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2018 Investment Outlook

Global economy

All signs point towards a sustained global expansion

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Key takeaways

- I believe the current US expansion has further to go and could become the longest in US history.
- Economic growth in the eurozone is gaining momentum but will face a headwind if there is a slowdown in credit creation.
- A modest increase in global trade is likely to support Asian economies, including China.

We approach the new year with confidence that the world's leading economies will continue to display strength and resilience. The US economy is likely to lead from the front, aided by a gathering upturn in the eurozone and the start of a renewed upswing in global trade. The likely expansion among developed economies should also have a positive impact on the export-oriented, manufacturing economies of East Asia as well as commodity producers in other emerging nations.

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United States

A strong labour market (the unemployment rate fell to 4.2% in September – a 16-year low) and benign inflation are likely to underpin moderate real GDP growth in 2018. I expect the US economy to expand by 2.2% in real terms in 2018.

For most of 2017, inflation has undershot the US Federal Reserve's (Fed) target. Fed governors and presidents have attributed this to one-off reductions in cellular phone contract prices and other exceptional events, asserting that the underperformance of inflation relative to the 2% target is "transitory." However, after several months of price weakness, the claim that these price changes are temporary is starting to lose credibility. A key moment will come in the spring of 2018, when 2017's price declines will fall out of the year-on-year comparison. My view is that the underlying problem is slow growth of money and credit. However, I expect no great harm to come from this modest degree of price weakness provided that core inflation starts to pick up again in 2018.

Against this backdrop, the Fed has continued with its policy of gradually normalising – not tightening – interest rates, and in September 2017 the central bank announced the start of a plan to shrink its balance sheet following the scheme announced in June. The "dot plot" released with the Federal Open Market Committee statement suggested another possible interest rate hike in December 2017 plus three further hikes of 0.25% in 2018. This would take the federal funds rate to a range of 2.0% to 2.25% by the end of 2018.

The plan to shrink the Fed's balance sheet is intended to gain momentum in 2018. Initially, the runoff will start at $10 billion per month during the fourth quarter of 2017, but is envisaged to rise to $50 billion per month in the final quarter of 2018. This means that private sector investors will need to replace the Fed as a holder of these securities, and therefore the US Treasury and government agencies will need to increase auction sizes accordingly. Selling an additional $50 billion of debt securities per month risks raising long-term interest rates, tightening financial conditions, and squeezing bank credit and money growth. In my view, the Fed will need to proceed with caution.

There is good reason to expect the current expansion in the US has further to go and could actually become the longest business cycle expansion in US financial history. This would imply a continuous upswing that exceeds the record trough-to-peak expansion of 120 months between March 1991 and March 2001 (as measured by the National Bureau of Economic Research). The only real threat to this prospect is the possibility that the Fed and other central banks could make a mistake and tighten too much during monetary policy normalisation. If they overdo the tightening, there is a real risk of a slowdown in 2018-2019 and a continuation of below-target inflation rates across many major economies. This is not my base case, but investors need to be mindful of this possibility.

Eurozone

Economic activity in the eurozone is at last expanding at a momentum close to its potential. This is largely a result of the asset purchase programme started by the European Central Bank (ECB) in March 2015 and the associated acceleration of the money supply (M3). To ensure that economic momentum is sustained, commercial banks need to create credit more rapidly than at present. Otherwise, when the ECB starts to taper its purchases, credit growth could weaken substantially.

Even though the economies of the single currency area may have recovered, the basis for sustained M3 growth of 5% or more in the eurozone – which I believe to be the minimum needed to ensure 2% real growth and 2% inflation after allowing for a 1% annual decline relative to income) – is distinctly fragile. The risk, therefore, is that tapering quantitative easing purchases will lead to a renewed and damaging slowdown in M3 growth, resulting in the inflation rate declining further beneath its target of "below but close to 2%." I expect inflation to remain below its target figure for the year ahead due to inadequate M3 growth.

United Kingdom
UK economic growth picked up a little in the third quarter of 2017 after a sluggish first half, but still remains below its recent trend. However, the British economy is likely to draw support over the next 12 months by buoyant elements of consumer and business spending. Going forward, I expect growth to hold up for two reasons. Firstly, monetary policy has been highly stimulatory, and secondly, the weaker pound has enabled the export-oriented manufacturing sector to be much more vigorous than expected. The UK labour market also appears to be in good health – the economy continues to generate good job growth, the unemployment rate is very low and the participation rate is at a record high. However, the Bank of England raised interest rates for the first time since 2007 in early November. The Monetary Policy Committee voted 7-2 to increase rates to 0.5% from 0.25%. In addition to imported inflation, there is a danger that accelerating money and credit expansion in the UK could add locally generated inflation to rising import prices. I expect growth to settle around 1.5% until the uncertainties of the Brexit negotiations are overcome.

Japan
The Japanese economy has had a decent run lately with real GDP increasing for six consecutive quarters, the first such extended stretch of growth for over a decade. While the labour market should remain tight in 2018, low wage growth is expected to persist, providing further evidence that the Phillips curve[1] is not a dependable theory of inflation. Despite huge qualitative and quantitative easing (QQE) by the Bank of Japan, inflation is likely to stay weak and below the central bank's 2% target, but should stay above zero. Economic growth for 2018 should remain stable (around 1.2%) but lag the US and eurozone.

China and Emerging Asia
Both China and emerging Asia are likely to draw support from a modest increase in global trade. While this should help underpin commodity prices, I don't believe it will be enough to translate into a commodity boom next year. Since China is by far the largest emerging market and also the biggest buyer of commodities on world markets, the growth of China's imports matters immensely to numerous developed and emerging commodity exporters around the world. If China can engineer a steady domestic recovery over the next year or two, the outlook for those commodity-exporting economies will improve considerably. However, in light of the continuing moderate recovery in developed western economies, China's upswing may not be sufficiently vigorous to drive a recovery in all commodity-producing economies.

> The global economy is experiencing its broadest and strongest upturn for five years and is likely to extend further, in my view.

1 The Phillips curve states that there is an inverse relationship between inflation and unemployment. According to the Phillips curve, lower rates of unemployment would imply higher rates of inflation.

Global economy

Global markets: 10 expectations for 2018

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Key takeaways

- My base case scenario remains that the stock market will continue to perform well in 2018 – although that doesn't mean we won't experience a pullback during the year.
- Global growth and still-accommodative monetary policies are likely to be key drivers of stocks.
- We need to be mindful of the potential for downside volatility.

2017 was a positive year for the economy and capital markets. The global economy grew at a faster pace than in 2016, and risk assets also rose significantly.[1] However, investors are wondering whether the current environment will continue through 2018. Following are my 10 key expectations for the new year:

1. **Upward bias for stocks globally.**
   As we enter 2018, there are two key drivers creating an upward bias for stocks and other risk assets globally: improving global growth and the continuation of accommodative monetary policy. These are two very powerful influences that I believe should support risk assets in general and stocks in particular. Now, that doesn't mean we won't experience a correction, particularly in the US, but it does suggest it could be more short-term in nature.

   The eurozone, Japan, the US and a number of emerging markets are experiencing rising growth, and that dynamic is likely to continue well into 2018, although there will likely be hiccups along the way. In addition, earnings growth is solid and improving in most major markets; this should also be supportive for global stocks. At the same time, most of these economies are experiencing relatively low inflation, which gives central banks more flexibility to remain very accommodative.

2. **More disruption and greater volatility.**
   Disruption – both positive and negative – is abundant right now, which increases the chance that volatility will rise from its extremely low levels.

   Geopolitical disruption. Tensions are rising in a variety of places around the world, from North Korea to Saudi Arabia. However, geopolitical disruption typically doesn't impact the stock market unless it becomes extreme. And, if it does have an impact, it's usually short-term in nature. What I worry more about is the potential for countries around the world to adopt more protectionist policies in response to the geopolitical disruption created by nationalist movements intent on de-globalization. We can't forget that many economists blame protectionism for exacerbating the Great Depression in the 1930s, and we can't ignore the threat of protectionism that is very real today.

   And then there is the risk of political disruption in the US stemming from lofty expectations about the success of the Trump legislative agenda, particularly tax reform and infrastructure spending. The US stock market rallied dramatically after the election, helped by an improvement in earnings but largely buoyed by legislative optimism. However, this agenda has not yet come to fruition – and, in my estimation, is in danger of not meeting initial expectations. This creates vulnerability for the US stock market.

   Monetary policy disruption. The large-scale asset purchase plans that have been a major policy tool of key central banks over the past decade are experiments that have had a very significant impact on asset prices – and market volatility. Now that central banks are starting to "normalize" this experimental monetary policy, there is the potential for disruption to capital markets. While this is not my base case, this is a distinct possibility, especially given that this potential is amplified by several different factors that all increase the odds of a policy error. First, in the US, there will be a significant number of new Federal Open Market Committee members in 2018, including the chair and the vice chair. Second, the US Federal Reserve (Fed) is utilizing two different monetary policy levers simultaneously – the federal funds rate and the Fed's balance sheet. Finally, several other major central banks are starting to normalize monetary policy, albeit ever so gently.

> Disruption – both positive and negative – is abundant right now, which increases the chances that volatility will rise from its extremely low levels.

1 Risk assets are securities, such as stocks or certain types of bonds, that carry a degree of risk.

3. **Lower for longer rates and a continued hunt for income.**
   While a number of central banks have begun to get slightly less accommodative – including the Fed, the Bank of Canada, the Bank of England (BOE) and the European Central Bank (ECB) – they still remain very accommodative in relative terms. Recent events suggest this will continue in 2018 – specifically the November 2017 nomination of Jerome Powell as the next Fed chair, given that he is likely to maintain the status quo set by outgoing Chair Janet Yellen, and the ECB's decision to keep the end date of quantitative easing open-ended. This suggests that the hunt for investment income will continue in 2018.

4. **Increased debt levels.**
   I expect leverage, including government and private debt, to increase and become riskier in some regions in 2018.

   The People's Bank of China's outgoing governor has warned repeatedly about the threat of high leverage in China's financial system and the importance of financial reforms. We will want to see if Chinese President Xi Jinping will prioritize those reforms. It will also be critical for the People's Bank of China to negotiate monetary policy effectively, given the risks of high debt levels and the need to support the Chinese economy without causing it to overheat.

   In addition, Japanese government debt is at very high levels, which will make it difficult for the Bank of Japan to normalize its monetary policy. The US also has a high level of government debt that is projected to climb much higher. On top of that, US consumer debt recently hit a new record, and defaults are rising for sub-prime auto loans. In Canada, the household debt situation is even worse – in late 2017, household debt as a percentage of disposable income was above the level reached by the US in 2007, before the start of the global financial crisis.

5. **Continued UK uncertainty, with fatter tails likely.**
   I believe the odds are increasing that there will be an extreme outcome to the Brexit negotiations – either a pre-Brexit relationship between the EU and UK, or no relationship at all. The longer it takes to reach an agreement, the more likely it is that companies begin to relocate. In addition, the UK faces another headwind to its economy: The BOE decided in November to raise rates for the first time in more than a decade. While there is no strong growth that the BOE needs to moderate, it is attempting to move the pound sterling higher in order to combat the relatively high level of inflation that the UK is experiencing as a result of Brexit-related currency shifts. However, the BOE intimated in its decision that it is not on any kind of significant tightening path, so sterling didn't show the strength that the BOE hoped for. This is problematic and suggests the potential for a stagflation scenario. We will want to follow sterling and inflation closely.

6. **A focus on critical economic reforms.**
   French President Emmanuel Macron has embarked on ambitious labor market reforms for his country. This has already inspired much-improved business sentiment that could result in higher capital expenditures. Macron also intends to take a lead on reforms for the European Union, which are vital to future stability and growth in the EU. In addition, Indian Prime Minister Narendra Modi is in the process of a transformative reform agenda for his country. In 2017, India enacted a Goods and Services Tax, a de-monetization plan, a new bankruptcy law, an inflation-targeting framework for its central bank, and a Real Estate Regulation Act. India's growth is moderating, and the country needs continued and more successful reforms in order for growth to accelerate.

7. **The need for infrastructure.**
   A number of major economies are desperately in need of infrastructure spending – particularly the United States and India. Infrastructure is a priority focus for India going forward, both rural (housing, roads, electricity) and national. In the US, there is a need to replace and rebuild a variety of different types of infrastructure, including water pipes, bridges and tunnels, and telecommunications structures. Infrastructure can be a very powerful form of fiscal stimulus in both the short term and the longer term.

I expect countries that actually spend wisely on infrastructure to see a significant tailwind to economic growth and benefits to several different sectors (industrials, materials, telecommunications). Conversely, failure to focus on infrastructure next year may have negative implications.

8. **The potential for currency surprises.** This past year saw significant and unexpected weakness for the US dollar, as diminished growth expectations and political setbacks weighed on the currency. In addition, emerging markets currencies have reacted to recent political developments. I would expect more surprises and fluctuations in 2018. A number of central banks will likely continue to slowly tighten monetary policy, which should, depending on timing, cause changes in the relationships of different currencies. A less-than-fully synchronized global economic recovery could also contribute to currency fluctuations.

9. **A mixed outlook for commodities.** While the US dollar weakened, the price of oil did not rise significantly in 2017 – despite a rise in prices for industrial metals. This suggests that relationships are changing among different commodities, with metals prices more greatly impacted by emerging market demand. I expect agricultural commodities to benefit from improving global demand, and gold to move based on several different influences, particularly the fear trade and the inflation trade. In general, I expect a mixed performance by commodities next year, but with a relatively lower correlation to equities and fixed income.

> The Trump legislative agenda has not yet come to fruition – and, in my estimation, is in danger of not meeting initial expectations. This creates vulnerability for the US stock market.

10. **Possible rotation in leadership.** We need to recognize that this is still a very macro-driven environment. Political developments – specifically the success or failure of key legislative initiatives such as tax reform or infrastructure spending – will likely cause relatively swift rotations in leadership between growth and value in the US stock market for the year. We are also likely to see rotations in leadership among asset classes, styles and sectors, as the global economic recovery will not be perfectly synchronized, favoring certain regions and asset classes at different times.

Market outlook

In summary, despite all the outstanding risks, my base case scenario remains that the stock market will continue to perform well in 2018. However, given rising risks to capital markets, we need to be mindful of the potential for downside volatility.

Chinese equities

2018 growth may moderate, but reforms and innovation bode well for the longer term

Mike Shiao
CIO, Asia ex Japan
Hong Kong

Key takeaways

- For 2018, we are expecting a moderation of growth.
- That said, there are several encouraging signs that may support better quality growth in the longer term.
- Going into 2018, we maintain our optimism for Chinese equities.

Chinese equities caught investors by surprise in 2017 with a strong rally. Contrary to the pessimism over the past few years, investors have turned upbeat toward China, and for good reason: Economic data in general exceeded expectations, and we have seen broad-based earnings growth.

For 2018, we are expecting a moderation of growth. That said, there are several encouraging signs that are worth monitoring. In our view, these will be supportive for a transition to better quality growth.

- Progress in deleveraging
- Supply-side and state-owned enterprise (SOE) reforms
- Industrial innovation
- Structural southbound liquidity
- MSCI A-share inclusion

Growth expected to moderate in 2018

We are of the view that gross domestic product (GDP) growth will gradually moderate in 2018 from 2017 levels, but should be on track to deliver the government's target of around 6.5% growth.[1] We believe consumption and services are the structural drivers for China's GDP growth going forward. Income growth continues to be strong in the high single digits. We believe consumption and services will continue to drive the economy in 2018, as underpinned by urbanization and rising income trends.

Investments and exports are expected to soften going into 2018. However these are less of a concern in our view. Exports, for instance, are unlikely to become a key growth contributor, given that China's export share to G3 economies has largely stagnated since the start of this decade. We expect the Fixed Asset Investments (FAI) in real estate to slow, as that is in line with the overall policy to prevent a property bubble. We believe the government's shift toward a Private-Public-Partnership (PPP) model, with the aim to attract private sectors to co-invest, is a very encouraging sign.

Progress in deleveraging

We have seen positive progress with China reining in overall debt in 2017, and we believe deleveraging will remain a high-priority agenda item for the government in 2018. So far, we have seen ongoing policy tightening in the financial industry in an effort to temper irrational credit growth. Results have been encouraging. Wealth management products, one of the proxies for shadow banking, have shown contraction in recent periods. We believe progress in deleveraging will continue in 2018, although in the short term, we may see pressure in terms of funding for smaller enterprises in China, which could weigh on short-term growth in 2018. However, over the longer term, a reduction of overall financial risk should lead to stability and better quality growth going forward.

Supply-side and SOE reforms

Supply-side reforms have seen remarkable progress over the past two years, with the coal and steel industries achieving their capacity curb targets faster than expected. We expect more disciplined supply-side controls to continue into 2018, leading to a more favorable supply-demand balance in industries with excess capacity.

We believe one of the key solutions to the problem of outstanding debt is to fix SOEs' lack of competitiveness. Early 2017 saw some positive momentum, and we expect this to continue. We have started to see SOEs increasing their dividend payouts and introducing mixed ownership in their structure. Both of these steps are evidence of the change in mindset to make companies more profitable and market-driven.

> Supply-side reforms have seen remarkable progress over the past two years, and we expect more disciplined supply-side controls to continue into 2018.

Industrial innovation

We are already seeing industrial innovation happening. Research and development (R&D) spending in China has increased fivefold since 2005, growing at 18% per year, and with the second-highest R&D investment globally.[2] With government policy support, we expect China to further move up the value chain. Becoming one of the top-ranked innovative nations by 2035 is a key government priority, and we can see that it is moving in the right direction.[3] The government is committed to fostering innovation-driven growth. With rising labor costs, we expect increasing automation to enhance productivity and efficiency gains in 2018.

1 Source: Xinhuanet. The Chinese government set the 2017 growth target of around 6.5% during the annual National People's Congress (NPC) held on March 5, 2017.
2 Source: UBS research, estimates as of Sept. 28, 2017. It is estimated that China could exceed the US spend by 2018 in purchasing power parity (PPP) terms if the current growth rate continues.
3 Source: Credit Suisse research, quoting President Xi Jinping's speech at the Party Congress held in October 2017.

Structural southbound liquidity

We are seeing strong flows from mainland Chinese investors into a broad group of Hong Kong-listed Chinese equity stocks. Currently, the MSCI China Index consists entirely of Hong Kong-listed Chinese equities (i.e., H-shares+)[4] and offshore American Depositary Receipts (ADRs), despite the MSCI A-share inclusion scheduled to happen in 2018. Year-to-date, US$28 billion has flowed into the Hong Kong stock market via the southbound link of the Stock Connect program.[5]

Our view is that the southbound flows signify a structural, long-term allocation to Hong Kong stocks by mainland Chinese investors. We believe these flows are here to stay because more mainland Chinese insurance and institutional investors are coming to the H-shares+ space in search of unique investment opportunities that are not offered elsewhere. Looking into 2018, we believe robust southbound flows will provide supportive liquidity to Hong Kong-listed Chinese equities.

> In our view, the positive developments of southbound liquidity and MSCI inclusion only mark the beginning of a rising asset class.

MSCI A-share inclusion

The "yes" decision in 2017 to include China A-shares in the MSCI Emerging Markets (EM) and China indexes is a milestone development. 2018 will see the first step of inclusion, with MSCI adding 231 A-share stocks to its EM and China indexes. The initial inclusion weight in 2018 is not meaningful, estimated to represent 2.6% of the MSCI China Index and 0.8% of the MSCI Emerging Markets Index. Our view is that A-share inclusion will provide a more complete investment universe for global investors and will better reflect the entire Chinese economy. Looking ahead, we should see increasing allocation to Chinese equities as an asset class, and this should be worth the attention of investors.

Conclusion

We have seen positive earnings upgrades in 2017, and we believe Chinese companies remain on track to deliver 2017 earnings growth of 17.9%, compared to -9.4% in 2016. [6] We do not see the earnings trend reversing in the medium term, although the rate of growth in 2018 may not be as strong as in 2017. The expected earnings growth for 2018 is 15.8%. [6] Despite the strong rally in 2017, China is still trading at reasonable valuations. The MSCI China Index is trading at a 15.8x price-to-earnings ratio, which is largely at the historical mean, and at a 14% discount to developed markets.[6]

While China's topline growth is expected to moderate, there is encouraging progress on the deleveraging and reform fronts that can help China achieve a balanced growth economy. Going into 2018, we maintain our optimism for Chinese equities. In our view, the positive developments of southbound liquidity and MSCI inclusion only mark the beginning of a rising asset class.

4 "H-shares" are defined by the Hong Kong Stock Exchange as companies that are incorporated in mainland China and whose listings in Hong Kong are approved by the China Securities Regulatory Commission (CSRC). This group of companies forms an integral part of the offshore Chinese equities listed in Hong Kong. In this outlook, "H-shares+" refers to a broader definition that includes H-shares, red chips and other Hong Kong-listed Chinese companies.

5 Source: Goldman Sachs, year-to-date data as of Sept. 27, 2017. Launched in November 2014, the Shanghai-Hong Kong Stock Connect is a securities trading and clearing links program that allows both international and domestic investors to make cross-border stock purchases between the Shanghai and Hong Kong stock markets. Launched in December 2016, the Shenzhen-Hong Kong Stock Connect is a securities trading and clearing links program that allows both international and domestic investors to make cross-border stock purchases between the Shenzhen and Hong Kong stock markets.

6 Sources: FactSet, I/B/E/S, MSCI, Goldman Sachs Global Investment Research, Invesco, as of Oct. 20, 2017

Asia ex Japan equities

Can stability in the region extend Asia's outperformance?

Mike Shiao
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Hong Kong

Key takeaways

- We see three positive fundamental structural drivers in Asia.
- Stable politics favors further reform in China and India.
- Bottom-up opportunities are arising from Asia's stable backdrop, in our view.

2017 has been a good year for Asian equities so far, rising 36% and outperforming the rest of the world.[1] The strong performance has been supported by steady economic conditions and robust corporate earnings. Yet still, Asia is trading at its lowest price-to-book ratio relative to the S&P 500 Index in 15 years.[2]

So where do we go from here? Our view is that there are three positive fundamental structural drivers that can help Asian markets remain strong in 2018:

- Stability on various fronts, including economic growth and policy decisions
- Good opportunities driven by earnings, liquidity and valuations
- A reduction in risk

Stable growth is in the forecast

Asia's headline economic growth is expected to steadily adjust from the recent annual growth rate of 6.0% to 5.8% in 2018.[3]

In China specifically, we expect growth to moderate, but to remain on track to deliver the government target of 6.5% growth, which is a decent expansion compared to other major economies.[4] Investments and exports are expected to soften, while domestic consumption will continue to be the key driver in our view. Income growth remains resilient, providing support to consumption.

The macroeconomic environment in India is also favourable, with manageable inflation and a stable growth outlook. The Indian economy has been rebooted under Prime Minister Narendra Modi's bold reforms. As the long-term benefits start kicking in, we expect to see improving fiscal balance, sustainable growth in private consumption, and better corporate earnings.

Elsewhere in Asia, retail sales growth is expected to remain robust in South Korea, while ASEAN economies (Association of Southeast Asian Nations) will likely see ongoing recovery in investments and exports.

Stable politics favors further reform

Asian leadership is stable, in particular within China and India. Chinese President Xi Jinping has smoothly transitioned to his second term after achieving a solid track record of reform in his first term. Supply-side reform has seen good developments, with the coal and steel industries achieving their targets for capacity cuts faster than expected. Looking into 2018, we believe strong leadership under Xi will result in further progress on reforms. In particular, state-owned-enterprise (SOE) reform needs to go hand-in-hand with supply-side reform, as most excess capacities centered around SOEs.

In India, Modi's government has enjoyed a single-party majority since 2014, allowing it to avoid the political paralysis of previous governments. This has given rise to bold reforms. Notably, the demonetization reform has successfully replaced 86% of the currency in circulation in India within a timeframe of just two months.[5] Together with the smooth rollout of the Goods and Services Tax (GST) bill, these successful track records formed a solid foundation for Modi to deepen reforms. Going into 2018, we expect India to see stronger "financial inclusion," i.e., a faster shift of household savings from physical assets (such as gold bars and cash) to financial assets. Banking and financial services should see increasing penetration.

Earnings expected to remain intact

Asia's earnings trend remains positive. Over the medium term, we do not see any particularly strong factors that could reverse the earnings trend. Asian corporate earnings have largely beat expectations in the latest reporting season, leading to upward earnings revisions across countries.

Over the medium term, we do not see any particularly strong factors that could reverse the earnings trend in Asia.

China's earnings trend remains positive, and we anticipate information technology and consumer-related areas will continue to deliver quality sustainable growth.

1 Source: Bloomberg L.P. Based on returns for the MSCI Asia ex Japan Net Total Return Index, expressed in US dollar terms, as of Oct. 25, 2017.
2 Source: Bloomberg L.P. Data as of Oct. 9, 2017.
3 Source: Bloomberg L.P. Recent level of GDP refers to the Asia ex-Japan year-on-year GDP growth rate as of June 30, 2017. 2018 expected GDP growth rate refers to Bloomberg consensus estimate as of Sept. 26, 2017.
4 Source: Xinhuanet. The Chinese government set the 2017 growth target of around 6.5% during the annual National People's Congress (NPC) held on March 5, 2017.
5 Source: The New York Times, as of Nov. 14, 2016

In India, we expect corporate earnings to gradually normalize after the short-lived impact of the GST bill, and will reap the economic benefits of reform initiatives,which are well underway. Corporate earnings in Korea and Taiwan are expected to benefit from the rising trend of artificial intelligence and big data. The need for faster processing power gives rise to the demand for semiconductors.

Liquidity trends look supportive
US interest rate hikes are likely to be gradual, allowing sufficient liquidity to go around the global financial system. In Asia, southbound flows coming from mainland Chinese investors should continue to provide structural liquidity support for the H-shares and Hong Kong stock market. In India, domestic mutual funds have seen strong inflows, with total assets under management doubling over the past three years. We believe the sticky and structural domestic allocation will continue into 2018.

Valuations remain accommodative
Despite the strong performance in 2017, Asian equities are currently trading on par with their long-term historical average on both a price-to-earnings and a price-to-book basis.[6] Compared to other regions, we are seeing a meaningful discount to developed markets in price-to-earnings terms, with a 12% discount to Europe and a 27% discount to the US.[7] We expect valuations to become even more appealing as further earnings kick in.

> Compared to other regions, we are seeing a meaningful discount to developed markets in price-to-earnings terms.

Assessing bottom-up opportunities
We see bottom-up opportunities arising from the stable backdrop in Asia. In the information technology space, we prefer the leaders in China's internet services industry, which enjoy a near-monopoly status and strong competitive edges. In particular, the user ecosystem that these leaders have built spawns many monetization opportunities, ranging from e-commerce to mobile payments.

In India, we favour the financial space, which is benefitting from India's move away from being a cash-dominated economy. Within this space, we prefer companies with high exposure to consumer-related financial needs and private sector banks that are more efficiently run. We also believe that the rising middle class in India creates opportunities across multiple segments ranging from household appliances to consumer finance.

Risks to watch in 2018
Stability on the macroeconomic and political fronts has resulted in a reduction in overall risk in Asia. While we do not see major uncertainty overhangs for 2018, below are the aspects that investors should monitor rather closely:

- **Trajectory of US interest rate hikes.** While the market is expecting gradual interest rate normalization in 2018, volatility could arise if interest rate hikes turn out to be faster or higher than what the market is currently pricing in. An unexpected turn of US Federal Reserve rates could have implications to how Asian central banks should continue with their monetary policies.
- **Geopolitical tension with North Korea.** It remains difficult to predict the interaction between North Korea and the US. Our view is that any major impact triggered by military aggression on either front would not only affect the Asian region, but would influence global economies at large.

Conclusion
Stability in Asia gives potential for the region to extend outperformance. A steady growth backdrop is conducive to bottom-up stock selection, allowing investors to focus on company fundamentals, without the need to worry about major top-down uncertainties.

6 Source: Citi research estimates. Long-term historical average refers to the period between Jan. 1, 1975, and June 8, 2017.
7 Source: FactSet Research Systems, I/B/E/S, MSCI, Goldman Sachs Global Investment Research, as of Oct. 20, 2017.

Asia ex Japan equities

Why Asia has done well this year?

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Key takeaways

- Our earnings growth outlook for 2018 is largely positive.
- Our regional outlook is based on positive trends in domestic consumption, global economic growth, interest rates and infrastructure spend.
- We see value in the technology and banking sectors as well as in South Korea.

2017 has seen Asian equity markets rally largely due to the strength of corporate earnings. At the start of the year, earnings growth expectations for 2017 were low at approximately 10%, but over the course of the year they have been revised up to 20%. The recovery has been helped by a combination of factors such as: solid global economic expansion, a lack of disruption from President Trump, falling bond yields in some Asian markets and a small earnings re-rating.

What is the outlook for earnings in 2018?

In our view, the outlook for earnings growth in 2018 is broadly positive. Consensus earnings growth expectations for 2018 have been gradually moving up over the course of this year and are now close to 10%. Recently, these expectations were boosted by China's second quarter 2017 results season, in which almost two-thirds of companies beat expectations[1]. Elsewhere, consensus earnings estimates for the Indian market[2] were marginally revised upwards for the full year 2018, post significant downward revisions over the summer months. Going forward, Indian earnings growth should benefit from easier year-on-year comparisons after the government's demonetization of high-value currency (November 2016) and the introduction of the Goods & Services Tax (July 2017) reduced prior year numbers.

These are the main factors which dominate the outlook for 2018 Asian earnings: domestic consumption (particularly in China), global economic growth, the interest rate environment and infrastructure spending. We expect consumption to remain strong in China, with support from wage growth, and to increase in India, driven by a very gradual revival in economic growth. Elsewhere, we believe consumption may continue to be relatively subdued – in particular, the debt overhang in Korea, Malaysia and Thailand renders it difficult for these countries to stimulate consumption significantly. Infrastructure spending, an obvious kicker to growth in much of the developed world, is also a factor that should support growth in Asia. For example, the Belt and Road (OBOR) infrastructure initiative is aimed at increasing cross-border trade within Asia and beyond. The emphasis placed on this program by President Jinping at the recent China Party Congress suggests that 2018 will see increased stimulus as a result of its implementation.

It is also helpful to consider the outlook for earnings growth from a sector perspective, and in particular, to look at the Asian technology and financial sectors, which account for well over 50% of the market. These sectors saw strong earnings growth in 2017, and we expect this trend will probably continue in 2018. For the banks, the main supporting factors will be: some top-line growth as economies pick up; net interest rate margin expansion on the back of higher interest rates; and continuing low bad debt provisioning requirements. In the technology sector, capital discipline and lessening competition is enabling the largest companies, such as Samsung Electronics and Taiwan Semiconductor Manufacturing Company, to capitalize on strong demand growth. Furthermore, select internet companies are taking advantage of increased internet penetration to grow their businesses profitably. So, in aggregate, we expect earnings growth to be reasonably attractive in 2018, but not as powerful as in 2017.

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What are the important themes for the region?

China. China is crucial for the prospects of the whole region, and so far gross domestic product (GDP) growth has remained stable at a respectable level (i.e. third-quarter 2017 real GDP growth of 6.8% [3] year-on-year) , helped by stimulatory government policies and continuing income growth. GDP data showed that consumption growth remained robust with retail sales growing at approximately 10% over the last 12 months. Progress has also been made in rebalancing the economy away from investment-led growth, with consumption as a share of GDP standing above 60% for seven consecutive quarters (as of the third quarter of 2017)[4].

1 Source: Bloomberg L.P., November 2017.
2 The Indian market is represented by the MSCI India Index.
3 Source: Bloomberg L.P., November 2017.
4 Source: Emerging Advisors Group as at June 30, 2017.

Although the debt mountain has remained high – China's debt-to-GDP ratio is still 270%[5] – the continued liquidity of the banking system, aided by strong domestic saving rates, means that the economy is unlikely to topple over in the short - term. Related to this, a further concern in China has been whether pressure on foreign exchange reserves as a result of capital flight could result in currency devaluation. This in turn would lead to the necessity of higher interest rates, which would dampen economic growth. Reserves have now stabilised, mainly as a consequence of government intervention, and the pick-up in global growth has also enabled the Chinese export growth recovery to strengthen foreign exchange reserves.

India. Another important theme within Asia is the progress of reform in India. Over 2017, the Indian equity market performed well in spite of the fact that earnings growth underperformed expectations. Under Prime Minister Modi, India has the best reform momentum amongst the countries we invest in: the implementation of the Goods & Services Tax is progressing well; tax revenue is increasing; the approval of the Bankruptcy Code has been a significant step towards cleaning up banks' balance sheets; the government's demonetisation of high-value currency in 2016 is shrinking the black market; and the Indian government's recent recapitalisation of the state-owned banks should enable the stronger banks to accelerate their loan growth.

Ultimately, investors have remained confident that these reforms are increasing the economy's potential growth rate, which should support higher earnings in the longer term while, at the same time, helping to control inflation and the fiscal and current account deficits. We concur with this view, but if these reforms do not actually produce improved economic growth over 2018, then investors will start to question whether the valuation premium attached to Indian companies is deserved.

> We believe the market valuations of many Asian companies do not reflect their ability to grow earnings, generate strong free cash flow and increase dividends.

Where are we finding value?
In many of our portfolios, technology has been our largest sector overweight relative to the index. Within technology, the Chinese internet companies have been producing stellar earnings growth on the back of consumption-led growth in China, and we expect this to continue in 2018. Consumers have been quick to adopt mobile internet applications, and companies that have been willing to innovate in online services, such as social media, gaming and e-commerce, have become dominant players. We have notable exposure to these companies as we believe the market is too skeptical about their ability to maintain strong long-term growth. Within our technology hardware exposure, we also have a preference for companies that have healthy balance sheets, strong free cash flow generation and growth potential, but remain undervalued. For example, we favor Samsung Electronics which, despite its strong share price performance, remains undervalued relative to the prospects for its main divisions, in our view.

We are also overweight the banking sector. We believe that banking systems with less extreme loan growth in recent years, such as in Korea and Singapore, and those that have been proactive in recognizing bad assets, as in India, will be better-placed. For example, in India we favor the well-capitalized private sector banks, which have seen their valuations fall to attractive levels such as ICICI Bank. Representing only 30% of total lending [6], the private banks still have potential to gain market share from the state banks, which struggle to compete on customer service, efficiency and credit appraisal.

Turning to the energy sector, the near-term outlook for oil prices remains uncertain, but we have been able to find some attractive opportunities that are still profitable even in a low oil price environment. For example, we are positive about the outlook for CNOOC, a Chinese oil business that we anticipate should benefit from management's focus on profitability and asset returns. Furthermore, we believe this company's oil reserves are being underappreciated by the market.

5 Source: People's Republic of China, International Monetary Fund, Country Report No.17/247, August 8, 2017.
6 Source: CLSA, Indian Financials, Sector Outlook, October 25, 2017.

Another source for attractive investment ideas is South Korea, which has long been amongst the cheapest markets in Asia[7].This discount partly results from the higher representation of cyclical stocks in the market and from the uncertainty caused by periods of aggressive behavior by the North Korean regime. However, Korea's history of poor corporate governance has also been a significant factor in the discount. This is best demonstrated by the low average dividend payout ratio as compared to the average for the Asian region[8]. However, we believe that this is starting to change for the better with positive implications for valuations. Firstly, Samsung Electronics has moved to a capital return policy which outlines that at least 50% of free cash flow will be returned to shareholders in the form of dividends and share buybacks. As Korea's most successful company, Samsung's more shareholder-friendly actions are likely to be copied by other business groups. Secondly, the Korea National Pension Service, a large shareholder in many Korean companies, has begun to be more forceful in demanding better shareholder returns.

What areas of the market are we avoiding?

From a geographic point of view, we remain concerned about Malaysia as we believe that many long-term problems in this country have not been addressed. Until they are tackled, high valuations combined with low growth and political uncertainty means that we will continue to avoid investing in this market.

Elsewhere, some of the defensive sectors are still too expensive, in our view, post a period where investors have been happy to pay a premium for earnings certainty, often on the back of a slightly higher than market average dividend yield. We believe if interest rates do rise gradually, then the rationale for buying such stocks will lessen further, and their overvaluation will become even more apparent.

Conclusion

So, in summary we believe that there is scope for Asian markets to go up in-line with earnings growth in 2018. The consensus earnings per share growth forecasts of 10% for 2018 [9] are dependent on a continuation of a benign global backdrop. In our view, such an environment is fertile ground for stock-picking opportunities. We believe the market valuations of many Asian companies do not reflect their ability to grow earnings, generate strong free cash flow and increase dividends.

7 Source: Bloomberg L.P. November 2017.
8 Source: Bloomberg L.P. November 2017.
9 Source: Bloomberg L.P. November 2017.

Global equities

The synchronised economic expansion: How much further to run?

Nick Mustoe
Chief Investment Officer,
Invesco Perpetual
Henley

Key takeaways

- The synchronized economic expansion has boosted global stock markets, benefited international trade and improved multi-national profits.
- The Federal Reserve, Bank of England, European Central Bank and Bank of Japan all face balance sheet unwinding in the years to come.
- It's unclear how global markets might react should interest rates rise and quantitative easing end faster than expected.

The global economy continues its synchronised recovery, as evidenced by robust data across regions. Indeed, all 45 countries tracked by the Organisation for Economic Co-operation are expected to post positive economic growth in 2017 for the first time in 10 years. Even more optimistically, 33 out of 45 countries are seeing accelerating growth. This has boosted international trade and commodity prices, and helped make the global expansion story gradually more self-sustaining. On this basis alone, the prospects for 2018 look positive, with broad-based improvements across the major developed economies and a number of emerging market economies expected to continue.

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The synchronised economic expansion that we've seen post the global financial crisis has helped stock markets rally and boosted the profits of many multi-nationals – creating what some might call a sweet spot for equities. The longer that global macro data continues to trend higher, the longer that the globally synchronised earnings upturn will remain compelling. Moreover, the benign global inflation environment has allowed central banks to keep monetary policy very loose – for now.

However, we will not remain at that sweet spot forever, and there is reason for caution. Are we in for a period of stronger, more decisive change in monetary policy? It's certainly possible. The US Federal Reserve (Fed) has said that it would stick with plans for further interest rate rises, and it has thrown its crisis-era stimulus programme into reverse. Meanwhile the Bank of England (BOE) raised UK interest rates in November, and the European Central Bank (ECB) announced that it was looking at how to reduce the amount of economic stimulus it is currently providing. Everyone has been so used to the accommodative stance of the past 10 years, and markets have become complacent.

But what if interest rates rise and central banks exit quantitative easing faster than expected? How would global financial markets react? This isn't a scenario that's priced in at the moment.

The beginning of a new era?

The global financial crisis of 10 years ago was a watershed event for financial systems around the world. Systematic losses by banks and the ensuing losses in economic output spurred governments into action. Governments in advanced economies stepped in to provide support to banks and other financial institutions, as traditional sources of funding dried up. Central banks reacted to the downturn by cutting interest rates and expanding balance sheets simultaneously by buying securities funded via the creation of excess reserves.

We are now entering the phase of the "great unwind," with the Fed beginning to slowly sell the $4.5 trillion in assets it bought to stabilise the economy. It's a real milestone to reach. Could this be the beginning of a new era? The Fed has made lots of reassuring noises about the care it will take, but this is an unprecedented action. No one can be sure that policy mistakes won't be made, disrupting bond and equity markets around the world. Even if the Fed's reduction of its balance sheet is uneventful, the BOE, ECB and Bank of Japan all have to go through the same process at some stage.

Low interest rates and low bond yields created a massive hunt for yield, which pushed up prices for many assets (and saw the cost of capital reduced). The last 10 years have seen asset owners do well, encompassing property as well as equities, and thereby greatly increasing wealth inequality. But what of those who have been excluded? Government policy continues to lag in this area.

1 Source: Office for National Statistics (ONS)

The employment picture remains strong. Unemployment levels have reached record lows of 4.3% in the UK for the three months ending August 2017, down from the post-crisis peak of 8.5% in 2011 and tying the lowest level since 1975.[1] In the US, the unemployment rate fell to 4.1% in October 2017, the lowest since December 2000.[2] However, real earnings continue to decline. There are many explanations as to why wages have not risen as unemployment declines, but the result is that central banks have been reluctant to raise interest rates. The risk in 2018 is that any upturn in wage growth could see central banks forced to raise interest rates more quickly than expected.

Just as no one had lived through anything like the scale of the 2007 global financial crisis, the recovery and post-recovery phases also see us in unchartered territory. The focus of the last 10 years might have been the wholesale rescue of the financial system, yet the policies which were aimed at growth creation mostly created asset price inflation in the end. The ultra-easy monetary policies – though undeniably necessary to prevent an even worse economic collapse in 2008 and 2009 – have arguably been carried on for far too long.

Economic growth prospects are as good as they have been since the global financial crisis, and there has been a real upswing in financial earnings. Equity valuations are trending at significant premiums to their long-term average and are arguably discounting a lot of the good news with low levels of volatility, showing that investors are optimistic about prospects. The risk to this scenario is that central banks have to change their monetary policy more quickly than financial markets are currently anticipating.

> Equity valuations are trending at significant premiums to their long-term average with low levels of volatility, showing that investors are optimistic about prospects.

2 Source: Bureau of Labor Statistics

European equities

Plenty of scope for active managers to add value

Jeffrey Taylor
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Key takeaways

- We expect healthy domestic fundamentals to enhance the performance of European equities over the long term.
- With wide disparity in stock and sector valuations, we believe active portfolio management can add value.
- As some sectors are substantially overbought, the case for a period of marked sector rotation is strong.

Europe is a rich, highly developed part of the world which is home to a vast range of companies. However, on occasion it still seems to struggle to attract attention from serious investors around the world. There's always a handy excuse: "Why bother when it's only a play on more interesting parts of the world?" or "There's never any earnings growth, is there?" or "Don't the politics make it un-investable?" Wrong.

The drivers behind the eurozone economy are now predominantly domestic. This is a fundamental break from the recent past when growth was dependent on exports to faster-growing parts of the world. Europe's recovery from the crisis years kicked in later than in the US, but is now firmly on track thanks to a steady, expectation-busting pickup in private consumption and (more recently) investment. Banks are lending again and unemployment is falling. A domestic demand-led recovery is far harder to stop in its tracks than one based on exporting your way out of trouble. This means Europe should be better able to cope with exchange rate fluctuations. It also has major ramifications for the kinds of stocks we want to own.

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Earnings growth should continue in 2018

Earnings growth is back. After a very respectable increase in 2017, the stars are looking well-aligned for 2018 given our economic outlook. Early indications also point to further acceleration in capital expenditures in 2018, implying positive knock-on effects for the corporate ecosystem.

And then there's politics

Politics is always good for a headline or sound bite in our news-obsessed world. Being a democratic kind of place with quite a lot of countries and, therefore, quite a lot of elections, Europe generates a lot of political news.

In the end, politics only matters from an investment point of view when it poses a genuine threat to financial markets. In reality, Europe has seen far more market-friendly political outcomes than many commentators have predicted in the recent past. Note that France elected President Emmanuel Macron (who is promoting a market-friendly reformist agenda) and rejected the divisive, destructive Marine Le Pen. Looking forward, we work from the maxim that it is important to distinguish between the probable and the merely possible, which leaves us relatively relaxed about the market implications of political trends within the future European Union of 27 states.

Buy the empty room?

So where to concentrate within the market? Years ago a broker made a comment which still rings true to us: "Buy the empty room when you go to an investment conference." In other words, those meetings with company management which few can be bothered to attend are often the most interesting. The "full rooms", i.e., companies with over-developed fan clubs, are often already over-represented in portfolios and indices alike, meaning that they could well be past their "sell-by dates" as investments.

There have certainly been times latterly when our portfolios have felt like the owners of an "empty room", with what we find attractive being well away from the main focus of the market. It's not a question of being awkward and contrarian just for the sake of it: we are simply trying to position our portfolios for the next phase in the markets to protect and enhance our clients' interests. We are seeking the best investment outcomes based on our view of how the European investment world develops from here. In 2016 we saw that sector rotation – a change in stock market leadership – can be powerful when it materialises, and as we currently see a significant bout of sector rotation as highly justified, we want to be ready for it.

We see value in out-of-favour sectors

We are valuation-focused portfolio managers – not strictly "value" or "growth" – and as such we'll look at most any investment. We don't particularly like these labels, but they can be very useful verbal shorthand. At the time of writing, we see striking valuation opportunities in out-of-favour sectors at the value end of the spectrum. In Europe, the prime examples are energy, telecoms and financials – especially banks.

There are also sectors which we want to keep well away from – typically many of those which have attained "bond proxy" status in recent years. To our minds, some have become eye-wateringly expensive as a result. Consumer staples such as food and beverage stocks are cases in point. These are often companies with extremely strong and respectable track records, and while it is easy to understand their market image, it's important to remember that a good company does not necessarily make a good investment.

> We see striking valuation opportunities in out-of-favour sectors at the value end of the spectrum. In Europe, the prime examples are energy, telecoms and financials – especially banks.

No matter how wide the divergence in valuations between sectors in our market, this is not just a valuation call. There are good reasons to believe that the operating performance of European integrated oil companies, telecoms and banks will improve from here. To cite just three factors at play: Management attention to capital allocation and return on capital in energy is much improved, there are incipient signs of a return to long-absent growth in telecoms, and bank incomes are rising while costs are falling.

Trouble ahead for bond proxies?

Meanwhile, in the much-loved and highly rated bond proxy end of the spectrum, we see trouble brewing: Organic top-line growth has often been disappointing; attempts to buy growth through mergers and acquisitions can pressure returns on invested capital; bond yields are likely to rise from very low current levels given the resilience of eurozone economic performance; a bit of inflation may be returning and there is a whiff of central bank regime change in the air.

It's always tricky to judge exactly when the mood music in the market will change, but we believe the case for meaningful sector rotation is very strong and, as active portfolio managers, we want to be prepared for it. We look forward to welcoming more people to our empty room.

Invesco

Fixed income

Adapting to the withdrawal of monetary stimulus

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Bond markets have been in a sweet spot in recent years. Economic growth has been positive, inflation has been relatively benign, volatility and default rates have been low, central bank policy has been accommodative and the demand for income has been high. One of the biggest challenges we as fixed interest investors now face is what happens when one of the central pillars of this supportive environment – the still huge amount of central bank stimulus – is reduced.

> Private investors will need to absorb a lot more supply in the US and Europe going forward. Since it is difficult to see strong demand at current yield levels, one would expect to see higher yields as the process unfolds.

The macro view – Stuart Edwards

When thinking about the bond market implications of central bank tightening, it is worth taking a step back to understand why central banks now want to withdraw liquidity. Since the global financial crisis, global economic growth has been relatively low but synchronised across developed markets. Recently, this has been helped by a pickup in global trade as a result of a resurgence in Asian trade flows and a recovery in North American imports. Meanwhile, labour markets have continued to tighten, but thus far the historically low unemployment rate has not fed through to wage growth, which remains muted. This does not, in my view, mean that the Phillips curve (the inverse relationship between unemployment and inflation) is dead – it has just flattened. For structural (as well as short-term) reasons, I believe labour markets need to tighten further before we see a pickup in wages. I am starting to see some signs that this is happening, albeit slowly. Although it is not my central view, I think the risk is that inflation turns out to be stronger (not weaker) than expected. Against this backdrop, central banks are seeking to normalise monetary policy.

How this plays out for markets will, in my view, depend on the pace of any tightening. So far, central banks have been very careful to communicate their strategies well in advance, and this should help to smooth the process of monetary policy normalisation. I expect (and markets are currently pricing in) the Bank of England to stop at 0.50% or possibly 0.75%, and both the European Central Bank (ECB) and the US Federal Reserve (Fed) to taper quantitative easing over a long period at a slow pace. If that view holds, then fixed income markets should remain well-supported. However, there remain risks. The ECB now owns nearly a quarter of the eurozone's outstanding debt, and the tapering of asset purchases comes at the same time that the US deficit is predicted to increase to over US$1 trillion. This means that private investors will need to absorb a lot more supply in the US and Europe. It is difficult to see strong demand for government bonds at current yield levels, and so one would expect to see higher yields as the process unfolds.

> One of the biggest challenges we as fixed interest investors now face is what happens when one of the central pillars of this supportive environment – the still huge amount of central bank stimulus – is reduced.

Credit markets – Paul Read and Julien Eberhardt

2017 has been good for fixed income investments, with corporate hybrids, subordinated financial bonds, and high yield and US dollar-denominated bonds delivering outsized returns. However, as a consequence of this strong performance, we now start 2018 with many areas of the European bond market looking expensive.

That said, a number of the factors that helped drive returns in 2017 remain in place. The demand for income remains very high, and the ECB is still a dominant force in European credit markets. Although it is tapering its asset purchases, it is doing so very gradually, and any actual hike in European interest rates still looks some way off. Amid improving economic data, "animal spirits" are also high. Meanwhile, companies have been able to take advantage of low yields by refinancing debt at more attractive terms, so there is currently little pressure on default rates. This mixed backdrop of positive fundamentals but expensive valuations leads us toward a more balanced investment outlook. It is difficult to see a scenario in which yields move meaningfully lower, and so income is likely to be the main component of return in 2018.

Key takeaways

- Bond markets have performed well for years primarily due to strong demand, low inflation, positive economic growth and accommodative monetary policies.
- With major central banks now normalising policies, there is a risk that investors will not absorb the extra supply until rates rise.
- Due to this and other factors, we believe it is unlikely that recent outsized bond market returns will be repeated in 2018.

Our strategy is to seek out relatively "safe" sources of income while staying defensive overall. Periods of market strength provide the opportunity to reduce exposure and wait for better levels at which to add. That said, there are still some parts of the market where we are finding opportunities, and others we avoid. Generally, we stay away from those parts of the market that are being manipulated, such as peripheral European sovereigns and bonds purchased through the ECB's Corporate Sector Purchase Programme. Outside of these areas, the price of bonds often better reflects the underlying risk of the investment. Some of these areas include subordinated financials, corporate hybrids and selective parts of the high yield market.

From a fundamental perspective, banks remain in a strong position. The bailout and rescues of the past year have removed weaker banks, leaving a stronger financial sector overall. Tighter monetary policy and steeper yield curves should, all else being equal, also be supportive of the sector. However, from a valuation perspective, the outlook for the sector, like much of the corporate bond market, has become more balanced. Additional tier one and contingent capital yields have fallen significantly in 2017, and so the standout valuation opportunity versus the high yield sector has, in our view, diminished. That said, there are still some opportunities, but we need to ensure that we are being rewarded for taking the risk.

US corporate bonds are another market where we are still finding opportunity. The expectation that the Fed will continue hiking in 2018 is, to some extent, already priced into the US Treasury market. Compared to German Bunds, US Treasuries also offer between 160 and 240 basis points of extra yield across the curve. Nonetheless, the two markets are interdependent. The 10-year Treasury tends to pull the 10-year Bund higher, while the Bund anchors the Treasury. As this tussle plays out in 2018, we think the likelihood is for higher Bund yields. Higher rates feed straight through to banks' bottom lines, so this should be supportive of our exposure to European subordinated financials.

Overall, it is difficult to see bond markets repeating the kind of performance we have seen in 2017. Our focus is therefore defensive, and we are taking relatively "safe" income where we can while waiting for better opportunities to add exposure.

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