Q1 2017 | Capital Markets Outlook

Balance optimism on earnings with caution about Congress

Key takeaways

A simple resolution to an uncertain election has let the market focus on positive economic trends.

Optimism for pro-growth policies may give way to impatience with the legislative process.

Italy's ongoing banking crisis underscores Europe's policymaking discord.

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY			●
U.S. large cap			●
U.S. small cap		○	●
U.S. value		○	●
U.S. growth		○	●
Europe	○	●	
Japan		○	●
Emerging markets		●	
FIXED INCOME	●		
U.S. government	●		
U.S. investment-grade corporates		●	
U.S. mortgage-backed			●
U.S. floating-rate bank loans		●	
U.S. high yield			●
Non-U.S. developed country	●		
Emerging markets		●	
COMMODITIES		●	
CASH		●	○

Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro	○		●
£ Pound			●
¥ Yen		○	●

Global allocation insights

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Rising GDP, interest rates, and energy prices have helped the market

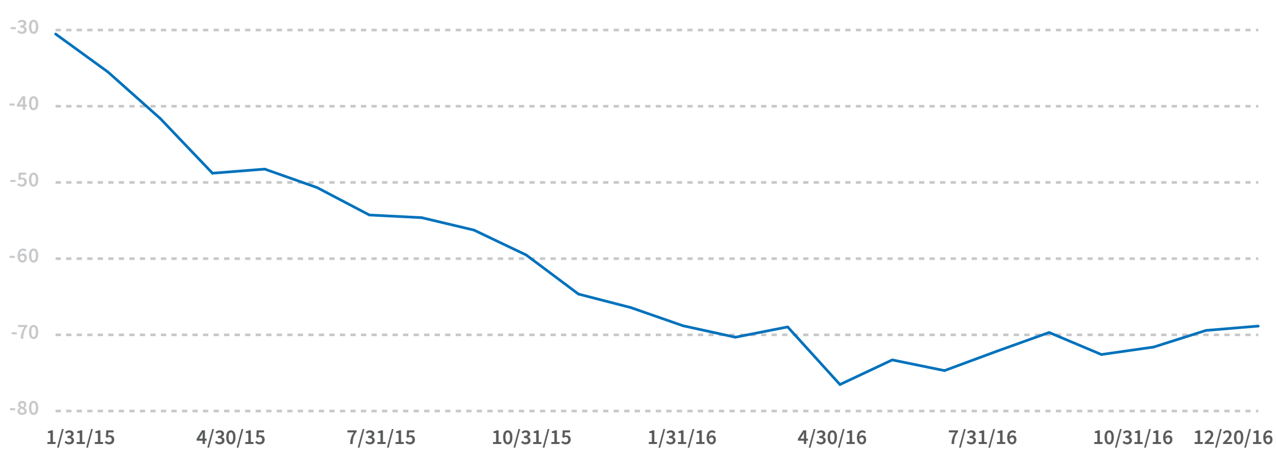
What a difference a day makes — in this case, Election Day. From August 15 through two days before the U.S. election, the S&P 500 had slid almost 5%, and failed to post a meaningful gain in the nine straight trading days ending on November 4. In the weeks since the election, in contrast, the index has reached eight new all-time highs. The financial press has generally attributed the post-election rally to a surge in animal spirits spurred by optimism surrounding the new administration's talk of lower taxes and deregulation. We would offer an alternative explanation: that the simple resolution of election uncertainty has allowed attention to focus on an uptick in macroeconomic activity in developed markets generally and in the United States in particular.

The Putnam GAA Economic Surprise indicator, which aggregates the variance of domestic economic data as actually reported from consensus estimates, bottomed in the middle of 2016 and has been trending steadily higher since then. Activity in other major economies has also either ticked up or stabilized in the second half of the last year. An uptick in interest rates around the world has also alleviated some of the pressure on bank profitability, which should be supportive of earnings in the financials sector in 2017.

Furthermore, the OPEC deal to limit production in concert with similar commitments from other important non-OPEC countries has brought an end to the two-year bear

The global economy has improved since the second quarter of 2016

Putnam GAA U.S. Economic Surprise Index



The Economic Surprise Index is a quantitative measure of how actual economic data releases compare with market participant forecasts. Economic surprise is the difference between economic forecasts and the subsequent actual data. A positive/negative surprise occurs when the actual economic data is better/worse than its forecast. The Putnam methodology aggregates the surprise across economic indicators relating to different parts of the economy. By tracking the index through time, it displays how forecasts relate to actual economic data throughout different periods. The outlook component comprises Chicago Purchasing Managers Index, Philadelphia Business Outlook Survey, The Conference Board Consumer Confidence, University of Michigan Consumer Confidence Index, ISM Manufacturing Index, ISM Services Index, and The Conference Board U.S. Leading Indicators. The output component comprises Advance GDP, industrial production, and U.S. census housing starts.

Source: Putnam Global Asset Allocation Group.

market in oil prices. The inflection point in oil prices is a positive development for S&P 500 earnings growth, as the drag from money-losing energy companies has been an important factor in the earnings stagnation at the index level for the past 18 months. A bottoming in commodity prices should also help the earnings picture in 2017.

S&P 500 earnings are poised to improve as energy sector rebounds

Revenue growth year over year of stocks in the S&P 500 Ex-Energy and the S&P Energy Sector indexes

Quarter	S&P 500 Ex-Energy	S&P 500 Energy Sector
4Q15	0.1%	-34.4%
1Q16	1.1%	-29.4%
2Q16	2.5%	-24.1%
3Q16	4.0%	-14.8%

Source: Bloomberg. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index. Past performance is not indicative of future results.

Lowering business taxes may take some time

These changes — more robust economic activity combined with a turn in the prospects of two important sectors in the market — are certainly important. In addition, there is clearly scope for the nascent surge in animal spirits to continue the previously mentioned prospects for lower taxes (particularly for corporations) and a less burdensome regulatory landscape. For example, we estimate that a change from the existing effective tax rate for S&P 500 companies to the 15% rate proposed by Trump, discounted back at the current cost of capital, would represent an immediate boost to earnings of somewhere between 15% and 20%.

Keep in mind that the optimism surrounding the pro-growth Trump policy talk is, at this point, still just that: talk. A precedent worth considering is that President Reagan had similar ideas for reforming and reducing business taxes, yet, despite his winning 49 out of 50 states in his re-election for a second term, it still took almost two full years to deliver tax *reform.* The legislative process for reform is much more burdensome than a simple change in any particular tax *rate*.

One fear is that at some point, there will be an air pocket between the pro-growth expectations, and the deliverable reality. We don't think we are there yet, primarily because, as we said, the current market environment may simply be reflecting the improved macro picture of the past several months that has gone somewhat unnoticed.

Some of Trump's campaign proposals could undermine growth

The larger fear is the current uncertainty regarding some of Trump's anti-growth rhetoric of protectionism during the campaign. Announcing that Peter Navarro will lead a newly created National Trade Council is a red flag in this area. Navarro has been one of the most vocal critics of China's mercantilism and will very likely be an advocate for making it more painful for other countries like China to send exports into the United States.

Anyone who has taken even an introductory economics class knows the equation GDP = C + I + G + X, where C is consumption, I is investment, G is government, and X is net exports (and where net exports = exports minus imports). Protectionist policies seek to raise GDP by raising X. But protectionism runs the risk of retaliation, putting exports at even greater risk, and perhaps reducing X unintentionally, and of increasing the cost of C. In addition, the United States for many years has also been the beneficiary of population growth, an unequivocal benefit to economic growth over time. At this time, it is also unclear what impact a Trump administration might have on future population growth and the growth dividend it provides.

Europe continues to confront policy challenges

We have also been highlighting the dangers presented by political risk over the past couple of quarters. While markets shrugged off both Brexit and the Italian constitutional referendum, we continue to monitor political risks in 2017, a year of major leadership elections in Europe, and a party Congress in China, a forum that takes place every five years and determines national leadership.

As we write this, the fate of the weakened Banca Monte dei Paschi di Siena (BMPS)* is still unresolved. The bailout via public/private partnership was unsuccessful, and the Italian central bank currently estimates a rescue will cost $7 billion (USD). Mere days into his new job as prime minister, Paolo Gentiloni described the solution to save Italy's bad banks

* As of December 31, 2016, Banca Monte Dei Paschi di Siena was not a holding in Putnam portfolios.

"will be long and complicated." His cabinet has approved a plan to earmark 20 billion euros for bank rescues. It took only hours for the Germany Finance Ministry to lecture the European Central Bank, cautioning it to monitor cheating against the new Bank Recovery and Resolution Directive.

One of Italy's oldest banks faces collapse as European authorities argue

Banca Monte dei Paschi di Siena's stock price (BMPS: IM) has plunged as it seeks capital

Source: Bloomberg.

Barely 70 years ago, Winston Churchill gave a speech in Zurich in which he said, "Yet all the while, there is a remedy which, if it were generally and spontaneously adopted, would as if by a miracle transform the whole scene, and would in a few years make all Europe, or the greater part of it, as free and as happy as Switzerland is today. What is this sovereign remedy? It is to re-create the European Family, or as much of it as we can, and provide it with a structure under which it can dwell in peace, in safety and in freedom." The European family is clearly going through some holiday squabbles. It is also somewhat ironic that, three generations after Churchill's speech, the United Kingdom would rather be a friend than a family member.

Optimism may be warranted for the near term

All that said, we are inclined to give risk assets the benefit of the doubt for the time being, albeit on a short leash. As the new administration turns words into actions, we will be actively assessing the proper multiplier to assign. For now, the inflection points in growth, in inflation expectations, and in the earnings prospects for the financials and energy sectors are enough reason to stay bullish.

Market trends

Index name (returns in US$)	4Q16	12 months ended 12/31/16
EQUITY INDEXES		
Dow Jones Industrial Average	8.66%	16.50%
MSCI EAFE (ND)	-0.71	1.00
MSCI Emerging Markets (ND)	-4.16	11.19
MSCI Europe (ND)	-0.40	-0.40
MSCI World (ND)	1.86	7.51
Nasdaq	0.08	7.27
Russell 1000	3.83	12.05
Russell 2000	8.83	21.31
Russell 3000 Growth	1.20	7.39
Russell 3000 Value	7.24	18.40
S&P 500	3.82	11.96
Tokyo Topix	-0.20	3.70
FIXED INCOME INDEXES		
BB Government Bond*	-3.72%	1.05%
BB MBS*	-1.97	1.67
BB U.S. Aggregate Bond*	-2.98	2.65
BofA Merrill Lynch 91-day T-bill	0.09	0.33
CG World Government Bond ex-U.S.	-10.84	1.81
JPMorgan Developed High Yield	2.48	18.22
JPMorgan Emerging Markets Global Diversified	-4.02	10.15
JPMorgan Global High Yield	2.41	18.27
S&P LSTA Loan	2.24	10.14
COMMODITY INDEX		
S&P GSCI	5.76%	11.37%

* BB is an abbreviation for Bloomberg Barclays.

Equity insights

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U.S. equities: Faster economic growth may fuel earnings improvement

Closing a year that began painfully for U.S. equity investors, the final quarter of 2016 delivered some pleasant surprises. The market advance that started in the third quarter continued through the end of the year, interrupted briefly by downturns in the weeks before the U.S. presidential election. In the election's aftermath, equity performance surged in anticipation of a new administration and the potential for corporate tax cuts, increased infrastructure spending, and a looser regulatory environment for many businesses. While most market observers expected post-election turmoil, many major U.S. equity indexes hit record highs throughout the fourth quarter and delivered solid positive returns for the year.

The surges in both share prices and sentiment were a welcome conclusion to a year of uncertainties. Investor optimism — even if misguided — can fuel equity performance, and optimism had been in short supply in recent years. However, we enter 2017 on a cautionary note, with an eye on sectors where valuations may have been stretched by the fourth-quarter rally. At the same time, we are pleased to be seeing more differentiation in the market. Equity correlations have declined, stocks are performing more independently, and there is clearer distinction between winners and losers. This expands our stock-selection opportunities, particularly in sectors that we believe were left behind in the post-election excitement. Examples include health care and consumer staples, which weakened with the fourth-quarter shift into more cyclical and industrial areas of the market.

For U.S. corporations, the earnings growth picture brightened in the latter half of 2016, and we believe profit growth will continue in 2017. In many cases, it will be easy to improve on the prior year's weakness, but other factors also contribute to our positive outlook. For example, a push toward infrastructure spending and deregulation should encourage capital expenditure and boost earnings growth in financials and a number of cyclical industries. However, the detrimental effect of a strong dollar remains an important potential headwind to earnings growth in the quarters ahead.

The late-2016 rallies — in equity prices, investor enthusiasm, and consumer and business confidence — are likely to power U.S. equity performance in the months ahead. But investors must be mindful of uncertainties that could interrupt, or even derail, the market's momentum, particularly the effectiveness of the new administration in quickly achieving policy changes.

Non-U.S. equities: The world, and especially Japan, could be lifted by faster U.S. growth

We continue to find significant value in international markets, particularly among developed-market stocks. The global economy is performing modestly better than expected. This may especially benefit companies in Europe and Japan whose operating leverage should materially boost margins in a better top-line growth environment. Furthermore, as a result of currency depreciation relative to the U.S. dollar, there is additional potential for improved earnings momentum among European and Japanese companies. In addition, if political pressures from European elections subside and new fiscal and trade policies under the incoming Trump administration surprise on the upside, there could be positive and mutually amplifying ripple effects throughout global equity markets. Also, though it has established a framework to begin tapering its quantitative easing programs late in the year, the European Central Bank (ECB) remains accommodative and quick to offer aid to systemically important sectors, as does the Bank of Japan (BoJ).

In our view, global reflation appears likely to occur as we believe the U.S. economy under President-elect Trump will accelerate — barring any negative effects from protectionist trade policies. This should lend the U.S. dollar strength relative to other global currencies, which could enhance a variety of non-U.S. equity opportunities. On the back of yen weakness, for example, we continue to like the near-term prospects of Japanese exporting companies, whose market share, sales volumes, and profits benefit from a depressed currency. In our view, the Japanese market remains a high-beta play on global reflation; that is, we believe Japanese stocks may prove to be especially sensitive to the restoration of global economic activity to higher levels.

With respect to European markets, we remain cautiously optimistic despite the various national elections that will occur in 2017. In the Netherlands, France, and Germany, voters will go to the polls this year, and while we expect populist candidates may perform well, we think they are unlikely to wrest political control from the establishment. Consequently, although current European politics has helped propel skepticism about regional integration, we do not expect resulting reconstituted coalition governments will call new referenda on EU membership.

In the United Kingdom, by contrast, we continue to believe that the economy and markets are headed toward a day of reckoning. Rising inflation, which is already evident in the fourth quarter of 2016 with respect to gasoline and imported food prices, will increasingly act as a tax on U.K. consumers. With uncertainty hanging over the U.K. government's negotiations on the terms of its departure from the European Union, we are somewhat cautious on U.K. domestic equities.

We regard emerging markets with perhaps the most caution. In general, we think emerging markets could suffer as a result of rising U.S. interest rates and a stronger U.S. dollar. Punitive tariffs or border-adjusted taxes, such as those promised to Mexico and China at different points by President-elect Trump in the run-up to the U.S. election, would be unambiguously bad for these countries. In addition, a strong dollar tends to correlate with weaker commodity prices, which could cause difficulties for a variety of commodity-exporting nations. High current account deficits in countries such as Turkey, Indonesia, and Brazil — among others — pose particularly difficult conditions for these countries. As a general rule, we will remain highly selective in our efforts to invest in attractively valued franchises across emerging markets.

Fixed income and currency insights

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Fixed income: Rising tide of economic growth creates numerous strategy choices

As we consider fixed-income markets in 2017, we are particularly optimistic about two factors. First, we think that the continuing global economic recovery will be positive for a variety of fixed-income sectors. Second, we think increasing levels of market differentiation across the global fixed-income landscape may be highly supportive of active fixed-income approaches. During the last several years of sluggish economic recovery, markets have experienced historically high correlations across a wide variety of asset classes. But as we enter a new political era, amid promises of pro-growth policies and post-U.S. election market exuberance, we expect to see more market, sector, and country-level differentiation — and diversification — which should create opportunities across a range of investment strategies.

As we believe we are entering an investment climate that is healthier overall, we also expect that the trend toward interest-rate normalization will continue, with substantial room for potential rate increases. Considering underlying U.S. economic growth, inflation forecasts, and the typical term premium that we would anticipate for this area of the market, we believe the normal yield on the 10-year U.S. Treasury should be significantly higher than where it currently stands. For this reason, we continue to de-emphasize interest-rate risk in many of our investment approaches, and find greater risk-reward potential across a variety of fixed-income sectors typically found outside of traditional fixed-income benchmarks.

We expect the corporate market to continue to generate attractive returns in an environment of constructive fundamentals and below-average defaults. In 2016, many high-yield issuers repaired their balance sheets and refinanced debt, which lends support to our constructive view across much of the credit spectrum. There has also been meaningful global demand for U.S. corporate credit, which has led to strong spread performance. We also continue to find attractive opportunities among select areas of emerging-market debt, particularly where idiosyncratic stories help differentiate what we consider attractively valued opportunities that can thrive in the evolving interest-rate and policy environments.

In the United States, the presidential election has opened up a set of potentially productive policy variables, particularly in the areas of fiscal spending and tax reform. With the apparent promise of greater cooperation across government, we think the change in the political climate could be helpful for the economy and welcomed by corporates. Simplifying the tax code, especially at the corporate level, could result in a substantial repatriation of capital. That could spell good news for share repurchases, deleveraging, and merger-and-acquisition (M&A) activity. Furthermore, tax reform for consumers should generally be a tailwind for spending, which could be beneficial for a broad range of U.S.-focused companies.

In securitized debt, we continue to like the prospects of commercial mortgage-backed securities (CMBS) and non-agency residential mortgage-backed securities (non-agency RMBS). With CMBS, we think the market will continue to make positive gains on the back of healthy real estate market fundamentals. With non-agency RMBS, we expect that the housing market's continuing recovery as well as the shrinking supply of this security type will support the total return prospects of this area of the market in 2017.

Currency: The dollar appears poised to advance based on growth pace and interest-rate differentials

The Republican sweep in November, spearheaded by President-elect Trump, dramatically changes the distribution of outcomes for growth, inflation, and monetary policy. Many of Trump's policies remain uncertain, in particular the timing and configuration of infrastructure spending and tax cuts. However, looser fiscal policy is highly likely, the deficit will be larger, and the term premium needs to be re-established. The greatest challenge for markets remains around Trump's policy regarding trade.

The potential fiscal boost from the Trump administration has yet to be incorporated into the Federal Open Market Committee's economic outlook. Currently, the Fed appears to be less concerned with the effect of a higher U.S. dollar and rates, and the appetite for running a high pressure economy seems to have abated. So with the market still pricing rates to remain below Fed projections, the potential for pricing in more hikes and a stronger U.S. dollar is greater. If Trump's protectionist rhetoric remains a more benign policy, then one should expect a continued reassertion of the strong U.S. dollar trend that began in 2008 and a more aggressive path of rate hikes by the FOMC.

The outlook for the euro will be dominated by relative monetary policy and mired in ongoing political risk. The ECB has announced a nine-month extension of quantitative easing at a tapered, €60 billion per-month purchase rate from April 2017. By surprising on the dovish side with regard to time horizon and at the same time tapering the purchase rate, the ECB has also bought itself time and side-stepped a series of potentially difficult discussions about further extensions during 2017. This should cap how high the euro can climb against the U.S. dollar given greater expectations for Fed rate hikes. The political risk in Europe is difficult for markets to price since the risk of a eurozone dissolution is not trivial, but in the short run, it is not very large. This will likely cause volatility to the single currency but is unlikely to be the principal driver of its direction.

The outlook for the British pound continues to be driven by the political landscape surrounding Brexit, with more fundamental aspects less relevant. Brexit Minister David Davis acknowledged in the House of Commons that making payments to the European Union in return for single market access was a possible outcome. This softening of tone toward a hard Brexit has and will provide support to the pound on a relative basis. Once positioning has adjusted, the pound should once again follow relative monetary policy that suggests a move lower against the U.S. dollar.

The Bank of Japan, after implementing its "yield curve control" in September, stated that it would ensure the 10-year Japan government bond (JGB) yield will remain around 0% by varying its JGB purchases and offering fixed-rate JGB purchases when needed. Owners of JGBs might watch rate differentials widen to other global bonds, and can sell to the BoJ at the yield cap and send capital overseas, resulting in a weaker yen.

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