



“ **A great many people think they are thinking when they are merely rearranging their prejudices.**

- William James

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Marine Le Pen has set out her stall for the French Presidential election in April. Her "Free France" manifesto begins with a pledge to restore full sovereign control over the currency, the economy, laws, and the territory. Le Pen is the insurgent candidate and the two-round ballot election is her biggest hurdle to the prize she covets – the Presidency. Nearly the whole of the French establishment on the Left and on the Right unquestionably accept the European Union (EU) as France's historic destiny. The *Front National's* denunciation of the EU, therefore, makes it the shibboleth of progressive values. So to the important question, can she win? I say, yes she can. Le Pen's second-round polling support has been rising in recent months, causing the financial markets to step back and take notice. Europe's periphery debt market has welcomed a new member – France! President Trump plans to send to Congress an outline for a comprehensive plan to overhaul the tax code for individuals and businesses by the end of this month. If we go by his campaign promises, small and medium size enterprises will likely get a reduction in taxes and regulatory burdens. This will be positive for US growth and in turn for the markets. I recommend that you remain long risk and overweight US equities. There is a low risk of a US recession over the next 12 months and even a modest pick up in nominal growth should push global earnings higher. I do not expect a rate rise at the March Federal Reserve meeting. Present conditions don't warrant it. I, however, do believe that President Trump's policies are going to be reflationary and that they will bring the Fed into action. We will see it raise rates at least three times this year, with all three hikes coming in the second half of 2017.

### Le Pen mightier than Macron?

In Victor Hugo's *Les Misérables*, Enjolras, the leader of *Les Amis de l'ABC*, an association of revolutionary republican students, waxes lyrical from the top of his barricade about the glorious time when "thinkers will be completely free, believers completely equal, no more hatred, jobs and rights ...." Sadly, Enjolras gets killed, and his wish list remains unfulfilled two centuries on.

France is a nation of unpopular leaders who can recognise the need for change, but who are held hostage by the status quo around them. There is no De Gaulle figure waiting in the wings. For all the supply-side hopes he raised before getting to the Élysée in 2007, Nicolas Sarkozy failed as President. After him, Francois Hollande, the "President Normal," left more of an abnormal economy, with 600,000 jobs lost under his watch. This has left the door open for Marine Le Pen who has detoxified her father's party, the National Front. She may have softened the edges a little, but she may equally be a snake-oil salesperson offering merely a knee-jerk reaction to the current causes of discontent in France.

Le Pen has set out her stall for the French Presidential election in April. Her "Free France" manifesto begins with a pledge to restore full sovereign control over the currency, the economy, laws, and the territory. Le Pen is the insurgent candidate and the two-round ballot election (designed in the 1820s, perhaps to prevent revolutionaries like Enjolras from winning elections), is her biggest hurdle to the prize she covets – the Presidency. As they say in France, in the first round you vote for the person you want; in the second you vote against the person you fear. I am not a fan of the two-round ballot and I am glad that in the UK, we have a system of one round, majority vote wins. To my great chagrin, Margaret Thatcher could never have been elected and re-elected in a French-style second round, as a united opposition would have colluded against her.

So to the important question, can Le Pen win? Yes she can.

Over the last three months, we have already seen four established candidates for the Presidency, two former Presidents and two former Prime Ministers — back out or be rejected by the voters. François Fillon, the former front-runner, is himself on the ropes for alleged corruption. Therefore, Le Pen's real adversary is Emmanuel Macron, a pro-European globalist and a member of the liberal metropolitan elite - at a time when that breed has fallen out with "populist" voters. "It is a duel of patriots against globalists," Le Pen likes to say, rubbing her hands with glee.

France has the highest taxes in the developed world, especially on businesses, slow growth and chronic unemployment - worst among the young and ethnic minorities. Small companies are afraid of growing too big for fear of incurring the regulatory burdens scale can bring. A leading sociologist, Michel Crozier, described France in 1970 as a "société bloquée" — a stalemate society. In the 1980s, President Francois Mitterrand lamented

national "moroseness." It's not that things don't change in France, they do. As Robert Toms, Professor of French history at Cambridge and author of *That Sweet Enemy: the British and the French from the Sun King to the Present* notes; "Of course, things in France do change, but the price of political stability is that certain fundamental rights and privileges remain untouched and therefore get more entrenched - advantageous retirement rights and pensions, certain influential professions like farmers sheltered by the Common Agricultural Policy, people in permanent employment, protected by laws penalizing redundancy and limiting hours of work." The public sector or "le service public" is the core of the French system: schools, public hospitals, railways, universities, local government, the post office. All are arms of the State. Nearly the whole French establishment on the Left and the Right unquestionably accept the European Union (EU) as France's historic destiny. The *Front National's* denunciation of the EU, therefore, makes it the shibboleth of progressive values.

*Brexit* and President Trump have created a sense that the unthinkable is possible, which could further weaken the taboo against voting for Le Pen. Giles Merritt from the Friends of Europe think tank in Brussels says - "Project Fear (with respect to *Brexit*) was a dreadful mistake. We now read in *Le Monde* that the UK has been the fastest-growing economy in the G-7, so of course, *Frexiters* are emboldened. Everybody here is transfixed with horror over what is happening in France. Le Pen is set to benefit from the years of accumulated gloom and disillusionment of the electorate towards the French establishment, but she still has a formidable wall to climb before she can get to *The Elysée*."

Le Pen's second-round polling support has been rising in recent months, causing the market to step back and take notice. The polls now indicate Le Pen losing the second round by 6 points. That is too close for comfort.

As a result, Europe's periphery debt market has welcomed a new member - France. Le Pen is a big tail risk for Europe and markets seem to be waking up to this. The market has stopped treating French government bonds on par with German or Dutch debt. The spread with German bond yields hit +0.84%, the widest in over four years. Six months ago, this was +0.22%. France and Ireland's 10-year yields are now practically equal, which is higher than the yield on the Latvia and the Czech Republic Government bonds. Over 60% of France's €2 trillion public debt is owned by foreigners. Therefore, the market would clearly act pre-emptively to any sign that opinion polls were tightening - and that is precisely what we've got here. I do however think the European Central Bank could contain the impact of rising bond yields.

I will leave you with this line from Hugo's *Les Misérables* - "Nothing is more imminent than the impossible . . . what we must always foresee is the unforeseen". As they say, forewarned is forearmed.

### Where to invest?

These days, deciding where to invest has become more about understanding politics (and its inter-linkages) than economics and the valuation of assets. As if that were not enough, your best laid analysis of investing in a particular sector or country can be undone by one tweet from President Trump. A fully valued asset can easily become over-valued or an over-valued asset could become even more over-valued, if it's the only asset investors trust (grudgingly or whole-heartedly). Think about the US Dollar, the Japanese Yen, the Swiss Franc and US Treasuries in the event of major geopolitical changes.

In her testimony to the US Congress last week, Federal Reserve (the Fed) Chair Janet Yellen signaled no change in the Fed's strategy of gradual withdrawal of monetary policy accommodation. Yellen merely repeated the familiar message that rate increases would continue, but at a gradual pace. Yellen also emphasized that the Fed's balance sheet will not be used as an active policy tool. Consequently, re-investments will not stop until the economy has become sufficiently strong, and that the normalization process is "well underway." The Fed's portfolio has expanded from less than \$1 trillion before the financial crisis in 2008, to roughly \$4.5 trillion today. Yellen repeated that the central bank wouldn't begin unwinding the Fed's balance sheet until the process of raising short-term rates is "well under way."

There is not much in recent inflation data that can spook the Fed to raise rates early. US inflation rose to +2.1% for the 12 months ending December 2016. This is the first time since July 2014 that the headline rate of growth is over +2%. July 2014 also coincided with a peak in the price of Oil at \$100. We have now seen another spike in oil prices that has brought about this +2.1% inflation reading.

More importantly, the Fed's preferred inflation metric, the Personal Consumption Expenditures Deflator (PCE), is showing even fewer inflation pressures. The Y-o-Y growth rate of the headline PCE deflator has not touched +2% since April 2012, which is nearly five years ago. This is the longest period of sub-2% PCE inflation since the early 1960s. In short, the Fed has been undershooting its long-term inflation target for the better part of nine years. I do not expect a rate rise at the March Fed meeting. Present conditions don't warrant it. I however, do believe that President Trump's policies are going to be reflationary and that these will bring the Fed into action. It will raise rates at least three times this year, with all three hikes coming in the second half of 2017.

Reports indicate President Trump plans to send Congress an outline for a comprehensive plan to overhaul the tax code for individuals and businesses by the end of this month. The US tax code hasn't been revamped since 1986, when President Ronald Reagan worked with a divided Congress to broaden the tax base and lower marginal tax rates. Attempts by lawmakers in both parties since then have failed. Treasury Secretary Steve Mnuchin has claimed the US administration can secure a US tax-code overhaul by August.

I am convinced that tax reform is coming and any comprehensive reform plan will very likely address individual, business and international tax issues. If you look at the US and the concerns of its businesses that corporate taxes are too high and too fraught with loopholes that benefit multinationals at the expense of the little guy with the domestic companies that only hire domestically are socked with the highest corporate tax rate in the G-20. If Trump's tax reform doesn't address the high tax rate that SMEs pay compared to large corporations then the "animal spirit" that leads to stellar GDP growth will never arrive. However, if we go by his campaign promises, small and medium enterprises will likely get a reduction in taxes and regulatory burdens. This will be positive for US growth and in turn the markets.

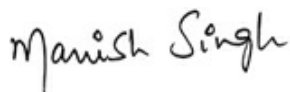
In Europe, the Eurozone expanded at the strongest pace in almost six years, likely helped by the weaker Euro

and a pickup in demand. As this improvement could eventually lead to higher inflation, the ECB will need to monitor this new situation closely. However, the other risk (did you say which one?) looming in Europe is Greece (once again). The talks are deadlocked. The deadlock is familiar. The IMF says Greece's debt is too high for it to receive more aid in the form of loans. Eurozone creditors, led by Germany, won't commit to major debt relief. Greece itself is resistant to more budget cuts. Germany says it won't continue to help Greece without the IMF and the IMF has so far stayed out of Greece's latest bailout. There is a Trump risk factor here, which few are talking about. The IMF board meeting is next week and there is lack of clarity over what position the US — which has the largest vote at the Fund — would take under Trump administration. If the Trump administration allegedly wanted to bring down the EU, why would it let IMF participate in the bail-out? This round could get ugly with Greece crashing out of the Euro. Having said all that Greek debt is not big in the overall scheme of things, and most have come to accept *Grexist* may not be a bad thing and necessarily pose a systemic risk to the Euro or the EU.

I recommend that you remain long and overweight US equities. There is a low risk of a US recession over the next 12 months and even a modest pickup in nominal growth should push global earnings higher. Any further upside from stronger growth, deregulation and tax stimulus or reform would be good bonuses, but ones that you can't take for granted, particularly their timing. A strong USD, US inflation and a steeper yield curve will all help US equities at first, before they begin to hurt. My sector preferences are Financials (XLF) and Technology (XLK). My views on Emerging Market (EM) equities haven't changed. A strong USD and a steeper yield curve are risks for EM equities.

Some of the stocks I hold/recommend: JP Morgan (JPM US), Bank of America (BAC US), Citi (C 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), Apple (AAPL 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), Pfizer (PFE US), Publicis Groupe (PUB FP), 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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