EFG

INSIGHT

QUARTERLY MARKET REVIEW

Q4 2017

HIGHLIGHTED IN THIS PUBLICATION:

- GLOBAL STRATEGIC ASSET ALLOCATION
- GLOBAL SECURITY SELECTION
- REGIONAL ASSET ALLOCATION
- REGIONAL PORTFOLIO CONSTRUCTION

Stable economies; disruptive trends

OVERVIEW

The global economic backdrop of stable real growth and moderate inflation remains a benign influence for financial markets. Yet important disruptive forces are becoming ever-more apparent, with potentially profound implications.

Stability on the surface

Overall global economic growth has been stable at around 2.5-3.0% p.a. for the last six years, as shown in Figure 1.[1] While much of that growth is generated by the US, still the largest economy in the world, China's share has grown consistently in recent years. Indeed, in 2017, China's contribution to world GDP will equate to the overall size of Turkey's economy. According to the IMF, that level of contribution is expected to continue for several years.[2]

1. World growth

Source: IMF World Economic Outlook database. Data as at 1 October 2017.

China's importance is partly due to the *arithmetic* reason that, although the overall size of China's economy is still smaller than that of the US (when measured on the basis of market exchange rates), it continues to grow three times as fast. However, a more *fundamental* reason is that China's growth is now on a more sustainable footing than in the past.

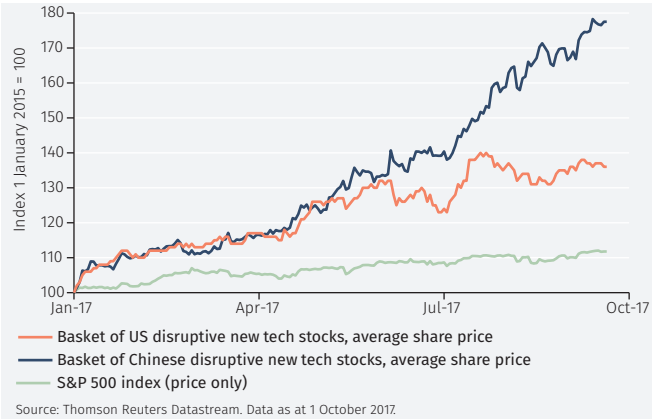
China: no longer "unstable, unbalanced, uncoordinated and unsustainable"

Such success for the Chinese economy has not always been assured, or even likely. Many have repeatedly expected a hard landing and in 2007, then-premier Wen Jiabao declared that China's economic growth was "unstable, unbalanced, uncoordinated and unsustainable".

Since then progress has been made on tackling each of those shortcomings. China has had relatively stable growth, in line with the country's successive five-year plans. The overall real growth rate has halved (it was 14% in 2007) – to an arguably more sustainable rate. Growth has become better balanced – it now relies less on exports and more on domestic demand; and within domestic demand, consumer spending now makes a larger contribution to growth than investment spending. Furthermore, the private and state sectors arguably have a more co-ordinated relationship with each other than a decade ago.

Private sector growth is vibrant in industries that are providing new services and disrupting existing businesses. This phenomenon can be seen around the globe. In the US, the strong performance of such stocks (see Figure 2) indicates the equity market's expectation of the success of those companies' disruptive technologies. Established business models in retailing, entertainment, advertising and transportation are being shaken by these and other similar disrupters.

2. US and Chinese disruptive new tech companies



Source: Thomson Reuters Datastream. Data as at 1 October 2017.

China has its own disruptive, new tech stocks. A basket of such stocks has seen an even sharper price appreciation than their US counterparts so far this year.

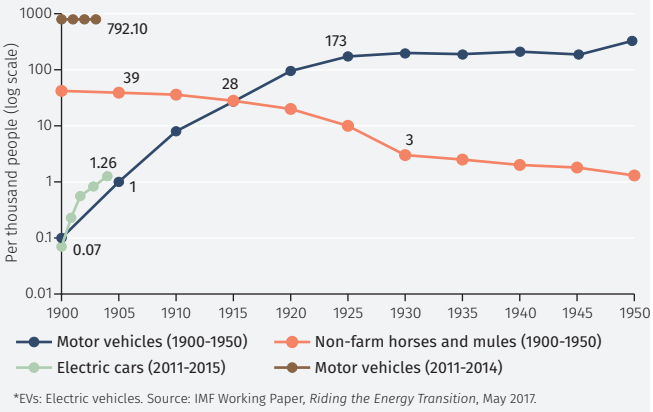
While such Chinese stocks may not feature as prominently in many investment portfolios, China's financial markets have the potential to be much more closely integrated in global markets in coming years (see Page 9 for a further discussion of this issue).

Creative destruction Version 2.0

These disruptive changes have something in common with the forces of 'creative destruction' identified by Austrian economist Joseph Schumpeter in the early twentieth century. At that time, the rapid adoption of electricity and the motor car changed the shape of western economies. IMF economists have recently compared the growth of motor vehicles and the demise of horse-drawn transport in the early twentieth century with the potential rise of electric vehicles (EVs) and the demise of ICE (internal combustion engine) vehicles (see Figure 3).

[1] Weighted according to market exchange rates; using Purchasing Power Parity exchange rates gives shows world growth around 0.5% higher as faster-growing emerging economies have a greater weight.
[2] Source: IMF World Economic Outlook database.

3. The rise of EVs (Electric Vehicles)?



*EVs: Electric vehicles. Source: IMF Working Paper, *Riding the Energy Transition*, May 2017.

4. Emerging countries' inflation rates

Source: Thomson Reuters Datastream. Data as at 1 October 2017.

In just 15 years, from 1900-1915, cars moved from being an expensive luxury to being as widely used as horses. That growth marked the start of a trend towards the ubiquity of the motor car. Could the rise of EVs be as fast? There are, of course, grounds for scepticism: EVs can be seen as an evolution of the motor car, whereas early 20th-century cars represented a fundamental change from equine power. Yet, the UK and France plan to ban the sale of ICE cars and vans from 2040, while China is reportedly considering even more aggressive moves, including ceasing production of ICE vehicles and aiming to become 100% electric.

Emerging market inflation

Although commentary on China is so often about its rapid growth, a key concern in the past has been the destabilising influence of high inflation. China saw 20%+ inflation rates in the late 1980s and mid-1990s – and suffered hyperinflation in the 1940s. Taming inflation has been an important, if often unrecognised, element of China's greater stability.

Inflation is now at low levels – not just in China, but also in other major emerging markets (see Figure 4). Inflation rates have, in some cases, dropped very sharply this year, paving the way for further interest rate reductions in economies such as Brazil and Russia.

Globalisation and inflation

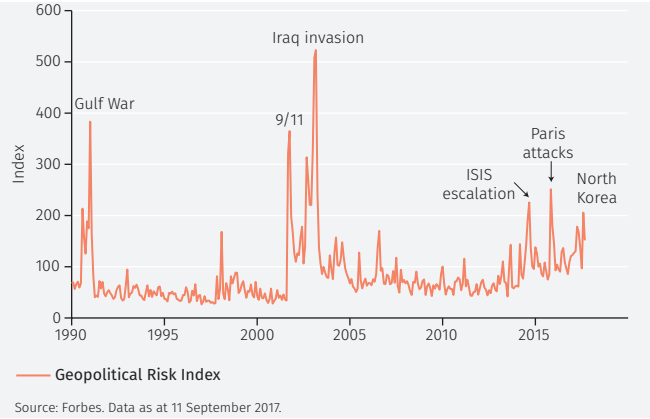
Part of the explanation of that drop is that globalisation has been accompanied by a weakening in the relationship between domestic economic conditions and domestic inflation; and a corresponding strengthening in the relationship between global forces and domestic prices.[3] Emerging economies are arguably now benefiting increasingly from the disinflationary trends that have long been a feature of advanced economies. Disruptive technologies – notably the facilitation of outsourcing – have played a key role in that trend.

Lower and less volatile inflation and interest rates in such emerging economies can create a more conducive environment for long-term planning, investment and future growth. Indeed, such stability certainly helps generate a more benign environment for the forces of disruption and creative destruction to develop.

Geopolitical risks

There are, of course, exceptions to this picture. The debilitating effects of economic mismanagement and hyperinflation are worryingly clear in Venezuela, while North Korea's unpredictable behaviour, and the US's reaction to it, have raised overall geopolitical risks (see Figure 5).

5. Geopolitical risk



Source: Forbes. Data as at 11 September 2017.

For the global economy, where supply chains have become ever-more integrated, the risks are clear: South Korea, for example, produces 40% of the world's liquid crystal displays and 17% of its semiconductors.[4] For now, geopolitical risks seem to be treated with equanimity in global financial markets but there is potential for sudden change. Financial markets, after all, have not proved to be very good predictors of major political shocks in recent years.

[3] A phenomenon discussed by Mark Carney, *[De]Globalisation and inflation*, IMF speech 18 September 2017.
[4] *The Economist*, 9 September 2017.

ASSET MARKET PERFORMANCE

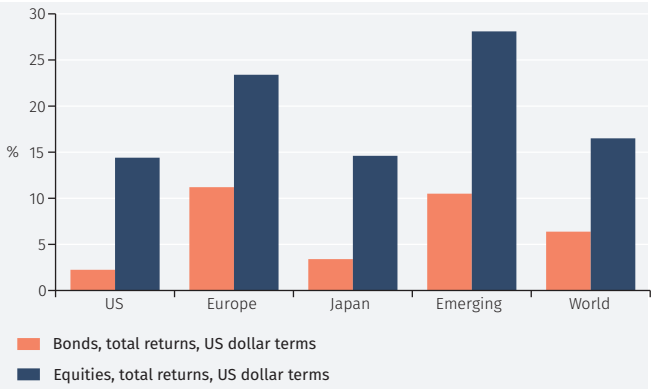
Equities outperformed bonds in the first three quarters of the year in all the major markets. The softening of the US dollar against other major currencies was an important feature.

Asset market performance

Over the course of the first three quarters of 2017, the US dollar weakened against all other major world currencies. The decline was most marked against the euro, against which the US dollar lost 12.1%.

The weakening of the US dollar meant that the 13.0% local currency return from the MSCI World equity index rose to 16.5% in US dollar terms. Overall world equity market returns exceeded world government bond market returns, with the pattern seen across all the main regions (see Figure 6).

6. Asset market performance



Source: Citigroup (bonds); MSCI (equities). Data for nine months to end-September 2017.

Bond markets

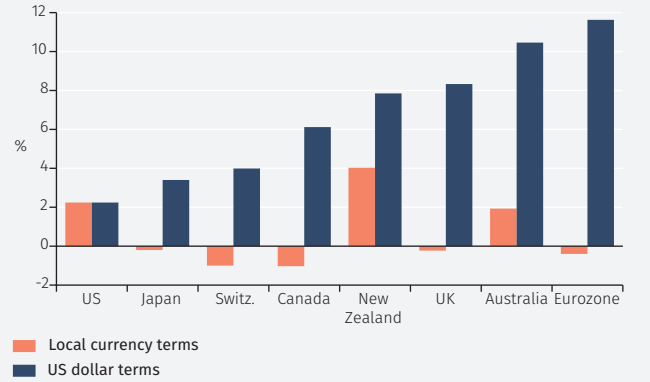
The rise in US government bond yields seen in late 2016 was partially reversed in the first three quarters of 2017: the ten-year government bond yield on 29 September 2017 was 2.33%, lower than the 2.45% end-2016 level. That reflected a general softening of expectations for interest rate increases during the year in the wake of surprisingly low inflation and the failure of hard economic data (such as GDP growth and retail sales) to match the high hopes from strong survey data.

In the eurozone, the 'core' markets (Germany, France, Italy and Spain) saw a general rise in yields, with consequent capital losses; but two peripheral markets (Greece and Portugal) saw yields decline and prices rise (reflecting greater optimism about the sustainability of those economies' public debt positions and, for Portugal, an upgrade in its credit rating).

Although in local currency terms there were marginal losses from overall eurozone bond markets, the strength of the euro against the US dollar transformed that into a gain of 11.6% in US dollar terms (see Figure 7), the best performance of all the major markets.

[5] All on the basis of Merrill Lynch indices in US dollar terms.

7. Bond market returns



Source: Citigroup. Data for nine months to end-September 2017.

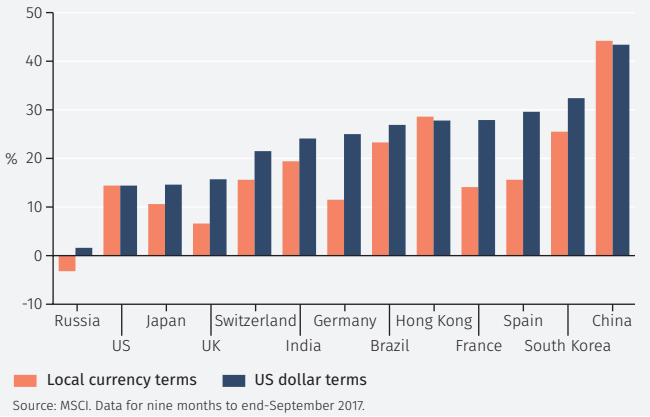
Emerging market bonds and global high yield bonds lagged that performance slightly (with US-dollar terms returns of 10.5% and 9.4%, respectively).[5]

Equity markets

Asian equity markets, notably those of China and South Korea, produced some of the strongest returns in the first three quarters of the year (see Figure 8). In both economies, economic growth remained firm; and in South Korea there was a notable improvement in export orders.

Undermined by currency weakness, the US equity market produced US dollar terms returns which were weaker than those from the major European markets, India and Brazil. The Russian market was one of the weakest, in both local currency and US dollar terms, due to weaker oil prices earlier in the year and the failure to improve relations with the US.

8. Equity market returns



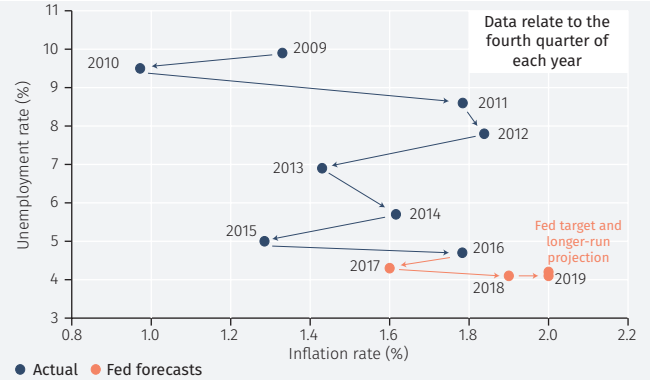
Source: MSCI. Data for nine months to end-September 2017.

'The mystery of the missing inflation' is the key issue the US Fed has faced in 2017. Nevertheless, the start of Fed balance sheet reduction and another interest rate increase are widely expected by year-end.

Mystery of missing inflation

Federal Reserve Chairwoman Janet Yellen recently described the fall in the inflation rate this year as a "mystery". The Fed's preferred measure of inflation – the year-on-year change in the Personal Consumption Expenditure deflator (excluding food and energy) – had moved very close to the Fed's 2% target in late 2016/early 2017. The rate touched 1.9% at that time but then started to decline: after a succession of months in which it came in lower than Fed, and general market, expectations that rate was just 1.3% by August. The Fed's dual mandate means it seeks to achieve low inflation and low unemployment: the latter has been successfully achieved, but inflation has persistently been too low since the financial crisis (see Figure 9).

9. US Fed targets



Sources: Federal Reserve Summary of Economic Projections and Thomson Reuters Datastream. Data as at 1 October 2017.

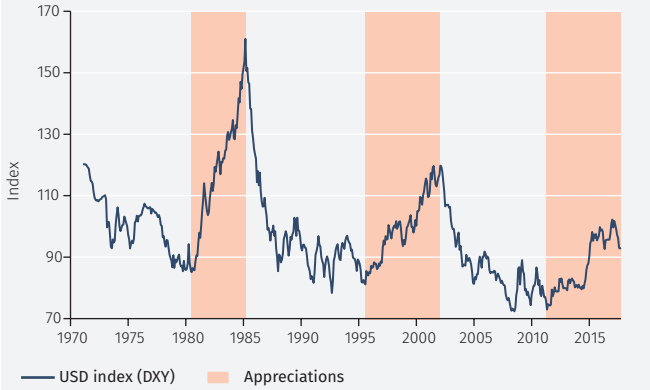
As inflation was first reported to be weaker than expected in the Spring and Summer, the explanation centred on special, one-off factors such as a change in mobile phone tariffs. The mystery was deepened by the fact that three factors which had acted to lower inflation in recent years – slack in the labour market, low energy prices and a strong dollar – were no longer having a depressing effect. Most measures suggest the labour market is close to full employment; energy prices have stabilised and moved higher; and the dollar has weakened (see Figure 10).

Structural causes of low inflation

The explanation of weaker inflation may well rest in important structural changes in the economy. Although these are well known and have been intact for some time, it may be that their influence and importance has intensified recently.

First, disruptive forces have been seen in, for example, Amazon's purchase of Whole Foods. This led to an immediate

10. US dollar index



Source: Thomson Reuters Datastream. Data as at 1 October 2017.

substantial cut in many of that retailer's food prices and a concern that other retailers would be squeezed as a result. The ability to compare prices easily using the internet means retailers often cannot maintain selling prices higher than their competitors.

There is one lesson from history that is potentially useful in understanding what may be happening. The launch of chain stores and mail order catalogues, reducing the reliance on high-priced local stores, is estimated to have cut retail prices by almost a quarter in the early twentieth century.[6]

Second, it is arguably now much more straightforward to outsource production, not just of manufacturing but for a wide variety of services. Technological improvements and integrated supply chains mean that companies no longer have to rely on hiring workers locally to meet higher demand.

Third, competition may have intensified in certain sectors where there is excess capacity. Secondhand car prices are known to have weakened, with at least part of that due to the growth of EVs; domestic US airline prices have been under pressure; and there have been price wars in the clothing sector.

Dollar: end of a trend?

To the extent that these factors reflect the dynamic nature of the US economy, they are welcome. That is one reason why we do not think the recent weakening of the dollar marks the start of a new downtrend. Furthermore, if tax reform plans are eventually agreed, that would provide another structural reason for favouring US assets. And, as always, the US dollar would be a safe haven if geopolitical risks were to increase further.

[6] Robert Gordon, *The Rise and Fall of American Growth* (Princeton, 2016).

Brexit remains the key focus of UK policy and economic developments. Although progress appears slow, we feel that a sensible deal can be agreed, with limited damage to the UK economy.

Brexit update

Although the UK is set to leave the EU in March 2019, the government has recently proposed a transition period of two years beyond that date, during which the UK will remain a member of the EU single market.[7]

Whether this can be agreed with the remaining EU members hinges on agreement on the size of the divorce bill. However, its size, indeed its very existence, remains unclear. Michel Barnier, the European Commission's chief Brexit negotiator recently claimed there was no divorce bill.[8] Rather, it is a "matter of fact" that the UK undertook to pay 14% of all EU budget expenses from 2014-2020. That amounts to €22bn a year and is the source of the claim that the UK can "take back control" of £350 million per week after leaving.[9]

However, the UK receives a rebate on its payments to the EU and payments from the EU (in the form of agricultural and regional subsidies, for example) of a similar amount. These are not taken into account in the £350m claim; and may well not be received during any transition period.

Short and long-term economic impact

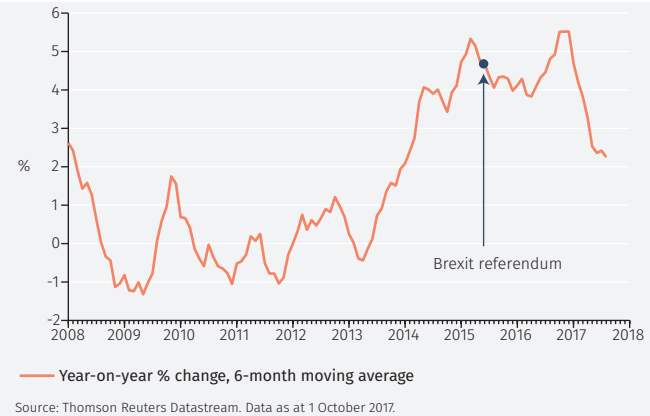
The weakness of sterling following the Brexit decision led to an increase in imported goods prices, which pushed up the inflation rate. At the same time, wage growth has been stable at just over 2%, so there has been a squeeze on real incomes. As the inflation rate subsides, the cap on some public sector wage increases is lifted and private sector wage increases firm (especially for lower-income earners) that squeeze on spending is set to ease.

Retail spending, which has actually held up well, may continue to do so (see Figure 11). Furthermore, the weaker value of sterling has contributed to a narrowing of the UK's balance of payment deficit, mainly because income from overseas has been boosted in sterling terms (see Figure 12); and public sector finances have not shown any deterioration, notably because tax receipts have held up well (see Figure 13).

These conditions make it likely that the 0.25% interest rate reduction made in the wake of the Brexit decision will be reversed soon.

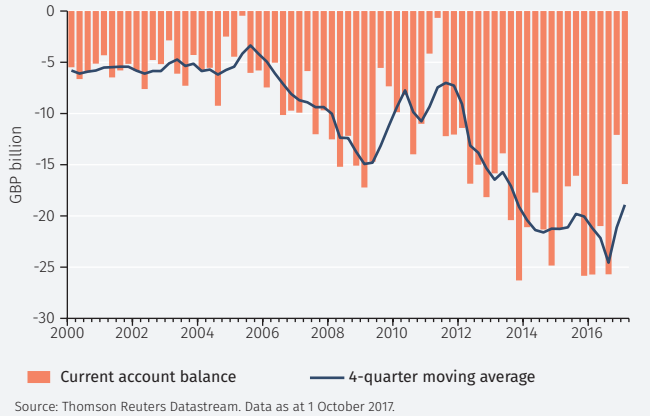
The next 2-3 years are likely to be mired in Brexit uncertainty, but with the rest of the EU enjoying improved economic conditions, the environment for a securing a deal may be more favourable than many expect.

11. UK retail sales



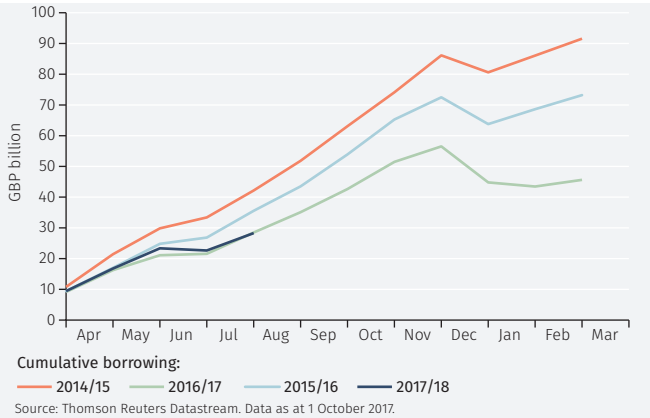
Source: Thomson Reuters Datastream. Data as at 1 October 2017.

12. UK current account balance



Source: Thomson Reuters Datastream. Data as at 1 October 2017.

13. UK public sector deficit



Source: Thomson Reuters Datastream. Data as at 1 October 2017.

[7] See 'Brexit transition turns into "big call" for EU27', *Financial Times*, 28 September 2017.
[8] William Keegan, 'What Barnier really said', *The Observer*, 6 September 2017.
[9] Boris Johnson, *Daily Telegraph*, 16 September 2017.

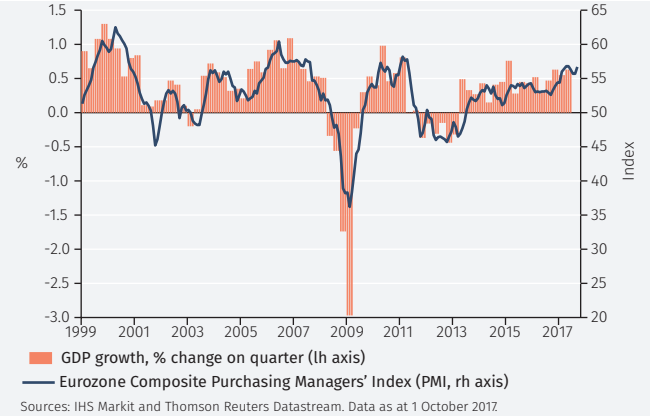
2017 is proving to be a good year for the eurozone economy. Overall economic growth is stronger, labour markets are in better shape and business and consumer confidence remain firm.

2017: surprisingly good growth

It is fair to say that the eurozone's economic turnaround has taken many people by surprise. A year ago, consensus expectations were for the eurozone to register real gross domestic product (GDP) growth of just over 1%, little more than half the rate expected for the US economy.[10]

That gap in expected performance has now largely disappeared with 2.0% GDP growth recorded for the eurozone versus 2.1% for the US.[11] Expectations of eurozone growth at that rate are supported by the trend in the Composite Purchasing Managers' Index (PMI), which has remained consistently in expansionary territory (a reading above 50) for the last four years and which has a reasonable correlation with the trend in GDP growth (see Figure 14).

14. Eurozone GDP growth and PMI index



Sources: IHS Markit and Thomson Reuters Datastream. Data as at 1 October 2017.

It is domestic, rather than export-driven, growth which has fuelled economic expansion so far in 2017. Consumers have been more willing to spend; companies have invested more; and governments have eased up on their austerity measures.

For consumers, record low interest rates, low energy and other commodity prices (as a result of low oil prices and the strengthening of the euro) and an easing of political concerns have been key to their change of sentiment and willingness to spend. Eurozone consumer confidence is at levels rarely seen since the single currency's formation in 1999 (see Figure 15). The key question, looking ahead, is whether this favourable trend can last.

Need for reform

There is a general recognition now that there is a need for reform in Europe. Partly, that has been triggered by the UK's decision to leave the EU; and, perhaps more importantly, by

15. Eurozone consumer confidence

Source: Thomson Reuters Datastream. Data as at 1 October 2017.

the election of President Macron in France. His domestic reform agenda includes cutting public sector employment, a programme of industrial regeneration, state pension reform and a modernisation of labour market practices. His eurozone reform plans involve a common finance ministry and a central budget. His background in finance might also help bring further progress in moving to a closer banking and capital market union.

It would be unwise, of course, to expect the state to provide all of the solutions to Europe's problems. It is fair to say that the forces of creative destruction are less intense in the eurozone than in the US, UK and even China – but there is clearly scope for them to be allowed to work more freely. The European single market, however, especially in services, remains far from complete. It is still constrained in its operations by different regional requirements, business practices and languages. The eurozone is not a market in which, for example, a Finnish lawyer can readily provide services in Portugal; or a Greek electricity company can supply Dutch households.

Premature concerns about ECB tightening

While the overall picture of the eurozone remains one of firm economic growth with subdued inflation, we think that any scaling back of the ECB's asset purchases will take place only gradually and an increase in eurozone interest rates is still some way off. One important reason for that is that the strength of the euro this year acts, in itself, as a tightening – thereby reducing inflationary pressures. Furthermore, underlying broad money supply growth remains relatively subdued, at around 2% year-on-year,[12] suggesting limited inflationary pressures in the next 2-3 years.

[10] *The Economist* (September 2016) Poll of Forecasters
[11] *The Economist* (September 2017) Poll of Forecasters
[12] Source: Thomson Reuters Datastream.

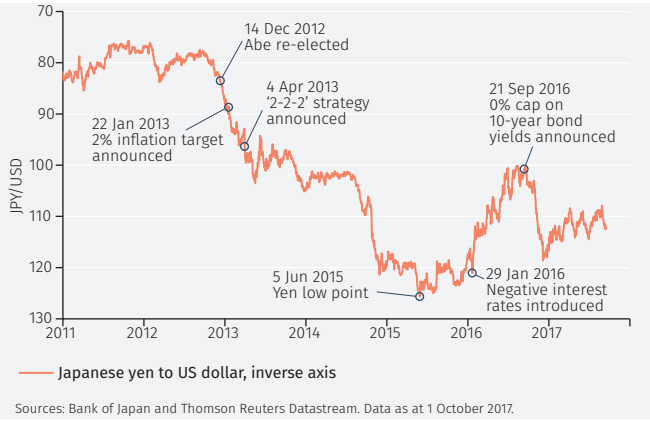
JAPAN

A general election has been called for 22 October 2017. It seems likely that 'Abenomics' will continue, but unpredictability has been a feature of elections around the world in the last twelve months.

Abenomics to continue?

One of the key aspects of 'Abenomics', the set of policies announced by Prime Minister Abe after his re-election in December 2012, was the attainment of 2% inflation. This was to be achieved by the Bank of Japan (BoJ) doubling the monetary base over two years and it was therefore dubbed the "2-2-2" strategy. The policy was initially associated with a weakening of the yen (see Figure 16) and, indeed, such weakness was thought as a key to the policy's success as it raised the costs of imported goods). Initially, the policy met with some success and the inflation rate did rise, albeit due to the weaker currency and the 2013 increase in the sales tax.

16. Japanese yen and Abenomics



Sources: Bank of Japan and Thomson Reuters Datastream. Data as at 1 October 2017.

Longer-term nature of low inflation

Disappointingly for the BoJ, that proved temporary. The latest data show its preferred measure of underlying inflation is running at 0.1% year-on-year – close to its average since 1994.

In that context, the merits of a continuation of the same set of policies would appear questionable. But why has inflation remained so low? There are two sets of explanations. First, those of a global nature: structural factors such as outsourcing to lower labour cost economies, more flexible working practices, the reduced bargaining power of organised labour and technological change.

Second, persistently subdued broad money growth: over the last 25 years this has averaged just 2% p.a. (see Figure 17).

One way in which the problem of persistently below-target inflation could be corrected is to admit defeat and lower the target to, say, 0%-1%. Alternatively, and more likely, renewed efforts to obtain a 2% rate could be made through additional easing measures.

17. Japan: broad money growth

Source: Thomson Reuters Datastream. Data as at 1 October 2017.

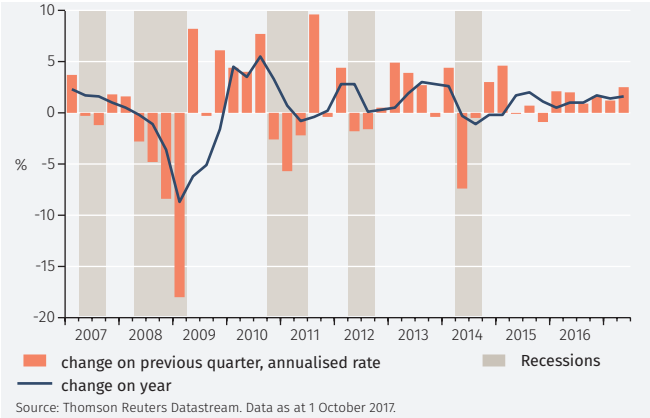
Real economy improvement

While Japan's inflation performance has been disappointing, the economy recently registered its eleventh consecutive quarter of positive real GDP growth, in sharp contrast to the recurrent recessions of the past (see Figure 18). The unemployment rate has reached a historic low; and shortages of skilled workers are reported in many industries.

Japan's economy is set to receive a further boost as it prepares to host the 2020 Olympics. Hosting the Olympics generally provides a boost to a country's real GDP growth (by 0.3% in the year of the event).[13]

However the BoJ policy issues are handled, we think it is appropriate to concentrate on the encouraging real improvements that are taking place in Japan, especially in the domestic economy. These are often under-appreciated by foreign investors.

18. Japan: 11 quarters of expansion



Source: Thomson Reuters Datastream. Data as at 1 October 2017.

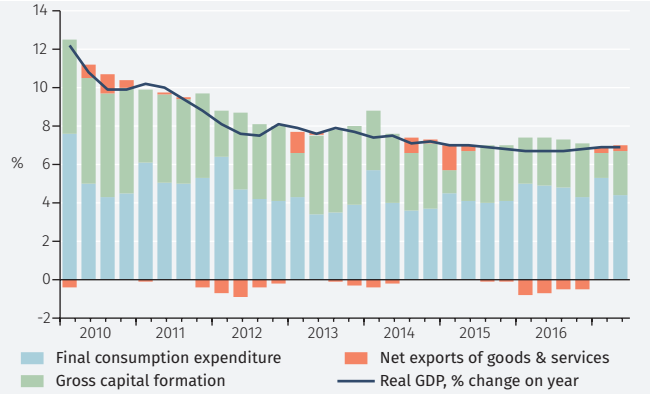
[13] Source: Data from *The Oxford Olympics Study 2016* and Thomson Reuters Datastream. The average covers all the summer Olympics from Tokyo in 1964 to Rio in 2016.

China is making progress on three important fronts: putting its economic growth on a more sustainable basis; stabilizing its currency; and moving towards greater integration in the global capital markets.

China's growth

China's economy expanded at an annual rate of 6.9% in both the first and second quarters of 2017, exceeding the government's target of "around 6.5%". The firm growth rate came despite moves by the central bank to tighten up on mortgage lending and cool the property market. Consumer spending is contributing a steadily increasing share of growth and net export dependence is now relatively limited (see Figure 19): China is still a major exporter but, simultaneously, is also a substantial importer.

19. China: contributions to GDP growth



Source: China National Bureau of Statistics. Data as at 1 October 2017.

Yet, risks remain. Growth has been partly driven by the rapid accumulation of debt. According to the IMF, no economy has seen as fast an increase in private sector debt relative to GDP as China; and the private debt/ GDP ratio exceeds that seen in the US before the financial crisis – and is close to the level reached in Japan before its bubble turned to bust in the early 1990s.

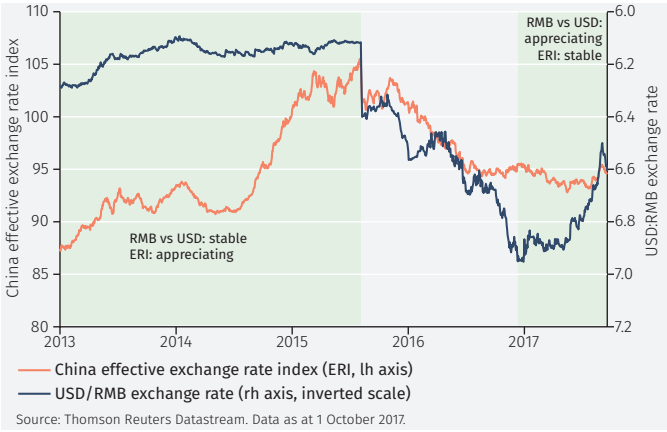
Exchange rate management

One aspect of China's successful economic management which receives less recognition is its stabilisation of the exchange rate. In late 2015, China moved towards a greater emphasis on stabilising the renminbi against a basket of currencies. Prior to that, the emphasis had been on managing the rate against the US dollar. That new policy has worked well: the index has indeed been stable, allowing an appreciation of the renminbi against the US dollar as the latter has generally weakened.

Stock market developments

That currency stability will help as Chinese assets become more widely accepted by international investors. China's share of global stock market capitalisation is currently 9.1% but the market has a weight of only around 3.2% in the MSCI All Country World Index (see Figure 21). The disparity is explained by the fact that China's capital account remains largely closed, restricting the ability of investors to move money freely into and out of China's markets. That has led MSCI to represent only a small proportion of the full stock market capitalisation in their index weighting for China. However, the proportion is likely to rise over time, as the development of systems such as Shanghai-Hong Kong and Shenzhen-Hong Kong Connect allow foreign investors much easier access to China's A-share market via Hong Kong.

20. China: key exchange rates



Source: Thomson Reuters Datastream. Data as at 1 October 2017.

Our longer-term view on China remains a favourable one: that growth will be maintained at a strong rate, with the desired rebalancing; that the private sector will continue to take full advantage of new disruptive technologies; and the financial markets in China will become steadily more integrated with the rest of the world.

21. China's share in the world

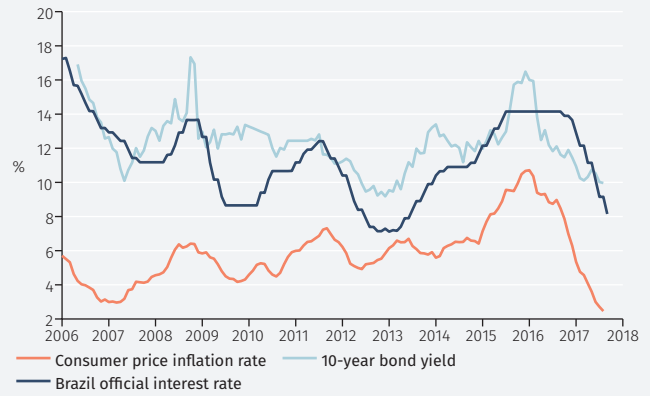
*Purchasing Power Parity.
Sources: MSCI, Bloomberg and Thomson Reuters Datastream. Data as at 1 October 2017.

Latin American growth has generally picked up this year, led by the region's largest economy, Brazil. With inflation falling sharply, further interest rate reductions are likely in that economy.

Growth returns to Brazil

After a multi-year slowdown, 2017 is set to be the year in which Latin America's growth resumes. In Brazil, the largest economy in the region, one of the most welcome surprises has been the very sharp drop in inflation. This has declined to just 2.5% (see Figure 22). With the main policy interest rate at 8.25% and 10-year government bond yields even higher, the prospects for further reductions in interest rates and bond yields look good. Meanwhile, lower inflation and interest rates have boosted consumer spending and Brazil is set to register growth of GDP in 2017 after two consecutive years of decline.

22. Brazil: inflation and interest rates



Source: Thomson Reuters Datastream. Data as at 1 October 2017.

Venezuela is a different story

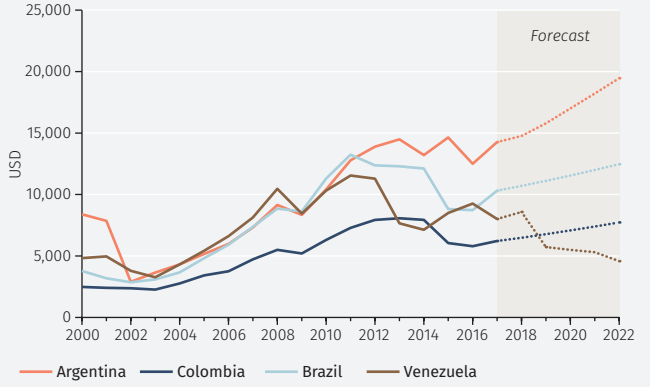
The picture across the region is, however, far from uniform. In Venezuela, the output of the economy is in sharp decline as the inflation rate heads to 1,000% plus, well into the territory generally regarded as hyperinflation (over 500%). Living standards, which have been in decline since President Maduro came to power in 2013 are projected to sink further (see Figure 23). The IMF forecasts a shrinkage in GDP per capita every year until 2022. The end result will be that Venezuela, which had a similar-sized GDP as Argentina in 2007, will be about one-sixth of its size by 2020.

Quite how the difficult situation will come to an end, and then be reversed, is hard to foresee. The monetary reforms used in other economies to curb hyperinflation (such as dollarisation) do not appear to be an option; and the economy is very far away from adopting the policymaking infrastructure that characterises most of the developed world.

Argentina: waiting for the boost from reform

In Argentina, the reforms undertaken by President Macri, who came to power two years ago, have had an adverse initial

23. Latin America: GDP per capita



Source: Thomson Reuters Datastream. Data as at 1 October 2017.

effect on growth and inflation still remains relatively high (at around 20%). It will take time for the effects of the reforms to boost long-term growth prospects. Fiscal policy tightening is clearly having an effect on reducing the budget deficit and restoring order to what have historically been chaotic government finances. But the timescale needed for such policies to work may still be too long for many voters – the country has mid-term elections on 22 October.

Mexico

Mexico remains overshadowed by the uncertainty of the "Trump factor" and, despite the strength of exports to the US, growth this year is forecast to be lower than in 2016. NAFTA[14] renegotiations are continuing: in the end it seems likely that quite modest changes will result.

Tackling corruption

The acquittal of Brazilian President Michel Temer (and his predecessor Dilma Rousseff) on charges of soliciting illegal campaign donations could have proved an important step in demonstrating that the economy has turned a corner in its fight against corruption, had it not been followed by new corruption allegations.

Only two economies in Latin America – Chile and Uruguay – score above 50 on Transparency International's Corruption Perceptions Index. A level below 50 indicates corruption is a serious impediment to growth. Chile, Brazil and Mexico have all slipped back in the rankings in recent years. Argentina is one of the few countries in the region to have made strong gains recently, reflecting the implementation of President Macri's policies. On tackling corruption and putting growth of a firmer footing, Latin America remains very much 'work in progress'.

[14] North American Free Trade Agreement.

So far in 2017, flows into US mutual funds and ETFs have marginally favoured bonds over equities; but since 2012, the two asset classes have attracted broadly similar inflows. What does this tell us?

Long-term mutual fund flows

2017 to date has seen US investors marginally favour bonds over equities, according to data on the flows into long-term mutual funds and ETFs (exchange-traded funds) collected by the Investment Company Institute (ICI), a Washington DC-based company.

In 2008, as the financial crisis took hold, there were substantial outflows from equities; and bonds were favoured from 2009 to 2012. Since the end of 2012, however, the two asset classes have attracted, cumulatively, broadly similar inflows.

What does this indicate about the relative preferences for the two assets?

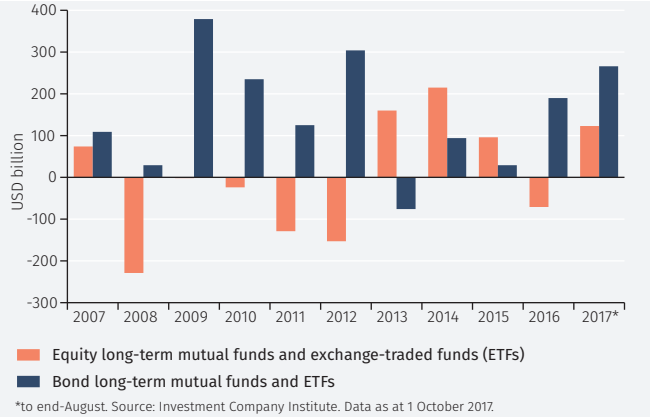
The search for safe assets

The two major equity bear markets since the year 2000 have shaken many investors' confidence in equities as a long-term investment. Within the flows to equities, the last three years have seen a preference for ETFs, which have consistently attracted inflows, more than offsetting the outflows from traditional mutual funds. This may reflect a desire to avoid stock-specific risks; or a perception of the advantages of lower cost index-tracking strategies.

From the gap, to the reverse gap...

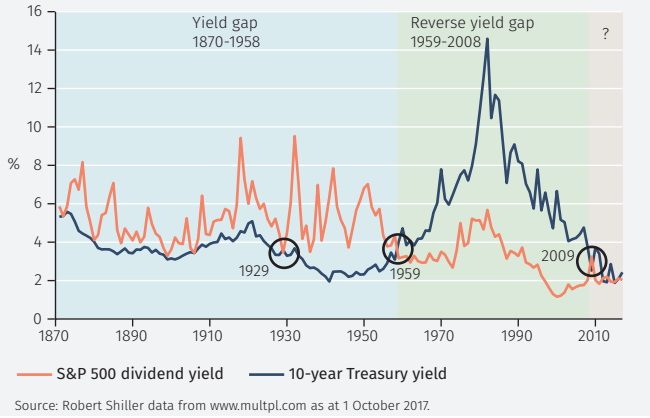
The other, much longer-term, explanation of changes in the relative attractiveness of bonds and equities lies in changing ideas about their relative attractiveness based on yield considerations. Data from Robert Shiller show that for almost a century there was a 'yield gap' between equities and bonds: equities had to offer a higher yield than 'safe' bonds in order to compensate investors for the risk involved in buying equities.

24. US fund flows



*to end-August. Source: Investment Company Institute. Data as at 1 October 2017.

25. US yield gap: a long history



Source: Robert Shiller data from www.multpl.com as at 1 October 2017.

That changed in 1959 when the 'cult of the equity' developed. Equities were seen in a different light. They offered participation in a company's earnings, which could reasonably be expected to increase over time as a result of economic growth and rising prices. A 'reverse yield gap' became the norm, lasting for fifty years until the time of the financial crisis.

...to mind the gap!

What should we expect now? Equities certainly should still be expected to offer the benefits of participation in long-term growth but the world is one in which there are important disruptive forces. What may be seen as a safe company may well have its business model completely disrupted by a new technology.

Looking for future leaders

This disruptive world is one in which we see even greater merit in the advantages of active management. Seeking out the future leaders in a rapidly evolving global marketplace should, we think, be a primary focus. Such a strategy should certainly be able to provide better returns than low-yielding bonds and passive equity strategies.

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