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Economic and Strategy Viewpoint

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2017 review: The dog that did not bark

- We look back at a year full of political noise which ultimately was not enough to suppress ebullient asset prices.
- Emerging markets perhaps suffered more from political risk than their developed counterparts, but still delivered the best returns on aggregate in a strong year for equities.
- Despite the lack of a political crisis, we think 2017 still showed that politics can and does matter. Relief rallies as tail risks failed to materialise provided evidence of this.

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Themes for 2018

- We highlight three themes in 2018. The first is "Goldilocks gives way to reflation" where stronger growth and higher inflation replace the market friendly combination of low inflation and robust growth seen in 2017. Second, is "The long farewell: the end of QE" where we highlight the forthcoming withdrawal of global liquidity. Third is "The return of political risk" where we draw attention to the US mid-term elections which may return Washington to gridlock.
- All three themes strike a note of caution for equity and credit markets in 2018, but investors may be focussed elsewhere so by popular demand we have added our thoughts on bitcoin.

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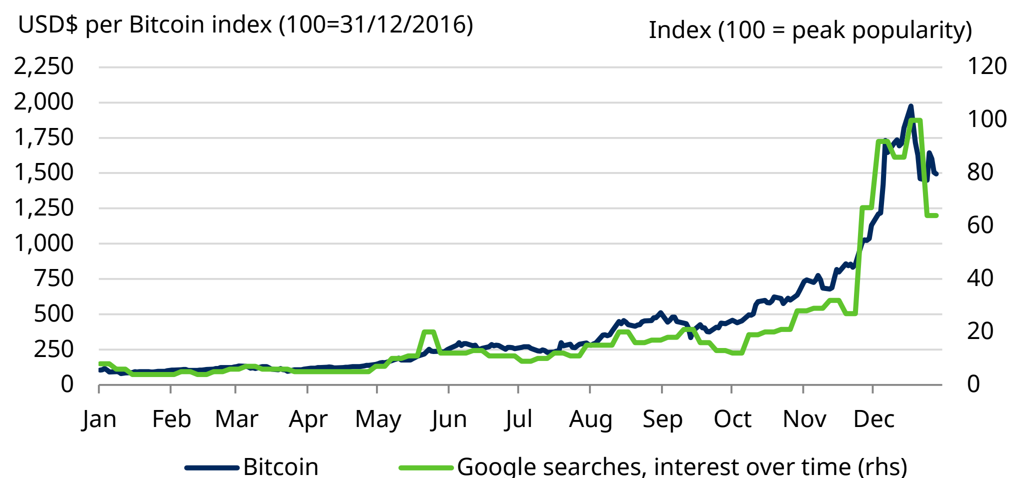
Views at a glance

- A short summary of our main macro views and where we see the risks to the world economy.

Chart: Bitcoin prices, and interest, surge



Source: Thomson Datastream, Google Trends, Schroders Economics Group, 2 January 2018.

2017 review: The dog that did not bark

A look back at a year when political risk threatened but worst fears were not realised

As a new year dawns, we like to take a step back and review the performance of markets and the lessons we can learn for the coming year. 2017 was full of political noise, but ultimately, investors held their nerves and continued to push risk assets higher. 2016 had ended with a relief rally in equities which delivered a respectable year in the end, but this was thanks to the electoral victory of Donald Trump, and the anticipation that he would deliver significant market-friendly fiscal stimulus. Of course, Trump's approach to politics brought concerns too, ranging from the deportation of illegal migrants to potential trade wars. These concerns have not gone away, but investors appear to have focused on the potential gains for corporate profits.

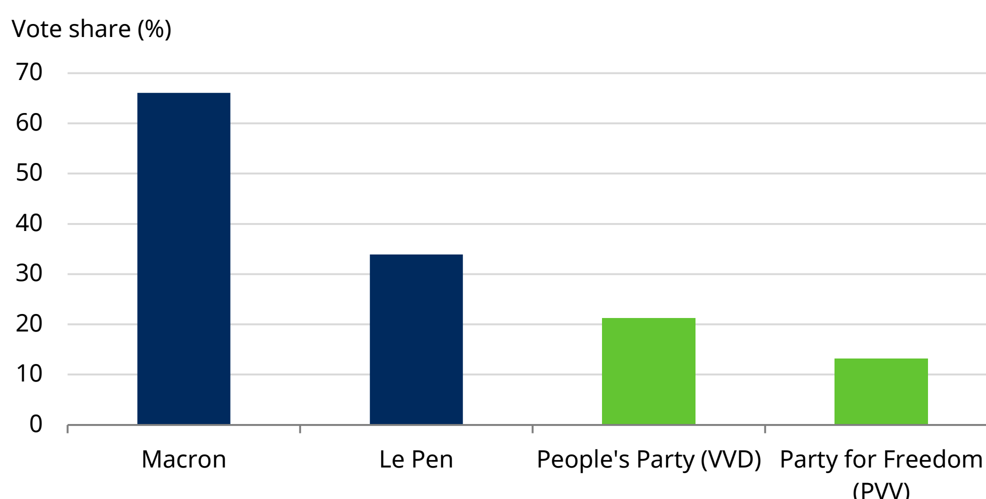
Spring heralds a new political landscape

Donald Trump became the 45th President of the United States of America, which was promptly followed by controversy over the attendance of his inauguration, which led to the administration accusing many respectable media outlets of peddling fake news. Over a million people joined the Women's March on Washington the next day, mostly in support of women's rights, but also in protest against many of Trump's political stances. For investors, many started the year fixated on the news flow from Washington, or more precisely, the @realDonaldTrump Twitter account. Markets soon became numb to the bombastic tweets and instead focused on the legislative agenda, and prospects of tax reforms.

It was not long before the US administration had to turn its attention to international issues. North Korea was escalating its direct threat in the South Pacific, and rhetoric towards the US. Trump did not help by inflaming the situation with tweets. However, concern was growing over what appeared to be North Korea's rapid progress in developing nuclear weapons, and its testing of ballistic missiles in the sea of Japan. Suddenly, geo-political risk was back, causing volatility in Asian markets, especially for South Korea.

The wave of populism seems to have crested with Trump and Brexit

Chart 1: Populism paused in Europe



Source: French Interior Ministry, Kiesraad, Schroders Economics Group. 2 January 2018.

In Europe, political risk had been well flagged thanks to the UK's Brexit referendum and the Italian referendum the previous year. 2017 could have been the year populists took control of the monetary union, with general elections in many major member states. The first hurdle was the general election in the Netherlands, where

the far right Party for Freedom was unexpectedly defeated by moderates. This could have been a signal of things to come, however, it was not until the results were known from the first round of the French presidential election before investors could relax. Emmanuel Macron finished first in the multi-party contest, before going on to convincingly defeating far-right candidate Marine Le Pen to become president. Suddenly, investors piled back in to European risk assets, and even government bonds, such was the concern about a Le Pen victory.

The failure of populism to deliver reversed the strong dollar

Towards the end of spring, the rally in equities paused as Trump's efforts to repeal and replace the Affordable Care Act (ACA) were voted down. This raised questions over his ability as a Washington outsider to effectively govern, and whether or not he would be able to push through his fiscal package. The repeal of the ACA was also supposed to help pay for Trump's tax cuts. This helped catalyse a weaker dollar trend for the year, along with a flattening of the yield curve and lowering inflation expectations.

Meanwhile, emerging markets did their best to maintain their normally dominant spot atop the political risk rankings. In South Africa, President Zuma fired his respected finance minister Pravin Gordhan as part of a larger reshuffle that purged many of his critics. The finance minister had been in a power struggle with President Zuma thanks to his ministry's efforts to root out corruption and cronyism in state owned companies. Unfortunately for Zuma, firing Gordhan did not send this problem away. Corruption also resurfaced in Brazil, with allegations against President Temer (who had himself replaced a president impeached for criminal administrative misconduct) prompting fears of impeachment and an end to efforts to reform the stricken economy. In a more market pleasing move, South Korea's presidential election delivered Moon Jae-in to power, replacing the impeached Park Geun-hye.

Summer highlights false economies

Riding high in the polls having just triggered Article 50 and starting the process of the UK's formal withdrawal from the European Union in March, Prime Minister Theresa May called a snap election in order to strengthen her political base, but also extend her term in office. The decision proved to be near fatal as her party's poor campaign and a backlash against her vision of a relatively hard Brexit cost her party its majority in the House of Commons. May managed to form a coalition with the Democratic Unionist Party (Northern Ireland) in exchange for several billion pounds of extra funding for the party's priorities.

The summer saw a series of political missteps, with time to tell how costly they will be

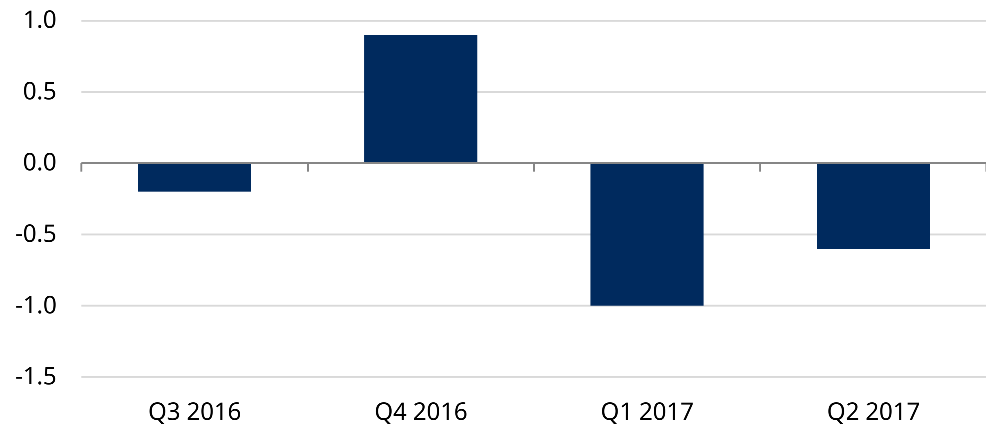
In June, President Trump announced that the US would cease all participation in the 2015 Paris Agreement on climate change mitigation, complaining that the accord put the US economy at a disadvantage. The announcement that the US will withdraw from the agreement by 2020 was condemned by world leaders, who argued for the urgency in the change in behaviour to head off larger natural disasters in the future.

2017 was one of the costliest hurricane seasons on record following hurricanes Harvey, Irma, Jose and Maria. According to the US based National Hurricane Centre, costs are estimated to reach $200 billion, which based on damage, is the second costliest season since 1900, even with adjustments for inflation, personal wealth and population. Fortunately, improvements in early warning systems and communication meant that it was only the 17th worst season in terms of lives lost – at 103 compared to 1,225 in 2005 following hurricane Katrina.

The damage was self inflicted in India, where policy upheaval continued following the 2016 demonetisation. The introduction of the new Goods and Services Tax proved highly disruptive, damaging economic growth which came in below 6% for a

second consecutive quarter. The policy should ultimately prove beneficial, but it has been executed less efficiently than might have been hoped.

Chart 2: Policy proved painful for India in 2017



Source: Bloomberg, Schroders Economics Group. 2 January 2018.

Autumn sees nudging change

Political intrigue but no reform in China

Hotly anticipated as a potential catalyst for reform, the 19th National Congress of the Communist Party of China was ultimately something of an economic non-event. The many imbalances threatening economic and financial stability, aggressively tackling excessive leverage, the distorting role of state owned enterprises and the problem of excess capacity were all largely ignored. Politically speaking, however, the event was an important one. President Xi Jinping is now seemingly cemented as one of the most powerful Chinese leaders in modern history, and further consolidation of power is expected in his second five year term. Unfortunately for the economy, part of this consolidation seems to be an ongoing central role for state owned enterprises.

Back in Europe, Germany's general election ended in stalemate as expected, with Angela Merkel's CDU/CSU coalition continuing to dominate. Many expected Merkel to form a coalition with the Green party and the liberal Free Democrats (FDP), to complete the first ever "Jamaica coalition", so-named due to party colours. Coalition talks broke down later in the year, forcing Merkel to look for support from the left wing Social Democrats, her party's junior coalition partner in the previous term. Talks are ongoing, but we should learn whether or not a new election will be held by the end of January.

Lastly, special congratulations are due to Richard Thaler for winning the Nobel prize in economics. Aside from central bankers, Thaler has been one of the most influential economists in recent years with his work on behavioural economics. His work has not only changed the way policy makers consider the construct of incentives, but has spread to behavioural finance, influencing investors' thinking.

Winter caps a strong year for markets

By this point in 2017, markets were up substantially with remarkably low volatility, and very few corrections to the rally. Economic growth has been revised up most of the year, with fresh evidence that 2017 was going to be one of the best years for growth since 2013. While investors had successfully navigated most of the expected big political events of the year, there was still time for a few black swans (both good and bad).

In October, chaos in Catalonia erupted when an illegal poll on independence was met by heavy handed policing. Claiming victory despite a very poor turnout, the leader of the Catalan parliament, Carlos Puigdemont, proceeded to declare the independence of the region. This was swiftly rejected by Madrid, which suspended the power of the Catalan parliament, and announced fresh elections for later in the year. Investors in Catalan regional debt took fright, but the situation soon calmed down, though not without nearly 3,000 Catalan companies moving their headquarters out of the region.

Elsewhere in Europe, the Austrian election saw the far right Freedom party finish in second place. It was invited to join the coalition government which it accepted, becoming the only far-right party in government in the European Union.

Meanwhile, the UK and European Union agreed on a joint progress report on citizens' rights, Northern Ireland, and the divorce bill. This allowed the EU Council to recommend opening the second phase of negotiations, which will include the framework for a future trade relationship. The progress report suggested a softer stance on Brexit from the UK, which helped the pound to recover some of its losses through the year.

Japan's snap election went more smoothly than the UK's

In Japan, Shinzo Abe called and won a snap election in order to secure a new mandate for two important policy proposals. The first was to reinvest the proceeds from the 2019 increase in VAT, rather than reducing the public deficit. The second is to change Japan's constitution to allow its military to take a more active stance. This was in response to the growing threat from North Korea.

The South African saga continued as first the country came to the brink of losing its local currency investment grade rating, with only Moody's maintaining the coveted status for the country's debt. Then, in December, the ruling party's leadership election saw a narrow victory for the pro-reform candidate Cyril Ramaphosa. This was a blow for President Zuma; a victory for his ex-wife instead was seen as the protection he needed against corruption allegations once he steps down as president. However, it was good news for markets, with the rand posting a sharp rally on the news. There is still considerable caution about the country's prospects, but this is an undeniable improvement. Meanwhile, over the border in Zimbabwe, President Robert Mugabe stepped down (after some confusion), concluding 37 years of rule.

Back in the US, concerns were growing amongst Republican party members ahead of next year's mid-term election following the unexpected victory of the Democrats in a special Senate contest in Alabama in December. Doug Jones overturned huge margins when compared to the Trump Clinton race of 2016 to defeat Republican Roy Moore. This followed another Republican defeat in November, where Democrats held on to Virginia in a closely fought swing state. With the fear that these contests were signs of things to come next year, House and Senate Republicans buckled down and agreed the long-awaited tax reform bill. Markets rallied on the news, with big permanent cuts for corporations as the centrepiece of the package. US companies will see their headline income tax rate plunge from 35% to 21%, bringing the US broadly into line with the average rate in the developed world. In addition, there will be a temporary tax discount on the repatriation of overseas earnings, along with more moderate and temporary tax reductions for individuals.

The bitcoin surge became harder to ignore

As the year drew to an end, the hyperbolic rise in the value of bitcoins drew the attention of the public and investors. The Chicago Board Options Exchange (CBOE) and the Chicago Mercantile Exchange (CME) both launched bitcoin futures as demand from traditional investors has risen. The crypto-currency has been around for some time, and was discussed in this publication the last time it soared in 2013. One of the attractions of bitcoins is the decentralised structure of the system. It is

not run or managed by a central bank, and therefore cannot be devalued like fiat currencies. Its popularity is clearly linked to the actions of central banks, and in some countries, due to the threat of wealth being appropriated by governments. Whether it finally becomes a mainstream asset or not is still up for debate, but we doubt it will be disappearing any time soon.

Central banks shift gears

Developed market monetary policy continued to be tightened over 2017, largely as the previous year had ended. However, in addition to the US Federal Reserve's (Fed) hikes, other central banks joined in, notably the Bank of Canada and the Bank of England. The European Central Bank kept quantitative easing (QE) going, but did taper its purchases during the year, and announced a further tapering and extension for 2018. The Bank of Japan did not change its policies on QE or yield curve control, though it was able to reduce its monthly purchases, and speculation is growing that it may raise its yield curve control target next year.

Divergent monetary policy in EM and DM as low inflation finally came to EM

In emerging markets, most central banks enjoyed disinflation last year, providing scope for cuts, particularly in Brazil and Russia. The two economies look to have successfully conquered structurally high inflation; Russian inflation is currently running at 2.5% from over 16% in 2015, while in Brazil inflation has fallen to similar lows from close to 11% in 2016. This has allowed a total of 175 bps of easing in Russia and 625 bps of cuts in Brazil in 2017. In the rest of EM it has been less spectacular, but we have also seen modest easing in a number of other economies, and for the most part there is little pressure to hike at the moment.

There are of course a couple of exceptions. Currency woes in Mexico and Turkey have pushed inflation higher in both countries, necessitating hikes by both countries' central banks. In Turkey's case, the central bank is facing significant resistance to orthodox monetary policy from the government, and so its hikes have so far been insufficient for the task at hand. Rates remain negative in real terms at present, with inflation just shy of 13%.

Finally, Chinese monetary policy has been somewhat tight for most of 2017, though conducted more through macroprudential channels than changes to policy rates, which have been stable. Following the Fed's December hike, the People's Bank of China (PBoC) did hike some rates by 5 bps, but this seems unlikely to have much effect. The PBoC also preannounced a targeted cut to the required reserve ratio, to take effect in January 2018. Though this is an easing measure, it largely serves as an offset to regulatory changes due to come in at the same time, which would otherwise tighten liquidity conditions.

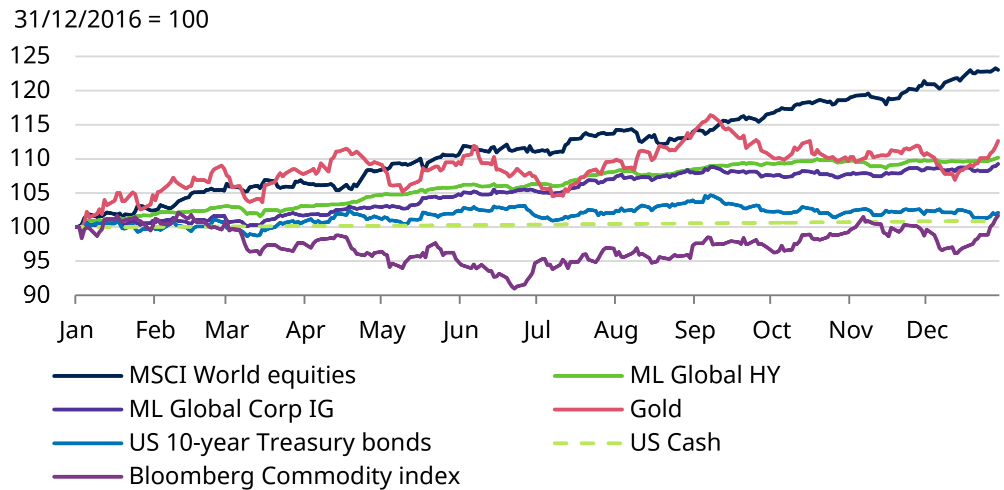
Cross-asset performance comparison

Looking across the major asset classes, equities (MSCI World) were the best performing asset class (+23.1%) by some way, with a largely smooth year of gains at the global aggregate throughout the year.

The risk on environment helped credit perform well, with global high yield ending the year in third place (+10.2%), and global investment grade credit in fourth (+9.2%). Rising interest rates clearly impacted credit, but the low yield high liquidity environment continued to be supportive.

Meanwhile, gold had a very good start to the year, with its performance up over 15% by the end of the summer. However, rising real interest rates hurt its performance in the final quarter, ending the year with 12.6% gains, still enough for second place overall.

Chart 3: 2017 Cross-asset performance (USD)



Source: Thomson Datastream, Schroders Economics Group. 2 January 2018.

Highest returns were found in equities, with commodities the weakest performer

With US Treasury yields starting the year at very low levels, further gains were difficult to achieve. Nevertheless, from the second quarter on, total returns remained in positive territory, with a year-end return of 2.1%.

When comparing the performance of US equities and Treasury bonds against their history, the S&P500 provided a strong, above average return (data since 1873 – see chart 4), while Treasuries had a below average year (data since 1900 – chart 5).

Chart 4: Equity returns distribution

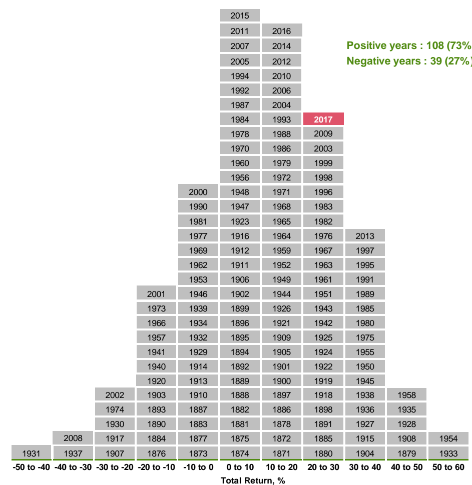
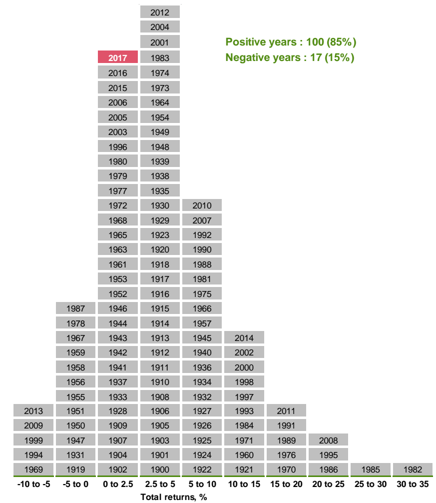


Chart 5: Bond returns distribution



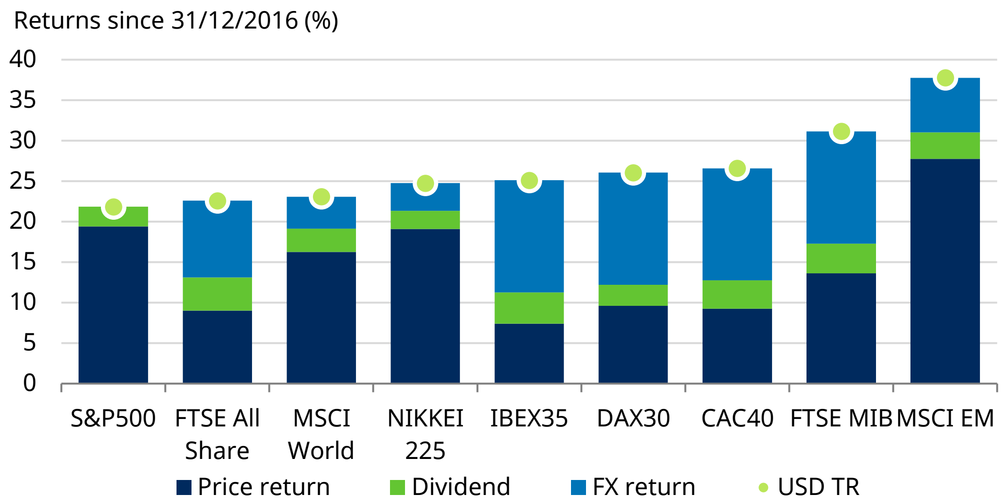
Note: Equity total returns using S&P500 from 1873, and bond total returns taken from US 10-year treasuries from 1900. Source: Thomson Datastream, Global Financial Data, Schroders Economics Group, 2 January 2018.

Comparing equity market performance

2017 was a great year for equity investors, with all of the major indices providing positive returns when cast in both local currency and US dollar terms. The star performer was the MSCI Emerging Markets index, which provided the highest returns using both metrics (+31% in local currency and +37% in USD). The S&P500 was the second best performer in its own currency (+21.8%), but fell behind most other indices when taking into account the depreciation of the US dollar.

Indeed, European bourses performed well, with the Italian FTSE MIB (+31.1%) playing catch-up after deep losses in 2016. The German DAX30 (+26%) and the French CAC40 (+26.6%) also posted strong gains.

Chart 6: Equity markets performance (total returns in USD)



Source: Thomson Datastream, Bloomberg, Schroders Economics Group. 2 January 2018.

Strong EM performance masks significant disparities across countries

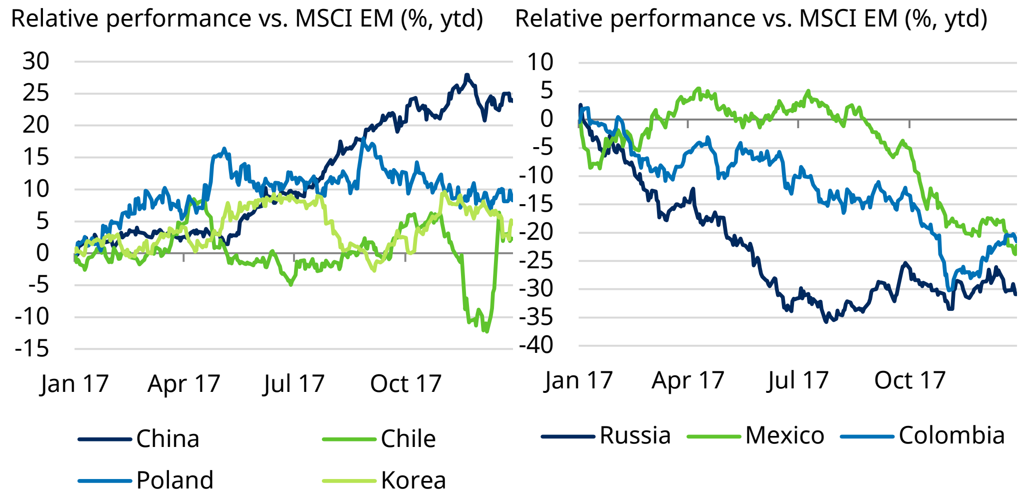
The worst performing market was the UK FTSE All Share index, though with 22.6% returns for US dollar investors, it is not bad by historical standards.

While it was clearly a great year for emerging markets overall, there is some considerable divergence within the EM universe. Chart 7, below, displays some of the best and worst performers, relative to the overall index. At one end of the scale, MSCI China had an incredible year, outperforming MSCI by over 20%, while at the other, Russia has been one of the most disappointing with a 30% underperformance.

It is hard to look past politics as an explanation for the divergence in performance, given a strong global growth backdrop. While Russian equities underperformed in the first half of 2017 as oil prices failed to stabilise, fading hopes that US sanctions would be lifted after Trump's election probably also contributed to the underperformance. While climbing oil prices have been a stabilising factor, the US investigation into Russian interference in the 2016 election seems to have weighed on sentiment for the market.

For Mexico, NAFTA talks have been a significant headwind for asset prices. The negotiations ran into trouble in September over the US desire to boost rules of origin requirements, which would be particularly harmful for Mexican manufacturers.

Chart 7: EM equity market relative performance (total returns in USD)



Source: Thomson Datastream, Schroders Economics Group. 2 January 2018. Individual indices are the MSCI country benchmarks.

Chile's stock market went on a wild ride in November and December due to presidential elections. In the first round in November, the market and business friendly right wing candidate Sebastian Pinera failed to gain a commanding lead, causing a plunge in Chilean markets. In the second round in November, he came out victorious and his victory led Chilean markets to record highs.

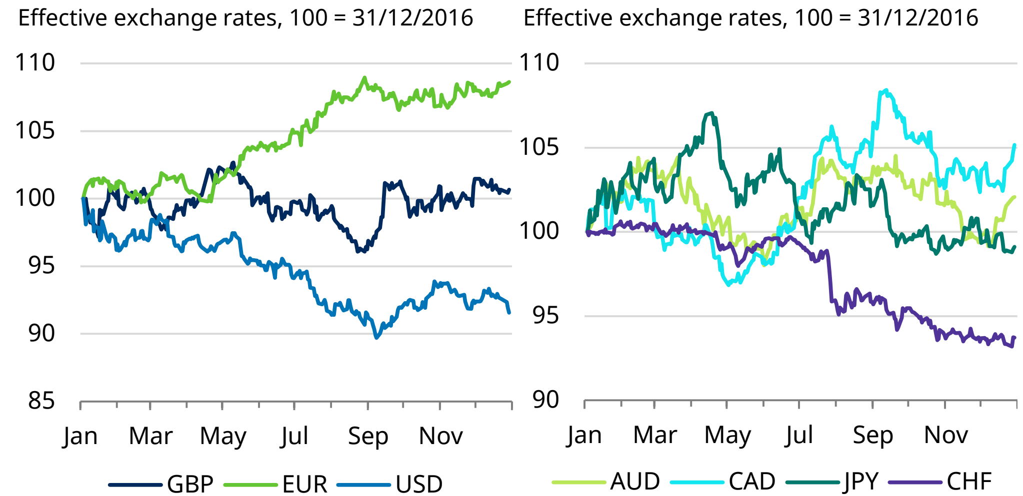
Finally, the outperformance of the Chinese market is remarkable given the tighter credit conditions and gradually slower growth seen in the second half of 2017. Strong global trade will have been supportive, as it was much better than anticipated throughout the year.

Comparing currency market performance

Dollar weakness and euro strength were key DM themes

It took a while for currency trends to become established in 2017, but from around May, it was clear that the US dollar was on a weaker path when measured using effective exchange rates (-8.4% for the year), while the euro was going in the opposite direction (+8.6%). Meanwhile, sterling gyrated throughout the year, largely being moved by the latest news on Brexit. It ended the year slightly up (+0.7%), thanks to progress to phase II of the Brexit negotiations, and hints at a softer Brexit stance from the UK government. Compared to the sharp depreciation in 2016, a period of stability is welcomed by domestic investors.

Charts 8 and 9: Currency performance in developed markets



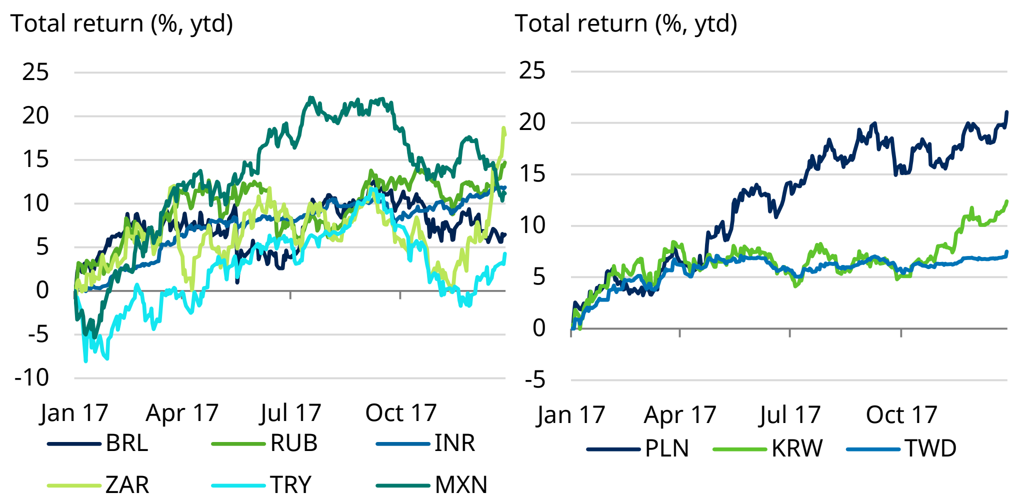
Source: Thomson Datastream, Schroders Economics Group. 2 January 2018.

Elsewhere, Japan saw the yen appreciate through the first half of the year, but ended largely flat by the end (-0.9%). The other safe haven currency, the Swiss franc, was steady until the summer, before it depreciated and ended the year lower (-6.3%). Meanwhile, the resource based currencies, the Canadian and Australian dollars, both tracked each other higher in the second and third quarters, helped on by an improvement in commodity prices. However, there was a pull back at the end of the year.

A weak dollar environment is typically helpful for EM assets, including currencies, and for much of the year this is what we saw. EM currencies delivered positive total returns, in some case very high returns, through the first three quarters of 2017. A carry strategy would have yielded a particularly strong return, with high yielders like the Russian rouble, Mexican peso, and Indian rupee performing well in total return terms.

Dollar weakness helped EM but could not save them from themselves

Chart 10: EM currency returns



Source: Bloomberg, Schroders Economics Group. 2 January 2018.

However, even in this supportive environment, some EM currencies struggled to perform. The Turkish lira, for example, had a rocky start to the year, while the Taiwanese dollar and Korean won offered very modest returns for much of 2017. The final quarter of the year saw something of a change in fortunes, with gains eroded for many of the high carry currencies, due to a deterioration in domestic

politics and a slight strengthening of the dollar as US policy expectations built. As a result, the lira and the rand gave up nearly all of their gains for the year. While the rand has since massively outperformed on the victory of Cyril Ramaphosa in the ANC leadership elections, the end result has been limited reward to year long holders of high carry currencies relative to the safer, low carry currencies like the won and the zloty.

Comparing debt market performance

Debt markets bore the brunt of political risk

Many argue that political risk did not have much impact on markets in 2017. Government bond investors would disagree. European political risk at the start of the year caused yields to rise and prices to fall in France and Italy ahead of the French presidential election. The risk of a Le Pen victory posed a threat to the survival of the monetary union, and therefore the Italian government's solvency given the help it is receiving from ECB QE. As the French electoral risk subsided, those two markets rebounded strongly, and ended the year as the two best performing. Italian BTP bonds returned 2.4% while French OATS returned 1.9% (all calculated in local currency terms). According to ECB capital flows data, the UK enjoyed significant flows from Europe, as investors sought to beat the low yields on offer in core markets. This helped keep a cap on gilt yields, and provided a return of 2.7%.

The worst performing government bond of the major markets was those in Japan. With almost no yield on offer and a tightly managed yield curve, investors eked out just 0.5% of gains.

Chart 11: Government debt returns

Total returns, 100=31/12/2016

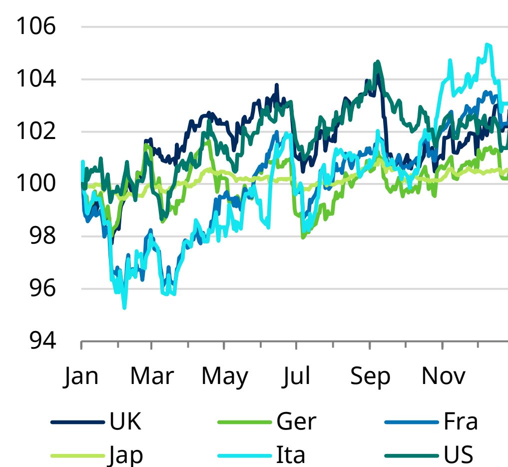
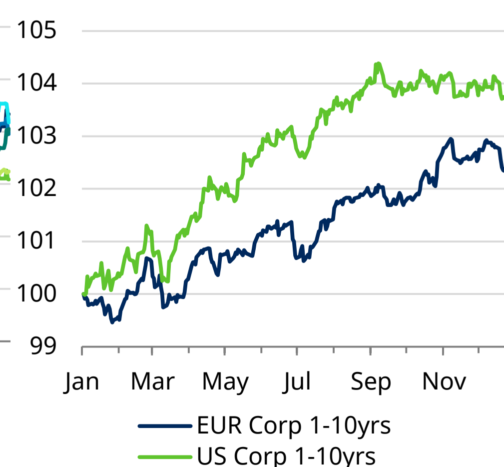


Chart 12: Corporate credit returns

Total returns, 100=31/12/2016



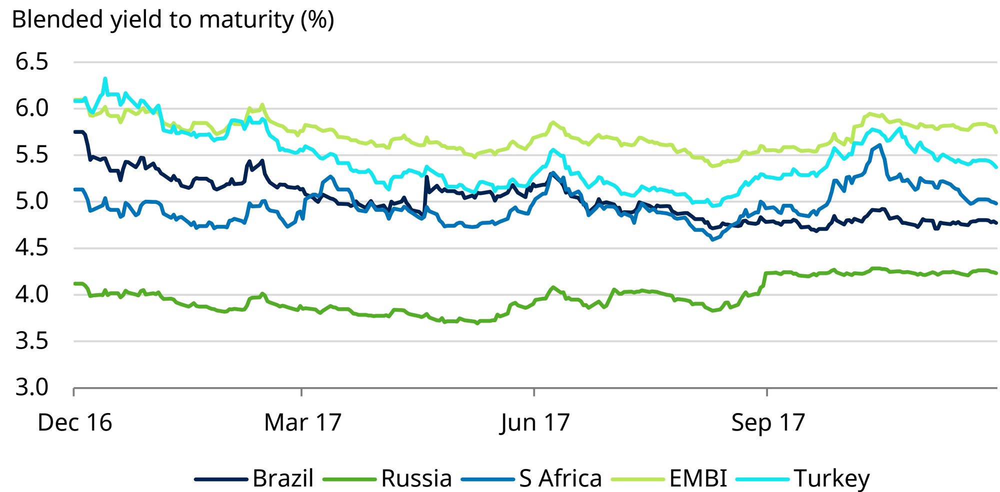
Source: Schroders Economics Group. 2 January 2018.

When comparing European and US corporate credit markets, we found that the US market outperformed in 2017, largely making up for the underperformance in 2016. However, if the currency effect is taken into account, then European credit would have significantly outperformed.

A good year for EM debt, one or two markets aside...

It was a quiet year for emerging market hard currency debt. Yields drifted lower over 2017 for the broad EMBI index, with a reversal in the final quarter. However, this was a function of particular markets rather than a broad based sell off. Both Turkey and South Africa saw a significant rise in yields as concerns grew over political risk in both countries. In South Africa particularly, a final downgrade of the country's debt seemed highly likely. Interestingly, despite Brazil's inability to reform its pension system and so address its fiscal problems, yields remained contained even as the EMBI yield climbed.

Chart 13: EM debt yields climbed at year end on political risk



Source: Thomson Datastream, Schroders Economics Group. 2 January 2018.

Lessons from 2017

Having reviewed events and performance of markets over the past year, we have found a few lessons worth considering for 2018:

– **The recovery phase of the cycle can be very powerful.** Though not the best phase of the cycle for returns, confirmation that the world is moving in a reflationary direction helps reduce the risk of secular stagnation.

– **Political risk still matters.** Events in Europe could have spoiled the party in 2017, and while markets ended the year with strong performances from risk assets, most investors were cautiously invested throughout.

– **Political risk can also be positive for markets.** Change in countries or governments that are failing are always welcomed. South Africa, where this process is still tentative at best, is a good example.

– **You cannot run a country via Twitter.** Investors would do well to focus on fundamentals rather than noise.

Themes for 2018

"I see no reason why we don't go to 4, 5, even 6 percent"

President Trump when asked for his forecast for US GDP growth in 2018.
(6th December 2017)

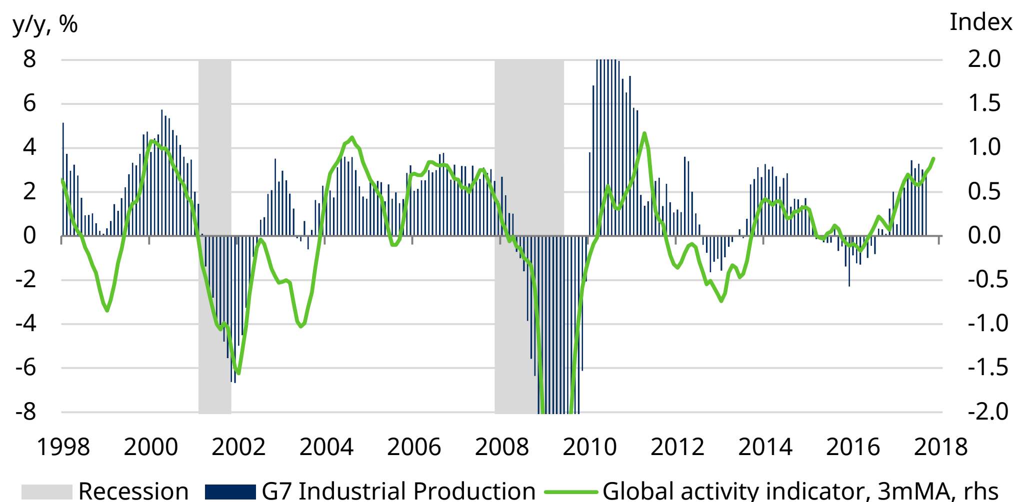
Global growth indicators continue to strengthen

Here are the three macro themes which we believe will influence markets in 2018.

Theme 1. Goldilocks gives way to reflation

As 2018 begins, the activity picture remains strong. Business is confident and leading indicators signal robust growth ahead (chart 14).

Chart 14: Global activity indicator remains robust



Source: Thomson Datastream, Schroders Economics Group, 20 December 2017.

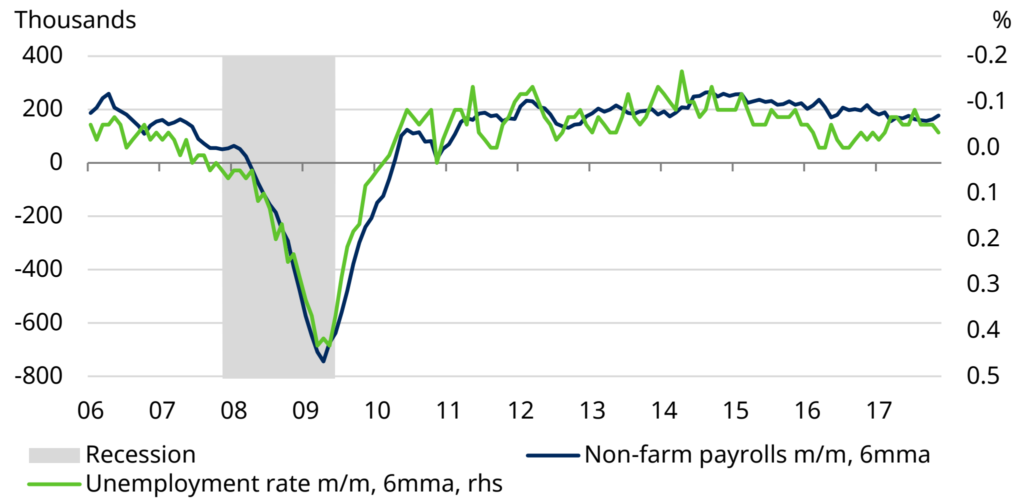
US consumer and economy ending 2017 on a high

We upgraded our global growth forecasts in November, but activity since then has proved to be even stronger than expected. Retail sales in the US have been very firm following a buoyant Black Friday and Cyber Monday, no doubt helped by sales of the new iPhone X. The Atlanta Federal Reserve estimate that US GDP is on track for 2.8% growth in the final quarter of 2017.

Business confidence in Germany is close to all time highs according to the Ifo institute survey and Japanese surveys (both Tankan and Shoko Chukin) are strong. The picture is less robust in the emerging markets where China's growth is moderate rather than booming, but overall the synchronised global recovery lives on. One of the key elements of the upswing is the revival in capital investment which is expected to continue judging from orders data in the US, Germany and Japan. The recently passed Tax Cuts and Jobs Act in the US will also boost capital spending through the increased depreciation allowance.

Alongside stronger capex we are likely to see firms continuing to add jobs. Since 2015, the US economy has enjoyed a period where the unemployment rate has not dropped as rapidly as might be expected from the growth in non-farm payrolls. Instead participation rates increased as people came back into the labour force. This supply side response has helped keep wages in check. More recently the unemployment rate has been falling more in line with payrolls and we do expect some modest upward pressure on wages as the labour market tightens in 2018 (see chart 15).

Chart 15: US payrolls and unemployment



Source: Thomson Datastream, Schroders Economics Group, 20 December 2017.

Cyclical forces to push up core inflation in the US

More generally we see consumer price inflation rising in 2018. Pipeline pressures are rising and we expect firms to respond to the recovery in growth by raising prices more aggressively in 2018. We have highlighted the long lag between GDP growth and inflation many times over the past year as one of the best explanations for the weakness of core inflation in 2017. Going forward it is a key element in our reflation forecast (chart 16).

Chart 16: Recovery points to higher inflation in 2018

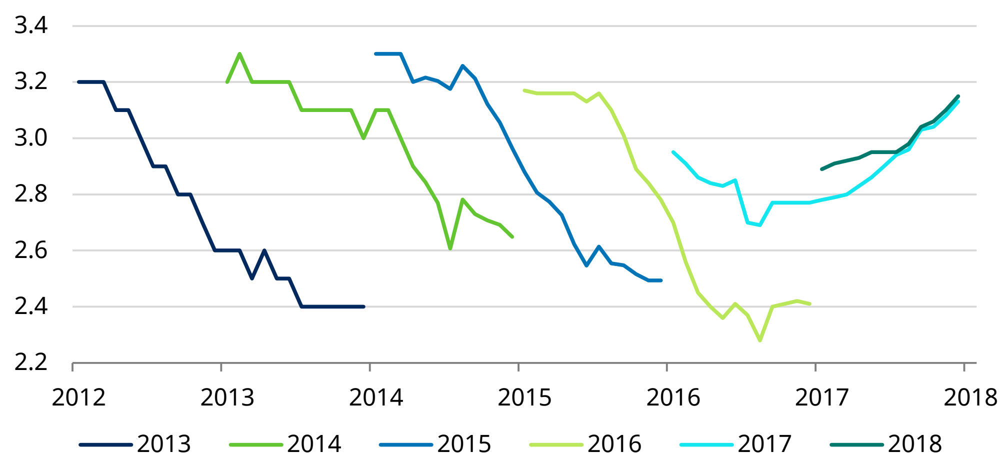
Source: Thomson Reuters Datastream, Schroders Economics Group, 20 December 2017.

Higher bar: growth expectations have been raised for 2018

So the growth picture is good and perhaps President Trump's forecasts for the US will be right. However, markets will face two challenges.

First, growth expectations are higher than a year ago. At that time the consensus for global GDP growth in the year ahead was 2.8%. Today the equivalent figure is 3.2% (see chart 17). Clearly the hurdle for markets to be positively surprised is higher.

Chart 17: Global growth expectations for 2018 have risen



Source: Thomson Reuters Datastream, Schroders Economics Group, 21 December 2017.

Inflation may challenge market multiples

Second, unlike in 2017, stronger growth is more likely to be accompanied by higher inflation and higher interest rates. As growth and inflation rise, the environment will become more reflationary and central banks will be keen to withdraw stimulus.

Interest rate increases are not necessarily bad for risk assets if they are accompanied by stronger growth, as in 2017. Further rate rises in the US will continue the process of normalising real rates and markets may well take them in their stride.

However, to the extent that rate rises are accompanied by greater concerns over inflation, investors will start to discount the end of the expansion. Consequently, a more inflationary environment will probably mean some compression on market multiples. Equity returns will be more dependent on a recovery in corporate earnings as a result. Such an environment would prompt a rotation toward more cyclical sectors and regions and a search for pockets of value.

Theme 2. The long farewell: the end of QE

Higher inflation expectations will also affect bond yields, a move which could well be exacerbated by the end of the great quantitative easing (QE) experiment.

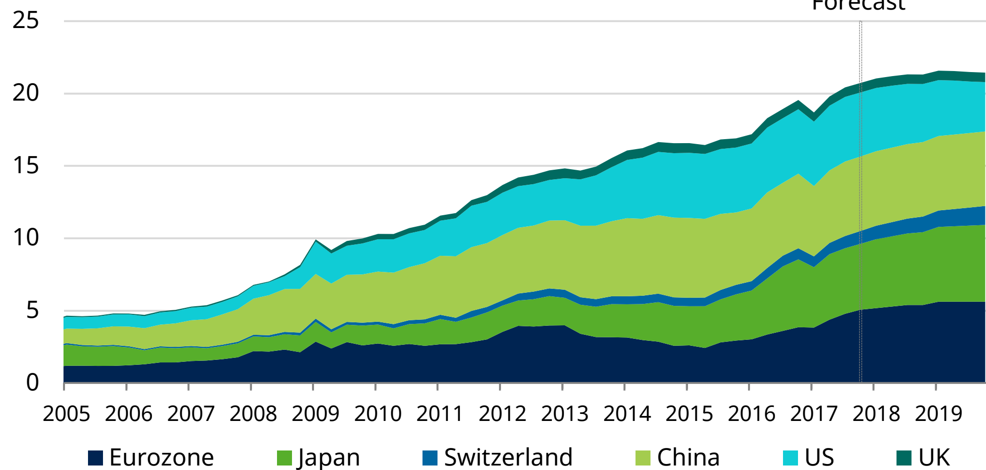
Policy rates in the eurozone are not expected to change in 2018, but here the focus will be on the European Central Bank's (ECB) asset purchase programme which is set to halve from €60bn to €30bn per month from January. We expect it will end altogether in September.

Relative to the asset markets affected, the ECB's programme has been more significant than that of the US Federal Reserve (Fed) as can be seen by the prevalence of negative five-year bond yields in core countries such as Germany and the Netherlands.

Meanwhile, the Fed has already started to reduce its balance sheet by allowing $10 billion of assets to expire per month in the fourth quarter. This will gradually step up until reaching $50 billion per month in the fourth quarter of next year.

These moves by the Fed and ECB mean that on our forecast the Bank of Japan (BoJ) will be the only central bank actively engaged in QE by the end of 2018. Intervention by the People's Bank of China and Swiss National Bank in foreign exchange markets may continue, but the net result is that the overall level of liquidity is set to slow in 2018 and should begin to contract in 2019.

Chart 18: Global liquidity set to peak



Source: Thomson Reuters Datastream, Schroders Economics Group, 20 December 2017.

Global liquidity is set to peak in 2018 and then contract in 2019

Investors appear to be split on the implications of this move. Some see little impact while others are more worried. The market is inclined toward the former whereas we are in the latter camp. Our view is that it will become a significant theme with implications for bond yields as a major non-price sensitive purchaser withdraws from the market. Whilst some see the BoJ as riding to the rescue with continued liquidity provision we would note that capital flows from Japan have eased off to the US since the hedging costs rose as the Fed raised short rates. Although we have added up QE around the world to create a dollar measure of "global liquidity", strictly speaking QE is not fungible. This would only be true if there was one homogeneous pool of global capital but in practice QE in one country can only spillover to others if investors are prepared to take the exchange rate risk.

We would not expect bond yields to return to pre-QE levels given the changes in the world economy since the policy began. The slowdown in productivity and greater regulation of the banking system mean equilibrium real rates will be lower. Furthermore, central banks will also still have some control over the yield curve via short term policy rates and forward guidance. Private investors will have to weigh these factors to determine fair value in a post QE environment.

Overall, the likely outcome of saying farewell to QE is likely to be some modest upward pressure on bond yields. In our view, the biggest losers will be those who benefitted the most, so we would watch areas such as the indebted periphery of the euroarea for signs of stress.

Theme 3. The return of political risk

We started 2017 worrying about populism and politics. Markets performed strongly and some now argue that politics does not matter and that the risks are blown out of proportion by a news hungry media. However, in our view a key to market performance in 2017 was that those risks failed to materialise.

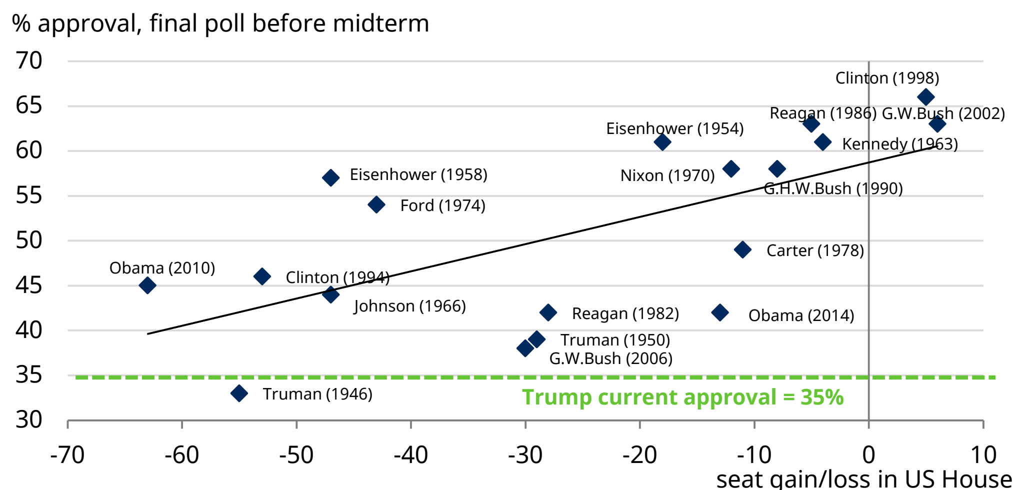
President Trump did not start a trade war with China on his first day in office and voters in Europe did not follow the path of the UK and reject the European Union. Instead, the new US president discovered the checks and balances of Congress and, indeed, from within his own party. Brexit rumbled on in the UK, but the Dutch and French elections delivered pro-EU centrist leaders. Those looking to break-up the EU failed to gain a mandate.

There is no guarantee that such benign outcomes will be repeated. The collapse of the centre vote in politics was illustrated once more with the election result in

Germany which saw Angela Merkel's CDU party perform poorly and struggle to put together a coalition government. Markets will focus on the Italian general election in March where the EU-sceptic Five Star Movement is leading in the opinion polls although are not expected to gain enough votes to govern without a coalition.

In this respect the bigger political challenge though will come in the US where the mid-term elections will be held in November. There is a relationship between the popularity of the president and the performance of his party in these elections which will see 33 Senate and all 435 House seats contested. The Democrats need to win 24 seats to take control of the House which is plausible. The president's party nearly always loses seats in the mid-terms and on President Trump's current ratings the Republicans could take a beating in November (see chart 19). There is time for Trump's approval to rise, but if the Republicans lose control of the House we would be back to gridlock in Washington.

Chart 19: The president's popularity and party performance in the mid-terms



Source: Gallup, Schroder Economics Group, 20 December 2017.

Given investors' enthusiasm for Trump's reforms this would not bode well for markets. We would see this as one to watch: the passage of the tax bill should lift the president's approval rating and the subsequent performance of the Republicans as we move through 2018. Nonetheless, investors will need to be closely tuned to opinion polls and signs of whether a "Democrat wave" is building.

In the emerging world politics has been an important driver in 2017 with reform of the North American Free Trade Agreement (NAFTA), corruption in South Africa and reform in Brazil all gaining the focus of investors. Next year will see important elections in several states particularly Mexico and Brazil.

And finally: the most frequently asked question of 2017

Bitcoin is looking like a bubble

Each of our themes injects a note of caution into the outlook for 2018, which is perhaps inevitable after the good performance of the world economy and markets in 2017. However, judging from our travels many investors are focussed elsewhere at present. The first question asked at each of our presentations recently has been, what do you think of bitcoin? Or, more directly, should I buy bitcoin?

After expressing regret at not having bought the digital currency some time ago, our answer largely depends on why you want to buy it. One motivation is as a currency. Bitcoin grew out of the financial crisis and a loss of confidence in the banking system. QE by the central banks further undermined confidence in conventional paper currencies as people began to fear a surge in inflation.

In this respect bitcoin is less of a crypto currency and more of a crypto commodity like gold: a safe haven in times of trouble. However, whilst there have been periods when the two have moved together (such as in 2014 and 2015) over the last couple of years the correlation has weakened. More recently it has become negative, with gold falling as bitcoin surged higher (see chart 20).

Chart 20. Bitcoin versus the gold price

Source: Thomson Datastream, Schroders Economics Group, 21 December 2017.

Arguably, bitcoin's chequered history means it has yet to gain the degree of trust given to gold. This does not mean it will never become a currency. The blockchain technology which underpins the system works and regulation has started to be introduced to protect holders of bitcoin. The more likely explanation for the divergence, of course, is that the correlation has broken down as people are buying bitcoin as a speculative investment.

Bitcoin price is being driven by FOMO and greater fool theory

In this respect bitcoin exhibits the pattern of a classic bubble with the price turning exponential. As with tulip bulbs in the 17th century, railway shares in the 19th and tech stocks in the 20th, bitcoin is a 21st century bubble sucking in more investors as it expands. Fear of missing out, or FOMO, is an important driver. With no long term anchor of value, the price is simply what people are prepared to pay for it with many buying on the hope that they can sell to a greater fool.

In many ways the bitcoin phenomenon is another manifestation of the excess liquidity in financial markets created by ultra low interest rates. For mainstream investors the question is whether a bursting of the bubble could create a systemic crisis in the world economy. At the end of December the market cap of cryptocurrencies was just over $600 billion (source coinmarketcap.com here), twice as high as at the end of November. Clearly a bursting of the bubble would inflict losses on recent investors, but given the speed of the price rises most would simply be reducing their capital gains. The greater risk would come once futures are established and investors can leverage. However, bank risk systems should be sufficiently robust to cope, shouldn't they?

Schroder Economics Group: Views at a glance

Macro summary – January 2018

Key points

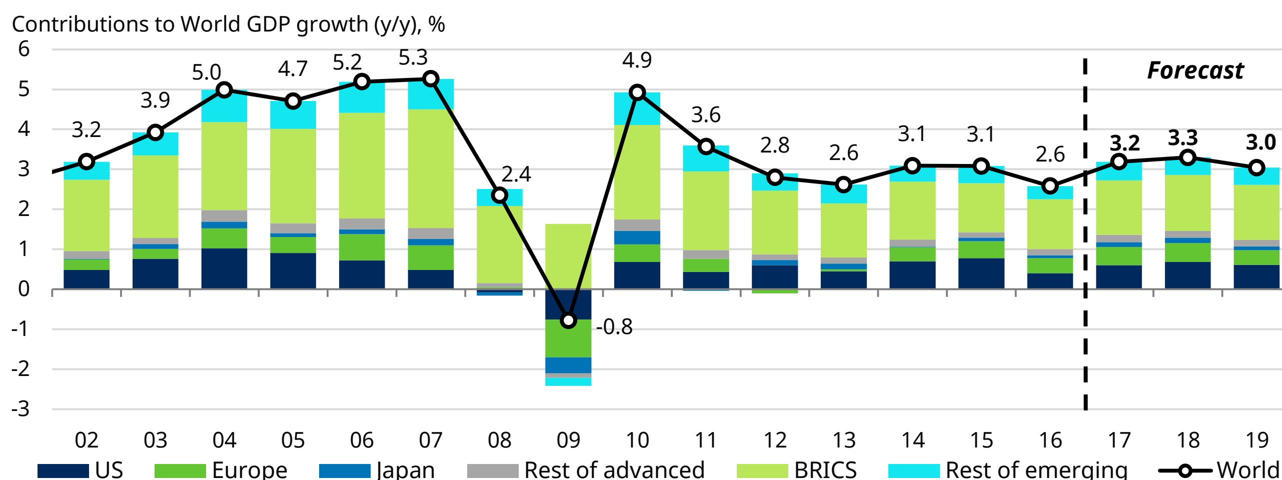
Baseline

- Global growth is expected to reach 3.2% in 2017 after 2.6% in 2016. For 2018 we expect 3.3%, before activity moderates to 3% in 2019. Inflation is forecast to remain at 2.3% in 2017 and 2018, before picking up to 2.5% in 2019. Core inflation in the US is expected to rise back above 2% in 2018 and the goldilocks environment is replaced by a more reflationary world economy.
- US growth is forecast at 2.2% in 2017 and 2.5% in 2018, incorporating notable upward revisions to reflect higher fiscal stimulus. The Fed has now started balance sheet reduction (quantitative tightening) and with core inflation rising, we expect three more rate hikes in 2018, and a final increase in 2019, ending the forecast at 2.5%.
- UK growth to remain broadly unchanged in 2018 after an estimated 1.5% in 2017. Inflation rose sharply in 2017, and is forecast to moderate to 2.2% in 2018. 2019 is very uncertain given Brexit, but we assume a transition period to be agreed with partial access to the single market. This means some disruption to trade, and higher inflation due to tariffs being introduced. The BoE is expected to hike two more times in 2019 (to 1%).
- Eurozone growth to pick-up in 2017 to 2.3% following robust surveys and an easing in political risk. Growth is likely to remain strong in 2018 and 2019, with enough spare capacity remaining to keep inflation subdued. The ECB should keep interest rates on hold, but will taper QE in 2018, making way for rate rises in 2019.
- Japanese growth forecast at 1.7% in 2017 and inflation at 0.4% supported by looser fiscal policy and a weaker yen. For 2018, we forecast growth of 1.8% and inflation at 0.9%. No further rate cuts from the BoJ, but with inflation below target more QQE is expected as the central bank targets zero yield for the 10 year government bond.
- Emerging economies upgraded to 4.9% for 2017 and next on lower inflation and interest rate cuts. Concerns over China's growth to persist, and the government is expected to lower its growth target next year.

Risks

- Risks are more balanced with fears of "secular stagnation" and "bond yields surge" providing deflationary scenarios, while "inflation accelerates" and "rise in global protectionism" would be stagflationary. Reflation risks have risen with the "US fiscal reflation" scenario and the introduction of the "global trade boom" scenario. Finally, there is a productivity revival scenario where growth is stronger, but inflation lower than in the baseline.

Chart: World GDP forecast



Source: Schroders Economics Group, 2 January 2018. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2016	2017		Prev.	Consensus	2018		Prev.	Consensus	2019
World	100	2.6	3.2	↑	(3.0)	3.2	3.3	↑	(3.0)	3.2	3.0
Advanced*	62.8	1.6	2.2	↑	(2.0)	2.2	2.3	↑	(1.9)	2.2	2.0
US	27.1	1.5	2.2	↑	(2.0)	2.3	2.5	↑	(2.0)	2.5	2.2
Eurozone	17.4	1.8	2.3	↑	(2.1)	2.3	2.3	↑	(1.9)	2.1	1.9
Germany	5.1	1.9	2.6	↑	(2.1)	2.3	2.6	↑	(2.0)	2.2	2.0
UK	3.8	1.8	1.5	↓	(1.6)	1.6	1.6		(1.6)	1.5	1.4
Japan	7.2	1.0	1.7	↑	(1.6)	1.5	1.8	↑	(1.5)	1.3	1.3
Total Emerging**	37.2	4.2	5.0	↑	(4.8)	5.0	5.0	↑	(4.8)	5.0	4.9
BRICs	24.2	5.2	5.6		(5.6)	5.8	5.8	↑	(5.6)	5.8	5.7
China	16.4	6.7	6.8	↑	(6.7)	6.8	6.4	↑	(6.3)	6.4	6.3

Inflation CPI

y/y%	Wt (%)	2016	2017		Prev.	Consensus	2018		Prev.	Consensus	2019
World	100	2.0	2.3		(2.3)	2.2	2.4	↑	(2.2)	2.4	2.5
Advanced*	62.8	0.7	1.7	↑	(1.6)	1.7	1.7	↑	(1.6)	1.7	1.9
US	27.1	1.3	2.1	↑	(1.9)	2.1	2.1	↑	(1.9)	2.1	2.4
Eurozone	17.4	0.2	1.5		(1.5)	1.5	1.4	↑	(1.1)	1.4	1.4
Germany	5.1	0.4	1.7		(1.7)	1.7	1.7	↑	(1.5)	1.7	1.8
UK	3.8	0.7	2.7	↑	(2.6)	2.7	2.2	↓	(2.3)	2.6	2.2
Japan	7.2	-0.1	0.4	↓	(0.5)	0.4	0.9	↓	(1.0)	0.8	1.6
Total Emerging**	37.2	4.1	3.3		(3.3)	3.2	3.4		(3.4)	3.4	3.4
BRICs	24.2	3.5	2.2	↓	(2.4)	2.1	3.0		(3.0)	2.9	2.9
China	16.4	2.0	1.7	↓	(1.8)	1.6	2.3		(2.3)	2.2	2.2

Interest rates

% (Month of Dec)	Current	2016	2017		Prev.	Market	2018		Prev.	Market	2019	Market
US	1.25	0.75	1.50		(1.50)	1.63	2.25	↑	(2.00)	2.11	2.50	2.28
UK	0.50	0.25	0.50		(0.50)	0.52	0.50		(0.50)	0.78	1.00	0.97
Eurozone (Refi)	0.00	0.00	0.00		(0.00)	-0.33	0.00		(0.00)	-0.27	0.50	0.01
Eurozone (Depo)	-0.10	-0.40	-0.40		(-0.40)		-0.40		(-0.40)		0.00	
Japan	4.35	-0.10	-0.10		(-0.10)	0.06	-0.10		(-0.10)	0.08	-0.10	0.10
China	4.35	4.35	4.35		(4.35)	-	4.35		(4.35)	-	3.50	-

Other monetary policy

(Over year or by Dec)	Current	2016	2017		Prev.		2018		Prev.		2019
US QE ($Bn)	4456	4451	4426	↓	(4433)		4006	↓	(4013)		3406
EZ QE (€Bn)	2003	1481	2183	↓	(2216)		2453	↓	(2546)		2453
UK QE (£Bn)	435	423	444		(444)		445		(445)		445
JP QE (¥Tn)	513.4	476	523	↓	(545)		563	↓	(645)		583
China RRR (%)	17.00	17.00	17.00		17.00		16.00		16.00		15.00

Key variables

FX (Month of Dec)	Current	2016	2017		Prev.	Y/Y(%)	2018		Prev.	Y/Y(%)	2019	Y/Y(%)
USD/GBP	1.35	1.24	1.30	↓	(1.32)	5.2	1.28		(1.28)	-1.5	1.25	-2.3
USD/EUR	1.20	1.05	1.15	↓	(1.19)	9.0	1.20	↑	(1.15)	4.3	1.25	4.2
JPY/USD	112.7	116.6	115	↑	(110)	-1.4	112		(112)	-2.6	110	-1.8
GBP/EUR	0.89	0.85	0.88	↓	(0.90)	3.6	0.94	↑	(0.90)	6.0	1.00	6.7
RMB/USD	6.51	6.95	6.60	↓	(6.90)	-5.0	6.50	↓	(7.05)	-1.5	6.40	-1.5
Commodities (over year)												
Brent Crude	66.6	46	55.0	↑	(52)	19.9	61.2	↑	(52)	11.2	58.7	-4.0

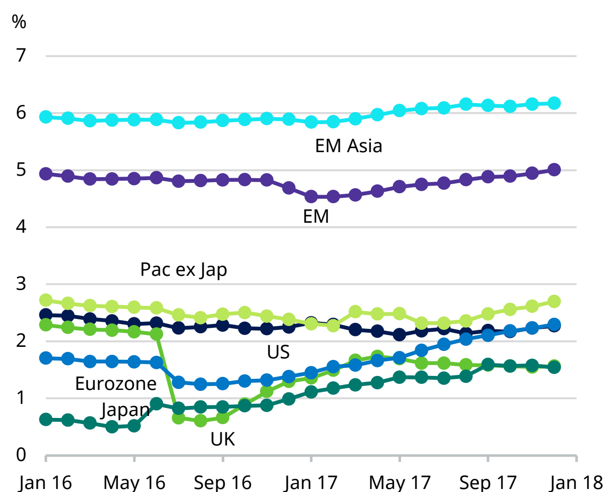
Source: Schroders, Thomson Datastream, Consensus Economics, December 2017
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 29/12/2017
Previous forecast refers to August 2017, except for the Fed and BoE rates forecasts which were updated mid-quarter.
* Advanced markets: Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia,

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

2017



2018

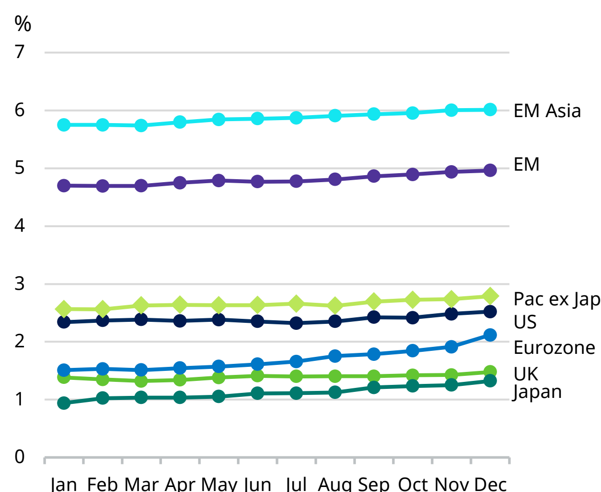
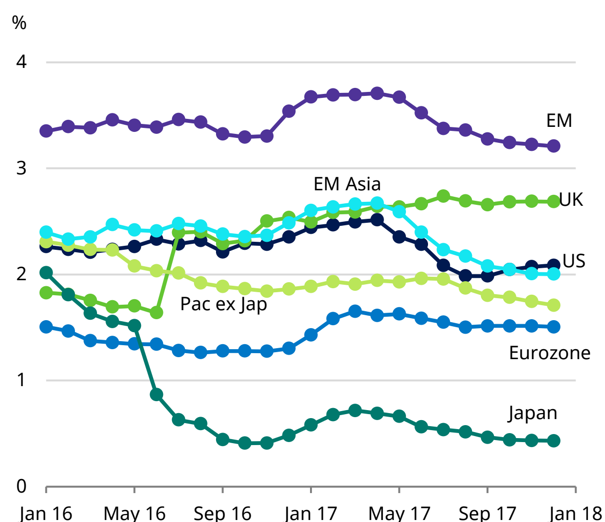
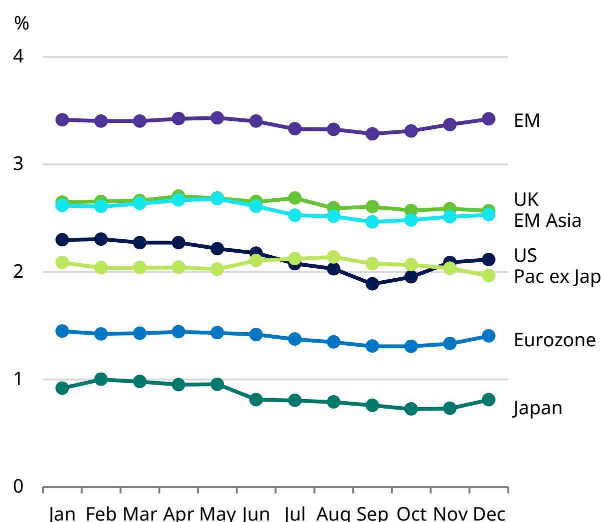


Chart B: Inflation consensus forecasts

2017



2018



Source: Consensus Economics (December 2017), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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