Lazard Insights

Global Outlook 2018

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Summary

- In the United States, we expect the ongoing recovery to last an additional three-to-five years, assuming that there are no exogenous shocks or abrupt policy shifts.
- We expect the euro zone to sustain growth through 2018 on the back of the ongoing recovery in consumer and business spending.
- China appears poised to deliver another year of world-beating real GDP growth in 2018, but we remain concerned about the country's increasing dependence on leverage to drive this growth as its historical competitive advantages have eroded.
- Japan is back on our agenda, amid its longest consecutive growth streak since the crisis. We expect continuing real GDP growth to drive core inflation higher, to about 1%.
- We are more optimistic than we were last year about the global economy and our confidence in the global recovery has strengthened.

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Year in Review 2017

Our *2017 Global Outlook* was generally optimistic about the US economy, with some reservations about how government policy might change under the new Trump administration. In the euro area, we saw positive economic signals, but were concerned that the busy political calendar could disrupt the region's momentum. We expected China to continue its efforts to manage capital flows and stabilize its currency against the backdrop of decelerating growth. Overall, we highlighted the positive environment for financial assets, all of which were expensive relative to history.

As we reflect on 2017 and look forward to 2018, it is worth noting that our outlook has not materially changed. In 2018, we continue to have a positive outlook for the United States, euro zone, China, and Japan. The primary differences relate to monetary policy and politics. Specifically, the risks related to monetary policy decisions by major global central banks have increased as the Federal Reserve continues to normalize its policy, the European Central Bank (ECB) tapers its balance sheet expansion, the People's Bank of China (PBoC) adjusts policy around the margins to manage system-wide leverage, and the Bank of Japan (BoJ) contemplates the reaction function that is most appropriate against this backdrop of change. Notably, with the exception of the ECB, these decisions will come during times of possible leadership change: PBoC Governor Zhou Xiaochuan is expected to retire in the first quarter of 2018, Jerome Powell has been nominated to replace Fed Chair Janet Yellen before her term ends on 3 February 2018, and BoJ Governor Haruhiko Kuroda's term ends on 8 April 2018.

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From a political standpoint, we believe there is ongoing policy uncertainty in the United States where the promise of tax reform could be on the horizon but protectionist sentiment still looms. In Europe, near-term political risk has declined but the Italian elections, separatism in Catalonia, and the Brexit process remain concerns. In China, investors question whether a second term for President Xi Jinping will differ from the first, and in Japan, Prime Minister Shinzo Abe's new term is likely to feature cosmetic constitutional change first, followed by more substantial changes thereafter. We recognize that financial assets, particularly equities, have delivered very strong returns in 2017 and now trade at even higher historical premiums relative to a year ago. In spite of elevated valuations, we continue to see upside in 2018, as earnings growth has accelerated globally and as fixed income assets continue to appear even more expensive than equities.

United States: Middle Class Momentum

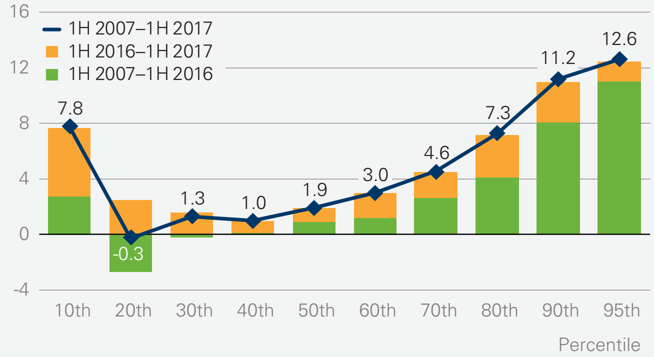
Our most out-of-consensus view is that the US recovery can be sustained for an additional three-to-five years from an already extended 8-year expansion. Evidence continues to accumulate supporting our middle class consumer recovery thesis. Wage gains have broadened across the entire income spectrum and stronger income growth has sustained the ongoing recovery in home prices that dominate the typical middle class balance sheet. At the same time, financial markets have delivered yet another stellar year for the typical wealthy investor who has the means to invest in equities, debt, and private businesses. We expect this economic momentum to be sustained assuming that there are no exogenous shocks or abrupt policy shifts.

The Middle Class Consumer Recovery: Last year we indicated that President-elect Trump was inheriting a solid economic situation, but that the election had introduced significant policy uncertainty. From an economic perspective, the data has reaffirmed our view that the United States entered the third leg of the recovery in 2015. The first leg, from 2009 to 2011, featured Quantitative Easing (QE), fiscal stimulus, and bank recapitalization. In the second leg, from 2012 to 2014, QE, corporate profit growth, and wealth effects drove growth. In the third leg of growth, we expect middle class consumers to lead the charge on the back of stronger wage growth and house price increases.

In 2017, wage gains broadened across the entire income spectrum in the United States as employers increased wages to attract qualified candidates (Exhibit 1). This wage growth combined with rising employment could contribute to already positive developments for middle class household income. In 2016, the median level of household income (net of inflation) rose by an additional 3.2%, following an increase of 5.2% in 2015, which was the largest since the Job Opening and Labor Turnover Survey began in the 1960s (Exhibit 2). In the United States, 4.0% of all jobs are unfilled, meaning 6.1 million jobs are vacant.[1] In light of the tight labor market and this record level of unfilled jobs, we expect wage growth to grind higher through 2018 with positive implications for consumer confidence and spending.

Exhibit 1
Wage Gains Have Broadened in the Last Year

Cumulative Change in Real Hourly Wages (%)



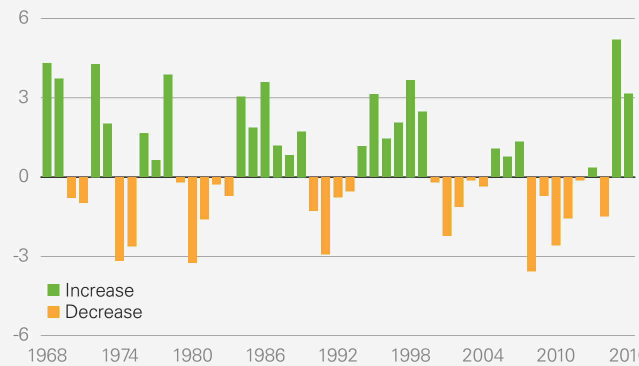
As of 30 June 2017

Sample based on all workers aged 18–64. The xth-percentile wage is the wage at which x% of wage earners earn less and (100 - x)% earn more. EPI analysis of Current Population Survey Outgoing Rotation Group microdata. Hourly wages are analyzed as annual averages.

Source: Economic Policy Institute, "The State of American Wages"

Exhibit 2
2015–2016 Was the Largest Two-Year Increase in Real Median Household Income since 1967

Median Inflation-Adjusted Household Income (% Change)



As of 30 September 2017

Percentage change is not statistically significant in 1970, 1979, 1982, 1983, 1992, 1993, 2000, 2003, 2004, 2009, 2012, 2013, and 2014. Income in 2016 CPI-U-RS adjusted dollars. Comparisons from 2012 to 2013 and prior are calculated based on income questions in the traditional survey. Comparisons from 2013 to 2014 and onward are based on income questions in the redesigned survey.

Source: Census Bureau, Haver Analytics

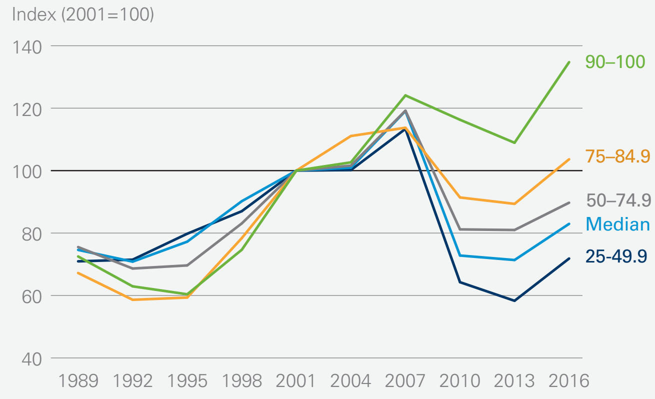
Wealth Increases: Another focal point for us in 2017 was the release of the 2016 Survey of Consumer Finance (SCF), a survey of over 6,000 households conducted by the Federal Reserve every three years. Yet again, the data reaffirmed positive trends for the US consumer. Specifically, the top 10% of households, as measured

by net worth, saw a stunning 33% increase in nominal net worth from \$4.02 million on average in 2013 to \$5.34 million in 2016. Meanwhile, the households in the 25th to 75th percentile of net worth saw their nominal net worth increase 16% from \$106,788 on average in 2013 to \$124,400 in 2016.

We believe these increases are very positive for consumer confidence and future consumption growth. However, we should note that even after the sharp increase in overall net worth, the average middle class household remains 13% below the level reported in the 2007 survey, which was prior to the onset of the Global Financial Crisis. Notably, given that this figure is in nominal dollars, the decline in inflation-adjusted net worth is even more severe (Exhibit 3). Our thesis that the US recovery has three-to-five more years of growth before the next recession is largely premised on the nascent recovery for the middle class and the degree to which there is still room for pent-up demand from this massive cohort of consumers to be unleashed by rising wages and home prices. With home price appreciation topping 6% year-on-year[2] in 2017, we believe the middle class balance sheet continues to improve and could see more gains in 2018.

Exhibit 3
Middle Class Wealth Has Begun to Recover

Median Inflation-Adjusted Household Net Worth by Wealth Percentile



As of 31 December 2016
Source: Federal Reserve "Survey of Consumer Finances"

Legislative Change: Last year we indicated that corporate tax reform was the most likely policy change from Washington, D.C. and that it could add to growth and inflation risk on the margin. However, the Republican leadership in Congress expended significant energy toward repealing the Affordable Care Act (ACA) through much of the year, at the expense of other priorities such as tax reform, infrastructure investment, and immigration reform. With the failure of the ACA repeal efforts, attention has finally shifted to tax cuts.

While Republicans have vocally embraced an aggressive timeline for tax cuts, we currently ascribe a 50% chance of corporate tax cuts being signed into law before the 2018 US elections. We support the goal of corporate tax reform, as we believe the current tax code is convoluted, ridden with loopholes, treats small businesses punitively, and creates incentives to retain profits outside of the United States. However, a tax overhaul only happens once every few **decades** because the details and the funding are so difficult to negotiate. We believe this tax package will be no different. Complicating the matter is that Congress is attempting to reform personal taxes alongside corporate taxes, opening another Pandora's Box as it relates to special interests and lobbyists. To the extent that there is an upside surprise, we believe corporate taxes are much more important to the equity market than to GDP growth and could lift the S&P 500 Index further from year-end levels.

In September 2017, Congress delayed raising the debt ceiling until late 2017 or early 2018 because it could not gather enough votes to do so. The proposed tax reform would increase the ten-year forecast for cumulative deficits by at least \$1.5 trillion. The premise for the members of Congress who opposed increasing the debt limit in many cases was that further increases in debt were intolerable. This is important because tax reforms are likely to pass on party lines and hence Republicans cannot afford many defections from disciplined fiscal conservatives.

Monetary Policy: Against this backdrop, markets will watch the Federal Reserve Open Market Committee (FOMC) even more keenly in 2018. Compounding the typical questions around policy will be the expiration of Janet Yellen's term as Chair in February. In November, President Trump nominated Jerome Powell to succeed Yellen as Chair of the FOMC. We expect that he will be confirmed without any significant challenges. Historically, he has voted in line with the overall Committee and his speeches lead us to view him as a monetary policy centrist (in the context of the current committee composition). However, the FOMC is characterized by a willingness of members to temper their differences when speaking publicly, and Powell could still surprise investors on the margin if he is less centrist than he appeared in the past on monetary policy. At this point, we expect to see two-to-three more rate hikes between November 2017 and the end of 2018, taking the Fed Funds target rate to a range of 1.75%–2.00%. We believe the tightening cycle should end around that level.

The Chair of the FOMC is not simply a monetary policy position, however. The leader of the Committee also has a critical regulatory leadership role and we expect to see change from Powell in this regard. Based on our discussions with financial executives who have worked with Powell, they expect a marginal softening of the Fed's approach to regulating the banking system. He is reported to be a supporter of most of the regulatory changes that occurred after the financial crisis, but is also described as "pragmatic" in terms of how he interacts with individual banks. If this reputation proves

accurate, Powell could provide some regulatory implementation relief to the banking system while abiding by the spirit of the Dodd/Frank and Basel III rules that inspired the regulations.

Mid-Term Elections: In November 2018, the United States will return to the polls with all 435 seats in the US House of Representatives up for re-election and 33 of the 100 seats in the US Senate up for re-election. In the House, the Republicans hold 239 seats, the Democrats hold 194, and 2 seats are vacant. In the Senate, the Republicans hold a slim majority in the Senate with 52 seats versus the Democrats with 46 and Independents with 2 (both of whom typically caucus with the Democrats). The Democrats face a very tough challenge if they hope to gain control of the Senate, given that of the 33 seats up for re-election, Democrats hold 23, Independents who lean Democratic hold 2, and Republicans hold only 8. If control of either chamber shifts to the Democrats, however, the outlook for policies promoted by President Trump would dim considerably and/or the President could be forced to moderate his agenda to appeal to the opposition.

Our Outlook: We currently expect the United States to enjoy 2.0%–2.5% real GDP growth and wage growth that grinds higher through the year toward 3.0%–3.5% in 2018. To the extent Congress passes any significant tax reforms that incentivize investment, we might have to raise our expectations.

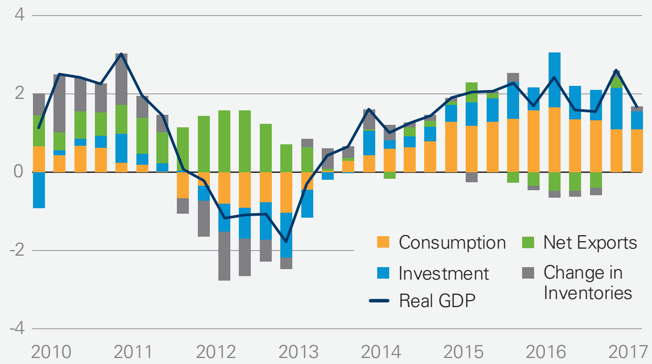
What Could Go Wrong? The primary risks we are monitoring include: the Fed leadership change, FOMC monetary policy risks, the potential for protectionist measures from Washington, D.C., and geopolitics.

Euro Zone: We Have Lift-Off

The euro zone surprised on the upside in 2017. The worst-case scenarios of divisive populist political victories were averted, while the economy continued to deliver relatively robust GDP growth. Despite progress, unemployment and underemployment remain elevated and core inflation remains low, suggesting significant runway for further growth. Particularly encouraging in this regard is that domestic consumption and investment have driven growth for the last three years, even while net exports were a drag on growth in six of the last seven quarters. We expect the euro zone to sustain growth through 2018 on the back of the ongoing recovery in consumer and business spending. Our base case scenario is that the ECB will continue expanding its balance sheet into 2019 and will not raise interest rates until 2019. In spite of this accommoda-tive policy, we see upside in long-term interest rates as investors will focus increasingly on the prospect for normalization of monetary policy. Equities, on the other hand, are likely to remain buoyant on the back of recovering top- and bottom-line growth.

Exhibit 4
Domestic Demand Is Leading the Euro Zone's Recovery

Euro Zone Real GDP Growth (%, Y/Y Contribution)

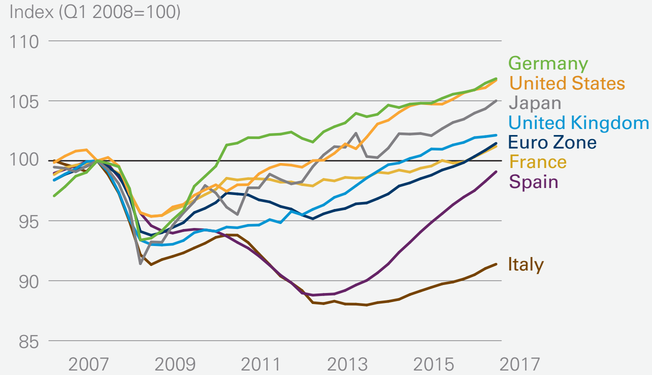


As of 30 June 2017
Consumption includes both private and government consumption.
Source: Haver Analytics, Statistical Office of the European Communities

Exhibit 5
Euro Zone Real GDP per Capita Has Only Grown 1.5% since 2008

Real GDP per Capita

Index (Q1 2008=100)



As of 30 June 2017
Source: Haver Analytics, OECD

Achieving Escape Velocity: In 2017, we believe the euro zone economy achieved "escape velocity". Domestic consumption and investment have now driven the bulk of real GDP growth over the last twelve quarters (Exhibit 4). In 2017, real GDP per capita for the region reached new highs and real GDP for the region reached a level that is 4.1% higher than in 2008. Importantly, while growth had been largely dependent on the stronger core econo-mies in the early years of the recovery, all member states are now in expansion. Notably, Spain's real GDP per capita has almost regained its 2008 levels after declining by over 11% from 2008 to 2013. Italy remains a laggard with real GDP per capita well below its 2008 level (Exhibit 5).

Economic sentiment, which reflects positive economic developments in the region, has reached a decade-plus high and continues to trend higher. Employment has been slower to recover than real GDP, standing just 1.8% above its 2008 level. However, employment is 5% higher than it was at the end of 2013 and this growth is leading consumers to increase spending on a range of goods and services after years of relative deprivation.

In spite of this significantly improved economic backdrop, inflation remains well below the ECB's mandated level of close to, but not more than 2%. In 2018, we expect growth to subside modestly from the 2%+ rates in 2016 and 2017. We also expect inflation to remain tame at levels in the 1.25% –1.75% range. This moderating growth trajectory combined with low, stable inflation is likely to create a conundrum for the ECB.

Monetary Policy—A Multi-Year Normalization: In our view, the ECB has handled monetary policy masterfully since Mario Draghi's famous "whatever it takes" speech in July 2012. In April 2017, the ECB took the initial step toward normalizing policy by reducing the rate of its asset purchases from €80 billion per month to €60 billion per month. In October 2017, the ECB indicated that through the first nine months of 2018 it would reduce its purchases further to €30 billion per month, with the potential for net increases in holdings beyond that date. Importantly, the ECB also indicated that, "The Governing Council continues to expect the key ECB interest rates to remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases."

We expect the ECB to stay true to its forecast and to continue to expand its balance sheet through the end of 2018, albeit at a slow pace. We also expect the ECB to maintain a negative deposit rate well into 2019 per its guidance as it tries to prod inflation rates toward its target level of 2%.

Populism and Weak Governments: Emmanuel Macron's presidential victory and the prospect for structural reforms in France lifted an anchor that had weighed down investor confidence in the region entering 2017. However, we believe the victory of En Marche! was an emphatic rejection of the status quo by French voters seeking change rather than a mandate for structural reform. For example, Macron's approval ratings dropped by nearly 20 percentage points within four months of his election victory. We believe he should grasp the opportunity to reform France's economy against the backdrop of economic strength in the broader euro zone, but he will have a difficult task in sustaining popular support through this period.

Beyond France, we believe there are continued political risks, with the recent events in Catalonia and the referenda in Northern Italy for more autonomy, reminding us that European politics are unsettled. However, the scheduled political calendar in 2018 is without question lighter than in 2017 with the Italian election in the first five months of the year being the most notable risk. The bigger risk in our view is that the governments in a number of countries are composed of coalitions with very thin majorities. For example, the Netherlands government is a four-party coalition with a single-seat majority. The Spanish government still is in the minority even after two elections and faces two protest parties that have the third- and fourth-largest number of seats in the Parliament, even amid the Catalonian separatist situation.

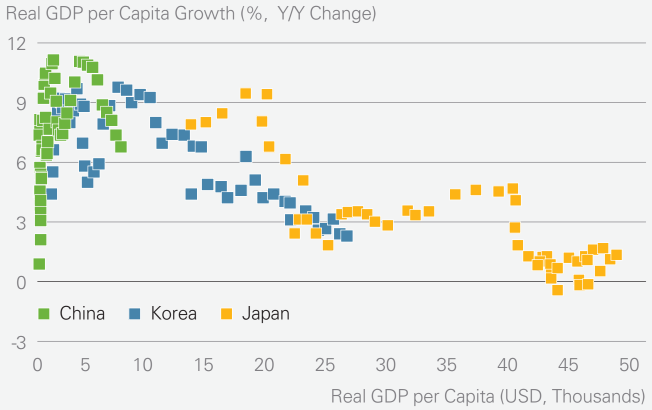
Overall, we caution that populism is alive and well in the United States and Europe and are concerned that one of the potential surprises in 2018 could be unanticipated elections due to a collapsed governing coalition or other regional tensions. Weak coalition governments also are poorly placed to execute on reforms at the European Union (EU) level, limiting the potential for major structural reforms beyond any single nation.

Slow Motion Brexit: After the 23 June 2016 vote to exit the EU shocked most observers outside of the United Kingdom, the government made a slow start at actually executing on Brexit. Progress has not accelerated meaningfully in the 17 months since. On 29 March 2017, the United Kingdom invoked Article 50 to begin the up to two-year process of exiting the EU. Any momentum in the initial months after this action hit a speedbump when the Conservatives gambled on winning an even stronger mandate in parliament in June elections, only to be forced to form a coalition with the Democratic Unionist Party to salvage a small governing majority. Since the election, Prime Minister Theresa May has faced a quiet uprising in her own party that complicates exit negotiations. Looking forward, the current negotiating position of the UK government appears weak and undefined from our perspective, as the debate has not progressed beyond the initial terms of divorce.

Our Outlook: We currently expect the euro zone to register 1.5%–2.0% real GDP growth. Inflation should remain low and deflation risk has decreased.

What Could Go Wrong? The primary risk factors we are monitoring include: the Italian election and embattled governments in the core economies, ECB monetary policy risks, the disruptive effect of slow progress on Brexit, and geopolitics.

Exhibit 6
Growth Trends Should Slow as Income Rises

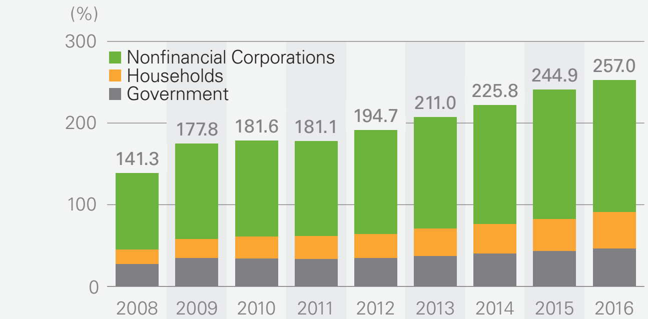


As of 2016

The horizontal axis represents the year-on-year percentage change in real GDP per capita growth (5-year moving average). The vertical axis represents real GDP per capita in 2010 US dollars.

Source: Haver Analytics, World Bank World Development Indicators

Exhibit 7
China's Leverage Has Increased as "Real" Advantages Decrease



	2008	2009	2010	2011	2012	2013	2014	2015	2016
Nominal GDP Growth (%)	12.8	13.8	18.4	15.8	10.1	10.6	7.4	6.4	9.6

As of 2016

Credit to the private sector is at market value. Credit to government is at nominal value. Credit data is break adjusted. Nominal GDP growth is the 4Q/4Q percent change.

Source: BIS, Haver Analytics, National Bureau of Statistics,

China's Economic Evolution Continues

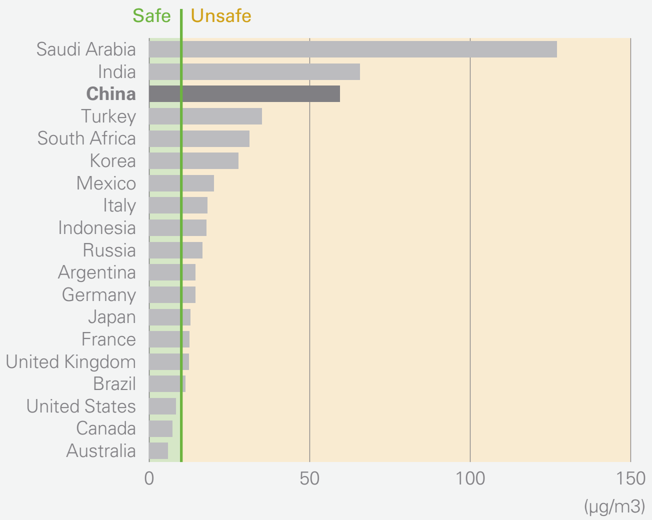
In 2017, investors focused first on the stabilization of growth and then on the leadership transition into Xi Jinping's second term as General Secretary of the Communist Party of China. The services sector continued to grow at a double-digit nominal pace, while the secondary sectors (manufacturing, utilities, mining, and construction) returned to similar levels of growth. This economic strength was sustained in large part through continued increases in leverage, particularly in the corporate sector. At the same time, China's leadership increased its verbal commitment to supply-side structural reforms (i.e., reducing excess capacity in certain industries such as cement, coal, and steel), reducing environmental degradation and mitigating risk in the financial system. While there were some signs of progress on these topics, we believe China needs to take a more forceful approach to dealing with the challenges facing its economy. Looking forward, we expect China to sustain world-beating levels of real GDP growth in 2018, but also believe that sustainable growth is more in the 3%–4% range over time, in line with the past trajectory of other rapidly developing East Asian economies (Exhibit 6). Our biggest concern is that the Chinese economy is increasingly dependent on leverage to drive growth as its historical competitive advantages have eroded (Exhibit 7).

Business as Usual in Politics: In October 2017, the delegates at the 19th National Congress of the Chinese Communist Party renewed Xi Jinping's term as General Secretary of the Communist Party. There was substantial speculation around the Congress about the rest of the Party's Standing Committee, with a focus on whether historical norms would be followed and potential implications for Xi Jinping's longevity as China's leader. While much remains in question, the addition of "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era" to the constitution leaves little doubt about Xi's status, putting him on par with Mao Zedong in the hierarchy of China's modern leaders.

As it relates to implications of the leadership "transition", we do not expect to see any meaningful shift in policy in 2018 that would slow economic growth substantially in the near term or that would accelerate the reforms we believe China needs to implement. We do expect an increased emphasis on environmental standards (Exhibit 8), "quality growth", and achieving a "moderately prosperous society". These priorities stated by Xi Jinping in his speech at the Congress (and frequently emphasized beforehand) highlight a subtle transition away from numerical GDP growth targets toward a more mature phase of growth. This change is positive in our view as the GDP growth targets were increasingly difficult to achieve and required incremental leverage that was becoming riskier over time. We do not expect a significant deceleration of growth, but would note that Xi has laid the groundwork for slower growth that is of a higher quality over time.

Exhibit 8
China's Environmental Costs Are Likely to Increase Substantially

Annual Mean Concentrations of PM2.5 in Urban Areas, 2014



As of 31 December 2014

Chart is based on annual mean concentration of particulate matter of less than 2.5 microns of diameter (PM2.5) [ug/m3] in cities. The mean is a population-weighted average for the urban population in a country. The World Health Organization considers annual mean fine particulate matter pollution levels higher than 10 micrograms per cubic meter to be unsafe.

Source: Ambient Air Pollution Database, World Health Organization, May 2016

Capital Flows and Currency: Entering 2017, we had expected ongoing depreciation of the Chinese renminbi against the US dollar. We were wrong, as the Chinese capital flows stabilized and turned slightly positive through much of 2017. At the same time, the renminbi actually appreciated against the US dollar, moving from a level just below 7 renminbi per US dollar to as low as just below 6.5 in September. We believe the authorities in China strategically intervened to prove to international investors that the renminbi is a safe currency, which would encourage more capital inflows into China. We do not expect any meaningful change in exchange rates in 2018 as stability of the currency has increased in priority for authorities. This policy adjustment also means we are less likely to see substantial currency depreciation in 2018 to support exporters, implying that structural reforms to reduce excess capacity will increase in importance.

Housing Remains Untamed: Through 2017, authorities at the local and provincial level tried to restrain home price speculation and rampant appreciation. Dozens of cities enacted new restrictions on property transactions to require owners to hold the property for anywhere from two-to-ten years before they are allowed to sell. These new restrictions are on top of already relatively conservative loan-to-value limits on mortgages to buy property. The restrictions succeeded to some degree. Out of 70 of the largest cities in China, by September only 13 saw home price appreciation exceeding 10% year-on-year, while 31 saw price increases of 5%–10%, and 24 saw prices increase 0%–5%. Only two cities had prices that declined over the prior year. At the peak in May and June, 31 out of the 70 cities had price increases in excess of 10%. Controlling home prices is a key priority for policy makers in China who have concluded that housing price bubbles that are followed by busts lead to capital outflows. To the extent China wishes to stabilize capital flows and its currency value, it will need to avoid future instances of rapid price appreciation in housing. We expect this will be a key priority in the years ahead for both these economic reasons and to mitigate the pressure on young first-time home buyers who are increasingly priced out of the market in major cities.

Our Outlook: We expect growth to decelerate in China in 2018 to a level between 6.0%–6.5%, heading toward a more sustainable 3%–4% real GDP growth rate over time. We believe the leadership of China will gradually transition its economic focus toward the three goals of a cleaner environment, higher quality growth, and a moderately prosperous society. These goals can be achieved at much lower GDP growth than in recent years given that the working age population of China has been shrinking for the last four years. We do not expect meaningful swings in the exchange rate, although we do believe the authorities will once again attempt to widen the ranges in which the renminbi can trade. Interest rates are likely to be tightened further on the margin, but we do not expect any major shifts in monetary policy at this point.

What Could Go Wrong? We believe the biggest challenges facing China are the ever-increasing corporate debt burden and the difficulty of steering a bigger and bigger ship. Corporate debt outstanding has more than doubled in the last five years in China. Unfortunately, the data is not entirely dependable, but estimates indicate that corporate debt could exceed the US dollar equivalent of $22 trillion. This figure compares to less than $14 trillion of total corporate debt outstanding in the United States, which has a GDP that is over 50% larger than that of China. In 2015, the risk of this debt increased sharply due to negative producer price changes. Fortunately, the Chinese government was able to engineer a positive inflection in its Producer Price Index (PPI) through fiscal and credit stimulus, and corporate debt servicing was eased with nominal GDP growth acceleration driving more revenue growth. Going forward, this might not be so easy or desirable and we are concerned that the debt situation remains unresolved.

The other challenge is managing monetary policy for a two-staged economy in which coastal, primarily service-oriented economies operate very differently than interior provinces that are more industrial. We have observed that the pace of tightening and easing cycles has increased and we believe that walking the tightrope of monetary and growth policies is getting more difficult as the complexity of the economy increases. Fiscal policy, if made more transparent and sustainable, would be a much better tool in our view to accomplish growth goals without inflating bubbles in the stronger parts of the economy.

Japan Is Back on the Agenda

Since the election of Prime Minister Shinzo Abe in 2012 we have been intrigued by Japan as it seemed that the moment had finally arrived for genuine structural change that could reinvigorate the economy and markets. Our patience ran out in 2016, however, after an increase to Japan's consumption tax and then a weaker global economy sapped momentum. Our enthusiasm has been rekindled as the Japanese economy has experienced its longest consecutive growth streak since the crisis (Exhibit 9). The reasons for our renewed interest are that:

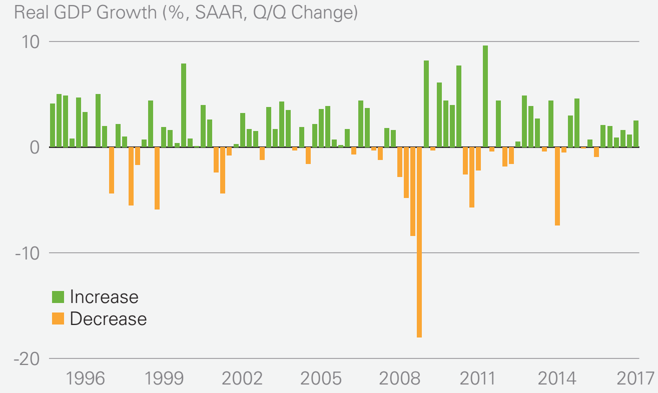
- Japan is the only major equity market not trading at a premium to its own 10-year history[3]
- Returns for Japanese companies are increasing on the back of corporate governance reforms and stronger global growth
- Signs of inflation are appearing again in the labor market

While we cannot categorically state that everything has changed in Japan, we believe that Japanese equities deserve attention from investors heading into 2018.

Wage Growth Is Improving: In our visits and research throughout 2017, we have seen ongoing signs of a tightening labor market in Japan. The number of active openings per active applicant has increased to 1.5 (Exhibit 10) and scheduled wages for part-time workers are now growing at 3% per annum. Wage growth at small employers has also accelerated through the year as labor shortages have worsened. In recent years, Japan offset part of this pressure through policies to increase the number of women in the workforce. However, at this point, the female labor force participation rate exceeds that of the United States for women aged 18–54, leaving less room for improvement. We expect wage growth to continue to grind higher into 2018 as aging reduces the availability of workers even while increased tourism, domestic economic activity, and preparations for the 2020 Olympics in Tokyo increase demand for labor.

The Snap Election Has Reduced Political Risk: The 22 October 2017 snap election was a great success for Prime Minister Shinzo Abe as the Liberal Democratic Party (LDP) renewed its super-majority in the lower house of parliament. This victory means Abe can go back to focusing on policy rather than re-election. We expect him to move quickly on a constitutional referendum. However, the referendum, which will be the first in modern Japanese history, will not be meaningful as it will merely codify the legality of having a national self-defense force in place. This is the first step to then moving to a more substantive referendum at a later date to allow a less defensive military posture. This would be a much more controversial move and could derail economic policy planning when it arises. The constitutional discussion matters to investors as it is perceived as a distraction from the economy and could sap enthusiasm for Japanese equities.

Exhibit 9
Japan Is in the Midst of Its Longest Consecutive Growth Streak since the Crisis

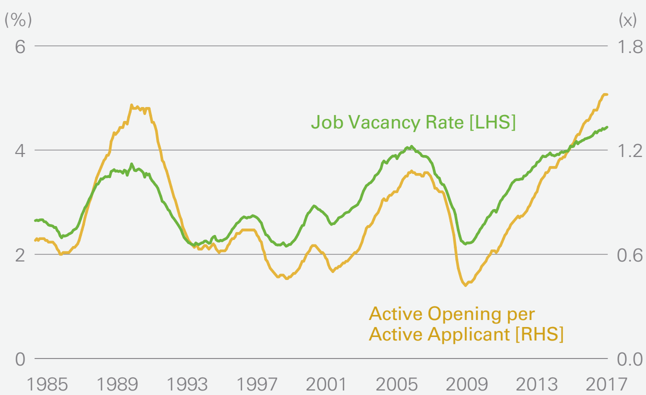


As of 30 June 2017

SAAR represents seasonally adjusted at an annual rate.

Source: Cabinet Office of Japan, Haver Analytics

Exhibit 10
There are 1.5 Job Openings per Applicant in Japan



As of 30 September 2017

Seasonally adjusted data.

The job vacancy rate is calculated as active openings as a percentage of (Employees + Active Openings).

Source: Haver Analytics, Labor & Welfare, Ministry of Health

Until then, we are hopeful that Abe will decide to postpone the October 2019 increase in Japan's consumption tax. Even better, in our view, would be for Japan to announce a multi-year, multi-step increase in the consumption tax (perhaps by 1 percentage point per annum) over five or more years. While this idea is not being actively considered in Japan to our knowledge, it would be a much less disruptive way to balance public finances, without as negative of an impact on consumption as in April 2014.

Beyond these measures, we are not expecting much on the structural reform agenda, as the US exit from the Trans-Pacific Partnership derailed the momentum Abe had built for reforms to satisfy the terms of the treaty. There appears to be little appetite for major reforms at this point based on our analysis of Japanese politics.

Monetary Policy Remains Very Supportive of Asset Prices: Lacking fiscal and structural reforms, Japan is likely to be in the same situation as it has been in recent years where the burden for stimulating growth falls disproportionately on the Bank of Japan and Haruhiko Kuroda. Kuroda's term as Governor of the BoJ is set to expire in April 2018, although we expect that he will be reappointed. If this is the case, we expect Yield Curve Control (YCC) to be sustained with a target of a 0% yield for the 10-year Japanese Government Bond, even while US and euro zone rates begin normalizing. One of the benefits of YCC to date has been that by targeting rates rather than quantities of purchases, the BoJ has been able to mildly slow the pace at which it has been growing its balance sheet.

Our Outlook: We expect Japan to sustain positive real GDP growth of approximately 1% in spite of a shrinking population, as its real GDP per capita growth catches up to the pace of the US and the euro zone. We anticipate that core inflation could rise to around 1% but fail to achieve the BoJ's 2% target, much less its stated objective of overshooting that target. Nonetheless, 1% inflation would be significant progress and sufficiently high to support the spirit of the BoJ's goals. If our global outlook is correct, we could see upside to our forecasts on the back of export strength. However, it is important to recognize that only a little more than 15% of Japan's real GDP is composed of exports, and that Japan also imports a similar percentage of GDP. As such, Japan is less export dependent than many investors believe, much like the United States where less than 15% of real GDP is composed of exports.

What Could Go Wrong? A change in monetary policy is the most likely risk to our optimistic assessment of Japan. Another risk is related to protectionist policies that might emanate from the United States. A less likely, but more severe risk is from North Korea and its saber rattling. An even less likely scenario would be an "accident" in the East China Sea around disputes with China over territory.

Investment Implications

It is important to recognize that the economy is not the only variable that drives investment decisions and asset prices. When allocating capital, investors have to consider a range of factors, which also include valuation, liquidity, and sentiment. As noted earlier, financial assets, in general, are not cheap relative to history or in absolute terms. Our strong belief is that security selection will be critical to generating returns in the years ahead, as global growth normalizes and the "easy money" of the market rallies in recent years is harder to come by.

When we zoom out and consider the landscape of investment options, we view fixed income as the least attractive asset class, with the exception of emerging markets debt. Equity valuations are high, but are less unattractive than debt. Overall, we believe equities are attractive when we take into account company fundamentals, especially improving earnings growth prospects.

Within fixed income, we are particularly negative on developed markets sovereign debt. In the euro zone, for example, nominal yields are negative on 50% of government bonds, meaning that in many cases, investors are guaranteed to lose money by owning these assets. In real terms, a substantial majority of euro zone government debt has a negative yield. Yields for US treasuries are higher, but that is measured against an extraordinarily low bar. With US core CPI ranging between 1.7%–2.3% over the last year, the real yield on a 10-year Treasury has barely been positive. Our negative view on developed markets sovereign debt takes into account not only current yields, but also our expectation that the long end of the curve is likely to sell-off over the next 6 to 12 months as the ECB tapers asset purchases, the Fed continues to normalize policy, and the economy continues to be resilient globally, raising inflation expectations and diffusing lingering downside concerns.

Looking beyond developed markets, we see value in emerging markets sovereign debt and find local currency debt particularly attractive with a yield over 6%.[4] Our expectation that developed markets sovereign long rates will trend higher should be negative for emerging markets long-term rates. However, with such a significant yield premium and in light of structural reforms since the 2013 "Taper Tantrum", we see solid relative and absolute returns in addition to their diversification benefits.

In equity markets, valuations are at challenging premiums relative to their historical levels. Using the 10-year median forward price-to-earnings (P/E) ratio as a benchmark for each market[5]:

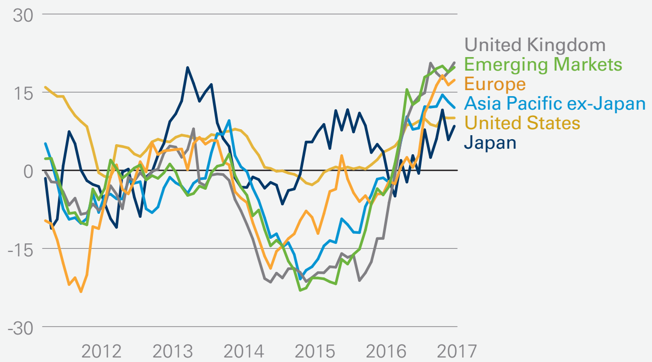
- The S&P 500 Index is trading at a roughly four P/E multiple premium relative to its historical average. Its forward P/E now stands nearly two standard deviations above its 10-year mean. This valuation is uncomfortable, but we also believe the United States still has right-tail optionality related to corporate tax reform. We put a 50% probability on tax reform being signed into law and believe S&P 500 earnings could increase as much as 10%–15%, depending on its details.
- The MSCI Europe Index is trading at a 3.2 P/E multiple premium relative to historical average. We see more room for earnings recovery than in the United States, but also recognize that future growth prospects are less compelling as Europe lacks significant exposure to the technology sector, a key driver of innovation. Technology comprises 24% of the S&P 500 Index versus only 5% of the MSCI Europe Index.

- The MSCI Emerging Markets Index is trading at an expensive, but less extreme, two P/E multiple premium relative to its historical average. We see more earnings upside in emerging markets, as years of high capital expenditures that depressed returns now begin to generate returns. The challenge with "emerging markets" is that this label is applied to a wide and diverse range of economies and companies.
- The MSCI Japan Index is the only major market index that is not trading at a substantial P/E premium to history, with the index trading at a premium of 0.3 P/E multiple relative to its 10-year median. We believe Japanese companies still have substantial room to improve their returns, as the macroeconomic backdrop has improved and the corporate governance reforms of recent years have better positioned many companies for future profit growth.

In spite of the premium valuations across many markets, we continue to see upside in these assets on the back of earnings increases that are likely to exceed 10% for all of the major markets in the 12 months ahead (Exhibit 11).

Exhibit 11
The Global Synchronized Recovery Is Lifting Earnings Estimates

Next 12 Months Earnings Growth – MSCI Regional Indices (%, Y/Y Change)



As of 31 October 2017
Source: Bloomberg, MSCI

Conclusion

We are more optimistic than we were last year as our confidence in the global recovery has strengthened. With global growth finally in sync, we hope policymakers will choose to allow the economy to gain momentum and avoid derailing growth, especially since the temptation to normalize policy prematurely will be enticing. The primary risk factors globally revolve around monetary policy, trade policy, populism and politics, and geopolitics.

For investors, it is unfashionable to be bullish on equities with markets at all-time highs and valuations at premium levels. However, we see upside in global equities as earnings growth expectations are strong and as fixed income assets are even more expensive than equities. Regardless of the asset class, we believe security selection will be a critical component of generating reasonable returns in markets going forward, given the risk of drawdowns on the back of unforeseen events and as different countries and companies deliver varying degrees of growth.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 As of August 2017. Source: Job Opening and Labor Turnover Survey
2 As of October 2017. Source: National S&P/Case-Shiller Home Price Index
3 As measured by median forward price to earnings
4 As of 2 November 2017. Source: JPMorgan GBI–EM Global Diversified Composite, Bloomberg
5 As of 27 October 2017. Source: Bloomberg

Important Information

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