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INVESTMENT STRATEGY QUARTERLY

Investment Strategy Quarterly is intended to communicate current economic and capital market information along with the informed perspectives of our investment professionals. You may contact your wealth manager to discuss the content of this publication in the context of your own unique circumstances. Published January 2017. Material prepared by Raymond James as a resource for wealth managers and investors.

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INVESTMENT STRATEGY COMMITTEE MEETING RECAP

Economic and financial market headwinds for the next six to twelve months include a strong dollar, rising interest rates and policy uncertainty. Top tailwinds include a healthy job market, potential for fiscal stimulus and accommodative monetary policy.

U.S. ECONOMY – Scott Brown, Ph.D., Chief Economist, Equity Research

- "The pre-election outlook held that slowing population growth – resulting in slower labour input and economic growth – was the 'new normal.' Post-election sentiment suggests that we are going to get some fiscal stimulus, but that will likely be ineffective in boosting growth on a long-term basis due to demographic constraints."

- "I'm not optimistic that we'll see a big increase in GDP growth. Economists have been raising their growth forecasts for next year, but only slightly, so you're looking at a little over 2% in 2017. We could see a quarter or two of strong growth but it's not sustainable, unless we increase immigration or get a sharp rise in productivity growth."

- "While there are a number of uncertainties in the economic outlook, the largest risk is in global trade. A trade war would boost inflation through higher import costs and disrupt supply chains in U.S. manufacturing. Cooler heads should prevail, but a trade war would undermine economic growth at a time when global trade is already slowing."

- "The job market should continue to tighten in the near term, putting some upward pressure on wages, although consumer price inflation is likely to be moderate. The Federal Reserve should continue to gradually normalize short-term interest rates. Increased government borrowing should lift long-term interest rates."

INTERNATIONAL EQUITY – Chris Bailey, European Strategist, Raymond James Euro Equities* (unless otherwise noted)

EUROPE

- "The pollsters got something right by correctly predicting that the 'no vote' would prevail in the Italian constitutional referendum. In my opinion, this vote is being blown up as something which massively undermines European stability."

- "There is no doubt that a backlash against the European political elite is happening and clearly there are issues to work through in Italy. Banks remain troubled, the political system is uncertain and the people are unhappy, but my feeling is that the Italians do not want to leave the European Union."

- "The direction of Brexit is, to me, quite clear. The timetable is slower, practical realities are showing a 'soft' Brexit as the likely endpoint, rather than a more divisive, aggressive kind of breaking up of relations between the UK and the European Union."

- "Europe is not perfect – there are going to be bumps in the road. However, versus three or six months ago, there's a little bit of hope. The catalysts would be more earnings growth and potential political stability with the upcoming elections in Germany and France. Combine this with last year's big outflows from European equity markets, and opportunities may surface going forward."

> "People are woefully underinvested in the equity markets, and I do think the economy is going to pick up."
>
> Jeff Saut, Chief Investment Strategist, Equity Research

CHINA

- "Concerns over Asia will be centred on China in 2017: the sustainability of growth, the banking system, the property market, and foreign exchange. However, the positive aspects which perhaps people are underestimating are the continuing reforms in China. And they are very impressive."

- "Just as labour force issues are coming to the forefront in the U.S. and demographic shifts are hitting home in Europe, China is now in a position where its labour force is starting to decline as well. It's a common refrain that China will get old before it gets rich. There's significant risk to all assets coming out of China, and I think it's very important to keep monitoring that."

– Paul Berg, CFA, Cougar Global Investments*

U.S. EQUITY

- "I think stocks are going substantially higher. I don't think the markets are overvalued or that the strong dollar will hurt corporate earnings. The markets are transitioning from an interest rate-driven secular bull market to an earnings-driven secular bull market."

- "You've got six stages of emotion that investors go through and, right now, I think we're nowhere near exuberance or ecstasy or any of the other phases you come to before a secular bull market ends."

– Jeff Saut, Chief Investment Strategist, Equity Research

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, CMT Senior Research Associate, Equity Research

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Jennifer Suden, CAIA Director of Alternative Investments Research

Tom Thornton, CFA, CIPM Vice President, Asset Management Services

Anne B. Platt, AWMA®, AIF® – Committee Chair
Vice President, Investment Strategy & Product Positioning, Wealth, Retirement & Portfolio Solutions

Kristin Byrnes – Committee Vice-Chair
Product Strategy Analyst, Wealth, Retirement & Portfolio Solutions

- “People are woefully underinvested in the equity markets, and I do think the economy is going to pick up. The market is telling us something is happening, and it’s good.”

  – Jeff Saut, Chief Investment Strategist, Equity Research

- “So far, the rally we’ve seen has been the kind of broad-based rally that you want at this stage. It’s been led by higher betas, and financials and energy are finally coming around. It’s not the narrow rally we saw last year.”

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

- “Near term the market has a nice tailwind to it – it’s completely convinced that fiscal stimulus is coming, which will generate GDP growth and make earnings targets much easier to achieve.”
- “I’m pretty comfortable about earnings going forward if we do get tax cuts because the magnitude of the moves would be big. However, it’s probably going to be tax reform rather than tax cuts – which takes a lot longer to do. The reality of these things actually happening may slow the rate of ascent.”

  – Michael Gibbs, Managing Director of Equity Portfolio & Technical Strategy

> “I think stocks are going substantially higher. The markets are transitioning from an interest rate-driven secular bull market to an earnings-driven secular bull market."
>
> Jeff Saut, Chief Investment Strategist, Equity Research

FIXED INCOME

- “Despite recent volatility, the fixed income markets really are not out of whack. We’ve remained in an accommodative policy, which has not resulted in inflation, and bonds in general have stayed fairly strong.”
- “Asset allocation is important and, from a strategic standpoint, we are staying the course. Rising interest rates and the widening of municipal market spreads further emphasize decent opportunities for fixed income.”

  – Doug Drabik, Senior Strategist, Fixed Income

- “Municipal bonds are unbelievably attractive right now. They’re trading above Treasuries in terms of yield across the curve, so for investors that pay high marginal tax rates, munis look fantastic.”

  – Benjamin Streed, CFA, Strategist, Fixed Income

- “Inflation has bottomed. If you think the baton should go from central bankers to the fiscal policy makers, you have a reason to believe. Risk markets will continue to rally into the first quarter.”
- “Near-term risk markets have more room to run with economic and fiscal policy optimism. Through Q1 of 2017, the market is going to do well. The curve is steep. There’s a term premium. Let’s not forget that we opened 2016 with a big downdraft. This is a retracement from Brexit low yields and not particularly concerning.”

  – James Camp, CFA, Managing Director of Fixed Income, Eagle Asset Management*

*An affiliate of Raymond James & Associates and Raymond James Financial Services.

REAL ESTATE – Paul Puryear, Director of Real Estate Research, Equity Research

- "Housing is fine. It's not robust. Demographic trends are acting as a drag and housing isn't fuelling economic growth like it has in past cycles, which in some ways could be a good thing. The two wild cards for housing in 2017 are inflation and interest rates."
- "Affordability issues have been exacerbated because incomes haven't kept up with inflation. Construction costs – particularly in labour and permits – are likely to get worse, not better."
- "On infrastructure spending, I'm more concerned about what it does to the inflation rate and the labour pool – both of which are strained right now."

ENERGY AND OIL – Pavel Molchanov, Senior Vice President, Energy Analyst, Equity Research

- "With OPEC's announcement to cut supply, you would think oil prices should celebrate, and they did to a degree. Still, prices are considerably lower than where we thought they would be at this point in time."
- "Saudi Arabia cutting production is a bullish signal for the market. Bullish in the sense of fewer physical barrels on the market but also in a psychological sense, because they finally called a truce after fighting a price war for the past two years. That changes how investors, and commodity speculators, think about downside and upside."
- "The fact that oil is not yet in the $60s is going to affect capital spending decisions by oil and gas producers across the spectrum around the world. Initial capital budgets will probably be on the lower end of expectations, but still mostly showing recovery from the prior year."
- "Headwinds for oil in 2017 include recovering production in Nigeria and Libya, unexpected supply growth in Russia, and a strong U.S. dollar."

ALTERNATIVE INVESTMENTS – Jennifer Suden, Director of Alternative Investments Research, PCG Investment Products

- "Two trends we are seeing in the hedge fund industry are fee compression, driven by a decline in the average management fee charged, and increased liquidations relative to launches. In fact, though the average launch size has grown, 2016 is turning out to be the slowest year for new hedge fund launches since 2009."
- "For an ultra-high net worth investor, we believe a minimum strategic long-term allocation of 20% to alternatives is warranted. Though it depends on the client's risk/return objectives, generally this allocation should be accomplished through a mix of hedge fund and private equity strategies, providing the ability to capitalize on the illiquidity premiums."

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US ECONOMIC SNAPSHOT

The economy appeared to be in good shape toward the end of 2016. While fiscal stimulus may provide a boost to growth in 2017, the amount of infrastructure spending and tax cuts we're likely to see is unclear. Improved business optimism could lead to greater investment, but economic growth is likely to be limited by constraints in the labour market. The Federal Reserve (Fed) is expected to raise short-term interest rates gradually. Increased government borrowing should pressure long-term rates.

SCOTT BROWN
Chief Economist, Equity Research

	ECONOMIC INDICATOR	COMMENTARY
FAVORABLE	GROWTH	Due to slower population growth, 2% GDP growth is the new normal. We may see a little more growth in the short term, as labor market slack is further reduced.
	EMPLOYMENT	Job growth slowed somewhat in 2016 (reflecting a tight labour market), but is still relatively strong. Job destruction remains very low. An aging population suggests less labour turnover.
	CONSUMER SPENDING	Strong job growth and moderate wage gains should continue to support consumer spending growth, but the benefit of low gasoline prices is fading (slower real wage growth).
	HOUSING AND CONSTRUCTION	Housing and construction has been a bit choppy from month to month, but there is a general trend of improvement in single-family activity. Supply constraints have been a factor, lifting home prices and rents.
	MONETARY POLICY	The Fed raised rates just once in 2016. The hawks want to move faster, but others, including Chair Yellen, are more cautious. Policy remains data dependent, with a focus on the job market and the inflation outlook. The Fed is aware that sharply rising rates may be destabilizing.
	FISCAL POLICY	State and local government budgets are in better shape and spending should add a bit to GDP growth over time. At the federal level, the scale of infrastructure spending and tax cuts is very much in doubt, but will likely add significantly to the budget deficit.
	THE DOLLAR	Monetary policy has contributed to the dollar's strength. A strong dollar should keep some downward pressure on commodity prices, but will place pressure on U.S. exporters.

NEUTRAL	BUSINESS INVESTMENT	After a period of softness (partly related to the contraction in energy exploration), we should see some pickup in capital spending in the near term.
	MANUFACTURING	Manufacturing is mixed across industries, but generally soft – reflecting weak global demand and a restrained pace of capital spending. The pace of auto sales has likely plateaued.
	INFLATION	We are seeing some mild deflationary pressure in consumer goods. Prices of services have been mixed, but generally higher (shelter, medical care). Firms still have a limited ability to raise prices. Labour cost pressures are rising, but are generally moderate.
	LONG-TERM INTEREST RATES	Expectations of further Fed rate increases and substantially larger federal budget deficits have put upward pressure on long-term interest rates, but low rates abroad ought to check the upward pace of long-term interest rates here in the U.S.
	REST OF THE WORLD	The global outlook looks a bit brighter, but is also uncertain: the Brexit pain lies ahead for the U.S., China's transition is likely to be uneven, and the possibility of trade conflicts is a major risk.

2017 Economic Outlook: Rates, the Pound... and the Bank of England

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

"Wherever you go, no matter what the weather, always bring your own sunshine." Anthony J. D'Angelo

Hands up if you remember the 'surprise' 1987 hurricane that tore across a swathe of Southern England? You may recall that the stock market crash that occurred in the same year occurred at a pretty similar point. Well this almost unique mixing of stock market and meteorological extremities was given another airing in early January when Andy Haldane, the highly respected Chief Economist of the Bank of England, observed that economic forecasting in the current epoch was about as well respected as weather forecasting was just shy of thirty years ago.

The decisions made by the Bank of England back in August to not only cut interest rates, but also re-impose quantitative easing stimulus, was broadly seen as a response to the greater economic uncertainty resulting from the Brexit referendum result, following various UK Treasury and internal Bank of England forecasts that showed the risk of a recession, before the end of the decade, had materially increased.

Five months later... the economic weather may not be the equivalent of blazing sunshine, but those threatening storm-laden clouds have moved away. Recent UK economic data has been remarkably solid given that there has been little clarity in the Brexit timetable or debate. A charitable view would be that the Bank of England has provided a suitably accommodative policy backdrop that has allowed the UK economy to continue moving forward despite the challenges out there.

> Recent UK economic data has been remarkably solid given there has been little clarity in the Brexit timetable or debate

So what comes next? Back in the late 1980s, the prevailing rule of thumb at the UK Treasury was that a 4% fall in the exchange rate equated to a 1% fall in interest rates, so applying this to the around 16% fall of the UK currency against currencies such as the US dollar suggests that policy has been dramatically loosened. Has the Bank of England gone too far, too fast?

If you have a very inflation-centred perspective you may well be very nervous. Assisted by the fall of the Pound and the rise of the oil price over recent months, the likelihood that official UK inflation will move – at least transitorily – to clearly over 3%, is very high. Given the prevailing economic doctrine that has underpinned many central bank inflation actions over the past generation has been to try to keep inflation under 2%, the obvious reaction should be that it is time for the Bank of England to raise interest rates, mirroring the increase in bond yields over recent months.

But what about the fear concerning Brexit outcome? The current uncertainty about the timetable and impact of so many issues around this debate suggests erring on the side of caution, and – in any case – economic growth forecasts for 2017 for the UK economy are typically only modestly above the 1% level, which is way below the typically hoped-for 2%+ growth. Economic growth numbers at face value argue against any form of imminent and material interest rate increase.

The concluding and ultimately most influential view may well come from the performance of the Pound during 2017. Having finished 2016 by lurking in a global currency table position juxtaposed between the Turkish lira and Argentine peso – not natural performance bedfellows for the UK currency – it is not surprising that considerable scepticism about the Pound's performance in 2017 is apparent.

I would argue though, that to expect a better 2017 for the Pound is a reasonable scenario. The magnitude of the Pound's fall during 2016

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UK ECONOMIC GROWTH RATES %		
	FOR 2016	FOR 2017
November 2016 *est*	2.00%	1.20%
September 2016 *est*	1.80%	1.40%
June 2016 *est*	1.60%	2.00%

Source: OECD

has only been materially beaten, in relatively modern economic history, by the 23% fall in the value of the UK currency at the time of the 1976 economic bail-out by the International Monetary Fund. Even the confidence-sapping 1992 Exchange Rate Mechanism forced exit – which famously made hedge fund speculator George Soros in excess of a billion dollars – induced a fall only broadly akin to what we have seen occur in the past seven months or so. Even a modest recovery in the Pound helps moderate some of the excesses above. Inflationary pressures are clipped a little, and very loose policy – via the effective tightening of a higher exchange rate – starts to moderate. I would also expect the Bank of England to halt its newly re-imposed quantitative easing actions during 2017 as overall conditions are not as worrisome as thought in the aftermath of the Brexit referendum vote – and it is always good to have some new policy tools to unveil again if conditions dictate.

So, pulling all this together… our call is for UK interest rates to stay where they were in 2016, and the Pound to rise. Economic growth will be positive – but relatively modest – and in all likelihood we will still be talking about the options around Brexit at the end of the year.

And faith in forecasting? Well, just like the weather, there will be a lot of continuing debates around the water coolers at all investment firms. After all, if we could forecast outcomes easily, the finance world as we know it probably would not exist.

Economic growth will be positive – but relatively modest – and in all likelihood we will still be talking about the options around Brexit at the end of the year

KEY TAKEAWAYS:

- The Bank of England were suitably worried about economic prospects to loosen policy dramatically last August
- The UK economy is unlikely to face short-term recessionary conditions, so time to tighten policy?
- Our view is that a rise in interest rates is unlikely. Rather, new QE will stop and the Pound will rise in 2017
- Forecasting remains as much as an art as a science

US Economic Outlook: Policy Uncertainty and Demographic Constraints

Scott J. Brown, Ph.D., *Chief Economist, Equity Research*, outlines his expectations for the US economy in the coming year.

Prior to the election, there was a growing consensus that demographic changes would be a major factor restraining economic growth in the U.S. and around the world. The expectation of the "new normal" is based on the idea that populations are ageing and labour force growth will be significantly slower than in previous decades.

Barring a substantial increase in immigration or a sharp pickup in the pace of productivity growth, real Gross Domestic Product (GDP) can be expected to trend at a 1.5 - 2.0% annual rate, rather than the 3.0 - 3.5% pace seen in previous decades. Post-election, those constraints will still be binding. Hence, fiscal stimulus (increased government spending and large-scale tax cuts) may not provide much of a lift. Moreover, policy uncertainties, particularly in regard to foreign trade, add more uncertainty and risk to the economic outlook.

REAL GROSS DOMESTIC PRODUCT IS EXPECTED TO TREND AT A **1.5-2.0%** ANNUAL RATE

U.S. ECONOMY

Recent data suggest that the economy is in good shape. Real GDP growth appears likely to finish 2016 at about 2% (4Q16-over-4Q15). Consumer spending growth has been relatively strong, fuelled by robust job growth and moderate wage gains. Low gasoline prices have helped, but the beneficial impact will fade over time as oil prices stabilise and move somewhat higher. Business fixed investment has been sluggish, reflecting the contraction in energy exploration, a sluggish global economy, and general uncertainty in the economic outlook. Residential home building has continued to improve.

JOB MARKET

Job growth remained strong in 2016, but was somewhat slower than in the last couple of years. That may reflect business caution ahead of the presidential election, but job growth will normally slow as the job market tightens. A tighter job market would normally lead to faster wage growth. Average hourly earnings have picked up, but the underlying trend appears to be moderate, suggesting that there is still some slack in the job market. Long-term unemployment and measures of underemployment are still above levels considered to be "normal," but they have been improving.

FEDERAL RESERVE

Federal Reserve (Fed) policymakers have remained focused on the job market and the outlook for inflation. As 2016 began, most Fed officials expected to raise short-term interest rates four times over the course of the year, but improvement in the labour market was slower than expected and inflation remained muted. Most Fed officials believe that the economy is getting close to full employment. Following the December 14 increase in the federal funds target rate, most officials expect two to four rate increases in 2017, with a median of three. However, that depends on the job market and the inflation outlook. If the job market tightens more rapidly than anticipated and wage growth picks up more sharply, additional monetary tightening could come sooner. Conversely, if growth is sub-par and inflation remains low, officials would be inclined to move more slowly.

DEMOGRAPHIC TRENDS IN THE U.S. AND ABROAD

Demographic issues, particularly slowing population growth, are expected to play a major role in the outlook for economic growth in the U.S. and the rest of the world.

Between 1960 and 2000, labour force growth in the U.S. averaged 1.8% per year as the baby-boom generation came into the job market and women entered the workforce in greater percentages. The Bureau of Labour Statistics now expects trend labour force growth to be about 0.5% per year.

Output (GDP) is the amount of input (labour) times the output per worker (productivity). Hence, GDP growth is labour force growth plus productivity growth. As the remaining slack in the job market is taken up, growth should exceed the longer-term trend, but the demographics will eventually become binding.

Productivity growth has been unusually soft in recent years. That may reflect softness in capital spending during the recession and early recovery. If so, productivity growth should improve as capital spending picks up. Longer term, advances in robotics and artificial intelligence could boost productivity significantly in the years ahead, offsetting the impact of slower labour force growth. However, it's difficult to predict how changes in technology will affect the economy.

Note that slower population growth and weak productivity growth are not issues unique to the U.S. Population growth is slowing worldwide. Productivity has also slowed outside the U.S., along with business fixed investment. In turn, global trade has slowed in the last couple of years – and that's absent of any significant increase in protectionist measures.

BETWEEN
1960 & 2000
GROWTH IN THE U.S. LABOUR FORCE AVERAGED
1.8% PER YEAR

EXPECTED
LABOUR FORCE
GROWTH TREND
0.5% PER YEAR

OUTPUT PER WORKER (PRODUCTIVITY)
X INPUT (LABOR)
OUTPUT (GDP)

US Economic Outlook: Policy Uncertainty and Demographic Constraints

PRESIDENTIAL ELECTION

Following the election, investors have been encouraged by expectations of a roll-back in regulations and a major fiscal stimulus package. Donald Trump's surprise victory has significantly changed the Washington outlook. Republicans control the House and the Senate, and while there are likely to be differences between the incoming administration and the establishment Republicans on a number of issues, it should be easier to get things done.

INFRASTRUCTURE SPENDING

Trump called for more infrastructure spending during the campaign. However, it's unclear how it will be funded. Additional federal spending may be hard to get through the House. The House no longer allows earmarks (specific allocations in spending bills), which means that you don't get the kind of "horse-trading" needed to reach a broad agreement.

TAX REFORM

Tax cuts, on the other hand, should be relatively easy to achieve, although substantially less than what Trump had proposed during the campaign. Presumably, lower taxes on households and businesses would be achieved through tax "reform." However, even with lower tax rates, few will want to get rid of the deductions they enjoy, which makes true tax reform difficult, if not impossible.

FISCAL STIMULUS

Fiscal stimulus can be effective in countering an economic downturn, but is unlikely to provide much of a boost if the economy is close to full employment. Most economists have raised their GDP forecasts for 2017, but only modestly – reflecting the restraining impact of labor market constraints. Hence, while there is some possible upside for growth as the remaining labor market slack is reduced, that should be limited, and fiscal stimulus is more likely to result in higher inflation or an asset price bubble.

INTEREST RATES

Tax cuts do not pay for themselves, and the bond market is currently anticipating an increase in government borrowing in 2017 and beyond. However, the rise in U.S. bond yields is expected to be kept in check somewhat by lower long-term interest rates abroad. In turn, higher U.S. bond yields put some upward pressure on long-term interest rates outside the U.S., complicating monetary policy effectiveness in Europe and elsewhere.

PROTECTIONISM: A GLOBAL RISK

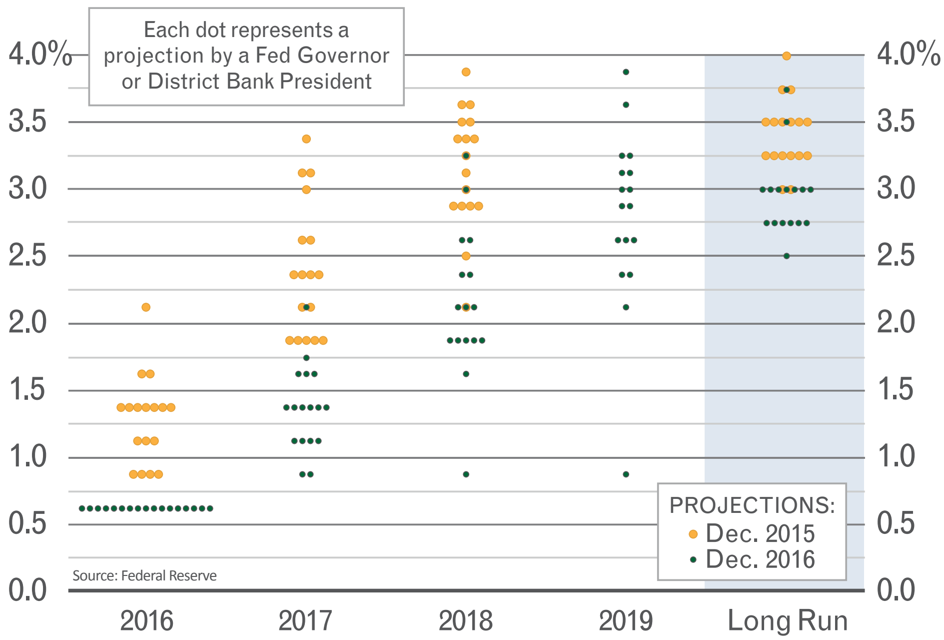
The bigger risk to the economy is the possibility of global trade disruptions. Entering trade agreements requires congressional approval, but the president can, by himself, pull out of existing agreements, such as NAFTA. Economists will tell you that neither side wins in a trade war. If the Treasury Department were to officially declare China as a currency manipulator – even though the country is trying to prevent its currency from weakening, rather than pushing it lower – that designation would automatically set off tariff increases, which would likely be met by countermeasures against U.S. exports. U.S. manufacturing uses parts and materials from around the world. Disruptions to the supply chain would have adverse effects on the overall economy. There's a strong belief that cooler heads will prevail, but a rise of protectionism remains a key risk to the global economic outlook.

OVERALL

New presidential administrations typically face a number of unforeseen challenges. Optimism about the economy may be short lived. However, there is significant positive economic momentum heading into the new year. Households and businesses are generally in good shape.

TARGET FEDERAL FUNDS RATE AT YEAR-END

At the Federal Open Market Committee meetings in March, June, September and December, senior Fed officials submit forecasts of the appropriate year-end federal funds target rate (the overnight lending rate that banks charge each other for borrowing excess reserves). Each dot in the dot plot represents a forecast of an individual Fed official. Note that there is uncertainty surrounding each dot and that not every official gets to vote on monetary policy. The dots are expectations, not a plan of action. Monetary policy decisions will remain data dependent, with a focus on the job market and the inflation outlook.



KEY TAKEAWAYS:

- Barring a substantial increase in immigration or a sharp pickup in the pace of productivity growth, real Gross Domestic Product can be expected to trend at a 1.5 - 2.0% annual rate, rather than the 3.0 - 3.5% pace seen in previous decades.
- Demographic issues, particularly slower population growth and weak productivity growth, are expected to play a major role in the outlook for global economic growth. These constraints will be binding post-election, limiting the impact of fiscal stimulus.
- There is significant positive economic momentum heading into the new year. Households and businesses are generally in good shape, and recent data suggest that the economy is healthy.
- Key risks to the global economic outlook are the possibility of global trade disruptions under the Trump administration and a resultant rise of protectionism.

All expressions of opinion reflect the judgment of the Research Department of Raymond James & Associates, Inc. and are subject to change. There is no assurance any of the trends mentioned will continue or any forecasts will occur. Real Gross Domestic Product (real GDP) is a macroeconomic measure of the value of economic output adjusted for price changes (i.e., inflation or deflation).

The Key to the UK Stock Market in 2017?

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

"A common mistake people make regarding dining rooms is to buy a matching set of table and chairs, which can be monotonous. I like to mix guest chairs in one style and head chairs in another for a more interesting, dynamic look." Candice Olson

Putting together an equities portfolio can be remarkably akin to choosing dining room furniture. The temptation is to choose one type of stocks or a single fund product that you are comfortable with. Possibly such a selection feels safe and sometimes, of course, it is hugely successful, but equally at other times it feels un-dynamic and not the most attractive approach.

After a particularly strong second half of 2016, the index of large cap UK equities moved to an all-time high in early January. Additionally, early data for full year 2016 performance has shown that only a small proportion of active equity funds outperformed index tracking equivalents during the year. In short, the most successful strategy for many UK fund managers and allocators would have been to hug underlying indices in passive products. This outperformance in 2016 – and in aggregate over the last three or five years - of many passive products investing in the UK market, has made the pressure to switch away from active equity allocations more acute. Looking at the likely drivers and influences on the UK stock market during the rest of 2017, I feel this would be a mistake.

The temptation is to choose one type of stocks or a single fund product that you are comfortable with

	% of active managers beating benchmarks
2016*	21
2015	72
2014	44
*YTD to end Nov	

Source: www.ft.com

In hindsight, investors needed to only make one decision in 2016 to probably guarantee outperformance. If halfway through the year they had sold all their defensive investments and allocations in sectors such as consumer staples, utilities and healthcare stocks, and switched them to the more cyclical financials, industrials and commodity-facing sectors, rewards would have benefited materially from the lower value of the Pound and would have been high. Sector rotation was the name of the investment performance game in 2016.

The theoretical "Perfect Hindsight Asset Management" always is a comfortable outperformer of course. The end of June was a challenging time for many investors to switch around their direct equity or fund style allocations because, just a few days beforehand, the surprise of the Brexit referendum vote had occurred. Such switches would have been correct from the context of generating performance last year, but would not have been an easy call to make. Passive funds, with their continuing exposure to the more cyclical areas, typically benefited from this shift, after lagging a little during the first half of the year.

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The differentials in sector performance that occurred during the second half did, however, start to bridge the valuation differences that had built up between more defensive and more cyclical shares. In practical terms, it has made sector selection choices less clear-cut and individual choices about shares across all different industry groups more important. In investment parlance terms, greater individual share dispersion has made a more stock selection specific approach the likely key to UK investment success in 2017. With such a backdrop, passive funds are going to have their work cut out to outperform again during the next 12 months. The mix of specific investment choices is going to matter more.

Looking at the overall prospects for the UK market in 2017 it is hard not to conclude that a sideways shift, as individual company prospects wax and wane in the ever-changing Brexit debate/Trump Presidency/ global economic growth backdrop, is very plausible. However, within an overall index which moves up or down a handful of percent points over the next 12 months or so, individual companies across a variety of sectors and styles will enjoy their own high or low points, outperformances and underperformances versus market hopes, and collectively offer a much greater share price dispersion experience for the average investor. This suits active and engaged investors.

In 2017, believe in the value of mix... and a more active, fluid approach to UK investment choices.

Greater individual share dispersion has made a more stock selection specific approach the likely key to UK investment success in 2017

KEY TAKEAWAYS:

- Passive funds typically outperformed in 2016 as many managers did not rotate their portfolios
- 2017 appears different due to the balance of risk and opportunities across all sectors
- Active and engaged investors are set - in our opinion - to outperform in 2017
- Keep flexible and fluid in your investment portfolios!

U.S. Equity Outlook: Markets in Transition

Jeffrey Saut, *Chief Investment Strategist, Equity Research,* weighs in on what a turning point in 2017 could mean for equity investors.

Winter officially began on Wednesday, December 21, with the arrival of the winter solstice. Recall that solstice means "standing-still sun;" and on December 21 at 5:44 a.m. (EST) the sun "stood still" over the southern Pacific Ocean at the Tropic of Capricorn. At that time, the sun's rays were directly overhead, giving the impression that the sun was truly standing still. No one is quite certain how long ago humans began heralding the solstice as a turning point, but a turning point it is: the sun sets a minute or two later each day from there until the summer solstice on June 21.

Similarly, the U.S. economy and the stock market appear to be at a turning point. Going forward, we look for improved economic growth, moderately higher inflation, a shift toward fiscal stimulus (although it is less clear what the policy adjustment will be), reduced gridlock in D.C., and a less divided government.

TRUMPONOMICS

While many worry about President-elect Trump’s potential trade policies, we believe they will be much less austere than his pre-election rhetoric. However, a harsher trade policy should be more than offset by the upcoming economic stimulus and an improving economy.

The new administration will favour tax cuts, deregulation, infrastructure spending and potentially bigger budget deficits, which justifies the bond market’s sell-off. The resultant steeper yield curve should mean the outperformance of the financial complex and the underperformance of stable/defensive stocks and bond proxies. “Trumponomics” should lift commodities, including energy, as inflation picks up at the margin.

MARKETS IN TRANSITION

While the economy is likely at a turning point, so are the equity markets. As we have been suggesting for months, it is our belief the equity markets are transitioning from an interest-rate-driven to an earnings-driven secular bull market. This should become increasingly evident in 2017. We believe we saw the “profits trough” in the second quarter of 2016, making quarterly earnings’ comparisons going forward look favorable. We would add that if the president-elect is able to lower the corporate tax rate to 15%, it could add another $26 in earnings to the S&P 500. Even if he only manages to get the corporate tax rate down to 25% it would still add approximately $13 in earnings.*

We believe that we are moving into an environment where earnings are already improving and, with the positive equity environment, we expect them to appreciate further and have tilted portfolios accordingly.

CORPORATE TAX RATE AND EARNINGS

TAX CUTS COULD MEAN INCREASED EARNINGS TO THE S&P 500.

LOWERED TO **15%** COULD ADD **$26**

LOWERED TO **25%** COULD ADD **$13**

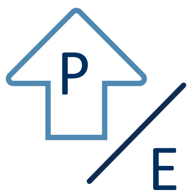
*Source: Thomson Reuters

Speaking to an earnings-driven stock market, we agree with Richard Bernstein of Richard Bernstein Advisors. He states that the earnings forecast for the S&P 500 (ending June 2017) is roughly $115, with the current S&P 500 price-to-earnings multiple about 24x. “If history were to repeat, then the multiple could compress by two multiple points during that period, which would give one an expected S&P 500 level of about 2,500 ($115 x 22 = 2,530), or about 20% expected return.”

PRICE-TO-EARNINGS: COMPARING MARKET ENVIRONMENTS

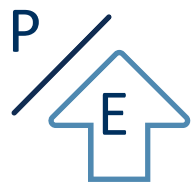
With falling interest rates, investors are more willing to expand their investment time horizon – and price-to-earnings multiples expand – due to fewer shorter-duration investments offering competitive returns.

INTEREST RATE-DRIVEN MARKET
(FALLING INTEREST RATES)



PRICE/EARNINGS
MULTIPLE EXPANSION

EARNINGS-DRIVEN MARKET
(RISING INTEREST RATES)



PRICE/EARNINGS
MULTIPLE CONTRACTION

MARKET LEADERSHIP

Because the equity markets are undergoing a transformation or turning point, investors should expect a change in the market's leadership. For months, we have opined that this leadership shift favours small-capitalization stocks, emerging markets, capital goods, industrials, healthcare, technology and financials. This implies that, in a rising interest-rate environment, commodities and industrials (machinery, steel, mining and energy) should be overweighted in portfolios. Healthcare remains interesting, despite its post-election rally, because it still has decent upside to get back to the valuation levels attained in 2015. Additionally, companies with significant amounts of cash offshore could benefit if the new president can actually manoeuvre repatriation tax legislation into existence.

The quid pro quo is that the interest rate-sensitive sectors (bond proxies) should be underweighted. We have also counselled that low-volatility stocks, or defensive names, have been driven to historically expensive valuations and consequently should be reduced in portfolios. Other potential casualties could be industries that benefit from large government subsidies. Even the FANGs (Facebook, Amazon, Netflix and Google) could suffer due to their expensive valuations. To wit, as economic growth increases, it should bring stronger earnings growth to a broader base of companies with, potentially, a concurrent contraction in the FANG's "growth premium."

BULLISH ON EQUITIES

The equity markets have rallied hard on the belief in a pro-growth administration, reduced regulation, lower taxes, increased infrastructure spending, a reset on trade toward the benefit of American companies, and the reflation trade. If this optimistic scenario comes to fruition, the Penn-Wharton Budget Model targets between a 1.1% to a 1.7% increase in GDP growth beginning in 2018. If true, GDP growth could ramp to approximately 3%, suggesting

SECULAR BULL MARKET

"If past is prelude, we should have another seven-plus years in this bull run."

CYCLES LAST	COMPOUND AT	ANTICIPATED
14-15	**16%**	**7+**
YEARS	PER YEAR	YEARS REMAINING

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stocks are not all that expensive. Verily, we have never wavered on the belief that we remain in a secular bull market. Such bull markets typically last for 14 – 15 years and tend to compound at around 16% per year. If the past is a prelude, we should have another seven-plus years in this "bull run." Will there be pullbacks? Of course there will be, but pullbacks should be viewed within the construct of a secular bull market.

DOW THEORY

Dow Theory is the interrelationship between the Dow Jones Industrial Average and the Dow Jones Transportation Average. We are one of the last practitioners of Dow Theory after the passing of our friend Richard Russell (Dow Theory Letters) last year. In the final analysis, what has happened is that the Dow Jones Industrial Average broke out to the upside in the charts from a 14-month consolidation in July of 2016. In the process, it registered a Dow Theory "buy signal." Dow Theory is not always right, and it is subject to interpretation, but it is right a lot more than it is wrong.

DOW JONES INDUSTRIAL AVERAGE

DOW THEORY'S PRIMARY TREND = EQUITY MARKET IS UP

Source: Yahoo Finance and Raymond James

HEADWINDS FOR U.S. EQUITIES

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

Stocks seem well-positioned to move higher in 2017, however, there are a few factors that have the potential to trip up the market in the months ahead.

POLITICAL UNCERTAINTY

While the incoming administration has finally given investors optimism that there is a path toward more robust economic and earnings growth, the market may already be pricing in perfection from the expected stimulus policies. The chance remains that congressional and bureaucratic resistance could force some sanitization of the proposals and, even if passed, their impact is still uncertain and it will take some time before the effects are felt.

INFLATIONARY CONCERNS

With the job market already approaching what the Federal Reserve (Fed) considers "full employment," there is the chance that fiscal stimulus increases inflation and the national debt without truly stimulating growth (possible "stagflation"). Increasing inflation may also press the Fed to raise rates faster than the market expects, which could put pressure on stocks.

GLOBAL CONSIDERATIONS

Conditions across the world remain a huge uncertainty, and there are a number of issues that could escalate and spill over into U.S. markets. Political and economic concerns remain in the UK, continental Europe, Japan, China and various other parts of the globe, and, as we have experienced over the last year, political fears can really take hold of a market in the short term. Russia and the Middle East remain wild cards, and any escalation in tensions could spook investors.

TRADING RANGE LIMITS

The S&P 500 is already at the upper end of the range it has traded within going back to 2007. Upside could be limited unless there are pullbacks along the way.

KEY TAKEAWAYS:

- We believe the equity markets are transitioning from an interest rate-driven to an earnings-driven secular bull market, which should become increasingly evident in 2017.
- Investors should expect a change in the market's leadership. This shift favours small-capitalization stocks, emerging markets, capital goods, industrials, healthcare, technology and financials.
- We have never wavered on the belief that we remain in a secular bull market. Pullbacks should be viewed as opportunities.
- Key risks for 2017 include congressional resistance against expected stimulus policies, increasing inflation and national debt, global political and economic concerns, and elevated equity prices.

International Equity Outlook: With Reappraisal, Can Come Opportunity

Chris Bailey, *European Strategist, Raymond James Euro Equities**, provides perspective on international opportunities and risks.

"If people perceive themselves as having very little opportunities to be fulfilled, then it cheapens their life and outlook. The solution is to reverse it; make sure they know opportunities abound." Michael Lee-Chin

In the investment world, what should worry us most is rarely obvious. It's the unknown – for better or worse – that moves broad financial markets and individual investments.

Recent sentiment surveys unveil a common fear factor among global fund managers: the future cohesion of Europe following the EU referendum vote. Beyond Europe's struggles, the spectre of a slowing Chinese economy would be the next biggest concern. However, these much-discussed risks and issues, while having the potential to impact the investment world in the future, shouldn't worry international equity investors in 2017.

EUROPE

BREXIT UPDATE

Europe had a volatile 2016 with the narrow decision by the UK electorate in late June to punish our political hierarchy and vote to leave the European Union, a precursor to much political angst. While the UK is not a member of the single-currency euro zone, last June's events again highlighted a lack of solidarity across Europe. This region of the world is still struggling, on average, with weak economic growth, too many fragile banks, a migration crisis that threatened to spill over into a populist swing against incumbent regional politicians, as well as a number of important elections in 2017 – most notably in France and Germany.

However, caution must be exercised on extrapolating too aggressively from Brexit. First, there are bound to be delays in the practical application of our decision to leave the European Union. In our opinion, procedural legal challenges are unlikely to stop Brexit from eventually occurring, but what is very clear is that a rapid Brexit is extremely unlikely.

There are no precedents to fall back on, and a complex agreement that covers future trade and labour movement between the UK and the European Union will be difficult to form. However, cooler heads have prevailed in recent months, as seen by a clear reduction in last summer's inflammatory rhetoric and an acknowledgement that the desertion of current trade agreements underpinning mutual wealth generation may not be in the interest of either party. 2017 is more likely to be a year of Brexit delay where investors are positively surprised by the establishment of the groundwork for a "soft" rather than a "hard" agreement between the UK and the European Union.

I say positively surprised because the ~$100 billion in outflows from Europe by global investment managers concerned about the region's future prospects, has left investors underweight versus their benchmarks. Initial steps toward a soft Brexit, coupled with mainstream political success in upcoming European elections, could induce some reappraisal of the region's prospects, especially as the European Central Bank and the Bank of England undertook new stimulus initiatives during the second half of 2016. And with reappraisal, can come opportunity.

CHINA

ECONOMIC GROWTH

International investor outflows from the Chinese equity market were also a theme in 2016. China has continued to deliver attractive headline economic growth rates, but rising concerns over the sustainability of these rates has investors worried. This is a relevant concern given that China is already the world's largest marginal consumer of many commodities and is anticipated to be a top contributor to global consumption levels as it transitions from an infrastructure-driven economy to a consumption-driven economy.

Rising debt levels have been at the forefront of these concerns, as they have the scope to potentially derail economic growth levels both domestically and internationally.

There is little doubt that corporate debt levels in many of the old-style State-owned Enterprises (SoEs) are a concern. SoEs are typically made up of lowly competitive industrial companies that still employ large numbers of people and sit uncomfortably in the Chinese political leadership's vision of a dynamic service sector-led economy. The better news is that Chinese government debt levels are very modest and the central government is slowly restructuring and merging these businesses, all of which can be financed via China's fledgling but fast-developing bond market.

PROPERTY MARKET

The property market in China has also attracted concern due to the sharp increase in prices in tier one cities like Beijing and Shanghai over the last year or two. As with many major cities around the world, sharply rising property prices threaten numerous aspects of the economy. In China, this price appreciation is placing pressure on the ongoing viability of the rural-to-urban shift – a driver in the modernisation and growth of the local economy. While there may be some bumps in the road in 2017, tailwinds such as real wage growth, tax incentives and other efficiency/flexibility-inducing supply-side reforms put in place by the Chinese government are priming the local economy for growth. With high savings rates and low consumption levels, China still has a lot of upside potential.

CURRENCY

The biggest squeeze for China may come from one aspect of policy the government is finding hard to sustain – the level of the Chinese yuan – which currently tracks the value of the U.S. dollar. A strong U.S. dollar typically causes issues

EUROPEAN POPULISM

In 2017, elections are all-critical in Europe with both France and Germany – the two largest economies in the euro zone – going to the polls. Concerns that electoral angst will be apparent is an issue that international investors are currently grappling with.

The cause of rising populism, and the seemingly associated discomfort with European cohesion, integration and ideals is complex, but a combination of low real wage growth, stubbornly high unemployment, social pressures from migration, and high living costs are all factors influencing populism.

Should investors worry about these elections in 2017? France is the first and biggest test, with a populist far right candidate likely to be one of the two final presidential candidates. However, the opposing candidate at this time has an agenda which is just what the French economy needs: deregulation, less government influence and lower taxes. Combine the current poll leadership of the latter with confirmation that Mrs. Merkel will run for a fourth term as German chancellor, and the chances of Europe gaining two pro-European, centrist officials from its two largest countries in 2017 is on the rise.

With the first European populist government in Greece toeing the line and sticking within the euro zone for the foreseeable future, the realities of populist governments in power have been stark. Has populism in Europe passed its high point? A confirmation of this in 2017 would be positive for perceptions toward European equities.

International Equity Outlook: With Reappraisal, Can Come Opportunity

for both China and the broader emerging markets. Dollar-denominated debt burdens build and commodity prices sometimes wane. While most emerging market currencies fell versus the U.S. dollar, China's yuan fell to a much lesser degree, causing increased competitiveness in Asia's largest economy. A more meaningful and realistic concern surrounding China's economic policy is the government's potential decision to formally devalue its currency, which could, in turn, unleash a round of foreign exchange and trade uncertainties as other countries react to China's shift.

Pulling it all together, the biggest concern for international investments would be if the U.S. dollar remains overly firm. That is the power of the world's current reserve currency looking into 2017.

> "Post-election uncertainty surrounding global trade disruptions remains a key threat to emerging market economies going into 2017. Various economies could be adversely affected by potential changes to established trade deals and/or tariffs on imported goods. Applying tariffs to U.S. imports raises the cost of foreign goods for U.S. consumers, making them more competitive with goods made in the US. While the implementation and subsequent success of such policies is questionable, investors are likely to err on the side of caution until clarity presents itself."
>
> Nicholas Lacy, CFA, Chief Portfolio Strategist, Asset Management Services

KEY TAKEAWAYS:

- Europe: 2017 is more likely to be a year of "Brexit delay" where investors are positively surprised by the establishment of the groundwork for a "soft" rather than a "hard" agreement between the UK and the European Union
- China: Tailwinds for China's local economy include real wage growth, tax incentives and other efficiency/flexibility-inducing supply-side reforms put in place by the Chinese government
- Broad Emerging Markets: Post-election uncertainty surrounding global trade disruptions remains a key threat to emerging market economies going into 2017

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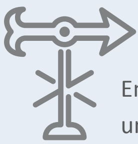


EMERGING MARKET EQUITY: HEADWINDS TURNED TAILWINDS?

Emerging market (EM) equities have been undervalued relative to their domestic counterparts for some time now. Still, bargain prices haven't been enough to lure investors back into these volatile markets, which lost more than 30% between April 2015 and January 2016.*

Things started looking up for these beaten down markets in 2016 as equities recovered and various headwinds began to subside. Despite rising growth prospects and improved earnings expectations, 2017 will likely remain challenging as U.S. policy under the new administration unfolds. Only time will tell if there is enough positive momentum to gain back the trust of wary investors. In the meantime, here is a look at some of the biggest headwinds turning potential tailwinds for emerging markets going into the new year.

With many emerging markets tied to commodity exports as a primary source of revenue, plummeting commodity prices sent countries like Russia and Brazil into recession territory. With prices coming off their lows in 2016 and trade imbalances continuing to improve, these economies will likely see the benefits of a continued commodity price recovery in 2017.

Many emerging countries with reform processes in place have started to see the fruits of their labour through increased growth prospects and improved earnings. Countries like China, Indonesia and India have implemented processes that encourage supply-side structural reform, fiscal consolidation and market deregulation.

China is perhaps one of the most visible emerging markets due to the sheer size of its economy. While headlines and sentiment have been mixed, the government continues to guide the economy through a "soft" transition from an infrastructure-based economy to a service-based economy. Additionally, structural reforms have been successful and improved earnings are likely given a rebound in growth.

The strong U.S. dollar has hurt EM countries on numerous fronts and remains a wild card going forward. Not only does it make the servicing of dollar-denominated debt more expensive for EM governments and publicly traded companies as local currencies fall, but it also erodes investment returns for U.S. investors who convert profits back to their own higher currency. A slowdown in the dollar's ascent would surely be welcomed by local borrowers and U.S. investors in 2017.

*Return data is based on the MSCI Emerging Markets NR Index from 4/24/15 – 1/15/16. Performance does not include commission and fees, which would reduce an investor's returns.

Fixed Income Outlook: A Tempered Trend for Interest Rates

Doug Drabik, *Senior Strategist, Fixed Income*, **Nick Goetze,** *Managing Director, Fixed Income*, **Benjamin Streed, CFA,** *Strategist, Fixed Income*

Recent history has introduced several different, yet impactful phenomena to the bond market including central bank control, the move to energy independence, and now a shifting political picture. Relative to the stationary interest-rate environment of recent years, anticipation for the 2017 bond market stands to be much more unpredictable and altering.

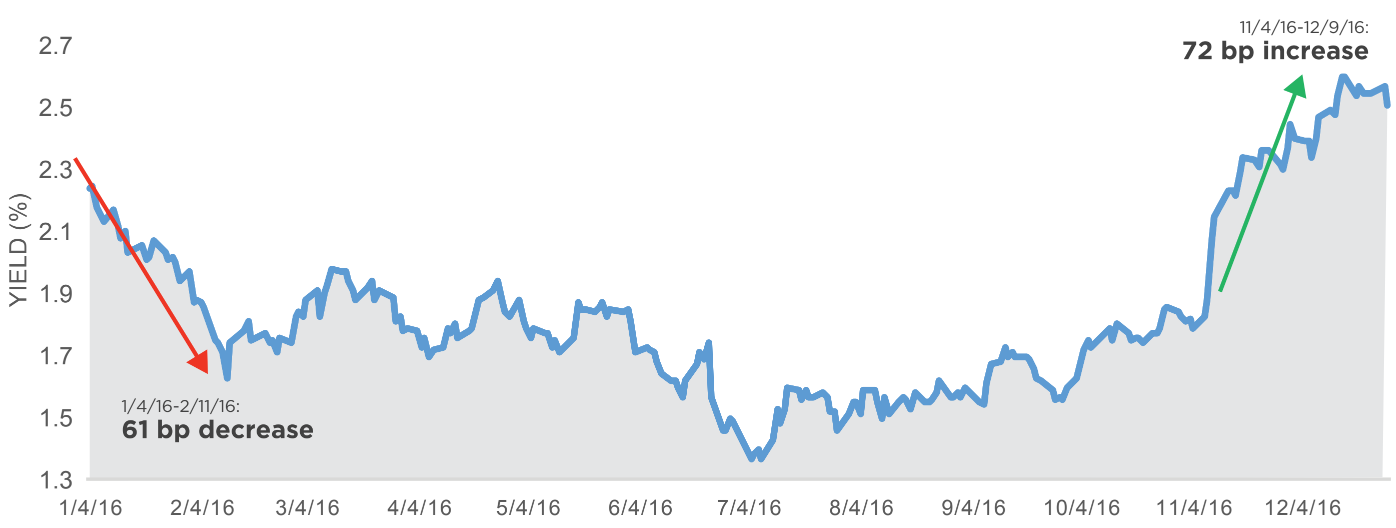
The market has idled on conflicting positive and negative economic data, continued low inflation and slow growth, but has been forcefully influenced by Federal Reserve (Fed) interaction. A marked 2017 political contrast is likely to reformat regulation and fiscal policy affecting many components of the bond market.

THE PRESIDENTIAL ELECTION

A post-election bump in interest rates was anticipated. President-elect Trump has been very clear about his plans to increase spending and decrease revenue via tax cuts, likely increasing the budget deficit and heightening the risks for higher inflation and higher interest rates. In a very short period of time, on the heels of the election, interest rates rose sharply on a percentage basis; however, they merely recaptured the early-2016 rate declines. Still, the expected fiscal policy change, ease on regulatory constraints, inflationary influences and slowly improving domestic economic numbers appear to finally give credence to projecting a trend up in interest rates.

BACK TO SQUARE ONE

2016 DAILY 10-YEAR TREASURY YIELD (Data through 12/28/2016)



Source: Federal Reserve

The Fed will certainly be in an improved position. The markets have depended on monetary policy to assist in controlling money supply and inflation. Inflation has not been a compelling force and, although the Fed ended its last quantitative easing program at the end of 2014, they simply took their foot off the gas pedal and remained in an "ease" position since. 2016 did not experience the Fed rate hikes most experts anticipated. It would take more than a few twenty-five basis point rate hikes to reverse policy from one of ease to one of tightening. A re-evaluation is suitable considering that the current monetary policy will possibly be met with an assist via fiscal policy. If so, the Fed will not have to "go alone" in 2017.

If, as proposed, corporate tax rates are cut to 15%, corporations stand to improve profitability without doing anything. Simplification of the tax code for individuals might reduce the current seven marginal tax brackets down to three. The top tax bracket is intended to drop from 39.6% to 33%, perhaps increasing individuals' disposable income. In the final months of 2016, municipal product spreads widened partly in anticipation of these changes; however, we do not anticipate a significant change in municipal bond demand as some benefits of lower marginal rates will likely be offset by reduced deductions and other allowance changes.

U.S. DOLLAR

U.S. dollar strength will impact demand for U.S. products and influence commodity pricing in 2017. The dollar has been gaining strength versus other currencies throughout 2016. If the Fed moves forward with several 2017 rate hikes, they will further support the dollar's strength. With a stronger dollar, U.S. exports become more expensive, lowering demand for U.S. goods and services overseas and thus hampering U.S. corporate earnings.

RISING INTEREST RATES

Although we anticipate interest rates to trend up, we do not anticipate an over-the-top interest rate shift. There are numerous headwinds tempering interest rate swings; many of which also hindered higher rates in 2016: global market influences such as interest-rate disparity, central bank immersion, demographics, dollar strength and corporate earnings. Additionally, in question is the feasibility of making policy and/or regulatory changes. If these changes do come to fruition, how long will it take those changes to filter into the economy and what impact will they make?

CONTINUED GLOBAL DEMAND

Bonds are likely to see continued demand in 2017. Several active and large global central banks including the European Central Bank (ECB), Bank of England (BoE), Bank of Japan (BoJ) and Peoples Bank of China (PBOC) continued quantitative easing programs throughout 2016. Toward year's end, the ECB started murmurs of slowing down. Global central bank intervention and/or detachment will be a significant influence on the bond market in 2017. We are entering the year with a significant yield disparity among top economic powers that will continue to have mitigating influence on U.S. interest rates until these global rates close the gap.

PORTFOLIO CONSTRUCTION

Our annual outlook would be remiss without the mention of the role of bonds within a portfolio. Most investors do not have endless cash flow or a perpetual means to produce income. The role of individual bonds typically excludes speculation, and strategic bond allocations are thought of in terms of "years" not "moments," virtually eliminating the effects of interest rate movements.

For wealthier investors, investment objectives generally focus on the preservation of wealth and income generation with capital appreciation as a secondary goal. Individual bonds provide continuous cash flow, income streams and return of face value at maturity, while a laddered bond portfolio can help to mitigate interest-rate risk and act as a ballast to equity exposure.

Fixed Income Outlook: A Tempered Trend for Interest Rates

Call protection, credit and duration will continue to be important bond characteristics in 2017. Although interest rates may continue to trend up beyond the time it takes for economic data to reflect any stimulus events, the aforementioned headwinds should keep the trend modest. Investors should work with their wealth managers and always maintain a long-term perspective when making strategic asset allocation decisions.

> Global central bank intervention and/or detachment will be a significant influence on the bond market in 2017

GLOBAL INTEREST RATE NONCONFORMITY

	2-YEAR RATE	5-YEAR RATE	10-YEAR RATE	30-YEAR RATE	SLOPE 30-2YR
UNITED STATES	1.246%	1.983%	2.490%	3.081%	184bp
UNITED KINGDOM	0.042%	0.470%	1.227%	1.855%	181bp
CANADA	0.770%	1.136%	1.719%	2.319%	155bp
FRANCE	-0.729%	-0.155%	0.647%	1.516%	225bp
GERMANY	-0.832%	-0.560%	0.178%	0.874%	171bp
SWITZERLAND	-1.181%	-0.748%	-0.257%	0.329%	151bp
JAPAN	-0.176%	-0.116%	0.029%	0.702%	88bp
HONG KONG	1.104%	1.625%	1.966%		

Source: Bloomberg, as of 12/29/2016

KEY TAKEAWAYS:

- The 2017 bond market stands to be much more unpredictable and altering relative to the stationary interest-rate environment of recent years.
- There are numerous headwinds tempering interest rate swings: global market influences such as interest-rate disparity, central bank immersion, demographics, U.S. dollar strength and corporate earnings.
- We are entering the year with a significant yield disparity among top economic powers that will continue to have mitigating influence on U.S. interest rates until these global rates close the gap.

All expressions of opinion reflect the judgment of Raymond James & Associates, Inc., and are subject to change. Asset allocation does not guarantee a profit nor protect against loss. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise.

Energy Outlook: Oil Recovers, Opportunities Arise

Pavel Molchanov, *Senior Vice President, Energy Analyst, Equity Research,* reviews 2016 and highlights the upside potential for energy in 2017.

A LOOK BACK

This past year has not been an easy one for the global oil market. While oil prices have bounced from the 13-year lows reached during the first quarter of 2016, both West Texas Intermediate (WTI) and Brent crude prices averaged in the mid $40s for the full year, about 10% lower than 2015.

The recovery has been slow for several fundamental reasons, including a strong dollar (especially with the recent jump in U.S. bond yields) and concern about high levels of refined product inventories worldwide. However, there are also reasons for optimism. Supply response in various non-OPEC geographies (U.S., China, Mexico, Colombia) is visible, and there are supply outages in some of the OPEC countries (Libya, Nigeria, Venezuela). Most recently, on November 30, OPEC announced its first coordinated production cut since 2008, alongside a similar commitment from Russia. History teaches us not to expect 100% compliance, but even partial implementation will still be a bullish driver for oil supply.

Looking to 2017, we remain of the view that there will be further recovery, to an average of $70/Bbl WTI and $73/Bbl Brent. This represents a cyclical peak, since we expect long-term prices to average in the $60s, but the higher 2017 level will provide a stimulus for the industry to get out of its two-year period of austerity and back to a more sustainable level of investment. Oil and gas capital spending was down globally by more than 20% in 2015 and 2016, the steepest two-year decline since at least the 1980s. The result was a non-OPEC supply decline of nearly 1 million barrels per day (1.5%) in 2016, as well as a large number of long-lead-time project cancellations (in countries such as Brazil and Canada) whose effects on supply will be felt in the latter years of this decade.

While there are a few companies (for example, in the Permian Basin) that are able to grow production even in the current commodity landscape, the vast majority worldwide cannot. For the industry as a whole to be able to afford a durable recovery in drilling activity, and thus supply growth, there must be recovery in cash flow, which in turn requires higher oil prices. This certainly does not mean that oil is heading back to its all-time highs above $100/Bbl, but we think it will be very difficult to achieve medium-term non-OPEC supply growth below the $60s.

> Looking to 2017, our view remains that there will be further price recovery

NATURAL GAS

In contrast to our upbeat view on the global oil market, we are much less enthused about North American natural gas. The exceptionally hot summer helped in 2016, adding to the fact that domestic supply was rolling over more or less continually during the year. However, some of the structural trends are still bearish: development of industrial gas demand has been frustratingly slow, the ramp-up in wind and solar has been eating into the market share gains of gas in the power sector, and liquefied natural gas (LNG) exports will not be needle-moving until 2018.

Following a 2016 average of around $2.40/Mcf for Henry Hub gas, we project a 2017 average of $3.25/Mcf, which is better but still not too bullish. 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, which helps explain the current oversupply in the global LNG market as supply ramps up from projects in Australia and elsewhere.

Energy Outlook: Oil Recovers, Opportunities Arise

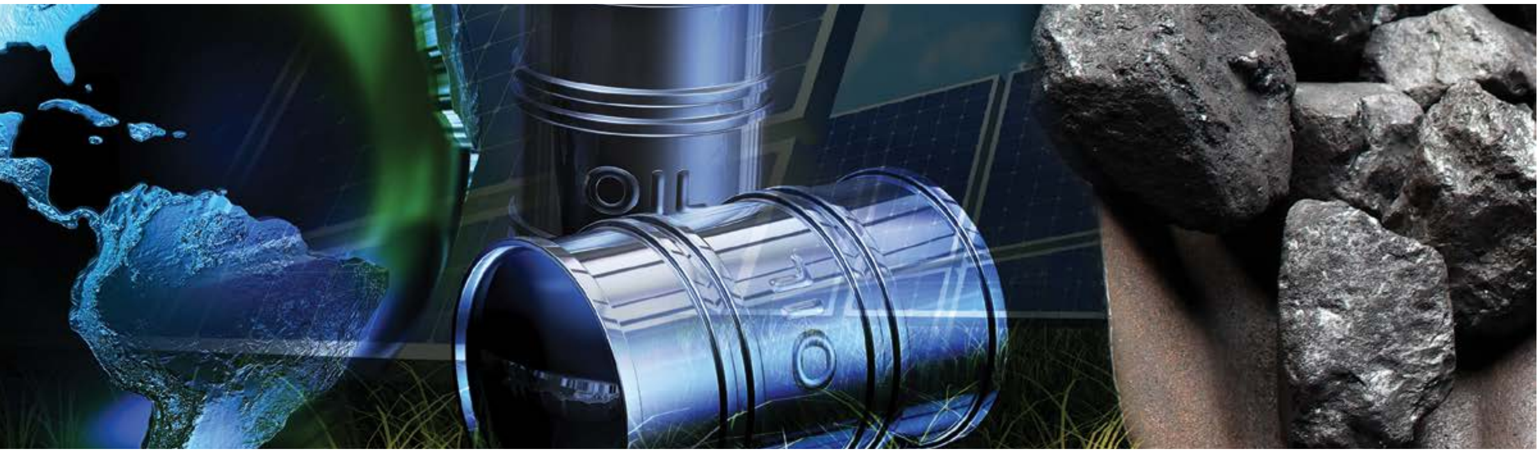
U.S. ENERGY POLICY OUTLOOK

Since we are on the topic of commodity markets, let's address the outlook for U.S. energy policy as the Trump administration and the new Congress take charge. When it comes to oil market fundamentals, the recent U.S. election – like almost all elections anywhere in the world – has very limited effect. One obvious beneficiary will be the Keystone XL pipeline, as well as some other delayed midstream projects, which the incoming administration will likely approve. Opening up Arctic and East Coast offshore acreage to drilling is also an open question, but under foreseeable oil price conditions, it is largely a moot point.

Where the new political landscape matters more is with regard to the electric power sector. The Obama administration's proposed Clean Power Plan will not take effect nationwide, although 16 states are already moving forward with their own de-carbonisation targets. Coal, whose market share in the electricity mix had

U.S. ENERGY MARKET SHARE BY SECTOR

	COAL	WIND & SOLAR	NATURAL GAS
	DOWN 17%	UP 6%	UP 14%
	NOT DECLINING AT A FASTER RATE	GAINING BUT AT SLOWER RATE	TREND OF FURTHER EXPANSION
2005	50%	2%	19%
2015	33%	8%	33%



plummeted from 50% in 2005 to 33% in 2015, will benefit by not declining at an even faster pace. However, it is hard to imagine coal's share rebounding, since its underlying decline was driven largely by technological changes (fracking and cheap gas, plus cheaper renewable power) and, to some extent, state-level regulations. Non-hydro renewables (mainly wind and solar, though including geothermal and biopower), which had soared from 2% in 2005 to 8% in 2015, should keep gaining share, but at a slower rate than what they could have exhibited under the Clean Power Plan. Natural gas (up from 19% in 2005 to 33% in 2015) is likely to be a mixed bag from state to state, but our bias would be for further expansion on the whole.

UPSIDE PARTICIPATION

For energy investors, we believe the most important theme in 2017 is to have exposure to the potentially continuing oil price recovery. This can be accomplished most directly with equities of oil producers (E&P and integrated companies), and indirectly via service contractors and midstream MLPs.

Since nearly all of these companies are involved in a combination of oil and gas, it is important for investors to consider the individual commodity weighting of any given company. Other business-specific factors, such as geographic exposure and balance sheet metrics, are also relevant. Selectively, there are opportunities in some of the gas-centric companies. Similarly, companies involved in refining and renewable energy, which are less tied to commodity price trends, should also be considered on a selective basis.

KEY TAKEAWAYS:

- Looking to 2017, we remain of the view that there will be further recovery, to an average of $70/Bbl WTI and $73/Bbl Brent.
- While the U.S. presidential election should have little effect on oil market fundamentals, one obvious beneficiary will be the Keystone XL pipeline, as well as some other delayed midstream projects, which the incoming administration will likely approve.
- For energy investors, we believe the most important theme in 2017 is to have exposure to the potentially continuing oil price recovery. This can be accomplished most directly with equities of oil producers (E&P and integrated companies), and indirectly via service contractors and midstream MLPs.

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