First State Investments

MULTI-ASSET OUTLOOK 2020: TO BE OR NOT TO BE "IN RISKY ASSETS"

- Familiar challenges remain in 2020. On the one hand, manufacturing activity and global trade has slowed substantially and expected returns are relatively low across asset classes.
- On the other hand, monetary policy continues to be supportive with further easing expected despite diminishing returns. Further, both corporate profitability and consumer activity remain strong.
- The 'swing factor' is a potential de-escalation of the various geopolitical concerns (global trade disputes, Brexit, Middle East tensions) and perhaps even fiscal policy easing for good measure. A re-escalation of the key geopolitical flashpoints would be a clear negative, however.
- Fundamentals (both macroeconomic and corporate) are intertwined with political developments as a resolution in trade uncertainty could quickly improve business confidence, capital expenditure, and ultimately feed through to the labour market in the form of lower unemployment and higher wages.

Geopolitical tensions continue to brew

We expect the US economy to extend the longest expansion in history and China to stabilise their economy successfully, absent any material external shocks. Chinese stimulus should hopefully bolster export demand and prove beneficial to the rest of the world, particularly Asia. The 'phase one' trade deal appears on its way to agreement, with tariffs on Chinese exports set to reduce and US exports to China expected to rise. However, as we can often see with these two superpowers, the ebbs and flows of positive progress can change instantly at the hands of both Beijing and Washington politicians. Further, the lagged impacts of global monetary easing should provide a tailwind for financial conditions and help boost economic activity after the US Federal Reserve saw three rate cuts in the second half of 2019.

Europe will be hoping for a speedy resolution to trade disputes to lift growth prospects as the European Central Bank ('ECB') – with their new President Christine Lagarde - appears to be out of viable policy options. We find it unlikely that Europe will manage to embark on a meaningful quantitative easing program while persistently low inflation and an internally divided ECB means that rate rises are also unlikely. While Brexit ramifications will remain a prolonged issue for Europe, new tensions are emerging with the rest of the world. The US and Europe have had a few unpleasant trade talks, whilst China and Germany are also facing altercations. Outside of coping with the effects of global trade disputes, the Eurozone could also be facing a new migration crisis as indicated by Turkey's President Erdrogan, accompanied by several national elections across the region.

Populism still popular

The political cycle will take centre stage in 2020 as political tensions escalate. The biggest event of the year is likely to be the US election although Brexit and European politics both get an honourable mention. After a conservative majority win in the UK general election in mid-December, all eyes are on Prime Minister Boris Johnson to see if he can be the first to meet the latest Brexit deadline, which is now set for 31 January 2020. Even if he does manage to construct a deal by then, this is just step one in a very complicated process. While Boris may have secured his seat, President Trump's 2020 election campaign may be distracted by noise surrounding his impeachment. Tensions have sparked in the Middle East and the region will be a particularly volatile point of attention throughout the year. Regardless of Trump's controversial policies and views, the US has told a good economic story whilst in Trump's hands. Low unemployment and steady GDP growth will continue to underpin optimism as long as trade disputes make progress and manufacturing strengthens.

Emerging market equities struggled to match the performance of their developed counterparts over 2019 and in 2020 we could see local political disputes, such as within China and Latin America, escalating. Notably, semi-autonomous Hong Kong has faced growingly violent anti-government demonstrations since April 2019. After the economy entered its first recession since the Global Financial Crisis, the forecast for the 2019 annual growth figure has predicted a 1.3% contraction. Despite this, an improvement in trade tensions should ease economic pressures for Hong Kong. Similarly, demonstrations in Chile appear disorganised and without strong direction. Nearby Argentina and Venezuela also face political action with less severe economic contractions predicted for 2020. All of these political flashpoints have the potential to spill over to other economies and disturb investor risk appetite.

Fundamentally speaking

As we move later into the economic cycle, a close eye will remain on equities outside the US, noting that recent earnings from Japan, China and the Eurozone have been lacklustre. Manufacturing surveys from most major economies have also tumbled quite a bit this year, with hopes that they have finally bottomed out. While the Eurozone, the US and Japan PMI numbers are still sitting in contractionary territory (less than 50), the ease in trade tensions is likely to continue supporting China after dipping to 48.3 in January 2019 and finishing 2019 above 50.

While we do not expect an imminent pickup in business investment, the US consumer remains strong and should drive the US economy. The consumer has reduced leverage, seen strong employment and wage growth, and benefited from rising asset prices. Globally, we expect inflation to remain muted and have lowered our expectations for inflation in emerging markets in our most recent asset allocation review.

Asset allocation and portfolio positioning:

Despite the various risks on the horizon, we are not shying away from having risk in our portfolios – however, this needs to be done in controlled and diverse manner. Remember: cash is the one asset class that is virtually guaranteed to deliver a negative real return in the period ahead. Therefore, our portfolio positioning going into 2020 focuses on global developed market equities, short-maturity bonds, and credit with diversification and liquidity being the key themes.

Growth assets

While stock markets globally continue to achieve all-time highs, we remain focused on the fundamentals and remind ourselves that bull markets do not simply die of old age. The US, notably, has had an equity bull run for just over a decade, with unemployment at a 50-year low and consumer confidence almost at a 20-year high. As such, we expect global equities to deliver earnings growth near historical trend levels with emerging markets benefiting from possible weakness in the US dollar following the reversal in monetary policy (i.e. shift to cuts in interest rates from previous rises). This liquidity provided from several central banks will encouragingly lower the risk of recession – for now – but commercial bank lending may remain subdued a little longer. Therefore, we prefer developed market equities while remaining cautious of their emerging counterpart.

Commodities finished 2019 with the Bloomberg Commodity Spot Index at its highest since late 2018. Even with the risk-on mood, precious metals such as gold moved higher at the end of 2019. We expect the trade deal optimism to support demand expectations. Oil prices were on the steady upward move during the year, with this trend expected to continue as OPEC nations have agreed to reduce production by the end of Q1 2020. Middle Eastern geopolitical flare-ups will almost certainly raise volatility across the energy complex this year.

With respect to currency, we continue to take global equity exposure unhedged although looking to hedge global fixed income exposures given relative currency valuations.

Defensive assets

Within fixed income, We remain negative on global government bonds with a preference for both investment grade corporate credit and emerging market bonds (hard currency). Overall, fixed income markets may face challenges this year, as most credit markets appear expensive relative to historical averages. Interestingly, global investment grade corporate bond spreads averaged 0.70% leading up to the Global Financial Crisis before a major sell off. More recently, spreads fell to around 0.85% in early 2018 before widening to 1.50% in early 2019. Current spread levels of below 1.00% are expensive relative to the long-term average of around 1.40%. While there is room to move lower, we do not expect anything substantial given the changes in the market composition and liquidity characteristics.

During 2019, we reduced our exposure to longer dated sovereign bonds as trade concerned weighed on growth prospects and yields fell. Negative yields, especially in Europe, illustrate the extent of downbeat expectations for growth and inflation. We believe improvement in the economic outlook will lift longer dated yields, steepening their yield curves and leading to negative returns for investors in the period ahead. US 10-year Treasury yields may rise incrementally but are unlikely to surpass 3%, in our view.

In Australia, the economic outlook remains subdued with a few signs of inflationary pressure coming through. The nation has also been battling catastrophic bushfires over the second half of 2019. While it is unknown how long the fires will continue for in 2020, negative impacts are expected on agricultural production, rural infrastructure and rural exports after losing livestock. We would expect construction activity to lift eventually as decimated private and public capital is repaired. While we have heard persistent talk about a possible rate cut by the Reserve Bank of Australia, we think it is unlikely. Australian bonds delivered their best performance in five years during 2019, and we are sceptical on whether this can continue quite as well in 2020. As large investors like pension funds seek to de-risk as the cycle continues on, bond yields will likely remain anchored at historically low levels. We prefer to hold fixed income exposure in emerging markets, which we believe provide diversification at attractive yields in higher growth, albeit slowing economies.

Kej Somaia
Co-Head of Multi-Asset Solutions

Source: First State Investments, data as of 10 January 2020.