Financial investors' wish list for 2018

Mohamed El-Erian | Allianz | 14 December 2017

If financial investors were to write letters to Santa Claus this Christmas, they would probably be tempted to ask for the continuation of the unusual combination of factors that has dominated over the last year: ultra-low market volatility; booming financial-asset values; correlations that lower the cost of portfolio risk mitigation; and, promising new opportunities (such as Bitcoin). But before making their wish list, investors should consider the longer-term risks associated with the decoupling of financial markets from economic and policy fundamentals.

Investors could be forgiven for hoping for more of the same. After all, with less than a month to go, 2017 is on course to be a hugely, if not historically rewarding year for them. As of 12 December, global stock markets - and in particular the S&P index - had returned around 20% for the year, and this on top of an already-strong multi-year run. Add to that unusually low volatility - in the US, 2017 so far has shown the lowest daily loss in the entire history of the S&P 500 index - and there has been little to keep investors up at night.

Usually, such strong stock returns are accompanied by lower prices for government bonds - the so-called negative correlation between risky and safe assets. Not so in 2017. Despite the impressive equity rally, the price of longer-term US Treasury bills was higher at the beginning of December than at the start of the year.

And then there is the precipitous rise of the crypto-currency Bitcoin. With its price having surged by an eye-popping amount this year (from around $1,000 to over $16,000 as of 12 December), even a small allocation of Bitcoin has made a material difference in investors' portfolios.

Five main factors have enabled this unusual situation.

- A synchronised pickup in global economic growth, which continues to strengthen.
- Progress in the United States on pro-growth policies.
- Skillful normalisation of monetary policy (which is still ongoing) by the US Federal Reserve.
- Passive investment products attracting large inflows.

- Continued large liquidity injections from three big central banks – the Bank of Japan (BOJ), the European Central Bank (ECB), the People's Bank of China (PBOC) – which, together with cash-rich corporate balance sheets, have served to lower funding costs for a significant set of households and corporates.

Now for the less exuberant news. Without continued economic and policy improvements, the factors that have delighted investors in 2017 risk generating an unpleasant reversal of fortune. This year's strong performance has, after all, been buoyed significantly by "borrowed" returns from future years.

With regard to mitigating portfolio risk, the increase in government bond prices leaves little room for this traditionally safe asset to compensate for a possible decline in stocks. Given how many value-at-risk-based models work, the persistence of low volatility has resulted in a crowded trade in a number of areas, which could turn out to be technically fragile.

As for Bitcoin, its vertiginous rise – fueled in part by the growing participation of institutional investors – may imply that it is on the path toward broad acceptance. But it may also turn out to be little more than a large financial bubble, implying serious damage when it inevitably collapses.

What, then, should investors really be hoping for in the coming year?

In general, the top priority must be improvement in economic and policy fundamentals to the point that they better validate existing elevated asset prices, while laying a foundation for greater gains over time.

Achieving this would require, in the US, the expansion of pro-growth policies – which, as recently announced by Donald Trump's administration, would include adding an infrastructure plan to deregulation and tax measures. European countries should also pursue more focused pro-growth measures at the national level, while supporting stronger regional efforts, facilitated by a reinvigorated reform-minded Franco-German leadership and a relatively orderly Brexit process.

As for Japan, Prime Minister Shinzo Abe should take advantage of his commanding majority in the Diet, won in October's snap general election, to implement the third arrow of Abenomics – pro-growth structural reforms.

Finally, to promote stable growth, all of the world's systemically important central banks – notably, the Fed, the BOJ, the ECB, and the PBOC – would need to continue coordinating their strategies, with a view to ensuring consistent monetary-policy stances.

Only with such efforts can the current pickup in global growth develop the structural roots that are needed to make it durable, balanced, and inclusive over the medium term. This is all the more critical at a time of fluid geopolitical risk and uncertain productivity, wage, and inflation dynamics.

However tempting it may be to focus our holiday wishes on our own immediate desires, it is imperative this year that investors' wish lists take into account the big economic and policy picture.

(c) Project Syndicate

Mohamed A. El-Erian is Chief Economic Adviser at Allianz and a member of its International Executive Committee.