FOCUS: More Fed rate hikes than the markets expect?

I urge readers to Google Donald Trump's "Contract with the American Voter" and read it, as it informs our global view for 2017. In our view, the fiscal stimulus measures that Trump has proposed will largely go ahead. We can anticipate US yields to rise where the 10-year yield could reach 2.75% in mid-2017. Assume that Congress will approve at least half (most likely?) of Trump's tax plans; he needs their approval constitutionally. We think the tax cuts will become effective in H2 of 2017 while higher infrastructure spending could start in late 2017. As Tax cuts are estimated to account for around 80% of the entire fiscal stimulus programme, they are by far and away the most important strategy in Trump's contract.

Economists are forecasting faster global GDP growth in aggregate for 2017 given the Trump reflation trade but, within that, Chinese momentum is expected to slow and US growth is expected to accelerate.

How does the FED react? We anticipate delivery of the "contract" to the letter. As a result, we foresee the FED implementing two or three rate hikes in 2017 and three or four further rises in 2018; more than the markets are pricing in right now. This will be supported by Trumps anti-free "everything" stance, as he is likely to have a more isolationistic stance than his predecessors which could shock financial markets and have a negative long-term impact on growth by the further unwinding of globalisation.

It is implied that inflation will make a comeback, especially in the US, as the reduction in flows of goods, services, capital, and people gradually increases supply constraints. This is primarily bad for global bonds, which have enjoyed a bull market for the past 35 years. This is also bad news for the shares of global companies who have benefited tremendously from the steady dismantling of barriers to the free flow of goods, capital and labour.

On the global equity front, investors in the short-term should favour consumer-oriented sectors and countries that are inward looking relative to their export-reliant counterparts, and small-to-medium sized businesses over externally-exposed multinationals. Higher bond yields and rates will reduce the 'search for yield' and make stock buy-backs less attractive. Both will **remove important pillars of support for stock prices.**

There are also a number of reasons to believe that a risk-on period, such as we are experiencing, could be short-lived and have limited upward potential. This risk-on period which amplifies the divergence between asset classes and sectors, as risk-free interest rates have increased quite sharply, is a period in which more risky asset prices tend to outperform safe asset prices.

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Those investors with long term strategies based on a thematic approach should remain **steadfast** as we still think the results in Austria and Italy point to emerging anti-euro; anti-Europe/Brussels tendencies and further confirms the move to the right away from the centre on the global political front. This will not affect the financial markets straight away; as the ECB intends to stay on top of the trends developing in EU; nor hopefully would they allow a collapse of the Italian banks which would threaten the entire Italian and European banking system.

Of much more concern is the potential for Sino-American tensions (trade wars) which will reinforce the ongoing de-globalisation debate. If the top two global economies are at geopolitical loggerheads, they are more likely to see their geopolitical tensions spill over into the economic sphere. The current calm is deceiving since economic and security tensions will eventually rise to the surface again - likely in a more disruptive way than ever before. China and the U.S. will not be able to prevent economic tensions from spilling over into broader strategic tensions. These geopolitical tensions will compound internal economic pressures in China resulting from rampant credit expansion, misallocation of capital, excessive money printing and capital outflows.

Therefore, in terms of regions, we continue to slightly favour the Eurozone, Switzerland and Japan compared to the United States and Asia with Emerging Markets remaining vulnerable. At the sector level, IT, healthcare and financials (not European) are our preferred sectors while we expect consumer discretionary, utilities, energy and materials to underperform.

With regard to the SA environment, local indicators have been fairly mixed. On the negative side were a drop in manufacturing PMI readings, weak vehicles sales and a rise in the unemployment rate to 27.1% in the third quarter from 26.6% in the previous quarter. On a more positive note, mining production expanded 3.4% year on year, retail sales bounced back to 1.4% y/y, and credit extended to the private sector expanded 7.2% y/y from 6.2% the previous month. Recently, ratings agencies saw fit to retain SA's investment grade rating although the relatively fluid political situation remains an ongoing concern for these agencies indicating we are not off the hook yet!

Potential global fiscal stimulus is a positive for risky assets (commodities?) in a global context but there is much to suggest that this is **"no silver bullet".** This fiscal policy strategy includes already very high debt to GDP ratios and potentially higher interest costs which will present a headwind to both economic growth and asset valuations. While higher commodity prices are a positive from a local SA perspective, the prospect of a rising interest rate environment globally could present capital flow challenges and negatively influence the all-important carry trade. We therefore maintain our neutral outlook on commodities overall but we expect lower oil prices and gold prices.

In spite of global yield curve steepening, the implied SA risk premium is in the region of 4.3% compared to long term averages of 5%. Equity valuations therefore still appear on the expensive side in comparison to other asset classes. Near term price weakness is a distinct possibility although longer term returns are likely to be in excess of inflation. Therefore SA equities in the long term potentially offer an attractive combination of value (P/BV and P/E ratios – ex Naspers – indicating multi-year lows); much more resilience in the face of ZAR depreciation given the significant offshore exposure of SA equity counters and the prospect of an upturn in earnings revisions as the domestic macro environment hopefully improves in 2017.

Our sector preferences encompass a combination of local cyclicals, which still appear cheap relative to the rest of the market and high quality, but more defensive, international counters that have de-rated significantly in recent months. Top picks include Firstrand, Shoprite, Tigerbrands, MTN, BHP Billiton, Sasol, Remgro, British American Tobacco and Naspers.

On the currency front, in SA, there are increasing signs that the current account deficit is likely to continue to shrink given weakening import demand. Forecast risks for ZAR remain as significant as ever on both sides of the forecast given the fluid political dynamic and substantial event-driven risk. Generally Emerging Market currencies will remain pressured, although they appear to be bottoming.

We remain neutral on USD/JPY. Risks remain for further JPY strength if risk aversion persists, especially given Japan's rising external surplus. For GBP, the large UK external deficit remains a risk and that is of more concern than BREXIT. We therefore expect GBP/USD to remain volatile. The USD, however, in spite of the elevated political risk premium associated with a Trump Presidency, is likely to rally as all three of Trump's signature policy stances, as we understand them, are bullish USD.

In conclusion we believe that the Trump policies will eventually increase the debt/GDP ratio until it becomes 'an albatross around the neck of the US economy'. Particularly when the next recession materialises. While we do not expect global equities to enter an outright bear market, anticipate global markets to move lower on a 3–6-month horizon − given political uncertainty in particular − presenting better buying opportunities in the future. The global economy is heading into a period of major event-driven risks such as the uncertainty about the path of Fed rate hikes and increased political risks with Article 50 to be signed in March; with elections in France, Germany and the Netherlands.

We believe the Fed will have to start rolling back monetary policy to the US economy in the course of next year. This will be coupled with a further increase in interest rates and the dollar exchange rate. At the same time, there will be doubts as to whether the Bank of Japan and the ECB will actually keep up the creation of ever more additional money (QE) after 2017. Hence, we see an equity market correction, which might become deep, because of more protectionism and major problems with (public) finances, causing the yield curve to flatten.

Finally we wish all a happy Festive Season and a **bountiful** New Year!

Mark Huxter – December 2016