

The investment outlook for 2017

Economic warming and political warnings



IN BRIEF

- A trend toward stronger U.S. economic growth and inflation could be accelerated by President-elect Trump's fiscal plans. This, along with a warming in the global economy, is positive for global equities and negative for fixed income. However, growing global debt, the rise of political populism and geopolitical threats all still highlight the need for diversification.
- Interest rates should rise in 2017 but only at a modest pace due to sluggish global growth and very cautious global central banks. Investors may want to be long credit and short duration in their fixed income allocations.
- U.S. equities should continue to perform well in the year ahead, bolstered by stronger growth in GDP and earnings. While interest rate increases should not derail equity gains, they could define winners and losers in 2017 with cyclicals (such as financials and technology) outpacing defensives (such as utilities and REITs).
- Emerging market (EM) stocks and bonds are threatened by the potential for higher U.S. interest rates to produce a higher U.S. dollar. However, with attractive valuations relative to developed market (DM) assets and the return of a widening gap between EM and DM growth, EM assets clearly have an important role to play in producing long-term portfolio growth.

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LATE-CYCLE WARM UP

Entering 2017, the U.S. economy is in the eighth year of economic expansion, making it the fourth longest since 1900. However, so far economic growth has averaged just 2.1% per year, the slowest of all the post-World War II expansions. While economic growth has been mediocre, very weak gains in labor force and productivity have ensured that, even at this pace, it has steadily taken up the slack in the U.S. labor market, with the unemployment rate falling from a post-recession peak of 10.0% to 4.9% by October 2016. In short, this American economic expansion has been like a healthy tortoise, ambling slowly but steadily down the road.

There are signs the tortoise may pick up the pace in 2017, with the potential to boost corporate earnings and confidence but also raise inflation and interest rates. At the moment, this looks like a modest acceleration. However, clearly there are risks if demand growth far outstrips the growth in supply.

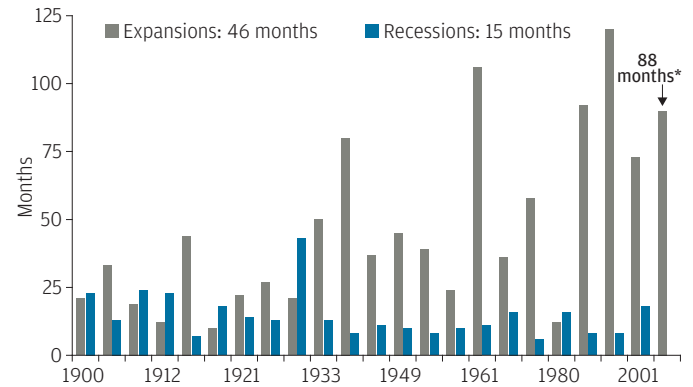
The first positive for growth is the fading of the drags that have slowed the U.S. economy for most of the past 18 months. Between the first quarter of 2015 and the second quarter of 2016, U.S. inventory growth fell from a big positive to a small negative, taking 0.6% out of the annualized GDP growth rate. Over the past two years, energy investment spending has also collapsed, taking an additional 0.3% out of GDP growth. However, entering 2017 both of these negatives appear to be behind us.

A second positive for growth comes from consumer financial conditions. Years of economic recovery have repaired household wealth, while very easy monetary policy has maintained the cost of servicing debt at record lows. This has allowed for solid growth in consumer credit and a continued recovery in the still suppressed housing market. Investment spending remains weak and international trade should continue to be a net drag on the U.S. economy because of a high dollar. However, the outlook for overall private sector growth appears solid, even without changes in fiscal policy.

Nevertheless, some changes in fiscal policy are now likely. Donald Trump has been elected U.S. president on a populist platform and Republicans also control both houses of Congress, making it much easier to pursue an agenda than was ever the case under President Obama. While Mr. Trump has taken many controversial policy positions, the ones that are most likely to affect the economy are those that intersect with the traditional instincts of the Republican Party.

The economic expansion has been slow but is now the fourth longest since 1900

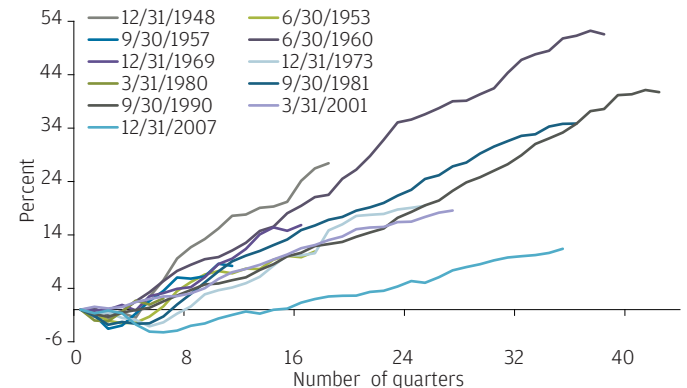
EXHIBIT 1A: AVERAGE LENGTH OF ECONOMIC EXPANSIONS AND RECESSIONS (MONTHS)



Source: BEA, NBER, J.P. Morgan Asset Management; data are as of October 31, 2016.

*Chart assumes current expansion started in July 2009 and continued through October 2016, lasting 88 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through October 2016.

EXHIBIT 1B: STRENGTH OF ECONOMIC EXPANSIONS—CUMULATIVE REAL GDP GROWTH SINCE PRIOR PEAK (%)



Source: BEA, NBER, J.P. Morgan Asset Management; data are as of October 31, 2016. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through October 2016.

We believe that the new administration may be a good deal less aggressive on trade issues, immigration and the Affordable Care Act than was suggested on the campaign trail. However, they may well go ahead with plans to boost infrastructure and defense spending and pass big tax cuts for both families and corporations. A crucial issue in any U.S. forecast is whether these fiscal measures are of the same scale as promised during the campaign. A big personal tax cut could further add to

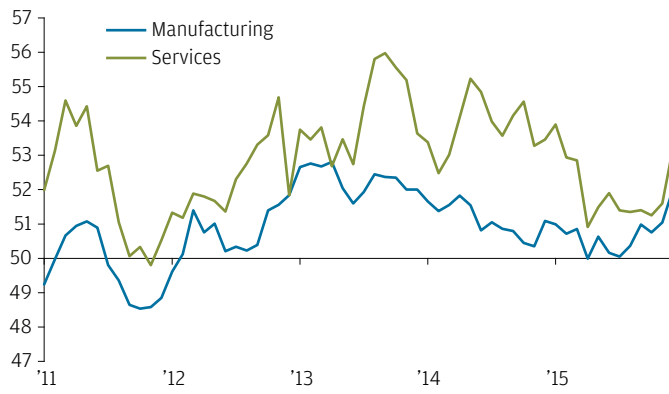
demand in the economy. Moreover, a big cut in corporate taxes could both boost demand for and the value of equities by increasing the after-tax value of corporate cash flows. Stronger investment spending and higher infrastructure spending could result in some productivity gains in a few years. However, in the meantime, it would be all demand and no supply, threatening to overheat an economy that is already warming up.

For the moment, we are assuming that Congress will pass some tax cuts and additional infrastructure and defense spending in 2017, further boosting an already growing budget deficit. However, we think this will probably amount to a “Trump-lite” plan, simply because of the remaining influence of fiscal conservatives.

Even with a watered-down version of Mr. Trump’s plans, the U.S. economy should see a pick-up in growth and inflation in 2017. Moreover, the global economy also appears to be strengthening, with global PMIs in October hitting their highest levels in two years. Despite the disruption of Brexit, Europe is continuing on a path of slow but steady growth and Japan is seeing at least stabilization. Meanwhile, China still seems willing to tolerate rapid credit growth in order to maintain a steady expansion. In other emerging markets, the commodity cycle has turned, providing some relief for economies that had been in deep recession, such as Brazil and Russia.

The global economy shows signs of acceleration in late 2016

EXHIBIT 2: GLOBAL PURCHASING MANAGERS’ INDICES FOR MANUFACTURING & SERVICES



Source: Markit, J.P. Morgan Asset Management; data are as of October 31, 2016. Data for length of economic expansions and purchasing managers’ indices are relative to the 50 level, which indicates acceleration or deceleration of the sector, for the time period shown.

Overall, this represents a warming up of the U.S. and global economies, which should be positive for equities and negative for fixed income. However, investors should also consider some key risks:

- First, after years of deflation worries, the U.S. could see a small burst of inflation due to inappropriately stimulative fiscal policy or increased monetary velocity.
- Alternatively, the U.S. dollar might appreciate too much in response to higher U.S. interest rates, squeezing U.S. exporters but also undermining a nascent EM recovery.
- Finally, the populist tide that led to Donald Trump’s election is a global phenomenon. Elections in 2017 in France, Germany and elsewhere have the potential to push key economies to adopt more nationalistic and less trade-friendly policies while also encouraging significant fiscal expansion in a world awash in government debt.

In short, the global economy is warming as we enter 2017, providing a positive impulse to equity markets. However, a populist tide and a transition from monetary to fiscal stimulus will require a very flexible and diversified approach to investing.

HEALTHY NORMALIZATION: WELCOMING RISING INFLATION AND RATES

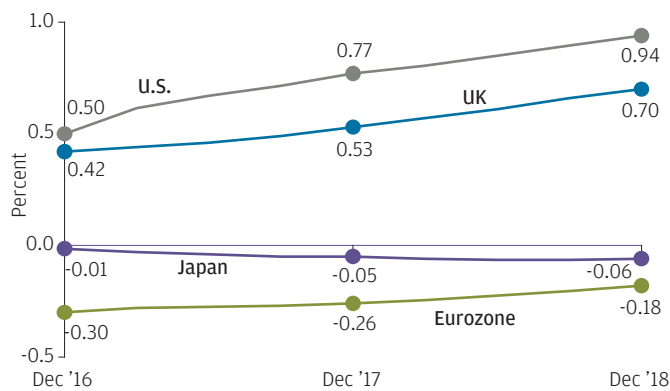
The period of extraordinary monetary policy intervention following the financial crisis has caused many economic indicators to move well beyond “normal” ranges. Interest rates are near all time lows, and inflation is subdued as a result of halved commodity prices, puzzlingly low wage inflation and sub-trend economic growth.

Next year may bring the end of global central bank easing and a healthy normalization in interest rates and inflation. A tight labor market and firming inflation in the U.S. should allow the Federal Reserve to continue to slowly raise rates. The Bank of Japan and the European Central Bank, which have both experimented with negative interest rate policies, may have reached the limits of monetary largesse. Both are aware of the damaging impact of negative interest rates on the banking sector. Japan, still facing low inflation and growth, has moved toward fiscal stimulus to spur economic activity. And the European Central Bank may be forced to move toward normalization as its quantitative easing program is plagued by low government bond liquidity and supply.

Policy rates for the U.S. and the UK are projected to rise gradually, while in Europe rates are expected to become less negative. The Bank of Japan has proven itself to be the boldest in pushing the boundaries of monetary policy. Although a recent pivot by the government toward fiscal policy and longer dated yield targeting implies the central bank may begin to step aside, the policy rate is expected to fall slightly deeper into negative territory.

Outside of Japan, global monetary policy is expected to tighten slowly in 2017

EXHIBIT 3: MARKET EXPECTATIONS FOR TARGET POLICY RATE*



Source: Bloomberg, J.P. Morgan Asset Management; data are as of October 31, 2016.

*Target policy rates for Japan are estimated using EuroYen 3m futures contracts less a risk premium of 6bps.

In short, global central banks are either acknowledging that they are out of monetary policy arrows or actually removing some of the measures they have used to pin interest rates to the floor. However, an aging demographic and weak productivity growth across the developed world have resulted in a lower growth, lower inflation environment, a reality that may limit the pace of global monetary tightening. Central banks will likely be on guard, raising rates slowly and steadily until they reach healthy and normal levels.

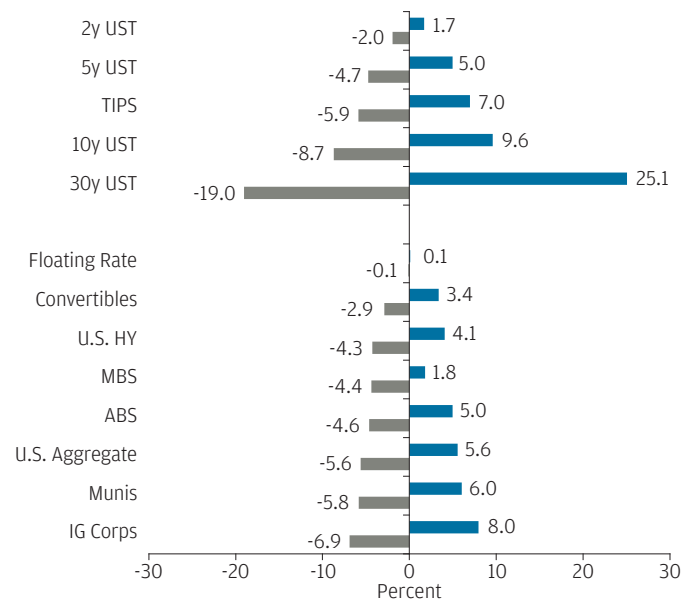
In the U.S. specifically, continued economic strength should cause inflation and interest rates to rise in 2017. However, still slow growth overseas, even lower policy rates in other developed markets and a recently higher dollar should all act as something of a yield-curve anchor, capping the potential pace of rate increases. Moreover, eventual equilibrium rate levels are also likely to move lower given a slower long-term pace of nominal GDP growth.

The trump card

A further consideration for the inflation and interest rate outlook in the U.S. involves the outcome of the presidential election. While it may be too early to tell, proposed plans by President-elect Donald Trump include significant fiscal stimulus and other pro-growth policies that complicate our outlook. Inflationary forces could build in an already warming economy as a result of large amounts of fiscal stimulus, which would in turn push rates higher quicker and put pressure on the Federal Reserve to move more aggressively to hike rates. In the weeks following the election, the expectation of higher inflationary pressure jolted global rates higher, pushing the 10-year U.S. Treasury well above 2.0% for the first time since January 2016. However, whether inflation truly materializes will depend on whether Donald Trump can push his agenda through Congress or whether gridlock is still the status quo in Washington.

As long-term rates rise in an improving economy, credit is more attractive than duration

EXHIBIT 4: PRICE IMPACT OF A 1% RISE/FALL IN INTEREST RATES*



Source: Barclays, U.S. Treasury, FactSet, J.P. Morgan Asset Management; data are as of October 31, 2016. Chart is for illustrative purposes only.

Sectors shown above are provided by Barclays and are represented by - Broad Market: U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; Corporate: U.S. Corporates; Municipals: Muni Bond 10-year; High Yield: Corporate High Yield; TIPS: Treasury Inflation Protection Securities (TIPS); Floating Rate: FRN (BBB); Convertibles: U.S. Convertibles Composite; ABS: ABS + CMBS. Change in bond price is calculated using both duration and convexity according to the following formula: $\text{New Price} = (\text{Price} + (\text{Price} * \text{Duration} * \text{Change in Interest Rates})) + (0.5 * \text{Price} * \text{Convexity} * (\text{Change in Interest Rates})^2)$.

*Calculation assumes 2-year Treasury interest rate falls 0.86% to 0.00%.

Fixed income investing in 2017: Creativity and nimbleness are key

Modest rate increases in 2017 should generally be seen as a positive for financial markets, indicating both stronger economies and more confident central banks. However, they also make for a more challenging environment for fixed income investing.

Traditional core fixed income can continue to act as a buffer against volatility in a broadly diversified portfolio. Incorporating fixed income that can protect the value of a portfolio when economic growth falters is key. High-quality, core fixed income is an especially important asset class given that we are in the later stages of the U.S. expansion.

While the prospect of rising rates is a positive sign from an economic perspective, it also signals that investors should diversify fixed income exposure within their portfolios to include less rate-sensitive sectors such as high yield, which should benefit from more stability in the energy sector and stronger economic growth elsewhere. Conversely, investors should be a little more cautious about high-quality, long-duration munis, as a combination of fiscal expansion and lower marginal tax rates would clearly threaten the tax-free sector.

This rate hike cycle will be more difficult than the last. Rates are rising from extraordinarily low levels and fixed income investors will not have the buffer of juicy yields that they enjoyed in past cycles to protect against capital depreciation as rising rates lead to falling bond prices. This means that a creative and nimble approach to fixed income investing will be crucial moving forward.

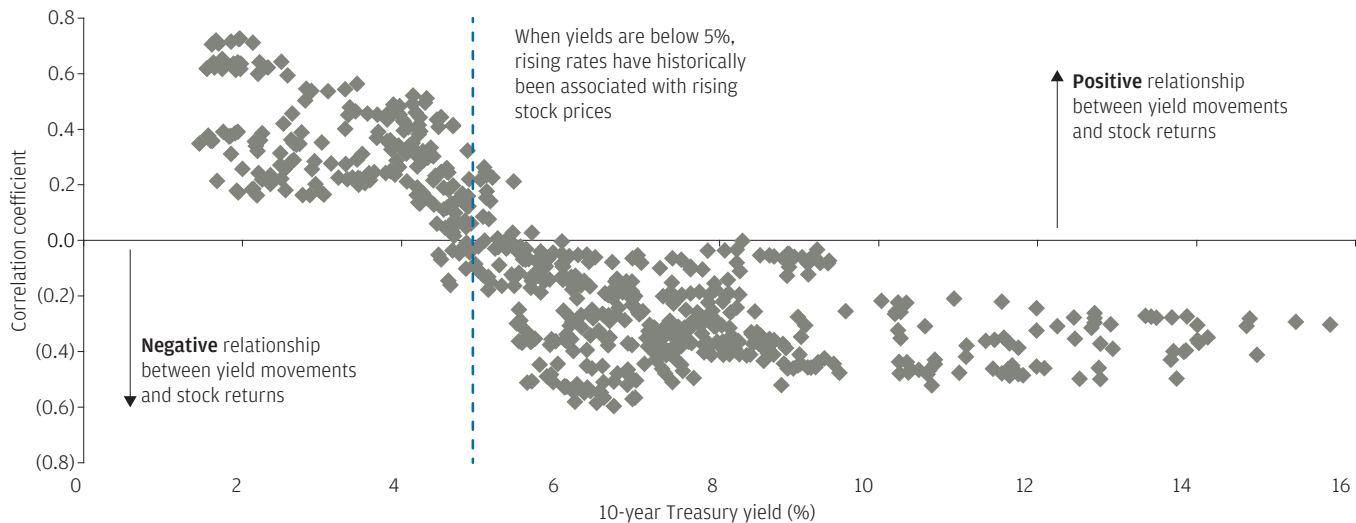
LOOKING BENEATH THE SURFACE: U.S. EQUITIES IN 2017

An upside to growth

2016 was a year of surprises, with some of the most unexpected developments occurring in political arenas rather than economic ones. However, one constant this past year has been a steady drumbeat calling for fiscal policy to play a larger role in stimulating growth, as many investors believe that monetary policy has reached its effective limits. Although it is unlikely that the abundant liquidity provided by central bankers will completely disappear any time soon, the 2016 U.S. presidential election may represent a first step toward a greater focus on fiscal expansion.

Modest increases in interest rates from very low levels shouldn't hurt the stock market

EXHIBIT 5: CORRELATIONS BETWEEN WEEKLY S&P 500 RETURNS, 10-YEAR TREASURY YIELD, ROLLING 2-YEAR CORRELATION, MAY 1963–OCTOBER 2016



Source: FactSet, Standard & Poor's, FRB, J.P. Morgan Asset Management; data are as of October 31, 2016. Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only.

This potential for looser and more proactive fiscal policy has created an upside risk to U.S. economic growth. If stronger growth does materialize, it should be accompanied by rising inflation and higher interest rates, a dynamic that some believe will be a headwind for equity markets in 2017. However, Exhibit 5 depicts the positive correlation between changes in interest rates and changes in equity prices when the 10-year U.S. Treasury yield starts below 5%. Thus, the level from which rates rise is key when it comes to determining any impact on returns. The reason for this is that when rates are low and rising, higher rates tend to reflect an improving growth outlook; in other words, when rates are rising for the “right” reasons, the stock market tends to be okay.

Follow the earnings

While in the near term the equity market may be supported by the factors highlighted above, in the long run stock prices follow earnings. Following an eight-year period where ample liquidity provided a backstop against which equity markets could appreciate, the question now facing equity investors is whether the stock market will successfully transition from being driven by easy money to being driven by more fundamental factors such as earnings growth.

Luckily, the recent U.S. profits recession has finally come to an end, as S&P 500 operating earnings per share rose over 10% in the third quarter from a year prior. This renewed profitability should provide support for equity markets going forward. Although rising wages and higher interest rates both pose a risk to margins, if these developments are accompanied by stronger nominal growth, it seems reasonable to expect stronger revenues to offset any decline in margins and provide support for earnings.

While we expect that earnings growth will be positive next year, we also expect that it will slow to a more sustainable pace. Current analyst estimates are for earnings to rise by 20% in 2017, which feels a bit too optimistic given where we are in the business cycle. That said, the outlook for earnings growth in certain sectors is quite bright, and it is our view that investors should take an active approach and position themselves to take advantage of these earnings trends next year.

Technology continues to look attractive from a fundamental standpoint, as the sector has higher margins than any of the other major stock market sectors (excluding real estate) and revenue growth projections are robust. Taken together, these

dynamics suggest that earnings growth should be solid in the coming year, with Standard & Poor’s currently expecting technology sector earnings to grow by 25% in 2017.

Additionally, potential policy changes stemming from the election have implications for earnings across a number of sectors. For example, higher interest rates should boost financial sector earnings, a dynamic that has recently been reflected in the out-performance of financial shares relative to the broader market. If an increase in infrastructure spending does come to pass, there likely will be upside for the earnings of both material and industrial companies, which coupled with easy year-over-year comparisons, could lead 2017 earnings growth in these sectors to be more robust than expected. Turning to health care, the headline risk that has weighed on the sector seems to be fading in the wake of the election result, which, coupled with the prospect of less regulation, could provide a lift to the sector’s profitability. However, the outlook for earnings in more defensive parts of the market, such as telecom and utilities, is not as bright, particularly when compared to some of the opportunities discussed above. This suggests that investors should follow the earnings, with a preference for cyclical sectors.

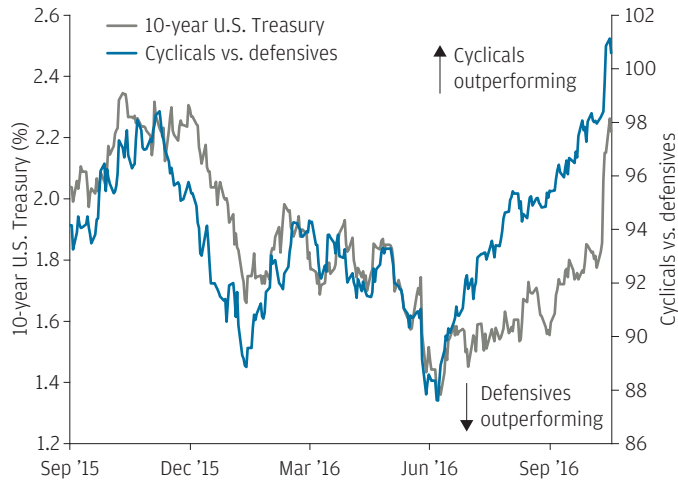
A more nuanced approach to equity investing

The post-election run has favored the more cyclical parts of the stock market, and led these sectors to look a bit rich compared to defensive ones from a relative valuation standpoint. However, our expectation is that an uptick in both growth and inflation will continue to put upward pressure on interest rates; as shown in Exhibit 6, rising rates are a headwind for defensive equities.

In sum, we are cautiously optimistic heading into 2017, and believe that the stock market will successfully transition to an earnings-driven regime. The result of the election suggests that we may be in store for a combination of stronger growth and inflation next year, something that would manifest itself in the form of higher interest rates and stronger earnings growth. We do not believe that a gradual rise in rates will create a major headwind for the U.S. equity market, but do believe that investors would be wise to focus on the sectors that could benefit from the growth, inflation and interest rate environment that we expect will occur next year. This suggests the small valuation premium that the cyclical sectors currently command may be worth paying, as portfolios that embrace a combination of better earnings growth and less interest rate sensitivity should generate decent returns in 2017.

Cyclicals should outpace defensives in a rising rate environment

EXHIBIT 6: CYCICALS/DEFENSIVES RELATIVE PERFORMANCE AND RATES*, 10-YEAR U.S. TREASURY YIELD



Source: FactSet, MSCI, J.P. Morgan Asset Management; data are as of October 31, 2016.

*Cyclicals represent the MSCI USA Cyclical Sector index and defensives represent the MSCI USA Defensive Sector index.

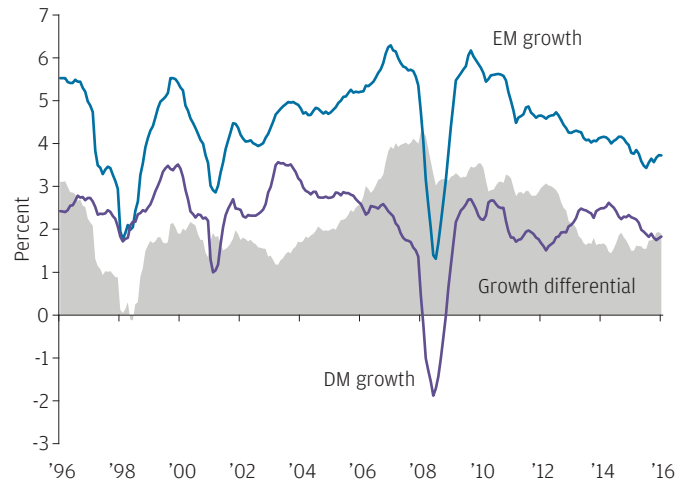
THE RETURN OF THE EM GROWTH ALPHA

Emerging markets, will almost always grow faster than developed markets due to a lower starting level of productivity and generally more favorable labor supply growth; however, the crucial question for investors is “how much faster?” Since the peak of the commodity supercycle a few years ago, the gap between EM and DM economic growth has been steadily shrinking, narrowing from a high after the financial crisis of 3.5% to just 1.4% in 2015. DM growth has struggled to gain traction post-Global Financial Crisis, but EM growth has slowed down even more. This has been caused by the slow-down and rebalancing of China’s economy, the accompanying fall in commodity prices (further exacerbated by oil’s collapse beginning in 2014) and low global trade volumes. As a result, EM economic growth has struggled to reaccelerate, with some commodity exporters (such as Brazil and Russia) even falling into deep recessions over the past couple of years.

The good news is that, so far in 2016, consensus expectations have been consistently pointing to an improvement in the EM growth alpha over the next 12 months, for the first time in

EM growth should accelerate relative to DM in 2017

EXHIBIT 7: EM VS. DM GROWTH—MONTHLY, CONSENSUS EXPECTATIONS FOR GDP GROWTH IN 12 MONTHS



Source: FactSet, MSCI, Consensus Economics, J.P. Morgan Asset Management; data are as of November 15, 2016.

“Growth differential” is consensus estimates for EM growth in the next 12 months minus consensus estimates for DM growth in the next 12 months, provided by Consensus Economics.

almost six years. This is a trend we expect to continue picking up steam in 2017. This return of the EM growth alpha has come from a fall in expectations of DM growth rates, as well as most recently from an expected pick-up in EM growth itself.

The improvement in the EM growth outlook is justified by the stabilization in several external variables that had been relentless headwinds to EM growth over the past few years. These include less appreciation of the U.S. dollar versus EM currencies, commodity prices coming off their lows of the past few years and the diminished risk of a Chinese “hard landing.” In addition, it is reasonable to expect that Brazil and Russia will be able to exit their respective recessions over the next couple of quarters, as leading indicators, such as the purchasing managers’ indices, have been improving from low levels.

After years of painful adjustments to a new world of lower commodity prices and a services-led Chinese economy, we expect that the worst is likely over for EM growth relative to DM growth.

Mind the gap

The EM growth alpha has historically been closely related to the performance of EM assets relative to DM assets, as a higher EM growth alpha signals a better outlook for EM equity and fixed income fundamentals and encourages inflows into the asset class.

EM equities, measured by the price-to-book measure, have been one of the only truly “cheap” asset classes for the past few years. However, these cheap valuations alone were not enough to allow EM equities to rebound on a sustainable basis. We needed to see a catalyst in the form of positive momentum of EM economic and earnings growth. The expected EM economic growth pick-up and the accompanying positive turn in EM earnings expectations suggest that the rebound in EM equities still has further room to run. In addition, investors should remember that a widening of the EM growth alpha has historically meant EM equities will continue outperforming DM equities.

For EM fixed income, the pick-up in EM growth also helps to encourage demand for the asset class, as it signals that fundamentals for EM countries and companies are improving. As a result, EM debt’s strong run in 2016 was not based purely on a blind search for yield from DM investors, but also had support from an improving outlook.

Stronger EM economic growth should allow EM stocks to outperform DM over the next few years

EXHIBIT 8: EM VS. DM GROWTH AND EQUITY PERFORMANCE—MONTHLY, CONSENSUS EXPECTATIONS FOR GDP GROWTH IN 12 MONTHS



Source: FactSet, MSCI, Consensus Economics, J.P. Morgan Asset Management; data are as of November 15, 2016.

“EM-DM GDP Growth” is consensus estimates for EM growth in the next 12 months minus consensus estimates for DM growth in the next 12 months, provided by Consensus Economics. “MSCI EM / MSCI DM” is the USD MSCI Emerging Markets Index price level over the USD MSCI The World Index price level, rebased to 1996 = 100.

As always, investors should remember that the term “emerging markets” encompasses a multitude of countries and dynamics. Active management will be key in differentiating between sustainable and temporary improvements.

Potential roadblocks to recovery

EM assets have suffered in the wake of the Trump presidential victory and the Republican sweep of Congress, raising the question of whether the nascent recovery in the EM growth alpha can be derailed by U.S. policy in 2017. Investors should remember that there is still much uncertainty around Mr. Trump’s policies over the next four years, and the impact on emerging markets will depend on the policy mix that is ultimately implemented. A focus on the pro-growth only aspects of the agenda, such as fiscal expansion and deregulation, can help improve U.S. growth, with positive implications for global growth as a whole, including for emerging markets. However, a policy mix that also involves very restrictive trade and immigration policies could have negative direct and indirect effects on EM growth, especially those countries with closer ties to the U.S.

The impact on emerging markets will also depend on the extent to which pro-growth measures are implemented in practice. A substantial tax and infrastructure program could justify the increase in U.S. growth, inflation and interest rate expectations, and thus the related increase in U.S. yields and the U.S. dollar. This would make the external environment a bit more challenging for emerging markets once again compared to before the U.S. election. This would increase the burden of proof for EM countries to deliver on promised reforms and higher economic and earnings growth. As a result, investors will need to be selective when investing in EM equities and debt in 2017, as the tide may no longer lift all boats equally.

A lot is still uncertain, thus volatility is likely to remain more elevated for EM assets in 2017; however, investors should be wary of overreacting before getting more clarity on U.S. policy.

CONCLUSION

The global economy appears to be strengthening as it enters 2017. In the United States, the strong headwinds of falling inventory growth and energy investment spending have turned into mild tailwinds. Europe is continuing on a path of slow but steady growth, and Japan is seeing at least stabilization. Meanwhile, China still seems willing to tolerate rapid credit growth in order to maintain a steady expansion. In other emerging markets, the commodity cycle has turned, providing some relief for economies that had been in deep recession, such as Brazil and Russia.

A better global economic climate has not yet triggered significant normalization moves from developed country central banks, while EM monetary authorities have been able to provide some interest rate relief as sharp declines in EM currencies, with their attendant inflation risks, have abated. On balance, labor markets continue to tighten, inflation remains low and earnings are improving.

However, while the global economic environment is warming, threats to continued growth are becoming clear. One risk is in the rise of an anti-trade populism across the developed world given Britain's decision to pull out of the European Union and Donald Trump's election as U.S. president on an anti-trade

platform. While it is not clear, in either case, how trade arrangements may ultimately be altered, higher tariffs in general would hurt global economic growth and could boost inflation. Moreover, with important European elections to be held in the next year, the possibility of a further radicalization of developed country politics remains a serious threat to the global economy.

Another risk centers around the growth of both government and private-sector debt, as borrowers have taken advantage of very easy monetary policy from DM central banks. A maintenance of this policy could threaten the world with higher inflation. A sudden reversal of it could lead to a sharp drop in asset prices.

Still, the most important aspect of the global financial environment entering 2017 is the same as in 2016. Short-term interest rates remain extremely low given the relative health of both the U.S. and global economies. 2017 should be a year of global economic warming but also one of growing risks. However, with cash paying less than nothing in real terms in most of the world, investors should still be overweight long-term assets, with a tilt toward those that should do best in a world with somewhat stronger growth, higher inflation and higher interest rates.

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