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There is an opportunity for the global economy to grow at a faster pace than current market expectations.

Risks remain

skewed to the upside

2017 has turned out to be a very good year for investors, especially those invested in offshore equity markets. We began the year with a positive outlook as the global economic recovery gathered pace and a picture of synchronised global growth began to emerge. Although this view was balanced by several possible risk events (namely a fragile political landscape in the US and Europe, and the anticipation of central banks reducing monetary policy support), these risks passed without event. Looking ahead, we see a similarly positive outlook for global markets, with risks skewed to the upside, and the thesis of synchronised global growth intact.

Growth expected to remain in line with 2017 levels

The overall outlook for global economic growth in 2018 is in line with the full-year forecasts for 2017. UBS Global Research (UBS) forecasts that the global economy will grow at a rate of 3.8% for both 2017 and 2018. However, the regions driving growth next year are expected to be subtly different from those that drove growth in 2017. India, Brazil and Australia are expected to show improvement in growth, whereas the Eurozone and China will likely see a slowdown.

Earnings growth will be an extremely important factor in the year ahead

Over the past year, stronger economic growth has been a key driver of corporate earnings. As price/earnings (P/E) multiples seem unlikely to expand materially from their current levels, earnings growth (and therefore economic growth) will be an extremely important factor in the year ahead.

Since the Global Financial Crisis, global growth has been unable to recover to pre-crisis levels. As a result, global economic output has lagged its pre-crisis trend, resulting in a gap between actual economic output and its apparent potential. A key determinant of market performance in the year ahead will be whether this output gap represents an opportunity that can be closed—or whether deeper structural headwinds are at play. On balance, we favour the view that there is an opportunity for the global economy to grow at a faster pace than current market expectations. Globally, monetary policy remains supportive across the major economies. This is particularly the case in Europe where the European Central Bank is taking a measured approach to tapering its quantitative easing (QE) program—but also in other regions where the benign inflationary picture is allowing a gradual approach to monetary policy normalisation.

A spike in inflation could lead to a significant change in monetary policy, and this would be expected to have a meaningful impact on global growth.

The dispersion of high PE versus low PE has increased this year, making stock selection more crucial as we move through 2018.

Europe and China appear to be the most likely drivers of upside variation

In terms of upside variation to global growth expectations for the year ahead, Europe and China appear to be the most likely drivers. There also appears to be some upside in the US if meaningful tax reforms are passed. The base case for Europe sees a modest slowdown from 2017 levels, driven by an appreciating currency and a slowdown in the recent labour market recovery.

Again, risks appear to be skewed to the upside. Finally, in China the transition from an investment to a consumption economy is expected to continue, with UBS expecting growth to slow from 6.8% in 2017 to 6.4% in 2018. The resilience shown by China's growth in 2017 came as a surprise to many, and the prospect of higher-than-expected growth in 2018 would have a meaningful impact on the global economy given the country's scale.

Overall, the global economic outlook for 2018 is positive, with growth expected to remain in line with 2017 levels, albeit with a different regional make-up. On balance, we believe risks are skewed to the upside.

The key risk to this view is inflation

The key risk to ongoing, or even improving, global economic growth appears to be inflation. The benign inflationary environment which persisted around the world in 2017 (with the exception of the UK) has allowed central banks to take a cautious approach to monetary policy normalisation, which is a key component of the thesis of ongoing growth next year. A spike in inflation could lead to a significant change in monetary policy, and this would be expected to have a meaningful impact on global growth. While not our central case, the most likely source of a spike in inflation would appear to be US fiscal reform, a rapid reduction in labour market slack, or a sharp rise in oil prices.

Domestic equities—continued global growth bodes well for resource company earnings

In a global context, domestic equities are expected to offer sluggish total returns over 2018. An indebted consumer and fading housing tailwinds will be partially offset by continued infrastructure investment. Forecasts for continued global growth bode well for resource company earnings, and coupled with already positive mark-to-market and relatively supportive valuations, these represent one of the few high-conviction areas across the domestic equity market.

The interplay of regulatory oversight and politics has been a key feature of 2017, and the Royal Commission into the Banking Sector will likely represent a material sentiment overhang. Given the size of the banking sector in Australian indices, coupled with barely positive earnings per share (EPS) expectations, this will represent a headwind to sustained outperformance for domestic equities.

There has been a decoupling between Australia and the rest of the world

Over the past four calendar years, the domestic equity market has posted very modest annual returns of 1.1%, -2.1%, 7% and 5.1%. Against the backdrop of synchronous global growth and record-low interest rates, this is disappointing and highlights the decoupling that has occurred between Australia and the rest of the world. With equities already trading at a 5% premium to their 20-year average, the case of a sustained re-rating rests with relative valuations versus global markets, the direction of interest rates and corporate earnings. Bond yields could be a key source of risk. If Australia gets caught up in a global move higher in interest rates, the likely contraction in earnings multiples, coupled with already subdued EPS growth, would make total absolute returns very difficult.

Growth areas of the market may be susceptible to underperformance

Given the earnings backdrop, high PE stocks have been strong performers, pushing this percentile of stocks back to their valuation highs from the middle of 2016. The dispersion of high PE versus low PE has increased this year, making stock selection more crucial as we move through 2018. As happened last time, this makes 'growth' areas of the market (for example, healthcare) susceptible to underperformance if bond markets sell off.

The key risks in the fixed income space are that interest rates rise faster than expected.

We expect the Australian dollar to be relatively rangebound against the US dollar, to depreciate slightly against the Euro, and to strengthen against the British pound.

International equities—the unwinding of QE policies is the greatest source of risk

2017 was characterised by record-low volatility, political change and a surge in technological disruption. Into 2018, the continued unwinding of central bank QE policies will represent a significant source of risk for both equities and asset volatility generally. The corporate earnings backdrop in the US and Europe should continue to remain supportive for a move higher in risk assets, albeit with significantly more tail risk than we have witnessed over the past 12 to 18 months. Arguably, portfolios with significant technology exposure face the greatest challenges. The trade-off will be between secular growth and already large overweight positions and full valuations. Further into 2018, it's likely that investors will begin to focus on the longevity of the US economic expansion.

The US is enjoying its second-longest economic expansion since WWII. And although it has been proven that the probability of a recession does not increase materially with time, investors are likely to still be very watchful of data points. This focus will be compounded by multiples that are elevated from an historical perspective.

European equity markets remain a preferred exposure. This is due to their nascent recovery versus the rest of the world and still relatively attractive valuations. Brexit negotiations and Italian elections remain possible exogenous shocks—but would likely represent buying opportunities if they resulted in a meaningful pull-back in share prices.

Emerging markets are arguably better prepared for the withdrawal of global liquidity than previous instances. The valuation gap to other regions has, however, closed on a P/E and price to book basis, making earnings a key driver.

Fixed income—markets should remain well-supported

At a high level, we expect fixed income markets to remain well-supported as interest rates move at a gradual pace. This is in light of central banks moving towards monetary policy normalisation in a cautious manner, as well as ongoing low inflation. Securities with a longer duration are likely to underperform, owing to their greater sensitivity to interest rate movements. In a general sense, this means that high-grade bonds, both domestically and internationally, look comparatively less attractive than bonds that provide a floating interest rate. In this space, international credit markets currently exhibit exceptionally low yields (reflecting the current interest rate environment), and very tight credit spreads (reflecting a positive corporate environment and low default rates). On balance, this component of the market appears fairly valued, and the outlook for 2018 should see prices remain well supported given our expectation that interest rates will rise only at a gradual pace. Domestically, the picture is similar, but higher yields relative to global peers are expected to support ongoing demand. We also believe that credit spreads can tighten further from here due to ultra-low default rates.

The key risks in the fixed income space are that interest rates rise faster than expected, with the most likely catalyst for this being a spike in inflation. If this were to occur, high-grade bonds would sell off more than expected, while credit spreads would likely widen in the corporate credit space.

Australian dollar—rangebound against the US dollar

While currency forecasts are notoriously hard to make, if we focus on several of the key drivers that influence the Australian dollar, it becomes a little easier to have directional bias over the next 12 months. Overall, we expect the Australian dollar to be relatively rangebound against the US dollar, to depreciate slightly against the Euro, and to strengthen against the British pound. However, a stronger current account surplus, as well as an improvement in global trade and growth, do pose upside risk to this outlook.

A divergence in central bank monetary policy would be marginally negative for the Australian dollar

The Reserve Bank of Australia is expected to keep interest rates on hold well into 2018, while many other central banks have begun to turn 'hawkish'. This divergence in monetary policy is expected to weigh on the Australian dollar over

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the near term, but only marginally as other central banks are expected to be conservative with their hiking strategy.

A softer iron ore price would be negative for the Australian dollar

The iron ore price has been very volatile in recent years, and there is little to suggest the future will be any different. Although it's difficult to forecast, both of our key research providers, UBS and Commonwealth Bank of Australia (CBA), think that iron ore prices will fall both this year and next. UBS is forecasting a price of USD 54/tonne 62% cfr by the end of 2018, while CBA is forecasting a price of USD 45/tonne.

A narrowing of the current account deficit would be a major positive for the Australian dollar

While iron prices are expected to soften, Australia's current account is expected to improve as liquefied natural gas exports increase and add to iron ore exports. This will improve our national income accounts, our trade balance and our terms of trade, which are major drivers of the 'Aussie'.

US fiscal reform would be a major negative for the Australian dollar

If the US Government can implement fiscal reform, which seems highly likely, the US dollar is expected to benefit from the repatriation of offshore profits and capital flows. This is as investors look to benefit from the lower tax rates and an expected subsequent improvement in corporate profitability.

A reversal of the Australian-US interest rate differential would be a major negative for the Australian dollar

The Australian-US two-year bond spread recently turned negative. Over the next six to 12 months, it may remain, on average, negative. This makes Australian bonds less attractive for global institutional investors, thereby reducing their need to buy Australian dollars to purchase these bonds.

In summary

We think the probability of a positive shock to economic growth outweighs the risk of a negative shock from inflation. We continue to think that European equities are the most attractive asset class, but recommend remaining cautious on valuations, and taking a prudent investment approach.

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