Three themes for 2019 and some black swans

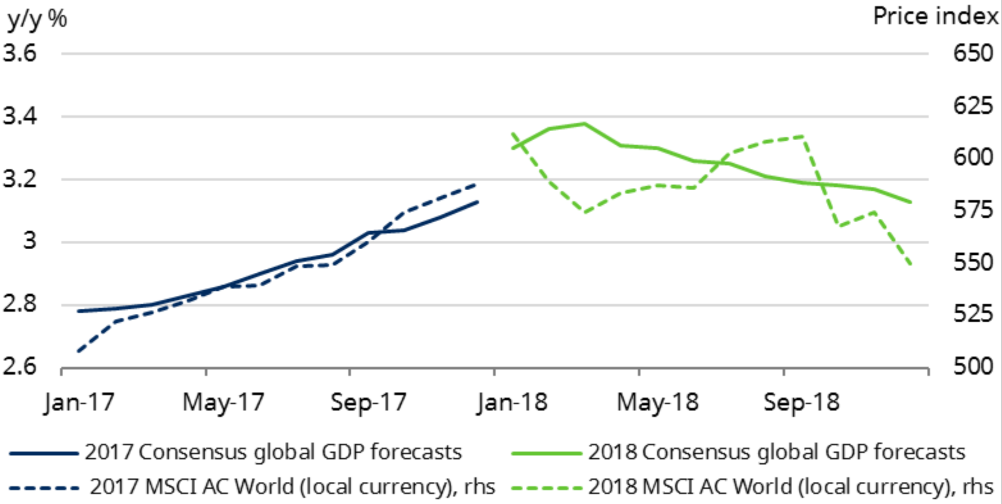
Our review of the past year makes for sobering reading, with US equity and government bond markets both returning less than cash. Such an outcome has only been registered on three previous calendar years since 1900 and highlights the challenge for investors in the current environment (see chart front page). Two factors have been important in delivering this outcome and will shape market performance in 2019.

Growth concerns

Global growth disappointed in 2018

First, global growth disappointed and remained a concern as trade tensions escalated. At the start of 2018 expectations were high as a result of the synchronised recovery in global activity in 2017. As we noted at the time though, the hurdle for positive macro surprises in 2018 had become greater, making the potential for gains more limited for equity markets. Whilst the actual outcome for global growth in 2018 is likely to be similar to that in 2017, relative to expectations, 2018 was a disappointment (see chart 11). Although the shortfall was not great, equity markets had become priced for a continuation of positive news judging from the level of market valuations and this stacked the odds against equities.

Chart 11: Global growth expectations and the equity market: 2018 vs. 2017



Source: Thomson Reuters Datastream, Schroders Economics Group, 17 December 2018.

As we went through the year, the world economy experienced a slowdown in export growth in part related to the threat from the trade wars, but also linked to the strength of the US dollar in our view. Economists produced a wide range of estimates for the impact from the US-China trade dispute and whilst we disagree with the more extreme numbers, there is evidence that the damage will extend beyond exports with capital spending also affected by the increased uncertainty associated with trade tensions.

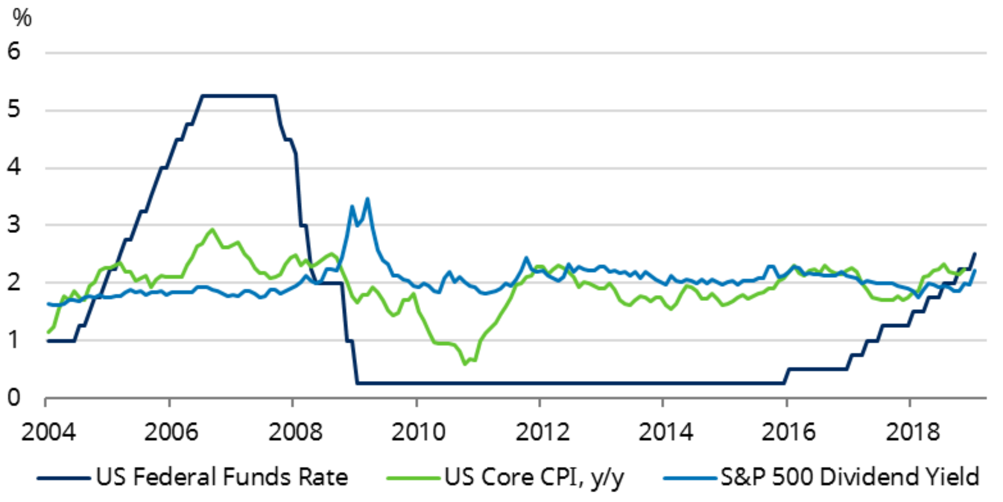
Of course, the disappointment on global growth does not account for the underperformance of sovereign bonds for which we would look at the second factor: the tightening of global liquidity.

Tightening liquidity

And liquidity tightened

The US Federal Reserve (Fed) raised interest rates four times in 2018 taking the Fed funds target range to 2.25 to 2.50% and, although the yield curve has flattened, bond yields are higher as a result of the rise in short-term rates. Furthermore, for the first time in ten years, cash yields more than underlying inflation and thus holds its value in real terms (chart 12).

Chart 12: Cash rates rise above inflation and equity yields in the US



Source: Thomson Reuters Datastream, Schroders Economics Group, 2 January 2019.

Cash has become more attractive in real terms and relative to equity

Cash is also attractive relative to equity, with the interest rate rising above the dividend yield on the S&P 500 for the first time since 2008 (Chart 12). Whilst this does not mean that equities are expensive (as dividends can be expected to grow in the future), it does reduce the search for income which has been driving investors into risk assets since the financial crisis and the collapse in interest rates.

The rise in US rates has had a wider impact through the effect on dollar borrowing costs. Recent analysis from the Bank for International Settlements (BIS) highlights the increased importance of dollar funding since the global financial crisis. Dollar strength has clearly squeezed liquidity in Asia and Latin America where dollar rates drive funding costs.

In addition to the rise in short rates, liquidity has been withdrawn via the Fed's programme of reducing its balance sheet, often referred to as quantitative tightening (QT). According to the BIS, the Fed's holdings of US Treasuries fellby more than two percentage points, to 15% of total marketable securities in 2018, about five percentage points below the 2014 peak.

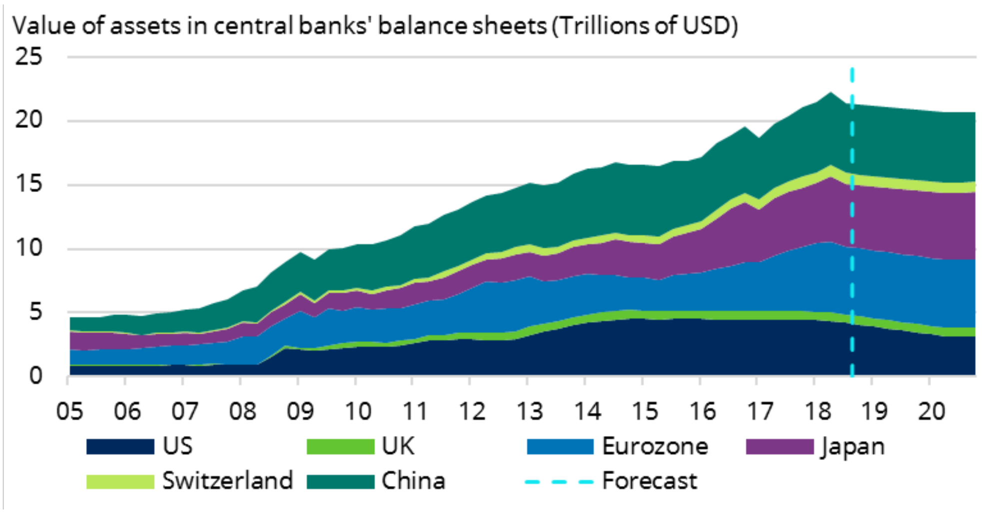
We discuss our outlook for equities below, but first highlight some key themes for 2019.

Theme 1. Liquidity ebbs and exposes the over-leveraged

Going forward, global liquidity is likely to slow further as, alongside a continuation of the Fed's QT, the European Central Bank brings its asset purchase programme to an end, as confirmed at its last policy meeting. These moves mean that the Bank of Japan is the only central bank actively engaged in QE in 2019. Intervention by the People's Bank of China and the Swiss National Bank in foreign exchange markets may continue, but the net result is that the overall level of liquidity is set to ebb in 2019 (see chart 13).

Central bank liquidity to peak

Chart 13: Global liquidity set to fall



Source: Thomson Reuters Datastream, Schroders Economics Group, 20 December 2018.

The question is how much impact will this have on bond yields? We never expected bond yields to return to pre-QE levels given the changes in the world economy since the policy began. The slowdown in productivity and greater regulation of the banking system mean equilibrium real rates will be lower. Furthermore, central banks will still have some control over the curve via short-term policy rates and forward guidance.

Nonetheless, we had expected a greater impact from Fed QT in 2018 and as US Treasury yields rose earlier in the year this appeared to be playing out. However, more recently Treasury yields have fallen back and although higher than at the start of the year, with 10-year yields currently below 3% the impact has been less than we expected.

The flow of funds data suggests that this reflects increased demand for Treasuries from households, private sector pension funds and government retirement funds. Overseas buyers have also contributed. Higher yields have no doubt helped, but the appetite for Treasuries has proved greater than expected particularly from those with long-term liabilities.

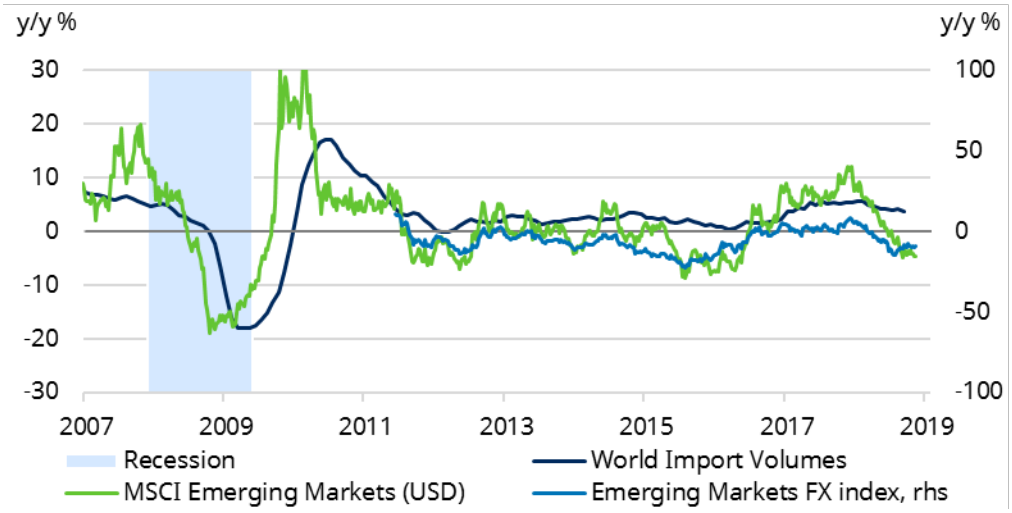
The end of the ECB's asset purchase programme will be another test for the bond markets as the central bank has had a significant impact, in markets where it was by far the largest buyer. We would expect upward pressure on yields; however, it would seem that the impact would be felt most by those outside the region, who benefited from the original asset purchase programme as investors moved out of core European markets. That means peripheral eurozone, some emerging markets and also lower grade corporate credit. The riskier areas tend to suffer as liquidity tightens as we have seen in emerging markets in 2018: as Warren Buffett said "It is only when the tide goes out that you discover who's been swimming naked".

Theme 2. The return of emerging markets

It may seem odd following on from theme 1, but emerging market assets can make a comeback in 2019. Tightening global liquidity and trade wars will not help; however, if our forecast is correct and the Fed decides to pause the tightening cycle in June 2019, there is a good argument to be made for the dollar to weaken. This would relieve the pressure on dollar borrowers and emerging markets. Arguably, those markets may already be discounting the worst, with both equities and foreign exchange having fallen significantly (chart 14).

Emerging markets are discounting a slower environment

Chart 14. Emerging market assets are pricing a weaker trade environment



Source: Thomson Reuters Datastream, Schroders Economics Group, G0008, 2 January 2019.

Macro developments will be important though and it may well need another bout of monetary and fiscal stimulus from China to be the catalyst for investors to return to the region. This would help to alleviate concern over another collapse in global trade as seen in 2007-08. However, whilst US-China trade will slow, unless the trade war goes global there is no reason to expect an outright contraction in trade as activity should be diverted elsewhere.

Theme 3. Populist pressures means governments turn to fiscal policy

The past year has reminded us how weak underlying growth in the world economy has become. The phrase "secular stagnation" is being heard again. Without the engine of US or Chinese demand, global activity tends to slow to a pace well below pre-crisis norms. Europe and Japan tend to blow with the global trade winds rather than generate their own domestic demand.

Governments looking for a quick fix are turning to fiscal policy

The US outperformed in growth terms in 2018 as a result of President Trump's fiscal policy stimulus. Others are taking note. The most striking example has been in France, where President Macron caved in to populist demands for lower taxes after several days of riots. Italy has been subject to more rigour from the European Commission, but has now gained agreement for a more expansionary budget in 2019. The UK is planning a fiscal boost in the event of a hard exit from the EU. Meanwhile, as mentioned above, look out for more fiscal policy stimulus in China. Japan may well be the exception with an increase in the consumption tax scheduled for October 2019. However, even here measures are being taken to offset the impact and following the announcement of the FY19 budget it looks like increased spending will offset the extra revenue.

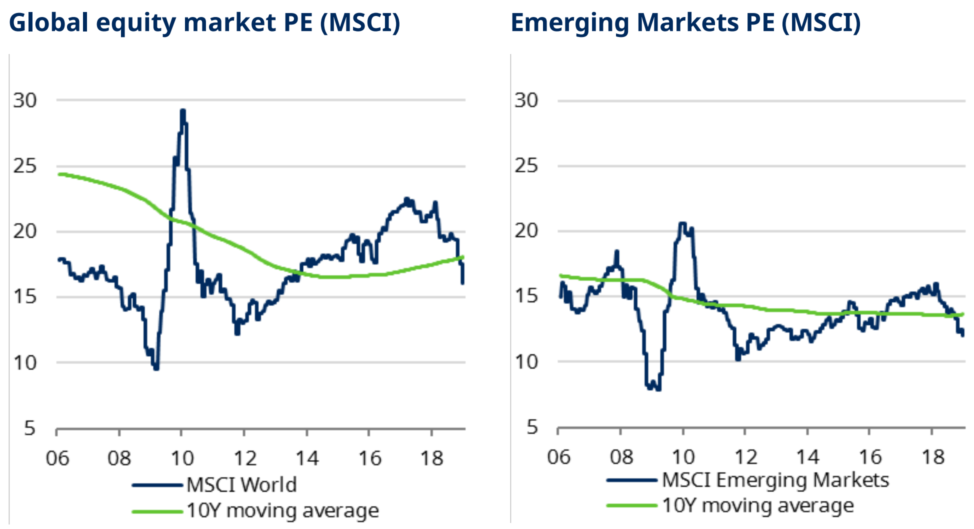
The key point is that governments seeking growth are no longer making economic reforms to increase competition or make labour markets more flexible. The approach today is to deliver a quick fix through a tax cut, increased public spending or regulation such as a rise in the minimum wage rate. Some of these measures are warranted and overdue, but governments are no longer strong enough to withstand populist pressures for a fiscal solution. This will mean greater public borrowing as the US is already finding with the budget deficit approaching 4% of GDP this year, which is remarkable for an economy with its lowest rate of unemployment since 1969. At this stage of the cycle the budget should be close to balance if not in surplus.

How are these themes likely to shape market performance in 2019?

Coming back to our review of the factors behind the weakness of markets this year: growth concerns and tighter liquidity. Clearly we still have concerns about the latter (theme 1), but recognise that governments will look to offset the macro effects through fiscal policy (theme 3).

On the growth front, our base case forecasts for 2019 are slightly below consensus and we see trade tensions rumbling on, suggesting that concerns over activity will persist. However, markets may already be pricing in much of the bad news with historic price earnings multiples now below their rolling averages (chart 15). This of course is no guarantee of positive returns in 2019, but means that markets are better positioned for disappointment and hence potentially more resilient to shocks than this time last year.

Chart 15. Equity markets have de-rated



Source: Thomson Reuters Datastream, Schroders Economics Group, G0042, 2 January 2019.

Black swans

This is an opportunity to think the unthinkable. We already use scenario analysis to calibrate the known unknowns. Black swans, however, are the unknown unknowns. By definition, we cannot anticipate them. However, we can think of four events which are plausible, but not being given much weight by markets.

Eurozone crisis 2

The eurozone does not have the mechanisms to contain a crisis

As argued above, the single currency area will feel the effect of tighter liquidity as the ECB ends QE. The worst outcome would be another Greek-style crisis. However, it is not clear that Europe has the mechanisms to prevent such an occurrence as it is yet to complete the banking union and is not a fiscal union. President Macron has proposed a fund to support growth in such circumstances, but this has yet to be created.

Peripheral bond markets have breathed a sigh of relief with the recent agreement on the Italian budget for the coming year, but the drama is likely to play out again in 2019 given the aims of the populist coalition. Any signs of crisis would cause the ECB to delay rate rises and even restart QE, but remember that it is often only through a crisis that the EU makes progress by creating the necessary support for reform.

No Brexit

This seems inconceivable given the time and energy currently being poured into sorting a withdrawal agreement. However, "no Brexit" is the only outcome that will not require a vote and with MPs seemingly hell bent on rejecting the current deal on offer and the EU refusing to talk further, there must be a possibility that the government cancels Article 50 and stays in the EU. It could certainly become a bargaining chip if PM May needs to win over the Commons.

Military action

There are plenty of hot spots which could ignite in 2019. The proxy war in the Middle East could become an actual war between Saudi Arabia and Iran. China has ambitions for Taiwan and across the region. The recent departure of defence secretary James Mattis indicates a more isolationist US, creating opportunities for others to fill the void. If Trump was to fully destabilise the UN, then Russian adventurism could return.

Trump does not run for re-election in 2020

Trump may have other plans

Although it is often difficult to read the president's intentions, he appears to be constantly campaigning and setting himself for a second term. However, he will have to see off the Mueller investigation on involvement with Russia in the 2016 election. Furthermore, he is already the oldest person to be elected president, taking office at the age of 70 and would be 78 if he served a whole second term. Health may be a factor. Or, he could simply decide to do something else: there has been talk of him founding a media empire – Trump TV anyone?

Schroders Economics Group: Views at a glance
Macro summary – January 2019

Key points

Baseline

– Global growth is expected to reach 3.3% in 2018, before moderating to 2.9% in 2019 and 2.5% in 2020. Inflation is forecast to rise from 2.3% in 2017 to 2.9% in 2018 and 2019, then falling to 2.7% in 2020. Meanwhile we continue to expect an escalation of the US-China trade war next year.

– US growth is forecast at 2.9% in 2018 and 2.4% in 2019. With core inflation rising, we expect two rate hikes in 2019, taking the Fed funds to a pause at 3% by mid-2019. However, as US fiscal stimulus fades and the economy slows to 1.3% 2020, the Fed is forecast to cut rates twice. The Fed should halt quantitative tightening in 2020.

– Eurozone growth is forecast to moderate from 1.9% in 2018 to 1.6% in 2019 as the full effects from the US–China trade war hits European exporters. Inflation is expected to remain under 2%, with higher energy price inflation in 2018 replaced by higher core inflation in 2019. The ECB is likely to end QE this year, before raising interest rates twice in 2019 and twice again in 2020. The refinancing rate is forecast to reach 1% and the deposit rate to reach 0.5% by the end of 2020.

– UK growth is likely to pick up to 1.4% and 1.5% in 2019 and 2020 from 1.2% this year. The risk of a no-deal Brexit should mean that the deal passes parliament ahead of a transition period that preserves the states quo of single market and customs union membership. Inflation is expected to fall to 1.8% in 2019 thanks to an expected rise in sterling, but stronger growth is expected to push inflation up to 2.1% in 2020. Meanwhile, staying on hold for the rest of 2018, the BoE is expected to hike twice in 2019 and twice in 2020 (to 1.75%).

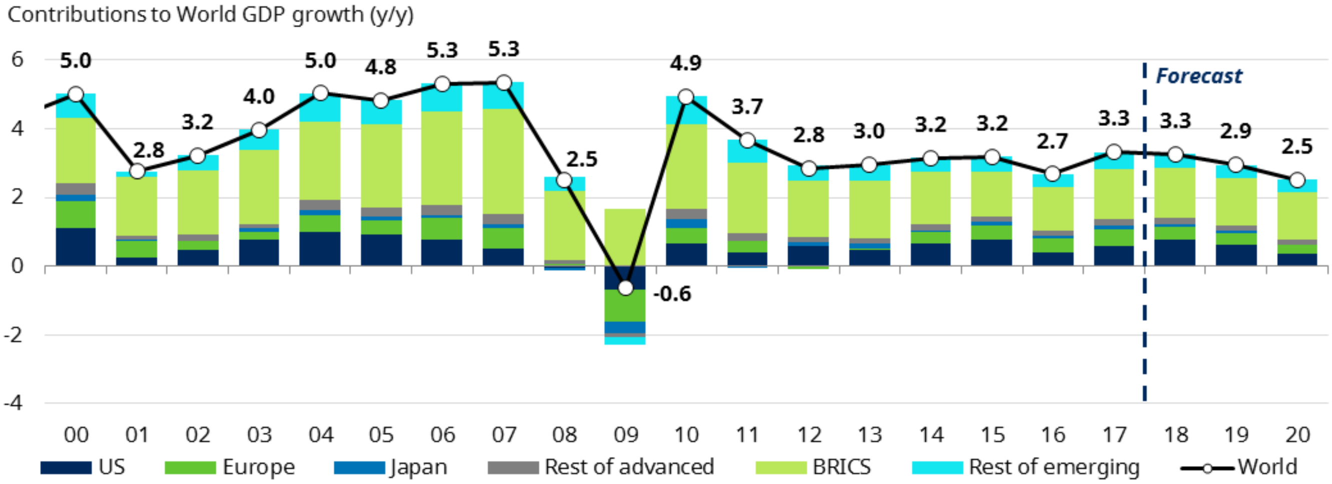
– Growth in Japan should stay fairly constant in 2019 at 1% from 0.9% this year, however activity should be volatile owing to the consumption tax hike. A slow recovery should follow resulting in no growth in 2020. Despite or expectation for much lower inflation in 2019, we expect the BoJ to make another tweak to yield curve control next year and ultimately raising rates to 0% at the end of 2020.

– Emerging economies should slow to 4.5% in 2019 and 2020 from 4.8% this year. We are optimistic that for most of the BRIC economies domestic factors can outweigh global problems in 2020. But China should continue its secular decline, exacerbated by trade wars and the PBoC should continue to ease.

Risks

– Risks are tilted toward stagflation with the highest individual risk going on the deflationary US recession 2020 scenario where the Fed overtightens in 2019. An outcome which would probably see a vacancy for the chair of the Fed.

Chart: World GDP forecast



Source: Schroders Economics Group, 26 November 2018. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2017	2018	Prev.	Consensus	2019	Prev.	Consensus	2020
World	100	3.3	3.3	*(3.3)*	3.2	2.9 ↓	*(3.1)*	3.0	2.5
Advanced*	61.4	2.2	2.3	*(2.3)*	2.3	1.9 ↓	*(2.0)*	2.0	1.3
US	26.5	2.2	2.9 ↑	*(2.8)*	2.9	2.4	*(2.4)*	2.6	1.3
Eurozone	17.2	2.4	1.9 ↓	*(2.0)*	1.9	1.6 ↓	*(1.7)*	1.6	1.2
Germany	5.0	2.5	1.6 ↓	*(1.9)*	0.0	1.4 ↓	*(1.7)*	1.5	1.3
UK	3.6	1.7	1.2	*(1.2)*	1.3	1.4 ↑	*(1.3)*	1.5	1.5
Japan	6.7	1.7	0.9 ↓	*(1.0)*	0.9	1.0	*(1.0)*	1.1	0.0
Total Emerging**	38.6	5.1	4.8 ↓	*(5.0)*	4.8	4.5 ↓	*(4.8)*	4.6	4.5
BRICs	25.3	5.7	5.7 ↓	*(5.8)*	5.7	5.5 ↓	*(5.6)*	5.6	5.4
China	16.7	6.9	6.6	*(6.6)*	6.6	6.2	*(6.2)*	6.3	6.0

Inflation CPI

y/y%	Wt (%)	2017	2018	Prev.	Consensus	2019	Prev.	Consensus	2020
World	100	2.3	2.9 ↑	*(2.8)*	2.9	2.9 ↑	*(2.7)*	2.7	2.7
Advanced*	61.4	1.7	2.1 ↓	*(2.2)*	2.0	2.0 ↓	*(2.1)*	1.8	1.9
US	26.5	2.1	2.6 ↓	*(2.8)*	2.5	2.7 ↑	*(2.6)*	2.1	2.4
Eurozone	17.2	1.5	1.8	*(1.8)*	1.8	1.6	*(1.6)*	1.6	1.5
Germany	5.0	1.7	1.9	*(1.9)*	1.9	1.8	*(1.8)*	1.9	1.7
UK	3.6	2.7	2.5 ↑	*(2.4)*	2.5	1.8 ↓	*(2.2)*	2.1	2.1
Japan	6.7	0.5	1.0 ↑	*(0.9)*	1.0	0.5 ↓	*(1.3)*	0.9	1.1
Total Emerging**	38.6	3.3	4.2 ↑	*(3.7)*	4.2	4.2 ↑	*(3.7)*	4.0	4.0
BRICs	25.3	2.2	2.7	*(2.7)*	2.8	3.3 ↑	*(3.2)*	3.0	3.0
China	16.7	1.6	2.2 ↑	*(2.1)*	2.2	2.6 ↑	*(2.4)*	2.3	2.4

Interest rates

% (Month of Dec)	Current	2017	2018	Prev.	Market	2019	Prev.	Market	2020	Market
US	2.50	1.50	2.50	*(2.50)*	2.80	3.00	*(3.00)*	2.66	2.50	2.51
UK	0.75	0.50	0.75	*(0.75)*	0.91	1.25	*(1.25)*	1.10	1.75	1.23
Eurozone (Refi)	0.00	0.00	0.00	*(0.00)*	-0.31	0.50	*(0.50)*	-0.25	1.00	-0.04
Eurozone (Depo)	-0.40	-0.40	-0.40	*(-0.40)*		0.00	*(0.00)*		0.50	
Japan	-0.10	-0.10	-0.10	*(-0.10)*	0.05	-0.10	*(-0.10)*	0.08	0.00	0.09
China	4.35	4.35	4.35	*(4.35)*	-	4.00	*(4.00)*	-	3.50	-

Other monetary policy

(Over year or by Dec)	Current	2017	2018	Prev.		2019	Prev.		2020
US QE ($Tn)	4.2	4.4	4.0	*(4.0)*		3.4	*(3.4)*		3.1
EZ QE (€Tn)	2.4	2.2	2.4	*(2.4)*		2.4	*(2.4)*		2.4
UK QE (£Bn)	435	435	445	*(445)*		445	*(445)*		445
JP QE (¥Tn)	545.5	521	552 ↑	*(549)*		572 ↑	*(563)*		592
China RRR (%)	15.50	17.00	14.00 ↓	*15.00*		12.00 ↓	*14.00*		11.00

Key variables

FX (Month of Dec)	Current	2017	2018	Prev.	Y/Y(%)	2019	Prev.	Y/Y(%)	2020	Y/Y(%)
USD/GBP	1.27	1.35	1.35 ↑	*(1.30)*	-0.2	1.42 ↑	*(1.35)*	5.2	1.38	1.4
USD/EUR	1.14	1.20	1.16 ↑	*(1.14)*	-3.4	1.21 ↑	*(1.18)*	4.3	1.25	1.2
JPY/USD	109.7	112.7	112 ↑	*(110)*	-0.6	110 ↑	*(108)*	-1.8	108	-1.8
GBP/EUR	0.90	0.89	0.86 ↓	*(0.88)*	-3.2	0.85 ↓	*(0.87)*	-0.8	0.91	0.9
RMB/USD	6.87	6.51	7.05 ↑	*(6.90)*	8.3	7.20 ↑	*(7.00)*	2.1	7.40	7.0
Commodities (over year)										
Brent Crude	53.1	55	73.6	*(73.6)*	34.1	71.7 ↓	*(73.2)*	-2.5	68.1	-5.1

Source: Schroders, Thomson Datastream, Consensus Economics, January 2019
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 31 December 2018.
Current forecast updated November 2018. Previous forecast refers to August 2018.

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

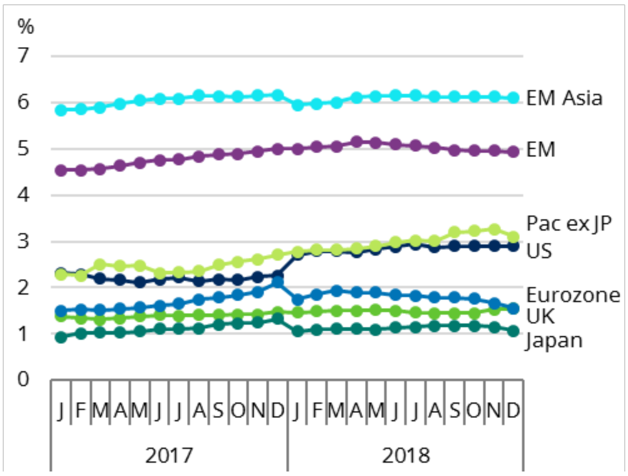
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

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

Chart A: GDP consensus forecasts

2018



2019

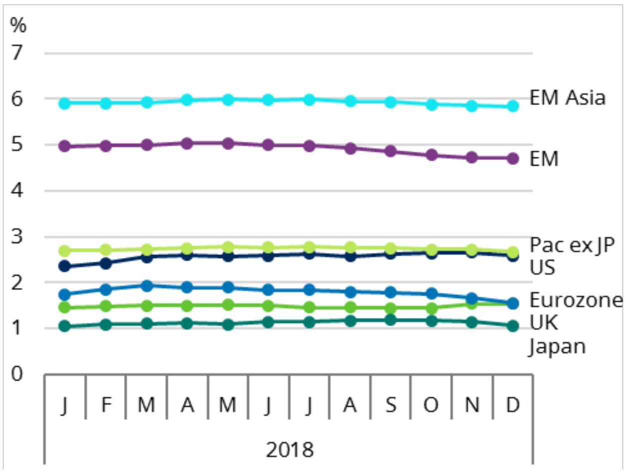
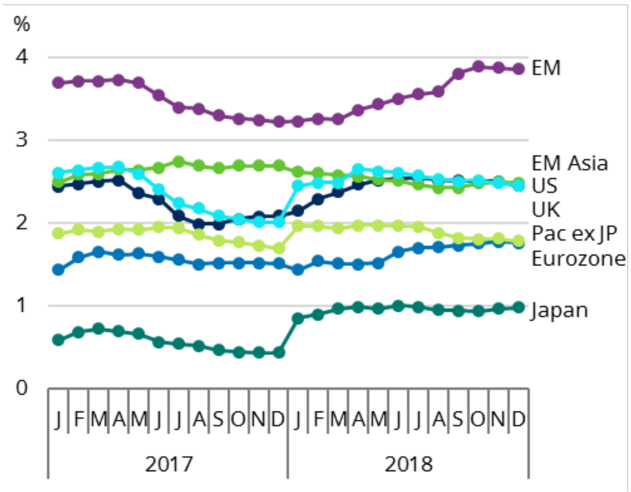
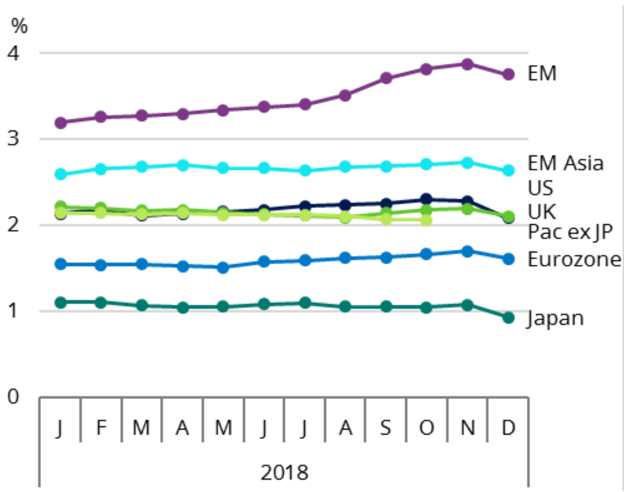


Chart B: Inflation consensus forecasts

2018



2019



Source: Consensus Economics (2 January 2019), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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