2017 Investment Outlook

"After the challenges of the past year, our investors provide insights into what lies ahead."

Martin L. Flanagan
President and CEO,
Invesco Ltd.
Atlanta

This past year has been marked by a series of macro events that helped shape a dynamic, challenging market environment. The UK's vote to withdraw from the European Union, oil price volatility, a contentious presidential election in the US and slowing growth in China all contributed to major market moves. With this as prelude, the year ahead promises to be interesting and challenging as well.

At Invesco, we're dedicated to delivering an investment experience that helps people get more out of life. In fact, our entire firm has been built over many years with a single focus: to help clients achieve their investment objectives.

With more than 6,500 employees and an on-the-ground presence in more than 25 countries, Invesco is well-positioned to meet the needs of investors across the globe. We provide a comprehensive range of investment capabilities and outcomes, delivered through a diverse set of investment vehicles, to help clients achieve their investment objectives.

Our experienced investment teams are located in key cities all over the world, which we believe is a real strength of our firm. Maintaining investment teams in major markets enables us to stay on top of developments that impact the markets and companies in which they invest.

An important part of achieving your investment objectives may be keeping ahead of the dynamics that drive movements in the global markets. Working with our investment teams, we've developed this 2017 outlook to provide insights that could help you plan for the future or make decisions about your investments.

We hope you find this information helpful, and remain focused as always on helping clients meet their investment objectives ... wherever the markets take us.

Content

How might economic recovery differ across developed and emerging economies?

John Greenwood
Chief Economist,
Invesco Ltd.
London

Key takeaways

- Under Donald Trump's leadership, US GDP is expected to accelerate, but CPI inflation will be broadly unchanged.
- The continued Brexit fallout is expected to slow Britain's GDP, while Europe's contentious political climate could stall economic growth.
- Emerging economies could be significantly impacted by the effects of China's current credit explosion.

Over the past several years, both the developed and emerging worlds have been responding to the long shadow of the Great Recession of 2008 and 2009, and the cycles in each area have diverged.

The recovery of the developed economies has been hampered by two factors: the slow process of balance sheet repair, especially among the banks, and the differing consequences of the implementation of quantitative easing (QE). These factors have combined to create sub-par growth, an agonizingly slow return to full employment, low wage growth and fractious electorates.

By contrast, the emerging economies implemented strong stimulus programs between 2008 and 2010. These proved so successful that some economies, including China, Brazil and Russia, had to reverse course and slam on the brakes in 2011 and 2012. As a result, between 2014 and 2016, they too experienced economic slowdowns, recessions, currency weakness and the pain of debt workouts.

For both developed and emerging economies, the outlook for 2017 will be closely correlated to how these differing problems are addressed.

Developed economies
In the US, Donald Trump will assume the presidency on Jan. 20, 2017, with Republican control of both houses of Congress. He has proposed a range of fiscal stimulus measures, including personal and corporate income tax cuts and numerous infrastructure spending programs, designed to boost growth and encourage the repatriation of capital held abroad. In addition, he plans to reform the Affordable Care Act (ending the incentive to employ workers for only 29 hours per week), lift the restrictions on energy production (liberating shale, oil, natural gas and clean coal) and revise the Dodd-Frank Act on banking regulation. Astonishingly, he aims to achieve a growth rate of "at least 3.5% and as high as 4%."

Despite some savings that could come from reducing regulatory burdens and canceling US contributions to UN climate change schemes, the US fiscal deficit seems likely to widen – as it did under President Ronald Reagan. Beyond harvesting such savings, fiscal deficits can only be financed by taxation, by borrowing or by the creation of new money and credit (as seen with China's fiscal stimulus from 2008 to 2010). Since taxation is automatically excluded, and the US Federal Reserve will not cooperate in the unwarranted printing of money (it is expected to raise rates in December 2016, and probably two or three times more in 2017), borrowing becomes the only means of financing these deficits. Immediately following the election result, bond yields have risen, inflation expectations are increasing and the dollar has strengthened.

Abroad, Mr. Trump has said he will renegotiate the North American Free Trade Agreement (NAFTA), withdraw from the Trans-Pacific Partnership (TPP) and impose substantial tariffs on "currency manipulators" to stop the inflow of illegally subsidized steel and other key industrial materials at below-market prices. He also plans to discourage US companies from offshoring jobs. In doing so, he aims to restore employment in manufacturing, mining, logging, steel, aluminum and other heavy industries.

Mr. Trump's program is aimed at rebuilding the core strengths of the American economy by giving a strong boost to the health of US businesses and households. I expect real gross domestic product (GDP) growth to improve to 2.5%, and Consumer Price Index (CPI) inflation to reach 2.1% in 2017.

In Europe the outlook is much less favorable. The slow progress of bank resolution, the weakness of the European Central Bank's (ECB) QE program and the consequent descent into negative interest rates are among the headwinds holding back economic recovery. Unemployment across the continent has remained at double-digit levels, and income growth is anemic.
As a result, disruptive populist and xenophobic political movements have mushroomed on the left and on the right. With conventional center-right or center-left governments in Italy, Holland, France and Germany facing referenda or elections over the next year, the risk of further disruptive political changes is significant. At some stage, one or more of these electorates could overwhelm the governing elites, posing an existential threat to the established order – the European Union (EU) or even the Eurozone. Real GDP growth is likely to remain around 1.5% at best, with inflation falling far short of the ECB's target of "close to but below 2%," in my view.

(continued on next page)

The British economy had been doing relatively well by comparison, conforming to the US model of gradual balance sheet repair, assisted by injections of QE-based money creation. Real GDP growth had averaged 2.3% since 2013, and – unlike we've seen in the Eurozone – deflation has not been an issue. However, the Brexit vote in June 2016 has threatened the UK with the loss of tariff-free access to the EU market, declines in foreign direct investment and a potentially major blow to London's status as the financial capital of Europe. So far the brunt of the fallout has been reflected in the 14% decline in the trade-weighted index of sterling, but when the formal negotiations with the EU begin after March 2017, the currency could easily fall further. Such falls would raise imported prices and be passed through to the CPI, undermining real wage growth. Since UK consumer spending comprises 65% of GDP, the reduction in economic growth would be significant. I expect 1.4% growth and 2.5% CPI inflation.

In Japan, as in the Eurozone, balance sheet repair among the banks and structural reforms have lagged, while the impact of "qualitative and quantitative easing" (QQE) has been much less than anticipated. Consequently, growth has been weak, and renewed deflation has been a persistent problem. The economic policies of Prime Minister Shinzo Abe, known as "Abenomics," have not lived up to their promise, leaving the prospects for 2017 little better than for 2016. I expect 0.7% real GDP growth and broadly flat consumer prices.

Emerging economies

Among the emerging markets (EM), excess credit creation and over-leveraging between 2008 and 2010 required a corrective process from 2013 to 2015, especially in Brazil, Russia, India and China. In 2016, that phase appears to have reached an end, as evidenced by the bottoming-out and the start of a modest upswing in commodity prices in the first half of the year, together with renewed capital inflows into EM economies. However, China is a major exception, having embarked on another episode of credit expansion from the start of 2014. Since China is by far the largest EM, and the largest buyer of commodities on world markets, the renewed surge in credit growth could yet cause another episode of inflation for China. This would not only derail China's adjustment to a more consumption-led growth model, but it would also have serious knock-on effects on other emerging markets, especially commodity producers and China's neighboring East Asian economies.

So far, the excess credit growth in China appears to have been largely contained within the financial and government sectors, but there are worrying signs that the credit explosion is starting to leak out into the broader economy. First, there has been a series of mini-bubbles in equities (2014 and 2015), housing and commodities (e.g., in soybean meal, PVC, iron ore, coking coal and steel futures). Second, the large, industrial, state-owned enterprises (SOEs) have seen a notable uptick in growth and profits. Finally, producer prices, which had been falling for four consecutive years, started rising again in October. The sooner the Chinese authorities address these issues, the less damage the economy and employment will incur, but further delays will exacerbate the adjustment when it finally occurs. Exactly how the Chinese authorities deal with the problem in 2017 (either by repression and direct controls or by restricting credit and allowing market forces to transmit the required adjustments) is one of the big unknowns for 2017.

Global equities

Looking for long-term opportunities after a year of surprises

Jeff Everett
Co-CIO, Global Core Equities
Atlanta

Key takeaways

- We anticipate central banks may rethink quantitative easing in 2017.
- Despite political rhetoric in some markets, we expect globalization to continue.
- We believe the factors driving the market have increased the importance of differentiated, fundamental research.

As 2016 winds down, global investors can reflect on a volatile year, full of surprises. A double-digit correction in the first six weeks welcomed investors into the new year, sparked by a December 2015 rate hike in the US, as well as concerns over the slowing Chinese economy. Post the decline, equities rebounded strongly, aided by global central bank support and surging commodity prices. Emerging market equities benefited most from the rally in commodities and, as of this writing, have outperformed the developed markets during the year after having underperformed significantly for the past five years.[1]

Central bankers – the Bank of Japan (BOJ), the European Central Bank (ECB) and the US Federal Reserve – soothed investors' nerves throughout the year with their accommodative policies and/or dovish rhetoric. Other factors driving investor sentiment included rebounding oil prices as well as a strengthening housing market in the US. The surprises of the year, however, were driven by elections. The United Kingdom's Brexit vote to leave the European Union provided a brief, but sharp, sell-off mid-year. This was followed by a quick recovery, but ongoing uncertainty in terms of how such an exit will actually happen. Donald Trump's November victory in the US presidential election led to a surge in the US equity market, highlighted by rotation into previously out-of-favor segments such as health care and financials. Despite these headlines and volatile price swings, as the year comes to a close, it appears that the markets have rewarded investor patience with a reasonable gain as payback for their perseverance.[1]

What will drive performance in 2017?

Today, we face a world of growing divergences between corporate profitability, sector and industry cross currents, multi-asset complexities as a result of public policymaker actions, and inevitable disruption from the possibilities of the internet, all overlaid with regulatory risks in numerous sectors and countries. In the midst of this, the Invesco Global Core Equities team continues to anchor our global research capabilities in a disciplined investment approach to uncovering overlooked opportunities and assessing risks. We believe the factors driving the market – corporate earnings, interest rates, globalization and demographics, to name a few key issues – have increased the importance of differentiated, fundamental research. Select segments of the market, financials and health care for example, demonstrated meaningful earnings recovery in the third quarter of 2016, but remained undervalued and ignored by global investors at the time of this writing. Looking at the bigger picture, health care companies offer investors exposure to two of the more intriguing and opportunistic longer-term global trends, in our view – aging, particularly in emerging markets, and an emphasis on healthier living.

Following their multi-year support of the markets, we anticipate central banks may rethink quantitative easing (QE) in 2017, perhaps expanding their current ultra-low interest rate policies to include infrastructure spending programs. We believe that by supplementing monetary-only stimulus (which has led to an extremely subpar recovery) with actual government spending, central bankers in the US, Europe, Japan and China could potentially spur improved secular economic growth.

We also believe the recent trend of central bank market support has been favorable to passive strategies. In general, the "rising tide lifts all boats" market backdrop has resulted in headwinds for active, research-oriented investment processes that are focused on individual company strengths and weaknesses. In turn, passive investing funds in the US have benefited from significant asset flows.[2] However, the changes we anticipate should begin to reverse this tide as company fundamentals and an improving global economy should reward well-positioned management teams, in our view.

It's important to note that our views are not built on short-term or even 12-month expectations. We search the globe and use multiple valuation criteria to find "growth-value anomalies" – companies that we believe have an attractive risk/reward profile over a time frame of three years or longer.

We complement our sector-based work with a geographic overlay so that we can better understand the macro picture and the issues facing the companies in which we invest. While the nuances of individual markets can be difficult to detect or measure, this is particularly applicable to the emerging markets. For example, the World Bank recently announced that in India, on average, it takes 26 days

(continued on next page)

to start a business and 190 days to gain a construction permit. In Mumbai, it takes almost 13 days for imports to clear customs, versus an average of nine hours in countries that are part of the Organization for Economic Cooperation and Development.[3] Local market characteristics are an extremely important factor in measuring a company's potential and risk.

What we see across global markets

We research all sectors with a global view, and despite political rhetoric in some markets, especially the US and UK, we expect globalization to continue. As such, we believe that continuing pressure on prices, threats from innovation, and regulation will require sharp research to identify and quantify profitable upside opportunities relative to the associated risk. As of early November, we continue to view several segments of the market as compelling opportunities. Within technology, we see prospects in the semiconductor-related industries, and within health care, our research has uncovered growth-value anomalies among select biotech-related stocks.

Our investment approach also leads us, however, to be quite cautious with some areas of the market, specifically the utilities and consumer staples sectors, which have been referred to as the "expensive defensives." Investors' focus in recent years on dividends and high-yielding stocks has led some groups, such as utilities, to be relatively expensive in our view, with unwanted risk due to valuation and the prospect of rising interest rates.

Conversely, we remain encouraged by the number of opportunities we are finding in the financials sector, specifically financial services. However, we do not view all financials similarly. For several years, we have been cautious on the banking industry, and even today we find limited opportunities in this sector, particularly in today's low rate environment. Conversely, our research on financial service companies and insurance companies indicates the potential for continued upside in a number of companies, especially those that embrace innovation and are less subject to significant capital and regulatory constraints. In addition, we find several companies within this latter group of financials to be more attractively positioned from a valuation standpoint.

In conclusion

The existing gap between company stock valuations and their growth prospects — when uncovered by our team of high-conviction, fundamentally based analysts — offers ample opportunity for long-term rewards, in our view. Our approach remains focused on finding these growth-value anomalies, and our disciplined stock research continues to identify the roots of change, disruption and innovation as these impact all companies in varied ways. We believe our approach is particularly well-positioned against the current market backdrop where we can use any increased volatility, especially when unrelated to company fundamentals, to potentially capture longer-term rewards for investors.

1 Total returns in US dollars from Jan. 1, 2016, through Oct. 31, 2016: MSCI EM Index, 16.30%; S&P 500 Index, 5.87%; and the MSCI All Country World Index, 4.79%. Source: FactSet Research Systems, Inc.
2 Morningstar, Sept. 30, 2016
3 Source: Gavekal Research, Nov. 3, 2016

Global equities

With valuations high, where can investors find equity opportunities?

Nick Mustoe
Chief Investment Officer,
Invesco Perpetual
Henley-on-Thames

Key takeaways

- A shift to fiscal policy could have profound implications for the bond markets.
- The impact on 'bond proxies' could mean further rotation out of 'defensives.'
- Valuation should reassert itself as a key driver of markets.

The prospects for 2017 are likely to be heavily informed by what we have seen in the years since the financial crisis. Since 2008/2009, economic policy has focused almost exclusively on austerity measures and loose monetary conditions, such as ultra-low (and even negative) interest rates and quantitative easing programmes. These measures were intended to slow the growth of debt relative to gross domestic product, to lower risk free interest rates and stimulate economic activity. Whilst they have been successful to the extent that they have averted a 1929-style depression and a collapse of the banking system, they have been largely ineffective in engendering significant growth in the real economy.

In addition, there has also been the unintended consequence of significant asset price inflation that, in most economies, has not benefitted the broad population. That has been reflected in political developments in 2016. The surprise outcomes of the UK Brexit referendum and the US presidential election are clear examples of electorates pushing back against the income and wealth inequality that they have experienced in recent years. There is scope for this to continue in Europe with French and German elections next year. This pressure on governments and central banks is likely to accelerate the much-anticipated shift away from monetary policy towards a more pro-growth fiscal policy.

What does fiscal policy mean for markets?

A global shift to expansionary fiscal policy, such as the tax cuts and infrastructure spending proposed by US President-elect Donald Trump, would likely mean a boost to the supply of bonds and also to expectations of future inflation. In such a scenario, investors would no longer see falling bond yields as the norm, which would have profound implications for the yield curve in fixed income markets, and by extension for perceived 'safer' bond-like segments (i.e., 'bond proxies') of the equity market.

In recent years, valuation has taken a back seat as stocks characterised by low levels of volatility have outperformed their more cyclical counterparts, not because of their fundamentals but because of their bond-like qualities. This outperformance has meant that many assets that are perceived to be 'defensive' are now very expensive. For example, as of 31 October 2016 global consumer staples traded at around 20 times next year's earnings, which is higher than their previous peak in 2007.[1] Such valuations are unsustainable in my view and render these parts of the equity market vulnerable to the resurgence of valuation as a key driver of returns. A shift to fiscal stimulus would support that resurgence and serve as a shot in the arm to those parts of the market that have lagged the considerable outperformance of 'safe haven' assets.

Where are the valuation opportunities?

In aggregate, markets appear quite expensive to me. Despite recent spikes in yields, it is still difficult to find any value in the bond markets. At first glance, equity market valuations also appear expensive, albeit less so than bonds. However, these high equity valuations mask extreme valuation disparities amongst both regions and sectors. If you dig deeper, I believe there is still value to be found in certain parts of the market.

In regional terms, I think that Europe is the stand-out opportunity, especially when compared to the US equity market. European companies have not re-leveraged to the same degree as their US counterparts, benefit from supportive financial conditions and still have significant scope to improve their earnings, which are a long way below their prior peak. To put the valuation disparity between these markets in context, the US equity market hasn't been this expensive relative to Europe for decades.

In sector terms, the cyclical areas of the market, particularly banks, should in my view continue to perform well. Banks are much better-capitalised entities now than they were in the immediate aftermath of the financial crisis. They have significantly improved their capital structures and reduced the volatility of their earnings streams in recent years whilst operating in an extreme environment of tight regulations and ultra-low interest rates that have depressed returns. I believe that there is potential for the interest rate and regulatory backdrop to improve throughout 2017. Whilst the banking sector has performed well from July 2016 through the time of this writing, it is still trading close to its financial crisis lows and therefore has plenty of further scope to perform.

(continued on next page)

Can the great rotation continue?

As we have seen in recent years, unforeseen risk-off events have the potential to shake investor confidence and render valuation a backseat driver in market movements. In those circumstances, 'defensive' assets could outperform again, particularly over short periods. However, we remain resolute in our belief that over the long term, valuation is the most reliable driver of returns. Many of the 'safe haven' assets that have performed well are now overvalued to the extent that they no longer necessarily offer the protection that investors have come to expect of them. Meanwhile, areas of the market, such as Europe and some of the more cyclical sectors, are pricing in an outlook that is much worse than the one that I envisage. That disparity is not sustainable. A shift in thinking amongst policy makers towards expansive fiscal measures should support further positive (even if only moderate) economic growth and an uptick in inflation. In my opinion, this would provide the right environment for the normalisation of valuations across markets.

1 MSCI World Consumer Staples Index as at 31 October 2016. Source: Bloomberg, L.P.

Using factors to take advantage of investment opportunities in the coming year

Bernhard Langer
CIO, Invesco
Quantitative Strategies
Frankfurt

Dan Draper
Managing Director,
PowerShares by Invesco
Downers Grove

Key takeaways

- Factors are quantifiable characteristics that can help explain the risk and returns of a given asset.
- Economic policies pursued by new administrations in the US and elsewhere in 2017 may affect factor performance.
- Investors can blend factors to accommodate different market and risk scenarios.

Although it may sound like a well-worn cliché, we are at a critical juncture as 2017 approaches. Two important tests of voter sentiment – the US general elections and the United Kingdom's referendum to leave the European Union – have occurred in less than six months' time, and the ramifications could prove profound. Although the United States is now in the seventh year of an economic expansion, the current recovery is among the slowest on record and has been subject to bouts of market volatility that have buffeted the financial markets and tested investors' resolve.

President-elect Donald Trump's surprise ascendency to the US presidency figures to influence factor performance in 2017 – at least in the near term. Immediately following the election, the global equity markets reacted favorably on expectations of lower corporate tax rates, less regulation and possible stimulus spending. This same outlook has pushed both short-term yields and the US dollar sharply higher, roiling the bond markets and putting pressure on emerging market shares. Whether or not investors' expectations will be realized, however, is far from certain.

What are factors?
Despite its newfound popularity, factor investing traces its roots to the 1960s and is supported by a substantial body of academic research. At their most fundamental level, factors can be thought of as quantifiable characteristics that can help explain the risk and returns of a given asset. Commonly deployed factors like quality, low volatility, value, size and momentum have been shown to be rewarded over long periods of time. Factors are the building blocks of factor-based portfolios and can be combined with other factors (i.e., a multi-factor strategy) or with actively managed funds.

Ongoing economic expansion in a slow-growth environment
The current slow-growth economic environment in the US has generally benefited low volatility and dividend-paying stocks, while creating headwinds to value shares. To what extent these conditions continue in 2017 will hinge in part on economic policies pursued by the new administration in the United States and by policymakers elsewhere. While lawmakers don't sell products or generate sales, the policies they pursue can make it easier or more difficult for companies to grow earnings. Public policy can also influence consumer confidence and investors' appetite for risk.

If US economic growth accelerates from its current pace, we believe the value and small-cap size factors could benefit. Both value and small-cap shares have the potential to perform well during periods of accelerating economic growth. Higher interest rates are not likely to dampen this performance potential, as both value and small-cap stocks can still do well in a rising rate environment.[1]

If stocks rally, it would not be surprising to see low volatility shares underperform. Because low volatility strategies attempt to attenuate the market's highs and lows, the low volatility factor may provide downside mitigation, but is expected to underperform in most bull markets.

Obstacles to US economic growth remain
This is not to say that investors can't benefit from low volatility factor exposure over the coming year. Despite signs of a cyclical upswing – including reduced inventory overhang, increased capital spending and a bottoming in the profit cycle – the markets are still fraught with risk, and sustained economic growth is far from certain.

Automakers have been generating strong sales, but this momentum could be cut short in the event of increased consumer credit defaults. Some senior auto executives believe the US auto market has peaked after an extended period of growth fueled by dealer incentives.[2] Additionally, we are seeing clear signs of wage inflation in the US.[3] Hourly earnings and, by association, wage costs, are growing at their fastest pace since the economic expansion began. This could pressure profit margins and increase market volatility – particularly if worker productivity remains stagnant. Going back to the 1990s, average hourly earnings growth has tended to lead market volatility by about one year. Increased wage costs could make a case for strategies with risk mitigation objectives.

Late in 2016, expectations for future US economic growth led to a near-term spike in Treasury yields and a rotation into cyclical sectors. In our view, a continuation of this trend

(continued on next page)

in 2017 could aid the value and small-cap size factors, but hurt dividend-paying stocks as bonds begin to look more attractive.

International growth prospects vary

Europe is still making its way in a post-Brexit environment. Despite fears to the contrary, European markets have adjusted well to Britain's vote in June to break from the European Union. However, with elections coming up in 2017 in France and Germany, the decision has created disintegration risks elsewhere in the EU. Meantime, many parts of the continent remain in a negative interest rate environment. Sustained economic growth would go a long way toward balancing out quantitative easing imbalances, but pockets of economic weakness remain and the European banking sector is still on shaky ground.

Emerging market prospects are mixed. While the end of the impeachment saga in Brazil and economic reforms in India provide reason for optimism, India's decision to pull high-denomination bills from circulation threatens to overshadow this progress. In China, a devalued yuan may signal that government officials are concerned about future economic growth and continued capital outflows.

In aggregate, a confluence of risks could lead to choppy trading patterns in the coming year, which we believe could make a case for low volatility factor investing. This "risk on-risk off" backdrop would likely not bode well for the momentum factor, as momentum stocks have historically performed well in a sustained growth environment with clear and stable market leadership. Should global economic growth prove more consistent, however, we would expect to see periods of outperformance from the momentum factor.

The benefits of blending factors

Of course, factors can also be blended to accommodate different market scenarios and provide potential diversification benefits. For example, pairing value with low volatility could make sense for expectations of economic growth with periodic market disruptions.

The potential implications for diversification are even greater for factors with very low excess return correlation. Combining momentum and low volatility, for example, provides exposure to two factors that historically have tended to behave very differently from each other. Or, given the uncertainty of the coming year, blending defensive factors like low volatility and quality may help mitigate risk, while still providing potential diversification benefits.

1 Source: FactSet Research Systems, Inc., as of Dec. 31, 2015
2 Source: Bloomberg News, Nov. 8, 2016, "Toyota and Nissan Say the U.S. Auto Market Has Peaked"
3 Source: Bloomberg L.P., Nov. 30, 2016

What will Asian equities benefit from in 2017?

Mike Shiao
CIO, Asia ex Japan
Hong Kong

Key takeaways

- We have a relatively constructive outlook for Asia ex Japan in 2017.
- Regional growth could be driven by robust consumption, a revival in regional exports and secular infrastructure investments spurred by fiscal initiatives.
- Though the US Federal Reserve interest rate normalization cycle could affect regional fund flows, significant volatility in Asian currencies is unlikely.

2016 was an eventful year for Asia ex Japan equities, with a volatile start followed by a turnaround in investor sentiment. The renewed interest in Asia ex Japan equities was fuelled by stabilizing economic conditions in the region, an ongoing commitment by Asian central banks to ease interest rates and a moderation in tightening expectations in the US. Outside of Asia, the uncertainty brought about by the Brexit referendum, along with the negative interest rate environment in the Eurozone and Japan, drove investors and asset managers to reallocate to Asia ex Japan equities after consecutive years of underweighting the asset class.

Heading into 2017, the Invesco Equity Investment Team in Asia believes Asia ex Japan equities will continue to benefit from the bottoming-out of earnings, accommodative monetary policy, and attractive valuations relative to history as well as to global peers. Moreover, we see several bright spots that could further spur regional growth, including robust consumption as e-commerce broadens, a revival in regional exports, ongoing reforms that enhance productivity, and fiscal initiatives that lead to secular infrastructure investments.

Our view: Earnings to bottom out

In 2016, Asia ex Japan earnings growth is expected to be largely flat after the consensus' ongoing downward revisions throughout the year. With limited top-line growth worldwide, Asian companies are finding ways to enhance earnings. We believe the bottoming-out of earnings will be a key factor in support of Asia ex Japan equities.

Our view that fiscal-year 2017 margins should be relatively resilient is twofold. First, Asian companies should see an improvement in earnings from tighter expense controls. Second, we believe the decline in input prices will provide relief for consumers as well as specific industries that are reliant on raw material inputs, including manufacturers, refiners and transportation companies. Similarly, after rounds of monetary easing, lower financing costs will also provide a better operating environment for corporates, in our view.

An extension of accommodative liquidity

With the consensus factoring in a very gradual interest rate hike trajectory in the US, Asia ex Japan equities should continue to benefit from ample liquidity in 2017. A number of Asian central banks have already eased further in the second half of 2016, with some central banks taking policy rates to record lows, such as in Indonesia and South Korea.[1] We expect easing to continue in 2017 for some countries, with most countries maintaining an accommodative stance in light of the low inflation outlook. Combining the existing Shanghai-Hong Kong Stock Connect with the Shenzhen-Hong Kong Stock Connect, which was scheduled to be launched in late 2016, Hong Kong-listed Chinese equities should continue to benefit from the huge potential for structural flows and improving liquidity.

Valuations remain attractive

Despite the rebound in most Asian markets in the first three quarters of 2016, Asia ex Japan equities were still trading at a meaningful discount to developed markets in price-to-earnings terms, with a 9% discount to Europe and a 22% discount to the US.[2] While earnings are generally more vulnerable to fluctuations, regional valuations have been equally compelling in price-to-book terms, trading at 1.3x,[3] which is comparable to levels following the global financial crisis in 2008 and the period following the technology, media and telecommunications bubble of the early 2000s. Although short-term volatility may persist, we believe valuations at this level could be compelling for long-term investors looking to gain exposure to Asia ex Japan's secular growth trends.

Possible catalysts ahead

Looking ahead, we believe Asia ex Japan could benefit from a number of structural themes translating into catalysts:

- **Robust consumption:** Domestic consumption continues to be a key economic growth driver with many Asia ex Japan economies transitioning from an export and manufacturing-driven model to one that is consumer-led. The solid growth in retail sales and private consumption in countries like China, India and Indonesia mainly stems from the decent wages growth in the recent years.
- **Ongoing structural reforms:** A number of structural reforms in the region designed to enhance productivity and reduce excess capacity may lead to improving return on equity and a potential market re-rating. Reforms in China are broad-based, with

(continued on next page)

supply-side reform expected to transform traditional state-owned enterprises with low efficiency into more streamlined and efficient enterprises. Korea is taking steps to restructure selected troubled industries. In India, 2017 will be a crucial year with the implementation of the goods and services tax that should remove interstate barriers and transform India's economy into a single national market.

- **Recovery in exports:** More export-driven markets, such as Korea and Taiwan, are expected to benefit from a recovery in consumer demand. The potential for stronger demand from the US, coupled with a low base year effect in 2016, will be positive for Asia. By product segment, we believe Taiwan should see better demand for IT components, such as semi-conductors from global IT firms and handset makers, while Korea should continue to benefit from the surging popularity of Korean cosmetic products and growing prominence in consumer electronics.
- **Fiscal spending and public investment to fuel real economies:** An expansion in fiscal spending and infrastructure projects will continue to act as another pillar to economic growth, in addition to the accommodative monetary conditions and domestic consumption. Demand for infrastructure projects in emerging Asia will likely remain strong, where countries in the Association of Southeast Asian Nations, in particular, are seeing a large need for increased power and transport infrastructure. Elsewhere, in China, fixed-asset investment remains huge in absolute terms, driven in part by ongoing urbanization.

Conclusion

Overall, we have a relatively constructive outlook for Asia ex Japan equities in 2017 with the bottoming-out of earnings and continuation of accommodative liquidity, as well as attractive valuations. Meanwhile, we are also aware of the potential risk that may arise from the external macro environment, the foremost being a more hawkish US Federal Reserve interest rate normalization cycle, which could have an adverse impact on regional fund flows and currency trends. That said, we believe it is unlikely that there will be extreme volatility in Asian currencies, as experienced in 2013 when the US began tapering, as the consensus has already priced in a gradual rate-hike scenario. As our investment approach is purely bottom-up and fundamental-driven, the team continues to find many attractive opportunities within the consumer-related areas benefiting from secular growth trends. We continue to rely on our core competency: looking for the best company-specific opportunities and quality franchises trading below what we view as their intrinsic value.

1 For Indonesia, a record low was reached on Oct. 20, 2016, at 4.75%. For Korea, a record low was made on June 9, 2016, at 1.25%.
2 MSCI AC Asia ex Japan Index relative to the MSCI US Index and MSCI Europe Index. Sources: MSCI, FactSet Research Systems, Inc., IBES, Bloomberg L.P., Goldman Sachs Global Investment Research, as of Sept. 30, 2016
3 Sources: Bloomberg L.P., Invesco, as of Sept. 30, 2016. Regional valuations defined by the MSCI AC Asia ex Japan Index

Economic uncertainty provides fertile ground for stock pickers

Stuart Parks
Head of Asian Equities,
Invesco Perpetual
Henley-on-Thames

Key takeaways

- Economic growth is likely to remain anaemic in much of Asia for a number of reasons.
- India probably has the best macroeconomic outlook.
- Many Asian companies have the ability to grow earnings, generate strong free cash flow and increase dividends.

2016 has been another 'muddle through' year. There have been positives such as China's economic growth surprising on the upside, lack of acknowledged problems in the Chinese banking sector and the reform agenda accelerating in India and Indonesia. However, there have also been negatives. For example, China's growth has been debt-funded, growth elsewhere has been disappointing, and political developments – both globally and in the Philippines, Malaysia, Thailand and South Korea – have unsettled markets.

So what may change in 2017?
In spite of the political surprises this year, more of the same seems to be in store for 2017. Economic growth is likely to remain anaemic in much of Asia for a number of reasons.

Export growth is not expected to improve given that global growth is unlikely to rise significantly. However, on the positive side, we anticipate that US President-elect Donald Trump's rhetoric on protectionism will probably be diluted by the necessities of pragmatism. As regards domestic consumption, it is expected to remain strong in China and increase in India, but may continue to be subdued elsewhere – in particular, the debt overhang in South Korea, Malaysia and Thailand renders it difficult for these countries to stimulate consumption significantly.

Infrastructure spend, an obvious kicker to growth in much of the developed world, has a more mixed picture in Asia. While China is looking to calm down its property markets after the price surge this year, India is planning on increasing its expenditure in this area, as will Thailand and the Philippines. Even this higher level of expenditure, however, is not expected to result in a growth boom.

On inflation, the recovery in commodity prices is now feeding through into wholesale prices, but a lack of demand means that this is unlikely to feed through to significant growth in consumer price inflation. Against that backdrop, the outlook for interest rates varies. While there may be scope for certain economies, such as India and Indonesia, to lower interest rates marginally, fears of capital flight in the rest of Asia, including China, will stop central banks from being too stimulative.

Turning to corporate earnings, 2016 has been the first year in the last five when expectations have stabilised with revisions turning up. This is mainly due to the low hurdle rate that was set – earnings were expected to grow by only around 5% in 2016, according to consensus forecasts at the start of the year. Earnings have been helped by the recovery in commodity prices, which boosted the profitability of basic materials companies. Furthermore, the lack of increased provisioning by banks to date, particularly in China, has also supported earnings. These trends are expected to continue flowing through in 2017, leading to the possibility of high single-digit earnings growth for the year.

Valuation levels in Asia are not demanding against that backdrop. As of Oct. 12, 2016, the region was trading at 13.2x 2017 earnings and 1.5x price to book.[1] These levels are unlikely to lead to significant price falls on the grounds of overvaluation, but they cannot be considered inexpensive given the muted earnings growth outlook. One of the major advantages of the region at these levels is that other equity markets look even less attractive. With bond yields remaining low and some developed markets trading at significantly higher multiples, Asia at least deserves consideration, in our view.

Assessing geographic conditions
Within Asia, neither at the geographic nor the sector level would we be able to claim that there are unequivocally positive stories. India probably has the best macroeconomic outlook. A combination of government reform and, by historical standards, low commodity prices, has pushed the economy's potential growth rate higher. At the same time, inflation is under control and the fiscal and current deficits are manageable. However, the problem is that index valuations already reflect this positive outlook in our view. There is therefore a need to be selective and opportunistic. The recent surprise decision by the government to scrap and replace all 500- and 1000-rupee notes is disruptive in the short term, bringing stock-specific opportunities, but it is testament to Prime Minister Narendra Modi's determination to root out corruption and annihilate the black market, which should be positive in the longer term.
In the Philippines, erratic presidential behaviour

(continued on next page)

has correctly been reflected in reduced valuations. However, like Mr. Trump, President Rodrigo Duterte's bark is probably worse than his bite, so if the market falls much further, there may be attractive opportunities.

In China, the authorities have managed a gradual economic growth slowdown, but the relatively high level of gross domestic product (GDP) growth, between 6% and 7%, has been fuelled by debt.[2] This is a concern because emerging market crises in the past have usually been preceded by similarly high levels of credit growth. Our team's view is that China's economy can manage such high debt levels for a few more years as long as it is funded by domestic savings, with the banks' loan/deposit ratios remaining under 100%. Also, foreign exchange reserves remain a significant buffer in the case of capital outflows. However, these trends need to be closely monitored as they are not sustainable. In the meantime, until there is genuine reform, the industrial sectors are unlikely to see durable improvements in capital allocation and earnings, which explains our limited exposure.

On a positive note, Chinese domestic consumption has remained stable. Households have not taken on a lot of debt, and wage growth has continued to be supportive. Consumers have been quick to adopt mobile internet, and companies that have been willing to innovate in online services such as social media, gaming and e-commerce have become dominant players. We believe that there are still good opportunities in the sector, although some companies are already beginning to reflect their growth opportunities in their valuations.

In South Korea, there are limited growth opportunities available in this mature economy, yet corporates are retaining large cash balances on their balance sheets. We believe that there is the potential for corporates to pay out a greater percentage of this cash in dividends to shareholders, as exemplified by South Korea's largest company, which has already started to increase its dividend payout ratio. If other South Korean companies follow this trend, we could eventually see a re-rating of the Korean stock market over the medium term.

Finally, we are avoiding Malaysian equities, as we believe that concerns about the economy are not reflected in current valuations.

Evaluating sector opportunities
In the technology sector, we have a preference for companies that have healthy balance sheets, strong free cash flow generation and growth potential, but remain undervalued. Examples would include companies in the Chinese internet sector, some Taiwanese component suppliers and Indian IT solution providers. There are likely to be further opportunities in the sector as exporters may see their share prices impacted by the anti-globalisation rhetoric coming from the US.

We have a mixed view on the banking sector. We believe that the global policy shift from monetary stimulus to fiscal stimulus has the potential to nudge up inflationary expectations and favour interest rate-sensitive sectors, such as banks, to the extent that interest rate rises are not significant enough to push up non-performing loans. We believe that banking systems that have seen less extreme loan growth in recent years, such as in Korea and Singapore, and those that have been proactive in recognising bad assets, as in India, will be better-placed. Here, we favour the well-capitalised private sector banks that have seen their valuations fall to what we see as attractive levels.

In conclusion
We believe that a lot of what we have seen in 2016 in terms of macroeconomic trends will continue in 2017. However, such an environment is fertile ground for stock-picking opportunities. Many Asian companies have the ability to grow earnings, generate strong free cash flow and increase dividends. Such companies are well-positioned to withstand anaemic economic growth, and many are currently undervalued by the market.

1 MSCI AC Asia ex Japan Index, 12-month forward price-to-earnings ratio and trailing price-to-book ratio. Source: Goldman Sachs Strategy Research as at 12 October 2016
2 Source, Goldman Sachs as at 19 September 2016

Growth, debt and liquidity promise to capture the spotlight

Mike Shiao
CIO, Asia ex Japan
Hong Kong

Key takeaways

- We expect China's policymakers to focus their efforts on near-term growth stability, with reforms taking a secondary role for now.
- Looking ahead, we expect growth to be stable and resilient, with consumption being the major contributor.
- China's debt problem will linger on, but we see no imminent risk to an economic blowout.

Looking ahead in 2017, the Invesco Equity Investment Team in Asia believes the focus of attention for the Chinese economy and equity markets will be on growth, debt and liquidity. We expect China's policymakers to focus their efforts on near-term growth stability, with reforms taking a secondary role for now. Consumption is expected to continue to be the growth driver. China's debt problem will linger on, but we see no imminent risk to an economic blowout. We are seeing a shift in loan activity from corporations to consumers, which we see as a positive development for the economy. Looking at liquidity, the existing Shanghai-Hong Kong Stock Connect and the planned Shenzhen-Hong Kong Stock Connect (which, as of early November, was expected to open in late 2016) will continue to enhance market accessibility from both north- and southbound channels. In particular, we believe that global investors in offshore Chinese equities should benefit from the strong liquidity in the southbound route. In this piece, we will elaborate our views on these three topics.

Growth: Stable and resilient, driven by consumption

China's policymakers have two main objectives: maintaining decent economic growth and pursuing structural reforms. In 2017, we expect China will put greater emphasis on maintaining growth, with less priority on structural adjustments for now – such as reforms and debt reduction – given that growth is still the most important element for China's long-term stability.

We believe the government will enhance growth through targeted infrastructure spending, offsetting the slowdown in private investments. We also expect the government to remain generally accommodative in the property sector, given the significance of this sector to overall gross domestic product (GDP) growth. That said, property measures will be differentiated across the country – with selective tightening in cities that are perceived to be overheating, and supportive polices in less affluent and overbuilt cities.

Looking ahead, we expect growth to be stable and resilient, with consumption being the major contributor. We expect retail sales in China to maintain an annual growth rate of about 10%,[1] supported by resilient wage growth. Disposable income per capita for the urban population grew in the range of 8% to 13% year-on-year[2] over the past year, and we expect this trend to continue. Also, we believe the consumption sector should continue to benefit from the rising demand in services. Ranging from hospitality, retail, financial services, health care, education and information technology services, the services sector should be a key source of growth looking ahead, in our view.

Debt: No imminent risk, but it will take time to resolve

We will continue to monitor China's debt condition closely. The overall debt is now 255% of GDP, compared to 150% 10 years ago.[3] The surge was driven by excess gearing, or leverage, following the aggressive stimulus program in 2008. While we acknowledge that the overall gearing level is high, we do not believe there is an imminent risk of a short-term crisis, based on three reasons:

- China's debt is mostly locally funded. This eliminates currency mismatches and systematic risks that could potentially be linked to foreign debts.
- Government and household debt remains low. Total government debt currently stands at about 45%. We estimate central government debt to be less than 20% of GDP – a comfortable level compared to major developed economies. Household-debt-to-GDP remains low at 40%, much lower than the 70% to 90% levels recorded in major economies.[4]
- The government has the balance sheet strength from the "asset side" to support the troubled-corporate industries through its vast holdings in quality assets, its ownership in listed companies and its flexibility to gear up if needed. We estimate state-owned enterprises (SOEs) represent around 50% of total A-shares and have a combined market cap of around RMB25 trillion (about US$3.7 trillion).

One positive development in the banking sector is the increasing penetration in household loans and the slowdown in corporate lending. Similar to the deleveraging process in an economy, rising consumer credit demand can help spur the economy while allowing time for troubled corporates to undergo restructuring and deleveraging. Also, household loans, particularly mortgages (backed with a house as collateral), have lower default risk than that of the

(continued on next page)

corporates, and thus are considered better-quality loans. Over time, the banking sector's loan book quality should gradually improve as the consumer loans rise, in our view.

Strong liquidity and market support for offshore Chinese equities

The Shanghai-Hong Kong Stock Connect program[5] has opened up accessibility between onshore and offshore Chinese equity markets, without the need for QDII/QFII/RQFII[6] quotas. The upcoming commencement of the Shenzhen-Hong Kong Stock Connect will complete the system, and both programs will allow two-way investments between onshore and offshore markets covering the majority of stocks listed on the Shanghai, Shenzhen and Hong Kong exchanges. In our view, this is an innovative approach that promotes higher market accessibility between the two markets but without losing control over capital flows.

The potential benefit for global investors from the increase in market accessibility via the Stock Connects is twofold:

- First, global investors in offshore Chinese equities should benefit from the abundant liquidity in the southbound route, which should also support the market. In the past weeks, more than 50% of the southbound daily quota was used, and close to 20%[7] of Hong Kong daily turnover was reached at peaks. In particular, the liquidity was attributed to the mainland flows, where mainland China investors' accounts increased from 11% to 22% over the three years ending Dec. 31, 2015.[8] Looking ahead, the expectation for renminbi weakness, generally cheaper relative valuations in H-shares[9] compared to A-shares, and higher dividend yields may be reasons for mainland investors to consider diversifying their exposure into offshore Chinese equities.
- Second, global investors can take advantage of the easy access to the onshore A-shares market via the northbound route. Both Shanghai and Shenzhen Connects will collectively cover 92% of the MSCI A-shares index by stocks or 97% by market cap.[10] This is a significant development. Without the restrictive QFII quotas or reliance on A-share ETFs, investors can now have direct access to the onshore markets to invest in specific A-share stocks.

Conclusion

In 2017, growth, debt and liquidity will be in the spotlight for the Chinese economy and markets. While we closely monitor the macro developments in China, our focus is on stock-specific fundamentals. As active, bottom-up investors, we adopt a selective approach to investing in companies with sustainable leadership and competitive advantages. Companies we select for our portfolios share a number of common, qualitative features — superior business models, competitive products or services, solid corporate governance with clear ownership structures, as well as transparency and corporate access.

1 Sources: CLSA, NBS, August 2016
2 Sources: CLSA, NBS, August 2016; quarterly year-over-year growth rate
3 Sources: Bank for International Settlements and Invesco, September 2016. Data as at first-quarter 2016
4 Source: JPMorgan, September 2016
5 Launched in November 2014, the Shanghai-Hong Kong Stock Connect is a securities trading and clearing links program that allows both international and domestic investors to make cross-border stock purchases between the Shanghai and Hong Kong stock markets.
6 QDII stands for Qualified Domestic Institutional Investor. This scheme permits registered Chinese financial institutions to invest a limited quota of funds in foreign financial assets, including offshore-listed Chinese equities. On the other hand, global investors can access China A-shares through the QFII (Qualified Foreign Institutional Investor) and RQFII (RMB Qualified Foreign Institutional Investor) schemes. However these schemes are available only to institutional investors who can fulfill capital and asset size requirements. Detailed submissions and pre-approvals are needed for the mentioned schemes.
7 Sources: Goldman Sachs Research, HKEX, Invesco, as at September 2016
8 From 2012 to 2015. Source: HK Stock Exchange Factbook 2015
9 "H-shares" refers to mainland Chinese companies listed on Hong Kong Stock Exchange. As at Nov 1, 2016, H-shares are trading at a discount to A-shares for the dual-listed Chinese companies.
10 Source: MSCI, FactSet Research Systems, Inc., Bloomberg L.P., Invesco, as at September 2016

Misperceptions generate opportunities

Jeff Taylor
Head of European Equities,
Invesco Perpetual
Henley-on-Thames

Key takeaways

- We are more optimistic than many on Europe's economic, political and earnings outlook.
- Gross domestic product growth of about 1.5% looks perfectly feasible for the Eurozone.
- An evolution of the European Union is far more likely than its disintegration.

Europe – whether including or excluding the UK and whether from an investment or a political perspective – is by definition complicated and often confusing, especially for people from other parts of the world. European equities have had a volatile 2016, pulled around by investor concerns around growth, the banking system, politics, deflation and earnings. As so often with this asset class, the market's perceptions can be out of synch with what is really happening on the ground. When the continent's complications cause the kind of outflows from European equities seen in 2016, and European equities become as unloved as they appear to be now heading into 2017, there can, conversely, be significant opportunities to exploit for investors like us who are willing to take a long-term view and overcome the vagaries of market noise.

At Invesco Perpetual, we are valuation-focussed investors who look at all sectors of our market – both growth and value – to find stocks that, to us, seem to offer the best risk/reward opportunities at any given time. Though most of our effort goes into stock analysis, we also set great store by understanding macroeconomic and political developments, as we know from experience how much they can influence stock and sector performance as well as investor psychology in our area. Going into 2017, such macro-inspired influences have led to unusually wide divergences among the valuations of different sectors and the valuations of stocks within sectors. Accordingly, we have positioned our strategies to exploit these dislocations. As explained below, we are more optimistic than many on Europe's economic, political and earnings outlook. Consequently, we are happy to embrace a selection of stocks in energy, cyclical and financial sectors that offer the appealing combination of earnings recovery and low valuations. Similarly we are open to more defensive stocks when the valuations are right – for example, telecommunications.

We also note that investor angst and misconceptions about Europe have led Europe ex UK and Eurozone equities to re-test the highs in equity risk premia seen during the global financial crisis in 2009 and Eurozone crisis of 2011/2012. Time will tell whether that is telling us more about equities in absolute terms or equities relative to bonds, but either way: Mr. Market, get a grip – for all its issues, Europe isn't that bad.

Growth: Europe has proven itself to be remarkably resistant to global macroeconomic turbulence in 2016, and a continuation of the modest but respectable economic recovery that the Eurozone is seeing is our base case for 2017. Gross domestic product (GDP) growth of about 1.5% looks perfectly feasible: It should be borne in mind that the Eurozone's growth is being driven by a pick-up in domestic demand, and thus is more likely to be durable in nature. Continental Europe went through a good many years of under-consumption and under-investment thanks to the region's successive crises: Now it's catch-up time. Accommodative monetary policy, a (finally) functioning banking system, falling unemployment and some wage inflation all help. Meanwhile, the UK's Brexit vote to leave the European Union has clouded the water for the UK, leading to great uncertainty about the economic and political future for the country and whether future foreign direct investment flows will shift from the UK to other parts of Europe. It should, however, be remembered that the British stock market is not just a reflection of the UK economy.

Politics: This has been another source of anxiety for many in 2016. The Brexit referendum overturned political orthodoxy in the UK, but we do not see a spate of copycat referenda as likely in 2017. An evolution of the European Union is far more likely than its disintegration. The electoral timetable is busy in 2017 with major votes due in the Netherlands, France and Germany, and it seems highly likely that we will go through periods of market volatility as a result. We shouldn't forget, though, that Spain proved in 2016 that radical politicians are not guaranteed to win every time.

Banks: Many investors have seen Europe's supposedly systemically weak banking system as a reason to give Continental European equities a body swerve. As we go into 2017, our bet is that it will become increasingly clear that the reality of Europe's banking system is substantially stronger than the general perception. Banks are lending again, as the data on new loan production show. Core capital ratios for the vast majority of major banks are substantially higher than in the bad old days of slacker regulation pre-2008. Banks' liquidity is vastly improved. We anticipate that the global "Basel IV" bank capital rules will not lead to even tougher capital demands by regulators. True,

(continued on next page)

profitability of European banks has been badly hit by low and negative rates, but margins are now showing signs of improvement and fee income is proving resilient. Nonetheless, there are still some institutions in need of more capital, including some well-known, headline-grabbing cases. These should be seen as the exceptions rather than the rule. We are invested in a selection of European banks. Indeed, many funds in our range are overweight the sector.

Deflation: The consensus in our markets has been for some time that rates and yields could only ever go lower, and that perceived "bond proxy" equities (e.g., consumer staples) were the only game in town. Our positioning has been a long way away from the consensus for some time. We see evidence of more inflationary pressures to come through in 2017, and we expect headline inflation to be comfortably above 1%, as compared with the approximately 0% typical of recent quarters. The recovery of oil and other commodity prices, rising producer price inflation in other parts of the world and some pick-up in service price inflation in Europe are all set to contribute. The perception of European deflation risks is likely to change. The market has already started to question whether the ultra-low bond yields are sustainable, as inflation expectations pick up and some signs of a pendulum swing from monetary to fiscal action emerge globally: The first hint of regime change is in the air.

Earnings: The bad news is that Europe as a whole has generally been a source of earnings disappointments in recent years. The good news is that analyst expectations are now extraordinarily low; in fact, they are more in keeping with a recessionary environment for which we currently see no justification. In an environment of positive GDP growth with inflation creeping higher, cyclically low margins making positive operating leverage logical, and falling financing costs, we would not be surprised to see positive earnings surprises out of Europe in the coming quarters. It may well be one of those rare periods when analysts are scrambling to upgrade their forecasts rather than downgrade.

Looking at international stocks through an EQV lens

Clas Olsson
CIO, International and Global Growth Equities
Austin

Key takeaways

- The general near-term outlook for international equities continues to appear somewhat mixed.
- We don't hedge our currency exposure in any of our strategies for four main reasons.
- Volatility can provide attractive buying opportunities for long-term investors like ourselves.

As we look toward 2017, the general near-term outlook for international equities continues to appear somewhat mixed, given a combination of global macroeconomic risks. In our view, some of the larger risks include possible instability relating to Brexit and the Eurozone, deleveraging in the largest emerging markets, and uncertainty created by the recent US presidential election as well as upcoming elections in Germany and France.

But no matter if the equity outlook is positive, negative or mixed, the Invesco International and Global Growth team takes a bottom-up view of investment opportunities – assessing companies by their Earnings, Quality and Valuation (EQV) characteristics. Below, I discuss the trends that we're seeing, and how those look through our EQV lens.

Developed markets: A 'lower for longer' approach to interest rates

In the US, the Federal Reserve has reduced its outlook for future interest rate increases in 2017 and 2018, indicating that rates will remain lower for longer. In Europe, the European Central Bank has kept its stimulus program unchanged, a signal that policymakers don't see an immediate risk to recovery in the region. And in Japan – amidst the backdrop of falling inflation, rising long-term bond yields and appreciating yen – the Bank of Japan unveiled new monetary tools in September, deciding to keep long-term rates near 0% and inflation about 2%.

Emerging markets: Slower growth on the horizon?

The expectation that US interest rates would likely stay lower for longer helped to improve investor sentiment in emerging markets in 2016. Firming commodity prices helped as well. However, some of the larger EM economies, such as China and Brazil, are in need of an extended period of de-leveraging, in our view. This process would likely trim their growth rates going forward, and thus keep commodity prices more subdued.

Slower growth in China would also act as a headwind to many smaller East Asian economies that are more heavily dependent on exports to that country. As a result, many of these emerging economies may remain highly dependent on a continuing US recovery for incremental growth in the year ahead. This challenging economic backdrop may bring ongoing volatility and stock market dislocations, thus providing more attractive buying opportunities for long-term investors like ourselves.

Examining EQV

Regardless of the macroeconomic environment, the team remains focused on applying our EQV investment process that seeks to identify attractively valued, high-quality growth companies.

Earnings. The difficult earnings environment we've experienced in the last few years started to improve during 2016, as the pace of global earnings-per-share downgrades slowed. While we still saw negative revisions in Japan, Asia ex Japan and emerging markets toward the end of the year, the US and Europe experienced upgrades in both earnings and sales. Given the heavy export focus, many Japanese companies have suffered from the yen appreciation. Asia ex Japan companies have been impacted by strength of the US dollar as a number of Asian currencies closely correlate to the US dollar.

The net earnings upgrades in Europe are the first since 2010. They're primarily driven by the UK, where the weakening currency is the main driver, but we're also seeing positive revisions in Switzerland, Germany and Spain. Whether or not this will continue is difficult to tell, but currency-driven revisions are typically short-lived and most likely need improving economic fundamentals to be sustainable.

Our team is often asked whether we hedge currencies. We don't hedge our currency exposure in any of our strategies for four main reasons:

1. While foreign currency exposure introduces some volatility over the short term, we don't believe it has a significant impact on long-term performance.
2. In our view, one of the key benefits international portfolios can potentially provide US-based investors is to lower correlations to the US market. Hedging currency exposure increases the correlation, thereby lowering the diversification benefit.

(continued on next page)

3. Currency hedging is also redundant to a large degree because many companies have global operations with exposure to many different currencies, and they often hedge their own currency exposure directly.
4. Finally, hedging is costly and can introduce unwanted leverage to a portfolio.

Quality. Companies' return on equity (ROE) has been trending down since 2012 on a global basis and is showing no signs of improving. Improvement is unlikely to happen before we get a top-line recovery. Having said that, the strategies managed by the Invesco International and Growth team all have ROEs that are about 5% to 10% higher than their respective benchmark indexes.[1]

Valuation. Because markets are up and earnings are down to flat, most regional valuations rose during 2016. Overall valuation levels in developed markets continued to appear full to us despite the high macro risk and challenging outlook for the earnings growth in the year ahead.

If you look at valuation dispersion as a way of indicating where you might find opportunities, emerging markets look most attractive to us — although less so than in the beginning of 2016, due to the strong bounce in emerging markets — and the US looks the least attractive.

1 Sources: Invesco, Thomson Financial, Compustat (data as of Sept 30, 2016)

Five reasons not to overlook Japanese stocks in 2017

Daiji Ozawa
CIO and Chief Portfolio Manager, Invesco Japanese Equities
Tokyo

Key takeaways

- Many investors have paid little attention to Japanese stocks after disappointingly poor performance in 2016.
- Yet, there are five reasons why we think they should consider taking a look at some Japanese stocks.
- We believe Japanese equites hold promise for us as long-term investors in 2017.

Without doubt, 2016 was one of the most disappointing years for Japanese equity investors since 2012. Subpar performance of not only Japanese equities, but also the overall economy – along with the government led by Prime Minister Shinzo Abe and the Bank of Japan led by Governor Haruhiko Kuroda – really hurt investor sentiment and discouraged them to be active in Japanese equities. Paradoxically, however, the Invesco Japanese Equity team based in Tokyo believes this is a good time to start having second thoughts. Here are five reasons why we are quite constructive on some Japanese stocks.

1. The economy

First of all, we expect the Japanese economy will pick up steam from a cyclical perspective. A more stabilized Japanese currency, coupled with a turnaround in emerging economies, definitely has helped to restore corporate sentiment with industrial production as well as exports – both of which seem to have bottomed out.

On top of that, in October Japan's National Diet approved the second supplementary budget of fiscal 2016, totaling about JPY4 trillion, or US$38 billion, which covers hefty spending packages to stimulate the economy, including infrastructure development, and a reconstruction program from the Kumamoto Earthquake. Now the government is making efforts to implement the program as swiftly as possible. Furthermore, it is said that the government is seriously thinking, although this is not confirmed yet, about formulating the third supplemental budget, just in case the National Diet has difficulty clearing the main budget in early 2017 due to a possible snap election.

The good news is that Japan is recovering in tandem with the global economy, which is gaining traction thanks to a bottoming of commodity prices together with more stabilizing emerging economies. It is important to remember that, historically, Japanese stock markets have been among the most highly correlated to global economic activities in the world. Thus, if you are constructive on the global economy – as we are – it may be hard to ignore this asset class in 2017, in our view.

2. The Bank of Japan

Nonetheless, some can argue that Japanese equity markets are hard to deal with because of their higher volatility, partially resulting from sometimes unpredictable and surprising actions by the Bank of Japan (BOJ) in the past. We believe this is not the case anymore. Rather, we have strongly sensed that BOJ Governor Kuroda is trying to improve communication with the markets, which should help reduce any surprises and curtail unnecessary volatility. In September 2016, the central bank announced "Quantitative and Qualitative Monetary Easing with Yield Curve Control" for the purpose of strengthening the sustainability of its monetary policies by scrapping the amount of target shifting to control the yield curve, The market was not surprised; rather, it was indifferent to some extent thanks to the BOJ's pre-communication efforts.

Whether Mr. Kuroda likes it or not, obviously he has fewer options for additional easing, including deepening a negative yield further, increasing the amount of the bank's Japanese government bond purchases, lowering long-end bond yields, and increasing exchange-traded fund purchases – all of which look to be quite tough to implement. It looks like the time has come for the BOJ to take a back seat and let the government take the wheel through fiscal policies. That is why Prime Minister Abe has already passed a sizeable economic package and started to work on the third supplemental budget.

3. Corporate governance

Thirdly, we believe that improvement in corporate governance is in full swing and about to enter into the next stage. With Japan's Stewardship Code in 2014, along with the Corporate Governance Code in 2015, we have seen tremendous changes in various aspects of corporate governance. According to Japan Exchange Group (JPX), an operator of the Tokyo Stock Exchange, 77.9% of First Section-listed companies (which are the exchange's large-cap companies) had two or more independent outside directors in 2016, compared with 48.4% and 21.5% in 2015 and 2014, respectively.

Although we acknowledge that the initial stage of the ongoing improvement was more focused on how to change old structures, companies and investors are now paying more attention to effectively utilizing new structures. According to a survey conducted by the Japan Investor Relations Association,[1] 88% of respondents said

(continued on next page)

they have medium-term business plans, and return on equity (ROE) targeting is the fourth-most emphasized item following sales and operating and recurring profits. Moreover, 61% of respondents stated that they have capital policies including share buyback and dividend policies, which has almost doubled from the previous survey. After setting new structures and targets, many corporations are now saying they're working on issues such as how to operate boards more usefully, how to evaluate those activities, and how to incentivize corporate management more effectively. Although we have to admit there won't be clear answers or quick fixes, we hope these efforts will bear fruit eventually.

4. Structural reform

Fourthly, we would add structural reforms as a positive factor for Japan, despite some disappointment especially against slow progress. It might sound odd, but we think one of the main reasons Japan has failed to achieve its 2% inflation target is a lack of any meaningful wage growth. Despite strong corporate profits as well as tighter labor markets, with an unemployment rate of around 3%, wages among full-time workers, accounting for approximately 60% of total workers, have barely moved for the last several years of the Abenomics era, according to the Ministry of Internal Affairs & Communication.[2] Theoretically this looks really strange, but in Japan it isn't given the fact that the conditions of full-time employment are far better than part-time, including wage levels, job security, fringe benefits, and social status. Thus, full-time workers have extremely strong incentive to put their job security first at the expense of wage increases. Therefore, as long as the current huge disparity of job conditions between full-time and part-time continues, it is highly unlikely that we will see a meaningful wage increase, or a good inflation induced by wage increase, in Japan. This view has been commonly shared in the government, and in order to improve Japan's productivity, the Abe cabinet is eagerly working on labor market reforms, including equal pay for equal work and loosening layoff restrictions, which can hopefully show unquestionable progress in 2017, as Prime Minister Abe insists.

5. Valuations

Finally, we would like to touch upon valuations. As of early November 2016, Japanese equity market price-to-forward-earnings ratios were comparable to most of the European markets but much cheaper than the US, according to MSCI.[3] In addition, if you take a look at price-to-book ratio (P/B), Japanese markets were among the cheapest markets in the world in early November.[4]

Still you could argue that given its historically lower ROE than global peers', Japan's low P/B is justified.[5] But as improvement on corporate governance is at full speed, entering the next stage, some Japanese companies are starting to deliver meaningful outcomes — not only with profits but also with share buybacks and dividend increases backed by well-thought-out capital policies. It appears that, overall, Japanese markets are entering into a medium-term re-valuation phase.

Despite slow progress, structural changes are underway and seem to be gaining momentum. As cyclical factors are also moving upward amid low expectations, coupled with lower valuation, we believe Japanese equites are favorable investment candidates that hold promise for us as long-term investors in 2017.

1 Survey conducted from Jan. 28 to March 7, 2016. The survey was sent to all listed companies in Japan (3,622), and 27.1% responded.
2 As of Oct. 31, 2016
3 Price-to-forward earnings ratios as of Nov. 10, 2016: 14.01 for the MSCI Japan Index, 14.52 for the MSCI Europe Index, and 16.74 for the MSCI US Index
4 Price-to-book ratio as of Nov. 10, 2016: 1.29 for the MSCI Japan Index, 1.72 for the MSCI Europe Index, and 2.80 for the MSCI US Index
5 Return on equity as of Nov. 10, 2016: 7.87 for the MSCI Japan Index, 7.65 for the MSCI Europe Index, and 12.39 for the MSCI US Index

UK equity valuations face four main challenges in 2017

Mark Barnett
Head of UK Equities,
Invesco Perpetual
Henley-on-Thames

Key takeaways

- Several challenges may force a reassessment of UK equity valuations.
- Bottom-up opportunities for the long-term investor have started to emerge.
- The most important discipline is to remain vigilant about valuation.

It is likely that the near-term outlook for the UK equity market will continue to be dictated by the movement of global bond prices and the sterling/US dollar exchange rate. These asset markets have exerted a major influence on UK equities over the course of 2016. The strong performance of the bond market – which, unusually, has been accompanied by a rising equity market – and the perceived benefit from the drop in sterling have been the driving forces behind the ongoing re-rating of UK equities.

Approaching year end, this valuation looks full, particularly relative to the disappointing overall level of underlying profit growth recorded this year (excluding the impact of sterling and the commodity bounceback). With bonds and equities rallying and central banks stepping up their activity, there is a nervousness in the market. It is highly unlikely that the re-rating of UK equities will continue unchecked against a backdrop of higher valuations and ongoing pressure on corporate profitability, and there has been a noticeable pick-up in the rate of profit warnings across the market over the recent period.

Challenges to UK equity valuations
Looking ahead to 2017, there are several challenges that may force a reassessment of the current valuations being applied to the UK equity market:

- **Profits.** The first is the lack of overall profit growth, which, absent a significant devaluation in sterling, would have seen another year of no growth in 2016. The underlying earnings outlook for next year looks similarly muted. Second, a more difficult near-term UK economic picture is likely to emerge. Alongside the Bank of England's (BOE) fiscal package, the UK Treasury is considering all options to avoid recession in the UK; additional measures around corporation tax, national insurance contributions and long-term infrastructure projects are all on the table.
- **Inflation.** The reappearance of inflation – largely as a result of the movement in sterling – will pressurise consumer budgets and hinder overall levels of economic growth. This factor, coupled with the ongoing uncertainty over the political path to Brexit, may put a brake on UK employment levels and investment intentions, further moderating activity in the domestic economy. To some extent, this has been priced into equities, as the performance disparity between globally and domestically exposed companies since the EU Referendum has been significant. Nevertheless, the backdrop to corporate profitability is unlikely to ease over the coming year as pricing power remains elusive.
- **Politics.** The political environment has the potential to deliver more surprises over the coming year, a third factor likely to continue to exert major influence on both corporate behaviour and stock market performance. The domestic political scene is currently overshadowed by the new government's evolving political agenda, while internationally, there are a series of important elections that need to be addressed; the potential for a sudden policy shift or unexpected election result is significant.
- **Bonds.** The final challenge is the pace and extent of a shift in the value of global bonds, which also has the potential to pressurise the outlook for positive returns from UK equities. Such a shift could result from a change in the Fed funds rate or simply from a realisation that the extreme low yields reached over the summer months across the world no longer represent a realistic view of the medium-term outlook for inflation and interest rates.

Remaining vigilant about valuation
Navigating any one of these obstacles, either individually or in combination, will continue to be challenging. In the view of the Invesco Perpetual UK Equites team, the most important discipline is to remain vigilant about valuation.

Notwithstanding the elevated level of stock market valuation, bottom-up opportunities for the long-term investor have started to emerge as a result of the substantial sector rotations that have occurred since the EU Referendum in June 2016. Where new bottom-up opportunities arise, our emphasis will continue to be on companies that can demonstrate a sustainable top-line growth and translate that into profit, free cash flow and dividends, without excessive financial leverage.

Eight years into a secular bull market in the US, we see three scenarios for future growth

Juliet Ellis
CIO, Invesco US
Growth Equities
Houston

Key takeaways

- It feels like we are at an inflection point in the economy.
- As we look into 2017, we are considering three economic scenarios, each with distinct opportunities and risks.
- Regardless of the outcome, we will stick with our disciplined investment process, balancing thoughtful portfolio construction and rigorous stock selection.

A number of years ago, we on the Invesco US Growth Equities team observed evidence that US equity markets were in the early stages of a secular bull market, similar to several other periods in the 1900s when equities rose significantly over a long number of years and their cumulative, positive returns significantly overwhelmed the impact of intermittent corrections. This perspective is visible only when stepping back to assess very long time periods, and it involves a degree of detachment from the immediacy of everyday market noise. It even dwarfs the relatively long-term mindset we as portfolio managers have when evaluating the US economic cycle and its impact on our portfolios. We believe that investors who can maintain that very long-term mindset for their equity allocation can be – and many have been – well-served.

US Bull markets: Past and present
The current secular bull market has delivered roughly 15% annualized returns[1] – that's in line with the last three historical secular bull markets: from 1921 to 1929, 1948 to 1965, and 1982 to 2000. Two of those bull markets lasted for around 18 years each, and all three had significantly higher cumulative returns than our current bull cycle. The overwhelming challenge for investors is to have that very long-term perspective in their asset allocation. The challenge for us as portfolio managers in responsibly managing clients' assets is to focus on the evolving prospects of our investments within the changing business and economic cycle.

Each secular bull market mentioned above has contained at least one US economic cycle; a boom, bust and recovery of businesses; interest rate policy shifts; gross domestic product (GDP) growth; or all of the above. Even the strongest bull markets do not move straight up, and our latest secular bull market[1] has seen its share of intermittent corrections.

The current economic recovery has not been "classic" in any sense. Overall economic growth has been subdued compared to past recoveries. Employment has been slower to improve than in the past, and businesses have largely refused to invest in future growth, either due to increased regulation or a lack of confidence in the good-but-not-great growth environment. Consumers continue to deleverage their balance sheets and have been slow to take on additional debt, while banks have been slower to offer it to them. Record low interest rates have led investors on a search for income in areas such as higher yielding dividend stocks.

It feels like we are at an inflection point in the economy, and recent US election results seem to be adding to the uncertainty. As we look into 2017, and observe the weight of the evidence, we are considering three economic scenarios in the US. We believe it is prudent to spend extra time considering the risks and exposures of our stocks to several potential outcomes.

Scenario #1: Slow growth environment
In our view, a likely scenario is a continuation of the current environment, with slow economic growth and interest rates staying at very low levels. Demographics, deleveraging and weak global trade are tilting the weight of the evidence toward this outcome for 2017 and beyond. Low Treasury yields and peak level profit margins have led businesses to underinvest and focus on returning capital to shareholders through buybacks and dividends. We expect a slow growth environment – not too hot, not too cold – will leave investors and businesses with less confidence and a continued focus on safety over higher-risk opportunities. If the current situation continues to play out into 2017, we see the following opportunities and risks.

Opportunities:
- Defensive yield strategies: utilities and real estate investment trusts (REITs)
- Secular growth through innovation: pharma/biotech and medical devices
- Market-share gainers: entertainment, social media, healthy living and e-commerce
- Valuation support: energy and retailing
- High visibility and high recurring revenue: "Software as a Service" (SaaS) and transaction processors
- Low fixed costs: franchise, IT services and enterprise cloud software

Risks:
- Interest rate spread-based businesses: banks and life insurance
- Commodity cyclicals: steel, and agriculture and construction equipment
- Legacy technology: license application software and enterprise hardware
- Low pricing power: food retailers, hospitals, communications equipment and hotels

(continued on next page)

Scenario #2: Accelerating business cycle
The traditional business cycle recovery has not materialized, as results have been mixed over the last several years, depending on which sector we evaluate. However, it is possible that we are just very slow to return to normal, and there is some evidence that we may yet see a more classic recovery and a reacceleration in growth.

For example, based on past experience during previous peaks, we could see $1 trillion of pent-up demand in consumer and business capital spending in areas such as housing and business fixed investment. Recent US election results point to corporate tax reform and infrastructure rebuild opportunities. Wage growth has steadily improved since 2012 and is in-line with history coming out of recession. Consumer income expectations are the highest since 2007 and could still be accelerating.

Oil may be bouncing around to find a supply/demand balance today, but as our existing sources of supply become depleted, there should be a necessary increase in energy-related capital spending to replace falling supply. If economic growth and inflation stay on track, proving sufficient for policymakers to raise rates, we may see the yield curve steepen, increased margins, higher wages, and an uncorking of self-replicating animal spirits. If the accelerating growth scenario plays out into 2017, we see the following opportunities and risks.

Opportunities:
- Late-cycle sectors: energy and financials
- Exporters: industrials and technology
- Secular growth through innovation: pharma/biotech and medical devices
- Market-share gainers: entertainment, social media, healthy living and e-commerce
- Labor growth: housing, health care providers and services, consumer services (restaurants/hotels)
- Fixed investment (infrastructure) spending: software, nonresidential construction, building materials and engineering

Risks:
- Bond proxies: utilities and REITs
- High-valuation safe havens: consumer staples
- Defensive technology: IT services and transaction processors

Scenario #3: US recession
There is evidence suggesting a potential US recession is looming, which would be unfortunate since the economy would miss out on the full benefits of a classic recovery from the global financial crisis. Monetary policy errors by the Federal Reserve could derail sentiment and growth. We are observing a peak in the benefits of improved credit on bank balance sheets, and rising credit risks could curtail lending and slow potential spending growth.

The retirement of the baby boomer generation (ages 52 to 70) will likely hamper consumer durable and apparel spending, but will likely increase health care, travel and entertainment spending. Rising health care costs are taking an increasing share of wallet at the same time gasoline prices are up year-over-year and potentially continuing to rise. It is entirely possible that we could see the slow improvement in US consumer activity just stop getting better, and the rising millennial/echo boomer population (ages 16 to 36) may not be able to offset the diminishing spending and productivity of retiring baby boomers.

If we've reached peak employment and peak profit margins and still not experienced material growth in this cycle, we could experience a downturn before things get better again. If the US recession scenario plays out into 2017, we see the following opportunities and risks.

Opportunities:
- Defensive yield strategies: utilities and REITs
- Secular growth through innovation: pharma/biotech and medical devices
- Market-share gainers: entertainment, social media, healthy living and e-commerce
- Valuation support: energy and retailing

Risks:
- Stocks relying on the credit cycle: banks
- High-valuation "safe havens": consumer staples
- Early cycle: autos, housing, airlines and transportation

Conclusion
We position our portfolios for 2017 as we have always done, evaluating the weight of the evidence we observe. In the low-growth environment of the past several years, and

(continued on next page)

regardless of future economic direction, one approach that we believe serves our investors well is to position the portfolio in long-term, secular share-takers — in other words, those businesses that are innovating and participating in the new global electronic economy. These areas of growth include:

- Innovation
- New mobility product cycles
- On-demand digital content
- Market share shifts to e-commerce and social media advertising
- Demographic shifts as baby boomers retire and echo boomers begin to spend

We continue to balance those secular growth businesses with "all-weather" businesses that we expect to perform well in all three potential scenarios that we have described. These all-weather businesses include either less-cyclical companies with a more defensive growth profile, or companies that provide strong valuation support to protect them on the downside. In our view, these businesses can be found in the following industries:

- Health care equipment
- Commercial services
- Consumer services
- Military/defense
- Retailers
- Energy

Throughout 2016, we moderated our pro-cyclical bias into a more balanced approach for the possible scenarios described above as each outcome has similar probabilities in our view. As the outlook continues to evolve, we will move thoughtfully and glacially along with it. Regardless of our macro views, we will continue to place our valued clients' investments only in select businesses where we have a thorough understanding, and in which our independent assessment leads us to believe they are growing faster and with higher quality of earnings than their peers.

1 Sources: Invesco, Macrobond. Based on the S&P 500 Index from February 2009 through September 2016, in US dollars

US value investing in an interconnected world

Kevin Holt
CIO, US Value Equities
Houston

Key takeaways

- We believe that energy and financials represent the best opportunity for value investors like us.
- There are three main macroeconomic questions we're watching into 2017, and one "wild card."
- We believe the risk/return relationship appears attractive for those who are patient enough to persevere.

While 2016 turned out to be a decent year for US equities, with the S&P 500 Index returning 5.87% as of Oct. 31, 2016,[1] we witnessed historically high volatility that illustrates the interconnectedness of global markets.

- To start the year, we saw a market plunge in China so severe that it caused market circuit breakers to kick in for the first time.
- At mid-year, the UK's Brexit decision to leave the European Union shocked the world.
- And at the end of the year, US voters concluded a controversial election season by choosing a Republican president and Republican Congress. While the process was tumultuous, this potentially has the ability to be a game changer in that market-friendly actions (less regulation, lower taxes and repatriation of US dollars held offshore) by the new administration are a real possibility.

Finding opportunity in energy and financials
From a sector perspective, I believe that energy and financials represent the best opportunity for our value investors.

- Oil prices appear to be normalizing after a two-year correction – in 2016, we saw prices of about US$29 a barrel in January, which rose to about US$50 a barrel in mid-October.[2] We believe that per-barrel prices of US$60 to US$65 are possible, assuming that we see demand growth of about 1 million barrels a day – a level that we've seen historically.
- For financials, the story continues to improve as we move further away from the credit crisis. Balance sheets are much improved, leverage ratios are significantly lower and many banks are sitting on meaningful excess capital. In fact, as of June 2016, the four largest banks and two largest investment banks in the US had excess capital in the amount of 16% to 42% of their outstanding equity.[3] As the regulatory environment eases, banks are being allowed to increase the amount of capital returned to shareowners. A normalizing interest rate environment, even if it is slow, should provide further fuel for these stocks, in my view.

As long-term value investors, we track valuation dispersion – in other words, the difference between the cheapest and most expensive stocks within a sector. When valuation dispersions widen, we see more opportunities to buy undervalued companies. Looking at sectors through that lens, we believe energy and financials have rarely shown more opportunity than they do today.

This can be seen in the valuation spread between the cheapest and most expensive stocks within each sector on a monthly basis from 1950 through July 2016. In the energy sector, the valuation dispersion is wider today than it was during 97% of the months in this time frame.[4] In the financials sector, the valuation dispersion is wider today than it was during 80% of the months in this time frame.[4]

Issues to watch in 2017
With all of the above in mind, there are three main macroeconomic questions we're watching going into 2017, and one "wild card" that bears mentioning:

1. Will China continue to devalue its currency against the US dollar due to weakness in Chinese exports? The answer to that question would have important implications for the Chinese economy and for its global trading partners.
2. What will be the ultimate outcome of Brexit, and will other nations follow? At the time of this writing, the structure of the future relationship between the UK and the EU was still in question, and other important elections loomed ahead across Europe. In France, presidential elections are scheduled for April and May 2017, and Italy scheduled a December 2016 constitutional referendum on the structure of its Senate.
3. Could we encounter economic weakness in the US? Growth in 2016 was already slow, so unexpected weakness could have a chilling effect.
4. And, the wild card question: What if we experience inflation? It's not on most people's radar screens for 2017, and we would be surprised to see it in the new year. But in three to five years, it could occur. In our view, this would mean that the economic cycle is alive and well.

(continued on next page)

As value investors, we are not here to call the trajectory of the global economy, but only to point out the bottom-up valuation disparities that present themselves today. It's our belief that even with the unsure global economic backdrop facing governments around the world, they will figure out effective fiscal reform to improve the current, very slow economic growth backdrop, and reversion to the mean will turn out to be alive and well in the equity markets. The question is how long this might take — but we believe the risk/return relationship appears attractive for those who are patient enough to persevere.

1 Source: FactSet Research Systems, Inc. Total returns in US dollars from Jan. 1, 2016, to Oct. 31, 2016
2 Source: US Energy Information Administration
3 Sources: Morgan Stanley and FactSet Research Systems, Inc.
4 Source: Empirical Research Partners Analysis. Based on an analysis of a 1,500 stock universe. Framework varies across sectors depending on what is efficacious

Assessing the landscape for policy changes and asset class fundamentals

Rob Waldner
Chief Strategist and Head of Multi-Sector, Invesco Fixed Income
Atlanta

Key takeaways

- We expect fiscal easing, deregulation and trade to be the focus of new US policies.
- Stronger growth in the US should pressure US interest rates up across the board.
- We look for continued headwinds for emerging markets growth.

Macro
Invesco Fixed Income's 2017 macro outlook is likely to be significantly influenced by the policy direction of the newly elected US President Donald Trump and his administration. We believe there are a few key policy elements that will likely be implemented early in the Trump administration. First, fiscal easing: Proposed tax cuts and possible infrastructure spending would potentially boost growth across the board in the US. Second, Mr. Trump has promised deregulation of the US economy. In particular, he has indicated a desire to reform the Affordable Care Act (also known as Obamacare), reduce regulation on the energy industry and amend the Dodd-Frank Act. These changes are also likely to boost US growth in the near term, in our view. Third, Mr. Trump won using an anti-trade message. We would expect some impediments to free trade to be implemented in the near term. Such measures may have a medium-term negative impact on global growth.

In the near term, we expect higher US interest rates. Stronger growth in the US should pressure US interest rates up across the board. While volatility could concern the US Federal Reserve (Fed), we believe the Fed will still raise rates in December and will likely raise rates in 2017. Stronger US growth, fiscal stimulus and higher US interest rates all point to the likelihood of a stronger US dollar across currencies. A stronger dollar and potential action on trade are all negative for emerging markets. We look for weaker emerging markets currencies and continued headwinds for emerging markets growth.

Bank loans
We expect the bank loans asset class to perform in line with the coupon in 2017, as prices hovered around par during the fourth quarter of 2016. Loan fundamentals should continue to be supported by a slow but positive gross domestic product (GDP) growth environment in the US, in our view, as company balance sheets are generally healthy and issuers are operating with a free cash flow cushion, aside from a few "pockets of weakness." We expect technical factors to remain firm as demand from long-term investors remains solid. Key risks to our view are generally not loan-specific. Rather, broader macroeconomic weakness could lead to a "risk-off" tone, and a recessionary environment could induce an uptick in defaults. Even under this scenario, however, senior secured loans remain relatively defensively positioned at the top of the capital structure.

Emerging markets
Emerging markets (EM) are unlikely to repeat the stellar 2016 performance they've experienced at the time of this writing, but we expect a year of low- to middle-single-digit returns, supported predominantly by positive carry. Given that EM assets are largely dependent on the global environment, we believe that sustained central bank accommodation; relatively stable, if subdued, growth and still-moderate inflation provides a favorable backdrop for EM assets. Additionally, investors' ongoing reach for yield, their preference for income and emerging markets' continued attractiveness versus developed markets suggest the momentum behind flows into EM assets will likely continue. Discernment in outlook is a key theme for EM countries. Now, as always, we focus on EM countries and credits with a variety of perceived catalysts (credible, active central banks, fiscal responsibility, etc). The main risks to our relatively sanguine view are a significant sell-off in US Treasury yields, unanticipated central bank policy shifts, significantly slower global growth or a sharp acceleration in US dollar strength.

European fixed income
European fixed income in 2017 will continue to be challenged by macroeconomic headwinds coupled with a number of elections that are scheduled across the region. The rise of anti-establishment parties, primarily linked to the poor sustained economic performance over past years, will mean we are likely to face another year scattered with bouts of heightened volatility. The European Central Bank (ECB) has enjoyed some success from monetary policy actions, with reduced fragmentation, but bank lending remains lackluster and we expect Brexit to be a drag on European growth. However, Europe remains in the early stages of the economic cycle, and we expect the ECB's quantitative easing (QE) program to be extended beyond March 2017 as inflation continues to disappoint and growth stays low. Hence, we are constructive on core government duration and expect future opportunities will likely arise from domestic political events and/or central bank action. Moreover, we are neutral in the periphery and remain cautious on the outlook

(continued on next page)

of Italy and Portugal, which is tempered by seeing value in Irish and Spanish bonds. In the currency space, we see limited opportunities, although we expect the euro to benefit from risk-off moves given its funding currency status. However, the challenging political calendar will likely prevent any material euro strength. Risks to our view would be an abrupt ending to QE or indeed any tapering of QE announced by the ECB in the near term.

Global high yield

We expect US high yield to perform well in 2017, albeit with limited room for spread tightening, given the current fair value level of spreads. Outside the US, high yield performance will be dependent on developments at the local level. Most corporate revenue in the US high yield market is tied to the health of the US consumer, which, we believe, will likely remain stable in 2017. The outlook for corporate revenue and profitably outside the US is more idiosyncratic and dependent on the country/region. Actions by the Fed could have an important impact on global high yield sentiment and the US dollar, which could lead to volatility in commodity prices and commodity-related high yield assets. Soft Chinese demand could also weigh on global high yield, as could disappointing growth outcomes in Europe. However, we are constructive on a number of developments in the US high yield market: Many US high yield companies have navigated the commodity price downturn successfully by cutting costs and improving balance sheets, debt-financed mergers and acquisition activity has been fairly muted, and default levels have ticked up only slightly. These developments are all likely to be supportive for US high yield bonds in 2017.

Global investment grade

We anticipate global investment grade credit will outperform sovereign counterparts in 2017 due to the favorable macroeconomic backdrop and continued market demand for yield. The expectation of a global recession remains low as liquidity, particularly outside the US, remains high. In the US, although rhetoric from the Fed is expected to target higher interest rates, we expect tightening to be limited. Additionally, the European Central Bank and Bank of England are expected to continue their quantitative easing efforts. The inclusion of corporate debt in their purchase programs further restricts the supply of yield-based assets available to investors and potentially supports global investment grade bonds.

The risks to our views include an unexpected deceleration in global growth, which could pressure credit fundamentals and risky assets. Alternatively, an acceleration in global growth and inflation could lead to higher interest rates, which could be particularly challenging for sovereign bonds given the limited protection provided by their very low yields. As we enter 2017, the investing landscape for corporate credit is marked by low credit spreads and absolute yields. Performance of the asset class may depend largely on avoiding problem sectors and issuers and capitalizing on opportunities as they arise.

Global liquidity

The year ahead should allow US money market fund managers to resume focus on adding value in a post-reform word. Short-term credit spreads could remain elevated if supply/demand imbalances persist as a result of reform, potentially presenting a continued attractive yield opportunity for prime and ultra-short strategies. Sufficient supply of US government securities should keep a floor under short-term interest rates; however, we will be watching potential developments around the US debt ceiling in early 2017, which could affect the supply of US Treasury securities in the short run. A slow-growing US economy will likely keep the focus on the Fed in 2017, but similar to recent years, forward guidance and a gradual approach to rate hikes with the least amount of disruption is likely the Fed's preferred path. Money market reform in Europe should start to take shape in 2017, but with a long path to implementation (similar to the US), the impact on markets might not be evident until 2018.

Structured

We expect the macroeconomic and capital market environment in 2017 to be generally supportive for structured securities as a slow macroeconomic growth trajectory and generally range-bound interest rates are traditionally conducive to lower prepayment risk and tighter credit spreads. We believe underlying residential and commercial real estate fundamentals in the US will be positive factors for the asset class as housing supply is expected to remain tight and consumer conditions will likely be healthy.

(continued on next page)

US commercial real estate values have risen considerably in recent years, but we believe the risk of an asset bubble is much more of an equity concern than an investment grade debt risk as collateral quality, credit enhancement and underwriting have improved considerably since the credit crisis. Foreign investor flows into US agency mortgage-backed securities (MBS) have been a material positive technical benefit driven by the historically high level of negative sovereign rates outside of the US, but we expect the pace of foreign flows to diminish given the increasing currency hedging costs we expect to continue through 2017. Principal risks to our view include: (1) a material change in Fed policy regarding the reinvestment of MBS coupons, prepayments and maturities, (2) the possibility of a more aggressive central bank interest rate stance, (3) an exceptionally large decline in US commercial real estate prices, and (4) disruption from new-issue commercial MBS supply challenges associated with new Dodd-Frank "risk retention" rules going into effect in the US on Dec. 24, 2016.

A cautious outlook, but opportunities still exist

Lewis Aubrey-Johnson
Head of Fixed Income Products, Invesco Perpetual Fixed Interest Henley-on-Thames

Key takeaways

- We are generally cautious about the prospects for bond markets.
- This caution reflects the low level of yields across large parts of the market.
- Despite our cautious outlook, we think there are still some areas of the market that are relatively attractive.

As the Henley-on-Thames based Fixed Interest Team looks ahead to 2017, we are generally cautious about the prospects for bond markets and have positioned our portfolios defensively with high levels of cash and other liquid instruments. This liquidity helps to mitigate the impact of periods of market weakness, while also enabling us to exploit any investment opportunities that may arise.

Central banks

Our caution reflects the fact that across many areas of the bond market, yields are at very low levels with broad swathes of the market offering little in the way of compensation for credit or interest rate risk. At least part of the reason for this is central bank policy.

The European corporate bond market is a prime example. Between the announcement of the European Central Bank's (ECB) Corporate Sector Purchase Programme (CSPP) on 10 March 2016 and a low on 7 September, euro-denominated investment grade corporate bond yields fell some 67 basis points to 0.63%.[1] As investors have sought to maintain income, the effect of the CSPP has rippled out to other sectors. The Bank of England's (BOE) own programme of corporate bond purchases begun in September 2016 has had a similar impact on sterling bond markets. At the time of writing in mid-November, the CSPP is scheduled to end in March 2017. As market rumours that the ECB was contemplating tapering the programme in early October highlighted, any reduction in this stimulus is likely to be negative for bond markets.

Inflation

There are tentative signs that the global economy is moving on from a deflation bias towards signs of reflation. The reason behind the move is threefold.

1. First, commodity prices have recovered. For example, by 10 November, Brent crude oil prices were up 75% from their low of US$27.9 per barrel in January.[2] Base effects are now starting to put pressure on headline inflation and pushing up the price of manufactured goods – this is one of the reasons why Chinese producer prices have now turned positive for the first time since 2012.
2. The second reason is a shift towards fiscal policy. US President-elect Donald Trump is widely expected to try to reflate the US economy with large increases in infrastructure and defence spending. Elsewhere, there are also signs of a tilt towards fiscal policy in Japan and Canada, and it is likely that others will join them.
3. Finally, there is a growing backlash against free trade. Although such a backlash is likely to be negative for growth, it could result in higher prices as tariffs encourage consumers to switch to more expensive domestic substitutes.

To be clear, we are not expecting inflation to surge anytime soon; structural factors such as Chinese overcapacity and a lack of global aggregate demand still linger. That said, a combination of tight labour markets in advanced economies and the factors detailed above are likely to continue the very gradual reflation trend over the next few years.

Political risk

Politics is likely to remain one of the key risks facing financial markets. Over the course of 2017, there will be French and German presidential elections and a general election in the Netherlands. These elections have the potential to significantly raise levels of volatility. Further, they will all take place against the backdrop of Brexit and the start of Donald Trump's tenure as President of the United States in January 2017.

Areas of relative value

Despite our cautious outlook, we think there are still some areas of the market that are relatively attractive. Inflation-linked bonds offer some opportunities for certain portfolios we manage, with inflation risks that are under-priced, in our view. At an index level, investment grade corporate bond yields and spreads are both extremely low and offer little value. However, we believe there are some parts of the corporate bond market that still provide a reasonably attractive amount of yield to compensate for risk.

Financials: Banks

Within credit, our favoured sector is financials, particularly subordinated bank capital (Additional Tier 1 and pre-Basel III Tier 1 bank capital). From a capital perspective, European

(continued on next page)

banks' positions have improved significantly since the financial crisis in 2008. This is highlighted by the European Banking Authority's stress tests. However, compared to their US counterparts, Europe's banks continue to strengthen their capital positions, and it is this process of repair that we believe forms the basis of the secular opportunity. Focusing on AT1 bonds, the ECB has addressed some of the risks affecting this sector in 2016 and given banks greater discretion to make cash payments including dividends and AT1 coupons (the lowest ranked form of debt capital).

These positive factors are not, in our view, currently reflected in valuations. For example, as at 8 November 2016, global contingent convertible (CoCo) bonds (which include AT1) offer a yield of 6.46%. This is around 4 percentage points of additional yield over the broader global corporate bond market.[3]

Financials: Insurance

In our view, the insurance sector provides further opportunities. Insurance companies issue subordinated bonds in order to comply with solvency requirements, and these can provide a relatively attractive level of income. As in the banking sector, regulatory changes mean there are some opportunities in legacy bonds. Subordinated insurance bonds issued before January 2016 count towards Tier 1 capital until 2026; however, they do not have some of the more aggressive solvency II capital features. We hold a number of these bonds, which we think have attractive credit characteristics, and we would expect them, much like legacy Tier 1 bank capital, to attract a premium due to their relative scarcity. Overall, the sector's creditworthiness is high, with solvency levels in excess of regulatory minimums.

Hybrids

We also see opportunity in non-financial hybrid bonds (subordinated securities issued by investment grade non-financial companies). At the time of writing in mid-November, the spread on hybrid bonds relative to senior bonds remains significant.[4] Typically, hybrid bonds are rated two notches lower than the issuer's senior debt, reflecting their capital risk. In a world starved of income, we think this premium, frequently available in investment grade issuers, is attractive. As with subordinated bank and insurance capital, the underlying features of these bonds may vary by issue; therefore, understanding these idiosyncrasies is crucial to unlocking the potential value.

High yield

Overall, valuations within much of the high yield sector look stretched – but there are some areas of the market that we think are relatively attractive. Our strategy is to be cautious and to focus on higher quality companies whose bonds offer relatively high levels of liquidity in a high yield context. Fallen angels (companies that have been downgraded from investment grade) can provide such opportunities when we believe they are implementing the right strategies to turn around their business.

1 Source: BofA Merrill Lynch Euro Corporate Index
2 Source: Bloomberg L.P.
3 CoCos represented by the BofA Merrill Lynch Contingent Capital Index, and global corporate bond market represented by the BofA Merrill Lynch Global Corporate Index
4 Source: JP Morgan

Taking the long view: What could challenge markets in 2017

David Jubb
Fund Manager, Invesco Perpetual Multi-Asset
Henley-on-Thames

Key takeaways

- Our team uses a two- to three-year investment horizon to help identify potentially attractive investment opportunities.
- Declining global productivity may contribute to continued slow GDP growth.
- Different central bank approaches to quantitative easing have produced differing results for money velocity.

In the Multi Asset team at Invesco Perpetual, we have a two- to three-year investment horizon, which we believe helps reveal attractive investment opportunities by accounting for both cyclical and structural market drivers.

Given this investment horizon, we form a central economic thesis that summarises the path we believe the global economy will follow over the next two to three years. This economic outlook does not drive the selection of our investment ideas, but is one of the tests for each idea before it is approved for the portfolio – we must believe that each idea has the potential to generate a positive return against our two- to three-year view of the world.

One of our intentions in choosing this time horizon is to avoid the tendency by some market observers and participants to focus on short-term noise. However, we are acutely conscious of the fact that our central economic thesis could be wrong and that short-term noise can cause major market volatility. That is why scenario testing is embedded into our portfolio management process. This is when we look at a range of possible, if not probable, scenarios and test the portfolio against them.

These scenarios tend to be extreme yet feasible scenarios that we feel have a probability of occurring in the following 12 months, however low that probability may be. This helps us identify what risks we are taking within the portfolio and hopefully provides us with the information we need to make the portfolio more robust in the face of potential market events.

We wanted to provide an insight into some of the structural issues or challenges that currently face the global economy and that are important considerations when constructing our portfolios. Some of these issues will underpin either the central economic thesis or the scenarios discussed above, which we use to test the portfolio. The issues we discuss are productivity, the velocity of money or lack thereof, the debt burden especially in regard to China, the vulnerability of the euro currency union and the potential for a cyclical downturn in the US.

Productivity

Eight years after the global financial crisis, the world is still in a low growth environment that looks set to continue despite the ongoing pace of technological change and the ongoing provision of money. One factor used to explain this weak growth environment is that global productivity has been on a declining trend since the late 1980s – measured using either the number of hours worked or all factors of production.

Germany has seen productivity growth fall from 4.5% in the 1970s to 2% in 2000 and 1% today. Japan has seen productivity slip from 5.2% in the 1970s to 2% in 2000 and to 1% today, while the US has seen productivity fall from 2.1% to 2% to below 1% over the same time period.[1]

The trend has long been a puzzle for economists, especially when set alongside greater globalisation, automation and the rise of new technology. Globalisation and automation have continued at a strong pace over the last 40 years, and the received knowledge was that these should encourage ever-higher productivity. This can be seen in that durables (manufacturing) productivity is much higher than non-durables. However, is there a base effect meaning that the impact of these forces has diminished, leading productivity back to a lower, long-term trend?'

The impressive growth of the financials sector is also a consideration. In the US alone, as a share of GDP, the financial services sector more than doubled in the three decades leading up to 2010.[2] However, it only acts as an intermediary, so its contribution to productivity is highly questionable.

It could be said that this financial sector growth has been spurred by the maintenance of the corporate and governmental debt overhang, which could in itself be another factor reducing productivity. For example, in any normalisation of interest rates, the need to service this debt becomes a priority. Any rise in the cost of capital could logically reduce the capital-to-labour ratio and hence productivity.

However, the big concern is that even as interest rates have been coming down, productivity has continued to fall, which points to the misuse of capital due to badly incentivised banks, meaning that too-low rates could be more directly responsible for this fall in productivity or, in other words, an ineffective use of debt.

(continued on next page)

It can also be argued that some of the new technologies that have become dominant, such as email and social media, actually impede productivity rather than enhance it.

Regardless of the explanation for this weakening trend in productivity, it looks unlikely to reverse and, coupled with weaker demographic trends, continued slow GDP growth seems a realistic prospect.

Debt

The global response to the global financial crisis time has been to increase debt further. From $142 trillion in 2007 (across household, government, corporate and financial), McKinsey & Company measured this at $199 trillion by mid-2014, and it was still rising.

China is a key focus in this conversation, given its recent debt expansion stands out since 2000 and its now significant role in driving global markets. Its private sector debt now amounts to 220% of GDP, and the median Chinese company has cash flows lower than its interest payments. However, identifying when high debt levels become excessive and need to be corrected is very difficult.

Optimistically, it is possible that China can grow out of its debt problems; even with slowing real growth, a reasonable pace of nominal GDP growth is likely to be maintained (circa 6.5% currently). In addition, the current account surplus means that a measured decline in the currency is possible, as long as capital flight is kept under control. Furthermore, China's capital stock, at just one-tenth of the US level per person, is still low even after investment as a percentage of GDP was 48% in 2011. This implies that investment-led growth is still a valid proposition and could carry on increasing – but most logically, this would require more debt financing.

However, there are some concerns. Shadow banking in China is growing aggressively. For example, wealth management products that feel like deposits to the customers are actually funding for corporate lending. Increasingly, these are used to repay existing debt and interest, which appears a poor use of capital. Also, companies have low cash flow relative to interest payments – so investment has likely been inefficient and there is considerable default risk if either debt costs rise or their cash flow dries up.

The Chinese government has also recently indicated that it is willing to tackle some of their state-owned zombie companies (i.e., those requiring state bailouts) with a few illustrations of debt-to-equity swaps being instigated. Some forecasts suggest that the banking system might need to write off around 20% of GDP in non-performing loans. While it is difficult to know what approach the Chinese government will take, this potential credit deterioration could have significant negative consequences both domestically and internationally.

Velocity of money

Another underlying concern is that the money created as a result of quantitative easing seems to have had little feed-through to the financing of productive, healthy investment spending. Indicative of this, the velocity of money has declined sharply in recent years, not risen, as it did from the late 1930s onwards.[3]

Rising velocity is normally a good thing as it is a useful measure of the efficiency of new money supply (i.e., new debt). So, the inevitable question is, have interventions following the global financial crisis contributed to the malaise by allowing capital to be misallocated? John Greenwood, Invesco Ltd.'s Chief Economist, has been a strong critic of Japanese and European central bank policies of quantitative easing (QE). These governments have bought assets from banks, who then place the cash on deposit with their respective central banks. This does not increase the velocity of money, unlike the UK and US QE programs which do so by backing non-bank players who then re-invest cash.

The impact of this is twofold: Firstly it could continue to underpin the low-growth world in which we find ourselves. Secondly given that the extensive QE programs to date have not necessarily found their way into all economic sectors, further unusual policy measures may have to be employed, or the onus may move back on politicians to underpin the next stimulus package for economies.

(continued on next page)

Euro currency union

Concerns about Europe have been re-ignited by the Brexit vote and, beyond the political issues, we see a number of continuing concerns for the Eurozone.

One of these is the imbalances in the European Central Bank's TARGET2 system, which is the cross border payment system that involves the national central banks and the European Central Bank. With Germany's claims on other Eurozone countries increasing once again, mirroring behaviour from 2011 and 2012, this may signal that the relative competitiveness of the peripheral countries is diminishing – hence a slow withdrawal and transfer to Germany. Concerns are that Portugal, Greece and Spain have increasingly limited opportunities to grow out of their large private sector debts, raising the prospect of defaults.

This comes at a time when peripheral European government bond spreads are around the lowest levels since before the global financial crisis, suggesting the market has all but forgotten the ongoing issues for these vulnerable peripheral Eurozone countries. For example, yields on Spanish and Italian 10-year notes are around only 100 basis points higher than those on German bunds.[4]

US cyclical concerns

Another concern is the US economic recovery. Here a number of factors point to the potential onset of a recession. In aggregate, the US consumer still appears to be in relatively good health. However, one risk is that consumer strength is being underpinned by credit growth, which is arguably unsustainable if economic growth does not pick up. Typically, a strong consumer would be accompanied by wage growth, but here the news is also relatively disappointing. The average weekly number of hours worked by individuals in the US has been falling on a year-on-year basis for most of this year, and the general move in the revisions of the payrolls numbers has been downwards. Furthermore, rent versus wage growth has been rising steadily, suggesting the consumer could come under some pressure if wages do not start to catch up with other day-to-day costs. Any pick up in wage inflation is typically underpinned by a strong corporate sector, but with tax receipts on the decline and profits weakening, a red flag is potentially emerging for the strength of the consumer as we move into 2017.

While the above do not form our central outlook, they provide plenty of food for thought and help us in the construction of our portfolio, feeding into the scenarios we create to test the strategy against. Clearly, there are more optimistic outcomes out there, but in a strategy where risk management forms the basis of our portfolio construction, it is crucial to examine both the downside and the upside. This is a key element of building a robust portfolio that has the potential to withstand market shocks.

1 Source: Federal Reserve Economic Database, 30 June, 2016
2 Source: National Bureau of Economic Research
3 Source: Federal Reserve Economic Database, 30 June, 2016
4 Source: Bloomberg L.P., as of 31 October, 2016

Private equity

Seeking to maximize returns and minimize risk in a volatile environment

Wendy Teramoto
Managing Director,
WL Ross & Co.
New York

Key takeaways

- 2017 may shape up to be a volatile year.
- Chinese demand, global oil production and interest rate policies are all trends we will be following closely.
- Uncertainty and volatility in the markets has not slowed down the pace of private equity investments.

The investment environment is one of constant change, and we at WL Ross & Co. expect 2017 to be a volatile year. We believe some events and trends can be predicted, while many cannot. The UK's Brexit decision to leave the European Union, the Zika virus outbreak and, of course, the completely captivating nature of the presidential election in the US are just some events in 2016 that very few predicted.

Top trends we will continue to follow closely in 2017

- **China.** There can be no discussion about the future without mentioning China. China will continue to demonstrate the sheer magnitude of its consumer and industrial consumption power. With a population of approximately 1.4 billion people, or roughly 19% of the worldwide population,[1] small changes in demand have a large rippling effect through many industries. The Chinese government's policies and practices will continue to impact the general demand flow of goods and commodities worldwide. No industry is immune to China. The most severe impact may be to commodities and commodity-related industries, including shipping, as China has continued to grow its share of global commodity consumption. Furthermore, a change in demand from Chinese consumers could have a pronounced effect on a number of finished goods — automobiles and other consumer durables, technology products and luxury goods are just a few of the areas with large exposure to China.
- **Oil.** We expect the price and production of oil to remain a hot topic into 2017. The last two years have been a roller coaster with crude oil being priced at $98 per barrel in August 2014, down to $29 in January 2016, and hovering near $50 as of mid-October as US crude production has proven to be more resilient than OPEC expected, keeping prices depressed.[2] The price of oil has and will continue to have a dramatic impact on many industries — some directly and many others indirectly. The fate of many companies will be unknown until pricing starts to normalize. We believe that current levels are unsustainable over the long term, and recent OPEC comments have signaled potential production cuts to improve pricing, but significant uncertainty remains around the timing of a recovery.
- **Interest rates**. Federal Open Market Committee (FOMC) policy will continue to have the investment world guessing. As the days near to each of the eight scheduled FOMC meetings a year, the volatility in the market is usually attributed to investors trying to answer the question of "Will they or won't they increase the interest rate?" These policies have a direct impact on both future investments and current investments. Movements in rates directly impact capital expenditures and overall debt strategies, which can have significant short- and long-term effects on cash generation. Global monetary policy of sustained low interest rates has kept valuations robust across asset classes, despite the ambiguity around the timing of a policy shift.

Finding opportunity during volatility

The continued uncertainty and volatility in the markets has not slowed down the pace of investments, and in fact the number of private equity funds raising capital reached an all-time high in the third quarter of 2016, with 1,720 funds in the market.[3]

Market volatility is many times caused by unpredictable events, so we believe it is best for investors to position investments to thrive in the predicted environment and survive through an unpredictably harsh one. While volatility can sideline some investors, our group has generally found opportunities in this type of environment. We eagerly await what 2017 will bring.

1 Sources: World Bank and US Census Bureau, 2013 figures
2 Source: US Energy Information Administration, as of Oct. 19, 2016
3 Source: Prequin, as of June 30, 2016

Real assets

Prices, performance and predictability dominate investors' view of real assets

Tim Bellman
Managing Director
Head of Global Research,
Invesco Real Estate
Dallas

Joe V. Rodriguez, Jr.
Managing Director
Head of Global Securities,
Invesco Real Estate
Dallas

Key takeaways

- Commercial real estate fundamentals remain robust in the US and are strengthening in number of other countries.
- US President-elect Trump's proposals to increase infrastructure investment could result in opportunities.
- Our focus continues to be on market fundamentals.

Investors have been drawn to real assets in general and to real estate in particular due to the comparative stability and attractiveness of their income returns and the prospects for growth.

A recent heightening of capital market, political and geopolitical risk levels has resulted in a less certain outlook for investment assets broadly, including real assets. This may reinforce the attractiveness of real assets' income potential, which is largely based on long-term contractual cash flows.

Three themes to watch in 2017
Presently three themes dominate investors' concerns about real assets for 2017: current prices, future performance and predictability in the light of political developments.

Prices. In many markets, the real estate yields/cap-rate spread over local long-term government bond yields are close to the long-term average spread. In Europe and parts of Asia Pacific, spreads as of mid-November were more than one standard deviation above the long-term average. This gives some comfort that, relative to other asset classes at least, real estate prices are not out of line. It also suggests that in a macro environment of modest inflation and low interest rates, there is little reason to anticipate an imminent or sharp upward movement in real estate yields/cap rates. Indeed in much of the world, yields/cap rates seem at least as likely to remain stable or even to fall further first, which could result in upward pressure on prices.

Performance. In many ways, the outlook for future performance depends on the potential for growth in real estate net operating income. The outlook for market fundamentals gives some reassurance. Commercial real estate fundamentals remain robust in the United States and are strengthening in Australia, much of Continental Europe and a number of other countries. Demand has softened slightly in some developed markets recently, but supply remains broadly in line with demand, and rents continue to trend upward. This should provide support to real estate returns, in our view.

Predictability. The future is inherently uncertain. This simple point has been brought home by the rising tide of populism that has swept across the world and poses a challenge to the established world economic and political order. Consequently, levels of political and geopolitical risk are elevated. The surprising result of the US presidential election has created an uncertainty about key aspects of US economic policy and international relations that will only become clear over the next few years. The surprising result of the United Kingdom's referendum on membership in the European Union has created an uncertainty at the heart of the world's largest economic group that is expected to last several years. In Asia Pacific, uncertainty lingers over the next stage for Abenomics in Japan and China's political transition in 2017. This level of uncertainty has implications for real estate markets and for investment strategy.

Where we see opportunity
What does this mean for real estate opportunities in 2017? First and foremost, it is important to emphasize that despite the elevated levels of uncertainty, we at Invesco Real Estate do not expect to change our general approach to investing in the United States, the United Kingdom or elsewhere:

- **Real estate markets.** Our focus continues to be on real estate fundamentals, identifying sectors, markets and/or assets that we believe should deliver sustainable outperformance. We will monitor carefully the impact of any changes in economic policies on patterns of real estate demand to determine where current opportunities may become less attractive and where new opportunities may arise.
- **Listed real estate stocks.** Our focus will remain on well-capitalized companies with high-quality assets with the best potential to deliver sustainable outperformance over the long term. We will watch changes in valuations and outlooks closely and make any adjustments to our portfolios accordingly.

At this relatively advanced stage in the economic and real estate cycle, we had already taken steps to position our real estate portfolios in preparedness for potentially more difficult times, should they emerge. The heightened economic policy uncertainty as a result of the US election or Brexit merely reinforces this approach, so any changes are likely only to be at the margin to take advantage of changes in the nature of the new opportunities arising.

(continued on next page)

Policy questions linger in the US

What might be some of the changes to market fundamentals? In the US for example, although we believe the overall impact to real estate cash flows will be muted, based on President-elect Donald Trump's pre-election policy stances, we think the following property sectors and markets are most likely to experience specific post-election adjustments in market fundamentals:

- Retail might benefit if proposed tax cuts spur consumer spending.
- Health care, particularly hospitals, might experience a negative impact from a reform of the Affordable Care Act (also known as "Obamacare").
- Industrial, especially coastal markets, may be negatively impacted if trade agreements are rewritten, causing a decline in imports and slowdown in port activity.

As investors in real assets, we find President-elect Trump's proposals to increase investment in a broad spectrum of infrastructure assets to be one of the most interesting topics to arise during the campaign. It is one of the few areas of policy in which there appeared to be a broad consensus, which might make it easier to put into action. How this increased investment is implemented may create opportunities both for investors in infrastructure and master limited partnerships (MLPs) directly, but also indirectly for real estate investors as some buildings/locations may become more competitive as they become more accessible. We plan to monitor these changes very closely.

Keeping an eye on the capital markets

What can we expect from capital markets? Capital markets can be volatile and subject to rapid shifts in sentiment. Specific sentiment impacts from interest rate expectations and policy decisions may include:

- Uncertainty around a Trump administration's specific policy choices and objectives may create short-term volatility as investor sentiment changes. This might trigger a short-term flight to the perceived safety of gold, the US dollar and hard assets.
- A change in Federal Reserve leadership and/or the direction of interest rate policy could have a direct and meaningful impact on cash flow discount rates and the value of real assets. For example, US-listed real estate investment trusts (REITs) currently traded at an estimated 8% discount to asset value as of November 2016.[1] Extreme price reactions to interest rate uncertainty may represent a buying opportunity.

Invesco Real Estate will stay current on the President-elect's policy initiatives, the British and European Union negotiations over Brexit, and any other major political developments that may emerge around the world. We will assess both broad market and real estate fundamental impacts as they become more visible. To reiterate, real asset investing is a long-term asset class based on relatively stable income derived from relatively long-term contractual cash flows. Our focus continues to be on market fundamentals: Identifying companies, sectors, markets, and assets that we believe have the potential to deliver long-term performance.

1 Source: Green Street Advisors

Important information

Data as of November 30, 2016 unless otherwise stated.

GLA-IVZCIO-BOOK-2-E 11/16 GL451