

Lessons from 2017 and the outlook for 2018

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2017 was noted for its lack of volatility, and this can be seen strongly in the performance of global equity markets. For the first time, global equities (based on the MSCI ACWI's 30 year history) saw a rise in every month of the year. The US market (S&P 500), while not posting a rise every month, saw a positive return every month once dividends are included, the first time since 1958. The largest fall for the US market intra year was 3%, which is the smallest intra year fall in any calendar year in the post war period.

Another area of note were signs of growing speculation, most notably with the interest in cryptocurrencies. Bitcoin saw a rise of 1,300% and created billionaires of the Winklevoss twins, who were previously known for claiming Mark Zuckerberg stole their idea for Facebook. It was also reflected in the art world, with a world record \$US450m paid for Leonardo Da Vinci's Salvator Mundi, shattering previous records – over double the previous record for a painting sold at auction and a third higher than the highest private sale.

So after a record breaking year, it is worthwhile reflecting on what lessons we can learn from last year. I think there are three key takeaways. First, is related to the phrase made famous by Bill Clinton's campaign strategist James Carville: "It's the economy, stupid". In a year where there were fears about where populism could take us, issues around the unique presidential style of President Trump, and fears of nuclear war with North Korea; it was the fundamentals of improving profits due to a recovery in global nominal economic growth that ultimately mattered to markets. This is not to say that politics don't and won't impact on markets, but it is through the actual or perceived impact on the economy.

Second, is the importance of inflation in the post GFC world. Real economic activity has been muddling through over the past half-decade, and where the real swings have been are in inflation. Markets have panicked during periods of deflation and charged higher during reflation periods. The key driver of the inflation volatility over the past several years has been the wild movements in oil, with prices ranging from \$US114 per barrel to \$US26 per barrel . This has led to large swings in headline inflation, which has impacted equities through profits relationship with nominal growth; and bonds through inflation expectations and a potential monetary policy response.

Last, it added data to the perennial question of central bankers and their watchers: what is more important – the level or the change in cash rates? With the US Federal Reserve (Fed) raising the official cash rate by 1% in four 0.25% steps over the past year and a bit, and

announcing that it will allow its huge balance sheet of government bonds and mortgages to shrink, the last year suggests that when policy is moved at a modest predictable pace, the change is not important. We will have to keep an eye out for what level cash rates will become problematic for the economy and markets.

So let's apply these lessons to the outlook for 2018. Generally politics will be favourable to the economy. Politics has moved from fearing debt and deficits, to using fiscal policy to support growth, this is seen in the US where tax cuts have just been legislated. While not a long term strategy it will support global growth in the near term. The most obvious cloud on the horizon is the Italian election early next year and this will need to be monitored, but so far populism has not impacted on the global economy.

Inflation will be the most important call in 2018. Last year inflation did not accelerate as much as expected as the stabilisation in oil prices saw headline inflation growing at a moderate level. While oil prices have been edging up recently, the moves have been modest relative to recent performance. So the question is whether the tight labour market in the US leads to an acceleration in wages and core inflation. Our base case is that it does, based on the fact that the US unemployment rate has fallen to around the historical tipping point that has led to rising wages and inflation. This would be a shock to markets, that are generally pricing in a continuation of the benign environment, and we would expect volatility to rise sharply as markets adjust to the new regime.

We would see this as a buying opportunity, as the fundamentals remain positive – with strong nominal growth and profits. How long this positive environment for risk assets lasts depends on the third lesson. Accelerating wages and inflation will see a continued rise in the US cash rate, and at some point it will rise to a level that will impact negatively on growth. Unfortunately, we will only know what level this is in hindsight. However, watching interest sensitive components of the economy; like housing, autos and other consumer durables; will help to pinpoint if we are around the breaking point.

Broadly the strategy is set for a regime shift in inflation leading to a rise in volatility – it is defensively positioned with a 27% exposure to equity markets and 12% exposure to higher yielding credit. Other positions that will benefit from a rise in volatility are the long USD v AUD position, S&P put options and of course exposure to safe and liquid short dated securities and cash. The strategy's interest rate sensitivity is also low, given a rising inflationary environment would be problematic for bond markets, with a duration of 0.9 years.

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