The engine of economic growth is ready to fire. The drivetrain is fiscal stimulus and regulatory reform. The chain reaction to get the cylinders moving comes from expectations for a rise in business investment, leading to gains in productivity that ultimately should produce growth. The economy has been sorely lacking in business and productivity, which has caused the U.S. economy to run rough over the past few years. Of course there are risks: geopolitical, trade and protectionism stand out. The markets seem to be pricing for expected better days ahead but are still factoring in these risks. This means there is room for risky assets to still rally further and bond yields to rise if those risks diminish. However, we need to be wary of the opposite, which is why a balanced portfolio is critical for 2017.
Some consensus forecasts for U.S. gross domestic product growth in the year ahead is 2.2 percent versus potential output of 1.5 percent, based on Consensus Economic data as of December 19, 2016. If these forecasts come out true, then 2017 could see growth run above potential by 0.70 percent. In an optimistic scenario, growth may run at 3.0 percent, which is double its potential. In both cases, excess capacity in the economy is declining and the economy is running hot with the latter being greater than the former. Inflation and wages may rise.

In the event that economic data falters, the economy has some buffer room in that economic growth needs to fall below its 1.5 percent potential output before excess capacity begin to mount. In order for the bear case to manifest itself, it would have to overcome the tailwinds to economic growth from fiscal stimulus and regulatory reforms.

Such is the prevailing wisdom in the markets today. But many things are subject to change over time. Fixed income will still be an important part of one’s asset allocation to achieve a balanced portfolio. Given our opening thesis into 2017 we look at strategies that seek to limit interest rate risk and take advantage of credit and spread risk to help achieve returns. As we see it, managing interest rate risk will be critical and there will likely come a time in 2017 to buy duration if yields and risky assets overshoot to the upside. Here is where we see opportunity:

- We need to be less reliant on duration for returns (beta). We are looking to optimize yield per unit of duration risk. Less rate sensitive versus more credit, idiosyncratic and thematic exposures.
- Asset returns are highly dependent on the economic regime. We believe the market is in the midst of a regime shift turning away from an over dependence on central bank policy to drive performance and toward fundamental economic valuations. This shift will take some time but it signals a return to more normal market conditions.

**INVESTMENT OPPORTUNITIES**

Think thematically in 2017. Winning characteristics for fixed income investment are likely to include the following: carry, idiosyncratic drivers, improving fundamentals and credit over interest rate sensitivity.

Some examples of sectors within the fixed income market that fit our thematic criteria are:

1. **Emerging markets.** This asset class is primarily reliant on three factors:
   i) Global growth, which is expected to rise by 0.5 percent in 2017 to 3.5 percent, according to the International Monetary Fund (IMF) estimates; ii) Rising commodity prices, which have been improving as China and global markets have stabilized; and lastly iii) Terms of trade. This last factor is the greatest unknown for 2017 as we are unsure of the future of U.S. trade and protectionism policies and how they may spillover to the emerging world. However, if it turns out less than feared, then emerging markets (EM) are poised to do very well in 2017, especially since fundamentals have already been improving.
   - Better terms of trade will likely benefit commodity exporters, such as Peru, South Africa, Colombia, Chile and Russia.
   - Local EM bonds should also benefit the most from commodity exporters with high interest rates to earn carry but also with an undervalued currency. Indonesia, Russia, Brazil and Colombia stand out as potential opportunities to invest in.

2. **RMBS.** This asset class has seen improving fundamentals but has lagged the rally in credit sensitive assets and, thus, has greater potential upside in 2017. Both fundamentals and technicals are appealing for this asset. Supply has been declining, which has been supportive of prices. Credit fundamentals have been improving, as we have seen falling delinquency rates due to a strengthening in the labor market and incomes. Home price affordability measures are favorable to new home buyers from a historical perspective. The winning characteristics in our 2017 investment theme fit our criteria nicely in residential mortgage-backed securities (RMBS). Investors can look to buy fixed rate, discount bonds with good carry and stable excess spread. Assets can be found in this space with high credit quality and could benefit from regulatory changes that can be supportive of these bond prices.

3. **High yield.** This asset class tends to be less interest rate sensitive and relies more on more idiosyncratic factors and credit conditions to drive performance. In 2017, we expect default rates to fall and economic fundamentals to improve. We tend to believe the single B and triple CCC segments of the market are most appealing, largely because they tend to be less sensitive to rates. Basic industries, manufacturing and food and beverage are areas we like.

These are just some specific examples of investment opportunities in fixed income for 2017. We believe that investors should hold a diversified portfolio and that fixed income should still be a large part of the mix. In addition, we advocate adding actively managed and unconstrained bonds funds to your fixed income allocation. These funds can have the benefit of reducing correlation risks and potentially produce higher returns.

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1 Diversification does not eliminate the risk of loss.
Public bank loans by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of term securities may be more sensitive to interest rate changes. In a declining result in periods of volatility and increased portfolio redemptions. Longer-

In the current rising interest-rate environment, bond prices may fall and may the creditworthiness of the issuer and general market liquidity (market risk).

interest payments (credit risk), changes in interest rates (interest-rate risk), investors should carefully review the strategy's/product's relevant offering conditions, and each investor should evaluate their ability to invest for the long-

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EMEA

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