HOVING & PARTNERS

WEALTH MANAGEMENT

QUARTERLY INVESTMENT VIEW

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1. Summary

Considering the major events of 2016 – Brexit, the Italian referendum, Trump and the rise of nationalist China – are they just a coincidence? **Things seem to change simultaneously and globally.** If so, does this give rise to a more nationalistic, protectionist scenario? That would be an important shift, requiring us to rethink almost everything and portfolios should be adjusted accordingly.

Entering 2017, sentiment has rarely been better. The election of Donald Trump has enhanced the feel good factor. Plainly, the equity markets are seeing that something "good" is coming. Maybe, just maybe, the market is realizing that for the most part deal maker businessmen, who know how to get things done, will be running the government for at least the next four years.

Deflationary forces are diminishing. The U.S. enjoys record employment numbers; U.S. wages are creeping up and strict immigration policies and enforcement should enhance this inflationary pressure. But also outside of the U.S., the economies in Europe and Japan have entered a cyclical upswing. We see already some inflation returning in Germany.

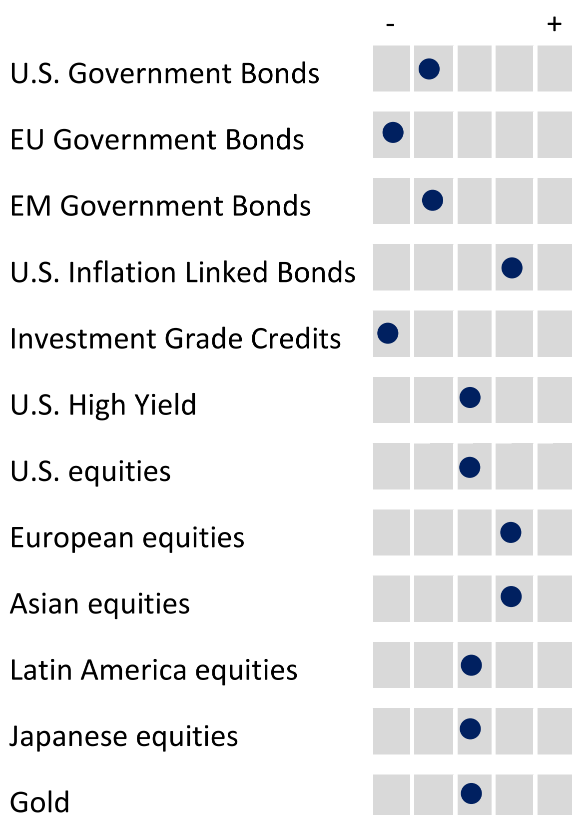
Monetary expansion is on its way out being replaced by fiscal spending. U.S. bond yields are expected to rise further with the 10Y-Treasury yield perhaps even rising above the 3% level. Be prepared for corrections in the equity markets if this happens.

At the February 2016 lows, stocks were cheap based on forward earnings. Currently, that is not the case, at least on a short-term basis. After the Trump Win equity markets rallied 8-10% from overnight lows, bullish sentiment has leaped, bearish sentiment has collapsed, expectations for economic growth have soared, the Fed has raised interest rates with the expectation for three more increases in 2017, and based on trailing earnings, most equity markets are no longer cheap.

While we believe the equity markets' earnings growth will allow stocks to grow into better valuations, **in the near term, there could be a market stumble.** This is just a short-term tactical trading call, because in the medium term we see limited downside as long as earnings come in somewhere near their estimated levels over the next several quarters. Any pullbacks should still be for buying, **as we expect 2017 to be a good year for equities.**

Our current strategy is to focus on the beneficiaries of an economic upswing and transforming world; from growth to value investing. Equities are the preferred investments over bonds as the latter still do not offer any value at the moment. Global stocks are likely to outperform U.S. stocks. Small cap stocks are preferred over large caps. Real assets such as Commodities and Real Estate represent value, as do emerging market stocks and more specifically Asian equities.

Asset Allocation



We remain positive on several secular growth themes; **1) Software** should receive a core exposure as companies are continuously cutting costs and manufacturing will become more software based. **2) Security** is a major issue and increasingly present to governments and large multinationals. **3) Payment systems** will undergo material changes moving from physical to digital. **4) Monitoring** and **connectivity** are getting increasingly more important as machine to machine communication takes off in sectors as healthcare and automotive.

The following would seem to be atop the list of concerns: Random Trump tweets and his temperament, shrinking global trade, China debt default, deficit expansion, strengthening US$, Russia's increasing presence on the geopolitical stage, China's increasing willingness to show military might, ISIS attacks, aging infrastructure, software security breaches. Europe still has to wrestle with massive immigration and socioeconomic issues.

2. The Trump factor

It will be difficult to predict the outlook for the U.S. economy under the stewardship of Donald Trump. There is no doubt that the President-elect has contrarian views that are upsetting the establishment. His business management style is reflected in the formation of his cabinet. The Republicans control both Congress and the Senate. This will help reducing red tape and over-regulation. Donald Trump is criticized with his open approach towards President Putin of Russia. Time will tell if this turns out to be the right decision for world peace. His views on global trade are more worrying. His aim to bring back manufacturing to the U.S. is positive, provided this is for competitive reasons. His policies to raise import duties – potentially hurting China's exports – will negatively impact global trade. Investors have taken a leap of faith that the combination of fiscal stimulus, infrastructure projects, deregulation and tax reform announced by the President-elect will spur U.S. growth, inflation and market inflows.

Trump may achieve many of his goals but markets seem to price these in now and these goals could take much more time to achieve than anticipated. There could be lots of disappointment later in the year.

3. Tectonic shift; from deflation to reflation

Global markets are at the beginning of a tectonic shift from deflationary expectations to reflationary expectations. What happens to economies at maximum debt when interest rates begin to rise?

Interest rates on the 10 year U.S. government bond soared from a low of 1.3% in July to 2.8% as bond investors anticipated higher economic growth and higher rates, causing bonds to lose value for the first time since the 2007 financial crisis began.

The last time there was a rapid increase in U.S. government bond yields was in 1994, more than two decades ago - catching investors unaware of the speed and pace of rate increases (under Alan Greenspan, the then Chairman of the Fed), caused the biggest losses on record (in the same year, U.S. equities also took a haircut).

This time around, the bond market faces a similar storm of potential changes to the bond curve, monetary policy tightening, and a “structural” return of inflation. This implies double-digit losses on bond holdings, sub-par growth and balance sheet risks.

Janet Yellen, the Chairwoman of the Fed, has kept rates low supporting the growth outlook. But the U.S. enjoys full employment and even risks “undershooting” the jobless level that keeps prices stable. Other regions like Europe and Japan are returning to growth and inflation is returning in Germany and Japan.

Stalking the Fed’s faster growth scenario is President-elect Donald Trump’s tax reforms and fiscal stimulus proposals.

In the last Fed meeting, three rate increases were announced for 2017. But policy makers face a world with high uncertainty.

The U.S. Dollar: Up or Down?

U.S. economic growth and interest rates are relatively high compared to Europe. This has supported a higher USD for some time.

We believe the big upward move in the USD against the EUR is behind us and we expect only gradual appreciation going forward as the Eurozone economy continues to recover.

Also, the last minutes of the FOMC showed that policy makers’ forecasts for rate hikes are dependent on the outcome of Mr Trump’s fiscal stimulus plans.

4. Stock markets

The U.S. stock market has had a roaring year, especially in the last two months. The European stock market had a mixed year overshadowed by political stress.

We believe the U.S. S&P500 is probably ahead of U.S. economic realities and a correction in stock prices is due in the next few months.

U.S. Small & Mid Cap companies remain promising with on average double digits earnings growth. The **Russell 2000** index tracker looks attractive, these stocks typically benefit from Donald Trump’s policies.

The **European stock markets** are relatively cheap on the basis of the low euro value, revenue growth of companies, very low interest rates and ECB stimulus.

Emerging market bond and equity funds were hit with redemptions when Donald Trump was elected. The fast rising U.S. Dollar lifted bond yields hurting U.S. Dollar denominated emerging market bonds.

The Mexican Peso and Turkish Lira plummeted to record lows. The fall of the Mexican Peso seems to be overdone. The fall of the Turkish Lira is more driven by political worries and probably the right reflection of its value.

Emerging market equities on the other hand profit from weak local currencies and higher commodity prices, should these prevail.

Although we remain positive on the U.S. Dollar longer term, we hedge overexposures against the EUR.

5. Commodities

After reaching a 13-year low of less than $27/barrel on 11 February 2016, the price of a barrel of Oil had increased to $53.72 by year-end, a spectacular increase of +99%. The price of Oil increased after Russia and Saudi Arabia agreed to reduce oil production. In the following OPEC meeting of 30 November 2016, production cuts were agreed upon, the first time since the beginning of the financial crisis.

On May 25 2017, OPEC meets in Vienna. The outcome may determine whether the Oil price will continue to climb or remain stable. Global economic fundamentals are improving, probably leading to more demand for Oil.

Goldman Sachs predicts a price of $59 a barrel for Brent crude over the next three to six months, with prices stabilizing in the longer term at around $55-$60. Prices above $60 are likely to cause a supply surge, mainly from the U.S. shale producers.

Populism, protectionism and potential escalation of political tensions pose a realistic threat to supply and demand of raw materials ranging from energy to metals.

Relations between the U.S. and Iran may escalate amid Donald Trump's stated desire to overturn the recent nuclear agreement with Iran. Venezuela faces a possible default hurting its output capabilities. China's demand for Oil may reduce due to an unexpected slow-down in China.

There are also risks to the supply routes that are vital to the flow of raw materials, such as the South China Sea, where the situation is escalating.

6. Outlook European Union

The deadline the UK has pledged for triggering Article 50 is end March 2017. Article 50 entails the formal notification to withdraw from the Union.

Talk of "hard Brexit" in which Britain foregoes access to a single-market for control over its borders has led to price falls in property and importers. The fall in the Pound Sterling (2016: -14%) helps exporters. The UK stock market, after initialing falling, recouped very quickly.

However, Article 50 has not yet been triggered and the outcome of political maneuvering may present some surprises:

German's political leaders – wanting to avoid a political shift to the right – may give in to pressures following their own immigration issues.

This year, Germany, France and the Netherlands face elections. The German and French elections determine the near-term outlook of the union. Right-wing parties want to stop the free movement of people within the union. The Schengen Convention signed in 1990 and put into effect in March 1995 is shared by the 22 union members and 4 associate members. This Convention has been the cornerstone of Germany's policies. It may cost Chancellor Merkel her re-election.

In Italy the loss of the Senate vote by Mario Renzi, who subsequently resigned, is a bad omen.

In the meantime Italy's banking system is "kaputt". Italy's banks have insufficient capital to cover bad debt. The nationalisation of Banca Monte Dei Paschi di Sienna, Italy's 3d largest bank, is against EMU rules. This political move is not going to solve Italy's structural problems. Mario Draghi's monetary policy have extended Italy's life line, but what has been achieved?

The single currency is under pressure as structural differences within the Union have not changed enough. If anti-euro forces and right-wing parties gain the upper hand in Europe, Germany may have to reassess its commitment to the single currency.

The Investment Committee

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Market Returns

Equity	**2016**
MSCI AC World Daily TR Net	9.0%
MSCI North America NR	11.6%
MSCI EUROPE NR	2.6%
NIKKEI Net Return	2.0%
MSCI EM NR	11.2%
SHANGHAI SE COMPOSITE	-12.3%

Bonds	
US Treasury	1.0%
Eurozone Sov	3.1%
Germany Sov	3.9%
USD EM Sov	9.9%
Loc EM Sov	0.6%
USD HY Corp	17.4%
EUR HY Corp	8.7%

Commodities	
ROGERS COMMODITY INDEX	11.6%
GOLD SPOT $/OZ	8.6%

Currencies	
USD - EUR X-RATE	3.2%
CHF - EUR X-RATE	1.5%
GBP - EUR X-RATE	-13.5%
JPY - EUR X-RATE	6.0%
NOK - EUR X-RATE	5.6%
AUD - EUR X-RATE	2.0%

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