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INVESTMENT STRATEGY QUARTERLY

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RAYMOND JAMES

2018 Themes to Watch

The following key themes are likely to occupy headlines and client conversations in the coming year.

INTERNATIONAL INVESTING

Change always matters in financial markets, and the simple question for international investors in 2018 is, "How much faith do you have in countries and companies outside the U.S.?" The good news is that valuations are generally lower and, in many cases, corporate earnings levels are growing more quickly than in the U.S. The missing ingredient is a belief that Brexit compromises between the UK and the European Union can be reached, and reform initiatives to boost economies in Asia and Europe have credibility, political drive and support.

The signs heading into 2018 on this front are positive, building on progress made in 2017. Such progress includes the well-received National People's Congress in China as well as Macron's election victory and actions thus far in France. Still, much work needs to be done. If further progress is made, a likely impact would be a stronger British pound, Euro and Japanese yen relative to the U.S. dollar, enhancing the potential diversification benefits for U.S. investors.

GEOPOLITICS

It's hard not to conclude that the key geopolitical relationship is between the United States and China ("G2"). The latter continues to spread its wings. This is best shown by its expansive "Belt and Road" initiative, which aims to link Europe and China in a giant economic region, as well as a continuation of its large trade surplus with the United States. The 'free versus fair trade' debate continues to rumble on, but, given the proclivity of both Chinese and Japanese investors to buy Treasury bonds, pushing too hard may have more significant consequences. A plausible compromise may be found via a lower dollar, which would take the competitive edge off of the surplus countries and reduce the need to aggressively renegotiate other trade deals (such as NAFTA), potentially benefiting global economic and market confidence. With Europe looking inward and the Middle East/Russia more focused on keeping oil prices firm, North Korea becomes the remaining significant geopolitical issue for 2018. Considerable Chinese economic influence on the 'Hermit Kingdom' adds another dimension to G2 interactions.

THE MODERN INVESTOR

The investment industry is constantly evolving as technological advancements create potentially faster, cheaper and more accessible methods to participate in the global financial markets. The near instantaneous transmission of information has created new trading patterns. Packaged products for individual investors have proliferated in a market that was previously dominated by institutions that traded far fewer investments. Handwritten stock orders have been replaced with high-frequency trading programs, and intricate retirement income solutions have largely supplanted individual bonds. These advancements have infused additional complexity into today's markets. The modern investor is faced with more choices and information than ever before. Fortunately, financial planning applications have been developed to navigate this intricate investing environment and enhance professional advisement, enabling investors to more easily work toward their long-term financial objectives.

ECONOMIC GROWTH

There has been much hand-wringing about the moderate pace of U.S. economic growth in recent years. However, we've seen a similar moderation in global economic growth, driven largely by the same factors as in the U.S. – that is, demographic constraints on labour force growth and a lacklustre pace of productivity growth, likely related in part to slower capital investment. The demographic constraints are still there, but productivity growth appears to be picking up around the world. Brexit is likely to be messy, Chinese debt levels are a concern and geopolitical tensions could be a problem, but the global economic outlook for 2018 is brighter. How central banks respond will dictate what happens in 2019 and beyond.

CENTRAL BANK POLICY

Current Federal Reserve Governor Jerome "Jay" Powell is set to be sworn in as Fed chair on February 3, and President Trump is expected to fill a number of vacancies on the Fed's Board of Governors. The change in leadership is expected to be smooth. The focus for monetary policy should not change. The unwinding of the Fed's balance sheet has been mapped out and officials will stick to that plan.

However, the outlook for short-term interest rates gets cloudier beyond the middle of 2018. How will officials respond to a tighter labour market and a strong economy? The Fed's monetary policy has long been the focus for financial market participants, but regulatory policy will be placed front and centre. Outside of the U.S., global investors will look to central banks to tighten policy at some point, which ought to have some impact on the dollar and on long-term interest rates here and abroad.

THE SECULAR BULL MARKET

U.S. stocks remain in a multiyear, broad-based bull market that shares more similarities to the 20-year post-World War II and 1982 - 2000 periods than the lost decades of the 1970s or 2000s. Secular bull markets have, on average, lasted about 14 years and enjoyed annualized returns of around 16%. Moreover, just like no one begins to measure the 1982 - 2000 bull market from the absolute price low in the S&P 500 set in 1974, we believe this secular bull market began not at the low of March 2009, but when it broke out above the prior-2007 peak in 2013, meaning it remains relatively early in its cycle. Stocks will fall at times during secular bull markets but, historically, these have offered more favourable opportunities to buy rather than reasons to worry. The S&P 500 is up about 285% (on a cumulative basis) since the March 2009 bottom, but this pales in comparison to the 1400% gained during the 1982 - 2000 period.

Is Inflation on the Rise?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens" John Maynard Keynes

Outside of a few select emerging markets, inflation worries have been notable by their absence for financial market participants in recent years. Of the major global central banks, only the Bank of England is currently mildly embarrassed due to the specific influence of lapping the post Brexit referendum vote weak Pound period, which had a mechanical impact of raising import prices.

So, is all quiet on the inflation front? As with many matters in the investment world, when there is seemingly a collective memory lapse is just the time when you should be worrying about something.

As with many matters in the investment world, when there is seemingly a collective memory lapse is just the time when you should be worrying about something

If you look at the inflation numbers in the US, Eurozone or Japan, two aspects stand out. The first is that headline inflation rates, according to official forecasts, are not predicted to breach this year or next year the 2% level that each of the area's Central Banks regard as a minimum level of inflation control. The second is that rising commodity prices - especially oil prices - are causing some building inflationary pressures.

Particularly influential on this latter point is the fall in the value of the US dollar. With many commodities (both energy and agricultural/food) dollar-denominated, a fall in this exchange rate is usually supportive in turn of both higher demand (in particular from the emerging markets) and ultimately higher prices. And 'cost-plus inflation' that starts in raw materials, quietly and persistently can go up the product chain.

The role of China here is crucial. A simple summary of the last fifteen or twenty years would observe that the great cost and productivity strides in mainstream manufacturing that the country made during this period, effectively exported disinflation to the world. As China employs economic reform measures to encourage the growth both of the service sector and personal consumption levels, slowly but surely it is shifting away from low-cost manufacturing. Whilst other low-cost nations in south Asia, Central America and Africa will progressively take global manufacturing market share, they are unlikely to be individually or collectively as influential in keeping pricing so low. And given how cheap many emerging market currencies are currently trading on conventional foreign exchange valuation mechanisms (like purchasing power parity (PPP)) – at the risk of higher imported inflation into the largest developed markets in the world – this is a legitimate concern for the next few years.

The effect of such a shift may be starting to have a small impact in global fixed interest markets, where both short and medium duration yields have started to rise (i.e. bond prices have started to weaken). Clearly there are other influences at work here including the progressive ending of the global central bank stimulus and even recent solid levels of world economic growth, however, any burgeoning inflation story underpins this trend.

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Country	Inflation rate %	Data point
Turkey	11.92%	Dec 2017
Mexico	6.63%	Nov 2017
India	4.88%	Nov 2017
Indonesia	3.61%	Dec 2017
United Kingdom	3.10%	Nov 2017
Brazil	2.80%	Nov 2017
Russia	2.50%	Dec 2017
United States	2.20%	Nov 2017
Canada	2.10%	Nov 2017
Australia	1.80%	Sep 2017
China	1.70%	Nov 2017
Germany	1.70%	Dec 2017
Euro Area	1.50%	Nov 2017

Source: Trading Economics

From an asset allocation and position selection perspective, investors generally would place a premium on assets with inflation protection capabilities, which tends to favour equities over conventional bonds and alternative assets such as gold versus cash. Additionally, there is the complex impact on borrowers who benefit from a higher price level but may face raised interest rates in the shorter-term. This could prove to be troublesome for a world where debt levels are still material in many countries.

Currently we are only in the early foothills of any inflation crisis but plausible macroeconomic eventualities, such as a lower US dollar and a continued shift of the Chinese economy, potentially is enough to induce a bigger concern. Time to run an inflation health check if you are an investor, fund manager or central bank board member.

KEY TAKEAWAYS:

- Worry when others do not appear to be worrying
- Central Banks are currently relaxed but watch the value of the US dollar
- Any burgeoning inflation story underpins the recent trend of higher bond yields
- Time to run an inflation health check on your investment selections

International Investment Opportunities Over the Next 12 Months

Chris Bailey, *European Strategist, Raymond James Euro Equities**, provides perspective on the global financial environment and what we may expect this year.

"The larger the island of knowledge, the longer the shoreline of wonder" Ralph W. Sockman

There is always a big world out there but any recent UK investor interactions with investments outside our own island have been highly influenced by the performance of the Pound. In 2016, international investment got a special boost because of the sharp decline in Sterling during the second half of the year. Meanwhile in 2017, gains in the North American markets particularly were clipped back a little by the bounceback of the UK currency against the dollar, whilst European and emerging market investments were less impacted due to the rise of the Euro and strong local market returns respectively. And picking up this latter point, I think from a UK perspective 2018 will be less impacted by foreign exchange considerations and more by the underlying realities of different markets - and there are some very distinct differences.

The big question for all international markets is not exclusively whether they can live up to this opportunity... but also if they can build international investor confidence in their change and reform regimes

In terms of economic growth levels or corporate earnings direction the US has nothing to be ashamed about looking across 2018, but financial markets often work on the basis of untapped potential and/or momentum and many other parts of the world - including both the developed markets in the Eurozone and collectively in the emerging markets - are offering lower valuations, stronger corporate earnings growth momentum and a continuation of central bank stimulus actions. The US, by contrast, will see the Federal Reserve start to contract its balance sheet.

The big question for all international markets is not exclusively whether they can live up to this opportunity... but also if they can build international investor confidence in their change and reform regimes. On this latter point, the US again has first mover advantage with President Trump's tax reform plan making legislative progress before the end of last year, albeit at the cost of sparking a rigorous debate concerning an equitable split of the gains.

Compared to other international market norms, the US stock exchanges typically trade on higher multiples. This partially reflects their greater technology sector weighting. However, their greatest challenge versus peers may well prove to be that other geographies still offer more low hanging fruit reform potential.

In recent years, the Eurozone has been the least successful in inspiring global investors. Low economic growth, overt economic challenges in the highly indebted southern European states and fading faith that incumbent politicians had any credible answers. 2017 at least saw some form of stabilisation aided by the lagged impact of very loose policy by the European Central Bank (ECB). The big fear a year ago was the raft of upcoming elections that could have ushered in a range of more populist politicians, which could have put at risk the continuation of the Eurozone in anything like its current form. Political reality though was best captured by the victory of the telegenic and youthful Emmanuel Macron in France, on the promise of change and reform. Suddenly there was some hope of changes in labour market flexibility, the tax burden backdrop and even the encouragement of entrepreneurial effort and zeal in an influential country within Europe, like France. So far - and aided by a Parliamentary majority - so good for President Macron.

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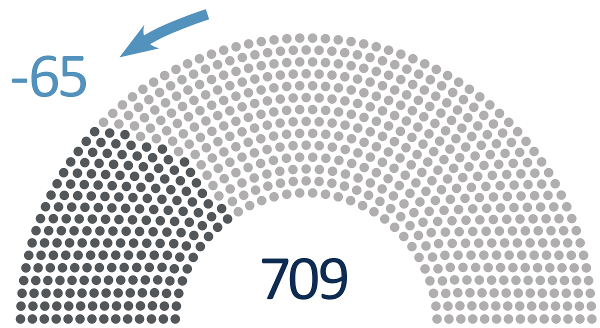
PARLIAMENTARY ELECTION TRENDS

2018's outlook starts and ends with the need for progress in reforms and faith in policymakers – the better performing markets and regions will be those that reform the most versus current expectations.

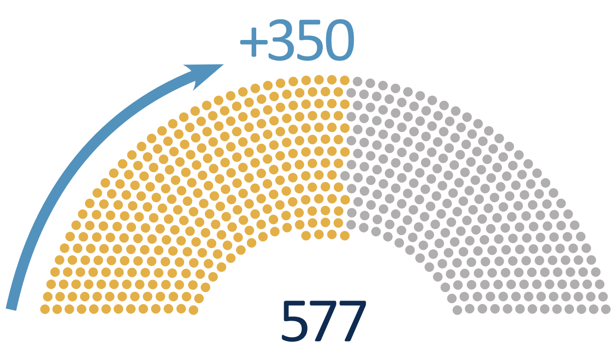
GERMAN BUNDESTAG

Angela Merkel's Christian Democratic Union and its sister party, the Christian Social Union, **collectively lost 65 seats** in the most recent elections. They now hold 246 seats.



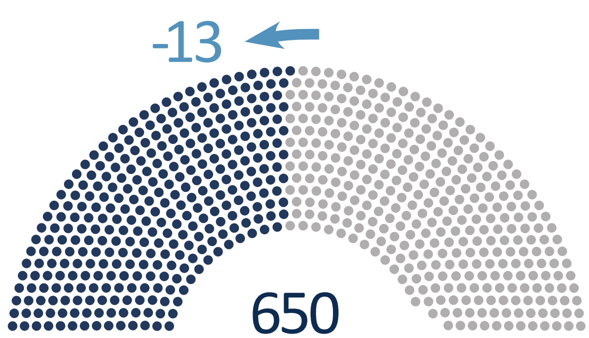
FRENCH ASSEMBLÉE NATIONALE

Emmanuel Macron's newly-founded party, La République En Marche! combined with the centrist Democratic Movement **picked up 350 seats** in the most recent elections.



BRITISH PARLIAMENT

Theresa May's Conservative party **lost 13 seats** in the most recent elections. They now hold 316 seats.



International Investment Opportunities Over the Next 12 Months

The other major supportive element for change within Europe is the German Chancellor Angela Merkel. Mrs Merkel's own political (re) election in late September did not go wholly to plan and, at the time of writing, she is still in deep discussions over how to put together a workable new coalition government to govern Europe's largest and most influential country. With well in excess of a decade of leading Germany, it is highly likely she is entering her final few years of top political office, which naturally should lead to thoughts of leaving a clear political legacy from her time and efforts in office. This is potentially good news for the cohesion of the Eurozone given Germany's historic reluctance to allow more fiscal stabiliser spending to help reduce economic imbalances across the region. The combination of a slightly more economically cuddly Germany, with a reform-minded France, could be an attractive mix for global investors.

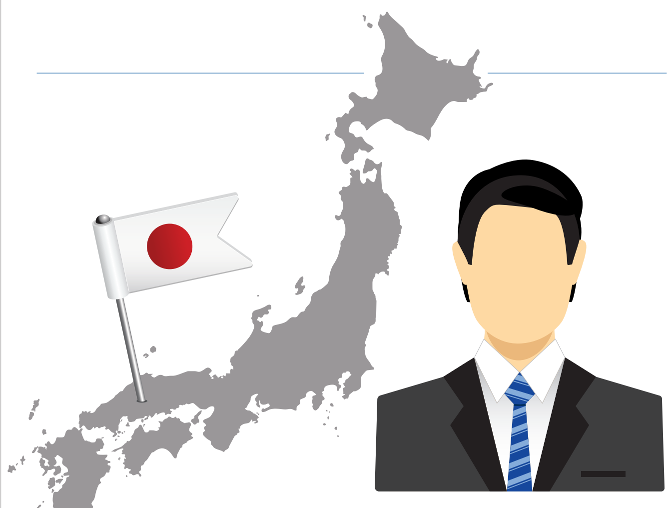
The mood music around Brexit has however improved recently, with a general acknowledgement by both the UK government and the continuing European Union of the need to have a transitional period of a greater length than the two years imagined in the immediate aftermath of the Brexit vote. On balance this progress should continue throughout 2018, and with it additional support for the pan-European markets.

> The combination of a slightly more economically-cuddly Germany with a reform-minded France could be an attractive mix for global investors

ASIAN POLITICAL TRENDS

"The Congress unanimously agrees that, the Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era, in addition to Marxism-Leninism [and] Mao Zedong Thought ... shall constitute the guides to action of the Party in the Party Constitution."

- Resolution on Amendment to the Constitution of the Communist Party of China, 19th National Congress



Japanese Prime Minister Shinzo Abe's ruling coalition retained its two-thirds supermajority following a recent snap election, which will enable him to reform the Japanese Constitution for the first time since its introduction in 1947.

> Both leading economic powers in Asia, China and Japan, saw important political developments over the last 12 months

This sort of backdrop suggests further appreciation of the British Pound and the Euro to levels closer to fairer value purchasing power parity (PPP). A lower US dollar, as seen in 2017, historically supports Asian and emerging market investment and currencies. Both leading economic powers in Asia - China and Japan - saw important political developments during the last year. For China, the twin accomplishments of the launch of the Belt and Road initiative (aiming to create a dynamic economic zone stretching from China to Europe) and a National People's Congress, which enshrined the continuing deeper embracing of the market economy, laid out a very positive agenda stretching out for the rest of the decade. Some pressures are building in property and bond markets but investors should be encouraged by the legislative support and burgeoning Chinese consumer and service sector opportunities. And this spills out into the broader Asian geographies.

Meanwhile in Japan, economic momentum has improved and the slow business of trying to introduce more dynamism to the local economy has been boosted by the re-election of Prime Minister Abe. Any signs of deeper reform will no doubt encourage global capital to return to a country that has so materially underperformed for much of the last three decades.

A lower dollar also tends to support commodity prices, which helps other important global economies including Russia, Brazil and a number of Middle Eastern nations.

The critical thought as we move into 2018 is that the better performing markets and regions from a global stock market perspective will come from those who reform the most versus current expectations (with the whole 'Brexit debate' and the interlinked domestic political stability being the dynamic reform element for the UK). The scope for such a surprise across Europe and Asia compared to the US still seems reasonable - and with it a lower dollar, which not only again increases the attraction of non-US international markets for UK investors, it may also take the edge off the 'fair versus free' trade debate. No huge surprises in global trade legislation helps all countries, allowing broader international tensions such as North Korea and the fight against terrorism to be more cohesively discussed and actioned.

In short, the outlook for international markets in 2018 starts and ends with the need for progress in reforms and faith in policymakers but would again, from a UK perspective, appear to favour the European and Asian/Emerging Market options. Cheaper valuations alone, though, are not enough.

KEY TAKEAWAYS:

- UK investors need to focus on the different underlying realities in international markets
- The US market has been popular but is now more highly valued
- Europe and the emerging markets offer more low hanging fruit reform potential
- The need for progress in economic reforms and faith in policymakers is key

Despite Brexit...
Can UK Equities and Bonds Have a Great 2018?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"Public sentiment is everything. With public sentiment, nothing can fail. Without it, nothing can succeed" Abraham Lincoln

No matter what your starting point, if you are thinking or talking about the British economy or prospects for the UK financial markets, it does not take long for the issue of Brexit to come up. There are multifarious influences on any economy or financial market but, unsurprisingly for a deeply internationally integrated country like the UK, the status of trade legislation and diplomacy with its geographically most proximate - and integrated - economic ally materially matters.

The Brexit word was never far from the lips of commentators appraising the latest economic projections for the UK economy, released by the Office for Budgetary Responsibility in late November. Muted growth, a shabby progression in productivity gains and a persistent budget deficit were all at least associated with the Brexit debate and the economic reality impact of the ongoing negotiations on consumer and business confidence and decision-making.

However, the UK's most-quoted stock market index ended 2017 at an all-time high and, while interest rates did edge up near the end of the year for the first time in a decade, borrowing costs - and gilt yields - remain strikingly low. UK investors in both asset classes had a reason to raise a toast to the gods of the financial markets during the festive season.

So what comes next? Well, in terms of the Brexit debate, 2018 is going to be an important year as 2017's preliminary discussions shift to a second and more detailed phase with an aim to have a sufficiently outlined deal by October, to allow ratification by any Parliament that wishes to do this before the end of the decade. However, timetables are starting to become blurred, with at least a 'transitional arrangement' period of eighteen months after the end of March 2019 sanctioned by European Union negotiators to allow legislation, required changes and preparations to be finalised. Fear then of a sharp 'cliff edge' in trade legislation, which could cause widespread economic disruption early next year, have abated.

Hope of less short-term economic uncertainty has the potential to buoy sectors and companies which are more UK or pan-European oriented

The best gauge for this improving tone has been the rising value of the Pound during the last year against international peers such as the Dollar and the Yen. A rising Pound always has the potential to shift preferences within a stock market such as the UK where a significant proportion of corporate revenues and earnings are generated internationally, and this could well occur in 2018. Hope of less short-term economic uncertainty - even if the UK's economic performance remains relatively dull - has the potential to buoy sectors and companies which are more UK or pan-European oriented, versus even more internationally focused areas which have tended to outperform in the last couple of years. This correctly should be viewed as opportunistic for UK stock market investors - especially those who are prepared to pick and choose their investments. The current very low level of positive sentiment generally reported in global investor surveys towards the UK equity market only adds to this potential.

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Bond investors have some different headwinds. Many equities are still offering a pick-up yield premium versus even medium or longer duration bonds, and any notion of an improving backdrop due to less Brexit uncertainty is likely to encourage further shifts into equities. However, there appears to be little justification at the moment for radical shifts in either Bank of England stimulus or interest rate policy, meaning that bond markets - where yields are already very low versus historical norms - are likely to be dull at best.

So while active equity stockpickers should have reason to hope that Brexit compromises can lead to opportunities, much rests on the hard-to-measure tone of the ongoing discussions between the UK government and the European Union. Brexit is not everything but it will continue to matter for the UK financial markets in 2018.

KEY TAKEAWAYS:

- Brexit timetables are starting to become blurred
- Low levels of positive sentiment towards the UK equity market means there is potential
- Bond markets are likely to be dull at best
- Much rests on the hard-to-measure tone of the ongoing Brexit discussions

The Brexit Year Ahead

January **Transition talks start** **29** Meeting of EU affairs ministers to sign off start of talks	**February** **23 Summit**	**March** **Trade talks start** **22-23 Summit**	**April**
May **17 Summit**	**June** **28-29 Summit**	**July**	**August**
September **20-3 Oct** **Conservative party conference**	**October** An outline deal is to be wrapped up to give EU parliament time to ratify **18-19 Summit**	**November**	**December** **13-14 Summit**

Source: Bloomberg

U.S. Equity Outlook: Staying Calm in the Face of the Bull

Andrew Adams, CFA, CMT, Senior Research Associate, Equity Research, shares themes for 2018 as investors may find some disruption amid the continued bull market.

The somewhat arbitrary change of the calendar shouldn't alter the underlying forward-looking expectations for the stock market – or provide much new insight into future winners and losers. Yet, the arrival of another year does provide a fine excuse to pause and reflect on current conditions and examine the themes that investors should monitor as they gaze ahead. Since it's difficult to look forward without knowing the direction you've come, let's turn our attention to the past before proceeding to what may be ahead.

A REVIEW OF 2017

First and foremost, the secular bull market is clearly alive and well. The S&P 500 has risen in 18 out of the last 20 quarters, including nine straight since late 2015. And while 2017 was a very good year in terms of total return in the U.S. stock market, the bigger story was the complete lack of downside, with some measures of volatility hitting their lowest levels in history. In early November, the S&P 500 set a new record by going 371 consecutive calendar days without a 3% dip from a previous high, a streak that has reached 412 days at the time of this writing on 21/12. What's more, the index only had seven sessions where it gained or lost more than 1% on a closing basis and never once did it gain or lose more than 2% (as of 21/12/17). The biggest driver of last year's performance was growth in corporate earnings, supporting our view that we've entered an "earnings-driven" stage of the secular bull market rather than one chiefly dependent on low interest rates and stimulus from the Federal Reserve. At the same time, the U.S. and global economies showed clear improvement in 2017, making it difficult to bet against world equity markets. The good news is that these underlying trends remain largely in place as we head into 2018, though we do believe it may be tougher going forward to maintain the same pace of growth considering both earnings and economic data will now have higher bars to clear after the improvement shown last year.

LOOKING BACK: 2017 EQUITY RECORD-BREAKERS

ALL THE WAY UP

S&P 500

S&P 500 HAS RISEN IN **18** OUT OF THE LAST **20 QUARTERS**

THE DOW

THE DOW CLOSED AT **70** **NEW HIGHS** AS OF 21/12/17

THE DOW

THE DOW HAD **86** **RECORD HIGHS** SINCE THE PRESIDENTIAL ELECTION.

TAX REFORM?

While we do expect earnings and the economy to maintain their strength into 2018, the much-discussed tax reform bill continues to be a huge wild card with respect to how much better earnings and the economy can get. It's likely that the current 2018 consensus

analyst estimate for S&P 500 bottom-up operating earnings per share of $145 does not fully reflect possible tax reform, because analysts have only recently learned what the specifics of the new tax laws will be. We could now see earnings estimates jump as analysts revise their models for the changes. However, it's unclear how much anticipated tax reform has already been priced into the market, which increases the uncertainty of what the eventual impact will be on individual stock prices. The combination of uncertainty regarding the market's reaction to a completed tax bill and the fact that it's been a while since the major averages experienced much downside at all have us treading with some caution as we head into 2018. We don't advise adopting a "set it and forget it" approach or throwing all caution to the wind, but neither do we see signs at this point that lead us to believe a significant correction or recession is imminent. We stand firm in our belief that this remains a secular bull market and any early year weakness would offer the first real buying opportunity since right before the 2016 U.S. presidential election.

> "The combination of uncertainty regarding the market's reaction to a completed tax bill and the fact that it's been a while since the major averages experienced much downside at all have us treading with some caution as we head into 2018."

> "We stand firm in our belief that this remains a secular bull market and any early year weakness would offer the first real buying opportunity since right before the 2016 U.S. presidential election."

1% 2% 3%

S&P 500 ONLY HAD **7** SESSIONS GAINING OR LOSING MORE THAN **1%** AT CLOSE

S&P 500 NEVER GAINED OR LOST MORE THAN **2%** AS OF 12/21/17

AS OF DECEMBER, S&P 500 HAD GONE **412** CONSECUTIVE CALENDAR DAYS WITHOUT A **3%** DIP FROM A PREVIOUS HIGH

GOING FORWARD

If we're correct that U.S. stocks remain in a secular bull market and that the global economy is in a growth phase, what has worked up to this point should remain the focus for most investors. We still prefer the more cyclical areas of the market over the more defensive, and continue to warn against overexposure to interest rate-sensitive sectors. Technology was the clear market leader in 2017, and it's tough to imagine a scenario where the secular bull market continues and technology companies don't at least keep pace with the S&P 500, given their proven ability to grow earnings. Financials should stand to benefit, too, with an environment characterised by a growing economy, less regulation, and possibly higher interest rates. Sectors we favour include Industrials, Materials, Consumer Discretionary, and Energy, and we remain interested in Health Care – despite some possible volatility if Washington turns its gaze back to reforming the Affordable Care Act. Large companies outperformed small and mid-cap companies in 2017, but we think there's a good chance we see smaller stocks do better in 2018 considering they should benefit from an environment of lower taxes and a growing economy. The weakening U.S. dollar also helped large,

U.S. Equity Outlook: Staying Calm in the Face of the Bull

> "The keys to market success in 2018 will be to stay flexible and not panic when we do eventually see some volatility."

multinational companies in 2017, but if the dollar remains more stable or even rises in value, smaller, more domestic- focused businesses could see the rewards. We also continue to recommend looking abroad, as we have truly seen a global economic recovery over the last couple of years that has helped boost world markets, not just U.S. stocks. Emerging economies continue to perform well on both an absolute basis and relative to the S&P 500, and we remain optimistic on them as long as the favourable trend endures.

OVERALL

To conclude, 2018 may have its work cut out for it to further the calm, consistent price appreciation of 2017's stock market. We anticipate having to deal with more downside and disruptions along the way this year, and investors will likely have to contend with more tightening by the Federal Reserve, potential geopolitical black swans and the smaller margin for error inherent to high valuations. However, the secular bull market is not yet showing signs it's in trouble, and the global economy appears to still be improving. The keys to market success in 2018 will be to stay flexible and not panic when we do eventually see some volatility. And, when in doubt, always remember it is a bull market, you know ...

KEY TAKEAWAYS:

- In 2017, the biggest driver of U.S. equity performance was growth in corporate earnings, supporting our view that we've entered an "earnings-driven" stage of the secular bull market rather than one that's chiefly dependent on low interest rates and stimulus from the Federal Reserve.
- We still prefer the more cyclical areas of the market over the more defensive, and continue to warn against overexposure to interest rate-sensitive sectors.
- We continue to recommend looking abroad, as we have truly seen a global economic recovery over the last couple of years that has helped boost world markets, not just U.S. stocks.
- We anticipate having to deal with more downside and disruptions along the way this year, and investors will likely have to contend with more tightening by the Federal Reserve, potential geopolitical black swans and the smaller margin for error inherent to high valuations.

[1] Performance as of 9/30/2017.

EARNINGS ESTIMATES AND STANDOUT SECTORS

J. Michael Gibbs, Managing Director of Equity Portfolio & Technical Strategy, discusses the potential impact of tax reform.

Due to the combination of GDP growth, strong upward earnings revisions, and relatively low interest rates and inflation, overall economic conditions are still supportive of equities longer term.

Having largely rebounded from the impact of last year's hurricanes, earnings are expected to rebound to double-digit year-over-year growth as we enter the New Year.

Major catalysts, which we believe aren't fully reflected in the current market, are the benefits from tax reform and repatriation. While there are many unanswered questions regarding how companies will utilise the tax savings and the ultimate impact to the bottom line, we believe tax reform and modest levels of increased buybacks can add ~8% to earnings (~$153.50/earnings per share) from our $142 estimate for earnings without tax reform. Using a P/E multiple of 18.75x on our estimated $153.50, we see the fair value of the market as ~2,875. We believe the approximately $2.4 trillion in overseas cash held by S&P 500 companies could be a further catalyst for the coming year if it's repatriated and used for significant share buybacks or mergers and acquisitions (M&A).

POTENTIAL CHANGES WITH TAX REFORM

+7-9%
EARNINGS PER SHARE (EPS) GROWTH FOR 2018

~$2.4 TRILLION
IN OVERSEAS CASH AS CATALYST IF REPATRIATED

GIVEN OUR BIAS TOWARD EQUITIES, WE FAVOUR THE FOLLOWING SECTORS:

FINANCIALS
Likely to benefit from rising interest rates, lower taxes, and less regulation.

ENERGY
Although we remain somewhat contrarian, given negative sentiment in the space, we see some improvement in U.S. activity.

TECHNOLOGY
Despite extended valuation, this sector continues to see some of the best fundamental momentum.

INDUSTRIALS
A nice harbinger for the overall health of the manufacturing recovery.

HEALTH CARE
While in the political crosshairs for drug pricing, this sector should be a nice beneficiary in the event of repatriation.

Energy Outlook: Consolidation of Oil Recovery, While Renewables Gain More Power

Pavel Molchanov, Senior Vice President, Energy Analyst, Equity Research, looks back at the year and highlights what 2018 may bring.

Despite many fits and starts, the global oil market showed some strength in 2017, sustaining a recovery following the down cycle dating back to mid-2014. West Texas Intermediate (WTI) and Brent crude averaged $50 per barrel for the full year – a three-year high. After a slow start, the recovery gained momentum in the latter part of the year, as evidence mounted that global oil inventories were falling sharply.

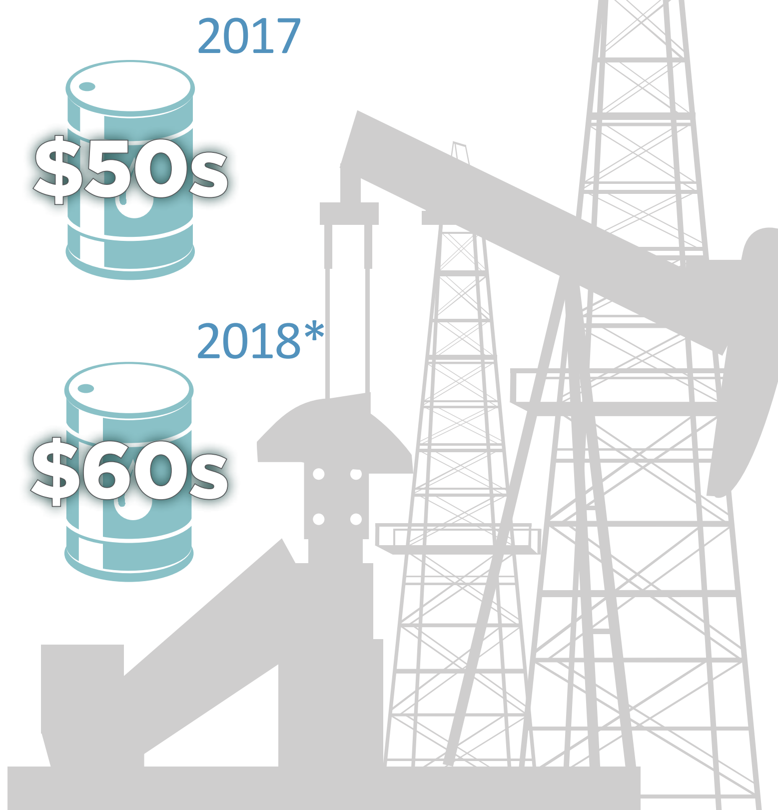
The inventory drawdowns came amid a broadly upbeat picture for global oil demand (up more than 1.5% in 2017), alongside supply that was reduced by both organic declines (China, Mexico, Venezuela) and the Organization of the Petroleum Exporting Countries' (OPEC) production cuts. Most recently, on November 30, 2017, OPEC announced a second extension of cuts through year-end 2018, confirming that the group aims to remain disciplined even after the price recovery that has already materialised.

OIL

Looking to 2018 and longer term, we project that oil prices will average in the $60s. Though still far from the $100+ highs seen in the first half of this decade – which, of course, is good for growth in demand – oil in the $60s should support a sustainable level of industry-wide investment. We define this as capital spending that enables global oil supply to grow broadly on par with global demand. While some companies (in the Permian Basin, for example) are able to meaningfully grow production at sub-$60 prices, it doesn't hold true for the industry as a whole.

A common misconception we encounter among investors is the notion that field-level breakevens (the cost of producing oil relative to the price level of oil) determine any given company's ability to sustain or grow production. In actuality, what matters more are corporate-level economics, taking into account not only the cost of drilling new wells, but also other cash outflows (corporate overhead costs, interest expense, and dividends). For many of the top multi-nationals, the emphasis on preserving dividends has led to intense selectivity in where and how to invest capital. Even traditionally growth-focused U.S. exploration and production companies are starting to exhibit greater capital discipline.

At approximately $60 per barrel, prices support a sustainable level of industrywide investment.



*Estimate

NATURAL GAS

In contrast to our positive view on the global oil market, we are less enthused about North American natural gas, hence our forecast that Henry Hub (the pricing point for natural gas futures contracts) will average under $3.00/Mcf in 2018, a decline from 2017 levels. Many of the structural trends remain bearish:

- The ramp-up in wind and solar has been eating into gas's market share gains in the power sector. In fact, gas actually lost share in 2017.
- Liquefied natural gas (LNG) exports are still not at truly needle-moving levels.
- Uplift in oil-centric drilling activity in areas such as the Eagle Ford Shale is resulting in a large increase in supply of associated gas.

Meanwhile, the European gas market is in even rougher shape, with demand languishing near 20-year lows. Asian gas demand has been growing, but not as much as the industry would have hoped, hence the mixed fundamentals in the global LNG market.

WIND & SOLAR

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NATURAL GAS

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OIL DRILLING

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RENEWABLES: WIND AND SOLAR

A major long-term theme that transcends the day-to-day choppiness in commodity prices is the main-streaming of renewables – more specifically, wind and solar – in the global electricity mix. This trend is irrelevant for oil since oil is not a common feedstock for power generation, but still helps explain the difficult market conditions for gas and especially coal, whose long-term outlook continues to deteriorate. Last November, 19 countries announced a full coal phase-out by 2030. Additionally, the largest U.S. electric utility is predicting that wind will become the lowest-cost source of U.S. electricity by 2020, without taking into account policy incentives. This marks a dramatic shift from just ten years ago.

As a result, we project that wind will comprise at least 15% of the U.S. electricity mix by 2030, up from 7% in 2017. China should reach at least 10% by then as well. Currently, there are only a handful of countries (mainly in Europe) where wind exceeds 10% of the mix. While solar's current market share metrics are even lower than those of wind, its rapid pace of cost reduction makes us optimistic about its growth potential as well, notwithstanding the regulatory changes that periodically cause dislocation in the solar value chain.

KEY TAKEAWAYS:

- Looking to 2018, and longer term, we project that oil prices will average in the $60s. Though still far from the $100+ highs seen in the first half of this decade – which, of course, is good for growth in demand – oil in the $60s should support a sustainable level of industry-wide investment.
- We are less enthused about North American natural gas as many of the structural trends remain bearish.
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WIND WILL COMPRISE AT LEAST **15%** OF THE U.S. ELECTRICITY MIX BY 2030

Asset Allocation Outlook: Similar Themes in a Complex Environment

Nicholas Lacy, CFA, Chief Portfolio Strategist, Asset Management Services, shares overall portfolio allocation themes and opportunities for 2018.

A GLOBAL VIEW

Unconventional monetary policy initiatives by central banks around the world are finally yielding economic and market improvements, similar to those experienced by the U.S. over the last several years. Inflation remains muted in Europe and Japan while stable (albeit, low) inflation in the U.S. and other areas provide a positive global backdrop for accelerating economic growth and further asset appreciation. In particular, European and Japanese equities should benefit from continued quantitative easing and asset purchase programs from the European Central Bank and the Bank of Japan.

Meanwhile, the Federal Reserve (Fed) and the Bank of England (BOE) are tightening policy by raising short-term interest rates. The Fed has begun gradually unwinding its balance sheet (by not fully reinvesting the proceeds of matured securities). However, this activity is intended to "normalise" policy and should have minimal impact on the overall economy.

While both banks are raising rates, they are doing so for very different reasons. The BOE has to contend with the fallout of Brexit and its impact on the British economy, making its motivations for policy fundamentally different than those of the Fed. That being said, the BOE and the Fed will face similar headwinds as a result of tighter monetary policy, unlike their Japanese and European counterparts who maintain more accommodative agendas.

U.S. EQUITY

Strong earnings growth in the U.S., as well as the prospect of regulatory reform and tax policy, drove equity valuations to 15-year highs in 2017. Unlike an asset bubble, current price levels are supported by positive earnings growth, a healthy economy, and a low inflation and interest-rate environment. As long as these tailwinds remain in place, U.S. equities should have more room to run.

> "Areas of the world expected to see the greatest improvements in earnings, valuations, and economic growth should, in turn, earn the greatest market returns."

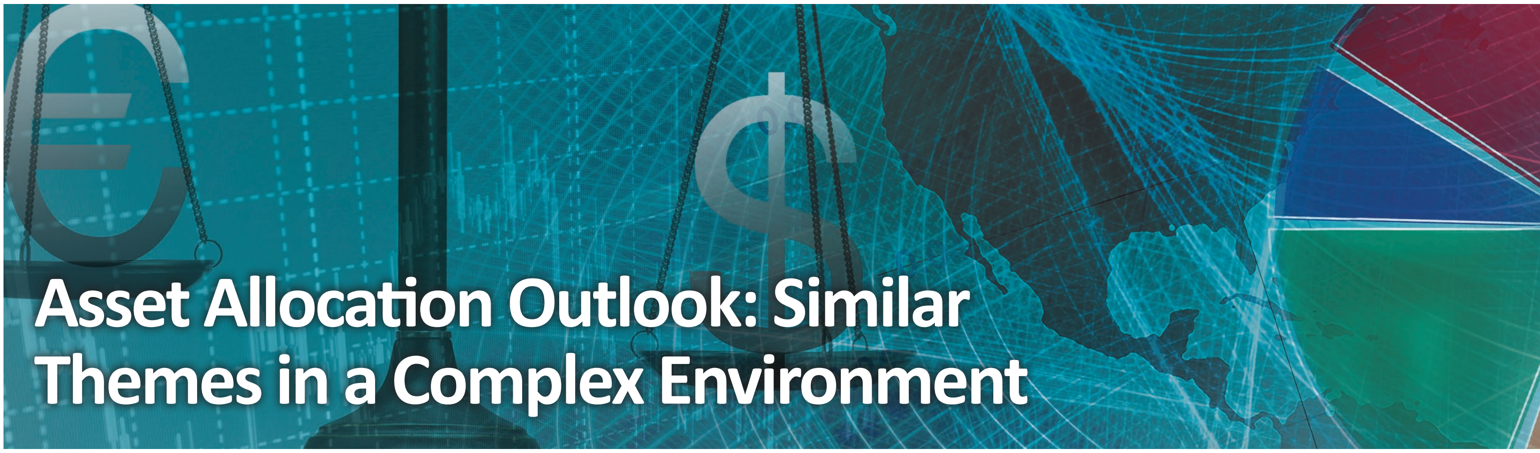
While large-cap stocks may provide some upside due to higher quality metrics, any substantial changes to regulation and/or tax legislation would be a tailwind for smaller companies, since they stand to benefit the most from positive policy changes. In the meantime, opportunities abroad are more encouraging as international equities exhibit stronger fundamentals and positive investor sentiment.

Publicly-traded real estate is facing headwinds as the likelihood of rising interest rates strengthens. More defensive areas of the market, particularly managed-volatility strategies or low-beta equities, may offer additional protection from interest-rate risk in this environment.

INTERNATIONAL EQUITY

While earnings growth rates in Europe and other areas of the world are exceeding that of the U.S., not all markets have enjoyed the strong equity performance that the U.S. has (in local currency terms). While valuations appear elevated in the U.S., other regions (such as Europe and Asia) remain "reasonably" priced relative to historic averages.

The improvement in fundamentals, earnings, and economic activity overseas justifies an increased allocation to international equities, particularly those of developed markets. While emerging equities earned significant returns in 2017, the majority of that return was generated by local markets (as opposed to developed markets, where a substantial part of return generation was attributed to a decline in the U.S. dollar). This currency adjustment leaves developed markets



Asset Allocation Outlook: Similar Themes in a Complex Environment

INTERNATIONAL EQUITY PERFORMANCE

YTD - 20/12/2017

NON-U.S. DEVELOPED MARKET EQUITY
is up 24% with 9% coming from currency effect.

EMERGING MARKETS EQUITY
is up 34% with 6% coming from currency effect.

more attractively priced relative to their emerging counterparts going into the new year. With richer valuations and naturally higher levels of volatility, emerging markets are expected to "take the back seat" for international performance and investor sentiment this year.

FIXED INCOME

A primary headwind for U.S. fixed income in 2018 is the path of interest rates as the Fed is expected to continue raising short-term rates, assuming economic data supports this activity. While short-term rates have been on the rise over the last couple years, longer-term rates remain low compared to historical averages, resulting in a flattened yield curve. For example, the yield on the 10-year Treasury note has not risen above 3% since July, 2011, and the difference between the 10-year Treasury yield and 2-year Treasury yield (known as the spread on interest rates) is at decade lows. The result is increased risk for longer-maturity bondholders since bond prices will eventually fall when yields begin to rise.

Credit-oriented bonds (such as U.S. corporates and high-yield bonds) substantially appreciated in value over the last two years as investors struggled to find yield in an extended period of low interest rates. The result was a significant compression in yields, with the spread between Treasury bonds and corporate/high yield bonds tightening to pre-financial crisis ranges. The positioning of these markets presents

Source: Bloomberg LP

significant risk to investors going forward as they are not being compensated for assuming additional credit risk with these holdings.

We maintain the long-term view that intermediate-term, high quality fixed income is the superior hedge to equity market risk, and strategic allocations to these core positions should remain intact. To further insulate a diversified portfolio from a rise in interest rates, investors may consider an allocation to short-term or floating-maturity bonds, which could help offset some of the potential loss incurred by longer-term holdings if rates begin to rise.

DIVERSIFICATION

The global financial markets are more complex now than ever before, presenting both opportunities and risks for investors. Working with your financial adviser to accurately gauge your risk tolerance in order to construct a diversified portfolio and financial plan is essential to achieving your long-term financial goals.

KEY TAKEAWAYS:

- Areas of the world expected to see the greatest improvements in earnings, valuations, and economic growth should, in turn, earn the greatest market returns.
- While valuations appear elevated in the U.S., other regions (such as Europe and Asia) remain reasonably priced. Carrying over from last year, we maintain a favourable view on non-U.S. developed markets, moving to a full overweight from an overweight position.
- Small- and mid-cap stocks appear the least attractive as we head into 2018, while large caps may provide some upside due to higher quality metrics relative to small and mid caps.
- While intermediate-term, high-quality fixed income in a diversified portfolio is still strongly recommended for its negative correlation to equities, also owning some shorter-term or floating maturity bonds may help offset some of the potential price depreciation when longer-term rates do begin to rise.

INVESTMENT STRATEGY COMMITTEE MEMBERS

Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

Andrew Adams, CFA, CMT, Senior Research Associate, Equity Research

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