



Investment Insight

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Goldilocks: Recent economic growth momentum has been strong across many economies and this continues into 2018. Easier financial conditions, reflecting buoyant markets for risk assets and low interest rates, imply sustained near-term tailwinds, and fiscal stimulus in the U.S. and elsewhere in the advanced economies is forthcoming. Meanwhile, China keeps suppressing domestic economic and financial volatility while fundamentals in many other emerging market economies continue to improve.

However, a Goldilocks-extended scenario is very much baked into the consensus and asset prices. Might 2018 be the cyclical peak for growth and the precursor to a more challenging period? In this week's **Inside Track** we look at recent views on these matters emerging from PIMCO's latest Cyclical Forum.

Shiller's list: US equities are at one of their most expensive levels in history when measured on the Shiller scale (which adopts a cyclically-adjusted approach by using 10-year average earnings for the "E" part of the P/E equation). Historically, valuations of this level have heralded weak share price performance over the subsequent 10 years. However, other current factors, such as low interest rates, provide a potential caution against bearish forecasts. In **Pic of the Week** we explore the matter further.

Quoted...

"If you have ten thousand regulations you destroy all respect for the law."

– Winston Churchill

The Inside Track

PIMCO's baseline forecast is for world real GDP growth in 2018 is in the 3% to 3.5% range. However, the following extracts from their recent report on their latest Cyclical Forum identify some gathering storm clouds on the horizon.

Borrowing from the future

First, the prospective U.S. fiscal expansion in 2018 appears dictated by the political cycle rather than the economic cycle. Fulfilling 2016's presidential election campaign promises and delivering tax cuts and spending increases ahead of 2018's congressional midterm elections makes political sense but could have detrimental longer-term economic consequences. Why?

Arguably, the last thing an economy operating at close to full employment in the ninth year of an economic expansion needs is a shot in the arm from fiscal policy. Adding around \$1 trillion to the public debt over 10 years without adding much to potential growth and thus future tax revenues could come back to haunt the public coffers if rates rise in the future. And most importantly, depleting the fiscal toolkit while the economy is good comes at a price: Higher fiscal deficits and debt levels imply that the room for fiscal stimulus in the next recession will be more limited.

Cyclical pressures could push inflation higher

A second major risk related to the 2018 outlook is that wage and/or price inflation may finally inflect higher as employment overshoots its natural level. There are good reasons why this hasn't happened so far, including low productivity growth, the recent rise in labor force participation and diminished bargaining power.

However, the risks of a cyclical inflation overshoot in 2018 are rising given the globally synchronized nature of the expansion, additional fiscal stimulus, recent rises in commodity prices and super-easy financial conditions. Global structural forces are still weighing down inflation, but the cyclical pressures are clearly on the up.

The risk of monetary overkill

A third risk for 2018 is that the reduction of monetary accommodation – well-intentioned as it may be given decent cyclical growth – turns out to be too onerous for economies and asset markets that have become addicted to low short rates and depressed term premia across the yield curve. The turn in the tide of global central bank policies poses significant risks to markets and economies, particularly as the new and still-evolving Fed leadership is untested.

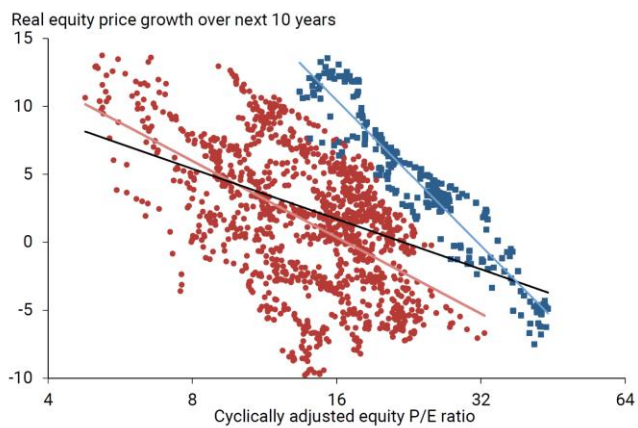
Pic of the Week

The tendency of P/E ratios to revert to their average levels suggests low returns after high valuations. The chart, compiled by the Federal Reserve Bank of San Francisco, shows monthly cyclically-adjusted P/E ratios and the corresponding real equity price growth over the following decade. In a nutshell, the data is showing that at almost any time in the past when valuations have been at current levels, the return on equities in the subsequent 10 years has been negative. As is often a feature of asset price bubbles, there is a "this time it's different" argument doing the rounds (cue evangelistic "new paradigm" pronouncements), and it's based on interest rates: viz. rates are going to stay historically low indefinitely and thus a lower-than-ever-before discount rate should be applied to future earnings, thus justifying higher P/E ratios. Sadly for the believers, last time it was different, it turned out not to be. Nor the time before, or before that. 'Nuff said.

Market View

	Last 7 days (€)	Last 12 mths (€)	YTD (€)	5Y Ann. (€)
Global equities	+1.7%	+9.7%	+2.0%	+13.0%
US equities	+1.6%	+9.1%	+1.9%	+16.6%
European equities	+1.8%	+11.7%	+1.9%	+9.4%
EM equities	+0.9%	+20.3%	+3.0%	+5.7%
Irish equities	+0.4%	+7.6%	+0.9%	+15.2%
Commodities	-0.4%	-2.7%	+0.2%	-7.1%
Hedge funds	+1.3%	+4.1%	+1.4%	-0.0%

Currencies	Current	YTD Δ
EUR:USD	1.2049	+0.4%
EUR:GBP	0.8892	+0.0%
EUR:CNY	7.8290	+0.3%
GBP:USD	1.3549	+0.3%
Bitcoin	13,743	-5.2%



Note: Red dots and trend line reflect data available through December 1996; blue squares and trend line reflect later data. Black line reflects trend for all data depicted.

Commodities	Current	YTD Δ
Gold	1,321.80	+1.5%
Copper	7,140.00	-0.2%
Oil	69.06	+4.8%
Wheat	430.63	+0.9%

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

Economic indicators	Bond yields
Ireland	+0.7%
Germany	+0.5%
USA	+2.6%
China	+2.0%

Week ahead: Key events

- 15/01 UK House Prices & PMI Data
- 16/01 UK Inflation & US Manufacturing
- 17/01 US Mortgage Applications Survey & Retail Sales
- 17/01 US Housing Market Index Data
- 18/01 Japan Industrial Production
- 18/01 US Housing Starts and & Initial Jobless Claims
- 19/01 Japan Department Store Sales & UK Retail Sales
- 19/01 US Export Sales

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