Allocation insight

5 January 2018

Market themes for the next 12 months

The passing of the tax reform in the US put a positive seal on the 2017 investment year. However, the investment environment in 2018 will most likely be more challenging than last year. The valuation levels of the various asset classes are elevated, and with the impact of central bank stimulus declining in the Western countries, market rates will go even more clearly up. We will look into the three elements most likely to influence our allocation decisions to identify possible changes in the investment environment this year.

i) Accelerating inflation in the US would affect the return levels across all investments

Elements driving inflation. According to economists, inflation results from two main reasons: 1) a change in the demand/supply balance, 2) a change in the amount of money circulating in the economy. Demand and supply bottlenecks, essentially workforce shortages, have been considered to be the causes behind demand or cost inflation. It has been thought that, when demand for workforce increases faster than supply, the general pay level rises, the funds available increase and the general price level rises. Similarly, an oversupply of workforce would lead to a decline in the general pay level, reduce consumer spending and cause negative inflation, i.e. deflation. Deflation has generally been considered undesirable from the perspective of economic development.

Economic growth in itself would justify higher interest rates

An abundant supply of workforce has been the main argument for maintaining monetary stimulus in the US. It also impacts the timing of the winding down of the stimulus programme, now that the unemployment rate in the US has fallen well below five per cent. The twofold mandate given to the Fed – maintaining an inflation rate of around two per cent and trying to achieve maximum employment – has largely been based on the idea of labour-market-based demand and cost inflation. Despite strong monetary stimulus and the current tightness of the labour market, the general inflation level, although having risen slightly, has not reached the target level set for itself by the Fed. So far, this has allowed for the monetary policy to be tightened at a very moderate pace, in spite of the fact that the economic growth in itself would justify higher interest rates.

Changes in the general inflation level are, however, also impacted by another source of inflation: a change in the amount of money circulating in the economy. It has two main drivers: a change in the amount of money put in circulation and the turnover of money circulating in the economy (Figure 1). Following the monetary stimulus programmes, the amount of money has increased heavily, by about +7% per year, but as the figure shows, money turnover has clearly declined over the past few decades, neutralising the inflationary effect of the amount of money. A number of reasons have been advanced to explain the declining turnover, but the tightening of bank sector regulation during the past few decades is particularly relevant. Reining in bank regulation is high on the US Republican administration's agenda this year. This, together with the declining consumer savings rate over the past few years, raises the inflation risk asymmetrically.

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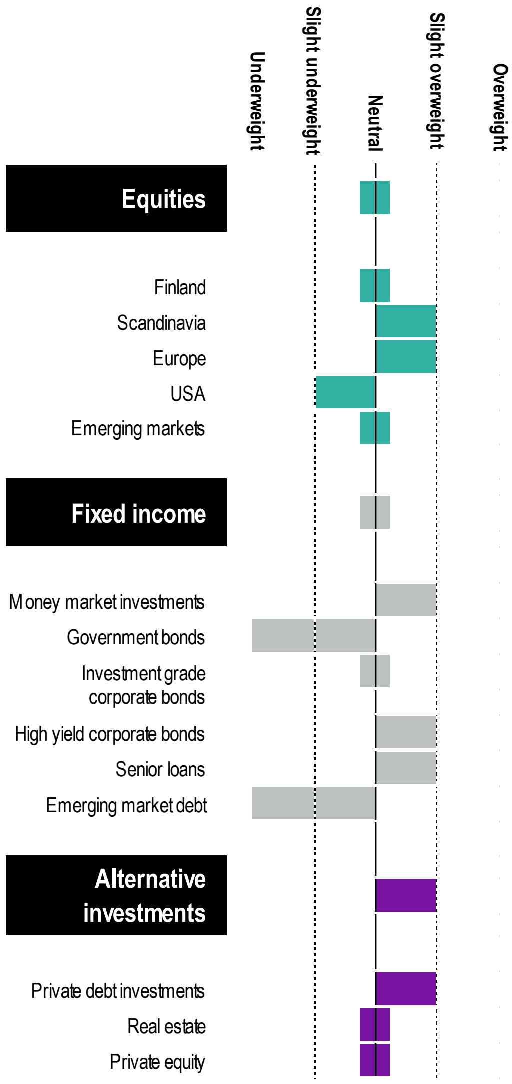

The impact of an exceptionally extensive monetary stimulus programme has been seen mainly in the capital markets in the form of rising investment valuation levels. At the current stage of winding down stimulus measures, it is likely that deflationary pressure is building up on the capital markets in the form of declining valuation levels. This will have a negative impact on the investment portfolio's total expected return. From the perspective of equity investors, the situation is not particularly problematic, as long as inflation accelerates at a slow and controlled speed and the monetary policy tightening measures are known and follow this trend.

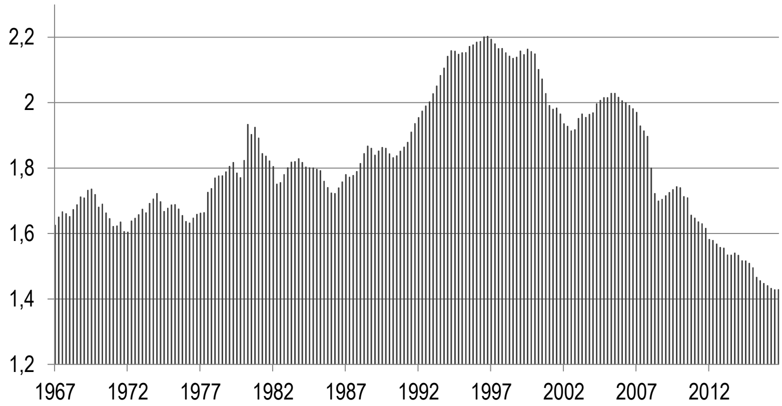

Figure 1. Velocity of M2 money stock in the USA. Source: Bloomberg.

Impacts on investors' portfolios. In equities, an inflation rate exceeding current expectations would probably lead to sector rotation from defensive to cyclical sectors (e.g. banking and insurance), which offer better protection against inflation. For fixed income investors, the situation would be more challenging, because fixed income investments fail to offer solid protection against accelerating inflation. In alternative investments, the liquidity premium compensates for the lower return expectation resulting from declining valuation levels.

From equity investors' perspective, the situation is not particularly problematic, as long as inflation accelerates at a slow and controlled speed

ii) Technology sector growth and earnings development plays a key role in equity allocation

One of the phenomena making its mark on the 2017 stock market year was the upsurge of the technology sector, driven particularly by giants that have built their business models around the internet and mobile communications. In the US, more than 35% and in the emerging markets around 25% of the equity market's total return comes from increased stock prices in the IT sector (Figure 2). Europe did not experience a similar phenomenon, partly because the technology sector makes up a clearly smaller proportion of the European equity market and partly because the new-age internet companies mainly come from the US and emerging markets. Examples of these companies whose share prices rose by more than +50% last year are Amazon, Facebook and Netflix from the US and Alibaba and Tencent from China.

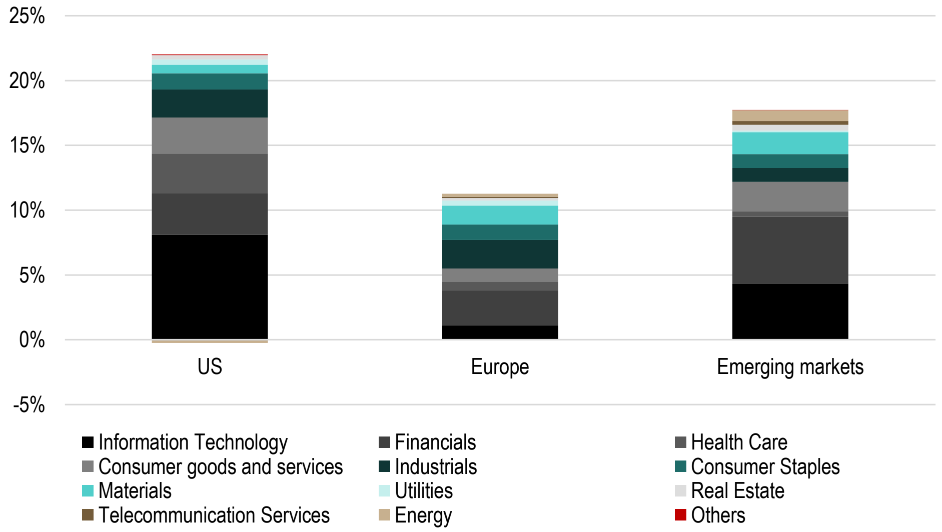

Figure 2. Total return breakdown by sector in 2017. US return in dollars, Europe's and emerging markets' return in euros. Source: Bloomberg.

Many technology companies have seen their stock price rise at a pace faster than their earnings growth rate, which has raised the companies' valuation levels. Following the stock price rise, their weight in regional main indices has increased – in the US and on the emerging markets, information technology is currently the largest sector. The development of the technology sector is thus likely to preserve its key role also in terms of geographical allocation. Should technology companies continue to go from triumph to triumph, the US and partly also the emerging markets would benefit, as last year. However, if a correction closer to the long-term average were to occur in the valuation of technology companies, Europe would be a likely relative winner. In our allocation solutions, we have positioned ourselves with caution in the strongly risen IT equities, while maintaining the broader technology sector slightly overweight.

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iii) The market participants' largely unanimous view of the future development of the economy and markets rarely becomes a reality

The global economy is expected to grow +3.6% this year. The OECD forecasts that growth in the 25 largest economies will accelerate simultaneously and that the number of countries experiencing a downturn will be historically low.

A small but controlled rise in market rates is expected and inflation pressure is anticipated to remain in check as a new chair will take over at the Fed in February. Companies' credit losses are expected to settle at a low level despite the fact that the degree of indebtedness in the corporate sector, particularly in the US, is at an all-time high, close to 50% of the GDP.

Corporate earnings are expected to grow worldwide by +11%, at the same pace as in 2017. Increased sales, driven by private consumption, are expected to be the main driver of earnings growth. Companies' earnings margins are expected to remain close to their all-time highest levels.

Politics and geopolitics are not expected to cause any particular price volatility. In Europe, Germany's government crisis is expected to be resolved without any major impacts on the real economy, and Italy's parliamentary election on 4 March to lead to a balanced outcome. The Republicans are expected to lose seats in the congressional elections taking place in the US in November, which would make it more difficult for Trump to push through the reforms he is championing. In Russia, the re-election of Putin in the presidential election in March is much more certain than which will be the top four teams in the FIFA World Cup taking place in Russia next summer. The markets do not expect the North Korea crisis to escalate.

Coming into this year, our asset class weighting is balanced despite the market participants' unanimously positive outlook. The primary reason for this is the relatively low compensation that an investor receives for taking market risk. This is reflected in the valuation levels of liquid asset classes. In equities, our focus is still on Europe and the Nordics, and in fixed income, in corporate debt with short-term interest rate risk. In alternative investments, we are weighting direct corporate bonds. We have been very selective in making real estate and equity investments.

Carolus Reincke
Head of Multi-Asset Solutions and Responsible Investing

Topias Kukkasniemi
Portfolio Manager, Allocation Solutions and Responsible Investing