The four seasons of 2017: Key themes for the coming investment landscape

With its highs and lows now behind us, 2016 looks to be a year of respectable returns. Our 2017 market outlook is for a stable investment landscape dominated by four big themes. We find they share features of the four seasons, though these themes may occur throughout the year.

• **Spring: Reviving growth**
  A moderate improvement in global growth momentum in recent months has likely set a constructive tone for risk assets. Consumption is expected to anchor growth in developed economies, although concerns about U.S. recession risk could return from time to time. Emerging markets (EM) could continue rebounding and once again outperform developed economies, owing to the stabilization of commodity prices and the U.S. dollar.

• **Summer: Headline inflation heating up, core subdued**
  Headline inflation is expected to rise in the first half of 2017 due to a recovery in energy prices. A tightening U.S. labor market could also push inflation expectations higher. President Donald Trump’s fiscal expansion plans, immigration and trade policy could also fuel inflation expectations. However, price pressures from global demand will likely remain tame due to plentiful spare capacity. This implies limited upside risk of rising core inflation around the world, despite the persistence of loose monetary policy.

• **Autumn: Monetary policy drying up**
  Central bank and government policy options to boost growth are increasingly limited. Market expectations of a tapering in quantitative easing (QE) by the European Central Bank (ECB) and Bank of Japan (BoJ) could rise, as those institutions reach the limits of balance sheet expansion. Still, global liquidity is likely to remain plentiful; we expect the hunt for yield to continue to be important for Asian investors. Fiscal stimulus could offer a short-term boost to growth, but is constrained by skepticism over its implementation as well as developed economies’ high levels of public debt.

• **Winter: Threat from politics and leverage**
  Many recent market shocks had their origin in politics, including the Greek debt crisis in 2015 and the Brexit referendum in 2016. Throughout 2017, we will monitor possible shocks from Europe and in the U.S. A second threat: High leverage across many economies could undercut the sustainability of global growth. China’s high corporate debt is not expected to implode, as Beijing has ample policy options available, but the effort to deleverage will likely continue to dampen growth.
What do the four seasons—our themes for 2017 investing—mean for investors?

In the investment landscape we anticipate, a well-diversified portfolio remains essential. A stable growth environment should benefit equities—especially cyclicals and financials—rather than the bond-proxy stocks that outperformed in recent years. Emerging markets could continue to benefit from a steady dollar, still-attractive valuations and the prospect of improved earnings led by domestic demand.

Government bond yields are likely to experience spikes during episodes when short-term inflation expectations rise and markets grow concerned about monetary policy’s limitations. However, central banks will still be expected to do all they can to keep liquidity plentiful, implying a bear steepening of the yield curve. Income will continue to be important to help boost investors’ real return.

This paper uses 14 charts* from the Guide to the Markets - Asia to spotlight themes across the 2017 investment landscape that we believe investors should monitor to construct an informed and rational view and guide investment decisions in 2017.

We wish you a prosperous 2017, and happy investing!

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*Data of these 14 particular slides selected from the 4Q 2016 Guide to the Markets - Asia reflect most recently available as of October 31, 2016.
Spring: Reviving growth

Stable, if modest, global economic growth should shore up recoveries and support confidence in 2017—tempered, however, by sluggish trade and corporate caution about business investment.

**ECONOMIC GROWTH: MODEST IMPROVEMENT IN MOMENTUM**

- Manufacturing PMIs, as shown on this page, have reflected an improvement in global growth momentum in recent months that we expect to carry into 1H 2017. Consumption is expected to anchor U.S. and European growth, though business investment will be dampened by cautious corporate sentiment.

- Investors may question the lifespan of the U.S. economic cycle, since it is the fourth longest expansion since 1900, but we detect no immediate threat of a downturn. This also partly depends on if President Trump’s fiscal plan of infrastructure spending and tax reform can be executed effectively.

- A rebound in raw material prices has helped commodity-dependent EM countries to recover. We expect EM growth to outperform developed market (DM) growth once again. China’s economic stability is helping calm investors and improve business confidence.

- EM central banks have been able to cut interest rates to support growth, given the recovery of their currencies. However, sluggish improvement in global trade and clouds over globalization could favor large EM economies with firm domestic demand.

Summer: Headline inflation heating up, core subdued

Headline inflation may be warming with energy prices rising from their 2016 bottom, and investors may worry, but we expect price stability and continuing central bank accommodation in 2017.

**INFLATION: ENERGY HELPS HEADLINE REBOUND; CORE SUBDUED**

- Since 2015, declining energy prices have lowered headline inflation worldwide, as this chart shows. However, this is expected to reverse at least for the first half of 2017, as oil prices bottomed in 1Q 2016, pushing headline inflation above core for the first time this decade.

- Combine headline inflation with rising U.S. labor costs and the possibility of an inflation shock could worry investors, leading to greater volatility in the long end of the U.S. Treasury yield curve.

- We expect core inflation to remain broadly stable. Global growth is in line with trend and there is still plenty of spare capacity before demand-side pressures build.

- Central banks around the world are unlikely to overreact and aggressively reverse their accommodative monetary policies in 2017.
Autumn: Monetary policy drying up

Investors’ concerns that DM central banks are running out of policy options are valid to some extent, but this does not imply central banks will reverse their ultra-loose policy stances anytime soon.

RATES: CENTRAL BANKS APPROACH POLICY LIMITS

• The BoJ and the ECB are facing limitations to their QE programs and investors may be concerned that these central banks are running out of policy options. The BoJ already holds more than one-third of outstanding Japanese government bonds, and the ECB’s rule on asset purchases will need to be relaxed for it to continue with QE.

• Negative interest rate policies’ unintended consequences are also casting doubt on their efficacy: A flat yield curve has given banks little incentive to lend. We believe, however, that the BoJ and ECB are still a long way from unwinding and shrinking their balance sheets. They may choose to reduce their monthly asset purchases to extend their QE programs’ longevity. This should help to keep bond yields low in the medium term, despite possible short-term corrections.

THE FEDERAL RESERVE: CAUTIOUS NORMALIZATION

• We expect the U.S. economy to expand at a rate of about 2% in 2017, supported by household spending, thanks to a healthy job market and slowly rising wages. This should allow the Federal Reserve (Fed) to stay on a gradual path of monetary policy normalization. We expect two to three interest rate hikes in 2017.

• We expect the Fed to proceed cautiously, however. It would be willing, for example, to pause normalization in the event of market volatility, or if concerns arise that flagging global growth could feed back into the U.S. economy.

A FISCAL BOOST: WILLING BUT INEFFECTIVE?

• Given the limitations of monetary policy, many believe stimulative fiscal policy could be the solution to boosting economic growth.

• However, given the high level of public debt in developed economies, as this chart shows, more fiscal stimulus is likely to cause markets to further question the strength of government finances and their ability to meet future obligations. Politics in many developed economies may also pose an obstacle to the swift implementation of a government spending boost or a tax cut.
Winter: Threat from politics and leverage

Investors may feel a chill as Europe undergoes elections, and fragmented parliaments and anti-establishment parties threaten to rattle political stability. Leverage, particularly in China, is a worry as well. Mindful of possible short-term volatility, we nonetheless expect steady corporate and economic conditions and no hard landing in China.

POLITICAL RISKS: A POSSIBLE SOURCE OF MARKET VOLATILITY

• Policy direction of the Trump administration will be a key focus in coming months. Investors will need to monitor national elections in Europe in 2017, including in France, Germany and the Netherlands, as well as the next chapter of Brexit.

• The rise of anti-establishment or populist parties, as shown on this chart of opinion polls, points towards a strong challenge to the integrity of the European Union and the political status quo in many member countries. Fragmented parliaments could delay reform measures—or actions to support financial stability—if needed.

• These political developments in Europe could fuel investor aversion in the short term.

• However, we stress that Europe is enjoying steady economic conditions and corporate earnings. It is crucial that investors understand political developments but take into account economic and corporate fundamentals when making investment decisions.

HIGH LEVERAGE: LIKELY TO WEIGH ON LONG-TERM GROWTH

• While investors' focus has been on China's rapid corporate debt accumulation in recent years, leverage has remained elevated across the global economy with little done to reduce it. Most countries on this chart lie above the horizontal axis, indicating rising private sector debt since 2010.

• These debt levels are likely to hinder growth and pose an obstacle to central banks when they normalize interest rates. An unexpectedly rapid rise in interest rates would raise debt service cost significantly and hurt growth.

• We do not expect an economic hard landing in China in the near term, since the Chinese authorities have policy options available to counter any sharp downturn. Nonetheless, high corporate debt is expected to weigh on business investment.
Investment Implications

Having surveyed the key themes we expect to influence the 2017 investment landscape, here is our view on what they imply for asset allocation.

DIVERSIFY AND THINK LONG TERM

• Since no single asset class can meet all the investment needs for all investors—or handle the four seasons of 2017—it is important to build a well-diversified portfolio with long-term objectives in mind. A multi-asset approach incorporating equities, fixed income and alternatives can help investors strike the right balance between risk and return.

DM/EM EQUITIES: A MORE BALANCED APPROACH

• With an environment of steady growth constructive for equities, we believe emerging markets should look increasingly appealing. An EM economic rebound should provide its equity markets with much-needed positive momentum in 2017, after a decent 2016.

• U.S. corporate earnings should benefit in the short term from a rebound in energy prices and a stable U.S. dollar, after a challenging 2015 and 2016. But companies will need to find new ways to grow after several years of profit margin expansion.

• Europe has more room for positive surprises given cyclically low profit margins. However, the banking sector is still likely to be under pressure.
EQUITIES: BEYOND VALUATION RE-RATING FOR EMERGING MARKETS EQUITIES

- EM equities are unlikely to repeat their stellar growth of the 2000s. But EM equities’ outperformance relative to developed markets and reasonable valuations, plus ample evidence that the U.S. dollar is stabilizing, should continue attracting international capital flows.
- The pickup in EM growth, especially in large economies such as China, India and Indonesia, has already benefited consumption-related companies and could cascade into industrials. This environment opens a significant opportunity for active managers and bottom-up stock selection.

EQUITIES: FROM DEFENSIVES TO CYCLICALS

- Bond-like (defensive) equities, which provide attractive income to investors, continue to serve an important function. But the underperformance of cycle-sensitive stocks (illustrated in this table) has opened opportunities for investors with a higher risk appetite and those looking beyond income to capital return.
- A steepening of the yield curve would potentially provide a much-needed lift to bank profitability.
FIXED INCOME: UNCONSTRAINED APPROACH TO MANAGE VOLATILE YIELD MOVEMENTS

- Although zero is no longer regarded as the floor for bond yields, it has proved to be tough to break through due to the negative impact on banks, savers and investors.

- Their lack of coupon income means DM government bonds offer very limited protection against a market correction, such as a sudden surge in inflation expectations.

- Although the above suggests a short duration bias, at least through early 2017, investors should take a flexible approach and not be bounded by benchmarks, as well as take into account bonds' price sensitivity to interest rate movements (duration risk). This chart illustrates the decline in return, both in price return and total return, for various types of bonds in the event of a 1% increase in local interest rates.

- High yield and EM debt are better positioned to handle a rise in interest rates given the negative correlation with treasury yields.

FIXED INCOME: TAKING CALCULATED RISKS

- Fixed income continues to be a critical component of any portfolio. However, as DM government bonds are becoming increasingly expensive, investors will need to seek other ways to balance their need for income with risk mitigation and diversification.

- We believe corporate credits and EM debt offer better opportunities. Corporate credits, including high yield corporate bonds, benefit from a stable economy and hence low rates of default. Improved sentiment towards emerging markets should also encourage inflows.

- While spreads can narrow further, they are close to long-run averages. This suggests that coupon should be the main source of total return.
Conclusion

Just as no single set of clothes suits every season, investors need a range of assets to build a strong portfolio that fits their particular objectives. We expect economic conditions in 2017 to be stable. However, Asian investors face challenges, both old and new, when it comes to realizing their financial goals. These include zero cash return and the need to generate income. Unconventional monetary policies and changes in global politics are creating new sources of volatility that financial markets are still learning to live with. A well-diversified portfolio, and a long-term vision, can help investors to weather all the seasons and benefit from the sunny days.

ALTERNATIVE AND OTHER ASSETS: BROADEN YOUR RANGE OF INCOME GENERATORS

- In addition to fixed income, investors should also consider broadening their horizons to generate income. High dividend equities, especially from emerging markets and Europe, could provide income plus the opportunity to participate in recoveries.
- A good selection of alternatives, such as private real estate and infrastructure assets, can generate income while enjoying relatively low correlation with public market assets.
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