Newscape Outlook for 2017

2017 could be the year of humiliation for central bankers

To understand 2017, it is worth reminding ourselves where we are now. 2016 was a transitional year that saw a "momentum crash" - a phenomenon whereby many of the prevailing trends reversed. Recall that in 2015, industrials, emerging markets and commodities sank as the outlook for the world economy deteriorated. As oil touched $27 per barrel, the overriding fear was for deflation and the price of bonds soared.

My view at the time, was that the malaise had gone too far as value opportunities were abundant. In the face of widespread fear, the world economy started to recover and the onset of deflation was averted. The oil price rallied back above $50 along with broader commodity prices. The greatest beneficiaries were countries such as Brazil and Russia that saw their markets double over the course of the year.

The surprise Brexit result caused a stir in late June that saw markets fall sharply – only to recover within days. The panic soon passed as the fears over economic collapse proved to be an exaggeration. Thereafter, the seeds of inflation were sown and the bond market took a turn for the worse. Financial stocks soared, especially after Trump was elected to be the 45th President of the United States.

A year for trend followers

In our opinion backing the past losers is often mistaken for value investing. In reality however, a stock that has fallen isn't necessarily cheap. Statistical analysis demonstrates that, as in most years, betting on the past losers has been one of the worst investment strategies on record. Instead, we believe the opportunity lies in the past winners in the hope of more to come.

It is worth remembering that momentum crashes tend to have a one-year shelf life. Normally, the big shift whereby the past losers zoom ahead of the past winners, is largely complete within 12 months. It has been known to last longer, but the impact has tended to deteriorate quite rapidly, with the strongest move in the early stages. In our view the time has come to leave alone the past losers and focus on the prevailing market trends.

The trends to look for

Looking at today's winners in the FTSE 350, that still offer reasonable value, the main theme is financials, which are closely followed by industrials. What's clearly missing from a year ago are the safe havens such as the consumer brands, utilities and property. These changes in market leadership are largely attributable to the fall in the bond market.

Industrials are likely to make further progress on the back of the impending stimulus programme. However, it is the financial sector that has been the post-Trump star. Higher bond yields and the expectation for rising interest rates throughout the year will be seen as a sign of economic strength. The Fed's own forecasts see US rates at 2.25% by the year-end (up from the current 0.75%), yet the market is more cautious – just as it was in 2015. Two year yields are still 1.2%, which is a clear sign that the bond market still sees rate hikes at a much more moderate pace.

Regardless of rates, the financial sector offers good value. With tax cuts, lighter regulation, firmer rates and government spending programmes, it would be surprising to see financials turn down. Just four months ago, there were fears that Italian banks, along with Deutsche Bank (DBK), would fail. On the contrary, DBK has rallied 80% since late September as investors have underestimated the impact of the recovery.

Despite DBK's survival, investors remain cautious. With the sector still structurally under-owned, there is a good chance this strength will prevail. This could be a good example of a "wall of worry".

Trump's policies appear to be good for America, but for the rest of the world, they are mixed. For the UK, Europe and Japan, one can only hope that it is business as usual. For Russia things should stabilise as relations improve. For Latin America, the key will be commodity prices. For Mexico, the outlook is glum, and for China, things could deteriorate.

China manages capital outflows

China remains a conundrum because intuitively, we know the economic miracle has gone too far, too soon, and without missing a beat. When Harold Wilson spoke of 4% growth in the UK in the 1960's, that was considered extreme at the time. The UK economy duly overheated only later to crash. China has spent much of the past two decades with a growth rate above 10%. This has only recently eased down towards 6%. By most measures, that is still firmly on the high side for a country of a billion plus people. It is surely unsustainable. The question is what the trigger will be.

Since the Credit Crisis, China has continued its upward journey in the face of a global slowdown. Prior to the crisis, it had an export-driven economic model. That achieved a great deal until the world could take no more. Low-priced Chinese goods have been a boon to the global consumer, but the political fallout has hits its limits – something reaffirmed by 2016's political surprises. There is a new movement to bring the jobs back home. If it succeeds in the US, the model will be replicated elsewhere. That doesn't bode well for global trade.

China's has maintained the growth rate by piling up debt. That is an effective way of bringing growth from the future to the present day. With debt levels now at uncomfortable levels, it is surely a matter of time before a crisis unfolds. According to the independent strategist, Russell Napier:

"the external surplus which saw China amass the world's largest foreign exchange reserves was not built upon trade alone. It was also based upon a capital account surplus that has been both large and persistent. That surplus has now gone and, as the decline in foreign exchange reserves indicates, it surpasses in size the current account surplus."

The falling Yuan has moved in step with the decline in foreign reserves. To make matters worse, Trump has appointed Robert Lighthizer, a harsh critic of China's trade policies as his chief trade negotiator. Unfortunately for China, which has been labeled a currency manipulator, the Renminbi is overvalued rather than undervalued. A tough year lies ahead and our strategy will be to take great caution with investments in the region.

There's just one caveat. China's economic indicators are turning up. The question is how long that upturn can last?

Commodities pause, but the trend is firm

With the widely-accepted narrative that Trump is a pro-growth president, commodity prices rallied hard after the election. We don't doubt that US infrastructure spending will rise, but do question how much of that is already priced in.

Taking copper as an example, it is a widely accepted barometer of economic activity, yet the rally appears to be ahead of events. The move in early 2016 turned the medium-term trend from bear to bull, yet the long-term trend remains less compelling. This could be overcome, but not quickly, as there is strong resistance to overcome.

The level of speculation in copper sits at an all-time high. In the short-term, the bulls are ahead of themselves. However, this was also the case back in 2003. There is a chance that they may turn out to be right, notwithstanding a likely setback in the first few months of the year. In conclusion, a near term stall seems likely before a resumption of the bullish trend later in the year.

In other commodities, the investment case is not dissimilar. And as for oil, the stall may drag on for longer, before higher prices become sustainable.

Cheap oil fuels the economy

Just consider that when you fill the tank, a typical driver is saving between £10 and £20 compared to 2014. That saving boosts disposable income, and when multiplied across the UK population, amounts to over £10 billion. Much of that will pay down debt, or be spent on life's pleasures. Collectively, cheap oil is as welcome as a tax cut and it shouldn't under-estimated how this will boost the economy.

In the past, investors have linked high oil prices to a strong economy. Historically, the boost in demand has squeezed the market. However as we enter 2017, the situation is being driven by supply. Since 2009, US production has ballooned and even the bear market drop from over $100 to $27, only shook off a small portion of that production. With the recovery in the oil price to back above $50, US production growth is back on track, and OPEC have had to cut production in order to prop up the oil price.

The history of OPEC is one of non-compliance. It seems unlikely that non-OECD production will be cut for long, and when one breaks, the house of cards could come crashing down. Currently, inventories sit near to record levels and excess production, that isn't required, is roughly 3 million barrels per day.

Investors are also over-excited. Net levels of bullish speculation, by traders that believe the price will rise, are close to an all-time high. That's a contrary indicator and explains why the price has been firm. Oil is back above $50 because speculators bought en masse, and not because demand has firmed.

The long-term outlook for oil is surely bullish, as new discoveries fail to keep up with demand. But as things stand, there is a supply glut. During the super-spike in 2008, where oil touched $148, inventories fell to 13 days. Today inventories hold 25 days' of demand, which is close to a 40 year high.

Currencies

The final question is the outlook for currencies. Of the majors, a recovery in the under-valued pound seems likely. However, the triggering of Article 50 will probably interfere with that. The yen and the euro are forecast to ease as their quantitative easing (QE) programmes drag on. QE is also seen as a headwind for the pound, but with value on its side, there is further room for appreciation as QE becomes unsustainable in the face of rising inflation.

Of course, the currency that will drive events is the dollar. The story in numbers comes from interest rate expectations. As things stand, never in recorded history has the rate differential between the US and the UK been so wide.

The norm used to be that the UK had higher inflation than the US – something that has been true most of the time. As a small island, compared to the US land mass, that's only to be expected, as a larger economy has the potential to be more competitive. However, the bond differentials suggest that US rates will be nearly 1.5% higher than in the UK over the next presidential term, that comes despite UK inflation forecasts being 1.2% higher than across the pond.

In Germany today, inflation is 1.7%, which is above the 20 year average of 1.4%. I'm not sure how many people realise this when the narrative is one of continued deflation. Germany did have deflation in the middle of 2016, and late last year, it started to surge. When you consider that growth is also above the two-decade average and unemployment is low, then the surge in inflation comes as little surprise.

While this is happening, there's Carney steering the Bank of England and Draghi, the European Central Bank. Both are serial printers that believe the world has been saved by their actions. I disagree, because similar recoveries have appeared around the world where central bank assistance has been minimal. In Europe, Greece has been excluded from the ECB's bond purchasing programme. Despite that lack of support, deflation is nearing the end and growth has turned positive.

The year of humiliation

Putting this together, 2017 could be the year of humiliation for central bankers that believe they are in control. Should the rise in inflation disconnect from oil and shift towards wages, then these ex-Goldman Sachs masters of the universe, will have egg on their face. They will lose control of events and markets will revert back to where they should be.

Under this scenario, Bund and Gilt yields will soar, and the euro and the pound will rise along with them. 2017 could see further upsets for the establishment. And that's before anyone mentions Le Pen.

Summary

The rise in inflation is likely to be a major theme. The surprise might be that it comes from wages rather than commodity prices. Following the commodity boom between 2002 and 2011, the entrepreneurs responded to the challenge and found all the world needs for the foreseeable future. To squeeze that supply, you'd need to see the world economy boom. That's entirely possible, but China will be the swing factor.

As for the politics, we can be sure it'll be an eventful year. Most likely the changes will be pro-growth and broadly positive for financial markets. The changes attempt to drag the world back towards to historic norms and draw a close to the post-crisis era.

Disclaimer

All information provided is from Newscape Capital Group Ltd ("Newscape") and is for informational purposes only. This market outlook is for informational purposes only and is approved and issued by Newscape which is authorised and regulated by the Financial Conduct Authority (193700). It is intended only for use by Financial Advisors and not for distribution to retail investors, if you are uncertain with regards to your eligibility you should seek independent professional advice on the matter. This document does not constitute professional advice, or an offer, or a solicitation of an offer, to sell securities and no securities are to be offered or sold other than to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses, or otherwise in circumstances which have not resulted and will not result in an offer to the public within the meaning of the Financial Services and Markets Act 2000. Past performance is not necessarily a guide to the future performance, investments can go down as well as up. Market and currency movements may cause the value of investments and the income from them to fall as well as rise. Unless otherwise stated, the source of all figures contained herein is Newscape. Whilst all reasonable care has been taken in preparing this document, the information contained herein has been obtained from sources that we consider reliable but we do not represent that it is complete or accurate and it should not be relied upon as such. Neither Newscape, its officers or employees shall be in any way responsible for its content. It is the responsibility of all users to be informed and to observe all applicable laws and regulations of any relevant jurisdiction, and to satisfy themselves that their use of this information and any subsequent investment in the portfolio is permissible under the applicable laws, rules and regulations of any applicable government, governmental agency, or regulatory organisation where they reside. This document is valid as of January 2017.

Contacts

Newscape Capital Group
86 Jermyn Street
London SW1Y 6JD
E: info@newscapegroup.com
T: +44 (0)20 7024 4810
F: +44 (0)20 7024 4811