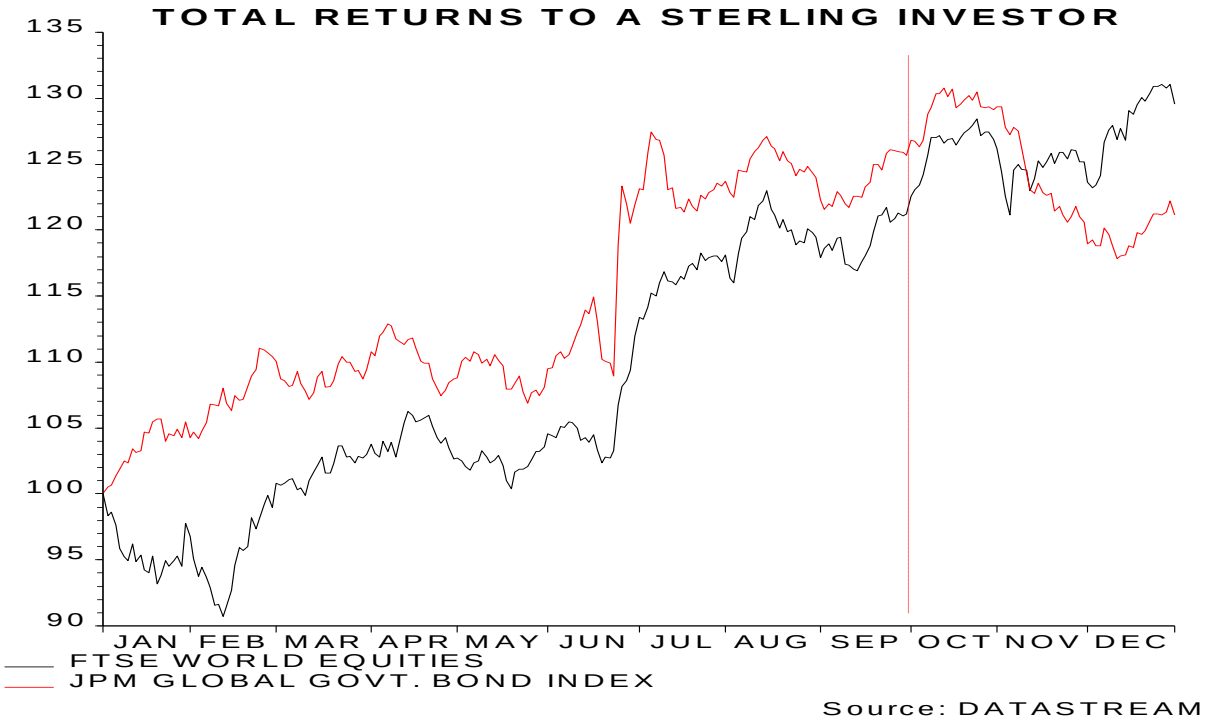
Market Comment

2016 will go down in the history annals as one of the more momentous years, in light of the two major political outcomes - the UK's decision to leave the European Union and the US electorate's decision to select Donald Trump as its next President. At the time of writing this review a year ago, we were in the teeth of investor nervousness following a move by the Chinese authorities to adjust the valuation of their currency downwards against the strengthening US dollar. Had one taken a straw poll of investors at that time, suggesting that those two political results would occur, very few would have predicted the pattern of investment returns portrayed on the chart. What is also remarkable is the shortening interval of negative market reaction: on the Chinese news last January, it took more than a month for sanguinity to reappear, after Brexit it was about three days and post-Trump it was merely hours.



In contrast to the pattern of previous years, consensus forecasts for global economic growth in 2016 edged upwards in the latter part of the year. Within the global total, the positive trend was visible for the UK, Japan and (to a lesser extent) Europe amongst the advanced economies, based in part on a stronger dollar helping their prospects and in part on ongoing monthly economic data releases. In the developing world, the better tone in commodity prices encouraged upgrades to both Brazil and Russia, which served to offset the reductions to expectations for India in the wake of their currency replacement programme. Overall it would seem likely that global growth for 2016 will emerge at a level just above 3%, so broadly the same as was achieved in 2015, but better than feared in late summer. The current prognosis for 2017 has also seen upgrades in the past quarter, both before and after the US Presidential election; although during the last month there has been much discussion amongst analysts about the likely positive impact of Donald Trump on US growth forecasts, it is too early to have much clarity, other than to suggest it might be felt more in 2018 than 2017.

As we discussed in the previous quarter's review, investors had begun to attach greater credence to a more reflationary stance by the authorities from the summer onwards. This was reflected not just through these (modestly) higher GDP projections, but also via the trends in global bond and equity prices. The chart is of course based on global indices as reported to a sterling investor, so reflects the sharp devaluation in the pound since the referendum. Given the magnitude of the exchange rate movement, this distorts the pattern of both global bonds and equities in local currency: ignoring sterling reveals that global government bond prices peaked in August and retreated from that high by close to 10% by the year end, with a very modest total return for the year around 5%, whereas equity markets

plateaued in late summer after the post-Brexit recovery before regaining upward momentum in the last two months of the year.

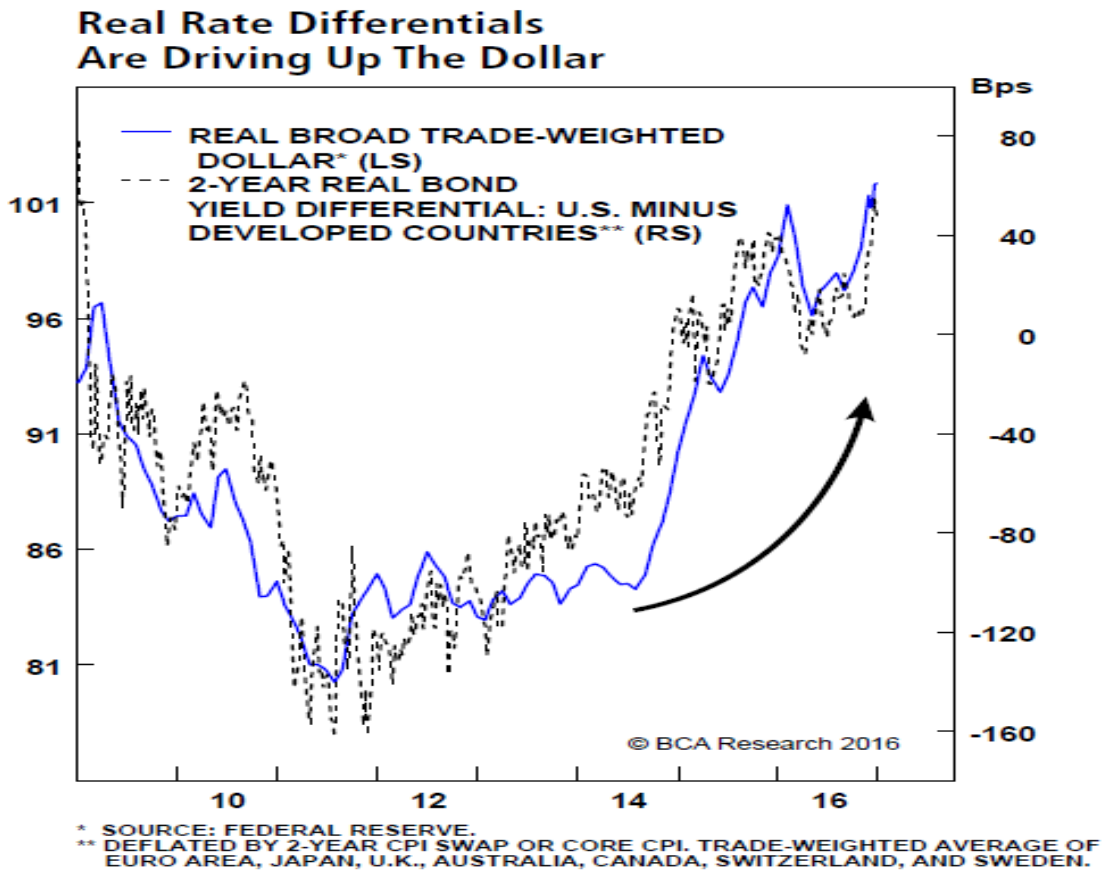
Bond Markets

Continuing the thought from the preceding paragraph explains a lot of the behaviour of global bond markets. At the heart of any discussion about returns is an analysis of the relative scales of supply and demand. On the latter front, investors have to some extent adopted a less positive stance, as the greater belief in reflation undermines potential nominal returns and enhances the merits of risk assets. Central Banks however are still providing liquidity, in the form of Quantitative Easing (QE) by the European Central Bank (ECB), the Bank of Japan (BoJ) and the Bank of England (BoE). The US Federal Reserve (Fed) has not augmented its QE programme since autumn 2014. As we noted in our previous review, the BoE felt it necessary to reintroduce QE following the Brexit decision and unveiled a further £60bn of Gilt purchases (on top of the existing £375bn) and £10bn of ammunition for the purchase of corporate bonds. It is worth noting that the Monetary Policy Committee was not unanimous on the logic of either of these programmes.

In Japan the BoJ had announced in September that it would seek to maintain an approximate rate of $60bn monthly purchases in its QE programme, although it was seeking to target the shape of the yield curve, holding 10yr yields around zero. No new measures were unveiled in its December meeting. Finally the ECB announced in early December that it would extend its QE programme (as expected) beyond the end of March 2017 – investors were predicting a further six months of extension, but Mr Draghi (the head of the ECB) announced it would run for an additional nine months. The monthly rate of these purchases would however be tapered with effect from April, to €60bn from the prevailing €80bn. This served to dilute concerns that the ECB might run out of eligible bonds to purchase, given its self-imposed limit of one-third of any sovereign issue.

Supply of sovereign bonds could be about to increase, given expectations of a wider reflationary stance by authorities across the developed world, especially post-Trump. Primary fiscal deficits (i.e. before accounting for interest payments on existing debt issuance) had shrunk to not much more than 1% in the US, zero in Europe and 2% in the UK, so there is clearly economic scope to be less austere, if the political will is there. We noted in a previous review that politicians would become more mindful of the populist stance the nearer they got to re-election and opportunities to issue additional debt at such low levels might well be seized. The fact that the US authorities are intent on raising rates and that no other major economy is either inclined or in a position to do so is supportive of dollar strength.

The chart opposite illustrates the close correlation between the dollar strength of the last two and a half years and the yield differential between short-dated Treasuries and their equivalents among other major currencies. In the minutes from the Fed meeting in December which accompanied the long-awaited rate increase, it was revealed that Committee members now saw the case for three further rate increases in 2017 and potentially a further three in the subsequent year. The longer term projection (for 2020 and beyond) now only had one member (out of the 16) believing that rates could be as low as 2.5% (down from three members as recently as September), suggesting that the Fed itself is now well on the road towards “normalisation”, even if it is a new, lower, “normal”.



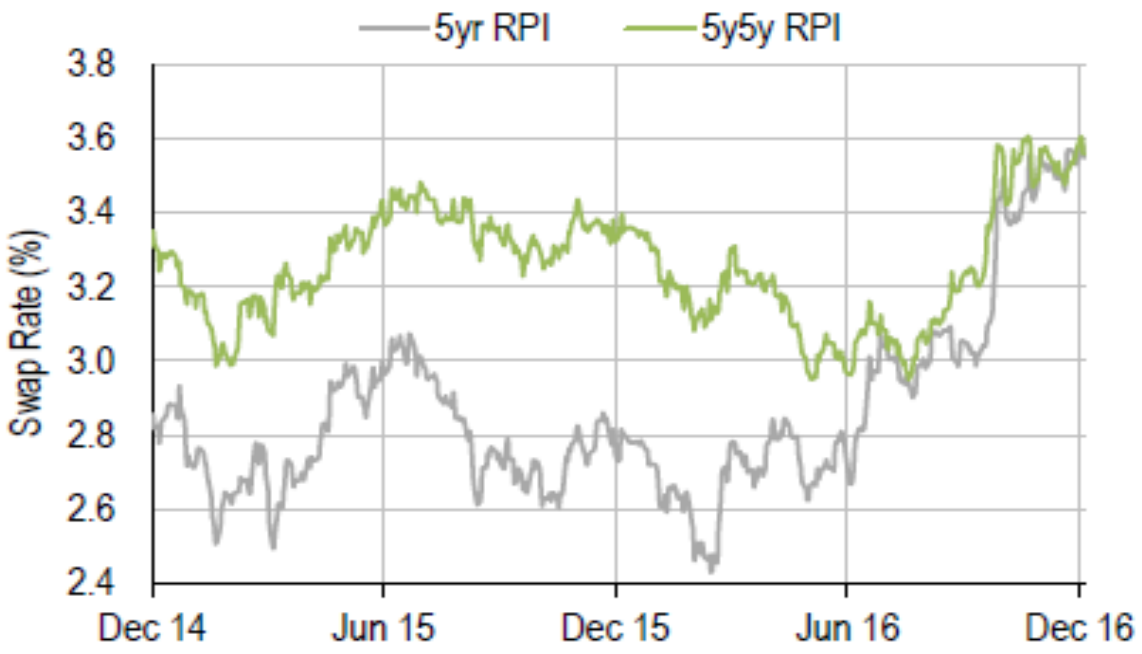
The corporate sector has certainly been tempted by the opportunity afforded by markets and three European companies issued two and three-year bonds with negative redemption yields. The rise in US interest rate expectations was accompanied (and was in part fuelled) by a rise in inflation forecasts. This meant that bond prices of sovereign issues gave back much of the ground made earlier in the year. Consequently 10yr Gilt yields rose by 45bp during the fourth quarter to end the year back comfortably above 1%. Dollar yields of that maturity rose by even more and even German yields rose back into positive territory. Index-linked bonds (where final redemption values and interest payments are determined by changes to inflation indices) did not perform well, even though inflationary expectations were rising, as increased risk appetite reduced their appeal. Corporate investment grade bonds performed less badly as yield spreads tightened on hopes that reflation would improve the outlook for profitability. High yield bonds experienced a solid performance, as fears of default waned, especially amongst resource companies as commodity prices rose.

United Kingdom

Compared to the fears of a dramatic deterioration in the health of the UK economy that abounded after the referendum outcome, the second half of the year provided a strong sense of stability. Apart from now knowing that the Government is intent on serving Article 50 of the Lisbon Treaty to begin the process of separation from Europe by the end of March, we are still not much the wiser about the terms on which future trade and employment arrangements with our Continental neighbours will be carried out. This process of negotiation could take two years or more (Canada has just concluded its own version of such trade terms, which took more than seven years from discussions being launched in May 2009), from the point at which notice is served. Given the High Court ruling that the Prime Minister does not have the legal authority to serve the notice and the Government's subsequent appeal to the Supreme Court, which is not expected to issue its ruling until around the end of January, uncertainty continues to prevail.

This uncertainty does not (at least yet) seem to have impaired growth in the economy. Q3 GDP was confirmed as 0.6% and subsequent monthly data releases support the view that the fourth quarter is likely to have seen that rate maintained. Economists who had slashed forecasts for growth for the second half of 2016 and for 2017 in the aftermath of the referendum spent much of the latest quarter increasing them again and this process has further to run. As we write this, the average of all forecasts for GDP growth in 2017 is 1.2%, but this belies a very wide range of individual estimates, from 0.9% to as much as 1.7% (pre-Brexit consensus was around 2%).

UK Inflation Expectations accelerating since Brexit



Source: Citi Research

The slide in sterling has prompted an increase in inflationary expectations, both in the near term and also over the medium term. The chart here illustrates how near term forecasts (a rolling five years) started to increase before the referendum, due to the bounce in energy prices, but have risen steeply since the Brexit decision. In part the trigger for this will be sterling devaluation, but the delay before the effect of this is felt should not be forgotten; many companies hedge forward their foreign exchange exposure and many others may not be able to pass on costs (remember the “Marmite war” between Tesco and Unilever), so price rises are not instantaneous. Current forecasts are for annual inflation (as measured by the Consumer Prices Index) to exceed the Bank’s 2% guideline during the spring (it was 1.2% in November) and is expected to peak at just below 3% sometime in the early part of 2018. The Retail Price Index (traditionally higher than CPI because of the housing contribution) is expected to exceed 3.5% by the same date. What will be more concerning to the Central Bank is the other line on the chart, which looks at market expectations for the second period of five years (i.e. 2021-26). This shows that such higher inflation numbers are in danger of becoming embedded in longer-term investor thinking, which might force the BoE to act in raising rates earlier than they wish.

UK equities recorded decent returns during the past quarter, as both large and small companies gained 4% at an index level. The laggard was the mid-250 segment of the equity market, where the capital gain was a mere 1%. Within the market, the strongest sectors over the three months were oil and mining shares (unsurprisingly given the rise in the raw material prices) and the banking sector (where reflation hopes and a steeper yield curve for bonds should be supportive of the prospects for higher lending margins). Each of those sectors gained more than 15% over the quarter. Laggards were sectors where there is correlation with bonds (so telecoms and utilities) or much lower levels of

economic sensitivity (beverages, tobacco and healthcare), all of which lost more than 5% during the three months.

United States

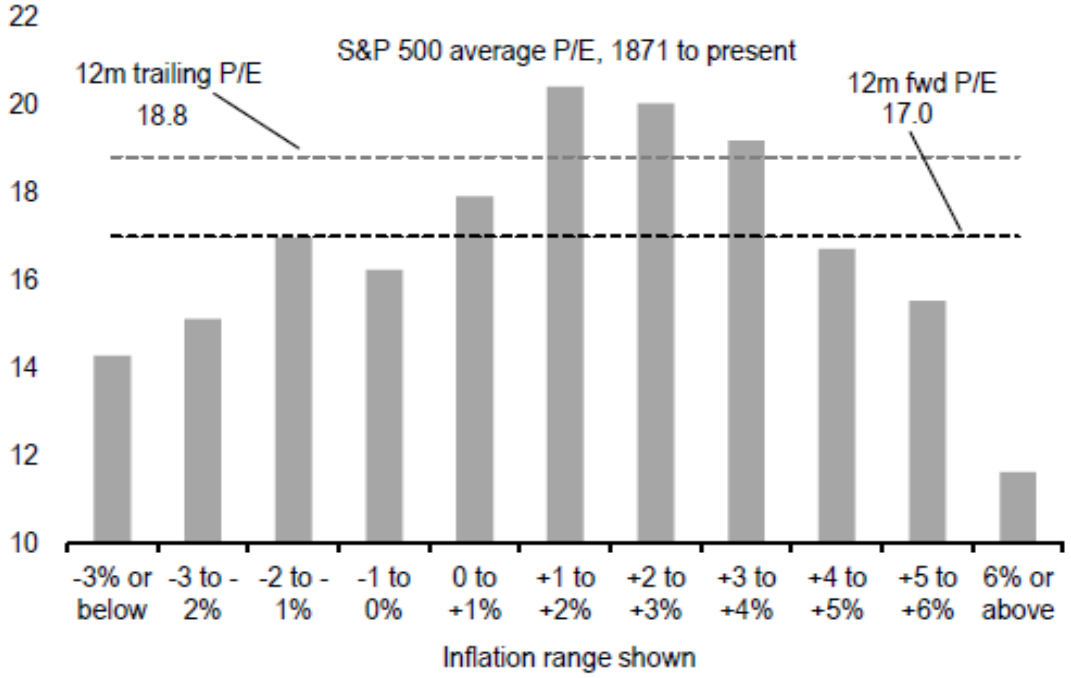
The two major factors for investors in the US at the end of September were the forthcoming Presidential election and the path of interest rate policy by the Fed. After the jolt to confidence levels from the Brexit referendum, investors became relatively convinced that the Fed would not move to raise rates ahead of the election and so it proved. Just as in that referendum however, the polls for the Presidential vote proved incorrect as Donald Trump emerged victorious with a comfortable majority in the Electoral College as well as Republican control of both houses in Congress.

The election of Mr Trump precipitated very surprising reactions in markets, confounding predictions of a meltdown in equities. Concerns that the new leader would bring confusion and chaos to both political and economic stewardship were (at least temporarily) discarded by investors (with the exception of his impact on sentiment in emerging markets) and replaced with a belief in the prospect of a reinvigorated and reflated America. Although it is still very early to assess the shape of his economic proposals, it seems unlikely that all the ideas of tax cuts, reform of Obamacare and higher infrastructure spending can be afforded without a huge surge in borrowing. Moreover the targeting of tax cuts towards the wealthy (for example reducing the top tax rate from 40% to 33%) and the corporate sector will do nothing to address the trend of rising inequality (into which he tapped to attract working class support at the polls) or to boost the financial wellbeing of many of those supporters.

One can see an element of dilution coming once he has assumed office. One can also see that the direct fiscal stimulus will not have much impact in the next six months, as any increased deficit financing will require getting past Republican colleagues in Congress (who had vehemently opposed the greater borrowing consequences of efforts by President Obama to increase spending in prior years). It looks probable that the major effect of fiscal measures will be felt in late 2017 at the earliest. However the President-elect's choices of his immediate circle of advisers and cabinet colleagues set out a stall to change the way in which the economic levers are managed. This grouping comprises people strong in business experience rather than political experience or nous - the initial reaction to this by other business leaders was encouraging and might bring forward a wave of proactive corporate spending to create the springboard for economic acceleration before any Government fiscal stimulation takes effect.

In step with any assessment of likely US economic growth in the next couple of years is an appraisal of the potential course of interest rates. At its December meeting the Fed did finally sanction an increase in rates by 25bp; more significant however was the forward looking picture provided by Fed members' views, which indicated that on average they felt that three further increases would be justified within the next year - this was an acceleration from the statement at their preceding meeting which implied only two such steps in 2017. Complicating good analysis of likely Fed policy shifts is a change in its Board membership, with two vacant seats to be filled this year and uncertainty about whether Janet Yellen's tenure as Chair will be extended beyond the current end-date of February 2018.

US Equity Ratings not vulnerable to higher inflation at present



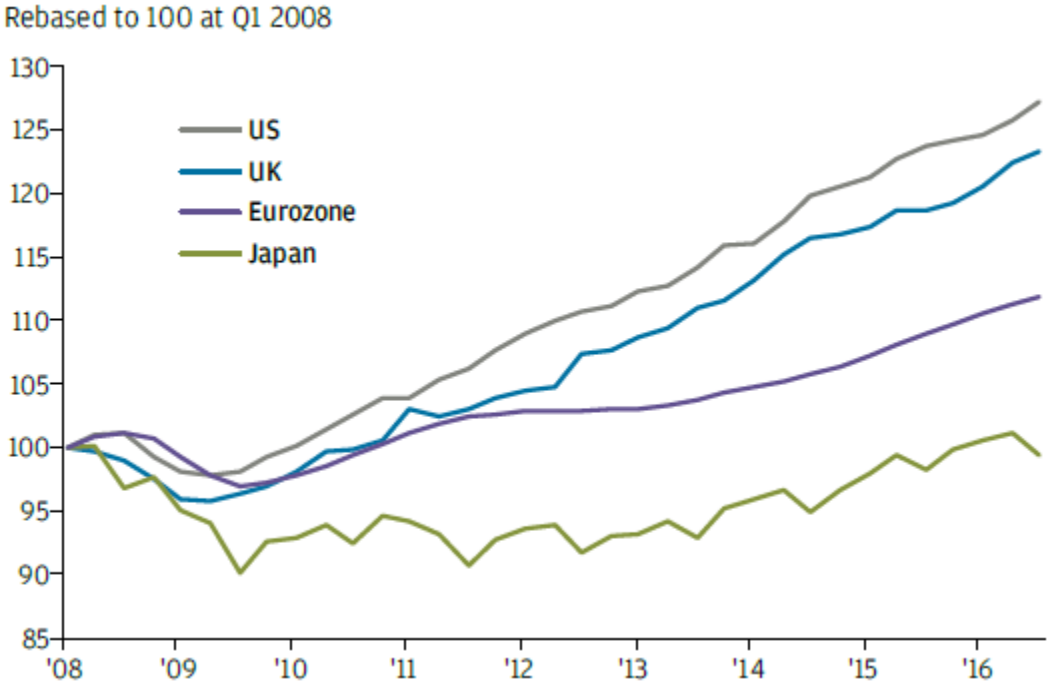
Source: Credit Suisse

We have covered above the potential for rate increases to reflect labour market tightening and any concomitant acceleration in wages becoming embedded in higher inflation expectations. The chart here indicates that equity valuations are not typically vulnerable to higher inflation until such inflation exceeds 3%, which is not for the moment part of investor thinking. Although Wall Street cannot be described as cheap on 19X annual earnings, it has continued to register all-time new highs and attract international cash flows throughout the last quarter. Progress from here is dependent on growing corporate profitability.

Europe

The economic recovery in Europe has continued to accelerate steadily with GDP surprising on the upside and forward indicators such as Purchasing Managers Indices implying the momentum should carry over into 2017. The chart opposite however illustrates how anaemic has been the recovery in this cycle compared with those of the US and UK. It also explains, as mentioned above, why the ECB felt the need to announce in December that they would extend QE beyond the current expiry date of March 2017, albeit at a lesser monthly rate of purchase. The threat of deflation in Europe has not been eliminated entirely as yet, and substantial excess capacity remains across the Continent. Unemployment has fallen in all parts of Europe but at different speeds: thus in Spain, where the rate exceeded 26% at its peak, it is now less than 20%; by contrast Italy saw its rate decline only by 1%. Germany, despite its inward migration, saw its unemployment rate fall from more than 11% to a mere 4%. Across the Continent as a whole the rate is now just below 10% - this compares with around 5% in each of the UK and US and only 3% in Japan.

Nominal GDP paths from pre-crisis peak



Source: JPMorgan Asset Management

The electoral bandwagon, having left the UK and US behind, has now moved to the Continent with polls due to be held in the Netherlands (mid-March), France (end-April and early May) and Germany (September). Moreover it is possible that the temporary administration in Italy will prove to be only a short term remedy before another full election is called. The opinion polls have had a poor recent record of accuracy, so investors are doubly careful not to become complacent, but none of these elections is expected to result in a disintegration of the European project. The first of these hurdles in the Netherlands has the Freedom Party, led by Mr Wilders, currently scoring twice the support he attracted in the last election in 2012: he has pledged if elected to propose that the country withdraw from the European Union. A greater threat to stability is posed by the French elections in which Marine Le Pen has a good chance of proceeding through to the second round. It is likely that she would then compete against François Fillon who was selected to represent the Republican Party. He has in some circles been likened to Margaret Thatcher in terms of his potential to implement reform across French society: that might be sufficient to spike the Le Pen guns, with her talking of holding a referendum on continuing French membership of the EU. The German election in September looks less risky with Angela Merkel confirming her intention to run for a fourth term. While her Christian Democrat party has not done that well in recent local elections, investors expect that the strength of the German economy will be sufficient to limit the populist turnout.

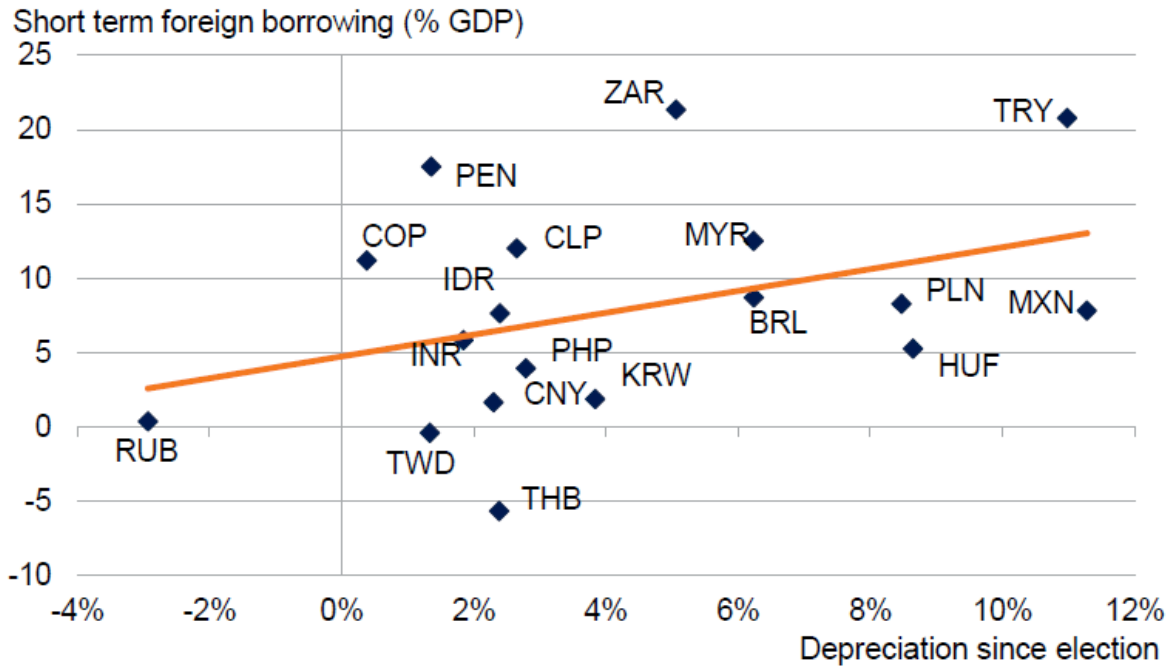
European equity markets recorded decent gains during the fourth quarter, as both global sentiment and economic evidence from the Continent provided support. Gains in local currency were around 6%, but Euro weakness subtracted about 1% of that for a sterling investor. Operational gearing in corporate P&L accounts should translate the combination of weaker currency (certainly against the dollar) and more rapid economic growth (both in Europe and internationally) into higher profits. Although ratings do not look especially cheap at around 15X earnings, growth of 12% is already included in analysts' forecasts for calendar 2017 and this might get revised higher if the economic outlook continues to generate positive surprises. In a world where monetary policy will ensure cash rates stay at negligible levels for some time to come, dividend yields of well above 3% should also act as an attraction for investors. Perhaps some of these investors will await a clearing of the political uncertainty before committing, but the high weighting of the European equity market to bank shares, which are now performing strongly, might encourage them to start early.

Asia & Emerging Markets

Growth in the emerging world in 2016 is likely to have matched both that of 2015 and consensus forecasts a year ago and be reported to be about 4.1%. The composition of this growth however is somewhat different, with a material (commodity-inspired) improvement in Brazil and Russia and a slowdown in India. The commodity trends should prompt further recovery in Brazil (GDP growth in 2017 expected to be about 1% after falling 3% in 2016) and Russia (1.2% from -0.6%). India saw downgraded forecasts for both last year and the forthcoming year following the disruption caused by the Government decision to withdraw high value rupee notes from circulation and replace them with new currency. This measure was intended to remove money from the black economy and increase transparency and tax receipts; it may have the desired effect in the medium term but it has hampered activity in the rural economy especially. Nevertheless the outcome in both the year just ended and the one to come is that growth should exceed 7%. The outlook for 2017 across the emerging world is for somewhat faster growth, perhaps as high as 4.6%. Within this aggregation China will remain a beacon of relative stability with growth continuing to moderate gently from the expected 6.7% in 2016 to about 6.5% for the year ahead. Although many economists are nervous about the seemingly relentless rise in Chinese debt, the autumnal timing of the Congress with its updated five-year plan will likely keep momentum from weakening too much.

A material element of these forecasts are predicated on a better growth climate in the advanced world but of course could be derailed by a move towards protectionism by President-elect Trump. He has made no secret, either during campaigning or in his tweets since winning, of his potential enthusiasm for trade barriers as well as the physical wall between the US and Mexico. Of course in any escalating rhetoric about currency manipulation or tariff barriers, the Chinese authorities will be keen to remind Mr Trump that they control around $1.2trn of the US Treasury market (29% of all those Treasuries owned by non-US investors).

EM currencies taking a hit post-Trump



Source: Thomson Datastream, Schroders Economics Group. 15 December 2016.

The chart here shows how foreign exchange markets reacted to Mr Trump's election victory - apart from the Russian rouble, all the other principal currencies of emerging economies failed to keep pace with the strengthening dollar. This is not simply about protectionism however, but also reflects investors' concerns about foreign currency borrowing: if US interest rates are more likely to be increased by the

Fed with Donald Trump at the White House, then debt servicing costs for many developing economies will also be likely to rise. The upward gradient of the best-fit line indicates that the market has applied a greater downward adjustment to the exchange rate of those countries with higher foreign currency indebtedness. Whereas in the past global investors have demanded a risk premium from emerging markets because of the scope for political uncertainty, their expected source of this instability was from within the developing world; now it seems that they will still demand that risk premium but now the source of any uncertainty might have moved to Washington!

This currency weakness and heightened concern over free trade meant that sterling investors had another lacklustre quarter of returns from exposure to emerging markets, with both Asian ex-Japan and broad global emerging indices generating the lowest gains among all equity regions. Whilst both economic fundamentals and share price ratings look supportive, investors have not added to their EM exposure in recent months and a resumption of the previous positive fund flow behaviour will need to await more clarity over Mr Trump's policies.

Japan

Although the economy remains stubbornly mired in the grip of low growth and minimal inflation, its stock market has performed well in both the calendar year as a whole and the latest quarter. To a modest extent GDP expectations increased in the latter part of the year both for 2016 and for 2017. The domestic economic climate is slowly getting better although the reform element of Mr Abe's programme has yet to provide the tailwind that was hoped for by international investors. The BoJ disappointed observers by not going further towards stimulating activity in its last meeting but the surge in the dollar following Mr Trump's election did prompt a material slide in the Yen, thereby improving Japanese competitiveness. The promise of more reflationary policies globally is also supportive for the economy (both absolute and relative) as Japan has a higher than average cyclical sensitivity. Recent strength in oil prices will aid the authorities in vanquishing the omnipresent fear of deflation.

Although the Yen fell sharply during the last quarter (even losing more than 9% against a weak sterling), this was more than offset by the booming equity market which rose 15% in local currency terms, by far the best performer of any developed index. Partly this was because of yen weakness, but investors were also aware that the Japanese stock market has a much greater exposure to cyclical constituents (61% compared with a mere 26% in the UK for example). Strategists have also reminded their readers that Japanese equities have the best performance record during previous periods in which US Treasury yields rose. Unlike Europe (the other developed market with cyclical recovery exposure), political risk appears very low down on the radar screen for investors and the Central Bank remains extremely supportive in QE policy.

Alternatives

Following the huge short term uncertainty for real estate precipitated by the UK decision to leave the EU, the subsequent six months have seen a restoration of much-needed stability. As covered earlier domestic economic growth remained resilient post-Brexit, confounding many commentators and meaning that the worst fears for the real estate sector did not come to fruition. Tenant demand for new space has continued at pre-referendum levels and lease renewals showed no evidence of a weaker negotiating hand for landlords. The supply of new space remains tight and positive economic and business confidence surveys point to occupational fundamentals continuing to be supportive. Although certain pockets of prime London commercial property now appear very expensive to domestic eyes (as yields are now below 3%), the decline of sterling prompted an increase in international appetite even for such richly priced assets. We understand that Chinese buyers accounted for 20% of all London commercial purchases in the second half of the year.

Across the UK real estate market as a whole, rental yields still offer investors an income premium of over 3.5% compared with Gilts, which remains appetising if the economy doesn't fall off a cliff. Over the last 30 years this premium averaged 1.4% so capital values should not be negatively impacted by further modest rises in bond yields. We would argue that any more pronounced rise in gilt yields could only occur in much more buoyant economic circumstances which would provide grounds for rental growth.

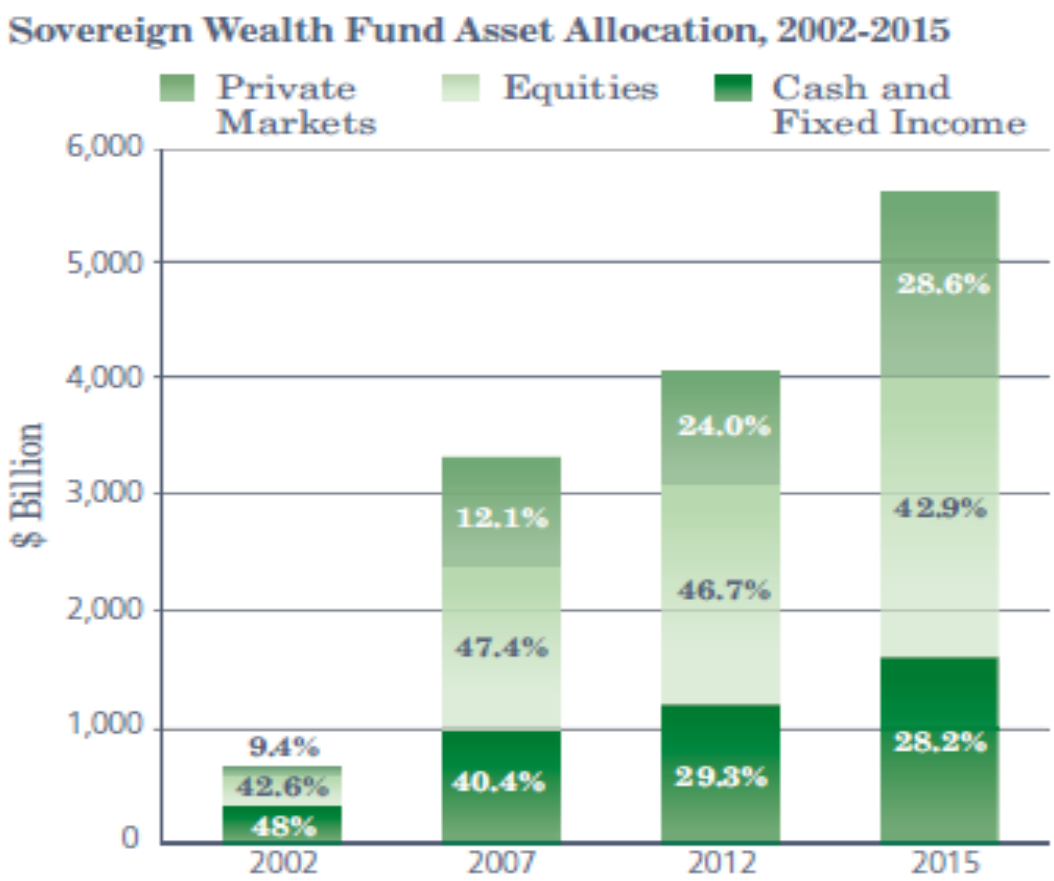
After the material downward spike in late June and early July in the prices of both quoted property securities and the real estate unit trusts, normal conditions have reappeared. Modest capital gains were achieved by both categories of securities during the fourth quarter and investors were also rewarded for their patience with annual yields typically of 4% or more. Against a backdrop of base rates likely to be held close to zero for some time, the outlook for real estate remains encouraging.

Outlook

After a year in which returns surprised on the upside, given the political events, the consequence of those returns is that starting prices (earnings multiples on equities and yields on bonds) leave less room for error. The macro climate has improved however, compared to the position a year ago, as deflation prospects are now more remote and likely nominal growth forecasts are higher (volume as well as price). Execution risk (the degree to which Governments and Central Banks get it right) remains high and, if anything, has increased in recent months with the appointment of Mr Trump to the US Presidency. Politics in Europe and the terms of UK separation from the EU remain clouds on investors' thinking. Opportunities however are also in evidence, if faster global growth can be obtained without much in the way of inflationary overheating. This leaves the outlook finely balanced, with risks to both the upside and downside.

At a time when the opportunity cost of keeping powder dry until the outlook becomes clearer (traditionally measured by the return on cash or short-dated sovereign bonds) is likely to remain low and might go further into negative territory once adjusted for inflation (if inflation does pick up as expected), it would not be surprising if investors have been searching for alternative investment opportunities outside the convention asset classes of bonds, equities and cash. Many institutional investors of course are not free agents in this quest, as they will be required to keep the shape of their future liabilities in mind when determining asset allocation strategy. This will include most pension schemes and insurance companies, where the ownership of bonds is not purely a fundamental decision based on likely returns.

In recent years, one of the most significant groups of investors has been Sovereign Wealth Funds – this grouping encompasses not merely the (natural resource orientated) authorities of the Middle East and Norway, but also of countries such as Hong Kong, Singapore and China. They can be considered to be a logical long term investor who can deploy their portfolios in an unfettered way to achieve the optimal combination of risk and return. As the table opposite shows, their total assets under management have grown substantially in recent years. More interestingly perhaps is the even more significant rise in the exposure to what is called "private markets" in this chart, namely areas such as real estate, private equity, private debt, infrastructure, structured products and hedge funds. As can be seen the value of assets in this area has mushroomed since 2002 from 9% of c$800bn to almost 29% of c$5.6trn, a 22-fold increase. This increase has been at the expense of traditional bonds and cash, suggesting that those investors have become increasingly concerned that bonds and cash were unlikely to produce the desired returns but did not want to add to their existing significant exposure to equities.



Source: Aviva Investors

Although we are sympathetic to this direction of travel and have indeed increased our allocation to a number of these newer asset classes, it is still most important to understand the role of diversification within the traditional assets of equities and bonds. At times of declining interest rate expectations, and particularly when accompanied by liquidity injections from Central Banks, all asset classes and almost all categories within each class generate positive returns above that from cash. If at least one of these drivers is no longer operative, then more judicious (and potentially more active) allocation becomes necessary. Many strategists think purely about correlations between asset classes, but the message of the past few months is that it is equally important to think about diversification within asset classes; as exemplified in the underlying performance of UK equities, certain sectors have behaved poorly, in line with the weaker tone to bond markets, whilst other equity sectors have registered strong advances. Successful portfolio stewardship has a wider set of risks and opportunities to be balanced.