2017 key themes and risks

Stephen Halmarick et al | Colonial First State | 10 February 2017

Key factors for global financial markets in 2017 are expected to be:

- The biggest event for global financial markets in 2017 is likely to have taken place on 20 January – when Donald Trump was sworn in as the 45th President of the United States.
- How the Trump Presidency unfolds will clearly have a significant impact not just on the US (see below for details), but on global markets in 2017 and beyond.
- Which Donald Trump turns up for work each day – pragmatic Trump, or populist Trump? Does he tweet at 3am in the morning on a consistent basis and how do markets respond?
- What foreign policies events/concerns/disasters will be created and/or averted?
- In terms of the global economic outlook in 2017 – the US is also likely to dominate. A large scale US fiscal policy easing is expected to support growth, so that global economic growth in the year ahead should be a little faster than recent years. This is likely to see global economic growth in 2017 close to 3.5%/yr, from nearer 3%/yr in 2016.
- The big question is, however, will the pace of trend or potential GDP growth in the US be raised permanently by Trump's policies, outstripping the cost of higher US debt and the rising cost of capital.
- If so, then the rally being enjoyed by 'risk' assets will become more entrenched.
- If not, then we are in for a multi-year 'boom-bust' cycle. As indicated by the Fed view below, there is more risk of the latter, rather than the former.
- Another key theme for 2017 is likely to be, once again, inflation.
- But the main focus for this year is likely to be a trend to higher headline inflation, given the recent increase in key commodity prices – especially oil.
- Underlying, or core inflation, is likely, however, to remain relatively subdued in 2017, although the direction of change is more likely to be up than down – especially given the ongoing improvements in most major economies labour markets.
- Global monetary policy settings are unlikely to be eased much further in 2017. Further tightening/normalisation of monetary policy is expected in the US and no

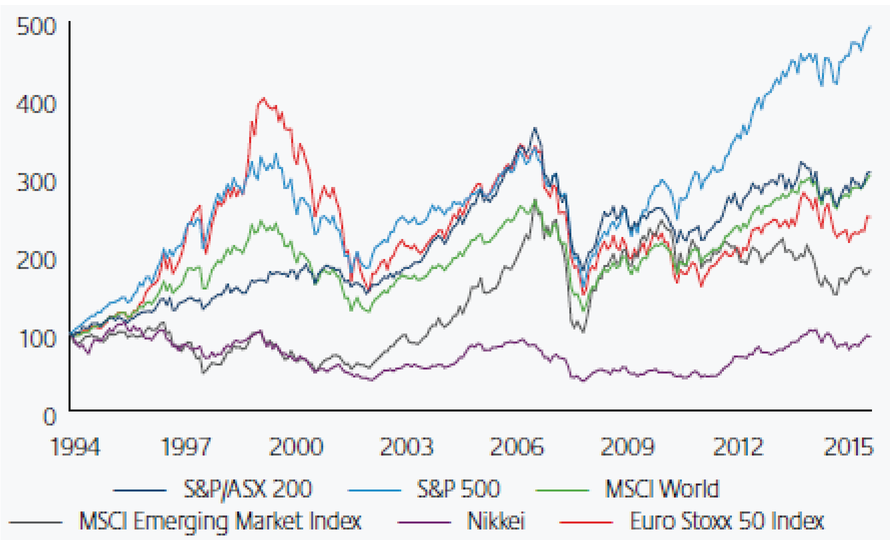
change in monetary policy by the other major central banks in 2017, ie. the ECB, the BoJ and the BoE. The RBA and RBNZ are also expected to be on hold in 2017.

- Another major theme for 2017 is expected to be the interplay between fiscal and monetary policy. A fiscal policy easing in the US is expected to lead to further monetary policy tightening. This trend may also become evident elsewhere, especially in the UK and Japan and perhaps even Europe.
- Key risks remain in Europe, especially around political and policy developments.
- The French Presidential election (April-May), the German general election (likely September-October), political uncertainties in Italy and the start of Brexit negotiations in the UK will also likely be key factors for global markets in the year ahead.
- Concerns about a sharp slow-down in the pace of growth in China proved (once again) to be unfounded in 2016. Government investment spending and a depreciating currency both helped China grow by an estimated 6.7% last year.
- For 2017, slower growth expectations still dominate, as government stimulus is likely to be reduced significantly. This should see growth moderate to around 6.5% in 2017.
- The biggest risk in China in 2017 likely revolves around the political machinations of the five yearly reshuffle of China's political leadership late in the year.
- Other key developments to watch in China include capital outflows and/or capital controls and any tightening in financial conditions - especially around the property market.
- No doubt concerns around the debt levels in China, especially at the local government and SOE level, will still linger in 2017.
- China's relationship with US President Trump will also be critical to watch.
- In Japan, the focus is likely to be on the BoJ's target of capping 10yr JGB yields at 0% and the expectations of further weakness on the Yen.
- Prime Minister Abe is also expected to call an election in H1 2017, which he is expected to win. This should then see Abe remain in the top job all the way out to 2021 - ensuring he is Prime Minister for the 2020 Tokyo Olympic Games.
- The Australian economy will likely continue to see growth average around 2.5%-2.75% in the year ahead, with housing, infrastructure and net exports (of both resources and services) more than offsetting weakness in business investment.
- Concerns around Australian household debt levels will likely be raised (yet again) in 2017. But household balance sheets remain in relatively good shape and with the RBA

expected to be on hold, the authors do not see significant downside risks to the Australian housing market in the year ahead.

- For financial markets, one of the dominant themes is likely to be further strengthening of the US dollar in 2017. This will have big implications for not only the US, but other developed and key emerging markets.
- For global bond markets, the return of (some) inflation, especially in the US, could be a major theme. Higher inflation could pose a major risk to both US and global bond markets. Most of the increase seen in global bond in yields so far appears to be driven by term-premium (which could still move further), but if inflation begins to increase meaningfully, then yields could have a lot further to go.
- This is expected to lead to a steepening in yield curves in the major bond markets through 2017.
- For global equity markets, stronger economic growth in the US and a better global economy should be supportive – especially if there is a noticeable increase in nominal GDP growth (ie. a bit of inflation pressure).
- Equity markets will, however, likely also have to deal with higher interest rates and an increase in the labour (ie. wages) share of the economy relative to the profit share.

Figure 1: Global equity markets – lots of 'good' news priced in



Source: Bloomberg as at 18 January 2017.

The United States

As noted, the biggest event for global financial markets in 2017 is likely to have taken place on 20 January – when Donald Trump was sworn in as the 45th President of the United States.

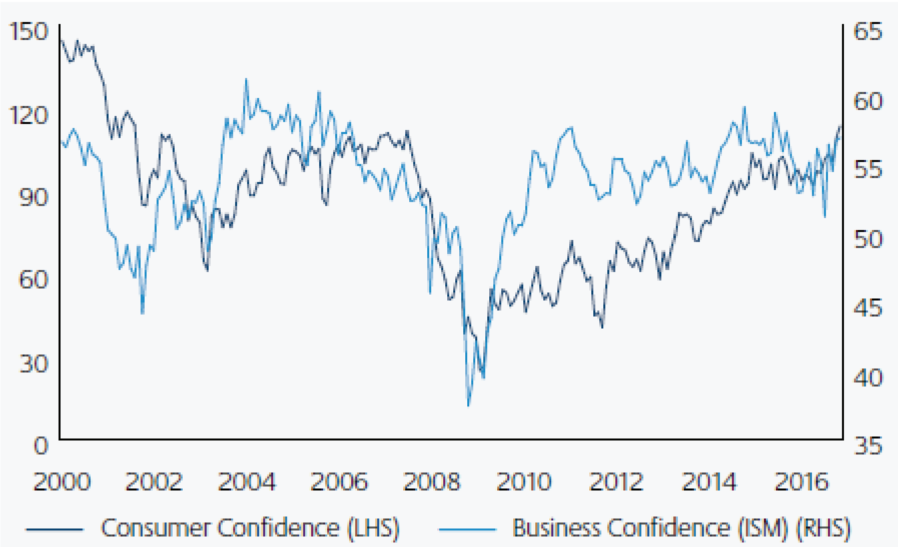
The implications for the US economy and financial markets from President Trump is likely to involve three phases.

Phase one was 'risk off', with the unexpected election victory by Trump seeing the US equity market and the US dollar sell-off and US bond yields rally. This phase, however, lasted less than 24 hours, with the market quickly moving into the second phase.

The second phase, which is expected to be the dominant factor throughout 2017, is supported by the view that Trump's policies will be expansionary and stimulatory – especially his company and income tax cuts, increased infrastructure spending and reduced regulatory environment (see below for details).

This phase has already seen a strong rally in equity markets, the US dollar, a sell-off in bond markets and is expected to be the primary factor driving markets throughout 2017. A noticeable increase in both business and consumer confidence has taken place since the election.

Figure 2: US Business and Consumer confidence



Source: Bloomberg as at 31 December 2016.

Further out, however, phase three may not be as positive. Although the timing for phase three is very difficult to determine, it could be anywhere between 2018-2020, this phase is likely to involve an increase in inflation and a more aggressive monetary policy tightening cycle from the US Federal Reserve.

Higher inflation, higher interest rates and the risks associated with Trump's anti-trade policies could sow the seeds for an economic downturn late in Trump's Presidency, seeing equity markets and the US dollar sell-off and bond yields rally again. As mentioned, however, the timing of phase three remains very uncertain and is unlikely to occur in 2017.

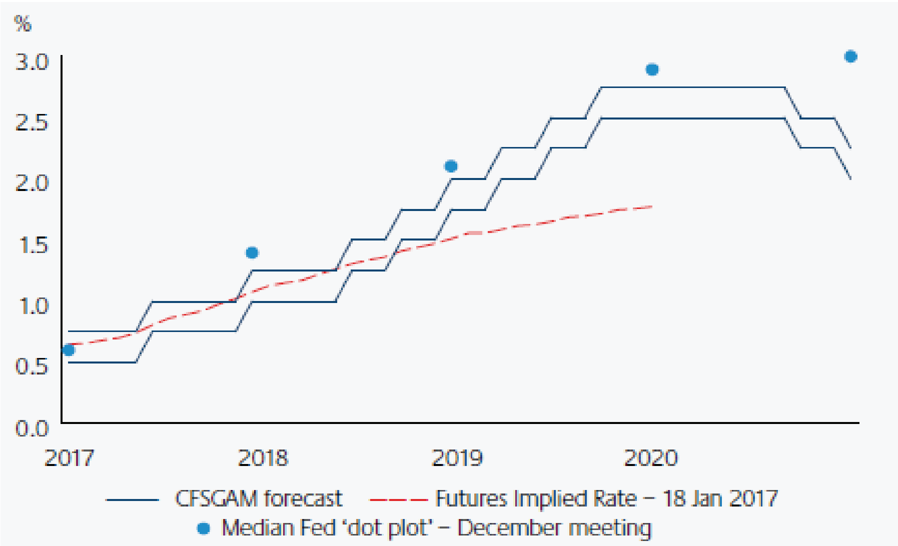
Indeed, after raising interest rates on 15 December 2016 by 25 bps, to a new range of 0.5%-0.75%, the US Federal Reserve is expected to remain on a gradual tightening path in 2017. With the Fed unlikely to pre-empt the impact of Trump's fiscal policy easing, expect only two further Fed rate hikes in 2017.

However, the authors have recently made some significant changes to their Fed view - to reflect the expansionary, stimulatory and, ultimately, inflationary policy of the Trump administration.

Given the US economy is expected to experience a significant easing of fiscal policy from late 2017 onwards, which pushes inflation higher than previously expected and brings forth the need for more tightening from the Fed, the two rate hikes in 2017 are expected to be followed by three rate hikes in 2018 (previously two) and a further three rate hikes in 2019 (previously two). This will give a peak in the Fed Funds target rate in 2019 of 2.5%-2.75%, ie. 50 bps higher than the authors' previous peak forecast.

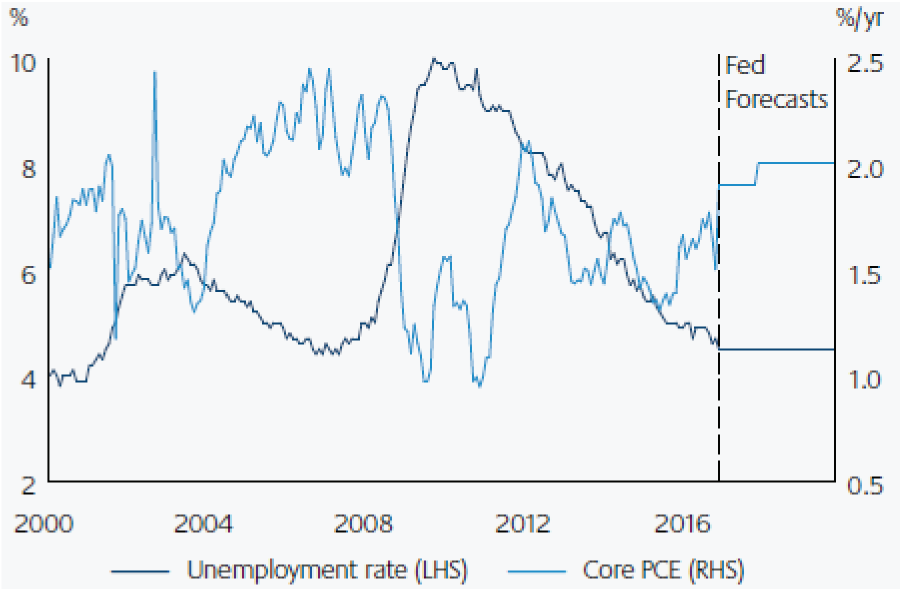
Now, however, two rate cuts in 2020 (previously no change) are expected as the significant tightening of financial conditions over 2018-2019 (from a higher USD, higher bond yields and a higher Fed Funds rate), combines with President Trump's anti-trade and anti-immigration policies to bring about a (significant) economic downturn

Figure 3: Fed rate expectations



Source: Bloomberg, data to 17 January 2017. Fed 'dots' as at December 2016. CFSGAM forecasts as at 15 December 2016.

Figure 4: US Unemployment rate and Core PCE rate – Actual and forecasts



Source: Bloomberg and Federal Reserve. Unemployment rate as at December 2016. Core PCE to November 2016. Fed projections from December 2016 FOMC meeting.

In terms of the main policy agenda for President Trump, the following is expected (with the +, – and ? symbols indicating the direction of impact on the economy and markets).

+ Significant fiscal stimulus through:

+ large income tax cuts (three rates 12%, 25% & 33%),

+ company tax cuts (to 15% or 20% or 25% from 35%) and

+ a 10% repatriation tax for cash currently held off-shore.

+ Increase in Infrastructure spending, ie. $US300bn government money, with private sector involvement potentially up to $US1 trillion.

+ Increase in Military spending – current and veterans.

+ Reduce regulatory burden – especially on energy to achieve "complete American energy independence".

– Strongly protectionist stance – name China as a 'currency manipulator' and impose 45% tariffs on selected imported goods.

– No support for TPP and change/withdraw from NAFTA.

– Scale back climate change regulations.

- Critical of Fed policy, pro-audit, Chair Yellen to be replaced in early 2018.

- Isolationist stance of foreign policy - critical of NATO/some allies and China. Closer to Russia.

- Tough stance on immigration - build a wall.

? Repeal and replace Obamacare.

It has been estimated that Trump's policy agenda will increase the level of US government debt by around 20% of GDP over the coming decade - as shown Figure 5 below. Other estimates put the cost of the Trump tax policies at between $US2.4tr - $US5.3tr.

The key question for markets over 2017, and beyond, is: will this be money well spent? Will President Trump's policies lead to a permanent shift higher in the US's potential economic growth rate?

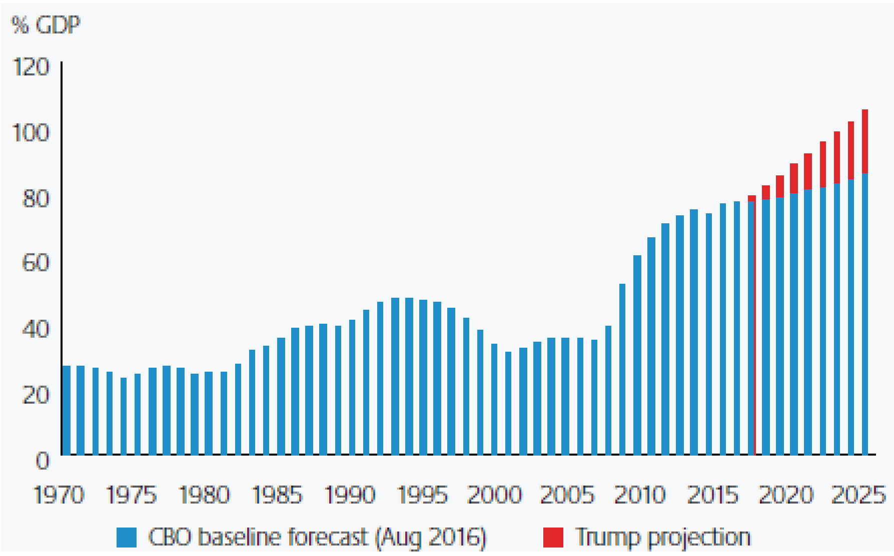
The optimists are saying 'yes' - that the suite of expansionary fiscal policy actions will lead to an increase in business investment, a rise in productivity and an increase in the wages share of the economy that drives growth higher.

This would then lead to an increase in the neutral level of interest rates, ie. R* would rise, and an increase in the rate of return on investments.

The pessimists are much more skeptical and fear a 'boom-bust' cycle over coming years.

As detailed in the revised Fed view above, the authors are more on the skeptical side than the opportunistic side.

Figure 5: US Debt expectations



Sources: CBO as at August 2016. CRFB as at October 2016. CFSGAM.

In this regard, it is interesting to note recent comments from Fed Chair Janet Yellen about the labour market.[1] The Fed Chair stated that the two biggest factors impacting on the US labour market were technology and globalisation.

Perhaps in an effort to push back against those who are looking to turn the clock back against both the advancements of technology and globalisation, the Fed Chair stated that "while globalisation will likely continue and technology will continue to advance, we don't know how fast the economy will grow, what new technologies will develop, or how quickly and consistently employment will expand. What is considerably more certain, however, is that success will continue to be tied to education, in part because a good education enhances one's ability to adapt to a changing economy."

The other factor that markets will need to consider in 2017 is the leadership of the Federal Reserve.

President Trump will get to nominate people to fill two Governor vacancies at the Fed in 2017 and, most critically, find a replacement for Chair Yellen in early 2018 – assuming that he will not reappoint Dr Yellen.

In terms of Janet Yellen's possible replacement as Chair in early 2018, neither President Trump nor the new Treasury Secretary (Steven Mnuchin) are likely to be looking for a monetary policy hawk.

Given the extent of fiscal policy easing that is planned, the new Fed Chair will more than likely be somebody that favours a conservative approach to monetary policy and would be less inclined to hike rates substantially. From the list of names below, this likely rules out John Taylor.

Possible new members of the Fed and specific candidates for Chair include:

- Martin Feldstein: Former Chair of the Council of Economic Advisors (CEA – 1982-84 President Reagan). Former CEO of National Bureau of Economic Research. Currently at Harvard.
- Richard Fisher: Former President of Dallas Federal Reserve.
- Thomas Hoenig: Vice Chair FDIC (2012 – current). Ex-President of the Kansas City Fed (1991-2011).
- Glenn Hubbard: Deputy Assistant Secretary to the Treasury (1991-1993). Chair CEA (2001-2003 for George W). Currently at Columbia University.
- John Taylor: Stanford University and established the "Taylor Rule" for monetary policy. Under Secretary International Affairs – Treasury (under George W. Bush). Member of the CEA (President George W. Bush).

- Kevin Warsh: Currently at Stanford Uni. Former Special Assistant to President George W. Bush on Economic Policy (2002-06). Former member of the FOMC (2006-2011) – acted as a special advisor to Wall St and the Fed through the GFC. At the time of his appointment to the Fed in 2006 he was the youngest appointment in the history of the Fed, at just 35yrs of age.
- Richard Clarida: Currently at Columbia University and strategic advisor to PIMCO. Former Assistant Secretary of the Treasury for Economic Policy and winner of the Treasury medal for outstanding service to the Treasury Department.

China

Economic growth in China could also moderate in 2017, perhaps down to around 6.5%/yr, as government investment spending slows and the official focus remains on medium-term structural changes to the Chinese economy.

But as shown in Figure 6 below, the high-frequency data in China has been very solid through H2 16 and so some slowdown from this strong pace of growth should be expected in 2017.

One of the bigger risk factors in China in 2017 revolves around the political machinations – with the five yearly reshuffle of China's political leadership in late 2017.

No doubt the political leadership will be looking for economic stability ahead of the political changes in late 2017. This could imply a growth target for the year of "around 6.5%", as opposed to the 6.5%-7% target on 2016.

Figure 6: China GDP growth and Premier Li index

Source: Bloomberg. GDP data to 31 December 2016. Li Keqiang Index data to 31 December 2016.

Inflation in China could trend a little higher through 2017, especially given the accelerating in the PPI evident over H2 2016.

Other key developments to watch in China include capital outflows and/or capital controls and any tightening in financial conditions – especially around the property market.

No doubt concerns around the debt levels in China, especially at the local government and SOE level, will still linger in 2017. It is doubtful that 2017 will be the year that these debt concerns come to a head. This is especially so given the strong desire there will be for 'stability' in 2017 ahead of the political changes towards the end of the year.

China's relationship with US President Trump will also be critical to watch in 2017. Key areas of focus/concern will revolve around the currency and trade policy, as well as security issues in the South China Sea.

Europe

After adjusting its monetary policy stance in late 2016, the European Central Bank (ECB) is expected to maintain the stance of monetary policy in 2017 – with €60bn of asset purchases per month planned until December 2017.

This should help limit the sell-off in the EU bond market from any pressure for higher bond yields – especially coming from the US. A narrowing interest rate spread with the US should also put further downward pressure on the Euro – something the ECB is unlikely to resist.

Ongoing low interest rates and a weaker Euro should act to support the European equity markets and the economy more generally.

As detailed in the forecasts, the EU economy is expected to continue to grow modestly in 2017, with growth of around 1.7%/yr, compared with the 1.6%/yr expected outcome for 2016.

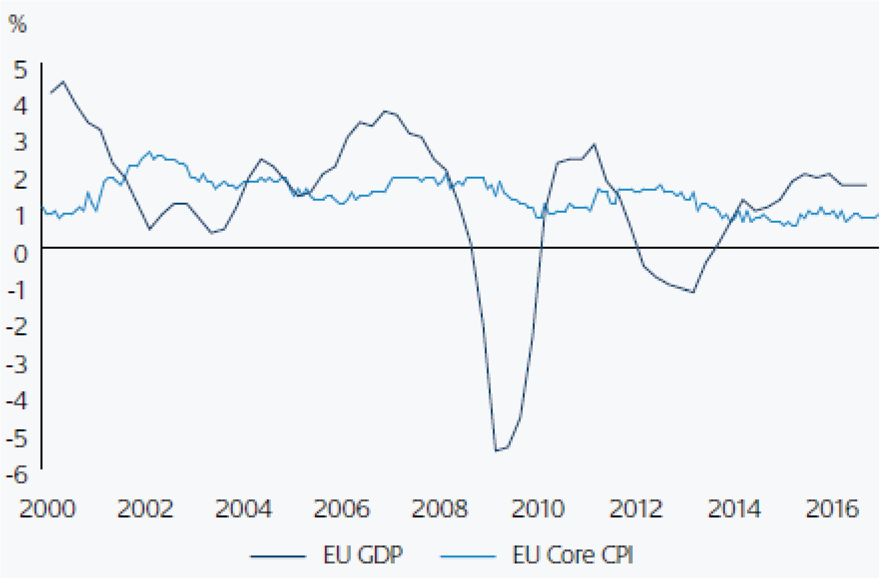
Growth should be supported by the very easy stance of monetary policy, and some minor support, if not neutral, from fiscal policy. The weaker Euro should also help those EU countries that are heavily export orientated, ie. Germany.

The risks remain, however, to the downside, with both US and UK anti-trade developments likely to weigh on the EU and the fragile nature of the banking system limiting credit supply.

Headline inflation in the EU is likely to rise to around 1.1%/yr in 2017, well up from 0%/yr in 2015 and just 0.2%/yr in 2016. The biggest swing factor here is the changing price of oil/energy.

Core inflation is still likely to rise in 2017, but to a much lesser extent – keeping the ECB on the sidelines with the current stance of monetary policy. The key factor behind the expected upward drift in core inflation is the gradual tightening of the labour market underway and some signs of wages pressures.

Figure 7: EU GDP growth and Core inflation



Source: Bloomberg. GDP data to 30 September 2016. CPI data to 31 December 2016.

The biggest sources of risk in the EU in 2017 are likely to be found in the political and banking sectors.

On the political front, three events are expected to dominate – the French Presidential election, the German general election and the negotiation strategy with the UK on Brexit.

- The 23 April/7 May French Presidential Elections. While Marine LePen (Front National) is currently trailing in the polls behind Francois Fillon (The Republicans), as we saw last year in the UK and US, the polls are not always reliable. The key risk if LePen is elected President would be a referendum on EU membership. If this were to occur, and be successful, the EU would likely disintegrate. This is not the base case, but will likely keep markets on edge until the election outcome is known.
- The German general election is expected to take place around late August–late October 2017. Chancellor Angela Merkel is running for a fourth term – a very difficult achievement. But opinion polls continue to suggest that Merkel will be able to form some sort of coalition government and remain in place. The Alternative for Germany (AfD) could do well, however, and have a strong influence on the election and the type of government formed afterwards.

- The expected activation of Article 50 by the UK in March will set the two year clock–ticking to negotiate the UK's exit from the EU. EU negotiators have a strong incentive to drive a hard bargain with the UK and this could well be a critical factor for markets in the year ahead.

On the banking front, the Italian banking crisis is likely to continue to unfold. While the government is in the process of raising capital, it seems unlikely that it will be able to bail out the banks without support from the broader EU, which has so far signalled little appetite for this. This could be a source of tension between Italy and Germany as the Italians push further back against austerity.

The United Kingdom

The most significant event in the UK during 2017 is likely to be the start of the Brexit negotiation process. Article 50 is expected to be invoked in March 2017, triggering the two year process of negotiating the terms and conditions of the UK's exit from the EU.

Not only will the terms and conditions of this exit be a source of uncertainty for financial markets in 2017, but questions still remain over the role of the UK Parliament during the negotiation phase and the final agreement.

The economic data in the UK has outperformed expectations in the months since the unexpected Brexit vote. 2016 GDP growth looks like coming in close to 1.6%/yr.

GDP growth of 1.6%/yr is expected in both 2017 and 2018. This is more optimistic than consensus (and the Bank of England, BoE) for both years, based on the 2016 easing of monetary policy, the weaker GBP and the expected easing of fiscal policy in the years ahead.

The downside risk remains, however, if negotiations around Brexit fail to come up with a solid new model for the UK's trading relationship with the EU.

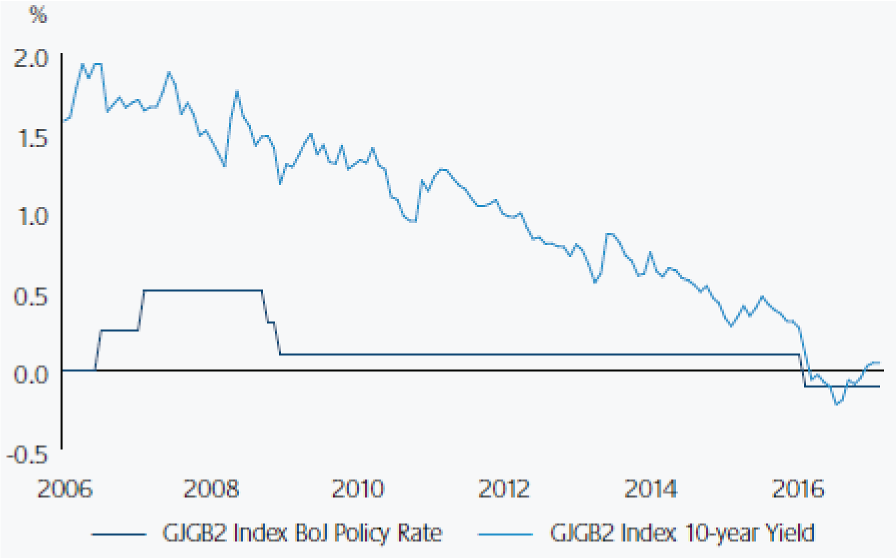
The pace of inflation in the UK has accelerated in recent months, driven largely by the sharp weakening in the GBP and rising oil prices. Inflation is expected to be above the BoE's 2% target in 2017 and 2018, before returning to target in 2019.

The BoE has recently signalled that monetary policy is likely to remain on hold for the foreseeable future, with the base rate at 0.25% and a £425bn annual pace of QE. These monetary policy conditions are expected to be retained through 2017, with some minor normalisation of policy in 2018 and 2019.

Japan

The big event for the year in 2016 in Japan was the "comprehensive reassessment" of monetary policy. This reassessment resulted in the decision to move away from targeting the size of balance sheet expansion to targeting the 10 year JGB yield at 0%.

Figure 8: Japan 10yr JGB and Short-end rate



Source: Bloomberg, data to 17 January 2017.

For 2017 the BoJ is expected to try and hold monetary policy steady throughout the year – with the short end rate at -0.1% and 10yr yields at 0%. The trend to higher global bond yields, especially from the US, works strongly in Japan's favour, if the BoJ can successfully hold 10yr yields down at 0%.

This would act to lower, ie. push further into negative, Japanese interest rates relative to the rest of the world, which in turn should weaken the Yen and strengthen the Nikkei. All this should help create some inflationary pressure in Japan and support nominal GDP growth.

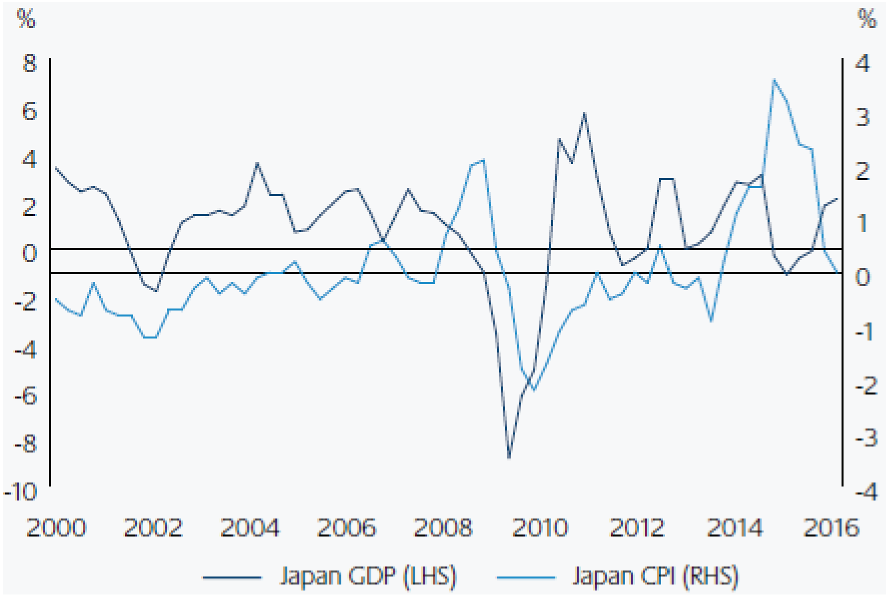
As detailed in the forecasts, however, economic growth and inflation are both expected to remain modest in Japan in 2017.

For 2017 a little more economic growth is expected than that experienced in 2016, with an annual rate around 0.9%/yr. Growth in 2017 should be supported by the renewed weakening of the Yen, further fiscal policy easing and the maintenance of extraordinary monetary policy easing.

For 2018 and 2019 growth is expected to remain modest, in a 0.5%-1.0% range, with Japan's very negative demographics likely to hold the growth rate back on an ongoing basis.

Like elsewhere, headline inflation has shown some pick-up at the end of 2016 as energy prices rise again. Some slight improvement in underlying inflation could be seen in 2017 and 2018, but the pace of inflation is very unlikely to meet the BoJ's 2% target in the years ahead.

Figure 9: Japan GDP growth and Inflation



Source: Bloomberg. GDP data to 30 September 2016. CPI data to 30 November 2016.

The other big event for Japan in 2017 is expected to be (another) snap Lower House election by Prime Minister Abe. This election, which could be expected before mid-year, is expected to see the re-election of Abe and the LDP – giving Abe the opportunity to remain Prime Minister until 2021 – ie. after the 2020 Tokyo Olympics Games.

Australia

In Australia, throughout much of 2016 the economic data continued to show relatively solid growth, although there was an evident slowdown in the September quarter relative to the first half of the year. Economic growth continues to be driven by exports of both resources and services, especially tourism and education, and the strength in residential construction. Infrastructure spending also remains strong, especially in NSW, while the largest source of weakness remains business investment.

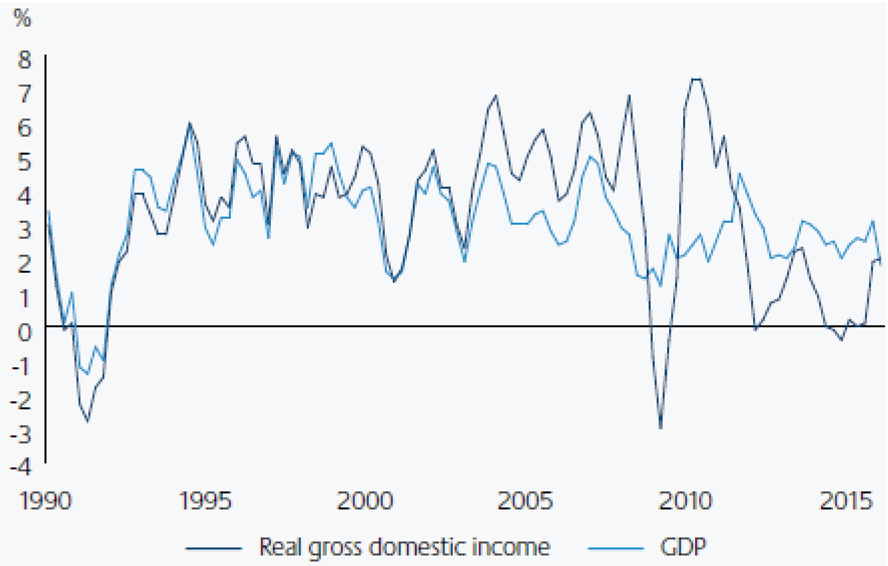
2017 is likely to bring a bit more of the same. Consumer spending growth looks set to remain relatively modest, as consumers continue to use the low interest rate environment to pay down debt, rather than increase spending.

The weak spot for the economy is expected to remain business investment – where both mining and non-mining investment continue to decline. Although it does appear that we are past the worst of this slowdown.

One of the most important development in recent months and which could dominate the discussion in 2017 is the improvement in the income side of the Australian economy.

As shown Figure 10, after running well below GDP growth for the past few years, national income growth accelerated from mid-2016 onwards (even as GDP growth slowed). A further improvement in national income growth – and nominal GDP growth – could be one of the most positive developments for Australia in 2017.

Figure 10: Australian GDP and income growth



Source: ABS. GDP data to 30 September 2016.

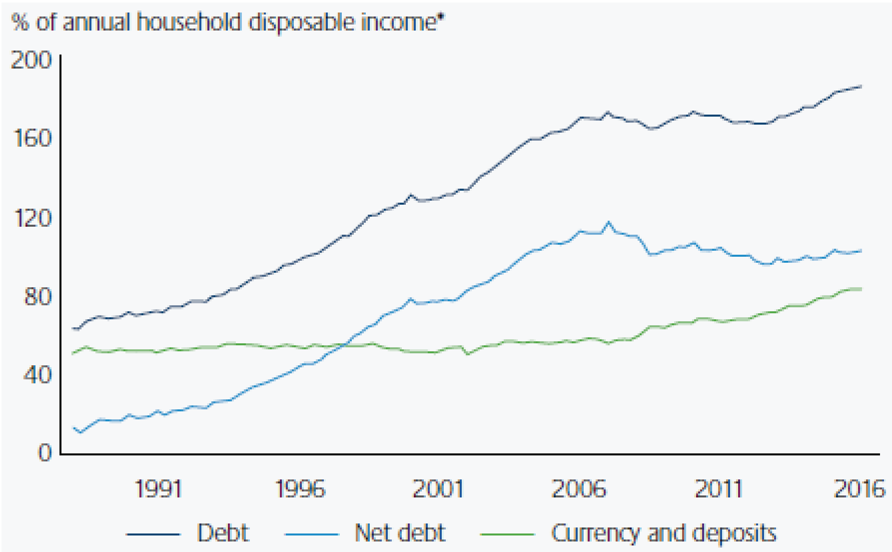
Inflation in Australia is expected to remain low in 2017, but with the headline rate likely to drift up closer to the RBA's 2%-3% target range over the medium term.

After having cut interest rates in May and August 2016 on the back of the low inflation environment, the Reserve Bank of Australia, under the new leadership of Dr Phil Lowe, is signalling a reluctance to lower interest rates even further.

Indeed, after the election of Donald Trump and on concerns around the level of household debt in Australia, the markets are now expecting that Australia's cash rate has bottomed and the 1.5% interest rate will be the low in this cycle. Indeed, no change is expected in the 1.5% cash rate throughout 2017.

Concerns that Australia is experiencing an unsustainable house 'bubble' are likely to linger in 2017 – but remain, in the authors' view, unfounded (as they have for the past 20 years or so).

Figure 11: Australian household debt levels



Source: ABS; RBA Governor CEDA speech, 17 November 2016. Note: Household sector includes unincorporated enterprises; disposable income is before the deduction of interest payments.

As shown Figure 11, while gross household debt to income continues to rise to very high levels, the unique nature of Australia's mortgage market (ie. variable mortgages that can be pre-paid) means that the net debt of Australian households has remained almost unchanged over the past decade.

Essentially, Australian households have been using the historically low interest rates to pay down debt - rather than leverage consumer spending, and this means that household balance sheets remain in relatively good shape. This should remain the case throughout 2017.

In terms of Australian markets, the end of the monetary policy easing cycle and global developments are likely to see Australian bond yields drift higher throughout the year ahead.

Over the second half of 2016 the Australian dollar traded in a relatively tight range around $US0.72 to $US0.77, but is starting the new-year at the lower end of that range. Some further modest depreciation of the Australian dollar could be expected in 2017 against a stronger US dollar.

One of the key risks for Australia in 2017 will be ongoing concerns over the budget position and Australia's AAA credit rating. While the credit rating agencies expressed some confidence in the budget after the late 2016 Mid-Year Update, this seems more like a delay in a potential downgrade, rather than a reprieve.

There is a greater than 50% risk of a credit rating downgrade, most likely by S&P, during 2017. However, a AA+ credit rating is still high by international standards and little impact is seen for the cost of borrowing for the Australian treasury. A greater impact could be felt by the States and the banks, as their credit ratings would also be affected by a lower sovereign rating.

New Zealand

The biggest news in New Zealand at the end of 2016 was the shock announcement by Prime Minister John Key that he was resigning. Key had been Prime Minister since November 2008 and was widely regarded as very successful.

He was replaced by former Finance Minister (and previous National Party leader) Bill English as Prime Minister, who then announced some significant ministerial reshuffling.

2017 is likely, therefore, to bring some political changes in NZ, but no doubt Bill English and the National Party will be keen to maintain the major policy initiatives of the Key government.

The next general election in New Zealand is due late in 2017. At this stage the opinion polls are showing the National Party well ahead at around 47% of the vote. The other major parties are well behind at 28% for Labour, 12% for the Greens and 9% for NZ First. A returned National Party government remains, therefore, the most likely option – unless the other three major parties can find some way to form a coalition if that opportunity arises.

In terms of the economic outlook, the groundwork looks to have been laid for the NZ economy to shift back into higher gear in 2017. Strong population growth and low interest rates have fuelled construction demand. A tourism boom has the retail sector humming. The labour market has tightened and NZ households feel more confident.

After cutting the official cash rate three times in 2016, down to 1.75%, no further rate cuts are expected from the RBNZ through 2017.

The RBNZ has, however, retained an easing bias, stating in November that "policy settings … will see growth strong enough to have inflation settle near the middle of the target range. Numerous uncertainties remain...and policy may need to adjust accordingly."

portfolio construction forum

RISKS

In addition to the key themes, there are a number of risks to the global economy and financial markets in 2017. These include:

- Substantially higher bond yields, ie. US 10yr above 3.5%, as a result of market concerns that the US Fed is 'behind the curve' on a President Trump-fiscal policy inspired inflation surge.
- An associated risk would be that the US Fed has to raise official interest rates more than three times in 2017.
- Audit the Fed: A number of Republicans in Congress, plus President Trump, have publically criticised the Fed and supported "Audit the Fed" legislation (as proposed in both 2014 and 2015). This legislation would take away flexibility from the Fed and impose policy rules, ie. the Taylor Rule. This would likely imply much higher interest rates in the US - which is probably one good reason why it won't happen, but the risk remains.
- New Fed Chair: Janet Yellen's terms as Chair of the Fed ends in February 2018. As noted earlier, President Trump will get to nominate a new Chair and this could be a focus for markets in 2017. Note that although Janet Yellen's term of Chair expires early next year, her term as a Governor extends all the way until 2024!
- US President Trump is true to some of his pre-election rhetoric and imposes significant trade restrictions and tariffs on the US's major trading partners, ie. China, Mexico and Canada, and initiates a trade war.
- China is named as a 'currency manipulator' and trade restrictions imposed lead to a significant breakdown in US-China trade
- US President Trump initiates a break-down in some of the major geopolitical structures, ie. NATO, the US relationship with China, the IMF/World Bank and the US relationship with Russia.
- Marinne Le Pen and the National Front win the French Presidential election and initiate Frexit.
- Angela Merkel loses the Germany general election and the AfD can either form government or be part of a larger coalition government.
- Brexit negotiations start off badly with negative implications for the UK's trade with the EU and doubts over London's position as a global financial centre.
- China's political leadership loses control of the economy and concerns over debt levels at the local government and SOE level spill-over into a wider financial crisis that leads to significant capital outflow from China.

- The security situation in the Middle East (specifically Syria) continues to spiral downwards – worsening the refugee crisis in Europe and escalating the risk of terrorist activities in major western nations.
- Other potential geopolitical flashpoints in 2017 would include the South China Sea and Eastern Europe/Russia.

ECONOMIC FORECASTS

United States

Figure 12: United States

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	2.2	2.3	2.3	2.6	2.0	2.3	2.0	2.0
Inflation – Core PCE	1.9	1.8	2.0	2.3	2.0	2.5	2.0	2.0
Monetary policy – Rates	1.2%	1.0%–1.25%	1.7%	1.75–2.0%	2.0%	2.5%–2.75%	2.0%	2.0%
Monetary policy – Other	Fed unlikely to alter balance sheet.	Fed unlikely to alter balance sheet.	No consensus.	Coupon reinvest-ment may be phased out.	Coupon reinvest-ment may be phased out.	Coupon reinvest-ment may be phased out.	Balance sheet slowly returns to normal.	Balance sheet slowly returns to normal.

Source: Bloomberg.

- GDP: Growth in 2016 is likely to come in lower than previously expected at around 1.6% (the authors' latest f/c was 1.9%). For 2017 the key development will be whether there is significant fiscal policy easing. The authors don't expect much of an impact from fiscal policy this year, so the GDP forecast of 2.3% is close to market consensus.
- However, economic growth should be supported through 2018 and 2019 by significant fiscal policy easing and so GDP forecasts for both years are above consensus at 2.6% and 2.3% respectively. Growth is also expected to be helped by the solid labour market and some long-awaited upward pressure in wages growth.
- Inflation: The Fed's favoured measure of underlying inflation, the core PCE, has picked up again in recent months and looks like ending 2016 at 1.7%.
- The significant fiscal policy easing and better growth is expected to put further upward pressure on inflation in the year ahead, leading to a forecast of above-target inflation in both 2018 and 2019.
- Monetary policy: After hiking rates in December 2016, the Fed is expected to tighten twice again in 2017 – although the Fed's own 'dots' imply three rate hikes this year.

- However, expect to see the Fed tighten three times in both 2018 and 2019 – in response to the above-target inflation outcomes from President Trump's policies. But, in 2020, the Fed is expected to ease monetary policy twice, as economic growth slows meaningfully.
- The Fed is not expected to sell any of the bonds it holds on balance sheet, but is expected to begin to cease reinvesting coupon income in 2018 or 2019.

United Kingdom

Figure 13: United Kingdom

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.2	1.6	1.3	1.6	1.5	1.25	2.5	2.0
Inflation – Core PCE	2.4	2.2	2.5	2.5	2.0	2.0	2.0	2.0
Monetary policy – Rates	0.5%	0.25%	0.7%	0.5%	1.0%	0.75%	2.5%	2.0%
Monetary policy – Other	QE retained at £425bn	QE retained at £425bn	No clear consensus.	Balance sheet to stabilise.	No clear consensus.	Balance sheet to stabilise.	Balance sheet to stabilise.	Balance sheet to stabilise.

Source: Bloomberg.

- GDP: The economic data in the UK has outperformed expectations in the months since the unexpected Brexit vote. 2016 GDP growth looks to have come in at around 2.2%/yr, above the most recent f/c of 1.6%/yr.
- GDP growth of 1.6%/yr is expected in both 2017 and 2018, more optimistic than consensus for both years based on the 2016 easing of monetary policy, the weaker GBP and the expected easing of fiscal policy in the years ahead.
- The downside risk remains, however, if negotiations around Brexit fail to come up with a solid new model for the UK's trading relationship with the EU.
- Inflation: The pace of inflation in the UK has accelerated in recent months, driven largely by the sharp weakening in the GBP.
- Inflation is expected to be above the BoE's 2% target in 2017 and 2018, before returning to target in 2019.

- Monetary policy: The BoE has recently signalled that monetary policy is likely to remain on hold for the foreseeable future, with the base rate at 0.25% and a £425bn annual pace of QE.
- These monetary policy conditions are expected to be retained through 2017, with some minor normalisation of policy in 2018 and 2019.

Europe

Figure 14: Europe

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.4	1.7	1.5	1.7	1.5	1.5	1.5	1.0
Inflation – Core PCE	1.3	1.1	1.5	1.4	1.5	1.5	1.5	1.0
Monetary policy – Rates	-0.18%	-0.4%	0%	0%	N/A	0%	N/A	1.0%
Monetary policy – Other	QE at €60/mth to Dec, 17.	QE at €60/mth to Dec, 17.	No consensus.	Some tapering of QE. TLTRO remains in place.	No consensus.	QE ended. TLTRO remains in place.	Significant period of very easy monetary policy.	Significant period of very easy monetary policy.

Source: Bloomberg.

- GDP: Economic data in the EU showed some good stability through much of 2016 and the expectation for growth at the end of the year is 1.6%.
- For 2017 and 2018, GDP growth forecasts are a little higher than consensus. Ongoing highly stimulatory monetary policy, neutral fiscal policy, the lower Euro and faster economic growth in the US should also support economic activity in the EU.
- However, the risks for the EU are skewed to the downside because of ongoing political concerns (ie. a new government in Italy and elections in France and Germany) and continued signs of instability in the banking system – especially in Italy.
- Inflation: Inflation in Europe (as elsewhere) remained very low through much of 2016 – but with headline inflation picking up towards year end on the back of higher energy prices.

- Aggressive policy action by the ECB and any further weakening of the Euro should help put upward pressure on inflation through 2017-2018. The forecasts for 2017 and 2018 have been, therefore, raised modestly.
- However, inflation is not expected to reach the ECB's 2% target out beyond 2018.
- Monetary policy: In late 2016 the ECB announced that, from April 2017 onwards its monthly asset purchase program (QE) would be reduced from €80bn/mth to €60bn/mth - but extended out to December 2017.
- This stance of monetary policy, with a cash rate of -0.4%, is expcted to be maintained throughout all of this year - before some tapering in 2018.

Japan

Figure 15: Japan

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	1.0	0.9	0.9	0.6	1.0	1.0	1.0	1.0
Inflation - Core PCE	0.6	0.4	1.0	0.8	1.0	1.0	2.0	1.0
Monetary policy - Rates	-0.1%	-0.1%	0.0%	-0.1%	+0.1%	0.0%	0.0%	0.0%
Monetary policy - Other	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	QQE, with NIRP and yield curve control.	N/A	Some increase in cash rate, but with yield curve control still in place.	Extraordinary monetary conditions to remain in place for foreseeable future.	Extraordinary monetary conditions to remain in place for foreseeable future.

Source: Bloomberg.

- GDP: Economic growth improved a little in Japan in 2016 and looks like it will come in around 0.9%/yr.
- For 2017, a little more growth is expected, with an annual rate around 0.9%/yr. Growth in 2017 should be supported by the renewed weakening of the yen, further

fiscal policy easing and the maintenance of extraordinary monetary policy easing via a -0.1% cash rate and a 0% 10 year JGB yield.

- For 2018 and 2019 growth is expected to remain modest, in a 0.5%-1.0% range, with Japan's very negative demographics likely to hold the growth rate back on an ongoing basis.
- Inflation: Like elsewhere, headline inflation has shown some pick-up at the end of 2016 as energy prices rise again. Some slight improvement in underlying inflation could be seen in 2017 and 2018, but the pace of inflation is very unlikely to meet the BoJ's 2% target in the years ahead.
- Monetary policy: After its 'comprehensive reassessment' of monetary policy in September 2016, the BoJ has switched its focus from targeting balance sheet expansion to targeting 10yr JGB yields at 0%. The cash rate target remains at -0.1%.
- The BoJ is expected to retain this policy through 2017 and to retain a very aggressive monetary policy stance for a number of years to come.

China

Figure 16: China

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	Consensus	EMR
GDP	6.5	6.8	6.1	6.6	6.0	6.2	6.0	6.0
Inflation - Core PCE	2.2	2.4	2.2	2.5	2.5	2.5	2.5	2.5

Source: Bloomberg.

- GDP: Economic growth in China was remarkably stable through 2016 - coming in at 6.7%/yr for the first three quarters before increasing to 6.8%/yr in Q4, easily achieving the official target of 6.5%-7.0%.
- For 2017, economic growth is expected to remain relatively solid at 6.8%/yr - although the government's official target has been lowered to 'around 6.5%'. Growth should be supported by a more neutral net export performance and the political imperative of stable growth ahead of the political leadership changes in late 2017.
- Over the medium-term, China is likely to be able to maintain a growth rate around 6%/yr, consistent with the government's target of doubling nominal GDP from 2010 to 2020.

- Inflation: China's inflation rate picked up in late 2016 on the back of higher food and energy prices. For 2017 and 2018, the inflation rate is expected to continue to edge higher and average around 2.5%/yr.
- In the longer-term, China has shown itself to be capable of managing inflation over the course of a cycle – with an average rate of around 2.5% expected.

Australia

Figure 17: Australia

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	7.8	EMR
GDP	2.6	2.75	2.8	2.9	N/A	2.75	3.0	2.75
Inflation – Core PCE	2.1	2.0	2.2	2.25	N/A	2.25	2.5	2.25
Monetary policy – Rates	1.4%	1.5%	N/A	2.0%	N/A	2.5%	No clear consensus	3.0%

Source: Bloomberg.

- GDP: The Australian economy hit a pothole in Q3 16 with a -0.5%/qtr print. A bounce-back is expected in Q4 16 to give growth for the year of close to 2.5%.
- For 2017, GDP growth is now expected to average 2.75%/yr (previous f/c 3.0%), as the economy continues to transition away from growth dominated by mining capex to other sources, including housing, infrastructure spending and services. Non-mining capex spending continues to disappoint and income growth remains very soft as the terms of trade and wages growth slow.
- Growth in 2018 and beyond is expected to average around 2.75%.
- Inflation: Inflation in Australia remained very low through 2016, with the headline CPI at 1.3% in Q3 16 – well below the RBA's 2%-3% target range.
- For 2017 and 2018 inflation is expected to head back towards 2% on the back of slightly higher energy prices and any trend to better outcomes for wages.
- Monetary policy: The RBA's easing cycle is expected to have come to an end with the cash rate at 1.5%. Better growth in the US and concerns around housing financial stability are expected to see the RBA remain on hold for all of 2017.
- A very modest tightening cycle is expected to get underway in 2018.

New Zealand

Figure 17: New Zealand

	2017		2018		2019		Long Term	
%/yr	Consensus	EMR	Consensus	EMR	Consensus	EMR	7.8	EMR
GDP	2.9	3.7	2.6	3.4	N/A	3.0	2.5	2.8
Inflation – Core PCE	1.7	1.5	1.9	1.8	N/A	1.9	2.0	2.0
Monetary policy – Rates	1.7%	1.75%	N/A	1.75%	N/A	2.25%	N/A	3.5%

Source: Bloomberg.

- GDP: The New Zealand economy pick-up in the third quarter with a 1.1%/qtr print, growth is expected to finish the year at 3.1%/yr.
- The economy looks set to continue its upswing in 2017 and 2018 supported by continued strong population growth. Construction and Tourism demand will also remain supportive, however both sectors may begin facing capacity and skilled labour shortages potentially limiting the pace of expansion going forward.
- Inflation: NZ headline inflation remained very low through much of 2016 but surprised on the upside to come in at 1.3%/yr in Q4 16, back within the lower bound of the RBNZ's 1-3% target band.
- The stronger economy in 2017 and 2018 is expected to lift inflation further into the target band towards the middle of the range.
- Monetary Policy: The RBNZ cut the cash rate by a further 25 bps in November for a total of 75 bps of rate cuts in 2016.
- The RBNZ is now expected to remain on hold for 2017 and 2018 as the impact of easy monetary policy begins to drive inflation and growth higher.

ENDNOTES

1. Chair Janet Yellen, University of Baltimore, December 19, 2016.

DISCLAIMER

This document is directed at persons of a professional, sophisticated, institutional or wholesale nature and not the retail market. This document has been prepared for general information purposes only and is intended to provide a summary of the subject matter covered. It does not purport to be comprehensive or to give advice. The views expressed are the views of the writer at the time of issue and may change over time. This is not an offer document, and does not constitute an offer, invitation, investment recommendation or inducement to distribute or purchase securities, shares, units or other interests or to enter into an investment agreement. No person should rely on the content and/or act on the basis of any matter contained in this document. This document is confidential and must not be copied, reproduced, circulated or transmitted, in whole or in part, and in any form or by any means without our prior written consent. The information contained within this document has been obtained from sources that we believe to be reliable and accurate at the time of issue but no representation or warranty, express or implied, is made as to the fairness, accuracy or completeness of the information. We do not accept any liability for any loss arising whether directly or indirectly from any use of this document. References to "we" or "us" are references to Colonial First State Global Asset Management (CFSGAM) which is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124. CFSGAM includes a number of entities in different jurisdictions, operating in Australia as CFSGAM and as First State Investments (FSI) elsewhere. Past performance is not a reliable indicator of future performance. Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell. Reference to the names of any company is merely to explain the investment strategy and should not be construed as investment advice or a recommendation to invest in any of those companies.

Hong Kong and Singapore In Hong Kong, this document is issued by First State Investments (Hong Kong) Limited and has not been reviewed by the Securities & Futures Commission in Hong Kong. In Singapore, this document is issued by First State Investments (Singapore) whose company registration number is 196900420D. First State Investments and First State Stewart Asia are business names of First State Investments (Hong Kong) Limited. First State Investments (registration number 53236800B) and First State Stewart Asia (registration number 53314080C) are business divisions of First State Investments (Singapore).

Australia In Australia, this document is issued by Colonial First State Asset Management (Australia) Limited AFSL 289017 ABN 89 114 194311.

United Kingdom and European Economic Area ("EEA") In the United Kingdom, this document is issued by First State Investments (UK) Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registration number 143359). Registered office: Finsbury Circus House, 15 Finsbury Circus, London, EC2M 7EB, number 2294743. Outside the UK within the EEA, this document is issued by First State Investments International Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registration number 122512). Registered office 23 St. Andrew Square, Edinburgh, Midlothian EH2 1BB number SC079063.

Middle East In certain jurisdictions the distribution of this material may be restricted. The recipient is required to inform themselves about any such restrictions and observe them. By having requested this document and by not deleting this email and attachment, you warrant and represent that you qualify under any applicable financial promotion rules that may be applicable to you to receive and consider this document, failing which you should return and delete this e-mail and all attachments pertaining thereto. In the Middle East, this material is communicated by First State Investments International Limited which is regulated in Dubai by the DFSA as a Representative Office.

Kuwait If in doubt, you are recommended to consult a party licensed by the Capital Markets Authority ("CMA") pursuant to Law No. 7/2010 and the Executive Regulations to give you the appropriate advice. Neither this document nor any of the information contained herein is intended to and shall not lead to the conclusion of any contract whatsoever within Kuwait.

UAE – Dubai International Financial Centre (DIFC) Within the DIFC this material is directed solely at Professional Clients as defined by the DFSA's COB Rulebook.

UAE (ex-DIFC) By having requested this document and / or by not deleting this email and attachment, you warrant and represent that you qualify under the exemptions contained in Article 2 of the Emirates Securities and Commodities Authority Board Resolution No 37 of 2012, as amended by decision No 13 of 2012 (the "Mutual Fund Regulations"). By receiving this material you acknowledge and confirm that you fall within one or more of the exemptions contained in Article 2 of the Mutual Fund Regulations.

Stephen Halmarick, Chief Economist & GM Economic and Market Research, Colonial First State Global Asset Management.