

HEALTH WEALTH CAREER

ECONOMIC AND MARKET OUTLOOK 2018 AND BEYOND



The global economy is currently growing at its fastest pace since the financial crisis. We expect this strength to continue into 2018, with the recovery eventually being brought down by tighter monetary policy at some point over the next few years. Stronger capital investment and productivity growth should support economic activity overall, although productivity growth in the developed world is unlikely to return to the levels seen in previous decades and has been an area of disappointment. The strength of GDP growth seen in 2017 has been driven by China and, to a lesser extent, the eurozone, but in 2018 we expect the strength to be broad based, with China slowing down a little.

Inflation remained low in 2017, despite unemployment falling to very low levels in most developed countries. We expect that further falls in unemployment will put some upward pressure on inflation in 2018, especially in the US. In the eurozone and Japan, inflation is also likely to rise, although it should remain below central bank targets.

Equities have risen sharply in 2017, and the rally since 2009 is now one of the longest and largest on record. This rally has pushed valuations to rich levels in the US, although valuations remain more reasonable elsewhere. These valuations mean that the five to 10 year outlook for equities is less positive than it has been in a while. However, over the next 12 months, economic strength should support corporate profit growth, providing support for equities. Despite the robust growth, we are wary of chasing the rally too far given the high valuations in the US and the risk of higher bond yields.

Global bond yields have risen modestly this year. In 2018, we expect bond yields to rise more materially as the Federal Reserve continues to raise interest rates and global quantitative easing (QE) is slowly replaced by quantitative tightening (QT).

We remain optimistic about both emerging market economic growth and emerging market equities and debt. In contrast to the developed economies, where growth has been ongoing for several years, the recovery in emerging economies and markets remains in its infancy. It will be many years before most emerging market economies face capacity constraints, and we thus see the scope for strong economic growth, higher corporate earnings and positive equity market returns to continue for some time.

The biggest risk to almost all financial markets is if the Federal Reserve raises rates more aggressively than expected. If the Fed does so because of economic strength, then the impact on equities and other risk assets may be modest. If the Fed does so because it is concerned about higher inflation, then this could be more of a challenge to asset prices. Various remaining geopolitical risks are difficult to quantify, such as the risks of a trade war involving the US or a further escalation in tensions between the US and North Korea. Brexit discussions also have the potential to undermine the UK and the European Union. This note focuses primarily on what we see as the most likely outcome. Our usual quarterly dynamic asset allocation reports will provide updates as 2018 unfolds, and we will provide comment on any of these risks as they develop.

GLOBAL ECONOMIC OUTLOOK

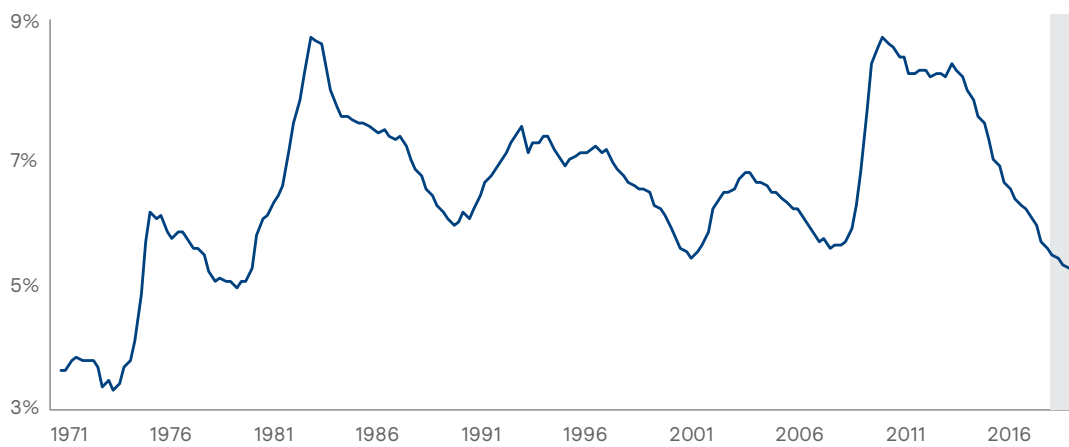
Economic growth in 2017 has been the strongest since the inventory-led rebound from the depths of the financial crisis in 2010. It has been on a par with the levels seen before the financial crisis. We expect this strength to continue in 2018, with most parts of the world seeing above-trend growth. Consumer spending should remain well supported on the back of very low unemployment (Figure 1) and slightly stronger wage growth, which has already boosted consumer confidence to very high levels (Figure 2). Business confidence is also at high levels, and that has led to strength in business investment. With profitability high and interest rates low, we expect this strength to continue.

The US is set to continue to grow at a decent pace in 2018. This strength is likely to occur regardless of whether the president succeeds in cutting taxes for businesses and individuals. Business spending strengthened in 2017 and is expected to continue into 2018. Consumption is also likely to be decent, supported by both employment growth and wage growth. Despite this better performance by the US economy, growth is likely to be weaker than seen in similar periods of strong growth in the 1990s and 2000s. This is because of less favorable demographics and weaker productivity growth that may reflect weak investment over recent years and, possibly, the difficulty of adequately measuring new technologies in GDP reports.



FIGURE 1: UNEMPLOYMENT AT MULTI-YEAR LOWS

Developed markets unemployment rate

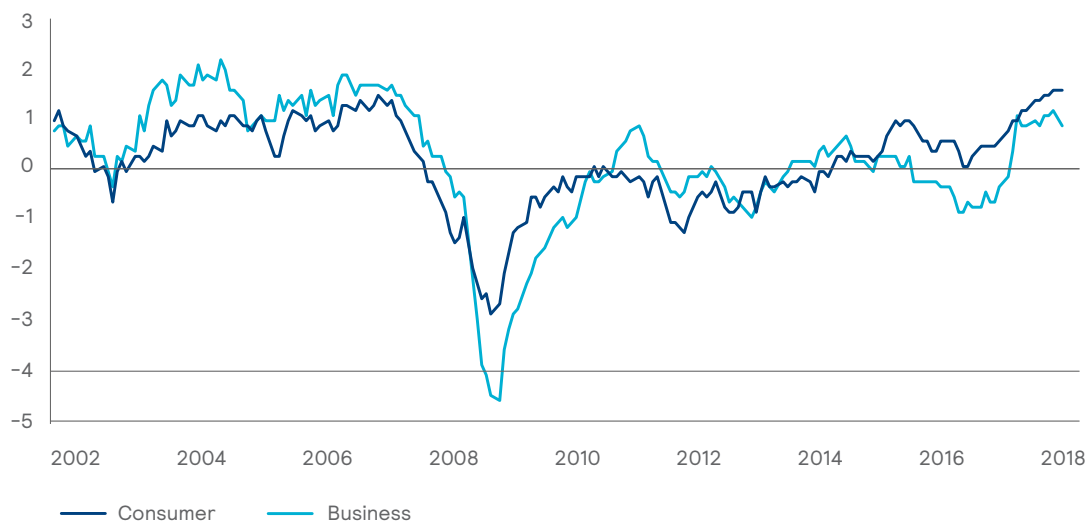


Source: JP Morgan

FIGURE 2: CONSUMER CONFIDENCE VERY HIGH

Global confidence

Standard deviation from 2010-forward average



Source: JP Morgan

Inflation in the US rose at the start of 2017 but has fallen since then. These falls have been difficult to explain given the ongoing strength in the labor market, recent weakness in the US dollar and firming commodity prices. At 1.3%, core inflation (on the PCE measure) is well below the Fed's 2% target and actually fell in 2017 (Figure 3). We expect this measure of core inflation to rise over the next 12 months to 2%, with some upside risks in the second half of next year if unemployment continues to fall sharply, which would put upward pressure on wage growth (Figure 4). Despite this, we remain alert to the possibility that powerful deflationary forces from globalization and technology could keep inflation lower than we and many expect.

Economic growth in the eurozone in 2017 has been at its strongest in many years and has been one of the key upward surprises this year. We expect this strength to continue in 2018, with strong investment supported by strong consumption growth as well. Political risks remain ever present, but, as has been the case in 2017, are unlikely to weaken growth. Unemployment, which has fallen by 1% over the last 12 months, is now at 8.8% – only slightly above the average seen since 2000. We expect unemployment to fall further to about 8% next year, which is probably close to the full employment rate. This could lead to some upward pressure on wages, but not to levels that are inflationary. Inflation in the eurozone remains well below the European Central Bank's (ECB's) 2% target. We expect core inflation to increase modestly in 2018 and 2019, but remain below 2% throughout.

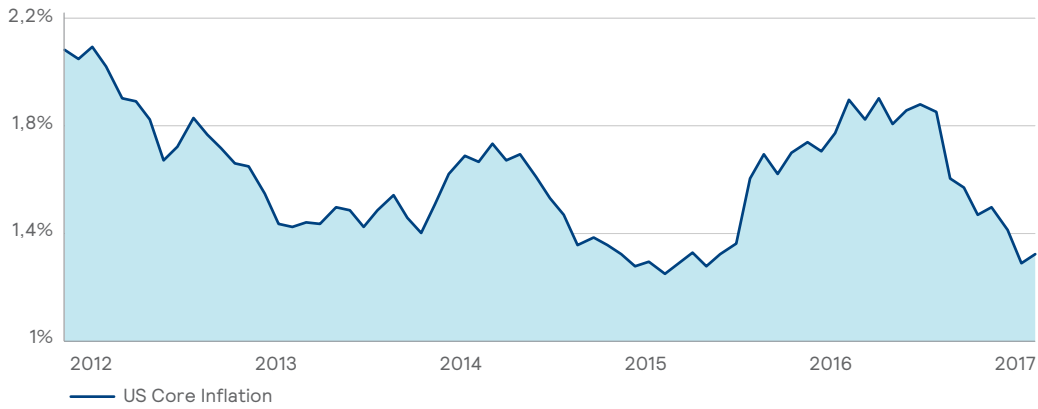
The UK underperformed the rest of the world in 2017, largely because of higher inflation on the back of the fall in sterling. With the currency now stable on a year-on-year basis, inflation has probably peaked and the drag on growth from higher inflation should fade as we move into 2018. However, unless progress is made in the Brexit discussions soon, businesses investment may weaken as businesses start to execute

contingency plans to guard against hard Brexit risks. How material business relocations will be on the whole economy is impossible to quantify. Our best guess is the UK will continue to grow but underperform other economies.

Japanese economic growth has been slightly stronger than expected over the year, and unemployment has fallen to its lowest rate since 1995. With Abe winning the recent election, political stability should lend support to the economy. Abenomics – the policy of reflating the economy using monetary and fiscal policy as well as structural reforms – has been a partial success to date, though meaningful structural reforms are unlikely to be implemented going forward. Economic growth is stronger than it has been for a while, and most measures of inflation are either zero or slightly positive. However, the economy needs to continue to perform well for some time to push inflation up toward the 2% the Bank of Japan (BoJ) seeks. We expect inflation to rise slightly in 2018 and 2019, but remain well below other countries and the BoJ's target.

After five years of persistent weakness, economic growth in emerging economies bottomed in the middle of 2016 and has strengthened since. Figure 5 shows that economic activity is currently at its strongest in the past few years. In the first half of 2017, the strength mostly came from China, but since then the strength has broadened, with most emerging economies now growing at a decent pace. Emerging economies have been helped by looser financial conditions at home, stronger export growth and stronger commodity prices. Emerging economies may strengthen further in 2018, although China may start to tighten policy by reining in credit growth now that the National Congress of the Communist Party is over. Although the recovery in the developed world is maturing in the emerging world, it remains in its infancy and therefore may continue for many years.

FIGURE 3: US CORE INFLATION SUBDUED, FELL IN 2017



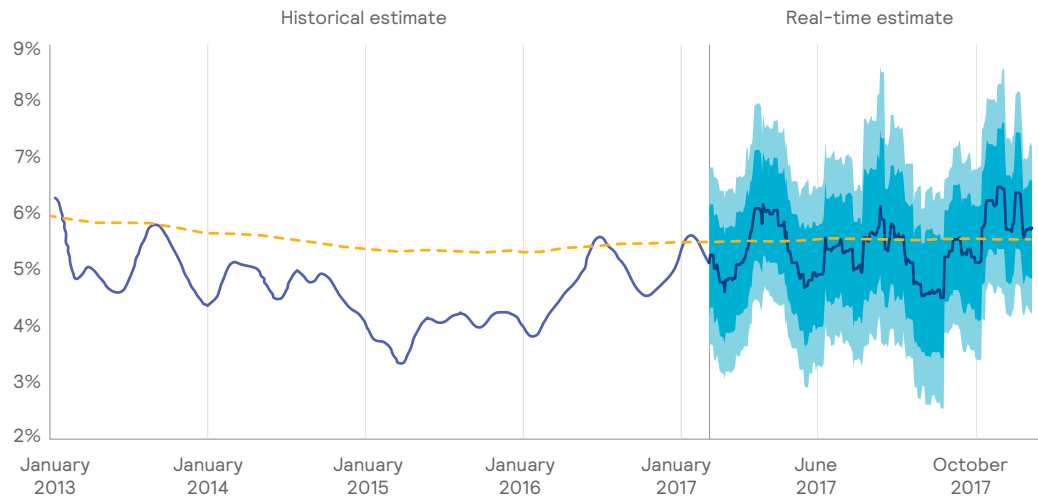
Source: Bloomberg

FIGURE 4: US WAGE PRESSURES BUILDING



Source: JP Morgan

FIGURE 5: EMERGING MARKETS – ECONOMIC ACTIVITY



Source: Fulcrum Asset Management

MONETARY POLICY OUTLOOK

Interest rate policy has been rather dull for quite some time. Some individual members of monetary policy committees have not changed interest rates during their entire tenures. There have, of course, been QE campaigns, but these have been very slow-moving and predictable. Over the next few years, monetary policy is set to become much less predictable and thus has more potential to impact financial markets than it has in recent years — for good or ill.

We believe we are at the early stage of a multi-year exit from QE and zero or negative interest rates in the developed world. Exceptionally loose monetary policy has, at last, led to what appears to be a self-sustaining and self-reinforcing expansion that will slowly lead to monetary policy being normalized. The process of normalization is most advanced in the US, which has already started to reduce the size of its balance sheet and raise interest rates.

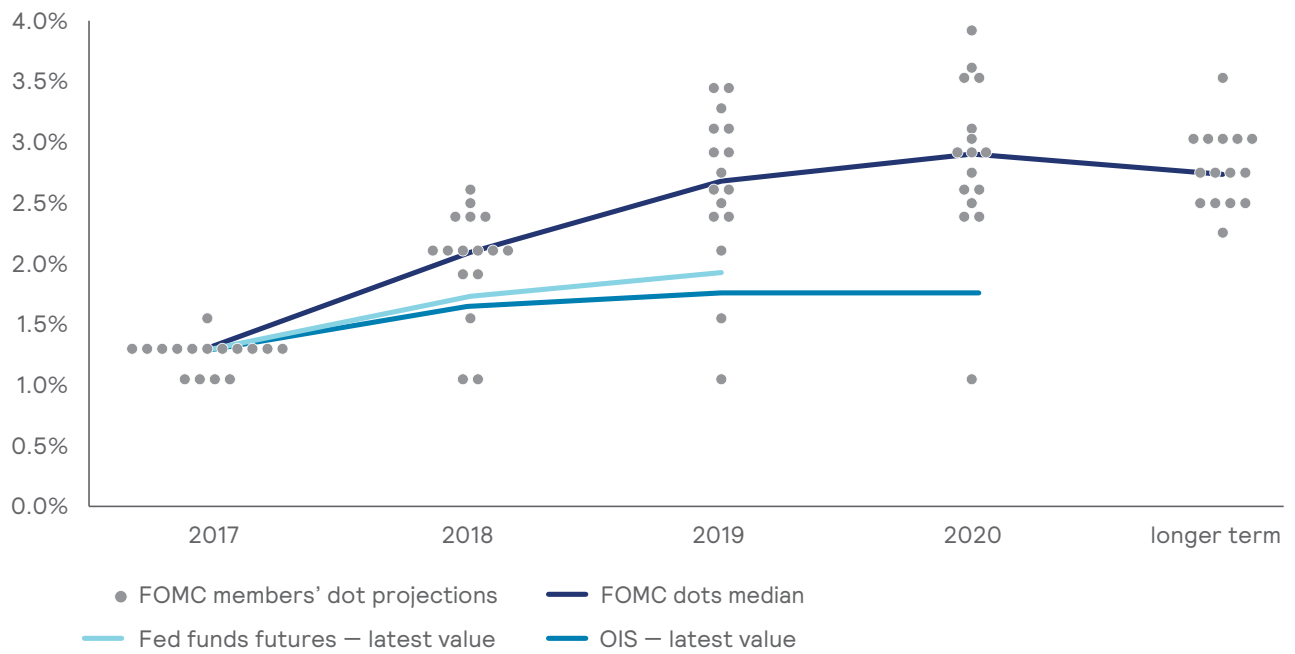
The eurozone and Japan are several years behind the US, because of the debt crisis in the eurozone and a reluctance to take action in Japan. The required action (aggressive QE) has now been taken, but the delay in implementing it means its removal remains a few years away. On the face of it, the UK is more like the US than the eurozone in terms of the need to do so and its externally loose monetary policy with unemployment now at the lowest level since the 1970s. However, while the Brexit uncertainty remains, the UK is unlikely to fully break free from the monetary policy regime seen over recent years.

Although it seems likely we are at the start of a multi-year period of monetary policy normalization, this doesn't necessarily mean that rates and yields will return to the levels seen in recent decades. Less favorable demographics and ongoing deflationary pressures from new technologies may keep yields lower than before, although we remain alert to populist pressures moving in the other direction.

In the US, we expect the Federal Reserve to raise interest rates three or four times next year, well above what looks to be priced into bond markets, and to continue to reduce the size of its balance sheet. Figure 6 shows the Fed's Dot Plot. The Dot Plot sets out where individual Federal Open Market Committee members speculate interest rates will be in the future. The average and median of these forecasts are just over 2% for the end of 2018 and just below 3% for the end of 2019. The purple line shows that bond markets are pricing in interest rates only at about 1.75% by the end of 2019. The BoJ and the ECB will proceed much more cautiously, continuing to buy bonds and keeping interest rates on hold. By the end of 2018, the ECB should have started to signal the end of its QE programs, but it has stressed it may err on the side of caution for some time; on the other hand, we expect the BoJ to retain some form of extraordinary monetary policy for the foreseeable future.

FIGURE 6: FED EXPECTS TO CONTINUE HIKING

Implied Fed funds target rate



Source: Bloomberg



MARKET OUTLOOK

EQUITIES

Equities have had another strong year. In fact, at the time of writing (November), US equities had risen for 13 consecutive months, the longest- ever monthly winning streak. The rally that began in 2009 is also one of the longest and largest on record, albeit following sharp falls in the preceding years. We believe equities will rise modestly in 2018, largely on the back of the economic strength that should lead to another year of strong earnings growth in most economies. Although we believe equities have started to climb into expensive territory, especially in the US, sentiment does not appear to be at the euphoric levels that presage the end of the bull market.

However, the strong returns in recent years probably mean weaker returns in the medium term, especially in the US. In the short term (a year or two), equity valuations tend not to play a dominant role in determining subsequent returns. Over longer time horizons (five to 10 years), valuations tend to be very important in determining subsequent returns. Somewhat intuitively, if you buy equities when they are cheap (that is, low cyclically adjusted price-to-earnings ratios or 'CAPE'), subsequent returns are better than if you buy them when they are expensive (that is, high CAPE). At the moment, CAPE is around 30, suggesting low real returns over the next decade. This should not be viewed as a forecast — especially as non-US equities do not look expensive. Rather, we believe that the balance of risks is not as favorable as it has been, and equities could be vulnerable if our economic outlook proves too optimistic or interest rates rise substantially.

We continue to believe that emerging market equities will outperform developed market equities. Although developed market equities have been increasing for almost nine years, the rally in emerging markets is relatively new, with emerging markets starting to rise only at the start of 2016, while the MSCI World Emerging Market Index is still lower than it was in 2011. With emerging market growth at last starting to pick up and likely to persist, we forecast that emerging market profits will rise over the next few years, which should continue to attract investors to the region.

DEVELOPED MARKET BONDS

Government bond yields have been range-bound in 2017, although they remain at exceptionally low levels everywhere. In the major bond markets, the most notable move has been the rise in two-year US bond yields, from around 1% to just over 1.5% in November. This rise was the result of the Fed raising interest rates by 0.25% in both March and June to 1.125%. Longer-dated bonds in the US and elsewhere were largely unchanged as investors continued to anticipate the Fed raising interest rates very slowly, with the main policy rate reaching only 2% in 2020. In addition, fears that the Trump presidency would yield much larger fiscal deficits have largely evaporated.

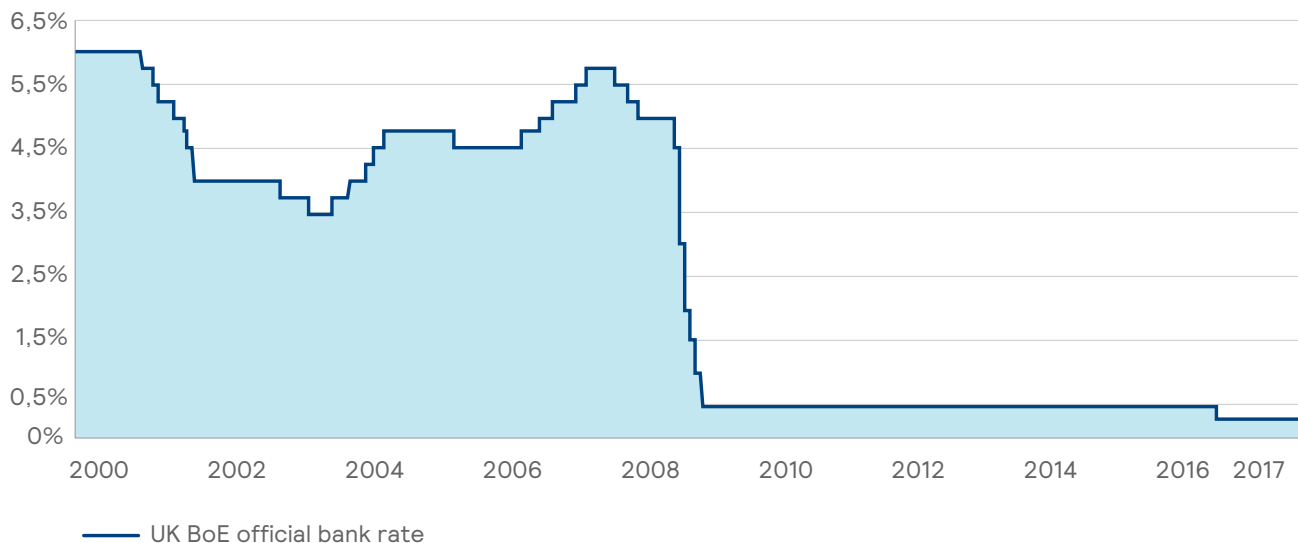
We expect the Fed to raise interest rates three or four times next year, as growth remains robust, unemployment falls further and inflation returns

slowly to target. This is likely to lead to higher yields in the US at all maturities, as the economy's ability to withstand high interest rates causes investors to increase their estimate of the long-run sustainable rate. The Fed's QT program – discussed later – may also put upward pressure on yields, although it is unclear by how much.

Government bond yields outside the US are also expected to rise, even though their central banks are likely to adopt a cautious approach

to withdrawing the current degree of monetary stimulus. In the UK, much depends on the success of ongoing Brexit discussions. At the moment, things remain very unclear, and unless progress is made soon, businesses may start to execute their contingency plans by relocating away from the UK, which would undermine activity. Conversely, any agreement that gives business confidence could prompt the Bank of England (BoE) to raise interest rates again having already unwound the post Brexit vote 0.25% cut in November (Figure 7).

FIGURE 7: BOE HIKES FOR FIRST TIME IN 10 YEARS



Source: Bloomberg

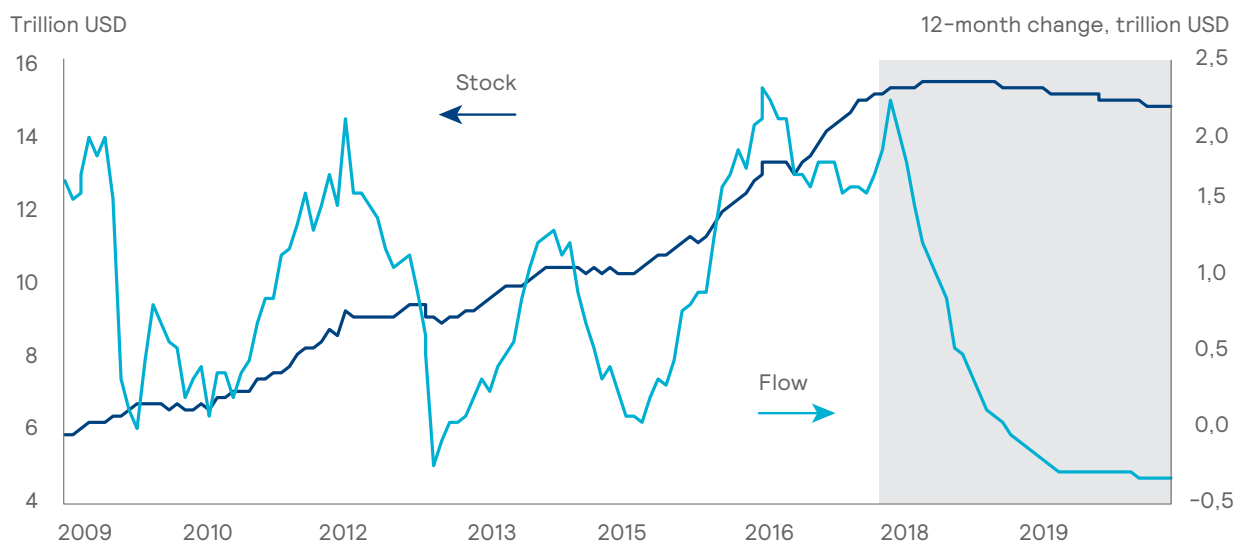
The Federal Reserve started reducing the size of its balance sheet in October by not re-investing all of its maturing bonds and principal repayments. The amount of bonds the Fed reinvests will fall slowly over time, and the Fed hopes that the reduction in the size of its balance will have no material impact on economies or markets. If the Fed continues with its current plans, then its balance sheet will be back to normal in about five years.

Although the Fed will be reducing the size of its balance, the ECB and the BoJ will continue to increase the size of theirs by buying bonds under their QE programs. The ECB announced that it will be buying €30 billion of bonds per month starting in January 2018, down from €60 billion per month in 2017, and this will continue until September 2018 or longer if inflation doesn't appear likely to return to target. The BoJ will also be continuing its QE program in 2018. Taken together, central banks will still be buyers of government bonds

in 2018, although at a much reduced rate than in recent years. If, as we expect, the ECB stops its QE program in 2019, then central banks will become net sellers in 2019 and for many years thereafter. If the ECB and the BoJ were to start shrinking their balance sheets at the same time as the Fed, these reductions would be very large. Figure 8 shows central bank bond buying over the last few years in yellow and a forecast for the next few years. The chart also shows the cumulative size of the balance sheets of the Fed, the BoJ, the ECB and the BoE.

Although the Fed is optimistic that its QT program will have a minor impact on the bond market, it should be noted that the amount of bonds bought by the public will need to rise substantially over the levels of recent years. If the ECB is also scaling down its QE purchases, there are risks that the rise in bond yields could be more significant than expected.

FIGURE 8: QE TURNS TO QT



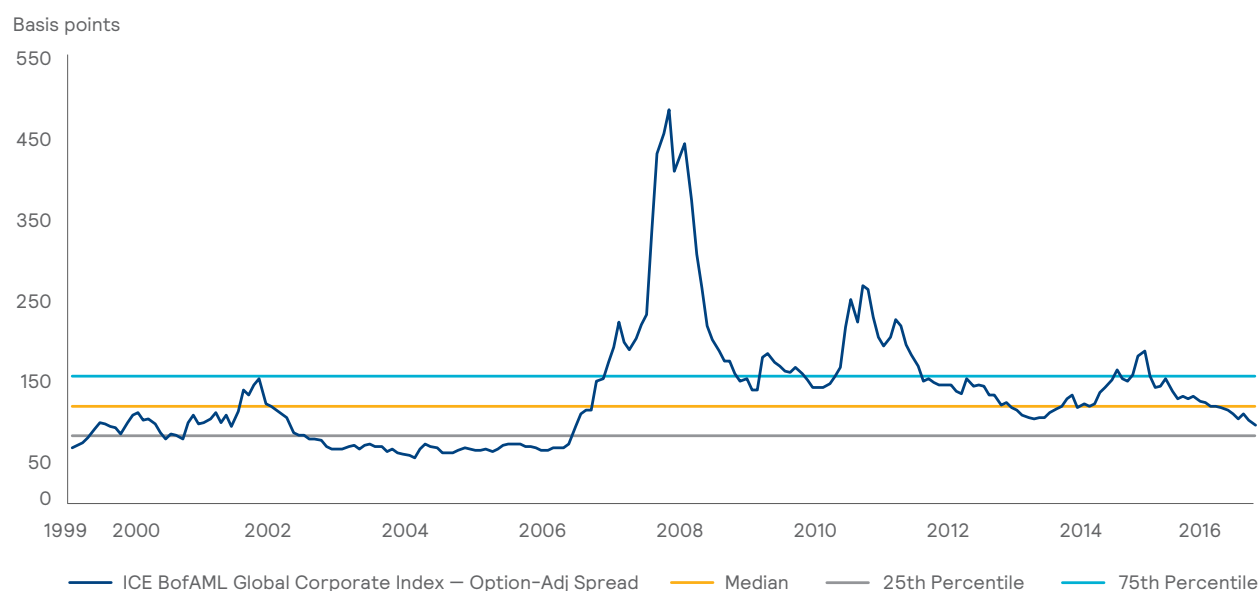
Source: Fed, ECB, BoJ, BoE, JP Morgan

CORPORATE BONDS

The performance of corporate bonds in 2018 will be a function, to some extent, of the performance of government bonds. As we expect government bonds to perform poorly, we believe corporate bonds will perform poorly as well. We expect corporate bonds to perform in line with or slightly ahead of government bonds in 2018,

as corporate defaults remain low because of the strength of the global economy. However, corporate bond spreads – the difference between the yield on government bonds and corporate bonds – are low and unlikely to go much lower (Figure 9). This means the upside for corporate bonds may be limited.

FIGURE 9: INVESTMENT GRADE CREDIT SPREADS TIGHTER THAN NORMAL



Source: Bloomberg

LOCAL CURRENCY EMERGING MARKET DEBT

The return on local currency emerging market debt is a function of the return of the bonds in local currency terms and the performance of those currencies in developed market terms. Yields in local currency terms are quite low, suggesting limited potential for bond prices to rally. However, with inflation low in most emerging economies and the possibility of further interest rate cuts in some, we believe local currency bond

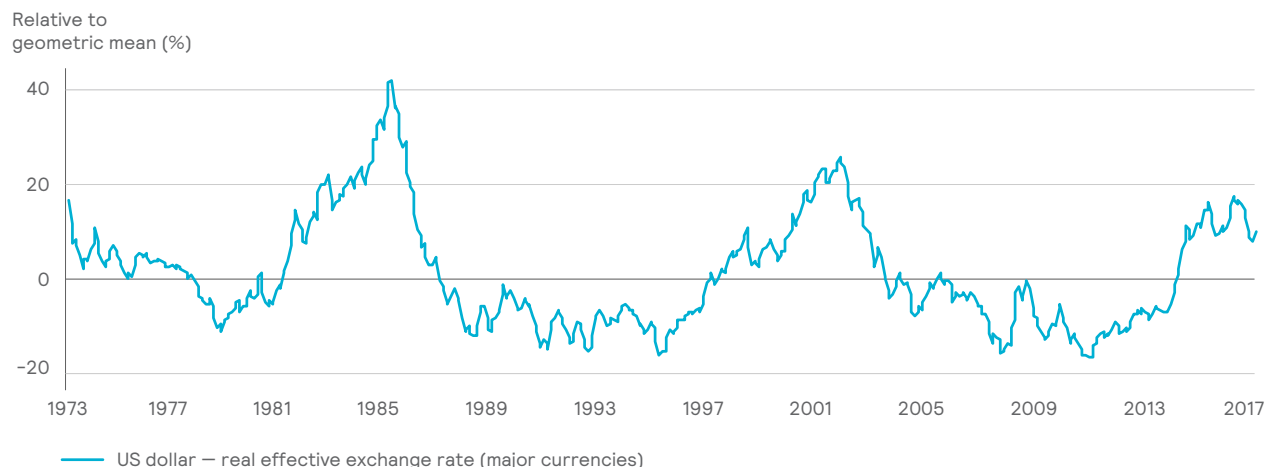
yields should be fairly stable yielding decent local currency returns. We also believe that emerging market currencies are moderately inexpensive and should rally against most developed world currencies in 2018. As a result, we believe local currency emerging market debt should do fairly well in 2018 and is the most attractive of the main fixed income asset classes next year.

FOREIGN EXCHANGE

The US dollar rose sharply at the end of 2016 but gave back most of those gains in 2017. Taking a slightly longer-term perspective, the US dollar rose sharply in 2014 and early 2015 and has been largely stable since (Figure 10). In 2017, the US dollar received some support from rising

interest rates in the US, compared with stable interest rates elsewhere. On the other hand, the US dollar was pressured by the strength of overseas economies and the lack of progress in implementing a variety of policies in Washington, DC.

FIGURE 10: US DOLLAR STABLE OVER THE LAST TWO YEARS



Source: Bloomberg

Over the next 12 months, we do not have strong views on the direction of the major currencies. Rising US interest rates versus stable interest rates elsewhere should continue to support the US dollar. However, ongoing economic strength outside the US will provide a headwind.

The fate of the sterling is likely to be almost wholly a function of the progress of the Brexit discussion. If the talks bring clarity and the likelihood of a favorable deal (which we won't

attempt to define), the sterling could rally. If the current fog continues, however, then the sterling could fall further. We believe the sterling is inexpensive, but that doesn't mean it will go up.

We remain positive on the outlook for emerging market currencies. We believe emerging market currencies are generally inexpensive, while their economies are in the early stages of what could be a prolonged period of economic strength.

SUMMARY AND CONCLUSION

The global economy appears to have entered a sustainable, coordinated upswing that we expect to continue in 2018. This economic strength should lead to continued growth in corporate profits. Inflation remains subdued, although we expect it to rise modestly in 2018, with downside risks diminishing further. The Fed is likely to continue to raise interest rates at a steady pace, while central banks outside the US will remain cautious, allowing their economic recoveries to continue.

Corporate profit growth and a still generally benign monetary environment provide a supportive backdrop to equities. However, we are worried about the possibility of periodic bouts of bond market weakness as the Fed continues to raise interest rates, and this could weigh on equities. Rich equity valuations in the US may also weigh on equity returns, especially over the medium to long term. Emerging markets remain attractive in both equity and foreign exchange terms, and we expect them to outperform the developed world, perhaps for some time.

The main risk to both economies and markets is monetary policy. Economies and equities (and, of course, bonds) could be undermined if the Fed raises interest rates aggressively, especially if this were the result of higher inflation. The usual cocktail of political risks remains. This report has not discussed these, although briefing will be provided, if necessary, as events unfold.



ABOUT MERCER

At Mercer, we make a difference in the lives of more than 110 million people every day by advancing their health, wealth, and careers. We're in the business of creating more secure and rewarding futures for our clients and their employees – whether we're designing affordable health plans, assuring income for retirement, or aligning workers with workforce needs. Using analysis and insights as catalysts for change, we anticipate and understand the individual impact of business decisions, now and in the future. We see people's current and future needs through a lens of innovation, and our holistic view, specialized expertise, and deep analytical rigor underpin each and every idea and solution we offer.

For more than 70 years, we've turned our insights into actions, enabling people around the globe to live, work, and retire well. At Mercer, we say we Make Tomorrow, Today.

For further information, please visit

www.mercer.ca

Join the conversation:

On Twitter: [@MercerCanada](https://twitter.com/MercerCanada)

On LinkedIn: www.linkedin.com/company/mercer-canada

Important Notices

References to Mercer shall be construed to include Mercer LLC and/or its associated companies. This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission. Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications. This does not constitute an offer to purchase or sell any securities. The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. For Mercer's conflict of interest disclosures, contact your Mercer representative or see www.mercer.ca/en/terms.html. This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Information contained herein has been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential, or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party. Investment management services in Canada provided by Mercer Global Investments Canada Limited. Investment advisory services provided by Mercer (Canada) Limited.

