MARKET OUTLOOK
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Who Knows? Navigating the Known Knowns and Underappreciated Knowns In Current Market Consensus

2016 was a year in which the pundits and other "wise ones" were roundly repudiated and the market just didn't care. No major election played out as predicted by our so called best minds; and despite various predictions of Armageddon should the angry mob prevail, global equity markets shrugged off each event – Brexit, President Trump and the Italian Referendum – as minor rain showers that refreshed their combined 8% gallop over the course of the year. TABLE 1 summarizes the return of key indices and asset classes.

TABLE 1

Asset Performance

	1m	3m	6m	12m	3yr	5yr
Equities (Local Currency)[2]						
Global Markets[3]	4.1	5.3	11.4	12.7	23.5	75.5
Developed Markets	4.3	6.2	12.1	13.2	27.3	87.8
U.S.	3.1	5.4	9.8	14.7	31.2	96.5
Euro-zone	8.2	8.5	18.2	9.0	24.5	85.4
UK	6.6	3.0	11.8	22.3	18.6	52.3
Japan	5.1	16.3	24.8	4.5	24.7	132.8
Emerging Markets	2.9	-1.1	7.9	15.0	14.6	34.8
Equities (U.S. Dollar-Basis)[2]						
Global Markets[3]	3.8	3.1	9.0	12.2	12.9	57.3
Developed Markets	3.9	4.0	9.5	12.3	16.8	69.8
U.S.	3.1	5.4	9.8	14.7	31.2	96.5
Euro-zone	6.9	2.8	12.9	7.8	-3.1	53.0
UK	4.2	0.4	6.4	3.6	-10.2	22.7
Japan	5.0	3.7	10.3	8.3	11.8	53.9
Emerging Markets	3.6	-3.2	7.3	17.9	-2.0	9.0
Government Bonds (Local Currency)[4]						
Developed Markets	0.1	-2.7	-4.2	2.5	12.8	17.7
U.S.	0.5	-2.9	-4.7	1.5	8.7	8.0
Euro-zone	0.2	-2.8	-3.5	1.9	17.7	36.2
UK	0.6	-4.3	-3.8	8.5	26.1	25.1
Japan	-0.9	-1.8	-4.5	3.1	9.6	14.0
Emerging Markets	1.2	-1.3	0.8	9.4	22.5	39.0

	1m	3m	6m	12m	3yr	5yr
Government Bonds (U.S. Dollar-Basis)[4]						
Developed Markets	-0.6	-6.7	-8.5	1.8	0.0	-2.5
U.S.	0.5	-2.9	-4.7	1.5	8.7	8.0
Euro-zone	-0.9	-8.0	-7.9	0.8	-8.3	12.8
UK	-1.6	-6.8	-8.5	-8.0	-4.7	0.4
Japan	-1.9	-12.0	-16.1	6.4	-0.9	-23.9
Emerging Markets	2.4	-5.5	-2.5	11.3	-10.6	-5.6
Currencies (vs. U.S. Dollar)						
Euro	-1.1	-5.1	-4.4	-1.5	-22.3	-16.7
Sterling	-2.2	-2.1	-4.3	-15.3	-24.5	-19.7
Yen	-1.8	-10.4	-12.5	2.3	-10.3	-33.6
Commodities						
Brent crude oil	5.6	8.5	16.7	66.4	-46.6	-49.6
Gold	0.7	-6.1	-13.6	7.7	-4.9	-27.2
Base metals	-4.2	9.8	12.9	25.1	-12.2	-16.2

Latest available data up to 5th or 6th January 2017.

1. *Total returns for equities and bonds. Spot market returns for currencies vs. the U.S. dollar and commodities in dollars.*
2. *MSCI Indices. (N.B. Developed markets = MSCI World Index).*
3. *Global Markets = MSCI All Country World Index Net.*
4. *JP Morgan GBI Global & EMU Indices for DMs; JP Morgan GBI-EM Global Diversified Index for EMs.*

Source: Capital Economics

The title of this paper reflects our belief that 2017 is unlikely to bring reprieve from the policy and market uncertainty which ruled its predecessor. We of course borrowed and amended this title from former defense secretary Donald Rumsfeld's description of the risks of the Iraq invasion and occupation to the press. It turns out that he was grossly over-confident in what he believed to be "known knowns" and thoroughly underappreciated the 'known unknowns" and "unknown unknowns". Those unknowns came back to ultimately haunt President Bush's (43) legacy. We believe that the current equity rally and the underlying consensus narrative which supports it will face such a fate over the next three years. Therefore, on PAGES 5-15, we examine the vulnerability of the consensus narrative underpinning the recent market rally relative to "underappreciated knowns" in a broad range of areas.

Our strategic and tactical views with respect to key countries, sectors and factor are summarized in TABLES 2-3 on PAGES 2-4.

TABLE 2

Global Country and Sector Positioning

Risk / Environment	-		N		+	
Global Equity Risk Environment				● Strategic		**Sentiment rally ripe for short term (2 months or less) consolidation; but beta risks will be supported by positive earnings momentum and fiscal expansion over the next 12 to 24 months.** Our systemic risk indicator entered into risk neutral in mid December and has stayed there in 2017. The deterioration is mostly due to currency inputs, particularly the U.S. dollar. However, both components of the equity market sentiment indicator remain in risk-on territory, underscoring that the sentiment driven Q4 rally that is already discounting improving growth and supportive policy in 2017 could face near term consolidation.
U.S. Dollar			● Tactical	● Strategic		**Stretched valuations and net speculative positions suggest a short term retracement. However, the next 12 months are likely to see further appreciation, particularly against the Yen and RMB.** With US interest rates rising, and yield spreads over Europe and Japan widening, there is a strong possibility that the dollar could rise further. The dollar could also get a big boost from tax changes proposed by president-elect Donald Trump and Congress. Like the Reagan presidency in early 1980's, the dollar entered into a structural bull run because of shifting ROIC (return on invested capital) expectations, as a result of so called "animal spirits" unleashed by corporate and capital friendly tax changes.

Regions / Countries	-		N		+	
United States		● Tactical	● Strategic			**Tactical underweight; neutral over the next 6 to 12 months.** Structurally, U.S. equities' more defensive posture underperforms when global growth strengthens. Additionally, after correctly predicting the Q4 rally, our tactical models appear to be pointing to some consolidation in Q1 2017. Countervailing crosswinds include earnings improvements, fiscal policy support for select sectors and improving but still benign inflation growth on the positive side. On the negative side, a near term risk of consolidation after the Q4 rally, less generous valuations, a pickup in wage growth and a strengthening dollar could cap earnings improvement.
United Kingdom			● Strategic			**Neutral but currency hedge.** Hard Brexit make GBP depreciation more probable but the globally focused FTSE 100 index could benefit from a pickup in global growth momentum.
EU (core)		● Tactical		● Strategic		**Tactical underweight; strategic overweight over the next 6 to 12 months.** We are taking some profits to our strategic overweight to Euro core. This reflects considerable risk of near term consolidation, is consistent with our tactical forecast as well as heightened political risk. Last quarter, we were overweight (Germany and Spain) but hedged the currency exposure. We continue to believe that the combination of attractive valuations, relative operating leverage to global growth along with positive earnings revision momentum warrant at least a neutral/slight strategic overweight. Upcoming elections in Germany, France and the Netherlands present a risk to this view, which we will continue to monitor. In deference to our models, we will reduce our weight to neutral.
EU (periphery)		● Tactical		● Strategic		**Tactical underweight; strategic overweight over the next 6 to 12 months.** After correctly forecasting outperformance for Spain in Q4, our tactical models are forecasting a reversal in Q1 2017. In deference to the model, we will reduce our weight to neutral relative to Spanish equities.
Japan		● Tactical	● Strategic			**Tactical underweight; strategic overweight over the next 6 to 12 months.** After correctly forecasting a performance rebound in Q3, our tactical models forecast another negative reversal, albeit with low conviction. Heading into 2017, the Abenomics experiment has gained momentum. Rising inflation and improving fundamentals are likely to weaken the yen further. Meanwhile, the BOJ is actively buying up the market, the only major central bank doing so. Foreign investors have not participated in the recent rally in Japanese equities. All these factors are likely to push the Japanese stocks higher over the course of the year.
Australia		● Tactical	● Strategic			Expect short term consolidation, hence a tactical underweight. Australia represents a leveraged China's policy reflation play and should remain well bid at least for the first half of the year.
Canada		● Tactical	● Strategic			**Expect short term consolidation, hence a tactical underweight.** However, ongoing rebalancing of supply/demand conditions in oil prices over the next year will support Canadian equities. Our tactical models forecast outperformance, albeit with low conviction.

● Strategic (6-12 months+)
● Tactical (3 months)
● Variance for Non-U.S. Portfolios

Regions / Countries	-		N		+	
Emerging Markets (Pacific Rim)		Tactical		Strategic		**Tactical underweight; strategic neutral. Expect short term consolidation/ underweight to Chinese, Korean and Taiwanese equities. However, over the next 6 to 12 months, we believe that an overweight to North Asian equities on a currency hedged basis will outperform the EM benchmark.** We are past the peak impact of China's reflation policy initiated in the second half of 2015. Indeed Chinese policy makers have begun to marginally tighten liquidity/credit conditions to battle China's growing credit bubble. While we believe that market consensus is overstating the case for meaningful additional stimulus ahead of the CCP's National Party Congress in September, we would expect the government to use various policy measures to avoid a downturn. This will support Chinese and China exposed equities but result in further Yuan weakness of around 5%, despite Beijing's attempt to moderate by expending more of its FX reserves.
Emerging Markets (South Asia)		Tactical		Strategic		**Tactical underweight; strategic overweight in the context on an EM portfolio.** India's demonetization efforts remain a short term policy risk as it has already been shown to erode consumption growth. This is why we have reduced our exposure to Indian small caps. However, its current and fiscal health render it less vulnerable to Fed normalization. We expect a rebound in Indian assets towards year-end as recent rate cuts and economic recovery drive sentiment ahead.
Emerging Markets (Europe)				Tactical, Strategic		**Outperform.** Russia will continue to rebound on the back of improved prospects for oil price stabilization, moderating inflation and a declining geopolitical premium as a result of Trump's election. Additionally, both the Polish and Czech economies are showing signs of strength with currencies which we expect to strengthen relative to the Euro.
Emerging Markets (Africa)		Strategic		Tactical		**South Africa presents a tactical outperformance opportunity.** Our tactical models are forecasting a rebound in globally focused and commodity intensive South Africa. However, for U.S. dollar based investors, we strongly suggest a currency hedged position.
Emerging Markets (LatAm)		Tactical, Strategic				**Underweight Brazil; neutral to overweight in Columbia and Argentina.** Brazilian equities benefitted from positive market sentiment in response to the impeachment of Dilma Rousseff and more benign dollar liquidity in 2016. With Brazilian equities now trading at least one standard deviation above their 7.5 year range, they remain vulnerable to deteriorating dollar liquidity as the Fed continues to tighten in 2017. Our tactical models confirm this concern with a moderate conviction underperform forecast. That said, we remain sanguine towards other LaTAm markets such as Argentina and Colombia.

TABLE 3

Sector Positioning

Sector / Style / Capitalization	-		N		+	
Consumer Discretionary		Strategic		Tactical, Variance		**Tactical overweight; strategic underweight in the U.S; overweight in Europe and Japan.** Our tactical models continue to forecast this sector's outperformance, which is somewhat surprising because this sector tends to underperform at the beginning of interest rate tightening cycles. That said, a healthy U.S. consumer and a strong labor market should continue to provide solid support to the sector's earnings, but rising interest rates are a growing headwind. Provided inflation and interest rates remain low by historical standards, downside risks to relative earnings will be limited.
Consumer Staples			Strategic	Tactical		**Tactical overweight; strategic underweight in the U.S; overweight for 3 months.** Our tactical models support an overweight with low conviction. This sector is on the pricey side but should benefit from a short term consolidation in energy prices. This is another sector which suffers in both a rising US dollar and inflation environment that typically accompanies fed tightening. However, it could also provide some shelter if January sees another consolidation event.
Energy		Tactical	Strategic			**Tactically underweight; neutral strategic weight.** Oil prices' late 2016 rise based on a combination of the recent OPEC agreement and a weak dollar has accelerated the balancing process and is now ripe for a pull back. Rising bond yields and range-bound oil prices implies relative headwinds for energy stocks. Our tactical models also predict some consolidation for this sector.
Financials		Variance		Strategic		**Despite near term risks of consolidation; overweight strategically.** Financial stocks are overbought and are at risk for near term consolidation. However, this sector is a strategic overweight reflecting its positive correlation to a steepening yield curve and more robust growth early in the tightening cycle. As of December 31, 206, the Financials sector had been out of favor for several years and currently trades at 1.35 times book value and 16.6 times trailing earnings, which is still relatively cheap compared to its historical averages of 1.78 times BV and 22.3 times earnings. Many financial companies should also benefit from promised regulator relief by the new administration and congress. Despite their recent bounce as a result of the ECB's and BoJ's attempts to offset profit impairment from negative rates, we are more comfortable expressing this overweight through U.S. companies.

- Strategic (6-12 months+)
- Tactical (3 months)
- Variance for Non-U.S. Portfolios

Sector / Style / Capitalization	-		N		+	
REITS		Strategic	Tactical	Variance		**We are neutral on REITS in the U.S.for now; but they face the crosswinds of an improving wage backdrop and an accommodative but gradually increasing interest rates. We are highly bullish on REITS in Europe and Japan as a result of the extremely favorable policy backdrop.**
Health Care					Strategic	**Outperform.** Our tactical models forecast moderate conviction outperformance. This sector has been a strategic overweight. Trump's election and the likely repeal of the ACA as well as the medical devices tax would be expected to boost this sector.
Industrials		Tactical	Strategic	Variance		**Short term consolidation but neutral strategic position for U.S. Industrials; overweight European and Japanese peers.** This sector should benefit from accelerating growth and infrastructure related fiscal expanion. However expected dollar appreciation is a headwind for U.S. companies relative to their European and Japanese peers which are especially geared towards Chinese infrastructure.
Information Technology				Tactical, Strategic		**Outperform.** Technology stocks have served as a source of funds for the rotation into deep cyclicals post the election, yet the fundamentals for the sector are strengthening. Improving global semiconductor demand and positive indications from companies geared to hardware sales suggest that cyclical conditions for technology companies are brightening, which should drive relative earnings higher, thus enabling the sector to resume outperforming.
Materials		Tactical	Strategic			**Short term consolidation but neutral strategic overweight.** Chinese reflation has supported this sector which typically outperforms early in the interest rate tightening cycle. Our tactical models forecast near-term consolidation
Telecommunications		Strategic		Tactical		**Tactical overweight; strategic underweight.** Cheap and provides defensive haven. Could also be boosted by M&A activity. Our tactical models are forecasting outperformance with moderate conviction.
Utilities		Strategic	Tactical			**Tactical overweight; strategic underweight.** Our tactical models are forecasting a short term bounce from recent selling pressures. However, rising bond yields and range-bound oil prices implies relative headwinds for utility stocks. These dynamics are behind our strategic underweight.
Style (Value at Left / Growth at Right)			Strategic			**Neutral - Focus on sector and industry exposures.** Although rising bond yields should continue to support value outperformance on a 6-12 month horizon, the post- election run-up in U.S. bonds yields is extended; such that a near-term consolidation or pullback phase is overdue. A pause or pullback in the uptrend for bond yields could therefore spur a bout of profit-taking in value stocks. Our neutral style exposure reflects a much greater focus on sector exposures. For example, the value index is overweight in financial, utility and energy stocks, while being underweight in technology and consumer discretionary stocks. As discussed above, we are overweight Financials but underweight Utilities; while being overweight both medical devices in Health Care and software/semiconductors in Technology, traditionally growth industries.
Capitalization (Small at Left / Large at Right)		Tactical, Variance	Strategic			**Ripe for short term pull back from overbought conditions; but reflationary policies and globalization will thereafter support small caps.** Despite Q4's small cap outperformance, our models support a U.S. large cap overweight. Over the intermediate 6 to 12 month period, small caps will be boosted by reflationary policies and if protectionist policies and corporate tax cuts are implemented. Deteriorating credit impulses in Europe leads to a neutral cap position there; but less so in Japan and EM. Therefore our cap positions have become more nuanced.

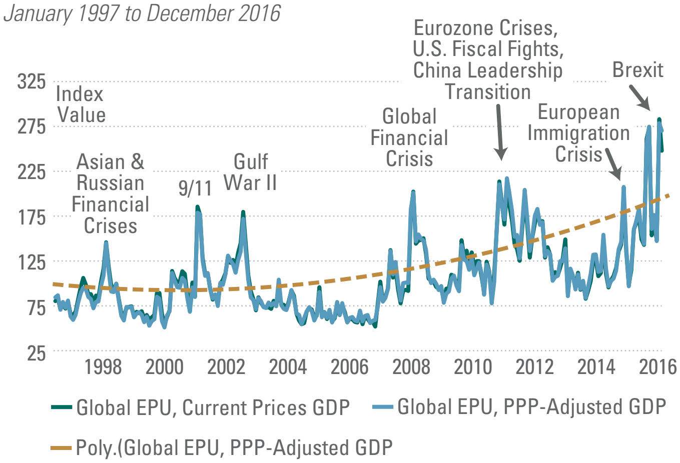
● Strategic (6-12 months+)
● Tactical (3 months)
● Variance for Non-U.S. Portfolios

Who Knows? Navigating the Known Knowns and Underappreciated Knowns In Current Market Consensus

This year, investors will once again be holding their breath as France, Germany and the Netherlands face their own electoral crucibles amidst a wave of change elections that have rewarded populist insurgents. In the U.S., we will have a President whose self-described negotiating tactic is uncertainty and whose unconventionality is most frequently communicated through 140 character tweets. Finally, China's ongoing struggle to maintain labor stability while addressing structural overcapacity caused by decades of credit fueled investment growth is likely to face even more uncertainty from a U.S. administration who has promised to label it as a currency manipulator, impose tariffs on its exports and challenge its regional hegemony. It is no wonder that policy uncertainty, which has markedly increased after 2008, is now at an extreme. (See CHART 1).

CHART 1 Global Economic Policy Uncertainty Index

January 1997 to December 2016



Notes: Global EPU calculated as the GDP-weighted average of monthly EPU index values for U.S., Canada, Brazil, Chile, U.K., Germany, Italy, Spain, France, Netherlands, Russia, India, China, South Korea, Japan, Ireland, Sweden, and Australia, using GDP data from the IMF's World Economic Outlook Database. National EPU index values are from www.PolicyUncertainty.com and Baker, Bloom and Davis (2016). Each national EPU Index is renormalized to mean of 100 from 1997 to 2015 before calculating the Global EPU Index.

Source: Index of Economic Uncertainty

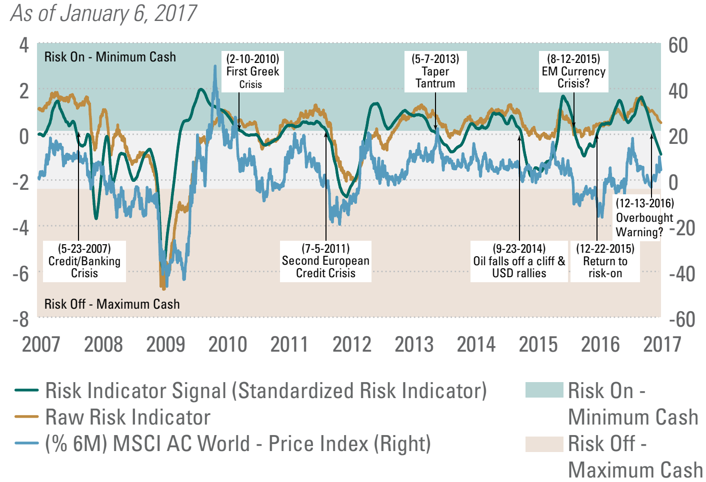
In such an environment, it is critical to be mindful of the changing policy and macro risks and most importantly, to evaluate the governing assumptions that underpin market consensus for underappreciated risks or "unknown" risks. For example, while we expect global equities to be higher in 12 months than they are today, the risks for stocks are tilted to the downside over both a shorter-term horizon of less than two months and a longer-term horizon exceeding two years.

The primary risks to the recent rally in global (and particularly U.S.) equities are that they are overbought; based on a consensus which is essentially pulling forward a "good news" narrative that is highly vulnerable to disappointment. Expectations of long-term U.S. earnings growth have also jumped to over 12%, something that strikes us as rather fanciful. Renewed rumblings in China could also spook the markets for a while. Consequently, we expect global equities to correct 5-10% from current levels, setting the stage for a more durable recovery. Once that recovery begins, higher-beta developed markets such as Japan and Europe should outperform the U.S. As the economy gains steam and inflation propagates towards the end of 2018, the Fed's tightening is likely to get to more contractionary levels. A higher/rising fed funds rate will lead to multiple contraction. Since 1979 (when forward EPS data commence), every time the Fed has embarked on a tightening cycle, the forward P/E multiple has been squeezed. This eventually, is more likely to occur towards the end of 2018.

Underscoring short term momentum risks, as discussed in our summary investment outlook on PAGE 2, our equity risk models appear to be flashing caution. While both the social media and futures component of our equity sentiment models are solidly in risk-on territory; the systemic equity risk model which has developed a solid forecasting record over its 7-year existence; crossed from risk-on to risk-neutral on December 13 and remains there today. (See CHART 2).

CHART 2 Global Equity Market Systemic Risk Indicator

As of January 6, 2017



Source: FIS Professional Estimates, Factset, Bloomberg and Google Trends data

THE PATH OF THE U.S. DOLLAR IS THE SINGLE BIGGEST RISK

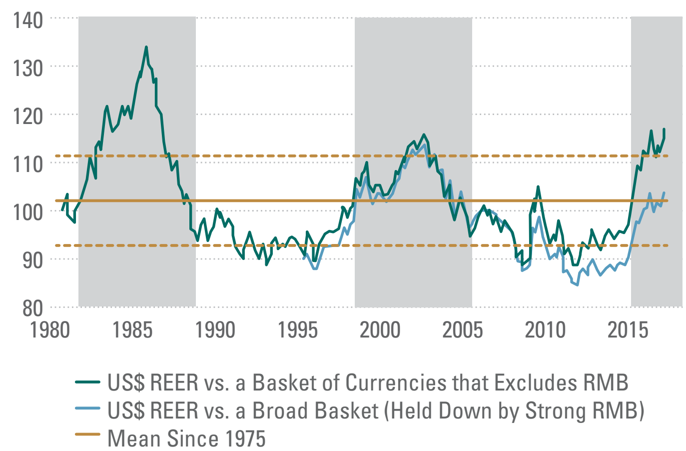
The US dollar enters 2017 up by 25% against a broad basket of currencies over the last two-and-half years. The single biggest question for investors in 2017 and an underappreciated risk is whether the dollar continues its bull run. A dollar reversal would be largely neutral. A move by the dollar into even more over-valued territory would be destabilizing in various ways. Additional dollar strength in advance of the tax changes would hammer US manufacturers, leading to a sharp deterioration in the US trade balance that could prompt an even more protec-

tionist response from Washington. And a stronger dollar could inflict severe pain on EM dollar denominated debt and certain EM equity markets.

Dollar bears note that the currency is overvalued in historical terms, argue the market is overly fixated on the possibility of President-elect Trump's reflationary policies in the US, while ignoring improved fundamentals elsewhere. The dollar is now overvalued by most measures. Against the euro, yen and pound, the dollar is now one to 2.5 standard deviations overvalued relative to its average long-run deviation from purchasing power parity. Similarly, against a broad basket of currencies that excludes the renminbi, the US dollar is now stronger in real effective terms than at any time since 1986. (See CHART 3). With the dollar's strength eroding US competitiveness, the rally is over-extended, especially against the euro, which is being held back by in part by an underappreciation of the area's economic growth and exaggerated fears over upcoming European elections in 2017. (See our summary on geopolitical risks in TABLE 4 on PAGE 13).

CHART 3 Echoes of the Early 1980s

BIS Real Effective Exchange Rates, CPI Based; Rebased Around Mean Since 1975



Source: Gavekal Data/Macrobond

Dollar bulls point to widening yield spreads and the likelihood that proposed changes in the US corporate tax code could prove strongly dollar-positive. Additionally, while exchange rates may revert to the mean in the long run, deviations often go further and last longer than valuation-focused analysis suggests. With US interest rates rising, and yield spreads over Europe and Japan widening, there is a strong possibility that the dollar could move from overvalued to even more overvalued in the course of this year.

The dollar could also get a big boost from tax changes proposed by president-elect Donald Trump and Congress. Like the Reagan presidency in early 1980's, the dollar entered into a structural bull run because of shifting ROIC (return on invested capital) expectations, as a result of so called "animal spirits" unleashed by corporate and capital friendly tax changes. The Congressional Republican majority is discussing border tax adjustments that would favor US manufacturers at the expense of foreign competitors in order to redress perceived imbalances in the global trade regime. Similarly, Trump's advisors are discussing what would amount to a subsidy for US exporters and/or a tariff on foreign imports into the US. Such policies would theoretically strengthen the U.S. dollar to a degree that would eliminate any competitive advantage gained by US business. Greater policy visibility following Trump's inauguration on January 20 could add further momentum to the US dollar's climb.

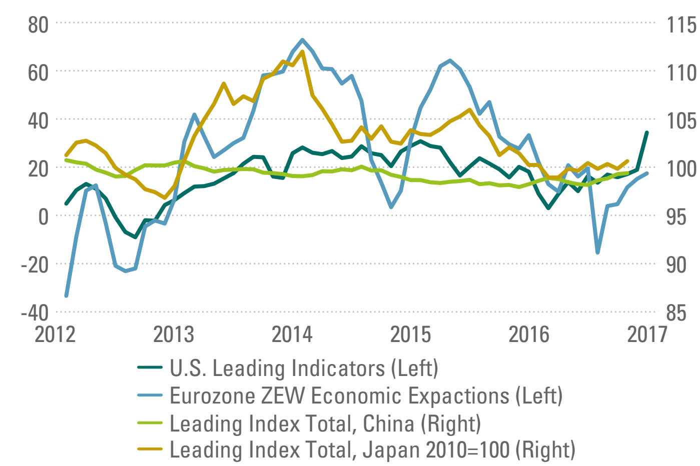
We believe that the dollar is due for short term consolidation but will end the year higher in 2017, particularly against the Japanese yen and the Chinese RMB. While this will increase the geopolitical risks associated with protectionism, it will also constrain inflation and possibly result in another feedback loop whereby Fed policy hike intentions are thwarted by decelerating inflation.

"KNOWN KNOWNS" THAT THE MARKET IS DISCOUNTING

Both U.S. and non-U.S. equities are discounting a significant pickup in growth and earnings. This is supported by leading economic indices which show a marked improvement in economic activity irrespective of policy changes in 2017. (See CHART 4).

CHART 4 Key Leading Economic Indicators Show Improvement Over Last Year

As of December 30, 2016



Source: FIS Group Professionals Estimates and Factset

The nine key elements underpinning the bullish consensus on **U.S. equities** are:

1. **Continued improvement in corporate earnings, primarily as a result of stabilizing oil/commodity prices.** After growing an estimated 2.6% in Q3, consensus forward EPS estimates now stand at $131.5, which represents a 12% year on year increase. In 2018, EPS estimates forecast a further 12% growth.

2. **Continued growth in real wages and income.** In December, Average Hourly Earnings of all employees rebounded to 2.93% on a year on year basis (vs. 2.49% prior), which is the highest gain since May 2009 (+2.49% prior). Private wages increased in 13 of the 14 major industry sectors; with average wages increasing 2.89% Y/Y. This will initially boost aggregate demand and not materially impact corporate profits until well into 2018.

3. **Inflation trending higher in fits and starts as a result of dollar strength.** With recent readings on headline CPI at 1.6% and core CPI at 2.1%; but well below the 4% and above levels that are historically associated with Fed induced bear markets and recessions. As we anniversary the drop in commodities prices, headline inflation should eclipse core inflation in 2017 and possibly climb to 2.5% by year end. Inflation at these levels is typically associated with P/E expansion because it allows corporations to raise prices. The link between P/E derating and high inflation is via the ebbs and flows of the fed funds rate or the discount rate.

4. **Higher interest rates at the long end of the yield curve because of 1 through 3 which while halting, will mark the beginning of the end of the 35-year long bond bull market.** During the second half of 2016, rising treasury bond yields was largely driven by net selling during the September through October period; with China, which unloaded $128 billion between May and October, being the largest seller. Treasury and global bond yields are likely to rise further in 2017; with the pace and magnitude being substantially driven by selling by the PBOC and other central bank's responses to improving global growth and inflation pressures. As we wrote about in our Q3 Outlook, we believe that we are in the last innings of the 35-year bull market. During the post-GFC period, asset allocation flows have heavily favored fixed income. As investors incur principal losses, some of those flows will enter the equity markets.

5. **Mildly higher interest rates at the short end of the yield curve as a result of two (or maybe three) 25bps. hikes by the Fed.**

6. **Accelerating GDP growth to around 2.5%.** Notably, the BEA recently reported that Real GDP increased by a seasonally adjusted annualized rate of 3.47% in Q3 2016, compared to the prior estimate of +3.12%. Overall, Q3 GDP increased +1.65% Y/Y.

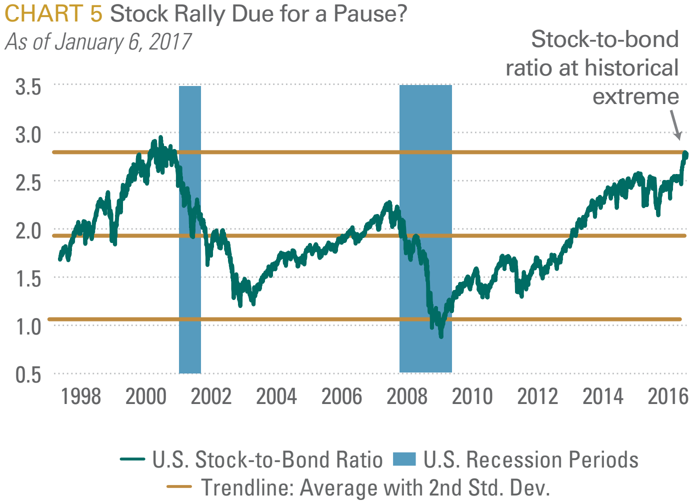
7. **Fiscal expansion with President Trump jawboning erstwhile deficit hawks in Congress to combine tax cuts and offshore profits repatriation with higher defense and infrastructure spending.**

8. **Elevated "animal spirits" unleashed by the rollback of Obama era regulations, particularly for the financial, healthcare and coal/oil industries.**

9. **Possible protectionist measures which should advantage small cap and domestically focused industries at the expense of large cap multinational industries.**

In combination, these expectations have fueled a 4.6 % post-election boom through December 31, 2016. During the first week of January, U.S. stocks rose again by 1.7%. Consequently, the stock bond ratio is now close to a two standard deviation extreme. (See CHART 5).

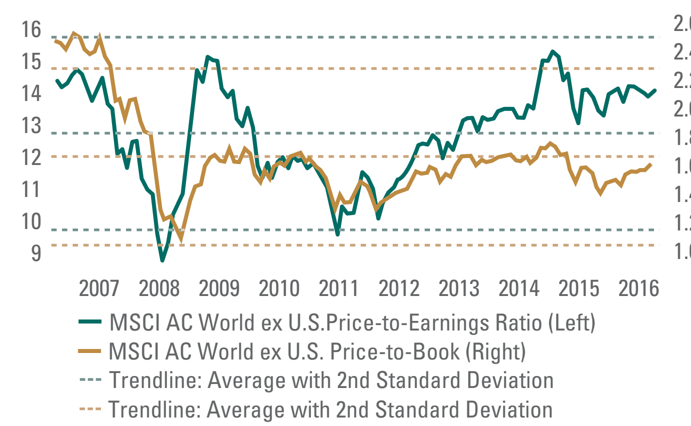
CHART 5 Stock Rally Due for a Pause?
As of January 6, 2017



Source: FIS Group Professionals Estimates and Factset

Non-US equity markts rallied by 4.5% in 2016. During the first week of January, they continued to advance by 1.9%. While the fundamentals vary across markets and while their valuations are less demanding than U.S. equities, they are no longer cheap. (See CHART 6).

CHART 6 MSCI AC World ex-U.S.
Price-to-Earnings Ratio (Left), Price-to-Book (Right)



Source: FIS Group Professionals Estimates and Factset

The four primary elements of the consensus narrative for key non-U.S. markets are:

1. Policy divergence from the U.S. as both the ECB and Japan continue to employ accommodative monetary measures that will generally support the U.S. dollar.

a. While the ECB has curbed its purchase program from €80 billion to €60 billion per month, it has expanded the scope of issues eligible for purchase and extends its duration to at least December 2017

b. In Japan, highly accommodative fiscal spending through the government's large-scale stimulus measures combined with the BoJ's 80 trillion yen per annum asset purchase and "QQE with Yield Control" programs to target zero percent on 10-year JGBs.

2. Strengthening industrial production data and positive economic survey data in both Europe and Japan.

3. Continued policy support by Beijing to promote growth and avoid labor unrest in advance of the communist party congress in September 2017.

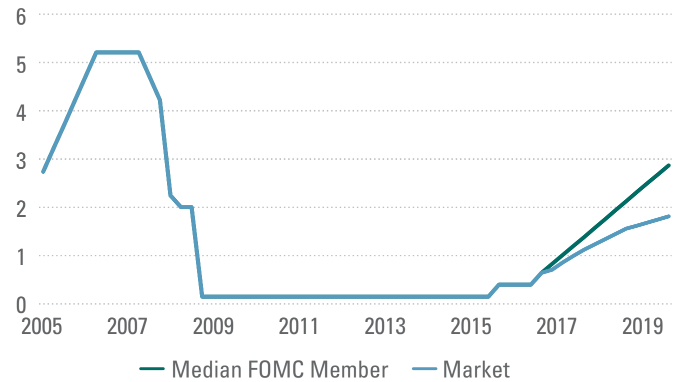
4. Higher operating leverage for both European and Japanese companies (that are also more leveraged to Chinese growth than the U.S.) as well as more attractive valuations provide more room for P/E expansion relative to the U.S.

SO WHAT COULD THE UNDERAPPRECIATED KNOWNS BE?

1. "GOOD NEWS" MAY ALREADY BE PRICED IN.

The consensus narrative described above has allowed investors to pull forward profit growth expectations into current prices; thus leaving less room for either earnings or policy disappointments. For most of the GFC period, investors were essentially forced to look pass growth disappointments and invest in riskier investments, as ultra-loose monetary policy punished the return on safe assets. In the U.S., as monetary conditions tighten, investors can be more discerning. Secondly, early in a tightening cycle, investors have historically underestimated the pace and extent of rate hikes every time and equity returns also faltered. Thus far, as we have written in the past, the FOMC's projections have tended to converge towards market expectations, instead of the other way around. In its December 2016 meeting, the median FOMC forecast implied three .25% hikes, while the market is only forecasting two such hikes. (See CHART 7). While the leadership of the Fed (Chair Yellen and Vice Chair Fischer) is expected to stay in place until 2018; President elect Trump, who has been highly critical of the Fed's extended period of monetary accommodation, will be able to fill two vacancies on the seven member committee. To the extent that President Trump's perspective on the distortive effects of the Fed's policies remains consistent with candidate Trump (which is yet to be determined); this could over time (but probably not within the next two years) shift the Fed's policy making to a more traditional hard-money approach. That would hasten the pace of interest rate normalization.

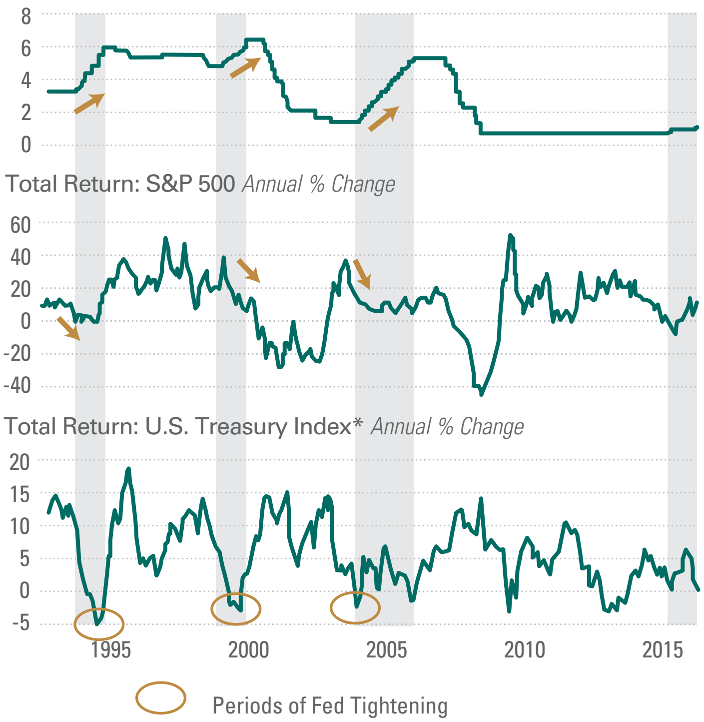
CHART 7 Market Currently Expecting a Slower Rate Hike Cycle Than the Median FOMC Member
As of December 30, 2016, Fed Funds Target Rate



Source: Bloomberg

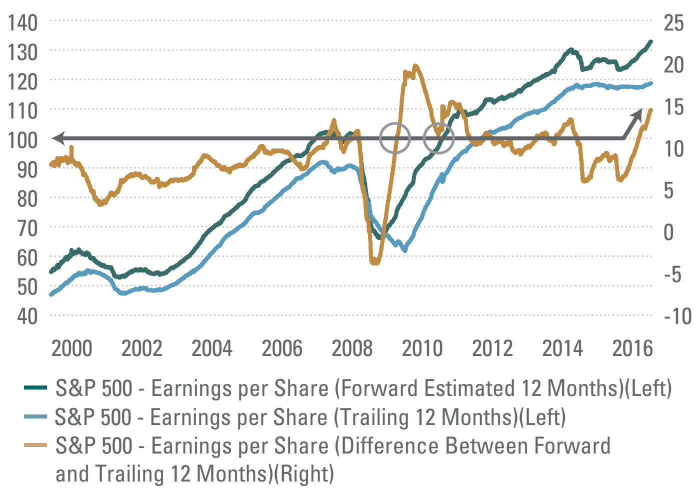
For historical context, there have been three other major Fed tightening cycles since 1985. In each case, the 10-year Treasury suffered an almost 10% or more annual loss, either following or just before short-term rates began their ascent. This was the case even when the Fed telegraphed a modest and steady 25 basis point-per-meeting pace of rate hikes from 2004-2006. (See CHART 8 on the next page). While the fed funds rate is significantly lower today than in prior periods, so is EPS growth; and the gap between trailing earnings growth and 12-month forward expectations is wide. For example, as shown in CHART 9 on the next page, the current gap between forward and trailing S&P 500 earnings per share was only exceeded in 2009 and 2011; both periods characterized by significant prior period market and economic dislocation or stress and which were boosted by quantitative easing policies by the Fed. With U.S. equities haven risen 14.7% in 2016 and 97% over the last five years; that is hardly the case today. Accordingly, equity valuations are significantly higher today. This suggests that there is a greater risk of earnings disappointment than was the case in prior early tightening periods. The longer the uptrend in stocks continues without interruption, the greater the risk of a pullback should growth disappoint.

CHART 8
U.S. Fed Funds Rate %



*Source: Bloomberg Barclays Indicies
Note: Shading denotes periods of rising federal funds target rate.
Source: BCA Research

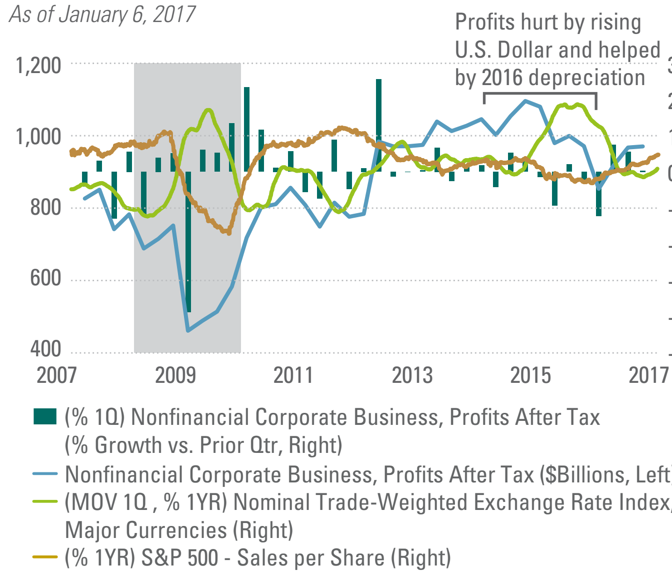
CHART 9 S&P 500 - Earnings Per Share
As of January 9, 2017



Source: Bloomberg

Additionally, the rosy consensus for U.S. equities downplays two countervailing headwinds: rising wage costs and an appreciating U.S. dollar. As shown in CHART 10, most of the profit improvement in non-financial business profits occurred in the second half of the year as oil price rebalancing stabilized margins in the energy sector and as the dollar corrected from its 9% rise in 2015. With a 66% appreciation in 2016, the balancing of oil prices largely occurred in 2016. On the cost side, improving but subdued wage and interest costs were not material headwinds.

CHART 10 Non-Financial Corporate Profits, Sales and the U.S. Dollar
As of January 6, 2017

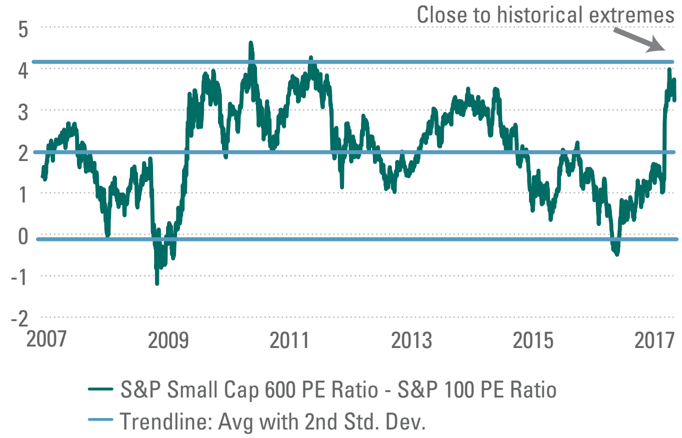


Shaded area indicates U.S. Recessions
Source: FIS Group Professionals Estimates and Factset

Going forward into 2017, wage growth is expected to pick up from the 2.9% year over year growth recorded in late 2016. The U.S. dollar's appreciation, which negatively impacts large multinational S&P companies in 2015, has already resumed.

One segment of the U.S. equity market which seems vulnerable is small cap stocks. The narrative here is that small cap stocks are least vulnerable to protectionist policies or a rising U.S. dollar because of their relative domestic exposure. They are also expected to most benefit from corporate tax reduction because unlike multinationals, they have had fewer opportunities to reduce their corporate tax through jurisdictional arbitrage. For example, according to a recent Goldman Study, a cut in the corporate tax rate from 35% to 25% would be expected to raise S&P 500 companies' profits by 8%. This narrative is also supported by a marked pick-up in companies surveyed by the NFIB Small Business Optimism survey which saw a marked spike after the November 8th election. As a result of this narrative, small cap stocks embarked on an almost hyperbolic gallop which as of the first week of 2017 has taken their Price Earnings ratio perilously close to the second standard deviation which has traditionally been a ceiling for further appreciation. (See CHART 11 on the next page).

CHART 11 S&P Small Cap 600 PE Ratio - S&P 100 PE Ratio
As of January 6, 2017



Source: FIS Group Professionals Estimates and Factset

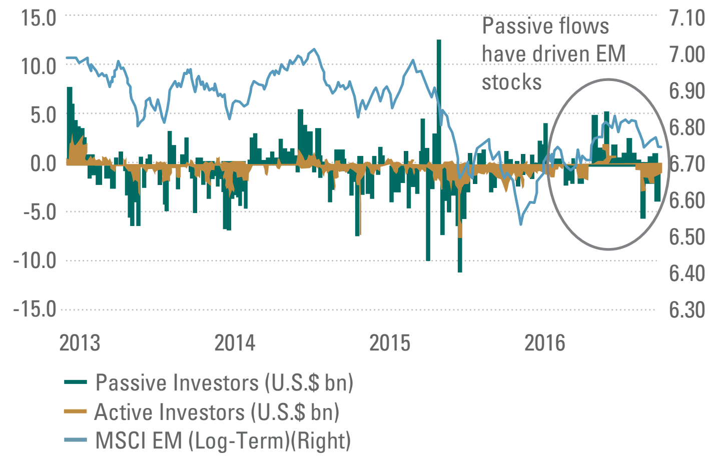
We recognize that valuations are not determinative of short term outcomes as markets can punch through and remain above historic deviation thresholds once a bullish narrative captivates investors; but they can help us evaluate the likely range of outcomes as well as the downside risks.

2. LITTLE ROOM FOR EARNINGS OR GROWTH DISAPPOINTMENT IN EM

Following their 8.6% gallop in 2016, EM equities are also a consensus favorite; based on assumptions of further Chinese reflation in advance of the communist party congress in September, that they would disproportionately benefit from a pick-up in global growth and that their improved fiscal and trade balances would allow them to better withstand further Fed tightening than they did in 2013. While this narrative is not without merit, we are again concerned that EM prices have seemingly discounted so much good news that there is little room for disappointment.

As discussed in our Q4 Outlook, most of the EM stock appreciation last year was driven by passive and particularly ETF investors; suggesting that the rally was primarily driven by portfolio rebalancing and early in 2016, short covering. As we suspected, these flows actually began to reverse in Q4, 2016. (See CHART 12).

CHART 12 Weekly Flows by Active and Passive Investors
As of December 28, 2016



Source: EPFR Global Equity Fund Flows Database, Morgan Stanley Research.

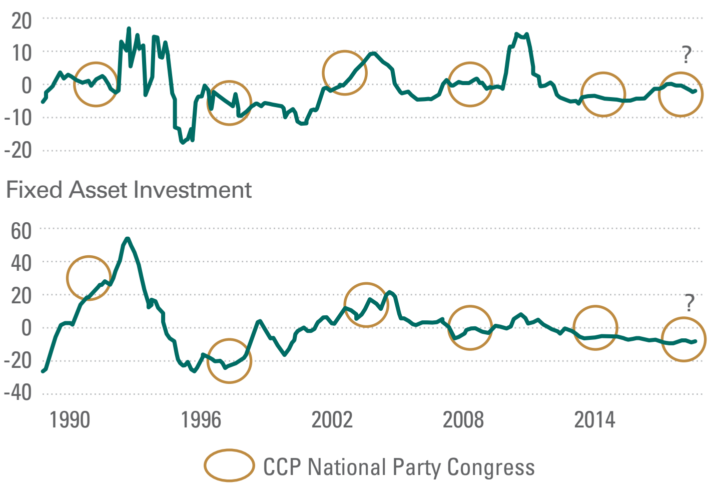
Perhaps more concerning is that after showing signs of improvement in early 2016 as a result of the delayed flow-through impact of Chinese reflation in 2015, EM EPS relative to developed market EPS has gone nowhere. (See CHART 13). Most of the improvement in earnings occurred after the sharp drop in the U.S. dollar which allowed export oriented EM companies to earn higher U.S. dollar prices on goods shipped overseas, despite increasing local input costs. This is why while Chinese PPI and labor costs increased markedly in RMB terms, they did not really translate into U.S. import prices (as is commonly misunderstood) because of the RMB's depreciation against the U.S. dollar. In fact, while Chinese export prices rose in RMB terms, the RMB's depreciation allowed Chinese export companies to reduce U.S. dollar prices while receiving more RMBs per unit.

CHART 13 After a Q1 2016 Improvement, Relative EM Earnings Have Flatlined
As of January 9, 2017

Source: FIS Group Professionals Estimates and Factset

Part of the bullish EM narrative is based on an expectation of meaningful Chinese reflation policies in advance of the CCP's National Party Congress in September, under the assumption that Beijing would want to minimize the probability of labor unrest. While an examination of prior five year periods with respect to credit expansion and fixed asset investment does not necessarily support this assumption, (See CHART 14), we would expect the government to use various policy measures to avoid a downturn.

CHART 14 *Annual % Change*
China Deviation from 5-Year Trend: Loans

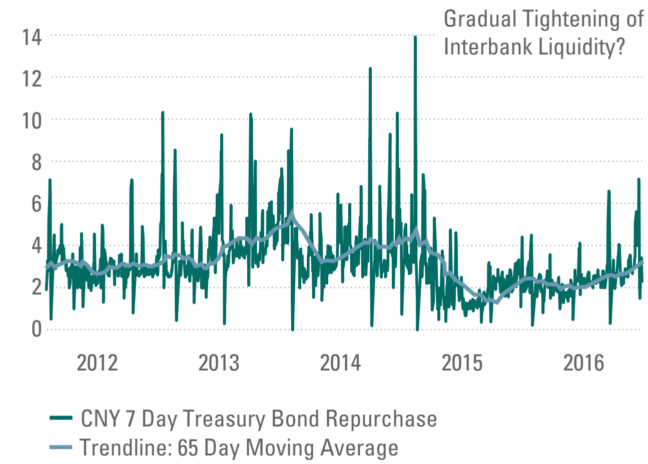


Source: BCA Research

Moreover, it is worth noting that monetary policy has actually been quite restrictive recently. As U.S. and European growth is firming up, Chinese policymakers may be emboldened to moderate unsustainable credit growth and not repeat the massive fiscal push of early 2016. This policy move is consistent with PBoC Governor Zhou Xiaochuan's statement this past October at the annual World Bank/IMF meetings in Washington, namely: "With the gradual recovery of the global economy, China will control its credit growth." Thus Chinese corporate bond yields climbed alongside rising global bond yields, and the People's Bank of China (PBoC) has also tightened liquidity in the interbank market for non-bank financial institutions. (See CHART 15 and CHART 16). At the margin, the Trump administration's threats to label China as a currency manipulator increase Beijing's sensitivity to avoiding a free fall in the RMB; which necessarily leads to further liquidity tightening particularly if the U.S. dollar is appreciating.

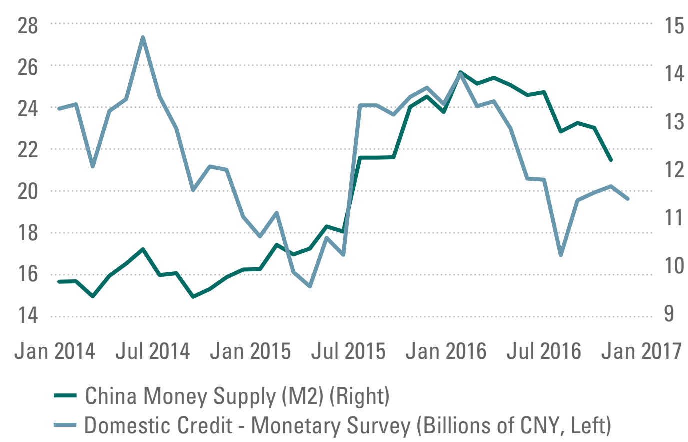
Beijing has also introduced measures to curb excessive bank credit growth and discourage "window dressing" accounting, the PBoC announced in late October that going forward it will include off-balance-sheet wealth management products (WMPs) in the calculation of banks' quarterly Macro Prudential Assessment ratios, starting from the third quarter. The clampdown on WMP accounting will reduce banks' capital adequacy ratios, curbing their ability to originate loans. Finally, property market tightening measures implemented of late are expected to lead to a slowdown in sales and renewed contraction in property starts. This will depress Chinese construction and demand for industrial commodities/materials as well as capital goods. This is intended to limit speculative activities among non-bank financial organizations (shadow banking). On a rate-of-change basis, this policy stance could result in a slowdown in the nation's industrial cycle later in 2017.

CHART 15 CNY 7 Day Treasury Bond Repurchase
As of January 9, 2017



Source: EPFR Global Equity Fund Flows Database, Morgan Stanley Research.

CHART 16 Beijing Reigning in Money and Credit Growth?
As of December 30, 2016

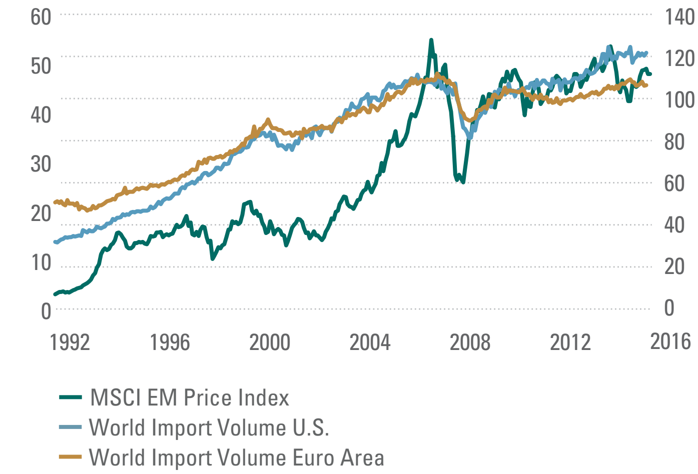


Source: FIS Group Professionals Estimates and Factset

Another linchpin on which the bullish EM narrative rests is that an anticipated pickup in global growth, which will further lift commodity prices, is positively correlated with EM shares. First, we believe that strengthening/robust growth in the U.S. and other developed economies is a helpful but not necessarily a sufficient fillip for lifting EM growth. Specifically, U.S. import volumes have been weak the past 12 months and will likely recover in 2017, but this may not be enough to significantly boost

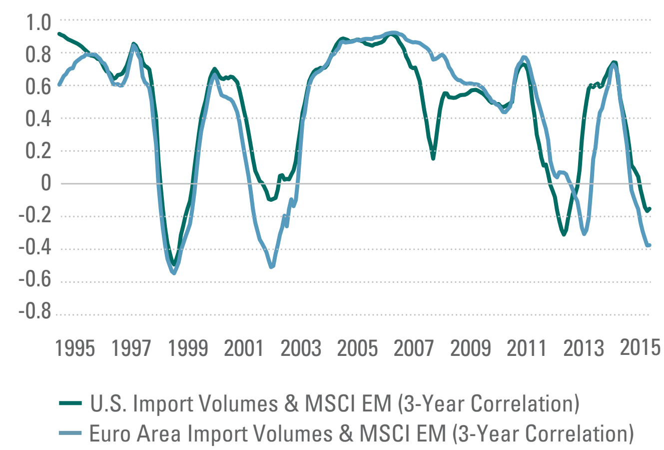
EM asset prices. For example, CHART 17 and CHART 18 evaluate the relationship between EM prices and import volumes for both the U.S. and the Euro Area. The charts show a somewhat attenuated relationship, where the 3-year correlation varied from above a .6 correlation in the late 1980s to 1990s and in three-year period ending in 2011 to a negative relationship in the late 1990s and more recently. This correlation disintegrated in the 1997-98 period, when real GDP growth was 4.5% in the U.S. and 3.5% in Europe. During this period, U.S. import volume growth was booming at a double-digit pace yet it did not prevent widespread crises throughout the EM during this period. Second, the importance of U.S. and European economies to EM has declined tremendously since the late 1990s, while the importance of China and intra-EM trade has grown. Third, EM prices tend to have an inverse relationship with the U.S. dollar, which is likely to strengthen. Today, in an era of floating exchange rates and improved current account balances, most EM countries are less vulnerable than they were in the 1997-98 crisis or even in 2013, when the U.S. dollar spiked up as a result of the Fed taper discussion. However, at the end of the day, EM prices are driven by EM fundamentals and strengthening DM imports are a helpful but insufficient condition for EM outperformance.

CHART 17 EM Prices Have Attenuated Relationship with DM Imports
In Thousands (Left), As of January 9, 2017



Source: FIS Group Professionals Estimates and Factset

CHART 18 No Enduring Correlation Between DM Imports and EM Stock Price
As of January 9, 2017



Source: FIS Group Professionals Estimates and Factset

3. GEOPOLITICAL "KNOWNS" AND UNDERAPPRECIATED UNKNOWNS

Whilst the risks highlighted above would classify as "known", with uncertain timing but reasonably quantifiable, (historically a 5% to 10% market or market segment decline), geopolitical risks can mostly be categorized as under-appreciated or over-stated known unknowns or unknown unknowns with less quantifiable and non-linear outcomes, with the clearest potential to fuel a left tail "black swan" type event.

TABLE 4 below delineates those risks, their likely impact, the market impact and suggested strategy should they play as well as their likeliness.

Risk	Nature of Risk	Likely Impact	Market Impact/Strategy	Likeliness (Unlikely, Somewhat Likely, Likely, Highly Likely)
Retreat from Globalization	Increased isolationism and mercantilism weakens 20th century institutions underpinning *Pax Americana.* Two leading economies not overwhelmingly dependent on globalization: (exports only 12% of US GDP and 19% of Chinese GDP)	Historically, corporate profits and globalization have been positively correlated because as globalization intensifies, global trade links deepen and "borders fall," boosting companies' international revenue exposure. The opposite occurs under de-globalization. Typically, higher top-line growth from foreign markets has also been associated with increasing overall sales and profitability. De-globalization is also inherently inflationary. However, structural demographic trends (older people consume less of most goods except for health care), will limit demand induced inflation.	Supportive of safe-haven assets and more closed economies. Trade dependent EMs, such as Korea, Taiwan and Vietnam will underperform. Black Swan risk. Isolationism raises the probability of devolution into nationalism/ jingoism; which in turn enhances the probability of regional or global conflict. Despite the fact that they are not cheap relative to their historical trading ranges, defense and cyber-security companies will be entering a structural bull market. Inflationary, therefore supportive of real assets and precious metals. Health care inflation will necessarily continue to be a source of technological disruption.	Highly Likely Somewhat likely Likely
Populist revolt in Europe	While refugee migration and terrorism are real sources of social angst; relative to both the U.K and the U.S., Europe's social welfare state bureaucracy has blunted globalization's negative redistributive impact on its middle class. This is why populism is a somewhat over-stated threat, particularly in Northern Europe.	Barring a high-profile terrorist attack, populist parties (perhaps outside of Italy) are unlikely to prevail. Rightward shift in policy likely.	Increased Eurostoxx volatility in light of the various elections slated for 2017. However, European assets should surprise to the upside both because of the overestimation of the risk of populist parties prevailing but also because of relatively attractive fundamentals (valuation and higher operating leverage to global growth).	Likely in Italy. Somewhat likely to prevail in France or Germany where support for the Euro remains very strong. (Outlier risk however is a high-profile terrorist attack)
Great power conflict -Eurasia	Russia continues to restore dominance/ control over former Soviet empire. Ukraine-like incidents in neighboring Belarus and Kazakhstan would not suprise.	Trump administration and likely winner of French election – Center Right Francois Fillion likely to support détente with Russia. Chancellor Merkel will not independently push for sanctions because of weakened parliamentary position as well as strong German economic ties to Russia.	Lower geopolitical risk premium on Russian assets. Bullish for Russian assets.	Likely, particularly if US signals acceptance with Russia asserting its sphere of influence in former Soviet empire vassal states.

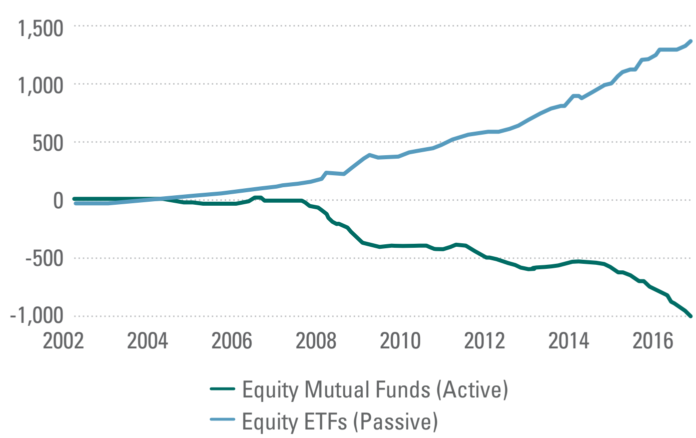
Risk	Nature of Risk	Likely Impact	Market Impact/Strategy	Likeliness (Unlikely, Somewhat Likely, Likely, Highly Likely)
Great power conflict - Asia	1. Sino-American symbiosis (America purchases/borrows & China exports/lends) becoming frayed. China will not be able continue to capture global market share while exporting deflation; particularly now that its higher value exports are encroaching on developed market economies. 2. China's attempt to assert regional dominance is being challenged by the Trump administration's questioning of the "One China" doctrine which requires that neither China nor the US seek regional hegemony. America's retreat from TPP will further facilitate China's regional economic dominance	1. China will defend domestic market (45% middle class and second largest market) from competition through non-tariff barriers. 2. Emergence of U.S. – China proxy conflicts relative to China's periphery (North Korea, South Korea, Hong Kong, Taiwan and Vietnam)	See "Retreat from Globalization" above	Likely
Middle East conflicts	1. ISIS territorial defeats in Syria and Iraq leads to disbursement of the group into local terror networks in Turkey and Europe. 2. Turkish escalation in Syria provokes Turkish-Russian conflict. 3. A post-ISIS vacuum emboldens Iraqi Kurds towards independence. 4. Escalation of proxy wars between Saudi Arabia and Iran.	1. Expanded ISIS attacks in Europe would stoke nationalistic, anti-immigrant and populist support. In Turkey they would embolden Erdogan's authoritarianism. 2. Turkish-Russian conflict, if allowed to escalate, could lead to interdiction of Russian shipping through the Bosporus. 3. Turkey is drawn into a direct conflict with Iraqi Kurds on Iraqi soil. 4. Saudi Arabia has already effectively surrendered in Syria and is looking for an exit in Yemen, but would defend any further Iranian meddling in their vassal state of Bahrain or elsewhere in the GCC, should Iran feel emboldened by their success in Syria.	1. See above for results of European populism. Turkish risk assets remain depressed, possibly even selloff further. 2. This is a threat to our otherwise positive outlook for Russian risk assets and could add to risk premiums across the region as well. 3 & 4. (Iraqi Kurds are too financially strapped to pick a fight they cannot possibly win). Temporary geopolitical premium attached to oil prices. But this will ultimately bring more shale production on-stream (neutral or long oil).	1. Highly likely 2. Somewhat likely 3. Unlikely 4. Somewhat Likely

AND FINALLY; ARE WE BEGINNING TO SEE THE MAKINGS OF A CYCLICAL ACTIVE MANAGEMENT COMEBACK?

Active management of publicly traded equities has been in a bear market. According to Bank of America Merrill Lynch's September 29, 2016 Flow report, since 2002 there have been $1.4 trillion of inflows into passive ETFs verses $1 trillion of redemptions from active mutual funds. As shown in CHART 19 during recent years the rotation out of active funds into passive managed investments has accelerated. Year-to-date $260 billion has flowed out of US long-only equity mutual funds, 3.9% of industry assets under management. In comparison, US equity ETF's have attracted $74 billion year-to-date, 3.3% of industry assets under management. (See CHART 19).

CHART 19 Investors Shun Active for Passive

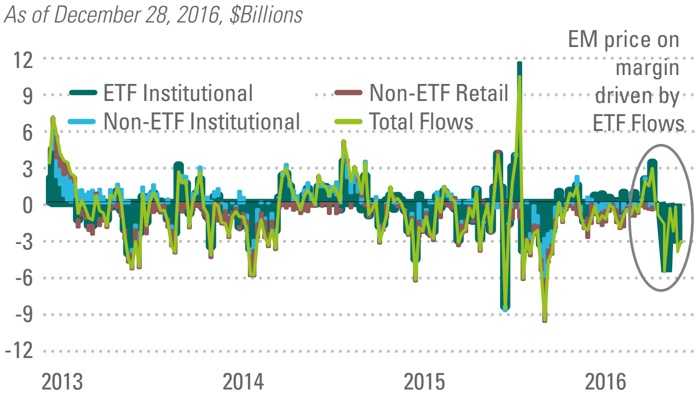
Cumulative Fund Flows, $Billions



Source: Bank of America Merril Lynch Global Investment Strategy, EPFR Global

Some observers have noted that with interest rate normalization and the return of stock volatility, we are beginning to enter into a period in which active security selection may begin to outperform passive strategies. In 2013, FIS conducted a study to evaluate the cyclical and structural dimensions of active management performance. We noted in that study that there were clearly structural elements in more efficient asset categories that would continue to challenge active managers. Those elements included increased market efficiencies, information technology's ability to increase information efficiencies such that the speed and scope with which information is disseminated undermines information advantages, and the growth of basket or index trading, which drives up stock correlations. The rally in the EM market last year is a poignant and recent example of this latter phenomenon where the vast majority of net purchases were through passive ETFs. (See CHART 20).

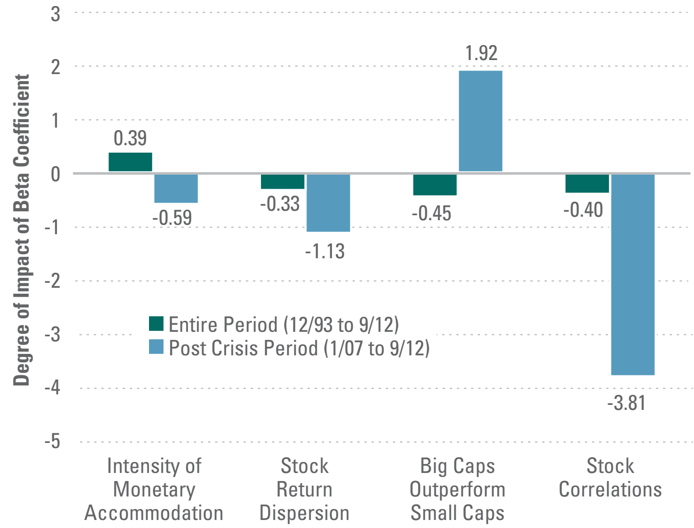
CHART 20 Dedicated EM Equity Flows by Type of Fund
As of December 28, 2016, $Billions



Source: EPFR Global Equity Fund Flows Database, Morgan Stanley Research.

But there are also cyclical elements that impact the relative performance of active managers. In that study, we conducted a regression analysis where the performance of the market benchmark within a universe of active managers was assigned as the dependent variable and various market conditions (e.g.: money growth; security dispersion; stock correlations) were evaluated as independent variables. Through this analysis, we created a statistically significant model for explaining the cyclical element of active managers' benchmark relative performance. To recap, CHART 21 depicts those variables that were most statistically relevant, as well as their beta coefficients.

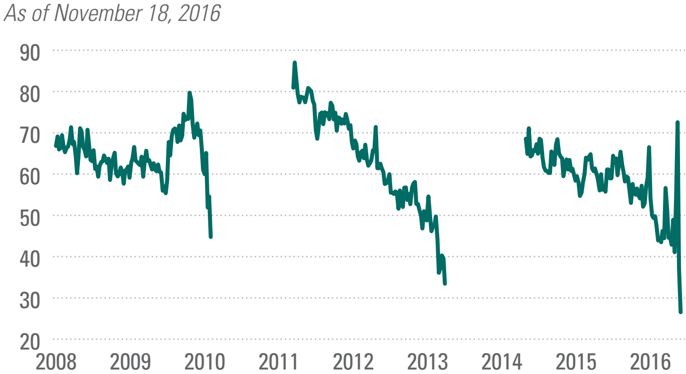
CHART 21 Factors that Primarily Impacted Active U.S. Equity Large Cap Managers' Relative Performance



Source: FIS Group, Is Active Management Alpha on Permanent or Temporary Disability?, May 2013

As shown above, the most significant negative factor were stock correlations and stock return dispersion. The third most significant variable was intensity of monetary accommodation, which tended to encourage yield/risk seeking, irrespective of fundamentals. While we have not yet re-evaluated this model at the same level of detail, we do note that stock correlations appear to be falling and market dispersion appears to be rebounding. (See CHART 22 and CHART 23 on next page). With the Fed once again telegraphing its intention to hike interest rates two to three times this year, this third variable appears to be gradually normalizing. Bottom line, we cannot say with certainty that this is the year that active management will regain its luster but it does appear that the conditions for it doing so are gradually returning.

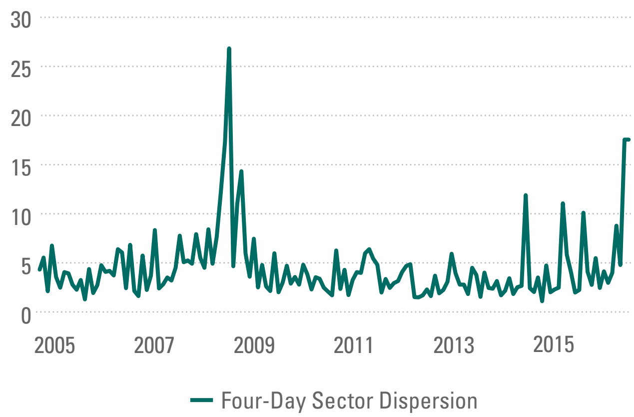
CHART 22 CBOE Implied Correlation Index
As of November 18, 2016



Source: Bloomberg

CHART 23 Four-Day Difference in Top vs. Bottom Sector Performance

(%); As of December 31, 2016



Source: Bloomberg

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