenging election outcome in December, resulting in the Italian prime minister's resignation, was barely met with a shrug by investors.

Of course, we shouldn't ignore the potential for political developments to rile markets. The upcoming French election in April and the likely runoff in May will be a test of strength for the same mix of nationalism and populism that tipped the scales in several 2016 contests. Should the French government be taken over by politicians hostile to the European Union, it could threaten political and economic stability in the region and perhaps even the already-weak euro itself. This would introduce greater downside for European equities, which, despite trading at a discount to their U.S. counterparts, could see their multiyear underperformance continue.

Another concerning development heading into 2017 will be the renewed U.S. dollar strength (Figure 17). High relative interest rates have made the U.S. attractive to investors currently holding European or Japanese fixed income. To the extent U.S. rates continue to rise faster than those in other developed economies, the dollar will be well supported, and U.S. investors with unhedged exposure to international stocks may see lower returns. While the dollar's surge in recent years has proven helpful to U.S. consumers, it has also hurt U.S. corporate profits and unsettled—albeit temporarily—the market's faith in China's economic model, creating broader headwinds for EMs. Further dollar appreciation from here would be problematic for our constructive global equity outlook. Fortunately, we believe the late-2016 rise in U.S. rates and the dollar is forward-looking, as the markets price in more tightening from the Federal Reserve. Assuming the Fed doesn't hike rates beyond what's currently priced in, we are unlikely to see a further decoupling of global interest rates or disruptive rise in the dollar in 2017.

Figure 17. Trade-weighted U.S. dollar index at multi-decade high



Sources: Bloomberg, Federal Reserve as of 12/23/2016.

> Further dollar appreciation from here would be problematic for our constructive global equity outlook.

The firmer U.S. dollar is not a problem for Japanese equities, which have tended to trade with a high negative correlation to the level of the Japanese yen. The Topix 100 Index surged with the U.S. dollar in late 2016 and, moving forward, should benefit from a more advantageous earnings outlook and reasonably cheap valuations. The key for Japan remains whether economic reforms and an evolving approach to monetary policy will jolt growth higher and make Japanese companies less reliant on exports.

EM equities have struggled since the U.S. election given the uncertainty about future changes to U.S. trade policy. This marked a drastic shift for EM stocks, which were among the best performers for the first 10 months of 2016. The reversal came in November as the U.S. dollar appreciated by close to 5% on average versus EM currencies—including an 11% gain against the Mexican peso. While weaker currencies hurt EM returns in the short term, they also make EM companies more competitive in the global marketplace by lowering the cost of exports. A threat to that competitiveness in the form of unilateral protectionist policies from the new Trump administration remains a concern for EM. We should consider this risk, however, in the context of recent improvements in economic momentum and earnings growth—some of which owes to clearer and more effective governance in places such as India and Brazil. And, like European shares, EM stocks trade at a discount to both their own historical average valuations and relative to U.S. markets.

We also expect continued disagreement among OPEC members and other major oil producers about limiting supply to keep prices stable. While improving global growth should support demand over the next several years, production increases in the U.S. and elsewhere should prevent energy prices from rising too far too fast. We expect crude oil to trade up to $60 per barrel by the end of 2017, helping Energy stocks recover from their 2014–15 collapse.

Investing in 2017

Stocks

Stocks are pricier and bonds slightly cheaper than they were a year ago. In other words, the incentive for reallocating money from bonds to stocks is not as high as it used to be.

But we still prefer stocks to bonds for the following reasons:

- Much of the narrowing in risk premiums has been U.S.-specific. The equity risk premium in Germany, for example, has rarely been as compelling as it is today, especially compared to same premium in the U.S. (Figure 18).
- Global central banks continue to promote accommodative policies that have thus far rewarded risk-taking. Once again, those policies now seem more likely to benefit investors in non-U.S. markets.
- Expansionary fiscal policy in the U.S. may have the dual effect of supporting stock prices while depressing bond prices.
- Current U.S. earnings estimates do not yet reflect an added boost from lower corporate tax rates.

Because stocks outside the U.S. offer the most attractive valuation compared to their local bond markets, we express our preference for equities through international developed and EM equities, with international developed-market bonds our least preferred asset class.

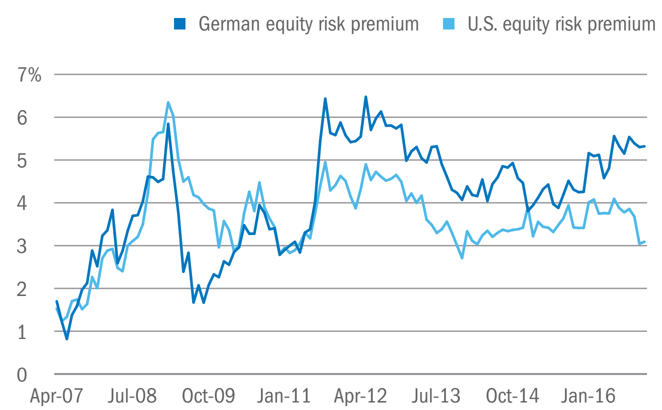
Within U.S. equities, we continue to prefer small-cap stocks despite their already notable outperformance since the election. Smaller companies stand to benefit from lower corporate taxes, the stronger U.S. dollar and, potentially, the windfall of increased consumer spending that could follow cuts in individual marginal tax rates. While many of these factors have already been reflected in market pricing, we don't think current valuations fully discount our expectations for better U.S. growth.

For similar reasons, we are adding Financials and Industrials to our list of preferred equity sectors, joining Technology and Consumer Discretionary. This pro-cyclical basket of preferred sectors should be supported by higher revenue growth and reasonable valuations. Energy remains a wildcard, with oil still volatile and well below its five-year average, but we believe this sector will benefit from a further move higher in commodity prices. We do not hold a favorable view of higher-yielding sectors such as Utilities, Consumer Staples, and Real Estate. While these areas have been coveted for their bond-like characteristics, their elevated valuations leave them exposed with interest rates now heading higher.

Bonds

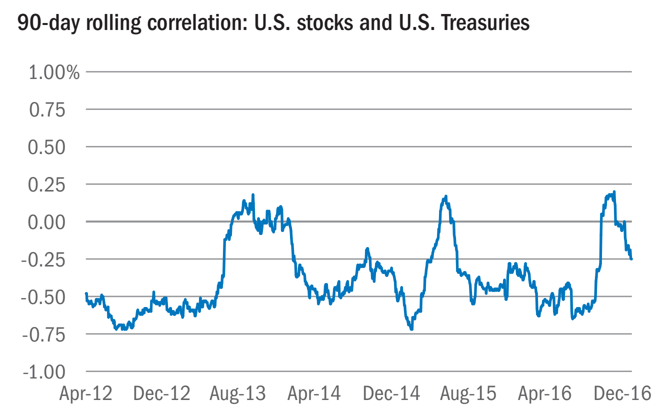
Of course, we think investors should still hold bonds in their portfolios. The diversification benefit they have historically offered in the form of negative correlation to stocks was muted as rates rose during the second half of 2016, but it may prove more valuable in 2017 (Figure 19). Most of the risks, political or otherwise, to our economic and market outlooks would likely result in a reversal of the recent uptick in global yields. Additionally, when viewed over a longer time frame, rising interest rates should be welcome news to bond investors, despite negative total returns in the short run. The best predictor of fixed-income returns is current yield—rising yields today mean better returns tomorrow.

Figure 18. Equity risk premiums now much higher in Eurozone than in U.S.



Sources: Robert Shiller, Bloomberg as of 12/31/2016.

Figure 19. Correlation between stocks and bonds turning negative again



Source: Bloomberg as of 12/31/2016.

We encourage a diversified approach to fixed-income investing that includes corporate and sovereign bonds, both in the U.S. and abroad. However, with corporate credit spreads now at more normalized levels compared to a year ago, the relative tactical opportunities within fixed income are more limited. That said, with U.S. yields now even higher compared to most of the developed world, investors looking to trim their bond allocation may want to consider starting with their international holdings, providing they use the funds to increase their international equity exposure.

Conclusion

Recovery from the financial crisis and recession has been slow and uneven, but we should see moderate improvement in the pace of global growth in 2017, led by the U.S. With political populism rising at home and abroad, we think the policy pendulum will swing toward increased fiscal stimulus, lighter regulatory burdens, and other pro-growth efforts—supporting a rise in interest rates, stronger inflation, tighter labor markets, and better wages. Of course, it will take time to know how effectively new policies will be crafted and implemented, and more time beyond that before we begin to see actual economic impact.

Against this backdrop, we have an overall constructive investing outlook for 2017. We expect most asset classes to improve on their 2016 performance, particularly outside the U.S. But we must also acknowledge that much of the benefit of expected U.S. policy shifts has already been priced in, and that snap reactions to election results rarely dictate markets' long-term direction. We are also wary of the prospect of further disruptive elections in the Eurozone and a still-fragile outlook for many EM countries. Therefore, our asset class preference are less numerous and less confident than usual, despite the apparent challenges for bond markets and still-low returns on cash.

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