Investor Insight

WINTER 2019-20

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What next for China?
Signs of an improvement in economic activity may be put on hold by the outbreak of Coronavirus.

The low-down on rates
With wages and consumption likely to slow, US interest rates can stay lower for longer.

Political risks remain
From Brexit and the US election to trade deals, political risk will remain a major theme in 2020.

Close Brothers
Asset Management

20|20 vision

Summary

- While the global macro-economic backdrop is still one of low growth, we see evidence of a cyclical upswing, although the Coronavirus outbreak may mean any improvements take longer to appear.
- The continuing backdrop of moderate inflation in the US should allow the Federal Reserve sufficient scope to keep rates lower for longer, which in turn should support growth and asset prices.
- Political risks remain prevalent. The US election may well begin to weigh on investors' minds as November approaches, while the UK's future relationship with the European Union (EU) remains uncertain as the two parties navigate their way through the transition period over the course of 2020.

Looking back at 2019

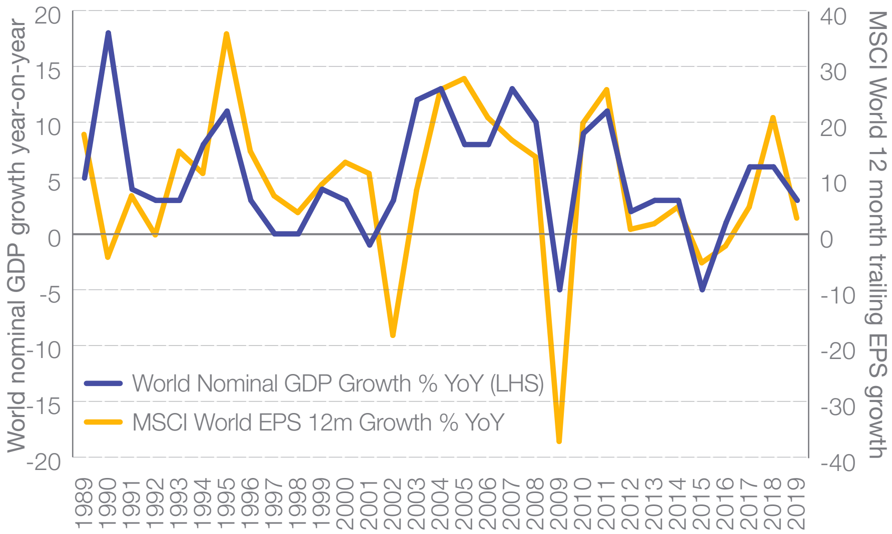
Despite weak global growth, 2019 proved to be an exceptional year for financial markets, with both shares and bonds prospering.

The slowing growth trend witnessed throughout the year was first due to the lagged effect of economic reforms introduced by Chinese policy makers, and then, in more prominent fashion, to the impact of the Sino-American trade dispute which continued to dominate the headlines.

This slowdown was most acutely felt in global manufacturing, with survey-based activity measures indicating a manufacturing recession and trade data in negative territory. This had the greatest impact on those countries where manufacturing is a larger proportion of the overall economy, and where trade (both imports and exports) is a larger share of gross domestic product (GDP). As a result, countries such as Germany and Taiwan felt the impact of the slowdown most keenly, while the US – a relatively closed, services-dominated economy - did not. While US manufacturers reported a negative impact from the slowdown in global trade, the overall effect on GDP was smaller and took longer to materialise.

From an investment perspective, global growth matters because it drives corporate earnings and monetary policy (see figure 1). As a result, nominal global growth is often a primary source of return for shares.

Figure 1: Nominal global growth drives earnings growth



Source: Bloomberg Finance L.P., DataStream.

The slowdown in nominal growth caused earnings-per-share (EPS) to slow, with global EPS growth in negative territory by the end of the year. We would have expected the lack of earnings growth to limit the performance of global equity markets. However, this low-growth environment led to an about turn by central bankers, as they began to ease monetary policy again by cutting interest rates and increasing liquidity.

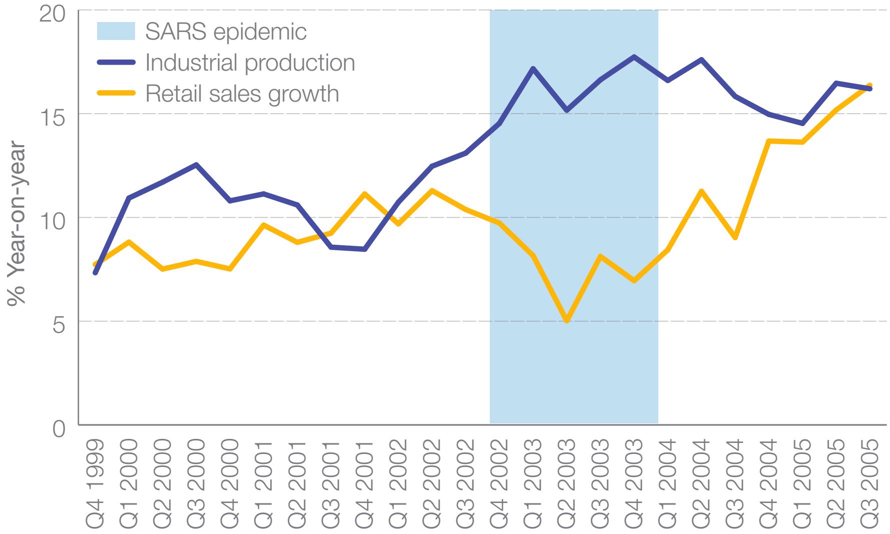
This easing impacts financial assets via two channels:

1. In the real economy, looser monetary policy is supportive of growth, as the cost of borrowing falls and consumers and firms are more inclined to spend and invest, boosting growth.

2. In the financial system, the expectation of lower interest rates reduces the discount rate used to price financial assets, increasing the present value of these assets.

As the performance of both shares and bonds in 2019 demonstrated, better liquidity conditions have benefited investors, but what should we expect in 2020?

Figure 2: Industry resilience through the SARS epidemic



Source: Bloomberg Finance L.P., DataStream.

What next for China?

Signs of an improvement in economic activity may be put on hold by the outbreak of Coronavirus.

Chinese policy makers seem committed to delivering on economic reform and the economy is maturing, so we expect that Chinese growth will continue to gradually slow over the long-term. In light of this, we believe that V-shaped recoveries, brought about by sizeable and indiscriminate stimulus measures (as seen in 2015), are less likely in the future.

Nonetheless, we do see signs that the measures taken by the administration to support the economy are having a positive effect. China's credit impulse (the change in total debt as a percentage of GDP) remains in negative territory, but the indicator is moving in the right direction. The progress made on a trade deal between the US and China is another positive factor. While the majority of tariffs imposed on American and Chinese goods remain in place, the Phase One deal signed in January signals a rapprochement, and limits the scope for further escalation. For businesses, the fact that things are not deteriorating further will offer a boost to sentiment, even if trade conditions have not yet improved.

The combination of more support from Chinese policy makers and an improvement in trade relations appears to be materialising in the data. Japanese machine tool orders and Korean industrial surveys - indicators sensitive to the Asian manufacturing cycle - show signs of inflecting upwards. In time, this improvement should ripple through the global economy to regions such as Europe.

However, the outbreak of Coronavirus in China at the start of 2020 poses a risk to this recovery. The situation is still evolving and it is not yet known how long the crisis will last.

If we use the 2003 SARS crisis as a guide, we would expect the crisis to cost 2 percentage points of GDP growth in the first quarter of 2020, with services sectors gravely impacted (see figure 2). Businesses exposed to Chinese retail, travel and hospitality are all likely to suffer, with many public spaces closed over Chinese New Year; usually a boom-time for consumption. The industrial sector is expected to be more resilient. While many factories have been closed to prevent contagion, this is likely to delay rather than destroy output. With this in mind, we would expect softer data over coming months, despite stimulus measures from policy makers. For the global economy, the greater resilience of industrial production may mean that the slowdown is felt less severely in other regions.

The low-down on rates

With wages and consumption likely to slow, US interest rates can stay lower for longer.

In 2019, we saw a significant easing of monetary conditions globally, led by the US Federal Reserve. While US GDP growth was strong in 2019, it was nevertheless slowing, and policy makers became concerned that weakness in the external growth environment and the manufacturing sector might spread across the wider economy. With a benign inflation backdrop, the rate setting Federal Open Markets Committee (FOMC) was able to cut rates to support growth without causing inflation expectations to rise dramatically. A number of central banks in other economies followed suit.

One impact of these rate cuts was to weaken the US dollar, which still functions as the world's reserve currency. A weaker dollar has an easing effect on the global economy, especially in emerging markets, where debt is often dollar denominated. Thus, lower US rates reduce the cost of financing for companies outside of the US via the currency channel.

So what should we expect from the FOMC in 2020? US growth remains stable, but it is slowing from the very high levels we saw previously. Consumer spending, the largest component of the US economy, is sensitive to the rate of real wage growth for workers, and although wage growth has been robust in a very tight labour market, recent data suggests that it is slowing. This may be because the cycle is maturing, or because businesses are not able to pass on price increases to end customers, resulting in declining corporate profit margins. The end result is that consumption growth is likely to slow modestly over time, which may keep inflationary pressures low.

The continuation of a moderate inflation environment in the US should allow the Federal Reserve to keep rates lower for longer, offering continued support to growth and asset prices.

Political risks remain

From Brexit and the US election to trade deals, political risk will remain a major theme in 2020.

In December 2019, two significant political risks reduced meaningfully. On 13 December, the Conservative party won a decisive majority in the UK general election, breaking the parliamentary deadlock that had prevented progress towards a Brexit withdrawal agreement. On the same day, it was announced that the US and China had reached agreement on the Phase One trade deal. These events certainly buoyed markets, but political risks are still very likely to persist in 2020.

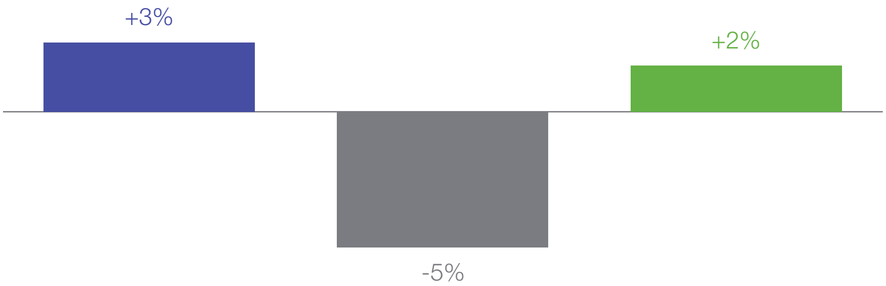
The US presidential election will take place in November 2020, with Donald Trump seeking a second term. As the election nears, we expect investors to begin to price in manifesto pledges, in terms of fiscal policy, regulation or sector-specific measures. While Trump is likely to be seen a pro-business candidate, what remains unclear is who his opponent will be, as the Democratic race unusually still has several contenders with widely differing views. Should a candidate considered to be less business-friendly win the nomination, investors may consider the stakes to be higher, which may cause volatility.

Here in the UK, legislative progress has been made on Brexit, but the UK and EU are only just beginning to negotiate the shape of their future relationship. With the UK scheduled to exit the transition period at the end of 2020, the government has less than twelve months to negotiate a comprehensive deal. We believe it is likely that tensions will emerge during the autumn, once the official deadline for requesting an extension to the transition period has passed, and as the deadline nears.

Positioning portfolios

Whist we are of the opinion that this remains a low-growth environment, we see evidence of a cyclical growth upswing in 2020, though the Coronavirus outbreak means that any improvement may take longer

Figure 3: Illustrative positioning relative to long-term neutral allocation



Shares	Bonds	Diversifiers
• Stronger economic growth should support corporate earnings • Low inflation allows interest rates to remain low, supporting growth and asset prices	• Low rates offer support to bonds • Risks to growth remain • But bond valuations look rich, especially for longer duration	• Diversification remains important • Alternatives as diversifiers can offer more attractive yield characteristics • Access to secular themes

Source: Close Brothers Asset Management.
Illustrative portfolio shows (RP4) Balanced. As at 31 January 2020

to materialise. With this in mind, we continue to believe that shares look more attractive than bonds.

Earnings growth was very weak in 2019, but the improvement in economic growth expected in 2020 should help going forward. What is more, current forecasts of earnings growth do not look high relative to history, suggesting that the market is pricing in only modest expectations.

While bonds continue to play an important diversification role in multi-asset portfolios at times of market stress, bond yields remain low relative to other asset classes. Alternative assets with income characteristics may be more attractive and offer further diversification.

Within equity markets, we favour those regions most likely to benefit from a cyclical upswing in growth expectations, such as Europe. However, given that the low-growth environment is likely to persist, we continue to see value in sectors with better long-term earnings growth potential, such as US technology. We also like areas of the market where fundamentals are being undervalued, such as domestically-exposed UK shares.

Within bonds, we continue to keep the duration of our portfolios close to the benchmark. Though political risks remain, investors are inadequately compensated for taking greater duration risk on current yields.

Within alternatives (diversifiers), we continue to favour the infrastructure sector, which benefits from its income characteristics, as well as some secular investment themes.

Conclusion

The last decade was unique in that it did not witness a US recession. Indeed, the current period of economic expansion now continues towards its twelfth anniversary, comfortably the longest period of post-war expansion on record. Though we continue to monitor the risks to markets closely, overall we believe that the economic backdrop, monetary conditions, and prevailing valuations favour shares over bonds. This could prolong the positive trend – if not quite the trajectory of last year – and we remain cautiously optimistic as we head into the new decade.

Close Brothers
Asset Management

As active managers, we aim to add value to client portfolios through the tactical asset allocation process (the tilting of asset classes) within agreed ranges and bottom-up security selection. Our **Strategic Policy Committee**, chaired by our Head of Investment Services, determines our tactical asset allocation. The committee uses an analytical framework that focuses on the key issues of economic growth, valuation of asset classes (relative and absolute), liquidity conditions, currency risk and policy management. Members discuss the implications of overweighting and underweighting individual asset classes, using data and judgment before arriving at a shared house view. Within our decision-making process, we incorporate proprietary analytics and research from specialist independent research firms.

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