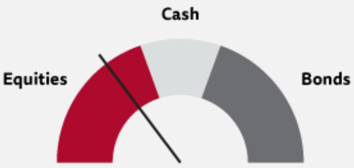
EVANS & PARTNERS

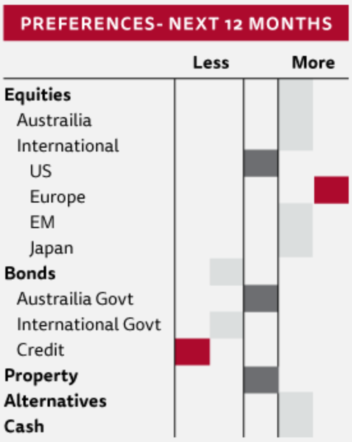
the OUTLOOK for 2018

December, 2017 **PORTFOLIO STRATEGY**

Tim Rocks
Chief Investment Officer

Asset Allocation:





Source: Evans & Partners

KEY FORECASTS

	Now*	12 Month Forecast
$A	0.757	0.716
US 10 yr	2.38	2.60
AUS 10 yr	2.50	2.70
ASX 200	5970	6300
S&P 500	2648	2700

*As of 1 Dec
Source: Datastream Evans & Partners

Don't Fade Away

During 2017 the stars aligned with rising GDP and earnings, falling inflation and easy monetary policy. These effects will carry into 2018 but they will fade. The critical factors will be the pace of reform in China and whether inflation returns as an issue for central banks. Our assumptions are:

- Economic momentum in the US and Europe continues into 2018. Europe is only in the early stages of a sustainable recovery.
- A renewed reform agenda weakens activity in China. We will be monitoring any spillover to the global economy and financial system but expect they will be limited.
- The pricing power from stronger demand gradually pushes global inflation back towards inflation targets. This will force a faster pace of policy tightening than is currently assumed by investors, particularly in Europe.
- Australian conditions improve led by a strong labour market and improving capital spending outlook.

RECOMMENDATIONS

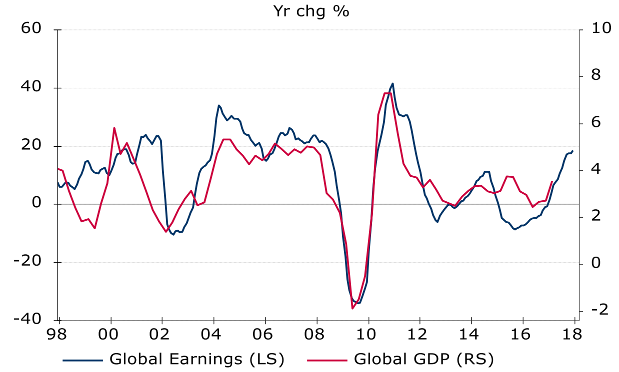
The implications for asset allocation are:

- Equities are preferred to bonds given the low level of rates and the potential for equity returns to be driven by earnings, however the gap will not be as great as in 2017. International equities are preferred to domestic equities although this is a tighter call now.
- Within equities, Europe is preferred given reasonable valuations and better prospects for earnings. Our order of preference for the other regions is emerging markets, then Japan, with the US as least preferred.
- We have raised our target for the ASX 200 to 6,300 based on improved prospects for economic and earnings growth. This is consistent with around 11% returns including dividends and the impact of franking.
- Within bonds, sovereigns are preferred over corporate credit and hybrids given extremely low levels of corporate and hybrid spreads. Australian sovereign bonds are preferred over their international equivalents.
- The decline in the $US has dominated all other factors in currency markets this year. Going forward, we expect some downside to the $A as commodity prices retrace and US rates rise relative to Australia. Our 12-month forward forecast for the $A is now $US0.72.

Key issues: earnings vs inflation

2017 has been an exceptional period for earnings. Global earnings have risen close to 20% over the past year and this has been the main driver of strong equity returns.

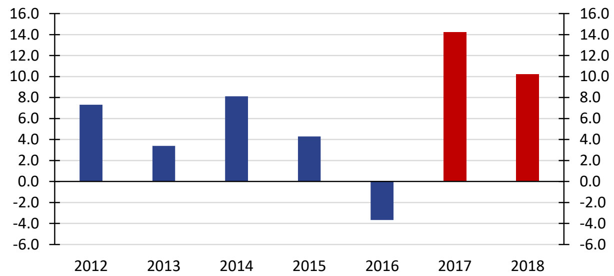
Global GDP and Earnings Growth



Source: Thomson Reuters Datastream, Evans & Partners

Equities are likely to have another good year if this momentum in earnings can be sustained and provided the increase in inflation is not too significant. At present, analysts are forecasting that buoyant earnings will continue; bottom-up forecasts point to growth of around 10% in earnings per share in 2018.

Global earnings growth (%)

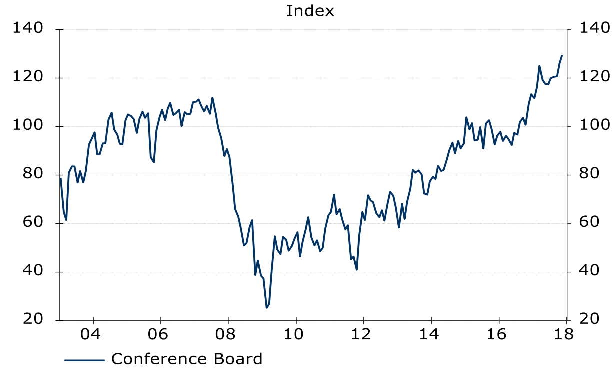


Source: Datastream, Evans & Partners

The recovery is broadening in the old world

The backdrop of strong earnings has been a surprising strength in developed world economies. The US economic cycle has consolidated over the past year; consumer spending is healthy and there are now encouraging signs that businesses are beginning to invest. The charts below show the bounce in consumer and business sentiment.

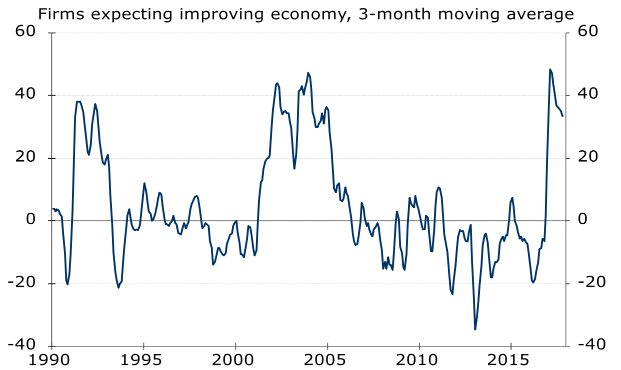
US consumer confidence



Source: Thomson Reuters Datastream, Evans & Partners

Small business sentiment surged around the time of the Trump win, and even though he has not delivered on much of his agenda, confidence has stayed high and this is now translating into higher investment as shown by a 10% rise in orders for capital goods over the past year. At the same time, the damage done by the hurricanes over the summer has provided a boost to the housing and auto markets, two sectors that were weaker earlier in the year.

US Small Business Sentiment

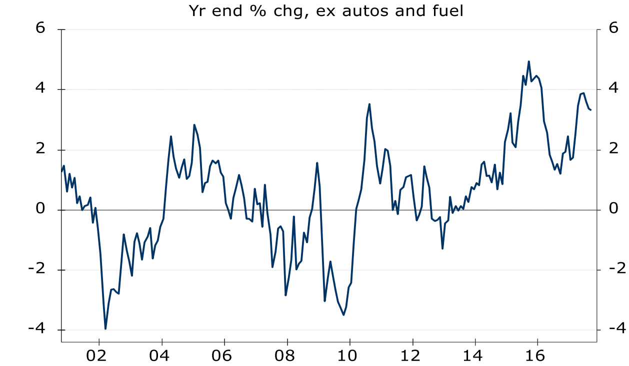


Source: Thomson Reuters Datastream, Evans & Partners

In Europe, the recovery that commenced in the industrial north in 2015 has steadily moved south through France, Spain and even to Italy in recent months. Changing attitudes to government spending and a banking sector that is functioning again have meant that Europe has finally been able to emerge from the shadows of the financial crisis. German conditions are buoyant now with strong retail sales and the highest level of business confidence in decades. Germany has particularly benefitted from substantial government spending associated with the refugee influx of 2015. In Italy, the bank recapitalisation earlier this year appears to have had an immediate impact on economic conditions.

German retail sales

Yr end % chg, ex autos and fuel

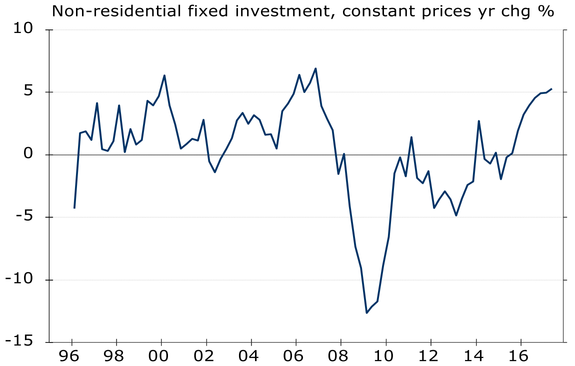


Source: Thomson Reuters Datastream, Evans & Partners

Better economic conditions have reduced political risk in Europe as shown by extreme parties not faring as well as expected in recent elections in Austria, France and the Netherlands. Importantly, the risk of Euro-zone break-up has materially declined. Nevertheless, some risk remains as shown by the stand-off in Spain over Catalonia, Merkel's challenges in forming government in Germany and the ongoing popularity of the Five Star movement in Italy in the lead up to 2018 elections.

Eurozone Capex

Non-residential fixed investment, constant prices yr chg %



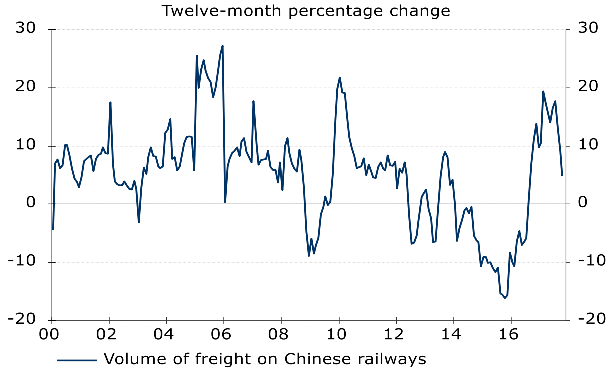
Source: Thomson Reuters Datastream, Evans & Partners

China is the major risk in 2018

The Chinese economy has been slowing in recent months as the stimulus of 2016 fades. There has also been some policy tightening in the property market that is beginning to bite. This is now apparent in the main economic data like industrial production and investment, as well as popular growth indicators like rail freight and electricity production.

China railway freight

Twelve-month percentage change

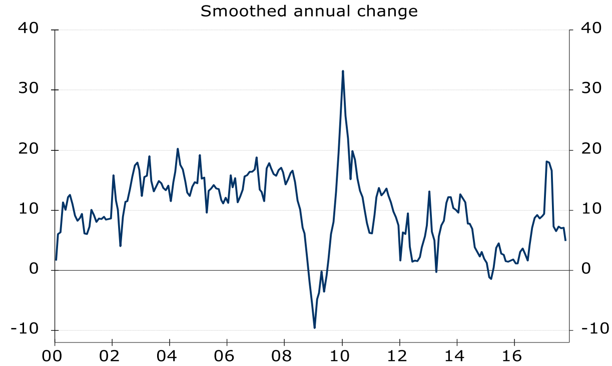


Source: Thomson Reuters Datastream, Evans & Partners

The risk in 2018 is that there is further slowing as structural reforms accelerate in the wake of October's National People's Congress and President Xi's enhanced mandate for reform. Measures already introduced have been aimed at cutting steel production, reforming the approval process for infrastructure approvals and addressing risks from the shadow banking sector. These reforms could have unintended consequences for growth, particularly if financial sector reforms result in lower credit availability.

China electricity production

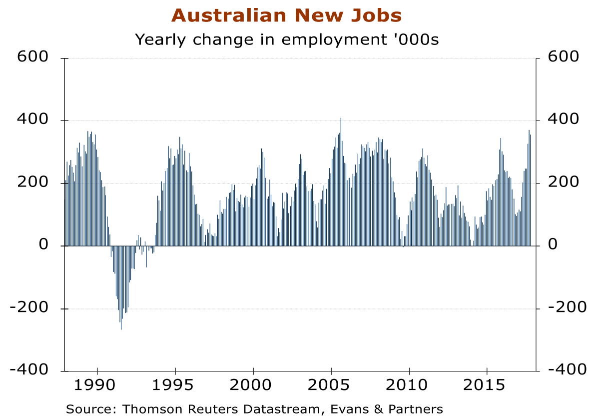
Smoothed annual change



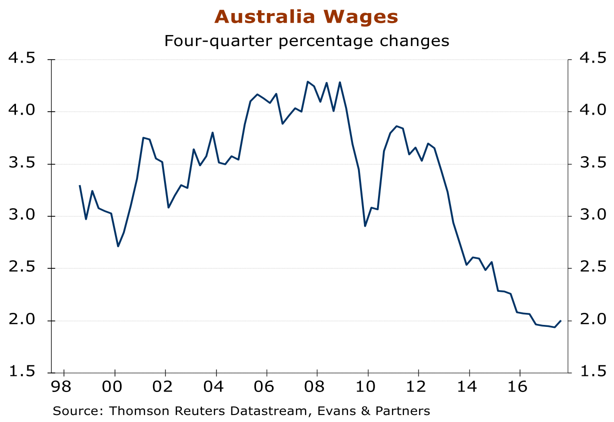
Source: Thomson Reuters Datastream, Evans & Partners

Australian signs of life

The Australian economy is set for a better year in 2018. There were encouraging signs in 2017, particularly in the labour market with nearly 400,000 jobs created. There is evidence of structural change in the Australian economy with much of these jobs being created in tourism, healthcare and construction. These sectors are likely to grow further in 2018 and offset weakness in housing construction.



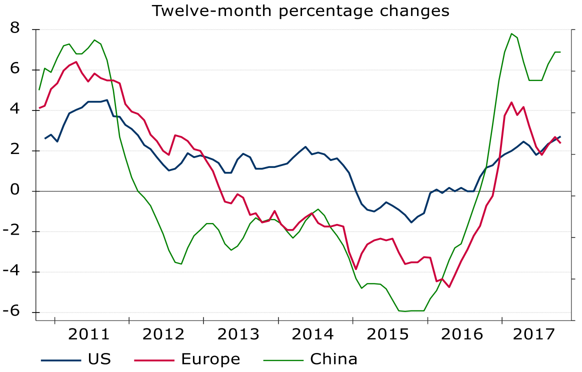
The lingering issues for Australia are that wages growth is weak, consumer confidence is low and rapid rises in electricity prices are hitting disposable income. Overall, this environment should support a better outlook for earnings for corporate Australia although this will be less apparent in the stock market because the ASX 200 is dominated by sectors (banks, resources) with earnings challenges.



Inflation: is 2018 the year?

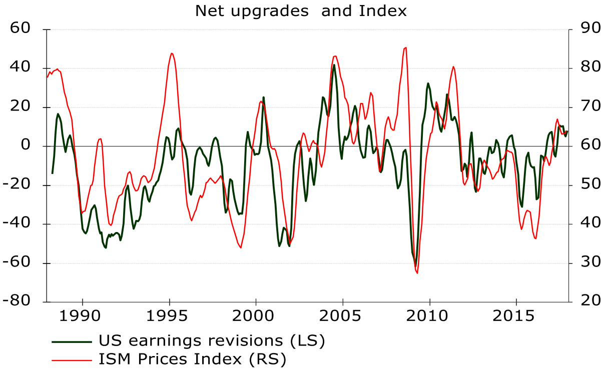
A critical issue for markets in 2018 is whether inflation will return. One of the great puzzles in this cycle has been the lack of inflation despite strong labour markets and rising capacity utilisation. Inflation has been below target in all major countries and has fallen further in the US and Japan this year.

2018 might be the year that this changes and inflation starts to rise back towards central bank targets. There have been some recent interesting developments that point to the return of pricing power in some areas. Most interesting has been an increase in prices at the manufacturing level in the US, China and Europe; manufacturers are charging retailers higher prices but they have not yet been able to pass these onto consumers.



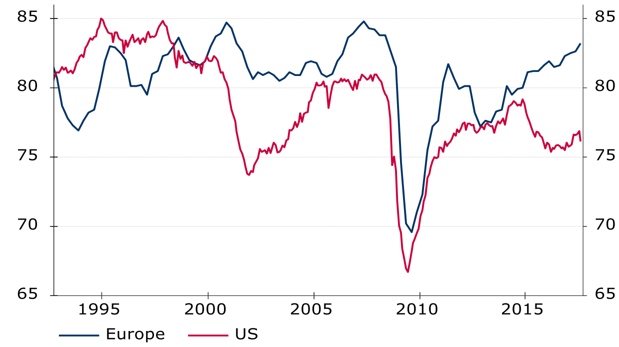
Source: Thomson Reuters Datastream, Evans & Partners

Rising pricing power appears to be what is behind the rise in profitability over the past year. The second chart below shows a tight link between manufacturers reporting price rises (the ISM prices index) and earnings revisions ratios.



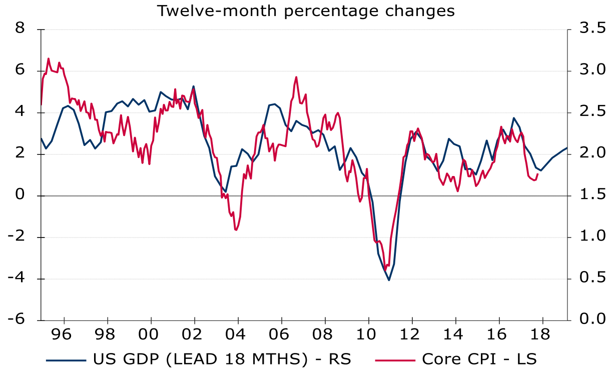
Source: Thomson Reuters Datastream, Evans & Partners

Improving pricing power should not be a surprise given the rise in capacity utilisation that is occurring, particularly in Europe. The lack of investment in this cycle means that supply constraints could be reached reasonably quickly if demand continues at its current pace.



Source: Thomson Reuters Datastream, Evans & Partners

Part of the issue may also be that it simply takes time for better economic growth to translate into price rises. The second chart below suggests the typical lag has been 18 months so we might only just be reaching the time when inflationary pressures should be felt.

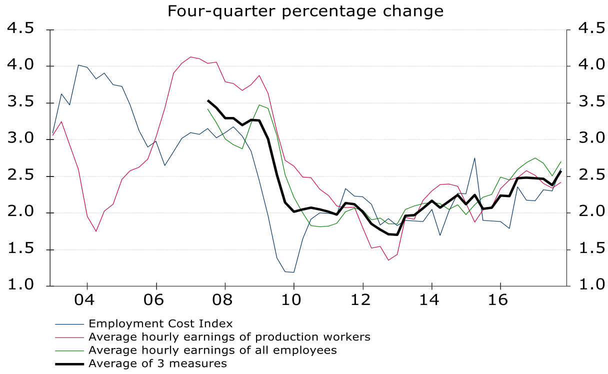


Source: Thomson Reuters Datastream, Evans & Partners

The other potential source of inflationary pressure is the labour market, where there has so far been little evidence of falling unemployment leading to wages growth. Nevertheless, there have been an increasing number of anecdotes of rising wages and US data are starting to edge higher again.

US wages

Four-quarter percentage change

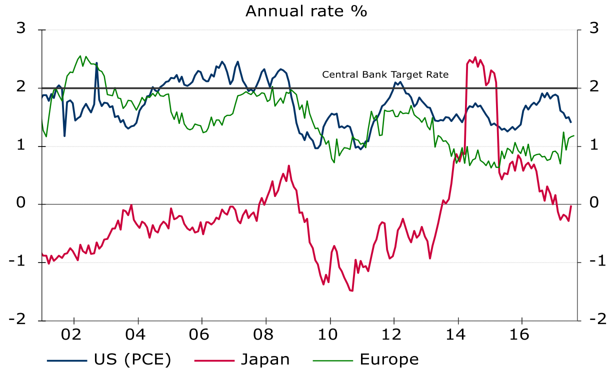


Source: Thomson Reuters Datastream, Evans & Partners

Offsetting this rising cyclical pressure on inflation are a number of powerful deflationary forces including demographics, accelerating technological disruption, the rise of e-commerce and rising labour force participation. These should ensure that inflation is contained. Nevertheless, an inflection point for inflation will be important for markets.

Core inflation

Annual rate %



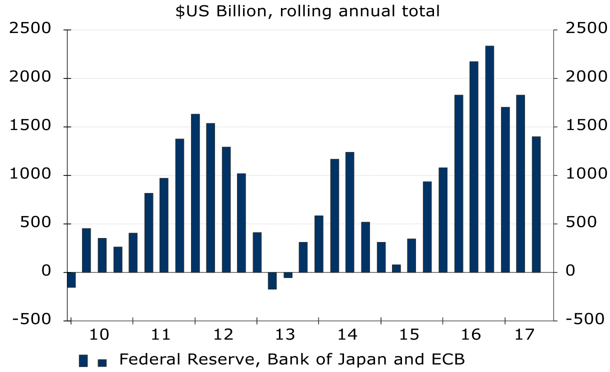
Source: Thomson Reuters Datastream, Evans & Partners

How will central banks respond?

Central banks will respond to higher inflation even if the rise only takes inflation back to the lower end of central bank target ranges. Central banks are already set to tighten financial conditions in 2018 as the Fed reduces its balance sheet and the ECB slows down its asset purchases. Total central bank buying of debt securities was around $US1.5 trillion over the past year and the impact on markets has been significant, particularly for corporate credit. Over the next year, net purchases may be close to zero depending on the pace of unwinding by the Fed and tapering by the ECB.

Central Bank Asset Purchases

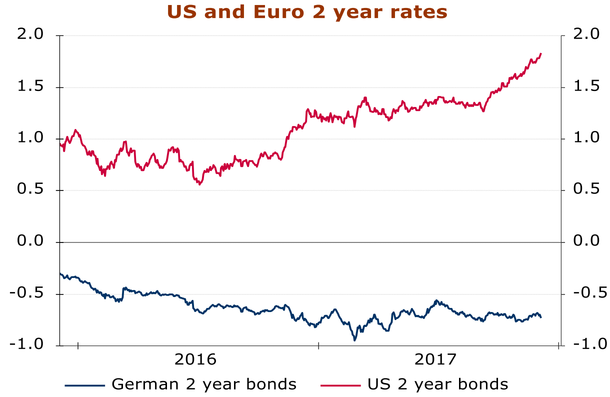
$US Billion, rolling annual total



Source: Thomson Reuters Datastream, Evans & Partners

Higher inflation could result in a faster pace of liquidity withdrawal and interest rates could rise faster than expected, particularly in Europe. Investors are not currently expecting a rate rise in Europe until the middle of 2019 and two year European rates remain negative. This does not appear consistent with prospects for the economy and inflation in 2018.

US and Euro 2 year rates



Source: Thomson Reuters Datastream, Evans & Partners

How to position for the inflation threat

Our expectation is that the rise in inflation will occur slowly enough that it will not be a major shock to markets, however investors should ensure that that they are not overly exposed to inflation risks through considering their holdings in the following assets:

- Interest rate-sensitive equities are vulnerable, particularly those where revenues are not linked to inflation. Toll roads, which typically have inflation linked prices, will likely perform better than REITs where the link to inflation is not as tight.
- European banks and insurance companies, which will be beneficiaries of rising inflation. Higher interest rates will boost earnings of banks through increasing margins and insurance companies through increasing returns on reserves. The European companies are best positioned to benefit because higher rates are not priced in for Europe until 2019.
- Fixed income securities will be vulnerable to changing views on monetary policy. Some lift in interest rates is priced in for the US but not for Europe. Investors could also consider inflation linked bonds as protection against rising inflation.

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