

# INVESTMENT OUTLOOK 2018

## THE TIDE IS HIGH

Please note that this document may contain technical language.  
For this reason, it is not recommended to readers without professional investment experience.

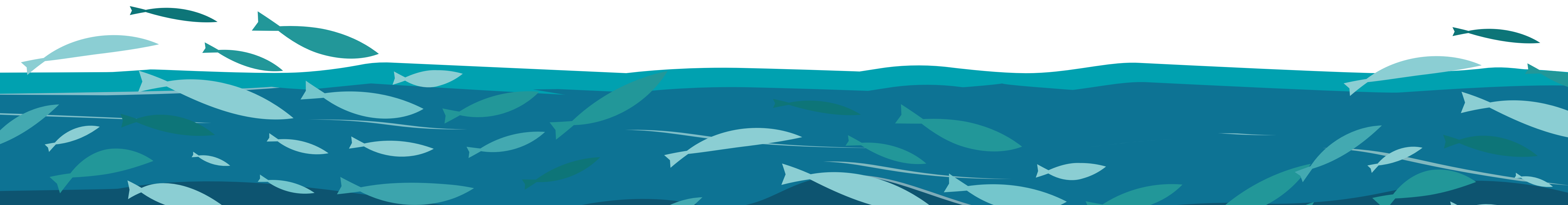


## - OVERVIEW -

# FACTORS DRIVING FINANCIAL MARKETS IN 2018

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- Financial markets are in the thrall of **positive macroeconomic** fundamentals and the longer-term investment implications of a low-rate, low-inflation environment.
- The expansion of G3 central bank balance sheets since 2009 has **lowered the risk premium** in equity, fixed-income, credit and emerging markets. In our view, this could continue, particularly as the aggregate size of central bank balance sheets looks set to continue to increase until late in 2018.
- The principal risk we see to this scenario is **an abrupt rise in inflation** triggering a major correction in debt markets. We ascribe a low probability to this outcome. On the contrary, we expect G3 central banks to continue to struggle to **achieve their inflation targets**.
- In 2018, while we see scope **for further gains in risk assets** (we do not, for example, consider valuations in equity markets to be excessive), but we are cognisant of the risk that *“capital superabundance can increase the frequency, size and longevity of market overshoots.”*<sup>1</sup>



**CLICK ON THE VIDEO BELOW TO FIND OUT MORE  
ABOUT OUR VIEWS IN UNDER 2 MINUTES.**



The asset manager for a changing world



## A RISING TIDE IN 2017

In 2017, the non-conventional policy measures of G3 central banks, in combination with the strongest – and most globally synchronised – acceleration in the pace of economic growth since the Great Financial Crisis lifted valuations across a broad range of asset classes.

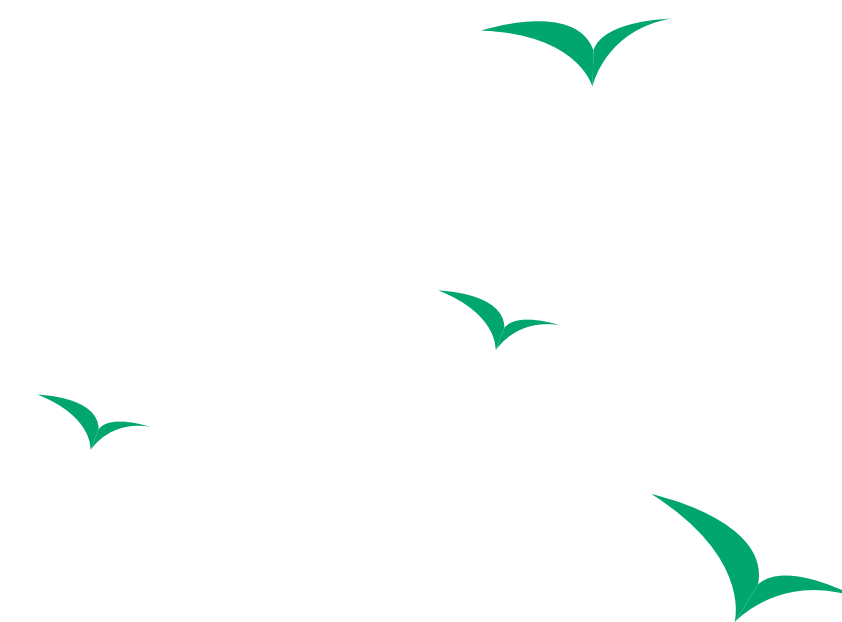
## ELEVATED PRICES FOR ASSETS AND A COMPRESSION OF RISK SPREADS

**Global stock prices**, as measured by the MSCI World index, have risen every month for the last 13 months (up to and including November 2017). Over the same period the **US S&P 500** index has also risen for 13 consecutive months. This is an almost unprecedented bull run; in the last 70 years, the only comparable runs of performance were sequences of 11 consecutive monthly rises during the 1950s.<sup>2</sup> Yields of **high-yield bonds** and **leveraged loans** fell to cyclical lows during the course of 2017. **Emerging market** assets, after a number of years of underperformance, put in a barnstorming run only corrected by a US dollar rally. On 15 November, Leonardo da Vinci's **Salvator Mundi** became the most expensive painting ever sold when it was auctioned at USD 400 million. The list goes on, but in short, **risk assets undoubtedly have the wind in their sails.**

## THE TIDE OF LIQUIDITY IS NOT SET TO RECEDE ANYTIME SOON

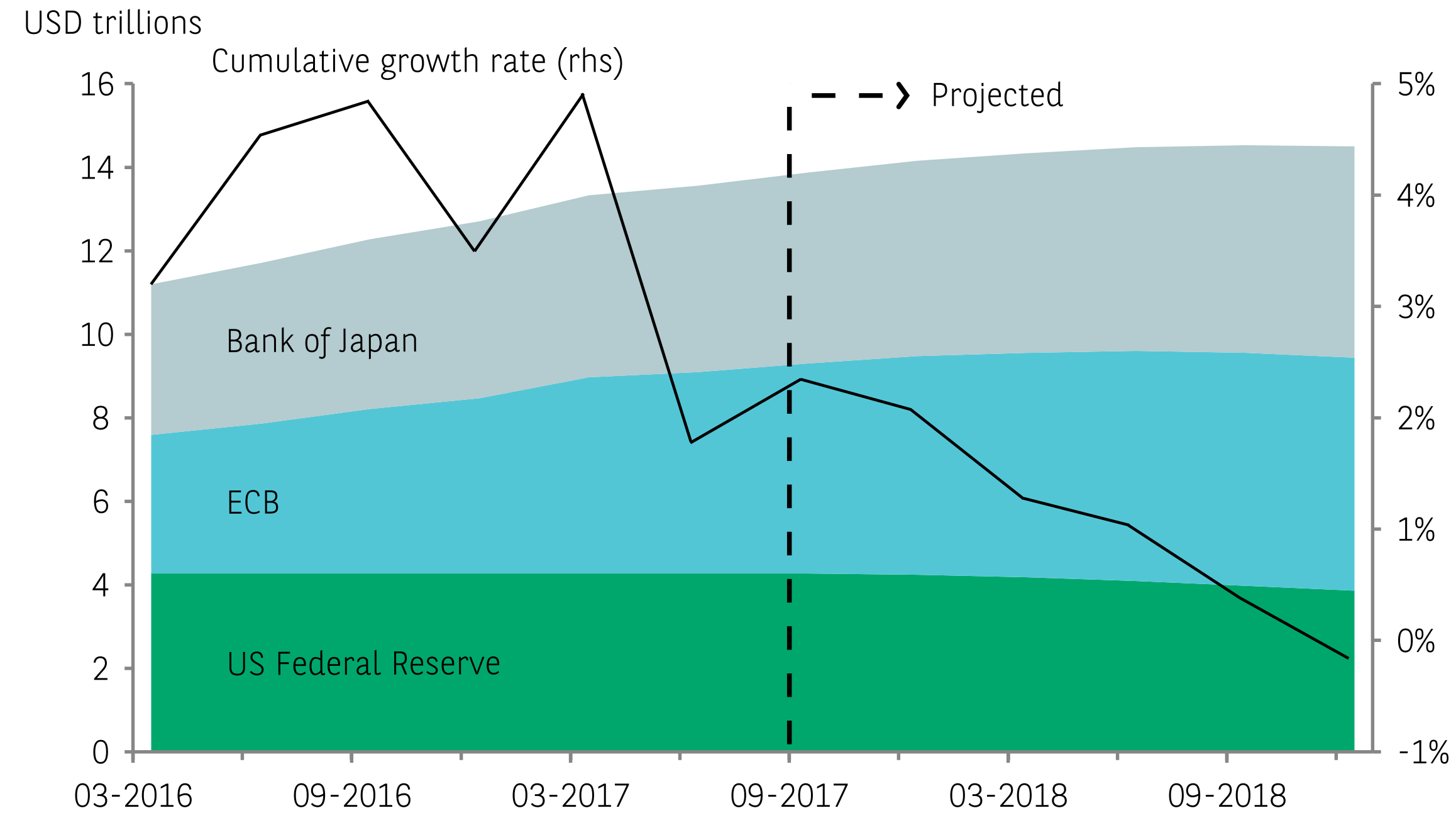
As the graph on the next page shows, G3 central banks now hold around **USD 14 trillion** of assets, compared to **USD 3 trillion** before the 2008 crisis. And the tide of liquidity is not set to recede anytime soon: aggregate G3 central bank balance sheets are forecast to **keep increasing** until at least the third quarter of 2018.

Over the course of 2018, a reduction in the amount of securities held by the US Federal Reserve should be **counterbalanced by growth** in the European Central Bank and Bank of Japan's portfolios, albeit at a slower pace. So, expansion in aggregate G3 central bank balance sheets should continue to effectively remove interest-rate risk and thus lower the risk of a 'tantrum' in sovereign debt markets.



# THE TIDE IS HIGH – AND THERE IS NO SIGN OF IT GOING OUT SOON

## CENTRAL BANK BALANCE SHEETS AND CUMULATIVE GROWTH RATE PROJECTIONS



Source: Federal Reserve Bank of New York, European Central Bank, Bank of Japan, BNP Paribas Asset Management projections, as of 31/10/2017

## OFFICIAL INSTITUTIONS CROWD OUT OTHER PURCHASERS OF DEBT INSTRUMENTS

OF THE **USD 1.5 trillion** OF DEBT  
ISSUED BY ADVANCED ECONOMIES SINCE 2010,  
**TWO-THIRDS HAS BEEN BOUGHT BY OFFICIAL PURCHASERS.\***

*"By reducing the stock of fixed-income instruments available to the private sector, central banks crowded out traditional investors, such as banks, insurance companies, and asset managers."\**

With sovereign bonds acting as a lighthouse across financial markets, this phenomenon lights the way for valuations in other asset classes.

\* Source: International Monetary Fund, Financial Stability Report, September 2017

## FULL STEAM AHEAD (BUT THE SEA IS STILL FULL OF REEFS)

In this environment, **the good times can roll on**, particularly as many investors are not overwhelmed by the feel-good factor. What little exuberance there is does not seem to be irrational. Valuations of risk assets are underpinned by **solid expectations** for growth in both advanced and emerging economies and a prolongation of the **low-rate, low-inflation** environment throughout 2018.

The monetary policy backdrop in developed markets remains **supportive of risk-taking**, with the absence of inflationary pressures suggesting that the withdrawal of exceptional policy measures will likely be extremely tentative. We thus subscribe to the view that gradualism will continue to be the hallmark of central bank policy and that when it comes, the unwinding of central bank balance sheets can **"run quietly in the background."**<sup>3</sup>

## IN OUR VIEW, THE MAIN RISK TO THIS FAVOURABLE ENVIRONMENT IS A RAPID AND SUSTAINABLE INCREASE IN INFLATION

Inflation remains conspicuous by its **absence**. Even after almost 10 years of non-conventional monetary policy, the average rate of inflation in the global economy is at below 3% and at around 2% in OECD member states. And this at a time when the pace of economic growth in major economies is outrunning their potential growth rate and there is **close to full employment**.

For the moment, many investors accept the idea that seismic, secular and global deflationary forces arising from technology and demographics are behind the **low-inflation paradigm**. Valuations of market indicators such as long-term swaps and inflation-linked bonds signal that investors expect US inflation to average around 2% for the next decade.

We see little prospect of a material rise in global inflation and also little prospect of central banks achieving their inflation targets in the years ahead. For these reasons, we expect the **low-inflation, low-rate paradigm to continue in 2018**.



THE AVERAGE RATE OF  
INFLATION IN THE GLOBAL  
ECONOMY IS AT BELOW

3%





## A WORLD AWASH WITH CAPITAL<sup>1</sup>

In our view, valuations in equity markets are high, but not extremely so. We believe it is reasonable to expect gains in earnings in 2018 and hence market appreciation on constant multiples.

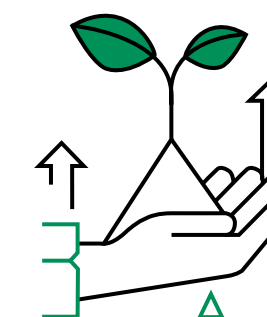
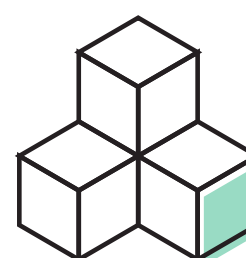
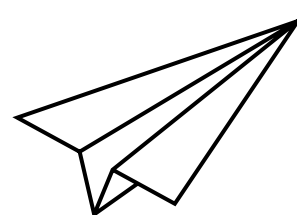
We do not see rising **interest rates** triggering a bond market sell-off in 2018. And interest rates of course matter. Remember your Finance 101 class - the price of a stock is the expected stream of future dividends, discounted back to the present value, using a discount factor that is a function of the interest rate and the expected growth rate of dividends. As such - and while they are not the only variable - the prospect of interest rates remaining low, or rising only very gradually, should continue to **underpin stock prices**.

When ranking asset classes in terms of their prospects in 2018, we see scope for **emerging market (EM) assets** to deliver strong returns. EM equities, for example, have lagged returns in developed markets by 60% since 2010, so there is potential for further outperformance, perhaps driven by an extension of the pick-up in economic conditions and the global trading environment.

Under the circumstances we have described, after almost 10 years of non-conventional policies from G3 central banks, liquidity is abundant and will continue to fuel the search for yield in a low-inflation, **low interest-rate world**.



**WELL THOUGHT-THROUGH IDEAS ARE REQUIRED TO SUCCESSFULLY NEGOTIATE THESE WATERS.  
IN OUR 2018 INVESTMENT OUTLOOK WE DISCUSS THE FOLLOWING STRATEGIES WE SEE AS  
OFFERING INVESTORS SOLUTIONS TO THE CHALLENGES THE CURRENT ENVIRONMENT PRESENTS:**



- In **2017**, the average level of volatility as measured by the VIX, was the lowest in its 24-year history. And this despite geopolitical tensions, known unknowns too numerous to mention and a populist outsider overturning conventions in the White House. We analyse the factors that could trigger a rise in volatility and the **steps we have taken** to ensure our investment processes integrate this eventuality.
- Bonds' coupons today generate insufficient returns. Factor investing, by seeking to generate returns from prices, has a role to play for fixed-income investors. We present our approach to applying **factor investing to bond markets**.
- Although it is less than a decade old, the green bond market raised USD 95 billion in 2016 and issuance looks set to reach USD 123 billion in 2017.<sup>4</sup> But green bonds only have a beneficial impact if the proceeds are invested in appropriate projects and if they are subject to a comprehensive and robust reporting mechanism. We explain how BNP Paribas Asset Management's Sustainability Centre puts green bonds through their paces to ensure they advance the **sustainable development agenda**.

1 On 14 November 2012, Bain & Company published an extremely prescient report entitled 'A world awash in money' explaining the notion of capital superabundance and the risks created as a consequence of long-term intervention by fiscal policy makers and central banks.  
 2 With thanks to our colleagues in the Quant Research Group at BNP Paribas Asset Management who found four periods of 11 consecutive months of positive performance for the S&P 500 since 1927. The last such run of performance ended in January 1959.  
 3 "We think this is a workable plan, and it will, as one of my colleagues, President Harker, described it, it will be like watching paint dry, that this will just be something that runs quietly in the background." Quote from Federal Reserve Chair Janet Yellen on how the Federal Reserve plans to reduce the size of its balance sheet at a press conference on June 14, 2017. Full transcript available at: <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20170614.pdf>  
 4 Bloomberg New Energy Finance, 26 September 2017

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