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INVESTMENT MANAGEMENT

2019 Market Outlook:
Multi-Asset

Dysfunction Junction?

Well-intended policies may have backfired, dampening global growth prospects

ANDREW HARMSTONE
Managing Director

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM

Government policies across markets have recently started to create risks to the global economy. While many were initially motivated by sound reasoning, some of these country-specific policies have become counterproductive as they have coincided with a dysfunctional U.S. approach to trade. With a layer of U.S. tariff tensions adding stress to markets around the world, these various policy-induced problems are reinforcing each other to weaken a global economy that should otherwise be growing at a strong pace.

U.S. tariffs: The dysfunctional policy that gave all the others traction

While domestic policies in a number of markets have created incremental headwinds, global economic growth might have been strong enough to push through the various national policy-induced sources of weakness—if it were not for the recent trade tensions. The U.S. approach to trade policy has dampened sentiment, hurt U.S. capex and slowed growth prospects around the globe, worsening the situation in a number of key economies.

Businesses that needed to replace obsolescent capital equipment have become reluctant to embark on large capital expenditures because their global supply chains have become unstable. The uncertainty is causing them to hold off, which has negative effects throughout the global economy.

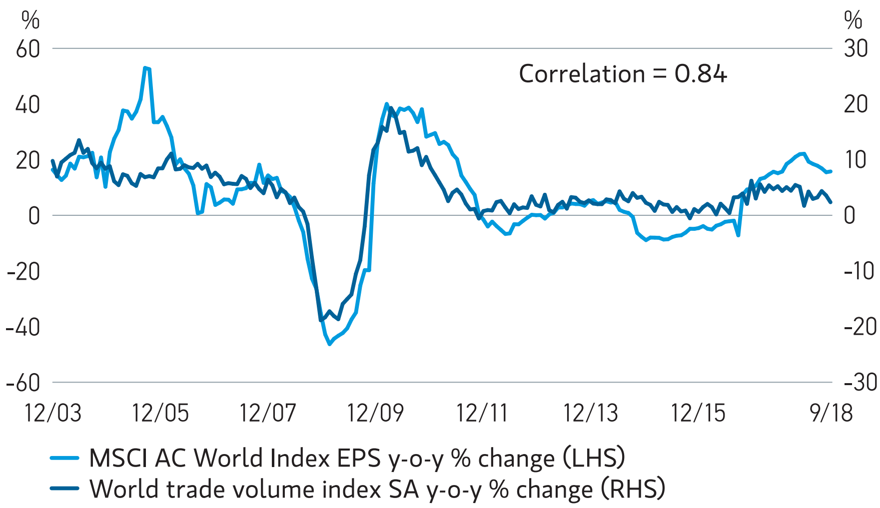
As *Display 1* shows, there is a strong correlation between world trade and earnings per share growth for the MSCI All Country World index. Negative periods in world trade impact corporate profits and slow growth, with the reduction of capital expenditures in the United States playing a big part in the mechanism.

But tariffs are not the only dysfunctional U.S. policy. A combination of very low interest rates and a banking system restrained from making loans has created a bubble in U.S. corporate debt. Keeping interest rates low was supposed to incentivise capital investment, but with rates too low for too long, it made sense to borrow excessively. Corporations used the cheap loans less productively, to buy back shares or pursue M&A deals.

At the same time, the very high capital requirements for the U.S. banking system—put in place after the 2008 crisis—made it difficult for banks to lend. This reduced debt in the part of the economy without access to other sources of lending, such as households, but corporations simply turned to the capital markets. In the U.S., total credit to nonfinancial corporations as a percentage of GDP is now higher than at the peak of the financial crisis *(Display 2)*.

DISPLAY 1

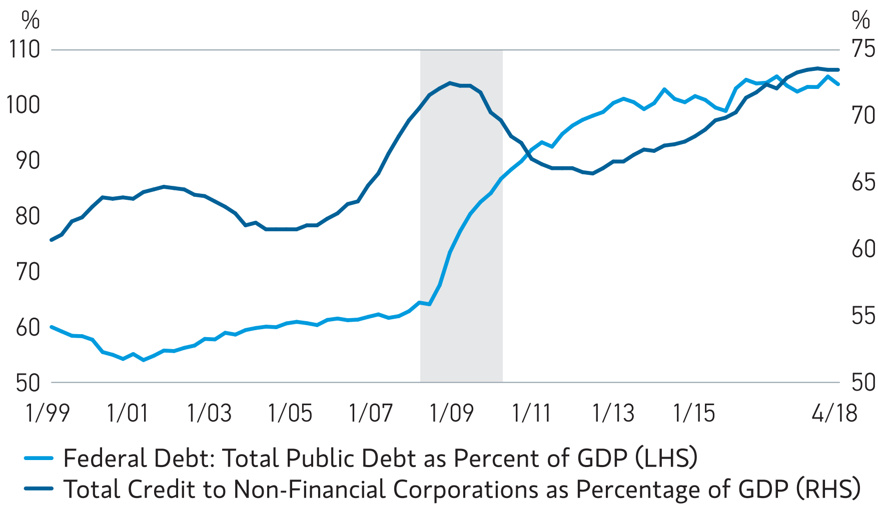
A strong link between world trade and EPS growth



Source: CPB Netherlands Bureau for Economic Policy Analysis, Bloomberg as of 27 November 2018. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

DISPLAY 2

Debt levels for U.S. nonfinancial corporations are higher than in 2008



Source: Federal Reserve Economic Data as of 27 November 2018. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

With interest rates still low and likely to rise, debt-service costs are likely to increase. The coverage ratio has been quite stable for all but the smallest 25% of companies. Among smaller-cap companies, however, interest payment risk is a lot higher—and they are the ones that tend to employ most employees.[1]

China: Rebalancing and tripping

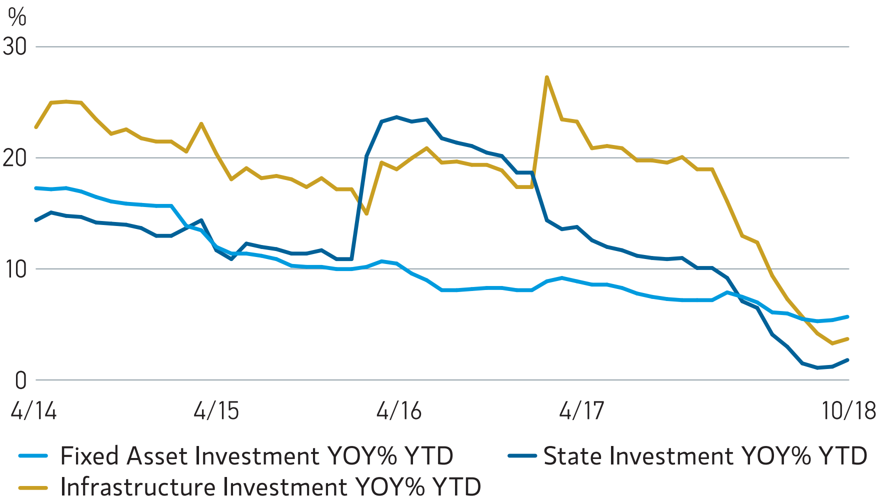
The Chinese economy has long been heavily reliant on debt. Reducing it is both a sensible policy and a primary concern for the government, but its recent attempt to reduce leverage is at the root of the weakness we are currently seeing in China. Total financing growth slowed from 13.4% at the end of December 2017 to 10.2% as of October 2018, and M2 growth[2] has moved to a historic low of 8%. But consumer confidence has dropped and household debt has grown to more than 10% of GDP over the last two years, as the debt burden shifted onto consumers.[3]

Display 3 shows how Chinese fixed asset investment has recently declined, driven by steep drops in state and infrastructure investment. It also shows how China addressed a similar slowdown in 2015—caused partly by encouraging investors to buy stocks in order to help state-owned enterprises refinance, with an objective of moving towards a more domestic consumption-driven economy—through a sharp increase in state investment followed by a big dose of infrastructure spending. However, this policy of investment-driven growth is exactly what the Chinese government has been trying to move away from.

These stimulative investments are typically financed through debt issued by the Chinese government or bank loans to corporations spending at the government's request. Either way, the investments rely on debt. By slowing investment, the government can reduce debt—unfortunately, this also slows economic growth, widens debt spreads and makes it more difficult for private entities to refinance.

DISPLAY 3

Chinese economy hooked on investment stimulus



Source: National Bureau of Statistics of China, Bloomberg as of 27 November 2018. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

Long-term, China does need to reduce its debt, and with a backdrop of strong global economic growth, its rebalancing would have been less painful. Unfortunately, its aggressive move to reduce leverage created significant weakness at the same time that trade tensions dampened sentiment and slowed growth prospects around the globe, worsening China's situation.

Europe: A menu of mistakes

It is not difficult to find dysfunctional policies in Europe, with all four of the continent's largest economies subject to regulatory or political headwinds that are amplified by global trade troubles:

- **UK** – The Brexit vote has created enormous uncertainty about the future of Britain and its ties to trading partners, with business investment contracting by 1.2% in Q3.[4] Global companies that need trading links to the rest of Europe, such as banks, are re-evaluating whether they want to be in Britain at all.
- **ITALY** – A populist government is aiming to reinstate many of the fiscally unsustainable policies that previous governments only managed to reduce with great difficulty. This has pushed up spreads in European and Italian bonds—raising funding costs, generating uncertainty and weakening the economy.
- **FRANCE** – Social unrest over living costs has led to the worst riots since 1968, undermining President Macron's longer-term ability to implement pro-growth reforms.
- **GERMANY** – Politics are also frustrating Germany precisely when it needs stability to deal with trade-related headwinds. It is facing the growth of a populist right wing element, a polarisation of the electorate on left and right, and the prospect of Chancellor Merkel being forced to step aside. She has been a stabilising force not only in Germany, but more broadly in Europe, for a long time.

Much of the downturn in Germany has been driven by a pullback in car sales, as Europe's car sector was hit by both the slowdown in China and new European emissions testing rules. Auto sales in China were down 12% and Germany's terms of trade have fallen 6.2% year over

[1] TS Lombard. "Macro Picture: Corporate Crunch" 15 November 2018.

[2] A measure of liquidity.

[3] People's Bank of China, Bloomberg.

[4] ONS (Office of National Statistics).

year, the sharpest decline since the early 2000s. Meanwhile, domestic European car registrations fell 7.3% in October, following a 23.5% decline in September.

Japan: Tough to unwind

Japan's dysfunctional policies were also initially justified. Their quantitative easing programme was intended to restart the economy, but its size and pegged rates have made it difficult to unwind without causing significant volatility. A tax increase planned for October 2019 could also turn out to have negative impacts if we see a repeat of Japan's 2014 tax hike, which was announced too far in advance and caused unnecessary uncertainty. Here, policymakers seemed to have learned from past mistakes, and this time the government has plans to mitigate the impact on consumers, such as hike exemptions on basic food items and pressure on providers to reduce wireless service charges. Moreover, forward earnings expectations are improving noticeably, suggesting Japanese equities look more attractive—at least as long as the Japanese Central Bank continues its QE programme.

Emerging markets: On the receiving end

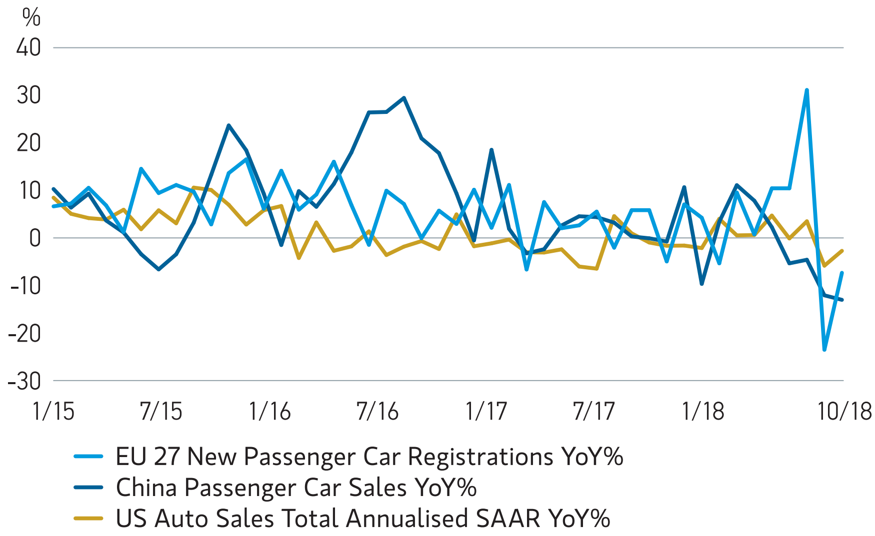
Emerging markets have generally been on the receiving end of policies implemented in the developed world, but there are a few exceptions. Following its cancellation of a major airport construction project, investors have become concerned that the new Mexican government may be relatively unfriendly to business, but it is still too early to judge how policies will evolve. Venezuela and Argentina have consistent policy-based difficulties. However, the bulk of policy dysfunction is focused on developed markets along with China.

Trends into 2019: A way out?

The keystone of the policy-induced weakness going into 2019 has been the U.S. approach to trade. After the recent G20 meeting in Argentina, Presidents Trump and Xi agreed to postpone any tariff escalation during a

DISPLAY 4

Auto sales in Europe, China and the U.S. are down



Source: ACEA, China Automotive Information Net, WARD's Automotive Group, Bloomberg as of 27 November 2018. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

90-day negotiation period. Despite the positive news, we believe this is more showmanship than substance, with tensions remaining high.

To some extent, the Chinese are willing to give the impression that the tariffs are impacting their economy more strongly than may actually be the case. By giving the tariffs credit for weakness caused by their aggressive deleveraging, they can deflect public concern about weakness grown from their own policies to Trump's highly visible tariff pressure.

In order of political likelihood, we see three potential upside catalysts that might restimulate the global economy:

1. **A MORE DOVISH FED AND/OR A SIGNIFICANT FISCAL STIMULUS**
   A significant infrastructure spending package in the U.S. is one of the few initiatives supported by both Democrats and Republicans. It could create a more supportive global backdrop for China's rebalancing act and have significant positive ramifications for the U.S.

2. **A TARGETED CHINESE STIMULUS PROGRAMME**
   China has not yet undertaken a stimulus programme because it would run counter to the government's goal of debt reduction, but it may be considering a targeted programme—enough to offset the weakness from deleveraging but not so strong as to lead to another counterproductive ramp up in debt levels. We believe the size and likelihood of this happening depends to some extent on the tariff situation. In any case, we expect a less aggressive deleveraging strategy for the moment when growth is slowing

3. **EASING OF TRADE TENSIONS**
   Genuine, positive developments in the U.S.-China tariffs negotiation would allow businesses to restart their investment programs and remove the primary stressor on the global economy.

In the absence of a positive stimulus of this sort, 2019 is likely to see continued weakness from policy until prices get to a point where valuations become attractive enough to spur demand. In most regions, we see valuations close to their fair value, but in the U.S. we still see about 4% or 5% more downside before we hit neutral levels. With the discrepancy between U.S. and European forward PE at the 97th percentile, for the first time since the financial crisis we may see more forward-looking downside risk in the U.S. than in Europe and the rest of the world.

Looking forward: Equities

While in 2018 U.S. assets were the most compelling investment (in hindsight), in 2019 we expect to find more investment opportunities outside of the U.S. Valuations and sentiment are more attractive in ex-U.S. asset classes, we expect the US dollar to turn from a tailwind to a headwind for investors and, most importantly, the U.S. is likely to lose its earnings and growth advantage. In other words, we are likely to see more synchronised GDP and earnings growth in 2019 than we did in 2018.

Despite attractive relative valuations and negative investor sentiment towards European equities, however, we are not ready to re-initiate an overweight position. Our key concern stems from what we view as still too-bullish earnings expectations in the eurozone. Twelve month forward earnings expectations currently stand at 9.5%, but sales are only expected to grow at 3.7% and core inflation is likely to accelerate, driven by rising wages.[5] A potential upside surprise could be the resolution of political concerns, but this is not our base case. A second potential positive would be a resumption of growth in European auto sales to China that could occur if the Chinese government eases up on deleveraging.

Consequently, we maintain an equal weight allocation to U.S. and eurozone equities with an underweight to U.S. technology stocks. 2019 will likely be another challenging year for equity markets, and we think positioning should be framed more in the context of sector level opportunities and style tilts than country bets. We also expect to find potential opportunities within oversold emerging market equities. At the same time, with valuations more reasonable and the positive potential catalysts above, it makes sense to cautiously increase equity exposure as forward-looking volatility is unlikely to be as high as it has been in the recent past.

Looking forward: Fixed Income

Strong U.S. growth in 2018 led to a significant repricing of U.S. Treasuries. The 10-year Treasury yield has gone up by about 50bps year to date, but with U.S. growth likely to reverse towards a medium trend of around 2% per year we feel the upside and downside risks are somewhat in balance.[6] Given their recent sharp downward adjustment, however, we maintain our underweight stance on Treasuries.

In Europe, we have seen downside surprises to economic growth due to a confluence of negative factors. While some of these factors such as Italian budget negotiation and Brexit are likely to drag on for longer, the impact of other factors such as emission regulation changes and a sharp reduction in auto sales should abate. The recovery in European economic activity is negative for euro government bonds. In the meantime, the ECB is likely to complete the QE programme and cease further balance sheet expansion. The extremely low yields from the likes of German bunds offer an unattractive risk-return proposition given the upside risk to yields. We continue to hold an underweight view on German bonds.

Similar to euro government bonds, we are negative on Japanese government bonds (JGBs). There is limited upside from JGBs, where the 10-year yield is less than 10bps. The potential relaxation of yield curve control by the Bank of Japan could lead to markedly adverse movements in yields and hence capital loss.

Within developed market credit we are putting a greater focus on quality given that we expect the recent widening in spreads to continue in 2019. A deteriorating profile for earnings in both the U.S. and Europe is likely to weigh on high yield credit. Moreover, given rising hedging costs and the prospect of US dollar weakness in 2019, we have a relative preference for European over U.S. credit.

From our perspective, one of the best opportunities in fixed income lies within emerging market debt. The asset class should benefit from the trends discussed above, namely weakening U.S. growth, a more dovish Fed and downside in the US dollar.

Investors cautiously returning

Counterproductive government policies across a number of markets have weakened the global economy. Many started with sound intentions, some outlived their usefulness and all were exacerbated by the trade war. This conjunction of dysfunctional policies has created a lot of volatility and corrected much of the excesses in pricing, with valuations outside the U.S. getting close to a point where investors might start looking to invest cautiously back in the market. Forward-looking volatility is unlikely to be as high as it has been in the recent past.

[5] IBES.

[6] Bloomberg.

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DEFINITIONS

Currency forward is a hedging tool that does not involve any upfront payment.

M2 is a measure of money supply used by the various central banks. In the Federal Reserve System, M2 includes all physical currency and deposits in checking accounts, and adds to this the amount of money in savings accounts, certificates of deposit up to $100,000 (or their equivalents), and money market accounts. The **MSCI All Country World Index (ACWI)** is a free float-adjusted market capitalisation weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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