

### 2017 Global Preview

Calendar year 2016 saw equities climb a wall of worry on the back of improving economic data. There were three major drawdowns during the year and all three were tied to political events. First, China’s attempts to devalue their currency did not sit well with markets, especially after the surprise devaluation in August of 2015. The combination of deteriorating economic data and plunging oil prices caused markets to sell off. Then in May markets began pricing in the possibility of Brexit and then rebounded, only to collapse when Brexit did, in fact, materialize. Finally, in October markets began to price in the possibility of a Democratic sweep of all three governing bodies (status quo, low growth) before the FBI email investigation returned and injected additional uncertainty into the outcome. After the election, markets rallied as investors rapidly priced in the positives (tax cuts and reforms, deregulation, fiscal stimulus) from a Republican sweep of the Senate, House and Presidency. However, 2017 has gotten off to a choppy start as investors begin to handicap the odds (delays, obstruction, legal challenges, pragmatism) of some of the positives and begin considering the downside of some of the more extreme policy proposals (Border Adjustment Tax, protectionism, interest deductibility).



**Dennis Mitchell**

Senior Vice-President,  
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**FIGURE 1: ANNOTATED CHART OF THE S&P 500 INDEX IN 2016**



Source: Bloomberg, Merrill Lynch US Equity & US Quant Strategy.

We believe that 2017 will be fundamentally driven by a continued recovery in corporate earnings, balanced against the gradual tightening of financial conditions (Fed rate hikes, ECB tapering, rates and inflation rising). The tightening of financial conditions should make it difficult for market multiples to expand further so companies trading at a discounted multiples with good organic growth should be the stars this year. The greatest risks remain political, with the commencement of Brexit negotiations and major elections in the Netherlands, France and Germany combined with the mercurial nature of the new US President.

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## Global GDP Growth

The outlook for global growth has materially improved with the US powering upward revisions (Figure 2). This is partially offset by anticipated weakness in some nations (UK, Mexico, Saudi Arabia, Italy) but overall the outlook has improved. We have to reiterate once again that economies respond to stimulus, both monetary and fiscal. For the last eight years, the US economy has limped along with increasingly ineffective monetary policy providing the stimulus. With the Republican sweep, the stage is finally set for fiscal stimulus to drive economic growth in the US and abroad.

**FIGURE 2**

OECD GLOBAL GDP FORECASTS				
COUNTRY/REGION	2015	2016F	2017F	2018F
<b>WORLD</b>	<b>3.1%</b>	<b>2.9%</b>	<b>3.3%</b>	<b>3.6%</b>
UNITED STATES	2.6%	1.5%	2.3%	3.0%
CANADA	1.1%	1.2%	2.1%	2.3%
EURO AREA	1.5%	1.7%	1.6%	1.7%
UNITED KINGDOM	2.2%	2.0%	1.2%	1.0%
JAPAN	0.6%	0.8%	1.0%	0.8%
CHINA	6.9%	6.7%	6.4%	6.1%
INDIA	7.6%	7.4%	7.6%	7.7%
RUSSIA	-3.7%	-0.8%	0.8%	1.0%
BRAZIL	-3.9%	-3.4%	0.0%	1.2%

Source: OECD, November 2016.

IMF GLOBAL GDP FORECASTS				
COUNTRY/REGION	2015	2016F	2017F	2018F
<b>WORLD</b>	<b>3.2%</b>	<b>3.1%</b>	<b>3.4%</b>	<b>3.6%</b>
UNITED STATES	2.6%	1.6%	2.3%	2.5%
CANADA	0.9%	1.3%	1.9%	2.0%
EURO AREA	2.0%	1.7%	1.6%	1.6%
UNITED KINGDOM	2.2%	2.0%	1.5%	1.4%
JAPAN	1.2%	0.9%	0.8%	0.5%
CHINA	6.9%	6.7%	6.5%	6.0%
INDIA	7.6%	6.6%	7.2%	7.7%
RUSSIA	-3.7%	-0.6%	1.1%	1.2%
BRAZIL	-3.8%	-3.5%	0.2%	1.5%

Source: IMF, January 2017.

However, the story out of the US is not all positive. The proposed Border Adjustment Tax would create a class of losing US companies (primarily in Discretionary and Staples, but also Technology, Healthcare and possibly Energy) that will see their business models severely impaired by the new tax regime. An estimated 75% of the US workforce would be impacted, including those at Wal-Mart, the United States' largest private employer. The elimination of interest deductibility would raise the long term cost of capital for every business and make the business models of some (REITs, MLPs) dramatically less appealing. However, in order to push through large tax cuts, the GOP must deliver a plan that is deficit neutral for 10 years, or face filibuster and defeat. So while we are encouraged by the prospect of some fiscal stimulus in late 2017 or early 2018, to the extent that the market has already priced this in, there is downside risk.

### Purchasing Manager Indices

The global Purchasing Manager Index Composite ("PMI") was 53.9 in January, firmly in expansion territory (Figure 3). Manufacturing and Services were balanced at 52.7 and 53.9 respectively. The 13 month trend in PMIs is very robust and indicative of sustained growth in economic output. Regionally, the US has assumed global leadership with Russia particularly strong on the back of rising oil prices and the recovery from a recession. Should the US trigger the removal of UN sanctions on Russia then this recovery would accelerate further. Europe is also very strong as UK PMIs show no indication of downside from Brexit and even France has recovered nicely. The only concerns would appear to be the continued malaise in Brazil, the deterioration of Indian PMIs, and the continued reliance by China on credit expansion to drive GDP growth. So while the stage appears set for continued robust growth in global economic output, we would point out that when global GDP growth is driven by developed markets it tends to be less robust than when it is lead by emerging markets.

**FIGURE 3**

GLOBAL JANUARY PURCHASING MANAGER INDICES					
MARKET	MANUFACTURING	SERVICES	MARKET	MANUFACTURING	SERVICES
<b>GLOBAL</b>	<b>52.7</b>	<b>53.9</b>	EUROZONE	55.2	53.7
UNITED STATES	56.0	56.5	UNITED KINGDOM	55.9	54.5
JAPAN	52.7	51.9	GERMANY	56.4	53.4
CHINA	51.3	54.6	FRANCE	53.6	54.1
BRAZIL	44.0	45.1	ITALY	53.0	52.4
INDIA	50.4	48.7	SPAIN	55.6	54.2
RUSSIA	54.7	58.4	IRELAND	55.5	61.0

Source: Trend Macrolytics, Markit Economic Research.

### PMI

The magic number for the PMI is 50. A reading of 50 or higher generally indicates that the industry is expanding. If manufacturing is expanding, the general economy should be doing likewise. As such, it is considered a good indicator of future GDP levels.

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## Global Equity Valuations

Global equities appear priced to deliver mid- to high-teens total returns in 2017 (Figure 4). A global dividend yield of 2.6% with a payout ratio of 62% provides ample cushion against a sustained rise in long bond yields. This is before factoring in stock buybacks which should continue, if at a reduced pace. The earnings multiple is right at its five year average, implying upside potential should robust earnings growth materialize, or downside potential should the political environment turn sour. Finally, at 16.5%, the earnings growth forecast is particularly strong. However, this is biased upwards by the anticipated strong recovery in earnings for the Financials and Energy sectors. Excluding the rebound in these two sectors, global earnings growth is closer to 10%. So putting all three components (yield, multiple and growth) together, global equities are poised to deliver mid- to high-teens total returns in 2017.

**FIGURE 4**

2017 GLOBAL EQUITY MARKET FUNDAMENTALS						
MARKET	FORWARD P/E MULTIPLE ESTIMATE			EARNINGS GROWTH	DIVIDEND YIELD	10 YEAR BOND YIELD
	CURRENT	3 YEAR AVG	5 YEAR AVG			
<b>MSCI WORLD</b>	<b>16.7x</b>	<b>17.8x</b>	<b>16.8x</b>	<b>16.5%</b>	<b>2.6%</b>	<b>0.9%</b>
S&P 500	17.7x	18.7x	17.5x	14.7%	2.1%	2.4%
FTSE 100	14.8x	21.6x	18.6x	85.0%	4.2%	1.3%
SHANGHAI	13.5x	15.3x	13.4x	17.0%	2.0%	3.4%
NIKKEI 225	18.1x	19.6x	19.2x	14.1%	1.7%	0.8%
S&P/TSX	16.8x	17.3x	16.7x	16.7%	2.8%	1.7%
EUROSTOXX 600	15.1x	18.6x	17.0x	26.9%	3.8%	0.7%

Source: Bloomberg. Note: Global bond yield is the Global Developed Sovereign Bond Index, Eurozone bond yield is EFSF yield.

At 17.7x 2017 EPS estimates, the S&P 500 is trading at its five year average. This multiple is supported by robust earnings growth estimates but at a time when long bond yields and inflation expectations are both rising. Investors have flocked to US equities in anticipation of fiscal stimulus and deregulation, making US equities a crowded trade. Long bond yields have risen above dividend yields and a cut in personal income tax rates would further erode the income thesis for US equities. Finally, US equities are further along in the recovery phase (balance sheets, capital levels, utilization rates, unemployment levels, margins) than most of their global counterparts and this is reflected in the earnings growth forecasts.

At 15.1x 2017 EPS estimates, the EuroStoxx 600 Index is trading below its five year average. Part of this is base effect as European equities have struggled to generate earnings growth despite lofty expectations to start the last three years. 2017 begins with even loftier earnings growth expectations, buoyed by the anticipated recovery in the earnings of Financials and Energy companies. Against this is the rising political risk tied to the commencement of Brexit negotiations and elections in the Netherlands, France and Germany, all core European Union members. In addition, the European Central Bank has commenced tapering and should cease QE at the end of the year. Dividend yields and payout remain very attractive and should continue to enjoy an advantage over long bonds for the duration of the year.

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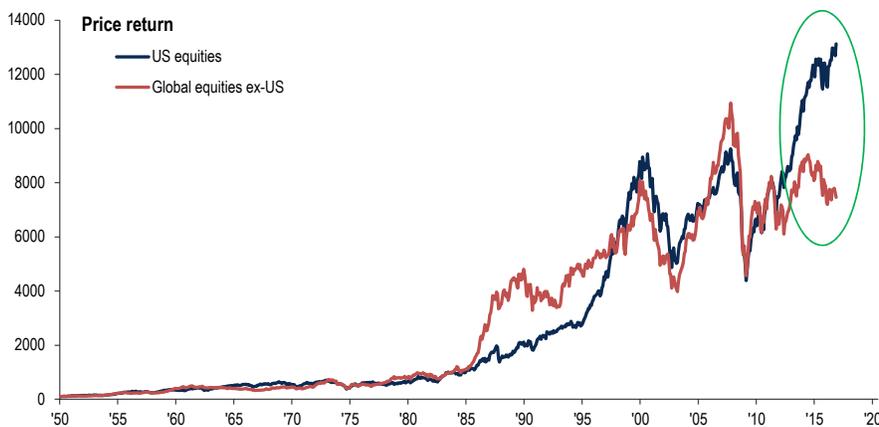
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The FTSE 100 Index is trading at 14.8x 2017 EPS estimates, which is well below its five year average. The rate of earnings growth forecast in the market is enormous due to a collapse in earnings expectations after Brexit (lowering 2016 estimates) and bullish revisions for 2017 on the back of Pound devaluation, cyclical recoveries in Energy and Financials, and the expectation for a soft Brexit. Going back to 2015, the anticipated two year earnings growth rate forecast is closer to 21%. Dividend yields and payouts continue to be very supportive of valuations and continued capital allocation to UK equities however, the tone of Brexit negotiations will certainly impact UK equities during the year.

## Portfolio Positioning

Our portfolios remain invested in companies domiciled in the US and Europe, however, post-Brexit and the US election, our allocation to the US increased at the expense of our allocation to Europe. Going forward, valuations and relative earnings growth rates make European and UK companies look relatively more attractive. Volatility around the three major elections (the Netherlands in March, France in April and May and Germany in September) and the commencement of Brexit negotiations (no later than March 30<sup>th</sup>) should provide good entry points for allocating capital into European equities.

**FIGURE 5: US VS. GLOBAL EX-US EQUITIES**



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg.

While US equities are a crowded trade we feel investors will be rewarded for allocating capital to this market. For better or worse, Republicans have so far stuck to their election agenda (deregulation, tax reform and cuts, immigration, Supreme Court, defense spending, jobs) so there is no reason to doubt that the promised fiscal stimulus (tax cuts, infrastructure and defense spending) will not materialize. The key will be how much and when and determining whether US equities have already priced this in. However, we feel strongly that 2017 will see Value outperform Growth, after trailing for six years.

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**FIGURE 6: GLOBAL "VALUE" PLAYS VS. US "GROWTH" PLAYS**



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, MSCI. Note: US "growth sectors" = US staples, discretionary, tech & healthcare; Global "value plays" = global banks & energy.

We anticipate more volatility-inducing events this year (elections, Fed rate hikes, Brexit) with less absolute impact on the markets. Accordingly, our approach will be to utilize this volatility to add to or initiate new positions, rather than attempting to anticipate the outcome of these events. We have been maintaining high single digit/low double digit levels of cash for several months now and that will remain the case for much of 2017. In an increasingly uncertain world, the optionality of cash remains attractive to us, both as a brake and a potential accelerator.

Thanks and **stay focused**,

**Dennis Mitchell**  
Senior Vice-President,  
Senior Portfolio Manager

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