GLOBAL EQUITY

Market Outlook 2017

Previously, capital markets had become highly conditioned to a "lower for longer" world, with the search for yield having implications both within and across risk asset classes. Even before the US election result, markets had started to factor in a more inflationary outlook. The exact cause of this more conducive pricing environment can be debated, but the rate of growth within China and its knock-on implications for commodity prices is certainly one contributing factor.

With this as a context, the ascendancy of Donald Trump to US president is certainly a push on a door that was already ajar. His election promises, whatever the ultimate reality, would appear more inflationary than the current status quo. When combined with ongoing optimism regarding US growth and a reasonably firm US labour market, we are clearly set for a significant test of bond investors' nerves. This has implications for how investors appraise companies within the equity markets.

Global growth prospects

Will renewed optimism be matched by reality? This is the key question we need to answer. We would summarise the case for cyclical optimism as follows:

- The election of Trump and success in both houses will result in policy promises having a reasonable probability of being delivered. Higher fiscal spending combined with possible protectionism and easier regulation on businesses are all inflationary in nature.
- Existing economic trends in the US are suggestive of a tightening labour market, making any growth surprise likely to be more inflationary.
- Chinese credit conditions, albeit too focused on the old state-owned enterprises, have been much easier than expected, with an impact on both global demand and commodity prices while this remains in place.
- While willingness to borrow has been a challenge to date, the impact of greater government borrowing in the US is driving the yield curve steeper, increasing margin opportunities for banks and hence the propensity to lend.
- Economic stagnation is the default setting for many investors, and hence there remains potential for reappraising the relative merits of equities and those businesses more reliant on a conducive economy.

However, we would counterbalance these views with the following observations:

- Quantitative easing (QE) has not convincingly changed the behavior of the private sector in most developed economies. Borrowing for investment and expansion has been limited, while refinancing to boost equity valuations has been rife. Fiscal profligacy has been attempted in countries such as Japan with limited lasting effect.
- Low rates have ensured the survivability of poorer corporations, and the sensitivity to rising rates and resulting defaults may be greater than in the past.
- Risk assets in aggregate have been elevated by QE. The willingness to direct growth through fiscal means suggests that valuation support for financial assets is now diminishing. The point where inflation becomes negative for overall valuations may be closer at hand than would be typical, despite the still low level of rates.
- While central bank policy has dampened market volatility, political turmoil and its uncertainty have been unleashed. Mr Trump's policies would appear to be harder to predict than most, particularly in the global sphere, making geopolitical issues an unknown headwind.
- The renewed rise in the US dollar will be a challenge for certain emerging markets, and with the UK already having taken a lead in the currency devaluation race, the prospects for growth in the global economy when measured in US dollars is less convincing.

In summary, the cumulative positioning of investors in companies and asset classes that are deemed safe in a "lower for longer" environment is undergoing a significant test at present. The scale and duration of changes to date would suggest that more capitulation is likely if the policy measures being promised by Mr. Trump are enacted. However, rotational mean reversion of risk premiums is not a new phenomenon and a fair degree of convergence has been enacted by the market post-election. The rate of growth in the real economy will remain a frustration for investors in 2017 and beyond, and hence profit delivery rather than hope will matter again over time. We continue to focus our portfolios where we have conviction on profit growth being delivered by business franchises we trust and are not necessarily dependent on a cyclical tailwind.

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