PERENNIAL VALUE MANAGEMENT

Perennial Perspective

There's something happening here
..........What it is ain't exactly clear

These lyrics are from a great song released exactly 50 years ago (penned by Stephen Stills – then with Buffalo Springfield). There's certainly "something happening" in markets as we saw an incredible change in mood post the Trump election with growth assets rallying big time (Aussie shares were up 12.4% for the year with over 80% of that return coming post Trump!).

So having shrugged off Brexit, Trump, Deflation and China fears are these new, positive "animal spirits" real, reflective of actual new activity, sustainable and what does it mean for markets in 2017 ? These are big questions to answer but here are our six key themes for 2017 and my best guess on how 2017 may play out for investors.

Six themes to watch
1. "Trumphoria" – a delicate balance.

"He tells it like it is."

The effect of the new US Presidency is about as clear as mud and how this plays out over the year can and probably will have massive geopolitical and market ramifications. Whilst the press are cynics as per the above cartoon, markets have lapped it up.

Chinese tariffs, the Mexican wall, Infrastructure etc. – there are a lot of moving parts here to say the least (and, of course, some very positive for certain equities). Just one example that hasn't received as much press – President Trump's proposed "border-adjusted tax" – If it goes through this will have major implications for certain sectors that import a high percentage of their raw materials. For example, a US clothing retailer that imports goods to on-sell in the US market may have to increase prices by 10-20% to maintain similar levels of profits, despite the company tax being reduced (naturally this will be offset to some extent by expected gains in the USD increasing their buying power). The question is whether Congress will approve this? I guess the good news for the new administration is that they are coming in at a time when the US economy is strengthening after years of monetary stimulus and employment has firmed considerably (US headline unemployment at 4.7%).

Overall – Can President Trump pull it off ? Massive spending, tariffs, border taxes and tariffs, diplomacy “hiccups”, new infrastructure etc. Long term it looks problematic to me but short term markets have effectively voted positively on a reflationary, higher spending and lower (local) US taxed United States. Our gut feel is that this is the biggest market risk factor for 2017. To me it lots like the positive “Trumphoria” feelings will be dented throughout the year as usually happens with a major reform agenda Government is elected. Having said that, this positive momentum can persist for the short term at least – After that reality will set in and growth assets with re-adjust. Our central view is that growth assets will generally produce overall positive, albeit single digit returns in local currency in the develop markets.

2. Bonds finally shaken, not just stirred

After a remarkable run for Government bonds, the new reflationary environment promises to make life difficult for longer duration fixed interest although it’s fair to say some of this has already been priced with bond total returns falling post Trump with the Australian Bond index down -2.6% since September ‘16 (Bloomberg AusBond Composite 0+Y) driven by rising yields as more inflation gets priced in.

Bonds can still be a good insurance policy if the World turns to goo but overall 2017 will likely be a good time to be invested in shorter duration credit assets. Interest rates are expected to move higher but credit spreads should perform reasonably well as corporate balance sheets are largely in good shape.

Overall – Probably time to (finally) underweight Government Bonds. Credit exposure a better bet, particularly given strong balance sheets.

Propping up China

If you are concerned that China tends to fudge their official statistics then the new Spaceknow index that monitors 2.2 billion individual satellite observations over China to observe actual changes and activity is also holding up well with the index at 51.2 (over 50 implies an expansion). Pressures on capital outflows, debt and property markets will still be observed during 2017.

With some antagonism expected from Trump, the Communist Party congress in the latter half of 2017, held twice each decade probably ups the ante in terms of political risk even though President Xi Jinping and Premier Li Keqiang will remain on the top level standing committee.

Overall – China will manage above 6% GDP growth in 2017 as they slowly move to a new, more sustainable model.

3. Other emerging markets

More generally outside of China, emerging markets may suffer under Trump and a predicted stronger US dollar. Potential Trump tariffs and a strong US dollar are a nasty combination and the Trump / Brexit posed threat on globalisation probably will also concern the leaders of these nations. Having said that the steady flow of continued globalisation is likely to occur in the longer term, and whilst President Trump’s policies are generally negative for emerging countries, the need for strong global trade to support global supply chains and consumers increasing desires will still prevail.

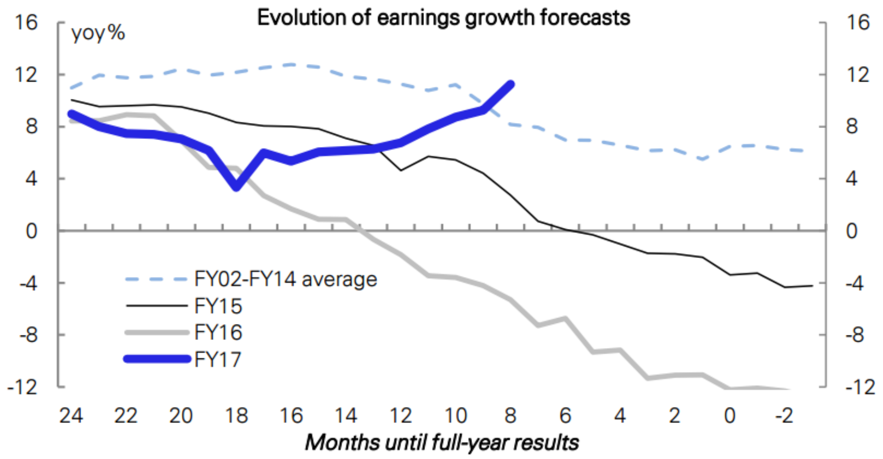
Overall – It could be a tough year generally for emerging markets, particularly those with high USD denominated debt which becomes more expensive to repay if the dollar strengthens as is expected.

4. Earnings where art thou

When we clear away all the US and Geopolitical rhetoric, perhaps the simplest and most fundamental question is - will individual companies actually increase their earnings per share? This is crucial as current valuations are already pricing in very high trailing PE multiples. IBES consensus numbers show developed markets earnings growth going from a subdued (estimated) under 1% growth in 2016 to over 12% growth in earnings in 2017 (and emerging markets eps growth from 8% to 14%).

Now the cynics out there will quite rightly point out that in recent years brokers have tended to be overly optimistic months before results and the actual numbers have tended to disappoint (as per the chart below). In terms of our market, the massive swing in commodity prices will at least see part of the earnings growth already baked in but whether we then hit the current 10% forecast is very much predicated on global growth, the continued build-out of the strong housing approvals and a tick up in infrastructure spending.

Chart - Australian share earnings growth forecasts. Shows how forecasts have changed as we get closer to the announced full-year results



Source: IBES, Datastream, Deutsche Bank

Importantly this new reflationary environment should further exacerbate the current trend favouring value shares. According to Credit Suisse rising rates will also dampen some shares eg Transurban, Sydney Airport, APA, Duet, ASX, Medibank and Scentre

Overall – Expect high single digit returns for Australian Shares with lots of volatility along the 2017 journey.

5. Euro Elections and politics to trump Trump?

The political landscape in Europe is also under scrutiny with important elections in The Netherlands (general Elections, March), Italy (after June, Renzi taking on the 5 Star

Movement) and Germany (sometime in August to October). Unlikely to be as pivotal at the US. In Germany Merkel currently looks likely to lead a new coalition.

We should also see the first on the likely trajectory/conditions of the UK's EEC exit, as PM Teresa May is likely to give official notice in the first half of the year, another important political negotiation with wider ramifications (remember there is a two year negotiation period).

Overall – Keep an eye on populism developing in Europe and Anti Euro sentiment gaining momentum.

6. Aussie Economy – Leadership needed

Australia is headed for a positive year with GDP growth expected to come in around 3%, with increased commodity prices a positive and the key issue revolving around the next driver of growth as the current East Coast building boom gradually subsides.

The dollar is hard to predict at this point with our strengthening Terms of Trade pushing it up and US interest rate rises/cross border flows (we are no longer flavour of the month) having the reverse effect. Overall perhaps we could see our dollar in the late 60s but this is a difficult one to predict.

Official Interest rates should remain unchanged put for the year.

Overall – Earnings look like recovering (see above) and Australia will benefit from a more positive globe with China holding up. However, we clearly need leadership to ensure new areas of Aussie growth.

The conclusion

Picking the exact direction of assets classes for the next 12 months is a difficult game – particularly with so many wild cards to pop up in 2017.

- It is hard to believe the rhetoric is nothing more than that – equity markets are probably a little too "pumped up" at the moment so don't expect a "Trumphoria" mega rally although positive returns for Aussie shares look likely for 2017
- Focus on lower duration, floating rate fixed interest
- If you thought 2016 was difficult to predict (Brexit, Aussie Election closeness, Trump etc) then hold on because we are probably in for another ride – stay diversified, watch valuations carefully and be careful with what you read.
- Overall expect modest returns in a year where "Trumphoria"/ animal spirits meet reality.

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