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Outlook 2018: Twin peaks

Global growth and QE reach for the summit

From the Research & Investment Strategy team

With contributions from:

Amaury Boyenval – Multi Asset Client Solutions

Julien Foll – Responsible Investment

Olivier Vietti – Fixed Income

2018 Global Strategy Outlook

By Maxime Alimi

- **A strong cyclical macroeconomic backdrop should support earnings, low default rates, public finances and investor sentiment.**
- **QE has lifted all boats. At present, almost all financial assets are expensive, with ultra-low interest rates the underlying driver of valuations.**
- **We see limited downside risks in 2018, especially with the global 'policy put' still well in place. However high valuations are likely to limit expected returns.**
- **Short-term optimism should be balanced by longer-term pessimism. A decade long search for yield has produced vulnerabilities and propagation channels for future shocks.**

Mixed feelings

With hindsight, 2017 looks like a Goldilocks environment for financial markets. Accelerating activity, low inflation, dovish central banks and risks that failed to materialise, have all contributed to supporting performance. All the major asset classes managed to clip positive returns this year, including government bonds and, after a bumpy ride, commodities.

Looking ahead into 2018, however, produces more mixed feelings. On the one hand, the growth backdrop looks strong and we expect that to continue. Positive macroeconomic factors should support corporate earnings, low default rates, public finances, credit ratings and overall market sentiment.

Also, for the first time in several years, political risks look more balanced. On the downside, while tensions between the US and North Korea are currently on the backburner, they could well resurface in 2018. The protectionist agenda of the White House has not disappeared even if efforts to renegotiate the NAFTA are struggling. And uncertainty remains in Europe, be it in Catalonia, Germany or the UK. But there are positives too, for example, the US tax reform package looks on track to deliver, if not a large boost to growth, a nice kick for US corporates and stocks. In addition, progress in European political integration appears possible in 2018, both for defence and economic policies. This will require a viable German government but the prospects of a more benign environment have never looked so favourable since the European sovereign crisis.

On the other hand, valuations have deteriorated across the board, as the mirror image of the strong asset performance this year. As such, the downside risks in the case of a correction have grown. We remain convinced that the QE-driven overvaluation in government bonds is the mother of all overvaluations. As the QE tide has lifted all boats, its withdrawal should ultimately put downward pressure on markets.

This however does not look imminent. If we are right, in that what matters is the global stock of QE, rather than flows, then the challenges will only begin when this starts to decline in H2 2018. Until then, the unwind of the Fed's balance sheet will be more than offset by ECB and BoJ purchases. In other words, the Great Decompression may only start in earnest in 2019. Also, we are convinced that a sluggish inflation backdrop not only allows central banks to be patient and to postpone the exit but it also gives them room to change their minds if necessary. The global 'policy put' remains well in place, reflected to some extent by ultra-low realised and implied volatility.

Still, a decade of ultra-low interest rates has led to the build-up of a number of vulnerabilities in the financial system. These risks are likely to be some of the primary propagation mechanisms when the next correction hits, at a time when both fiscal and monetary policies will probably be unusually constrained. There are reasons to believe that the next bear market will be sizable.

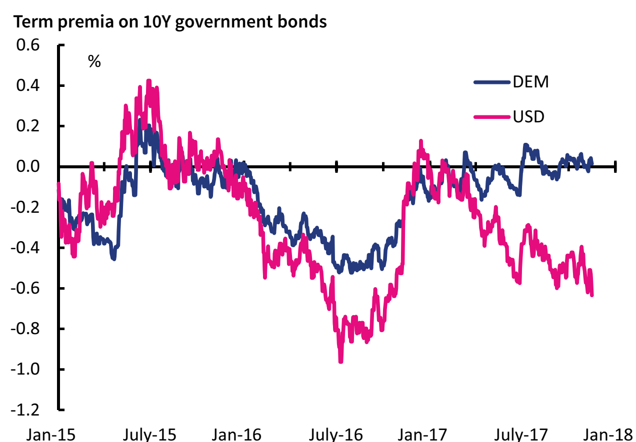
Overall, these thoughts leave us bullish over the short-term and bearish medium-term. Overvaluation is not per se a trigger for correction and the strong macroeconomic backdrop and lack of major risk in the near term suggest that the current positive environment can persist for a while yet. High valuations are probably a cap for forward returns, however. A repeat in 2018, of 2017 strong performances is possible, but looks to us more of an upside scenario. Conversely, the downside case, even though low probability in the near term, has the potential to be ugly. Considering this distribution of risks and returns, long-term investors have started to build up cash allocations.

Rates: higher and flatter

We expect global long-term interest rates to rise mildly in 2018, most probably in the second half. A break of US 10-year real rates above 0.6% will be an important signal.

Exhibit 1

The US term premium dives as nominal yields are capped by global QE



Source: Adrian, Crump, Moench (2014) and AXA IM Research

We also anticipate a small increase in long-term inflation break-evens in the US, the euro area and Japan. As realised core inflation picks up over the course of the year, markets should adjust. We are cautious however and are only pencilling in a modest 10-20bps of increase at the 10-year tenor in each market from current levels.

We expect the short-end of the US curve to sell off further on the back of the repricing of Fed policy in 2018 and 2019. This leaves us with a target of 2.3% for the yield on two-year treasuries by end 2018.

The significant flattening of the US curve in 2017 constitutes proof that the short and long end of the curve can live separate lives (Exhibit 1). We see room for additional flattening as these dynamics persist. With US 10-year real rates rising to a 0.6-0.9% range over the course of 2018, we forecast 10-year nominal yields around 2.7% and the implied 2-10 year curve at just 40bps.

In Europe, the short end of the curve is unlikely to move as much in 2018. The ECB's forward guidance is clear that the deposit rate will not move before well after the asset purchase programme (APP) is over i.e. mid 2019 at the earliest. We see limited upside for 10-year bund yields in a context of very strong technicals and ECB purchases still heavy until September. With slightly higher inflation expectations and real rates, we have a year-end target of 0.8%, implying probably some steepening of the curve.

The positive year-end for peripheral countries in Europe has been influenced by a still "open-ended" ECB tapering plan and the unexpected upgrades of sovereign debt in Portugal and Italy by ratings agencies. The recent spread compression has influenced valuations, which are now broadly neutral. Although the macro outlook remains constructive, the forthcoming Italian elections and the aftermath of the Catalan crisis could see political risk resurface. Having said that, such episodes might also represent better entry points. Portugal keeps the highest upside potential because it could be on the receiving end of an upgrade to investment grade by Moody's and Fitch. Technicals are the main driver of our expectation that a mild widening looks likely in 2018, however. The supply/demand factors will be less supportive with net supply turning positive due to ECB tapering.

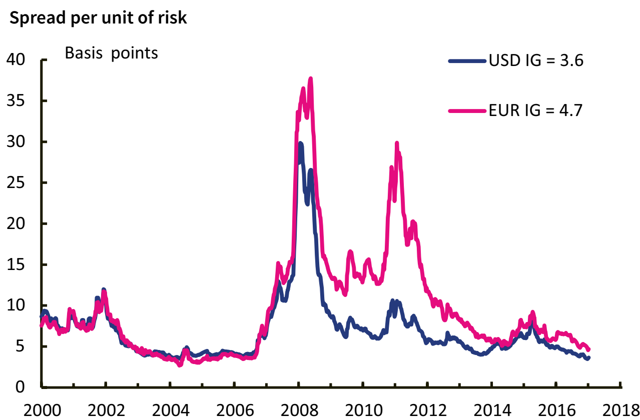
Credit: from richer to rich

The credit market forecast remains constructive for 2018 as a result of the healthy macroeconomic backdrop, central banks' prudence and a benign default outlook. Returns are set to be much more modest than in 2017 as we see spreads moving marginally higher.

Valuations are extended across the board but are especially rich in the US IG and EUR HY (Exhibit 2). Historical mean reversion suggests that spreads are likely to drift wider over the next twelve months. Similarly, our base case scenario for steady GDP growth and an uptick in equity volatility (on the back of QE reduction) is consistent with a modest spread widening in 2018 which, however, does not outstrip the spread carry. Indicatively, for a spread widening by 8-12% in IG and HY respectively, annual excess returns should be in the 40 55bp range for IG and 65 75bp for HY net of defaults.

Exhibit 2

IG credit at all time tights



Source: BofAML and AXA IM Research

We maintain our preference for HY over IG for the superior carry of the former and due to the higher duration risk of the latter. One potential risk for HY markets is a renewed deterioration in the default outlook but this time with the telco/cable and retail sectors at the centre, due to weakening earnings.

Supply/demand technicals are also likely to remain supportive despite the gradual exit from global QE. Neither the US nor the European credit markets are likely to see a material increase in net supply. Tapering of ECB QE should also prove manageable, as (i) the reduction of purchases has been well flagged (ii) higher all-in yields would attract yield-target buyers like insurers and pension funds (iii) higher all-in yields should discourage opportunistic issuers, reducing supply and (iv) the share of credit purchases is likely to rise as the overall purchase amount is reduced. One possible dynamic that may unfold with the corporate tax reform in the US, is a decline in net supply in US dollar credit due to the loss of interest deductibility with a concomitant increase in euro credit supply by US corporates (reverse Yankees) in search of potentially cheaper refinancing.

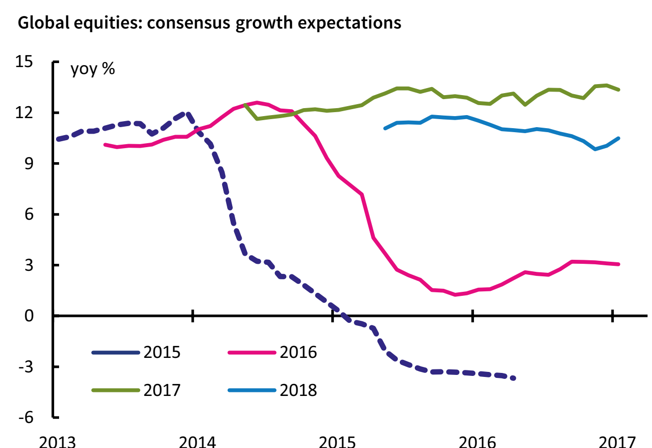
Equities: there is such a thing as soft landing

The upbeat macro environment should translate into supportive earnings growth in 2018. Global equity market earnings growth is expected to be around 10%, which we find realistic (Exhibit 3). We see earnings delivery as the main support for equity markets, in line with recent performance.

Once more, the technology sector is likely to be a key contributor to returns. The sector makes up 16% of the all-country world benchmark and contributed around 36% of returns in 2017. Again, earnings delivery is key to sustain the momentum; analysts' earnings expectations for tech are very dispersed relative to history and other sectors, however, suggesting a large scope for surprises. The tech sector has been a key reason why US equities have outperformed the euro area in 2017. In our opinion, a positive view on European equities has to be tweaked to avoid the implicit short tech bias. Conversely, we expect European financials to outperform in a context of improving economic momentum, a rebound in the credit cycle, a steep yield curve and progress achieved in cleaning balance sheets.

Exhibit 3

Global earnings are delivering in line with expectations



Source: IBES and AXA IM Research

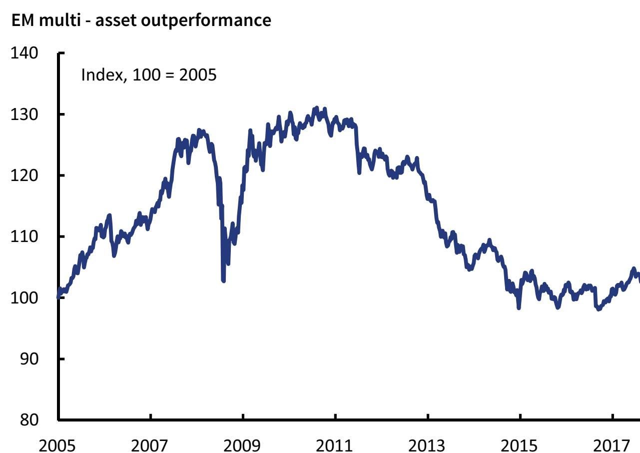
The positive environment is however reflected in valuations. Today, it looks hard to make a positive valuation argument except for EM where there is still some possibility of positive re-rating. Our central scenario as a result is that price returns will be less than earnings growth in 2018, allowing for a soft landing in valuation multiples. We expect 5-10% returns for global equities, with a positive bias for EM and the euro area.

Emerging markets: still in a sweet spot

Emerging markets had a great year in 2017 and we expect further outperformance compared to developed markets as valuations are less stretched overall after several years of deep underperformance. We believe a multi-year cycle of outperformance may have started in mid-2016, only briefly interrupted by concerns around the Trump election (Exhibit 4).

Exhibit 4

The EM outperformance cycle has just begun



Source: JP Morgan, BofAML, MSCI and AXA IM Research

Beyond the macroeconomic prospects, the financial environment remains favourable. For sure, a key positive for EMs in 2017 has been the depreciation of the US dollar, something we do not expect to see repeat itself in 2018. However, we do expect the asset class to continue to benefit from the search for yield and from a number of other supports. First, China looks on track for another stable year, supporting EM export demand and regional trade in Asia. Second, the outlook for commodities looks balanced. Third, US financing conditions are unlikely to tighten much. And finally, despite robust inflows into the asset class since mid-2016, it seems that EM remains under-owned across institutional investors.

Across EM asset classes, equites look the most attractive from a risk/reward perspective, given solid prospects for earnings and the relative discount to DM equities.

A key risk in 2018 could be protectionist rhetoric resurfacing and which in turn threatens investor sentiment, especially in Mexico subject, to NAFTA renegotiations.

Foreign exchange: EUR/USD down and up

The steady depreciation of the US dollar was the 'divine surprise' of 2017, unexpected by most investors after the sharp rally following Donald Trump's US presidency election win in late 2016. This can be explained by a convergence of factors: disappointment over the White House's delivery of its policy agenda, downside surprises on inflation and doubts about the Fed, as well as the theme of resynchronisation of monetary policy across the Atlantic.

Symmetrically, the large mover of 2017 has been the euro. Strong economic momentum, large inflows into domestic equities and the ECB's turn to the exit can all explain this rebound which caught most investors off-guard.

In 2018, we have no firm conviction about the direction of the EUR/USD exchange rate by year-end. We mostly see support for the US dollar in the short term and 1.15 looks a reasonable target. By year end however, new steps towards the exit by the ECB are likely to provide fresh support to the euro, leaving us about where we are currently. Valuation also speaks for the euro as most long-term purchasing power parity (PPP) models point to a fair value level around 1.25-1.30.

In our view, key drivers for the EUR/USD exchange rate in 2018 are likely to be:

- Relative monetary policy dynamics
- Relative political risks
- Overall risk appetite as the euro has, since 2014, clearly become a risk-off, carry-funding currency

More broadly, we do expect the US dollar to regain some of the ground lost in 2017. We see the most attractive crosses currently being USD/AUD, USD/CAD and USD/CHF.

Out of QE: the perilous way back

A number of risks have started to build up. A decade of ultra-low interest rates has affected both the decisions of economic agents and the shape of financial market trends. The question now is how to find a way back if indeed QE ends.

None of these risks looks likely to materialise in the near term, in our view but they could become vulnerabilities or propagation channels for future shocks, aggravating the downside.

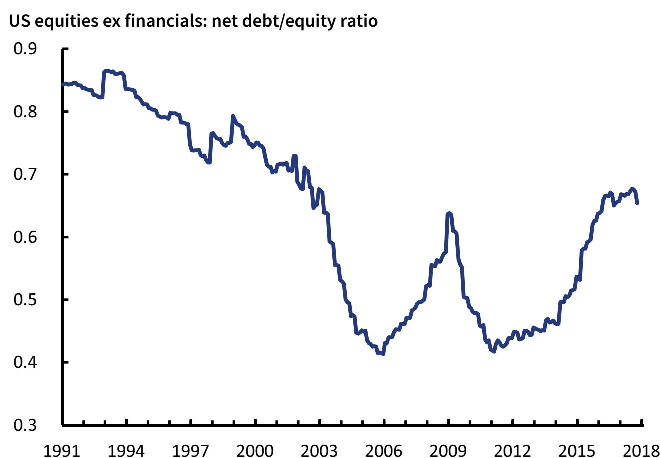
Leverage

Low interest rates were intrinsically designed to smooth the deleveraging process and make borrowing more attractive. In the US, leverage has moved away from households and banks, the primary culprits of the last crisis, to non-financial corporations, governments and central banks. Corporates in particular have engaged in large-scale, debt-to-equity conversions, issuing debt to buy back shares (Exhibit 5). This has been a major driver of equity market performance since 2015.

Exhibit 5

US companies have swapped equity for debt

US equities ex financials: net debt/equity ratio



Source: Datastream and AXA IM Research

When interest rates eventually go up, or when profit margins decline on the back of labour costs, or when sales growth slows with the business cycle, it is far from clear how companies will manage the transition back from debt to equity.

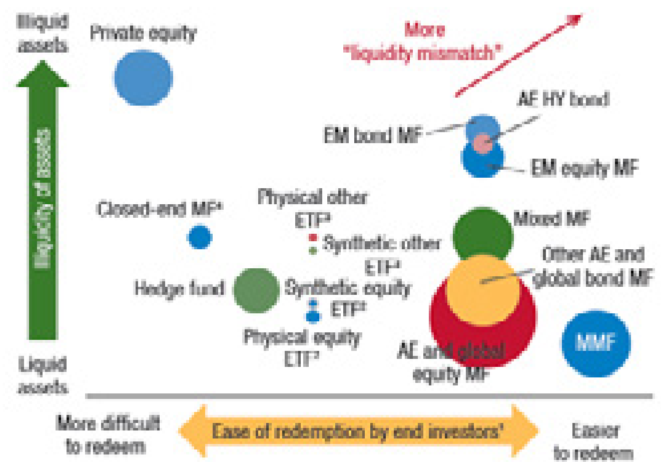
Liquidity

We see two types of liquidity mismatches that could become vulnerabilities. First, the search for yield has encouraged the expansion of asset management funds and exchange-traded funds (ETFs) into alternative and niche asset classes, such as emerging markets, high yield and volatility. The mismatch between redemption risks and market liquidity could be tested in stressed times. Exhibit 6[1] shows the mismatch than has appeared between the ease of redemption from funds and the liquidity of the underlying assets.

Second, ultra-low interest rates have led a number of investors to increase their exposure to illiquid assets as a way to capture the liquidity risk premium. This has been especially true in jurisdictions where regulation is more lenient towards liquidity risk[2]. Besides the risk of overvaluation in these asset classes, the true ability of investors to remain illiquid in a stressed context is subject to question, and could increase the likelihood of a fire sale of investors' remaining buckets of liquid assets.

Exhibit 6

Liquidity mismatches in asset management



Source: BarclayHedge; Deutsche Bank; ETFGI; European Fund and Asset Management Association; Lipper; Preqin; and IMF staff estimates

Herding

The global search for yield has led investors to follow similar strategies, in particular carry[3]. The unwind of these strategies may prove disorderly, especially where underlying market liquidity is limited. Moreover, the increase in risk-budgeting investment strategies (e.g. risk parity, Commodity trading advisor (CTA), drawdown control and volatility targeting) has increased the size of investors subject to abrupt fire-selling constraints in case of volatility spikes. This is especially true if these investors had to leverage themselves to match their constraints in a very low-volatility environment.

Regulation has led to other types of herding behaviours. For example, micro-prudent European insurers bought more duration as rates were going down in 2014 - 2015, in order to manage their duration gap, which contributed to an amplification of the move and in the end increased volatility.

1 Extracted from the IMF's Global Financial Stability Report, "The asset management industry and financial stability", April 2015.

2 Alimi, M. & Boyenval, A., "European insurers' investments in a persistent low-yield environment", page 26

3 Signori, O., "The search for yield – hidden market risks call for prudence in 2018", page 22.

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