Drawing Meaning From 2016, And A Roadmap For 2017

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Part 1: The Year In Review

"*1916 was a dreadful year. 1917 will surely be better*"

—Tsar Nicholas II of Russia

My aim is to look at the key events of last year and draw lessons for 2017

The year 2016 will be remembered fondly by few. Regardless of their political persuasion, most clients I have met recently were as happy as Nicholas II to put the past year behind them. Yet, while most active managers will understandably be keen to turn the page on a tough year, it still makes sense to look at the key events we have just endured. From these, I hope to draw lessons for the coming year.

This paper is long in part because a lot happened in the past year. However, my goal is not to review every event in detail. Entire books have already been written on some of 2016's hotter topics (immodestly, I would claim that some of the better books have been written by Gavekal writers—on China's shifting landscape see Arthur Kroeber's: ***China's Economy-What Everyone Needs to Know***, and Tom Miller's forthcoming ***China's Asian Dream***. On Donald Trump's election, Italy's inability to reform, the impact of extremely low interest rates and overly loose monetary policies, see Charles's most recent book: ***Stagnation Or Bust?***).

The aim of this paper is thus not to rehash, or even resume, arguments and discussions we have made before (everything we have written—the good, the bad and the downright embarrassing—is archived on our website). Instead, this paper aims to first review the events that impacted markets in 2016. Second, it attempts to draw lessons in a way that hopefully helps our clients navigate 2017 more efficiently.

1— January and the China fears

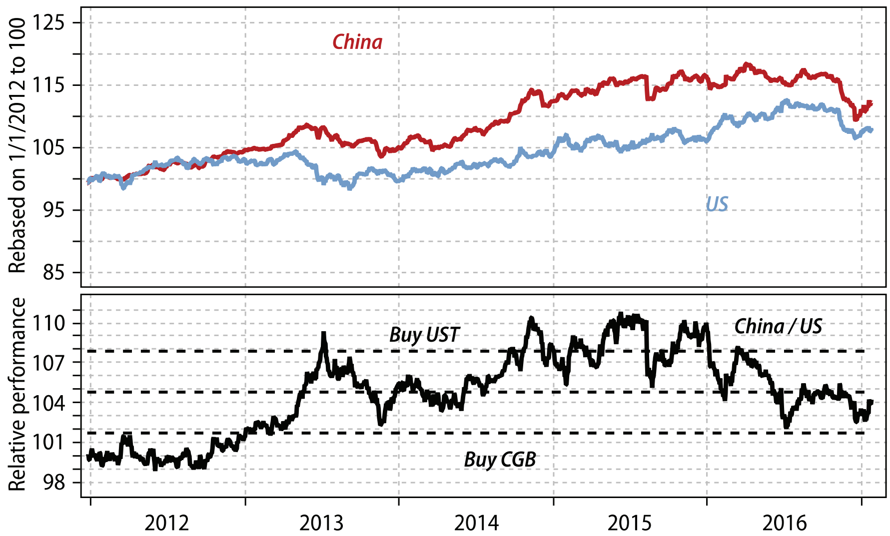
2016 started with concerns of renminbi devaluation and a deflationary shock, and commodity prices plunged

2016 started off with similar concerns to those that rocked markets in the summer of 2015, namely, a massive renminbi devaluation which would deliver a major deflationary shock to the rest of the world. Commodity prices plunged and fears mounted that a big ore producer may fail. There were also worries that adverse market movements could inflict serious damage on the fragile and stretched balance sheets of many banks.

But lo and behold, China did not devalue, or at least not in a way that would have allowed the many renminbi shorts to make money from the trade. With the renminbi falling broadly by the interest rate differential between treasuries and Chinese government bonds, the People's Bank of China ensured that the renminbi's credibility as a potential reserve and trading currency was not unduly affected; i.e. central bankers who, at China's behest, had shifted a portion of their reserves from treasuries to CGBs five years ago were not left sitting on losses (see chart overleaf).

Evolution of a US$100 invested in in 5 year CGBs & treasuries

Merrill Lynch 5-7 year government bond index, total return in USD



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Investors in Chinese government bonds were not left with losses

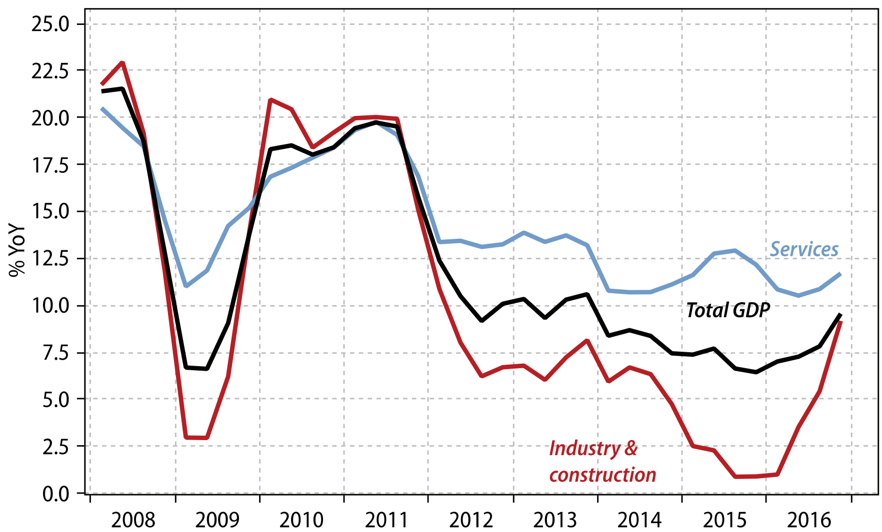
And instead of collapsing, Chinese growth was once again stimulated by a Chinese government whose ability to pull policy levers remains potent.

The Chinese government managed to support growth in the very sector that skeptics had expected to collapse, property

Most of the rebound in growth came from the very sector that, according to ardent China bears, was supposed to trigger the economic collapse, namely, property (perhaps people were projecting their US experiences onto China?). In fact, as the year went on, precious little was heard about the threat of "ghost towns" and instead sales numbers, prices, and construction activity all moved higher. So much so that, by the end of 2016, articles in the general media started to report, with surprise, how yesterday's ghost town now seemed to be getting full (see article).

Chinese construction activity picks up strongly in 2016

Nominal change in value-added by sector



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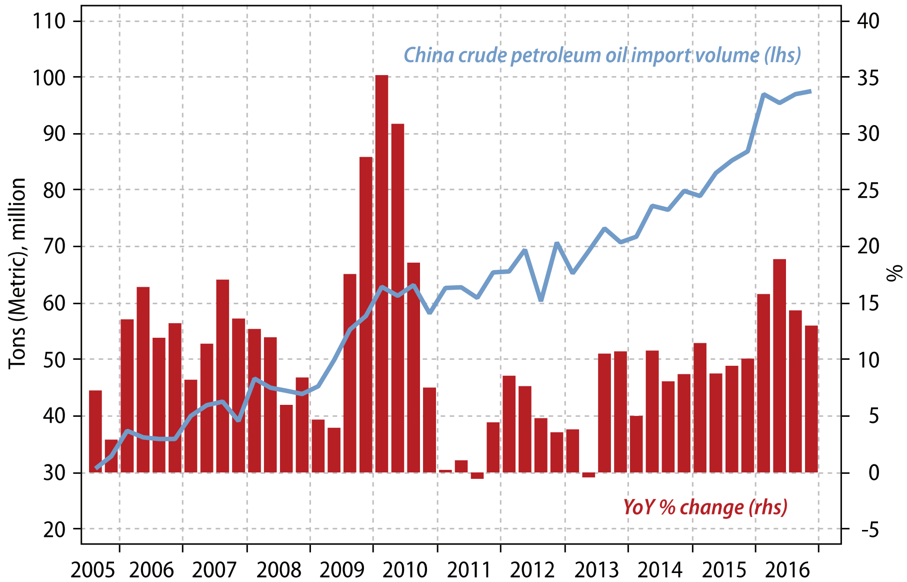
Chinese property growth pulled commodities up in the second half of 2016

And with the Chinese real estate sector picking up, commodities went along for the ride with oil, copper, steel and coal all bouncing back strongly in the second half of 2016.

Chinese oil imports hit a new high in 2016



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So what lessons should we draw from last year's China panic?

- **Lesson #1:** Investors across the western world remain deeply concerned about China's ability to keep the show on the road.
- **Lesson #2:** This skepticism most likely stems from both a lack of familiarity with China and a deep lack of trust in Chinese data and policy announcements.

Chinese policymakers favor stability and growth, and have the policy tools to achieve those goals

- **Lesson #3:** While China's growth rate continues to slow down structurally, policymakers still have policy levers to pull to cushion the impact of slower growth on the broader population.
- **Lesson #4:** The pursuit of social stability will most likely continue to be the first and foremost driver of China's policymaking.
- **Lesson #5:** China's willingness to take short-term pain for long-term gain seems to be much lower today than it was twenty years ago under Zhu Rongji's premiership.

And what questions does China's 2016 rebound lay in store for 2017?

- **Question #1:** Is China's new inability to reform a result of generational change, and hence structural. Unlike China's "baby boomers", who experienced the Cultural Revolution and knew how to "*Chi Kou*", or "eat bitterness", China's millennials today certainly have much higher expectations from life. Or is it a consequence of China's political calendar, since Xi Jinping should be able to embrace hard reforms with little fear of being deposed once he has consolidated power at the Communist Party's 19th congress this fall. Or does the party simply think it would be hypocritical for the current leadership to ask for sacrifices when so many of its members have, over the past decade or so, very prominently embraced luxurious lifestyles?

- **Question #2:** China was the key driver of the commodity price rebound. But how sustainable is that? Does China's import strength reflect strong final demand, or is it simple inventory-building at a time of low prices?

Does the rebound in Chinese inflation mean inflation globally has done falling, and what would this mean for bonds?

- **Question #3:** With Chinese growth rebounding, so did inflation. For the first time since 2011, China's producer price index is back in positive territory. So does this mean that inflation across the world is now done falling (when was the last time you bought a deflating good that wasn't made in China?)? And if so, what are the consequences for global bonds?

Chinese producer prices rocket

China PPI & OECD CPI

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Last year certainly was not a good year for bond yields

Surprisingly, global bond markets were slow to catch on to the fact that the Chinese government was back to stimulating its economy. The China panic drove 10-year treasury yields down from 2.25% to 1.75% in the first six weeks of the year, and bonds then just traded sideways. Then came the second big "surprise" of the year—namely, the Brexit vote—which saw bond yields everywhere take another gap down; by early summer 40% of outstanding OECD bonds were offering negative nominal returns (see left hand chart overleaf).

2 — The Brexit shock — June 2016

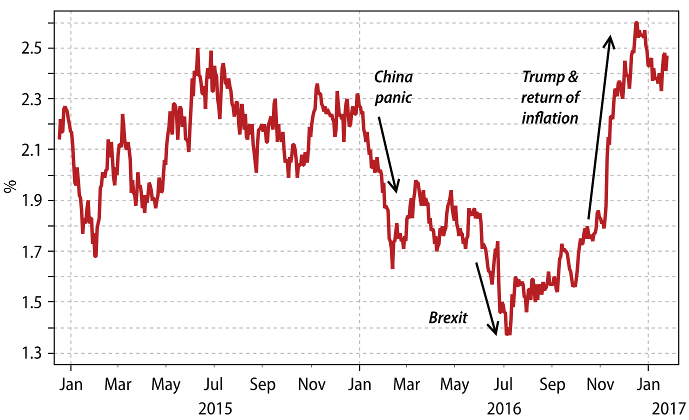
Like almost all our clients, our firm was fairly evenly split as to whether Brexit would turn out to be a great thing (Charles, Louis…), or a disaster (Anatole, Tom Miller). Funnily enough, those Gavekal researchers who were most adamantly against Brexit ended up as its biggest beneficiaries since the pound's tumble made their US dollar denominated salaries, bonuses and dividends more attractive!

The Brexit vote outcome was the first hit to the credibility of economic "experts" everywhere

Nonetheless, the Brexit vote was the first hit to the credibility of economic "experts" everywhere. Not only did most apparently reputable commentators predict that Brexit would not happen; those same experts were similarly adamant that Brexit would trigger a market meltdown of epic proportions, even perhaps a repeat of the 2008 crisis. These underlying fears undeniably contributed to the final gap down in bond yields witnessed everywhere around the world during the summer.

A wild ride for treasuries

United States 10-year government bond yield



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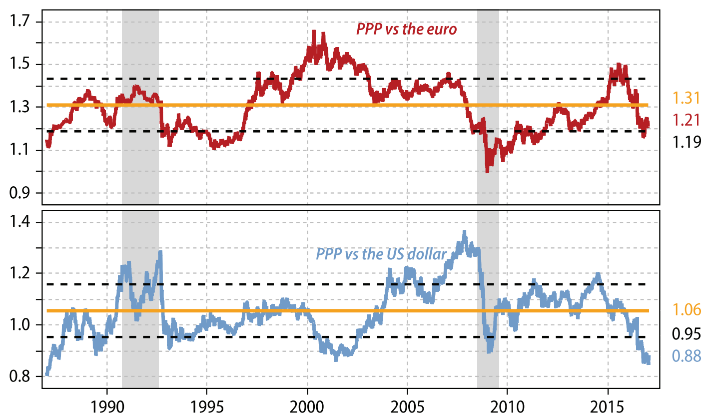
The oversold pound spells trouble for the UK's neighbors

GBP purchasing power parity versus the euro and the US dollar | Grey bars = UK recessions



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While bond yields have recovered since the vote, the impact of Brexit on sterling persists

In addition to pushing bond yields everywhere to ridiculously low levels (see US Bonds As A Hedge: It's Complicated and The End Of A Bubble?), the Brexit vote triggered sterling's collapse to being two standard deviations undervalued (on a purchasing power parity basis) against the US dollar and one standard deviation against the euro (see The British Pound: A Two Year View and Sterling Sellers Look Flushed Out). This level still prevails today and it will likely impact Britain's neighboring economies directly in the not so distant future (see Is Perfidious Albion Undermining The 'Shanghai Agreement'?).

Death by expert

The widely anticipated crash following a vote in favor of Brexit never materialized

During the campaign, the Conservative Party politician Michael Gove was derided for saying people "have had enough of experts" when confronted with the fact that most economists were predicting that a Brexit vote would spark an economic disaster. Six months later, Gove's words show that he was attuned to the current political mood. Clearly, the Brexit vote symbolized the rejection of a certain way of looking at the world; a reality that Charles noted both before the vote (see Trump And The Tree People and Fear Not Brexit) and after (see History Moves Again, Again, The Collapse Of The Left and Trouble With Monopsonies).

- **Question #1:** Will Brexit go down as the moment when the tide of globalization went into reverse? In a way, this would be ironic as globalization really started with Britain (some 300 years ago) and, over that period few countries have benefited more. But perhaps the spoils of globalization have been too unevenly distributed.

Is Brexit the beginning of the end for globalization, the EU and labor force growth through immigration?

- **Question #2:** Does Brexit mark the beginning of the end for a European Union project which has proven itself out of touch and out of solutions in dealing with the self-inflicted disaster in southern Europe?
- **Question #3:** Does Brexit now mean that immigration flows will slow, thereby ensuring that European nations have to accept gradually shrinking labor forces and structurally lower GDP growth rates (*a la* Japan)?
- **Question #4:** Does the very low British pound (along with a crazy-low Swedish krona) condemn the European Central Bank to ever crazier monetary policies, in order to prevent disruption to its nations' domestic manufacturing sectors?

Still, the main lesson of the Brexit vote should have been that voters would be more willing to accept a leap into the unknown than was the prevailing wisdom. That much would be proven in November in the US. But before we get to a certain political apprentice, another election took place which had consequences; namely, the Philippines' presidential election.

3 — The Duterte election — June 2016

After Xi Jinping rose to power China began reaching out to its neighbors and beyond

Xi Jinping's rise to power four years ago marked two profound changes. First, China embarked on a massive anti-corruption drive to clean up the Party and render government institutions less inefficient. Second, China shifted from being an inward looking economic development story and began to reach out to its near neighbors and beyond. Over the past few years, we have written about this latter shift at length (see **A Dream Of Asian Empire** and **What Does China's Propaganda Ministry Do All Day?**). My colleague Tom Miller has a book coming out on this very topic next month (see ***China's Asian Dream***). So how is this shift in China's orientation linked to Philippine politics and the rise of Rodrigo Duterte?

Recall that during this period, the signature strategic initiative of President Obama was the US's "pivot to Asia". Think back to the days of Lyndon Johnson or Richard Nixon and it is inconceivable that a Filipino presidential candidate would declare in such bold terms his intention to jettison his American ally, call for US troops to leave the archipelago, and welcome China's warm embrace (even in the early 1990s when US troops left their bases in the country the language was far more restrained).

To some extent the election of Duterte in the Philippines was a confirmation that this shift worked

To some extent, Duterte's election came as the 2016 confirmation of China's foreign policy shift from Deng Xiaoping's "*taoguang yanhui*" (or "hide our strength and bide our time") to Xi's "*fenfa youwei*" (a more proactive foreign policy to instill a sense of "common destiny" across Asian nations). Xi must be thanking his lucky stars that just as China has begun to pursue "diplomacy as a great power", "consolidate its leadership in Asia", and seek a "new type of great power relationship with the US" (all Xi's words), the US political left, along with the military-industrial complex-supported neo-conservative wing of the Republican Party, are focused almost exclusively on Russia.

A Chinese vision

2016 was the year that confirmed the roll-out of the "China Dream"; a dream that will have investment implications for years to come and raises important questions:

Will Xi make tough choices to transform the renminbi to "Asia's deutschemark"?

Question #1: Xi Jinping's vision for China is clearly an imperial one. But one cannot build an empire on someone else's dime. So if Xi really wants his empire, he must transform the renminbi into something similar to Asia's deutschemark; a trading and reserve currency in its own right. But in turn, this entails hard choices. For a start, the renminbi will have to be a decently strong currency. China will also need to continue opening its capital account. The problem with such priorities is: What happens when the goals of having both a strong currency and greater capital account openness come into conflict?

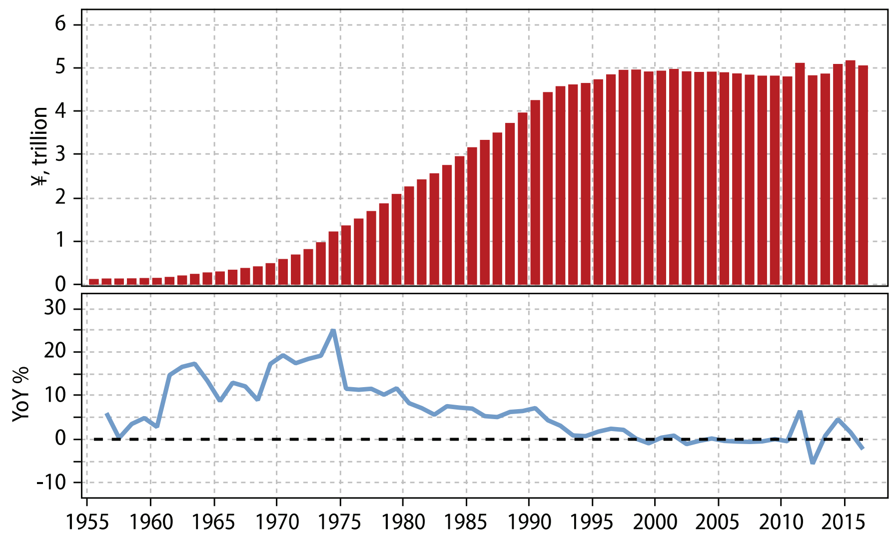
Question #2: Will former President Obama's pivot to Asia continue under President Trump? Or will Trump continue a US disengagement from Asia, perhaps striking a "huge" deal with China such that China revalues the renminbi and in return takes over the South China Sea? After all, the US has no overwhelming strategic imperatives in this region.

Will Trump leave the US's Asian allies to fend for themselves, and what would this mean for defense spending?

Question #3: Given China's growing expansionism, isn't a large increase in Japanese, Korean and Taiwanese defense spending now almost baked in the cake? But where will the weapons be bought—the US, Japan, Europe or perhaps even Russia? After all, one of the more intriguing developments of recent months has been Shinzo Abe's charm offensive toward Vladimir Putin.

Might a steady trend be about to break?

Japanese defense spending: in Yen and YoY % change



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Question #4: As China continues to sell treasuries and re-invest the proceeds into the "infrastructure diplomacy" of the Asian Infrastructure Investment Bank, the One Belt, One Road initiative and the Silk Road fund, does the level of China's official foreign exchange reserves really matter? And if neither China (investing its surpluses into its neighboring countries' infrastructure), nor Japan/Korea/Taiwan (now much more likely to buy Lockheed jets or Raytheon missiles) line up to buy US treasuries, who will fund the likely coming rise in US dollar debt?

Question #5: On the premise that military hardware will hopefully prove unproductive (i.e. bombs and missiles stay in their silos) will higher defense spending in the likes of Korea or Japan depress their currencies?

4 — Modi's bank note withdrawal

"The end of cash" may have started in India last year…

Staying in Asia, the next big surprise of 2016 had to be Prime Minister Narendra Modi's decision to take India's larger bank-notes, accounting for 80% or so of the value of outstanding bank notes, out of circulation. Indeed, while the "end of cash" had in recent years become a hot topic in academic circles, the assumption was that big initiatives would be tried in countries such as Denmark or Sweden, where cash has already become something of a quaint relic. Certainly, not in India, where more than three - quarters of commercial transactions occur in small shops with no hook-up to credit or debit card networks.

Undeniably, Modi's bold decision showed that the former Gujarat governor intends to be a transformational Indian leader. It also showed that he was willing to accept short-term pain for the prospect of long-term gains. But, most surprisingly, this decision has been broadly well-received by a general public which identifies broad tax-evasion and corruption among Indian "elites" as an endemic problem. So, as with Brexit, the Filipino election, and the Trump election, the broader "us" vs the narrower "them" meme seems to also have legs in India.

...will other countries follow suit, prompting a collapse in the velocity of money?

1) The first question raised by Modi's decision is whether it marks the harbinger of things to come in other economies? And, if so, will we witness a collapse in the velocity of money around the world as "dark" money flows "off the grid" into assets such as art, gold, real estate, diamonds and bitcoins. When prices of such "scarcity assets" rise, there is precious little impact on the productive capacity of an economy.

2) Alternatively, could Modi's cash crackdown point to global financiers facing a tougher environment? Let's face it: once a country's monetary base is fully trackable, it becomes easy for governments to impose capital controls. Hence if "Singapore really is the nicest city in India to live in" as I was once told, the crackdown on Indian money flows may in part explain Singapore's underperformance over the past three years (see chart overleaf). And if the end goal is to track every cent in the system, where does this leave real estate in key money centers? Not just Singapore, but also Hong Kong, London, Zurich, and Vancouver.

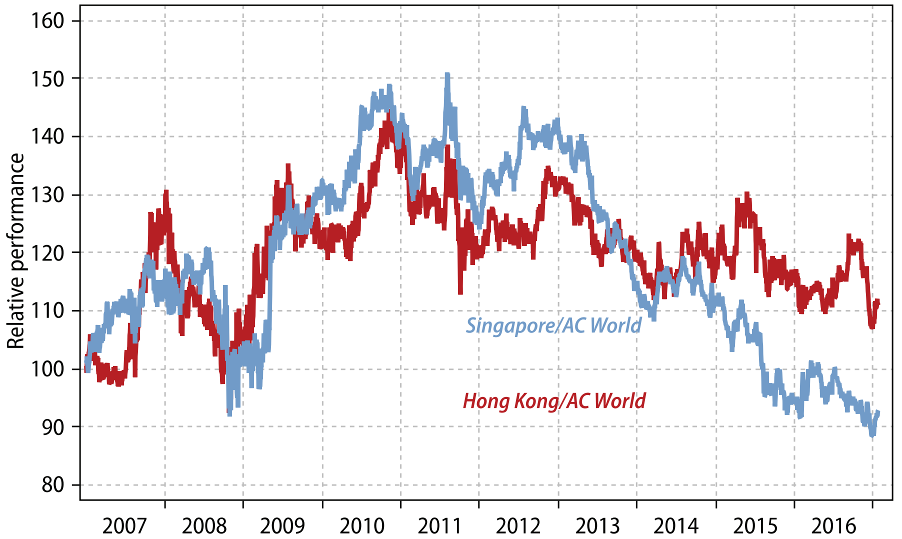
Will the Indian economy implode, or is this just a speed bump?

3) Following Modi's sudden and violent "war on cash", does Indian economic growth implode? Or is this just a speed bump on a road that remains otherwise very exciting?

Of course, all of these events were dwarfed by the surprise, and uncertainty, triggered by events in the US in November.

Awful Singapore

Relative performance of HK and Singapore MSCI to the MSCI AC Index



5 — The Election of Donald Trump

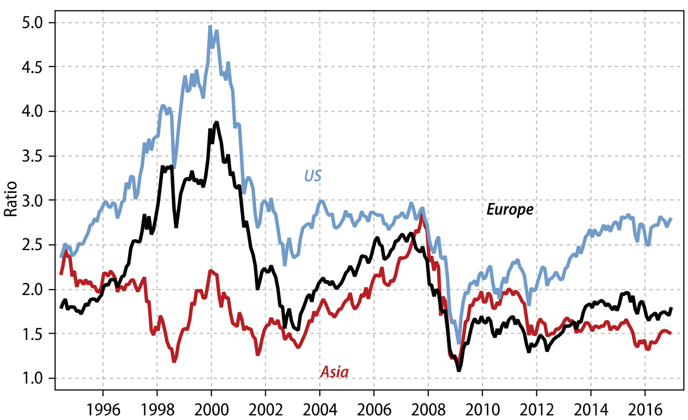
Most investors expected the wrong market reaction after a potential Trump election

Beyond the surprise of the US election result itself, most investors were wrong-footed by the markets' reaction. Instead of selling-off, US investors embraced the reflationary theme with gusto: bonds sold-off, cyclical equities surged, industrial metals massively outperformed precious metals and small-caps outperformed large-caps. Basically, every asset class started to behave as if the US economy was set to exit recession.

The point was that the US had not just experienced a recession. And though fixed income instruments were undeniably priced for an economic calamity (see **The End Of A Bubble?**), US equity markets were not.

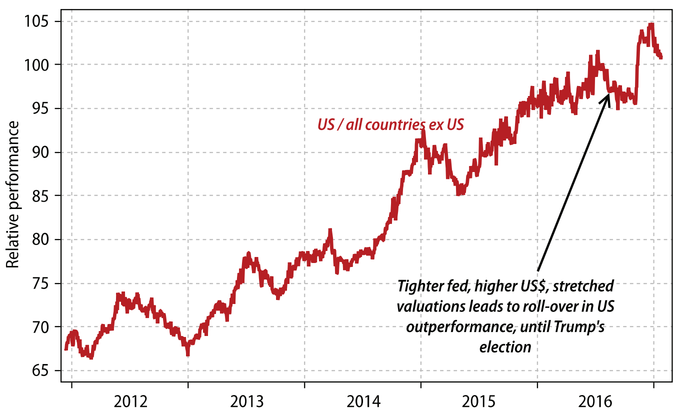
Only the US got a real post-crisis recovery

Price-to-book in Asia, USA, Europe, MSCI IMI index



Epic US outperformance

USA MSCI relative to MSCI All Countries ex USA



US equity markets, whose five year stretch of outperformance coming into the election seemed about to roll over on a tighter Fed, a higher dollar, and stretched valuations, instead just gapped higher.

A US economic reset?

The markets were clamoring that, thanks to Donald Trump, returns on invested capital in the US were set to soar. A development that raises its own set of follow-up questions, including:

Whether deregulation or protectionism will drive US growth determines the future of many US multinationals

Question #1: What will be the driver of this renewed US growth? Will it be deregulation and tax-cuts (and we note that, so far, Trump has chosen only one lawyer for his cabinet, his attorney general. Surely this has to be good news)? Or will it be protectionism? If the latter, this is surely terrible news for many US multinational companies which have been some of the biggest winners from the globalization trends we described more than a decade ago? (see ***Our Brave New World***).

Question #2: How long can the US economy, and markets, brush off higher US interest rates and a strong dollar? With close to record high corporate debt, and record high credit card debt, won't higher interest rates have a swift impact on earnings growth? On the flipside, won't US tax reform boost US corporate earnings meaningfully for years to come?

There seems to be a contradiction between policies that imply bigger deficits and policies that aim at shrinking trade deficits

Question #3: Even without a rise in spending (corporate handouts and infrastructure spending promises) and tax cuts, the US$20trn outstanding debt was set to rise over the next five years. But who will finance this rise in debt? For now, the Fed seems unlikely to do so. If the increase in debt is financed by either US banks and/or an increase in US private savings, then the US economy will start to look like Japan did over the past twenty five years; i.e. nothing to celebrate. Alternatively, the rise in US debt is funded by foreigners. Yet this implies a broader capital account surplus which, *de facto*, means that the US must embrace a wider current account deficit (not exactly Trump's economic program). Is there not a contradiction between fiscal policies that seem to imply bigger deficits and trade policies aimed at shrinking trade deficits? Aren't these the policies that most Western countries followed in the 1930s?

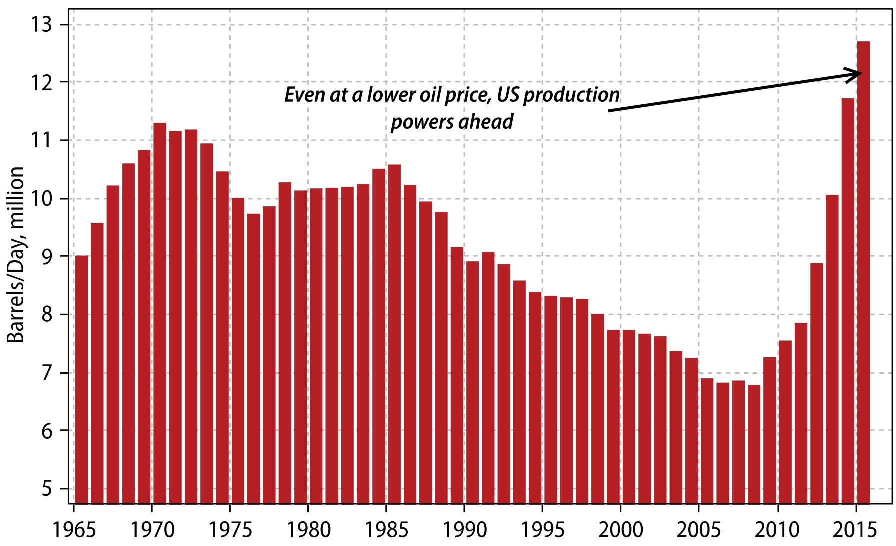
Challenge confronting investors: when do rising rates and US$ start to hurt?

What seems certain is that expansionary oil policies in the US imply continued growth of oil supplies

Question #4: One sector where Donald Trump's policies can have an immediate impact is energy. The opening of new pipelines such as Keystone, the relaxing of drilling rules (with Oklahoma Attorney General Scott Pruitt set to head the Environmental Protection Agency and Rick Perry set to run Energy) the tightening of carbon emission standards over the last eight years will likely be reversed. The increase in oil supply that we have witnessed in recent years will thus likely continue apace, especially if estimates of Permian Basin reserves, along with Alaskan reserves, are at all accurate. And if an increase in US oil production is almost "baked in the Trump cake", doesn't that mean that the oil price is, at the very best, capped at around US$50 a barrel? And if so, doesn't that mean that the recent rebound in inflation will soon start to fade away?

The new oil giant on the block

US oil production, BP statistical review of world energy



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This last question on energy brings us to one of the other important developments of 2016: the unfolding civil war (between Shia and Sunni Muslims) tearing apart the Middle-East and its dire financial consequences for two of the Middle-East's power houses: Saudi Arabia and Turkey.

6 — The Turkish implosion and the Saudi dilemma

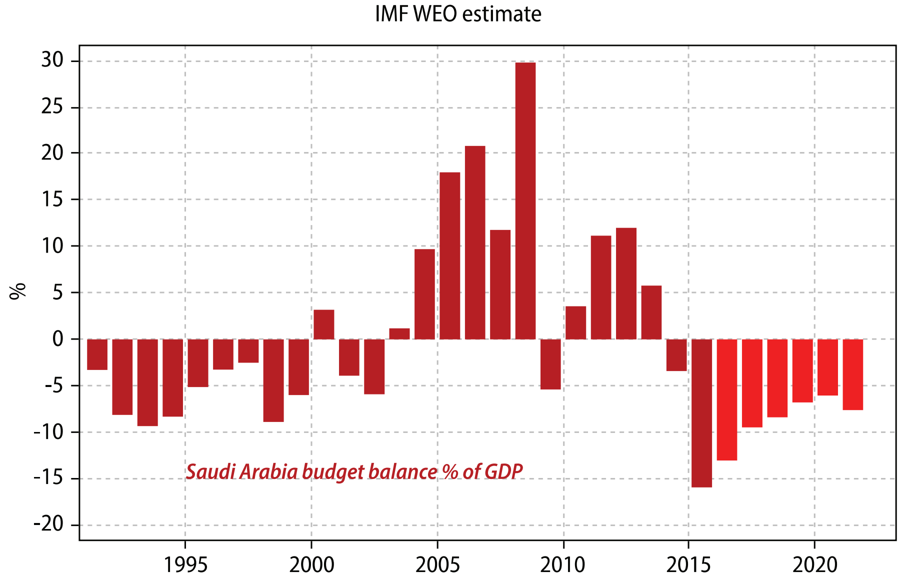
The election of Trump strikes a blow against both the Saudi Arabian and Qatari governments' lobbying efforts in the US

We will go out on a limb and suggest that the reason that the Saudis and Qataris were found to be among the largest donors to the Clinton Global Initiative is not that their respective governments are keen on promoting women's rights or education and access to healthcare in the world's poorest countries. And in that regard, Trump's election does strike a blow against years of lobbying by the Saudi/Qatari governments on both sides of the aisle. And this new lack of access of the Gulf monarchies to the higher echelons of the US government could not come at a worse possible time; in the midst of a destructive and unending civil war across the Middle-East.

The house of Saud is financing a number of very expensive undertakings…

Take Saudi Arabia as an example. Beyond an ever-expanding royal family that now counts thousands of princes, the House of Saud today has to finance ever-increasing domestic social benefits, a war in Yemen (in which it is directly involved), wars in Syria and Iraq (where it has to indirectly finance the various Sunni militias), and the Egyptian government (to keep the Muslim Brotherhood at bay). All of this leaves little spare cash lying around for additional projects (maybe that's why the funding of the Clinton Global Initiative is now being cut?).

Saudi Arabia: from massive surpluses to enormous deficits



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…which means that the oil will keep flowing…

These financial strains imply that Saudi, Qatar and others must keep the oil pumping (thereby capping its price), but also that any economy, or business (defense contractors, luxury cars, Swiss banks, Mayfair real estate) that depend on Middle-Eastern money flows, may struggle in 2017.

…and that the flow of surplus money into the Turkish economy will continue to shrink

And this brings us to Turkey, whose economy is already struggling. Over the past decade, Turkey's current account deficit has continued to widen. But that did not matter because Gulf money kept pouring into the Turkish economy, financing the construction of shopping malls, hotels, and residential real estate projects. But as the flows have abated, the Turkish lira has gone into free-fall. Combine this with the establishment in the ruins of the Iraqi and Syrian states of a growing Kurdish quasi-state entity, and the plate for Recep Tayyip Erdoğan is looking increasingly full. Like Joseph Stalin in 1941, Erdogan may soon regret having purged Turkey's entire army, air force and navy officer corps.

Question #1: Will the House of Saud survive the decade? And if it doesn't, is that bullish or bearish for oil prices? If the House of Saud collapses, does that mean that Europe (well, really just Germany as France is full nuclear and Poland is full-coal) then becomes solely dependent on Russia for its energy needs? Is there a better hedge than owning Russia against a possible spillover of the Middle Eastern civil war into Saudi Arabia?

Question #2: Given his country's growing financial strain, will Erdogan play his "refugee card/blackmail" on Europe this summer? And, if so, will this destabilize the upcoming European elections, especially the German election in September?

The future of Saudi Arabia impacts Turkey, which in turn could impact Greece, Italy and so the rest of Europe

Question #3: Is the collapse of the Turkish lira yet another nail in the Greek, and to a lesser extent, Italian coffins? Will the more budget-conscious European tourists now head to Turkey instead? Or will the region's instability keep the tourist euro at home in Europe?

However one cuts it, it is hard to avoid the conclusion that events in the Middle East could end up having a disproportionate impact on Europe over the coming 12 months. Which brings us to the last surprise of 2016; namely, the Italian referendum and the French Republican primary.

7 — Fillon, Renzi, the Italian referendum and the French election

As in Britain, the Philippines and the US, the ballot boxes in Europe also delivered some unexpected results toward the end of the year. First up was the triumph of François Fillon in the primary of the French center right party. Here was a man calling himself a Thatcherite (in France, one may as well profess support for the England rugby team or the German soccer team) who, despite polling fourth before the vote, won in a landslide. This victory opens up the real prospect that, by this summer, France will not only have the most supply-side driven political leader in its history, but the most supply-side leader in the western world! Who ever thought one would live to see that day?

France is a "coiled spring"; can the potential election of François Fillon release it?

And this matters because if there is one "coiled spring" economy in the West, it has to be France, where consumption, industrial production and capital spending have spent 20 years flatlining. Meanwhile, the underlying structure of the French economy remains healthy. Unlike in Italy, the banks are not bust. Unlike in Scandinavia, real estate is not over-priced. The educational system performs very honorably. France has an operational army (few European countries can say that!). The health system functions. In short, the reforms that France needs to undertake (deregulation of the labor laws, pushing back the retirement age and getting rid of the wealth tax) in order to boom are not impossible to confront, at least for one with political courage.

Stop obsessing over Le Pen

Ignore the risk of Le Pen in France, this time the populists will not score a surprise victory

Meanwhile, most investors outside France seem chiefly focused on the political risk surrounding Marine Le Pen's candidacy. But given the way French elections work, Marine Le Pen's odds of becoming the next French president have to be seen as very long, at best. So most investors' perception of a risk—which is very remote at best—is blinding them to the opportunity that lies in European, especially French, equities. And of course, the reason investors are overly nervous about French political risk has everything to do with the projection of recent political traumas (Brexit, Trump) onto France, and very little to do with a rational analysis of the underlying situation.

Although Renzi was shown the door in Italy, this did not result in a sell-off

If anything, the Italian referendum confirmed this. Indeed, coming into the December vote, the general perception of investors was that a rejection of the proposed constitutional reforms would (i) show Prime Minister Matteo Renzi the door, and (ii) most likely trigger a crisis of confidence in Italian assets that could spread across the eurozone. The rejection unsurprisingly came out of the ballot box, but the Italian sell-off completely failed to materialize. Instead, Italian equities never touched their summer lows and bounced back in spite of bad news flow.

Surprising resiliance in Italy

Italy FTSE banks index

Gavekal Data/Macrobond

The French election will most likely end happily, unlike the expected pro-populist outcome in the Dutch election

In my experience, markets that rise on bad news tend to do very well on good news; this brings us back to the European electoral calendar. Looking at the year ahead, the French presidential election will most likely turn out a happy result (whether Francois Fillon or Emmanuel Macron). However, clients who fear dark clouds may want to wait until after the March 15th Dutch election as that particular result will most likely favor anti-European Union parties and could trigger some uncertainties.

Part 2: Putting It All Together — The Asset Class Review

1 — The US dollar

Performance in 2017 likely hinges on getting the dollar call right

Even more than getting it right on US interest rates, performance in 2017 will most likely be driven by getting the US dollar call right, or not. And forming a view on the US dollar with any high degree of certainty is a challenge.

The known positives include:

- Rising positive carry on US dollar debt instruments relative to those of the rest of the world.
- The fact that the Federal Reserve has a tightening bias, while most other central banks still have an easing bias.
- The possible continued improvement in the US trade balance through greater domestic energy production, and possibly even exports.

The known negatives include:

Many of the negatives for the dollar have to do with the new president

- The US president is a clear mercantilist—and mercantilists tend to dislike strong currencies.
- The US president sees himself as a "deal-maker", and a "deal-maker" who is not afraid of using the bully pulpit—he may turn to other countries and say "revalue your currencies, or else…".
- The US president most likely inspires fear in most of America's trading partners, for no one is quite sure what the above "or else" might mean.
- The US dollar is increasingly overvalued on a purchasing power parity basis against the currencies of most other countries
- Almost everyone is bullish on the US dollar, and after years of massive outperformance, almost every investor is overweight the US dollar in their global mandates

The uncertainties include:

- Is there really a US$10trn "short position" among non-US based entities as intimated by a Bank for International Settlements report a few years ago? If so, how come the US dollar's recent rise has not generated more pain, margin calls and forced asset disposals?
- Will Donald Trump really risk unleashing a significant contraction in global trade and with it a global depression, or is he just bluffing? If Trump is serious, then should we not witness a collapse in the demand for US dollars (as the world will have fewer US dollar denominated trade flows to fund), and even perhaps a questioning of the US dollar's role as a global reserve currency?

A number of swing factors are in the hands of foreign investors and governments

- Will the European Central Bank and Bank of Japan maintain their quantitative easing-forever policies? What if nominal growth in both regions starts to rebound? Or what if President Trump starts to put pressure on Europe and Japan to revalue their currencies?

A relaunch of US manufacturing depends on a weaker dollar

From our conversations, most investors seem to believe that the risk on the US dollar is to the upside; that if we enter into a challenging environment, the dollar will shoot up (risk-off and all that). I am not so sure. For me, Donald Trump's professed desire to relaunch manufacturing in the US cannot happen without a weak dollar. Thus, if we are to conclude that Trump is serious about "Making America great again" this will have to come through a weaker dollar.

In that regard, Trump may be helped by the rebound of nominal growth in Japan and Europe. Indeed, a year ago, Chinese PPI was at -5% and the renminbi was falling against the yen and the euro. China was thus exporting into Euroland and Japan a double deflationary impact. Fast forward 12 months and Chinese PPI is now at +5% while the renminbi is up against both the euro and the yen.

As deflationary pressures are reducing and economic data surprise on the upside, will central banks in 2017 pull back on excess liquidity?

Suddenly reduced Chinese deflationary pressure is coinciding with most regions' economic data coming in better than expected. Hence, there is the potential for upside surprises in Japanese and European inflation and nominal growth. Should these come to pass, will central banks continue to provide financial markets with buckets of excess liquidity? Could the story of 2017 be that the likes of the Bank of England, Riksbank, Reserve Bank of Australia, European Central Bank, Bank of Japan and the People's Bank of China, perhaps after some non-subtle prodding from President Trump, follow the Fed by withdrawing excess liquidity?

At the same time, the market is currently discounting three interest rate hikes from the Fed in 2017. At the start of 2016, the market was discounting four interest rate hikes and the Fed delivered one. Will the Fed in 2017 prove more hawkish than the market expects (that would undeniably boost the US dollar) or more dovish (that would most likely limit its gains)? Anyone betting on historical form would pick the latter.

All of the above leads me to believe that the US dollar will not melt up this year—in fact it may finish lower

Putting all of the above together brings me to the conclusion that 2017 will not be the year of the US dollar melt-up. In fact, unless US growth massively surprises to the upside (see **Something's Gotta Give**), the dollar will finish lower for 2017. And this will be very positive for a number of asset classes that have been left by the wayside in recent months. But this last question (on US growth) brings us to the other key driver of markets: US interest rates.

2 — US & OECD government bonds

At any one time, there are three possible reasons to hold long-dated bonds:

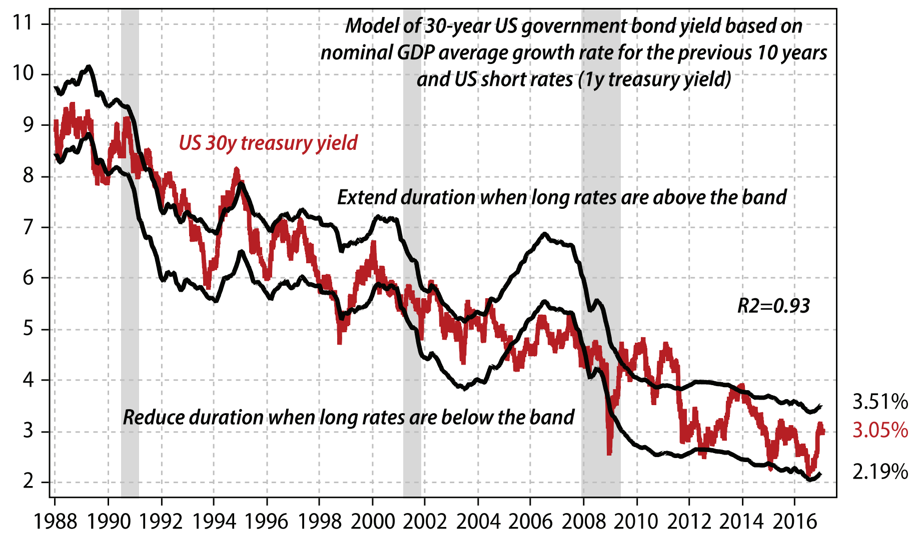
a) **As a hedge against an equity market meltdown.** Whenever equities do very poorly, bonds tend to deliver handsome returns:

b) **Because they offer attractive value.** Historically, when real yields in a given country are above that country's structural growth rate (around 2.3% in the US, 1.5% in the eurozone and 1% in Japan), then bonds become an increasingly "safe bet" (see first chart overleaf).

When real yields are above the structural growth rate, then bonds become an increasingly "safe bet"

The "model" for US long rates

Shaded grey: US recessions

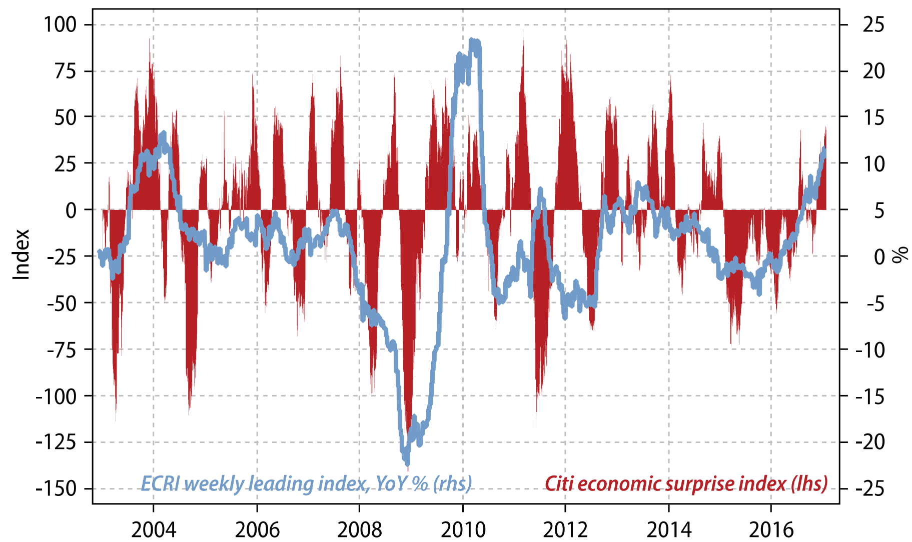


Gavekal Data/Macrobond

c) Bonds will offer clear value especially **if nominal GDP growth in the coming period ends up decelerating.**

Inflation shocks in the works?

US ECRI index & Citi curprises



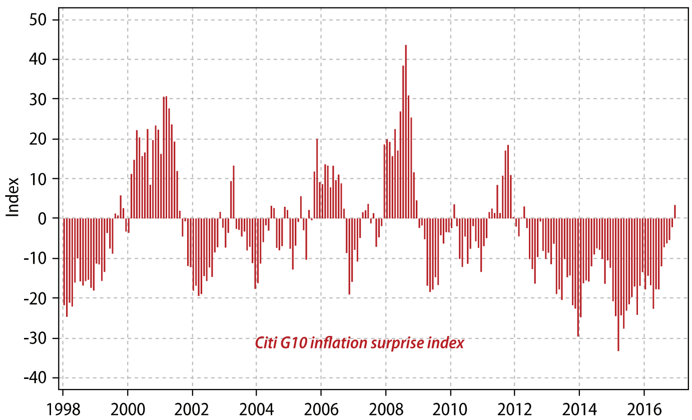
Gavekal Data/Macrobond

US bonds are still not a compelling investment

Following the past six months' pullback, bonds are nowhere near as overvalued as they were last summer (see [The End Of A Bubble?]). Nonetheless, valuations are still not attractive enough to make US bonds a compelling investment proposition. Meanwhile, inflation is trending higher: for the first time since 2011 (when much higher food and energy prices helped trigger the Arab spring), global inflation is surprising on the upside (see left chart overleaf).

The end of the deflationary affair, perhaps

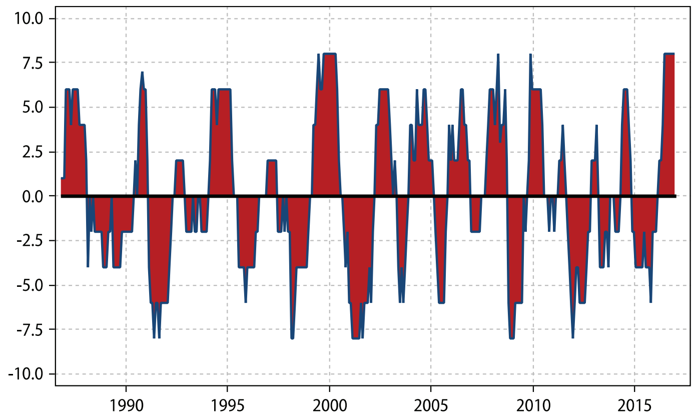
Citi G10 inflation surprise index



Gavekal Data/Macrobond

The Gavekal P-indicator points to more inflationary times

Various market based and fundamental data aimed at gauging future price movements



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The only reason to hold US bonds is as a hedge against an equity meltdown

So out of three reasons to own US bonds today, the compelling one is as a hedge against a meltdown in the US equity market. A meltdown which will not happen if, as we predict above, Donald Trump manages to browbeat other countries into a new Plaza Accord of sorts. Instead, it looks more likely that US bond yields will follow changes in US inflation. And on that front, our indicators point toward rising pricing pressures over the coming six months (see right hand chart above).

Thus, I don't expect to get excited about extending duration in the US before the summer. By then, real yields may have reached the attractive "value zone" and inflation may simultaneously be about to top out. Of course, this assumes that Donald Trump does not embark on an aggressively protectionist program; for if serious disruptions are thrown into the global supply chain, the inflationary pick-up may last longer.

The other looming risk for US bonds is that yields are anchored by the massive QE policies in Europe and Japan that are keeping yields in those countries at crazy low levels (-1.5% real on 10-year bunds!). Of course should Donald Trump manage to end QE policies in Japan and Euroland (say by threatening massive duties on the auto sector), it is likely that JGBs and bunds would suffer a meltdown of epic proportions. This would be terrific news for domestic financials and pensioners, but bad news for local exporters (as the euro and the yen would shoot up). It would also be bad news for bonds everywhere, including the US, as yields would reset higher.

It seems to early to load up on treasuries, at least in the first half of the year

Putting it all together, it seems too early to pile back into treasuries, although by the summer, the fundamental backdrop may have meaningfully changed.

Indeed, by this summer, the Chinese stimulus of 2016 is likely to be fading and so YoY data comparisons in that economy will get tougher. This "fading" of the Chinese stimulus will likely hit commodity prices, just as higher oil production in the US starts to kick in. Thus, by the summer, we may well be getting softer growth data, and softer inflation. This would provide a better backdrop for bond buying.

3 — Global equities

One of the interesting developments of recent months is how the US dollar has been a "risk-on" currency for the US equity market, and a "risk-off" currency for most emerging markets. Thus, it is easy to assume that this trend will continue and that equity allocation decisions this year will be driven by the direction of the dollar. Investors who are bullish on the dollar should buy US small-caps; those bearish on the dollar can load up on the much more attractively valued eurozone and Asian equity markets.

However, who knows whether this relationship will hold? Or even whether the US dollar will end up moving very much in 2017? So instead of looking in the rear-view mirror to determine the potential driver of equity price changes, let us suggest that, beyond changes in the dollar, global equity price changes in 2017 will be driven by:

Beyond changes in the dollar, equity price changes will this year be determined by eurozone growth…

- **The upside surprise in eurozone growth**: markets have lately behaved as if the US economy is a "coiled spring", ready to bounce thanks to tax cuts and deregulation. But given the low US unemployment rate, the record high credit card and corporate debt, and the fact that the current expansion is seven years old, the US does not fit the "coiled spring" description. Instead, and as mentioned above, France could be just such an economy. And in the coming [Chinese] year of the Rooster, the French national bird may well end up singing, for it wouldn't take much by way of tax cuts and/or labor market deregulation to build on the cyclical momentum that now seems to be picking up (ISM and construction picking up). Most importantly, the arrival of a supply-sider in the French presidency will allow for a mending of the Franco-German relationship. On the assumption that Fillon or Macron wins in May, Angela Merkel will be able to turn to the Bundestag and say "France is now making genuine reforms so let's open the valves a little wider and embrace fiscal stimulus for the whole of Europe".

…and whether Britain can strike a favorable Brexit deal with Europe

- **A decent Brexit deal being struck**: As of today, it is easy to feel despondent on the likelihood of a decent Brexit deal (see Hard Brexit Means Soft Sterling). Yet, 2017 could see positions unlocked fairly quickly for a simple reason: both German auto-makers and French farmers will be keen for a deal that drives the pound higher, quickly. And given that both group are their respective countries' largest and most powerful lobby groups, Merkel and Fillon/Macron will likely be keen to strike a face-saving deal with the UK. The imperative could be to move on in order to tackle more pressing issues.

- **The pick-up in the IPO pipeline in the US and in China**: Following the 2008 crisis, most pension funds poured capital into private equity, in both China and the US. The flows of capital helped the birth of many a unicorn. However, the private equity cycle most likely now requires a number of Chinese and American unicorns to come to market in the coming quarters. The question is whether increased supply will weigh on the broader market, especially the tech sector?
- **Populist anger at corporate tax deals:** Companies in sectors such as healthcare or technology owe their outsized profits to the protection that governments provide for their intellectual property. Yet, many companies in these sectors have gone out of their way to avoid paying the governments from where they get their pound of flesh. So will 2017 prove to be the year when a populist voter backlash threatens outsized, monopolistic margins that depend on government protection?

If unrest in the Middle East was to spread to Saudi Arabian soil, all bets are off in the oil markets

- **Changes in energy prices**: The very likely increase in oil and gas supply in North America should keep energy prices under pressure. Unless, of course, the civil war currently tearing the Middle East apart directly threatens Saudi Arabia. Then all bets are off. In such a scenario, energy prices would sky-rocket with Canada, Norway and Russia being the largest beneficiaries (and thus the natural hedges against such a scenario).
- **The likely rise of interest rates into the summer, and the roll-over thereafter**: If global interest rates indeed follow inflation higher in the coming months then "bond proxies" such as staples, telecoms and utilities will struggle. The turning point will likely be a post-stimulus roll-over in Chinese growth. At such a point, a Chinese-induced commodity correction would again boost global "bond proxies".

A steeper yield curve, and hope that Trump will ease regulations, seem to be driving financials higher

- **The outperformance of financials everywhere**: After eight years of severe underperformance, banks in the past six months seem to have broken out of their consolidation range. And behind this breakout lies two realities: (i) the hope that the US regulatory touch will become a little lighter under a Trump administration, and (ii) a steeper yield curve persists, allowing banks to make money for free. These two factors seem likely to impact markets in 2017. Thus, those indexes which are overweight banks (CAC40, FTSE) should do better than those which have a lower exposure to financials (Nasdaq, Dax).

What are the investment consequences if globalization is coming to an end?

- **The query over the end of globalization**: A number of countries (including the US) and companies (most multinationals) have thrived in the past decade by not only optimizing their labor costs, but also their tax base (see **Peak Hubris?**). But today, the election of Donald Trump, combined with the Brexit vote and the growing rise of populist parties across Europe, puts into question whether the past three decades' "globalization trend" is coming to an end? And, if so, what might the investment consequences be? Should investors focus on small, frontier markets or even larger emerging markets (i.e. Indonesia, India) whose primary drivers remain domestic development and whose companies are still not very integrated into global supply chains? Or alternatively should they just focus on service oriented Western companies which are less likely to be impacted by the end of globalization?

- **The growing problem of ageing and soaring medical costs**: President Trump and the GOP Congress may very well decide to shelve Obamacare. But this will do little to change the underlying reality of (i) rising medical costs, and (ii) an ageing population. So will demographic pressure result in political pressure? And if so, will pharmaceutical companies become the new financials, i.e. the political punching bag which doubles up as a key funding source?

Part 3: Investment Conclusions

Like a three-legged stool, a well-built portfolio stands on three legs: (i) carry trades, (ii) return-to-the-mean trades, and (iii) momentum trades. In addition it makes sense to own a few "hedges", especially when the economic cycle is long in the tooth, valuations of most assets are getting stretched and central banks are embarking on a tightening cycle.

For 2017, these would be our preferred trades:

1 — Carry trades:

The second half of 2016 has not been kind to carry-traders and it is not obvious that, with inflation most likely accelerating around the world until the summer, reaching out for yield will be rewarded richly. Major risks for fixed income investors include:

There are a number of tangible risks for fixed income investors this year…

a) A serious problem in Saudi Arabia and a consequent spike higher in energy prices (and global inflation).

b) An end to QE programs in Europe and Japan, whether that be the result of pressure from President Trump, or simply because such programs have outlived their usefulness.

c) A rise in US tariffs, which triggers higher US domestic inflation, and thus more tightening by the Fed.

d) Rising bankruptcies in the US as higher interest rates take a bite out of the cash-flows of highly levered US corporates (see chart overleaf).

Meanwhile, the hopes of fixed income investors have to be that:

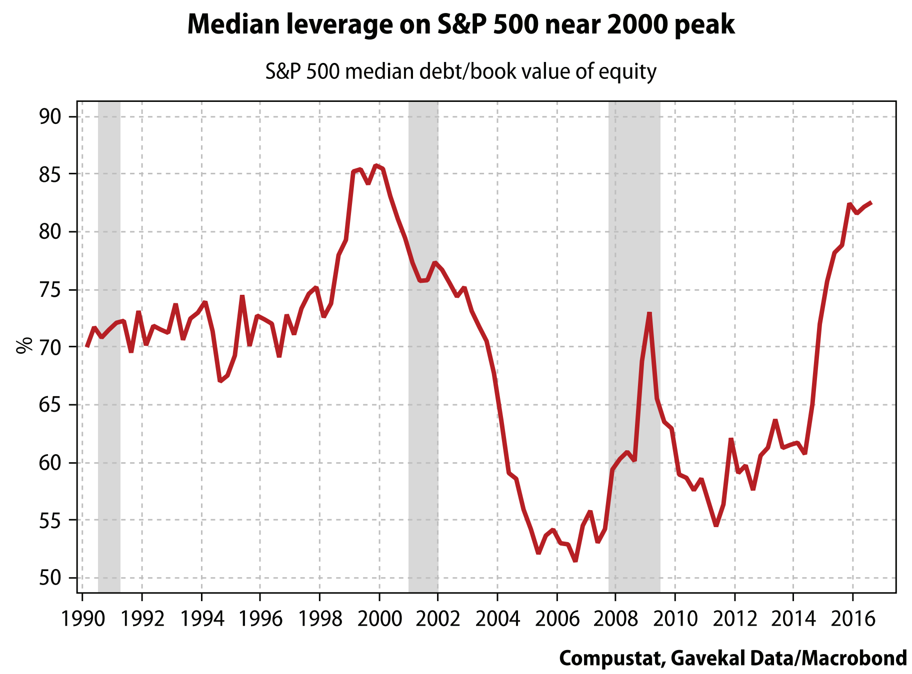
…while the opportunities for outperformance seem less likely to materialize

a) Energy and commodity prices soon roll-over.

b) The Chinese economy slows down hard in the second half of 2017.

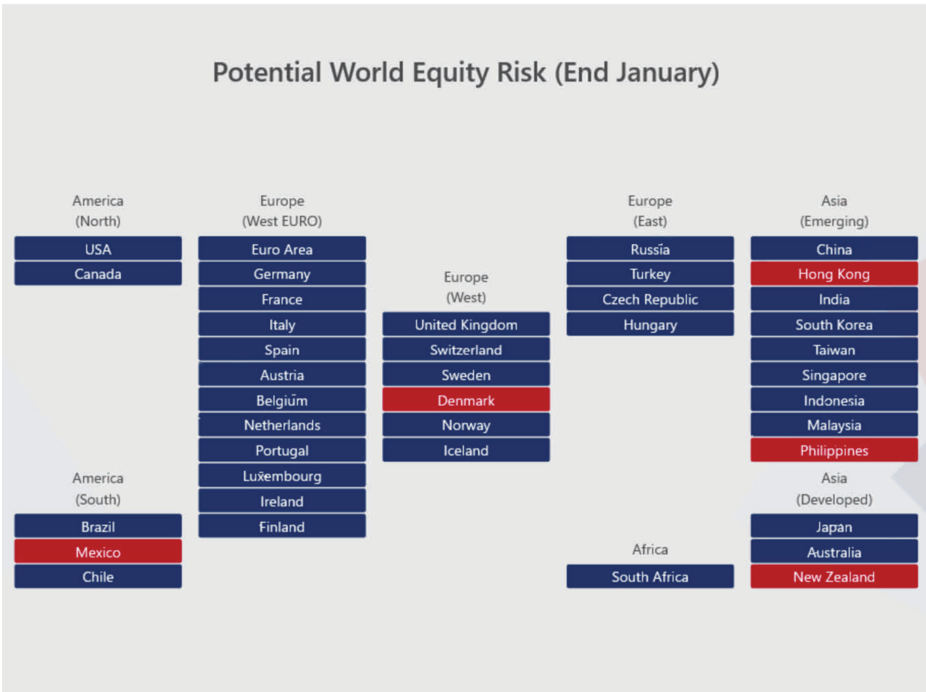
c) Central banks everywhere keep rates low, pushing investors to once again reach out for yield.

d) A financial market accident happens.



A major accident is not imminent

On the question of accidents, the latest heat map from the Gavekal TrackMacro software seems to suggest that a major accident is not imminent, with only a few, relatively minor, countries flashing red.



Minimizing exposure to carry trades makes sense

So putting it all together, it probably makes sense to minimize the exposure to carry trades in portfolios. Or at least to deploy capital in fixed income stories with a strong fundamental background.

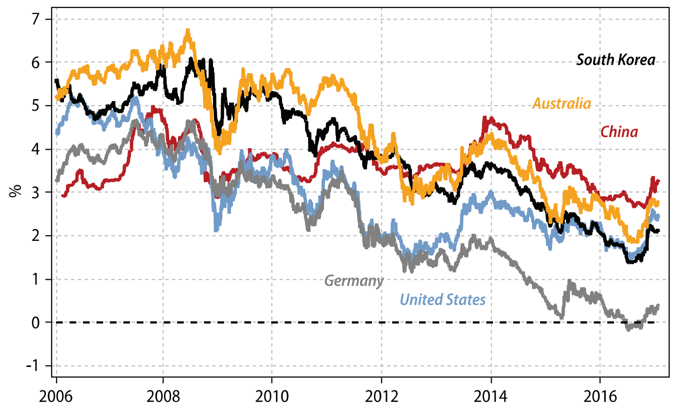
And this brings me to Chinese bonds. For the past five years, we at Gavekal have argued that investors should include Chinese bonds in their portfolios. First because, if China is serious about becoming an empire (and we think this is Xi Jinping's goal), China needs to continue delivering

We have long argued that investors should include Chinese bonds in their portfolios

returns on Chinese bonds that are at least similar to those offered by treasuries. Second, because as China continues to open up its capital base to foreign investors, at some point in the not too distant future, Chinese bonds will likely be integrated into global indexes. And when this happens, few bond managers will accept being underweight Chinese bonds, if only because Chinese bonds offer yields that are higher than those offered in almost any OECD country.

In the course of 10-years Chinese yields have barely moved

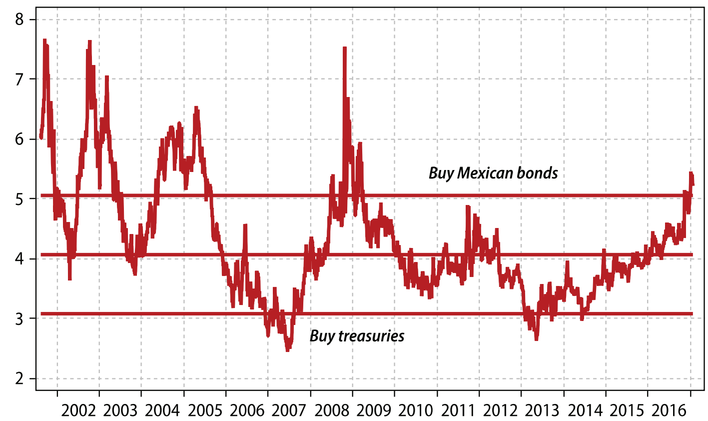
10-year government bond yields, by country



Gavekal Data/Macrobond

Mexican bonds certainly look oversold

Spread between Mexican & US 10 year government bonds



Gavekal Data/Macrobond

The arrival of President Trump adds uncertainty to the Chinese trade. On the one hand, China may feel that revaluing the renminbi (as it did in the first week of 2017) might shelter it from Trumpian wrath. On the other hand, could the imposition of tariffs push China into devaluing more?

Though Trump adds uncertainty to this trade, Mexican bonds are sending a buy signal and the peso is undervalued

The other major target of Trump's ire has been Mexico, where the peso is now undervalued on a purchasing power parity basis by more than one standard deviation. The spread between treasuries and Mexican government bonds is also more than one standard deviation above its mean (see right hand chart above).

But of course, like the China bond trade, the Mexican equivalent implicitly assumes that global trade does not fall into a 1930s-style spiral on the back of a surge in US protectionism.

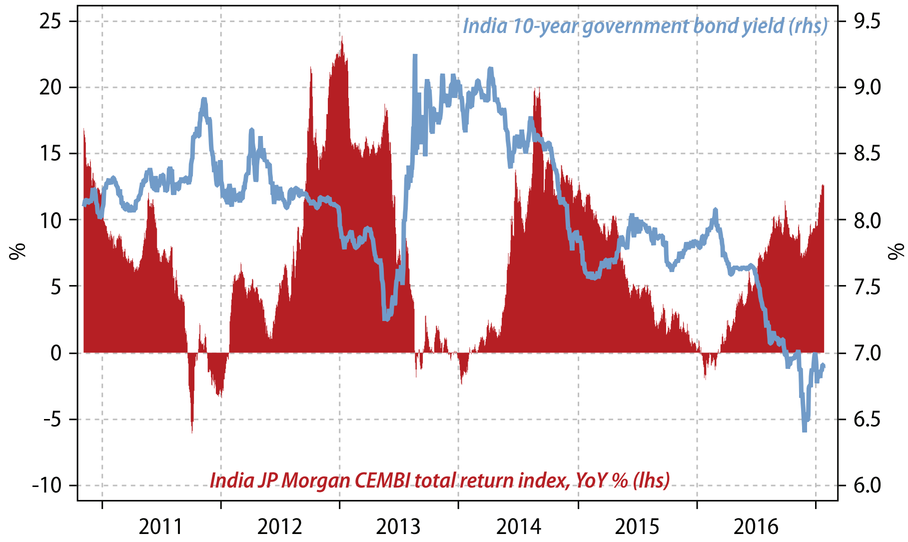
Opportunity in Indian bonds

Indian bonds are not too dependent on what Trump does in the white house, and they come with yields to boot

Finally, one interesting carry trade that probably does not depend too much on Trump's actions is Indian fixed income (see **Modi Finds His Mojo**). Indeed, if you like your bonds to come with a yield (and yields are nice as they cushion changes in interest rates!), India is one of the few remaining markets (with Indonesia, Argentina, Brazil and a few other emerging markets) whose yields offer bonds the possibility of genuine capital gains. Indeed, in 2016 Indian bonds registered gains of about 10% (see chart overleaf). Should energy and food prices stay restrained in 2017, the same causes could well produce the same effects.

Indian bonds could be set for another big year

India: bond yields and bond market performance



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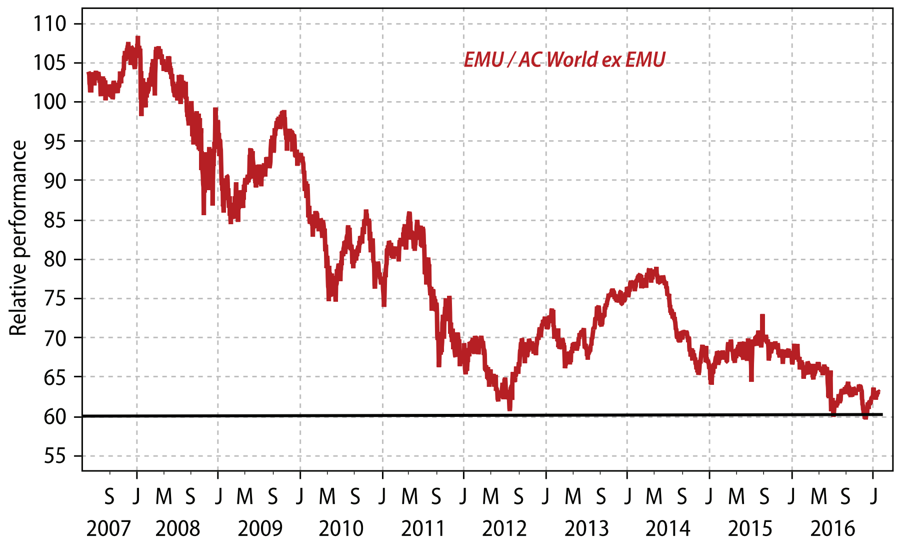
2 — Return-to-the-mean trades

The most obvious return-to-the-mean trade this year are European stocks which sit at euro crisis lows

Given all of the above, the first obvious return-to-the-mean trade of 2017 should be eurozone stocks. Indeed, on a relative basis, eurozone stocks sit today at the same lows that were touched in the depths of the euro crisis in 2012. Thus, anyone underweight the single currency area over the past decade has not had many opportunities to regret that decision.

Are EMU stocks bottoming?

MSCI IMI index, total return in USD terms



Gavekal Data/Macrobond

An earnings recovery is likely in European-focused companies

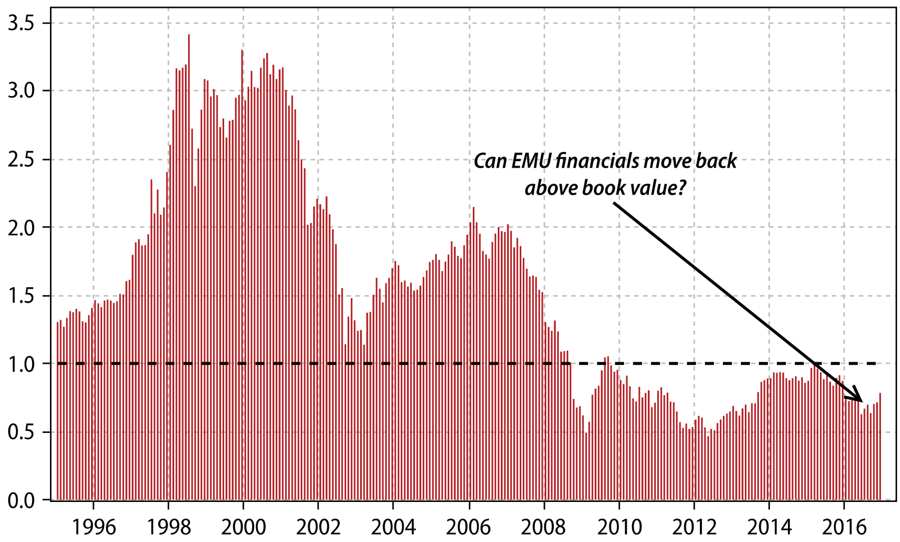
But will the same be true for the coming years? The likely rebound in nominal growth should lead to an earnings recovery among domestically-focused European companies. Meanwhile, a key reason almost every investor is underweight eurozone stocks is the perception of high political risk. However, just like in 2014, this year could see Euroland political risk fall, rather than increase.

Financials, which feature heavily in eurozone indexes, may also have bottomed

Another reason to overweight eurozone stocks is the possibility that a bottom may have been seen in financials globally (my second "return-to-the-mean" trade). Given financials' heavy representation in euroland indexes, and the fact that almost all lending transactions in Europe go through a bank, the bottoming of financials (on the back of easier regulations, less fines, and a steeper yield curve) should offer eurozone stocks a strong tailwind. To put this another way, if eurozone financials cannot move back above book-value in the current environment, they probably never will!

Eurozone financials: if not now, when?

MSCI mid & large cap EMU financials index, price-to-book value ratio



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Anatole fears another leg down for sterling during Brexit negotiations

Another important return-to-the-mean trade for 2017 has to be the pound sterling, though this one is much more controversial within our little shop. Anatole fears another downdraft triggered by Brexit negotiations that turn south and/or an overall move higher in the US dollar against almost everyone. For my part, I think sterling is extremely attractive for the following reasons:

1) The pound is extremely cheap. In fact the last time it was this cheap against the euro, the entire eurozone shortly afterward entered a near-death spiral financial crisis (see chart on page 5).

I think sterling is attractive given its valuation against the euro and the likelihood of a deal with the next leader of France

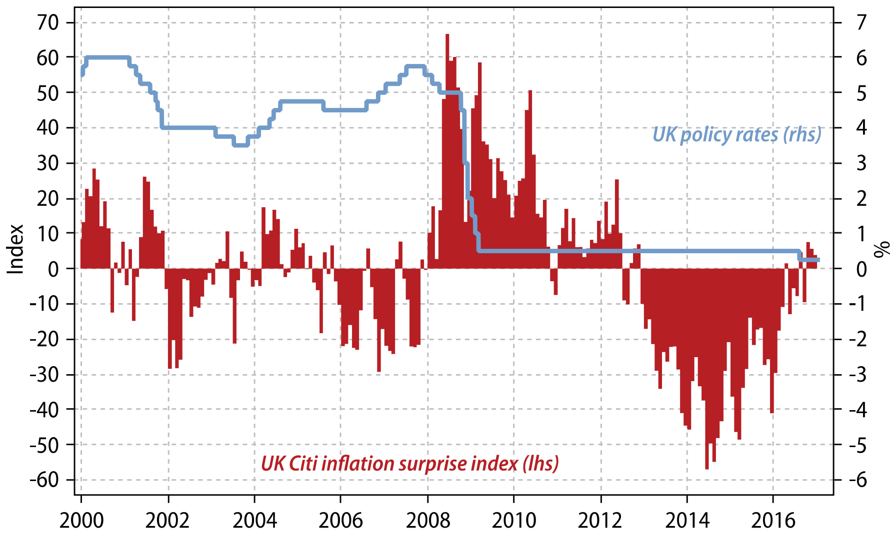
2) With this memory in mind, as already outlined it is likely that whoever ends up as president of France, along with the German chancellor, decides to cut a decent deal with Britain and push the pound higher. Any inkling of a "deal" being struck (which could well be a 2017 story) will likely see the pound hugely gap up.

Sterling has stopped falling on bad news

3) This is all the more so since the pound is now acting like a stock that no longer goes down on bad news. When Theresa May announced last week that she would walk away from any "bad deal" and Britain was happy to have its relationship with the EU governed by the World Trade Organization (i.e. the worse-case scenario), sterling rose, rather than fell. And as all currencies fell against the dollar in the weeks that followed Trump's election in the US, the pound was one of very few to hold its own. This likely points to the fact that almost anyone who was going to sell/hedge their sterling exposure has, by now, done so.

The only way is up for UK rates, and maybe soon

UK Citi inflation surprise index and UK policy rates



Gavekal Data/Macrobond

4) Finally, another reason to like the pound is that the Bank of England's room to ease any further is getting constrained. Indeed, not only is inflation ticking higher (unsurprising given the pound's devaluation), but BoE Governor Mark Carney has come under fire from the government for not only misjudging the economic impact of Brexit (a debate he would have done better to stay out of), but also maintaining interest rates too low and thus contributing to the unaffordability of housing. Such public pronouncements most likely mean that the next move for UK interest rates will be higher, not lower.

Hong Kong oversold?

Hong Kong equities seem priced for a crisis, but this will depend on the direction of the US dollar

Another possible return-to-the-mean trade for 2017 is Hong Kong stocks, though this will likely be entirely driven by the direction of the US dollar. Historically, Hong Kong equities have fared well when the dollar has been weak as the linked exchange rate system forces the quasi central bank to print aggressively. The market tends to fare poorly when the US dollar is strong as the system then drains excess liquidity from Hong Kong. Currently Hong Kong equities trade on a price/book ratio below 1.25 (see left hand chart overleaf) which means the market is pricing in the kind of "crisis" seen in 2008 (global meltdown), 2002 (TMT bust) and 1997-98 (Asian crisis).

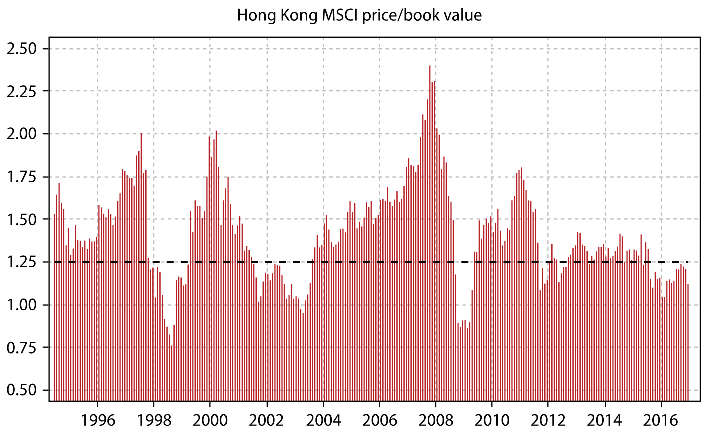
Hong Kong is undergoing a political "crisis"...

It could, of course, be argued that Hong Kong is going through a "crisis" as the disconnect between the citizenry and its political leaders has never been wider. Simply put, Hong Kong leaders have failed to tackle the number one issue on people's mind: the unaffordability of real estate. Which is perhaps not surprising in a city where most of the elite's wealth is tied up in real estate. Just as turkeys don't vote for Christmas, the Hong Kong bourgeoisie (and their representatives) are not keen to unleash a large supply of real estate unto an extremely tight market. But unfortunately, the end result is an increasingly medieval feeling society where people either own land or work all day for someone who does.

...but the election of a new chief executive this year could grant the city a honeymoon period of sorts

Against this backdrop, why be enthusiastic about Hong Kong? First the current Hong Kong chief executive will pack his bags before June 30th, and whoever succeeds him will benefit from a honeymoon of sorts, or at least from sheer relief that the unpopular incumbent has gone. Second, Hong Kong, as a city of immigrants, is handy at reinventing itself and making the best of a bad lot. The population remains resilient and Hong Kong remains worth a bet when the market so deeply discounted.

Hong Kong equities are unquestionably cheap



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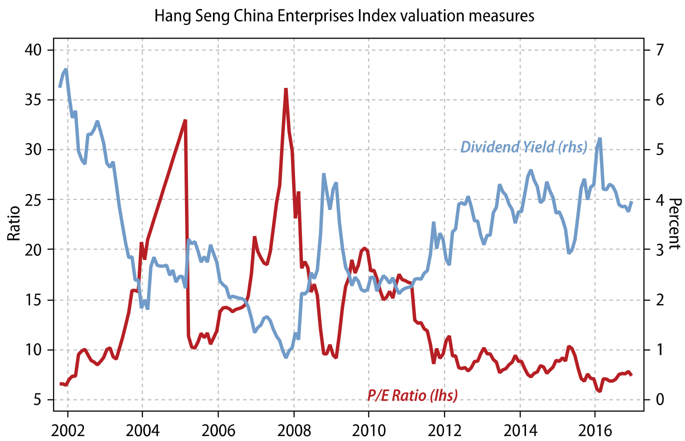
Hong Kong listed H-shares are also cheap on pretty much any measure



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H-shares are priced for serious challenges on the mainland, so if China does not implode valuations should go higher

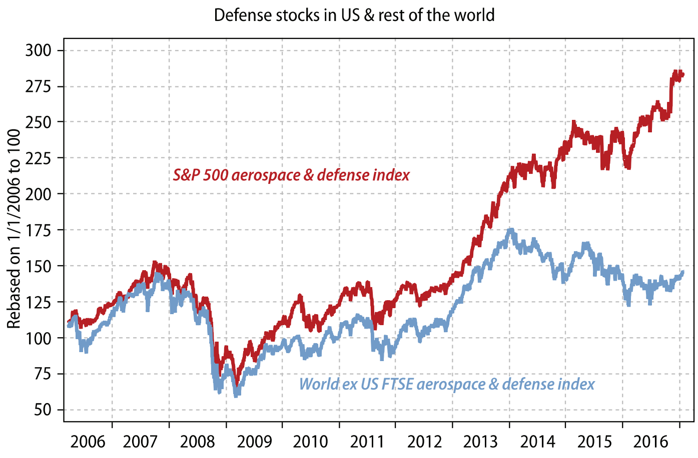
And if Hong Kong stocks are cheap, H-shares are doubly so. Valuations for these Chinese stocks—whether price/book, price/earnings, or dividend yield—point to China-based companies facing serious challenges on the earnings front (see right hand chart above). However, if China does not implode (see **Five Macro Questions For 2017**), then Hong Kong's status as China's main financial center should allow for higher valuations.

3 — Momentum trades

Reading through the lines of Donald Trump's platform, it is easy to conclude that his overall plan is to "do less with less". Indeed, why spend more than the next 30 countries combined on military technology when one's army ends up stumbling against a bunch of goat herders armed with AK-47s in far-away mountains? Donald Trump's questioning of NATO's necessity and the use of foreign alliances should be seen in the context of a broader struggle over military spending (it possibly explains why the US military-industrial complex, and the neo-con right, is so keen to dress up

Vladimir Putin in bogeyman clothes). With that in mind, it is hard to be too enthusiastic on US defense stocks, which, over the past decade, have rewarded their investors handsomely.

US defense stocks have hugely outperformed global peers



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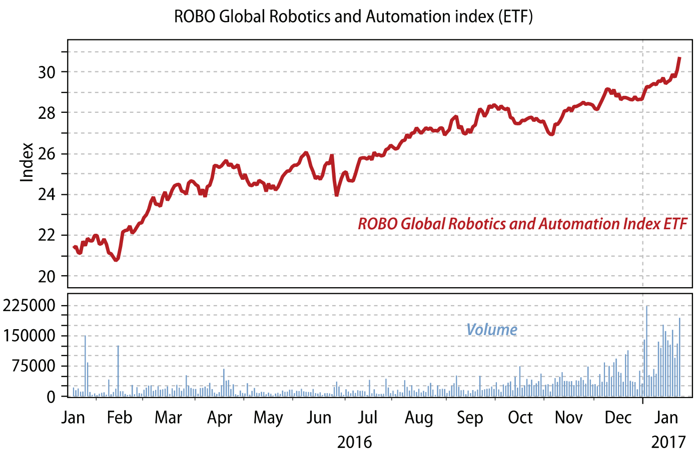
Robotic stocks have relentlessly risen over the last year



Bloomberg, Gavekal Data/Macrobond

If the weight of military expenditure starts shifting from the US to other nations, their domestic defense industries should benefit

The point is the outperformance off US defense stocks relative to foreign peers, especially in the past three years. However, the current geopolitical trends (civil war in the Middle East, an assertive Russia and an expanding China) point to nations such as Japan, South Korea, Germany, France, the UK, Saudi Arabia, Taiwan, Vietnam and India all boosting military spending. These countries may buy from American firms but, when the choice is available, most will choose to buy weaponry from domestic defense contractors. Increased exposure to Japanese, and perhaps European, defense stocks makes sense.

The robots really are coming

If manufacturing does return to the US, this will be positive for robots

Another key component of the Trump platform is his desire to bring factories back to the US. And this may well happen, even if they do not deliver many jobs to the US rust belt. Indeed, any factory that moves back is likely to embrace automation and robotics, rather than go out and hire a new army of blue-collar workers (for more on this long-running theme, see our 2012 book, ***Too Different For Comfort***). This trend should be positive for robotics, which have incidentally done quite well in the past year, as recorded by the ROBO.US ETF (for full disclosure, I personally own a 10% stake in this ETF)—a momentum that will likely be sustained through 2017 (see right hand chart above).

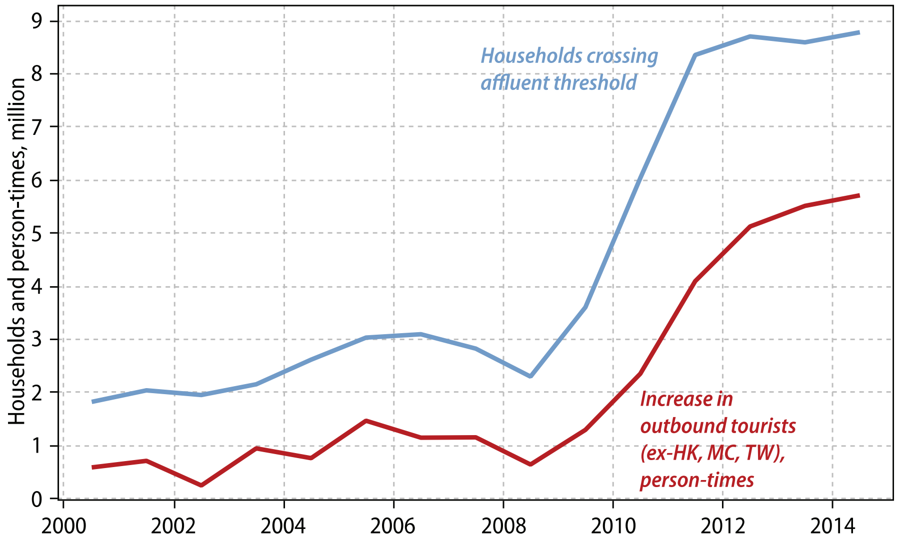
Another structural trend is the sustained rise of consumption in emerging markets

Beyond robotics and the likely rise in ex-US defense spending, another key fundamental trend is the sustained rise of consumption in emerging economies, if only because of the acceleration phenomenon (see **Chinese Equity Demand And The Acceleration Phenomenon** and the chart overleaf). There are many different ways to invest for this structural trend; these include higher calorific food and drink consumption, an expansion of managed savings and the rapid growth in tourism, which benefits airports, airlines, gambling operators and online travel specialists.

With growing affluence in China came an increase in overseas travel

Affluent households are driving Chinese overseas travel

Annual increase of tourist visits vs. households crossing thresholds, 3ycma



UNWTO, Wind, Gavekal Data/Macrobond

The world's most underbanked area, South Asia, should see a growth in financials

Staying on this last trend, another key momentum trade has to be the growth of financial services across South Asia, one of the world's most underbanked areas. Indeed, when Narendra Modi came to power, it was estimated that a quarter of the world's "unbanked" population lived in India. Since then, at least 175mn people have opened a bank account. Such growth is hard to find elsewhere. Just as importantly, given Modi's "war on cash", not having a bank account will soon no longer be an option in India. And with savings coming out of mattresses and pillows, banks in India can hopefully move beyond just financing healthcare emergencies.

After an initial burst of post-Modi enthusiasm, Indian banks have lagged

Gavekal Data/Macrobond

4 — Hedges

Watch out for accidents and disappointments, and hedge appropriately

Murphy's Law states that what can go wrong, will go wrong. Unfortunately that particular law is of little use to investors for whom things can "go wrong" in so many different ways. For example, possible accidents in 2017 might include:

- **A spike in oil prices** (following the spread of the Middle Eastern civil war). This would push inflation higher across the western world, force central banks to tighten and trigger a re-rating of risk premiums. The obvious hedges against such a scenario would be Russia (equities), Canada (REITs) or US energy plays (MLPs), any one of which would thrive if Saudi Arabia hit the wall.
- **Disappointing US economic growth.** This may result from weak capital spending due to uncertainty over tax, regulation and trade rules. In this event, it is a safe bet that the Fed would pare back tightening expectations, thereby weighing down the US dollar and most likely triggering a rebound in gold, silver and precious metals miners.
- **Eurozone troubles.** This will hardly be a huge shock, for without the European Central Bank's actions the single currency show would have imploded a long time ago. So what happens if pressure from the US and possibly Germany causes the ECB to abandon its QE forever policy. Horribly indebted Italy may suffer, but the first casualty may be the German bond market as ten-year bunds currently yield the princely return of -1.5% real. In that respect, shorting bunds today seems like a decent hedge against an end to eurozone QE.
- **A China bust.** Our core belief remains that leading up to the 19th Party Congress in the fall, Chinese leaders will seek to keep the show on the road. Thus, China is unlikely to deliver the kind of shock seen in the summer of 2015 and January 2016. If this assessment proves wrong, then copper, iron ore, coal and shipping would roll over hard. So, for those concerned about a China bust, shorting copper may make sense.

Diversified positioning should help clients achieve a better outcome in 2017 than Nicolas II experienced in 1917

For the past few years, I have argued that we were entering **Revolutionary Times**. To underline this point, I even took to quoting Lenin, who, looking back at Russia's Revolution, opined that "there are decades when nothing happens, and there are weeks when decades happen". And in such times, building resistant portfolios is a challenging task. Of course, this is what diversification is for. With that in mind, we trust that the positioning of our clients heading into 2017 is rather more optimal than Nicolas II's was as he moved into 1917.