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GLOBAL ECONOMIC AND EQUITY REFLATION DESPITE LESS DOVISH CENTRAL BANKS

Global Investment Committee Outlook

Global Growth Should Continue Firm

Perhaps the most important factor in the coming two quarters is that we do not foresee geopolitical risk impacting markets much despite the numerous serious issues present. Given such, global economies and risk markets should perform moderately well, with central banks gradually reducing their accommodation, bond yields rising, the USD moderately strengthening and equity markets rising further. The two major potential deviations from this path, in our view, are that geopolitical risk could accelerate or that bond markets react very negatively to central banks' less dovish stance, particularly if the US enacts large fiscal stimulus.

Looking back, equity markets have matched or even exceeded our fairly bullish targets in June, with the SPX a bit above our end-September target of 2499, TOPIX 2% higher than our 1633 target and the Hang Seng also above our bullish target. The Eurostoxx Index was below our target in Euro terms, but its USD return was higher than we expected due to the very strong performance of the Euro. Our G-3 bond yield targets for end-September were very accurate, as well, as yields rose very moderately. As for currencies, our Yen estimate for September is on target, but the EUR and GBP were stronger than we anticipated.

The US economy has been firm, like we predicted in June, while Japan and Europe were even stronger than expected. Looking forward, the US economy will be distorted for a while due to the hurricane effect, but the underlying trend should remain sturdy, as it should for the other G-3 countries and China. As for detailed numbers, US GDP, at a 2.3% Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR) in the 4Q17-1Q18 period, should match consensus expectations, with a 2.1% rate in the 2Q18-3Q18 period, which, although not booming, is quite firm. Growth should come from increased personal consumption, fixed asset investment, government spending and inventories, while net trade will likely be negative.

Meanwhile, the Eurozone's and Japan's GDP will likely grow at 1.8% and 1.4%, respectively on a HoH SAAR basis in the 4Q17-1Q18 period and 1.8% and 0.9%, respectively, in the following period, approximately equaling consensus, led by personal consumption and capex. These results should re-assure risk markets and corporate profit estimates should continue to show sturdy growth for CY17 and CY18.

Lastly, China's official GDP should be 6.1% HoH SAAR in both periods, which is similar to consensus forecasts. Here too, personal consumption will likely lead the way, while fiscal stimulus will continue to provide some (but fading) support, but pollution related industrial cutbacks, a crackdown on high personal mortgage and corporate leverage, a slowdown in cellphone production, tight controls over real estate, and tighter financial system (including the insurance industry) regulation will cause economic growth to be slower than previous periods.

There is great market uncertainty about Trump's legislative success, but we still believe that a good portion of his joint tax plan with Congressional Republican leaders will eventuate in the 4Q17 or soon thereafter. Essentially, Republican legislators have more in common on tax policy and they are desperate to overcome their internal divisions so as to achieve some success before the next legislative elections fourteen months hence.

As for geopolitical issues, we believe, as have markets so far, that such will be handled without crisis due to the strong economic incentives of all major players, although the situations in North Korea and the Middle East are at very dangerous levels. Even the stability of domestic US political system is under threat now that both sides have been fueled into such a frenzy.

Central Banks: Continued Shifts towards Normalization

Since March, we have expected Fed to hike three times in CY17 and to start balance sheet reduction by year-end, which was a much more hawkish view than consensus, but this now seems highly likely to be accurate. Along with December, we now expect 25 bps hikes in the 2Q18 and 3Q18.

The ECB and BOJ have remained very dovish, as we predicted in June. The ECB has led to the market to expect QE tapering of E5BB per month cumulatively starting in January, which would mean no QE purchases at CY18-end. Meanwhile, the BOJ has done nothing to reduce accommodation, although it is buying fewer bonds than expected to achieve its 10-year bond yield target. Both are more confident about their economies now, but are unlikely to reverse accommodation too quickly. We expect the ECB to hint, after it begins its indicated taper, that it will raise interest rates in late 2018 or early 2019. We also expect the BOJ in the 2Q18 to hike its 10-year JGB target by 20 bps. As for inflation, we expect the US Core CPI to be 2.5% YoY in March, and as we expect the Brent oil price to be $62 then, we expect the headline CPI to be 2.4% YoY.

Rising USD and G-3 Bond Yields

Given our scenario, we expect G-3 bond yields to continue rising gradually in the next few quarters. For US 10Y Treasuries, our target for March-end is 2.5%, while those for 10Y JGBs and German Bunds are 0.05% and 0.6%, respectively. These are not major changes from current levels and we expect only moderate further increases through September 2018, as well, at 2.7%, 0.25% and 0.8%, respectively. For Australia, we expect 3.0% in March and 3.2% six months after that. This implies (coupled with our forex targets) that including coupon income, the Citigroup WGBI (index of global bonds) should produce a -1.3% unannualized return from a base date of September 22nd through December in USD terms, -2.1% through March and -4.2% through September 2018. Thus, we continue to maintain an underweight stance on global bonds for USD-based investors. The WGBI index in Yen terms should be +0.6% through March and +1.0% through September 2018. As for JGBs, we target the 10Y to have a -0.1% total unannualized return in Yen terms through March, with -2.1% through September 2018, so within bonds, we clearly prefer overseas bonds for Yen-based investors.

Regarding forex, from the 111 level at our June meeting, the Yen is now 112.5 compared to our September-end forecast of 112, while from the 1.12 base level, the EUR is 1.17 vs. our 1.10 forecast. Clearly, confidence in Europe has improved due to confirmation of the relatively strong macro data and improved political prospects. Because Fed policy will tighten faster than BOJ policy and we expect finally some US legislative reflationary success, we expect the Yen to weaken to 114:USD at end-December and 115 in March. For the EUR, we expect it to be 1.18 and 1.17, respectively vs. the USD then, with the AUD at 0.78 for each period. As for commodity prices, they have been quite volatile and mixed during the past quarter. Looking ahead, they should rise moderately due to continued global economic growth, with our Brent forecast at $61 in December and $62 in March 2018.

Still Overweight Global Equities

Our June meeting's MSCI World Index target for end September implied a very bullish 5.0% unannualized return, and the result was only slightly below that by September 22nd (and probably exceeded by month-end). As mentioned, despite all the political wrangling, we still think a good portion of the Republican tax reform will be enacted in the 4Q17 or soon thereafter, including moderately-sized corporate and middle-class personal income tax cuts and some additional infrastructure spending (mostly for hurricane repairs), although it will be important for markets whether this is financed with short term deficits or offset by spending cuts. This success is mostly built into US equity prices, so they will likely decline if the results disappoint some investors, but in the end, the animal spirits that have been released should keep the profit outlook fairly strong and equity prices from falling too much. Other major global equity markets (see text below) should also perform reasonably well, so aggregating our national forecasts from our base date of September 22nd, we forecast that the MSCI World Total Return Index will increase 1.4% (unannualized) through December in USD terms (3.3% in Yen terms), 7.3% through March (10.3% in Yen terms) and 11.2% through September 2018 (17.2% in Yen terms). Clearly, this suggests a continued overweight stance on global equities for USD-based investors (and Yen-based investors, as well).

US equity valuations seem too high if the Republican tax agenda is not passed, but we think significant portions will be enacted and that the global economic reflation cycle will be hard to stop. Interest rates should rise, pressuring valuations a bit, but, crucially, we do not expect them to rise too rapidly and Fed policy will remain quite accommodative. US deregulation and accelerated share buybacks (due to a tax holiday on repatriation of foreign profits) are further icing on the cake, and although there are moderate profit headwinds from a mildly stronger USD, CY17 and CY18 earnings should be quite strong. Currently, because the tax cuts are not legislated, analysts are not adjusting their EPS forecasts for such, but this is likely a major anomaly that makes the market much less expensive than it appears. Indeed, we estimate that the market is trading on about 16.5 times CY18 EPS (and even less if buybacks due to the repatriation "holiday" are greater than expected). In sum, these factors should send the SPX up only slightly to 2516 (1.1% total unannualized return from our base date) at end-December but much faster to 2784 by September 2018 (13.3% total return). These are stronger returns than its peers and, thus, justifies a continued overweight stance.

As mentioned earlier, European equities did not rise as much as we forecasted back in June, but this is because the EUR was strong, while in USD terms, they performed even moderately better than the MSCI World Index. Looking forward, we expect them to continue performing well, with Euro Stoxx rising to 395 and the FTSE to 7480 at end-December, and to 423 and 7880 through September 2018, which translates to 2.4% and 8.4% unannualized MSCI Europe returns in USD terms for those periods. Consumer confidence has risen, fears of a banking crisis have greatly diminished and global growth should cause consensus profit estimates to rise, but the recent rise of the EURUSD rate will be somewhat of a headwind because foreign profits are a very high proportion of the total. BREXIT rhetoric will likely become harsher, but we expect UK equities to perform in line with the rest of the region, partly due to rising commodity prices, to which UK corporations are highly geared. Valuations in Europe are a bit high, but because of the improving intermediate-term profit outlook, we think they can be sustained despite a less dovish ECB stance ahead. In sum, we are positive and have a slightly overweight stance on the region.

In our last reporting period, Japanese equities performed moderately well in both local currency terms and USD terms, but slightly below the MSCI World Index. We expect TOPIX at end-December to hit 1715, with 1829 through September 2018 for a total return of 1.7% and 6.1% in USD terms respectively (3.5% and 11.8% in Yen terms). These are, of course, relatively muted gains in the short run, as our Japanese equity team is not as confident in market sentiment as before, partially due to election uncertainty (although our base case is for Prime Minister Abe to survive), but the one-year returns are very respectable. As for the fundamental drivers, we expect continued corporate governance improvement (including profit orientation and improved returns to shareholders) to be a prime positive factor, but macro factors are likely to play a positive role too. Japan's economy will likely grow well above its trend, driven by improved consumer and corporate sentiment, as well as likely improvements in net trade after 2Q17, as the global economy, especially in China, continues to grow. Such, combined with a weaker Yen, should be a positive driver for corporate profits, while valuations are very reasonable, so the outlook is positive, in our view; however, given that the other regions' USD-termed equity returns are higher, we maintain our slight underweight stance.

As for the Developed Pacific-ex Japan region, we expect Hong Kong and Australian equities to perform only mildly well, coming after the outsized gains in the Hong Kong market so far this year. As we expect their currencies will be relatively stable, this leads to a 0.9% unannualized return in USD terms through December and 6.7% through September 2018. Thus, we will shift from an overweight stance to an underweight one on the region.

Investment Strategy Concluding View

Global equities returned 4.3% vs. Global bond's 2.3% in unannualized USD terms in the prior quarterly reporting period through September 22nd. Looking forward, there is no doubt that the US carries many uncertainties and that geopolitical tail risks remain quite large, but the Global Investment Committee remains upbeat because the net impulses for global economic growth and corporate profits continue to improve. Similar to our last meeting, this justifies an overweight stance on global equities, particularly for the US. Meanwhile, global bond yields should rise somewhat, so we maintain an underweight stance on global bonds, with a slight overweight stance on USD cash for USD-based clients. For Yen-based clients, however, Yen cash looks less attractive than global bonds, but more attractive than JGBs.

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