Summary

- Brexit and Trump's US election win have set the world on a different course. Europe also faces a raft of significant elections and referendums, plus the emerging markets are dealing with their own issues.
- For pension funds, 2017 will be a time for vigilance. Trustees are becoming more engaged to navigate the choppy waters.
- Uncertainty surrounds president-elect Trump's tax cut and infrastructure plans, but these could also bolster the economic forecast.
- Britain's financial sector looks set to be affected, both by the prospect of a push for softer regulation in the US and by Brexit.
- Opportunities look set to arise in alternatives, emerging markets and dynamic asset allocation.

Rocky times ahead

Sandra Haurant looks at the challenges facing the investment world in the year ahead

When it comes to turbulence, unrest and uncertainty, 2016 will take some beating. The seismic shifts of Brexit and Trump's US election win have set the world on a different course, one for which there is little in the way of navigational aids.

Choppy waters?

But while 2016 shook the world, the dust has yet to settle. Trump's campaign, election and transition periods after all, were a preface for his presidency. After his inauguration we will see which of his campaign trail policies will be enacted upon fully.

On this side of the Atlantic, Brexit has seen the country pulled in a new direction, too, with no knowing where it leads until the triggering of Article 50 and the results of the negotiations that will follow. Also, Europe faces a raft of significant elections and referendums, and emerging markets find themselves dealing with their own issues, along with those problems in the so-called developed world.

For pension funds, 2017 will certainly be a time for vigilance. Indeed, JLT Employee Benefits senior investment consultant Aniket Bhaduri says that he has seen a real shift in the approach of pensions trustees towards the end of 2016.

"I was meeting with trustees and at the end I said 'When do you want to meet next?' And they said, 'as soon as possible'. That is the kind of engagement we are seeing with trustees at the moment."

If trustees are seeking ways to navigate choppy waters, so are the fund managers. "The election of Donald Trump as US president has thrown an extra element of uncertainty into our outlook," Russell Investments global chief investment officer Jeff Hussey states in the group's *2017 Global Market Outlook*.

"We believe markets are assuming that the new administration will have a policy mix that will boost growth, equities, and the US dollar, and will push the Fed into more tightening. But there are large uncertainties about the president-elect's views."

The US environment

BlackRock is similarly careful about prospects for the US.

The BlackRock Investment Institute's *2017 Global Outlook* says: "US president-elect Donald Trump has pledged to slash taxes and boost infrastructure spending. How much will this boost growth? Uncertainties over the details of the plans as well as the fiscal multiplier – how much each dollar of fiscal expansion boosts GDP – make estimates difficult."

BlackRock estimates that GDP could be lifted by anywhere between 3 per cent and 23 per cent over the next decade, driven largely by tax cuts, and adds that deregulation could give an additional boost. But, it continues: "There are big caveats. Nobody knows how Trump will govern. Will he be a pragmatist or populist? His plans could be watered down by fiscal conservatives or, conversely, could lead to a surge in debt levels and interest rates that undermine growth. Corporate tax cuts could be offset with measures such as eliminating the deductibility of paid interest. This would be a game-changer for equity and credit markets, reducing the incentive for companies to issue debt and buy back shares."

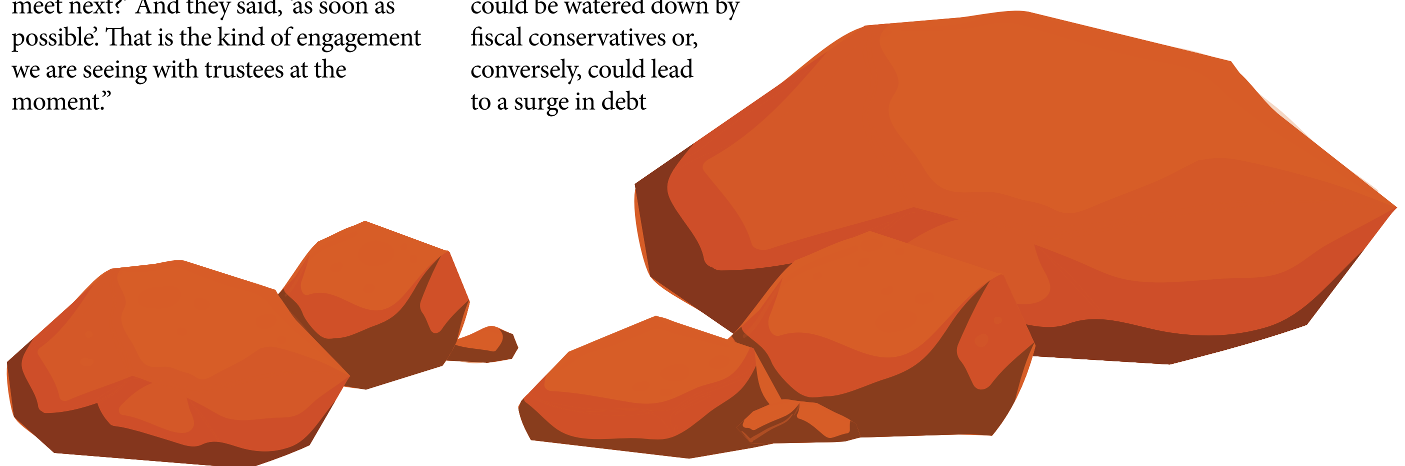
In a positive scenario, BlackRock says: "Within the US, while uncertainty surrounds president-elect Trump's tax cut and infrastructure plans, we believe they could further bolster the economic forecast. Indeed, the economy has proved resilient in the face of multiple geopolitical surprises."

Political change

And there will be more surprises, as Europe gears up for a series of elections and referendums that could have an enormous impact.

Invesco chief economist John Greenwood says: "With conventional centre-right or centre-left governments in Italy, Holland, France and Germany facing referenda or elections over the next year, the risk of further disruptive political changes is significant. At some stage, one or more of these electorates could overwhelm the governing elites, posing an existential threat to the established order – the European Union (EU) or even the Eurozone."

Greenwood anticipates real GDP



growth to remain around 1.5 per cent at best, with inflation falling short of the ECB's target of 'close to but below 2 per cent'.

Goldman Sachs Asset Management (GSAM), for its part, is not predicting a break up of the European Union in 2017, but it does foresee major changes: "We think the potential for meaningful populist gains in core European countries may present the biggest potential risk of a significant market inflection point in 2017 … Concerns about a Eurozone break-up could lead to stalled businesses and investment decisions while driving increased volatility in financial markets," it says.

Meanwhile, in Britain the financial sector looks set to be affected, both by the prospect of a push for softer regulation in the US and by Brexit. GSAM says: "The outlook for the UK banking sector will remain uncertain into 2017 as the government and policymakers decide whether to continue to adopt EU regulatory standards without being able to influence them, or whether to diverge and establish a less stringent regulatory framework."

And across emerging markets, challenges faced by the West could weigh heavy. Trump has spoken of tariffs on imports from Mexico and China, and as Bhaduri says: "If there is a tariff on Mexican imports, we would see the peso devalued further and Mexico losing its investment-grade status."

China continues to be a key focus, not just because of its relations with the States. Invesco Perpetual fund manager Dave Jubb comments: "*[China's]* private sector debt now amounts to 220 per cent of GDP and the median Chinese company has cash flows lower than its interest payments … Being optimistic, it is possible that China can grow out of its debt problems, even with slowing real growth, a reasonable pace of nominal GDP growth is likely to be maintained (circa 6.5 per cent currently)."

"For pension funds, 2017 will certainly be a time for vigilance"

But, Jubb says, there are concerns: "Shadow banking in China is growing aggressively. For example, wealth management products that feel like deposits to the customers are actually funding for corporate lending. Increasingly, these are used to repay existing debt and interest, which appears a poor use of capital."

The negative scenarios may not occur, but the investment world is watchful. "The probability of a Chinese hard landing is not one that we are expecting, but Chinese data can change very quickly," says Bhaduri.

With the world affected by so much upheaval, it seems instability will become the new normal in the coming year. So what does this mean for investments? GSAM sees opportunities, notably in alternatives, emerging markets and dynamic asset allocation.

"We think de-risking would be premature, with developed economies likely to continue growing (albeit slowly) and emerging market growth improving as Russia and Brazil rebound from recession. Equities may benefit from recent earnings improvements and market expectations of fiscal spending and de-regulation, but this is balanced by the potential for rising bond yields and political uncertainty." Because of this, GSAM is predicting low returns on traditional equity and fixed income assets, adding: "Alternative sources of return may offer more opportunity."

It is difficult to think of time of more global political upheaval, but the markets have been through plenty of turmoil before. "A rational investor should understand that these cycles happen," says Bhaduri.

"Even if there is not a big bear market phase, there will still be a normalisation. We are talking to our pension funds and saying 'brace for it'. If there is a valuation happening in 2016/17, then in 2019 or 2020 there might be a small asset underperformance, or a stagnant asset performance, instead of the kind of growth investors have been used to seeing over the last nine or 10 years," he says.

"There is not one asset class that we can say is cheap now. So we are looking at different asset classes and how they will perform smarter and better and aiming to reduce risk as much as possible."

It is, then, time for vigilance. It has always important to review portfolios, and never more so than in uncertain times. After all, as Bhaduri says: "Those days of setting up a strategy for three years and forgetting it for another three years are gone. As a retired colleague of mine used to say, if you are flying from London to New York you cannot just set the course and fly. You have to have some direction on the way; because winds are coming from all sides."

These are, indeed, turbulent times.

Written by Sandra Haurant, a freelance journalist