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.

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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.

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Data as of November 15, 2017 unless stated otherwise.

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