Quarterly Market Outlook

October 2017

Strong Global Growth

An environment of continued central bank stimulation has resulted in a strong pickup in global economic growth over the past year. This has been a tailwind for equity markets in particular. Global equities (MSCI World) were up nearly 5% during Q3 and are now up over 16% in 2017.[1] After one of the strongest bull markets in history, many markets have reached all-time highs with valuations at levels only seen during the Dot Com Bubble and prior to the Great Depression. Investors buying at these levels are likely to see low returns over the next decade.

Emerging Market Equities

The biggest beneficiaries of the pickup in global growth have been emerging markets, as these economies tend to be export dependent. After years of weakness, emerging market economies are just beginning to recover from low levels of activity. This has resulted in attractive valuations, with little fear of monetary tightening. Investor inflows have driven strong performance in emerging market equities thus far this year (MSCI Emerging Markets is up nearly 28% YTD[1]). While emerging markets will likely be more susceptible to periods of increasing volatility, we expect the long-term trend of outperformance versus developed markets to continue.

Market Complacency

Strong investment returns and central bank intervention have led to complacency among investors, reducing the expected returns investors are willing to accept for risk. Most investors have far too much concentration in assets (such as equities, high yield credit and real estate) that depend on a continuation of the current environment. While we don't foresee large near-term risks to growth, there will inevitably be negative surprises that drive a meaningful pickup in volatility. Holding exposures to assets and strategies that perform well in different economic environments is critical to protecting capital in more challenging markets.

Shift towards Monetary Tightening

After 9 years of aggressive central bank stimulation we are entering a new environment of monetary tightening. The Fed plans to begin reducing its balance sheet in October, initially at a pace of $10 billion per month and accelerating over time. The ECB and Bank of England have also been discussing strategies for tightening monetary policy over the coming months. What has been a tailwind for asset markets will become a headwind. We suspect central banks will move slowly, but there is always the risk of policy errors and/or unintended consequences from central bank actions. Given little room for additional easing, we are concerned that the next economic downturn may be very difficult to reverse.

[1] Source: Bloomberg. YTD calculations represent the period from12/31/16 – 9/30/17.

Elevated Debt Levels

Global debt levels have continued to increase since the 2008 crisis, now reaching 327% of global GDP.[2] This makes the global economy very sensitive to increases in interest rates. As we noted in our last update, China is a large driver of this upswing and is worth watching closely. Here in the US, we are concerned about the rapid increase in corporate debt, which has supported the equity market through stock buybacks, and is now above cyclical highs reached in 2002 and 2008. We also see risks associated with entitlements and public pension liabilities which are underfunded and multiples of GDP. All of these factors limit the long-term sustainability of the current trend in growth.

Commodities

After a slow start this year, commodity prices rebounded strongly in Q3, particularly for industrial commodities such as oil and copper, which were both up nearly 10%.[1] With increasing global demand and a reduction in commodity investment in recent years, we think we are in the early stages of a multi-year trend of higher commodity prices. This is likely to add to nascent inflation pressures.

Washington Stalemate

Another attempt by Republicans to repeal and replace Obamacare failed, leading many to question the ability of the Trump administration to work effectively with Congress. The next focus for the administration will be tax reform. Given the incentives to achieve a political victory before mid-term elections, a deal is probable in the coming months. We expect any reduction in tax rates to place upward pressure on interest rates, as it would likely increase the fiscal deficit.

Wealth Inequality

The recovery in global growth since the 2008 crisis has disproportionately benefitted the owners of capital versus labor, which has exacerbated wealth and income inequality globally. In the US, for example, the top 1% of families own nearly 40% of the wealth in the country.[3] This trend is unsustainable from a societal perspective, and increases the odds of more extreme political outcomes, such as the rise of nationalist/populist candidates.

[2] Source: The Institute for International Finance.

[3] Source: Federal Reserve. https://www.federalreserve.gov/publications/files/scf17.pdf.

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