Global market perspective

Economic and asset allocation views

January 2020

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Introduction

All the major asset classes ended 2019 on a positive note; equities rallied particularly strongly, especially growth stocks. Part of the reason last year was so robust was the rebound from the awful fourth quarter of 2018. Despite the deterioration in global trade and growth expectations, investors started 2019 relatively optimistic about an US-China trade deal. By spring, it became apparent that both sides were still far apart, and markets with relatively high exposure to global trade such as Japanese and emerging markets equities were the laggards for the rest of the year. Meanwhile, the easing of monetary by central banks not only led to a re-rating in risk assets but also spurred gains in government bonds. As the year drew to a close, equities received a further boost from the agreement of the "Phase One" deal and the dollar weakened.

While the US-China trade talks took central stage in 2019, there were plenty of other political events keeping investors vigilant over the year. In the US, shortly after the Democrats took over the House of Representatives in the 2018 mid-term elections, President Trump became only the third president to be impeached. Across the Atlantic, an extension to Brexit was granted but Theresa May was replaced as Prime Minister by Boris Johnson. The winter general election in the UK resulted in a landslide victory for the Conservative party, which means Johnson can now deliver Brexit by the end of January. In comparison, it has been a relatively quiet year for the eurozone although political risk returned to Italy and two elections in Spain could see far left Unidas Podemos in government (see 2019 Review on page 13).

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 more modest compared to 2019 (see strategy note on page 24). An additional concern for investors is the rise in leverage in the corporate sector in the US and we take a closer look at the health of the corporate sector through the lens of credit markets (see research note on page 28).

In terms of asset allocation, we are positive on equities and credit. We have also increased our exposure to more cyclical markets such as Japan and the eurozone. This is in recognition of the significant loosening of monetary policy which has helped to underpin market valuations and led to some cyclical stabilisation. Sovereign bonds continue to offer little value relative to equities. Against this backdrop, we have downgraded government bonds to neutral and remain positive on gold as a hedge in the portfolio against a weaker growth outcome as flagged by our economic risk scenarios.

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13th January 2020

Asset allocation views: Multi-Asset Group

Global overview

Economic overview

We upgraded our global growth forecasts at the end of last year, in response to a fall in trade tensions between the US and China. Our 2020 forecast is increased from 2.4% to 2.6%, with growth set to remain at that level through 2021. The world economy looks set to avoid a recession as the cycle extends; imbalances which would spark a downturn are absent, while activity is gaining support from easing trade tensions and monetary policy.

We maintain our forecast of 2.6% global inflation for 2020, easing off to 2.5% in 2021. Despite the recent rise in the oil price driven by geopolitical events, we expect the impact to be unsustainable. Instead, our assumption of stable-to-lower oil prices means that the developed world sees some downgrades to inflation in the near-term. Inflation should also remain largely contained in the emerging economies, beginning to climb through 2021 as the region starts to fill some of its negative output gaps.

Compared to our last forecast update, the balance of risks has become more evenly weighted. Previously, the skew was toward weaker growth and higher inflation; in this update, upside and downside risks are balancing each other. This reflects the addition of reflationary scenarios and removal of some stagflationary outcomes.

Central bank policy

We expect the Federal Reserve (Fed) to ease rates to 1.5% in April 2020, before delaying the next cut until 2021 as it pauses for the presidential election. Our forecast pencils in one more cut for the European Central Bank (ECB) in 2020 (down to -0.6%) while we see UK interest rates rising to 1% in 2021. This move in UK rates has been pushed back one year after the Bank of England's (BoE) recent dovish turn, where it indicated a smooth Brexit alone would not be sufficient for a rate hike.

Emerging market (EM) central banks have mostly surprised to the dovish side in 2019, prompting downward revisions for rates as we continue to test the waters for the new neutral interest rate. China is an exception; though we expect further easing, we revise down our expectations following the recent trade developments.

Implications for markets

Compared to last quarter, we have turned more constructive on global equities. Our cyclical models still suggest that we are in the slowdown phase of the cycle, which is typically challenging for equities. However, the significant loosening of monetary policy last year has helped to underpin market valuations and led to some cyclical stabilisation. The recently announced phase one US-China trade deal is likely to support activity and corporate profit margins.

Within equities, we upgrade the US to positive. Loose monetary policy conditions and the easing of trade tensions are both supportive of corporate activity. The phase one US-China trade deal included some rollbacks of existing tariffs, which could significantly reduce the risk of earnings downgrades this year. Economic activity indicators such as the PMI appear to be stabilising, providing further support to the market, though we are conscious that rising wage costs may pose a threat to US profit margins.

We have upgraded UK equities from a negative to a neutral stance. Our UK growth expectations for 2020 remain muted, but the recent Conservative majority should help reduce uncertainty over Brexit. This development should

stimulate new investment, though business confidence needs to pick up from current lows. Our view on Europe ex UK has strengthened through the quarter, leaving us positive on this market. Recent economic data in Europe continues to suggest some stabilisation, while the markets will also be lifted by the US-China trade deal.

Meanwhile, Japanese equities present more attractive valuations than most developed counterparts, and the typical headwinds for exporters such as a strong yen appear to be fading. Hence, we have turned positive on Japan. The Pacific ex Japan view is neutral overall, though we do look more favourably on some individual countries within this region. Looking across the emerging markets, we see attractive valuations compared to their developed peers. There has also been a strong improvement in earnings revision momentum, which moves our view on this region to positive.

Turning to the duration view, we remain neutral on government bonds for now as this asset class still has a hedging role in a portfolio context. Valuations in the government space remain expensive as yields remain at or near historically low levels. The cyclical models continue to point to a slowdown, but the global economy has shown signs of stabilisation in recent months, which has resulted in bond yields moving higher off their recent lows. Among the bond markets, we have turned negative on US Treasuries and double negative on German Bunds, UK gilts and Japanese government bonds (JGBs). We remain neutral on emerging market debt (EMD) denominated in both USD and local currency.

On corporate credit, we are still positive on the asset class, particularly the US market. Despite concerns over fundamental quality, the technical picture is supportive as central banks keep liquidity conditions benign. We remain overweight US investment grade (IG) but neutral on European IG bonds. On high yield (HY) credit, we stay positive on US and neutral on Europe.

Our outlook on the broad commodity complex remains neutral. We remain overweight gold as a key macro hedge for portfolios. In contrast, we have turned negative on the energy market given dulled global demand and well-supplied physical market. Meanwhile, global growth concerns have weighed on industrial metals, but downside is limited due to increased central bank stimulus. Hence, we maintain a neutral stance on the sector. We are also neutral on agriculture because poor fundamentals appear priced in. However, the sector outlook remains lacklustre given elevated stock levels.

Table 1: Asset allocation grid – summary

Equity	+ (0)	Bonds	0 (+)			Alternatives	0	Cash	0 (+)
Region		Region		Sector		Sector			
US	+ (0)	US Treasury	- (++)	Government	0 (++)	UK property EU property	0 (-) +		
Europe ex. UK	+ (-)	UK gilts	- - (+)	Index-linked	+	Commodities	0		
UK	0 (-)	Eurozone Bunds	- - (+)	US IG EU IG	+ 0	Gold	+		
Pacific ex. Japan	0	Emerging market debt (USD)	0	US HY EU HY	+ 0				
Japan	+ (0)	Emerging market debt (local currency)	0						
Emerging markets	+ (0)								

Key: +/- market expected to outperform/underperform (maximum ++ to minimum – -) 0 indicates a neutral position.
Note: The above asset allocation is for illustrative purposes only. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions. For alternatives, due to the illiquid nature of the asset class, there will be limitations in implementing these views in client portfolios. The views for equities, government bonds and commodities are based on return relative to cash in local currency. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged). Source: Schroders, January 2020.

Regional equity views

Key points

+ (0)	Equities	
+ (0)	US	We have moved to positive on US equities. Normally at this late stage of the economic cycle in the US, we would be worried about recession risk. However, we think the risk of recession has reduced, and the imbalances that usually cause a recession are absent. Loose monetary policy conditions and the easing of trade tensions are both supportive of corporate activity. The phase one US-China trade deal included some rollbacks of existing tariffs, which could significantly reduce the risk of earnings downgrades as we enter 2020. Meanwhile, economic activity indicators such as the PMIs appear to be stabilising, providing further support to the market. One risk to the outlook is the prospect of higher wage costs eating into US profit margins, while it is also apparent that valuations remain elevated relative to their history.
0 (–)	UK	We have upgraded UK equities to a neutral position. Our growth expectations for 2020 remain muted, but the recent Conservative majority should help reduce uncertainty over Brexit. This development should help to encourage new investment, though business confidence needs to pick up from current lows. However, the reduced uncertainty around the EU withdrawal bill could also support sterling. This would impact the corporate profitability of UK multinationals which dominate the FTSE 100 index.
+ (-)	Europe ex. UK	Compared to last quarter, we have turned upbeat on European equities. Recent economic indicators in Europe continue to suggest some stabilisation. The US-China trade deal may buoy equity markets this year, or at the very least delay downward trending earnings forecasts.
+ (0)	Japan	Valuations are more attractive than most other developed markets, whilst the typical headwinds for exporters - such as a strong yen - appear to be fading. The risk to domestic demand, post the consumption tax hike, also looks to be falling.
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	Within the universe, we are neutral on Australian equities where valuations are expensive relative to history and other markets, but price momentum has been positive. While Singapore equities offer attractive valuations and high dividends, earnings momentum is negative. Overall, we are neutral on the market. Despite the lacklustre macro data, we are positive on Hong Kong equities given fiscal spending by the local authorities and policy easing from the Chinese central bank.
+ (0)	Emerging markets	We are positive on emerging markets due to the attractive valuations relative to developed markets, as well as the recent strong improvement in earnings revision momentum. A weakening of USD would offer further support to the region.

Key: +/- market expected to outperform/underperform (maximum ++ minimum – -) 0 indicates a neutral position.

Fixed income views

Key points

+	Bonds	
0 (++)	Government	Valuations in the government space remain expensive as yields remain at or near historically low levels. The cyclical models continue to point to a slowdown and recession risks have reduced but remain elevated. However, the global economy has shown signs of stabilisation in recent months, which has resulted in bond yields moving higher off their recent lows. Overall, we remain neutral on government bonds for now as duration still has a hedging role in a portfolio context. Among the sovereign debt markets, we have turned negative on US Treasuries given the better growth outlook and evidence that the ongoing stimulus is starting to impact domestic activity. We are already witnessing impacts from the Fed's current low interest rate policy through the housing sector. We have downgraded German Bunds to double negative given unattractive valuations and our concern that real bond yields could rise on the expectation of a turnaround in economic data. At the same time, the ECB has acknowledged that we are near the limit of what the central bank can do in terms of monetary policy. Similarly, we are double negative on UK gilts as the government majority should remove uncertainty around getting an EU withdrawal bill through parliament and encourage more fiscal spending, which is unsupportive for gilts. On Japanese government bonds, we also hold a double negative view as we see some encouraging signs in exports and manufacturing activity.
 + 0	Investment grade (IG) corporate US EU	We remain positive on US IG due to attractive valuations, against an unusually benign backdrop, as low interest rates are keeping default rates low. In comparison, we have kept our neutral view on European IG as this sector increasingly suffers from low yields and high levels of supply. On the latter, this is due to a rise in supply by foreign issuers looking to capitalise on the region's depressed rates.
 + 0	High yield (HY) US EU	We stay positive on US HY given the more supportive technical picture; in particular, better-than-expected earnings and stable levels of supply. Nonetheless, we continue to have concerns over fundamental credit quality. In Europe, we maintain our neutral view as fundamentals are weakening and there is more "call risk" (the risk that a bond issuer will redeem its bonds before they mature) than the market is currently pricing.
0 0	EMD USD-denominated EMD local currency-denominated	On EMD denominated in USD, we remain neutral given the strong backdrop for demand but valuations are unattractive. From an EM local currency perspective, we have remained neutral but acknowledge spreads have pushed back out to historically average levels. Higher carry should offset the pressure from higher global yields.
+	Index-linked	We retain our positive view on US-breakevens as the ongoing impact of tariffs is likely to feed into inflation in 2020. In addition, the Fed's ongoing commitment to boost inflation remains supportive of this market.

Note: The views for government bonds are based on return relative to cash in local currency. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged). Key: +/- market expected to outperform/underperform (maximum ++ minimum – -) 0 indicates a neutral position.

Alternatives views

Key points

0	Alternatives	
0	Commodities	Overall, we are positive on commodities which is largely a reflection of our overweight positioning on gold as a key macro hedge for portfolios. Recession risks have reduced but remain concerning. Additionally, ongoing central bank liquidity underpins the negative real rate environment, which should support gold prices. In contrast, we have turned negative on the energy market. Despite the recent rise in the oil price, our base case is that there is political risk de-escalation. At the same time, the sector is faced with dulled global demand and a well-supplied physical market. We remain neutral on industrial metals. Global growth concerns have weighed on metals, capping any potential gains. However, the downside is limited due to increased central bank easing and the potential for further stimulus from Chinese authorities. On agriculture, we still hold a neutral view. Resilient US crop productivity coupled with US-China trade tensions has led to a correction in crop prices, such that the negativity towards the market appears largely priced in. However, the sector outlook remains lacklustre given elevated stock levels.
0 (-)	UK property	We expect the all property initial yield to rise from 4.7% to 4.8% by the end of 2020, but the increase will largely be driven by retail. By contrast, yields on London offices are likely to fall this year as they are unusually high compared with office yields in main financial cities around the world. Regional office and industrial yields will probably be flat this year. Meanwhile, we forecast that all property total returns will be around 2% in 2020, before improving to 5 to 6% per annum in 2021-2022, as the economy accelerates and rental growth resumes in the office and industrial sectors. Our main focus for diversified portfolios is on offices in certain London sub-markets and winning cities, such as Bristol, Leeds and Manchester and on standard industrials outside London. We also favour some niche types (e.g. hotels with management agreements), which are benefitting from long-term structural forces and offer attractive returns. We are cautious of retail, but may invest opportunistically in bulky goods retail parks where rents have re-based to sustainable levels, or where there is the potential for higher value alternative uses.
+	European property	The zero, or negative level of bond yields in the Eurozone means that that there is fierce competition among investors for real estate. While the retail sector has suffered a sharp drop in liquidity, investor appetite for apartments, hotels and niche types such as student accommodation and care homes has grown. The German open-ended funds are seeing high inflows and the uncertainty over Brexit has encouraged US and Asian investors to favour the continent over the UK. We expect that office and industrial yields will fall by a further 0.25% in 2020 and that yields on hotels and other types will also compress. The downside is that this leaves capital values more exposed, should bond yields rise at some point further in the future. Shopping centre yields will probably increase by 0.5 to1.0% over the next 12 months, as investors price in lower rents. In the office market, we currently see most value in either re-development projects in central business districts, or in stabilised assets in adjacent areas where yields are higher. In the industrial market, we favour multi-let estates and smaller distribution warehouses where it is still possible to buy good assets on yields of 5%, or higher. We also see value in hotels with management agreements. We are cautious about most retail assets, because we do not believe that current yields reflect the risks of higher vacancy and falling rents.

Note: Property views based on comments from the Schroders Real Estate Research team. The views for commodities are based on return relative to cash in local currency. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged).
Key: +/- market expected to outperform/underperform (maximum ++ minimum – -) 0 indicates a neutral position.

Economic views

Central view

Global growth upgraded as the cycle extends

At the end of last year, we upgraded our global growth forecasts in response to the easing in trade tensions between the US and China. Our 2020 forecast is increased from 2.4% to 2.6%, with the world economy looking set to avoid a recession as the cycle extends. We also broaden our forecast out to 2021, where we see growth remaining at 2.6% in a year marked by the return of US-Sino trade tensions.

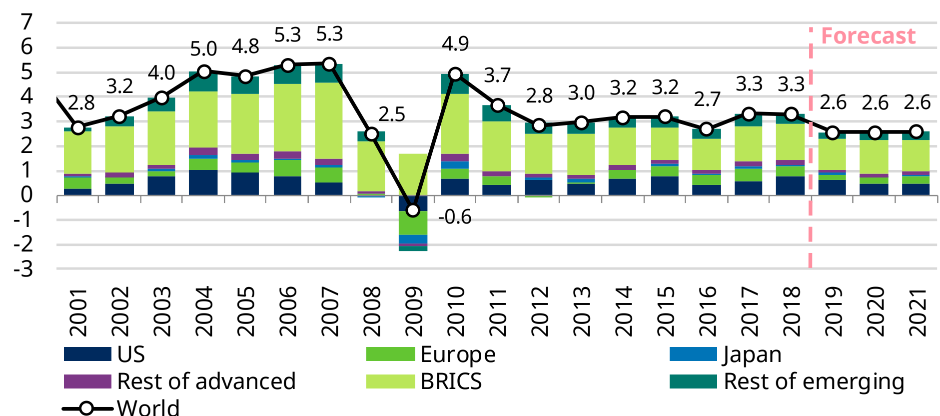
Underpinning the increase in the growth forecast was our assumption that the now confirmed "phase one" trade deal would be reached. This should see global trade and capital investment strengthen, with activity consequently improving in Europe and Japan as well as the US.

Looking further ahead, the winner of the US presidential elections (November 2020) will want to follow up on this deal with China. This will involve looking to deliver a more wide-ranging agreement which covers the thorny areas of intellectual property and state subsidies of export industries. Negotiations are likely to be fraught and we would expect tariffs to rise again in the second half of 2021.

Meanwhile, global inflation remains relatively stable at 2.6% and unchanged from our previous forecast. Despite the recent rise in the oil price driven by geopolitical events, we expect the impact to be unsustainable. Instead, our assumption of stable-to-lower oil prices means that the developed world sees some downgrades to inflation in the near-term. Inflation should remain largely contained in the emerging economies, beginning to climb through 2021 as the region starts to fill some of its negative output gaps. The reverse may be true of China, where inflationary pressures are currently on the rise but should abate as the impact of swine flu fades.

Though our model forecasts US core CPI (excluding food and energy) to rise above the Fed's inflation target, we do not see this causing any concern. We expect the Fed to ease rates to 1.5% in April 2020, before delaying the next cut until 2021 as it pauses for the presidential election. We pencil in one cut for the ECB in 2020 (down to -0.6%) and see further easing in China, albeit less than anticipated prior to the recent trade deal. We have pushed back a UK rate hike to 2021, with the BoE indicating that a smooth Brexit alone will not be enough for them to raise rates.

Chart 1: Global growth and forecast



Source: Refinitiv Datastream, Schroders Economics Group. November 2019.

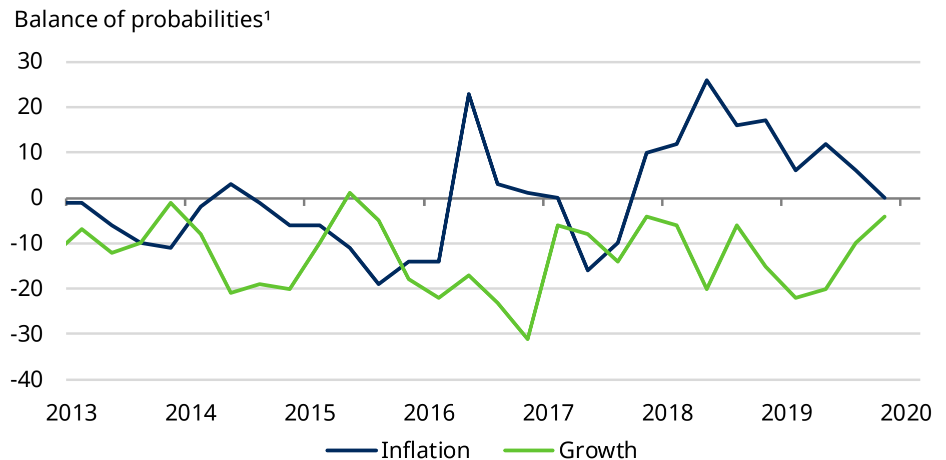
Scenario analysis

Balance of risks has become more evenly weighted

Full details of the scenarios can be found on page 12.

We have updated our scenarios to reflect the shifting balance of risks to the world economy. In September, the skew was towards weaker growth and higher inflation; in this update, upside and downside risks are balancing each other. This reflects the addition of reflationary scenarios and the removal of some stagflationary outcomes (chart 2).

Chart 2: Growth and inflation vs. baseline (probability weighted)



[1]Probabilities based on Economics team estimates.
Source: Schroders Economics Group, 20 November 2019.

We introduce a "US swings left" scenario to capture the possibility of a radical Democrat winning the presidential election, rather than our central assumption of a Trump win. Changes in regulation and taxes would affect growth in 2021, while an increase in the minimum wage would raise inflation in the US. At the global level, inflation would be lower as a consequence of a weaker dollar, making this scenario deflationary. The impact would be felt before 2021 through a weaker equity market and lower business confidence in 2020.

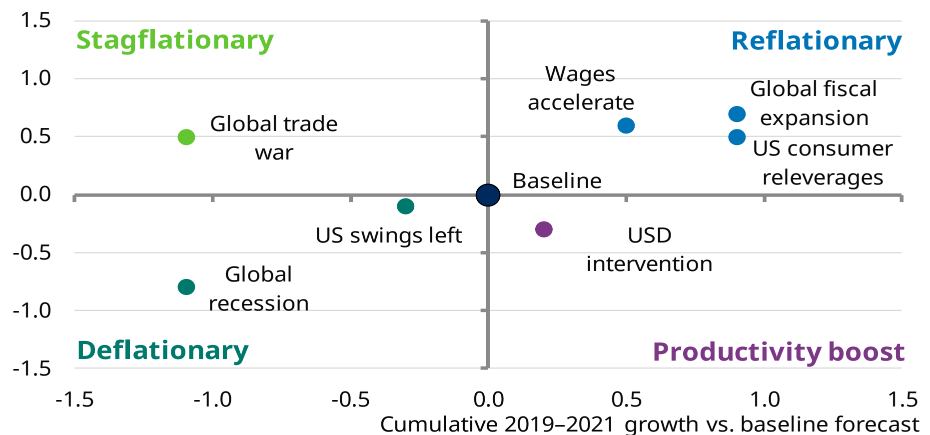
Our second new scenario is "Wages accelerate". We have had this scenario in the past and had dropped it as the Phillips curve (which describes the inverse relationship between unemployment and wages) flattened. However, whilst the relationship between unemployment and wages has weakened, there is still a correlation with wages and the employment-population ratio (a broader measure of labour market slack). The increase in the employment-population ratio has been a favourable supply side development, allowing the US economy to keep finding workers and grow. Though our baseline factors in some rise in wages alongside a further rise in the employment-population ratio, this scenario captures the risk of an unexpected acceleration.

This scenario is reflationary as higher real wages initially drive up consumer spending and growth. International trade accelerates, boosting growth in the rest of the world. However, as the economy hits capacity limits, inflation picks up and the mix of growth turns more adverse. The Fed ends its easing cycle and tightens monetary policy with the fed funds rate rising to 3% by the end of 2021. Since markets seem to have priced out the risk of inflation ever returning, this scenario is a good reminder that we are near the end of the cycle.

In our October Viewpoint[1], we highlighted the extended period of de-leveraging by the household sector in the US. Our central scenario assumes that the ratio of debt to income remains stable; but, it could rise as households respond to lower interest rates by borrowing more. This would bring about a situation where the US consumer becomes a driver of global growth - "US consumer releverages". As in the "Wages accelerate" scenario, the outcome is more reflationary than the baseline. The trade off between growth and inflation is slightly more favourable, but the response of the Fed is similar with rates rising to 3%. Stronger growth also brings higher rates elsewhere, but the degree of tightening is less, reflecting the greater amount of slack outside the US.

The three new scenarios replace "Italian debt crisis", "Food prices surge" and "US-China trade deal", with the latter being partially incorporated into the new baseline. The other scenarios are unchanged.

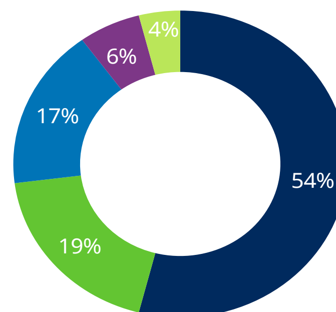
Chart 3: Scenario analysis – global growth and inflation impact



Source: Schroders Economics Group. November 2019.

The impacts of the different scenarios on growth and inflation and their probabilities are shown in charts 3 and 4. Deflationary risks are viewed as the most likely surprise, but these are closely followed by the prospect for a reflationary outcome. It is worth noting the low allocation to the baseline, relative to our previous forecasts – the global economy looks vulnerable to an array of surprises.

Chart 4: Scenario probabilities



Source: Schroders Economics Group. November 2019.

[1] https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/viewpoint/economic-and-strategy-viewpoint-october-2019.pdf

Table 2: Scenario summary

		Summary	Macro impact
1	**US swings left**	The S&P 500 drops by 10% in Q3 2020 as the opinion polls point to a change of President to a left wing administration, followed by another 10% fall in Q4 on the result. Policies include increased regulation, higher minimum wage and plans to reverse Trump's tax reforms.	**Deflationary**: For the US, a fall in business sentiment and negative wealth effects from the correction in the equity market hurt growth in the second half of 2020. There is further GDP weakness in 2021 on increased regulation, higher minimum wage and plans to reverse Trump's tax reforms. These factors also boost inflation. The Federal Reserve reacts by cutting interest rates to 1% by the end of 2021 and the dollar weakens. US growth is lower and rest of the world's currencies appreciate versus the dollar. This is deflationary for the rest of the world as export demand falls.
2.	**Global fiscal expansion**	Following the populist expansion in fiscal policy in the US, other countries decide to follow its lead either due to changes in governments, or in response to populist movements. The G7 and BRIC economies all loosen fiscal policy significantly through a combination of tax cuts and spending increases.	**Reflationary:** Fiscal loosening against a backdrop of above trend growth boosts confidence further, along with GDP growth. Some economies with low rates of unemployment see wage pressures rise, causing domestically generated inflation, while others with slack remaining, still see higher inflation through commodities and higher import prices. Central banks respond by tightening monetary policy more quickly, which eventually cools activity.
3.	**Global trade war**	The US administration decides to impose tariffs on auto imports from the rest of the world thus extending the trade war into new territory. Meanwhile the dispute with China worsens as even the "phase 1" trade talks fail and the US increases tariffs on imports from China.	**Stagflationary**. Higher import prices push inflation higher whilst weaker trade weighs on growth. Capital spending is also hit by the increase in uncertainty and the need for firms to review their supply chains. Central banks are expected to focus on the weakness of activity and ease policy by more than in the baseline.
4.	**Wages accelerate**	After a considerable period where wages have been unresponsive to tightening labour markets, pay begins to accelerate in response to skill shortages. Wages accelerate around the world and economists revise their estimates of spare capacity considerably lower. Some economies such as Japan welcome the move as they seek to raise inflation expectations, while the US faces stagflation as it effectively runs out of capacity, forcing the central bank to tighten policy.	**Reflationary**: As US wage growth picks up, US core inflation rises to 2.6% by the end-2021 and the Fed responds by tightening more aggressively, taking its target rate to 3% by end 2021. As the Philips curve reasserts across the world, household real incomes rise supporting consumption although the rise in wages, squeezes corporate margins somewhat. Interest rates also rise more rapidly in Europe, Japan and emerging markets. The overall impact is positive for growth and inflation.
5.	**USD intervention**	Unhappy about the strength of the US dollar, President Trump decides to intervene in the currency market, directly, devaluing the trade weighted dollar by 20%. The depreciation is achieved against most currencies including many EM currencies that typically track the USD. Central banks around the world react by lowering interest rates to try to reverse the move, but this is only partially achieved over the course of 2020.	**Productivity boost**: A weaker dollar helps boost global trade thanks to cheaper export financing. Looser credit conditions lift activity, particularly in emerging markets. Inflation outside of the US falls, boosting purchasing power of households.
6.	**US consumer releverages**	After a sustained period of debt reduction, US households rediscover the joys of debt and the housing market is boosted by successful Fed easing. As the US consumer releverages, household debt as a share of GDP rises toward 80%.	**Reflationary**: Stronger US consumption boosts US growth and global trade. Inflation is also higher as demand increases and oil prices rise. As for interest rates, the Fed raises these to 3%. Other economies benefit from the boost to global trade.
7.	**Global recession**	The slowdown in Europe, China and Japan gathers momentum as contracting export growth undermines business confidence causing capital spending to contract. Meanwhile, the US economy proves to be more fragile than expected and causes business and households to retrench. Output begins to contract thus bringing an end to the cycle whilst commodity prices and inflation fall. The Fed eases, but markets slump on fears of a wider global recession.	**Deflationary**: Weaker growth drags global trade lower, hitting the US which is also affected by increased market volatility and tighter financial conditions. The USD is expected to strengthen putting added pressure on EM. Monetary policy is eased around the world.

Source: Schroders Economics Group. November 2019.

2019 Review: Liquidity fuelled rally

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"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&P 500 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 of 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 elections in Spain could see far left Unidas Podemos in government

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 remain in 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 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%.

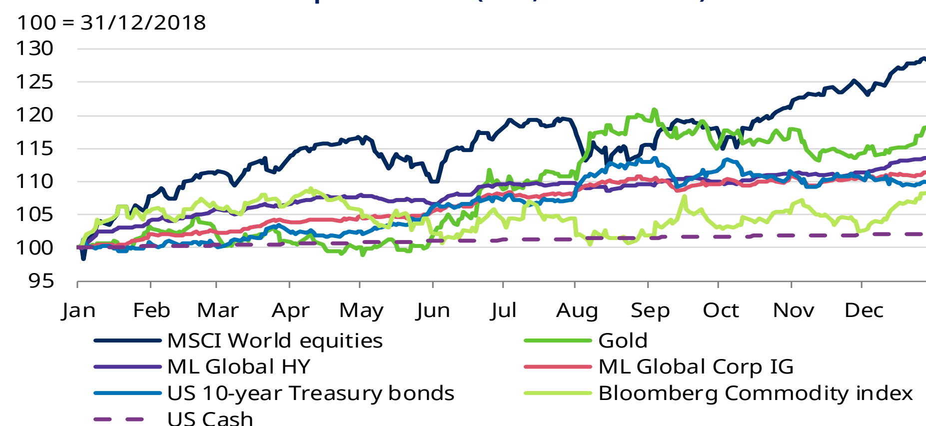
Lastly, after five years of negative rates, Sweden's Riksbank ended its experiment by raising its main repo rate from -0.25% to zero. The Swedish central banks signalled that it would keep interest rates on hold for some time, and that this was not the start of a hiking path. Indeed, asset purchases 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 5: 2019 Cross-asset performance (USD, total returns)

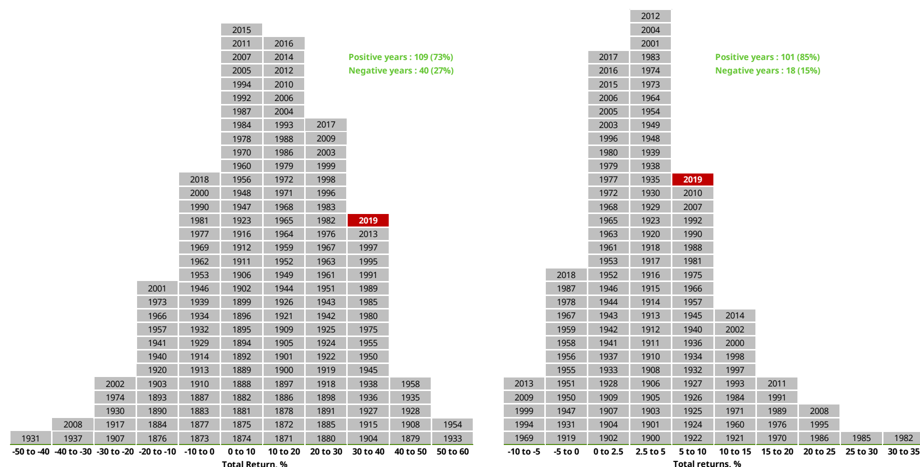


Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

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 charts 6a and 6b. This has not been seen since 1997.

Chart 6a: Equity returns distribution **Chart 6b: 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.

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 3 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 3: 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.

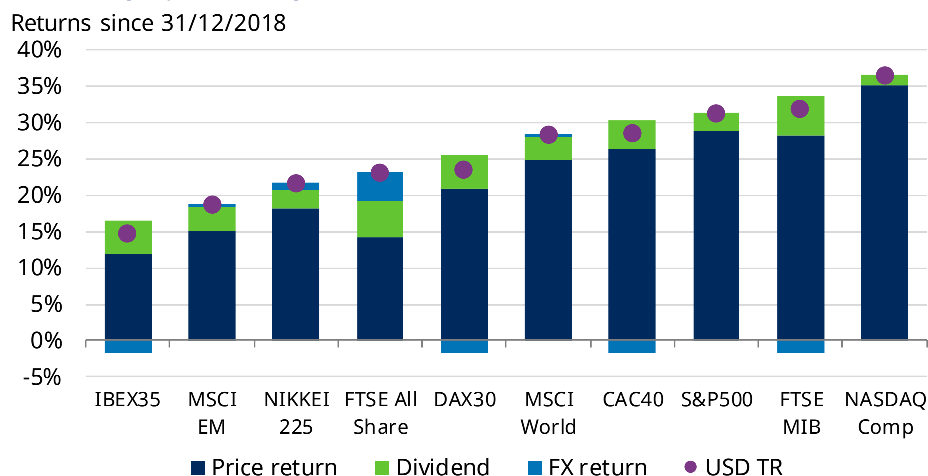
Investors started the year with relative optimism that the US and China would strike a trade deal. However, by the spring, it became apparent that both sides were still far apart, and bourses with relatively high exposure to global trade and manufacturing were left lagging behind, largely for the rest 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 the worst

Chart 7: Equity markets performance (total returns in USD)



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

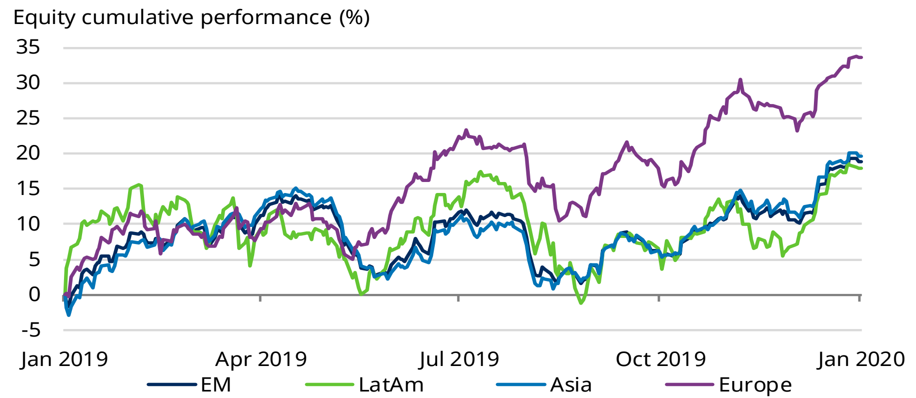
European equities overall had a strong year (EuroSTOXX50 up 29.3%), but the region once again underperformed the US (S&P500 up 31.5%), with 2019 being the fourth consecutive year of underperformance. Despite the rise in risk assets, defensive, high dividend paying growth stocks performed best. Tech stocks 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, Greece and Colombia

Chart 8: Regional equity performance in EM



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

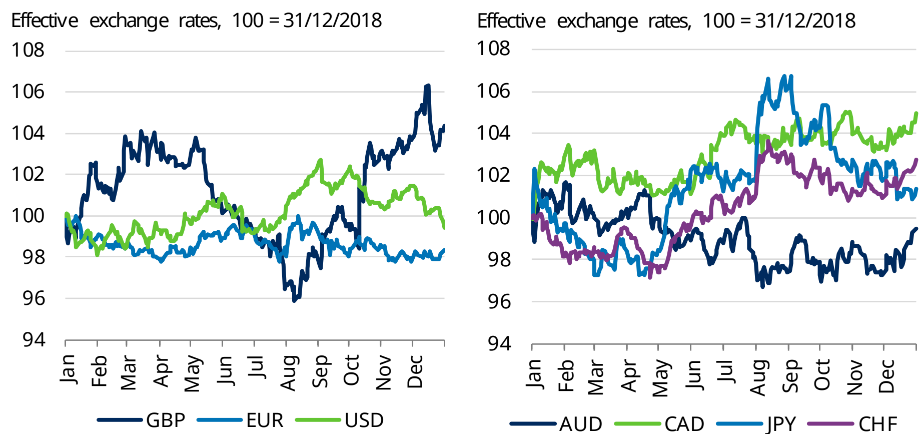
Comparing currency market performance

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 9a). 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

Charts 9a and 9b: Currency performance in developed markets



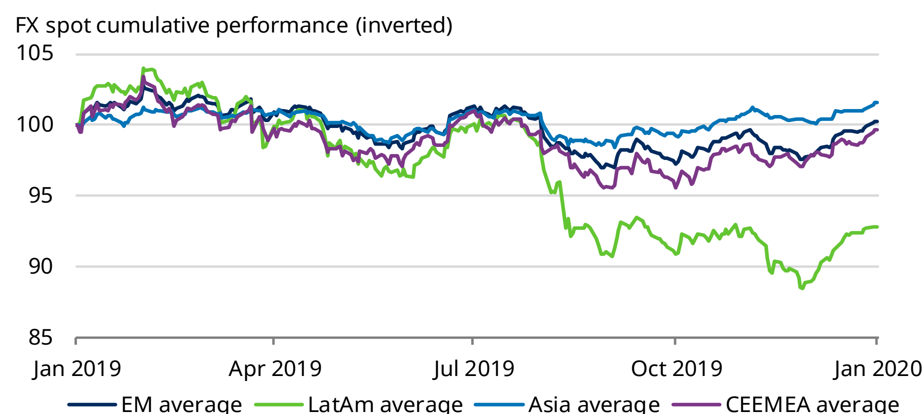
Source: Refinitiv Datastream, BIS, Schroders Economics Group. 2 January 2020.

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 10: EM regional currency performance in 2019



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

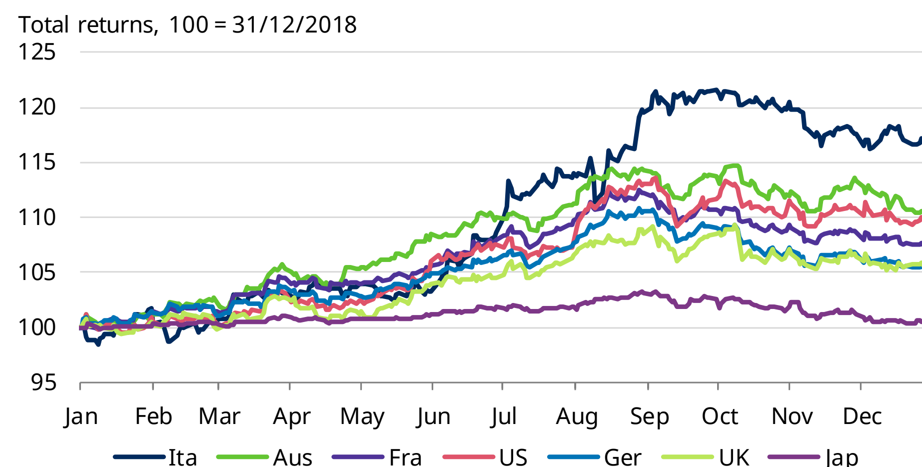
Comparing debt market performance

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 11: Government debt returns (10-year bonds)

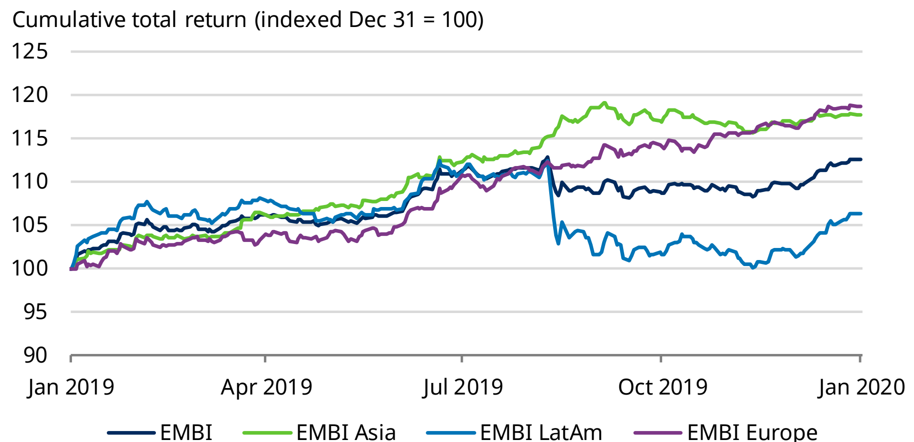


Source: Refinitiv Datastream, Schroders Economics Group. 2 January 2020.

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 12: 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?

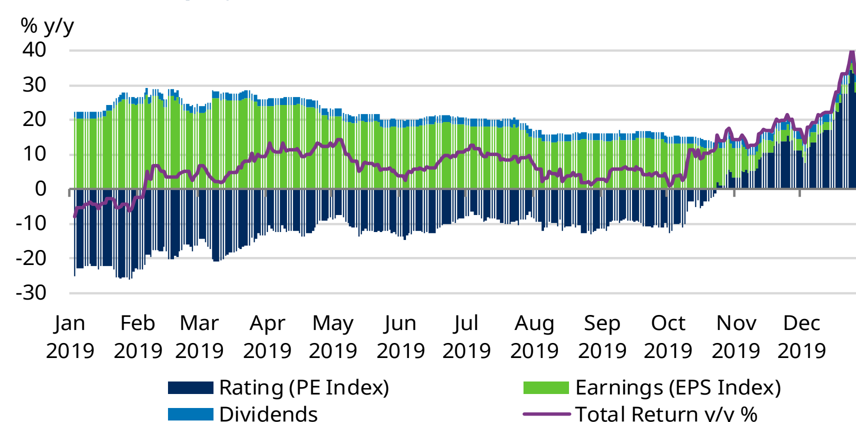
Keith Wade
Chief Economist and Strategist

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 13).

Chart 13: US equity market drivers: return breakdown



Source: Refinitiv Datastream, Schroders Economics Group, 31 December 2019.

In many ways, market performance in 2019 was a reversal of 2018 with the US Federal Reserve 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 restarted quantitative easing (QE) as, debatably, did the Fed[2]. 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 14). During this period the US Treasury yield curve inverted and there was widespread talk of recession.

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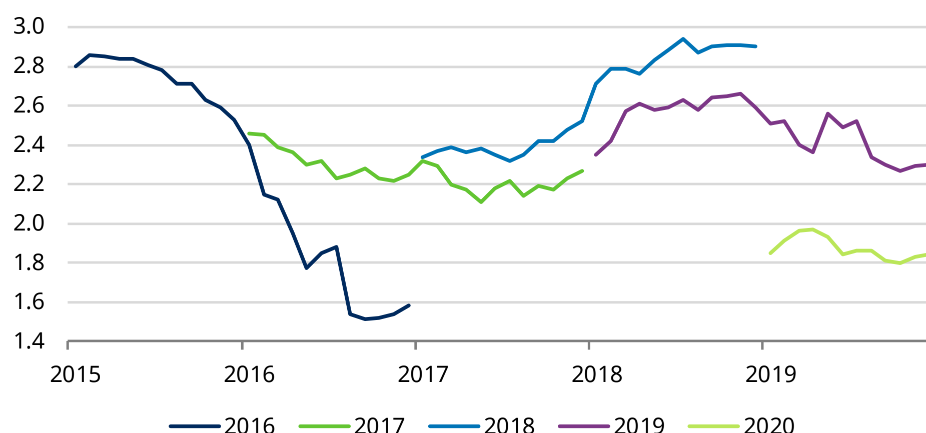
[2]The US central bank presented the move as a technical adjustment to smooth spikes in money markets although many saw it as a return to QE through the effect on the Fed's balance sheet.

Chart 14: Consensus GDP growth expectations in US



Source: Refinitiv Datastream, Schroders Economics Group, 31 December 2019.

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.

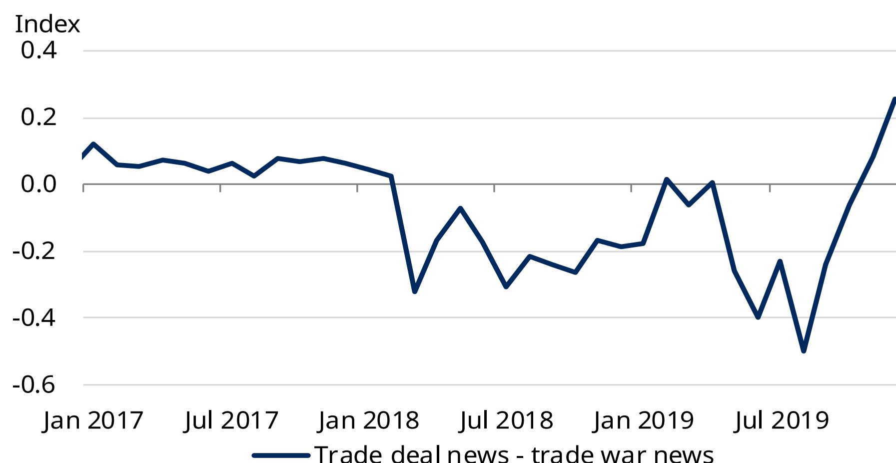
Trade tensions have eased

The second factor has been the easing in trade tensions between the US and China (see chart 15). 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 15: 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 4: 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
2020	-1.6	-1.3	-1.8
2021	-4.8	-4.1	-4.6

Source: Schroder Economics Group, 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 4).

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 16).

But there is still little alternative

Chart 16: Equities pricing in global rebound

Source: Refinitiv, Schroder 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 mergers and acquisitions (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.

No credit canary in the corporate coalmine

Martin Arnold
Economist

"Loans and debts make worries and frets."

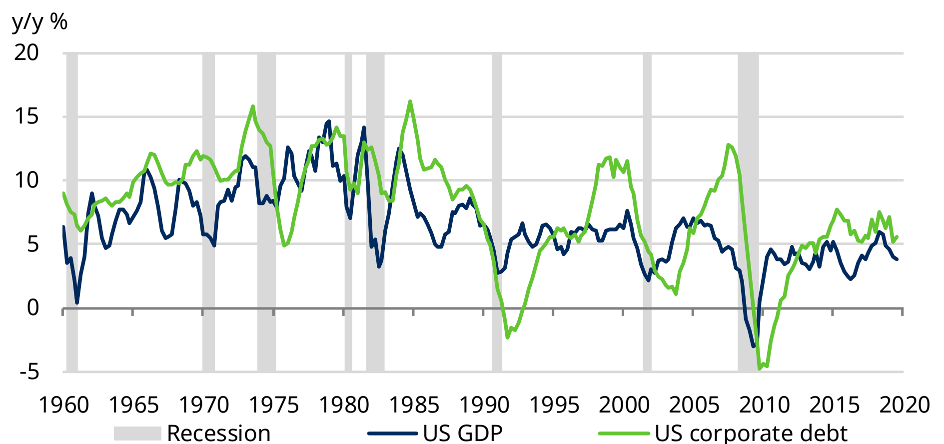
English proverb

The provision of credit is a critical element for generating sustainable economic growth. Vulnerability of both the household and corporate sectors can give forewarning about the health of the economy. In this report, the health of the corporate sector is viewed through the lens of credit markets. Generally, while there is some evidence of a deterioration in the credit space, low interest rates – driven by accommodative Federal Reserve policy – are underpinning the market. Nonetheless corporate credit is becoming less attractive from a valuation perspective, and any change from the current sub-par economic growth environment will likely exacerbate any move higher in yields.

Currently corporate credit growth is hovering around 5% per annum. Although below the longer-term average, debt growth (chart 17) remains robust but has declined from the 2018 highs. Slower credit growth since the financial crisis is one reason the subsequent recovery has been the weakest in history.

Credit expansion supports economic growth

Chart 17: US growth and credit

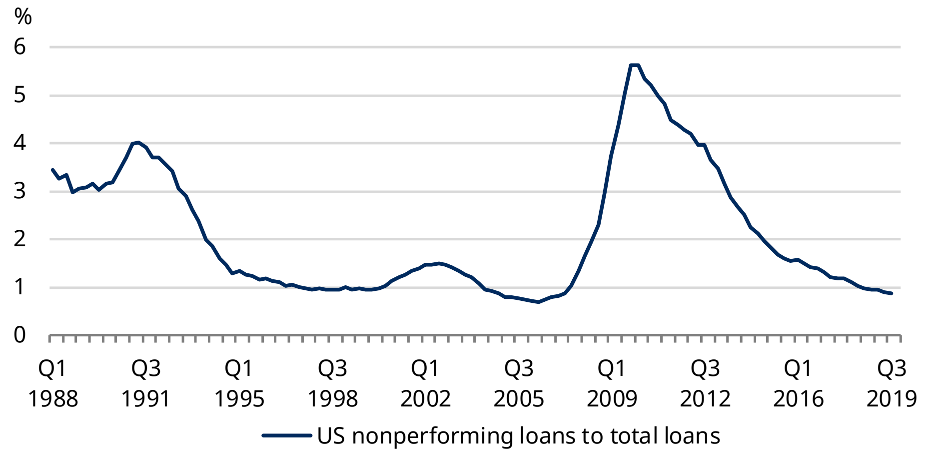


Source: Refinitiv Datastream, Schroders Economics Group, 31 December 2019.

Overall, borrowers do not appear to be under a great deal of financial stress with nonperforming loans (as a proportion of total loans) at US banks nearing record low levels (chart 18). Indeed, previous recessionary periods have been preceded by a turn higher in nonperforming loan rates (NPLs), which had started to move up as the strain on borrowers rose. Importantly, although NPL's are generally perceived as a lagging indicator, this turn higher has not yet occurred.

NPL's near historical lows

Chart 18: US nonperforming loans



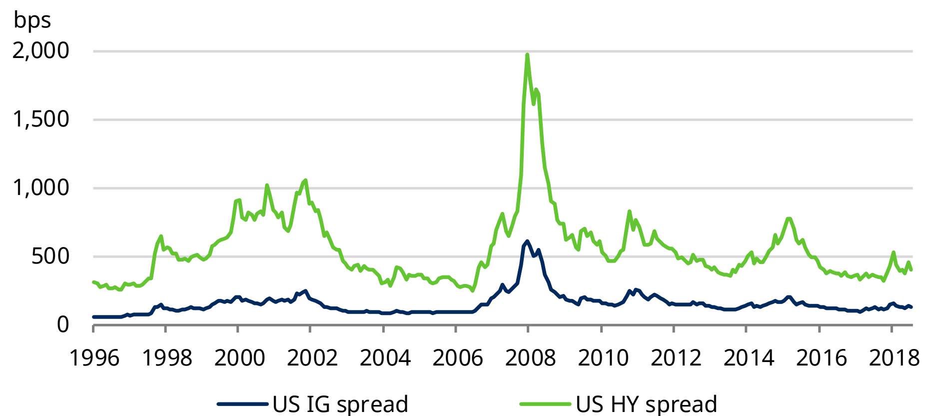
Source: Refinitiv Datastream, Schroders Economics Group, 31 December 2019.

In an attempt to determine whether corporate credit growth is sustainable, it is instructive to look at the underlying dynamics of credit markets to determine the overall vulnerability of the corporate sector. Vulnerability can be measured using various metrics, such as leverage, affordability and liquidity. The corporate bond universe can be broadly broken down into investment grade (IG) and high yield (HY) segments. Corporate bonds are independently rated to reflect the degree of credit risk for investors. IG bonds are the best quality and lowest credit risk to investors, while HY are bonds of quality below that of IG. Higher yields for the HY segment reflect the higher risk of default for investors.

The Fed is supporting credit markets

Between 2016 and 2018, credit spreads narrowed for both IG and HY markets (chart 19). Despite a jump in Q4 2018, spreads have remained relatively stable for most of 2019, highlighting the lack of concern about default stemming from a pronounced growth slowdown. Ordinarily, narrower spreads would signal that companies are healthy and there is lower credit risk, and less potential for default. However, in times of unprecedented monetary stimulus, there is more to the story: Fed policy, in particular quantitative easing, has been partially responsible for the moves. Investors face low or negative interest rates on the vast majority of sovereign debt, so they have been forced further out on the risk curve seeking additional yield. As a result of investors moving into riskier investments, compensation rates for leverage have become more depressed.

Chart 19: US corporate credit market pricing

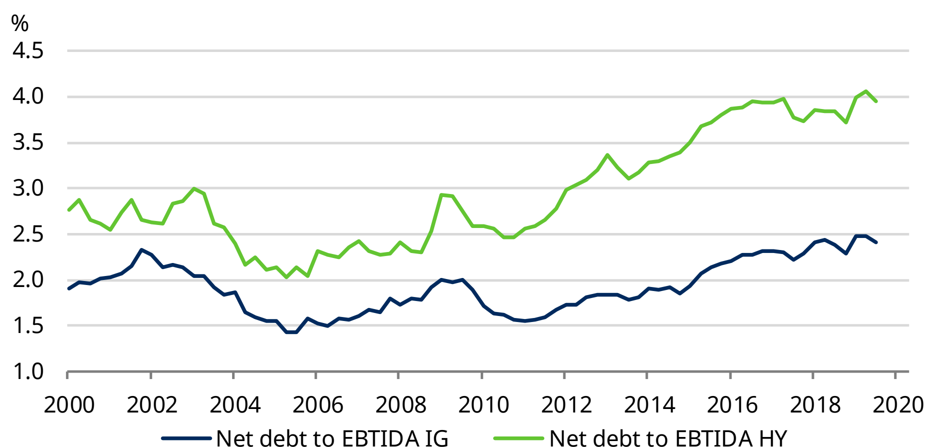


Source: Bloomberg, Schroders Economics Group, 31 December 2019.

Leverage has risen strongly since the financial crisis

Leverage in corporate credit markets has been rising for both the IG and HY segments as a proportion of corporate earnings since the financial crisis (chart 20). In recent years debt growth momentum has waned, with companies more reluctant to borrow more, alongside companies that are actively reducing debt levels. This slowing growth trend is exacerbated after allowing for an accounting rule change in the US that saw leverage ratios spike in early 2019.

Chart 20: US credit market leverage



Source: Bloomberg, Schroders Economics Group, 30 November 2019.

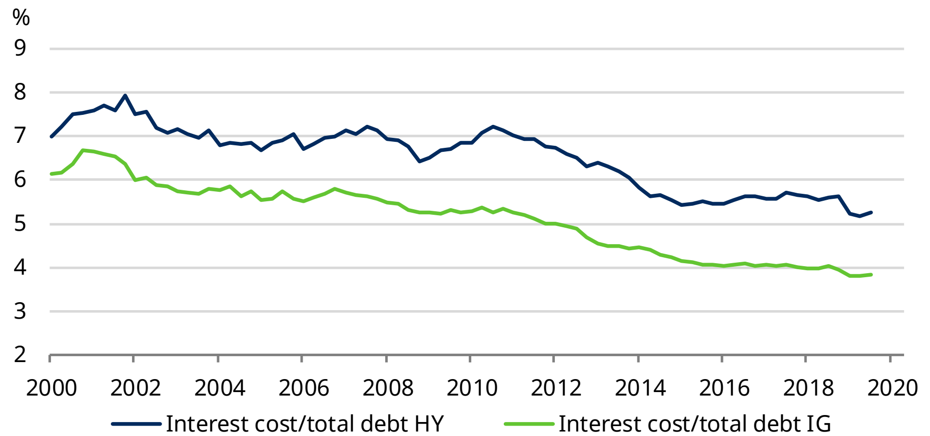
The reluctance of corporates to borrow is flowing through to the real economy in the form of lower rates of capital expenditure, thereby inhibiting overall economic growth.

Credit returns have been strong in current sub-par economic growth environment

The current environment of slowing but modest economic growth has been beneficial for credit investors in 2019. The credit return profile has benefitted from lacklustre economic growth, as investors have been somewhat reluctant to embrace a more aggressive "risk-on" stance in equity markets. Over a longer timeframe, returns have been more modest and investors should be wary of any move to a more risk-on mindset in 2020, as this could prompt flows out of credit market instruments.

The current health of the US corporate sector has been supported by both accommodative central bank policy (low interest rates and quantitative easing) and healthy household balance sheets (rising jobs and wages). Although overall leverage has increased significantly since the crisis, major central banks have pursued very accommodative monetary policies, keeping benchmark rates low or negative, and in turn making debt more affordable for corporates. There has been a downward trend for the cost of credit for much of the last two decades, with rates at record lows for both IG and HY segments of the market (chart 21).

Chart 21: US cost of debt

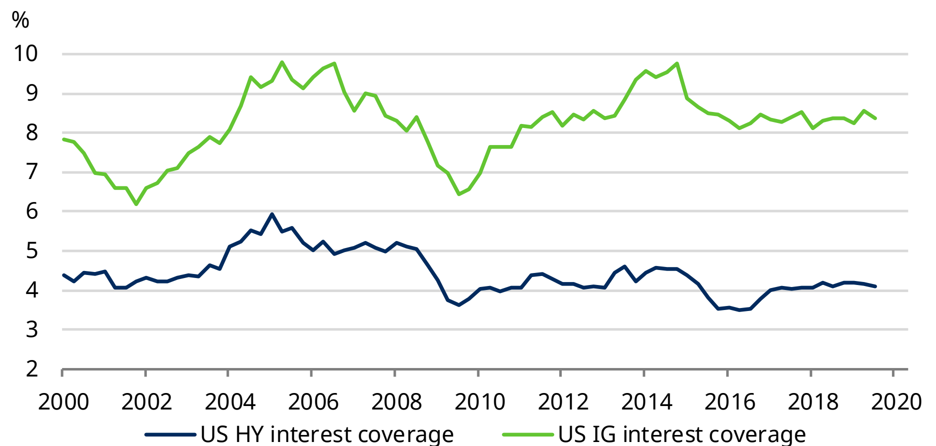


Source: Bloomberg, Schroders Economics Group, 30 November 2019.

Interest cover is stable

Lower interest rates help keep debt servicing burdens manageable (chart 22) and robust household consumption is underpinning growth, albeit slowing, in corporate earnings. Although the cost of debt has been falling, so have earnings estimates, which has kept interest cover levels relatively stable. Both debt servicing burdens and household consumption bear watching, as a rapid deterioration in either could be an early warning signal that a recession is on its way.

Chart 22: US interest coverage

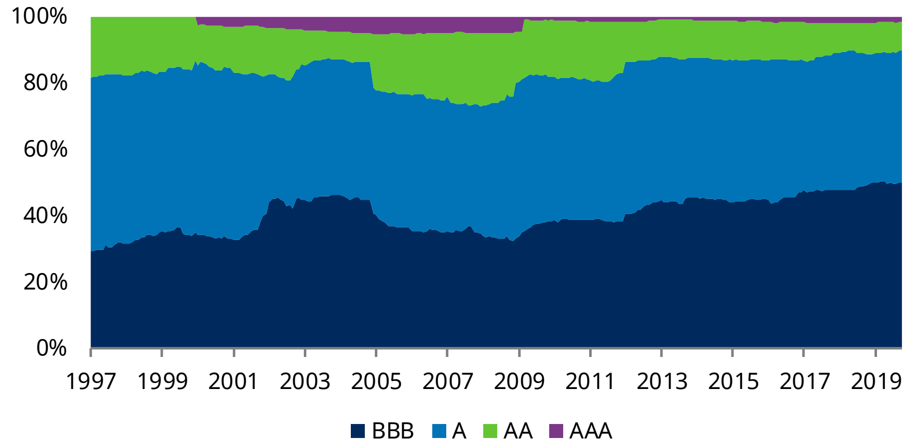


Source: Bloomberg, Schroders Economics Group, 30 November 2019.

Credit quality deteriorating

Admittedly, credit quality has been deteriorating in recent years. Investment grade debt accounts for nearly three-quarters of US corporate debt issuance. Of that, around half is the lowest quality of the IG universe, the BBB segment, the segment that has been growing (chart 23). Rising amounts of lower quality debt, mainly in the investment grade universe, is somewhat concerning but there are mitigating circumstances.

Chart 23: US IG credit composition (BoFA Merrill Lynch US investment grade)

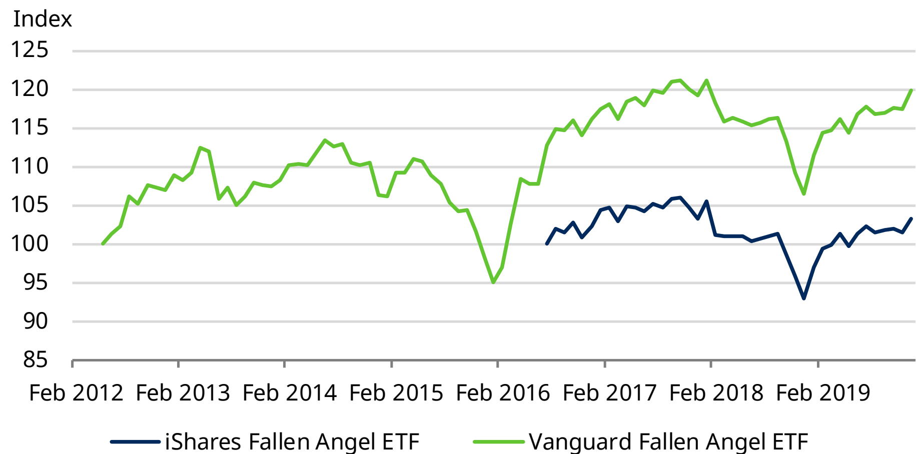


Source: Bloomberg, Schroders Economics Group, 30 November 2019.

Downgrades relative to upgrades at multi-year lows

2019 was notable because the number of "fallen angels" (downgrades to HY from IG), relative to "rising stars" (upgrades from HY to IG), within corporate credit, has reached the lowest in a decade. Certainly, a greater amount of upgrades compared to downgrades is one reason for the growth in the BBB segment of the IG universe. Additionally, investors remain content with the health of the HY segment of the market. If weakness were evident, it would likely show up in the lowest rated sections of the market. The performance of fallen angel exchange-traded funds (ETFs) is evidence of the lack of investor concern over default rates (chart 24).

Chart 24: Fallen angel indexes



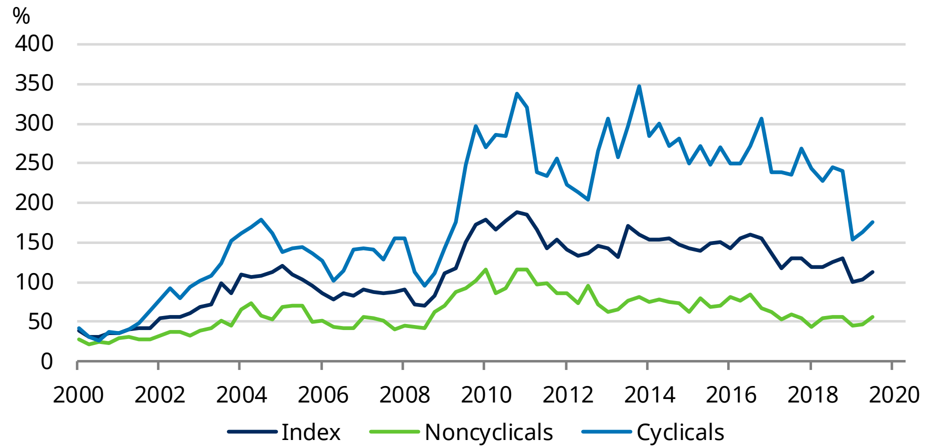
Source: Refinitiv Datastream, Schroders Economics Group, 30 November 2019.

Cyclical sectors appear most problematic

Although credit market pricing, boosted by ample liquidity, appears to highlight that investors remain confident about the health of the corporate sector, there are some early warning signs that highlight the need for caution. On a sectoral basis, cyclical sectors[3] appear to be those most affected by declining cash levels (chart 25).

[3] Noncyclical sectors: Communications, Consumer Discretionary, Healthcare, Utilities. Cyclical sectors: Consumer Discretionary, Industrials, Materials, Technology.

Chart 25: Cash to short term debt

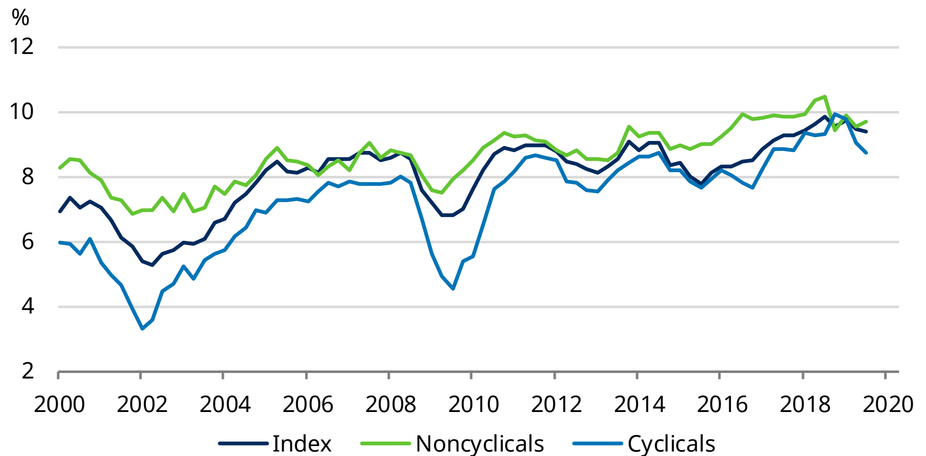


Source: Bloomberg, Schroders Economics Group, 30 November 2019.

Profit margins rolling over

Profit margins have also exhibited more pronounced declines within cyclical sectors, as US economic activity has slowed (chart 26). Declining profit margins, albeit from elevated levels, could be an early indicator that slower growth is likely to continue well into 2020, especially if it results in job market weakness. We expect a further deterioration in 2020, as rising wages continue to squeeze margins. Such a situation is likely to weigh on credit valuations, pushing both IG and HY spreads wider.

Chart 26: US IG profit margins



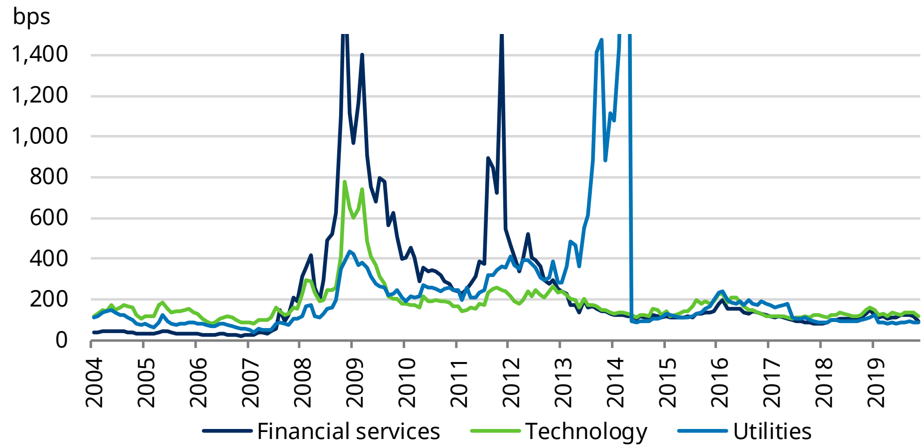
Source: Bloomberg, Schroders Economics Group, 30 November 2019.

Credit default swap (CDS) markets confirm the relatively benign environment within credit markets. CDS are effectively an insurance policy covering the holder of the swap in the event of a default of a company on its debt.

CDS markets largely unconcerned about default

The CDS spreads of the largest sectors (financial services, technology and utilities), which together account for over 40% of the debt outstanding remain at depressed levels (chart 27). Overall, the market appears confident in the creditworthiness of the majority of issuers.

Chart 27: US credit default swap spreads

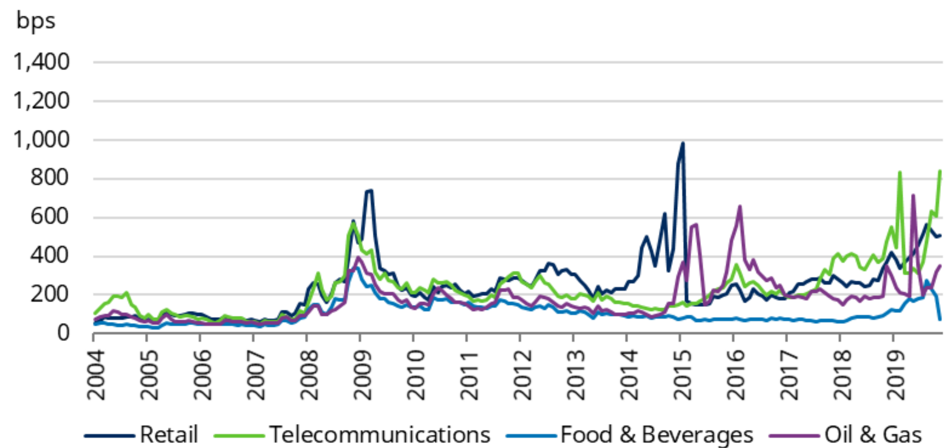


Source: Refinitiv Datastream, Schroders Economics Group, 31 December 2019.

Cyclical CDS moving higher

Significantly, it is the more cyclically exposed CDS that are experiencing the largest increases in spreads. And of the sectors that have seen a deterioration in CDS spreads (telecommunications, food & beverages, retail and oil & gas) they account for a not insignificant 20% of the IG and HY bond universe (chart 28), so there are early signs that should give investors some pause.

Chart 28: US credit default swap spreads

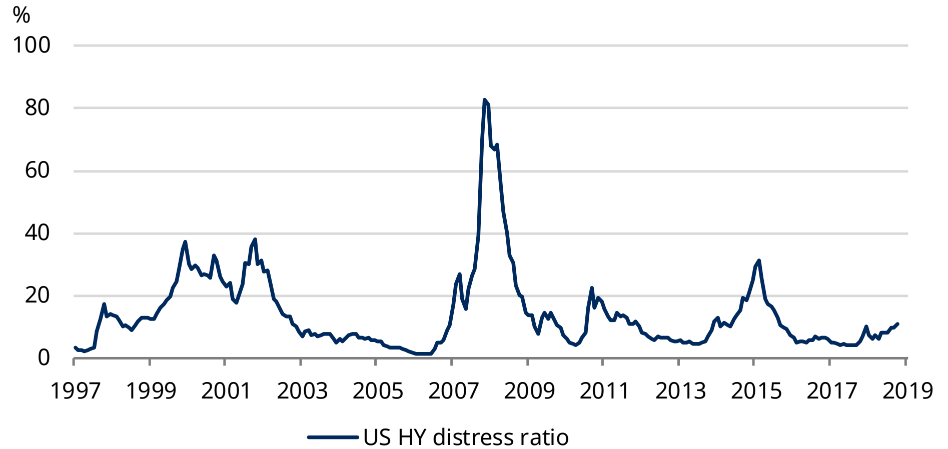


Source: Refinitiv Datastream, Schroders Economics Group, 31 December 2019.

Default rates in the HY space have also moved higher in recent months, largely due to the energy sector, which has accounted for nearly half of the defaults this year. Energy sector defaults, however, have been idiosyncratic and not related to the economic cycle. Although default activity has risen, it has been from around multi-year low levels seen earlier in 2019. What is concerning, however, is that the distress rate – the proportion of issuers in the HY segment that have spreads of over 1000bps – is creeping higher and has now reached the highest level since July 2016, suggesting that the default rate could continue higher in 2020 (chart 29).

Distress ratios hit highest since 2016

Chart 29: US distress ratio

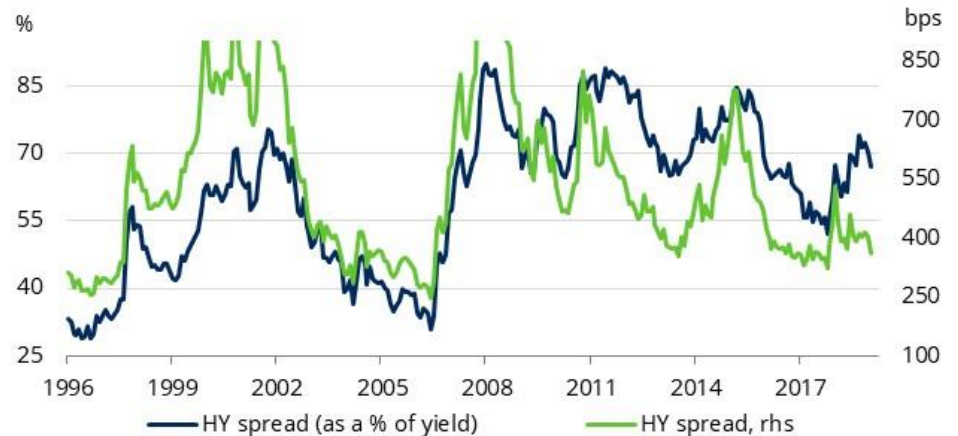


Source: Bloomberg, Schroders Economics Group, November 2019.

Another potential early warning sign of more corporate strain to come, is the 'default' portion of the HY spread[4]. This has been rising at a time that the spread has been relatively stable, suggesting that the market is potentially under pricing the risk of future defaults (chart 30). Should a further deterioration in the economic environment continue into 2020, corporate credit spreads could widen further.

HY credit 'default' spread highlights need for caution

Chart 30: US HY credit 'default' spread



Source: Refinitiv Datastream, Schroders Economics Group, 31 December 2019.

Although credit quality remains relatively robust and there is a reason to hold credit in a portfolio in the current economic environment, it has become less attractive because there are some signs that the corporate sector will feel increasing financial strain in 2020. If "lower for longer" growth continues, it seems likely that monetary policy will continue to make the cost of debt manageable.

[4]The 'default' portion of the HY spread is calculated as the HY spread as a proportion of the overall yield-to-maturity.

Signs that are cause for caution, not alarm

Overall, there are some signs that are cause for caution, not alarm in the corporate credit market. It is particularly important to watch the more cyclical sectors and the marginal indicators like the distress ratio and the 'default' part of the HY spread – these areas could indicate a further deterioration in the corporate credit market. The Fed's accommodative policy continues to make credit attractive, but there is less room for spread compression. While alarm bells are not ringing at this stage, corporate credit, particularly HY, is unlikely to be as profitable for investors in 2020, as it was in 2019.

Market returns

	Total returns	Currency	December	Q4	2019
Equity	US S&P 500	USD	3.0	9.1	31.5
	UK FTSE 100	GBP	2.8	2.7	17.3
	EURO STOXX 50	EUR	1.2	5.2	29.3
	German DAX	EUR	0.1	6.6	25.5
	Spain IBEX	EUR	2.6	4.6	16.6
	Italy FTSE MIB	EUR	1.1	6.5	33.8
	Japan TOPIX	JPY	1.4	8.6	18.1
	Australia S&P/ ASX 200	AUD	-2.2	0.7	23.4
	HK HANG SENG	HKD	7.0	8.4	13.0
EM equity	MSCI EM	LOCAL	5.8	9.6	18.5
	MSCI China	CNY	7.9	14.0	23.3
	MSCI Russia	RUB	5.2	12.7	38.8
	MSCI India	INR	1.0	6.1	10.0
	MSCI Brazil	BRL	7.0	10.4	31.5
Governments (10-year)	US Treasuries	USD	-1.1	-1.9	9.5
	UK Gilts	GBP	-1.1	-3.0	5.2
	German Bunds	EUR	-1.6	-3.8	5.0
	Japan JGBs	JPY	-0.6	-1.8	0.6
	Australia bonds	AUD	-3.1	-3.4	9.9
	Canada bonds	CAD	-1.9	-2.5	4.1
Commodity	GSCI Commodity	USD	7.0	8.3	17.6
	GSCI Precious metals	USD	3.7	3.5	17.6
	GSCI Industrial metals	USD	2.9	1.8	2.6
	GSCI Agriculture	USD	4.4	5.8	-0.3
	GSCI Energy	USD	9.4	11.5	29.7
	Oil (Brent)	USD	5.9	8.9	24.8
	Gold	USD	4.0	3.2	18.7
Credit	Bank of America/ Merrill Lynch US high yield master	USD	2.1	2.6	14.4
	Bank of America/ Merrill Lynch US corporate master	USD	0.3	1.1	14.2
EMD	JP Morgan Global EMBI	USD	1.9	2.1	14.4
	JP Morgan EMBI+	USD	2.5	3.4	12.6
	JP Morgan ELMI+	LOCAL	0.3	1.0	5.1
	Spot returns	**Currency**	**December**	**Q4**	**2019**
Currencies	EUR/USD		1.8	3.0	-1.8
	EUR/JPY		1.0	3.5	-2.7
	USD/JPY		-0.8	0.6	-0.9
	GBP/USD		2.4	7.5	4.0
	USD/AUD		-3.8	-4.1	0.1
	USD/CAD		-2.4	-2.1	-5.1

Source: Refinitiv Datastream, Schroders Economics Group. 31 December 2019.
Note: Blue to red shading represents highest to lowest performance in each time period.

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