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HOUSE VIEW UPDATE 2016 Q3

Global Investment Committee Still Cautious on a Six Month View, except for Japanese and Asia-Pacific Equities

Clinton Win but Continued Sluggish Global Economic Growth

The Global Investment Committee estimates that Hillary Clinton will win the Presidency, but that the Congress will be split, so many of her largest plans will not come to fruition. Even if she wins by a large margin, which is dubious, there may be a great deal of unrest and continued investigations of her activities. Thus, markets might initially be somewhat relieved by her victory, but they never really doubted such, while the continued uncertainty about her leadership, and several anti-business executive actions or regulatory decisions (which are not subject to congressional approval) promulgated by her will likely provide headwinds to any risk rally and economic optimism.

Besides those in the US, there are many other concerns that should keep global growth from matching consensus for the next four quarters. Geopolitical risks in:

1. Asia, particularly as the US has unilaterally sanctioned Chinese firms for North Korean deals, which might invite reprisals,
2. Europe, including the Italian referendum, hardening BREXIT realities, a right-wing Austrian Presidency, and continued political upheaval elsewhere,
3. the Middle East, where the toughest fight against ISIS is about to begin in Mosul, and
4. terrorism, including cyber-terrorism, are all likely to keep global economic growth somewhat sluggish.

As for the major economies, US GDP, at 2.0% Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR) in the 4Q16-1Q17, will be far from recessionary conditions, but lower than the 2.4% consensus expectation. Also during this period, Japan's and the Eurozone's GDP will likely grow at 0.8% HoH SAAR compared to the consensus of 1.0%, while China's official GDP should be 5.5% HoH SAAR (translating to about 5.9% YoY growth) vs. the 6.0% consensus.

Noteworthy about our meeting, is that although it is not our base case scenario, quite a few members thought that at least one seriously negative geopolitical shock would occur in the quarters ahead, but that economies and markets would reverse the negative effects before too long.

How will Central Banks Respond? Fed is "once and done"

Despite somewhat sluggish growth, we forecast that the Fed will hike in December or March, as growth is strong enough to handle a small increase from such low levels. Thereafter, however, Fed guidance will likely be highly uncertain about any further hikes, especially as more dovish members will rotate onto the FOMC next year. Connected to such, our view is, thus, that the ECB and BOJ will continue on hold for the next twelve months, with extensions of QE, and continued dovish rhetoric, but with no new policies.

As for inflation, we expect the US Core CPI to decelerate to 1.9% YoY by March, with some deceleration in housing rent, and as we expect the Brent oil price to be at similar levels ($47) at that time, we expect the headline CPI to be quite mild, at 1.8% YoY, despite the low base of comparison in March 2016.

Relatively Stable Bond Yields

Given our new scenario of moderate economic deceleration, we expect yields to remain fairly stable for the next two quarters. For US 10Y Treasuries, our target for March-end is 1.70%, while those for 10Y JGBs and German Bunds are zero. For Australia, we expect 2.1%. This implies (coupled with our forex targets) that including coupon income, the Citigroup WGBI (index of global bonds) should produce a 0.2% return from a base date of September 23rd through March in USD terms. Thus, we move to a neutral stance on global bonds for USD-based investors (with an overweight cash stance). This index should fall 0.7%, through March in Yen terms, and as for JGBs, we target the 10Y to have a -0.5% total return in Yen terms through then, so within bonds, we slightly prefer JGBs for Yen-based investors.

Despite Japan's continued super-aggressive monetary stance vs. the Fed, we expect the Yen to stabilize at 100:USD at end-March, mostly due to fears that the Fed will not hike rates more than once. We expect the AUD to strengthen to 0.78 vs. the USD at that time too, thanks to stable commodity prices and higher local interest rates. As for the EUR, we do not believe the ECB will make any major QE moves and the region will continue its high current account surplus, which, coupled with likely capital repatriation, should push the currency to 1.13 by end-March. On the GBP, we expect it to remain at 1.30:USD at that time.

For those interested in the "barbarous relic," we expect gold at $1250 by end-March.

Staying Slightly Underweight Global Equities

We have been cautious on global equities since our September meeting last year, and while they have risen 7% in USD terms (including dividends) through September 28th, global bonds in USD terms have risen even further, at 10%. Our new macro-backdrop scenario continues this moderately negative view on global equities, particularly in Europe, but we are bullish on Japanese and Asia-ex Japan equities. We expect a very slight decline in US equities while those in Europe should have a -3% unannualized total return in USD terms through March due to continued banking problems and decelerating economic growth.

Hardening rhetoric regarding the BREXIT negotiations will likely hurt investment sentiment there, as well, despite the recent positive trend. Aggregating our national forecasts from our base date of September 23rd, we forecast that the MSCI World Total Return Index will decline 0.6% (unannualized) through March in USD terms (-1.5% in Yen terms) and recover mildly thereafter. **Thus, we will maintain our slight underweight stance on global equities for USD-based investors (and Yen-based investors, as well).**

Why are we mildly bearish on US equities? We realize that long-term interest rates remain low, and that investing for dividends makes sense for long-term investors, but this trend has become a fad in the US and many investors are not prepared to experience capital losses and will sell on market dips. Clearly the stock market is very expensive and valuations are even higher than three months ago (not to mention vs. the longer-term) as 2016 earnings estimates have continued to decline. Indeed, the SPX is now trading over **18 times NTM** (next twelve month) bottom-up consensus earnings (and if one fully expenses for option grants, the PE is probably a full point higher, and this does not even include the recent expansion of supposedly one-off write-offs). **Thus, we expect a slight de-rating due to lower global economic growth prospects, a slower corporate profit outlook and a somewhat challenged risk appetite.**

In particular, there is accelerating surge of social and political discontent about high corporate profits, especially when combined with corporate malfeasance or unethical behavior, and this is bound to have negative ramifications, especially when coupled by aggressive environmental, banking, international trade and drug pricing regulatory/criminal investigative actions by a Clinton administration (and also increased state legislation). As always, however, one source of support is continued share buybacks, which are not affected much by economic fundamentals, although such fell 21% YoY in the 2Q and some companies are threatened with credit rating cuts if they continue large buybacks. Meanwhile, many hedge funds and volatility-based macro funds are de-leveraging and losing assets. In sum, these factors should send the SPX slightly lower to 2115 at end-March, or a -1.2% total unannualized return from our base date.

As mentioned above, Eurozone equity prices in USD terms should fare a bit poorly in USD terms, with Euro Stoxx declining to 310 at end-March, and the FTSE to 6500. In sum, we, like most other investors (and nearly every "expert") were surprised at the post-BREXIT rebound in Europe, but we remain cautious, especially as the BREXIT negotiation rhetoric is becoming harsher. Thus, **we will continue our underweight stance on the region.**

Although many investors complain bitterly about Japanese equities, they actually performed in line with global developed-market equities in the 1HCY16 in USD terms and strongly outperformed in the 3Q. The stronger Yen certainly has been a headwind, but coupled with low equity valuations, and our expectation that the Yen will basically stabilize, **we expect TOPIX to end March at 1425 (for a total return of 7.7% in USD terms** and 6.7% in Yen terms). As important drivers, corporate governance continues to improve and buybacks are surging. Also, the doubling of BOJ purchases of ETFs has been and should continue to be a major positive factor.

Meanwhile, even though Japan's economy is not very strong, this should not concern investors greatly. As we have long reported in our "Show Me the Money" pieces, we believe that Abenomics is working reasonably well, especially for corporations, as 2Q16 pretax profit margins (on a four quarter average) remained near historical highs despite the stronger Yen, within which the non-manufacturing sector remained at peak profit margins. On an after-tax basis, the improvement is even better due to lower corporate taxes.

Finally, **in Japan, we do not see political disruption because it has maintained a highly egalitarian public policy (and controlled immigration) despite being long-ridiculed by most Western investors and economists for such.** Indeed, Japan has arguably the most stable political leadership in the developed world at this stage, which is another reason for us to maintain our overweight stance.

As for the Developed Pacific ex-Japan region, we expect Hong Kong shares to increase moderately and Australian equities to surge through March. The former will be boosted by continued low long-term interest rates, continued growth in the Chinese economy and increased equity inflows from Chinese investors. Australian equities are likely to benefit from continued economic growth and low interest rates. In sum, for the region's developed markets, we expect a 6.5% unannualized return in USD terms through March, so **we will shift from an underweight stance to a large overweight stance on the region.**

In sum, we forecast that Japan and **Developed Pacific ex-Japan will outperform over the next six months, while the US and Europe should underperform and, thus, deserve underweight stances.**

Investment Strategy Concluding View

We forecast that **global equities will, overall, decline somewhat, so we will take a slightly underweight stance overall, but recommend regionally overweighting Japan and Pacific ex-Japan.** Due to our expectation for global bond yields to be relatively stable, we **recommend a neutral stance on global bonds, while we overweight cash for USD-based**

and Yen-based clients. It has continued to be a wild roller-coaster ride for investors, and unfortunately, it is not likely to be very calm for the foreseeable future. Indeed, investors must keep a keen eye on geopolitical risk and we will clearly be ready to act if such appear to accelerate into a situation that could significantly impact markets.

Important Information