OUTLOOK 2020: A FAMILIAR QUANDARY

The starting point for investors is very different now compared to the begininng of 2019.

While policymakers are more supportive and corporate earnings look set to grow by low to mid-single digits, stock market valuations are less compelling.

As we look ahead to what the coming year might hold for investors, it's worth reflecting how different our starting point is to twelve months ago. At the beginning of 2019, the FTSE 100 had fallen by about 10% in just three months, while US shares had performed even worse, losing approximately 20%.

The start of 2019, however, also saw the most important event of the year – the Federal Reserve's U-turn on raising interest rates. While economic data seemed set to continue weakening, investors now knew that the Fed had their back. Stock market valuations looked reasonable, tipping enough people into an optimistic bent and prompting a dramatic rally that has led shares to new all-time highs.

This year, we're left wondering where to go next. Economic data has largely stabilised, though there are soft patches. Central banks, most notably the Fed, but also the European Central Bank, remain supportive, with low inflation having allowed them to become progressively more accommodative of markets throughout last year. Completing our trifecta of optimism, corporate earnings are likely to grow this year, in contrast to 2019, which was largely a year of subdued numbers.

The trouble is that market valuations are much more stretched. That leaves little room for error over the year ahead. And while we don't necessarily believe anything will go wrong – the global economy continues to muddle through – recent events in the Middle East highlight how geopolitics or unanticipated developments can upset markets.

Chart 1: Global shares continued to do well in 2019

Source: Refinitiv, January 2020. Chart shows global shares (FTSE All World) rebased to 100 at the end of 2016 and finishing at the end of 2019.

Manufacturing data continues to be the main concern for investors.

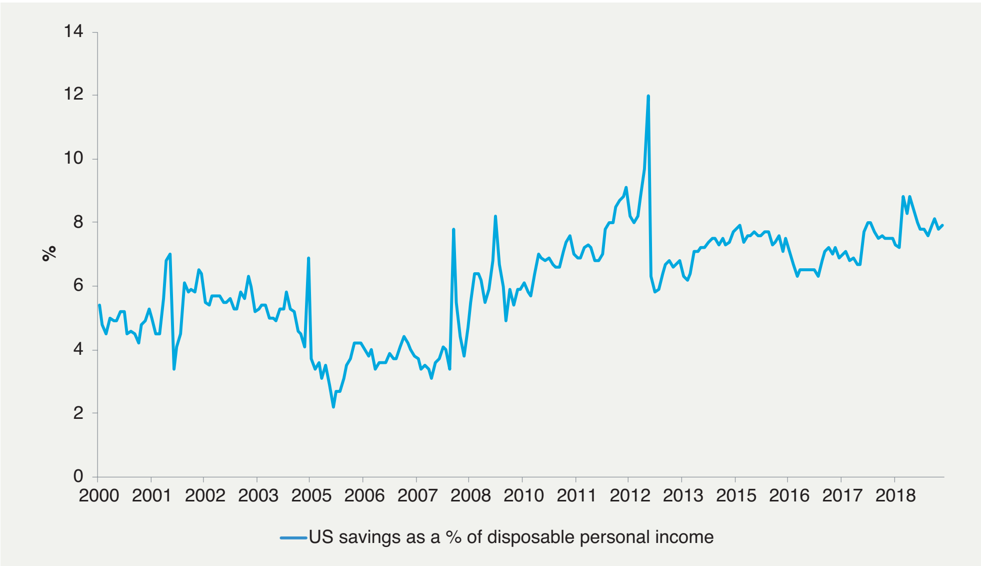
Soft economic growth held up by the consumer and services

In some ways, 2020 will be very similar to 2019. Investors will spend much of the year worrying about the health of the manufacturing economy, with survey data showing the sector is in contraction in the US and across much of Europe. While Chinese manufacturing is showing some tentative green shoots, this is still very early. Boeing's announcement that it will suspend production of the 737 Max, which hasn't yet made its way through to the data, is unlikely to improve the picture in the short term.

However, consumer behaviour remains supportive of the economy, with few signs that households are financially overstretched.

What really matters, however, is whether this spills over into consumer behaviour and the services sector. The consumer is responsible for over 70% of US GDP, making it a much more important factor in GDP. The good news is that US consumers are continuing to save a historically high proportion of their income – relative to recent history at least. This suggests that the current economic expansion has further room to run and that any future recession could be relatively mild, certainly compared to the 2008 crash.

Chart 2: US savings rate shows consumers remain in good health



Source: Refinitiv, January 2020

More broadly, there are some encouraging signs in service sector data.

There are two further reasons to be cheerful. First, employment continues to grow in the US, with workers benefitting from rising real wages – i.e. more money in their pocket after taking account of inflation. Second, US service sector data has shown some tentative signs of improvement, with the December survey reading showing a rebound in overall activity. While this is only a snapshot from one month, European data showed the same picture.

The pressure on manufacturers should ease with the Phase 1 trade agreement between the US and China, but various issues prevent a more comprehensive US-China deal.

Can the industrial sector start to help out?

Of course, investors might still breathe easier if we saw an industrial rebound. There are few obvious catalysts for this however. The recently agreed Phase 1 trade deal between the US and China contains a few provisions to reduce tariff rates, but these remain relatively small scale. Markets mainly welcomed the agreement as it signalled an end to further tariff escalation.

Any wider agreement between the US and China will have to overcome three, likely insurmountable, barriers. China's disregard of US intellectual property (IP) is the biggest issue. The US is unlikely to want to compromise on this, with many in the country now regarding China as a strategic competitor. Indeed, tougher action on Chinese infringement of American IP is one of the few bipartisan areas of agreement.

Other issues include whether it is actually possible for the US to close its trade deficit with China (even assuming a commitment from both sides) and what might be termed more ideological disputes, such as over the protests in Hong Kong, or the treatment of the Uyghur Muslim population.

Will markets be rooting for Trump?

Trade tensions will inevitably be influenced by the upcoming presidential election. On a positive note, a desire to get re-elected may well encourage Trump to claim victory in the trade dispute with China, regardless of the actual state of affairs.

Investors are nervous about some of the potential Democrat nominees for President.

In many ways, it is the Democrats that are worrying investors. While Joe Biden, the current front-runner, is a moderate, his closest rivals (Elizabeth Warren and Bernie Sanders) are firmly to the left of him. According to the political blogging website fivethirtyeight, Biden has approximately a one in three chance of winning the Democrat nomination, based on where he was in the polls across the second half of 2019.

Elizabeth Warren and Bernie Sanders, two firmly left-wing candidates, are proposing radical economic reforms that would have far-reaching consequences for investors.

With the first primaries being held in early February, there is still plenty to play for. Combined, Warren and Sanders also have around about a one in three chance of the nomination. Warren has sprung to prominence with her controversial stances on breaking up technology companies like Facebook and Amazon, as well as her proposals to regulate the banking industry more tightly and ban fracking. A ban on fracking would have a dramatic impact on US industrial activity alone, leading to a string of bankruptcies and even having a knock-on impact on global oil prices. Sanders has many similar policies, and will be familiar to investors from the 2016 primary election when he pushed Hilary Clinton closer than many expected.

UK investors face their own political risks, though the real impact on assets like sterling is likely to come in the second half of the year.

Get Brexit done?

Of course, UK assets come with their own political risk in the form of Brexit. The next phase of the negotiations is unlikely to be played out in the headlines as much as before, though we should still expect 'tactical leaking' as both sides battle to control the narrative. The good news is that Boris Johnson's new majority should allow him to be taken more seriously by Brussels. UK assets – i.e. the pound, shares and government bonds – appear well anchored for the time being and we would not expect significant moves until later in the year. If Johnson is serious about diverging from EU rules and controls, then the end of 2020 could still bring a risk of a no deal Brexit.

2020 has already delivered one surprise in the form of Qasem Soleimani's assassination.

The Iranian regime will not want a war with the US, though the risk of miscalculation remains high.

We remain overweight shares in the belief that positive economic growth will underpin a modest rise in company profits and dividends. Diversifying assets such as government bonds, gold and absolute return funds also have a role to play.

Unknown unknowns

With the assassination of the Iranian general, Qasem Soleimani, 2020 has already shown it can surprise investors. These events are unknowable or unpredictable in advance – they are what Donald Rumsfeld memorably called the unknown unknowns. Personally, I prefer Harold Macmillan's response to what would determine his government's course: 'events dear boy, events.'

Clearly, the Iranian regime does not want a war with the US. The price would be prohibitive for America, but the cost to the Iranian regime would be terminal. Yet as one Foreign Affairs commentator put it, 'the events of the past few days demonstrate that the risk of miscalculation is incredibly high.' Iran could use Shiite militias to strike at US forces in Iraq, support further missile strikes similar to the September attack on Saudi oil facilities, or significantly accelerate its nuclear programme. Whether the US – or Israel for that matter – would tolerate a nuclear-capable Iran is open to debate. We are no more protected from events today than Macmillan was 60 years ago.

Risk on – but nuanced

As alluded to in the title, investors face a quandary in 2020. On the one hand, the global economy continues to muddle through. Growth is not stellar but consumers remain willing to spend, cushioning the impact of a sluggish to contracting industrial sector. Although we should see low to mid-single digit corporate earnings growth, stock market valuations are already factoring this in.

Overall, we remain overweight shares in the belief that positive economic growth will underpin a modest rise in company profits and dividends. We also believe it prudent to hold some diversifying assets. While we are underweight bonds due to their low yields, the asset class should still offer protection in the event of a market sell-off. Diversifying assets could also include 'event risk' hedges like gold, which has performed well recently, or absolute return funds, which aim to deliver returns regardless of the direction of markets. While investors should probably expect more muted gains this year than in 2019, we may have a very eventful year indeed.

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