Commentary

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Outlook 2017: The Good (economy), The Bad (policy), and The Ugly (politics)

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The outcome for markets in 2017 will be determined by the contrasting influences of a clearly improving global economy, a continued transition away from easier monetary policy toward easier fiscal policy, and extreme uncertainty in the political outlooks, particularly in the U.S. and Europe. Global equity markets are entering 2017 on a wave of optimism fueled by the now visible improving economic outlook and expectations of tax reforms, fiscal stimulus, and reduced regulatory impediments to business in the U.S. And these are indeed the positive drivers for both the U.S. and global economy and markets in 2017.

We are cautious that some of the optimism may be running ahead of the likely reality. In particular, while the economic outlook has clearly improved, as reflected in the recent data and rising inflation expectations, with it comes a shift in the outlook for economic policy, with the U.S. Federal Reserve Board potentially tightening rates faster than expected.

The fiscal cavalry risks arriving in a very pro-cyclical fashion and having more of an inflationary versus a growth impact. If so, a further backing up of interest rates on inflation concerns will provide some market indigestion for equities already at the upper end of a normal valuation range. Equity upside will be dependent on earnings growth to offset any multiple contraction driven from a higher discount rate.

Rather than an easy ride higher for equities, we expect a more sideways trajectory, with periods of higher volatility as the tug of war plays out between earnings and rates. One area where Trump's policies could prove unambiguously positive from a market perspective would be if expectations for less oppressive regulations across a range of industries, including banking and energy, encourages greater optimism among firms to lend, invest, and hire in anticipation of better growth.

The big potential negatives from a Trump administration are from the potential for significantly more protectionist anti-trade policies beyond headline grabbing photo-ops, and the complete uncertainty of how the new administration will operate. And that is just in the U.S. Add in Brexit, French and German elections, China's 19th party congress, and for 2017, the biggest uncertainty clearly lies in the political realm.

For 2017, we expect that the interplay of an accelerating global economy, more ambiguous policy impacts, and an outright uncertain political backdrop should be acceptable for risk assets. A reasonable base case is that equities should return 8-10%, in line with expected earnings growth, high-yield credit

around 5-6%, investment grade 2-4%, and government bonds slight losses. But there is a far lower degree of confidence in this projection given the higher risk of political or policy missteps and the possibility of triggering a broader financial market tightening through more aggressive backing up of U.S. rates beyond 3%, a significant spike in the U.S. dollar akin to the 25% rise in 2014/15, or an ever-escalating trade war as Trump attempts to tweet jobs back to the U.S. and picks a fight with China.

Let's take a closer look at The Good, The Bad and The Ugly drivers for markets in 2017. For the most part this analysis will focus on the U.S. as for 2017 it remains both the key driver for the global economic recovery and the source of heightened political uncertainty.

The Good

As we enter 2017, evidence continues to pile up that the global economy is in the midst of a synchronized recovery following the beating inflicted from the combined shocks of a 25% appreciation of the U.S. dollar and collapse in energy prices from mid-2014 to mid-2015. This culminated in the broad market sell-off across risk assets into the first quarter of 2016. Following some significant policy adjustments from the Fed and the European Central Bank, it also turned out to be the bottom for most markets, commodities and economies, and set the stage for a broadly synchronized global recovery for economies, commodities and financial markets in 2016.

Indeed, the data is supportive almost across the board, starting with the 3.5% third quarter bounce in U.S. GDP and from recent survey data such as the ISM, PMIs, and consumer confidence all coming in above expectations. The string of better-than-expected economic data has been echoed across Europe and China as well.

Stronger economic growth, along with rising inflation, underpins expectations for an acceleration in earnings following roughly two years of zero growth. In fact, earnings have already shown evidence of acceleration from their nadir in the first quarter of 2016, with third quarter S&P earnings up approximately 15% from the first quarter. We expect to meet our expectations of 8-10% EPS growth for 2017, led by rebounding growth in energy and financials.

The Bad

The current recovery faces threats both endogenous (internally generated) threats and exogenous (externally generated).

Endogenous threats:

- are normally occurring factors in the economy, such as rising inflation as the output gap closes, driving up the prices of scarce resources such as labour and commodities; as inflation rises monetary policy tends to tighten and rates continue to rise

- are unlikely to result in financial conditions tightening sufficiently to derail the recovery for at least a couple of years, as we have only just begun the tightening process and policy remains quite simulative
- could be enhanced by a repeat of the rapid rise in the U.S. dollar, such as we saw in the 25% appreciation in 2014-15; a moderate pace of increase, say 5-10%, is likely manageable, but much faster would be a concern.

We will be monitoring foreign exchange markets closely in 2017.

Exogenous threats:

- result in the normal interaction of the lifecycle of economies and markets
- are more externally driven independent of the economic cycle
- will be likely in the form of policy errors and politics; policy errors include the potential for too much stimulus should all the potential tax cuts and infrastructure spending be implemented, because beyond driving higher growth it could drive higher inflation
- include Trump's economic policies, which have bond markets skittish about inflation.

We will be monitoring very closely the risk to both the economy and valuations from rising interest rates through the year. While we expect to see progress on Trump's economic initiatives this year, we expect that most of the actual economic impact that might result will occur in 2018. That should also help calm the bond markets following the initial surge in rates post the election. The pro-business Trump cabinet also will increase optimism among business leaders, which in turn may encourage an acceleration in investment spending and hiring. We will be watching upcoming capex orders and intentions closely in coming months to see whether the recent bounce in confidence surveys actually translates into increasing economic activity.

The Ugly

Politics could be the biggest potential source of surprise for 2017. We have always argued that when it comes to managing investments that it is essential to remove the emotional aspects and focus on the economics, earnings, rates, valuations, financial conditions, and policy settings. While politics clearly affects many of these conditions over a longer time horizon, for the most part it is the economic and business cycle dynamics that shape them in the next one to two years. And as we enter 2017, we believe this is one of the rare times that politics do matter more than usual and we will need to pay close attention.

Market commentary

We have little doubt that the unpredictable nature of the president-elect will, at a minimum, drive periods of elevated market uncertainty and volatility. The risk of missteps are high and numerous, and investors will need to stay attuned to what actually gets done versus what is said.

While the U.S. is the clear driver of both the global economic recovery and of potential political instability, it must be mentioned that the political challenges in 2017 are truly global. On the watchlist in Europe will be French and German elections. Also in Europe is the expected trigger of Article 50 by the U.K. to start negotiations to leave the European Union, which may also generate volatility.

Over in China, 2017 is a big political year with the 19th party congress in the late fall. As leaders jockey to solidify their positions for reappointment, they will be very protective of China's interests. Trump's protectionist-oriented trade plans have already set the stage for conflict with China.

Overall, we expect political developments will keep us on our toes in 2017 both in the U.S. and globally. At Signature, we will continue to stay abreast of such developments and importantly always seek to understand how and where they might impact portfolios from both a potential risk and opportunity perspective.

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