Press on, but watch your step

2017 outlook from Lyxor ETF
2017: Press on, but watch your step

Interpreting the events of 2016 isn’t easy. Join the dots and you end up with a Rorschach Test. Looking forward might be simpler.

Global growth could be on the up as governments spend their way to further recovery. Expect equities to outdo bonds, but choose your targets wisely.

Markets are likely to be tactical, movements short lived and sentiment often surprising. You knew there had to be a flipside to the coin right? So many known unknowns mean you may need a strategy a little more refined than a headlong rush into longs.

Move forward with the fiscal push, but watch your step. Safe havens are few, so take precautions. Use hedges, limit your sensitivity to market moves and wear shorts wisely.

How the key events might pan out

Prepare for the fiscal push (Jan/Feb)
Synchronised, and supersized, fiscal expansion could be on the way

Ride the political wave (Apr/May)
Brexit and a wave of European elections are imminent

Tackle the Trump effect on EMs (Jul)
Protectionism, dollar strength and faster fed hikes await, but all is not lost

Don’t bank on (all) bonds (Feb/Mar)
2017 could be the year the government bond bubble finally bursts

Go further for yield (Jun)
So many potential game-changers could complicate the hunt for yield

Other things we are watching out for

Key questions abound: Can Trump deliver his policy agenda? How “hard” will Brexit actually be? Can Europe’s leaders push back the wave of populism? Will active managers stage a comeback? Growth may be on the up, but it’s likely to be a bumpy ride.

For more on what 2017 has in store, and more on the events that made 2016 a year of firsts for ETFs, visit www.lyxoretf.co.uk.

What’s next?

More key central bank meetings
Policy still has a vital role to play, keep an eye on taper talks in Europe

Further rate hikes
Watch out for hikes at the September & December meetings

Yet more crucial elections in Europe
All eyes turn to Germany in the autumn

Leadership transition in China
Expect further stimulus spending to pave the way for new leadership
Prepare for the fiscal push

Could global growth surprise to the upside next year? Forecasters certainly seem to think so. Synchronised, and supersized, fiscal expansion could hold the key.

The unlikely new leader of the free world won’t hold back if his campaign promises of massive infrastructure spending, corporate tax cuts and financial deregulation are anything to go by. Should he get his way in Congress – still a big if, despite the Republican Party’s majorities – it could extend an already unusually long expansionary cycle into 2019. Whatever happens, his first 100 days will be fascinating.

Elsewhere, China started sooner, and is likely to spend more. Old habits die hard; and painful long-term reform is on the backburner for now. Expect another push in October ahead of the leadership transition. Europe could arrive fashionably late. Rather like New Year’s Eve, Australia has already kicked off.

A great reflation could be under way. A great rotation from bonds into equities already is. Fiscal expansion favours equities over bonds, always has. Questions include how much upside is left, where to look for the next layer of opportunity and whether apprentice policymakers can keep their promises. The market is priced for perfection, but great expectations are often dashed.

In the US, valuations are already rich. Dig deeper for domestic opportunities in certain sectors (including financials, IT and healthcare) or factors, like Value. European stocks have room to grow now ECB support is assured. Further afield, select commodity producers and emerging markets could benefit as infrastructure spending picks up and oil and metals prices stabilise.

Global growth forecasts:

<table>
<thead>
<tr>
<th>Year</th>
<th>No stimulus</th>
<th>Fiscal Push</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>2.6%</td>
<td>2.9%</td>
</tr>
<tr>
<td>2017</td>
<td>2.9%</td>
<td>3.3%</td>
</tr>
<tr>
<td>2018</td>
<td>2.9%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>


Prepare for the Fiscal Push

Ideas to consider

Rotate to equities, fight inflation
Don’t bank on (all) bonds

Bondholders are staring down the barrel. There, we said it. We’ve kept quiet for years as people said “they can’t get any higher, surely?”, and called the bond market’s demise only to see yields get even lower. This time though, we’re sticking our neck out. Too many factors collide in 2017 for it to be anything other than the year the government bond bubble finally bursts. It could get messy.

The key factor will be developed world governments and their switch to fiscal, rather than monetary, policy to try to kick-start the next stage of their recoveries. Deflation and secular stagnation are distant threats, massive infrastructure spending and tax cuts are on the way. Full employment and mounting wage pressure will fuel the great reflation in the US. Faster Fed hikes, Brexit and ECB progress towards the QE exit door will gatecrash the government bond party. High valuations mean investment-grade credit may also be asked to step outside.

The correlation between US, Euro and global credit indices is high and likely to remain so for some time. Spreads will widen as yields rise. Shelter could be hard to find in the first half of the year. Keep your powder dry.

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Hedging with linkers, breakevens and floating rate notes could help you hold firm as the fiscal dynamics kick in, the impacts of higher energy prices are felt and rates start rising. Look to short-dated bonds to reduce your rate sensitivity. Use shorts to protect against, or exploit, losses.

Don’t bank on (all) bonds

Ideas to consider

React to rising rates

Market value of the global bond market since 1990

Source: Bloomberg, Lyxor International AM. Data at 3 January 2017. Past performance is not a reliable indicator of future results.
The UK should trigger Brexit in March. How they get there, and how “hard” it will be is yet to be confirmed. The process won’t be straightforward and its impact is almost impossible to predict. There’s no room for complacency.

The people will have their say in Europe from 15 March onwards. Can its leaders withstand the rise of populism? The March vote in the Netherlands is an early primer for what might follow. The political climate could change dramatically, and with it the eurozone as we know it. Elections in France are the major flashpoint. Heads could roll.

Unexpected outcomes were all the rage in 2016. It would be a surprise if we didn’t see any more surprises. Triumph and disaster are equally possible, so prepare your portfolio to treat them both the same. Reduce your risk by pursuing a strategy that limits your sensitivity to market moves. Minimum Variance indices could help.

We wish currency forecasters and investors luck in 2017. Calling what will happen after Trump’s inauguration, Brexit and the wave of European elections isn’t easy to put it mildly. It could be better to take the risk out of the equation with currency hedged strategies.

Someone once wrote about the need to keep your head when all about you are losing theirs. As an investor, 2017 could test your mettle.

Ride the political wave

Ideas to consider

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Pick your investments wisely
Go further for yield

As the surprises stacked up in 2016, so too did demand for higher-yielding assets. So many potential game-changers could make this year’s hunt even harder.

A rebound in energy prices and a more robust US economy point to higher rates, fewer corporate defaults and an improving outlook for US high yield bonds. They’ve shown their resilience before. The ride could be bumpy, but patience could be rewarded later in the year.

China surprises to the upside and reflation really kicks in. Look to hard currency debt and stay liquid.

Away from bonds, most companies are still growing or maintaining their dividends, rather than committing to large scale investment. Dividend growers – companies capable of sustaining and growing their payouts over time – are more resilient than bond proxies when rates rise. Use Smart Beta funds to pinpoint the high quality companies most capable of keeping their dividend promises.

Global yields

<table>
<thead>
<tr>
<th>Bond Type</th>
<th>Global Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Corp High Yield</td>
<td>6.1%</td>
</tr>
<tr>
<td>Global High Yield</td>
<td>5.9%</td>
</tr>
<tr>
<td>EM USD Aggregate</td>
<td>5.1%</td>
</tr>
<tr>
<td>Pan-Euro HY Euro U</td>
<td>4.3%</td>
</tr>
<tr>
<td>US Corp</td>
<td>3.4%</td>
</tr>
<tr>
<td>Peripheral Europe</td>
<td>2.9%</td>
</tr>
<tr>
<td>US Treasury</td>
<td>1.9%</td>
</tr>
<tr>
<td>Pan-European Aggregate</td>
<td>0.7%</td>
</tr>
<tr>
<td>German Bund</td>
<td>0.3%</td>
</tr>
<tr>
<td>10Y JGBs</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

Tackle the Trump effect on EMs

Having been a surprise haven for return seekers for much of the year, Trump’s victory forced EMs to confront possible protectionism, dollar strength and faster fed hikes. Temporary troubles await.

Yet the post-Trump tantrum may have been a little overdone, especially at the country level. A US-led reflation could prove positive for many EM assets, especially if deals limiting oil supply hold and metals prices climb as infrastructure spending ramps up. Oil prices can only travel so far however - US producers could fill the gap left by OPEC cuts.

Longer-term, the opportunity for further EM expansion is still great, as economies urbanise and modernise, while economic and political reforms come to fruition.

Be selective. Look to the countries leading the reform charge. Parts of Asia, like India and the ASEAN bloc and, to a lesser degree, Latin America could be well placed. Their eventual success will depend on the efficient implementation of reform. Investors have been quick to penalise those whose progress has stalled.

The short-term outlook has been clouded by recent events. Latin America’s prospects in particular would look very different from behind a wall. Geopolitical risk is never far from the surface. Havens could include countries less reliant on the US for funding or trade, but still well exposed to the current commodity rally, like parts of Eastern Europe.

Switch focus to the quality of the infrastructure

Urbanisation first, productivity is next

GDP per capita, USD, 2016

Urbanisation

Urban population, % of total, 2015

GDP per capita, USD, 2016

Brazil

Russia

China

India

Korea

Germany

United States

Single country equities

Smart Beta

Regional equities

Broad EM indices

Ideas to consider

Be selective

Past performance is not a reliable indicator of future results.
Knowing your risk

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Capital at risk
ETFs are tracking instruments: their risk profile is similar to a direct investment in the Underlying index. Investors’ capital is fully at risk and investors may not get back the amount originally invested.

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The fund objectives might not be reached due to unexpected events on the underlying markets which will impact the index calculation and the efficient fund replication.

Counterparty risk
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Concentration Risk
Smart Beta ETFs select stocks or bonds for their portfolio from the original benchmark index. Where selection rules are applied, the risk profile of the Underlying index may be concentrated. When a significantly high number of assets are allocated to one stock or sector, the impact of a downturn in the market can be materially increased.

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ETFs may be exposed to currency risk if the Underlying index is denominated in a currency different to that of the investment currency.

Liquidity risk
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