

HEALTH WEALTH CAREER

ECONOMIC AND MARKET OUTLOOK 2017 AND BEYOND

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The global economy is starting to reflate while monetary policy will likely become less supportive for economic activities and financial markets. The changing political landscape adds a new layer of uncertainty



SUMMARY

As we end 2016, there are at last some signs that the global economy is starting to reflate, with slightly stronger growth and higher inflation expected in 2017. Globally, fiscal policy has started to turn more stimulative, while a recovery in emerging economies seems to be taking hold after several years of very weak growth. These reflationary signs, while welcome, will raise monetary policy challenges, with policy becoming less supportive for economic activity and financial markets. The impact of the new administration in Washington DC adds a new layer of uncertainty, with markets focusing on the degree of fiscal stimulus and whether trade restrictions are imposed.

After three years of relatively stable equity markets, 2017 offers the prospect of more material moves in both directions. In US dollar terms, global equity returns have been a little lower than our long-term assumptions over the past three years. In 2017, better real and especially nominal economic growth should at last lead to a recovery in corporate profits. Improved profits and reduced deflationary fears should support equities, although less accommodating monetary policies and any moves by the US to restrict trade with Mexico or China would undermine them. On balance, we see equities generating modest positive returns, although material moves in either direction cannot be ruled out.

While equities have been relatively stable over the past few years, the same cannot be said of bonds. Government bond yields in all developed markets reduced sharply, reaching their lowest yields of all time in mid-2016. Since then we have seen a sharp sell-off, although yields still remain very low. We expect government bond markets to remain weak in 2017, with yields rising further. It remains to be seen whether the signs of reflation emerging will be sustained into 2018 and beyond. Any large sell-off could provide a buying opportunity.

We are becoming more optimistic on emerging market (EM) equities. If their economies continue to recover, then profits could rise for the first time in many years, supporting equities at a time when they are cheap on most measures. The key risk comes from the new US administration, which on the campaign trail promised to impose tariffs on Mexico and China. Such measures would be hugely damaging to the global economy as a whole and to emerging economies such as Mexico in particular.

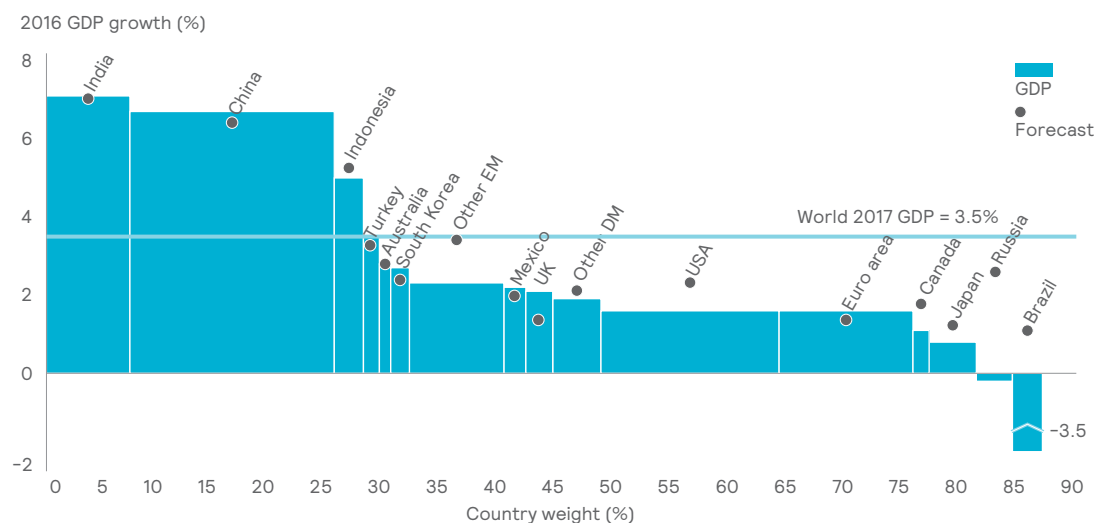
In summary, we think that global growth will pick up modestly in 2017, led by the emerging markets. However, economic growth is unlikely to be strong, with productivity growth remaining soft by historical standards. Higher inflation, on the back of a recovery in commodity prices and stronger labor markets, should support moves by the Federal Reserve (Fed) to raise interest rates at least twice in 2017, while the European Central Bank may start to consider reducing the degree of their accommodation as the year develops.

We expect both bond yields and equity prices to rise in 2017, although any signs that the Fed is behind the curve could undermine both materially. The fundamentals for emerging market equities are positive, although the risk of trade tension with the US is a real, if unquantifiable, risk. The prospect of a material fiscal stimulus plan that would support US growth from 2018 onward should support the US dollar, although in contrast to past governments the new Trump administration is likely to resist significant appreciation. The key risks to this outlook are discussed in depth at the end of the note, but they include more aggressive monetary tightening by the Fed and the increased risk of severe trade tensions.

GLOBAL ECONOMIC OUTLOOK

2016 was another disappointing year for global growth, with a satisfactory performance in the developed world offset by very weak growth in some emerging economies, like Brazil. We expect to see stronger growth in 2017, with EMs stronger (although not strong) and a slightly firmer tone to the developed world, with the notable exception of the UK. This improved performance in the emerging world should push global growth to moderately above the now lower trend, having been a bit below trend for several years. Figure 1 shows the Goldman Sachs economic growth forecast for 2017 relative to 2016, with the size of the blocks being the size of the economy. You can see the EM economies are forecast to be the same or slightly stronger, while the US is a bit better and the UK a bit weaker. We believe these forecasts are reasonable.

FIGURE 1: GLOBAL GROWTH STRENGTHENING A LITTLE IN 2017, LED BY EM



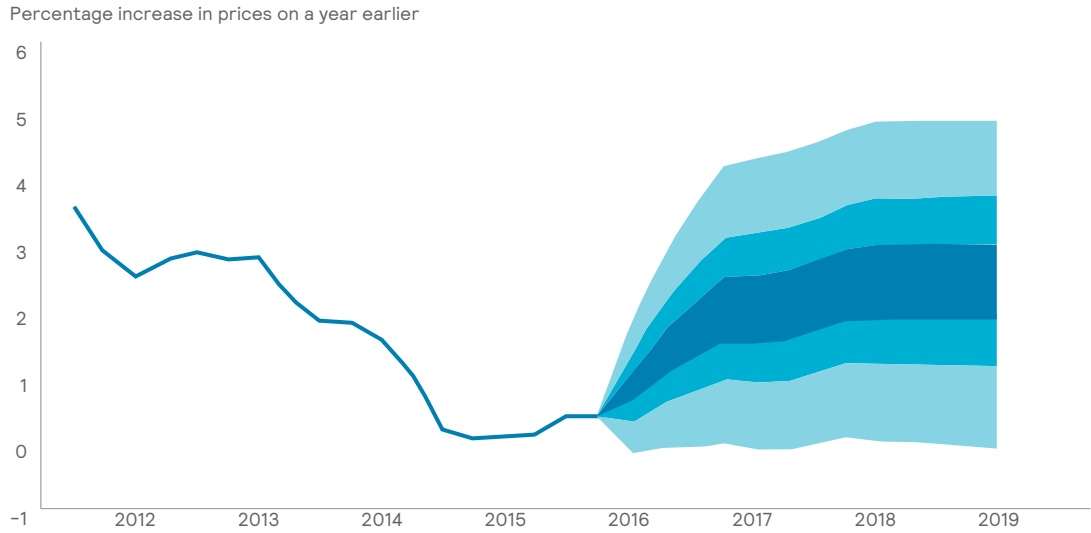
Source: Goldman Sachs

In the US, we expect the economy to grow at or a bit better than the 2% seen in recent years. Possible tax cuts and infrastructure spending by the new Trump administration create some upside risk, although if enacted, these changes are more likely to boost growth in 2018 than 2017. The proposed corporate tax reform, which includes cutting headline corporation tax rates and encouraging companies to bring home funds locked overseas, could lead companies to increase capital expenditure and thereby improve productivity growth. The recent strength in the US dollar, if sustained, will dampen economic activity, while any material escalation in trade tensions (discussed later) would also hurt US growth and raise US inflation.

In the UK, the government's Brexit plans will remain central to the economic outlook, with Article 50 set to be triggered by the end of March 2017. Thus far, Prime Minister May has said that she wants to maintain the closest possible trade relationship while having greater control on immigration. In practice, that rules very little out and very little in. The UK has three primary options: a hard Brexit with the UK trading only using the World Trade Organization (WTO) framework; a comprehensive free trade agreement (FTA); and joining the European Economic Area (EEA), with the EEA either being the final resting point or being used as a stepping stone while a more complete disengagement is negotiated over the subsequent few years. A transitional deal that extends the two-year time frame is also possible for any of the three options. Ultimately, we think the UK will avoid a hard Brexit.

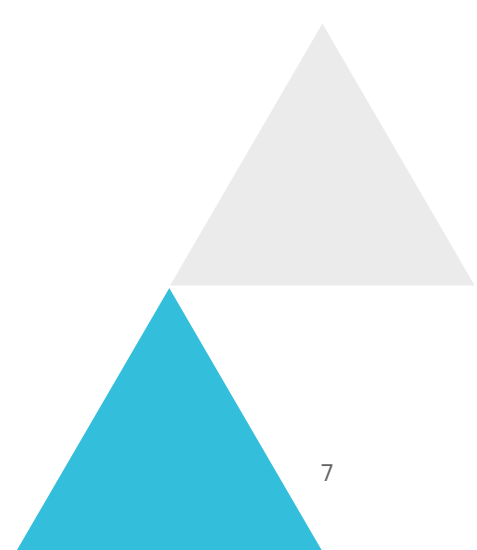
While UK economic growth has held up in 2016, we think it will weaken noticeably in 2017, on the back of weak investment related to Brexit uncertainty, and a sterling related sharp rise in inflation that will hold back household real income. Figure 2 shows the Bank of England expects inflation to rise above 2% and stay there for a few years. Signs that the UK is heading toward a transitional Brexit deal could limit the UK's downturn, while any path that risks a hard Brexit would cause more significant weakness.

FIGURE 2: UK INFLATION LIKELY TO RISE ABOVE TARGET



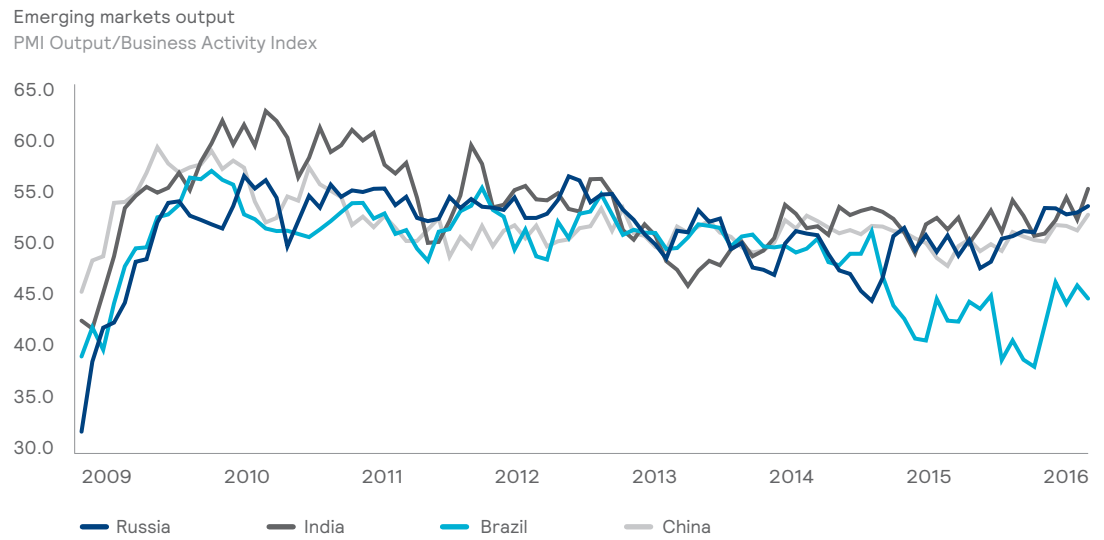
Source: Bank of England

The Eurozone appears to have strengthened in the second half of 2016, supported by stronger consumption and export growth. The ongoing decline in unemployment, the weakness in the euro and the recovery in the global economy should continue to support consumption and investment. The main risks to the Eurozone economy in 2017 are political rather than economic. The fallout from the recent Italian referendum and upcoming elections in Holland, Germany and especially France could undermine confidence in the EU and euro as a whole, triggering a new bout of political uncertainty.



Many emerging economies appear to have stabilized, with most economies strengthening. For some, such as Brazil, that means moving from depression-like conditions to modest growth, while for others it implies stronger growth. Following currency weakness over the past few years, emerging economies are competitive with the developed world, while the recent uptick in commodity prices should support those economies that are big commodity exporters. Figure 3 shows that business confidence, which often closely tracks GDP, has strengthened in recent months in the key EM economies.

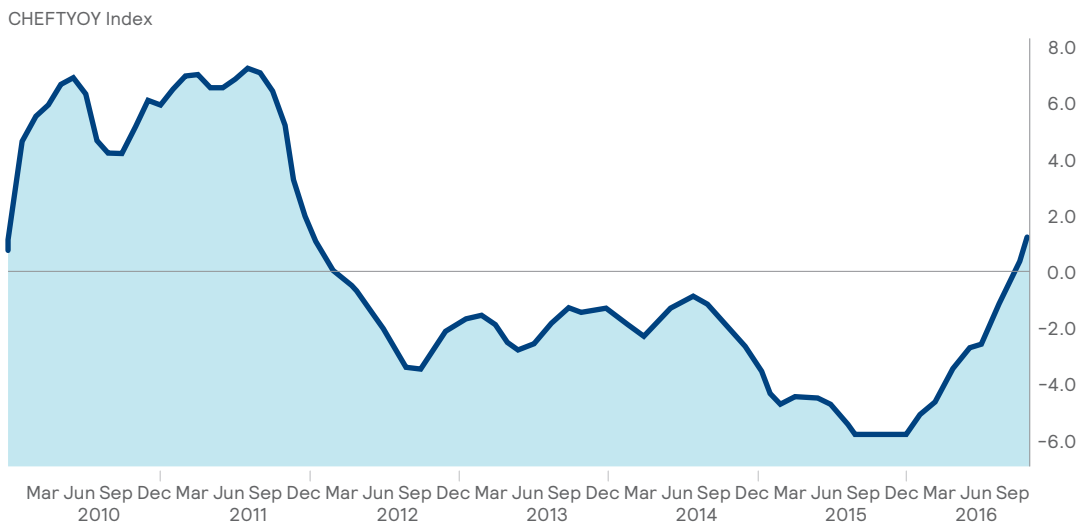
FIGURE 3: KEY EM ECONOMIES LOOKING STRONGER



Sources: IHS Markit, Nikkei, Caixin

After weakening at the start of 2016, the Chinese economy strengthened mid-year on the back of increased government spending. On a multiyear view, the Chinese economy is likely to slow further as it moves away from exports and investment and toward consumption. Ahead of key political events in late 2017, we expect fiscal support will remain sufficient to underpin growth of just over 6%. Thereafter, however, if activity were to slow abruptly, the Chinese government would increase its support again. While this fiscal support may be ultimately unsustainable, the Chinese authority's fiscal strength is unlikely to be tested in the near term. In China, while consumer price inflation has been largely stable over recent quarters, producer price inflation (PPI) – figure 4 – has stopped declining after a long period of deflation. This means that China is exporting less or no deflation to the rest of the world.

FIGURE 4: CHINESE PPI DEFLATION OVER

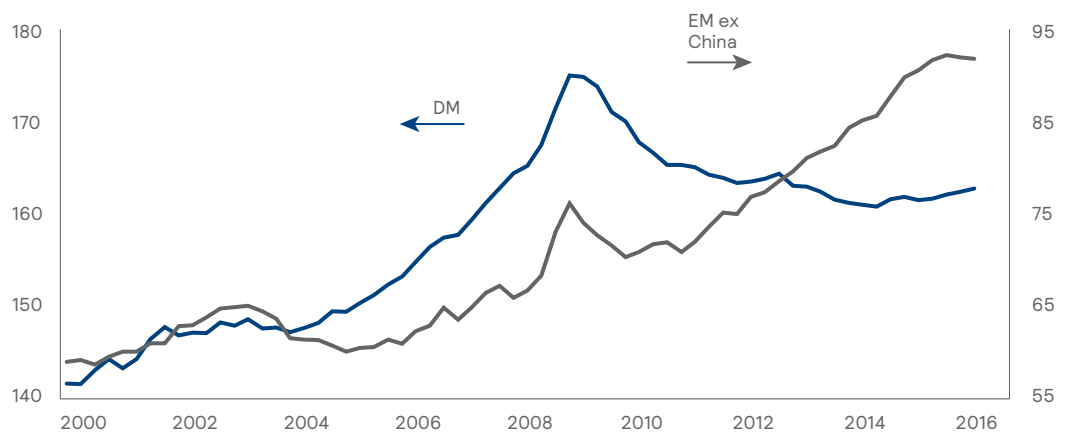


Source: Bloomberg

The introduction of material tariffs against Mexico, China and, possibly, other countries by the new administration represents the biggest risk to EM economies. While, at this stage, events are difficult to predict, we expect President-elect Trump to seek to renegotiate many agreements but stop short of triggering a trade war, because that would ultimately hurt the US. Emerging markets are also vulnerable to a sharp rise in the dollar, should that occur.

FIGURE 5: BROAD PRIVATE NONFINANCIAL CREDIT

% of GDP; both scales



Sources: BIS, central banks, J.P. Morgan

Global inflation is set to move higher as past falls in the price of oil and other commodities drop out of the year-over-year comparisons. Figure 6 shows that global headline inflation could rise from 1.5% in 2016 to almost 2.5% in 2017, in part on the back of oil price movements. If oil stays at its current \$50 a barrel, then in year-on-year terms, crude oil in US-dollar terms will be up by over 50% by January 2017. In sterling terms, the price of crude oil will have doubled. This will push inflation in the US and the UK well above their 2% targets, and we should see higher headline inflation in the Eurozone and Japan as well.

FIGURE 6: INFLATION MOVING HIGHER



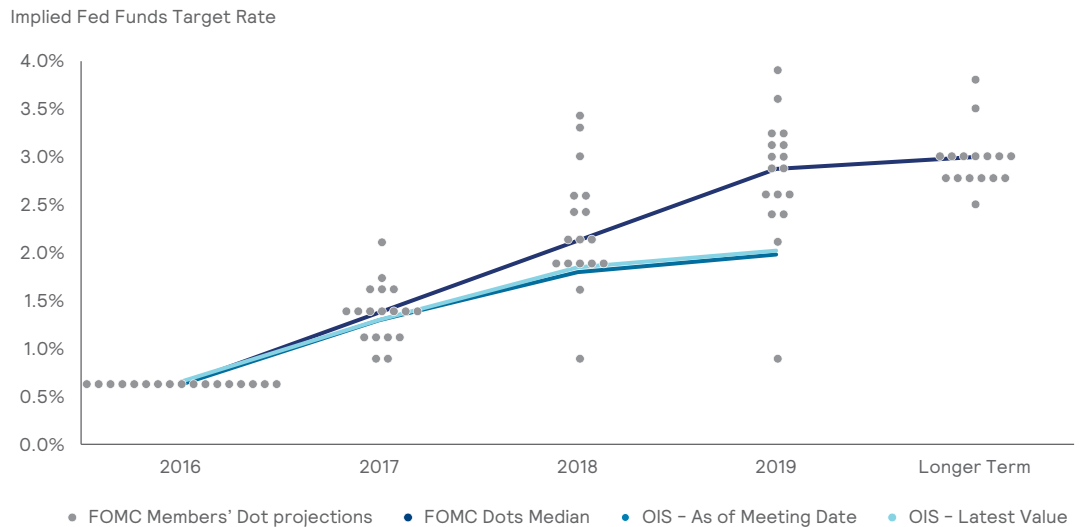
Source: J.P. Morgan

On a core basis — stripping out food and energy prices — inflation is likely to be much more stable, at just above 2% in the US and the UK, but still well below 2% in the Eurozone and Japan. While unemployment rates continue to fall, we have at last started to see signs of wage inflation in the US and to a lesser extent elsewhere. This could push core inflation in the US modestly above target, especially if the new US administration succeeds in pushing a major fiscal expansion plan through Congress. In summary, we think inflation risks in the US are now modestly on the upside, while there is less downside risk in the Eurozone and Japan.

Over the past few years, one of the key concerns of many has been that the global economy could fall into a deflationary spiral, with central banks unable to do much about it. While these risks have not disappeared, they have fallen, in part helped by a slightly stronger global economy, rising commodity prices and the potential for greater use of fiscal policy.

Slightly stronger global growth, lower unemployment rates and rising headline inflation will have implications for monetary policy. In the US, the Fed is likely to raise interest rates with more urgency than in 2015 and 2016, when interest rates were raised only 0.25% in each year. The Fed sees three interest rate increases in 2017 (figure 7), which we think is a reasonable case base. In the Eurozone, the ECB is likely to continue to provide substantial stimulus to ensure the recovery continues. However, by the end of 2017, it is possible that the ECB could start to consider winding down its purchases completely.

FIGURE 7: FED EXPECTS TO RAISE INTEREST RATES OVER NEXT FEW YEARS



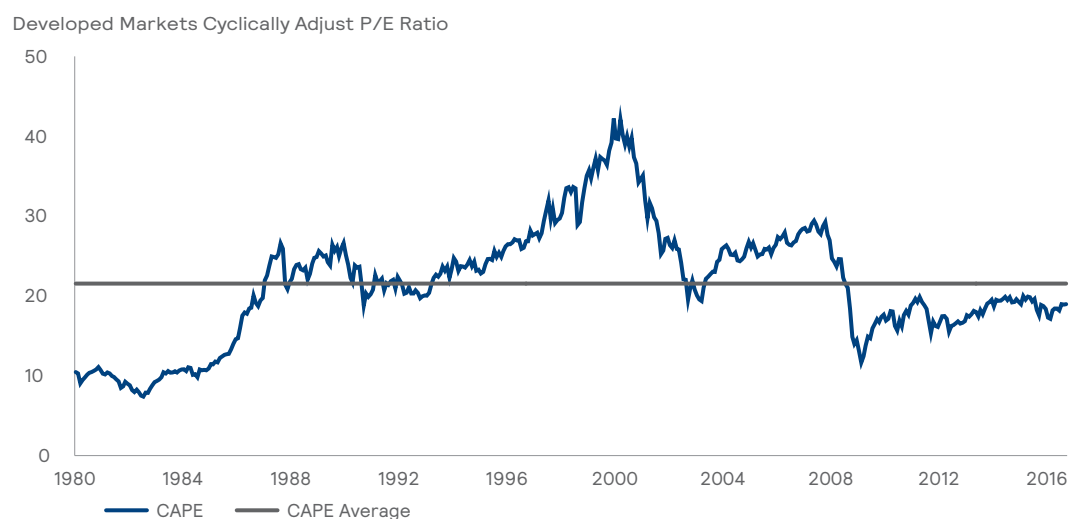
MARKET OUTLOOK

In the short term, if President-elect Trump's policies are taken at their word, the first three to six months of a Trump administration could see a period of policy change and renegotiation, which may trigger a substantial increase in market volatility. This includes both external (trade and foreign relations) and internal (tax and immigration) policy adjustment.

Over the long term, the most important determinant of future equity returns is valuation. We think global equities are fairly valued, expensive in the US but cheaper elsewhere. As a result, this gives non-US equities a bias to slightly outperform US equities, with equities as a whole generating returns in line with historic norms. With valuations in the ballpark of fair value (figure 8), we look to fundamentals to determine whether equities will do well or badly. Here a recovery in corporate profits could be offset by a rise in interest rates. Taking this all together, we expect equities to generate reasonable although not spectacular returns over the next 12 months.

The recovery in both global growth and inflation should support corporate growth — figure 9 shows a strong correlation between nominal GDP growth (real GDP growth + inflation) and corporate profit growth. Corporate profit growth should also be supported by a turnaround in the commodity-linked companies, which should start making profits again on the back of the recovery in commodity prices. Banks could also start to become more profitable again, especially if the new US administration seeks to reduce the level of fines faced by banks for past errors.

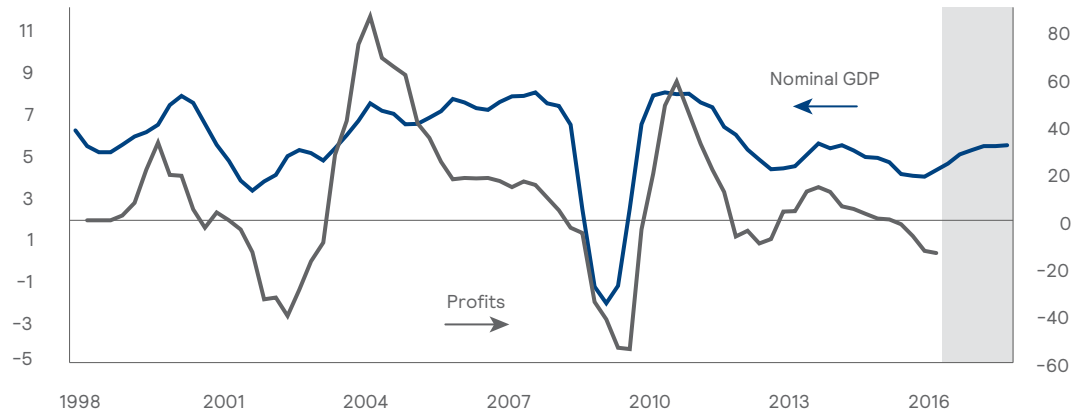
FIGURE 8: EQUITIES FAIR VALUE



Source: Thomson Reuters Datastream, IBES

FIGURE 9: PROFITS COULD RISE

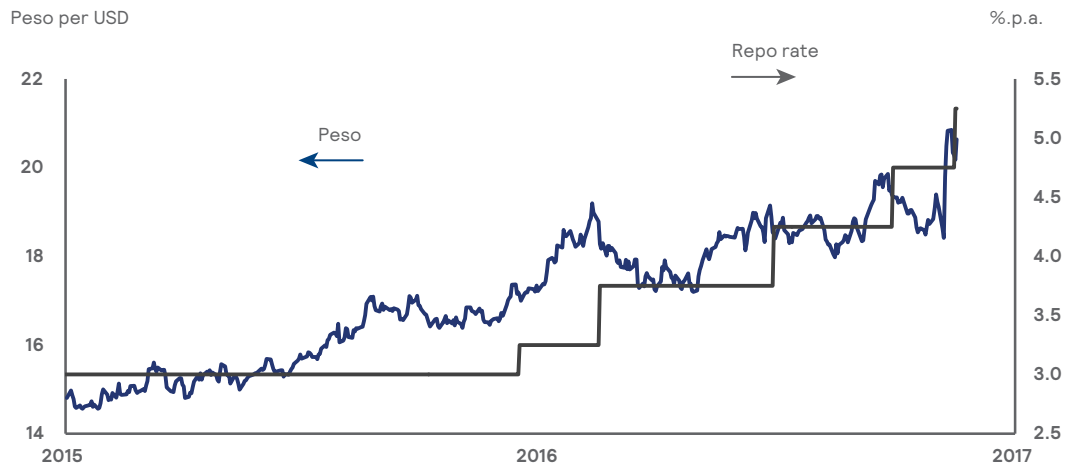
Global nominal GDP and corporate profits
% oya; both scales



Source: J.P. Morgan, MSCI earnings

While stronger profit growth after a number of disappointing years is supportive for global equities, the prospect of higher US interest rates will act as a hindrance. While we doubt US inflation will become uncomfortably high, any sense that the Fed is “behind the curve” would cause economic and especially financial market damage. Any material escalation in trade tensions with either Mexico or China could also undermine both developed and especially EM equities. Even the threat of action has caused the Mexican peso to weaken sharply and forced the Mexican central bank to raise interest rates — see figure 10.

FIGURE 10: MEXICAN PESO WEAKENS SHARPLY



Source: J.P Morgan

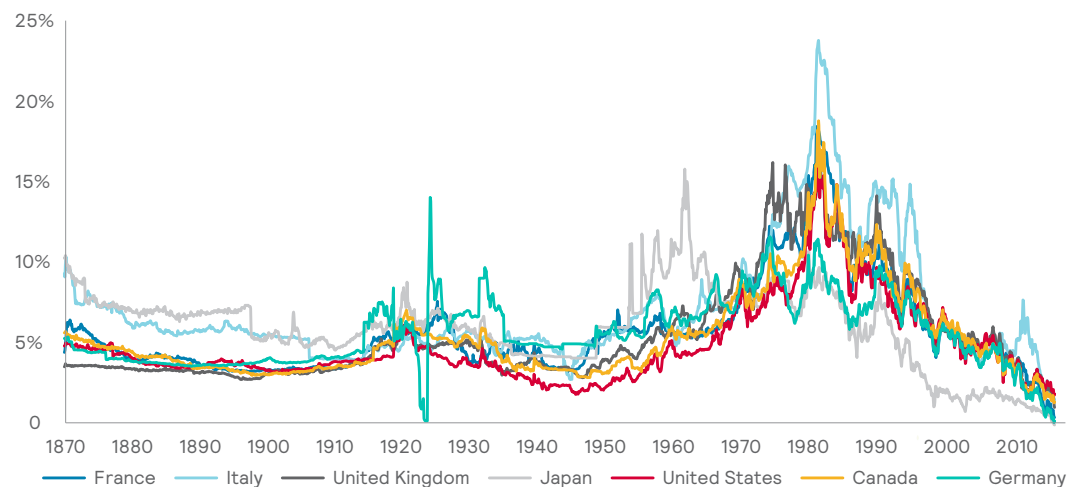
Absent the trade risks for EM equities coming from the new US administration, the outlook for EM equities is the best it has been for some time. Profit growth should start to increase for the first time in several years, while valuations on both the equity and FX side are favorable. As noted earlier, we think President Trump will try to renegotiate various deals, with minor tariffs possible, but will stop short of precipitating a more material trade war. As a result we expect EM equities to do well, although our confidence in that view is held back by uncertainty over what President-elect Trump will do.

We expect small-cap equities to perform broadly in line with developed equities, with support coming from stronger profit growth but with the sector held back by challenging valuations. Low-volatility equities are expected to underperform developed market equities on the back of less favorable valuations and the likely rise in bond yields that could lead to outflows from those who have seen low-volatility equities as an income alternative to low-yielding government bonds.

DEVELOPED MARKET BONDS

After reaching all-time lows in all developed economies in mid-2016, government bond yields have risen sharply over the past few months on signs of economic recovery, rising inflation and fears that President Trump’s fiscal stimulus plan could lead the US economy to strengthen at a time when it is already at full capacity. Yields remain at very low levels even after these recent increases. Figure 11 shows that global bond yields are still very low, despite rising 1% in recent months.

FIGURE 11: US YIELDS STILL CLOSE TO ALL-TIME LOW



Source: Deutsche Bank, Global Financial Data

We expect global bond yields to rise further in 2017 as the Fed raises interest rates again, the economic recovery continues and headline inflation increases. We expect bond yields in the Eurozone to follow US yields higher as the unemployment rate falls below 10% while inflation risks become more balanced. In the UK, the Bank of England is likely to stay on hold, perhaps with a slight bias to cut rather than hike rates. This could provide some support to shorter-dated bonds, although longer-dated bonds could be hurt by the completion of the Bank of England's bond-buying program and rising global bond yields. In Japan, the Bank of Japan has pledged to buy bonds in unlimited quantities to keep 10-year yields at 0%. We expect they will succeed.

NONGOVERNMENT BONDS

We think nongovernment bonds will modestly outperform government bonds. With the global economy strengthening, we think that defaults outside the commodity sector will remain low, while defaults within the commodity sector will fall on the back of higher commodity prices. However, with spreads at or even lower than the average of the past few decades and commodity gearing increasing, there is little scope for spreads to contract materially. Figure 12 shows global high-yield spreads at a little below the average of the past 30 years.

FIGURE 12: HIGH-YIELD SPREADS NO LONGER HIGH



LOCAL CURRENCY EMERGING MARKET DEBT

The outlook for EMD is closely tied to the outlook for US government bonds and whether the new administration imposes material tariffs or trade restrictions on countries such as Mexico and China. As noted earlier, such restrictions would undermine emerging market economies and currencies.

FOREIGN EXCHANGE

The US dollar has risen sharply over the past few years and again quite sharply since the US election on November 8. The US dollar has been supported by the prospect of higher interest rates, while interest rates in other emerging and developed economies are either on hold or falling. If President Trump's tax plans are enacted, then interest rates could rise by more than is expected, putting further upward pressure on the US dollar. While a stronger dollar against most other developed currencies is our central case, we would caution that the US dollar is already quite expensive, while President Trump may be less supportive of persistent US dollar strength than many of his predecessors. Elsewhere, we think the British pound will strengthen as long as it avoids the hardest of Brexits.

Relative to emerging markets, the US dollar's performance will in large part be the result of the trade policies pursued by the new administration. Emerging market currencies are generally cheap, and we expect economic growth to strengthen, which should both support the sector's currencies. However, aggressive tariffs of some kind could push emerging currencies much weaker. On balance, we expect the new administration to push for a "better deal" but stop short of triggering a damaging trade war.

FIGURE 13: EM CURRENCIES CHEAP



Source: Thomson Reuters, Credit Suisse research

ALTERNATIVES

Hedge funds posted relatively disappointing results over 2016. That said, given current bond and equity market valuations after 8 years of stellar returns, the strategic rationale for alternative strategies is compelling. Looking forward, we expect hedge funds to generate net-of-fee returns well in excess of cash, and we prefer strategies that exhibit low correlation to traditional asset classes. Uncertainty in terms of trade, currency, and central bank policies should create particular opportunities for macro-oriented strategies.

For investors with a tolerance for some illiquidity in their investment portfolios, private market asset classes can offer a range of attractive opportunities. Asset classes like private debt, real assets (e.g., real estate and infrastructure) and private equity are playing an increasingly important role within investors' portfolios. Investors have been seeking exposure to private market asset classes to enhance returns, improve income yield and provide better diversification in their portfolios. We believe the opportunity set for private market investing remains robust, but investors should be aware of the increasing volume of capital being allocated to certain areas of the market and should seek to build their private market exposures over time to diversify risk concentrations.

RISKS

There are always plenty of risks attached to the economic and market outlook every year, and it is almost impossible to know whether these risks, when considered in their totality, are higher or lower than normal. However, as we approach 2017, the risk of the Fed's having to raise interest rates aggressively is higher than it has been for some time, while some political risks also seem elevated. On the positive side, global deflation could lead to a pickup in investment, boosting productivity and greatly diminishing the deflationary fears that have been hanging over the global economy.

Fed raises rates aggressively: The pickup in inflation and growth that we expect to see in the US increases the risk that the Fed starts to raise interest rates much more aggressively than it has so far. The Fed has felt able to move very slowly, with inflation on some measures below their 2% target and unemployment at or near normal levels. In 2017, it is likely that inflation will rise and unemployment will fall, forcing the Fed to move more aggressively.

President Trump starts trade war: Trade war: President-elect Trump has said that he might impose trade tariffs on some countries and pull out of NAFTA. This could lead to a trade war, which would be damaging to the global economy.

European elections: The fallout from the Italian referendum and forthcoming elections in Germany, Holland and especially France could once again raise fears over the existence of the EU and the euro in its current form. Any risk of breakup would have global ramifications. Meanwhile, the UK will enter formal negotiations with the EU on its departure.

Deflation ends deflationary fears: An increase in inflation and a more modest increase in global growth should reduce fears that the world could enter a prolonged period of deflation. This could boost overall confidence, prompting a pickup in global capital investment, and reduce real debt levels, which remain a key vulnerability in some parts of the world.

Productivity picks up: Productivity growth has been very poor in many parts of the world over recent years, and most expect it to remain weak over the next few years. A pickup in global investment as well as the ongoing introduction and spread of new technologies could allow economic growth and profit growth to pick up without leading to higher inflation.

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