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Global equities: Five charts on where we stand

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2017 was an excellent year for stocks. Developed markets were up more than 16% in local currencies, emerging markets almost 28%. In my [previous column](#) on global equities last November, after a couple of weeks of weaker markets and higher volatility, the conclusion was that *“Both economic and earnings growth remain supportive, but moving into 2018, the momentum will be receding and new risks are emerging. There is further upside for equities, but a replay of the strong 2017 performance is improbable and the odds of a correction are clearly on the rise.”*

Two months on, as new information has been coming in, it is time to revisit the outlook for 2018. Here are five charts, which show, how markets have developed since our last update and to what extent the verdict above still holds.

1. Economic growth remains supportive for equities: Economic growth is not showing any meaningful signs of deceleration. In the last two months of 2017, global PMI stayed well above the 50 point threshold (services) or even moved higher (manufacturing). The sell-side consensus forecast for global growth in 2018 has climbed to 3.7% in recent months, which is also in line with what the IMF expects. A particularly positive feature of the current upswing is the fact that it is broad-based – the world looks good everywhere – and (so far) non-inflationary. Even the US economy, which is already in a later stage of the cycle, will get another boost from the recent tax reform via its impact on business investment and consumption. While US and global growth will likely peak in 2018, recession risks are very low.

2. Monetary policy has been accommodative, but will become less so going forward. While the US central bank started reducing its balance sheet in the third quarter 2017, both the ECB and the Bank of Japan continue adding liquidity to the system. The total balance sheet of all three central banks combined will most likely still show moderate growth in 2018. Moreover, real policy rates remain in negative territory across the developed world. Thus, at least in the first half of 2018 monetary policy will most likely not have a negative impact on risky assets. This could change in the second half, when the ECB is supposed to stop quantitative easing and speculations about the bank's next policy steps – balance sheet reduction, interest rate hikes – will move to the forefront.

3. Don't count on another year of multiple expansion. Equity markets are expensive. Maybe not as expensive as it seems^[1], and also not that expensive relative to other asset classes such as bonds, but at face value most stock indices – particularly the US market – have been trading on elevated levels by historical standards for quite a while. It is well known, that valuation itself is rarely a trigger for a market reversal as long as fundamentals and sentiment provide support. However, the chart below indicates – based on US data since 1975 – that when the PE reaches 20x, US equities tend to de-rate on average over the following twelve months.

This is not an iron law, of course. Even when the PE was 22.5x or higher, in about a fifth of all cases, aggregate valuation continued climbing higher, but in the vast majority of cases and on average, a de-rating took place. With the trailing US PE presently hovering in the low 20s, the message is that investors who bet on a further multiple expansion may be up for a disappointment at the end of the year.

4. Positive earnings will be crucial for markets to maintain their momentum. After several years of disappointing earnings growth, companies delivered in 2017. In contrast to previous years, analysts' earnings forecasts were raised during the year. An exception was Europe, where the strength of the common currency weighed on earnings. Still, earnings in Europe rose by about 15%. On the back of solid economic growth the outlook for 2018 is again positive. In addition, the recent tax-reform will impact US companies positively. Many broker estimates suggest that US earnings are getting a 6-10% boost from lower taxes.

5. The outperformance of emerging markets could take a breather in 2018. One of the key factors determining the relative performance of equity markets in the emerging and the developed world is faster economic growth in the former. After 2010, for several years, the shrinking growth gap between emerging markets (EM) and developed markets (DM) contributed to a massive underperformance of EM equities. In the course of 2016, the growth gap began widening again and, subsequently, EM equities started outperforming their DM peers. This process was briefly interrupted by the election of President Trump and his anti-globalization agenda. However, in 2017 EM finally managed to outperform DM equities by c.10% (based on MSCI indices in local currencies).

A replication of this performance in 2018 is less likely though. While the outlook for EM economies is clearly positive, the developed world is also set to post solid economic growth this year. The EM-DM growth gap will remain broadly stable according to consensus. In addition, headwinds – at least for some emerging markets – will come from rising US rates, while at the same time the tailwinds from rising crude and metal prices will probably fade. If DM stocks indices continue climbing, EM will follow; nevertheless, a meaningful outperformance would be a surprise.

Bottom line: The fundamental backdrop remains positive for equities, at least in the first half of the year. Support is provided by buoyant global growth and a solid earnings outlook, but monetary policy normalization and the fact that growth will most likely peak sometimes during the year make it unlikely that 2018 will simply be a repeat of 2017 in terms of performance.

[1] For example, recently a group of McKinsey scholars argued that the aggregate valuation of the S&P 500 is distorted because “Four megacap companies—Amazon, Facebook, Google (Alphabet), and Microsoft—together valued at more than \$2 trillion, account for 10 percent of the index and, as a group, trade at a PE ratio of 29. Excess cash among the remainder accounts for another \$1.2 trillion. (The S&P 500's total market capitalization at the time of this writing in December was \$23.4 trillion.)”. Adjusting for these effects, according to the authors, lowers the S&P500's earnings multiple to 16.9x, which looks pretty unexciting. <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/looking-behind-the-numbers-for-us-stock-indices>

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