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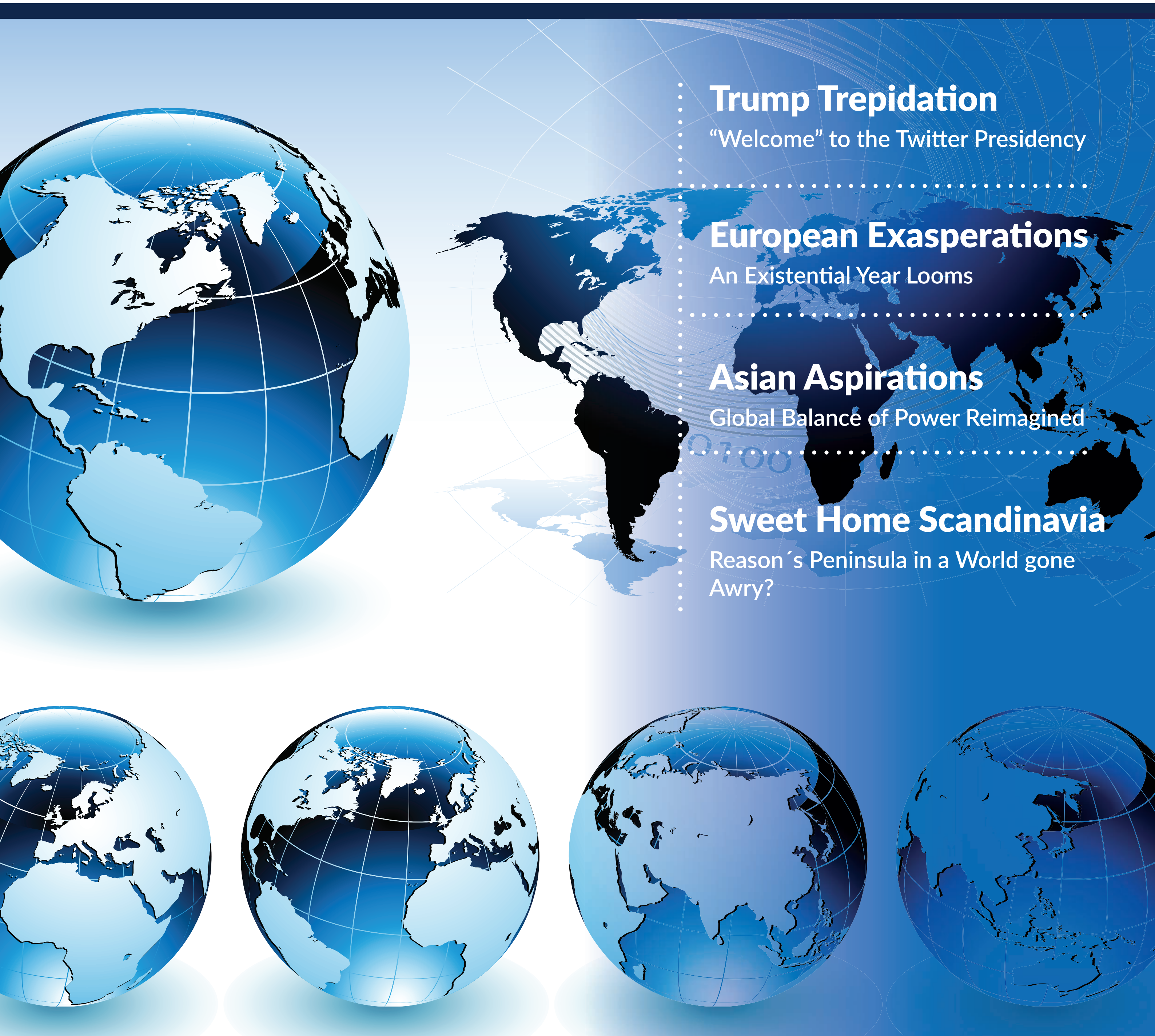

Trump Trepidation
"Welcome" to the Twitter Presidency

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An Existential Year Looms

Asian Aspirations
Global Balance of Power Reimagined

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The Age of Uncertainty

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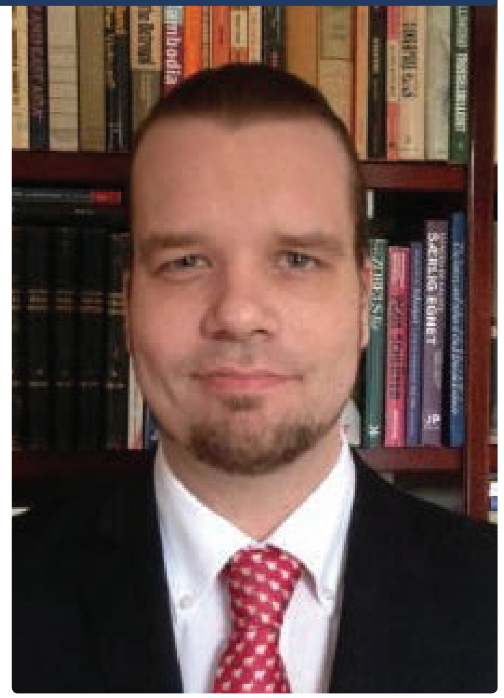
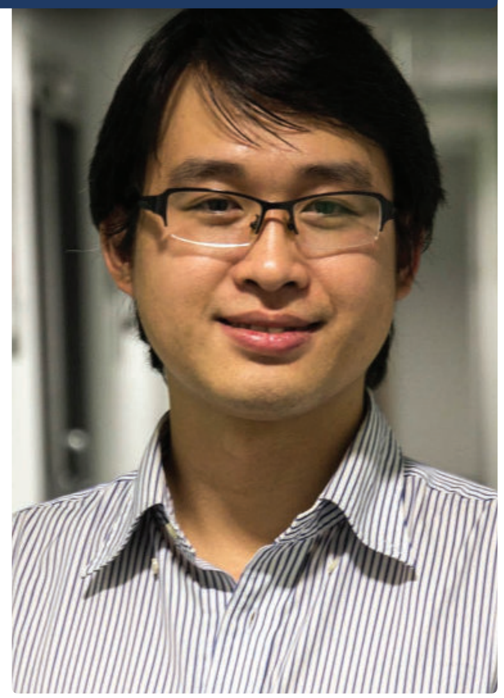
The Authors:

GLENN W. LEAPER, PHD
AUTHOR



Glenn W. Leaper, Associate Editor and Political Risk Analyst with Nordic Business Media, completed his Ph.D. in Politics and Critical Theory from Royal Holloway, University of London in the summer of 2015. He is involved with a number of initiatives, including communications consulting, journalism and writing his post-doctoral book. Glenn currently resides in Vienna, Austria, having an international background spanning the UK, France, Spain, Belgium and Denmark. He holds an MA in English and a BA in International Relations.

JINGCHAO ZHOU
AUTHOR



Jingchao Zhou, Public Communications Consultant with the United Nations, holds an M.Sc. in Economics from Vienna's University for Business and Economics with a main focus on emerging markets and sustainable development. His previous work includes acting as Chief Information Officer and co-founder of StartUs, a professional career network platform where he was instrumental in establishing key information management systems. Jingchao currently resides in Vienna, Austria.

HEDGENORDIC

INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals and those who take an interest in the region.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars for investment professionals.

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February 2017: Sustainable Investing
February 2017: CTA & Macro Strategies
March/April 2017: Nordic Industry Report
April 2017: Multi Asset Investing
June 2017: Real Assets
September 2017: Tomorrow´s Hedge Fund
November 2017: Equity Strategies

CONTACT:

Nordic Business Media AB
BOX 7285
SE-103 89 Stockholm, Sweden
Corporate Number: 556838-6170
VAT Number: SE-556838617001

Direct: +46 (0) 8 5333 8688
Mobile: +46 (0) 706566688
Email: kamran@hedgenordic.com
www.hedgenordic.com

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The Editor...

"Vox Populi": Risk in the Age of Uncertainty

2017 dawns on a very different world than that which was anticipated and priced in at this time last year. Though Donald Trump was leading in the GOP primary polls, most political experts attributed his rise to his buffoonish antics, an overzealous media and an angry fringe minority who could not be taken seriously.

David Cameron's UK referendum to remain in the European Union looked like an astute move that would further cement his premiership following re-election by a wide margin just the year before, silence naysayers and allow for more negotiation space both vis-à-vis the EU and the British people. And Mateo Renzi looked set to end years of political instability by leading Italy into a more pro-European future through sheer technocratic competence by comparison with his immediate predecessors.

Mr Trump is now president of the most powerful nation on earth, the EU has suffered a mortal wound while Mr Cameron's successor Theresa May scrambles for a deal to avoid sinking the UK economy, and the idea of repackaging the EU for a new generation is now as invisible as Mr Renzi himself. "The people have spoken," those backing Brexit, Mr Trump and other populist movements that will be of consequence in 2017 like to say. And yet, the results in 2016 were not decisively in their favour – Mr Trump won the Electoral College by a handful of close states (while losing the popular vote by close to 3 million), while Brexit was decided by under 52% of the British vote. This suggests that while the headwinds are certainly with the populists, they do not enjoy the popular mandate they imagine. It also suggests the 2017 political landscape is also far too close to call and rife with uncertainty – and that investors and prognosticators, not to mention the political establishment, will be far more careful in making assumptions.

"The pricing of political uncertainty has moved from being an emerging market issue to an emerged market issue," suggests Axel Weber, chairman of UBS. He urges investors to think about the difference between "risk" and "uncertainty": political risk refers to events that can be predicted with a certain probability; uncertainty refers to unknown future shocks. Properly speaking, then, 2016 was a year of 'political risk', where what was predicted with good probability turned out to be wrong. 2017, then, is very much a year of uncertainty, with potential aplenty for future shock: Would the EU be able to survive a win for Marine Le Pen in France? At what cost will Trump pursue the protectionist, isolationist and antagonistic policies he pledged in his campaign? How do other major players in the world such as China react to a major geostrategic realignment in which consensus policies subtending the globalization of the past 25 years no longer hold?

Investors used to think of emerged markets as a haven of stability, as opposed to emerging markets as fraught with political risk. No longer. The uncertainty in emerged markets themselves can no longer easily be priced in or hedged.

Ergo, this Nordic Business Media mini-report on Political Risk in 2017: The Age of Uncertainty.

Uncertainty, of course, can also mean opportunity. But risk diversification will be essential, which is why this report attempts to gauge and work through some of the major implications of last year's consequences for this year's events. We look at the possible effects of the Trump presidency, questions surrounding what will be a fateful year for Europe and how some of the major global players are likely to react. We also look at Scandinavian reactions and consider whether pragmatism may be the only adequate response to a world changing almost beyond recognition. For does the Vox Populi truly know what it wants to replace the "old world" with?

It's going to be a bumpy ride. We hope this report will be of assistance in hedging bets.

Glenn W. Leaper, PhD
Nordic Business Media

www.hedgenordic.com - January 2017
NORDIC BUSINESS MEDIA

Trump 'em All

by Glenn W. Leaper, PhD

Top of the agenda for conceptualizing political risk in the year ahead is the great unknown represented by President Trump. Having begun his first hundred days and with his cabinet in place, his legislative agenda is now expected to take shape beyond the populist but often unrealistic policy promises made during his campaign. Whether he will be able to enact this agenda, despite the Republican sweep of congress - particularly in terms of foreign policy realities, the global economic repercussions of an isolationist United States, and the domestic protectionist framework in which he has couched his proposals - is the question that will dominate the risk forecast this year.

BUY LOW, SELL HIGH

As if the campaign had not sufficed to vent his inner id, Mr Trump's penchant for reckless statements is unlikely to be tempered by the decorum of the office he has assumed. At least, initially. An indication of the risk associated with his sheer temperament was a story late last year that vigilant Wall Street traders and hedge funds are developing trade algorithms to parse through his tweeting. This followed tweets he had issued on slashing funding for the Lockheed Martin F-35 fighter jet program (a central component in the planned overhaul of America's nuclear triad) - causing the company to lose $4 billion in value - and Boeing's stock taking a dive after he announced that the cost of Air Force One was too high. This was either instinctively rash or disingenuously populist, but it was a portent of things to come in the 'Twitter presidency' (Lockheed Martin CIO Christopher Li promised to re-negotiate costs).

"The immediate concern for investors will be the reaction of the U.S. Federal Reserve, which was expected to increase interest rates throughout 2017 as a reaction to the stronger dollar."

Markets tend to self-correct, as they did in the case of Boeing, but such is the unpredictability of what Mr Trump might say or do that it remains difficult to chart a clear, consistent outline for either his domestic or foreign policy – despite, or rather because, of what he says – and not least in light of previous norms and rules of engagement for an American president. Buy low, sell high for eight years, was the tongue-in-cheek comment among traders following the aforementioned twitter incident. The fundamental question, though, is what can happen when Mr Trump's unguarded personal vision collides with international, domestic and social realities, a legislative procedure to which he is not accustomed, or the conflicting personalities appointed to his Cabinet. Traders will likely have their hands full keeping up, not least due to the immediacy of social media and his addiction to communicating personally on it, where what he says may not reflect policy – or inadvertently change it. "The whole age of computers has made it where nobody knows exactly what's going on," he said recently, addressing Russian cyber-attacks his own intelligence services have concluded helped get him elected.

U.S. markets traded at record levels following Mr Trump's victory (with some hedge funds reacting ebulliently, quickly spotting opportunities), showering him with premature praise despite the uncertainty and previous broad preference on Wall Street for the more likely market and other stability offered by Mrs Clinton. For now, the market is anticipating the lower corporate tax rates and regulatory easing promised by Mr Trump, and thus better profits. The immediate concern for investors will be the reaction of the U.S. Federal Reserve, which was expected to increase interest rates throughout 2017 as a reaction to the stronger dollar, but is now likely to try to accommodate monetary policy to a more bullish market and higher inflation in consequence of Mr Trump's anticipated economic policies (see pp. 7-8). Despite being critical of Fed Chair Janet Yellen during the election, Mr Trump's opportunity to shape the Fed in 2018 when Mrs Yellen steps down may encourage him to respect its independence in the meanwhile.

"Mr Trump's rapprochement with President Putin makes possible a greater balance of global power between the U.S. and Russia, which could in turn promote more global stability."

When it comes to the U.S., its interest rates, stock markets and currency traditionally set the pace for the rest of the world. Over the longer run, however, all bets are off, underscoring, as Dominic Rossi, global equities CIO with Fidelity International, suggests, how "known financial risks have been displaced by an unprecedented level of unknown political risks."

KNOWN AND UNKNOWN UNKNOWNS

Former U.S. Secretary of Defence Donald Rumsfeld famously quipped that, alongside known knowns, known unknowns, and unknown knowns, there are unknown unknowns. The latter category most accurately describes the political risk assessment of this young presidency, which, according to its considerable detractors, stands to undermine the very foundations of the post-WWII global order, based on Mr Trump's wild pronouncements of upending the international order and his seemingly limited grasp of global complexities. Mr Trump's vagueness on the structuring and refinancing of his economic package may well have done much to fuel investor imaginations, but the euphoria may prove short lived: "should the new administration take longer than anticipated to accept the realities of governing," says Stefan Kreuzkamp, CIO of Deutsche Asset Management, "the market's enthusiasm may come to an abrupt end." Investors, particularly those who are not U.S.-based, will have to sit tight while the implementation of his policy agenda unfolds, but a glance at the known unknowns should provide a sense of just how uncertain the unknowns loom on the horizon.

First, while Republican control of both houses of Congress offers an opportunity to break years of political gridlock on Capitol Hill, this is no guarantee of either party unity or the ability to force through aspects of Mr Trump's agenda that remain unpalatable to members of both parties, such as his impulse to lift sanctions on Russia. President Obama similarly enjoyed control of both chambers in his first two years, and while that proved the opportunity to sign into law his signature Affordable Care Act ("Obamacare"), it was portrayed as ideological overreach and redoubled Republican efforts to stymie the rest of his presidency, which was subsequently often bereft of direction. The GOP itself was of course further radicalized via the tea party, resulting, in many ways, in Mr Trump. It is conceivable Democrats may now too be radicalized, first, in opposition to Mr Trump, but also amid recriminations within the party itself that could see it split into a 'Sanders'-type and 'establishment' wings, much as the GOP did before it. Though there are areas where Democrats may conceivably back Mr Trump, such as on infrastructure spending, the overall picture suggests a further fragmentation of politics, and therefore more potential for social and other unrest, and a continuing erosion of trust in the system and its institutions.

Mr Trump is, therefore, as unlikely to be able to change the tone in Washington as his predecessor was, or to, as he puts it, "drain the swamp," also considering the long list of personal conflicts of interest that make him unlikely to become a unifying figure (and more likely a target of endless investigation and partisan fighting). While Republicans may currently themselves be unified in wanting to repeal the ACA, the political reality that it may prove politically impossible to repeal health care to the around 20 million people who have now bought into it may also undermine the first issue on Mr Trump's legislative agenda. Considering that much of the rest of his agenda is not especially well defined at the policy level (or indeed, in relation to conservative orthodoxy on many issues, creating the potential for internal dissent), much of the tenor of his presidency may be defined by whether he succeeds or fails on the one issue that unites him most with the rest of the GOP.

> **"An even more central danger to Mr Trump's presidency will be whether he can maintain his base of political support while inevitably breaking the more infeasible among his campaign promises."**

An even more central danger to Mr Trump's presidency will be whether he can maintain his base of political support while inevitably breaking the more infeasible among his campaign promises, such as the pledge to build a wall between the U.S. and Mexico (to be paid for by Mexico – Mr Trump recently announced the American taxpayer would pay for it in the first instance, to be reimbursed by Mexico "later"). In addition, while his protectionist instincts and vow to kill America's trade deals, such as NAFTA, may have won the hearts of his supporters in the most hard-pressed manufacturing regions of the country, he appears to have misunderstood that the greatest threat to the manufacturing sector is not as much trade as it is technological automation, something even he is powerless to stop. Consequently, closing the U.S. to free trade while manufacturing jobs continue to disappear would potentially hurt all layers of American society and possibly deprive him of his political base, no matter how many jobs he personally intervenes to save (if, for example, the makeshift deal to stop a few hundred jobs from leaving Carrier in Indiana is an indication of his governing intentions going forward). Mr Trump will find protectionism to be infinitely harder while managing the globalizing world than it is to promise manufacturing jobs at his campaign rallies, just as the revelation that protectionism is not the solution to America's economic woes may severely undercut him in the longer run.

"A VERY CONSIDERABLE PRESIDENT"?

All presidents experience a learning curve, however. Mr Trump needs to have a steep one to overcome many of the obstacles of his own making. Some of his cabinet choices, such as Vice President Mike Pence and Secretary of Defense James Mattis, have been wise selections as experienced and knowledgeable hands to help smooth the transition between the president's mercurial predilections and the requirements of the job. Others, such as national security advisor Mike Flynn and political director Steve Bannon, are deeply problematic in the sense that they nurture and encourage Mr Trump's already radical and conspiratorial worldview. The former will be necessary to counterbalance the latter, and it is to be hoped that, as in most administrations historically, the more radical elements are weeded out by necessity as the demands of the job intensify once the Rubicon from ideology to governing realities has been crossed.

U.S. Vice President, **Mike Pence**

Nowhere is this reliance on more experienced hands to be desired than in the realm of foreign policy. Even beyond his worrying admiration of Russian autocratic method, praise for Russia's campaign in Syria and consideration of Vladimir Putin as potentially his closest ally, or his deliberate provocation of China with the likely intention to start a trade war, the grand Weltanschauung of Mr Trump appears to be to undermine every extant pillar of the liberal Western order. Thomas Wright of the Brookings Institution suggests that Mr Trump's view of the world has hardened since his business heyday in the 1980's, believing that since then "the U.S. has been taken for a sucker by other countries because of trade deals and security commitments." This accounts for his unorthodox views that America has no strategic interest in military engagement in Asia, has no need to maintain troops in Europe or lead NATO as a counterbalance to a militarily resurgent Russia, or prop up allies in the Middle East such as Kuwait or Saudi Arabia without being compensated in oil as the proverbial pound of flesh to be extracted for American beneficence.

Mr Trump believes the negotiating skills honed over his long, successful - and often equally unsuccessful - career in real estate and other ventures would suffice in safeguarding America's geostrategic interests and bringing its enemies to heel. While his predecessor's foreign policy has often been justly criticised as being perhaps too cerebral and, therefore, timid, Mr Trump would nevertheless do well in heeding the advice of security and foreign policy experts and institutions that every bilateral alliance and security challenge America faces is a question of diplomatic balance and tactical advantage of a different order than what usually accompanies business negotiation. Nevertheless, no less an expert on diplomacy than former Secretary of State Henry Kissinger sees "extraordinary opportunity," with there being a possibility of Mr Trump going down in history as "a very considerable president" on foreign policy. According to Dr Kissinger's thinking, Mr Trump's rapprochement with President Putin makes possible a greater balance of global power between the U.S. and Russia, which could in turn promote more global stability. Geostrategic implications and risk are considered in this report, but suffice it to say at present that if anything is certain, it's that a period of great upheaval lays ahead.

This editorial began with the premise that Mr Trump is unlikely to change, with a caveat – "initially." Any realistic assessment of the political risk of his presidency will hinge on his potential to do so over the mid- to longer term as he finds himself compelled to accommodate the realities of governance. Conversely, should he refuse to do so, political risk for the U.S., its allies, on the geopolitical chessboard and in financial markets remains higher than at any point since at least the end of the Cold War. But is Mr Trump, after all, predictable in his unpredictability? Could there be patterns of discernment that over time allow a better understanding and pricing in of his motivations, and thus, their more seamless integration into geostrategic and financial frameworks, while these in turn moderate his outlook? It seems unlikely at the time of writing, but in fairness, the jury is still out. For Mr Trump, nevertheless, the key to perseverance and success in governance may well be to supress, to some extent, the very brash force that sustains him and gives him power.

One thing that appears certain is that, in 2017, political risk is set to eclipse economics by dint of the unprecedented challenges presented by the unique personality of President Donald Trump.

www.hedgenordic.com - January 2017
NORDIC BUSINESS MEDIA

by Glenn W. Leaper & Jingchao Zhou

Trumponomics

The initial market reaction to Donald Trump's election was unexpected exultation, as previously worried traders chose to focus on Mr. Trump's fiscal plans, including tax restructuring, infrastructure spending and deregulation. However, this enthusiasm may quickly dissipate should uncertainty continue, Mr. Trump's plans continue to look vague and the numerous economic contradictions contained therein supersede the economic reality Mr. Trump claims he can deliver. The expected boost in growth is likely to lead to a stronger dollar and higher inflation, so much will depend on how the U.S. Federal Reserve will accommodate Mr. Trump's policies. However, the economic outlook for

2017 remains relatively stable. There are U.S. equity opportunities inherent to the very uncertainty posed by Mr. Trump's anti-trade proposals, though it remains unclear what will and will not be implemented. The inability to project beyond the first six months is a central element of the political risk posed by Trumponomics so far.

THE GENERAL OUTLOOK

Market analysis is divided on the Trump administration's economic development and outlook for 2017. On one hand, Mr. Trump's promises on infrastructure spending, deregulation and tax reform have sent markets into premature euphoria. On the other, the vagueness subtending Mr. Trump's plans could put an abrupt end to this elation if it transpires that Mr. Trump is not as much outlining thought-through policy as scrambling to chase economic realities, regardless of the verbal band-aids he deploys to take credit for positive developments, and disavow responsibility for negative ones.

> **"Markets are starved for growth plainly visible in the eagerness with which [they] seized on Trump's growth-focused message."**

According to a survey conducted by the Wall Street Journal, the majority of economists are forecasting the U.S. economy will grow by about 2.2% in 2017, pushing the inflation rate above 2%. This is mostly in line with predictions from Goldman Sachs, which forecasts that 2017 will be accompanied by higher growth, but higher risk, and slightly higher returns. "Markets are starved for growth," Goldman wrote in a forecast, which is "plainly visible in the eagerness with which [they] seized on Trump's growth-focused message." His fiscal stimulus, in contradistinction to years of monetary policy, sparks a "welcome growth agenda and reflationary impulse" which the Republican congress gives a good chance of being enacted. "Economic issues, notably tax cuts, infrastructure and defense spending will push up the headline Consumer Price Index," they conclude.

Former U.S. Treasury Secretary Larry Summers, however, warns investors may be underestimating the risks posed by Mr. Trump's presidency. "This is probably the largest transition ideologically and in terms of substantive policy we've seen in the U.S. in the last three quarters of a century," he said. "Those kind of transitions have to be – given the central role of the U.S. in the global system – matters of enormous uncertainty. I don't think that's fully recognized by markets." Forecasters at Oxford Economics concurred, citing Mr. Trump's policies as "the single largest risk to the global economy" and the increased probability of a sharp slowdown of the U.S. economy in a recent client survey.

THE TRUMP TRIFECTA

Mr. Trump´s three-pronged plan consists of fiscal stimulus, especially as concerns infrastructure investment and military expenditure, combined with deregulation and a generous tax cut for middle and upper income households and businesses. Mr. Trump is expected to use fiscal policy stimulus to attempt to boost what has been a lackluster monetary-policy led economic recovery, says Diane Sobin, Head of U.S. Equities with Columbia Threadneedle Investments. The boost to growth, according to Salman Ahmed, Chief Investment Strategist with Lombard Odier, will also "result in higher inflation and further strengthening of the U.S dollar."

Mr. Trump also wants to cut both income and corporate taxes, with the objective of lowering the business tax rate from 35% to 15%. This, however, is unlikely to happen, "given that the cost to U.S. revenue would be in the trillions," says Grant Wardell- Johnson of the Australian Tax Centre KPMG. More likely is a compromise package that could get through Congress under a budget reconciliation process, but even the combination of a moderate fiscal stimulus and tax cuts would increase the level of U.S. debt significantly.

> **"The U.S. dollar is being propelled higher by the expectation that Mr. Trump's fiscal stimuli will breathe life into America's anemic growth."**

Mr. Summers, for his part, dismisses the idea that any tax policy introduced to encourage U.S. companies to repatriate profits along the lines of Mr. Trump's protectionist "Make America Great Again" theme would boost investment and hiring. "The vast majority of the companies who have large overseas cash also have substantial amounts of domestic cash," Mr. Summers said. "The reality is that cash that is brought home will be used to pay dividends, buy back shares, to engage in mergers and acquisitions [and] to rearrange the financial chessboard, not to invest in large new amounts of capital. It is chimera to suppose that there will be large increases in capital investment as a consequence of that repatriation."

Of course, among the incentives for repatriation in the first place are Mr. Trump's policies of deregulation, particularly in the financial and pharmaceutical sectors, in addition to reducing corporate taxation and increasing minimum wage flexibility, which are intended to stimulate investment activity. But because of the likelihood of a higher budget deficit as a result, it is not clear whether the U.S. Congress will approve such actions, even with a Republican majority (where fiscal conservatives are likely to disapprove). The measures, could, however, boost the U.S. economy in the short term by 2018, but "any trade restrictions and rapidly rising yields due to the increased deficit could somewhat soften this upswing," according to Phil Poole, Global Head of Research with Deutsche Asset Management.

TRADE TANTRUMS

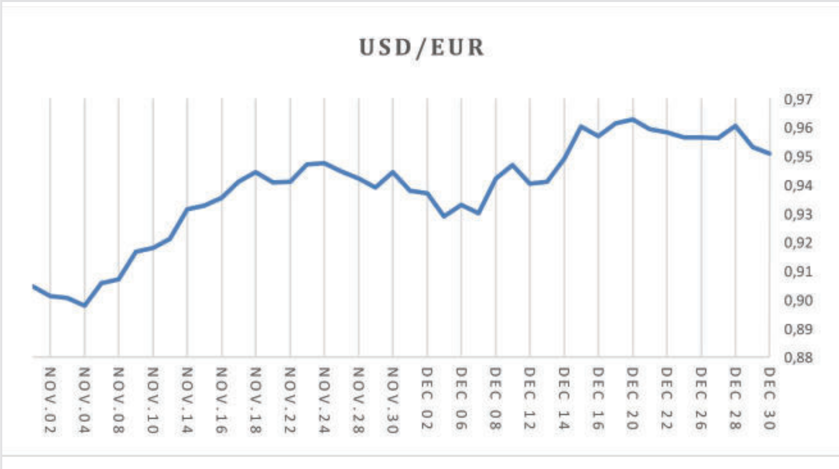
Considering Mr. Trump's intentions to scrap the Trans-Pacific Partnership (TPP) and renegotiate various terms of the North American Free Trade Agreement (NAFTA), and his threats that the U.S. may leave the World Trade Organization (WTO), all of which would likely impact global trade and economic growth negatively, the supply chains of U.S. businesses could also be compromised, increasing production costs and reducing competitiveness. "The result could be a decline in U.S. growth," says Mr. Poole, "leading us to believe that the new U.S. administration is likely to proceed cautiously on the issue." More cautiously, it is hoped than what one is led to believe from Mr. Trump's statements.

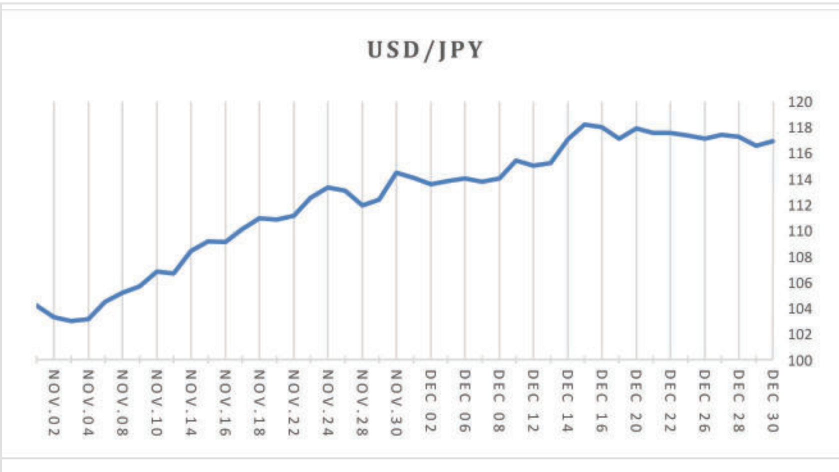
Though Mr. Trump's protectionist trade policy tops the list of policy priorities that have consumed economists and global markets, Goldman Sachs Head of Global Credit Charles Himmelberg thinks, despite sharing these concerns, that "the popular media narrative on the downside risk of a trade war is overstated," given that pro-trade congressional Republicans could act as a counterweight on Mr. Trump's impulses, forcing him to moderate. Should Mr. Trump's administration aggressively pursue its anti-trade and anti-immigration agenda regardless, "consumer and business spending are likely to weaken materially, potentially up to the point of a U.S. recession – indeed of stagflation," warns Mr. Ahmed. "We expect trade stagnation [in this case] rather than trade reversal, [which would raise] the specter of trade wars" adds Willem Buiter, Global Chief Economist at Citigroup. Considering the potentially damaging consequences for the U.S. economy, then, "there is good reason to think that the establishment wing of Mr. Trump's team will blunt his aggressive stance and instead focus attention on his fiscal policy priorities," Mr. Ahmad speculates.

FEDERAL RESERVATIONS?

With Mr. Trump's election, the trade-weighted U.S. dollar index was driven to a 13-year high. The U.S. dollar is being propelled higher by the expectation that Mr. Trump's fiscal stimuli will breathe life into America's anemic growth, and, combined with inflation expectations, is reflected in the likely rise in both longer-term U.S. interests rates and in the short term, with at least two interest rate hikes projected

DEVELOPMENT OF USD EXCHANGE RATE SINCE TRUMP'S ELECTION





Data obtained from Bloomberg

for 2017. However, appreciation of the dollar could be slowed by intervention from the U.S. Federal Reserve or the Treasury Department, or a sharp correction in the stock market due to a deterioration of the risk environment, which could strengthen other currencies such as the euro or the yen instead, according to Dirk Aufderheide, Chief Currency Strategist with Deutsche Asset Management. However, "[Deutsche] believe[s] the dollar will remain strong and expect the euro and the U.S. dollar to reach parity by the end of 2017," he says.

The key appears to be the reaction of the U.S. Federal Reserve. How does the Fed react to Mr. Trump's multi-trillion dollar infrastructure spending plans, and how far does Janet Yellen plan to accommodate fiscal expansion, considering the high employment rate? The big concern for credit markets, according to Tim Haywood, GAM's Investment Director for Absolute Return Fixed Income Strategies, is the potential fallout should interest rates tighten significantly faster than market consensus anticipates.

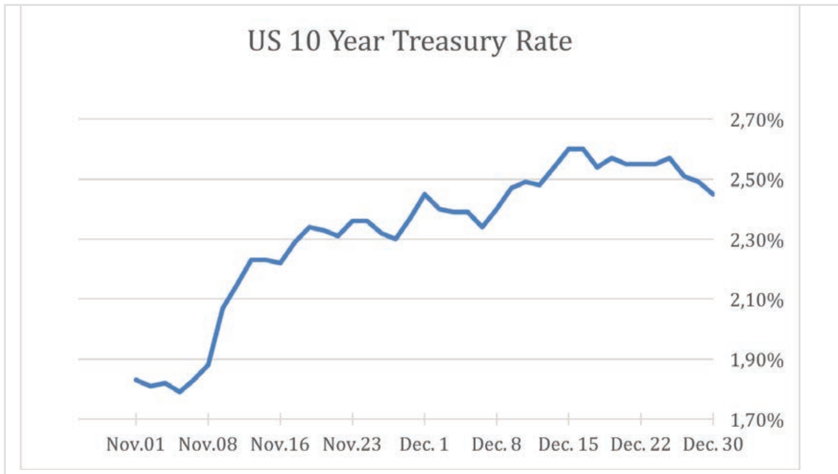
OPPORTUNITIES AND OPPROBRIUM

Mr. Trump's election pushed the yield on 10-year U.S. securities past the 2.5% threshold, last seen in 2014, due to both the higher growth expectations associated with Mr. Trump's proposed stimulus and expectations of higher inflation. "After fearing the specter of deflation for such a long time," says Jason Wasmund, Global Head of Fixed Income at Deutsche Asset Management, "any increase in yield is welcome, at least as long as inflation rates refrain from shooting towards three percent, which we do not expect in 2017. Nor do we expect Trump's economic policy to have much of an impact on GDP next year." Mr. Wasmund cautions against further sweeping rises yields, however, "[e]specially in light of our forecast for a budget deficit for 2017 of 3.5% of GDP. It would also be the first major fiscal package to be implemented at a time when the United States is almost at full employment and not in a recessionary environment."

Though U.S. equities have suffered some turbulence since Mr. Trump's election victory, 2017 is likely to be a better year for "old fashioned stock picking," says Gregg Schoenberg, founder of Wescott Capital. With rising interest rates, divergent central bank policies, fiscal policies whose effects remain unforeseeable and Mr. Trump's personal Twitter bully pulpit to hound whichever corporation irks his wrath, this provides a favorable backdrop for fundamental equity managers to prove their worth in 2017. "We think a larger share of them will outperform the S&P 500, Russell 2000 and other widely used benchmarks versus previous years. In turn, active managers will secure much needed oxygen in their struggle against the rising tide of index-based products," Mr. Schoenberg thinks.

Given the uncertainties and risks provoked in part by Mr. Trump's often contradictory tendencies, he might do much to steady markets by elucidating a more detailed overall policy – and sticking to it, in his verbal and twitter missives, at least.

THE TRUMP EFFECT



Data obtained from Bloomberg

by ***Glenn W. Leaper, PhD***

U.S. Foreign Policy: World Order No More?

For many of America's allies, among the most unsettling aspects of President Trump's 2016 campaign was his insistence on upending the current world order, tearing apart longstanding international commitments and desecrating hallowed principles subtending the post-Cold War liberal world order. But in a complex world, Mr. Trump's proposals both found support domestically and provided opportunity for long-term rivals, from Russia to China through the Middle East. The stakes for all major geopolitical players are high.

"GEOPOLITICAL RECESSION"

"The triumph of 'America First' as the primary driver of foreign policy in the world's only superpower marks a break with decades of U.S. exceptionalism and [the] belief in the indispensability of U.S. leadership." So write political risk analysts Ian Bremmer and Cliff Kupchan, President and Chairman respectively of the Eurasia Group, in their 2017 forecast "Welcome to the Geopolitical Recession." "With it ends a 70-year geopolitical era of Pax Americana, one in which globalization and Americanization were tightly linked, and American hegemony in security, trade, and promotion of values provided guardrails for the global economy. In 2017, we enter a period of geopolitical recession."

On this reading, 'America First' will mean the U.S. will become an 'absent superpower' henceforth acting on near-term national interests, instead of aiming for longer-term global order and common values. This is likely to create near-term chaos and pockets of political risk: a resurgent China, an aggressive Russia, increasing potential for direct conflicts and the weakening of global institutional architecture. The new U.S. position is not isolationism but a unilateralism that prioritizes its own economic interests above its traditional promotion of democracy, civil rights or the rule of law, and risks the use of force with less regard for the consequences. "The global environment is really much more volatile… [with] America itself [as] the biggest risk," Mr. Bremmer commented. "If there's going to be a big hiccup in the global markets in coming years, it's much more likely to come from the geopolitical environment than it is likely to come from an economic or financial crisis."

> **"China, by contrast to Russia, has felt Mr. Trump's wrath throughout the previous year's campaign."**

Other analysts have long seen the need for changes to the U.S.-led global framework, emphasizing a more discriminate pursuit of trade policies: "The U.S. was the world's largest manufacturing economy from the 1870's to 1900's," says George Friedman, Chairman of Stratfor Geopolitical Futures. "There's a [strange] thinking that protectionism is going to cause economic dysfunction. What is novel is the idea of free trade, which since 2008 hasn't distributed wealth broadly." By this account, he says, Mr. Trump's positions are not radical. In Mr. Bremmer's opinion, however, an administration that "does not want to be the world's policeman [or] the architect of global trade… in a world where the Europeans are already much weaker [and] the transatlantic relationship is a casualty," makes "a world with no global leader" the greatest geopolitical risk for 2017.

MARKETS MOORED

One key aspect of this risk is that whatever Mr. Trump says will be a principal driver of risk in today's global markets. From Mr. Trump's perspective, Mr. Bremmer explains, unilateralism is not bad for American markets, where geopolitical concerns in the Western hemisphere take a back seat and the U.S. does not have the same security issues as, say, Europe (immigration, or the limited ability of terrorists to hit the American homeland by comparison). As a consequence, he says, "we could see a geopolitical environment [which is] by far the worst we have experienced in decades, yet investments into U.S. markets and the strength of the U.S. dollar are going to grow" in the short term.

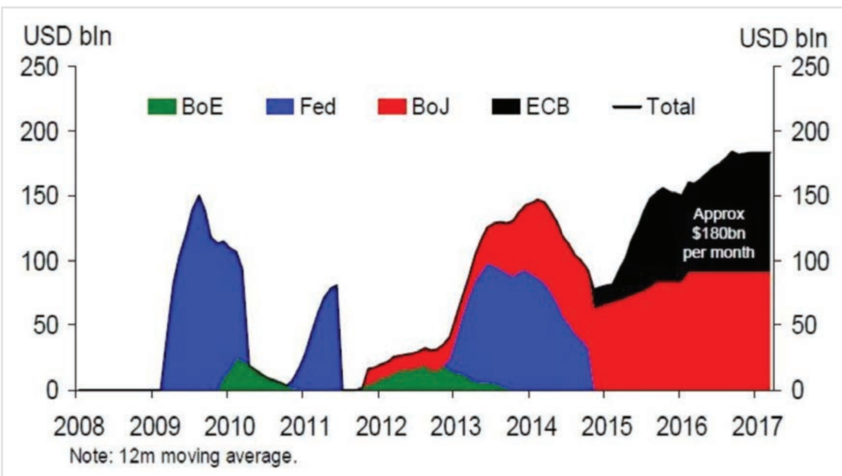
However, in the course of 2017, Mr. Trump's 'independent America' will become not only a threat to international relationships, but also to the U.S. and global economy. The Eurasia Group forecasts both the U.S. Federal Reserve and the European Central Bank (ECB) will be called into question and ironically become more political, if Mr. Trump's campaign accusation of the Fed creating a "false economy" through quantitative easing continues. In the meanwhile, Mr. Trump's proposed dismantling of existing free trade relationships could put him on a collision course with Silicon Valley, with its responsibility for the ever-increasing automation reducing manufacturing jobs in the workforce. Mr. Trump's populist America will likely be one of his personal whims as to which corporate forces are in favour, and which are not - which is likely to lead to domestic and international strife.

EUROPEAN EXERTIONS

With the European Central Bank (ECB) also having announced a sight tapering of its future asset purchases, it will feel less of a mandate to support the weaker economies of the Eurozone as populism also spreads across that continent. "The ECB's policies are 50% to blame for the surge of the populist, anti-immigration alternative for Germany, which grabbed a historic share of the vote at German state elections last month," was the startling comment from Wolgang Schäuble, the German Finance Minister last April. Mr. Trump's emphasis on fiscal stimulus in the U.S. and the ECB's political predicament could lead to a "taper tantrum" later in the year, suggests Larry Hatheway, Group Chief Economist and Head of GAM Investment Solutions.

But America's unilateralism will impact Europe in ways beyond the economic. Mr. Trump's threat to ignore NATO treaty requirements unless European members pay their share and take greater responsibility for their own defense, for instance, might be a reasonable suggestion - if European politics were currently tranquil. It is not, however, with a year ahead that includes Brexit negotiations and populist challenges to fragile European unity from the far right in elections throughout 2017 – a far right, moreover, that Mr. Trump and his associates appear to be encouraging. Considering European history, this is imprudent. The smart way to encourage Europe to take greater responsibility for its security would, similarly, be a gradual 'tapering' of U.S. support to give Europeans time to build up their own defenses; abnegation of America's responsibilities in NATO, on the other hand, could potentially hasten the potential unraveling of the European Union.

MONTHLY FED, ECB AND BOJ ASSET PURCHASES



Source: DB Global Markets Research

Alongside immigration and terrorism, nowhere is the need for such guarantees more apparent than in Europe's dealings with Russia, along with the threat of Russian cyber-warfare and meddling in European elections similarly to its success in influencing the U.S. elections. The EU faces a series of ongoing challenges from the East, not least considering its common security policy, dependence on Russian gas, sanctions on Russia over Ukraine and the eventuality of further Russian aggressive expansionism e.g. in the Baltics. Mr. Trump, for his part, is famously conciliatory towards Vladimir Putin, refusing even to entertain the possibility of Russian misconduct, and naming Rex Tillerson, the former Exxon executive who has previously argued for the lifting of sanctions on Russia, as his Secretary of State. This, says Stephen M. Walt, professor of International Relations at Harvard University, invites Mr. Putin to think of Mr. Trump as a pawn, overly eager to give Moscow what it wants without getting anything significant in return.

Conversely, as Henry Kissinger has suggested, rapprochement between the U.S. and Russia invites the possibility of a greater balance of global power, which could in turn promote global stability, assuming it could drive a wedge between Russia and China, and Russia restrains influence to its near-abroad. However, Russia will see a "massive opportunity to expand its power" in Mr. Trump, "while traditional U.S. allies now see their connection with the U.S. as deeply problematic," says Mr. Walt. In addition, if U.S. officials ignore Russia's interference in domestic U.S. politics itself, it will continue threatening the integrity of America's electoral process in years to come (and thus the symbolic stature of democracy itself).

ASIAN ANTAGONISM

China, by contrast to Russia, has felt Mr. Trump's wrath throughout the previous year's campaign. Provocative actions from Mr. Trump have included taking a phone call from Taiwan's Tsai Ing-wen (casting doubt on longstanding U.S. "One China" policy), appointing China hawks such as Peter Navarro (National Trade Council) and Wilbur Ross (Dpt. of Commerce), repeatedly threatening to slap a 45% tariff on Chinese-made goods, and continually (falsely) claiming China is manipulating its currency and "stealing" U.S. jobs. Realigning the U.S. trade relationship with China was a central pillar of Mr. Trump's campaign, from the premise of the U.S. having hemorrhaged millions of manufacturing jobs since China's accession to the WTO in 2001.

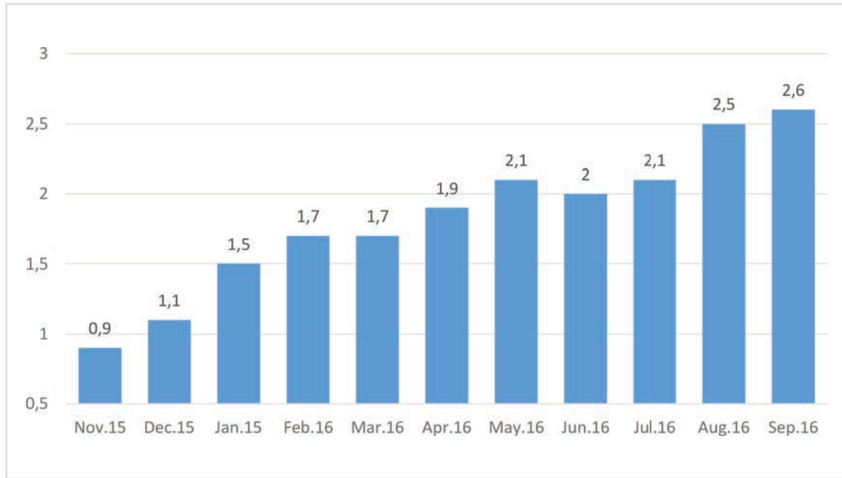
Is it, however, in U.S. interests to antagonize China to this degree? China is the only country that can compete with American influence atop the global geopolitical pyramid, is a major U.S. economic partner and is an aspiring regional hegemon in South-East Asia. It also happens to be on the verge of a leadership change, making President Xi Jinping particularly sensitive to provocation and "more likely than ever to respond forcefully to foreign policy challenges," says Mr. Bremmer. Simultaneously, China faces a nationwide debt crisis caused by expansionary monetary and fiscal policies. China faces business defaults and bankruptcies, low industrial profits, winnowing returns on investment and the very real prospect of yet another slowdown in the real estate sector," says Strafor analyst John Minnich. "How well Beijing manages these problems in the months ahead will, to a great extent, determine China's economic, social and political stability for years to come."

"If there's going to be a big hiccup in the global markets in coming years, it's much more likely to come from the geopolitical environment than it is likely to come from an economic or financial crisis."

Mr. Trump clearly has the opportunity to rattle Mr. Xi, with any misstep from the latter likely provoking "global economic volatility," says Mr. Bremmer, adding that Mr. Xi may unwittingly increase the chances of significant policy failures by prioritizing stability over difficult policy choices in the run up to the party congress in August. However, Mr. Trump does not hold all the cards: Mr. Xi may no longer feel bound to either China's economic partnership with the U.S. or military restraint in South East Asia, particularly after Mr. Trump's shunting of the Trans-Pacific Partnership, which was a major component of President Obama's 'pivot' to Asia and was intended to strengthen ties with key U.S. allies at China's expense. Undercutting U.S. allies such as Japan in the process, then, has provided China with an opening to tailor both economic and military relations in the region to its own benefit. "There is no question that China is going to see an independent America as an opportunity to spend and invest in alternative architecture that fragments the world into a less unified system," says Mr. Bremmer, citing China's "major opportunity" to take on greater global leadership. The fight Mr. Trump has picked with Beijing has "weakened the U.S. position at the same time," Mr. Walt concurs.

MEDDLING MIDDLE EAST

IRAN CRUDE OIL EXPORT, NOV 2015-SEP 2016, IN BPD



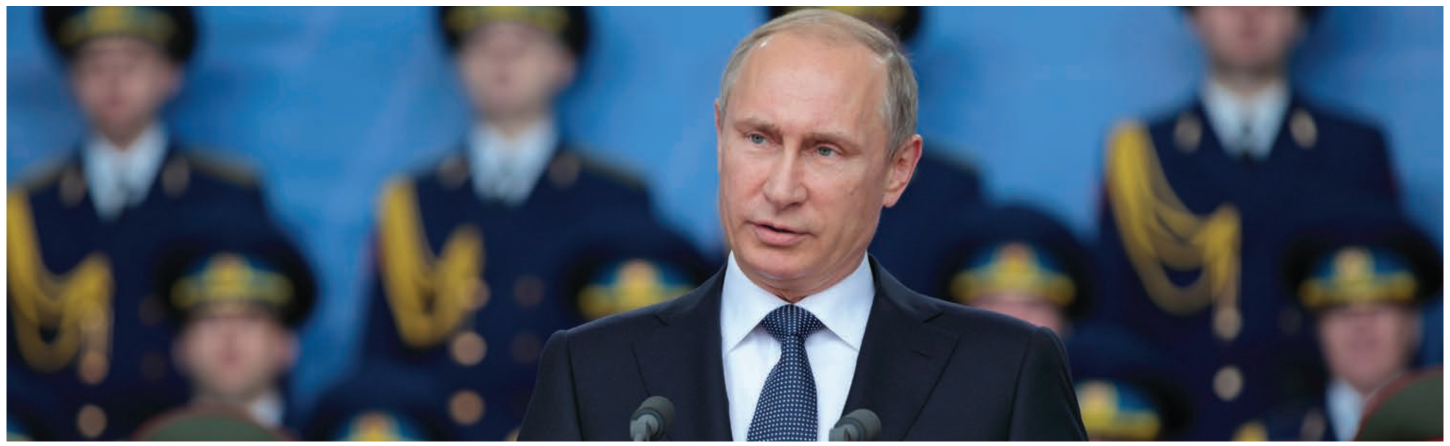
Source: Data compiled from Reuters reports.

Meanwhile, in the Middle East, Mr. Trump appears poised to continue the mistakes of his predecessors and possibly make new ones of his own. Having thrown his unequivocal support behind Israel's Prime Minister Benjamin Netanyahu, but more significantly the settler movement that continually pulls the latter's governing coalition rightwards, Mr. Trump appears to have abandoned efforts to achieve a two-state solution, which will do little to improve prospects of peace and stability. Mr. Trump has laudably promised to crush the terrorist organization Islamic State, though ceding the ground to Russia in Syria, as he has hitherto suggested he will, creates yet more complications. As Russia and Bashar Assad's regime are allies of Iran, Mr. Trump can't effectuate his rapprochement with Moscow and Damascus without also strengthening Iran's position.

Mr. Trump has repeatedly denounced the U.S. nuclear deal with Iran. However, if he abandons it, Iran is likely to resume enriching uranium and "leave [him] with the choice of either a nuclear-armed Iran or starting another war in the Middle East," says Mr. Walt. With Mr. Trump's national security apparatus likely to push him to adopt a more confrontational approach to both Iran and Islamic extremism, this could "strengthen Iran's hard-liners, keep the U.S. pinned down chasing terrorists in various places, and encourage Tehran to deepen ties with China," he adds. With Iran having sharply grown its oil production after sanctions were lifted in January 2016, and a majority of the Republican congress pushing for sanctions to be re-imposed or at least a re-negotiation of the nuclear deal, "[s]uch a development could significantly impact Iranian oil output in an already tightening market and lead to higher oil prices," says Roberto Cominotto, Investment Director for Energy Equities with GAM.

A Realist approach to the Middle East, counters Mr. Walt, would focus on the regional balance of power and seek to ensure no single state is able to dominate its energy resources. "The U.S. should cultivate business-like relations with all states in the region and play contending forces off each other," Mr. Walt maintains, as it has sought to do historically. But the contradictions inherent to Mr. Trump's hardline policies may forestall any playing of smart balance-of-power politics.

As Mr. Trump's predecessors have almost uniformly found, clear-cut positions taken on the campaign trail tend to be enveloped and ultimately drowned by the reality of the complexity of governance. Mr. Trump, however, does not remotely resemble his predecessors. Whether this will be a good or a bad thing, only time will tell - but it's certain to be an uncertain and bumpy ride.



Vladimir Putin, President of Russia

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Leviathan Awoken: European Elections 2017


Beppe Grillo


Marine Le Pen


Geert Wilders


Angela Merkel

“The first notable election 2017 will be in the Netherlands.”

“If the Trump-Brexit trend continues, it could come at great cost to the European project.“

by Glenn W. Leaper & Jingchao Zhou

The story of Europe in 2017, in the populist imagination, is one of a nationalist David up against the ‘elite’ Goliath, with elections potentially set up like dominos to fall ignominiously one by one.

The political reality at the time of writing is more sanguine, but European political risk could well be the financial markets’ biggest test yet, says Richard Champion, Deputy CIO with Canaccord Genuity Wealth Management. How will European political outcomes affect financial markets in 2017?

With the ECB having announced a slight tapering of its bond-purchasing program and future asset purchases, outcomes “should validate the shift towards higher global bond yields, should growth remain resilient and if higher oil prices lift Eurozone inflation,” says Larry Hatheway, group chief economist and head of GAM investment solutions. Deutsche Asset Management expects real gross domestic product in the Eurozone to be 1.3% (down from 1.6% in 2016), with consumption likely to be the main driver. “We consider the higher oil price and political uncertainty to be the main reasons for somewhat slower growth in 2017,” says Phil Poole, Global Head of Research with Deutsche AM. Following 2016, when the Brexit referendum and the election of Donald Trump provoked significant moves in currencies, fixed income and equities, there is potential for further market dislocation with the political uncertainty of 2017.

Starting with a general election in the Netherlands in March, through to the presidential election in France in May and the parliamentary election in Germany in September (and a likely Italian election to be held by the end of the year), over 40% of Europe’s collective GDP will be voting in 2017. If the Trump-Brexit trend is set to continue, it could come at great cost to the European project. As the European Union itself kicks off the year with considerable internal difficulties Brexit top of the agenda and Russian interference lurking in the background, would a victory for Marine Le Pen in France or the shock removal of Angela Merkel as chancellor of Germany potentially spell the end of the European project?

Comparisons to Mr. Trump and Brexit should not be drawn in too much haste, however. As Salman Ahmed, Chief Investment Strategist with Lombard Odier explains, “the main mitigating factor is the electoral design of European countries, which adhere to a more proportional representation structure, thereby reducing the likelihood of a populist government coming into power without mainstream support. This stands in marked contrast to the “first past the post” systems in the UK and the U.S.” There is reason, then, for a measure of calm, which is not to say the political risk for Europe in 2017 is not inordinately high. The following considers central challenges represented by the major European elections this year.

Dutch Debacle

The first notable election will be held in the Netherlands on March 15. While the effects of strong results for Geert Wilders and his anti-immigration Party for Freedom (PVV) may be overstated in terms of the parliamentary makeup in the Netherlands, the firebrand has fully embraced Trumpism and is running a campaign on the coattails of the latter, hoping for a bandwagon effect. Mr. Wilders was tied in polls with the conservative-liberal People's Party for Freedom and Democracy (VVD) as of early January, and intends to turn the election into a horserace between himself and Prime Minister Mark Rutte, the leader of the VVD, abetted by the media's interest in promoting a U.S.-style election. If he succeeds, the risk is that other parliamentary parties will be bypassed, likely costing them exposure and votes.

However, gaining national office in the Netherlands is dependent on multi-party coalitions in an already fragmented system; Mr. Wilders is, by design, isolated from the other parties in this context, and he would find it hard to build a coalition behind him even if he were to win outright. This seems unlikely, as Mr. Wilders and PVV would need to win 76 seats to gain an outright majority. For comparison, the PVV stood at a predicted share of around 35 seats in early 2016 – still far enough off the mark that it would take nothing short of an electoral earthquake to install Mr. Wilders in power. For all intents and purposes, Mr. Wilders is likely more interested in the long-term normalization of his policies and incrementally greater influence than he is in assuming the mantle of power – and responsibility. There is likely to be a long period of uncertainty as a new government is formed with or without Mr. Wilders, but this is normal in the Netherlands and should have little market impact.

Italian Irritation

Italy's former Prime Minister Matteo Renzi lost his job following an important reform referendum that would have been a crucial step towards rendering Italy's cumbersome parliamentary system more efficient by weakening its entrenched Senate. The failure of the referendum has led to yet another potential crisis in the Eurozone's third largest economy, opening up the opportunity for Beppe Grillo's Five Star Movement (M5S) to potentially take over 40% of the seats in parliament in the next election. The

Over 40% of Europes GDP will be voting in 2017


Francois Fillon


from left: Mateo Renzi, Angerla Merkel, François Hollande

M5S is technically a far-left movement that also appeals to nationalists and has been gaining traction, winning mayoral elections (including in Rome) by making corruption and Italy's negative growth since 2007 the centerpiece of its attack on the political establishment. The M5S has promised to hold a referendum akin to Brexit and to renegotiate Italy's membership of the Eurozone, which would cast further market doubt on the ability of Italian banks to recapitalize.

Following the 'Italicum', an electoral law passed in 2015 granting a party that wins over 40% of the popular vote disproportionately high representation in parliament with a "bonus seat" structure, in the bid, ironically, to create more stability, there is therefore a theoretical possibility the M5S could take control of parliament in the event of elections and be in a position to form a government. However, Italy's supreme court was set to rule on a change to this law on January 24, and if the measure passes, "the likelihood of a populist-led government in Italy declines sharply, despite the strong showing of M5S in recent polls," says Mr. Ahmed. Last but not least, the Italian constitution bars a referendum on international treaties and instead requires a two-thirds parliamentary majority for such measures to pass. "This further reduces the risk of an Italian exit given the backdrop of still relatively high support for the EU within the country," Mr. Ahmed adds. Appearances to the contrary, political risk for the EU in the case of Italy appears relatively contained.

FREXIT Fears

The same cannot be said of France's presidential election on May 7, where the stakes for the EU are highest. If Marine Le Pen of the far-right Front National (FN) were to win the second round, it could be the greatest shock in post-war European politics, with the risk of France being pulled out of the Eurozone. "This would not only have a devastating impact on Europe, but could have ripple effect far beyond European borders," says Enzo Puntillo, GAM's head of Fixed Income in Zurich. Ms. Le Pen has dominated the French media spotlight for several years; a decidedly smoother operator than her father, Jean-Marie Le Pen (who progressed to the second round of France's presidential election in 2002 before being beaten decisively by Jacques Chirac thanks to a coalition between the left and center-right to stop him), Ms. Le Pen has considerably broadened the party's appeal, winning large regional elections in recent years and positioning her "FREXIT" platform for 2017.

> **"If Marine Le Pen of the far-right Front National (FN) were to win the second round, it could be the greatest shock in post-war European politics."**

The FN incorporates aspects of both the right and the left's agenda: Aside from the usual far-right tropes on immigration and the "failed" European project, Ms. Le Pen proposes retaking control of France's borders and currency, establishing 'voluntary partnerships' between nation states in lieu of European institutions, and promising a referendum to re-introduce the French franc. Recognizing the economic risks of currency fluctuations in withdrawing from the euro unilaterally and the lack of support from most French voters, Ms. Le Pen recently backpedalled slightly, calling instead for a return to a ECU-style currency in parallel to the franc. Yet, "[a]ny victory for Ms. Le Pen and her anti-EU agenda would likely mean a referendum on EU membership – a vote that a recent Pew Research Center poll showed could lead to FREXIT (under article 11 of the French constitution, the President can bypass the parliament to hold a referendum)," Mr. Ahmed explains.

Conventional wisdom holds that Ms. Le Pen and the FN are set to repeat her father's fate. Amid a severely fractured left and a center-right now united behind former Prime Minister Francois Fillon and his Les Republicains, Ms. Le Pen is expected to progress to the second round of voting on May 7, presumably facing off against Mr. Fillon, but it is assumed the political mainstream will coalesce once again to defeat the far right. Mr. Fillon's agenda is avowedly pro-market with structural reform of the economy at the center of his program. "[Mr. Fillon's platform] has the potential to ignite animal spirits and increase economic growth in Europe's second-largest economy," says Niall Gallagher, investment director for European equities with GAM.

There are key differences, however, between 2017 and 2002 that indicate the level of political risk in this election. First, "France... is a key tail risk because its electoral system doesn't operate according to proportional representation," says Mr. Ahmed. Second, Ms. Le Pen has made strides towards normalization of her positions and has expanded the FN's support geographically and across party lines. Euro-skepticism and distrust of the elites is no longer

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necessarily seen as a far-right position, instead uniting people from across the political and class spectrum. Third, fragmentation on the left suggests it may not automatically unite to help defeat Ms. Le Pen, not least behind a self-proclaimed Thatcherite like Mr. Fillon whose bland exterior is unlikely to set pulses racing. As President Trump demonstrated in the U.S. GOP primaries, it can suffice to have enough candidates squabbling amongst themselves to demoralize efforts against a radical outsider, who then takes on the elite figure best representing the establishment and still wins by a hair's breadth.

As for the incumbent Socialist party (PS), it still does not have a standard bearer, and a crowded field of various smaller leftist parties seems set to haggle for influence, if not to remain in contention until the first round of voting. Manuel Valls, President Hollande's reformist Prime Minister, remains the most likely candidate, but will have to see off challenges from other ex-ministers, among them Benoit Hamon and former economy minister Arnaud Montebour, during the socialist primaries in January (challenges based on Mr. Valls' engineered pro-business turn in government). Others are refusing to run in the socialist primaries but are threatening independent runs instead, such as Emmanuel Macron, another former – and popular - economy minister running a private campaign on a reformist platform without a clear allegiance to left or right. There is risk internecine rancor on the left may prevent it from uniting fully against Ms. Le Pen.

The prognosis for France's election is not clear-cut and it would be complacent to assume the far right can be marginalized as easily as in the past based on the evolution of domestic political conditions, the normalization of anti-EU platforms and the fragmentation of both political classes and the citizenry. It remains likely, but certainly not inevitable, that Ms. Le Pen's FN will be defeated. Much will depend on the mood in the country and the uncertainty in the months ahead.

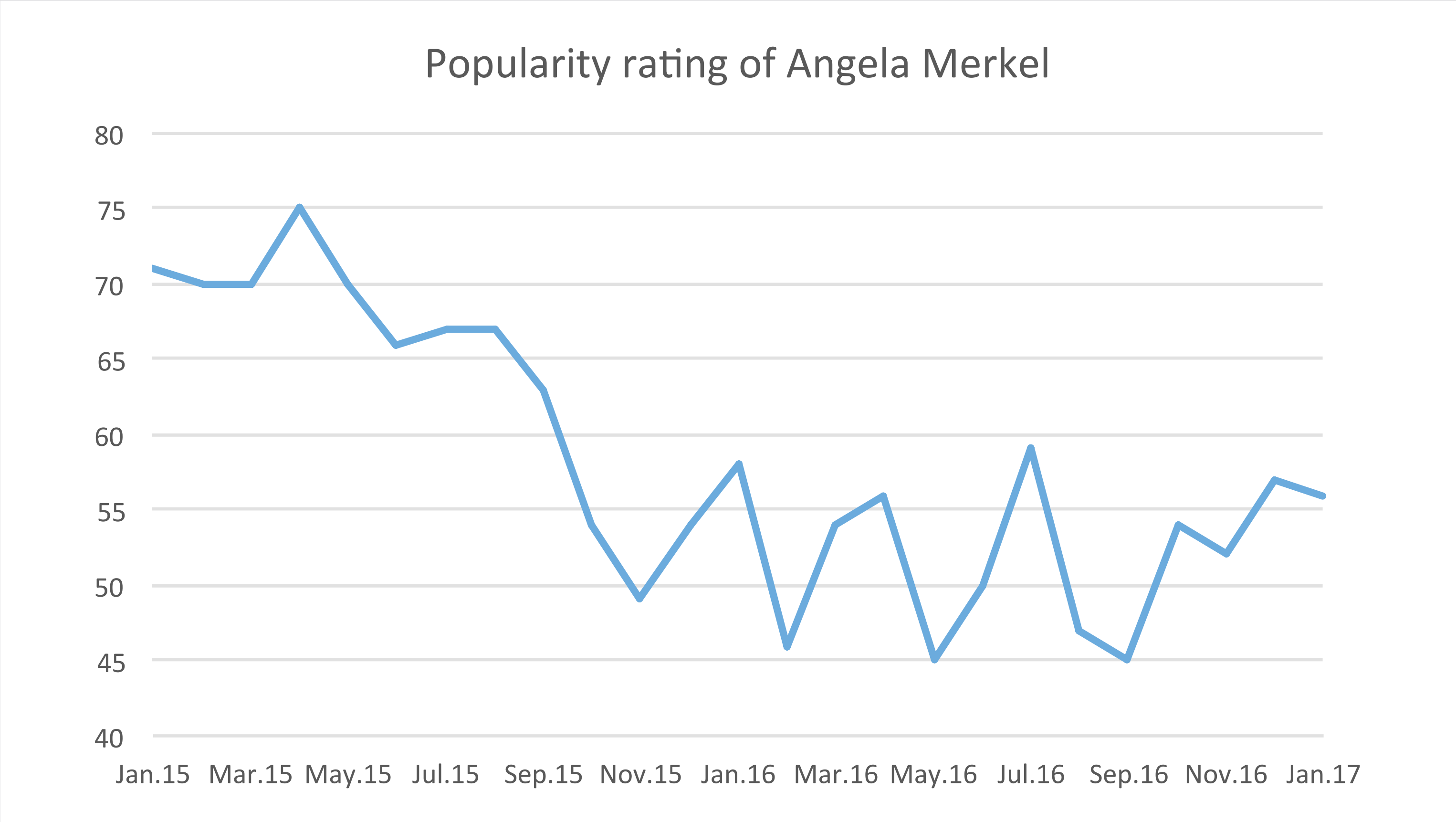
Markets for Merkel

The German Federal elections, to be held at the latest by the end of September, would represent the last stand of the "old" European order, if an upset in the French election came to pass. Chancellor Angela Merkel faces various political and economic challenges, including ongoing domestic dissatisfaction with the refugee crisis and corporate crises such as Deutsche bank. Ms. Merkel heads into September with no serious opposition, but "she will need to appease

"Running for her fourth term, the last years have undermined Ms. Merkel's previously insuperable popularity, and she now finds herself between a rock and a hard place."

far-right critics, which will leave her a diminished figure," says Ian Bremmer of the Eurasia Group. The governing coalition of Ms. Merkel's Christian Democratic Union (CDU) Christian Social Union (CSU) and Social Democratic Party (SPD) has been bleeding support to the far right, and with the Alternative für Deutschland (AfD) approaching 20% in the national polls, and there is market nervousness at the possible destabilization ahead. AfD, which trades on anti-immigration and anti-EU sentiment, has been chipping away votes in regional elections in the Eastern part of the country until events of the past years (terrorism, immigration) has set it on track to win over 90 seats, or 15% of the vote in the Bundestag. This would make it the first far-right party to gain representation since 1949.

Running for her fourth term, the last years have undermined Ms. Merkel's previously insuperable popularity, and she now finds herself between a rock and a hard place. Her austere toughness on Greece and other periphery countries during the Euro crisis made her unpopular on the German left, following years of political domination of the German center. Meanwhile, her "Willkommen" policy on Syrian refugees in the effort to uphold European values have made her an obvious target for the far right. Accordingly, her approval ratings have seen wild fluctuation over the past year (see chart):



Source: data compiled from infratest-dmap (http://www.infratest-dimap.de/umfragen-analysen/bundesweit/ard-deutschlandtrend/2015/januar/)

While Mrs. Merkel has secured the full backing of the CDU, the attack on the Berlin Christmas market on December 19 following a string of terrorist attacks exposes her greatest election challenge in a nutshell: keeping Germans safe while convincing them of the need to continue the slow and painful integration of hundreds of thousands of refugees. The CDU-CSU will be concentrating on forestalling the loss of too much ground to the AfD by toughening its rhetoric, leaving it vulnerable to the SPD on its left flank, which, however, remained in some disarray as to who to nominate to run against Mrs. Merkel, with the party finally coalescing behind former EP President Martin Schulz. Should Mrs. Merkel prevail, with German public finances being in robust health, "there is every possibility that a round of fiscal spending may come to the fore, and this may be taken as a

"Events may just conspire to produce surprises on the upside as well as the down,"

positive by markets," according to Mr. Champion. All is not bleak, therefore, says Mr. Champion. If Ms. Merkel prevails and her steady leadership in Germany and the European Union continues, it will go a long way towards stabilizing markets, just as the likely victory for Mr. Fillon would usher in structural market reforms that, from an equity point of view, would be very positive. "Events may just conspire to produce surprises on the upside as well as the down," he says. Indeed, the European outlook can cautiously be seen through a glass half-full: neither the Netherlands or Italy are likely to experience political revolutions, and the chances of establishment figures prevailing in France and Germany are high. However, 2017 remains a crucial year for the future of Europe, which would be unlikely to survive a Trump-style shock upset in France. The question would then become whether Europe is irreversibly headed back towards an era of borders, competing nation-states and potential internecine aggression, and thus a potential end to the historical period of free movement, free trade, open financial markets and a unified front against the less liberal instincts governing much of the rest of the world.

Over 40% of Europes GDP will be voting in 2017

BREXIT

STAGE 3: BARGAINING - DEPRESSION - ACCEPTANCE?

While the tail end of 2016 allowed for a relative acclimatizing to the reality of Brexit, that reality and the difficult negotiations it involves begins at the outset of 2017, with the target date for the triggering of Article 50 set for the end of March. Following a long-awaited speech in which U.K. Prime Minister Theresa May emphasized her government's commitment to what has come to be known as 'hard Brexit', the pound sterling spiked momentarily after a long slump due to the long-awaited (partial) clarity of her remarks. The complications and the longer-term political and financial risk, however, are only just beginning to unfold.

HARD LANDING

In Ms May's January 17 speech outlining Britain's negotiating stance, it was made clear the U.K. intends to pursue a 'hard Brexit' when it finally triggers Article 50. This meant the unambiguous implementation of the key Brexit principles of

1) taking control of immigration,
2) leaving the jurisdiction of the European Court of Justice (which polices the single market), and
3) taking Britain out of the free movement zone.

The Prime Minister outlined 12 negotiating priorities, reassuring the EU that the U.K. will still be its "best friend and neighbour," but signalling a hard line negotiating stance and ruling out associate membership of the EU "or anything that leaves us half-in, half-out." "We do not seek to hold on to bits of membership as we leave," Ms May emphasized. "The United Kingdom is leaving the European Union. My job is to get the right deal for Britain as we do."

Meanwhile, the verdict of the Supreme Court appeal that determined whether the government is required to consult parliament before pressing ahead with Article 50 came down at the end of January, which the government lost. With the single market, free movement and the customs union yet to be debated in parliament at all, the implications of, or whether it will even be possible to trigger, Article 50 by the target date of end March, remain unclear.

There is no clear indication, either, of exactly what the parliament would get to vote on or the extent of the influence of MPs to shape terms. However, Ms May did state "the government will put the final deal… before a vote in both houses of parliament." For better or worse, the "muddled thinking as clear as mud" recently departed EU ambassador and negotiator Sir Ivan Rogers suggested Ms May's cabinet suffered from is now hardening into an approach likely to push it beyond the point of no return: Britain is ready to play hardball with the EU.

"PERMANENT PURGATORY"

One point of contention that remains is what Ms May intends to do about the EU customs union. Full membership of said union "prevents us from negotiating our own comprehensive trade deals," she said, in a nod to the government's "Global Britain" theme. But while Ms May does not want Britain to be bound by the common external tariff, she also said the government wants "a customs agreement" and tariff-free access to the EU. It is as yet unclear whether this means a new agreement altogether or partial membership, but the government is likely to be looking for sector-by-sector deals and a special deal for the City of London that would give Britain freedom to provide financial services across borders. To avoid a potential "cliff-edge" in which Britain leaves the bloc at the end of the stipulated two year negotiations triggered by article 50 without a deal in place, the Prime Minister argued for a "phased process of implementation," that would, however, not amount to an indefinite transitional deal, which she labelled "permanent purgatory." "The best possible deal is almost certain to fall somewhere between a hard and a chaotic Brexit," said Martin Wolf of the Financial Times. (The departed Mr Rogers, for his part, had expressed concern Article 50 negotiations could realistically "take up to 10 years.")

Just prior to Ms May's comments, moreover, U.K. Chancellor Phil Hammond suggested Britain would be ready to transform its economic model into that of a "corporate tax haven" if the EU fails to provide it with a favourable agreement on market access once Brexit goes into effect. He thereby suggested Britain would abandon the European-style social model in terms of taxation and regulatory systems in the event it were closed off from European markets. "We could be forced to change our economic model," he said, "and we will have to change our model to regain competitiveness… We will do whatever we have to do." Mr Hammond said he was hopeful an interim deal could be

> **"The best possible deal is almost certain to fall somewhere between a hard and a chaotic Brexit."**

created to cover the period between Britain leaving the EU and "the full introduction of a long-term future arrangement." Michel Barnier, the EU's chief negotiator, warned that Mr Hammond's threat "risked some kind of trade war with Europe" that would be damaging to all.

As for the City of London, having dropped its demands for "passporting" rights to sell services throughout the single market following intensive lobbying, it now hopes for a post-Brexit deal resting on the EU legal concept of "equivalence" – a measure granting non-member countries with adequate regulatory standards access to European financial markets. The disadvantage would be that the City would then be 'at the mercy' of Brussels – for example, if Brussels suddenly changed its financial rules, which would not be the best foundation for long-term investments in Britain from banks and insurers.

No deal at all, however, could result in thousands of financial sector jobs being moved to competing hubs abroad, such as Frankfurt or Paris, though it is not a given the EU itself would want an influx of large banks in the shadow of potential future financial crisis. Securing "equivalence," on the other hand, would likely allow London to retain its status as a global financial centre.

EXCHANGE RATE GBP TO EUR

Data source: European Central Bank Exchange Reference Rate

STERLING POUNDING

The pound sterling spiked immediately following Ms May's comments, which were seen to be providing long-sought clarity and as somewhat conciliatory, despite its content. This, however, followed steep declines to the sterling after leaks of the Prime Minister's speech earlier that week sent the pound tumbling below the "key psychological level" of $1.20, said Kathleen Brooks, research director at City Index Direct, with further declines expected. Deutsche saw a "material negative" for market implications over the longer term, with "deterioration of political rhetoric... as a key catalyst for further sterling weakness [and the possible trade shock from] a full exit from the Single Market with the GBP and EUR/USD possibly close to parity.

> **"The main source of inflation seem(s) to be the sterling and the pass-through is very clear and we've broken some key**

For the Bank of England, the weakening of the pound presents a difficult balancing act with its implications for consumer prices (already rising at the quickest pace since 2014), exacerbating tensions in trying to control inflation while supporting economic growth. "The main source of inflation seem(s) to be the sterling and the pass-through is very clear and we've broken some key levels," said Steven Major, global head of Fixed Income research at HSBC. "The question is whether it affects what the BOE is thinking or whether they view it as transitory." With inflation at 1.4% in December, it is expected to breach the BOE's 2% target within months as the pound's 19% slide since the referendum feeds through to import prices. This means "BOE officials may have to make the uncomfortable decision between tolerating an even bigger inflation overshoot of tightening policy – even if that causes more short-term pain – to keep price-growth in check," according to Bloomberg analysts.

In addition, "[i]t will be hard for the U.K. to immediately reap the benefits of a weaker pound (which has further to fall in 2017, and which is

UK Prime Minister
Theresa May

already feeding into higher inflation)," after a prolonged period of de-industrialization, says Michael Cembalest, Chairman of Market and Investment Strategy with J.P. Morgan Asset Management. However, Mr Cembalest suggests, since business surveys and commercial property enquiries bounced back from their initial swoon since Brexit, retail sales are holding up and job listings reflect logical responses to a weaker pound. "Perhaps the most important thing to watch is business investment plans, which plummeted after the vote. More recently these plans have improved a little, as businesses wait and see what the deal with the EU will look like once Article 50 is triggered," he says.

> **"The future of Scotland, it seems, is destined to be outside one of the two unions of which it is currently a member."**

The BOE is expected to announce its next policy decision on Feb. 2, but the median forecast of economists is no rate change from the current record-low of 0.25% until at least the second quarter of 2019. While the future looks uncertain, trade deals may provide a source of relief: it is widely accepted the U.K. will be unable to negotiate or sign up to trade deals during the two-year exit process following the triggering of Article 50. Despite this, the pound could still be bolstered if some compromise is reached with the EU and the U.K. is able to have non-EU trade agreements 'ready to go' before it leaves the EU and the single market. Such a safety net would likely restore some degree of confidence in the pound, says Oliver Meredew of Future Currency Forecast.

FURTHER FALLOUT

There is, of course, a further broad array of long-term political risk due to the still unclear nature of how Brexit negotiations will transpire that touches upon wider issues, from the constitutional integrity of the United Kingdom to the implications of strict immigration control for the union's pensions and retirement system. For example, a study commissioned by the Guardian newspaper showed that drastic cuts to migration as a result of Brexit will force Britons into longer working lives and skew the ratio of working-age people to pensioners, delaying pension payments. "The message from Brexit is if you don't want immigrants, you're going to have to work longer. That's how the sums work," said Oxford University's Professor Sarah Harper, chair of the U.K. government's foresight review on ageing societies. "If all migration into the U.K. was to be halted, then over the next five years, those coming up to retirement would have to work about one-and-a-half-years longer just in order to maintain current GDP output."

In addition, there remains the question of Scotland: A majority of Scots (62%) voted in favour of Remain in the June 2016 referendum, which in turn has ensured that the issue of its constitutional future remains on the agenda, despite the Scottish vote to reject independence in September 2014. According to some polls, support for EU membership does not necessarily translate into support for independence. With the Scottish National Party (SNP) minority government's commitment to explore its options, including continued membership of the single market, bespoke arrangements for Scotland or the option of holding another independence referendum, Ms May's apparent resolve for a "Hard Brexit" may trigger a second Scottish independence referendum.

"The future of Scotland, it seems, is destined to be outside one of the two unions of which it is currently a member... A hard Brexit would indisputably be the catalyst for the SNP to call a second referendum. What is not certain, however, is whether the reality of a hard Brexit will be enough to tip opinion polls in the SNP's favour," says Paul Anderson, a researcher at Canterbury Christ Church University. "In pursuing a hard Brexit, Theresa May risks the constitutional future of the U.K."

The seemingly endless complications resulting from Brexit encouraged Saxo bank to make the following "outrageous prediction" for 2017 (which it emphasized should not be considered its official market outlook, but an outlier with potential for upsetting consensus): "What if Brexit never happens, as the U.K. Bremains?" Hypothetically, it could be speculated, the EU is disciplined into a more cooperative stance towards the U.K. due to its numerous populist challenges; "by the time Article 50 is triggered and presented to parliament, it is turned down in favour of a new deal. The U.K. is kept within the EU's orbit, the bank of England hikes the rate to 0.5% and the euro plummets 0.7300 to pound sterling." Following Ms May's "hard Brexit" speech, this bit of fun speculation from Saxo remains ever more fanciful. But the complex negotiations, challenges and contradictions facing the Prime Minister are not. The ghost of "Bremain" is likely to haunt proceedings for years to come.

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BLOCKED BLOC: EUROPE'S YEAR OF RECKONING

Glenn W. Leaper & Jingchao Zhou

As if Brexit, populist uprisings across the continent and crucial elections did not suffice, the European project is beset by a host of other (but related) problems certain to emerge into full-frontal view in the course of 2017.

A near-sclerotic institutional impasse amid Brexit negotiations and partisan fragmentation means the European Union will be busier putting out fires than legislating confidently. Despite slow but steady economic growth, there are major differences on the way forward on economic policy with multi-track growth levels, while Italy's banking problems could spill over into a Europe-wide financial crisis and Greeks begin to ponder – wait for it – 'Grexit'. Meanwhile, Europe's security situation deteriorates as it finds itself with increasingly belligerent neighbours and caught in a geopolitical vice between an increasingly confident Russia and a United States that appears to have thrown the EU to the wolves (or bear, in this case).

Political Pretences

Kicking off a year already stacked with elections with potentially existential consequences for the EU, the European Parliament (EP) elected Antonio Tajani of the European People's Party (EPP) as its new president on January 17 with a narrow majority. Perhaps indicative of the new norm in the age of populism, Mr Tajani has previously represented Silvio Berlusconi's Forza Italia in the EPP, and is tainted by involvement in the Volkswagen 'Dieselgate' scandal.

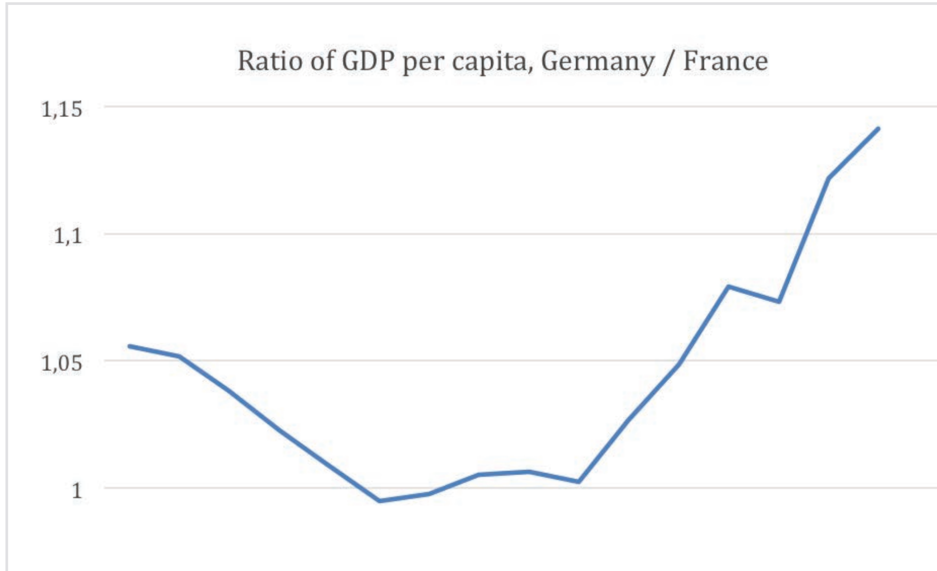
Meanwhile, Commission President Jean-Claude Juncker is unlikely to find the relationship as cosy as the one he had with outgoing president Martin Schulz, the two working well together to push through the Commission's agenda in the EP despite belonging to different parties. Mr Juncker will step down in 2019, which means jockeying for the presidency of the EU Commission has already begun, with regulation Commissioner Frans Timmermans, current foreign policy chief Federica Mogherini and current Commission Vice President Jyrki Katainen in likely contention.

The most controversial matters facing Brussels this year are likely to include fiscal and economic policy amid continuing political gridlock. Conservatives will demand EU countries honour stringent fiscal rules, while socialists continue pushing for an end to austerity. On lawmaker agendas is the long-awaited reform of EU asylum rules and the on-going debate about the balance between security and civil liberties. In a year dominated by tough elections and Brexit, which is expected to consume most of the EU's time, focus and resources once Article 50 is triggered, diplomats and parliamentarians expect the Commission will "propose little and decide even less" - especially if it affects countries going to the polls. The big question for markets is: "What is going to happen with the Eurozone. The Eurozone really isn't working for southern Europe and that, politically, is very dangerous," says Craig Mackenzie, chief investment strategist with Aberdeen Asset Management. "The build-up of these populist pressures may lead to necessary change, which might in the end help Europe in the long term, but it would likely be pretty destabilizing in the short term and be potentially bad for the markets."

A Snail's Pace

Most analysts agree that the Eurozone economy will remain relatively stable in the course of 2017, though GDP projections vary. Moody's estimates a growth rate of 1.3%, while J.P. Morgan Asset Management projects growth closer to 2%. Moody's observes a divergence between the larger and smaller countries in the Eurozone, with "some smaller countries - such as Ireland, Luxembourg, Malta and Slovakia - likely to record stronger growth of above 3%," while the largest economies - "Germany, France and Italy - will continue to grow at well below 2%." The outlook remains lacklustre, then, compared to the economic recovery of the U.S. and other developed markets, and unlikely to make itself felt in the pocketbooks of average Europeans – a key element in the populist discontent.

It is simultaneously, however, the result of a "higher level of political uncertainty, the risk to the euro because of that uncertainty, and finally the ECB finishing off their quantitative easing program by mid-2017," says Krishna Memani, CIO



Source: compiled with data from World Bank World Development Database and head of Fixed Income of Oppenheimer Funds, all of which end up being a problem for the performance and growth of European assets. Mr Mackenzie expects the European economic recovery "to continue at a snail's pace, with gently positive implications for European equities and nothing too frightening for European bond markets."

Though the economic outlook is relatively stable, the Eurozone faces political and economic risk that could, if not meticulously managed, derail the economic recovery and threaten already weakened EU institutions. One risk is the widening divergence of economic performance among the EU's biggest economies, especially between the biggest two, Germany and France. The German economy has continued to outperform the French economy since the outbreak of the financial crisis in 2007, which has created numerous disagreements across many areas of economic policy since the Euro Crisis.

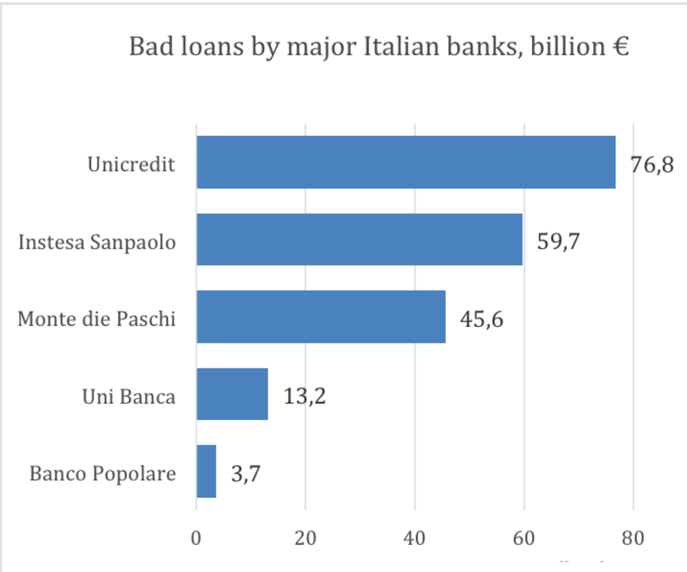
> **"It's striking to see the continued outperformance of Germany vs. France, which is not a healthy dynamic between the Eurozone's two largest countries."**

"It's striking to see the continued outperformance of Germany vs. France, which is not a healthy dynamic between the Eurozone's two largest countries," comments Michael Cembalest, Chairman of Market and Investment strategy at J.P. Morgan Asset Management. It is also a reason markets heavily favour Francois Fillon, the centre right candidate, in the French election, due to his platform to restructure the stagnant French economy. Meanwhile, "economic growth dynamics in the euro area in 2017-18 will be broadly credit neutral and debt metrics have stopped deteriorating for most, though not all, euro area sovereigns. However, rising political and policy risk in some euro area countries could undermine on-going reform efforts," offers Sarah Carlson, a Senior Vice President at Moody's.

"Southern Satyrs"

One such political risk is the banking crisis in Italy and how it unfolds in 2017. Banca Monte dei Paschi di Siena (MPS), one of Italy's largest banks, has struggled to cope with 28 billion euros' worth of non-performing loans, accounting for 36% of the bank's loan portfolio. After efforts failed to solve its financial problems privately, the Italian government announced a 20 billion euro fund rescue package approved late last year. Many analysts, though, believe even this amount is not enough to solve MPS's problem. According to estimates from Goldman Sachs, recapitalization would require at least 38 billion, while London Capital Group suggests a sum closer to 52 billion euros will be necessary. "There's a clear risk of Italy's banking problems spilling over into a wider financial crisis, which could put further pressure on the political and economic stability of the euro area, especially in the light of upcoming elections," warns Chris Williamson, Chief Business Economist with IHS Markit. A "precautionary recapitalization" plan is under discussion, but it is politically sensitive, as Germany has already questioned whether such a plan is compliant with EU rules.

Another key political risk is Greece's sovereign debt and the uncertain development of its economy. The Greek government distributed a sizeable 'Christmas gift' to Greek pensioners at the end of last year, hinting at a possible snap election at some point during 2017. However, despite the fiscal gift, New Democracy, the centre-right party, still leads in the polls. In addition, EU finance ministers froze implementation of the Greek debt-restructuring plan on the basis that the move violated the terms of its bailout program, putting Greece back on risky ground. While tough reforms have been implemented, progress on fiscal consolidation has largely been built upon large



Source: Handelsblatt

increases in taxation, resulting in a multi-year recession. With the living standard now below the level it was when Greece joined the EU, "Greeks are losing patience with the euro too, as they continue to see their living standards deteriorate. Support for the EU in Greece is lower than in any other European country, and the next talk of 'Grexit' might now come from Greeks themselves," concludes Danae Kyriakopoulou, Head of Research with the Official Monetary and Financial Institutions Forum. Conversely, a possible snap election could be positive for the reform effort, as Kyriakos Mistotakis, New Democracy's leader, has advocated for a strict reformist agenda. The (aptly named) Nicholas Economides, professor of economics at NYU Stern School of Business, explains why he thinks such a reform effort is likely to succeed: "First, the IMF fully supports the reforms and is willing to battle with the Europeans for debt restructuring, less austerity, and more reforms. Second, many Greeks, having tried everything else, now see reforms as the only way out of the crisis," he said.

Russian Roulette

Europe is vulnerable on many other fronts, not least the worsening security situation given the multiple emerging threats both from within and without its borders, and the transmogrified geopolitical environment. Alongside the well-documented policy paradoxes between open borders, immigration and security, a proliferation of challenges have emerged to Europe's east, Russia and Turkey foremost among them.

> **"The Eurozone really isn't working for southern Europe and that, politically, is very dangerous."**

Following drastic deterioration in EU-Turkey relations in 2016 due to President Erdogan's post-coup policies, these are unlikely to improve in the course of 2017, potentially leading to serious political and security risks. The assassination late last year of a Russian ambassador provides Mr Erdogan with yet another pretext to continue his crackdown on every major secular institution in Turkey, including universities, media, business and the police, in turn perpetuating the condemnation from Brussels and mutual antagonism. Whether this eventually imperils the migration deal struck between the EU and Turkey in March 2016 remains unlikely, but the anger at immigration in European countries facing elections and fears of Islamist infiltration that could tilt European elections means Mr Erdogan is in a position where he can likely afford to ignore Europe's opprobrium. Meanwhile, Mr Erdogan's rapprochement with Russia is set to continue, making it virtually certain that he continues being an increasingly unreliable partner, particularly as concerns commerce and energy deals, not to mention the foreign policy headaches Turkey's involvement alongside Russia in the Syrian conflict creates for the European bloc.

> **"There's a clear risk of Italy's banking problems spilling over into a wider financial crisis, which could put further pressure on the political and economic stability of the euro area."**

In the meantime, Europe finds itself in a vice between an increasingly openly belligerent Russia and an American partner that seems to have abandoned it - to Russia's benefit. With President Trump deeming NATO obsolete, promising to lift economic sanctions on Russia and openly encouraging other European countries to go the way of Brexit, the positives for business and trade through a forced closer economic relationship with Russia are drastically outweighed by the severe consequences for European stability and its geopolitical role in the world.

Based on previous patterns of behaviour (e.g. Georgia in 2008, Ukraine in 2014, etc.), it is not inconceivable Mr Putin might choose to test NATO's resolve with border skirmishes and other destabilization tactics in the Baltic countries. Should a situation arise where NATO is forced to invoke Article 5, the nominal leader of the alliance refuses to intervene and European countries are unable or cannot find the political will to act militarily independently of the alliance, the bloc would suffer a humiliating crisis of confidence from which it may not be able to recover politically, whether internationally or at national and local levels.

"There is a real danger that a deal with Putin would accelerate the unravelling of the political West and play into Putin's grand strategy of making Russia great again – indeed, greater than it was under the czars and the commissars," warns Strobe Talbott, a veteran U.S. negotiator with Russia and deputy secretary of state under President Clinton. It follows that Mr Trump, seeing himself as a great dealmaker, will be eager to cut a deal with Mr Putin to lift U.S. sanctions in exchange for a nuclear deal, an alliance on the Syrian conflict and assistance in combatting terror. The net effect of this, however, is likely to be to sell out the interests of Eastern European countries in the former Soviet orbit and return central and Eastern Europe to the degree of insecurity in Russia's shadow experienced during the Cold War. "Unlike in 1945, Russia does not have the military forces to occupy and hold territory in Eastern Europe," however, says Antonio Missiroli, director of the EU Institute for Security Studies. Nevertheless, from Mr Putin's perspective, the symbolic and psychological damage done to the European project by proxy may suffice in the near term, while he goes about implementing his own version of Mr Trump's "Make America Great Again."

Mr Trump himself being the "world's foremost geopolitical risk" aside, therefore, it will be Russia that is set to consume European foreign, security and domestic policy in the years ahead, and 2017, with its daunting challenges, will be the crucible that determines the balance of European power for years to come. Mr Putin's disinformation, fake news, and "Kompromat" efforts that worked to such effect in deciding the U.S. election in Mr Trump's favour are set to be repeated both in Germany's elections, as confirmed by German intelligence services, and France's, where Ms Le Pen openly takes funding from Mr Putin and speaks of him in glowering terms. "Meddling is going on from Paris to Ukraine, from east to west and north to south, within Europe and at its borders, and always with the intent of undermining the credibility and effectiveness of democratic institutions. And it is either being denied or downplayed," says Constanze Steinmueller of the Brookings Institution.

Denial or downplaying of any of the political, economic, financial or international threats facing the continent is no longer a bankable proposition. The European project's reckoning has come in 2017. We hope it prevails.

The Dragon and the Eagle

by ***Jingchao Zhou***

2017 is poised to be a year of challenges in South-East Asia, and particularly for the Chinese government. It faces not only further economic slowdown provoked in part by lackluster economic reforms, but also a more hostile international environment. The vaunted anticorruption campaign of President Xi Jinping has also had the adverse effect of putting the trial-and-error character of projected economic reforms on hold. President Trump's hard line campaign rhetoric against China threatens to disrupt existing political and institutional structures built up arduously between the two countries over the last two decades. The verdict of the International Tribunal for the Law of the Sea (UNCLOS) has compelled countries in or around the South China Sea to intensify their military presence. North Korea is determined to build up its nuclear deterrence despite international condemnation and sanctions. In addition, Mr. Trump's claim that Japan has not been compensating sufficiently for the security provided by the U.S. military could create the perfect pretext for Japanese Prime Minister Shinzo Abe to push for the abolishment of Article 9 of the Japanese constitution, which forbids Japan from going to war. These issues present not only a new constellation of political risk for China, but could also irrevocably alter the existing regional and international order.

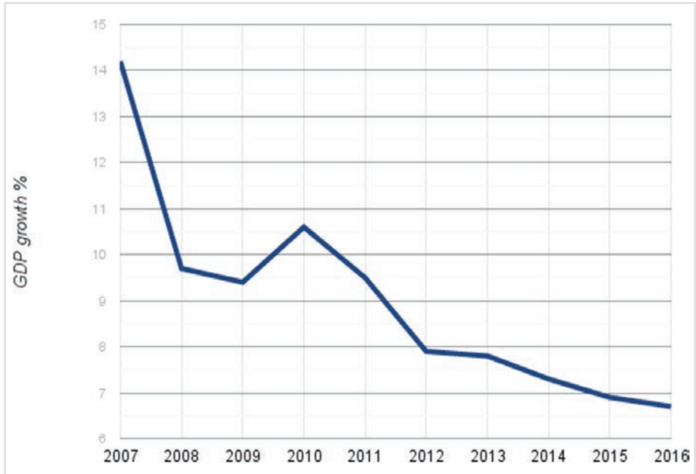
"CHINESE DEMOCRACY"

2017 will be a significant year in internal Chinese politics, as the Chinese Communist Party holds its 19th National Congress in the autumn. Far-reaching change in the constitution of the top leadership of the Communist Party is expected. The majority of the Politburo Standing Committee is expected to retire, and a new Central Committee, General Secretary and Central Military Commission will be elected. These elections will determine the development of political, economic and foreign policies for the next five-year period to come.

> **"With increasing internal and external uncertainties, this smooth sailing is unlikely to continue."**

The most important of these will be the election of the Politburo Standing Committee (PSC), which is essentially the top leadership of the Party. Five of the seven members of the Standing Committee will retire, leaving only President Xi and Premier Li Keqiang from the current lineup. Since 1977, changes in the PSC reflect the results of power sharing between reformists and traditionalists within the Communist leadership and the agreed-upon direction of political and economic reforms. At the 18th National Congress in 2012, however, the size of the PSC was reduced from nine to seven, which was widely seen as a victory for Mr. Xi's drive to consolidate power. This drive is expected to continue, with speculation as to whether even Mr. Li will be ousted during the 19th Congress. With rumor brewing that Mr. Li and Mr. Xi are divided over economic policy, Mr. Li's free market reforms could be brushed aside in favor of Mr. Xi's more hands-on, centralized approach to the economy.

CHINA`S ECONOMIC GROWTH (2007-2016)



Based on data published by the World Bank Group

Mr. Xi was named as the "core" of the leadership last October, a symbolic status previously only granted to Mao Zedong and Deng Xiaoping. Mr. Xi has also used his large-scale anti-corruption campaign to purge political opponents since he assumed office in 2012. If he succeeds in stocking the PSC with even more of his political allies and loyalists this year, he could wind up being the most powerful figure in Chinese politics since Mao, and would possibly be in a position to extend his rule beyond 2022. If this scenario materializes, it will have serious consequences for China's political and economic future.

ECONOMIC BAND-AIDS

Under Mr Xi's leadership, the Chinese government has managed to make some progress with its economic reforms, such as the establishment of the Shanghai Free-Trade Zone in 2013, the reduction of industrial overcapacity, restructuring of the corporate sector and the liberalization of the financial market. However, the Chinese economy still faces serious challenges in 2017.

Its first challenge is to meet its economic growth target whilst ensuring that the transformation from an export- to consumption-oriented economy continues smoothly. Even though China's GDP growth has slowed from 14.2% in 2007 to an estimated 6.7% in 2016, the Chinese government has prepared for a "soft landing" and has consistently met its growth targets. Nevertheless, with increasing internal and external uncertainties, this smooth sailing is unlikely to continue. Two of the engines powering the Chinese economy have been fiscal spending and the rebound in the property market. Recently, however, several policies have been enacted in order to prevent an overheating of the latter, leaving open the question of whether the property market will continue to grow as robustly as it did in 2016.

The second challenge is debt sustainability. Despite having implemented policies such as loans for bonds swapping at the local government level, China has failed to halt the rising total debt level. According to Bloomberg, since 2011, total loans have grown by 14.5% per annum, while annual GDP growth rate has slowed to less than 7%. As a result, the overall debt-to-GDP ratio was expected to reach 260% by the end of 2016. A large part of Chinese debt has been used to finance infrastructure projects in order to stimulate growth, which has had diminishing returns and has started to become increasingly ineffective. This, in turn, will likely limit the government's ability to enact pro-growth policies, as more debt almost certainly leads to more market anxiety.

> **"Loans have grown by 14.5% per annum, while annual GDP growth rate has slowed to less than 7%. As a result, the overall debt-to-GDP ratio was expected to reach 260% by the end of 2016"**

Whether the government can overcome these issues and implement more economic reforms is crucial for China's economic development. According to BMI Research, if Mr Xi fortifies his "core" leader position at the 19th National Congress, he "will be positive for the centralization of power in Beijing as the president strengthens his grip over the party," and further reforms could "proceed at a smoother pace." However, according to BMI, "reforms to reduce the dominance of state-owned enterprises (SOEs) are still likely to remain slow". Facing continued economic slowdown, internal and external political uncertainties, moreover, "the government will adopt pro-growth measures to boost economic growth ahead of the political transition," according to Vincent Chan, Head of China Research at Credit Suisse.

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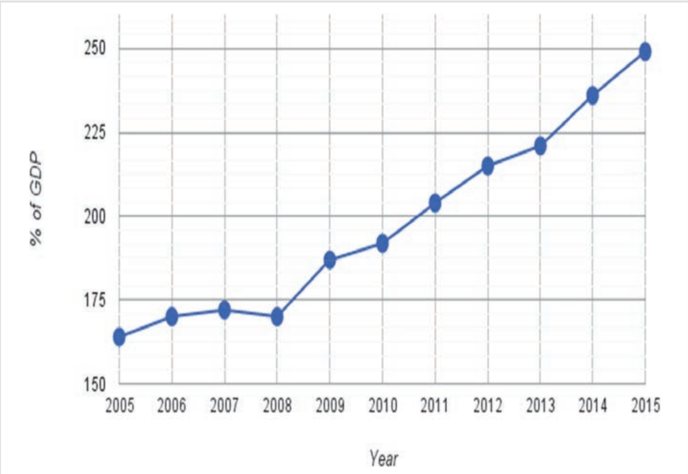
The third challenge will be a series of potential clashes on trade and currency issues with other countries. 15 years after China joined the World Trade Organization (WTO), it has yet to be granted Market Economy Status due to rejections by the U.S., EU and Japan, who have all recently launched anti-dumping cases against China's cheap steel exports. A

CHINA`S TOTAL DEBT TO GDP RATIO



Source: Nomura (http://www.businessinsider.de/china-debt-to-gdp-statistics-2016-1?r=UK&IR=T)

change in official status would help it to avoid penalties, but as things stand, Beijing has accused them in turn of "double standards" and "covert protectionism." As legal battles likely continue throughout 2017, the bigger challenge for China's foreign trade is the Trump administration. Even if Mr. Trump were to refrain from implementing every hostile policy he has threatened against China, just one or two of these could start a trade war, disrupting global markets significantly.

Another flashpoint between China and the U.S. in 2017 is likely to be currency valuation. The U.S. Federal Reserve hiked short-term interest rates last December and is projected to hike interest rates at least twice more in the course of the year. With expectations that the U.S. interest rate will rise and the U.S. dollar will strengthen, Chinese businesses and asset owners will want to purchase more foreign assets, which would drive the Yuan down. China could slow down the depreciation by adopting more capital control policies. However, if the market anticipates such policies, it could accelerate the purchasing of foreign assets and drive the exchange rate further downwards. This would inevitably lead to a clash with Mr. Trump, as he has insisted, all evidence to the contrary, that China has been weakening the Yuan to the advantage of its export sector. This has not been the case for a number of years.

FOREIGN FIRES IN HOSTILE WATERS

The Economy is not the only area where Beijing and the Trump administration are on a collision course. On one hand, buttressed by a more outspoken foreign policy and slower economic growth, China's own populist nationalism has been resurgent in recent years. Any measures from Mr. Trump's administration targeting China will be met with strong domestic nationalist sentiment urging countermeasures. On the other hand, unlike his predecessors, Mr. Trump does not see China as a potential partner on global issues, but rather as a geopolitical opponent. Based on his many provocative statements and choice of China critics in his cabinet members, most notably Peter Navarro as Head of Trade

Japanese Prime Minister, **Shinzo Abe**

Policy Council and Wilbur Ross as Commerce Secretary, it is clear that he wishes to realign with Russia while targeting China on trade and economic issues.

> **"Unlike his predecessors, Mr. Trump does not see China as a potential partner on global issues, but rather as a geopolitical opponent."**

However, Mr. Trump is not be the only head of state cozying up to Russia. Japan's Prime Minister Shinzo Abe met with Vladimir Putin four times in 2016, and though they did not yet reach a peace deal and resolve the issue of the disputed Kuril Islands, a $2.5 billion bilateral economic deal was announced in December. This rapprochement reflects a step towards Abe's goal of forging new partnerships with China's neighbors, especially Russia, the Philippines, Vietnam and India, in order to counterbalance Beijing's

growing assertiveness and influence in the region. Mr. Trump's accusations that U.S. allies in Asia are not paying enough of their dues for American protection will no doubt accelerate Mr. Abe's counterbalancing plan. Most worrisome for China, however, is that due to Mr. Trump's pronouncements, Mr. Abe will almost certainly attempt to achieve his ultimate political goal in 2017: abolishing Article 9 of Japan's Constitution, to free Japan from the prohibition on the sovereign right to use military force in eventualities other than self-defense. World War II history has never really been resolved among the countries in East Asia; an amendment to Article 9 would therefore not only further contribute to the deterioration of relations between Japan and China, but also fuel the growing nationalism in both nations. It will be a serious challenge for Beijing to forcefully respond to Japan while controlling for nationalists' resentment at home.

> **"Trump has expressed willingness to meet with Mr. Kim for nuclear talks, but has also compared Mr. Kim to a "miniac".**

The disputed islands in the East and South China Seas will continue to be another major geopolitical risk for China and other concerned parties, as China continues to 'build' islands for military purposes. In reaction, countries such as Vietnam, the Philippines and Taiwan are also expanding their military and civilian presence in the South China Sea. As a result, a military incident between two or more of the countries in the region with China is increasingly likely in 2017. If such an incident comes to pass, China hawks in the U.S. will have their pretext for retaliation and tougher measures against China.

Finally, the ever-bellicose North Korea seems likely to continue testing American (and Chinese) resolve with nuclear tests and an increasingly capable missile program intended to reach the U.S. China has not been effective in convincing Kim Jong Un to stop the North Korean nuclear and missile program. As a response to DPRK's nuclear and missile tests in early 2016, the U.S. is currently deploying its most advanced missile defense system, THAAD, in Japan and South Korea. Though intended as deterrence towards North Korea, this system can also greatly limit China's missile strike capabilities. To make matters worse, Mr. Kim announced during his New Years' speech that North Korea is almost ready to test an intercontinental ballistic missile. This move is set to raise the stakes for negotiations ahead

Chinese President, **Xi Jinping**

of Mr. Trump's inauguration. Mr. Trump, for his part, has expressed willingness to meet with Mr. Kim for nuclear talks, but has also compared Mr. Kim to a "miniac". As a result, China, as the only ally of DPRK, and as the longtime mediator between the U.S. and DPRK, will have a difficult task working with Mr. Trump in containing North Korea's nuclear capability while trying to maintain the geopolitical status-quo in the region.

How China navigates these dangers in 2017 will depend partly on how it balances the challenges and renewed hostility from the West with containment of popular nationalist sentiment at home. This balance, or lack thereof, will play a large role in determining how the Chinese government handles potential conflicts in the South China Sea and elsewhere. After a jaw-dropping 2016 that China's leadership probably didn't fully anticipate (this despite domestic propaganda making the case for Trump in the election campaign, following wariness with Hillary Clinton's outspoken criticisms of human rights abuses), the heightened uncertainty will dominate the agenda in 2017. Moreover, tremors from the political earthquakes of 2016 will continue to be felt throughout the Asia-Pacific geopolitical landscape.

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EMERGING AND SUBMERGING MARKETS

by Jingchao Zhou

Two key risks that will determine the trajectory of the 21st century – climate change and automation - will continue to have their biggest impact on developing countries. Climate change and the disruptive forces of nature have already shown their destructive effects on many parts of the developing world.

More violent natural disasters and fragile ecosystems are expected to further dislocate people, creating increased potential for conflicts like those in Syria and Libya. Meanwhile, the effects of automation are starting to be felt on developing markets, which still lag in terms of coping with the autonomous technology that will soon produce things more cheaply than their poorest and cheapest workforce is capable of. What follows is a look at the political risk in some of the key emerging markets for 2017, with India and Russia enjoying the best prospects and Turkey and Brazil suffering the worst.

The aforementioned fundamental long term trends, combined with the slow recovery in many developed economies, lackluster economic reform in some

> "A lot of emerging markets are very exposed to commodity prices, and improved commodity prices is also good for their growth."

emerging economies and global political instabilities make 2017 an uncertain year for emerging markets. In the latest quarterly emerging markets (EM) report from Credit Suisse, analysts believe that U.S. interest rates, China's economic performance, commodity prices and President Trump's policies will largely determine EM performance for the year. Other analysts are divided in their predictions. Many optimistic analysts think the overall EM positive performance in 2016 will continue in 2017. Craig Mackenzie, chief investment strategist at Aberdeen Asset Management, believes that "a lot of emerging markets are very exposed to commodity prices, and improved commodity prices is also good for their growth." This view is also shared by Ricardo Adrogué, head of emerging markets debt at Baring Asset Management: "Our assessment of emerging markets is actually strengthening at the time that developed market institutional framework is weakening," he says. Conversely, pessimistic analysts believe that a more hostile global financial climate, led by interest rate hikes in the U.S., increasing doubts about the Chinese economy and political uncertainties in many countries may reflect badly on emerging market economies. Three credit rating agencies - S&P, Moody's and Fitch - have recently lowered their credit outlooks for emerging markets. Capital flight risk, geopolitical risk and potential weakness in the banking and energy sectors are among the biggest concerns.

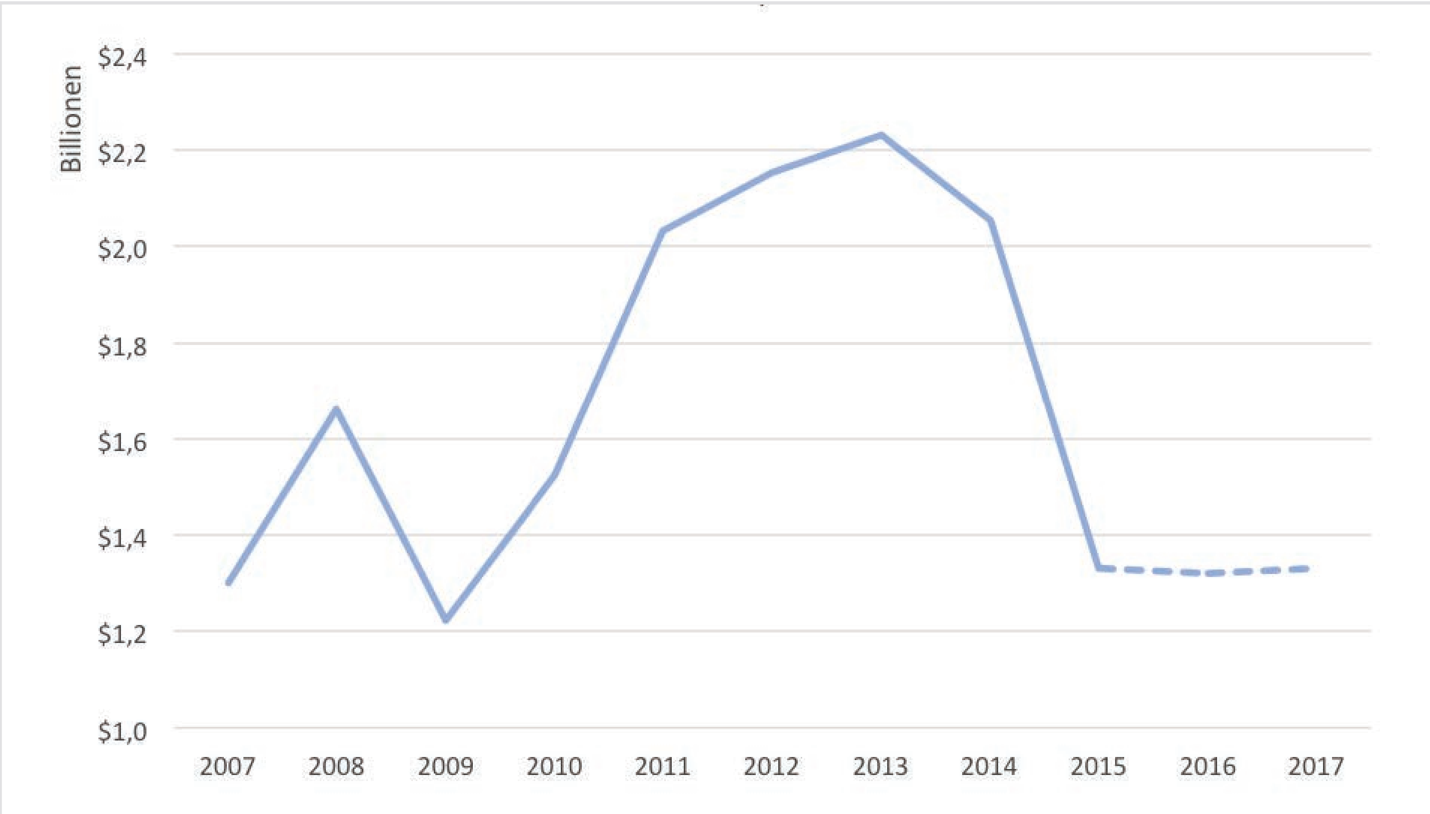
RUSSIAN RENAISSANCE

Having achieved many of its geopolitical objectives in 2016, Russia heads into 2017 on strong ground. With the EU consumed by multiple elections, BREXIT negotiations and the (Russia-backed) surge of far-right populism across the continent, the invasion of Donbass has become a frozen conflict while the government in Kiev descends into chaos, in part due to its own corruption. NATO may no longer be in a position to protect the Baltic states from Russian encroachment. Bashar Assad is likely to survive one of the bloodiest civil wars in recent history in Russia's

close ally Syria (with Mr. Putin's considerable help). Most importantly, with Donald Trump installed as U.S. president, most economic sanctions on Russia are expected to be lifted. It is not surprising, therefore, that many analysts are optimistic about Russia's economic performance in 2017.

The Russian economy is estimated to grow by 1.2% in 2017, even though this projection is still lower than projections for global growth, the U.S. and even the EU. Nevertheless, Russia is expected finally to recover after a two-year recession. Russian stock index RTS rose by 52% in 2016 in dollar terms and is likely to continue being bullish in 2017. The rising price of oil will also play a large role in Russia's economic recovery, rising about 50% YTD. According to an estimate from UBS Group, the ruble will be the best carry trade opportunity in the EMEA region in 2017, with a potential return of 26%. Nathan Griffiths of NN Investment Partners agrees with the optimistic view on the Russian economy, seeing the "Russian equity market as an obvious candidate. Higher oil prices, a stronger ruble and easing inflation

NOMINAL GDP, RUSSIA



Source: data and estimation according to OECD Economic Outlook 2016

should encourage the country's central bank to loosen monetary policy."

The potential political risk for Russia, however, might be overconfidence. It is still uncertain how far the Trump administration will go to accommodate Russian political and economic interests at the cost of giving up U.S. influence in Syria, the Middle East and damaging its relationship with the EU. Furthermore, the Russian economy has not been subjected to the necessary reforms that would allow it to achieve sustained growth. Nepotism and corruption will continue to plague Russian economic potential in the medium to long term.

BRAZILIAN BOMBAST

2017 will be a year fraught with risk for Brazilian politics. Four months after the impeachment of former President Dilma Rousseff, President Michel Temer is on shaky ground. His majority in Congress has been weakened, the bill to cap spending was passed by a much smaller margin than expected, leaders in his own coalition are showing discontent, and there have been renewed protests against corruption and austerity over the past months. As a result, Mr. Temer's disapproval rating has surged: according to a recent opinion poll by Folha de S. Paulo, 51 percent of respondents rated Mr. Temer's government as bad or terrible, 40 percent thinks his government is even worse than his predecessor's, and 63 percent wanted him to resign. In addition to bad economic indicators, allegations his campaign illegally took money from Odebrecht SA, Latin

> "The Russian equity market as an obvious candidate. Higher oil prices, a stronger ruble and easing inflation should encourage the country's central bank to loosen monetary policy."

America's biggest construction company, have contributed to his unpopularity. If the investigation finds evidence to implicate Mr. Temer or his advisers, there is concern he may

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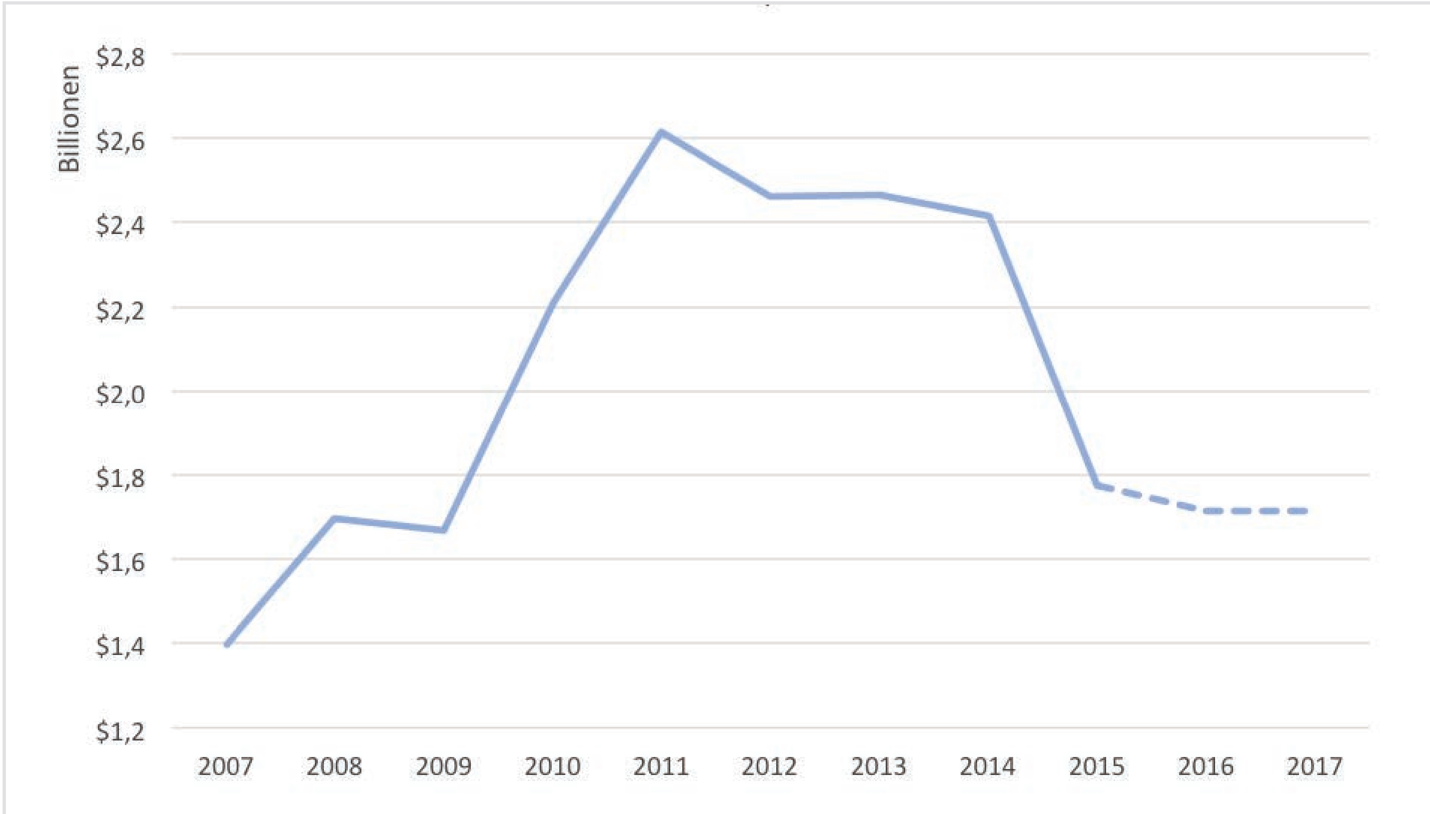
NOMINAL GDP, BRAZIL



Source: data and estimation according to OECD Economic Outlook 2016


President Michel Temer

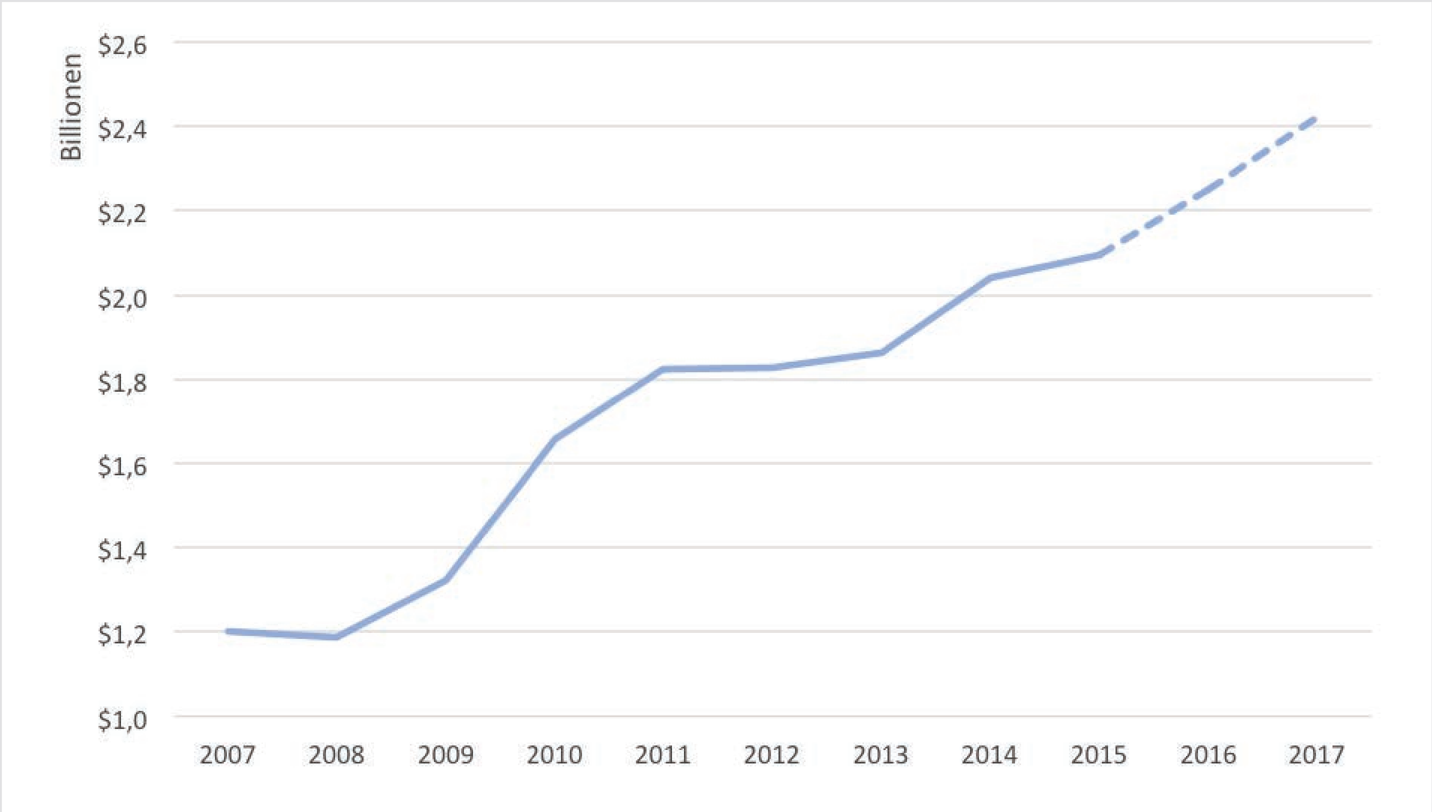
not be able to finish his term in office, creating yet another political crisis in Brazil. Making matters worse, following a deep, multi-year recession, the International Monetary Fund (IMF) has more than halved its 2017 growth outlook for Brazil from 0.5% to 0.2%, citing economic activity in Brazil as weaker than expected.

Under these circumstances, lawmakers may finally feel some urgency to implement important structural reforms. A pension reform proposed by Mr. Temer is up for congressional approval in early 2017. Further spending cap and labor reform are also under consideration. Many investors are cautiously optimistic about Brazil's performance in 2017. Credit Suisse suggests in its Investment Outlook Report for

> "There is evidence to support that Brazil is finally using fiscally responsible decision-making to reach its growth potential"

2017 that Brazil "is showing tentative signs of economic recovery. Confidence indicators are stabilizing, though at low levels." Malcolm Dorson, portfolio manager at Mirae Asset Global Investments, concurs that Brazil "may be on its way to recovery. Although the economy is still very fluid and many challenges remain, there is evidence to support that Brazil is finally using fiscally responsible decision-making to reach its growth potential."

NOMINAL GDP, INDIA



Source: data and estimation according to OECD Economic Outlook 2016

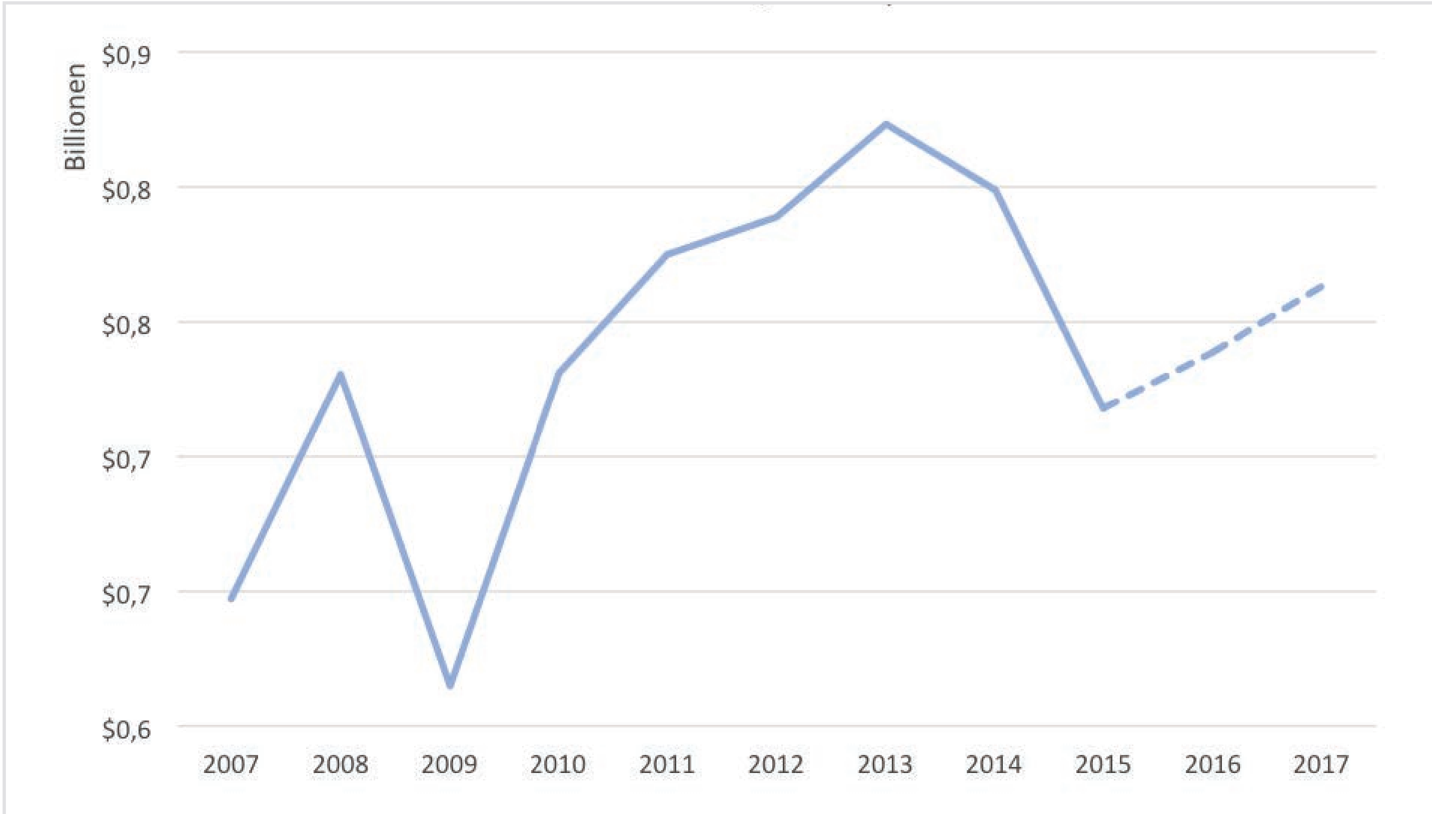
INDIAN INGENUITY

Following a year in which Narendra Modi passed a milestone goods and services tax, implemented monetary and bankruptcy policy reform and liberalized Foreign Direct Investment in a number of important sectors, one element of risk facing India this year may ironically be a contented Mr. Modi concentrating on winning state elections and consolidating power, causing reforms to slow. With upcoming elections in Uttar Pradesh, Goa, Punjab, Uttarakhand and Manipur scheduled to take place between February 4th and March 8th and 240 million people expected to vote, Mr. Modi's Bharatiya Janata Party (BJP) is looking to build upon its 2014 results in state governments. "This means that the polls will take place only shortly after the national government announces the budget for the fiscal year 2017/18 on February 1st," according to the Economist Intelligence Unit, causing concern for opposition parties but with the economic benefit of ensuring that funds are spent early in the fiscal year. The biggest political prize is Uttar Pradesh, with close to 200 million residents and which could allow the BJP to capture the upper house of India's New Delhi parliament,

overcoming a significant hurdle to making progress on its reform agenda, but where the BJP will have to overcome a likely alliance between the ruling Samajwadi party and the Indian National Congress.

Not that India's progress hasn't been remarkable; Financial Services company Nomura Group expect India's GDP to rise to 8.0% in 2017, up from 7.8% in 2016 and 7.3% in 2015. Nomura credits India's long-term focus on reform

NOMINAL GDP, TURKEY



Source: data and estimation according to OECD Economic Outlook 2016, the appeared economic contraction from 2013 to 2015 are results of changing national accounts method.

and 'judicious policies', an outlook lending itself to gradual but sustainable expansion engineered and advocated by Mr. Modi, whose pro-business, pro-technological progress platform has reinvigorated India's growth. This perspective is shared by the governor of India's central bank, Raghuram Rajan, who credits Mr. Modi's "ambitious structural reforms to revive growth" with bringing macroeconomic stability (Mr Rajan steps down later this year). These have included efforts to boost productivity in the agricultural sector, a strong push to deregulate business, efforts to improve public-sector banks and an 'immense effort' to expand financial services by providing bank accounts and

"Demonetization is a big drag on commerce and will result in a decline in GDP growth."

direct benefit transfers. "In the world's largest democracy, it shouldn't be surprising that reforms progress only gradually," Nomura's yearly report on India relates, "but over time they add up, which is more than can be said for most other large EM economies." Other areas of reform have included: streamlining the bureaucracy, boosting infrastructure spending, reforming the power sector and a flexible inflation policy targeting the country's monetary policy framework.

The great question for the BJP's electoral chances will be whether Mr. Modi's demonetization campaign caused enough disruption to economic growth in the first quarter of 2017 to turn significant combinations of voter blocks against him that would cost him one or more of the larger states. The removal of 80% of the currency in circulation in the effort to fight corruption within a month "is a big drag on commerce (and) will result in a decline in GDP growth," says Mark Mobius, Executive Chairman of the Franklin Templeton EM group. Be that as it may, major shifts to the economic or political agenda are unlikely regardless of the election outcome, and Mr. Modi's focus on modernizing rural India is set to continue, postponing land and labor reforms further down the line after Mr. Modi has presumably consolidated his power and his reforms are seen to be paying off.

TURKISH TREACHERY

After the failed coup in July 2016, Turkey, once an example of secular Islamic democracy, has turned to disarray. Not only does President Recep Tayyip Erdogan continue to abuse the state of emergency to persecute all dissident sentiment in the country's judiciary, bureaucracy, media, academia and even business sector, he has also taken crucial steps towards making himself a new Sultan. The Turkish parliament (very selflessly, it should be said) has approved a new draft constitution that would pave the way for a presidential system to replace the current parliamentary system. If this proposed constitution is approved in a referendum to be held between late March and mid-April, it will not only hand Mr. Erdogan even more power, removing many checks and balances to the presidency, but also potentially extends his mandate until 2029. According to various opinion polls, voters are split on the question of expanding the power of the presidency, though the latest poll conducted by ORC shows that 62% of respondents are inclined to vote yes in the upcoming referendum. It is worth noting, however, that polling companies in Turkey are usually affiliated with political parties, prejudicing results, and that public opinion is likely to be more equally divided. Nevertheless, the split in opinion suggests that Mr. Erdogan will have to campaign aggressively in order to win the referendum. Consequently, Mr. Erdogan's government is likely to continue cracking down on the Kurdish opposition and the "Gulenists", which is popular among his support base. But in order to win the referendum, he will also need to boost the country's troubled economy.

> "Geopolitical tensions, weak global trade and the drop in capital flows to emerging economies weighed on growth in the third quarter"

The Turkish Statistical Institute revealed late last year that the Turkish economy contracted by 1.8% in the third quarter, for the first time since 2009. Annual growth forecasts are likely to be revised downwards, according to the estimation of OECD, and Turkish GDP growth has slowed to under 3%. The failed coup, terrorist attacks and bad weather were the major factors for the unsatisfactory economic performance, according to Deputy Prime Minister Mehmet Simsek, who suggested that "geopolitical tensions, weak global trade and the drop in capital flows to emerging economies weighed on growth in the third quarter."

Most worrying, however, are indicators related to manufacturing – the backbone of Turkish economy: Agricultural output shrank 7.7%, industrial production was down 2.7% and services contracted 8.4%. Tourism, another important sector in the Turkish economy, declined by one third as of September 2016. It seems almost certain that Mr. Erdogan's administration will enact pro-growth policies, not only to gather public support for the upcoming referendum, but most crucially, to maintain the Justice and Development Party's (AKP) key source of legitimacy: economic growth. As a result, OECD concludes in its forecast that "uncertainties are high but fiscal, prudential and monetary policies are supportive and should spur household consumption from late 2016 onwards."


President Recep Erdogan

The question that remains is whether the optimism can be sustained over the longer term not just because of the uncertainty posed by the referendum and Mr. Erdogan's political crackdown, but also because of challenges to national security and in Turkey's relationship with the EU. With Mr. Erdogan moving away from democratic principles, it is certain that the relationship between Turkey and EU will deteriorate, with the EU-Turkey refugee deal likely to be seriously challenged. The likelihood of further terrorist attacks will increase as a result of the government crackdown on the opposition. Russia-based investment bank, Renaissance Capital, suggested that "with a planned three-month extension of the economically costly state of emergency, cost cutting from FX-indebted Turkish corporates, terrorism sustaining a crisis in tourism, and with almost all decisions in Ankara viewed through the short-term lens of creating an executive presidency, it's not difficult to classify Turkey among the riskiest markets in the world at the start of 2017."

by **Glenn W. Leaper & Jingchao Zhou**

Sweet Home Scandinavia

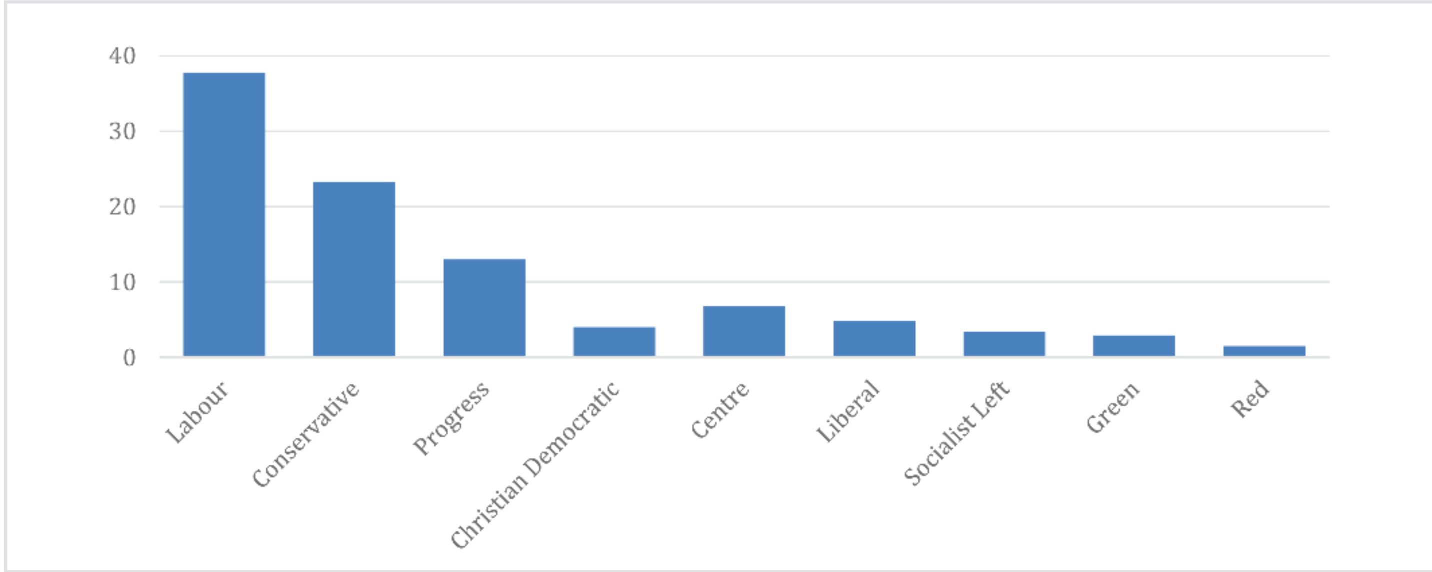
The small, open economies in the Nordics by and large enjoy a positive and stable outlook for 2017 in the context of the recovery of global markets, though there are differing prospects for each, with Norway and Finland slowly emerging from near-recession, Denmark holding steady and Sweden slowing down somewhat. The region is not without its share of political risk, however, with a Norwegian election later this year and populist parties in each country seeking to exploit contradictory economic information and unemployment to ram through anti-immigration, anti-establishment commandments in the shadow of Trump. As elsewhere, the 2017 terrain is uncertain, even as Scandinavia is, generally speaking, in good economic shape.

OUT OF THE (NORWEGIAN) WOODS?

The main event on Norway's calendar for 2017 is the parliamentary election in September. The present government of Norway, a minority coalition comprised of the Conservatives (Høyre) led by Prime Minister Erna Solberg, and the Progress Party (FrP), alongside two other smaller coalition partners, has strongly advocated free market policies, tax cuts, reduced government intervention, tighter immigration and the continuation of the Norwegian welfare state. The coalition lost support in local elections in 2016, including control of Oslo and Bergen, with the main opposition, the Labour party, whose leader Jonas Gahr Støre, will be running against Ms. Solberg for the premiership this year, increasing its share to 33%. With 169 seats in parliament up for grabs, Høyre and the FrP are tied at the hip for the 2017 election in terms of campaigning on the completion of health care, education and public sector reforms, but the Christian Democrats, who currently support the governing coalition, could potentially tip the election to Labour. The central campaign issues revolve around weak economic growth, social division, immigration, fighting global warming in the Arctic, and especially unemployment, particularly in the southwest, due to lower oil prices. Polling in December showed the ruling coalition improving on its likely vote. Should oil prices rise in 2017, the economy would receive an infusion that would also benefit the government.

> "A lot indicates that the worst is over for the Norwegian economy."

OPINION POLL FOR THE NORWEGIAN PARLIAMENTARY ELECTION 2017



Source: Ipsos poll, 12-14th Dec 2017

With Statoil, Norway's biggest company, recently announcing an end to its cost- and staff-downsizing and with executives at some of the hardest hit companies in the oil and offshore business, such as Mikael Johansen of Westcon Yards Florø, seeing an upturn after having finally "hit bottom," there is potential good news ahead for the sitting government. According to a recent survey in Dagens Næringsliv (DN), leading Norwegian economists also expect a better year ahead, with rising oil prices, a strengthening Norwegian krone and higher housing prices. Despite the fact that fiscal stimulus policy will be eased in 2017, Danske Bank expects relatively stable economic growth as a result of higher household consumption and investment. Inflation is expected to remain low, at around 1%. "A lot indicates that the worst is over for the Norwegian economy," Øystein Dørum, a longtime chief economist for DNB now with national employers' organization NHO, told Norway's Dagsavisen. This also appears to be borne out outside the oil sector, with rising mainland GDP growth projected to pick up to 1.5% in 2017 (twice the 2016 rate), along with rising consumer confidence and receding inflation suggesting the strengthening of household demand, according to Swedbank. High homebuilding and expansionary fiscal policy are propping up growth, according to Danske, though private demand remains weak.

Norwegian Prime Minister **Erna Solberg**

> "Slightly lower growth expectations for the coming years primarily reflect a weakened outlook for Denmark's export markets."

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Knut Anton Mørk, a former chief economist for Handelsbanken, is more pessimistic, expecting a far lower growth rate of just 0.5%. "We must expect many surprises (in 2017), especially political," Mørk said, referring to the parliamentary election and noting that problems for the oil and offshore sector are not over, particularly since troubles in the Autumn, and that the world economy may stagnate, creating worries about financial instability. Risks are also rising for a boom-and-bust cycle in house prices and construction activity, according to Swedbank, as there are signs of supply-side reactions to the housing market, which, together with new credit restrictions, could potentially rein in growth. The electoral outcome will depend on the perception of stability, or lack thereof, over the coming year.

Danish Prime Minister **Lars Løkke Rasmussen**

DANISH DYNAMITE

Political stability is expected for the foreseeable future following the establishment of a new government in Denmark last November, which saw the minority government led by Prime Minister Lars Løkke Rasmussen's liberal Venstre party replaced by a coalition government comprising Venstre, free-marketers Liberal Alliance and the Conservatives. The change came amid pressure to hold snap elections that Venstre likely would have lost, boxed in by both the social democrats on the left and the Danish People's Party (DF) on the far right. The new government is more than likely to remain stable throughout the year, however, the terms of which, most notably, included further concessions to the liberal bloc on top rate tax cuts.

Now in its fifth year, Denmark's economic recovery is expected to remain on track in 2017, supported by a rising employment rate, a booming housing market and stronger global and domestic demand. However, the economy risks running out of labour resources needed to support sustainable growth, according to Danmarks Nationalbank (DN), the central bank.

"The Danish economy is in a solid upswing, and as the signs of labour shortage are becoming still clearer, the structural government budget should be brought to balance within the next couple of years so that fiscal policy will contribute to stabilizing the economy," DN´s Governor Lars Rohde said late last year. With no monetary policy changes expected from the ECB in 2017 and no rate adjustments expected from DN, interest rates are expected to remain low over the coming years, albeit accompanied by likely rising inflation to the 1% mark at the outset of 2017 (for the first time in 3 years).

Danske expects it to rise to 1.3% in the course of the year, which is still subdued, it says, despite it being much higher than levels over the past few years. Current cyclical trends and the outlook for low rates for longer could trigger a distinct tightening of fiscal policy in the years ahead. The promised tax cuts are feasible within the framework of a tighter fiscal policy, provided public consumption grows at a slower pace than the economy as a whole. The government platform builds on capping growth in public spending at 0.3% annually, which would provide the necessary space for the tax cuts, according to Danske.

> **"You can expect politicians to use Trumpian technique. This game-changing approach to elections tells populists to keep on the chosen path."**

According to Statistics Denmark, national accounts show positive GDP and productivity figures; as the prices of Danish imports have fallen relative to the price of exports, the improvement in the trade balance has had the same effect as higher productivity. These factors, however, create a "more distinct possibility of robust recovery, which would also involve a risk of the economy overheating – not right away, but over the course of the next few years," according to Danske's assessment. "The slightly lower growth expectations for the coming years primarily reflect a weakened outlook for Denmark's export markets," Mr

Swedish Prime Minister **Stefan Löfven**

Rohde said. Economic growth in Denmark is also impaired by declining North Sea energy output in oil and natural gas production, which contributes to the overall sluggish forecast for Danish exports, and possibly by the effect of U.S. President Trump's highly protectionist agenda on global trade. Instead, household spending is expected to drive expansion, Mr Rohde said, and consumer spending and investment is projected to grow as a result of rising incomes. One element of political risk for the year, with the global economy threatened by political instability in Europe and elsewhere and a slump in global consumption and investment, could be a hike in domestic rates that strengthen the krone, which may force a currency intervention from DN but thereby also push down market rates.

SWEDISH SLOWDOWN

Prime Minister Stefan Löfven's government coalition between his Social Democratic party and the Green party is expected to last until the 2018 general election. Cooperation will continue with the opposition center-right bloc following the immigration troubles of 2015 - despite the collapse of their previous alliance - in the continuing effort to see off the challenge from the far-right Sweden Democrats (SD). SD frequently receives more than 20% support in opinion polls, it now being the second most popular party in Sweden, consistently polling only within a percentile lower than the governing Social Democratic Party. Political scientist Stig-Björn Ljunggren worries U.S. President Trump's election will grease the skids for Sweden's populists: "You can expect politicians [in Sweden to try] to use Trumpian technique. This game-changing approach to elections," he emphasizes, "tells populists to keep on the chosen path."

After an initial adjustment period, the Swedish economy grew by 3% on average in 2016, due to increasing domestic demand. While growth is expected to slow down to around 2% through 2017-2018, the long-term outlook remains stable, reflecting what Danske calls a "Riksbank (Sweden's central bank)-induced real interest rate unconsciousness." Fiscal policy is becoming more expansionary, SEB suggests, with household credit growing and the krona remaining undervalued. But given the international situation of low global interest rates and the ECB's tendency towards further stimulus measures, Sweden is likely to slow its own monetary normalization process so as not to trigger an undesirably high krona exchange rate. According to Swedbank, strong household consumption, increasing housing investments and public spending will continue to support economic growth in the years to come. Meanwhile, the unemployment rate appears stuck at around 7%. Sweden's Riksbank projects inflation will average 1.4% in 2017, possibly picking up to

> **"If the U.S. under President Trump leads the way in lifting economic sanctions on Russia, the likely recovery of the Russian economy may provide a boost to Finnish exports."**

Finnish Prime Minister **Juha Sipilä**

2.2% in 2018. This means, despite the negative benchmark repo rate at -0.5 percent and expected SEK 30 billion asset purchases by the Riksbank in first half of 2017, that inflation still may not meet the 2 percent target. In addition, the low level of public debt and a near- balanced budget indicates that Sweden still has substantial fiscal space to implement additional economic stimulus policy to support growth, and to alleviate temporary migration-related costs.

Sweden has a healthy demographic future, compared to other industrial economies, such as Germany or Japan. As of January 2017, the Swedish population surpassed 10 million for the first time and the birthrate is one of the highest in Europe. In terms of short-term risk, however, it still faces considerable challenges integrating immigrants into society and the labour market while preventing social and political disruption. In addition to domestic challenges, increasing geopolitical uncertainties and the weakening of global trade institutions will create more risk for Swedish economy, which is well integrated into global value chains. These challenges will continue feeding the SD party's message, and the party stands to gain further in the next election as it drains support from both right and left against the background of new global norms rendering its message increasingly acceptable to the mainstream.

FINNISH FORTITUDE

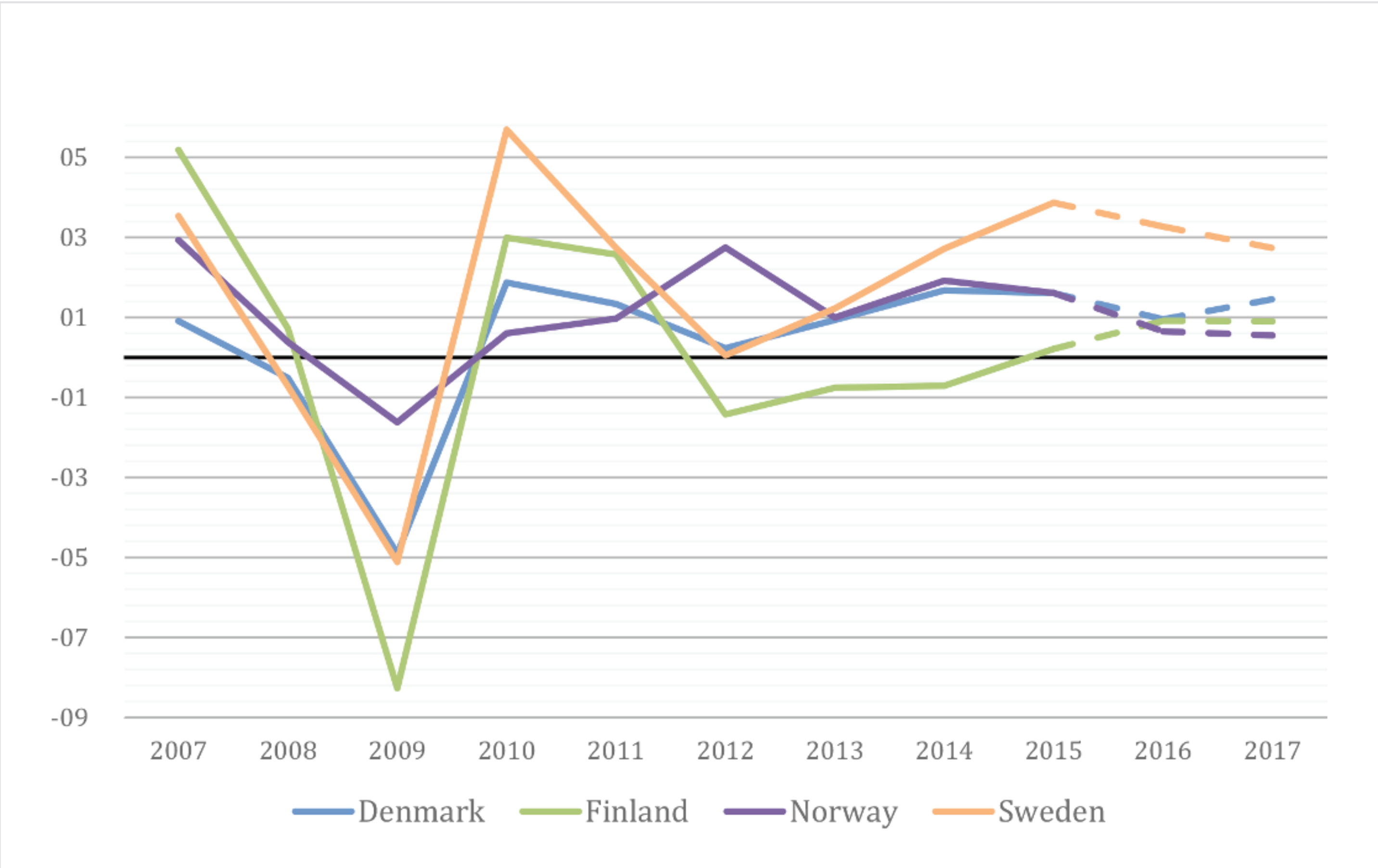
The ruling Centre Party (CP) returned to power in 2015 with the help of a former political outsider, millionaire Juha Sipilä, who campaigned on a pro-reform platform. Mr Sipilä is since Prime Minister of a coalition government with CP's junior partners, the liberal conservative National Coalition Party (NCP) and the populist nationalist Finns Party (FP). As a result of the nationalist element in the coalition, several restrictive policies on immigration have been introduced, but the rest of the coalition government has prevented disruption of its relationship with EU and NATO. Mr. Sipilä has also introduced various reforms in the effort to revive the country's economy. Most notably, he has initiated a competitiveness pact to cut unit labor costs by 5 percent, liberalized restrictions on retail store opening hours, and pushed through pension reforms that raise the retirement age to 65 by 2027. Most recently, as the first country in the world, Finland initiated a large-scale test of universal basic income for 2000 randomly chosen households. These reforms have been crucial steps for the recovery of the Finnish economy and may lay the foundation for future sustained growth.

Recovery has been slow, however, following Finland's economic recession from 2012 to 2014, and stagnation in 2015. The Finnish economy is set to grow by 0.9% in 2016, according to OECD estimates. This is largely due to rising household consumption and investment, especially in the construction sector. The economic recovery is expected to continue in 2017, though the growth rate is likely to remain sluggish, as growth in private consumption and investment in construction is expected to have reached its peak.

Danske, however, forecasts a higher growth rate of 1.3%. As a small, open economy, Finland's export performance has been disappointing in recent years, in no small part because of the downfall of Nokia. However, if the U.S. under Mr Trump would lead the way in lifting economic sanctions on Russia, the likely recovery of the Russian economy may provide a boost to Finnish exports. In addition, the Finnish government could utilize its potential fiscal maneuverability (e.g. low government deficit and debt) to support economic recovery by further cutting tax and social contributions. After the unemployment rate sat close to 10% in 2015 following years of recession, it has now been reduced to 8.1%, a rate albeit still slightly higher than the EU average. A boost in exports would surely help to create more jobs in manufacturing and service.

Similarly to other Scandinavian economies, Finland is sensitive to the global economic and trade environment. As such, increasing global geopolitical instability, the further economic slowdown of China and potentially the European common market, and the volatility of Russian and U.K. markets are the biggest threats to Finnish economic recovery. On the political front, the CP and NCP will continue to try to limit the influence of FP within the coalition to ensure that Finland's relationship with the EU and NATO is not jeopardized.

REAL GDP GROWTH RATE, 2007-2017



Source: OECD Economic Outlook database

The Day That Never Comes?

Better Days? President **Obama** and Nordic leaders in the White House, May 13, 2016. From left are Prime Minister **Sigurður Ingi Jóhannsson** of Iceland, Prime Minister **Lars Løkke Rasmussen** of Denmark, Prime Minister **Erna Solberg** of Norway, Prime Minister **Stefan Löfven** of Sweden, and President **Sauli Niinistö** of Finland. (Official White House Photo by Chuck Kennedy)

by ***Glenn W. Leaper & Jingchao Zhou***

NORDIC REACTIONS TO THE TRUMP ADMINISTRATION

If America's Scandinavian allies were hoping there were two Donald Trumps – the vulgar, offensive one of the campaign trail, and a more dignified version humbled by the office he has inherited and the aand the awesome responsibility thrust upon him, his inauguration speech as president on January 20th left no illusions that President Trump intends to do exactly what he promised: put America first.

Mr. Trump's overtures to Russia and the latter's increasing assertiveness makes the Nordic countries uneasy, not least for historical reasons and considering possible provocations from Russia in the Baltics (or perhaps Kosovo) to test NATOs newly compromised position. This raises a host of new national security challenges for Scandinavian nations: as members of NATO, Denmark and Norway face different security challenges to Sweden and Finland, with concerns ranging from the threat to welfare states to the Arctic region, but the verdict is near-unanimous: economic and security insecurities will determine decision-making within Nordic governments in 2017.

"A MAJOR THREAT"

Finland, which offered to host the first summit between Mr. Trump and Vladimir Putin (the honor fell to Iceland instead), has been militarily neutral since WWII, but its role has been in flux over the past years with tensions between Russia and Western European nations flaring. When Finland and Sweden sent representatives to a NATO summit in Poland last summer, Mr. Putin went so far as to suggest the Kremlin could retaliate by moving Russian troops closer to the Finnish border if Finland were to forge ahead with potential membership. Finland and the U.S. signed a deal last October pledging closer defense ties through joint cyber-defense research, information exchange and other military ties. Finland, however, simultaneously thawed its frozen trade relationship with Russia after a meeting of the

> **"Something we are very scared of is this rhetoric, this new kind of protectionism. It is a major threat."**

Finnish-Russian Trade Commission following a boycott as a result of Russia's annexation of the Crimea in 2014, where joint efforts to explore for oil and gas along their shared border were agreed upon. Meanwhile, Ukrainian President Petro Poroshenko used a recent visit to Finland to warn of the political risks to the Baltic region from Nordstream II gas pipeline project, which transports natural gas from Russia to Germany by significantly reducing gas transshipments through Ukraine.

In talks with Mr. Poroshenko on the implementation of the Minsk agreement and security in the Baltic Sea, Sauli Niinistö, Finland's president, said he found President Trump to be purposefully ambiguous about his foreign policy objectives, but was concerned about the Trump administration's sabre rattling toward China and suggestion to drop sanctions against Russia He also said, nevertheless, that he found the idea that Russia is waging a disinformation campaign within Finland "far-fetched." Mr. Niinistö's trade minister Kai Mykkanen says he hopes his country can withstand the populist, anti-trade backlash sweeping the world, which represents a particular threat to small, open economies like Finland's. "Something we are very scared of is this rhetoric, this new kind of protectionism. It is a major threat," he said.

INCREASE MILITARY SPENDING?

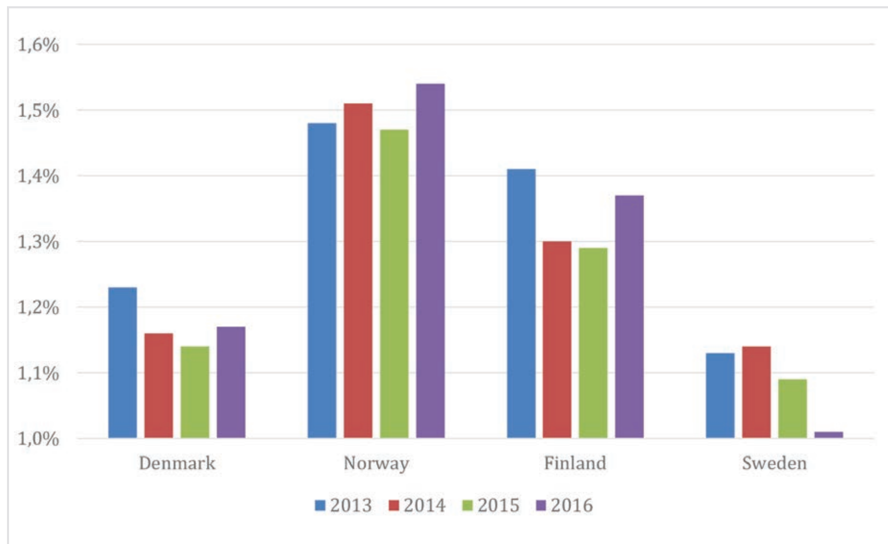
Sweden, another open but small economy (in relative terms), also seems apprehensive about the increasing geopolitical uncertainty and worsening of the global trade environment due to Mr. Trump's anti-trade rhetoric, as well as Brexit. According to Robert Bergqvist, chief economist at SEB, Sweden is "very dependent on the international environment. Roughly 50% of our economy has a connection to it. So if the new Trump administration introduces any measures that slow down global economic growth and globalization, that's negative for Sweden." Sweden shares worries about the geopolitical risk from Russia, Mr. Bergqvist says: "If we can expect any new relations between the U.S. and Russia that increase geopolitical tensions in Europe, and any new steps from Trump that suggest we're going to have more geopolitical uncertainties, that could have political implications for Sweden, and therefore economic implications." Peter Dahlen, managing director of the American Chamber of Commerce in Sweden, which represents business interests and works to promote trade between Sweden and the U.S., does not, however, think the Trump administration will have a big impact on Swedish businesses, professing more concern about the global ramifications of Mr. Trump's renegotiation of NAFTA instead.

Meanwhile, by contrast with Finland's Mr. Niinistö, the Swedish Institute of International Affairs accused Russia of using false documents and disinformation as part of a coordinated campaign to influence public opinion and decision-making in Sweden, its research finding that Russia uses misleading reports about Sweden on Russian state-run news websites, that Russian politicians make public interventions in Swedish domestic affairs, and that Russia employs other, more covert methods to influence domestic opinion. In the face of the increasingly unstable global environment and the threat from Russian assertiveness, the Social Democratic government is under pressure from the Center-right and the Moderate parties to increase military spending. The Swedish Armed Forces (SAF) has requested between $7-9 billion, with only $6.1 billion approved for its 2017 budget. A special investigator has been appointed to calculate the adequate amount of spending in order to modernize the army beyond 2020, calculations likely to be deeply affected by changing geopolitical relations between the U.S. and Russia.

"NOT THE WAY FORWARD"

"This week could very easily mark the end of the world as we know it," Danske Bank Markets warned in its report upon President Trump's inauguration. "This week's events will likely dissolve the traditional economic and political

MILITARY EXPENDITURE AS PERCENTAGE OF GDP, 2013-2016



Source: NATO, Ministry of Defense of Finland and Sweden global alliances that we have become accustomed to since World War II." For former finance minister, now minister of defense, Claus Hjort Frederiksen, Mr. Trump's trade policy will adversely affect Danish companies and cause major uncertainty in global markets. "He wants to build walls. In my opinion, that is not the way forward," Frederiksen said, underlining he expects Denmark to become poorer as a result of Mr. Trump's victory. "I think it will have negative consequences because the uncertainty will be so great that many companies think twice when it comes to investments," he said. The U.S. is Denmark's third largest export partner, accounting for nearly 10% of Denmark's total exports. According to Statistics Denmark, Denmark's exports of goods and services to the U.S. amounted to more than 100 billion kroner ($14.8 billion) in 2015. In addition, more than 50,000 Danish jobs are directly tied to Danish exports to the U.S. If President Trump implements his trade tariffs, it could be a serious blow to Danish companies. Furthermore, Mr. Trump's injunction that each NATO member pay its 2% share could have far-reaching social consequences, and for Denmark's welfare state as well. Helge Pedersen, a Copenhagen-based chief economist at Nordea Bank AB, estimates meeting the 2 per cent mark again would require about 15 billion kroner in extra defense spending – which is how much Denmark spends each year on supporting its universities, or five years of child support for its families.

"Roughly 50% of the Swedish economy has a connection to the international environment. If the Trump administration introduces measures that slow down global economic growth and globalization, that's negative for Sweden."

Mr. Trump's presidency is also likely to have implications beyond Denmark, through to Greenland and the Arctic. U.S. military bases are central to the relationship Denmark and Greenland have with the United States. Greenland's Thule Air Base, 1200 km north of the Arctic Circle, may take on new strategic importance for the U.S. Greenland's location means it walls off North America from the rest of the Arctic and provides a strategic buffer against China, North Korea, Russia and Iran. With its powerful U.S. radar installation, Thule Air Base is a key part of U.S. defenses against intercontinental ballistic missiles. Copenhagen and Nuuk's governments must now analyze how President Trump will impact their Arctic presence. Having lost a previous contract, Nuuk is now trying to persuade the U.S. it must be compensated for use of the land on which the base is located. "Naalakkersuisut, Greenland's elected government, looks forward to continuing cooperation and negotiations on how we can ensure that Greenland's contribution to defense cooperation can be updated," wrote Greenland premier Kim Kielsen in his official congratulatory letter to President-elect Trump. Moreover, Denmark and Greenland exert influence through the Arctic Council, which links the western Arctic states with Russia and gives all members an equal voice, making decisions only with the support of Indigenous groups. The previous administration was engaged in the Arctic through its concern for climate change, but such concern is not shared by Mr. Trump. William Moomaw of the Fletcher School of Law and Diplomacy is pessimistic: "President Trump will undermine most attempts to address climate change, and the U.S. will become a drag on the future development of the Paris Accord. This has devastating consequences for the Arctic," he told the publication Arctic Daily. Copenhagen and Nuuk have long prioritized preventing climate change, environmental protection and individuals with livelihoods in oil and gas development, mining, shipping routes and fisheries in the Arctic region. Sustainable development is a priority for Greenland's Indigenous community, and the Obama administration had placed tight restrictions on oil and drilling off the coast of Alaska, leading Shell and other oil companies to halt their activities there. All that is known of Mr. Trump's intentions in the region is his skepticism concerning climate change and now his executive order to roll back restrictions on oil and gas exploration in Alaska. Whether Mr. Trump takes Arctic considerations under advisement in negotiating a new deal for the Thule air base, with its strategic importance for defense against intercontinental ballistic missiles, is unlikely.

"I think Trump will have negative consequences because the uncertainty will be so great that many companies think twice when it comes to investments."

"A GREAT SUPPORTER OF NATO?"

Norway recently increased its commitment to NATO and its national defense, deciding last year to significantly increase its defense budget and accelerating its plan to join the US-NATO missile defense system. It has allowed 300 U.S. Marines to be stationed in the country for the first time since WWII in an agreement with the previous administration to deter Russian aggression in the region. Norwegian Defense Minister Ine Marie Eriksen Søreide said Norway would "further increase our land forces in the northernmost part of the county... We do not consider Russia a direct military threat to Norway today, but we pay close attention to the Russian military activity in the High North." Such moves have put the relationship between Norway and Russia on ice.

NATO Secretary General **Jens Stoltenberg** (right) with President of Ukraine **Petro Poroshenko,** Brussels, Oct 20, 2016

The current Secretary General of the NATO is of course Norwegian Jens Stoltenberg, who served as Prime Minister of Norway from 2000 to 2001, and again from 2005 to 2013 and also as Norway finance minister. Ironically, Stoltenberg served as a United Nations special envoy on climate change and global warming. Stoltenberg came to tragic fame following terrorist attacks in Norway, when right wing radical Anders Behring Breivik on 22 July 2011 set a bomb off in Oslo outside the government building which houses the prime minister's office, and the following shooting spree on Utøya island, which killed 69 young people.

Following Mr. Trump's election, it is conceivable that Norway has struck a softer tone towards the Trump administration in order to offset Russian countermeasures, at least compared to its Scandinavian peers. King Harald was the only Scandinavian monarch to congratulate the president, a break with longstanding tradition in the other Nordics. Prime Minister Erna Solberg has defended him, saying upon speaking with Mr. Trump that "he did not say NATO was obsolete... he said he is a great supporter of NATO, he just wants us to pay a little bit more of the bill, which Obama also wanted and as all American Presidents have." Separately, Ms. Solberg defended Britain's decision to leave the EU but maintained that Norway's half-in, half-out model, which grants it access to the single market through its membership of the European Economic Area, gave it greater flexibility to adapt as the E.U. evolves. Norwegians, nevertheless, see Mr. Trump as a clear and present danger: 49% of Norwegians believe President Trump poses a 'very large', or 'fairly big' threat to world peace, according to recent polling. "As a professional, I have studied American and international politics for a lifetime, and I can say that Donald Trump represents such an unknown quantity that reasonable people are experiencing insecurity and uncertainty," said Svein Melby, a senior researcher at the Institute for Defense Studies.

"Trump did not say NATO was obsolete... he said he is a great supporter of NATO, he just wants us to pay a little bit more of the bill."

The security and other political risks are clear. The remaining question is whether they are clear to President Trump. He could do worse than maintaining and safeguarding the traditionally close and mutually beneficial relationship between the Nordics and the United States.

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