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2017 – a list of lists regarding the macro investment outlook

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EDITION 1

Key points

> 2017 is likely to provide reasonable investment returns.
> Watch President Trump, the Fed and the $US, various Eurozone elections, global business conditions indicators and business confidence in Australia.
> The investment cycle still favours growth assets over cash and bonds - despite likely bouts of volatility.

Introduction

Despite a terrible start to the year and a few political surprises along the way, 2016 saw good returns for diversified investors who held their nerve. Balanced super funds had returns around 7.5%, which is pretty good given inflation was just 1.5%. 2017 is commencing with less fear than seen a year ago but there is consternation regarding Donald Trump's policies, political developments in Europe and the growth outlook. This note provides a summary of key insights on the global investment outlook and key issues around it in simple dot point form.

Seven lessons from 2016

- Global growth may be constrained – but it's far stronger and more resilient than was feared at the start of 2016.
- The US Federal Reserve is not stupid - it is not on "rate hike autopilot" and takes account of global conditions and the $US and the impact of both on the US.
- China won't tolerate a rapid slowing in economic growth - yes it wants to reform the supply side of its economy and slow down the growth of debt but it will not do so blindly.
- Geopolitics is having a rising impact on investment markets – in part a populist backlash against establishment politics with implications for economic policy, eg, globalisation.
- But, turn down the noise - fears that Brexit, Australia's messy election, a Trump victory and an Italian "No" vote would lead to financial catastrophe proved ill-founded. Retreating to cash after these would have been costly.
- The terror threat is alive and well but the impact on investment markets is limited.
- Stick to an investment strategy - 2016 proved distracting for investors but they would have done okay provided they stuck to an investment strategy that prevented them from getting blown around by swings in market sentiment.

Key themes for 2017

- Global growth of around 3.2% or just above, with the US around 2.5%, Europe and Japan lagging and China running around 6.5%. Australian growth of around 2.5%.
- A gradual rise in underlying inflation, albeit from low levels.
- Global monetary conditions remaining easy but less so, with gradual monetary tightening in the US and China offset by ongoing easing in Europe, Japan and Australia.
- Reflecting this, global shares are likely to trend higher and we favour Europe and Japan over the US (which may be constrained after its 2016 outperformance and Fed hikes).
- Australian shares are likely to have solid returns as resource sector profits surge following the rebound in bulk commodity prices, overall profits rise 10% and interest rates remain low.
- Still low yields and capital losses from a gradual rise in bond yields are likely to see low returns from bonds.
- Commercial property and infrastructure are likely to continue benefitting from investors' ongoing search for yield, but this demand will wane as bond yields trend higher.
- Australian capital city residential property price gains are expected to slow to around 3-4%, as the heat comes out of the Sydney and Melbourne markets and rising supply hits.
- Cash and bank deposit returns will remain poor.
- The downtrend in the $A from 2011 is likely to continue as the interest rate differential in favour of Australia narrows and it undertakes its usual undershoot of fair value.

Key risks for 2017

- President Trump could set off a global trade war and wider political tensions with China (eg, in the South China Sea).
- US fiscal stimulus under Trump could overheat the US economy resulting in an aggressive Fed & a further rebound in the $US causing problems for emerging countries.
- A further rapid rise in bond yields would be bad for shares and assets that have benefitted from the search for yield including real estate and infrastructure investments.
- Success by populist parties in Europe could reignite Eurozone break up fears.
- China could have its long feared hard landing.
- Australia could be vulnerable as apartment supply surges and housing construction slows.
- Factor X – there is always something from left field. Last year it was the rise of populism in some Anglo countries.

Five things to watch

- President Trump - whether we get Trump the pragmatist or Trump the populist.
- US inflation and the Fed – how quickly both move up.
- Elections in the Netherlands in March, France in April/May, Germany around September and possibly in Italy.
- Global business conditions indicators (PMIs).

- Business confidence & non-mining investment in Australia.

Three reasons why global growth is likely to continue

- We have not seen the excesses (massive debt growth, overinvestment, plunging spare capacity or excessive inflation) that normally precede recessions.
- The US monetary tightening cycle is in its very early stages and global monetary conditions are still very easy.
- Fiscal austerity has faded and we are seeing early signs of a shift from monetary easing (which arguably has become less potent) to fiscal stimulus.

Three reasons to expect Trump the pragmatist to ultimately take precedence

Donald Trump's anti-establishment mandate, bellicose approach and inexperience will no doubt continue to create much uncertainty about his policies in the short term. His war with the media, issues around Russia and potential conflicts of interest add to the risks. However, there are reasons to expect that on the policy front pragmatism will ultimately prevail with the focus being on the growth boosting potential of tax cuts, infrastructure spending and deregulation:

- Economic and political realities (including Congress) invariably take some of the edge off more radical policies once politicians attain power.
- Trump has a focus on growth and jobs and won't want to threaten this which suggests pragmatic policy outcomes.
- As a businessman he is likely to ultimately seek win/win solutions with other countries (notably China) even though he may use a bellicose negotiating stance.

Three reasons why Chinese growth will likely come in around 6.5% and not much lower

- Stimulus measures over the last two years highlight the government has no tolerance for a collapse in growth.
- The services sector is taking over from manufacturing.
- Deflation is receding as indicated by rising producer prices.

Three reasons why geopolitics is more important

- The slow post GFC recovery, rising inequality in some countries and stress around immigration are leading to a backlash against establishment politicians.
- The relative decline of the US is shifting us away from the unipolar world that dominated post the Cold War (where the US was the world's cop) to a less stable multi-polar world (where skirmishes and proxy wars are more common). The symbiotic relationship between the US and China is fading.
- The information revolution is enabling us to make our own reality, with the decline of traditional media in favour of online news sources that can be less reliable or self-selected. Conspiracy theories go mainstream!

Four reasons why the Eurozone won't break up

Eurozone break up fears will again feature with elections in the Netherlands, France and Germany and maybe Italy. But there are three reasons why it won't break up... well at least not yet:

- Most of Europe does not have the problems with inequality that have helped drive Brexit and Trump.
- Eurozone break up risk arguably peaked a few years ago when austerity and unemployment were at their peak.
- Support for Eurosceptic parties has not picked up significantly since Brexit and Trump and support for the Euro in mainstream Europe remains high.

Five reasons why Australia won't have a recession

- Interest rates can still fall further if needed.
- The drag on the economy from falling mining investment is fading and should bottom in the next year or so.
- National income is rising thanks to rising commodity prices.
- Sectors such as tourism and higher education (both helped by the lower $A) along with state capital spending should help offset the gap left by slowing housing investment
- Stronger export volumes (from resource projects) will provide a partial offset to lower commodity prices.

Five reasons the RBA is more likely to cut than hike

- The outlook for business investment is still weak.
- To offset a slowing contribution to growth from housing.
- The $A needs to fall further.
- To offset the monetary tightening from bank mortgage rate hikes for existing home owners.
- Inflation is likely to remain below target for longer.

Three reasons why the super cycle bond bull market from the early 1980s is likely over

- Deflation is waning with commodity prices hitting bottom.
- Global spare capacity is gradually being used up.
- Bonds are over-loved having benefitted from a huge flow out of equities since the GFC.

Five reasons why shares are likely to provide decent returns by year end…

- Shares are not overvalued against still low bond yields and interest rates.
- A global recession looks a long way away.
- A pick up in global growth should help profits.
- Monetary conditions are still very easy and while the Fed will continue to tighten other central banks are still easing.
- There is a lot of pessimism around.

...but three reasons to expect continued volatility

- Much uncertainty remains in the short term around President Trump's policies.
- Geopolitical risks could flare up – particularly between the US and China and in Europe.
- Shares are not dirt cheap anymore.

Nine things investors should remember

- The power of compound returns – saving regularly in growth assets can grow wealth substantially over long periods. Using the "rule of 72" it will take 29 years to double an asset's value if it returns 2.5% pa (ie 72/2.5) but only 9 years if the asset returns 8% pa.
- The cycle lives on – markets cycle up and down and we need to allow for it and not get thrown off by rough patches.
- Diversify – don't put all your eggs in one basket.
- Turn down the noise – this was a big one in 2016 where the noise around political events really just created distractions.
- Starting point valuations matter – for example low bond yields will mean low medium term bond returns.
- Remember that while shares can be volatile, the income stream from a diversified portfolio of shares is more stable over time and higher than the income from bank deposits.
- Avoid the crowd – at extremes it's invariably wrong.
- Focus on investments providing sustainable and decent cash flows – not financial engineering.
- Accept that it's a low nominal return world – when inflation is 2% a 7.2% super return (the average for balanced growth super funds over the last three years) is pretty good.

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