Top Five Macro Themes for 2017

By Teri Mason, CFA, VP, Director of Macro Strategies & Tom Fahey, VP, Associate Director of Macro Strategies

What a difference a few months can make. The world economy now looks to be on sounder footing, with economic data surprising to the upside, developed and emerging market economic momentum improving, global manufacturing recovering and the US profits recession ended.

For much of 2016, we were focused on a world lacking in demand and the attendant problems. We were waiting to see who might step up to borrow and spend to spur growth. After a recession scare early in the year, markets rallied, as the Federal Reserve (Fed) went dovish in February and global bond yields declined substantially. Subsequently, markets seemed exuberant as we were still in a profits recession for most of the year. Economic execution and a profits rebound were needed to justify market levels. They are now showing up.

We're modestly optimistic about 2017, but there are a host of unknowns as we become acquainted with our new President-elect Trump, what policies he may pursue, and how they will impact the world body politic.

MACRO THEMES FOR JANUARY 2017

1. The Global Macro Picture Has Brightened
2. Global Political Volatility Should Persist
3. Bigger Booms & Busts Likely Ahead
4. Financial Conditions Have Been Tightening, Raising the Risk Of A Policy Mistake
5. Markets Are Still Ahead Of Fundamentals, Though The Gap Is Shrinking

1. The Global Macro Picture Has Brightened

DEVELOPED AND EMERGING ECONOMIC MOMENTUM IS IMPROVING

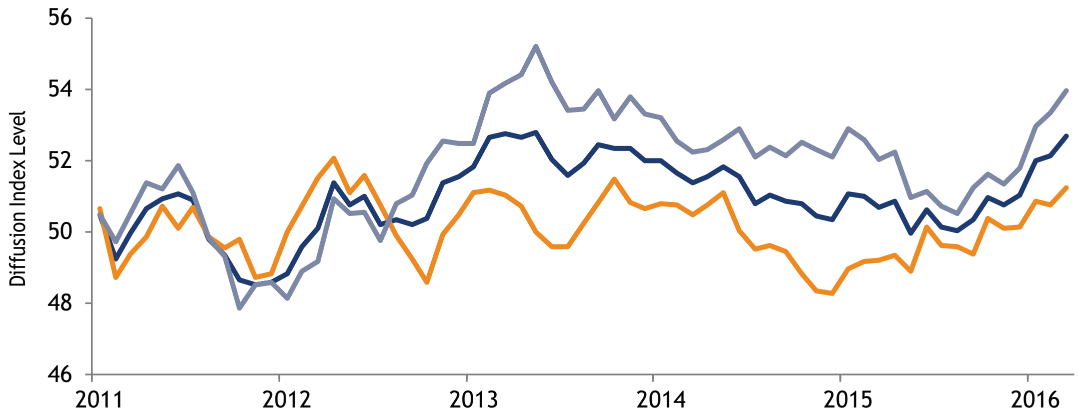
Source: JPMorgan, IHS Markit, Haver Analytics.
Data as of 11/30/2016.

Diffusion Index is a measure of the percentage of stocks that have advanced in price or are showing a positive momentum over a defined period.

Global Manufacturing PMI

Emerging Markets PMI

Developed Markets PMI



- The global economy is less likely to stumble as evidenced by the rising global Purchasing Managers Indices (PMIs). In Europe, there have been a lot of worries about politics, including the Brexit overhang in the UK which will likely dent growth in 2017. However, euro area growth trends look good, with real GDP expected to be near 1.2-1.4% in 2017. China performed better than we expected in 2016, though we remain concerned that markets are too complacent regarding capital flight, the devaluation of the renminbi and financial stability risks. A year ago, a lot of economists were lowering their growth estimates across many countries. Now, we see more stable trends (fewer cuts) which makes us think 2016 may be the trough for global GDP growth. We expect global growth in the 3% range in 2016, ticking up to 3.25% in 2017.

THE PROFITS RECESSION APPEARS TO BE OVER

US profits and non-farm payrolls

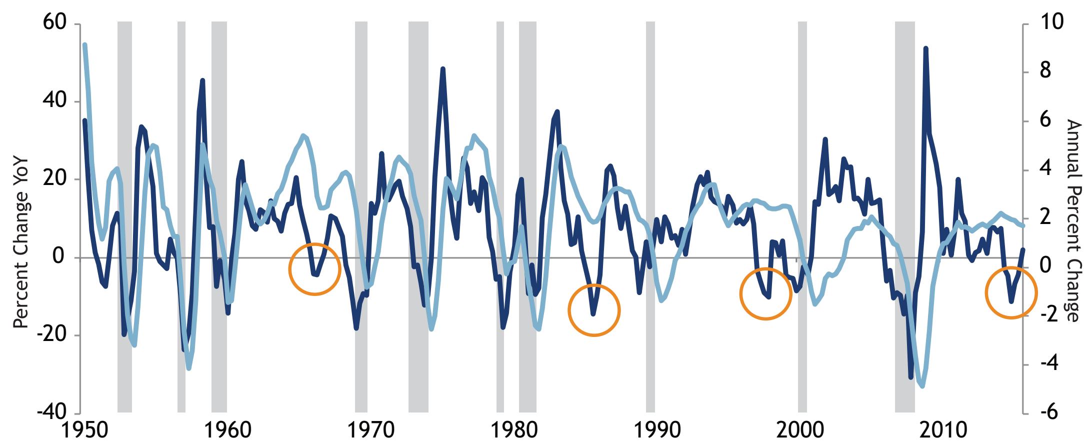
Source: Thomson Reuters Datastream.
Data as of 9/30/2016.

Past performance is no guarantee of future results.

Corporate Profits (Yoy%)

Non-farm payrolls (Annual % change)

NBER defined recessions

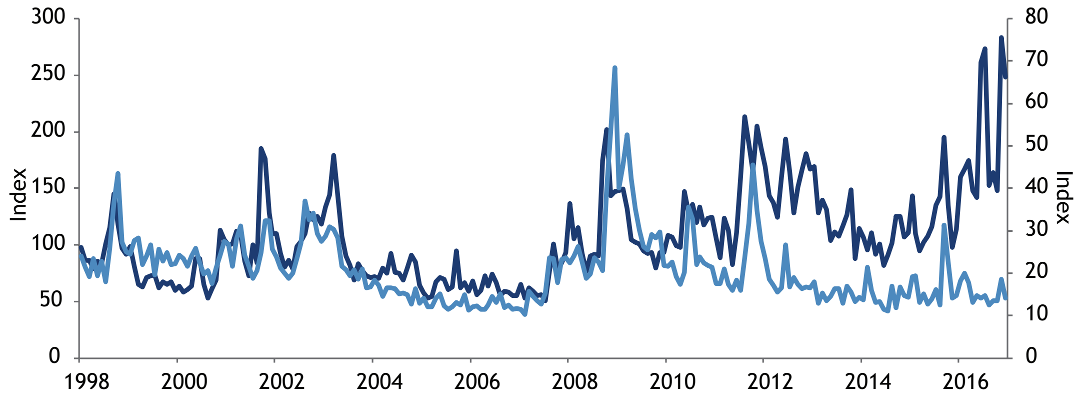


- In the US, the profits recession appears to be over, and the possibility of an economic recession is off the table at least for 2017. For the first time in years, the Fed raised its key interest rate forecast in its so-called dot plot chart (see page 4). The US government may be the one to step up and borrow and spend, which is good for global demand but likely won't hit until 2018. We expect US real GDP growth of approximately 1.5% in 2016, improving to 2.1% in 2017.
- We think economic growth will be strong enough for S&P 500® Index earnings growth of 7% in 2017 and even as much as 15% in 2018 if corporate taxes are cut to 20% from 35% today, as suggested in Trump's policy statements. Growth could be substantially better in 2018 depending on fiscal policy. For now, we think fiscal policies could add 0.25%-0.50% to our growth forecasts going forward, but significant hurdles lie ahead. The Republican Congress will likely pursue tax reform and infrastructure spending programs, but deficit hawks may restrain what they're able to push through.

2. Global Political Volatility Should Persist

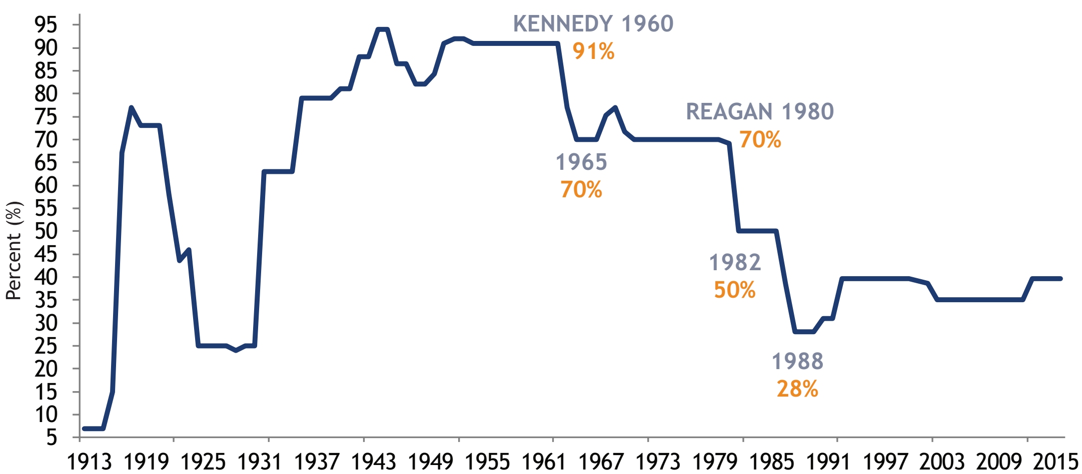
ECONOMIC POLICY UNCERTAINTY VERSUS EQUITY VOLATILITY

Source: Thomson Reuters Datastream.
Data as of 12/31/2016.



US TOP MARGINAL INCOME TAX RATE

Source: Internal Revenue Service, Ned David research.
Data as of 12/31/2016.



- President-elect Trump is an unknown quantity, having never held public office before. As he fills in his cabinet, we're starting to get a sense of his priorities, but he seems to enjoy being unpredictable (a debate tactic designed to keep your opponent off guard). This type of unpredictability can increase market volatility, but so far, equity volatility has been remarkably absent.
- Will Trump attempt to implement some of his more strident proposals from the campaign? Or will the realities of governing cause him to tone down his actions? We're assuming the latter for now but remain watchful of the former. For example, Trump is clearly no fan of free trade, and he has broad authority to act, but we think cooler heads will prevail. Sparking a global trade war is in no one's best interest, so we assign it a low probability. We are closely monitoring proposals relating to border adjustment.
- We can't forget that after Brexit and Trump, markets are likely to be keenly sensitive to political risks around the Dutch, French, and German elections in 2017. Geopolitical tensions with Turkey that renew refugee flows could doom Chancellor Merkel in Germany. China has their twice-a-decade Party Congress with their own leadership changes this fall.

3. Bigger Booms And Busts Likely Ahead

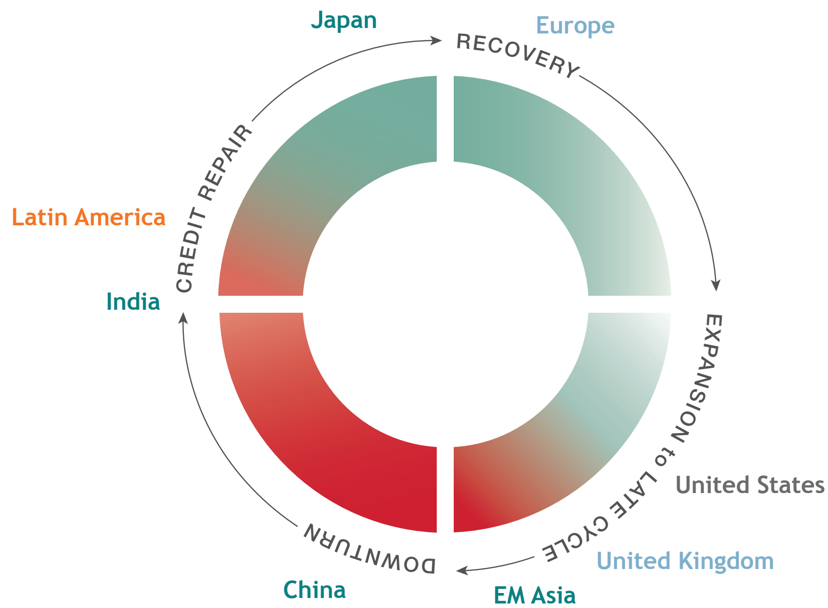
WHERE ARE WE IN THE CREDIT CYCLE?

Source: Loomis Sayles. Views as of 12/31/2016.

Chart provided for illustrative purposes only.

Regions:

- Asia
- Europe
- Latin America
- Other



- Diverging credit cycles among countries and regions can provide opportunities.

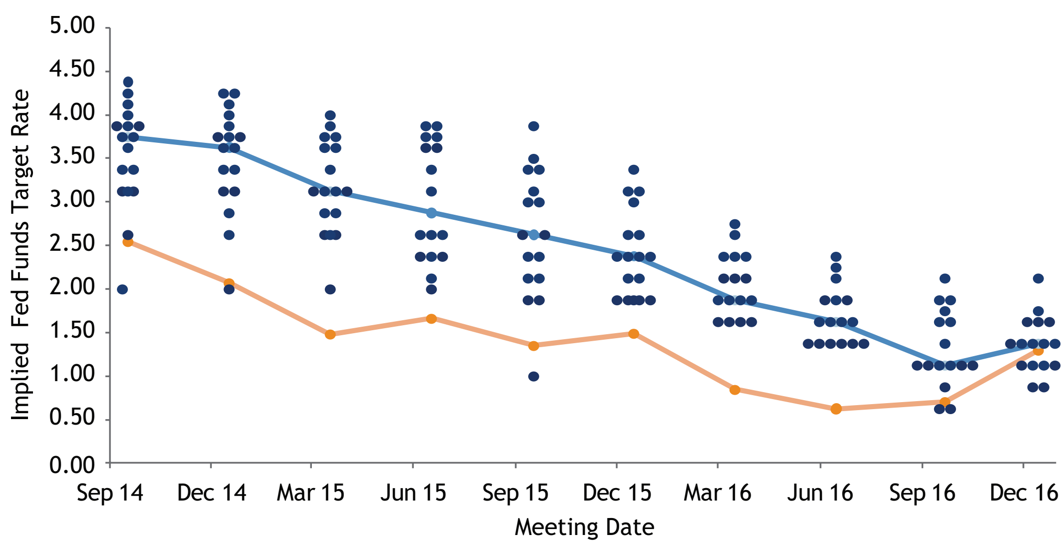
THE FED DOTS TURN ON INTEREST RATE FORECAST

First hawkish hike in a decade

Source: Bloomberg. Data as of 12/29/2016.

Used with permission from Bloomberg Finance L.P.

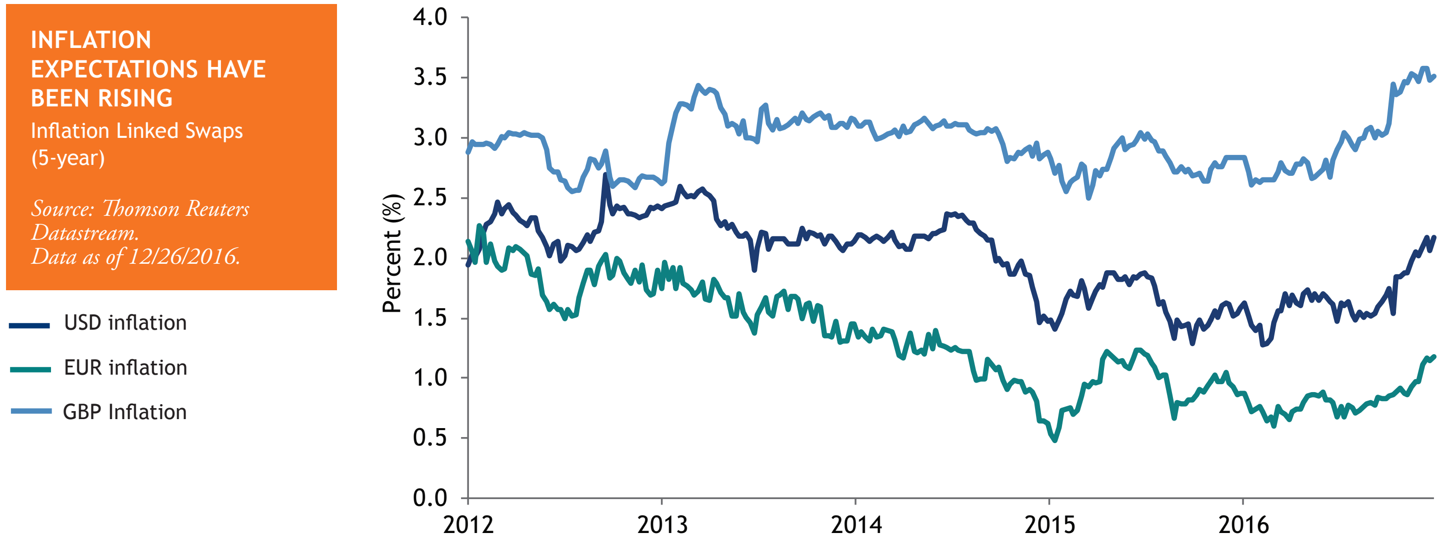
- Federal Open Market Committee (FOMC) members' dot projections
- FOMC dots median
- Overnight index swap - as of meeting date



- The US remains in the late stage of the credit cycle, and we expect 2017 to be a fairly benign year. But 2018 could see fiscal stimulus and monetary tightening, which could increase recession risks later on. President-elect Trump is likely to be bolder than President Obama and that can increase the cyclical amplitude of this cycle—a bigger boom and then a bigger bust. Higher fiscal spending will likely extend the credit cycle, but with that we could see greater corporate leverage. We believe this is a significant change from the more benign low growth, low inflation, easy Fed policy that we have experienced since the financial crisis in 2008. After Trump got elected, we saw the Fed's dot plot interest rate forecast increase for the first time which could be a warning that markets may be complacent about tightening monetary policy.

INFLATION EXPECTATIONS HAVE BEEN RISING
Inflation Linked Swaps (5-year)

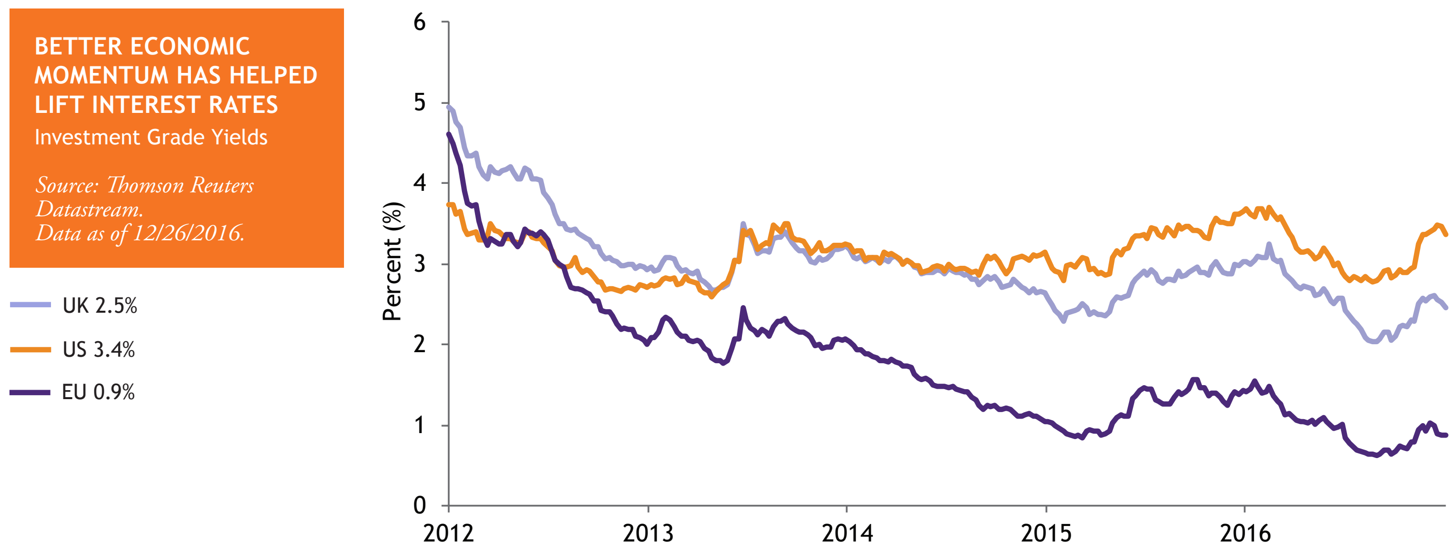
Source: Thomson Reuters Datastream.
Data as of 12/26/2016.



- Inflation risks have been rising in developed markets. In the US, Trump will be unleashing fiscal stimulus at a time when the unemployment rate is below 5 percent, putting upward pressure on inflation. Across developed markets in general, inflation is rising and curves are steepening. We also see Chinese producer price inflation rising for the first time since 2013, and that could spill over to global goods price inflation.

BETTER ECONOMIC MOMENTUM HAS HELPED LIFT INTEREST RATES
Investment Grade Yields

Source: Thomson Reuters Datastream.
Data as of 12/26/2016.



- Fixed income assets have been supported by a search for yield, but as rates rise and prices fall, it could spark a rotation into equities.

4. Financial Conditions Have Been Tightening, Raising The Risk Of A Policy Mistake

- Yields have risen, the dollar has been strengthening and oil prices are up. It seems that with every turn of the calendar since 2008, we have had a first half swoon in growth. Barring that potential shock, both growth and inflation trends are expected to rise but remain fairly benign in 2017. However, both could rise more substantially in 2018, leading to a more hawkish Fed. The market is not priced for that. We think the Fed will hike interest rates two times in 2017 and four times in 2018, but risks seem tilted for more hikes which would be a major shift, compared to years of revising interest rate expectations lower.

5. Markets Are Still Ahead Of Fundamentals, But The Gap Is Shrinking

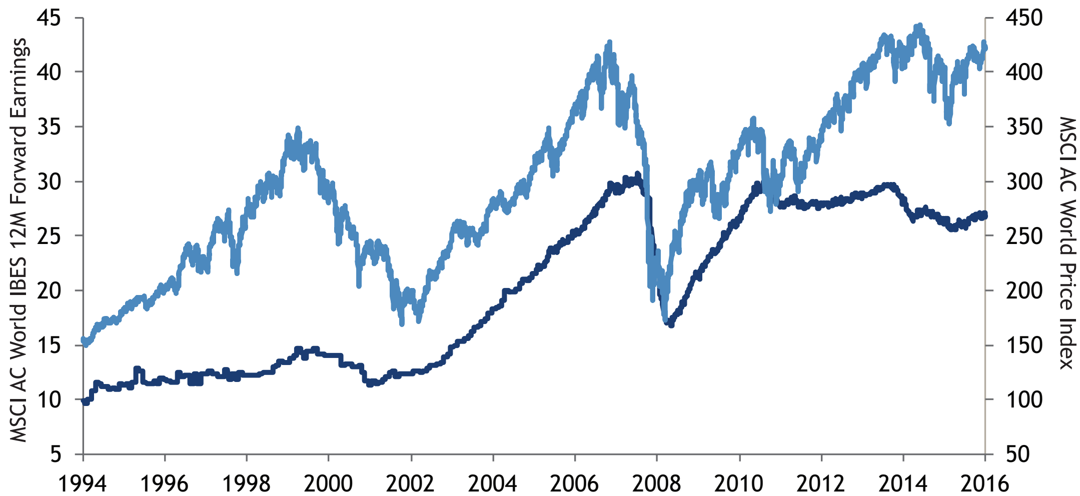
MARKETS HAVE PERFORMED WELL, MAYBE TOO WELL

We really need an earnings pick up to support equity multiples.

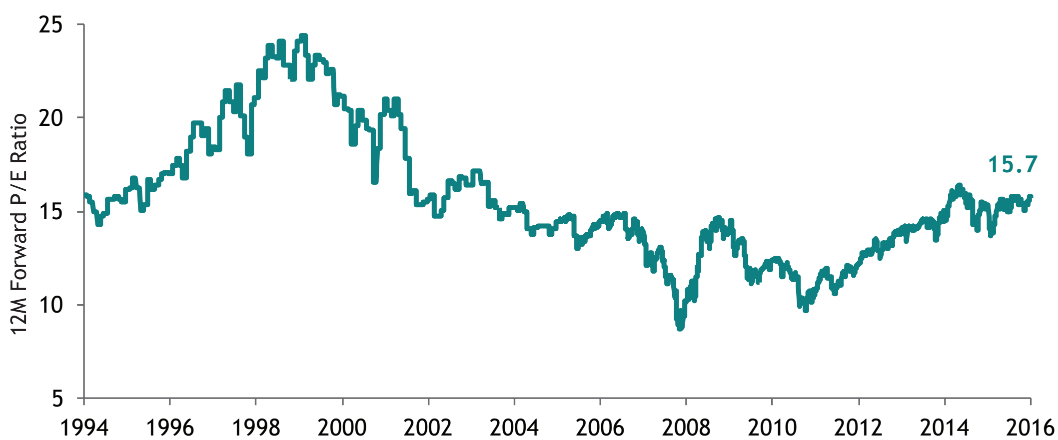
Source: Thomson Reuters Datastream, Scott Barber. Data as of 12/30/2016.

MSCI AC World Price Index (right scale)

MSCI AC World IBES 12-month forward earnings (left scale)



MSCI AC World IBES 12-month forward P/E Ratio

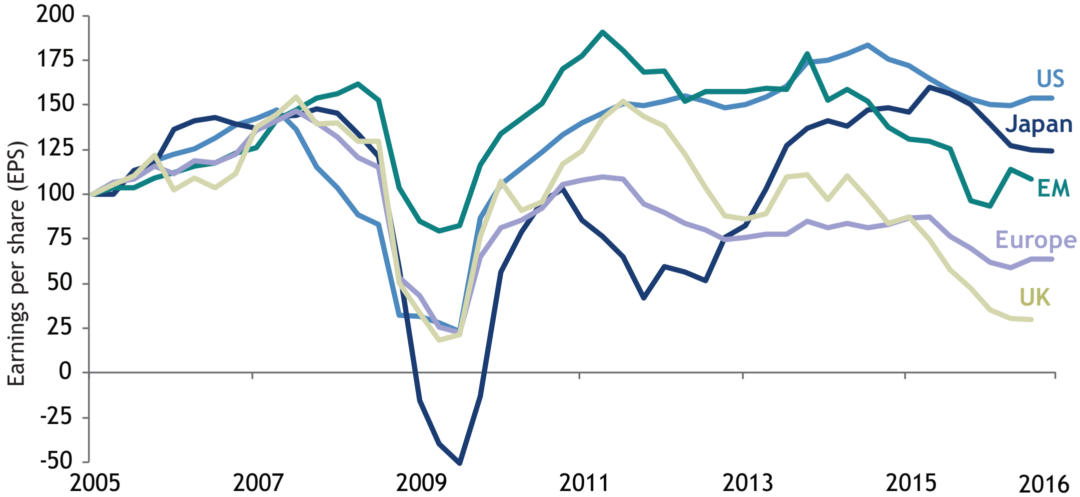


- Equity price-earnings (P/E) ratios are currently high, but earnings are poised to accelerate. We have a positive view on dividend growth for 2017 based on higher earnings and repatriation of capital from overseas. We worry that markets have discounted a lot of good news about corporate tax reform and could be disappointed—more by the timing than the actual delivery. It could take longer to get tax changes through Congress than investors anticipate.

US EARNINGS ARE CURRENTLY THE BEST OF THE BUNCH

Trailing EPS before extraordinary items

Source: Bloomberg, Thomson Reuters Datastream. Data as of 12/31/2016.



- The earnings recession outside the US has been even worse which helps explain why US equities have outperformed. It would be fantastic to see a global earnings trough in 2017 that would provide support to global growth expectations.

US AND EM REMAIN THE HIGH YIELDERS

Low Yields Globally Have Supported Flows into US Credit

Yield Versus Market Size Across Fixed income

Source: Morgan Stanley Research, Bloomberg, Markit, Sifma, S&P LCD, Citigroup Index LLC

Data as of 10/14/2016.

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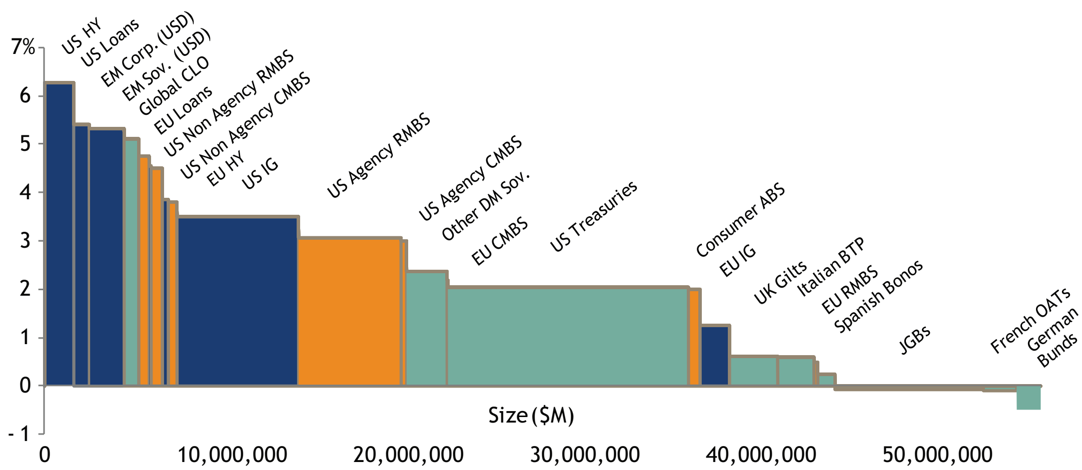

- In credit markets, the turn in commodities is positive. We believe the peak in defaults is behind us, now that energy and metals and mining companies have moved into credit repair. However, like the equity markets, credit investors may have overdone the reflation excitement.

- Generally speaking, we have a positive macro view for 2017 and then expect greater amplitude of the cycle as we move into 2018. We think by then, the rubber will hit the road. Trump's policies, in whatever form they take, will start impacting growth, inflation, earnings, and leverage. The Fed will take notice and likely ramp up efforts to manage the inflationary effects, and we will have a "normal" cyclical recovery on our hands. As we move through 2018, the risk of a policy error will rise, as we all know that expansions don't die of old age but are murdered in Washington.

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Disclosure

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