

Global Investment Forum 2016 — 2021

Secular Outlook



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Our 2016-2021 Global Investment Forum Secular Outlook is the result of two days of collaboration and debate among BMO's international investment leaders and strategists – and select independent experts – that help to round out our perspective on the relevant and enduring themes that will impact global economies, and capital markets, for years to come.

Make Headwinds Your Tailwind

Why is it important to develop a longer-term perspective, when it seems that capital markets narrowly focus on the short term – bouncing from one sensational headline to the next? **Portfolios built to take advantage of secular themes can enjoy a favourable tailwind; those that ignore them are bound to struggle in the face of formidable headwinds.**

At any given time, there are only a handful of big picture events that have a pronounced effect on all, or parts, of the global economy, and shape outcomes for countries – and investors. When these consequential macro-economic themes come into play, they tend to stay in play for very long periods of time, becoming investible events. Similarly, at BMO Global Asset Management, our secular view informs strategic portfolio allocations, and sets the guidelines for active asset allocation opportunities that may arise from ongoing tactical strategy work.

Three Actionable Scenarios

We capture the thought leadership of BMO Global Asset Management's annual Global Investment Forum in three pragmatic scenarios, starting with a high-conviction base case – an overview of what we believe will likely play out economically on the global stage, and the areas of investment that should either be emphasized or de-emphasized. While the informed exploration of our base case contemplates what could go right, it also serves as the jumping off point to consider catalysts for a second scenario that surprises to the upside – and a third, in which we uncover potential problems, and ask ourselves what could go wrong.

Annual Scorecard: A Look Back at 2015

Overall, our longer-term forecast scores a good grade as trends we identified in past Secular Outlooks are still in play.

The Forecast Over the last couple of years, our forecast of persistently low growth, low inflation and low yields has been accurate. On the one hand, we expected highly accommodative monetary policy to persist broadly from most central banks, thereby stimulating economic activity and supporting risk assets. On the other hand, we anticipated that global debt levels would dampen the rate of growth – with recovery U.S.-led, albeit at a somewhat slower pace than experienced historically.

Equities vs. Fixed Income Our expectation of a strengthening U.S. dollar against a broad basket of currencies has also been ‘on the money’. Our call to overweight equities versus fixed income added value, as did our strong emphasis on investments in U.S. equities across a broad range of capitalization sizes. We were also careful to underweight commodities and commodity-focused countries and equity sectors, especially over the last year or so – and that too has proven appropriately defensive for portfolios.

Interest Rates Our fixed income forecast called for the U.S. Federal Reserve to begin raising interest rates. While well out in front on this projection, given the December 16th announcement, we continue to expect that increases in the Fed’s discount rate will find a new, albeit lower, “normal” over the next few years.

Upside and Downside Surprise Last year we adjusted our expectations down on a surprise to the upside, and reassigned a higher probability to a downside surprise, as risks to our forecast, particularly in China, were materializing notably.

We call our base case scenario “Firing on More Than One Cylinder”, reflecting a broader outlook for developed market growth beyond the U.S., with other geographies – such as Europe and Japan – showing the potential to come on track over our time horizon.

Firing on More Than One Cylinder (60% Probability)

Our base case, *Firing on More Than One Cylinder*, calls for a broadening of global economic growth over a number of key geographies. In this scenario, while the U.S. continues to lead the expansion – relative to the rest of the world – a more balanced recovery is in the cards as Europe and Japan now show signs of improvement and opportunity.

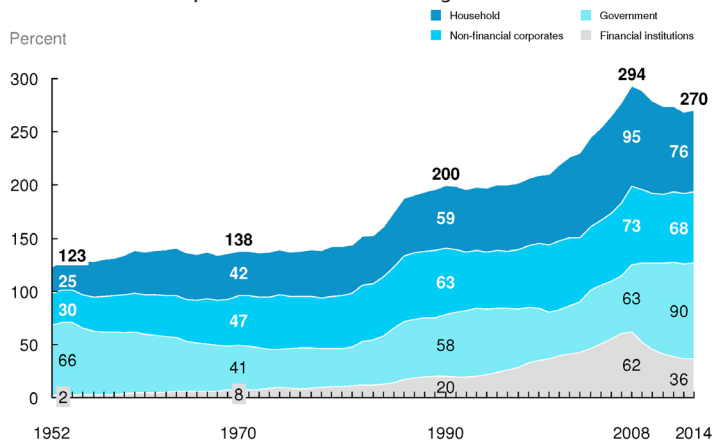
A Tale of Three Regions Our view is predicated on a belief that the U.S. economy is a resilient engine, and will continue to chug along with its modest growth trajectory; Japan, though at an early stage in the cycle, realizes expansion potential, having put favourable policy change and structural reform in place to address – and contain – challenges; and the rebound in Europe, which has been much slower to recover from the Great Financial Crisis of 2008, is on more solid footing. (Given slow global growth, even a slight contribution from Europe could prove meaningful). Our overall view is tempered by generally lower expectations for global GDP growth, and returns for many asset classes may be muted, necessitating a strategy that factors in the long-term, durable macro trends outlined in this report. Over the timeframe of this scenario we expect that the phrase “lower for longer” will be frequently employed to refer to energy prices, inflation and interest rates.

Energy’s Sharp Decline In our primary scenario, we can expect the sharp decline in energy prices to be a primary driver of growth for all three regions over the next few years; as net importers, their consumers and manufacturers alike stand to benefit substantially. Lower energy prices result in a transfer of income from commodity producers to consumers, behaving much like a household tax cut that improves real income. Unlike the U.S., European consumers are acting on pent up demand and already spending most of their extra disposable income, having postponed purchases in recent years. For our analysis of the oil story, see page 6.

The story for commodity producing countries is a very different one. Canada is a case in point: lower oil prices have slowed that economy and driven the Canadian dollar sharply lower. The expectation that the lower currency would stimulate the manufacturing export sector has, to date, not materialized though it does take some time for this to have any significant impact. The hollowing out of Canadian manufacturing over the last few decades, and the fact that a sizable part of the remaining industry has tooled up to support the energy and mining sectors, weighs heavily against manufacturing fully offsetting energy exports. While high Canadian household debt is concerning, on the positive side, home sales/building starts are healthy, federal government debt is modest by any standard, and the newly-elected government is inclined to provide some much-needed fiscal stimulus for infrastructure.

FIGURE 1
United States Debt-to-GDP Ratio

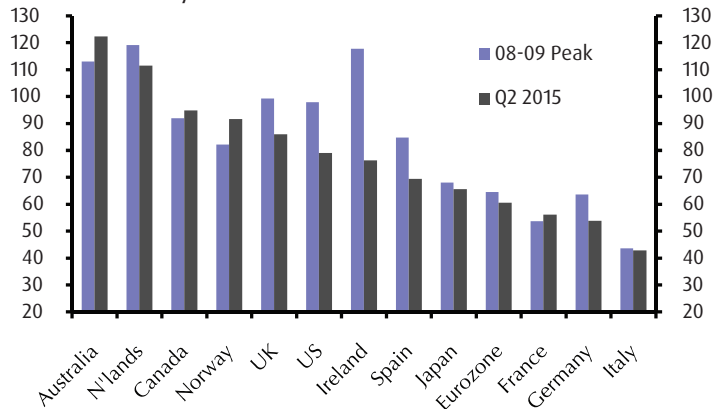
Total US debt has peaked and is contracting.



Source: McKinsey Global Institute

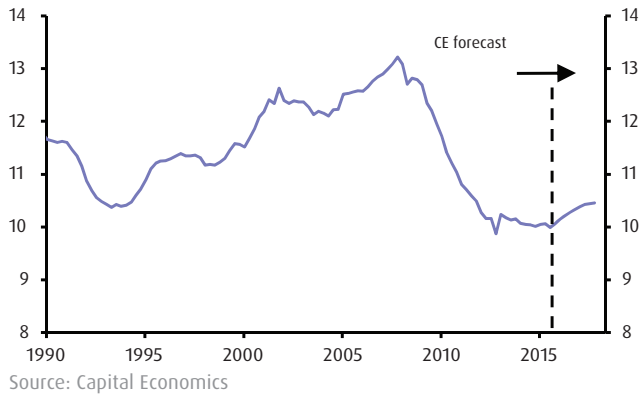
FIGURE 2
Household Debt (as a % of GDP)

Debt reduction by US households relative to other countries.



Source: Capital Economics

FIGURE 3
US Household Debt Service as a Share of Disposable Income
 The cost of servicing debt in the US has improved significantly.



The Debt Overhang A massive debt overhang is a headwind for a number of countries, where high sovereign debt-to-GDP ratios are an impediment to growth, are deflationary, suppress interest rates and limit both fiscal and monetary policy options. The U.S., however, has been singularly effective in getting its economic house in order, addressing debt across all three broad sectors of the economy: government, corporate and household, in particular, where consumers have vastly improved balance sheets.

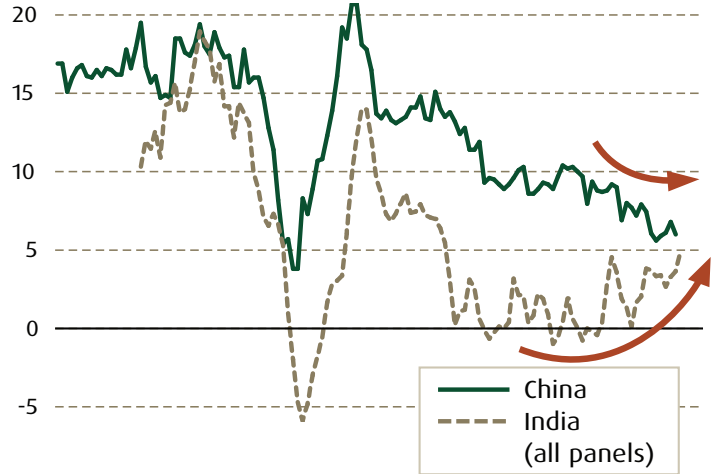
Cycle Signals The unemployment rate is one signal that suggests we may be further along in this cycle. In the U.S., robust job gains since 2008 have been consistent with those of a strong recovery despite a shrinking participation rate. Wage gains have been modest, although expected to increase as the employment picture tightens further. Japan too, included in our base case, has experienced strong wage growth and has a modest 3.4% unemployment rate.

The housing market in the U.S. continues to firm, with sales in 2015 likely to post the best numbers in eight years. Despite this improvement, the sector has been running below its long-term trend, and policy choices may be the culprit. The Federal Reserve has been an aggressive buyer of mortgage bonds, which helps to keep mortgage rates low. Yet at the same time, the government has been insisting that the banks keep lending standards restrictive. A result is that the rental vacancy rate is near a 30-year low, despite affordable mortgages and strong consumer balance sheets. A tightening labour market is a sure sign that the fundamentals for housing are improving, and we expect the sector to contribute to growth over the intermediate term.

While the U.S. consumer is in great shape, U.S. manufacturing and exports are under pressure as a result of the stronger dollar. In this primary scenario, the rate of appreciation in the U.S. greenback slows or even retreats modestly. Manufacturing rebounds as global growth and international trade expands.

China's Crucial Role No discussion of enduring trends would be complete without acknowledging the role that China now plays on the world stage, particularly the impact of its economic challenges on global GDP growth. Despite mounting debt, sharp elbows on world trade markets, and factors such as adverse demographics, the world's second largest economy is still expanding at a compound rate, is diverse, and – secularly – has a burgeoning service sector less reliant on manufacturing and exports. Policymakers have a difficult road ahead as China undergoes a dramatic shift in its economy from industrialization to consumer-driven. Key to our base case view is that their adjustments moderate, but do not break, China's growth trajectory – and it's our contention that they have ample flexibility – and firepower – to contain potential crisis.

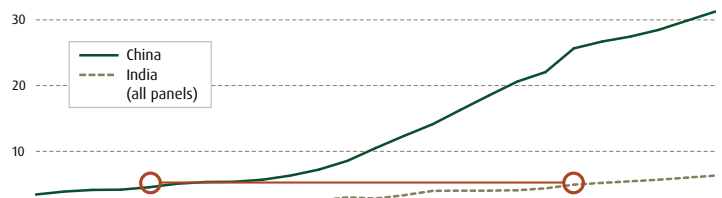
FIGURE 4
Industrial Production (%YoY)
 Industrial production levelling off for China, picking up for India.



Source: The Macro Research Board

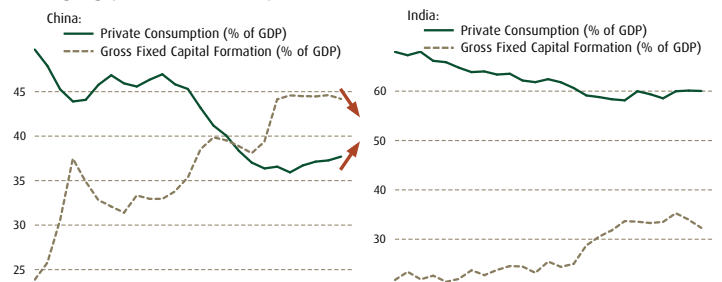
India GDP growth in India is gathering momentum and shows considerable promise of emerging as "China 2.0": Indian GDP, expressed as a percentage of either Developed Market or Global GDP, looks strikingly similar to where China was a decade and a half ago. Favourable demographics drive the savings rate, with India saving more as China consumes more – and a high savings rate typically drives high investment. Infrastructure and manufacturing lead the Indian economy with the support of lower oil prices.

FIGURE 5
GDP (% of Developed Markets, Current US\$)
 India now where China was 15 years ago.



Source: The Macro Research Board

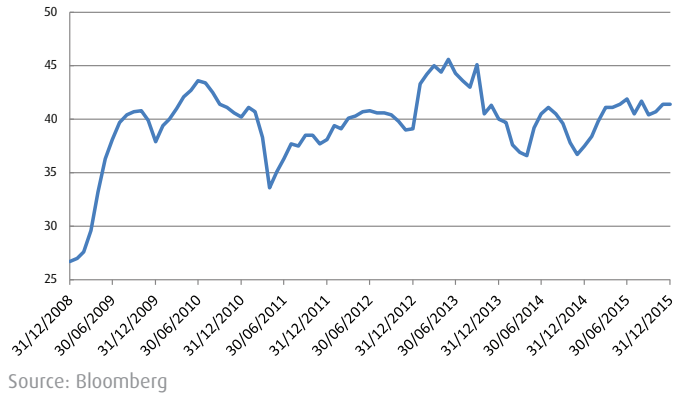
FIGURE 6
Private Consumption/Gross Fixed Capital Formation (% of GDP)
 Changing private consumption trends in China and India.



Source: The Macro Research Board

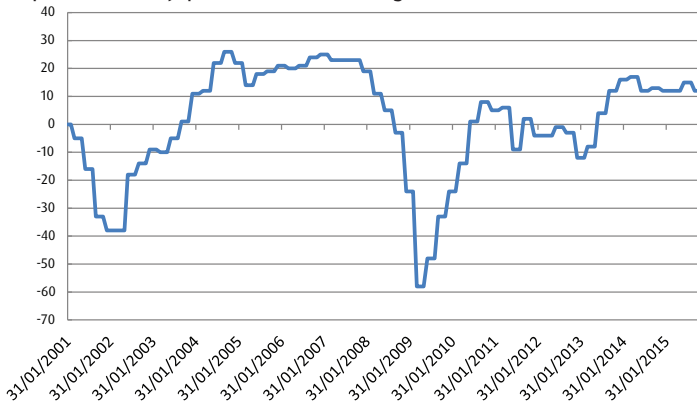
Japan Growth in Japan bounces back from the impact of the significant slowdown in China. In this scenario, the structural changes of Abenomics continue to show positive impact on that country's competitiveness. A weaker yen continues to support manufacturing and export growth. Japan is able to cope with a high government debt-to-GDP ratio by a strong commitment to further stimuli, and adverse demographics are somewhat offset by higher female participation in the workforce.

FIGURE 7
Japanese Consumer Sentiment
Improvements in Japanese consumer sentiment.



Source: Bloomberg

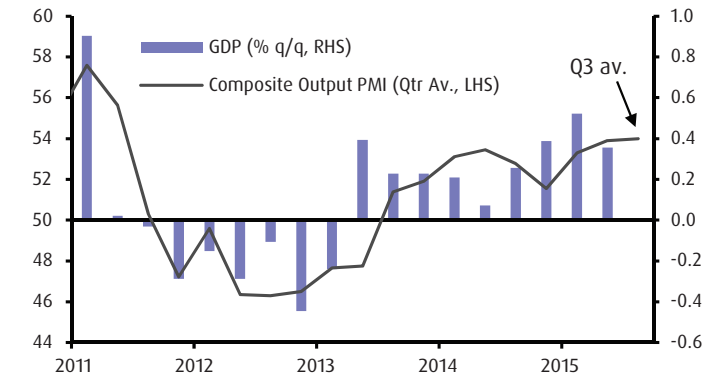
FIGURE 8
Japan Tankan Survey
Improvement in Japanese manufacturing sentiment.



Source: Bloomberg

Europe In our base case, Europe is able to see past its event-driven issues and focus on a more fulsome economic recovery. Rigid austerity is balanced with prudent fiscal stimulus. Having overcome fundamental, existential threats from Greek solvency, massive unemployment and a double dip recession, Europe emerges with renewed confidence. This translates into improved, albeit sluggish, growth over most of the member countries. The situation has been aided and sustained – despite Greek sovereign risk and the tentacles of its impact – by a movement toward fiscal policy/burden sharing; an embrace of stimuli; lower oil prices; and stalwart austerity from Germany as a role model.

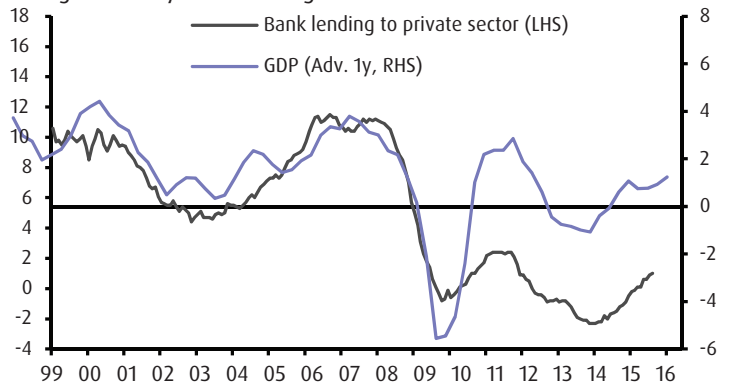
FIGURE 9
Eurozone Composite PMI and GDP
Rebound in Eurozone PMI and GDP.



Source: Capital Economics

Despite ongoing structural issues (Grexit and Brexit risks), broad debt, and budget deficits – our view is that Europe is unlikely to come unglued over a three to five-year time horizon, and, in fact, more likely sees a warm unabated tailwind from a strong commitment to quantitative easing by the European Central Bank; more pronounced growth in areas such as the U.K.; and a resurgence of countries with lower debt levels.

FIGURE 10
Bank Lending to Private Sector and GDP
GDP growth may be bottoming.



Source: Capital Economics

Two events bear watching carefully: how well the eurozone fares with reducing unemployment, and how successful it is in economically integrating the huge influx of refugees.

Policy as a Barometer of Change One major refinement to our base case view is that policy decisions, specifically the risk of getting it wrong, will be much more consequential over the next few years – a key period of policy change. While the last five years have been about convergence on issues of monetary accommodation, quantitative easing programs, and austerity – we now see far less homogeneity, and are entering a period of divergence, with greater investor scrutiny on policy appropriateness and effectiveness. The Fed raised its discount rate this year, however, key questions remain: what will be the pace and magnitude of further rate increases – and what does a “new normal” level look like? Can policymakers in China continue to liberalize its financial systems, while undertaking a massive economic restructuring – and how much resolve will they have for continued financial reform in the face of any major slowdown? Clearly, predicting policy poses uniquely difficult challenges.

• **Investment Implications in Our Base Case Scenario**

The fundamental premise of this high-probability scenario is the broadening of the economic recovery to other key geographies, specifically Europe and Japan. While the expectation is that growth will continue to slow in China, that deceleration occurs in an orderly way with that country gradually and successfully transitioning from an industrial-led to a more balanced, consumer-led economy.

• **Equities**

In our base case, we remain overweight equities relative to fixed income, given the persistently low yield environment throughout most of the globe, as well as the likelihood of further interest rate increases in the U.S. An important caveat is worth noting: this recovery, now entering its eighth year, is starting to show signs of maturing. The three to five-year timeframe we reference in this outlook may well include a recession, particularly in the U.S. Also noteworthy: valuations in U.S. equities are not inexpensive, and a more selective approach to equities is required especially within that asset class.

The emphasis on U.S. equities focuses on non-resource cyclicals, which include Information Technology, Financials, Consumer Discretionary and Industrials. A further emphasis is placed on companies that have domestically-generated revenue. Commodity and other cyclical sectors are underweighted.

International equity diversification is appealing given this scenario’s nascent recovery in Europe and a continuation of easing in Japan. Lower currencies in both of these regions should prove to be an effective tailwind. Within Europe, countries that are large importers of oil are overweighted, while equities in peripheral countries are underweighted.

Emerging markets should not be viewed as a homogenous asset class; rather an important distinction should be made between commodity producers and commodity importers. Countries in the latter group should be emphasized; India, with its reform agenda and favourable demographics, is particularly appealing. The commodity exporters (Russia, Brazil, Venezuela) are downplayed

until there is a clear and convincing sign that the oil supply/demand imbalance is being worked out.

• **Fixed Income**

Fixed income investors have faced an enormous challenge since the Great Financial Crisis. The deliberate, sustained low interest rate policies of central bankers around the globe have made it difficult to generate levels of income that even approximate returns that were previously enjoyed. Our central scenario calls for “lower for longer” interest rates though the consequence of a persistent, albeit gradual, recovery is that eventually rates are pressured upward. We don’t expect any dramatic surge in interest rates, barring an unexpected systemic shock. Inflation-linked bonds work well in this scenario, as do credit products (both investment grade and high yield). The caution, though, with credit products is that they will likely underperform should evidence of a recession appear. Emerging market debt, short-dated and sovereign bonds have more modest allocations in our base case, and Canadian preferred equity is also underweighted.

• **Alternative Assets**

The investment environment in *Firing on More Than One Cylinder* lends itself particularly well to a number of alternative strategies. Hedge funds that exhibit skill exploiting style premia are attractive. Those include long/short strategies that take advantage of longer-term style trends, such as the tendency of cheaper stocks to outperform more expensive ones; trading momentum, in that an asset’s recent performance continues; higher-yield assets that outperform those with a lower-yield; and the likelihood of lower-risk, higher-quality stocks to outperform riskier ones.

• **Other Considerations**

Long only commodity-related strategies are avoided during the early part of this scenario. As oil “catches a bid” that investment posture should be reversed.

Finally, in our base case, a fiscal spend would be a welcome companion to monetary policy. Infrastructure, particularly where sovereigns partner with the private sector, can be rewarding.

Firing on More Than One Cylinder (60% Probability)

Implications for Capital Markets

Over emphasize		Under emphasize
Equities		
Developed Markets		
U.S.	Non-resource cyclicals including: Information Technology, Financials, Consumer Discretionary, Industrials Domestically-oriented companies U.S. dollar	Commodity/cyclical sectors: Energy, Base Metals, Precious Metals Income sectors: Utilities, Pipelines, Telecom
Non U.S.	Europe Japan Countries or regions that are large oil importers	Peripheral eurozone equities Canadian equities until oil prices firm Euro and yen exposure Commodity/cyclical sectors: Energy, Base Metals, Precious Metals
Emerging & Frontier markets	India (demographics and reform agenda) Commodity importers	Commodity exporters (Russia, Brazil, Venezuela) Chinese equities
Fixed income		
	Inflation-linked bonds	Emerging market debt
	Credit products: investment grade and high yield until evidence of a recession become clearer	Sovereign bonds
	Peripheral Europe	Short-dated bonds Canadian preferred equity
Alternatives		
	Style premia	Insurance linked
	Infrastructure	Commodity-related
	Property	
	Long/short relative value strategies	
	Private equity	
	Alternative fixed income, where alpha strategies go beyond duration and credit as a source of value-add	

A Secular Shift Leaves Oil Lower... for Longer

The price of energy and oil, more specifically, is so heavily determined by shorter-term, cyclical factors that constructing an actionable longer-term view is challenging. Despite that, a number of influencing factors are likely to endure for some time: further enhancements to drilling technology, continued environmental pressure, and increased development and refinement of alternative energy sources.

The Supply/Demand Imbalance

The price of oil has dropped by more than half since early 2014, yet supply continues to be near its all-time high. Recent estimates show that global demand, despite growth this year to 1.7 million barrels per day (mmb/d), is unlikely to sustain that pace next year. Supply still exceeds demand, and correcting this imbalance is essential to firmer oil prices.

Our expectation is that global supply growth will slow sharply in 2016: the Saudis aren't likely to boost production further as their fiscal budget is already struggling with current pricing; U.S. and North Sea production is trending down; Russian production has likely topped out due to the allegedly poor treatment of foreign investors, especially oil companies; Canadian production is slowing; and finally, OPEC members are motivated to restrain output moderately next year, which could nudge prices upward. Iran, however, could add around 0.6 mmb/d by sometime next year, if it complies with all of the requirements of its nuclear program deal. This would slow the oil market rebalancing, but not reverse it.

Our Outlook for Oil Prices

Our short-term forecast is for the WTI benchmark to average just under US\$50/barrel this year, and rise to an average of US\$57 next year. It's our view that if the price of oil settled anywhere under \$60/barrel, it would seriously constrain new projects in the United States, and continue to slow output growth in Canada and elsewhere.

While global demand isn't likely to increase as fast as it had during the past decade or so, due to moderating growth in emerging markets, and the ascent (if still small share) of alternative fuels, it will still be growing for at least another decade, as new projects are needed.

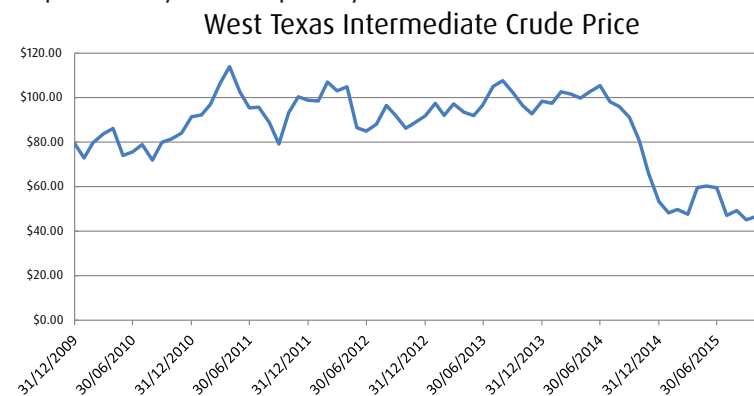
The risk to a \$57/barrel forecast is likely skewed to the downside, given challenges to more robust global economic growth. Looking beyond 2016, the global market is likely to remain in an excess demand condition (compared to surplus supply this year, and likely through the first half of next year), leading to a further paring of excess global inventories and a moderate rise in prices.

What has happened over the past year has led to a sea-change in oil company strategy and investor preference - from investing to expand oil production at any cost (oil prices over \$95/barrel are a huge incentive) to investing to optimize profitability. Improvements in capital and operating efficiency will at the same time reduce production growth, costs and equilibrium prices.

FIGURE 11

WTI Price History

Oil price history over the past 5 years.

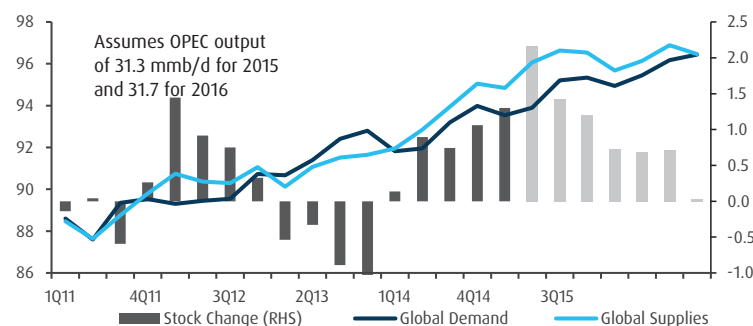


Source: BMO Global Asset Management

FIGURE 12

Oil Supply/Demand Imbalance

Excess supply versus demand over the past 4 years.



Source: Barclays Research

Growing Global Debt. Why Worry?

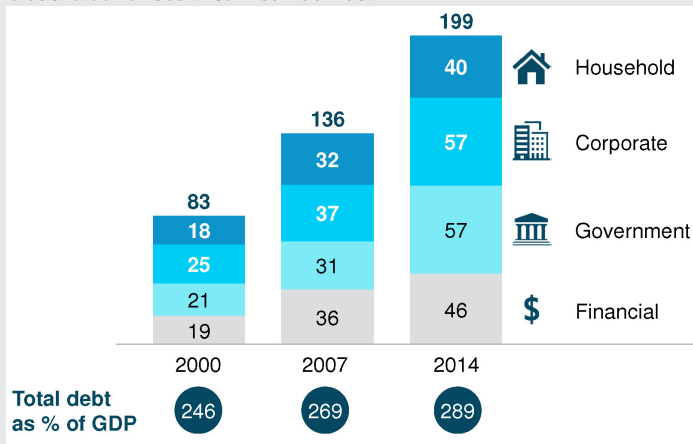
The preoccupation among economists, investors, and international media about global debt ratios centres on the issue of unsustainability; particularly the vulnerability of financial systems, and the implications of unprecedented debt levels on economic growth, and capital markets, for resolving the overhang. Our thought leaders weigh in – with an unorthodox view.

The Backdrop: Some Staggering Numbers

Against the backdrop of a 35-year period of continuously declining rates, global debt has risen by \$63 trillion since the 2008 financial crisis – without aggregate deleveraging – creating continued concern about stymied global growth, volatility, and financial system vulnerability. And at first blush, the statistics appear staggering.

FIGURE 13
Total Global Debt

Global stock of debt has mushroomed.

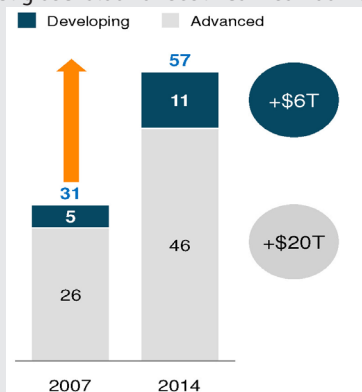


Source: McKinsey Global Institute

Emerging market debt has increased ninefold since 2000, with China's debt quadrupling and ex-China levels growing significantly; household debt has continued to rise among emerging and developed markets – outside the core 'crisis' countries – to include Thailand, South Korea, Sweden, France and Canada among others; and the stock of government debt across a wide swath of advanced economies has increased by \$26 trillion since 2007, leading to concerns of default or restructure, most notably with Greece.

FIGURE 14
Government Debt Has Grown by \$26 Trillion...

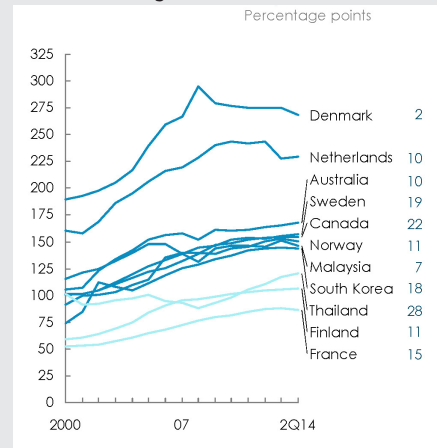
Demonstrates that global stock of debt has mushroomed.



Source: US Treasury Department; McKinsey Global Institute

FIGURE 15
% Change in Debt-to-Income Ratio, 2007-2014

Household debt continues to grow.



Source: McKinsey Global Institute

All of which begs the question: *can this significant stock of global debt be sustainable against the headwinds we face, including prognostications of a lurking global recession?*

Consider the Positives: Quality, Ownership, and Serviceability of Debt

Upon closer look at the nature of global debt, key characteristics point to reduced risk – and ultimately – sustainability.

Concurrent to a decline in shadow banking and a rise in corporate bonds and new sources of corporate lending, we've seen debt ownership shift to central banks and other sovereigns as a result of quantitative easing, and a resulting improvement in both credit quality and debt serviceability.

In the U.S., debt has peaked; personal balance sheets strengthened; and credit quality improved, evident in higher FICO scores – the standard measure of consumer credit risk. While Japan leads the pack in terms of government debt, the Bank of Japan has become the largest holder of government bonds as a result of stimulus, and similarly, the European Central Bank has extended the depth of its bond-buying program to the tune of €1.1 trillion. While China causes concern, we believe it has the firepower and policy flexibility to recapitalize and contain its debt issues, which are in actuality largely real estate related, and at the government level. And while all eyes are on Greece, where debt is a drag on the economy, the bailout concessions have effectively forgiven interest payments to creditors, allowing the country to focus on servicing its stock of debt through growth.

Among the new paradigms to consider: should central bank owned debt even be included in debt-to-GDP statistics, or do we need another measure for this type of leverage – an ex-official holdings ratio?

A New Paradigm to Ponder

We'd like to offer an interesting consideration, contrary to the current mantle of austerity: isn't it time that our leaders took advantage of historically low interest rates to issue more debt?

If fiscal policy initiatives were sound, and debt serviceable, a concerted effort on the part of the developed world to increase debt-to-GDP – in a fiscally responsible manner – would allow governments to use sovereign debt to address the infrastructure deficit in partnership with private capital – a win-win scenario worth deliberating, and perhaps necessary, as central banks have alluded to the fact that monetary policy alone may no longer be able to do the 'heavy lifting' of the economy.

Policy Panacea (20% Probability)

Our surprise to the upside is predicated on policymakers around the globe getting it right, both in the short and intermediate term. This scenario does not require all of the potential catalysts below to come into play; a few will suffice to move the needle.

Europe The European Central Bank, continuing to play a key role in this economic region, stands resolute on its commitment to “do whatever is necessary” by holding interest rates low, and expanding quantitative easing appropriately. European growth, fuelled by low currency and low energy costs, responds; unemployment rates trim across a number of countries, particularly in the Mediterranean periphery; margins expand; and market multiples improve. European governments do not squander their growth dividends; instead, they take practical steps to retire debt, and stick to more sustainable budgets. Further challenges with Greece are addressed by a more accommodative approach to debt forgiveness that ensures either a successful outcome, or that risk of contagion to other vulnerable countries is convincingly ring-fenced.

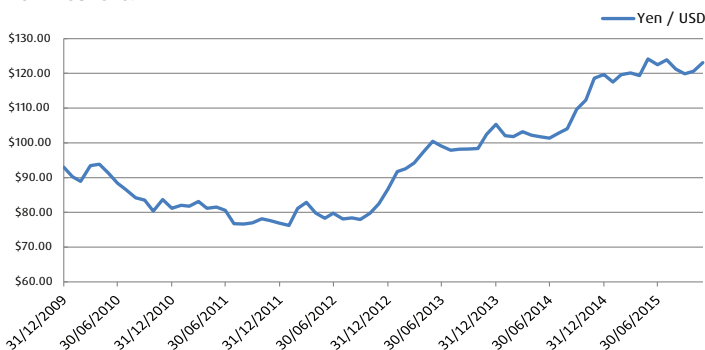
The U.S. The U.S. Federal Reserve begins to tighten interest rates in a well-communicated manner – and at a measured pace. Markets acknowledge the initiative as a positive economic sign and respond accordingly: GDP growth is stimulated as businesses and manufacturers make capital investments; consumers ramp up spending, achieving previous on-trend GDP growth; and housing also firms to trend.

China China deftly continues the repurposing of its economy with a slower pace of investment squarely focused on productive projects, yet remains the world’s best growth leader. Missteps are minor; the Fifth Plenum affirms China’s commitment to financial liberalization and reform as set out in its newest Five Year Plan.

India With an economy today that looks much like China’s before its growth ascent, India’s policy reforms and supportive demographics expand the investment rate in this scenario. The country also leverages its inherent advantages in attracting foreign capital – specifically, its use of the British legal system (protection of property), democratic governance, and its highly educated, English-speaking population.

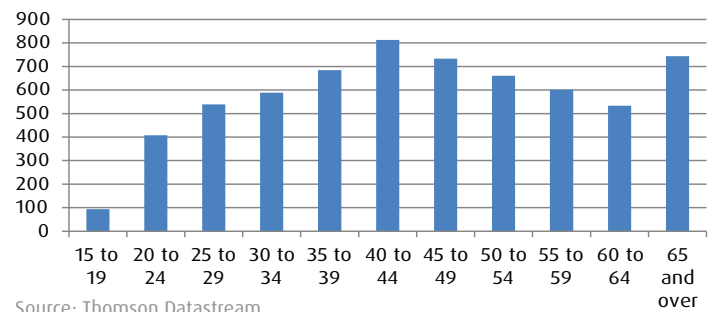
Japan In Japan, an emboldened Abenomics fulfills its promise to bump much needed inflation up to its 2% long-term target. Further gains in wages, as well as monetary and fiscal stimuli, prompt a shift in inflation expectations, motivating consumer and corporate spending – and engineering a further drop in the yen, to the benefit of Japanese exporters. A deflation threat is not replaced with an inflation scare.

FIGURE 16
Price Chart of Yen/USD Over Past 5 Years
Yen weakens.



Source: Bloomberg

FIGURE 17
Japan – Employed Persons by Age (0000s)
Demonstrates the older age profile of the Japanese workforce.



Source: Thomson Datastream

And finally, in an upside surprise, low oil prices act as a catalyst for increased industrial output and more robust consumer spending. Demand for oil and energy generally increases in this scenario over time, and commodity-producing countries reap the rewards as exploration and production companies rebound.

Investment Implications in a Surprise to the Upside

In the *Policy Panacea* scenario, the robust growth in global GDP is best captured with a full “risk on” asset class exposure.

- U.S. equity portfolios emphasize the highly cyclical sectors, notably Energy, Materials, Information Technology, Consumer Discretionary, Industrials, and Financials (with the same sector emphasis applied to equities in both Europe and Japan); small cap stocks are favoured over large
- While the selection of U.S. companies favour those with high foreign-generated revenue, the opposite is the case for both Europe and Japan, where a high domestically-generated revenue is preferred
- Canadian equity is included in the mix, as are stocks of Emerging Market countries that produce commodities – particularly oil
- For fixed income investors, inflation-linked bonds are preferred over sovereign bonds, and short-dated securities emphasized over longer-dated
- Alternative investments such as commodities and global macro strategies should do well in this scenario

Policy Panacea (20% Probability)

Implications for Capital Markets

Over emphasize		Under emphasize
Equities		
Developed Markets		
U.S.	U.S. including cyclical and commodity-based equities: Energy, Materials, Information Technology, Consumer Discretionary, Industrials and Financials	Large capitalization equities
	Small capitalization equities	U.S. equities with a strong domestic orientation
	Companies with high foreign-generated revenues	Non-cyclicals including: Consumer Staples, Utilities and Telecom
Non U.S.	Eurozone and Japanese particularly cyclical equities	Low beta, high yield equities
	Eurozone and Japanese companies with high domestically-generated revenues	Large capitalization equities
	Small capitalization equities	Countries that do not have a high commodity, cyclical orientation
	Canadian equities	
	Euro and yen currency exposure	
Emerging & Frontier markets	Emerging market equity	
	Oil exporters e.g. Russia, Brazil, Venezuela	
	China	
Fixed income		
	Inflation linked (break-even wideners)	Nominal rates
	High yield bonds	Sovereign bonds
	Emerging market local	
	Investment grade corporate debt	
	Emerging market debt	
	Short-dated bonds	
Alternatives		
	Commodities	
	Style premia strategies	
	Global macro strategies	
	Long/short relative value strategies	

Debt IS a Four Letter Word (20% Probability)

If a surprise to the upside is predicated on policymakers getting key decisions right, it's equally likely that a policy error or two will result in a surprise to the downside – and given the number of consequential policies contemplated or in play, there are opportunities for miscues.

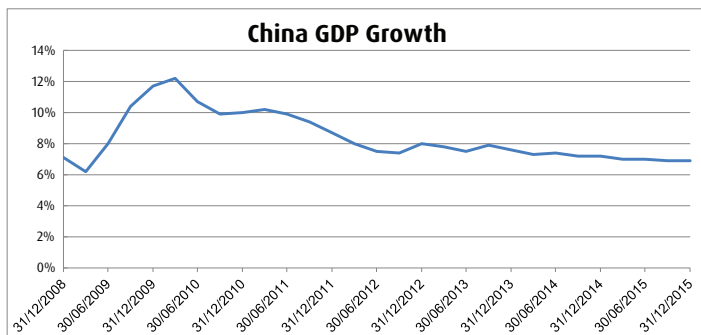
In this scenario, with a maturing expansion, tightening labour market and aggressively stimulative monetary policy, the U.S. Federal Reserve walks a tightrope in that either acting too quickly, or failing to act in time, can have a potentially disastrous outcome.

The assumption by the Fed has been that it has the tools to deal with a re-emergence of inflation, but once that inflation genie is out of the bottle, it's difficult to contain. If the central bank stays at the party too long, the downside surprise includes aggressive rate hikes – required to choke off reaccelerating inflation – and, ultimately, the overall impact on global GDP growth, which would have a tough time withstanding a retrenchment.

FIGURE 18

China GDP Growth Over Past 7 Years

Slowing trend in GDP growth in China.



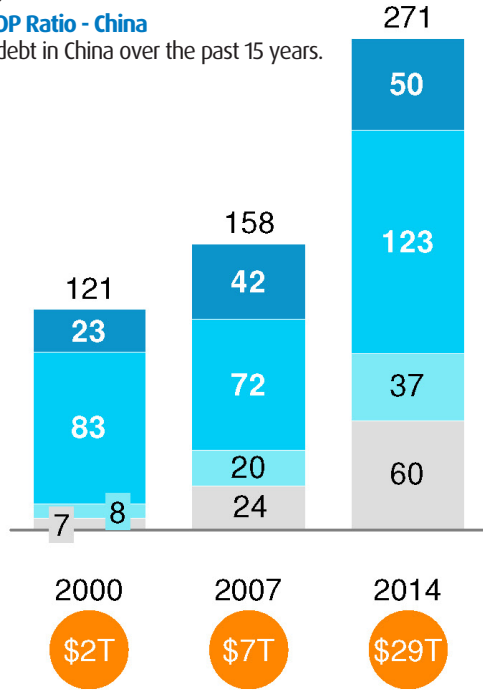
Source: Bloomberg

Other Factors to Consider in Our Debt IS a Four Letter Word Scenario

- Policymakers in China are not able to repurpose their economy away from investment-led to consumer-led. A hard landing occurs, which spreads to other emerging market economies – or worse – results in an Asian-led global recession

FIGURE 19
Debt-to-GDP Ratio - China

Growth in debt in China over the past 15 years.

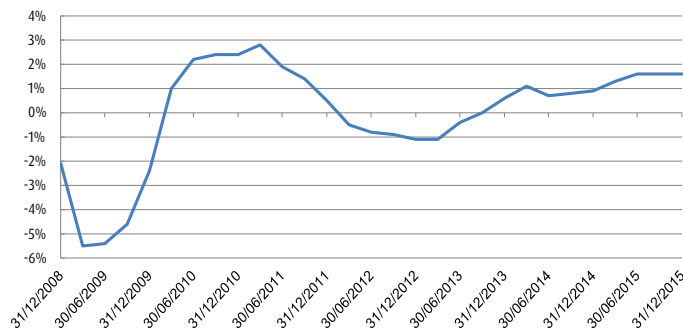


NOTE: Numbers may not sum due to rounding.
Source: McKinsey Global Institute

- Our theory that global debt is sustainable doesn't ring true, and debt eventually quashes global growth
- Abe's arrows miss the target, and Japan's reform efforts fail. Adverse demographics, weak inflation and an inability to grow fast enough to manage debt exacerbate deflation and recession
- In Europe, quantitative easing and central bank policy are exhausted and the fix fails; social backlash ensues; structural reform or a referendum resulting in "exits" (with Greece and Great Britain both on the radar) lead to contagion – and the eventual breakup of the eurozone

FIGURE 20
Eurozone GDP Growth Over Past 7 Years

Recovery emerging in Europe.



Source: Bloomberg

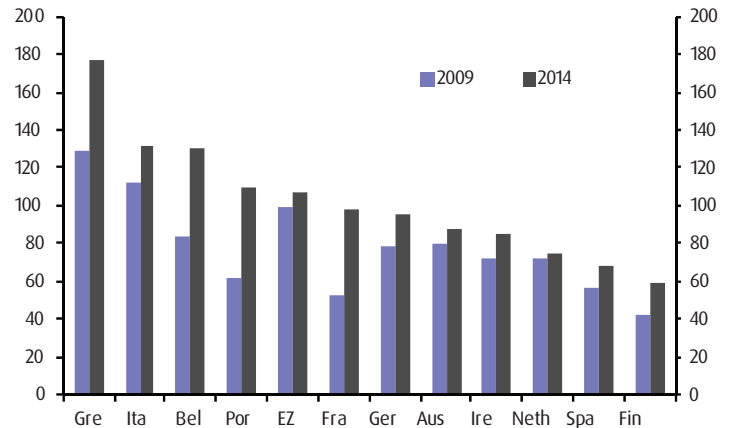
- Weak oil prices are further upset by political instability; likely theatres include the Middle East, Saudi Arabia, Russia, and Venezuela

Investment Implications in a Surprise to the Downside

- U.S. dollar assets are preferred, including cash, as capital flees to quality and safety

FIGURE 21
Growth in Sovereign Debt in Europe

Demonstrates the growth in sovereign debt in the Europe over the past 7 years.



Source: Capital Economics

- Large cap U.S. equities, particularly those companies with low debt, are emphasized
- Long-dated U.S. treasuries are the vehicle of choice for fixed income investors
- Core European equities, from countries like Germany and the Netherlands, are preferred non-U.S. holdings
- Non-cyclical sectors are favoured over cyclicals
- Attractive alternative type investments include gold, volatility futures, and long/short strategies

Investments to underemphasize in this scenario include strategies premised on growth or momentum, small capitalization equities, Canadian equities, and stocks from periphery European countries. Exposure to currencies of commodity producers should be minimized; and fixed income investors should avoid inflation-linked notes, high yield, short-dated bonds and debt from emerging markets.

Debt IS a Four Letter Word (20% Probability)

Implications for Capital Markets

Over emphasize		Under emphasize
Equities		
Developed markets		
U.S.	U.S. cash/U.S. dollar exposure	Growth and momentum equities
	Large capitalization U.S. equities, particularly quality companies with lower debt	Small capitalization equities
	Non-cyclicals/stable sectors including Consumer Staples, Healthcare and Telecom	Cyclicals including Energy, Materials, Consumer Discretionary, Industrials, Information Technology
	Defensive equities	
Non U.S.	Eurozone core equities (Germany, Netherlands)	Canadian equities
	Non-cyclicals/stable sectors including Consumer Staples, Healthcare and Telecom	Equities of eurozone peripheral countries
		Currencies of commodity producer countries
Emerging & Frontier markets	Countries that are commodity importers e.g. India	Emerging market countries, particularly those with a strong commodities orientation
	Countries or economies with currencies that are tied to the USD e.g. Hong Kong	Currency of emerging market countries, particularly those with a strong commodities orientation
Fixed income		
	Long-dated U.S. treasuries	Inflation linked
	Longer maturities	Peripheral europe
	Euro core Gov't bonds	High yield
		Investment grade corporate bonds
		Short-dated bonds
		Emerging market debt
		Emerging market local
Alternatives		
	Gold	Commodities and commodity-based strategies
	Style premia	Private equity
	Infrastructure	
	Volatility futures (VIX, V2X)	
	Long/short strategies	
	Infrastructure	

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This Secular Outlook is a reflection of that market leadership, serving not only as a benchmark for our asset allocation strategy but also as part of our commitment to add value through innovative ideas, solutions, support – and access to the insights of renowned global thought leaders.

Conclusion

Two Investor Risks, One Important Distinction

Our recent Global Investment Forum – an international think tank – reaffirmed that most of the longer-term economic themes we've identified over the last couple of years continue to remain in play.

While we acknowledge the prevalence of a broad range of potential perils to global economies and markets, the basis of this Outlook is the important distinction between two fundamentally different types of risks that investors will likely face in the coming years.

The first is secular or structural in nature, which tends to be enduring and investible and, at times, necessitates avoiding or underweighting an asset class or geography. Alternatively, event-driven risks, while difficult to anticipate, can be mitigated through careful portfolio management – at a minimum, diversifying across geographies, asset classes and securities with discipline and prudence.

We believe that a “risk on” allocation is still appropriate, however a bit more caution is in order. We maintain our positioning of overweight equities versus fixed income.

Our longer-term view remains solidly constructive on further global economic growth. This is reflected in the 80% cumulative probability we've assigned to our first two scenarios, especially our base case, *Firing on More Than One Cylinder*, which asserts that while the U.S. will lead economically, equity valuations are not inexpensive, and so the potential for better returns may be found through selective European and Japanese equity investments. To be sure, the expansion, for some economies, is starting to show signs of maturity, and the intermediate window becomes problematic as it may likely encompass a recession. Overall, it's a challenging environment, but one that can be navigated with the right global expertise, resources, and experience.

A critical component to that philosophy – and to our market leadership in the midst of distracting headline news and prevalent interim crisis, is our commitment to report on the themes we believe will endure in our five-year timeframe; secular risks, or shifts, that prove essential to inform overarching strategic portfolio allocations, and to establish guidelines for active asset allocation opportunities that may arise from our ongoing tactical strategy work.

Investments cannot be made in an index.

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