Risk or resilience?

As U.S. stock market indexes have reached record highs, global markets remain strong and have grown steadily over the first two quarters of the year. Corporate earnings are trending upward and U.S. business confidence indicators are climbing. What may be in store for the remainder of 2017?
Global growth on track

AFTER BEING ELECTED ON A PROMISE to disrupt Washington, President Donald Trump now finds his legislative agenda stalled, his administration shrouded in controversy and his approval ratings at record lows. Yet the U.S. economy continues to improve.

Around the globe, there is a steady drumbeat of geopolitical uncertainty. Voters in the U.K. and France ushered in sweeping changes to the political landscapes in those countries this spring, and Germany will hold its own elections in September. Then eyes turn to China, which will choose its future leadership before year’s end.

Through it all, the eurozone economy continues to strengthen and China is solidifying its position as the world’s No. 2 economy.

Global markets remain strong, despite the political changes.

“The resilience of the market is impressive,” says Phil Sanders, CFA, CEO of Waddell & Reed Financial, Inc. and CIO of Ivy Investment Management Co. “Given that resilience, what might investors expect for the remainder of the year?”

We still forecast global economic growth of 3.6% for 2017, unchanged from our annual outlook as the year began. That estimate reflects slightly faster growth in the eurozone and the U.K., versus our prior forecast, and slightly slower growth in the U.S.

“Based on our analysis, we think U.S. gross domestic product growth (GDP) is tracking at 2.3% for the year,” says Ivy Global Economist Derek Hamilton. “This is a slight downtick from our initial estimate of 2.5% for the year, but indicates the U.S. economy is still outpacing most other developed markets.”

<table>
<thead>
<tr>
<th>COUNTRY/ZONE</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global</td>
<td>3.1</td>
<td>3.6</td>
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<tr>
<td>Japan</td>
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<td>1.2</td>
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<tr>
<td>Eurozone</td>
<td>1.7</td>
<td>2.0</td>
</tr>
<tr>
<td>U.K.</td>
<td>1.8</td>
<td>1.3</td>
</tr>
<tr>
<td>U.S.</td>
<td>1.6</td>
<td>2.3</td>
</tr>
<tr>
<td>China</td>
<td>6.7</td>
<td>6.7</td>
</tr>
<tr>
<td>India</td>
<td>7.9</td>
<td>7.4</td>
</tr>
</tbody>
</table>

Sources: 2016, International Monetary Fund actual data; 2017, Ivy forecast.
Geopolitical change adds uncertainty

A NUMBER OF EUROPEAN countries held elections during the first half of 2017 that could impact the markets this year and into 2018.

Among the surprises were the shocking general election results in the U.K. Prime Minister Theresa May and her ruling Conservative Party lost a majority in Parliament just days before Brexit negotiations with the European Union (EU) were set to begin. We believe the Conservative push for fiscal austerity is likely to be tempered and Brexit negotiations now will be even more difficult.

France elected reform-minded Emmanuel Macron president in April and then gave his centrist party — named “En Marche!” — an overwhelming majority in the country’s parliamentary elections in June. Confidence in the French economy stands to rise if Macron is able to push through his reforms. Those include tackling the contentious issue of labor reform, reducing corporate taxes and cutting public spending, which topped out at a whopping 56.5% of GDP in 2016.

Angela Merkel of Germany, who has become a leading voice of the EU partnership in the wake of Brexit, seeks reelection for a fourth term as chancellor later this year. Italy is facing increased pressure for new elections, possibly as early as this fall. An attempt to establish electoral reforms among the country’s leading political parties failed in June, creating political and market instability in the EU’s third-largest economy.

At the same time, the synchronized growth of the global economy has benefitted emerging markets equities and currencies, although there have been some notable exceptions. The two strongest performing equity markets among emerging countries in the past year have been hurt by differing headwinds. Brazil has been negatively impacted by renewed charges of political and corporate corruption just as it exited a multi-year recession. Should the political will to continue fiscal reform wane, there is a risk the country could return to negative growth and poor equity market performance.

Russia, whose economy and budgets are heavily influenced by the price of oil, has had a poor start to the year because of the underperforming energy sector.

China will appoint a large portion of its future leadership when the 19th Party Congress convenes later this year. While five of the seven current members on the Politburo Standing Committee could be replaced, we think President Xi Jinping’s economic agenda is unlikely to be affected. An increase in exports, improving corporate profits and continued government spending is likely to fuel China’s sustained economic growth in the 6.5 – 7.0% range.

In general, we believe positive global trade, strong domestic consumption in Asia and positive conditions for technology, consumer durables and selective financial services firms are likely to continue to provide support for emerging economies in the second half of the year. India, Indonesia and South Korea also could benefit from strengthened fiscal policy programs now under way.

What’s next for the Trump agenda?

AIDED BY REPUBLICAN MAJORITIES in the House of Representatives and Senate, Trump began his term with an aggressive agenda. His wish list is big: repeal and replace the Affordable Care Act (Obamacare), overhaul the budget, bring about comprehensive tax reform and deliver an infrastructure plan. However, we are six months into his presidency and Trump’s pro-growth agenda is stuck.

After failing in an initial attempt to pass healthcare reform legislation, the House Republicans passed the American Health Care Act (AHCA) in May. While the plan predicts a savings of $119 billion with the possibility of lower health premiums, the cost of an estimated 23 million Americans losing coverage makes the AHCA a tough pill to swallow for many. Senate Republicans began the summer working on their own reform bill, but it also faces strong opposition. Bipartisan agreement on healthcare is difficult, given the bitterness that consumes Washington today, and an acceptable replacement for Obamacare appears unlikely by year’s end.

We nevertheless think Republican leaders in Congress want to pursue legislation that shows their constituents they can fulfill election promises. There has been little movement on Trump’s proposed budget and infrastructure has yet to gain traction. We believe there could be movement on tax reform by early 2018 — or a possible tax cut — as next year’s mid-term elections draw closer.

Leaders in Congress want to pursue legislation that shows their constituents they can fulfill election promises.

Trade and immigration policy — two of Trump’s signature campaign issues — also will be watched carefully going forward. Proposals to revisit the North America Free Trade Agreement or other moves toward trade barriers coupled with restrictions on immigration could be harmful to U.S. and global economic growth.
Steady economic expansion

**U.S. ECONOMIC ACTIVITY** continues at a stable pace. After a surge in optimism following Trump’s inauguration, consumer confidence waned slightly in the spring, but remains upbeat overall. U.S. industrial production and exports are both up for the year.

Overall business confidence is trending upward. The Small Business Optimism Index has posted high optimism rates for six straight months, the longest streak in 34 years.

**SMALL BUSINESSES OPTIMISTIC ABOUT THE FUTURE**


Index readings are based on 1986 = 100 and show rising and falling rates of optimism.

**LARGE COMPANIES HAVE GROWING OPTIMISM**


*Projected. Data from CEO Economic Outlook Survey Diffusion Index; readings of 50 and above indicate optimism about business expansion.

Large companies also share this overall optimism. The CEO Economic Outlook Index reached its highest level in three years, while actual equipment spending and planned capital expenditures (CAPEX) both have increased within the first six months of 2017. We believe corporate spending will continue for the year.

Jobs and job growth are among the interesting conundrums of the U.S. economy. In May, the unemployment rate fell to 4.3%, the lowest in 16 years. However, job growth has decelerated from a monthly average of 181,000 jobs over the previous 12 months as the labor market nears a level that economists consider full employment. Job growth is likely to continue gradually slowing down as skilled labor becomes increasingly difficult to find, Hamilton says.

Even with the Trump agenda slowed, we think a sound domestic economy and strengthening corporate balance sheets will maintain a steady U.S. market trajectory.
Fed leads the way

WHILE THE STOCK MARKETS AROUND THE WORLD continue to post gains, there is a lingering question about the strength of the global economy. The result in part is a rising stock market yet a benign bond market, as evidenced by a flattening yield curve.

Some of this is predicated on activities of the U.S. Federal Reserve (Fed). As expected, the Fed raised the key federal funds rate by 0.25 percentage point on June 14 to a target range of 1.0 – 1.25%, furthering its efforts to normalize rates. Mark Beischel, Ivy’s Global Director of Fixed Income, believes an additional rate increase is possible in December.

The Fed also adjusted its inflation projections. It now believes inflation will fall short of its 2% target for the year and remain below that threshold in the short term.

Along with the latest rate hike, the Fed provided more detail on how it will begin to reduce its $4.5 trillion balance sheet. The Fed’s plan will implement a system of set limits for running down its portfolio, which includes Treasuries, mortgage-backed securities and government agency debt.

The Fed unveiled the plan to begin unwinding its $4.5 trillion balance sheet.

This roll-off cap approach will start at defined monthly levels — $6 billion for Treasuries; $4 billion for agency and mortgage debt — and increase by the monthly level each quarter for one year until the caps reach $30 billion and $20 billion a month, respectively.

Beischel says he anticipates the Fed will begin this process as early as September. The Fed’s actions followed a decision in early June by the European Central Bank to keep interest rates on hold for an extended period of time. Beischel says other central banks will pursue similar monetary policies based on the recent strength of the U.S. dollar.

Growth in an evolving market

WE BELIEVE REAL ECONOMIC GROWTH will remain muted for the longer term. That said, we believe inflation will drive greater nominal growth this year and Trump’s perceived aggressive stance on fiscal spending (infrastructure spending and tax cuts) will push out the risk of a global recession.

We believe global monetary policy remains relatively easy and we do not see that changing materially unless inflation accelerates at a higher pace than expected. We think further central bank easing is unlikely, while tapering and tightening is likely to occur through the year.

“The U.S. economy has been a global beacon of strength since late 2016,” says Sanders. “While the U.S. has continued a steady expansion, today, we see other parts of the global economy doing fairly well.”

In U.S. equities, the growth sectors, led by technology and healthcare, have outperformed value stocks for much of 2017. Energy and financials have lagged. Valuations have expanded, but, in our view, the levels remain reasonable.

While the U.S. continues a steady expansion, other parts of the global economy are doing well.

Long term, we think emerging market countries will try to improve their populations’ standards of living. To accomplish that goal, the countries will require stable economic growth above current levels. There are increasing signs of stress in these developing countries, although in many cases their growth remains ahead of their developed market counterparts.
Revisiting key sectors

AS WE LOOK AT HOW KEY SECTORS ARE PERFORMING AT MIDYEAR, TECHNOLOGY SHINES AMONG growth sectors while traditional value stalwarts like energy and financials continue to underperform. Proposed increases in defense spending also may offer potential for investors.

ENERGY
Despite small fluctuations in supply levels throughout the first half of 2017, oil inventories remain high relative to recent history. In May, the Organization of Petroleum Exporting Countries (OPEC) announced an agreement to maintain its current reduced output levels through March 2018 in an effort to support prices. David Ginther, CPA, co-portfolio manager of Ivy Energy Fund, says the market is dismissing a recent decline in inventories as insignificant, relative to the total inventory number. If crude oil remains around $50 per barrel, he says, significant shortfalls in supply are likely within two years. On the global production stage, the U.S. is the only area where production is growing and that growth is not likely to compensate for growing global demand and declining rates from existing wells.

Ginther says he still believes there are potential opportunities within the oil sector at current prices. He estimates global oil demand is growing 1.2 – 1.4 million barrels per day (bpd), an increase of 20 – 40% compared to recent historical average. After two years of slowing supply growth, reacceleration has begun in certain areas of the world, with the U.S. leading the way. The pace of domestic supply growth could reach 1 million bpd by the end of 2017, Ginther says.

The market’s reaction to media reports remains the greatest source of volatility for oil prices now.

He also believes the market’s reaction to media reports remains the greatest source of volatility for oil prices now. Energy is a highly political sector and often subject to geopolitical risk. Ginther says the market is selectively pricing in fundamentals and is not taking all inputs into account.

TECHNOLOGY
One of 2017’s standout sectors has been technology. Fueled by gains in the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google-parent Alphabet), technology has delivered strong financial results amid continued secular shifts in the sector.

There is growing confidence in the economy among technology companies.

The semiconductor subsector has been a strong performer this year, with the semiconductor index advancing almost 50% since early 2016. We believe many technology stocks remain relatively inexpensive. Growing confidence in the economy and optimism within many companies’ management teams is likely to drive further corporate investment and may lead to renewed topline revenue growth.

HEALTHCARE
On the healthcare front, stocks across the sector have performed relatively well despite concerns about pricing pressure and policy uncertainty as a result of the debate in Washington. This uncertainty remains a risk for the sector in the near term.

In our view, biotechnology, healthcare technology systems and pharmaceuticals are among the greatest innovators and early adopters of new science and technology. Even with the concerns around drug pricing, we believe biotechnology and pharmaceutical companies that bring economic value to the market (fewer hospitalizations, better patient productivity, etc.) have the opportunity for appreciating stock prices.
FINANCIALS
While it has been delivering on returns at a slow and steady pace, the financial sector has lagged this year. Seeking to loosen the regulatory environment, House Republicans passed the Financial Choice Act, which would roll back the Dodd-Frank reforms enacted during the Obama administration. The bill also called for repealing the Volcker Rule, which restricts government-insured banks from engaging in risky investment activity. The bill now heads to the U.S. Senate, where it will face highly partisan scrutiny.

The first stage of the Department of Labor’s fiduciary rule officially went into effect in June. The rule, requiring financial advisors to act in the best interests of clients, is set for full roll out in January 2018.

DEFENSE
We remain optimistic on the defense sector. Trump’s proposed budget calls for a 10% increase in defense spending, including heavy investments in additional assets like jets and ships. Additional defense industries likely to see increases in spending include cybersecurity and information technology. Looming like a black cloud is the growing tension between the U.S. and North Korea. Despite global condemnation, Kim Jong Un’s regime continues undeterred in its quest toward nuclear weapons.

OTHER AREAS TO WATCH

<table>
<thead>
<tr>
<th>SECTOR/INDUSTRY</th>
<th>POTENTIAL ISSUES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aerospace, multi-conglomerates</td>
<td>Vulnerable to limits on trade, protectionist policies.</td>
</tr>
<tr>
<td>Automobiles</td>
<td>Concerns about production shifts outside U.S. may pressure stocks.</td>
</tr>
<tr>
<td>Consumer cycicals</td>
<td>Improved sentiment; tax reform delayed, pace of wage growth in question, but potential to boost spending.</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>Loosening of M&amp;A environment, perhaps easier approvals of pending proposed deals.</td>
</tr>
</tbody>
</table>

Growing tension between the U.S. and North Korea looms like a black cloud.

While it remains to be seen whether Trump gets everything he wants from Congress, we think increases in defense spending are likely, which bodes well for companies with government-funded defense contracts.

Past performance is not a guarantee of future results.
Investment return and principal value will fluctuate, and it is possible to lose money by investing. International investing involves additional risks, including currency fluctuations, political or economic conditions affecting the foreign country, and differences in accounting standards and foreign regulations. These risks are magnified in emerging markets. Investing in the energy sector can be riskier than other types of investment activities because of a range of factors, including price fluctuation caused by real and perceived inflationary trends and political developments, and the cost assumed by energy companies in complying with environmental safety regulations. These and other risks are more fully described in a Fund’s prospectus.

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