



2018 – a list of lists regarding the macro investment outlook

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EDITION 1

Key points

- > 2018 is likely to remain good for diversified investors. The investment cycle still favours growth assets over cash and bonds. But expect more volatile and constrained returns as US inflation starts to turn up.
- > Watch US inflation, bond yields, President Trump, the Italian election, China, the Sydney and Melbourne property markets and global business conditions PMIs.

Introduction

Although 2017 saw the usual worry list – around President Trump, elections in Europe, China, North Korea and Australian property – it was good for investors. Balanced super funds had returns around 10%, which is pretty good given inflation was around 2%. This year has started favourably but volatility may pick up as geopolitical threats loom a little larger and US inflation rises. This note provides a summary of key insights on the global investment outlook in simple dot point form.

Five lessons from 2017

- The global economy is finally emerging from its post-Global Financial Crisis (GFC) hangover. Talk of secular stagnation was overdone. Slow global growth since the GFC largely reflected a typical constrained aftermath from a major financial crisis.
- The withdrawal of extreme monetary stimulus won't cause economic chaos if central banks don't move too quickly and recovery is entrenched – this is clear in the US where the Fed has now been able to move away from zero interest rates and start reversing quantitative easing.
- The Eurozone is far more resilient than many give it credit for – with voters across numerous countries opting for centrist pro-Euro parties as opposed to the populist parties that many said were going to sweep to power.
- Turn down the noise – retreating to cash on talk of war with North Korea, worries about Trump, ahead of elections in Europe and perennial talk of a property crash in Australia – would have been costly in terms of missed returns.
- Stick to an investment strategy – 2017 had its share of distractions for investors but they would have done okay provided they stuck to an investment strategy that prevented them from getting blown around by various scares.

Key themes for 2018

- Still in the sweet spot for investors – a further rise in global growth to around 3.9%, driving solid earnings growth with continuing low inflation and easy global monetary conditions should keep investment returns favourable.

- But expect more volatility as US inflation stirs, the Fed hikes more than the market expects, other central banks edge towards less stimulus and political risk increases.
- Apart from the likelihood of more volatility through the year, global shares are likely to trend higher through 2018 on the back of rising earnings and still easy monetary conditions.
- Australian shares are likely to do okay but underperform global shares with returns around 8% with moderate earnings growth. Expect the ASX 200 to reach 6300.
- Commodity prices are likely to push up with global growth.
- Low yields and capital losses from a gradual rise in bond yields are likely to see low returns from bonds.
- Unlisted commercial property & infrastructure are still likely to benefit from the search for yield, but it is waning and listed variants are vulnerable to rising bond yields.
- National capital city residential property price gains are expected to slow to around zero as the air comes out of the Sydney and Melbourne property boom and prices fall by around 5%, but Perth and Darwin bottom out, Adelaide and Brisbane see moderate gains and Hobart booms.
- Cash & bank deposit returns to remain poor at around 2%.
- After a short-term further bounce higher, the \$A is likely to fall against the \$US as the gap between the Fed Funds rate and the RBA's cash rate goes negative. Solid commodity prices will provide a floor for the \$A, though.

Seven things to watch

- President Trump – the risks around the Mueller inquiry and renewed political pressure from the mid-term elections risks more populist policies (with trade conflict with China and Mexico and a possible escalation with North Korea and Iran high on the list) after the business-friendly policies of 2017.
- How quickly US inflation turns up – a rapid upswing would see a far more aggressive Fed, a strong rise in the \$US and bond yields, and pressure on emerging market shares.
- Bond yields – a rapid rise in bond yields would be bad for shares and assets that benefitted from the search for yield.
- The March Italian election – the Five Star Movement is likely to do well, which may create investor angst, but they are unlikely to be able to form government and are less anti-Euro. Moreover, support for the Euro remains high in the rest of Europe so Italy is unlikely to trigger a domino effect.
- Whether China, post the Party Congress, embarks on a more reform focussed agenda, slowing short-term growth.
- The Sydney and Melbourne property markets in Australia – too fast a slowdown could threaten broader growth.
- Global business conditions indicators (PMIs).

Four reasons why global growth is likely to be strong

- The post-GFC hangover has faded with high levels of confidence helping drive stronger investment and consumer spending. Self-sustaining growth has returned.
- Global monetary conditions are still easy. While some fret about a flattening US yield curve, this is unlikely to signal a growth downturn because it's been driven by rising short rates rather than falling long rates, high demand for long bonds as a portfolio diversifier and continuing QE in Europe and Japan holding down global and hence US bond yields.
- Fiscal austerity has faded, with the US seeing stimulus.
- We have not seen the excesses – massive debt growth, overinvestment, capacity constraints or excessive inflation – that normally precede recessions.

Three reasons why a grizzly bear market is unlikely

Shares are overdue a decent correction and even a brief (or gummy) bear market (where shares fall 20% but are back up a year after) is possible. But a deep (or grizzly) bear (where shares fall 20% and a year after are even lower) is unlikely:

- A recession is unlikely with growth more likely to accelerate. Most grizzly bear markets are associated with recession.
- Short-term sentiment measures are bullish but longer-term sentiment and positioning suggests investors are far from euphoric. (Some of the euphoria may have even been siphoned off to schemes like Bitcoin!)
- The liquidity backdrop for shares is still positive, with low rates still providing an inducement to allocate to shares.

Three reasons why risks around Trump may rise a bit

For 2017, we expected Trump the business-friendly pragmatist to dominate, but there are several reasons why we may see a bit more of Trump the populist in 2018:

- Much of his business-friendly policy agenda has been implemented notably tax reform and deregulation. So the good news from these sources is largely behind us.
- The Mueller inquiry is getting closer to Trump. We don't see the Republicans impeaching Trump unless there is clear evidence of wrongdoing. Even if he is replaced by Vice-President Pence, policy wouldn't change much – but markets may worry about it and this may be intensified if Trump lashes out and creates populist distractions.
- The mid-term Congressional elections in November (with polling pointing to the GOP possibly losing control of the House) will see a renewed focus on issues around trade (as evident in just imposed US tariffs on solar panels & washing machines) and inequality as Trump tries to boost his base.

But the 2016 fears around Trump are still unlikely to be realised – he has a focus on growth and jobs and won't want to threaten this. A full on trade war with Mexico or China is unlikely as a surge in consumer prices won't go down well with his base.

Three reasons why the trend in bond yields is likely up

- Deflation risks have retreated and are being replaced by inflation risks as global spare capacity is being gradually used up (led by the US) and commodity prices trend higher.
- Long bond yields remain well below levels consistent with nominal growth of around 3-3.5% in developed countries.
- Bonds are over-loved with a huge post-GFC inflow.

Three reasons why Chinese growth won't slow much

- The Chinese Government's tolerance for a sharp slowing in growth is low given the risk of social instability it may bring.
- Monetary & fiscal policy has not been tightened significantly.
- In the absence of much lower savings (the main driver of debt growth), rapid deleveraging would be dangerous.

Five reasons Australia won't have a recession (again)

A downturn in the housing cycle and uncertainty around the consumer are the main risks facing Australia but against this:

- The drag from falling mining investment has faded.
- Non-mining investment and infrastructure spending are turning up.
- National income is no longer falling as commodity prices have stabilised or are trending higher.
- Stronger export volumes from resource projects like LNG and stronger global growth will provide an additional boost.
- Interest rates can still fall further if needed.

The next move in Australian interest rates will likely be up, but the RBA will wait for more confidence on growth & that inflation has bottomed before starting to gradually hike later this year.

Five reasons to expect more share market volatility

- As US inflation rises it will likely result in a more aggressive Fed than the market is allowing for.
- Geopolitics may be a bit more negative than it was in 2017 if Trump becomes more populist.
- Volatility indexes like VIX are around record lows and net speculative short positions on VIX (bets volatility will fall further) are near record highs, warning of some reversal.
- Low volatility years like 2017 often lead more volatile years.
- The US share market is expensive on some measures.

Three reasons Bitcoin is a bad "investment"

- It's impossible to value, generating no income flow – making it highly speculative (as evidenced in extreme volatility) and subject to a crowd-driven mania (as we saw in 2017).
- New supply potential is huge – eg, from other crypto currencies and futures trading which is allowing easy shorting and syphoning away demand.
- Governments are likely to ramp up regulation of it, are unlikely to give up their monopoly of legal tender (and the "seigniorage" they earn from it) and will likely develop their own crypto currencies using block chain.

Nine things investors should remember

- The power of compound returns – saving regularly in growth assets can grow wealth substantially over long periods. Using the "rule of 72", it will take 29 years to double an asset's value if it returns 2.5% pa (ie 72/2.5) but only 9 years if the asset returns 8% pa.
- The cycle lives on – markets cycle up and down and we need to allow for it and not get thrown off by rough patches.
- Diversify – don't put all your eggs in one basket.
- Turn down the noise – increasing social media and the competition for your eyes and ears is creating much noise around investing that is really just a distraction.
- Starting point valuations matter – for example still low bond yields will mean low medium term bond returns.
- Remember that while shares can be volatile, the income stream from a diversified portfolio of shares is more stable over time and higher than the income from bank deposits.
- Avoid the crowd – at extremes it's invariably wrong.
- Focus on investments with sustainable, decent cash flows – not financial engineering and schemes like Bitcoin.
- Accept that it's a low nominal return world – when inflation is 2%, a 10% superannuation return is pretty good (and probably not sustainable at that rate).

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