

Economics

## **Talking Economics - 2016 review: The underdogs bite back**

Political upheaval and the need for ongoing support from central banks dominated global economic headlines in 2016, but what lessons have we learnt and what can we expect in 2017?

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In summary:

### **The underdog bites back**

2016 got off to a shaky start, with risk assets selling off, oil falling to \$28 per barrel and investors still concerned about the risk of China devaluing its currency sharply.

In the summer, the UK's surprise vote to leave the EU was the first big shock of the year, which led to the resignation of Prime Minister David Cameron.

In the emerging markets, Brazilian president Dilma Rousseff was impeached and removed from office, driving a rally in Brazilian risk assets.

The second major shock of the year was the rejection of the peace deal between the Colombian government and the Farc group while the new UK Prime Minister, Theresa May's hawkish Brexit stance also surprised markets.

By winter, Donald Trump was US president-elect, the Italian Prime Minister Renzi lost his job and the European Central Bank (ECB) extended quantitative easing (QE) until 2017. OPEC cut production at the end of November and the US Federal Reserve raised interest rates in December.

### **Cross-asset performance comparison**

Looking across the major asset classes, global high yield bonds were the best performers (+14%), recovering from elevated default risk related to the energy sector, followed by commodities and global equities.

Meanwhile, gold had a very strong start to the year and was up almost 28% at the half-way point although headwinds in the second half of the year meant the yellow metal ended 2016 up just 7.3%.

The bottom two performers were unsurprisingly global investment grade corporate bonds (+3.3%), and the US 10-year Treasury, which was the only asset class that failed to generate a positive absolute return.

## **Comparing equity market performance**

The S&P500 was the best performing equity index in US dollar terms, but in local currency terms the FTSE All Share did best.

However, this was largely thanks to a sharp depreciation in the pound, which helped to lift profit expectations for exporters following the vote for Brexit.

Once adjusted for the currency depreciation, the UK index underperformed (-1.2%). Elsewhere, political developments in Europe weighed on the region's indices while emerging market equities did well despite Trump's victory, especially Latin America and Eastern Europe.

## **Comparing currency market performance**

It was a year of two halves for several currencies. The US dollar started the year weakening on a trade-weighted basis but rallied to end 2016 up 1.7%.

In Japan, the yen appreciated sharply as the central bank lowered its base rate into negative territory but weakened later in the year on hawkish Fed rhetoric and a change in Japanese monetary policy.

Meanwhile, the ECB was left frustrated when it expanded its QE programme yet saw its currency appreciate.

The stronger rise of the euro was largely due to the closer trading relationship with the UK, which had seen a precipitous fall in the pound.

While the Mexican peso was the worst affected emerging market currency following the US presidential election result, emerging market countries with higher short-term, foreign-denominated borrowing saw their currencies underperform amid USD strength and higher yields.

Notably, the Chinese renminbi has proved resilient but falling reserves show that the authorities are propping up the currency.

## **Comparing debt market performance**

While US Treasuries performed poorly, other government bonds provided positive returns for investors.

UK gilts were the best performers (+7.6%) while other European markets did well, helped by ongoing QE with German Bunds returning 5.4% and French government bonds 4.2%.

In emerging markets, government debt performed well in the risk on environment which prevailed for most of 2016. Emerging market debt also benefited from falling inflation, particularly in Latin America.

## **Lessons from 2016**

### **The Trump trade: how far can it go?**

Despite predictions of an equity market meltdown, Donald Trump's election as US president has brought an extraordinary rally in risk assets with developed markets performing particularly well.

Bond yields have risen, yield curves have steepened and cyclical sectors have rallied – all signs of an increase in growth expectations.

Emerging markets have suffered however, and experienced capital outflows as they are seen as the losers in Trump's new world.

## What might stall the reflation trade?

The impact of the new president's fiscal policies will not be felt until end-2017 and into 2018 and there are some tricky waters to be navigated before they take effect.

As a reminder, our baseline forecast assumes a fiscal package of \$280 billion (1.5% of GDP) which we estimate would translate into a boost to GDP of 0.75% in 2018.

However, Trump may encounter resistance from Republicans who prefer tax reform to tax cuts, and there are also questions over the impact of infrastructure spending on real growth.

These factors, amongst others, mean we are sceptical that the impact on US activity will be as substantial as the market is currently anticipating.

This might not be a bad thing as the US economy is, in our view, capacity-constrained and would be at risk of overheating should too large a boost be delivered (see our latest forecast update from last month for more on this).

A smaller fiscal stimulus would mean less inflation, less monetary tightening from the Federal Reserve and probably a weaker US dollar. This in turn would take some of the pressure off the emerging markets.

Nonetheless, at present markets do not seem to be anticipating problems either in terms of delays by Congress, or in boosting growth significantly.

Such optimism is likely to be questioned in the new year: prepare for a reappraisal of the Trump trade.

## Brexit, Trump...Le Pen...Grillo?

Although 2016 has had its fair share of surprises and the decisions and progress of the Trump administration will be critical for markets in 2017, politics will also continue to loom large in Europe.

General elections in the Netherlands, France and Germany all feature next year, and these could create the potential for a possible breakup of the euro.

Our outlook for the European economy is one of steady growth, but this does not incorporate any major electoral upsets.

Against this backdrop, we would expect the European Central Bank to keep asset purchases running through the year and well into 2018. As a result, the main conduit for political risk is likely to be through a weaker euro.

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