Investment outlook – Fall 2018

Global financial markets have delivered mixed results so far this year on the back of decent, but uneven, economic growth, firming inflation and tightening monetary policies. Although a variety of leading indicators have softened somewhat, the consensus outlook for global growth in 2018 and 2019 remains the best since 2011.

U.S. economy leads the global expansion

Bolstered by large-scale tax cuts and increased government spending, the U.S. economy has accelerated to its fastest growth rate in four years. In the second quarter, U.S. real GDP grew 4.2% and is tracking a similar rate for the third quarter. We continue to believe that the speed limit for developed-world growth has increased since the global financial crisis as confidence among businesses and consumers has been restored. While global growth is still running at an above-average pace, many major economies aside from the U.S. are losing steam. The Eurozone economy is expanding at a slower pace than it did in 2017 and Chinese growth is showing further evidence of deceleration. The mild slowdown in economic momentum since the start of the year leads us to lower our developed-world growth forecasts slightly and they are now mostly below consensus. Our emerging-market growth forecasts are also below the consensus estimate.

Key threats to our positive outlook

Protectionism, China's economic slowdown and the aging business cycle are among the key risks that threaten our base-case view of solid, albeit moderating, economic growth. Trade tensions between the U.S. and China are the most concerning, as more tariffs could lead to a loss in economic activity for the world's two largest economies. Chinese policymakers are now actively delivering stimulus to counter the country's slowing economy, but doing so may reintroduce worries of too-high debt levels. Other risks we are closely monitoring include rising populist sentiment in Europe, approaching deadlines for Brexit, U.S. mid-term elections and tightening financial conditions.

Late in the business cycle, but few signs of ending

Our assessment of a variety of indicators leads us to believe that the U.S. economy remains at a fairly late stage in the business cycle, but that a recession is unlikely within our one-year forecast horizon. Economic slack has diminished and demand is running slightly ahead of sustainable levels. Credit spreads are narrow and delinquency rates on a variety of loans are beginning to rise, both of which are consistent with late-cycle behaviour. The slope of the yield curve – a popular tool for predicting recessions – has flattened meaningfully and indicates that the cycle is indeed advanced. But the yield curve has not yet inverted, which would be a strong indicator of imminent recession.

U.S. dollar strength likely to persist over the longer term

We remain bullish in our 12-month forecast for the U.S. dollar, which is benefiting from strong relative economic growth, currency-supportive monetary and fiscal policies, as well as risk-aversion caused by emerging-market challenges. For these reasons, though, the U.S. dollar has become extremely overbought in the near term and could experience a temporary pullback. That said, we continue to expect long-term U.S. dollar strength in light of Brexit, an economic slowdown in Europe and competitiveness issues in Canada. We look for a weakening in the British pound, Canadian dollar and euro, but expect continued strength in the Japanese yen over the next year.

Tight economies push inflation higher, but not to problematic levels

Shrinking economic slack and historically low unemployment rates are finally putting upward pressure on consumer prices after many years of unusually low inflation. Also contributing to higher inflation has been a rally in commodity prices and protectionist actions. Oil prices may struggle to deliver further gains, though, as inventories are no longer falling and U.S. supply continues to soar. A number of other structural factors linked to demographics and technological advancements will likely keep a lid on price increases and prevent inflation from rising to problematic levels.

Monetary policy is becoming less accommodative

In response to strengthening labour markets and firming inflation, central banks have continued a gradual tightening of monetary policy. The U.S. Federal Reserve is the furthest along, having raised rates seven times so far this cycle with plans to deliver several more hikes. The Bank of Canada and Bank of England have also joined the tightening trend, albeit with less intensity. The European Central Bank (ECB) and Bank of Japan continue to stimulate their economies with large-scale bond-buying programs and negative-interest-rate policies, but the ECB is expected to end its QE program later this year, paving the way for rate increases in the second half of 2019.

Models predict gradual increase in bond yields

We don't expect a significant near-term increase in the U.S. 10-year yield given that it is trading near our modelled equilibrium level. However, the equilibrium level rises over time and indicates gradual upward pressure on nominal bond yields over the longer term. Our model, composed of an inflation premium and real interest rate, suggests the entire increase in yields over the next few years will come from rising real rates of interest, as higher inflation has already been priced in. Moreover, as time passes and memories of the financial crisis fade, investors are starting to demand a higher after-inflation return on their savings. Our model assumes that real rates revert to their historical norm over the next half-decade and that the increase is distributed evenly over time. As a result, we could be in for a sustained period of rising yields that would act as a headwind to bond returns for many years.

U.S. equities climb to record while other markets wane

Global equities were mixed over the quarter, with the S&P 500 Index rising to an all-time high while many other markets posting negative returns. Emerging-market stocks fell nearly 20% from their January peak and are now trading at their cheapest levels relative to our estimate of fair value since 2016. In contrast, the rally in the S&P 500 Index pushed it above fair value, propelled by soaring earnings and revenues. In the second quarter, profits in the U.S. climbed 26% year over year and revenue growth was 10%. Our analysis of a variety of scenarios suggests that stocks can deliver decent upside with reasonable assumptions, as long as earnings continue to come through as analysts expect. We recognize, however, that given the late stage in the business cycle and the fact that valuations are above equilibrium, earnings growth is now critical to sustaining the bull market in stocks.

Maintaining mild overweight stocks and underweight bonds

Weighing the risks and opportunities, we believe it is appropriate for a balanced investor to maintain a slightly above-benchmark exposure to risk assets. In our view, economic growth will be sufficient to drive further gains in corporate profits and revenues. In this environment, equities should outperform fixed income over our forecast horizon and we remain overweight stocks and underweight bonds as a result. That said, given the aging business cycle and the fact that U.S. equities are above fair value, we have reduced our total-return expectations and caution investors to expect heightened levels of volatility over the coming quarters, and we are holding less exposure to stocks than we have at earlier points in the bull market. We are also holding a larger fixed-income position than we have in the past since bonds should provide a cushion in a balanced portfolio in the event of a recession and/or deterioration in the outlook for 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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