

Walking a tightrope in 2018

We expect another strong year for growth with the global economy firing on almost all cylinders. But the market has priced in this optimism, implying greater vulnerability for disappointment. We expect the low interest rate environment to continue into 2018. While interest rates can drift up, we do not think this is the beginning of the end for the bond markets.

The conditions driving the recent impressive equity market gains could stay in place for much of 2018. However, I also see potential sources of downside risk in 2018 given the tightening of QE measures across the globe, combined with structural headwinds for growth such as debt and demographics. We start the year with a tactically cautious view on equities. Timing any corrections is difficult but also crucial for our clients' investment outcomes as market returns may stay strong until just before a correction.

Investors looking to adopt a prudent strategy can do so in three ways. The most active way is to stay long equities but keep the finger on the trigger to reduce risk when we see more late cycle signals. A more systemic way is to gradually lower the equity exposure as we go deeper into 2018. Finally, investors could add appropriate hedges to their portfolios. In our portfolios that are long market risk, we prefer to be long inflation and long the US dollar and Japanese yen.

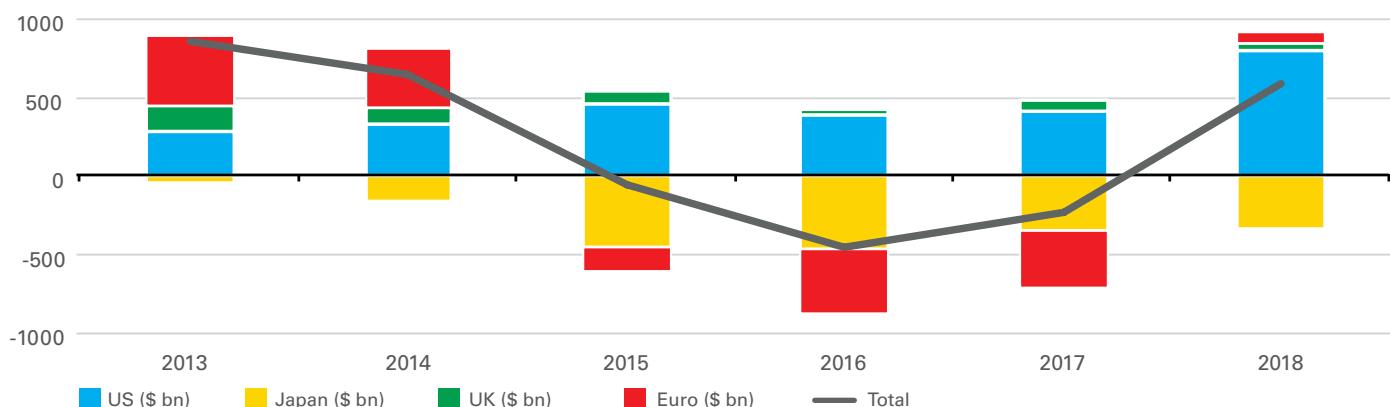


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LOOKING BACK ON 2017

Global growth was both more pronounced and more widespread in 2017 than previously. After several years of disappointment, levels of business investment rose. Unemployment fell in developed markets, but wage and inflation pressures remained largely absent. This allowed central banks to proceed in the gradual removal of monetary accommodation. Emerging market fears dissipated as capital outflows reversed and growth stabilised.

Buoyed by stronger growth and low discount rates, asset prices have been strong across the board. Almost all equity markets delivered double-digit returns. In the bond market, tighter credit spreads accompanied stable government bond yields.

Figure 1: Net of redemptions and QE, government bond supply is set to soar in 2018

Source: Morgan Stanley, LGIM estimates

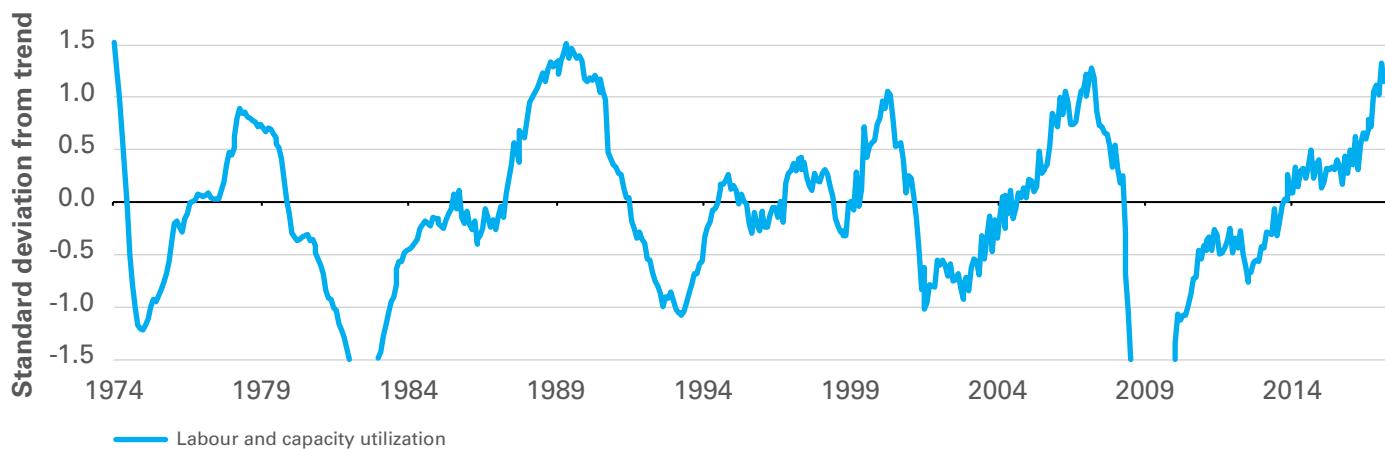
MOVING LATE CYCLE?

We expect robust global growth to continue into 2018. Easier bank lending conditions and expected US tax cuts should provide the foundations for this growth.

The near-term growth risks appear balanced. Elevated confidence indicators could translate into stronger actual demand. The main downside risk is the potential for China's crackdown on shadow banking to develop into a hard landing. There is also the uncertainty about the economic and market reaction to the slowing in central bank asset purchases. In the case of the Federal Reserve, this also includes balance sheet shrinking. Our CIO, Anton Eser, also highlights in his latest update his concern that this global tightening of liquidity could end up in a rude awakening for markets.

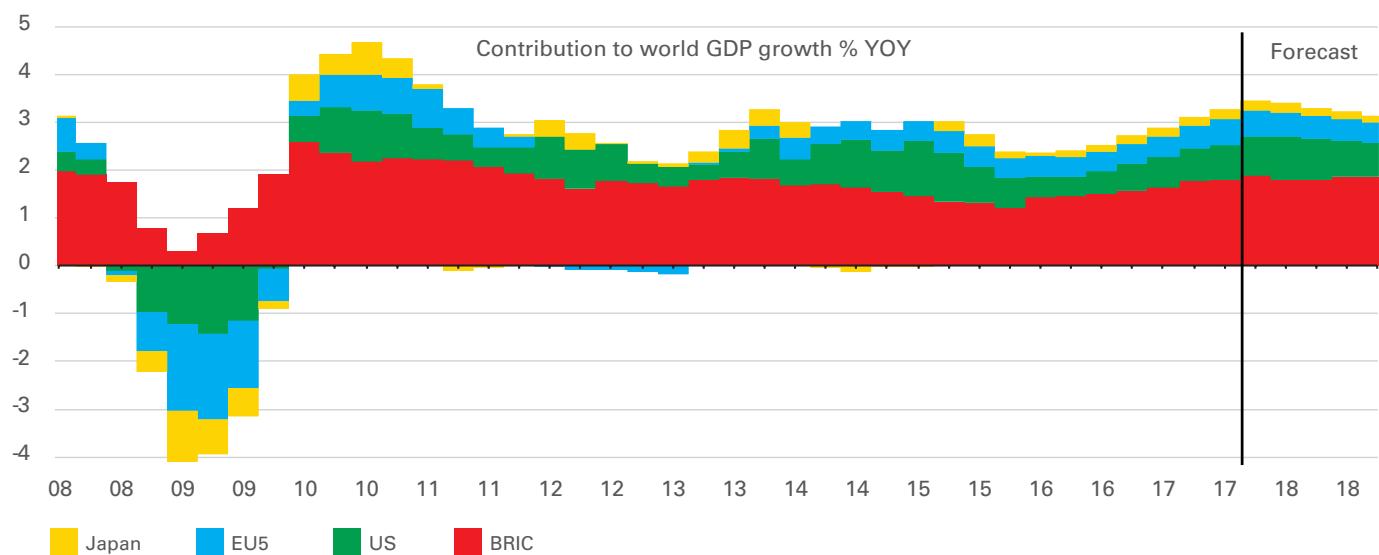
After almost nine years of uninterrupted equity market gains, there is a strong case to be made that it is time for a reversal of fortunes or at least a slowing in the rate of asset price appreciation. However, an extended run of strong returns is not always reason to believe that a correction is imminent. If wage inflation remains around current low levels and growth does not slow down, we would expect equities to have an excellent 2018.

That said, this scenario is an optimistic one. Increasing recruitment difficulties and rising manufacturing utilisation are evidence of diminishing slack (Figure 2). Unless growth slows, core inflation is likely to rise. In turn, that will put pressure on corporate margins and the discount rates applied to future cashflows.

Figure 2: Global resource utilization has shot up

Source: LGIM and Macrobond

Figure 3: Global growth starting to slow in 2018 from a robust base



Source: LGIM and Macrobond

We need to be particularly wary of nascent recession risks in 2019. This takes into account the typical 6-12-month lead of markets over the economic cycle. At that stage, unemployment will likely be well below sustainable levels. Higher interest rates will also start to bite into corporate and household cashflows. This means we expect to lower our equity exposure as we go deeper into 2018.

POLITICAL RISKS: EVOLVING NOT DISAPPEARING

We continue to worry about political developments. President Trump could still pivot towards a more protectionist agenda and the renegotiation of the North American Free Trade Agreement (NAFTA) with Canada and Mexico is the most immediate concern. Conflict in Asia or the Middle East could also change the benign macro backdrop. The European electoral calendar is comparatively quiet in 2018 with the Italian election in the spring. Latin America will again be under the political spotlight with Mexico, Brazil, Colombia and Venezuela all holding presidential elections.

The biggest political risk for 2018 could be what is not even on the calendar. In 2017, China's leadership prioritised 'stability at all costs' ahead of October's National Congress. In 2018, this could mean a greater focus on tackling the structural challenges of high debt, environmental dilapidation and slowing trend growth. Such a pivot would imply downside risks to the near-term outlook.

BADLY TIMED US FISCAL STIMULUS

If inflation rises, the Federal Reserve could raise interest rates faster than the market expects over the next couple of

years. As interest rates move further away from the zero lower bound, markets may be willing to price in a more aggressive normalisation path. That could be destabilising for currency, bond and equity markets. We are guarding against higher inflation via both the US dollar and Treasury Inflation Protection Securities (TIPS).

US core inflation defied our expectations and weakened during 2017. There are three scenarios that could keep inflation low again in 2018.

First, disappointing US growth could take the heat out of the labour market. However, growth looks strong and there are few signs that the US economy will slow to below its potential rate. Business and consumer confidence has remained high, supporting the market. Despite the delay to tax reform, it seems likely that Congress will deliver a stimulus worth close to 1% of GDP in 2018. Yet, this fiscal boost risks overheating the economy at this stage in the cycle. Unemployment is very low and still on a firm downward trend.

Second, an improvement in productivity would prevent unit labour costs from rising, even as wage growth climbs. If technological progress and greater retail competition keep inflation down, this should help solve the productivity puzzle.

Third, rising wage pressure could lead to a margin squeeze if firms are unable to pass on higher cost. This could increase corporate stress and bring the cycle to an earlier end.

Fixed income markets will have to adjust to the policy priorities and communication style of Jerome Powell as the new chair of the Federal Reserve. Asset prices could be shaken up as markets have become used to the gradualism and transparency of the old regime. Also, considerable turnover on the committee could lead to a fundamentally different perspective on the monetary policy outlook.

EURO AREA – CYCLICAL SWEET SPOT

The recent growth momentum appears set to continue into 2018. Many economic reporting figures have delivered sustained positive surprises in recent months. Despite rapid falls in unemployment, wage and inflation pressures appear subdued.

Monetary policy is particularly sensitive to these assumptions. Any change to the ECB's forward guidance and preannounced path of asset purchases would likely prove disruptive. In the event of disappointing growth and inflation, there is little room for the ECB to manoeuvre as it is running out of assets to purchase.

2018 is unlikely to be the year in which the experiment with negative interest rates comes to an end. Compared to alternative markets, we are negative on the euro but upbeat about the prospects for euro-denominated assets.

The greatest opportunities we see are in European equities. The strong global economy and lower starting margins should benefit earnings growth. On a relative basis, valuations are less ambitious and therefore offer greater upside potential.

In contrast, flat credit curves and tight spreads means that return prospects for European corporate bonds are thin. The withdrawal of ECB asset purchases will affect those assets where market pricing has been most distorted by the purchase flows.

UK – BREXIT BLUES

The UK economy slowed during 2017. Real incomes were squeezed as the Brexit-induced fall in sterling began to bite. This is in stark contrast to the rest of Europe where growth accelerated through the year.

The housing market has also cooled and remains at risk of a more serious correction should sentiment deteriorate.

Low interest rates and near full employment should prevent the forced selling involved in a crash. Brexit uncertainty is

a drag on business investment and this is likely to persist through 2018. We continue to expect though that a transition deal will be agreed. We remain attentive to the danger of no agreement or outcomes which could lead to an early general election.

Those negotiations will likely remain tense up until March 2019. But we believe that both sides have an incentive to avoid a disruptive schism with their largest export partner.

We believe sterling offers compelling value given the large price movements of recent years. After November's hike in interest rates, the current economic uncertainty means that we don't expect the rate of future hikes to speed up. But, with the turn in the interest rate cycle, the international value of the pound is also likely to find some support from the Bank of England.

THE EMERGING WORLD – SOUNDER FOOTING

Global manufacturing picked up steam in 2017, supported by a recovery in world trade growth. A reversal of capital outflows underpinned the strong performance seen across emerging market equity, debt and currency markets.

The good news is that global inventories appear lean as we head into 2018. This should continue to act as a tailwind to emerging market output growth. There is also a positive domestic demand element. Consumer spending has improved, particularly in Brazil and Russia. Parts of Central and Eastern Europe are also growing at a rapid pace.

Prospects for India should also improve as the drags created by the goods and sales tax reform and the demonetisation programme fade.

As ever, China is the elephant in the room. Industrial activity appears to be slowing as the growth rates of various monetary aggregates diminishes. Alongside the recent increases in Chinese domestic interest rates, this is consistent with the authorities trying to take the heat out of rapid credit growth.

So far it appears controlled. Capital outflow and currency pressures have eased. Given the alarming increase in China's debt in recent years, the authorities' attempt to reduce leverage could be a positive development for the medium term. That can be seen by slowing growth in money and credit aggregates in Figure 4. But, there are risks the economy could slow more than expected in the near-term as funding becomes increasingly scarce.

Figure 4: Chinese credit growth



Source: LGIM and Macrobond

We are therefore optimistic on the prospects for emerging market debt (both in hard and local currency), where gearing to global trade is particularly supportive. Our outlook for emerging equities is more balanced given the greater Chinese exposure.

Going into 2018 we are tactically cautious on equities but not extremely so. This positioning will evolve over the year as we identify emerging threats and potential triggers for corrections. The risk of a correction will materially increase when we see the economy move to late cycle. If you would like to hear more from us please register for [our 2018 Outlook Webinar](#) taking place early in the year.

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