GLOBAL MULTI-ASSET OUTLOOK 2019

Once again, the Federal Reserve (Fed) policy has proven itself to be the key determinant of global liquidity, and 2018 was clearly tight. We endorse the notion that growth and easy policy elsewhere can help to offset Fed policy, but at least in the developed world which is still mostly what matters, policy is due to tighten there as well with the ECB ending quantitative easing (QE) by the end of 2018 and the BOJ reducing asset purchases despite its official stance in keeping policy easy.

China now too is a key contributor to global liquidity and, in 2018, reform efforts leading to a credit crunch clearly added to the global squeeze. The command economy has decidedly begun to reopen the liquidity spigots, but not in the usual form of massive government-led investment, which is positive from a reform perspective. Rather, injections to date are aimed to protect the real economy from the credit squeeze and escalating trade war. So far, the transmission has been rather weak, but we do expect authorities will ultimately get the mix right for growth to improve.

Our base case is that growth and now a slightly less hawkish Fed can overcome the slow withdrawal of liquidity across the developed world. However, tighter liquidity coupled with still high geopolitical uncertainty from trade wars to BREXIT and beyond, volatility will remain elevated. But like any late cycle, gains from risk assets can still be quite meaningful before the cycle ends. We remain anchored in our outlook but data dependent with firm signposts that look through volatility to either confirm our view or suggest a different path. Following are some of the key themes that we are currently following for 2019:

Key Themes

Stabilizing dollar:

Outsized US growth owing to fiscal stimulus and steady Fed tightening figured prominently during 2017 in driving the dollar higher and risk assets in the rest of the world lower. Now, with stimulus-induced growth waning in the US and the end of Fed tightening within sight, the dollar is likely to stabilize and perhaps weaken at the margin, lending relief to risk assets and emerging markets (EM) in particular. The main risk to this thesis is ever-tighter liquidity that risks a deeper dollar shortage if dollar borrowers are forced to deleverage.

China stimulus begins to lift growth:

Through fine tuning, China is likely to find the right policy mix to lift growth in Q1, but more derived through local demand, given the emphasis on consumption and less on infrastructure investment. Improving growth in China is positive for EM and commodities, but less pronounced than earlier stimulus. The principal risk is that trade wars escalate once again, and/or that rising defaults damages confidence to the point that stimulus transmission continues to be hampered. China property is also important to watch, as deterioration could also weigh on growth.

Tariff war morphs to tech cold war:

Despite the ongoing bluster, Trump knows tariffs are sure to inflict pain in the US, so cutting a deal is clearly a better set up for the 2020 election. The deal would fall short of dismantling 2025 as China deems this point as non-negotiable. So we will likely see more one-off targeted policies and attacks on certain tech companies like ZTE and Huawei. China will respond in kind, and tensions will remain high. Supply chains will continue to reconfigure to protect local technology, data and IP. The outlook is not positive but, on balance, better than the alternative driven by escalating tariffs.

European outlook is less certain:

BREXIT and Italy will continue to simmer, though we think both of these points of stress will avoid worst case scenarios. More worrying in Europe is the ailing banking system, such as Deutche Bank and the Italian Banks. As the ECB removes QE, we see the potential for further stress among banks and slower credit expansion keeping growth disappointing. The ECB is likely to re-start programs such as the TLTRO to rollover loans coming due under prior programs, so there are unlikely to be imminent flashpoints.

Liquidity tight, explosions continue:

Steady removal of liquidity by central banks will continue to add stress to those most dependent on external sources of liquidity. Turkey and Argentina could return to instability, but there macro vulnerabilities elsewhere and poor fundamentals in corporates such as GE and other lower quality credits that may begin to struggle to rollover debt on weaker cash flows. Banks in the US are much healthier than they were in 2008, but European banks are a still a risk.

On balance, we remain constructive on growth, albeit less strong in the US as stimulus wears off. Liquidity is tighter, but still healthy growth in the US, a more stable dollar and positive momentum in China can nevertheless help to lift broad money in global terms. However, as we enter this late stage of the cycle, it is important to distinguish risks and vulnerabilities to be avoided or hedged accordingly. Mistakes can and will happen, so close monitoring is essential.

Asset Class Outlook

Equities:

Equity market valuations vary quite considerably with the US still showing the most expensive against the rest of the world. The balance of risk factors discussed above suggests that 2019 will deliver low but still positive returns, in the absence of any major tail risk event. The cheaper valuations on offer in Japan and parts of Emerging markets offer a good combination of higher returns upside and greater downside cover in a falling market than the more expensive markets of the US and core Europe. In spite of our value-centric investment philosophy we believe it is too early for an outright overweight of value vs. growth or defensives vs. cyclicals companies.

Value stocks are very inexpensive compared to growth stocks on a range of measures currently. However this valuation discount might be little more than false economy if it suggests owning highly geared or cyclical companies in an environment where rates and growth risks are both rising. Similar to our colleagues from the equity security selection teams, we favour owning companies with stable and growing cash flows instead. Small cap companies too may offer greater insulation from global trade risks than large cap multinational companies.

Sovereign Bonds:

While the majority of DM sovereign bonds continue to be expensive, US Treasuries are an outlier with a more neutral valuation. The tightening of US monetary policy and rising Treasury yields in 2018 led to a significant underperformance of US bonds relative to other, lower yielding markets. However, looking ahead we believe a role reversal is likely with European bond markets in particular underperforming US Treasuries. With the ECB stepping away from its buying program, European bond yields will be forced to find their own clearing level in the absence of net central bank buying. As a result, the asset class overall will struggle to generate positive returns for investors so we prefer low duration and, in a portfolio context, investment grade credit that offers a better yield with similar protection characteristics.

Credit:

US and Asia investment grade (IG) are attractive as wider spreads have improved valuations and US treasury yields have risen. In the US, we prefer high quality as the index is increasingly filled with lower quality BBBs – now more than 50% – a fair amount of which is over-levered and at risk of downgrades to junk as the stimulus impetus ebbs and cash flows deteriorate. We do not like US high yield (HY) for similar concerns on deteriorating cash flow against quite high leverage, the risk of which is still not adequately compensated for in the spread. As a result, US HY is still expensive. Although HY is priced more attractively in Asia, the bulk of the index is comprised of Chinese property developers that still suffer from poor fundamentals and potentially further headwinds, so we stay clear. Different than in the US and Asia, European corporates have used improved cash flows to actually pay down debt. However IG is less attractive due to our bearish view on European sovereigns. It is in the European HY space where value is starting to appear.

Commodities:

Fundamentals would seem to still support oil, but the outsized influence by speculators on price make movements difficult to read. The large decline experienced since early October is perplexing as fundamentals seem still supportive. The chief concern is that the fall may be associated with a demand shock which would be very negative for the global economy, so it certainly bears a close watch. Gold is attractive having proven to be a safe asset in turbulent times, despite the headwinds of a rising dollar and real yields.

Conclusion

The US is clearly late cycle and valuations are rich while the rest of the world is hampered by slower growth and increasingly tight liquidity. However, it is early to suggest growth cannot improve to extend the cycle globally. We expect conditions to improve on the back of a less hawkish Fed, averting a full blown trade war, and more constructive growth in China as efforts to stimulate take hold. Emerging markets could perform quite well in such an environment, but sticking to quality remains key as tighter liquidity will continue to take victims that suffer from weak fundamentals. Key downside risks include escalation of a trade war, a strong dollar that forces a bout of deleveraging and efforts to stimulate China growth fall flat. Europe also bears a close watch for its still ailing banks, uninspiring growth and rising populism, just as the ECB is preparing to end its asset purchasing program. Upside risks include a firmly weak dollar and strong China growth, which would add to tailwinds for risk assets across the board. Closely following signposts will remain key for capitalizing any of these trajectories.

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