Cidel

Our Key Themes for 2017

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The focus at the beginning of 2017 has been almost exclusively on politics and the impact of anticipated policies on investment returns. What those policies are and how they will be implemented will indeed have an impact on the prospects of individual companies, sectors and asset classes. Here are the issues that, to our mind, will most influence investment valuations throughout the year.

Risk appetite picking up, volatility expected to increase

The most straightforward reflection of a pick up in risk appetite has been the increase in prices of risky assets (particularly stocks and high yield bonds). Underpinning this however has been a set of market conditions that have been supportive of increasing risk exposures. Economic conditions in developed and emerging economies were experiencing gradual improvement over the course of 2016. The surprising US election results indicated changes would be coming that would positively impact corporate earnings in the short term. Lower tax rates, a lower regulatory burden and the potential repatriation of US profits held offshore are the positives the markets have focused on since early November. Various confidence surveys have shown improvement recently (Figure 1). In aggregate, both traditional equity and equity long/short hedge funds have responded to this change in environment by focusing on opportunities with more upside potential.

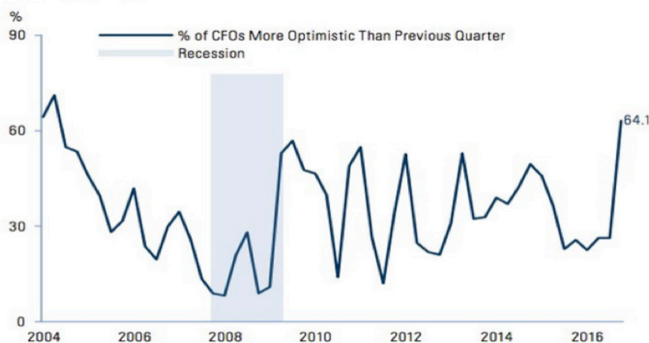

Figure 1

However, the rise of a more protectionist, anti-global agenda (as evidenced by Brexit and the election of Trump) should have been perceived as a negative for equity markets, but to this point has been largely ignored. Typically, a high degree of economic policy uncertainty has correlated with higher equity market volatility, but in 2016 the two data series diverged (Figure 2). We expect volatility to increase significantly during the Trump era and economic uncertainly to remain elevated.

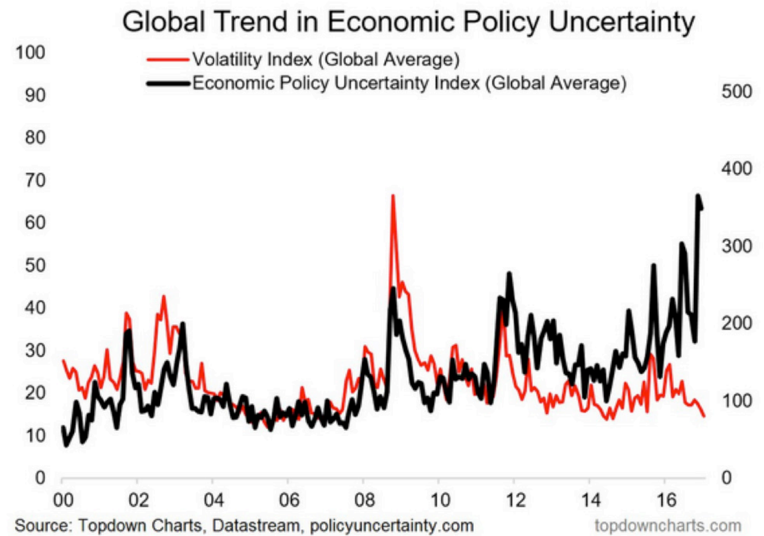

Figure 2

Bottom Line

Investors should benefit from exposure to strategies with better downside protection characteristics as volatility picks up.

Fund flows may start to favour equities

The last two years have seen continuous redemptions from equity mutual funds and exchange-trades funds (ETFs), with a corresponding increase in purchases of fixed income mutual funds and ETFs. Recently the percentage of equity ownership dropped to just over 50% from 65% just a decade ago. The two dramatic drops in the equity markets since 2000 have changed people's perceptions about the risk of equity investing.

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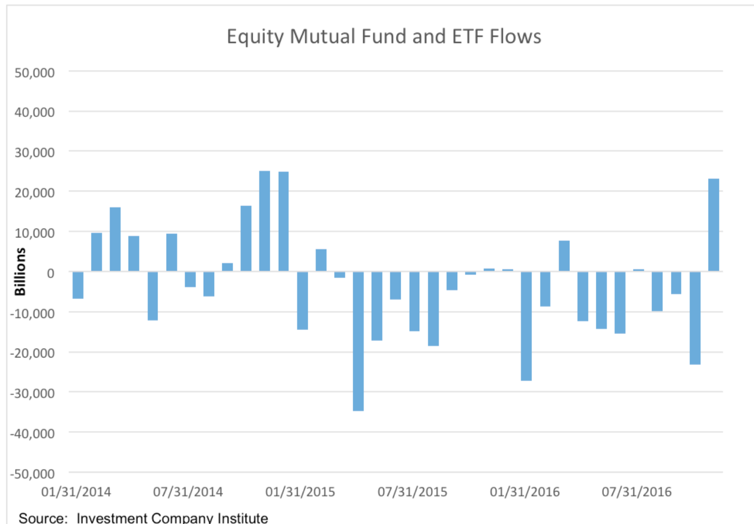

Figure 3

Many no longer see it as an investment vehicle but more of an arena for gamblers. It may be too early to call for a turnaround in these flows but it would not be surprising to see a renewed interest and flow into equity markets based on the expectation of lower taxes and regulation under the new administration and most importantly from investors who feel they have missed the surge in equity prices over the past 7 years.

Bottom Line

Equity market flows may finally be a tailwind for investors.

Wage growth may not drive inflation as much as expected

Recently, the unemployment rate in the United States has fallen below 5% and we have seen an uptick in wage growth. Currently, annual wage growth is running at about 2.4% and many commentators are citing this statistic as the reason that inflation rates will start to increase in the near future. We are somewhat more skeptical about the prospects for a significant increase in inflation unless we see sustained increases in commodities and capacity utilization.

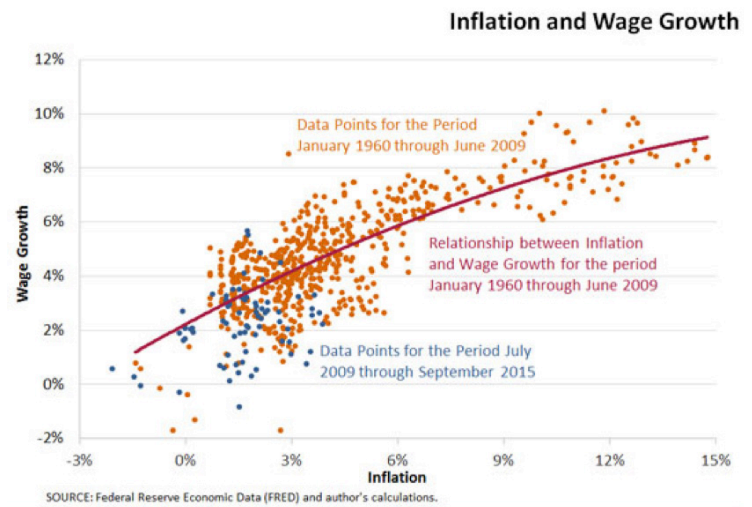

Figure 4

Figure 4 (above) relates wage growth with subsequent inflation rates. From the chart we can see that wage growth at current rates is still consistent with low inflation rates. No doubt we will see salaries increase for individuals with specialized skills but we don't expect the general level of wage increases to soar.

Bottom Line

While CPI may not increase dramatically this year, leading to a more stable bond market than many expect, investors still need be cognisant of the interest rate risk in their fixed income portfolios.

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Technology will continue to displace manufacturing jobs

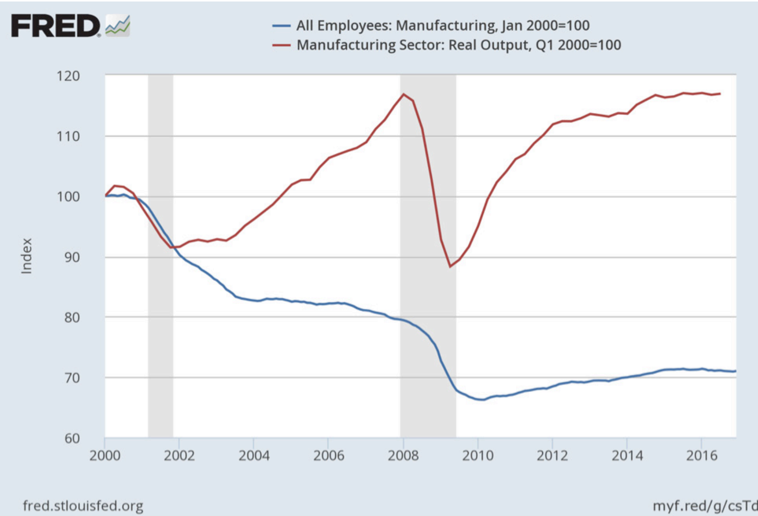

Figure 5

With the election of Donald Trump there has been quite a bit written about trade deficits and the potential, if any, benefits of enacting tariffs or other trade barriers. No matter what kind of policy is enacted it will not stop corporations from aggressively implementing new technology, whether it be robotics, inventory management and other technological improvments to manufacturing and design. Looking at Figure 5 (above) one can see that the domestic output of the manufacturing sector is at record highs yet the number of employees needed to achieve this level of production is lower. This trend will continue and will limit the ability of employees to extract any meaningful wage concessions from their employers.

Bottom Line

Corporate earnings will continue to grow as capital and technology continues to substitute for labour.

A broader opportunity set opening up for Investors

The change in market environment has created a broader opportunity set for investors. Unlike several years ago when the key central banks were all providing ultra-loose monetary policy with short term rates anchored near zero, we are now in an environment of policy divergence (Figure 6). The US began raising rates just over a year ago but is expected to increase the frequency of tightening moves this year and next. Europe is in tapering mode with respect to their bond buying program. And, the Bank of Japan moved to yield curve targeting last year. Divergent monetary and fiscal policy creates opportunities for managers investing in interest rates and foreign exchange. While monetary policies have been diverging, a tendency towards looser fiscal policies has been emerging. The end of the multi-year theme of austerity should result in increased public spending and is supportive of a pickup in global growth.

Bottom Line

Diversification between domestic markets, foreign markets and alternative investments will yield much better risk adjusted returns.

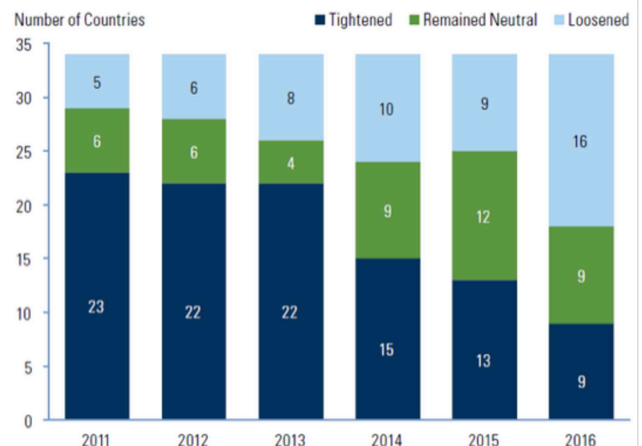

Figure 6

*Cidel is an operating name of Cidel Asset Management Inc.

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