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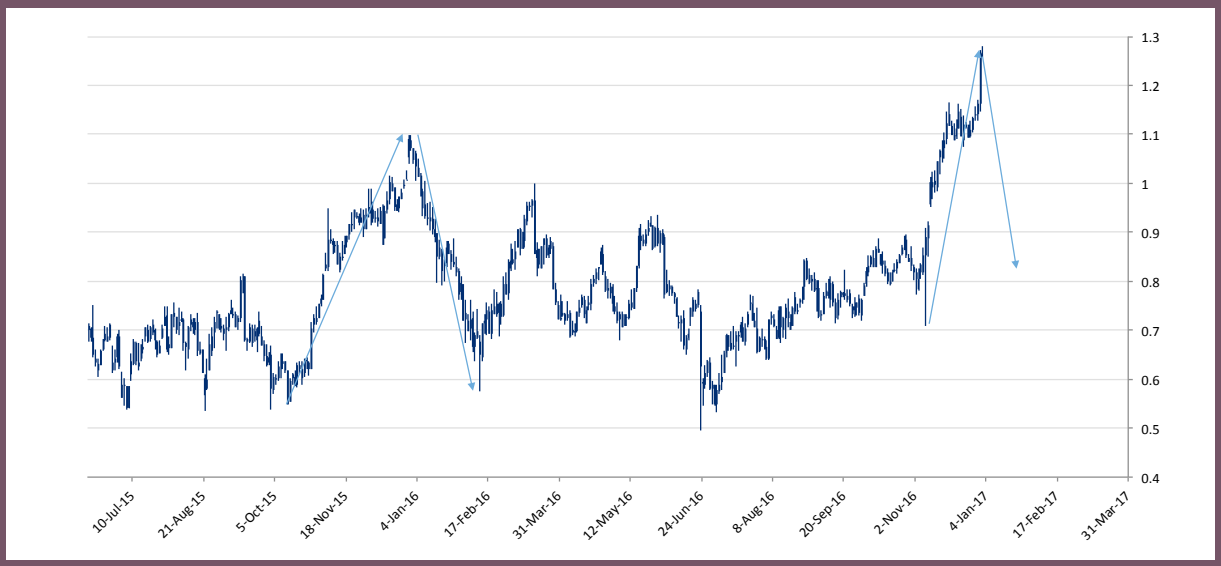
Investment Outlook

December 2016



Top chart shows: US two year treasury yield in %

Deja Vu

Market wrap: November marked yet another shock this year with Trump winning the US presidency. While we discussed in detail its implications on markets in our previous edition, here we look back at the performance of key asset classes and discuss the outcome of the first Fed meeting since the elections and views on the economy.

During the month, US indexes ended on a positive note, the S&P 500 adding 3.42% and the DOW 3.1%; in Europe markets were more tamed as the DAX fell 0.23% and the EuroStoxx 50 dropped 0.12%. Emerging markets did not fare too well and got penalised by the selloff in their currencies and credit widening on the back of Trump's protectionist policies; consequently the MSCI EM lost 4.67%. The month also saw the success of OPEC in cutting output after long months of negotiations, a move that helped propel crude oil prices by 5.5% in the last trading day.

The most significant move came in interest rates worldwide, ignited by the US economic growth and inflation expectations. Bond markets around the globe suffered significantly, led by US yields moving 55 points to 2.38% on ten years towards the end of the month. This was a considerable shift if we consider the unusually low volatility the bond market has seen prior to the elections result. The implication of rates movement are large and far fetching as they affect currencies, loans, mortgages, borrowing costs, etc. Therefore, it is essential to understand where rates could be heading in the future in order to determine the ideal asset allocation.

Marking the anniversary of the first rate hike

The Fed responded to investors by raising rates for the first time in 2016, with a more-than-expected hawkish language which resulted in rates moving higher – since the election results the yield curve between the five and the ten year maturity has shifted upwards by about 75 bps, while on the longer end the 30 year gained less, up by only 50 bps. The market now has fully priced in future rate increases, but since markets are not always perfectly efficient, we expect to see a further but moderate deterioration. We think the 10 year yields could reach 2.75%-3% in 2017; however, the markets will be more sensitive to economic data going forward until the next meeting, where we will wait to hear more on timing of the hikes.

The chart above provides an insight into what could happen following a rate hike by the Fed; exactly one year ago, rates were raised for the first time since QE began and it was assumed four more hikes would happen in 2016. Looking back at the past year, we only saw one hike; the reasons for that are many, with both similarities and differences to today's market conditions, both of which are necessary to examine to understand whether we will see the Fed sticking to their plans or disappoint the markets again.

By being more hawkish than expected the Fed made a strategic move to gain the upper hand on market expectation and lead rather than be led, a topic we had touched on in our previous writings. They were able to achieve this because they currently have more

room to manoeuvre compared to 2015: markets are at record highs, yields are sharply higher in anticipation of growth and inflation, and therefore the impact of a bullish guidance would have a less detrimental effect than last year's. Looking back at what happened then, markets across the world sold off sharply after the rate hike, with stocks, emerging markets, crude oil, Perps and Cocos coming down substantially. That reaction caused the Fed to reverse track and change the hawkish tone, postponing and reducing their initial predictions to just one hike during 2016. The question that begs now is: Will we see last year's pattern again in 2017? So far, the market seems to have digested well the rate hike, but it is worth remembering that just as it happened in 2015, by January all hell broke loose.
We think this time it could be different, but only slightly.

Similarities and differences

Today's US economy seems to be more resilient that what it used to be in 2015.
First of all, the unemployment rate stands at 4.6% compared to 5% last year, a clear sign the labour market is stronger, job creation sturdy and we are very close to textbooks' full employment. In short, the market can absorb higher rates today better than it could during the previous year.
Secondly, core price inflation was at 1.4% last year versus 1.7% currently. This is still a tad away from the Fed's 2% long-term target, but markets are expecting it to move soon since Trump seems willing to reflate the economy. On this point we have some doubts that inflation will materialise as fast as markets expect, given the time-lag of any economic policy. The CPI and PCE data will greatly influence rates going forwards should they be slower than expected.
Thirdly, with the Dow Jones industrials close to 20,000 points and the S&P 500 8% above its 2015 level, a correction from here will not be important enough to provoke the Fed to change its path.
Adding the three together, we think markets will be more resilient to this year's tightening than they were last year. In our opinion we might see a smoother replay of the 2015 post-rate hike and, should history repeat itself, we expect a mean reversion trend which could take the S&P 500 back to 2,180 and the two year yields close to 0.8%.

Investment Conclusion

The path of rates is clear, markets have largely priced in the fiscal and monetary policies laying ahead and when equity valuations are at their highest downside risks to fundamentals tend to be more easily quantifiable. We think negative news are more likely than positive ones and that a correction in equities could come from either future disappointments or merely by profit taking.
This means that investing in bonds today could prove to be the winning strategy of 2017.

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