Portfolio Strategy

Global Portfolio Advisory Group

Special Report: Top 10 Risks for 2018

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January 8, 2018

In preparation for the kick-off of a new year, we recently published our flagship medium-term investment strategy report, "Portfolio Compass", which lays out our broad investment strategy settings across major asset classes. However, in an effort to address "off-base-case" scenarios, we have developed a list of Top 10 Risks for 2018 to highlight issues which may prove to be sources of transient market volatility or significant risk to our overall constructive market views for this year. In no particular order, we provide our list of top risks, each of which is described in more detail on the pages that follow.

Top 10 Risks for 2018

1. **Crowded consensus views**
2. **Geo-political flashpoints**
3. **Fiscal policy misused**
4. **Inflation finally inflects higher**
5. **Central banks overtighten**
6. **China slowdown due to government clamp down on financial system**
7. **Special counsel probe of possible Russian interference in U.S. election stymies U.S. presidency**
8. **Oil prices decline materially**
9. **Speculative bubbles burst**
10. **Material appreciation of the U.S. dollar**

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Top 10 Risks for 2018 - Descriptions

1. Crowded consensus views

As with most years, most strategists and investors set out their investment strategy for the coming year based on widely available data and similar analytical approaches that lead many market players to arrive at the same (or very similar) conclusions. This may result in very crowded positioning in trades tied to these conclusions, significantly reducing the odds of large gains in these positions. In fact, this beachesituation significantly improves the chances of contrarian trades (those that run counter to consensus views) winning out. Some of 2018's widely adopted consensus views and trades include expectations for higher long-end bond yields, a weaker U.S. dollar (USD), stable-to-higher oil prices, and outperformance in credit and in emerging market, value, European, and Japanese equities.

2. Geo-political flashpoints

Markets have been attuned to a number of geo-political risks over 2017 that had the potential to cause occasional bouts of volatility and intensify downward pressure on financial markets. For 2018, we could see risk from North Korean missile launches, Russian aggression in Eastern Europe, Middle East tensions boiling over (i.e. Saudi Arabia versus Iran, ISIS, Syria, Kurdistan-Iraq), and the rise of populism/far-right ideologies in Europe. Each of these carries its own probability of occurrence. While all would likely be met with risk-off trade in the market, depressing yields and equity markets, we would expect their impact to be transient.

3. Fiscal policy misused

The Trump administration has just passed its tax reform bill and has begun outlining its plan for a large-scale infrastructure spending program. The risk in these plans is that the U.S. economy is currently operating with little-to-no spare capacity as reflected by the unemployment rate, which is hovering at a 17-year low. Adding fiscal stimulus at this time could risk overheating the economy late in the economic cycle and increase recessionary risks down the road.

4. Inflation finally inflects higher

Markets and central banks have long been waiting for inflation to finally move higher. This has resulted in delayed tightening and rising market valuations. However, it is possible that as unemployment rates continue to fall (as forecasted by the U.S. Federal Open Market Committee [FOMC]) and wage growth meaningfully accelerates, inflation could climb faster than currently expected. In our view, this would have knock-on effects in the form of higher bond yields as well as a lower USD. A lower USD would put further upward pressure on inflation as commodity prices firm. Due to delayed tightening, the FOMC would find itself "behind the curve" and need to tighten its monetary policy faster than expected. A more intense Fed tightening campaign could put downward pressure on both bonds and stocks at some point in 2018.

5. Central banks overtighten

Global central banks are at varying stages of monetary policy tightening, led by the U.S. Federal Reserve, which expects to increase rates by 0.75% in 2018. With other major central banks (Canada, Europe, U.K., China, etc.) expected to move in the same direction, it is possible that these forces combine to increase debt servicing burdens more than anticipated and prematurely weaken the global economy. These forces could also increase recession risks, weighing on global equity markets and bond yields, in our view.

6. China slowdown due to government clamp down on financial system

China has been trying to tighten financial conditions for several years in order to curb excessive lending in its financial system. While it has kept its lending rate unchanged recently, the government has employed various macro-prudential policies. Policies already in place or future additional tightening could clamp down on the economy and domestic markets more than expected, potentially hurting demand for commodities and/or real-estate.

7. Special counsel probe of possible Russian interference in U.S. election stymies U.S. presidency

The investigation of possible Russian interference in the 2016 U.S. presidential election recently yielded its first result. The guilty plea by former U.S. national security adviser Michael Flynn and his agreement to testify against Trump transition team officials was the first indication of how close the investigation is to the White House. Assuming this investigation is allowed to continue, it is possible testimony could implicate others close to the U.S. president or name him directly. While the investigation is unlikely to result in impeachment, in our view, new revelations and charges could derail economy-supportive policies, acting as a headwind for global markets.

8. Oil prices decline materially

After the oil price recovery in 2016, the price of crude has been propped up thanks in part to a supply agreement among OPEC, Russia and other major producers. Continuation of this agreement, and compliance with it, will be crucial determinants of the global crude oil supply/demand balance over the next year, in our view. Additionally, we believe U.S. shale producers collectively have emerged as the new swing producer on the global crude oil landscape. If these companies continue to boost production, they could put downward pressure on the crude oil quote and potentially re-ignite the price wars that led to the 2014-2016 oil price collapse.

9. Speculative bubbles burst

Mania-like markets typically generate enticing large returns, which then attract new throngs of investors who, chasing performance, put themselves at risk. Some possible candidates exhibiting some mania-like characteristics include disruptive-technology start-up companies garnering sky-high valuations from private-equity investors, new high-volatility digital technology assets, over-heated real estate markets, etc. Historically, speculative bubbles have burst of their own accord or due to regulatory or monetary policy action. A bursting of one or more of these bubbles could generate large investment losses, triggering concerns over financial system stability, cross-asset selling to cover losses, and contagion across global markets. Investor sentiment would also suffer, in our view.

10. Material appreciation of the U.S. dollar

We expect the U.S. dollar's multi-year strengthening trend to reverse itself as other major central banks begin tightening, U.S. inflation picks up, and the global economic expansion catches up with the U.S. However, if instead the U.S. dollar gets stronger, then it could put pressure on U.S. companies' international earnings and hamper our equity overweight recommendation. Additionally, we believe a higher USD would pressure international economies, undermining our expectation for continued strong global growth. Finally, a strong USD would dampen the U.S. economy through terms of trade and could put upward pressure on inflation.

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