INVESTMENT RISKS IN 2017

SCOPE AND PURPOSE

Our tendency is to research small companies in considerable depth in order to pursue an analytical edge. We believe that, given there are inordinate economic organisations and think tanks, we cannot gain an edge in macroeconomic understanding. Therefore, in our macroeconomic research, we seek to identify circumstances that could detrimentally impact financial markets and investor expectations. By doing so, we can organise our portfolio in order to maximise capital preservation in the case of unfavourable conditions. Accordingly, we are less concerned with using macroeconomic research to identify money–making opportunities, such as long/short positions in currencies and/or market indices.

The nature of our investments means we are more exposed to economic downtrends than uptrends. The success of small companies is often contingent on several catalysts that are external to broader economic movements. For example, government approval for a construction project. On the other hand, if there is a serious economic downturn, small companies are often the first to experience outflows. This is due to two main factors. First, companies with lower liquidity are likely to experience greater downward pressure on prices when there are sellers. Second, smaller companies are often viewed as having a greater reliance on capital markets. When these markets dry up, the companies' prospects may be diminished. Consequently, we feel justified in our focus on risks rather than potential opportunities.

This paper identifies risks to market conditions across major global economies, with a focus on the impact any issue may have on the Australian equity market. We take the broad view that the performance of Australian stocks correlates to those in the US.[1] For the sake of clarity, our view is that the events contained within this report will most likely not occur; however, we wish to construct the portfolio in such a way that we can continue to perform if these or other macroeconomic shock events do not happen, whilst cushion against any downturn if they do. The paper examines the global economy at large, the US, China, and Europe.

THE GLOBAL ECONOMY: GEOPOLITICAL TENSIONS

The movement towards multipolarity

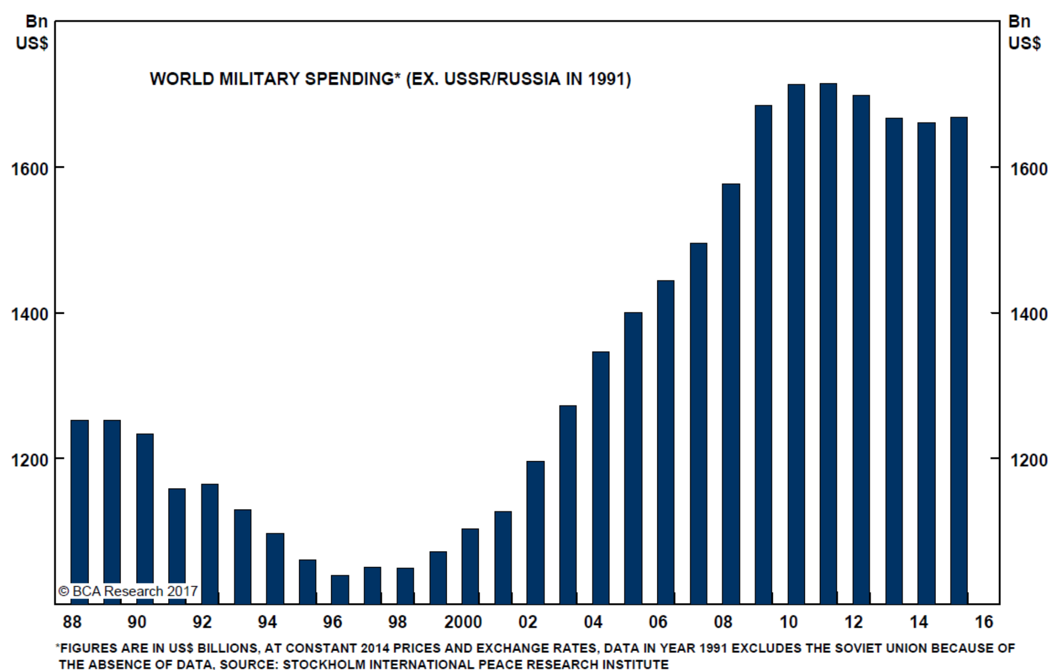
There is an argument that the movement towards multipolarity is increasing the chance of global conflict. Multipolarity is a geopolitical state in which the world has four or more "poles" of power: influential nations that pursue their interests independently. The opposite is unipolarity, in which one nation dominates. Whilst unipolar and multipolar states are theoretical extremes, there do appear to be times when there is a leaning towards one. In the last couple of decades, there has been a gradual decline in the global power of the US, the superpower for most of the twentieth century. This has resulted from the country's diminished focus on both foreign affairs and its hegemonic responsibilities, and the rise of emerging nations such as China and India. This has in turn created a vacuum for regional powers to pursue their own spheres of influence. It is

[1] http://ro.uow.edu.au/cgi/viewcontent.cgi?article=1034&context=aabfj.

argued that multipolarity tends to induce more conflict, since it creates greater nationalism and more competition amongst nations. Indeed, BCA Research, a leading global economic forecaster, shows that the frequency of conflict between two states per year has increased in the last 5 years from twelve in 2012 to twenty–one in 2016.[2] On the other hand, it is argued that unipolarity results in greater stability, since one nation has sufficient power to control other nations. An example of this is Britain's hegemony for most of the 19th century following the end of the Napoleonic Wars and the Treaty of Paris in 1815. During this period, there was considerable global stability.

The current multipolar climate means that many nations seem to be moving towards greater patriotism and insularity. This trend is demonstrated by the success of President Trump's campaign: his slogan, "Make America Great Again", and intention to refocus US attention on domestic rather than global affairs.

What market implications does this have? It may lead to greater volatility and consequently a movement towards safe–haven assets. This could benefit gold and US assets, since the US will likely continue to be seen as a secure destination. The increased chance of conflict should also benefit stocks in the defence sector. BCA economists have argued that we are currently in a similar arms race to that experienced in Europe at the turn of the 20th century, when the ascendancy of Germany was challenging the hegemony of Britain. British rearmament companies prospered, such as Vickers, which became the sixth largest company in Britain, and Armstrong Whitworth, the eleventh largest. The following chart demonstrates that we are in a period of increased military expenditure.



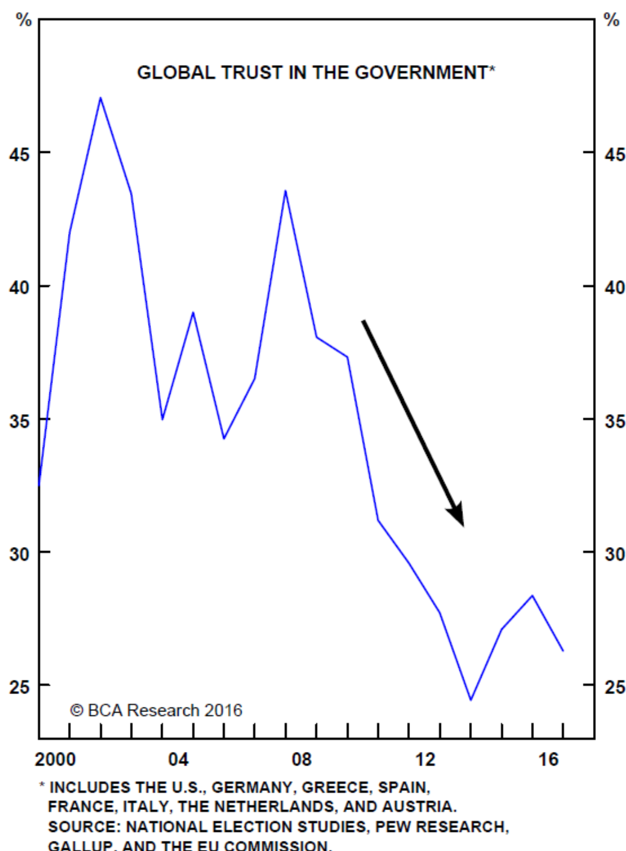
In the US, the Congressional Budget Office projects defence spending will rise from $586bn in 2015 to $739bn by 2026, before any fiscal stimulus proposed by Trump.[3]

---

[2] BCA *Geopolitical Strategy*, December 2016, p. 4. Global conflict is defined as the number of conflicts between two states or a state and an organisation supported by another state.

[3] BCA *Geopolitical Special Report*, "Brothers in Arms," 11 January 2017, p. 5.

The return of the charismatic leader



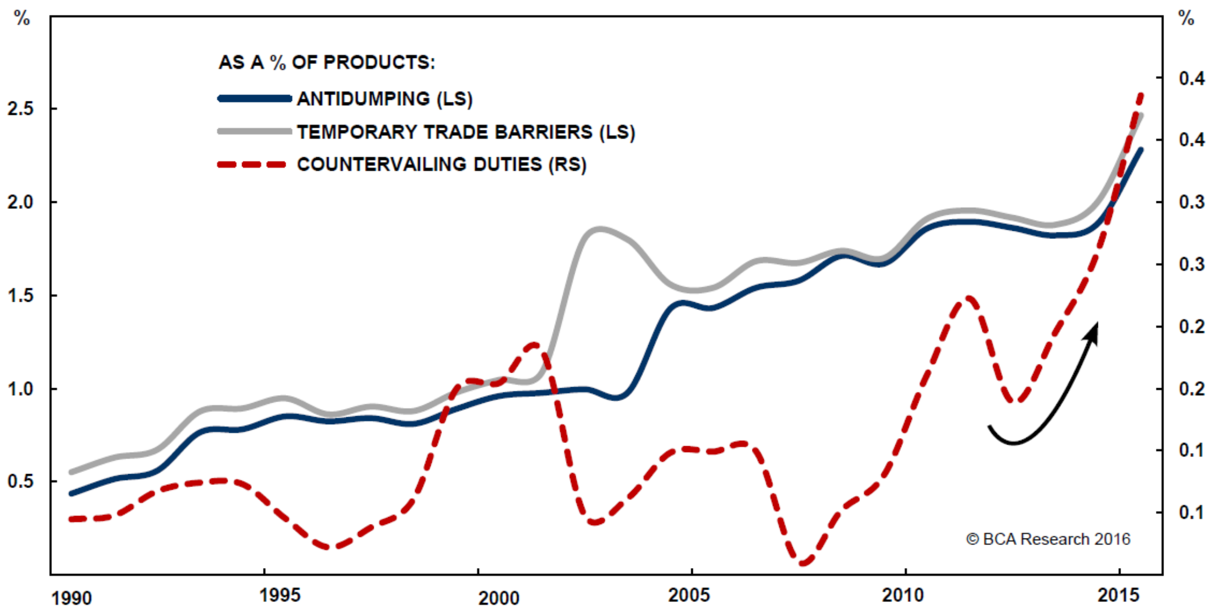
German sociologist Max Weber outlined three forms of leadership: traditional, legal–rational, and charismatic.[4] Traditional authority is a form of leadership in which the authority of a regime is tied to tradition or custom, such as monarchs within dynasties. Legal–rational authority is a form of leadership in which the authority of a regime is tied to legal rationality and legitimacy, and bureaucracy. This accounts for so–called developed states in the twentieth and twenty–first centuries, and is ideal for investors as it provides predictable behaviour amongst policymakers and business leaders. Day–to–day politics can be ignored; a grasp of the laws that govern the state are paramount. Charismatic authority is a type of leadership which derives from the charisma of a particular leader. It has been argued that we are moving away from legal–rational authority to charismatic authority.[5] This is evident amongst leaders in Russia, the US, Turkey, Hungary, and the Philippines. There is a chance that France will follow (more below). The reason for this shift is obviously multifaceted. However, a possible explanation is the increasing mistrust of the governing elite, especially following the 2008 financial crisis.

The wave of populist political leaders could conceivably lead to increased uncertainty. Unlike in predictable legal–rational leadership, it is difficult to foretell the actions of charismatic leaders. This is certainly the case with Trump: nobody seems to know what his term will bring and each step has its surprises. The most recent example is the controversy over the travel ban. It has led to dissension within his party, with Trump's conduct being criticised by Republicans such as Ben Sasse, senator for Nebraska. Moreover, the speaker of the House of Commons in the UK has barred Trump from addressing the UK parliament in his upcoming visit on the grounds of being "racist and sexist". Without making any value judgments, it is likely the hysteria will diminish over time; however, at least in the short run, whilst the uncertainty remains, safe assets could be the most desirable, such as cash and gold.

Deglobalisation

As a result of the shift towards multipolarity and nationalism, there may be a movement towards deglobalisation. This is most likely to be felt in the sphere of trade. The following chart shows that protectionism has been on the rise in the last decade.

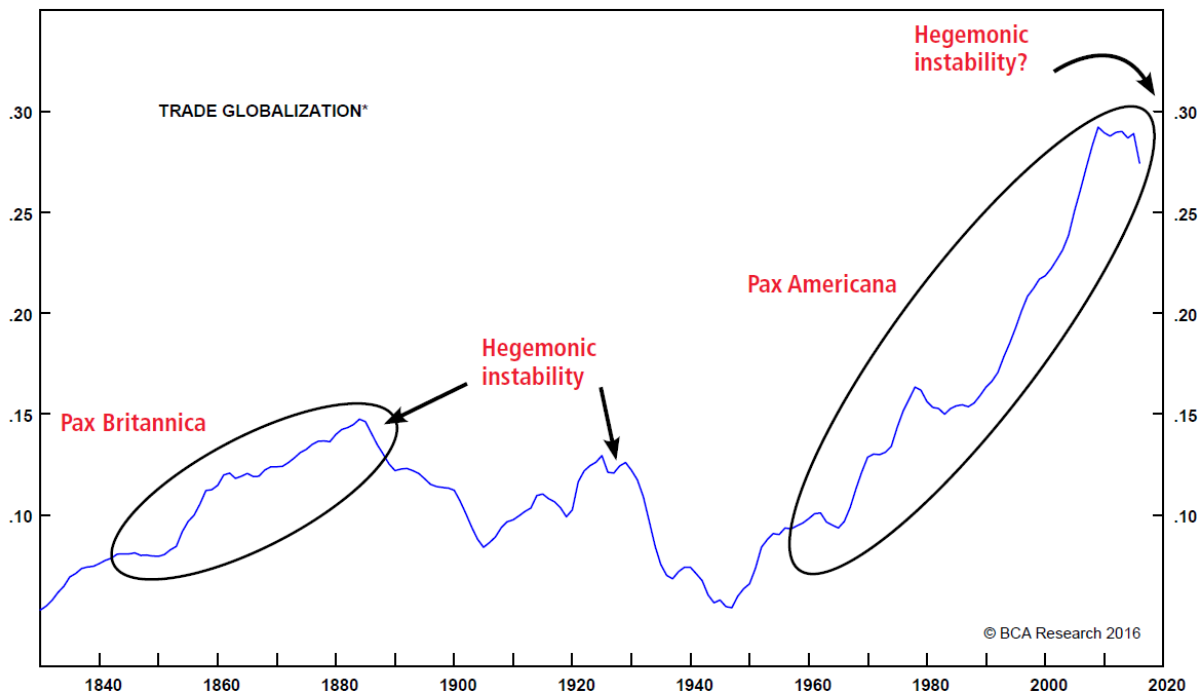
[4] Max Weber, 1958, "The Three Types of Legitimate Rule," *Berkeley Publications in Society and Institutions* 4 (1): 1–11.
[5] BCA *Geopolitical Strategy*, December 2016, p. 11.



SOURCE: WORLD BANK, TEMPORARY TRADE BARRIERS DATABASE.

It is possible that this trend will continue if Trump follows through with his election promises. He seemed to find particular support in identifying US overreliance on China, which in 2016 accounted for $347bn of the US's trade deficit of $763bn.

It is argued that the increased protectionism and insularity may be signalling a reversion to a more mercantile global economy, in which there is a focus on net export growth, with spheres of influence guarded by trade barriers. Further, the following chart demonstrates the inverse relationship between hegemonic instability (i.e. multipolarity) and trade:



* TRADE GLOBALIZATION IS MEASURED BY IMPORTS AS PERCENTAGE OF GDP FOR 148 COUNTRIES WEIGHTED BY POPULATION.
SOURCE: BCA CALCULATIONS AND CHASE-DUNN C., KAWANO Y., AND BREWER B., "TRADE GLOBALIZATION SINCE 1795: WAVES OF INTEGRATION IN THE WORLD SYSTEM," AMERICAN SOCIOLOGICAL REVIEW 65 1, 2000.

With less trade globalisation and a more inward approach, we could expect greater inflation. A reduction in trade could also engender a reduction in global commodity prices,[6] which would harm Australia's economy. Under this hypothesis, the most attractive investments are small caps with a domestic focus and closed economies levered on domestic consumption. The least attractive are multinational corporations and emerging markets.

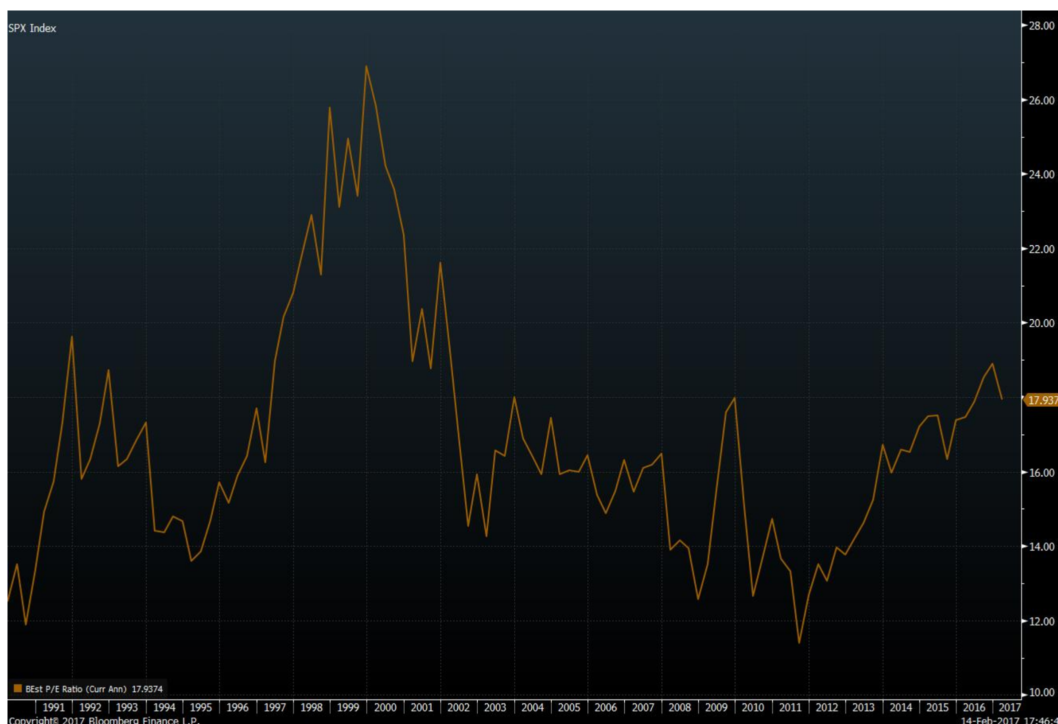
THE US

The US still looks to be in good shape going forward. Economists predict GDP growth of 2.8% in 2017, compared to 1.6% in 2016.[7] This increase is expected to be driven by household consumption, improved capital spending, and housing activity. In addition, Trump's fiscal policy may have a positive contribution. This involves $4tn expenditure over ten years; however, this is unlikely to have a major impact until 2018. Tax reform proposals should be similarly beneficial but will also take time to enact and is unlikely to be felt until 2018. Economists predict the tax cuts should add between 0.5% and 1% to GDP growth from 2018 onwards; however, they also believe it will come at the expense of adding $6tn to outstanding federal debt over the next decade.[8]

The Fed has projected three interest rate hikes during 2017, totalling a 75bps rise. Recent US inflation data has shown a material increase. Short term US rates are seemingly half that of the inflation rate. If inflation continues to rise (this is particularly relevant given recent indications of renewed fiscal stimulus), the Fed may need to increase rates faster than the market expects. Although this may not be detrimental to markets, it could facilitate a softening of current buoyant market activity. Economists are predicting a cyclical recession risk from 2019 onwards. If interest rates have gradually risen by that time, it may give the Fed room to stimulate the economy. There is also a widely held view that the USD will strengthen due to the increase in rates and inflows to the US as a safe haven in the face of global uncertainty. On the other hand, Trump has signalled his intention to weaken the currency in order to strengthen US exports.

In terms of equities, there are signs that the US market is overvalued, and some economists consequently have a bearish outlook.[9] The average forward P/E ratio for the S&P 500 at the beginning of 2017 was 19x, a height unparalleled since 2002.

[6] Excluding gold.
[7] BCA *How to Think About Global Bond Investing in 2017*, 20 December 2016, p. 2.
[8] BCA *The Bank Credit Analyst: Outlook 2017, Shifting Regimes*, January 2017, 68 (7), 10.
[9] *Ibid.*, 37.



The long term impact of Trump on US equities remains to be seen. Nevertheless, since his election three months ago, the S&P has risen by 10%. There appears to be optimism surrounding his term, particularly his policies to cut tax rates and increase fiscal spending. Business may also be aided if Trump manages to ease regulatory burdens, especially in the energy and financial sectors.

CHINA

Although the Chinese economy still appears to be expanding by around 5%, it has been propped up by an unhealthy growth in credit. Private debt–to–GDP is above 200%. Over the last seven years, growth in private debt–to–GDP was 90%, compared to 35% in the US in its comparable seven–year credit boom in 1983–1990.[10] Making matters worse, a lot of this debt pertains to the so–called “old economy,” comprised of manufacturing and industrials. The fact that the Chinese banking sector is largely under state control does provide some comfort; however, we still see the high debt level as a potential problem in China’s economic growth and consequently global commodity prices, which could ultimately affect Australia’s exports and market sentiment.

As mentioned above, there is an increasing question mark over Sino–American relations. If the US succeeds in limiting its imports of China’s goods, China could retaliate by restricting US business in China. Further, both countries may be levered apart by tensions over the South China Sea, especially given the possible relationship between Trump and Putin.

There is also a question mark over the renminbi. Chinese forex reserves have fallen under US$3tn for the first time in 5 years.[11] The central bank has been aggressively selling USD to curb renminbi depreciation

---

[10] *Ibid.*, 30.

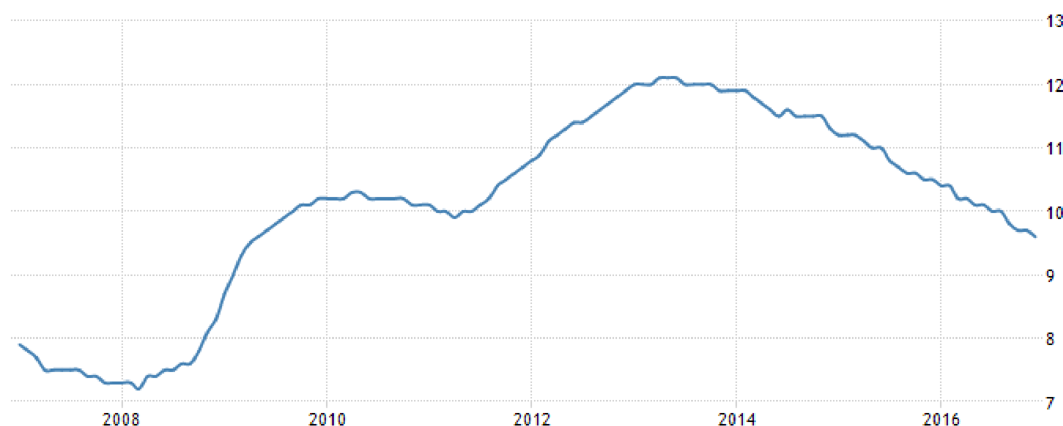
[11] https://www.ft.com/content/39b97f86-ed18-11e6-930f-061b01e23655. See this article for the following discussion.

since 2014, when reserves were US$3.99tn. If China cannot continue these payments and thus maintain the relative strength of the renminbi, this could have a negative impact on Australia, since Chinese demand for Australian exports could diminish. However, China's central bank has been focusing on other means of appreciating the renminbi by restricting the movement of cash offshore. Such measures include tighter approvals for foreign acquisitions, stricter rules on forex purchases, and limits on cross–border renminbi remittance. Almost $75bn worth of deals, including 30 acquisitions of European and US groups, were cancelled in 2016 by Beijing authorities. Nevertheless, according to a Financial Times survey of 1,000 urban Chinese households, there is still an expectation that the renminbi will fall 5.5% during 2017 to a ten–year low. This belief is mainly predicated on an increased appetite amongst Chinese for foreign currency, as well as the expected increase in US rates and general inflows into the US.

EUROPE

The European banking sector is increasingly fragile. European banks have more than €1tn of non–performing loans (NPLs) and have provisioned for only half the amount. Italy is the biggest concern. It has €265bn worth of NPLs, of which €200bn are in default. Its banks have total provisions of €85bn. Matters are still up in the air concerning the recapitalisation of Banca Monte dei Paschi di Siena, with the Italian government's request for €20bn from parliament still uncertain. Italy is in talks with the European Council and there remains the possibility that regulators could impose tough conditions in exchange for the state rescue of the bank (i.e. EU bail–in rules). The reason for the increased concern over Italy's debt problem, which has existed for some time, is that the European Central Bank (ECB) has taken over from Banca d'Italia (Italy's central bank), and has adopted a more stringent approach to NPLs. Italian bank UniCredit is about to undergo a €13bn rights issue at a 38% discount to the current market price.

There are mixed views concerning the economic outlook of the EU. BCA is pessimistic and predicts that economic growth in the bloc is unlikely to accelerate.[12] However, recent economic data show some positive signs. The bloc has now posted fourteen consecutive quarters of growth and the unemployment rate (9.6%) has been gradually declining, returning to single digits for the first time since 2009.



[12] BCA *The Bank Credit Analyst: Outlook 2017, Shifting Regimes*, January 2017, 68 (7), 28.

GDP growth for 2016 was 1.7%, marginally outpacing the US by 0.1%, with Spain growing by 3.2%. The explanations given for an improving EU economy include the fact that the financial crisis is now nearly a decade old, the better–than–expected impact of Brexit, and the increasing impact of the ECB's loose monetary policy, which has finally encouraged borrowing and spending amongst households and companies. Indeed, domestic demand fuelled most of the EU's growth during 2016.

In terms of currency, ECB monetary policy is likely to remain extraordinarily loose. It will continue its QE program in order to boost inflation, with asset purchases of €80bn a month until April this year, which will then be reduced to €60bn a month until December. Simultaneously, the Fed will tighten its monetary policy, which could put downward pressure on the Euro.

There are also three major elections in Europe in 2017, in the Netherlands, Germany, and France.

The election in the Netherlands, in March, is the first in Europe this year and may set the tone for France and Germany. It is already shaping up as unpredictable. Geert Wilders, referred to in the media as the "Dutch Trump," leads the Freedom Party (PVV), which has been labelled anti–Muslim and populist. The PVV currently leads the polls for the preferred vote, at 18%. The incumbent party, the Liberals (VVD) led by Prime Minister Marke Rutte, trails with 16%. Wilders is unlikely to become Prime Minister since no other party has signalled an intention to form a collation with the PVV. Nevertheless, if his party wins the preferred vote, it may send a message to Europe about the Dutch population's stance on immigration and nationalism. Marke Rutte has responded to the disfavour of his party by attempting to appeal to Wilders' voters. In an open letter to the Dutch people in January, he condemned people living in the Netherlands who decline to shake women's hands, fail to "act normal," and accuse regular Dutch people of being racist. This has been interpreted as an oblique criticism of Muslims living in the Netherlands. With 70% of Dutch voters yet to make up their minds and eight parties holding over 5% of the vote in recent polls, the election is impossible to predict. However, the recent trend in the campaign corresponds to the more general narrative of increasing nationalism.

The French election holds the greatest potential for turbulence. The first round of the election is on 23 April, the second on 7 May. There has been a collapse in support for the incumbent Socialist Party, led by Francois Hollande. Until recently, it was assumed that Marine Le Pen of the National Front party would win the first round and lose the second to Francois Fillon, the centre–right candidate of the Republican party. However, he has been embroiled in a scandal concerning unwarranted payments of public money to his family in 2005 and 2007, when he was a senator. There is mounting pressure on Fillon from within his party to step down as a candidate. The other hopeful is Emmanuel Macron, who is running with *En Marche!*, a centrist party he established in April 2016. Following the scandal with Fillon, financial markets appear to be increasingly pricing in a Le Pen victory, with French 10–year bonds rising sharply in late January to reach a one–and–a–half year high of 1.1%. According to UBS Wealth Management, she has a 40% chance of winning.[13]

What are Le Pen's policies and what would be the impact of a Le Pen victory on markets? Her main policies are tightening on immigration and reshaping the EU. She states that she intends to place a special tax on job contracts for foreigners and reduce immigration by 80%. She also intends to abandon the Euro, reinstate the franc, and pursue protectionism. She would follow her election by six months of talks with the EU to reshape it into a loose confederation of states, ending the Schengen Area and predominance of EU law. If these talks

[13] https://www.ft.com/content/a5519f64-eaeb-11e6-930f-061b01e23655.

are unsuccessful, she would hold a referendum to leave the EU. She is labelling the election "globalisation vs. patriots." It would seem likely that in the short run, her policies could have a destabilising effect on markets as they put a serious question mark over the future of the EU. In this instance, gold and cash could be favourable.

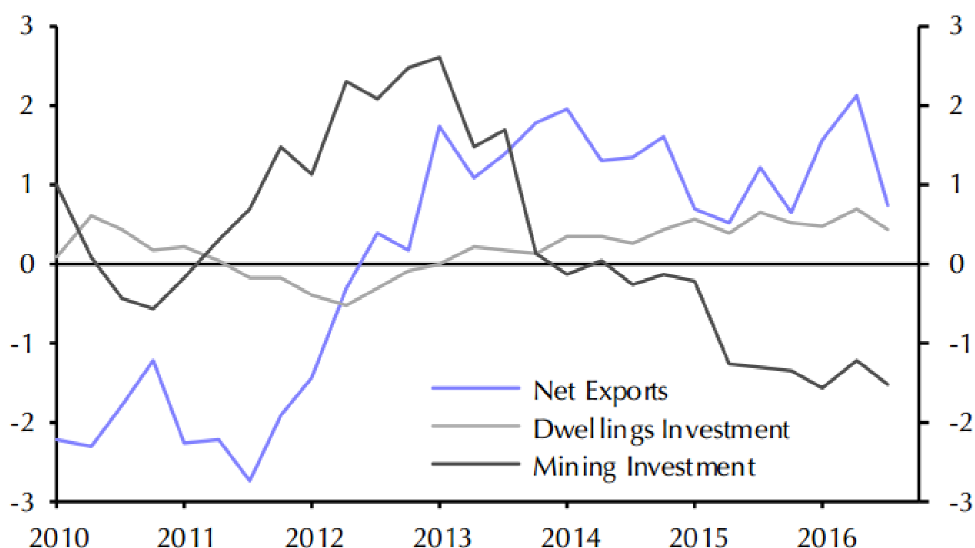
The German election will take place on 24 September and seems to be less consequential than the elections of the Netherlands or France. According to the latest polls, Merkel's party is now second to the Social Democrats (SPDs), led by Martin Schulz. Schulz is the former European Parliament President, with a centre–left outlook. The SPD's share of the votes has risen dramatically in the last two weeks since Schulz assumed leadership, from 21% to 31%. Merkel's coalition's share has reduced from 32.5% to 30%, whilst the anti–immigration "right" party, the Alternative for Germany (AfD), has lost most ground.

In terms of Brexit, we do not see any serious problems ahead for the UK. We in fact believe it will continue to be positive. The UK was the fastest growing economy in the EU in 2016.

As evident in the large portion of this review dedicated to European affairs, we see the EU as the area with the greatest macroeconomic risks in 2017.

AUSTRALIA

GDP growth experienced its first negative quarter for five–and–a–half years in 3Q16. This was largely due to mining, which was the biggest drain on the Australian economy. This was offset by increases in net exports and dwellings investment; however, the former seems to be in a downward trend. The following chart shows the three major contributors to year–on–year GDP changes.

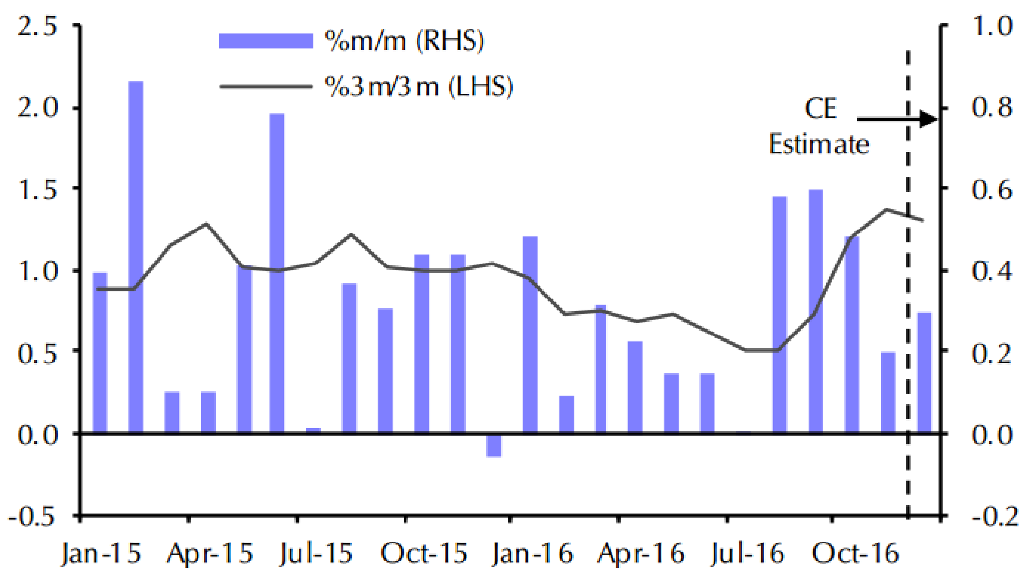


Source: Thomson Datastream

Moreover, there has been a substantial decrease in building approvals, which declined by 13.2% between December 2015 and December 2016.[14] This suggests that dwellings investment may be subdued in the fourth quarter of 2016, increasing the chances of a second negative quarter and consequently a technical

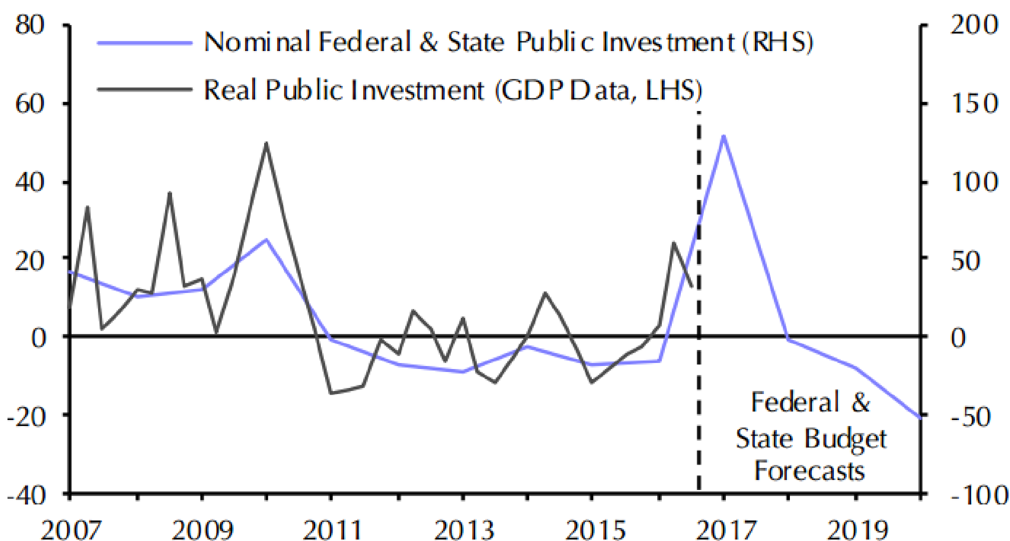
[14] http://www.abs.gov.au/ausstats/abs@.nsf/mf/8731.0.

recession. However, as evident in the chart provided by Capital Economics, below, retails sales have increased in the last half–year, indicating strong private consumption.



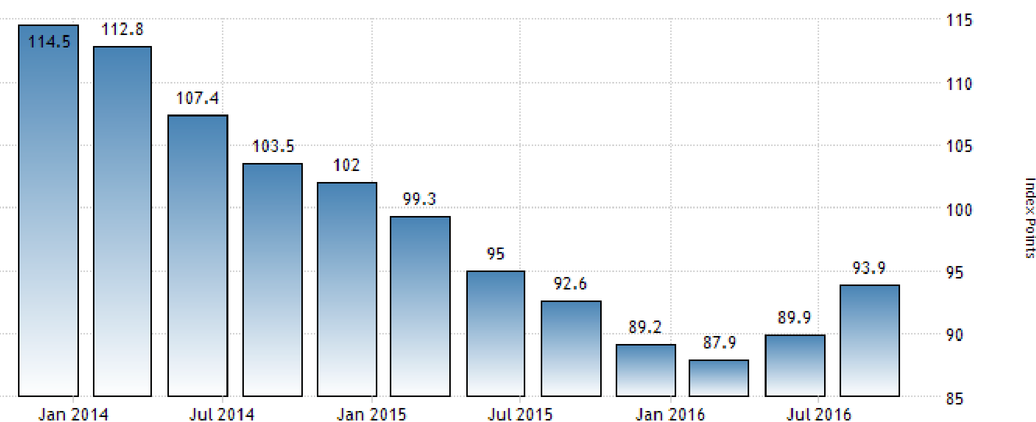
Sources: Thomson Datastream, Capital Economics

Additionally, public investment at a state and federal level has increased. This is demonstrated in the following chart, which shows year–on–year percentage growth.



Sources: Thomson Datastream, State & Federal Budgets

Finally, Australia's terms of trade appears to be improving, which should lead to an increase in domestic demand and a rise in wages and inflation.



This should bode well for Australia's economy; however, the continuation of this trend relies on commodity prices remaining buoyant. Capital Economics believes that Australia will narrowly elude a technical recession, and GDP growth will be around 2% in 2017.[15] This is still slightly below the country's 10–year average growth rate of 2.7%.[16]

The RBA predicts that headline inflation should increase to within its 2–3% target range, largely due to increased petrol prices. However, underlying inflation growth will be more gradual, with continuing subdued growth in labour costs.[17] Therefore, at its current level of 1.5%, it will be some time before it falls within the RBA's target range. Unlike in the US, there is no indication that interest rates will be increased in the near future. Indeed, it could be in the RBA's interest to keep rates low in order to maintain a weaker currency and strengthen the competitiveness of Australia's exports. As a result, Capital Economics is predicting two further reductions in 2017, bringing the interest rate to 1% by November.[18]

As outlined throughout the review, the Australian economy may be impacted by global events. Trade policies could have a particularly adverse effect. Although a more protectionist US would not directly harm Australia, which sends less than 5% of its exports to the US, a global movement towards protectionism would be detrimental. Australia is an open economy that relies on its exports, particularly of commodities. In terms of the iron ore price, much depends on China's economy and appetite. Capital Economics has a bearish view, indicating that China's growth is slowing and its demand for iron ore should simultaneously fall.[19] We have discussed above China's increasing debt issues and the potential weakening of the renminbi. The latter in particular would be damaging to the value of Australian exports.

---

[15] Capital Economics Webinar, *Australia: Recession or Rapid Recovery?*, 1 February 2017.
[16] http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2015&locations=AU&start=1961&view=chart.
[17] http://www.rba.gov.au/media-releases/2017/mr-17-02.html.
[18] Capital Economics Webinar, *Australia: Recession or Rapid Recovery?*, 1 February 2017.
[19] *Ibid.*

CONCLUSION

The chance of the worst–case scenarios outlined above actually occurring is low. Nevertheless, their potential creates uncertainty, which in itself has an impact on markets. We could equally have painted a rosy picture of future economic growth; however, as noted in the introduction, our purpose has been to delineate the risks to the global economy. To reiterate, we believe the greatest perils lie in Europe, particularly in the elections and banking sector, followed by Sino–American relations. Above all, while such issues remain unresolved, we see significant uncertainty pervading the investment environment. If you would like to discuss any of the views presented in this review in further detail, please feel free to contact Mitch Taylor 0422650356; mitch@supervisedinvestments.com or Joseph Constable 0438541558; joseph@supervisedinvestments.com.