

Outlook for 2017

Runaway Train?

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Over the last year and a half, global markets have been shaken by a series of seismic volatility shocks. These began in August 2015 with a massive volatility reading of over 40, as measured by the VIX index, compared to a typical reading of 15-20.¹ This spike in volatility, which was driven in part, by fears that the Chinese economy was in serious trouble, contributed to the Chinese stock market collapse and the surprise devaluation of the yuan. This initial shock was followed by a quick succession of major aftershocks spaced over 2016 including the collapse in oil prices in January/February, Brexit in June and finally the U.S. election in November (Display 1).

These successive tremors have raised enough ‘dust’ to obscure investors’ view of the evolving economy. Until recently, seasoned economic observers such as U.S. Federal Reserve Governors felt that “near-term risks to the economic outlook appear roughly balanced” and that inflation and “global economic and financial developments” required “close monitoring.”²

Both U.S. Presidential candidates campaigned on platforms that included meaningful fiscal stimulus, with Clinton promising the “largest investment in good-paying jobs since World War II.”³ As a candidate, Trump hammered on the point that U.S.

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¹ Bloomberg

² 2 November 2016 Federal Reserve press release.

³ 22 June 2016, Hillary Clinton’s 2016 presidential election campaign website www.hillaryclinton.com/issues/jobs



DISPLAY 1
Elevated volatility in 2016



As of 2 December 2016; Bloomberg

economic growth was weak, calling the current recovery “the weakest so-called recovery since the Great Depression.”⁴ In a September 2016 speech to the New York Economic Club, Trump promised to boost annual economic growth to 3.5% and create 25 million jobs. His plan includes a proposal for a substantial fiscal stimulus from major tax cuts.

It must have come as something of a surprise to the President-elect after the November election that the engine that is the U.S. economy turned out not to have been derailed by the recent economic tremors. On the contrary, the train came bursting out of the dust with a full head of steam, already traveling at a 3.2% annualised growth rate in the third quarter, according to the U.S. Bureau of Economic Analysis (BEA). Moreover, by November the unemployment rate had fallen to 4.6%, so low that there is a question about whether the U.S. economy could absorb many more jobs—not to mention 25 million more.

The unexpected strength of the U.S. economy may be a result of two themes we have emphasised over 2016. First, that both Chinese and global growth would likely stabilise. Second, that the oil sector could shift from being a drag on the economy (due to investment cutbacks) to being a positive contributor, as savings at the gas pump allowed consumers to spend more on discretionary purchases in other areas.

Importantly the current strong economy has rattled bond investors who are now scrambling to sell out of sovereign debt with unusually low yields, a shift we anticipated and are now seeing come to fruition. Even the U.S. dollar’s rise, as a result of rising interest rates on sovereign debt caused by bond investor selling, is in our view likely to accelerate this global revival, as it becomes cheaper for Americans to import goods and services from abroad. This is all stimulative for the overall global economy.

The options market weighs in

The options market has also indicated a significant shift in investor perceptions, from worrying about the next bear market to worrying about missing the next bull market. The volatility skew chart, (Display 2) compares the implied volatility on a one-month call option on the S&P 500 Index, written today, against one written a month ago.

It shows that implied volatility is generally lower now. The exception is for out-of-the-money calls, where there seems to be high demand for upside participation with less regard for downside risk, even though the index has already climbed by more than 5%. In the words of Myron Scholes, “*The risk for investors has swung dramatically in recent weeks from protecting against the ‘bear’ to the possibility of missing riding the ‘bull.’*”⁶

⁴ 15 September 2016 Factsheet: Donald J. Trump’s Pro-Growth Economic Policy will Create 25 million jobs

⁵ 29 November 2016 National Income and Product Accounts Gross Domestic Product: Third Quarter 2016 (Second Estimate) Corporate Profits: Third Quarter 2016 (Preliminary Estimate)

⁶ Myron Scholes and Ash Alankar, 28 November, 2016.

DISPLAY 2
A high demand for upside participation



As of 6 December 2016; Bloomberg

This change in the options market may signal that sophisticated investors are taking the view that downside risks have been greatly reduced. Similarly, volatility has collapsed in the last few weeks, with both the Euro Stoxx 50 and the Nikkei 225 echoing the VIX in showing current volatility below their five-year averages. Although that can sometimes indicate complacency, today it seems to reflect market participants' shift to a more positive outlook, at least in the short run.

An untested braking mechanism

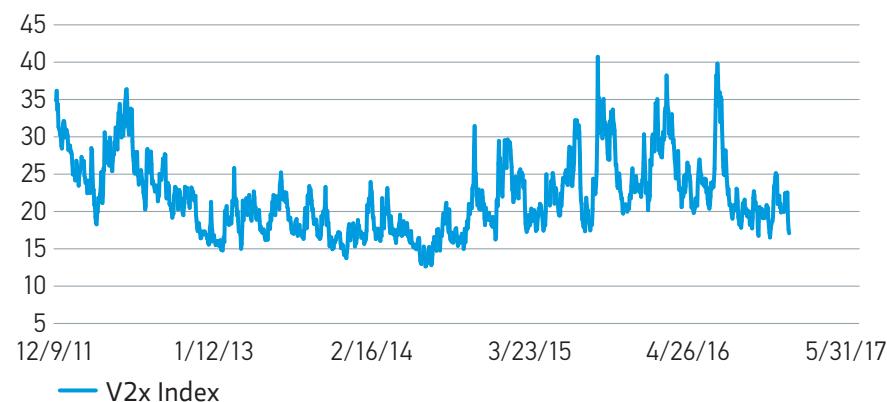
The positive view investors appear to be taking of the economic outlook is, in our view, significantly influenced by an expectation that as President, Trump will in fact implement a large ("a trillion dollar") fiscal stimulus programme of tax cuts and infrastructure building. Reuters reports a Trump transition representative saying that the enactment of "infrastructure funding legislation" is one of the top priorities for the first 100 days Trump is in office.⁷

Infrastructure spending may be a good way to generate jobs for people without college degrees, a key Trump constituency. But are those additional jobs really needed? The Fed Chairman Janet Yellen, in her 15 December press conference, said that while "there may be some additional slack in labor markets... at this point ... fiscal policy is not obviously needed to provide stimulus to help get us back to full employment."⁸

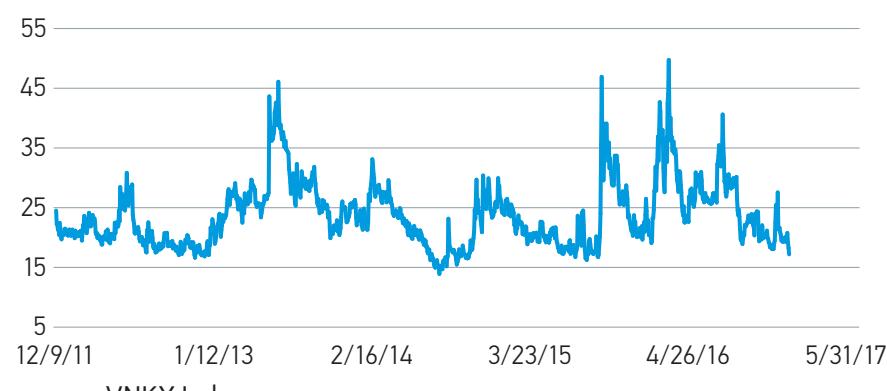
Moreover, while infrastructure workers generally do not need college degrees, they do need to have specialised skills. Reuters has indicated that, appropriately skilled workers may be in short supply. If significant new fiscal stimulus is enacted and a lack of skilled workers is a bottleneck, then this could easily lead to wage inflation as opposed to real growth. A year from now we may start to face the

DISPLAY 3
Across regions, volatility has fallen

Euro Stoxx 50 Volatility Index



Nikkei Stock Average Volatility Index



As of 7 December 2016; Bloomberg

⁷19 December 2016 Trump's infrastructure splurge would collide with U.S. skilled labor crunch

⁸14 December 2016 The Guardian Janet Yellen: US interest rate rise 'vote of confidence' in economy – as it happened

inflationary consequences of stimulating an economy that's already near capacity.

A key restraint on an overly stimulated, inflationary economy is an alert central bank, ready to tighten monetary policy to put a brake on excessive growth. One of the problems central banks face, however, is that the most astute time to raise rates is when nobody thinks it's time to raise rates, to act before it is obvious they need to act. As Paul Volcker said, "*The long term gets here before you know it.*"⁹ It remains to be seen if the Fed needs to and is ready to raise rates aggressively when 'nobody thinks it's time to do so'.

Even if the Fed is ready to act decisively when the economy is overstimulated, it is important to note that the braking mechanism now available to the Fed is new and untested. In the post-war period, when the Fed wanted to slow the economy it used money market operations to drain 'excess reserves' from the banking system. These excess reserves are the funds banks lend to businesses, which in turn finance the investments the businesses want to make. When the Fed drained these excess reserves, interest rates on whatever was left rose sharply and investment-led growth had to slow. Since the 2008 crisis, however, the Fed's quantitative easing ("QE") programmes have generated enormous excess reserves, to the tune of \$2 trillion as of November 2016 (about 11% of nominal GDP).¹⁰ Prior to 2008, the level of excess reserves was minuscule at \$1.5 billion.¹¹

In view of the enormous size of excess reserves, it is unrealistic to expect the Fed to be able to drain them from the banking system in the way it used to do, prior to 2008. An alternative way to keep banks from lending the excess reserves, when the economy is overstimulated, is to pay a high enough interest rate on the excess reserves that the banking system keeps at the Fed. If this rate, called the Interest Rate on Excess Reserves (IOER), is sufficiently

above the rate the banks can earn by lending the money to businesses, then the excess reserves will stay at the Fed instead of being lent out. Businesses will then likely face a shortage in investment funds and the economy could slow just as before.

The obvious problem with this approach is that the Fed may have to pay a very high rate of interest to banks to keep excess reserves from being lent, if the economic engine is super-heated. While in theory there is no limit to what the Fed can pay, there are political obstacles. First, to anyone other than a monetary economist it may seem strange to be paying bankers not to lend out money. It is like paying someone not to do their job. This point is likely to be raised in Congress if IOER is discussed. Moreover, if IOER needs to be raised to high levels Congressional scrutiny is very likely, as the Fed currently runs a 'profit' on the interest it earns on the U.S. Treasury bonds it owns. This profit is turned over to the U.S. Treasury and reduces the U.S. budget deficit—a highly visible and politically-charged item. If the Fed has to pay a high IOER, the interest it pays may exceed its income from the bonds it holds. In this way a high IOER can 'increase' the U.S. budget deficit, which would most likely trigger a review in Congress.

Will the brakes fail?

If the Fed does not act quickly enough, or if the political heat from raising IOER sufficiently to truly put a brake on the economy means that the Fed does not prevent the U.S. economy from overheating, then there may be one other mechanism to slow an overstimulated U.S. economy. This is rising interest rates in the longer end of the U.S. Treasury market, that is controlled more by market forces than by the Fed. We have in fact seen these longer-dated interest rates rise sharply recently. It's important to keep in mind, however, that interest rates are global, with arbitrage between different

markets for yield. If foreign economies that still have active QE programmes, especially Europe and Japan, are still behind the U.S. in terms of economic growth, their central banks may try to offset a rise in rates in these regions.

If Japanese interest rates start rising above their targets because U.S. rates are going up, for example, the Bank of Japan will likely start trying to push their rates back down. And if Japanese rates don't go up, Japanese investors may continue to demand U.S. bonds, which could push U.S. yields back down. Similarly, with European growth lagging behind that of the U.S., it seems reasonable to expect QE in Europe to continue to depress European bond yields and hence U.S. bond yields too. In other words, active QE bond-buying by central banks with unlimited pockets in Europe and Japan, trying to keep yields down, will likely restrain the degree to which U.S. rates can climb. This raises the risk that U.S. rates will be unable to rise sufficiently to adequately slow an over-stimulated U.S. economy.

Therefore, if the new administration comes in and seriously stimulates the economy with a lot more infrastructure spending, tax cuts, defense spending and so on, we may find that U.S. interest rates simply cannot go up enough to stop the excess growth. With Europe and Japan also driving it forward, we may find that the runaway train's brakes no longer work properly.

Equities: Running hot on expectations

Even though we don't know with certainty what the Trump administration's new policies are going to be, the market is already anticipating that they will be significantly stimulative: bond deals are increasing, the U.S. dollar is rising, and the yen and euro are down. But if bond yields don't rise enough to offset the stimulus—either because the engine is allowed to run hot or because European and Japanese banks actively suppress

⁹ Paul A. Volcker and Peter G. Peterson, October 22, 2016.

¹⁰ 2016 November Aggregate Reserves of Depository Institutions and the Monetary Base - H.3

¹¹ Why Are Banks Holding So Many Excess Reserves? Todd Keister and James McAndrews, Federal Reserve Bank of New York Staff Reports, no. 380, July 2009, JEL classification: E58, G21, E51

DISPLAY 4
Emerging markets appear to have bottomed



Source: As of 1 December 2016; Bloomberg

growth in U.S. yields—the environment could be constructive for equities.

Japan: Skipping the hedge

With its markets in both the U.S. and China currently stabilised, Japan looks to benefit from a drop in the yen. And with the FX rate mispriced adversely, many investors are skipping the hedge and taking on the currency risk. With the U.S. dollar going up, that seems like a reasonable bet. Oil prices are always a factor for Japan, but these seem stable as well. Despite a proposal to cut production at the recent OPEC meeting, we believe U.S. shale producers could step in as soon as prices go above \$50.

**Emerging markets:
 Unjustified underperformance**

From the moment of Donald Trump's election, we've seen significant underperformance in emerging markets. They outperformed developed markets from the end of May until the U.S. election, when emerging market equities sold off, especially in Latin America. Quarter to date, the S&P 500 is up 1.46%¹² and the MSCI All Country World Index is down 1.18%,¹² for a difference of 2.64%.¹² And given that half of the MSCI is made up of developed

market companies included in the S&P 500 Index, the difference in performance is over 5%.¹²

Latin American markets were the hardest hit, but **Asian** markets are down as well. Even **India**, which doesn't seem to be a direct target of Trump's policies, sold off. India's situation, though, is complicated by Modi's sudden and drastic change to the country's monetary structure. The net effect has been big and probably unjustified, particularly if a strongly growing U.S. economy, stronger dollar and bullish commodities are pulling the rest of the world up, as their exports to the U.S. improve. The underlying economic outlook for many of these countries is really quite good in our view, even if there may be some adjustments in terms of tariffs brought in by the expected new Treasury secretary, Steven Mnuchin.

As the chart above shows, the emerging markets sell-off appears to have found a bottom, which supports our view that it was not justified by a deterioration in fundamentals. In fact, we believe the sell-off was overdone and that it probably makes sense to maintain or even increase exposure to emerging markets at the moment.

Elsewhere in the emerging world, **EMEA** and particularly **Russia** appear to be likely beneficiaries of President-elect Trump's willingness to rethink sanctions on Russia. So this area could outperform, though the markets may have recognised that already. The Russian market, for example, has dropped less than Mexico's, which is perceived as being the most likely to suffer from Trump's policies.

Fixed income: Know where risks lie

Even if the environment may be constructive for equities, rising interest rates appear very unfavourable for sovereign debt. Within fixed income assets, high yield securities are generally less sensitive to rising rates. Given current positive economic conditions, the high yield sector could benefit from declining default rates and a possible contraction of credit spreads. But even in the best environments, high yield securities are not completely immune to a sustained rise in interest rates.

Against this backdrop, a shift toward assets with greater credit risk and less interest-rate risk makes sense to us. Within higher quality allocations, we would lean toward shorter-duration assets.

**Looking ahead to 2017:
 Hoping to stay on track**

Our outlook for 2017 is upbeat over the near term. Investors currently have plenty of reasons to cheer: a thriving U.S. economy, stability in China and the long-awaited benefits of low-priced oil to consumer discretionary spending.

Over the longer term, though—particularly later in 2017 and beyond—we need to watch whether the new 'fireman in chief' for the U.S. (and in many ways global) economy, President-elect Trump, may stoke the economic engine with more stimulus than it can absorb. The danger of a 'runaway train' rises if inflationary pressures start to build due to shortages of skilled labour or other capacity constraints. The Fed's new braking system may be tested sooner than expected.

¹² As of 1 December 2016; Bloomberg.

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