https://blog.en.erste-am.com/capital-markets-outlook-for-2018-will-the-party-hold-on/

Capital markets outlook for 2018: Will the party hold on?

Gerold Permoser

2017 is drawing to an end, and the bottom line is positive. The outcome is significantly better than we had expected. Since the financial crisis in 2008, the global economy has never expanded more quickly and especially concertedly than in 2017. Also, inflation has surprised on the downside, falling short yet again of the expectations held by central banks and analysts.

Coupled with the ambitious valuations, we expect the economy to continue growing strongly and broadly in 2018, which reminds us of 1999. The rest is known history. What does that mean for the capital markets in 2018? Will the party be followed by a hangover?

Strong economy favours equities and riskier bond segments

We expect the economy to continue growing strongly and broadly in 2018. In the USA, tax breaks could boost the already great performance of the economy further, and in Europe, the economic upswing has become so broadly-based that even the weaker countries in the peripheral states are benefiting. In the emerging markets, too, the problem countries of recent years such as Brazil and Russia seem to have overcome their recession and are picking up momentum again. A phase of strong economic activity makes a case for holding risky assets in the portfolio.

US economy caught in the longest phase of expansion in its history

The US economy is currently experiencing the longest phase of expansion in its history (N.B. US records started in 1850) and is clearly ahead of Europe, which has to be seen with caution. Long periods of expansion usually lead to imbalances building in the economy and/or the financial system. They emerged for example in 2008 on the US property market or in 2000 when the dotcom bubble burst. At the moment, there are no signs suggesting the existence of such imbalances in the US economy.

Changes in the interest rate policy of the central banks as main risk

Thus, the US central bank and its policy of tightening interest rates slowly but surely remain the main risk for the economy. Excessive interest rates have often been the reason for the US economy (and others) to fall into recession like at the beginning of the 1980s, for example. We assume that the US economy is not yet reaching this threshold. However, if the interest rates actually increase by 1% in the space of a year, as the US Federal Reserve announces, it remains to be seen how the still extremely heavily indebted US economy will come to the fore. From today’s perspective this seems to be a risk for 2019 and not for 2018.

Inflation remains moderate

The experts of Erste AM are acutely interested in the further development of inflation. In 2017, inflation remained yet again below expectations both in the USA and in Europe. In view of the good level of growth, one can therefore expect unutilised capacities to become increasingly scarce. In the USA, the unemployment rate is currently 4.1%, i.e. at the lows of recent decades. The same is true for the OECD region overall. From an economic point of view, the risk remains that inflation might not only rise in 2018, but actually do so by a surprising extent. This would force central banks, especially the US central bank, to tighten their interest rates more than currently anticipated by the market.

Additional supply of US Treasuries will cause moderate yield increase

The US central bank has started this year to let the Treasury bonds acquired within the Treasury bond purchase programme expire. This means that these bonds will not be reinvested up to a certain volume. Overall, a total of USD 229bn worth of additional Treasury bonds should therefore enter the market. We expect this additional supply to exert a slight upward pressure on Treasury bond yields in 2018. In total, the European and the Japanese central bank will still be buying more government bonds in 2018 than will be issued net in the USA, Europe, and Japan together.

Good opportunities for brave investors

We are starting optimistically into 2018 and continue to see good opportunities for our investors. The good growth continues to favor weighting risky asset classes prominently in the portfolios. In contrast, government bonds are assuming moderate yield increases, which makes them relatively unattractive.

However, in the US, still the world’s largest and most important economy, we are in a late phase of expansion. History teaches that there is still something to be had for brave investors in this phase, but you cannot ignore the risks. Against this background, we will pay particular attention to possible indications of an end to the expansion phase.

Legal note:
Prognoses are no reliable indicator for future performance.

Gerold Permoser

Gerold Permoser has been Chief Investment Officer at Erste Asset Management since early April 2013. He is responsible for all asset management activities and investment strategies for all investment funds held by the Erste Asset Management Group in Austria, Germany, Croatia, Romania, Slovakia, the Czech Republic, and Hungary. Before joining the company, he served this function at Macquarie Investment Management Austria KAG. Permoser has gathered experience in investments since 1997.

He began his career as a fixed-income analyst at the Creditanstalt in Vienna. He moved to asset management at Innovest KAG in 2000. He made significant contributions in the investment field there and advanced to CIO (director of asset allocation and research). Gerold Permoser studied at the University of Innsbruck and is a CFA charter holder. He offers training at the University of Vienna and at various post-graduate institutions for analysts and portfolio managers (i.e., at VÖIG, the Association of Austrian Investment Fund Companies).