

Outlook and Insights

Mellon Capital's proprietary expectations for economic growth, leading economic indicators, and inflation expectations



Executive Summary

by Jeff Zhang

In this publication, we draw on the firm's expertise to share our current investment outlook on several key asset classes. A discussion of the key elements of our outlook follows.

Donald Trump's victory in the U.S. presidential election drove market sentiment during the quarter, with equities and the U.S. dollar gaining while sovereign bonds tumbled. While the initial reaction to Donald Trump's somewhat unexpected victory was negative, as with Brexit, equities quickly recovered and extended its gains as investors digested the potential economic implications not only of a Trump presidency but also Republican control of both houses of Congress. Developed market sovereign bond yields accelerated higher after the election, continuing the trend that began in August amid expectations for less accommodative monetary

policy, and after higher growth and inflation expectations began to be priced in. The yield on 10-year U.S. Treasury note rose 56 basis points in November, the biggest monthly jump since 2009, and 85 basis points for the quarter to close at 2.44%.

Despite the change in investor expectations following Trump's victory, uncertainty remains about the extent to which his proposed tax cuts, infrastructure spending, and rollback of regulations will be implemented. While the U.S. presidential election is behind us, investors will continue to monitor upcoming elections in Europe, where success for anti-European Union parties could result in significant market dislocations.

The Federal Reserve (Fed) raised its target interest rate by another 25 basis points for the first time in a year and only the second time in the last decade. In a widely anticipated move, Fed officials cited a labor market that is near full employment and inflation moving toward its target levels for their decision to raise rates.



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The Global Economy

by Karsten Jeske

MELLON CAPITAL'S PROPRIETARY EXPECTATIONS FOR ECONOMIC GROWTH, LEADING ECONOMIC INDICATORS AND INFLATION EXPECTATIONS

After a soft patch that lasted for three quarters, the U.S. economy finally bounced back in the third quarter of 2016 with a solid 3.5% annualized growth rate. The increase in growth was entirely due to a strong and overdue rebound in the inventory component as well as strong export growth. While consumption growth was solid, both business investment and residential housing investment still appear quite weak, so it would be premature to call the most recent data a fundamental change in the growth trend. Thus, we have made only a slight upward revision to our one-year-ahead U.S. growth forecast to 2.0% from 1.9% last quarter, and currently assign a probability of about 47% of growth

below 2%, a 53% probability of 2-4% growth, and essentially zero weight on growth above 4%.

Of course, the number one unknown going forward is the economic impact of the surprise U.S. election result. Donald Trump winning the presidency along with Republican majorities in both the House of Representatives and the Senate could end the Washington policy gridlock and finally bring fiscal stimulus in the form of tax relief and infrastructure spending. Moreover, relief from federal regulations has the potential to act as a supply side productivity boost. But not all risks are to the upside. Tariffs, trade restrictions, or even an all-out trade war could easily derail the fragile recovery. It remains to be seen what the exact net effect will be.

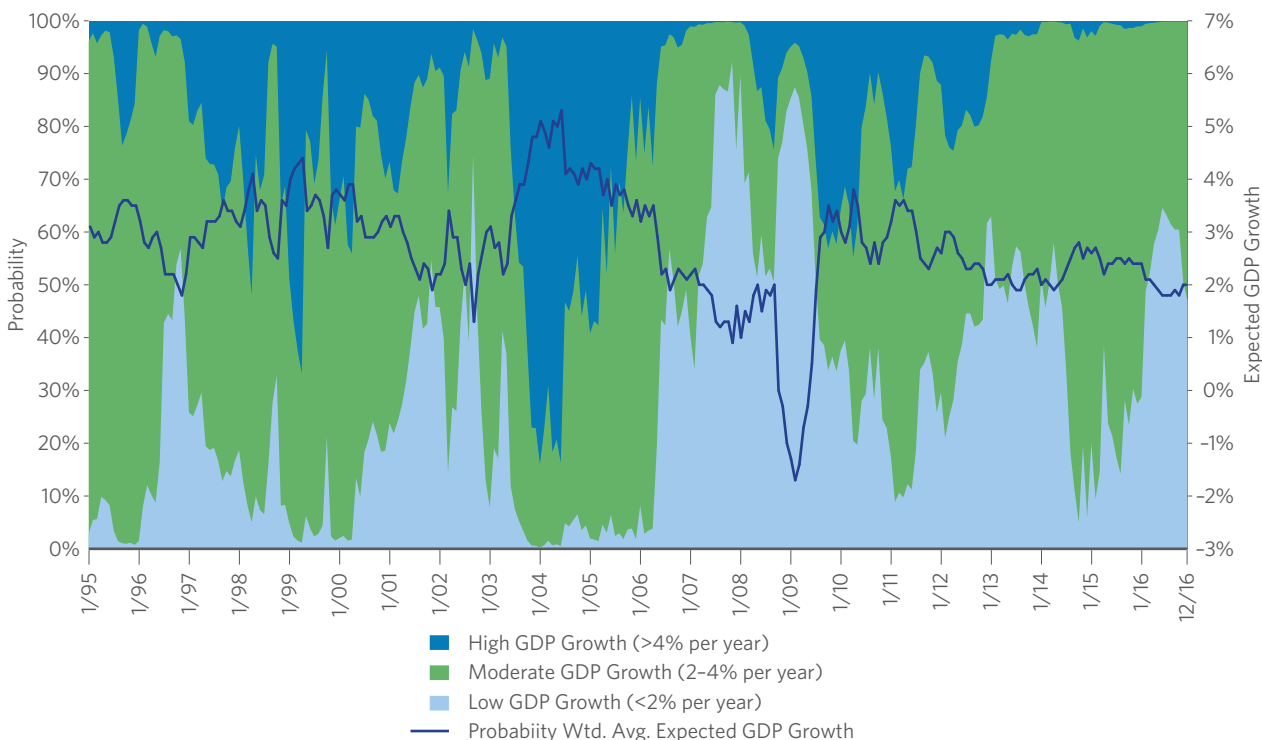
Less of a surprise was the outcome of the December Federal Open Market Committee (FOMC) meeting; the committee raised its target interest rate by another 25 basis points in a widely anticipated move. Also notable is



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Figure 1: U.S. GDP growth expectations for one-year ahead GDP

January 1995–December 2016



Data source: Proprietary calculations of Mellon Capital utilizing Thomson Reuters Datastream

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that the FOMC members project two to three more rate hikes in 2017, with three being the median, which is not very far away from the path implied by the Federal Funds futures market. With the FOMC and financial markets mostly in agreement it raises the prospect of orderly future rates hikes with subdued risk of financial market stress and volatility.

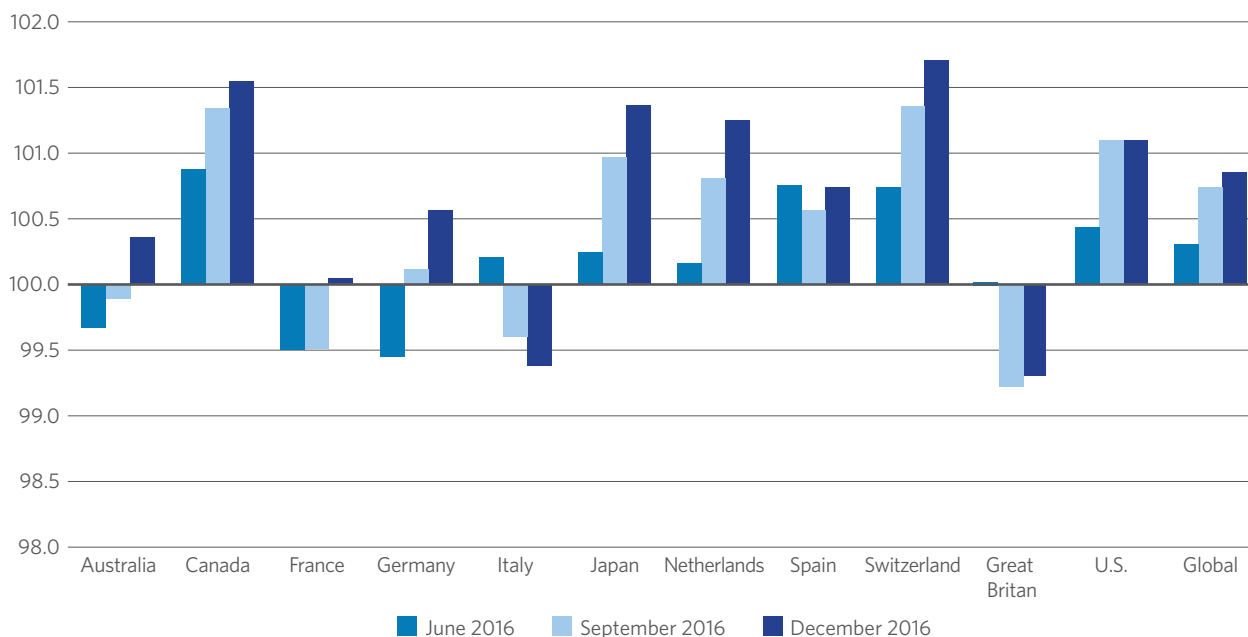
Global Leading Economic Indicators

At Mellon Capital, we generate our own proprietary measure of leading economic indicators (LEI). Our calculation is based on a number of high- and medium-frequency measures of the macro economy and financial markets that we believe are highly effective at estimating subsequent economic growth. A level slightly above 100 would indicate a significant probability of a mild economic recovery. The further the LEI measure is above 100, the faster the pace of economic growth. Conversely, a level approaching 99, and certainly below 99, would indicate a significant probability of a mild economic contraction.

The global weighted average LEI continued its upward trajectory to 100.9, and this move was very broad-based. In fact, the only country experiencing a deterioration in its LEI was Italy, no doubt due to a flare-up of problems in its banking sector. The rest of Europe saw healthy increases in their LEI. Notably, the United Kingdom saw a slight improvement as well, though from a relatively low level, so a more pronounced drop in economic conditions in the aftermath of the Brexit vote has been averted, at least for now. Australia and Canada benefited from stronger commodity prices and even Japan faces a brighter outlook after three consecutive quarters of economic growth. Quite intriguingly, the U.S. saw only a very marginal increase in the LEI since September, but notice that the LEI level was already quite high in the Fall, so the recent equity rally mostly confirmed the already elevated LEI level without pulling it any higher.

Figure 2: Leading economic indicators

June 2016–December 2016



Data source: Mellon Capital

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U.S. CPI Inflation

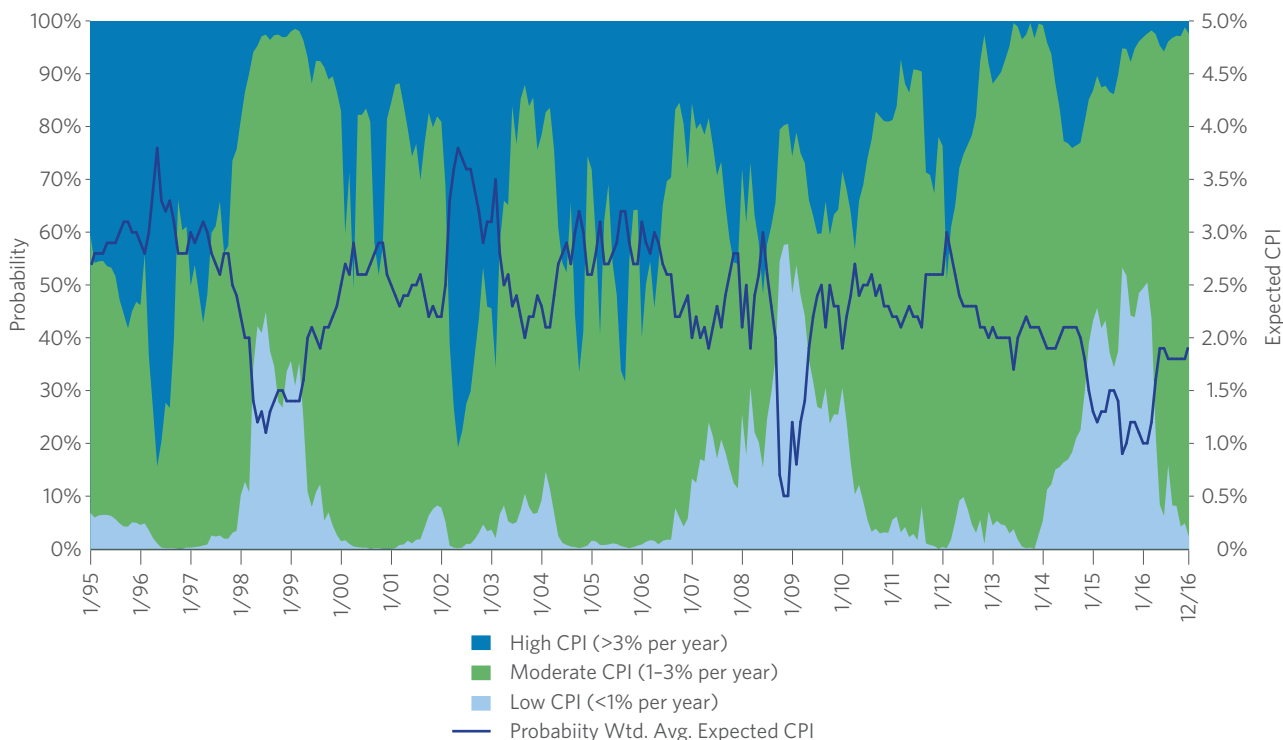
U.S. headline inflation picked up noticeably from last quarter and now stands at 1.7% year over year (November 2016 over November 2015), while Core Consumer Price Index (CPI) inflation moderated slightly to 2.1% over that same time window. Much of the acceleration in the headline figure came from base effects; specifically, calculating year-over-year numbers with price levels that were depressed due to the energy price declines in late 2015. Over the next few months we expect further increases in the year-over-year headline numbers, especially when comparing price levels with those in February 2016 at the commodity price trough. On a strict 12-month forward basis, though, our forecast for inflation stands at 1.9%. As for the distribution of likely inflation readings over the next twelve months, we predict a 2% probability of inflation below 1%, 96% probability of inflation falling into the 1-3% range, and a 2% probability of Inflation above 3% over the next year.

Our point forecast is a bit lower than the 2.0–2.3% range of the other forecasters, but it reflects our cautious view after several years of inflation forecasts mostly surprising on the downside. Of course, as mentioned in the section on GDP growth, there is still uncertainty about the economic effects of the new political situation in Washington. More spending and debt are often associated with higher inflation pressure, though historical correlations are spurious. We also stress the fact that not all pro-growth policies need to be inflationary. Less regulation can enhance productivity and has the potential to grow GDP without raising costs.

Much of Europe also experienced healthy PMI indicators and solid growth rates, actually higher than the recent growth rates in the U.S.

Figure 3: U.S. CPI growth expectations for one-year ahead CPI growth

January 1995–December 2016



Data source: Proprietary calculations of Mellon Capital utilizing Thomson Reuters Datastream

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Implications for Asset Allocation

By Vassilis Dagioglu and Paul Benson

STOCKS/BONDS/CASH

We find that both global equities and global bonds are attractive relative to cash, with a preference for equities. In our view, global equities are attractive as earnings growth and earnings revisions are mostly positive, growth and inflation expectations have increased, while liquidity from central banks in the Eurozone, U.K., and Japan should continue to support risky assets. The sharp rise in global bond yields since August has made global sovereigns attractive relative to cash.

EQUITY MARKET ALLOCATION

Among developed global equity markets we find the U.K. and Australia to be relatively attractive as both countries have experienced rising earnings expectations. Improved commodity prices and positive global growth expectations have benefitted Australian earnings, while U.K. earnings continue to climb due in part to the depreciation of the pound. Conversely, we dislike U.S. stocks due to relatively slower earnings growth and recent outperformance. Despite the support from a Trump induced reflation expectations, U.S. valuations remain stretched and we find U.S. equities overvalued relative to other global stocks.

CURRENCIES

The U.S. dollar remains attractive based on relative economic fundamentals and expectations for the Fed to gradually raise interest rates. We also like the New Zealand dollar due to its high real rate, while it should also benefit from the resilience in the New Zealand economy. Negative interest rates and an aggressive quantitative easing program make the euro an attractive short position. We dislike the British pound due weak macro signals, an expanded quantitative easing program from the Bank of England, while the potential for a “hard exit” from the European Union may also weigh on the pound.

FIXED INCOME

Fixed Income: Sovereigns

Among sovereign bonds, we continue to prefer U.S. and Australian bonds as we believe that they are positioned to outperform due to higher yields and wider term premiums. We continue to hold short positions in German bunds and U.K. gilts, as we expect that they will experience outflows as investors demand higher yielding bond markets. German bonds provide relatively small term premiums in comparison to other global bonds. Gilt yields have fallen significantly. While the Bank of England’s quantitative easing program will continue to be a tailwind for U.K. bonds, recent signs of economic resilience as well as rising inflation expectations may place pressure on U.K. bonds.

Fixed Income: U.S. Treasuries

Our interest rate outlook is primarily dependent on fundamentals: growth and inflation expectations. As such, we believe the recent move higher in Treasury yields can be characterized as a “normalization” of interest rates, as interest rates moved more in-line with inflation and growth fundamentals. Term premiums have moved from extremely negative to less negative or even slightly positive territory, which may reflect greater riskiness or uncertainty around real rates and inflation variables. At the time of this writing, 10-year Treasury term premiums are at or near zero, having recovered from extreme lows of as much as -65 bps earlier in 2016. With market inflation expectations near our own inflation forecast, and term premiums no longer in deeply negative territory, we believe interest rates can stabilize near current levels over the near term. Lack of clarity with respect to President-elect Trump’s economic policies and their impact on growth may, however, cause interest rate volatility to remain at an elevated level.

Fixed Income: Credit

We remain modestly constructive on U.S. credit, with our outlook heavily influenced by data that sheds light on default and liquidity risks. The credit market can be characterized



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as being in the late stages of the credit cycle. Leverage has generally been increasing, as expected late in a cycle. However, we see the probability of a recession as quite low. While interest rates moved higher following the U.S. presidential elections, credit spreads continued to tighten, reflecting the healthy underlying fundamentals and global demand for U.S. credit as Eurozone and Japanese interest rates are still either negative or very low, and non-U.S. spread products provide limited yield for yield-seeking investors globally.

Fixed Income: Treasury Inflation-Protected Securities (TIPS)

We continue to find TIPS attractive relative to nominal U.S. Treasuries. Following the U.S. presidential election, 10-year breakeven rates rose 30 bps to stabilize at around 2.0%, slightly higher than our current inflation expectations of 1.9% over the next twelve months. While development around President-elect Trump's economic policies, particularly with respect to energy, may shift market inflation expectations, we view solid U.S. wage growth, low unemployment, stabilizing energy prices, and expectations of expansionary fiscal policy to continue to fuel a gradual upward trend in inflation.

COMMODITIES

We see the largest divergence among signals within grains. The soy complex (soybean and soybean oil) remains relatively attractive due to better roll yields and favorable investor positioning. Fundamentals for corn and wheat are unfavorable, meanwhile, with relatively bearish inventories and roll yields. Within energy, we still see downward pressure on natural gas as the bearish curve shape dynamics persist despite the recent rally. Positions in the petroleum sector are relatively muted, with a positive bias in heating oil and gasoil. We are overweight industrial metals, mostly through aluminum and nickel due to relatively bullish inventory levels.

EQUITY INDEXING:

by Karen Wong

The strong momentum in asset flows into U.S. and international index assets continued in the fourth quarter as investors poured a record \$42 billion into U.S. equity index funds in November on the post-election relief rally. Conversely, November saw the 32nd consecutive month of outflows for actively managed U.S. stock strategies. Assets in indexed U.S. mutual funds now stand at \$2.9 trillion versus \$3.6 trillion in actively managed U.S. equity assets, with indexed assets benefitting from strong U.S. equity markets as well as continued investor interest in indexed strategies.¹

During the 4th quarter, the S&P 500® continued to hit new highs, closing above 2,200 for the first time in November and reaching a record level of 2271.71 on December 13th.² The S&P 500® returned 11.96% for the year, while developed markets represented by MSCI EAFE returned 1% for the year, and emerging markets represented by MSCI Emerging Markets returned 11.19%.³

MSCI conducted their semi-annual rebalance at the end of November. This particular rebalance was quieter than normal, as only 55 securities were added and 34 securities were deleted from the MSCI ACWI Index.⁴ MSCI did not conduct any major country changes during this rebalance period, so we will look to the next semi-annual rebalance upcoming in May for country updates.

Lastly, our Carbon Efficiency Strategy reached its second year anniversary at the end of October. Since its launch, the fund has closely tracked the Russell 3000 index gross of fees, while bringing down its carbon exposure by more than 50%.



Karen Wong
Head of Equity Indexing

¹Source: Morningstar. Data through 11/30/16.

²Source: S&P Dow Jones. Data based on the S&P 500 index as of 12/31/2016.

³Source: S&P Dow Jones, MSCI. Data based on index data as of 12/31/2016.

⁴Source: MSCI. Data based on the MSCI ACWI index as of 9/30/16.

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ACTIVE EQUITY

by William Cazalet

The fourth quarter of 2016 was dominated by the run-up to, and outcome of, the U.S. Presidential election. While the initial reaction to Donald Trump's somewhat unexpected victory was negative, as with Brexit, the market quickly recovered and extended its gains as investors digested the potential economic implications not only of a Trump presidency but also Republican control of both houses of Congress. The S&P 500® gained just over 3.8% for the quarter, almost exactly matching its performance for the previous three months, and capping a year of positive performance during all four quarters.

Sectors and industries most likely to benefit from Trump's economic, fiscal, and other policy proposals—unsurprisingly—gained the most in the fourth quarter. Positive economic surveys and rising consumer confidence provided further tailwinds to equity markets. Already helped by

the more solid prospect of higher rates and boosted further by the anticipation of a friendlier regulatory environment likely under the new Republican administration, financials staged an impressive 21% rally during the quarter—the strongest performance of any sector in any quarter during 2016. Energy and industrials, also expected to benefit from less environmental regulation and a more muscular stance on trade and defense spending, also rose by over 7%, still a distant second to financial stocks. In contrast, real estate fell by almost 4.5% and healthcare declined by 4%.

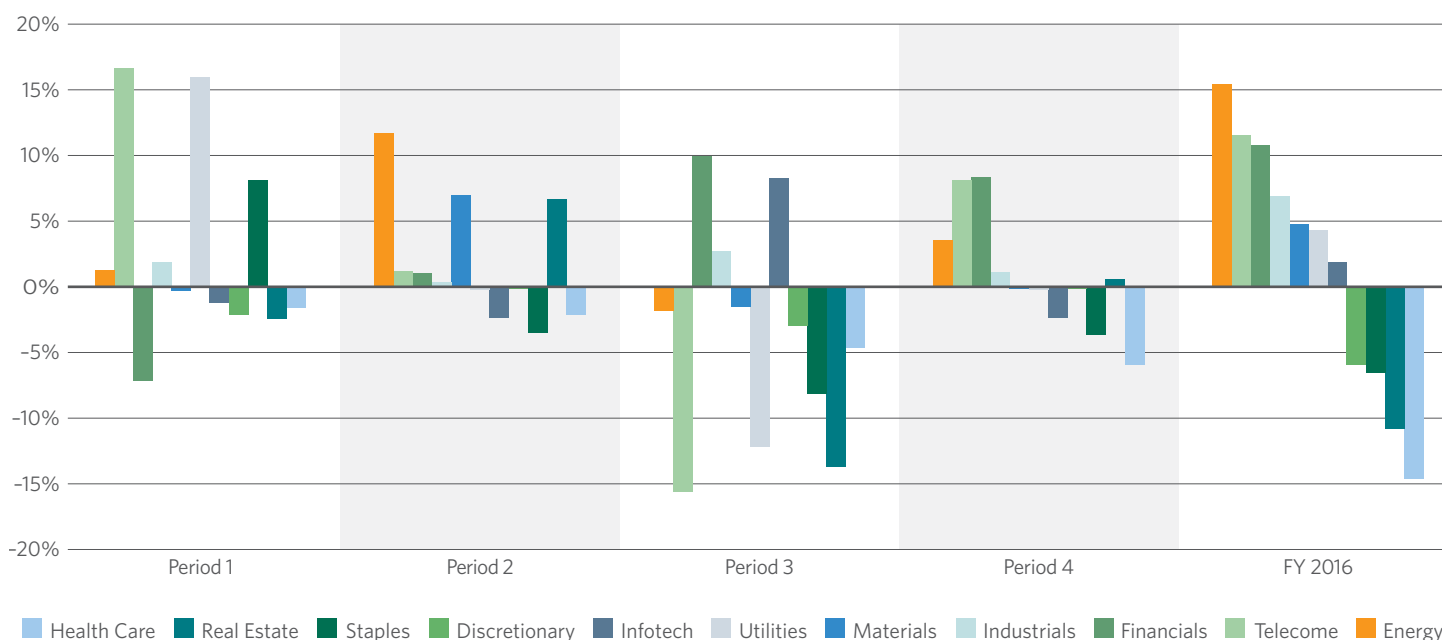
The S&P 500® Index ended the year up almost 12% but, in contrast with recent years, mega cap and large cap indices were broadly beaten by mid cap stocks, which were, in turn, bested by small cap stocks as investors anticipated that smaller companies, with more of their revenue exposure to the domestic market,

(continues)



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Figure 4: S&P 500® Sector Performance net of Benchmark, FY 2016 and Discrete Periods



Period 1 Market Correction: January 1st–February 10th.

Period 2 Energy Rally, Defensive / Income Rotation: February 11th–June 23rd.

Period 3 Post-Brexit Risk-on Rally, Election Run-up: June 24th–November 8th.

Period 4 Post-U.S. Election Rally: November 9th–December 31st.

Source: Bloomberg.

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would be the most significant beneficiaries of looser fiscal policy and 're-shoring' policies.

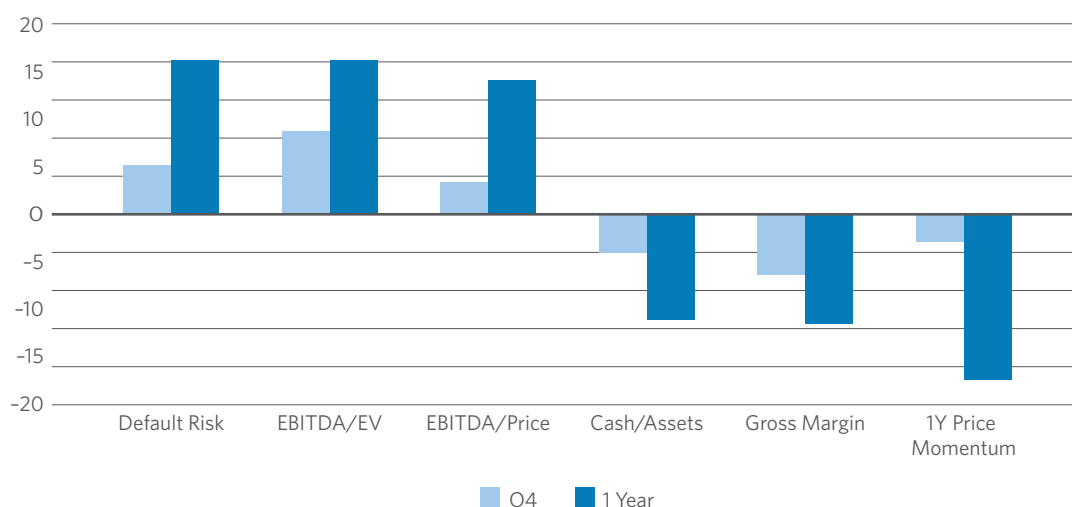
2016 as a whole was marked by a series of rotations that saw strong sector performance followed, in many cases, by reversal in the same sectors. Market performance, could be broken into four periods:

1. The fall in the market early in the first quarter; the S&P 500 bottomed out on February 10th.
2. The energy rally that continued into the second quarter, also marked by a continued

preference for lower volatility, more bond-like sectors such as telecoms, utilities and consumer staples.

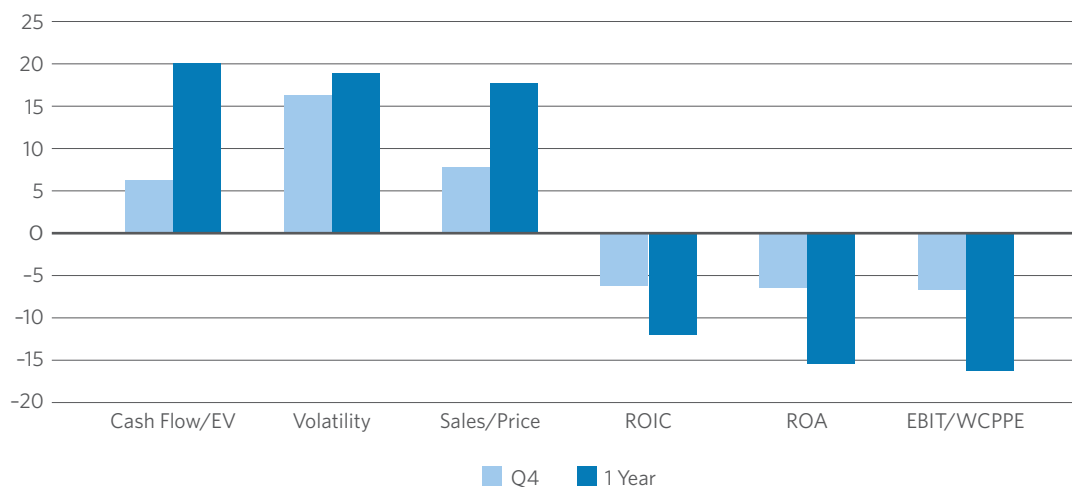
3. the post-Brexit, risk-on rally that saw a rotation out of the preferred sectors of the previous period into financials and information technology.
4. The post-U.S. Presidential election rally that saw a continued surge in financials but also a move back to at least some of the more defensive sectors, such as telecoms.

Figure 5: Russell 1000 Quintile Spreads (Sector Neutral) Top 3 and Bottom 3



Source: Nomura.

Figure 6: MSCI Europe Quintile Spreads Top 3 and Bottom 3



Source: Nomura.

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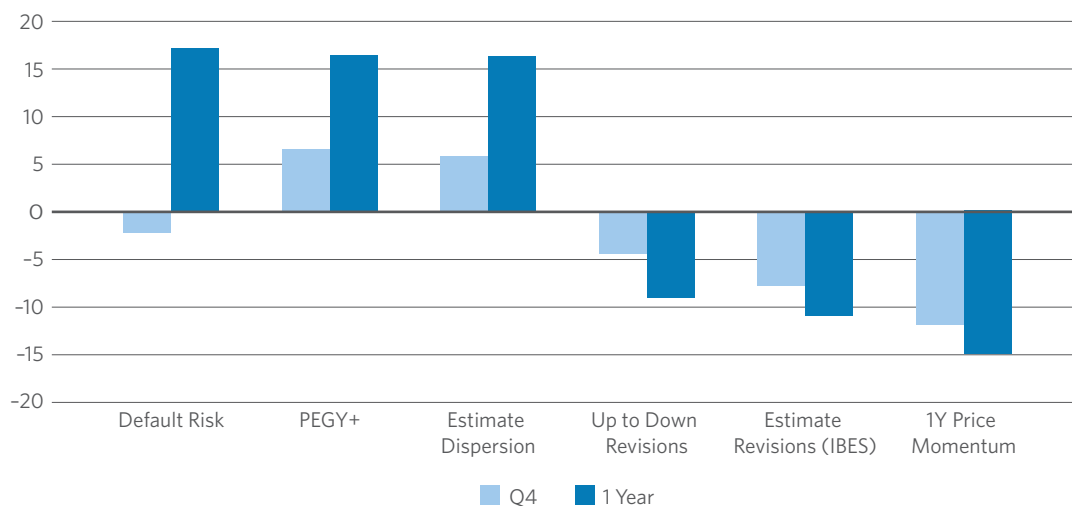
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After a dire 2015, the energy sector ended the year as the strongest performer, up 27.36%, and closely followed by telecoms (23.48%) and financials (22.75%). Healthcare was the biggest laggard in 2016: it trailed the S&P 500® in three out of four quarters, and ended the year as the only sector with a negative absolute return (-2.69%), underperforming the index by almost 15%.

The performance of energy was replicated in both Europe and Japan, where it was one of the strongest sectors in Q4. In Europe, it was

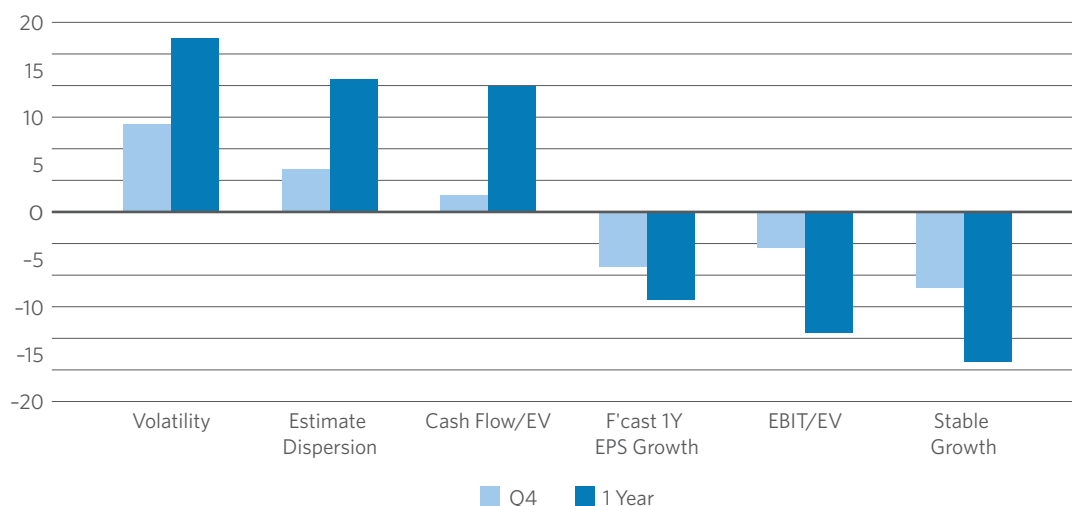
also the best performing sector for the year while in Japan it was beaten only by telecoms over the same period. European and Japanese utility stocks, however, failed to replicate the returns of their U.S. counterparts in 2016, and while in Japan telecom was the strongest sector in the TOPIX over the year, European telecom companies ended the year as the worst performer in MSCI Europe. There was some consistency in the performance of healthcare, with the sector in Europe and Japan ending the year as the second weakest performer in both regions.

Figure 7: TOPIX Quintile Spreads Top 3 and Bottom 3



Source: Nomura.

Figure 8: MSCI Asia-Pacific ex-Japan Quintile Spreads Top 3 and Bottom 3



Source: Nomura.

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From a factor standpoint, value was the strongest performer in Q4; the Russell 1000 Value index beat its Growth counterpart by more than 10% over the course of 2016, with 5.5% of that out-performance coming in the fourth quarter alone. Value factors such as EBITDA/enterprise value and earnings yield were the best performing factors among Russell 1000 stocks during Q4, although default risk was the best performing factor for this universe over the whole of 2016—a function of the strong recovery in the energy and (to a lesser extent) materials sectors.

Value performed strongly outside of the U.S. as well, with the book/price ratio being one of the strongest performers in Europe in Q4 and for the full year (sales/price and EBITDA/price also performed strongly for the full year). Even in Japan, where value was more challenged, especially early in the year, book/price rallied strongly in the second half of the year to finish as one of the strongest performers for 2016.

Conversely, last year's factor leader, price momentum, had a weak showing in Q4. One-year price momentum was among the most negative factors in 2016 in the U.S. and Japan, and performed poorly in Europe as well. Quality factors, such as return on invested capital and return on equity were weak across regions, and especially in Europe, both during Q4 and for the year as a whole.

After several quarters of year-on-year earnings declines in the U.S., third quarter S&P 500 earnings rose 3.1%, just over 6% better than estimated. The positive surprise was largely down to a better showing for energy, where net income was 50% higher than forecast. In Europe, 60% of the companies in the Stoxx 600 beat their consensus EPS estimates (the highest percentage in over a year); EPS growth was narrowly positive (+2% with energy stripped out). In Japan, 54% of Topix companies beat their earnings estimates with EPS declining 1% year-on-year, on softer revenue numbers (only 34% of companies beat their revenue estimates, and Topix revenue has fallen 8% year-on-year).

Key Risks to our Outlook

TRUMP ADMINISTRATION

While some of President-elect Donald Trump's key policy proposals received plenty of airtime and analysis during the Presidential election campaign, there is still considerable uncertainty on whether his actual policies will match his pre-election rhetoric. Although there are some differences between the reforms to the tax code proposed by the President-elect and the new Republican Congress, it seems like there is overall positive momentum for the reforms, which will likely further boost already improving consumer confidence. As with any policy reforms, however, the devil will be in the details and the market may be sensitive to early policy missteps or disappointments on the part of the new administration.

EUROPEAN ELECTIONS 2017

While the U.S. presidential election is behind us, 2017 sees a number of key elections in Europe: in the Netherlands (general election, mid-March), France (first round of the presidential election in late-April, legislative elections in mid-June) and Germany (federal elections, which include the election of chancellor, sometime between late August and late October). While the outcome of the German election in favor of incumbent chancellor Angela Merkel currently looks more predictable, both the Dutch and French elections will reveal the extent of populist and, specifically, anti-European Union sentiment in those countries. There is even the possibility, sometime in 2017, of an election in Italy, where not just one, but two, main opposition parties are also opposed to the EU. An upset to the status quo in any one of these countries, never mind two or more, could cause significant dislocations across markets and asset classes.

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