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MORE ECONOMIC AND EQUITY REFLATION, DESPITE LESS DOVISH CENTRAL BANKS

Global Investment Committee's 2017 Outlook

Global Growth Should Exceed Consensus

For 2017, the Global Investment Committee estimates that G-3 central banks will surprise on the hawkish side, but that global economic and equity reflation will continue. Recently, the primary impetus for US equities has been that Trump's tax cuts' effect on corporate earnings are being priced in, but their effect is also now boosting confidence macro-economically, among both corporates and consumers. This is true not only in the US but, either directly or indirectly, in much of the developed world. Moreover, this is accompanied by monetary policy that is extremely loose in all major countries, and although we believe such will become more hawkish than consensus, it will remain very accommodative and allow GDP growth to surpass consensus.

Obviously, there remain concerns about the quality, quantity and timing of the implementation of Trump's economic plans, as well as concerns about geopolitical issues, but we believe, as have markets so far, that such will be overshadowed by the policy benefits that eventuate. As we look to the year ahead, there will likely be set-backs and times of doubt, as always, but the odds favor positive rather than negative risk-sentiment on most of the globe.

As for the major economies, **US GDP**, at a 2.5% Half-on-Half Seasonally Adjusted Annualized Rate (HoH SAAR) in the 1H17, should exceed the 2.1% consensus expectation, and with our estimated 2H17's 2.2% rate, CY17 growth should nearly hit 2.5% YoY, which, although not booming, is quite strong and greatly exceeds CY16's 1.6% rate. Growth should derive from increased personal consumption, fixed asset investment, government spending and inventories, while net trade will likely be negative.

Meanwhile, **Japan**'s and the **Eurozone**'s GDP will likely grow at 1.9% HoH SAAR in both halves, compared to the consensus of 1.4%, leading to CY17 growth of 1.8% YoY. This compares to the CY17 1.4% consensus estimates for both countries, so risk markets should be positively surprised by such and corporate profit estimates should rise significantly above current market expectations. As will be detailed below, weak currencies will be an important driver of economic growth, but personal consumption, after the last two year's torpor shifts to greater optimism, should be the main driver. Japan will also benefit from the large fiscal stimulus enacted last year.

Lastly, **China**'s official GDP should be 6.9% HoH SAAR in both halves (translating to about 6.7% YoY growth), leading to CY17 growth of 6.8% YoY vs. vs. the 6.5% consensus. Here too, personal consumption will likely lead the way, while fiscal stimulus will continue to provide support.

Central Banks More Hawkish than Consensus

We are quite a bit more hawkish than the market on G-3 central banks, as although they are desperate to prevent panic from tapering, it will be very hard to justify such low rates with such sturdy economic growth, even if inflation has not reached target levels. On the topic of inflation, we estimate that central banks quietly acknowledge that CPIs do not necessarily capture true inflation very accurately.

In particular, the housing rent component is very hard to measure and market prices in major cities seem sturdier than official statistics. Meanwhile, higher oil prices and weaker currencies should push up inflation in the Eurozone and Japan, and it would likely prove a policy error to wait too long to begin removing excessive accommodation.

We forecast that the Fed will hike in each of the first three quarters of 2017, as it normalizes policy amongst sturdy economic growth. Although this is higher than the market consensus of "one or two" hikes, the policy rate should remain at a very accommodative level. This would push the USD sharply upwards unless there were at least some hawkish actions by the BOJ and ECB.

Investors should also remember that Japanese voters resented high food inflation when the Yen was so weak last year, thus, we expect the Abe administration to share its concern over such possibility to the BOJ. So, we expect the BOJ to shift up its 10Y target by 20bps in both the 2Q and 4Q and to taper ETF purchases in the 2Q. This may sound shocking, but it is just normalization and the markets should not need such aggressive stimulus at the time. Notably, the BoJ holds a very large portion of outstanding JGBs, so we believe it can control the yield curve according to its preference.

As for the ECB, BREXIT will remain a concerning headwind, but the ECB cannot sit still. Thus, late in the 1Q, we expect hints of indirect tapering, such as narrowing the scope and risk-level of assets purchased, and admitting that 3Q tapering is likely due to the lack of eligible securities. Despite these moves in Japan and the Eurozone, policy will remain extremely accommodative and time will be required to reverse negative policy rates; thus, their currencies should depreciate even a bit further as the Fed proceeds towards full normalization.

As for inflation, we expect the US Core CPI to hit 2.4% YoY in June, and as we expect the Brent oil price to rise to $63 then, we expect the headline CPI to hit 2.9% YoY, which certainly will capture the Fed's attention. We note that the medical component of the CPI (and PCE deflator) is highly unpredictable and very hard to measure accurately, especially given the changes related to Obamacare.

Rising USD and G-3 Bond Yields

Given our reflationary scenario, we expect G-3 bond yields to continue rising throughout 2017. For US 10Y Treasuries, our target for June- end is 2.85%, while those for 10Y JGBs and German Bunds are 0.25% and 0.65%, respectively. These are not major changes from current levels, and we expect only moderate further increases at year-end, as well, at 3.1%, 0.45% and 0.9%, respectively. For Australia, we expect 3.3% in June and 3.75% at year-end. This implies (coupled with our forex targets) that including coupon income, the Citigroup WGBI (index of global bonds) should produce a -3.1% unannualized return from a base date of December 15th through June in USD terms, and -4.9% return at year-end. Thus, we **maintain a heavy underweight stance on global bonds for USD-based investors.** The WGBI index should rise 0.6% through June in Yen terms, and as for JGBs, we target the 10Y to have a -1.5% total unannualized return in Yen terms through then, so within bonds, we prefer overseas bonds for Yen-based investors.

Despite our expectation for the BOJ's less dovish monetary stance, its policy will remain very dovish vs. the Fed, so we expect the Yen to weaken further to 123:USD at end-June.

As for the EUR, the somewhat hawkish announcements that we expect from the ECB will clearly cause volatility in the market, and we expect it to end at parity vs. the USD at end-June.

These trends should continue in the 2H for both currencies, with year-end levels hitting 125 and 0.98, respectively. We expect the AUD to be 0.75 and 0.76, respectively, vs. the USD, thanks to rising commodity prices and higher local interest rates.

As for commodities, they have been quite volatile and driven by non-market events, especially the OPEC-Russia agreement, but overall, they have clearly broken their negative correlation with the strong USD, at least for the time being. In many ways, this was logical, as global reflation, especially in China, has increased demand for commodities after a long and severe bear market.

Chinese demand for copper, steel and oil should remain quite high, given its fiscal stimulus, continuing firm housing construction and strongly increasing auto consumption.

Commodity demand from elsewhere in the world should also rise, despite technological efficiencies, due to improving economic growth. How fast commodity supply will rise in the next six months is an important question, but very difficult to answer, particularly regarding US oil production, for which it is important to remember that regulation by important US oil-producing states, particularly regarding fracking, can be much more stringent than Federal law. In sum, we don't expect a major increase in all commodity prices, but they should continue upward, particularly oil prices, with our Brent forecast at $63 in June and $69 in December as we expect OPEC-Russia production discipline to hold quite well.

Overweight Global Equities

We believe that Trump's surprise victory augurs well for US equities over the intermediate-term, mostly due to lower taxes on corporates, but also due to stronger global economic growth. Obviously, it is a challenging outlook in several regards, and there is great uncertainty about his methods, but his goal is clear: to spur investment and new jobs in the US via lower taxes and decreasing regulations.

We also forecast that there will be at least a moderately positive effect on the rest of the developed world economy, although none will benefit as much as the US due to the large fiscal and regulatory stimuli that are planned.

European equities should improve along better global and local economic growth, coupled with a weaker EUR, although BREXIT should remain a concerning headwind.

The outlook for Japanese equities looks very positive in Yen terms due to rising earnings from a weaker Yen and stronger domestic and global growth, but in USD terms, equities gains are somewhat lessened.

We are also positive on Developed Asia-ex Japan and Australian equities, with continuing strong growth in China being the main factor.

Aggregating our national forecasts from our base date of December 15th, we forecast that the MSCI World Total Return Index will increase 9.0% (unannualized) through June in USD terms (13.1% in Yen terms) and 12.9% by year-end (19.0% in Yen terms). **Clearly, this suggests an overweight stance on global equities for USD-based investors (and Yen-based investors, as well).**

Aren't US equities too expensive?

We realize that long-term interest rates are rising, although, crucially, we do not expect them to rise too rapidly, and that central banks are less dovish, but we estimate the Trump tax cuts will be quickly implemented and will greatly increase future corporate profits.

Indeed, this expectation is the major reason why US equities have already risen (along with the expectation that his market-unfriendly proposals are mostly rhetoric). Moreover, his policies clearly are, so far, greatly improving corporate investment and consumer sentiment. Deregulation and accelerated share buybacks are further icing on the cake, and although there are profit headwinds from a stronger USD, the net effect of it all should greatly boost CY18 earnings.

Currently, because the tax cuts are not legislated, analysts are not adjusting their EPS forecasts, but this **is likely a major anomaly that makes the market much less expensive than it appears.** Indeed, we estimate that the market is trading on about 15 times CY18 EPS (and even less if buybacks due to the repatriation "holiday" are greater than expected).

In sum, these factors should send the SPX to 2478 (10.7% total unannualized return from our base date) at end-June and 2533 at year-end (14.1% total return), **justifying an overweight stance.**

Europe

European equity prices should perform very well in local terms, and reasonably well in USD terms too, with Euro Stoxx rising to 375 and the FTSE to 7220 at end-June (390 and 7450 at year-end). This translates to 4.4% and 7.9% returns in USD terms. Since the US election, stock prices have risen sharply in EUR terms, but only slightly so in USD terms; however, the improvement in USD terms should accelerate as consensus profit estimates rise, particularly in the banking sector, which seems to have bottomed out, and from the heavily weighted multinational and mining sectors, which should benefit greatly from global growth, higher commodity prices and a weaker EUR.

BREXIT rhetoric will likely become harsher, and, thus, we expect UK equities to underperform the rest of the region, but the market will likely ignore the threats of a major disruption of European trade. Valuations in Europe are not high and because of the improving intermediate-term profit outlook, we think they can be sustained despite a surprisingly less dovish ECB stance, and, thus, equity prices can rise along with earnings. In sum, **we are quite positive, but will continue an underweight stance on the region.**

Japan

Japanese equities similarly, have performed well in local currency terms, but only slightly so in USD terms. However, we expect TOPIX at end June at 1683, with 1770 at year-end, for a total return of 6.2% and 10.7% in USD terms respectively (10.1% and 16.7% in Yen terms). These are, of course, major gains, allowing the BOJ to reduce its ETF purchases in the 2Q, as such were always meant only as a backstop for risk sentiment, and it can accrue the unused purchases for later date, if needed.

This view is a major departure from market consensus, but it seems completely logical, will not affect bond yields (nor equity prices for very long), and likely will prove popular internationally (and likely to many domestic traditionalists, as well), in our view, due to the program's heavily unorthodox nature. It may also prevent the Yen from weakening too much, which as mentioned before, would become a problem with Japanese voters.

As for the fundamental drivers, corporate governance improvement, including profit orientation and improved returns to shareholders, continues, of course, to be a prime positive factor, but macro factors are likely to play a much stronger positive factor in 2017.

Japan's economy will likely grow well above its trend, driven by improved consumer and corporate sentiment, as well as likely improvements in net trade, as the global economy, especially in China, continues to grow. Such, combined with a weak Yen, should be a strong positive driver for corporate profits, while valuations are very reasonable, so the outlook is bright, in our view; however, given US equity returns are higher, **we reduce of our overweight stance to neutral.**

Asia Pacific ex-Japan

As for the **Developed Pacific-ex Japan** region, we expect Hong Kong and Australian equities to perform well, and as currencies will be stable, in our view, this leads to a very strong 9.1% USD unannualized return in USD terms through June and 16.1% at year-end. This is greatly due to China's continued rise, and especially for Australia, China's continuing growth and the global reflationary effect on commodity prices (despite somewhat more hawkish central banks and moderately higher USD and bond yields). Thus, we **will maintain large overweight stance on the region.**

Investment Strategy Concluding View

This is the most positive view that the Global Investment Committee has had on global equities in a long time, as although the surprising Trump victory carries many uncertainties, the net effects for global economic growth and corporate profits have clearly improved. This justifies **an overweight stance on global equities, particularly for the US and Pacific ex Japan.**

Meanwhile, global bond yields should rise somewhat further, so we **maintain an underweight stance on global bonds, with an overweight stance USD cash** for USD-based clients. For Yen-based clients, however, cash looks less attractive than global bonds, but quite a bit more attractive than JGBs.

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