Global Connections

Itaú BBA

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2017 Global Investment Outlook: America First?

America First can mean many things. It can mean America is number one; it can mean put America first; it can mean America is the best place to invest, or add the letter s to America and it can mean let's extend America further southward. It can mean some, all or none of these things.

Investors need to analyze which of these possibilities President-elect Trump means when he says "America First." This Outlook will do so using my Global Risk Nexus framework, which analyzes the global interplay between the four crucial elements of: economics, politics, policy and markets. Given the uncertainty surrounding politics (Brexit, Trump,) and policy (tricky transition from monetary to joint fiscal-monetary) this framework seems very well positioned to add insight (though it's not perfect by any stretch – I did not expect Donald Trump to be elected president, for example).

Let's begin with the global economic outlook, where we will consider six key questions. We will then move to politics and discuss how an inexperienced president and a party that has been out of power for some time will govern, given control of all three major branches of government. We will discuss Europe's Year of Politics and cover China as well.

Moving to policy we will assess how the four major elements of the president-elect will influence policy (the four elements being negotiator, borrower, builder and tweeter). The narrow policy path for success between "full bore" Trump and "unmoored" Trump will be examined together with the implications of US Economic Nationalism for trade in general and Mexico in particular. (Hint, what are the odds of President Trump pulling a Nixon-goes-to-China and embracing Mexico?).

Last and certainly not least we will tie all of this together into what it means for financial markets in 2017, assessing the risks as well as the opportunities before concluding with the Five Top Trades for 2017.

6 KEY GEO-ECONOMIC QUESTIONS

1) Are We Still in a Low-Growth, Low-Inflation and Low-Interest-Rate World?

Yes; relative to any point other than the past six months all three indicators remain very low. Demographic and productivity challenges suggest status quo. Direction and degree matter, however, and the direction is up, especially in the Developed Markets (DM).

However, the degree of change is likely to be slight, with many forecasters suggesting only minimal increases in GDP growth next year (OECD forecasts 2% GDP growth for its members in 2017, with US GDP growth of only 2.3%). 2017 year-end consensus forecasts for the 10-yr UST bond are 2.5%, within 10 bps or so of where it is today.

Very high debt levels, excess labor and commodity supply coupled with significant slack in productive capacity combined with a strong dollar and higher rates all argue against a sudden inflation spurt.

There is the risk, however, of a "hot-house" effect whereby the Trump Administration presides over a big fiscal stimulus with huge tax cuts ("biggest since Reagan"), a very large debt-funded infrastructure program complete with a Buy American/protectionist component that leads to a spike in inflation. Fear that the Fed has lost control of the bond market could lead to the return of the bond vigilantes, sharply higher rates and a short-circuiting of the stock market rally and economic pickup.

2) Just How Tricky Will the Transition from 100% Monetary Policy to Joint Fiscal-Monetary Policy Be?

The tricky transition is likely to be just that, tricky. Donald Trump's election has clearly accelerated the fiscal narrative (see "Waiting for Fiscal," published on April 29, 2016). Fiscal stimulus is a much-needed positive given higher rates and a stronger USD. It is also good politics. Expect the Fed to slow-walk rate hikes and the Trump Administration to try and speed-walk stimulus. How that interplay works out is one of 2017's key unknowns.

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One takeaway from Brexit and US elections is that politics and the markets' discounting of politics moves quickly, whereas policy and the economy move slowly. This disconnect is most apparent in the surge of both the USD and UST rates, both of which are arguably anti-growth, raising the prospect of a first-half slowdown next year. This is especially the case given that the major Trump effect in 2017 will likely be via the unleashing of animal spirits in the consumer. The growth benefits of a fiscal stimulus package are likely to come only in 2018 and be dependent on policy design and implementation.

In Europe and Japan, the transition should be more muted. The ECB is likely to extend its asset purchase program deeper into 2017 while the European Commission has recommended fiscal stimulus equal to 0.5% of GDP, a marked departure from the prior austerity regime. Japan's fiscal package was passed earlier this year so it should have more of an immediate effect on 2017 growth and inflation. The BOJ's promise to hold the 10-yr JGB at zero is likely to enhance the positive effect of the stimulus (an important point to bear in mind).

3) Is Globalization Decelerating?

Yes, globalization is likely to decelerate further, but it's important to again note the degree. Finance, the tip of the globalization spear, has been reversing since 2009, while in trade terms, 2016 will be the first year in a decade plus where trade growth will be less than global GDP growth, itself pretty lackluster. Broadly speaking, EM and surplus countries such as Germany and China are most at risk.

Regular readers will recall the Tri Polar World global growth theme (see "The Tri Polar World 2.0 – A New Global Growth Model," published on March 26, 2015), which argues that regional deepening is the new global growth model. When viewed through the Tri Polar prism, decelerating globalization can also mean accelerating regionalization and thus more of an opportunity than a threat.

The key is to avoid a 1930s-style trade rollback; here one can expect the president-elect to be a negotiator rather than a destroyer of existing trade deals. It's feasible for example that he seeks to reopen NAFTA and comes to realize it should be extended to the tip of South America rather than discarded. It's clear that the president-elect holds very few fixed positions and so many things are possible, not all of them bad.

4) Will China Blow up in 2017?

No, China is unlikely to blow up in 2017. China's focus over the next year is to ensure stability in the run up to the Party Congress in the Fall. Thus one should expect continued stimulus, gradual RMB depreciation and very little on SOE reform. China risk is likely to be elevated in 2018-2020 rather than in 2017. I leave for China tonight and should have more to report post trip.

5) Is 2017 the Year Japan Enters Inflation?

Yes, expect Japan to enter an inflationary state in 2017. This may well be the biggest geo-economic surprise of the year, given how many have given up on the idea. Yen weakness (likely back to 2016 lows of 125 vs. the USD and beyond), bottoming consumer inflation expectations, record low UER of 2.5% leading to expected wage gains, a fiscal spending boost and the BOJ anchoring of rates at zero all suggest Japan could surprise and exit 2017 with inflation in train.

6) Will 2017 Mark the Collapse of the Euro?

No, the Euro is highly unlikely to collapse in 2017. One always needs to remember that Europe has a massive current account surplus of 4% of GDP. The French are unlikely to elect the Far Left, while Angela Merkel is highly likely to be reelected given record low German unemployment. A modest growth upswing and unemployment at a three-year low will also boost the Euro's fortunes.

Bottom line: The downward drift of the developed economies' growth, inflation and rates has been arrested. Having said that it is very hard to make the case for a surge in any of those factors. A narrow policy path exists to modest upticks in growth and inflation that will lead to the same in the interest rate sphere.

POLITICS

Within the US political context, there are a few key points to keep in mind. One is that Donald Trump will govern with an America First or economic nationalism mentality. This is a core principle of his and one that extends quite far back in his personal history. The sound bites about how America is ripped off in trade deals is red meat to his political base as well as a deeply held personal belief that ties in with how he sees himself as a deal maker and negotiator. Secondly, the Republican Party now controls the White House, Senate and House of Representatives. It is a hierarchical party that wants to have success governing after years of being in the opposition. Expect internal debates, not party disunity.

It is quite feasible that Donald Trump both accelerates America's geo-political decline abroad while boosting hope at home. His tendency to tweet his thoughts out on all subjects and at all hours is likely to mean a bumpy ride for policymakers, CEOs and investors alike. His disregard for convention and apparent lack of preparation leaves him at risk of capture by those around him, as evidenced in the search for a Secretary of State. The brofest between Putin and Trump suggest the US-China relationship is most at risk, given internal Chinese politics and Trump's need to channel the anger of his political base.

Europe in 2017 will be a year of politics rather than policy. Elections in France, Germany and the Netherlands are likely to lead to plenty of spilt ink but do little to change the underlying dynamic of a slow shift to pro-growth policies. There is the prospect of a shakeup in the French economy should Francois Fillon win the election which arguably would be quite good for France as well as the European project. A 25-year low in German unemployment and a reduction in the magnitude of the migrant crisis suggests fairly easy reelection for Angela Merkel. The high point in bearish sentiment on Europe may have already passed given post Brexit polls showing growing support for Europe.

POLICY

Donald Trump is a negotiator, borrower, builder and tweeter in chief. As negotiator he will want to reopen trade deals to be able to say he got a better deal. A better deal will be defined in the context of America first and jobs for Americans. For the rest of the world this suggests the days of the US acting as a consumer of last resort and being a global demand-engine are unlikely to return. That demand and those jobs will be encouraged to stay within the US. This is most worrisome for the EM. How this plays out as policy remains an open question.

TRUMP PULLS A NIXON

Expect NAFTA to be reopened, something Canada and Mexico have both signaled they are ok with. The real question is whether a President Trump can be sufficiently visionary and strategic enough to seek a newly negotiated, better NAFTA that extends southward to include all of South America. The timing is right; political winds in South America are more favorable than at any point in decades given new governments throughout the region. If you think Trump to South America is impossible, remember that Nixon went to China!

The first 100 days will be important to see how Team Trump gets off the ground. Deregulation should be first up as it's easy to do without a lot of congressional engagement. Labeling China a currency manipulator is also easy to do without congressional participation. The fact that Senator Schumer, leader of the Senate Democrats, is in favor of such labeling may mean it will come up fairly early. It will also play well with his political base.

The borrow-and-build components come into play with the fiscal stimulus program. Both tax cuts and infrastructure spending requires congressional sign-off and so will be much more drawn out and unlikely to impact the 2017 economy beyond generating confidence. Republicans want tax cuts, while Democrats want infrastructure spending, so the hashing out will take time. Expect little more than position setting in the first 100 days.

On monetary policy, the Fed will be quite happy to no longer be the only policy actor in town and to get a little more insurance in its pocket via a rate hike later this month. One should also expect the Fed to move slowly going forward so as to not spook the markets as it did a year ago with its talk of four rate hikes. The bond market is likely to be in charge of the long end of the curve which does raise the risk of the return of the bond vigilantes if the Fed is seen as falling behind the curve. Fed voting members in 2017 are expected to be more dovish and so the stage could be set for some fireworks in this regard.

JAPAN ENDS DEFLATION – THE SURPRISE OF THE YEAR

Elsewhere, expect Japan to break its deflationary cycle as fiscal stimulus, a weak yen, wage gains and rising consumer inflation expectations lead to increased consumption and inflation. Europe as noted will see politics take the lead over policy. China will seek to maintain its economic status quo as internal politics takes precedence.

Policy risks center around the narrowness of the US policy path between the "full-bore Trump" effect noted above or the "unmoored Trump," where the first 100 days are a disappointment as team-building gives way to infighting, leading to a loss in confidence, a deeper-than-expected first-half slowdown and a growing sense that the Fed again made a mistake with its December hike, leading to a potential market replay of Q1 2016.

The past month has witnessed dramatic moves in global financial markets. Bonds, currencies and parts of the equity markets have all experienced dramatic moves. The vast majority of these price moves has been driven by expectation of what is to come rather than what has occurred. Policy communication and execution will be critical to sustaining and extending positive financial market pricing. The risk of disappointment and price reversal is certainly not trivial.

MARKETS

We remain in a low-growth, low-return world, with US equity valuations, higher interest rates and a USD back to its highs for the year, all arguing against sharply higher US equity prices. Fiscal stimulus is urgently needed to offset these shifts and avert the development of negative feedback loops in what remains a highly indebted world (see "Why the World Needs a Weak Dollar (The Case for a 21st Century Plaza Accord)," published on February 26, 2016).

On the plus side, DM GDP growth is bottoming, as are earnings, while fiscal stimulus is being embraced as a way for the political class to keep their jobs. Bottom line: favor equity over fixed income.

Within equity, favor DM over EM and non-US over US. Consensus S&P forecasts for YE 2017 is roughly flat on current price levels, while valuation, ownership levels and upside to prior highs all suggest non-US DM may outperform the US. Emerging Markets are likely to face an overhang of a strong USD and trade/protectionist concerns emanating from the Trump Administration. Dedicated EM investors will likely lead the way on both the debt and equity side.

Favor small- and mid-caps over large-caps, especially in the US, given small/mid-cap avoidance of USD risk, their greater exposure to tax cuts and the focus on America first and infrastructure build-out with a potential Buy American tint to it. Within sectors, financials looks the most appealing in both the US and Europe as they protect against rising rate concerns, don't have the same FX exposure that other sectors have and should be a prime beneficiary from the deregulatory approach that is likely to be favored in the new administration.

On the Fixed Income side, one can leave aside the question of the end of the 30-year bull market on bonds. It is a good headline grabber, but the more pertinent questions revolve around credit, duration, currency exposure, etc. Favor credit over duration, HY over IG and USD exposure over non-dollar.

Within FX, favor USD vs. the rest, especially in the case of broad policy divergence and low yield like the Yen and some of the EM low yielders. Expect the Fed to slow-walk rate hikes, so unbridled (and unhealthy) dollar strength is unlikely. The euro parity trade thesis seems overdone and unlikely to be realized given its CA surplus and peak bearish sentiment.

In the Commodity segment, there is limited conviction from this armchair. Oil seems to have found a trading range between $45-55 for Brent crude but the likelihood of the oil production cuts sticking seems limited. Industrial metals seem suffused with speculation while precious metals struggle with rising real rates. Were real rates to stabilize and inflation pick up, then gold might do well… for now it's a volatility hedge. A broad basket of agricultural products does not show any sign of inflation worries.

TOP 5 TRADES FOR 2017

1) Long hedged Japan equity.

   Under-owned by the foreign investor community, undervalued, and protected by the BOJ commitment to hold 10-yr JGBs at zero, a major beneficiary of a strong dollar and OPEC deal as well as a play on global growth pickup. Japan returning to inflation is likely to be THE surprise of 2017… this is the best way to play.

2) Long US small-mid cap equity

   Large-caps at risk to strong dollar and tit-for-tat protectionism. Small-mid caps provide best exposure to deregulation, tax cuts and Economic Nationalism, which is sure to be a centerpiece of a Trump Presidency. Buy on pullback.

3) Long US High Yield Credit

   Fiscal embrace reduces recession risk, appetite for yield remains, strong relative performance over past month, stable oil helps.

4) Long US/EU Financials

   Provide both offense and defense to the portfolio – benefit from higher rates, deregulation, better economic growth, EU banks attractively valued and oversold (look at response to Italian referendum), US banks = rare big-cap sector not exposed to strong USD.

5) Long Mexican Equity

   Donald Trump could end up embracing Mexico; he has already made it 20% more competitive simply by being elected (peso has fallen 20% since spring). Currency is extremely cheap, at 3 STD from 10-year average, while the equity market is at a four-year low in relative value terms to rest of Latin America. Brazil had a monster move in 2016, and dedicated EM investors will dictate markets in 2017.

Four runners-up: long volatility (hard to find a good instrument) given Tweeter in Chief, Tricky Policy Transition. Long Inflation Protection (again hard to find good instrument). Long USD EM debt, given attractive spread vs. UST, its oversold nature and benefit from the OPEC deal. Long Chinese equity, which is likely to benefit from new capital controls as well as property crackdown – there are only so many places for money to go in China, and stocks are roughly 50% off highs.

Be careful as we approach year-end; several of the Top 5 (Japan hedged, US small/mid cap and US financials) have enjoyed recent run-ups. Positions should be built on pullbacks, which are quite likely given the speed of the moves and the faith that they were built on. The easy money has been made, and in many cases it was a years' worth of performance in a matter of weeks. Buy equity on pullbacks, sell duration on rallies, be nimble and don't bet the farm, even on Donald Trump.

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