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INVESTMENT VIEWS

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EQUITIES : The Trump reflation trade takes the US to new highs
BONDS : The global bond market sell off continues
CURRENCIES : The Yen slumps as the US dollar drives higher
COMMODITIES : Oil rises on production cut unity as gold slides

Across Europe, mainstream political parties are being forced to adopt the policies of more extreme, often right leaning, rivals. Anti-immigration, nationalism and euro-scepticism are on the rise, forcing incumbent centrist parties to veer right in an attempt to disarm protest parties that are drifting into the political mainstream. The Brexit and Trump victories are no longer seen as Anglo-Saxon anomalies, as the architects of the EU political construct are forced to re-engage with their distant, disgruntled, domestic electorates.

The EU faces various electoral tests in 2017. The Netherlands (15th March), France (23rd April) and Germany (before October 22nd) all have general elections. Italy and Greece may also go to the polls given the debt induced political instability plaguing those countries. Based on the 2016 experience, trying to parse the precise result of each election seems like foolishness, bordering on arrogance. However, there seems to be a few conclusions we can draw, regardless of the ballot results.

As noted above, the growing popularity of right wing parties in three key states (the German AfD, the Dutch PVV and the National Front - NF - in France) is forcing their opponents to embrace less EU integration and populist moves like banning the burka. The unexpected success of François Fillon, the Republican French Presidential candidate, owes much to policies that he shares with his key rival, the NF's Madame Le Pen. These include his hard line approach to Islam, national security and foreign policy. Even though he advocates remaining in the EU (unlike Madame Le Pen), he places far greater emphasis on national sovereignty than current incumbents. Thus, even if Le Pen fails in her bid for the Presidency, 2017 will herald a more inward looking France that is less committed to the EU and its need for greater integration.

A similar reality is evident in the Netherlands where Geert Wilders' far right PVV is favourite to win the most seats, displacing the more moderate VDD. The election is decided by proportional representation, suggesting that some form of coalition is all but inevitable. If the PVV wins, it will either form a ruling alliance aligned to its core values or make way for a brittle coalition of the minorities. Either way, a strong showing from the PVV suggests the Netherlands will soon become a less engaged member state.

Finally, Chancellor Merkel is looking increasingly weak as she runs for her 4th term in office. She has been forced to acknowledge the downside of her open embrace of mass immigration, as the AfD has exploited popular disquiet over domestic incidents blamed on immigrants. Corporate crises at national icons like VW, Deutsche Bank and Lufthansa have also undermined her hard won reputation for competence.

Here again, a form of proportional representation means that the more extreme elements will probably fail to achieve a ruling majority. However a possible six party fracture will undermine Merkel's authority as she is forced to compromise to corral a disparate coalition.

This matters as a strong Merkel has been the binding force during the many periods of EU crisis both during and after the 2007/08 meltdown. With a less assertive, inward looking Germany the unresolved challenges (Greek debt, Turkish relations, Italian banks) become a far greater threat to on-going EU unity. Furthermore, if the unexpected happens, the EU will be less able to react in an orderly, coherent fashion. If the 5 Star movement wins an Italian election or Le Pen become French President, Merkel will be a less effective unifying influence. The politians of southern Europe would find their voice.

So any crisis will be more of a threat to EU integrity as key member states turn inwards to address fractious domestic elections; largesse (financial or political) for the common EU good will not play well with increasingly Eurosceptic electorates. The unresolved, existential structural fragilities of the union will be re-examined.

This suggests that the ECB will be forced to remain uber supportive, even if a softer euro and global reflation pushes EU inflation beyond their 2% target. Fiscal repair and painful policies to improve productivity will be put on hold as unstable coalitions fail to assert their authority or "first time" governments pursue more populist agenda's. EU growth will remain in the doldrums, as productive capacity ossifies and debts rise.

Closer to home, with Prime Minster May set to trigger Brexit by the end of March, progress will stall until after the German election. Thereafter the nature and pace of the negotiation will be dictated by the new EU political landscape; the further the lurch to the right, the more likely the UK achieves an attractive deal.

Finally, the true winner in all of this is Putin. Trump is openly courting closer US/Russian ties and several major EU parties (including AfD, Renzi, 5 Star, Fillon and Le Pen) echo his sentiments. Even if the more hawkish elements of the US Congress tie Trumps hands in this regard, Russia will surely end 2017 with lighter sanctions and an enhanced presence on the world stage. With the rising oil price slowly dragging the Russian economy out of its recessionary malaise, it will be interesting to see what Putin does with his resurgent political and financial fortunes.

IN OTHER NEWS…

The failure of many to predict 2016 political outcomes was embarrassing, especially for those that purport to be political scientists. That said, even the most illustrious have fallen foul of the fickle fate of forecast folly, a few of which we share below.

"I see no good reason why the views given in this volume should shock the religious sensibilities of anyone" *Charles Darwin in the foreword to "The Origin of the Species" 1859*

"It will be years – not in my time – before any woman will become Prime Minister" *Margaret Thatcher, 1979 to 1990 UK Prime Minister, 1969*

"Stocks have reached what looks like a permanently high plateau" *Irving Fisher, Professor of Economics, Yale University, 1929*

EQUITIES

Several stock markets touched record highs last month, shrugging off the Italian referendum "No" vote, a liquidity squeeze in China's banking system and a well telegraphed US interest rate hike. A wave of terrorist attacks across Europe and the Middle East also failed to halt the advance. The MSCI World index added 2% in dollar terms.

The putative "Trumponomics" boost to growth helped underpin a resurgence of global "animal spirits", as a reflation zeitgeist started to take hold. US markets broke to new highs with the S&P 500 adding 2%. Economically sensitive stocks benefitted from this change in mood whilst bank shares continued their recent advance. As expected, the Federal Reserve announced a 0.25% base rate increase at its December meeting; it is only the second rate rise in a decade. Higher rates and rising bond yields make the spread between deposit taking and lending more profitable for the banks. Surprisingly hawkish comments from Chairwoman Yellen after the FOMC gathering reinforced the moves.

There remains huge uncertainty over the detail and delivery of Trump's policies but his Cabinet is starting to take shape. His nominees are dominated by business moguls with little experience of government. Though their combined net worth is estimated at a record U$10bn, it will be interesting to see how they deal with Washington "realpolitik".

The President-elect's proclivity for enforcing policy via the bully-pit of social media has already left its mark on some. A Twitter rant against Lockheed Martin, over the cost of its US fighter jet program, sparked a U$4bn slump in the firm's market capitalisation whilst Boeing faced similar scrutiny over the budget for a new Presidential jet. The healthcare sector also took a hit when a Trump tweet warmed to Clinton's plan to tackle egregious drug pricing.

Outside the US, global reflation and another 1% gain in the trade-weighted US dollar set the tone for equity markets. The greenback has now rallied by more than 5% since the election on rising rates and improved economic expectations.

The euro dropped almost 1% against the dollar last month; it lost more than 6% last quarter. The boost to EU export competitiveness has been reflected in upbeat manufacturing data, pushing the Eurostoxx index 8% higher in December. This came despite the emphatic defeat of Prime Minister Renzi in the Italian referendum on constitutional reform. On 4th December almost 60% of voters blocked his plans to dilute the Senate's powers; a prerequisite to passing much needed structural reforms. The loss prompted his resignation and the appointment of Paolo Gentiloni as the interim leader.

It could prove to be a short-lived promotion as a general election, possibly as soon this spring, seems likely. The market has so far taken this in its stride despite the subsequent collapse of debt-ridden Monte dei Pasche (MdP), the world's oldest bank. Renzi's removal scuppered a market based recapitalisation and the Italian parliament was forced to sanction a €20bn bank bailout fund; at least €5bn will be used to recapitalise MdP. The government has also promised to compensate the 40,000 retail savers who will lose their investments in the bank's debt securities, as they are "bailed in" under new EU bank rescue rules. The disregard of the new rules will anger northern European paymasters; German politicians have been vocal in their calls for strict enforcement.

Looking east, Japanese stocks continued to recover from their summer slump with the Topix gaining 3% and 15% over the month and quarter respectively. The move was accompanied by renewed selling of the Yen; an unhedged dollar investor would have lost money tracking the index over the quarter. Unlike past periods of currency weakness, exporters lagged the recent rally. In line with the global reflation trade, banks and cheap cyclical stocks outperformed. This rally has not gone unnoticed. Goldman Sachs reports overseas investors were net buyers during the final months of 2016, having dumped ¥16trn of Japanese stocks between mid-2015 and last September.

Underpinned by talk of firmer global growth, energy stocks were amongst the lead performers as non-OPEC producers aligned themselves with the cartel's November agreement to cut output. The WTI oil price gained 7%, to a 2016 high of U$54/barrel, whilst the Brent contract surged 16% to U$56/barrel. This helped the resource heavy FTSE 100 finish the year with a flourish as both BP and Royal Dutch Shell saw gains of over 10%. The mega-cap index ended 2016 at a record 7,143; a total annual return of 19%. It was flat for the year in US dollar terms due to the post-Brexit slide in sterling.

In emerging markets, the dollar's advance, rising bond yields and worries about the disruptive impact of Trump trade policies held back indices. A notable exception was Russia as the blossoming Trump/Putin bromance suggested punitive sanctions may wane; the RTSI ($) equity index added 12% in December.

Chinese listings also struggled amidst tightening liquidity conditions. Efforts to control domestic credit growth and signs of inflation led to a sharp bond sell-off, amplifying fears over the country's huge debt pile. The yield on 10 year China sovereign debt rose from 2.7% in October to a December high of 3.4%. The Hang Seng echoed mainland concerns, losing 4%. Property developers also weighed on the index, as rising dollar loan rates and increased stamp duty cast a shadow over elevated residential values.

In Latin America stocks headed lower, as Trump trade worries amplified country specific concerns. In Brazil, the Bovespa fell 3%. The economy remains under strain, losing 1.5m jobs in 2016 (source: Macrostrategy). Though arguably making positive policy progress, President Temer is now facing corruption allegations. Over 60% of Brazilians want him to resign. Whilst obviously troubled, local markets have already priced in a lot of bad news.

BONDS

The US Treasury sell-off continued last month, with the US 10 year Treasury yield rising 0.1% to 2.5%. Inflation expectations are rising, albeit from a low base, due to rebounding commodity prices and Trump's pledges. On the face of it, his infrastructure, immigration, tax and anti-trade plans are inflationary. That said, Republican Senate Majority leader, Mitch McConnell, considers the level of accumulated US debt to be "dangerous" and wants policies to avoid adding to the budget deficit. Despite two Republican houses, we suspect that Trump may not have it all his own way when his proposals finally reach Congress; delivery may fall well short of rhetoric.

Whilst the Fed's 0.25% rate rise had been well flagged, Yellen's hawkish comments at the subsequent press conference came as a surprise. Judging by the "dot plot" guidance, policymakers now expect 3, rather than 2, quarter point rate hikes in 2017. This time last year they forecast 4; 1 materialised. 2017 could well follow a similar pattern.

UK inflation risks continue to mount with CPI accelerating to a 2 year high of 1.2% y/y in November, driven by clothing and fuel. Indeed, Brent oil finished the year with an annual gain of 83% in sterling terms. Firms with overseas production costs are already reacting; during the Christmas week, Tesla announced a 5% price rise on all models from 1st January. It echoed fellow carmakers in blaming "currency fluctuations". Despite this, the 10-year gilt yield slipped 0.2%, finishing the year at 1.2%. We feel gilts remain vulnerable as the impact of a soft sterling starts to show up in 2017 data.

Core European sovereign debt markets also rallied last month as the ECB reinforced its dovish stance. Inflation remains quiescent in the Eurozone despite an upturn in economic activity during the final quarter; the weak euro is helping to fill exporters' order books with a key manufacturing survey (the PMI) hitting a 5-year high in December. A 10-year German Bund now offers a yield of 0.2%, down from 0.3% at the start of last month.

Perhaps the most significant bond market correction is taking place in China; the 10-year government bond yield spiked from 2.7% to 3.1% and, as noted above, hit 3.4% intra-month. Rising commodity prices and tight labour markets pushed producer price inflation from 0.1% y/y in September to 3.3%.

Short-term borrowing costs in China have also surged, as Authorities try to manage credit growth and related asset inflation. In Hong Kong, 1month HIBOR (the inter-bank lending rate) rose from 0.4% to 0.75% in December, indicating a shortage of liquid funds in the system. The mainland equivalent (SHIBOR) followed suit, rising from 2.9% to 3.3%. The exact cause is hard to divine, but some banks seem to be hoarding cash ahead of an earlier than usual Lunar New Year. New regulations, demanding banks raise fresh capital, have also been blamed. To avoid disorderly markets, the Central Bank provided several billion yuan of loans to the banks. With capital outflows from China accelerating into the year end, the evident fragility of the Chinese debt pyramid remains a point of concern.

CURRENCIES

The rise in US rates spurred fresh gains for the dollar last month, especially against the Japanese yen and the euro. The spread between US and German 10 year sovereign yields touched 2.4%, the most since 1989. The move was driven by divergent Central Bank policies and inflation outlooks; the Fed seems committed to raising interest rates, whilst the ECB continues to ease. At its December meeting, the latter announced a reduction in its monthly bond purchases from €80bn to €60bn, but extended the scheduled expiry from March to the year-end. This dragged the euro 1% lower to U$1.05; we have sympathy with talk of euro/dollar parity.

The Aussie dollar was another laggard, falling 2% to U$0.72. Economic concerns intensified with Q3 GDP shrinking 0.5%, the first contraction since 2011. With the base rate at 1.5% and inflation of 1.3%, there is scope for rates to fall further. That said, the latest RBA minutes suggest policymakers feel constrained by a rampant housing market. Even cheaper money could create an unsustainable housing bubble, with many cities bid up by overseas buyers (the Chinese in particular). If the recent rise in commodity prices moderates and China continues to slow, the Aussie could well drift lower as we move through 2017.

The fallout from Prime Minister Modi's shock November 8th decision to remove all 500 and 1,000 rupee notes from circulation continued last month. The Indian currency initially rallied, but finished December little changed around INR68. With over 85% of all transactions being cash based, the demonetisation has impaired growth; a host of indicators point to an abrupt slowdown in the fourth quarter. India remains an interesting potential investment, but we wait to see if the political fallout from this policy threatens Modi's longevity.

Sterling firmed at the start of the month, almost touching U$1.28 against the dollar, before falling back to $1.23. Comments from David Davis and PM May provided some support as both hinted they would be receptive to a transitional Brexit deal. This could smooth the commercial relationship with Europe until long-term trade accords are agreed.

Finally, the Chinese authorities have introduced a raft of measures to limit currency outflows, as domestic investors seek non Yuan assets. The Chinese currency fell 6% against the dollar and a basket of its major trading partners in 2016, ending at CNY6.98/U$1. Even though intervention by authorities may stem the outflows in the short term, the relative growth, inflation and interest rate outlook suggests the yuan will remain under pressure. The chances of a one off devaluation remain. That said, we doubt the economy will be allowed to roll over ahead of this autumn's National People's Congress; President Xi hopes to consolidate power at the gathering. As a result, credit growth continued to accelerate, rising by CNY18trn in the year to November. The increase equates to 26% of total Chinese GDP, illustrating the government's powerful commitment to economic stability.

GOLD/COMMODITIES

The agreement by non-OPEC members to curtail their daily oil production by 0.558m barrels per day (bpd) gave fresh impetus to the oil price last month. The move added to the 1.2m bpd quota cut already announced by OPEC. Even though these cuts represent almost 2% of current daily output, mixed views on the supply outlook remain.

Though many analysts believe that the oil market will tighten, if history is anything to go by, some of the cartel members may fail to meet their commitments. High existing inventories could also limit the impact of the cuts, whilst the US shale oil industry will also be a factor. The crude rally has reignited US output with the number of active rigs rising 66% from the summer nadir, to 525 (source: Baker Hughes). A collapse in junk bond energy spreads is helping to finance the revival; last month Chesapeake, a US energy firm, increased a private placement of 8% senior debt notes from U$750mn to U$1bn due to high demand. Set against this, the unfolding economic and political collapse of Venezuela puts its 2m bpd of output at risk. On balance we see oil being range bound around the $45-$60 levels.

Rising economic optimism and the Fed's talk of for a faster tightening in 2017 prompted a 2% fall in the gold price last month. Given our less rosy outlook for growth, we retain our bullion holdings. Many industrial metals also suffered losses despite better Chinese data. The China Beige Book noted activity increased across all industries in the final quarter. Iron ore and coking coal were amongst the worst performers, as investors booked profits ahead of the year end. High inventories in these markets are also weighing on sentiment.

POLICY SUMMARY MATRIX

The matrix set out below is a summary of our current policy stance on the various equity and bond markets which we monitor. It is not intended as anything other than a guide on where we stand and we will change the content as our views alter. Cash exposure is a residual and will tend to be high when negatives outweigh positives and vice versa.

6-12 MONTH VIEW	OVERALL	EQUITIES	BONDS	ALTERNATIVES
+	ALTERNATIVES	Latin America	Inflation Linked	Uncorrelated Strategies, Gold
O		UK, Australian Asia, High Yield Technology Healthcare Resources	Australian	
−	EQUITIES BONDS	US, European Japanese	US, UK European Japanese Corporate High Yield	

MARKET PERFORMANCE

All performance numbers show % changes except for bond yields which show yield changes.

	31-DEC-16	1 MTH	3 MTH	12 MTH
CURRENCIES (VS USD)				
GBP	1.2340	-1.3%	-4.9%	-16.3%
CHF	0.9815	-0.1%	-4.7%	-1.6%
AUD	0.7208	-2.4%	-5.9%	-1.1%
JPY	116.96	-2.2%	-13.4%	+2.8%
EUR	1.0517	-0.7%	-6.4%	-3.2%
BOND YIELDS (10 yr)				
UK	1.24	-0.18	+0.49	-0.72
US	2.45	+0.06	+0.85	+0.18
Germany	0.20	-0.07	+0.33	-0.42
Australia	2.77	+0.04	+0.86	-0.12
Japan	0.04	+0.02	+0.14	-0.22
EQUITIES				
US. S&P 500 (USD)	2,238.83	+1.8%	+3.3%	+9.5%
UK. FTSE 100 (GBP)	7,142.83	+5.3%	+3.5%	+14.4%
MSCI Europe ex UK (EUR)	1,210.70	+5.9%	+5.8%	-0.3%
Japan. Topix (JPY)	1,518.61	+3.3%	+14.8%	-1.9%
China. Shanghai Comp (RMB)	3,103.64	-4.5%	+3.3%	-12.3%
HK. Hang Seng (HKD)	22,000.56	-3.5%	-5.6%	+0.4%
Australia. All Ords (AUD)	5,719.10	+3.9%	+3.5%	+7.0%
MSCI Pacific ex Japan (USD)	1,172.68	-0.7%	-3.4%	+3.6%
MSCI World (USD)	1,751.22	+2.3%	+1.5%	+5.3%
MSCI World (GBP)	1,418.57	+3.6%	+6.6%	+25.7%
COMMODITIES				
Oil (WTI)	53.72	+6.7%	+7.6%	+20.5%
Gold	1,152.27	-1.8%	-12.4%	+8.6%

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