The prolonged global expansion could continue if fiscal and monetary policies remain supportive

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Key takeaways

- We take a two- to three-year view of the world when building our central economic thesis.
- We believe it is vital to consider both cyclical and structural forces in building this thesis.
- We must believe that all of our ideas can make a positive return in our central economic scenario to ensure we have ideas that can excel in various economic conditions. However, it is important to note that our ideas do not derive from it.

2018 has been a relatively volatile year, however this has been limited to bouts of volatility while, rather surprisingly, levels of market volatility overall have remained fairly subdued.

Throughout 2018, we have seen a blow-up of exchange traded funds (ETFs) that were designed to benefit from falls in the VIX index, a large election surprise in Italy, further US sanctions on Russia, another International Monetary Fund bailout for Argentina and more general pressure on emerging markets (EMs) from the strengthening of the US dollar and increasing US interest rates. There has also been heightening rhetoric around trade and we have seen the beginning of tariffs, which could potentially lead to trade wars. The populist theme has also played out in the raft of elections across the globe, which while there have not been many huge surprises, the rise of populist share of the vote has caused some market worries.

Despite this, the US economy has continued to grow more quickly as the year has gone on and generated enough inflation to keep the US Federal Reserve (Fed) comfortable hiking rates. Growth in the rest of the world has moderated from the peak seen at the end of 2017 into 2018 but most regions are still probably growing above potential. During 2018, headline inflation globally has picked up, mainly from the increase in the oil price, while core inflation remains subdued.

What is our central economic thesis looking forward into 2019?

Our central economic thesis is our two- to three-year outlook for the global economy, we update this every month and will re-visit the thesis in times of extreme market stress. However, as we approach 2019, we summarise our views below:

Trade-off between cyclical factors and structural vulnerabilities

- US momentum and Chinese policy are key to extending the current economic cycle
- A stronger USD and trade disruption unveiling weaknesses in emerging economies
- Becoming increasingly difficult for current policy to offset balance sheet strains

Inflation is likely to remain contained

- Positive real wage growth could test policy makers' resolve
- But a lack of pricing power and debt overhang will keep inflation low versus history
- Core bond yields ultimately capped by structurally lower nominal economic growth

'Price discovery' by Central Banks supports only a gradual change in policy

- US policy versus rest of the world - spread will eventually narrow
- Global liquidity is grinding lower, capping the upside for credit growth
- Political populism will continue without a self-sustaining recovery and policy change

Risk assets require a selective approach, particularly in EM

- Regional drivers matter from here, e.g. the euro, US corporate cash, EM local debt
- Credit is still vulnerable; equity returns determined by earnings growth and income
- Diversified alpha an additional source of value

Volatility to reset at higher average levels

- Fixed income and currency volatility sensitive to Central Bank action
- Market volatility impacted by investor behaviour (e.g. search for yield)
- Sporadic bouts of volatility emanating from developed markets (DM) or EM may be linked

How has our thesis evolved throughout 2018?
At the turn of the year, we amended our central economic thesis to acknowledge that cyclical factors were driving the global economy and the structural vulnerabilities had been moved into the background. While we made this acknowledgment, our forward-looking view could be described as the economy "bumbling along" as opposed to our previous "cautious optimism". As the year has progressed, some of these structural vulnerabilities have come back to the fore, while the cyclical drivers have weakened somewhat. Our current thesis touches on the trade-off between both going forward, which will likely lead to more bumps along the road.

We acknowledge that this prolonged cycle can continue while monetary and fiscal policy is supportive, but going forward it is likely to rely primarily on US momentum continuing and China being the marginal player. However, the recovery could be derailed by continued monetary tightening in the US. This is starting to put pressure on EMs and, while the Fed often comments that they are only focused on the domestic macro, if they over tighten they could end up tripping themselves up.

There is also a fine balance to be struck in China, where it feels that further easing measures are needed to keep the Chinese growth machine churning. While growth would likely then continue, this will further add to the imbalances being built up. China and the rest of Asia are also especially vulnerable to the trade war rhetoric coming from the US administration, which is an obvious risk over our time horizon, especially if it escalates.

We have always believed in being selective across the EM complex, but this is something that is even more important now given the aforementioned external influences at play. The current debate is around whether the countries that have seen stresses are idiosyncratic stories or whether these external pressures are revealing more systemic frailties. Thus far, it has generally been high yielders with current account deficits that have been the hardest hit (namely Turkey, Argentina, India, Indonesia and South Africa). This year, we have reduced our overall EM exposure. However, as always, it has not been an asset allocation decision rather via a few individual idea views. We still believe there are constructive emerging market stories available but we are likely to approach them with more caution than previously.

Where does our thesis remain the same?
The team continues to feel that inflation globally remains contained and while wage growth and trade disruption remain as risks, it is more likely that profit margins will be squeezed as opposed to large price increases being passed on to consumers. Equity profit margins currently are fairly healthy and, while labour markets appear tight, current wage growth is rather subdued. This means that companies can afford to absorb the increased costs on their books.

With inflation contained and structural levels of gross domestic product lower than previously, we maintain our belief that global bond yields will remain capped. Also, while there has been divergence between policy rates in the United States and the rest of the world, we are not convinced that this will continue over our time horizon.

Whether this divergence is reversed due to the Fed changing tack and loosening policy over the next two to three years or the rest of the world's central banks hiking rates, it seems clear that global liquidity is grinding lower as most central banks have started some form of quantitative tightening. This will make it difficult for most economies to continue the above-potential growth path they have enjoyed over the past 18 months, which will add further complexity to policy makers' decision making.

We remain of the belief that market volatility should reset at higher levels. This is a long-held view of ours on, which we have previously got wrong and, while the last year has seen levels of volatility stabilise from a seemingly everlasting decline, as mentioned previously we are yet to see them really pick up. We now have outright volatility views in currency and equity, as well as taking advantage of low levels of volatility to buy options or create option structures within some of our currency, equity and interest rate ideas.

More recently, we have been asked about our time horizon and whether we will look at changing our return or volatility targets. However, we will always look forward over the next two to three years – it would be imprudent to overrule this view in order to try and boost short-term returns, especially given current market uncertainty.

We firmly believe that it is important to not succumb to this type of pressure as while it is very difficult to accurately predict a change in regime, it is important to consider that one could come at any time. We continue to scenario test around a number of market environments so that we can build a robust portfolio, which has the potential to work in our central scenario, participate more fully in upside scenarios and remain robust in case of potential market shocks.

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