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WHY 2017 WAS SO GOOD FOR EQUITIES

In 2017, global economic growth was steady, prolonged and widespread. Political risks remained subdued, despite the news headlines, and volatility in equity markets was at record lows. The result was a stellar year for equities with assets across the world and investment spectrum seeing gains. In particular, Emerging Market (EM) and Asian equities took a strong lead (see fig.1).

Nothing in the investment world is uniform and there were certainly blips, failures and losses. And neither was it the best year ever for Asian equities; the MSCI Asia Pacific ex Japan index, as one example, had better years as recently as 2009 and 2003.

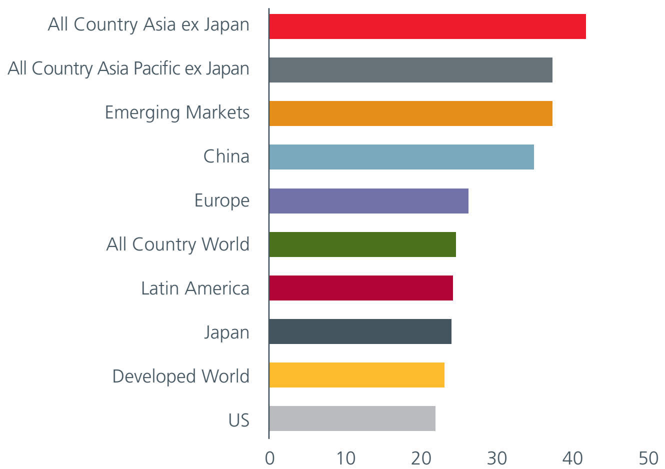
But what made 2017 special was the quality of the gains. In other words, the 2017 equity gains were backed by strong corporate earnings and robust economic growth. Set this against the 'recovery' years of 2003 and 2009 when markets bounced from low points, or the speculative gains of the dotcom era in the 1990s.

So why 2017? The answer is simple. It wasn't one thing. It was a combination of various positive factors coming together over one 12-month long period while there was a notable absence of entries in the negative column too. The outperformance of risk assets in the mature years of a bull market is far from exceptional. And neither will it go on forever so the golden question remains, how long will it last?

CORPORATE EARNINGS WERE STRONG

The first pillar supporting equity outperformance everywhere last year was corporate earnings. Growth in corporate earnings measured against Earnings Per Share (EPS) grew by around 14% in

Fig.1: MSCI global indices returns in 2017, USD (%)



2017 in Developed Markets (DM) – not bad at all and enough to propel the markets in Europe and the US to record highs. But that solid growth figure pales in comparison to EM which saw EPS grow by a whopping 23% on average, according to JP Morgan analysis.

A stock's performance is reflective of the company's future earnings growth so, all things being equal, stock prices will rise when EPS rises. And that is reflected in various country and sector performances for the year (see fig.2).

The result was a net increase in the amount of money being invested into emerging markets and especially Asia. JP Morgan estimates inflows into equities to be in the region of USD77 bn (fixed income has attracted more at about USD109 bn). And where demand goes up, so do prices.

Backing up the strong corporate earnings was the key pillar of broad economic growth. According to the International Monetary Fund (IMF), in 2016, global growth was below 3%. For 2017 it is likely to settle around 3.6% – the fastest pace the world has seen since 2011 when it was still recovering from the financial crisis – and it predicts 3.7% for 2018.

For DMs, economic datapoints saw unemployment levels approach near-record lows; manufacturing data at highs, business surveys hit record peaks, and inflation stay at lows. For now, forward looking manufacturing and business confidence surveys are also showing no signs of weakness. In November, the German Ifo business climate survey hit 117 – the last time it was this high was when Neil Armstrong went for a walk on the moon.

REFORM, REFORM, REFORM

For EMs, the emphasis was also on low inflation, robust manufacturing figures as well as a recovery in commodity prices. However here, reform is just as important, and almost everywhere, the world's developing economies moved forward.

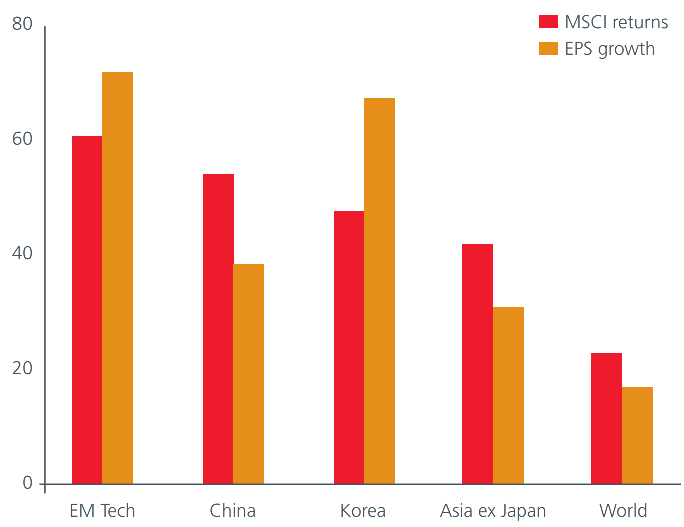
To take just one example (and the biggest), China started to cut back production in parts of its economy that simply produce too much. Steel and cement production, for example, was curbed partly in recognition that it needed to cut back in excesses but also in response to pollution levels which had reached unsustainably unhealthy levels.

The net result of these de-frothing measures was an improvement in profit margins, cashflows and balance sheets...and stock performance. And by the way, the move by China to finally do something about its environment will not only prolong the sustainability of its economic rally but with the US pulling out of the Paris climate agreement, could potentially turn the country into a leader of environmental reform. Who would have thought that a few years ago?

Reform didn't stop at China's borders. In India, the government recapitalised its state-owned banking system and finally introduced Goods and Services Tax (GST) in an attempt to equalise tax rates. Tax reform in the Philippines helped push that index to all-time highs; social security reform in Brazil came to the top of the legislative pile; a pro-market president was elected in Chile; Indonesia cut interest rates....

In fact, the positive macroeconomic datapoints for 2017 are almost endless.

Fig.2: MSCI returns and EPS growth in 2017, USD (%)



LIQUIDITY STAYED BUOYANT

This takes us to the third reason for equities' outperformance in 2017: liquidity. In normal economic cycles, strong economic growth would lead to central banks shrinking their balance sheets to avoid inflation accelerating out of control while taking advantage of good conditions to pay down debt.

It's true that the US Federal Reserve System (Fed) did begin to shrink its balance sheet and the European Central Bank (ECB) said it would start to relax Quantitative Easing (QE) in 2018. But in 2017 central banks remained net buyers of bonds, especially in the big markets of Europe and Japan – and that meant there was plenty of money to be put to work in the equity markets.

The dynamic in EMs was different with several central banks still managing to cut interest rates. In China, liquidity remained plentiful despite the government introducing several measures to reduce it especially in starting to regulate its shadow banking system and deleveraging its colossal debt pile.

This was enough to stop debt growing – it even began to fall by some measures – and was also enough to encourage the stock market because it reassured investors the government would not allow rampant liquidity, built solely on credit, to underpin equity performance.

STOCK MARKET GAINS (ALMOST) EVERYWHERE

The result of this perfect storm of conditions is that equity markets globally recorded strong gains through the year.

In DMs, one outstanding aspect was the lack of volatility and the consistency of equity market returns. In the US, equities showed positive returns in every month of the year – the last time this happened was 1958 – while the rally was unusually broad with consumer discretionary, materials, healthcare and financial stocks among those returning gains of more than 20% to add to the surging Information Technology (IT) gains of more than 40%.

The story was the same in eurozone where one economic datapoint after another reflected robust economic growth while corporate earnings improved. In the end that strength proved Europe's undoing as the euro rallied and began to drag on blue-chip earnings and subsequently equity performance, while Spain and the UK had their own domestic political wobbles to worry about.

In Japan too, the major catalyst proved to be strong corporate earnings given an extra boost by strong export data. Low unemployment, continuing benign inflation and political stability also helped with Prime Minister Abe comfortably winning re-election.

And amid the gains, there were strong outperformers and underperformers around the world. For all the strength of DMs, which gained around 20%, EMs outperformed with the MSCI EM Index gaining 34%. In fact, the index outperformed its DM counterpart in ten months out of 12. Within EMs, Asia outperformed Latin America, Europe, the Middle East and Africa (EMEA); China and Korea outperformed in Asia, and South East Asia (SEA) underperformed.

From another angle, Momentum outperformed other styles. Technology stocks topped the sector league table by some distance backed by strong earnings. The sweet spot was Chinese and Korean IT stocks that rose 92% and 64% respectively, while Chinese and consumer discretionary and insurance names hardly had a bad year with 62% returns each, according to MSCI Index data.

The strength of tech's performance in 2017 was exceptional but should not be underestimated for its strength was underpinned not only by corporate earnings per se but also by improved balance sheets and margins. In addition, in Asia, the drivers for IT's outperformance were twofold: first was the Apple supply chain ahead of new iPhone models launched in the autumn; and the second was demand for server Dynamic Random Access Memory (DRAMs) ahead of an expected expansion of Artificial Intelligence. Both benefitted large IT companies in north Asia, and helps explain eastspring investments

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north Asia's outperformance over SEA, and indeed the rest of the EM universe.

Yet in places, the strength of IT formed illusions, not in terms of its scope or depth but its effect on other parts of the world's stock markets.

Take South Africa. At a glance, the MSCI South Africa performed admirably in 2017 with a return of 33%. That was in line with the MSCI EM index and positive noises around the election of a new African National Congress (ANC) leader in December appears to point to a country on the move. But scratch the surface and a different return emerges. The biggest stock in South Africa is Naspers; it owns a stake in Chinese internet business Tencent and as a result of that company's stock rise, Naspers rose almost 90% over the year. Ex Naspers, the MSCI South Africa index rose a more modest 16%, according to JP Morgan analysis, a substantial underperformance against other emerging countries (see fig.3).

There were other illusions elsewhere. Oil prices in 2017 were supported by an agreement by Organisation of the Petroleum Exporting Countries (OPEC) members and non-members in 2016 to cut production, a decision that led to Brent rising by more than 20% over the year (or an almost 50% rise in the second half of the year after it hit a low in June).

All things being equal that ought to support "oil indices" such as Russia. But hopes of the US easing sanctions on the country faded as the year progressed and Trump's campaign and transition team found itself under investigation over links to Russia. This meant that the MSCI Russia index was almost flat for the year, giving up gains of around 18% in the six weeks post the election of Trump.

Here's the point that South Africa, Russia and also Qatar (which saw its market fall 15% over the year) prove: for all the positives in the world economy and stock markets in 2017, investors need to be mindful of the hidden crevasses that exist everywhere and will continue to exist in 2018. Many of these we can't even imagine today. To borrow a phrase from former US Secretary of Defense Donald Rumsfeld, "there are also unknown unknowns – the ones we don't know we don't know…it is this category that tend to be the difficult ones." How true.

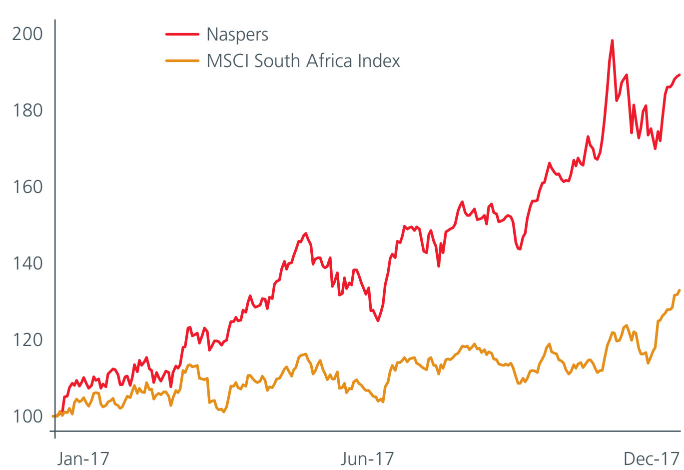
THE LACK OF BAD STUFF

As well as all the positives that support equity asset classes, there was also a lack of bad things happening too. A quick glance at half a dozen broker reports from the end of 2016 showed there was concern among the investment community of a few factors, none of which materialised to any great effect.

The first was inflation. An unexpected rise in inflation would cause central banks to raise interest rates faster than was being expected at the beginning of the year but in the major economies around the world, inflation remained stubbornly low. With the possible exception of the UK and, toward the end of the year, Germany, inflation remained well below expectations of both central banks and the investment community.

There are several reasons for this and the jury is still deliberating on its final verdict but the very low unemployment figures in developed markets haven't fed through to wage growth as would normally be expected at this stage in the cycle. One reason for this is because many workers are

Fig.3: Naspers vs MSCI South Africa Index (USD)



being pressed to accept short-term, low-paid contract work; this is the so-called "gig economy" effect.

The second worry at the beginning of the year was the progress of populist movements that saw Donald Trump elected as US president and the United Kingdom voting in a referendum to leave the European Union. With elections in the Netherlands, France and Germany looming, it was a fair worry that a populist movement could have stopped the globalisation train in its tracks. But instead, the populism shrivelled with mainstream candidates prevailing in Europe, and, by the end of the year, the US and UK were beginning to look a bit isolated.

Together with this dark cloud over politics in Europe was the "known unknown" of the Donald Trump presidency. Would he clamp down on global trade as per his promise on the campaign trail? The answer was no. Despite pulling out of the Trans-Pacific Partnership (TPP), which had barely got off the ground, and starting to renegotiate the North American Free Trade Agreement (NAFTA) trade arrangement, no new customs barriers were posted around the US. Meanwhile, the rest of the world got on with the job of integrating trade and lowering tariffs.

The third worry was that of geopolitics. Would the war of words between North Korea and the US turn hot? What would Russia do? Would Syria collapse? Again, the answer was no. Syria did not collapse and perhaps more importantly, the US-North Korea war of words stayed that way despite Pyongyang's nuclear and ballistic missile tests.

Some of those risks still exist for 2018 of course but in 2017, they stayed under the covers.

WILL IT CONTINUE?

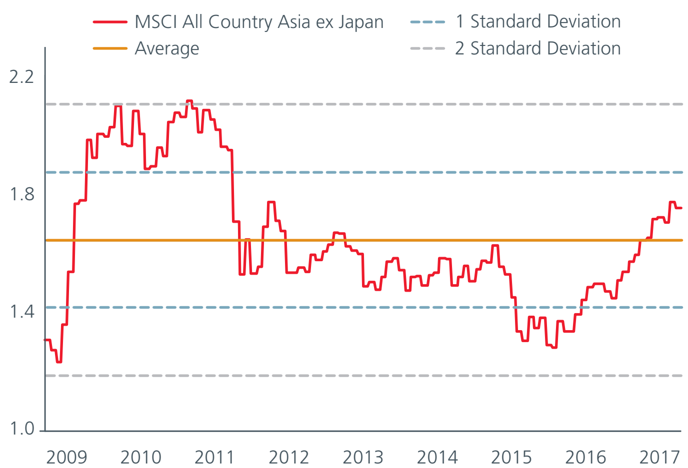
December saw equity markets end on a perfect high – the final trading day of the year notwithstanding – as major indices reached fresh record highs at the end of the month. In December the market driver changed again, this time away from surging technology and robust economic growth, to the potential for what could be delivered in 2018.

This took the form of US tax reform, which by almost all estimates, could benefit many US domestic stocks as the corporate tax rate will be slashed, and the cash potentially distributed to shareholders in the form of dividends and share buybacks. It is a technical support in so much as it doesn't add to underlying corporate profits but it is a support nevertheless and was responsible for both a sector rotation away from technology and into cyclicals (including banks), and a final surge of stocks in general around the world.

By the end of the year, equities were certainly more expensive than at the beginning but measured by book value or price-to-earnings, not excessively so (see fig.4).

Eastspring's 2018 outlook details how the drivers for equities' outperformance in 2017 will still be around in 2018. That suggests the party isn't over just yet but at the same time, there are crouching bears potentially waiting their turn. That means watching carefully for signs of inflation, a deteriorating geopolitical landscape and liquidity drying up, while also being mindful of those unknown unknowns too.

Fig.4: Asia ex Japan equities on a price-to-book basis is still not expensive (x)



Sources: Fig.1. MSCI, Thomson Reuters Datastream, as at 29 December 2017. Fig.2. Thomson Reuters Datastream, as at 9 January 2018. Fig.3. Thomson Reuters Datastream, as at 29 December 2017. Fig.4. Thomson Reuters Datastream, as at 5 January 2018.

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