Big Questions (Part 1)

Click here to view as PDF.

"The absence of near-term warning flags…may reinforce yield-seeking behavior and amplify the buildup of financial vulnerabilities that come to fore over the medium term."
-INTERNATIONAL MONETARY FUND, in a report released on January 22, 2018

The year 2018 is still in its infancy, but some of the hot-button questions of late-2017 have been (or are currently being) answered: Will the Bitcoin bubble burst? Will political gridlock in Washington, D.C. lead to a federal government shutdown? Will anything slow down this raging bull market?

In terms of overall market impact, the answers to these questions have been less than resounding. Yes, Bitcoin has shed nearly half of its value from mid-December 2017, but crypto enthusiasts are the only ones who have seemed to notice. And, yes, the federal government did shut down last weekend, but the halt was only temporary and the S&P barely paid attention, closing +81bps (or up .81%) in Monday's session, despite the fact that the extension will only keep the government open through February 8th barring any headway on immigration or budget issues.

As to the question of whether anything will slow down this raging bull market: nothing has (yet). Our predilection for calling an immediate top has waned over the last several months as even usual bears, including last week's featured Guest author Jeremy Grantham, have stayed in hibernation and adjusted their short-term forecasts. But, as our recent Roundtable EVA makes clear, in the medium-term, there is widespread belief among those in the deep-value camp that pressure is building and the market tea-kettle will inevitably begin blowing off steam.

The author of this week's Gavekal EVA comes from a voice that has long (and correctly up to this point) penned his stance that we're still not at a peak, but in a global bull market. Anatole Kaletsky, co-founder of our partner firm, Gavekal, is a man admired globally for his investing prowess and ability to foresee shifting tides. This week, Anatole gives his perspective on six "big questions" related to the global economy for 2018:

1. Will 2017's change in global growth leadership from the US to Europe and emerging markets (EMs) continue?
2. Will inflation accelerate in the US, but not in other major economies?
3. Will eurozone and EM equity markets again beat the US, as they did in 2017? (Validating an Evergreen viewpoint from the start of 2017)
4. Will political conditions continue to stabilize, and financial expectations therefore improve in all five of the BRICS —Brazil, Russia, India, China, and South Africa?
5. Will the increase in the US crude oil price above US$60/bbl be sustained? (Rebounding oil prices also validate an unpopular viewpoint we had the start of 2017 that oil prices would fall by 15-20% before rallying later in the year.)
6. Will technology-based assets underperform "old economy" stocks?

The verdict is still out on the answers to these questions, and only time will tell if fortunes favor those who continue to buy and hold in this aging equity run. Next week, we will continue with our “big questions” theme, as David Hay and Anatole Kaletsky discuss “5 Big Bond Market Questions.”

Image not found or type unknown

Michael Johnston
Marketing and Communications Manager
To contact Michael, email:
mjohnston@evergreengavekal.com

THE BIG QUESTIONS FOR 2018
By Anatole Kaletsky

Many of the important questions confronting investors at the beginning of 2018 are the same as they were 12 months ago. And in most cases I would suggest the same answers. This may seem boring or stubborn, but it is quite reasonable in the middle of a long-term economic expansion and structural bull market. Contrarian thinking only works at turning points. Trend-following is the best investment strategy in the middle of a trend. The key issue, therefore, is to distinguish between trends that may be ending and those that have longer term staying power. Investors should also try to identify what new events could act as catalysts for trend changes. And where this year’s predictions are similar to—or differ from—those of 12 months ago, it’s important to understand where last year’s forecasts went right or wrong.

For me the six main questions for 2018 are:

1. **Will 2017’s change in global growth leadership from the US to Europe and emerging markets continue?** In my view, the answer is “Yes”, because the US economy is near its capacity limits and cannot grow faster than its long-term trend. Meanwhile, most European and emerging economies still have high unemployment and lots of excess capacity, and can therefore sustain above-trend growth rates for at least the next two or three years. **If correct, this prediction will not be a game-changer but will merely extend the trends prevailing already.**

2. **Will inflation accelerate in the US, but not in other major economies?** I think the answer is “Yes”, for the same reasons as above. However, I also expected inflation to accelerate and bond yields to increase last year. Instead, both inflation and growth ended the year exactly where they started. So why repeat the prediction of higher inflation and bond yields now?

The simple answer is that US unemployment is now 4.1% instead of 4.8%. I was wrong about 5% unemployment being a non-inflationary growth limit, and maybe 4% isn’t either. But whatever the exact number may be, the US is certainly closer to its non-inflationary growth limit now than it was a year ago. In addition, the Trump tax cuts, if they actually stimulate higher US consumption and/or investment (which they may not do by any meaningful amount) will add to US inflationary pressures, since new production capacity will take several years to boost non-inflationary trend growth. My prediction of higher US inflation and bond yields last year was partly motivated by the expectation of Trump tax cuts. Since these tax cuts only passed two weeks ago, the risk of economic overheating also subsided. But 2018 could well be the year when Trumpflation actually happens, especially if Trump is emboldened by the tax cuts to follow through on his protectionist promises too. **If the prediction of higher US inflation turns out to be right, it will be a game-changer, producing much more volatile market conditions and even greater under-performance by US equities and bonds** relative to assets in Europe and Japan, where inflation is not a risk.

3. The two points above imply an answer to 2018’s biggest asset allocation question for equity investors: **will eurozone and EM equity markets again beat the US, as they did in 2017?** My answer is an emphatic “Yes”. This year, however, European outperformance is more likely to show up in domestic equity prices than in currency movements, because the euro is no longer very undervalued, as it was in January 2017. Meanwhile, US fiscal stimulus and the prospect of monetary tightening will help to underpin the US dollar to some extent. Last year, I correctly predicted that European stock markets would beat Wall Street and that the euro would strengthen against the US dollar, but I didn’t expect the dollar to be so weak that currency movements accounted for the whole of Europe’s equity outperformance. That was partly because the Trump tax cuts expected a year ago failed to materialize at the time and all the Trumpflation trades went into reverse shortly after the inauguration. This year, the US dollar’s weakness is likely to be less pronounced, which should contribute to the underperformance of US equities relative to Europe and Japan, even in local currency terms. **If this prediction turns out to be right, it will not be a game-changer, but will merely extend the trends prevailing already.**

4. **Will political conditions continue to stabilize, and financial expectations therefore improve in all five of the BRICS**—Brazil, Russia, India, China, and South Africa? My answer is “Yes”. This provides another reason to expect substantial emerging market outperformance, both in equities and in bonds. **If this prediction turns out to be right, it will not be a game-changer, but will merely extend the trends prevailing already.**

5. **Will the increase in the US WTI crude oil price above US$60/bbl be sustained?** I don’t think so. But last year I didn’t think oil prices would climb above US$55/bbl. This turned out to be wrong, mainly because of the change in Saudi Arabia’s domestic politics and the surprising degree of cooperation between Saudi, Russia and Iran. I still don’t expect this cooperation to last, and therefore believe that oil prices will fall back into the US$40-55/bbl range. **If this prediction of stable to lower oil prices turns out to be wrong, it will be a game-changer, adding to inflationary pressures, especially in the US economy**, and therefore aggravating the risks outlined in the second point above.

6. **Will technology-based assets underperform “old economy” stocks?** I think so for three reasons. Firstly, there is a clear shift from adulation to skepticism among politicians, consumers and ultimately investors. The highly profitable tech giants like Apple, Google and Facebook are increasingly seen as rent-extracting monopolies rather than productive innovators. Secondly, it is becoming increasingly clear that the network effects and natural monopolies so profitably exploited by today’s established giants may not apply to the next generation of tech-based businesses. Companies with enormous valuations that are still consuming cash instead of making profits such as Tesla, Netflix, Uber and Airbnb will never become the next Google or

Facebook. Thirdly, the rampant speculation in crypto-currencies may be the canary in the coalmine that suggests that bullish sentiment is approaching its limit. If this prediction that investors will lose faith in technology stocks turns out to be right, it could prove a game-changer, affecting sentiment towards equity valuations generally and triggering the long-awaited stock market correction. **But if an equity correction is caused by rotation out of tech stocks rather than higher inflation, it should be seen as an opportunity to buy on dips**, since the structural bull trend will soon resume with different sectoral leadership.

OUR CURRENT LIKES AND DISLIKES

No changes this week.

LIKE

- Large-cap growth (during a correction)
- International developed markets (during a correction)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12% (buy less aggressively due to the recent sharp rally)
- Gold-mining stocks
- Gold
- Select blue chip oil stocks (wait for a pull-back after their recent strong run)
- Mexican stocks (at lower prices after this year’s robust rally)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Short euro ETF (due to the euro's weakness of late, refrain from initiating or adding to this short)
- Intermediate municipal bonds with strong credit ratings
- Investment-grade floating rate corporate bonds

NEUTRAL

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India,appear undervalued
- Select European banks
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds
- Long-term municipal bonds
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Solar Yield Cos (taking partial profits on these)
- Large-cap value
- Canadian REITs
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%

DISLIKE

- US-based Real Estate Investment Trusts (REITs) (once again, some small-and mid-cap issues appear attractive; also, some retail-exposed REITs look deeply undervalued)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Canadian dollar-denominated bonds (the loonie is currently overbought)
- Short yen ETF (in fact, the yen looks poised to rally)
- Emerging market bonds (local currency)
- Emerging market bonds (local currency)
- Floating-rate bank debt (junk)
- US industrial machinery stocks (such as one that runs like a certain forest animal, and another famous for its yellow-colored equipment)