

**nikko am**

Nikko Asset Management

INVESTMENT SUMMIT 2017

A new direction?



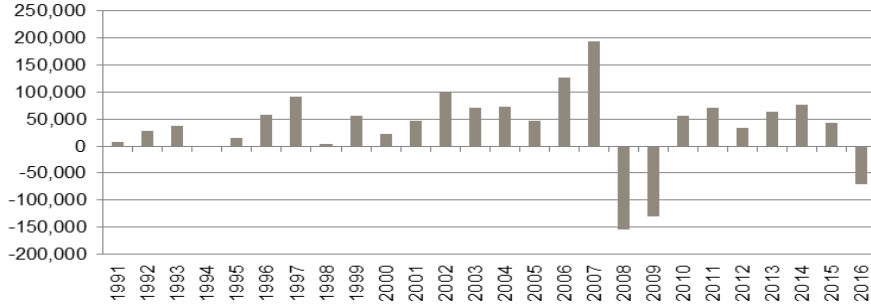
# J. P MORGAN ALTERNATIVE ASSETS MANAGEMENT

Outlook for Hedge Funds  
– Peter Gray, Head, Asia Client Solutions

# Recent Hedge Fund Performance Trends

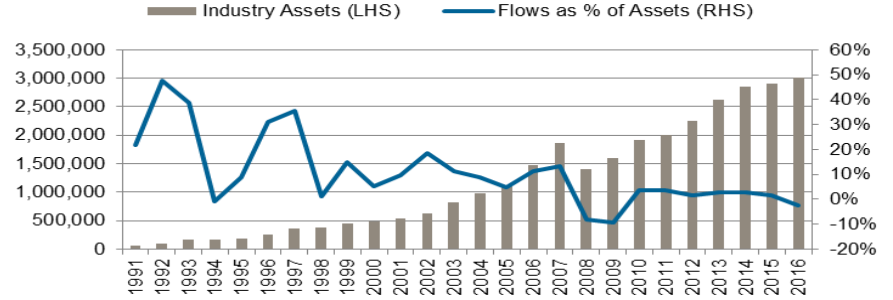
## Hedge Fund Industry Flows (\$mm)

2016 was the first year of outflows since 2009



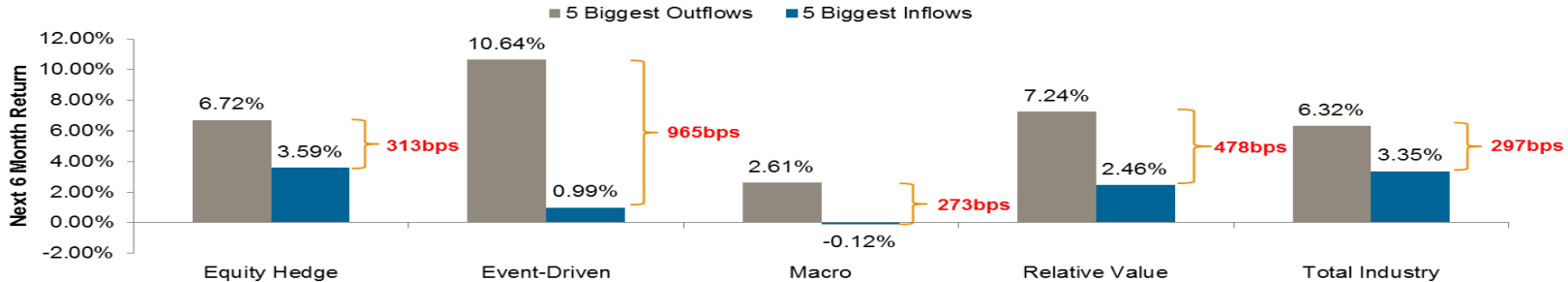
## Hedge Fund Industry Outflows compared to AUM (\$mm)

Outflows modest as a percentage of AUM and industry assets are at all-time highs



## On average, investors detract value when timing hedge funds

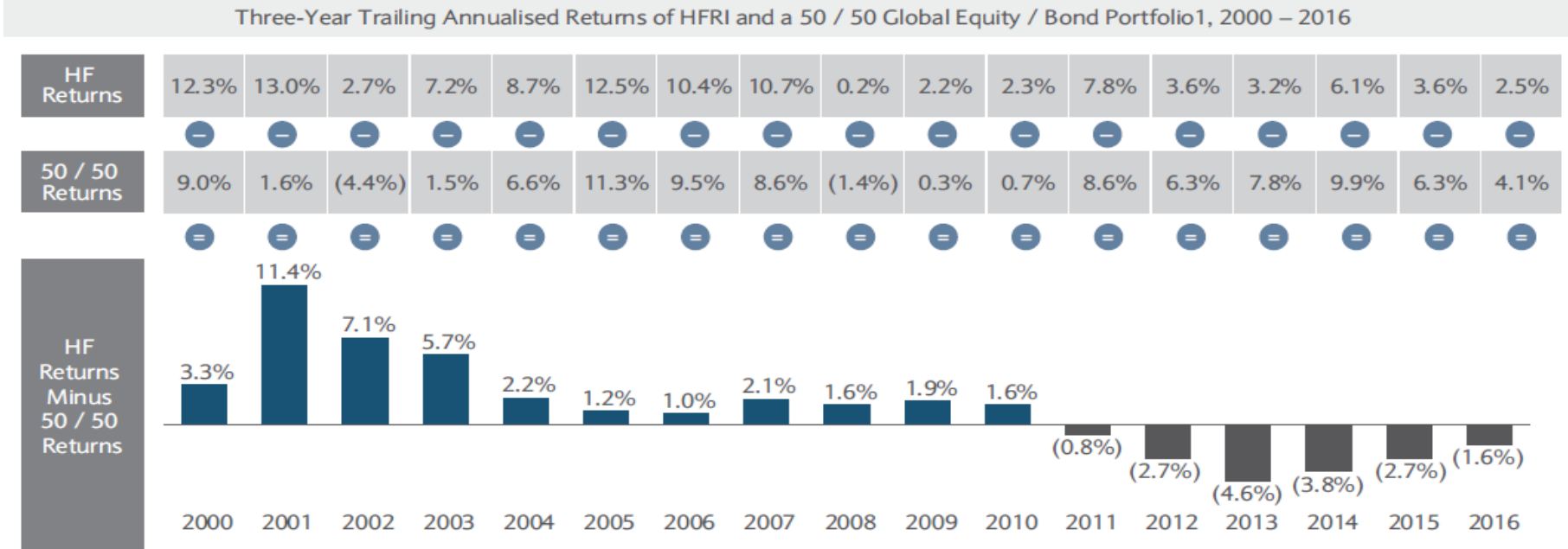
Six month returns following the five worst and best quarterly flows by strategy



Source: JPMAAM HFS, Bloomberg. Data estimated as of December 2016. Indices are unmanaged, do not charge fees, and are shown for illustrative purposes only. Past performance is not indicative of future results.

# Recent Hedge Fund Performance Trends

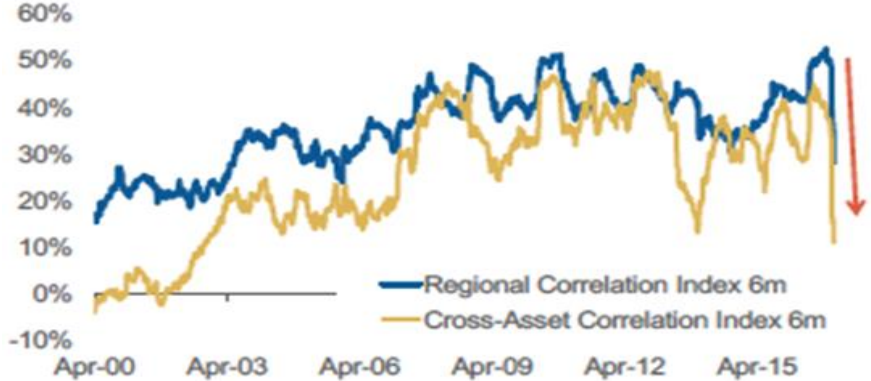
Hedge Fund Returns versus Long – Only Indices  
 Three-Year Trailing Annualized Returns of HFRI and a 50/50 Global Equity/Bond Portfolio, 2000 - 2016



Source: HFR, Bloomberg  
 1. 50 / 50 portfolio composed of MSCI Total Return Net World USD Index and Barclays Global Aggregate Bond Index USD Hedged

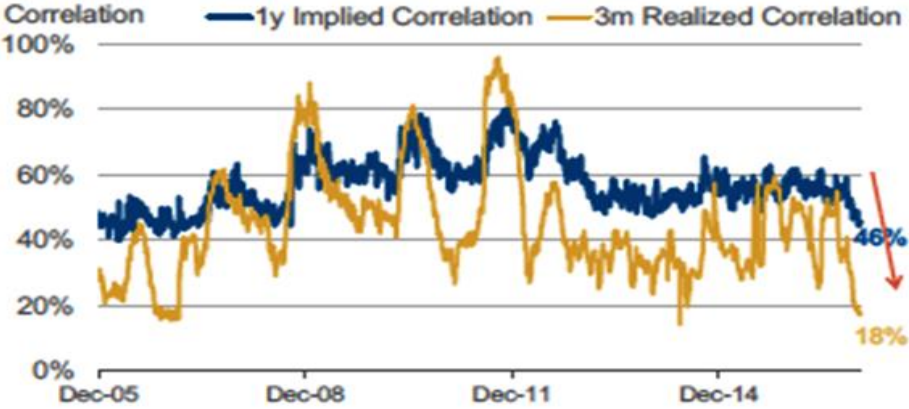
# 2017 Hedge Fund Outlook: Correlations

Lower correlations create a supportive environment for Macro and Multi-Strategy managers



Source: Bloomberg, Morgan Stanley Research

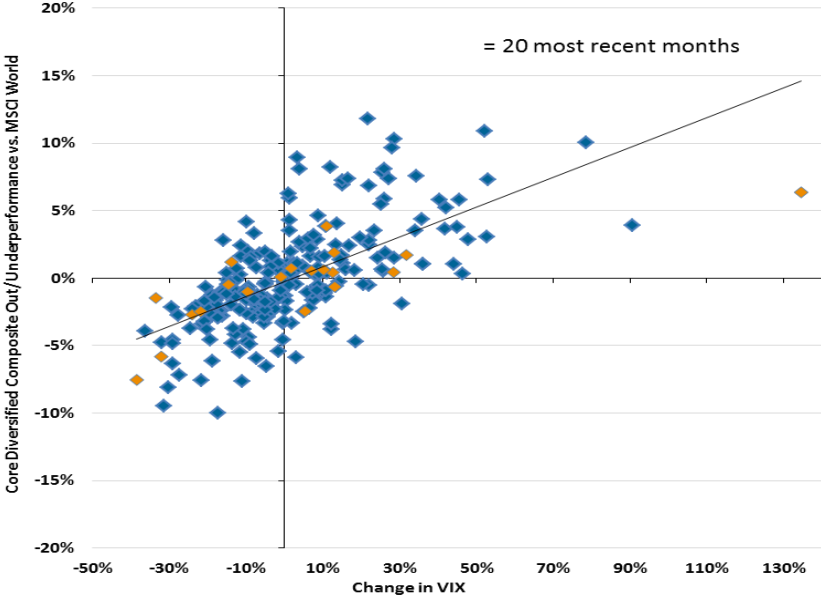
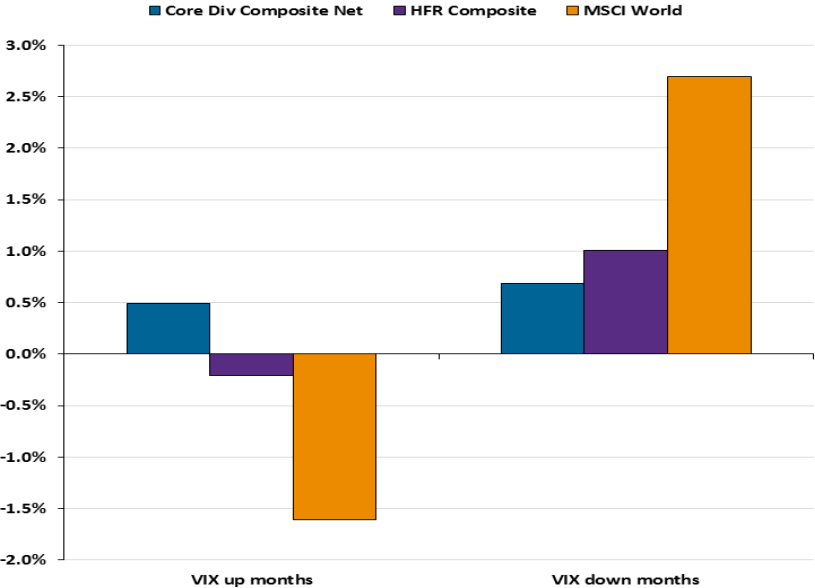
Lower correlations within equity indices are positive for active managers



Source: Bloomberg, Morgan Stanley Prime Brokerage, Data as of 6 Feb 2017

# 2017 Hedge Fund Outlook: Volatility

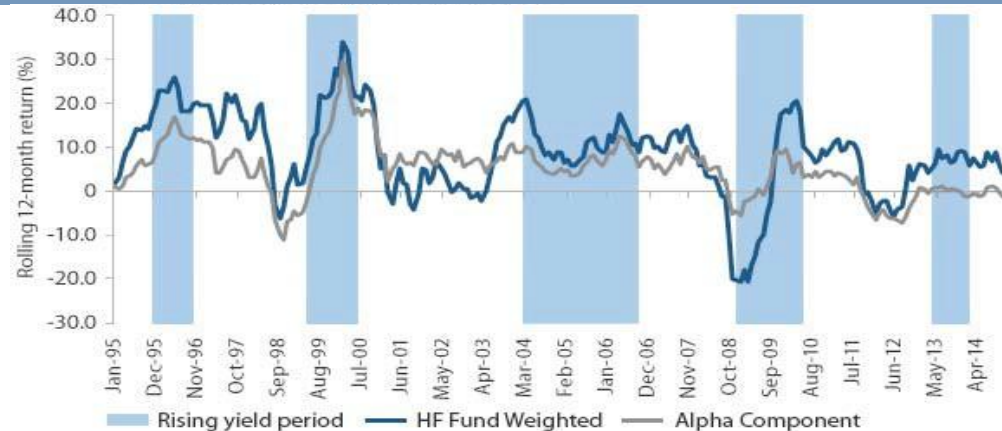
Hedge Funds typically do better in higher volatility environments



Source: JPMAAM. Performance estimated as of Jan 2017. Please see Important Notes for information relating to the construction of these indices. HFR Composite reflects performance of HFRX Global Hedge Fund Index (April 2003 onwards), HFR Fund Weighted Composite Index (April 1995 – March 2003). Past performance is no guarantee nor necessarily indicative of future results.

# 2017 Hedge Fund Outlook: Rising Interest Rates

Rolling Hedge Fund Returns vs. Return of Alpha Component in Rising Rate Periods



Sources: Bloomberg, Barclays, HFRI, and Rock Creek

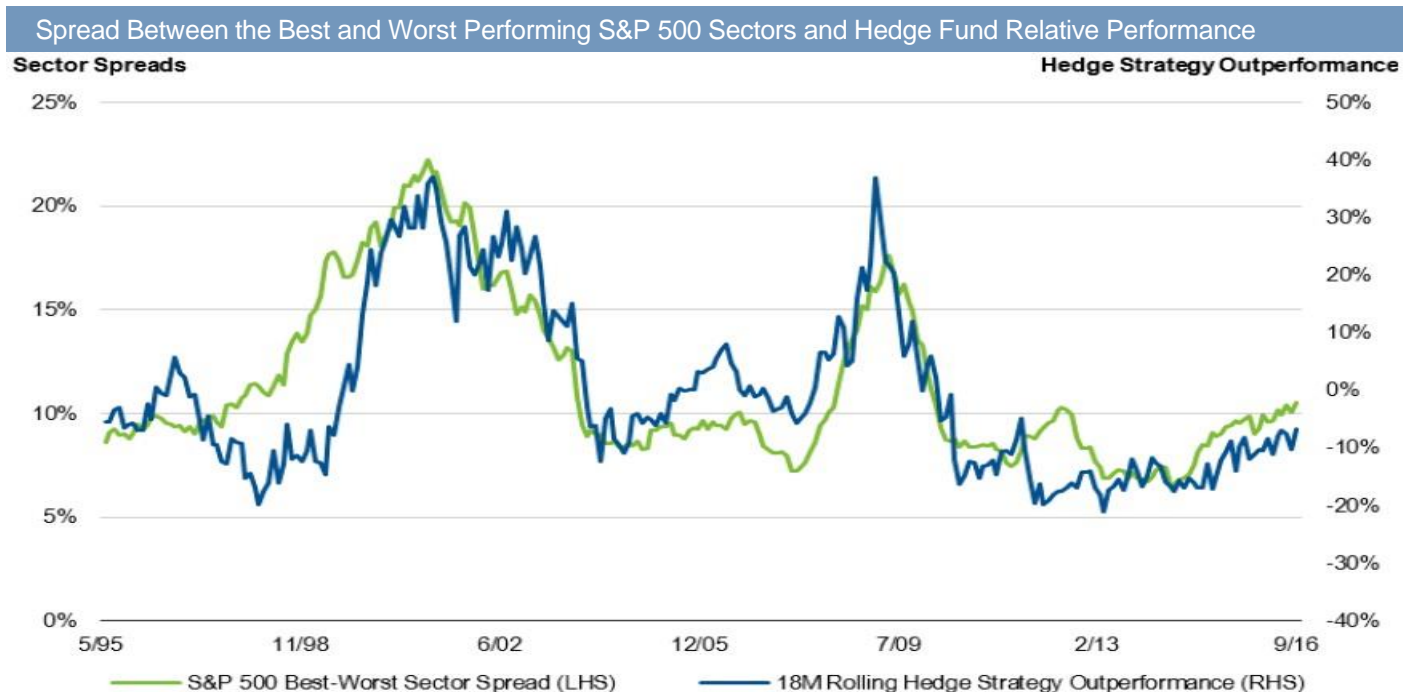
1995-2015	HFRI Index (%)	Beta component (%)	Alpha component (%)
Rising-yield periods (per annum.)	13.4	5.0	8.4
Declining-yield periods (per annum.)	6.4	2.9	3.4
Overall average return	8.7	3.6	5.1

Sources: Bloomberg and Rock Creek

Source: "The Case for hedge fund strategies in a rising rate environment", Wells Fargo Asset Management

# 2017 Hedge Fund Outlook: Sector Dispersion

Rising interest rates can cause greater price dispersion between firms with strong and weak fundamentals



Source: "Hedge Fund Strategy Investing 2017 Outlook", Franklin Templeton Investments



# JPMAAM HFS Sub-Strategy Outlook

As of January 2017

Rank	Strategy	Sub-Strategy	Performance	Dislocation / Inefficiency	Liquidity	Riskiness - Downside Volatility and Basis	Heatmap Score	Q1'17	Dec'16	Q4'16	Q3'16
<b>Current</b>			<b>49%</b>	<b>27%</b>	<b>12%</b>	<b>12%</b>	<b>100%</b>				
1	Credit	Banking System Dislocation									
2	Relative Value	Statistical Arbitrage / Quantitative									
3	Opportunistic/Macro	Discretionary Macro									
4	Relative Value	Volatility Event									
5	Long/Short Equities	Low to Mid Net									
6	Long/Short Equities	Flexible Net									
7	Credit	Structured Credit (CLO/CMBS)									
8	Opportunistic/Macro	Opportunistic									
9	Relative Value	Volatility Arbitrage									
10	Credit	Corp Credit RV									
11	Opportunistic/Macro	Quantitative/ CTAs									
12	Long/Short Equities	Activist									
13	Relative Value	Multi-Strategy									
14	Opportunistic/Macro	Commodities									
15	Merger Arbitrage/Event Driven	Multi-Event Driven									
16	Opportunistic/Macro	Emerging Markets									
17	Relative Value	Convertible Bond Arbitrage									
18	Credit	Corporate-Distressed									
19	Long/Short Equities	Long Biased – Asia									
20	Opportunistic/Macro	Reinsurance									
21	Merger Arbitrage/Event Driven	Merger Arbitrage									
22	Long/Short Equities	Long Biased – US									
23	Credit	Corporate-Capital Structure									
24	Credit	Corporate-Litigation/Liquidation									
25	Credit	Corporate-Performing HY									
26	Credit	ABS-Mortgage									
27	Long/Short Equities	Long Biased – Europe									
28	Relative Value	RV Capital Markets									

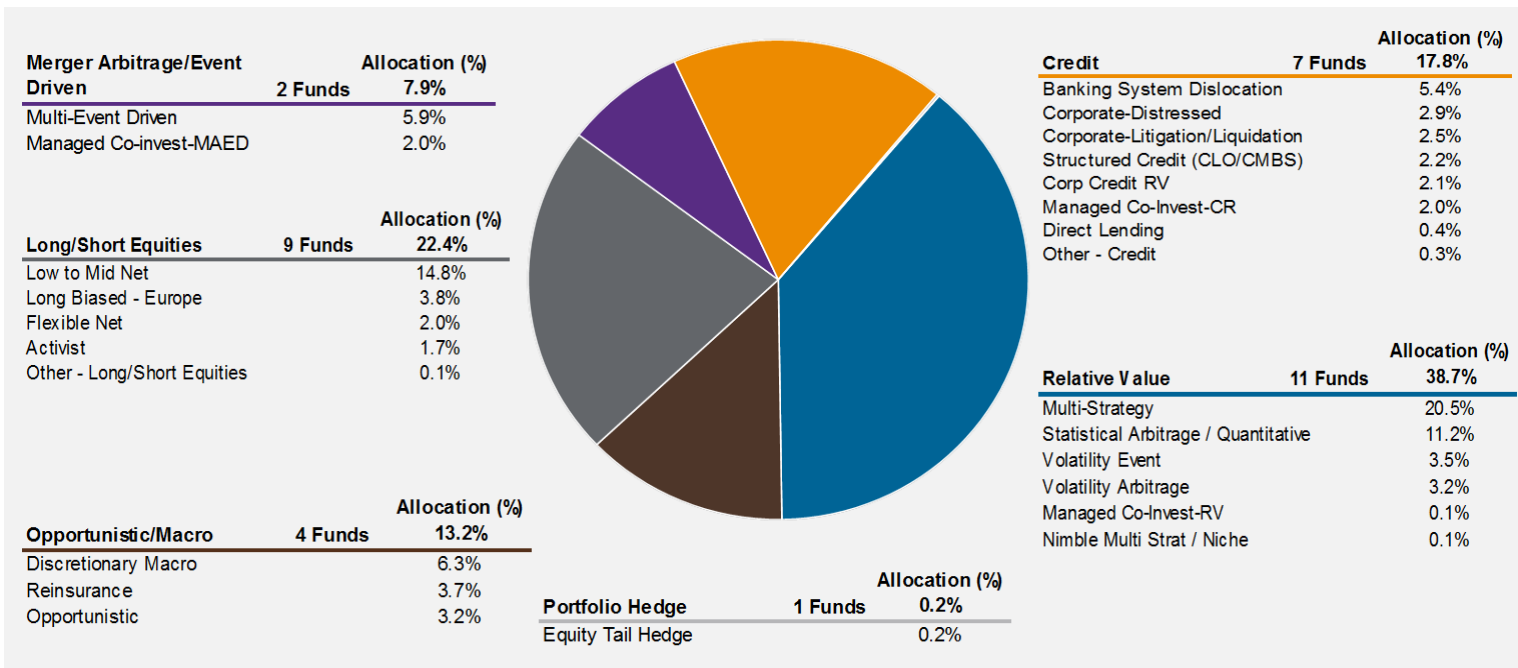
The rankings herein represent our current strategy views based upon the factors outlined above. Weightings and underlying data are adjusted by JPMAAM's investment committee. These rankings may not directly relate to a given sub-strategy's sizing in our portfolios due to several factors that are not considered in this model most notably cross correlations and scalability. Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Information as of January 2017.

# Portfolio Construction: Multi-Strategy Fund II, Ltd.\*

**Investment Objective:** Long term capital appreciation through a portfolio having a diversified risk profile with relatively low volatility and a low correlation with traditional equity and fixed-income markets.

AUM: \$2.06b

Total Funds\*: 34



Assets as of January 1, 2017. Allocations are made at the manager's discretion and can be changed without notice. Allocations exclude cash. Manager count does not include investments in internal programs and managed co-investments. Strategy allocation is estimated through January 2017 and has been rounded. AUM information is rounded. Please refer to the Important Notes section of the presentation for important disclosures regarding target returns. \* Multi-Strategy Fund II, Ltd. was formerly named "J.P. Morgan Multi-Strategy Fund II, Ltd." and was renamed as of November 1, 2016.

# Manager Case Study

Manager A	
Strategy	Relative Value, Multi-Strategy
Manager AUM	\$930MM
JPMAAM allocation in MSF II Ltd	7%
Manager Description	<ul style="list-style-type: none"><li>■ Global, multi-strategy market-neutral fund focused on Asia investing and trading in long and short opportunities across the capital structure</li></ul>
Trade Example	<ul style="list-style-type: none"><li>■ Large Japanese corporation has a listed, partially-owned subsidiary, active in the housing market. The subsidiary currently trades at a discount to its book value. It has substantial cash on its balance sheet as well as real estate holdings</li><li>■ Outside shareholders – including the Manager - hold a significant minority stake in the listed subsidiary.</li><li>■ The large corporation proposes to make the subsidiary wholly-owned via a share-exchange. Shareholders will vote on the proposal in mid-2017</li><li>■ According to the manager, the corporation's offer to shareholders undervalues the subsidiary by more than 50% and disadvantages outside shareholders</li><li>■ Manager is in process of lobbying other shareholders and the Japanese government. It is also applying corporate-governance pressure on the acquiring corporation</li><li>■ Manager has asked a Japanese court to rule on the fairness of the proposed acquisition price</li></ul>

Source: Bloomberg, JPMAAM

# Risks to consider when making hedge fund investments

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## Limited liquidity

- invested capital is generally accessible for redemption only on a quarterly or annual basis

## Volatility

- investment strategies used by the investment adviser and/or portfolio managers, utilizing futures, options and short sales, can be highly volatile

## Loss of capital

- investors can lose up to the full amount of their invested capital

## Leverage

- hedge funds often use leverage, sometimes at significant levels, to enhance potential returns

## Dependence on manager

- the Fund's success is dependent on the investment manager to develop and successfully implement investment strategies that meet investment objectives

## Limited transparency

- with little or no public market coverage, investors must rely on the investment manager for periodic information

## Conflicts of interest

- the investment adviser and/or portfolio managers could be subject to various conflicts of interest, which could influence how those portfolio managers invest the Fund's assets

Not a complete list of risks. Please read the Fund's Offering Memorandum for a more complete list of the risks associated with investing in a hedge fund

# Important Notes

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## Definitions of Other Indices

All index performance information has been obtained from third parties and should not be relied upon as being complete or accurate. Indices are shown for comparison purpose only. While an investor may invest in vehicles designed to track certain indices, an investor cannot invest directly in an index. Indices are unmanaged, do not charge fees or expenses, and do not employ special investment techniques such as leveraging or short selling.

The **Goldman Sachs High HF Concentration Index** represents the S&P 500 companies with the largest hedge fund ownership measured as a percentage of float. Index levels are in total return USD.

The **Goldman Sachs Low HF Concentration Index** represents the S&P 500 companies with the smallest hedge fund ownership measured as a percentage of float. Index levels are in total return USD.

The **Goldman Sachs VIP Index** the U.S. companies names that appear on hedge funds top 10 holdings most frequently. Index levels are in total return USD.

The **Morgan Stanley High Dividend Consumer Staples** basket is diversified across 26 U.S. listed Consumer Staples stocks with above average dividend yields. The basket is optimized for liquidity and borrow, with no constituent initially weighted greater than 4.5%. Index levels are in total return USD.

The **Morgan Stanley MLP Hedge** basket consists of 45 U.S. stocks and is designed to measure the performance of the Energy MLP sector. The basket is optimized for liquidity and borrow, with no constituent initially weighted greater than 13.0%. Index levels are in total return USD.

The **Morgan Stanley Software** basket is diversified across 34 U.S. listed stocks and is designed to measure the performance of the Software-as-a-Service and traditional Enterprise Software industries. The basket is optimized for liquidity and borrow, with no constituent initially weighted greater than 5.0%. Index levels are in total return USD.

The **Morgan Stanley China Internet** basket consists of 12 U.S. listed stocks and is designed to measure the performance of China's leading Internet companies. The basket is optimized for liquidity, with no constituent initially weighted greater than 12.5%. Index levels are in total return USD.

The **Morgan Stanley Diversified Banks** basket consists of 31 U.S. stocks whose revenues are driven by commercial or consumer banking. It contains both Large Cap and Regional Banks. The basket is optimized for liquidity and borrow, with no constituent initially weighted greater than 6.0%. Index levels are in total return USD.

The **Morgan Stanley Pharmaceuticals** basket is diversified across 26 U.S. listed stocks and is designed to measure the performance of the broad Pharmaceuticals industry. The basket is optimized for liquidity and borrow, with no constituent initially weighted greater than 6.0%. Index levels are in total return USD.

The **Morgan Stanley Biotechnology** basket is diversified across 38 U.S. stocks and is designed to measure the performance of the Biotech industry. The basket is optimized for liquidity and borrow, with no constituent initially weighted greater than 5.75%. Index levels are in total return USD.

**Hedge Funds:** Investments in Hedge Funds involve a high degree of risk and are only suitable for investors who fully understand and are willing to assume the risks involved. Hedge Funds often engage in leveraging speculative investment practices that may increase the risk of investment loss. The regulatory environment for hedge funds is evolving and changes therein may adversely affect the ability of hedge funds to obtain leverage they might otherwise obtain or to pursue their investment strategies. The Investment Manager of the Fund(s) is subject to the Global Investment Management policies and procedures, including but not limited to Conflicts of Interest, Market Abuse, Anti-Money Laundering, Data Protection and Risk Management which will be applicable to the ongoing management of the Fund(s).

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# Important Notes (Continued)

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# NIKKO ASSET MANAGEMENT EUROPE

Global Equity Outlook

- Will Low, Head of Global Equities



If you know **how to look**,  
you see what others miss.

# TRUMP – THE TOPIC DU JOUR...

## Trump – Investor assumptions

- America First... Protectionism
- Spend to grow... Upcycle
- Investment incentives... Tax cuts
- Fewer constraints... Deregulation
- Faster growth... Rate hikes

## Questions Arising

1. Policy vs. Implementation?
2. Washington compliance
3. Trump driving confidence or uncertainty?
4. Timing



Since mid 2016....  
Reflation winning  
over Deflation



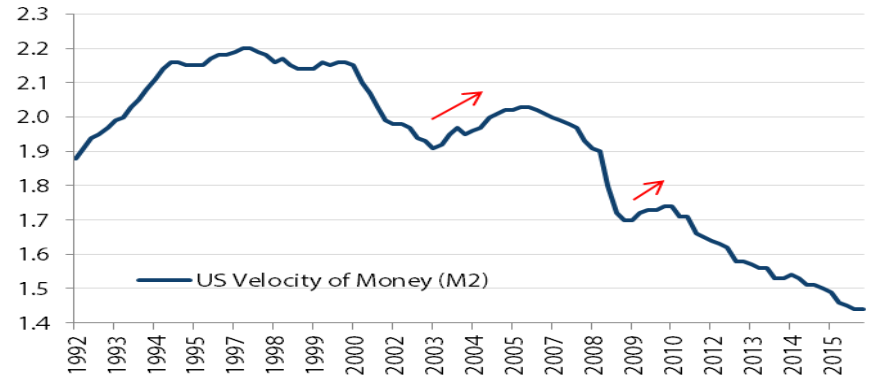
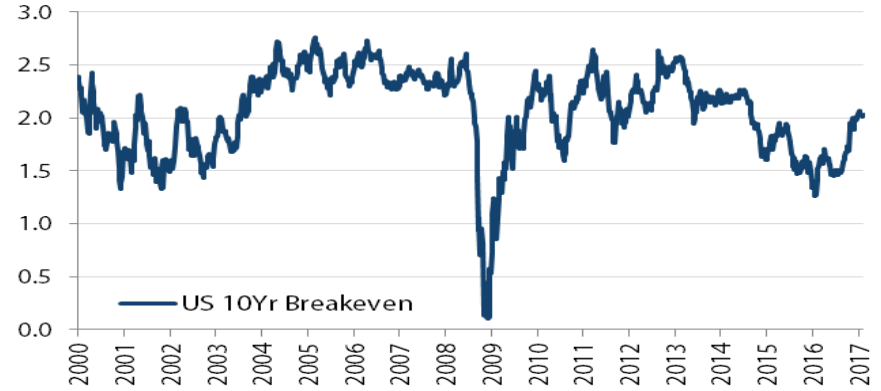
# ANIMAL SPIRITS UNLEASHED – GROWTH SURPRISE?

## Case for Bulls

- Full employment
- Corporate capex ignited
- High profit margins and lower taxes
- Rising inflation expectations

## Case for Caution

- US\$ strength
- Consumer indebtedness
- Robotics hindering personal income growth
- Modest growth in economic stats...to date



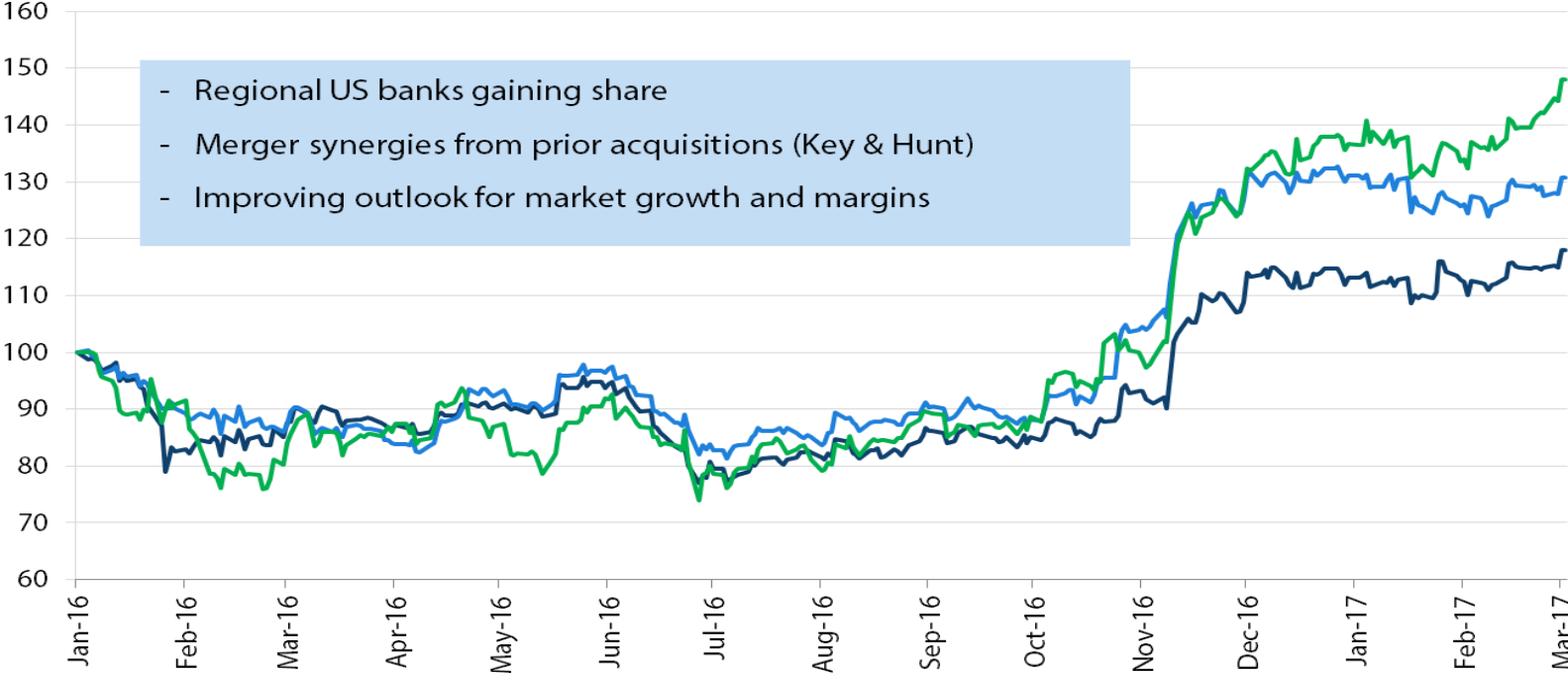
Source: Bloomberg

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# IMPLEMENTATION – US REGIONAL BANKS

— Huntington Bancshares Incorporated - Price Relative to MSCI AC World (SR) (USD)  
— KeyCorp - Price Relative to MSCI AC World (SR) (USD)  
— SVB Financial Group - Price Relative to MSCI AC World (SR) (USD)

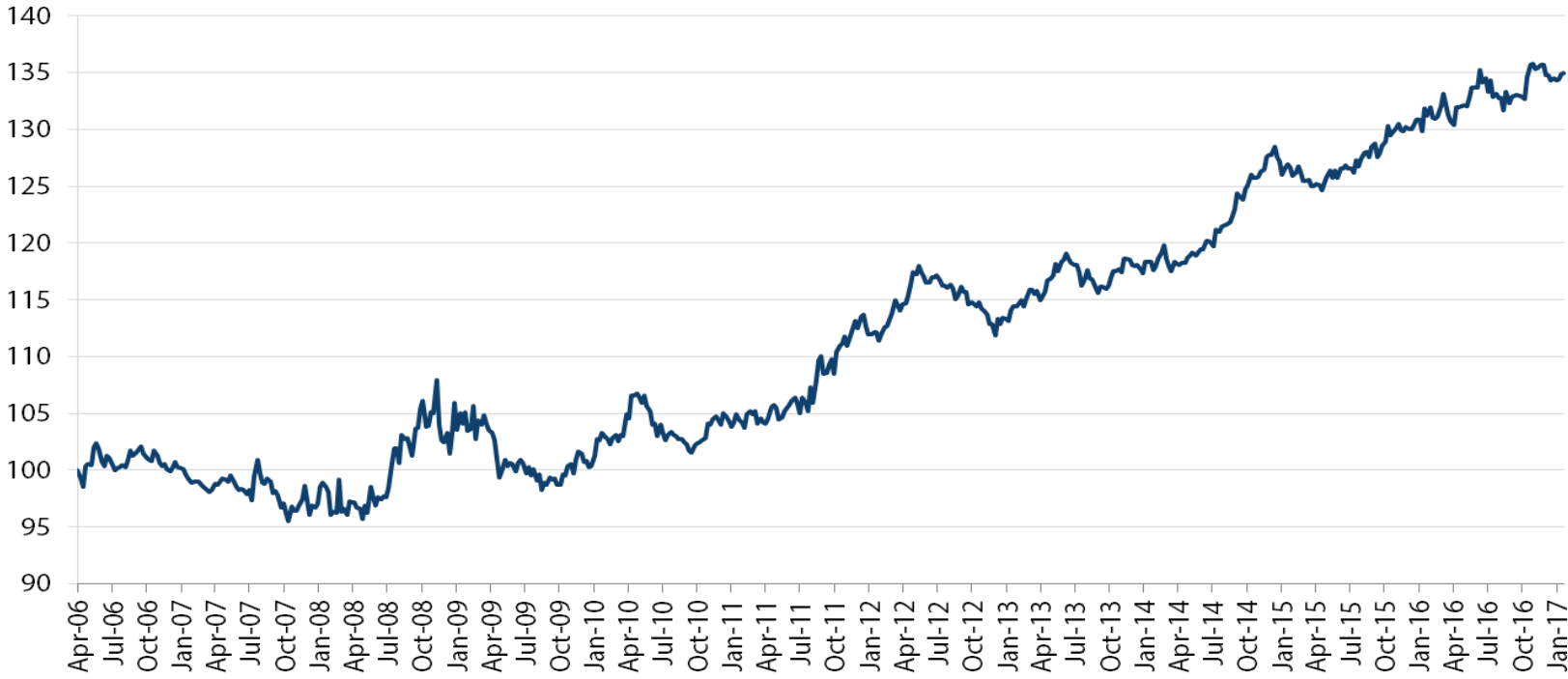
US Regional Banks – only banks we hold



- Regional US banks gaining share
- Merger synergies from prior acquisitions (Key & Hunt)
- Improving outlook for market growth and margins

# US MARKET STILL THE GLOBAL LEADER

— MSCI USA Price Return USD Index (USD) / MSCI World Index (USD)



Source: Factset, as at March 2017

# INVESTOR POSITIONING – BACK TO RATIONALITY?

## Consensus mid 2016

- Positioned for capital protection
- Cynicism over China
- Bond proxies de rigeur
- Fashion for low vol strategies

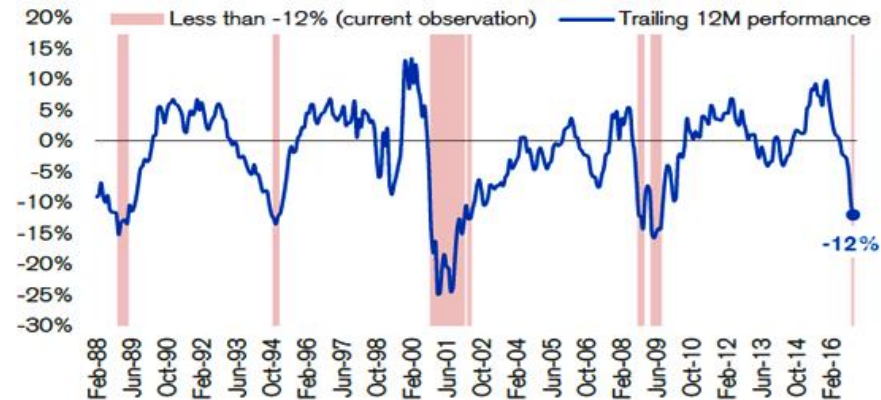
## Where we are now

- Valuation dispersions more normal
- Chinese growth assumed
- Rising price for inflation protection
- Profit growth expected to accelerate

*“our observation when researching companies from the bottom up is that the valuations now being paid for companies that form this subset (low vol and stable yield) are becoming difficult to rationalise.”*

Nikko AM Global Equity newsletter, August 2016

Rolling 12-month performance of global stocks and high quality & growth characteristics vs. low quality & growth



Source: Credit Suisse HOLT as of 12/31/2016. Universe: Largest 1000 stocks by market cap in each major region. High (low) Quality & Growth = top (bottom) half of regional universe on HOLT Quality and Growth scores.

# JOINING THE DOTS – NET NEUTRALITY

## Current status quo

- All data treated the same
- Video dominates data use
- Business models exploiting 'cheap' data utilities
- Network strain

## Changes – Actual and Possible

- New director at FCC
- Internet company's installing fibre
- Model to evolve to encourage?
  - More network investment
  - More efficient usage

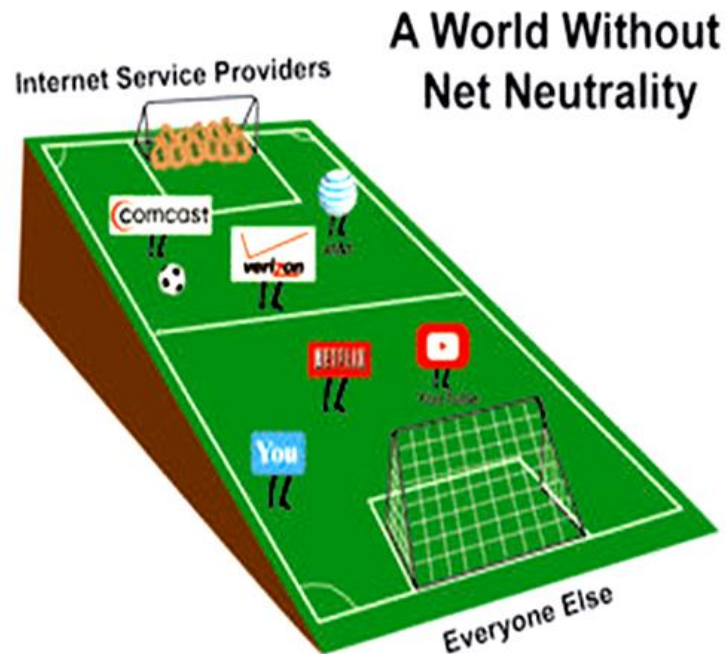
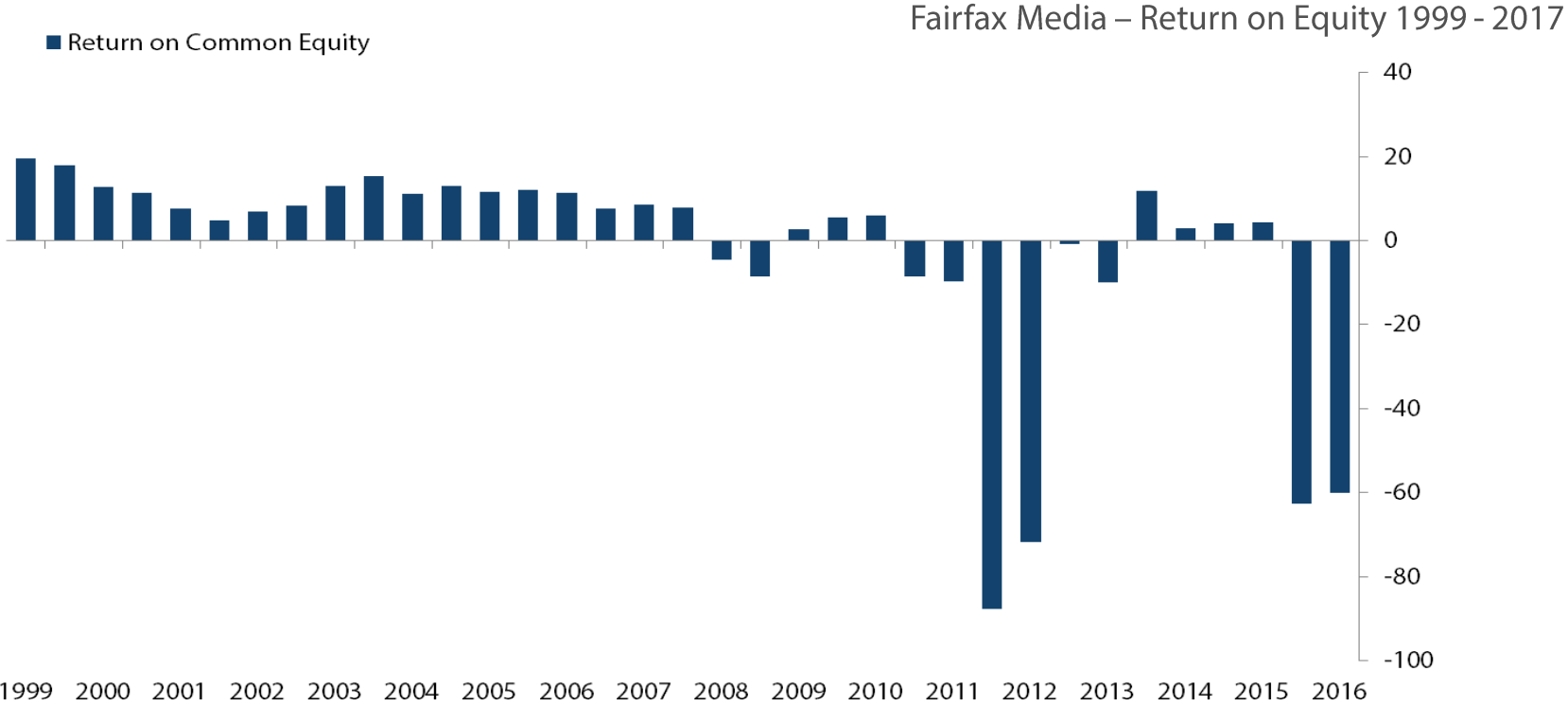


Image source: bankersadda.com

# BUSINESSES CHANGES...



Source: Bloomberg. Stock and sector mentions are for illustrative purposes only of the portfolio performance. This is not a recommendation in relation to any named stocks or sectors and no warranty or guarantee is provided that the names will remain within the portfolio.



# JOINING THE DOTS – UNDERESTIMATED GROWTH

## Future Quality Holdings



Drug availability

Sinopharm



More efficient healthcare solutions

ICON, Lapcorp



Infrastructure upgrades / replacement

CRH, Summit, Ichigo



Faster data

American Tower, AT&T



Defence spending

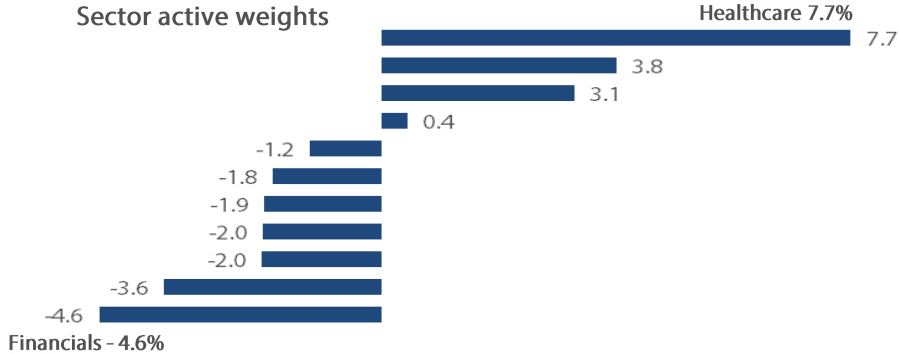
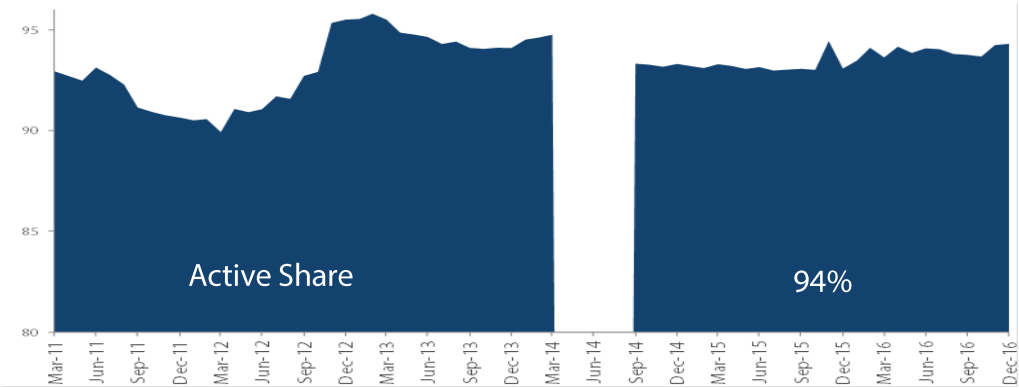
BAE Systems



Emerging market consumption

Geely, Treasury Wine

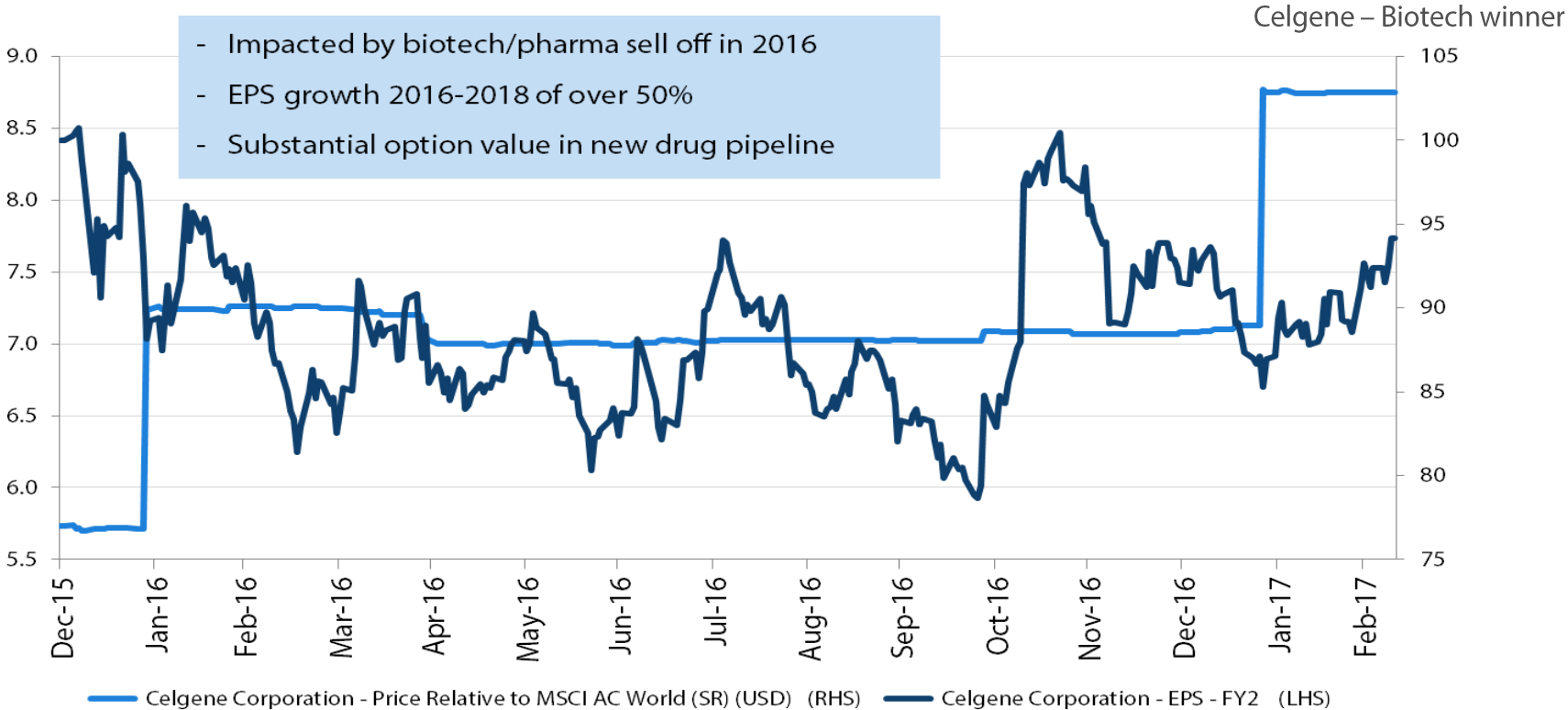
# NIKKO AM GLOBAL EQUITY PORTFOLIO – FEBRUARY 2017



## Largest Active Weights

Company	Active weight
Microsoft	3.2
Huntington Bankshare	2.8
Celgene	2.7
SVB Financial	2.7
Facebook	2.6
Keycorp	2.6
Laboratory Corp of America	2.6
Siemens	2.5
BAE Systems	2.5
American Tower Corp	2.4

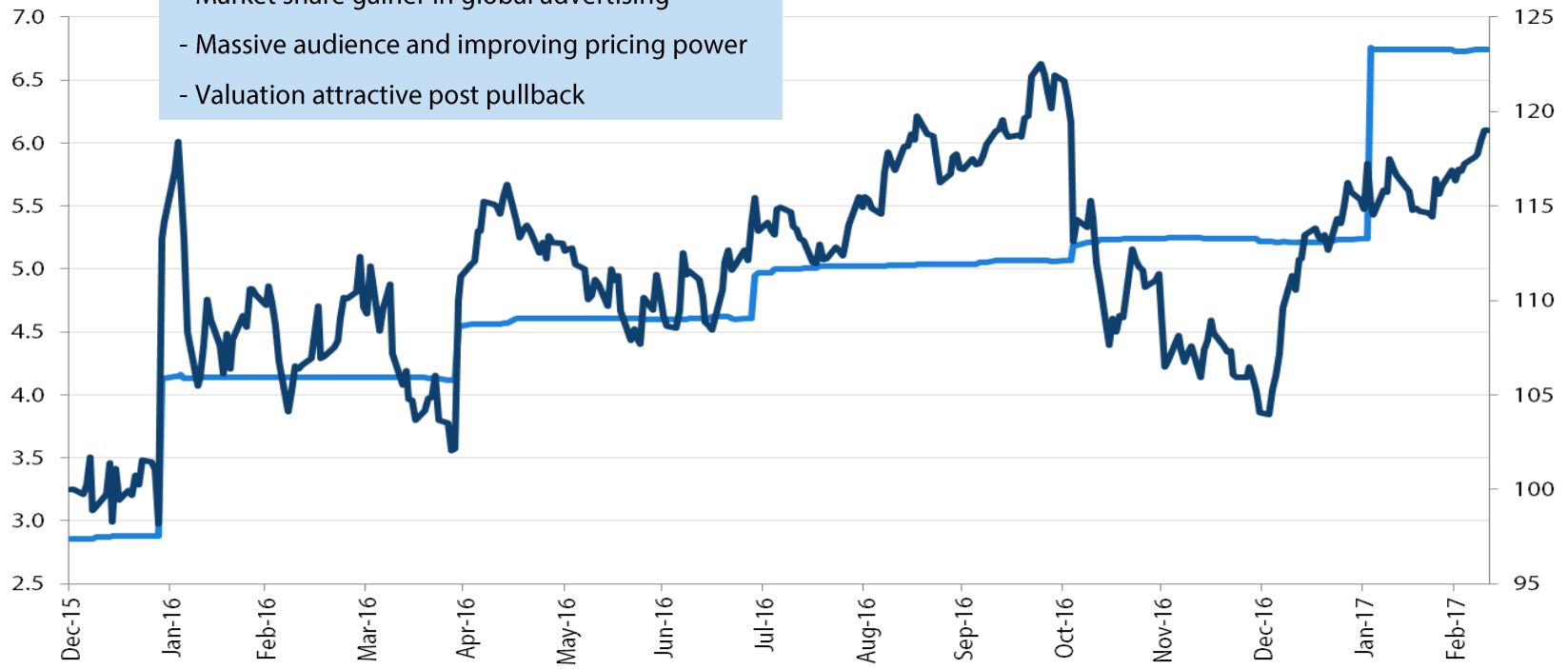
# CELGENE – WINNER WITHOUT BIOTECH



# FACEBOOK DOMINANCE UNCHALLENGED

Facebook – Growth leader

- Market share gainer in global advertising
- Massive audience and improving pricing power
- Valuation attractive post pullback



Facebook, Inc. Class A - Price Relative to MSCI AC World (SR) (USD) (RHS) Facebook, Inc. Class A - EPS - FY2 (LHS)

# UNINTENDED CONSEQUENCES?

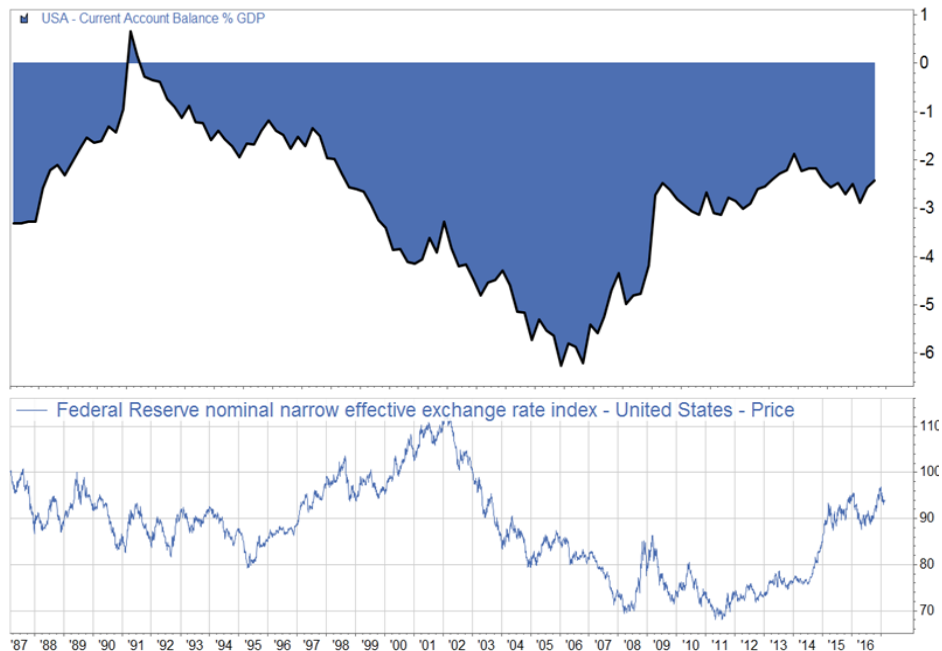
## Current World Order

- US\$ = Reserve currency
- US current acc deficits
- US Credit growth = Globalisation

## Trump Polices

- Protectionism = lower deficits
- US credit growth > Global credit growth?
- Tighter policy ex USA?

US Deficits have been the norm

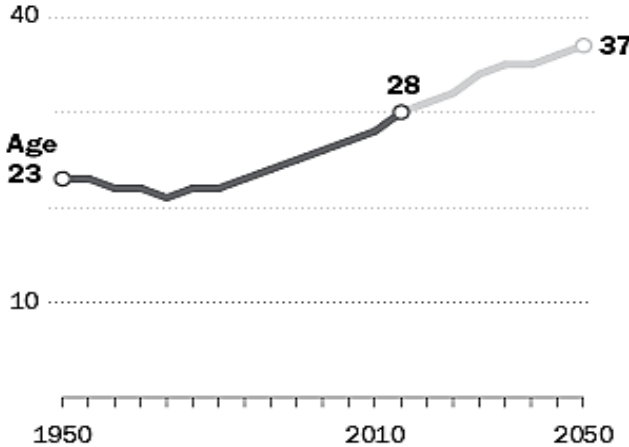


## How to assess correlations and risk in a new order?

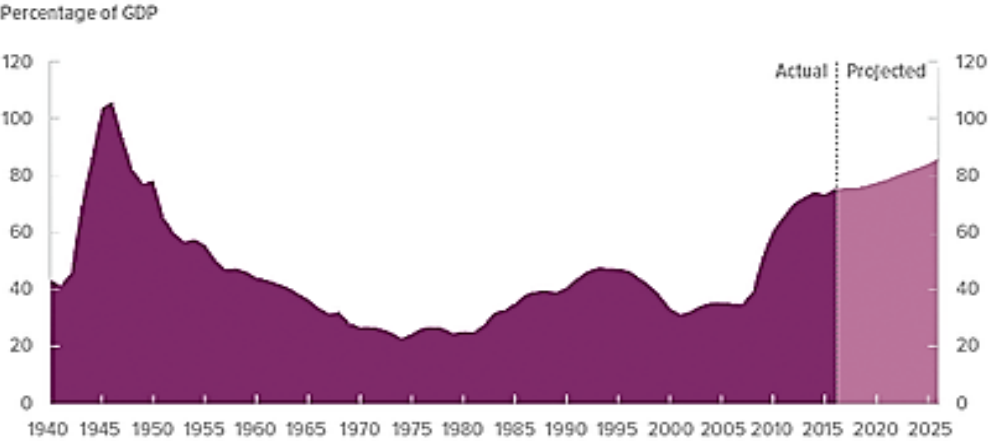
# HAVE THE PROBLEMS GONE AWAY?

## Debt and demographics still suggest slow growth long term

Median Age of World Population, 1950-2050



Federal Debt Held by the Public



Source: United Nations, World Population prospects: The 2010 Revision. Lighter colour denotes projected figures. Pew Research Center.

Source: Congressional Budget Office, January 2016

# Future Quality

The team aims to identify businesses with, or with a path to, high and sustainable returns, which are under-appreciated by the market. We call this 'future quality'.

# IMPORTANT INFORMATION

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# GOLDBLOCKS' EVIL TWIN COMES TO VISIT

Inflation and The Perils of Globalization?

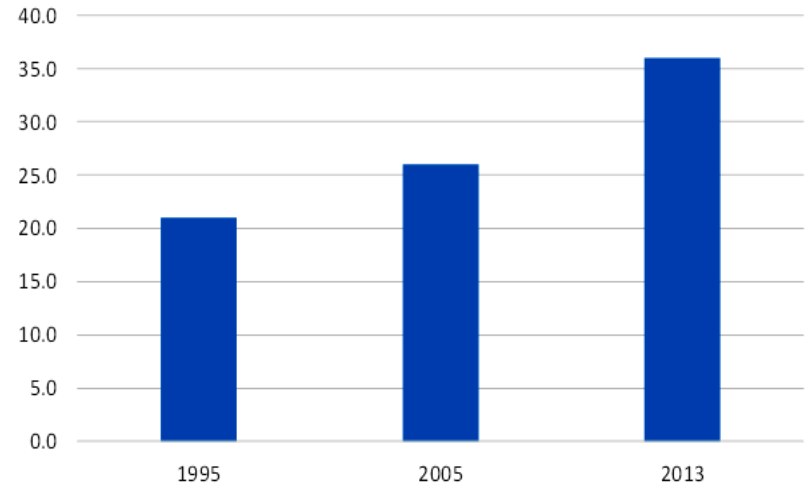
Andrew Hunt, International Economist

Data cut off 21<sup>st</sup> February 2017

# THE BERLIN WALL REVISITED

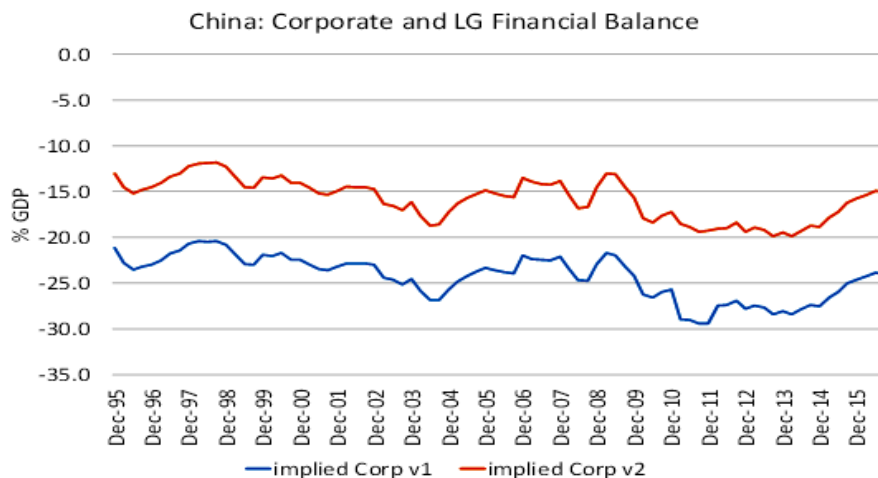
- The Fall of the Berlin Wall was viewed as confirmation of the ‘superiority of the Western Economic System.’
- The Fall of the Wall ushered in an expansion of World Trade, increased globalization, and a profound change in the process of ‘inflation.’
- However, the original event involved only 130 million people entering the ‘capitalist system,’ and they accounted for <1% of global trade.
- Today, we believe that even larger changes are afoot in a much larger part of the global economy.

Asia: Share of World Trade  
UN data



# THE NORTH ASIAN MODEL DID NOT PROFIT MAXIMIZE

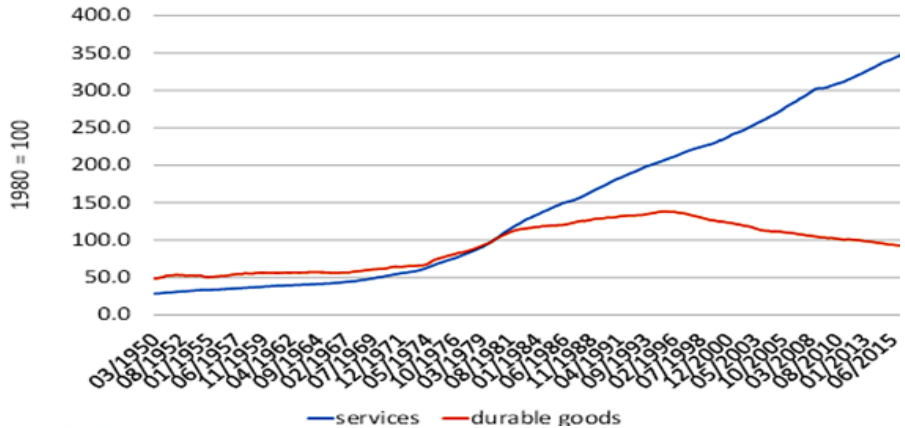
- Post the Fall of the Wall, the WTO model was expanded massively to include the large North Asian economies.
- But China and Korea did not change their non-profit-maximizing models.
- Instead, China used massive quantities of credit to support its (trade) volume growth and employment.
- China, in the 2000s, has resembled the Vietnam-era US industrial model with a low tolerance for unemployment.



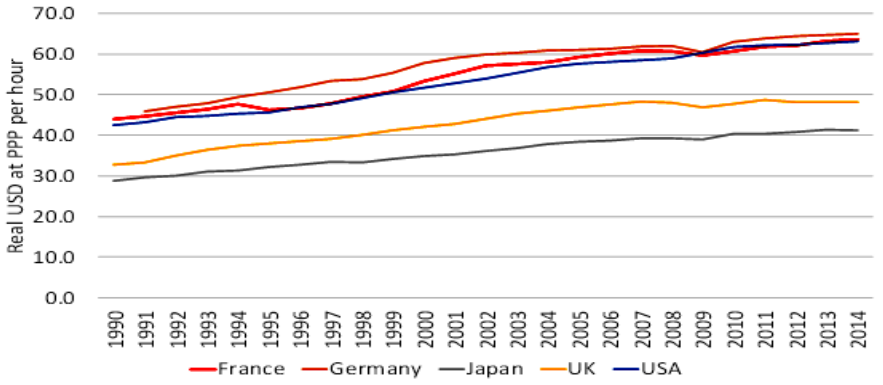
# GLOBAL POLITICAL RISK INCREASED

- To 'cope' with the implied high real FX rates, the West was obliged to reconfigure its economies towards an over-reliance on *credit intensive, low productivity growth services* such as real estate, financial services, and hospitality.
- The 'over reliance' on services (and loss of productivity growth generating manufacturing sectors) have lowered trend GDP growth rates and added to inequality and regional imbalances. Hence there is more pressure for trade protectionism.
- Add to this cocktail the perception of inequality, social injustice and high immigration flows and the "unelectable" have become electable.

USA: Relative Prices



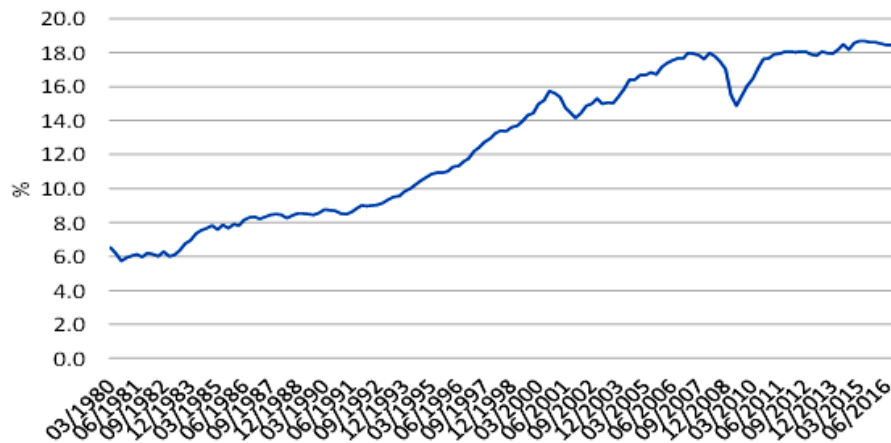
GDP Produced Per Hour Worked  
OECD, World Bank data at PPP



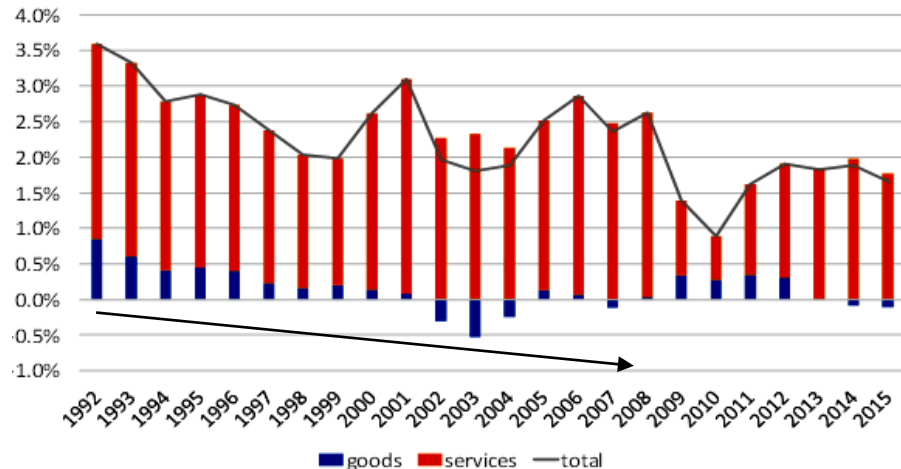
# THE MYTH OF GOLDILOCKS

- Markets of course had little time for the technicalities of low inflation in the 1990s and 2000s.
- But, it was the rise in import penetration rates that broke the link between domestic money, credit and capacity utilization, and inflation rates.

USA: Import Volumes  
% volume of domestic demand



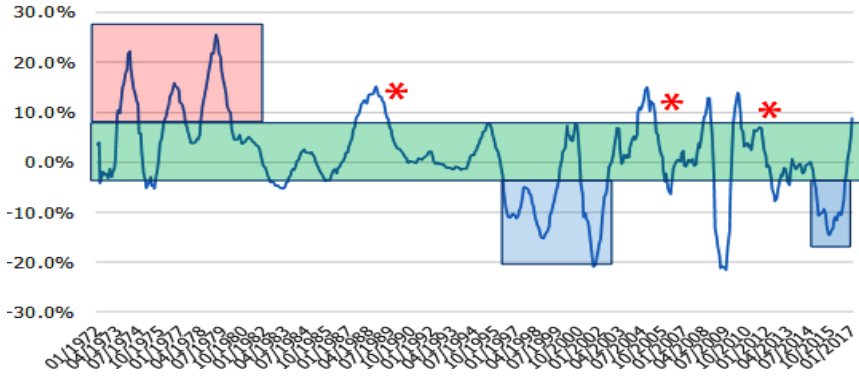
USA: Sources of Core CPI Inflation  
PPT contribution to increase in core CPI



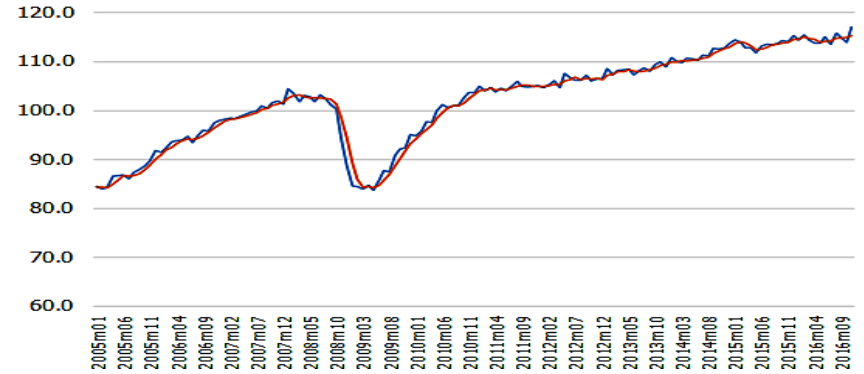
# NORTH ASIA: THE MODEL IS CHANGING

- But today, Asia is moving towards exporting inflation.
- Now that the growth in world trade volumes has stalled, Asia is being obliged to change its export model.

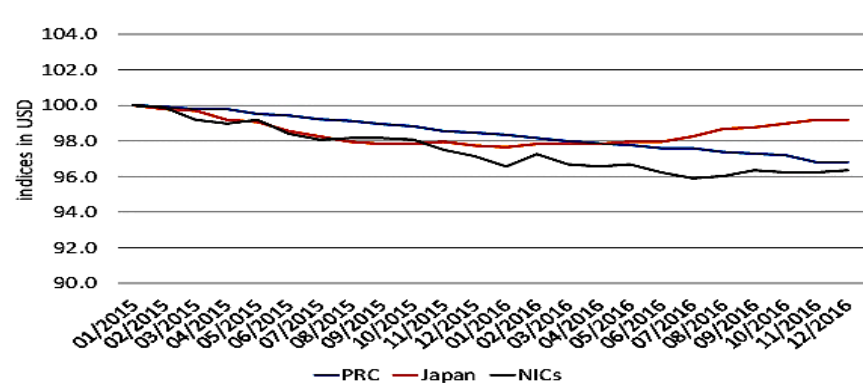
Korea: Export Prices in USD  
% YoY



CPB World Trade Volume Index



USA: Import Prices from Asia



## ASIA: POLITICS HAVE ALTERED

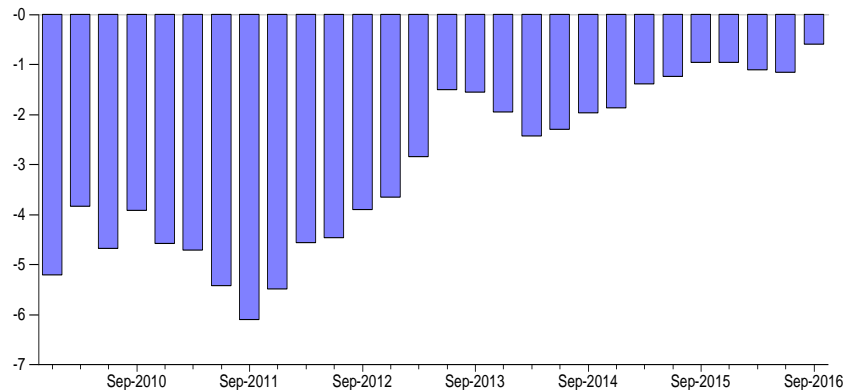
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- Abe was clearly a “new type” of Japanese PM.
- Modi is also a departure from the past.
- “Duterte Harry” is an interesting character.....
- Korean politics have become unstable to a near unprecedented extent....
- Malaysia’s political situation is fluid
- Thailand too is suffering
- *Changing political landscapes are not only the prerogatives of the EU and USA.*

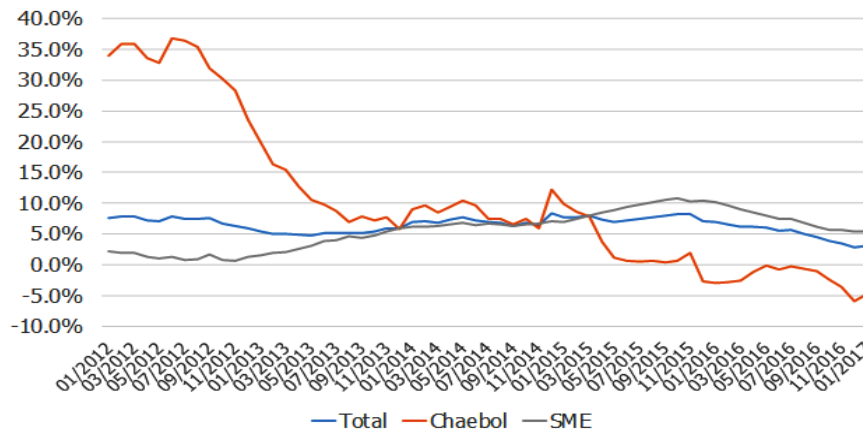
# A NORTH ASIAN CORPORATE CREDIT SLOWDOWN

- Meanwhile, and perhaps more importantly, credit growth has slowed to North Asian Corporates.
- *The loss of credit is forcing a change in their business model*

Korea: Corporate Sector Financial Balance  
% GDP



Korea: Corporate Credit  
% YoY

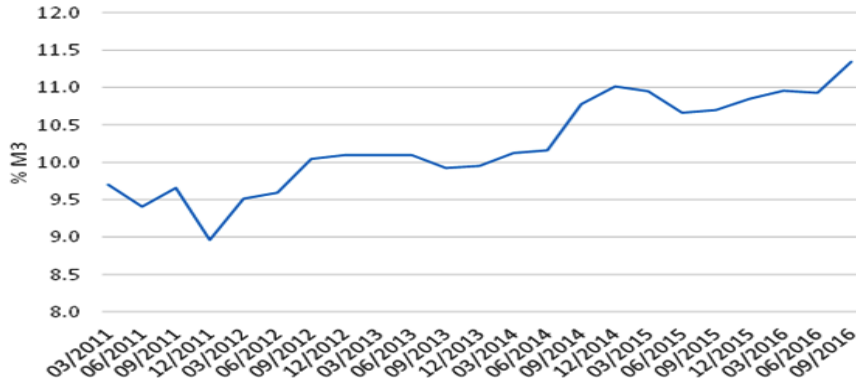




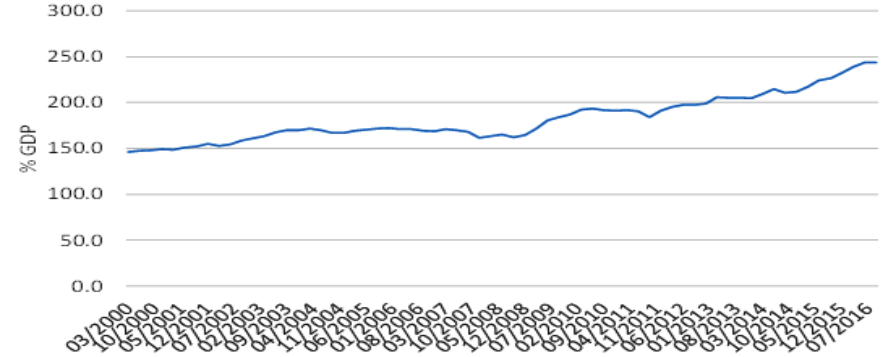
# CHINA AND INFLATION

- However, China faces the most profound changes.
- China has created a massive stock of excess money balances. As a result, household portfolios are heavily skewed to domestic assets in comparison to elsewhere in the region.

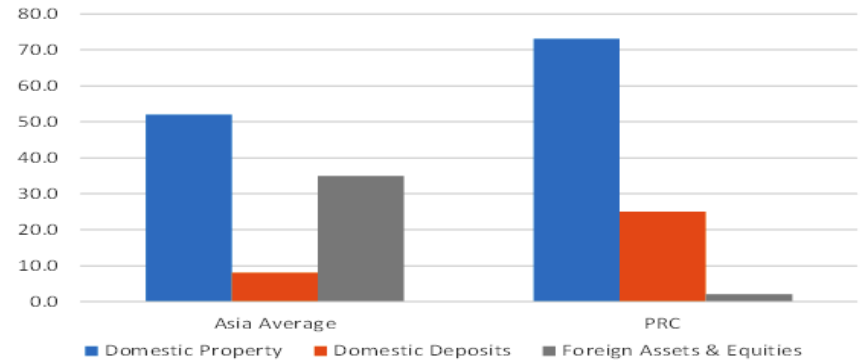
China: Private Sector Foreign Assets



China: Broad Money % GDP



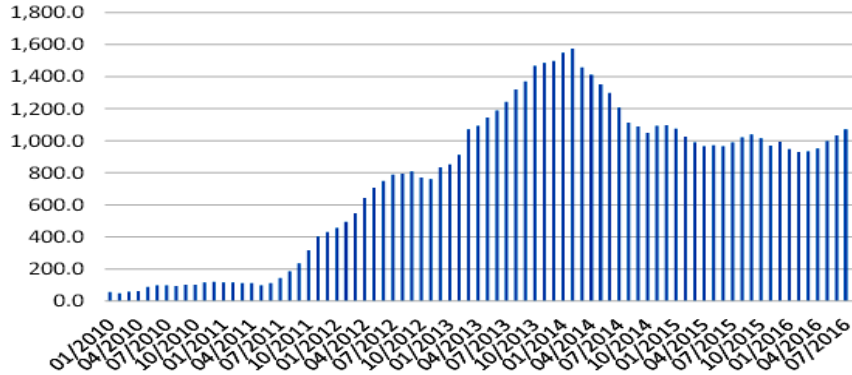
Household Asset Allocation



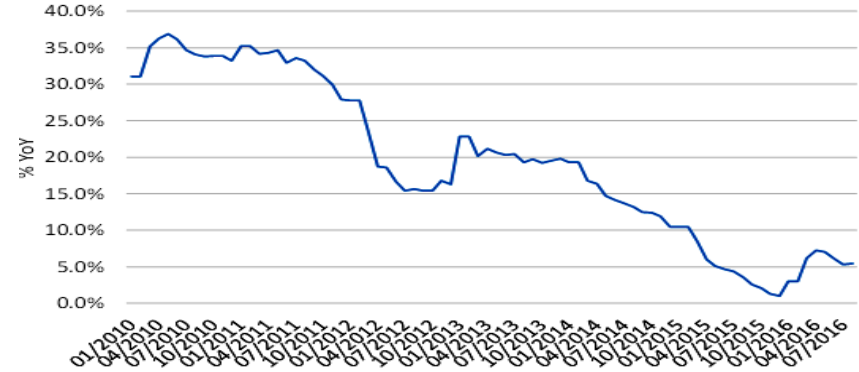
# CHINA: DIVERSIFICATION

- Now, China's (limited number of) savers are looking for alternative stores of value.
- Domestic real estate and equities are benefitting but the primary focus until now has been a move away from the RMB and RMB assets.

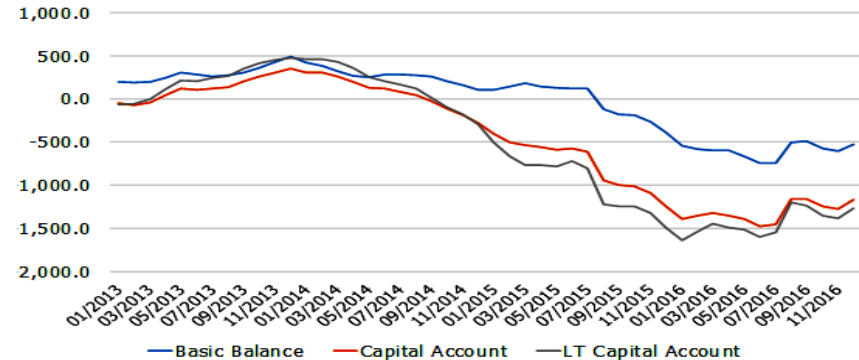
China: Gold Imports via HK tonnes over 12months



China: Real Estate Investment



China: Balance of Payments USD billion over rolling 12 months



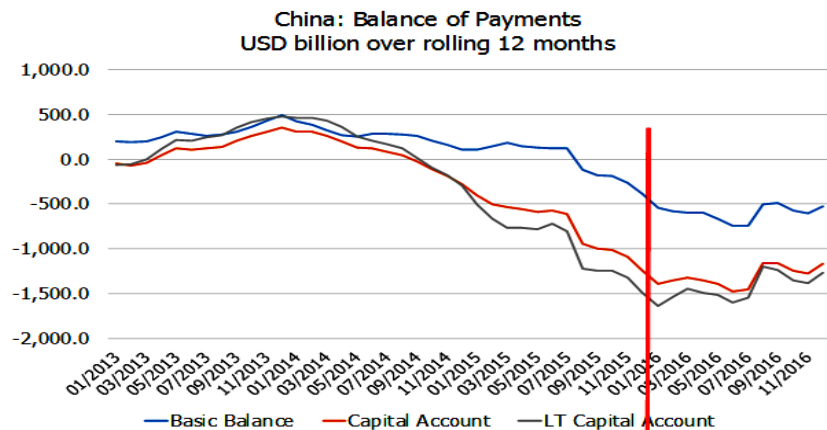
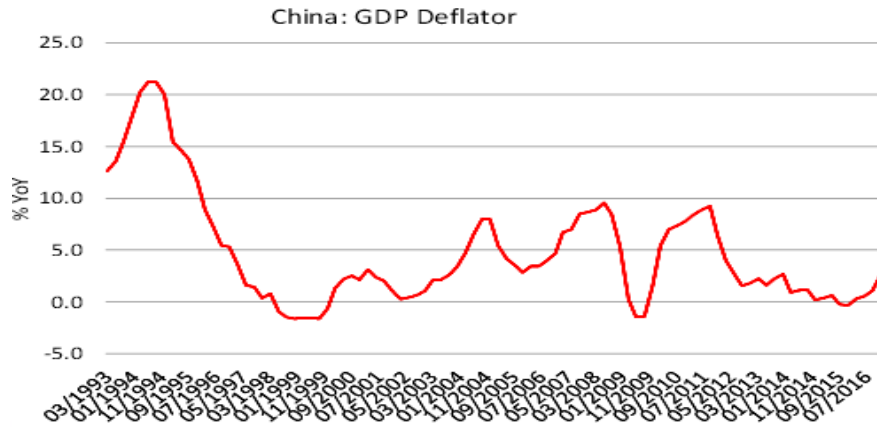
# CHINA: 'SPLAT THE RAT'

- As the scope of the capital controls has increased, China's savers have become ever-more inventive....



# CHINA: CAPITAL CONTROLS

- But, we fear that the latest tightening of capital controls may have been a step too far.
- Could the closure of the capital account lead domestic inflationary pressures to rise sharply?
- This was the experience of the CEE economies during the 1980s



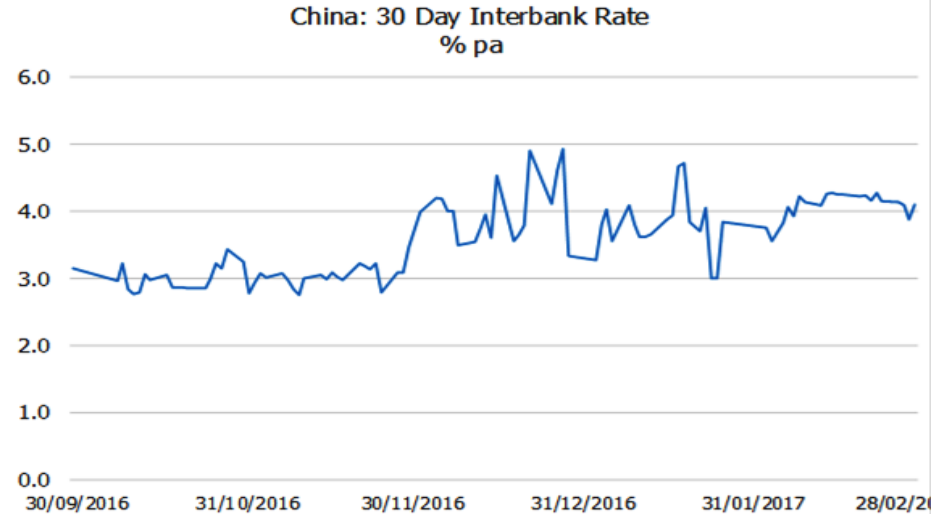
# CHINA: STRONGER GROWTH

- We wonder, could China's latest boom-let be the result of a move out of 'cash'?



# CHINA: A TIGHTENING

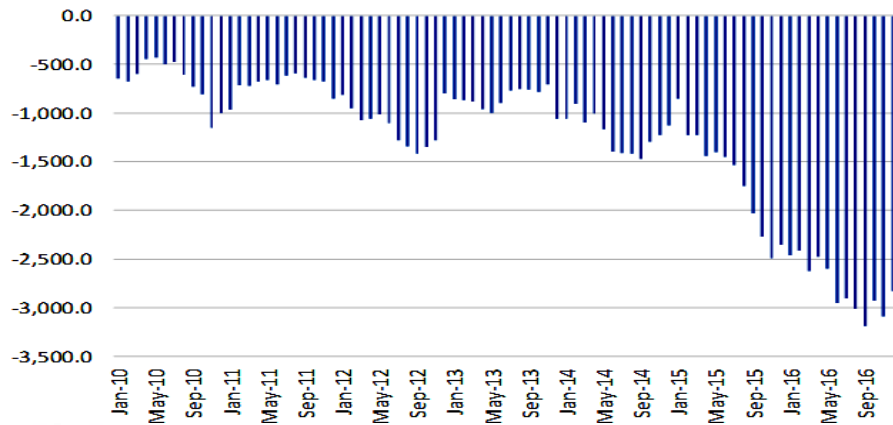
- Over recent weeks, the authorities have reacted to the situation by tightening funding conditions within the banking system, hence have witnessed higher rates and the renewed importation of wholesale funding.



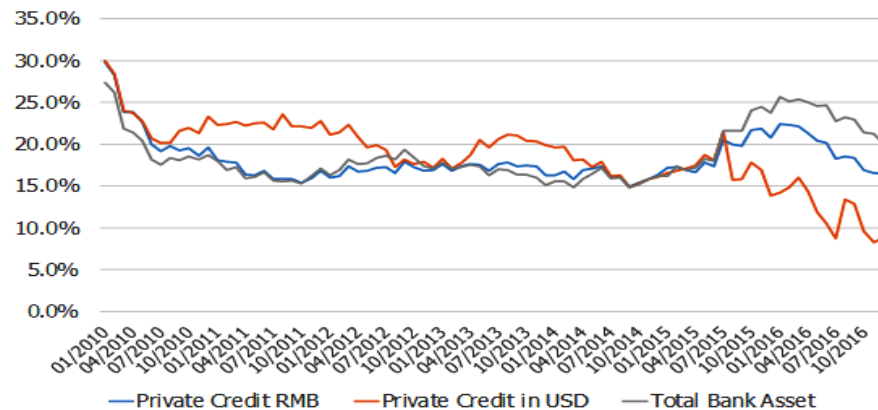
## CHINA: FIGHTING THE BOOM?

- China was using a heavily monetized budget deficit to support its economy. Now, this has ceased.
- Moreover, the domestic credit data has softened.
- *China's government is clearly leaning against the latest boom.*

China: Budget Balance  
RMB billion over 12 months

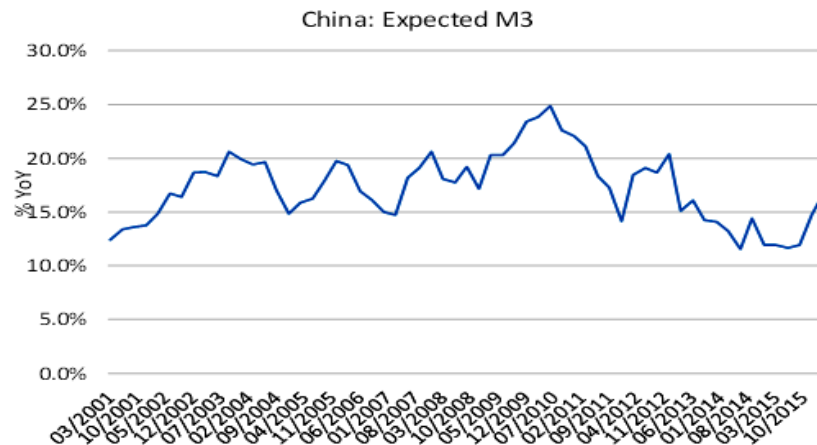


China: Credit Growth  
% YoY



# CHINA: EXPECTATIONS ARE EVERYTHING

- With the Autumn Congress approaching, Xi will not wish to see a sharp slowdown in the economy.
- But high inflation would be even more damaging?
- Hence, China is attempting to protect the internal and external values of the RMB.
- Ultimately, it will be the expectations of savers that prevail.
- Inflation expectations are now everything....

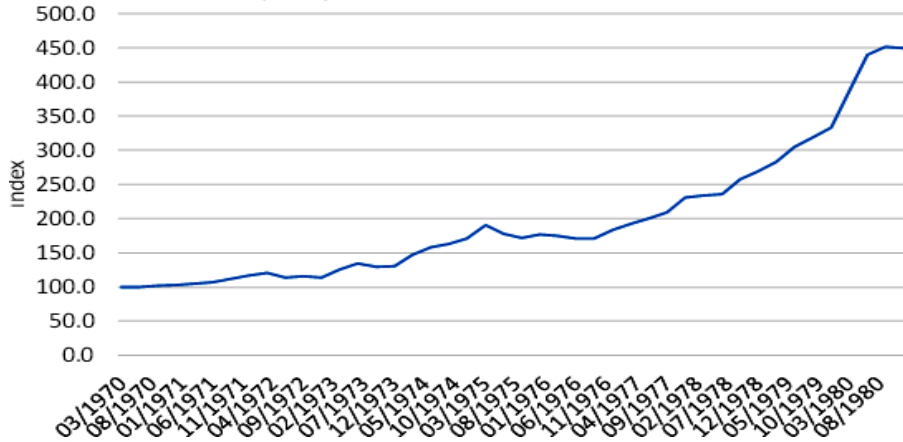




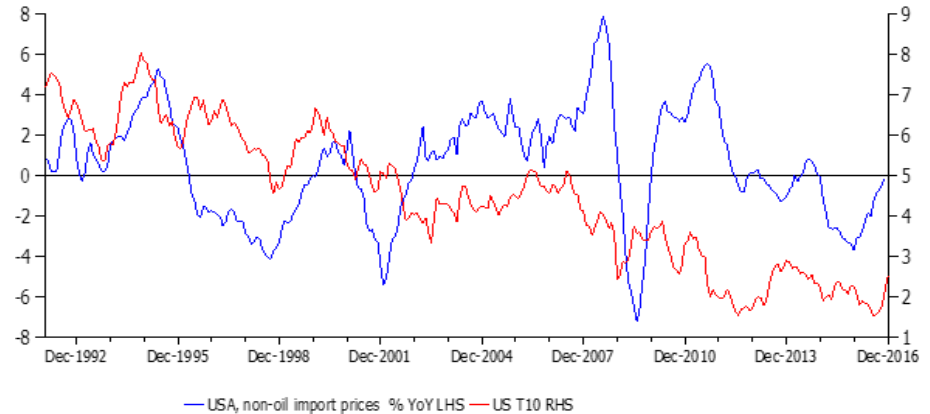
# EXPORT PRICES ARE EVERYTHING FOR GLOBAL BONDS

- If China's inflation rate rises, ultimately the RMB will fall.
- However, during periods of stagflation, we usually find that dollar denominated export prices tend to rise.
- China could export its inflation to the world, albeit spasmodically.

UK: Export Prices Under "Stagflation"  
Export prices in USD 1970-1980



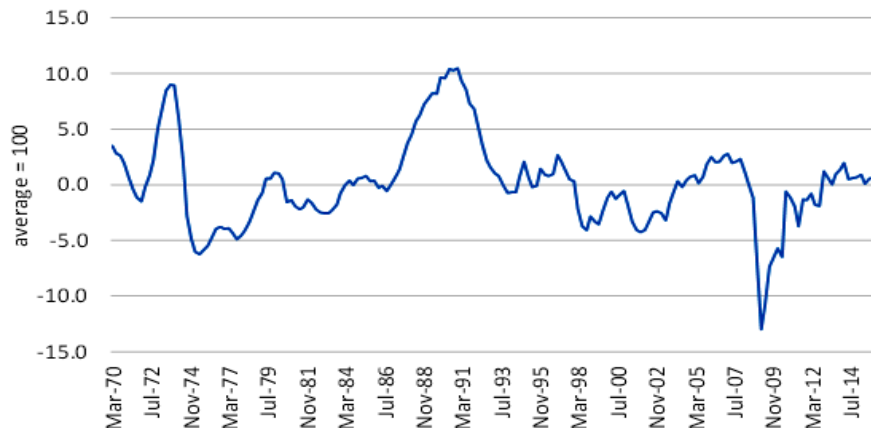
USA: Import Prices and Treasury Yields  
% change, % pa



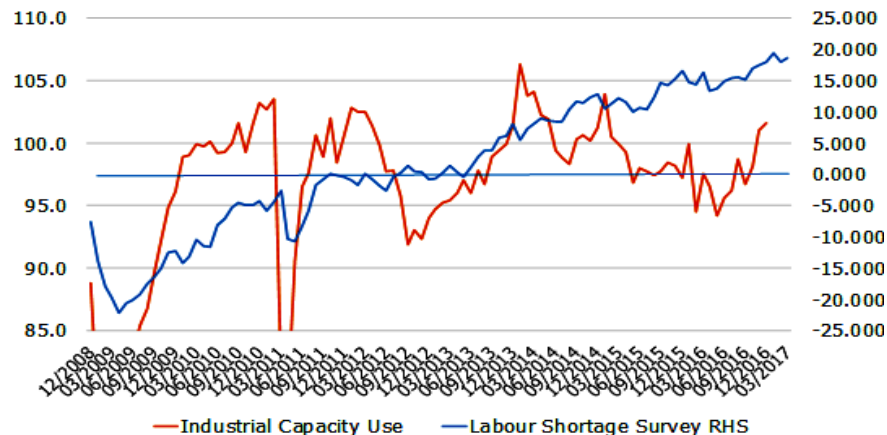
# JAPAN: A TALE OF TWO SECTORS

- In aggregate Japan's economy is overheated (just).
- There is excess capacity in the manufacturing sector but deficient capacity in the service sectors.
- In such a situation, a large expansionary policy / weak Yen would make no sense!
- Japan needs a strong Yen to force restructuring.
- But a strong Yen may be inflationary for the world

Japan: Demand Pressure Index

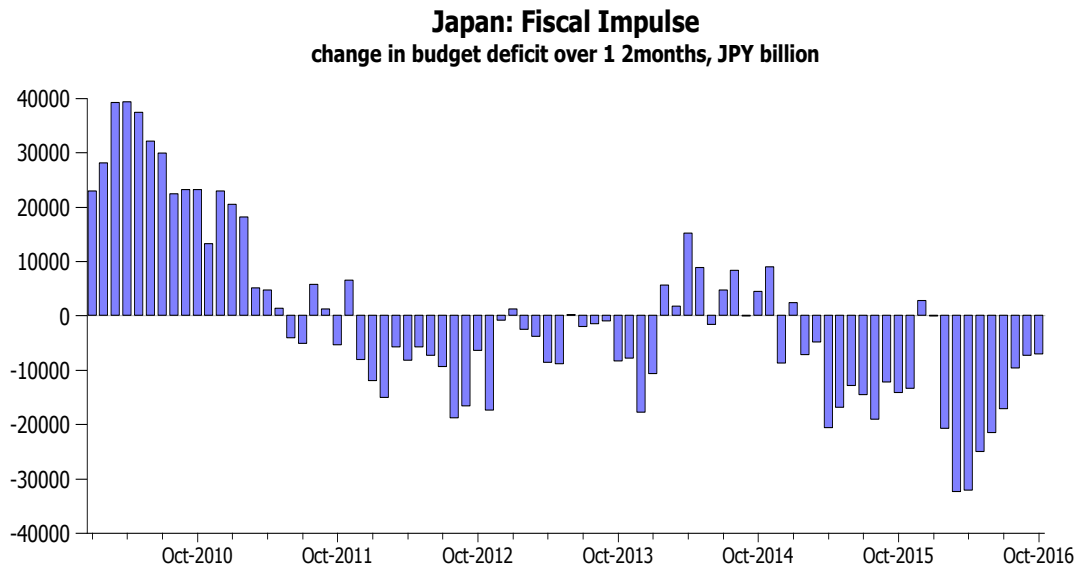


Japan: Capacity Utilization indices



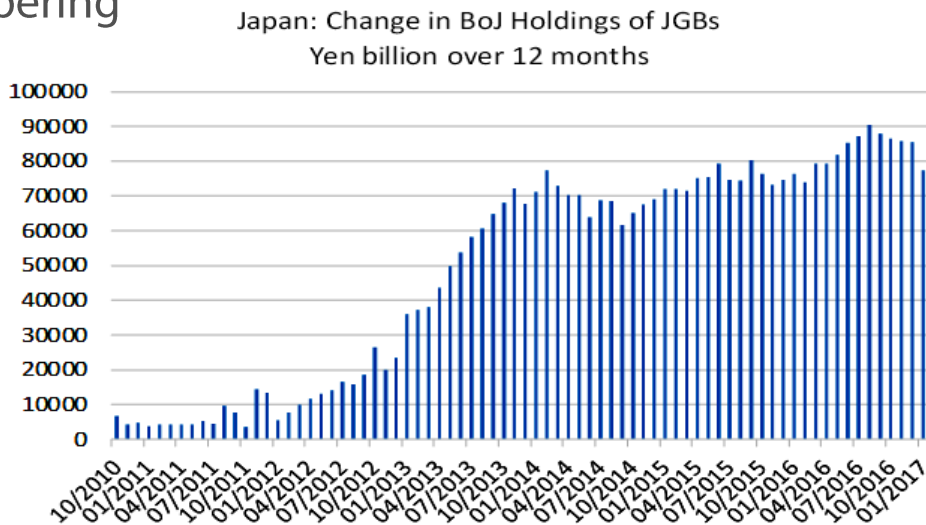
# JAPAN: FISCAL AUSTERITY MEDIUM TERM TARGET

Given the economy's short term position, and its longer term outlook, the MoF will keep a tight rein of fiscal policy.



## JAPAN: QQE FADING AT THE BOJ TAPERS

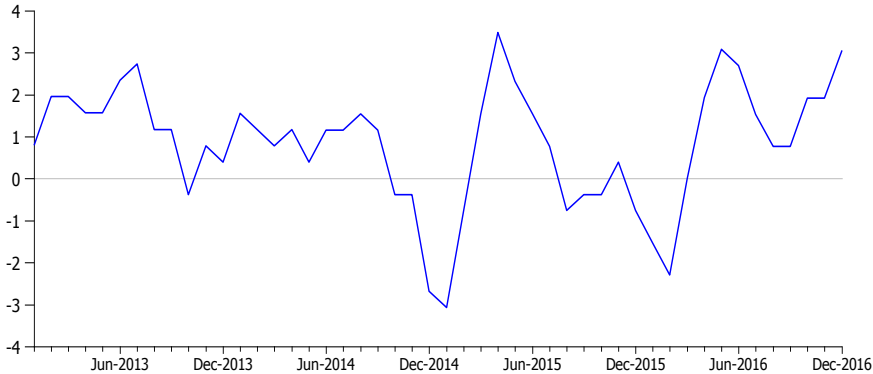
- The First Arrow of Abe-nomics was fired well before Abe by Gov. Shirakawa.
- His desire was to insulate the commercial banks from *potentially* 'toxic' JGBs.
- By 2017H2, his target will have been reached.
- Hence, the BoJ is tapering



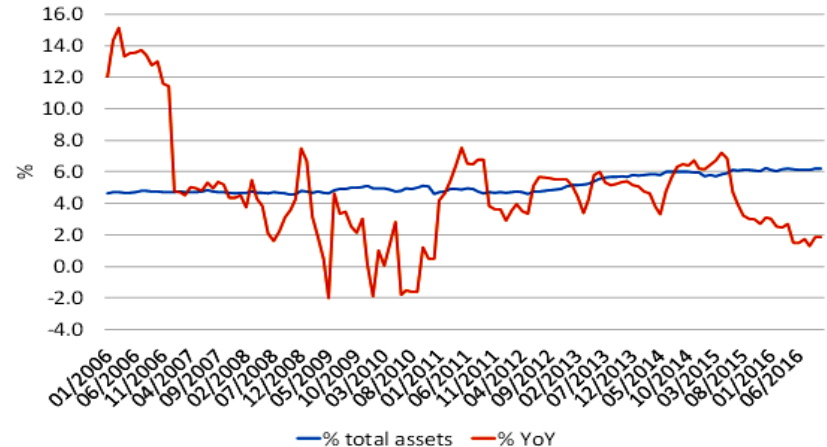
# EUROPE: INFLATION HERE TOO

- The Bundesbank is plainly and increasingly overtly concerned by rising import prices and the negative impact of negative rates on its banks, insurers, and households.
- A direct quote from Buba:  
*“On a Cost Benefit Analysis, the C now exceeds the ‘B’ within the QE”*

Germany: CPI  
% 3 month annualized

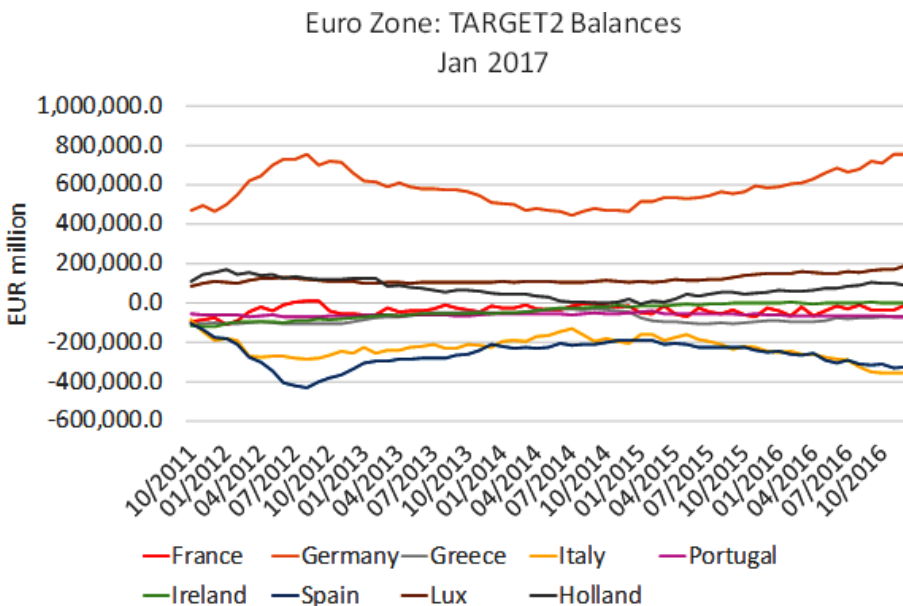


Germany: Bank Capital



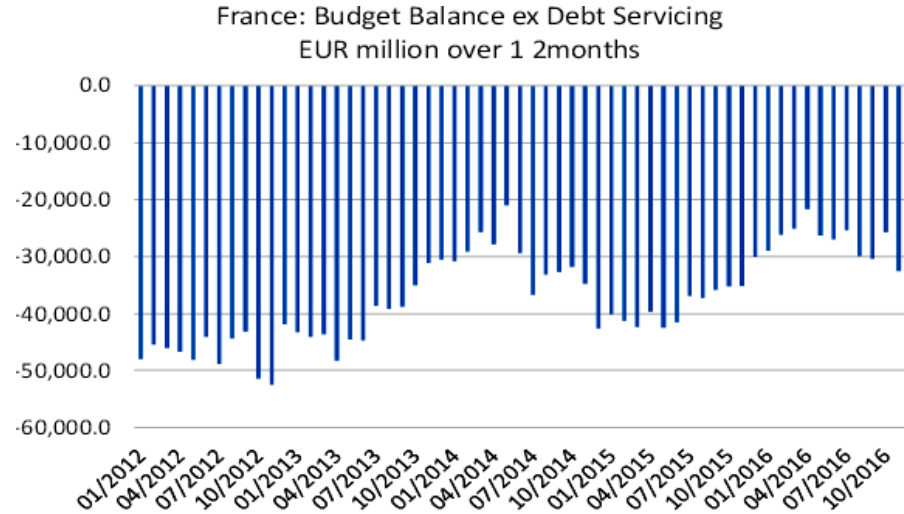
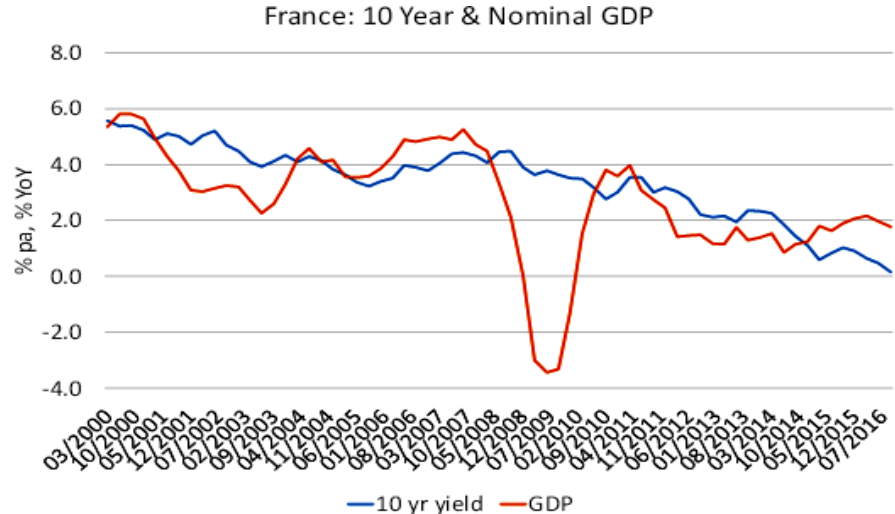
## EUROPE: A NEED FOR HIGHER RATES

- The Euro System relies on the largesse of the ECB's "off balance sheet" TARGET 2 lending system
- In theory, TARGET2 is Europe's settlement (akin to FEDWIRE) but unlike the US system, there is no settlement date!
- A quote from the Bank of Spain: *"The growing TARGET2 balances are a big problem... But at these rates they are not our problem"*
- However, we are interested in lengthening the maturity of our liabilities.



# EUROPE: U-TURN REQUIRED, BUT...

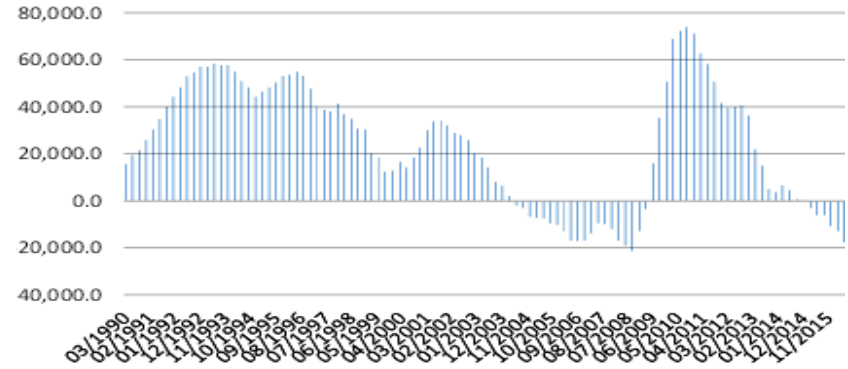
- The ECB needs to move the repo rate back into positive territory.....
- But any resulting sell off in bonds could compromise the illusion of French fiscal responsibility.
- The ECB is juggling too many balls.
- *There is however a non-zero probability of higher official rates in 2017.*



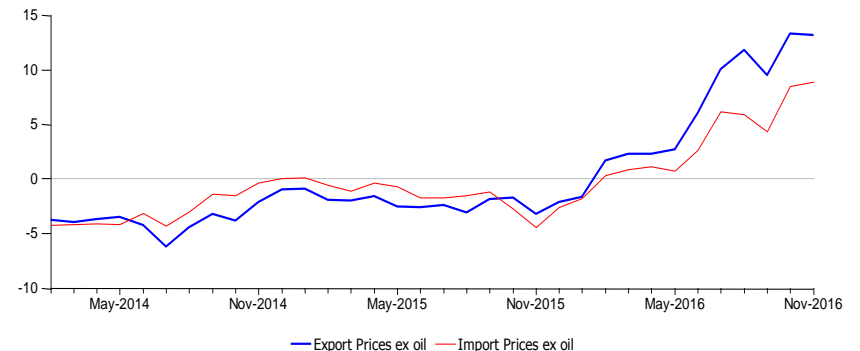
# THE UK: POLICY IS TOO EXPANSIONARY

- BREXIT does provide an opportunity for the UK to boost income growth and 're-balance'.
- However, the BoE's vested interest has led to policy conditions being too expansionary.
- Hence, the household sector is 'deficit financing' its spending.
- Meanwhile, companies have enjoyed a sharply improved terms of trade boost.
- In the near term, growth has surprised on the upside but the current account balance will ultimately suffer.

UK: Household Sector Financial Balance  
GBP million over 12months



UK: Trade Prices  
% YoY

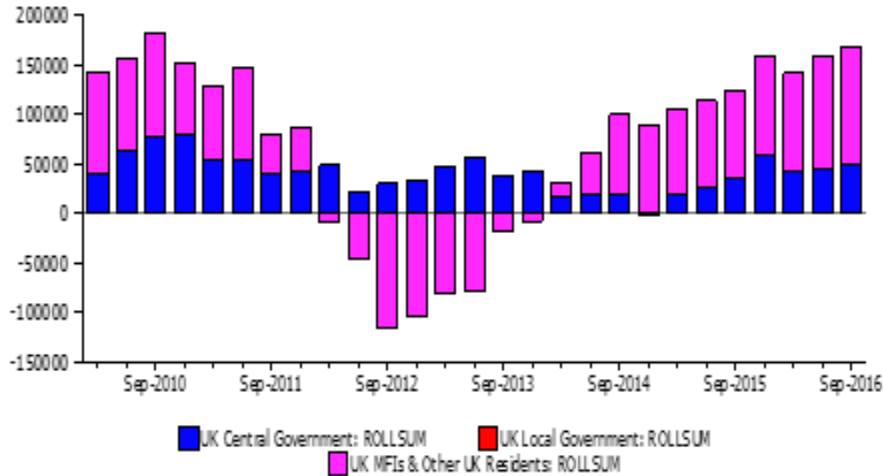




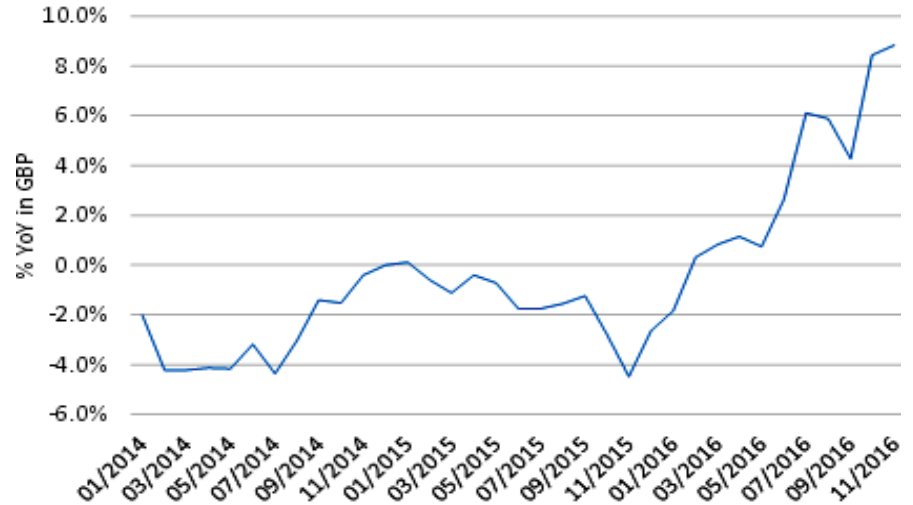
# THE UK: INFLATION SENSITIVITY

Specifically, if global inflation rises, foreigners may cease buying UK bonds & the economy could suffer a profit and income-sapping deterioration in its terms of trade.

**UK: Non-Resident Acquisitions of GBP Bonds**  
GBP mn over 4 quarters

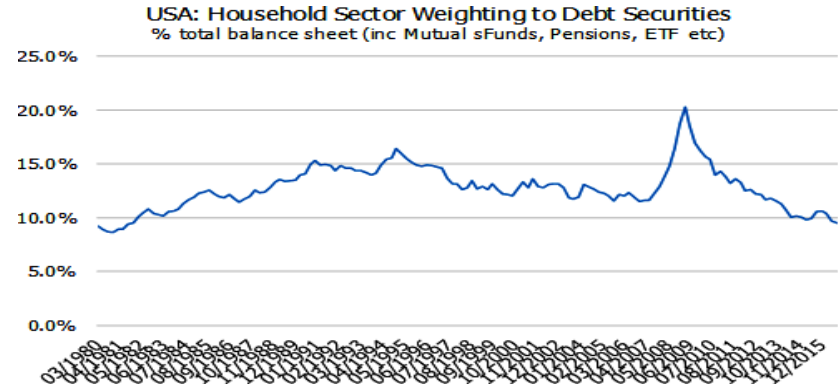
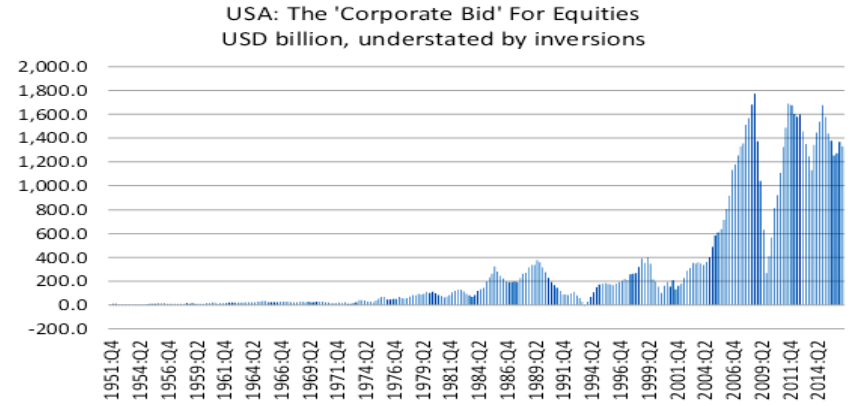


**UK: Import Prices**



# USA: TEFLON EQUITIES?

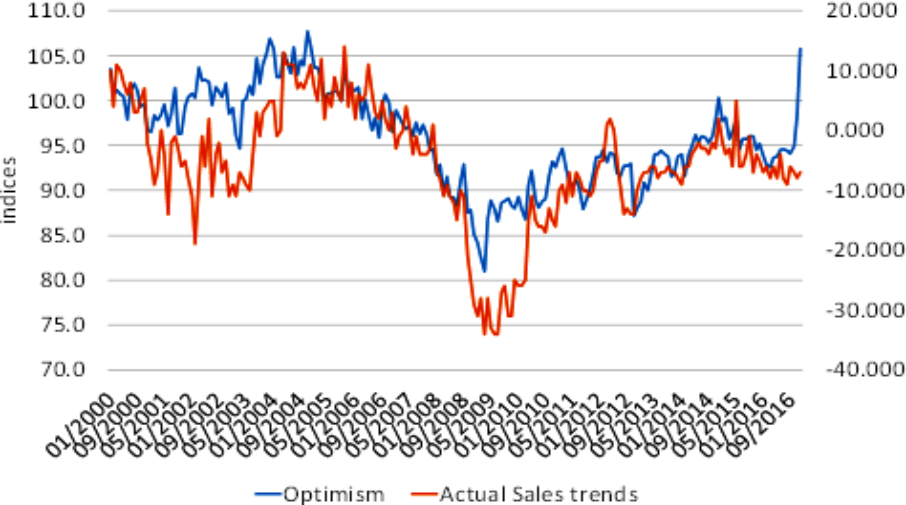
- There may – or may not – be optimism over Trump but what is clear is that the cash pay-out to the owners of US equities is immense at present.
- With \$1.4 trillion of pay-outs, plus foreign inflows, Wall Street has naturally acquired Teflon-coating.
- Moreover, we fear that savers are fleeing bonds into inflation-proof equities.



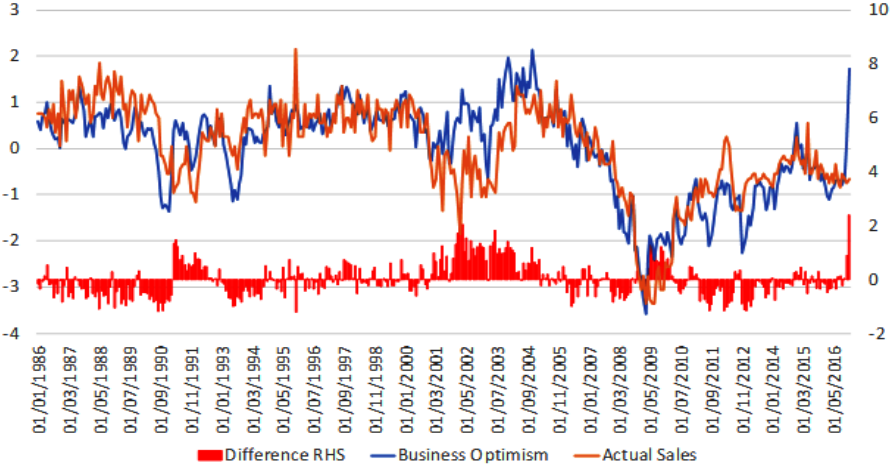
# USA: FOMC OVERKILL, OR WAIT-AND-SEE?

US optimism is high but actual sales are sluggish.

USA: NFIB Survey Results

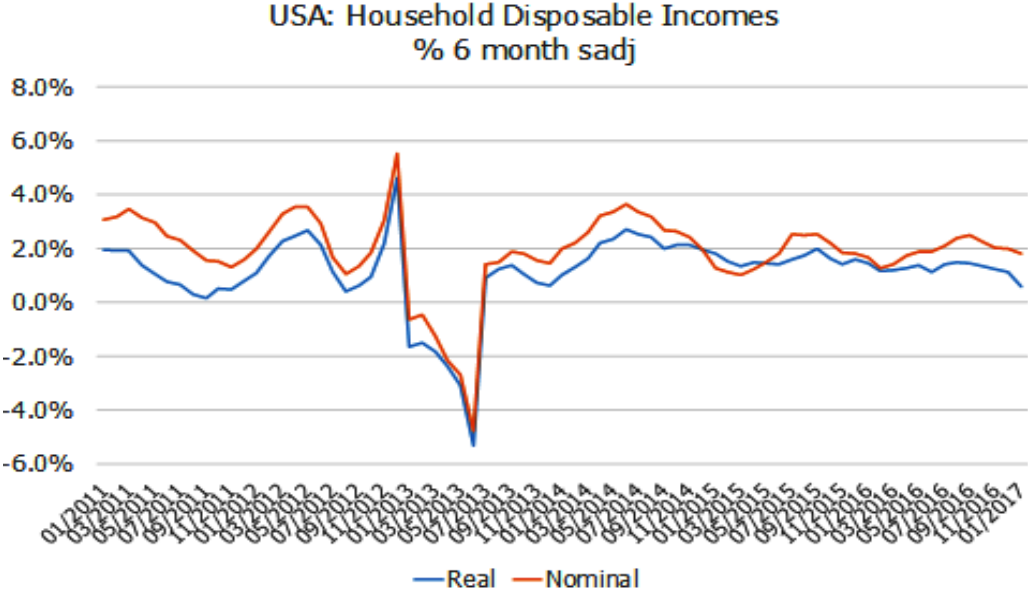


USA: NFIB Optimism & Current Sales standardized indices 1986-2016



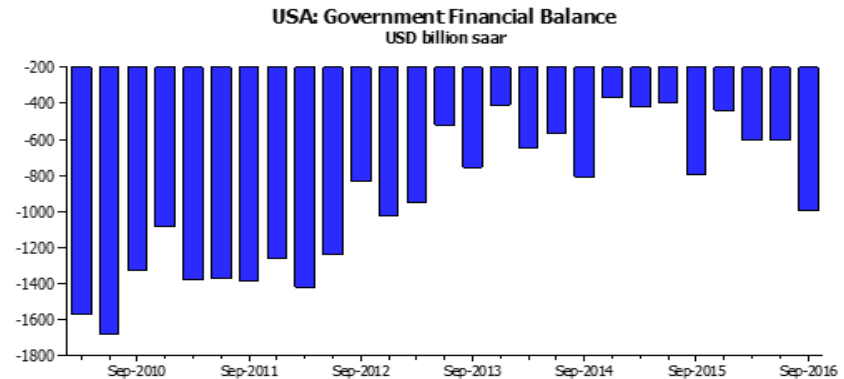
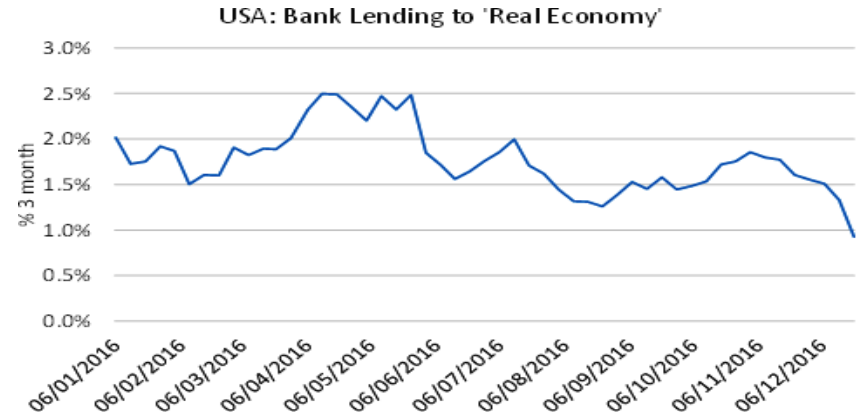
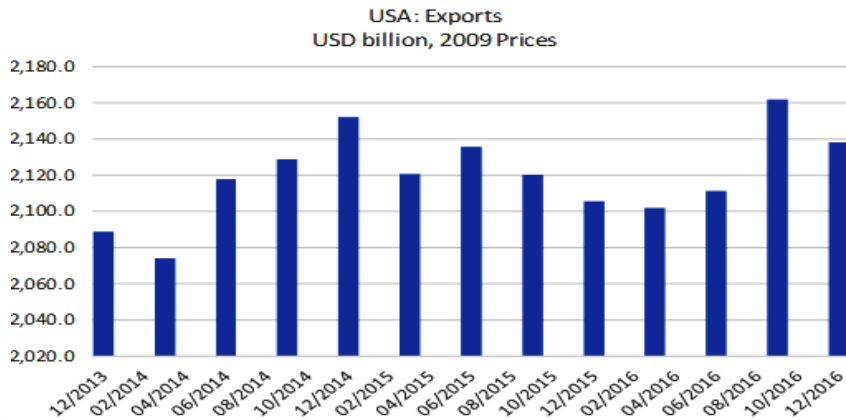
# USA: INCOME TRENDS SOFT

Disposable income trends are weak, retail sales trends 'so-so', and construction is soft.



# USA: CREDIT, EXPORTS AND PUBLIC SPENDING

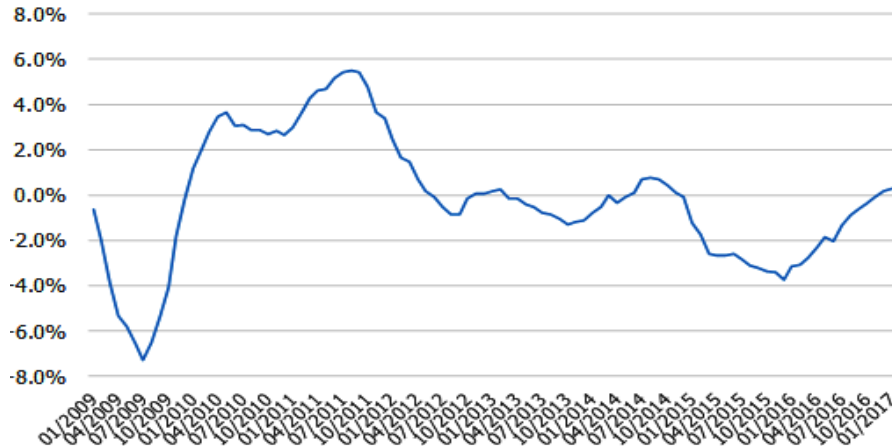
- Fiscal policy was eased ahead of the election, it may tighten in the near term.
- Markets are assuming that net trade will improve (despite protectionism / stronger USD)
- Meanwhile, credit growth has recently dived.



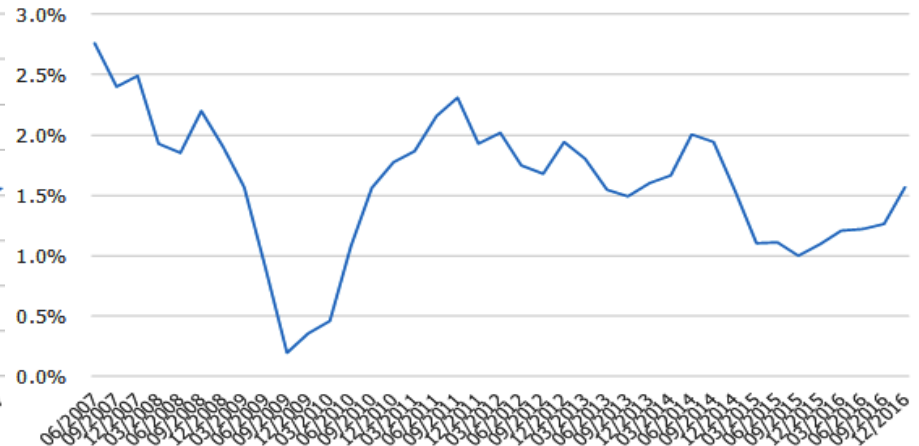
# USA: BUT IMPORT PRICES ARE RISING

- When he looks up from his Twitter Account, could Trump find stagflation to be a threat?
- Yellen may already fear this

USA: Non Oil Import Prices  
% YoY

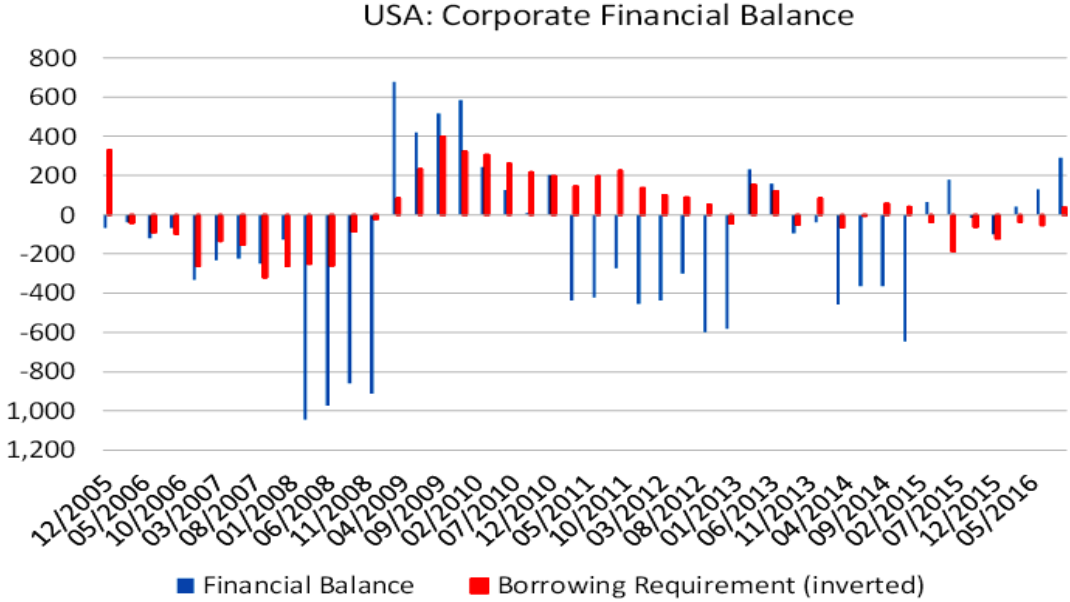


USA: GDP Deflator  
% YoY



# USA: TRUMPING CORPORATE CASH FLOW

Faced with weak economic trends, Trump may turn his eye to the corporate sector's financial conduct and Zaitech.....



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