Investment Insight

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ARIA | CAPITAL

Overheating? *With the US market hitting fresh highs on a regular basis, investors have been questioning the merits of maintaining the current level of exposures to the region, and rightly so in our opinion. Those maintaining their holdings cite strong economic momentum and lower-for-longer interest rates to rationalise their increasingly expensive investments. However, to what extent does the economic data outlook support this thesis? In this week's* ***Inside Track*** *we share the views of Deutsche Bank's Chief Economist, Peter Hooper.*

Pro-Active: *Since the global financial crisis and ensuing recession took hold, it is estimated that $2 trillion in assets have been dis-invested from active strategies to the benefit of passives. The extraordinary stimulus provided by central banks in recent times has resulted in passive investors making above-normal returns solely by hitching their wagons to the market.*

However, increasingly we hear concerns being voiced about "hidden risks" in passive funds and EFTs. As the volume of passive trades in the market increases, the concentration of exposure in fewer stocks becomes greater, ultimately producing a very crowded trade. Passive investors who buy a broad index in the expectation of getting a broad spread of risk may, in fact, be getting nothing of the sort. In ***Pic of the Week*** *we take a closer look.*

Quoted...

"If you want to become a billionaire, find a way to help a billion people." – Peter Diamandis

The Inside Track

The following are some thoughts from a recent note by Peter Hooper, Chief Economist at Deutsche bank, on the US economy and how he sees the Federal Reserve managing an economy that, at least for now, appears to be on solid ground.

As 2017 draws toward a close, the US economy is on good footing for continued above-trend growth in 2018 and beyond. Private sector fundamentals are mostly solid, the labor market has more than achieved full employment, and financial conditions are highly supportive of growth. The primary quandary in the economic picture is where is inflation?

We continue to expect real GDP growth of 2.5% for 2017 (Q4/Q4), in line with the above-consensus forecast we presented around mid-year. A key development has been a broadening of growth drivers beyond consumer spending, as capex and trade have strengthened in recent quarters. Our 2018 forecast is also unchanged at 2.3%, while we raised our 2019 projection a tenth to 2.1%. We expect growth to slow significantly in 2020.

With growth above potential over the year ahead, we expect significant further labor market tightening. Contrary to the FOMC median and consensus, which see unemployment levelling off at just above 4%, we have it falling to 3.5% by early 2019. It should begin to rise again in 2020. Although inflation should remain low through year-end, our medium-term view that core inflation should normalize is intact. Supporting this constructive outlook are positive signals from a variety of leading indicators including real GDP growth and import prices, among others. We also discuss a few structural forces that may weigh on inflation.

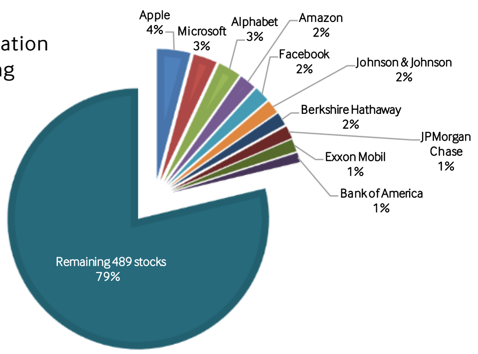
Our Fed view is unchanged: we expect the next rate increase in December, followed by three hikes in 2018 and four in 2019. This expectation is above the Fed's projections, as above-target inflation and an undershoot of unemployment below NAIRU force the Fed to raise rates further than the median FOMC projection envisions. Fed tightening should be sufficient to begin to move unemployment back toward NAIRU by 2020. The most notable recent Fed development is a near-wholesale transition in leadership. Jerome Powell's nomination for Chair should represent a good degree of continuity for monetary policy, though consensus may be more difficult to forge if uncertainty lingers about inflation.

Potential policy changes in Washington represent the greatest uncertainty to this outlook. Regulatory reform has already given animal spirits and private spending a lift. Tax reform is an important wild card, though it faces significant political challenges. Conversely, potential disruptions to trade policy would be a negative development.

Pic of the Week

Avoiding over-concentration of risk is one of the key considerations of sensible investment management. Passive investors in, for example, the S&P500 Index may invest in the index in the belief that they are wisely avoiding such risk concentrations. But are they? While the top 10 stocks in the index comprises just 2% of its membership, they are currently responsible for about 17% of the index's variance (usually used as a measure of risk) and over 20% of its capitalisation-weighted exposure. Many of these top 10 stocks have performed well, driving the index on to new highs. However, should the tide turn (or, inevitably, when it turns), passive strategies may suffer considerably compared to their active counterparts. Caveat emptor.

S&P500 Capitalisation Weighting



Market View

	Last 7 days (€)	Last 12 mths (€)	YTD (€)	5Y Ann. (€)
Global equities	+1.0%	+10.7%	+6.2%	+13.0%
US equities	+0.6%	+8.8%	+4.3%	+16.3%
European equities	+1.3%	+16.4%	+10.1%	+10.3%
EM equities	+3.5%	+22.1%	+20.4%	+6.6%
Irish equities	+2.3%	+9.7%	+5.6%	+16.2%
Commodities	+0.8%	-5.1%	-13.3%	-8.4%
Hedge funds	+0.5%	+3.2%	+2.0%	-0.1%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+0.6%	+0.6%	+7.2%
Germany	+0.4%	+1.6%	+2.8%
USA	0.0%	+2.0%	+2.5%
China	+1.8%	+1.9%	+6.8%

Currencies	*Current*	*YTD Δ*
EUR:USD	1.1852	+12.7%
EUR:GBP	0.8910	+4.6%
EUR:CNY	7.7977	+6.8%
GBP:USD	1.3302	+7.7%
Bitcoin	8,203	+762.0%

Week ahead: Key events

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28/11 US House Price & Consumer Confidence
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Commodities	*Current*	*YTD Δ*
Gold	1,290.98	+12.2%
Copper	6,875.00	+25.0%
Oil	63.24	+11.3%
Wheat	422.75	+3.4%

Central Bank rates	*Current*
Eurozone	0.00%
USA	1.25%
UK	0.25%

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