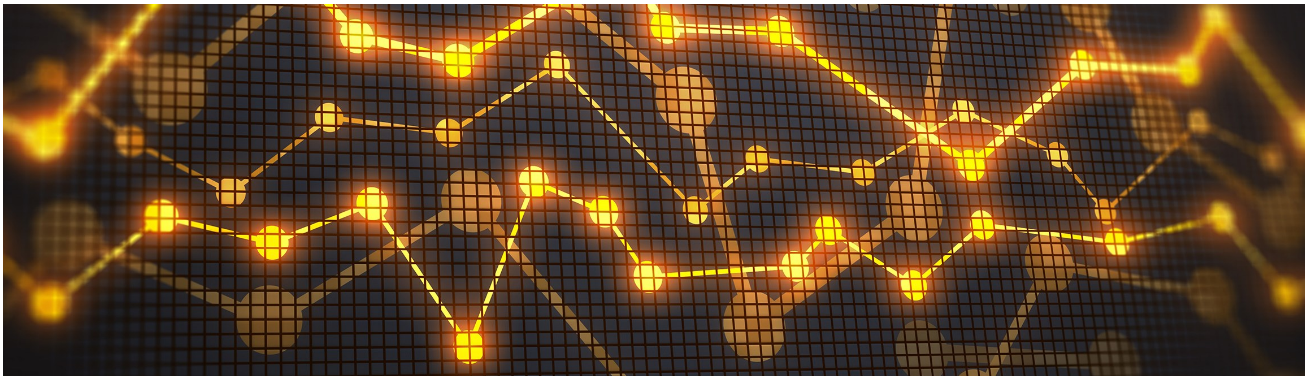
2018 Outlook: Guard Against Real-World Inflation

2017/12/04



Summary

The gradual reversal of expansionary monetary policies – at differing paces globally – will require some investors to adjust their approaches. Protecting purchasing power will remain a priority as official inflation understates real-world costs.

Key takeaways

- Adjustments to monetary policy will be slow and we expect interest rates will remain low, so financial repression should continue. Investors should remain wary of the impact of inflation.
- We expect volatility overall to remain relatively muted; volatility spikes could present opportunities.
- In a low-volatility environment marked by disruption and geopolitical risks, active management – including fundamental research and ESG approaches – will be crucial to finding return potential and managing risk.
- Investment ideas for 2018: oil, European equities, some emerging-market debt, banks in the US, tech and infrastructure in Asia.

Since the depths of the global financial crisis, central banks have supported financial markets and the economies they serve through expansionary monetary policies, increasing their balance sheets to previously unheard-of sizes. The strong growth in corporate profits and diminishing fears of deflation show that this approach has worked, and central banks will be careful not to stifle current gains.

So, while we anticipate the scale of central bank support will diminish in 2018 – led by the US Federal Reserve – we expect the overall shift to be slow and the precise actions to vary from one central bank to the next. Interest rates will stay low overall. Consequently, investors should continue to be wary of financial repression and keep a careful eye on inflation, not least because official data appear to understate rises in real-world costs.

Beware disruption

In addition to macroeconomic considerations, several dominant investment themes, including geopolitical risk and business disruption, will persist in 2018. We encourage investors to take a fresh look at these themes and the far-reaching implications for portfolios.

Here are six key themes that we think could shape markets in 2018, as well as our regional outlooks and top investment implications.

Six key themes for 2018

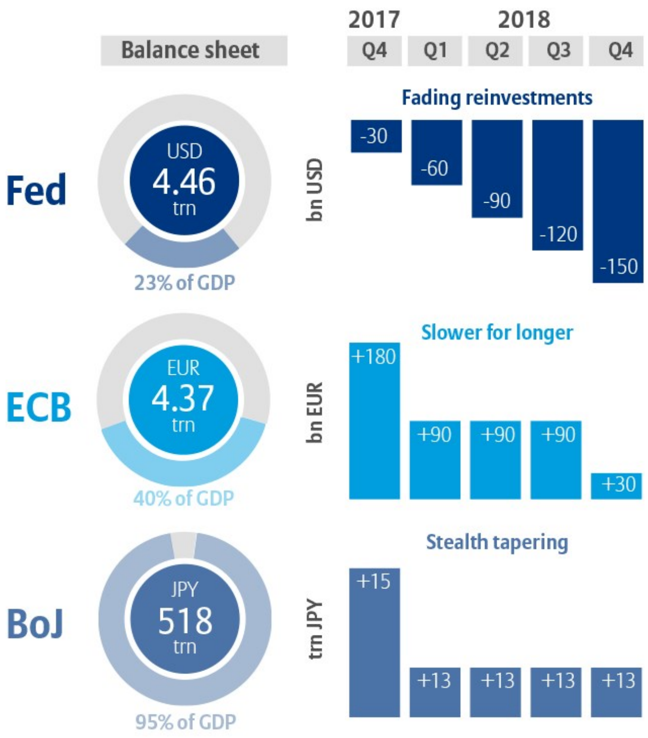
1 Central bank dynamics will be harder to navigate

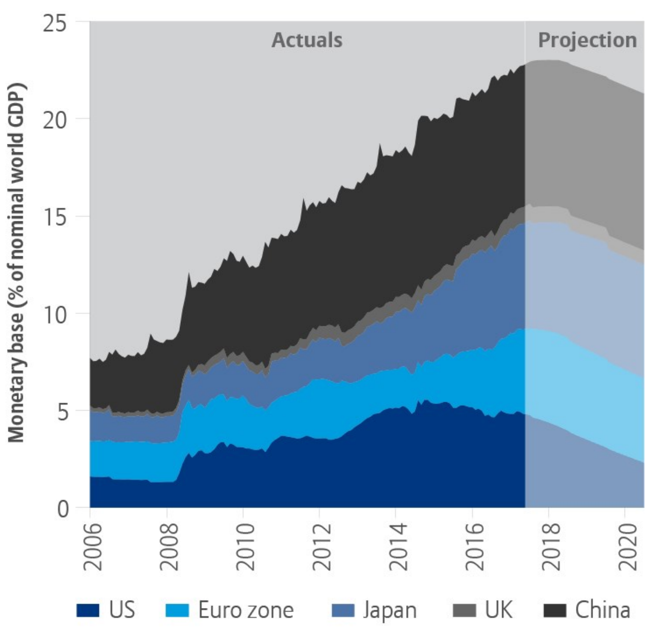
Central banks have had a dominant influence on markets for the past decade and we expect this to continue in 2018. Positioning for central bankers' next moves will become more complex as policies start to diverge globally:

- The US Federal Reserve will likely raise rates further: we anticipate three hikes in 2018, not all of which have been priced in by the markets.
- The European Central Bank will focus on slowing its bond-buying programme while keeping policy rates unchanged.
- The Bank of Japan has begun a "stealth reduction" of its monthly asset purchases, which seems likely to continue.
- The Bank of England recently raised rates for the first time in 10 years, but concerns are rising about growth prospects as well as above-target inflation.

Scale of Central Bank Support Is Set to Diminish in 2018

As central banks gradually reverse their expansionary monetary policies, any associated liquidity shortfall – real or feared – could be disruptive to the markets.





Source: Allianz Global Investors Global Economics & Strategy, Bloomberg, Datastream. Data as at November 2017.

2 Protecting purchasing power will remain critical

Although the direction of monetary policy is reversing, the pace of change will be glacially slow and we expect interest rates to stay low. Consequently, financial repression will continue and protecting purchasing power will again be an important investment objective. It will be crucial for investors to understand how rising prices are impacting their income requirements, given that even relatively low levels of inflation can significantly erode purchasing power over time. Moreover, the standard inflation measures used by central banks are failing to capture real-world costs.

3 Beware liquidity shortfalls and volatility spikes

However careful central banks are in adjusting their monetary policies, the effects are uncertain. Of particular note is the increased risk of liquidity shortfalls and volatility spikes:

- In select asset markets, severe liquidity shortages could occur with little warning. As a result of their quantitative easing programs, the Fed, ECB and BoJ own one-third of the tradable global bond market and have effectively created liquidity out of thin air. Selling off these holdings could cause issues in the markets, including sharply higher bond yields.

- Liquidity is also being affected by concentrated flows into exchange-traded funds (ETFs) and the prevalence of high-frequency trading. These factors can stifle volatility and "herd" performance into fewer stocks.

- Overall, we expect volatility to remain relatively muted in 2018, particularly as central banks continue to err on the side of caution with respect to financial stability. Nevertheless, changing policies and any associated liquidity shortfall – real or feared – could trigger spikes in volatility. This presents risks as well as the chance to enter or add to positions. A highly valued, late-cycle market like the US could be cause for concern. ECB tapering and any further BoE rate hikes could create buying opportunities out of market volatility in the EU and UK.

4 Geopolitics — and plain old politics — are major risks

In our latest annual *RiskMonitor* survey, nearly three out of five investors said that recent political events had prompted them to enhance risk management. Geopolitics is now the top risk for investors and it will retain the potential to destabilize the global economy in 2018.

- Risks are rising in petro-states from Venezuela to Nigeria to the Middle East. Sudden tensions could trigger an oil-price spike. We note that oil remains generally underrepresented in portfolios.

- The EU's future is not clear cut. We expect Brexit negotiations to grow more tense as the UK's departure deadline looms. Italy's upcoming election poses a tail risk to European stability as the country struggles under its debt burden.

- President Donald Trump's tax reform proposal represents a potential flashpoint ahead of midterm elections in November. The midterms represent another critical moment for the Republicans and a litmus test on Mr Trump's own popularity.

- Populist politicians with anti-globalization views are enjoying a resurgence. This could create serious long-term headwinds for economies and markets, including lower growth and higher inflation.

As well as keeping an eye on potential global flashpoints such as North Korea, investors will need to watch domestic political developments to gauge their potential impact on monetary and fiscal policies. Many voters resent globalization, feel squeezed by austerity and sense that inequality is rising. Politicians may be forced to respond.

5 Disruption will continue

We expect business disruption to continue to be an important investment theme in 2018. The market is rewarding a small group of companies that are reinventing industries and pushing traditional businesses aside. This is reflected in the concentration of stocks that are outperforming: in each of the past three years, just 60 or so stocks in the S&P 500 have outpaced the rest of the companies in the index.

Yet these disruptors are facing closer scrutiny as their size and influence attracts the attention of lawmakers and regulators:

- In the EU, tech giants have been fined for anti-competitive practices, and rigorous new dataprotection rules will take effect in 2018.

- The US Congress is probing the role that certain technology firms played in allegedly helping Russia influence recent elections.

It is important to note that disruption is not only driven by technology. Demographic shifts are also reshaping industries and financial markets. As high-spending baby boomers retire, the economic boost they have provided is diminishing, including in some emerging markets. Looking further ahead, ageing societies will change business dynamics.

These disruptive trends highlight the importance of stock selection and the value of active management. Managers with the ability to conduct fundamental research across equity and credit markets globally can help investors take the right risks in a low-volatility environment. Active investment approaches focused on environmental, sustainability and governance (ESG) factors also allow investors to factor in other important risks and impacts.

6 Selectivity will be even more important

The global economy is doing reasonably well – but growth is becoming patchier. Regional differences are likely to become more pronounced. At the same time, many assets appear richly valued. Consequently, investors will need to be increasingly selective in 2018. Their expectations of active managers will increase as they seek more dynamic ways of sharing performance and fiduciary implications with their managers.

From an equity perspective, we favour Europe over the US, where the combination of reduced monetary stimulus and potentially overheated markets could turn into a major headwind if economic data lose momentum. We think yield-seeking bond investors may find some relatively attractive opportunities in sovereign debt in Asia and emerging markets.

2018 regional outlooks

United States

We expect markets to be flat overall in 2018, with more downside than upside risks. Treasury yields may rise moderately, but supposedly "risk-free" assets will remain overpriced.

- The Fed's normalization of monetary policy could trigger volatility spikes, while providing scope to tighten when the economy eventually contracts. US banks could be interesting as rates rise.

- Earnings should be decent if wage growth stays muted and global growth remains robust, but valuations are a concern. Rising inflation, regulatory scrutiny of big-tech firms and fewer share buybacks could pressure stock prices.

- President Donald Trump is keen to pass tax reform ahead of the midterm elections in November 2018. If he succeeds, highly taxed telecoms, industrials and consumer staples could benefit, though more fiscal stimulus could trigger more rate rises. The markets may have a short-term positive response once the elections are over, which is generally the case when political uncertainty passes.

Europe

Europe delivered largely positive surprises in 2017, with healthy economic growth, pro-establishment elections, and strong leadership from French President Emmanuel Macron and German Chancellor Angela Merkel. A clear industrial strategy is taking shape in Europe, as cross-border mergers in the industrial and financial sectors are finally finding political support. However, political risk hasn't gone away entirely.

- The euro's strength in 2017 was supported by stronger economic indicators and successful pushback against the populist tide, and we expect continued gains in 2018.

- Even if Italy's spring 2018 elections don't have an anti-EU outcome, Catalonia-style nationalism could gather momentum elsewhere in the EU.

- Brexit negotiations are looming: should investors and businesses prepare for a hard Brexit, and will the Bank of England be swayed more by Brexit-related inflation or Brexit-induced lower growth? Either way, we expect the UK consumer to have a tough year overall.

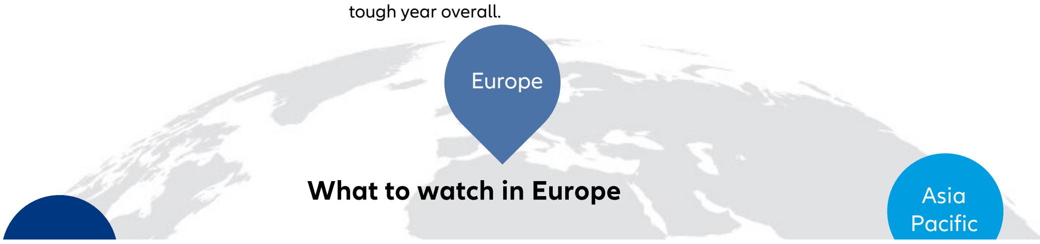
Asia Pacific

The theme of economic differentiation continues in Asia, where transregional trade – particularly with China – will become increasingly important if globalization loses steam elsewhere.

- Watch the continuing importance of China as a strategic asset class and its growing geopolitical and economic influence through its "One Belt, One Road" development initiative and its mega-cap tech firms.

- In Japan, "Abenomics" remains in effect: despite improved growth, policymakers continue grappling with inflationary pressures weighed down by structurally low wage growth. Expect an even more accommodative fiscal stance.

- The tech sector continues to drive performance in Korea and Taiwan, but not in the Association of Southeast Asian Nations. Infrastructure could be the growth story in ASEAN markets and in India if governments and the private sector spend and invest.



What to watch in Europe

US

What to watch in the US

- US banks as the Fed raises rates
- Telecoms, industrials and consumer staples if tax reform passes
- Downward pressure on highly valued markets

- A rising euro
- Domestic GDP growth should support local consumption
- Brexit-related inflation
- Wider Treasury-bund spreads

What to watch in Asia Pacific

- China's growing geopolitical influence and mega-cap tech sector
- More monetary stimulus from the Bank of Japan
- The tech sector in Korea and Taiwan
- Infrastructure in ASEAN markets and India

Investment implications

Throughout 2018, Allianz Global Investors will continue to use our fundamental research and insights – and our strong global network – to help our clients balance risk and reward. Based on our key themes, here are our five top investment implications for 2018:

Hunt for income