Investment Committee: 2019 in Review & Outlook for 2020

January 2020

Daniel Ardern
Chartered Financial Planner

2019 Review

January 2019 was an uncertain time for financial markets. We entered the year having seen a prolonged & consistent sell-off in global stock markets in the final quarter of 2018. This was a reflection of the global economic environment at the time and perhaps to a greater extent, the changing policies of central banks.

In response to the Global Financial Crisis, in December 2008 the US Federal Reserve (Fed) cut interest rates to 0%. US interest rates began rising again at end of 2015, and in 2018 the new chair of the Federal Reserve (Fed), Jerome Powell, quickened the pace to 'normalisation' by raising rates four times to a high of 2.50%.

Furthermore, in line with their intention to return to normalisation, in 2018 the Fed began to reverse the quantitative easing programme that has largely been in place since the Global Financial Crisis. This continued until the start of 2019.

To compound the impact of the Fed's less-accommodative stance, at the start of 2019, it appeared as though it was the intention of other global central banks to follow suit. The European Central Bank, for example, ended its quantitative easing programme in December 2018.

On a political level, 2019 began as though we would continue on the path to de-globalisation. The trade war between the US and China was seemingly escalating, a no-deal Brexit was still on the table, and there was the potential for Italy to follow the UK in leaving the EU. Furthermore, unrest and the threat of military action in the Middle East did not seem to be going away.

This all feels fairly doom-and-gloom, so why did the global stock market recover strongly during 2019?

Firstly, it can be said that the returns experienced by stock markets in 2019 are not necessarily reflective of the global economy over the period. In fact, global GDP growth slowed in several key regions (US, China, EU & emerging markets). Much of this can be attributed to the continuing trade war between the US and China and the associated uncertainty for businesses. As we have seen in the UK with Brexit, where there is uncertainty, businesses delay decisions to invest. The consequence of this is that output growth slows, causing the expansion of the global economy to also slow.

The worsening outlook for the global economy caused central banks to change their stance. It increasingly became clear that interest rates would fall in the US, and global financial markets reacted accordingly; the global stock market delivered double-digit returns in the first half of 2019 and bond prices also rose significantly.

The impact of supportive financial conditions also had a positive impact on labour markets, with low unemployment and gradually rising wages boosting consumer confidence.

As the year wore on, the tension between the US and China started to ease. On the 26 November, President Trump stated that "We are in the final throes of a very important deal…it's going very well". Furthermore, it became apparent that governments were considering ending the austerity policies that have dominated politics since the Global Financial Crisis.

As we go into 2020 therefore, the outlook for the global economy appears to be relatively positive. Global growth forecasts have been upgraded, although, as we will see, political uncertainty could have a significant influence on investment returns in 2020.

2020 Outlook

As we enter 2020, talk of a US-China trade deal has boosted the outlook for the global economy. A 'phase one' deal was announced in October 2019, but has yet to be finalised. If an agreement is reached, global trade conditions will improve, as will business investment intentions. The outlook for China, Europe and global emerging markets could also potentially improve if a deal is agreed.

As I am writing this, Iran's top military leader, Qassem Soleimani, has been killed in a US air strike. The oil price has spiked as a result, and whilst a war between the US and Iran is by no means certain, hostility has escalated. Further oil price increases could be on the cards, the effect of which on the global economy would largely be negative.

Of potential further concern is the position of central banks. With low interest rates and the apparent ineffectiveness of quantitative easing on the global economy, there are few tools in the monetary policy toolbox to respond if we enter a recession. Fiscal policy now appears to be coming to the fore, and the hope is that the appropriate inflationary, productivity and other economic conditions can be achieved to return to normalisation in the medium to long term.

Global Stock Markets

As things stand, global stock markets still appear to be trending upwards. On a valuation basis, it could be argued that certain regions and industrial sectors are over-extended. However, over the past few years, momentum investing has been the top performer and it will take a significant reversal in sentiment for this to change.

A degree of political uncertainty still exists that could 'upset the apple cart' for investors.

Since his time in The White House, President Trump has proven to be difficult to predict. This unpredictability may only heighten following the recent vote for impeachment in the House of Representatives and with the presidential election in the pipeline.

We consider that the principal risk to investors lies in the trade talks between the US and China. As stated above, further unrest in the Middle East will potentially be negative for stock markets, particularly if we see further spikes in the oil price.

In respect of Brexit, a trade deal still needs to be negotiated between the UK & EU. Prime Minister Johnson has set a deadline of the end of 2020 for the deal to be done. Political commentators remain sceptical that a meaningful deal will be able to be negotiated within this timeframe.

Over the previous 10 years, with interest rates so low, the business environment has largely been accommodative. Whilst rates remain low, assuming all else remains equal, businesses should continue to be profitable on the whole. For investors, low interest rates also mean few alternatives for making positive inflation-adjusted returns. Therefore, unless we experience a black swan event, we may well see yet another positive year for investors.

Global Bonds

Bond investors are a pessimistic lot. Bond prices rise when economic conditions worsen to the extent that we see a cut in interest rates.

Bonds did very well during 2019. This was predominantly a result of falling interest rates, low business investment intentions and low inflation.

Going into 2020, the principal factor that could cause a sell-off in bond markets is the easing of fiscal policy. In order to finance a fiscal spending programme, governments issue government bonds. The act of doing this causes bond prices to fall and yields to rise. This is most likely to occur in the UK and potentially Germany. In the US, President Trump is unlikely to get any fiscal policies through the House of Representatives, which is controlled by the Democrats.

An improvement in economic conditions (in particular, a return to inflation) would also be negative for bond investors.

Whilst political uncertainty remains, it is unlikely that bond prices will fall significantly. As uncertainty falls away, however, expect bond prices to fall, particularly if central banks change tack once again.

Summary

The political and economic uncertainty that we are currently experiencing only serves to accentuate the importance of strategic planning when constructing and monitoring investment portfolios.

It is imperative that an awareness of the risks associated with investment portfolios is maintained to ensure overexposure to individual asset classes, geographic regions and industrial sectors is limited should the unexpected occur.

In constructing investment portfolios, Gresham Wealth Management aim to achieve strong risk-adjusted returns over the long term and minimise short term losses in times of market stress.