meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

For international equity investors, 2016 ended on a strong note for non US dollar based investors and a reasonable one for US dollar based ones. Donald Trump's victory in November pushed the US dollar sharply higher so, together with a solid performance from shares, the result was very positive. Bond yields rose quite sharply as the implications of a Trump victory filtered through to bond yields. There was a wide dispersion of currency movements with the US dollar rising 15.0% against a very weak yen. In commodities, oil rose on the agreement by the oil producers to limit supplies but gold endured a very poor quarter.

The tables below detail relevant movements in markets :

International Equities 30.09.16 - 30.12.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.5	+5.9	+0.7	+7.3
Finland	+1.6	+0.3	-4.6	+1.6
France	+9.7	+8.2	+2.9	+9.7
Germany	+7.8	+6.4	+1.2	+7.8
Hong Kong, China	-7.7	-2.9	-7.6	-1.6
Italy	+17.2	+15.7	+10.0	+17.2
Japan	+15.2	+5.1	N/C	+6.5
Netherlands	+4.9	+3.5	-1.6	+4.9
Spain	+8.5	+7.0	+1.8	+8.5
Switzerland	+0.8	+1.1	-3.9	+2.4
UK	+4.2	+4.2	-0.9	+5.6
USA	+3.7	+9.0	+3.7	+10.5
Europe ex UK	+6.3	+5.4	+0.2	+6.8
All World Asia Pacific ex Japan	-0.6	+0.9	-4.1	+2.2
All World Asia Pacific	+5.8	+2.6	-2.4	+4.0
All World Latin America	+1.2	+4.2	-0.9	+5.6
All World All Emerging Markets	-0.8	+2.2	-2.8	+3.6
All World	+4.5	+6.7	+1.5	+8.1

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : -3.4%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	30.09.16	30.12.16
Sterling	0.75	1.24
US Dollar	1.59	2.46
Yen	-0.08	0.00
Germany (Euro)	-0.19	0.11

Sterling's performance during the quarter ending 30.12.16 (%)

Currency	Quarter Ending 30.12.16
US Dollar	-4.8
Canadian Dollar	-2.4
Yen	+9.5
Euro	+1.3
Swiss Franc	-0.9
Australian Dollar	+1.1

Other currency movements during the quarter ending 30.12.16 (%)

Currency	Quarter Ending 30.12.16
US Dollar / Canadian Dollar	+2.5
US Dollar / Yen	+15.0
US Dollar / Euro	+6.4
Swiss Franc / Euro	+1.7
Euro / Yen	+8.0

Significant Commodities (US dollar terms) 30.09.16 - 30.12.16 (%)

Currency	Quarter Ending 20.12.16
Oil	+13.2
Gold	-13.4

PERFORMANCE DURING 2016

International Equities 31.12.15 - 30.12.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+13.2	+34.4	+12.7	+16.0
Finland	+0.8	+16.8	-2.1	+0.8
France	+8.9	+26.1	+5.7	+8.9
Germany	+6.7	+23.5	+3.6	+6.7
Hong Kong, China	+3.8	+23.7	+3.7	+6.8
Italy	-7.1	+7.6	-9.8	-7.1
Japan	-0.3	+22.7	+2.9	+5.9
Netherlands	+9.5	+26.9	+6.3	+9.5
Spain	+3.3	+19.6	+0.3	+3.3
Switzerland	-2.8	+14.3	-4.2	-1.4
UK	+18.9	+18.9	-0.3	+2.7
USA	+11.8	+33.4	+11.8	+15.2
Europe ex UK	+4.6	+21.2	+1.6	+4.6
All World Asia Pacific ex Japan	+8.6	+28.7	+7.9	+11.1
All World Asia Pacific	+4.7	+26.0	+5.6	+8.8
All World Latin America	+25.0	+57.0	+31.7	+35.6
All World All Emerging	+12.1	+35.4	+13.5	+16.9
All World	+9.9	+29.6	+8.6	+11.9

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +10.1%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	31.12.15	30.12.16
Sterling	1.96	1.24
US Dollar	2.27	2.46
Yen	0.27	0.00
Germany (Euro)	0.63	0.11

Sterling's performance during the year ending 30.12.16 (%)

Currency	Year Ending 30.12.16
US Dollar	-16.2
Canadian Dollar	-18.5
Yen	-18.7
Euro	-13.7
Swiss Franc	-14.7
Australian Dollar	-15.4

Other currency movements during the year ending 30.12.16 (%)

Currency	Year Ending 30.12.16
US Dollar / Canadian Dollar	-2.7
US Dollar / Yen	-3.0
US Dollar / Euro	+3.0
Swiss Franc / Euro	+1.3
Euro / Yen	-5.8

Significant Commodities (US dollar terms) 31.12.15 - 30.12.16 (%)

Currency	Year Ending 30.12.16
Oil	+50.5
Gold	+8.2

MARKETS

International equity markets ended 2017 on a very satisfactory note. In local currency terms in the last quarter, the FTSE All World Index returned +4.5%, in sterling terms +6.7%, in US dollar terms +1.5% and, in euro terms, +8.1%. Looking at local currency returns first, we note above average performances from the FTSE Japan Index (+15.2%), the FTSE Australian Index (+6.5%). On the other hand, there was some relative weakness from the FTSE All World All Emerging Markets Index (-0.8%) and the FTSE All World Latin American Index (+1.2%). Looking at sterling adjusted returns, the picture changes. As a result of the weakness of the yen, the FTSE Japan Index returned a below average, but still very good, 5.1%. As a result of the strength of the US dollar, the FTSE USA Index returned a very strong +9.0%, whilst the FTSE Europe ex UK Index returned a below average, but still very satisfactory, +5.4%. The FTSE UK Index showed a below average, but, again, still very satisfactory return of +4.2%.

International bond markets endured a poor quarter as the election of Donald Trump raised the prospect of a more rapid increase in interest rates. Taking the ten year government bonds as a benchmark, the UK bond's gross redemption yield rose by 49 basis points to 1.24%, the US Treasury bond by 87 basis points to 2.46%, the Japanese Government Bond by 8 basis points to 0.00% and the German Bund by 30 basis points to 0.11%.

Currency market movements were mixed. The US dollar was the strongest currency last quarter. Against the US dollar, sterling fell by 4.8%. It also fell against the Canadian dollar by 2.4% and against the Swiss Franc by 0.9%. On the other hand, sterling rose by 9.5% against the yen, by 1.3% against the euro and by 1.1% against the Australian dollar.

In the commodity markets, following the oil producers' agreement to limit supplies and, as measured by Brent crude, oil rose by 13.2% but gold suffered a large fall of 13.4%.

Looking back at 2016 as a whole, we see some remarkable performances. Taking equities first, the FTSE All World Index returned a highly satisfactory +9.9% in local currency terms. In sterling terms, the index's return was an astounding +29.6%, a function of a good international equity performances and, even more, of currency weakness. In US dollar terms, the FTSE All World Index returned +8.6%, whilst, in euro terms, the return was +11.9%. Looking at local currency returns first, the most remarkable rise came from a previous laggard, Latin America. In local currency terms, the FTSE All World Latin American Index returned +25.0%. Next in our table was the UK, where the FTSE UK Index returned +18.9%. The FTSE Japan Index was just in negative territory at -0.3%. The FTSE Europe ex UK Index also underperformed, returning just +4.6%. However, when we look at sterling returns, the currency's weakness produced a remarkable effect. The FTSE All World Latin American Index returned an extraordinary +57.0% and the FTSE All World All Emerging markets +35.4%. With the Australian dollar also recovering strongly, the sterling adjusted FTSE Australia Index returned +34.4% and the FTSE USA Index +33.4%. As a result of the strength of the yen in 2016, notwithstanding recent weakness, its negative local currency return became +22.7% for the sterling adjusted FTSE Japan Index. Europe ex UK and the UK lagged behind with the sterling adjusted FTSE Europe ex UK Index returning +21.2% and the FTSE UK Index, as we mentioned above, +18.9%. Even the lowest sterling return in our table, from the FTSE Italy Index at +7.6%, would have been considered highly acceptable in the low inflation environment in which we find ourselves.

For the international bond markets, it was a rollercoaster year. Again, taking ten year government bonds as the benchmark, there was a dramatic fall in yields in the UK, Japanese and German markets. The gross redemption yield on the ten year UK government bond fell by 72 basis points to 1.24%, on the Japanese Government bond by 27 basis points to 0.00% and on the German Bund by 52 basis points to 0.11%. However, there was a dramatic rise in US Treasury bond yields following Donald Trump's victory. The US Treasury bond saw its gross redemption yield end the year 19 basis points higher at 2.46%.

Sterling's fall over the year, following the EU referendum on the 23rd June, was dramatic. Over the year, sterling fell by 18.7% against the yen, 18.5% against the Canadian dollar, 16.2% against the US dollar, 15.4% against the Australian dollar, 14.7% against the Swiss Franc and 13.7% against the euro.

In the commodity markets, oil, as measured by Brent crude, recovered by 50.5%, whilst gold, notwithstanding a poor first quarter, ended the year up 8.2% compared with the same time last year.

ECONOMICS

The year end provides a time for reflection and, in the fields of investment and economics, there is much to reflect upon. We like to look back on our investment outlook twelve months ago, as stated in our economic review, to see where we went wrong, where we went right and what surprises occurred. It is true to say that 2016 was an eventful year, an understatement if ever there was one.

Our views on economic growth and inflation were broadly correct. We expected modest economic growth at very low inflation levels and that is likely to be the outcome for 2016. In its October World Economic Review, the IMF forecast growth of 3.1% in 2016, fractionally down on 2015's 3.2% level. For consumer prices in Advanced Economies, it forecasts at 0.8% (0.3%) and, in Emerging Markets and Developing Economies, it forecasts 4.5% inflation (4.7%). So there are no surprises there. As a result, we forecast modest nominal rises in companies' revenues, profits and dividends. Against this background, we thought that share prices would end the year higher but with some negative periods. Whilst we were right on the direction of share prices and our support for equities, where we also pointed out their yield attractions, we underestimated the strength of equity prices, at least in sterling terms. We maintained our equity positions throughout the year. We were very negative on bonds, as we have been for a long time, expressing the view that they were dangerously overpriced. Over the year as a whole, if we take, for example, ten year government bonds as a benchmark, we were wrong on sterling, yen and euro denominated bonds, taking the German Bund as a benchmark, but right on US Treasuries. At the end of the year, following the US elections, bond yields moved sharply higher. At one stage, about US$13 trillion of bonds were standing on negative yields, a truly extraordinary situation. What we did not mention in our concluding paragraph were currencies because, at that stage, we did not focus on the EU referendum, as its date was uncertain, and we had not factored a "Leave" vote into our thinking. However, as always, that eventuality was covered by our long standing and deliberate policy of investing internationally rather than being UK centric. We did not invest for the possibility of Brexit, but our fundamental policy decisions covered that. For sterling based internationally focused investors, a significant exposure to international equity markets provided some spectacular sterling gains as our table of 2016's equity indices shows. At the end of 2015, Donald Trump was not even the Republican Presidential candidate, so not many people would have expected to see him in the White House in January 2017 and, if they had, they would have been unlikely to have expected US equity markets to have reacted so positively to his election. Nevertheless, our policy decisions were correct, even though we did not factor in all the drivers of strong international equity performance for sterling investors whose overseas securities were not hedged, and we certainly did not anticipate the magnitude of sterling returns. Perhaps if the EU referendum had resulted in a "Remain" vote and Hillary Clinton had been elected as the next President, the outcome in return levels terms would have been as we had anticipated.

Besides being a bad year for the Remainers, Democrats and pollsters, it has been a dreadful year for economists, with their worst moments coming after the EU referendum and US elections. We have in reviews in 2016, following the 23rd June vote, referred to biases caused by "groupthink". Thus, right up to the time the first results came in from the EU referendum, the belief in financial markets was that "Remain" would win and the pound touched US$1.50 immediately before the first result was declared. Because most people in financial markets wanted "Remain" to win, they were guilty of believing that the rest of the country would vote that way too. With the opinion polls predicting a close result, the risk/reward ratio was so out of line for with the weight of money which was favouring sterling bets. Whilst the currency movement was the economic event for that night, many economists, civil servants, "Remain" ministers, particularly in the Treasury, central bankers and senior officials of what might be called supranational organisations forecast a sharp and immediate recession in the UK which, to date, has not happened. It is difficult to believe that their own prejudices did not distort their thinking when it came to the after effect of a Brexit vote. It is, of course, early days but, despite many issues, the UK economy is performing relatively well. There will certainly be difficult days ahead and they may be correct at some stage but, right now, the majority of economists have read the post Brexit course of the economy incorrectly. After a post Brexit fall, the FTSE 100 stands at record levels in nominal index terms. The one thing they were right about was sterling, which has fallen heavily, a mixed blessing. The second major embarrassment was Donald Trump's victory in November with the Republicans maintaining their hold on both houses of Congress. As with Brexit, a Trump victory was considered unlikely but they were blindsided by the market's reaction to his victory. We all know that a lot of nasty stuff was said but certain aspects of his economic policy, if enacted, should be favourable to markets, namely personal and corporate tax cuts and deregulation and that, after the initial shock of his victory, is what markets have focused on. Of course, a lot depends on what President elect, Donald Trump, actually does, or is able to do, after his inauguration in January, and we will discuss this later, but, for the moment, many economists and market forecasters have been proved wrong. 2016 has not been a good year for economists; perhaps 2017 will be better.

These were two specific events which wrong-footed many people but other long running features of the world economy continued in the background. Probably the main one was very loose and non standard monetary policy which has been the main tool of economic management since the financial crisis. Towards the end of 2016, one detected a subtle change in emphasis towards fiscal policy. During 2016, we saw quantitative easing being ratcheted up in the eurozone, the UK and Japan with extensive use being made of negative interest rates and with vast swathes of the bond market selling on negative gross redemption yields. At its peak in June 2016, it was estimated that US$12.2 trillion of bonds were selling on negative yields. Not so long ago, the fear had been that the world economy was facing deflation but few now believe that this is likely. The IMF, for example, in its October World Economic Outlook, forecast inflation of 1.7% in Advanced Economies in 2017 and 4.4% in Emerging Markets and Developing Economies. Negative official interest rates and negative bond yields are not desirable and, following Donald Trump's victory in November, there was a strong change in sentiment. If he has his way, and a number of his party in Congress are fiscal hawks who like balanced budgets, his fiscal expansion resulting from tax cuts and increased infrastructure spending is likely to result in higher inflation, increased federal borrowing and higher interest rates. As we have often said, there is very little more that monetary policy can do to stimulate economic expansion. If interest rates do not rise meaningfully at some stage, then, when the next recession comes and economies need an economic stimulus, it will be very difficult for monetary policy to provide it. This increases economic risks because monetary and fiscal policy should, ideally, work together or be co-ordinated. The Federal Reserve has, in December, raised interest rates for the first time in 2016, the first of a series which is expected in 2017, although, it must be noted, this was what was being said this time last year. With the potential for fiscal expansion next year, tighter monetary policy is desirable. In the UK, post the referendum, the new Chancellor has abandoned the previous target date for eliminating the budget deficit and allowed for looser fiscal policy to offset any shock caused by Brexit. In the eurozone, budget deficit rules are being gently relaxed in certain cases or not being adhered to.

The second continuing issue is China. In the first trading day of 2016, the Chinese market fell heavily with a knock on effect in other markets. Given the good performance of many equity markets in 2016, it is easy to forget that 2016 started off very badly before recovering mid quarter to produce a positive return for the first quarter. One immediate concern is the attitude of the new US Administration towards China, for this is one of the most delicate areas covered in Donald Trump's policy statements in the run up to November's elections. Threatening to designate China a currency manipulator and applying penal tariff rates threatens to ignite a trade war which could easily lead to a recession as China retaliates. It is perhaps unfortunate that the renminbi has been weakening against the US dollar. It fell by 6.5% in 2016. Although China has large foreign exchange reserves, these are being run down quite rapidly as money leaves the country for different reasons, one of which may reflect a lack of confidence by rich Chinese themselves. At the end of November 2016, China's foreign exchange reserves stood at US$3.052 trillion, the fifth straight month of decline and the lowest level since March 2011. The all time high was US$3.993 trillion in June 2014. It is also likely that the central bank has been intervening in the foreign exchange market to support the renminbi. Given that China is running a substantial current account surplus, the rundown of reserves is a concern. So, whilst Brexit and the US elections have been taking centre stage in the latter six months of 2016, China is an important influence on investors' thinking and could become an even more important one in 2017.

In this review, we will look forward to some of the issues which we think may arise in different areas of the world in 2017 but, firstly, we will set the scene for the world economy in 2017 as detailed in the IMF's World Economic Outlook projections made last October. Of course, forecasts will change as the months go by and new information becomes available but it is useful to consider what the IMF thought last October, before the US elections, and see what variables in 2017 may affect those projections.

Overall, the IMF saw economic growth of 3.4% in 2017 against its forecast of 3.1% growth in 2016. Within that figure, it saw Advanced Economies growing by 1.8% in 2017 against 1.6%, whilst it saw Emerging Market and Developing Economies growing by 4.6% against 4.2%. Within the Advanced Economies group, the USA was forecast to grow by 2.2% in 2017 against 1.6%, the euro area by 1.5% against 1.7%, Japan by 0.6% against 0.5%, the UK by 1.1% against 1.8%, Canada by 1.9% against 1.2% and the other Advanced Economies by 2.3% against 2.0%. Within Emerging Markets and Developing Economies, Russia was projected to grow by 1.1% in 2017 against -0.8% in 2016, China by 6.2% against 6.6%, India by 7.6% the same as in 2016 and Brazil by 0.5% against -3.3%. So, overall, the IMF was expecting a modest improvement in the world economy in 2017. Events in 2016, however, made forecasting economic growth particularly difficult for 2017.

So, in looking forward to 2017, we will start with the USA and this must, of course, relate mainly to Donald Trump's economic policies. But there is an important caveat and this is the restraint which the checks and balances in the US constitution can place upon the President. In terms of passing legislation, the Republicans have an important advantage because they control both houses of Congress, so the executive and legislative branches of government are both in Republican hands. However, as we saw in the contest for the Republican Presidential nomination, there were bitter divisions and Mr Trump is certainly no mainstream Republican. Many Republican members of Congress are orthodox on economics, preferring balanced budgets, so Mr Trump might find opposition to some of his plans from within his own party in Congress.

The Presidential election campaign was exceptionally nasty, with things said which, even by the standards of elections, were shocking. We will put those aside and concentrate on Mr Trump's economic policies as outlined, accepting that they are not all likely to happen because, even with control of Congress, compromises will be necessary at home and abroad. That Wall Street has performed so strongly since the election suggests that some investors are optimistic about what Mr Trump's policies might mean for the US economy and it is easy to see what they are focusing upon, tax cuts for individuals and companies including the possibility of favourable tax treatment for US companies' cash trapped overseas by penal tax rates for cash remitted to the USA. The US corporate tax rate is high (35%) by overseas standards, although there are tax breaks which can reduce the actual tax rate. The US has become less competitive as other countries have cut their corporate tax rates. One obvious effect is that earnings per share would rise, very helpful at a time when US share prices are at record highs. Another hoped for effect, if companies feel optimistic enough, is that business investment will rise, something that is necessary to support the long term productive potential of any economy. That is perhaps a more desirable outcome than the money being used to buy back companies' shares, something which has undoubtedly helped to sustain share prices. Buying back shares on the right terms shows good capital discipline but the extent of share buyback programmes in recent years has reflected companies' lack of optimism about business opportunities. Tax cuts for individuals would also be well received as higher disposable incomes, particularly for those with a high marginal propensity to consume, should also boost economic activity. A second area which has the potential to please investors is deregulation, something which unites Republicans. A certain amount of regulation is always necessary but it has grown sharply in recent years and the USA is no exception. Whilst regulation is a cost of doing business, excessive regulation acts as a brake on economic activity. Cutting back on excessive regulation is a benefit for business and the US economy and the market is right to like this aspect of his proposed policies although we do not, of course, know the detail. But there is a third area which is certainly not good news and that is his protectionist tendencies and proposals which he made in the run up to the election. What Mr Trump talked about and made proposals for is, sadly, part of a growing trend away from free markets towards protectionism. It also resonates with voters and, despite not obtaining as many votes as Hillary Clinton, he won the Electoral College through chalking up victories by small margins in so called rust belt states like Pennsylvania, Michigan and Wisconsin. These states helped to swing the election for him. The reason he won those states was that his protectionist policies resonated with voters whose job opportunities in manufacturing had been diminished by overseas competition. The financial crisis has led to an increase in anti globalisation views and activity and, against this phenomenon, the case for free trade has to be made more strongly than ever because it produces many more winners than losers. Investors have much to lose if protectionism gains traction, as it threatens to do. Consumer welfare is increased by free trade. Being able to buy something at a low price from whichever country can produce it most cheaply and efficiently increases the amount of money which is available for spending thereby increasing economic activity and economic growth. It is more complex than this, of course, but it makes the point as to why investors must welcome free trade. The concerns about Mr Trump's policies for tariffs on Chinese imports and dismantling NAFTA because Mexican production costs are lower than in the USA, to give two examples, are very well founded. If US consumers are having to pay more for goods they could buy more cheaply elsewhere because of import tariffs, they will have less money to spend which will damage economic activity and growth and increase unemployment. The policy proposals of Mr Trump are enormously dangerous. China would certainly react, a trade war would ensue and a recession would be highly likely. Similarly, if the USA decides that China is manipulating its currency, repercussions would follow. It is hard to overstate how dangerous these pre-election proposals were and it is to be hoped that wiser counsels will prevail.

All this would be doubly unfortunate because the US economy is progressing satisfactorily and this has enabled the Federal Reserve to raise interest rates by 0.25% in December, with the target rate for the federal funds rate now being 0.50% - 0.75% with more rises expected in 2017. This target range is well below what one would expect in normal circumstances given the moderate growth rate of the US economy and the inflation rate. The personal consumption expenditures price index, excluding food and fuel, which is what the Federal Reserve watches, stands at 1.7% so the federal funds target rate is well below what is normally desirable. Similarly, with an unemployment rate of 4.6%. If we look at the "good" side (as read by the markets) of Donald Trump's economic policies, the tax cuts and expected infrastructure spending (although it is difficult to turn on the taps immediately because there are some long lead times), the budget deficit is going to rise, the amount of government borrowing will increase, interest rates will continue to rise and the US dollar will become stronger. Overall, this mixture should increase economic activity in the USA and elsewhere and be helpful to equity markets, even though higher interest rates and an increase in the value of the US dollar will be headwinds. However, all of this could be undone by ill advised protectionist policies. Somehow, Mr Trump will have to try to work his way out of these pledges with minimal damage to the US economy.

Whilst the recent events in the USA have been the most headline grabbing ones, there are plenty of issues to consider in relation to the eurozone in 2017 and, after a year of shocks in 2016, this is where the next ones could occur. The EU will have to consider how to deal with Brexit, but the shockwaves which Brexit has unleashed in the EU have meant that nothing is certain. The growing strength of anti EU and anti euro feeling in some countries, encouraged by the UK's decision, could mean electoral upsets in 2017 for the established parties. With elections in France, Germany, the Netherlands and, perhaps, Italy, it is possible, although at this stage unlikely, although this was said about Brexit, that upsets may occur. For instance, in Italy, only one of the main parties supports the euro. If Italy, the EU's third largest economy, were to leave the euro, the common currency would almost certainly be finished because its credibility would have been lost, not to mention all the collateral damage this would cause. As many observers outside the euro establishment now agree, the eurozone was a totally misconceived currency union which does not meet the criteria of one and, without a political union, it is hard to see it being successful. In current circumstances, a political union would be improbable. For struggling southern eurozone members, the inability to have a flexible currency to cope with shocks and increasing uncompetitiveness, has been a serious impediment to economic success in recent years. Whilst the economic news in the eurozone has been a little better recently, growth is insufficient to make inroads into the debt of some economies and this will remain a drag on economic growth. Another area of weakness in the eurozone, which was an issue in 2016 and will be in 2017, is the banking sector. As 2016 ends, the problems of Banca Monte dei Paschi di Siena SpA loom large. This is posing a huge problem for the European Central Bank which may have to bend its rules on state aid. The Italian government is desperate not to have to "bail in" retail subordinated bondholders. This would lead to an electoral disaster and even more anti EU feeling. All in all, 2017 will continue to present many economic problems for the EU, not to mention the obvious political ones.

It is even more difficult to divine the prospects for the UK in 2017 following the Brexit vote and there are a substantial number of imponderables. It is important to state at the start that it is likely to be many years before Brexit can be judged a success or failure as the UK economy will take time to adjust to its new economic circumstances. In the short term, for the second half of 2016, those forecasting an immediate economic downturn have been proved wrong probably because, as mentioned earlier, they were guilty of groupthink. This is not to say that they will not be proved correct at some stage but that their more immediate forecasts have been incorrect. Whilst the FTSE 100 index has recovered to be at around an all time high, the pound has been the one important casualty of Brexit although, even here, the conclusions are debatable with some saying that sterling was previously overvalued, whilst others point to the inflationary consequences. We can see why the FTSE 100 index has been strong. Most of the business of companies in the index is overseas, meaning that the sterling value of their overseas profits on translation increases and exports may become more profitable depending upon their pricing policy. With a substantial amount of dividends being declared in US dollars and euros (c. 40%), dividends in sterling terms have received a boost at a time when dividend growth was under pressure. Equities have also been supported by some positive economic news. Real GDP was revised upwards in the third quarter from 0.5% to 0.6% quarter on quarter to give a year on year increase of 2.3%. Unemployment, despite evidence of a slightly more subdued jobs market, remains at half the EU level at 4.8%. The latest purchasing managers indices are also healthy, with the latest composite index at 56.7, a strong figure. What we can be sure of is that the negotiating period for the UK's exit from the EU will be protracted, whilst each side formalises its plans. There is also some domestic uncertainty as some use court cases to try to stop the process of leaving the EU or refashion the terms which the UK will seek. Against this background, it is likely that sterling will remain a weak currency, particularly against the US dollar. There seems no reason for it to rise. If that is the case, the effects are twofold. Firstly, the benefit to UK corporate profits and dividends will continue. The second effect will be unhelpful. Inflation is bound to rise as the effect of import price increases works through the

UK economy, so it is possible that inflation may reach 3% in 2017. Although pay is beginning to increase, consumers' disposable increases will be adversely affected, thus dampening down economic activity and economic growth, although not stopping it. The Chancellor of the Exchequer, by pushing back the date for a balanced budget past 2019/2020, is making some allowance for the expected slowdown in economic activity in the short term resulting from Brexit. The Office for Budget Responsibility has cut its forecast for economic growth in 2017 to 1.4% from 2.2% last March (but still higher than the IMF's forecasts). In 2018, the growth forecast has been revised down from 2.1% to 1.7%. It is against this background that fiscal policy has been loosened. One of the major economic headwinds for the UK (and other countries) has been the recent poor productivity record which has hit growth, notwithstanding the very high employment numbers in the UK. The Chancellor announced measures to try to tackle this problem. So, whilst there are unlikely to be any political shocks in the UK in 2017 (the Fixed Term Parliaments Act makes it difficult to call a General Election before the five year parliament is completed), the UK faces the inevitable economic uncertainties resulting from the Brexit negotiations. It does, however, start from a relatively good economic position.

Turning to Japan, the Bank of Japan is taking extraordinary measures to try to stimulate inflation towards its target of 2.0% from its position of near zero at present. As well as using quantitative easing to buy bonds, it is, at the same time, trying to use purchases to target a ten year government bond yield of zero per cent and it is also using QE to purchase equities through exchange traded funds. It also has a negative official interest rate. These are desperate measures. Initially, the Bank of Japan's move to negative interest rates earlier in 2016, far from depressing the yen, pushed it higher, exactly the opposite effect to what was intended, but Donald Trump's victory in November has caused the yen to fall sharply but, nevertheless, it ended 2016 higher than a year previously. Mr Abe's political position is very strong but he has not pushed the third arrow of "Abenomics" structural reform as hard as the other two, monetary and fiscal, and that will be necessary to increase the long term productive potential of the Japanese economy. We would not expect Japan to be an area which grabs the attention of other major markets in 2017.

China, as mentioned earlier, is likely to be one of the big centres of attention in 2017. Whilst its economic growth rate, on the published figures, appears to be steady at 6.7%, there are concerns about the magnitude of the fall in the country's foreign exchange reserves at a time when the country is running a current account surplus, since it could suggest a capital flight and a loss of confidence internally. The foreign exchange reserves are not yet at danger level but the magnitude and regularity of the falls is becoming disconcerting. Whilst the People's Bank of China now targets a basket of currencies against which to value the renminbi, its slippage against the US dollar, at a time when Donald Trump seems to be targeting China, must be a concern. If the USA does categorise China as a currency manipulator, the situation could turn ugly, especially as China holds a substantial amount of US Treasury bonds. Overall, indebtedness in China is high, which renders it vulnerable to interest rate rises and more problems for the banks. So, for 2017, China will be the centre of attention for what may happen internally, namely its foreign exchange reserve levels and, externally, for what Donald Trump may try to do on tariffs on Chinese imports and the Chinese reaction, which is bound to be swift, and all of this could be very bad news for the world economy. By taking a telephone call from the Taiwanese President, Donald Trump has shown that he does not mind treading on sensitivities.

Emerging Markets do not easily fit into any category but a rise in US interest rates is a negative for many emerging markets. They attracted large inflows seeking higher interest rates when US bond yields were at rock bottom but, when US interest rates started to rise and the sell off in the Chinese stock market occurred at the beginning of 2016, sentiment started to change. Money moved in search of a currency gain, with the US dollar being likely to strengthen. With considerable US dollar borrowings in many emerging markets, the financial and economic effect of a currency and interest rate rise would be of concern. So, although the IMF expects a faster growth rate in 2017 amongst Emerging Markets and Developing Economies, a lot will depend on what happens in the USA. The fastest growing market on the IMF's forecasts is expected to be India, but the sudden demonetisation policy announced towards the end of 2016 has thrown everything into confusion. By taking 86% of the cash out of circulation and not being able to replace it immediately, the policy has caused significant short term dislocation in what is largely a cash economy and there is bound to be an effect on economic growth. At the moment, it is still too early to speculate on the economic and political repercussions of a policy which was meant to attack money launderers and the unofficial economy.

In terms of returns for sterling based investors, 2016 was an exceptional year, one that does not come along very often. The last year when sterling returns were as high was 1999. Returns of such a magnitude inevitably lead one to review future strategy very carefully, especially against the view expressed a year ago that, whilst shares were the right asset class in which to be invested, returns would be modest but satisfactory. That is what we meant when we said that shares would end the year higher but with some negative periods. Although we were well positioned for Brexit and a Donald Trump victory last November, neither of those events were factored into our thinking. Our positive case for a diversified high quality portfolio of international equities remains. The Brexit negotiations are likely to be unsettling and prolonged. The UK, whilst it is currently performing relatively well in economic terms, does carry a higher than normal risk and overseas equities represent an insurance policy against this risk, just as they did in 2016, although one would certainly not expect sterling to fall anywhere nearly as sharply as it did then. The economic data worldwide seems to be improving, sometimes from a low level, even in the eurozone. The advent of a Trump Presidency and Republican control of both houses of Congress could boost corporate earnings in the USA. They have already started to turn upwards and a rise in corporate earnings will help to validate the post election rise on Wall Street. However, there are risks which could temper this optimistic view. The biggest one we see is the growth of protectionism and some of Donald Trump's ideas are alarming in this respect. One must hope that the realities of office dampen his protectionist views. Protectionism poses one of the biggest risks to economic growth. Elsewhere, the high profile political problems of 2016 will continue and, economically, China and the eurozone require careful monitoring. With inflation and the budget deficit likely to rise if Donald Trump's fiscal expansion plans look as if they will come to fruition, we remain very negative on bonds. The point we always emphasise is that, if one holds a portfolio of good quality shares and equities fall back, long term investors will nearly always see them recover and move forward again whilst dividends will still be collected. In the case of bonds which, in our view, are a long way from being correctly valued, the recovery may never occur or, if it does, returns will be minuscule for those holding bonds to redemption, as evidenced by current gross redemption yields. There have been some serious losses in the bond market recently. Returns on cash, whilst they may rise during the year, will still be very poor and only attractive for the exceptionally risk averse investor. Our best estimate is that the highest returns will come from equities but that they will be much more modest than in 2016 and will come unevenly with some negative periods of performance.