2018 OUTLOOK
Provided by The Capital Group

2018 Outlook: Time for Balance and Flexibility

When it comes to the global economy, the threat of storm clouds always seems to be hovering overhead. But heading into 2018, investors can see blue skies just about anywhere they look. From reduced political tensions in Europe to reform initiatives in India, to a more stable China, underlying conditions are decidedly upbeat. Indeed, the synchronized global economic recovery is gathering a head of steam.

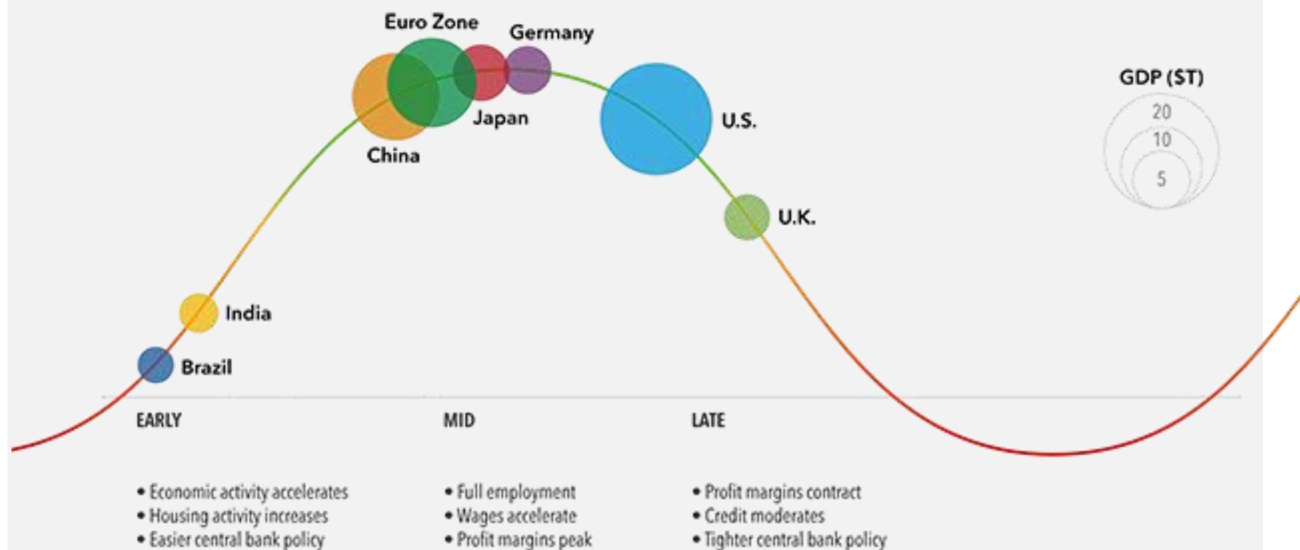
Much of the good news, however, is reflected in asset prices, as stock and bond markets around the world have delivered positive results for much of the past year. In an environment characterized by healthy underlying growth but relatively high valuations, it is time for balance and flexibility in portfolios. Here are key takeaways and investment implications to consider as you position portfolios for 2018:

Key Takeaways

- The global economic expansion is gaining momentum, but with valuations rising across most asset classes, selectivity is essential.
- The U.S. economy is strong, but markets are expensive. Maintain a core allocation to U.S. equity, but consider rebalancing toward international and emerging market equities.
- There is still room to run in international and emerging markets. Seek meaningful exposure to Europe's improving health and rising consumer purchasing power in emerging markets.
- It's time to de-risk core bond portfolios. Ensure your bond portfolio is broadly diversified and does not have excessive high-yield exposure.

Global Economies Continue to Gain Ground

Among the First to Experience Recovery, U.S. Edges Toward Late-Cycle Territory



Sources: Capital Group, FactSet. GDP data are as of 6/30/17. Country position within the business cycle are estimates by Capital Group economists.

After eight years of steady but modest growth in the U.S., many investors may be concerned that the American economy is nearing the end of the cycle. But don’t cue the closing credits yet. Corporate profit growth remains healthy and inflation has been relatively tame. That said, with wages rising look for wage inflation to pick up modestly later in the year.

For much of the rest of the world, it is still early in the cycle. Europe appears to have entered a prolonged period of strength, and the euro-zone economy is expected to grow nearly 2% in 2018, according to the International Monetary Fund (IMF).

Overall, the IMF expects global gross domestic product (GDP) to increase 3.7% in 2018, from 3.6% in 2017, with each of the world’s major economies firmly in the growth column.

Market Levels Suggest Better Opportunities Abroad

Valuations Point to Relatively Attractive Opportunities Outside the U.S.

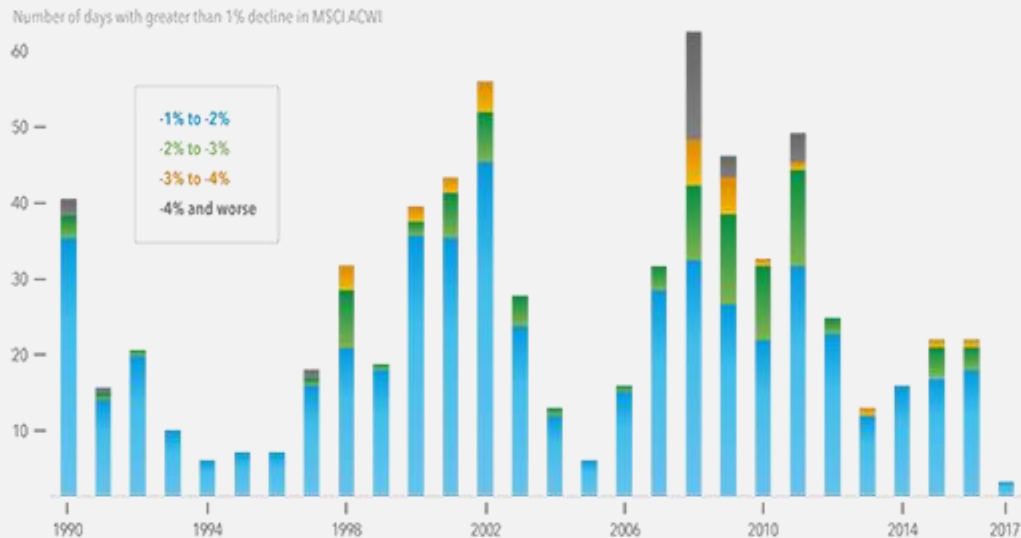
Sources: Capital Group, FactSet, MSCI, RIMES, Thomson Reuters. As of 9/30/17. Market capitalization is each country or region's weight within MSCI All Country World Index (ACWI). GDP is each country or region's percentage of total world nominal GDP. Price-to-earnings ratios are as of 9/30/17.

Most of the world's major equity market indexes achieved or neared multiyear highs in 2017, as investors set aside concerns about politics and focused on the broadening expansion. European stocks went on a tear in 2017, rising 23% and outpacing U.S. shares for the first time since 2012. Emerging markets equities also outpaced the U.S., soaring 32%.

In fact, market levels suggest that these better investment opportunities may continue in non-U.S. markets. Consider that the U.S. accounts for 52% of global market capitalization, near a historic high, and its market cap is 106% of its GDP. Granted, a number of factors justify a relatively higher share of market cap for U.S. companies, as it is the home market for many of the world's dominant companies, and roughly 40% of Standard & Poor's 500 Composite Index company earnings come from overseas.

Also consider that the forward P/E ratio for the U.S. market, at 17.9, is notably higher than other major markets. Conversely, the emerging markets share of global market cap appears relatively modest compared with its contribution to GDP. And, emerging economies are expected to contribute half of global GDP by 2021.

Market Volatility Is Low, but Don’t Get Too Used to It



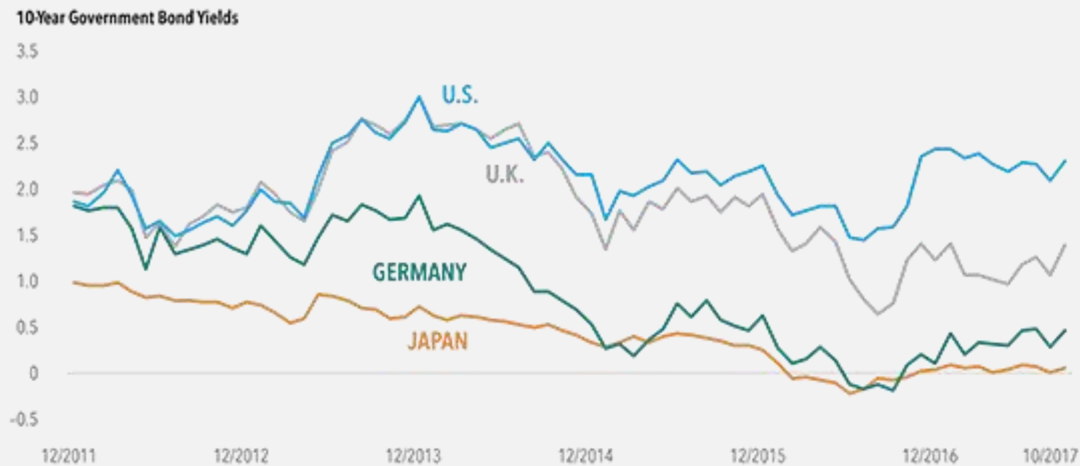
Sources: MSCI, RIMES as of 10/11/17. Data represents price returns in U.S. dollars.

Complacency appears to have spread as global equity market volatility has fallen to historically subdued levels. As of October 11, the MSCI ACWI declined by more than 1% on only two days in 2017, the fewest number on record. It also marked the first time since 2005 that there wasn’t a single daily decline above 1.5%.

While subdued volatility may be welcome, it cannot continue indefinitely. After all, the world is no less dangerous or uncertain than it was, say, 10 years ago. The possibility of trade skirmishes between the U.S. and China, an unexpected spike in inflation or the remote chance of conflict with North Korea could all trigger higher volatility. Taking elevated valuations into consideration, it is important to guard against complacency, but also be sure not to overact to inevitable bouts of market volatility.

Global Rates Should Stay Low Despite Improving Economies

Higher Relative Yields Should Continue to Support Demand for U.S. Bonds



Source: Thomson Reuters as of 10/31/17.

A number of factors have kept yields low, such as modest economic growth in the U.S., persistently low inflation and strong demand from global investors for U.S. bonds. Long-term rates could rise modestly as U.S. economic growth remains robust and the Federal Reserve has started to trim its balance sheet, which means it will no longer be the largest buyer of bonds. Capital Group's fixed income team expects the benchmark U.S. 10-Year Treasury yield to remain in a 2.25% to 3% range despite a higher policy-driven rate.

Despite these relatively low levels, U.S. interest rates remain higher than many other developed markets, partly because the U.S. economy has sustained a significantly higher growth rate. The higher yields in the U.S. relative to other developed markets should continue to support demand for U.S. Treasuries. Meanwhile, against the backdrop of low interest rates in developed economies, demand for higher yielding emerging markets debt has risen substantially. The fixed income team expects this demand to continue. Many emerging markets economies are growing at a steady clip and do not have any significant economic imbalances.

Consider holding broadly diversified fixed income portfolios without tilting too heavily in favor of credit or interest rate exposure. Although at tight valuations, credit and mortgage-backed securities provide a yield spread over Treasuries that can add meaningful additional income over time. On the other hand, Treasuries and municipal

bonds provide valuable diversification from equities and credit. Meanwhile, emerging markets bonds continue to offer value, supported by improving fundamentals.

History Suggests Stock Picking May Rise in Importance in 2018

Sources: Capital Group, Morningstar, Standard & Poor's. As of 9/30/17.

A rising tide has lifted most ships. Investors could find any number of ways to generate solid returns in 2017. The equity bull market spread across the globe last year, as nearly all of the 47 stock markets that comprise the MSCI ACWI posted gains. This broad upward trend further amplified good news for U.S. equity markets, which have experienced eight years of solid gains. As a result, valuations are elevated across regions and asset classes.

As a result, careful stock picking will be essential going forward. This conclusion may not be surprising coming from Capital Group. But clearly, given the level of valuations generally, stock prices going forward may be vulnerable to the likelihood of rising volatility. What's more, following years of lengthy risk-on, risk-off periods of investing, equity market correlations recently have fallen to multiyear lows. Such an environment can be favorable for investment managers with a careful, research-driven approach to stock selection.

What This Means for Portfolios

The synchronized global expansion appears to be entering a period of sustainability, but with volatility at multiyear lows, complacency has spread across markets, and valuations are higher across a range of asset classes. Equities still represent attractive return potential, but at this stage in the cycle, position for resilience during inevitable periods of volatility. Ensure portfolios are well-diversified, with the flexibility to pivot to select areas of opportunity.

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