Global Perspectives, December 2017: Outlook for 2018

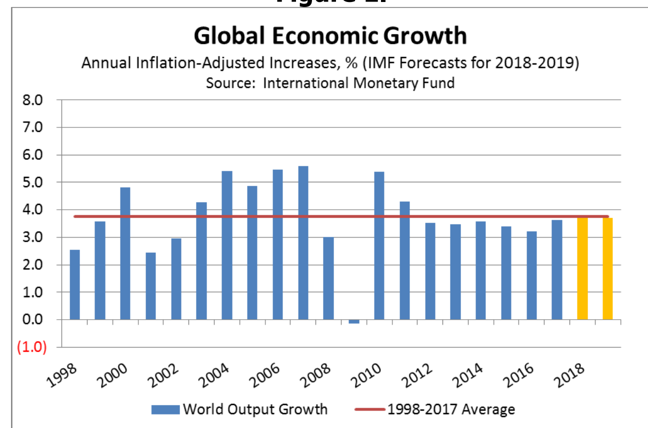
The year 2017 was a doozy for global stock markets. For U.S. stocks, the S&P 500 index is on track to post a total return of more than 22%. Other world markets as a whole look like they'll gain even more. Other asset classes didn't provide nearly that kind of performance, but it's important to note that they generally offered returns that were in line with their long-run averages. Now, as we approach the New Year, the question is how the investment environment looks for 2018.

Economic Overview

Here at WMI, our approach to developing investment strategy is very "big picture" and "top down." We focus on tracking the global economy and financial markets as the best way to identify the big, long-lasting trends that might present attractive investment opportunities. We believe our analysis also helps us identify some of the major short-term and long-term risks that need to be considered.

Importantly, the global economy is now growing at its best sustained pace since before the Great Recession of 2008-2009. To make matters even better, the expansion has become well "synchronized," with all of the major economies now growing and many of them getting even stronger. As shown in Figure 1, the International Monetary Fund (IMF) currently forecasts that global economic output growth will accelerate slightly from about 3.6% in 2017 to 3.7% in 2018. We think that bodes well for corporate profits around the world. Nevertheless, today's economic acceleration follows a long period in which consumers, businesses, and governments were struggling to deal with high debt and collapsed asset prices left over from the recession. Many individuals and organizations continue to keep a tight lid on spending. On top of that, some major central banks have already started to remove some of the monetary stimulus they were providing to help support the post-recession recovery. Those issues are exacerbating the broad, long-standing challenges from factors such as slowing population growth, population aging, tepid investment, and excess supply in some commodity markets. The projected global economic growth in 2018 is therefore still slightly below its average annual rate of 3.8% over the last two decades, and there seems little chance that growth will surprise very much to the upside. The good thing is that modest growth has kept inflation pressures from building very rapidly. We think that will allow the key central banks to keep raising interest rates and cutting their asset purchases only gradually over time, though we are keeping an eye open for any sign that the policymakers might make a mistake and tighten policy faster.

Figure 1.



The acceleration in the global economy comes in part from strengthening in the dominant U.S. economy. The IMF currently forecasts that growth in U.S. gross domestic product (GDP) will accelerate from 2.2% in 2017 to 2.3% in 2018, compared with an average annual rate of 2.2% since 1998. In our view, the economy remains in a well-established, self-sustaining expansion phase, in which increased demand spurs greater production and more hiring, which in turn prompts even further increases in demand, and so on. The rate of growth may be historically modest, but we think that has helped slow the buildup of inflation pressure and the other kinds of imbalances that have tripped up the economy in the past. Therefore, for the time being, we think the Federal Reserve can keep tightening monetary policy only gradually, i.e., the policymakers should be able to raise interest rates and reduce their bond purchases slowly enough to avoid disrupting the financial markets too much. The risk is that the tax cuts just signed into law will probably give the economy a further jolt just as it was already strengthening. That could

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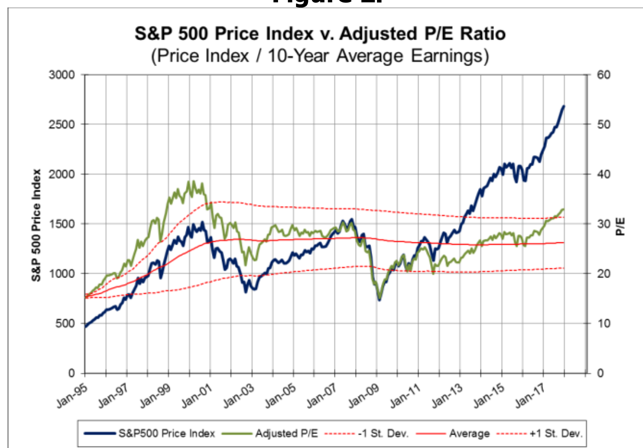
mean inflation will become a problem sooner than it otherwise would have, while budget deficits down the road will likely be even worse than previously expected.

U.S. Stocks

U.S. stocks remain in a bull market. Prices continue to rise, just as they have since early 2009. Valuations have therefore become elevated, with the price/earnings ratio on the S&P 500 Index now well above its level just before the 2007 market crash, although the P/E ratio is still much lower than before the Tech Crash at the turn of the century (see Figure 2). Nevertheless, because of the relative strength in the U.S. economy and the possibility that growth could soon broaden, boosting earnings further, we think the bull market will probably continue well into the New Year. Other indicators are also encouraging. For example, our analysis shows that bull markets in stocks have historically continued until earnings per share reach statistically extreme levels and then pull back, but earnings still have not quite reached those levels (see Figure 3). Our analysis also shows that bull markets have historically continued until short-term interest rates rise to the point where they are equal to long-term rates, but rates likewise have not yet gotten to that point, although they have gotten closer.

Figure 2.



Technical indicators also suggest stocks could potentially keep moving higher, at least in the near term. For example, the S&P 500 price index remains above its 20-day simple moving average (SMA), while its 20-day SMA stands above its 50-day SMA, and its 50-day SMA stands well above its 200-day SMA, all of which we consider to be a pattern consistent with an entrenched upward trend. In addition, the recent string of consecutive month-end record highs in the index suggests stocks will continue to climb, though perhaps with new records coming less frequently. Another positive indicator is that over 77% of the stocks in the S&P 500 index are now trading above their 200-day SMA, indicating the market uptrend is quite broad. Finally, the Dow Jones Transportation Index has recently been rising in line with the overall market, which has traditionally been a positive sign for stocks. The main short-term negative is that momentum indicators (such as the "moving average convergence/divergence," or MACD) suggest stocks have become relatively over-bought and are now more susceptible to a short-term pullback or correction.

Figure 3.

Foreign Stocks

As more countries joined the global economic expansion in 2017, foreign stocks unexpectedly posted strong gains. In our view, the jump may have been somewhat excessive in comparison with the true improvement in foreign economic growth, so it is not clear that non-U.S. stocks as a group can continue to rise strongly in 2018. Moreover, the economic headwinds from factors such as population aging and limited investment are stronger in many foreign countries than in the United States. Nevertheless, we continue to see particularly strong momentum in several individual foreign markets, including:

Japan. Over the long term, we think factors such as population aging and low inflation will be challenges for Japan's economy, corporate profits, and stocks. All the same, Japanese businesses and Japanese stocks are currently enjoying a short-term jolt from the relatively weak yen and rising exports. Loose monetary policy has also helped buoy activity. Unemployment stands near a 24-year low, and inflation has accelerated modestly. Japanese stocks therefore rose strongly throughout 2017, and all indications are that they have enough momentum to continue rising for at least a while yet in 2018.

Germany. With economic activity now strengthening in countries such as the United States and Japan, the

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demand for German goods and services has improved. Just as important, Europe's domestic economic and financial conditions finally appear to be normalizing from the crisis years immediately after the Great Recession, so German exports to other European countries are also strong. With businesses producing more and more, unemployment has become quite low, profits are high, and German stocks are on the rise.

India. Like most emerging markets, India's economy and Indian stocks can be volatile. Nevertheless, we believe Indian stocks will tend to benefit over time from the country's relatively high population growth and rapid increases in per-capita income. We also think the government's recent moves to reduce trade barriers, lower taxes, attack corruption, and bolster property rights could raise Indian companies' profitability in the coming years. Believing that a lot of the good news is already reflected in Indian stock prices, we have recently pared back our exposure to the country, though we still include exposure to India in our more aggressive strategies.

Fixed Income

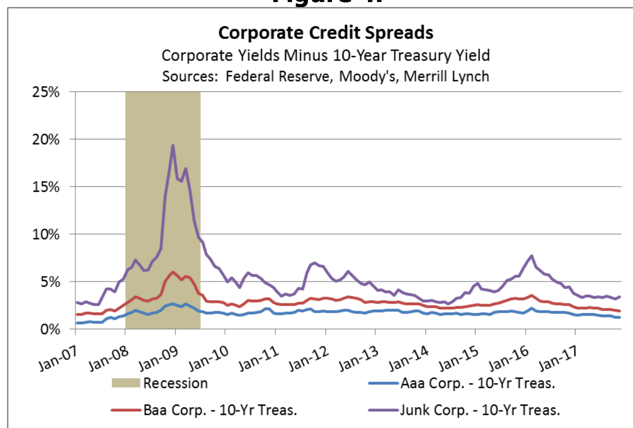
We believe the primary role for fixed-income investments is to lend a measure of stability to a portfolio and produce a relatively secure stream of income. All our bond strategies therefore focus on U.S. fixed income. As expected, U.S. bond prices rebounded through most of 2017, but they began to weaken again in the fourth quarter in response to accelerating economic growth, continued rate hikes by the Federal Reserve, and prospects for a major tax cut that promised to goose economic growth further and probably widen the federal budget deficit going forward. At the end of 2017, prices should be modestly below their levels at the end of 2016. Yields have risen almost to the top of their recent range. As measured by the S&P U.S. Aggregate Bond Index, U.S. investment-grade bonds are on track to provide a total return of about 2.9% for 2017.

As 2018 unfolds, we see both positive and negative factors for U.S. fixed income, and we suspect those factors will roughly balance each other in the new year and keep total returns low. Among the challenges, we think the risk of accelerating inflation and faster interest-rate hikes by the world's central banks will keep bond investors on edge during 2018. Coupled with the prospect of wider federal budget deficits, that will likely discourage some bond buying. Among the positive indicators, however, we think current yields are high enough to entice insurance companies, pension funds, and many other yield-seeking investors to buy again in spite of their concerns. On top of that, we suspect that the rich valuation of stocks could prompt some investors to shift part of their funds back into bonds. We think the most attractive bond sectors in 2018 will be:

Investment-Grade Corporate Bonds. During the mid-to-late stages of an economic expansion, as we appear to be in now, total returns from investment-grade corporate bonds have historically been strong compared with the return from federal government bonds. Fed rate hikes are often relatively small compared with larger yields that corporates usually offer, so these bonds can hold up well in a rising-rate environment. Moreover, today's healthy economic environment suggests corporate finances will remain solid and defaults should be minimal for the time being. Indeed, there has been no significant sign of any widening in the "credit spread" (the difference between yields on riskier corporate bonds and low-risk Treasury obligations), as has historically happened before a recession and a spike in defaults (see Figure 4). Finally, a provision in the tax reform will discourage firms from issuing as much debt as in the past, and we think that over time, the reduction in the supply of high-quality corporate bonds will tend to raise their value.

Municipal Bonds. Although the impact of the tax reform will not touch the municipal sector as broadly as the corporate sector, there are some provisions that will likely reduce the supply of certain kinds of municipal bonds. As with corporates, we think the reduction in supply will tend to buoy the value of existing obligations.

Figure 4.



Alternatives

For the "alternative" investments that we consider, we continue to believe that the three most important market themes include rising interest rates, a reduction of excess supply in some commodity markets, and continued moderate growth in demand. We think those and other trends will play out in the key alternatives as follows:

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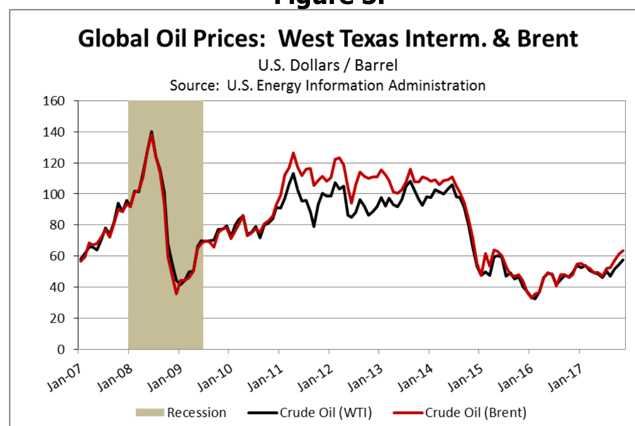
Real Estate. In our view, fundamentals remain relatively healthy for publicly-traded real estate investment trusts (REITs). We think healthy U.S. economic growth should boost the demand for properties ranging from warehouses to data centers, which in turn should buoy rents. Nevertheless, some real estate sectors continue to face headwinds. For example, many retail firms are closing stores in response to on-line competition, and there has been a surge of supply in the apartment sector. Even more important, investors betting on faster growth continue to shift funds into riskier stock sectors. Probably most important, rising yields on fixed-income securities have made the rich dividends paid by REITs look relatively less attractive, while higher interest rates will make it more expensive for REIT companies to build or buy the new properties necessary to boost their dividends in the future. Because of the risk that the on-going rise in interest rates and yields could continue or even accelerate, we suspect REITs will continue to be challenged. We have therefore recently pared back our exposure to REITs in several of our strategies, and we expect to keep our exposure to them relatively low through much of 2018.

Commodities. We remain cautiously optimistic regarding the outlook for crude oil and natural gas prices. We continue to think that rising usage, falling output in some producing countries, and reduced investment in new exploration and development will ultimately bring supplies back down into balance with demand over the medium term, allowing prices to trend upward. Indeed, global energy prices have already started to rise (see Figure 5). We look for similar trends in many other key commodities, such as industrial metals, so we want to maintain at least some commodity exposure in most of our strategies. Because of our caution regarding the impact of rising U.S. oil output in the near term, however, we are maintaining only limited exposure to commodities in our strategies for the time being. One area where we are looking to maintain focused exposure is in gold and precious metals. In our view, the various financial markets seem a bit too sanguine regarding geopolitical risks regarding countries ranging from North Korea and Iran to Russia. Gold has often performed well during an international crisis, providing a bit of cushion when other asset prices are falling. We are therefore maintaining our exposure to the yellow metal. In contrast, we still do not see the long-awaited rebound in agricultural commodities. While global weather trends continue to buoy supplies, we are becoming increasingly convinced that rising output in the developing countries could be having an out-sized negative impact on pricing and will continue to do so for a while yet.

Figure 5.



Risks and Conclusion

At present, we believe the main domestic risks in 2018 include a possibility that the tight U.S. labor market will boost wages too high, capping corporate profits and potentially prompting the Federal Reserve to raise interest rates faster and further than currently planned. Another key domestic risk is that protectionism or other policy surprises under the Trump administration could spook the markets. On a related note, the behavior of various political actors to date suggests to us that there is an unappreciated risk of an acrimonious political crisis in the coming year, depending on the findings of the special counsel investigating ties between Trump administration officials and the Russian government. As discussed above, we also continue to focus on the risk of an international security crisis involving North Korea, Iran, Russia, or China.

Despite the remaining risks, however, we believe the outlook for 2018 is positive for U.S. stocks, select foreign stocks, corporate bonds, and certain commodities. We are therefore looking to keep all our various strategies fully invested, but with somewhat over-weight positions in areas such as equities and corporate bonds. We continue to keep an eye out for any risks that could hurt our returns or undermine our portfolios, and we will continue to keep you well informed as our observations and strategies evolve over time.

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