



December 2017 Outlook

2018: Expect the Unexpected

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM | MACRO INSIGHT | 2018

A new year always brings a few surprises. Coming into 2018, there are three possible surprises for investors on our radar: a monetary policy surprise; an inflation surprise; and a volatility surprise. With strong global economic growth, lofty equity valuations and historically low volatility, we believe the market may not be fully prepared for them.

POTENTIAL SURPRISE #1: Interest rates rise faster than expected

At this point in the cycle, most investors expect interest rates to continue their upward trend, but there is lack of agreement on the number and timing of rate hikes.

• **SHORT-TERM RATES**

Market expectations for short-term rates are only slightly below FOMC¹ projections in 2018. Assuming a typical rate hike of 0.25%, the market expects about two hikes and the FOMC projects about three (*Display 1*). In 2019, however, the discrepancy becomes larger, with the market predicting fewer rate hikes than the Federal Reserve (the Fed).

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¹ FOMC stands for the Federal Open Market Committee, which sets monetary policy in the US.

It can be dangerous to bet against either the Fed or the markets, but here investors have to choose. With the global economy running at full steam, we think the evidence points towards the Fed's projections.

• LONG-TERM RATES

We also expect a significant surprise in 10-year rates. The spread between 10- and two-year rates is currently about 50 basis points. If the Fed in fact raises interest rates three times in 2018—for a total of about 75 basis points—with no change in 10-year rates, the result would be an inverted yield curve. We see this scenario as highly unlikely. Given the currently strong economic environment, borrowers will have an incentive to issue debt in longer maturities, while yield-seeking investors will be motivated to stay short to avoid being locked in at low rates. These forces are likely to drive long-term rates higher.

Moreover, widening interest rate differentials (between the US and both Europe and Japan) have driven up the cost of hedging to the point that hedged long-dated US bond yields are increasingly unattractive to European and Japanese investors. The annualised cost of hedging US debt into euros and yen is 2.6% and 2.2% respectively, which is gradually becoming uneconomic. European or Japanese investors buying a hedged US 30-year bond based on an annualised 1-month contract would get a yield below that of the equivalent domestic yield. (Display 2). For example, a Japanese investor could do better by investing in a Japanese 30-year bond at 80 basis points, rather than a hedged US 30-year bond at 70 basis points. (Display 3).

DISPLAY 1

Second-guessing the Fed

FOMC projections vs market-expectations



Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. Source: Bloomberg as of 20 December 2017.

DISPLAY 2

High-priced hedging erodes yields on US Treasurys...

12-month hedged yield on 30-year US Treasurys for European and Japanese investors

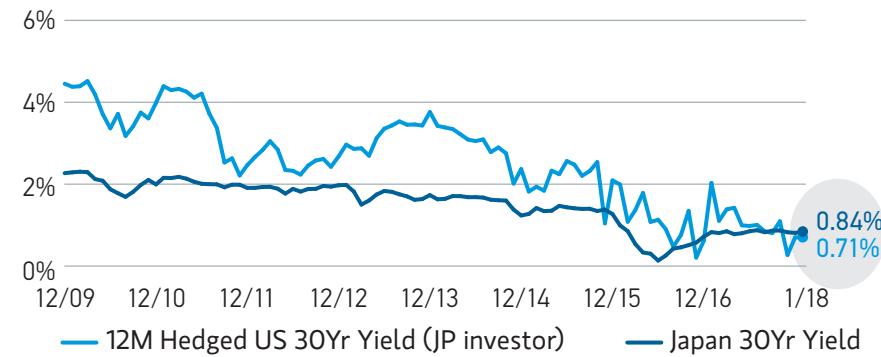


Source: Bloomberg as of 9 January 2018.

DISPLAY 3

...making domestic bonds more attractive

30-year US treasury yields and 30-year yields on JGBs



Source: Bloomberg as of 9 January 2018. JGBs – Japanese Government Bonds. Past performance is no guarantee of future results.

Furthermore, there are indications that the Bank of Japan (BoJ) may want to cut back on its QE² programme. Recently, the BoJ's governor, Haruhiko Kuroda, said interest rates are lower than optimal for growth. Higher rates at home would likely diminish Japanese appetite for US Treasuries and could put further upward pressure on US rates.

Finally, the long end of the curve does not seem to be pricing in strong US growth—*yet*. Nominal 10-year bond yields tend to track nominal Gross Domestic Product (GDP). Recently, US nominal GDP growth has increased to 4.1%, its highest level since June 2015. Meanwhile, 10-year bond yields remain relatively depressed at around 2.5%. We see this as unsustainable, with rates potentially rising faster than the market may expect (*Display 4*).

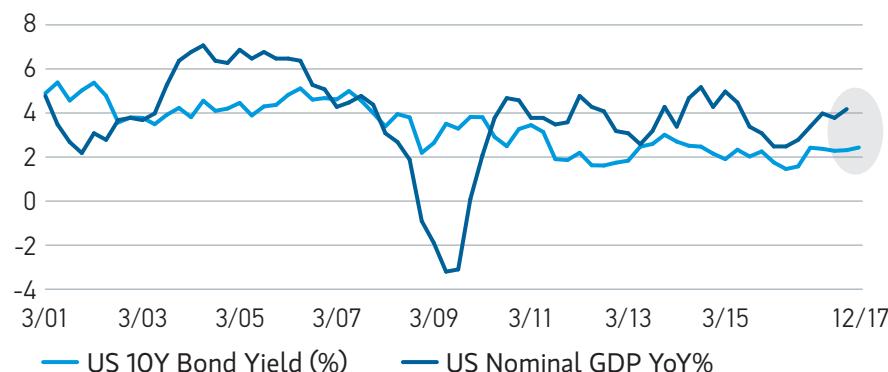
POTENTIAL SURPRISE #2: Inflation pressures heat up

Inflation expectations in the US remain subdued, with consensus expecting an increase to 2.17% by the end of 2018. This forecast may prove too conservative.

We expect productivity to start rising as a result of business investment in fixed assets. This will give a window for businesses to raise wages without adversely affecting their bottom line. The currently low unemployment rate will also put upward pressure on wages.

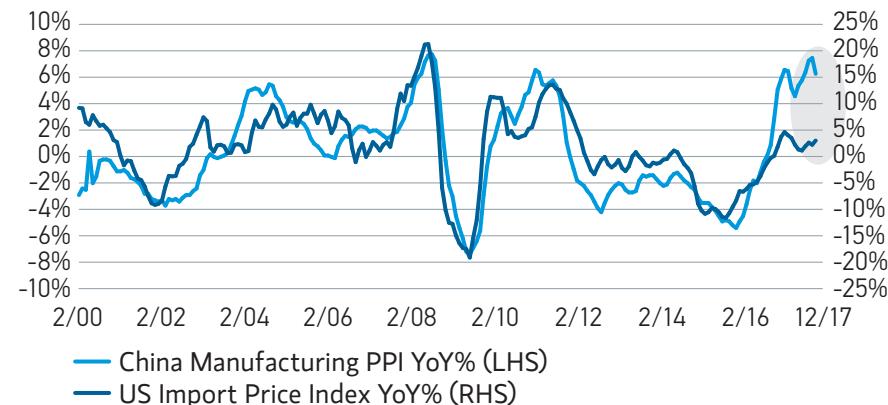
The most recent wage numbers showed disappointing overall growth because much of the increase in employment was in the low-wage sector, which brings down the overall average wage. Holding the mix between low and high wages constant shows that actual wages—not

DISPLAY 4 Interest rates are lagging economic growth



Source: Bloomberg as of 20 December 2017

DISPLAY 5 U.S. import prices are lagging Chinese PPI



Source: Bloomberg as of 20 December 2017

just employment—in the low-wage sectors increased. In other words, we are already seeing wage growth, which will feed inflationary pressures.

These pressures are not isolated to US sources. Chinese producer price inflation (PPI) usually feeds into US import prices,

but import prices have not yet followed the sharp run-up in Chinese PPI (*Display 5*). This gap is likely to correct in the months ahead, giving further fuel for inflation.

Energy prices are also a source of inflationary pressure. November's month-on-month headline inflation was 0.4%,

² QE stands for quantitative easing, a method by which central banks seek to implement monetary policy.

which would translate into a quite high annualised rate of 4.8%. Investors often discount headline inflation because it includes the volatile components of food and energy, but these do flow into the inflation forecast over time. Rising oil prices have been exerting steady upward pressure on producer prices (Display 6).

POTENTIAL SURPRISE #3: Volatility will make a comeback

Considering our outlook for higher interest rates and inflation—both of which are destabilising to the markets, especially given the currently high level of valuations—we do not envision a continuation of the past year's extraordinarily low and declining volatility. When one takes into account the high level of geopolitical uncertainty in the current environment, a resurgence of volatility seems even more likely (Display 7).

• MARKET VOLATILITY

One of the justifications for high equity valuations has been that they look reasonable in light of extremely low bond yields. If bond yields rise as we expect, that case weakens and equity volatility is likely to increase. Bond volatility itself may turn out to be quite unexpected for fixed income investors, and those holding longer-dated maturities may start to get uncomfortable. If interest rates rise faster than expected, we could see a sharp re-adjustment and a new bout of volatility.

• GEOPOLITICAL UNCERTAINTY

Significant political risks, many of which arose in 2017, are likely to continue in 2018. Whilst uncertainty about the situation in North Korea is currently less of a concern to investors, continued US political uncertainty and elections worldwide will increasingly come into focus this year.

In the US, the tax bill and the proposal to raise the debt ceiling passed relatively smoothly through Congress;

DISPLAY 6

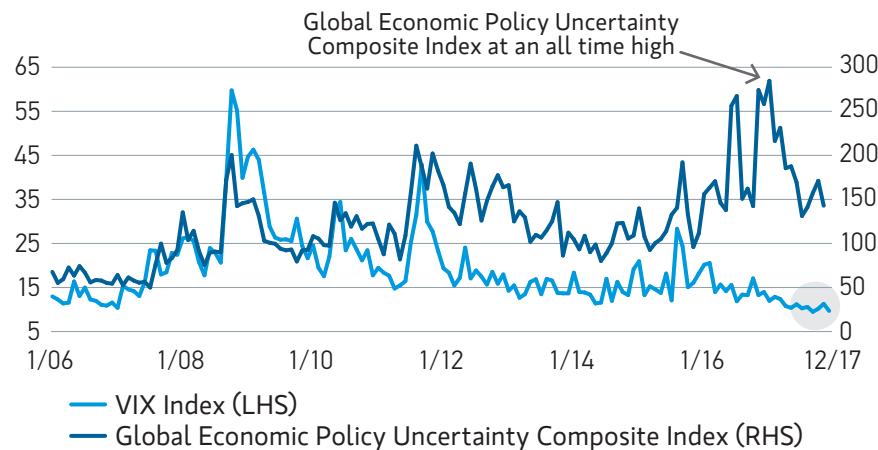
Rising energy prices are driving production costs higher



Source: Bloomberg as of 20 December 2017. 4MMA is 4-month moving average.

DISPLAY 7

Extraordinarily low volatility unlikely to persist



Source: Bloomberg as of 20 December 2017. Global Economic Policy Uncertainty Index can be accessed at www.policyuncertainty.com. The VIX is the Chicago Board Options Exchange (CBOE) Volatility Index®, (VIX®), a key measure of expected volatility using S&P 500 stock index option prices. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

however, if Democrats win the House and the Senate in the mid-term elections, the ensuing political friction could spill over into markets.

Europe also has important elections in 2018. In Italy, the populist Five Star Movement has indicated willingness to form a coalition. In 2013, they

received the most votes for the Chamber of Deputies, but won only a few seats because they refused to form coalitions. Their newfound openness to partnership increases their chances for creating a government.

Elections in Mexico could also cause volatility to ratchet up. The left-wing

Morena party, which opposes NAFTA, has been leading the polls.³ A win by Morena would increase the likelihood of NAFTA falling apart, which would rattle investors.

Keeping in mind these three potential surprises, let's review key asset classes across the globe:

Emerging markets and commodities: Sensitive to the US dollar

• EMERGING MARKETS

In emerging markets, corporations still have significant amounts of dollar-denominated debt, which exposes them to movements in interest rates and the possibility of a rising dollar. In the short term, there is upward pressure on the US dollar due to expectations for further rate hikes in 2018 and beyond. However, other regions that have been experiencing strong growth but thus far have suppressed their interest rates—including Japan and Europe—are likely to raise their interest rates as well. This is likely to offset strength in the US dollar relative to other currencies.

Arguably, the dollar is overvalued in the longer term. We think a short-term increase is likely, with a potential reversal following as we move further into 2018. Given solid growth and earnings fundamentals in emerging markets and limited upside in the US dollar, we expect the region to remain well supported.

• COMMODITIES: A WEAKER CORRELATION

Commodities tend to be negatively correlated to the dollar (*Display 8*). In 2014, there was a negative 45% correlation of commodities with the US dollar. Since then, the correlation has become less negative, ranging between 20% and 25% over the past two years.

DISPLAY 8

Commodities are inversely correlated with the US dollar



Source: Bloomberg as of 18 December 2017. Past performance is no guarantee of future results.

A short-term rise in the US dollar argues negatively for commodities, but again, we expect any negative US dollar impact to be limited. If the US dollar does indeed reverse once the rest of the world starts tightening monetary policy, then we are likely to eventually see a strong run in commodities as the global economy accelerates.

China: A calculated slowdown

The Chinese economy has slowed down, dampening growth in the rest of Asia. We believe this is more a deliberate government policy to remove leverage from the economy than true weakness. If Chinese growth slows too much, the government will just re-stimulate again. We do not see the recent cooling as a source of concern.

Tensions in Korea have also been negative for Asia, but with the Olympics coming up in South Korea, we believe US unilateral action to be less likely. We expect both of these issues to be resolved relatively soon, but until we see a bit more clarity we are neutral Asia ex-Japan. Looking forward longer term, the region seems quite positive.

Japan: Supported by positive trends

As we discussed in our previous piece *The Third Arrow: Governance*, we think structural reforms have taken root and are giving Japan further upside potential. There is some geopolitical risk associated with the Asian region, particularly with North Korea. There is a good chance this will be resolved in a peaceful way, but it is nonetheless a risk.

Conclusion: Expect some volatility in 2018

Last year, we expected interest rates to rise as a result of Trump's tax cuts and other fiscal stimulus. The delay of those measures postponed the rise of interest rates and inflation, leading to an unprecedented period of low volatility.

Now, however, there are a number of factors that can fuel volatility: rising interest rates, growing inflation and various political risks. The year ahead could be a bit of roller coaster ride. For experienced investors who can anticipate these risks—particularly those with the latitude to adjust their portfolio allocations—there will be plenty of interesting opportunities.

³ <https://www.reuters.com/article/us-mexico-election/mexican-leftist-lopez-obrador-leads-presidential-race-polls-idUSKBN1DM286>

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