Market review

A growing trend towards sustainable investing

2019 began with some uncertainty following the challenges investors faced in 2018 when, for only the second time since 1900, both equities and bonds generated negative returns. Markets in 2019 provided something of a reprieve although the challenges that characterised the previous year did not fully disappear. There were gradual and periodic improvements in trade relations between the US and China and lower interest rates continued with rate cuts in the US.

But the trends of the year were not only driven by economic factors. 2019 also saw investors increasingly look to their investments to address global challenges relating to the environment and broader society. Against a backdrop of widespread climate protests and social unrest across the globe, investors increased their focus and asset allocation towards sustainable investing to ensure that their money was put to work in a responsible way.

How economic factors affected markets

On the economic front, much of the focus was on the Federal Reserve which, having raised rates throughout 2018, reversed their view in 2019 and cut interest rates three times during the year. Whilst this was welcomed by investors, it was clear that the cuts reflected concerns about US growth prospects. Concerns that were heightened in the first quarter when short-term rates moved higher than long-term rates. This yield curve inversion has historically preceded a recession.

It was not just the US that suffered with signs of slowing growth. The Chinese economy experienced its worst growth in nearly three decades, prompting both the government and the central bank to take steps to support the economy. Some of the slowdown can be attributed to weaker trade because of the US-China trade war which began in 2018. To date, the US has applied tariffs of around $500 billion on Chinese exports; China in turn has imposed $185 billion worth of tariffs on the US.

Europe was also afflicted by growth concerns. Italy moved into recession at the beginning of the year while Germany, the largest economy in Europe, narrowly avoided doing so during the year. However by the third quarter, the economic outlook was sufficiently negative that the central bank opted to introduce a number of growth-supportive measures. Europe also remains at risk of becoming involved in its own trade war with the US. Duties have been imposed upon European steel and aluminium exports, while the automobile industry is widely viewed as the next to be at risk.

The UK was also not immune to fears around growth, but did just manage to avoid recession. No interest rate cuts were forthcoming however, as the central bank appeared optimistic that global growth would stabilise and a Brexit deal would eventuate. The year was defined by an ever shifting Brexit timeline and narrative, with the country undergoing a change in prime minister, a general election and three extensions of the Brexit deadline.

Risk appetite returns to financial markets

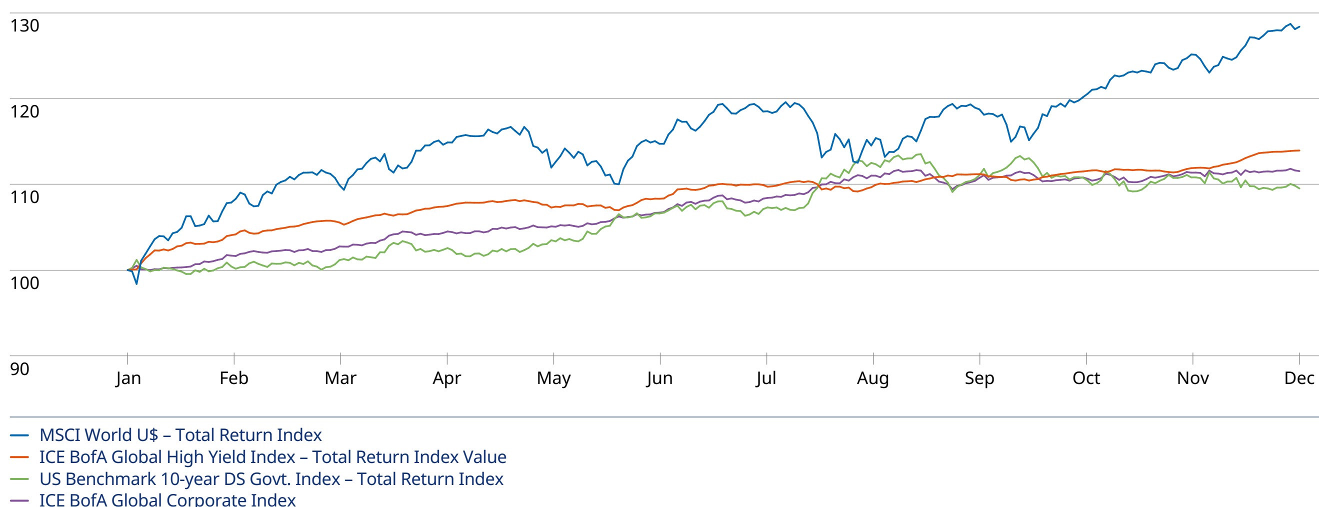
In contrast to the previous year, financial markets in 2019 generated widespread positive returns. Riskier assets outperformed, with equity markets generally outperforming fixed income assets. In turn, the riskier, lower quality and high yielding parts of the bond market outperformed better quality, but lower-yielding, government bonds.

Within equity markets, growth assets performed especially well given the combination of a relatively muted growth and low interest rate environment. The MSCI World Growth Index returned 34.1% in US dollar terms over the period. However, as the year progressed, more value-oriented shares saw something of a recovery with the MSCI World Value Index posting returns of 22.7%, driven to some extent by the attraction of extremely low valuations in these parts of the market.

In terms of regional performers, the US stock market once again stood out, with the S&P 500 Index returning 31.5%. Europe also performed well; the MSCI EMU Europe returned 26.5% in euro terms, helped by the economically-supportive policy measures implemented by the central bank during the year. UK indices delivered a more muted performance, with Brexit uncertainty limiting investors' risk appetite. The FTSE All Share posted returns of 19.2% in sterling terms.

Many Asian markets have been amongst the most heavily impacted by the US-China trade dispute, given their importance in global supply chains. Slowing Chinese growth was unhelpful too, as the wider Asian economy relies heavily on Chinese demand for its products.

Asset class returns in 2019



Source: Schroders. Thomson Reuter Refinitiv data correct as at 31 December 2019. Total returns form MSCI World Index, BofA Global High Yield Index, BofA Global Corporate Index and US 10-year Treasury priced in dollars. Past performance is not a guide to future returns.

The MSCI China Index returned 23.3%, as the economy was impacted by challenged trade relations with the US. Emerging markets as a whole came in behind their developed peers with the MSCI Emerging Markets Index returning 18.9% in US dollar terms (18.5% in local currency). US dollar strength weighed on those markets with dollar-denominated debt as well as commodity exporters.

The US dollar acted as a safe haven currency for investors' nervousness and consequently strengthened through most of the year. It ended the year only slightly lower as optimism on the US-China trade war increased. The euro depreciated over the year as central bank policy measures lowered the attractiveness of the currency for international investors. Sterling was the stand out performer, ending up 4%, although it was also highly volatile reflecting changing sentiment on Brexit.

Amid growth fears and expectations of ongoing cuts to interest rates, bond market yields fell as prices rose over the year. Corporate bonds, especially those in high-yielding, riskier parts of the market, outperformed government bonds as investors responded to improved risk sentiment as the year progressed, searching for ways to generate income in a low interest rate environment. Emerging market bonds benefited from these factors too and performed well.

The less risky part of the bond market, government and investment grade corporate bonds, also put in a good performance. The US 10-year Treasury yield ended the year significantly lower at 1.91% down from 2.69% at the start of the period. On two occasions during the year, it moved lower than the yield on the three-month Treasury bill.

European government yields also saw significant moves lower. The German 10-year yield fell below zero early in the year, as did France's later on. A growing proportion of bond yields became negative yielding during the year. Italy's 10-year yield declined from 2.77% to 1.42% while the UK's 10-year gilt yield also fell from 1.27% to 0.82% as both countries experienced significant political uncertainty.

Outlook

Looking forward to 2020, the world remains as unpredictable as it was at the end of 2019. The year had started off reasonably well given investors' relief about the signing of an initial trade deal between the US and China. This should have been beneficial for global trade and capital investment, boosting economic growth in the UK, Europe, Japan and the US.

However, the outbreak of Covid-19 creates a new and highly unpredictable challenge. Whilst we had expected global economic growth to improve, we now expect there to be a marked slowdown in activity, particularly in Asia. The eventual outcome is very dependent on how successful authorities are at containing the outbreak. The backdrop will be further complicated by the outcome of the US presidential election.

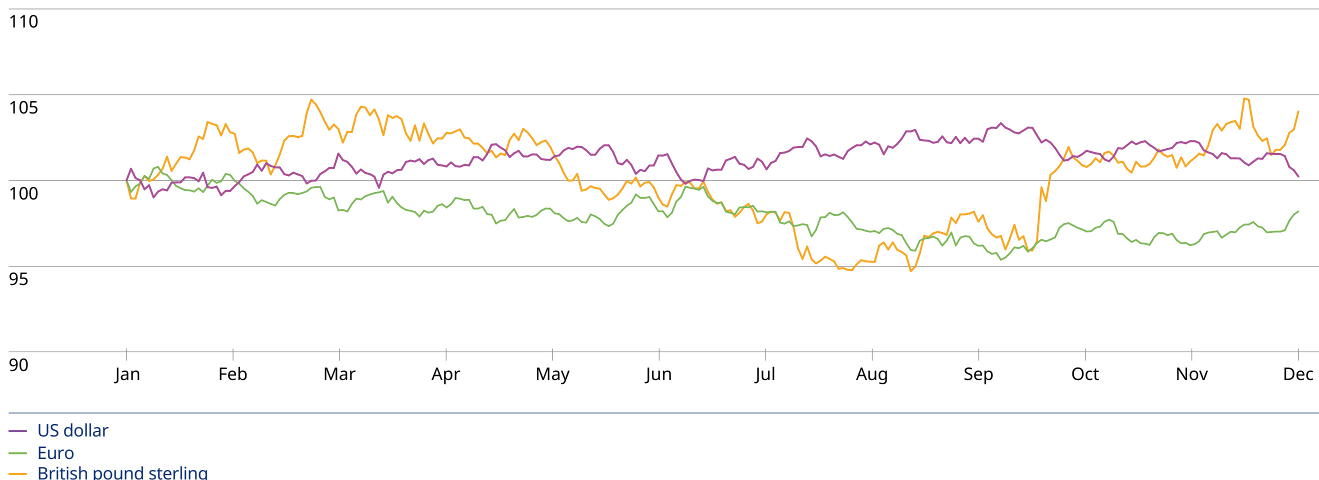
Risk assets, such as equities, will continue to benefit from ongoing low interest rates, which are also supportive of fixed income markets. However, there are heightened risks. Geopolitical uncertainty remains high and could trigger another flight to safety. The profit outlook is also challenging for corporates given rising costs, particularly in the US, and the contraction in trade created by Covid-19.

It remains challenging to predict with any certainty how events will unfold throughout 2020. We expect economic growth to weaken, but an easing of trade tensions and the actions of central banks to stimulate growth through low interest rates and easy monetary policy will provide an important offset to weakness in earnings.

In short, investors will have to continue to seek the themes that will deliver growth in a difficult environment. This may be enough to keep share prices moving upwards, but not at the same growth rates seen through 2019, not least because the bond markets remain relatively unattractive to investors. It may be another year in which asset allocation could prove challenging.

Our focus will remain on delivering positive investment outcomes for our clients and our wider stakeholders, whatever the economic or political backdrop.

Currency returns in 2019



Source: Schroders. Thomson Reuter Refinitiv data correct as at 31 December 2019. Price performance for the US dollar is based on the dollar index (against a basket of currencies). Price performances for euro and sterling are against the US dollar. Past performance is not a guide to future returns.