

Economic and market outlook 2017

The times they are a changing



Overview

2016 marked an inflection point both in terms of monetary policy and political direction. An appreciation by central banks of the undesirable consequences of negative interest rates was a welcome development and brought some relief to a beleaguered financial sector.

Political shifts have been seismic in many regions, with unhappy voters resulting in populist mandates and the corresponding uncertainty that they bring. As we look to 2017, we see both the potential for significant change in terms of economic stimulus and reform, but also the downside of poorly constructed and implemented policies designed to appease a disenfranchised electorate. What seems likely is that the realities of economic and market conditions will exert a considerable force and constrain many of the headline grabbing initiatives that have been pledged.

The good news, which we point to in our Global section on pages 4 and 5, is that growth is expected to increase in the coming year, with more balanced contributions coming from developed and emerging markets, while inflation and bond yields appear to have passed their lows. Importantly, given the high levels of outstanding debt both in the public and private sectors, we are not anticipating that bond yields will move appreciably higher from current levels. Risk assets of credit and equities are likely to post further gains in 2017, provided that earnings improve as expected, but volatility will be high as

investors grapple with politics and earnings, while weaning themselves from the predictable tailwind of liquidity provisioning by central banks.

The Trump effect is the great unknown, and on page 6 we discuss the potential around fiscal spending on infrastructure, tax breaks, and the prospects of protectionism. Our expectations are for a considerable watering down of pre-election pledges. While we are constructive on US growth, with unemployment now at 4.6% and inflation moving towards the Fed's target, even a modest fiscal impulse at this stage in the cycle could lead the Fed to normalize policy at a faster pace.

While fiscal measures are much needed in the Eurozone, they remain a pipedream at this stage and on page 10 we point to Q1 as the likely high point for growth in the region. Importantly, we were disappointed that the ECB reduced its stimulus package from €80bn to €60bn per month and deem this to be a mistake, given only trend-like growth and inflation still far from target. This comes against a highly uncertain political backdrop, with critical elections in France, Germany, and the Netherlands, as well as potentially in Italy.

Perhaps even more challenging is the perilous situation of European banks that remain undercapitalized, over leveraged and too dominant in terms of their sheer size - in the order of 300% of European GDP. We see signs of complacency in credit markets, discussed on page 11, with no pricing of a possible bail-in of senior creditors. This demands a cautious investment approach.

The much anticipated Brexit is reviewed on page 8. Despite a better

than expected economic outcome since the referendum, we remain convinced that growth will be severely impacted once Article 50 is triggered at some point in the first half of the year. We see sterling coming under renewed pressure and suspect that UK equities, as well as gilts, will lag as inflation rises, growth slips, and real wages are squeezed.

More promising are the prospects for Japan. On pages 14 and 15 we focus on improving consumption and capital spending, while the equity market is attractive, helped by a weakening currency, decent earnings and the potential for foreign inflows. This is also true for the Chinese market, discussed on page 16, where valuations are also compelling, but we do expect economic growth to slow marginally, though once again stress that a hard landing is very unlikely. Other emerging markets show improving prospects, discussed from pages 18 onwards, but will be dependent upon the USD showing only modest gains following its stellar rally.

While a watershed may well have been reached in terms of the direction of politics, we do not see the fundamentals of high debt, low interest rates, or benign inflation changing dramatically in the year ahead.



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Global

Outlook

- 2017 is expected to be a year of better growth, with both EMs and DMs participating
- Global inflation is likely to be past its nadir, but underlying trends will remain weak
- Policy will stay supportive globally, despite rising rates in the US

Implications

- High indebtedness and central bank actions are likely to hamper a further rise in bond yields
- Volatility in credit is likely to be front loaded, with European banks representing a key risk
- There is still upside for stocks, provided earnings growth accelerates

Risks

- The political landscape has changed and this could be disruptive for economies and markets
- A Eurozone banking crisis is a global risk to both financial markets and economic activity
- A sharp rise in the dollar would damage growth prospects, particularly for EMs

2017 is expected to be a year of better growth

Even without a Trump induced fiscal boost in the US, 2016 is likely to mark a low point for global growth. Activity indicators rose strongly in Q4, and we anticipate the better momentum to continue into 2017 as the global economy returns to trend-like growth. The turnaround reflects better prospects in both EMs and DMs, which have finally synchronised allowing the global cycle to reengage. A combination of factors are at work, with fading recessions in some EM regions, notably Latam, a stabilisation in oil related capital spending, and stronger fiscal spending in DMs combined with still favourable financial conditions. An increasing number of EM countries are also embarking on structural reform, which is supportive to growth. While this is encouraging, the global economy remains vulnerable, with high debt limiting policy choices and aggregate demand, and structurally weak growth in many regions.

Policy is changing, but it is patchy and reactive

2016 marked a turning point for monetary policy, as central banks stepped back from negative interest rates. The narrative around government spending changed, and fiscal policy turned mildly expansionary in many DMs for the first time since 2010. The size of the stimulus is still limited, and we fear that most of the fiscal expansion has been on consumption rather than in investment. With the exception of the US, we see a continuation of this trend for 2017, with fiscal policy making a mildly positive contribution to growth, but in an uncoordinated and patchy manner. While this helps support near-term

growth and makes the expansion less vulnerable, it will not resolve the debt problem nor the issue of persistently weak growth. An exception could be the US, where Trump has pledged to stimulate the economy using tax cuts and infrastructure investment. In isolation, this has the potential to provide a boost to the US and the global economy.

Global inflation is likely to be past its nadir, but underlying trends are weak

We believe that 2016 also marked a low for inflation. We expect headline inflation rates to rise in early 2017, as oil price effects drop out from the annual comparison. Underlying inflation will stay benign in most DMs, however, reflecting weak wage growth, entrenched disinflationary expectations, and a lack of belief that central banks are able to raise inflation. There is also structural overcapacity in the global industrial sector, which exerts downward pressure on goods prices. Almost a decade after the great financial crisis, however, there are pockets of stronger inflation emerging, most notably in the US and the UK. Many of Trump's pledges are also inflationary, and risks to US inflation are now skewed to the upside. That said, a strong dollar will work to equilibrate inflation across regions, and we expect disinflationary forces to still dominate globally, unless a decisive policy shift materialises more broadly.

Economic prospects are at the mercy of policy makers

Political risk will remain high in 2017, with a number of key European elections and the triggering of Article 50 in the UK. Uncertainty is also high around the political agenda of Trump, and whether he will follow up on his

more extreme pledges. Political trends reflect the failure to generate better growth prospects after the great financial crisis and the erosion of the middle class in DMs. Tensions around these issues will persist and will continue to shape the political agenda.

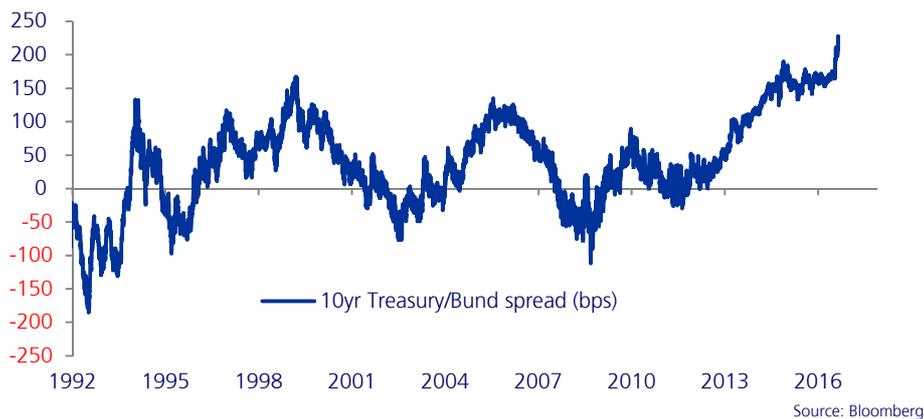
Central banks will remain supportive

Central banks will provide the bulk of the stimulus that is required to keep the global economy on track. With the exception of the US, where the Fed is set to hike rates, we expect monetary stimulus to remain in place, with a continuation of asset purchases in the Eurozone, UK and Japan, albeit in a more stochastic and unpredictable manner, and rate hikes will be minimal. Policy divergence should underpin dollar strength. Although a mild dollar appreciation from here on will be manageable, a sharp move higher would put pressure on the global economy, shaping our call that the Fed will be gradual in tightening.

High debt and central bank support will hamper a further rise in bond yields

Government bond yields have risen sharply over the past quarter. The last leg was triggered by a rise in inflation expectations, on anticipation of inflationary policies in the US. Other bond markets have lagged behind, with the Treasury/Bund spread rising to a multi-decade high. While the increase in yields has been steep, yield levels are still low, and the moves are best described as normalisation after summer excesses. Nominal growth, particularly in the US, is set to rise in 2017. By historical standards, this would drive another leg up in yields. From a fundamental perspective, however, a further surge in yields looks unlikely. Outside the US,

Bond market sell off not evenly distributed



central banks are working hard to offset higher yields, with the BoJ targeting the yield curve and the ECB focused on maintaining loose financial conditions in the periphery. Even within the US there are mechanisms in place that will limit yields from rising sharply. With a debt to disposable income ratio of over 100%, US households are vulnerable to higher interest rates, as became clear during the 2013 'taper tantrum', when the US mortgage market suffered. US mortgage rates have risen by close to 50bps in less than a month, and this is likely to weigh on housing activity and consumer spending. All this suggests that it is too early for the 10yr Treasury yield to break above the 3% level, and for European and Japanese yields to follow. Bonds are likely to be volatile though, and we do not rule out a further move up in yields in H1 as markets test new levels. As for peripheral bond markets, we anticipate that they will remain fragile and vulnerable to sell-offs on political and event risk, and any further deterioration in the banking sector.

Credit markets are in for a rough ride

We expect credit markets to have a rough ride over the coming year as investors grapple with fatter tails on both sides of the expected return distribution, a serious shift in supply/demand technicals and unappealing valuations. While credit markets were not adversely affected by the Brexit and the Italian referenda results, the real impact of these events will likely become more apparent in 2017. While we expect broader global credit to have positive excess returns over the course of the year, there will be significant divergences within this and we expect volatility to be front loaded. While there is uncertainty around the potency of the widely expected fiscal stimulus from the US, a meaningful shift from monetary towards fiscal stimulus will be beneficial in boosting nominal growth and hence the earnings prospects of corporations. That said, the low volatility and search for yield that credit benefited from for the last few years is likely to ebb. On the margin, spreads have

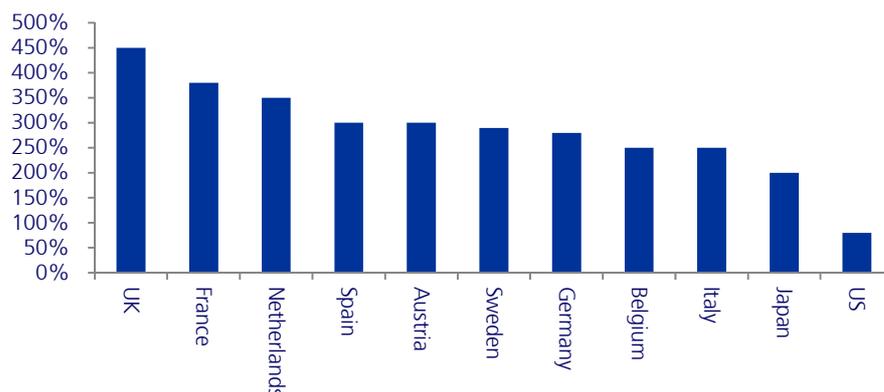
already become less attractive relative to underlying government bond yields, which was a core pillar of the search for yield in credit. Liquidity provisioning and easy monetary policy will also become less dovish at the margin, causing another key support for the market to weaken. Volatility in investor flows due to gyrations in bond yields can also be expected, as was the case recently. All of this said, repatriation of cash by US companies may be a game changer for US credit, but the devil lies in the details. We think that the fragility of European banks represents the greatest risk to credit, and policy makers and banks need to be proactive in addressing this risk. Leverage for non-financials has increased notably and spread per unit of leverage has now moved from being very appealing a few years back to being very low. All in all, there are a number of cross currents that are likely to cause volatility in the first half of the year.

Still some upside for stocks in volatile trading

We see 2017 as a year of change on a number of levels, not least of which is the primary driver of the aging equity bull market. While further gains are expected, we suspect that the environment will be more

challenging, with political uncertainty dominating. Until now, the cycle has been fuelled by liquidity provisioning by the central banks as they have struggled to meet their inflation targets. This has driven most assets higher and allowed equities to prosper despite rather dismal earnings, as discount rates plunged and valuations climbed. However, we now appear to have reached an inflection point. Liquidity has started to be constrained, with US rates rising and the unintended consequences of negative rates forcing a policy change in other regions. While fiscal stimulus and potential tax adjustments, particularly in the US, are grounds for optimism from an earnings perspective, uncertainty has risen and we suspect higher equity market volatility will follow. It will no longer just be a matter of investors believing that there is a tailwind of liquidity at their backs to support stocks, but rather a return to fundamentals, where earnings growth matters. That noted, bull cycles usually end with excessive exuberance. While multiples in many regions are rich, there are few signs yet of bubbles and excess. Consequently, although subject to increasing bouts of volatility, we believe that equities can rally further, provided the political backdrop is not too disruptive and that earnings do indeed improve. The trajectory will be lumpy, however, as investors adjust to the uncertainties of earnings growth and fiscal initiatives, and away from the dependability of monetary expansion.

European banks are mammoths (assets as % of GDP)



Outlook

- Households remain upbeat and investment is expected to pick up
- Trump's policies will provide a fiscal boost and increase inflationary pressure
- The Fed continues to gradually tighten monetary policy

Implications

- Treasury yields continue to climb higher but are bound by debt levels and loose monetary policy abroad
- Credit markets are likely to see front loaded volatility, with cash repatriation being a key support
- Equities may benefit from a fiscal boost, lower regulation and a return of animal spirits

Risks

- Trump follows up on his more controversial pledges, derailing markets and business sentiment
- Inflationary pressures force the Fed to act more aggressively than expected
- An ever stronger dollar puts the US economy and financial markets at risk

The US economy enters 2017 on solid footing

After a slowdown over the summer, the US economy is gaining traction again. GDP grew by an annualised 3.2% in the third quarter following a relatively weak first half of the year. The change in dynamic came from a long awaited rebound in investment. The drag from inventory drawdowns seems to have come to an end and improving business sentiment should support further investment spending going forward.

Household spending is expected to continue at a decent pace, as an ever tighter labour market has improved employment conditions and led to accelerating wage growth. At the same time, consumer sentiment remains at elevated levels. In particular, households' expectations with regard to their financial situation going forward is hovering around the highest level in a decade. However, with inflation picking up, real income growth has lost some momentum. Therefore, household spending is expected to hold up well, but is unlikely to accelerate significantly. Higher interest rates will also provide some headwind at the margin – mortgage rates are now roughly back at the five-year average. Nevertheless, with consumption spending set to continue at a solid pace and investment expected to pick up, increased fiscal spending has the potential to lift US growth above its potential in 2017.

Donald Trump wants to boost infrastructure spending

Trump's victory is a vote against the political establishment and the status quo, but it is also a vote against globalization, free trade and

migration. There is reason to worry if the world's largest economy, the success of which rests on liberal government, free trade and open borders, moves towards a more protectionist stance. On the positive side, with the Republicans controlling both Congress and the presidency, there is less chance of gridlock and stalemate and the potential for a more business-friendly environment going forward. Tax cuts, less regulation and increased fiscal spending would be a welcome support for the US economy.

However, there are significant downside risks. Most of Trump's policy announcements are inflationary. Imposing tariffs on imports would be a burden both for consumers and for firms that rely on imported goods in their own value chain. If Trump follows up on his pledges to curb migration and deport millions of illegal immigrants it could lead to a shortage of labour in an already tight labour market. While this would support wages in some affected sectors, it would lead to higher service inflation, which is running at more than 3% already. Finally, increased fiscal spending in an environment in which the output gap is already relatively low has historically led to higher inflation while the fiscal multiplier was rather modest. The US economy is growing close to its potential rate, which has been depressed since the financial crisis, dragged down by unfavourable demographics and low productivity growth. These structural headwinds are not expected to disappear any time soon. What the US needs is not a short-term fiscal boost but a sensible plan to lift the economy back to a higher trajectory.

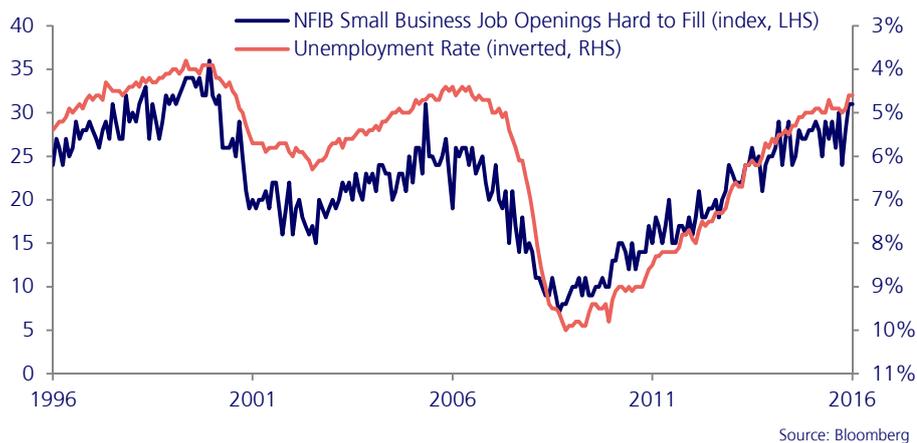
Here is where Trump's infrastructure plan comes in. Trump pledged to increase infrastructure spending by up to one trillion USD over ten years. As this is supposed to be budget-neutral, the intention would be to attract private investors with tax credits and/or attractive long-term yields. While involving private investors is not a bad idea and works rather well in other regions, it requires infrastructure with a revenue stream. It is therefore not suitable for projects like sewage systems, water pipes, toll-free roads etc., which are much needed and would provide a greater boost to potential growth. In fact, there are a relatively small number of projects that appear attractive to private investors. In addition, for investors without a federal tax liability like pension funds, endowments or sovereign wealth funds, tax credits are no particular incentive.

Nevertheless, we expect Donald Trump to go ahead with his plans to increase fiscal spending and it is likely that he will get some support from the Republican controlled Congress, although the amount will be lower than what he announced during his election campaign.

US yields soar on higher inflation expectations

Whether the additional spending can lift the potential growth rate remains to be seen, but the fiscal boost will support the economy in the short term. However, as the US economy is already growing close to its potential rate, fiscal stimulus will fuel inflation, which is already approaching the Fed's target. Were price pressure to further accelerate due to Trump's policy steps, the Fed could be forced

Filling job vacancies is becoming increasingly difficult



to act more aggressively than expected, with the risk of choking off the benefits of any growth-supporting measures. This is even more likely if Trump follows up on his announcement to fill the open positions in the Federal Open Market Committee with more hawkish members.

Treasury yields have reacted to the higher inflation expectations in the aftermath of Trump's election victory. Despite the sharp move higher, it is not more than an unwinding of the extreme movements that pushed US yields to all-time lows over summer. We expect yields to continue to climb higher, as growth remains decent and inflation continues to rise. However, the degree to which the US can disconnect from the rest of the world is limited. Interest spreads between the US and other major markets are already stretched. The global hunt for yield will potentially channel funds to the US, driving up the value of the dollar. A stronger currency will then act as a headwind for both inflation and corporate earnings.

US credit will likely outperform other credit markets, but not escape volatility

We expect modestly positive excess returns versus Treasuries for the year, but with volatility that is likely to be front loaded. The tails of the return distribution for US credit have become fatter on both the upside and the downside. While fiscal policy is widely expected to provide a boost to growth and earnings, there is still significant uncertainty around it. A shift towards a marginally less dovish monetary policy in the rest of the world and tighter policy in the US will, at the margin, weaken the search for yield. However, repatriation of foreign cash and prospects of a stronger dollar may still offset this issue, or even overwhelm it, depending on the details of the repatriation encouraging measures and the fiscal stimulus.

We feel less concerned around US banks in contrast to our cautious stance on European banks, where we think it is imperative that a

pre-emptive boost to capital should be undertaken. That said, US banks would also be impacted were European banks to suffer material stress. We are concerned around US non-financials, as leverage continues to increase, leaving companies quite vulnerable to the next downturn and to a sharp rise in borrowing costs. We are marginally more constructive on Municipals as we expect fund redemptions seen recently to ebb, while credit quality remains strong and net issuance trends supportive. Tax reform will remain a key question as will implementation of fiscal policy, but our supportive stance assumes grandfathering of existing tax exemption. In ABS we remain constructive on senior tranches of CLOs, Auto ABS and CMBS. We expect higher CLO issuance and credit enhancement will protect the product from significant deterioration, even if loan spreads and rates were to increase. While some parts of Auto ABS will experience higher delinquencies, losses should remain manageable. Senior CMBS tranches will remain well supported, although retail and hotels have downside risk.

Equity markets give Trump the benefit of the doubt

A strengthening dollar is one of the main risks for financial markets globally and in the US in

2017. The dollar has appreciated by more than 40% against key currencies since 2011. Major central banks like the ECB and the BoJ are expected to keep their monetary policy very loose while the Fed is in tightening mode. Therefore, the dollar is likely to climb higher in the coming months. This is a headwind for US firms that generate a significant amount of their earnings abroad. Domestically, margins could also come under pressure since wage growth is accelerating, which usually cannot be passed on fully to consumers. Valuations in the US stock market are already rich and earnings estimates for the coming years seem overly optimistic. In an environment where margins face significant headwinds and the Fed is tightening financial conditions, a further PE expansion is unlikely and would signal investors' exuberance with the risk of a major setback. Nevertheless, US equities could be supported by the revival of animal spirits, ignited by the prospect of additional fiscal stimulus, corporate tax cuts, less regulation in the financial sector and a booming economy. Investors are currently giving Donald Trump the benefit of the doubt and are focusing on the positive aspects of his expected policy. However, we would caution against completely ignoring the negative aspects of Trump's campaign pledges. It is possible that Trump will soften on some of his controversial positions. But having won the election mainly thanks to those pledges, it is unlikely he will not follow up on at least some of them. Uncertainty with regard to Trump's policy moves will weigh on investment and trade, and his intention to reduce US military support for American allies has the potential to raise geopolitical instability in an increasingly multipolar world. All in all, 2017 is expected to be a challenging year for US equities and could well see the final spurt of a very long bull market.

Treasury yields jump on higher inflation expectations



Outlook

- Economic growth is expected to weaken as Brexit uncertainty takes hold
- Rising inflation will be a headwind for household spending
- The BoE has to keep its monetary policy loose to soften the Brexit blow

Implications

- Gilt yields rise with global interest rates, but are capped by the BoE's bond purchases
- Credit markets are vulnerable, with banks representing a key risk
- The outlook for UK equities is poor, as growth is softening and the currency boost fading

Risks

- A political stand-off with the European Union increases the risk of a hard Brexit
- Weaker economic growth and higher rates undermine the British real estate market
- The banking sector comes under pressure if Britain risks losing access to the EU single market

Direct Brexit impacts have been limited so far

The British economy has coped well with the uncertainty in the aftermath of the Brexit referendum so far. GDP growth slowed less than expected in the third quarter. While private consumption lost some momentum, investment spending held up remarkably well, growing at 1.1% despite the uncertain outlook. Where the impact of Brexit is visible is in imports, which contracted markedly given the weaker currency. One hope of the Brexit supporters was that a weaker pound would boost exports and thus soften the blow to the economy. However, sterling fell to a multi-decade low during the financial crisis and there was still no exceptionally strong effect on exports. In fact, export growth returned to the average growth rate and has basically remained there ever since. A similar pattern seems to be evolving right now. The trade-weighted pound touched a new multi-decade low after the Brexit referendum while exports grew at an underwhelming 0.7% in the third quarter. A currency-induced export boom seems as elusive now as it did when the pound tumbled last time. More important than the currency is the economic development in Britain's export markets. The European Union is by far the UK's most important trading partner. Growth in the Eurozone is expected to slow down from its current pace but above all, the relationship between Britain and the EU is set to worsen going forward.

Britain cannot have its cake and eat it

One reason why Brexit effects are hardly yet visible is that Article 50 was not triggered right after the referendum and negotiations

on Britain's new relationship with the EU have still to begin. It is highly unlikely that the UK will be able to keep all the benefits of free trade with its main trading partner while not having to adhere to a significant part of the unloved EU regulations and processes. The EU is facing challenging times, not least because of a number of national elections on the continent next year. In such an environment, politicians will want to show a tough stance against runaway members. If leaving the EU does not hurt, even more voters will choose to support the populist parties in the remaining EU member states. Given the strong links between the UK and the EU economies, Britain's uncertain future relationship with the EU, and the other EU members' reluctance to let the UK get away too easily, the British economy is facing some significant headwinds in the quarters, and maybe even years, ahead. We expect the economy to slow down markedly once Article 50 has been triggered, which is expected to happen in the first half of 2017. This is mirrored by the government's forecast for GDP growth to slow down to 1.4% next year. The Office for Budget Responsibility expects that the British economy will grow by a cumulative 2.4 percentage points less over the next five years following the decision to leave the EU, which is in line with our expectations.

Not surprisingly, the government has adjusted its budget plans in the aftermath of the Brexit referendum. In the Treasury's autumn statement, Chancellor Hammond scrapped the target of reaching a budget surplus by 2019/20. That was a welcome move since the economy will have to face significant

challenges anyway. The government is now expected to borrow £122bn more over the next five years than expected under the initial plan. By allowing the budget to be off balance for a longer period, Hammond has signalled the government's willingness to soften the impact of Brexit. However, even the watered down deficit adjustment is a headwind for the economy and looks ambitious. A deficit reduction of 1.1% of GDP in 2019/20 would be a major drag on the economy just at the time when the UK is actually expected to leave the EU.

Parliament's involvement will delay the process but reduces the risk of a hard Brexit

The exit process and the final result remain very unclear. The government is very opaque with regard to its views about Britain's future relationship with the EU. New uncertainty was introduced by the High Court's ruling that the parliament will have to vote on Brexit. If the Supreme Court validates the decision, which is expected to be the case, the government's plan to trigger Art. 50 in the first quarter of 2017 could be delayed. While it is unlikely that parliament will ignore the referendum result and vote against Brexit, it will probably soften the government's strict stance regarding the trade-off between migration and free access to the EU market. In fact, it is not easy to precisely interpret the voters' will, as the referendum was on leaving the EU, but not on the future relationship. The risk of a hard Brexit seems lower given the parliament's involvement. Accordingly, sterling has recovered some of its weakness, strengthening about 6% on a trade-weighted basis. Nevertheless, the pound is still 20%

The pound tumbles on Brexit fears



Source: Bloomberg

lower than a year ago and remains the main pressure valve for any Brexit related nervousness. We expect the pound to come under renewed pressure in the coming quarters.

The BoE reinitiates its bond purchasing program

While the economy is holding up well on the surface, the effects from Brexit are becoming increasingly visible. Producer input prices for materials and fuels have soared by more than 12% compared to last year, driven by a weaker currency. This puts margins under pressure and will lead to significantly higher retail prices in the future, representing a headwind for consumer spending. A first glimpse of what is likely to come were the quarrels between retailers and foreign producers as to who will bear the lion's share of the import price increases caused by the lower pound. Inflation expectations have risen significantly, pushing yields higher as well. 10yr gilt yields are now back to where they were before the Brexit referendum. However, based on longer-term inflation expectations, the expected real return on gilts is deeply negative. The fact that yields do not fully incorporate expected inflation is to a large part due to the Bank of England's reinitiated bond purchase program that distorts the prices in the gilt market. Rising inflation and a lower growth outlook present a dilemma for the BoE. It indicated that it is willing to look through a short-term inflation acceleration but still explicitly took a neutral stance, indicating that the next step in monetary policy could be in either direction. The relatively hawkish stance was another reason for the rebound in sterling. However, while gilt yields are expected to creep higher in line with global bond yields, the BoE will be forced to keep its accommodative monetary policy to support a weakening economy.

Credit is not as cheap as it looks

Risks are skewed to the downside for the sterling credit market. While the real impact and uncertainty related to Brexit is likely to

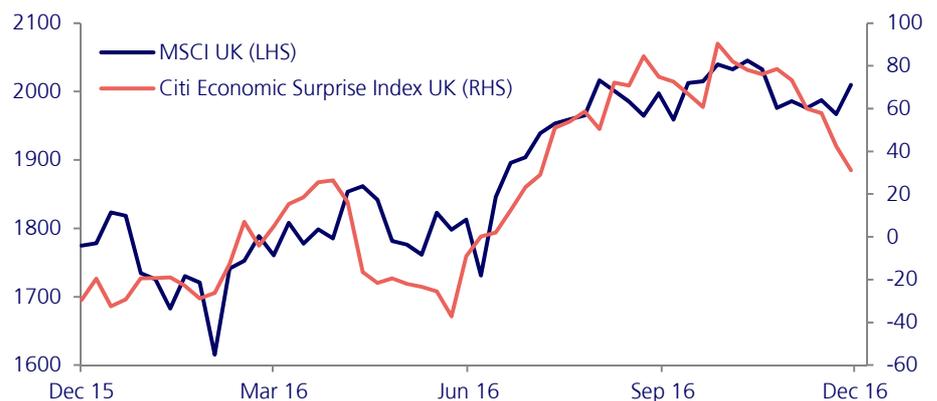
gain more visibility in 2017, the situation around European and UK banks continues to remain fragile. UK banks remain highly linked to European banks, while also being exposed to domestic uncertainty. While sterling non-financial spreads look optically cheaper compared to other markets, this is attributable to the different duration as well as the composition. On a currency hedged basis, sterling credit loses its spread advantage, which implies that demand from foreign investors will have to be based on an expectation of at least a stable currency. Concerns around the pension deficit are likely to ease somewhat amid higher yields. The BoE's QE had little impact on sterling credit beyond the initial shock, in contrast to that seen after the ECB's announcement. Given the level of spreads today, we don't expect this to change significantly as the effects of central bank purchases on spreads have limits. While there is significant linkage between European and sterling credit markets, we think sterling credit is vulnerable on two fronts with valuations that are unconvincing.

The stock market does not look attractive

The equity market sell-off following the Brexit referendum has quickly turned into a strong

rebound. Propelled by the tumbling pound, the FTSE 100 has rallied to briefly touch a new all-time high. Currency effects directly translate into higher earnings as many companies listed in the FTSE 100 earn most of their profits abroad. The currency effect becomes apparent in the relative underperformance of the FTSE 250, which consists of more domestically focussed British companies. Naturally, sectors with an international exposure had the strongest performance, led by industrial metals and mining. These companies got an additional boost from the rebound in the respective commodity prices like copper and iron ore. REITS and Real Estate Services were among the worst performing sectors, underlining the headwind that real estate is facing in the UK as economic growth falters and yields move higher. The market also benefitted from investors' relief that the UK is not rushing into the exit process and that triggering Article 50 has been postponed until next year. Following the relief rally, momentum in the UK stock market started to weaken as the outlook is deteriorating and the currency has rebounded from its lows. An expected relapse in the pound as we approach the actual exit process will support the FTSE 100 thanks to the translation effect. But the upside potential looks limited and negative momentum is expected to remain in place for the time being.

Equities face headwinds as economic surprises turn negative



Source: Bloomberg

Eurozone

Outlook

- Recovery continues, though political uncertainty will impact growth
- Core inflation likely to remain low, headline will be boosted by energy
- ECB continues with QE, but early reduction in size of purchases may be a policy mistake

Implications

- Equities supported by earnings growth, but with volatility because of political cycle
- Credit spreads will be flat, with banks proving to be a key risk
- Periphery bond spreads to widen and French bonds likely to sell-off before the election

Risks

- A non-mainstream party coming to power in a major Eurozone country
- Global/EM growth proves to be weaker than expected
- Fragilities in the banking sector become systemic

2017 Eurozone outlook

After a soft patch during mid-2016, the pace of growth in the Eurozone has picked up as we enter the new year, supported by still highly accommodative monetary conditions, a weaker euro and an improvement in global growth, with EMs in particular doing better. There has also been little negative macroeconomic impact from the UK Brexit vote so far, though we expect this to change in 2017. Indeed, not all of these positive factors are likely to remain as supportive in 2017, whilst additional headwinds are looming on the horizon, especially political risks. Consequently, although we expect the Eurozone economy to continue growing in 2017, we expect a somewhat slower pace of growth, 1.2%YoY (i.e. around trend), as opposed to the above trend pace experienced in 2016.

Political risks will be high in 2017, with France and Italy key

2017 sees general elections scheduled in France, Germany, and the Netherlands, with non-mainstream parties that advocate strong anti-euro/EU views doing well in the opinion polls in both France and the Netherlands. In addition, Italy, which also has a very large non-mainstream movement, could see early elections held in 2017. The Italian Five Star movement and the French National Front have both said they favour leaving the euro and EU. The upshot is that political risks will be on the horizon. France holds its presidential elections in April and May in two rounds. Currently, most polls suggest National Front leader Marine Le Pen will make it through to the second round, though she would then be defeated by whoever was her opponent.

However, given recent political upsets, investors may be cautious in assuming that the polls will be correct. As we get closer to the French elections we anticipate there will be more volatility in French and Eurozone asset markets, especially if the polls tighten ahead of the elections. In Germany, the mainstream parties still command a significant lead over other parties, suggesting another grand coalition is the most likely outcome. If Italy decides to hold an early election in 2017 we would view this as a negative for risk assets given the very large support for non-mainstream parties. For now, we expect the cyclical recovery to continue in the Eurozone, but would caution that political risks could start to unnerve investors and affect growth to some extent next year.

A year of two halves?

We still expect Brexit to have a substantial negative impact on the UK economy, with some spillover to the Eurozone, so the pain from Brexit has simply been delayed rather than avoided. Monetary policy will likely remain supportive overall, but the ECB plans to reduce the size of asset purchases in 2017 and this could act as a tightening in financial conditions, especially if it leads to higher yields, as we expect. Political risks and events will also likely impact business confidence, investment and overall growth, as well as generating financial market volatility. Q1 could be the high point in the Eurozone business cycle, with growth moderating later in 2017.

The ECB's reduced pace of asset purchases adds to risks

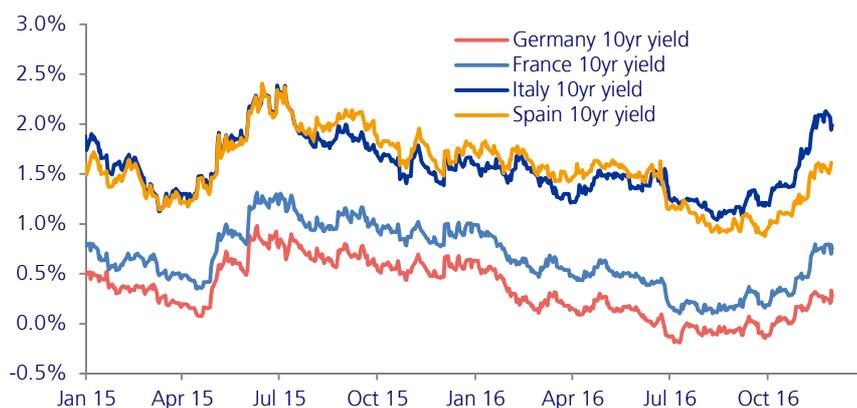
The ECB has recently said it will continue with

its QE asset purchases throughout all of 2017 but at a reduced pace. The ECB and the national central banks within the Eurosystem already own around €1.5tn of government bonds. However, inflation is still well below the ECB's 2% target. Indeed, core inflation hardly budged in 2016 and remains stuck below 1%. Headline inflation, currently 0.6% YoY, is likely to rise sharply early in 2017 due to base effects from higher energy prices, but from a very low level and the ECB will look through temporary energy price effects anyway. More monetary stimulus will be required in 2017 to help inflation move higher and offset deflationary threats. However, we think the ECB has made a policy mistake in announcing a reduction in the size of purchases so soon as inflation is still very low and political and event risk is high in 2017. If inflation fails to pick up as the ECB expects, or the Eurozone experiences another shock, it will have to change tack and increase its stimulus or make technical changes such as relaxing the capital key.

Fiscal policy will only be modestly supportive

Hopes for a large fiscal stimulus in the Eurozone 'a la Trump' are unlikely to be realised. According to OECD projections, the change in the cyclically adjusted primary deficit from 2016 to 2017 will be of the order of 0.3pp of GDP, after a 0.4pp boost in 2016. In November 2016, the European Commission suggested loosening fiscal spending by up to 0.5% of GDP in 2017. However, this was rejected by Eurozone finance ministers with Germany, for example, criticising the proposal and suggesting a much smaller fiscal stimulus is likely. The

Eurozone bond markets susceptible to increased political risks



Source: Bloomberg

Stability and Growth Pact, even if it is not adhered to strictly, still acts as a constraint on European governments enacting a large fiscal stimulus and prevents a large boost to Eurozone growth from fiscal spending.

Corporate earnings will pick up

Paradoxically, despite the more subdued economic growth forecast, the outlook for corporate earnings should be stronger in 2017 than in 2016. Energy and mining sector profits will benefit from favourable base effects because of higher commodity prices. Many Eurozone financial institutions will see better earnings because of higher yields and steeper yield curves, and domestically focused companies will continue to benefit from the ongoing recovery in consumer spending and the fall in unemployment. We expect earnings to grow around 10-15% YoY in 2017. The consensus is for around 11% earnings growth. The key point is, whereas in previous years consensus expectation for earnings growth proved to be overly optimistic, positive expectations are much more likely to be realised this time around, which should support equities.

Government bond markets likely to remain fragile and susceptible to sell-offs

We expect periphery bond markets to remain fragile, with yields gradually moving higher, given the number of political risks and events identified above, as well as the fact that the ECB plans to reduce the size of QE asset purchases in 2017. Core bond markets should remain well supported, but yields gradually drift higher too. However, even within core markets there may be greater investor differentiation. In particular, French OATs could be vulnerable in the run up to the two rounds of the French presidential elections in April and May, especially if opinion polls tighten in favour of National Front leader Marine Le Pen versus the other candidates. A short OAT, long Bund position could be a hedge against these political risks with an attractive risk/reward trade-off.

Credit markets will see volatility, with banks being a key risk

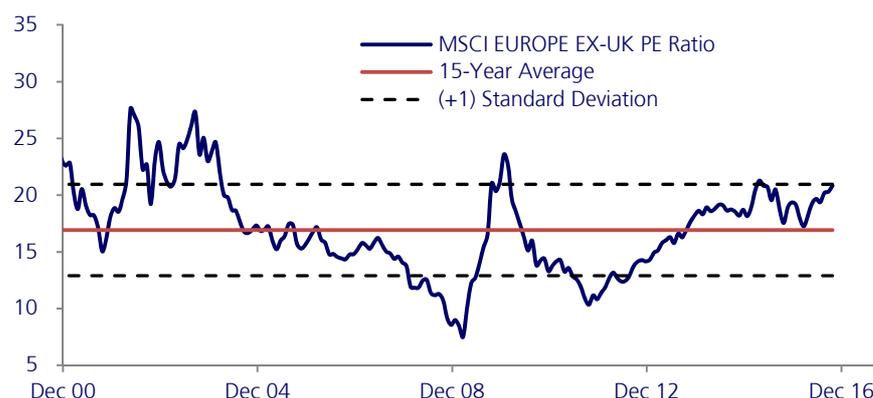
We expect front loaded volatility and nearly flat excess returns in 2017. Contrary to consensus we are concerned about European banks, which we feel represent the most significant risk to global credit and other markets. European banks are abnormally big and heavily interlinked, which has been the result of excessive dependence on banking as opposed to capital markets in Europe, as well as to cross-border linkages. At the same time, perceived capital strength and profitability appear to have weakened after showing some encouraging signs just after the Eurozone crisis. With political risks having risen and the impact of Brexit likely to be felt in 2017, banks are the weakest link in the chain of vulnerabilities in the credit markets. While issues around Italian banks and Deutsche Bank are most frequently highlighted, we think that concerns around banks are systemic, not idiosyncratic. In fact, the sovereign bank linkage has increased since the Eurozone crisis due to cheap funding from the ECB. Within the bank capital structure, we are most concerned around senior debt, where any prospect of bail in is not priced in. We have been negative on covered bonds for the last two years due

to price distortion stemming from the ECB's QE programme. While there has been underperformance, our fundamental concern around banks still make us cautious on them. European non-financials have seen a rise in leverage and it is quite important to see cash flows improve next year. The impact of ECB purchases on price is likely to diminish somewhat, as it tapers asset purchases next year. We remain constructive on European ABS and CLOs, although supply will remain modest.

Equities: favourable trends but with extreme volatility

In terms of the equity market, a re-rating is likely given the reasonably favourable macro backdrop and the improved earnings outlook across a number of sectors, if some of the political risks can be successfully navigated. The Eurozone has gone from being a very popular investment with international investors a couple of years ago following the resolution of the Greek debt crisis, to an unloved market today. This suggests a rotation back into the Eurozone could be an additional boost to equities. However, we would expect most of the gains in Eurozone equities to be provided by earnings growth rather than multiple expansion given that valuations are already high. The key political events we will be monitoring are the French and possible early Italian elections. If we have stable mainstream governments in place following these elections, which is our base case, then there is a strong case for Eurozone equities to move higher. However, though it is not our central scenario, the election of extremist parties to power in either Italy or France would be a negative for Eurozone equities, calling into question the integrity of the Eurozone and possibly leading to a substantial drawdown in equity markets.

European equity market valuations are high



Source: Bloomberg

Switzerland

Outlook

- Growth prospects hinge on global developments, as domestic growth drivers are notably lacking
- Inflation is expected to turn positive in 2017, but underlying price pressures will remain weak
- The SNB is expected to maintain its policy of negative rates and forex interventions

Implications

- Negative yields will persist, but the long end of the yield curve is likely to stay positive
- Low yields will remain a headwind for the financial sector

Risks

- Rapidly rising forex reserves trigger a policy change from the SNB
- High household debt in a deflationary environment
- The implementation of the immigration referendum remains unresolved

The Swiss economy is resilient

The Swiss economy has recovered during the past few months, following sluggish developments in H1 and into Q3. The turnaround has been fairly broad-based with all sectors, bar financials, showing improvements in the surveys. The upturn in economic activity appears to reflect a more positive external environment, with Eurozone activity and demand holding up better than anticipated. We expect the upswing to last, as global conditions look favourable from a cyclical perspective, with strong global new orders and some improvements in global trade. We therefore expect GDP to recover in Q4, following no growth in Q3.

External demand will shape the outlook over the coming year

Beyond the near-term cyclical recovery, the prospects for 2017 will hinge on global developments, as domestic growth drivers are notably lacking. The Eurozone, which remains the key export market for Swiss businesses, is plagued by political risk and sluggish growth. Emerging markets, which are the recipients of close to one-quarter of Swiss exports, are expected to compensate for some of the weakness coming from the Eurozone, but upsides to demand from this region are limited as well. We therefore anticipate the Swiss economy to continue to grow at a sluggish annual rate of around 1.3% in 2017. While this is below what we would consider trend growth, and broadly flat compared to what we anticipate for 2016, it nonetheless represents a decent expansion given currency headwinds and sluggish growth in the neighbouring economies. Nominal growth is likely to recover more firmly as deflationary

headwinds wane, with inflation expected to turn mildly positive in 2017.

Consumption is unlikely to be a growth driver

With an expenditure share in GDP of close to 60%, household consumption is an important component of demand. Having slowed from an annual growth rate of close to 2.5% in 2012/13 to below 1% in 2014/15/16, weak consumption has weighed on the GDP expansion. Going forward, we do not anticipate a sharp consumption rebound, as consumer confidence remains weak relative to its long-run average, with concerns around the labour market and job security lingering. While the real exchange rate has come down since 2015 as a result of falling prices in Switzerland, it is still strong, weighing on retail sales and tourism. We anticipate weak trends to continue in these sectors in 2017, resulting in sluggish retail and consumption growth.

Investment set to remain lacklustre, with construction a significant drag

Investment has also been weak over the past few years, reflecting a combination of slowing growth in the construction sector and subdued capex spending. Prospects for business investment will continue to be downbeat, given sluggish final domestic demand and margin pressure in both the financial and the manufacturing sectors. Construction investment has decelerated sharply, down from a strong expansion of 3% YoY over the past five years to only 0.4% YoY in the first three quarters of 2016 (annualised rate). Going forward, we do not anticipate the construction sector to provide a

boost to the economy given the slowdown in the housing market that is underway, with falling prices in some pockets of the market.

A mild fiscal tailwind likely to remain in place

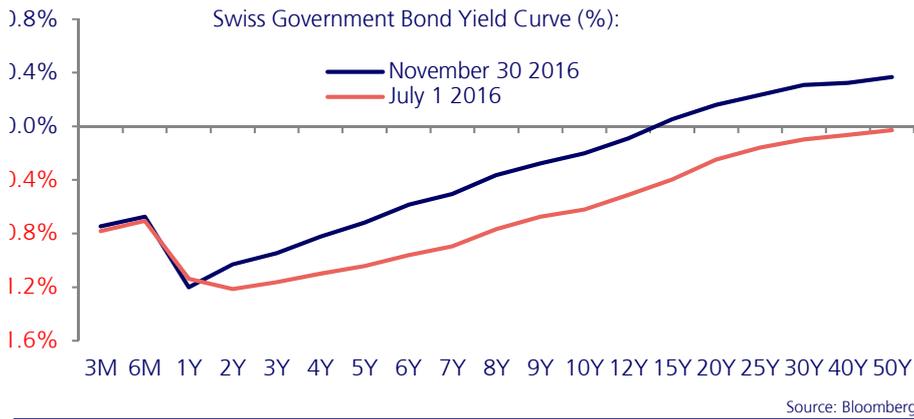
There is fiscal space in Switzerland, given a combination of low debt, low funding costs, and a persistent current account surplus, but we do not anticipate a sharp turnaround in fiscal spending over the course of 2017, in part as a result of the government's debt break. That noted, fiscal spending has contributed positively to GDP growth over the past year, up 2.6% YoY in Q3, indicating some fiscal discretion. Going forward, we have pencilled in a mild fiscal tailwind for 2017.

Net trade remains resilient, helped by the global cycle

With sluggish domestic demand, net trade will be decisive in shaping growth prospects for Switzerland. As we had expected, exports did not collapse following the Swiss franc appreciation in 2015, and we have seen a firm recovery in goods export volumes (ex merchandising and valuables) since then, while services exports have been more mixed. Export prices have come under pressure, however, given the uncompetitive exchange rate, and we anticipate this pattern to continue into 2017.

The most recent data show that exports (ex merchandising and valuables) expanded by 6.4% YoY in Q3, despite exceptionally weak global trade, confirming once again that for Swiss exporters, the state of external demand is more important than a competitive

Steeper yield curve benefits the economy



exchange rate. Terms of trade have improved notably given low oil prices, and this is being reflected in a solidly positive trade balance and a current account at close to 10% of GDP. The strong external position and the structural current account surplus underpins our view that the Swiss franc is not very far from its fair value. Going forwards, we anticipate currency strength to continue.

Inflation set to stay weak, with domestic and external headwinds

While the real side of the Swiss economy has been resilient over the past couple of years, inflation has been notably weak, with downward pressure on prices arising from falling import prices, falling oil prices, falling profit margins, and downward pressure on costs. This led to nominal GDP expanding by only 0.2% in 2015 and by 0.6% so far in 2016, and to inflation tracking in deeply negative territory throughout this period. For 2017, we anticipate consumer price inflation to turn positive for the first time since 2014, albeit only marginally so, with CPI inflation expected to average around 0.3% YoY. The rise in inflation is likely to be frontloaded in 2017, as oil price base effects are expected to come through in Q1. The underlying trend, however, is set to remain weak. The deflationary environment is reflected in very low wage inflation—at a multi-decade low of only 0.5% YoY in H1 2016—and services inflation still stuck at close to zero.

Housing market weakness is expected to persist

Despite the weak nominal environment, house prices ticked up in Q3, resulting in an all-time high price to rent ratio, with mortgage lending and real house prices still on an upward trend. Rents fell further, however, at -1.3% YoY, and we anticipate the housing market to continue to slow. High household debt, at close to 120% of GDP, will weigh on mortgage lending and house price inflation, potentially reinforcing the deflationary environment. Debt servicing costs are low, however, implying that financial

stability risks are contained.

SNB policy expected to stay unchanged

We anticipate the SNB to stay focused on stabilising the franc using a combination of negative policy rates and forex interventions given the backdrop of persistent deflation and a fragile economy. To achieve this, the SNB needs to maintain a negative yield differential towards the Eurozone, which constrains its ability to set monetary policy independently. We expect the ECB to maintain asset purchases and the negative deposit rate at least into the end of 2017, and therefore do not see any prospects for a rate hike in Switzerland over the coming year. With elevated political risk in the Eurozone and a fundamentally strong franc, we also expect bouts of safe haven flows to trigger SNB interventions in the forex market, despite the SNB balance sheet now tracking at close to 100% of GDP. We also do not rule out a further rate cut, or a broadening out of the negative deposit rate, should persistent pressure on the currency arise, but this is clearly not part of our base case.

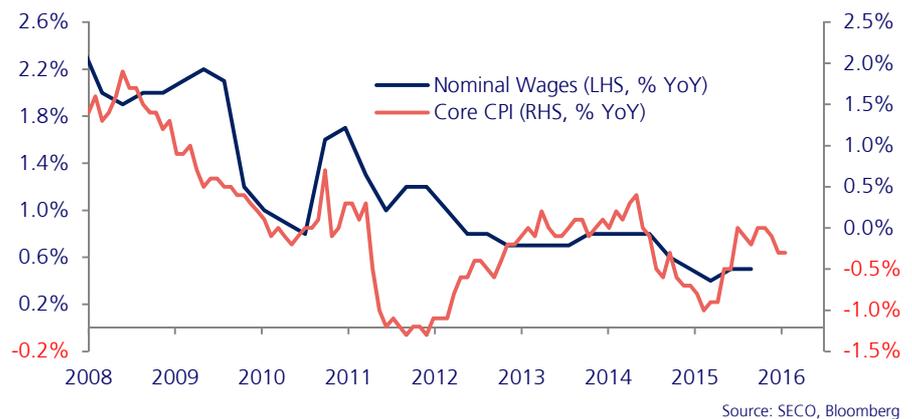
Bond yields

The Swiss yield curve has steepened in the global bond sell-off and yields are now positive beyond the 12yr maturity. This is a

large change compared to mid-year, when the whole yield curve turned negative, in an unprecedented move. As we highlighted back then, the catalysts that could trigger a meaningful rise in Swiss yields would either be a rise in Bund yields or a sharp reversal in demand for perceived safe haven assets. We have seen a rise in Bund yields, but we expect ECB QE to remain a distortive factor, limiting a further rise in Bund yields. While demand for safe haven assets has receded compared to the immediate aftermath of the Brexit vote, political risk is elevated, also constraining further moves in the Swiss yield curve.

Though we do not expect bond yields to fall back to the extreme levels recorded in Q3, the negative yield environment is expected to persist in Switzerland. This poses a risk to the outlook by hampering profitability in the financial sector and potentially contributing to a buildup in imbalances. That noted, the major Swiss banks are perceived as safe havens within the banking sector due to their stronger capital position and better asset quality, although they will not be completely immune to Eurozone tail risks.

A deflationary environment



Japan

Outlook

- Private consumption and capex are expected to underpin solid growth next year
- US economic policy could be either a tail- or a headwind, depending on which measures are implemented
- A constructive combination of both fiscal and monetary policy should support growth

Implications

- The weaker yen is significantly improving the outlook for Japanese equities
- Earnings revisions are moving into positive territory following a five-year low marked this summer
- Foreign investors are warming up toward Japanese equities following underweight positioning

Risks

- Deterioration in the global growth environment, particularly in the US and China
- The weaker yen is short-lived, with a marked turn higher
- Abenomics 2.0 fails to lift trend growth

Decent growth outlook

Japan's economy has shown anaemic growth over the last three quarters, but has at least avoided falling into another recession. Industrial production growth has accelerated in the third calendar quarter, and momentum seems to be remaining solid in the current quarter based on official production surveys. Even when discounting for the fact that these surveys tend to be too optimistic, the recovery trend is expected to last into next year. Transport equipment is contributing following the recovery from the Kumamoto earthquake related production disruptions. Electronic parts and devices are also contributing to growth. The shipment/inventory ratio is benefitting from decreasing inventory in these sectors. On a YoY basis, we expect industrial production to move to positive territory, albeit below 1%, following two years of shrinkage. Overall, we expect real GDP growth to pick up some steam next year.

Will consumers come back to the stage?

Since the consumption tax increase in 2014 consumers have been holding back, despite very favourable labour market conditions and some – albeit timid – wage growth. However, as overall employee compensation keeps improving, we believe consumers will finally start spending more. The gap between real compensation and private consumption is not expected to expand further, as the rising worker's savings rate is expected to peak. This is a crucial assumption, as rising per capita wages and slowly improving consumer confidence can only become effective if the savings rate does not rise further. This should help to underpin a firm footing for private consumption. Taxes and social security

contributions are not expected to rise further, as the latest tax reform plans also encompass some tax cuts. In addition, the replacement cycle for durable goods has become too extended, suggesting that a pickup in demand in this category should help to underpin overall consumption. Generally, we do not expect a sudden boom in consumption, but a pickup in demand from low levels.

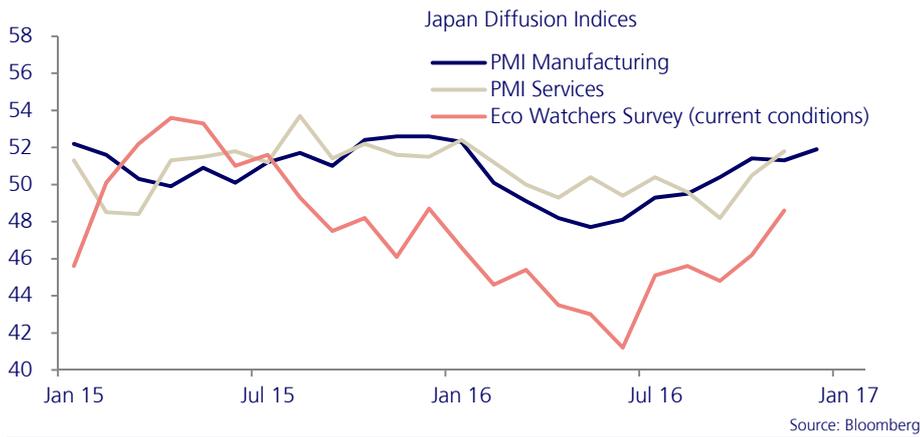
Labour market condition should improve further next year, albeit at a slower pace. The job-to-applicant ratio, at 1.40, has just marked a 25-year high and may even exceed the cycle high seen in 1991 at 1.44. We believe there is a good chance that tighter labour market conditions due to a lack of labour supply will increase the number of jobs to applicants to levels last seen in the mid-1970s. This is reconfirmed by the falling labour conditions diffusion index. While this leads to rising wages for part-time workers, it is not fully reflected in full-time worker compensation. Labour market flexibility remains somewhat sticky in Japan, and Japan's labour unions seem to be less aggressive when it comes to wage negotiations compared to other developed countries. However, one of the government's core policy targets is to convince companies to become more generous in next year's wage negotiation rounds, which should finally be easier amid the improving earnings environment.

Capex will be another growth pillar next year

Improving global economic conditions should help motivate companies to increase capital

investment. Supply-side constraints push companies to improve productivity, particularly in the non-manufacturing sector, where productivity is far below international standards, and particularly in segments like retail, lodging, eating&drinking and healthcare services. While we believe it is an illusion that Japan will soon achieve international productivity levels, there is certainly pressure to improve productivity by investing more into automation, as it has been previously witnessed in the manufacturing industries, where Japan has indeed set the standard. The improving earnings environment following the latest yen depreciation should also underpin corporate willingness to invest more, as there is a rather close relationship between earnings revisions and capex. The latest capital goods production plans have been somewhat ambiguous. It may take some time until corporate sentiment improves, but we are confident that at some point in Q2 or Q3 the improvement in the earnings outlook will finally become visible in a greater willingness to invest more. This should also be bolstered by the seasonal pattern of corporations showing some caution in the first half of the year before capex plans start to accelerate. Housing investment may turn out to be somewhat lacklustre, despite the encouraging housing start statistics seen recently, with housing starts holding in well just below the annualised one million mark. Housing starts had been rather lacklustre following the rush demand boom before the 2014 consumption tax hike, but recent strength is encouraging, particularly as rental housing starts have been consistently firm. This may well be due to land owners wishing to escape fierce

Japan's economy is picking up steam



inheritance law implications. However, we would like to see better built-for-sale housing sales as well. As long as this is not the case, housing is not expected to be a major driver of GDP growth.

Exports are expected to pick up, but risks remain

Recently, export growth has been mainly driven by brisk demand from China and other Asian nations, while exports to the US and particularly Europe have faltered. Asian demand has probably benefitted from the electronics production cycle. This beneficial impact may slow. At the same time, demand from China may also suffer somewhat as we expect Chinese growth to slow and as Chinese imports for reconstruction of areas hit by natural catastrophes will not be maintained at the recent level. This brings the US back into focus. As we regard current economic conditions in the US favourably, with private consumption brisk, the impact on demand for Japanese products should also be noticeable. US capital goods orders have stopped falling. Were US capex to pick up steam, Japanese general machinery exports should benefit.

However, it is difficult to project the development of Japanese exports to the US due to uncertainty about the economic policies of Donald Trump. On the positive side, strong infrastructure spending, corporate tax cuts and deregulation should boost the economy and imports of Japanese goods. On the other side, higher import tariffs and the cancellation of the TPP trade deal hamper global trade. It remains to be seen whether tariffs of 45% on Chinese imports and 35% on Mexican imports will be implemented, we rather doubt it. If so, they would certainly affect the supply chain of Japanese manufacturing exporters, particularly in the auto and general machinery industry. Trade deals with other Asian nations and Russia could be pushed forward, in order to counterbalance the negative impact from a TPP failure, but this will have more of a

medium-term impact and will not be a topic for the first half of 2017. Overall, we do not believe that 'Trumponomics' will be implemented fully in line with what was pencilled in before the election, but it is difficult to make reliable forecasts.

Good news from the policy front

Whereas the outlook for exports is uncertain, fiscal and monetary policy should underpin growth in 2017. Following three years of tightening, fiscal policy is expected to turn expansionary next year. The latest economic stimulus package totals JPY 28tn, or about 5½% of GDP. As always, the headline amount is misleading. However, the 'mamizu' or 'clear water' component, reflecting the direct, growth effective portion, still amounts to a respectable JPY 7.5tn, or 1½% of GDP. Public investment and cash transfers to households are expected to push GDP growth up by about 0.5 percentage points, and public construction orders received have already started to pick up. A third supplementary budget and a generous ordinary budget for next fiscal year would add fire, but we do not want to be too aggressive in our expectations on that front, considering the cautious attitude within the Ministry of Finance. Meanwhile, we expect monetary policy to remain stimulatory,

following the BoJ's move to yield-curve-targeting and the fact that real yields will fall as inflation finally picks up. Even though the core CPI is not expected to reach the 2% inflation target any time soon, the BoJ's loose monetary policy should underpin economic growth, not least indirectly due to a weaker yen. The strong yen has been a major headwind for the economy for most of 2016. With the Fed expected to hike rates twice next year, the yield differential should keep the yen weak against the US dollar, supporting demand for Japanese goods.

Japanese equities are shining again

The Japanese equity market was certainly not everybody's darling for most of 2016, as foreigners kept selling the market in the first three quarters of the year amid a stronger yen. Only recently has appetite been revived, with foreign buying picking up steam following the weaker yen, which again was the consequence of rising US inflation expectations following Trump's election win. We believe that this trend should continue well into 2017, though we have recently seen some exaggeration in the swing from a negative to a positive attitude on Japanese equities. Several investment banks have followed suit and have increased their recommendation for Japanese equities, with some even swinging from bearish to ultra-bullish within a short period of time. Positioning, however, is not yet extreme, so there is enough room for Japanese equities to move higher and to outperform global equities. The seasonal pattern remains supportive until late spring. The earnings revision ratio has constantly moved up to positive territory following a five-year low marked in July, which should also be reflected in a more optimistic corporate earnings outlook between March and May 2017, when companies give their outlook for the next fiscal year starting in April. We expect recurring profit growth to reach the double-digit percentage range, which should underpin higher index targets as the market is fairly valued.

Weaker yen beneficial for a better earnings outlook



China

Outlook

- China's growth will continue to gradually slow, but avoid a hard landing
- The service sector is expected to continue to blossom, but overcapacity needs to be tackled in the old industries
- Inflation should rise modestly, while capital outflows need to be contained

Implications

- Foreigners and domestic institutional investors have scope to increase weightings in Chinese equities
- Earnings growth should be decent, while valuations remain fair
- The CNY has some more scope to depreciate versus the USD, but not on a trade-weighted basis

Risks

- Capital outflows cannot be brought under control
- Frictions between the US and China escalate into a trade war
- Political infighting intensifies around the 2017 Communist Party position reshuffling

Once again, no hard landing expected

Market fears about a hard landing in China's economy were quite extreme and persistent early in 2016, which made our call for growth of around 6½% for the whole year look unrealistic at times. We stuck to our assessment, which turned out being right as it is highly likely that reported growth will come in at 6.7% for the year, in line with the government's growth target. Growth momentum is firm going into 2017, but we believe it will be difficult to maintain that level throughout the year. We have pencilled in a growth rate of 6.3%, which in our view reflects a healthy, but very modest slowdown. Once again, no hard landing is expected. Some headwinds will slow growth in 2017. Growth in 2016 has been mainly supported by the booming property market, strong auto sales and a pickup in infrastructure investment. We expect two of these components to lose steam. Auto sales will no longer grow at double-digit rates due to expiring tax breaks. While we do not expect a collapse, growth rates will slow down to single digits. As for the property market, 2016 experienced another frenzy, which probably culminated last autumn when investors flocked to Hangzhou following the G7 meeting in order to buy property, as they believed that tier-2 cities would experience the next wave of the property boom, following the boom in tier-1 cities like Shenzhen earlier in the year. Nationwide property sales growth spiked above the 50% mark in September. Authorities were quick to implement cooling measures like home purchase restrictions and tighter lending standards for developers. However, as the land auction premium remains elevated and

land auctions stand at record highs in some tier-2 cities, we believe that tightening measures may accelerate. This should lead to a slowdown in the property market in 2017. Swings in China's property cycle are usually quite extreme and also tend to have an impact on the economic cycle, which suggests that quarterly GDP growth rates will come down on a sequential basis and also on a YoY basis.

The government will support the economy through infrastructure spending. As soon as the expected slowdown in the property cycle becomes evident, fears of an economic slump could re-emerge. The government will then need to accelerate infrastructure spending through policy banks and loosen fiscal policy accordingly. The pipeline of potential projects is long. Investments can be implemented quickly, particularly to support growth before the leadership transition around the 19th National Congress of the Communist Party in November 2017. As in previous cycles, the government will do everything to facilitate a smooth economic environment before this major event, at which five out of the seven members of the politburo standing committee will be replaced, with only the president and prime minister expected to keep their posts for another five years. Both fiscal and monetary policy are expected to remain loose throughout next year. Will Trump play hardball with China? As if domestic issues were not difficult enough to handle, there are also specific risks coming on the external front. President-elect Trump has suggested imposing a 45% tariff on Chinese imports and has labeled China a

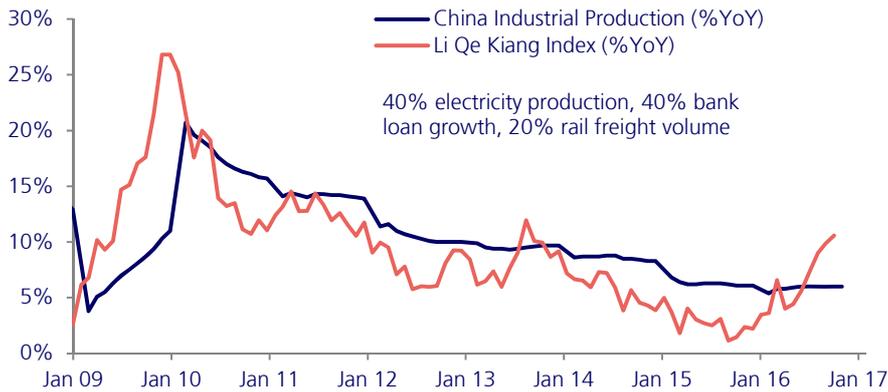
currency manipulator. If he were to play hardball with China, risks to our benign growth outlook would increase significantly, as China would retaliate and there could be negative indirect implications due to the vulnerability of global trade. While the US is China's biggest trading partner, China is the third largest US export market. In the medium term, China should be able to benefit from more bilateral and multilateral trade agreements with other Asian and emerging countries, but negotiations will take time and would not be able to quickly counter sudden trade frictions with the US. This could translate into a growth shock. However, we do not believe that Trump will implement policies to the same extent as he advocated during his election campaign.

The future Trump administration's relationship with China experienced a bad start following the telephone call Trump had with Taiwan's President Tsai, a definite 'no go' from the perspective of mainland China. It remains to be seen whether this 'courtesy call' is just interpreted as a political faux pas or the start of a serious deterioration in relations between the world's two biggest economies, with China also being the biggest foreign holder of US Treasuries. We would hope for the former as both sides are aware of the punitive powers each possess.

Hong Kong: The growth outlook is benign, but risks are high

Hong Kong should benefit from better global economic conditions, as evidenced by improving global PMIs and a revival in global trade. However, risks to this rosy scenario are significant. Should Trump play hardball and

Credit impulse helps the economy to recover



Source: National Bureau of Statistics, Bloomberg, ZIG

initiate a trade war while growth in China is expected to slow down, the impact could be severe for a small open economy like Hong Kong. Higher US interest rates would also have a negative impact on financial conditions in Hong Kong due to the peg. On the domestic front, demand is slowly improving, as tourist arrivals appear to be bottoming out. The fact that sales in the jewellery category are no longer falling in double-digit terms shows that mainland Chinese tourists are cautiously coming back. However, should the yuan weaken further versus the USD and HKD, the pickup by Chinese buyers may take longer. Property prices should take another hit following the increase in stamp duty for non-residents, while property relaxation measures are not expected for next year. Fiscal stimulus in the form of an expansion of public welfare policies will prevail. Potential mass protests against China's involvement in local politics is another risk.

Taiwan: Vulnerable to conflicts with both the US and China

Taiwan's economy would also suffer if the new US government were to impose tariffs on Taiwanese exports, or if a 45% tariff were to be imposed on Chinese exports, as two-thirds of Taiwan's exports to China are re-processed for China's exports. Assuming that US trade measures would be more tame, the global trade environment could be rather conducive for Taiwan's external trade, particularly if commodity prices firm further. The cyclical tech products upswing should continue well into 2017. On the domestic front, private consumption should remain lacklustre amid falling house prices, with real estate constituting a substantial portion of private wealth. We expect the Central Bank of China to keep monetary policy neutral, following rate cuts totalling 50bps since Q3 2015. Another major fiscal boost seems unlikely, as the debt ceiling does not allow violating fiscal rectitude, even though we expect infrastructure and military spending to pick up somewhat. 2017 will also be a critical

year for cross-strait relations, as relations to Mainland China have cooled down since President Tsai was elected, particularly following the telephone call with President-elect Trump. China is Taiwan's core export market, while diversification to other export destinations will take longer to be realised. Tourism from Mainland China has also taken a hit recently, which may be a problem throughout the year from an economic point of view.

South Korea: Domestic demand will remain lacklustre, while risk on the external front prevails

High household debt remains a structural problem in Korea, which is keeping a lid on private consumption growth. Indeed, debt servicing costs should rise further due to the restructuring of loans. In addition, an end to tax incentives and stricter anti-corruption laws will hamper durable goods consumption, particularly in the luxury segment. Construction investment has given a boost to the economy this year, but we expect less support in 2017. Our outlook for fiscal support is more optimistic. Though the fiscal boost from the 2017 budget will be small, a sizeable supplementary budget should help to alleviate the impact of front-loading expenditure from the second to the first half

of the year. The Bank of Korea is expected to stay put. It will not cut rates further, as this might fuel the severe household debt problem, but it should also refrain from raising rates despite the Fed hiking rates further and despite rising inflation, as the share of variable-rate loans is still too high. Political turmoil will prevail in 2017, with President Park's impeachment process on accusations of influence-peddling and corruption ongoing.

Constructive view on Chinese equities

Overall, we maintain our cautiously constructive view on Chinese equities. Domestic 'A'-shares have risen significantly from their cycle low marked at the end of February. Chinese shares have suffered from the Trump-induced rise in global bond yields. Rising yields tend to negatively correlate with emerging market performance. Foreign investors had just started to dally with emerging markets following five years of underperformance versus developed markets, but quickly changed their mind following the turn in the bond market. However, it has to be noted that within emerging markets, China has not been the prime target for selling, and foreign investors remain underweight in this asset class. On the other hand, domestic institutional investors have started to discover Hong Kong listed shares due to their high dividends and as a vehicle to allocate funds away from pure RMB investments. The expected correction in the property market should also contribute to a southbound shift toward equities denominated in HKD, which, due to the peg, are seen as investments close to the USD. Many insurance companies and pension funds have already opened trading accounts in Hong Kong, which should underpin steady investment flows. Earnings growth is expected to rebound into 2017, while valuations remain fair, allowing further upside for stocks.

Recovering from a bad start



Source: Bloomberg

ASEAN

Outlook

- Given global uncertainties, domestic-oriented and reform-focused countries will likely fare better in 2017
- We expect stable growth in Malaysia, stronger growth in Indonesia and higher inflation across Asia
- China's economic and diplomatic role in South East Asia is likely to increase

Implications

- A strong US dollar, higher US yields and heavy foreign positioning are headwinds to Asian fixed income
- We keep a positive stance on Asian equities, as fears of protectionism seem exaggerated
- A bottoming out in earnings and a recovery in the macro environment are also supportive

Risks

- Fiscal conditions tighten as yields rise faster than expected, disrupting Asia's fragile debt balance
- Private investment fails to pick up, leading to another year of 'low quality' growth
- The US trims its diplomatic and economic involvement in Southeast Asia

Trump and Asia

President-elect Trump has pledged to renegotiate diplomatic and economic relationships with Asia. His election has increased the downside risks for the region. First, a protectionist stance by the US would dampen the timid recovery observed in Asian trade. Second, financial conditions could tighten were bond yields to climb further. Third, weaker local currencies could, combined with higher commodity prices, rekindle inflation pressures. We view the worst-case scenario of Asian stagflation as unlikely though, given the ongoing slack in Asian economies and the increased reliance on the Chinese economy.

Leaving the implications of the US presidential election aside, Asia presents a fragile balance: domestic debt levels are high and productivity has stagnated since 2008, with Indonesia and the Philippines being two notable exceptions. We think that the biggest hope for Asia lies in a recovery in capex, driven by infrastructure investment that is primarily financed by China. Geopolitically, with two more countries, the Philippines and Malaysia, moving to the 'China camp', China's diplomatic, economic, and military supremacy over the region will probably expand. Overall, we see Asian economies continuing to recover in 2017, notably thanks to the support of China. A moderate pickup in inflation will likely prevent Asian central banks from lowering policy rates further.

In Malaysia, policy continuity but increased headwinds

2017 will probably be an election year and Mr Najib's coalition has a high chance of winning

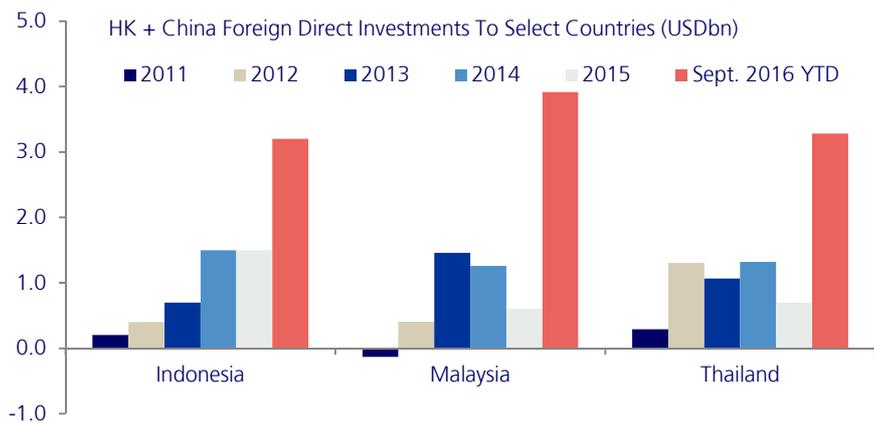
a new mandate, thanks to upcoming changes in the boundaries of electoral districts and a divided opposition. The 2017 budget also carries a populist tilt: despite a conservative deficit target of 3% of GDP, the share of planned expenses allocated to public welfare has increased to 82%, with the bulk dedicated to emoluments and retirement charges of civil servants. Together with renewed cash assistance to low-income households, this should support disposable income. We think that household consumption will grow at a stable rate as cash handouts offset the hurdles of household debt (88.5% of annual disposable income) and the cool down in the property market. As for external demand, increased uncertainty around US trade policies are a risk for Malaysia, which was going to benefit the most from the Trans-Pacific Partnership (TPP). However, Malaysia will likely strengthen its economic ties with China further. Prime Minister Najib recently reached a major bilateral agreement covering trade, education and defence. The deal is, in our view, a geopolitical milestone and speaks for China's growing 'soft power' over the South China Sea. Fresh financing and FDIs from China will likely have a salutary effect on Malaysia's tight financing situation. Overall, we see stable growth for Malaysia with resilient household consumption, strong Chinese FDIs, and higher oil prices balancing out the downsides of higher bond yields and uncertainty around trade.

Indonesia, the case in point of effective policies

In 2017, Indonesia will likely reap the benefits of the '13 packages' of reforms passed in

2015/16, including the simplification of business license attribution, liberalisation of the negative investment list, and establishment of special economic zones. Improvements are already tangible: Indonesia's ranking in the World Bank's 2017 Doing Business survey jumped 15 notches to 91. Green shoots are also visible in private investment and consumption, while the NPL cycle should near its end in 2017. Turning to fiscal policy, next year's budget, drafted by the competent new Finance Minister, Sri Mulyani, combines fiscal orthodoxy (the 2017 deficit target is 2.4% of GDP) with a stronger commitment to infrastructure spending (+22% YoY planned for 2017). We highlight the importance of infrastructure development as a sustainable driver to increase productivity and reduce regional disparities in a country as large as a continent. The successful tax amnesty operation will strengthen the tax base. The government is on track to achieve its target of IDR 160tn (1.3% of GDP) of collected revenue by March 2017. Importantly, policymakers are focused on channelling these inflows into the real economy. Having attracted sizeable portfolio inflows lately, Indonesia is exposed to the rise in global bond yields, but Indonesian bonds should be resilient thanks to their high carry incentive and to solid domestic demand from institutional investors. Replenished FX reserves and a contained current account deficit should give the central bank some manoeuvring space. Following six policy rate cuts in the past year BI is likely to shift its focus to easing the transmission of monetary policy to the real economy. Increasing FDIs as well as strong popular and parliamentary support for the government are other

Chinese FDIs to ASEAN are accelerating



Source: Bank of Thailand, Bank Negara Malaysia, Indonesia Investment Coordinating Board

positives. To be sure, structural developmental and economic challenges persist, but we are strongly convinced that Indonesia is moving in the right direction to address them.

Other ASEAN countries

We expect sluggish growth in *Singapore*, because of the following negative drivers: a lacklustre trade recovery, the Fed normalising its policy, immigration restrictions, the property market deleveraging, and limited fiscal room to manoeuvre. The pro-FDI and pro-innovation strategy pursued by the authorities is positive, but will take time to unfold, while slightly stronger oil prices will probably not suffice to revive investment in the marine and offshore exploration sector. We reiterate our bullish view on the *Philippines*, where rapid growth is supported by buoyant infrastructure spending and FDIs. Low levels of public debt leave ample room for fiscal stimuli. Additionally, efforts to cut the red tape and unlock growth for the poorest Filipinos should boost productivity and consumption. President Duterte's controversial leadership style is unlikely to derail the country's growth trajectory, while stronger relations with China would compensate for weaker ones with the US. In *Thailand*, 2017 will be a year of political transitions: new elections are scheduled for H1, while the monarchy succession is ongoing. Risks of protests and revolts are still latent. The economy is in a vulnerable state: private investment is weak and households are crippled by debt. Fiscal policy will remain the only bright spot.

India, a progressive turnaround

2016 has seen an impressive pipeline of milestone reforms being passed, as Modi's BJP managed to strike political compromises in the Upper House of Parliament. In 2017, the Uttar Pradesh elections will be key for the continuation of the BJP's reform momentum. Among the key reforms passed, the Goods and Services Tax should boost productivity. The primary sector, which employs close to

half of India's workforce, should benefit from new tenancy laws to reduce the fragmentation of land holdings. Ongoing large investments in transport and logistics will also support growth. The recent 'demonetisation' policy will likely boost tax revenues and step up the fight against corruption; we expect the toll on GDP growth to fade after Q1 2017. We are more concerned by structural weakness in private capex, but are expecting the authorities to engineer a reform to clean bank balance sheets. The service economy will likely continue to strive, as the e-commerce revolution unfolds. In our view, the pace and nature of reforms seen in India is remarkable and very positive, as it precisely targets the structural obstacles to growth. Patience is, however, warranted, as reforms will probably take years to bear fruit and counter the deeply entrenched developmental unbalances.

Financial markets, is the Asian rally at an end?

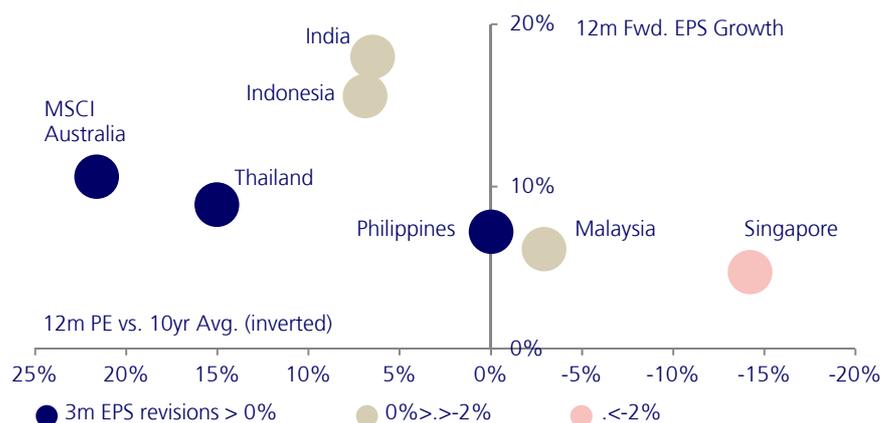
In an environment of higher global yields and recovering commodity prices, Asian fixed income assets are likely to underperform Asian equities. Among equity markets, the countries with a strong domestic growth and

reform story should fare well.

Even though the rise in global yields is likely to occur progressively, it will probably weigh on Asian sovereign debt and credit assets, as the 'run for yield' investing strategy turns less alluring. The share of Southeast Asian debt denominated in US dollar is not as large as it was during the 2013 'taper tantrum', and most Southeast Asian economies are in better shape thanks to larger FX reserves and healthier current accounts. However, in some countries, foreign positioning in local currency debt is important, for example in Malaysia. A stronger US dollar also makes local currency debt less attractive. We believe that the fixed income returns seen in 2016, a year of monetary easing for a lot of Asian central banks, are unlikely to persist in 2017.

Turning to equity markets: Asian markets have now priced in the uncertainty resulting from the US election, and there is the potential for positive surprises, especially regarding the fears around trade wars. In parallel, a reflationary scenario, where more countries shift to fiscal stimuli, would be marginally positive for Asia. Finally, as China continues its economic transition in a stable way and increases its international financial and economic role in Asia, it should benefit the region. Equity markets with convincing macro and reform stories, such as the Philippines, Indonesia, and India should be less vulnerable to potential external shocks. Episodes of market volatility are seen as opportunities, especially if valuations cheapen closer to their long-term averages.

We keep a positive stance on Asian equities



Source: IBES, Thomson Reuters Datastream

Australia

Outlook

- Real GDP growth should track at ~2.7% YoY in 2017
- Higher commodity prices will likely support terms of trade and nominal growth
- Consumption should remain weak, dragged by high debt levels and slow wage growth

Implications

- Stronger terms of trade are positive for company earnings
- The Australian equity market would benefit from a 'reflation trade'
- Sovereign yields are expected to follow global yields higher, albeit at a modest pace

Risks

- Global bond yields rise faster than expected
- Private investment fails to bottom out
- The property market continues to heat up

Higher commodity prices – back in the pit?

In 2016, terms of trade increased for the first time in two-and-a-half years, reflecting the surge in global iron ore and coal prices. Commodity prices have probably passed their trough, though the speed of rising prices may be contained. As for iron ore, which accounts for the lion's share of Australian exports, prices are likely to moderate, but export volumes should rise. In China, Australia's major export market, seaborne inventory levels are currently close to their highs of mid-2014. However, Chinese authorities remain firmly committed to their ambitious infrastructure programme. Operational efficiency and further ramp-up of production will ensure the competitiveness of Australia's iron ore exports.

Turning to coal, we see further positive effects from high prices as Chinese domestic restrictions continue, but less so from higher volumes. As for LNG shipments, they should significantly increase in 2017 given additional capacity in Western Australia and Queensland. LNG prices will reflect stabilising oil prices. Even though mining net exports should recover, mining investment is still expected to fall, as large projects are completed and fewer are started. The drag of mining investment on growth is expected to subside, but the destruction of resource related jobs will probably continue as projects evolve from exploration to the less labour intensive production stage. The demand for bulk commodities could undergo a positive shock were more developed markets, led by the US, to boost fiscal investments in infrastructure.

Is the non-mining sector the new growth engine?

The recovery in non-mining capex will probably not offset the fall in mining investment. According to the latest ABS capex survey, investment intentions for the manufacturing sector are not buoyant, but have stabilised at slightly higher levels than in 2016. A capacity utilisation level of ~80%, trending slightly above the long-term average, is also encouraging. In Victoria and New South Wales, a timid pickup in non-residential building approvals is also helping. On the trade side, we continue to expect structural demand from China for high-quality food and services, such as tourism and education, to grow solidly. The AUD remains way below its 2013 peak in trade-weighted terms, and Australia is benefiting from the bilateral CHAFTA treaty with China. The non-mining economy will therefore contribute modestly to growth.

The residential property market seems past its peak

Growth in residential property prices would have probably started to cool this year, had the RBA not cut rates in May and July. The rate cuts were passed on to borrowers by banks, which translated into a surge in housing prices in Sydney and Melbourne. However, prices in Darwin, Perth and Brisbane fell in Q3. Nationally, housing price inflation is tracking below its 2015 peak. Two leading indicators reveal that the residential market may be at a turning point: new home sales have stabilised and so has housing financing. APRA's macro-prudential rules have seen slower disbursement of interest-only lending and of high loan-to-value

financing. Stricter mortgage guidelines will be considered next year (effective in December 2017), including an interest rate buffer of 200bps to assess serviceability. We expect the deceleration in residential price growth to affect the states with lower growth rates, such as Western Australia, where rent growth and settlement prices have already declined. Given the important pipeline of new building approvals, the residential market slowdown should be slow and progressive. The risk of a price crash is not our main scenario, given the low level of interest rates, even with bond yields creeping slowly higher in 2017. The risk of oversupply in some segments of the apartment market can be contained if developers delay housing construction starts.

Household demand and inflation

Household debt has continued to drift up, reaching 186% of income in Q2 2016, but debt-servicing ability has been supported by monetary easing: interest-bearing debt has been stable at 80% of disposable income. Also, interest-earning deposits including mortgage offset accounts and household superannuation accounts are balancing part of the liabilities. These statistics and the contained level of NPL lead us to exclude the scenario of a debt solvability crisis. However, the high level of debt, combined with sluggish wage growth will continue to weigh on household consumption. We see little prospect for the saving ratio to decrease much further. We acknowledge that average weekly earnings per employee have stopped decreasing, and that consumer confidence is trending up. Yet, it is too early, in our view, to call for a rebound in domestic demand. Consequently, ongoing headwinds are

Business surveys are sending encouraging macro signals



Source: Bloomberg

weighing on demand-driven inflation. The slack in the labour market persists. Additionally, the competition between retailers is expected to intensify next year, with Amazon entering the Australian market. In contrast, we see some positive drivers for inflation emerging in 2017. A hike in the tobacco excise should provide a modest boost, while higher energy and raw materials prices will likely put pressure on final prices. Global producer prices are trending up, which could push tradable inflation up. Also, a more radical shift to fiscal support by developed economies could help. We therefore expect Australia's CPI to slowly return to the 2% minimum target of the RBA.

Cautious monetary policy and timid fiscal action

The nomination of Dr Lowe to the helm of the RBA marks a significant shift in Australia's monetary policy. The new governor has introduced a framework to identify the root causes of disinflation and define the objectives and strategy of the RBA. The structural drivers of disinflation, such as excess capacity and technological progress, imply that central banks have limited power to address the root causes of low inflation. Additionally, Dr Lowe has highlighted the early signs of stabilisation in labour earnings growth and non-mining capex decline. We interpret this as a signal that the RBA will wait for structural factors of low inflation to fade, and will be content with a medium-term inflation target below the 2-3% official target. The RBA will increase its focus on maintaining employment growth and containing the risks linked to high debt levels. Turning to fiscal policy, we are encouraged by the recent compromises reached by the Liberal-National Coalition to pass budgetary savings legislations. However, Australia remains under pressure to reduce its fiscal deficit, given its high public debt level and its willingness to maintain a AAA sovereign rating. The 2017 budget is slightly contractionary, although some initiatives, such as tax cuts for SMEs, should support the

economy. Looking at the budgets of the states, in New South Wales, a pipeline of infrastructure worth ~AUD 70 billion over four years is currently under way, which is encouraging. Yet other states have more limited fiscal capacity.

Geopolitics and globalisation

Australia has historically played the delicate role of a political and military ally of the US, while bolstering its economic and diplomatic relations with China. We expect ties with China to continue to strengthen, helped by trade agreements and migration movements. However, on the military side, Australia has increased its defence: it has invested USD 50bn this year in a new submarine fleet and is reinforcing its collaboration with other US allies in the South China Sea. The election of Mr Trump has introduced uncertainty around the diplomatic agenda of the US. A more passive military stance by the US in the South China Sea, which would reinforce China's hegemony, cannot be excluded. On the economic front, the potential shift to protectionism in the US remains a moderate threat for Australia. The US accounts for ~9% of Australian exports, ranking behind China and Japan. Going forward, exports to Asia will be more significant for Australia. Despite the cancellation of the Trans-Pacific

Partnership (TPP), Australia will likely maintain and even increase its market share of regional exports, thanks to its existing bilateral agreements with several Asian countries.

The outlook for Australian equities is favourable

Australian corporations have seen operating profits edging up recently. The stabilisation in commodity prices will likely benefit nominal GDP growth and equity earnings. We also see initial green shoots in the economies of Australia's main trade partners. Looking at the most important sector in the ASX 200, Financials, we see tailwinds from the rise in long duration bond yields. The recent earnings reporting season has shown that downward pressure on margins remains contained, and so does the level of NPLs. The big four Australian banks display capital levels close to regulatory targets, but accounting rules for risk-weighted assets could become stricter following APRA's consultation next year. Stricter rules are a downside risk to margins and dividend yields. With Australia's correlation with the US market being relatively strong, the ASX 200 should benefit from stronger US equities were a Trump presidency to live up to expectations on fiscal and business-friendly policies. Turning to Australian sovereign bonds, limited auction volumes for 2017 should keep a lid on supply. However, Australian yields are expected to follow global yields higher, as a result of the Fed normalising its policy and inflation expectations picking up. The AUD will be supported by stronger terms of trade, but kept in check by a stronger dollar.

The growth in terms of trade should support earnings



Source: IBES, Thomson Reuters Datastream

Outlook

- Mexico's growth will shift down on US political uncertainty and domestic tightening policies
- Chile is at an inflection point due to better political prospects and a rebound in copper prices
- Argentina is being fixed, but reforms remain unfinished and electoral challenges persist

Implications

- Mexico will suffer from uncertain US policies that will translate into lower growth and higher inflation, southern Latin America will experience better growth with disinflation
- Chile has reached bottom, but growth will remain subpar ahead of elections
- We believe that Argentina is an idiosyncratic turnaround story, experiencing a cyclical recovery

Risks

- For Mexico, a less beneficial NAFTA agreement proposed by the new US administration
- For Argentina, failure in the execution of orthodox policies and a delay in fiscal adjustment
- For the Andean region, an exogenous shock in the form of weaker global trade

Mexico: playing defense in an external uphill battle

Donald Trump's victory has brought uncertainty to Mexico and will translate into lower growth, higher inflation, higher rates and an investment slowdown for the country. The economy is at a complicated juncture — twin deficits are now even more exposed although the currency safety valve has acted appropriately, reaching its cheapest level since the Tequila crisis.

Consequently, Mexico must play defence with no plan B. The combination of a restrictive fiscal policy and monetary tightening is not a good mix for economic growth.

Conservatively, we have cut our GDP growth expectation to 1.5% for next year, as investments will certainly slowdown, while we raised our inflation target to 4% due to the currency pass-through effect.

Faced with a potential rating downgrade, the government will tighten the fiscal belt by cutting spending, with the goal of generating a primary fiscal surplus for the first time in a decade, as the debt-to-GDP ratio has worsened from 38% to 50% in just three years.

The central bank hiked by 225bps in less than a year to counteract the currency weakness. Inflation is now above target while domestic consumption is showing signs of fatigue. The central bank will have to be pre-emptive and tighten further until it gains more insight as to what the US's trade policy will be. We believe that it will keep hiking in sync with the Fed.

Domestic demand has been brisk thanks to a strong labour market, booming remittances in local currency terms, and a decent credit impulse. Still, it is about to cool off as confidence has been dented. Despite a weaker currency, we have not seen a considerable pickup in industrial production. In addition, with 25% of the economy depending on America, we see significant risks related to trade.

Mexico is one of the few trillion-dollar economies in the world and the rhetoric of the US administration towards Mexico in the first half of 2017 will be key in gauging the long-term economic impact of a less friendly neighbour. Mexico saw its exports-to-GDP ratio climb from 12% in 1994 to 35% in 2016, with billions of foreign investments made over the past decades thanks to NAFTA.

There is low visibility on how FDI, remittances and portfolio flows might be impacted, so the risk premium is adjusting consequently. The market is trading at 16 times next year's earnings and the estimates seem high at 17% growth. The currency is probably the cheapest on a global basis, but there will be no catalyst for a turn of its fortune in the short term. The yield curve has adjusted in line with our expectations as outlined in our October report, "Trump or Treat?". We believe that opportunities will arise in Mexican assets, as fortune favours the brave, but are cognizant that there is no visibility yet. Gubernatorial elections will be held in June 2017 as a prelude to the 2018 presidential elections that could see rising political risk

and a move away from pro-business parties. We believe that this might be the most underappreciated risk for Mexico.

Andean region: growth has troughed and monetary easing could make up for restrictive fiscal policies

Chile has been stuck in low gear due to public disaffection with economic reforms that have hit confidence indices hard. We believe that we are at an inflection point and that the country should experience a slow acceleration from here based on better political prospects due to the upcoming presidential election in November, an improvement in the copper price, a turnaround in confidence indices and the potential for a mild monetary easing campaign.

Chile should grow slightly above 2% at best, which remains a far cry from the above 4% average rate of the last ten years, but an improvement from the 2016 print. Inflation has declined below the 3% mark for the first time in three years and, coupled with unemployment reaching a five-year high, could open the door for moderate rate cuts in 2017. It would be modest with a total of 50bps to be frontloaded in the first half of the year.

Still, there will be less fiscal support next year, as the government is reigning in real public spending to 2.7% in real terms, which is the lowest level since 2003.

Equity market multiples are attractive and offer a good discount, both on a historical

Mexican central bank has been reactive to currency weakness



The region has turned the corner, but with a clear North-South fracture

The main message from Latin America, including Brazil, is that the economies have turned the corner and will finally deliver positive growth, albeit muted. The disinflationary movement is a contrast to the global reflation narrative. Monetary easing that will compensate for a more restrictive fiscal stance is certainly the story for 2017. Politics is turning more towards economic orthodoxy.

Mexico, in contrast to South America, will experience lower growth with rising inflation. It will not have countercyclical mechanisms, as both monetary policy and fiscal policy will be tightened. Still, the economy will grow in line with its regional peers and inflation will converge, but from a lower base. All in all, albeit coming from a low base, Latin America will be an important contributor to the delta of global growth for 2017.

basis and relative to peers.

Peru has delivered the best regional growth in a difficult context and we believe that it will remain the case in 2017. The central bank will remain on hold, while investments will pick up with a focus on infrastructure helped by fiscal spending. We expect growth to be above 4% next year and inflation to remain under control.

In Colombia, fiscal reform will be critical in maintaining investment grade status and will take its toll on growth, but the central bank has decent room to manoeuvre with rate cuts to be initiated next year. The recovery of the oil price above the government assumption for its 2017 budget is a welcome development. Under-owned and cheap, the market could be the surprise of 2017 after sitting at the bottom of the regional performance list over the past cumulative two years.

In Venezuela, the economic depression coupled with hyperinflation and an overvalued exchange rate have triggered political acrimony. The country has maintained a high willingness to pay its debt at the cost of declining imports but a credit event remains a possibility next year, as sensitivity to the oil price is higher than before.

we expect inflation to overshoot the target and end the year at around 22%. The process of fixing the country is well entrenched, but unfinished. Therefore, the government has tilted its program towards growth in order to secure a better scorecard ahead of the legislative elections to potentially secure more representativeness.

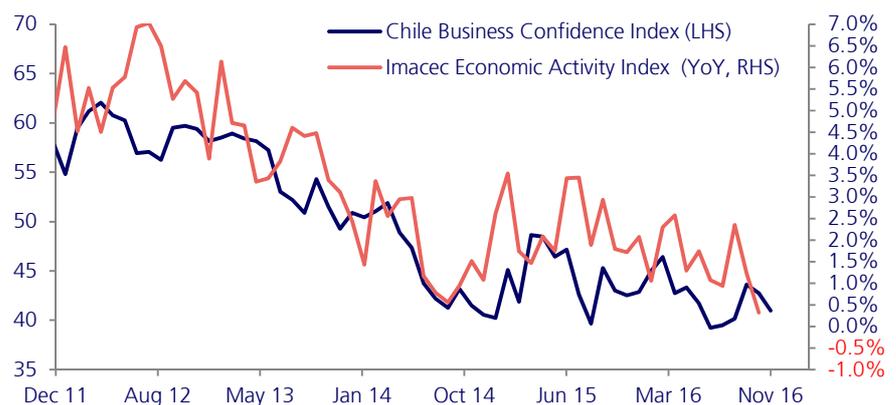
The fiscal needs will mean that external financing will be critical and the weight of the country in the bond indices will keep rising steadily. The June MSCI revision for inclusion within the EM index will be an important milestone for equities that trade at a cheap 10 times P/E and are among the most attractive in an asset class that could garner strong inflows.

The main challenge remains moving away from a model based on consumption and propelled by fiscal spending, towards one that relies on investments and exports, while boosting productivity. Expectations are probably too high and the path to reform is still filled with ambushes due to the lack of a majority at the legislative level.

Argentina: the dawn of a cyclical recovery in the midst of congressional elections

We expect the economic recovery to be above 3% in 2017, as the administration is focusing on making inroads into legislative power, with elections to be held in October. Clearly the fiscal adjustment has been softened and rather postponed to 2018, while monetary easing has been accelerated with a focus on reigniting growth rather than reaching the 17% inflation target of 2017. The economy is quite indexed and the wage negotiations of the first quarter will be critical in gauging the inflation rate for 2017. Still,

Confidence in Chile might bounce on political change



Brazil

Outlook

- The country will leave behind its worst economic recession, but the pace of growth will be subdued
- Reforms remain key for the long-term adjustment of the fiscal balance
- With disinflation entrenched, the central bank has initiated its monetary easing campaign
- The political situation will remain vulnerable and the weak link on the path to redemption

Implications

- Constraints on consumption will prevent a sharp rebound and put the onus on investments and exports
- Expect a cautious pace of monetary loosening, as the central bank hones its new credibility
- Equity markets will run on earnings growth rather than the risk premium compression based on hope in 2016

Risks

- Political instability could undermine the coalition necessary to pass fiscal reforms
- Execution challenges that could lead to reforms being watered down

The end of the recession is the first step in a long journey towards fiscal redemption

The country experienced a severe contraction over the past three years that translated into a cumulative per capita GDP decline of slightly more than 10%. We believe that the economy will exit its worst recession in a century and grow again in 2017, albeit at a slow pace. The statistical carry-over should be negative for 2017 and consequently, we do not expect growth to cross the 1% mark. We estimate that 2021 is a reasonable target for GDP to reach its previous peak of 2013, on the condition that social security and pension reforms are implemented. It is precisely the fiscal, pension and social security reforms that will be the keys to stabilising the debt level trajectory as the debt-to-GDP level has crossed 70%. Over the past two years, that ratio has deteriorated by a sizeable 15%. To stabilise the debt dynamic, Brazil needs both economic growth and fiscal primary surpluses.

As we estimate that growth will be muted and remain below the necessary 2% to improve the situation, the focus will turn to long-awaited fiscal reforms. The 2017 budget proposal would result in a deficit equivalent to 2.1% of GDP, which is far from what is required to stabilise the negative debt path. Clearly, fiscal policy will not be of use to stimulate the economy in the next few years. Therefore the confidence shock of reforms is paramount in paving the way for the economy to recover.

The spending cap targets a freeze in real government spending, which should be

contained at zero percent real growth over the next ten years and beyond if necessary—a massive improvement from the 6% real spending growth of the past few years. It will reverse a twenty-year trend of uninterrupted real increases in government expenditures.

Social security and pension reforms are in the pipeline, but are sensitive topics for the population as a whole. However, without comprehensive social security reform, the spending cap will be useless. Social security reform will represent a significant step toward lowering debt going forward. The vulnerability of the reform process is not minor and the execution risks are high, but there is no other way for the administration to put the economic train back on the rails.

Anatomy of an economic recovery

After a 3.8% contraction in 2015, we expect 2016 to end with another sizeable decline of 3.4% before the economy can finally turn the corner and resume growth within a 0.5% to 0.9% range, tilted towards the high end.

As Brazil has one of the highest consumption weights within emerging markets, we believe that it will be the main reason for growth to remain subdued in the upcoming quarters. Rising unemployment should only peak in the second quarter of 2017, with wages still declining in real terms. Deleveraging continues in full force, but indebtedness will remain a drag on consumption while credit will keep contracting in real terms. Inflation has not declined enough to give consumers any breathing room. It will take some time for the economy to gather momentum because

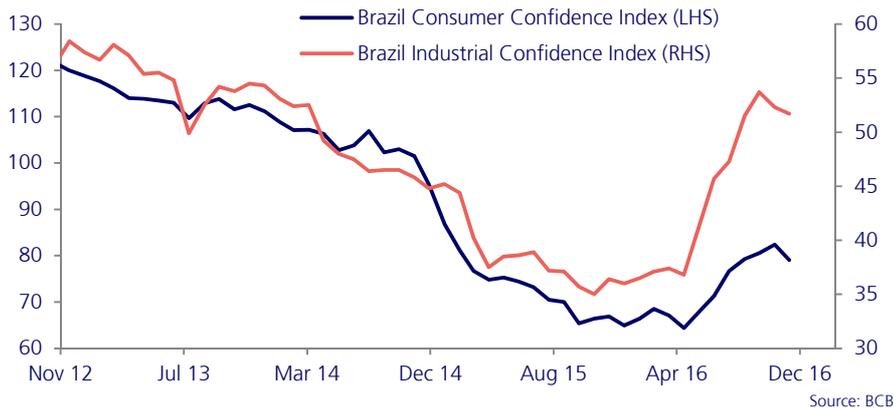
of the combination of fiscal adjustments and weak private consumption.

Consequently, investment pickup will be key and the negative output gap will offer strong operating leverage to companies. The high level of idle capacity will allow the economy to grow without inflationary pressures. The inventory cycle should also be helped by a positive contribution from exports, with the commodity complex having stabilised. The sharp currency depreciation coupled with the severe contraction of the domestic economy paved the way for a dramatic turnaround in the external accounts. The current account deficit has sharply adjusted from \$104bn, equivalent to a 4.3% deficit in 2014, to a mere \$20bn, equivalent to 1% of GDP by the end of 2016. The main reason for the adjustment is to be found in the depressed economy. Still, the currency is back to fair value and we do not expect too much appreciation in real terms from here. The stabilisation of the commodity complex is a boon for the export component of the economy and external accounts should benefit from it, but any improvement will be modest as most of the adjustment already occurred in 2016.

Brazil is a strong emerging markets disinflation play in a reflating world

As inflation started to recede, the central bank finally cut its reference rate for the first time in four years. By being more hawkish than expected, the central bank clearly wants to hone its renewed credibility. It made it clear that anchoring inflation expectations and fiscal rectitude will be key in the decisional process. It will keep an eye on

Muted economic recovery due to constraints on consumer



currency volatility, as it recently reinstated intervention by selling dollars in the futures market to smooth the uncertainty from US elections.

We expect the economic rebound to be non-inflationary, with operating leverage due to a deep negative output gap. This should be a comfortable situation for the central bank to cut interest rate despite the less conducive external environment. There will be lower inflationary pressure as well, due to pressure from administrative prices dissipating and alleviated food price inflation. We project that the inflation rate should end 2017 slightly above the central bank target at 5.1%. We believe that rate cuts spread over a longer period of time will be the mantra of the monetary easing cycle. We expect the reference rate to reach 11% by the end of the year, which will amount to a 275bps cut from the end of 2016. We can say that Brazil will experience disinflation with a good dose of monetary easing in 2017.

Assessment of the various asset classes

Although most of the adjustment has been made on a REER basis, we believe that the currency rally has brought the BRL back into fair value territory. A good part of the run can be justified by the improvement in terms of trade and the return of the carry trade. The equity market has rallied and remains one of the best performing markets of 2016, with a return of close to 40% in local currency and more than 50% in USD. Although on a P/E valuation basis the market seems rich as multiples have expanded, it is not the case on a P/B basis. Earnings growth is expected to be above 15% for 2017 and operating leverage should not be underestimated. However, we stress that hope needs to make room for execution to justify the price one is ready to pay at this stage.

The fixed income market still offers opportunities in the context of a monetary easing campaign that has just started. The real rate offered makes it quite competitive

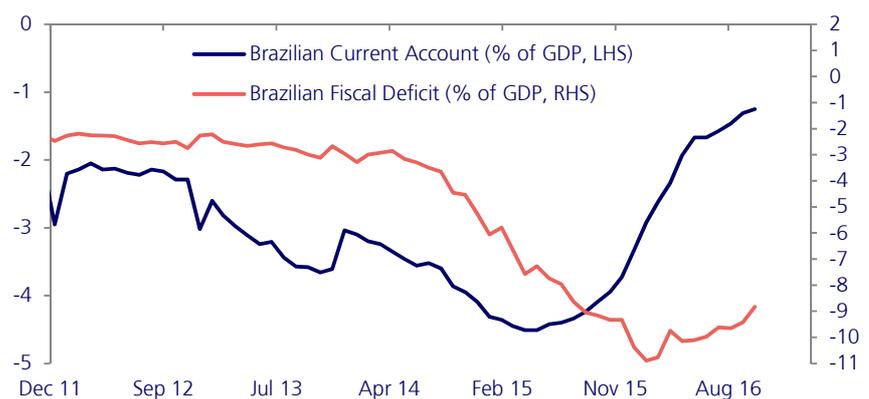
compared to equities for local pension funds. We would tilt our preference to this asset class for the upcoming year.

Panorama: the return of economic growth is welcome, but it will be from a low base and muted

Lower inflation and the return to positive growth are welcomed developments in Brazil after a long and deep recession. To be fair, from such a low base, one should expect economic growth, but other neighboring countries have shown that the rabbit hole can be bigger for longer! Fiscal tightening is an impediment to stronger GDP growth but, at the same time, the necessary condition for growth to resume. Monetary loosening is the confidence boost that economic agents desperately needed from an institution that has regained its credibility.

The political situation remains fragile and the reform agenda vulnerable to the resurgence of political turmoil and corruption scandals. Presidential elections will be held in 2018, confining the window of opportunity to push through the necessary reforms to 2017, which makes it delicate, as the global environment is becoming less benign.

Fiscal adjustment not as swift as external adjustment



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