Investment outlook

The macro environment is transitioning away from slow growth, low inflation and highly stimulative monetary policies to faster growth, normal inflation and tightening central banks. The expansion is highly synchronized and global growth is running at its fastest pace in eight years.

Global macroeconomic environment remains positive

Benefiting from positive momentum in 2017, the economic backdrop is quite good by post-crisis standards. Many of the macroeconomic indicators we monitor are at or near cycle highs. Financial conditions are still reasonably supportive, fiscal stimulus should provide a tailwind, and the headwinds of secular stagnation may be fading as evidenced by reviving risk appetite and improving productivity growth. We upgraded several of our developed-world growth forecasts for 2018 and they are mostly above consensus. Our emerging-market growth forecasts are slightly below the consensus but still suggest robust growth ahead. Taken together, our global growth forecast for 2018 is 4.0%, which would be the fastest growth rate since the global financial crisis.

Risks are constantly evolving, but potential upside exists too

Key risks to our outlook are the aging business cycle, rising interest rates and protectionism. Several factors suggest the business cycle is in its later stages: a closed output gap, extremely low unemployment rates, a U.S. Federal Reserve (Fed) that has been tightening for some time, narrow credit spreads and optimistic sentiment. Financial conditions remain supportive but have tightened somewhat as a result of higher interest rates. Were this upward trend to continue, it could drag on growth and highlight debt vulnerabilities. Tariffs imposed by the U.S. and the renegotiation of NAFTA represent headwinds to global trade, and other risks we are monitoring relate to European populism, geopolitical risks and Chinese debt. Although the economy faces a number of challenges, we should not ignore clear upside potential from structural reforms in Japan and U.S. fiscal stimulus. On balance, we expect the positives to outweigh the negatives, enabling further growth in the global economy.

U.S. fiscal stimulus provides tailwind to already solid economy

Although it is unusual to deliver fiscal stimulus at a time when economies are strong enough to justify central-bank tightening, tax cuts and increased government spending in the U.S. will help push along an already strong economy. The tax-cut package amounts to US$1.5 trillion of stimulus over the next decade and will likely boost U.S. GDP by 0.4% in 2018 and 0.3% in 2019. The additional government spending in the budget should add a further 0.2% to growth in 2018 and 0.1% in 2019.

Currency movements to be driven largely by country-specific factors rather than broad U.S. dollar trend

Our currency outlook has been shifting in recent quarters away from double-digit returns for the U.S. dollar as we recognize changes in economic and monetary trends. Uncertainty associated with turns in long-term trends justifies our patient approach in calling the start of a downtrend, which, once firmly established, we expect to last for many years. Past turning points in broad dollar trends have unfolded through a process whereby the greenback makes highs versus different currencies in sequence rather than all at once. This pattern is repeating, and we see an environment that is shifting in favour of the euro and yen, while we retain a less rosy outlook on the British pound and Canadian dollar.

Inflation transitions to more normal regime

For a significant portion of the post-crisis era, deflation had been a concern, but investors may now be recognizing that a regime shift is underway. Our view is that inflation is simply transitioning to more normal levels after many years of being too low, rather than shifting higher to problematic levels. In fact, a number of structural headwinds related to demographics, globalization, technological change and sector-level shifts may limit just how fast prices can ultimately rise.

Era of extreme monetary stimulus is ending

Faster economic growth and higher inflation warrant the gradual removal of highly accommodative monetary policies. The Fed has made the most progress among the major central banks: it has raised interest rates five times this cycle and appears on course to hike four more times over the next year, and is actively shrinking its balance sheet. The Bank of England and Bank of Canada have also joined the tightening trend. Central banks in Europe and Japan are still delivering quantitative easing to stimulate their economies, but the pace of their bond-buying has slowed. Global monetary policies are still quite easy by historical standards, but the transition from extraordinary stimulus to normality is clearly underway.

Increase in yields alleviated valuation risk in sovereign bonds

Our models continue to suggest the long-term direction for bond yields is higher, but that the meaningful increase in yields over the past quarter has alleviated valuation risk in the near term. Bond yields are already reflecting an inflation premium close to our expectations so, barring an inflation shock, any meaningful increase in the U.S. 10-year bond yield over the coming years is likely to come from a rise in real (after-inflation) interest rates. In our view real interest rates are unlikely to remain well below their long-term average now that the economy has regained its footing. The resulting upward pressure from rising real rates on nominal bond yields means that fixed income may act as a drag on investment returns for many years.

Stock markets undergo correction, earnings outlook remains solid but valuations are vulnerable

Stocks corrected last month after a year of strong performance and unusually low volatility. Investors were unsettled by the prospect of higher inflation and interest rates. Our models do see these as a drag on equity-market valuations, but the impact is relatively small. Much more important to valuations is investor confidence, which is currently high and bolstered by solid growth in corporate profits. Earnings have been growing quite nicely and, bolstered by the U.S. tax cuts, are expected to advance 19% in 2018 and another 10% in 2019. Of course, earnings forecasts have always had a tendency to slip as time moves forward and demanding valuations are vulnerable to disappointment. In this environment it may be prudent to lower total-return expectations and anticipate higher sustained levels of volatility.

Asset mix: reducing bond underweight and maintaining slight overweight in stocks

Reflecting the balance of risks and opportunities, our asset mix is now closer to neutral than it has been in many years. We have been dialing back our equity exposure as the cycle advanced and valuations became less compelling. That said, we think it’s too early to call the end of the bull market. We recognize that equities are not as attractive as they were at previous points in the cycle but, in our view, the potential upside in corporate profits is worth a mild overweight in stocks. In fixed income, we have held big underweights for a long time but have been narrowing that gap as the business cycle matures and yields move higher. In fact, we added one percentage point to our fixed-income position this quarter, sourced from cash. The outlook for bonds remains unexciting, but the recent rise in yields has lowered valuation risk, and bonds serve as ballast against rising volatility and/or unexpected deterioration in corporate profits. For a balanced, global investor, we currently recommend an asset mix of 58% equities (strategic neutral position: 55%) and 40% fixed income (strategic neutral position: 43%), with the balance in cash.

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