



Investment Insight

Friday, 13 January 2017

The future is here. Each year for the past two decades, JPMorgan Asset Management has published its long-term capital market assumptions. The publication provides risk and return expectations, over a 10 to 15 year horizon, for more than 50 asset and strategy classes. JPM's message this year is circumspect, but not gloomy. They recognise that current and prior policies have, in part, mortgaged the future and suggest that the difficult but unavoidable upshot of this year's message remains that, as a consequence of monetary policies which probably prevented economic Armageddon, we've borrowed returns from the future. Now that future is here. In this week's **Inside Track** we delve into their research in some more depth.

Mind the gap. Any long-term comparative analysis of US and European equity valuations will show that US equities generally trade at a premium. It's no different today, but the size of the current premium is almost at the maximum it's been over the past 15 years. Not alone that, on a Price/EBITDA basis, US equities are as expensive as they've been at any time over the same period. While the US economic situation at the end of the Obama era is quite encouraging, expensive stocks are expensive stocks. In **Pic of the Week** we take a look.

Quoted...

"We are not asking for a penny piece of community money for Britain. What we are asking is for a very large amount of our own money back, over and above what we contribute to the community, which is covered by our receipts from the community." –

Margaret Thatcher, 1979

The Inside Track

JPMorgan Asset Management's 2017 long-term capital market assumptions is a scholarly tome in which they predict long-term return assumptions across all asset classes. The common thread of sluggish growth and an extended period of exceptionally low rates runs through their assumptions for bonds, credit, equities and alternative assets alike. The following are some key extracts for major asset classes.

Fixed income: Credit a relatively bright spot

Government bond returns exhibit the most direct sensitivity to our forecast of low economic growth and a protracted normalization phase. Our projected returns for cash and government bonds are low in all major currencies, with the impact of near zero interest rates felt all along the yield curve. Credit markets are a relatively bright spot in the fixed income universe, as they were last year. We start from a point of somewhat tighter spreads, but returns remain attractive over our forecast horizon in high yield and longer-dated investment grade corporate credit in particular.

Equity: A less rewarding but still important source of returns

We reduce our return expectations for global equity markets roughly in line with cuts to our growth estimates, also recognizing the higher valuation starting point in world equities compared with last year. Our total return forecasts range from the mid to high single digits across all major equity regions. However, the source of returns differs markedly: DM returns come principally from increased payouts to shareholders, while EM returns are driven more by EPS growth. The implied equity risk premium (ERP) remains elevated in this year's assumptions, and in some markets sits above the long-term average. The elevated ERP does not signal that equities are cheap, however. To our mind, it suggests instead that bonds are expensive and that our expectations of low growth could lead to greater earnings volatility.

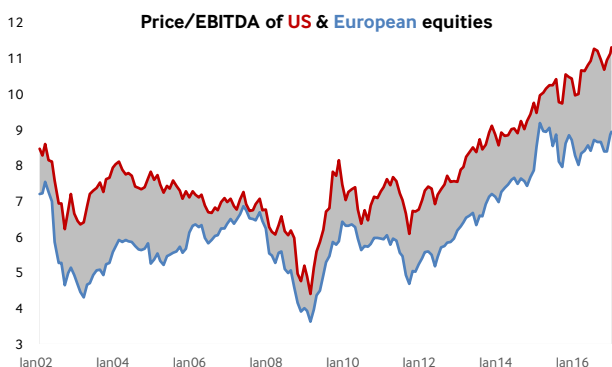
Alternative assets: Real assets resilient even as public market betas decline

In our return forecasts for alternative assets, real assets fare generally better than financial assets. Real estate returns in particular appear likely to be quite resilient against the background of a deteriorating growth outlook, as a pause in supply and improvements in operating cash flow contribute to an appealing valuation picture. The relative attractiveness of real estate compared with other long-duration assets has picked up markedly, and we would expect demand for real assets to remain robust across our forecast horizon.

Despite the trimming of our inflation forecasts, commodities are one of the few asset classes where long-run return expectations rise this year compared with last. Sluggish global growth—and especially the slower pace of Chinese growth—make it unlikely that we will see the early onset of a renewed commodity supercycle. However, eradication of supply excesses in key commodity sectors points to a modestly better outlook for the asset class.

Pic of the Week

The US market and markets in general have moved ahead nicely since the US elections in November. There is much talk of Donald Trump's economic policies being expansionary and particularly good for US companies with a large domestic exposure, which will include many small and mid-cap US stocks. However, there's some concern that this optimism is already in the price of US equities. As the chart shows, they are as expensive now in both absolute and relative (to European equities) as they have been at any time in the past 15 years. To justify this valuation we need to see very sold profit growth. Without that, there's every chance of a correction.



Market View

	Last 7 days	Last 12 mths	YTD	5Y Ann.
Global equities	+0.4%	+15.6%	+1.9%	+9.5%
US equities	+0.1%	+17.1%	+1.4%	+11.9%
European equities	-0.2%	+7.1%	+1.0%	+7.4%
EM equities	+0.6%	+22.6%	+2.8%	-1.4%
Irish equities	-0.2%	-0.4%	+1.3%	+17.7%
Commodities	+1.1%	+10.0%	+1.1%	-9.0%
Hedge funds	+0.2%	+4.5%	+0.4%	+1.5%

Economic indicators	Bond yields	Inflation	GDP YoY
Ireland	+0.9%	-0.1%	+6.9%
Germany	+0.3%	+1.7%	+1.7%
USA	+2.4%	+1.7%	+1.7%
China	+3.2%	+2.1%	+6.7%

Currencies	Current	YTD Δ
EUR:USD	1.06	+0.9%
EUR:GBP	0.87	+2.2%
EUR:CNY	7.35	+0.1%
GBP:USD	1.22	-1.4%
Bitcoin	826.35	-13.2%

Week ahead: Key events

16/01 UK House Prices
17/01 Japan Industrial Production
17/01 UK CPI & US Manufacturing
18/01 Germany CPI & UK Unemployment
18/01 US CPI & Industrial Production
19/01 US Housing Starts & Initial Jobless Claims
20/01 China GDP, Industrial production & Retail Sales
20/01 UK Retail Sales

Commodities	<i>Current</i>	<i>YTD Δ</i>
Gold	1,195.55	+3.8%
Copper	5,689.75	+3.0%
Oil	56.07	-1.3%
Wheat	426.25	+4.5%

Central Bank rates	<i>Current</i>
Eurozone	0.00%
USA	0.75%
UK	0.25%

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