How might 2017 look for investors?

Beware of the misalignment between valuations and fundamentals

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While 2016 was generally a positive year for investors, politics and economics have provided some big surprises and highlighted how intertwined politics and economics have become. The macro picture of reasonable economic growth, falling unemployment and low inflation belies a more complex micro-picture where extreme policy measures have distorted not only the pricing and allocation of risk, but also the distribution of the ensuing gains. Voters clearly weren't happy.

When considering the outlook, a good place to start is to determine where we are as 2017 begins. From the broadest investment perspective, there are two key areas to focus on: economic growth and inflation.

In general terms, economic growth is buoyant enough. The US economy is expanding at a 3% annual pace, which can be considered at, or above, its trend rate. Europe too is growing around its, albeit lower, long-term trend of just under 2% – notwithstanding a fragile political and banking backdrop. Chinese policy stimulus has shored up the near-term growth trajectory of an overleveraged Chinese economy that is officially growing at an annual speed of 6.7%. Even though the Australian economy shrank 0.5% in seasonally adjusted terms in the September quarter, we are on a steady course as a rise in commodity prices is boosting the terms of trade and stabilising, even reversing, the decline in national income that followed the end of the mining boom. While no major country or region is booming, it's important to note that recession does not appear imminent either (albeit Australia is technically just one quarter away from such an outcome).

It is a similar story with respect to inflation. While deflation fears were running rampant at the start of 2016 as oil prices plunged, a recovery in oil prices and adequate growth in key economies have shifted expectations so that people expect low inflation, not deflation. With US inflation still below 2%, a tightening US labour market (the jobless rate is just above its post-crisis low of 4.6%) and with Donald Trump promising to stimulate an economy that is already growing, we start 2017 concerned about an inflation surprise and a Federal Reserve lagging in its response.

In contrast to what is a relatively benign macro outlook, the starting point for key markets is more problematic. For equities (particularly US equities), investors seem to interpret the policy direction as a win-win. For years, low interest rates, quantitative easing and a dovish Fed provided an almost free option for investors who weren't enamoured with the alternatives. But equity investors have been as optimistic about the recent policy shift towards fiscal stimulus and driven US stocks to record highs. Under the surface, there has been rotation away from the defensive yield-proxies towards growth-oriented sectors (such as resources) but all within an upward trend.

For bond investors, the spillover from an adequate economic back-drop, a less-favourable inflation outlook and the prospect of fiscal stimulus have pushed yields higher – US 10-year government bond yields rose more than 100 basis points from their mid-year lows as did the equivalent Australian bond. While media coverage has turned negative with respect to bonds, we need to remember that yields are not that far from where they were 12 months ago. Likewise, credit investors had a rollercoaster ride over the year when a strong finish more than made up for a tough start. High-yield credit ended up doing better than global equities over the year. In the forex markets, the US dollar has risen to a 14-year high on a trade-weighted basis.

Outlook from here

When it comes to asset allocation, starting points matter because asset returns are heavily influenced by current prices. So the first thing that can be said is that notwithstanding the rapid recent rise in bond yields, prospective returns from bonds remain very low (in the case of the US and Australia) and negative in the case of Japan and Germany.

Second, investments that have been sought by investors to compensate for low yields (the so-called 'bond-proxies' such as A-REITs) remain expensive and thus offer minimal, if any, return over the next couple of years. They are vulnerable to any further rise in yields (in spite of a sell-off in many of these assets in the latter months of 2016) and could post losses.

Next thing to note is that the strong performance of credit in 2016 has left the risks around credit somewhat asymmetric – not much upside but significant downside should circumstances turn against company debt. Modest expected returns reflect this outlook.

Fourth, prospective equity returns are low in absolute terms (albeit in many cases still higher than those expected on bonds). But within the equity universe, there are some big differences in return prospects. Australia offers, on our numbers anyway, the highest prospective returns (albeit still modest by historical standards at about 8% p.a.). At the other end of the spectrum, we are less positive about US equities where expensive valuations imply modest returns ahead (in the order of 2% to 3% p.a.) – arguably not enough to justify the risk of ownership.

Fifth, emerging markets have been dented by the stronger US dollar and concerns over what might happen to US trade policy under Trump and how this might affect US relations with China. We do not think that their recent underperformance has made emerging-market equities (or debt) cheap enough to justify the risks, despite the fact that emerging-market equities offer close to the highest expected returns in our universe. What this return forecast does not capture is the potential downside for emerging markets if things (Trump, the US dollar, etc.) go awry. We'd much rather own Australian equities than emerging-market equities, despite both offering similar returns.

The rise in US bond yields and the robust performance of US equities after Trump's election victory have led to a significant narrowing of where US equities and US bonds sit in terms of expected returns versus the probability of loss. While we think it's too early to switch from equities to bonds (or, in fact, from cash to bonds), we can see that the relative prospective returns between bonds and equities are nearing the point that could prompt sizeable allocation shifts between the asset classes.

As a final observation, it is clear that achieving high real rates of return by simply hoping for strong underlying market performance would be optimistic (based on our expected returns anyway). Appropriate active asset allocation and contributions from sector and stock selection will be important if decent rates of return are to be achieved.

Risks to watch

So what risks are we most concerned about as 2017 unfolds? The Trump factor clearly can't be dismissed. While equities have broadly embraced the rhetoric around tax cuts and infrastructure spending, no one knows what the reality might be (and we suspect nor does Trump). Any disappointment could be damaging. On the Trump presidency more broadly, there are plenty of risks.

On the economic side, we see the risk of an inflation surprise on the high side more likely than a shock to the downside, given the relative tightness of the US labour market and the tepid Fed response to date of only two increases in the US cash rate. Evidence that points to faster inflation (particularly any pickup in wages) could propel bond yields higher. That would obviously be bad news for bond holders but it might also damage equities were the Fed to respond with higher interest rates. Such an outcome would not be unfavourable for our current asset-allocation positioning, given we have a relatively modest equity holding and limited duration. (We are short duration versus benchmark in fixed-income portfolios and have a preference for cash over bonds in multi-asset portfolios.) The flip side of this would be resumed concerns about recession or deflation but we don't see these as likely outcomes.

While US politics will generate uncertainty, the focus in 2017 is likely to shift to Europe, where elections in France and Germany will dominate. If 2016 is any guide, the shift away from incumbents is likely to ensue and it may pay to expect the unexpected. The banking system in Europe remains vulnerable; Italian banks are especially problematic. Banking failure would be hugely damaging and place significant pressure on financial markets and the foundations of the EU.

The bottom line is that, despite the recent bounce in risk assets, the broader structural problems facing the global economy remain. Debt levels are at record levels and will rise further if the shift to fiscal stimulus takes hold. China has pushed its day of reckoning out, but has not solved its problems of excessive leverage. This is problematic for Australia. While commodity prices have stabilised, they remain hypersensitive to Chinese growth. The other big risk for Australia is housing – in particular, what happens to record housing prices amid a possible glut of apartments.

We are, therefore, approaching 2017 from a perspective of being 'alert but not alarmed'. This may have a familiar ring because we have argued this perspective for some time. While markets have not stood still over the year, we have not seen the sort of broad price action that is required to reset the market outlook. Nor have we seen enough change to fundamentals to rejig the assumptions on which our return forecasts are based.

Across most assets, valuations remain on the fuller side of fair value but, importantly, are a long way from historical extremes. The possible exception to this remain certain bond markets (Europe) and the bond proxies (A-REITs). As we've seen recently in the bond market, repricing can, and frequently does, occur quickly. Markets can reset quickly and opportunities can appear just as fast. Avoiding the downside of these adjustments is in many ways as important as capturing the upside when it unfolds. We still see cash as an important investment, even if cash returns are uninspiring at present. There will come a time when risk premia have rebuilt sufficiently to change the outlook and make us more comfortable to take a broader market exposures (be that be bonds or equities).