momentum
investments

The Macro Research Desk

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Asset class returns in 2017 determined by monetary/fiscal policy switch

Stimulus baton passed from monetary to fiscal policy in the developed world

Developed market (DM) monetary policy stimulus most probably has moved beyond its peak, with limited scope for more policy accommodation through interest rate cuts and quantitative easing (QE) against the backdrop of historically low interest rate levels, bulging central bank balance sheets, accelerating inflation and mounting evidence of diminishing effectiveness. Meanwhile, disgruntled DM voters have intensified pressures on politicians to improve their economic circumstances by making their voices heard in a tangible way through the ballot box in 2016. In essence, electorates are now demanding a direct positive stimulus to all income levels, rather than the previous stimulus aimed at the wealth levels of only a selected few via the support of asset prices. In response to this anti-establishment sentiment, there has been a renewed political focus on fiscal transfers, either through higher public spending or cutting tax burdens, as a means to improve the livelihoods of voter constituencies.

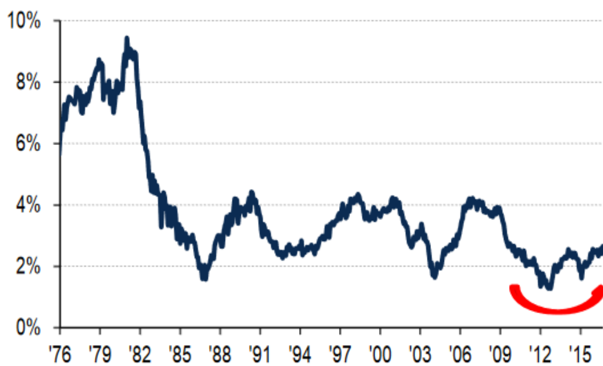
Elevated volatility levels expected in 2017

Uncertainty about the probable differences between policy measures originally mooted by Candidate Trump on the campaign trail and those eventually implemented by President Trump is likely to cause a higher level of volatility in financial markets during 2017. In addition, there are a multitude of European elections coming in 2017 (the Dutch general election and French presidential election in 1H17, followed by the German general election in 2H17) that could extend the global trend of distestablishmentarianism that started with Britain's decision to leave the European Union (Brexit) and the election of Trump as United States (US) president in 2016. These could increase the likelihood of an eventual break-up of the Eurozone. Furthermore, the uncertain implications for different asset classes of the start of a secular trend reversal in global interest rate policy and the potential end of the era of free movement of goods, capital and labour could induce further instability in investment markets in 2017.

Fundamentals and valuations point to a preference for global equities over bonds

There is increasing evidence that the global economy is in the process of transitioning from an era of deflation to reflation. A tight labour market in the US has already led to rising wage pressure (see chart 1), potentially aggravated going forward by the negative effect of immigration restrictions under President-elect Trump on the pool of available labour. Higher commodity prices are also pushing up input prices in the production process.

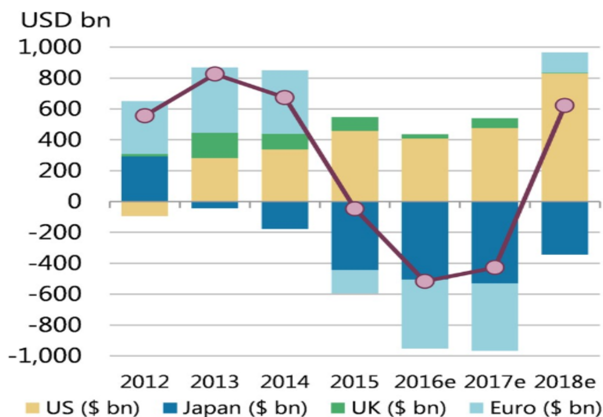
Chart 1: Growth in US average hourly earnings (%YoY)



Source: BofA Merrill Lynch

By nature, global inflation-protected securities should outperform nominal bonds in a rising inflation environment. In addition, dwindling bond-buying support from DM central banks (epitomised by European Central Bank QE tapering in 2017) against the backdrop of rising supply linked to fiscal expansion (see chart 2) is likely to put upward pressure on global yields during 2017.

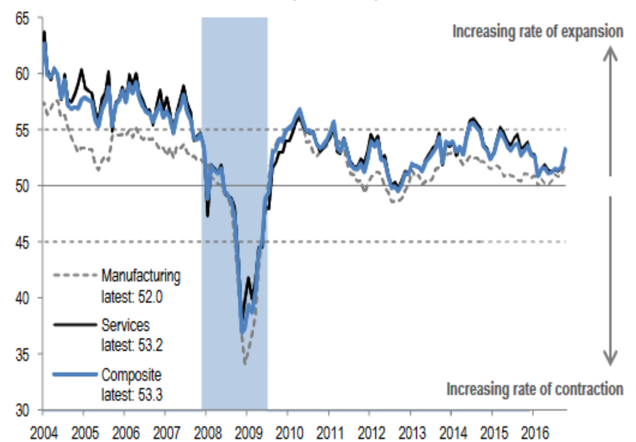
Chart 2: Gross sovereign issuance net of redemptions and central bank purchases, notional in US dollar, 2012-15 actual, 2016-18 expected



Source: Morgan Stanley

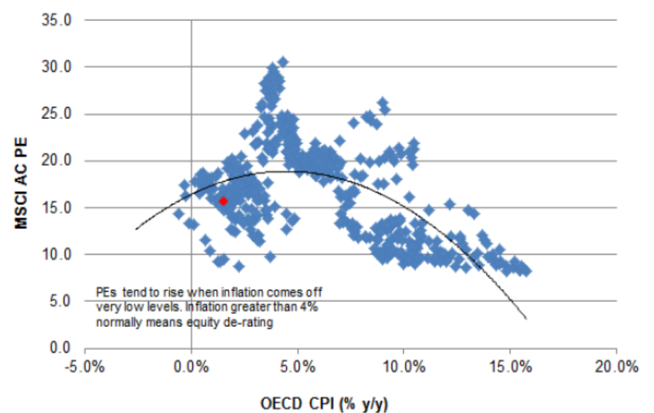
In contrast, accelerating nominal global gross domestic product (driven by improving real activity (see chart 3) and rising inflation) is supportive of corporate profits (likely to be further enhanced by additional fiscal stimulus worldwide) and should offset potential valuation pressures from political uncertainty and rising inflation. Indeed, while higher inflation is unequivocally negative for fixed-income investments, a moderately rising price profile from low levels has historically been associated with rising equity valuations (see chart 4) and returns.

Chart 3: Global Purchasing Managers' Index (PMI)



Source: JP Morgan

Chart 4: Reflation typically supportive of global equity valuations as inflation comes off low levels

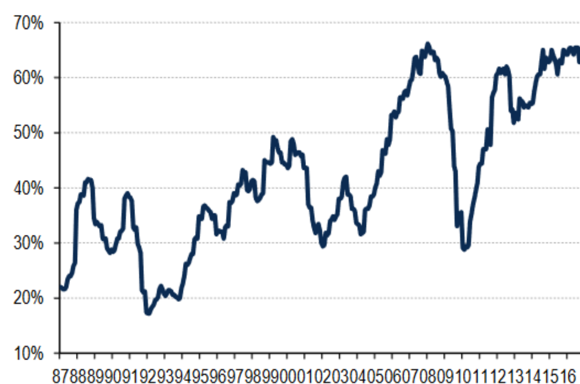


Source: RMB Morgan Stanley

Although rising yields are reducing the corporate earnings accretion incentive to issue debt to finance stock repurchases, healthy corporate balance sheets amidst accelerating profit momentum should still facilitate ongoing healthy income distributions to shareholders in

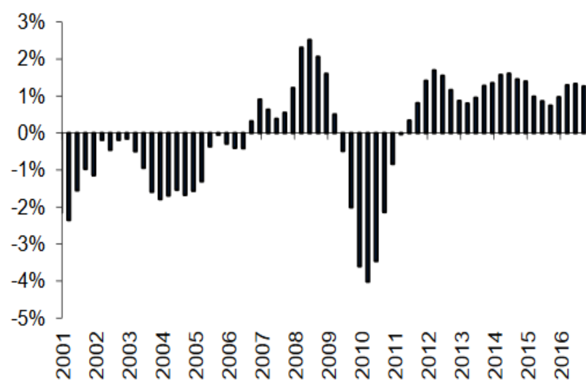
the form of dividends and share buybacks (see charts 5 and 6) and keep equities the superior income-producing investment for global investors, with a significant total yield pick-up over bonds (see chart 7). US corporate distributions to shareholders could be further enhanced if Trump's corporate profit repatriation policy is enacted.

Chart 5: Near-record level of S&P 500 companies are buying back shares



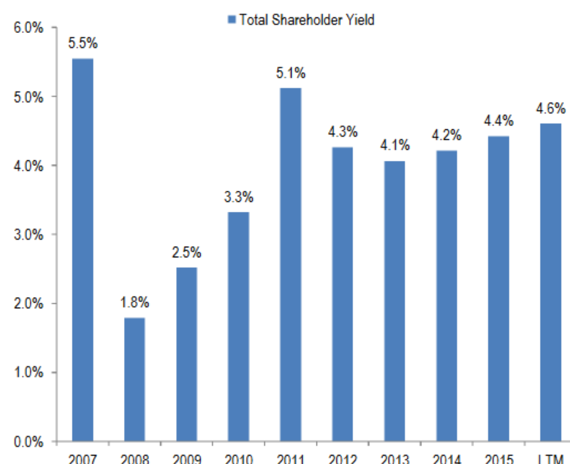
Source: BofA Merrill Lynch

Chart 6: Buybacks have added 1% to 2% to US earnings growth in recent years



Source: BofA Merrill Lynch

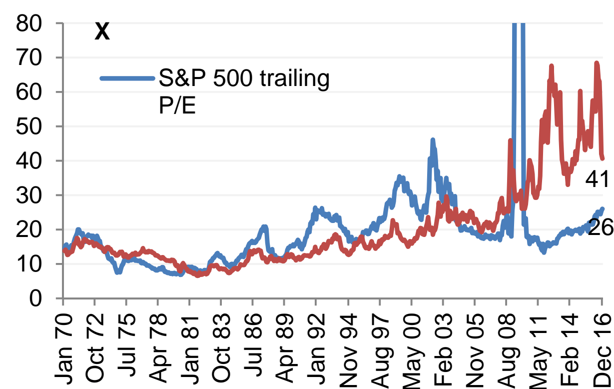
Chart 7: Total US shareholder yield



Source: JP Morgan

Although there has been a slight convergence between the valuation metrics of global equities and bonds in the final months of 2016, as bonds sold off and equities rallied in the aftermath of the Trump triumph, the relative valuation differential remains hugely skewed in favour of global equities (see chart 8).

Chart 8: US equity and bond market P/Es

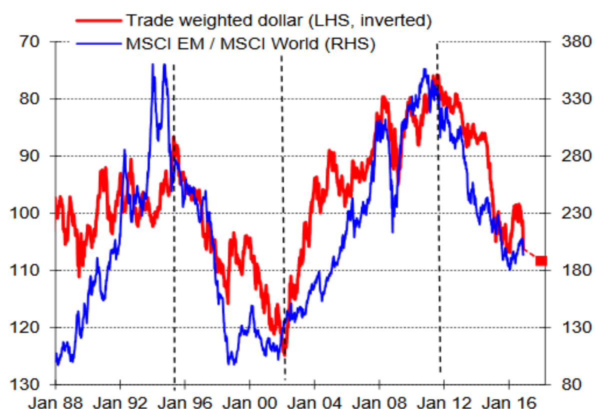


Source: INET BFA, Momentum Investments

Regional equities – will 2017 be Japan's year?

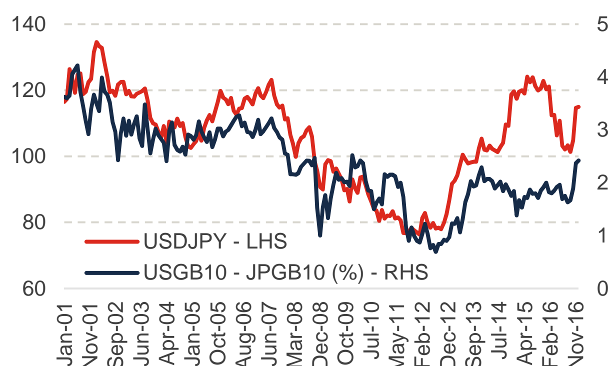
An expected strong US dollar is likely to be a headwind for US and emerging market (EM) equities (see chart 9), while providing support for Japanese equities via a resultant weaker yen (chart 10), although global investors would be wise to hedge the yen exposure to protect US dollar returns. Bank of Japan (BoJ) and Global Pension and Investment Fund (GPIF) equity buying (estimated at 2% of market capitalisation by Morgan Stanley) should be an additional underpin for Japanese equities, while the market is under-owned by global investors and valuations are attractive. The high-beta nature of the Japanese equity market to an improving global growth profile and ongoing stock buybacks should also shore up earnings.

Chart 9: EM equities typically underperform during strong US dollar periods



Source: Credit Suisse

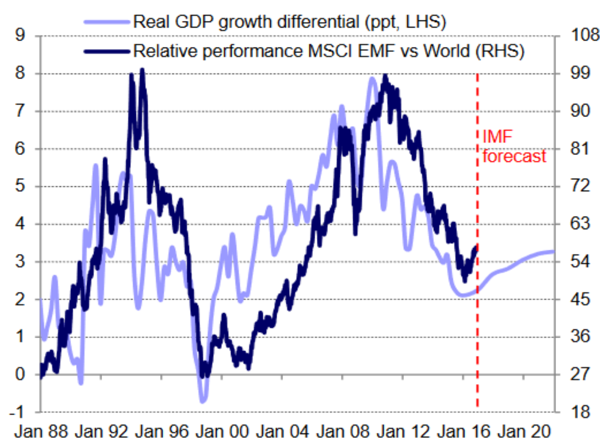
Chart 10: A rising US/Japan bond yield differential implies a weaker yen



Source: INET BFA, Momentum Investments

While EM equities typically benefit from reflationary policies, as reflected by prospective rising growth differential forecasts with DM in chart 11, the region does face higher risk from the threat of increased trade protectionism, as politicians globally try to appease their respective constituencies by instating trade barriers against globally competitive imported products.

Chart 11: EM equities should benefit from expected widening growth differential with DM



Source: Credit Suisse

Although Morgan Stanley notes that European equities should benefit from its cyclical value characteristics (among others its high financial and commodity exposure) in a scenario of higher inflation and bond yields, political risk could undermine its returns during a busy election year in 2017. But the latter could also induce politicians to front load fiscal stimulus measures in the year, while a weak euro should provide some additional support for the market.

SA bonds fundamentally supported by lower inflation and eventual interest rate cuts

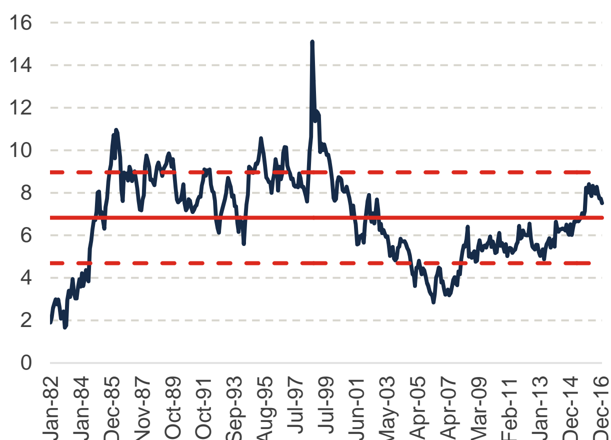
With DM interest rate policy options fast running out, monetary easing is now becoming an EM story, with high real EM policy rates providing central banks with the necessary leeway to cut interest rates (see chart 12). This should be supportive for EM debt, in conjunction with lower inflation and better growth expected in the region during 2017. However, the risk to monitor for the asset class would be EM currency weakness in an environment of US dollar strength, rising DM bond yields and protectionism threats.

Chart 12: EM ex-China real rate differential with US (%)

Source: Morgan Stanley

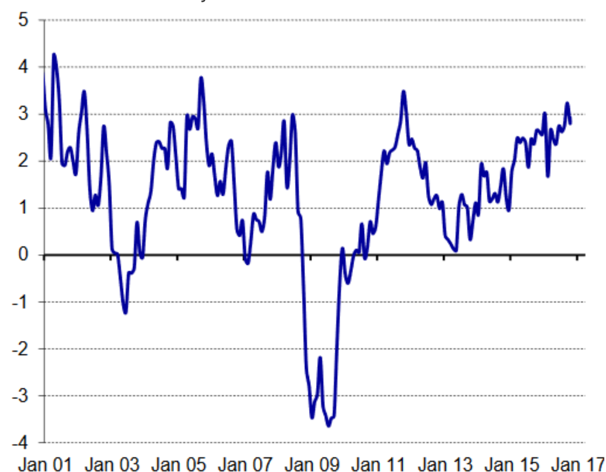
Although higher core DM yields should cause some erosion of the relative carry trade attractiveness of EM and SA bonds, the magnitude of the available nominal and real yield differentials should remain a positive underpin for SA fixed interest during 2017 (see charts 13 and 14), even if associated rand weakness somewhat softens the domestic inflation downtrend and delay South African Reserve Bank (SARB) interest rate cuts. While sovereign debt rating downgrade risk is likely to remain a threat for as long as tangible structural policy reform progress is absent in SA, the local bond market is indeed already valued as if in junk status, with limited downside risk, in Momentum Investments' view. With SA inflation break-evens still perceived as too high against the backdrop of an anticipated falling domestic inflation trend in 2017, SA inflation-linked bonds look expensive compared to vanillas.

Chart 13: SA nominal bond yield differential with average of US and Germany (%)



Source: INET BFA, Momentum Investments

Chart 14: SA real bond yield differential with average of US and Germany (%)



Source: Credit Suisse

Sustainable commodity upside requires widespread supply discipline

As the opportunity cost of holding gold rises in line with interest rates, it will likely be less attractive as an investment in 2017. Geopolitical risk could help gold somewhat, unless this is solely related to anti-establishment voting that implies more fiscal spending and hence higher interest rates.

In Momentum Investments' view, unless there is runaway inflation in the pipeline, gold price returns are likely to play second fiddle to industrial metals during a period when fiscal spending is likely to be partly driven by infrastructural investment. Although an expected strong US dollar is not positive for commodities in general, ongoing major public sector stimulus in China could continue to underpin the country's recent solid economic performance and could provide some demand-side support for commodities. But for commodities to show a sustainable and meaningful uptrend, widespread supply discipline from major producers is required.

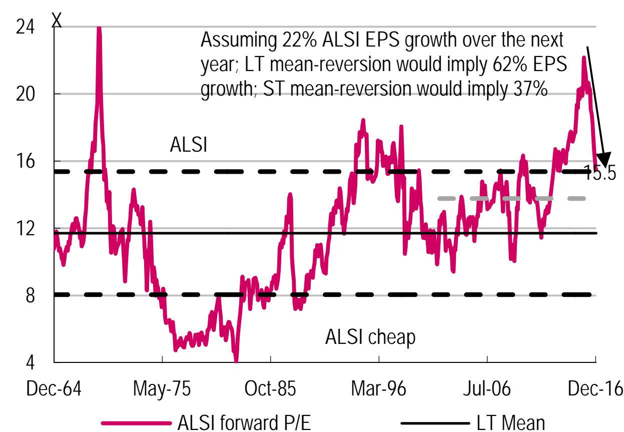
SA equity valuations have improved meaningfully

As is evident from charts 15 and 16, a flat SA equity market during the past two and a half years has improved valuation levels meaningfully. Due to the significant offshore exposure of the SA equity market, it should be well protected against any potential rand weakness forthcoming from a rising global interest rate cycle. For the domestically orientated part of the SA equity market, an expected pick-up in local economic activity (albeit still at a slow pace) should provide some top-line support for corporate profits in 2017. A positive real disposable income effect from plummeting food inflation, better weather conditions, a positive global growth impulse, as well as an increasing possibility for an interest rate cut towards the latter part of 2017, should provide some growth impetus in the year.

Chart 15: Price/book valuation of SA equity market at seven-year low

Source: RMB Morgan Stanley

Chart 16: SA equity market forward P/E



Source: INET BFA, Momentum Investments

Momentum Investments favours all equity, SA bonds and SA listed property in 2017

Momentum Investments expects global equities to benefit fundamentally from reflation policies during 2017, not only providing investors with superior investment growth, but also delivering much better income flows than the traditional income-producing investments like global bonds and cash. In contrast, rising inflation and negative supply/demand dynamics from concomitant fiscal expansion and QE tapering would be fundamentally negative for global bonds. In addition, equities also have the added advantage of much more attractive valuations than fixed income, thus further enhancing potential future relative returns from the equity asset class. As such, Momentum Investments has a strong preference for global equities over global bonds and cash in the company's portfolios going into 2017. Some expected rand weakness during next year in response to political and sovereign rating downgrade risk should add to the returns on global investments for SA investors.

Although the local equity market's earnings recovery is very much dependent on the sustainability of the commodity price rally, less expensive valuations now point to relatively decent future returns, in Momentum Investments' view. The company considers local bonds to have an attractive risk/return profile against the backdrop of the ongoing global carry trade and an improving

envisaged domestic inflation and policy rate profile. Momentum Investments' view that the inflation risk premium currently discounted by inflation-linked bonds remains too high makes the company still favour vanilla bonds over inflation-linked bonds in its portfolios.

Recent underperformance from listed property has meaningfully improved its future return prospects, in Momentum Investments' opinion, particularly against the backdrop of an improved domestic bond market outlook. Although risk-adjusted domestic cash returns still look decent in a low-return environment, re-investment risk should increase going forward, as the local interest rate cycle peaks.

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