AQUILA FLASH

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Outlook 2017

The world economy should pick up speed and grow around 3.5% next year. The Fed will continue to move away from its previous ultra-stimulative monetary policy stance, while the ECB is likely this month (December 2016) to extend the timescale of its bond purchase program. The US dollar will rise in the year to come and interest rates are likely to be somewhat higher at the end of 2017 than they are today. In this context, we prefer credit risk to duration risk. While US equities look very expensive, there are attractively-priced equity markets elsewhere, for example in Europe and among emerging markets. We have a neutral weighting in equities but are minded to view market setbacks as an opportunity to add to equity positions.

US business cycle: The US economy is picking up steam – but the upcoming fiscal stimulus will be partially neutralized by higher inflation.

The most recent US economic data points are encouraging. The latest Manufacturing PMI reading is 51.9 while that for the Service sector stands at 54.8. The unemployment rate has now fallen well below the important barrier of 5%. In future, the US economy will be characterized by a less expansionary monetary policy and a more stimulative fiscal stance. This will probably shift the US yield curve higher and put renewed upward pressure on the dollar. The upcoming stimulus package is likely to be around $1000bn, or about 0.3% of US GDP. There will be a strong focus on the renewal of America's often dilapidated infrastructure. We expect the incoming Administration will at the same time push strongly for the repeal of "anti-growth" regulation. Right now, it is unclear how far world trade will be affected by the tariffs and other non-tariff measures of protection that might be introduced by the new Administration. As the US economy is nearly at full employment and capacity utilization is high, we expect that the upcoming stimulus will have a much stronger effect on nominal, as opposed to real, GDP. But moderately rising inflation and interest rates should be good in particular for financial equities. We note that US stocks, led by the financial sector, have responded very positively to Mr. Trump's election victory, pricing in future developments to some extent.

Sentiment indicators rose strongly on the US election result. It seems that following Mr. Trump's victory Americans now view the future with more optimism, especially regarding the economy and their own personal financial situation. We are probably in a "honeymoon phase" so far as Mr. Trump is concerned. Sooner or later the rose-tinted spectacles will come off and investors will focus on the harsher reality, with disappointment setting in.

We forecast a slight acceleration in the US growth rate next year to 3%. Given that the US economy is operating near full employment, the upcoming stimulus is likely to be partially neutralized by higher inflation. With the pace of wage gains picking up in response to the stimulus, we expect higher inflation and a moderate rise in US interest rates. Given a rising US interest rate differential vis-à-vis other countries, the dollar is likely to appreciate.

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European business cycle: Much higher political risks could disrupt the growth trend.
In recent quarters the EU has been able to grow faster than expected. The Purchasing Managers‘ index for Manufacturing (the Markit PMI) rose to 53.7 in November, the highest reading in eleven months. The equivalent figure for the Service sector was 54.1, also a high for the year so far. For the Eurozone, we predict a growth rate of 1.8% in 2017, assuming there are no serious political crises. But crises are a significant risk given the impending referendum in Italy and the upcoming national elections in France, the Netherlands and Germany. It is not difficult to imagine a series of headlines that would make investors fearful once more for the survival of the Eurozone. The cluster of upcoming elections represents a veil of uncertainty for Europe's economy and her capital markets. If and when the uncertainty lifts, the way could be open for a strong rally in European equities. But that is a story for another day.

The Swiss economy gains momentum but a Eurozone crisis could cause a disruptive appreciation of the franc. The SNB would have no choice but to “manage” the situation.
The Swiss Purchasing Managers‘ index has also been rising – to 54.7. Particular strength is shown in the index of orders for semi-finished goods, which stands at 55.6. We expect Swiss GDP growth to pick up slightly in 2017; to 1.8%. This forecast assumes no serious crisis in the Eurozone. Were one to occur, the SNB might well find itself forced to move to an even lower exchange rate floor against the euro than last time; one of parity. Such a stabilization policy would be buttressed by a move pushing Swiss interest rates even further into negative territory and potentially massive forex market interventions. Today's franc exchange rates are probably indefensible in circumstances of a renewed Euroland crisis

The world economy should expand by around 3.5% in 2017.

Bonds: Interest rates are on the turn
In the wake of Mr. Trump's victory the previous tendency for bond yields to rise has become more pronounced. Mr. Trump's plans for “printing press” - financed infrastructure spending and tax cuts suggest that the US Budget deficit and US inflation are both set to rise. But those problems are for the future. The recent sharp rise in yields suggests also a massive repositioning on the part of investors. Perhaps the “lower for longer” mantra on bond yields had held sway for too long.
Over the medium-term Mr. Trump‘s reflationary policies should boost the economy, albeit for a limited period. In this context, we prefer credit risk to duration risk.
Recent bond losses have been particularly pronounced in the high yield and emerging market segments. We view this development as a welcome opportunity to build up positions. Both high yield and emerging market bonds, in hard and local currencies, provide good diversification opportunities within the bond asset class.

Swiss property: Low interest rates and the absence of investment alternatives support the market but very high NAV premiums advise caution
Given continuing record low interest rates, Swiss property offers an attractive investment alternative. A sharp price correction seems unlikely in the near term. We see particular risks in the office sector and in the retail-related commercial sector, especially in areas near the Swiss national border. Property equities and property funds are still in strong demand, so much so that they generally trade at a substantial premium to net asset value. Possibly excessive premiums should be considered before initiating or adding to positions. Even so, relative to Swiss Confederation bonds, Swiss property looks better value or, alternatively put, “less bad”.

Valuation argues against US equities but in favor of Eurozone equities
Just how expensive are the equity markets? Just how expensive are the equity markets? Outside the years 1929, 2000 and 2007, US equities when measured by the Shiller P/E ratio have never been as expensive as they are today, with a Shiller P/E around 27. This figure is much higher than the usually quoted P/E metric because it is based on “normalized” earnings. Stock prices are compared with inflation-adjusted corporate earnings over the previous 10 years on a rolling basis. Given that interest, or discount, rates have been manipulated downwards for years by the central banks (and on a global basis, not just in America) one could view all equity markets as overvalued. But is this really so?

Our answer is “no”. Attractively valued equity markets do exist. Italy, for example, trades on a Shiller P/E of 10.6, while Spain and Portugal trade at 10.9. But Germany and Switzerland are considerably “dearer” with Shiller P/Es, respectively, of 17.3 and 21.1. While Russia has a very cheap Shiller P/E of 5.1, and Poland’s is just 8.9, not all emerging markets are cheap. The ratios for the Philippines and Mexico are, respectively, 22.6 and 22.4.The chances of a shift in these relationships – with expensive markets becoming less highly-rated and cheaper markets becoming dearer – are high and this is the basis of our allocation to emerging markets. But short term momentum considerations, whereby bond yield trends over the previous 6 to 12 months have some predictive power for yields in the month to come, argue against equity purchases in European peripheral markets at present.

Current investment strategy

Aquila currently has a neutral weighting in equities, with overweights in emerging markets and the US and underweights in Europe and Japan. Momentum is driving the overweight allocation to the US. While valuation clearly favors European markets, and argues against US equities, valuation tends to be dominated by momentum when it comes to shorter-term market performance. We expect to reduce our US equity exposure, and to build up positions in Europe, in coming months.