2016 - what a year! Who would have predicted on January 1st 2016 that within 12 months the UK would have voted to leave the EU and that a reality TV show host/property tycoon would be waiting to wipe his feet on the doormat of the White House? And even if you did have such powers of perception, it would surely be a step too far to believe that equity markets might rise over the same period, in such extraordinary circumstances. Yet, rise they did.

However, positive markets over the year do not tell the whole story and 2016 was actually a "year of two halves". The general trend leading up to the Brexit vote in June was weak equity markets and strong gold and yen – all hallmarks of a "risk-off" environment for equities. The trend since the vote has been the reverse as markets rallied and gold plummeted.

This is our 2016 year in review where we summarise the key factors that have influenced markets over 2016 and look ahead to what might be in store for you in 2017.

Timeline – major market factors of 2016

The start of 2016 was dreadful for equities. You will recall that in August of 2015 China devalued the Renminbi, sending the markets into a tailspin, with worries about the prospects for growth in Chinese GDP. Then in early 2016, having promised not to devalue again, they did once more. Panic gripped the markets:

'Sell everything except high quality bonds. This is about return of capital, not return on capital. In a crowded hall the exit doors are small.' RBS 12/01/2016

All major indices tumbled (by mid-January FTSE 100 and S&P 500 had fallen more than 10%, whilst the Japanese Nikkei fell more than 20% and European markets fell c18%). At the same time Brent Crude had fallen to $27.67/barrel (off 30% over the month!), a low not seen since 2003 (the peak was in 2008 at around $145/barrel!). The world was in panic mode as "risk-off" sentiment hit the markets hard. Having pushed interest rates up once in 2015, China's move made even the Federal Reserve freeze what everybody assumed was the inevitable turning of the interest rate cycle.

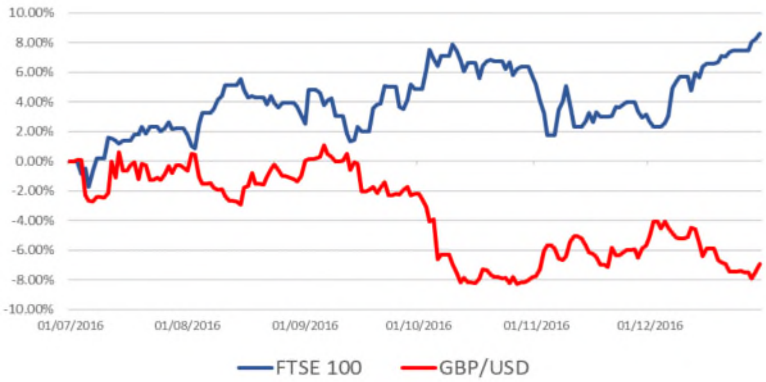
Yet this was all a knee-jerk reaction to China's slowdown and with hindsight a large overreaction. February saw world markets recover rapidly, as fears of a recession in the US receded and bargain hunters stepped in to drive prices higher again.

Date	Event
15/01/2016	Global equity markets lose $4tn in value - fears of China's economic slowdown
20/01/2016	Brent Crude hits $27.67/barrel lowest since 2003
28/01/2016	Bank of Japan embraces a negative interest rate policy
11/02/2016	S&P 500 down 10.5% since Jan 1
10/03/2016	ECB cuts interest rate to 0% and increases QE to €80bn a month from €60bn
23/06/2016	BREXIT - United Kingdom votes to leave the European Union
24/06/2016	$2.08tn wiped off global shares, sterling hits 31-year low
23/09/2016	Moody's downgrade Turkey's credit rating to 'Junk'
08/11/2016	Donald Trump is voted President of the United States
08/11/2016	Demonetisation in India - Lower denomination bank notes rendered obsolete
30/11/2016	OPEC deal to cut oil production signed
04/12/2016	Matteo Renzi loses constitutional reform bill in Italy
10/12/2016	Non-OPEC countries agree to join OPEC deal to cut global oil production
14/12/2016	US Federal Reserve raises interest rates - hints at 3 rises in 2017
21/12/2016	Banca Monte dei Paschi (world's oldest bank) shares suspended on default risk

At around this time the world was also starting to embrace the bizarre concept of negative interest rates. The European Central Bank (ECB) and the Bank of Japan (BOJ) continued to pump new money into their respective economies via quantitative easing (QE - a concept we haven't had to mention in a while!). However, this wasn't preventing huge deposits being hoarded by the banks, all of which had been told by their regulators to increase their capital reserves. Both central banks had already started to force down interest rates into negative territory (i.e. investors pay to lend to them!) and the traditional model and accepted order of banking was consequently turned on its head.

The Eurozone and Japanese economies were going through a similar process (no growth or inflation and a massive QE programme) and so it should be no surprise that their stock-markets fared very similarly (very poorly) over the first six months of 2016 (down 12.33% and 18.17% respectively – see below). Meanwhile the UK and US markets, with both economies "out the other side" of QE and showing good signs of growth also behaved in remarkably similar fashion, finishing the quarter up 4.2% and 2.69% respectively. The most notable point here is the massive divergence between the four major stock markets Euro/Japan and UK/US, an understandable reflection of these economies' different stages in the economic cycle.

Then we had Brexit. Not many saw it coming, us included. By midday on the 24th June $2.08tn had been wiped off the value of global companies as stock markets shuddered at the thought of the UK leaving the EU. However, the panic subsided as quickly as it had come as another knee-jerk reaction led bargain hunters back into equities. In less than a week markets were at a higher point than where they started before Brexit. Regardless of one's views about the longer-term benefits of Brexit, the biggest political upheaval in decades should have led (and still could lead) to far more volatility than it did. On 24th June sterling fell more than 10% in one day against the US dollar from $1.46 to $1.32. So why did markets, particularly the FTSE 100, bounce so quickly? Because 70% of earnings of the FTSE 100 are generated overseas in currencies other than sterling. Therefore, a one-off increase in the value of USD leads to a massive one-off boost to profits for FTSE 100 companies and investors piled in to take advantage of this quick-fix injection of revenue. However, it's only a one-off (unless USD moves higher again against GBP!).



FTSE 100 dances to the dollar's tune – UK equities rise and fall when the US dollar moves up or down

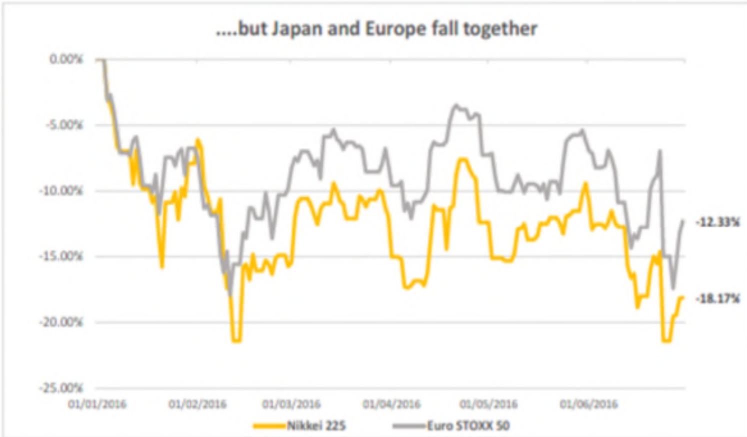
After the initial furor, the rally in global equities continued, save a few blips, for the whole of 2016. Then Brexit became yesterday's news as investors turned their full focus to the US election on November 8th and yet again the underdog came out victorious (a £1 bet on Brexit and Trump would have netted you 20 times your stake. Throw Leicester City's Premier League victory into the mix too and £1 would have netted £30 million!). We were far more sanguine about the market implications of a Trump victory. Trump was the pro-business and pro-economy candidate, regardless of how he proposes to actually implement his policies and balance the books. Whilst markets immediately toppled once again, a conciliatory speech by Donald Trump on the 9th November convinced serious investors that he has what it takes to drive corporate America on further still. Regardless of what you think of him as a person, his pledge to cut taxes and increase spending along with the proposed one off amnesty for US global corporations hoarding profits overseas wishing to move those profits back to the US has captured the imagination of "risk-on" investors across the world.

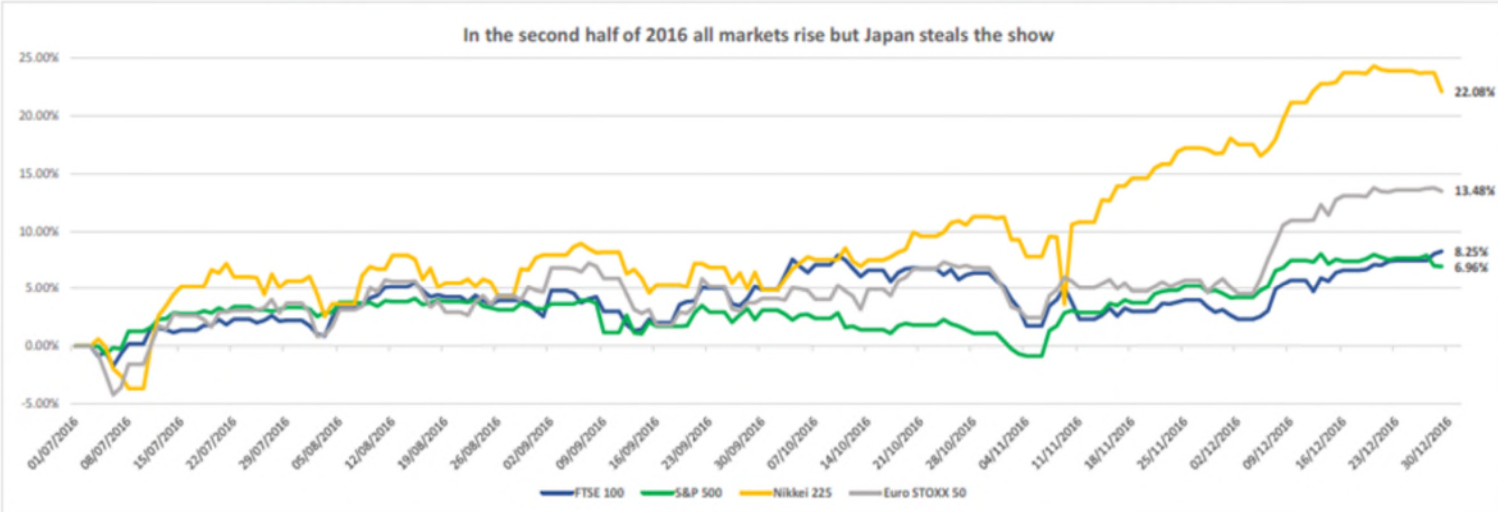
Yet, Trump's victory was not good news for all asset classes. Emerging market equities stumbled on fears that the dollar would rise further (ramping up USD based borrowings in their base currency) and fixed interest markets sank because of the expectation that a Trump White House would lead to significantly increased borrowing and higher interest rates (the 10-year US Treasury yield rose an enormous 11.3% the day after the election). President Trump poses significant risk for bond investors over the coming years, if strong US growth prospects continue.

In general though, Trump has been good news for investors, helped immeasurably by unemployment at 9-year lows and domestic economic growth amongst the strongest in the developed world. Trump or no Trump, the US economy was in rude health anyway. On December 14th, the US federal Reserve announced a widely-expected hike in interest rates from 0.5% to 0.75%, almost a year after the previous increase from 0.25% to 0.5%. Janet Yellen described the move as a vote of confidence in the US economy and, under Trump, the market is now expecting a further 3-4 rate hikes in 2017. So, Donald Trump's successful, if vitriolic, election bid has on balance proven the icing on the cake for bullish investors in the second half of 2016.

There has been other news, such as OPEC's deal to cut oil production, demonetisation in India, Italy's PM standing down after losing his constitutional reform bid and Turkey's downgrade by Moodys' to "junk" status. Yet most of this has been interpreted as no more than background noise when compared to the importance of Brexit and Trump.

Since Brexit, European and Japanese markets followed the same trajectory as each other, just a reverse of the first half of 2016. The result was a stellar second half for Japan after an abysmal first six months (the index was flat overall) and a good period for the





for equities given the magnitude of change implied by victories for Brexit and Trump.

However, developed market equities aside, it hasn't been good news for our currency. Sterling fell 27% during 2016, making our exports more competitive but ramping up inflation on imports. We believe that this is the clearest indicator of the financial markets' real views about the possible impact of Brexit on the UK economy. The prospects for the UK will be uncertain, regardless of current positive data and equity market movements.

Also, there is now real concern that the 30-year bull market in fixed interest investments has come to an end. We have lived through a period of ever declining interest rates, leading to massive gains for holders of government and corporate bonds. The interest rate cycle in the US has now officially "turned" and we expect that other central banks, including the Bank of England, will start to follow suit over time. This will make it difficult, but not impossible, to find reliable gains in the bond markets over the next few years.

The year ahead

What should you look out for in 2017? We urge investors to watch out for the following:

- Further volatility and probable weakness in sterling. Some hedge funds expect sterling to fall to $1.10. This may be a step too far but is certainly possible.
- Evidence that Trump can convince Congress and the markets that his plans for the economy are viable and credible.
- Further raising of interest rates in the US as the strength of the US economy forces the Federal reserve into further hikes.
- Continuing monetary stimulus from the Japanese and European central banks. We like the prospects for Japan more than those for Europe.
- Volatile and challenging fixed interest markets as interest rates increase in the US. Long-dated bonds will suffer more as interest rates rise.

By the end of this quarter Trump will have his feet under the desk and the initial timetable for Brexit should be available. Before then, caution is recommended. Markets have performed well and these two major influencing factors of 2016 will definitely be the key drivers of market returns in 2017 as well. We feel that a soft Brexit and a pragmatic Trump may lead to good returns for equity investors in 2017, at the expense of holders of government and corporate debt.