



#### Asset allocation: 2016 Outlook: The Case for normalization

Our global asset allocation strategists discuss several key themes and catalysts for the year ahead: First, rate normalization cycles have always been associated with significant price losses on 10-year Treasury securities. Second, although credit spreads tend to tighten with higher rates, the over-allocation to credit – especially high grade – tends to keep credit vulnerable to rate hikes. Third, the equity risk premium is at a 70-year high and should fall as rates rise, providing some upside to equities. Fourth, although oil should continue to be pressured by a rising dollar, it now looks close to fair value. Fifth, rising EM growth and more favorable positioning should support EM once US rates re-price the Fed. As a result, our asset allocation is overweight equities in the US and Japan but neutral European equities and underweight EM; underweight bonds, cash and commodities; and long the dollar.

#### Geopolitics: The EU's geopolitical crisis eclipses its economic crisis

Our geopolitical strategist considers the implications of the accelerating external and internal geopolitical threats to the EU. The migration crisis, the war in Syria, and tensions with Russia related to its association with the Ukraine are likely to push the economic disputes of the euro crisis to the back burner and bring the geopolitical dimension – the original motivation for European unity – back to the forefront. The still-incomplete Union now has to develop policy through a security lens, as bringing stability to its surroundings is vital to the stability of the EU.

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### Risks to the Outlook:

#### Downside risks

- **Fed exit tantrum.** We have assumed that the market's reaction to Fed normalization will be relatively muted, partly because we assume the Fed will strive, initially at least, to ease its way gradually into the exit process. Given the current gap between Fed expectations and market expectations, the reaction to the exit path we forecast, as well as to the tapering of reinvestment, could be substantially more negative than we envision. Ten-year yields could spike above the nearly 3% peak level reached during the taper tantrum in 2013. This shock could spill over into a sharp drop in risk asset values, with negative implications for consumer and business spending domestically, as well as major declines in emerging market and other risk assets abroad.
- **Inflation surge.** The negative scenario we have just described would be intensified substantially if the Fed proves to be significantly behind the curve and inflation pressures pick up more rapidly than expected, forcing the Fed to tighten policy a good deal more aggressively than now envisioned. This could easily happen if labor force participation continues to trend down, GDP growth picks up more in line with consensus expectations, and productivity growth remains depressed. Under these circumstances, unemployment could easily move below 4% over the year ahead, and wage inflation, which is already showing signs of stirring upward, could surge enough to influence longer-term inflation expectations and push up core price inflation substantially more than currently expected or desired.
- **European politics:** Our baseline expectation is that the common threat to security highlighted by the recent terror attacks in Paris unifies Europe at least temporarily. This should prevent various national idiosyncratic events from undermining area-wide stability. The risk is that the differences of opinion between countries on divisive themes like the refugee crisis spill over into other policy areas, creating less beneficial outcomes to situations such as Greek debt relief talks, the minority government in Portugal, fiscal