Boom then bust?

Can cyclical tailwinds paper over the structural cracks? And what's the outlook for global trade, China and equity investors?

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Our global views in a snapshot:

Economic outlook

1. Will cyclical or structural forces prevail?

Long-term risks are increasing

Political outlook

2. Has the populism movement stalled?

Protectionism is alive and kicking

China's outlook

3. What are the implications of no term limits?

Most significant risks are in the medium term

The 'goldilocks' environment of steady global growth and low inflation has started to give way to stronger growth and rising inflation concerns. This is particularly acute in the United States, where President Donald Trump's **Trillion dollar binge** is leading to something of an economic boom. But while we believe the economic upswing appears intact for now, despite recent equity market volatility, we also believe that the risks of an eventual bust are rising.

As our CIO outlined in his **2018 Outlook**, we are also extremely aware of the structural pressures driven by weak global demographics and the withdrawal of central bank liquidity. Rising populism, too, is continuing to cloud the investment outlook given the potential impact on global trade. Indeed, Trump's recent trade tariffs and the responding measures from China warrant careful attention. The Chinese Premier's consolidation of power could also have important ramifications for investors.

While cognisant of the medium-term risks, we are inclined to **lean against** market weakness for now. This means that we have bought equities in particular on market weakness, as they are supported by the ongoing cyclical strength in the US economy. We particularly favour the **technology sector**, where earnings have risen sharply and could prove more resilient than other sectors as we enter the later stages of the economic cycle.

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OUR VIEWS AT A GLANCE

- **Reduced exposure to credit markets –** these could fall first as we approach the end of the cycle
- **Positive on equities in the short term –** particularly in Europe and Japan which are at an earlier stage of the cycle and have higher medium-term growth prospects
- **Constructive on emerging market hard currency debt –** most emerging markets have sound fundamentals, spreads are attractive on a relative basis and the outlook is improving
- **Favour yen and US dollar exposure as a hedge –** these currencies could rise if risk assets fall

Overview			Strategic allocation		
Equities	●	●	●	●	○
Duration	●	●	●	○	○
Credit	●	●	○	○	○
Inflation	●	●	●	●	○
Real estate	●	●	●	●	●

Fixed income			Strategic allocation		
Government bonds	●	●	●	○	○
Investment grade	●	●	○	○	○
High yield	●	●	○	○	○
EM USD debt	●	●	●	●	●
EM local debt	●	●	●	●	○

Equities			Strategic allocation		
US	●	●	●	○	○
UK	●	●	○	○	○
Europe	●	●	●	●	○
Japan	●	●	●	●	○
Emerging markets	●	●	○	○	○

Currencies			Strategic allocation		
US dollar	●	●	●	●	○
Euro	●	●	○	○	○
Pound sterling	●	●	●	○	○
Japanese yen	●	●	●	●	○
EM FX	●	●	●	●	○

This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of Mar 2018
The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.

Tim Drayson,
Head of Economics

WHEN CYCLICAL MEETS STRUCTURAL

One important part of the Asset Allocation team's investment process is mapping likely asset price returns to where we are in the economic cycle. Today, we see signs that the US is moving into the later stages of the economic cycle, with above trend growth continuing to drive unemployment down and inflation edging back towards target. With strong momentum and the US fiscal stimulus only just starting to gain traction, the risk of recession appears low for the next year. However, we expect recession risk to increase in 2019.

Our macro mapping would suggest that if growth remains robust and inflation contained, equities could perform well, though the risk of overheating in 2019 appears to be increasing. In addition, we continue to worry about the disappointing trends in structural factors like productivity, debt and demographics. These ultimately determine long-run growth and asset prices, so how do we combine the two views? We see them as complementary, rather than as competing. Here are a few examples:

- Our approach allows us to be positive about the near-term cyclical outlook while increasingly worried about the lack of policy tools available to deal with the next downturn. With US short-term interest rates likely to peak well below the level of the previous cycle and the US running a large budget deficit, the ability to deal with future shocks appears limited

- Weak productivity growth means that the 'neutral' long-term real interest rate is likely to remain low. But during an expansionary phase, it also implies a more rapid erosion of spare capacity and therefore an earlier build-up of inflationary pressure. This makes us more hawkish than the market regarding Federal Reserve (Fed) rate hikes, while being reasonably comfortable with Treasury yields, (i.e. we expect the yield curve to flatten). It also means the Fed might have to push rates into economically restrictive territory before this cycle is complete

- The debt overhang is likely to prove to an impediment to growth in the long run, but when we were in the mid-cycle phase, low interest rates meant that debt servicing was manageable. There is a high vulnerability to growth in many parts of the world should interest rates be forced suddenly higher. As we move increasingly 'late cycle', this is another factor likely to make us more cautious on risk assets

Overall, a cyclical pick-up in inflation triggering a tightening in financial conditions seems to be the most likely cause of the next downturn. An escalation of protectionism would add to inflationary pressure. But once the downturn begins, the structural headwinds to growth threaten to amplify or extend the weakness, potentially forcing a more radical approach from policymakers. This could ultimately involve more money printing.

Lars Kreckel,
Global Equity Strategist

NEW POLITICAL PARADIGM – RELOADED

It's no surprise that our new political paradigm theme, which we wrote about several times, continues to change over time: it's part of the package. Investor focus ebbs and flows with headlines, policy implications differ across countries and the market impact of policies can change over the cycle. But at the heart of the theme still lies our view that populism is on this rise.

Whilst populists have not recently had the headline grabbing victories of 2016, beneath the surface the trend towards populism has continued apace. More than 45% of French voters supported a populist in the first round of the general election. In Germany, both large centrist parties had their worst results in many decades and the right-wing AfD became the third largest party in parliament. Both populist parties, at opposite ends of the political spectrum, did better than expected in Italy's election, receiving close to 50% of the total vote. Populism is alive and well in Europe.

The start of 2018 has served as a reminder that rising populism isn't all about turning on the fiscal taps. This has been best encapsulated in the US, where last year's rally was at least in part fuelled by the market narrative shifting towards 'Good Trump' the de-regulator, tax cutter and infrastructure builder. But a fiscal boost is only one of the potential policy implications of populism. More recently the pendulum has swung back towards 'Bad Trump' and the less market friendly policy options for populists we highlighted in last year's blogs: protectionism, cutting Immigration, isolationism and geo-political aggression.

For us, the fiscal boost is likely to remain the primary driver of the new political paradigm theme, but it will share some of the limelight with protectionism. Our base case is that there will be more noise than action on trade wars and tariffs. Trump can get a lot of political mileage with his core voters from talking tough. At the same time, precedents from last year's tweets against corporates moving production abroad, NAFTA negotiations and this year's steel and aluminium tariffs show actions have tended to be much less aggressive.

Erik Lueth,
Global Emerging Market Economist

FROM COLLECTIVE LEADERSHIP TO ONE-MAN RULE

In March, China held its National People's Congress, its most important political event in a decade. It put in place the programme and personnel for President Xi Jinping's second five-year term, after the appointment of the top seven leaders (the Politburo standing committee) in September. The congress was noteworthy for its focus on institutional reorganisation and has cemented China's transition from collective leadership to one-man rule.

Economic targets, the key focus of previous Congresses, were a mere side show. The growth target was set at "around 6.5%", dropping the "or higher if possible" of last year in a nod to Xi's focus on the quality, rather than quantity of growth. The deficit target was lowered, but most spending occurs off-budget anyway. Other targets were largely unchanged.

Term limits for the presidency were abolished, likely making Xi leader for life. This follows a massive anti-corruption purge and the side-lining of government through working groups that report directly to Xi. The Congress also restored the primacy of the communist party and further blurred the lines between party and government by merging some of their agencies.

Despite all the politicisation, the Congress also marked the hour of the technocrats. Xi's economic advisor and former academic Liu He was made head of financial supervision; Deputy Governor Yi Gang became head of the People's Bank of China (PBoC), and Deputy Minister Liu Kun became Finance Minister. All are soft-spoken, well-versed in their respective tasks, and highly regarded.

Finally, financial supervision was streamlined to avoid regulatory arbitrage. The banking and insurance regulators were merged and turned into implementing agencies, while the PBoC was given the power to draft regulatory guidelines. Above all sits the newly created Financial Stability and Development Committee, headed by Mr. Liu He.

What are the policy implications of these institutional and personnel changes? In the short term, a strong leader can advance painful reforms and the focus on financial stability is definitely the right one, given China's extreme leverage. On the other hand, there is the risk of policy deterioration as the concentration of power undermines discourse. The appointment of able technocrats currently provides some reassurance on this point.

The bigger risks are more medium-term. How can China avoid the bad emperor curse? After all former Premier Deng Xiaoping introduced term limits and collective leadership to prevent another totalitarian leader such as Mao Zedong. Moreover, there is also the risk of a clash with the West, as it becomes clear that rising living standards don't necessarily lead to liberal democracy.

We remain underweight emerging market equities. For now this has more to do with the aforementioned risks we see around excessive debt in the Chinese economy and the risk of further escalation in trade tensions than with Chinese politics.

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