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Asset Management

ASSET ALLOCATION

The investment landscape in 2018

Annual outlook

November 2017

Pictet Asset Management Strategy Unit

2018 promises to be another good year for equities, thanks to broad-based global economic growth

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01

Overview: all about the growth

It seems that wherever investors look, there are reasons to rein in those animal spirits. For one thing, the political landscape remains treacherous. Brexit, North Korea's sabre-rattling and US President Donald Trump's unconventional approach to policymaking all have the potential to send markets into a tailspin next year. Another red flag is stocks' remarkably long winning streak. Both the MSCI World and S and P 500 indices are now testing historical boundaries, having notched up gains in each of the past 12 months. Higher interest rates are also a concern. With the US Federal Reserve and the Bank of England having hiked borrowing costs and the European Central Bank soon to pare back its bond purchases, financial markets will no longer be able to feed on out-sized servings of monetary stimulus.

For all this, though, 2018 promises to be another good year for equities. The main reason is growth. We expect the global economy to expand at a healthy clip in 2018 – growing at 3.4 per cent against 3.3 per cent in 2017, surpassing economists' consensus forecasts.

ECONOMIC GROWTH, INFLATION AND EARNINGS FORECASTS FOR 2018, YEAR-ON-YEAR, %

	GDP GROWTH		INFLATION		EARNINGS GROWTH (CONSENSUS)	
	2017	**2018**	**2017**	**2018**	**2017**	**2018**
US	2.2	2.4	2.1	2.6	10.1	11.6
EURO ZONE	2.3	2.1	1.5	1.7	10.4	9.1
UK	1.5	1.0	2.6	2.4	20.1	7.0
SWITZERLAND	0.7	1.9	0.6	0.9	6.1	13.7
JAPAN	1.5	1.4	0.4	1.1	17.1	5.8
CHINA	6.8	6.6	1.6	2.4	20.8	14.9
EMERGING MARKETS	4.9	5.0	3.3	3.5	21.5	12.3
GLOBAL	**3.3**	**3.4**	**2.4**	**2.7**	**13.3**	**10.5**

Source: Pictet Asset Management, I/B/E/S, Thomson Reuters Datastream

Encouragingly, the expansion in 2018 should be more broad-based than in recent years, characterised by a solid rise in government and business investment, as well as healthy consumer spending. Emerging economies should fare especially well, benefiting from low inflation and a recovery in commodity prices. Our enthusiasm for stocks isn't dimmed by the prospect of additional interest rate hikes in the US. Even if the Fed tightens the monetary reins – we expect up to three hikes next year – real interest rates in the US, Europe and Japan will remain negative for quite some time.

But what is good for stocks will not be good for developed market bonds. Rate rises from the Fed are sure to weigh on what we consider to be expensive US government and corporate debt; we expect yields on these securities to ratchet higher over the course of 2018.

Heading in the opposite direction will be the US dollar, which our models indicate remains overvalued, particularly against emerging market currencies. We expect the greenback to continue its depreciation as inflationary pressures build in the US.

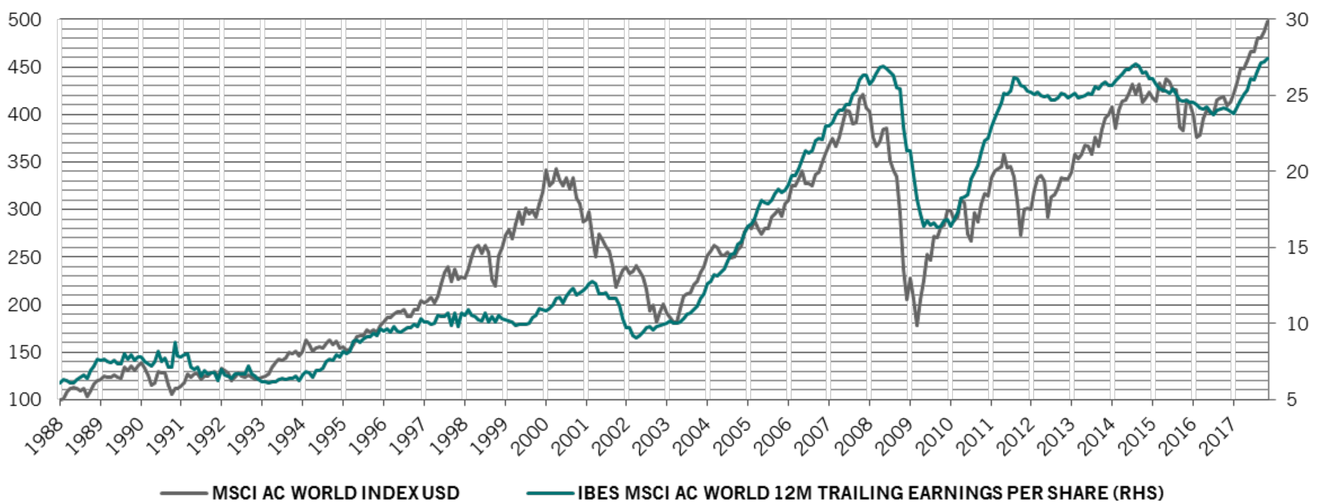
So much like any other year, investors will face a wall of worry in 2018. But as far as equities are concerned and emerging asset are concerned, they should be able to climb it.

02

A benign investment climate for riskier assets

Reasonably smooth conditions for equities, choppier ones for bonds. That's the conclusion to draw from our analysis of the investment climate for 2018. Our framework, which combines economic gauges, liquidity indicators, valuations and technical trends, points to a continuation of the bull run in stocks but difficult times ahead for US fixed income in particular.

EQUITY RALLY SUPPORTED BY RISING PROFITS
Global equities versus earnings growth (%)



Source: Pictet Asset Management, Thomson Reuters Datastream, data covering period 31.12-1987 21.11.2017

Our **business cycle** analysis shows global economic growth will be led by robust consumption and a revival in capital spending, which should increase by 5 per cent globally in 2018 from 3.3 per cent this year. The low cost of capital, surging business confidence and the lagged impact of this year's surge in corporate earnings should motivate companies to invest again, rather than buy back their own shares.

Europe's business spending has more room to rise as construction sector confidence has turned positive for the first time since 2006 In Japan, public infrastructure spending and consumption should d lift capex by 1.4 per cent.Overall, we expect US growth to accelerate to 2.4 per cent, while emerging economies should expand by 5 per cent. The euro zone and Japan will keep above-potential growth rates of 2.1 per cent and 1.4 per cent respectively; China's GDP should slow to 6.6 per cent.

While we expect growth to pick up, **liquidity** conditions – which have proved supportive for riskier assets through 2016 – will become tighter.

Money supply growth in the US has slowed to 5 per cent, the lowest since 2011, and it hit an all-time low in China in October.[1]Coupled with rising inflation, this will lead to a significant slowdown of excess liquidity, which in turn will weigh on stocks' price-earnings multiples.[2] We estimate that major central banks will inject just USD500 billion of net liquidity next year, compared with USD2.5 trillion this year.[3] We also expect three US interest rate rises in 2018.

What concerns us in particular is fragile growth in private lending worldwide. Commercial banks should have already begun to replace central banks in providing liquidity into the financial system. But this doesn't appear to be happening in the US, where bank lending continues to weaken and loan demand remains soft. The picture is brighter in Europe and Japan where bank lending is growing above 2 per cent.

Valuations for most equity markets remain reasonable, but could come under pressure if inflation gathers steam. Wage growth, which accounts for nearly two thirds of final inflation, is ticking up in developed economies, while Chinese core inflation has reached a six-year peak. By our estimates, a 1 per cent rise in inflation leads to a decline in price-earnings (p/e) ratio of 5-10 per cent. In fixed income markets, developed market credit is the least attractive, with US high yield debt already coming under pressure. Our model that takes into account inflation, leading indicators and short-term rates suggests that the US 10-year yield is around 100 basis points too low.

Our **technical** readings suggest that a reallocation away from US stocks should continue next year. EM and corporate credit has seen more robust inflows than government bonds, and this trend is also likely to extend in the coming months.

[1] Both measured by M2

[2] Excess liquidity refers to the difference between money growth and nominal GDP growth

[3] Policy liquidity flow calculated as central bank net injection over preceding 6 months, as % of nominal GDP, using current-USD GDP weights (US: 38.5%, China: 23.6%, EMU: 23.4%, Japan: 9.5%, UK: 5.0%)

03

Equity regions and sectors: gas in the tank

Equities may be expensive, particularly US stocks, but as long as corporate earnings are going up they've still got a way to run.

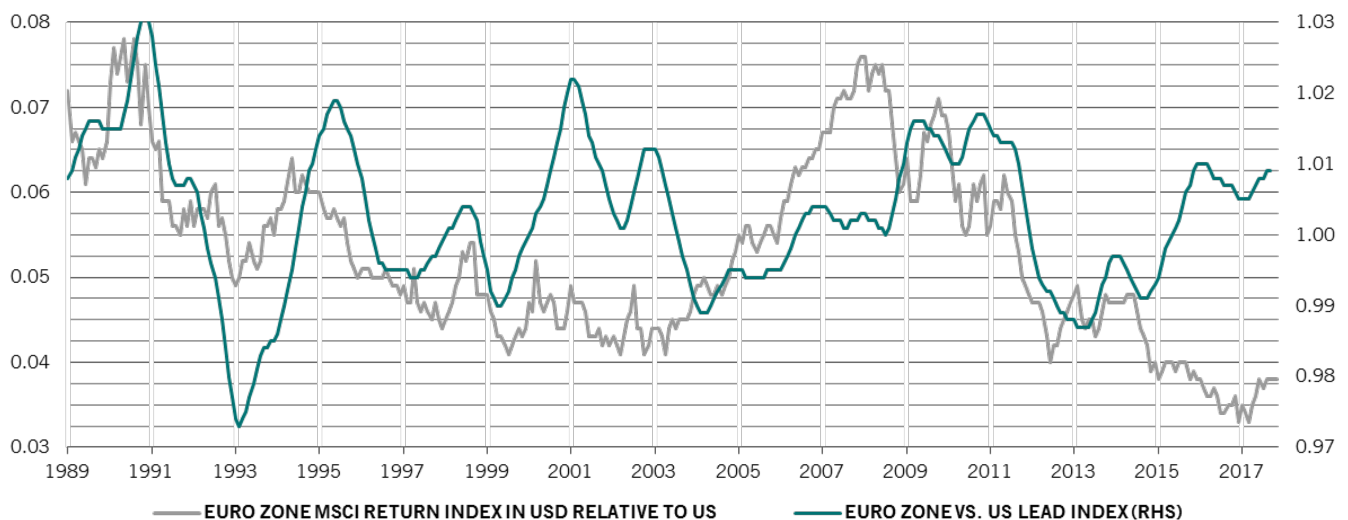
Though the US market is richly valued on some metrics – for example, on a p/e basis it's running at 20 per cent above the long run average – its price-to-book ratio is only 0.7 standard deviations above trend, well below the two standard deviation mark that's usually considered a sell signal.

Instead, the US market is likely to be driven higher by dollar weakness and President Trump's tax plan. Both should support corporate earnings and help mitigate the Fed's planned tightening of liquidity, which is likely to push p/e ratios lower.

European, Japanese and EM equities have even better prospects. For instance, UK, Japan and EM equities are trading at a 30 per cent discount to the US – though these differentials look less extreme once the US markets more cyclical sectoral tilt is taken into account.

The sun is shining especially brightly for euro zone equities. The pace of the region's economic growth is twice the long-term average at 2.2 per cent, inflation is below target, and the ECB is unwilling to retrench too far from its easy money policy. That Europe's cycle is lagging the US's is fairly normal. In the past three bull markets, the euro zone has outperformed the US by an average of around 20 per cent in the two or three years before the market peaks. Another reason why euro zone stocks should outpace their US counterparts is growth. As the chart shows, while US stocks have witnessed a strong positive correlation with domestic economic growth, that relationship has not been as strong in Europe. European stocks have failed to fully factor in the region's improved economic performance; once they do, they should do better than US equities.

ECONOMIC TRENDS SET STAGE FOR EUROPEAN STOCKS TO OUTPERFORM US



Source: Pictet Asset Management, Thomson Reuters Datastream; data covering period 31.12.1988-21.11.2017

Easy central bank money also makes a solid case for Japanese equities, as liquidity boosts growth and lifts p/e ratios. At the same time a weaker dollar is supportive for emerging market equities, with commodity producers looking particularly attractive amid a bullish outlook for materials prices. Emerging European equities are one of the few sources of good value in absolute terms, and Russia in particular is likely to benefit from the rebound in oil prices. Russian equities are also supported by very cheap valuations – shares are trading at just 6 times 12 month forward earnings – a cheap currency and a supportive central bank, which is cutting rates from a very high level of 5 per cent in real terms.

Meanwhile, we have a preference for sectors that have hitherto lagged and fare best late in the economic cycle – in other words, those that are positively correlated with bond yields: financials, energy and mining stocks fit into our scenario.

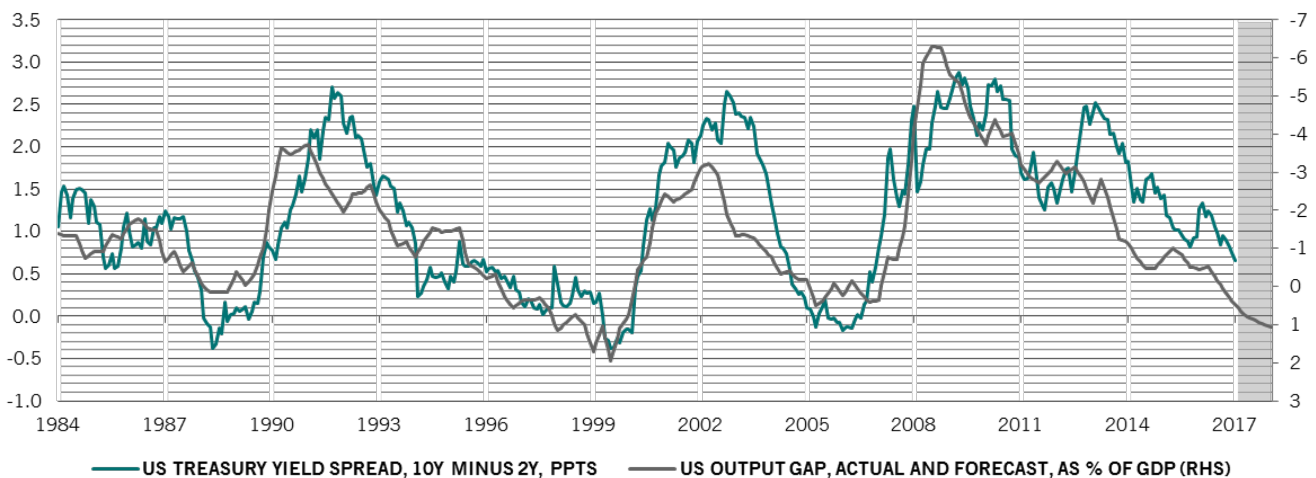
04

Fixed income and currencies: EM to shine

Up, up and away. Bond yields across the developed world are heading higher, as a mix of rising inflation and solid economic growth paves the way for a gradual tightening of central bank policy.

We expect this trend to continue throughout 2018. Since the end of the global financial crisis, US bond yields have been equal to about 60 per cent of the US's nominal GDP growth rate, which suggests that 10-year Treasury yields should reach 3 per cent next year from around 2.3 per cent currently. This should be accompanied by continued flattening of the US yield curve – a development that typically occurs as the economic cycle matures and the US output gap shifts further into positive territory (see chart).

US YIELD CURVE FLATTENS AS OUTPUT GAP TURNS POSITIVE



Source: Pictet Asset Management, Thomson Reuters Datastream, data covering period 31.12.1983-21.11.2017

The magnitude of the upward move in German Bund yields could be a bit more modest, as price pressures are relatively muted on that side of the Atlantic and liquidity conditions remain loose. In both cases, however, investors are likely to be left nursing losses next year – the last time this happened was in 2013 and before that in 1999. With the return of inflation, tighter monetary policies and very high valuations, we think the era of making easy, low-risk money from bond investing is now over.

Going further up the fixed income risk curve won't necessarily help either. High yield credit tends to be the first market to show signs of stress due to its weaker credit profile, and also historically performs less well in the later phases of the economic cycle. Low liquidity, very high levels of recent bond issuance and the asset class's increasing popularity among retail investors – who tend to have a shorter investment horizon than their institutional peers – all present additional risks.

Despite trading at an ostensibly attractive 6.2 per cent yield, US high yield bonds face several obstacles. These come in the shape of higher US rates, tighter lending conditions by banks in some areas (credit cards, commercial real estate) and the bottoming out of default rates. European corporate bonds are more attractive from a fundamental perspective but are also the most expensive asset class on our scorecard, yielding just 3 per cent.

Better return prospects can be found in emerging markets, most of which are enjoying an ongoing inflation-free economic recovery. Russian bonds in particular stand out due to a 7.6 per cent yield, a credible central bank, high real rates, falling inflation and a cheap currency.

In fact, EM currencies are — on average — still trading at around 20 per cent below their fair value. That puts local currency EM bonds in a strong position to benefit from the expected gradual depreciation of the US dollar: a 10 per cent depreciation in the greenback should boost returns on EM local currency debt by around 11 percentage points.

We continue to see a weaker dollar as a medium-term trend, supported by an only modest pace of economic growth and a tightening Fed, and occasionally interrupted by partial corrections.

That view also supports our positive stance on commodities for next year, particularly when taken together with a disciplined approach to supply in the sector, strong global growth and a broad boom in capital expenditure.

For those concerned about inflation, a more direct investment in gold could be a better route within the commodity-related sector. Treasury Inflation Protected Securities (TIPS), meanwhile, are worth considering in the broader investment universe even at a modest 0.45 per cent yield: US TIPS tend to outperform Treasuries by 100 basis points for each 0.1 percentage point increase in inflation expectations according to our models.

05

In brief

ANNUAL OUTLOOK 2018

Global asset classes

Reasonably smooth conditions for equities, choppier ones for bonds.

Equity regions and styles

US equities look expensive; Europea, Japanese and EM markets have better prospects.

Fixed income and currencies

EM local currency debt to benefit from weaker dollar, stronger commodities and improving economic growth.

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