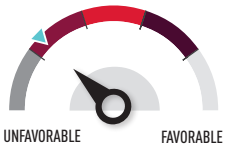
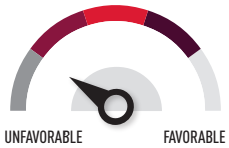
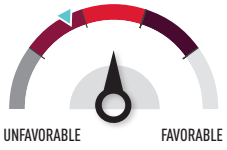
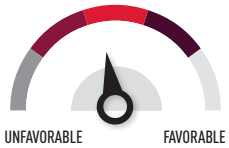
CAPITAL MARKETS VIEW

Fourth Quarter 2017 - Global Edition

OUTLOOK	EQUITY INSIGHTS	LONG-TERM VIEW
	**UNITED STATES** • A second straight quarter of double-digit earnings growth was seen in Q2 though P/E ratios remain at cycle highs of more than 21x, well above long-term averages. • Modest economic growth and tight labor markets allowed the US Federal Reserve to continue to normalize policy, but with inflation low, moves will remain gradual. The balance sheet roll-off is set to commence in October, and a further quarter-point rate hike is expected in December. • Operating margins remain elevated at nearly 14%, but they may prove unsustainable over the long term if companies face wage pressures or begin to accelerate capex spending. • Washington policy paralysis means an uncertain path for pro-growth reforms, with tax reform measures seen as more likely to pass than a major infrastructure package. While the fiscal impact of the tax act is expected to be limited, tax reform has been broadly embraced by financial markets. • Rebuilding efforts in the wake of hurricanes Harvey and Irma should provide modest fiscal stimulus in late 2017 and early 2018. • A weaker dollar and a synchronized global growth upturn should remain a tailwind for US multinationals.	
	**CANADA** • Strong earnings growth in materials and industrials helped propel the MSCI Canada index to new highs while bringing valuations more in line with longer-term averages. • A G7-topping annualized growth rate of 4.5% in Q2 following on the heels of a 3.7% rate in Q1, strong job gains and rising disposable incomes prompted the Bank of Canada to hike rates twice during Q3, to 1%, despite inflation running well below target. However, recent data suggest economic momentum has slowed, particular in the housing sector, and that the market may be pricing in too much additional tightening from the BOC. • Rising earnings, recovering energy prices, increased business investment, falling unemployment and solid global demand are tailwinds, though uncertainty surrounding the future of NAFTA and a significant cooling in the housing market are potential headwinds.	

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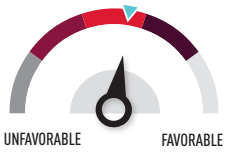
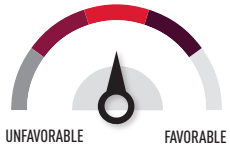
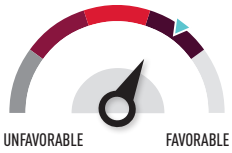
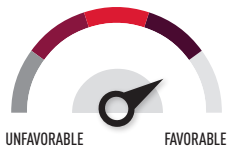
	**EUROPE EX-UK** • Earnings have shown two straight quarters of growth, with MSCI Europe ex UK index companies showing Q1 earnings growth in excess of 30% followed by Q2 growth of 14%. • Sales growth, trailing 12-month P/E ratios (19.1x) and dividend yields are all in line with their 20- year averages, suggesting European equities are less stretched from a valuation perspective than most of their global counterparts. Yet net margins are expanding, now at 6.7% versus a 20- year average of 5.8%. • Currency moves have played a large role in recent performance, with euro strength holding back the market in recent months, though prices ticked up at quarter-end as the euro gave back some gains. • Markets have taken in stride the potential for the European Central Bank to announce a tapering of bond purchases late this year. The ECB recently raised its GDP forecast while lowering its inflation outlook, suggesting any tapering will be quite gradual. • Europe has fully participated in the synchronized global growth upswing, and its economic expansion has been broad-based across countries and sectors.	
	**UNITED KINGDOM** • Earnings have shown three consecutive quarters of double-digit earnings growth. However, most earnings gains have been concentrated in energy and financials. • While sales grew 21% in Q2, net margins compressed to just 4.9%, well-below the 20-year average of 8.2%. P/E ratios remain extremely rich, at 24.1x LTM earnings versus a 16.1x 20-year average. • Net trade is supportive of the broad economy owing to the global recovery and a relatively weak exchange rate, though sterling has recovered some lost ground of late. The export sector has partially offset the uncertainty surrounding Brexit. • While the UK government seeks a two-year transition deal with the European Union to maintain the status quo following Article 50 negotiations, EU negotiators continue to focus on more immediate issues such as the UK's exit payment, the rights of EU citizens in the United Kingdom and the Northern Ireland border. Brexit uncertainty is likely to persist for some time, as is uncertainty over the continued tenure of Prime Minister Theresa May. • Domestically oriented firms must contend with high inflation that stems entirely from sterling weakness and is squeezing household real incomes, which in turn is holding down consumption.	

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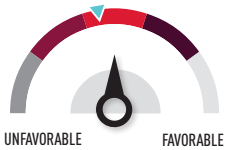
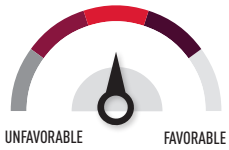
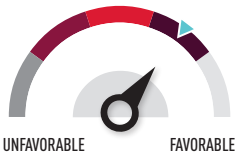
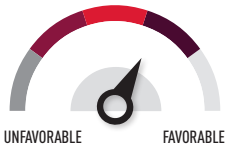
	**JAPAN** • The market has shown solid growth, with the MSCI Japan index rising on the order of 10% on a total return basis year to date, aided by reasonable valuations, profit-focused corporate reforms and an upswing in economic growth. • The market P/E multiple of just less than 15x compares favorably to 20.8x for the MSCI World Index, but is high compared with the 20-year average near 9x. Given the improving corporate governance environment, margin expansion appears justified. • Rising corporate profits and upbeat business sentiment have largely offset lackluster wage growth and muted consumer spending as exports remain supported by solid global demand. • While the Fed has embarked on balance sheet normalization and the ECB is contemplating tapering asset purchases, Bank of Japan policy is likely to remain highly accommodative for the foreseeable future while inflation continues to run well below target despite very tight labor markets. • Political volatility is possible as Prime Minster Shinzo Abe has called a snap election to seek a mandate to face the challenges posed by North Korea and an aging population that will require a rebalancing of the social security system. Some fear Abe could lose his parliamentary supermajority, potentially setting off ripple effects that could prevent BOJ Governor Kuroda from being reappointed. The vote is set for 22 October.	
	**ASIA EX JAPAN** • Supported by a broad-based upturn in global trade, Asian markets have been among the world's best performers year to date. Despite the solid performance, valuations continue to run below the 20-year average of 18x, trading at 15.7x. • China's stronger-than-forecast 6.9% GDP growth rate has been a key contributor to the synchronized upturn in the region, while retail sales have been rising in excess of a 10% annual rate. However, deleveraging may become a renewed focus late in 2017 after the Communist Party Congress in late October. Standard and Poor's became the last of the three major credit rating agencies to lower China's credit rating in September. • The region's tech-heavy orientation has helped drive returns in 2017, but any demand slowdown for products such as smartphones could prompt increased volatility. • India's economy continues to adjust to the government's demonetization policy and the introduction of a goods and services tax at mid-year. Growth slowed to a 5.7% annual rate in the April–June quarter from 7.9% a year earlier.	

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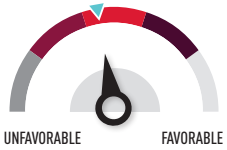
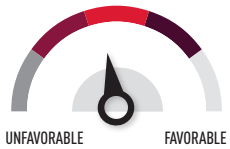
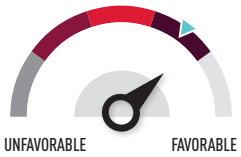
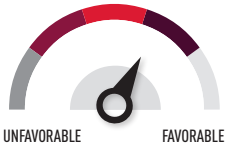
	**AUSTRALIA** • Australia has been among the world's worst-performing markets year to date, with weak relative performance. • P/E multiples are in line with long-term averages, at 17.6x. • Earnings growth has been concentrated in the materials sector owing to the global commodity price rebound. Earnings growth outside the dominant sector has been sluggish. • High levels of household debt combined with subdued wage gains are crimping consumption despite solid gains in employment. • Rebounding commodity prices and record-low interest rates are tailwinds.	
	**EMERGING MARKETS** • A resynchronization of global growth, if sustained, should support global energy demand. Valuations are on par with their 20-year average of 15x but trade at a significant discount to developed market equities, which trade at nearly 21x. • Expanding profit margins have contributed to outperformance, with margins today approaching 9% versus 8% a year ago. • Supported by a widening EM–DM economic growth differential, emerging markets have outperformed developed markets by a substantial margin year to date in 2017. • Low debt levels relative to developed markets and a growing middle class, which could increase domestic demand for goods and services in emerging markets, are tailwinds for the asset class, while potential US trade restrictions and rising interest rates are short-term risks.	

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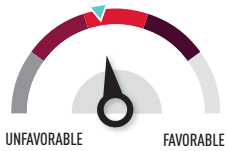
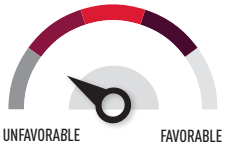
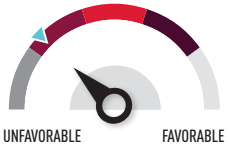
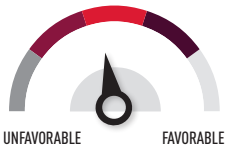
	**US TREASURIES AND AGENCIES** • A modest uptick in inflation and indications that the Fed will likely increase the federal funds rate in December have pushed Treasury yields modestly higher in recent weeks. • We believe, however, that the Fed and other central banks are disposed toward "dovish" tightening, and are likely to continue gradual and transparent policy normalization. • Since longer-term rates are historically very low, the process of unwinding the balance sheet and removing liquidity from the system could apply some upward pressure on rates. However, the US and global economies continue to be buffeted by a variety of headwinds, including extraordinarily high debt levels, unfavorable demographics and the disinflationary effects of globalization and technological advances. Consequently, we maintain the view that long rates will likely be contained in a low range going forward relative to their history. • Economic statistics are being distorted by temporary impacts from hurricanes Harvey and Irma, making analysis of Q4 data more challenging.	
	**GLOBAL EX US SOVEREIGNS** • Major developed sovereign bond yields generally remain near historically low levels but have risen recently amid an improving growth backdrop. • Yields have also risen recently as central banks have prepared to normalize monetary policy. • Policy normalization is likely to be gradual, however, given the absence of inflationary pressures and the still-fragile nature of the global economic recovery. • Given the low level of yields and the potential for modest upward pressure on rates as accommodative monetary policy winds down, we feel there is better value in credit-related markets such as global investment-grade debt. • Canadian yields have risen substantially amid rapid GDP growth and two Bank of Canada interest rate hikes, the second of which caught markets somewhat by surprise due to inconsistent messaging from the bank. Concerns over potential property and debt bubbles persist. However, markets may be pricing in too much BOC tightening given weakness in recent data.	

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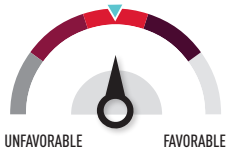
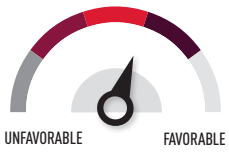
	**EMERGING MARKET SOVEREIGNS** • The asset class remains supported by a positive global macro backdrop of moderate, synchronized growth and subdued inflation. • We expect that a widening differential between emerging market and developed market growth will remain a key support for EMD. Historically, capital has flowed to EM assets when emerging economies' economic activity has expanded at an accelerating pace relative to that of developed economies. • Despite some exceptions, EM country fundamentals appear resilient. Many continue to make progress on adjusting macro imbalances and implementing structural reforms. • Developed market central bank monetary policy normalization poses a risk to the asset class. However, the pace of tightening is likely to be tempered by very modest inflationary pressure. • A "lower for longer" global rate backdrop has supported strong inflows into EMD, but as a result, valuation in the asset class has become tighter and positioning relatively crowded. This represents a source of vulnerability to any significant increase in market volatility, which has been very low versus history. • Local currency EMD offers better value than hard currency EMD but has historically exhibited higher volatility. Despite full valuation compared with its own history, hard currency EMD still offers reasonably good value relative to certain other credit markets, which have similarly become more expensive.	

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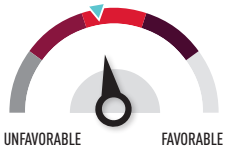
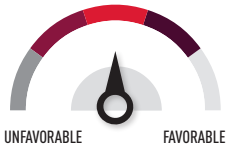
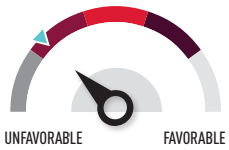
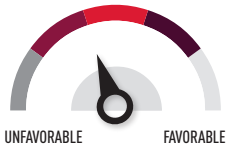
	**GLOBAL INVESTMENT-GRADE CORPORATES** • In major IG regions, spreads generally tightened as company and economic data continued to present a relatively benign backdrop for investment-grade credit. • In the United States, company fundamentals are solid but are past peak for this cycle. Interest coverage has declined over the past few years, and earnings in noncyclical industries are in the low to mid-single digits, well below the levels of the early years of the post-GFC recovery. Technicals are favorable as issuance is proceeding at the same pace as it has the past two years, yet inflows are running at multiyear highs. • In Canada, we continue to expect credit to outperform over the course of the cycle, though many credits appear fully valued. While we do not anticipate any near-term recession or major credit event in Canada, it is difficult to see spreads narrowing materially from current levels. • The economic cycle in Europe appears to be a few years behind that of the US. Economic activity continued to surprise to the upside and has supported the improvement of company fundamentals. Supply has picked up since summer; however, new issues have been consistently oversubscribed even as an announcement regarding the tapering of central bank asset purchases has neared. • We continue to favor investment-grade over high-yield in a generally tight spread environment. Regionally, we are biased toward US investment-grade versus Europe on greater duration concerns in the region. We favor a relatively defensive position in both the US and Europe and stress selectivity in an environment where overall index spreads are tight.	
	**GLOBAL HIGH-YIELD CORPORATES** • Although experiencing some sensitivity to North Korea–US nuclear brinksmanship in early August, high-yield spreads tightened over the course of the quarter. As in investment-grade, the economic backdrop remained supportive for credit fundamentals. • In both the US and Europe default rates and distressed ratios are low and continue to decline. Company fundamentals remain somewhat better in Europe, where levels of company leverage are at the low end of the historical range and interest coverage is at cyclical highs. • In the US, supply has not kept pace with investor demand, which is unusual against such a benign credit backdrop. The supply picture may be changing, however, as new issue activity accelerated recently. In Europe, technicals are favorable where a moderate amount of supply has been met with heavy demand. • With spreads fully reflecting the positive fundamental environment, investors might consider underweighting the riskier parts of the high-yield market. We also favor selectivity over broad market factor exposures.	

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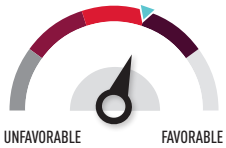
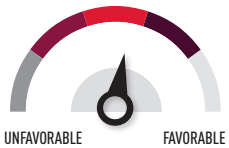
	**US MUNICIPAL BONDS** • Municipal bonds continue to offer relatively attractive tax-equivalent yields while exhibiting stable credit fundamentals. • Slow but steady US economic growth should continue to help municipal bond fundamentals. Supply/demand technicals, while difficult to forecast, also appear supportive for now, with supply likely to remain at a manageable pace. • While not our base case, a swift and sizable increase in US Treasury yields may negatively impact the municipal market due to its longer duration and US-centric investor base. Historically, however, such impacts tend to be short-lived. • Continued headline risk around pension concerns may lead to periodic bouts of volatility; however, in our view the vast majority of municipalities should continue to offer attractive income and stable credit quality.	

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Our expectations are developed across 26 countries comprising 18 developed countries and 8 emerging market countries.

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