QUARTERLY MARKET COMMENTARY

Britain is out of the EU but Trump is in as President of the United States. Both results still need to be ratified whether it is through the UK law courts or the inauguration process in the US but in both cases, the results went against expectations and what the polls were predicting.

Once again, politics is taking centre stage in global economic policy and what is becoming clear is that politics has entered a new phase of 'anti-establishment' protests by the vast majority of the populace. It will be interesting to see how the Italian Referendum in December and elections in Germany and France in 2017 unfold but perhaps we should not be surprised to see further 'shock' results!

We have previously written about the impact of BREXIT on the UK and the wider European region – in this update we are going to concentrate on the US.

Donald Trump will be officially inaugurated as the 45th US President at the end of January. This went against the majority of US polls who had Hilary Clinton in the lead. A Donald Trump election win, together with a Republican majority in both the House of Representatives and the Senate has broad implications for investments globally. So let's take a look at how markets reacted, why and the longer term implications.

News of a Trump victory initially led to a sharp sell-off amongst risk assets such as equities, as investors moved towards more defensive assets like government bonds (non-US), gold and the Japanese Yen (considered a safe haven currency). This simply reflected that Trump was an unknown – he has never held a formal political or military position and so his triumph introduced significant uncertainty to the outlook for US government policy, economic activity and interest rates.

The most notable move on the announcement was the dramatic sell-off in US government bonds (yields rose), the largest one-day fall since 2011, when US debt was downgraded. Driving this were expectations of higher government spending on infrastructure and defence, as well as apparent selling by the Chinese central bank. The US Dollar weakened and as result, US interest rate futures slumped, with the probability of a US interest rate rise in December 2016 falling from 84% to 50%.

The Mexican peso fell by 11% against the US Dollar on the day in view of tighter restrictions on cross border trade, whilst emerging market equities and debt fell in value, as these are largely priced in US Dollars. Accordingly, the region witnessed, following a strong period of growth, 'capital flight' as investors looked to unwind positions in US Dollar commodity driven economies.

The above is probably not unreasonable in view of the uncertainty it brought but let's take a closer look at the detail. Yes, the rhetoric from Trump was all about immigration and the 'Mexican wall' and without question, he is a populist leader who will focus his policies on those sectors with mass market appeal. Therefore, it was felt that his administration may act on its own interests first so issues such as NATO, Trade Agreements and Climate Change were immediately on the radar.

His tighter immigration control policies are likely to hit sectors with high shares of 'low-cost' labour such as agriculture, fishing and forestry. If you remove low cost workers from the economy, then the average wage is increased and thus potentially inflationary.

A reduction in monetary policy, in favour of fiscal policy with increased spending on infrastructure and defence, is also potentially inflationary as additional money supply is provided to the economy.

The proposed reduction in corporation tax from 35% to 15% and lowering of income tax rates for consumers is likely to be supportive to the market but this could be offset by a fall in domestic growth through potentially lower trade.

However, in the weeks that have followed, sentiment has improved with investors initially heartened by the more measured tone of Trump's victory speech and hopes of a pro-business policy agenda. In general terms, the Republican party is considered pro-business and is unlikely to allow some of the more 'confrontational' proposals such as the Mexican wall and high trade tariffs on certain countries being implemented.

Indeed, Trump appears to have become more conciliatory recently with his agreement with Barak Obama on retaining certain parts of 'Obamacare' and divesting all of his business interests to concentrate on his political responsibilities. This, coupled with the fact that the US economy appears to be in a relatively strong position has seen risk assets increase in value and the probability of rising US inflation leading to an almost certain US interest rate increase in December 2016 from the Federal Reserve.

We seem to have entered a period of calm before the inauguration as Trump puts his administration team into place. Only time will tell how Trump plans to adapt and implement his specific policies. However, with renewed debt ceiling discussions due in March, a concise and strong approach to such a decision will be required to demonstrate his political ability.

Elsewhere, there is growing concern over political events in Europe. With the BREXIT result, there is growing concern, not of the fate of the UK, but the remaining European Union. Italy goes to the polls in December and that not only threatens the current Prime Minister, Renzi, but this is also seen as the biggest threat to Europe since the UK's referendum on EU membership. Support for right wing parties in France and Germany is also growing, which threatens Hollande and Merkel in the elections in 2017.

In China, the authorities continue to rebalance their economy from a manufacturing and export led basis to a service driven and domestic consumption one. The belief that an economic 'hard-landing' would be witnessed appears to have dissipated as the Chinese authorities continue to take action, such as domestic lending rate cuts and reducing the reserve ratio requirements, so that bank lending is more available. Consensus figures suggest that overall Gross Domestic Product (GDP) is around 5% p.a. which has effectively halved since 2011 but growth could be supported with renewed weakness in the Chinese currency, the Renminbi.

In summary, despite the good gains made by most stockmarkets in recent months, significant political and economic headwinds prevail. Central Banks appear ready to intervene and provide stimulus if they feel it is necessary but the view is that monetary policy is tired and fiscal policy is now required by governments. Accordingly, the results of their action and the longer term impact of such action is becoming more difficult to comprehend. In our view, it is more important than ever for medium to long-term investors to maintain a diversified portfolio in order to benefit from market rises when they happen and to dilute volatility in the event stockmarkets fall. It is impossible to predict when markets will fall and rise but, in general terms, a sensible investment strategy involves riding out market volatility.

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