



# What are we watching in 2018?

## Outlook summary for Asia-Pacific investors

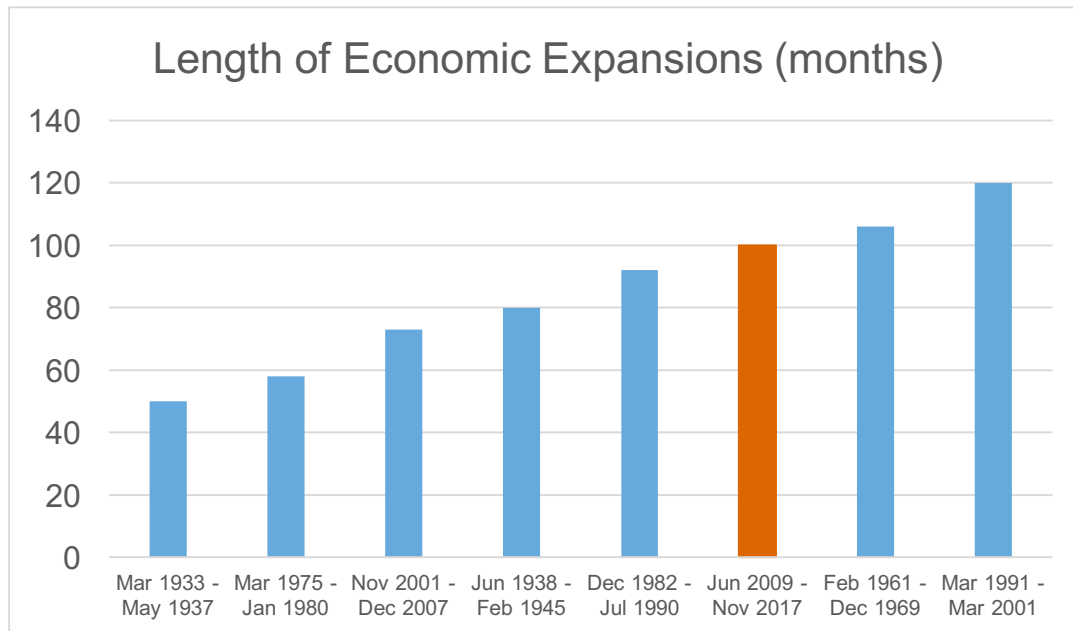
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As investors enjoy some rest and relaxation over the summer festive season and catch-up on TV viewing, our investment strategists share what we are watching in 2018, why we're watching it, and the implications for investors' portfolios.

2018 in our opinion, will be no time for investors to be dozing in their couches. Action and animated films are on the schedule for the year ahead, with an outside chance of horror. Investors need to be paying more attention than ever to economic and political episodes that may trigger melodramas, as the 10-year anniversary of the Global Financial Crisis arrives.

### 1. Golden Oldie – Ageing Economic Expansion

The global economic expansion since 2009, has now lasted 100 months in the North Atlantic economies and is the 3rd longest on record over the past century<sup>1</sup>.



Source: Russell Investments, Datastream

In Australia, the expansion is the oldest on record since modern GDP data was first formulated in 1959.

<sup>1</sup> <https://russellinvestments.com/au/insights/library/how-much-runway-is-left-for-the-us-expansion>

We'll be watching for any signs that the cycle is nearing its end, including rising corporate default levels, growing wage and cost pressures, and over-exuberance in equity markets.

We expect the market will likely be able to push higher through the first half of 2018, while recession risks may show themselves towards the back end of next year. We are looking for a substantial flattening of the yield curve and anticipate the U.S. 10-year Treasury yield to reach 2.7% by the end of 2018. We think the market is underestimating the return of inflation.

### Implications for portfolios

*An ageing economic expansion means that as the cycle matures, inflation pressures will rise and first bonds, and then equities, will see their returns undercut. We think the best investment opportunities in the equity markets lie outside the U.S., with Japan, Europe and emerging markets expected to outperform in 2018. That's partly because the economies and markets in those regions are at an earlier stage of the financial life-cycle. The latter half of the year may see an environment in which investors should begin moving into more defensive asset classes.*

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*"...the best investment opportunities in the equity markets lie outside U.S. ..."*

## 2. Super-heroes – Central Bank Heads

Key characters to focus on will be the Central Bank heads - who are some of the world's most powerful un-elected officials. There will be new incumbents at the U.S. Federal Reserve (the Fed) in 2018, at the People's Bank of China, at the Reserve Bank of New Zealand, and possibly at the Bank of Japan, in the event that Haruhiko Kuroda steps down in April. "Super" Mario Draghi, at the European Central Bank (ECB) will remain at the helm through 2018, as will Philip Lowe at Australia's own Reserve Bank.



Particular developments to watch out for include:

- The pace at which Central Bank balance sheets are normalised, the rhetoric surrounding that topic from the Governors, and the reaction of asset prices<sup>2</sup>. If it transpires that the expansion of central bank balance sheets since the GFC was the major driver of the nine-year bull market in listed assets, then a reversal of that expansion is cause for caution.
- The pace at which official interest rates rise. We are expecting three rises from the Fed and no more than two from the Reserve Bank of Australia (RBA). This would leave Australian rates no higher than those of the U.S., for the first time since 2000.
- The Australian dollar will require careful monitoring, should Australia shed its traditional yield premium.
- We expect the ECB to taper bond purchases down to zero in 2018. Similar to the Fed, we expect that the communication surrounding this shift will be clear and well in advance, and as such do not anticipate any adverse reaction.

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<sup>2</sup> <https://russellinvestments.com/au/insights/library/turning-the-tide>

## Implications for portfolios

*With rising interest rates expected around the globe, investors should be looking to reduce their duration exposure. This development would also be a headwind for other yield-oriented investments such as real estate trusts. However, we would recommend only a modest underweight, as we do anticipate ten-year U.S. bond yields to peak out at around 3% in 2019.*

### 3. Reality TV – Australian Housing

Closer to home, Australia's housing cycle continues to defy the doomsayers. We'll be watching mortgage default rates, the interaction of mortgage rate changes and affordability, and supply and demand (including from China).



We expect house price growth will slow next year, on the back of further lending restrictions, as well rising interest rates as the RBA hikes rates once or twice next year. Apartment prices, particularly in Brisbane and Melbourne, are likely to see price declines due to excess supply.

*"We expect house price growth will slow next year"*

## Implications for portfolios

*The need to be mindful of housing risks will likely act as a brake on Reserve Bank tightening in 2018, which is a negative for the Australian Dollar, but a positive for the bond and equity markets. We doubt that a housing lull alone would be enough to drag down bank shares, although in combination with other factors - such as technological disruption and a Royal Commission - the banks could face headwinds.*

### 4. Tragi-comedy – Geopolitical Uncertainty



Multiple channels of tragi-comedy will be running, as the global political farce rolls on.

We'll be tuning into the Italian election (due to be held by May 2018), developments in Germany and Austria, Brexit negotiations, mid-term elections in the U.S. and Australia - where a federal election is likely, and a change of Government, also on the cards.

## Implications for portfolios

*The key to riding the global roller coaster of continued geopolitical uncertainty in 2018 is to ensure portfolios are well diversified geographically, across different assets and return sources and to dynamically adjust the portfolios as changes occur in the market.*

*It will also be important to be ready to exploit market perturbations at short notice. Using our cycle, value and sentiment process, we assess the probabilities and potential consequences of events to remove noise and re-focus on fundamentals, in order to make objective and disciplined investment decisions.*

## 5. Bollywood – India, China & Emerging Markets

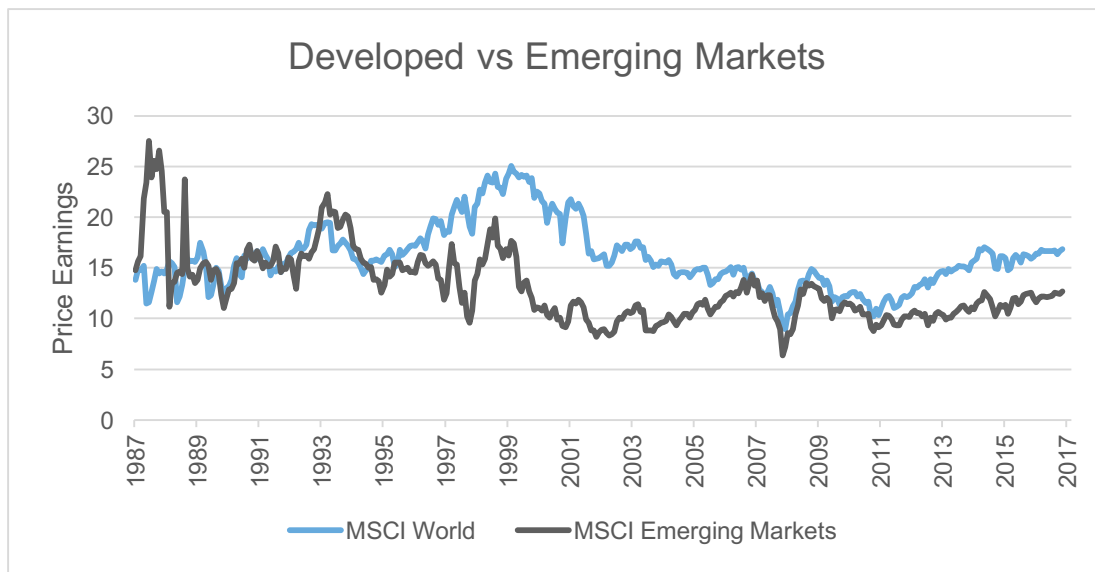


Emerging markets is one of the few investment classes still offering reasonable value.

Moreover, convincing reform programs in markets such as China, India and Mexico are on track to keep returns moving higher.

In particular, China - like the Australian housing market - has been defying the nay-sayers for many years now. We remain optimistic that, following renewal at the 19<sup>th</sup> National Congress of the Communist Party of China in late 2017, China will be able to achieve sturdy growth while managing pressure points such as deleveraging, pollution, water shortages and the transition from capital to consumption spending.

*“China, India and Mexico are on track to keep returns moving higher.”*



Source: Russell Investments, Datastream

Our key watchpoints for emerging markets over the next year will be the intensity with which the Chinese government pursues reform; commodity prices; and the U.S. dollar.

### Implications for portfolios

*Investors can diversify portfolios to gain exposure to growth opportunities in emerging markets, whether it be through equity or debt as both offer attractive value.*

*Our positive emerging market equities view is driven in part by our outlook on China. Within China, A-shares offer more value and opportunity in our view than the H-Share index, which is overrepresented by expensive Chinese tech names.*

## 6. Golden Globe 2018 Award goes to ... Commodity Markets

Late cycle dynamics favour hard assets (e.g. gold) over shares and bonds. That's because, late in the cycle, strong volume growth with low inflation is succeeded, post-intermission, by slower volume growth but resurgent inflation. We'll particularly be watching the gold price for signs of rising inflation and/or any loss of faith in fiat currencies.



### Implications for portfolios

*Investors can gain exposure to commodity prices through a number of mechanisms, one of which is the Australian equity market given the high proportion of miners and commodity related companies. Emerging markets and collateralised commodity futures funds ("CCFs") are other possibilities.*

## 7. Apocalypse – North Korea

Despite intense pressure from both China and the U.S., both the belligerent rhetoric and the missile launches themselves from North Korea, are refusing to vacate the news screens. We'll be following the rhetoric regarding the South China Sea and the Korean Peninsular closely.



For Australia in particular, the Quadrilateral Security Dialogue (QSD<sup>3</sup>) will need careful handling; and any change of Government in Australia could change the balance yet again.

We expect that the Chinese sanctions will hold back any escalation. We have also seen commentary from Donald Trump indicating he remains open to dialogue. It is potentially going to be a volatile period moving forward, but we are not expecting any outright conflict.

### Implications for portfolios

*In the event of escalation, a global incident would see a move to safe haven assets, many of which are already expensive in our view (including U.S. Treasuries, U.S. dollar and the Swiss franc). Paradoxically - given Japan's proximity to North Korea - the Yen could also benefit. Gold stands out in our view as an attractively priced safe-haven asset. Investors need to be nimble in responding to significant market triggers.*

*"Investors need to be nimble in responding to significant market triggers."*

<sup>3</sup> Quadrilateral Security Dialogue to add India to the Trilateral Strategic Dialogue (TSD) between the US, Japan and Australia.

## 8. The Science Show – Decarbonisation & Responsible Investing

Climate change continues to disrupt agricultural and real estate markets. As well, rising sea levels continue to lap at the world's major cities - we'll particularly be watching developments in Shanghai, Cairo, Bangladesh, Osaka, Hong Kong, Miami, Alexandria, the Hague and of course, the North Pole.



We have seen a seismic change in the responsible investing arena as investors and shareholders look to encourage companies to reduce their carbon footprint and regularly report it.

### Implications for portfolios:

*Investors can implement responsible investing objectives through different options available such as exclusionary screens and enhanced index exposures<sup>4</sup>.*

For more details, [download](#) the full 2018 Global Market Outlook report.

### FOR MORE INFORMATION

Contact **Russell Investments** on **612 9229 5111** or visit **[www.russellinvestments.com.au](http://www.russellinvestments.com.au)**

### IMPORTANT INFORMATION

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<sup>4</sup> <https://russellinvestments.com/au/solutions/responsible-investment/overview>

Institutional clients may choose a centralised portfolio management approach to tailor exposures to their responsible investment beliefs.