The year 2016 proved to be yet another roller-coaster ride in financial markets, with investors starting the year in a panic and appearing to end it in euphoria. However, to us, the significant structural difficulties facing the world economy suggest that conditions ahead may not be as rosy as many market participants believe.

**ROUND TRIP**

For much of 2016, disinflationary forces were dominant; the expectation of low growth and low interest rates into the foreseeable future seemed to become the consensus. At the time of writing, belief in successful reflation appears, however, once again to be in the ascendancy. Market-based interest rates have risen sharply, as have commodity prices and inflation expectations. In a rerun of late 2015, the U.S. Federal Reserve raised short-term interest rates by 0.25% at its final meeting of the year, after several quarters of disappointing expectations, and indicated that it was likely to make three more increases in 2017.

Once again, the consensus appears to believe not only that policy has worked for the U.S. economy, but that it has paved the way for an improved global outlook. As a result, risk-asset prices have taken another turn upward, led this time by economically sensitive sectors. Valuations also seem to imply that conditions will remain rosy into 2017, and beyond. We suggest that the geopolitical and economic uncertainties ahead certainly do not.

To this heady cocktail has been added the extra unpredictable ingredient of the Trump presidency, which, against all prior forecasts, has boosted reflationary expectations further.

Once again, year-end optimism in markets seems to our mind to be primed for disappointment.

**TRUMPED UP**

Is it likely that the Trump administration will be able to transform the growth prospects of the U.S. economy? We believe it looks like a challenge from both a structural and cyclical point of view.

Dealing with the longer-term picture first, economic growth over time can mostly be explained by trends in growth in the working

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1Source: Bloomberg data, January 1, 2017
population and its productivity. The reality is that our modern economies have become mature demographically; indeed, the extent of aging is unprecedented in human history. Working populations are growing only slowly, and in some economies are shrinking, not something any new administration can change, particularly if the political undercurrents favor less, not more, immigration.

Growth in productivity has also been falling (to 1% per annum in the last decade, from a post-war average of 2%), causing most official forecasters to continue to downgrade the 'potential' growth rate of the U.S. It’s interesting that periods of strong U.S. productivity growth have been associated with globalization and outsourcing of supply by the U.S. corporate sector. Given that the incoming president’s platform has been based on bringing many of these jobs home, we think it is unlikely that his administration will reverse the longer-term decline, and suspect it could even challenge current levels of productivity.

On a cyclical basis, growth usually accelerates from the bottom of the cycle when the level of GDP is depressed and unemployment is high. In contrast, Mr. Trump will assume control of an economy that is in its 90th month of expansion (the fourth longest in a century), with unemployment at cycle lows of 4.6%. Much is being made of the comparison of Donald Trump with Ronald Reagan, also a somewhat unconventional Republican politician who presided over perhaps the greatest boom the U.S. has ever seen. In practice, we don’t believe the comparison bears much scrutiny; after a rocky start (a double-dip recession!), Mr. Reagan presided over an economy where much of the excesses had been cleansed, government debt was low, and equity-market valuations and profit margins were modest. Interest rates and inflation were high, and were set to fall for many years. On almost all measures, Mr. Trump faces the diametric opposite: the level of U.S. government debt exceeds 100% of GDP, interest rates and inflation are suppressed, and the cyclically adjusted price-to-earnings ratio on the S&P 500 Index stands at 28x, compared with 9x when Mr. Reagan took office.

What’s more, in our view, years of cheap money have both brought forward demand and encouraged capacity to be put in place to satisfy it. Controlling excess capacity isn’t helped by the ability of almost all enterprises to readily refinance in the credit markets, keeping so-called ‘zombie’ companies in business.

To be clear, we are not saying that we believe the new administration cannot improve the growth profile or should not strive to improve efficiency, but simply that we think growth is unlikely to be transformed by changes in the approach to policy stimulus.

GREAT EXPECTATIONS

It’s in this context that we view the claims being made in the U.S. media that the new ‘business-savvy’

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2Source: Newton, 2016
3Source: http://www.bbc.co.uk/news/business-38181041
4Source: http://www.multpl.com/shiller-pe/ as of January 17, 2017
administration’s proposed policies of tax reform, infrastructure spending and deregulation will double real U.S. growth to the order of 4% per annum with some skepticism.\(^5\)

We think the reality of U.S. politics is that there is a great deal of inertia in the system. The overriding lesson of the Obama years has been that the commander-in-chief struggled to get his domestic agenda fulfilled, even when starting with majorities in both the House and Senate. Changes to the tax code, for example, look fiendishly complex to negotiate given that the Trump team will push for larger corporate tax cuts and little reform, while Congressional Republicans are seeking greater reform and a fiscally neutral rate reduction.

The new president may well make some good points about too much regulation strangling the corporate world. Reducing the level of regulation is likely to be beneficial for an economy, but we do not think that is likely to be accomplished without shorter-term pain in terms of job losses.

The idea that deregulation will help unlock much-needed lending growth in the banking sector seems to miss the fact that already-excessive levels of indebtedness and an aging population naturally constrain the demand for borrowing—as well as the possibility that some of the controls on pre-crisis activities may actually have been useful!

Although Mr. Trump has centered his campaign on rebuilding America, large-scale infrastructure projects are notoriously difficult to put in place. Even the $800bn plus American Recovery and Reinvestment Act of 2009, which was signed into law by President Obama in February 2009 in the teeth of the financial crisis, and which included a ‘Buy American’ provision, proved difficult to implement. Furthermore, Congress has just spent five years negotiating a new Highway Act, and there seems little appetite for another huge program. Moreover, the Trump team envisages funding via public-private partnership (PPP)-type arrangements with the private sector, thereby narrowing the range of available projects.

Even if one were to give Trump the benefit of the doubt, we find it hard to see his team’s policies generating any significant traction before 2018 at the earliest. How successful the new president’s experiment will ultimately turn out to be we suspect will depend largely on whether the policies implemented genuinely improve the efficiency of the economy, rather than just being another phase in Keynesian demand management or an attempt to claw back market share from overseas. Indeed, amid the current euphoria about the prospect of ‘Trumponomics,’ it’s striking to us that the protectionist side of the Trump agenda is being downplayed, despite a constant stream of tweets in what has previously been considered the quiet period for an incoming president.

With this in mind, it’s worth noting that a U.S. president, via executive order, tends to have more influence in areas of trade and foreign policy than at home. Ironically, the reason

executive orders were initially introduced was to enable the president to circumvent the more protectionist inclinations of Congress. In Mr. Trump’s case, the roles are clearly reversed!

A President Trump frustrated by Congress on the domestic side could well decide to wield power where he can. His aggressive stance on trade and international relations—including the proposal to raise revenue from ‘adjustable border taxation,’ and evidenced by his willingness to challenge the established order towards China, Israel, Iran and the North American Free Trade Agreement (NAFTA) before he entered office—perhaps suggests that the scope for the new administration to unsettle the current calmness of markets is significant.

Indeed, contrary to the apparent consensus, it seems likely to us that much of Mr. Trump’s agenda could turn out to be a net-growth negative, if not for the U.S. then for the world as a whole.

**MONETARY POLICY GIVES WAY TO FISCAL POLICY?**

What is different about 2016’s reflationary enthusiasm more generally is the widespread expectation that the focus of policy stimulus (demand management) will shift to fiscal policy.

We have suggested for several years that, in an era of super-low borrowing costs and intractably low growth and sub-par investment, the calls for more fiscal injection—particularly in the form of infrastructure spending—would grow; after all, who doesn’t want better infrastructure?

We see fiscal stimulus appearing, however, in tandem with continuing monetary support, rather than as a transition from one approach to the other. Why? Because ‘cheap’ money underpins current levels of spending (and therefore GDP) and asset prices—this is what makes a persistent policy of monetary inflation so hard to reverse. The idea that we could see a move to a new approach to demand management that forces interest rates up without any adverse implications for asset prices stretches credulity. In the U.S., for example, with household net worth once again above 600% of disposable income (similar to levels seen in the last two bubbles), any return to a more ‘normal’ interest rate, and by implication a more normal level of wider asset valuation (the valuation of the U.S. equity market is over 60% higher than average on a cyclically adjusted price-to-earnings basis), could threaten to undermine net worth quickly, and could rapidly spill over into expectations about inflation and growth.

It is just this kind of interplay that has caused central bankers to set policy to suit markets; rather than being data-dependent, their policymaking has become market-dependent. Indeed, we think 2016 provides a good example of this, and the phenomenon might provide a better explanation of the chain of events in the year than trying to link market behavior directly to events or fundamentals.
INVESTORS RUSH FROM ONE SIDE OF THE BOAT TO THE OTHER

The events of the last 12 to 15 months followed what we believe is now becoming a predictable pattern:

• Enthusiastic market performance encourages expectations of recovery/normailization
• Policymakers attempt to withdraw stimulus (or actually finally tighten, as in the U.S. in December 2015)
• Markets extrapolate tightening of financial conditions, and risk-asset prices fall
• Policymakers step back from further tightening (as in the U.S. in the spring of 2016), or actually add more stimulus (as in the cases of the European Central Bank (ECB), Bank of Japan, and the People’s Bank of China)
• Investors cover short positions, and markets rebound
• Bullish sentiment in the financial markets seeps into indicators in the real economy (such as purchasing-manager surveys), which are seen as leading indicators of economic activity
• The consensus reverts to expectations of recovery/normailization (even if increased levels of debt make that highly unlikely)
• Repeat…

Although this kind of interplay between markets and the economy may have always been in place, we would argue that its impact has become magnified in an era of ‘financialization.’ Having spent years encouraging financial-asset inflation, we think it is hardly surprising that capital has been attracted to financial speculation rather than taking risk in the real economy, and policymakers have had to adapt policy to suit these enlarged markets. Indeed, since the days of Alan Greenspan’s chairmanship of the Federal Reserve, some kind of implicit ‘put’ has been in place, and the tendency toward asymmetric policymaking (i.e., supporting asset prices when they fall, but not withdrawing stimulus when they rise) has been more marked since the financial crisis, with doing ‘whatever it takes’ becoming the dominant approach.

In this kind of system, it is easy to see how events such as the UK’s European Union (EU) vote, the U.S. election, and the recent Italian referendum, which might have been seen universally as bad news, can quickly become good news. It can become embedded in the psychology of financial-market participants that policymakers will either supply liquidity ahead of the event (such as with the UK referendum) or respond if things turn nasty. Short positions are quickly squeezed as the Pavlovian response takes hold.

In 2016, the response to this kind of conditioning seemed to accelerate: in the case of the UK’s vote on EU membership, it took a few of days for sentiment to turn around; on the election of Donald Trump, it took just a couple of hours. The potentially disastrous Italian referendum (which had seemed like it could be the final denouement for Italy’s insolvent lenders) turned rapidly into a buying opportunity within a matter of minutes!6
The rate of credit expansion in recent years in China exceeds that of Spain and Ireland in the run-up to their bubble peak in 2008, as well as that of the U.S. during its mortgage boom and the increase in indebtedness in Japan during the 1980s. And although the starting point is very different from these earlier examples, at $32 trillion, we calculate that banking assets in China are now twice those in the U.S., despite the economy being 40% smaller. Furthermore, we believe the misallocation of capital that has occurred is evidenced by the fact that continued strong increases in the use of credit have had less and less impact on growth – total social financing rose 11% year over year to November in U.S.-dollar terms, but nominal GDP (measured in U.S. dollars) increased by just 2% year over year in the 12 months to the end of Q3. As emphasized in our China influence theme, we believe that the contribution to world growth that has come from China means that the potential for a greater slowdown matters not just for the Asian region, but to economies and markets globally.

Equally important, we suggest, will be events in commodities, notably oil. Markets latched onto the year-end agreement from the Organization of the Petroleum Exporting Countries (OPEC) to restrict oil output for the first time in eight years as an indication of a return to pricing power for the oil cartel. This has contributed to heightened anticipation of rising prices more generally, as evidenced by the rise in the break-even inflation expectations implied by bond markets.

MEANWHILE, IN THE REST OF THE WORLD...

Amid all of the U.S.-centric euphoria, we perceive political and economic uncertainty in the rest of the world never to have been higher.

To our mind, most prominent among sources of uncertainty, and despite a short-term pickup in sentiment indicators, is the EU’s rolling crisis. France and Germany have general elections during 2017. Given the echo of the same popular discontent in these economies that delivered Brexit and Trump in 2016, the potential for further rejection of market liberalism is obvious. The failure of Prime Minister Matteo Renzi to win the Italian referendum on constitutional reform, and his subsequent resignation in December, has opened the possibility that the three largest economies in the Eurozone will face the uncertainty of elections in 2017. Perhaps 2017 won’t prove to be the opportunity for the ECB to cease doing ‘whatever it takes’ to save the euro bloc. These difficulties suggest to us that the second quarter is not entirely propitious timing to begin the countdown on complex EU exit negotiations, as planned by the UK government.

Less commented on, but arguably at least as significant financially, will be events in China. The consensus opinion remains that the leaders of the centrally controlled economy will continue to manage to ‘pull the right levers’ to keep GDP ticking along. Under the surface, though, China’s sovereign balance sheet continues to deteriorate at an alarming rate.

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6Source: Bloomberg data, January 1, 2017
7Source: Bloomberg data, January 1, 2017
in the fourth quarter. Whether OPEC can maintain its supply discipline, and how the energy output of the U.S. shale oil industry responds to higher prices, will face considerable scrutiny. Given the high level of speculative positions seeking to benefit from further oil-price increases, any disappointment at the pace of output cuts—or signs of inventory-building—is likely; we anticipate, to see pricing expectations reverse quickly.

INVESTMENT IMPLICATIONS

The strong theme of this and previous editions of this piece is that structural factors inherent in modern economies suggest rates of growth and inflation lower than we have experienced in the past. Attempts to force economies to grow faster, we believe, are likely to lead to distortions which end up undermining economic activity and living standards even more profoundly.

Policymakers chose to tackle the effects of globalization by unleashing a monetary inflation in much of the industrialized world, which we think has served to widen competitive disadvantage (with the emerging world) and increase wealth and income disparities. Throughout history, we believe one constant has been that monetary inflations are always highly divisive as they effectively transfer money from one section of society to another.

Although a free-trading globalized world is likely to have been a net positive in aggregate, those who have lost out feel doubly disadvantaged, and this anger has contributed to the kind of political upsets we have seen in 2016.

In our view, what is missing from politics is a rational debate about the realities of how we organize a world that looks increasingly new (from a demographic and technological standpoint) without reverting to economic nationalism in a nostalgic bid to return to a past era. 2017 may well provide some answers, which should make for interesting times.

In the meantime, market valuations are once again pricing in elevated expectations for growth and pricing power. We would expect these to become increasingly challenged as the less positive aspects promoted by the new president, and likely disappointment at the pace at which tax reform and deregulation can be delivered, combine with the wider challenges of the global backdrop.

This being the case, we would not extrapolate the strong performance of cyclical sectors in 2016 (energy, materials and financials were the global equity market’s top performers in sterling terms) as the resumption of more ‘normal’ conditions. We believe instead that the swing in valuations means that opportunities to build/reaffirm holdings in companies and sectors that are able to provide consistency of earnings without the necessity for support from a cyclical upswing have been presented.

The need for companies and individuals to be able to manage the dramatic disruption from technological change creates opportunities for those delivering and enabling these new goods and

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8Source: Bloomberg data, January 1, 2017
services. Record levels of indebtedness mean, we believe, that those with stronger balance sheets should prove a safer home for capital than their more highly leveraged counterparts as the competitive environment remains extreme. Although political risks abound, a U.S. health care sector selling below market multiples for the first time in nearly seven years, for example, continues to look to us like an attractive longer-term prospect. We also remain enthusiastic about selective media and technology stocks.

While enthusiasm about Trumponomics could well keep U.S. Treasury prices under pressure in the early part of the year, we believe renewed conviction about interest-rate ‘normalization’ is likely to prove as ephemeral as it has at the outset of each of the last three years. Structural challenges remain, and mean that, even if 2016 did mark the end of the bond bull market, the ability of yields to rise is, to our mind, more muted than the consensus believes.

We think this environment, along with the scope for geopolitically inspired volatility (triggering further aggressive changes in market positioning), should provide support for other ‘haven’ assets. It is also likely to present a volatile picture for currency markets, and key to currency strategy is the outlook for the U.S. dollar.

The dollar, via the ‘Eurodollar’ system, remains the linchpin of the global monetary order. Only time will tell how it reacts to the apparent Trump agenda of increasing economic nationalism. Although the U.S. dollar retains significant attractions for us because of our views about continued economic disappointment in the wider world, it is our contention that the unit’s recent rebound has been built on overenthusiastic expectations about U.S. interest-rate hikes. A repeat of the stalled interest-rate ‘lift-off’ witnessed 12 months ago could challenge the widely held consensus in the inevitable ascent of the U.S. currency.

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9Source: Bloomberg data, January 1, 2017

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