Economic & Market Insights – Q4 2017
Riding the bull: an exhilarating yet precarious activity

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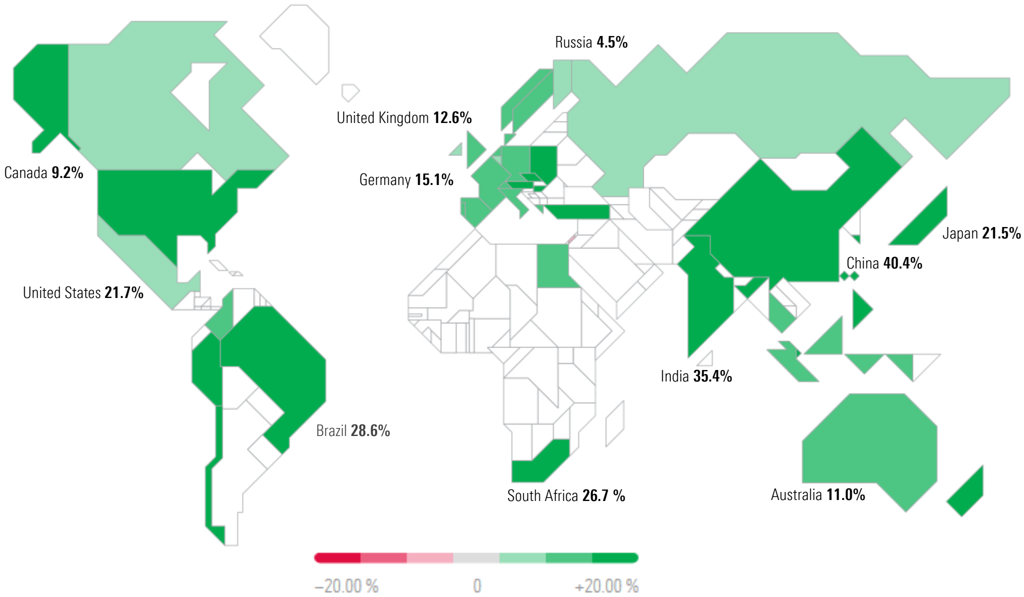
For Financial Professionals Only

The fourth and final quarter of 2017 left risk-taking investors feeling overwhelmingly upbeat as they enter 2018. Healthy economic and company-driven data is widespread and continues across the majority of key markets. This resulted in a wall of green across regional equity markets for both the quarter and indeed the year.

Exhibit 1 Global yearly performance for equities in 2017 show a wall of green (local currency terms).

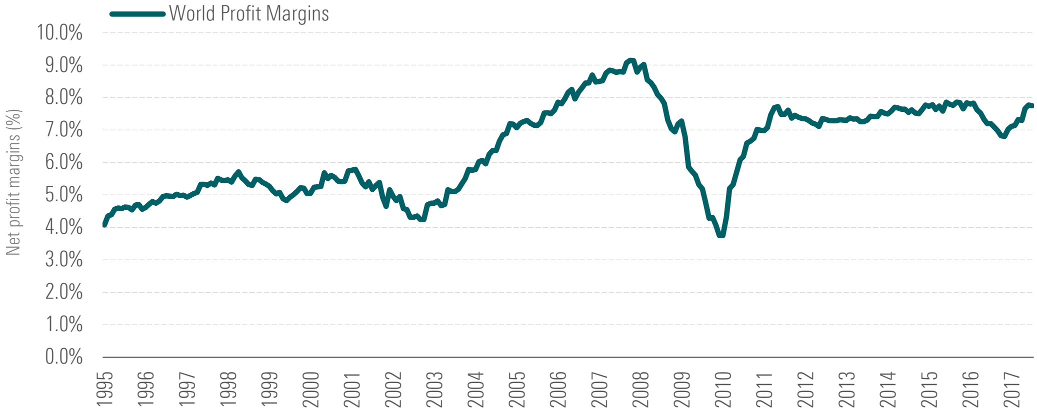


Source: Morningstar Direct, performance data in local currency terms at 05/01/17

Economic growth and confidence gauges also continue to strengthen, especially in the US, Europe and China, while corporate profitability continues to improve and unemployment edges lower. This is a typical recipe for a cyclical market upswing in **equities**, with participants pricing in the optimism and stretching valuations. In fact, global equities reported another 6% gain for the quarter in local currency terms, extending calendar year performance to 25% overall (the best result since 2009). Asia was the standout region, with India increasing more than 12% over the quarter, while Japan also delivered a very impressive 8%.

This is having a meaningful impact on investor sentiment, with the "lifting of all boats" pushing confidence measures to new highs, marking a profound and potentially complex period for investors. Investors seem to be embracing everything that lies ahead of them at present, with Brexit speculation, European political change and the normalisation of interest rates all being taken in stride as corporate profits climb higher. Sterling investors also benefited broadly as there was very little dispersion between sterling and major currencies over the quarter.

Exhibit 2 Profit margins have expanded over 2017 and are nearing post-crisis highs.

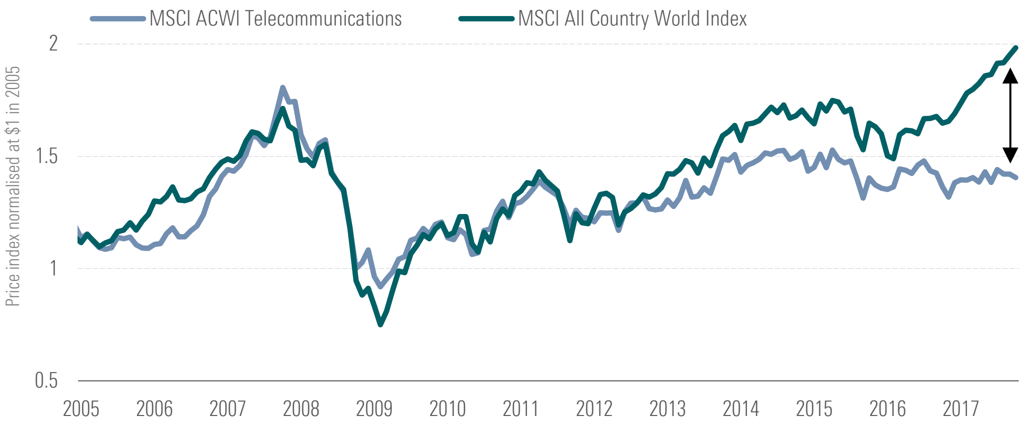


Source: Morningstar Investment Management calculation to 30/09/17

Without question, global growth continues to be supported by China's growth trajectory, which continues to run ahead of the government's expectation (GDP growth of 6.8% year-on-year is ahead of the 6.5% expectation for 2017). This rise in China conveniently coincided with the five-yearly China Party Congress in November, at which President Xi Jinping was re-elected for a second term, with Chinese equities rallying by another 8% in local currency terms for the quarter.

European enthusiasm has been another clear development, although performance in the region was modest over the quarter. The Catalonian independence vote posed a risk to Spanish and Eurozone stability, however the initial fear was followed by a sense of calm. All of this leaves the European Central Bank with a challenging situation, as it pulls back on stimulus (cutting quantitative easing from €60 billion to €30 billion per month from January 2018) while grappling with stubbornly low inflation. The so-called bond proxies also struggled in relative terms, with telecommunications and utilities the laggards among the equity sectors. This widens sector dispersion further, reinforcing the need for fundamental diversification and outlines the patience that is often required to be successful as a valuation-driven investor.

Exhibit 3 The performance differential since 2012 is stark.



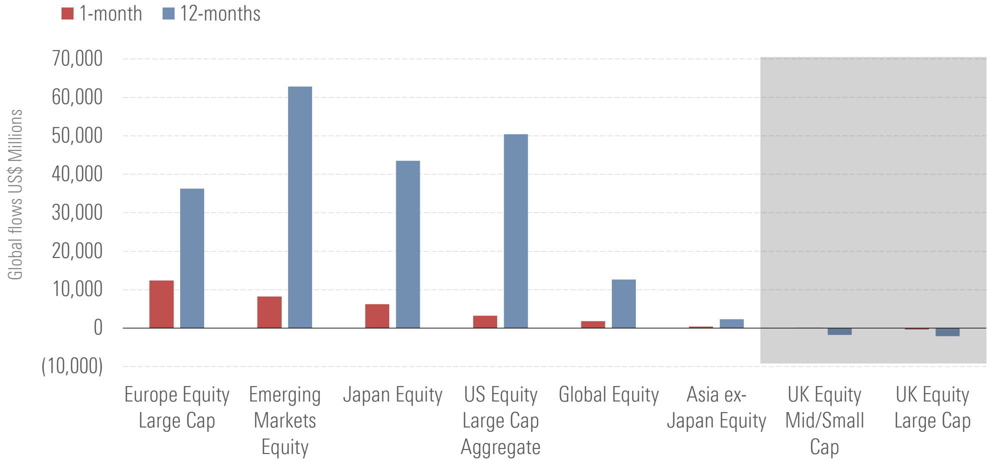
Source: Morningstar Investment Management calculation, Morningstar Direct to 30/09/17
Note: Past performance is not a guide to future returns. For illustrative purposes only.

More broadly, the central bank path to normalisation continues to gather press around the globe, as the Bank of England raised interest rates for the first time in ten years and joined the Federal Reserve in increasing short term borrowing costs.

This shift hampered returns within **fixed income**, with the global aggregate index practically flat. In fact, returns in the fixed income space were underwhelming across the board, with government and corporate bonds delivering similarly subdued results, while inflation-protected bonds scraped out a modest gain.

The UK has been on a proverbial rollercoaster, with the highs and lows of political jabbering, but ended the last quarter of 2017 with positivity. Specifically, Brexit negotiations were deemed to be constructive and positive, as the European Union declared that "sufficient progress" had been made, including agreements on the divorce bill, the Irish border and the status of Europeans living in the UK. While the uncertainty continues to hamper investor sentiment in the region, the FTSE All Share did deliver approximately 5% in local currency terms, while UK Gilts rallied around 2%.

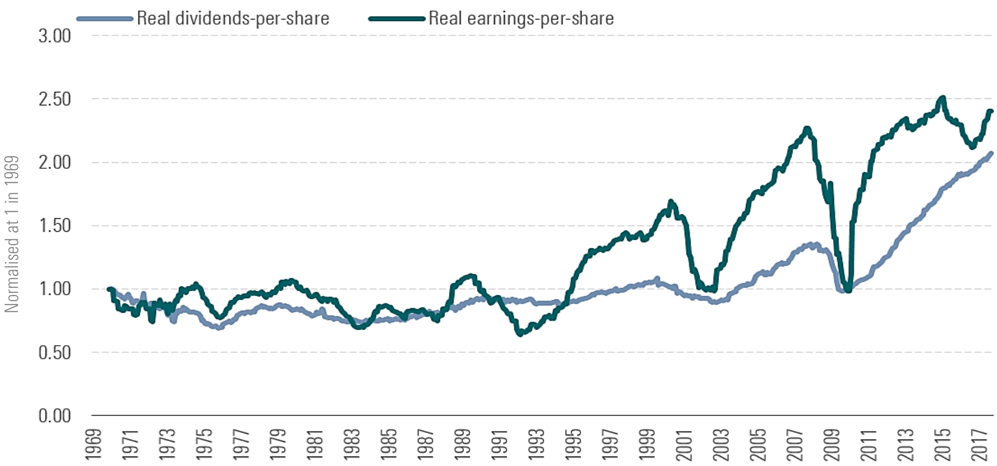
Exhibit 4 Managed fund and ETF fund flows are now moving out of the UK into other regions.



Source: Morningstar Investment Management calculation, Morningstar Direct, to 30/09/17

Across the pond, U.S. President Donald Trump also confirmed that his much-anticipated tax reform bill had passed congress, possibly the biggest upheaval to the tax system since the 1970s and a form of fiscal stimulus that pundits hope will further propel the US economy. This combined with a raft of positive dataflow saw US equities increase by another 6% over the quarter in local currency terms.

Exhibit 5 Underlying the US equity growth story has been a strong improvement in dividend growth.



Source: Morningstar Investment Management calculation, to 30/09/17

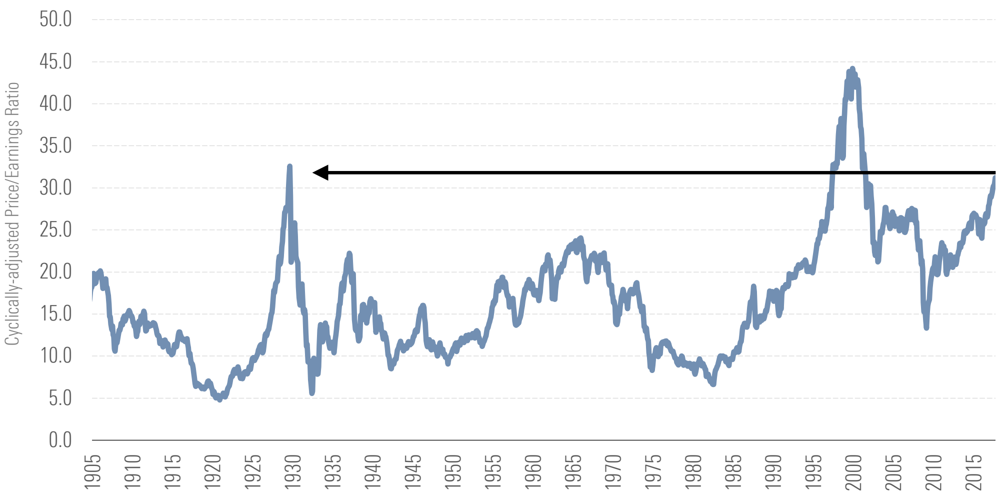
The last big mover of the quarter was oil, increasing by approximately 15%, which is a two and a half year high and approximately double the commodity crisis lows from February 2016. This helped propel energy and mining companies, and followed a meeting in Vienna between two dozen oil-producing nations, where they agreed the extension of OPEC-led oil supply cuts.

Outlook

As one reflects on the market developments, it is important to see the forest through the trees. We are clearly in the midst of a cyclical upswing, and while it is very difficult to know how long it will last, we do know that valuations are stretching beyond reasonable levels.

To validate such a thesis, we do not need to look far. The global share market has rallied by 25% over 2017 (in local currency terms) and emerging markets are up by 27% – a clear sign of optimism among market participants. This has pushed valuation metrics such as the cyclically-adjusted price/earnings ratio to new highs, with the U.S. currently at the highest level since 2000, and before that 1929.

Exhibit 6 Long-term valuations appear stretched in the U.S. according to metrics such as the CAPE.



Source: Morningstar Investment Management calculation, Shiller data, to 30/09/17

While we naturally welcome positive returns for our investors, we must similarly acknowledge the challenges it presents. As was the case for much of 2017, the market expects global economic growth to remain fairly synchronized, with recent business and consumer confidence surveys reinforcing a growing sense of optimism. While the European economy is outperforming the US economy (according to recent GDP growth rates), the UK is generally thought to be on a different trajectory as it battles between slower investment growth and rising inflation.

Looking through the market noise comes a simplified formula for investment success – find assets that are fundamentally healthy and ideally undervalued in a long-term context, and otherwise maintain patience through the cycle. While easier said than done, if one can do this in a pragmatic and repeatable manner, then an opportunity exists to maximise reward for risk at a portfolio level.

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