CIO MONTHLY NOTE

December 2016

Higher US rates accentuate the positives in 2017

2016 was full of global political surprises that had ramifications for economies and markets everywhere. But is it all bad news?

Definitely not. Although it took many by surprise, a Trump presidency in the US could actually be good for global growth. President-elect Trump has announced the kind of significant fiscal stimulus that many central bankers, and even the IMF, have been urging in recent years. In response to this stimulus, combined with the proposed US corporate tax cuts, the market has started to price in upgrades for both economic growth and earnings estimates. This is positive for equities.

Given improved economic conditions in the world's, largest economy, the US Fed raised interest rates at their December meeting as expected (unanimous decision) and indicated they will continue to do so in a very measured way over the next 18 months targeting three more rate increases in 2017. While additional rate rises are anticipated, targeting three more hikes in 2017 will create some additional bond market volatility for investors. It now comes down to the pace of economic activity. The expected Trump-driven stimulus, combined with proposed corporate tax cuts, add to the case for higher interest rates in the US. Fortunately, the US economy is robust enough to sustain limited and prudent rate hikes. It is the rate of the rises that will create some nervousness. On a positive note, this does not look like a repeat of 1994 as there appears to be very limited signs of sustained price pressures. This is a good combination of drivers for equities.

Despite potential instability in Europe around the lead up to Brexit, and a possible looming "It-exit", we also believe global growth for 2017 will be revised higher on the back of US and the recent China stimulus.

The outlook for domestic equities remains constructive and we set a 6,250 target for the ASX300 by year-end 2017, with an improved profit cycle compared to the previous year. Commodity price rises will drive some earning upgrades for the current financial year. We also predict the Australian cash rate will be on hold at 1.5% until 2018 and it is simply too early to suggest the Australian economy is able to sustain the prospect of higher cash rates.

The higher interest rates in the US should put further downward pressure on the Australian dollar over time, which makes our exports more competitive. In general, a lower AUD will help drive domestic earnings higher. However, in the short term there is a complicated counter driver as the recent stronger commodity prices imply the AUD will not fall too far in 2017.

For the year ahead we expect equities to outperform bonds and cash given the expectation of global upgrades, which are positive for future earnings. We are pleased our various portfolios, in particular the high growth MicroCap strategy and the more defensive Contango Income Generator LIC (ASX:CIE), have both performed well in 2016. We anticipate that 2017 will be one of increased corporate activity in the local equity market with more M&A activity and also a strong pipeline of new IPOs.

From all of us here at Contango, we wish you all a Merry Christmas and the very best for your investments in 2017.

George Boubouras
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