Investment outlook

Global economic growth is running at its fastest clip in seven years thanks to a number of positive factors. The expansion is increasingly broad-based and signs of weakness in the economy are not yet in evidence. Robust confidence measures and risk appetite are also fueling macroeconomic strength.

Global expansion gains momentum

We are increasingly of the view that the secular stagnation that held back economic growth for much of the past decade may be finally fading as the bad memories of the financial crisis recede, a new generation of business leaders rises to power, animal spirits revive and business investment picks up. Also buoying the economy is the fact that financial conditions remain friendly thanks to still-low government bond yields, narrow credit spreads, rising equities and oil prices in a sweet spot that supports global growth without punishing oil exporters. Looking forward, we anticipate further strong, above-consensus GDP growth and rising, above-consensus inflation. Our global GDP forecast is for 3.8% growth in 2018 – an upward revision from the prior estimate. Growth in 2018 should just surpass 2017, itself the fastest pace in several years.

Challenges remain, but upside potential exists too

There are a number of risks that could challenge our above-consensus view. The business cycle is aging, protectionism is on the ascent and international relations have become precarious in several pockets of the world. After dodging several populist threats, European politics now face another onslaught of challenges in the form of elections, independence movements and nationalist governments. Chinese risks have shrunk given stabilizing growth and improving debt metrics, but the country's economy is still likely to decelerate over time and the highly indebted corporate sector is vulnerable to rising interest rates. Canada's housing market is also susceptible to higher borrowing costs, as are a variety of exotic investment instruments that rely on leverage to boost returns in a low-yield world. Fortunately, the current environment also features a number of positive developments. These are related to fading concerns surrounding secular stagnation, structural factors inhibiting an unwelcome surge in inflation and the potential for governments to deploy fiscal stimulus, particularly in the U.S.

Post-U.S. election optimism persists

The election of President Trump a year ago appeared to have had a significantly positive effect on global confidence. The rationality of this optimism is debatable – Trump's proposed policies have at best mixed implications, few have been implemented so far, and fewer still would appear to benefit any country but the U.S. Nevertheless, we cannot ignore that consumers and businesses both began to feel much more confident about their economic prospects immediately after the election, and this positive sentiment can boost economic growth.

U.S. dollar bull market maturing

We're nearing the end of the U.S. dollar upswing, but it's a process that will take time, possibly years. Patience is now required as the environment is one where foreign-exchange fluctuations are no longer driven predominantly by the direction of the U.S. dollar, but rather by the relative merits of each currency. Differences in growth and balance-of-payments dynamics are likely to be the key factors going forward and, with that in mind, we expect the euro and the yen to fare better than the pound and Canadian dollar.

Firming inflation may be limited by structural forces

Several factors suggest higher inflation over the next year. Commodity prices have rebounded, developed-world economies are approaching their full potential and we detect rising wages amid an increasingly tight labour market. Counteracting these positives are some structural pressures that may limit how quickly inflation can rise. The constraints include adverse demographics, the effects of globalization and some technology-induced deflation. To be clear, inflation can still accelerate and likely will, but not by quite as much as traditional models might indicate.

Central banks continue to dial back accommodative policies in response to firming economic backdrop

As growth has picked up, economic slack diminishes and inflation begins edging higher, central banks are responding with a slow pivot away from extreme monetary stimulus. The U.S. Federal Reserve (Fed), the Bank of Canada (BOC) and the Bank of England (BOE) have all begun travelling down this tightening path, with the Fed leading the way. Others, such as the European Central Bank (ECB), are still some distance away but are beginning to at least reduce their rate of stimulus delivery.

Global bond yields remain too low according to our models

We expect bond yields to continue moving higher, but that the pace will likely be gradual and occur over a period spanning many years. Our fixed-income models suggest that real (after-inflation) interest rates are currently too low. Some of the factors that have been depressing real interest rates include unorthodox monetary policy and a heightened demand for safe-haven assets. But in an environment where economic growth is gaining momentum and secular stagnation may be starting to lessen its grip, we would expect real interest rates to ultimately rise back towards their long-term average as investors (savers) at some point demand a true after-inflation payment to defer consumption. Our models assume this reversion occurs over the next five years, though we would place emphasis on the direction rather than the exact timing.

Global equities narrow discount to fair value, become more dependent on earnings growth to sustain the bull market

Global stock markets continue to be supported by the synchronized global expansion and better-than-expected corporate profit growth around the world, but the recent rally has pushed equities closer to fair value. The S&P 500, in particular, hovers just below the midpoint of its fair-value band and, while our model doesn't suggest stocks are as expensive as some other popular metrics, we recognize it may be prudent to lower total-return expectations and consider the potential for higher volatility in the months ahead. Without support from rising valuations, further gains in stocks will likely be paced by corporate profit growth. Earnings have indeed been coming through and analysts are optimistic that the positive trend can persist. Corporate tax cuts in the U.S. could provide an additional boost to profits, though at least some portion of the anticipated changes has already been priced in. Given current valuations, stocks would be vulnerable if earnings underwhelm and/or Congress fails to enact the proposed tax changes.

Asset mix: maintaining overweight stocks, underweight bonds

In our base case scenario of improving economic growth and firming inflation, prospective returns for sovereign bonds are especially unattractive. The capital loss from rising yields is likely to offset any income earned from coupon payments, resulting in low or even negative returns for sovereign bonds, perhaps over many years. In comparison, stocks continue to offer superior total-return potential. We recognize, however, that the deep discounts available at earlier stages of the bull market have been erased and that further gains for equities will depend on earnings growth. We are watching ever more diligently for signs of a top in equity markets, but we are not seeing an abundance of signals that would indicate the end of the cycle. We had been reducing risk exposure in our asset mix over the past several quarters, but have opted to pause this quarter given the absence of technical deterioration, the ongoing strength in profits and the increased possibility of meaningful U.S. corporate-tax cuts coming to fruition. As a result, we have maintained a moderate overweight in stocks and underweight in fixed income. For a balanced, global investor, we currently recommend an asset mix of 58% equities (strategic neutral position: 55%) and 39% fixed income (strategic neutral position: 43%), with the balance in cash.

Global Asset
Management

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