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Global economic summary & outlook

November 2016

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International

The election of Donald Trump as the next President of the United States imparts a measure of uncertainty to international trade and U.S. relations with certain countries such as China, Mexico, Iran, and others. We expect that the Trump administration will accelerate U.S. economic growth, drive inflation higher and strengthen the dollar. Currencies in certain countries (e.g., Mexico, Brazil, China and Japan), which might be more greatly affected by the new administration's policies, were especially weak against the U.S. dollar following the election. Higher growth expectations have in turn driven sovereign yields incrementally higher in many international markets.

The election of Donald Trump as the next President of the United States imparts a measure of uncertainty to international trade and U.S. relations with certain countries

The balance of recent global economic data appears slightly positive, especially among the BRIIC countries (i.e., Brazil, Russia, India, Indonesia and China). As the world focuses on the U.S. Federal Reserve's (Fed) approach to its next rate increase, we note that many countries in the developed and developing world continued to cut interest rates in 2016. While the Fed positions itself to increase rates and possibly dampen domestic growth, the trend of lower rates worldwide should nonetheless act as incremental stimulus for global growth in 2017.

Notably, in Russia, the economy experienced gross domestic product (GDP) growth of +0.1% in the third quarter, ending an 18-month long recession. Brazil's economy also exhibited signs of improvement, and a measure of inflation for the first 15 days of October suggests prices grew at the slowest pace since 2009. The Banco Central do Brasil cut rates 25 basis points (bps) to 14%; the move was the first rate cut in four years. Other recent data suggest that fourth quarter economic activity in India and China is trending favorably.

A subtle shift toward higher inflation expectations seems even more relevant to fixed income markets, despite limited data which actually supports this view. The shift has put upward pressure on longer-term interest rates in some developed markets.

Investors continue to increasingly discount the effectiveness of global monetary policy, putting pressure on governments to implement alternative stimulus programs to bolster growth. China, Japan and the U.K. have already utilized fiscal policy to promote economic growth.

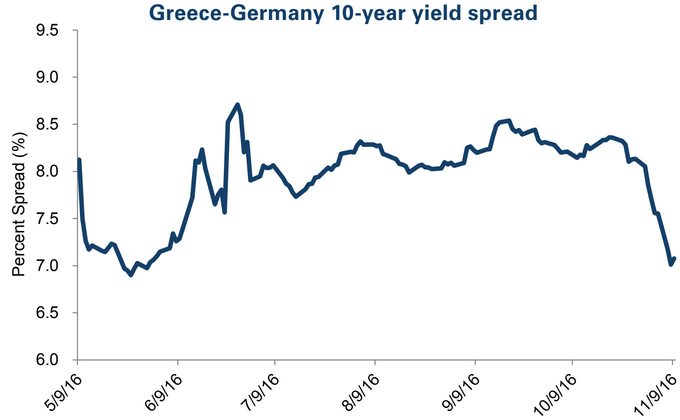
Until Fed policy becomes clearer, we expect a relatively stable fixed income environment with upward pressure on longer-term rates, as economic data confirm a global recovery.

Investors continue to increasingly discount the effectiveness of global monetary policy

Europe — summary

- Eurozone inflation inched up +0.4% on higher oil prices, but the rate of increase remains well below the European Central Bank's (ECB) 2.0% target rate. Longer yields throughout Europe have drifted higher, but remain range-bound. Separately, the pan-European budget deficit fell to an eight-year low.
- A European index of executive and consumer confidence moved to a 10-month high. GDP reports continue to depict an uneven recovery across Europe with countries such as Spain and Ireland leading the way, while France and Italy lag.
- The U.K.'s High Court ruled that a Parliamentary vote would be required to trigger Article 50, which initiates the Brexit process. The vote represents an unexpected challenge. However, Prime Minister Theresa May maintains that she is committed to a "hard" Brexit and would likely call a general election as a last resort, if further moves threaten the process. Meanwhile, U.K. economic data remains supportive, as GDP grew +0.5% in the third quarter and consumer credit rose 6.7% year-over-year in September. The falling U.K. pound supports exports, but also drives import prices higher.
- Thanks to the support of the Citizens Party, which opposes Catalan nationalism, Spanish Prime Minister Mariano Rajoy formed a new government following a June election which didn't yield a clear majority. Although it represents a step in the right direction, the new government faces very difficult decisions requiring the approval of other coalition parties. The proposed 2017 referendum regarding Catalan independence remains an outstanding challenge.
- Greece continues to face enormous economic challenges and awaits the release of additional International Monetary Fund (IMF) funds as part of its ongoing bailout. In October, European finance ministers generally gave the country a positive review and Wolfgang Schäuble, Germany's Federal Minister of Finance, expressed hope that the IMF would release funds before year end. The yield spread between Greek and German sovereign notes narrowed sharply on the news. In another sign of investor confidence, Greece successfully rolled over a six-month bill program at 2.97%.

Greece-Germany 10-year yield spread



As of: 11/9/2016. Source: Bloomberg

- On October 30 Canadian and European Union (EU) officials ratified the Comprehensive Economic and Trade Agreement (CETA), an EU-Canada trade deal, after negotiators reached a compromise with the Belgian region of Wallonia, which feared heightened competition from the Canadian agricultural industry. To become fully effective, CETA requires additional legislation and approvals in the Canadian House of Commons, the European Parliament and the national parliaments of EU member states.
- An investor sentiment survey published by Sentix, a German research firm, suggests for the first time that Italy is now more likely than Greece to leave the EU. The result is most likely due to disappointing Italian economic growth and a weakening banking system. The looming Italian referendum, scheduled for December 4 threatens to increase anti-European sentiment, if new proposals are not approved.

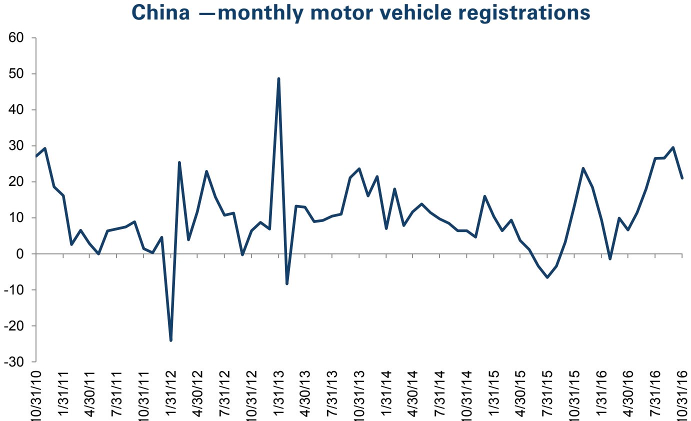
Europe — outlook

- The eurozone economic outlook is improving gradually. While the ECB's quantitative easing program lowered sovereign yields and absorbed corporate bond supply, it has been less effective at stimulating growth. We believe European yields will remain range-bound until investors sense that economic growth is accelerating. It appears unlikely that the ECB will implement policy changes before the end of 2017, because of elections scheduled in Belgium, Austria, France and Germany. Elections in the U.K., Italy, and Spain could also arise, if certain events unfold.

Rest of the world (ex-Europe and U.S.) — summary

- Haruhiko Kuroda, the Governor of The Bank of Japan, stated that there was no need to reduce asset purchases for now. Japan continues to struggle with deflation after the Core Consumer Price Index (CPI) fell 0.5% in September. The Bank of Japan pushed back its 2% inflation target to 2018.
- Australia's non-seasonally adjusted CPI increased 0.7% in the third quarter, exceeding the 0.5% consensus estimate. The slight pickup in inflation likely means that the Reserve Bank of Australia will keep rates on hold for the foreseeable future. Australia remains one of the few developed countries with interest rates higher than the U.S.
- The BRIIC countries are exhibiting tentative signs of economic growth.
- Russia's economy emerged from a long recession, reporting +0.1% GDP growth in the third quarter of 2016. In 2015, western nation sanctions and the fall in the price of oil severely affected the Russian economy.
- Industrial production in Brazil rose 0.5% in September and the country's economic outlook continues to gradually improve; although GDP growth for the full year 2016 likely will not reach positive territory. Favorable inflation trends contributed to Banco Central do Brasil's decision to cut rates for the first time in four years. Inflation is still running at 8.3% per annum, but is gradually declining.
- The Caixin China Composite Purchasing Managers Index (PMI) Index rose to 53.7 from 52.6, reflecting increased business confidence. Chinese auto sales continued to rise, affirming a pick up in the economy. Exports declined 7% in September on a year-over-year basis, continuing a disappointing trend and implying sluggish economic growth in Asia ex-China. However, both manufacturing and services PMI surveys exceeded 50, implying continued economic growth.

China —monthly motor vehicle registrations



As of: 10/31/2016. Source: Bloomberg

Rest of the world (ex-Europe and U.S.) — outlook

- Given the combination of loose monetary policy and some recent examples of fiscal stimulus, we expect an acceleration of global growth in 2017. Stable to higher commodity prices, ex-energy, continue to support our outlook. Currently, inflation concerns appear muted as significant areas of the world experience disinflation or outright deflation. For this reason, while we anticipate mild upward pressure on long-term rates, we do not currently expect a secular upward shift in interest rates. Although global markets anticipate a further rate increase from the U.S. Fed soon, some investors remain concerned that a rate increase not justified by economic fundamentals could jeopardize economic growth.

We expect an acceleration of global growth in 2017

Domestic

Initial market reaction to Donald Trump's election victory seems to include an assumption regarding increased fiscal stimulus and lower taxes. Consequently, equity markets have traded up slightly, bonds sold off, the yield curve steepened, and implied inflation break-evens jumped higher immediately following the election. Importantly, a Trump advisor stated after the election that the president-elect would neither seek Janet Yellen's resignation prior to the February 2018 expiration of her current term nor nominate her for another term. However, while most investors expect the Trump administration to initiate dramatic policy reversals, information regarding specific details remains scarce. We anticipate that uncertainty may linger and markets may react sporadically as actual policies emerge in the areas of taxes, regulatory reform, trade legislation and national security.

Recent economic data has not proved particularly noteworthy, and continues to depict the U.S. economy on a slow growth track with little evidence of inflationary pressures. Consequently, we believe a speech given by Ms. Yellen represents one of the most intriguing economic events of the past month. Ms. Yellen proposed that the 2008 recession may provide evidence of hysteresis (see next page), and that it may require reconsideration of certain accepted economic theories. Her question regarding hysteresis could add support for a lower-for-longer Fed interest rate policy.

We anticipate that uncertainty may linger and markets may react sporadically as actual policies emerge

United States — summary

- On October 28 the U.S. Department of Commerce's Bureau of Economic Analysis released its advance estimate of GDP growth. The report stated that real GDP grew at an annualized rate of +2.9% in the third quarter of 2016, beating the +2.6% Bloomberg consensus estimate. However, the underlying components of the number reflected weaker-than-expected trends and could portend slower growth going forward. Specifically, inventories and net exports contributed 0.61% and 0.83%, respectively, to the +2.9% GDP growth rate.

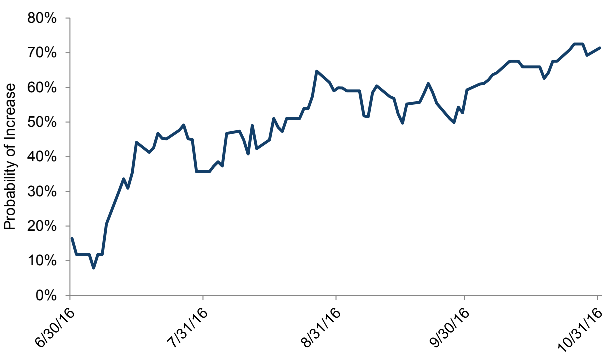
On October 14 Janet Yellen, Chair of the Board of Governors of the Federal Reserve System, gave a speech at the Boston Federal Reserve Bank entitled "Macroeconomic Research After the Crisis." In this speech, Ms. Yellen highlighted the concept of hysteresis as the idea that persistent shortfalls in aggregate demand could adversely affect the supply side of the economy.

- Accepted theory holds that, over the long term, economic output is driven by the growth in supply. Hysteresis essentially reverses that assumption and suggests that severe and persistent changes in demand can affect aggregate supply. Chair Yellen views today's environment as possible evidence of hysteresis by noting that economic activity in most advanced countries appears to have failed to recover to the trend exhibited before the 2008 recession. Consequently, she posed the question of whether existing views of how the economy works require modification.
- Ms. Yellen noted that two previous significant economic events reshaped economic theory and the behavior of the Fed. The Great Depression led the Fed to believe that weak demand should be met with monetary easing, while stagflation in the 1970s led the Fed to believe that anticipatory or preemptive tightening of monetary policy should be used to head off inflation.
- Chair Yellen further proposed that, if hysteresis sometimes occurs as a result of a deep recession, the next natural question should be whether it might be possible to reverse the effect by temporarily running a "high-pressure economy" with robust demand and a tight labor market. Ms. Yellen also hypothesized that hysteresis could make it even more important for policymakers to act quickly and aggressively in response to a recession, as decisive action could help reduce the depth of any economic downturn, thereby limiting any supply-side damage that might otherwise ensue.
- The implications for monetary policy going forward could be very profound, and provide clues regarding Ms. Yellen's thoughts on future Fed policy. Indeed, a lower-for-longer Fed policy conforms to the "high-pressure economy" she proposes and could potentially mitigate the effects of hysteresis.

United States — outlook

- The probability that the Fed will raise its target fed funds rate by year end steadily increased during the second half of the year and, as of October 31 equaled 71.4%, as measured by fed funds futures.

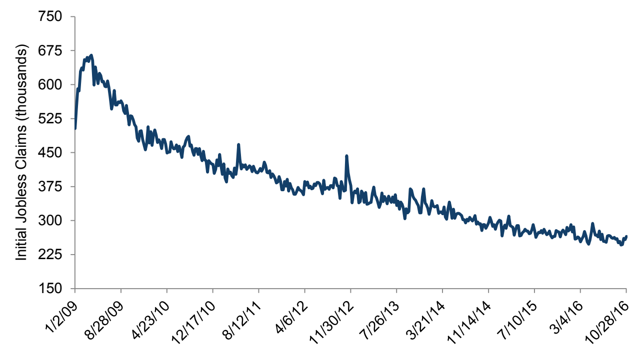
Probability of at least one U.S. Fed rate hike by its December 14-15 meeting



As of: 10/31/2016. Source: Bloomberg

- Rhetoric from Fed officials continues to indicate that they expect to increase the fed funds target rate at the December 14-15 meeting; markets appear priced for this move.
- The employment situation continues to be very healthy, as initial jobless claims remain historically low since the financial crisis.

U.S. weekly initial jobless claims



As of: 10/28/2016. Source: U.S. Department of Labor

- We anticipate that headline inflation will drift upward as higher oil prices begin to compare against lower prices in prior periods. However, core inflation (i.e., ex-energy and food prices) should remain well contained.
- We continue to expect that U.S. economic growth will remain at subdued levels in the coming quarters.