Shifting winds

2018 Global Market Outlook – Q2 Summary

"It's been an eventful start to 2018 for global financial markets. Volatility is back, the U.S. Federal Reserve (Fed) is picking up the pace of hiking and trade war threats are increasing. But global growth is still strong and the U.S. economy is getting a jolt of fiscal stimulus. The tailwinds still outweigh the headwinds for now; however, this balance could shift as the year progresses."

Andrew Pease, Global Head of Investment Strategy

Key market themes

U.S. equities remain very expensive. The Shiller P/E ratio for the S&P 500 stands at 33x – its highest level outside of the late 1990s. We therefore continue to have an underweight preference for U.S. equities in global portfolios. With 10-year U.S. Treasury yields hovering around our 2.8% fair value estimate, **we move back toward a neutral preference on U.S. government bonds for the first time in several years**.

We continue to advocate caution with respect to UK equities given the uncertainties surrounding the Brexit negotiations as well as the economic slowdown. The Brexit negotiations are heating up and pressure is building to negotiate a new customs union with the European Union. We think it is too early to expect the government to change course before the summit, either voluntarily or by force through a Commons vote, but as time passes the pressure builds to resolve issues, which a customs union would help do.

Eurozone equity valuations are neutral while core government bonds are long-term expensive. We continue to favour eurozone financial markets, particularly over U.S. equities. Strong fundamentals and relatively attractive valuation underpin our view, while sentiment is currently not a differentiator.

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We believe Asia-Pacific economic data and equity markets should see another solid year of performance as global growth underpins demand and monetary policy remains relatively accommodative. Valuations are looking less expensive following the February sell-off, with Japan standing out as offering fair value. **A negative turn in the current U.S.-China trade discussions stands as a key risk**.

Economic Indicators

- One of the main takeaways from the start to the year is that volatility is back. The VIX index averaged just 11.1 in 2017, the lowest annual average on record. The combination of central bank tightening, rising inflation, protectionist pressure, and geopolitical risks, means that volatility is almost certain to be higher this year.

- Our preference for the past few years has been to "buy the dip" as our broadly positive views on the cycle outlook supported equities and credit. For now, the cycle tailwinds are stronger than the headwinds, so we are still looking to add risk when the market pulls back.

- We believe the headwinds will increase as the Fed becomes more aggressive, inflation picks up and profit margins come under pressure from rising labour costs. Buying dips will likely become more challenging as we move through the year and markets become more sensitive to recession risks.

Asset class views

Equities: Broadly neutral

Our cycle, value and sentiment investment decision-making process has **us broadly neutral global equities.** We're underweight U.S. equities because of expensive valuation, and we believe much of the good news is priced in. Positive cycle views and relatively better valuation give us small overweights to Europe, Japan and emerging markets within global equities.

Fixed income: Fair value in the U.S., expensive elsewhere

One of the stories of 2018 has been the lift in government bond yields. As of mid-March, the 10-year U.S. Treasury yield has risen by 50 basis points, U.K. gilts are up 30 basis points and German bunds have risen 23 basis points. **Only Japanese government bonds (JGBs) have bucked the trend**, where the Bank of Japan's yield curve control policy is keeping the 10-year yield below 10 basis points.

Our fair value includes our expectation that there is a good likelihood the U.S. could experience a recession by 2020, which means the Fed will be lowering rates. Bunds, gilts and JGBs, however, remain very expensive based on our methodology.

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Currencies: Yen rally has further to go

The euro enjoyed a tremendous 12-month period and is maybe now due for a short-term correction. In the medium term, we think a move to 1.30 is more likely for EUR/USD than a fall back towards 1.15 as the ECB starts its gradual exit from quantitative easing. In our view, the Japanese yen, which started 2018 on a firm footing, has taken over from the euro as the most attractive developed market currency. While the yen has been cheap for some time, cycle and sentiment indicators in our investment decision-making process are now also falling into place.

We have not been dollar bulls since March 2017 but the extent of the U.S. dollar weakness in 2017 and early 2018 has been puzzling. While we would not chase the weaker dollar narrative at this stage, we do not see a lasting recovery on the horizon. Meanwhile, a surprise hawkish shift by the Bank of England lifted GBP/USD to a post-Brexit high of 1.43 in late January, which is close to the PPP fair value. Sterling has since simmered down due to snags in the EU-UK Brexit negotiations. We expect a transition deal to result, which would be supportive of the pound.