Media Release

Investing amid political uncertainty

London 13 December 2016: Columbia Threadneedle Investments 2017 Market Outlook

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- Political uncertainty, rising populism and policy divergence will continue to dominate in 2017. Interest rates have moved away from emergency settings in the US and are likely to continue along a hiking path, but monetary policy in Europe and Japan will remain very accommodative. Sharp changes in politics suggest that an easy monetary policy stance is likely to remain commonplace while the US pulls away with President Trump at the helm.
- The outlook for the Asia and Emerging Markets (EM) will be challenging for those countries that are exposed to the threat that Trump poses with protectionist policies including China, Mexico, Colombia, Malaysia, Korea and Thailand.
- A world where the US tightens policy but other central banks retain an accommodative stance should mean a stronger US dollar, all else being equal. That is likely to be a further headwind for EMs, as there is a strong inverse correlation between the dollar and EMs.
- Asia is generally looking more promising, with attractive valuations, competitive currencies and an upward trend in earnings revisions, resulting in increased flows into the region.
- We still regard equities as more attractive than bonds and expect to retain that positioning for now in our asset allocation portfolios, although with less conviction than we have done for some time. Compared to their longer-term history, equities still offer better value than bonds – though this could change, should the 'bond bubble' burst in 2017.
- We have a more optimistic view on commodities for next year. QE has sent a false signal to producers to keep investing, which has led to current price levels reflecting the overshoot required to force producers to close mines and oil fields, this in turn will stimulate demand
- Overall the continued political uncertainty could make global equity markets more volatile and the underlying fundamentals more challenging. This should present active investors with an opportunity to demonstrate their value.

A time for active investors

In 2017 we expect opportunities for active, discerning investors to increase. Amid rising political uncertainty, fundamental analysis and expert asset allocation will be critical in order to achieve long-term returns.

In this world, a focus on valuations and fundamentals – 'old school' investing if you like – should be more important than it has been in recent years, when markets were backstopped by abundant and growing liquidity.

Europe: geo-politics to take centre stage
The US markets have become increasingly important for Eurozone exports, so changes in Trump's stance on international trade could impact Europe too. However, the more pressing issue is the upward trend of support for European populist parties. The potential for political instability in Europe is rife with a number of elections and referendums in 2017. This has been kicked off by the resignation of Italian Prime Minister Matteo Renzi after an overwhelming majority voted against the recent referendum he proposed, throwing Italy into uncertainty at a time when its banking system is particularly vulnerable. In 2017 we will see the Dutch, French and German elections to name but a few European political events. If there were to be a move toward populism in any of these countries, there could be destabilisation of an already fragile economy if a significant member state were to leave the single currency.

Any speculation that the European Central Bank (ECB) might remove QE or at least start tapering has been met by a sell-off in Euro Area fixed income assets and a sharp rally in cyclical stocks, though we do not see a move of this kind being considered until later in 2017, if at all. Although the back-up in bond yields has not been as intense as 1994 or 2004, the rise in cyclical equity prices has hurt the relative performance of European equity portfolios, even as such stocks appear increasingly overbought. If we see a weaker euro this would benefit the region, with 55-60% of sales generated overseas; however, with so many other moving parts this is not something to be relied on. For the market as a whole, 5%-10% earnings growth in 2016 and 2017 seems achievable. However, three scenarios could challenge this view: an ECB 'taper'; sharp rises in US bond yields; and European politics – these are the key things that investors in Europe should look out for next year.

Fixed income: is the 'bond bubble' about to burst?
2016 has been another great year for fixed income but now we have a scenario where the market is displaying 'bubble-like' characteristics. Trillions of dollars of bonds have yields well into negative territory, meaning yields are well out of kilter with growth and inflation and real yields / term premia have been squashed globally. This is a concept that we have discussed before and we suggested that perhaps the election of Donald Trump would be the catalyst that bursts the bubble. The rationale keeping the bubble inflated for now is that low global growth and inflation have a strong correlation with low interest rates and low bond yields and the general feeling that rates should indeed be depressed. Maybe in 2017 the hope that 'this time is different' will be shattered for the bond market after Trump's inauguration leads to a change in the economic setting.

Trump's victory led to a pick-up in bond yields as markets started to anticipate the promised fiscal response and resulting uptick in inflation that would take place once Trump is inaugurated. If significant fiscal policies are put in place then this would be less positive for bonds going forward as it could put an end to the 'lower for longer' environment that had benefited fixed income. However, there is a big question mark over where the funding for significant infrastructure projects would come from and, even if found, for fiscal spending to translate to growth would take some time. Perhaps this misses the point though – the Fed will most likely continue on a rate hiking path and maybe the commitment to do more will be enough to set the wheels in motion and for markets to see a turnaround.

The big question for investors is how bonds are being used. Bonds have typically been used for diversification and hedging purposes, but with increased correlation between asset classes during stressed market environments (when diversification is most needed), new methods of hedging are arguably needed. Core government bond yields are unattractive and are close to the most expensive levels in history; however, investment grade and high yield credit spreads still appear reasonable, suggesting opportunities in credit markets remain.

To find yield and attractive risk-adjusted returns, investors need to choose carefully. Broad credit spread dispersion within the global investment grade index suggests that value can be realised using security selection. The credit cycle is not yet over but it is time to be more cautious. Easy policy conditions and low stable growth and inflation and have led to positive excess liquidity (though this could be challenged if QE begins to be reined-in next year and rate rises start again, leading to rising inflation in some regions). As geo-political risk continues to increase, volatility in markets is likely to increase and spreads could tighten to the point of being overstretched.

Emerging markets: the 'Trump effect' will create opportunities for investors

The impact of the Trump administration on EMs could be significant, but comes with perhaps even greater levels of uncertainty. Mexico, Colombia, Malaysia, Korea and Thailand are the countries most exposed to US protectionism. But the key difference today is that the aggregate current account position of EMs is in surplus today, rather than in deficit as was the case during the taper tantrum of 2013. Moreover, EM real yields are meaningfully more positive. Also, those countries with the largest current account deficits (South Africa, Turkey) are seeing appreciable currency weakness.

On the EM equity side, earnings revisions have been improving for the first time in a number of years and valuations are low compared to developed market equity markets – and on an outright basis are in line with 20-year averages.

If the point of Trump's protectionist rhetoric is to skew future investment away from EMs, then we may have seen an over-reaction and this can create good opportunities for investors. The obvious concerns are Mexico and China where most of the negative rhetoric by Trump has been focused. The hope is that the Senate and Congress can temper some of this and a sensible middle ground can be reached before anything too dramatic occurs. Nevertheless, it is worth asking whether the American public that voted for Trump will be happy if the Mexican wall fails to appear. On the other hand there is scope for any prospective normalisation of Russia's relationship with the West to correspond with market growth from a re-rating, but the economic boost that China witnessed from easing in the property market is likely to ebb as sales volumes have begun falling, and we can expect corresponding construction growth to slow in the first half of 2017.

Asia: attractive valuations

A Trump presidency introduces uncertainty with regard to the outlook for China's exports with the threat to impose punitive tariffs on Chinese imports. The US has become China's largest trading partner again (18% of total exports); however, it is worth remembering that the Chinese economy has already re-balanced significantly away from exports – net exports as a share of GDP has fallen to 3.4% from 8.6% pre the Global Financial Crisis. If the US becomes more protectionist under the new president, China is likely to accelerate its push to diversify its export markets more towards emerging markets and generate more momentum behind projects such as 'One Belt and One Road'.

Uncertainty is furthered by the outlook for the renminbi in the face of a stronger US dollar and whether the new US President labels China a currency manipulator. In equities this means domestically-oriented stocks in China should be favoured, particularly in the services space and those stocks that are in a position to build multinational business platforms.

More generally in Asia we see opportunities to invest. Valuations are more attractive, currencies more competitive and earning revisions are trending upwards, all of which are reflected by the increased flows into the region. However, with downward revisions to global growth forecasts, we are likely to experience heightened volatility, reflecting greater uncertainty. The more export-orientated markets of North Asia are most likely to be directly impacted in the short term, which will postpone the anticipated trough in their export performance. The more domestically-orientated markets of South East Asia, on the other hand, may prove more resilient given supportive domestic demand trends and scope for further monetary easing.

UK: reasons for optimism amid Brexit uncertainty

Arguably Brexit is just a symptom of excessive global debt and the inequalities that have only widened in a QE world – now the UK needs to embrace free trade outside the EU. Since the referendum, UK GDP and other data has been positively surprising and although this could simply be because Brexit itself hasn't actually happened yet, it has been argued that Brexit will help the UK to rebalance and reduce its reliance on the property market. In 2016, the UK would have had one of the best rates of economic growth among the G7 (though with expectations of earnings at 1% in 2017 the outlook will be more challenging). Nevertheless, factoring in the collapse in sterling has helped with the current account deficit and has also helped the UK seem relatively attractive, though the full benefits of this are yet to be felt. Perhaps this could attract foreign investment back into a country from which some investors have fled?

With the additional implications of President Trump's plans, sectors such as mining seem less attractive; however, there is still a cautiously optimistic case for UK equities despite the ever-looming uncertainty of how Brexit will come to pass. In the meantime, there are plenty of opportunities for the skilled active manager to find quality investments in the UK.

Commodities: prices set to rise

The rally in commodities from 2009 to early 2011 was primarily driven by QE in the US and the China stimulus. QE sent a false signal to producers to keep investing, which has led to current price levels reflecting the overshoot required to force producers to close mines and oil fields. This in turn will stimulate demand and leads to our more optimistic view on commodities for next year. Commodity prices have remained low over the last two years providing a boost to consumers from lower oil prices in developed markets and low food prices in EMs. Perhaps it is time for an increase in prices here too.

The growth outlook for EMs is more favourable and with monetary policy having been largely exhausted and the rising populism revolution, fiscal expansion could be on the horizon. Fiscal stimulus in the form of infrastructure construction is of course positive for commodities and even without that infamous wall there will be plenty to do in the US and more widely that could benefit the commodities industry.

As Walt Whitman said: 'The future is no more uncertain than the present'. If that holds true then 2017 will be a year of volatility as markets make sense of the promises and policies the politicians have promoted. Perhaps we will see a long awaited turnaround and a path back to pre-crisis levels? That said, it is about time that we accept that there may be a new norm in town. Either way, volatility in markets provides the perfect opportunity for active management.

Figure 1: Columbia Threadneedle Investments EMEA – asset allocation positioning

	Strongly Dislike	Dislike	Neutral	Favour	Strongly Favour
Asset Allocation		I/L Government	Equity Cash Credit	Property Commodities	
Equity Region			EM US EU x UK UK	Japan Pac x Japan	
Global Equity Sector		Energy Real Estate Materials Utilities Telecoms Consumer Staples	Financials Consumer Cyclicals	Industrials Health Care	Technology
Bond – FX Hedged		Japan	Germany US UK	Nordics Australia EM Local	
Credit			Corporate IG EMD	Corporate HY	
Commodity			Livestock Softs Energy	Base Metals Precious Metals Grains	
FX		JPY AUD EUR GBP	Nordics	USD	
Portfolio Risk		X			

Source: Columbia Threadneedle Investments, December 2016.

Figure 2: Columbia Threadneedle Investments EMEA – GDP forecasts 2016/17

	GDP forecasts	
	End 2016 (%)	**End 2017 (%)**
US	1.5 (1.5)	2.0 (2.2)
Euro area	1.6 (1.6)	1.1 (1.3)
Japan	0.7 (0.6)	1.0 (0.9)
UK	2.0 (2.0)	1.0 (1.1)
Brazil	-3.2 (-3.3)	1.2 (1.2)
Russia	-0.4 (-0.6)	1.5 (1.2)
India	7.3 (7.6)	7.4 (7.6)
China	5.5 (6.7)	5.0 (6.4)

Source: Columbia Threadneedle Investments, December 2016. Figures in brackets represent current consensus view.

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Notes to Editors

About Columbia Threadneedle Investments
Columbia Threadneedle Investments is a leading global asset management group that provides a broad range of actively managed investment strategies and solutions for individual, institutional and corporate clients around the world.

With more than 2000 people including over 450 investment professionals based in North America, Europe and Asia, we manage €416 billion[1] (£361bn / US$468bn) of assets across developed and emerging market equities, fixed income, asset allocation solutions and alternatives.

Our priority is the investment success of our clients. We aim to deliver the investment outcomes our clients expect through an investment approach that is team-based, performance-driven and risk-aware. Our culture is dynamic and interactive. By sharing our insights across asset classes and geographies we generate richer perspectives on global, regional and local investment landscapes. The ability to exchange and debate investment ideas in a collaborative environment enriches our teams' investment processes. More importantly, it results in better informed investment decisions for our clients.

Columbia Threadneedle Investments is the global asset management group of Ameriprise Financial, Inc. (NYSE:AMP), a leading US-based financial services provider. As part of Ameriprise, we are supported by a large and well-capitalised diversified financial services firm.

Source: Columbia Threadneedle Investments as at 30 Sept 2016

[1] Source: Ameriprise Financial Q3 2016 earnings release.

www.columbiathreadneedle.com

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