MARKET INSIGHT

2016 Review / 2017 Outlook

Harold Wilson is attributed as saying that a week is a long time in politics. One wonders what he would have made of the political drama throughout 2016, an extraordinary year of political upheaval where the improbable became routine. It was also a year when markets were more influenced by political shenanigans rather than central bank pronouncements on interest rate policy and monetary easing (QE) from which they regularly took their lead in recent years. 2016 started with some confident assumptions about how the politics would all pan out.

In the UK, despite Prime Minister David Cameron returning from his EU negotiations with little to show for it, the alarm bells hadn't started ringing in government as late as February. The campaign for leaving was fragmented between different groups lacking a coherent outlook and Remain was comfortably ahead in most of the polls. Indeed, when Cameron formally announced the referendum date of 23rd June, such was his confidence that it wouldn't happen, he threw in the intention to trigger the Article 50 process immediately following a leave vote; something that we now know is far less straightforward than originally thought.

"All political lives end in failure." - David Cameron's first words on learning he had lost the EU referendum

It wasn't just the polling agencies that got it wrong in 2016 as we saw with both Brexit and the US Presidential election. The post-election reaction of stock, bond and currency markets often flew in the face of warnings by politicians and central bankers. As UK justice secretary Michael Gove put it "people in this country have had enough of experts". When David Cameron threw in the towel unexpectedly early only a few hours after losing the UK referendum on 24th June, his sudden departure left a gaping hole in government on a day when Pound lost over 8% to the US dollar. The currency markets may not have liked it but the effect of a weaker Sterling gave an immediate boost to shares in overseas earners in the FTSE 100 index and, against all the dire warnings, the headline index rose 12% in a matter of weeks.

The UK bond market rose with it as nervous investors piled into the safe haven of Gilts. That particular fear trade only lasted 6 weeks before rebounding in the autumn but it was a reminder of how quickly markets can react to political uncertainty. As we all know, if there's one thing markets hate it's uncertainty, and markets were going to have to get used to it ahead of the US Presidential election.

"We'll either have the first female president or the first one who started a Twitter war with Cher." - Hillary Clinton

President Obama was, of course, not up for re-election but Republican Donald Trump's victory against Obama's Democrat replacement, Hillary Clinton, caught short-term traders facing in the wrong direction. Again, the media warnings of financial disaster were disregarded as the S&P500 index of leading US shares immediately began a 6% climb on its way to a record high into year-end. The US dollar also defied expectations, putting on a gain of 5% against major currencies.

"Is France a northern European export powerhouse, or a Mediterranean indebted and dependent economy? Yes to both." - Francois Hollande

Not to be left out, on the first day of December, Francois Hollande announced that he would be the first French President since the Second World War not to run for a second term in office. That he would fall on his sword was unexpected but the reality was that with the lowest popularity rating of any president since the war, his chances of winning were very low and markets initially shrugged off the news. However, the speculation over the prospect of National Front leader, Marine Le Pen, potentially winning the 2017 French presidential election would grow in the wake of the next political upset two days later in Italy.

"The amateurs are conquering the world because the 'experts' destroyed it." - Beppe Grillo, Leader of Italy's Five Star Movement

Prime Minister Mateo Renzi's promise to deliver on a referendum on Italian constitutional reform backfired in a resounding defeat at the hands of his anti-EU opponents. The result itself was unsurprising since Renzi's polling as far back as October, when the referendum could've been held, was so far behind that there was nothing to lose in postponing a month. However, Renzi's subsequent resignation came far earlier than many expected and whilst his replacement, Paolo Gentiloni, is a trusted establishment personality to replace him, it opens up the possibility of an election earlier than May 2018; possibly 2017. In preparation for that, Beppe Grillo, one time comedian and actor turned head of the Italian Five Star Movement political party, has moved to sever ties with Nigel Farage's EFDD in order to form a new alliance with pro-EU Alliance of Liberals and Democrats for Europe. This may buy his party some additional credibility in an election he is already threatening to win standing on a platform of dropping the Euro currency.

"If the euro fails, Europe fails." - Angela Merkel

Only Germany's Angela Merkel has been left standing from the picture taken in April in Hannover last year. Her re-election in the autumn is by no means guaranteed given her close association with Germany's controversial asylum policy which some blame for the attack on the Berlin Christmas market which killed 12 and injured dozens more. In addition, with the rise of populist parties looking to upset the status quo in elections this year, any suggestion that Merkel's position, as the political linchpin in EU, is in jeopardy, is an obvious concern and not just for the electorate. Nearly a third of respondents in December's Merrill Lynch Global Research investor survey cited the rise of populism in politics as being their biggest concern in 2017.

As things stand her political opposition is weak and her continued premiership may hinge on the lack of a credible alternative if nothing else. But there are risks to the establishment in the Netherlands and France. Polls are predicting a victory in the Dutch elections for Geert Wilders and his right-wing party advocating an end to immigration from Muslim countries. Planned for March, it will be the first of the major elections in 2017 carrying a downstream risk for France and, hence, the future of the Euro itself.

Anecdotally, investors in the US and Asia appear more wary of Marine Le Pen potentially winning the French Presidency starting a month later in April. French equity funds have experienced over $2 billion of outflows in the first week of the New Year, a marked acceleration on previous years. The polls and bookies predict only a 27% chance of her winning compared to her Republican right wing opponent, François Fillon, polling at 62%. However, investors are acutely aware that these figures are actually closer than Clinton vs Trump polls 6 months prior to the US Presidential election. With the political shocks of 2016 still fresh in the memory, it's important to remember that, in politics at least, anything can happen.

Economics

USA

Whilst performance of stocks and bonds owed much to the direction of currency movements and their reaction to geopolitics, stock markets wouldn't have reached all-time highs by year end without being underpinned by good news on the economy. In the US, annual GDP picked up to 1.7% year-on-year and unemployment fell from 4.9% to as low as 4.6% in November against steady payroll data and a pick-up in wages. A rise in the price of gasoline was evidently not enough to dent consumer confidence which held up well judging by loans and credit which rose steadily throughout 2016. Even retail sales put in a strong recovery at year end after the Presidential election.

Interestingly, an under-reported statistic with regard to the unemployment figure is the large number of people missing from it. In today's US labour market, jobless workers are only counted as unemployed if they are actively seeking work. Estimates vary widely about how many people this is but is conservatively put at around 2.3 million, which would push the unemployment rate up to 6.1% if they were counted. Furthermore, it does raise the question of how many more people might come forward for work if the economy picked up and the opportunity presented itself. It throws up the intriguing possibility that a full blown jobs recovery, envisioned by Donald Trump, could take place without the collateral damage of crippling wage demands associated with a tight labour market.

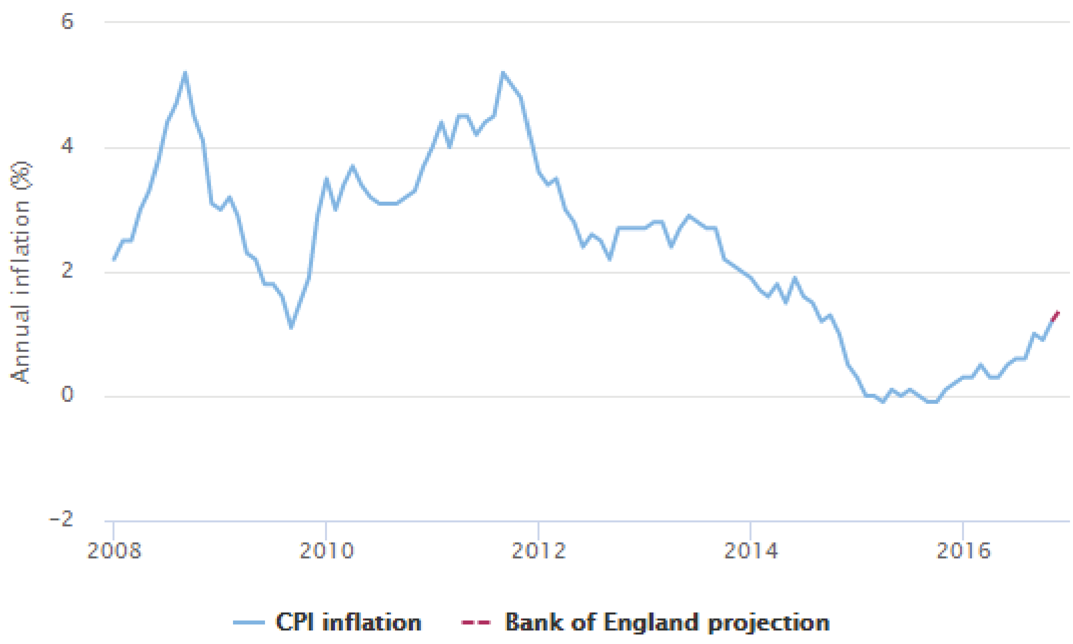
Source: EPI analysis of Current Population Survey public data series

United Kingdom

The story in the UK was just as good with unemployment falling a few points from 5.1% in the springtime to 4.8% by year end, and wage growth managed to outpace inflation which didn't really accelerate until the fourth quarter. Contrary to warnings from none other than the Bank of England, industrial production put in a respectable 2% in November.

The year-on-year figure is now 1.2% and accelerating owing to the base effect of having hit a low in January 2016 of 0.3%. The price of oil also bottomed in mid-January and will feed into goods prices over time. In addition, the fall in Sterling after Brexit will have a delayed effect and start to bite into the costs of imported goods. However, this is all fully understood by markets (index-linked bonds are becoming more expensive) and, more importantly, understood by the Bank of England. As it stands, the Bank's inflation target is set at 2% but already the Monetary Policy Committee has indicated that will look through inflation rising above it. The Bank has some form here. In 2009 and again in 2011, inflation rates of 5% were tolerated in the interests of not killing off a recovery by hiking rates. In 2017, the implicit guarantee is the Bank of England will continue to hold rates low as inflation takes hold. This is encouraging because, at this stage, inflation is not a dirty word. If there is to be a return to some degree of normality, this is what the early stages should look like.

UK Inflation: Year-on-year



Source: Office of National Statistics

Eurozone

Scanning the headline figures of the eurozone is an exercise in futility if one is to look at anything other than the direction of travel. Some countries like Germany are growing at 1.7% annually whilst countries like Italy are growing at only 1%. Spain, for example, looks fine with growth of 3.2% today but is really only bouncing back from 5 years of negative or zero growth.

It's a similar story with unemployment which in Germany runs at a tight 4.1%, and forecast to fall to 3.9% in 2017, whilst Spain and Italy are still mired in rates of 19.7% and 11.5%.

Naturally, this makes a one-size-fits-all approach to monetary policy a bit tricky to say the least. The ECB holding base rates low whilst simultaneously engaged in QE to keep future rates low may on the face of it help to keep prospects of economic recovery and debt servicing alive in the poorer states, but the resulting weakness in the Euro is a huge boon for export-heavy Germany able to hold Euro prices low for international buyers. In short, it is a wholly inappropriate policy to be running for Germany and not one the Bundesbank would be running if they were an independent central bank concerned only with Germany and the Deutschmark. Indeed, the Bundes-bank has often made public its unhappiness with continued low rates and expanded QE for it devalues the considerable bank savings built up by their population, notably the retired.

However, European Central Bank Governor, Mario Draghi, will likely be tested in 2017. At some point, the schedule for the ending of QE could well come up again, particularly if US growth accelerates, and set up the conditions for a Euro-style "taper tantrum" whereby bondholders, reliant on QE to keep yields low, and thus prices high, could simultaneously start selling the bond sector across the board and effectively conduct a "buyers strike" for new issuance from eurozone governments. It's a prospect Mario Draghi is acutely aware of and, whilst he has demonstrated deft handling of the conflicting demands of bondholders and the Bundesbank, one feels that his big test of withdrawing the bond market methadone is yet to come.

Stock and bond markets

"The stock market is the only market where things go on sale and all the customers run out of the store."

The main US stock index, the S&P 500, ended 2016 up 10%, the fourth rise in the past five years. The main sector drivers were energy +23.95% following the recovery in crude oil (OPEC production cuts) and financials +20.14% which made almost all of it following Trump's election victory (more politics) and the prospect of higher inflation and interest rates. Some individual company shares contributed to the rise by virtue of their sheer size. The "FANG" stocks, Facebook, Apple, Netflix and Google put in rises of around 20% or more; the rise in the price of Netflix valuing the company on a par with the total stock market value of Portugal.

The UK's FTSE 100 ended 2016 at an all-time high of 7,142.83, up 14.4% for the year although the story was somewhat different as the index owed most of the gain to the post-Brexit surge in international US dollar earners in mining and energy which dominate the index owing to the large size of those companies. Banking shares also performed well into year-end on the prospect of rising inflation and no further cuts in interest rates.

In Europe, Germany led the gains +6.87% with France not far behind as, despite the ongoing eurozone problems, their economies held up better than expected. The Italian stock market was a notable loser, falling over 10%, beset by worries over their banking sector, not least the need for a state bailout of Monte dei Paschi di Siena, the world's oldest bank.

Japan managed to get the right side of zero with the Nikkei 225 index recording a 0.42% gain for 2016. However, some sense of disappointment was evident given that direct support for the market, in the form of the Bank of Japan buying of shares across the board and other measures designed to increase private investment in the stock market. There was also the undeniable reality that without a weakening of the Yen in the wake of the Trump-inspired US dollar strength, the market could well have finished the year down 10%. The pick-up in the index almost perfectly matched the 11% rise in the US dollar against the Yen, sparking, as it has done for years, foreign buying of Japanese exporters typically in familiar household names such as Toyota, Canon and Hitachi.

Superficially, this had the effect of making Abenomics, the economic rescue plan advocated by Prime Minister Shinzo Abe, look like it might actually be working since, broadly speaking, the whole project rests on the need for a weak Yen to have any chance of working. Whether the markets can turn a blind eye to the real cause of Yen weakness, following the failure of the Bank of Japan to engineer it on its own remains to be seen. But we are where we are and if the Yen stays weak against a US dollar then all that's really needed to justify a properly bullish outlook for the classically cyclical Japanese stock market in 2017, would be an improving US economy dragging the global economy up with it. Japan won't get there on its own.

"A person with his head in the oven and his feet in the freezer is, on average, comfortable."

So far, the consensus outlook for 2017 for stock markets is positive and some have forecast Japan to come out better than most. This may seem unusually bullish considering all the geopolitical distractions and the US and UK stock markets trading at record highs because it suggests that stocks are getting expensive. On the face of it this is true; the headline price to earnings ratio for US stocks is sitting at an eye watering 28 times' company earnings in 2016. Ignoring the dot.com bubble where they hit 44 times, today's valuations is higher than the 2007 euphoria prior to Lehman's collapse and only a stone's throw from the peak prior to the 1929 crash.

The forecast for 2017 is a far more palatable 18 times. This is not very much more than the average of the last 10 years and implies that company earnings will grow strongly in the next 9-12 months in order to justify the price you have to pay for stocks today. That looks like a big ask but one needs to remember that we are talking about the average valuation of a stock market with polarised valuations at the individual stocks level. During a period when some bombed out stocks in banks, oil and mining have received a reprieve from a death sentence, it's not surprising that a turnaround in three key themes can have an effect. In general, to succeed, or more to the point survive, in these sectors, size helps.

If the central banks in the US and UK are prepared to stand back and let inflation rise without raising rates (it's too early to include Europe and Japan in this happy scenario), then we would expect the bond market to price higher rates 5 or 10 years hence even if base rates stay low. For banks who want to borrow short term and lend for the longer term, this steepening of the yield curve is beneficial and necessary. The forecast of future rates, is all good for profits.

Central banks are independent of prevailing politics of the day, we are told. However, if the above plays out, governments would be delighted to see such indirect assistance for the banks given how unpopular they remain amongst the electorate. Prime Minister David Cameron was a little unlucky in this regard in that he and the Chancellor of the Exchequer, George Osborne, were acutely aware that a recovery in the UK economy was nigh on impossible unless the banks were at least back on their feet after the great financial crisis. But he also recognised that further outright assistance for them would've been deeply unpopular, controversial and probably illegal. But based on current economic trends, a brighter future for banks may lay ahead.

"It has become cheaper to look for oil on the floor of the New York Stock Exchange than in the ground." - T. Boone Pickens, famous Texas oil magnate (but born in Oklahoma)

One could've had a pretty good handle on the state of both the global economy and geopolitics in 2016 just by looking through the prism of the oil industry and spared oneself the noise of all the politics. If 2016 could be split into a play with three acts, oil was the best supporting actor in all three.

Firstly, in January where the headlines spoke of Chinese economic slowdown and the defenestration of Federal Reserve interest rate forecasts. The side story was oil plummeting to $27 per barrel from $68 a year earlier. Any economic student could've told you at the time that the problem was one of excess supply but somehow the pernicious narrative of falling oil reflecting a slowing economy and, therefore, falling demand seemed to stick even in the most highly regarded newspaper columns.

Eventually, markets woke up to the dawning realisation that not only was demand still rising steadily but that drilling capacity was being removed at such a pace that, at some point, supply would start to fall leading to the inevitable economic reality that the price of oil must rise. It did. By the summer, the price of Brent oil had nearly doubled to over $50 per barrel. The effect on shares in the oil sector, some of which were priced for inevitable bankruptcy, was profound.

The second act was a brief post-Brexit fall in oil to around $45 per barrel as investors again thought the sky was falling on the global economy but talk was already of a more stable oil market which seemed to extend to stock and bond markets generally.

Oil played a role in the middle of final act of 2016, the Trump election victory where investors took the firm view that his Presidency would be inflationary and good for the economy. These alone would've been supportive of oil stocks the world over but OPEC, against expectations, pulled an agreement to cut production out of the air, the price of Brent crude stormed confidently back towards $60 a barrel.

By year end, even shares in mighty BP and Royal Dutch Shell had risen 50% and 60% respectively. Not bad for the UK's second and third largest companies by market cap behind HSBC considering that on the ground very little had changed in terms of production and sales. The change was entirely in the price of oil in US dollars and the consequent impact of the shares priced in a weakened Sterling.

Real estate "my kingdom for a yield"

Throughout the 1980's and 90's it was commonplace for real estate to feature as a permanent allocation in most people's pension schemes and with good reason. Investment in real bricks-and-mortar commercial property gives one a rental yield and, whilst the valuation of those yields can be affected by changes in interest rates and inflation, rents can move with them to compensate.

As an asset class, property fell out of favour as the stock market doubled from the mid-1990's until peaking in the dot.com boom of 2001; the returns on offer simply outweighed by the new era of share ownership. But, on the whole, property worked well for the cautious investor over time as one would expect it to do in a normal interest rate environment, but unfortunately the latter has been anything but.

The collapse in interest rates, and the accompanying QE monetary policy keeping future rates low, made property funds increasingly attractive throughout 2015 as investors saw yields evaporate in bonds and equities as both grind higher. For those desperate for yield the prospect of safe and sustainable rental yields became irresistible even for short term investors. But if you're in the business of short term trading, the one thing you need is liquidity and bricks-and-mortar property, as opposed to property shares, is far from ideal in a market where everyone is in the same trade.

At TAM, we drastically reduced our property exposure before the liquidity issue came to a head in the spring of 2016. Funds that had trouble redeeming sales from their funds recovered the situation in a relatively short time but the administrative weaknesses of the sector have been exposed. Had the industry's bricks-and-mortar allocation to property been more on a par with the late 1980's, there might well have been greater liquidity than was ultimately the case in 2016. But the reality is that the amount of commercial property owned by the unit trust industry is a tiny fraction of the total market and the movement in prices created as a result of money flows bore no resemblance to the price or rentals of the assets in the funds. For this reason, the whole sector is under review by managers and regulators to see what changes, if any, need to be made to either the way they are invested or marketed to the investment industry. In the meantime, it is unlikely that the sector will be a part of TAM investment strategy in 2017.

What next for TAM portfolios?

It's natural that everyone is trying to look through the fog of geopolitics to try to see what happens next in financial markets. Financial strategists and fund managers in frontier and emerging markets have been doing this forever. We're just not used to it so much in the developed world and even less so since central banks waded in to the game in the wake of the great financial crisis of 2008.

These forces at work have been an unusual combination and on occasion, in the case of equities, a distraction from the business of identifying good investments with solid management, balance sheets and cash flows. This is an ongoing recovery unlike any other and the rise of the stock market from 2009 to the present day has been quoted as "the most hated ever", since the rise has been a confusing mix of capitalism vs artificially created free money courtesy of co-ordinated central bank monetary policy.

Looking forward to 2017, the opportunities in equities appear to present themselves against a backdrop of continued low interest rates, rising inflation and moderate economic growth. Central banks will continue in their cautious approach to the abandonment of QE and a carefully expressed intention to return to a more normalised environment to interest rates and inflation. In that environment, equities do not look overly expensive.

The US economy is more than one step ahead here and whilst there will be many naysayers to the Trump Presidency, investors will accept that he is here to stay and in many areas set to drive economic growth on full throttle. Interestingly, the financial markets appear to be taking a much more positive view of Trump than the media but our job here is to understand and invest for the former and not the latter.

TAM portfolios are now positioned for a Trump led cautiously optimistic economic outcome for 2017 in the US, which we expect to extend globally. We believe there remains much cash sitting waiting for market falls to invest… they may not get it in the short term.

The world has changed for UK investors, particularly as the domestic led, almost deflationary environment of 2012-2015, has been replaced by a mild inflationary growth era for international earners. Market leaders have changed and we do not believe this is merely a short term position given a weakening currency and rising energy prices will lead to imported inflation.

We also believe that a brighter outlook for the UK post-Brexit will emerge once international markets understand and accept the new normal for a UK which will turn outwards to engage with international trade, something well within the capability of the world's fifth largest economy.

In conclusion it's not quite "buy while stocks last" but there is some real potential for pockets of significant growth in 2017.

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