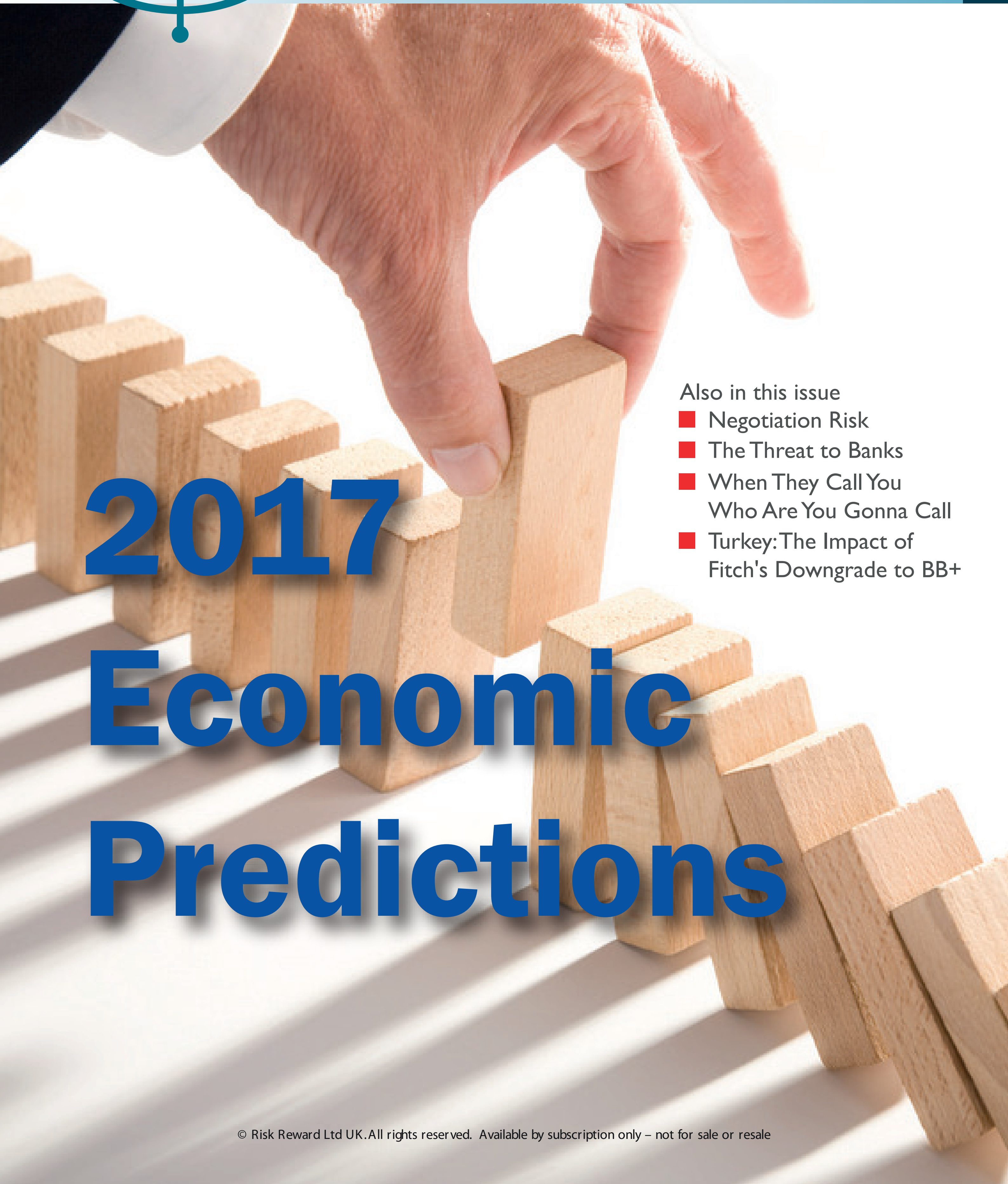
GLOBAL riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

Q2 2017



2017 Economic Predictions

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2017: Economic Predictions

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At last we are here, the actual year of living dangerously. 2016 was an unusual year where we had a variety of national elections each of which has perhaps a rather unanticipated outcome. There will be perhaps others next year. Why has this happened and what that will mean for 2017?

In the past few months the U.K. had the Brexit vote whereby a small majority the people rose up and delivered what was an unexpected result to both the government and the financial markets.

The UK wanted to leave Europe. It took the view that an unelected elite in Brussels and Strasbourg were ruling Europe in a way the UK could not understand. Of course at present we do not have Brexit or even the start of Brexit. Even if we start the process we need parliamentary approval and then the approval of all the European Union Member states. We will most likely achieve this, but will Brexit be the main issue on the UK government's agenda for 2017? Probably not.

Our view is that when everything settles down 2 years from now in 2019 Brexit and non-Brexit UK will look pretty much the same. There will be a few deckchairs shuffled around and perhaps the government will save a little money, but actually the UK will look much the same.

Also in the UK there was a leadership election(s) for the labour party with Jeremy Corbyn being elected with a little help from his friends. Again he was not the centralist candidate and had not been expected to win. Multiple, socially diverse voices rose up and delivered what was an unexpected result to the markets.

These voices took the view that an elite were ruling the labour party in a way they could not understand. They voters thought of themselves as the rank and file. They were the Labour party. They needed a leader that was more like them.

But in fact Jeremy Corbyn is not like them. He is a career politician who has been on the edge of the Labour party for years. In 2019 when this all settles down the Labour party will go back to being much the same. Again a few deckchairs will have been moved around but nothing will really change.

The USA presidential election produced a new President elected with a little help from his friends. Again he was not the centralist candidate and had not been expected to win. Again we found that multiple, diverse voices rose up and delivered what was an unexpected result to the ruling establishment and financial markets. Again people took the view that an elite were ruling the country and that they 'wanted their country back.' They wanted change and the new President campaigned on a change platform.

But he isn't one of them and It is not expected that he will deliver change. In 2019 when it all settles down the USA will go back to being much the same and again after some deckchairs will have been moved around.

Why in 2019? Because we believe that is the beginning of the next long term economic trend (2017 and 2018 being the end of the period after the last trend or the period before the start of the next trend, the period of maximum uncertainty. These next 2 years are the period of living dangerously.)

We foresee Increasingly key roles in both government and the international business community will be held by people without the background or skills to react rationally to extreme changing circumstances.

In these upcoming two years we are entering the period of rising interest rates, a massively indebted global community, fixed rate housing loans in the USA, increased global unrest and with banking regulations designed for a different environment. Not a good scenario.

So here are our predictions for 2017 and 2018:

(1) Rising Interest Rates

There are two possible scenarios. Either interest rates will rise slowly or they will rise quickly. If there is inappropriate intervention they will rise more quickly then they would have done. Our expectation is that LIBOR interest rates will increase by 175 basis points in 2017 and 250 basis points in 2018. However since at an increase in interest rates of 125 basis points the debt crisis in the USA will become unsustainable we will have to see if the preventative action required will be taken on a timely basis. Our concern is that actions will not be executed quickly and we could easily see a spike in interest rates.

We are concerned that the US housing loan market is dominated by fixed rate loans. If interest rates rise the result will have perverse outcomes: for example at this point nobody repays their loans early any more. They just hold them and continue to repay them if they can. If they try to refinance and move to a new loan it would be at a higher rate so better to not change lenders. This also means the housing market slows down and we can see both increased unemployment and unfilled job vacancies. Sounding familiar? This is the market we believe we are moving into.

For the US banks and quasi governmental bodies the problem is obvious. If you are giving out housing loans at around 3.5% you cannot afford an increase in funding of 125 basis points. It renders the industry unprofitable and unsustainable. So the stress interest rates for LIBOR are 7% in 2017 and 13% in 2018.

(2) Fixed Income Bonds

In an interest rising environment you can only issue bonds where the price is maintained due to the redemption value. That means an average maturity of no longer than 18 months. The problem is that the market is used to longer dated paper which will disappear because there is never a right time to buy it. It will always be better value tomorrow. Of course when you are talking about debt issuance the key issuers are governments and it is not in our opinion possible to fund the global debts with short dated notes. That would suggest we will get defaults but probably not in 2017, or at any rate not early in 2017.

However in 2018 we do expect both defaults and extensions to existing paper issuance. Neither year will be good for fixed income bonds.

(3) Gold

As a consequence we do expect this to be a market where certain commodities will be seen as a safe haven from the world's financial turmoil. We would expect gold to strengthen by 10% in 2017 and this trend to continue into 2018.

(4) Oil

The oil price has never been harder to predict. 2017 and 2018 will not be years where there is global growth so no increase in energy usage can be anticipated. At the same time a reduction in energy usage through changing power production will also make a small difference, but this is only at the peripheries. They key issue will be the continued global unrest and whether OPEC can manage its members effectively. In combination we expect 2017 to be a year of benign decline for oil ending the year around $43 and probably not much different in 2018.

(5) Stock Markets

This is a time when defensive stocks will perform well again. The stock market will rise primarily due to the lack of a real alternative for most people. We expect the FTSE to increase by 9% in 2017 an

The outlook is bumpy and inflation will start to kick in during 2017. With a fair wind and competent people the results will not be too bad. However this is the period of perverse outcomes and we do have other key elections upcoming in Europe.

Risk Reward Limited has provided high-quality, service excellent, good value guidance to banks, insurers and asset managers worldwide for more than 15 years and can provide you with the help you need to navigate these difficult waters. Contact our London or Miami offices to arrange a preliminary consultation.

The author invites comments via email to
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