Beware of bonds as inflation heats up

Percival Stanion looks at which investments are likely to fare the best – and worst – in 2017

Investors will need to buckle up this year. Political turmoil, rising inflation and tighter financing conditions will face off against improving economic growth and rising corporate earnings. That adds up to a challenging environment for equities and potentially a pretty grim one for bonds and bond-like dividend-paying stocks.

The winners in this climate should include cyclical shares, as well as traditional hedges against volatility and inflation, such as gold, the VIX (Volatility Index) and inflation-linked bonds. We also think it is prudent to hold ample cash – both as insurance against market falls and, arguably more importantly, to be ready to take advantage of any dislocations and mispricing that could follow from political upsets or policy actions.

On the policy front, we forecast two more interest rate hikes from the US Federal Reserve in 2017. The European Central Bank, meanwhile, has already said it will reduce liquidity injections to €60 billion per month from March.

In total, we believe that together the Fed, the ECB and their counterparts in the UK, China and Japan will generate some $800 billion of net liquidity in 2017 – less than half last year's $1.7 trillion and compared to an average of $1.2 trillion per annum over the past seven years.[1]

That spells the end of one of most potent investor-friendly trends of recent years – ample liquidity. Its partner – benign inflation – is also fading from view. From the US in the West to China and Japan in the East, we see price pressures accelerating this year in virtually every major economy, with global inflation hitting a four-year high.

In the US, Donald Trump's presidency is likely to further stoke the fire as promises of extensive infrastructure spending and tax cuts pump billions of dollars into an already-expanding economy and boost commodity prices. The combination of rising inflation and tighter liquidity is likely to push down bond prices.

More positively, global corporate earnings should benefit from stronger economic growth and could rise by as much as 13 per cent in 2017. Bigger profits could, in turn, encourage companies to step up capital expenditure, enabling business investment to surpass consumer spending as the economy's main fuel.

This is reflected in our sector allocation: we have a strong preference for cyclically-sensitive sectors such as industrials and financials. If economic growth and corporate earnings accelerate as we expect, cyclical stocks should rally to trade in line with their long-term 10 per cent premium to defensive stocks (from 6 per cent as at 16 Dec 2016).[2]

Regionally, we like the Japanese stock market for its strong cyclical credentials, a track record of solid performance during periods of global reflation and attractive valuations. Europe also offers compelling value, but we feel this relatively low valuation is currently justified by geopolitical risks and banking sector stress.

US equities could rise by 7-10 per cent in 2017 if all the tax cuts proposed by Trump are implemented – which is not a given. However, US stocks are close to being the most expensive ever versus Japanese and European peers so a further outperformance is unlikely unless markets enter a risk-off phase or the US dollar depreciates markedly.

In fixed income, in contrast, it is European government debt that looks expensive versus US Treasuries. Our preference instead is for emerging market local currency debt, which offers some of the highest yields in mainstream fixed income and tends to have shorter durations, making it less vulnerable to interest rate hikes. Possible threats to its performance, however, include a stronger US dollar and Trump's protectionist stance on global trade.

In the currency markets, the dollar is likely to strengthen in the coming months due to stronger US growth and Fed rate hikes. But over the course of 2017 as a whole we expect heightened volatility. The US dollar is currently some 20 per cent overvalued on a trade-weighted basis, according to our models.

Sterling, meanwhile, looks cheap following its steep depreciation. While weak growth may materialise eventually as Brexit unfolds, we believe that in the short term the UK economy and assets are more likely to exceed expectations, which in turn presents potentially attractive investment opportunities.

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[1] Central bank liquidity is the sum of asset purchases and credit operations net of sterilisation operations. Source: Thomson Reuters Datastream, Pictet Asset Management.

[2] Source: Thomson Reuters Datastream, Pictet Asset Management.