Outlook 2017: A Break in the Clouds

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Was 2016 the year everything changed? It will certainly be remembered as a year of many "surprises," from "Brexit" to President-elect Trump. The political winds have clearly shifted against the free-trade consensus that has underpinned the global economy for the past 30 years, and signs are emerging that markets have had their fill of expansionary monetary policy.

We and others have remarked that over the past several years markets have hung on the words of central bankers to an unhealthy degree. Even after the UK vote to leave the European Union, while equities sold off in the immediate aftermath, they rebounded strongly based seemingly on optimism central bankers would do "more." Yet the ongoing rally in risk assets is hard to pin solely on central banks, especially in the wake of the November 8 US presidential election. Indeed, since the election the US Federal Reserve has doubled down on its promises of a December rate hike, and equity markets loved it! After years of investors buying into "don't fight the Fed" (or the ECB, or the BOJ…), the futility of negative interest rates may have finally sunk the narrative that has been hanging over markets for far too long.

We can't dismiss the possibility that recent events herald a positive change for economies and markets. What if growth (and moderate inflation) return, and improving corporate fundamentals driven by organic growth take precedence? Seven years into a US economic expansion, and an incredible equity bull market run, it does seem odd to consider what could go right. But cycles do not die of old age, and the nascent global reflation trade suggests the current one may not yet be over. Thus, as we review the outlook for major asset classes, we do see the potential for a break in the clouds.

Of course, the sun doesn't shine forever, and overall our views are little changed. The things we have been worried about for some time—high valuations for certain risk assets, record-low interest rates, slow economic growth—have not gone away. We remain concerned that investors are stuck in a low-return world where they will struggle to earn 5% in real terms. As we look across asset classes in the pages ahead, we see moderate to expensive valuations, solid but not spectacular fundamentals, and wildcards such as geopolitical shocks.

By far the biggest wildcard for the 2017 outlook is the rise of protectionism and an anti-globalization backlash across the developed world. The most important point for investors is this: *no one knows what will unfold*. We have been nonplussed at the remarkable confidence many (most?) market observers seem to have in their post–US election predictions. For our part, we are content to take the evidence as it comes.

On this point, the recent increase in dispersion, both among countries and sectors, is a positive sign. While still early, this could herald a (long overdue) shift from passive outperformance to active. Few things have been more hated in recent quarters than active managers, particularly hedge fund managers, and if there is one thing that being steeped in market history has taught us, it is that no trend lasts forever.

Color us cautiously optimistic, but still toting an umbrella.

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- **Developed markets equities** would appear poised for decent gains in 2017 given starting valuation levels and healthy earnings growth prospects, were it not for recent political developments that have clouded the outlook. Ironically, given the many current uncertainties on the policy front, an outlook calling for US equities to once again outperform peers *seems* the surest call to make. The outlook for developed markets equities outside the United States in 2017 is less certain despite more supportive valuations and equally or more attractive earnings growth expectations. Broadly speaking, an environment of improving economic growth and still historically low bond yields, along with largely absent equity valuation extremes, should be supportive of equity market performance, but downside risks remain elevated. As long as these risks remain at bay, the global reflation trade that has driven the rotation from defensive to cyclical sectors and from growth to value should enjoy further legs.
- **Emerging markets equities** are reasonably valued, both in absolute terms and relative to developed markets, particularly more richly valued US equities. Fundamentals have improved, as have valuations of emerging markets currencies. But Chinese debt could once again raise investor hackles, and the potential for the United States to seek aggressive postures toward trade partners could continue to cause volatile markets. We still prefer emerging markets equities to overvalued US equities, but given risks to the emerging markets outlook for 2017 as well as our cautiously more constructive take on US equities, we are watching this recommendation closely and recommend appropriately conservative position sizing.
- Within **credits**, high-yield bonds seem unlikely to have another banner year in 2017 given current yields and macro headwinds. Leveraged loans seem better positioned, and could even outperform equities in a risk-off environment. Investors that can tolerate short-term volatility (and, in some cases, are willing to lock up capital) may find richer pickings, especially if they are willing to look at niches like structured credit, bank subordinated debt, and private credit strategies. A different approach is allocating to opportunistic funds, the best of which should be able to seize on relative value opportunities and even go short when markets look overheated. These funds may prove especially interesting if macro volatility increases, whether due to tighter monetary policy or political risks going from simmer to boil.
- Prospects for **real assets** are broadly positive for 2017, given investors are likely to place value in assets offering income, diversification, and inflation-protection potential in the changing political environment. Across real assets, our favorable view is backed by solid or improving fundamentals, from the tight real estate construction pipelines in the United States and continental Europe to the declines in energy and mining capital expenditures. While our

optimism doesn't extend to all real asset categories—clear near-term weaknesses exist in UK property and commodity futures—investors with positions that are low relative to policy should consider whether that call remains appropriate.

- **Sovereign bonds** are on the move, and market dynamics mean investors should make sure deflationary hedges are sufficiently low duration to withstand a larger-than-expected short-term spike in yields. The end to the 35-year bull market in US bonds may have been seen in 2016, and rising Treasury yields will pull up yields globally as other countries import inflation via depreciating currencies. Investors should stay alert and poised to lock in higher bond yields if and when the rise proves self-defeating (i.e., causes growth to stall). Not only could nominal bonds soon be trading at fair value, but the opportunity may present itself to lock in attractive long-term real yields in TIPS if they enter the lower bound of our fair value range.

- Rising interest rates and rising political uncertainty should benefit the **US dollar** relative to European and emerging markets currencies over the next year or so, as history implies the path of least resistance for the dollar is up. Yet the rally in the US dollar will not be a straight line and the currency may have already risen too far and too fast following the US election in the absence of concrete policy proposals from the new administration. But a period of near-term consolidation aside, additional USD strength is likely in 2017.

- Taking into account our views across asset classes, and considering the number of economic and political wildcards, suggests that **investors should make sure portfolios are aligned with risk tolerance and return objectives and positioned to persevere in a variety of environments**. Periods of volatility surrounding elections and referendums should be expected, making diversification and liquidity provisioning critical. This includes stress-testing portfolios, principally with regard to liquidity, in varied stressed environments. Even with their recent increase, bond yields remain low, dragging down prospective returns for a variety of asset classes. We remain concerned that capital markets are unlikely to deliver most investors' long-term return objectives over the next five to ten years. To improve the likelihood of meeting return objectives while maintaining adequate defense, we recommend investors seek value-added returns in a variety of private investments, maintain neutral allocations to risk assets and limit tactical positioning in global equities, revisit defensive positions, allocate some capital to real assets that offer attractive return prospects even if commodity prices stay flat, and consider the prospects for reducing spending to maintain purchasing power. ■

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