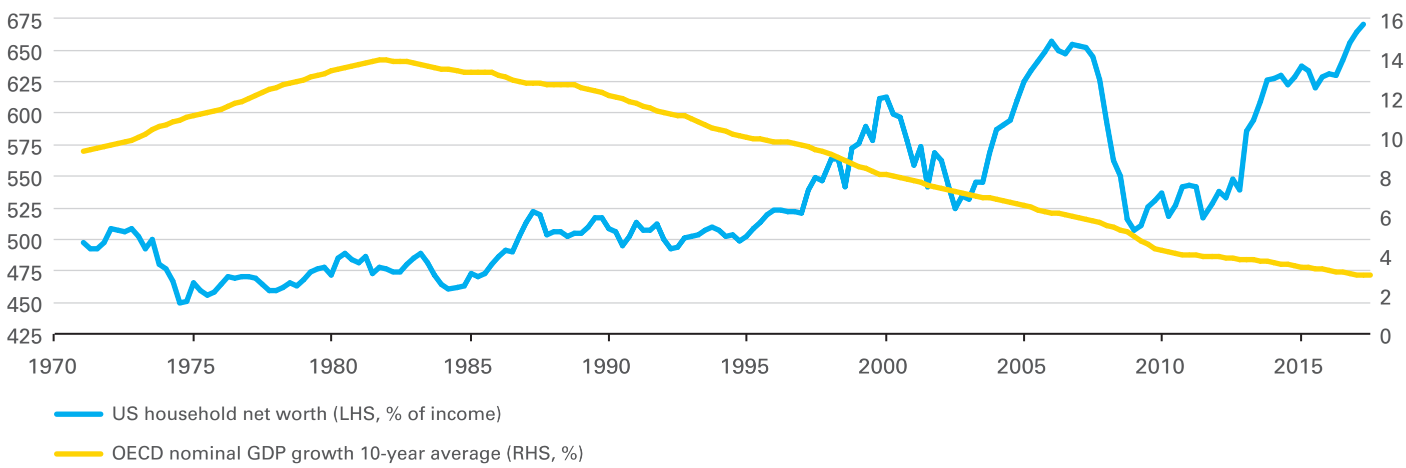
CIO Investment Outlook

The consequences of monetary tightening will define the 2018 investment landscape.

Anton Eser became Chief Investment Officer of LGIM in 2017. Prior to this, Anton was Co-Head of Global Fixed Income leading the London based Fixed Income team and managing LGIM's flagship global credit portfolios.

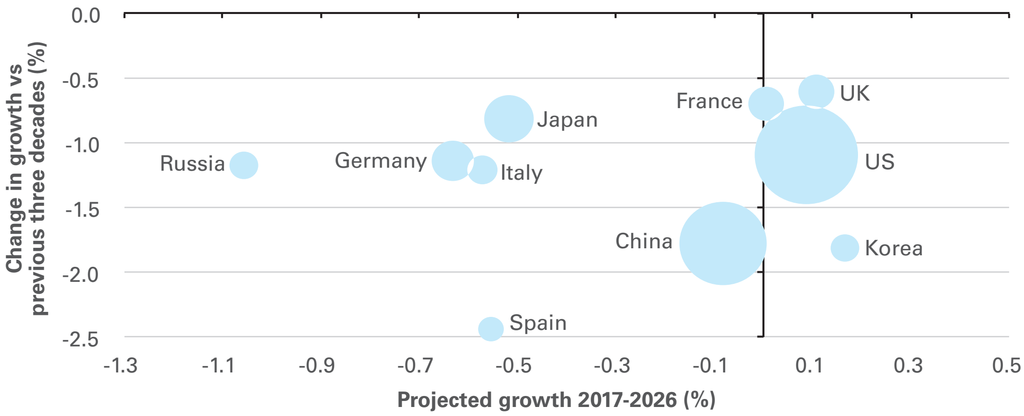
Twelve months ago, I worried 2017 could see markets come down to earth with a bump, triggered by rising populism and the clamour for protectionism. However, I underestimated central banks being able to keep the liquidity taps aggressively turned on, supporting growth and asset values. Despite low nominal GDP growth, loose monetary policy has kept volatility low, asset valuations high and structural problems such as poor demographic trends and high debt at bay (*Figure 1*). The key difference in 2018 is that central banks are now removing their support. As long as economic growth and corporate earnings remain robust, then equity and credit markets may maintain their lofty valuations. But as the tide of quantitative easing goes out, I suspect we may be surprised by how many have been swimming naked.

Figure 1: Clear divergence between economic growth and asset valuations



Source: Macrobond

Figure 2: Labour forces in decline



Source: LGIM estimates, Macrobond, adjusted for productivity

DEMOGRAPHICS

- Weaker global growth
- Low interest rates and inflation
- Hard choices for politicians

LOW YIELD WORLD

Monetary tightening has the potential to significantly challenge one of our key long-term research findings; the structural downward pressure on interest rates.

According to our estimates, the labour force of the 12 biggest economies is set to grow by 1% less than its historical average. China and the US are set for big negative shocks, with China's labour force growing by 1¾% less than in previous decades (*Figure 2*).

Until there are significant structural reforms or selective debt restructuring, low real yields are a necessary condition. While technological innovation and energy efficiency may provide a modest offset, investors relying on a 'normalisation' of economic growth trends could be sorely disappointed. However, this structural trend could be challenged in the coming months by monetary policy tightening.

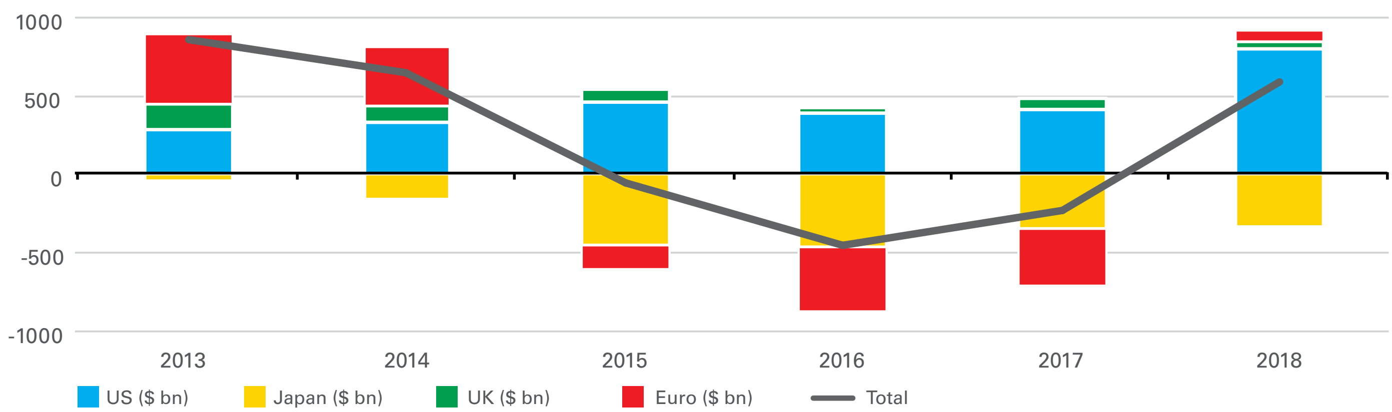
MONETARY TIGHTENING

Following the global financial crisis, central banks used extraordinarily loose monetary policy to try to stimulate economies. Unfortunately, the knock-on consequences of this stimulus were to discourage creative destruction and encourage the formation of unproductive debt.

Easy monetary policy has both propped up asset prices and allowed labour markets to tighten to such a degree that cyclical inflation pressure is starting to build. As a result, central bankers are confident enough to start removing support.

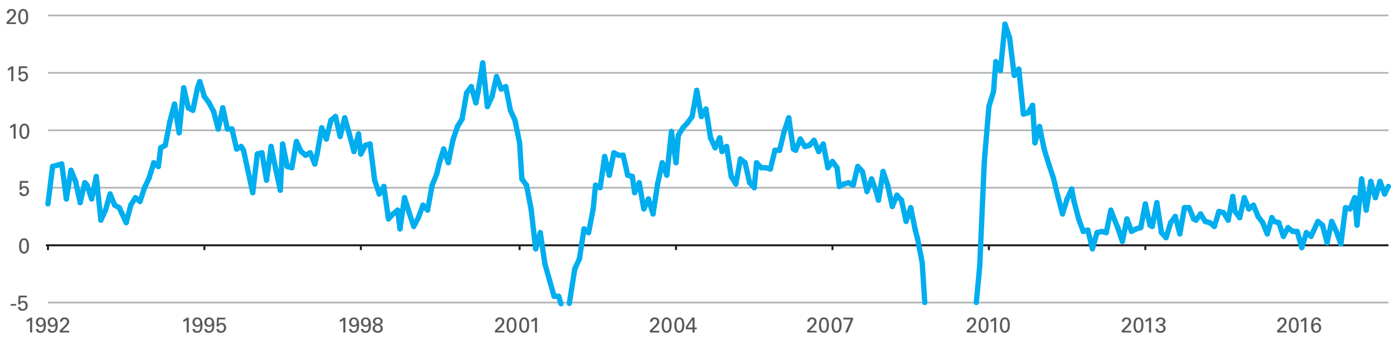
We are about to see a dramatic shift in the amount of government debt hitting the private market (Figure 3). In recent years, central bank purchases have crowded out investors, forcing them to choose between zero-yielding deposits or much riskier investments. I see this dynamic reversing in 2018. As interest rates rise to attract money into government bonds, we could see the 'hunt for yield' trade that has supported credit markets in recent years start to fade.

Figure 3: Net of redemptions and QE, government bond supply is set to soar in 2018



Source: Morgan Stanley, LGIM estimates

Figure 4: World trade growth (%) remains subdued despite recent recovery



Source: Macrobond

In a world of excess debt and weak productivity, this is clearly a difficult backdrop and should ultimately prove self-defeating. In other words, I do not think yields can rise back to pre-crisis levels before they negatively affect growth. But investors may wish to hedge against cyclically rising inflation in the meantime. Protecting against inflation can often be expensive, especially in the UK where the demand for UK inflation-linked bonds is higher than the supply. There are other inflation markets such as Europe or the US where inflation protection is cheaper. I would argue that investors should think of their portfolio in a holistic manner, allocating to asset classes that can provide inflation protection.

CHINA AND GLOBAL TRADE

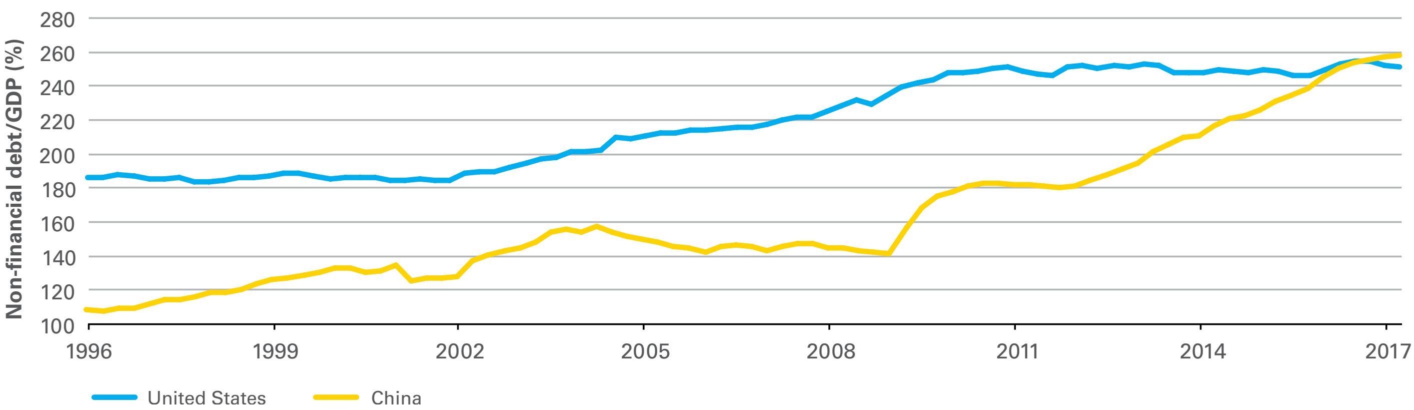
Globalisation has been in President Trump's crosshairs, renegotiating the North American Free Trade Agreement (NAFTA) and withdrawing from the Trans-Pacific Partnership. Interestingly, trade has staged a cyclical rebound in 2017 thanks to recovering commodity markets and a technology-led surge, but the structural direction appears to be less rosy (*Figure 4*).

China has historically been a big winner from globalisation, and has also been a driver of commodity markets thanks to its appetite for infrastructure and housing development. However, Chinese policy makers are increasingly nervous about the resultant rapid debt build-up (*Figure 5*).

The latest attempt to reign in debt creation focuses on the USD15trn asset management industry, the largest component of which is bank 'Wealth Management Products'. These vehicles attract short-term deposits with quasi bank guarantees to fund long-dated, sometimes questionable loans.

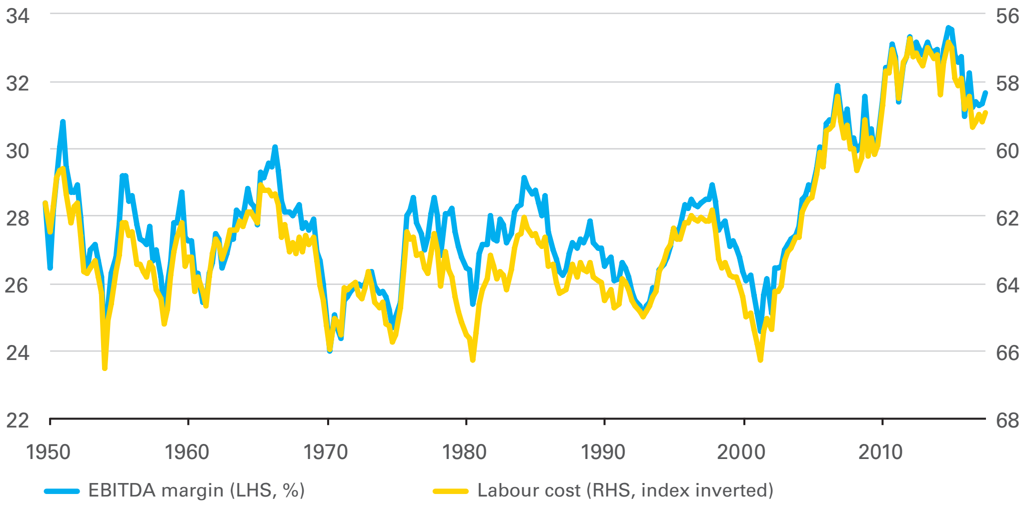
The volumes involved and the growth rates are unsustainable, but if tighter regulation and higher yields lead to a sharp contraction in debt creation, the Chinese economy could be set for a serious backward step. I suspect policymakers are just looking to gently apply the brakes in the coming months rather than bring the juggernaut to a screeching halt. This does not solve the long-term sustainability problem nor does it exclude the risk that policymakers miscalibrate and over-tighten.

Figure 5: Debt keeps rising



Source: Bank for International Settlements

Figure 6: Corporate margins are high, while labour costs are low



Source: BEA, NBER, Minack advisors

TECHNOLOGY

- Technology change affects all sectors
- Productivity potential
- Deflationary
- Stranded labour

US TAX REFORM

At the time of writing, President Trump stands on the cusp of delivering his first major piece of legislation. Through his tax reform bill, he hopes to slash the corporate tax rate in order to encourage investment and job creation.

Whether lowering corporate taxes has this desired effect in the long term is still up for debate, but the near-term impact is more straightforward. If tax reform fails to pass into law, US equity investors hoping for higher after-tax profits face significant disappointment. If tax reform is passed, then stock markets should receive a boost as hope and hype turns into reality. But attention would turn to the reaction of the much-changed Federal Reserve who would be animated by the prospect of stronger growth just as labour markets tighten to pre-crisis levels, arguing for an even faster pace of monetary tightening.

POPULISM

Despite President Trump's rhetoric, corporate profitability has not actually been a significant problem in recent years. US profit margins are already at elevated levels, while the real squeeze has been felt by workers (*Figure 6*). It is therefore not difficult to connect low wage growth and the rise in populism we have seen in recent years.

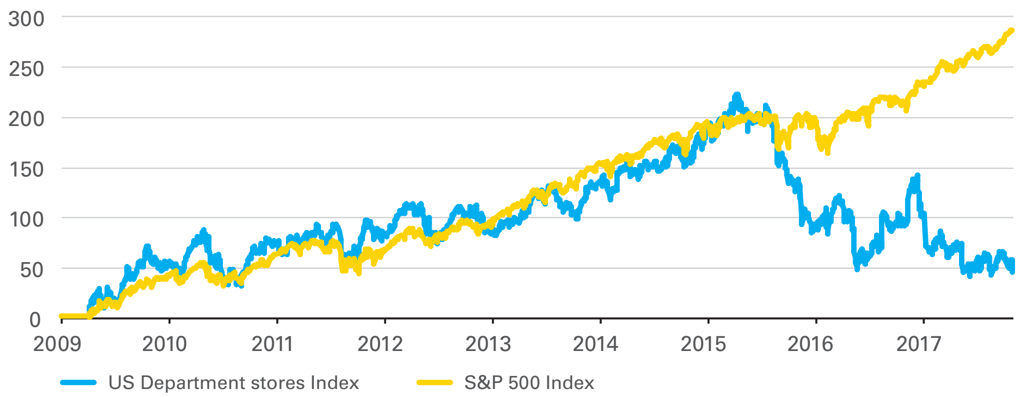
In terms of investment implications, it is hard to see where populist risk premium is adequately priced into markets. This made some sense when central bank support was dampening volatility, but could change in the coming months as policy is tightened.

Politics will be a major focus for us in the coming year. In conjunction with our three other themes, demographics, energy and technology, we will analyse what long-term political and policy shifts mean for investors and their portfolios.

Europe remains susceptible to further bouts of populism in 2018. There is serious nationalist tension in Catalonia, as well as important Italian elections in the coming year. This is all happening as the next stage of the Brexit negotiations ramps up.

Other areas of the globe could also come under the populist spotlight. Nearly two out of three Latin Americans will be asked to vote for a new president over the next 12 months, with another eight Latin American elections scheduled in 2019. The recent uptick in growth is modest to say the least, and roughly 20 million 15-29 year-olds in the region are unemployed. This appears to be fertile ground for a return of populism from either the left or right of the political spectrum.

Figure 7: Indexed share price returns (%): US department stores have begun to crack



Source: Bloomberg L.P.

ENERGY

- Revolution is here
- Different implications for commodities
- Huge renewables capital requirement

However, it is not just the political establishment experiencing severe disruption. The populist spirit into which Donald Trump so successfully tapped was enabled by a broader disruption across the corporate world.

DISRUPTION

During his presidential campaign, Donald Trump drew significant attention to disrupted sectors and businesses, promising to "bring back" jobs in coal and manufacturing for example. Clearly, the danger of disruption is now the new standard for businesses. The average life expectancy of an S&P 500 company has gone from over 60 years in the 1960s to under 30 today. Projecting ahead, 50% of today's S&P 500 could be replaced by 2027. The threat of disruption from different sectors looms large and companies which do not use innovation to fuel growth risk loss of market share or worse, being rendered obsolete.

Many stressed sectors and companies have been able to survive thanks to the easy liquidity conditions created by central banks. This will change as policy tightens. Retail is the prime example of a sector with a number of at-risk incumbents (*Figure 7*), who have been slow to embrace technological advances or retain vast, unprofitable physical property assets.

Technology has an important role to play in addressing the broader productivity puzzle. Management teams across all industries are embracing technology to improve, with industrial companies providing a good example of where the 'artificial intelligence' hype could be turned into practical and commercial reality. Similarly, cloud computing and digitisation provide opportunities across multiple industries for efficiency gains and productivity improvements, alongside a growing market for the enterprise IT companies supporting these shifts. In the consumer space advertising is the epicentre of the battleground between incumbents and the technology players, and we will be looking closely at how TV companies respond to the growing competition for both content and advertising spend through 2018.

The energy sector also faces substantial disruption, with the aforementioned coal industry at one extreme. While coal mining and trading is a substantial economic activity, we forecast that over the next 10-20 years the largest coal consumer, China, will increase its self-sufficiency and accelerate the long-term global shift away from coal usage.

At the other extreme are renewable sources of energy. Reorienting the global energy system to meet climate change objectives requires a huge amount of capital. Estimates vary but the total investment required could be as high as US$30 trillion between now and 2050, equivalent to the value of all pension fund assets in the G7 economies. This will take a number of different forms, both in renewable energy generation itself (e.g. wind and solar farms) and in the associated infrastructure. As an example of the latter, one estimate for the US suggests that the capacity to store electricity will need to be increased 4,000 times to cope with the intermittency of renewables. For investors, these assets present a range of investment profiles, from high risk, high return equity to highly predictable cash flows appropriate for paying pensions. What is not in doubt is that renewables are going to be playing an increasing role in long-term investors' equity and credit portfolios.

CONCLUSION

There has been a clear divergence between economic growth and asset valuations in recent years. Central bank support has more than offset underlying structural economic problems. I believe that as monetary policy tightens, the gap will narrow.

While I am optimistic about the long-term productivity improvements and investment opportunities highlighted by our technology and energy research, I think the demographic drag looks set to dominate growth prospects for now. As monetary policy support is withdrawn in 2018, many investors face a rude awakening if the risk premium is more accurately priced into markets.