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Global Perspective

2018 outlook – big bang or steady state?

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In 1964, the discovery of Cosmic Microwave Background Radiation (CMB) by Robert Wilson and Arno Penzias was a giant leap forward in humanity's understanding of the universe. This landmark finding put the Big Bang Theory on strong ground, suggesting that the cosmos had a finite beginning about 13.8 billion years ago and putting to rest the steady-state theory, which postulated that the universe has no beginning or end.

We believe 2018 is shaping up to be of similar importance for the economy, markets and investments. In 2018 we will begin to learn whether central banks' decade-long Quantitative Easing programmes – totalling $8 trillion globally – were a success. What will happen once these programmes begin to draw to a close? Will the current steady state of strong growth and low inflation continue? Or will there be a "Big Bang," heralding a new era for economies, markets and investors; an era characterised by a more realistic assessment of sustained central bank support and leading to the resumption of heightened volatility and a re-rating of asset valuations?

2017: the "Goldilocks" year

After the political earthquakes of the previous year, 2017 turned out to be a year of lower uncertainty, especially after Macron's victory in France. Somewhat surprisingly, 2017 was also characterised by even lower risk, reflected in very low volatility across the risky asset spectrum for much of the year, and in a fall in macro volatility, in terms of growth and inflation.

In 2017 we finally witnessed a traditional, synchronised global growth upswing beginning to take hold. What remained missing though, was a convincing upturn in inflation compared to 2016. And this has called into question the traditional understanding of the relationship between the economic environment and inflation (commonly referred to as the Phillips curve).

We believe the unexpected absence of inflation explains why key central banks remained cautious in shifting their monetary policy stance, despite stronger than expected growth in 2H2017. With the global economy in a so-called "Goldilocks" scenario – running neither too hot to spark fears of runaway inflation, nor too cold to cause concern that growth might stall – central banks did not need to slam on the brakes and the environment shifted convincingly to "risk-on" mode.

Risks that have emerged

Despite this favourable top-down environment which was supportive of risk-taking, the shoots of a number of risk factors began to appear during the course of 2017. Chief amongst them was the ongoing geo-political tension between North Korea and the US. This issue continues to move in and out of focus as there are still no signs of a concrete resolution. From a markets perspective, despite the precarious nature of the situation, the pricing of this geo-political risk has been largely absent, apart from the few days following the heightened tensions in August. While we take some comfort from the involvement of China as a balancing force, given the country's relationship with North Korea and its strong incentives

to maintain the no war status quo, we still view this issue as a significant binary risk which should not be ignored.

Trade protectionism is another risk we think is likely to strengthen further in 2018. The current US administration with its narrow, mercantilist mind-set is increasingly using international trade as a bargaining chip in a variety of situations. Indeed, the rising probability of NAFTA being abandoned in coming months may create a new negotiating template for the world's largest economy, even if NAFTA's future may become subject to a lengthy legal process in the US.

On a more local basis, the ongoing Brexit negotiations represent another risk factor which became more visible during the course of 2017. After months of uncertainty, the UK finally agreed to pay a divorce bill and tackle the Irish border and EU citizens' rights issues. However, the weak May government remains vulnerable to the thorny issue of envisaging a post-EU relationship. We expect additional uncertainty and continued noise around the topic in the months ahead. That said, we still estimate the probability of a "no-deal" outcome to be below 20%, given the limited choices facing the UK and the signs of compromise starting to appear – increasing chances of a "soft" Brexit.

Wizards of expectations – central banks to remain in the spotlight in 2018

Despite the excitement around disruptive technologies, the rise of crypto currencies, Artificial Intelligence and robotics, we expect good old central banks with their printing presses to remain the most important driver of key risk asset prices next year. As the era of quantitative easing (QE) by central banks gradually draws to a close, the impact of this monetary policy regime change will depend on what made QE work in the first place.

Literature shows a number of transmission channels through which QE has affected economic outcomes, namely: liquidity, interest rates, credit, FX and signalling. Signalling – meaning the articulation of central banks' intentions to the outside world – is arguably the most important channel at the disposal of central bankers. The most compelling example of the power of signalling is the "Whatever it takes" remarks of ECB president Mr. Draghi in 2012 – referring to the ECB's commitment to saving the Euro. And the ECB's subsequent unveiling of its Outright Monetary Transactions program was so credible and comforting to markets that in the end it never had to be deployed.

For key central banks, managing communications to the outside world will be key to ensuring a smooth exit from the extraordinary accommodative monetary policy adopted over the past decade. Fortunately, it does seem that central bankers are becoming more adept communicators. In 2017 – in contrast with 2013's taper tantrum – both the Fed and the ECB managed the communication of their monetary policy plans well in advance of any policy moves. And the increased transparency they provided helped to reduce the risk of a knee-jerk market reaction. However, this juggling act is far from over and 2018 may be a tougher test for central banks, especially if inflation starts to kick in as global capacity further erodes.

A central banker's dilemma

With inflation remaining comfortably below target levels, central banks have not felt an urgent need to sharply cut back on their monetary policy stimulus measures. However, the long-term risks associated with a sustained period of easy monetary policy are in evidence – valuations are high across a variety of assets. This is especially true of government bonds which, in the era of extraordinary monetary policy, have become more of a policy tool than an asset class. It is becoming harder for central banks to focus solely on inflation (low and stubbornly stable) and ignore asset prices (broadly high).

The Bank of Japan is the most extreme example of the central bankers' dilemma: inflation remains far below BoJ's target, while the economic upswing and rising asset valuations are making the case for a policy shift stronger by the day.

Indeed, we think that in the second half of 2018 the BoJ may be forced to change its yield curve control policy and, as a result, the 10-year yield target (around a 25bps upward shift) with a related shift in the parameters of its ETF buying program.

In Europe, we expect the ECB to introduce another round of scaling back the pace of its asset purchases. We expect the ECB to accompany this with another 3-month extension of the asset purchase programme; when it comes to reducing monetary stimulus measures, below-target inflation is continuing to keep the ECB cautious. However, communications leading up to that decision will be key, and if growth data remains as strong as it is now, then a case for a more abrupt end to stimulus measures may strengthen. In this event, the ECB may struggle to balance its competing priorities – namely, making progress towards the inflation target and assuaging Germany's concerns over the continued use of the printing press.

Out of all the key central banks, the Federal Reserve is perhaps in the best position, with US monetary policy now mostly on auto pilot. Here the only moving part is the pace of interest rate hikes – which is economic data-dependent – rather than the speed of balance sheet normalisation. We expect at least two hikes next year, with risks titled towards one additional hike. Indeed, the nature of risks imply that the current flattening of the yield curve may continue, with a serious likelihood of inversion taking place over the course of 2018 – which, unlike in the past, may have no relevant information about the future course of the US business cycle as non-investors remain the dominant driver of dynamics.

With a number of board positions remaining to be filled, the Federal Open Market Committee may look completely different in 2018 from the current configuration. That said, the appointment of Jerome Powell as the next Fed chair has helped reduce one main source of uncertainty around future Fed policy.

Overall, the delicate dance done by key central banks in 2017 will need to continue in 2018. However, the task of balancing growth, inflation and stability concerns while not creating shock waves in markets should be simpler provided inflation remains subdued. With modest inflation rates, central banks can afford to take their time in recalibrating their policies, and the importance of financial stability concerns in central banks' objective functions can rise gradually.

Increasingly, central banks' delicate balancing act is leading to questions about the efficacy of transparent inflation targeting itself. According to some experts this may be contributing to subdued inflation. Indeed, we expect such debates to become more prominent in 2018, with alternative viewpoints on the conduct of monetary policy being considered against the backdrop of significant personnel changes in key central banks.

Turning to inflation risks, the array of indicators we watch leads us to believe that the current healthy mix of strong growth/subdued inflation appears set to continue in coming months. However, our fear is that the

old model of inflation (inflation rises non-linearly as capacity constraints increase) is not dead and could prove to be the spanner in the works. If that is the case, in the second half of the year policy makers could suddenly find themselves woefully behind the curve, with inflation rising and asset prices significantly overvalued.

Future of the current business cycle – ECB-driven boost in Europe and fiscal stimulus in the US

In the context of the protracted and ongoing economic recovery, investors may be asking whether a turn in the business cycle is imminent. We believe it is shocks which kill business cycles not age, as we discussed in our **recent piece**.

On the shocks front, so far the macro thrust is still positive, with an ECB-driven economic boost continuing to benefit the European economy, as confirmed by the latest business surveys. Over in the US, expectations of a fiscal stimulus are firming up sharply given the faster than expected progress in the two Chambers of Congress in December.

The US fiscal stimulus would boost economic growth, which is already looking solid, in 2018. And markets continue to see it as a positive development despite the potential impact on the future public debt profile and the stage of the US business cycle. We think this positive perception can continue as long as growth remains strong, and it would only be shaken if fiscal easing then translates into tighter monetary policy. That said, as details of the fiscal plan become clearer, over the short-term there will be sector-specific implications which are already being picked-up by the market as more details become available. Beneficiaries of the stimulus plan vary from sector to sector, i.e., technology firms and the utility sector are seen as at a relative disadvantage.

The proposed US fiscal stimulus may have a positive impact on investment. The plan to allow the full expensing of new equipment for five years could be a powerful incentive for investment. Moreover, the proposal to permanently reduce the tax rate on foreign earnings could also support investment, as the repatriated funds could be used in a tax effective way to fund capex needs. We estimate that as much as USD 1 trillion could be repatriated. However, given the concentration of these foreign earnings in a limited number of firms and based on previous experience, the phenomenon of repatriated funds being redirected to shareholders rather than being used for investment is a risk factor we will watch. The repatriation could also have an impact on financial markets outside the US. We estimate that at least 80% of the foreign earnings are already in USD. If big sums get repatriated, the reduction in USD holdings outside the US could put pressure on USD funding overseas. It could also impact FX market pricing if it happens within a short time frame.

Returning to Europe, we believe there a good chance that above-trend growth will continue over coming quarters, given Europe's lower capacity utilisation rates relative to the US. This top-down dynamic, coupled with the valuation advantage European equities enjoy over their US counterparts, means we maintain the regional preference we adopted early in 2017: Europe over the US.

Emerging markets – still positive but idiosyncratic drivers are re-asserting themselves

Turning to emerging markets, we maintain the positive view we initiated in 1Q2016. However, we now see EM dynamics as more mid-cycle, with valuations (particularly in fixed income) much closer to fair-pricing than 18 months ago. The improvement in fundamentals at the aggregate EM universe level continues and is aided, in our view, by the ongoing gradual rise in commodity prices – see **Commodity prices and inflation**. However, the incidence of idiosyncratic risks has increased, as witnessed recently in Turkey and South Africa.

From an asset class perspective, we now have a stronger preference for emerging market equities. This is because of the asset class's positive global growth beta and its valuation advantage, which we believe remains significant. Second on our list of preferences is emerging local current debt, aided by currency valuations (below fair value), real rates (which remain high) and bond valuations (at a discount versus other segments of the EM bond market). In third place for us is hard currency debt where we see the current tight spreads as vulnerable to the higher rates environment. However, we think that pockets of opportunities are still available in certain sub-segments of the hard currency debt market, such as Asia. Crucially, investment implementation approaches are of equal importance to asset class selection, in our view, as the dispersion in returns rises further and idiosyncratic risks (country, segment, sector and company) increase in importance.

China – tentative signs of slowdown but tail risks remain low

The current economic rebalancing act in China is becoming evident in the high frequency data since the 19th National Congress, as rising consumption becomes the dominant driver of economic growth against the backdrop of a heavy debt burden.

On the positive side, the recent slowdown in credit growth and debt accumulation bodes well for the Chinese economy's long-term financial stability, in our view. However, the rebalancing of growth towards stronger consumption against this backdrop of slowing credit stimulus is a trend which we think needs careful monitoring in the months ahead.

On the tail risk front, we remain comfortable with the situation as China's external dynamics continue to improve. Given this and China's renewed focus on maintaining CNY stability, we rate the likelihood of a balance of payments crisis over the next 12 to 36 months as very low (see **China's misunderstood debt challenges**).

Non-cyclical risk factors: fractured liquidity

Over the past 18 months we have been highlighting consistently the issue of fractured liquidity: pressure on secondary market fixed income liquidity resulting from the changing regulatory landscape. Recent papers have shone a spotlight on the topic, and the outgoing Fed chair has also noted that "algorithmic traders and institutional investors are a larger presence in various markets than previously and the willingness of these institutions to support liquidity in stressful conditions is uncertain."

The appointment of Jerome Powell as Fed chair offers some potential for reducing the weight of recent banking sector regulations, mainly through rule re-interpretation. As heavy regulation has contributed to fractured liquidity, this outcome could be beneficial for the functioning of bond markets. However, with discussions on this topic yet to start, it is too early to have any clarity on the future direction of regulation and its true impact on market liquidity.

How can investors mitigate the challenges listed above? We continue to believe that in a fractured-liquidity environment, investors should rethink how they construct their fixed income portfolios. We believe investors should focus on bringing quality into the heart of their portfolios within

a low-turnover framework that reduces their need to access the market. This also means moving away from the commonly used market-cap benchmarks, which reward leverage by design.

Fractured liquidity in bond markets

A recent **Fed paper** by Choi and Huh (2017) provides additional metrics around the issue using US corporate bond data over the 2006/2015 period.

Choi and Huh show that customer trades which are matched with other customers have lower bid-ask spreads compared with trades when customers are demanding liquidity (around a 20% to 40% difference). In addition, the authors show that the fraction of customer-to-customer trades had risen to around 30% in the high yield market compared to around 20% pre-crisis and similarly had doubled to around 13% for the investment grade segment based on 2015 data, thus showing the reduced role of dealer balance sheet activity. Moreover, the authors conclude that bid-ask spreads appear low because average bid-ask spreads are a biased measure of the true-cost of demanding liquidity and as dealers become less willing to take inventory risk in the post-regulation period, customer liquidity provision increases, which worsens the underestimation problem.

In the sovereign fixed income space, academics such as Darrell Duffie have charted out in detail how the changing regulatory set-up has created enormous impact by reducing risk appetite of dealer-bank institutions (especially, the role of Supplementary Leverage Ratio), which has been visible in the widening of bid-ask spreads in the US repo market. In addition, analysis carried out by Duffie (2017) implies that bank capital levels could actually be pushed higher while still improving liquidity of markets for safe assets such as low-risk fixed income instruments by relaxing the leverage-ratio rule and increasing risk-based capital requirements.

Secular trends – mainstreaming of ESG and disruptive technologies

In 2017, an emphasis on climate change within the broad Environmental Social and Governance (ESG) framework turned out to be an important secular development. A rising body of evidence is pointing to a causal link between human activity and Earth's average surface temperature. And as part of its latest World Economic Outlook report, the IMF shared a detailed study of the impact of climate change on economic outcomes, using a cross-country data-set.

Based on the IMF's analysis, weather can influence economic activity through various channels. The impact on agricultural output, capital and labour stock are obvious and depend on the severity of the event. Furthermore, the IMF reports that evidence from surveys and other sources show that exposure to heat above a certain point reduces labour productivity. In addition, temperature rises can lead to persistent output losses, if the rate of factor accumulation is also affected – an assertion which seems to have empirical support. The IMF's analysis also yields that in hot climates higher temperatures may reduce future labour supply because of the influence on mortality rates.

All in all, governments have a key role to play in dealing with an issue that – through various channels – has a measurable negative impact on real GDP per capita.

As for investors, internalising the cost of climate change in capital allocation decisions is also a potent tool. By this we mean helping to align companies' incentives with the goal of maximising long-term economic growth and, by extension, delivering long-term investment returns.

The Big Data revolution is producing a variety of metrics and increased transparency – especially, when it comes to climate impact. This represents an important step towards assessing the climate change challenge. And it makes the link between climate considerations and investment portfolio construction more tangible as data can be plugged into existing frameworks to help tilt portfolios in the desired direction.

Binding regulations around climate change could be considered as a new investment risk factor and investors would do well to take this into account in investment decisions. In the absence of widespread binding regulations, voluntary decisions remain the first course of action and, given the nature and quality of data available, are entirely feasible to implement in a credible and transparent manner.

On disruptive technologies, the rise of crypto-currencies, Artificial Intelligence and machine learning have been major developments in the financial industry. There is much "excitement" around bitcoin price rises, but as bitcoin's long-term intrinsic value is closely tied to the willingness of governments to allow an anonymous digital medium of exchange system to flourish, we remain sceptical. That said, the block-chain technology that underpins bitcoin appears to be ground breaking in terms of its potential usage in other applications.

In addition, the Big Data revolution already in action, coupled with the sharp rise in the availability of cheap computing power is opening up some interesting possibilities. For example, numerically complex data manipulation techniques such as machine learning are beginning to become a practical and fertile avenue for identifying additional opportunities in global markets. We are closely following this development and assessing the usefulness of these techniques for our global investment management framework.

Looking to the future

We expect the current "goldilocks" scenario – broadly solid economic growth and subdued inflation – to continue into 1H2018 and we remain comfortable with our value calls in emerging markets and Europe.

One key change to our view is that we now adopt a stronger negative view on duration risk (i.e., we expect rates to rise further) in advanced economies. As a result, we expect bond market returns to move deeper into negative territory.

We will be watching carefully a number of developments: upcoming shifts in monetary policy in key advanced economies as net global quantitative easing turns negative in 2H2018; the growth rebalancing act in China; and signs of inflation re-appearing as asset valuations reach cyclical highs.

Also, in the event of a turn in the business cycle, bonds would provide a much lower capital buffer to equity downturns than in years gone by, given that starting bond yield levels are so low in advanced economies. We believe this makes a strong case for outright, ex ante drawdown management, especially in a balanced portfolio setting. We see this as an important portfolio attribute for the current environment.

Moreover, as concrete evidence of fractured liquidity continues to emerge, we maintain our view that quality-driven portfolio construction within a

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low-turnover framework is important in fixed income. And this is especially valid as investors continue to traverse down the credit rating spectrum in their search for yield.

As evidence mounts that climate change is impacting real economic outcomes, we think investors have an important role to play in internalising the costs of weather disruptions linked with human activity. Here, we believe the increased availability of more reliable and credible data and assessment methods make it feasible to use existing investment frameworks to transparently create incentives. Incentives that will help in mitigating the impact of climate change on both long-term economic growth and, by extension, investment returns.

We broadly expect the current steady state of strong growth and low inflation to continue into 2018 but are far from complacent when it comes to watching for the key risk factors we have discussed. A return with a vengeance of inflation, poorly-handled braking by central banks, not to mention North Korea vs. Trump – shocks could come from a variety of angles and lead to a Big Bang in markets. Investors should balance the pursuit of returns with the goal of building safety into their portfolios.

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