Opening Bell 2017

Steven Bell assesses the prospects for economies and markets in the year ahead.

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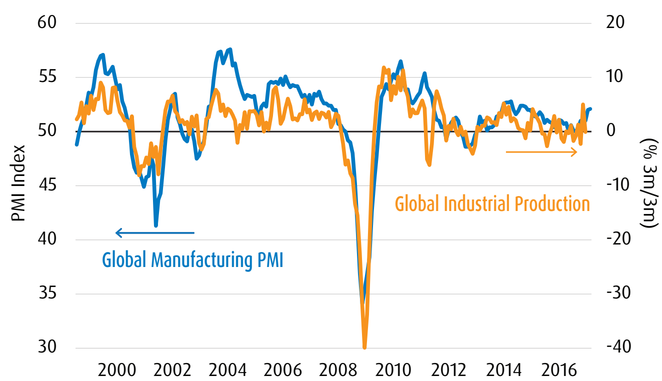
Global healing

The world seems a very different place as we start the year, with reflation the theme of the moment. Trump's victory is widely cited as the key driver of change – it certainly shifts the outlook due to his commitments to fiscal expansion and his attitudes to trade.

Closer inspection, however, suggests that changes were already underway and with hindsight, it seems that the extent of 'secular stagnation' was exaggerated. Indeed, a number of key indicators suggest that the world's economy has been healing for some time. One key indicator, JP Morgan's global manufacturing PMI, turned up last May ending a multi-year slowdown.

Monetary policy has played an effective role in this healing process but seems to have reached its limits with negative rates having disappointing effects in Europe and Japan. The baton should be passed to the fiscal authorities and Trump looks set to run ahead with it. Whether other countries will follow suit remains to be seen.

Global production turning up



Source: Bloomberg, Datastream as at 03 January 2017. PMI = Purchasing Managers' Indices.

Before looking at the US in more depth, it makes sense to check the health of China – the other global economic powerhouse. Here again the healing process is visible. State support for the property market and increased public investment are evident in improved Chinese PMI data. Importantly, private investment is now also beginning to turnaround. In 2017, the authorities look set to remain proactive at least until the plenum in October and we expect the economy's upward trajectory to continue – a positive cyclical trend that should extend more broadly across the region.

US fiscal policy to drive returns?

In an environment of high unemployment and spare capacity, risk assets will most likely benefit from a policy of reflation. But, whilst those conditions exist in many countries around the world, they are missing from what remains the most important economy from a global perspective, and the one most likely to get a major fiscal boost. In the States, unemployment is very low and spare capacity is limited. Fiscal expansion here, therefore, is unlikely to provide many more jobs but is likely to lead to higher inflation, imports and interest rates. How this plays out will be a key driver of investment returns over the course of 2017.

Talking Trump

Donald Trump's Contract with the American Voter

- Middle Class Tax Relief & Simplification Act
- End Illegal Immigration Act
- Clean Up Corruption In Washington Act
- Restoring National Security Act
- Affordable Childcare and Eldercare Act
- Repeal and Replace Obamacare Act
- American Energy and Infrastructure Act
- Restoring Community Safety Act

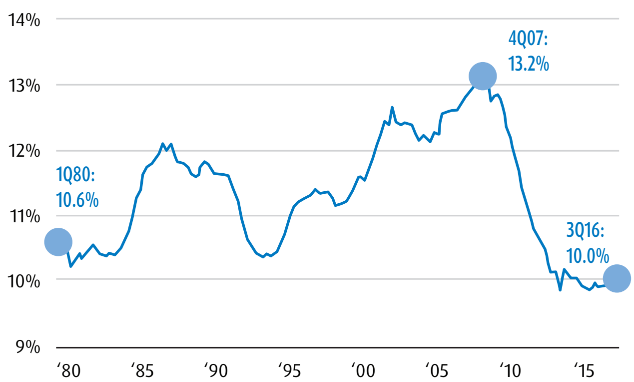
After an eventful US election season, where will the economy and markets go from here?

With planned tax cuts and higher spending amounting to around 2% of GDP, Trump's fiscal measures represent a significant move, particularly given where the US currently stands economically. In fact, the US economy is already relatively healthy. Consumer finances look good with low levels of debt and reasonable income growth supporting spending. This health extends to corporates with S&P 500 earnings per share growth turning positive ahead of Trump's victory with further improvement expected to be seen for Q4 2016. Margins, on the other hand, are contracting – a development that has historically been followed by recession. Against broader healing trends, however, we see limited prospect of that eventuality occurring in 2017.

The US consumer's finances look good

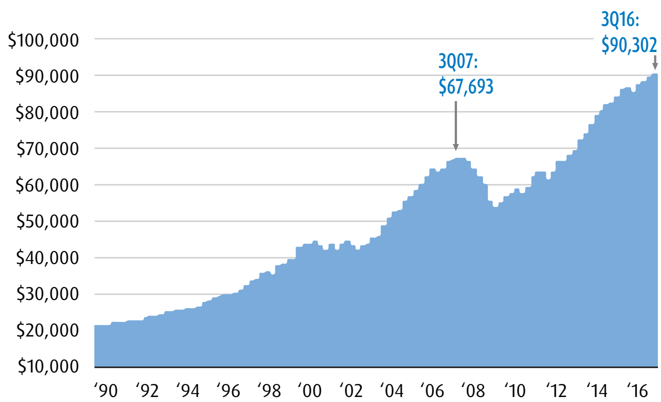
Household debt service ratio

Debt payment as % of disposable personal income



Household net worth

Not seasonally adjusted, USD billions



Source: JP Morgan, Q4 2016 Guide to the Markets; FactSet, FRB.

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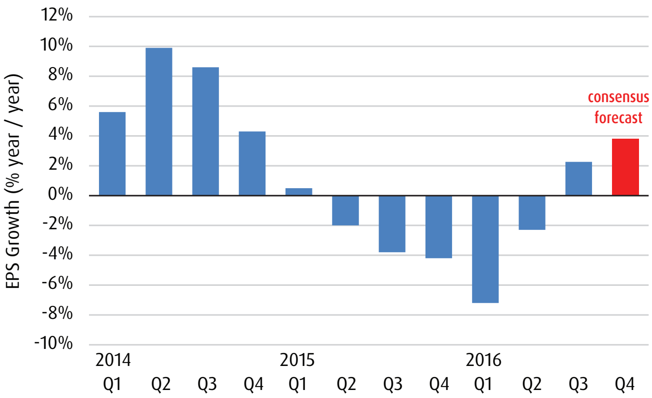
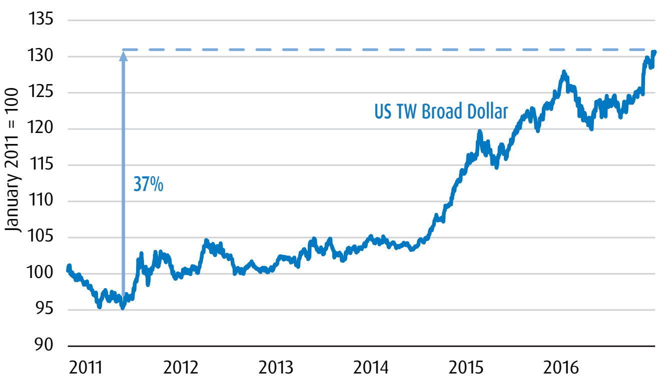
US corporate earnings are looking good too



Source: Bloomberg as at December 2016. EPS = Earnings Per Share.

Wage inflation poses another drag on profits but a US dollar that has risen 37% from its trough in late 2011 should serve to reduce inflationary pressure and therefore limit the extent of any interest rate rises. This in turn eases any concerns over the immediate outlook for bond markets. Yields are likely to rise but I don't believe that 2017 is the year of the 'big bond short'.

The mighty dollar



Source: Bloomberg as at 23 December 2016. Broad Trade Weighted (TW) Index for Dollar as calculated by US Federal reserve.

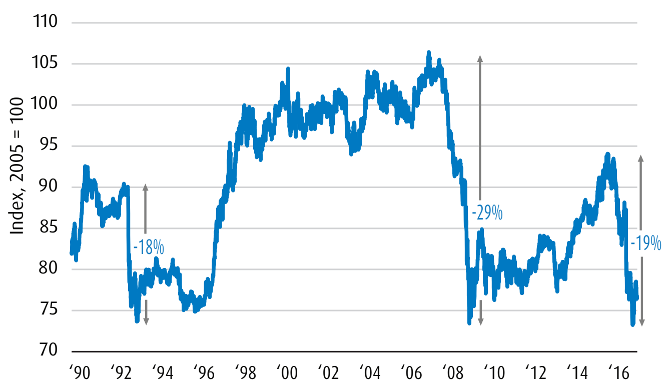
Trade is the other key area of Trump-driven change. His campaign rhetoric was headline grabbing in this area, particularly with regards to trade relations with both Mexico and China, and his post-election appointments suggest tough actions ahead. Not least of these is the proposed border tax – something we are likely to hear a lot about in the coming weeks and months. But what are the implications? Subsidising exports raises aggregate demand while taxing imports boost prices. This would tend to raise US interest rates but if other countries retaliate and we end up with a trade war, capital flight could mean lower US rates. This suggests that being long the dollar may be a safer option than selling US bonds. Yet if the dollar rises much further though, the US may look to combat what they see as the 'cheap currency' policies of countries like China and South Korea. Many Asian countries might favour a stronger currency over US protectionist measures. Trump's preference for negotiating bilateral rather than multilateral trade deals makes such trade-offs easier to achieve. Another relevant theme is the new administration's desire to see its allies pay more for the US military umbrella. Currency strength versus the dollar makes it easier for domestic budgets to accommodate increased spending on military equipment priced in US dollars. Dollar strength may be focussed on the Japanese yen and European currencies.

Trump has already had some 'quick wins', such as Ford's cancelation of a planned plant in Mexico, favouring Michigan instead and may secure more such as giving the go-ahead to the Keystone pipeline. Of much more concern though, is how measured and even-tempered Trump will when tensions arise be they domestic or international. The risk is that financial markets take fright.

The UK and Europe

After the result Brexit referendum I, alongside many others, expected the UK economy to enter a recession. Whilst that didn't occur, sterling's fall certainly was dramatic and the UK economy still looks set to slow. Employment figures have been weak and investment is on a downward trend – not surprising given the high levels of uncertainty.

GBP Broad Trade Weighted Index



Source: Bloomberg as at 08 December 2016.

In contrast, Europe has been doing surprisingly well, albeit partly because the consensus was too pessimistic. This is a major support for the UK. In fact, on the Citi Group Index of economic surprises, Europe is the strongest major region in

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the world. Heading into 2017 we may see some modest fiscal expansion in Italy and potentially France. In the latter, there is some expectation that April's presidential election will result in yet another populist victory. As things stand currently, however, the likelihood of a Le Pen presidency looks relatively low.

Implications for investment markets

Higher US rates and a strong US dollar will see markets struggle to make much headway and although equities are our favoured asset class, stronger economic data could see bonds rally and shares fall at some point. In terms of sectors, recent trends look set to continue with cyclically orientated areas outperforming and bond proxies struggling. The prospects for emerging markets remain difficult as dollar strength and rising rates outweigh the benefits of better growth. But 2017 might be the year in which European equities finally outperform, ending half a decade of disappointment.

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