

Schroders

Global Market Perspective

Economic and Asset Allocation Views Q1 2017



Schroders

Introduction

Risk assets ended the final quarter of 2016 on a high note with equities rallying, particularly cyclical markets, where the election of Donald Trump as President of the United States lifted reflation hopes. By contrast, government bonds gave away most of the gains over the year whilst commodities performed well as the markets collectively bought into the “Trump reflation trade” helped along with firmer macro data. For foreign exchange markets, after a period of relative calm over the summer, the US dollar strengthened over the final quarter which led to pressure on emerging market currencies.

For the first time in nearly two years, we have upgraded our global growth forecasts. This is a reflection of the better than expected recovery of activity worldwide and the prospect of looser fiscal policy in the US coming through later in the year. Alongside this positive development, we are likely to see further rate hikes by the Federal Reserve (Fed) as the labour market continues to tighten and inflationary pressures build. Elsewhere though, the European Central Bank (ECB) and Bank of Japan (BoJ) are expected to keep monetary policy on hold reflecting the earlier stage of their respective cycles.

Meanwhile, in terms of our asset allocation views, we have upgraded equities to positive given the rotation towards a reflationary setting which should be a more supportive backdrop for earnings growth. Our analysis also suggests that the equity risk premium can absorb moderately higher bond yields. In a similar vein, we have turned positive on markets that stand to benefit most from this reflationary theme such as Japan and Europe ex UK. In comparison, we have downgraded emerging market equities to neutral given potential headwinds from a stronger USD and re-pricing of US rate expectations.

In this quarter’s Perspective, along with a summary of our asset allocation views, we take a look back at 2016 and a few lessons worth considering for 2017. In the global strategy note, we explore how far the Trump trade can go and the potential for such optimism to be questioned in the new year. We also take a closer look at the reflation rotation amongst US equity styles and sectors in the research note.

We wish all our readers the very best for 2017.

Tina Fong, CFA

Editor, 11 January 2017

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Editors

Keith Wade, Harvinder Gill and Tina Fong

Asset Allocation Views: Multi Asset Group

Global Overview

Economic View After a series of downgrades, our forecasts for global growth have been revised up with 2016 now expected to come in at 2.6% (previously 2.3%) and at 2.8% in 2017 (previously 2.6%). For 2017, the upgrade was largely a reflection of a more optimistic view on the emerging markets (EM), the UK and the US.

Inflation is expected to pick up in 2017 to 2.4% from 2% in 2016, primarily led by oil price base effects in the advanced economies. The picture in 2018 is more mixed as price pressures continue to build in the US, but tend to moderate elsewhere.

This quarter we have made changes to our scenarios to reflect the election of US President Trump and continuing political risk in Europe. On the whole, while our baseline growth forecast has risen, scenarios are skewed even more to the downside. Specifically, the scenarios “Currency wars return”, “Secular stagnation” and “Bond yields surge” all take global growth and inflation lower over the forecast period.

Central Bank Policy

For the US, we still expect the Fed funds rate to rise to 1.25% by end 2017. Moving into 2018, the Fed is expected to tighten further as fiscal policy supports economic growth and with US inflation rising, policy rates are expected to end the year at 2.25%. The Bank of England (BoE) is expected to keep rates on hold throughout the forecast period. The European Central Bank is also assumed to keep the deposit rate at current levels with asset purchases to be maintained at 60 billion euros per month beyond the end of 2017. The Bank of Japan is expected to keep rates on hold, but maintain quantitative easing (QE) as, in a rising US rate environment, purchases will be needed to maintain the 10-year Japanese government bond (JGB) yield at zero. The People’s Bank of China (PBoC) is still expected to ease policy this year.

Implications for Markets

Looking at our asset class views, we have upgraded equities to positive. We believe that there has been a rotation towards a reflationary setting given the recovery in global growth and expectations of more fiscal expansion particularly in the US. This should provide a more supportive backdrop for earnings growth, particularly those more cyclical areas of the market. Meanwhile, global valuations are generally looking fair when we compare the equity risk premium relative to history, but we recognise that this is being supported by the low interest rate environment. Our analysis suggests that the equity risk premium can absorb moderately higher bond yields. Importantly, our positive view on equities is based on earnings growth rather than a re-rating of multiples.

Within equities, we have a preference for markets that offer access to the reflationary theme such as Japan and Europe ex UK where we have upgraded to positive over the quarter. There have been encouraging signs of improvement in the Japanese data and the weaker yen should provide a boost to corporate earnings. Importantly, analysts’ earning expectations have yet to incorporate the recent depreciation in the currency. On Europe ex UK, we have turned positive on the market as the recent outturn in the data has been on a stronger footing. Crucially, investors are likely to finally unlock the value found in European financials with a steeper yield curve.

In comparison, we have downgraded emerging market equities to neutral given headwinds from a stronger USD environment along with the prospect of more protectionist policies from the Trump administration. Nevertheless, EM equities continue to offer a valuation discount versus their developed peers. We have also upgraded EM growth expectations for this year.

Meanwhile, we have retained our neutral stance on the US, UK and Pacific ex Japan. Despite the high-quality nature of the US market, valuations have become richer. The prospect of corporate tax cuts and repatriation of overseas cash are likely to provide a substantial boost to corporate earnings. However, corporate earnings could be challenged by a stronger USD and higher interest rates along with the squeeze on profit margins from the pick up in wages. On the UK, we believe that the tailwind for revenue growth of multinationals from the weakness in the currency has faded. Nonetheless, on our measures, the UK market is one the most attractive in the

Asset Allocation Views (continued)

Implications for Markets (continued)

developed universe from an equity risk premium perspective.

With regard to the duration views, we have maintained the negative position on government bonds which remain vulnerable to shifts in interest rate expectations as central banks attempt to normalise policy with rates rises or less accommodative monetary conditions. Amongst the bond markets, we are negative on US Treasuries, UK Gilts and German Bunds, but neutral on Japanese government bonds. We have also maintained our neutral stance on emerging market sovereign debt (EMD) in USD. Instead, we prefer harvesting the carry in EMD local currency bonds given that valuations are more attractive and fundamentals continue to improve at the margin.

Turning to credit markets, we have stayed neutral on high yield and negative on investment grade (IG) bonds. While valuations for both sectors are no longer compelling, investment grade spreads are more sensitive to shifts in interest rate expectations with a lower carry cushion. For US IG credit, fundamentals are deteriorating in this sector and the elevated USD LIBOR funding costs makes returns unattractive for overseas investors after taking into account the higher hedging costs and low carry. For European credit, spreads are highly correlated with the US such that we are also negative on this segment, although to a lesser degree. This is because valuations are more attractive compared to US IG credit and there is also less rate sensitivity particularly with continued asset purchases by the ECB.

We have retained our overweight positioning on commodities as there is evidence of a meaningful supply adjustment in some of the sectors. For agriculture, we have remained positive as future supply of major grains may be impacted from low prices. For industrial metals, this sector remains oversupplied but we have started to see some rebalancing. Moreover, this segment is likely to benefit from the prospect of US infrastructure spending and Chinese stimulus. Hence, over the quarter, we have upgraded industrial metals from a negative to neutral stance. In comparison, in an environment of higher real rates and a stronger USD, we have downgraded gold to neutral. However, gold remains a hedge against the increase in political risks this year. On energy, we have retained our neutral stance despite the agreement to cut production by OPEC and non-OPEC producers. While supply-demand dynamics of the sector are more balanced, a large surplus of oil inventory still exists plus US shale production is rising again.

Table 1: Asset allocation grid – summary

Equity	+ (0)	Bonds	-			Alternatives	+	Cash	0(+)
Region		Region		Sector		Sector			
US	0	US Treasury	-	Government	-	UK property EU property	- +		
Europe ex UK	+ (-)	UK Gilts	-	Index-Linked	0	Commodities	+		
UK	0	Eurozone Bunds	- (0)	Investment Grade Corporate	-	Gold	0 (+)		
Pacific ex Japan	0	Emerging market debt (USD)	0	High yield	0				
Japan	+ (0)	Emerging market debt (local currency)	++						
Emerging Markets	0 (+)								

Key: +/- market expected to outperform/underperform (maximum ++ to minimum - -) 0 indicates a neutral position. The above asset allocation is for illustrative purposes only. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions. For alternatives, due to the illiquid nature of the asset class, there will be limitations in implementing these views in client portfolios. Last quarter's GMP positioning in brackets. Source: Schroders, January 2017.

Regional Equity Views

Key Points

+ (0) Equities		
0	US	<p>We remain neutral on US equities as the high-quality nature of the market makes it attractive to hold despite higher than average valuations compared to the rest of the world.</p> <p>The prospect of corporate tax cuts and repatriation of overseas cash are likely to provide a substantial boost to corporate earnings. However, earnings could be challenged by a stronger USD and higher interest rates along with the squeeze on profit margins from the pick up in wages. .</p>
0	UK	<p>We have revised up our growth forecast for the UK this year, although a slowdown in the economy is still expected due to weaker business investment and higher inflation putting a dampener on consumer spending both consequences of Brexit. The BoE is expected to keep rates unchanged as growth has not fallen by as much as expected, while inflation is set to rise sharply.</p> <p>Against this backdrop, we believe that the tailwind for revenue growth of multinational corporates from the weakness in the currency has faded. Nonetheless, on our measures, the UK market is one the most attractive in the developed universe from an equity risk premium perspective.</p>
+ (-)	Europe ex UK	<p>Despite the tapering of QE by the ECB, monetary policy remains ultra-accommodative in the region, which should provide some support to the economy. The recent outturn in the data has also been on a stronger footing. Crucially, we expect investors to finally unlock the value found in financials with a steeper yield curve led by higher yields at the long-end of the curve.</p> <p>Meanwhile, political risks in the region are likely to remain a source of uncertainty given the upcoming general elections in the Netherlands, France and Germany. However, we believe that some of these concerns have been priced in by the market.</p>
+ (0)	Japan	<p>Over the quarter, we upgraded Japanese equities as attractive valuations were coupled with encouraging signs of improvement in the economic data. We also expect the economy to receive a lift to growth this year from additional fiscal stimulus, which should be supportive of top-line earnings growth.</p> <p>The BoJ is likely to offer more QE to anchor the long-end of the JGB curve towards zero. Not only would this keep monetary policy accommodative, a weaker yen should provide a boost to corporate earnings. Importantly, analysts' earnings expectations have yet to incorporate the recent depreciation in the currency.</p>
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	<p>We remain neutral on Pacific ex Japan equities driven by our neutral stance on Australia and Hong Kong, but are negative on Singapore. Based on our analysis, the expected equity risk premium for Australia and Hong Kong appear reasonable, but is looking low for Singapore equities when compared to other developed markets. Moreover, the Singaporean economy is highly sensitive to the prospect of higher US interest rates and a downturn in the global trade cycle.</p>
0 (+)	Emerging Markets	<p>Emerging equities continue to offer a valuation discount versus their developed peers. We have also upgraded EM growth expectations for this year. However, our growth indicators on the emerging markets have recently eased at the margins particularly when compared to the latest improvement in activity in the developed world.</p> <p>Furthermore, we recognise that emerging equities are vulnerable to a stronger USD environment along with the prospect of more protectionist policies from the Trump administration. Hence, we have downgraded EM equities to neutral.</p>

Key: +/- market expected to outperform/underperform (maximum ++ minimum --) 0 indicates a neutral position.

Fixed Income Views

Key Points

- Bonds		
-	Government	<p>Compared to last quarter, bond valuations have improved but are still unattractive at current levels. Global growth and inflation expectations have also moved higher with the recovery in activity and commodity prices. We continue to be of the view that government bond markets remain vulnerable to shifts in interest rate expectations as central banks attempt to normalise policy with rates rises or less accommodative monetary conditions.</p> <p>Amongst the bond markets, we are still negative on US Treasuries as the short-end remains exposed to further yield adjustments, particularly with the Fed hiking rates this year. Moreover, the prospect of fiscal expansion feeding through at the end of this year and 2018 suggests more aggressive tightening by the Fed.</p> <p>Similarly, we have retained an underweight positioning in UK Gilts. The BoE is likely to remain on hold with regards to interest rates and QE given the less negative outlook on the economy. At the same time, there is the risk that longer-term inflation expectations could accelerate given the depreciation in the GBP, although the central bank is likely look through the rise in the headline rate.</p> <p>Meanwhile, we have downgraded German Bunds to negative given that yields at the long-end are vulnerable to less dovish rhetoric from the ECB particularly given that valuations are stretched when compared to other developed sovereign debt markets.</p> <p>On JGBs, we have turned neutral as the continued weakness on the currency, as a consequence of the BoJ keeping yields at the long-end well-anchored, is increasingly testing the limits of the central bank's willingness to do more QE purchases.</p>
-	Investment Grade (IG) Corporate	<p>We remain negative on US IG bonds given very unconvincing valuations and deteriorating fundamentals, which are at risk from greater sensitivity to higher rate expectations. In addition, given the low carry offered by US IG credit, the higher cost for currency hedges due to elevated USD LIBOR funding costs makes returns unattractive and should continue to deter foreign demand for this segment.</p> <p>European IG spreads are highly correlated with the US such that we are also negative on this segment, although to a lesser degree. This is because valuations are more attractive compared to US IG credit and there is also less rate sensitivity particularly with continued asset purchases by the ECB.</p>
0	High yield (HY)	<p>US high yield should continue to benefit from the stability in the oil price and investors search for yield. However, valuations have been eroded further as spreads have tightened significantly. Overall, we are neutral, as HY offers less rates sensitivity with a higher carry cushion.</p> <p>On European HY, we remain neutral. Europe is in an earlier stage of the credit cycle compared to the US, and technical factors remain broadly positive. Nonetheless, spreads remain firmly anchored around their long-term averages and valuations appear to be unattractive at current levels.</p>
0	EMD USD-denominated	<p>We remain neutral on emerging market debt bonds denominated in USD as valuations have continued to turn less compelling. Instead, we prefer harvesting the carry in EMD local currency bonds given that valuations are more attractive and fundamentals continue to improve at the margin. With falling inflation expectations within some of the countries in the universe, such as Brazil and Russia, there is scope for more policy easing or less aggressive rate hiking by central banks.</p>
++	EMD local currency-denominated	
0	Index-linked	<p>We still expect inflation expectations to be lifted by base effects from the oil price along with the rise in wages and prospect of stronger growth. However, the valuation support for break-even inflation rates has moderated following a significant improvement in sentiment. At the same time, we have remained negative on the nominal bond equivalents.</p>

Key: +/- market expected to outperform/underperform (maximum ++ minimum - -) 0 indicates a neutral position.

Alternatives Views

Key Points

+	Alternatives	
+	Commodities	<p>We have retained our overweight positioning on commodities as there is evidence of a meaningful supply adjustment in some of the sectors. There has also been a reduction in the drag on returns from the negative carry in certain commodity segments.</p> <p>On agriculture, consumption growth has been strong but prices continue to reflect high levels of global stocks. Instead, farmers are coming under increasing financial pressure from low prices, which may impact future supply. Overall, we maintain our positive view on the sector.</p> <p>In comparison, we have turned neutral on precious metals as gold is vulnerable to an environment of higher real rates and a stronger USD. However, gold remains a diversifier in the portfolio and a hedge against the increase in political risks this year, particularly in Europe.</p> <p>Despite the agreement to cut production by OPEC and non-OPEC producers, we have retained our neutral stance on the energy complex. While supply-demand dynamics of the sector are more balanced, a large surplus of oil inventory still exists and US shale production is rising again. There could also be a potential upset in supply from the return of production by Libya and Nigeria. Overall, we need to see evidence that the energy curve has moved into backwardation before upgrading this segment of the market.</p> <p>We have upgraded industrial metals to neutral given that demand is likely to benefit from the prospect of infrastructure spending under the Trump administration and Chinese stimulus to keep the economy well-supported until the 19th National Party Congress. While this sector is still oversupplied, particularly copper and aluminium, we have started to see some rebalancing with lower prices feeding into supply.</p>
-	UK Property	<p>In the occupier market, the outlook is mixed post Brexit where demand for offices in central London by financial services has been hit by concerns over access to the EU single market. Elsewhere, demand for retail space outside London is generally weak given the squeeze on retailers' profit margins. In contrast, there is continued demand for regional offices from professional service firms and the government's plan to consolidate the civil service outside London will provide further support. The industrial and distribution sectors also benefit from the continued growth of online retail.</p> <p>In the investment market, the majority of domestic and foreign institutions and REITs have remained on the sidelines, although the sharp fall in sterling has encouraged foreign private buyers back into the market. UK local authorities are also very active, using their low cost of capital to acquire properties in order to pay for local services. Overall, our base case is for the all property initial yield to rise by 0.25-0.5% in 2017, with most of the increase affecting secondary property. Yields on prime assets with secure income streams should be less affected, but yields on "bond proxy" assets such as supermarkets are likely to rise.</p>
+	European Property	<p>In the investment market, we believe that the era of yield compression in continental Europe is now largely over and that real estate yields will be broadly flat over the next couple of years, for two reasons. Firstly, despite the favourable outlook for rents and the large gap of 3-4% between real estate and government bond yields, we expect that the recent upturn in Eurozone bond yields will draw some capital back to these assets. Secondly, we anticipate that certain investors who entered the market in 2012-2014, such as the US opportunity funds, will now start to sell and take profits.</p> <p>We forecast total returns of 5-7% per annum on average for investment grade European real estate between end-2016 and end-2020, assuming the Eurozone economy continues to grow. The bedrock will be an income return of 4.5%, but capital values should also increase on the back of a steady rise in rents.</p>

Note: Property views based on comments from the Schroders Real Estate Research team.

Key: +/- market expected to outperform/underperform (maximum ++ minimum --) 0 indicates a neutral position.

Economic View

Central View

Forecast update and scenarios: growth and risks rise under Trump

After a series of downgrades, our forecasts for global growth have been revised up with 2016 now expected to come in at 2.6% (previously 2.3%) and at 2.8% in 2017 (previously 2.6%). The increase for last year largely reflects a better than expected performance for global growth in Q3 which is extending into Q4. Overall, the forecast changes represent the first upgrade to global growth for nearly two years.

For this year, the upgrade is primarily led by a more optimistic view on the emerging markets, the UK (which appears to be weathering the effect of Brexit better than expected) and the US (where the benefits of looser fiscal policy begin to come through later in the year). Extending our forecasts out to 2018, global growth is expected to pick up further to 3% as US fiscal expansion fully kicks in helping lift growth across the world economy.

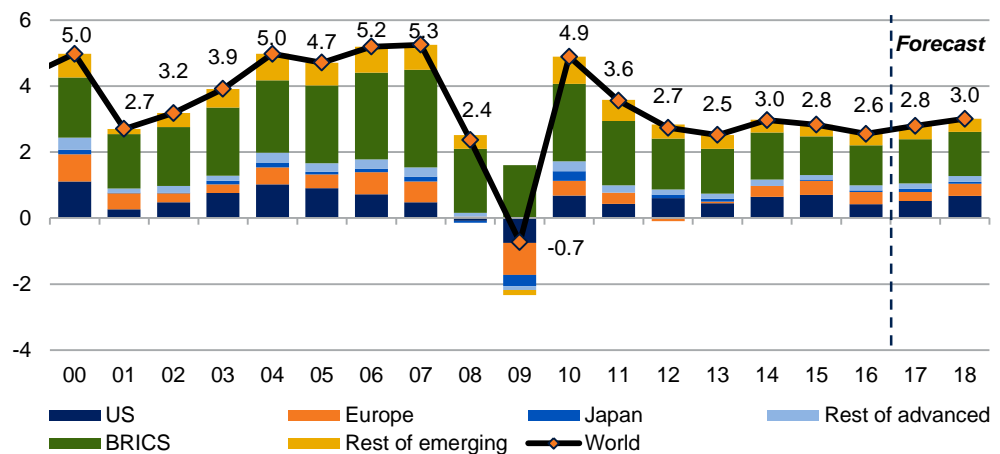
Meanwhile, our EM growth forecast was upgraded mainly due to a more optimistic view on Chinese growth. We expect as much stimulus (largely fiscal) as necessary to keep growth on target and provide President Xi with the political capital he needs heading into the 19th National Party Congress. Otherwise, growth prospects for Brazil, India and Russia were downgraded.

Inflation is expected to pick up in 2017 to 2.4% from 2% in 2016, primarily led by oil price base effects in the advanced economies. The picture in 2018 is more mixed as price pressures continue to build in the US, but tend to moderate elsewhere. The US is further advanced in the economic cycle than Europe or Asia and hence is expected to experience greater inflationary pressure. Overall, despite a pick-up in the US, global inflation is forecast to stabilise at 2.3% in 2018.

In terms of monetary policy, we continue to expect the theme of divergent monetary policy to play out with the Fed expected to raise rates to 1.25% by the end of 2017. US rates are then expected to reach 2.25% by the year-end of 2018 on the back of fiscal policy support and with US inflation rising. However, interest rates elsewhere are expected to remain on hold reflecting the earlier stage of the cycle in Europe and Asia. The BoJ is expected to keep rates on hold, but maintain QE as in a rising US rate environment, purchases will be needed to maintain the 10-year Japanese government bond yield at zero.

Chart 1: Global growth and forecast for 2017 and 2018

Contributions to World GDP growth (y/y), %



Source: Thomson Datastream, Schroders Economics Group. 25 November 2016.

Economic View (continued)

Macro risks: Scenario analysis

Full details of the scenarios can be found on page 11. The risks to our base case are skewed towards a weaker growth outcome versus the baseline.

We have reviewed and updated our scenarios and are making three changes: we are amending the “US recession”, “Global reflation” and “Brexit shakes EU” scenarios.

First, we have brought back the “**Russian rumble**” which assumes that President Putin decides to take advantage of a sycophantic US president and invade the rest of Ukraine taking the capital Kiev in the process. Western sanctions increase and Russia cuts oil and gas supplies to Europe, but there is no military response. Oil prices rise as Russian supply is locked out and financial market volatility increases in response to heightened geopolitical tension. The macro effect is one of stagflation.

“US recession” becomes “**Bond yields surge**” as the downturn in the US is triggered by a severe tightening of monetary conditions as bond yields rise sharply on fears of fiscal expansion. Housing and capital spending lead the downturn in this scenario with the overall global effect deflationary in nature.

“Global reflation” becomes “**US fiscal reflation**” as this seems more likely given the differences in international opinion on the merits of fiscal action. There is a US fiscal stimulus in the baseline (worth around 1.5% GDP), but this is doubled in the scenario to 3% of GDP. The result is a major reflation with the Fed having to tighten more aggressively to counter the acceleration in wages and prices as the US overheats.

“Brexit shakes EU” becomes “**Le Pen breaks Europe**”. Of the three major elections in the Eurozone in 2017, the French Presidential vote has the greatest potential to produce a shock. Front National leader Marine Le Pen is expected to lose in a run off, but given the recent dire performance of the opinion polls we should not rule out another surprise. If elected she would call a referendum on France’s membership of the EU creating the potential for a “Frexit”, the loss of a cornerstone of the EU and ultimately the break up of the euro. In this scenario, the euro comes under significant downward pressure, bond spreads blowout and business confidence collapses. Eurozone demand and activity slumps with deflationary spill-overs to the rest of the world.

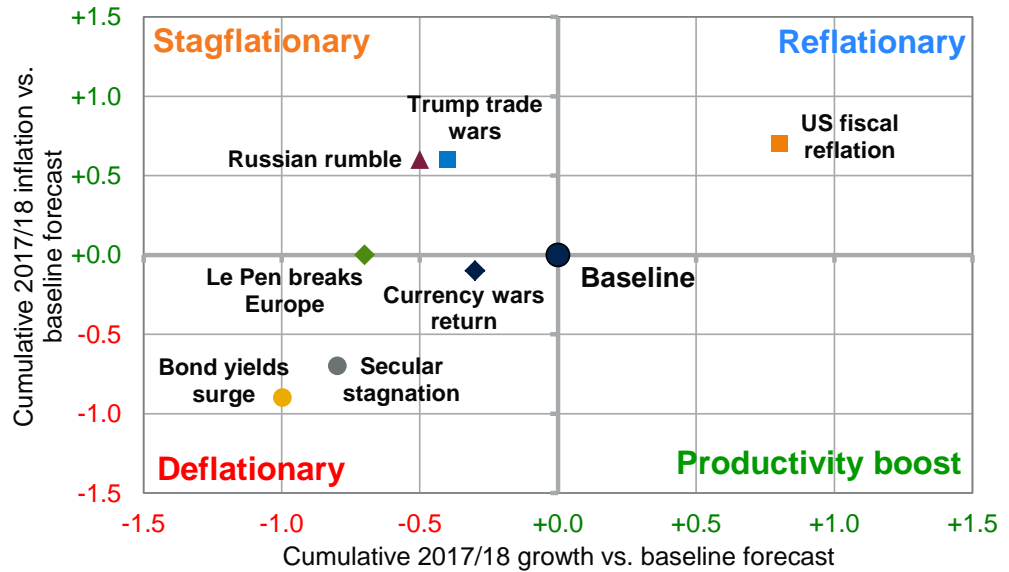
In the “**Secular stagnation**” scenario, weak demand weighs on global growth as households and corporates are reluctant to spend, animal spirits remain muted and capital expenditure and innovation stay depressed. Supply side adjustment is slow with over capacity persisting around the world, particularly in China, with the result that commodity prices and inflation are also subdued. There are elements of the baseline here, but this scenario takes them to a greater extreme such that global growth and inflation are some 0.5% lower in 2017 than in the base case.

Meanwhile, the “**Currency wars return**” scenario depicts a situation where we see a further round of currency devaluations, with financial markets unnerved as it is seen as a symptom of a chronically weak world economy. On the whole this is a stagflationary outcome as inflation rises through weaker currencies, while global activity suffers from increased uncertainty and financial market volatility.

Otherwise, “**Trump trade wars**” describes a situation where US turns protectionist and pushes up tariffs on its trading partners, tearing up North American Free Trade agreement (NAFTA) in the process.

Economic View (continued)

Chart 2: Scenario analysis – global growth and inflation impact

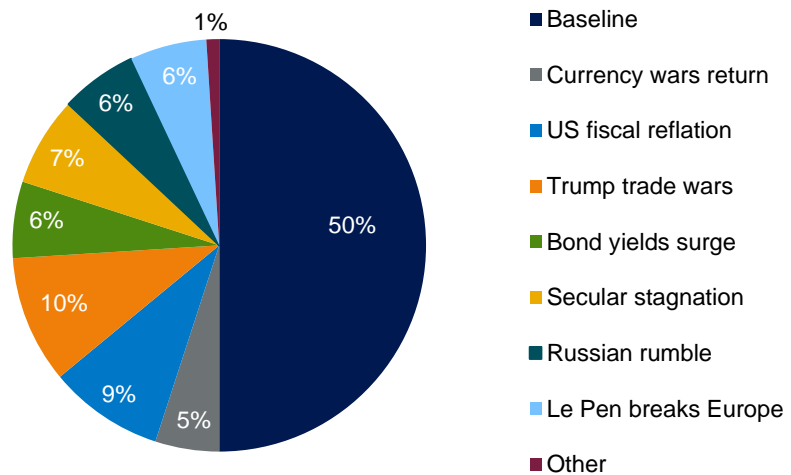


Source: Schroders Economics Group, 25 November 2016.

Chart 2 summarises the impact each scenario has on global growth and inflation relative to the baseline. There remains a bias towards weaker growth outcomes with six scenarios, representing a combined probability of 40%, expecting growth lower than the central scenario.

Similar to last quarter, there are no scenarios that fall in the productivity boost category (higher growth and lower inflation than the baseline). The probability of a reflationary scenario compared to the baseline has fallen to 9%. This partly reflects the more reflationary view in the baseline forecast.

Chart 3: Scenario probabilities (mutually exclusive)



Source: Schroders Economics Group, 25 November 2016.

Economic View (continued)

Table 2: Scenario summary

Scenario	Summary	Macro impact
1. Currency wars return	Sustained capital outflows cause China to devalue the CNY by 10% in Q1 2017. Japan responds by devaluing the JPY by 8%. This is likely to be achieved through a combination of rate cuts and increased QQE. The ECB then responds by stepping up its own QE programme and pushing the EUR down by 10%. Hence the currency wars restart. Weaker equity markets then have a further knock on effect to activity through negative wealth effects, slower consumption and weaker investment as growth expectations decline.	Modest deflation: The currency moves largely cancel each other out over the forecast period. There is, however, a redistribution of growth with those who devalue only gaining a temporary benefit. However, the USD does strengthen as a result of each devaluation, thus putting deflationary pressure on the US. There is also a general deflationary effect on activity from heightened financial market volatility.
2. US fiscal reflation	President Trump is true to his word and succeeds in pushing a massive stimulus package through Congress (3% GDP versus 1.5% in the baseline). Global growth accelerates to 3.7% in 2018 with the US growing at just over 4%. Higher commodity prices (oil heading toward \$70 per barrel) and tighter labour markets push global inflation up to nearly 3% in 2018. US Fed funds reaches 3.25% by the end of 2018, 100 basis points higher than in the baseline.	Reflationary: Stronger growth and higher inflation compared to the baseline. Central banks respond to the increase in inflationary pressure with the fastest response coming from the US. As well as raising rates to 3.25% by end-2018, the FED starts to actively unwind QE by reducing its balance sheet. The BoJ likely signals a tapering of QQE, with modest increases in interest rates. Fed action and inflation concerns result in tighter monetary policy in EM compared to the baseline. The ECB also starts to unwind QE and raises rates.
3. Trump trade wars	The election of Donald Trump as President brings a more protectionist tone to US trade policy with a significant increase in tariffs. The President imposes tariffs on China and Mexico and tears up NAFTA. Other countries retaliate and the world economy descends into a trade war.	Stagflationary: Higher tariffs push up inflation and reduce demand thus pushing the world economy in a stagflationary direction. Countries which are dependent on international trade are most vulnerable in this scenario. Local scarcity and a mismatch of supply and demand causes commodity prices to rise pushing the world economy further in a stagflationary direction.
4. Bond yields surge	Concerns about the scale of fiscal stimulus lead to a major sell off in bond markets. The tightening of monetary conditions then tips the US economy into recession in 2017 H1. Corporate confidence and the equity market are badly hit, resulting in widespread retrenchment. Weaker demand from the US hits global activity.	Deflationary: Weaker global growth and inflation compared to baseline as the fall in US demand hits activity around the world. The fall in inflation is given added impetus by a drop in commodity prices, which then adds to pressure on energy and mining companies and producers. The Fed has to ease by Q2 2017 when rates are cut back with the QE programme restarted. Interest rates are generally lower around the world with all the major central banks cutting rates further.
5. Secular stagnation	Weak demand weighs on global growth as households and corporates are reluctant to spend. Animal spirits remain subdued and capex and innovation depressed. Households prefer to de-lever rather than borrow. Adjustment is slow with over capacity persisting around the world, particularly in China, with the result that commodity prices and inflation are also depressed.	Deflationary: Weaker growth and inflation vs. baseline. The world economy experiences a slow grind lower in activity. As the effect from secular stagnation is more of a chronic than acute condition it takes policy makers time to identify the trend. However, as economic activity fails to accelerate, more stimulus is added. The US reverses its interest rate hike, while the ECB and BoJ prolong their QE programmes.
6. Russian rumble	Russia invades the rest of Ukraine. The west retaliates by significantly increasing sanctions and Russia cuts gas and oil supplies to Europe.	Stagflationary. Europe is hit by the disruption to energy supply resulting in a fall in output as alternative sources are put in place. Higher oil prices hit global inflation and the breakdown of relations between Russia and the west creates significant volatility in financial markets.
7. Len Pen breaks Europe	The UK's decision to leave the EU galvanises anti-EU support across Europe. Large and widespread protests follow as anti-establishment parties gain momentum. France, the cornerstone of the project elects Marie Le Pen as President who then holds and wins a "Frexit" referendum in Q4 2017. France begins to negotiate its withdrawal, but does not actually leave in 2018. The future of the euro and EU are cast into doubt.	Lower growth vs. baseline. The EUR comes under great pressure as investors fear the break-up of the EU. Bond spreads blow out and business confidence collapses. Monetary policy is loosened further in Europe, and with currency depreciation, inflation is higher vs. the baseline. However, this is ultimately a deflationary shock for the world economy as a result of weaker demand from Europe.

Source: Schroders Economics Group. 25 November 2016.

2016 Review: The underdogs bite back

Craig Botham
Emerging
Markets
Economist

Marcus Jennings
Economist and
Strategist

Azad Zangana
Senior European
Economist and
Strategist

2016 got off to a shaky start, with risk assets selling off

Brexit risk started to hit the pound, while many obsessed over China's currency devaluation risk

The summer saw the first big shock, with the UK voting to leave the EU...

At this time of year, we like to take a step back and review the performance of markets and the lessons we can learn for the coming year. 2016 will be remembered for a couple of major political shocks, but also the reasonably good performance of markets despite those unexpected outturns.

Investors had ended 2015 with poor returns from risk assets, and only small gains from safe haven fixed income bonds. Concerns over China devaluing its currency were still present, and weakening profits in the US had a significant number of economists predicting a recession in 2016. Commodities had a terrible 2015, and oil was under pressure again at the start of 2016, with few signs that the global excess supply was going to ease.

Spring slump as macro fear rose

2016 began with an immediate sell-off in many risk assets, as investors tried to come to terms with various risks. A key concern for investors was the impact of oil prices falling even further in the first two months of the year. Falling oil prices have become synonymous with a weaker performance from energy sectors and producers, and had called into question the credit worthiness of many firms.

One reason for the drop in oil prices was the announcement that the United Nations had concluded that Iran had implemented the steps required under its nuclear accord. This would allow the US and Europe to lift sanctions and allow Iran to sell oil to the world once again.

At the same time, investors were still concerned about the risk of China devaluing its currency sharply, despite announcing its intent to track a basket of currencies at the end of 2015. A sharp depreciation would have been deflationary for many parts of the world, but China's deviation from the currency basket in February hurt its credibility.

Meanwhile, the British pound was falling sharply as more investors woke up to the risk of Brexit, ahead of the UK's referendum in the summer. GBP was suddenly one of the worst performing currencies over recent months as investors and economists considered the implications of an exit result.

Separately, China fully unveiled its 13th five year plan by the end of April, with growth still a top priority. To achieve it, the government pledged to push forward supply side, structural reforms. In addition, the concept of development was broadened to incorporate more social aspects: welfare, household registration (hukou) urbanisation, pollution and other environmental considerations. Progress in 2016 has proved limited.

Summer Brexit shock

Just weeks before the UK's Brexit referendum, the Federal Reserve backed away from raising interest rates, bowing to pressure from markets that too much risk was on the horizon.

The re-run of the Spanish general election was largely as expected, giving Prime Minister Mariano Rajoy a larger share of the votes, which eventually led to him returning to office after the Socialist party agreed not to oppose him. The threat of Podemos (extreme far left party) has faded for now.

While the Spanish election was largely uneventful, the UK shocked most people by voting to leave the EU. The result led to the resignation of Prime Minister David Cameron, who was then replaced by Theresa May. Chancellor George Osborne was given his marching orders after setting out what was perceived to be an overly pessimistic assessment of the impact of Brexit, and threatening a "punishment budget". His successor Philip Hammond vowed to "reset fiscal policy", signalling an end to fiscal austerity. Meanwhile, the Bank of England cut interest rates to 0.25%, and restarted quantitative easing with £60 billion of new purchases of Gilts and corporate debt.

2016 Review (continued)

...while Dilma was finally ousted, helping to return some optimism to Brazil

Meanwhile in continental Europe, the European Central Bank had already announced an increase in its QE programme from €60 billion to €80 billion per month earlier in the year, but it added corporate debt to the mix of assets for the first time in the summer.

Over in EM, the Olympics, held in Rio, was a relative success for the host nation, but could not save the embattled President Rousseff. Her impeachment and removal from office at the end of August helped drive a rally in Brazilian assets as investors looked toward the possibility of reform in a more stable political environment. Her successor, President Temer, has had some success but is increasingly facing calls for his own impeachment.

Autumn provides more shocks

Back in the UK, the new prime minister's speech at the Conservative Party conference shocked markets by suggesting that she was going to prioritise sovereignty and control over immigration over access to the single market – implying that a “hard Brexit” was her default position for negotiations. In a separate speech at the conference, May also criticized the BoE's QE policy for worsening inequality in the country, which later triggered several attacks from her government towards the central bank, and in particular Governor Mark Carney. A better than expected outturn of economic data immediately after Brexit prompted complaints of politicised forecasts from the central bank. The pound tumbled further in response, but Gilts yields sold off as an extension of QE became less likely.

Another central bank facing criticism was the Bank of Japan, having failed to halt the meteoric rise in the yen. With the supply of assets to buy running low and banks complaining of flat yield curves hurting their profits, the BoJ announced that it would attempt to target a yield to maturity of zero on its benchmark 10-year government bond. This helped steepen the curve slightly, but also reduced the incentive for speculators to push the curve into deeper negative territory.

Winter of discontent

By winter, Trump was president-elect, Renzi had lost his referendum and his job, while OPEC was busy raising oil prices

The world was shocked by the victory of Donald Trump in the US presidential election in November, especially as he had been significantly behind in the opinion polls in key swing states. The defeat of the establishment's favourite candidate Hillary Clinton marks a major change in US politics, and potentially an even bigger change in international relations. Trump's threats to rip up the North American Free Trade Agreement; build a wall across the border with Mexico; name China a currency manipulator and impose huge tariffs; deport 11 million illegal immigrants; pull out of the Paris climate change agreement; pull out of NATO and the policing of other regions all have negative consequences for the world. For the US and most developed markets, his victory helped start a reflation rally as his pro-business policies and promise of huge fiscal stimulus helped ignite animal spirits.

We will of course learn more about how many of Trump's threats and promises will survive his post-campaigning policy formation, but what has been apparent so far is his willingness to test diplomatic relations, particularly with China.

Meanwhile in India, a different type of experiment was under way. In a boon to academic monetary economists but a blow to hundreds of millions of Indians, Prime Minister Modi announced on 8 November that effective immediately 500 and 1,000 rupee notes would no longer count as legal tender. Holders of the obsolete notes had until 30 December to deposit them in a bank account. The withdrawal of 86% of banknotes has seen long queues at ATMs on a daily basis and heavily inconvenienced the populace, particularly in rural areas. The immediate data has shown a hit to production and consumption but estimates vary wildly on how negative a growth shock the policy will prove. The move was originally aimed at tackling corruption and tax evasion, but only 5% of assets in tax evasion cases are held in cash.

2016 Review (continued)

In Europe, discontent was on the rise. Angry with European Union policy to distribute asylum seekers across the EU, Hungary held a referendum that was designed to give the government ammunition to reject the edict. Despite the government spending huge sums campaigning against migrant quotas, the turn-out for the referendum was less than 50% and therefore deemed insignificant, even as 98.3% of voters supported the government position. Hungarian Prime Minister Victor Orbán vowed to fight the EU, calling for “a cultural counter-revolution within the EU”.

In Austria, a re-run of the presidential election risked the far right taking control of the largely ceremonial position, only for Alexander Van der Bellen to win as an independent candidate.

Italy's prime minister, Matteo Renzi, was less fortunate in his plebiscite. He had staked his career on a referendum designed to introduce badly needed political reforms, only for the public to convincingly reject it, and more importantly him. The vote was widely seen as a vote on his future rather than on reforms. This was a rare example of where opinion polls were correct, and so the impact on markets was more muted. Renzi has since stepped down and had been replaced by former foreign affairs minister Paolo Gentiloni, with a general election expected for the end of 2017.

Helpfully, a few days after the Italian referendum, the ECB had announced that it would extend QE until the end of 2017. The monthly purchases were being scaled back to €60 billion per month, but the announcement proved to be more significant when ECB President Mario Draghi announced that central banks would be allowed to buy bonds with a new lower maturity, and bonds yielding below the deposit rate. This effectively was the removal of the floor for bond yields, and acted as an interest rate cut.

Going in the opposite direction, the Fed hiked interest rates in the US – the first hike in a year. The Fed had prepared investors in previous months, citing rising inflation, low unemployment and improving growth dynamics. The only minor surprise came from the Fed's “dot plot”, which showed an upward revision from two to three hikes for 2017. Then again, the Fed had forecast three hikes for 2016, but only delivered one.

Lastly, after months of speculation and much scepticism from analysts, OPEC agreed its first production cuts in eight years at the end of November. The deal, which extends beyond OPEC members to include Russia and ten other oil producers, sent oil prices sharply higher, with a reduction in output of around 1.8 million barrels per day. Keeping prices at these new levels though will rely upon adherence to the agreement, something which has historically proven sketchy. OPEC's efforts could also be undermined by US shale producers, who are likely to increase output to take advantage of the higher prices.

Cross-asset performance comparison

Looking across the major asset classes, global high yield bonds were the best performers (14.8%), recovering from elevated default risk related to the US energy sector. On other side of the coin, and aside from cash, US 10-year treasuries underperformed the most, managing to return just 0.9% over the year.

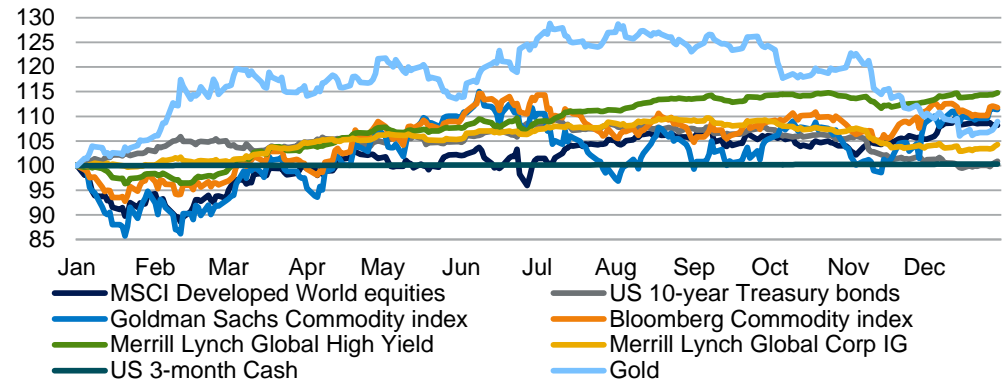
Commodities were the second best performing asset class, gaining 11.7% in 2016, after being the worst performing asset class in the previous three years. US dollar weakness at the start of the year, China stimulus and an OPEC deal all helped lift various parts of the Bloomberg commodity index

Global high yield bonds were the best performers of the year, followed by broad commodities and gold

2016 Review (continued)

Chart 4: 2016 Cross-asset performance (USD)

31/12/2015 = Base 100



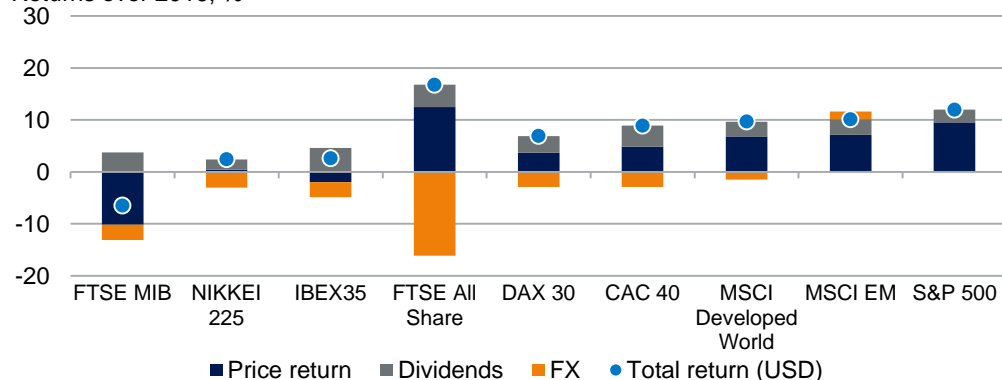
Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Global equities had another solid year with the MSCI World equity index returning (8.2%) after an initial weak start which bottomed in February. There were also concerns in the middle of the year around the Brexit vote, and also in the autumn in the run-up to the US election. However, an improvement in the earnings outlook and a politically driven reflation rally in the US helped secure reasonable returns.

The bottom two performers were unsurprisingly global investment grade credit (4.3%), and the US 10-year treasury (0.9%)

Chart 5: Equity markets performance (total returns in USD)

Returns over 2016, %



Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Elections in Spain and general negative sentiment towards European banks probably hurt the IBEX 35, whilst the eventual defeat of Renzi badly hurt investors in the FTSE MIB

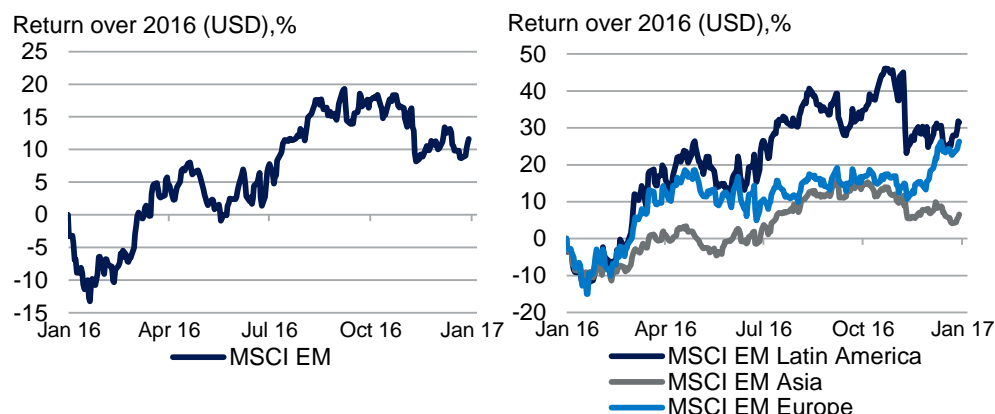
The S&P 500 was the best performing equity index in USD, but in local currency terms, the FTSE All Share did best

EM equities did well despite Trump's victory, especially Latin America and Eastern Europe

After a rocky start, emerging market equities as a whole staged a strong rally in 2016. Despite taking a tumble post the US election, they end the year some 11.6% higher than they began it. Within emerging markets, Latin America saw the biggest gains, but also the biggest Trump related falls. Given the incoming president's rhetoric, it is perhaps unsurprising that Mexico has been the underperformer in the region. The best narrative has undoubtedly belonged to Brazil, but its equity market performance has been near identical to Chile's suggesting that global themes – a risk on rally and higher commodity prices – have been the real drivers of performance. Asia proved to be the year's underperformer thanks to concerns about the Chinese economy in the first half of the year.

2016 Review (continued)

Chart 6a and 6b: Emerging market equity performance (USD)



Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Comparing currency market performance

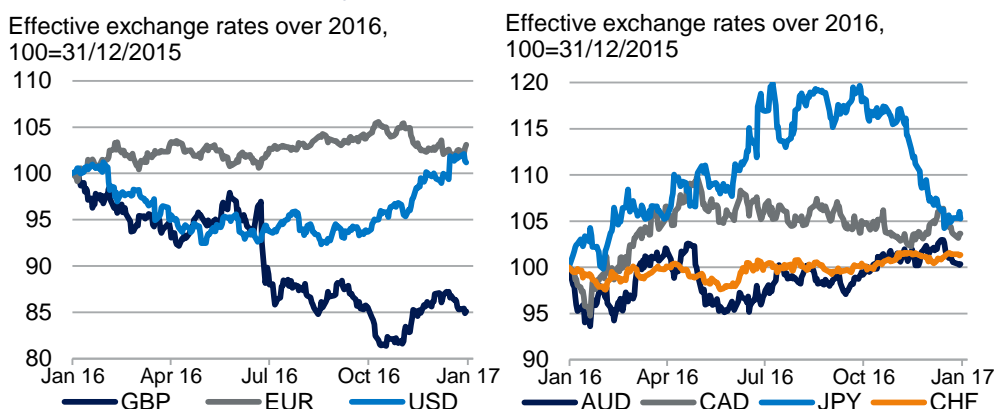
It was a year of two halves for several currencies as sentiment swayed one way or the other. For example, as it became apparent to investors that the Fed was not going to hike rates early in the year, the US dollar started to fall on a trade weighted basis, and undid most of the gains made over 2015. As oil markets bottomed out along with some of the activity indicators, the dollar started to rally, ending 2016 up 1.2%.

Although the euro fell against the US dollar, it outperformed it on a trade weighted basis throughout most of the year. The ECB was left frustrated when it expanded its QE programme yet saw its currency appreciate.

The stronger rise of the euro was largely due to the closer trading relationship with the UK, which had seen a precipitous fall in the pound. Sterling's depreciation started in 2015 as the Brexit debate started to gain media attention, but it continued to fall through the spring. The eventual result saw the pound fall further, but sterling was not done there. At its low in October, the pound had fallen 18.6% year-to-date but recovered somewhat after government ministers started to openly discuss seeking access to the EU's single market in exchange for paying fees.

Elsewhere, the yen appreciated sharply in H1 2016 as poor sentiment encouraged Japanese investors to return to the safe haven of the yen. However, the BoJ's change in policy later in the year, but also the more hawkish sentiment from the Fed, helped lower the yen from its highs, ending the year up 5.3%.

Chart 7a and 7b: Currency performance in developed markets



Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Worth noting was the impact of the US election on the EM foreign exchange universe, particularly in Mexico. The peso had been tracking the likelihood of a Trump win for much of 2016 and sold off sharply on the result. Threats of a 35% tariff, given that 80% of Mexican exports head to the States, constitute a substantial headwind.

It was a year of two halves for both the US dollar and Japanese yen

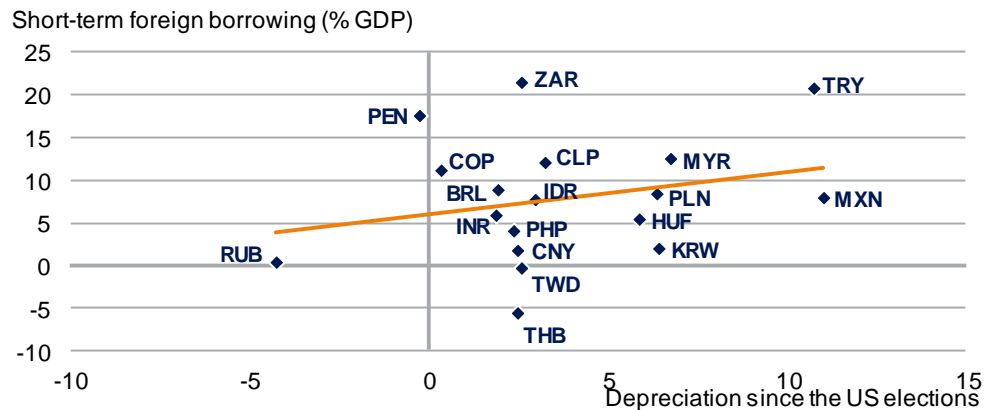
The worst performing currency was easily the British pound

2016 Review (continued)

While the Mexican peso was one of the worst affected EM currencies, it was not the only victim. All EM currencies initially sold off following the US election, but as with the Taper Tantrum of 2013, we have seen differentiation as time has gone on. As was the case three years ago, economies with greater reliance on foreign financing have seen their currencies come under greater pressure; Turkey is a prime example. The correlation is not perfect – political factors, for example, have seen a rally in the South African rand despite its equally high reliance on foreign funds, and Mexico’s vulnerability to tariffs has trumped its relatively low borrowing – but the relationship is nonetheless apparent (chart 8).

Countries with higher short term borrowing in foreign currencies underperformed amid USD strength and higher yields

Chart 8: Foreign borrowing and EM FX



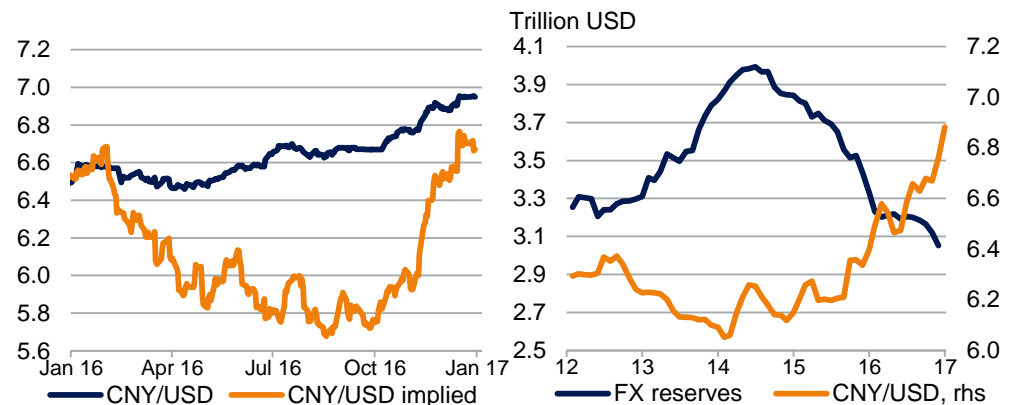
Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Despite President Trump’s rhetoric against China, it should be noted from chart 8 that the renminbi (CNY) has proven resilient in the wake of the election. More generally over 2016, the authorities in China have proven reluctant to allow the currency to strengthen.

Based on the behaviour of currencies in the renminbi’s trade weighted basket (deemed a more appropriate “reference” for the currency than the bilateral rate against the dollar), the currency should have appreciated in early 2016 but instead weakened slightly versus the dollar (chart 9a). However, note that the sharp depreciation of other currencies in the final months of 2016 has been resisted, and that in general currency weakness in China has been accompanied by falling reserves since 2014. The authorities are propping the currency up, not artificially weakening it.

‘Currency manipulator’ label not borne out by the evidence

Chart 9a and 9b: Preference for weakness, but China is supporting currency



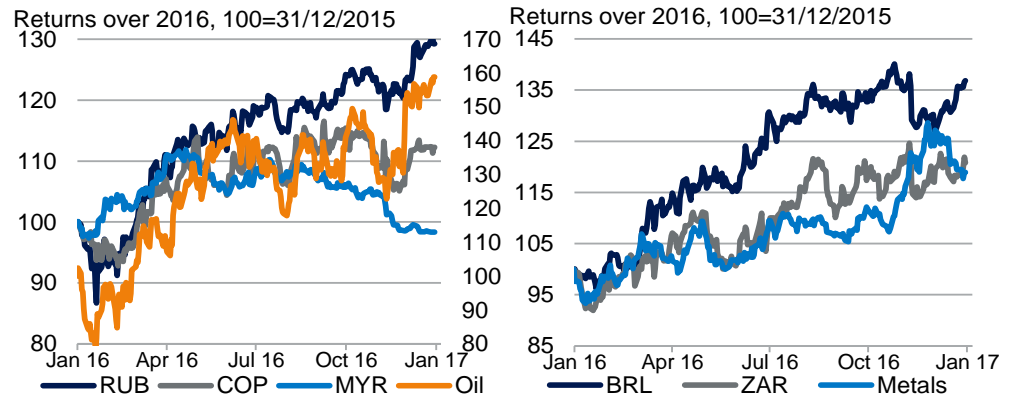
Source: CFETS, Thomson Datastream, Schroders Economics Group, 31 December 2016. CNYUSD implied shows the behaviour of the currencies in the CNY trade weighted basket versus the USD.

2016 Review (continued)

Stronger commodity performance provides a tailwind for some EM currencies

Commodity prices, which weighed on a number of EM currencies in 2015, turned more supportive in 2016. Oil rallied for much of the year which drove strong performance in the Russian rouble but other oil currencies such as the Colombian peso and Malaysian ringgit did not see the same effect as concerns over the extent of borrowing counteracted the beneficial impact of higher trade revenues (chart 10a). Meanwhile, stronger metals prices coincided with a better performance for the Brazilian real and South African rand, with the real outperforming the rand thanks to the impeachment of President Rousseff, prompting optimism on the potential for reform.

Chart 10a and 10b: Commodity prices and EM FX



Source: Thomson Datastream, Bloomberg, Schroders Economics Group, 31 December 2017. Currencies shown in total returns.

Comparing debt market performance

There was a mixed return profile across government bonds as divergent monetary policy took effect in 2016. When comparing the total local currency returns of 10-year government bonds, underperformers included Italian BTP bonds (0.2%) and US treasuries (0.9%), with the former suffering from political risk. On the other side of the spectrum, Gilts rallied 9.3%, in part to due a rate cut and extension of QE by the Bank of England.

Another interesting result of the year was the similar performance of European and US corporate credit based on the Merrill Lynch total return indices (chart 11b). Despite European credit beating US credit by 1.0 percentage point when it came to price returns, due to the lower yield on offer in Europe, on a total returns basis, European and US credit returns were the same in 2016 (4.2%).

While Italian BTPs performed poorly, other government bonds provided a greater positive return for investors

Chart 11a: Government debt returns

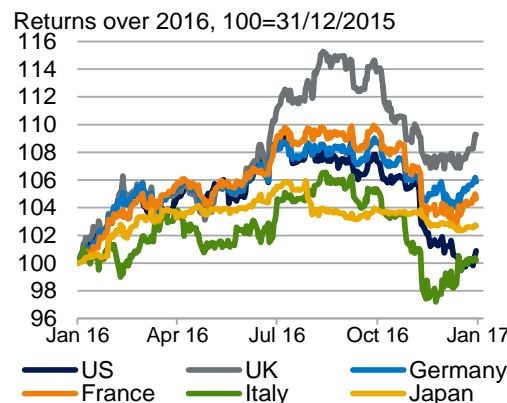
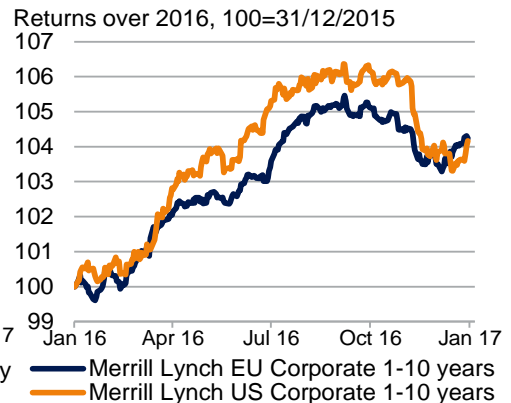


Chart 11b: Corporate credit returns



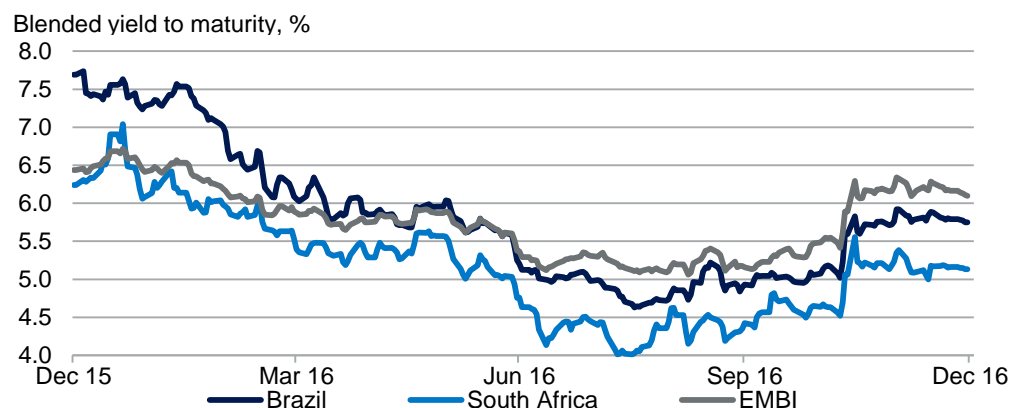
Source: Thomson Datastream, Bloomberg, Schroders Economics Group, 31 December 2017. Currencies shown in total returns.

Yields on EM government debt tracked lower in the risk-on environment which prevailed for most of 2016, before jumping higher following the US election and the global increase in yields. Furthermore, EM debt also benefitted from falling inflation with this particularly having been the case in Brazil, which provides great scope for

2016 Review (continued)

gains given a double digit policy rate. Brazil and Mexico had divergent fortunes in 2016 as yields started the year 200 bps apart but ended it at almost identical levels. EM debt as a whole (based on the JP Morgan EMBI index) saw returns of 9.8%.

Chart 12: EM debt rallies on inflation, plummets on Trump



Note: JP Morgan bond indices. Source: Thomson Datastream, Bloomberg, Schroders Economics Group. 31 December 2016.

Lessons from 2016

Having reviewed events and performance of markets over the year, we have found a few lessons worth considering for 2017:

- **If Leicester City Football Club can win the English Premier League, then anything can happen.** With odds of Leicester winning at 4,000–1 at the start of the 2015–16 season, this was clearly the biggest shock of the year. Maybe we should have seen this as a sign of things to come.
- **Opinion polls are often wrong.** Heavy reliance on betting markets and opinion polls has been proven to be the wrong strategy this year when it comes to investing around event risk. A healthy dose of scepticism and sensible hedges are required.
- **Macro forecasts are often wrong too.** Most forecasters have had to revise up estimates for growth. Such large errors are rare, but then again, so are such events.
- **Global politics is shifting, and the establishment is in trouble.** A wave of anti-globalisation sentiment is spreading, as did anti-austerity in previous years. The liberal political elite is in trouble and without change or faster economic growth, more radical policy may be pursued.
- **The power of central banks is diminishing.** Monetary policy is running out of road and negative interest rate policy has serious unintended consequences. Both Japan and Europe utilised this policy more this year, only to find that their respective currencies appreciated, while they hurt the profitability of their banks. Could we see a renaissance of fiscal activism? Perhaps under Trump, but probably not under Merkel.
- **Structural change is needed, and rewarded.** Reform, even the prospect of it, still has the power to drive markets despite repeated disappointments. We saw this in Brazil last year, and briefly in India following the passage of the Goods and Services Tax bill before the uncertainty created by demonetisation.
- **EM reliance on external liquidity has not gone away,** and will probably provide some testing times in 2017 for investors. Higher US yields will pile pressure on some emerging market economies.
- **Growth remains the key priority for China,** despite lip service given to reforms. The authorities remain confident and will not be rushed on this front. This could make trade negotiations interesting.

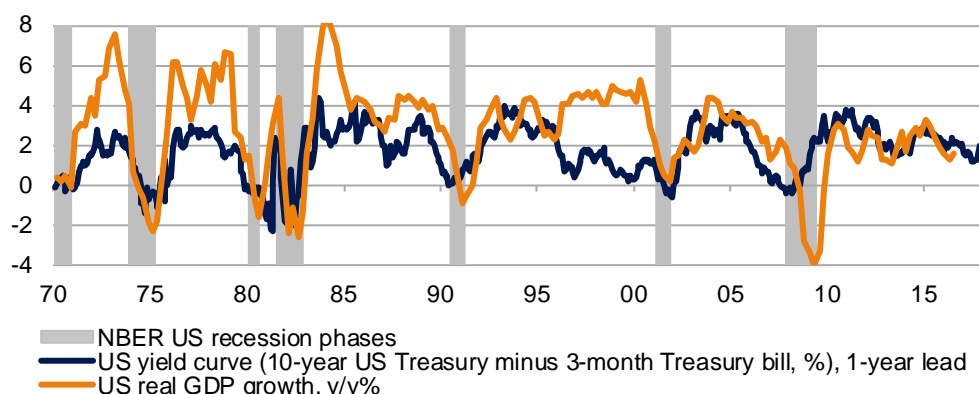
Global strategy: The Trump trade: how far can it go?

Keith Wade
Chief Economist and Strategist

Despite predictions of an equity market meltdown, the election of Donald Trump as president of the United States has brought an extraordinary rally in risk assets. Each of the main US equity indices have reached a new record high since 8 November. Concerns that the new president would bring chaos and confusion have been put aside and instead markets have bought into the “reflation” or Trump trade. Bond yields have risen, yield curves have steepened and cyclical sectors have rallied – all signs of an increase in growth expectations (chart 13).

Markets are pricing in higher growth, inflation and interest rates

Chart 13: US yield curve signals stronger GDP growth

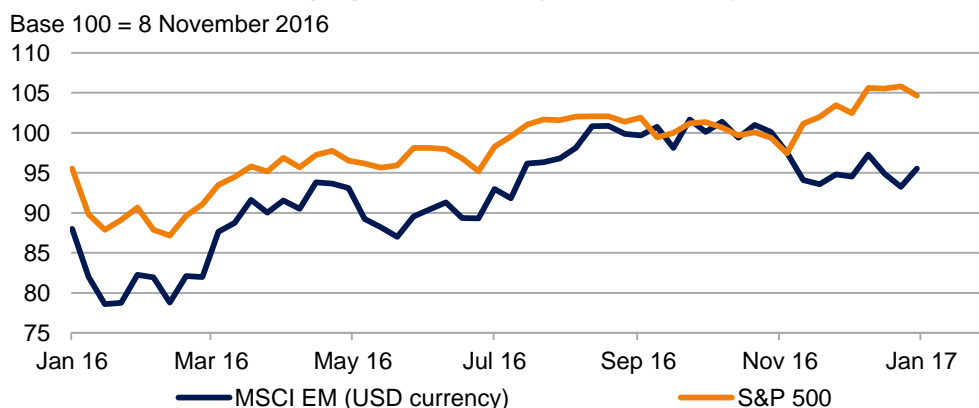


Source: Thomson Datastream, Schroders Economics Group. 31 December 2016.

The rally in US equities has been followed in other developed markets with Europe and Japan also performing strongly since the election. Note that we have seen a significant change in the market: previously driven by falling bond yields and a search for yield, the latest rally is one where investors are looking for growth to drive returns. However, despite the return to cyclical, the emerging markets have not fared so well and are below their pre-election levels (chart 14).

Emerging markets have suffered...

Chart 14: US and emerging market equity part company



Source: Thomson Datastream, Schroder Economics Group, 31 December 2016.

In short, it would seem that investors have fully bought into Trump’s promise to “make America great again”: activity will be stronger and trade deals more favourable to the US. Inflation and interest rates are heading higher. The dollar has strengthened and capital has flowed out of emerging markets, which are seen as the losers in Trump’s new world.

Pressure on the emerging markets

The pressure can be seen in the foreign exchange markets where capital outflows have weakened emerging market currencies. One key focus has been the Chinese yuan which has been falling against the dollar whilst China has seen a drop in foreign exchange reserves. The turning point in the CNY correlates closely with the switch from rising to declining FX reserves in 2014 (chart 15 on the next page).

...as capital leaves the region

Global strategy (continued)

Chart 15: China's currency and foreign exchange reserves in retreat



Source: Thomson Datastream, Schroders Economics Group. 31 December 2016.

Some of the drop in reserves reflects revaluation effects from a stronger dollar and higher rates; however, over the past year the fall in reserves also reflects net outflows of capital (given that China runs a current account surplus). Capital controls have been tightened and with the latest restrictions on multi-national corporations they have become more restrictive. The January reset of the annual foreign exchange allowance (\$50k per person) promises to be a key challenge for the authorities when we can expect to see a further decline in reserves.

The risk of a one-off devaluation of the CNY remains significant as the authorities seek means of stemming capital outflows. The approach of pumping liquidity into domestic assets to make them more attractive is running out of road as one bubble after another bursts. The alternative is to curb the enthusiasm for the dollar by making it more expensive: a sizable one-off devaluation may be the only means of killing off expectations of further depreciation. The recent depreciation of the Japanese yen will have added to pressure on the CNY and consequently the risk of a response and another round of currency wars remain high.

Risk of
currency wars
remains high

What might stall the reflation trade?

At this stage the reflation trade has strong momentum as investors jump on the Trump band wagon. However, as we have argued before, the impact of the new president's fiscal policies will not be felt until end-2017 and into 2018. There are also some tricky waters to be navigated before they take effect.

As a reminder, our baseline forecast assumes a fiscal package of \$280 billion (1.5% of GDP) which we estimate would translate into a boost to GDP of 0.75% in 2018.

We are already assuming a considerable scaling back of Trump's plans (see table 3 for the unexpurgated cost). On these plans, the budget deficit is expected to rise significantly and push the debt/GDP ratio to well over 100%.

Table 3: The cost of president-elect Trump's fiscal proposals

Policy	10 year \$billion impact	% GDP
Individual income tax revenue	-3,343	-1.8
Corporate income tax revenue	-2,633	-1.4
Estate and gift tax revenue	-174	-0.1
Total tax policies	-6,150	-3.3
Infrastructure spending	-550	-0.3
Health spending	-50	0.0
Total spending	-600	-0.3
Total tax and spending	-6,750	-3.6

Source: Tax Policy Centre, CRFB, Schroders Economics Group, 20 December 2016.

Global strategy (continued)

Republicans want tax reform not tax cuts

Such largesse goes against the grain for many Republicans who will fear the impact on the budget deficit. Not surprisingly, most are more focused on tax reform than tax reduction and House Speaker Paul Ryan has made it clear that Republicans want deficit neutral tax reform. Essentially this would mean offsetting tax cuts by closing loopholes and eliminating deductions. Whilst we would still see the headline cuts in tax rates, the net fiscal stimulus would be reduced as other measures claw back revenue. Consequently the impact on US activity could be less than the market is currently expecting. Markets are likely to be highly sensitive to the course of these negotiations.

Fiscal multipliers may fall short

Even if much of the package does get through Congress, the impact on activity may still prove disappointing. Fiscal multipliers on tax cuts are lower than direct government spending as households can choose to save some of the gains, or spend on imports rather than domestic production. Estimates vary, but are typically around 0.5 that is for every \$1 of tax cut, output rises by \$0.50.

The biggest beneficiaries of the Trump tax cuts are the wealthy: estimates suggest that his plan will raise the income of the top 1% (with incomes above \$1 million) by 14%, or more than \$215,000. By contrast the middle of the income distribution get around \$1000 or 2%. Whilst some may see this as concentrating the gains in the hands of "wealth creators", in practice such a distribution will be saved rather than spent, thus reducing the impact on the economy.

The fiscal multiplier on infrastructure spending is higher with estimates up to 1.5 times the amount invested as expenditure flows through the economy. Consequently we might be more confident about the effect of this spending on growth. There are also the longer-term benefits to be gained from the completed assets (e.g. new road, airport, or bridge).

Timing and take-up issues with infrastructure

As always though there is an issue with timing: infrastructure plans take time to be approved and implemented (e.g. Heathrow's third runway in the UK) and often the stimulus is felt years after the original proposals were made. Furthermore, the issue with the current plan is that the expenditure is to be driven by private sector subsidy rather than direct spending. This is likely to take the form of a tax break (worth 82 cents in the dollar) for firms who invest in private infrastructure projects. Clearly, there is a risk that the private sector take up will be slow and that stimulus takes even longer to come through than direct government spending.

So there are political and economic reasons to question the scale of the stimulus likely to be provided by the Trump plan. The appointment of fiscal hawk Mick Mulvaney to be director of the Office of Management and Budget for the incoming Trump Administration only increases the likelihood that the impact will be less than markets are expecting.

In practice this might not be a bad thing as the US economy is, in our view, capacity constrained and would be at risk of overheating should too large a boost be delivered. A smaller fiscal stimulus would mean less inflation, less monetary tightening from the Federal Reserve and probably a weaker US dollar. This in turn would take some of the pressure off the emerging markets. Nonetheless, at present markets do not seem to be anticipating problems either in terms of delays by Congress, or in boosting growth significantly. Such optimism is likely to be questioned in the new year: prepare for a reappraisal of the Trump trade.

Global strategy (continued)

Political risk shifts to Europe and the euro in 2017

Brexit, Trump...Le Pen...Grillo?

Although 2016 has had its fair share of surprises and the decisions and progress of the Trump administration will be critical for markets in 2017, politics will also continue to loom large in Europe. General elections in the Netherlands, France, Germany all feature next year. Our outlook for the European economy is one of steady growth, but this does not incorporate any major electoral upsets.

In our scenario analysis, we identified the French presidential election as the one which carries the greatest chance of an upset (Le Pen breaks Europe). The opinion polls suggest the Republican Francois Fillon will win, but given the failure of opinion polls in 2016, markets are likely to be sceptical until the results are announced. Marie Le Pen would like to hold a referendum on France's membership of the EU, creating the potential for a potential break up of the euro.

The German elections look less risky with Angela Merkel's Christain Democrats widely expected to retain power, but following the resignation of Prime minister Renzi there is plenty of scope for a shock from Italy. No general election has been called, but a vote is widely expected towards the end of 2017. With the 5 Star movement in front in the polls there is the scope for Beppe Grillo to come to power and bring a referendum on the euro. Against this backdrop we would expect the European Central Bank to keep asset purchases running through the year and well into 2018. As a result the main conduit for political risk is likely to be through a weaker euro.

Research note: Reflation rotation amongst US equity styles and sectors

Tina Fong, CFA
Editor

Since the US 10-year Treasury yield hit a multi-decade low in the summer of last year, there has been a significant shift of fortunes amongst US equity styles and sectors. Previously, investors appeared to be concerned that the world could enter a period of secular stagnation such that they had a love affair with defensive, high quality and bond proxy strategies. Now, the meaningful re-pricing of bond yields in recent months suggests that the market is now embracing the reflationary theme, which has been driven by the strengthening in the US economy and the prospect of higher inflation from the recovery in the oil price. In a post US election world, this has been further fuelled by the hope of greater fiscal reflation from the incoming Trump administration. Clearly there is room for disappointment with such optimism over the “reflation” or Trump trade, which is discussed in the global strategy section.

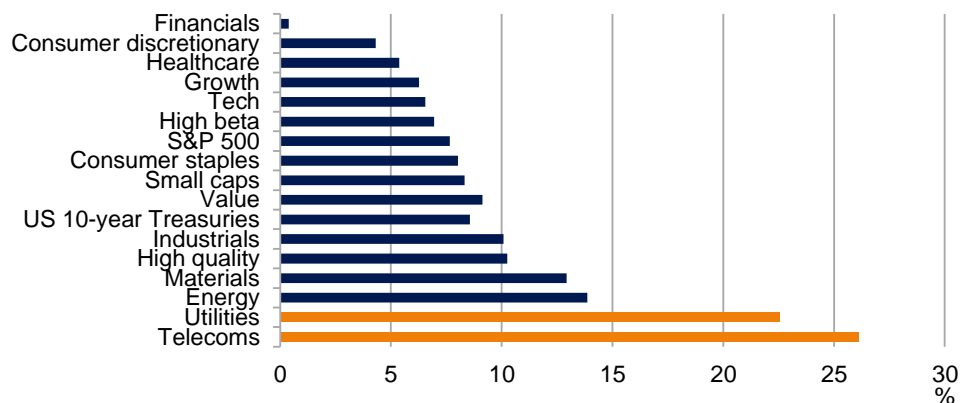
In this note, we examine the rotation of US equity styles and sectors due to the reflation theme by looking at some of the winners and losers. We also consider the typical behaviours of these asset markets in the expansion/ reflation phase based on our measures of the US cycle.

Performance rotation

At the start of the year, US recession fears and concerns over a devaluation of the Chinese currency meant that investors flocked further into high quality, defensive and bond proxy strategies with the utilities and telecoms sectors outshining the rest (chart 16). By the summer, there was a significant re-pricing of bond yields which was boosted by the election of Donald Trump. Over the last three months, those styles and sectors that were deemed by the market as the “reflation trade” have taken over the performance leadership. In other words, the cyclical areas that are highly positively correlated with moves in US Treasuries have outperformed such as value and high beta styles (chart 17 on the next page). By contrast, the defensive and most sensitive to higher bond yields such as the utilities have been hit the hardest.

Styles and sectors deemed the “reflation trade” has taken over the performance leadership

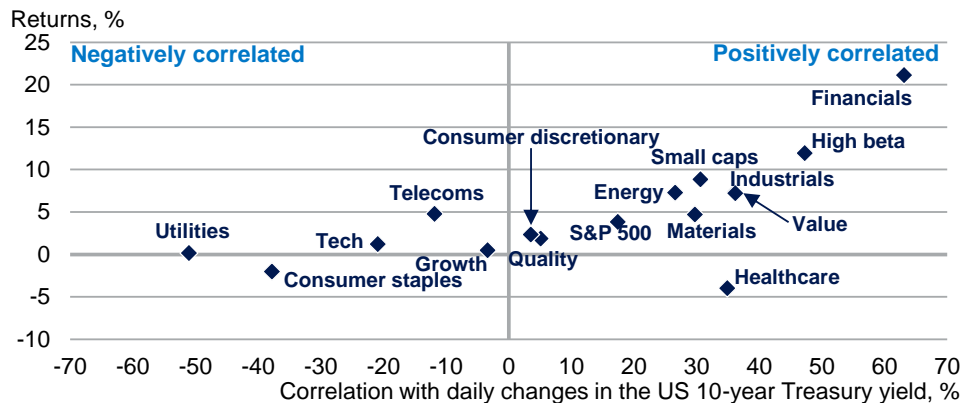
Chart 16: Performance of S&P US styles and sectors – first 6 months of 2016



Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Research note (continued)

Chart 17: Performance of US styles and sectors and correlation with movements in US Treasury yields – last three months (Q4 2016)



Note: Styles and sectors are based on the S&P total return indices. Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

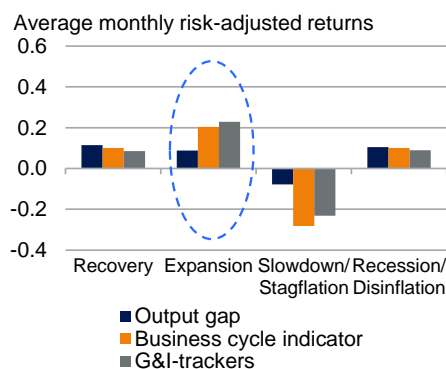
Reflation phase of the cycle – equity styles

The recent fortunes of US equity styles and sectors have broadly been consistent with their behaviour typically seen during the reflation/expansion phase. Charts 18a and 18b shows the average monthly risk-adjusted returns of cyclical versus defensive sectors and high quality in the different phases of the US cycle based on our proprietary economic cycle measures.¹ The highlighted blue circles indicate the latest phase according to the cycles.

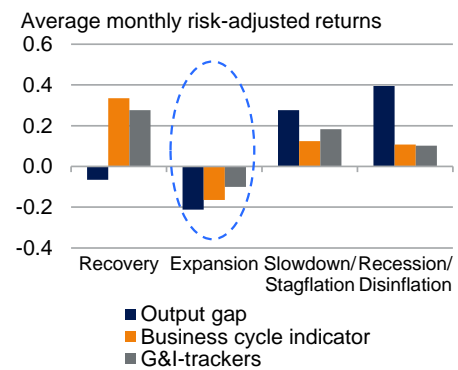
Cyclical sectors tend to beat their defensive peers when the US cycle is in expansion....

Chart 18a and 18b: Performance of cyclicals and high quality by cycle phase since the 1990s

US S&P cyclicals versus defensive sectors



US S&P high quality versus S&P 500



Note: We calculate the average monthly risk-adjusted returns calculated over completed phases of the cycle. Cyclicals is an equally weighted basket of S&P tech, industrials, materials, energy and consumer discretionary whilst defensives consists of consumer staples, health care, telecoms and utilities. Source: Schroders Economics Group, Thomson Datastream, 31 December 2016.

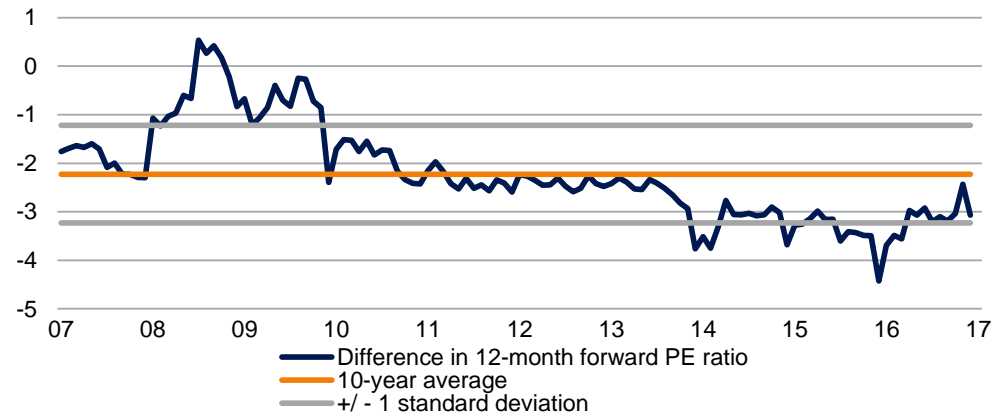
...whilst high quality stocks perform poorly

In a reflationary regime, cyclical sectors tend to beat the more defensive areas of the market given the stronger growth and inflation environment. In comparison, high quality strategies perform poorly in the expansion phase and excel in the slowdown/stagflation phase when investors seek their more defensive and stable income attributes. In this phase, market volatility generally increases in response to the Fed tightening monetary policy, but also the unfavourable trade-off between higher inflation and weaker growth. While our cycle measures suggest that we are in the expansion/reflation phase, we must be cognisant that the US economy is also exhibiting late cycle behaviour with the tightening in the labour market and the Fed hiking interest rates.

¹Output gap is based on our calculation using capacity utilisation and unemployment rate where a positive/ negative and rising/falling gap determines the phase of the cycle. Business cycle indicator is based on a combination of macro, consumer and credit indicators where phases are determined by the change over a 12 month period. The I-trackers consist of various leading inflation indicators whilst the G-trackers use a collection of growth indicators. Phases of the cycle are based on looking at the change in these indicators over the month.

Research note (continued)

Chart 19: S&P Value versus growth – 12-month forward PE ratios

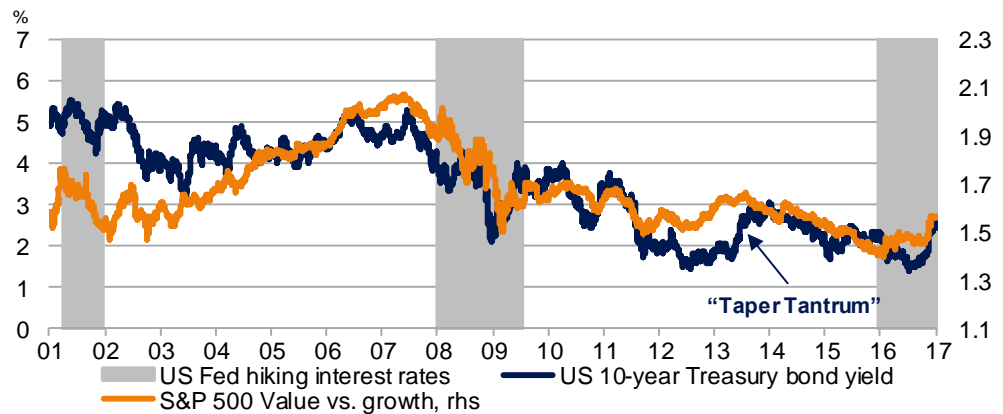


Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Value style benefits from a rising rates environment...

Meanwhile, the rotation into value stocks over the past year has meant that the valuation discount compared to growth equities has been gradually eroded based on the 12-month forward price-earnings (PE) ratio measure although it still looks reasonable relative to its 10-year historical average (chart 19). Clearly, the value trade has benefitted from the pick up in US Treasury yields and the rising rates environment (chart 20). To some extent this is reinforced by the performance profile through the cycle where value seems to do well in the slowdown/stagflation when the Fed is hiking interest rates towards the end of the cycle (chart 21a on the next page).

Chart 20: US S&P Value versus growth trade is sensitive to higher bond yields



Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

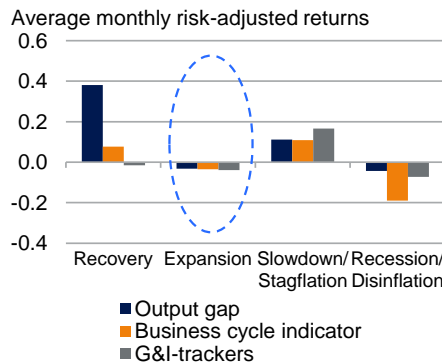
..and tends to be a late cycle trade

However, we would have expected that value also outperforms during the expansion phase given the reflationary backdrop and the rise in bond yields. Instead, risk-adjusted returns tend to be marginally on the negative side, which could be the result of the strong returns of tech sector (seen as growth stocks) overshadowing the performance of other value sectors during the expansion phase. Overall, while valuations do not appear as cheap as before, the value style has the potential to run further given its late cycle characteristics and the prospect of more rate rises by the Fed particularly over the course of 2018.

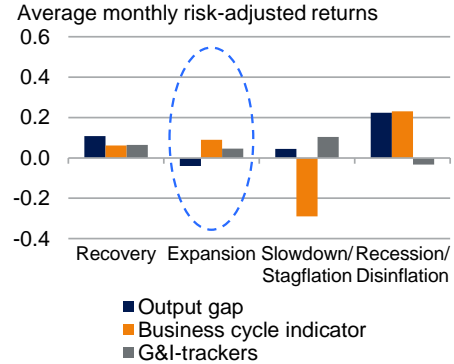
Research note (continued)

Chart 21a and 21b: Performance of value and small caps by cycle phase since the 1990s

US S&P Value versus growth



Russell 2000 versus S&P 500



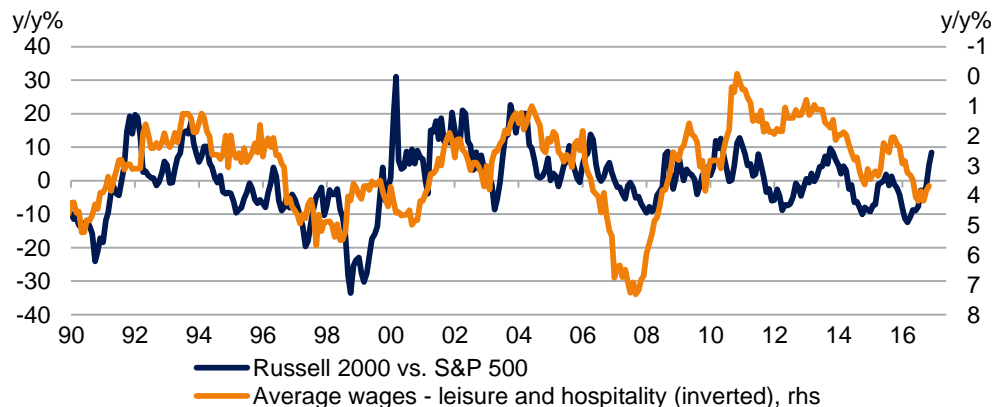
Note: We calculate the average monthly risk-adjusted returns calculated over completed phases of the cycle. Source: Schroders Economics Group, Thomson Datastream, 31 December 2016.

Higher US rates and wages suggests a challenging backdrop for US small caps

For US small caps, the best phase of the cycle is during recession periods, which is underpinned by low interest rates and benign liquidity conditions (chart 21b). The expansion and slowdown periods are more challenging as rising inflation and wages are putting a squeeze on corporate profits particularly for small companies where margins have less room to cushion the higher costs.

So far, small caps have rallied strongly against their larger peers helped by the reflationary story and also President-elect Trump’s emphasis on his “America First” policy with a focus on domestic corporates. Unless earnings growth delivers, small caps remain vulnerable to a backdrop of rising rates and wage growth. Chart 22 shows that there is a good relationship between the outperformance of the Russell 2000 relative to the S&P 500 and wage growth in the leisure and hospitality sector, with the latter appearing to be better at capturing the wage costs for small businesses.

Chart 22: US small caps tend to underperform when wages are rising



Source: Thomson Datastream, Schroders, 31 December 2016.

Shift towards the cyclical

The US financial sector has clearly been a winner with the rise in interest rate expectations and steepening in the yield curve which should boost banks’ net interest margins and profitability. During the “Taper Tantrum” period in the spring of 2013, the bear steepening of the curve coincided with a strong rally in financials relative to the broader market (chart 23 on the next page). While there has been some curve steepening, the performance of financial stocks has been exceptionally strong, which could be partly attributed to the anticipation of an easing in the regulatory environment for banks under the Trump administration. For instance, the amendment or repealing of the Dodd-Frank Act could potentially reduce the regulatory burden for the smaller banks. In practice, however, it could be difficult to drop the Dodd-Frank regulation given that it was brought in to

Research note (continued)

Steeper yield curve should be supportive of financials...

increase the banks' capital buffers in the aftermath of the last global financial crisis. Overall, the steepening in the yield curve and tightening in interest rates should remain supportive of financials.

Chart 23: US yield curve and financials

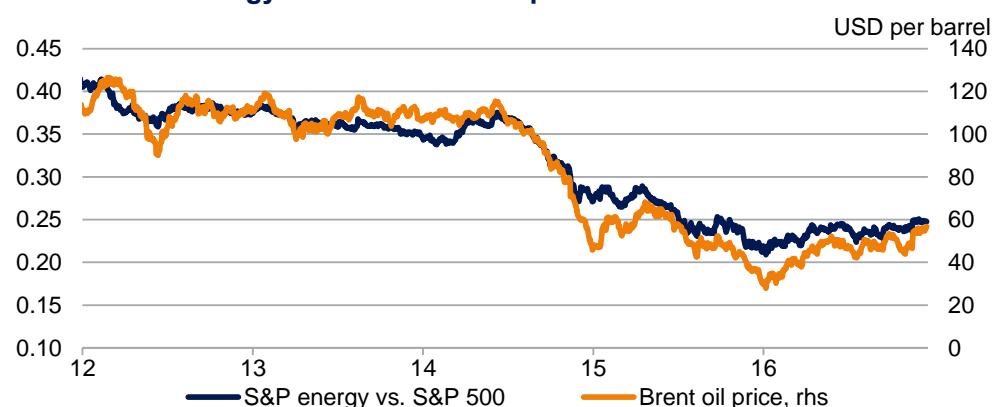


Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

...but the performance of other cyclicals could give way to fundamentals unless we see more concrete fiscal spending plans

The other winners from this reflation rotation have been the material, industrial and energy sectors, which have also benefitted from the promise of greater infrastructure spending by President-elect Trump. For the energy sector, the new President has stated that he will allow vital energy infrastructure projects like the Keystone Pipeline. While this would be helpful for the energy complex, the performance of the sector has been mainly driven by the recovery in the oil price, which has been recently lifted by the agreement to cut production by OPEC and non-OPEC producers (chart 24). However, this has to be balanced with US shale production rising again based on the oil rig counts.

Chart 24: US energy stocks and the oil price



Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Importantly, unless we see more concrete infrastructure plans which feed into meaningful earnings growth, there is the risk that the recent performance of industrials and materials could give way to underlying fundamentals. Despite the rally in the industrial stocks, this has yet to be supported by the recovery in core capital good orders (chart 25 on the next page).

In comparison, the tech sector has been the loser in the reflation rotation towards cyclicals. This has been partly driven by investors shifting funds from growth stocks like tech into value companies such as financials, which offers more of a valuation discount and benefits from the rising rates environment. Concerns over Trump's anti-immigration rhetoric could also hit the employment of temporary foreign workers on skilled-worker visas where a significant proportion is based in the tech sector. On the other hand, there has also been a discussion by the new administration on a potential one-off tax cut on repatriated overseas profits. Tech could be one of the main beneficiaries as they tend to maintain a large pile of

Research note (continued)

overseas earnings outside of the US. In an academic study by the National Bureau of Economic Research (NBER), they found that of the \$299 billion companies brought back when there was a one-time tax holiday for the repatriation of foreign earnings in 2004, 92% went to shareholders in the form of buybacks or dividends.²

Chart 25: Performance of S&P industrials and core capital good orders



Source: Thomson Datastream, Schroders Economics Group, 31 December 2016.

Conclusion

Since the summer, those styles and sectors that were deemed by the market as the “reflation trade” have taken over the performance leadership such as value, high beta and cyclicals. Instead, investors’ love affair appears to have ended with defensive, high quality and bond proxy strategies such as utilities. The fortunes of these markets have broadly been consistent with their behaviour typically seen during the expansion phase with cyclical names outperforming at the expense of high quality and defensive strategies.

Meanwhile, the reflation phase is not the best for value and small cap stocks as the latter excels in the recession periods due to low interest rates and benign liquidity conditions. However, small caps have rallied strongly against their larger peers helped by the reflationary story and also President-elect Trump emphasis on domestic corporates. Unless earnings growth delivers, small caps remain vulnerable to a backdrop of rising rates and wage growth. For value, this style tends to do well in the slowdown/stagflation when the Fed is hiking interest rates towards the end of the cycle. While valuations are not as compelling as before, the value style has the potential to run further given the prospect of more rate rises by the Fed particularly over the course of 2018.

Finally, the winners in this reflationary story have been cyclicals such as financials, industrials, materials and energy, which have benefitted from the re-pricing of bond yields and the promise of greater infrastructure under the Trump’s administration. For financials, the steepening in the yield curve and tightening in interest rates should remain supportive of this sector. In comparison, the shift towards value stocks has meant that growth stocks like tech have been the losers. For the other cyclicals such as material, industrial and energy sectors, there is a risk that the strong performance seen recently could give way to underlying fundamentals unless we see more concrete infrastructure spending plans this year, which translates into earnings growth.

² NBER paper, “Watch what I do, not what I say: The unintended consequence of the Homeland Investment Act,” June 2009.

Market Returns

	Total returns	Currency	December	Q4	YTD
Equity	US S&P 500	USD	2.0	3.8	12.0
	UK FTSE 100	GBP	5.4	4.3	19.1
	EURO STOXX 50	EUR	7.9	10.0	4.7
	German DAX	EUR	7.9	9.2	6.9
	Spain IBEX	EUR	8.0	7.8	2.6
	Italy FTSE MIB	EUR	13.6	17.6	-6.5
	Japan TOPIX	JPY	3.5	15.0	0.3
	Australia S&P/ASX 200	AUD	4.4	5.2	11.8
	HK HANG SENG	HKD	-3.4	-5.3	4.3
	EM equity	MSCI EM	LOCAL	0.2	-1.4
MSCI China		CNY	-4.1	-7.1	1.2
MSCI Russia		RUB	7.5	15.7	35.1
MSCI India		INR	-0.9	-6.2	1.1
MSCI Brazil		BRL	-2.9	2.4	37.2
Governments (10-year)	US Treasuries	USD	-0.4	-6.0	0.9
	UK Gilts	GBP	1.8	-4.0	9.3
	German Bunds	EUR	0.8	-2.7	5.9
	Japan JGBs	JPY	-0.1	-1.1	2.7
	Australia bonds	AUD	-0.1	-5.9	5.4
	Canada bonds	CAD	-1.0	-5.8	-0.5
Commodity	GSCI Commodity	USD	4.7	5.8	11.4
	GSCI Precious metals	USD	-2.0	-13.2	8.4
	GSCI Industrial metals	USD	-5.4	5.7	17.6
	GSCI Agriculture	USD	-1.3	-3.1	-4.2
	GSCI Energy	USD	8.4	8.7	18.1
	Oil (Brent)	USD	13.2	15.8	58.9
	Gold	USD	-1.4	-12.4	9.0
Credit	Bank of America/Merrill Lynch US high yield master	USD	2.0	1.9	17.5
	Bank of America/Merrill Lynch US corporate master	USD	0.6	-2.9	6.0
EMD	JP Morgan Global EMBI	USD	1.4	-4.2	10.2
	JP Morgan EMBI+	USD	1.3	-5.3	9.6
	JP Morgan ELMI+	LOCAL	0.3	0.8	4.1
Currencies	EUR/ USD		-0.8	-6.7	-4.2
	EUR/JPY		1.5	8.0	-5.9
	JPY/ USD		-2.3	-13.7	1.8
	GBP/USD		-1.4	-5.0	-16.5
	AUD/USD		-2.3	-5.7	0.4
	CAD/USD		-0.1	-2.4	3.0

Source: Thomson Datastream, Bloomberg, 31 December 2016.

Note: Blue to red shading represents highest to lowest performance in each time period.



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