# OUTLOOK 2018

## STICK AROUND FOR DESSERT

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In our 2017 outlook, we were cautiously optimistic, and the year turned into quite the feast for investors, with developed and emerging markets equities posting double-digit returns in nearly all major currencies. Looking ahead, while we would be the first to concede that the rally in some assets has eaten into tomorrow's gains and intermediate returns may lag from here, at this point it is too early to leave the party, and we recommend that investors stick around for dessert.

A variety of dynamics influence our constructive view, many of which are simply a continuation of themes from 2017. Global growth has synchronized and strengthened, central banks haven't yet taken away the punch bowl, political risks have diminished in several markets, and some countries look set to relax fiscal policy. Hopes are particularly high for US tax reform, and shifting political realities in some Eurozone countries could mean governments loosen the purse strings.

In the pages ahead, we review how these dynamics could affect key assets in investors' portfolios, including developed and emerging markets equities, sovereign bonds, credits, real assets, and currencies. Heading into 2018, we remain constructive on developed ex US and emerging markets equities, while keeping a wary eye on US stocks, where stretched valuations mean future returns will likely not keep pace with those of the past. In fixed income markets, 2018 looks to offer more of the same, though as some central banks pull back their purchases, high-quality bonds may be in greater supply, and we don't recommend taking long duration bets. Most liquid credit assets are not priced to generate significant gains, yet a rising economic tide could keep defaults low and allow investors to clip coupons, creating a supportive environment for structured credit. Among real assets, with growing levels of free cash flow, better balance sheet positions, and undemanding valuations, natural resources equities and energy MLPs are on firmer ground relative to the start of 2017.

Thus, as 2017 comes to a close, we are again cautiously optimistic for the year ahead. However, the fact that the consensus cites so few risks on the horizon worries the contrarian in us, and with markets very complacent, it may not take much to see volatility pick up. The situations in North Korea and the Middle East are known risks—increasing geopolitical tensions could see investors start to depart the party. Still, given the unpredictability of political events and lack of attractive alternatives, investors may want to hold neutral equity allocations, remain careful with bonds, and look for upside in more niche, often private, strategies.

## Executive Summary

- **DEVELOPED MARKETS EQUITIES** have the potential to deliver a second straight year of healthy returns in 2018 based on a still-supportive macroeconomic backdrop, decent earnings growth prospects, and reasonable starting valuations (outside the United States). Among major developed regions, Eurozone and Japanese stocks seem to offer the best prospects as their earlier stage economic recoveries now appear sustainable, policy remains more supportive, and valuations are still undemanding. By comparison, US stocks are quite expensive, making their upside potential more dependent on further earnings growth. Better performance through the cycle means the US earnings bar is higher, but US tax policy is an important wildcard in the near term. UK stocks have the least promising outlook, given ongoing headwinds to sentiment from Brexit, and an unfavorable sector composition in the current reflationary environment. However, the uncertain environment and bearish investor positioning arguably mean UK valuations already reflect rather dire scenarios.

- Several factors that supported strong **EMERGING MARKETS EQUITY** returns in 2017—including decelerating debt growth, constrained inflation, stable currencies, and dovish monetary policy—seem poised to continue in 2018. Earnings remain below prior cyclical highs and may have further room to run as well. However, earnings, and recent share-price gains, are now heavily concentrated in pricey technology stocks. Investors should consider whether any explicit or residual style biases within their emerging markets allocation might lessen or increase this concentration in fast-growing but expensive technology shares. While emerging markets are ebullient, and could well be primed for a pullback in the coming year if optimism regarding earnings growth fades or if risk aversion (or the US dollar) rises, the potential catalysts for such a pullback are not in view today.

- Investors need to be patient when investing in **CREDIT** in 2018 given the current paucity of attractive choices. This said, a rising macro tide may continue to limit downside risk, even if weakening investor protections and excessive inflows are setting the stage for intermediate-term disappointment. Given the combination of stable fundamentals and the availability of cheap finance, we are constructive on higher-carry structured credit and select lock-up opportunities including real estate credit focused funds and capital appreciation funds. Should dispersion across credits increase, long/short credit funds could also be of interest, though rising equity markets could mean returns might continue to trail those in other hedge fund categories.

- In 2018, investors may want to focus on natural resources equities and energy MLPs among public **REAL ASSET** investment options. These resource-focused companies—in contrast to richly priced US REITs and structurally challenged commodity futures—are potentially best positioned to continue to grow free cash flow, aided by continued global economic growth and tightening in oil supply/demand fundamentals. With higher levels of free cash flow, these companies would be better able to strengthen balance sheets and return capital to investors. In short, we see resource-focused companies at current prices as having more upside potential than downside risk.

- **SOVEREIGN BOND** investors have experienced unexciting returns in 2017 and 2018 looks to offer more of the same. Labor-market tightness in many countries and rising commodity prices raise the risk that price pressures might eventually overshoot the diminished expectations of central bankers and bondholders. Should investors perceive that central bank posture is becoming less dovish (or should inflation dynamics eventually indicate that it *should* become less dovish), today's bond indexes, with their long durations, would suffer. Although US Treasuries moved into what we consider to be fairly valued territory in October, sovereign bonds in other developed markets generally remain overvalued (and in some cases very overvalued), and investors should consider holding some cash in lieu of these richly valued sovereign bonds.

- **CURRENCY MARKETS** may be range bound in 2018 as the outlook for global monetary policy becomes more complicated, with global central banks beginning to tighten policy to different degrees. Even as we see increased odds for a US dollar rebound in 2018, the strong-dollar cycle is clearly near its end. The current cycle has reached the duration of the past two cycles (i.e., more than six years), and although it has not yet seen the same magnitude of USD strength, the dollar is overvalued versus most currencies. On a basket basis versus developed markets currencies, the US dollar is at real exchange rate levels that historically have resulted in weakness on a multi-year horizon. As a result, we expect the dollar to weaken over the intermediate term, although this may not occur until after the next US recession.

- Looking across the landscape, **WHILE CONDITIONS REMAIN SUPPORTIVE OF A RISK-ON ENVIRONMENT IN 2018, INVESTORS SHOULD NOT BE COMPLACENT ABOUT DOWNSIDE RISKS**, as positive conditions cannot last forever. For the time being, investors are still being compensated for taking risk and, as a result, we remain neutral on risky assets. Investors should seek to determine how much risk they are taking in portfolios relative to neutral risk allocations and adjust positioning accordingly. Diversification and adequate liquidity remain key to managing portfolios through the cycle. ■

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