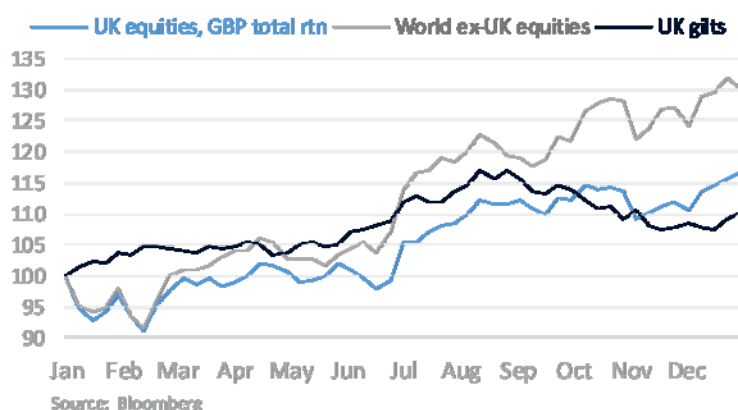


# GLOBAL INSIGHT

## Overview

- With sub-par growth and low inflation in 2016, a new US president taking office and Britain leaving the EU, our feature article looks forward to 2017.
- We assume a softer rather than harder Brexit but recent comments from PM Theresa May cast doubts on this assumption. Over the next year we expect slower growth rather than recession but also lots of uncertainty.
- In continental Europe, Italy looks like the weakest link. The government has trimmed its growth forecast to 1%; the banks have €356bn of bad loans; and a caretaker government faces strong anti-EU sentiment.
- No one has a detailed battle plan for Donald Trump's presidency. The markets hope for corporate tax cuts, extra infrastructure spending and less regulation but fear higher trade barriers and curbs on immigrant workers.
- Finally, the steep increase in Chinese corporate debt in recent years is the key risk in Asia. We think it is under control but we could be wrong
- In the Macro View, we point out that G7 growth may be less than 2% for the seventh year in a row in 2017, despite faster growth in the US.
- Despite rising oil and metals prices, inflation should remain low and so most central banks will be on hold, with the important exception of the US Fed.
- In the Investment Outlook, we have become more positive on equities and more cautious towards bonds.
- Among equity markets, we favour Europe and Japan (currency hedged) and are wary of the UK and the US. In fixed income markets, we see government yields moving higher with the possible exception of the UK.

International equities were best asset class in 2016



## HOTTINGER



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### Economic Highlights

- G7 economy is set for a 7th year of sub-2% growth
- The UK should weather the start of the Brexit process
- Trump has promised fiscal stimulus ... will he deliver?
- The Fed duly raised rates by 25bps in Dec but should be on hold in first half of 2017

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Based upon information  
available up to and including  
12th January 2017

## Key Issues in Charts

In June the UK voted to leave the EU ...



- On 23rd June the British people took the momentous decision to leave the EU. David Cameron stepped down as prime minister and was replaced by Theresa May.
- The key impact was a steep fall in sterling, which ended 2016 nearly 12% below its pre-vote level. Trading has often reflected hard versus soft Brexit mood swings.
- In contrast, the weaker pound buoyed large cap equities with overseas earnings. The FTSE 100 was up 16%.

In November Donald Trump was elected the 45th US President ...

- On 8th November Donald Trump won a bitter US presidential election by 304 electoral college votes to 227 but received 2.9m fewer votes than Hillary Clinton
- Financial markets fell shortly after the result but rebounded as the Trump team put out a pro-growth message. The S&P 500 is up 6% since the election.
- However, the same message was bad for the US Treasury market. The 10yr yield has risen nearly 50 bps.



And in December Italy rejected constitutional reform



- PM Matteo Renzi lost a constitutional referendum on 4th December by the wide margin of 59% to 41%.
- The result was widely predicted and the markets took the news without fuss. Mr Renzi resigned and was replaced by a caretaker government.
- However, Italy's problems—a weak banking system, poor economic performance, an urgent need for structural reforms, strong anti-EU sentiment—remain.

## Looking Forward to 2017

After years of subpar growth and low inflation, 2017 starts with Donald Trump's promise to turn on the fiscal taps and with global economic policy uncertainty at a record high. Overall, markets should remain resilient and global growth should be around 3%. But there is a real danger of dramatic upset in Europe, the US and Asia. Here are some thoughts on what to watch out for.

*“Overall, markets should remain resilient and global growth should be around 3%.”*

Economic policy uncertainty hit fresh highs in 2016



Source: Baker, Bloom, Davis

**Brexit Begins.** Every preview of 2017 begins inevitably with the UK's decision to leave the EU. We assume a softer rather than harder Brexit, although this has been cast into doubt after recent comments by PM Theresa May, and, over the next year or so, we expect slower growth rather than recession. However, investor uncertainty is itself a risk and could become a self-fulfilling prophecy.

Sterling fell immediately after the Brexit vote and, in trade-weighted terms, depreciated by 15% during 2016, even though the economic impact was much less than feared. But, put simply, markets do not like uncertainty and Brexit is riddled with it.

It would not surprise us if credit spreads widened, as investors demand a higher premium against the risk of lower growth and higher risk of default. Already we have seen a rebound in ten year gilt yields due to an increased fear of higher inflation ahead and despite their safe haven qualities. And domestically-focused equities have struggled even as the share prices of FTSE 100 companies with strong overseas earnings have soared.

**Is Italy The Weakest Link?** In continental Europe, the most immediate cause for investor concern comes from Italy. The government has downgraded its growth forecast to a meagre 0.8% in 2016 and 1% in 2017 which implies a higher budget deficit than previously thought and less room for fiscal stimulus.

This worsening of public finances is unwelcome when Italy has the third largest sovereign debt burden in the world and several banks on the brink. Propping up a banking system with €356bn of non-performing loans is no easy matter.

Moreover, the planned bail-out of Banca Monte dei Paschi di Siena (BMPS) has brought tensions between Italy and the EU to a head. As it stands, a government intervention to the tune of €6.5bn is in place despite strong EU opposition to



*“The government has **downgraded its growth forecast** to a meagre 0.8% in 2016 and 1% in 2017.”*

*“Looming elections in France, Germany and the Netherlands also bear watching.”*



*“Trump’s protectionist stance will have an immediate impact on America’s direct trading partners but there may be a two year time lag before we see countries borrowing US dollars start to deleverage.”*

state aid in any industry and calls for BMPS’s private investors to be bailed-in.

Further market concerns stem from the political situation. The No vote in the Italian referendum has opened the door to an early general election and a possible win for the anti-euro opposition parties who have all threatened to pull Italy out of the euro.

It would be no surprise if the Italian people registered a protest vote. While Germany and France have at least weathered two eurozone recessions over the past decade, Italian GDP per head fell by more than 12% between 2007 and 2016, according to the IMF.

We recommend watching the spread between ten year Italian and German government bonds which is currently around 160 bps. This is nowhere near the levels of the 2011-12 eurozone debt crisis but we would get concerned if it climbs above 300 bps and continues rising.

Looming elections in France, the Netherlands and Germany also bear watching. Of these, the rise of the extreme right-wing party, Front National, in France is the most worrying. The party’s economic platform includes strict anti-immigration policies and is generally seen as market-unfriendly. While a victory might not instantly result in catastrophe, a Le Pen presidency could plant the seeds for a break up the Euro Area.

**A New US President.** No one has a detailed battle plan for Donald Trump’s presidency. The unexpected victory aside, specific policy pledges on the campaign were scarce and plans continue to be vague.

We do know, however, that Trump promised extra infrastructure and defence spending and that he is keen on corporate tax cuts. We also know that if he does revoke some of the world’s biggest trade deals, the move could have two effects – a stronger US dollar and a wider US current account deficit.

This will reinforce US growth’s reliance on consumer spending and exacerbate the slowdown of the export sector. It is also likely that the Federal Reserve will counterbalance easier fiscal policy by raising interest rates and that this in turn will raise bond yields further and cause volatility in the fixed income markets.

In practice, it is unlikely the Federal Reserve will carry out all three interest rate rises implied by its 2017 projections. Tighter monetary policy relies on a demand stimulus from Trumpian tax cuts. However, the tax cuts will take time to materialise and may not be all that expansionary, if Congress is not especially amenable to President Trump’s proposals.

Trump’s protectionist stance, including his call for a 45% tariff on trade with China, is genuinely dangerous for some other countries. The US dollar remains the key global reserve currency and so a decrease in US trade and therefore dollar availability together with dollar appreciation will place emerging markets under pressure to deleverage. Their dollar reserves will shrink and they will be increasingly unable to borrow more dollars.

This will have an immediate impact on America’s direct trading partners but there may be a two year time lag before we see countries borrowing US dollars start to deleverage.

**Is China Over-borrowed?** China may have a debt problem. Its credit-to-GDP ratio is worryingly high, having increased by roughly 60 percentage points over the past five years. An IMF study found that in 38 out of 43 global instances where the ratio grew by more than 30 percentage points, the result was a fi-

nancial crisis, much slower growth or both.

The real concern is that China's growth has been fuelling the rest of the world's post-2008 recovery and its sheer size is so great that, if China has a crash landing, then there is no alternative economic engine to hand.

China's debt mountain is clearly a problem but there are good reasons to think the position as not as bad as some analysts fear. For one, China's *public* debt ratio is modest and so the government has room to take private sector bad debts onto the public balance sheet in the event of a corporate debt crisis.

Furthermore, Asia's role in world trade is likely to increase. The future Trump administration's policies are likely to withdraw the US from the world stage somewhat and, according to the Global Enabling Trade Report, ASEAN is now more open than both the EU and the US. Thus, a stronger Asia ex-China may help offset any glitch in Chinese growth.

The People's Bank of China did announce in December a "slight easing bias" to monetary policy and it seems likely that the government will attempt to stimulate the economy to grow out of its debt problems. But it stands that investors should keep this on the risk register and monitor China closely.

**A Frontier Market To Consider.** China has been notable over the past decade for investing in sub-Saharan Africa. The China-Africa Development Fund has invested a total of US\$4bn in Africa in nine years. The fund mainly focuses on long-term investment projects, although China's activity in sub-Saharan Africa as a whole is really not discriminating in any way.

Of all the countries, Kenya is the one to watch for investment. Over the past decade, the size of Kenya's economy has more than doubled and the revenues of many of its blue-chip firms have nearly tripled. In US dollar terms, the Nairobi Securities Exchange has gone nowhere but this looks set to change.

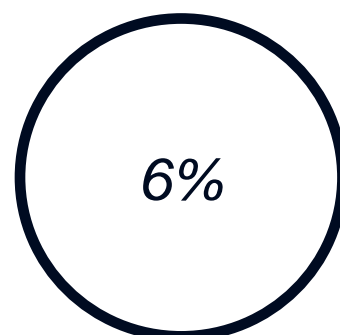
Kenya's GDP has been forecast to grow at a 6% pace through 2020 and the stock market will benefit from rising consumer spending and the arrival of foreign investors. We should of course stress that this is a frontier market and is not for the faint-hearted. Thorough due diligence is essential.

**Concluding Thoughts.** A stronger US dollar and less emphasis on monetary policy in the major economies could go some way to fuelling inflation this year and may favour equities relative to bonds.

A rising dollar could also make it easier for Europe to recover, as there is more room to import inflation via a weaker currency. With political instability a very real possibility, however, most forecasters have recently been marking down their forecasts for eurozone growth in 2017.

Investors should keep an eye on China's private debt bubble. A banking system bailout could rock the stock market and push up government borrowing costs but it is not time to panic yet.

***"The real concern is that China's economy so great that, if China has a crash landing, then there is no alternative economic engine to hand."***



*"Kenya's GDP has been forecast to grow at a 6% pace through 2020."*



**Growth of major seven economies**

## Macro View

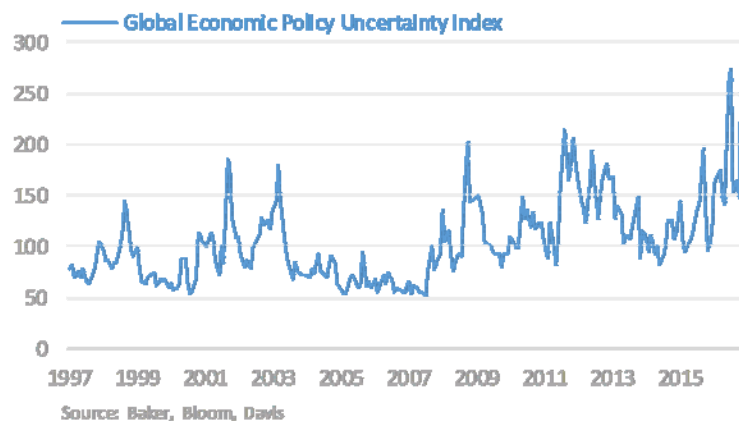
**2016 – A Moderate Year.** The word of the year to describe the global economy in 2016 is moderate. Moderate growth, very moderate inflation, moderate policy changes. The major seven economies grew by around 1.5% and inflation was about 0.8%, both well below forecasts at the start of the year.

G7 growth has now been less than 2% for six years in a row and we expect it to record a seventh in 2017. And the markets have spent more time worrying about deflation than inflation for much of the past five years. The 2010s have been a truly dismal time.

On the plus side, there was little genuine danger of either boom or bust in most of the G7 last year and any downward price pressures were narrowly focused. Moreover, the global economy sailed serenely through a series of major political upsets. Even so, it was a moderate year.

**UK – Divorce Proceedings.** It is impossible to discuss the UK economy without bearing in mind how the UK might leave the EU. We now know that there was no great impact after the vote. Growth was 0.6% qoq in the third quarter and around 0.4% in the fourth.

UK economy rides the Brexit storm



***“The UK’s long-run potential growth rate could be as much as 0.25% a year lower than otherwise.”***

So how will the Brexit effect unfold? Over the next couple of years, after Article 50 is triggered, presumably in March, there could be negative side-effects on both consumption and business investment from (probably) protracted and acrimonious talks. Of course, the talks could be short and harmonious. It just seems unlikely.

Beyond that, it is impossible to say because we do not know the timing or terms of EU exit nor the trade deals done with other nations. However, some scepticism is warranted. The UK’s long-run potential growth rate could be as much as 0.25% a year lower than otherwise.

In addition, 2017 growth will be dampened by not only Brexit uncertainties but also weaker consumption, as the weak pound boosts inflation and squeezes real incomes. Overall, we expect UK growth to be say 1.25%-1.5% and inflation to peak at just over 3% in 2017.

**United States – All Change.** America also had its defining political moment of the year when Donald Trump was elected the 45th President of the United States. During his campaign, he promised corporate tax cuts, infrastructure spending, deregulation, trade barriers and migration curbs.

The puzzle is how much might actually get done. Although both Congress and the president are Republican, they have different agendas. For example, Congressional Republicans are fiscally conservative such that it is unlikely that both tax cuts and spending increases will pass.

Fortunately, the American budget process moves along fairly smartly. The president will submit his budget during February and Congress should complete its scrutiny in June. So we should have a good idea of the extent of fiscal stimulus by mid-year. However, even if his proposals pass in full, the Fed may offset most of the fiscal stimulus with monetary tightening.

US growth picked up in the third quarter after three lacklustre quarters but has since retreated to around a 2% pace in the fourth. We think that annual average growth was 1.6% in 2016 and will be around 2.25% in 2017.

**Euro Area – Election Year.** Political factors are also at work in Europe. In December, the Italians voted No to constitutional change and, looking ahead, there are Dutch, French and German elections during 2017.

However, turbulent politics has not disturbed economic calm. Real GDP has increased steadily for 14 quarters in a row by an average of 0.4% a quarter. Encouragingly, growth is broad-based and the monetary fragmentation of 2011-12 has slowly healed.

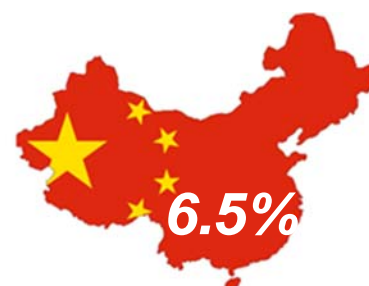
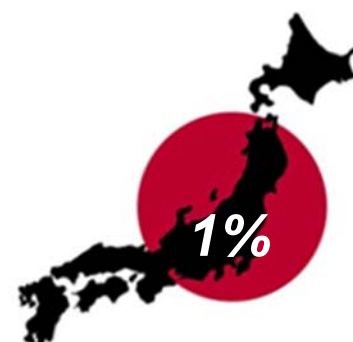
On the downside, though, the economy still relies upon the life support of very relaxed monetary policy; there is little chance of fiscal stimulus or structural reform; and the banking system remains fragile in places. Even so, both growth and inflation are likely to be around 1.5% this year.

**Japan – Waiting On Abe.** The key question in Japan is whether Abenomics will ever succeed in generating self-sustaining growth and inflation. The answer seems to be No, mainly because only one of the three arrows (monetary policy) has been truly fired. According to the IMF, fiscal policy was restrictive between 2011 and 2015 and is neutral now. And structural reform has been half-hearted at best. Expect growth and inflation of around 1% in 2017.

**China – In Transition.** The Chinese economy has defied Western analysts for several years. Worries about a debt crisis have succeeded fears of a hard landing but the economy continues to march on. China certainly has issues, as it aims to transform from a manufacturing/exporting economy to a consumer/services one, but we expect the economy to grow by around 6.5%.

**Central Banks – Parting Ways.** The central bank divergence trade remains in force. The FOMC pencilled in three rate increases into its forecasts for 2017, likely in June, September and December, with a big proviso that fiscal stimulus from the new president could strengthen the case for higher rates.

Meanwhile, the European Central Bank is still easing policy, even if the pace of quantitative easing will slow to €60bn a month from 1st April, and the Bank of Japan and the Bank of England are on hold.



*“But the equity markets greeted the prospect of “Trumponomics” with a sharp rotation from defensive to cyclical sectors.”*

## Investment Outlook

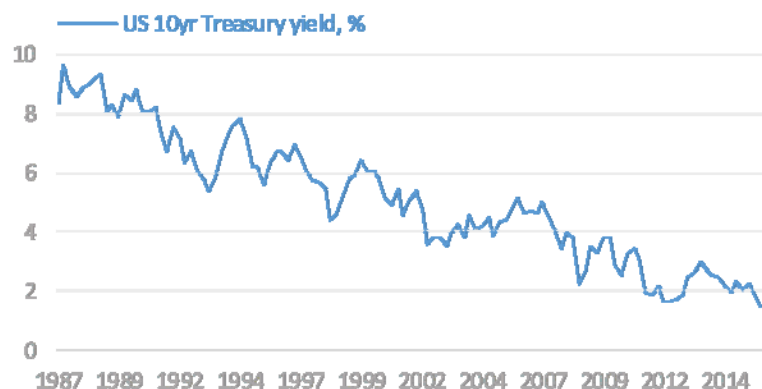
**Fourth Quarter Review.** If the UK's vote to leave the EU defined the third quarter, then Donald Trump's election as US President characterised the fourth. It was a pivotal moment for global investment markets.

Ahead of the November election, markets reacted nervously to any pro-Trump news, fearing protectionist policies from a president who had never held political office. In the event, market losses after the election result were short-lived as Trump's team wasted no time in putting out a pro-growth message.

Prior to the election, the US equity bull market was looking tired: valuations appeared stretched and corporate earnings were weak. But the equity markets greeted the prospect of “Trumponomics” with a sharp rotation from defensive to cyclical sectors. Financial stocks gained from a steeper yield curve; oil stocks rose on better growth prospects and an OPEC agreement; but “bond proxy” equities, such as utilities and consumer staples, posted declines.

Government bond yields had already started to rebound from their historic lows – the 10-year US Treasury bottomed at 1.36% – but the surprise Trump victory and fears of inflationary policies ahead led to an exodus out of sovereign bonds. The rise in yields was given further impetus by a 25bp rate increase from the Federal Reserve on 14th December. The US 10-year yield spiked to 2.60% and gilt and bund yields similarly rose.

Has 30 year bull market in Treasuries ended?



Source: Bloomberg

There was also a political shock in Italy last quarter. Prime Minister Matteo Renzi stepped down after his defeat in a constitutional referendum but, once again, markets were unfazed by the event. His replacement, Mr Gentiloni, is viewed as a safe appointment and should allow the government to focus on recapitalising the Italian banks.

**2017 Prospects.** Looking ahead, much rests on Donald Trump's first actions after his inauguration on 20th January. Thus far, his cabinet appointments have favoured political novices but business old hands and his policies appear both inflationary and pro-growth.

However, selecting Peter Navarro, a known China hawk, to run White House trade policy office has ruffled some feathers. Still, we assume that Trump



knows well that some 11.5 million US jobs are linked to export industries and that this may temper his sabre-rattling.

**Governments.** For government bond markets, the reflation trade since the summer may have further to run, underpinned by a shift from monetary to fiscal expansion. In particular, the new US administration will be raising funds for its infrastructure programme.

Paradoxically, it may look to the European Central Bank and the Bank of Japan to continue their asset purchase programmes to keep yields low and thereby make US Treasuries look relatively attractive. This should not present a risk in the short-term but both central banks have already scaled back monetary stimulus from unlimited purchases. Therefore, we remain underweight US Treasuries and eurozone bonds, and short duration.

UK gilts could be more interesting. The rise in the 10-year yield from 0.5% to 1.4% was driven by a rise in inflation expectations due to sterling weakness after the Brexit vote. But unless the pound continues falling, the increase in inflation should last only 12 months or so. Thus, there is some protection for gilt investors. In addition, the Bank of England stands ready to ease policy if the economy slows ahead of the UK leaving the EU.

**Credit.** Corporate bond markets had a good year in 2016. Credit spreads narrowed significantly; issuance reached record levels; and Bank of England and ECB purchases buoyed investment grade markets. Moreover, the high yield market, with its large exposure to the energy sector, profited from the recovery in the oil price, as defaults and bankruptcies receded.

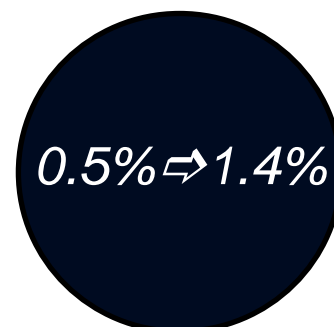
Nevertheless, Absolute Strategy Research points out that corporate debt levels are rising, a theme that could resonate in 2017. Emerging markets have accounted for much of the increase, particularly in China where nominal corporate debt levels have trebled since 2009. In Europe, there has been no aggregate deleveraging since 2009 and, in the US, corporate gearing is rising. In the short term, there is limited cause for alarm but these trends suggest caution.

**Equities.** Turning to the equity markets, in the US, the practice of issuing cheap debt to buy back shares has been a key support for share prices. The sharp rise in bond yields has made this trade less lucrative and removed a key source of demand for equity markets.

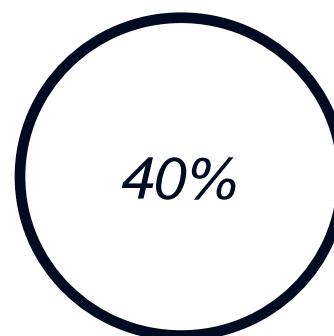
But the policies of President-elect Trump could provide a timely boost to companies' cash flows if corporate tax is slashed from 35% and a "tax holiday" allows US firms to repatriate up to \$2.5 trillion in foreign earnings. A corporate tax cut would provide the greater boost in directly increases earnings.

The year-end rally in US stocks was assisted by a positive earnings season in the third quarter after five quarters of a "profits recession". Elsewhere, third quarter earnings were lacklustre: earnings per share growth was stagnant in Europe and contracted in Japan. But the future is more positive: Morgan Stanley thinks that European EPS will grow in 2017 for the first time in five years.

Given that 40% of eurozone sales are made abroad, the weaker euro should boost many companies. In addition, the financial sector has been hampered by low interest rates but higher bond yields and improving economic data should help earnings going forward.



***“The rise in the 10-year yield from 0.5% to 1.4% was driven by a rise in inflation expectations due to sterling weakness after the Brexit vote. But unless the pound continues falling, the increase in inflation should last only 12 months or so.”***



***“Given that 40% of Eurozone sales are made abroad, the weaker euro should boost many companies.”***

*“The longer-term consequences of Brexit are unknown, however, on balance **we expect sterling to weaken amid the uncertainty.**”*



*“**China’s debt** has ballooned to 255% GDP and the risks are high.”*

Political risk has been a major concern for European investors, with elections due in the Netherlands, France and Germany, but the uncertainty should recede as the year progresses. Indeed, an election victory for Francois Fillon, once described as a "Gallic Thatcher", could be bullish for French equities.

In the UK, the fall in sterling after the EU referendum dominated earnings reports. Post-Brexit, companies with high overseas sales and profit exposure fared well. In contrast, imported inflation due to the weak pound has been bad for those companies unable to pass on price increases.

The longer-term consequences of Brexit are unknown, with talks yet to begin and the Prime Minister keeping her plans close to her chest. However, on balance we expect sterling to weaken amid the uncertainty, which may help the internationally-exposed FTSE100 but not the domestically-focused FTSE 250.

In Japan, a strong dollar and rising global yields delivered a much-needed decline in the yen. The Japanese equity market, with its bias towards exporters, has already risen as a result but we believe there could be more to come, given undemanding valuations, corporate reforms and supportive economic policies.

The US election result was a game-changer for emerging markets. Until November, attractive valuations, rising commodity prices and a stable US dollar were compelling. But Trump's policies are positive for the dollar and thus negative for emerging markets. The best hope is that the dollar levels off and fears of US rate hikes ease so that stronger US growth and increased commodity prices can benefit some emerging markets.

**Investment Outlook.** At first sight, financial markets appear set fair for 2017. However, we see four potential pitfalls which could upset the apple cart.

One, Donald Trump will be inaugurated on 20th January and markets have discounted much of the good news, including tax cuts, infrastructure spending and a bonfire of regulations. There is room for disappointment. Even if he is able to deliver his policies, the result could be an overheating economy, Fed rate hikes and problems for an over-valued equity market.

Two, the big danger in Europe is the rise of populist parties in a election year for the Netherlands, France and Germany.

Three, in Britain, the government is due to announce its Brexit plan this quarter. At present, markets assume there will be a soft rather than harder divorce but “there’s many a slip ‘twixt the cup and the lip”.

Four, China is making a difficult transition from a manufacturing/export-led economy to a services/consumption-based one. So far, so good but in the process China’s debt ratio has ballooned to 255% of GDP and the risks are high.

To sum up, we have become more positive on equity markets and more cautious towards bonds. In terms of equity regions, we favour Europe and Japan (currency hedged) where valuations are relatively attractive and the strong dollar favours the regions’ exporters. The UK faces a time of uncertainty but sterling weakness should lift the FTSE 100 to fresh highs. The US equity markets, already powering to record levels, may pause for breath once Mr Trump takes office. In fixed income markets, we see government yields moving higher except in the UK where the uncertainty over Brexit may lead to monetary easing later in the year.

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