Macro Insight

For Professional Investors Only

The balanced expansion

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“It is important that we know where we come from, because if you do not know where you come from, then you don't know where you are, and if you don't know where you are, you don't know where you're going. And if you don't know where you're going, you're probably going wrong.”

Terry Pratchett

“…the global economy is enjoying broad, synchronized growth beyond what anyone expected. The question now is whether this strong performance will continue in 2018. The answer, of course, will depend on monetary, fiscal, trade, and related policies...”

Prof Michael Boskin, Stanford University

“While most pundits and many market participants try to decide which potential outcome will be the right one, I am much more interested in finding out where the market mispricing is… most market participants I know do not think in these terms.”

“The Philsopher” from The Invisible Hands

2017 was the year of Goldilocks

2017 has been a year of surprisingly-strong returns for investors; global high-yield bonds have delivered over 10%, global equities over 20% and emerging markets above 30% in US dollar terms. But what has driven this phase of bumper returns?

First, all the economists were wrong on inflation. Inflation trends continued to under-shoot central bank targets and were very subdued across major economies in 2017. This has meant that central banks have been able to continue with an uber-gradual rate cycle. Any risk of an aggressive policy normalisation was avoided in 2017.

Second, we have been climbing the “wall of worry” in risk markets. At the start of 2017, investors were fearful of political and policy shocks. But these tail risks either didn’t materialise (European elections), or if they did (Federal Reserve (Fed) balance sheet tapering), the market implications were more benign than expected. Ultimately, these events were just noise and “risks that weren’t”. All the while, the bull market has built itself up on anxiety.

Third, the macro-economic environment has been Goldilocks. We have enjoyed a combination of globally-synchronised growth, low inflation, and booming corporate profits. Over 90% of global equity performance in 2017 can be explained by the improving corporate fundamentals.

Looking forward, there are two questions. First, can this Goldilocks economic regime continue? And, second, (perhaps even more importantly) how much Goldilocks is currently being factored into market pricing?

The balanced expansion

Our conclusion is that the forces that have driven Goldilocks economics in 2017 are now beginning to wane. But the macro-economic picture continues to look good; growth is “balanced” across sectors and regions, with negligible recession risk.

Globally, growth remains strong across advanced and emerging economies. Our Nowcast model (a big data approach to estimating the economic cycle) is tracking global growth at a pace of 4.2%. It is the strongest rate of economic expansion since the early 2010s. While it may appear modest by historical standards, the breadth and scope of global growth is impressive. The better-than-expected growth in 2017 has shifted expectations, so the potential for surprise is less than it was. But there is no indication of recession in the leading indicators, little sign of macro-economic imbalances, and even hints of sustained growth momentum in parts of advanced and emerging economies. What’s more, there are upside growth risks too (in the shape of the US tax reform). Global growth trends look like a “balanced expansion”.

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Inflation remains low relative to growth and labour market trends, and below central bank targets. The regime remains one of historically low inflation (price stability), but cyclical pressures are now beginning to build - especially in the US. This acceleration in inflation is most evident in an important new indicator from the Fed, the "underlying inflation gauge" (now reading just under 3%, the fastest rate since the crisis). And higher inflation rates means that, in turn, the policy mix is set to become less favourable for risk assets than it has been in 2017.

What is discounted?

The key question for investors is not so much how we feel about the economic outlook, but about the degree of optimism that is now reflected in market prices. What kind of growth and inflation mix is discounted?

Crucially, we think, the market continues to assume continued low inflation. This creates an opportunity for contrarians. Sustainable returns on global bonds remain very low. The term premium (which rewards us for taking inflation risk) is negative. Yet, as above, there are clear signs that inflation trends are accelerating cyclically. Investors are being offered good odds to bet on a new reflation narrative emerging. Given starting valuations, prices could react significantly if this economic view pans out. Consequently, we think a combination of being underweight global government bonds and long of inflation hedges (e.g. TIPS) makes sense.

Even if Goldilocks were to wane, the "balanced expansion" of global growth continues to make the case for equities relative to competing asset classes. Typical late cycle equity markets (Japan) should do well and importantly remain favourably priced. In Asian equities more generally, there is a reasonable "margin of safety" in current valuations should a less favourable macro backdrop emerge. And we would make the same argument in local-currency emerging market debt.

The outlook for global credits remains tricky. The economic environment is still very supportive for the corporate sector (good growth, no cost pressures, high profit margins). Credit defaults and downgrade are set to remain very low. But a lot of good news is already priced in today's skinny credit spreads. The prospective return distribution is not as attractive as it was. And any deterioration in the growth data, a faster impulse of inflation, or even a policy error (unlikely in our view) could create an abrupt re-pricing of the asset class. We are underweight global credits in our multi asset portfolios.

What could go wrong with the balanced expansion thesis?

A popular argument among economists is that, after such a historically long economic expansion, we are "due a recession". The flattening of the US yield curve (and its assumed imminent inversion) is a key part of this narrative. But we don't buy into the recession story. Put simply, economic cycles don't run on clocks. Growth trends are still synchronised across advanced and emerging economies. The expansion is balanced and we believe recession risk is effectively zero for now.

Another concern in the market is that we are going to see a "policy error" from the Fed. The idea here is that, even if inflation remains low, central banks like the Fed will still pursue rate hikes due to concerns about financial stability and (perceived) asset market bubbles. Of course this is a possible scenario for 2018 but, for now, we would still put relatively low probability on it materialising.

The major concern for us has been and continues to be that we see a more decisive increase in inflation pressures. The most likely source of this shock is clearly in the US. But it would pose a significant challenge to global financial markets. Faster inflation means that policy makers would have to hike interest rates more aggressively than expected. And given how some asset classes are priced today (especially fixed income), this would require a significant adjustment in market pricing. Under this scenario, it is hard to know where the safe-havens for investors would be.

For now, the "balanced expansion" remains intact and continuing with a pro-risk positioning in multi-asset portfolios (with a focus toward local currency emerging market bonds and global equities) makes sense. As always, we need to remain open-minded to different economic scenarios unfolding. And we need to watch the growth and inflation data closely for any signs that the cyclical landscape is shifting.

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