# 5 Investing Themes in a More Diverse Economic Environment with Potentially Higher Inflation

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OUTLOOK 2017

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## Key Insights

- **Overall assessment**: The low growth/low inflation scenario that has characterised the last few years is set to give way to a more scattered and economically heterogeneous phase with inflation moving modestly higher, particularly in Developed Markets. In this new dynamic scenario, we believe investors should embrace an active and risk aware mind-set based on 5 major investment themes.
- **Theme 1 - Reflation trends make a flexible and unconstrained approach to fixed income paramount.** We believe that the "Trump effect" could offer opportunities for investors in corporate bonds, inflation-linked bonds, loans, floating rate and steepening strategies.
- **Theme 2 - Profiting from potentially stronger growth via equities** Global, US and Asian equities may benefit the most from a broad reflation environment and national initiatives, where earnings growth will tend to be supported.
- **Theme 3 - The search for income continues, but will require an increasingly selective approach.** In the search for income, investors could consider opportunities in credit and Emerging Market bonds. Investments linked to real asset dynamics could also benefit in a potentially higher inflation environment.
- **Theme 4 - Currencies: strong dollar, tactical opportunities.** We think that the USD will stay supported on the back of the Fed's interest rate normalisation process and the current phase of asynchrony of Central Bank policies.
- **Theme 5 - Hedging, protection strategies and diversification[1] to deal with geopolitical risks.** With multiple risks on the radar, we believe that broadening the source of diversification and incorporating efficient hedging strategies will continue to be extremely important to try to protect investors' assets.

*We are likely to see multi-speed growth with widening economic divergence within regions and inflation moving modestly higher, particularly in Developed Markets.*

We believe that investors will find themselves navigating a markedly different environment, in terms of both economic and financial markets, in 2017.

As the incremental benefits of extraordinary monetary policy fade, and the schism between the political establishment and the electorate widens in more countries, a new economic and political framework is going to take to the stage in the new year. We are likely to see multi-speed growth with widening economic divergence within regions and inflation moving modestly higher, particularly in Developed Markets (DM).

[1] Diversification does not guarantee a profit or protect against a loss.



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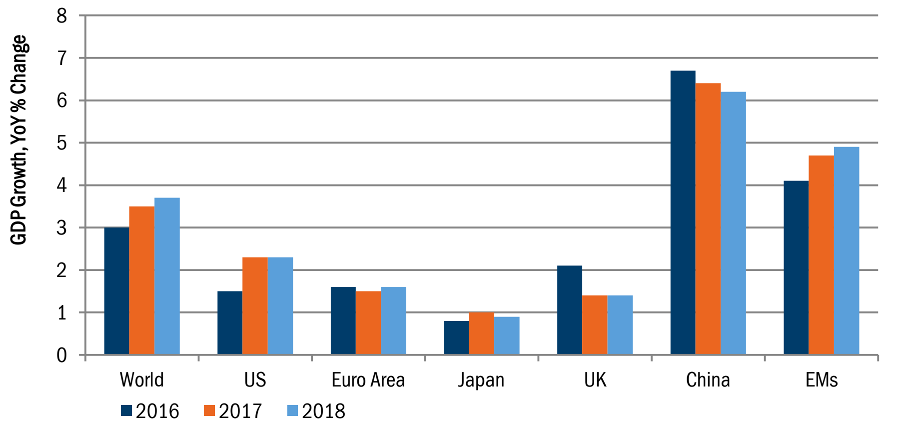
**Graph 1: 2016-2018 GDP Outlook**

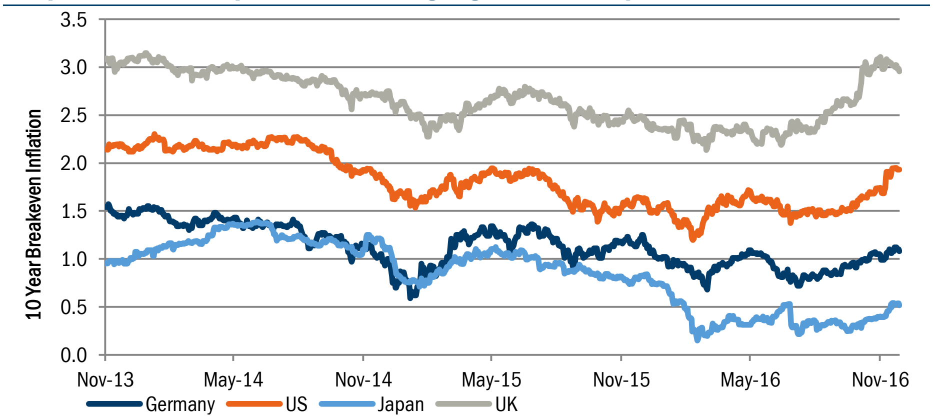



Sources: Pioneer Investments' forecast. Data as of November 24, 2016.

*More expansionary fiscal policies enacted mainly through tax cuts could help stimulate growth and inflation.*

The low growth/low inflation scenario that has characterised the last few years is set to give way to a more scattered and economically heterogeneous phase. In our view, more expansionary fiscal policies enacted mainly through tax cuts will be the primary approach chosen by governments to address social discontent, while also trying to stimulate growth and inflation and reduce future debt burden.

**Graph 2: Inflation Expectations Moving Higher in Developed Markets**




Sources: Bloomberg, Pioneer Investments, Data as of November 24, 2016.

European governments will likely be forced to proceed in this direction, towards a more benign fiscal policy and more pro-growth initiatives to deal with the ongoing challenges of a weak growth, *lowflation* and the rising risk of political instability. Germany, which, relatively speaking, has ample fiscal flexibility, could enact expansionary fiscal policies ahead the 2017 elections (for now commitment is mainly to a very mild tax reduction). Expansionary fiscal measures are also expected in Japan to lift the anaemic growth. While this might be a winning strategy in the short term, we doubt these measures will address the need for increased productivity and more "quality" growth in the medium term.

We believe that the US and their foreign policy developments are going to be key. If the most extreme aspects of Trump's protectionist campaign assertions are reined in, his pledged substantial infrastructure spending and promised tax reforms could provide a on- off boost to US growth and inflation.

*China and Emerging Markets will, in our view, proceed or even accelerate in the transition of their economic model towards more domestically-driven quality growth.*

Under the reasonable assumptions of a moderate "Trump factor" and a more benign commodity cycle, China and Emerging Markets (EM) will, in our view, proceed or even accelerate in the transition of their economic model towards more domestically-driven quality growth with the US playing a somewhat diminished role. Over the coming year, their outlook will be highly sensitive to news flow from the US (USD and rates in particular), in our opinion. We do acknowledge, however, that they are less vulnerable today than they were a year ago and better equipped, in terms of reserves and fundamentals, to deal with the new economic challenges.
Here, again, the winners will be those with more fiscal and monetary capacity and further commitment towards structural reform. Asia, in this regard, continues to be our most favoured area.

In the context of this new dynamic scenario, there are five major themes that investors with an active and risk aware mind-set could pursue.

## Theme 1 - Reflation trends make a flexible and unconstrained approach to fixed income paramount

*We believe that the "Trump effect" could offer opportunities for investors in corporate bonds, inflation-linked bonds, loans, floating rate and steepening strategies.*

We believe that the "Trump effect" will favour reflation trades that can be played across a broad spectrum of fixed income investment strategies around the world. Within the theme of reflation, we like inflation-linked bonds in the US and in Euroland, where we believe that they still price in a very low inflation pattern.

**Graph 3: US Treasury Curve Set To Continue Steepening**


Sources: Bloomberg, Pioneer Investments, Data as of November 24, 2016.

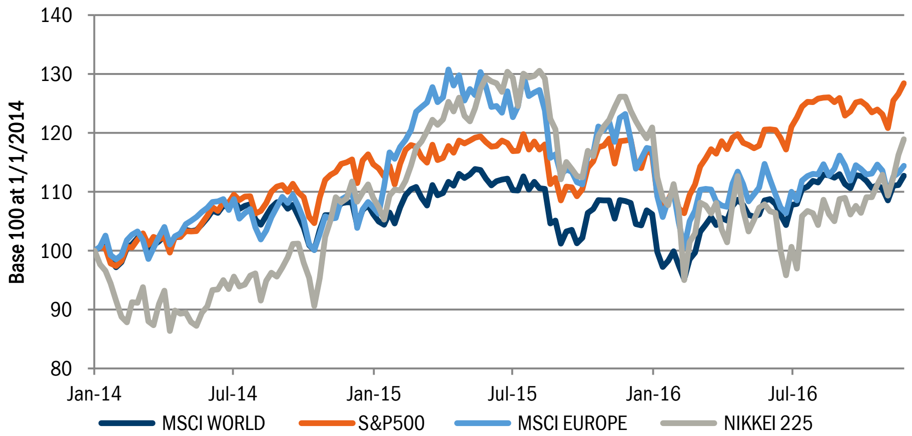
We believe that the US Treasury curve will continue to steepen on improving macro fundamentals, as we are potentially entering a new regime of expansionary fiscal policy. Assuming that the path of Fed hikes stays relatively slow, US corporate earnings are likely to improve in this environment and defaults are probably going to normalize, after the energy sector-related spike in 2016. In this environment, corporate debt will probably outperform sovereign debt in both Europe and the US, even though the asset class' total return may be limited compared to 2016. Loans and other floating rate strategies could be compelling opportunities. Investments linked to real asset dynamics could also benefit in a potentially higher inflation environment.

## Theme 2 – Profiting from potentially stronger growth via equities

*Global, US and Asian equities may benefit the most from a broad reflation environment and national initiatives, where earnings growth should see better support.*

Global, US and Asian equities may benefit the most from a broad reflation environment and national initiatives, where earnings growth should see better support. This will be less so in Euroland, where growth perspectives are more moderate and political and headline risk remains high. We also favour Japanese equities, as Japan is now the centre of pro-growth and reflationary experiments and the internal political turbulence appears to be more contained. Premier Abe's efforts to combine monetary policy with fiscal expansion and a strong dollar all support positive momentum for Japan, as does the potentially more dominant role for Japan in Asia, should the US becomes more domestically-oriented.

**Graph 4: Equity Markets Performance**



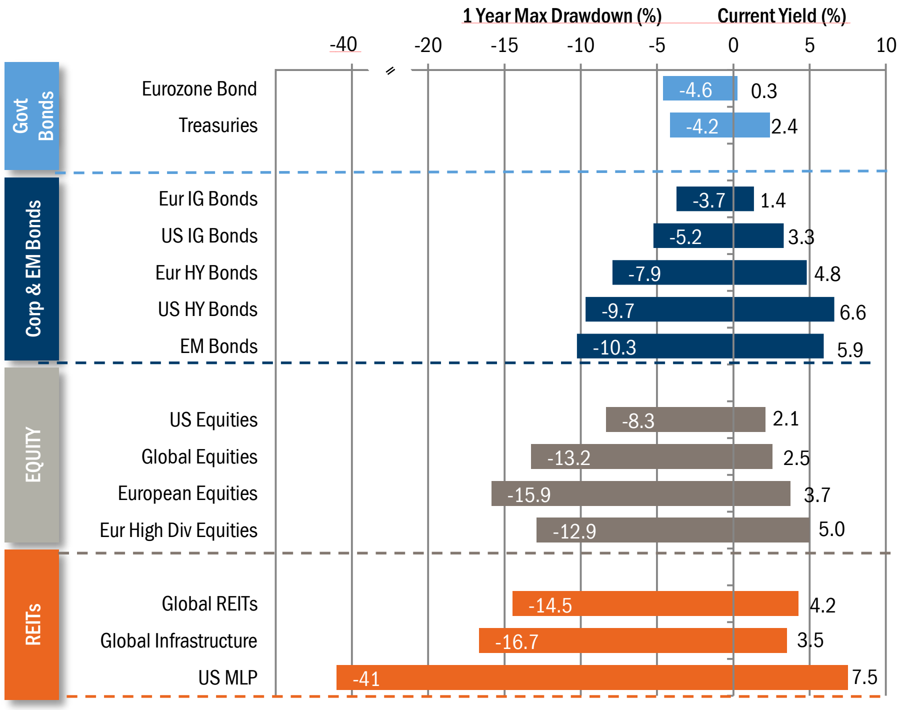

Sources: Bloomberg, Pioneer Investments, Data as of November 28, 2016. **Past performance is no guarantee of future results.**

## Theme 3 - The search for income continues, but will require an increasingly selective approach

*In search for income, investors could consider opportunities in credit markets and emerging market bonds. Investments linked to real asset dynamics could also benefit in a potentially higher inflation environment.*

There are still pockets of value left in European and US credit, however the margin for carry is now slimmer than a year ago. EM can play a role in the search for income, but with a more selective approach and the need to pay close attention to the evolution post US election. We also believe it will be important to broaden the sources of income by incorporating multi-asset approaches, fixed income (especially flexible, unconstrained, higher yielding) and equities, while also focusing on security selection and emphasizing quality. Investments linked to real asset dynamics could also benefit in a potentially higher inflation environment.

### Graph 5: Search for Yield Across the Board



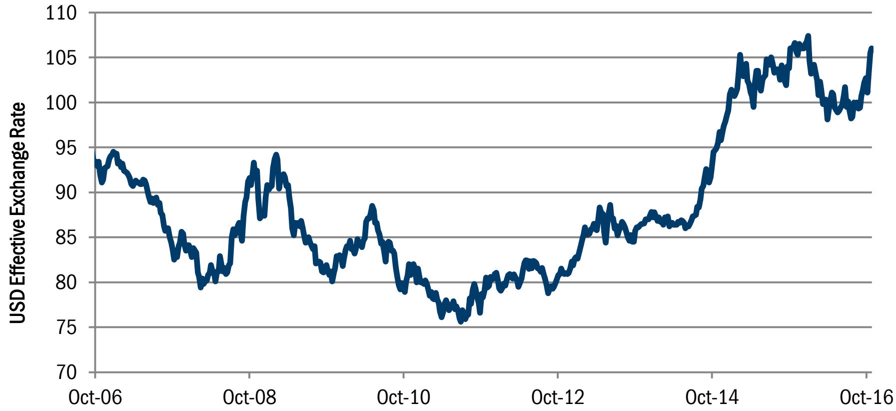

Source: Bloomberg. Data as at November 28, 2016. Eurozone Bond = JPMorgan GBI Germany, Treasuries = JPMorgan GBI US, EUR IG Bonds = Barclays Pan European Aggregate Corporate Bond, US IG Bonds = Barclays US Aggregate Credit, EUR HY Bonds = Barclays PanEuropean High Yield Bond, US HY Bonds = Barclays US Corporate High Yield, EM Bonds = JPMorgan EMBI Global, US Equities = S&P 500, Global Equities = MSCI World, European Equities = MSCI Europe, Eur High Div Equities = MSCI Europe High Dividend Yield, Global REITs = FTSE EPRA/NAREIT Global, Global Infrastructure = Dow Jones Brookfield Global Infrastructure Index, US MLP = Alerian MLP Index. All indexes are total return in local currency. Max Drawdown is the largest 1 year decline in value registered since December 2010 based on an analysis on monthly data. Drawdown – The peak-to-trough decline during a specific record period of an investment, fund or commodity, usually quoted as the percentage between the peak and the trough. Yield is the Yield to maturity for bonds and the dividend yield for equities. **Data represents past performance, which is no guarantee of future results.** Please see additional MSCI disclaimer in the Additional Notes.

## Theme 4 - Currencies: strong dollar, tactical opportunities

*We think that the USD will stay supported on the back of the Fed's interest rate normalisation process and the current phase of asynchrony of central bank policies.*

We think that the USD will stay supported on the back of the Fed's interest rate normalisation process and the current phase of asynchrony of central bank policies, which could be exacerbated should the "Trump effect" spur economic growth and inflation. Opportunities could also come from volatility in EM currencies. In general, we see currencies being an important lever for tactical asset allocation and a key value-add through active portfolio management.

**Graph 6: USD Strengthening**




Sources: Bloomberg, Bank of England, Pioneer Investments, Data as of November 24, 2016. An effective exchange rate is a measure of the value of a currency against a `basket' of other currencies, relative to a base date. It is calculated as a weighted geometric average of the exchange rates, expressed in the form of an index. The effective exchange rate indices for sterling and other currencies published by the Bank of England are based on the method the IMF uses to calculate effective exchange rates for a number of industrialised countries. The weights used are designed to measure, for an individual country, the relative importance of each of the other countries as a competitor to its manufacturing sector. The trade weights reflect aggregated trade flows in manufactured goods for the period 1989 to 1991 and cover 21 countries. The base date for the index is 1990, and is set at 100.

## Theme 5 - Hedging, protection strategies and diversification to deal with geopolitical risks

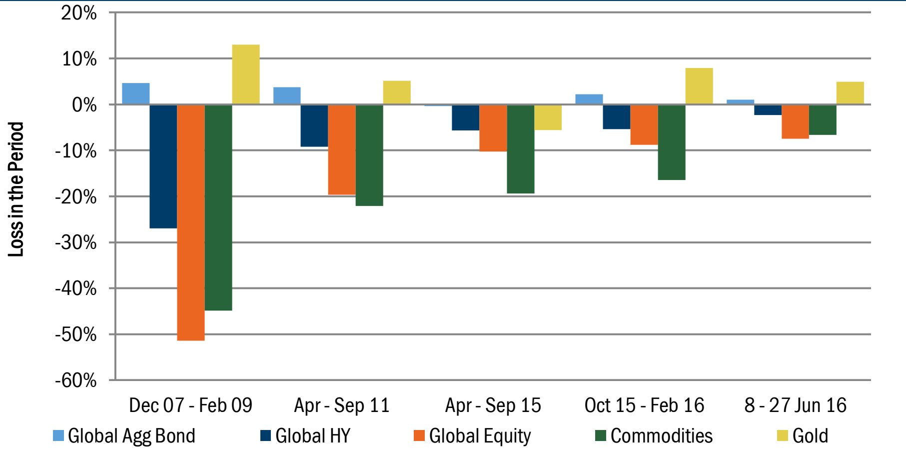
*With multiple risks on the radar, we believe that broadening the source of diversification and incorporating efficient hedging strategies will continue to be extremely important to try to protect investors' assets.*

Even though we expect a slightly stronger economic growth in 2017, we continue to see a number of structural risks on the radar, such as the risk of policy mistakes, the high debt exposure of global economies and geopolitical risks, especially in Europe where the political calendar in 2017 will be very crowded.

In this environment, we believe that broadening the source of diversification and incorporating efficient hedging strategies will continue to be extremely important to try to protect investors' assets. In this regard, gold could help smooth potential spikes in volatility as well as real assets more generally which may offer inflation protection and have a generally lower correlation[2] with traditional asset classes that may help during phases of market stress.

[2] Correlation: the degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to one another. Correlation is expressed by a correlation coefficient that ranges from -1 (never move together) through 0 (absolutely independent) to 1 (always move together).

**Graph 7: Asset Classes Losses During Major Periods of Turmoil**




Sources: Bloomberg. Data as of November 30, 2016. Inflation = US CPI, Cash = Merrill Lynch 3-month US TBill, US Bond= Barclays US Aggregate Bond Index, EER Bond = Barclays Eur Aggregate Bond Index, Global HY = Merrill Lynch Global High Yield Index, EM Bond = Merrill Lynch USD Emerging Markets Sovereign & Credit Index, US Equity = S&P500 Index, EUR Equity = MSCI Europe Index, EM Equity = MSCI Emerging Markets Index, Commod. S&P GCSI Commodity Index. All indices are total return in USD. Note that these are examples only and there can be no assurance of future events. **Past performance is no guarantee of future results.**

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Date of First Use: December 1, 2016.

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