EQUITY

# Winded Markets May Face a More Difficult Climb in 2018

December 26, 2017

admin

Global stocks benefited from broad economic growth in 2017, and some forecasters expect growth next year to be slightly better. Yet Franklin Equity Group's Coleen Barbeau thinks equity valuations, particularly in the US market, already reflect that rosy outlook. Here, she explains why investors should be cautious as we enter the new year.

Coleen Barbeau

Senior Vice President, Director of Portfolio Management
Portfolio Manager, Franklin International Growth Fund
Franklin Equity Group®

After running hard in 2017, global equity markets may find it more difficult to maintain pace in 2018. Although we think the economic backdrop is likely to remain largely unchanged in the new year, we see a more entrenched global economic recovery giving central banks more leeway to withdraw stimulus.

This past year, the information technology sector and other growing areas of the market have benefited from optimism about the global economic recovery and improving corporate earnings.

We've also seen ebbing political and policy fears. The populist impulse that characterized 2016 looks to have receded. In 2017, a number of world leaders from Chancellor Angela Merkel in Germany to Prime Minister Shinzo Abe in Japan won reelection.

As economic conditions have continued to improve in Europe and parts of Asia, we have seen markets outside the United States push into the lead. Emerging markets also began to outperform in 2017, amid sturdy growth in China and India and a turnaround in Brazil.

**Why the Favorable Global Backdrop Should Persist in 2018**

As we near 2018, we think the global economy can continue to hum along. According to the International Monetary Fund, the pace of global economic growth is likely to remain steady in 2018, with global gross domestic product growing a projected 3.7% in 2018 after expanding 3.6% in 2017.[1]

Based on projections, we think the United States is likely to see solid growth, low inflation and limited wage growth, while in Europe the economic expansion can become further entrenched. Growth in China may weaken modestly amid a slowdown in the property market and government investment.

In addition, we think Chinese President Xi Jinping is likely to continue the government's crackdown on corruption and the shadow banking system. We believe Xi has carefully orchestrated the implementation of both of these measures so as to not rattle markets.

In Japan, the global economic expansion has fed through to a better equity market performance in 2017. However, the country has an aging population and limited immigration policies that have led to labor shortages that have kept the recovery anemic.

As a result, we think Japan may be the only economy to still maintain an extraordinary monetary policy throughout 2018. Although the focus on the yield curve has led to fewer bond purchases, the Bank of Japan may have little choice but to continue to inject significant amounts of liquidity into an economy that remains beset by demographic challenges.

In contrast, monetary policy in the United States by the end of 2018 may look almost normal, with the US Federal Reserve likely to hike rates two to three times while continuing to shrink its balance sheet.

We also expect the European Central Bank to likely be in a place to end its quantitative easing program and begin policy normalization by the end of 2018. However, at this time, it’s unclear how markets will react as balance sheets are unwound and quantitative easing ends.

**Finding Value in Global Equity Markets**

We believe this rosier global outlook is largely priced into global equities. The US market is looking the most expensive to us at a time when US corporate earnings are already well past their prior peaks.

In our view, many other markets are less expensive, but more fairly valued on a historical basis and will need to see a significant pickup in earnings growth to continue their run. And with the US market having gone more than a year without a major correction, we see the heightened potential for the advance to falter.

We see a number of issues that could throw stocks off their stride in 2018. A more protectionist US trade policy and potential changes to the North America Free Trade Agreement could bring new economic uncertainty into the global economy. In addition, the US decision to pull out of the Iran nuclear deal or a ratcheting up of tensions in the Middle East as Iran and Saudi Arabia vie for greater influence could also have dire consequences for the region and investor sentiment.

For these reasons, we think 2018 may be a more challenging year for stocks overall. However, we believe it can create greater opportunities for individual stock selection. We anticipate that non-US companies with compelling secular growth stories and unassailable competitive advantages can standout regardless of how the broader markets perform over the course of the year.



**What Are the Risks?**

**Franklin International Growth Fund**

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size and lesser liquidity. These and other risk considerations are discussed in the fund's prospectus.

*Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.*

---

1. Source: International Monetary Fund, World Economic Outlook, October 2017. There is no assurance that any estimate, forecast or projection will be realized.