BBVA | Research

The financial markets in 2018 - key factors

Diario Expansión (Spain)

Sonsoles Castillo

02 Jan 2018

The new year will probably start much as the old one ends, with the markets in positive mood. Risk appetite has been the dominant note for much of the year, except for a few brief bouts of volatility generated by political events (elections in Europe) and geopolitical tensions (North Korea and the Middle East). A final push has come from the recently approved US tax reform, which will have a positive impact on growth in the next two years.

It is not a bad balance, bearing in mind that this past year was beset by lingering doubts about the strength of the economic recovery together with a high degree of political and monetary uncertainty in the three major economic areas. In the United States, serious questions arose as to the continuity of the Trump administration's economic and foreign policies. In Europe, the threat came from the rise of populism; in China, from what political and economic agenda the communist party would decide on for the next few years. Not to forget that 2017 was also the year in which the US Federal Reserve took renewed steps to normalise its monetary policy. Not only did it raise interest rates by 75 basis points, but it also started to drain liquidity from the system by embarking upon the reduction of its balance sheet.

Nonetheless, with no major disruptive events, and with a surprisingly positive economic cycle, investors have continued to take risks, seeking returns in all asset classes and geographical regions. To the point where a growing number of opinions and indicators are saying that some assets may be starting to be overvalued. And this is the first of the key factors to consider for 2018.

The second one will be liquidity. Yes, 2018 will probably be the year in which world liquidity sees its first inflection point since the onset of the global financial crisis. Now that the improvement in the economy is confirmed, the major central banks, not just the Federal Reserve, will have to start withdrawing the monetary stimulus measures, otherwise they will run an increasing risk of financial instability. The European Central Bank will end its asset purchasing programme in the autumn, and sooner rather than later the Bank of Japan will do likewise. So the litmus test will be investors' reaction to an environment of less plentiful liquidity and higher financing costs. In principle, the emerging markets may suffer most from this change in global monetary conditions, since a large part of the capital inflows they have seen in the past few years is thought to have been due to the abundance of "global liquidity".

The third key factor in my opinion will be what happens with long-term interest rates. The great unknown. So far neither the Federal Reserve's rate hikes nor the improvement in the economic cycle have triggered the dreaded sell-off in the bond market. Long-term interest rates have remained firmly anchored, well below what we might consider to be values consistent with expectations of improving growth and inflation in line with the Federal Reserve's target. We know that there are structural arguments explaining why interest rates are lower than in past decades, but that does not necessarily mean that we are at sustainable levels. Especially if we suddenly start to see unexpected upticks in inflation, something we have grown unaccustomed to. A combination of rising oil prices, the closing of the output gap associated with a more advanced phase of the economic cycle and the tightening of the labour market in certain countries could fuel inflation.

Admittedly the bright economic outlook invites optimism. There are reasons to think that the positive tone of the markets may continue in 2018. But we must bear in mind that this has largely been factored in already and that we shall have to adapt to a context of less liquidity in which some readjustment to long-term interest rates seems inevitable. An end to complacency?

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.