New year, new challenges
What will 2017 bring for global investors?  
December 2016

IN BRIEF

• 2016 will be remembered for political upsets, with the UK vote to leave the European Union and the election of Donald Trump highlighting voter dissatisfaction with mainstream politicians and parties. For investors, it will probably also go down as the year when global deflation fears came to an end, long-term interest rates finally started to rise, and central banks stopped being the “only game in town”.

• Faster reflation and reduced emphasis on monetary policy would both tend to increase the returns of equities relative to bonds in the future, and to point investors in the direction of cyclical assets over more defensive ones. Within fixed income, it would also tend to argue against holding long-dated bonds. But the structural and supply-side factors that are constraining global investment and productivity growth, and pushing up the relative demand for safe assets, have not gone away. These structural constraints, coupled with the fact that the US is much further along the reflationary road than other parts of the developed world, suggest the search for both income and new forms of “safety” will continue to be crucial for investors.

• Politics and policy are likely to dominate headlines again in 2017, with Brexit negotiations due to start and key elections in Europe. But for investors, we would argue that the real economy will continue to be the most important factor—especially supply-side dynamics in the US, the resilience of the eurozone and UK recoveries in the face of uncertainty, and the pace and extent of any further appreciation in the dollar.
NEW YEAR, NEW CHALLENGES

A TURN IN THE WEATHER

Since the global financial crisis, growth has consistently fallen short of expectations, especially in the developed world. Globally, economic output is 9% lower than if it had merely returned to its pre-crisis trend, and for the advanced economies the average shortfall is closer to 13%. The US has done better than most, but with average growth of just 2.1% a year over seven years, this is the slowest economic expansion since World War II. As the governor of the Bank of England (BoE), Mark Carney, has pointed out, real earnings for the median worker in the UK are no higher than in 2006—the worst performance since the 1860s.

The break with the past is even more noticeable when you measure demand in nominal terms, especially in the eurozone and Japan. Eurozone nominal GDP in the third quarter of 2016 was 11% higher than at the start of 2008. Over the preceding eight years, the cash value of the economy had grown by 40%. As Exhibit 1 shows, the UK and US have been more successful at sustaining nominal demand, but even in these economies, nominal demand has been consistently weaker than in the past.

Nominal growth since the crisis has been subpar across the developed world, but weakest in the eurozone and Japan

### Exhibit 1: Nominal GDP Growth

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Source: FactSet, national statistics agencies, J.P. Morgan Asset Management; data as of 12 December 2016.

This environment of subpar growth and equally supine inflation has meant that super-loose monetary policy, instead of being a temporary response to the global financial crisis, has started to seem like a permanent fixture. Financial institutions and businesses with long-term pension obligations found this environment of super-low interest rates and flattening yield curves immensely difficult. But for the typical investor it served their portfolio remarkably well.

The S&P 500 has risen by 292% on a total return basis since early 2009, and a 50/50 portfolio of global bonds and equities has delivered an average annual total return of 76%. That is significantly higher than the 5.1% average annual return between 1998 and 2008, despite the weaker performance of the global economy.

Will the coming years bring more of the same? Investors and voters were asked this question, in different ways and at different times, in 2016. Now we get to the end of this tumultuous year, we can see that the answer from both groups has been no. Voters have decided against business as usual and, increasingly, investors are expecting a change as well. Whether either will be satisfied with the outcome remains to be seen.

FASTER REFLATION, BIGGER RISKS—ECONOMIC AND POLITICAL

Commentators like to suggest that the great reflation trade began the day after the US presidential election. It didn’t. In fact, bond markets had been pricing significantly higher expectations for inflation since the summer. This was partly due to the automatic effects of higher oil prices, which rose by around 50% over the course of 2016. But there was also upward pressure on US prices being generated by the domestic economy which had been masked by the lingering effect on import prices of the stronger dollar. Underlying core personal consumption expenditure (PCE) inflation, a measure watched closely by the US Federal Reserve (Fed), has now risen above 2%, up from a low of just 1% following the global financial crisis.

Along with higher inflation, there were also signs of stronger economic momentum in both the developed and emerging market economies, with manufacturing and services purchasing managers’ indices (PMIs), for once, starting to pick up together during the summer (see Exhibit 2). This improvement included China, where industrial production and profits have recently been moving higher.

### Exhibit 2: Global PMIs

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Globally, real government spending has been growing at its fastest rate in several years in 2015 and 2016. As Exhibit 3 demonstrates, US fiscal policy had also turned slightly supportive before the election, with the budget deficit set to widen in 2016 and 2017 due to tax and spending changes that had already been passed. In that sense, the shift in emphasis from monetary to fiscal support was also in train well before Trump’s victory in November. But his plans for a major new fiscal stimulus package in the US have accentuated this trend and potentially magnified the risks.

Higher US public investment to support long-term potential growth could be positive for the global economy. But in general, the kind of tax cuts and investment spending that President-elect Trump and the Republican Congress have tended to focus on are not those that economists would say are likely to give the highest economic return. Also, it’s fair to say that this extra stimulus will be happening in the part of the developed world that needs it least. The risk is that any short-term boost to growth will come with a shortening of the economic cycle, rather than an increase in US potential growth, and will therefore bring the date of the next recession closer.

That would clearly be a worrying prospect for the eurozone, where inflation is now past its low point but still a long way from target (see Exhibit 4). In its latest December forecasts, the European Central Bank (ECB) even reduced the inflation forecast for 2018 slightly, to 1.5%. The forecast for 2019 is just 1.7%, a level which the ECB president, Mario Draghi, believes to be too far from 2% to be considered on target.

Some would argue that rising US inflation and interest rates will make it easier for Europe to recover, by giving European policymakers more room to import inflation via a weaker currency. That is possible, but it is noteworthy that most forecasters have recently been marking down their forecasts for economic growth in the eurozone in 2017. In January 2016, the consensus was for growth of 1.6%-1.7% in both 2016 and 2017. The forecast for 2016 has not changed, but the consensus prediction for 2017 is now 1.3%.
NEW YEAR, NEW CHALLENGES

Compared with Europe, the prospects for emerging market economies look positively calm. China’s long-term imbalances have not been resolved and remain a downside risk for emerging market economies as a group. But growth seems to be stabilising for the time being, and Brazil and Russia are now both past the worst of their recessions and heading for positive growth. The average current account deficit of the “Fragile 5” economies (Brazil, India, Indonesia, South Africa, Turkey) has moved from 4% of GDP at the start of 2013 to just over 2% of GDP. As Exhibit 5 demonstrates, exchange rates have also moved a long way since the time of the taper tantrum.

Emerging market currencies have depreciated significantly since 2013

EXHIBIT 5: EMERGING MARKET CURRENCIES VS. USD VALUATION

Downside risks to the emerging market economies from a major reversal in US trade policy cannot be dismissed. But if there is going to be a major change in US and global trade policy, this is more likely to occur in 2018 and 2019. Global trade has been a persistent source of weakness in the recovery so far, and this was not expected to change very much, even with a more supportive US president. What is expected to change is US monetary policy.

IMPLICATIONS FOR MONETARY POLICY AND THE COST OF MONEY

2016 was a year of two halves for bondholders, with the yield on 10-year US Treasury bonds falling steadily until the summer, only to rise by more than 100 basis points between July and December. Most forecasters are expecting yields to continue to rise in 2017, but arguably investors should be focused not on the scale of the increase but the reason. As Exhibit 6 shows, this latest rise seems to be due roughly half to higher inflation expectations and half to higher real rates. This contrasts sharply with the “taper tantrum” of 2013 – the sharp rise in yields that occurred when the Fed started to talk about winding down its bond purchase programme. That

The recent rise in US bond yields has been evenly divided between real and nominal yields

EXHIBIT 6: CHANGES IN US 10-YEAR BREAKEVENS, REAL YIELDS, 2009-16
% proportion due to breakevens and real yields


should bode well for US equities, which historically cope well with rate increases when they come from a low level and are associated with stronger real economic activity.

On the face of it, the relatively rapid rise in US yields flies in the face of conventional wisdom at the start of 2016, which was that the US yield curve was now at the mercy of the extremely loose monetary policies of overseas central banks. Over the medium term, we believe that both structural forces and the continued need to reflate the economy in both the eurozone and Japan are likely to keep global long-term interest rates at much lower levels than in the past. But this structural downward pressure has been tempered recently by the recognition that neither the ECB nor the Bank of Japan (BoJ) now sees much to be gained from pushing the long-term cost of money significantly below zero.

This important change was flagged up clearly in September, when the BoJ announced that it would henceforth target a 0% yield on 10-year Japanese government bonds. The message to investors was that the central bank was committed to maintaining nominal yields at extraordinarily low levels, but did not think it was desirable for the yield curve to be flat or even downward-sloping, as it had been at various times since the start of 2016, particularly given the implications for the financial sector. There was also a not very hidden lesson of this new policy for the government: that the central bank would underwrite almost any amount of additional public borrowing until the economy achieved consistently higher levels of nominal demand.

It would be very difficult for the ECB to follow a similar path to the BoJ—both practically and legally. But at its December meeting it was grappling with a version of the same problem—namely, that it was running out of ways to keep monetary policy highly supportive without fundamentally distorting the yield curve and/or running out of German sovereign bonds to buy. In the end it struck a neat compromise, reducing the monthly amount of bond purchases, but also extending the time frame for quantitative easing by nine months.
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The December ECB moves were initially interpreted by the markets as mildly hawkish, given that inflation forecasts provide little reason to slow the rate of bond purchases. But by scrapping the rule that prevents purchases of bonds with yields below the deposit rate and extending the range of bonds that the ECB can buy, Draghi bought himself greater flexibility to respond to bouts of market volatility next year and made it easier for quantitative easing to continue into the future, if inflation fails to materialise. It is a pity he was not in a position to also strike a bargain with Germany’s policymakers to loosen fiscal policy, which would not merely support growth but, incidentally, give the ECB more Bunds to buy.

UK rate expectations have jumped around in 2016, reflecting changing assessments of the economic impact of Brexit. By the end of 2016, markets were pricing in a small rise in the official policy rate in 2017 and very gradual tightening in the years after that. The latter seems reasonable, but we would be surprised to see a rate rise as early as 2017, given the BoE’s concern about the possible consumer reaction to higher inflation and the Brexit-related uncertainties hanging over UK businesses. A forecast for 1% growth does not provide a lot of room for downside surprises.

When it comes to global monetary conditions, all roads still lead to the Fed. As Exhibit 7 indicates, markets are now pricing in a slightly faster path for US rate rises than they were in the summer. But the change is perhaps less dramatic than the headlines about reflation and fiscal stimulus might have led one to expect, and market rate expectations are still below the average predictions of Fed policymakers themselves.

For several years, investors collectively have bet that the Fed would not tighten as fast as its own rate forecasts suggested—and for several years, investors have been proved right. But, historically, the record has been for investors to underestimate the pace of rate hikes. It’s healthy now to see investors raising their expectations to be closer to the Fed’s, but there is now scope for considerable market volatility if the Fed starts to worry more about inflation and the implications of looser fiscal policy and/or investors decide the US central bank is falling behind the curve.

IMPLICATIONS FOR INVESTORS AND RETURNS

The shifting fortunes for bond and equity markets through 2016 have rewarded investors with risk-oriented portfolios but also highlighted once again the benefits of diversification. A basic portfolio of 50/50 developed market stocks and government bonds would have delivered a total return of 4.4% since the start of the year. The same portfolio barely broke even in the 2015 calendar year. The Barclays US 30-year bellwether Treasury index fell by nearly 15% in the second half of 2016.

Japan and the eurozone were the best-performing equity markets in 2015 in dollar terms. As Exhibit 8 shows, 2016 was rather different, with both regions underperforming the US and the star performers within the emerging market world, notably Brazil and Russia.

Looking ahead to 2017, we would expect the recent increase in bond yields to benefit financials, which are disproportionately represented in the main EuroStoxx index. Financial stocks have outperformed in the second half of 2016, but registered a 2.5% loss on a total return basis for 2016 as a whole. A weaker euro could also help corporate earnings, at the margin. But investors will need to balance these likely positives against the negative economic effects of tighter financial conditions and political uncertainty. Overall, we believe the eurozone will struggle to outperform other developed markets at the index level, but the point about financials again underscores the importance of selectivity and active management. The main Japanese stock index could fare better, if investors retain confidence in the BoJ’s new policy of targeting the 10-year bond yield and the yen continues to weaken against the dollar.

We would expect the US to continue to outperform in 2017, especially the small cap sector, which is theoretically less affected by a stronger dollar and could benefit more than most from corporate tax cuts. However, investors will need to be alert to important sectoral shifts if the reflation theme continues to gain steam. The UK, with its large cap bias and exposure to the rest of the world, has done better than many in 2016, but for non-UK-based investors the benefit was more than offset by the falling value of the pound. Though UK equities look reasonably well supported at current valuations, they are clearly less attractive than they were at the start of the year. We will be looking to see whether earnings momentum can continue to improve in 2017, though within the equity market the relative shift back from mid and small cap equities to the larger businesses probably has further to run.

Investors have raised their forecasts for US rate rises, but not very dramatically

**EXHIBIT 7: MARKET OUTLOOK FOR THE FED FUNDS RATE IN 2017 AND 2018, JULY 2016 VS. DECEMBER 2016**

![Bar chart showing changes in market forecasts for US rate rises from July 2016 to December 2016.]

NEW YEAR, NEW CHALLENGES

Emerging markets are probably the toughest call for investors in 2017, having seen a dramatic recovery in investor sentiment in the first half of 2016, which was halted in its tracks by the outcome of the US election. Other than a major negative shock from China, which we do not see on the immediate horizon, the greatest risk for emerging market assets today is either an early US recession or, more likely, a further upward lurch in the dollar and/or relapse in commodity markets.

At the end of 2016, there were signs of renewed dollar strength, but little sign of another collapse in commodity prices. We do not discount either possibility, but—as mentioned above—the current account and currency adjustments we have seen in emerging economies since 2013 mean they are much less vulnerable to these downside risks than they were before. Emerging market assets also have the unique advantage—in the current environment—of being risk assets that are still reasonably attractively priced. Overall, we believe it is too soon to give up on the emerging market (EM) recovery, though the prospects for higher global rates should make investors more confident in EM equities than EM bonds.

THE RETURN OF TAIL RISK: KEY CALLS TO WATCH

The biggest risk to the global economy at the start of 2016 was the possibility of a profit-led recession in the US. As we enter 2017, the immediate risk of the US slipping into recession seems a good deal lower than it was. In fact, the upside risks to global growth and inflation in the short term are probably higher than they have been for several years, and there is a good chance that forecasters will be revising up their 2017 forecasts for a change, not revising them down.

However, the medium-term risks to the global economy and financial markets seem both higher and more various than they were a year ago. Here are the key calls we will be watching most closely as the year proceeds:

- US reflation does more good for the global economy than harm, contributing to faster global growth and the end of deflation fears, without causing major financial disruption in global markets due to sharp repricing of US rate expectations and/or a dramatic further rise in the dollar.

- Eurozone political uncertainty does not turn into a renewed existential crisis for the single currency area, with mainstream candidates victorious in the Dutch, French and German elections, and investors do not go back to questioning the sustainability of public debt in Italy and other countries or the potential break-up of the eurozone.

- The UK slows down markedly in 2017 but does not fall into recession. We assume the economic impact of Brexit will be negative, but not enough to trigger a downturn. However, we should be alert to the consumer impact of higher inflation in an environment in which many businesses have put investment plans on hold.
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