

2017 Investment Views

EXECUTIVE SUMMARY

We enter 2017 with a “glass half-full” perspective on the investment landscape in the year ahead. Our expectation is for positive returns in global equities, a choppy environment for bonds and mixed returns across alternative asset classes.

Recognizing that many factors may drive markets, and asset classes can diverge from economic performance, we believe the overall global economic growth backdrop has improved over the past six months. While we continue to see overall economic growth falling below potential across most regions, a changing narrative could help several asset classes. The prior narrative centered on central banks providing pro-growth policies that drove asset prices higher. The more recent narrative rests on late-cycle U.S. growth being bolstered by fiscal stimulus from the new administration, with the potential for some assistance from slowing, yet still growing, non-U.S. regions, which continue to be aided by supportive central banks.

We see several opportunities across asset classes and regions and hope this commentary provides you with some overview perspectives from around the world. As always, please don't hesitate to let us know if we can provide additional thoughts or details.

GLOBAL ECONOMY

Slow U.S. growth remains the status quo, with risks from rising prices and policy volatility.

- Over the past five years, the U.S. economy grew at an annual rate of around 2 percent and we expect this trend to continue. Consumer spending, which represents over two-thirds of the economy, continues to benefit from strong payroll growth. Business spending remains modest. The impact of new government spending may not be felt until 2018 if policies are implemented in 2017. A relatively tight labor market should lead to wage growth in 2017.

Inflation pressures could arise next year due to higher-demand prospects coupled with recent oil price gains.

- Risks to the U.S. economy may stem from policy mistakes. The U.S. Federal Reserve (Fed) may be forced to raise interest rates more quickly than capital markets currently expect if inflation surges and economic growth remains firm late next year. If tax cuts and infrastructure spending fail to meet market expectations, we could see economic growth soften.

European political uncertainty may be an economic headwind.

- Potential growth remains slow across Europe, which is likely a reflection of productivity challenges due to demographic headwinds and sluggish corporate investment trends. Bank deleveraging pressure and structural stresses within labor markets create additional challenges. While there are downside risks, we anticipate slow growth in Europe. Brexit-related uncertainties could be a drag on business spending and sentiment, possibly leading to a modest recession for the United Kingdom. Ongoing policy accommodation from the European Central Bank (ECB) and the Bank of England (BOE) continue to provide important support for this region. Of notable importance is that banks remain under stress and must deleverage to meet global bank risk regulations. That could prove to be a headwind to credit growth.
- The implementation of Brexit and upcoming elections are major risk factors for the European region. Brexit is likely to be triggered in the first quarter of 2017 and negotiations may remain a headline risk for the next two years. Elections in Italy, France, Germany and the Netherlands add to the economic uncertainty given the rise of eurosceptic parties.



Investment products and services are:

NOT A DEPOSIT	NOT FDIC INSURED	MAY LOSE VALUE	NOT BANK GUARANTEED	NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY
---------------	------------------	----------------	---------------------	--

Important disclosures provided on page 6.

Structural reforms should support growth in Japan, but growth will remain slow in 2017.

- Corporate and labor market reforms are tailwinds for the Japanese economy, along with monetary stimulus, including asset purchases. Both economic growth and inflation should improve, but volatility in global trade is a potential risk to results next year.

Growth in China continues to slow.

- China's 2016 stimulus program is winding down and growth is likely to soften over the course of 2017. Consumer spending represents a larger proportion of the economy, but global trade is still a major contributor to its economic growth. Stimulus has contributed to a growing debt overhang in the private sector. We believe China will avoid a debt crisis, but higher debt levels may temper growth prospects. The key event is the 19th National Congress of the Communist Party of China, scheduled for late 2017, which will set government policy for the next five years.

Commodity producers Brazil and Russia may see further recovery as oil prices stabilize.

- The OPEC deal put a floor on oil prices, at least for now. This could be a key benefit to oil producing nations, such as Brazil and Russia. Many oil-dependent economies contracted in 2016 but are likely to experience a modest recovery in 2017.

Commentary provided by:

Robert L. Haworth, CFA – Senior Investment Strategist

EQUITY MARKETS

Look for U.S. equities to grind higher in 2017 as corporate earnings increase, the pace of inflation and wage gains trend moderately higher, and future Fed rate hikes occur in a measured and deliberate manner.

- In 2016, major global events affected equity prices, including a plunge in oil prices to below \$30 per barrel early in the year, further deceleration in China's growth rate below 7 percent, the surprise U.K. vote for Brexit in June, and the unexpected outcome of the U.S. elections.
- Despite these potentially destabilizing events, equity markets proved remarkably resilient in 2016. U.S. equities outpaced international stocks, small caps outperformed large companies and cyclical stocks

generally led defensive sectors. We expect these trends and overall market resiliency to continue next year. Our 2017 S&P 500 price target is 2,400, based on a multiple of 19 times our below-consensus 2017 earnings estimate of \$127.

Changes in the political and investment landscapes in the United States provide a basis for higher earnings and stock prices.

- Investor, business and consumer sentiment indicators all surged sharply higher post-election on expectations of President-elect Trump's domestic policy agenda. U.S. equity prices rallied around four key pro-growth developments: lower taxes, deregulation, greater infrastructure spending and higher inflation.
- Consumer spending continues to benefit from a positive combination of firming wages, rising home prices, improving sentiment and low gasoline prices at the pump.
- These factors set the stage for economic growth, earnings acceleration and (presumably) higher stock prices. All of this is contingent on the magnitude and timing of legislative action on policies, such as corporate tax reform, infrastructure spending, repeal of the Affordable Care Act and adjustments to Dodd-Frank financial regulations.

Growth-oriented sectors should benefit from accelerating earnings growth, modestly higher U.S. inflation, reduced regulatory scrutiny and lower taxes.

- Technology, Healthcare and Consumer Discretionary remain recommended sectors based on valuation and favorable longer-term growth prospects. Industrials, Materials, Energy and Financials, while favorably positioned in light of Trump's victory and a GOP-controlled Congress, appear to be "rich" entering 2017 after rallying in the immediate aftermath of the election. Interest rate-sensitive sectors, such as Utilities, Real Estate Investment Trusts (REITs), Telecom Services and, to a degree, Consumer Staples companies face headwinds since rates appear to be headed higher.
- Small- to mid-sized U.S. stocks are well-positioned to outperform international equities given the U.S.-centric political agenda and strong dollar. Both of these factors tend to benefit smaller companies that primarily do business in the United States.

- For the long run, we favor companies that grow revenues faster than their peers, generate high returns on invested capital and have strong “thematic” appeal. These include companies that focus on global consumers, eCommerce, cloud computing, anytime-anywhere connectivity, an aging population and self-directed healthcare.

While domestic politics will dominate the key macro events in foreign equity markets in 2017, we see the glass as “half full” with respect to return opportunities.

- Voters in the Netherlands, France and Germany, representing more than half of the eurozone economy, will go to the election polls in 2017.
- In 2016, we experienced the surprising vote for Brexit, Trump’s victory in the U.S. presidential election and the “no” vote in the Italian constitutional referendum. There is a significant possibility of a victory by an anti-establishment party committed to leaving the euro in one of these three “core” eurozone countries.
- With the 19th National Congress of the Communist Party of China convening in the fall of 2017, the desire to maintain its stable economic growth will continue to supersede all other domestic economic concerns. Issues, such as reforming state-owned enterprises (SOEs), enacting productivity-enhancing policies or tackling high levels of financial system leverage will take a back seat.

Among foreign developed equity markets, we favor Japan over Europe because of lower political risk, modest deflation, earnings improvement and stronger regional economies.

- While deflationary fears have abated, inflation remains well below targets in Japan and the eurozone. We expect monetary policy across foreign developed markets (United Kingdom, eurozone, Japan) to remain extremely accommodative in 2017.
- Both the Bank of Japan (BOJ) and ECB remain committed to steepening their respective yield curves. This likely benefits bank earnings and stimulates credit growth to the private sector.
- Unlike the eurozone, Japan faces little political risk. Prime Minister Abe’s ruling party holds a decisive majority in parliament. His current terms as president of the ruling Liberal Democratic Party (LDP) and prime minister of Japan run until at least 2018.

Emerging market equities performed well in 2016. U.S. trade policies and the U.S. dollar will be keys for emerging markets in 2017.

- Firming commodity prices helped emerging market equities post strong gains in 2016, led by commodity-oriented economies, such as Brazil and Russia.
- Foreign-exchange reserves declined, indicating a reduced flow of dollars reaching emerging economies. If the dollar gains significantly more strength in 2017, it would likely force additional deleveraging in emerging markets, potentially inhibiting economic growth.
- An important issue to watch is Trump’s campaign pledge to pull the United States out of the Trans-Pacific Partnership (TPP) and impose across-the-board tariffs of up to 45 percent on Chinese imports.
- The risk of implementing substantial tariffs is rising prices that would most visibly impact middle- and working-class consumers, the core of Trump’s constituency. It could also provoke a strong Chinese retaliation in response. We anticipate that in the end, any trade actions concerning China will likely prove to be more symbolic in nature.

Commentary provided by:

Terry D. Sandven – Chief Equity Strategist

Thomas M. Hainlin, CFA – National Investment Strategist

FIXED INCOME MARKETS

We expect a subdued return profile for bonds in 2017.

- The combination of a historically low interest rate base and the Fed’s bias towards raising their interest rate target creates a challenging backdrop for traditional bond categories.

We believe that inflation will be the key driver of Federal Open Market Committee (FOMC) policy in 2017.

- Signs of an upturn in both current and forward looking measures of inflation will dictate the trajectory of the fed funds rate. The Fed appears willing to allow inflation to exceed its 2 percent inflation target rather than risk derailing continued economic recovery. Look for the FOMC to increase the policy rate twice next year, with the risk of a third increase occurring should fiscal measures generate a more rapid increase in inflation than the Fed currently anticipates.

- There is a risk of rates falling again should the eurozone come under additional stress from either election outcomes or a potential banking crisis.

It is likely that the BOJ and the ECB will remain accommodative throughout the year.

- The current pro-growth quantitative easing (QE) programs in both regions will likely continue. There may be some modifications to the mechanics of the existing QE programs. We believe the key risk to our forecast is that rates in overseas markets actually move lower.
- Recent yen weakness has taken pressure off the BOJ, but should the yen regain strength, the BOJ may need to become more aggressive.
- The ECB must contend with a full docket of elections throughout the first half of the year and a financial system that is under pressure from non-performing loans. Either could create pressure for the ECB to become even more accommodative in its monetary policy.

We expect the yield curve to flatten later in the year.

- The Fed's effort to normalize interest rate policy is likely to put disproportionate pressure on the short end of the curve relative to the long end.
- In our view, there are three potential obstacles to substantially higher long-term rates:
 - Diverging central bank policies across the globe that continue to favor foreign investment in the U.S. debt market.
 - Many corporate pension plans are approaching fully-funded status and continue to reduce equity positions in favor of longer-dated debt.
 - Demographic realities of a spike in retiring baby boomers who begin to boost their investment in U.S. bonds.
- There is the risk that late cycle inflation and the potential fiscal boost may negatively impact performance of longer-dated securities. Risks to the long end of the curve moving higher are considerably more poignant from a bond price standpoint than risks to the short end.

- For buy and hold investors focused on generating income and reinvesting maturities, we believe the appropriate strategy is to invest in the intermediate to long end of the yield curve.
- For investors more concerned about performance and potential price declines, we believe the appropriate strategy is to maintain exposure to the short to intermediate part of the curve where negative price action associated with rising rates may be less impactful.

Despite recent softening, we expect a stronger U.S. dollar.

- The case for a stronger dollar is supported by higher U.S. interest rates and Fed policy normalization, in contrast to continued accommodation measures by the BOJ and ECB.
- We believe the pace of dollar appreciation is likely to be in the 2 percent to 3 percent range throughout 2017.

Non-dollar debt will struggle as the dollar strengthens.

- The likelihood of a stronger dollar is reason to remain wary of non-dollar-denominated debt. We expect any price appreciation of foreign-denominated debt to be eclipsed by U.S. dollar strength. This has the potential to result in negative performance for U.S. investors in non-dollar-denominated bonds.

We expect high yield debt to continue to outperform the other fixed income market sectors in 2017.

- At this late stage in the credit cycle, we expect default rates may climb modestly toward the latter half of the year.
- Stabilizing oil prices, the potential for stronger economic growth, improving risk sentiment and below average inflation may create a favorable environment for high yield debt. In addition, the higher coupons offered by issuers in this sector can help offset potential price declines as the Fed continues to raise interest rates. Historically, during periods when the fed funds rate is rising, high yield bonds are among the most attractive in the fixed income market.

*Commentary provided by:
Jennifer L. Vail – Head of Fixed Income Research*

REAL ESTATE MARKETS

Leading indicators for the real estate market look stable, but returns within public real estate could be affected by interest rate movements.

- Job creation, wage growth, household formation levels, and consumer and builder confidence support real estate investments, but if interest rates continue to increase, real estate's bond-like properties could outweigh other favorable fundamentals.
- **Housing:** Building and sales activity remain modest compared to pre-housing bubble levels. Job and wage growth, as well as relatively low mortgage rates, should support demand. Expect housing starts and sales to demonstrate continued improvement.
 - Inventories are generally low, which should boost home prices and lead to further gains in home building.
 - The current level of sales activity and construction remains below long-term averages, indicating additional room for recovery. Risks to our housing forecast include the pace of wage growth, limited labor and materials, the availability of credit and the balance sheet health of first-time homebuyers.
 - Though the sector began its recovery early in this cycle, multifamily investment is set to continue, with demand driven by household-forming millennials and baby boomers. However, we believe some multifamily markets will be challenged to balance supply, demand and rent rate growth.
- **Direct commercial:** Current cash flow yields are reasonable and the economic environment remains positive. The opportunity has shifted to value-added and opportunistic strategies from core strategies. The market appears to favor direct strategies at this time.
- **U.S.-listed commercial:** In our view, REITs should see growing demand as investors search for a substitute for low-yielding fixed investments in an environment of rising inflation. Commercial real estate fundamentals, such as vacancy trends and cash flows should benefit from an improving economy. However, we are clearly later in the economic cycle and lending conditions may begin to tighten.

- **Foreign-listed commercial:** Continued low interest rates around the globe should provide some support. Inflation pressures remain modest outside the United States, limiting the pace of income growth. Political uncertainty may limit demand for foreign REITs. Currency trends are likely to be a headwind based on our near-term expectations for a stronger U.S. dollar.

Commentary provided by:

Edgar W. Cowling, Jr., CCIM – Director of Specialty Assets

COMMODITIES MARKETS

Fundamental supply overhang means price gains are likely to be modest in 2017.

- While the commodities bear market may be over, we are unlikely to see a bull market in 2017. Market structure remains a challenge and fundamentals across many raw materials continue to point to concerns of an oversupply.
- The oil market should improve in 2017, with the overhang in inventories drawn down later in the year. Prices will likely struggle to exceed \$60 per barrel, reflecting a boost in output by U.S. shale producers seeking to capitalize on rising prices.
- U.S. interest rate increases and a stronger dollar may dampen demand for gold in 2017. Events such as political strife and expansion of negative interest rate policies in Europe, or a crisis in China (neither of which are expected to occur) would be required to stimulate prices.
- The surge in the price of copper is likely to moderate in tandem with China's subdued growth in 2017. Still, prices are unlikely to revisit their lows, reflecting some improvement in U.S. housing and infrastructure investments.
- It may be appropriate to consider investments that benefit from lower-than-normal prices. Qualified investors may want to explore private strategies, which can benefit from illiquidity discounts and operational improvements in acquired companies.

Commentary provided by:

Robert L. Haworth, CFA – Senior Investment Strategist



This commentary was prepared in December 2016 and the views are subject to change at any time based on market or other conditions. This information represents the opinion of U.S. Bank and is not intended to be a forecast of future events or guarantee of future results. It is not intended to provide specific advice or to be construed as an offering of securities or recommendation to invest. Not for use as a primary basis of investment decisions. Not to be construed to meet the needs of any particular investor. Not a representation or solicitation or an offer to sell/buy any security. Investors should consult with their investment professional for advice concerning their particular situation. The factual information provided has been obtained from sources believed to be reliable, but is not guaranteed as to accuracy or completeness. Any organizations mentioned in this commentary are not affiliated or associated with U.S. Bank in any way.

Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning the construction of portfolios and how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes will be suitable for every portfolio.

Past performance is no guarantee of future results. All performance data, while deemed obtained from reliable sources, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for investment. The **S&P 500 Index** is an unmanaged, capitalization-weighted index of 500 widely traded stocks that are considered to represent the performance of the stock market in general.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. **International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible difference in financial standards and other risks associated with future political and economic developments. Investing in **emerging markets** may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in **fixed income securities** are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in **high yield bonds** offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. The **municipal bond market** is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with an investment in **commodities**, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. Investments in **real estate securities** can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties (such as rental defaults). **Private debt investments** may be either direct or indirect and are subject to significant risks, including the possibility of default, limited liquidity and the infrequent availability of independent credit ratings for private companies. **Private equity investments** provide investors and funds the potential to invest directly into private companies or participate in buyouts of public companies that result in a delisting of the public equity. Investors considering an investment in private equity must be fully aware that these investments are illiquid by nature, typically represent a long-term binding commitment and are not readily marketable. The valuation procedures for these holdings are often subjective in nature.