The investment landscape in 2018: It's all about the growth

2018 promises to be another good year for equities, thanks to broad-based economic growth, believes Percival Stanion

Rising interest rates. Brexit. North Korea's sabre-rattling. US President Donald Trump's unconventional approach to policymaking. They all have the potential to send markets into a tailspin next year. Throw in stocks' remarkably long winning streak – both the MSCI World and S&P 500 have scaled historic peaks – and investors have good reasons to worry.

For all this, though, 2018 promises to be another good year for equities. The main reason is growth. We expect the global economy to expand at a healthy (and above consensus) 3.4 per cent this year.

This growth will be led by robust consumption and a revival in capital spending, which should increase by 5 per cent globally in 2018 from 3.3 per cent this year. A low cost of capital, surging business confidence and the lagged impact of the recovery in corporate earnings should motivate companies to invest again, rather than buy back their own shares.

Eurozone equities to lead the way

The sun is shining especially brightly for euro zone equities. The pace of the region's economic growth is twice the long-term average, at 2.2 per cent; inflation is below target; and the European Central Bank's policy normalisation is following a very cautious path.

While US shares have witnessed a strong positive correlation with domestic economic growth, this relationship has not been as strong in Europe. Here, stocks have failed to fully factor in the region's improved economic performance; once they do, they should outperform US equities.

Our enthusiasm for equities isn't dimmed by the prospect of additional interest rate hikes in the US. Even if the Federal Reserve tightens the monetary reins – we expect up to three hikes next year – real interest rates in the US, Europe and Japan will remain negative for quite some time.

Potholes for bonds

But what is good for stocks will not be good for developed market bonds, where we see yields climbing steadily during next year. For one thing, fixed income is likely to react much more than equities to Fed rate hikes. What's more, and in complete contrast to European stocks, US bonds are reflecting an overly optimistic view of the economy.

Since the end of the global financial crisis, Treasury yields have been equal to about 60 per cent of the US's nominal GDP growth rate, which suggests that 10-year paper should trade at 3 per cent next year from around 2.3 per cent currently. This should be accompanied by continued flattening of the US yield curve – a development that typically occurs as the economic cycle matures and the US output gap shifts further into positive territory.

The magnitude of the upward move in German Bund yields could be a bit more modest, as price pressures are relatively muted on this side of the Atlantic and liquidity conditions remain loose. With both Bunds and Treasuries, however, investors are likely to end up nursing losses next year for only the second time since 1999.

Weak dollar boost for EM

We also forecast weakness for the US dollar, which our models indicate remains expensive. Its depreciation should be particularly visible against emerging market currencies, which are some 20 per cent undervalued versus the greenback.

Add to that an inflation-free economic recovery, rising commodity prices and attractive valuations compared to developed markets, and prospects for EM assets start to look rosy. A 10 per cent depreciation in the US dollar should boost returns on EM local currency debt by around 11 percentage points, according to our models.

As ever, investors will face a wall of worry in 2018. But as far as equities and emerging assets are concerned, they should be able to climb it.

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