ECONOMIC INSIGHTS

2017: How Policy and Politics Shape the Global Outlook

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Zane E. Brown
Partner, Fixed Income Strategist

Factors such as fiscal policy and trade developments will influence major global economies in the year to come, with significant potential implications for U.S. investments.

In Brief

- Differences between the U.S. economy and many advanced economies with regard to monetary policy, currency movement, and economic growth may define investor preferences among many asset classes in 2017.
- In the shadow of "Brexit," trade tariffs between the United Kingdom and the European Union will result in more expensive imports and slower economic growth in both regions.
- Aggressive monetary policy in Japan continues to keep interest rates low and often negative. In China, growth seems dependent on government stimulus programs that are, however, losing their effectiveness.
- Investors may find more appealing options in the United States, where current modest growth rates may be boosted by policies of new U.S. leadership, including contributions from government spending and tax cuts.
- *The key takeaway*—A resilient U.S. economy, spurred by fiscal stimulus, could make 2017 a respectable year for a variety of U.S. investments.

As the dust settles from **the U.S. presidential election**, what might investors expect in the coming year? New U.S. leadership working with a Republican-unified Congress likely will have a meaningful impact on U.S. investment values, especially if legislation involving infrastructure spending, repatriation of U.S. corporate foreign cash, and tax reform become early priorities in 2017.

Just as influential will be macro factors that weigh on global growth and interest rates. The uncertainties of the "Brexit" process, as the United Kingdom negotiates its separation from the European Union (EU), the related tilt toward protectionism in many nations, the pursuit of currency weakness by major non-U.S. economies, and continued "lower for longer" interest-rate policy should combine to support interest in U.S. investments.

Differences between the U.S. economy and many advanced economies with regard to monetary policy, currency movement, and economic growth may define investor preferences among many asset classes in 2017. Here, we survey what 2017 may bring for major global economies—and key U.S. investment categories.

Bracing for Brexit

Brexit negotiations seem likely to lead to slower growth in the United Kingdom, as well as in the European Union, while U.S. growth appears relatively attractive, especially if Republican pro-growth initiatives are passed. British prime minister Theresa May's intention to begin exit negotiations with the European Union by the end of March 2017 has been compromised by a High Court ruling that requires Parliament's involvement. Parliament could delay the March date, and could include conditions that complicate the negotiating process.

Such uncertainties may serve to postpone business investment decisions within the United Kingdom or, worse, speed up decisions to relocate some operations outside the United Kingdom. Prime Minister May's hope may be that the U.S. trade uncertainties that accompany a Donald Trump presidency could encourage a more conciliatory approach by EU negotiators.

Lower for Longer

The Trump trade factor aside, Brexit negotiations could be contentious. The EU seems intent on making an example of the United Kingdom to avoid an exit contagion among other countries seeking preferential treatment on immigration quotas or economic contributions. Trade tariffs between the United Kingdom and the European Union will result in more expensive imports and slower economic growth in both regions. In addition, problems with adequate capital among some German banks and excessive nonperforming loans among many Italian banks seem positioned to further restrict growth in the European Union.

Without the ability to conduct coordinated fiscal stimulus among eurozone countries in the manner a Republican-unified Congress can create in the United States, a continuation of "lower for longer" interest rates by the European Central Bank seems to be the default policy response. Low and negative interest rates should continue to characterize much of the debt in the eurozone, increasing the relative appeal of U.S. interest rates, particularly U.S. corporate debt. In the United Kingdom and the European Union, slower growth, lower interest rates, and the potential for higher import prices may combine to create a "grass is greener" perspective of the United States with regard to many asset classes.

Japan and China Effects

Similar policies in Japan and China act to position U.S. assets favorably, in our opinion. Aggressive monetary policy in Japan continues to keep interest rates low, and often negative, creating demand there for higher-yielding U.S. fixed-income securities. Slow economic growth in Japan also helps position U.S. equities and U.S. high-yield debt favorably relative to Japanese alternatives.

Growth in China seems dependent on government stimulus programs that are losing their effectiveness. Exports fell for the seventh month in a row in October, for example, while incentives that promoted auto purchases are set to expire later this year. The government spending and credit growth that supported expansion in the first half of 2016 seem about to be reined in, according to research firm Cornerstone Macro.

Slower growth in China suggests the fortunes of emerging markets that are dependent on China growth also may suffer, reducing their investment allure. Once again, growth in the United States, enhanced by potential fiscal stimulus and relatively attractive rates, could continue to attract global investors.

U.S. Persistency

Even before the potential impact of fiscal stimulus, domestic consumption seemed capable of producing another year of U.S. gross domestic product growth close to 2.0%, despite some slowdown elsewhere in the world. Persistent job creation (the monthly average of new jobs added was 181,000 in 2016 through October 2016, according to the Bureau of Labor Statistics) and gradual wage improvement (+2.8% year over year, as of October) currently support domestic growth. President-elect Trump's growth initiatives and a Republican-unified Congress hold hope for meaningful economic contributions from government spending and tax cuts, potentially pushing the U.S. economy, and U.S. equities, higher.

Election Impact

While Trump will have Republican majorities in both the U.S. House and Senate, he will not be a typical pro-business Republican leader. His protectionist leanings could create headwinds for large U.S. companies that may have outsourced jobs. His penchant for trade restrictions could produce reciprocal policies from countries that represent significant markets for U.S.-made goods, creating growth obstacles for U.S. exporters. And a strengthening U.S. dollar, courtesy of Republican pro-growth policies, likely will also hurt overseas earnings of U.S. international companies.

The resulting environment suggests **small- and mid-cap U.S. stocks that are relatively U.S.-centric** may have better opportunities for earnings improvement. Similarly, economically sensitive companies in the high-yield bond sector are positioned to perform well, especially should a scenario unfold where yields on debt of higher credit quality are pressured from economic growth, the additional government debt issued to finance fiscal stimulus, and fear of rising inflation.

In addition to the fiscal stimulus of corporate and personal tax reform, U.S. infrastructure spending may generate bipartisan support and could create jobs and help economic growth. To the extent such spending is financed by tax-favored repatriation of foreign corporate cash, the stimulus could promote optimism about economic growth and stock market valuations in general. A similar program, which passed in 2004, taxed cash repatriation at 5.25%, and compelled the return of about half the $600 billion in cash outside the United States. This, in turn, produced an increase in job creation during the 15 months the program was in operation, and also encouraged increases in corporate dividends and share buybacks. With $2.5 trillion in overseas corporate cash currently sitting outside the United States, the economic and stock market impact could be even more meaningful this time.

U.S. Opportunities

Even without help from the government, the U.S. economy, in 2017, looks relatively attractive compared with the economies of much of the rest of the developed world (and China). In the context of a Trump presidency, U.S.-centric stocks, such as mid- and small-cap companies, face fewer challenges than larger, more globally focused firms whose non-U.S. sales and profits may be under pressure by political developments as well as the potential for slowing growth and currency weakness from other nations.

U.S. fixed income will continue to appear relatively attractive, especially lower-quality, economically sensitive debt and shorter-maturity, higher-yielding investment-grade alternatives. A resilient U.S. economy, spurred by fiscal stimulus, could make 2017 could a respectable year for a variety of U.S. investments.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise, and as interest rates rise, the prices of debt securities tend to fall. Investments in high-yield securities (sometimes called junk bonds) carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes. The longer the maturity date of a security, the greater the effect a change in interest rates is likely to have on its price.

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. Mid- and small-cap company stocks tend to be more volatile and may be less liquid than large-cap company stocks. Mid- and small-cap companies also may have more limited product lines, markets, or financial resources, and typically experience a higher risk of failure than large companies.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

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Gross Domestic Product (GDP): The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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