Lazard Insights

Global Outlook **2017**

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Summary

- In the United States, evidence suggests that the recovery from the financial crisis is broadening to the middle class. Although uncertainty remains with regards to Trump's policy agenda, our base case expectation is that new policies could lead to slightly stronger growth, modest inflationary pressure, and marginally higher interest rates.
- The euro zone economy has gradually improved since 2013 and we expect this cyclical recovery to continue, supported by the ECB's accommodative monetary policies. However, with a busy political calendar in 2017, we believe political risk is rising.
- We expect growth in China to decelerate further in 2017, as it transitions to a service-oriented economy. We also expect the renminbi to continue to weaken against the US dollar, despite ongoing intervention by the Chinese authorities.
- Overall, we think the environment is favorable for risk assets. Although equity valuations appear expensive globally they look relatively attractive when compared to fixed income. The current investment landscape will generate winners and losers favoring security-specific analysis and active allocation decisions.

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Year in Review 2016

Our outlook for 2016 focused on four main topics: monetary policy, oil prices, China, and geopolitical and political risk. While our outlook for the US Federal Reserve's monetary policy became more dovish as the year progressed, our expectations for sustained aggressive policy in Europe and Japan played out. At the start of 2016, we suggested that oil prices were close to stabilizing. Oil prices subsequently reached their lows in the first quarter before nearly doubling by December. We forecasted that China would be challenged by a two-speed economy in which service sector growth outpaced manufacturing growth. This divergence narrowed in 2016 but, in our view, still remains a challenge going forward. Finally, we noted the range of elections in 2016, but certainly did not anticipate that voters in the United Kingdom would choose to exit the European Union (EU), that Donald Trump would be elected US president, or that Italian voters would reject constitutional reforms by a 20-percentage point margin leading to the resignation of Prime Minister Matteo Renzi.

As we reflect on 2016 and look forward to 2017, it is worth noting that on many levels our expectations have not changed meaningfully. However, the logic behind our expectations has changed. In this paper, we will review our 2017 outlook for the United States, the euro zone, and China.

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United States: Positive Economic Outlook, Significant Policy Uncertainty

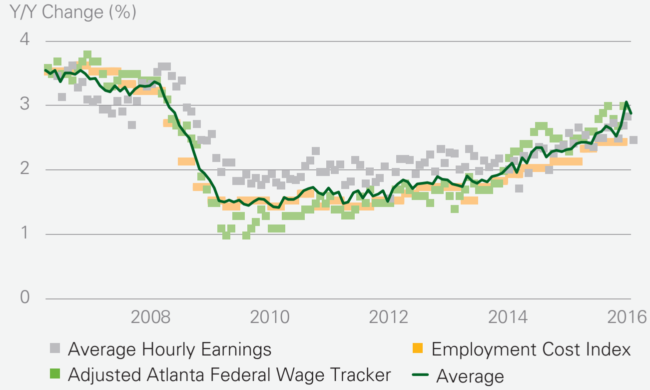
In the United States, we believe that President-elect Trump is inheriting quite a good story in spite of the campaign rhetoric. As we expected, the foundation for economic growth continued broadening in 2016, with the middle class finally participating more fully in the recovery. In our view, the most likely result of Trump's election is corporate tax reform with provisions to encourage the repatriation of overseas earnings. However, we also believe markets largely have ignored the increased uncertainty that Trump presents given the lack of a clear policy agenda. Our base case expectation for the United States is that growth rates will accelerate by roughly 20 basis points (bps) over the period from 2017 to 2018, assuming lower corporate tax rates and a sizable infrastructure investment program will begin to be implemented later in the year. On the back of this slightly stronger growth, we expect slightly more upward pressure on inflation and marginally higher interest rates than we had anticipated prior to the election. Importantly, while we believe inflation and inflation expectations bottomed in the first quarter of 2016 and will continue to grind higher, we do not expect a spike in inflation anytime in the next one to two years.

Our view that the economic recovery is broadening is based on the recent strengthening of household income (Exhibit 1) and balance sheets. After bottoming well below 2.0% following the crisis, annual wage growth has been slowly accelerating since 2011, and reached nearly 3% in 2016. We expect this trend to continue as the labor market tightens further, and for wage growth to reach its pre-crisis levels of approximately 3.5%, in the next one to two years.

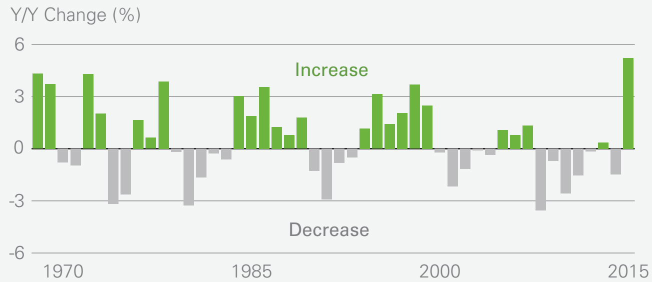
Together with wage growth, continued jobs growth is contributing to rising household income. In 2015, the median household income adjusted for inflation rose by 5.2%. That was the strongest increase in this metric since the survey began in 1968. This is also important as we are not looking at the average, but are instead viewing the median household income. As such, we believe this is a better reflection of what is happening for middle class households in the United States that drive the bulk of consumption.

Exhibit 1
Rising Wages Support Middle Class Income

Three Common Wage Measures and Their Average



Median Inflation-Adjusted Household Income, 1967–2015



Average Hourly Earnings (AHE) and Atlanta Fed Wage Growth Tracker (Wage Tracker) as of November 2016. Employment Cost Index (ECI) and median inflation-adjusted income as of September 2016.

AHE are for all employees. ECI is for wages & salaries of civilian workers excluding incentive-paid occupations. The ECI is a disaggregated quarterly series. The Wage Tracker is adjusted downwards by 0.6 percentage points to reflect its historical spread with other wage measures.

Median income percentage change is not statistically significant in 1970, 1979, 1982, 1983, 1992, 1993, 2000, 2003, 2004, 2009, 2012, 2013, and 2014. Percentage increase in 2015 is not statistically different from the increase in 1998, 1986, 1978, 1972, 1969, and 1968. Income in 2015 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: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta, Goldman Sachs, Haver Analytics, US Census Bureau

Consumer balance sheets are also improving. The most important asset for the middle class (which we define as households in the 25th to 75th percentiles of net worth) is housing. For the typical middle class household, housing accounts for 60% of total assets. The S&P/Case-Shiller 20-City Composite Home Price Index has now recouped 80% of the losses experienced during the US housing bust. However, house prices are still down 7% from the pre-crisis peak in aggregate. It is also worth noting that the house price recovery has been very uneven with high-income areas at all-time highs, while low-income areas are still suffering from large declines.

Momentum from accelerating wage growth and the nearly complete recovery in home prices should translate into stronger consumer confidence and spending in the years ahead, a fortunate situation for President-elect Trump, in our view. However, Trump's election has broadened the range of potential scenarios investors need to consider. So far, investors have focused primarily on the positive scenarios in which lower corporate income tax rates and increased infrastructure spending could add momentum to growth and increase inflation on the margin. Some, but not enough, investors have focused on the likely increase in budget deficits that might result from the new administration's plans. We believe it is particularly important to consider how Trump's election might potentially lead to structural shifts in the economy. The three areas we would highlight are the rising anti-globalization sentiment, inflation, and interest rates.

Anti-globalization: A number of commentators have pointed to rising anti-globalization and anti-elite sentiment to explain the results of the UK and Italian referendums and the US Presidential election. We believe this sentiment is rooted primarily, but not exclusively, in economic frustration. Many voters are angry that they have been left behind economically. In the United States and the United Kingdom, the vote ultimately could have significant protectionist consequences. While many of the underlying concerns behind this populism are legitimate, we also believe that globalization's contribution to economic inequality and the hollowing out of the middle class is often overstated. Specifically, technology and automation have played major roles in displacing workers. Put simply, not all of the jobs that have been lost have moved offshore. Unfortunately, protectionism could in fact worsen the situation rather than resolve it.

Inflation: In a surprisingly short period of time, market consensus has swung from a view that inflation would be low for years to a view that inflation might rise quickly. We agree that we have seen the lows in inflation and expect inflation to grind higher as wage growth accelerates. In fact, inflation expectations bottomed in February 2016 when oil prices were at their low. Since bottoming, medium-term inflation expectations rose through much of the year (Exhibit 2). However, we do not agree that inflation is going to rise very rapidly. We would temper fears of elevated inflation, but recommend that investors re-evaluate how they address the risk of higher inflation in their portfolios.

Interest rates: To the extent inflation has bottomed and the Fed will have to react to rising inflation pressures, it follows that we have seen the low in interest rates in the United States. However, we would again caution against extrapolating recent moves in the 10-year US Treasury yield. In fact, where we used to think the 10-year US Treasury yield was locked below 2.5%, we now think the upside risk might be to 3.0% over the next one to two years.

From a cyclical perspective, the outlook for corporate profits is compelling if tax rates are reduced significantly. Combined with the ability to repatriate overseas earnings, this could lead to another wave of mergers and acquisitions (M&A), buybacks, and dividend increases that then lead to a more efficient allocation of capital by companies and their investors. Overall, it is difficult to gauge an economic impact of such changes, but it would almost certainly be positive for growth on the margin in the intermediate term. However, we should note that the proposals currently under discussion in Washington include much more complex options including border adjustment taxes that could have very disparate impacts on a range of companies. Exhibit 3 highlights the current aggregate effective tax rate for each industry within the S&P 500 Index to illustrate which groups might benefit the most from a lower US statutory tax rate. Note that there are large variances within each sector.

To date we have not seen any clear indications of how President-elect Trump will pay for his corporate tax reductions and infrastructure spending plans. Morgan Stanley and Bank of America Merrill Lynch are both forecasting the US federal budget deficit will exceed $800 billion in fiscal 2017 after bottoming at $438 billion under President Obama's leadership in fiscal 2015. The deficit forecast is important to watch as a 4%–5% deficit as a percentage of GDP in a peacetime recovery is extremely high. It seems unlikely that the Republican House in particular will abide by such a lack of fiscal discipline. If we are correct, this implies that the size of corporate tax cuts or of new infrastructure spending might be short of market expectations.

Exhibit 2
Inflation Expectations Bottomed in February 2016

5-Year, 5-Year Forward Inflation Expectation

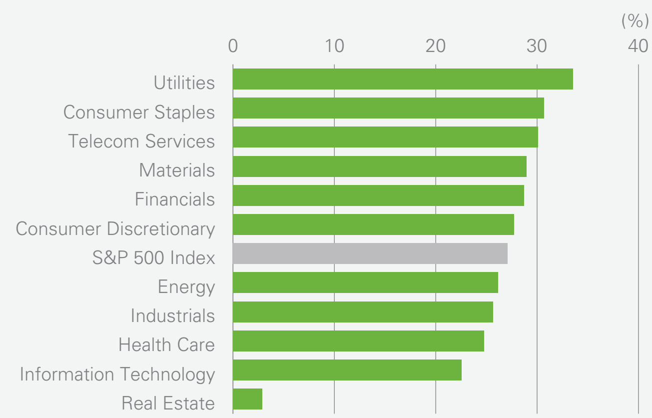
As of 14 December 2016

The 5-year, 5-year forward inflation expectation rate is the average inflation rate that the 5- and 10-year inflation-indexed Treasury Yields at Constant Maturity indicate the market expects in years 6 through 10.

Source: Federal Reserve Bank of St. Louis

Exhibit 3
Corporate Tax Cuts Could Meaningfully Lift Profits

Average Effective Tax Rate by S&P 500 Index Sector, Last Three Years



As of September 2016

Data are based on S&P 500 Index companies. Sector averages are calculated using trailing 12-month sums for income tax expenses and pretax income. Figures displayed are the average of effective tax rates calculated for the past three 12-month periods.

Source: Bloomberg

Euro Zone: Recent Momentum at Risk

The euro zone economy has gradually improved since 2013. Inflation remains low, but deflation fears have subsided somewhat. There are still signs of pent-up demand and upside for companies, but employment must continue to improve in order to unleash this demand. Unfortunately, even while the economy has improved, political risks have also increased, as evidenced by the results of the UK and Italian referendums.

In 2017, our base case expectation for the euro zone is real GDP growth of around 1.5%, with sustained low inflation. We expect the European Central Bank (ECB) to continue its easy money policies with negative interest rates and large purchases of government bonds as announced on 8 December. The divergence between ECB and Fed monetary policy will likely weaken the euro against the US dollar.

Recent growth in the euro zone economy has brought real GDP above pre-crisis levels, but outcomes have diverged significantly between individual countries and domestic demand remains weak (Exhibit 4). Real GDP in Germany and France began to recover at the same time US growth began to recover in 2009. Real GDP did not turn in Italy and Spain until 2013. Since then, we have seen more of a coordinated recovery in real GDP. However, the recovery in real domestic demand has been slower, especially in Spain and Italy. In Spain, real GDP declined by 9% from 2008 to 2013, but real domestic demand declined by 18%. The difference between the two data series can largely be explained by exports, which have helped lift GDP but not domestic demand.

Despite the GDP recovery, both headline and core inflation remain well below the 2% target set by the ECB. In addition, unemployment for individuals 25–74 years of age remains elevated relative to historical standards, although the situation has improved from the worst levels following the financial crisis (Exhibit 5). The one exception is Germany where unemployment is now well below the pre-crisis levels. The trends are similar although the unemployment rate is much higher for individuals under 25 years of age.

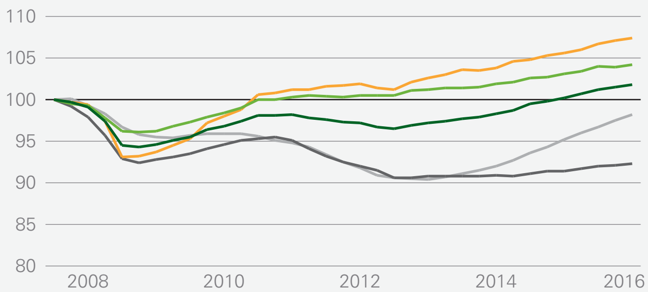
One driver of growth within the euro zone has been ECB policy. The ECB's balance sheet as a percentage of GDP has increased to 34% as of November 2016 and is likely to rise to 40% by the end of 2017 based on the announced asset purchase plans from the ECB. We expect these bond purchases to keep interest rates and the value of the euro low through much of 2017.

Unfortunately, political risk in Europe continues to rise. The vote on 23 June for the United Kingdom to exit the EU was a shock to the financial system. The 4 December decision by Italian voters to reject constitutional reforms that would have streamlined governance was less surprising, but the magnitude of the rejection was indeed a shock

Exhibit 4
Euro Zone Demand Remains below Pre-Crisis Levels

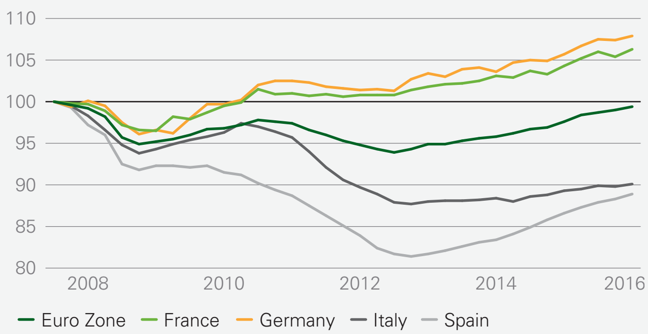
Real GDP

(1Q 2008=100)



Real Domestic Demand

(1Q 2008=100)

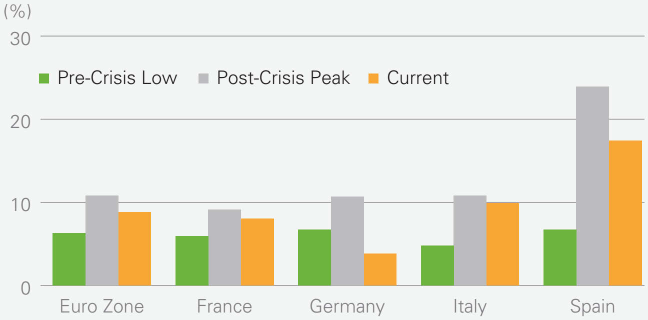


As of September 2016
Domestic demand is final consumption expenditure plus gross capital formation.
Source: Haver Analytics, Statistical Office of the European Communities

Exhibit 5
Euro Zone Unemployment Remains High, but Has Improved

Unemployment Rate, Ages 25–74

(%)



As of October 2016. Italy as of June 2016.
Harmonized unemployment rate.
Source: Haver Analytics, Statistical Office of the European Communities

with votes against the reforms outnumbering those for the reforms by a 20-percentage point margin. As a result of this vote, Prime Minister Matteo Renzi followed through on his threat to resign and Italy has put in place a new government just as key Italian banks are attempting to recapitalize.

We believe political risks will continue to rattle markets through 2017. UK Prime Minister Theresa May has indicated that she will invoke Article 50 to begin the process of leaving the EU in the first quarter of 2017. There is also a busy electoral calendar in 2017, with a Dutch general election expected in March, a French presidential election in April and May, a French legislative election in June, and a German general election likely later in the year. The French election is the most worrisome to us, as there is a meaningful chance that the National Front, a nationalist political party, could win the election on an anti-euro, anti-EU, and anti-immigration platform.

China: Economic Rebalancing Continues

From an economic perspective, China was an upside surprise in 2016 as the government boosted spending meaningfully and as credit flowed freely into the domestic economy. However, easy credit inflated fears of a housing bubble across the largest cities leading to incremental measures to clamp down on borrowing and speculation. As the year wound down, the Chinese renminbi depreciated further, increasing the pressure on the capital account as Chinese companies and residents tried to move capital outside of the country.

Looking forward, we expect growth to decelerate further in 2017 and the renminbi to continue to weaken against the US dollar despite ongoing intervention by the Chinese authorities. We also expect to see the transition from an export-oriented industrial economy to a more middle-income service economy sustained. One key wildcard in this outlook is how potential protectionist policies from the new administration in the United States could affect China's trade response and ultimately growth.

China's official budget deficit rose to more than 4% of GDP through the course of 2016, supporting growth through fiscal stimulus. Credit growth which had troughed at a 13% year-over-year growth rate in mid-2015 rose to 16%–17% in 2016 (Exhibit 6, left chart), lifting investment. However, the bulk of the investment growth was in the public sector where state-controlled enterprises increased their fixed asset investment growth rates from just over 10% in 2015 to over 20% in 2016 (Exhibit 6, right chart). At the same time, growth in private company investment fell from around 10% to only 2%–3% implying a lack of confidence in future growth among private business managers.

One result of the flood of credit and fiscal stimulus in China was a housing bubble. In particular, as of April 2016, home prices in Shenzhen were 62% higher than they were a year earlier. They later subsided, but the pattern is clear across the four Tier 1 cities (Shenzhen, Beijing, Shanghai, and Guangzhou) where home prices ended the year up 23%–32% from the prior year-end. The performance of Tier 1 cities is in contrast to those of Tier 2 cities which were up almost 14% and Tier 3 cities which were up 4%. As a result of the boom in house prices, a range of cities imposed new regulations on home purchasers to try to cool prices. However, regional divergences will likely continue to pose a challenge to Chinese authorities in 2017 and beyond. Tier 1 cities are the ones that have shifted most successfully to a services-oriented economic base and hence are least in need of fiscal or monetary stimulus. Many Tier 3 cities are more industrial and need stimulus the most, but are still not responding as strongly as authorities might like.

Exhibit 6

Credit Growth in China Accelerated in 2015 and 2016 but…

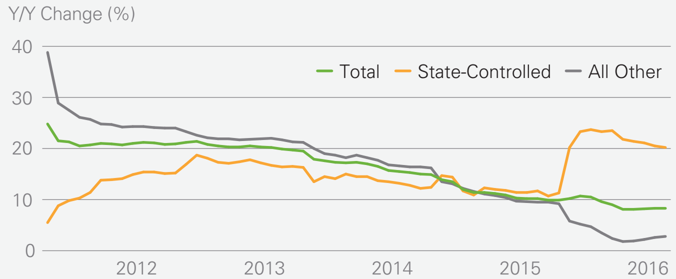
Total Social Financing Outstanding, Excluding Equity and Including Local Government Bonds

As of November 2016

Source: ChinaBond, Haver Analytics, People's Bank of China

…the Majority of Investment Growth Was in the Public Sector

Investment in Fixed Assets, Urban Areas



As of November 2016

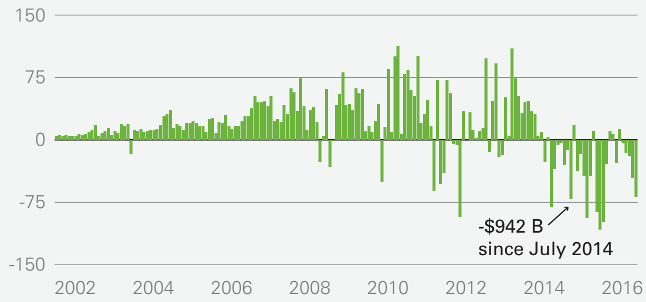
January data for each year are interpolated.

Source: China National Bureau of Statistics, Haver Analytics

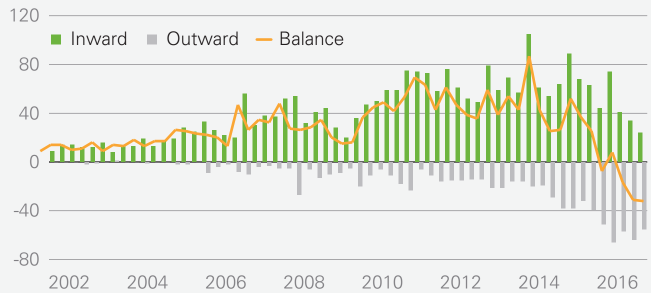
The renminbi depreciation versus the US dollar that began with a surprise 2% move in August 2015 was sustained through 2016. The cumulative depreciation has now reached over 11% since August of 2015, with the renminbi approaching the psychologically important level of 7 to the US dollar. One result of this depreciation and of slower economic growth is that Chinese companies and citizens are more likely to want to shift their assets out of China. China's foreign exchange reserves declined by over $940 billion since July of 2014 (Exhibit 7, top chart) even while the country ran persistent trade surpluses. Some of this decline can be explained by the process of marking to market assets that are in euros and yen during a period in which the US dollar strengthened substantially against other currencies. However, a large amount of the decrease in reserves resulted from capital outflows (including repayment of non-renminbi debt by Chinese corporates). The magnitude of direct investment into and out of China has shifted from, on net, flowing strongly into China as recently as 2014 to flowing meaningfully out of China in 2016 (Exhibit 7, bottom chart).

Exhibit 7
Chinese Authorities Tightened Restrictions on Capital Outflows

Monthly Change in FX Reserves



Inward/(Outward) Direct Investment



Foreign exchange reserves as of November 2016. Direct investment as of September 2016.

Source: Haver Analytics, People's Bank of China, State Administration of Foreign Exchange

Market Forecast

How does this relate to investors? So far we have focused primarily on the macroeconomic outlook and key sources of political uncertainty for the United States, the euro zone, and China in 2017. Clearly, when investing, we take into account other factors beyond the macroeconomy. In its asset allocation decision-making, the Lazard Multi Asset team also considers valuation, liquidity, and market sentiment, assigning probabilities for various outcomes over a six- to twelve-month time horizon.

In the Multi Asset team's latest *Market Forecast* of economic conditions in the United States, we forecast a small, 10% chance of recession in 2017, as well as a somewhat symmetric 10% risk of overheating. As mentioned earlier, we believe that the one certainty from the US election is that the range of scenarios has widened, as is reflected in this forecast. In the case of Europe, we see the highest downside risk with the chance of recession at 20% and the probability of below-potential growth at 55%. In China, we see the most likely outcome as decelerating growth in line with decelerating potential GDP growth.

Investment Implications

Since the US election on 8 November, interest rates have increased across a range of instruments ranging from a 70 bps increase in the 10-year US Treasury to a 45 bps increase in US investment grade corporate yields. European and Japanese 10-year government bond yields have been less affected, rising only 10–20 bps. The one surprise to us has been that US high yield corporate bonds have seen an almost 30 bps decrease in rates. Part of the explanation for this large spread tightening is that the energy, mining, and materials components of the high yield index account for about 10 bps of the decrease in yields for the index. The other difference is that the investment grade index has a duration of 7 years while the high yield index is only 4.1 years.[1] All said, the high yield action does show the power of a higher coupon in protecting investors as long as credit conditions stay constant.

In 2016, we acknowledged that equities were not cheap relative to history, but were still attractive relative to fixed income, in our view. We also noted that the ongoing quantitative easing from central banks globally was likely to continue driving equity prices higher. This has played out and we still see room for upside. The basis for our positive view of equities, however, has changed.

In the United States we are more focused on the prospects for what could be a sweeping reduction in corporate tax rates and a tax reduction on earnings repatriated from overseas. This potential policy change lacks detail right now, but in a very positive scenario in which the federal statutory corporate tax rate declines to 15%, interest expense is no longer deductible, and foreign earnings are no longer taxed, S&P 500 Index earnings could increase by as much as 15% according to analysis by Goldman Sachs. If that bull

case were to occur, US equities would be trading at a 16.5 times forward earnings rather than 19 times (Exhibit 8). To be clear, such a large upside scenario may be the best case rather than a bull case scenario, but it frames the range of scenarios facing investors.

Outside of the United States, valuations are more attractive, but these markets lack the potential incremental catalyst of major tax rate reductions. Nevertheless, we remain positive on global equities even though they are expensive relative to history, given their better value compared to fixed income.

We should note that stocks have rallied substantially in the last six weeks, and in many cases have likely priced in an appropriate degree of potential upside from prospective policy and environmental changes. Moving into 2017, we expect to see investors waiting for more details on how policies from Washington, D.C. might change before charging higher. That said, we also believe that as details are released, it will be critical to focus on company-specific implications of policy changes and ensure that winners are separated from losers in both equity and debt markets.

Exhibit 8

Equity Valuations Are Not Cheap, but Are Still Better than Debt

Forward P/E (NTM)	S&P 500	MSCI Europe	MSCI Japan	MSCI EM
Current	18.9	16.4	16.3	13.7
10-Year Median	15.2	13.0	15.0	11.9
Current minus 10-Year Median	3.7	3.5	1.4	1.8

Forward ROE (NTM)				
Current (%)	14.70	11.40	8.60	11.80

10-Year Government Bond Yields	United States	Germany	Japan	China
Current (%)	2.57	0.30	0.06	3.24
10-Year Median (%)	2.63	1.93	0.98	3.56
Current minus 10-Year Median (bps)	-6	-163	-92	-33

As of 14 December 2016

Forward P/E is the Bloomberg estimate. Forward ROE is I/B/E/S consensus from FactSet. All data reflect rounding. Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: Bloomberg, FactSet, I/B/E/S Consensus, J.P. Morgan

Conclusion

In conclusion, we are generally optimistic in terms of the growth outlook for 2017 and now believe growth could be slightly stronger than we expected before the US election. While we believe inflation has bottomed, we do not expect a sharp acceleration in price gains. Instead, we believe inflation is likely to grind higher on the back of wage growth with the potential for more rapid increases if protectionist policies are put in place.

Interest rates are likely to rise in sympathy with inflation expectations and in reaction to Fed policy decisions, but we would warn that there is a self-governing feedback loop that limits how high long-term rates can go without undermining the very economic strength that led to higher inflation expectations and interest rates.

We see a positive environment for equities, barring unforeseen geopolitical and policy shocks, on the back of potentially positive tax policy changes and low global interest rates. However, we believe that security selection is critical in times of substantial policy changes that can create winners and losers.

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 The high yield index is the BofA Merrill Lynch US High Yield Index and the investment grade index is the BofA Merrill Lynch US Corporate Index.

Important Information

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An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. High yield securities (also referred to as "junk bonds") inherently have a higher degree of market risk, default risk, and credit risk. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Emerging markets securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging markets countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in these countries. Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

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