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Economic and Strategy Viewpoint

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Keith Wade
Chief Economist and Strategist
(44-20)7658 6296

Azad Zangana
Senior European Economist and Strategist
(44-20)7658 2671

Craig Botham
Senior Emerging Market Economist
(44-20)7658 2882

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2019 review: Liquidity driven rally

- We look back at a year full of challenges for investors as trade wars flared up again, the UK was beleaguered by Brexit, while unrest and protests elsewhere in the world kept investors on their toes.

- Following the disastrous end to 2018, almost all asset classes got off to a strong start in 2019. Top quintile total returns were achieved for both equities and bonds, which was helped by central banks loosening monetary policy.

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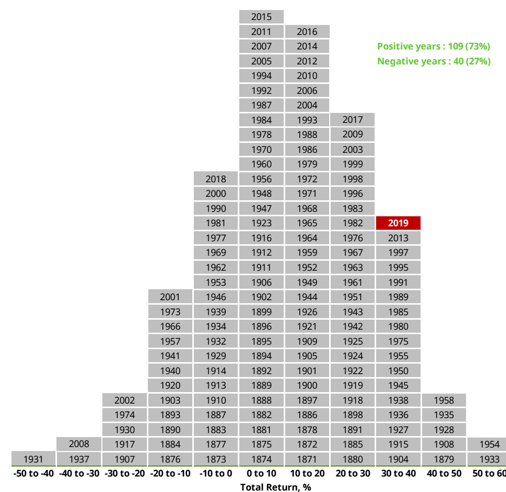
Strategy note 2020: reality bites?

- Investors were able to ignore the weakness of corporate earnings in 2019 as markets re-rated following the easing of monetary policy by the US federal reserve and other central banks.

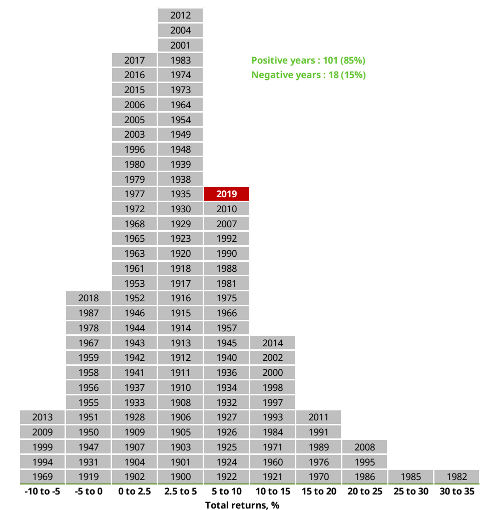
- As we head into 2020, the profits outlook remains difficult given margin pressures. Moreover, equity markets already appear to be pricing in an economic rebound and in the absence of a significant liquidity impulse and further re-rating, returns are likely to be constrained to single digits.

Chart: Equity and bond returns since 1900

Equity returns distribution



Bond returns distribution



Note: Equity total returns using S&P500 from 1873, and bond total returns taken from US 10-year Treasuries from 1900. Source: Refinitiv Datastream, Global Financial Data, Schroders Economics Group, 2 January 2020.

2019 review: Liquidity driven rally

"A rising tide lifts all boats."

Popularised by US President John F Kennedy (1961–1963).

At this time of year, we like to take a step back and review the performance of markets and the lessons we can learn for the coming year. 2019 began with a bounce in markets following an awful end to 2018. The fourth quarter had wiped out most gains for the year, leaving both the S&P500 and US 10-year Treasuries with negative returns.

While there were plenty of political events last year, most were overshadowed by the US-China trade war. The conflict re-escalated early in the year, knocking investors' confidence, and forcing central banks to reverse course and ease once again.

Before we look back over the performance of the major asset classes, we summarise the key events for the investment world.

Trade war

Trade war fears returned after negotiations between the US and China broke down

As the trade war between the US and China rumbled on from 2018, the year began with relative optimism as the two sides hammered out a deal in January talks in Beijing. Negotiations continued throughout the following months with mixed signs of progress until an abrupt deterioration in May.

As is so often the case, the market disruption came via Twitter. President Trump announced via tweet that the US would increase tariffs on $200 billion worth of goods from 10% to 25%, with further new tariffs to follow.

With the truce broken, matters escalated quickly. The threatened tariffs were applied on 10 May, and the Chinese response came three days later: increased tariffs were announced on $60 billion of US exports, to be imposed in June. The trade war also expanded beyond tariffs, as the US placed Chinese firm Huawei on its "entity list", barring the firm from purchasing from US firms, cutting it off from key tech components. Additional firms were named to this list in June.

Following this rapid escalation, both sides took a breather in July, with new talks taking place. Immediately after their muted conclusion, on 1 August President Trump announced new tariffs of 10% on $300 billion of goods, to start 1 September. Again, the prospect of further escalation was raised should China not deliver on a deal. China responded by suspending purchases of some US agricultural goods and later announcing tariffs on $75 billion of US goods.

Both sides announced new and increased tariffs, but a "Phase One" deal was close to agreement

After the September tariffs went ahead as announced, the two sides again agreed to hold talks that month. Progress seemed better than at the previous round of talks with the US announcing a "Phase One" deal in October and delaying a planned further tariff increase. In President Trump's words, the deal would involve up to $50 billion of Chinese purchases of US agricultural products annually, stronger intellectual property protection, and greater transparency on its currency management. Nothing was signed at this stage, and markets were unnerved by subsequent Chinese demands for a tariff rollback from the US.

With two days to go before the 15 December tariff deadline, the two sides announced that they had reached a Phase One trade deal. Full details were waiting to be finalised but the US agreed to a limited tariff rollback, reducing the September tariffs on $120 billion of goods to 7.5% from 15%. China agreed to increase purchases of agricultural products by $32 billion over two years, and total US goods and services by at least $200 billion over the same timeframe (though this seems an overly ambitious promise). China will also implement greater intellectual property protections and end the practice of forced technology transfer. The deal is set to be

signed in January 2020, with implementation to follow a month later. Markets were exuberant.

Impeachment

The consequences of the 2018 US mid-term elections started to become apparent early on in 2019 as the Democrats took control of the House of Representatives, with a promise to end the government shutdown, but without funding President Trump's proposed border wall. Wrangling over domestic issues continued without much impact, until 9 September, when the House Intelligence Committee was notified about an "urgent" and "credible" whistle-blower complaint. It was alleged that in a telephone conversation, President Trump promised Ukrainian president Volodymyr Zelensky $250 million if he would reopen an investigation into the son of Joe Biden, former Vice President and one of the favourites to win the Democratic Party's primary nomination.

President Trump had domestic problems, the biggest being the impeachment process which is now with the Senate

Weeks later, Speaker of the House, Nancy Pelosi announced the start of a formal impeachment inquiry, which the president refused to take part in, calling the process a "witch hunt". Apt phrasing as on Halloween, the House of Representatives voted 232–196 in favour of formally proceeding with an impeachment enquiry against the president.

On 18 December, the House of Representatives voted along party lines to forward two articles of impeachment against the president to the Senate. He is alleged to have abused his power and obstructed Congress, becoming only the third president to be impeached by the House.

An impeachment trial will now be conducted by the Senate, where the president is expected to testify. However, with the senate being controlled by Republicans, it seems unlikely that a two-thirds majority will be achieved to impeach, especially with an election due in 2020.

"Get Brexit done!"

The year started with Prime Minister (PM) Theresa May's Withdrawal Agreement deal being voted down by the House of Commons, followed by a vote of no confidence in the government. May survived to continue, but did not manage to win a "meaningful vote" in the House of Commons in time for the initial 31 March 2019 deadline.

An extension to Brexit was granted to seek a solution to the impasse in parliament, however, indicative votes failed to shed light on a path that would carry a majority. The PM's deal was voted down again after she had secured assurances with regards to the "Irish backstop". In an emergency EU summit in April, a new deadline of 31 October was agreed, and the UK was warned to use the time wisely.

The UK spent the year arguing over Brexit, which eventually cost Theresa May her job

Given the extension, the UK was forced to take part in the European elections on 23 May, where the governing Conservative party finished fourth, winning a devastating 8.8% of votes. The newly-formed Brexit party had finished first with 30.7% of votes, but in aggregate, remain-leaning parties (including Labour) finished ahead of the pro-Brexit parties.

Following the abysmal election showing, Theresa May agreed to step down, triggering a leadership contest which would eventually be won by the hardened Brexiteer Boris Johnson. His campaign to leave the EU by 31 October, "do or die", was simple and effective. However, the task proved impossible. Shortly after taking the premiership, his hardened stance of favouring a no-deal Brexit over a delay led to rebellions and the expulsion of members that did not vote with the government. Defections followed, including his own brother, and within weeks, the government had lost its majority as it managed to break a record for the number of votes lost in the Commons.

The government eventually decided to go back to the negotiating table and managed to secure a revised Withdrawal Agreement which helped alleviate some of the fears about the "Irish backstop".

Boris Johnson took over and won an election by a landslide, promising to "get Brexit done"

A vote on the revised deal passed the first reading stage on 19 October, forcing the government to request an extension to 31 January 2020. During the scrutiny stage of the new legislation, it was clear that the rebel alliance had planned to amend the legislation to make it impossible for the government to threaten a no-deal exit. It would potentially even compel the government to hold a confirmatory referendum on the deal. The government halted proceedings and called for a general election. This required the support of the opposition, which was provided once the risk of no-deal Brexit was removed.

The rare winter election resulted in a landslide victory for the Conservatives, with the simple slogan: "Get Brexit done". The opposition Labour party did all it could to avoid the subject, which resulted in its worst election result since 1935. With a huge majority of like-minded MPs, Johnson can now deliver Brexit by the end of January 2020. Headlines around Brexit should become less frequent, but we are far from the end of this saga.

Eurozone's relatively quiet year

The most influential events for investors in the eurozone were occurring outside the monetary union. The US-China trade war was having a profound impact on external demand, while Brexit was causing demand from the UK to fluctuate wildly. The year began with markets priced as if the region was in recession, especially Germany, which had seen the biggest impact from the slump in exports. However, it wouldn't be Europe without a mini crisis in the summer.

A reasonably quiet year in Europe had its moments. Political risk was back in Italy, and two Spanish elections could see far left Unidas Podemos in power

Political risk returned in the eurozone's most vulnerable spot, Italy, and all eyes were on how it would be resolved. Having been rated considerably higher in opinion polls than in the 2018 general election, Matteo Salvini, deputy prime minister and leader of the League party, decided to call a vote of no confidence in Prime Minister Giuseppe Conte. Investors were concerned that a majority government led by the League could bring out the worst tendencies of the far-right, including their eurosceptic views. However, Salvini's political gambit backfired as Conte managed to re-negotiate the formation of a new coalition, this time between the Five Star Movement, Democratic Party and Free and Equal.

Elsewhere, the minority coalition government in Spain collapsed and elections were held on 28 April. However, the result was a stalemate, only for the election to be re-run on 10 November, and for a similar result to emerge. A pre-agreement deal emerged between the Socialist Party (PSOE) and the far left Unidas Podemos party for a four-year coalition government. However, the two would still be short of a majority, and need other parties to abstain in a vote of confidence, which is likely to occur very soon.

Abenomics continues

In October, Japan rolled out the twice-delayed hike in its value added tax (VAT) from 8% to 10%, driven by the need for fiscal consolidation. However, in December, the Japanese government announced a fiscal stimulus package worth 1.8% of GDP to be spent over the rest of 2019 and 2020. Meanwhile, Shinzo Abe became the longest serving prime minister in the history of Japan's constitutional government.

Mid-year contagion fears

Amidst the temporary calm engendered by the trade war truce toward the start of the year, two emerging market (EM) currencies managed to notably underperform

their peers. Argentina and Turkey saw marked weakness from March onward as domestic problems began to mount. Argentina's situation worsened first, as the economy's deterioration accelerated. President Macri's reforms proved unpleasant medicine and seemed ineffective. Persistent inflation in the face of terrible growth numbers saw borrowing costs rise and greater reliance once again upon the IMF.

Domestic issues in Argentina and Turkey led to large currency depreciations

Markets were not the only ones to punish Macri's failings. The electorate also took a dim view of a contracting economy, soaring prices, and fiscal austerity. The August primary elections saw Macri lose decisively to the Fernandez-Fernandez ticket, much to the consternation of markets. This put further pressure on the peso, in a vicious political and economic cycle; a weaker peso generated higher inflation, further worsening Macri's political prospects and increasing the odds of the return of Kirchnerism. In due course the inevitable happened, and on 24 October the dual Fernandez ticket was victorious.

Turkey's woes began in April when the US halted delivery of military equipment and threatened sanctions over the country's decision to buy Russian missile technology. Turkey's fundamentals had long been shaky, with high carry the only real defence for the currency. The sanction threat appeared to be the final straw. Domestic politics also generated headwinds for the lira, with disputed local elections going against the ruling party.

As pressure on the currency mounted, so too did tensions between the government and the central bank. Effective policy rates were already high at this time, at 27%, and the central bank faced pressure to cut them to support the economy. This went against its own (and orthodox economists') preference for stable or higher rates to defend the currency and so keep inflation under control. In the end, the government won, replacing the central bank head with a more pliable alternative. Rates have since been cut aggressively, helped by inflation falling sharply on high base effects and a weaker economy. The threat of sanctions also receded, reducing one source of pressure on the currency. However, in December sanctions reappeared as a credible risk, and this story seems set to run into 2020.

Rising unrest

Aside from the global trade war, a shared theme in 2019 was increased civil unrest. Central and South America saw a particular concentration of protests, with notable flare ups in Bolivia, Chile, Colombia, and Ecuador, alongside long running problems in Argentina, but politically significant disorder also occurred in Iraq and Hong Kong as the year progressed. Nor was this limited to emerging markets; France, Italy and the UK all saw protests linked to domestic concerns, while mounting anger over inaction on climate change led to a globally coordinated protest movement. It would have been easy to overlook these domestic stories given an overwhelming focus on the geopolitical backdrop. It would also have been a mistake.

Hong Kong protests

Domestic issues elsewhere sparked protests, but Hong Kong's protests gained most attention

China had more than its fair share of headaches this year. At the same time as it dealt with the trade war, a problem was brewing closer to home. On 3 April, Hong Kong's government introduced plans for changes to legislation that would allow for criminal suspects to potentially be extradited to China. This sparked protests that grew as the year went on, expanding not only in size but in aims to include demands for greater democracy. At times the protests have shut down the city's roads, airport and greatly interfered with its economic life. Hopes that public sentiment might be turning against the protests seemed to be dashed when pro-democracy groups made sizeable gains in November's local elections. A resolution still seems distant, and from an investor perspective the protests have meant considerable underperformance in equities – though the currency peg has easily defied predictions of collapse.

Nationalism rises in India

India too has had problems at home, and not limited only to its slowing economy. A concern for investors has been whether Prime Minister Modi might, as the economy struggles, seek to maintain support by pandering to the Hindu nationalist element of his support. Some of these fears started to be realised in late October, when the constitutional autonomy of the region of Jammu and Kashmir was revoked, and it was subjected to a severe crackdown in response to the protests that followed. Later, in December, the government provoked more widespread protests with a citizenship bill portrayed by opponents as an anti-Muslim law. The bill provides an amnesty, and a route to citizenship, for illegal immigrants from neighbouring states, but only if they are Hindu, Sikh, Buddhist, Jain, Parsi and Christian.

Brazil pension reform

A bright spot in EM was Brazil as reforms helped boost confidence and asset prices

Better EM news could be found in Brazil, where pension reform finally passed in October 2019. The pension reform bill ultimately delivered savings in line with the more optimistic estimates, and in passing the reform the country took a sizeable step toward fiscal sustainability. The journey is not complete but investors and households should now have greater confidence that a more violent fiscal dislocation will not occur, and this confidence should encourage credit growth, investment and consumption. Policymakers' attention has now pivoted to fiscal reform. Asset performance received some support from this achievement, but also faced headwinds from political unrest in nearby Argentina and Chile in October.

Central banks

Monetary policy saw a dramatic reversal in 2019. The US Federal Reserve (Fed) had ended 2018 with its fourth rate hike in a year, and warned of more to come. Six weeks later, it announced that it may need to ease policy as equities were tumbling.

In reaction to falling equities, central banks started to stimulate again

Insurance cuts were all the rage, as a slowdown in activity, especially global manufacturing, was starting to concern the Fed. By July, the Fed had delivered its first of three rate cuts. It was not done there though. The Fed announced the end of its quantitative tightening programme, and by October, had announced billions of extra funding for the repo market, which had seen interbank rates spike up for various technical reasons.

Not to be outdone by the Fed, the European Central Bank (ECB) also delivered a cut to its deposit rate, and restarted its QE programme with monthly purchases of €20 billion. Moreover, forward guidance was strengthened, suggesting purchases could continue for years to come.

ECB president Mario Draghi managed to deliver the easing just before the end of his term. His successor, Christine Lagarde, kept the ship steady in her first press conference, but announced a review of all key ECB policy tools, and the wider impact of its actions on society and the environment.

As for the Bank of Japan, policymakers kept the target range of the 10-year government bond yield and QE programme unchanged. However, forward guidance was changed to hint that rates could be lower than the present level of -0.1%.

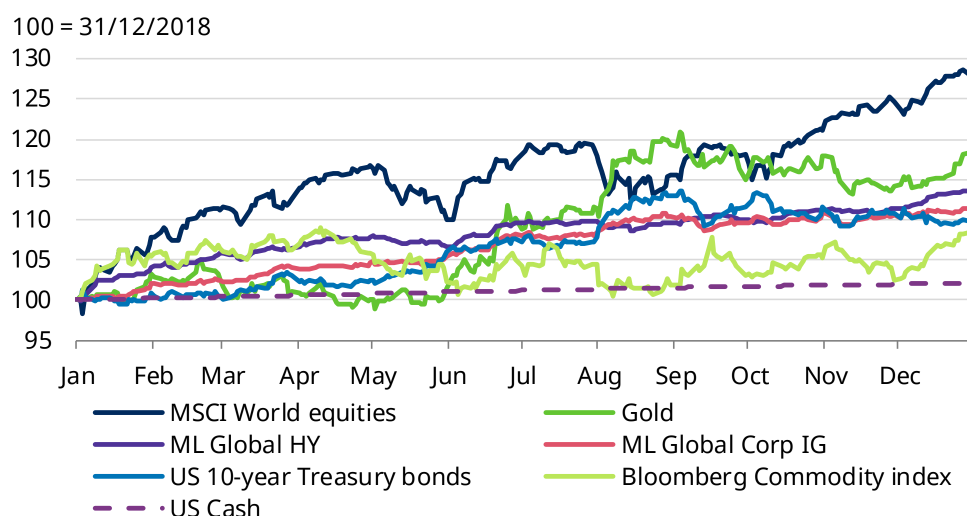
Lastly, after five years of negative rates, Sweden's Riksbank ended its experiment by raising its main repo rate from -0.25% to zero. The Swedish central banks signalled that it would keep interest rates on hold for some time, and that this was not the start of a hiking path. Indeed, asset purchases are expected to continue for at least another year. Instead, the change in policy was in reaction to growing negative side effects, including the changing of behaviours within the economy. Is the Riksbank the canary in the monetary policy coalmine for 2020?

Cross-asset performance comparison

Looking across the major asset classes, global equities were the best performer (28.4%), followed by gold (18.7%) and global high yield credit (13.7%). Indeed, it was a year where all assets enjoyed the increase in liquidity and low interest rates provided by central banks. All of the major asset classes beat US cash (2.1%), with the next lowest return coming from the Bloomberg Commodity index (7.7%).

Risk assets recovered in 2019 as equities led the way, followed by gold

Chart 1: 2019 Cross-asset performance (USD, total returns).



Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

When comparing the performance of US equities and Treasury bonds against their history, the S&P500 (31.5%) had its best year since 2013 (32.4%), while the 10-year US Treasury bond (9.5%) had its best year since 2014 (10.9%). While it is not unusual for both equities and bonds to provide positive returns in the same year, the normal negative correlation of their returns has been far weaker of late, partly in response to higher liquidity as mentioned earlier. Indeed, the returns from both US equities and Treasuries in 2019 were in the top quintile for their respective histories (since 1873 and 1900) as shown in the chart on the front page. This has not been seen since 1997.

Whilst the performance of risk assets was strong, it is worth remembering how 2018 ended. Part of the reason 2019 was so strong was the rebound from the fourth quarter of 2018. As table 1 shows, the returns figures are less stellar when taking Q4 2018 into account. For example, the MSCI World equities index has only returned 11.3% since October 2018, compared to 28.4% for 2019 as a whole.

Returns should however be viewed in the context of the sell-off in Q4 2018

Table 1: Cross-asset performance (USD)

	2019	Since Q4 2018
MSCI World equities	28.4%	11.3%
Gold	18.7%	27.6%
ML Global High Yield	13.7%	9.4%
ML Global Corp Investment Grade	11.4%	10.6%
US 10-year Treasury bonds	9.5%	14.5%
Bloomberg Commodity index	7.7%	-2.4%
US Cash	2.1%	2.7%

Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

Comparing equity market performance

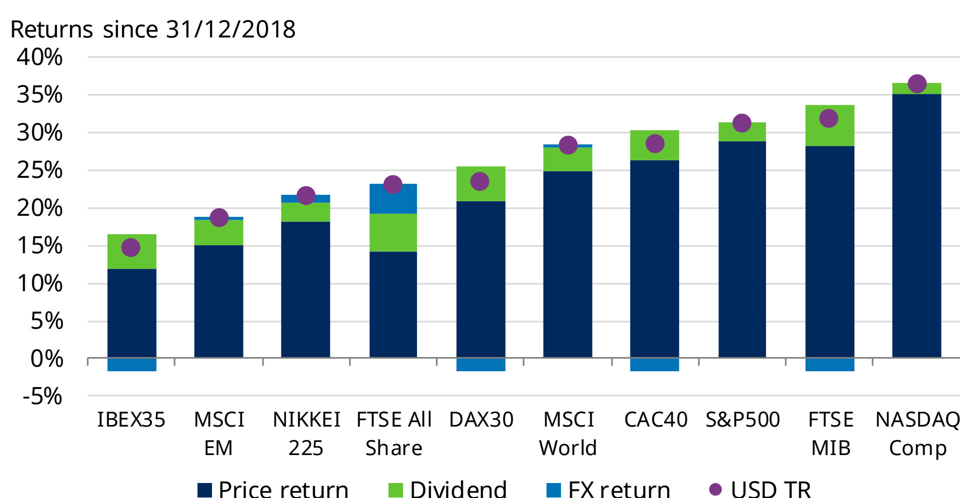
2019 was undoubtedly a strong year for equities but political risk (both negative and positive) meant that it was a significant gap between the best and worst performing markets. The best performing market was the NASDAQ Composite (36.7%), while the Spanish IBEX35 was the worst performer (14.8%) in US dollars.

Investors started the year with relative optimism that the US and China would strike a trade deal. However, by the spring, it became apparent that both sides were still far apart, and bourses with relatively high exposure to global trade and manufacturing were left lagging behind, largely for the rest of the year. For example, MSCI Emerging Markets (18.9%), Japan's Nikkei225 (21.7%) and Germany's DAX30 (23.7%) all underperformed the MSCI World index (28.4%).

Political risk also made a difference, for example, signs of stability in Italy helped lower bond yields and lift the FTSE MIB (32.9%) to be the second best equity market in 2019. Meanwhile, gridlock in Spanish politics was unhelpful for the IBEX35 mentioned above.

Within equities, the US NASDAQ was the best performing market, while the Spanish IBEX35 was the worst

Chart 2: Equity markets performance (total returns in USD)



Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

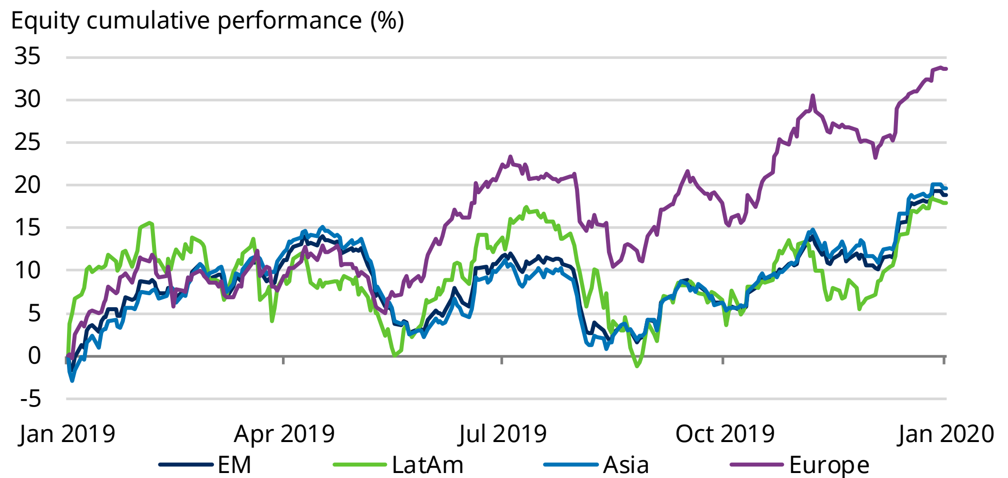
European equities overall had a strong year (EuroSTOXX50 up 29.3%), but the region once again underperformed the US (S&P500 up 31.5%), with 2019 being the fourth consecutive year of underperformance. Despite the rise in risk assets, defensive, high dividend paying growth stocks performed best. Tech stocks have also done extremely well and the US has more of these types of companies listed, while European markets have more “value” style stocks including especially banks, which have suffered with the impact of negative interest rates and low bond yields.

In emerging markets and considered in dollar terms, EM Europe (MSCI) was the best performing region, delivering over twice the total return of other EM indices. This outperformance was driven chiefly by Russia, perhaps on a mix of relative stability in a turbulent year and easier monetary and fiscal policy prompting greater optimism about the earnings outlook. The year end saw a last burst of performance across markets as the “Phase One” trade deal was agreed and the dollar weakened.

Most individual EM markets delivered positive dollar returns, with notable performances again from Russia (52.7%), Greece (43.6%) and Colombia (31.2%). It was a difficult year in which to lose money in EM equities, but investors in Argentina (-20.7%) and Chile (-16%) were likely cursing their luck by the end of the year.

In EM equities, Europe led the way thanks to Russia and Greece

Chart 3: Regional equity performance in EM



Source: Refinitiv Datastream, MSCI indices, Schroders Economics Group. 2 January 2020.

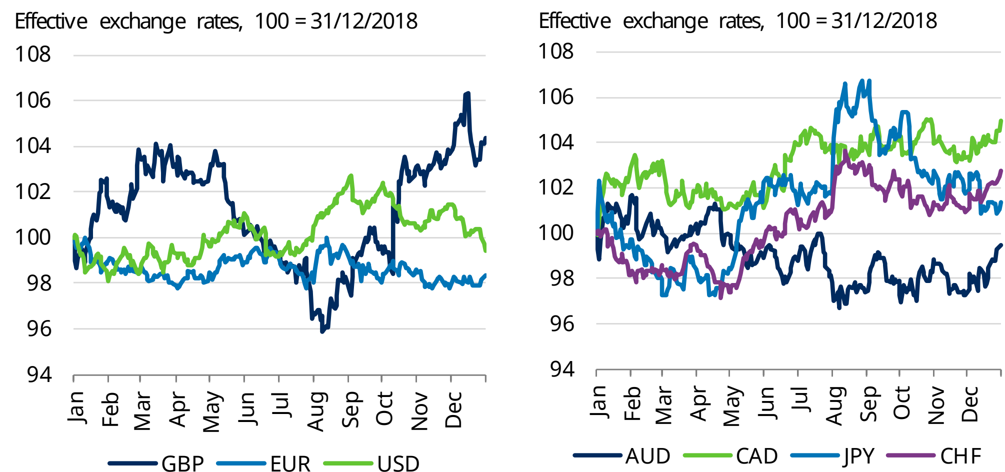
Comparing currency market performance

Like equities, currency markets reflected concerns over the trade war throughout 2019. The US dollar started the year lower on the back of optimism, but safe haven flows returned by the summer, and the dollar ended the year slightly down on a trade weighted basis (-0.6%), despite the Fed loosening monetary policy (chart 4). The euro took the other side of the trade for most of the year (-1.6%), although the ECB also eased policy to help depreciate the currency.

The standout performer was the British pound, although it was far from a straight path to end the year up 4.4% as the twists and turns of the Brexit created great uncertainty. Indeed at times, volatility in the pound was more than twice that of the Mexican peso!

The British pound was the best performing developed market currency

Chart 4 and 5: Currency performance in developed markets



Source: Refinitiv Datastream, BIS, Schroders Economics Group. 2 January 2020.

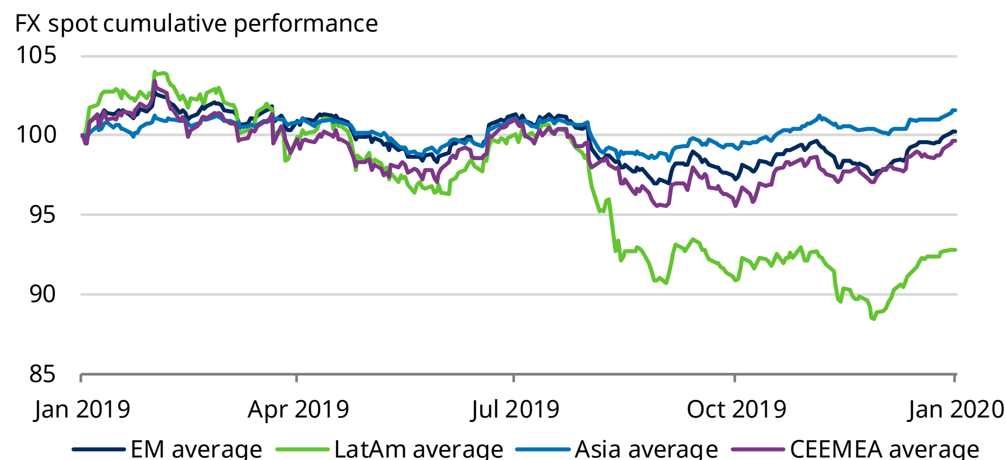
Elsewhere, safe haven currencies had a reasonable year once again, as the Japanese yen (1.4%) and Swiss franc (2.8%) made gains. There was a divergence in the resource currencies as the Australian dollar struggled in 2019 (-0.5%) while the Canadian dollar had a very strong year (5%). While the higher exposure of Australia to China may have been a factor, the other important difference was their respective monetary policies. The Bank of Canada was expected to cut interest rates at the start of the year, but was one of the few central banks that remained on hold, and now has the highest

nominal interest rate amongst the G10. Meanwhile, the Reserve Bank of Australia lowered its main interest rate by 0.75%.

On balance, most emerging market currencies look little changed from their position at the start of the year, particularly in EM Asia and CEEMEA, where Russia leads the EM pack with spot gains of around 11% (though Turkey is something of an exception, weakening 11%). For the most part, EM currency performance has simply been the inverse of the dollar index. Latin America, however, has clearly seen some underperformance. Both the Chilean and Argentinian pesos are regional laggards, but Argentina's weakness is in another league; the peso ended the year almost 59% weaker. In both cases, domestic politics are to blame.

In EM, Asian currencies were the best performers, with LatAm struggling

Chart 6: EM regional currency performance in 2019



Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

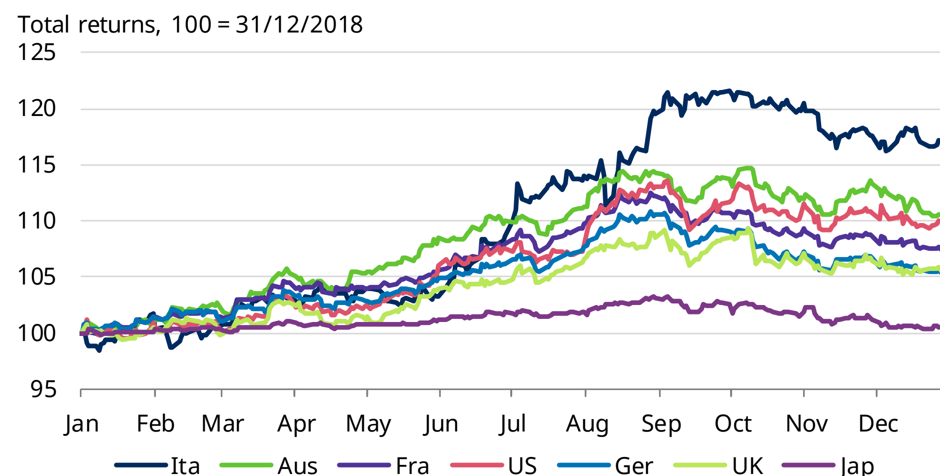
Comparing debt market performance

With central banks easing in 2019, government bonds were always going to do well. US Treasuries (9.9%) outperformed most thanks to having room to cut rates. However, Italian BTPs take the prize for best performing bond market with a return of +16.9% thanks to political risk abating and the ECB restarting quantitative easing. Next was Australian bonds, again, thanks to significant interest rate cuts.

Japanese government bonds were the worst performer (0.6%), though that is largely due to the bonds offering next to no yield at all. German bunds and UK gilts were the next two (both 4.9%).

Italy's government bonds were the best performing in the developed markets thanks to political risk abating

Chart 7: Government debt returns (10-year bonds)

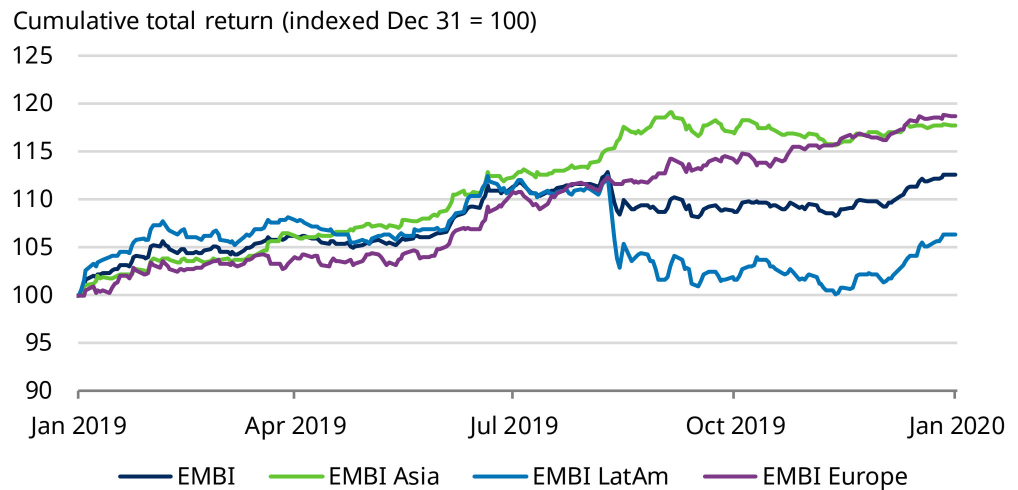


Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

EM hard currency debt had a good year; the overall index returned 12.6%, led by Europe at 18.8% while Latin America struggled thanks chiefly to problems in Argentina, the regional index returned 6.3% for 2019. Returns were consistently positive across regions until the middle of the year when Argentina's political situation abruptly worsened, tanking Latin American returns even as Europe and Asia continued to rally. Given the weight of Latin America in hard currency EM debt indices, this was also enough to temporarily derail the broader EMBI index returns, though the rally resumed towards year end.

EM USD government debt had a strong year, with EM Europe and Asia the best performers

Chart 8: EM debt returns by region



Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

On an individual country basis, Argentina was unsurprisingly one of the worst performers, down 24% for the year, the only major EM economy with a negative return. Elsewhere in Latin America returns were actually quite strong, at 16% in Brazil and 21% in Mexico, for example. As in the currency space, Russia was (narrowly) the best performing major market with 22% returns.

Lessons from 2019

Having reviewed events and performance of markets over the past year, we have found a few lessons worth considering for 2020:

– Negotiating deals, be it trade deals or Brexit is never easy. Once politicised, never count on a deal being done until all parties have signed off.

– Where there is a will, there is a way. Or at least a fudge in last minute negotiations. Again, the “Phase One” US-China trade deal and the revised UK-EU Withdrawal Agreement show that the details don't always have to make sense.

– Central banks, but especially the Fed, are seemingly beholden to the mercy of the market. The fear of being "behind the curve" will help policy makers find all sorts of reasons for their actions.

– Politics is no longer just about "the economy, stupid", with voters and politicians both supporting economically harmful policies. This is illustrated by the pursuit of Brexit and the damaging trade wars conducted by the US, or otherwise prioritising other issues at the expense of economic growth, as demonstrated by the nationalist pivot in India.

– Investors should not underestimate the determination of people and politicians to tackle climate change. While the COP25 meeting failed to reach a conclusion, climate change is quickly becoming one of the most important secular issues for investors, and policy makers are preparing to take action.

– Lastly, no one would have predicted the extent of Russian outperformance at the start of the year. There is clearly still value to following sound economic policy, as well as offering relative political stability.

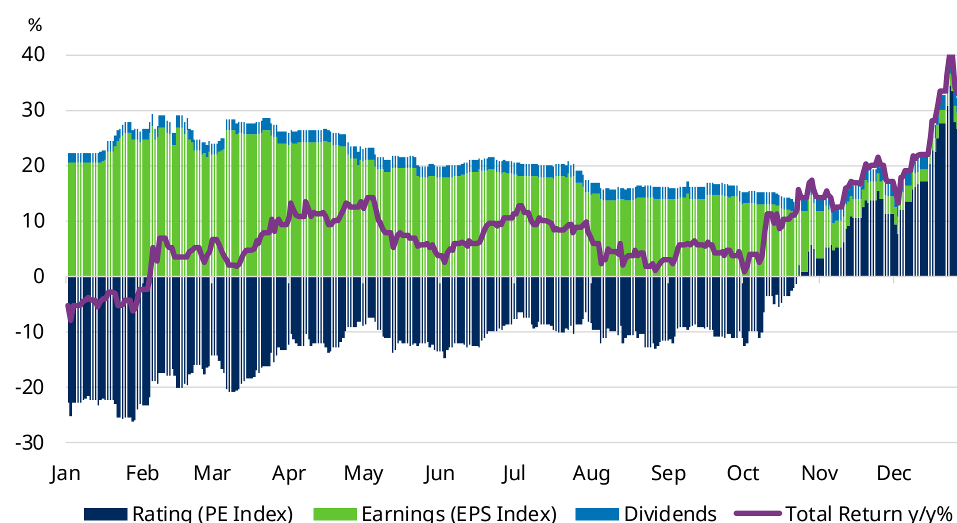
Strategy note 2020: reality bites?

Bonds and equities performed as the US Federal Reserve changed tack

This time last year financial markets expected the US fed funds rate to be approaching 3% by the end of 2019; the outcome has been a policy rate of 1.5% to 1.75%. US bond markets have responded positively and the re-appraisal of policy rates was a key factor in driving markets in 2019 as risk assets have re-rated allowing global equity returns to reach 28%.

Once again the US led the way with a gain of 31.5% for the S&P 500 Index. The breakdown of US returns shows that a revaluation of the index through a higher price-earnings ratio (PE) accounts for 25 percentage points of the gain. Higher earnings per share (EPS) and dividends accounted for the remainder with just under 3 percentage points each (Chart 9).

Chart 9: US equity market drivers: return breakdown (2019)



Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

In many ways, market performance in 2019 was a reversal of 2018 with the US Federal Reserve (Fed) playing the key role in both years. The decision by the US central bank to end rate hikes and ease policy in early 2019, often referred to as the "Fed pivot", was critical. More widely, the Fed's move was bolstered by policy easing elsewhere such that we saw 56 central banks cut rates 129 times in 2019, according to data from CBRates. In addition the European Central Bank (ECB) restarted quantitative easing (QE) as, debatably, did the Fed[1]. For a more detailed analysis of the performance of markets in 2019 see the previous section.

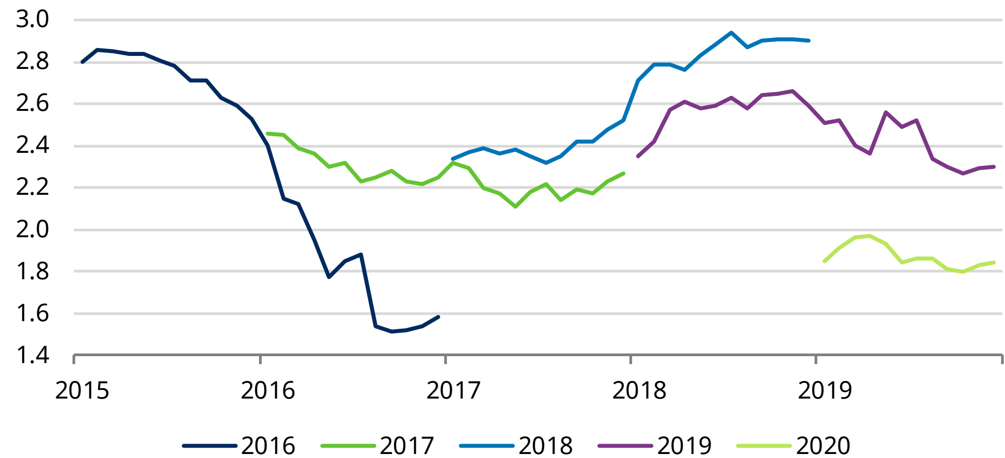
Recession fears were present for much of the year as trade slumped

Central bank easing does not always lead to a re-rating of markets. Although lower rates create a strong incentive for investors to switch out of cash and search for yield in riskier assets, such a move also requires confidence in the outlook. If lower rates are associated with lower growth then markets can simply de-rate as they anticipate weaker or falling corporate earnings, for example. The classic case is Japan, where central bank easing and zero interest rates has not led to a sustained re-rating of equities as growth expectations have fallen significantly.

For a while it looked like the US might suffer a similar fate in 2019; after an initial boost when the Fed signalled its change in policy, the equity market languished as global trade slumped and growth expectations dipped (Chart 10). During this period the US Treasury yield curve inverted and there was widespread talk of recession.

[1]The US central bank presented the move as a technical adjustment to smooth spikes in money markets although many saw it as a return to QE through the effect on the Fed's balance sheet.

Chart 10: Consensus GDP growth expectations in US



Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

Prospects for 2020

It was not until Q4 that the tide turned for equities: two factors changed which remain key to the outlook.

Thanks to consumers, US economy defies recession fears

The first was the continued resilience of the US economy. Despite being the longest expansion on record in the US, consumer spending has shown little sign of flagging. In the third quarter of 2019, the consumer offset weakness in net exports, inventory and business capital investment to keep GDP growth at just under 2%. In the fourth quarter the latest estimates suggest that household spending continues to be the mainstay of growth whilst the drag from capital spending (capex) and net exports has lessened somewhat.

Concerns that the slowdown in global trade would have a knock-on effect to the domestic economy have not materialised. Manufacturing, the sector most affected by the trade cycle, is important, but at 10% of US GDP does not have the weight to cause a recession in the economy as a whole. This can be seen in the continued growth in employment where the service sector has continued to hire. When combined with modest inflation and firming wages, the consumer remains well underpinned.

Indeed, household spending could be a source of upside surprise in 2020. As we have noted in our scenario analysis, balance sheets are in good shape and the easing of monetary policy is supporting housing which has previously been a precursor of stronger consumption.

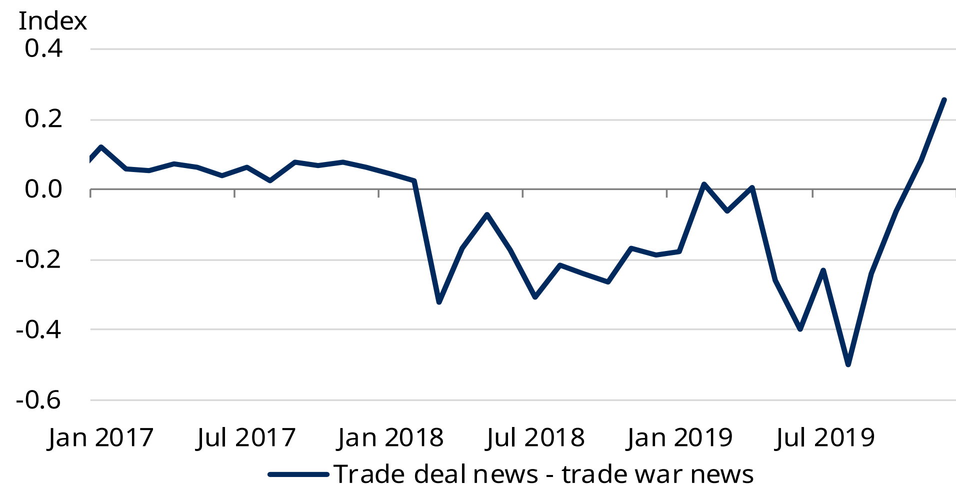
Trade tensions have eased

The second factor has been the easing in trade tensions between the US and China (see Chart 11). The key reason behind our recent upgrade to global growth forecasts, the prospect of a phase one deal has helped reduce the tail risks associated with an all-out trade war. Current expectations are for a deal to be signed on 15 January, although this could of course be delayed. The deal is relatively light (see previous section for details) but should help trade stabilise and, by providing some clarity, enable firms to restart capex spending.

Whether this persists is not clear. Our thinking is that Trump will focus more on fighting the Democrats than the Chinese in the 2020 election campaign which would suggest an easing in international tensions. However, rather than placing a phase two deal on the back-burner until after the election in November, the president has suggested he would like to start negotiating the next deal as soon as possible. Such an outcome could of course re-ignite trade tensions, particularly given the more difficult nature of the phase two negotiations where there will be more focus on

intellectual property and state subsidies of industry. Watch out for some unhappy tweets from President Trump.

Chart 11: Sentiment shifts in favour of a trade deal



Source: Schroders Economics Group, Data Insights Unit, 6 January 2020. Series measures net count of positive trade deal news.

But not everywhere

Although the US-China talks have tended to dominate market sentiment, there are of course other areas where geopolitical risks could remain high. At the time of writing US-Iranian tensions have escalated following the US assassination of Iranian general Soleimani. The region is now braced for an Iranian response and although we would not expect a sustained oil shock, prices have risen sharply.

In the UK the election has only brought temporary relief as Prime Minister Johnson's strategy is to deliver a trade deal by the end of the year, something probably beyond even his remarkable powers of escapology. If a UK-EU deal is delivered it will likely involve the prime minister caving in to EU demands and would not be particularly broad or advantageous to the economy.

The other area would be Hong Kong Special Administrative Region, where tensions with the mainland have calmed a little recently. It is difficult to see a major change of position from either side in the current stand-off although the reduction in violence is a step forward. In the meantime the Hong Kong SAR economy is suffering badly due to the fall in tourism and would welcome some fiscal relief in 2020 particularly if targeted at those left behind by the region's growth.

Reality bites?

Will investors recognise the reality of the profits outlook?

Our central outlook of steady growth, a continuation of easy monetary policy and an easing in the US-China trade tensions bodes well for risk assets. We will not see such a generous boost to liquidity in 2020 as in 2019, nonetheless central banks are some way from raising rates and could ease if the nascent recovery was threatened. Inflation remains subdued so the Fed "put" can remain in play.

As always there are many threats to the rosy scenario. Geopolitical events are one factor, as discussed above, the other would be corporate profits. Despite a better backdrop for global growth the US profits outlook looks poor. We expect US corporate profits to decline in both 2020 and 2021 as margins come under pressure from rising wages.

Liquidity delta will slow

Table 2: US profits to stagnate

% y/y	Economic profits	S&P 500 EPS (Operating)	S&P 500 EPS (Reported)
2019	-4.0	-0.4	-0.3
2020f	-1.6	-1.3	-1.8
2021f	-4.8	-4.1	-4.6

Source: Schroders Economics Group. Please note forecast warning at end of document. 29 November 2019.

We recognise that we made a similar forecast last year and whilst this had precious little bearing on the performance of equity markets, we were broadly right about the profits and EPS outturn. When the final figures are in, our expectations are that 2019 will show a decline in top-down economic profits of 4% with S&P500 earnings down by just under 0.5%. For 2020 we predict another small decline in both measures (table 1).

Will 2020 be the year investors wake up to the reality of the profits outlook? There is certainly less scope for another liquidity-driven re-rating in equity markets. Some further easing is possible in the US and elsewhere such as the emerging markets, but the impulse would be smaller and this time may even give in to fears of a Japan style environment as mentioned earlier.

Another difference with last year is that markets already seem to be pricing in a bounce in growth. We noted last year that markets were priced for a slowdown. This year global equities are anticipating a brisk recovery in indicators such as the purchasing managers index (Chart 12).

But there is still little alternative

Chart 12: Equities pricing in global rebound

Source: Refinitiv, Schroders Economics Group. 2 January 2020.

Overall, this would suggest a far more subdued year for equity markets with, at best, single digit gains and probably driven by factors such as M&A and returns to shareholders via asset sales and restructuring. It is also an environment where companies with good long run growth prospects beat cyclicals, thus continuing the outperformance of sectors such as technology and healthcare.

In short, investors will have to seek the themes which will deliver growth in a difficult environment. This however, may be enough to keep equities grinding forward given the lack of any competition for funds from the bond markets.

Schroders Economics Group: Views at a glance

Macro summary – January 2020

Key points

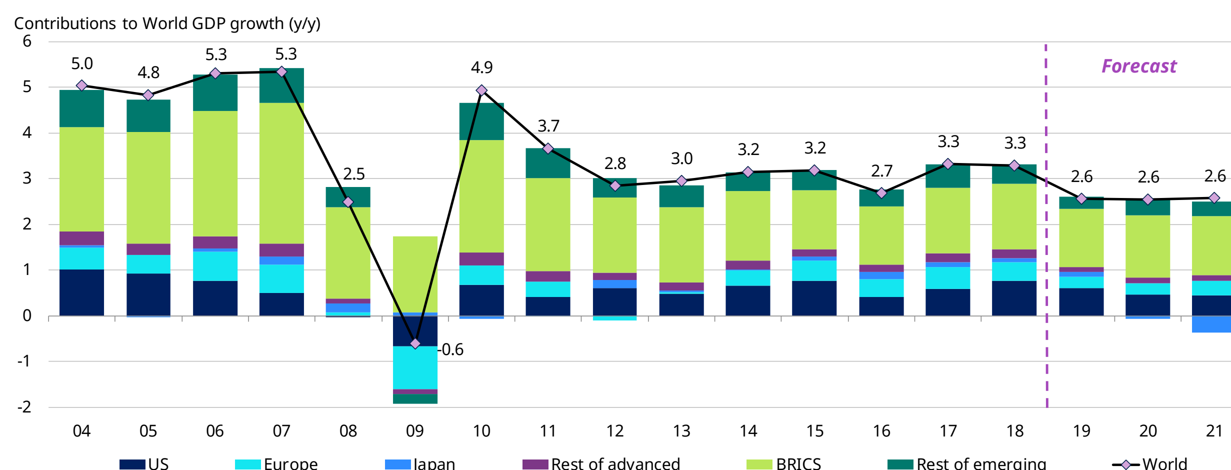
Baseline

- After expanding by 2.6% in 2019, global growth is expected to remain stable in 2020 as a slowing in advanced economies is offset by an acceleration in emerging markets. The world economy looks set to avoid a recession as the cycle extends into 2021, where we expect global growth to continue at 2.6%. Meanwhile, global Inflation is also forecast to remain stable at 2.6% in 2020.
- We assume a "phase one" US-China trade deal. However 2021 is likely to be marked by a return of trade tensions. Negotiations around a wider ranging deal covering the thorny areas of intellectual property and state subsidy of export are likely to be fraught and we expect tariffs to rise again in the second half of 2021.
- US growth is expected to slow from 2.3% to 1.8% in 2020. US core inflation continues to rise, peaking next year before declining through 2021, however the drag from energy means that headline inflation should remain just above target at 2.1% in 2020. With growth below trend, we expect the Fed to cut rates by 25bps in April, before laying low as the presidential election gets underway before easing again in 2021.
- Our expectation is for growth and inflation in the Eurozone growth to remain fairly stable at 1.2% and 1.3%, respectively. Both should pick up slightly in 2021 but with inflation still only at 1.5%, the ECB should continue QE through 2021 after another rate cut to -0.60% in Q1 next year.
- UK growth is likely to fall to 0.8% next year from 1.3% in 2019. We assume that the UK leaves the EU at the end of January 2020 and enters a transition period that preserves the status quo of single market and customs union membership until the end of the year. For 2021 the UK moves on to a new trade arrangement with the EU, negotiated on a sector-by-sector basis. Inflation is expected to fall to 0.8% in 2020 due to lower energy prices, weaker growth and a recovery in sterling. As inflation picks up in 2021, the BoE is forecast to hike rates to 1%.
- Growth in Japan should fall to 0.2% in 2020 from 0.8% as the economy is hit from the VAT hike. We expect a further rate cut from the BoJ to help support activity and weak inflation.
- We expect most of the BRIC economies to enjoy accelerated growth in 2020, taking the EM growth rate to 4.4% from 4% in 2019, a pace which will slow marginally in 2021. China alone is expected to slow further, though not to breach the 6% barrier until 2021 when it slows more abruptly to 5.5%. Inflation remains under control, with the except of the impact of swine flu in China, and allows for additional easing across EM in 2020, with a more mixed picture the following year as economic recovery starts to generate modest inflationary pressure.

Risks

- Risks to inflation are balanced and we still see a slight downside risk to growth. However the downside risks to growth are lower than earlier on in the year reflecting the addition of reflationary scenarios and removal of some stagflationary outcomes. The highest individual risk scenarios are both deflationary – US swings left and global recession scenario.

Chart: World GDP forecast



Source: Schroders Economics Group, November 2019. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2018	2019		Prev.	Consensus	2020		Prev.	Consensus	2021
World	100	3.3	2.6		(2.6)	2.6	2.6	↑	(2.4)	2.5	2.6
Advanced*	61.4	2.3	1.7	↑	(1.6)	1.7	1.4	↑	(1.1)	1.4	1.6
US	26.5	2.9	2.3	↑	(2.1)	2.3	1.8	↑	(1.3)	1.8	1.7
Eurozone	17.2	2.0	1.2	↑	(1.1)	1.2	1.2	↑	(0.9)	1.0	1.4
Germany	5.0	1.9	0.6	↑	(0.5)	0.5	1.0	↑	(0.8)	0.9	1.4
UK	3.6	1.4	1.3	↑	(1.1)	1.3	0.8	↓	(1.0)	1.1	2.1
Japan	6.7	1.1	0.8	↓	(1.2)	1.0	0.2	↑	(-0.1)	0.3	1.0
Total Emerging**	38.6	4.8	4.0	↓	(4.2)	4.0	4.4	↓	(4.5)	4.2	4.2
BRICs	25.3	5.7	5.1	↓	(5.2)	5.0	5.4		(5.4)	5.1	5.1
China	16.7	6.6	6.2		(6.2)	6.1	6.0		(6.0)	5.8	5.5

Inflation CPI

y/y%	Wt (%)	2018	2019		Prev.	Consensus	2020		Prev.	Consensus	2021
World	100	2.7	2.6	↑	(2.5)	2.6	2.6		(2.6)	2.5	2.5
Advanced*	61.4	2.0	1.5		(1.5)	1.5	1.6	↓	(1.7)	1.6	1.6
US	26.5	2.4	1.8	↓	(1.9)	1.8	2.1	↓	(2.2)	2.0	2.0
Eurozone	17.2	1.7	1.2	↓	(1.3)	1.2	1.3		(1.3)	1.2	1.5
Germany	5.0	1.8	1.3	↓	(1.4)	1.4	1.5		(1.5)	1.4	1.7
UK	3.6	2.5	1.8		(1.8)	1.8	1.4	↓	(1.9)	1.8	2.0
Japan	6.7	1.2	0.6	↓	(0.7)	0.6	0.9	↓	(1.0)	0.7	0.6
Total Emerging**	38.6	3.8	4.4	↑	(4.1)	4.3	4.2	↑	(3.9)	4.1	4.0
BRICs	25.3	2.8	3.1		(3.1)	3.1	3.4	↑	(3.3)	3.2	3.0
China	16.7	2.2	2.8	↑	(2.7)	2.8	3.2	↑	(2.8)	2.9	2.5

Interest rates

% (Month of Dec)	Current	2018	2019		Prev.	Market	2020		Prev.	Market	2021	Market
US	1.75	2.50	1.75		(1.75)	1.90	1.50	↑	(1.25)	1.61	1.25	1.60
UK	0.75	0.75	0.75		(0.75)	0.79	0.75	↓	(1.00)	0.71	1.00	0.76
Eurozone (Refi)	0.00	0.00	0.00		(0.00)	-0.40	0.00		(0.00)	-0.38	0.00	-0.31
Eurozone (Depo)	-0.50	-0.40	-0.50	↑	(-0.60)		-0.60		(-0.60)		-0.60	
Japan	-0.10	-0.10	-0.30		(-0.30)	0.02	-0.30		(-0.30)	0.03	-0.30	0.07
China	4.35	4.35	4.00		(4.00)	-	3.50		(3.50)	-	3.00	-

Other monetary policy

(Over year or by Dec)	Current	2018	2019		Prev.		2020		Prev.		2021
US QE ($Tn)	4.0	4.1	4.0	↑	(3.8)		4.2	↑	(3.8)		4.3
EZ QE (€Tn)	2.4	2.4	2.4		(2.4)		2.6		(2.6)		2.9
UK QE (£Bn)	422	435	445		(445)		445		(445)		445
JP QE (¥Tn)	557.0	552	575	↓	(583)		609	↓	(623)		649
China RRR (%)	13.50	14.50	13.00	↑	12.00		10.00	↑	9.00		9.00

Key variables

FX (Month of Dec)	Current	2018	2019		Prev.	Y/Y(%)	2020		Prev.	Y/Y(%)	2021	Y/Y(%)
USD/GBP	1.32	1.27	1.30	↑	(1.24)	2.1	1.35	↑	(1.32)	3.8	1.35	0.0
USD/EUR	1.12	1.14	1.12	↑	(1.08)	-2.0	1.15	↑	(1.14)	2.7	1.12	-2.6
JPY/USD	108.3	109.7	110	↑	(103)	0.3	110	↑	(105)	0.0	107	-2.7
GBP/EUR	0.85	0.90	0.86	↓	(0.87)	-4.0	0.85	↓	(0.86)	-1.1	0.83	-2.6
RMB/USD	6.96	6.87	7.00	↓	(7.20)	2.0	7.20	↓	(7.30)	2.9	7.40	2.8
Commodities (over year)												
Brent Crude	66.0	71.6	63.9	↓	(64.2)	-10.8	58.1	↓	(59.5)	-9.0	56.3	-3.1

Source: Schroders, Thomson Datastream, Consensus Economics, November 2019
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 02/01/2020
Previous forecast refers to August 2019

* **Advanced markets**: Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Hong Kong SAR, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

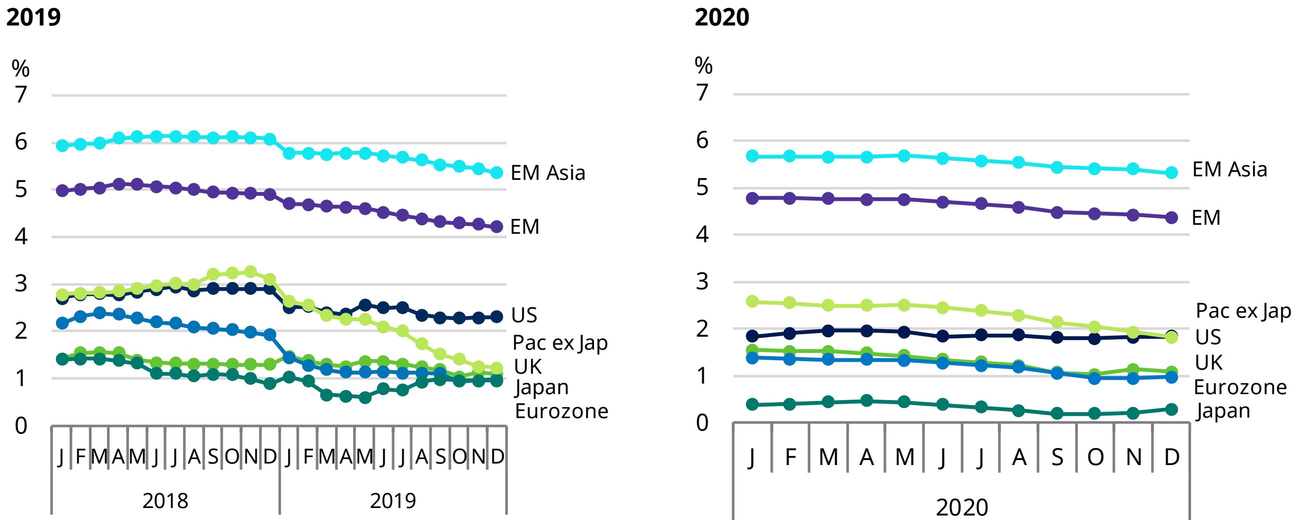
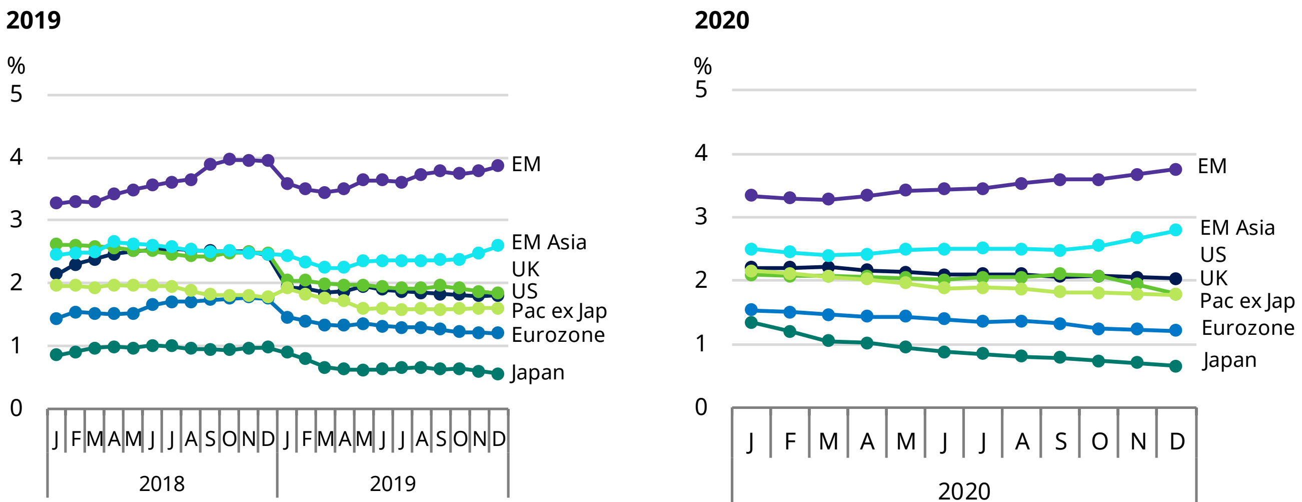


Chart B: Inflation consensus forecasts



Source: Consensus Economics (6 January 2020), Schroders.
Pacific ex. Japan: Australia, Hong Kong SAR, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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Schroders

Schroder Investment Management Limited

1 London Wall Place, London, EC2Y 5AU
Tel: + 44(0) 20 7658 6000

schroders.com

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