Market Roundup

SIGNATURE GLOBAL ASSET MANAGEMENT™

Global Outlook

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Outlook 2017: The Good (economy), The Bad (policy), and The Ugly (politics)

The outcome for markets in 2017 will be determined by the contrasting influences of a clearly improving global economy, a continued transition away from easier monetary policy toward easier fiscal policy, and extreme uncertainty in the political outlooks, particularly in the U.S. and Europe. Global equity markets are entering 2017 on a wave of optimism fueled by the now visible improving economic outlook and expectations of tax reforms, fiscal stimulus, and reduced regulatory impediments to business in the U.S. And these are indeed the positive drivers for both the U.S. and global economy and markets in 2017.

We are cautious that some of the optimism may be running ahead of the likely reality. In particular, while the economic outlook has clearly improved, as reflected in the recent data and rising inflation expectations, with it comes a shift in the outlook for economic policy, with the U.S. Federal Reserve Board potentially tightening rates faster than expected.

The fiscal cavalry risks arriving in a very pro-cyclical fashion and having more of an inflationary versus a growth impact. If so, a further backing up of interest rates on inflation concerns will provide some market indigestion for equities already at the upper end of a normal valuation range. Equity upside will depend on earnings growth to offset any multiple contraction driven from a higher discount rate.

Rather than an easy ride higher for equities, we expect a more sideways trajectory, with periods of higher volatility as the tug of war plays out between earnings and rates. One area where Trump's policies could prove unambiguously positive from a market perspective would be if expectations for less oppressive regulations across a range of industries, including banking and energy, encourages greater optimism among firms to lend, invest, and hire in anticipation of better growth.

The big potential negatives from Trump's administration are the possibility of significantly more protectionist anti-trade policies beyond headline grabbing photo-ops, and the complete uncertainty of how the new administration will operate. And that is just in the U.S. Add in Brexit, French and German elections, China's 19th party congress, and for 2017, the biggest uncertainty clearly lies in the political realm.

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For 2017, we expect that the interplay of an accelerating global economy, more ambiguous policy impacts, and an outright uncertain political backdrop should be acceptable for risk assets. A reasonable base case is for equities to return 8-10%, in line with expected earnings growth, high-yield credit around 5-6%, investment grade 2-4%, and government bonds slight losses. But there is a far lower degree of confidence in this projection given the higher risk of political or policy missteps and the possibility of triggering a broader financial market tightening through more aggressive backing up of U.S. rates beyond 3%, a significant spike in the U.S. dollar akin to the 25% rise in 2014-15, or an ever-escalating trade war as Trump attempts to tweet jobs back to the U.S. and picks a fight with China.

Let's take a closer look at The Good, The Bad and The Ugly drivers for markets in 2017. For the most part this analysis will focus on the U.S. as for 2017 it remains both the key driver for the global economic recovery and the source of heightened political uncertainty.

The Good

As we enter 2017, evidence continues to pile up that the global economy is in the midst of a synchronized recovery following the combined shocks of a 25% appreciation of the U.S. dollar and collapse in energy prices from mid-2014 to mid-2015. This culminated in the broad market sell-off across risk assets into the first quarter of 2016. Following some significant policy adjustments from the Fed and the European Central Bank, it also turned out to be the bottom for most markets, commodities and economies, and set the stage for a broadly synchronized global recovery in 2016.

Indeed, the data is supportive almost across the board, starting with the 3.5% third quarter bounce in U.S. GDP and from recent survey data such as the ISM, PMIs, and consumer confidence all coming in above expectations. The string of better-than-expected economic data has been echoed across Europe and China as well.

Stronger economic growth, along with rising inflation, underpins expectations for an acceleration in earnings following roughly two years of zero growth. In fact, earnings have already shown evidence of acceleration from their nadir in the first quarter of 2016, with third quarter S&P 500 Index earnings up approximately 15% from the first quarter. We expect to meet our expectations of 8-10% EPS growth for 2017, led by rebounding growth in energy and financials.

The Bad

The current recovery faces threats both endogenous (internally generated) threats and exogenous (externally generated).

Endogenous threats:

- are normally occurring factors in the economy, such as rising inflation as the output gap closes, driving up the prices of scarce resources such as labour and commodities; as inflation rises monetary policy tends to tighten and rates continue to rise
- are unlikely to result in financial conditions tightening sufficiently to derail the recovery for at least a couple of years, as we have only just begun the tightening process and policy remains quite simulative
- could be enhanced by a repeat of the rapid rise in the U.S. dollar, such as we saw in the 25% appreciation in 2014-15; a moderate pace of increase, say 5-10%, is likely manageable, but much faster would be a concern.

We will be monitoring foreign exchange markets closely in 2017.

Exogenous threats:

- result in the normal interaction of the lifecycle of economies and markets
- are more externally driven independent of the economic cycle
- will be likely in the form of policy errors and politics; policy errors include the potential for too much stimulus should all the potential tax cuts and infrastructure spending be implemented, because beyond driving higher growth it could drive higher inflation
- include Trump's economic policies, which have bond markets skittish about inflation.

We will be very closely monitoring the risk to both the economy and valuations from rising interest rates through the year. While we expect to see progress on Trump's economic initiatives this year, we expect that most of the potential economic impact will occur in 2018. That should also help calm the bond markets following the initial surge in rates after the election. The pro-business Trump cabinet also will increase optimism among business leaders, which in turn may encourage an acceleration in investment spending and hiring. We will be watching upcoming capex orders and intentions closely in coming months to see whether the recent bounce in confidence surveys actually translates into increasing economic activity.

The Ugly

Politics could be the biggest potential source of surprise for 2017. We have always argued that when it comes to managing investments that it is essential to remove the emotional aspects and focus on the economics, earnings, rates, valuations, financial conditions, and policy settings. While politics clearly affects many of these conditions over a longer time horizon, for the most part it is the economic and business cycle dynamics that shape them in the next one to two years. And as we enter 2017, we believe this is one of the rare times that politics do matter more than usual and we will need to pay close attention.

We have little doubt that President Trump's unpredictable nature will, at a minimum, drive periods of elevated market uncertainty and volatility. The risk of missteps are high and numerous, and investors will need to stay attuned to what actually gets done versus what is said. While the U.S. is the clear driver of both the global economic recovery and of potential political instability, it must be mentioned that the political challenges in 2017 are truly global. On the watchlist in Europe will be French and German elections. Also in Europe is the expected trigger of Article 50 by the U.K. to start negotiations to leave the European Union, which may also generate volatility. Over in China, 2017 is a big political year with the 19th party congress in the late fall. As leaders jockey to solidify their positions for reappointment, they will be very protective of China's interests. Trump's protectionist-oriented trade plans have already set the stage for conflict with China.

Overall, we expect political developments will keep us on our toes in 2017 both in the U.S. and globally. At Signature, we will continue to stay abreast of such developments and importantly always seek to understand how and where they might impact portfolios from both a potential risk and opportunity perspective.

Foreign exchange
Matthew Strauss, CFA
Vice-President, Portfolio Management and Portfolio Manager

Even though October saw the U.S. dollar slowly recouping some of the losses sustained in the first half of 2016, it was the surprise Trump victory that really lit the fire on the U.S. dollar rally. Supported by rising U.S. yields, the U.S. dollar rallied 5% against the euro and almost 10% against the Japanese yen in a matter of weeks. The U.S. dollar index ended the year in positive territory after meaningful losses during the first four months of 2016. The dollar index recorded an impressive 10% rally between the low in May and the weeks following the U.S. election. With U.S. yields expected to remain elevated or even higher compared to recent history and U.S. rates expected to rise, albeit gradually, during 2017, the U.S. dollar is expected to continue to grind higher against both developed market and emerging market currencies. Uncertainty around this call is elevated as detailed policies of the Trump administration remain unclear.

The U.S. dollar was not the only currency in 2016 to be heavily impacted by politics. In fact, many of the most dramatic currency moves in 2016 found their origins in political developments. The British pound was by far the worst performer among developed market currencies, depreciating by almost 20% following the Brexit vote. We remain bearish on the British pound as the government is expected to invoke Article 50 late in the first quarter of 2017. Political influence was also clear in the emerging world, with the Mexican peso declining by 17% in 2016 (on worries about the implications of a Trump administration on U.S.-Mexico relations). However, the Turkish lira outdid the Mexican peso as a result of the failed coup in Turkey and general political uncertainty within the country. Politics also worked the other way around, with the Brazilian real (improved domestic

politics) and Russian ruble (expectations of sanctions being lifted and a better U.S.-Russia relationship) easily topping the list of best-performing major and emerging market currencies.

Following the dramatic recovery in the Canadian dollar during the early part of 2016 (a 16% rally against the U.S. dollar), an orderly and gradual reversal materialized during the remainder of the year driven mostly by widening U.S.-Canadian interest rate differentials. Oil provided, and continues to provide, an offset to widening rate differentials and briefly forced a reversal in the depreciating trend in early December when the currency traded to a high of 76 cents before closing the year just above 74 cents, 3% above the level where it started 2016. Despite expectations of stable to higher oil prices, the widening interest rate differential will likely outweigh the positive factors, dragging the Canadian dollar toward or even below 72 cents in 2017.

Emerging markets
Matthew Strauss, CFA
Vice-President, Portfolio Management and Portfolio Manager

Despite the "Trump scare," which saw emerging market equities fall 7% in less than a week after the surprise U.S. election victory by Donald Trump, emerging market equities closed the year up 11.3% in U.S. dollar terms. Even though the performance gap narrowed compared to developed market equities, emerging market equities still managed to outperform their developed market counterparts by 300 basis points in 2016 – the first outperformance since 2012.

Performance came from commodity companies as both the energy and materials sectors recovered sharply from depressed levels with higher commodity prices (thanks in turn to OPEC and China). From a country perspective, politics and commodities dominated the two best-performing countries as both Brazil and Russia came out of political limbo and benefited from the commodity upswing. That Mexico and Turkey anchored the other side of the performance spectrum should not come as a surprise, as both suffered from negative political developments – the difference, though, being that one is dealing with domestic political uncertainties (Turkey) while the other (Mexico) is facing an increasingly difficult trading environment because of U.S. politics. Also assisting the positive performance for emerging markets in general were significant foreign inflows into emerging markets in the third quarter as global yields trended lower following the U.K. referendum. Despite significant outflows in the fourth quarter, annual bond and equity inflows for 2016 remained positive on an annual basis, generating the first positive calendar year number since 2012. Earnings also turned positive after a few difficult years.

Emerging market equities will find it challenging to outperform developed markets equities for a second consecutive year. Not only are the commodity-related sectors more fairly priced compared to the depressed levels recorded at the beginning of 2016, but investors will have to navigate a number of uncertainties, many coming from developed markets: the Trump presidency, European

elections, higher U.S. rates, and a stronger U.S. dollar. A stable China also continues to be a key assumption for positive emerging market performance. Countering these uncertainties are emerging economies that have clearly passed the worst of the current business cycle, steadier domestic politics compared to the last few years (with obvious exceptions), stable commodity prices (coal and iron ore might be the exceptions), fairly robust earnings expectations, and an increasing economic growth gap between emerging and developed markets as emerging economies gain more traction. Overall, we remain constructive and fully invested.

Health care
Jeff Elliott, PhD, CFA
Vice-President, Portfolio Management and Portfolio Manager

After a difficult 2016 for the health care sector broadly, we see similar themes persisting for at least the first half of 2017, with U.S. policy overhangs making returns in the therapeutics space challenging. We continue to believe managed care is the most attractive sub-sector in health care, at least until clarity on health care reform and drug pricing is available. Although we believe concerns over fundamental changes to the U.S. drug reimbursement system are unlikely, noise during the process of "repealing and replacing" Obamacare will likely keep fund flows into the biopharmaceutical space muted, despite significantly more attractive valuations than 12 to 18 months ago. Our investments in the biopharmaceutical space remain focused on innovative companies that do not rely on drug price increases for growth (e.g., Roche, Celgene, Bristol-Myers, Merck).

Managed care (our biggest overweight in 2016) remains attractive, as many of the priorities of the Trump administration, and our expectations for economic growth derived from these, will benefit the space. Higher interest rates, lower corporate taxes, economic growth, and continued privatization of entitlement programs all benefit the managed care industry, while border taxes and a stronger U.S. dollar would have essentially no impact. We also believe that life science tools (e.g., Thermo Fisher) and medical technology (e.g., Medtronic) are relatively well-positioned, although these companies do generally have exposure to U.S. dollar fluctuations and could be somewhat negatively impacted by border taxes, should these be instituted.

In our view, health care in 2017 could end up being a tale of two halves, with a potential rally in therapeutic stocks after U.S. health care policy priorities are clarified; however, we expect continued volatility as this unfolds.

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Infrastructure
Kevin McSweeney, CFA
Vice-President, Portfolio Management and Portfolio Manager

Our outlook for 2017 infrastructure can be divided into two major sectors: North American energy infrastructure and global transportation infrastructure.

We are constructive on North American energy infrastructure given the backdrop of growth in oil and gas production and the higher prices for oil and gas, providing confidence that counterparties to pipeline or processing contracts will remain financially strong. We think that ongoing productivity improvements in extraction technology, a pro-energy regulatory bent in the United States, along with expected OPEC discipline mean that North American oil and gas have a chance to grow. We think that the market is underpricing the scale and duration of growth in production, and that pipeline/midstream companies have a chance to grow earnings and maintain or – in some cases – expand their trading multiples.

For global infrastructure such as ports/toll roads/airports, we believe the sector will be characterized by solid underlying performance but will be battling headwinds should government rates – as we expect – face upward pressure. Given a backdrop of expected economic improvement in Europe and the United States, we prefer to focus on the consumer-exposed road and airport industries with a focus on those assets with pricing flexibility around inflation or demand, while concerns around global trade volume and protectionism (as well as valuations) keep us on the sidelines with ports.

Technology, media and telecommunications
Malcolm White, CFA
Vice-President, Portfolio Management and Portfolio Manager

Technology had a volatile 2016 in the first half of the year as slower secular growth and high valuations collided as the sector de-rated in a more defensive market.

We were able to find areas of investment that outperformed the market, mainly in the semiconductor and optical component segments, which benefited from good demand, tighter supply conditions, and industry consolidation.

The outlook for 2017 is different once again. Technology performance slipped after the election as investors rotated to other industries that are expected to be beneficiaries of the policies tied to the new presidency in the U.S. This, however, can be a double-edged sword when the expected policies are not delivered or in the worst case the reality is the opposite of expectations. Fortunately, a technology sector that has little expectations can't disappoint accordingly. Nonetheless, we are

monitoring potential positive policies such as overseas cash repatriation and negative offsets such as tax reform and border taxation applied to U.S. imports. Regardless, policy action should lead to a backdrop of improved economic activity that can augment capital expenditures, which will benefit the technology sector. Software names that underperformed last year look attractive in this light as valuations appear attractive relative to the underlying growth of these businesses.

U.S. media and telecommunication names also look interesting in the context of corporate tax reductions and the possibility of mergers and acquisitions. There are selective opportunities in Europe and Asia as these regions underperformed in 2016 and hence valuations do look attractive in 2017 under the similar backdrop of improving economic conditions.

Financial services
John Hadwen, CFA
Vice-President, Portfolio Management and Portfolio Manager

We have been overweight U.S. banks for a few years now, with the view that valuations were very undemanding relative to their ability to improve capital positions and capital returns to shareholders. This positioning has generated some grey hairs over the years given volatility during JP Morgan's "whale" episode, negative interest rates, the collapse in energy prices, Brexit, and fraud at Wells Fargo. Our investment view has largely played out, although it took longer than I had initially hoped back in 2010.

U.S. banks have offered strong, steady dividend growth from the 2010 trough, and it is important to note that the sector is returning as much capital in share repurchases as in dividends, so total capital return is well above the $42 billion 2007 level.

Regardless of the progress the U.S. banks were making, they were largely viewed as the lepers of the equity market given the challenging operating environment and headline risk. Excessive pessimism prevailed over the sector in recent years and I remained confident (most days) that sentiment was just too negative, believing it could get better someday…and then Trump won.

It seems that capitalism is coming back to life, businesses want to embrace the Republican agenda, and expectations for economic growth and employment are on the upswing. Our macro base case outlook calls for a few rate increases and high probability of a cut in the corporate tax rate to 20% or 25%. This base case outlook does support material earnings growth for the sector. Healthy loan growth, ongoing low credit costs, net interest margin expansion, potentially more capital flexibility, less risk of additional regulatory headwinds, and the tax cut can support a 25-35% improvement in the sector's return on equity over a few years. While I am less comfortable with valuations, I feel much better about earnings and dividend growth in coming years. It looks like the U.S. banks will improve returns and become better businesses.

While the U.S. banks have faced a tough environment, the European banks have faced a hopeless one. Rates were much, much lower (even negative), the economy was slower and less well prepared for inflating regulatory requirements, the U.K. referendum ended in Brexit and there's still a few hundred billion dollars in non-performing loans just in Italy. The European banks have underperformed U.S. banks by about 100% over the past five years. Europe provides good hunting grounds for attractive investment opportunities given material market underperformance in recent years; however, it is our view that many of the seemingly undemanding valuations are completely appropriate and good stock selection in this market is crucial. We do have conviction that the sector offers attractive and growing dividends and many European banks are more levered to a potential improvement in the operating environment because returns in many cases are so disappointing.

While earnings growth has moderated for Canadian banks they continue to be excellent compounders of capital, which supports strong dividend growth and the occasional acquisition. The stock performance was very strong again in 2016, leaving valuations somewhat full given a challenging economic backdrop domestically. Our base case expectation is for domestic earnings to be up just a bit, and foreign earnings slightly stronger, supporting positive but modest earnings growth and price appreciation.

High-yield bonds
Geof Marshall, CFA
Senior Vice-President, Portfolio Management and Portfolio Manager

The Signature credit team is always focused on company fundamentals but cognizant of the many extraneous factors that can drive sentiment and valuations. In 2017, we find ourselves focused on policy, macro, and tax developments. On the policy side, we are watching the U.S. Federal Reserve, but so is everyone else. The FOMC's December meeting minutes reiterated their gradual intentions to interest rate hikes but strength in the labour market continues, President Trump has promised new fiscal stimulus, and a cautious Fed may not be able to keep pace with inflation. Our view is a dovish Fed may let inflation run above target for a time after years of disappointing to the downside. However, the new president will have two open seats on the FOMC to fill this year and his leanings seem more hawkish.

As mentioned in a previous commentary, a key risk we are monitoring on the macro front is further strength in the U.S. dollar, which could prove a headwind to U.S. export competitiveness and derail growth, possibly enough to cause defaults to re-accelerate.

On the political side, especially relevant to credit investors will be potential U.S. tax code changes. Lower corporate tax rates would increase cash flows and companies' ability to pay down debt. This would be unquestionably good for corporate bond investors. Should the new administration cut the

tax rate on repatriated overseas cash then debt-financed share repurchases and commensurate new bond issuance could slow. This would be broadly supportive of valuations as bond supply would drop. If interest expense deductibility is eliminated and accelerated depreciation allowed on new capital spending we could see further debt reduction. More importantly, these initiatives could spell the end of inward-looking management milking business assets for dividends and reward business owners for investing with an eye to earnings growth.

There are many variables here that could have positive or negative bearing on credit in 2017, more so than the usual suspects: China, European elections, central bank policy mistakes, and now market-moving tweets. Last year's double-digit and equity-beating returns are not likely to be repeated this year. Energy and metals bonds may provide attractive, risk-adjusted returns and an inflation hedge, but they cannot be +40% again in 2017. That said, broad valuations are fair if growth persists and modest spread tightening can absorb the impact from rising government bond yields. This implies mid-single-digit or "coupon-like" returns from high yield could be achievable this year.

Interest rates
Kamyar Hazaveh, MMF
Vice-President, Portfolio Management and Portfolio Manager

Cyclical forces mainly behind the move in the markets
Economic growth and inflationary pressures in the United States and globally had been cooling for about a year and a half before bottoming around mid-year 2016. Leading indicators of industrial growth and inflation have been on the rise since then, pushing real interest rates and inflationary expectations priced into the bond market consistently higher.

The perception of policy imbalance and inadequacy on all fronts (monetary, fiscal, trade) leading to societal inequality suddenly dawned on the consensus after Brexit and the Trump movement in the U.S. This is behind the reluctance of central banks in Europe and Japan to extend further accommodation, which in turn takes away one of the major tailwinds behind the bond market since the Global Financial Crisis (GFC).

Inflationary expectation priced into the U.S. bond market over the next 10 years rose approximately 0.36% during the final quarter of 2016. Throughout the same period, nominal interest rates in the U.S., Canada, U.K., Germany, and Japan rose by 0.85%, 0.73%, 0.49%, 0.33%, and 0.14%, respectively.

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Structural shifts are challenging but cyclical turns are a certainty
The recent sell-off in the bond market has the pundits calling once again for the end of the bond bull market. The proposed policy changes under the new U.S. administration are the main reason for the consensus optimism.

As drastic as the ideological and policy changes in the new U.S. administration might be, their impact on the U.S. and global long-term potential economic growth might be limited or uncertain. On the other hand, free market economies will continue to experience cyclical downturns and upturns. These cyclical turns are going to be more pronounced if the European and Japanese central banks are not as accommodative as they have been in the recent years and the U.S. Federal Reserve is on the tightening path. Our strategy remains focused on anticipating cyclical changes in growth and inflation to navigate the investment environment.

Positioning
In our valuations, U.S. benchmark 10-year bonds are trading at the top end of the current fair value range of about 1.8% to 2.60%. The U.S. Federal Reserve Board is facing a favourable growth and inflation window and will likely be able to lift overnight rates again in 2017.

Across our various tactical, global, and Canadian bond strategies, we remain modestly underweight duration, overweight inflation exposure, overweight credit spread exposure, and underweight allocation to euro- and yen-denominated assets.

Global resources
Robert Lyon, CFA
Senior Vice-President, Portfolio Management and Portfolio Manager

Oil and gas prices both rose sharply in 2016 after multiple down years. While it would be optimistic to think that energy will repeat the performance of 2016, there are several reasons to expect at least modest gains from here. Firstly, the underlying supply-demand balance for oil has been improving steadily, and we expect this trend to continue over the coming quarters. With weak oil prices of the past few years, oil and gas companies had little ability to grow production while global energy demand continued to rise. The question now becomes how rapidly the U.S., in particular, and other producers can raise production as the oil price recovers. We will be watching this closely as the pace of production growth will likely determine just how high the oil price can go. The November OPEC agreement to reduce supply by an expected 1.3 million barrels per day should help to advance the timing of the recovery, and we expect a more balanced oil market should be readily apparent by mid-2017. Energy equities have clearly anticipated and priced-in some of the rebound, but we are still finding selective opportunities in the sector.

Like energy, most metal prices also experienced a strong price recovery in 2016. Looking ahead, a recovering global economy and possible help from U.S. infrastructure spending could extend the rally well into 2017. Economic growth in China – by far the most important consumer of global commodities – remains robust. Of particular importance for commodity consumption is that industrial activity as measured by China's manufacturing PMI has recovered strongly throughout 2016. Add to this a still-healthy U.S. economy and a surprisingly good rebound in Europe, and the result is a fairly healthy demand for commodities. Commodity supply, on the other hand, is nearing the end of a multi-year growth phase that was driven by investment decisions made several years ago during the commodity boom. China has also helped the supply story in commodities, by closing excess capacity in certain commodities where China was a large supplier – particularly coal, cement, and steel. When we put all of these issues together, the result is a fairly healthy supply-demand combination that bodes well for the broad rebalancing of commodity markets.

One issue to watch for early in the year will be gold prices. After a strong rise in the gold price during the first half of 2016, most of the gains were reversed during the second half as markets began to price in a stronger U.S. dollar and a rise in U.S. interest rates. If these expectations reverse, or even just level off, this could set the stage for yet another early year rally for precious metals, much as we have witnessed for each of the past three years.

Utilities, automotive and industrials
Massimo Bonansinga
Vice-President, Portfolio Management and Portfolio Manager

Global easing seems to be over and utilities shares do not like raising rates. Technological innovation, distributed energy, energy conservation – they all contribute to check demand and reduce growth opportunities.

Not all is negative. While power generation is lagging, investments are needed to keep the infrastructure viable and able to accommodate technological changes. For example, balancing grids is becoming increasingly complex and necessitates investments to avoid service disruption.

Utilities are not all the same and there is still value in the group after a good 2016. We favour utilities in jurisdictions with clear regulatory regimes and exposure to infrastructure investments.

Global automotive sales have been good in 2016, with a strong U.S., good European recovery, and record-setting China.2017 will show a more moderate pace. The U.S. market is likely to be flat, Europe will slow its growth, and China, after taxation rebates have been partially reversed, will be flat to modestly up. The wild card is Brazil, which should begin a slow recovery after the economic crisis destroys demand, and perhaps Russia, where sales should rebound from very low levels. India is battling demonetization and will probably be flat to slightly down.

Global auto stocks are not expensive but re-rating may have to wait for some more clarity on the direction of the U.S. tax reform. We favour restructuring stories and strong product cycles. Tire makers are also interesting despite raw materials headwinds, provided they are able to keep their pricing discipline.

Industrials will benefit from the improvement on some of their end markets (e.g., U.S. upstream oil and gas). Short-cycle sentiment has improved with Trump rhetoric and waning of the resource drag. Orders are slowly responding while valuations have rallied ahead of fundamentals in some sub-sectors.

Construction should continue to the upside in 2017 with Europe and the U.S. still growing at a moderate pace. Rates do not seem to be growing fast enough yet to disrupt the trend.

Transportation will have to cope with higher fuel cost but increased economic activity will keep the industry growing. Airlines are still very profitable and enjoy a robust passenger growth rate. Rails had a good 2016 and should get continued support from bulk recovery and improved domestic activity.

Valuations are mixed. While we've increased our cyclical exposure we favour investments that combine cyclical opportunity with self-help, secular growth, cash generation, M&A, and some valuation cushion.

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