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2017 Outlook – Luck Comes To The Prepared

*'In the long history of humankind (and animal kind, too) those who learned to collaborate and **improvise most effectively** have prevailed' (Charles Darwin, 1809-**1882)***

Luck comes to the prepared

Being prepared means being ready to maximize your opportunities by trusting your intuition, being risk conscious but expecting good things to happen, and being swift and disciplined in execution. Ultimately, enjoying what you do is a key element as well.

Most of us would agree that we live in a world of extraordinary and substantial change – political, economic, and technological alike. In the midst of a media world driven by 'news and noise', with a correspondingly amplified impact on confidence and sentiment, many people are confused, feel disadvantaged and even threatened. There is a longing for any relief, ranging from a return to the 'good old times' to a desire for 'simple solutions for complex problems'.

However, we should not concentrate on the rear mirror view, as these are also times of unique and great entrepreneurial and investment opportunities. The growing performance and valuation disparities offer a rich field for active investors, be it in the real economy or capital markets.

The 2017 watch list

We firmly believe that the world will continue to be driven by macro rather than micro factors. Geopolitics, security, and macroeconomic issues will consequently require close attention. In any one particular calendar year, only a few things really matter, with everything else being temporary distractions. So let us share with you the five most important developments to watch in 2017:

- Mounting distrust in Western governments and 'global elites' – this is the most worrying, and there is no improvement in sight.
- Rising long-term government bond yields – the mother of all bubbles is overdue for bursting, with debt monetization set to follow.
- Falling corporate credit cycle – US monetary conditions are tightening, balance sheets deteriorating, and default rates rising.
- Increasing merger and acquisition activity – defensively addressing consolidation pressures (e.g. financials) and offensively addressing strategic positioning (e.g. China).
- Brexit – messy and negative for the UK, bringing the GBP down to EUR parity, followed by higher inflation and interest rates and recession.

Politics dominating economics

We expect a continuation of the nationalist and populist wave, coupled with further fragmentation of the traditional two-party system in Western democracies. Politics at large will not only matter again, it will unfortunately dominate economic rationale. Brexit was a political decision: economic expert opinion was not only consciously and actively put aside, it was discredited and belittled.

It is economic commonsense that without open trade and immigration there is no growth, progress or high and rising living standards. It is another matter altogether to explain this to a majority of voters, a task which is not only complex but has often proven impossible in the more recent past. The next US President should focus as a top priority on delivering sustainable bi-partisan solutions on taxes, trade, infrastructure, and immigration.

From a geopolitical perspective, there is a deeply worrying trend to be observed, namely the culture of strongman rule, with examples including Putin, Erdogan, and Duterte. However, as history has shown time and again, undermining state institutions and judicial independence does not lead to peace and prosperity. Western countries would be well advised to remain actively engaged, but in a principled and resolute manner, as subservience is by no means the way to prevail in the long run.

Reversing long-term debt cycle

Since the 1980s, the global economy and capital markets have benefited from falling interest and inflation rates and expanding credit, with the central banks making it easy to raise and service debt. Looking ahead, debt cannot be raised much, interest rates cannot be lowered much, and most importantly fiscal and structural policy have to complement unconventional monetary policy, if not take over from it altogether.

Monetary policy normalization is overdue and has been postponed due to anemic global growth (particularly in world trade), sub-par inflation, disruptions in developing countries, and a generally negative geopolitical backdrop.

We have entered the latter stage of the multi-year corporate credit cycle. Rising leverage and weakening earnings have resulted in a marked deterioration in fundamentals. Add to that the structural illiquidity of most fixed income markets, and you have a recipe for disruption, volatility, and losses once interest rates and inflation start to rise.

Cash is king

We think a highly defensive stance is warranted at present. High cash levels will protect against potential losses, and crucially will allow investors to be financially, intellectually, and emotionally ready to seize upcoming opportunities.

Rising interest and inflation rates and high-risk asset valuations are a bad combination. Capital markets are mean reverting from fear to greed and vice versa.

It is important to differentiate very carefully between uncertainties, risks, and opportunities. For instance, geopolitical heavyweights and hotspots such as the Middle East or China are major ongoing uncertainties – for some a risk, for some an opportunity, but a pertinent issue for almost everybody.

Financial industry – winners and losers

The health of the financial system and institutions is key as they are the cardiovascular system of capitalism. However, with banking services needed rather than banks, the dispersion between winners (a few) and losers (many) is set to accentuate.

If you are leveraged and loss making, the available options are reduced to: a) sell assets; b) raise capital; c) cut costs and generate revenues; d) change your business model and strategy; e) unwind and close down; f) do nothing and hope. Sadly, most have done the latter, primarily because there has been no relevant alignment of interests between shareholders and boards, particularly in the 'too big to fail' banks.

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If you would like more information or would like to discuss this in more detail, please don't hesitate to contact us.

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