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Market Update
Global Equity

Commentary:
Recent Macro Trends Should Persist in 2017

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Looking to the balance of this year and into 2017, we expect a number of the recent macroeconomic and market trends to persist.

First, we believe it is likely that we will continue to see a modestly positive uptrend in inflation. We are seeing signs of cyclical elements of inflation picking up while acknowledging that structural disinflationary forces are still intact. U.S. core and services inflation are increasing and approaching pre-crisis levels, and the relatively stable U.S. dollar is driving up the inflation of import prices. The core consumer price index (CPI) outpacing the core producer price index (PPI) suggests a potential return to corporate pricing power. Ultimately, these forces are likely to lead to less accommodative central-bank policy, led by the U.S. Federal Reserve (Fed). In addition, the efficacy of European and Japanese central-bank actions is increasingly being called into question.

> **"Forces are likely to lead to less accommodative central-bank policy."**

The global bond markets have begun to recognize these influences to a degree, and we believe this is likely to persist, leading to a continuation of equity-market leadership driven by the more cyclical elements of the economy.

To some degree we have seen this play out this year in the form of regional and industry stock performance. Emerging markets, on average, have outpaced developed markets by a wide margin, joined by resource-exporting countries such as Canada and Australia. Among the industry leaders this year have been the mining, energy, and construction industries. This is likely a function of their being "cheap" but also reflective of growth estimates getting less bad and in some cases turning up. While we have not yet seen this consistently materialize in earnings growth, the market appears to be anticipating a recovery.

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From a portfolio strategy perspective, we have been considering a further move into some of these more cyclical areas of the market as we think the risk to growth remains to the upside. Beyond these areas, industries and companies within the financial sector are of interest to us. They remain among the worst performers of the last several years including this year, in many cases for good reason—regulatory overhangs, low profits, and low returns have now persisted for years. However, the prospect of higher rates and steeper yield curves could drive earnings growth and lift the currently depressed valuations.

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Implied in this inflation and rising-rate environment is a broadening of nominal growth rates across markets and industries. This also has implications for equity markets. Valuations are above historical averages, although this has been less concerning given the protracted low-rate environment. With broader growth, valuation as a factor is likely to take on more importance. Further, the market has assigned a significant valuation premium to those companies that have been able to deliver top- and bottom-line growth against what has been a difficult backdrop. We, and others, have noted that the valuation of these high-quality, dependable performers has been extended relative to the rest of the market for some time now. This scarcity premium is likely to come under some pressure in an environment of broader growth. In addition, higher rates could compress the valuations of so-called long-duration stocks and make the higher-yielding "bond-proxy" stocks less appealing. ■

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