



## WHAT WILL DISRUPT THE EQUITY CYCLE IN 2018?

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Disruption. The buzz word of 2017. That and artificial intelligence (AI). Love AI. It's real as well. Soon, your smartphone will not only be able to hear you and learn from those interactions, it'll also be able to see you as well as understand the physical space you're in. Audio and visual technology combined may open up very interesting developments in the next decade from a communications and entertainment perspective. And though Alexa—Amazon's virtual assistant—and I have finally started to see eye to eye (or voice to voice, to be precise), we'll have to see if my iPhone X recognizes me first thing in the morning before I've had a coffee and transformed into a human being.

While disruption in a technological sense has come to the forefront of many dimensions of investing in 2017 (e.g., inflation, the value-growth cycle, and the bankruptcy of beloved Toys R Us), it is the potential disruption of the equity cycle that is on the minds of most investors as we close out a spectacular year for global equities. So what could end, or at least disrupt, the equity cycle in 2018?

### ARE VALUATIONS EXTREME?

Bearish voices tend to focus on valuations being “unsustainably high,” and valuations are certainly above the last cycle highs of 2007 in many cases. However, modest premiums to the previous cyclical peak in valuations terms are neither an especially strong thesis in isolation nor an especially good timing tool. Valuations that are higher than average (as opposed to extreme) can stay there for some time if fundamental data points are strong to improving—and they have been improving. Add in the accommodative monetary policy backdrop and the valuations of many other asset classes (many bonds look positively bubble-like on valuation grounds compared with equities), and it's unlikely to be today's prevailing valuation environment alone that ends the cycle.

However, our job is to look forward, and here, we are alert to the prospect of a valuation bubble forming. While we are a long way off the individual and collective valuation highs of 1999 (check out Japan's price/earnings ratio in 1989 for an even bigger bubble), there are signs that optimism may spill over into exuberance. Should the Goldilocks world of stable-to-improving growth combined with low volatility persist next year, it will be increasingly important to step outside of any extremes of optimism that form. But we probably have to go higher in a market sense before we arrive in bubble territory, given our view that valuations are not yet extreme in the context of better corporate earnings and a better economic environment.

### WILL INFLATION END THE EQUITY CYCLE?

So what else? Perversely, if a decade of easy money and QE show themselves as having a tangible impact on the real economy after so many false starts, we may have to begin to worry about accelerating growth and the impact of inflation on the credit cycle. Leverage has clearly increased in segments of the global economy over the past three years, and the preparedness of individuals and corporates for a world of higher interest rates is untested. While the wage growth-inflation cycle has remained truly anemic, if we're going to see a pickup in wage inflation, it's likely going to happen now given falling unemployment, rising commodity prices, and improved consumer and corporate sentiment.

Our expectations for inflation are still muted, however, given the price-suppressing, secular impact of technology, globalization, and demographics upon inflation. Factors that don't sit that well within econometric models are hard to measure, but these influences are real and showing themselves in inflation data that should be higher, all else equal. Therefore, while inflation and rates may rise in 2018, the inflation cycle still looks modest to us, which will give corporates and consumers some time to adjust as interest rates begin to gradually rise. Meanwhile, if growth and inflation accelerate, the market, in this mood, will likely see the positive side near term. It's still a risk to be conscious of, however, given the lessons learned from the global financial crisis and the unknowns associated with how investors will react if the credit cycle does begin to change for the worse.

#### **MORE GOLDBLOCKS OR IS THIS A FAIRY TALE?**

In prime position for some sort of disruption to the low-volatility, positive-sentiment environment is the boring normality of greater uncertainty. Almost everything has gone right in the trailing year, from corporate earnings rebounding to PMI's accelerating to China stimulating its economy. Add in the extra bonus of less extreme political voices and outcomes in Europe and the U.S. (disputes with North Korea aside), and you can somewhat justify the strong rebound in investor enthusiasm, especially given its grudging absence over the past decade.

It's hard to envisage a repeat of 2017 as we begin to compare higher fundamental data points with considerably higher expectations. In corporate profit terms, whether its European exporters facing euro strength or the secular-growth winners facing blow-out, year-on-year earnings comparisons, there likely will be some disappointment to potentially shake the confidence, assumptions, and time horizons of investors. In many respects, this may actually prolong the bull market even further, given the concerns that stem from the alternative scenario of more smooth growth and stability. In this case, the ongoing search for risk in a market sorely lacking in volatility will likely push markets into full-on euphoria.

Outside of corporate fundamentals, the same year-on-year improvement comparison is also true of politics and economics. Brexit and the U.S. midterm elections are fast approaching and will no doubt be accompanied by a stream of political and increasingly extreme rhetoric on Twitter. More political tweets—if only that trend could be disrupted. Regardless, the inequalities of the world have continued to grow with asset market levels, so the protest vote will likely reemerge as time passes. Economic data is also likely to challenge those with less confidence in their positions as China's stimulus program fades. That's not a prediction of China-crisis II, it's just the base effect rolling forward, which may ease commodity prices, a trend in itself that has been assisting sentiment.

#### **SO WHAT DOES THIS MEAN FOR EQUITY MARKETS?**

It most likely means a bumpier ride as a greater breadth of sentiment emerges on less universally positive data points. While challenging for investors that want to allocate capital to themes associated with obvious improvement, some injection of uncertainty feels normal as well as healthy. This is especially true for fundamental stock pickers who have been enjoying an ongoing environment of low correlations, a backdrop that many would like to persist.

Despite the likely evolution of the equity cycle and the injection of some complexity, we have been cautiously optimistic and remain so. Why? To quote John Templeton: "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." While there will be stock and macro risks to navigate in the coming quarters, we believe markets are still in the optimism phase of the cycle, rather drunk on euphoria. At a minimum, we still see plenty of stock opportunities abounding within portfolios.

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