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General Economic Overview – Quarter 4 2016

Economic conditions changed little in 2016, with the broader consensus still predicting a ‘lower for longer’ environment for global growth, inflation and interest rates. The continued expansion of monetary policy in 2016 was the strongest influence on asset pricing alongside the various political events which took place during the year. In January and February, markets sold off based on fears of a recession, with some commentators describing the December 2015 Fed rate rise as a policy mistake. There were also concerns about a rapid and uncontrolled devaluation of the Chinese currency alongside falling commodity prices. Markets did eventually stabilise and rally, only then to be hit by political upheaval following the UK EU referendum, uncertainty surrounding other European elections and of course the US elections. No sooner had investors come to terms with lower interest rates than market sentiment turned, based on the belief that the ineffectiveness of extreme monetary policy was ever more apparent, and that the authorities and governments would turn to a fiscal response to try and boost the anaemic post-GFC growth rate.

After strong returns following the referendum, government bond markets started to turn in late summer, and this quickly led to sector rotation in equity markets. Many parts of the equity market had benefited from ever-lower bond yields, whilst other sectors had been hamstrung by this, especially in the financials space – zero and negative bond yields are not a good environment for the business models of either banks or insurance companies. This gradual change in market sentiment then suffered a further shock with the unexpected election of Donald Trump as the US President, which proved the catalyst for a rapid re-pricing of bonds and an equity market sector rotation with a change in market leadership.

The final quarter of the year was dominated by the political issues that ran through from June when the UK voted to leave the European Union and the fundamental valuation of stocks has taken a back seat to the changes taking place in governments across the globe. One of the more surprising effects of the US election was the response of the US market, which rebounded strongly after the Trump victory based on the transition from fears of recession to optimism about reflation. This has also had the effect of delivering a market rotation towards more cyclical or value orientated stocks such as banks which are potentially big winners from higher interest rates – the S&P banks index has seen a 22% increase since the election. By contrast the effect on fixed interest markets has been negative in capital terms, with higher yields and a steeper yield curve in the US resulting in investors moving away from these assets in the final months of the quarter, believing that the US will continue to raise rates in 2017. Globally a stronger dollar has halted the emerging market rally that had been developing through quarter three and led to a recovery in Japanese stocks as the yen weakened.

Far from being a stock-pickers year, 2016 has proven to be one where macro managers making the correct top down calls have been the ones to add most value.

Equity Markets Overview

Although markets started the year with a significant jolt downwards they ended the year on a high with the UK benchmark indices reaching all-time highs on the 30th December.

Whilst this is significantly above the close in 2015, Wall Street has seen a 32% rise in value in sterling terms and was the strongest market, particularly the smaller cap stocks. The fear of a China slowdown and further commodity price falls during 2016 saw markets fall at the beginning of the year but end after a year of political surprises on a Trump-induced high.

UK

The UK economy has performed better than expected in the final quarter, and over 2016 overall, given the fears over the Brexit vote. It may be that the real effects of leaving the EU have yet to be experienced as little has changed and negotiations are still at a very early stage. All the current discussions have been about the type of exit we are likely to see and whether we will remain in the single market. The strain can be seen across Europe as the political move to what has been named the populist movement, has caused uncertainty and instability across many countries. The change in leadership in the UK was as smooth as was possible and Prime Minister Theresa May has so far delivered a balanced approach, stabilising markets. One of the other main impacts of the EU vote has been significant sterling weakness, falling to a 31-year low versus the US dollar and a 5-year low versus the euro. This may actually be one of the key factors to the UK avoiding a technical recession, as this makes exports much more attractive and imports more expensive, but it will also have an inflationary impact. CPI has started to rise and expectations are that this will rise further and producer prices are already seeing relatively steep rises, particularly on the input side. Companies will need to be convinced that the UK will be a stable environment to do business, and business leaders and external countries have warned Prime Minister May about the importance of retaining access to the single market.

The UK market ended the year on an all-time high which shortly after the June vote looked unlikely. The main source of support for this was the belief that the exit from the EU will be accommodative rather than negative, combined with a weaker currency and the generally positive effect of the US elections on other developed markets. It is widely expected that the main economic impact for the UK will be felt in 2017 with economic forecasts much lower than for 2016 – the IMF being the latest to reduce this year's growth forecast. One of the main short-term impacts seems to have been on business investment, with companies holding off significant business expenditure until they know more about the environment they will be operating in.

US

The benchmark US indices ended the year on highs after significant falls at the beginning of the year – the S&P 500 index ended the year with an 11% gain (local currency) and perhaps more significantly had risen 21.5% from the lows set at the beginning of the year. The election of Donald Trump as US President was a surprise to many, but even his most ardent supporters must be taken aback by the markets' positive reaction, a completely non-consensus view.

With the Republicans not only holding the presidency, but also control of both Houses of Congress, markets have been reassured in the belief that a pro-business agenda in the States will be forthcoming and that policies will be put in place that promote growth without protectionism – of course the new president is not due to be inaugurated until January 20th, and so it is too early to be certain about the policy programme of the next administration. The market has moved away from government bonds and also bond substitutes in favour of more economically sensitive areas, which is understandable as fiscal expansion will be one of the more easily implemented pieces of Trump policy. Economic uncertainty will continue until policy details are announced and it becomes clear which ones Congress will approve. The new president also faces the dilemma of the need to satisfy his core supporters, many of whom have never previously voted Republican - many Trump supporters in poorer states such as Virginia remain dependent on government largesse in terms of some form of social welfare in a state where the average wage is a mere \$13,000. Trump will need to satisfy popular support whilst also keeping the conservative and traditional pro-business elements of the Republican Party in Congress onside.

Rising interest rates were expected and arrived in December but there was more interest in what was likely to happen thereafter. The Fed 'Dot Plot Chart' following their last meeting showed expectations for three rate rises this year, a more aggressive line on tightening than had been priced into the markets for 2017. One important point to note is that the Fed's expectations of interest rates have not moved up to reflect the growth levels targeted by Trump and his supporters (3.5-4% real GDP growth) and if the new administration is successful in quickly lifting the US growth rate, monetary tightening may prove more aggressive than outlined by the Fed at their recent meeting. Many feel that global market expansion in 2017 may well depend on the effectiveness of the new President's economic policy.

Europe

European markets are aligned with the UK and showed this in their reaction to the vote by the UK to leave the European Union. Like many developed markets the main European indices ended the year up, having made a good positive return for the sterling investor although much less than other global markets such as the US or emerging markets.

Economic growth in Europe in 2016 was slightly better than expected but growth forecasts for 2017 remain open to revision due to the UK beginning its post-Brexit trade negotiations (Europe is the UK's single biggest trading partner). The UK referendum has also led to some discussions about the future of the European Union given the potential rise of populist politics in several European countries, particularly France, Austria and Italy. Elections are due to be held in a number of countries through 2017 and the results of these should be closely monitored for evidence of any acceleration in movements towards further possible EU membership referendums. This is very much against what the European Union leaders are trying to achieve and they have stated their resolve in making the Union stronger going forward. It has not been a good start to this process as Italy was first in line with its constitutional referendum vote in December, which ended with the defeat and resignation of Matteo Renzi.

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It is likely that political events will dominate the landscape in 2017 as they have in 2016, but Europe is in a stronger economic position than it was twelve months ago especially in terms of the economic health of the peripheral countries, perhaps with the exceptions of Greece and Turkey. A clear plan for the UK to leave the EU would be beneficial to all parties but this is unlikely to happen in the short term given the complexities and various vested interests.

Asia

As usual with Asia we look to China to set the benchmark for the region and this quarter is no exception. Chinese company management are now more positive and the wider population is gaining confidence to spend again. Retail sales, although slowing from the +12% year-on-year levels that had been recorded, are still expanding in double digits with the latest number showing year-on-year growth of 10.8% and the consumer in China seems stronger than his Western counterparts in either the States or Europe. After the missteps in policy in 2015, the Chinese leadership have recognised the role of the market and now appear less willing to intervene and happier to work more as a referee and policeman and so the policy framework in China appears to be more stable. Whilst the progress of reform is slow, the government has closed some inefficient and polluting coal mines and steel producers. China is not a free market capitalist economy and policy measures which would lead to mass unemployment and social unrest are never likely to be enacted. Recent trade numbers have surprised on the upside helped by the depreciation of the RMB and better corporate orders and leisure and travel continue to increase also aided by continued strong wage growth in the country. Even at a time when corporate profitability was under pressure, the government in China has been keen to create a more even society and expect the rich to help out. The level of debt in China remains a concern to many and is more of an issue at the corporate level than the personal level today. Whilst debt levels at local government level can look high, investors often forget that both local authorities and the central government have two sides to their balance sheets, with not only liabilities but also assets in the form of equity stakes in corporates.

Elsewhere within the ASEAN region, the Indonesian economy remains domestically driven and doesn't have a large export sector with the exception of commodities. This year's strong rally in commodity prices has been positive, and explains why the Indonesian currency has been up against the US\$ in 2016 despite the setback that occurred in November.

Thailand has also been in the news following the passing of the King in October. This created some market volatility but the market was flat in November as investors focussed on the prospects for a pickup in economic activity in 2017. The military government has been putting in place infrastructure that should benefit growth next year and the agricultural sector in the southern part of the country is also buoyant aided by strong rubber prices.

Smaller ASEAN countries such as Malaysia and Singapore continue to face challenges. Malaysia's attempts to discourage FX outflows post the Trump victory has backfired, and corruption issues remain. Singapore has continued to suffer from a weak global trade environment and still has problems in the oil service sector as oil majors continue to reduce capital expenditure.

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The ASEAN markets led gains in Asia for much of the year until the election of Trump. The concern for these smaller South-East Asian countries now is that tightening monetary policy in the States will have knock-on effects in liquidity in their own domestic economy, hitting both the stock market and real economic activity. The future path of the dollar is of vital importance to Asia and the ASEAN region in particular.

Japan

The Japanese economy was much stronger than expected in 2016 with rising exports and falling imports playing a key part. One major concern at present relates to the inability of the Bank of Japan to generate any meaningful level of inflation despite significant monetary policy. The strength of the yen for much of the year has been a particular headwind in this regard, and the Bank pushed back its forecast for reaching its inflation target. The Bank did announce a change to its QQE policy in September, targeting a 0% level for the 10-year bond yield with the idea being to steepen the yield curve, which in turn, would improve the environment for the banking sector. The level of government debt also continues to be a major concern, although with interest rates remaining at very low levels, Japan should be able to service this debt for some time without any major issues provided that bond yields do not rise significantly and economic growth improves.

More recent months have seen Yen weakness as the US dollar has strengthened following the recent US elections; this is a positive for Japanese companies which have significant exports and foreign earnings.

Emerging Markets

Emerging markets performed well over 2016, although this was focused in the third and early fourth quarters. In the final part of the year the strength of the dollar became a headwind - despite greater individual economic strength in the region, a strong US currency is always a significant headwind for Asian economies and their stock markets.

Whilst there has been headline news about the weakening of the Chinese RMB post the election, China has moved away from a soft dollar peg to a basket approach where the RMB is actually trading more strongly than prior to the election. Both the Euro and Yen have weakened significantly since the US election, and both are included in the currency basket monitored by the Chinese authorities. The strong US dollar has been less of a headwind to North Asian markets such as China and Korea than the ASEAN region mentioned above.

India is the other economic powerhouse of the region and, on the same day as the US Presidential election, announced its own seismic shock with a radical macroeconomic experiment whereby the country's two largest currency bills, which account for over 80% of legal tender, were declared invalid – Prime Minister Modi decommissioned 86% of India's currency supply in an economy where 90% of transactions are in cash. The argument in favour of this was the fight against corruption and tax evasion, as well as to quell the use of counterfeit notes, often used to finance terrorist activities. Unfortunately the Reserve Bank of India had not printed nearly enough notes to replace the old ones and so commerce in the country was disrupted, especially in the SME sectors, as wages and suppliers

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are typically paid in cash and many people, especially in rural areas, do not have access to electronic payments.

In other parts of the emerging world, Latin America had benefitted from the rebound in commodity prices, with Brazil a strong performer in 2016 after the impeachment of President Rousseff, whose statist policies had damaged corporate profitability. Whilst the economy in Brazil remains in recession, there is hope that the worst is now past and a new phase of economy recovery can begin. The Trump election has impacted negatively on Latin American currencies and stock markets, with Mexico particularly hard hit after comments by Trump during the election campaign. The Brazilian Real too has suffered along with the Mexican Peso.

In Russia, there have been signs of economic stabilisation after the strengthening in the oil price and there are now hopes of a more relaxed period of foreign relations with the United States. The pressure on the country from sanctions may therefore ease. For Eastern European countries, the continued recovery in the Western European economies has been a positive.

Fixed Interest

Fixed interest markets have had to contend with rising inflationary expectations and the prospect of more aggressive US monetary tightening. Even a rise in US short term rates to 2% in 2017 would only see real interest rates at zero with inflation at the 2% level. With investors having grown accustomed to many years of falling bond yields and disinflationary pressures, estimates for fair value in core government ten year yields vary considerably. Traditional thinking would suggest ten year yields should be around nominal GDP levels, and so there could be further price weakness in government bonds over the next 12 months. Whilst secular forces suppressing inflation, such as demographics and the post-GFC debt overhang remain in place, there are cyclical pressures pushing inflation higher, such as the rise in the oil price from Q1 lows – estimates for when the oversupply situation in oil comes to an end remain sharply divided. There are signs in certain economies, including the States that wage inflation is picking up as labour markets continue to tighten. On balance, further weakness in government bonds with higher yields seem likely over the course of 2017 although periods of consolidation after the recent upward sharp moves are always possible.

In relative terms, corporate credit remains attractive as investment grade spreads seem interesting when looking at the likely rate of defaults. A similar argument can also be made about high yield. High yield debt has always shown a stronger correlation to equities than government bonds and therefore the improved growth outlook is a positive for this asset class.

Certain niche funds such as those offering floating rate note exposure could be some of the best performing bond funds over the next six months. The bulls of fixed interest see powerful negative secular forces restraining the impact of any pro-growth Trump policies, but whilst this may be true in the medium term, cyclical factors look likely to make 2017 challenging for conventional fixed interest in 2017.

Property

The impact of the UK's EU vote on the direct UK commercial property market has lessened, but the much reduced transaction volumes following the referendum and falling prices are evidence that the short-term impact was very negative. The vast majority of the previously suspended UK direct property funds have re-opened and the market value adjustments have been removed or greatly reduced, suggesting a large degree of return to normality.

Ostensibly, the fundamentals of the asset class have not changed that much but there may continue to be a valuation impact on those properties, sectors and regions that have seen the highest price rises over the last few years, which would include Central London. To counter this, the large fall in the valuation of sterling versus overseas currencies makes property more attractive to overseas investors and there has been anecdotal evidence of overseas buying, particularly from property funds having to sell assets to meet redemptions. Returns were reasonable in 2016 and are expected to remain so into 2017, but with absolute returns much lower than recent years. Returns are increasingly likely to be driven by income with capital growth very limited or negative and rental growth becoming an increasingly dominant factor for performance. This asset class remains a solid option for income seeking investors and for diversification purposes, but there is increased concern about the asset class's underlying liquidity given recent events. The yield gap for secondary markets versus prime property remains attractive but individual property selection will remain important here.

The REIT market has had a more difficult quarter given the US rate rise in December and the threats of interest rate rises into 2017.

Summary

It is clear that the macro environment is in transition and we would argue this move actually started in September, with Trump proving to be the catalyst which accelerated the speed of change. This has driven not just the fixed interest markets but sector leadership in equities. Whilst the central case is for higher levels of growth, uncertainties on both policies and geopolitics from a President known for his unpredictability, mean it could be argued that the tail risks of either higher or lower growth have increased. Investors cannot yet be certain what Trump policies will emerge, what reaction will come from the Fed to higher growth and higher inflation, and how China will react to a more assertive United States.

This should result in increasing attention being paid to economic and market fundamentals, rather than the distortions caused by QE and zero interest rate policies. With markets already highly rated, 2017 is likely to see some bumps along the way at least. The Brexit vote demonstrated the disillusion amongst the wider population for globalisation and investors now need to focus on what levels of protectionism are likely to come to fruition. Whilst globalisation was favourable to a lower for longer interest rate environment, de-globalisation is unlikely to be so.

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Next year could also see further concerns over the Chinese currency regime's transition from a US\$ peg to a managed basket and whether a decline in the currency will both be orderly and avoid American charges of currency manipulation which could significantly heighten global trade tensions.

In the short term, markets are likely to continue to focus on prospects for higher levels of growth - seasonally, this is usually a positive time for equity market strength and cyclicals in particular often perform well in the December / January periods, so in the short term it is hard to see what is likely to break the market's positive mood, although the catalyst for most market setbacks is rarely readily apparent. If it is to be a geopolitical event which causes that market shock, investors need to remember that Trump will not actually be inaugurated as President until January 20th and on the economic front, it will not be clear for a while after this how policies that rely on Congressional approval will pan out.

Investors will need to ask whether the global economy is really responding to the increased level of fiscal stimulus, and in a way which does not cause a marked pickup in inflation and therefore an end to the accommodative monetary policies that have supported high equity market valuations.

As a result, for patient investors, some level of caution seems justified as valuations which were already high prior to the US election have seen long term value deteriorate further. Markets are now highly dependent on a significant improvement in corporate earnings for 2017 and whilst consensus numbers suggest this is possible, bottom-up analyst forecasts are often trimmed back as the year progresses. Whilst conventional fixed interest assets look expensive, especially if the optimistic growth forecasts come to fruition, investors should not abandon the goal of diversification and strategic type bond funds or niche products holding FRNs, may be the best way to achieve this whilst reducing the prospect of serious losses if growth accelerates dramatically. Absolute return funds continue to have a place in investor portfolios, but careful manager selection is vital. Whilst 2016 has ended on a positive note for equity investors, a completely smooth ride for 2017 appears unlikely.

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