The Investor

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2018 Investment Outlook – Ireland & the World

The dark clouds of stagnant wages, widening inequality and underproductivity across much of the Western world are shrouding a remarkable and easily forgotten fact: the world economy is booming.

After a year of relatively healthy global economic growth, economists are predicting much the same for 2018. The view is that all key indicators are essentially on track for growth that will be stronger than in 2017. This partly arises from the fact that forecasters generally got it wrong last year by underestimating economic performance, particularly for the Eurozone and Japan. If anything, 2017 proved to be even more resilient than many had hoped. World stocks rose 20% and global growth was its strongest since 2010, with market volatility falling to its lowest on record.

The International Monetary Fund (IMF), for example, saw 2017 global growth at 3.4% with developed economies advancing 1.8%. It now sees them at 3.6% and 2.2% respectively. It had the Eurozone and Japan growing 1.5% and 0.6% respectively. It now puts them at 2.1% and 1.5%.

This performance has made some economists optimistic. However, there are many potential political and economic risks to the status quo. The main three risks are: Central Banks, trade and bubbles. In the first case, the danger is that there will be a policy mistake, squeezing debtors. The second relates to renewed US protectionism or anger over Chinese exports triggering tit for tat, growth-stifling trade barriers. The third alludes to sudden market losses that could dry up spending and demand. Part of the global economic success of 2017 was put down to a combination of extraordinarily loose monetary policy and competent management by Central Banks in their attempts to wean the world off such largesse.

> *"Faster growth is reaching roughly two thirds of the world's population"*
>
> ***IMF, December 2017***

Entering 2018, the Federal Reserve is lining up for three more US rate hikes, the European Central Bank (ECB) is slowly cutting back on its asset purchases and China is increasing rates. All of this is being carefully flagged by the policymakers, but mistakes can happen and any significant shift of gear could cause a sharp retrenchment in consumer and corporate spending. The amount of US corporate debt outstanding, for example, is nearly $8.8 trillion, according to the US Securities Industry and Financial Markets Association (SIFMA). That is up 35% since 2010 and is a major driver behind corporate expansion. US corporates are the most exposed to higher interest rates. This implies Central Bank tightening (to curb overly robust growth or inflation) risks creating a credit squeeze, hence the caution in Washington, Frankfurt, Beijing and Tokyo.

Bubbles are hard to gauge until they have popped, and there is a tendency to say "this time it is different", until it isn't. However, if economists have learned one thing from this century's financial market crashes it is that they are inclined to bring the house down with them. There are plenty of examples of assets that have soared continually and steeply in the past year, Bitcoin's staggering rise being the most obvious. However, with stock markets in the stratosphere, it would not take much to reverse the situation.

World GDP Forecasts

	2017 (estimated)	2018 (forecast)	2019 (forecast)
World	3.5%	3.9%	3.5%
Ireland	7.0%	5.5%	4.5%
United Kingdom	1.5%	1.2%	1.1%
Eurozone	2.2%	2.1%	1.8%
United States	2.3%	3.0%	2.4%
Japan	1.5%	1.1%	1.0%
China	6.6%	6.4%	6.2%

Source: Merrion 31.12.17

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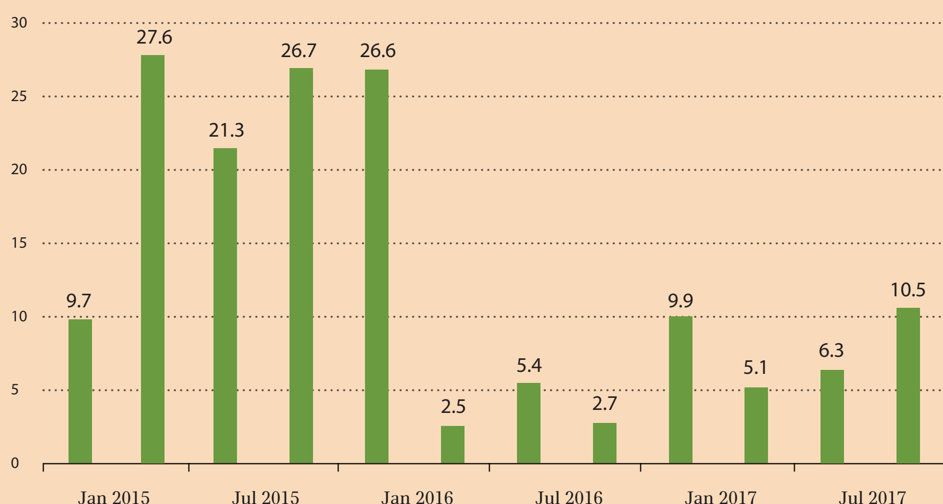
Ireland GDP Annual Growth Rate



Source: tradingeconomics.com | Central Statistics Office Ireland

Ireland

The latest Quarterly National Accounts showed that Irish GDP grew by 4.2% in quarter 3 of 2017 and 10.5% in the year in real terms. On the expenditure side of the accounts, exports increased by 4.4% compared with the previous quarter, which when combined with an import decrease of 10.9% meant overall net exports for the quarter increased by 63.1%.

- *Capital formation declined by 36%*
- *Personal consumption accounted for 51.7% of domestic demand and rose by 1.9%*
- *Government expenditure recorded an increase of 0.7%*

Total domestic demand declined by 13.1% in the quarter. When combined with the 63.1% increase in net exports, the result was an overall rise in real GDP of over 4%, with an overall increase in GNP of 11.9%.

In the first three quarters of the year, GDP was up 7.4% on average on the same period last year, leaving it very well placed to top the Eurozone growth league table for the fourth year running. Meanwhile, GNP was up 11.2% in the year in the July to September period, and was 5.7% higher on average on an annual basis in the first three quarters of 2017.

The latest set of figures were distorted by the absence of imports of intellectual property in particular and aircraft for leasing. Modified domestic demand, a measure aimed at removing the distortions from the multinational side, was up 2.9% in quarter 3 and 9.1% in the year, when stocks are included. Excluding stocks, the annual rise was around 5%, which would seem to be a fair reflection of growth in the economy in the quarter.

All in all, the latest GDP numbers are very positive, especially when one allows for the distortions of intellectual property on the economy, but it is clear that all forecasts for Irish economic growth for 2017 were too low. Even allowing for some slowdown in the final quarter, it now looks like GDP growth in 2017 will be around 7%, with growth of 5.5% projected for 2018.

'Brexit' will of course have implications for Ireland, but as of now, the economy remains very resilient. The labour market continues to strengthen and the unemployment rate is set to drop below 6% from the high of 15.9% in late 2011. The property market remains the main concern, with tentative signs that lack of supply could lead to overheating and a repeat of what we saw during the height of the Celtic Tiger era. Still, the overall economic backdrop remains favourable for the time being.

Europe

GDP growth is projected to remain above 2% in 2018 but ease to 1.8% in 2019, supported by the ongoing recovery of global output and trade, accommodative monetary policy and diminished political uncertainty. Growth is broad based, driven by domestic and external demand. Wage growth is set to remain moderate, and inflation is projected to rise closer to, but still below, 2% by the end of 2019.

The ECB recently announced a reduction in its asset purchases from €60 billion a month to €30 billion from the start of January, which is justified by an improving economic outlook and by the need to reduce the risk of financial imbalances. Policy rates should remain on hold well past the end of asset purchases and until inflation is clearly and persistently rising to the target, as emphasised by ECB guidance.

The Eurozone fiscal stance is expected to be slightly expansionary. Private debt remains high by historical and international standards, and policy measures such as improving insolvency frameworks should support a faster reduction. High private indebtedness has led to a large stock of non-performing loans in some countries, which is hurting bank profitability and restraining new lending.

In the UK, uncertainty over 'Brexit', low wage growth and weak productivity are weighing on the economy but the Bank of England is not keen to see the pound weaken and add to an inflation rate that is expected to exceed its 2% target over the next three years. Although Britain appears to have cleared a key hurdle in 'Brexit' talks and focus can now shift to a discussion of a trade agreement, slow progress to date suggests that uncertainty will remain high. Even if an eventual deal is likely, its terms will not be clear for some time.

United States

Trump's 2016 election campaign was peppered with 'America First' rhetoric and served with a dollop of belligerence towards other countries. In office, the Trump

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administration has done a few things in the name of US interests to upset multi-lateralists. It has, for example, blocked the appointment of judges at the World Trade Organisation and withdrawn the US from a now 11 member Pacific Rim trade pact. Other measures have not progressed as far, notably the threat to withdraw from the North American Free Trade Agreement and the pledge to bring China to heel over its allegedly unfair trade practices. But the US trade deficit has increased despite growth driven US exports, and while the US/China deficit has dropped a little, it remains well in Beijing's favour.

According to the US Conference Board, China's economic exposure to the US is nearly five times higher than US exposure to China. That would suggest that any imposition of trade barriers could hit growth in China, growth which is behind much of the wealth in exporting nations like Germany. It is far from just a US/China matter: the World Bank estimates world trade accounts for 52% of world GDP, more than doubling the clout of world trade over the past 50 years.

US economic expansion is projected to continue in 2018 and 2019. Buoyant asset prices along with strong business and consumer confidence will support consumption and investment growth. The impact of slowing employment growth on consumption will be partly offset by wage growth acceleration as the labour market tightens further. Fiscal policy is projected to become more supportive in 2018 as measures are introduced to lower tax rates on corporate and personal income and stimulate investment and consumption. At a time when unemployment is at its lowest level since 2000, the assumed fiscal boost will also contribute to further wage growth, thereby providing the conditions for monetary policy to continue normalising gradually.

China

China will deepen structural reforms and curb risks to the country's financial system while maintaining steady economic growth in 2018. China saw better than expected economic growth in 2017 even as it stepped up a campaign to cut debt, though there are rising concerns that the tighter policy environment could weigh on growth in the world's second largest economy in 2018. In the first nine months of 2017, the economy grew 6.9% from a year earlier. Growth was underpinned by stronger exports and sustained state spending, positioning China to exceed its growth target of around 6.5%. China will aim for growth of 6.5% again in 2018.

Beijing has in the past twelve months made progress in controlling the level of debt in the economy as a portion of GDP, with corporate debt ratios declining slightly. Concrete measures will also be taken to strengthen the regulation of local government debt, promote private investment, and deepen reform of state owned firms in 2018. In the property sector, which saw a rapid run up in prices in recent years (though gains have slowed), China will maintain the stability and continuity of real estate tightening measures.

Meanwhile, French President Emmanuel Macron has said that China and Europe should work together on Beijing's Belt and Road initiative, a project which aims to build a modern day Silk Road.

Market Performance 01.01.17 to 31.12.17

Market	Index	Local Currency	Euro
World	FTSE (€)	9.0%	9.0%
Ireland	ISEQ	8.0%	8.0%
UK	FTSE 100	7.6%	3.4%
Europe	FT/S&P Europe Ex. UK	9.8%	9.8%
US	S&P 500	19.4%	4.8%
Japan	Topix	19.7%	8.8%
Hong Kong	Hang Seng	36.0%	18.4%
Bonds	Merrill Lynch Euro over 5 years	0.3%	0.3%

Source: Bloomberg: 01.01.17 – 31.12.17

Japan

Japan has revised upwards its growth projections for the current and next fiscal years, forecasting the economy to expand by 1.9% and 1.8% respectively on the back of steady improvement in domestic demand. Consumer price inflation is estimated at 0.7% for this fiscal year and 1.1% next year, underscoring the challenge for the Bank of Japan to accelerate inflation to its 2% target as prices continue to lag an economy growing at a steady pace.

Japan's economy has expanded at a steady pace in the past twelve months, lifted by surging exports growth that has kept the manufacturing sector humming. A key conundrum for policymakers remains persistently low inflation that is complicating the Central Bank's efforts to exit its massive stimulus.

Prime Minister Shinzo Abe believes Japan's economy is showing signs of emerging from deflation, with a tightening job market pushing up wages. Some policymakers are keen to declare an end to deflation, which would help Abe argue that his policies have succeeded in reflating the economy. However, doing so could also give the Bank of Japan justification to withdraw crisis mode stimulus, a move which would strengthen the yen.

Smaller Companies – a long term investment opportunity

With a proven track record of delivering strong risk-adjusted returns above those of larger cap peers over time, smaller companies may deserve a higher allocation in investor portfolios.

Over the longer term, smaller company returns have outstripped those of their large cap peers. This is known as the 'smaller companies effect'. Traditional academic theory suggests that abnormal returns are fleeting, arbitraged away by investors seeking to exploit the anomaly. However, various factors suggest that the asset class could continue to generate premium risk-adjusted returns over the long term. Here, we examine the reasons for these outsized returns and outline why the factors behind this small cap effect are likely to persist for considerable time.

The smaller companies effect

The first 10 years of the millennium were frequently described as a 'lost decade' for equities. Global stock markets have since strengthened substantially, however, long term returns from large cap and small cap equities have diverged starkly. Indeed, between 1 January 2000 and 1 September 2017, global large cap equities delivered a 75.5% total return. By contrast, total returns from global smaller companies have been dramatically stronger, at 187.2%.

In most cases, smaller companies deliver a premium return over their larger counterparts. Rolf Banz in his University of Chicago doctoral thesis, later published in the Journal of Financial Economics, first identified and computed the 'size effect' for US stocks. In analysing US common stocks listed on the New York Stock Exchange, he discovered that, on average, smaller companies enjoyed higher risk-adjusted returns than larger peers and that the 'size effect' was long term, persisting for over 40 years.

There are powerful forces at work in the world of investing that tend to steer investors towards the largest companies and away from smaller stocks. These forces ensure that the undervaluation of smaller companies is not fully arbitraged away, allowing steady outperformance over time.

An underappreciated sector

There are **two key factors** that suggest smaller companies will remain under-appreciated in the longer term, which should mean that the sector will continue to reward those investors who choose to seek it out:

- **Institutional investor behaviour**
  As a whole, institutional investors' world view traditionally has tended not to separate smaller companies from the wider 'equity' category as an asset class, thus overlooking an area with strong excess return potential.

- **The rise of passive investments**
  According to Thomson Reuters Lipper data, passive investments constituted only 5% of total European mutual fund assets under management in 2004. By 2011, this figure had increased to 8% and by 2016 to 12%. Due to the sheer number of stocks involved and much lower levels of dealing activity, smaller companies markets offer investors opportunities to exploit inefficiencies and generate enhanced returns.

An under-researched sector

It makes economic sense for some analysts and banks to restrict themselves to covering a small number of very large companies. It is not unknown for the analysts at 'bulge bracket' investment banks to work full time on only two or three companies. Many hundreds of pages of research about these companies are published on a regular basis.

There is undoubtedly less research available on smaller companies. Indeed, on average, the sell-side community has 22 analysts covering large cap stocks and just 6 assigned to small caps. Moreover, the small cap research that is available is often much shallower. This information gap opens up opportunities to find compelling investment ideas that others have yet to discover.

Risk and risk-adjusted returns

Since the millennium, some of the largest and most stable companies in the world have either imploded or declined precipitously in value. Scale, size and international reach do not necessarily equate to low risk, as investors in RBS, BP or Nokia know only too well. Consequently, the risk differential between the largest and smallest companies may not be as great as one might assume. While lower risk smaller companies have been shown to outperform higher risk small caps, the asset class as a whole also outperforms on a risk-adjusted basis. In other words, small caps generate higher returns per unit of risk assumed.

To conclude, concern on the part of some investors regarding apparent risk is unlikely to dissipate soon. However, over the long run, research shows that investing in smaller companies has resulted in premium returns compared with those achieved by large caps. Ultimately, the small cap effect should continue to provide those investors deploying a robust and consistent stock selection process with attractive long term returns.

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