m 2017

markets

Globalisation under siege

2017: Challenges, extremes & political change

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Will the year ahead see greater volatility, extremes and more political change?

For some, the answer is most definitely yes, while others believe there could be a smoothing out of markets following a disruptive and uncertain 2016.

What many do agree on though is that 2017 will likely see a continuation of protectionist sentiment – a reverse of the decades of globalisation once heralded as the way to multi-lateral prosperity. But now, as political extremism flares up in Europe and the US, it appears that – for the first time in a generation – globalisation is under threat.

At the same time, central banks continue to adopt ever more radical interventions in an effort to re-spark sustained economic growth. Add in the themes of technologically driven disruption and stubbornly low yields across traditional asset classes and it seems clear the next 12 months will offer as many challenges as opportunities.

How these changes play out in 2017 is a key question for investors. Here, managers and experts from across BNY Mellon Investment Management look to provide some answers.

Sinead Colton,
head of investment strategy,
Mellon Capital

Globalisation meltdown?

De-globalisation trends are rife. As governments retrench to focus more domestically and political change continues unabated, Sinead Colton, head of investment strategy at Mellon Capital, discusses key milestones for the year ahead and what they might mean for global markets and investor expectations.

In 2016, for the first time in 15 years, the World Trade Organisation (WTO) forecast global trade growth, at just 1.7%, would not keep pace with global GDP growth. Over the longer term, world trade has usually grown 1.5 times as rapidly as total economic output, said the international agency.[1]

Roberto Azêvedo, the WTO's director general, warned "this dramatic slowing of trade growth is serious and should serve as a wake-up call," adding that it is particularly concerning "in the context of growing anti-globalisation sentiment".

Growing anger

Sinead Colton, head of investment strategy at Mellon Capital, says it is important to recognise what is driving this de-globalisation. "In many parts of the developed world, we can see anger that there has not been widespread participation in the somewhat lacklustre growth since the financial crisis.

"Arguably the impact of QE has disproportionately benefited asset owners, helping wealth distribution to shift significantly toward the highest earners."

In conjunction with this perceived inequality, austerity policies from many governments have led to cuts in public service funding. Colton says the way citizens respond to such a combination of factors differs across the globe, but that a couple of common enemies are starting to emerge – immigration and trade.

US election fallout

In the US, the manifestation of de-globalisation was intrinsically linked to the presidential election. During the campaign trail, both candidates were outspoken against the Trans-Pacific Partnership (TPP), a trade agreement seven years in the making.

Colton says that for many people in the US, North American Free Trade Agreement (NAFTA) is associated with factories closing down and jobs moving overseas, even though many economists argue the pact has had a net positive impact on US GDP. "If, as expected, President Trump pulls out of the TPP, the US will lose its voice in the Asian region from a trade perspective. The next most likely step is the progression of a trade pact led by China – the

1 *The Wall Street Journal:* 'World Trade Set for Slowest Yearly Growth Since Global Financial Crisis', 27 September 2016.

Regional Comprehensive Economic Partnership (RCEP). This would open up trade between the Association of Southeast Asian Nations (ASEAN) states and the six states with which they have existing free trade agreements (Australia, New Zealand, India, Japan, South Korea and China)."

China and India are excluded from the TPP, so they have been negotiating the RCEP in tandem. If the TPP breaks down because of a US withdrawal, China would be in the driver's seat, with RCEP poised to fill the gap, says Colton. After two terms of President Obama attempting to steer the US into a dominant position to shape global trade policy, it appears likely the US will become more protectionist during the next presidential term.

All eyes on the UK

Following the UK's 2016 Brexit vote, Colton says the country will be the "one to watch" in 2017. Prime Minister Theresa May aims to trigger Article 50 by the end of March 2017 if she can. While there is no certainty this will happen, when and if it does, the countdown for negotiations will begin. At that point the UK government's bartering power arguably diminishes as the two-year negotiation timetable counts down, Colton continues. An extension of this negotiation period could possibly be granted, but this requires unanimous agreement from all 28 EU states – the UK plus the 27 who will remain.

The government seems to be coming down more firmly on the side of limiting the free movement of people and potentially willing to give up the benefits of full EU access as a result, says Colton. Developments will be watched keenly.

Elsewhere in Europe

With French and German elections next year, we will also see a great deal of discussion around immigration. "German Chancellor Angela Merkel does not want to appear too soft because she has been losing ground to the right-wing AfD (Alternative for Germany) party in some of the regional elections. In France, President Francois Hollande has also faced nationalist forces in the right-wing and eurosceptic Front National."

Leader of Front National Marine Le Pen has gained some impetus following the Brexit vote and terror attacks in France during the summer of 2016 and she has vowed to hold a referendum on EU membership if elected. She is not alone, as anti-establishment parties in the Netherlands, Germany, Italy and Austria have also called for referenda on EU membership.

Says Colton: "Former president Nicolas Sarkozy had also thrown his hat in the ring for the French presidential election in 2017, with a focus on citizenship and anti-immigration rhetoric but withdrew in late November." Meanwhile, President Hollande decided in early December not to seek another term.

China's growing influence

"Broadly speaking protectionism does not seem to be on the rise in Asia. Undeniably, China wants to play a more dominant role on the world stage and some of the dynamics being set in motion elsewhere could help them achieve that," Colton believes.

An increase in tariffs that are not conducive to broader global investment in other regions could enhance China's influence within Asia. She says Japan is somewhat unique in that it has embraced globalisation selectively. "To the same extent we see China's influence increasing both within Asia and globally, it is also reasonable to expect Japan's influence will wane."

De-globalisation to stay?

How realistic is it to expect the underlying drivers of discontent to diminish? Colton says that if we start to see stronger global economic growth, where the benefits are distributed more broadly across society, you could see the popularity of anti-establishment parties abate.

"Average wages in the US have not increased significantly during the economic recovery yet but perhaps an increase in the minimum wage could have a positive impact there," she comments.

The austerity message has already been downplayed across many economies and could result in increased government spending. Colton believes this should help boost growth, with the caveat that it remains to be seen if that can filter its way through society more successfully than the injection of liquidity through asset purchases did.

"In the US, the consumer has been the strongest driver of the economy. For a more sustainable recovery, we need to see economic strength become more broadly based. An increase in investment from companies, rather than the large amounts of share buybacks prevalent in recent years, is also necessary. This has been largely missing from the recovery over the past four to five years."

However, investment by companies is unlikely where there is domestic uncertainty, so it's reasonable to expect companies in the UK will look to delay capex until they have greater clarity around Brexit.

"We do not believe protectionism is a way to stimulate global growth. It may provide short-term gains for individual economies but over the long term, I would expect it to be a drag on global growth.

"The IMF estimates world output could be reduced by as much as 2% over the long-run if import prices rise by 10% due to the introduction of new tariffs (World Economic Outlook, October 2016).

"Globally accessible markets are very important to most businesses because they mean companies are less reliant on consumers or markets in their domestic area and have much broader prospects. With greater restrictions and, therefore, fewer opportunities, logic dictates that companies in aggregate would be less profitable, which would likely result in lower investment and lower growth overall," concludes Colton.

WHAT TO WATCH IN 2017

UK triggering Article 50.

Anti-establishment rhetoric in French and German elections.

Mellon Capital

Focus on: developed markets fixed income

Peter Bentley,
head of UK and global credit, Insight Investment

Thant Han,
global fixed income portfolio manager, Standish

Lucy Speake,
head of European fixed income, Insight Investment

Ongoing central bank interventions, increased political risk and the potential for rising defaults all look set to be key themes for 2017. Here managers from Insight and Standish ask the question: what could the next 12 months have in store for fixed income investors in developed markets?

Outside of monetary policy decisions, what do you see as the biggest challenges for the year ahead for corporate debt investors?

Peter Bentley: From a top-down perspective, investors increasingly need to be aware of political event risk. The surprise outcome of the UK referendum and US election highlighted this. In 2017, Germany and France both go to the polls in an environment in which fringe separatist political movements are looking to consolidate their growing support.

Lucy Speake: One important challenge is the rise in idiosyncratic credit risks in investment grade markets. A significant contributor is a wave of M&A, which often benefits a company's shareholders at the expense of its bondholders. In a low growth environment, management teams struggle to deliver shareholder growth organically and so M&A or shareholder buybacks become a natural solution. However, this usually leads to an uptick in leverage ratios, which is a risk for credit investors.

Issues surrounding corporate governance are another factor. Examples include last year's Volkswagen scandal and the controversy surrounding Deutsche Bank and the US Department of Justice.

Thant Han: Financial market regulation is tightening, dealer inventories have fallen to reduce balance sheet risk, and trading volumes have declined despite increased supply via cheap funding. While we believe this indicates we're in the later stages of the expansion phase of the credit cycle, we think we still have at least a year before we transition into a downturn phase.

Even though we've already reached the average length of the previous two credit cycles, the prolonged period of historically low interest rates has made this time different. The downturn phase is typically characterised by a recession – but we're not forecasting that in the near term since we don't see the excesses that usually precede these periods.

The consumer is broadly in good shape, bank balance sheets are strong and corporate liquidity is solid. History also suggests the expansionary phase continues well after monetary policy tightening (which has yet to occur in any meaningful way).

Do you believe default rates will increase in 2017? Which sectors look vulnerable?

Peter Bentley: We expect the default environment for investment grade issuers to remain benign in 2017, with positive growth and low yields allowing issuers to refinance their debt at attractive levels. Strong investor demand is also evident, even at these low yield levels.

An uptick in defaults has been evident in the US high yield market but this was mostly related to energy companies struggling with lower oil prices. Should commodity prices fall further, this would put additional pressure on this sector. In Europe and the UK, there is still support from central bank purchases.

Thant Han: While ratings have been migrating lower for a while now, the trend accelerated because of commodity-related downgrades. In our view, increased demand for returns and indiscriminate buying of spread products make most segments of the corporate bond market vulnerable to a correction. We think event risk in the industrial sector remains elevated due to the historically low 'all-in' cost of debt. This suggests it makes sense to have a skew towards defensive sectors such as utilities and financials where equity capital appears double pre-crisis levels due to regulators' demands.

We also note lending standards have a high correlation to default rates; tighter standards are typically followed by higher defaults. In the US, after several years of loosening, banks have just recently started to tighten these standards so we do believe default rates have scope to move higher.

What do you see as the biggest tailwinds for your asset class in 2017?

Lucy Speake: We expect stable, positive growth across the US and Europe next year and this should create a supportive environment for credit. At the same time, some of the tailwinds that drove the asset class in 2016, notably the ECB's corporate bond purchase programme, are likely to fade away, and we are mindful of that.

Thant Han: The most relevant tailwind for eurozone bonds is accommodative monetary policy. Subpar economic growth trends and low inflation in the eurozone make a strong case for the European Central Bank (ECB) to stay the course with unconventional policy measures and zero-bound interest rates for the foreseeable future. Elsewhere, other major central banks, such as the Bank of Japan (BoJ), have adopted policies to cap select Japan Government Bond (JGB) yields from rising while in the UK unconventional measures remain deeply entrenched in the Bank of England's (BoE) policy framework in the aftermath of the Brexit result. In the US, the lower-for-longer era of central bank policy appears to be drawing to a close. That said, the US interest rate futures market is no longer pricing in a path for higher longer-term interest rates despite expectations of a rate hike over the near term. All-in-all, this suggests developed markets rates should stay low in 2017.

What's the outlook for central bank intervention in the next 12 months and how might this affect your market?

Lucy Speake: We expect global monetary policy to remain accommodative across the developed world through 2017.

In the US, the pace of interest rate hikes is likely to be slow. In Europe, we believe the ECB could well maintain its current negative interest rate policy for the foreseeable future.

Meanwhile, monetary policy is showing signs of reaching its limits. The ECB and the BoJ are finding eligible government bonds increasingly scarce and may need to adjust the rules or expand the universe of eligible assets. However, policy makers have also shown increased concern about the impact of negative interest rate policies and flat yield curves on their banking sectors. The BoE, for example, has ruled out a negative interest rate policy and the BoJ has added flexibility to its annual purchases to target higher yields at longer maturities.

Peter Bentley: While we expect monetary policy to remain supportive of credit markets we believe speculation over policy decisions may create volatility in credit spreads. We think investors able to implement absolute long or short directional exposure could exploit this. Credit easing initiatives, such as targeted long term refinancing operations (LTRO) in Europe and the term funding scheme (TFS) in the UK will relieve pressure on banks from the low policy rate environment.

In the UK, the package of accommodative measures already announced to combat Brexit risks has important implications for sterling and the path of inflation. Those able to adopt active currency exposure may be able to add value through periods of currency volatility.

Notably, the TFS will be supportive of the mortgage market and this may feed through to sentiment in UK structured credit markets such as residential mortgage-backed securities (RMBS), which we believe offer excellent value.

Thant Han: Fed officials might fight about quarter percentage points but ECB and BoJ policymakers seem to be having significant doubts about their ongoing projects. The ECB has to tune its programme in order to extend asset purchases. Hemmed in by their own rules, they appear reluctant to do so.

We think (though no one can be sure) the intent of the BoJ's cap on the 10-year JGB yield was to put in place automatic accommodation should inflation rise. The problem here is the lack of a direct mechanism to push inflation higher. The BoE shows more eagerness to pull the levers of policy and will probably do so soon.

The extended stay of major central banks in the terrain of unconventional policy, along with their inability to generate inflation, has positioned about one-third of the universe of developed sovereign debt in negative territory. This provides powerful support to any fixed income instruments with a positive coupon.

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The end of monetary policy?

David Hooker, inflation-linked corporate bond manager, Insight Investment

As global quantitative easing (QE) increases and interest rates outside the US continue to be cut, Insight Investment's inflation-linked corporate bond manager, David Hooker, assesses the practicality of monetary policy in the coming year.

Some monetary authorities and commentators alike have begun to question whether the current policy regime can solve the world's economic problems. With confidence in the effectiveness of monetary policy in decline, 2017 could be a year where the debate about the future of monetary policy moves into the political mainstream.

Central banks went into the aftermath of the global financial crisis with the belief that monetary policy could be the panacea for the global economy's ills. By cutting interest rates, central banks have attempted to influence the overall level of activity in the economy by lowering the cost of borrowing for consumers and businesses in order to encourage them to spend more and save less. Once key policy rates approached or reached zero, cutting interest rates further was (initially) deemed to be unpalatable.

Central banks turned to unconventional policies such as asset purchase programmes to loosen policy further. The hope was that by boosting asset prices this would encourage increased spending through the creation of a positive wealth effect for asset holders. Some central banks have since resorted to negative interest rate policies as doubts over the effectiveness of traditional policy measures grew.

Asset purchases and credit easing coupled with cuts in interest rates are the current instruments of choice for central banks. In August 2016, the Bank of England (BoE) demonstrated this when it launched an aggressive package of monetary measures to counter the potential economic impact of the UK's June decision to leave the European Union including; a cut in interest rates, asset purchase programmes in government and corporate bond markets and credit easing through the Term Funding Scheme.

Time will tell what impact the measures taken by the BoE will have. However, some have begun to question the effectiveness of monetary policy given that growth in major economies remains lacklustre at a time when interest rates and bond yields are low (the so-called Keynesian liquidity trap), leading to calls for an entirely new policy framework to be explored.

Even as the BoE was introducing its package of measures, other monetary authorities had begun to question the effectiveness of the current monetary policy regime. The US Federal Reserve noted that both monetary and fiscal policy appeared better positioned to offset large positive shocks than adverse ones. The Bank of Japan (BoJ) carried out a comprehensive review of its current policy measures as it attempted to demonstrate its commitment to end deflation. Following its review, the BoJ shifted the focus of its monetary stimulus in September from expanding the money supply to controlling interest rates, a move deemed by some economists as further evidence that BoJ policy had reached the limits of its effectiveness.

Private debt rising

The sustained rise in worldwide debt is further choking global growth. As interest rates have pushed lower, although debt servicing costs have been reduced, absolute debt burdens have pushed higher as the economic response has underwhelmed. It is argued that this mounting private sector debt burden has served to undermine economic growth and that an active fiscal policy could be a more effective policy tool to help tackle it.

In the UK, for example, commentators question if ebbing confidence in the outlook for the UK economy, borne from a lack of clarity regarding the future economic relationship between the UK and its major trading bloc, can be bolstered by monetary policy alone. A targeted fiscal response aimed at boosting investment would have perhaps been a better response given the specific shock the UK faced. However, critics of fiscal policy would point to Japan to highlight the limitations a reliance on debt funded infrastructure spending and stimulus packages has on growth in the medium and longer term.

The distributional impact of monetary policy has also begun to attract attention. It is generally perceived that asset purchase programmes have benefited those who own assets compared to those without and these tend to be held by the wealthy. Policies, that were initially described as “emergency policies,” are increasingly being criticised by the “losers” of the distribution effect as the economic benefits of these policies are becoming less visible or even counterproductive.

Central banks generally dismiss this, claiming all monetary policy actions have distributional consequences and they are technocrats doing a job mandated to them by governments. It is governments that should act to correct this, they say.

It is hard to argue that independent central banking is not political. Central banks need the support of the population to exist. With emergency measures enduring for close to a decade, confidence in monetary authorities has understandably diminished.

Populist effect

Economic unhappiness often leads to the rise of populist parties or populist policies. Populist momentum can be a very powerful catalyst for reform. Initially they are often seen through promises of extra government spending, usually on infrastructure projects to stimulate economic growth and social initiatives to combat inequality. Established political parties are good at taking the policies of populist parties and implementing them so it does not necessarily result in the demise of the current political incumbents. But the independence central banks enjoy is a gift of politicians. To ensure political survival it may be deemed necessary for governments to change the framework of monetary policy. What eventually replaces the current global policy framework and over what time scale is open to debate.

However, while the outlook for the global economy remains uncertain, the dominance of monetary policy and independence of central banks is likely to wane. This debate could move from academic circles into the political mainstream through 2017, but it is probably not until the next economic crisis hits that we are likely to see the rise of the new monetary order. This could have significant implications for inflation and the independence of central banks.

WHAT TO WATCH IN 2017

A possible further decline of confidence in the effectiveness of monetary policy.

Could the debate about the future of monetary policy move into the political mainstream?

Liberté, égalité, Frexit?

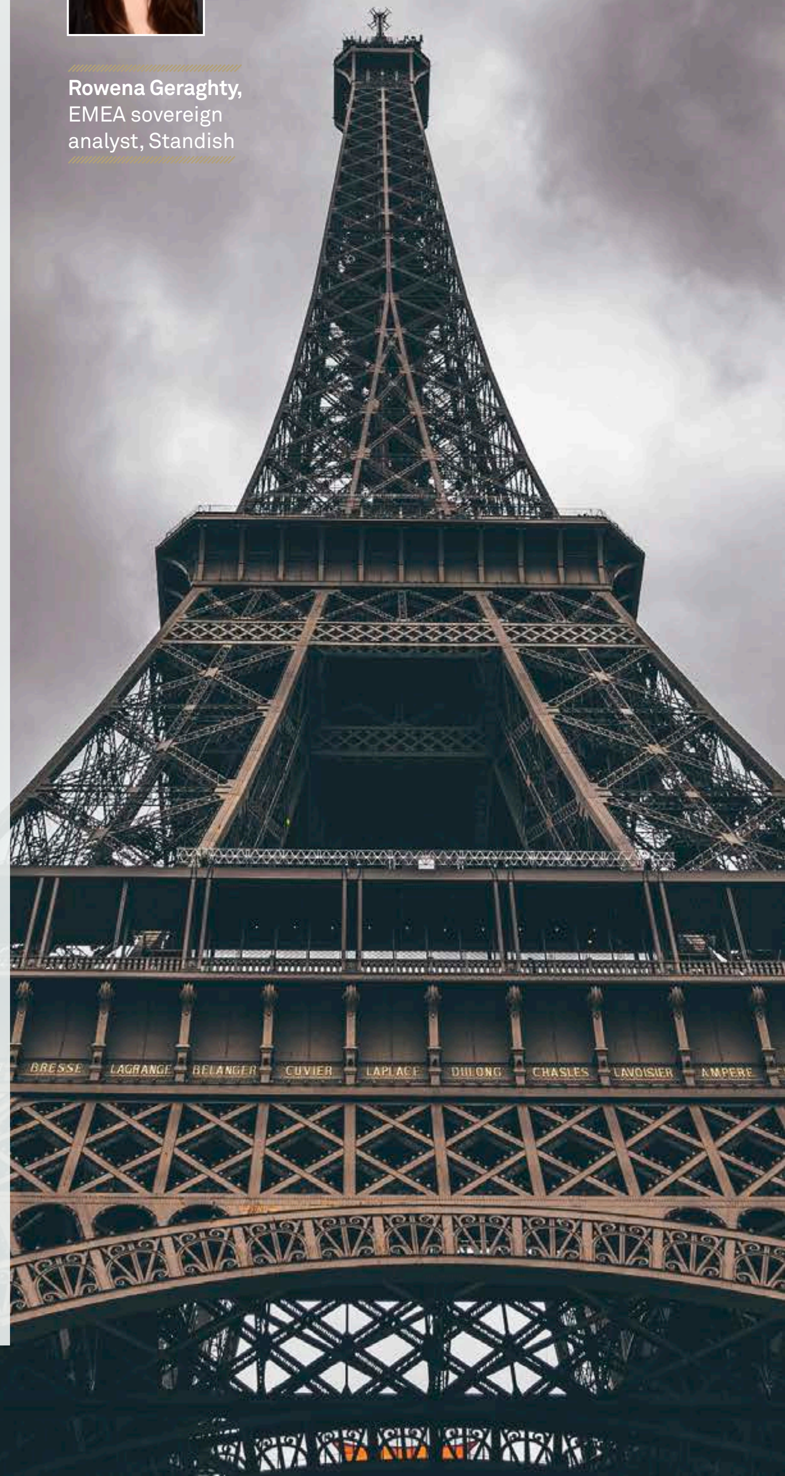
France's unruly elections demonstrate how the sources of political risk facing the eurozone are shifting in 2017 from the European Union's peripheral member states to those at its core.

Rowena Geraghty, EMEA sovereign analyst, Standish

For much of the past decade, political risk in the eurozone has bubbled up from the so-called peripheral countries such as Greece, Ireland and Portugal. In each case, bailouts from the European Union and International Monetary Fund stabilised sovereign debt crises, helped keep contagion in check and limited financial market fallout to occasional outbursts of volatility. Now, however, the focus of geopolitical risk concerns in Europe has shifted to the willingness of citizens of the bloc's largest economies to continue to support the "ever closer union" called for in the 1957 Treaty of Rome upon which the EU's legal foundations rest.

In 2017, France will hold national elections that are likely to replace the current socialist government, a stalwart backer of the euro and ongoing European integration. Later in the year, German voters will also cast ballots in federal elections. In both countries, polls show diminishing faith in current leaders' ability to address challenges including chronic unemployment and ongoing mass immigration from outside Europe. The decline of the elites has created an opening for maverick political entrepreneurs who emphasise national, rather than pan-European concerns. Some, like Marine Le Pen, leader of France's populist, eurosceptic Front National (FN) have called for a British-style referendum on leaving the EU. That scenario may seem farfetched but if it did go ahead, it could have more significant market and economic implications than the UK's vote to do so.

Rowena Geraghty, EMEA sovereign analyst at Standish, views a Frexit as unlikely but notes: "Unlike the UK, France is one of the founders of the European project. France now serves as the only decent counterweight to Germany in the EU and its exit would have a more profound impact than the UK's. Market volatility could return to levels last seen before European Central Bank (ECB) President Mario Draghi pledged to do "whatever it takes" to save the euro in



2012. Peripheral governments' borrowing costs would materially increase, concerns regarding banking systems could resurface in some countries. The potential for recession would become a talking point."

In the short-term, however, despite those geopolitical risks, Standish still expects the eurozone economy to grow by 1.2% in 2017, down slightly from the 1.5% growth rate for 2015 and 2016. This forecast is somewhat below the ECB's growth forecast and reflects what Standish sees as some evidence of stress in confidence, such as underwhelming manufacturing PMIs. Standish also expects eurozone inflation to tick up to 1.0% in 2017, from 0.1% in 2015 to 0.2% in 2016, prompting further easing from the ECB beyond the scheduled end of its asset purchase programme in March.

France holds its all-important run-off election after a series of two-round primaries. Familiar names including ex-prime minister Alain Juppé are in the mix. With a dozen candidates competing in primary elections for the nominations of the Republican and Socialist parties, the lack of both a strong incumbent and a single credible challenger potentially creates an opening for those such as Le Pen, although this is not our base case, says Geraghty.

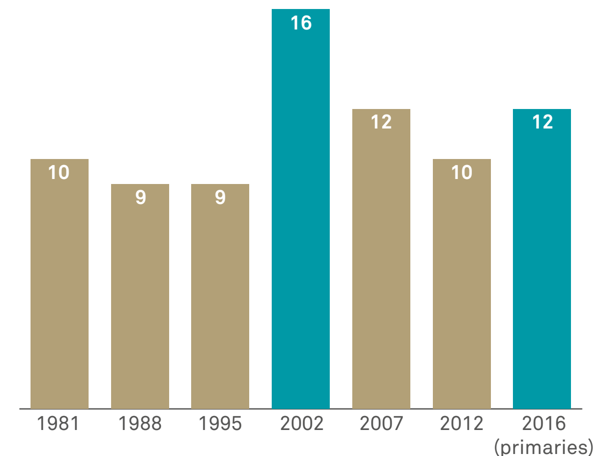
Former economics minister Emmanuel Macron is another wild card, she adds. The former investment banker has never run for office but has drawn attention by challenging French socialist institutions such as the 35-hour work week and the country's vast public sector. Macron's entry into the race as an iconoclastic candidate without party could draw support away from both Socialist and Republican candidates and create a potential opportunity for the FN. In 2002, an unusually crowded field of candidates fragmented the electorate.

Ominous historical echoes notwithstanding, Geraghty expects Juppé, one of France's most popular politicians, to emerge victorious and the spectre of Frexit to fade. Even without Le Pen pushing France out of the EU, though, a strong showing by the FN could conceivably push a centre-right winner such as Juppé to adopt a more eurosceptic policy stance. This would have repercussions for Germany, the other nation at the heart of the EU, as well as for France. "A more assertive French president – Hollande is almost so quiet as to be extinct – could lead to livelier debate with Germany and EU institutions over policy, especially on immigration," says Geraghty.

Germany holds federal elections later in 2017, but state elections in 2016 suggest Chancellor Angela Merkel has her own challenges. In Merkel's own

THE FRENCH SELECTION

In the 2002 presidential election, an unusually large field of candidates fragmented the vote and helped the National Front make its strongest showing in years. Could history repeat in 2017?



Source: French Interior Ministry: 'Résultats des élections législatives 2012', accessed 27 October 2016.

Mecklenburg-Vorpommern constituency, the governing coalition of her Christian Democratic party (CDU) and the Social Democratic Party (SPD) faced the insurgent Alternativen fur Deutschland (AfD) party. Merkel campaigned for her party, and despite insisting "Wir schaffen das" ("We'll manage it"), the CDU came third with 19% of the vote behind the SPD with 31% and AfD with 21%.[1] The CDU's weak showing hints at Merkel's unpopularity and AfD's relatively strong result suggests many Germans want alternatives to open borders and further European integration.

Even if they do not win power themselves, political insurgents such as Le Pen and AfD may exert pressure on those who will, raising questions of globalism versus nationalism and 'Europe' versus 'Frenchness' and 'Germanness'. The 2017 elections may be another step in the realignment in the politics of core Europe; not between right and left or east and west but between the pro-globalisation governing elites and a middle class that no longer sees its interests being represented by that elite.

WHAT TO WATCH IN 2017

23 April: First round of French general election.

7 May: French general election run-off.

September/October: German federal election.

STANDISH

1 *The Guardian:* 'It's too soon to write Merkel off', 5 September 2016.

At the peak

Frothy valuations and a crowded fundraising market mean global returns from private equity may fall in 2017, though it is still expected to outperform more traditional asset classes, according to Siguler Guff's Ralph Jaeger.

Ralph Jaeger,
managing director and portfolio manager of emerging markets private equity, Siguler Guff

For yield-hungry investors, private equity has been one of the more attractive asset classes in recent years and it is unlikely to lose its appeal given the increasingly lower returns expected from more traditional investments over the coming year.

However, 2017 may be more challenging in this area of the market. There are signs private equity may be near the top of the cycle: with valuations some consider stretched, deteriorating credit conditions and private equity firms struggling to put un-invested cash to work.

Following several years of strong growth, investors will need to be more discerning in the future, says Ralph Jaeger, managing director of the multi-strategy private equity investment firm Siguler Guff. Although Jaeger expects private equity to continue to outperform public equity markets on a relative basis, investors could find their expectations put to the test as firms fail to generate returns as high as they were in the past.

"A lot of capital is being risked in private equity vehicles in developed markets," he says. "That makes me question whether they will produce returns commensurate with what investors expect them to achieve."

Strong recovery

For some private equity players, the trauma of the financial crisis has been long lasting – the casualty rate has been even higher than that following the bursting of the tech bubble in 2000. Of the 4,019 buyout firms that had raised a new fund between 2002 and 2008, 26% have failed to raise another since 2009.[1]

However, since then it has been a time of renewed growth, aided by a supportive macroeconomic backdrop and favourable financing conditions. Debts were paid down as firms found themselves able to refinance on better terms, helped by central banks reducing interest rates to near zero levels.

Reduced regulatory and reporting requirements for private companies have also been supportive in developed markets, with more businesses deciding to remain private. A growing number of public companies have also been choosing to go private in order to benefit from this lighter regulation, providing greater investment opportunities for private equity fund managers.

Over the past several years the good times for private equity fundraisers have continued as money has flowed in from pension funds, family offices and wealthy private investors struggling to find adequate returns elsewhere.[2]

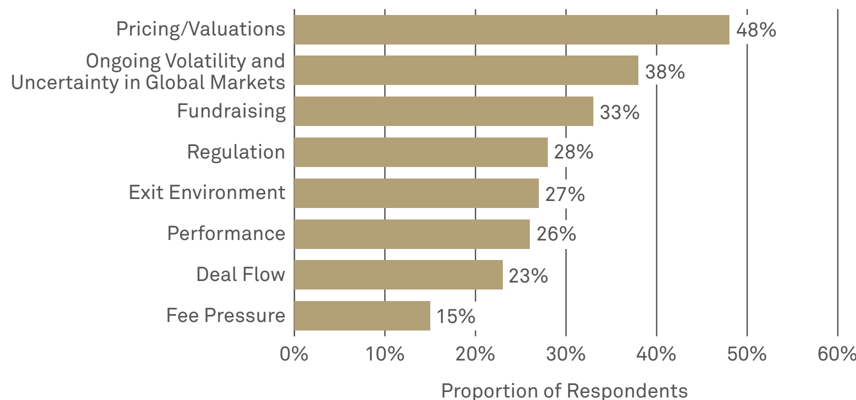
Under stress

However, cracks in this positive façade are beginning to show as the cycle that began in the depths of the financial crisis appears to be reaching its peak.

The huge inflows to private equity funds have resulted in a build-up of unprecedented amounts of unused capital: un-invested dry powder stood at a record of US$526.6bn in H1 2016, up 11% up from H1 2015.[3]

1 *Forbes:* 'The Private Equity Shakeout That Didn't Happen', 23 March 2016.
2 *Preqin:* 'The Q2 2016 Preqin Quarterly Update Private Equity', 19 July 2016.
3 *The Business Times:* 'Private equity deals in S-E Asia fall in H1, notably in tech sector', 29 September 2016.

FUND MANAGER VIEWS ON THE BIGGEST CHALLENGES FACING THE PRIVATE EQUITY INDUSTRY IN THE NEXT 12 MONTHS



Source: Preqin Fund Manager survey, June 2016.

There is no shortage of potential investment targets but fierce competition between established private equity houses, new players and corporates, all flush with cash, has forced up valuations.[4] In 2015 buyout funds were on average paying more than 10 times earnings before interest, taxes, depreciation and amortisation, surpassing the elevated multiples of 2007.[5]

Valuation pressure comes at a time when tumult in the high yield debt markets has made lenders more reluctant to provide leverage to bankroll private equity deals.[6] Banks have been backing out of deals or shunning them altogether, making it even more difficult for private equity fundraisers to put money to work.[7]

However, as times get tougher, the long-term perspective of private equity firms can be an advantage. Even though debt financing has become more difficult to obtain, private equity firms have time to wait for credit conditions to improve. Their average investment period is 5.5 years.[8]

Nor have firms been idle even as higher valuations have made it more difficult to get deals done on the buy-side. There has been an increase in sell-side activity as private equity firms see this as an opportune time to exit portfolio companies to the benefit of some investors.[9]

As valuations rise and buyers become reluctant to pay the high prices being asked for assets by sellers, something has to give. Jaeger says: "We are pretty much at the peak of the cycle in terms of valuations, especially in developed markets. However, we think private equity will continue to outperform public markets in the year ahead although we wouldn't be surprised if returns become more compressed."

Despite these tougher conditions, private equity retains many attractive features for investors in need of yield.

Jaeger says: "The increased popularity of private equity investing is as much a factor of investors, particularly pension funds, not finding other areas to invest that provide the yields they need. That is unlikely to change.

"In the past, private equity has tended to outperform the S&P 500 by 500 to 800 basis points. If interest rates remain broadly where they are now in the next 10 years we would expect outperformance by 300 to 500 basis points."

The macro view

The macroeconomic background for the asset class also looks accommodating for the year ahead, although ongoing volatility and uncertainty in financial markets remain a concern. For UK and European private equity players, the Brexit vote has been one of the more de-stabilising factors over the past year.

However, Jaeger says: "I don't believe Brexit will have a significant on-going impact. Demand flows in the UK and EU have continued as usual and it has had no impact in emerging markets and the US."

Allocation choices

Jaeger believes investors looking to private equity will need to be more discriminating going forward. He says: "That means looking at more contrarian strategies: sector focused strategies, special situations, more illiquid strategies, those that are geographically diverse. It will be important to not get caught up following the herd."

For investors who have so far focused on developed markets, the emerging markets could be a potential hunting ground. Private equity opportunities in emerging markets look more attractive than those in the US and Europe, says Jaeger. They tend to be much less leveraged, operate in higher growth environments and valuations tend to be lower than in the public markets, meaning they do not look as stretched as those in the US and Europe. Many businesses have also evolved over the past decade to be formidable competitors on the global stage.

"I expect US private equity to continue to outperform European private equity but I also believe that a discerning emerging markets strategy has the potential to outperform both."

However, the risks in emerging markets are higher so the need to be selective in this area is even more important. Jaeger says: "The divergence between the good and bad performing private equity funds is significantly higher in emerging markets by a factor of two compared to what we see in developed markets."

WHAT TO WATCH IN 2017

Rising buyout multiples.

Divergent return opportunities.

An increase in value-driven deals in emerging markets.

4 *Bloomberg:* 'Blackstone's Top Dealmaker Says Now Is The Most Difficult Period He's Ever Experienced', 27 September 2016.
5 *Bain & Company:* 'Global Private Equity Report 2016', 22 February 2016.
6 *Reuters:* 'Private equity deals hit as banks curb lending for leveraged buyouts', 15 January 2016.
7 Ibid.
8 *The Wall Street Journal:* 'Average Private Equity Hold Times Drop to 5.5 Years', 10 June 2015.
9 *Bain & Company:* 'Global Private Equity Report 2016: Exits: a great year to be a seller', 22 February 2016.

SIGULER GUFF

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Focus on: global fixed income

Paul Brain,
global fixed income leader, Newton

Ulrich Gerhard,
short-dated high yield bond manager, Insight Investment

Adam Whiteley,
BNY Mellon global credit co-manager, Insight Investment

For sovereign and corporate debt investors, 2016 offered its fair share of surprises – not least an unexpected vote for Brexit, a rancorous US election and a world of central bank-fuelled negative yields. But could 2017 offer more of the same? Here, fund managers from Insight Investment and Newton give their views on the likely opportunities and challenges over the next 12 months.

What do you see as the biggest tailwinds for your asset class in 2017?

Ulrich Gerhard: We expect growth in the US and Europe to remain stable and positive next year. At the same time, we do not expect this growth to be strong enough to prompt a reversal in monetary policy. Although purchases of investment grade bonds by the European Central Bank (ECB), a key indirect tailwind this year, could fade in 2017, the monetary environment overall will likely remain supportive.

Adam Whiteley: We take a similar view and expect the fine balance between US and European growth to continue to create a particularly supportive environment for credit. Although tailwinds in Europe in 2016 – such as central bank corporate bond purchases – could fade away in 2017, conditions for global credit overall remains supportive.

Paul Brain: Since the financial crisis, the initiatives from the authorities have been supportive for government bonds. The moves to very low official rates and then quantitative easing (QE) have driven bond yields down and prices up. The fragility of the global economy, despite the monetary stimulus, means these supports are unlikely to be removed quickly. Government bond yields will continue to be artificially depressed as a result.

Do you think the trend of negative yields in sovereigns – and corporates – will continue? Are there any areas that look vulnerable to negative yields?

Paul Brain: In Europe and Japan, negative yields at the front end of the curve are an essential part of the authorities' monetary stimulus plans. While growth remains hard to get, we believe these plans will stay in place. The move towards fiscal stimulus will take a long time both to implement and to make a significant change to the prospects for economic growth. Until there is clear evidence such stimulus has succeeded, negative yields are likely to remain. The outlook for longer dated securities is more uncertain as inflation expectations will rise and fears of a reversal of the current loose monetary policy framework will raise volatility.

Ulrich Gerhard: In Europe, we believe the ECB will maintain its current negative interest rate policy for the foreseeable future. In the UK, the Bank of England (BoE) appears biased towards cutting its base rate further.

While this will likely be supportive of a negative yield environment, central banks have demonstrated increased concern regarding the effects of negative interest rate policies and flat yield curves. The BoE, for example, has ruled out a negative interest rate policy, while the Bank of Japan (BoJ) has added flexibility to its

annual purchases to target higher yields at longer maturities. This indicates the universe of negative yielding securities may not increase and could in fact shrink. Furthermore, it's not unprecedented for government bond yields to sharply increase absent a central bank catalyst – as demonstrated by the sell-off in German bunds in the second quarter of 2015.

How much of a factor is political risk? Which regions/countries would you view as presenting the most significant risks and why?

Paul Brain: Political risk is on the rise as politics moves away from the centre. The politics of populist parties create uncertainty and raises risks. Europe is probably the epicentre of these concerns just because of the number of different governments and the potential for change through numerous elections.

Ulrich Gerhard: We see political event risk as a particularly important factor for high yield credit investors. Most recently, we saw this in the surprise outcome of the UK referendum and the resulting increase in political and economic uncertainty in the UK and Europe. Much is still to be determined as to the nature of the UK's exit and the economic implications for Europe and the UK, making further episodes of volatility likely.

In 2017, Germany and France both go to the polls in an environment in which fringe separatist political movements are looking to consolidate their growing support. Announcements from organisations such as OPEC also have the potential to create volatility in risk assets, which is particularly relevant to high yield sectors such as energy, pipelines, basic materials and metals and mining.

High yield credit portfolios capable of applying a truly global approach are better equipped to deal with political risks than regionally constrained portfolios, given their greater diversification. The US market for example offers lower exposure to Brexit-related political risks, while the European market is less exposed to the energy and metals and mining sectors.

Furthermore, a short duration approach to high yield, without the constraints of a benchmark, can leave an investor less vulnerable to credit risks. Diligent credit analysis can provide cash flow visibility across shorter time periods, allowing for greater certainty of repayment. During volatile market conditions, whether they are driven by political or macroeconomic factors, this can help investors pinpoint compelling value opportunities.

Adam Whiteley: We agree global credit portfolios are better equipped to deal with political risk than regionally constrained portfolios, partly because of the opportunity they offer to diversify. For example, global credit indices only allocate around 5% to sterling credit and so were less volatile on an excess return basis versus sterling credit markets in the aftermath of the Brexit referendum result.

Global developed credit portfolios can seek to minimise the volatility induced by regional politics as their universe incorporates credit markets denominated in currencies such as the US dollar, euro, sterling, Japanese yen, Australian dollar and the Canadian dollar. The ability to manage risk actively can further open up relative value opportunities between regions, allowing investors to potentially benefit from the volatility created by political event risks.

What areas of hidden or unrecognised value do you expect to focus on in the coming year?

Adam Whiteley: We expect the ability to allocate across different regional markets to prove a compelling source of outperformance for credit investors. From a more bottom-up perspective, we believe that credits that are de-leveraging, possibly following activity such as M&A – could offer opportunities to managers able to conduct thorough bottom-up credit analysis.

Likewise, we expect managers with the ability to allocate off-benchmark exposure to add value. We believe areas such as asset-backed securities will continue to offer excellent additional fundamental value. Fundamentals in emerging market debt are also improving and the differential in growth between emerging and developed markets is increasing even as external imbalances recover and countries such as Argentina, Indonesia and Brazil implement important reforms.

Paul Brain: The rise in inflation expectations, for the first time in many years, has brought the area of government inflation-linked securities back into focus. Global growth is still challenged and when markets over-anticipate interest rate increases there will be opportunities to invest. Elsewhere, we expect government bond markets across the globe to grow at different speeds and so diversifying into markets where rates could be cut (for example Asia) could give the global investor an important opportunity for outperformance. Finally, currencies will continue to diverge with those that have a loose fiscal and tight monetary policy stance, likely to outperform.

NEWTON
Investment Management

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More of the same?

Protectionism may be on the rise but the world is so interconnected today it may not be as far-reaching as some expect and many global companies remain well-situated to maintain delivery of sustainable income in 2017, says Newton global income equity manager Nick Clay.

Nick Clay,
global income equity manager, Newton

The year ahead looks beige – a year in Nick Clay's opinion likely to follow the same trend of the past few: a continuation of uncertainty, market and asset class volatility, low growth and central bank interference. It will be an environment, Clay says, where although there appears to be less risk, in reality there are plenty. Against such a backdrop, the sustainability of income remains vital, he says.

There is much talk in markets today that the coming year will likely see more political divergence and an upswing in protectionism manifesting itself as rising trade barriers. However, Clay says much of this is noise and argues many companies are still well placed on the global stage. "The world is too interconnected to be dismantled easily – especially among those companies that have intellectual property. For capital-light companies strong in this area, trade barriers become harder to impose."

Clay points out that money gravitates to those companies with intellectual property, something that is causing a widening wealth divide, creating discontent and leading to political and trade upsets. "The share of global wealth among the top 1% of the world's population is back to levels last seen around 1929. This isn't a result of trade agreements." In 2015, it was reported the richest 1% of the world's population now owns 50% of its total wealth.[1]

Citing the US jobs market as an example of the structural changes leading to political upsets, Clay notes that virtually 95% of all US jobs created in the past 16 years have been in sectors such as healthcare, education, restaurants and social assistance. "Not only do jobs such as these pay less than average, they also feature fewer work hours, meaning take-home pay in these new jobs is some 40% below average; the incidence of those holding two jobs has concurrently been on the rise. The effect of this shift on total US earnings is a reduction of around 3%. The US may have improved employment figures but in fact many are now worse off."

Among the 10 jobs projected to grow the fastest in coming years, half pay less than US$25,000 a year and three-quarters pay less than the typical

1 *Fortune:* 'The top 1% now owns half the world's wealth', October 2015.

annual US wage of US$35,540, according to US news reports in April 2016.[2] Meanwhile in September 2016 it was reported that multiple US job holders rose to 7.8 million, representing 5.2% of all those employed, up from 4.9% in September 2015.[3]

Partly this is the result of a shift in the US away from manufacturing jobs and more towards technology and other areas that are more led by intellectual property, says Clay. "Companies such as Uber, AirBnB, Amazon – where does the wealth end up? With a very few."

Although many companies might consider the current pace of technological change as a threat, for those whose product or service is embedded in everyday life, this is less of a problem. Incumbent systems, such as Microsoft, for example, are so entrenched it is difficult for competing companies to derail them. Likewise, another company Clay cites as an example is Computer Associates, a leader in software for mainframes used by global banks. "If you started from scratch today you likely wouldn't have or need a mainframe computer system but for legacy businesses it is too deeply-rooted," he says. The same thesis can be applied to a company like Western Union. "Many think of it as just a bricks-and-mortar cash transfer company that can be disrupted by the uptake in online transfers and smart phones. Yet some 80% of all transfers conducted via Western Union are in cash and around 85% of those that receive the transfer do not have a bank account – even if they may have a phone. Increased regulation around such businesses also means few entrants are competing in this space. Western Union is not without an online presence either – it's now one of the largest online cash transfer businesses."

Meanwhile, the nature of the current globalised economy means for developed markets there will be a greater focus on capital-light companies featuring strong barriers to entry, providing them with the protection to fight off potential competition and disruption.

Clay believes these types of companies look positive for the provision of sustainable dividends over the year ahead, even as market valuations and volatility remain high. "One approach to likely volatility is to hide from it – but where? Now is not about hiding, it's about surviving."

Markets were fairly resilient through 2016, much of which Clay attributes to what he terms the "blind faith" of investors that central banks will intervene in times of great difficulty. He points to the somewhat short-lived downturn in the UK following the Brexit decision as evidence that a reliance on intervention by the authorities has become almost Pavlovian.

This support – or even just the appearance, or expectation of it – will continue to feed through to asset prices and valuations in 2017, Clay notes.

So is this the year when the support will stop working or a new central bank intervention tool will have to be created? Clay doesn't think so. Ultimately, he says the question is more who will pay for it. "Quantitative easing isn't a free experiment: somewhere, someone will pay. Ultimately, it's baking in low returns for the next 10 years. In this environment, every asset class looks expensive and correlations increase. "

The ability of companies to put up prices in this environment is zero, Clay argues. "So who is going to take the margin hit? It's not the consumer."

Since dividend growth in this environment may be under pressure and lacklustre, sustainability of shareholder payments will be ever more important. As such, Clay believes capital-light business models – and those with discernible intellectual property – will likely fare best.

WHAT TO WATCH IN 2017

Global capacity and productivity levels.

Politics – internally in Europe.

Forthcoming European election results.

2 *CNN:* '5 of America's fastest growing jobs pay less than $25,000', April 2016.
3 *USA Today:* 'The job juggle is real. Many Americans balancing two, even three gigs', October 2016.

NEWTON
Investment Management

Riding the rental revolution

Sandeep Bordia,
managing director and head of research and analytics, Amherst Capital Management

A booming US rental property sector is attracting new interest from a range of commercial and institutional investors but can this growth be sustained? Here, Amherst Capital Management's Sandeep Bordia considers the market outlook for 2017.

The US housing market has witnessed a seismic shift since the global financial crisis of 2008, when millions of Americans lost their home in foreclosures[1], following the sub-prime and US banking crises.

According to 2016 research from Harvard University[2] the national home ownership rate has been on an unprecedented decade long downward trend, sliding to 63.7% in 2015. The US Housing Vacancy Survey also shows the number of households renting increased by nearly nine million between 2005 and 2015 (see chart opposite).

This rental demand trend has been exacerbated by demographic shifts which have seen a new generation of young adults and families increasingly unable to afford their own homes.

Tighter rules on mortgage lending, rising house prices for owner occupiers, stagnating real incomes and limited Federal assistance for low earners have also played their part in boosting demand for rented residential property in both the multi-family and single family rental sectors (SFRs). According to the Harvard analysis, the failure of supply to keep up with rapidly rising demand has led to the longest period of rental market tightening since the late 1960s.

Commenting on other factors behind rental market growth, Bordia adds: "While all of the main drivers that buoyed the rental market in recent years remain intact, another factor is the rise in student debt – which has quadrupled over the past 13 years.[3]

"While graduation usually allows students to go into better paying jobs and afford a mortgage, for ex-students who took out loans but did not graduate, it becomes much harder to qualify for a mortgage."

Institutional interest

This rise in demand for rental property – particularly single family rentals (SFR) – and healthy returns has attracted a range of retail and, increasingly, institutional

1 *Bloomberg:* 'Millions of Spenders Are Ready to Come Back From the Mortgage Crisis', 07 July 2016.
2 *Joint Center for Housing Studies of Harvard University:* 'The state of the nation's housing 2016', 22 June 2016.
3 *FRBNY/Equifax* Credit Panel, as of 2016 Q1.

investors. While it's estimated institutions currently account for just 1-1.5% of the market, demand for SFRs continues to grow and the average number of new rental households has increased by 770,000 a year since 2004.[4]

Institutional investors can access the market via a range of methods, including buying single family properties outright to rent or invest in securitised debt packages backed by those properties. With institutions able to benefit from ongoing economies of scale, purchasing power and geographic reach, Bordia believes there is room for ongoing growth in their share.

"Institutions certainly enjoy a range of advantages over smaller 'mom and pop' type retail investors, including access to cheaper and more appropriate finance lines.

"Most of the existing institutional SFR operations have also made a lot of investment in infrastructure and technology, which helps them throughout the lifecycle of the property portfolio from acquisition to ongoing maintenance and repairs.

"Geographical diversification is another benefit. Most retail investors, even if they own more than a couple of properties, tend to have their investments concentrated in areas near where they live. For institutions, it is easier to spread portfolio investments across geographies. They can buy properties in Florida, Georgia or whichever region offers the best risk/reward," he adds.

Within the wider US property market, investment research analyst Morningstar expects multi-borrower securitisation, including single-borrower, single-property loans, to drive long-term growth in single-family rental issuance.[5] It adds that cash flow coverage of debt service remains robust and delinquency rates are low with vacancy and retention rates also in line with its latest forecast.

Regional spread

Commenting on institutional investor appetite for rental property across the US, Bordia notes investors are looking beyond major US cities to explore the potential of smaller cities and towns where demand is high.

"From a geographical perspective, institutional investors have been more active in certain specific cities and closer to urban areas. They are looking beyond New York and San Francisco to cities like Minneapolis, Denver, Chicago, Cincinnati and Nashville. These are not the biggest metropolitan areas but can offer lower capital risk exposure," he adds.

With demand steadily rising, Bordia remains optimistic about prospects for the sector for 2017. However, he also remains alert to potential risks. "While we anticipate high single digit unlevered returns in the sector in the year ahead, no asset class is entirely immune from risk.

One of the reasons for institutions grabbing a higher market share in the single family rental market is because many retail investors have not been able to qualify for a mortgage or are not getting rates which are attractive. If that were to change and mortgage availability comes back to the market, it could prove challenging for institutions to ramp up portfolios. However, we are seeing no sign of widespread improvement in credit availability.

"Looking ahead, the real risk to the market is not political, regulatory or related to mortgage credit availability – it is the threat of a major economic downturn. If the US economy were to seriously underperform, it is likely rental occupancy numbers would fall and rent growth would flatten. That said, we see no major threats on the horizon indicating a downturn is imminent."

While there has been a handful of recent securitisations in private label mortgage market, Bordia also thinks it unlikely the market will see a return of the high risk property investment strategies that damaged both investors and corporate reputations in the late 2000s.

"The few securitisations we have seen in the private label have tended to be of pristine quality and with total annual issuance of less than a few billion dollars – in a market which had US$2.5 trillion outstanding at the peak. Since the financial crisis, a lot of new regulation has been introduced and there is almost zero appetite for some of the more risky investments which were common back then," he adds.

RENTING HAS SURGED OVER THE PAST SEVERAL YEARS AS HOME OWNERSHIP HAS STALLED

Average annual growth in households (millions)

Source: JCHS tabulations of US Census Bureau, Housing Vacancy Surveys.

WHAT TO WATCH IN 2017

New US government economic strategy.

US Federal Reserve activity for potential tightening.

Rental demand.

Amherst CAPITAL MANAGEMENT
A BNY MELLON COMPANY

4 *New York Times:* 'More Americans are renting and paying more as home ownership falls', 24 June 2015.
5 *Morningstar Advisor:* 'Sizing Up the Single-Family Rental Market', 18 February 2016.

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Buyback or pay-out?

John Bailer,
US equity income manager,
The Boston Company Asset Management

The US is a market as known for its share buybacks as for its pay-outs. Here John Bailer, US equity income manager at The Boston Company, explores US dividend trends and looks at what income investors might expect in the year ahead. What headwinds do companies face in 2017?

Against a backdrop of elevated anxiety, income-producing stocks are often the first place investors turn to for so-called 'safe harbour' allocations. This has arguably led to valuations of such dividend payers looking steep, with the US utilities sector, for example, trading at 18.2x P/E in the summer of 2016, following a Brexit-fuelled volatility spike.[1]

Often termed bond proxies, these large cap defensive stocks have enjoyed investor favour due to their higher yielding profiles in an investment environment where as much as US$12 trillion of the fixed income market was negative yielding by October 2016.[2]

The question for 2017 is whether such equities can continue to curry investor support and whether their pay-out ratios are sustainable?

The historical average pay-out ratio of the S&P 500 is 57.3%, with the 1930s marking a peak in ratios of 90.1%.[3] In the 1970s, 80s, 90s and 2000s the average pay-out ratio dropped significantly below this long-term average and buybacks were more the norm, says John Bailer, US equity income manager at The Boston Company Asset Management.

"The pay-out ratio now is around 45% so there is some room before it hits the historical average. Part of the culture of buybacks has been driven by taxation – capital gains were taxed at a lower rate so companies were better off buying back stock.

"The other important factor has been management compensation, which has been very stock option orientated. When you're dealing with stock options the value of the stocks goes down when you pay out dividends. Management compensated largely with stock options are much better off buying back stock and this has encouraged the wider trend of buybacks."

Changing management carrots

Since the financial crisis, the composition of management compensation packages has changed and boards are starting to allocate a higher percentage via restricted stocks, says Bailer. "This has prompted management teams to favour a combination of stock buybacks and dividends so we are seeing a slow movement towards more of the latter."

1 *FactSet*, 31 July 2016.
2 *Bloomberg*, 2 October 2016.
3 *Ned Davis Research* – historical average for period 31 March 1926 to 31 December 2015.

FIGURE 1: DIVIDEND PAY-OUT RATIOS S&P 500

Decade	Average payout ratio
1930s	90.1%
1940s	59.4%
1950s	54.6%
1960s	56.0%
1970s	45.5%
1980s	48.6%
1990s	47.6%
2000s	35.3%
HISTORICAL AVERAGE = 57.3%	
CURRENT PAYOUT RATIO = 45.5%	

Source: Strategas Research Partners, 1930-2009, Ned Davis Research for historical average (see footnote below) and TBCAM for current pay-out ratio, as of 31 December 2015.

FIGURE 2: FINANCIALS VERSUS UTILITIES

	Income stock financials (Incl REITS)	Utilities Select Sector SPDR Fund (XLU)
Dividend yield	3.4%	3.3%
YTD Performance	3.6%	22.4%
Projected 3-Yr Dividend Growth Rate	9.9%	5.5%
Historical 3-Yr Dividend Growth Rate	21.0%	4.9%
Price/Earnings Ratio (FY2)	11.9x	18.2x
Price/Book Value ratio	1.2x	2.0x

Source: FactSet, 31 July 2016.

Management teams have seen companies with higher yields obtaining higher valuations on the stock market and Bailer believes this is encouraging them to think again about dividend distributions. The current low-growth environment has led to company caution when it comes to building out capacity and investment, so firms have over US$4 trillion in cash on their balances sheets, he adds.[4] This means companies have ample capital to return to shareholders.

In 2016, firms were not shy in doing so: S&P 500 dividends increased 5.2% year-on-year in the third quarter, putting the yield of the index at 2.1%.[5]

Bailer believes if the perception of the market changes and US economic growth starts to look more robust then capex could increase but he is not concerned this capital would be taken out of dividend pools. "I think the higher capex goes, the more companies will move out of buybacks. The last thing they want to do is to cut dividends because it is deemed a taboo by the market and share prices tend to suffer as a consequence."

He believes the current pay-out ratio of the S&P 500 is not egregious and as such, he does not see it diminishing in 2017.

Sector scout

"I believe in the majority of industries dividend cuts are not a significant threat. A few areas like the energy explorers and producers and the owners of energy infrastructure cut their dividends following the oil price drop. But I believe those cuts have now filtered through," says Bailer.

Meanwhile, he believes financials are an interesting sector from an income investor's point of view and that an active manager can find good value in higher dividend yielding stocks, particularly in financials (see Figure 2).

"The market still treats financials as risky and is sceptical of them due to the overhang from the financial crisis. The valuations of many financials in the sector are at all-time lows and while governments are forcing banks to hold a lot more capital, in the past five years they are making the best loans they have ever made. Yet everyone still thinks first and foremost of the dividends cut in the wake of the global financial crisis."

Yet Bailer notes how the Tangible Common Equity ratio (a measure of the losses a bank can take before shareholder equity is wiped out) for financials is at its strongest since the 1930s. So balance sheets are in "incredibly good shape", he says, even as Comprehensive Capital Analysis and Review (CCAR) severe adverse scenario tests carried out by the Federal Reserve show the banking sector should have resilience in the face of a range of even serious headwinds.

Tax implications

Another potential boon for pay-out ratios in 2017 could be if the new president, Donald Trump, manages to pass a repatriation tax holiday. "According to some reports, US companies are holding in excess of US$2.1 trillion in profits overseas, so if even a fraction of that is brought back onshore I believe it would feed into dividends. M&A would also likely be a beneficiary," says Bailer.

Over the longer term, he hopes Washington will work towards reforming the tax code so the corporation rate no longer sits at 35%: "We believe it is a bi-partisan issue that needs to be fixed."

The tech sector in particular could be ripe for increasing pay-outs if tax reform is agreed. Bailer says management teams in big tech are gradually moving to compensation through restricted stocks like the rest of the market. He hopes to see greater pay-outs from the tech sector following this development.

For the long term, Bailer notes sustainability remains key when it comes to dividend payments. Even so, he stresses high pay-out ratios should not always be viewed as a red flag. "There are some instances when pay-out ratios as high as 90% are sustainable – REITs, for example, are mandated to pay out a high portion of earnings and some utilities can also maintain such levels. What it comes down to is whether investors can be confident in the company's ability to generate sufficient cash consistently."

The main headwind he could envisage in 2017 would be a further drop in energy prices, which could see more companies in that sector cutting dividends but this is not his base case. "I think a lot of that played out in 2016 and I think the rest of the sectors in the US are in pretty good shape," he concludes.

WHAT TO WATCH IN 2017

A repatriation tax holiday.

Sustained pay-out strength in the financial services sector.

Progression in favour of dividends and away from buybacks.

THE BOSTON COMPANY
ASSET MANAGEMENT, LLC

4 Cash balances based on S&P 500 balance sheet an includes short-term equivalents as of 30 September 2015.
5 *Evercore*, 4 October 2016.

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Rules of engagement

Is the UK likely to become more isolated in 2017 and what will this mean for its economic growth? The renegotiation of its trading relationship with the rest of Europe will be a central focus for the year ahead, with uncertainty likely to continue. Here, UK equity manager Christopher Metcalfe discusses what may be in store, highlighting areas of concern and the sectors that may hold opportunities.

Christopher Metcalfe,
UK equity manager,
Newton

UK dividends remain attractive and may even see a surge of investor interest in the coming year as greater certainty surrounding Brexit emerges and continued sterling weakness boosts UK company dividends. Some of the biggest dividend payers in the UK are overseas currency earners, which is also helpful for investors.

We believe we are still in a deflationary environment and do not expect this to change in the medium term. As a result, we think equity income is likely to remain attractive with c3.7% yield on the FTSE All-Share Index looking attractive when compared to UK Gilt yields.

We remain cautious on UK growth for the year ahead but much will depend on how Brexit is implemented – which way will it go? It could come down to the default World Trade Organisation trade rules or a Canadian-style relationship, whereby the UK would receive preferential access to the EU single market and most trade tariffs could be eliminated.

Greater clarity may come in 2017 if Prime Minister Theresa May is able to keep to her proposed schedule for triggering Article 50 – legal challenges not withstanding. However, even once the accession has begun it will likely take more than two years for any trade relationship with Europe to be negotiated.

The Peterson Institute for International Economics (PIIE) released a study of how long the US took to agree 20 bilateral trade deals: the average negotiation period was 1.5 years, and 3.5 years to get to the implementation stage. At the more conservative end of the spectrum, it has taken Canada seven years (so far) to strike its agreement with the EU, according to the World Economic Forum.

In the meantime, how will UK-domiciled companies respond? We think it is too

early to see if companies will enter into their own trading negotiations with other countries. That said, the global nature of many UK-listed firms should stand them in good stead, irrespective of the UK's ongoing relationship with Europe.

Growing global debt

The growing global debt burden is another cause for concern – particularly the speed of debt accumulation in China. A possible consequence of the latter for the UK is the impact on the mining and banking sectors. The luxury goods sector could also suffer if the Chinese consumer becomes more sensitive to increasing debt levels.

The UK financial services sector is also under pressure, which we do not see alleviating anytime soon. Post-Brexit there are huge uncertainties concerning the 'passporting' of products and services, an EU practice that has enabled London to become a leading financial centre.

However, we would temper the doomsayers on this point: financial services are a key UK offering and we question if companies are really going to relocate. Irrespective of our membership in the EU, London remains a highly skilled area for financial services, with the breadth of language skills, real estate and infrastructure to support it, few cities can compete.

Do other European cities even have the space such companies need? Are the banks really willing to soak up the costs involved in such a relocation when they have increasing regulatory requirements for robust capital ratios?

On the other hand, there are the positive effects Brexit may have on the manufacturing sector. Sterling has depreciated significantly against a basket of world currencies since the June 2016 vote and some companies have seen the benefits of this – both from a translation point of view and a transaction one.

Manufacturers could see a 10-15% earnings upgrade in the coming months simply as a result of the currency effect making their goods more competitive.

Yes, large ticket items such as cars have seen a drop off in sales in recent months. However, retail, particularly online, has remained strong.

UK equity income investors could also see the upside of ongoing sterling weakness. Some 40% of UK dividends are declared in dollars, so a sharp, sustainable depreciation in sterling boosts dividend payments for UK investors. As a result, the Q2 Capita Dividend Monitor, updated for Brexit, expects underlying dividends in 2016 to be up 0.5% due to the exchange rate boost versus an expected decline of 1.7% pre-Brexit. It is the diversity of the UK market's earnings and significant dollar exposure which caused the FTSE All-Share to reach record highs post the EU referendum.

With respect to dividend growth we believe it still looks stable and while it may slow as 2017 progresses, distributions still look robust.

Another benefit of lower sterling may be an increase in M&A activity. The £24bn bid for the UK's ARM Holdings by Japanese company SoftBank boosted global M&A activity in the third quarter and marked the third largest deal in 2016 (as of September), according to Deologic.

There are other aspects to watch in the coming months. Job vacancies were falling in the autumn of 2016 but we will need to keep a close eye on such data as 2017 progresses. We expect capex to falter as the Brexit negotiations reverberate through the year.

As a result, we remain less than sanguine about UK retailers and instead think dollar earners and multi-national firms will maintain more stable revenue streams against this backdrop.

Fiscal spending

Fiscal spending is likely to grow in the year ahead with greater indications on how it will be allocated expected. Housing could benefit but we believe there may be more attractive ways to play the infrastructure story, such as cement companies or infrastructure consultants.

In this environment, we believe UK dividends will remain an attractive area for investors regardless of the political theatre that might surround Brexit. Investors may have to start looking through the short-term noise to 2020 before we see any clear impact – positive or negative.

WHAT TO WATCH IN 2017

UK interest rates and fiscal spending plans.

Scottish independence again?

Sterling fluctuations and the impact on consumer spending.

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Miyuki Kashima,
head of Japanese equity investment, BNY Mellon Asset Management, Japan

From the outside looking in

Those with a yearning for stability could do worse than choose Japan in 2017, according to BNY Mellon's Miyuki Kashima. The year ahead looks bright for the world's third largest economy, she says.

For international investors, Japan can be something of a paradox. On the one hand, it has suffered from two decades of stagnant growth and yet it remains the world's third largest economy. It has one of the fastest ageing populations of any developed country but remains a sounding ground for world-beating technology and robotics. It has a domestic economy that accounts for around 85% of its GDP but is often viewed by international investors as primarily an export or currency play.

For Miyuki Kashima, head of Japanese equity investment at BNY Mellon Asset Management Japan, while these popular perceptions of Japan are important, they miss a wider point. Having experienced its own asset bubble and crash in the late 90s – as well as a quarter century of sluggish growth – Japan, she says, has important lessons for policy makers in the rest of the world as they come to terms with the ongoing fallout from the global financial crisis.

Take the question of fiscal stimulus. In Washington and elsewhere – and as the efficacy of quantitative easing is increasingly called into question – policy makers are beginning to ask whether infrastructure spending could be the key to reviving demand. The US has already spent some US$48.1bn on infrastructure, via the 2009 American Recovery and Reinvestment Act, and an additional US$73 billion is slated to be added to that.[1] But the question is, does this spending work?

Here, says Kashima, Japan has its own story to tell. Between 1991 and late 2008, the country spent US$6.3 trillion on construction-related public investment[2] – a mind-bending sum which critics say has contributed to Japan having the highest level of public debt among developed economies; it has also made the country less – not more – dynamic.[3]

Yet, says Kashima, thanks to that same spending programme, Japan's infrastructure now ranks fifth-best globally, while its train infrastructure (now privately owned and funded) ranks first in the world.[4] More importantly, she says, is the question of whether and how much this splurge on infrastructure served to bind society through some difficult times. She explains: "For me it's one of the great unknowns. How would our society have looked if all those jobs hadn't been created? What would have happened to social cohesion? It's easy to criticise the sums spent but would Japan have enjoyed its current high levels of social and economic stability in their absence? I believe it's an extremely relevant question for other countries in the post-global financial crisis world."

A similar theme – a sense that Japan has been there and done that – extends to the political sphere. Here, says Kashima, the 2013 return to power of Prime Minister Shinzo Abe was a milestone. It marked the first time a former prime minister returned to office since 1948 and was all the more remarkable, given that, between 2006 and 2013, Japan had no less than seven prime ministers; more than one a year. It also marked a return to form of the ruling Liberal Democratic Party (LDP) after three years in the wilderness; only its second absence from power since the end of the Second World War.

Explains Kashima: "There's a sense that after the economic doom and gloom of the early 2000s the Japanese electorate wanted to try something different. They broke with the past by electing the Democratic Party of Japan as an alternative to the LDP; didn't like it and have now reverted to the establishment party. From the outside looking in, it's maybe not too much of a stretch of the imagination to say something similar is happening with politics in the rest of the world. In this sense, Japan offers an oasis of stability amidst the current global political turbulence."

In the meantime, Abe's landslide re-election offers him a mandate to continue with Abenomics, the economic reform programme that bears his name. Kashima notes that despite negative coverage to the contrary, Abenomics is delivering on at least some of its promises. Recent data paints the Japanese economy in a positive light: Nominal GDP has enjoyed 13 consecutive quarters of year-on-year growth. Jobs and industrial output data has also been encouraging.[5]

This isn't to say Abenomics is without its problems, however. Says Kashima: "Yes, you can argue the government is missing its growth targets or that companies are not investing enough. But that's to miss the wider point. Just the fact that the government has committed to a growth target – for the first time since the 1960s – is remarkable in itself and I'm surprised it's not more of a talking point with investors. It takes a lot of courage for a government to come out with an official growth target because anything they do now will be measured against it. The main thing for me is that it makes sense to aim high. Even if we don't reach the target there's quite a good chance the government will do whatever it can to prevent GDP declining again."

Looking forward, Kashima remains bullish on the prospects for the Japanese economy. She notes that while a strengthening yen may have been at the forefront of most investors' minds, it is only a small part of the story. She concludes: "Investors who focus on Japan as a currency play are missing a far more important truth: a domestic economy that is performing well on its own terms and is home to companies offering attractive returns to international investors, regardless of how the currency performs."

WHAT TO WATCH IN 2017

Improvements in nominal GDP.

Positive jobs data.

Strengthening yen.

1 *City Journal:* 'If you build it…', Summer 2016.
2 *The New York Times:* 'Japan's Big-Works Stimulus Is a Lesson', 5 February, 2009.
3 *City Journal:* 'If you build it…', Summer 2016.
4 *World Economic Forum:* 'Competitiveness Rankings', 26 September 2016.
5 Japan Macro Advisors, Trading Economics, 24 October 2016.

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Regime change

Paul Lambert, head of currency, Insight Investment

Despite a steady outpouring of market-moving news over the past year, currencies have largely shrugged off events, causing many investors to expect a new, lower volatility regime in the months ahead. But there are reasons to believe the prospect of higher volatility exists and with it the resumption of currency trends in 2017.

Currency investors were relatively stoical during some significant events in 2016, including the attempted coup in Turkey, shifting political sentiment in Europe and the US and mixed signals from key central banks. The main exception was sterling, which fell to a 31-year low against the US dollar after the UK electorate voted in June to leave the EU.

The Deutsche Bank Currency Volatility Index – which indicates investors' expectation of future currency volatility – reflected this, largely tracking sideways in 2016. Implied volatility was low despite events that ordinarily could have caused significant shocks to the market.

As we head into 2017, we believe the problems evident at the start of 2016 have not been solved but merely kicked down the road. Bonds are even more fully valued now than they were at the start of 2016, while equity valuations are further out of line, with gains having relied on an ever lower discount rate and multiple expansion to justify current levels.

A lot will rest on the global growth outlook in terms of where we go from here. While it appears global growth is picking up, we would caution that recent upticks have largely been seasonal. There are tentative signs that inflation is also ticking higher. If real growth were to rise it would provide a supportive backdrop for risk assets and push up real interest rates, which would be broadly supportive for the US dollar, particularly against lower yielding currencies.

Risks to this scenario would, in my view, include a stronger-than-anticipated pick-up in inflation, something which would likely result in central banks being less accommodative. Risk assets would be expected to struggle in this environment and the US dollar would likely perform well against high beta currencies. The US dollar's performance against low-yielding currencies will depend on whether the Federal Reserve is seen to be ahead of or behind the curve in terms of normalising policy.

In either case, a pick-up in volatility could materialise across all markets. This may well present currency investors with greater opportunities as new trends emerge. A situation where the sideways move in currency markets and low volatility environment extends into 2017 could occur if the pick-up in global growth begins to fade and inflation remains muted.

Meanwhile, it's worth noting how stable the US has been with respect to growth and policy. Growth has been firm enough for the output gap to close but at a relatively slow pace. Moreover, the asymmetry of risks is skewed towards too little rather too much inflation, meaning policy makers have been happy to stand back and risk an overshoot in inflation to the upside.

However, as time goes by, we move ever closer to a time when policy makers will have to attempt to slow growth to a point where the labour market is no longer tightening. Getting this policy shift just right is a tall order. Too much tightening risks causing a slowdown; too little could lead to inflation and delayed, but perhaps greater, monetary tightening later on. Both are likely to inject volatility into the foreign exchange market.

Putting the question of volatility to one side, one core consideration for currencies is how a potential shift by the world's central banks from monetary to fiscal stimulus could play out. The euro area, for example, looks like it could benefit from a more fiscally focused response to economic weakness. However, the political construct of the euro area and the balance between those that have the room to ease fiscally and those that need to means the European Central Bank is likely to have to take the strain in supporting the currency for the foreseeable future. In contrast, the US and UK may have less need for a shift away from monetary to fiscal policy but politically it would be easier to deliver. To the extent that a country shifts away from monetary to fiscal policy easing, this should be relatively supportive for the domestic currency.

Reserve status for the yuan?

Another core question for investors in 2017 is whether China can continue along its current growth trajectory. In currencies, the corollary of this is the question of whether the Chinese renminbi can continue to make progress on its long march towards reserve status. Here, we note how in 2016 the yuan's status was enhanced by its inclusion in the IMF's Standard Drawing Rights basket.

Looking forward, we believe the renminbi is likely to continue to grow in importance as a traded currency, even as the US dollar remains unchallenged as the global reserve currency. While other currencies such as the euro, pound and yen are included in the reserve baskets of many central banks, their weight is relatively small compared to that of the US dollar. Further liberalisation of China's capital account and the associated internationalisation of China's capital markets should allow the renminbi to continue to develop as an international unit of exchange. It's certainly likely that the renminbi will be added to more central banks' reserve baskets over time but it's also likely to have a relatively small weight for the foreseeable future.

In other emerging market countries, we note that currencies are not all born equal. Some emerging market countries, such as Chile, for example, are large commodity exporters and so the movements of their currencies are dominated by changes in their terms-of-trade, which result from swings in the pricing for basic materials. Other emerging markets – Korea for instance – have no meaningful commodity exports and so their currencies tend to be driven by other factors. Factors such as commodity price swings and political developments in countries like Brazil and South Africa will likely create different drivers within emerging markets in the months ahead. While there will be differentiated themes within emerging market currencies, strong capital flows into the asset class is a tide that has helped to lift most boats.

If the US Federal Reserve follows a path of very gentle interest rate tightening against a background of firming global growth, we feel the general support for emerging markets is likely to remain intact. If, however, the Fed raises interest rates more sharply than currently discounted, especially if it is due to rising inflation, then this may have a more negative impact on emerging markets as an asset class.

WHAT TO WATCH IN 2017

An increase in currency market volatility.

Bond yield instability which could indicate investors are bracing for a major shift across markets.

Disruptive forces

With rising global trade barriers, increased uncertainty around the sustained direction of US interest rates and questions over Chinese growth, 2017 could be a watershed year for investors in emerging markets. Here, Rob Marshall-Lee, leader of Newton's emerging and Asian equity teams, looks at some potential winners and losers.

Rob Marshall-Lee, emerging and Asian equity team leader, Newton

Among the specific forces of potential disruption set to continue to shape emerging markets (EM) is the rebalancing towards internal sources of growth. One impetus for this is the sluggish growth in the developed markets, the traditional destination for exports. This trend is particularly marked in China, which is already shifting its economy away from manufacturing and fixed asset investment (now judged to be unsustainable due to the build-up of debt) to more of a focus on consumption and services.

So far, this transition has taken place in fits and starts, with periodic slowdowns spurring increased amounts of 'fine tuning' by the Chinese government via both monetary and, latterly, fiscal, policy. The most visible cost of this support has been the speed at which China's debt burden has continued to grow. (China's debt-to-GDP ratio has leapt from 147% of GDP in December 2008 to 255% more recently.)[1] The Bank for International Settlement is among the sirens warning that China is paving the way for a financial crisis.[2] That said, the growth in the domestic services economy has been remarkably robust despite the slowdown in the more capital intensive industries.

While there may be the temptation to avoid China completely, there is also a danger of missing structural growth opportunities. The Chinese market may be heavily dominated by state-controlled companies but roughly one third is in private ownership. Privately owned companies tend to offer the more attractive opportunities, especially in healthcare and internet companies, in our opinion.

The economic reforms being undertaken in India under the leadership of Prime Minister Narendra Modi offer promise and are set to be good for growth over the next decade. (Under the previous government, growth had been stifled.) There is, for instance, pent-up demand for consumer durables after an earlier slowdown and Indian consumers are not burdened by high levels of personal debt. There is potential for a catch-up in productivity with an easing of regulatory constraints and onerous laws.

Weaker sentiment towards commodities and related economies has already exerted an influence on investment flows into emerging markets and, by extension, can also have an effect on the valuations of all equities in those markets. This can be the case for even those that are inherently attractive underlying investments. For example, most stocks in India benefit from a weaker oil price, which is also positive for its currency. This valuation squeeze now appears to be reversing from depressed levels.

Reliance on commodities

For 2017, a useful way to differentiate the emerging markets is likely to continue to be a separation of the countries that are reliant on commodities from those that are driven by manufacturing. There is an excess supply of commodities and prices are highly unlikely to rise as they did in the 2000s, despite a near-term rebound

1 *Financial Times:* 'China financial stress indicator hits record high', 19 September 2016.
2 *Bloomberg:* 'Warning indicator for china-banking-stress-climbs-to-record', 19 September 2016.

linked to short-term Chinese stimulus. The commodity bull market followed a commodity bear market which had lasted since the1980s. We do not see a repetition of this scenario given the extensive investment in commodity supply, such as iron ore, for which Australian exports have increased approximately seven-fold since 2000.

China's rapid growth and voracious appetite for raw materials were the driving forces behind the industrial commodity 'super cycle' that lasted until 2011. Tightening measures following excessive stimulus post the global financial crisis and the managed growth slowdown that resulted, saw commodity prices fall almost as fast as they had initially risen. These rebounded somewhat as the near-term outlook for China's growth overall has improved, yet we strongly expect the slowdown to resume in due course, which will likely translate into renewed commodity price weakness.

The length of this recent boom and the capital misallocation that resulted is likely to take some time to work through the affected economies, adding to the pain of adjusting to a new reality. For example, commodity producer Brazil's fiscal deficit is running at 9.6% of GDP, suggesting that macroeconomic risks in the medium term may be higher than investors currently perceive.

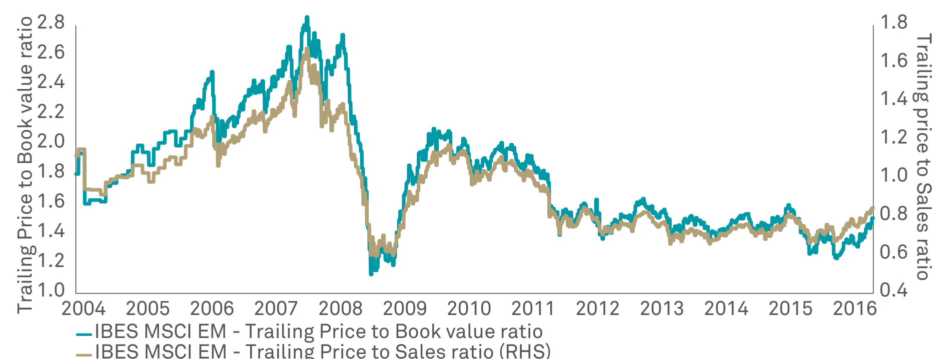
Power to the young

Demographic trends are not uniform across emerging markets and the differences can offer an economic advantage. There is substantial potential for future growth in countries where there is a rising population of young people, a cohort more likely to be future consumers. This is in marked contrast to many countries in the developed world, which are experiencing shrinking working-age populations.

The Philippines is expecting more than 30% growth in its working-age population by 2035.[3] Such an economy as the Philippines' should also be able to harness productivity gains and rising consumer wealth. In addition, considerably lower debt levels than in the developed world, and versus its own history, should further insulate the domestic internal growth drivers from external shocks.

EMERGING MARKETS – ATTRACTIVE ENTRY POINT?

Valuations are still near 2009 lows



Source: Thomson Reuters Datastream, in USD, as at 25 August 2016.

While Nigeria and Kenya are also likely to experience very high growth in their working-age populations, Asian economies are generally more attractive on a risk-reward basis. This is because of, at this juncture, their better economic policies and governance overall, which can make a sizeable difference over the long term.

Of note, while China is often characterised as having an ageing population, there is less of a demographic time bomb there than the perceptions around the previous one-child policy would suggest.

Atypically, the younger segment of the working population normally earns the higher wages, whereas the older part of population usually works on farms, for instance. Urbanisation has further to go and will offset much of the decline in the urban workforce. Increased mechanisation in factories will also free up labour from this sector going forwards.

Challenge of technology

To complicate the picture further, there is a range of factors – not just confined to the emerging markets – that have the potential to be disruptors.

Technology is accelerating change around the world. For instance, the move towards 'cloud' computing has the potential to disrupt not just mid-level employees but lawyers and accountants, the type of employees that previously would have been unscathed by such developments. In the emerging world, increased robotisation could make it more difficult for less developed countries to follow the typical economic development path that relies on transitioning from using cheap and abundant labour in agriculture to light manufacturing in order to generate per-capita income growth.

Change always brings relative winners and losers, and the outlook for e-commerce, travel, education and healthcare spending in emerging markets is bright.

Over the course of 2017, investors will continue to face the question of whether it a good time to consider investing in emerging markets. An examination of long-term measures through the economic cycle, such as trailing price-to-book value ratios, points to attractive valuations.

Since the 'taper tantrum' of 2013, emerging market currencies have broadly depreciated against the US dollar with many of the economies we favour also seeing improvements in their external balances. This suggests that at least a partial rebalancing to a less accommodative global monetary environment has already taken place.

With a renewed slowdown in China in 2017, we think sectors exhibiting structural growth characteristics will outperform the more cyclical sectors.

WHAT TO WATCH IN 2017

China's ability to avoid a hard landing.

US interest-rate cycle.

Consumer retrenchment in commodity-driven economies.

3 *Newton, UN Population Information Network: 'World Population Prospects:* The 2015 Revision', as at April 2016.

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Focus on: emerging markets debt

In 2016, tightening US monetary policy and collapsing commodity prices were something of a spanner in the works for emerging markets. Does 2017 offer better prospects for fixed income investors? Here, managers from Newton, Standish and Insight consider the opportunities in the world's emerging markets for the next year.

Colm McDonagh, head of emerging market debt, Insight Investment

Javier Murcio, emerging markets portfolio manager, Standish

Carl Shepherd, fixed-income portfolio manager, Newton

What do you see as the biggest tailwinds for emerging markets (EMs) in 2017?

Javier Murcio: The past year has proven the asset class can deliver attractive returns for fundamental reasons, not just technical ones. The commodity price outlook has improved and EM economies should be able to grow fast again in 2017 as the recovery in commodities provides more stability for the external accounts of these countries. Global interest rates and commodity prices remain the main drivers of this asset class and lower rates going into next year will provide another tailwind.

Carl Shepherd: Probably that Chinese growth is higher than was previously expected. A firming up of oil prices has also helped stall the slide in commodity EM currencies. A free-falling currency imports inflation, facilitates rash decision-making and makes planning an economy more difficult. This perhaps doesn't constitute a tailwind but it is certainly a stabilising factor, which makes the carry trade attractive again. Lastly the reassessment of the pace of US rate rises we think is a help, i.e. the Fed was less hawkish than was expected in early 2016 and continues to appear that way.

Colm McDonagh: Fundamentally we think emerging market growth is improving, particularly in some of the larger developing economies as they recover from the growth shocks we've seen in recent years. Secondly, a number of EMs have engaged in fresh economic reform. There's also no doubt the opportunity cost of investing in emerging markets is currently very low. This was definitely a technical driver behind some of the investment inflows we saw in 2016.

Is political risk a factor for the coming year? If so, which countries/regions present the biggest risks and why?

Javier Murcio: In our investment universe, there are always elections somewhere. The outcome of the US election was important, particularly for trade policy. There are a lot of elections in Europe between now and the end of 2017, so political risk is always part of the mix. Russia's involvement in the Middle East could have implications for central and eastern Europe and Turkey, for instance. Brazil faces a very important vote in congress some time in the first half of the year. Local elections in Argentina will be important signals of how much support the administration there has.

Colm McDonagh: Politics in developed markets will probably be the dominant driver of asset returns in the short term. Brexit, the aftermath of the US presidential elections, ongoing discord in the Middle East and relations between Russia and the West all have the potential to influence markets, including the EM sector. Notwithstanding the varied politics throughout emerging markets, we see the current electoral cycle across these markets as less of a cause for concern than the picture in more developed markets.

Carl Shepherd: Political risk is certainly a factor. Aside from the very

specific idiosyncratic risks to individual countries with weak institutional frameworks, the bulk of political risk lies in the developed world. The US election is now behind us, but we will get a better idea in 2017 how far the new president is actually going to go in enacting policy, which could threaten globalisation and free trade.

Right wing parties and populists have increased the fractiousness of the EU, and the three largest economies within the EU are experiencing significant political events: elections in Germany and France and the UK is expected to trigger Article 50 to begin negotiations to leave the EU. Added to this, Japan and China both need to decide whether to stick to their current monetary policies or consider alternatives. Therefore any of these items have the ability to engender a 'risk on' or 'risk off' dichotomy or affect global trade, investment and confidence for the better or worse.

Will the US retreat from globalisation and what could this mean for EM?

Javier Murcio: Political pressure is there but free trade is already embedded in the way businesses operate in the US. We may not see further liberalisation by the US but several other countries are doing treaties with Europe and China. We'll also continue to see China's influence grow and not only in Asia. In Latin America for example, China now counts for at least a third of trade in many countries. This reflects the influence of commodities but also influence through investment. The rise of China reorders the world as we know it but I don't think of that as a risk.

What's the outlook for issuance in the coming year? Do you think the commodities recovery will affect borrowing?

Javier Murcio: Issuance through 2016 was slower than expected for a number of reasons. Some countries are able to pre-finance themselves and don't need to go to the market. Local markets are major sources of funding now. Those factors that inhibit issuance are partly balanced by big re-entries into the market by Argentina and Saudi Arabia, one of the most welcome developments in capital markets in a long time.

Carl Shepherd: The market will be very wary. If you drew up a winners and losers list from likely Trump foreign policy, Saudi Arabia would be on the losers list. For the moment, they are able to spend money they already have to plug any gaps and won't want to issue into weak demand for EM debt. Issuers will be in a wait-and-see mode and probably only the very desperate will issue early in 2017. Should things prove to be not as bad as anticipated then there may be a rush for issuance later in the year.

From what we can estimate from economic policy it will likely be inflationary, we can see this from the sell-off in US Treasuries. That is only going to push yields higher in EM debt, thus increasing the cost of borrowing and issuance.

Colm McDonagh: In the coming year we expect more issuance to come from sovereign markets and corporate issuance to remain subdued. The fact that major issuance has come out of the Middle East (Qatar, Saudi Arabia) reflects what has happened in the commodities sector and the cyclicality of economies in the region. Yet such major issuance also creates a larger investment universe for emerging market debt funds and increased investment opportunity.

Elsewhere, we continue to see new markets opening up. Access to the Chinese domestic market is becoming easier and we expect we will see continued progress in accessing the Indian onshore government bond market. In the United Arab Emirates we expect to see further development of the local currency market, while Argentina is creating a tradable domestic bond curve.

What's your outlook for investor inflows/outflows in EM debt for the coming year?

Carl Shepherd: Inflows have been particularly strong in the hard currency space for EM in 2016. If the US Fed remains reasonably dovish in 2017 and commodity prices hold up then I expect flows to remain robust but with a greater allocation to local currency debt. The local currency indices are deeper, more liquid markets and have a higher rating. The last commodity downturn had a weakening effect on EM currencies, even as future inflation expectations increased. Therefore we could expect another round of domestic rate increases to counter this – which would result in yields rising and therefore prices falling.

Colm McDonagh: We have a fundamental belief we will see investment inflows come back into emerging market debt but we also believe the mechanism by which people make that allocation is shifting. Already there is evidence of long-term strategic flows coming back into the market. But most institutional investors are currently trying to figure out how they access EM fixed income, without some of the volatility we have seen in recent years. For a number of reasons – including the rally in EMD we have seen this year – there will be those who invest in emerging markets as they have done many times in the past.

Onwards and upwards

Iain Stewart,
Real Return team leader, Newton

Increased state intervention – and the greater use by governments of the cheap funding available to the public sector – seems inevitable in 2017 and beyond, says Real Return team leader at Newton, Iain Stewart. In the minds of policy makers, the transition from low interest rates to no interest rates and the shift from buying government debt (QE) to purchasing other assets appear to represent a logical and seamless progression of monetary policy.

The distortions caused by policy interventions are again being seen most clearly in financial markets. When central banks explicitly connect the rising prices of risk assets with prosperity, and provide cheap money and near-zero deposit rates to make it happen, unsurprisingly markets oblige.

The narrative of policy makers was shown to be spectacularly misguided in the last cycle. This narrative held that easing financial conditions, loosening credit constraints and boosting asset prices can mechanically lead to increased spending power and a virtuous cycle of rising spending and incomes. Asset-price manipulation also misses the important point that, in market economies, price is the signalling mechanism for economic activity.

The corporate debt markets exemplify the distortions that have arisen. According to Citigroup's credit strategist Matt King,[1] with central banks now large buyers of corporate debt as part of their own QE programmes, normal relationships have been turned on their heads.

Distortions and dysfunction

No longer do corporate credit spreads appear to widen in response to, for example, a pick-up in defaults. Neither do they appear to widen as a reaction to rising corporate leverage, falling government bond yields nor to mounting policy and economic uncertainty. Instead, it becomes all about monetary policy and this, King believes, is leading to growing distortions and dysfunction.

Although central banks deny that their policies are producing adverse effects on financial stability, similar distortions can clearly be seen in other assets, such as equities and real estate – perhaps it is in evidence in all assets. Expectations, as embedded in market valuations, seem to have diverged from the reality of a still-weak outlook for economic activity.

Further interventions may in due course transmute into hybrids between monetary and fiscal policy (such as 'helicopter money' or variants of 'people's QE' – for people instead of banks). Key to such a transition is the acceptance that injecting money into economies via the financial system (not surprisingly) enriches asset owners and exacerbates trends in wealth and income disparities set in train by globalisation. In this sense, policy settings are the UK's referendum on EU membership, the extraordinary nature of the US presidential race and the rise in populist politics generally.

Unorthodox measures that were meant to be temporary have turned out to be unceasing. Potential bad news for

1 Citi European Credit weekly: 'Seven signs markets are deeply dysfunctional', 19 August 2016.

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the financial markets has tended to be associated with ever more stimulus; the UK's EU referendum in June 2016 proved to be no exception. Central banks globally were prepared with liquidity provision around the time of the vote on 23 June 2016.

Brexit, what Brexit?

The Brexit 'rollercoaster' (market weakness and subsequent euphoria) led the popular press in the UK to prematurely declare Brexit a success. Arguably, this speaks more to policy-inspired market distortion than it does to rational discounting of what Brexit inevitably means. Moreover, much of the late 2016 rebound seen in the broader UK equity indices reflected the initial devaluation of sterling.

It seems that the UK may be on a path towards a total break with the EU (exiting both the customs union and the single market) in 2019. While there is now some clarity about the likely 'when', the enormity of the task still remains daunting and the range of outcomes highly uncertain. Whatever the ultimate impact of Brexit on the UK's prosperity, in the near term, the UK seems likely to be poorer (in GDP and currency terms) and to experience heightened economic volatility.

From an international point of view, the UK offering to the rest of the world has been a stable, business-friendly, English-speaking gateway to the world's largest consumer market. This has resulted in inward investment that has helped to offset the UK's persistent current account deficit. Without that connection with Europe, we cannot expect international business to allocate as much capital to the UK as it might previously have done. Further pressure on the currency should be expected.

Abundance

Policy may succeed in dragging future demand into the present but ever easier market conditions also encourage supply of goods and services. Indeed, it is highly probable that current monetary policy interventions are actually exacerbating the challenges to pricing power faced by the corporate sector and thus thwarting policy makers' quest for higher inflation. Put simply, persistently cheap money may be deflationary rather than reflationary.

A clear example of this is that the loosening of financial conditions prevents weak and overleveraged businesses from failing; after all, weak fundamentals are no impediment to raising cheap funds in the corporate credit markets. The desperation for income encouraged by zero and even negative interest rates has loosened covenant restrictions on borrowers and enabled maturities to be extended. Financial 'zombies' can now fund themselves far into the future. Moreover, ultra-loose conditions also alter their behaviour. Rather than profit maximisation, 'zombies' set prices to achieve cash flow and market share. In a world of plentiful supply, healthy companies have to respond by mirroring these price reductions or face a drop in sales volumes.

Technological change

Technological change is immune to monetary machinations, although the extent of disruption can be accelerated by policy. In a world struggling to generate growth, we have increasingly witnessed a scramble to invest in growth stories. Ever larger funding rounds at higher and higher valuations extend the effects of technological change more rapidly than would otherwise be the case. Consumers benefit from the advance of better, and often lower cost, goods and services. The challenge, however, is to incumbent capital and employment. Once again, the consequence is a greater loss of pricing power for both.

An investor's currency base is likely to be increasingly important, although the effect of aggressive monetary policy on foreign exchange rates reduces the ability to express strong positions. The inevitable push to do 'more' and the need to retain extremely low real yields (on account of extreme levels of debt) makes exposure to precious metals attractive to those mandates which can hold them.

The fragile and challenging growth backdrop and pricing environment emphasise the importance of cash-flow generation, strength of balance sheets, and the ability to sustain pricing, or adapt to lower prices. We believe companies that are able to sustain and grow their franchises without the need for support from a generalised cyclical upswing in demand can be expected to continue to command premium valuations. While valuations have become more challenging for many steady 'bond-like' compounders, the absence of a catalyst for a significant upswing in bond yields suggests that this differential can remain.

With little real change in the investment landscape, we do not think the trend to ever more manipulation of financial asset markets is likely to end well and this tempers our attitude to risk.

WHAT TO WATCH IN 2017

The transition towards fiscal policy.

Further weakness in sterling.

Continued investor appetite for growth stories driven by the weak yield environment.

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