QMA a PGIM company

Q1 2017 OUTLOOK & REVIEW

QMA's Dynamic Asset Allocation Group

KEY POINTS

Economic Outlook

- After several years of slowing growth, 2017 looks to end the deceleration trend, as the US once again becomes the lead driver of global economic activity.
- Donald Trump's US presidential victory and promises of pro-growth policies are likely a game changer in that, at least in the near term, they finally break the economy out of its "lower for longer" rut.
- The prospect of fiscal stimulus occurs at a time the US economy is already strengthening, with growth having picked up to an annualized pace of near 3% in the second half of 2016. This also raises the risk that the president-elect's agenda causes the economy to overheat, leading to a potentially more severe downturn in the next two to three years.
- We look for the US Federal Reserve (Fed) to hike interest rates two to three times in 2017. Together with continued easy monetary policies by the Bank of Japan and European Central Bank, this likely will drive the overvalued US dollar even higher.
- The boost these trends give the export sectors of certain countries should help Europe and Japan continue expanding at a decent rate. But emerging markets (EM) could be hurt, particularly in tandem with slower growth in China and a possible pause or rollback in open trade policies.
- While our base case view is positive, the risks around it are greater than usual. These include the possibility of an aggressive Fed response to over-accelerating growth in the US, a more severe downturn in China, and the eruption of trade wars. There is also the upside risk that political and market developments trigger a positive chain reaction that challenges the whole secular stagnation narrative and results in better longer-term growth prospects.

Investment Outlook

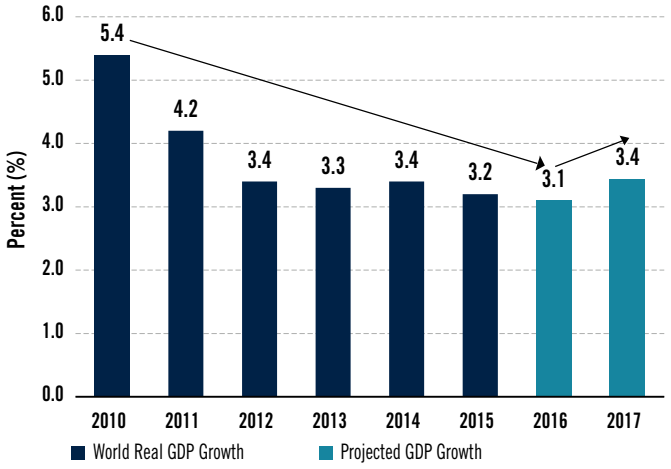
- We expect equities to outpace bonds in 2017, potentially by a substantial margin. Stocks benefit from a corporate earnings recovery that began in the second half of 2016, and should pick up in 2017.
- With the pro-growth policies centered in the US, the outperformance of the US stock market could well continue. Overall, we foresee 8-10% returns for the S&P 500 Index.
- Within US equities, we are focused on areas most leveraged to US domestic growth. These include small caps over large caps, value stocks over growth stocks, and the energy and financial sectors. Energy should benefit from a likely continued rise in oil prices, Financials from higher interest rates and regulatory rollback and cheap pre-election valuations.
- Europe and Japan should also benefit from the reflation trend, with more room for valuation to re-rate upwards. Currency-hedged exposure to European and Japanese equities is thus another favored area—but investors may need to be nimble depending on how things shake out in China.
- We are less positive on commercial real estate, where lofty property values may see declines from rising finance costs; neutral on commodities, due to a slowing China; and underweight EM equities.
- In fixed income, we are avoiding duration, leading us to hold extra cash and significantly underweight government bonds. But we still like US credit, including high yield, despite tighter spreads, as better economic growth and higher oil prices should stop the deterioration in credit fundamentals.

Global Economic Environment: *Changing It Up*

Global growth has been sluggish and slowing for the past several years, but 2017 is likely to be a year where economic growth improves and breaks the deceleration trend (Figure 1). The best prospects for improved growth among the major developed economies are in the United States. Donald Trump's victory in the 2016 presidential election has delivered Republican control of the White House and both houses of Congress for the first time since 2006, along with an agenda aimed at boosting wage growth and domestic employment. This has significantly increased the probability that pro-growth economic policies will be passed in 2017.

1/ Growth to Heat Up and Break Slowing Trend

World Real GDP Growth (2010 - 2017)



As of 10/2016.
Source: IMF, QMA. For illustrative purposes only, projections are not guaranteed.

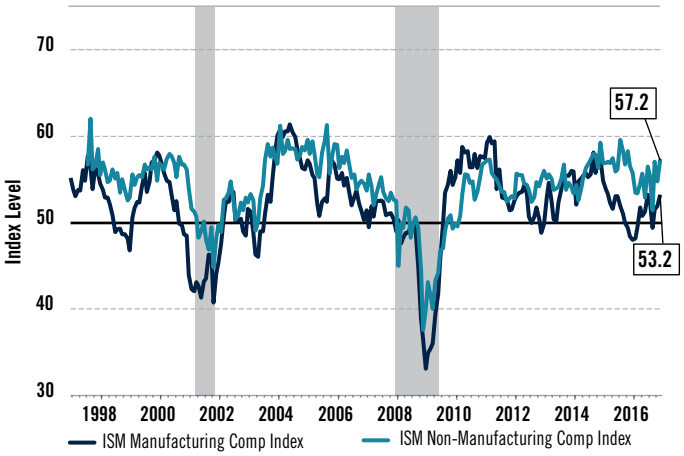
Trumponomics has promised both pro-growth (tax cuts for individuals and corporations, regulatory rollback for select sectors, increased infrastructure and defense spending) and anti-growth elements (restrictions on immigration and trade). But the president-elect has generally signaled he will prioritize the pro-growth aspects of his program at least initially. Markets have embraced this stance and a pro-risk rally has ensued centered on US assets.

We believe Trumponomics is a game changer that in the near term breaks the economy out of the "lower for longer" rut that until recently had been the likely trend line for the foreseeable future. It's highly atypical for significant fiscal stimulus to be implemented this late in an economic cycle when the economy is so close to full employment. This significantly reduces the probability of an economic recession in 2017 and means US reflation is likely to be the year's dominant theme. However, all this also raises the risk that the economy overheats and leads to a potentially more severe downturn in the next two to three years.

US economic growth had already been strengthening prior to Election Day. In the first half, the economy expanded by a pace of just 1.1% annualized, but that seems to have picked up noticeably to a pace near 3% in the second half of 2016. The Institute for Supply Management's purchasing manager indexes show the US economy has solid momentum heading into 2017 (Figure 2).

2/ US Economic Momentum is Solid

ISM Manufacturing and Non-Manufacturing Indices

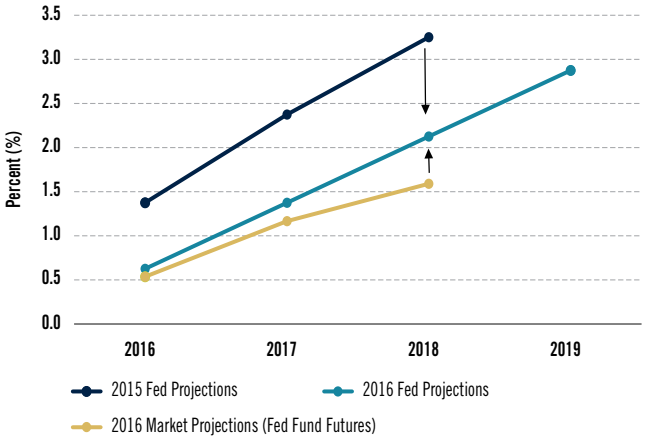


As of 11/30/2016.
Source: Thomson Reuters Datastream, QMA.

Interest rates should continue to rise in 2017 on the back of more robust growth, greater inflation pressure and bigger government budget deficits. The Fed could hike interest rates two to three times during the year, and we expect the dot plot of Fed governors' projections and market expectations for future rate levels to continue converging (Figure 3). With the Fed hiking and the Bank of Japan and European Central Bank continuing with zero interest rates and quantitative easing, the overvalued US dollar will experience even more upward pressure.

3/ Fed "Dots" and Market to Converge

2016 Saw the Fed Move Toward Market;
Will 2017 See Market Move toward the Fed?



As of 12/2016.
Source: Federal Reserve, DataStream, QMA.
Shown for illustrative purposes only. There is no guarantee these projections will be achieved.

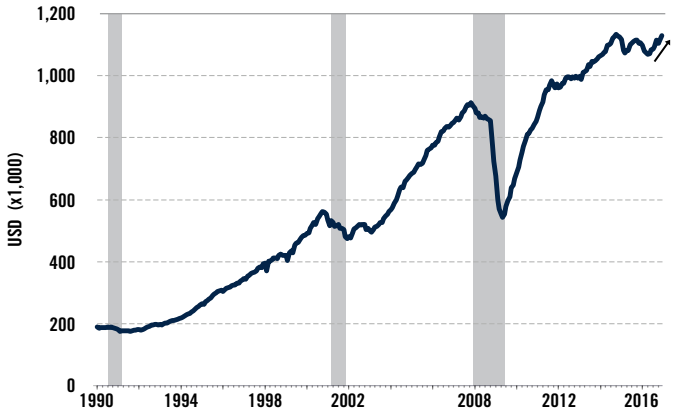
The rising dollar will be the mechanism that transmits US strength to the rest of the developed world as more-competitive currencies boost export sectors. Although the UK will be weighed down by the uncertainty of Brexit negotiations, Japan and Europe should continue expanding at a decent rate. EM growth will be supported by the return of growth in Latin America, as Brazil and Argentina exit recessions. But Chinese growth is likely to slow, as policymakers have pulled back on the massive fiscal and credit easing that engineered a boost to growth in 2016.

Asset Allocation for 2017: *Stocks over Bonds, Avoid Interest-Rate Sensitivity*

Stocks should outpace bonds in 2017 and could do so by a substantial margin. Rising interest rates should translate into negative returns for government bonds. Meanwhile, equities likely will benefit from an earnings recovery that began in the second half of 2016 and should pick up in 2017 (Figure 4).

4/ Earnings Recovery to Continue

S&P 500 Forward Earnings Per Share (12 Months Forward)



As of 12/2016.
Source: Thomson Reuters Datastream, QMA.

Faster GDP growth should lead to better corporate revenue growth, despite the fact that faster domestic wage growth will continue to pressure profit margins and a rising dollar is a headwind for foreign operations. Another wild card for overseas-related business is whether recent Trump trial balloons about protectionist tariffs turn into something more problematic. At 17.5 times forward earnings, the S&P 500's price-to-earnings (P/E) ratio is clearly above its long-term average. Still, valuation is a poor market timing tool and is unlikely to be an obstacle to solid equity returns in 2017. In addition, our research shows that stock returns and P/E ratios actually tend to do better during times of normal interest rates than ultra-low-rate regimes. (See our recent QMA Insights "Why Investors Should Worry Less about the Fed.") Overall, we foresee 8-10% returns for the S&P 500 Index, and would not be surprised to see returns even a bit higher, or on par with 2016.

We are less positive on commercial real estate. While rising inflation and faster economic growth will be good for rental growth, the long-term nature of leases means the impact will take time to flow through to revenues. Meanwhile, property values are at lofty levels and may see value declines from rising financing costs.

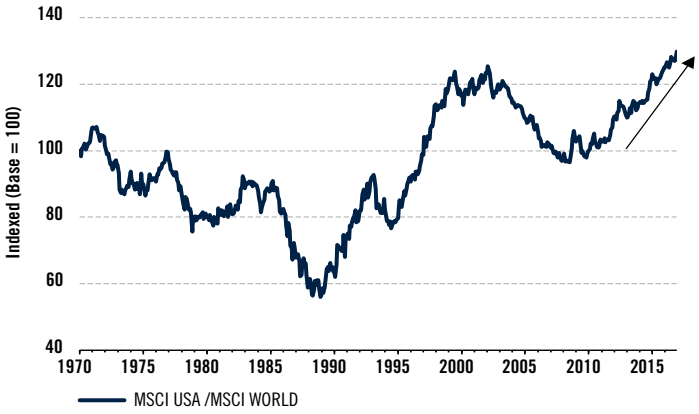
We are neutral on commodities. Oil and natural gas prices should see an upward bias as the markets move back into balance in 2017. But the broader commodity complex will face the headwinds of a rising US dollar and slower growth in China.

Trumponomics Means America First: US Reflation is The Dominant Theme

Which equity markets are likely to perform best in 2017? The US has consistently outpaced the rest of the world's equity markets in the post-financial crisis environment (Figure 5). Since most of the pro-growth policies under discussion are due to be implemented in the US, there is good reason to believe this will continue in the New Year. Indeed, the pro-risk trade has been centered on the US since the election, with the dollar strengthening and US risk assets outperforming.

5/ US Outperformance Likely to Continue

US vs. World Relative Performance in USD (Total Return 12/31/1969 - 11/30/2016)



Source: Thomson Reuters Datastream, Fathom Consulting.
Past performance is not a guarantee or reliable indicator of future results.

While the US market is pricey relative to other markets, we think it deserves its premium due to its superior economic and earnings performance. But Europe and Japan will also benefit from the reflationary shift, and their valuations are more attractive with more room to re-rate upwards. Weaker currencies would also be a tailwind for European and Japanese stocks in local currency terms.

Therefore, we expect to keep our equity overweight focused on these three markets – the US, Japan, and Europe – the latter two on a currency-hedged basis. We have a preference for Japan over Europe given the lower political risk (see Key Risks section for

more detail on European politics) and more expansionary fiscal policy, even as we keep an eye on the Japanese fallout from a slowing China.

We are underweighting EM equity, as we believe the relative bear market in EM stocks will reassert itself in 2017 (Figure 6 on next page). This secular bear market is probably in its late stages, but we do not believe it is over yet. EM saw a rebound in relative performance in 2016 as Chinese policymakers' implemented significant stimulus, which fueled a positive mini-cycle in Chinese growth with positive repercussions for commodity prices and commodity-producing economies across the emerging world. We believe the impact from those interventions has peaked and is now winding down and expect we could again see a deepening of concern about Chinese growth that rattles global markets, as it did in early 2016 and the summer before that.

6/ EM Relative Bear Market is Not Done Yet

EM vs. World Relative Performance in USD
(Total Return 12/31/1987 - 12/15/2016)

As of 12/15/2016.
Source: Thomson Reuters Datastream, Fathom Consulting.

EM has been the biggest beneficiary of expanding globalization, so the populist pause or rollback in this trend is likely to hurt these markets the most. The combination of rising US interest rates and a rising dollar are also headwinds. Rising US rates promote reverse capital flows, which tighten financial conditions for emerging economies, and a stronger dollar puts pressure on commodity prices, which tend to weigh on these countries' relative performance. A growth scare in China would also be the signal to tactically shift European and Japanese equity exposure back to the US, which likely would be much more insulated from China-related turbulence.

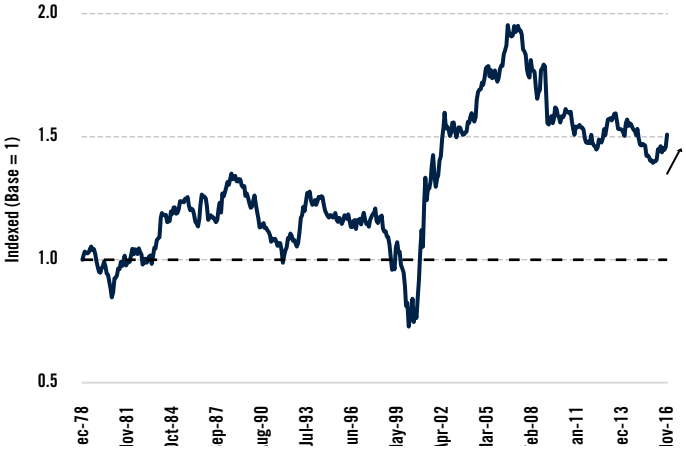
US Equity Strategy: Focus on Areas Leveraged to US Domestic Growth

Within the US equity market, we are focusing on areas most leveraged to US domestic economic growth. This means small caps over large caps, as small caps are more economically sensitive and have lower foreign sales exposure. Small caps will also be bigger beneficiaries of c orporate tax reform, as the larger multinationals in the S&P 500 Index already have low effective tax rates due to their ability to manage international operations to exploit lower tax domiciles.

We favor value stocks over growth stocks. Growth stocks have had a strong run since 2009. A key factor driving this outperformance was scarcity of economic and profit growth. In the second half of 2016, however, this trend reversed. After a five-quarter profits recession, corporate earnings are growing again, and as growth becomes more abundant we expect value stocks to continue to rebound (Figure 7). Small caps and value stocks also tend to be winners during periods of rising inflation.

7/ Value Stocks Should Outperform Going Forward

Relative Performance of Russell Value® to Growth Indices
(1978 - 2016)



As of 11/30/2016.
Source: Bloomberg, Frank Russell Company.
The Russell Indices are trademarks/service marks of the Frank Russell Company. Russell® is a trademark of the Frank Russell Company.

Our top sector picks are Energy and Financials. This reinforces our preference for value stocks, as these sectors are heavily weighted in the Russell 1000® Value Index. Indeed, US Financials are one of our highest-conviction ideas. They are a major beneficiary of rising interest rates and regulatory rollback. Further, they were one of the few areas in equity markets that were cheap prior to the election (Figure 8). After a steep year-and-a-half decline beginning mid-2014, energy stocks came roaring back in 2016 on a sharp move up in crude oil prices. We expect the recovery in oil and natural gas prices to continue in 2017 and drive a robust earnings and continued share-price revival. On the other hand, we are underweight the bond-proxy sectors such as REITs, Utilities, and Consumer Staples, as these sectors are expensive and vulnerable to rising interest rates.

8/ Financial Stocks: One of the Few Areas That Are Genuinely Cheap

S&P 500 Banks Price-to-Book Value

As of 11/30/2016.
Source: FactSet, QMA.

Fixed Income Strategy: US Credit Risk over Duration Risk

Our view of faster US growth, rising rates, and rising inflation drives our fixed income strategy. We believe the 35-year secular bull market in bonds probably ended in 2016 (Figure 9). Thus, we are avoiding duration, which means we are holding extra cash and are significantly underweight government bonds. Within government bonds, we favor the inflation protection of TIPS over nominal bonds.

9/ Secular Bull Market in Bonds is Probably Over

10-Year Treasury Yield

As of 12/9/2016.
Source: Thomson Reuters Datastream, QMA.

We still like US credit, including high yield, despite tighter spreads, as better economic growth and higher oil prices mean credit fundamentals should stop deteriorating (Figure 10). Short-duration high yield and floating-rate leveraged loan mandates should do especially well. The same factors weighing on EM equity returns will also put upward pressure on EM bond spreads, so we have been decreasing exposure to EM credit. Within the EM bond space, we prefer to stick to hard-currency sovereign debt.

10/ High-Yield No Longer a Deal But Still Attractive

Bloomberg Barclays Corporate High Yield - Option Adjusted Spread

As of 12/2016.
Source: Bloomberg.

Base Case View Is Pro-Risk, But Risks Are Also Greater: VIX Headed Higher

While our 2017 base case view is positive and argues for an investment strategy embracing risk, the risks around it are greater than usual. A Trump presidency is unlikely to be consistent with a VIX at 13, and we believe volatility is headed higher (Figure 11). Even though US reflation will be the dominant theme, this trade is likely to wax and wane. 2016 turned out to be a very good year for US stocks but saw a 14% drawdown early in the year on a China growth scare, and the coming months could bring more of the same. So, it shapes up as a year where it pays to be flexible, liquid, and tactical around the dominant trend.

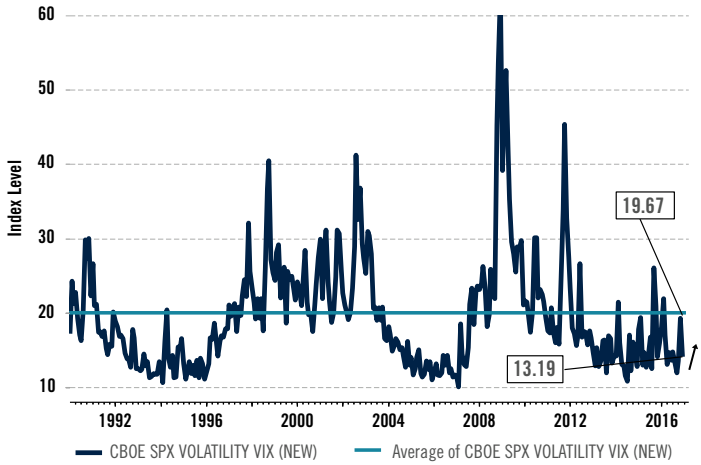
We think the risks are probably tilted to the downside, but there could be upside risks as well. Either way, we expect it to be an interesting year and believe investors should take advantage of the opportunities while they last, keep their seat belts fastened, and their eyes peeled for signs of the following.

Key risks

Boom-Bust Path to Recession: Trumponomics may be too successful at stimulating above-trend economic growth and could lead to a surge in inflation and an aggressive Fed response that winds up shortening the current expansion rather than invigorating and extending it.

11/ Does Trump Seem like a VIX 13 President?

CBOE Volatility Index (VIX)



As of 12/14/2016.
Source: Thomson Reuters Datastream, QMA.

China Rolls Over: Considering the degree to which China's economy is structurally burdened by overinvestment and domestic credit excess, the slowdown we are anticipating could be worse and more protracted than we expect. Given the Chinese economy's size, this slowdown could overwhelm the positive impact of better US growth and lead to the return of the commodities bear market, which could trigger more general economic and financial market instability across the emerging markets and beyond.

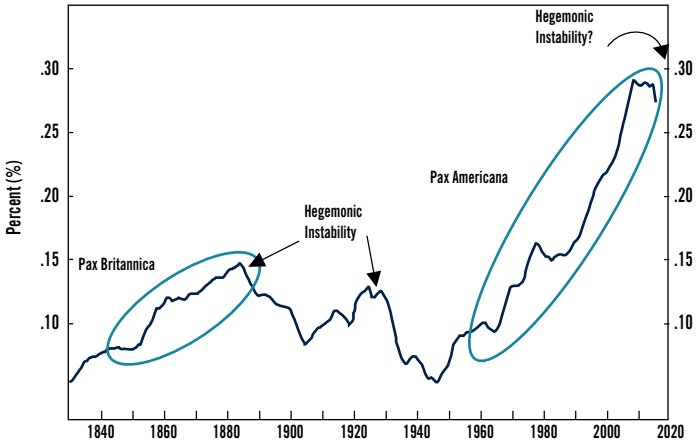
Global Populist Revolt Gathers Steam: Trump's election has occurred in the context of a shift toward populism across Western democracies. This includes the UK Brexit vote and Italian voters' decision to shoot down a referendum on constitutional changes that would have enabled structural economic reforms of the sort their country needs to remain in the Eurozone longer-term. Over the next several months, the UK will likely trigger Article 50 officially starting the separation process from the EU, and there will also be elections in France and Germany. If Eurosceptic forces gather steam, or the stability of the common currency is once again called into question, it could fuel risk-off episodes.

Trade Wars Erupt: The darker side of the Trump agenda for financial markets relates to his anti-globalization rhetoric. At this point, most observers believe he will focus on symbolic measures such as labelling China a currency manipulator and/or targeted measures against China and Mexico that won't move the dial much on overall growth. However, in recent days, the Trump team has floated the idea of 5% tariffs on imports. If this is any indication we could experience a more significant retreat from globalization, that would be a much more dire scenario that could easily spark trade wars and a global recession.

Geopolitical Flare-Ups: The Eurasia Group's president Ian Bremmer coined the "G-Zero" to describe an emerging power vacuum in international politics where the US lacks the resources and desire to continue as the primary provider of global public goods, no other power(s) steps in to fill the slack, and international conflict increases as every nation pursues its own core interests (Figure 12). The election of Donald Trump is likely to turbocharge this trend toward a G-Zero world. Most expect him to ramp up military spending against the Islamic State and other terrorist groups but make little effort to preserve what is left of the US's historic efforts to take a lead role in maintaining global security. At the same time, he likely will eschew multi-lateralism, which he views as a constraint on his ability to pursue US interests. "We are headed toward a more Hobbesian world with fewer global norms, prone to economic and military conflict," writes the Eurasia Group in its own 2017 outlook.[1] In other words, not exactly the kind of stability markets like best.

12/ Multi-Polarity Breeds De-Globalization and Instability

Is the 70-Year Climb in Trade Globalization* at an End?



As of 12/14/2016.
Source: BCA Research 2016.
*Trade Globalization is measured by imports as percentage of GDP for 148 countries weighted by population.

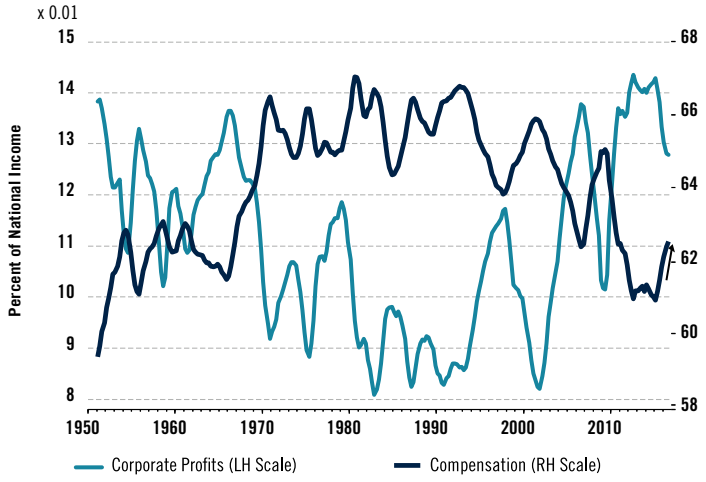
Median US Voter Shifts: There are watershed moments in US politics that signal major shifts in the consensus governing philosophy. FDR's New Deal ushered in a period of increasing government involvement and wealth redistribution that lasted until the Reagan Revolution in 1980, when the pendulum swung back toward free-market capitalism and even left-leaning politicians moved right to stay marketable with the median voter. But we think government spending for certain initiatives is about to make a big comeback, as slow growth, stagnant wages and the rising inequality of the post-crisis period have led to another shift in the median voter. Donald Trump won the GOP primary in part because he differed from his rivals on government spending, entitlements, and trade, and his success in the general election was based on his appeal to white working-class voters who feel they are the victims of globalization.

[1] "Year-Ahead Outlook 2017," Eurasia Group, 12/7/2016.

This may be bad for corporate profit margins, as it should result in a shift in national income in favor of wages at the expense of profits (Figure 13). But it may eventually be good for economic growth by putting more money in the hand of the lower income slice of the population who are more likely to spend it and boost aggregate demand. In the meantime, it could produce quite a bit of uncertainty for financial markets.

13/ Pitchforks Finally Move the Needle

Labor Share of Income to Rise

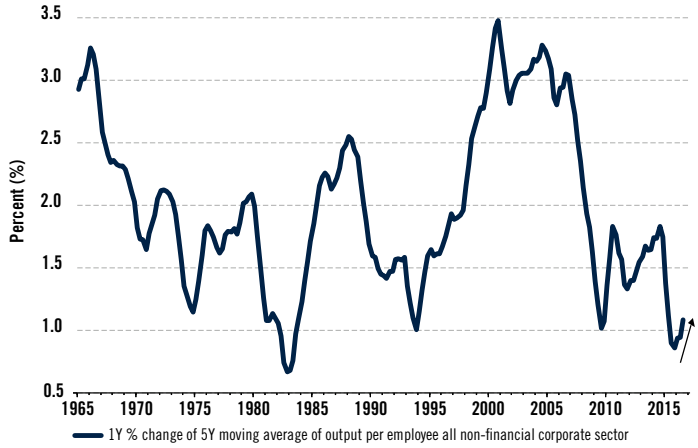


As of 9/30/2016.
Source: Thomson Reuters Datastream, QMA.

Animal Spirits Reignite and Debunk the Secular Stagnation: It's also possible that our longer-term doubts about the viability of the president-elect's high-stakes strategy turn out to be wrong. Some observers believe there is hidden productivity growth in the economy waiting to be unlocked. Fed Chair Janet Yellen raised this issue in a speech this past fall when she pondered the benefits of running a "high-pressure economy," asking whether there are circumstances when changes in aggregate demand can have an appreciable effect on aggregate supply. Under this view (which Yellen subsequently clarified she does not necessarily endorse), damage to the supply side of the economy stemming from deficient demand and manifesting itself in very slow productivity growth might actually be reversed. A period of robust demand, for example, should lead to tighter labor markets and rising wages that could pull more people back into the labor force. Increased business sales could, in turn, boost investment spending and add to the productive capacity of the economy. We note the various measures of consumer and business confidence have been in a sharp uptrend since the election. If this is a sign Keynes' animal spirits[2] are starting to reignite, we could see an increase in US secular growth prospects that challenge the whole secular stagnation narrative. That would truly be a game changer.

14/ Can a High-Pressure Economy Revive Productivity Growth?

US Secular Productivity Growth
(Non-Financial Corporate Sector)



As of 9/30/2016.
Source: Thomson Reuters Datastream, QMA.

[2] John Maynard Keynes, The General Theory of Employment, Interest and Money, 1936.

SPECIAL RISKS

Foreign investments may be volatile and involve additional expenses and special risks, including currency fluctuations, foreign taxes and political and economic uncertainties. Emerging and developing market investments may be especially volatile. Investments in securities of growth companies may be especially volatile. Due to the recent global economic crisis that caused financial difficulties for many European Union countries, Eurozone investments may be subject to volatility and liquidity issues. Value investing involves the risk that undervalued securities may not appreciate as anticipated. Small and mid-sized company stock is typically more volatile than that of larger, more established businesses, as these stocks tend to be more sensitive to changes in earnings expectations and tend to have lower trading volumes than large-cap securities, creating potential for more erratic price movements. It may take a substantial period of time to realize a gain on an investment in a small or mid-sized company, if any gain is realized at all. Diversification does not guarantee profit or protect against loss.

Emerging markets are countries that are beginning to emerge with increased consumer potential driven by rapid industrial expansion and economic growth. Investing in emerging markets is very risky due to the additional political, economic and currency risks associated with these underdeveloped geographic areas. Fixed-income investments are subject to interest rate risk, and their value will decline as interest rates rise. Unlike other investment vehicles, U.S. government securities and U.S. Treasury bills are backed by the full faith and credit of the U.S. government, are less volatile than equity investments, and provide a guaranteed return of principal at maturity. Treasury Inflation-Protected Securities (TIPS) are inflation-index bonds that may experience greater losses than other fixed income securities with similar durations and are more likely to cause fluctuations in a Portfolio's income distribution. Investing in real estate poses risks related to an individual property, credit risk and interest rate fluctuations. High yield bonds, commonly known as junk bonds, are subject to a high level of credit and market risks. Investing involves risks. Some investments are riskier than others. The investment return and principal value will fluctuate and when sold may be worth more or less than the original cost.

IMPORTANT INFORMATION

Sources: QMA, Thomson Reuters Datastream, Federal Reserve, Bloomberg, FactSet Research Systems.

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QMA's investment team operated for many years within one of Prudential Financial, Inc.'s (PFI) asset management companies, known today as PGIM, Inc. QMA's predecessors began managing domestic equity accounts for US tax-exempt clients in 1975. In 2004, QMA became a registered investment adviser with the SEC under the Investment Advisers Act of 1940 and the quantitative management business of PGIM, Inc. was transferred to QMA. No changes in investment professionals or process occurred as a result of this change in legal structure.

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ABOUT QMA

Serving investors since 1975, QMA targets superior risk-adjusted returns by combining research-driven quantitative investment processes built on economic and behavioral foundations with judgment from experienced market practitioners. Ultimately, each portfolio is constructed to meet the individual financial needs of the client. An independent boutique backed by the capabilities of one of the world's largest asset managers, QMA is the quantitative equity and dynamic asset allocation business of PGIM, the global investment management businesses of Prudential Financial, Inc. Today, we manage approximately $116 billion* in assets for a wide range of global clients.

*As of 12/31/2016.