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Stepping into a year of extraordinary uncertainties

The year of 2016 was full of surprises. Unexpected events came one after the other, followed by even more unexpected outcomes. We had “Brexit” in June, which led to a substantial drop in the British pound, yet the British FTSE100 index soared 16.36% since then as at the end of 2016 due to an improvement in export. We had Donald Trump being elected as the President of the U.S. in November which was a typical black swan event, but the U.S. futures market pulled back for only a few hours before it took off for the “Trump rally” which continued into January, pushing the stock markets to historical highs and the greenback to 14-year high. In December, the Italians said “No” to the constitutional referendum which was thought to be a critical event for the European Union, but the impact to the market turned out to be minimal. We expected the U.S. Federal Reserve to hike interest rate throughout 2016 but the decision was pushed back month after month and did not materialize until one year after the first hike in December 2015. Neither did we expect the deal for Organization of the Petroleum Exporting Countries (OPEC) to scale back production to come through. Yet against all odds it did, and crude oil price doubled from its lowest in February by the year end. However, there is no room to catch our breath in 2017, as it could well be a more disorienting year as we move deeper into uncharted waters. Numerous events are on schedule, results of which may rattle both the financial and political stability.

All eyes are casting on the rolling-out of Donald Trump’s policies upon his inauguration as U.S. President in January. He has been vocally hostile against China, free trade, current immigration policy and corporate overseas investment, while promising expansionary fiscal policy, massive infrastructure spending and lenient tax cuts. Even the FOMC minutes in December showed that half of the participants incorporated some of the above in their forecasts for the coming year, which may signal a more aggressive path of rate increases. Much of the possible impact from Trump’s electoral rhetoric has been priced-in in various asset classes, thus failure of implementation could lead to a reversal of the “Trump rally”.

In addition to the starting of official negotiations of “Brexit” in the first quarter between United Kingdom and European Union, several national elections in Europe, including that in France, Germany and Netherlands will take place in 2017. The results of which may reshape the political landscape of European Union as a wave of populism sweeps across the continent, and it could also be a pivotal year for the Euro.

Rising inflation would be another spotlight of the year. Persistent deflationary pressure and anemic economic growth in developed economies has been the very reason for their loose monetary policies in the past few years. However, recovery of energy prices are fueling headline inflation and improving PMIs figures are recorded from key economies. As the global growth and headline inflation rates start to gain momentum, the European Central Bank and Bank of Japan may follow the U.S. Federal Reserve in tapering of quantitative easing and interest rate normalization. Price of both equities and bonds (especially longer-dated government bonds) have been buoyed by the abundance of liquidity and low interest rate environment over the years, thus the normalization of these policies may mean headwinds to these asset prices.

China as one of the largest economies cannot avoid the limelight either. On one hand, the nation is benefiting from the uptick in the global industrial production cycle, as evident by the improving economic data such as Producer Price Indexes (PPIs), Purchasing Managers’ Indexes (PMIs) and industrial production. On the other hand, the alarming level of corporate debt may lead to investor aversion as cost of debt service can rise rapidly along with interest rate hike, and the expectation of yuan depreciation amid strengthening of USD will further expedite capital outflow and decrease China’s foreign-exchange, kicking off a downward spiral of market confidence.

We have only listed some of the key concerns above which can introduce substantial volatility to the market, but what can be more unpredictable is the market response to the outcome of an event, as we have witnessed in 2016. It would therefore be impossible to identify an asset class which would have a definite edge in a constantly changing investment environment, and a very cliché yet practical strategy would be to stay diversified and be defensive, with a long term vision for investment. Going back to the basics, a well-diversified long term portfolio should include equities with sound fundamentals, which selected Asian equities (such as that of India, Indonesia, China) fit into this category. Developed market equities such as U.S., European and Japanese stocks are currently at higher level but they still warrant a moderate weighting in the portfolio along with the revival of global economic growth. Fixed income assets, especially emerging market sovereign debts and corporate high yield bonds, are very constructive elements in any balanced portfolio in the current investment environment. Default rates should be low in a recovering environment, and the yield spread, despite narrowing, remain attractive as a source of stable income to investors. Finally, a small investment portion in precious metals and global natural resources may help in weathering extreme investment climate and delivering pleasant surprises over time.

TABLE 1: Global Stock Markets Performance

	2016 Q4 Return		2016 Return	
	Local Currency	USD	Local Currency	USD
Dow Jones Industrial Average	8.66%	8.66%	16.50%	16.50%
Euro STOXX 50	10.05%	3.37%	4.83%	1.76%
Euro STOXX 600	5.82%	-0.60%	2.30%	-0.70%
German Stock Index DAX	9.23%	2.60%	6.87%	3.30%
CAC 40	9.72%	3.06%	7.87%	4.27%
Nikkei 225	16.34%	1.17%	2.35%	5.83%
Hong Kong Hang Seng Index	-5.28%	-5.26%	4.28%	4.23%
Hang Seng China Enterprises Index	-1.94%	-1.92%	1.44%	1.39%
Shanghai Composite Index	3.31%	-0.76%	-10.50%	-16.33%
Shanghai Shenzhen CSI 300 Index	1.76%	-2.25%	-9.25%	-15.16%
Singapore FSSTI	0.79%	-5.01%	3.78%	1.65%
Korea KOSPI	-0.82%	-9.64%	3.44%	0.98%
Taiwan TWSE	0.97%	-2.47%	15.49%	17.36%
India SENSEX	-4.30%	-6.19%	3.47%	0.81%
Indonesia JCI	-1.07%	-4.87%	17.52%	20.34%
Thailand SET	4.24%	0.62%	23.90%	24.64%
Russia RTS	17.33%	17.33%	59.40%	59.40%
Brazil IBOV	3.19%	3.02%	38.93%	69.07%
S&P Pan Arab Composite Index	12.76%	12.76%	7.93%	7.93%
MSCI World Index	1.99%	1.99%	8.18%	8.18%

Source : Bloomberg (as at 30/12/2016)

TABLE 2: Major Currencies Performance (In terms of USD)

	Change in 2016 Q4	Change in 2016
	In terms of USD	
Euro	-6.39%	-3.18%
British Pound	-4.87%	-16.26%
Japanese Yen	-13.35%	2.79%
Hong Kong Dollar	0.01%	-0.07%
Chinese Renminbi (CNY)	-3.93%	-6.50%
Australian Dollar	-5.95%	-1.07%
New Zealand Dollar	-4.83%	1.51%
Singapore Dollar	-5.79%	-1.96%
Korean Won	-8.82%	-2.93%
Taiwanese Dollar	-2.77%	2.10%
Indian Rupee	-1.93%	-2.61%
Indonesian Rupiah	-3.13%	2.34%
Thai Baht	-3.15%	0.79%
Russian Ruble	2.58%	20.12%
Brazilian Real	0.35%	21.97%

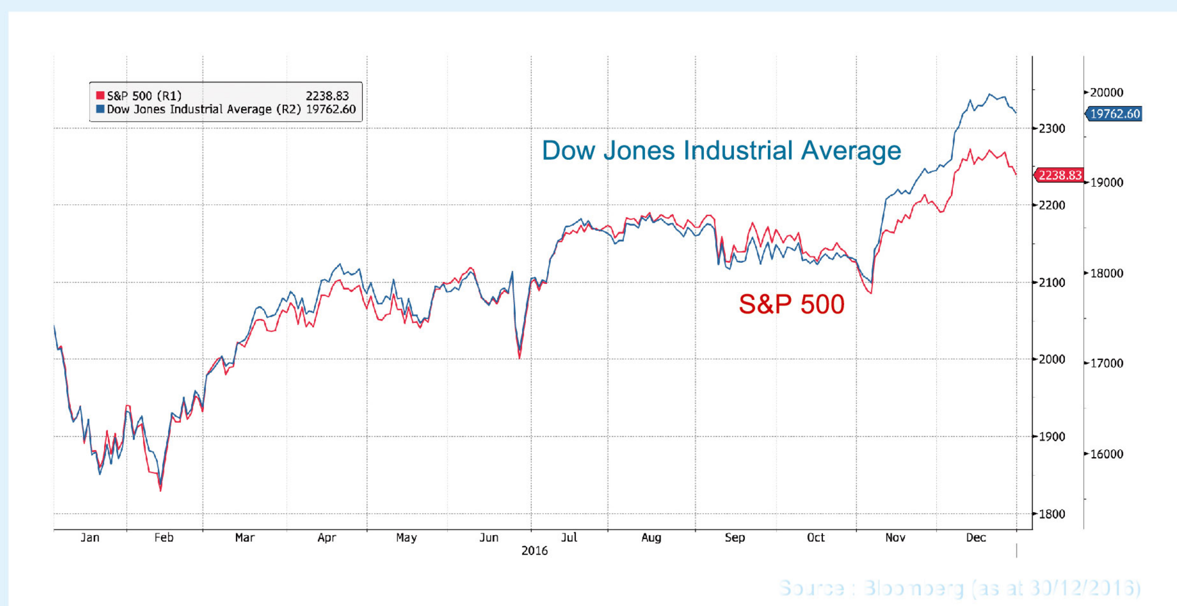
Source : Bloomberg (as at 30/12/2016)

Review highlights and outlook around the globe:

United States

- The result of the U.S. Presidential election was a huge surprise to the market. It marked yet another outcry for populism after the British referendum, and immediate market reaction was huge. The S&P 500 Index futures was down 5% on the election night triggering premarket circuit breakers, but thereafter the U.S. stock markets rallied, breaking record-high time after time since then. The Dow Jones Industrial Average and S & P 500 managed to deliver a stunning total return of 16.5% and 11.95% respectively in the year of 2016. Trump's election pledges on stimulus measures have been the main causes of the bullishness, but uncertainties on the fulfillment of his promises leave many investors skeptical, as practical roadblocks for execution are obvious.

EXHIBIT 1: S&P 500 and Dow Jones Industrial Average



- The Federal Reserve has finally taken the second step in interest rate normalization by raising 0.25% on the benchmark interest in December, which was a full twelve months after the first hike at the end of 2015. The FOMC minutes and the dot plot showed heightened hawkishness by the FOMC members, predicting that there will be three rate increases in 2017, as Trump's intended fiscal expansion was taken into account which may boost inflation.
- Headline Inflation rate has increased 1.7% year-on-year in November which was the fastest in two years, while the core inflation rate (which excludes volatile food and fuel costs) rose 2.1% during the same period. If supported by the continually robust labor market statistics and stimulus policies, coupled with rising energy prices, inflation for 2017 can head towards rapid upward trajectory.
- PMIs were strong and constantly improving for both the services and manufacturing sector. The ISM manufacturing PMI rose to 54.7 in December with overall manufacturing conditions improved to the strongest level in nearly two years. Trump's promise to bring back jobs which moved overseas has led to anticipation on fewer regulation and lower taxes, thus stronger business confidence. The ISM non-manufacturing PMI came in 57.2 in the same month which was well above the expansionary level and signaling strong growth.
- The Dollar index, which tracks the greenback against six major world currencies, rose to an intraday high of 103.82 on January 3rd. It was the highest level since December 2002. The encouraging PMI figures, which fed into expectations of a faster interest rate hike, had been the catalyst for the boost of the index. The index may struggle or retreat at this high level as profit-taking actions may take place, and the same will also happen if the Fed deviates from market anticipation and delay the next rate hike. The strength of the dollar has important impact on almost all asset classes, thus investors should pay special attention to its trend.

EXHIBIT 2: The Dollar Index

Source : Bloomberg (as at 30/12/2016)

Europe

- The Eurozone's manufacturing sector gained speed in December, posting its best reading since April 2011. The Final Eurozone manufacturing Purchasing Managers Index (PMI) rose to 54.9 in December from 53.7 in the previous month, in line with the earlier estimate. Growth was seen in different countries; moreover, the average PMI reading during the year of 2016 was 52.5, which was the highest annual average since 2010.

TABLE 3: Countries ranked by December Eurozone Manufacturing PMI

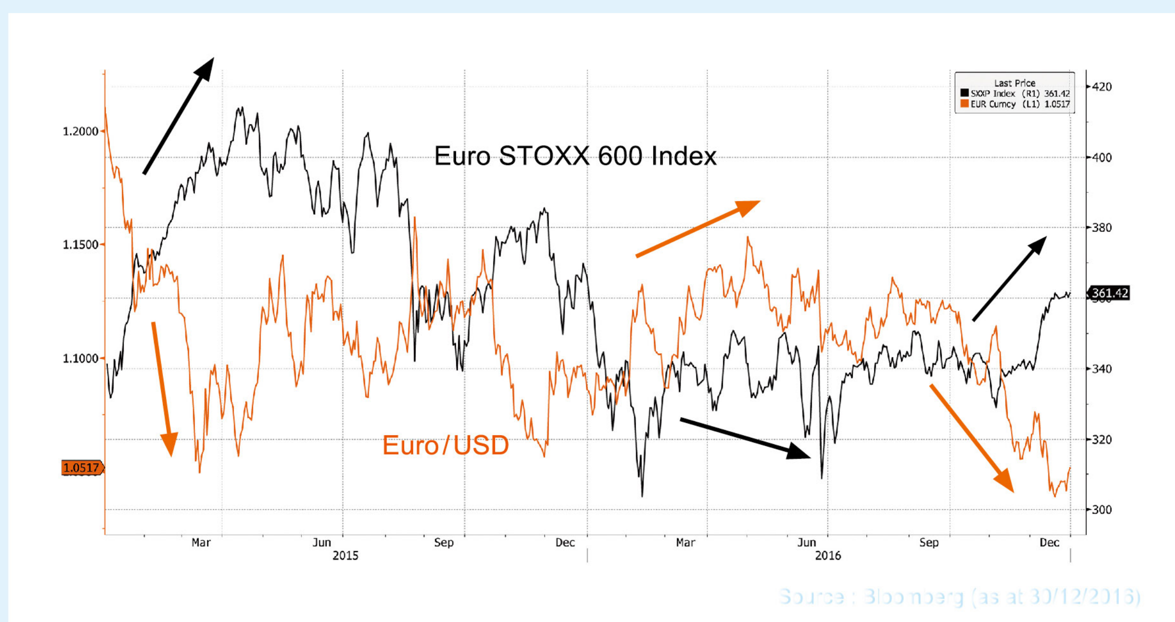
Countries	Manufacturing PMI
Netherlands	57.3 (68-month high)
Austria	56.3 (68-month high)
Germany	55.6 (35-month high)
Spain	55.3 (11-month high)
France	53.5 (67-month high)
Italy	53.2 (6-month high)
Greece	49.3 (4-month high)

Source: IHS Markit

- The Euro area economy advanced 0.3% in the third quarter of 2016, which was the same as the previous quarter figure and in line with the earlier estimate. Since several economic indicators showed positive growth, the GDP of the fourth quarter should have a stronger growth and this slow and steady growth trend is expected to continue in 2017.
- As widely expected, the European Central Bank(ECB) held its benchmark refinancing rate at 0% for the seventh straight time on December 8th meeting and extended its quantitative easing programme until December 2017. The ECB will maintain its asset purchase programme at the current monthly pace of €80 billion until the end of March 2017. However, starting from April 2017, the net asset purchases will be cut to €60 billion per month until the end of December 2017, or beyond, if necessary.

- One of the focuses in Europe in the fourth quarter of 2016 was the Italian Constitutional Reform Referendum. On 4th Dec, the Italian voters finally chose to reject constitutional changes backed by the Government and the Prime Minister Renzi resigned as promised. As the political uncertainty was cleared and supported by the weak Euro, the European stock market responded positively after the referendum which was in contrast to the expectation of most analysts. In December, the Euro Stoxx 600 rose 5.77% while the Italian FTSE MIB index jumped over 13%.

EXHIBIT 3: Euro and European stock market were negatively correlated



- The Euro fell over 6% in the fourth quarter as the divergence of monetary policy between the U.S. and Europe continued. The falling trend of Euro may continue in 2017 as it is believed that Trump's "American First" policy may further strengthen the U.S. Dollar. A weaker Euro may mean good news to Europe since it will improve Eurozone's competitiveness, growth potential and ultimately the long-awaited inflationary pressure may be triggered.
- The European economy seems to recover gradually; however, 2017 is set to be an election year for Europe as there are several crucial elections in The Netherlands, France and Germany. These three countries represent 56% of the Eurozone economy. The rise of nationalism and populism is obvious and there are growing trends of anti-globalism and anti-refugee in Europe. All of these may create political chaos and uncertainties which will affect the fragile economic recovery in Europe at the end. For these reasons, we would remain cautious towards the investment outlook of European equity market.

TABLE 4: Key Elections in Eurozone in 2017

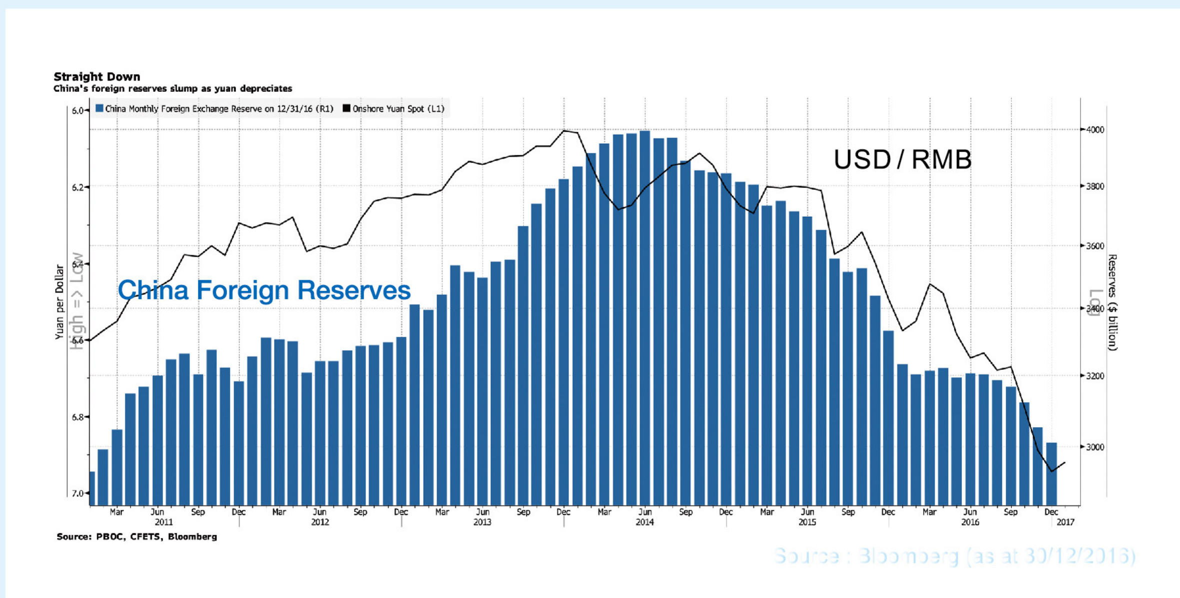
Date	Countries	Election type
15 March	Netherlands	Dutch parliamentary election
First round in April, runoff in early May	France	French presidential election
May 7 and 14	Germany	German regional election
The earliest possible date is in late August	Germany	German parliamentary election

Source : Bloomberg (as at 30/12/2016)

Asia

- The Japanese Yen was the worst performing major currency in the last three month of 2016 and it depreciated over 13% against the U.S. Dollar. As Japan is an export-oriented economy, the falling yen helped many companies in lifting overseas earnings when converted to yen and profit margins improved. As a result, the Nikkei 225 rocketed more than 16% during the same period.
- Currently, USD/ JPY is at around 115-120 level and it is likely to weaken further in the first quarter of 2017. However, the Japanese Yen is a highly volatile and unpredictable currency, we will only consider to increase Japanese equity exposure (with currency-hedged strategy) if the Japanese Yen appreciates significantly and returns to over-bought region.
- Along with Japanese Yen, Renminbi also depreciated and it dropped over 6% against the U.S. Dollar in 2016 and reached 8-1/2 year low. The foreign reserve also tumbled to $3.01 trillion in December, the lowest in almost six years. To manage the currency stability, the Chinese Government imposed various measures to control capital outflow. The latest one was introduced by the China's State Administration of Foreign Exchange on the last day of 2016. Although the annual foreign exchange limit of USD50,000 per person has not been reduced yet, individuals are now required to produce a more detailed and stringent explanation for what the funds will be used for after exchange.
- It is believed that the Chinese Government may further tighten capital controls if Renminbi outflow continues and it may become more difficult for mainland Chinese to buy foreign assets. As such, the Stock Connect program would be the major legal channel for making overseas investments. Under the current system, mainland Chinese investors can buy Hong Kong stocks through the Shanghai and Shenzhen stock link programs. The capital is automatically converted into Hong Kong dollars for the settlement of their stock purchase transactions. That would not take up their annual foreign exchange quota, and they do not need to seek approval for the use of foreign exchange. Besides, there is no limit to the amount they can invest through the program. Only when they sell the stocks will their funds be converted back into Renminbi and remitted to their onshore accounts.
- To a certain extent, the pressure of capital outflow in China originates from the concern of Renminbi depreciation and the mainlanders would like to protect their wealth. For this reason, the stock link program may be a good investment tool to serve this purpose.

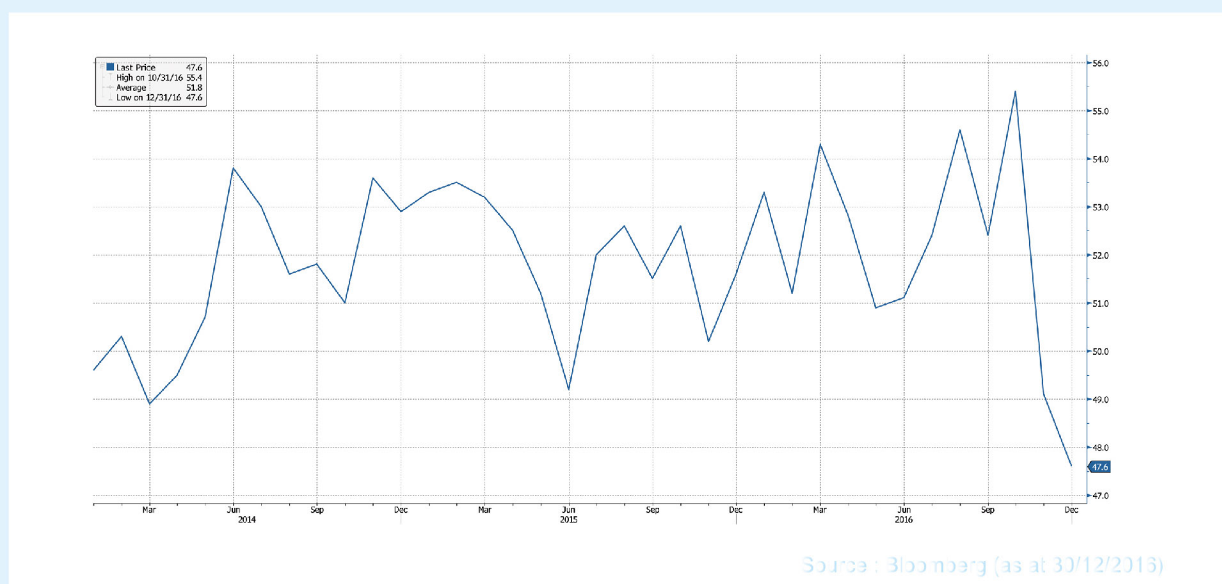
EXHIBIT 4: China Foreign Reserves slumps as Renminbi depreciates



Source: Bloomberg (as at 30/12/2016)

- In the third quarter, Hong Kong was one of the best performing global major stock markets. On the contrary, the Hang Sang Index dropped over 5% in the fourth quarter and has underperformed most regional markets. Despite there are still uncertainties ahead like the pace of the U.S. future rate hike, Trump's China policy and the stability of the China economic development, etc. which can impact the Hong Kong stock market, we believe that the valuation of the same is relatively reasonable at the current level and it may be a good timing to invest for medium to long term.
- India stock markets disappointed investors in the fourth quarter and the Indian SENSEX Index only recorded 0.81% gain in 2016. The main reason for the poor performance was due to the sudden launch of demonetization the 500 and 1,000 Rupee notes on 8th November, the same day that Donald Trump was elected as the U.S. President. The Modi government only allowed 50 days (between 10th Nov and 30th Dec) for the people to exchange above said Rupee notes in banks and post offices. Since India is one of the most cash dependent countries in the world which almost 90% of all transactions were conducted in cash, such sudden move had almost halted the country's normal business activities.
- Not surprisingly, The Nikkei India Services Purchasing Managers' Index fell for the second consecutive month in December 2016 and recorded at 46.8. With factory production also falling, the composite PMI shrank to 47.6, the lowest since September 2013.

EXHIBIT 5: Nikkei India Composite PMI fell below 50 in Nov and Dec 2016

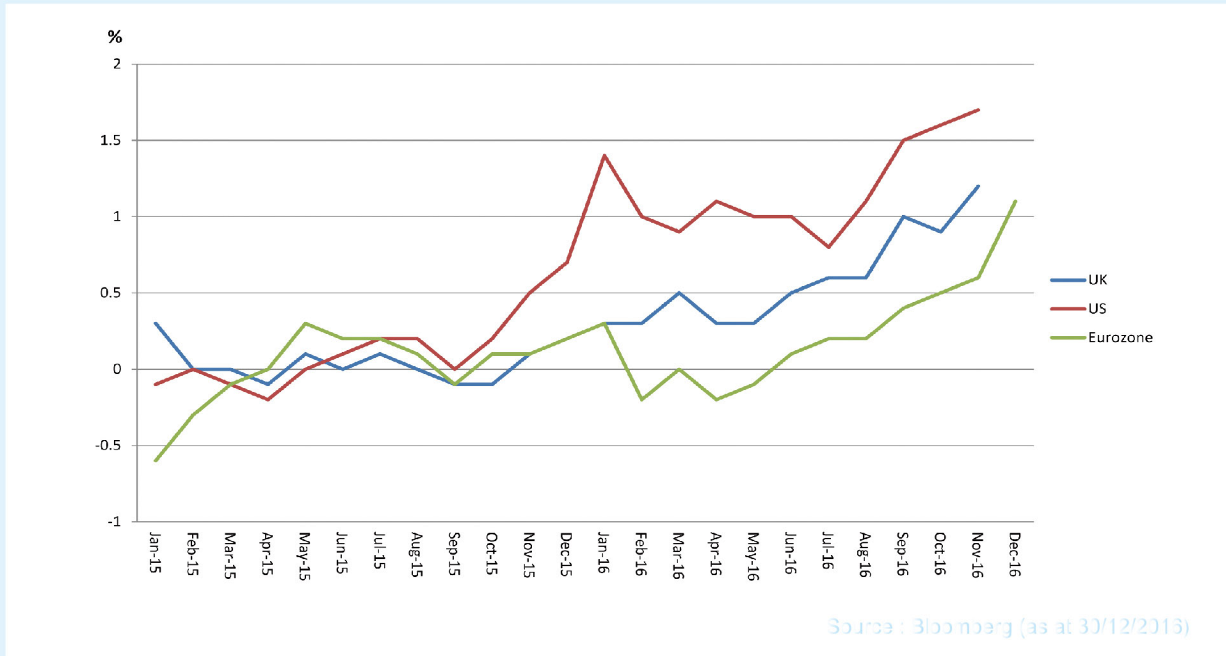


Source : Bloomberg (as at 30/12/2016)

Fixed Income

- After years of worrying about deflation in Western countries, inflationary pressure may return in 2017. According to the consumer price index of the U.S., Eurozone and U.K., the consumer price started rising in the second half of 2016 and the latest figures were at recent years high.

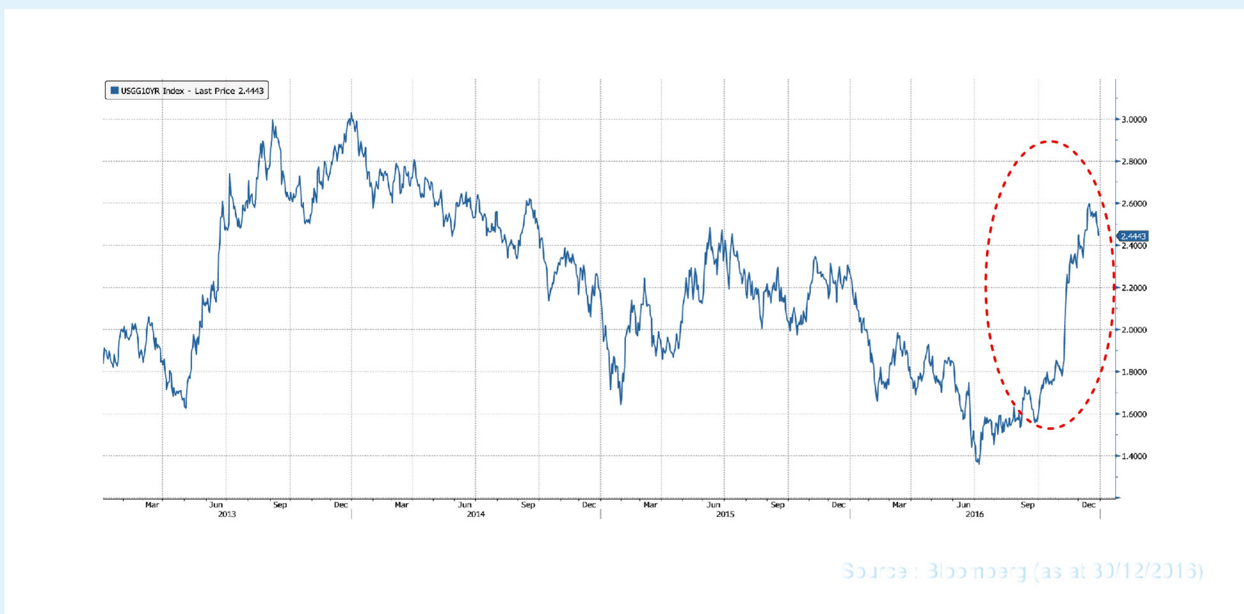
EXHIBIT 6: Consumer price index of the U.S., Eurozone and U.K.



Source : Bloomberg (as at 30/12/2016)

- Since the new U.S. president-elect Donald Trump proposed fiscal stimulus and tax cut to boost the economy, the market anticipated that it might trigger inflation and the pace of rate hike would increase in the future. The U.S. treasury yield responded to this message quickly and rose significantly in the last 2 months of 2016. We are not sure whether the market has over-reacted or not as we do not know Trump's exact economic policy as yet. We are not too bearish towards the investment outlook of government bonds of developed countries since it can always provide diversification function for the investment portfolio. However, it will be more prudent to select shorter duration bonds so as to reduce interest rate risk.

EXHIBIT 7: US 10 Year Treasury Bond Yield



Source : Bloomberg (as at 30/12/2016)

- High yield bond was one of the investment darlings in 2016. The Bloomberg Barclays Global High Yield Bond Index delivered over 14% return last year. The strong performance was mainly due to improved global economic and business environment and strong yield hunting demand. Global economic growth is expected to improve in 2017 and the default rate of high yield bond may remain low, but the yield spread between high yield bond and U.S. Treasury has already narrowed to 3.68%, which reflected that high yield bond price rose quite a lot in 2016. For this reason, we would hold a neutral view on the investment outlook of the high yield bond sector.

EXHIBIT 8: Yield Spread between U.S. High Yield Corporate Bond and 10 – Year U.S. Treasury

Average	Highest	Lowest	Last Quarter	Now
4.61%	8.40%	2.21%	4.58%	3.68%
（1/1/2010 — 31/12/2016）	（11/2/2016）	（23/6/2014）	（30/9/2016）	（30/12/2016）

Source : Bloomberg (as at 30/12/2016)

Commodities

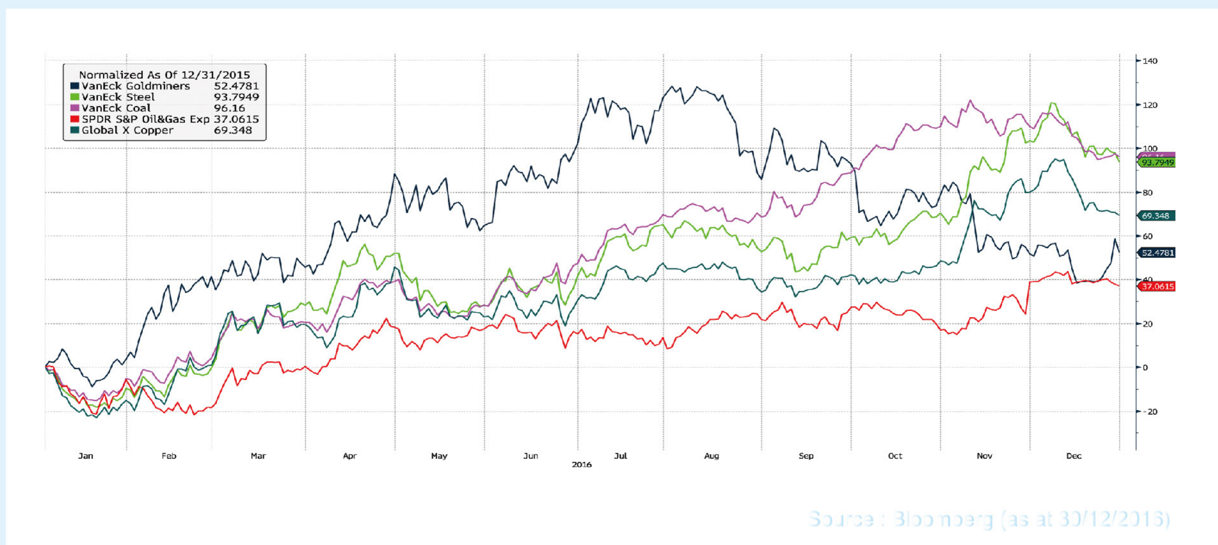
- Gold lost much of its appeal since the election of Trump. In fact, gold price dropped 10.2% between the election date and the end of 2016. The current market sentiment is typically bearish for this yellow metal. A soaring USD, a risk-on attitude at Wall Street, and an increased probability of a faster rate hike, all serve to increase the cost of this non-yield bearing asset. However, as the concern over the political developments in Europe grows, and skepticism on materialization of Trump's policies develops, couple with an increasingly inflationary outlook around the globe, gold stands a good chance in making a rebound in the next six months and may play an important role in risk mitigation for one's portfolio.
- An agreement on the production cut was reached among all 14 members of the OPEC at end of November to cut oil production to 32.5 million barrels a day, which was the first time in 8 years. Crude oil prices have plunged since mid-2014 and reached its lowest in February 2016, but as the deal was struck, oil price managed to make a gain after two years of consecutive loss. The floor-digging movement of oil price has hurt the oil producing countries substantially, putting pressure on them to work together to protect their interest. The price of WTI futures and Brent futures soared 18.77% and 22.51% respectively between November 29th (agreement date) and December 30th 2016. However, there has always been a level of obscurity on the stockpiles and global production level, so compliance from respective members and overall supply level would be hard to track, and the initial boost on price is apparently more a knee-jerk reaction at this stage. Beware also of the risk of backsliding, as U.S. may increase their shale oil production as encouraged by an uptick of oil price. We do not see any evidence of massive oil price surge in the near term, and one should not ignore the other side of the equation when forecasting the trend of oil price – the demand of crude oil, which is highly related to economic growth.

EXHIBIT 9: WTI and Brent oil futures

Source : Bloomberg (as at 30/12/2016)

- 2016 has overall been a good year for commodities, after years of sinking until hitting the trough in early 2016. Major commodity ETFs which average the companies in respective industry groups are congruent in reflecting the overall rebound of commodities, such as, SPDR S&P Oil&Gas Exp, VanEck Steel, VanEck Gold miners, VanEck Coal etc. We cannot identify a clear trend for commodities as a group at this stage, but we know that commodity prices were by statistics negatively correlated with the U.S. dollar and positively correlated with global economic growth. As the probability for the U.S. dollar to make substantial surge from current level is slim and moderate recovery of global growth is evident, we will remain cautiously optimistic with the outlook of commodities in 2017.

EXHIBIT 10: Performance of various commodity ETFs



Source : Bloomberg (as at 30/12/2016)

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