GLOBAL MULTI-ASSET

Market Outlook 2017

2016 may best be remembered as the year in which Trump won and the world changed. A real estate developer cum reality TV star is now leader of the free world. So what has really changed? The Republican Party now has control of the White House, the Senate and the House of Representatives, making the passage of reform potentially smoother than the troubled partisan years of the Obama administration. The question becomes which reforms will take centre stage. Gleaning what we can from Trump's fluid election platform; taxation, infrastructure, immigration and trade would appear to be top of the agenda.

As a real estate developer, the concept of borrowing to build is not foreign to Trump, so a decent infrastructure spend would seem a definite. As a CEO, Trump is well versed in the benefits of a lower corporate tax rate so this would also appear likely given it plays to the Republican core.

Outside the US the reaction has been one of concern (unless you are Vladimir Putin) as global leaders wonder how much of Trump's inflammatory election promises on trade and immigration were more bluff and bluster than policy. What does seem probable is that all future trade deals will be done on a 'transactional' basis, avoiding grand bargains like the now scuppered Trans Pacific Partnership. The US priority is no longer exporting a value system to the world, but rather brokering the best deal for itself. This will make geopolitics more unpredictable.

The market reaction to these potential changes has been meaningful. The US Dollar has rallied sharply and US Treasury bond prices have fallen, presumably on expectations that infrastructure spend and tax incentives will drive growth and inflation. The equity market response has been more muted, possibly because the aforementioned market moves place pressure on company margins. Given the already high valuations in the US equity market, investors may need to see actual results coming through in earnings before pushing markets too much higher.

Given all of the above it seems appropriate to us to maintain our cautious approach to Developed Market (DM) equities going into 2017. The suggested reforms do provide a platform for potential growth, provided they are delivered. But we remain concerned about the bond market. The current dramatic re-pricing was overdue, but where does it stop? Given bond markets have not reflected fundamentals for some years it is hard to assess how much the increase in inflation expectations will impact bond prices. If they keep falling, there is a risk they short circuit the nascent earnings recovery and negatively impact equity markets as well.

Emerging Market (EM) equities are attractively priced. However, increasingly tight financial conditions caused by higher rates and a resurgent dollar are a source of concern given high levels of leverage. While Trump policies would appear to be an unmitigated disaster for global trade growth, we believe the near-term impact could be limited if the focus is on renegotiation of trade deals rather than on pushing tariffs. Hence as long as global demand remains supported by China, and the increasingly likely US fiscal stimulus, we expect to see a further broadening of the EM economic recovery. The key however will be whether the right balance can be achieved between improving global demand and a tightening of financial conditions. As we believe the jury on this is still out we would hesitate to go all-in on EM either.

Our view on commodities is more constructive due to improved supply versus demand fundamentals. Supply growth has slowed considerably across many parts of the energy, base metals and agricultural commodity sectors. Persistent oversupply appears to have been addressed through production cuts. Deflation in cost curves also appears to be abating. Hence commodity price inflation is likely, even if we see only a marginal acceleration in global growth.

The low rate environment has made Credit a must-own asset class in global multi-asset portfolios. However, stretched valuations, duration risk and late cycle fundamentals are currently significant headwinds for high grade credit, while a potential pickup in earnings growth and improved access to credit are potentially powerful tailwinds for high yield credit. We think it is still too early to reverse our preference for high grade over high yield because of the uncertainties over evolution of policy and transmission to growth. At the same time a significant unknown has appeared in the form of "high yield tourists" from Europe and Japan given the negative rates policies of the European Central Bank (ECB) and Bank of Japan (BOJ). Any signs that they too are about to join the US Federal Reserve (Fed) in reversing accommodation could lead to a quick return home for these tourists. This could lead to significant stress in the high yield bond market. Hence on balance a neutral view on credit and a wait-and-watch approach to a potential high grade vs. high yield rotation would appear to be the most prudent course of action.

Thus it is not hard to arrive at a constructive view on commodities, a cautious one on equities and credit, and a clear preference for cash over sovereign bonds. However this hardly appears to be a recalibration of views of a magnitude necessary to navigate a truly changed world. Indeed as we wrote in our 2016 outlook, signs were already in place for a energy-led mean reversion in commodity prices. Our views on equities and bonds remain similarly unchanged. As such it would be remiss of us to miss noting the significant upgrades that we have made to our navigation instruments.

First, we've come to conclude that our investment views need to explicitly account for the following:

- **Polls are wrong:** Brexit, Trump and the Italian referendum result are among the profession's recent failing
- **Assumptions are wrong:** Bonds and equities cannot be relied to move in opposite directions to diversify multi-asset portfolios
- **Binary options are fraught with danger:** It is sub-optimal to bet on binary outcomes in a multi-modal world

Second, we identify three potential fault lines along which the increased uncertainty of outcomes could potentially travel:

- **Political risk:** Populist movements will continue to resurface around the world leading to continued pressure to renegotiate social contracts
- **Market volatility:** Central banks are less capable of suppressing yields and volatility amid higher geopolitical and policy uncertainty
- **Safe havens:** Cash may be king, however the USD has strengthened significantly

Third and last we convert the above into an actionable investment strategy: humility. In an environment where we are just as likely to get it right as wrong – as is any other investor, for that matter - we prefer to adopt a diversified approach that is consistently applied across four broad opportunity sets.

The first two comprise traditional asset class opportunities across DM and EM while the last two comprise alternative sources of return harvested through our Relative Value (RV) and Alternative Risk Premium (ARP) strategies. RV is designed to opportunistically exploit short-term mispricing across equity markets, bonds and currencies while ARP such as value, momentum and carry offer additional sources of uncorrelated returns. Much like a four-cylinder engine this strategy entails having different cylinders fire at different times. For instance EM performed poorly in 2015, but fired in 2016. Our outlook for 2017 suggests the last two will be increasingly important drivers of multi-asset portfolios but our humility will keep us also searching for appropriately priced investment opportunities across the first two.

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