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Investment Commentary

Quarter Four 2016

INTRODUCTION

Well, so much for 2016: the year that brought us Brexit and President-Elect Trump – and a host of ‘experts’ muttering “how did we get it so wrong?”

What will 2017 bring? We’ve had a look into the crystal ball in one of the special sections below. It’s going to be an eventful year…

…but first, let’s look back on 2016 in general and the last quarter of the year, in particular. It was a quarter that saw the US Election and the first Autumn Statement from UK Chancellor Philip Hammond – as well as some excellent performances from the stock markets which we cover in this report.

UK

This time last year, David Cameron was gearing up to negotiate a deal with his European colleagues that would secure victory for the 'Remain' camp in the EU Referendum. Well, we know what happened and by the end of March 2017, Theresa May must trigger Article 50 and begin the formal process of the UK leaving the EU. She has repeatedly said that "Brexit means Brexit" – but it remains doubtful as to whether the picture will be any clearer come 1st April.

The man charged with steering the UK economy through the period leading up to Brexit is the new Chancellor, Philip Hammond, aided by the Bank of England Governor, Mark Carney, who has now confirmed that he will remain in that position until 2019.

Hammond duly delivered his first Autumn Statement in November (announcing at the end that it would also be his last) and concentrated on a largely cautious set of measures. There was a heavy reliance on investment in the UK's national infrastructure as Hammond stated that he was determined to "build a country that works for all."

He announced that forecasting over the next five years would be more difficult than usual but some commentators are starting to feel that he may have been over-cautious. There has certainly been plenty of good news for the UK over the last three months: Nissan committed itself to its Sunderland plant, announcing plans to build both the Qashqai and the X-Trail SUV there, following Government "support and assurances." In December, the uncertainty came to an end for the steelworkers at Tata's Port Talbot plant when the company gave a commitment to secure jobs and production there and at other steelworks across the UK.

The growth of the UK economy was revised upwards for the third quarter – from 0.5% to 0.6% - and figures released early in the New Year showed that manufacturing orders and output had hit their highest level for 2½ years.

The feelgood factor certainly manifested itself on the stock market, with the FTSE 100 index of leading shares ending the year at a record high of 7,143 – up by 4% in the final quarter and 14% for the year as a whole.

EUROPE

If there has been one constant in the European section of this report it is the German trade surplus each month. The last figure available is for October, when the surplus was €19.3bn. Unemployment in Germany is at a 35 year low of 4.1% and inflation is steady at 0.8%.

That's not to say that individual German companies are not having problems. Volkswagen continues to suffer from its emissions scandal and has just reached another settlement – this time with the US authorities over 80,000 VW, Audi and Porsche cars. It has also announced plans to shed 30,000 jobs.

Another German company having problems in the US was the beleaguered Deutsche Bank, fined $7.2bn over mis-selling of mortgage backed securities. However, the real banking problems appear to lie in Italy, where several banks are in trouble from years of bad debts and loans that will never be repaid. The Italian government may well seek €20bn from the European Stability Mechanism, although Angela Merkel has apparently ruled out EU aid for the country's banks.

The chief sufferer among the banks is Monte dei Paschi, the world's oldest bank, which failed to raise the €5bn it needed to re-capitalise from private investors. The Italian government was forced to step in, with the bank crippled by years of losses. Before Christmas, the bank's funding shortfall was put at €5bn – a less festive assessment after the holiday put the figure at €8.8bn.

Commentators are now predicting a "period of uncertainty" in Italy. With the government of Matteo Renzi having been heavily defeated in a referendum on constitutional reform in early December, "uncertainty" may prove to be an understatement as we enter 2017.

However, there was no uncertainty on the main European stock markets with both the German and French indices up by 9% in the final quarter. The German DAX index closed the year at 11,481 – a rise of 7% for the year as a whole. The French index was up 4% for the full year, closing on 31st December at 4,862.

Finally, a word for our old friend, Greece, where the far-left government of Alexis Tsipras is becoming increasingly unpopular as it fails to deliver its promised populist reforms. Don't be surprised to see the country feature rather more prominently in this report next year – but in the short term the stock market followed the lead of Germany and France, rising 14% in the final quarter of the year to close at 644.

LOOKING AHEAD TO 2017

It's tempting to think that nothing can follow 2016. Brexit, President Trump… Surely there can't be another year with as many shocks reverberating around the world?

Don't be so sure: 2017 has the potential to be equally as dramatic. March will bring us an election in Holland: at the moment the signs are that the far-right Freedom Party will win the most seats. This doesn't mean that its leader, Geert Wilders, is likely to be the next Dutch Prime Minister. It does mean that he will have a greater influence on Dutch – and hence European – politics.

By early May, we will know who is to replace Francois Hollande as the new French President. Right now, the polls seem to favour the self-confessed fan of Margaret Thatcher, Francois Fillon. But don't discount Marine le Pen, leader of the Front National: a victory for her would send shockwaves through Europe and could well lead to the break-up of the EU. It currently seems unlikely that she will be the next President of France, but this time last year both Brexit and President Trump were deemed far more unlikely by the 'experts.'

September sees elections in Germany and Angela Merkel's bid for a fourth term as Chancellor. Expect her to come under increasing pressure from the right-wing Alternative fur Deutschland, especially if the summer brings a continuation of the refugee crisis and/or more terrorist attacks. AfD are likely to become the first far-right party represented in the Reichstag since the Second Word War, but in insufficient numbers to prevent Mrs Merkel's fourth term.

Across the Atlantic, we'll see the inauguration of President Trump on Friday 20th January. He's likely to devote a lot of his efforts to negotiating new trade deals with China. Expect some warm words between the White House and the Kremlin as well – which will send shivers through the Baltic States and Poland.

The big event in China will be the 19th National Congress of the Communist Party. This will be held in the Autumn and all the signs are that it will see President Xi Jinping consolidate his hold on power, with five politburo members standing down, all likely to be replaced by Xi loyalists.

UNITED STATES

We all know the result by now: by 306 Electoral College votes to 232, the 70 year old billionaire Donald J Trump defeated Hillary Clinton and will soon be sworn in as the 45th President of the United States.

Donald Trump has stated that the US will quit the Trans-Pacific Partnership – a trade agreement with countries around the Pacific Rim but excluding China – on his “first day in office.” For now, it is probably best to wait and see whether the rhetoric of the campaign trail gives way to the harsh realities of the Oval Office. As we’ve commented elsewhere, however, the new President is likely to spend a large part of his first year in office dealing with China.

So far, he seems to have been successful in his declared aim of protecting American jobs. Japanese company, SoftBank, is to invest $50bn in the US, creating up to 50,000 jobs and Ford have just abandoned plans to move some production to Mexico: instead, they will now invest $700m to enlarge their plant at Flat Rock in Michigan.

It was confirmed that the US economy grew at its fastest pace for two years in the third quarter. For the three months to September, the economy grew at an annual rate of 2.9%, with analysts having predicted just 2.5% - and so it came as no surprise when the US Federal Reserve raised its benchmark interest rate by 0.25%, only the second increase in a decade. The rate was moved to a range of 0.5% to 0.75% as the Fed cited stronger economic growth and rising employment. Some analysts are expecting further rises, with Kathleen Brooks of City Index saying, “the US economy will be on fiscal steroids in the next few years.”

Trump’s Presidency is widely expected to be favourable to business and new Treasury Secretary Steven Mnuchin has vowed a tax overhaul ‘not seen in decades’ in a bid to boost the US economy. This mood certainly infected the stock market, with the Dow Jones rising 8% in the final quarter of the year to 19,763, where it was up 13% for the year as a whole.

FAR EAST

At the beginning of the year, the Chinese government set a target of 6.7% for economic growth: although the figures for the final quarter are not yet available, so far it appears to be exactly on course – to no-one's surprise. There are some suggestions that the real rate of growth is below the government-determined figure and there are some worrying signs about the world's biggest economy.

The principal concern focuses on the levels of Chinese debt. At 260% of GDP, it is worryingly high and October saw the International Monetary Fund warn about the extent of both corporate and personal debt. China is edging towards "a financial calamity," said the IMF and must, "wean itself off addiction to debt."

The ratio of government debt to GDP in China is around 66% - which compares unfavourably to India, the world's fastest growing economy, where it is just 41%. But why should we worry? In the UK it's 84%.

One small point to note is that Zhou Xiaochaun, the head of China's central bank and the man who's steered the economy for 15 years, will step down in 2017. We've written elsewhere about President Xi cementing his hold on power, and you can expect Zhou's successor to be a committed supporter of the President.

And what of Japan, the other main power in the region? As we'll see below, its stock market ended the year very strongly, once more putting its faith in the 'Abenomics' of Prime Minister Shinzo Abe. Figures released for the third quarter showed that the economy had expanded more than expected, due to higher exports. GDP grew at an annualised rate of 2.2% in Q3, the third consecutive quarter of expansion, although there are some fears that a Trump Presidency could hurt the Japanese economy if the anti-free trade rhetoric becomes a reality.

The final quarter was not a good one for two household names in the region. First of all, Samsung had to tell owners of Galaxy Note 7 to turn them off as the phone developed a worrying propensity to explode and/or catch fire: $20bn was wiped off the company's share value in two days.

The shares of Toshiba also suffered a sharp nosedive, falling by 40% between Christmas and New Year on worries that its US nuclear business – responsible for a third of the company's revenue – may be worth less than previously thought.

How did all this excitement translate onto the region's stock markets? 'Mixed' is probably the best answer we can offer. China's Shanghai Composite Index ended the year at 3,104, down 12% for the year as a whole but really all the damage was done in the first quarter: the index was up 3% for the final three months of the year. Hong Kong closed at 22,001 – virtually unchanged for the year as a whole and down 6% in the final quarter. The Japanese market also managed to stand still in 2016, closing at 19,114 for a rise of just 80 points in the year: but it did enjoy a rise of 16% in the final quarter. Finally, to the always unspectacular South Korean market: despite Samsung's problems, it only fell 1% in the final quarter and ended the year up 3% at 2,026.

EMERGING MARKETS

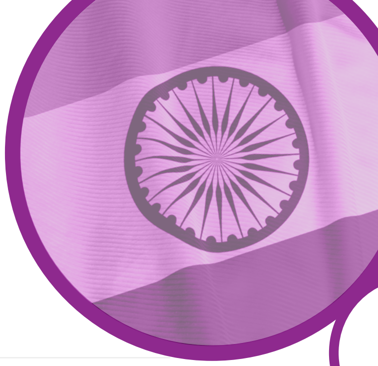
We've written elsewhere about the Indian economy – now the fastest growing major economy in the world and likely to be a key driver of economic growth in both the region and the wider world over the coming years. But the Indian financial system received something a shock in the last quarter of the year, as the 1,000 and 500 rupee notes (roughly equivalent to £12 and £6) were scrapped, in a move described as a "surgical strike" on tax evaders. "Honest people have nothing to fear," said Finance Minister Arun Jatley. Sadly, both honest people and tourists were left queuing hopefully at cash dispensers as the surprise move caused widespread chaos. Hopefully, they'd found some cash by December as the deadline for handing in the banned notes came and went.

There were also changes to the Indian tax system in moves called 'the biggest reforms since independence.' The new Goods and Services Tax is an attempt to introduce a simplified, countrywide system, to replace the previously fragmented state to state system.

The final quarter of the year wasn't a good one for Brazil's oil producer, Petrobras, which announced massive losses for its third quarter. Analysts had been expecting a profit: instead the company announced losses of 16 billion reals, equal to £3.86bn.

In Russia, a major stake in Rosneft, the country's largest oil producer, was sold as commodities trader Glencore and Qatar's sovereign wealth fund together paid $11.3bn for a 19.5% stake in the company. Russia has been looking to sell some state assets in a bid to balance its budget and end a two year long recession.

Despite the problems at Petrobras, the Brazilian stock market took the honours for 2016 among those we cover in this report. It closed the year at 60,227 – up a modest 3% in the final quarter but a spectacular 39% for the year as a whole. The Russian market did almost as well, enjoying a 13% rise in the final quarter of the year to end 2016 at 2,233 – a rise of 27% for the year as a whole. The Indian stock market, on the other hand, had a much more subdued year: overall, it was up just 2% to 26,626 having fallen back by 4% in the final quarter.



EMERGING MARKETS

We've made reference previously to India now being the fastest growing economy in the world, so we thought it might be useful to give some more detail about its economy – which will be one of the main drivers of global economic growth over the next 50 years.

India now has a population of 1.34bn, compared to China's 1.38bn. It's important to note that India's population grew by 10m more than China's last year – so it's entirely possible that India could one day overtake China in both economic and population terms.

Currently, India is ranked as the 6th largest economy in the world with an estimated Gross Domestic Product of $2.3tn for 2016.(The UK is currently the 5th largest economy, with a GDP of just under $3tn.)

Over the past two decades, India's economy has grown at approximately 7% a year, with 7.3% growth expected for 2016 (compared to the 6.7% expected for China). The World Bank has forecast growth of 7.6% to 8% for 2017.

The long term outlook for India's economy is good, as it has a young population (hence low dependency rates). India has the potential to become the world's third largest economy within ten years and one of the top two by the middle of the 21st Century.

Much of this growth is based on India's rapidly expanding service sector, which has had a growth rate of approximately 9% a year since 2001 and contributes more than half the country's GDP. IT, software and business process outsourcing are particularly prominent. Agriculture, manufacturing and the motor trade are also significant contributors to the economy, and India has one of the world's fastest growing e-commerce markets.

For those interested in the numbers, inflation is 3.63%, unemployment is just below 5% and the Reserve Bank of India has just surprised most observers by holding interest rates steady at 6.25%.

CONCLUSIONS

So that's that for 2016. As we've written above, 2017 may well be every bit as dramatic. We will, of course, be here to keep you up to date with all the news and to answer any questions you might have.

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