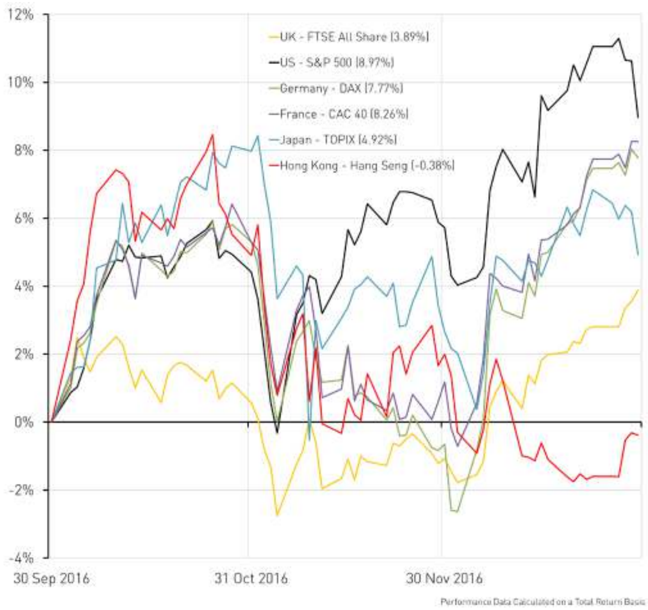
WINTER OUTLOOK

REVIEW OF THE PAST QUARTER:

Following strong US macroeconomic data, the final quarter of 2016 confirmed what investors had already priced in: an inevitable rate hike by the Fed in December and divergent global monetary policies. Perhaps the biggest surprise was the positive market reaction to Donald Trump's election win and the subsequent jump in expected inflation. With the anticipated emphasis on fiscal stimulus, we witnessed significant moves into the punchier, economically sensitive sectors such as banks and manufacturing. Irrespective of whether Trump's rhetoric will be realised and the time lag of policy implementation, inflation appears to have finally arrived. Current inflation can largely be attributed to oil trading above US$50, following the unilateral agreement to cut production.

"Hard Brexit" fears continue to weigh on the pound with UK equity markets only slightly up for the quarter. Performance within the Eurozone was mixed as generally positive numbers were offset by the uncertainties in Italy, where a rejection of constitutional reform resulted in the resignation of Italian Prime Minister Matteo Renzi and the failed recapitalisation and subsequent nationalisation of Monte dei Paschi di Siena – Italy's third largest bank.

Emerging markets sold off as the rising cost of debt, possible protectionism and expensive US dollar-priced commodities all took their toll.



ASSET CLASS RETURNS

UK	US	Japan	Europe	Emerging Markets	Commodities	Property	Corporate Bond	Gilts	Cash
+3.89%	+8.97%	+4.95%	+6.58%	+0.75%	+11.18%	+1.34%	-3.10%	-3.43%	+0.03%

THE ACTUARIAL VIEW:

Although UK markets appear to have done well despite the uncertainty of the year, when viewed from the outside this doesn't hold up, with the FTSE 100 underperforming the S&P 500 by over 10 per cent since June. In contrast, index-linked bonds have done exceptionally well, off the back of an increase in inflation expectations. Property markets have suffered, with falling prices and low liquidity causing issues for many investors.

This poor recent performance, has had the opposite effect on the asset-class prospects. UK equities have lagged international markets, despite the protection of a large proportion of earnings coming from overseas; this has led to an improvement for prospects, which in turn has led to a shift towards corporate bonds and UK equities and away from international equities. Similarly, there has been an improvement in the prospects for both emerging markets and Asia. Property prospects are still poor, but improving following valuation falls. Devaluation has likely removed the need for the Bank of England to introduce further cuts, meaning the recent rise in yields is perhaps justified. However, currently we believe there is little change in the prospects for either gilts or cash.

WHAT TO LOOK FOR IN Q1 2017:

- **Bank of England (BoE) Monetary Policy Committee meetings:** The next meetings are scheduled for 12 January, 2 February and 16 March. The BoE held on to its ammunition in the past quarter in anticipation of either an inflation shock or a recession risk to guide their policy.
- **Federal Reserve Meetings:** The next meetings are scheduled for 1 February and 15 March. The hawkish tone and predicted rates hikes in 2017 mean markets will be eagerly anticipating whether economic data continues to support the Fed's rate normalisation or otherwise.
- **Inauguration of President-elect Trump:** This takes place on 20 January, and the world will finally start to see if there is any substance to Trump's policies.
- **Eurozone elections:** Markets will be observing whether populism continues to dislodge the status quo during the Dutch elections scheduled for 15 March.

ASSET CLASS SCENARIOS:

UK EQUITY

Most Likely: Many market participants are predicting a tough ride for UK equities in 2017 due to the upcoming Brexit negotiations. Nevertheless, it is more likely that the near-term outlook for the UK equity market will continue to be dictated by the movement of global bond prices and the UK sterling/US dollar exchange rate. A looser fiscal stance and resilient consumer spending should further support a rally in equity markets.

Worst Case: Brexit negotiation will most likely make 2017 another volatile year. The domestic economy will slow down next year as consumers' purchasing power is eroded by imported inflation as a result of UK sterling's fall. There are, of course, some mitigating factors but consumer spending is the largest part of GDP, and the stress on UK consumers may outweigh the benefits to manufacturers and exporters.

Best Case: UK sterling has fallen sharply against the US dollar and euro this year, which provides a big boost for exporters and an opportunity for import substitution by domestic suppliers. At the same time, the UK remains a full member of the European Union with full access to the Single Market. For the time being, it is the best of both worlds for UK companies, with a very competitive currency and full access to the European economy.

GLOBAL EQUITY

Most likely: A Trump shift from monetary to fiscal stimulus could help global equities. The outperformance by defensive shares might be over and the baton will be passed to value. While US valuations are ten per cent above ten-year averages, almost all other markets are cheap by the same comparison. This means returns are likely to be strong globally, with the most powerful gains being outside of the US.

Worst case: Current high valuations offer little protection. Unforeseen risk-off events still have the potential to shake investor confidence and render valuation a backseat driver in market movements. In those circumstances, 'defensive' assets could outperform again irrespective of their valuations.

Best case: The expectation is that Trump will be more expansionary in terms of fiscal policy, while he is also expected to cut taxes. This is likely to improve global growth, which is positive for global equity markets. Stronger fiscal policy would worsen government deficits but lead to an increase in global inflation. Banks are an industry to watch. Of course slightly higher rates help, but there are hints of an easing of the regulatory burden that could allow more to be returned to shareholders.

EMERGING MARKET EQUITY

Most Likely: The market discriminates between those countries most and least exposed to the impact of potential US tariffs, with many of the least-exposed, such as Brazil and Russia, outperforming. A more stable energy market, political tailwinds and interest rate cuts also support those two countries. India struggles as monetary reforms take their toll. China manages an orderly devaluation.

Worst Case: The Federal Reserve raises rates twice, causing the dollar to strengthen and increasing outflows from emerging markets. Global investors rebalance their portfolios towards the developed world in anticipation of higher returns. The Chinese authorities struggle to control outflows and a disorderly devaluation becomes a possibility. Politics in Brazil and Russia deteriorate.

Best Case: Scepticism grows about the scale of Trump's fiscal programme, causing the dollar to weaken, while the Federal Reserve keeps rates at their current levels. Emerging-market currencies strengthen, with their economies seeing inflows as investors seek higher returns. Rate cuts in Brazil and Russia increase business investment and consumer spending, while China's demand for commodities remains solid.

CASH

Most Likely: The Bank of England keeps interest rates at their current level despite good economic data, due to fears of the effects on business and consumer confidence of triggering Article 50. With inflation around the 2 per cent target, investors lose money in real terms in cash.

Worst Case: Fears of the effects of triggering Article 50 grow and consumer spending falls while businesses announce relocation plans. A further rate cut follows to discourage saving, while inflation above 2 per cent ensures real returns from cash are more negative.

Best Case: The Bank of England admits it made a mistake in lowering rates after the June referendum and increases rates back to their previous level, producing modest increases in rates of return on savings accounts. However, after inflation is taken into account, returns on cash are still negative.

FIXED INCOME

Most Likely: Monetary policy in Europe and the UK remains supportive, while the US sees another rate increase. Yields diverge somewhat: in the US they drift higher at a slower pace than in the last quarter; while in the UK and core-EU countries, yields remain subdued as economic and political issues inspire more caution. Spreads drift lower in the UK and US as economic data suggests they will continue to operate near full capacity.

Worst Case: Trump's legislative programme, announced after his inauguration, gives a fresh boost of confidence to investors, with tax cuts more prominent than tariffs on trade, and yields falling further on expectation of a booming economy and high returns on business investment in the US. As a consequence of this optimism, US corporate bonds will do well.

Best Case: Poor economic data and concerns about major politico-economic events, such as the Brexit process and European politics in general, increase risk aversion in the markets, so core government bonds rally. Corporate spreads widen on fears of a recession, with the high-yield sectors suffering the most.

PROPERTY

Most Likely: In the UK, despite a rebound in December, commercial real estate is not expected to show any sign of growth. Volatility should still be present, especially if the government triggers Article 50 in March, as expected. Europe could experience the same uncertainty. In the US, real estate is still compelling despite the recent rate rise. Only quick rises will be seen as detrimental.

Worst Case: In the US, the Federal Reserve raises the target range quicker than anticipated by market participants, prompting a real-estate investment trust (REIT) sell-off. For UK investors this could be subdued by a stronger US dollar. Closer to home, any news related to Brexit threatening employment will hurt the office market, which is likely to be mirrored by gains on the continent.

Best Case: Trump focuses his inaugural address on growth and US consumers' spending power. If wage-growth data shows an uptick, this could be a tailwind for US REITs. Robust economic figures in the UK and a smooth start to the EU divorce negotiations would be positive for property.