

Goldilocks! What's next?

Weekly Digest

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– Jernej Bukovec, CFA

2017 was a Goldilocks period for global markets. All major economies were growing at a healthy pace while inflation remained in check. Monetary policy remained accommodative while post-2009 fiscal austerity eased. The US Congress, even with all the politics, passed one of the largest tax cuts seen in the past 30 years. Oil prices increased just enough for the oil industry to recover, but remained low enough that consumers didn't feel the impact. Despite the number of geopolitical risks in 2017 – North Korea, Trump, European elections – we escaped from all of it without a major political accident. As a result, the markets had one of the strongest and calmest years on record. So, can the Goldilocks market continue or will 2018 bring a change?

The bulls would be quick to point to the first synchronised global economic growth post-2009; to the double-digit growth in earnings; that even sales growth has picked up after 5 years of stagnation and that the US tax reforms will ignite US domestic investment while low inflation will enable central banks to move much slower in hiking interest rates.

Despite all the positives, 2018 might not be smooth sailing. There are clouds forming on the horizon that warrant caution. First, valuations suggest that some markets are priced for perfection with most of the good news already priced in. Although global equity markets do not seem too expensive at 18 times forward earnings, adjusting for leverage and peak margins, the valuations appear much higher. Looking at EV (Enterprise Value) to Sales, the valuations of global markets are 30% above long-term averages and close to the levels only reached during the tech bubble. The rate of global growth is expected to decelerate in the second half of 2018 while inflation might

continue to speed up, a sign we are approaching the later stages of the business cycle. Monetary policy is tightening and the QE unwind will be in full motion by the end of the year, pushing bond yields higher. This will all be happening while government and corporate debt is at record levels, meaning higher rates might have a much greater negative impact than observed during past tightening cycles.

2018 might also be the year when the global working-age population peaks, which can be an additional headwind for global GDP growth. Markets are assigning a lot of optimism to the US tax cuts to reignite the Capex cycle and stimulate future growth, but what the market does not realise is that the world is already over-invested: the global investment to global GDP ratio when also including China is the highest that it has ever been and it might be more difficult for global investment in aggregate to continue to increase.

For now, investors are still bullish and are not yet assigning much probability to the potential negative news-flow. Portfolio Managers are taking the view that some of those risks are real and that now is not the time to be overly aggressive. As everyone else is bullish, we are becoming increasingly more cautious. Portfolio Managers have been adjusting allocation to risk assets and increasing allocations to asset classes that can better weather the storm.

As for what is coming after the Goldilocks period? Who knows, but in the original story, Goldilocks falls asleep and then the three bears show up. Let's hope that the market doesn't also fall asleep to be awoken by the bear!

The Marketplace

- Brent crude was up 3.8% to \$65 a barrel
- Gold fell by -1.7% to 1353.7
- Relatively flat week overall in world markets, some bigger gains in Asia
- Threat of further regional conflict in Syria. UN declares 30 day ceasefire

Market Focus

US

- The Dow Jones finishing the week at 25309.9, up 0.4%
- US 10 year treasury yield at highest levels in 4 years after hitting 2.93% last week
- The NASDAQ rose 1.5% to 6896.6
- The VIX volatility index dropped to 16.4. A big drop from its high of over 50 earlier in February
- Trump seeks to expand the Committee on Foreign Investment (CFIUS) which would see more robust scrutiny of deals with foreign powers, particularly China
- The S&P was up 0.6% to 2747

UK

- Average weekly earnings rose 2.5% in the last year and the employment rate rose to a near record 75.2%. Unemployment however rose to 4.4%, which is the highest since August 2016. All-in-all, a muted picture
- The FTSE fell -0.7% to 7244.4

- GDP rose 0.4%, below the expected 0.5% on the back of rising inflation. Household spending at the lowest level in five years
- UK to seek a more flexible transition period in Brexit negotiations. Jeremy Corbyn is to advocate staying in the customs union
- The European Commission have voiced scepticism on passporting for services in any post Brexit deal: There are issues around the thorny language of the UKs 'mutual recognition' and the EU's 'equivalence'

Europe

- Composite PMI fell to 57.5 from 58.8 in January. Euro area still on track for quarterly growth of 0.9%, its fastest rate in eight years
- Angela Merkel seeks to stabilise her party ahead of the new coalition government with appointments designed to satisfy the right of her party as well as the balance of men and women
- The Stoxx 600 index has a flat week, finishing up 0.1% at 381.2. It's climbed over 4% since its low on February the 9th

Asia

- In China, president Xi Jinping's reign set to continue indefinitely after the Communist Party repeals presidential term limits
- The Hang Seng rose 2.5% to 31267
- The Nikkei rose 2% to 22153.6

Asset Class/Region	Currency	Currency returns			
		Week ending 23 Feb. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	0.6%	-2.6%	3.0%	17.8%
United Kingdom	GBP	-0.4%	-3.2%	-5.1%	3.2%
Continental Europe	EUR	0.2%	-3.5%	-1.1%	7.0%
Japan	JPY	1.3%	-4.1%	-3.1%	15.5%
Asia Pacific (ex Japan)	USD	1.2%	-3.9%	2.6%	27.1%
Australia	AUD	1.8%	-0.1%	-0.6%	8.3%
Global	USD	0.2%	-3.1%	2.0%	18.2%
Emerging markets equities					
Emerging Europe	USD	1.4%	-1.4%	8.7%	25.8%
Emerging Asia	USD	1.5%	-4.0%	3.7%	33.7%
Emerging Latin America	USD	1.8%	-0.7%	12.4%	21.6%
BRICs	USD	2.0%	-3.1%	8.0%	36.7%
MENA countries	USD	0.4%	-1.0%	4.3%	2.4%
South Africa	USD	-0.1%	2.9%	5.7%	32.1%
India	USD	-0.4%	-6.5%	-1.8%	22.1%
Global emerging markets	USD	1.4%	-2.9%	5.2%	30.6%
Bonds					
US Treasuries	USD	0.0%	-0.9%	-2.3%	-0.4%
US Treasuries (inflation protected)	USD	0.1%	-1.2%	-2.1%	-0.1%
US Corporate (investment grade)	USD	-0.1%	-1.7%	-2.6%	2.5%
US High Yield	USD	-0.1%	-1.1%	-0.5%	4.1%
UK Gilts	GBP	0.6%	0.0%	-2.1%	-0.4%
UK Corporate (investment grade)	GBP	0.2%	-1.3%	-2.1%	1.7%
Euro Government Bonds	EUR	0.0%	0.0%	-0.4%	1.3%
Euro Corporate (investment grade)	EUR	0.1%	-0.1%	-0.3%	1.5%
Euro High Yield	EUR	-0.2%	-0.9%	-0.5%	4.5%
Japanese Government	JPY	0.2%	0.4%	0.2%	1.1%
Australian Government	AUD	0.5%	0.1%	-0.4%	2.9%
Global Government Bonds	USD	-0.5%	-0.4%	0.9%	7.0%
Global Bonds	USD	-0.4%	-0.7%	0.3%	6.9%
Global Convertible Bonds	USD	0.3%	-0.9%	2.8%	9.2%
Emerging Market Bonds	USD	-0.4%	-2.3%	-2.8%	1.7%

Asset Class/Region	Currency	Currency returns			
		Week ending 23 Feb. 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	-0.6%	-5.8%	-9.8%	-9.1%
Australian Property Securities	AUD	1.3%	-4.1%	-7.3%	-5.2%
Asia Property Securities	USD	1.0%	-5.9%	1.1%	18.1%
Global Property Securities	USD	0.1%	-5.2%	-4.1%	6.4%
Currencies					
Euro	USD	-1.1%	-0.9%	2.4%	16.5%
UK Pound Sterling	USD	-0.4%	-1.4%	3.4%	11.5%
Japanese Yen	USD	-0.5%	2.6%	5.7%	5.8%
Australian Dollar	USD	-1.1%	-2.7%	0.3%	1.6%
South African Rand	USD	0.2%	2.7%	7.1%	11.3%
Swiss Franc	USD	-1.0%	-0.3%	4.1%	7.8%
Chinese Yuan	USD	0.2%	-0.7%	2.8%	8.5%
Commodities & Alternatives					
Commodities	USD	1.1%	-0.9%	2.3%	6.2%
Agricultural Commodities	USD	0.9%	1.8%	3.9%	-3.7%
Oil	USD	3.8%	-2.5%	0.7%	19.0%
Gold	USD	-1.7%	-0.7%	1.8%	6.5%
Hedge funds	USD	-0.3%	-1.4%	1.0%	5.2%

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