PVV is likely to be a big victor in the March elections. Depending on those results, the French polls can easily shift in favor of the Front National party and do so quickly, while improving the chances for the AfD party in Germany.

Asia by comparison will be an island of political stability in 2017. Chinese President Xi Jinping will likely see his support strengthened after the twice-a-decade leadership adjustments bring more allies into position of influence later in the year. Indian Prime Minister Modi and Japanese Prime Minister Abe's standing domestically are at historic and multi-year highs respectively. Both are coming off a successful 2016 and will be looking to capitalize on that success in 2017 emphasizing market friendly reforms. Indonesia, Malaysia and the Philippines are not too far behind with somewhat similar stories, while South Korea and Thailand remain the two spots where internal uncertainty clouds are likely to linger on for most of the year.

Any "largescale" uncertainty clouding the Asia story is likely to come from across the Pacific with the incoming U.S. administration. Threats of tariffs against China, shifts in the One-China policy of the past four decades, and potential escalation of tensions with North Korea could all act to negatively impact the Asia story for 2017. With the departure of the U.S. from the TPP (a setback to free trade and economic reforms in Asia), China's version of the agreement, the Regional Comprehensive Economic Partnership (RCEP) which includes the ASEAN economies, Korea, Japan, Australia, New Zealand and India has gained some momentum and likely to make progress during 2017.

Brazil which remains one of our favorite stories within emerging markets, will likely continue with its volatile political trend in 2017, though not likely to see another Presidential change. Michel Temer remains a very unpopular leader and is not likely to remain in office beyond the 2018 elections. In the meantime, he is likely to continue with transforming public institutions with his mix of fiscal austerity and legal reform that despite their deep un-popularity with the electorate are likely to be viewed positively by the financial markets.

Elsewhere, Argentina, Mexico, Iran, Russia, Saudi Arabia, South Africa, and Turkey are likely to have our attention in 2017, as economic and political developments both internally and externally involving those countries are likely to impact and at times significantly affect the global financial and commodity markets during the course of the year.

Financial Markets in 2017

If as we discuss above, the proposals from the incoming U.S. administration are simply financial engineering with no expected real impact on long-term economic growth, do we believe that the reflationary expectations are over-done? Will the very aged business cycle and associated bull market in equities benefit less than currently assumed by the markets? Or that the 35-year bull market in bonds is probably not over? A resounding "Yes" from us to all of the above!

The deficit expanding fiscal stimulus and tax cuts will need to be financed. Lenders will require higher spreads relative to other sovereign markets which in turn strengthens the US Dollar. The stronger Dollar will further widen the trade deficit by reducing or slowing the growth of exports relative to imports. Corporate earnings will be negatively impacted countering a large part of the benefits of tax cuts. The wider trade deficits will further pressure protectionist measures emanating from DC, impacting jobs and reducing the willingness of foreign central banks from reinvesting their Dollar earnings into U.S. Treasuries.

Offsetting lower marginal and statutory tax rates with equivalent eliminations of deductions will simply

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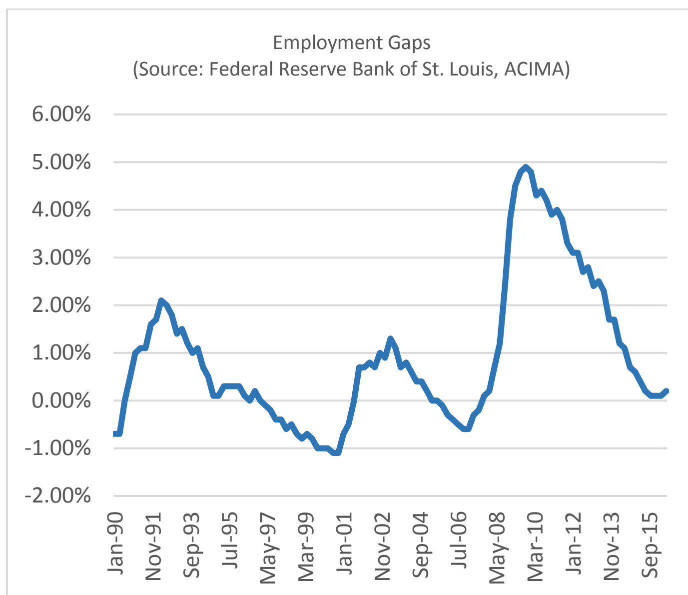
lesson the burden while leaving fiscal expansion to be financed, putting into question the very reason for the tax cuts to begin with.

The negative long-run impacts on investment and savings from widening structural deficits are well known[4], However, a positive cyclical impact on economic growth from fiscal expansionary measures when slack in the labor markets is non-existent remains questionable at best[5] (Chart Four). Any acceleration in growth will be short-lived and temporary with little if any impact on revenue growth via taxation for the government, implying greater deficit financing. But if external savers are less willing to finance the deficit, domestic savings can only do the job if the trade deficit shrank significantly, implying even more protectionism from Washington.

Chart Four



The bottom-line: unfunded fiscal expansion and tax cuts, will only be manageable if protectionism reduced the trade deficit and forced domestic savings to rise relative to investment. This kind of environment and outcome is not conducive to accelerated economic growth, in fact it would cause the exact opposite and could be the catalyst behind the next contraction and weaker equity markets. Weaker investment will eventually negatively impact employment and wages, which in turn should lower long-term interest rates and flatten the yield curve.

Adding to our concerns are an economic cycle in the U.S. that is now seven and a half years old, embedded earnings expectations in the markets that are more focused on the impacts of tax cuts on next year's earnings than on capital investment opportunities, and an optimism that seems to be universal. The sell side firms that we track are all and without an exception forecasting higher stock prices with total returns in the neighborhood of ~ 6.5% for the year (Chart Five). Remarkable! The legendary Merrill Lynch strategist Bob Farrells rule #9 of investing comes to mind*: "When all the experts and forecasts agree -- something else is going to happen"*[6]. Given the forward-looking nature of equity markets, such forecasts imply a sense of optimism at end of 2017 for corporate earnings during 2018 that would imply an economic expansion approaching the longest cycle of the past 70 years. Impossible? No. Improbable? Yes.

With such a setting, we remain under-weight U.S. equities and high yield debt, and over-weight investment grade debt. Our preference is to be the banker and not the investor to higher credit quality companies. We believe neutral risk-free interest rates for ten-year maturities are in the range of 2.25%-3.25% and as such are neutral on Treasuries but favor longer-term over shorter-term maturities (another contrarian perspective of ours) given the late stage of the cycle.
While we believe the U.S. Dollar has some upside especially against developed economy currencies, that upside will occur in-line with increased volatility in the FX markets. Parity against the Euro, and 1.1 USD's per British Pound are certainly in the cards. We do not rule

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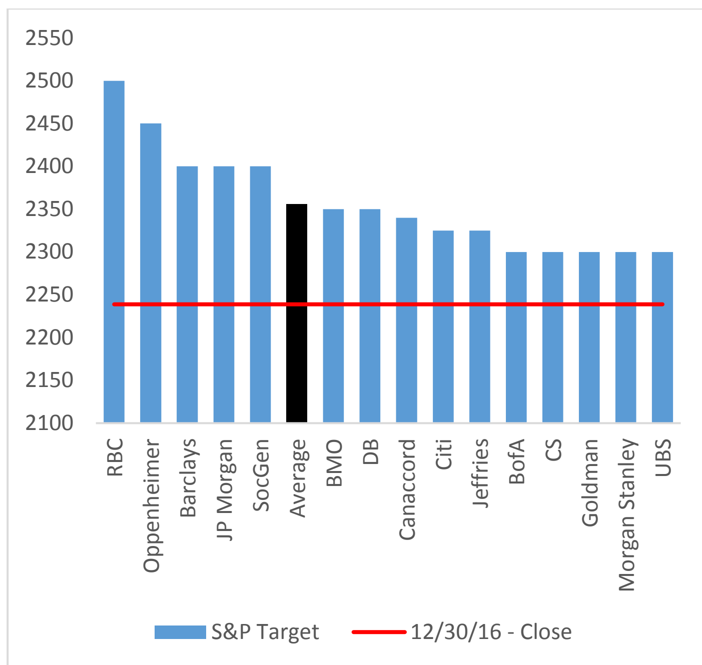
out the possibility of parity against the Pound if Brexit negotiations turn sour at some point. We remain favorable towards the Brazilian Real, South African Rand, and the Russian Ruble, and depreciation potential for most Asian currencies, the Mexican Peso, and the Turkish Lira.

Chart Five



Within Europe, we believe the Southern economies are likely to see slight improvement in growth for 2017 over 2016 (Can Greece finally see real growth?), while Northern economies should see growth in line with 2016 as the weaker Euro should help with exports. We are slightly more optimistic in our growth projections for the Euro-zone as a whole than consensus, but are mindful of the aging of the cycle especially in Germany. Not so for the U.K.! We believe a contractionary environment will likely occur during the course of 2017 and into 2018, with consumer inflation pushing closer to the 3.0% year over year mark. Confidence and hiring will begin to be impacted as the markets begin to appreciate the lengthy and drawn out Brexit negotiations.

Consistent with our U.S. stance, we remain cautious towards the equity markets of developed economies in general and remain under-weight (including Europe and especially the U.K.), but take exception with Japan, Australia and Canada. We believe the continued economic rebound in Asia led by a resurgent Chinese economy will be supportive of commodity prices and demand for final goods which should help the export natured economies of all three countries.

Speaking of China, we remain optimistic and believe policymakers have succeeded in steering the country out of what to us was the cyclical downturn of 2015-2016. Yes, there remain parts of the world where conventional monetary policy tools still work! Admittedly that is an interesting statement for us to make for such an unconventional economy.

We continue to have a more unorthodox perspective on analyzing the Chinese economy and financial markets, and believe that despite the structural slowdown in growth rates (as the country transitions to a more consumer oriented economy), it's the cyclical volatility around the new trend that should define investment perspectives/themes and not absolute growth. While we are mindful of the sharp increase in credit/leverage in the system and the concerns that it is raising amongst China watchers, we would note that such concerns are not anything new. China remains a credit hungry economy, a fact that is likely to remain in place for years to come and periodic acceleration is a necessary evil as the economy transitions to consumerism.

As China continues its currency liberalization, the Yuan is expected to depreciate further in 2017 and we are predisposed to agreeing with consensus (Chart Six). We expect this depreciation to cause some consternation with the protectionist crowds in

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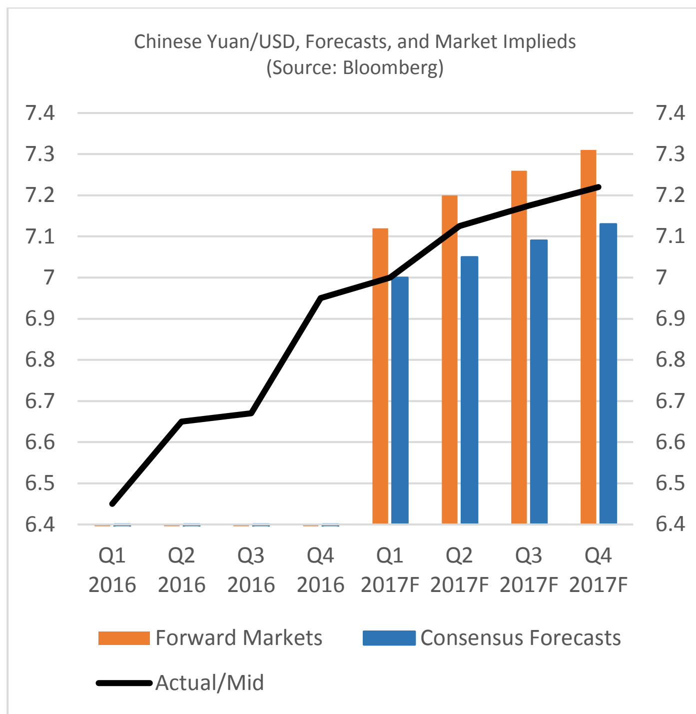
Washington who continue to argue the currency's undervaluation (which we vehemently disagree with) via manipulation. We are recommending an overweight position in the equity markets of the mainland as well as Hong Kong.

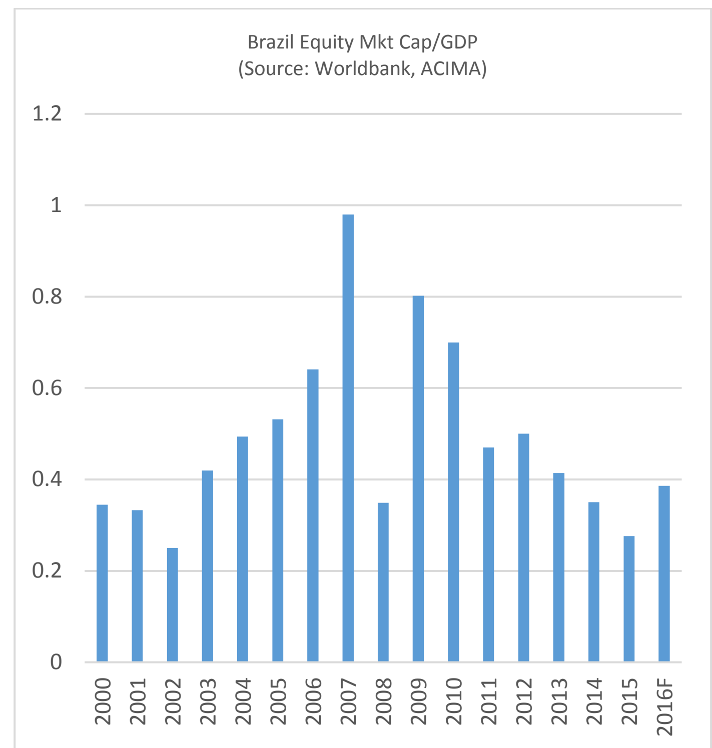
Chart Six



Taiwan and Southeast Asia will likely benefit from the China spillover as will South Korea, though with the latter we will continue to have a wait and see approach given the political uncertainties.

Latin America in general and Brazil specifically, remain a favorite equity market for us as the economy begins to exit its politically ignited and deep recession. Relative macro valuations continue to remain attractive (Chart Seven). While remaining on the side-lines we are beginning to like the story coming out of Argentina and will continue to monitor the situation as progress on the political and economic front combined with relatively cheap valuations are making for an attractive combination.

Chart Seven



In EMEA, we remain positive on Russia and South Africa as our optimism for global commodity prices should positively impact top-line growth for both countries. Inflation however, continues to remain one area of concern for us in South Africa. The wild-card for Russia is clearly how relations with the U.S. evolve during 2017 and to what degree? We are also positive on Turkey and expect the second half 2016 contraction to reverse quickly in 2017. Unemployment should peak in Q1 and begin its gradual decline. We believe growth could exceed 3% in 2017 and with valuation at their lowest levels since 2013 we recommend being overweight. We are mindful of the geopolitical volatility

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within and including Turkey's neighbors, but believe markets have priced in that risk appropriately.

Our optimism for emerging markets equities extends into the high yield markets as it did in 2016. We recommend remaining over-weight high yield (both sovereigns and corporates) and under-weight investment grade as the economic cycles favor risk taking on the credit curve as well as the term structure. We expect double digit and high risk adjusted returns in 2017. The recent pullbacks post U.S. elections are presenting some very interesting opportunities across parts of Asia and Latin America. The wild-card remains policies of the incoming U.S. administration especially in regards to China, and Mexico, two countries that were repeatedly targeted during the campaign. Volatility in the FX markets may pose some risks for the riskier credit, Dollar denominated debt with longer maturities.

Within global sectors, we continue to recommend over-weights to energy, and materials. We favor financials, technology and consumer cyclicals in emerging markets, Canada, Australia and Japan, and staples and healthcare in other developed markets. We recommend under-weight exposures to financials, and technology in the U.S. and Europe as well.

From a style and size perspective, in general we continue to favor value over growth and larger caps over smaller caps in developed markets and vice versa in emerging markets.

With that we wish our readers a very happy, healthy, and prosperous 2017!

As always, stay tuned;

Ardavan Mobasheri
Chief Investment Officer
January 1st, 2017

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