NATIXIS INVESTMENT MANAGERS

CAPITAL MARKET NOTES

2018 Outlook

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2018 – A Year of Living Dangerously

2018 could shape up to be a challenging year. As the economic expansion matures, investors may face difficult choices. Fiscal and monetary trends could collide with extended valuations and geopolitical risks to create market volatility that has been absent for several years. For investors, it may seem like déjà vu as many of these themes have been predicted, but not realized, in recent years (see last year's scorecard).

Trump-Kim throw-down in North Korea is still on the horizon, Brexit moves from theory to reality as we approach the March '19 exit date, and the risk of populism continues to have negative implications for elections in Italy, Mexico, and Brazil. Thus far, buoyant markets have overpowered geopolitics, but that could change in 2018. Such is the nature of black swans.

2017 Scorecard

Forecast		Results
Global economy gains broad-based strength	☑	Global economic expansion continued/accelerated in 2017
Messy Brexit divorce weighs on UK but not EU	☑	UK data has deteriorated while EU economy is picking up strength
Little change in the trajectory for Japanese growth	☒	Japanese economy showed some stronger signs of life
China stabilization benefits EMs	☑	Emerging market equity and fixed income generated solid results
Earnings and stocks push higher but returns constrained	---	Stocks were up, but significantly more than we expected
Corporate bonds continue to outperform sovereign in spite of valuation	☑	Investment grade, high yield, and senior loans all performed well
US TIPS and municipal bonds outperform nominal Treasuries	---	TIPS lagged nominal US Treasuries, but munis generally outperformed
Investor patience will be tested: volatility up	☒	Global capital markets remained in a very low volatility environment

A World of Potential Trouble

Moving into 2018, we believe there is still plenty for investors to be worried about. Surely you've heard this list in some form, but here's our spin.

Diminishing Monetary Stimulus

Central banks are pulling back; not completely, but at the margin. In the US, the Fed is both raising rates (probably 3 times next year) and reducing its balance sheet. Yes, the normalization process will unfold slowly, but quantitative tightening will happen at an ever-increasing pace. In Europe, the ECB has already begun tapering, and bond purchases may be fully phased out by Q3:18. Moreover, while few expect the ECB to raise rates, there are rumblings among the hawks at the bank that yields are too low, creating an outside possibility of an unpleasant surprise next year. Finally, in Japan, the BOJ will keep rates pinned near 0%, but its QE program will likely expand at a slower rate.

While we believe central bank action will be gradual, markets could still react negatively to draining liquidity, even at a slow pace. In addition, an unintended consequence of unwinding such an extraordinary amount of post-crisis stimulus is that we simply cannot know which over-levered player might spark the next liquidity panic – or when.

Geopolitics Remain in Focus

It's hard to imagine geopolitics getting more headlines in 2018 than they have already received. But we are hardly out of the woods yet. Merkel's ability to further integrate Europe has been hindered by her struggle to form a governing coalition. A

Extended Valuations

After nearly $18 trillion in global QE, it is universally understood that most broad asset classes are expensive to one degree or another. P/Es are high across the global equity markets while base sovereign yields and credit spreads are near historic lows. Valuation alone isn't generally a problem; it usually takes a catalyst to trigger a selloff. But if an investment's margin-of-safety is the inverse of valuation, elevated prices remain a source of potential risk.

What, Me Worry?

In spite of these headwinds, risk assets have continued to perform well. Many observers see a disconnect between today's market risks and sky-high equity prices, but investors shouldn't overthink the situation. We believe this disconnect has a straightforward explanation: robust and synchronized global growth. Following years of positive but sub-par growth, the economic acceleration that began in mid-2016 has masked these economic and political concerns. This is the global "status quo trade" we've discussed for months: As long as the global economy is chugging along, investors seem content to ignore these risks.

Playing Chicken

This status quo trade makes it very easy to distill our 2018 investment outlook down to one question: Will the global economy remain on track? If so, we are likely in for more of the same – positive returns for stocks and bonds. However, if the global economy falters, we think the pain could be significant, as there would be little valuation or central bank support against falling prices.

In simple terms, we believe investors are playing a dangerous game of macro chicken. With low yielding sovereign bonds offering little competition, investors are compelled to ride the "carry train" (credit spreads in bonds and the earnings yield in stocks) for as long as they can – hoping of course that they'll be able to jump off before the economy goes off the tracks.

Outlook for 2018

We remain on the carry train too, although half-heartedly at best. Our themes for next year include…

- The global economy shows almost no signs of weakening as yet. The resulting earnings growth should support stock prices while credit fundamentals remain solid. The market remains "risk on" (for now).
- As we push later into the year, geopolitics, tighter monetary policy, and growing inflation may make 2H a little more harrowing.
- We expect equity returns to be positive but below average. Stocks across most regions and cap ranges will only fire on one cylinder (earnings growth) as P/E expansion has been largely depleted at these valuations.
- In the bond market, we expect real yields to push only modestly higher. Inflation is a far bigger wild card. Regardless, high quality bonds remain in an environment where investors will be lucky to realize their yield (as it is partially offset by some level of rising rates/price depreciation). Credit spreads can remain fairly tight as the economy grows, but expect spread volatility to rise in the second half.
- The US yield curve may continue to flatten somewhat as hikes at the short end modestly outpace rising rates at the long end. Even so, we're still some time away from an inverting yield curve presaging recession.
- Solid fundamentals and strong *relative* value arguably make emerging markets the most attractive play in both equities and fixed income. However, our enthusiasm is constrained as EM already appears to be universally loved by investors – a very crowded trade.
- We believe the US dollar will see some modest strength thanks to attractive interest rate differentials, the Fed's relatively tighter policy, a sugar-high from US corporate tax reform, and a flight-to-quality if markets get more skittish (as we expect).
- Volatility across asset classes has been muted by stronger growth, the market's overall direction (up) and by central bank largesse. We believe markets will become bumpier as central banks begin to pull back in earnest.

We reiterate our view that investors should stick with risk assets as the global economy strengthens and stay aboard the carry train for now. But they may want to exercise more caution. Mean reversion, late cycle fundamentals, receding central bank liquidity, and stretched valuations all argue for a more vigilant approach in 2018. Given that we'll never know exactly when the train may jump the tracks, foregoing some upside for a safer ride seems warranted.

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