

# Beyond the horizon

Where are markets headed in the new year?

By MICHAEL STROBAEK

**D**ESPITE all the risks such as the unexpectedly strong slowdown of the Chinese economy in the first half of the year or the Brexit vote, 2016 has so far (in November) been a good year for investors. For example, the global equity markets (measured by the MSCI AC World) have risen by around 4 per cent since the start of the year. The bond markets (measured by the Barclays Global Aggregate Index) have even increased by nearly 5.5 per cent. Even the commodities indices, which were under strong selling pressure in recent years, have risen by about 7 per cent since the start of the year.

Despite these encouraging performance figures, the best word to describe investor sentiment is “uncertain”. The economic recovery in the US is now entering its seventh year and the Fed is preparing the markets for interest rate hikes. This in turn is stirring up concerns that the current phase of expansion could be slowly coming to an end, especially since important emerging economies such as China have already started slowing down.

Meanwhile, we are seeing an almost deceptive calm in financial markets. While volatility has increased after the surprise outcome of the presidential election, it is still below average and has already started to decline. It is quite remarkable that such significant political surprises apparently have not thrown markets off in terms of volatility. So how likely is a sustained correction in risky assets?

A look at the economic situation can help to answer this question. Globally, economic growth is fairly moderate although it still seems relatively robust, driven mainly by the recovery in consumption. The latter is supported by a still very expansive monetary policy, which is also helping to reduce debt.

## Macroeconomic imbalances

At the same time, macroeconomic imbalances (such as current account deficits in some countries) have improved considerably. The downside risks to the current level of growth thus seem limited. However, the prospect of positive surprises seems just as unlikely, mainly because investment in equipment and infrastructure is weak and therefore growth in productivity is still low.

Demographic trends are also weighing on momentum. So while growth is only moderate, it is likely to be fairly resilient even as central banks may be slightly less accommodative going forward. In Japan and Europe, negative interest rate policies are reaching their limits, while in the US, the Fed is likely to raise rates slightly. To counterbalance the less accommodative monetary policy, we can at least expect some degree of fiscal stimulus in the US.

What does this mean for the financial markets? For one thing, real interest rates are likely to stay low. Since low real interest rates are usually accompanied by muted financial market volatility, we also expect the level of volatility to be relatively low next year. Of course, event risks such as the elections in Germany could lead to a short-term rise in

volatility, but such spikes should turn out to be good buying opportunities.

The markets' behaviour after the Brexit vote is one example. Despite the far-reaching implications of this event, volatility only rose briefly and then fell again, with the stock markets profiting the most. And while a similar pattern can be expected after the US election, equity investors should still exercise some caution.

## Stagnating earnings growth

After the rally of the recent years, valuations are at the upper end of the scale. More importantly, however, earnings growth is stagnating. This means the market is susceptible to temporary setbacks. Only when key corporate figures such as sales and earnings rise again appreciably can we expect to see a sustained renewal of the uptrend. For example, this could be the case in the aftermath of the US election or if consumption continues to increase, as we have already seen in some regions. In this respect, 2017 should prove to be a divided year for most investors – with phases of weakness at the beginning followed by an improvement thereafter.

Owing to the changes in monetary policy, we expect returns in the bond market to be weaker in the coming year than this year. The yield curve should steepen in many regions, which is negative for long-term bonds. For this reason, credit spreads are still attractive in some sectors – especially bank or emerging market bonds. In a risk/return comparison, the additional yield offered by these bonds seems quite impressive.

Overall, we have a neutral outlook for fixed income as a whole, but still prefer bonds with shorter maturities in banks and emerging markets over long-dated government bonds. To sum up, we will probably see neither a strong boom nor a bust in 2017. Given the comparatively low volatility, we would expect to see more of a gradual improvement in the growth environment and moderate capital market returns.

For Asia, a supportive confluence of firming economic growth, reasonable valuations and improving profitability suggest to us that local equities will perform well in 2017, possibly outperforming their global counterparts. To the extent that global liquidity has long been the marginal price setter for Asian equities, performance may be even stronger should capital inflows increase.

Consensus expectations of 12.3 per cent EPS (earnings per share) growth for

the MSCI Asia ex-Japan (versus -5 per cent in 2016) underscore analyst optimism, with cyclicals – financials, technology and commodities – seen outperforming. We expect the Chinese and Hong Kong markets to lead regional equities in 2017, as the recovery in earnings, attractive valuations and buoyant liquidity accelerate south/north-bound flows.

India's robust macro story remains intact, and a rebound in earnings growth should continue to steer the market higher. South Korea and Taiwan equities are likely to fare better than their South-east Asian counterparts, which are grappling with either subdued earnings or expensive valuations.

In terms of fixed income, despite the likely rise in US interest rates and modestly stretched valuations, we expect Asian US dollar investment grade credit to post total returns of around 4 per cent in 2017, well down on the 8 per cent recorded in 2016. They nevertheless remain an essential part of a balanced portfolio. ▣

Michael Strobaek is Global Chief Investment Officer, Credit Suisse



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