



Market Viewpoints

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Political correctness is tyranny with manners.

- Charlton Heston



With *Brexit* and the election of President Trump, a new era is upon us. An era in which the certainties that have held true for decades are suddenly no longer valued. They are vulnerable. Globalization, immigration and liberalism which have defined the last three decades could get undone by protectionism, nationalism and populism. Yes, trade wars could be a reality and, yes, the US and China really could go to war in the next five years. No, their trade relationship will not prevent it. The UK-German economic relationship didn't prevent the slaughter at the Battle of the Somme a century ago. However, there is a silver lining. The current populist wave in the US and Europe is not about "pitchforks and soak the rich" and potentially has a positive side to it. Unlike past populist movements that arose from a desire to upend society, today's movement is driven more by the longing to restore things to the way they were in the "good old days." In other words, it may have reactionary elements, but it is not truly revolutionary. The grievances if handled correctly, will pave the way for a brighter future. The markets are probably right to think that Trump heralds a friendlier approach to business, in the form of lower taxes and less regulation. The S&P 500 Index (SPX) has been flat since mid-December, as investors take a wait and see approach to the policies of President Trump and their impact on assets.

A new era begins

Calendars are a human construct devised to keep track of time. It is historic events that really signal the beginning or the end of an era. Arguably, the 20th Century didn't start until June 28, 1914 when the assassination of Archduke Franz Ferdinand of Austria set off events that led to World War I. Just over a hundred years later, with *Brexit* and the election of Donald Trump as President of the United States, we may be witnessing events that will define the 21st Century. The start of a new era where globalization, immigration and liberalism which have defined the last three decades, are all undone by protectionism, nationalism and populism. Yes, trade wars could be a reality and, yes, US and China really could go to war in the next five years. No, their trade relationship will not prevent it. The UK-German economic relationship didn't prevent the slaughter at the Battle of Somme a century ago.

The German General Erwin Rommel once made a distinction between a risk and a gamble. Both involve an action with only a chance of success; a chance that is heightened by acting with boldness. The difference is that with a risk, Rommel suggested, if you were to lose, you could recover. On the other hand, with a gamble, a defeat could lead to a slew of problems that could likely spiral out of control and could well lead to disaster. Donald John Trump has been sworn in as the 45th President of the United States. In choosing Trump, a political novice, have the American people taken a risk or a gamble?

Going by his inauguration address, Trump is going to govern just as he campaigned. He is at war with his detractors and he is unlikely to have a "honeymoon period" with the establishment or the media because there has been no marriage to speak of. Polls suggest Trump is the least popular new President in at least four decades. It's too early to say what kind of leader Trump will be, but the world is crying for leaders who are not purveyors of polished speeches and pollster-vetted communication. Great leaders tend to be divisive - loved or hated, nothing in between. In more recent history, look at Margaret Thatcher and what she achieved. The Trump era promises to recognize the social concerns that unfettered immigration can bring and economic concerns that unfettered globalization can inflict.

A new era is upon us; one in which certainties that have held true for decades are suddenly no longer valued. They are vulnerable. In this new era, no relationship is secure. For more than 60 years, the US has promoted European unity. In fact the US helped rebuild Europe with the Marshall Plan. The US supported the single European market and backed Europe's eastward expansion following the end of the Cold War. However, things are looking different for Europe now with Trump in the White House.

Former US Secretary of State Henry Kissinger famously wondered: "Who do I call if I want to call Europe?" That call is not getting any easier under Trump, who would rather see the European Union (EU) unravel. He called the EU: "basically a vehicle for Germany," adding that "other (nations) will leave (the EU)," as the UK plans to do.

Der Spiegel reports that an offer from Chancellor Angela Merkel's team for her to travel to the US, at short notice, to meet the new President has not yet received a reply, while the German Ambassador to the US's last meeting with Jared Kushner, Trump's son in law and Senior Advisor, ended with Kushner asking, "What can you do for us?"

So desperate has the Merkel Chancellery become for tips on the new President's thinking, that her staff have taken to passing around the March 1990 issue of *Playboy* which contains a long interview with Trump, in which he talks about what he sees as America's most dangerous adversaries. He doesn't mention Russia or China, but Japan and West Germany, countries that he says had robbed the US of its self-esteem. "Their products are better because they have so much subsidy," he said, while America is ensuring that those countries aren't "wiped off the face of the earth in about 15 minutes." He concludes his point by eloquently suggesting that: "Our allies are making billions screwing us." In 2015, German export to the US totalled Euros 114 billion and US exports to Germany were at Euros 60 billion. Even the successes of America's Silicon Valley are failing to offset this huge imbalance.

Under the Trade Act of 1974, President Trump can impose tariffs of up to 15% for as long as 150 days on countries that accumulate large current account surpluses. The US Congress has also granted the President trade promotion authority until at least 2018, when it comes up for renewal. That means that Trump has broad freedoms to negotiate free trade agreements. Or if he chooses, put an end to them. The US must provide only six months advance notice, for example, to back out of the North American Free Trade Agreement (NAFTA).

Populist sentiment is of concern to many people and media reports are always full of dire outcomes. Yet, it is also worth noting that the current populist wave in the US and Europe is not about "pitchforks and soak the rich" and potentially has a positive side to it. Unlike past populist movements that arose from a desire to upend society, today's movement is driven more by the longing to restore things to the way they were in the "good old days." In other words, it may have reactionary elements, but it is not truly revolutionary. Their grievances if handled correctly, will pave the way for brighter future.

As for those that can't catch a breath criticizing President Trump, I give you this quote from George Bernard Shaw - "The reasonable man adapts himself to the world: The unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man." Let's hope Trump is that unreasonable man who will bring about progress in a world, which is at a crossroads and stagnating.

Leave if you want, but you need to settle your bill first!

With the excitement (or not) over the inauguration of President Trump, an important piece of news in the Eurozone went completely unnoticed.

Reuters reported, quoting European Central Bank (ECB) President Mario Draghi, that any country leaving the Eurozone would need to settle its claims or debts with the bloc's payments system before severing ties. This comment was a rare first admission of the possibility of the Eurozone losing a member. It came in a letter to two Italian lawmakers in the European Parliament, released last week. "If a country were to leave the Euro system, its national central bank's claims on or liabilities to the ECB would need to be settled in full," Draghi said in the letter. The threat of defaults on cross-border debts has often been credited as one element keeping the Eurozone together throughout the financial crisis and may also force them into a fiscal union:

- Based on data as of the end of November 2016 from the Eurozone payment system, Italy's bill for leaving the Eurozone would be Euros 359 billion (\$383 billion)
- Weaker Eurozone economies including Italy, Spain and Greece have accumulated huge liabilities, while Germany stands out as the biggest creditor with net claims of Euros 754 billion. That sum is the total debt owed by other Eurozone central banks to the Bundesbank, which now amounts to 49% of Germany's net foreign assets

Thus, Germany's balance of payments surplus with the Eurozone is financed not by the transfer of foreign currency reserves, gold or other liquid or near-liquid assets, but by an open-ended overdraft facility granted by the Bundesbank. Under this peculiar system, the exporter is paid but not by the importing country, but Germany's central bank, which never receives payment from the importing country but a mere credit note from the importing country's central bank.

Should weaker countries end up leaving the Eurozone, their national central banks would likely go bankrupt. That is because their debt is denominated in Euro, whereas their debt claims would be converted to a new currency, that would likely plummet in value. The Bundesbank, as large net creditor, wouldn't be made whole. In view of negotiations set to begin in 2018 on a possible European fiscal union, which would imply systematic transfers from the EU's north to its south, Germany would do well to understand the risk of not signing such a treaty. They are on the hook anyway. 2018 is shaping up to be the most crucial year for the Euro and the Eurozone. It either breaks up or a full fiscal union ensures its future.

Where to invest?

We are in a topsy-turvy world. The leaders of the US and China, rhetorically at least, appear to have switched roles. "We will open our arms to the people of other countries," Chinese President Xi Jinping intoned at Davos recently and added, "pursuing protectionism is like locking oneself in a dark room."

In the US meanwhile, House Republicans are pushing for a radical overhaul of the existing tax code, including adding a "border adjustment" mechanism that would effectively subsidize exports and tax imports. This would boost US GDP growth, narrow the trade deficit, and boost inflation and the US dollar. President Trump has been blowing hot and cold on it, although this week he indicated that he was in favour of a "border tax." I see a more than a 50% chance that some version of the "border tax" proposal will be implemented and the market in under-pricing this risk. Clear winners in such a scenario would be US Financials, Industrials and US Small Cap stocks. Losers: Technology and Retail stocks that manufacture goods

abroad.

According to various estimates, the USD could rally +10-15% if the border adjustment tax is introduced. Such an outcome could prompt the US Federal Reserve (Fed) to raise interest rates more aggressively than it otherwise would, in response to rising inflation, stemming from a narrowing US trade deficit. A stronger USD would also push down commodity prices. Of course, a protectionist backlash against the US might ensue, which could make world trade very messy.

As I have advocated for the last few months, Emerging Market equities carry the highest risk of any, if Trump were to carry out his protectionism threat. Goldman Sachs estimates for every unit cut in US imports, production losses in Asian economies would be 2.6 times, compared with 1.7 times elsewhere. Asia's vulnerability is rooted in the large share of its exports to the US that are discretionary consumer goods – cars, electronics and retail merchandise - usually hit by demand shocks.

Equities have gone nowhere in last five weeks. The S&P 500 Index (SPX) is flat since mid-December, as investors take a wait and see approach to the policies of President Trump and their impact on assets. However, it's not doom and gloom. US consumer confidence has risen over recent months. According to the Conference Board's measure, in December, it reached its highest level since August 2001. The same trend is evident in Europe, which faces key elections in the Netherlands, France and Germany. The main Eurozone-wide measure of business and consumer confidence in December reached its highest level since March 2011.

Global inflation rose in second half of 2016, picking up to a projected +2.1% year-on-year (yoy) pace in December from +1.6% in June. The turn towards higher inflation and stronger growth is shifting central bank rhetoric. At the Fed, a hawkish tilt evident at the December meeting has gathered steam in recent speeches. Chair Janet Yellen's recent remarks have emphasized that "the economy is near maximum employment and inflation is moving towards [the Committee's] goal." She also noted that "allowing the economy to run markedly and persistently 'hot' would be risky and unwise."

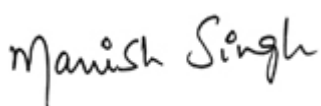
In the Euro area, a +1.1% yoy rise in consumer prices in December (+1.7% rise in Germany) is giving ammunition to the hawks at the ECB. At last week's ECB press conference Draghi was unable to signal unconditionally the asset purchase plan could last through year-end. Inflation could be a big factor this year particularly in the Eurozone. The ECB could get trapped between a rock and a hard place. Rising inflation without a corresponding tightening in interest rates could turn real rates negative, erode the savings of depositors in Germany and northern Europe and agitate them into pushing the ECB to raise rates, which the indebted southern Europe can ill afford.

Since Trump's election, the clear winners have been Financials, which have rallied over +12%, nearly triple the gain of the SPX. Other sectors that have outperformed include cyclicals such as Industrials, Materials, and Energy. On the downside, just two sectors are in the red since Trump's election and they are both defensive in nature (Utilities and Consumer Staples). One other notable underperformer has been Healthcare, as that sector faces bipartisan headwinds in Washington.

The markets are probably right to think that Trump heralds a friendlier approach to business, in the form of lower taxes and less regulation, and that inflation is more likely to be pushed up. It's also true that unlike previous bouts of uncertainty – sub-prime, dot com, et al. there is nothing specific for investors to panic about. I maintain my bias to US equities however, I am in no rush to start buying with both hands. Buy the dip is still the mantra and Financials, Industrials and Energy remain my three favourite sectors. US energy independence is a key boost for energy stocks.

Some of the stocks I hold/recommend: JP Morgan (JPM US), Bank of America (BAC US), Allergan (AGN UN), Celgene (CELG UW), General Electric (GE), General Dynamics (GD US), United Rentals (URI), Northrop (NOC US), BAE Systems (BA/LN), Boeing (BA UN), Google (GOOG US), Microsoft (MSFT US), Amazon (AMZN UW), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Gilead Sciences (GILD US), Societe Generale (GLE US), BNP Paribas (BNP FP), UBS (UBSN VX), Salesforce (CRM US), Estee Lauder (EL US), Johnson & Johnson (JNJ), Walgreen Boots (WBA US), Glencore (GLEN UN), Rio Tinto (RIO LN), Pioneer Natural Resources (PXD), Blackrock (BLK), United Health (UNH), Comcast Corporation (CMCSA).

Best wishes,



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