2018: What Could Go Wrong?

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Everything seems to be going perfectly for the stock market. Global growth is synchronized and accelerating. Inflation is still low. Earnings should reach double digit growth in 2018. Consumer and business confidence are at multi-year highs. And the recently passed tax reform bill should provide a strong tailwind for S&P 500 earnings and U.S. GDP growth. It's no wonder that stock markets are setting new highs on a daily basis.

Of course, when things are looking so good, it's prudent to take a step back and look for potential negative events that could derail the rally. Valuations are at historically high levels. Investor sentiment is optimistic, bordering on euphoric. But these factors alone do not end market rallies. A catalyst is needed. Below are some potential events that could causes a market correction later this year.

Central Bank tightening:

There is little doubt that the massive amounts of global quantitative easing (QE) by the world's major central banks has provided liquidity to the global markets and bid up asset values. As QE winds down and eventually reverses, will this also reverse some of the market appreciation? This is certainly a risk for 2018.

The combined size of the major central bank balance sheets is still growing although the growth is decelerating. Of the four major central banks (The Fed, ECB, BoJ, BoE), only the Fed is planning to shrink its balance sheet in 2018. The aggregate of the four is expected to increase by an estimated +$451b in 2018. This would represent +2.25% growth over 2017's combined balance sheets but would be 1/3 the growth rate compared to 2017 over 2016.

So the question will be what matters more for the liquidity effect on the stock markets, the absolute level of the balance sheets or the second derivative change? And will the market look forward in 2H'18 to a 2019 where the absolute level of balance sheets will decline.

As of October 2017 the Fed has begun the process of unwinding its balance sheet by $10b a month, growing by $10b each quarter until it reaches $50b/month. This pace is expected to remove $1.4 trillion in Fed reserves over the next four years. So far this has had no effect on market liquidity. But this unwind is uncharted territory for the Fed and it is unclear how things will end up, especially considering the extreme growth in the Fed balance sheet since 2009 (see chart on following page).

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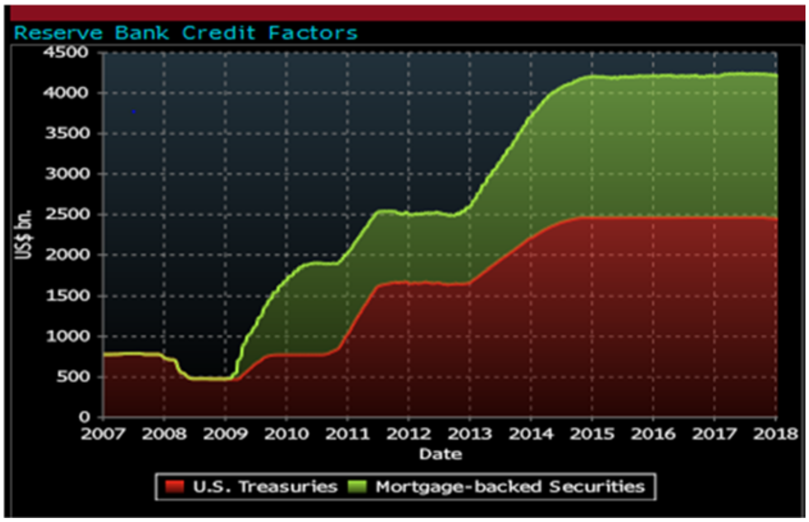

Source: Bloomberg

The ECB tapered its QE at the start of the year through Sept'18 to 30b EUR (from 60b EUR). It is likely that the bond buying will stop after this date as the ECB has been remarkably accommodative considering the improving economic conditions of the Eurozone. Several officials within the ECB governing council have struck a more hawkish tone of late. And the probability of an ECB rate hike at the Dec'18 meeting has risen to 52% from just 26% one month ago.

The Bank of Japan (BoJ) is still planning to expand its balance sheet throughout 2018 to try and reach its illusive 2% inflation target. But it has been trimming monthly purchases of longer-date government bonds. Some believe this is the start of a shift away from its ultra-accommodative policy.

The BOE has stopped its latest QE program but has not indicated when it plans to start unwinding its balance sheet. It did implement its first interest-rate increase in a decade this past November.

China Slowdown

China has become a large driver of global growth so any slowdown there should be watched closely. The volatility in China's stock market, currency, and FX reserves in mid-2015 caused a global market sell-off, including the flash crash of Aug 24th.

China's economy was stable in 2017, with GDP growth of +6.9%. Estimates call for a decline to +6.5% growth in 2018. This rate of slowdown would not be enough to derail the global economy. The risk is if China's deceleration is much sharper.

The Chinese government started tightening financials conditions in 2017 in order to control financial risks, limit shadow bank lending, and prevent a future credit bubble. As shown from the chart on the next page, liquidity really started tightening in the 2nd half of last year.

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Source: RENMAC

The government is also focusing more on quality growth rather than maximum GDP at any cost. While this is healthier for the long-term, it could lead to a sharper slowdown in 2018 than markets are anticipating. It takes some time for the tightening's impact to be felt in the economy but early signs are here. Dec'17 economic data was softer overall including large decline in bank loans, money supply, and retail sales.

Property prices have also declined of late. Home prices fell 0.3% in November from a year earlier In Beijing and Shanghai. Prices also dropped in some other large cities such as Chengdu and Shenzhen. This compares to price increases between 20-30% y/y, just one year ago. Chinese property activity was one of the engines of global growth in 2017 so this decline is something to pay close attention to.

Trade Wars

One of the major risks heading into the Trump presidency has been trade wars. That risk did not play out in year one but things could heat up in 2018. The administration will most likely rule in favor of domestic industries in import cases involving aluminum, steel, solar panels, and washing machines. The U.S. is also weighing an aggressive response related to its broader investigation of Chinese trade practices, including a section 301 investigation of China's treatment of intellectual property. Any action by the U.S. will most likely be followed by Chinese retaliation, with the net result being negative for the global financial markets.

There is also the risk that the U.S. pulls out of NAFTA. Negotiations have been ongoing with no progress made so far. It's conceivable that the U.S. could even pull out of the WTO, which would certainly shake investor confidence.

Mid-term Elections

Uncertainty heading into the Nov'18 mid-term elections could create a market sell-off. The recent pattern with elections has been that the market sells off during the pre-election uncertainty, then rallies post-election regardless of result. However, with the economy accelerating, the market will probably favor the status quo and react favorably to the Republicans holding on to the senate and/or House. Therefore, a Democratic sweep could create short-term volatility.

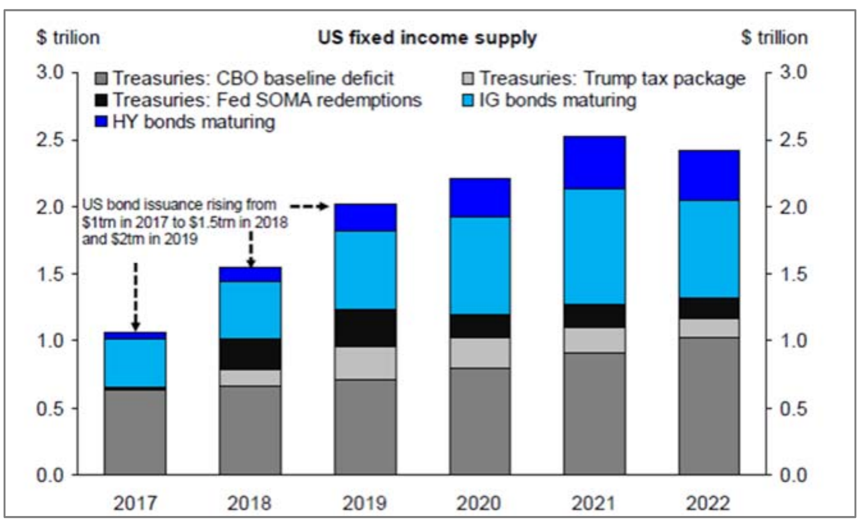
Democrats need to pick-up 24 seats in the House, which is about the average House mid-term loss for the party in the White House since World War II. In the Senate, the Republican margin is now 51-49 after the GOP loss of the special election in Alabama. A lot more Democratic seats are up for election this year (26) compared to those held by Republicans (8), so Democrats start with more vulnerability. But the recent voting results in Virginia and Alabama signal that a 2018 Democratic wave is possible. Keep an eye out for the special House election in Pennsylvania this March and another one in Arizona in April to see if the Dems momentum continues.

The health of the economy (accelerating GDP growth, robust job market) should help the Republicans. The question for them is if this is enough to offset President Trump's low approval rating. Currently, Trump's approval ratings are the lowest of any president at this point of the presidential cycle.

Runaway Interest Rates

Since bottoming in July'16, treasury rates have been moving upward, albeit in a gradual manner. The controlled rate increase has been positive for the stock market. A risk for 2018 is interest rates start increasing at a pace that equity investors are not comfortable with. This move could be caused by inflation finally emerging or an over-aggressive Fed hiking interest rates more than expected.

Another possible reason for a spike in interest rates could be the changing supply-demand dynamics with treasury bonds. Because of the rising government budget deficit and the Fed running down their balance sheet, the supply of US bonds will roughly double from 2017 to 2019 (see chart below).



Source: Deutsche Bank Research January 2018

Will there be enough demand to soak up all this supply? One key component of Treasury bond demand, foreign buyers, will most likely decline. Foreign investors currently hold 44% of outstanding Treasury bonds. As the QE in Europe and Japan is decreased and eventually withdrawn, the relative attractiveness of U.S. treasuries from foreign buyers will be reduced. China and Japan have already started reducing their treasury holdings.

Another big source of demand has been mutual fund buying. Could 2018 finally be the year of the "Great Rotation" where fund flows reverse out of bonds and into equities or cash? This is possible if bond holders actually start experiencing losses for the first time in memory. Inflows into domestic bond mutual funds and ETFs has been a cumulative $1.8 trillion since 2008. This compares to negative inflows for domestic equity funds over the same time period. A reversal of this trend would obviously be another blow to fixed income demand. Of course if the bond fund outflows went into equity funds, it would provide yet another lift to this bull market.

Geopolitical Events

North Korea/Iran: Although a low probability, there is a chance that the conflict with North Korea or Iran escalates into something much more dangerous.

Italy: Another political risk is the upcoming Italian election, scheduled for March 4th of this year. If The Five Star Movement (M5S) gains power, there is a chance they will attempt to leave the European Union. Since Italy is the 3rd largest country in the Euro Zone, this would endanger the future of the EU.

Black Swan event: Something completely off most investors' radar could emerge in 2018 to spook the market.

Conclusion

Despite heightened valuations and investor sentiment, it makes sense to stay invested in this stock market. Earnings are accelerating, global economic growth is booming, central banks are still relatively accommodative, and there are no immediate geopolitical risks. However, while one is enjoying the daily new highs, it pays to prepare for the inevitable next downturn. While we don't predict market tops, our proprietary indicators and vigorous monitoring of potential negative catalysts can be useful in properly positioning portfolios as risk levels rise.

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