Stock markets, bond markets, the economy, understanding their significance, and responding policy — some years they push and pull without overreacting. The way to assess the new each other lightly as markets follow their environment is not to ask, “What’s broken?” or “What’s fixed?” but “How will businesses, markets, and the economy adapt?” The theme often following a period of change, understanding for tackling portfolios may be similar. Read the pushes and pulls and how they interact gauges and make adjustments, while staying strategic and maintaining a long-term view.

2016 was a milestone year, a year of important changes for markets, the economy, and certainly politics. S&P 500 corporate earnings turned positive reversing more than a year of declines. After a one-year hiatus, the Federal Reserve raised rates for the second time in the current cycle, in what might finally be the start of a more regular path to interest rate normalization. Fears of deflation shifted to talk of “reflation.” Oil ended a multi-year decline that saw prices fall from over $110/barrel in 2011 to a low of just over $26 in February 2016. And most dramatically, the American electorate rebuked the political establishment by choosing the nation’s first president who has held neither a prior political office nor high military rank, but instead has built an entire career in the private sector. The U.S. election, along with the U.K.’s referendum vote to leave the European Union (EU), may also come to be viewed as important milestones, if it leads to nations shifting away from a decades-long trend toward increased globalization.

We have already seen a number of changes taking place as markets try to assess the dynamic new environment. Heading into the New Year, interest rates have moved dramatically, cyclically oriented value stocks have asserted market leadership, and oil prices found a new foothold as several major oil producing countries agreed to production cuts. New gears have been engaged, energy is building and repositioned. Being prepared for 2017 is about gauging these market milestones, understanding their significance, and responding without overreacting. The way to assess the new environment is not to ask, “What’s broken?” or “What’s fixed?” but “How will businesses, markets, and the economy adapt?” The theme for tackling portfolios may be similar. Read the pushes and pulls and how they interact gauges and make adjustments, while staying strategic and maintaining a long-term view.

- **Smaller path to policy changes.** A Republican president working with a Republican Congress should smooth the path for implementing policy changes. Both the timing and the actual details on issues such as fiscal stimulus, tax reform, deregulation, and trade will help set the market direction.
- **Earnings growth returns.** With the earnings recession at an end, in 2017 we expect mid- to high-single-digit earnings growth potentially supported by an accelerating U.S. economy, rebounding energy sector profits as oil prices stabilize, and steady profit margins.
- **Fed in play.** Fed policy is driven by the dual mandate of keeping inflation low and the economy near maximum employment. Both sides of the mandate may look different in 2017, as the labor market approaches full employment and inflationary pressures increase.

Gauging the market milestones as they impact 2017 will require a good plan and the right attitude. It’s about smart, not fast; patience, not impulsiveness; judicious adaptability, not careless return-chasing. After a momentous year, use LPL Research’s Outlook 2017: Gauging Market Milestones to help keep a firm but responsive touch on the controls and eyes on the right gauges as you pursue your financial goals.
In 2016, the U.S. economy navigated some difficult challenges including low oil prices, a strong dollar, tightening financial conditions, and the threat of deflation. As we turn the calendar to 2017, concerns have shifted. Oil prices have stabilized; while the dollar, despite receiving a post-election boost, is unlikely to create the kinds of headwinds it created over the last three years. Increased anxiety over deflation in 2015 and early 2016 has flipped to “reflation” concerns. Conversations about fiscal austerity, through mechanisms like budget tightening, have started to a drum beat for fiscal stimulus through tax reform and the threat of a policy mistake has risen over the course of 2016. The pro-growth policies likely to be enacted in the first half of 2017 by Trump, including corporate and personal tax cuts, increased spending on infrastructure and defense, and deregulation, may help to boost economic growth in 2017 and 2018 and increase the economy’s potential growth rate (while changing the mix of growth drivers). However, they may also lead to some of the “overs” that tend to emerge at the end of expansions (overconfidence, overborrowing, overspending), naturally accelerating the economic cycle and bringing a recession sooner than otherwise might have been the case.

Focusing on 2017, between the economic momentum that started in late 2016, the boost from fiscal policy likely to be enacted by mid-2017, and a more business-friendly regulatory environment, real gross domestic product (GDP) growth may accelerate to a range closer to 2.5% in 2017, after spending most of the first seven-plus years of the expansion averaging just over 2.1%. The boost in 2017 comes as the main drivers of growth shift from an emphasis on the consumer to a mix that includes manufacturing, capital expenditures, and government spending (Figure 1). Potential contribution from trade (net exports) remains a wildcard, as the Trump administration’s trade policies, while attempting to dampen the balance of exports and imports, may have a dampening impact on long-term trade growth. In addition, the deficit could make a comeback as a key economic topic for markets and policymakers in the aftermath of a potential shift to fiscal stimulus through lower taxes and increased infrastructure and military spending.

The timing of the passage of Trump’s proposals on taxes and infrastructure, as well as the speed of implementation, will be an important factor in their growth impact in 2017. We assume passage by mid-year 2017 (Figure 2), but an earlier passage and start to implementation would pull more of the growth effect forward into 2017, while passage and implementation delays into late 2017 may push back the impact on growth, employment, and inflation until very late 2017 or early 2018.

Of course, new risks could be around the corner. The Fed may start raising rates in earnest, if slowly, after a one-year hiatus between December 2015 and December 2016. Raising rates at this stage would simply reflect an improving economy, but finding the proper pace for rate increases will be a challenge. President-elect Donald Trump has expressed intentions to renegotiate trade agreements, but will face the challenge of improving them without starting a harmful trade war. And although fiscal stimulus may give a boost to growth, long-term challenges for the federal debt and budget deficit loom in the background.

Path to Normalization: Federal Reserve Is Fueling Up

At the start of 2016, the disconnect between the Federal Reserve and the federal funds futures market about the anticipated future direction of monetary policy was striking. The Fed, which had just initiated its first tightening cycle in more than 11 years in December 2015, anticipated raising rates by 200 basis points (2.0%) over the course of 2016 and 2017, which would put the fed funds target rate at about 2.375% by the end of 2017. Meanwhile, the market was pricing in just four 25 basis point hikes over the course of 2016 and 2017, putting the fed funds target rate at just 1.375% by year-end 2017. The 100 basis point disparity, the equivalent of four 25 basis point rate hikes, was so wide that it led to a number of destabilizing global imbalances in the first few months of 2016, which in turn contributed to the financial market turmoil over the first six weeks of the year.

As of late 2016, the Fed has raised rates just once more, at its final meeting of the year in December, leaving the fed funds target rate at about 0.625%. If its outlook for the economy, labor market, and inflation is met, the Fed said it would raise rates 75 basis points in 2017 and 75 basis points in 2018, leaving the fed funds target rate at 2.125% at the end of 2018. Meanwhile, the market now sees roughly two hikes in 2017 and two in 2018, putting the fed funds target rate around 1.825% at year-end 2018. At around 25 basis points, the disagreement on the path of rates over the next two years is likely to prove much more manageable for global markets to absorb than the 100 basis point gap at the start of 2016.

Our view is that we may meet the Fed’s forecasts for the economy, labor market, and inflation in 2017, leading the Fed to raise rates twice during the year. The economy might receive a boost from fiscal stimulus, which can lead to a virtuous cycle of added confidence and the release of what economists colorfully refer to as the economy’s “animal spirits,” where greater confidence leads to increased activity. If this happens, it will push GDP growth above its currently muted potential, tighten resources, increase labor costs, and ultimately drive inflation. Given this possibility, our estimate of two rate hikes has an upward bias with three hikes more likely than one, especially if inflation moves above 2.0% and remains there, as we expect.
Pressure Increases on Labor Market

The disconnect between the Fed and the market regarding the path of interest rates will likely narrow further in 2017; however, the disconnect between the Fed and the market on the labor market will likely widen. The market may view a potential slowdown in the pace of job creation as a recession signal, while the Fed may continue to see it as consistent with a labor market near full employment. Since early 2010, the unemployment rate has dropped from nearly 10% to the most recent reading of 4.6%, a new cycle low. In its most recent set of economic projections (released in mid-December 2016), the Fed’s policy arm, the Federal Open Market Committee (FOMC), projected the unemployment rate at 4.5% by the end of 2017, just a modest improvement from current levels. Fed Chair Janet Yellen has noted that although the unemployment rate is not the perfect measure of slack in the labor force, if she had to focus on just one number, that would be it. Of course Yellen has often noted that the Fed watches job creation as a recession signal, while the market is that less slack in the labor market leads to wage pressures. Wages represent around two-thirds of business costs and, over time, higher wages lead to higher inflation. Wage inflation (as measured by the year-over-year gain in average hourly earnings) has moved from a low of near 1.5% in 2012 to near 3.0% at the end of 2016, but has not yet reached its pre-Great Recession pace of 4–4.5%. But the market, and perhaps even the Fed, may be surprised by how quickly wages could accelerate toward pre-Great Recession levels even if job creation slows in 2017. In the six years from early 2010 (when the U.S. economy began regaining lost momentum) to mid-2016, the economy created a total of just under 15 million jobs, or an average of just under 200,000 per month. Since the middle of 2016, job creation has slowed to 175,000 per month and is likely to slow further over the course of 2017. A few Fed officials are on record saying monthly job growth as low as 80,000 per month would be sufficient to push the unemployment rate lower, but the center of gravity of the Fed probably sees that number closer to 100,000–125,000. As we look ahead to 2017, we continue to expect a slowdown in job creation as the recovery matures, but in our view it would take a slowdown to around 25,000–50,000 jobs per month to signal that a recession is imminent. The market, on the other hand, may see a fairly typical later-cycle slowdown in jobs to the 100,000 to 125,000 per month range as a recession signal.

Inflation Bubbles Up, But Doesn’t Boil Over

In the aftermath of the Great Recession, inflation expectations have swung between concerns over hyperinflation in the years following the launch of quantitative easing (QE) in 2009 to concerns about deflation in late 2015, as the impact of sharply lower oil prices and plenty of spare global capacity exacerbated already slow GDP growth. In general, slow economic growth, spare capacity (available labor and production resources), and the globalization of product and labor markets have all acted as restraints on inflation in recent years, and except for a few brief periods in 2009 and early 2015, the Consumer Price Index (CPI) has exhibited neither hyperinflation (as feared in response to central bank “money printing”) nor protracted deflation. Instead, the CPI experienced stagnant or declining (but still positive) growth, also known as disinflation, for much of this recovery. Fears of deflation by late 2015 had led to ramped-up efforts by central banks outside the U.S. to expand QE and a year-long delay in the Fed raising rates a second time. By the second half of 2016, in the U.S. at least, the factors pushing inflation higher may have begun to win the battle over disinflationary forces, marking an important transition for the economy. For most of 2015 and 2016, as headline CPI was held down by falling oil prices, inflation in the service sector (which accounts for 80% of GDP and two-thirds of the CPI) accelerated to a new cycle high of 3.0%. Goods prices (one-third of the CPI), which have been in a deflationary environment for most of the past three years, remained in negative territory for the majority of 2016, but as oil prices stabilized near $45 per barrel in late 2016, goods deflation began to give way to year-over-year price increases. If oil and gasoline prices stay in their recent ranges, the overall increase in average hourly earnings will be enough to provide an improved backdrop for corporate America that will help support equities while creating a mild headwind for bonds.

How to Invest

The second half of an economic cycle usually sees increased financial market volatility, and we believe the current cycle may continue that pattern. But despite the greater uncertainty that comes with a potentially less accommodative Fed, increased policy uncertainty, and the broad increase in populist political movements, we believe economic milestones passed in 2016 have provided an improved backdrop for corporate America that will help support equities while creating a mild headwind for bonds.
Over the course of 2014, Fed Chair Janet Yellen mentioned several labor market indexes that she and other Federal Open Market Committee (FOMC) members were watching closely to assess the effectiveness of monetary policy. In May 2014, Fed staffers released a white paper introducing the Labor Market Conditions Index (LMCI). This paper received a great deal of attention from market participants who believed it may contain clues to the timing of interest rate hikes. Several of these labor market indexes—which have been referred to as the “Yellen indicators”—are being closely monitored by the Fed chair and the FOMC. This infographic details the progress of these indicators over the last two years. In our view, movement toward maximum employment keeps the Fed on track to raise rates twice in 2017, with three more likely than one.

### Labor Force

<table>
<thead>
<tr>
<th>Label</th>
<th>Description</th>
<th>Pre-recession High</th>
<th>Recession Low</th>
<th>Current Reading</th>
<th>Change From 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>UR</td>
<td>Unemployment rate: % of labor force</td>
<td>4.40% – 10.00%</td>
<td>4.6%</td>
<td>23%</td>
<td></td>
</tr>
<tr>
<td>LPPR</td>
<td>Labor force participation rate: year-over-year change, % of unemployed</td>
<td>0.4% – 1.1%</td>
<td>0.2%</td>
<td>13%</td>
<td></td>
</tr>
<tr>
<td>PTER</td>
<td>Part-time employment for economic reasons: % of labor force</td>
<td>2.7% – 6.7%</td>
<td>3.7%</td>
<td>27%</td>
<td></td>
</tr>
<tr>
<td>LITU</td>
<td>Long-term unemployed: 27 weeks or more, % of unemployed</td>
<td>15.9% – 45.3%</td>
<td>24.8%</td>
<td>24%</td>
<td></td>
</tr>
<tr>
<td>DIU</td>
<td>Duration of unemployment: weeks</td>
<td>7.3 – 25</td>
<td>10.1</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>PPE</td>
<td>Private payroll employment: millions of workers</td>
<td>116.0 – 107.2</td>
<td>122.9</td>
<td>58%</td>
<td></td>
</tr>
<tr>
<td>GPE</td>
<td>Government payroll employment: millions of workers</td>
<td>22.6 – 21.8</td>
<td>22.2</td>
<td>43%</td>
<td></td>
</tr>
<tr>
<td>THE</td>
<td>Temporary help employment: millions of workers</td>
<td>2.7 – 1.7</td>
<td>3.0</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>AWH</td>
<td>Average weekly hours (job): hours</td>
<td>33.9 – 33.0</td>
<td>33.6</td>
<td>22%</td>
<td></td>
</tr>
<tr>
<td>AWHPW</td>
<td>Average weekly hours of persons at work: hours</td>
<td>39.7 – 36.2</td>
<td>38.3</td>
<td>11%</td>
<td></td>
</tr>
<tr>
<td>WR</td>
<td>Wage rates: average hourly earnings, year-over-year % change</td>
<td>4.2% – 1.3%</td>
<td>2.4%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>HW</td>
<td>Composite help-wanted: index</td>
<td>4250 – 2750</td>
<td>4723</td>
<td>-23%</td>
<td></td>
</tr>
<tr>
<td>HR</td>
<td>Hiring rate: % of payroll employment</td>
<td>4.5% – 3.2%</td>
<td>3.5%</td>
<td>-31%</td>
<td></td>
</tr>
<tr>
<td>TRUE</td>
<td>Transition rate from unemployment to employment: % of unemployment</td>
<td>29.6% – 15.9%</td>
<td>25.3%</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>JPHI</td>
<td>Jobs plentiful vs. hard to get: diffusion index</td>
<td>11.4% – 46.1%</td>
<td>4.8</td>
<td>9%</td>
<td></td>
</tr>
<tr>
<td>HP</td>
<td>Hiring plans: diffusion index</td>
<td>19% – 10%</td>
<td>15%</td>
<td>17%</td>
<td></td>
</tr>
<tr>
<td>JH</td>
<td>Jobs hard to fill: %</td>
<td>21% – 8%</td>
<td>31%</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>IUR</td>
<td>Insured unemployment rate: % of covered employment</td>
<td>1.9% – 5.0%</td>
<td>1.5%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>JLOS</td>
<td>Job losers unemployed less than 5 weeks: % of employment</td>
<td>45.4% – 14.7%</td>
<td>36.3%</td>
<td>31%</td>
<td></td>
</tr>
<tr>
<td>QR</td>
<td>Quit rate: % of payroll employment</td>
<td>60% – 39%</td>
<td>61%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>JLEA</td>
<td>Job leavers unemployed less than 5 weeks: % of employment</td>
<td>48.8% – 17.5%</td>
<td>34.0%</td>
<td>5%</td>
<td></td>
</tr>
</tbody>
</table>

Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics. 11/30/16

The time frame for all data is the last 12 years: 2004–2016.
In 2016, we saw two key events that may be remembered as important markers in a reversal of trends favoring increased globalization and free trade loosely in place since the end of World War II: the U.K.’s referendum vote to leave the EU (“Brexit”) and the U.S. election, where both candidates had campaigned on free trade skepticism. Trump’s trade platform, which included renegotiating the North American Free Trade Agreement (NAFTA), the imposition of select trade tariffs, and a more aggressive stance on foreign currency, was decidedly stronger. The greatest risk may be in Europe. Over the next year, Europe will continue to see several important tests of the shifting global political mood reflected in the Brexit vote and U.S. election, highlighted by elections in France and Germany, and political wrangling around the structure and timing of the U.K.’s exit from the EU. An Italian referendum vote in December 2016 continued the trend of populist victories, although the outcome of presidential elections in Austria were considered pro-EU. Partial withdrawal from the EU, and perhaps even a rejection of the euro, are at issue in all of these political events, even if not formally on the ballot. This was not the case with the Brexit vote, since the U.K. never adopted the euro and continues to use the pound. While the Brexit vote was momentous, a change in currency for any individual country would be much more difficult, and riskier, than just leaving the EU, and a deeper threat to both the euro and the EU itself.

Despite these positive developments, we remain cautious on both developed foreign and EM economies and markets. They remain an important part of a strategic asset allocation plan, and we recommended establishing modest positions in EM early in 2016, but would only strengthen the recommendation under the right conditions. We will watch these economic and political events closely to determine if and when an additional investment might be warranted. The greatest risk may be in Europe. Over the next year, Europe will continue to see several important tests of the shifting global political mood reflected in the Brexit vote and U.S. election, highlighted by elections in France and Germany, and political wrangling around the structure and timing of the U.K.’s exit from the EU. An Italian referendum vote in December 2016 continued the trend of populist victories, although the outcome of presidential elections in Austria were considered pro-EU. Partial withdrawal from the EU, and perhaps even a rejection of the euro, are at issue in all of these political events, even if not formally on the ballot. This was not the case with the Brexit vote, since the U.K. never adopted the euro and continues to use the pound. While the Brexit vote was momentous, a change in currency for any individual country would be much more difficult, and riskier, than just leaving the EU, and a deeper threat to both the euro and the EU itself.

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Stocks fundamentally represent ownership of a share of a company (i.e., equity), and appreciation in stock prices is ultimately driven by earnings growth. S&P 500 earnings passed an important milestone in 2016, returning to growth in the third quarter after mildly contracting for several quarters during an extended mid-cycle earnings recession. Expected mid- to high-single-digit earnings growth from corporate America in 2017 should help support recession, the S&P 500 produced an average gain of 12%. These numbers are also consistent with the first year of the presidential cycle. In the first year of the four-year presidential cycle (as 2017 will be), when the U.S. economy does not enter into a recession, the S&P 500 posted gains 92% of the time, with an average return of 9.3% (data back to 1950) (Figure 5).¹

Mid-Cycle Support Suggests Solid Stock Market Gains

Our forecast for U.S. economic growth in 2017 supports our expectation for stock market gains next year and the continuation of the bull market past its eighth birthday. In years when the U.S. economy does not enter recession, the S&P 500 produced an average gain of 12%. These numbers are also consistent with the first year of the presidential cycle. In the first year of the four-year presidential cycle (as 2017 will be), when the U.S. economy does not enter into a recession, the S&P 500 posted gains 92% of the time, with an average return of 9.3% (data back to 1950) (Figure 5).¹

Company Earnings Picking Up Steam

Earnings growth returned in late 2016 and may continue to gain momentum in the coming year. We expect earnings growth in the mid- to high-single-digits in 2017, well above the flat earnings of 2016 and more consistent with long-term averages. Better economic growth, potentially the fastest since the end of the Great Recession, would be supportive of corporate profits (Figure 6). Our forecast of 4–5% nominal U.S. GDP growth (real GDP plus inflation as measured by CPI) makes the consensus revenue growth forecast for 2017 near 5% achievable. Historically, nominal GDP growth has correlated well with S&P 500 revenue growth. The Institute for Supply Management’s (ISM) Purchasing Managers’ Index (PMI) for manufacturing, which has shown high correlation to corporate profits historically, has been above 50 in the last three months of 2016 (September through November data) and eight out of the past nine months, which is also an encouraging sign.

Profit Margin Headwinds Emerging?

Overall, corporate profit margins have been resilient despite the energy downturn as companies have done a terrific job controlling costs. Wage pressures (the biggest component of companies’ costs) are starting to build and may continue to do so in 2017 as steady job growth likely continues. Minimum wage increases in some states add to the upward pressure, along with the potential for higher borrowing costs as interest rates and commodity prices rise. Lackluster productivity gains in recent years make margin expansion even tougher. Profit margins may have a challenging time returning to the record highs set in late 2014, but we expect them to at least hold steady as energy sector profitability recovers and overall revenue growth picks up, which can help profit margins through scalable operating efficiencies. Steady margins would translate revenue growth directly through to earnings growth. Those factors, along with modest added support from share buybacks, may keep our profit growth target well within reach.
of 2016 and may only have a minimal negative impact in the fourth quarter of 2016, after reducing earnings by an estimated 4–5% during mid-2015 when the annual increase in the U.S. dollar index approached 20%. Should the dollar remain at current levels—at the high end of its recent range—the year-over-year change would average about 3% in 2017.

**Earnings and Protectionism**

S&P 500 firms derive a substantial amount of their revenue overseas in foreign currencies (we estimate 35–40%, on average), so a more protectionist U.S. trade policy could hurt corporate profits. Trump has expressed interest in using tariffs on imported goods from China and Mexico in support of fairer trade. It is difficult to predict how U.S. trade policy will play out, but we see Trump moderating his stance based on his desire to drive economic growth, which would be at odds with a strongly protectionist policy. Checks and balances in Congress, competing priorities, and the time involved in reviving trade rules suggest the earnings risk from trade in 2017 would be manageable.

**Elevated Valuations, But For How Long?**

Elevated stock market valuations are another risk to our forecast, but one we believe is only relevant in a scenario in which the market begins to, or actually does, price in a recession. The current PE of 18.7 (trailing four quarters) is above the higher post-1980 average of 16.4, and even above the higher post-1980 average of 16.4. We don’t see high valuations as a reason to sell, as they have not been good indicators of stock market performance over the subsequent year, as shown in Figure 7. The correlation between the S&P 500’s PE and the index’s return over the following year, at -0.31, is relatively low (based on 45 years of data). Stocks can stay overvalued longer than we might think they should, so we focus more on macroeconomic and fundamental factors for indications of an impending market correction or bear market.

**How To Invest**

We see similar performance between growth and value, with accelerating economic growth and improved financial sector performance, based on a steeper yield curve and reduced regulatory burden, favoring the value style while our sector views and relative valuations generally favor growth. Small caps may outperform in early 2017, due to the possibility of supportive policies and expanding bank credit under a Trump presidency. An aging business cycle may favor larger caps later in the year.

On a sector basis:

- Healthcare may benefit from a more benign regulatory environment.
- Technology valuations reflect overly pessimistic expectations based on assumed policy impact, and may present an attractive opportunity.
- Industrials may benefit from increased infrastructure spending.
- Reduced regulatory barriers and potentially higher oil prices support master limited partnerships, though rising interest rates carry risk.

There are several politically sensitive sectors that may get a boost from a Trump presidency:

- **Energy.** Trump will likely be positive for fossil fuels. He has promised less regulation on drilling, along with expansion of drilling areas. Should oil and natural gas prices hold up, some pipelines may get built that would not have under Democratic leadership. Refiners may see easing ethanol requirements. Companies tied to energy infrastructure may also benefit. A risk is that increased production sends oil prices down and hampers sector performance.
- **Financials.** The election outcome has put upward pressure on interest rates and steepened the yield curve (the difference between short- and long-term interest rates), supporting bank profitability. Trump has indicated a desire to roll back financial regulations, including the Dodd-Frank Wall Street reform law. Implementation of the U.S. Department of Labor’s fiduciary standard for retirement plan accounts, slated for April 2017, could now be delayed, which could benefit the financial services industry. Finally, deregulation and infrastructure spending may boost bank lending.
- **Healthcare.** Trump has stated his desire to repeal and replace the Affordable Care Act (ACA), which could negatively impact the segments of healthcare that rely most on ACA-insured patients, such as hospitals. But with the form of the ACA’s potential replacement still unclear, it is uncertain how many people, if any, might actually lose coverage. Lowering drug prices through regulatory action is unlikely to be a top priority for Trump, which is good news for pharmaceutical stocks. And some health insurers, which have been experiencing widely reported profit pressures through the ACA exchanges, may benefit from an overhaul.
- **Industrials and materials.** Trump has put infrastructure spending at the top of his agenda, discussing numbers as high as $1 trillion in additional spending over 10 years. Within industrials, construction and engineering firms are poised to benefit, as are related materials companies. Industrials are also poised to benefit from increased defense spending, another emphasis of the Trump campaign. Less energy regulation may support the segment of industrials tied to energy infrastructure, and we expect fiscal policy to boost U.S. and perhaps global growth, also benefiting the sector. More restrictive trade policy would be a significant risk for these sectors.
- **Small caps.** Lower corporate tax rates and other policies aimed at bringing jobs back to the U.S., a key campaign goal for Trump, are positive for small caps. More bank lending is also positive because small companies are generally more dependent on bank credit. Conversely, small caps do not benefit as much as large caps if tax repatriation occurs since larger companies have more cash parked overseas.

Commodity returns may be competitive with equity market returns in 2017 as fiscal stimulus and stronger global growth potentially lift existing supply overhangs in the oil patch and certain other commodity markets. A stronger U.S. dollar is a risk to broad commodities prices, particularly gold.

The fundamental outlook for select oil and gas investments, including master limited partnerships, remains positive. Years of flat oil prices led to 2016 spurred successful exploration for oil, resulting in an oil glut. Barring a major geopolitical event, this oil glut will likely keep prices subdued—averaging below $60/bbl—through 2017. There will be winners even at these prices, such as the production, drilling, and service companies operating in low cost areas, notably West Texas. The late 2016 agreement by the Organization of Petroleum Exporting Countries (OPEC) and key non-OPEC oil producers to curtail production may provide some added support for oil prices, but the ability of U.S. oil producers to bring new production on line quickly is likely to prevent a major price increase.

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normalizing interest rates in earnest from the emergency levels instituted post-financial crisis in 2009.

Immediately following the election of Trump and a Republican majority in both houses of Congress, interest rates rose, the Treasury yield curve steepened, and the market digested increased prospects of fiscal stimulus through spending and tax cuts and its potential impact on economic growth and inflation, two of the key drivers of interest rates. Higher rates of economic growth and inflation, along with our base case of two potential Fed rate hikes, would put bond prices under pressure in 2017, leaving most of the return potential for bonds in their income component, or “coupon.” Low and negative yields on sovereign bonds in international markets, however, may continue to put downward pressure on U.S. yields, limiting the future strength of the post-U.S. election run-up in rates as 2017 begins.

The restraining effect of international rates could become larger if additional countries vote to leave the EU, as in the case of Brexit, potentially forcing the European Central Bank (ECB) to expand or extend quantitative easing. Nevertheless, for rates to decline meaningfully, we would likely need to see the onset of a recession in the U.S. in 2017, a scenario we believe to be unlikely.

Gauging Gradual Progress

Despite our expectation for muted bond market performance in 2017, we continue to believe fixed income plays a vital role in a well-diversified portfolio. Even in a low return, low-yield environment, high-quality bonds serve as an important diversifier, helping to manage risk from equities and other higher risk asset classes. During equity market pullbacks since 2010, the S&P 500 averaged a -11% total return, while the broad bond market returned 1.6%, on average (Figure B). Although this absolute return is not very exciting, the outperformance relative to equities (+12.6%, on average) demonstrates high-quality fixed income’s value as a risk mitigation tool.

Returns Losing Steam, Not Broken

Scenario analysis for the broad bond market in 2017 shows the influence that interest rates can have on high-quality fixed income returns (Figure B). If Treasury yields are flat it would result in an estimated 3.1% total return. A 0.25% increase in intermediate-term Treasury yields could reduce the total return to an estimated 1.6%, while a 0.25% decrease could boost the broad bond market’s total return to 4.5% for the year. We expect the 10-year Treasury yield to end 2017 in its current 2.25–2.75% range, leaving bond prices near flat with the majority of their total returns driven by coupon income. Our bias is toward the upper end of the range, and we do see the potential for the 10-year Treasury yield to end the year as high as 3.0%, should meaningful fiscal stimulus be enacted. Even with that wider range, our return estimates for the broad bond market range from approximately 0.5% to 4.0%. This drives our expectation for the broad high-quality bond market’s “muted” return, relative to the 10-year average total return of 4.6% and 25-year average of 6.3%.

The onset of a U.S. recession or a major unexpected shock to the global economy could push rates lower and bond prices higher; however, prices on high-quality fixed income securities are flat it would result in an estimated 3.1% total return. Should meaningful fiscal stimulus be enacted. Even with that wider range, our return estimates for the broad bond market range from approximately 0.5% to 4.0%. This drives our expectation for the broad high-quality bond market’s “muted” return, relative to the 10-year average total return of 4.6% and 25-year average of 6.3%.

The onset of a U.S. recession or a major unexpected shock to the global economy could push rates lower and bond prices higher; however, prices on high-quality fixed income securities are more likely to be under pressure from several major sources in 2017.

Fiscal stimulus. Long-term bond yields compensate investors primarily for the risk of not being invested in higher return opportunities related to economic growth and inflation (which eats away at real returns). The “term premium” in fixed income markets represents the additional compensation that investors demand for holding longer-term bonds relative to shorter-term bonds. If Trump is able to pass fiscal stimulus measures, including tax cuts, through a united Congress, that term premium could continue to rise with the increased prospect of greater growth and higher inflation. This would push long-term yields higher, pressuring bond prices. In addition, at least one top rating agency has warned that should all of Trump’s proposed economic and fiscal policies be enacted, it would be negative for U.S. sovereign creditworthiness due to its impact on the deficit, which may also be putting upward pressure on yields.

Ongoing Fed rate hikes. Fed rate hikes will likely push short-term interest rates higher in 2017. Though potentially painful for many fixed income investors, normalization of interest rate policy by the Fed is also a positive milestone for the health of the economy. Raising interest rates further will also give the Fed more tools at their disposal should the economic recovery sputter.

Foreign selling. Foreign countries have been liquidating Treasuries during 2016 at a pace above that seen in recent years. Many foreign nations sell Treasuries to fund international payment obligations or to devalue their currencies in response to liquidity issues, export weakness, or defaults at home. Investors are less apt to hold longer duration Treasuries if they find Trump’s tariff proposals credible, due to the possibility of a trade war. Until clarity on U.S. trade policy is provided, we expect more volatility in the Treasury market.

Increasing risk premiums due to political uncertainty. Trump’s policies are likely to be pro-business and anti-regulation, but his outsider status and complicated mix of priorities may increase policy uncertainty from the nation’s highest office. Investors demand additional compensation in the form of higher yields for the added risk. The more Trump’s plans are known and understood by markets, the lower this additional yield compensation may need to be.
If oil prices do not falter, and move modestly higher in 2017 as we expect, the theme of improving fundamentals is poised to continue into 2017, as default levels for high-yield bonds are projected to decline from 4.5% at the end of 2016 to roughly 3–3.5% in 2017, based on estimates from credit rating services. This is good news for the high-yield bond market, much of that improvement is already reflected in current valuations, leaving high-yield with little room for error in the case of equity market weakness or another destabilizing force. Non-financial corporate debt-to-earnings levels, which can indicate how much debt firms in the high-yield market are carrying on a relative basis, continue to increase. This is a negative fundamental trend, on balance, but the limited amount of high-yield debt maturing in 2017 should help support the asset class.

However, we do expect high-yield valuations to widen slightly during 2017, which would support prices, in part due to the prospect of business-friendly policies from a Trump administration. Nevertheless, we believe interest payments will drive the majority of high-yield’s return, similar to high-quality fixed income. Given that, we anticipate mid-single-digit returns driven by interest income for high-yield bonds.

**Bank On Higher Short-Term Rates**

While longer-term Treasury rates are largely driven by expectations of future U.S. economic growth and inflation, short-term Treasury yields are more sensitive to Fed policy. With the prospects of additional Fed rate hikes in 2017, short-term rates are poised to continue to move upward. One potential beneficiary is bank loans, which are similar to high-yield bonds in that they are below investment grade, but different in that they are generally less volatile and have interest payments that fluctuate based on global short-term interest rate benchmarks. Bank loans may represent a similar, but somewhat more conservative option than high-yield bonds for investors who seek yield while simultaneously mitigating interest rate risk. Bank loans are also less sensitive to the energy sector, which only represents approximately 3% of the bank loan market, compared to roughly 14% of the high-yield market. Although the yield of bank loans is lower than that of high-yield bonds and the prospects for capital appreciation are more limited, the sector remains a solid option for income investors who understand their risk, in our view.

**Municipal Outlook**

Post-election, as fixed income markets digested the economic implications of a Trump presidency, yields in the tax-sensitive municipal market began to spike, though not as much as Treasury yields, making relative valuations more expensive again. Prices should stabilize relative to Treasuries once the new administration clarifies its tax policy. The overhang of underfunded pension liabilities may drive credit risk up in certain states until they shore up their fiscal positions. If Trump’s infrastructure plan necessitates borrowing by states and municipalities, excess supply could also pressure the municipal market in 2017, but this is another area where the impact cannot be fully evaluated until we have greater policy clarity.

**How to Invest**

We continue to favor intermediate-term bonds for 2017, with an emphasis on investment-grade corporates and mortgage-backed securities, given the backdrop of range bound interest rates. Lower-quality fixed income will likely be supported by business friendly policies, in line with our positive view on equities. Therefore, a small allocation to high-yield and/or bank loans may make sense for some investors.

**Alternative Investments: Ready for a Tune-Up?**

Alternative investments have been challenged over the past few years, causing some investors to reconsider their allocations to these investments. We believe that there may still be a place for alternative investments as the market environment changes. By their nature, most alternative investments have relatively low, if not negative, correlations to both stocks and high-quality bonds. Given that the past few years can be characterized as a bull market in both of these areas, it is not surprising that alternative investments have had flat performance. However, the future is not destined to mirror the past. We may be entering a period of lower returns for both bonds and stocks. Alternative investment managers with flexibility in their mandates may be able to find sources of additional return not available through traditional asset classes and strategies. This extra return may come with additional risks, such as reduced liquidity or a higher degree of volatility. There are a number of investment strategies that fall under the label “alternative” with different risk and return characteristics and not all may be appropriate for every market condition. Master limited partnerships (MLP) are one non-traditional asset class that may be poised to deliver strong returns in 2017 after a relatively strong 2016. Notable tailwinds for the asset class include a pro-energy administration taking over the White House and a more balanced crude oil market. These factors may result in higher U.S. energy production, which should benefit pipeline MLPs. Growth opportunities also exist in the export market for various natural gas products. Interest rate risk is a consideration but, given the history of MLPs in rising rate periods, we don’t believe that this risk is as prevalent as with traditional “bond proxies,” such as real estate investment trusts (REIT) and utilities.

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor’s portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.
market outlook that covers a calendar year is an important tactical tool for positioning portfolios, but any tactical plan needs to be built on a foundation of sound, long-term strategy. Given the year-to-year volatility of equity markets, even a good tactical record is something that must be built over time. Strategic forecasts average out the effect of cycles and can be more focused. For perspective, in order to capture 60% of S&P 500 individual year returns over the last 50 years, you would need to have forecasted a total return between -3.4% to 26.5%. On the other hand, to capture 60% of rolling 20-year returns over the same period, you would only need a range of 8.1% to 26.5%. On the other hand, to capture 60% of rolling 20-year returns over the same period, you would only need a range of 8.1% to 26.5%. On the other hand, to capture 60% of rolling 20-year returns over the same period, you would only need a range of 8.1% to 26.5%.

### Stabilizers:
Market forces that help stabilize long-term equity returns, contributing to the likelihood that stocks will continue to rise and outperform bonds over the next 10–20 years.

- **Consistent long-term earnings growth.** Since the end of World War II, the long-term trend in nominal earnings growth has consistently tracked near 6% growth despite short-term fluctuations (Figure 12). The trend may slow, but its resiliency demonstrates the dynamic role of free markets that incentivize corporate America, over the long term, to compete, to innovate, and to control expenses.

- **Technological innovation.** Technological advances are not just about computer processor size and speed. They occur across the economic landscape and include fields like healthcare, agriculture, and manufacturing. The pace of future innovation can’t be known in advance, but based on the waves of innovation over the last 50 years and the infrastructure in place for future advances, we remain confident that technological advances will continue to support economic growth.

- **Spread of democracy.** In 1900, an estimated 12% of the world’s population lived in democracies; in 2015, that number was estimated at over 50%, with the general trend punctuated by two large expansions following the end of World War II and the collapse of the Soviet Union. Democracies typically have large private sectors where market forces have considerable influence, but also tend to support institutions that help advance prosperity, like transparent legal systems and broad educational opportunities. A critical mass of mature democracies is likely to provide a strong backdrop for a dynamic response to economic challenges.

- **Productivity rebound.** Productivity growth slowed considerably during the Great Recession, and there are no signs yet of the trend reversing (Figure 13). The reason for slower growth has been attributed to many sources, including declining returns from technological development, underinvestment, lost skills during the deep contraction in employment, and even mismeasurement. Productivity gains would have to play a key role in improving the growth trajectory of the economy and should remain under careful watch.

- **Trade policy.** The U.S. and other developed economies have generally favored increased trade liberalization since the end of World War II. More recently, global trends of increased populism have raised concerns about a return to protectionist policies that could lead to a trade war. While far from where we are now, increasingly restrictive trade policy could weigh on global growth and contribute to a significant rise in inflation. Free trade, however, is not an unqualified good and vigilance is required to make sure that free trade also remains fair trade.

- **Geopolitical tensions.** Geopolitics always remain a wild card for markets. Declining tensions may open markets and create a “peace dividend,” whereas rising tensions can restrict economic growth.

On balance, we believe the stabilizers will continue to fulfill their function, but frictional forces may lower the expected range of returns compared with the last 50 years, pulling it down an estimated 1–3%. There are gauges to watch that might mitigate or increase that shift. A longer timeline does also increase the chance that something unforeseen might occur or that something will come along that can change market dynamics. At the same time, markets and corporate America have been able to rebound from such high-impact global events as the Great Depression and World War II. Lower return expectations compared with the last 50 years increase the value of good planning and put a premium on the value of sound, conflict-free investment advice to help formulate a reasonable set of goals, understand potential returns and their risks, and, often most difficult, patiently execute that plan.

### Expect added friction:
Three factors have worked their way into the machinery and may lead to decreased returns over the next 10–20 years.

- **Valuations.** S&P 500 valuations, as measured by PE, are above average relative to history. A strong relationship exists between higher valuations and below-average long-term returns. Although a changing sector mix, low interest rates, and low inflation likely raised the level of fair valuations, current valuations may put pressure on stock returns versus their long-term average over the next 10 or more years. The timing of this impact is difficult to estimate, and historically valuations have had no real significance for forecasting one-year returns (see Figure 7).

- **Profit margins.** As with valuations, a changing sector mix and technological developments have likely shifted the sustainable long-term level of profit margins higher, but companies may be running leaner now than is sustainable long term, based on the age of assets and low investment levels. In addition, long-term forces that have helped expand margins for decades, such as a large international supply of inexpensive labor, may be running their course as the global economy rebalances.

- **Demographics.** The ratio of the nonworking age population to the working age population is expected to continue to rise in every major developed economy over the next 25 years and beyond. An aging population provides some benefits that could partially offset slower growth of the workforce, but it does put pressure on other areas of the economy and is likely to weigh on growth.

### Gauges to watch:
A major change in these factors could meaningfully shift return expectations over the next 10–20 years, positively or negatively, and should be monitored.

- **Productivity.** Productivity growth slowed considerably during the Great Recession, and there are no signs yet of the trend reversing (Figure 13). The reason for slower growth has been attributed to many sources, including declining returns from technological development, underinvestment, lost skills during the deep contraction in employment, and even mismeasurement. Productivity gains would have to play a key role in improving the growth trajectory of the economy and should remain under careful watch.

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- **Geopolitical tensions.** Geopolitics always remain a wild card for markets. Declining tensions may open markets and create a “peace dividend,” whereas rising tensions can restrict economic growth.
Milestones provide markers for the completion of one stage of a journey and the start of the next. They are a time to review progress and anticipate what’s ahead. Our outlook for 2017 requires gauging a number of significant changes in short and long-term market trends and judging how financial markets, corporations, policymakers, and the broad economy might respond. 2016 saw imbalances and corrections, sentiment shifts, inaccurate political projections, and meaningful reversals in some asset classes. Looking ahead to 2017, we will be watching for accelerating economic growth, the extension of the earnings rebound, a steadier path toward interest rate normalization, and the impact of potential policy changes such as tax reform, increased government spending, deregulation, and a more aggressive trade stance. Only time will tell if the market’s post-election optimism is warranted, or if markets are pricing in too much too soon. But no matter what happens, we’ll continue to help you monitor the changes and keep your hands on the controls.

Individuals also have their own milestones: life events, educational and career accomplishments, major purchases, and many smaller milestones that represent personal achievements. When it comes to meeting investing goals, the truly important accomplishments are not particular portfolio values but the actions that help to create and maintain an achievable path to getting there, actions like meeting with a financial planner; setting up direct deposit for a retirement account; creating an education savings account; or making a first retirement withdrawal.

The significance of some of these milestones are only recognized looking toward 2017, your advisor can help you read the gauges as wheels start turning on a possible mid-to-late cycle growth rebound, a new presidential cycle, and the efforts of corporate America to deliver profit growth. With conflict-free advice in hand, you’ll be able to calibrate your long-term financial plan in order to keep on course for reaching the milestones that are important to you.

DEFINITIONS

Purchasing Managers’ Indicators (PMIs) are economic indicators derived from monthly surveys of private sector companies, and are intended to show the economic health of the manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change. Two principal producers of PMIs are Markit Group, which conducts PMIs for over 30 countries worldwide, and the Institute for Supply Management (ISM), which conducts PMIs for the U.S. The U.S. Institute for Supply Managers (ISM) manufacturing index is an economic indicator derived from monthly surveys of private sector companies, and is intended to show the economic health of the U.S. manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change.

Quantitative easing (QE) is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the financial markets. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

INDEX DEFINITIONS

The MSCI EAFE Index is a free float-adjusted, market-capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada. The MSCI Emerging Markets Index is a free float-adjusted, market-capitalization index that is designed to measure the equity market performance of emerging markets.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolios of sophisticated investors.