Markets Summit 2017 - The winds of change - key takeouts

Will Jackson | PortfolioConstruction Forum | 17 February 2017

The jam-packed Markets Summit 2017 program delivered 20+ high conviction ideas on how the winds of change are affecting the outlook for economies and asset classes - and the implications for portfolios. **Here are our key takeouts from the Critical Issues Forum (plenary) sessions over the two days.**

THE ECONOMIC AND GEOPOLITICAL CONSEQUENCES OF MR TRUMP
- Professor Niall Ferguson, PhD, Senior Fellow, The Hoover Institution (Stanford)

> Synopsis
> We are just weeks into a new and unfamiliar era for the world and there is no subject of more importance to investors than what Donald J. Trump will do with the powers of the US presidency. His political opponents, who include a large proportion of journalists as well as outspoken members of the coastal elites, speak of Trump and his advisers as if an authoritarian regime is being established in Washington. His admirers draw parallels with the first phase of Ronald Reagan's presidency. There are pluses and minuses of Trumponomics: on the one side, tax reform, deregulation and infrastructure investment; on the other side, protectionism, immigration restriction and likely fiscal incontinence. Can Trump deliver a doubling of the US growth rate and a revival of manufacturing the Rustbelt states that helped elect him? What are the main headwinds his administration faces? And how big is the risk of a trade war between the US and China - or even an actual war?

Financial historian Niall Ferguson opened Markets Summit 2017 by asking: Is it morning again, in America? In answering his rhetorical question - a reference to Ronald Reagan's 1984 campaign slogan - Ferguson compared the inaugural speeches of US presidents Reagan and Trump. Both men pledged to tackle US industrial decline, and blamed part of the problem on government. But their remedies were radically different, Ferguson noted. While Reagan viewed free trade as essential for national prosperity, Trump used his speech to advocate a protectionist approach of "America First" - a phrase previously associated with the US isolationist, and reputed fascist, Charles Lindbergh.

Ferguson dismissed as overdone fears amongst liberal elites "in California, Massachusetts and the upper-East side of Manhattan" that Donald Trump is "some kind of American Hitler". Similarly, Ferguson argued that concerns over protectionism have been exaggerated, and that the president will likely seek to boost the US economy through fiscal stimulus and deregulation, rather than relying on trade restrictions. As a result, Ferguson proposed that the US is unlikely to enter trade wars with China and Mexico. Rather, Ferguson believes the president's tough talk on protectionism is probably a bluff - an opening negotiation ploy, which will ultimately result in a major US-China deal, and a renegotiation of the North American Free Trade Agreement (NAFTA).

TRUMP THE GAME CHANGER - THE ONLY CERTAINTY NOW IS UNCERTAINTY

- Stephen Halmarick, Chief Economist & GM Economic and Market Research, Colonial First State Global Asset Management (Sydney)

Synopsis

2017 will present many risks and opportunities, as the winds of change sweep through the global economy and markets. Geopolitics will dominate - in the US, UK, Europe and China. All eyes are on Donald Trump, who represents the first true change from centrist politics in over two decades. But can his policies lead to a permanent shift higher in the potential economic growth rate in the US? If the answer is 'yes', then markets are right to be bullish. But the greater risk is a boom-bust scenario where significant fiscal policy easing leads to higher inflation, higher interest rates and tighter monetary policy. So the global environment will continue to present uncertainties for Australia. The RBA is likely to balance these risks and keep monetary policy on hold, while economic growth continues its transition and remains close to its long-term trend. With all this to consider, the only certainty for 2017 is uncertainty.

Stephen Halmarick expressed scepticism on the long-term effectiveness of President Trump's economic policies, and warned that investors should prepare for a boom-bust cycle. While growth will likely strengthen in 2017 and 2018, Halmarick said, US fiscal stimulus would fuel stronger-than-expected rises in inflation, short-term interest rates and the US dollar. Halmarick forecast that tightening financial conditions, combined with negative effects from Trump's protectionist policies, will eventually trigger an economic downturn - prompting the Federal Reserve to cuts rates twice in 2020.

For markets, Halmarick predicted that rising yields and interest rates in 2018 and 2019 would derail the risk-on shift which has characterised the post-election period. Such a mood change could negatively affect Trump's popularity in the lead-up to the 2020 presidential election, Halmarick argued.

Turning to other global regions, Halmarick presented a positive outlook for Australia and dismissed fears that the economy was experiencing a significant downturn following its contraction in the third quarter of 2016. Tailwinds for Australia include an improvement in business investment and a pick-up in commodity prices, Halmarick proposed, while household debt concerns are overblown, in his view. In contrast, Halmarick was cautious on the UK and continental Europe - owing to ongoing political turmoil in the region - and Japan, where he anticipated continued low growth.

POPULIST DISCONTENT SPELLS DANGER FOR MARKETS
– Jeremy Lawson, Chief Economist, Standard Life Investments (Edinburgh)

Synopsis
In recent decades global growth, corporate earnings and asset returns have benefited strongly from a global policy consensus that has promoted the ever freer flow of capital and trade across borders. That consensus is now being threatened by a populist backlash in the advanced economies that is partly a response to the dislocations globalisation has wrought, but also to the economic disruption caused by the global financial crisis as well as deeper social and demographic forces. Despite growing market optimism about the near-term outlook for growth and earnings, investors should not ignore the risks from rising populism. If western governments cannot find a way to reconcile open markets with more stable and evenly distributed income growth, globalisation could begin to reverse, with dire implications for risk assets.

Jeremy Lawson offered three key takeaways for Summit delegates:

- That Brexit, the election of Donald Trump, and rising populism are symptoms of deep, structural change;
- That globalisation would be further challenged by a continued breakdown in policy consensus; and,
- That reduced global integration would likely have "dire" implications for investors.

Lawson – a former senior economist with both the Reserve Bank of Australia and the Organisation for Economic Cooperation and Development – noted the trend towards increased global trade since the 1960s, as tariff rates declined and treaties proliferated. As well as boosting international commerce, Lawson said globalisation had fostered a tighter cross-border integration of information, capital markets and culture, allowing a substantial shift in the distribution of manufacturing activity, from West to East.

However, he noted, while the "global middle" (predominantly emerging market workers) and the "global 1%" benefited from globalisation, the process negatively affected the job security and living standards of lower- and middle-class employees in the developed world. Coupled with a growing frustration at the rise of liberal values in western society, Lawson argued that "angry white men" had increasingly turned towards populist parties with anti-globalisation agendas, a trend he noted was even evident in Australia, despite the economic benefits brought to the country by international trade.

With the US adopting a protectionist approach, Lawson called on China to drive the global trade agenda. For investors, continued retreat from globalisation would bring about an environment of lower corporate profits and equity returns, he warned.

INTO THE UNKNOWN: IGNORE LEFT TAIL RISKS AT YOUR PERIL
– Joachim Fels, Managing Director & Global Economic Advisor, PIMCO (Newport Beach)

Synopsis
With Trump, Brexit, Italy's "No" and China's currency woes, the world economy and markets have embarked on a journey into the unknown. The world has now fully arrived in the radically uncertain, "stable but not secure" predicament. The only certainty is that the tails of the distribution of potential macro outcomes have become fatter. Rather than betting big on one direction or the other, investors today should consider a patient approach and aim for capital preservation until the veil of uncertainty over future policies starts to lift.

Joachim Fels argued that investors should pay attention to left-tail risks in an environment of heightened political uncertainty. While risk assets have been buoyed by positive sentiment on the potential effects of Trump's policies – notably the prospect of higher growth and inflation rates – Fels said investors should question the bullish consensus. After all, he noted, each of the six post-Second World War Republican presidents who preceded Trump experienced at least one recession during their leadership. President Dwight Eisenhower – "the declared idol of Donald Trump" – witnessed three such downturns.

Fels urged investors to consider probabilities and scenarios, and presented three scenarios of his own:

- Staying Alive – a baseline scenario which assumes an orderly transition from monetary to fiscal policy;
- Here Comes the Sun – a bullish environment, similar to recent market conditions; and,
- Dark Side of the Moon – a "credible" bear scenario, where US fiscal reforms are watered down, and international trade tensions rise.

Fels highlighted three key risks which could create problems over the next two years:

- Positive investor sentiment and consumer confidence may easily be "popped" by disappointment, possibly triggered by a delay in the implementation of Trump's tax reform, deregulation, or infrastructure programs;
- Fiscal stimulus will show up in inflation rather than output growth; and,
- The Federal Reserve will hike interest rates more aggressively than expected, triggering a recession in 2018 or 2019.

Summing up, Fels said investors should "respect uncertainty" and pay greater attention to the return OF capital, rather than the return ON capital. "Hard duration is a good diversifier –

a good hedge against – risky assets, and the risk of drawdowns in portfolios," he added.

WE ARE ENTERING A YEAR OF NATIONALISM BY TRIAL AND ERROR
– Charles Dallara, PhD, Partner & Chairman of Americas, Partners Group (New York)

> **Synosis**
> The arrival of President Trump, following the election of Prime Minister Theresa May, and the shifts toward populism and nationalism in other key European capitals, appear to be heralding a new period of nationalism, posing major risks for the global economy. Over the course of the year, President Trump will likely retreat from his confrontational and protectionist policies, as he sees that the risks could destroy more jobs than they create, and as he works to find cooperative solutions to complex problems surrounding job creation. Thus, 2017 will be divided into roughly two periods: the first half – trial and error, volatility and more setbacks than successes for Trump's new economic policies; and, in the second half, a shifting of gears to less confrontation, more cooperation and the prospect of a win-win for the US and the world. Meanwhile, fragmentation will continue in Europe, leading to weak growth despite fiscal stimulus. And in Asia, expect strong performance by both the Indian economy and Indian markets, but growing risks that China's capital outflows and rising debt will weaken the underpinnings of growth and investment in this important economy.

Charles Dallara, who was an adviser on financial regulation to the Trump campaign, cast doubt on the newly-elected president's protectionist rhetoric. Similar to Professor Ferguson, Dallara proposed that Trump's tough stance on trade would likely prove to be an "aim-high" negotiating tactic, which could lead to win-win deals for the US and its trade partners. The probability of trade wars was further reduced by the checks and balances present within the US government system, Dallara said, and by the complexity of modern supply chains.

In addition, Dallara noted that China is no longer a "currency manipulator", an accusation Trump levelled at the world's second-largest economy prior to his inauguration, and that solutions to the US/China trade problem would likely be found, as they were with Japan in the 1980s.

In contrast to his relatively upbeat outlook on global trade, Dallara said rising neo-nationalism – or "nationalism by trial and error" – posed potentially the biggest geopolitical risk to the global investment environment since the Cuban Missile Crisis of 1962. Combined with high asset prices and the, albeit low, possibility of a trade war, Dallara urged investors to exercise caution, and to skew their portfolios towards secular themes robust enough to survive a period of sluggish growth.

THE WINDS OF CHANGE ARE STRONGER THAN YOU THINK
– Ronald Temple, CFA, MD, Co-Head of Multi-Asset & Head of US Equity, Lazard Asset Management (New York)

> Synosis
> A cold breeze is blowing through the global economy. Is it the beginning of the Great De-Globalisation? As increased political uncertainty continues to elevate portfolio tail risks, investors should question the assumption that inflation and interest rates will be "lower for longer" and instead consider that inflation could be whipped into a storm by trade, monetary and border policy, while unusually high stock, sector and regional correlations could break down in the near term. Any major dispersion will create an opportunity for those with a strict valuation lens to extract value by maintaining nimble capital and investing with fewer constraints.

Ron Temple argued that the world economy is at a crucial turning point, and that the rising global integration which characterised the post-Cold War period has ended. The big question, he proposed, is whether globalisation is stalling or going into reverse.

Temple noted that global trade growth outpaced economic expansion for decades, as tariffs and non-tariff barriers declined, leading to the creation of sophisticated, international supply chains, and capital flows became more fluid. In addition, there was a convergence of monetary policy, as many economies adopted the 2% inflation-targeting regime pioneered by New Zealand. As a consequence, investors gained confidence that central banks would be able to keep a lid on rising prices.

However, the growing influence of populist politicians – driven by disenfranchised workers in the developed world – has created a policy environment in which inflation could return, Temple argued. He noted that President Trump's corporate tax reforms – which will likely see the tax rate fall from 35% to 20% – will be paid for with a border adjustment tax which penalises imports. Such a measure would have a substantial impact on prices of US consumer goods such as clothing, most of which is imported.

While Temple estimated the chance of a global "divergence" at just 25%, he said investors should consider their decisions on the basis that inflation rates will rise above central bank target levels.

4 FUNDAMENTAL DECISIONS TO MAKE FROM MARKETS SUMMIT 2017
– Tim Farrelly, Principal, farrelly's Investment Strategy (Sydney)

> Synopsis
> When positioning a multi-asset, portfolio for the medium-term, there are four

fundamental decisions we must make from the high conviction insights presented today:
1. Growth assets: long or short? Why?
2. Equities: over- or under-weight US? Why?
3. Real/Alts: increase or decrease? Why?
4. Debt - long or short duration? Why?
These questions are, in some cases, interdependent NOT independent. What's your view? What's your rationale for your view? How does each answer impact on the others? And what's your central thesis for portfolio construction going forward?

Tim Farrelly noted that investors face heightened geopolitical risks - from the impact of President Trump's policies on US corporate profits, to a potential break-up of the European Union. However, rather than focusing on such hard-to-predict factors, Farrelly proposed that investors should pay closer attention to inflation and interest rates.

Key questions included whether yields would return to the "old normal" of 5% to 6% - given the substantial implications such a shift would have for several asset classes, including bonds, equities and property - and whether rising prices would drive global interest rates substantially higher. While Farrelly noted that wage pressures would likely result in higher US inflation, he argued that the effect would not be transmitted to other economies, but would be absorbed by exchange rates and a US stronger dollar.

Regarding real assets and alternatives, Farrelly proposed that Sydney commercial property may represent good value provided interest rates do not increase substantially. Meanwhile, gold performs strongly in environments of high and rising inflation, and may provide tail insurance, he added.

NOW IS THE TIME TO ACCUMULATE DURATION

- Brett Lewthwaite, Executive Director & Head - Fixed Income and Currency, Macquarie Investment Management (Sydney)

Synopsis

As we begin 2017, there is (once again) an air of optimism that interest rates are about to return to normal. The US Federal Reserve are forecast to hike three times and the current cyclical uptick is about to be extended as the US embarks on fiscal stimulus. However, this optimism dismisses the significant structural headwinds that are prevalent - and the possibility of a policy error from president Trump. These factors limit the extent to which bond yields can move higher so investors should accumulate duration at these more attractive levels and ensure portfolios have an appropriate defensive allocation in anticipation of the next downturn.

Brett Lewthwaite examined the changing consensus on inflation and interest rates over the past 12 months, and explained why bond bears were likely to be "wronger for longer".

He described how a cyclical uptick in yields, which began in early 2016, was derailed by "a huge capitulation to 'lower for longer'" following last June's Brexit referendum result. However, the election of Donald Trump had revived talk of rising animal spirits, pushing bond yields higher again. "Can the cyclical uptick continue?" Lewthwaite asked. "Maybe, but I need more evidence."

Restating his “lower for longer” case, Lewthwaite noted that ultra-loose monetary policy and a halving of commodity prices since 2006 had failed to restore economic growth to levels seen before the Global Financial Crisis. Massive indebtedness continued to act as a brake on growth and interest rates, he warned, while anti-globalisation policies would likely place further downward pressure on the global economy. As a result, investors should use bond sell-offs to accumulate duration, Lewthwaite argued.

AUSTRALIAN EQUITIES PORTFOLIOS ARE VULNERABLE TO INFLATION

– Martin Conlon, CA, Head of Australian Equities, Schroders (Sydney)

> Loose monetary policies have disfigured share markets by pushing investors into stocks with bond-like characteristics. The worry for investors is that bond-sensitive stocks now form a record 60% of the ASX’s market cap. That means Australian equity investors are vulnerable to interest rates rising if consumer prices rise as much as the growth in credit says they should. A sensible way to mitigate the risk of higher inflation and higher interest rates would be to hold a greater proportion of the ASX allocation in real-asset stocks and reduce exposure to artificially inflated financial stocks.

Headline inflation measures failed to capture loss of purchasing power over the past 25 years, Martin Conlon argued. Traditional benchmarks such as CPI remained stable throughout the period - suggesting central bankers were successfully meeting their mandates - but an eight-fold expansion in credit supported strong inflation in financial assets. According to Conlon's definition, real inflation has been running at double-digit rates annually.

As a consequence, Conlon said he favours companies which had not benefited from the inflationary tailwinds of the past 25 years. He singled out the resources industry as attractive, given that companies in the sector have seen spikes and collapses, and tend to be under-geared. Over the next 10-20 years, banks face the biggest problems, Conlon argued, posing a significant risk for Australian equity index investors given the banking sector represents about a quarter of the domestic stock market.

Central banks are "struggling to keep the Ponzi scheme going", Conlon warned, and investors should focus on de-geared assets. "From here, mid- to single-digit returns will be a good outcome," he concluded.

CREDIT – THE EPICENTRE OF THE NEXT CRISIS

– Vimal Gor, Head of Income & Fixed Interest, BT Investment Management (Sydney)

> Markets have run hard in recent months on speculative exuberance. However, the critical question is will President Trump prove to be a tailwind, or a headwind for the global economy? Is he the saviour of the US economy or the wrong man at the wrong time? We highlight the forces of change that may in fact see credit underperform in the medium term. It is a long list that includes rising US borrowing costs, a risk of contagion from emerging markets, worsening demographics, a frothy Chinese credit environment and European banking woes; a litany of potentially market-disrupting issues that every investor needs to hear.

"Trump is the wrong man, at the wrong time" and his inflationary policies risk destroying an over-leveraged credit market, according to Vimal Gor. Regarding the unfortunate timing of Donald Trump's presidency, Gor noted that the US economy is running at potential and that labour shortages are creating wage pressures. However, Trump's anti-trade measures – including a rolling back of NAFTA – and fiscal program will likely stoke inflation.

Gor also questioned whether the US economy would be able to digest the additional debt required to fund Trump's policies, and proposed that the US dollar may "break free" if the Federal Reserve tightens monetary policy quicker than other central banks. Additionally, higher US interest rates risk triggering both a sell-off in risk assets and a recession in 2018, Gor warned.

In credit markets, lending standards are rising and the default cycle is beginning to turn, threatening over-leveraged US companies. Key barometers for investors to monitor include US lending standards, leverage ratios and debt coverage ratios, Gor noted.

STEREOTYPES AND NOISE OBSCURE GOOD DECISIONS

– Kerr Neilson, CEO and Founder, Platinum Asset Management (Sydney)

> Many of us take comfort from an illusion of knowledge derived from headlines, partial information and opinion pieces. As a result, impressions of the world are driven for many by stereotype: Japan's demographics; Europe's sclerosis; China's excessive leverage; India's chaos. When applying discipline, fact and data to the assembly of a portfolio, one is led to investment opportunities overlooked by many who pursue their 'feelings' rather than data. Today, Japanese exporters, Chinese consumer companies, Indian utilities and European banks offer attractive attributes for medium-term

investment.

Kerr Neilson discussed the effects of information overload and biased reporting, and urged investors to base their decisions on facts. He proposed a framework which rates investment opportunities according to strength of evidence and weight of conviction. Such an approach allows investors to evaluate whether they are over- or under-confident, and whether emotions are influencing their decisions.

To illustrate how emotions may play a role, Neilson noted that investors had high conviction on consumer packaged goods companies in March 2016, owing to the perceived safety and predictability of names such as Colgate and Nestlé, despite a lack of sales growth in the sector. At the same time, they failed to spot the opportunity in commodities, owing to negative sentiment on the asset class.

Looking ahead, Neilson encouraged delegates to consider whether a 50% allocation to US stocks is sensible, given current valuations, and to seek fund managers who are not tied to an index.

EXPECT TURBULENT US-CHINA TIES TO TEST THE REGION
– Linda Jakobson, Director, China Matters (Sydney)

> US-China relations under President Donald Trump will be turbulent. Trump's confrontational remarks during the months he was president-elect, coupled with his transactional approach to dealing with foreign countries, are bound to increase friction between Beijing and Washington. While no government in the region wishes to choose between the US and China, no one wants to see the US neglect the Asia-Pacific either. This will be testing for an economically interdependent region. Intraregional ties will be strained. A major crisis over Taiwan, the South China Sea, or a trade war would deeply affect the region as a whole. In an era of volatility, Canberra should reach out to Beijing.

In the penultimate session of Markets Summit 2017, Linda Jakobson proposed that President Trump would create tensions within the Asia Pacific region, and that Australia should pivot away from the US – its long-standing ally – towards China.

Jakobson, who lived and worked in China for more than 20 years, noted the strengthening of US-China ties that occurred in the period following the 9/11 New York terror attacks in 2001. However, actions by President Donald Trump had served to "rattle nerves" in Beijing over recent months, Jakobson said, while the erratic temperament of the newly-elected commander-in-chief raised further risks.

Jakobson set out five flashpoints which could raise US-China tensions:

- Efforts by Trump to use Taiwan as a bargaining chip, which she said could provoke a "violent reaction" from Beijing and even result in a "Cuban missile crisis-type incident";

- The appetite of anti-China hardliners in the Trump administration to confront China over its claims in the South China Sea;
- The possibility of a Trump-inspired US-China trade war;
- The US view that Beijing is failing to pressure North Korea over its ongoing nuclear weapons program; and,
- A flare-up in the Senkaku/Diaoyu Islands dispute between Japan and China.

Antagonism between the US and China would have substantial economic and political implications for Asia Pacific, Jakobson argued, and would stoke tensions between pro-US and pro-China countries in the region, given many nations rely on the one hand on the US for security but on the other hand on China for their standard of living. In conclusion, Jakobson proposed that Canberra should seek a new type of relationship with both Washington and Beijing.

THE WINDS OF CHANGE
- Jonathan Pain, Author, The Pain Report (Sydney)

> The tectonic plates of the political and economic landscape are rupturing as the winds of change herald a new geopolitical reality of anti-establishment populism and nationalism. The cosy Post-Cold War liberal and globalist consensus has fractured and we must now brace for a period of instability as we search for a new political and economic equilibrium. The good news is that after eight long years of Alice in Wonderland monetary policy, animal spirits have emerged from hibernation and lower for longer, is no longer. The first derivative of reflation is easy: stronger growth, higher inflation and rising bond yields. The second and third derivatives are more complex as the first derivative collides with record debt and the third derivative ushers in a new political reality of instability. Brace yourselves for a wild and entertaining ride.

The election of Donald Trump has "profound ramifications" for the world, and investors should base their decisions according to scenarios which are possible, plausible and probable, Jonathan Pain argued.

He too attributed the rise of Trump and other populist figures in the developed world to cultural aspects, and a sense among some voters that national values are under threat. Investors must understand the drivers of political change, he argued, given the substantial impact such shifts may have on asset prices. Pain cited as examples the elections of reformist leaders Shinzo Abe and Narendra Modi, which catalysed strong upturns in the Japanese and Indian stockmarkets.

However, in contrast to the elections of Abe and Modi, in 2012 and 2014 respectively, Pain said Trump's arrival on the world stage, in November 2016, was "earth-shattering". Pain forecast that the president's policies will "pour fiscal fuel on a bond fire that was already alight" and trigger much stronger US economic growth, with inflation of more than 3%.

US foreign policy will be less predictable, Pain said, but he encouraged investors to "get inside the head of" Steve Bannon, Trump's chief strategist. Bannon believes that the West is in the midst of a holy war and that Islamism threatens the future of western civilisation, Pain warned.

Election results may shock markets again in 2017, Pain predicted, given that commentators are underestimating the likelihood of a victory for French nationalist, Marine Le Pen.

In terms of scenarios which are possible, plausible or probable, Pain rated reflation as probable, trade and currency wars as plausible, and a Le Pen victory as possible. Meanwhile, extreme market volatility is "inevitable", he said.

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