

# Perspectives

*Keeping you informed and engaged about macroeconomic trends and market events*



## The Underestimated

*"We know from chaos theory that even if you had a perfect model of the world, you'd need infinite precision in order to predict future events. With sociopolitical or economic phenomena, we don't have anything like that."*

—Nassim Nicholas Taleb

WITH TRUMP, BREXIT, A RESOUNDING "NO" TO ITALIAN CONSTITUTIONAL REFORM, and China's currency woes, the world economy embarked on a journey into the unknown in 2016, and, in a surprising twist, the markets liked it. While the prospect of shake-ups and swamp-draining may have fed the market's optimism, 2016 was also noted for a turnaround in global economic data, particularly a recovery in the mini-recession of global manufacturing. Indeed, after a weak start to the year, the global leading economic indicators tracked by the Organization for Economic Cooperation and Development (OECD) picked up in

the second half of the year, and the global manufacturing purchasing managers index rose to a 27-month high in November. In fact, the OECD upgraded its 2017 forecast for global economic growth to 3.3% in 2017, and upgraded the outlooks for the United States, Europe, Japan, and many other countries. Unlike a year ago, the global economy is accelerating as we head into 2017.

It will be an acceleration off a low base, though, as the world remains mired in a low-growth trap, producing the upside of a protracted period of economic recovery but the downside of an expansion that has

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Hopes for fiscal stimulus have driven a regime shift in markets from "lower for longer" toward reflation. The lows in bond yields are behind us as the risk of deflation fades, but some equity markets have moved quickly to price in optimism.

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The U.S. economy boasts a strengthening labor market, recovering housing market, record-high stock market and low interest rate environment. President-elect Trump is poised to continue that reflation with low tax rates and fiscal stimulus, but has risky foreign policy, trade, and immigration proposals.

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Since the shocking Brexit vote, the U.K. economy has been resilient, and little evidence of contagion has emerged in Eurozone data. In Japan, BoJ policy efforts coupled with President Abe's reforms have sparked a meaningful economic turnaround.

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Emerging market fundamentals have improved, and while antiglobalization threats are a risk, rising commodity prices and reasonable equity valuations may provide an offset.

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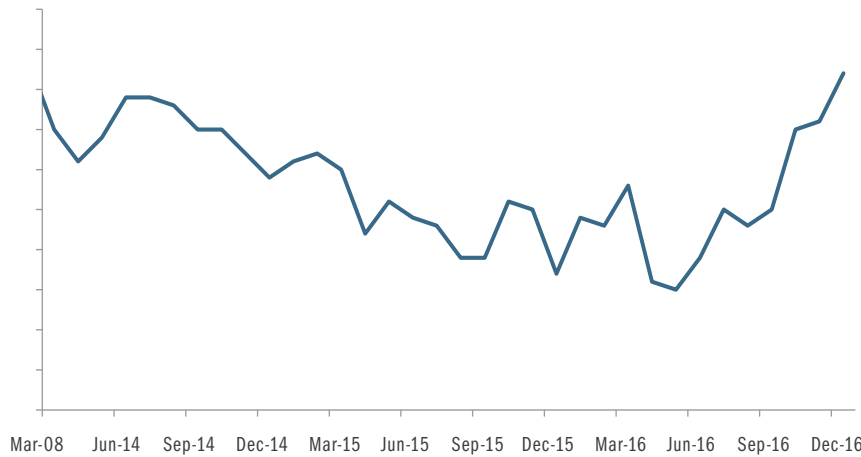
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**Markit Global Manufacturing PMI stages an impressive recovery in the second half**



never quite seemed to be able to get out of first gear. A grave risk to that acceleration is the recognition that the ability for the global economy to continue a positive path forward must hinge on the more active use of fiscal policy, as monetary policy initiatives have all but been exhausted in a zero and negative interest rate world.

And with new actors on the global stage making those fiscal policy decisions, the path forward is anything but clear. In the past, we have seen the benefits of collective and coordinated fiscal and monetary policy has enabled greater gains at lower cost: the most recent being in the aftermath of the 2008 financial crisis, when leaders of monetary and fiscal policy from around the globe took steps to restore the credit markets with reduced interest rates and “shock and awe” monetary and fiscal stimulus. The pitfalls of uncoordinated action and approaches have been exemplified more recently by the moves to austerity budgets that triggered the European sovereign debt crisis. As for populism, while in the early stages it can unleash powerful animal spirits and bring forward consumption, it can also end badly, as the people of Italy have experienced under the regime of Silvio Berlusconi and almost all Latin American governments experienced at one time or another since the end of World War II.

While the chances of Brexit or a Trump presidency might have been underestimated, the market’s sanguine, if not pollyannaish, reaction to these seismic shifts were

even less expected, leaving many scratching their heads and looking for another shoe to drop. Some expect the so-called “Trump effect” on markets to fizzle out, as the proposed market-friendly changes in taxes and regulations are offset by the negative consequences from Trump’s trade and immigration policies. Others see momentum building in markets that will benefit from a pro-business administration, with the risk of igniting inflation the only real threat to forward-looking gains.

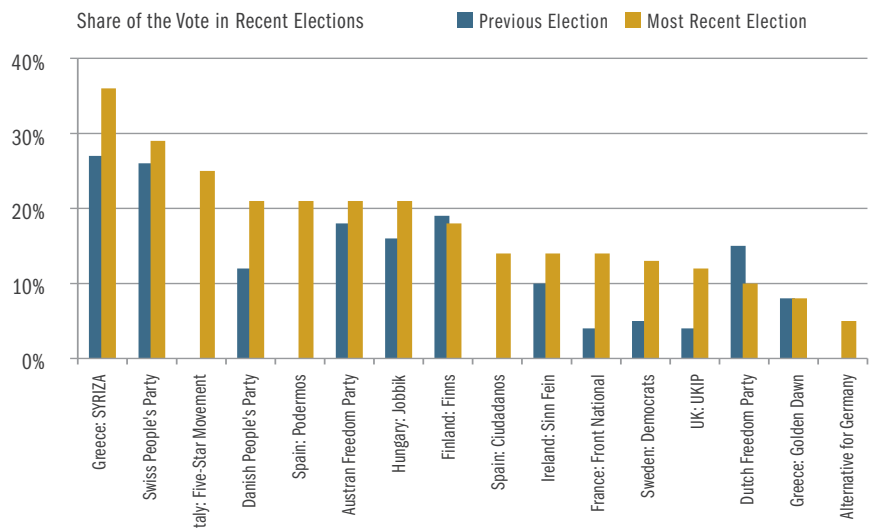
Understanding the prioritization of major shifts in policy will be important to having a hope of estimating the pace and direction

of market action in the year ahead. For this reason, Trump’s first 100 days will set the tone. Also important will be the way global relationships evolve, as Brexit and Trump’s proposed trade policy changes may have a destabilizing effect that could sow the seeds of future conflict. The words and actions of Prime Minister May and Angela Merkel, as well as Trump’s interactions with China, Russia, Japan, and other global powers all have the potential to be game-changing.

Electoral jolts continuing in Europe in 2017 are a more concrete risk that could swiftly create an inflection point in the markets. Of the elections to come in Europe this year, we view the French Presidential race as the most critical race to watch, given the implications for the euro and EU and ultimately, the global banking system. While Brexit has certainly damaged the cohesion of the EU, it is also true that the U.K. had always maintained an arm’s length in its membership, as one of the few EU members that was not a member of the currency union. As such, Brexit was unlikely to create a bank run as depositors were not threatened with having their savings converted to some new currency of questionable backing.

In contrast, a decision by French voters to elect far-right candidate Marine Le Pen of the National Front would raise the bar of risks, especially as it relates to the banking system. Le Pen has vowed to put a French

**Populist parties gaining traction across Europe; are there more Brexits to come?**



exit on the ballot as soon as she is elected. While being placed on the ballot is not a guarantee that voters would vote to Frexit, the mere risk of it would likely send most equity markets and the euro lower.

The French election has two stages, a preliminary one held on April 23 that will determine the two largest vote getters who will square off for a final round on May 7. While Le Pen is not favored to win the election, she is far from a longshot in betting markets with current odds of her winning at about 1 in 3.

For now, François Fillon, a center-right candidate with business friendly policies, is leading the polls. His victory would be very bullish for France and the Eurozone as it would likely remove the threat of a Frexit and provide an important inflection point for Europe and the euro. While there are

other high profile elections in Europe in 2017, including the Netherlands and Germany, we believe it is unlikely further exit ballots will appear. The right-wing, populist, euroskeptic, anti-immigrant party led by Dutch Geert Wilders is gaining traction, but he is still far from the majority required to form a government. While Angela Merkel at this time has only about a 50/50 chance of winning her election in betting markets, Germany's constitution does not provide for a national referendum such as Brexit or what Le Pen is proposing in France, and polls indicate that more than 80% of Germans still believe in the union, even if they have lost faith in Merkel. And while following the resignation of Prime Minister Renzi, there is plenty of scope for a shock from Italy, for now no general election has been called. That said, a

vote towards the end of 2017 could gain momentum, and with the Five-Star movement leading the polls, there is a possibility for Beppe Grillo to come to power and bring a referendum on the euro there in early 2018.

Of course, other risks exist for the markets, including changing monetary policy, the continued threat of terrorism, and geopolitical developments in emerging markets (for example, unpredictable policies in the Philippines, Russia's foreign policy adventures, political uncertainty in South Africa, and ongoing political and economic uncertainty in Venezuela). As always, the markets will grapple with challenges and opportunities, and if the last eight years have taught us anything, staying invested and diversified is the most important way to level the playing field between the expected and unexpected.

## GLOBAL ECONOMIC OVERVIEW: A Mild But Synchronized Upturn Underway

**FOR SEVEN YEARS**, the global economy has been mired in a long, slow, fragile, and ultimately mediocre recovery. While a shift from subpar to stellar is unlikely, we do expect 2017 will mark a year of relatively stronger growth and higher inflation. In the U.S., a virtuous circle of rising wages, good job gains, robust household spending, and rising corporate profits should encourage capital spending and induce another round of growth. The impact of Trumponomics remains to be seen, but optimism over lower tax rates and the prospects for fiscal stimulus could pull forward business and consumer spending to the U.S. econo-

my's benefit. As for Europe, a broad range of data releases have confirmed that an economic revival was underway in 2016, in spite of political machinations. Low growth is sustainable assuming an EU disintegration is averted, especially as strong ECB asset purchases through 2017 should limit the increase in European bond yields and keep monetary policy supportive. As for the U.K., while 2016 economic data showed resilience despite Brexit-related uncertainty, the outlook for 2017 depends heavily on how the proposed "hard" Brexit scenario plays out, including the pace and terms of trade negotiations and the risks

to the important U.K. financial services sector. For sure, Japan has been a key beneficiary of the global deflation narrative and expansionary fiscal and monetary policy. Finally, emerging economies continue to slog on, and as a whole are better prepared to face the headwinds of higher U.S. rates and a strong U.S. dollar than in recent history. The manufacturing cycle has absolutely picked up in recent months, and current account deficits have been coming down. A recovery in oil prices has also given a short-term boost to the outlook of emerging economies in Latin America and Russia.

## U.S. ECONOMY: The Great Reflation

**SINCE THE ONSET OF THE GREAT RECESSION**, monetary policy has arguably been at the epicenter of the U.S. financial and investment universe. First, it was the extremes of near-zero policy rates and quantitative easing enacted by the Federal Reserve in an effort to kick start the economy coming out of the recession, followed more recently by the "on again, off again" guessing game of

when the first Fed funds rate hike would take place, which finally occurred in December 2015. Now, one year later, the Fed has concluded to raise rates by a quarter point for the second time—only this time the media buzz and market reaction following the announcement was limited. In part, it was because President-elect Trump's surprising victory in the Novem-

ber presidential election had already shifted attention in a different direction, away from monetary policy and toward the proposed fiscal policies of the incoming administration.

During the course of his campaign, the President-elect put forward a number of proposals aimed at providing fiscal stimulus, primarily focusing on three key areas:

tax reform, infrastructure spending, and regulatory reform. Tax reform in particular would suggest significant economic stimulus: lower taxes, more capital spending, corporate cash coming back into the U.S., and less drag from excessive regulation enacted over the last several years. An end to punitive taxation of foreign earnings of U.S. companies would eliminate company inversions and allow the hundreds of billions of offshore dollars to come back for U.S. capital spending. Although there

is still much left to be determined, the intended direction of future policy appears clear, with the stated goal of providing a boost to economic growth domestically.

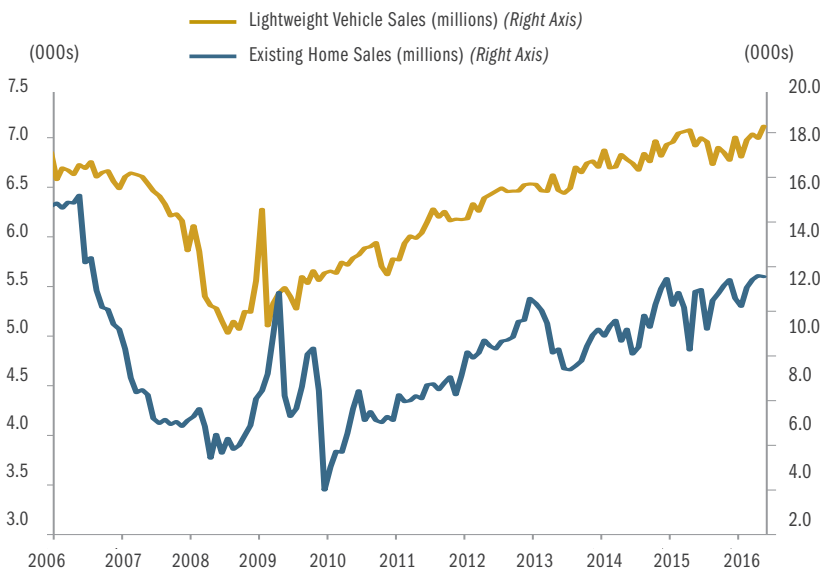
As a result, incoming data following the election indicated that consumer confidence and small business optimism soared in December. Yet even before the election, there were already signs of an improving U.S. economic landscape. GDP grew at its strongest pace in five quarters in Q3, at a 3.5% annualized rate, more than double the

pace of the prior quarter. Consumers did the heavy lifting in pulling the economy forward this year, while business investment was a drag. A hope and expectation of the Trump economy is for businesses to begin to pull their weight.

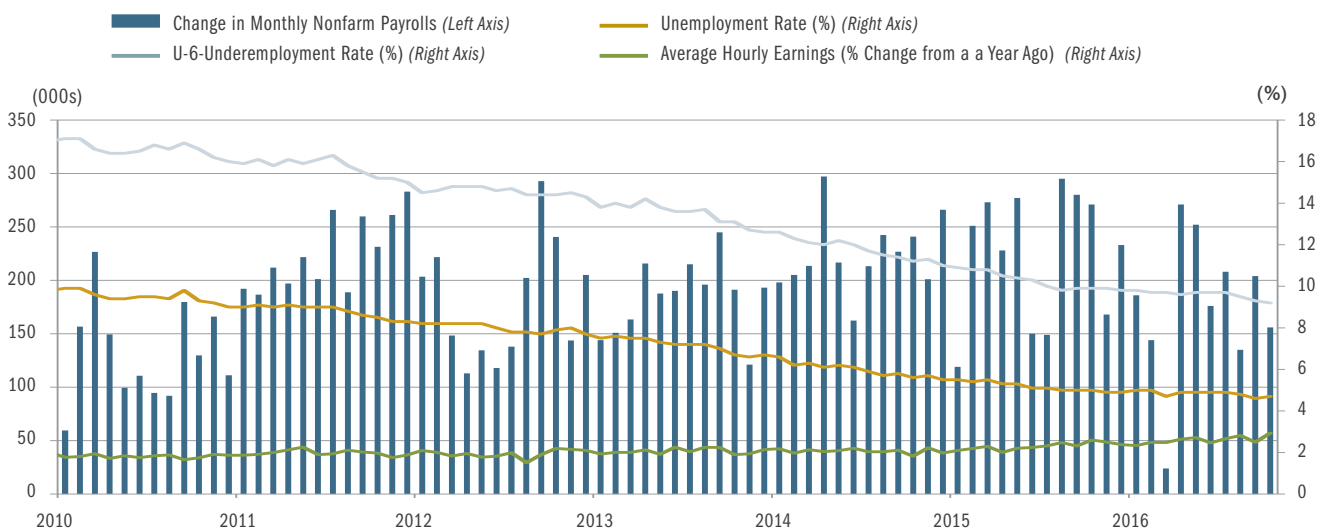
Strength in GDP and personal consumption was made possible by continued improvement in the labor market. Job creation remains strong, with the U.S. economy adding an average of 165,000 new jobs per month from October through December. The unemployment rate has remained below 5% for eight consecutive months based on revised data in the December jobs report. The more comprehensive U-6 unemployment rate, which includes all persons marginally attached to the labor force (including discouraged workers), plus those employed part-time for economic reasons, also continued to improve in 2016: it currently sits at its lowest level since 2008 at 9.3%. It was particularly encouraging to see these metrics improve alongside a growing labor force participation rate. The labor force participation rate for 25-54 year olds, which excludes most college students and retiring Baby Boomers, saw its first meaningful improvement this year since before the financial crisis. We remain hopeful that continued tightening in the labor market will translate into stronger wage growth in 2017.

Another positive development for the U.S. consumer in 2016 was a further recovery in the housing market. Homes sales

**Home and auto sales hit highs in 2016, showing the strength of the U.S. consumer**



**The labor market continues to strengthen and drive growth**



hit a record in 2016, and, according to the S&P/Case-Shiller National Home Price Index, home prices recently eclipsed their peak from 2006. There are a couple caveats to this data though. First, this is not the case in all parts of the country (location, location, location, as they say). Second, the recovery has been uneven among price ranges. Higher-end home prices have recovered much faster than more moderately-priced homes.

Also important to monitor has been the shift in inflation expectations, which reversed their downward trend from earlier in the year, but went into overdrive in the aftermath of the election. At the same time, long-term interest rates rose substantially, swiftly erasing the nearly 1% decline that had accumulated throughout the first

half of the year. However, though the Consumer Price Index (CPI) reached 1.7% on a year-over-year basis in November, its highest level in a year, the core Personal Consumption Expenditures (PCE) Index dipped to 1.6% in November, remaining well below the Fed's 2% target.

As noted earlier, the Federal Reserve recently announced an increase in the short-term federal funds rate on December 14 for just the second time since 2006. Based on the latest projections from members of its Federal Open Market Committee, the Fed expects to raise interest rates three additional times in 2017. Of course, the FOMC projected four rate hikes in 2016 but raised rates just once. Even as the Fed is expected to raise rates in 2017, both the European Central Bank (ECB) and Bank of Japan (BoJ)

are likely to continue their quantitative easing programs. Despite diverging monetary policies, we believe that exceptionally low interest rates overseas are likely to pressure rates here at home, while at the same time maintain our currency at a 14-year high.

In summary, while the economic recovery has been uneven for some Americans, overall, the strengthening labor market, recovering housing market, record-high stock market and low interest rate environment have greatly improved the balance sheets of millions of households. Only time will reveal the specifics of future fiscal policy, and whether or not it will live up to expectations. However, current data suggests that the U.S. economy is staged for continued growth in year ahead.

**DEVELOPED INTERNATIONAL ECONOMIES: Defying Expectations (For Now)**

**THE U.K. SPRANG ONE OF THE GREAT SURPRISES** this year by voting to leave the European Union, the outcome which economists and experts alike touted as an economic catastrophe. Since the vote, however, the U.K. economy has outperformed most forecasts and economic data as shown amazing resilience, with a few indicators rebounding with surprising strength. Indeed, U.K. GDP is expected to show a 2.2% annualized reading for 2016, and indi-

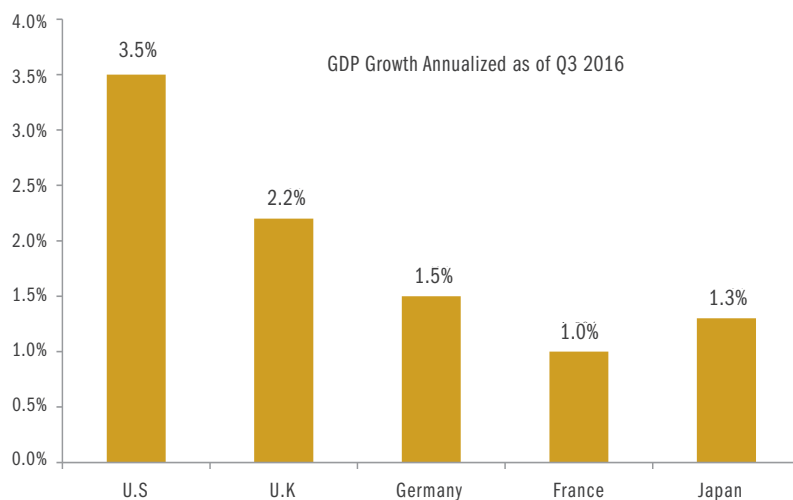
cators of consumer health including new car registrations and home sales have continued to rise. It may yet be a different story in 2017 as trade negotiations begin in earnest after British Prime Minister Theresa May triggers Article 50, the legal route to leaving the EU.

The actual act of EU departure could take any number of forms: it could closely resemble the current arrangement or become complete U.K. removal from the EU's single market, which Prime Minister

Theresa May has telegraphed. Britain's High Court may have made the process more difficult by ruling that the government needs Parliamentary approval before triggering Article 50. So, uncertainty could stifle the U.K. economy in the interim. Offsetting that uncertainty is a Trump administration more willing to negotiate a bilateral trade agreement with the U.K. In contrast to President Obama, President-elect Trump has said the U.K. would not have to go to the "back of the queue." For its part, the Bank of England has finished its policy easing and may look at rate hikes next year, depending on how the Brexit plays out.

Eurozone data has also been durable with little evidence of contagion from the Brexit vote. Economic sentiment has improved; bank lending rates have plunged and loan demand is rising as lending standards ease; credit is more available; investment is rising; and business surveys are near several year highs. Joblessness has fallen a great deal, but at 9.8%, is still high. Household spending is driving the expansion. Consumers seem to be eager to spend some of their gasoline and interest savings, and the U.K. vote has not changed those fundamentals. So, the ubiquitous forecasts of recession or slump in Europe are proving

**Post-Brexit U.K. GDP shows no weakness**



way off base. Issues from Brexit trade negotiations may haunt the EU in the longer term, but the economies are paying little heed for now. Though the outlook was not as weak as many had feared, the ECB chose to extend their quantitative easing program to December 2017, but at a reduced pace of €60 billion per month. On the domestic political front, Italy saw a change of prime

minister with Matteo Renzi resigning after losing a referendum on constitutional change. Paolo Gentiloni, also from the centre-left, is the new prime minister. In Spain, Mariano Rajoy was elected for a second term as prime minister after ten months of deadlock following inconclusive elections.

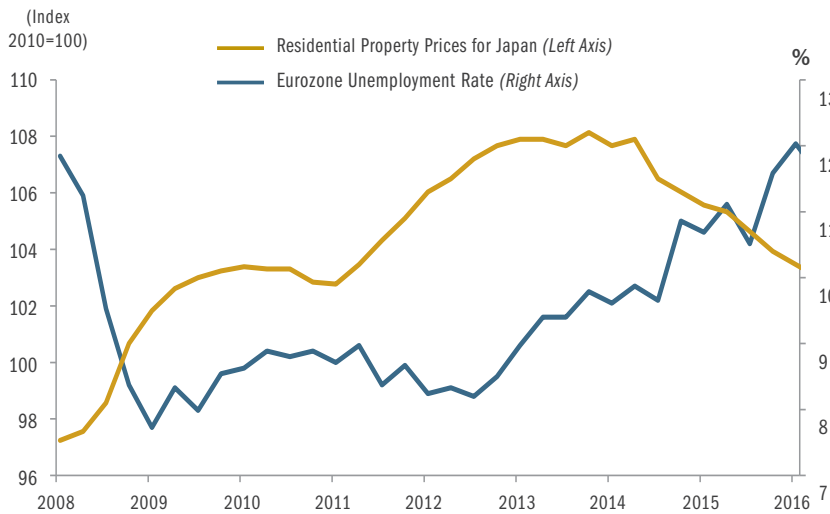
In Japan, the biggest news in the quarter came from the BoJ which made two signif-

icant policy changes in the last few months. First, they are using bond purchases to peg the yield on ten-year government bonds at 0%, making the size of monthly bond purchases much more flexible. Second, the BoJ committed to keep the current policy in place until well after inflation reaches the 2% target. Though some investors shrugged off this news as much ado about nothing, these changes are significant as the BoJ balance sheet can keep growing through 2017 and stay very large for a very long time. This is essentially government spending financed by new money from the central bank, i.e. Milton Friedman's "helicopter money." It may take a while for markets to recognize it, but this is surely a big negative for the yen in the long term. It is likely a positive for Japanese company profits and thus positive for the local stock market in yen terms.

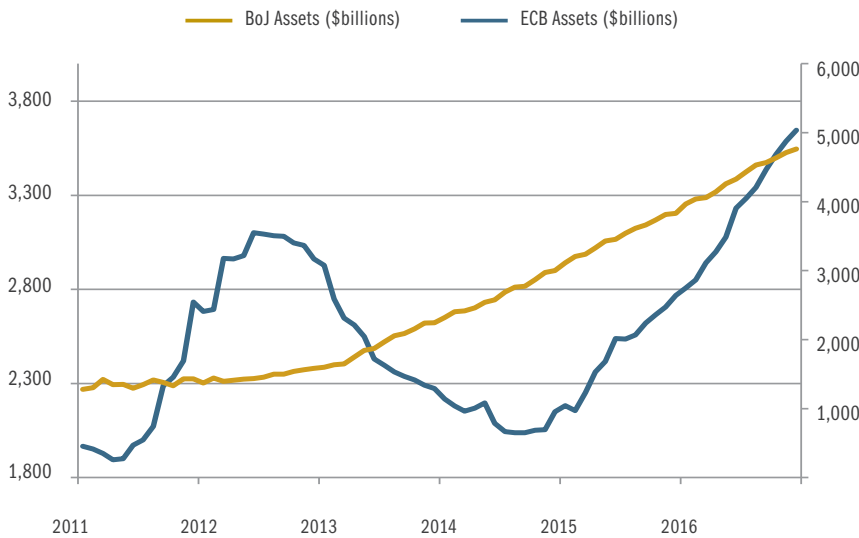
As for economic data, Japan's job market has continued to improve, with unemployment falling to its lowest level since the mid- 1990s. Confidence surveys also suggest that economic momentum has been picking up, even though retail sales have remained soft. Bank lending is moving up, and manufacturing looks firm. The removal of the next VAT (value-added tax) increase was helpful for expectations. Despite the strengthening economy, core inflation is likely to fall back to zero over the coming months and remain far below the BoJ's 2% target over the next two years. Indeed, the central bank's own forecast is for inflation to remain below 2% until at least fiscal-year 2019. Yet, we expect BoJ policy rates to stay on hold. There is growing concern about the impact of low and negative interest rates on financial institutions. This is justifiable, since low rates directly hurt bank profitability and may prompt an unwanted tightening in credit conditions. However, if the yen fails to weaken materially from its post-U.S. election strength, the call for further policy loosening may grow stronger.

On a final, less hopeful, note it was notable that the Australian economy posted its worst decline since 2008, as businesses, consumers, and governments all cut back on spending, a shock result that threatens both the first Aussie recession in a quarter of a century and the country's vaunted AAA.

**European unemployment and Japanese real estate prices, once in the doldrums, are staging a turnaround**



**The ECB and BoJ will remain active in QE to keep growth momentum alive**



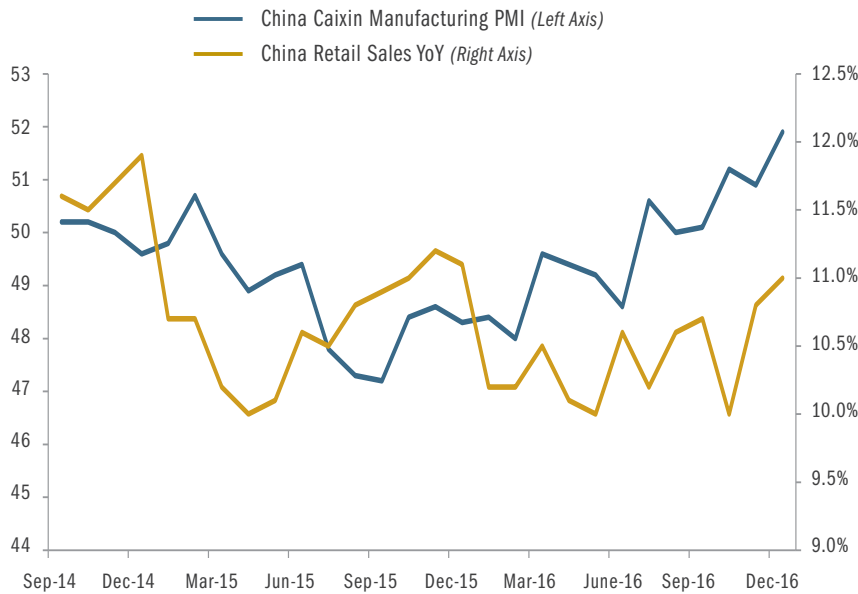
**CHINA & EMERGING ECONOMIES: On A Roll**

**THE STORY FROM CHINA** is one of economic stabilization and mild rebound. Deflation pressures are easing in the world’s second-largest economy. Producer prices in China have fallen year-over-year for almost five years, putting both private

much of the upturn relies on fiscal stimulus, and state-owned enterprises are behind a good deal of the recent investment gains. However, in the last quarter, private companies increased their capital spending. Lower interest rates have eased the pres-

As for other emerging markets, the synchronized global economy’s rising tide has lifted emerging market countries, weak and strong alike. Current accounts, which hit their lowest point in 2013, have posted three consecutive years of improvement. As oil prices have firmed and political crises eased, Brazil and Russia may exit their recessions. Brazil has taken an important first step in freezing public spending for up to 20 years in an attempt to tame its large budget deficit. In Mexico, President Enrique Peña Nieto introduced energy, telecom, education, and tax reforms in 2016. Meanwhile, in Argentina, President Mauricio Macri in his first full year in office allowed the peso to freely float, lifted taxes on grain and beef exports, and negotiated with the country’s holdout creditors. A tech-related output bounce in Asia is supporting growth momentum. Price pressures are easing with a softening of food prices and limited pass-through of oil prices, giving central banks further room to provide additional stimulus. And while several developed markets are facing low or negative interest rates, there has been some room for emerging market central banks to cut rates, if they wished. Colombia’s central bank reduced its benchmark interest rate in December for the first time in almost four years, a surprise move after months of tightening that led inflation to fall faster than expected. Central banks in Peru and Chile kept their key rates on hold in December, though Chile’s bank signaled that a rate cut was likely in the near term given prolonged economic weakness.

**Chinese growth rebound evident in manufacturing and retail sales**



and state-owned companies under terrific profit stress. Now, year-over-year producer prices have been positive for two months, which is providing a terrific profit boost. Manufacturing business surveys are well up from their lows and at their highest levels since July 2014; surveys of service companies are the highest since June. Confidence is improving. One driver of the modest revival has been the property market, since house prices have been surging in first- and second-tier cities. Housing starts picked up dramatically early this year; the gains have eased substantially, but are still rising. Passenger vehicle sales are soaring, up 20% over the prior year. The economy has more than stabilized, and with deflation easing, nominal growth is improving. Chinese GDP posted 7.8% annualized growth in the third quarter versus only 6% at the low. Credit and money supply growth also remains strong. To be sure,

sure from high debt levels and the central government will likely keep the stimulus coming. This all bodes well for the Chinese economy in 2017.

What does not bode well for China and many emerging markets is Donald Trump. As a candidate, Donald Trump assailed U.S. trade with China and promised to add a huge tariff to all Chinese imports. Any emphasis from Trump on trade, tariffs, cancelling trade agreements, stopping immigration, or other anti-globalization measures will be a big headwind for emerging markets, particularly in Asia and Latin America. However, talk is cheap on the campaign trail, and for now, it appears Trump’s advisors are focusing more on tax and regulatory reform than a significant hit to trade. The positive from a Trump presidency is the anticipated boost in U.S. growth from the potential fiscal stimulus. Faster growth in the U.S. is positive for virtually all world economies.

Investor flows have picked up and were —before the U.S. election result—expected to accelerate further in 2017. That may be different now, but investors would do well to remember the long-term investment opportunity in emerging nations from the rise of a middle class. After all, compared with developed markets, most emerging markets have more attractive demographics and a stronger tailwind from rising consumption as the middle class expands and real wages increase.

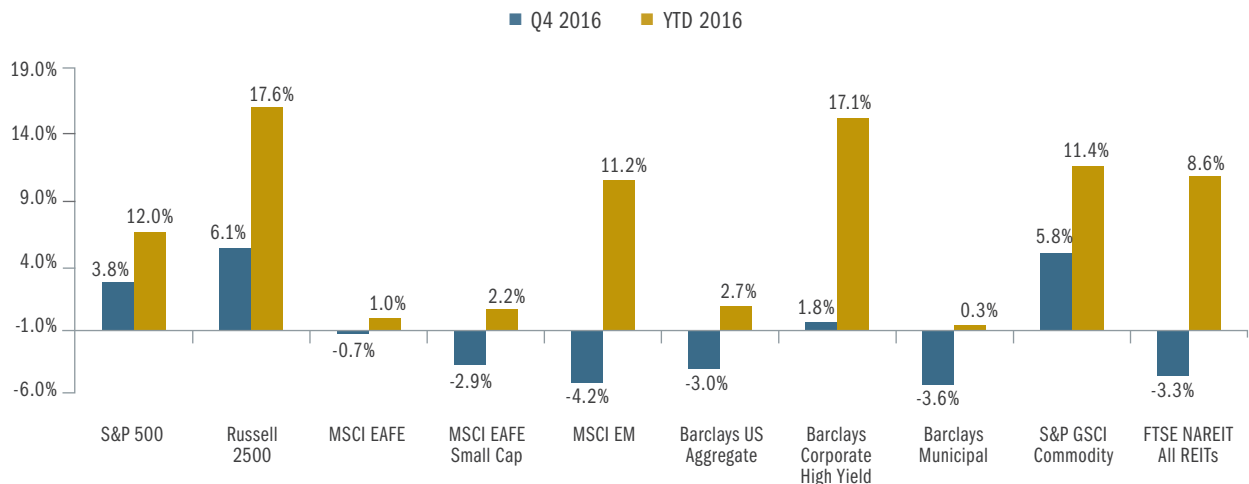
## GLOBAL MARKET OUTLOOK: Surprising Strength

AS 2016 WINDS DOWN, global investors can reflect on a volatile year, full of surprises. A double-digit correction in the first six weeks welcomed investors into the new year, sparked by a December 2015 rate hike in the U.S., as well as concerns over the slowing Chinese economy. Post the decline, equities rebounded strongly, aided by global central bank support and surging commodity prices. Central bankers soothed investors' nerves throughout the year with their accommodative policies and/or dovish rhetoric. Other factors driving investor sentiment included rebounding oil prices as well as a strengthening housing market in the U.S. The surprises of

the year, however, were driven by elections. The U.K.'s Brexit vote to leave the European Union provided a brief, but sharp, sell-off mid-year. This was followed by a quick recovery, but ongoing uncertainty in terms of how such an exit will actually happen. Donald Trump's November victory in the U.S. presidential election led to a surge in the U.S. equity market, highlighted by rotation into previously out-of-favor segments such as health care and financials. In contrast, emerging market equity gains were cut back on concerns that a Trump administration would lead to trade protectionism, higher inflation, and a stronger U.S. dollar. European and Japanese equities

struggled throughout the year, as any positive momentum continued to be cut back by political uncertainty. There was nothing uncertain about the sell-off in the bond markets in the final month of the year, as global bond yields surged in the fourth quarter, led by U.S. Treasuries with the Fed raising rates and expectations for profligate fiscal spending from Trump lifting inflation expectations. Optimism that the policies of the incoming U.S. administration and Congress would emphasize tax reform and deregulation boosted the corporate credit markets, while municipals suffered on fears of permanently compromised demand due to lower tax rates. Commodities rallied

### Some markets melt up in the wake of Trump



during the quarter, led by energy, while REITs imploded as interest rates surged. Despite the many headlines and volatile price swings of 2016, the markets rewarded investor patience with a reasonable gain as payback for their perseverance.

### U.S. stocks enjoy an unexpected Trump bump

U.S. equities rose for the fifth straight quarter, ending the year up 12.0%. Despite a common perception that markets preferred Hillary Clinton, stocks soared following Trump's victory on hopes of increased

fiscal stimulus, reduced regulatory restrictions, and lower corporate taxes. Following the November election, the reflation trading theme dominated, leading to big equity inflows and the largest exodus from bonds since the "taper tantrum" in 2013. A Republican majority in Congress is likely to reduce gridlock in Washington, and there may be momentum behind tax reform and repatriation of overseas profits. The Fed gave the U.S. economy another vote of confidence in December by deciding to increase the policy rate for the first time since December 2015. While market participants had largely priced in a Fed rate

hike, the statement and press conference following the meeting were more hawkish than expected, particularly the shift in view toward three rate hikes in 2017 versus the two previously expected.

Within the S&P 500 Index, eight of the eleven sectors posted positive results in the fourth quarter. Financials stocks soared following Trump's win. Banks were the greatest beneficiaries as the post-election backup in bond yields and expectations of deregulation served as a major tailwind. The energy sector saw big gains after OPEC agreed to its first cut in oil production in eight years. After posting the worst return



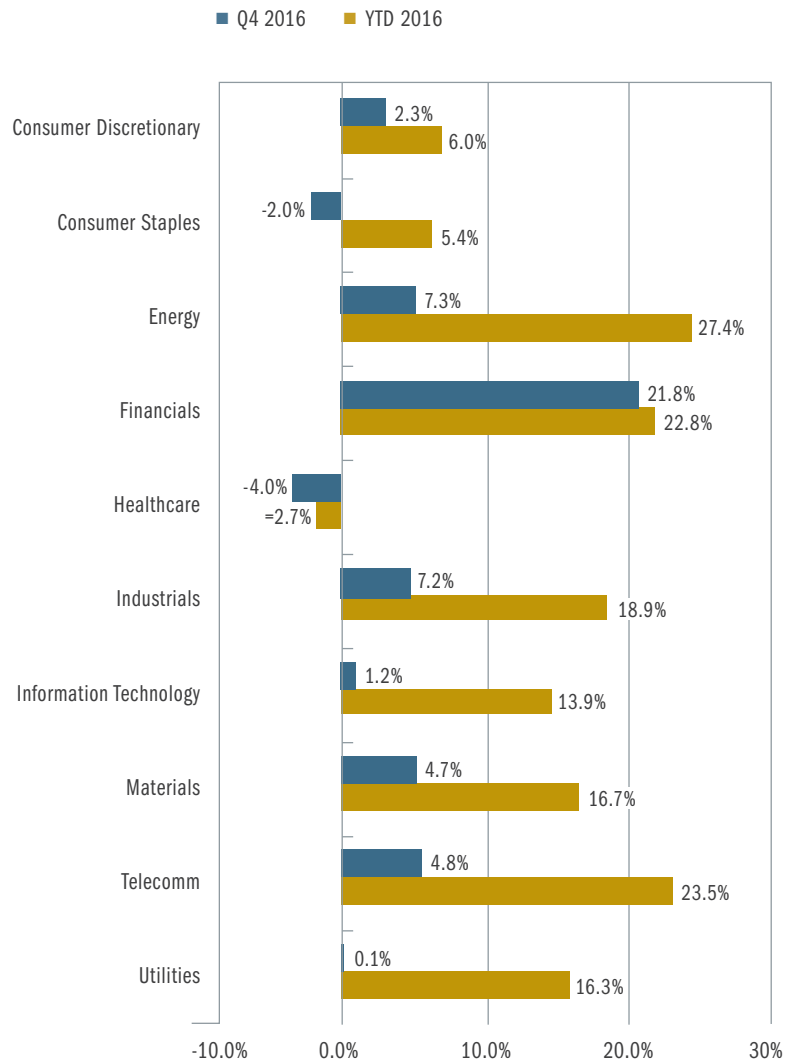
in 2015 (-21.1%), energy was the top-performing sector in 2016 (+27.4%). Infrastructure plays (industrials, materials) also outperformed amid Trump's call for a ramp-up in infrastructure spending. Some of the biggest laggards during the quarter were the bond proxies, including REITs, consumer staples, and utilities. Health care stocks were also weak following several high-profile earnings disappointments and renewed political fears. Health care was the only sector to post a negative return in 2016 (-2.7%).

In terms of capitalization, small caps surged higher in the wake of Trump's election, supported by the expected pro-growth policies of his administration and more insulated from the risks of a strong dollar and protectionist trade policies. Value dominated growth throughout the year, thanks to the commodity recovery, rising interest rates, and the perception that Trump's pro-growth policies would support more cyclical economic sectors. Overall, while valuations do not appear as cheap as before, the value style may have the potential to run further given its late cycle characteristics and the prospect of more rate increases by the Fed over the course of 2017.

### Developed international equities suffer

Eurozone equities were flat over the quarter, as the outcome of the Italian referendum and resignation of Prime Minister Matteo Renzi weighed on results. As in the U.S., activity was marked by a rotation away from the more defensive, 'bond proxy' sectors, and towards value areas of the market that are seen as beneficiaries of rising bond yields. This rotation picked up momentum after the U.S. presidential election victory for Donald Trump in November. Financials was the top performing sector as rising bond yields eased concerns over banks' profitability. In addition, Italian banks performed well as expectations grew that the government would intervene to support them if required. Commodities-related stocks were also strong, especially in the energy sector.

### S&P sector leadership continues its big reversal, with value segments on top



The U.K. markets lost some modest ground in the fourth quarter, despite the new U.K. Chancellor of the Exchequer Philip Hammond officially abandoning his predecessor's pledge to run a balanced budget. He set out modest spending plans in his first Autumn Statement and left the option open to borrow and spend more. Meanwhile, Prime Minister Theresa May criticized the Bank of England's (BoE) stimulus policies. Gilt yields rose, accentuating the rotation from defensives and towards cyclical areas of the market. The pound sterling had a bit of a roller coaster, falling sharply in early October following the prime minister's rhetoric concerning a "hard Brexit" at the Conservative Party

conference. The currency subsequently recouped some of its losses after the BoE upgraded U.K. growth projections, the High Court ruled parliamentary approval was required to start the EU exit process, and the government struck a more conciliatory tone over Brexit.

Japanese equities rose each month in the quarter to produce a strong total return of +15.0%. However, with the drastic weakening of the Japanese yen, returns in U.S. dollar terms were flat, and only modestly positive for the year. Although the rise in interest rates could ultimately outweigh the BoJ's desire to maintain 10-year yields around zero, the current conditions remain manageable. Therefore, as widely expected,

there were no changes made at the December meeting of the policy committee. While the U.S. election was the key event driving investor sentiment, market leadership in Japan remained broadly unchanged from previous quarter. As a result, the market was driven upwards by financial-related sectors, especially securities companies, banks and insurance stocks, which are seen as the major beneficiaries of higher interest rates. Conversely, defensive areas such as foods and pharmaceuticals, which had lagged the market since July saw further sharp underperformance, especially in November and early December.

**Emerging markets cut back on their comeback**

The MSCI Emerging Markets index recorded a negative return in the quarter, owing to uncertainty over U.S. trade and foreign policy, as well as the prospect of tighter U.S. dollar liquidity. Those markets and currencies perceived as most sensitive to a tighter global interest rate environment posted the steepest declines, which included Turkey, Malaysia and Indonesia. Uncertainty around a potential change to U.S. trade policy was also a headwind to certain markets in particular. Mexican equities and the peso were directly impacted by these concerns and the central bank hiked rates 50bps to 5.25% to support

the currency. The Chinese market also lost value in part given concerns of protectionist policy implementation by the U.S. The potential for U.S. monetary policy tightening to accelerate has supported the U.S. dollar and led the renminbi to devalue, increasing pressure on capital outflows from China.

Over the strait in Taiwan, the market was down, driven by the technology sector on the back of uncertainty surrounding trade policies following the outcome of the U.S. presidential election. Similarly, Korean equities were down on protectionist concerns as well as on an ongoing corruption scandal involving President Park Geun-hye. The Philippine market was the biggest loser given governance concerns that President Rodrigo Duterte’s brutal crackdown on drugs could harm business sentiment. Meanwhile, India’s market declined as the economic fallout from an abrupt government ban on existing 500 and 1,000 rupee notes weighed on investor sentiment

By contrast, a recovery in energy and commodity prices was beneficial for a number of markets. Russia registered the strongest index return, boosted by a rally in Brent crude. This followed the agreement of production cuts by OPEC, with further agreements with ten non-OPEC members including Russia subsequently reached. Expectations for higher fiscal spending in the U.S. triggered a strong

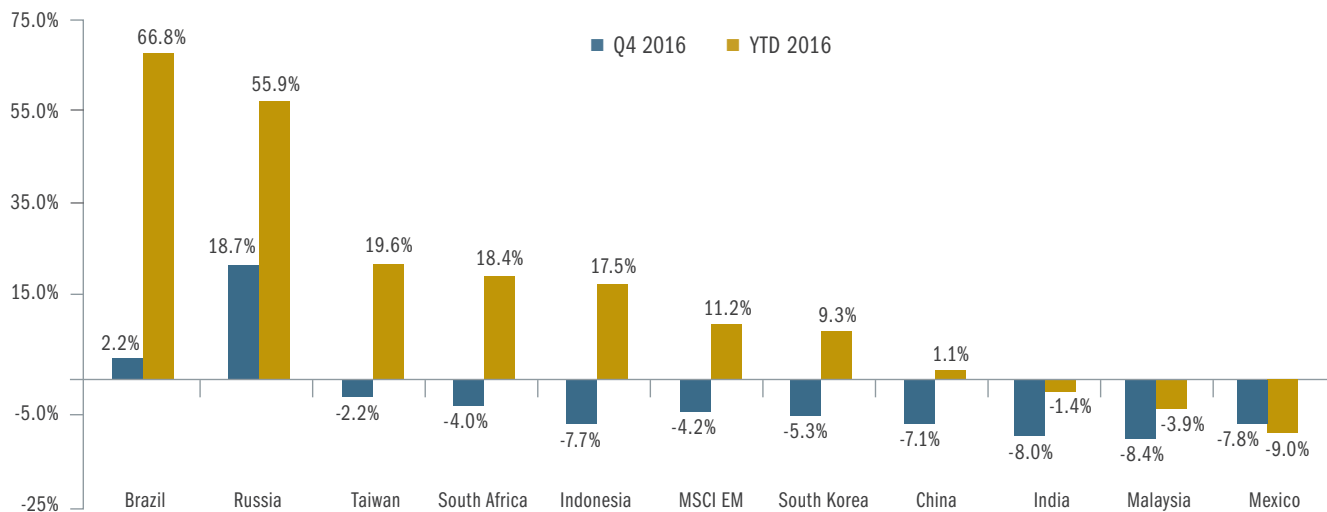
rise in industrial metals prices, particularly iron-ore but also copper. This benefited Latin American equities with Peru, Chile and Brazil all registering positive returns and outperforming.

For the year, emerging markets were a top market segment, as strength in the second and third quarter enabled the asset class to still put up an over 11% return.

**Fixed income focuses on central banks**

The cyclical bottom in yields likely occurred on July 8, 2016, when Brexit fears drove the 10-year U.S. Treasury yield down to a low of 1.36%. Since then, the collapse has been extraordinary as rates have nearly doubled to 2.6%. We have long been waiting for U.S. monetary policy to normalize and start reflecting the underlying fundamentals of the U.S. economy—we are finally getting it. Concurrently, we are also seeing a hand-off from ultra-easy accommodative monetary policy to the anticipation of a more pro-growth fiscal policy focused on tax reform and deregulation. This combination has boosted equity markets and sapped demand for the U.S. Treasury safety trade. While some investors appear unnerved by the rapid move in rates, it is notable that rates have mostly just unwound the 2016 fear-induced rally and are only slightly higher than they were at the end of 2015.

**Emerging market equities deliver strong returns in 2016, but (mostly) slump on Trump election**



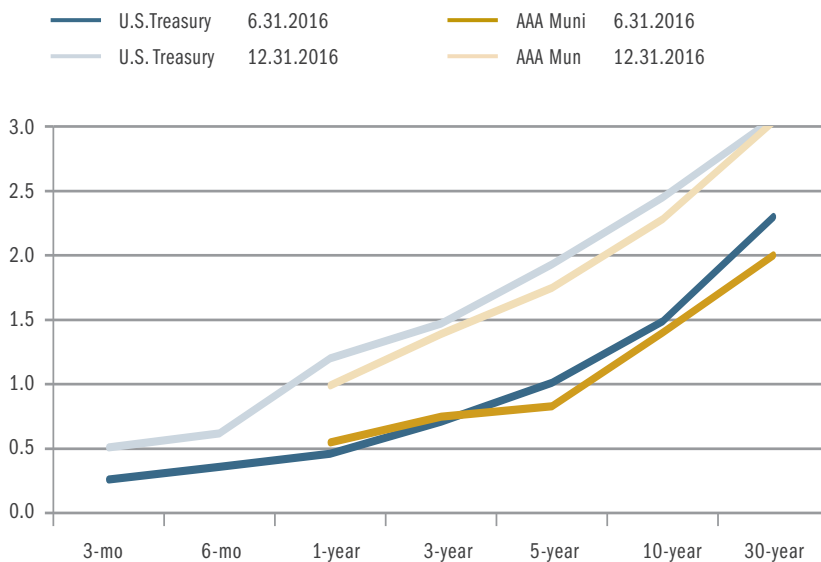
The rapid narrowing of credit spreads during 2016 resulted in the significant out-performance of lower-credit-quality categories, such as high yield, emerging-market debt and leveraged loans. For example, the metals and mining sector surged as it is expected to benefit from an increase in infrastructure spending under the new presidential administration. Likewise, at the end of November, OPEC members agreed to cut the cartel's oil production, pushing the price of a barrel of oil back above \$50 and providing further support for high yield bonds. Going forward, Trump's pro-business policies are perceived as a boon to the business sector, and will support even further tightening in credit spreads.

In contrast, municipal bonds may be under siege from President Trump. While underlying fundamentals remain solid for municipal bonds, the prospect of lower tax rates may sap demand for the asset class, while at the same time issuance may surge in fulfillment of the President's bold infrastructure spending proposals. However, even if personal income taxes for the top bracket are reduced to the 33% level suggested in the Trump and GOP plans, munis would retain a significant tax-equivalent advantage over comparable Treasuries. We caution investors to remember as well that throughout all cycle phases, diversification is the key to downside protection in a bond portfolio. Historically, fixed-income strategies with designated allocations in both high-quality bonds and higher-yielding sectors have helped mitigate downside risk.

**Hedged strategies hemorrhage assets and performance**

2016 was a year most hedge funds would be happy to forget. And while the same goes for 2015, 2014, 2013, 2012, 2011, and 2010, in fact virtually every year since the financial crisis, in 2016 - a year many said would mark a renaissance for active managers - the HFRI Fund Weighted Composite Index returned a paltry 3.3%. Not everyone did poorly: credit related strategies led hedge fund performance, including distressed credit, convertible arbitrage and event driven strategies. On the other end of the spectrum, dedicated short bias managers were down -5.1%.

**Treasury and municipal yields surge higher thanks to the Fed and Trump**



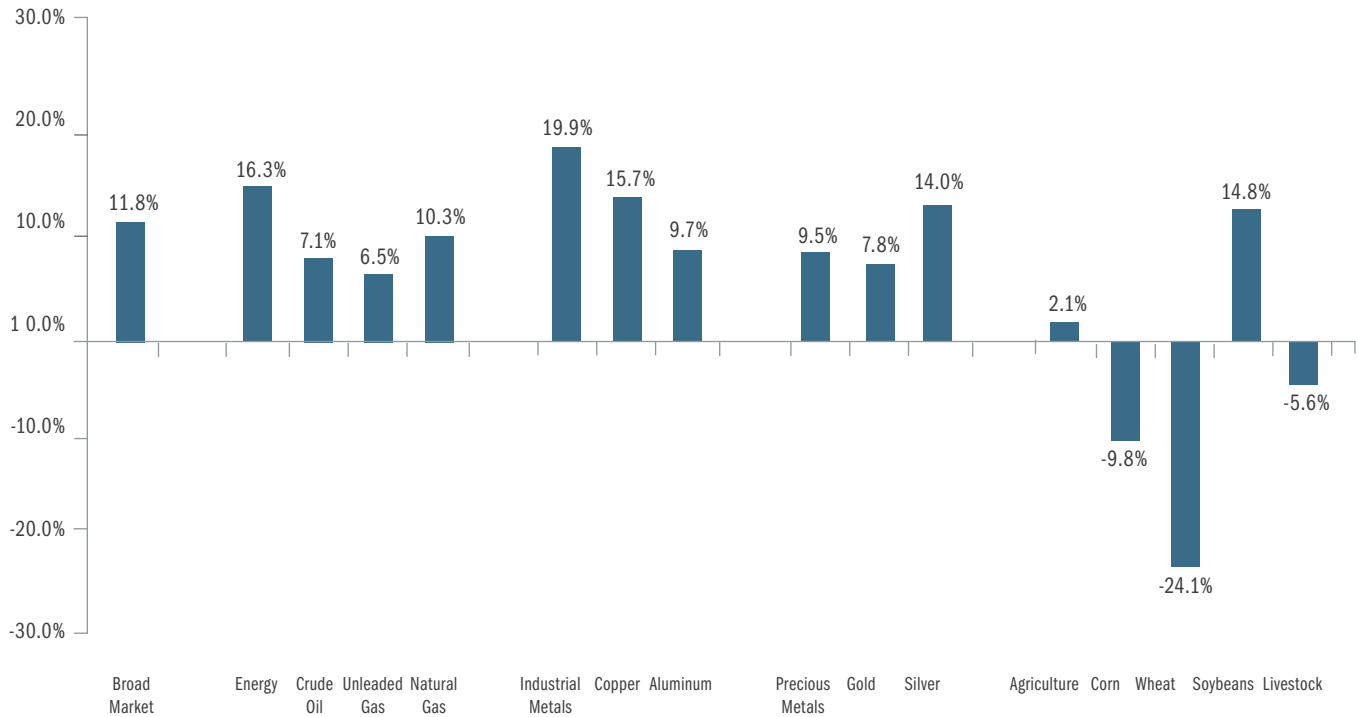
In recent weeks there has been a fresh burst of hope that 2017 will be better for the hedge fund community as a result of the recent collapse in cross-asset correlation; it is hoped that the resulting returns dispersion will make it easier for hedge funds to stand out in a world in which correlations had been abnormally high following the financial crisis due to central bank intervention.

**OPEC cuts kick start commodities**

Commodities strengthened over the quarter, with three out of the four sectors posting gains for the period. The energy sector rallied following OPEC's November 2016 meeting, where it was announced that the organization's members would lower oil production by 1.2 million barrels per day to 32.5 million barrels starting on January 1 — the first cut in eight years. Non-OPEC producers subsequently agreed to trim a further 600,000 barrels. Gasoline, gas oil, heating oil, and crude oil all strengthened on the news. Natural gas also rallied as forecasts for cooler temperatures helped boost the outlook for demand, while the U.S. became a net exporter of the commodity for the first time in more than 60 years. Industrial metals benefitted from

continued Chinese manufacturing growth, declines in stockpiles, and speculation that Trump will increase infrastructure spending, leading to rallies in copper and zinc. Nickel pulled back on a stronger U.S. dollar and fears that Indonesia would relax its export ban on low-grade nickel pig iron ore. Agriculture & livestock was driven by robust performance across lean hogs, live cattle, and feeder cattle. Cattle prices rallied due to high beef live-to-cutout spreads and seasonal trends, while supply for both feeder and live cattle declined. Hogs benefitted from lower weights and healthy export sales, which helped reduce supplies. On the other hand, soft commodities retreated in part from surging U.S. bond yields, a stronger dollar, and Trump's election win adding pressure on emerging markets. Corn posted a strong quarter as farmers have been restricting supply by holding onto the grain, which provided pricing opportunities despite record crops. Soybeans advanced on export prospects and increased concerns over South American growing conditions. Precious metals pulled back over the quarter on increased expectations of interest rate hikes, a stronger U.S. dollar, and improving growth prospects for the U.S. following Trump's election. Both gold and silver ended the quarter lower.

**Commodities on fire in 2016**



**Looking ahead**

2016 has had its fair share of surprises, but markets rewarded investors who had a long-term view and stayed invested and diversified. We urge more of the same in 2017. The decisions and progress of the Trump administration will be critical for markets in 2017, and politics will also continue to loom large in Europe. China’s debt profile remains worrisome, although the country appears to have the tools to deleverage its banking system.

While we are optimistic around the potential for equity markets to post positive returns in 2017, we acknowledge several factors that could create the catalyst for a correction at some point during the year. Valuations are certainly not cheap at current levels in some markets, and any combination of disappointing earnings growth, lack of movement on increased fiscal spending, or indications of an acceleration of Fed rate hikes could

derail the current uptrend, albeit over a short-term period.

Investors should always maintain a healthy respect for the impact of change on the market’s psyche, and there is no doubt that 2017 will be a year of transitions. Populism is challenging globalism and creating new tail risks. Concerns about low growth are giving way to concerns about inflation. Years of focus on monetary policy are giving way to a close watch over fiscal policy. And concerns about new regulation are acceding to hopes for de-regulation.

In our view, it makes a lot of sense to mentally prepare for higher volatility, but investors should not scare themselves into not seeing the investment opportunities out there. While it is good to be a contrarian when everyone seems optimistic, it is even better to figure out whether the optimism is well founded or not.

Historically, the tried and true method for dealing with volatility has been to stay

diversified. However, diversification does not just mean keeping an equity-bond allocation in line with your goals and appetite for risk. It also means keeping the equity and bond allocations themselves diversified. Not all parts of the bond market move in tandem, as evidenced by how high-yield bonds dramatically outperformed Treasuries in 2016. Similarly, not all parts of the equity market have moved together. While 2015 was all about momentum and growth, 2016 saw a huge rotation of leadership towards more cyclical parts of the market. Rotations can change, though, which means it may be prudent to keep a globally-diversified portfolio across all the sectors. After all, diversification is not just about having a wide mix of assets in your portfolio. It is also about having a wide mix of ideas represented in it, because—calling back to market pundits’ pessimistic take on collective optimism—expectations don’t always become reality.

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