Our predictions and preferences
Review of 2018 Outlook

Each December, we review the Outlook we presented a year earlier. In 2018 our predictions proved to be sound. Some came right pretty quickly – such as the expectation of US tax cuts. Others – such as our expectation for a weaker yen – materialised only late in the year. Bitcoin was, indeed, in a bubble a year ago. Overall we scored 8/10.

Growth continues with risk of slowing later in the year
We expected that global gross domestic product (GDP) growth would continue in 2018 at around the same rate as in 2017. Although the final data are not yet available, the IMF’s latest estimate is that growth will be 3.7% in 2018, the same as in 2017. Some softening was evident towards the end of the year.

Monetary policy divergence
We expected global monetary policies to diverge, with the Bank of Japan and the European Central Bank (ECB) continuing to expand their balance sheets while not raising interest rates; but the US running down its asset holdings and raising the Fed Funds rate towards 2.8%. Policy followed that expected path although, to be fair, it had been pretty well-signalled.

Renewed yen weakness
At the end of 2017 the yen was trading at yen112.5/US$ and we expected it to weaken. Despite some early year volatility, it did, but only marginally, to yen113.2/US$ by 12 December 2018.
Prefer consumer discretionary sector
In the US the consumer discretionary sector of the S&P500 index produced total returns of 6.8% in US$ terms in the year to 12 December 2018, well ahead of the 1.0% return from the overall S&P500 index. It was the third-best performing sector after healthcare and utilities.

China cleans up
China has made further strides in cleaning up the environment and improving corporate governance performance. However, this did not translate into equity market performance.

US tax reform, with a cut in corporation tax to 20%
US tax reform, especially with the large cut in corporation tax we expected, did indeed go through. At the time we made our prediction, it was not obvious that it would do so. It also gave the expected boost to corporate earnings in 2018.

Prefer long-dated to short-dated US corporate bonds
We thought that the yield spread between long-dated and short-dated corporate bonds was too wide and would narrow. The spread did narrow but the greater sensitivity of long-dated bonds to rising yields meant that returns from such bonds were lower than from short-dated bonds.

Bitcoin bubble, blockchain boom
Indeed, Bitcoin was in a bubble and our chart of the Bitcoin price entitled “Blowing Bubbles” hit the mark. Blockchain technology has, however, continued to be more widely adopted.

Bullish on copper, cobalt, lithium and nickel
We were bullish on the prices of the key commodities used in the production of electric vehicles: copper, cobalt, lithium and nickel. Three of the four rose in price early in the year, but finished 2018 weaker than at the start of the year.

No cut in working hours and no move towards greater income equality
There was no cut in the average length of the working week and no move towards greater income equality. We showed the ratio of the typical US CEO’s pay to that of the typical US worker. On the latest data, it rose from 271 times (when we wrote a year ago) to 312 times (US$18,855,000 for the CEO compared to US$60,491 for the worker) on the latest data.
Global growth continues

“I think it is a myth that expansions die of old age”, former Fed chair Janet Yellen claimed in 2015.¹ In Australia expansion has continued for 27 years; in other advanced economies they have barely started. We think global growth will continue in 2019. Fears of a sharp downturn in global growth are misguided.

Three years after Janet Yellen claimed the US economic expansion would not, as some considered likely, die of old age her words look suitably prophetic. At that time, and repeatedly since, there have been periodic claims that the US and other developed economies are headed into recession. That has not happened and we do not see it happening in 2019.

Expansions typically come to an end for three main reasons: a financial crisis, as in 2008/9; a rise in inflation which triggers excessive monetary tightening; or an external shock (for example, a natural disaster).

While the latter is impossible to predict, we can be pretty sure the first two triggers will not be seen in 2019 throughout the developed world.

Banks and financial institutions are generally much more resilient than they were in 2008.

There are some concerns in certain areas of financial markets – such as in parts of the corporate bond market – about excessive borrowing and poor credit quality, but we see these as being concentrated in specific areas and not a generalised problem.

A sharp rise in interest rates to curb inflation does not seem to be on the cards anywhere. In 2019, inflation rates in all developed economies will be restrained by the recent fall in oil prices; and nowhere is wage inflation high enough to trigger a wage-price spiral.

1. Global expansions

<table>
<thead>
<tr>
<th>Country</th>
<th>Expansion duration (years)</th>
<th>Cumulative growth (%)</th>
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</thead>
<tbody>
<tr>
<td>Australia</td>
<td>27</td>
<td>137</td>
</tr>
<tr>
<td>US</td>
<td>9%</td>
<td>23</td>
</tr>
<tr>
<td>UK</td>
<td>9%</td>
<td>19</td>
</tr>
<tr>
<td>Japan</td>
<td>6%</td>
<td>8</td>
</tr>
<tr>
<td>Eurozone</td>
<td>5%</td>
<td>12</td>
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¹ Source: Federal Open Market Committee, Transcript of Chair Yellen’s Press Conference, 16 December 2015
President Trump will aim to keep US growth strong in 2019, with an eye on paving the way for his re-election in 2020. There are four key areas in which President Trump may be able to influence developments.

First, we think – whether it is because of Trump’s tweets criticising the direction of Fed policy under Jerome Powell or not – the Fed will adopt a softer tone in 2019, with interest rates not rising as far and as quickly as the markets were discounting in late 2018.

Second – an area where President Trump’s tweets have arguably been even more influential – lower oil prices will help to boost growth. President Trump has tweeted that these are “Like a big Tax Cut for America and the World”, a point with which we agree.

Third, we think the US will back down on some of the measures that have been taken in its trade war with China. China, in turn, will be willing to make concessions on intellectual property rights, technology transfer and foreign ownership of Chinese companies.

Finally, measures to boost US infrastructure may eventually start to come through.

Very little progress on the US$1 trillion infrastructure plan launched before the 2016 presidential election has actually been made. Although such infrastructure projects are long-term in their nature, we think that 2019 may well see the announcement of significant developments on this front.

Certainly, there are headwinds to growth but we feel confident that the US expansion will continue and that by mid-year, President Trump will be able to tweet that he has delivered the longest expansion ever seen for the US economy. The expansion will overtake the 10-year long expansion of 1991-2001 even though the cumulative growth delivered will be little more than seen in a typical, shorter post-war recovery.
Emerging markets recover

One thing that risks being overlooked when there are periodic crises in emerging markets (Argentina and Turkey in 2018, for example) is that their growth has consistently been ahead of that in the developed world. We think that 2019 will be a year to (selectively) take advantage of that trend.

When there are problems in emerging economies – of the type seen in Argentina and Turkey in 2018, for example – there is always a concern that they will lead to contagion to other emerging markets. Such predictions have a firm basis in history. The Asian financial crisis in 1997/98, for example, started in Thailand and quickly spread to Indonesia, Malaysia, the Philippines and South Korea. Few Latin American countries escaped its debt crisis of the 1980s.

Greece’s problems spread to other peripheral eurozone economies in 2009/12: and although Greece was not classified as an emerging market when the crisis started, it was by the time it finished.

There were some early signs of that contagion in 2018, but it never developed to a very serious extent. We think that there are two main reasons:

First, many emerging economies now have flexible rather than fixed exchange rates: the exchange rate can take the strain of any outflows of foreign money.

Second, many emerging economies are better run than in the past. The picture is not uniform, but in Asia we would cite the Philippines and Indonesia as two economies with consistently market-friendly policies. In Latin America, hopes are high that, under the new Brazilian president, reforms will build on those already implemented.

Just as it would be completely wrong to judge ‘developed’ or ‘advanced’ economies as a homogeneous group, it would be wrong to apply the same approach to emerging economies.

3. Advanced and emerging market growth

![Graph showing real GDP growth in advanced and developing economies](Image)

US industrial sector

We think the US industrial sector of the equity market is pricing in a recession in the US economy. As that seems very unlikely to us, it is our favoured US equity market sector for 2019.

The US industrial sector of the S&P 500 index performed poorly over the course of 2018. Such weak relative performance of the industrial sector has only previously been seen during recessionary conditions in the US. These are shown in Figure 4a as periods where the ISM manufacturing index is below 50.

We think this displays far too much pessimism about the US industrial sector and that its performance could rebound in 2019.

One important reason is that the industrial sector should benefit as stronger infrastructure spending starts to come on stream. This has been much slower to materialise than we, and many expected, but we think it could well be a key element of what we describe as President Trump’s “all out for growth strategy” ahead of the 2020 elections. Globally, there is a high need for infrastructure spending. Research by McKinsey estimates the total required spending on roads, rail, ports, airports, power, water and telecoms at US$69tr by 2035.

The total would be US$20tr higher if additional spending to reach the United Nations’ sustainable development goals were included.

Although this need is often considered greatest in emerging economies, where the infrastructure is underdeveloped, recent research by Oxford Economics (see Figure 4b) shows that the gap between needed investment in infrastructure and that which is expected to take place is greatest in the Americas region (and much of that in the US itself).

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4a. ISM and S&P industrials

[Graph showing relative performance of S&P Industrials to S&P 500 index (% change over last 12 months) and periods of recession (ISM manufacturing index below 50).]


4b. Infrastructure investment gap by region, 2016-2040

[Bar chart showing investment need over investment expected (at current trends) by region (Americas, Africa, Europe, Oceania, Asia, World).]

Real rates stabilise

One often-overlooked feature of the US bond market is the trend in real yields. After a rise in 2018, we think that they should now stabilise.

US Treasury Inflation-Protected Securities (TIPS) are a sector of the US bond market which still attracts relatively little attention. Such securities provide a regular coupon and final principal repayment set in real terms. Both the coupon and principal increase in line with US inflation.

The conventional US 10-year Treasury bond yield, which does not provide such inflation protection, is much more widely reported. Indeed, it is a staple of financial news bulletins and is often described as the single most important financial instrument in the world or the “global risk-free rate”.

The yield gap between conventional Treasuries and TIPS is the break-even inflation rate: the inflation rate at which the yield on the two would be the same (see Figure 5a).

Viewed in this context, the rise in the conventional 10-year Treasury yield from just under 2.5% to a peak of over 3% during 2018 was entirely due to the rise in real yields.

For 2019, we think real yields will now stabilise or maybe even fall. One reason is that TIPS are likely to gain in popularity amongst US pension funds, as they have done with pension funds in other financial markets around the world.

In particular, they allow such funds to invest in an inflation-protected asset which is often well matched to their inflation-linked liabilities. This potential increase in demand will tend to depress real yields. In the UK, for example, similar inflation-protected bonds provide a negative real yield.

Furthermore, a lower oil price has typically brought not just a lower break-even inflation rate (see Figure 5b) but also lower real yields. The latter relationship may seem curious, but it can be explained by the fact that much of the benefit of lower oil prices for consumers is actually saved: higher savings then depress real yields (see Figure 5b).
Value in US corporate bonds

We think that US investment grade corporate debt offers good value and will produce positive returns in 2019.

2018 was a year of concerns about some areas of the US corporate bond market. Overall returns from both the investment grade and high yield sectors of the market were negative: falling prices more than offset coupon income.

The general concerns in 2018 surrounded high levels of corporate debt in some sectors; the relatively high proportion of companies which are in the investment grade universe but have a relatively low credit rating within that sector; and, hence, the vulnerability of some companies to being downgraded to the high yield universe.

Overlaying those issues during 2018 was a concern that interest rates may rise quite quickly and that economic growth would slow, with the potential for the US to enter a recession.

That combination, it was considered, would have the potential to push some companies into difficulties in servicing their debt.

We see a much more benign macroeconomic outlook. We do not expect a US recession and we think the extent of interest rate increases will be quite modest: we see one or two 25 basis point increases in the Federal Funds rate in 2019. Indeed, market expectations changed quite quickly towards the end of 2018 to be in line with that view.

Furthermore, for investment grade companies, the degree of leverage is not particularly high by historic standards and the coverage of debt interest payments by earnings is comfortably high.\(^2\)

Nevertheless, this is a market in which an emphasis needs to be on active management and individual security selection.

In that context, the yield on US investment grade corporate debt (see Figure 6a), which increased to 4.4% in late 2018 looks attractive to us. We think that yield is a fair compensation for the risks involved and that yields will not rise significantly further in 2019.

Therefore, further price falls seem unlikely. Over the last 44 years, there have not been two consecutive years of negative total returns for the US investment grade market (see Figure 6b). We think that positive returns will be seen in 2019.

\(^2\) Total leverage was 2.5 times EBITDA (Earnings Before Interest, tax, Depreciation and Amortisation) and on a net basis (after taking into account cash holdings) was 1.5 times in 2018 Q2. Interest coverage (the ratio of EBITDA to interest payments) was 11 times in 2018 Q2. Source: Deutsche Bank Research.
Sterling rebounds

Sterling’s value has been depressed for much of the time since the 2016 Brexit referendum. We think that as the way forward for the UK becomes clearer, sterling’s value will recover.

Sterling’s value against the US dollar and the euro has been depressed for much of the time since the vote to leave the EU in June 2016. We use two measures of sterling’s fair value to establish a range in which it should reasonably trade.

First, a simple measure of relative Purchasing Power Parity (PPP) between the UK and the US. This currently estimates the appropriate rate at US$1.73/£, a rate much stronger than sterling’s US$1.28/£ rate on 10 December 2018.

Second, a measure of the equilibrium exchange rate produced by the Peterson Institute for International Economics. This measure takes into account, as well as PPP considerations, the size of the UK’s current account deficit, its financing and the requirement to maintain domestic economic activity at close to its full employment and potential output levels. That rate is currently estimated at US$1.35/£.

So, with sterling below its ‘fair value’ range set by those two rates, we think, on fundamental grounds sterling should appreciate. Furthermore, global investors have been underweight the UK since the Brexit vote and may well be inclined to reassess their exposure once there is more clarity on the way ahead.

The prediction is based on a successful agreement between the UK and the EU on the terms of Brexit. We think that, in the end, and perhaps very close to the UK’s scheduled withdrawal date of 29 March 2019, that will be agreed.
The healthcare sector has become progressively more important in all economies around the world in recent years. In the US, the sector has become the largest employer, with more people employed in it than in manufacturing or retail trade.

US healthcare spending amounts to 17% of GDP (see Figure 8), almost twice the OECD average. In 1960, such spending was just 5% of GDP. Growing healthcare spending, partly as a result of ageing populations with longer life expectancy, and partly because of the improved technology now available, is an issue in advanced and emerging economies alike.

Over the last twenty years, price inflation for medical care and hospital services in the US has run well ahead of general price increases. Furthermore, there is a mounting concern that many of the services provided are not strictly necessary.

The US National Academy of Medicine estimates that the US healthcare system wastes US$765 bn per year (one quarter of all the money spent) on unnecessary or needlessly expensive care. In 2015, an investigation by an independent research firm found that since 1980, the number of CT scans had grown from fewer than 3 million to more than 80 million per year, with a third of them judged unnecessary. Warren Buffett regards such a high level of healthcare spending as a serious impediment to US companies’ competitiveness in world markets.

What can be done to curtail costs and provide a more efficient service? The solution, we think is on two fronts. First, greater competition. In the US, for example, the provision of healthcare can be very fragmented, with few providers in some states, limiting the scope for competition. A new joint venture between Amazon, J P Morgan and Berkshire Hathaway is a key development in this respect.

Second, digitisation, which would further help competition. Digitisation can take three main forms. Making healthcare records available in digital form; using digital technologies in the management of that information (for example, in identifying diseases and medical conditions); and digital transformation – developing new forms of digital technology. In the latter category, enhanced facilities in smart phones and watches are a rapidly-developing area.

We think we are just at the start of exciting new developments in this sector and we are actively seeking ways of gaining exposure. This will be a key theme for 2019 and beyond.
Europe: another crisis averted

Europe seems to stumble from one crisis to another. We think the latest – relating to Italy – will ease in 2019, but more fundamental problems remain.

The latest crisis in the eurozone relates to Italy and the difficulties in coming to an agreement with the European Commission on the new government’s fiscal plans. As is so often the case in such eurozone matters, a compromise will, we think, be achieved. Consequently, concerns about Italy’s credit standing should improve and the yield spread between Italian and German government bonds should narrow further.

Nevertheless, the inescapable fact is that Italy’s fiscal stance remains far from the guidelines of the European Stability and Growth pact, at least according to the strict interpretation adopted by, most notably, Germany and other northern European economies.

There is a wider concern as well. Although the euro crisis may ease, the growth of populism and the decline of mainstream political parties remains an important theme. We expect it to be evident in the elections to the European parliament in May 2019.

Social problems also persist, notably with high (especially youth) unemployment, the effects of immigration, high income and wealth inequality and the uneven distribution of the tax burden. These elements of discontent came together in the protests of Les Gilets Jaunes in France in late 2018. On the surface, these were against fuel price increases but they represented deeper social concerns. We doubt very much that significant progress will be made on tackling these issues in 2019.

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9. Government 10-year bond yields, Italy and Germany

China-US cold war

Tensions between the US and China may ease to some extent in 2019. However, there is very unlikely to be a big reduction in China’s trade surplus with the US. Longer-term, China will pivot towards the rest of Asia as the US turns towards other suppliers.

Late 2018 saw some reduction in tensions between the US and China on trade. Further tariff increases and a broadening of the range of Chinese imported goods on which tariffs are imposed looks to have been avoided.

Nevertheless, we doubt very much that there will be any significant narrowing of the trade surplus which China runs with the US. When final data become available for 2018 it seems likely that China’s surplus will be larger than that it was in 2017.

Indeed, the US trade deficit is a function of the US domestic investment savings gap. If the US economy remains strong and Trump is successful in imparting further stimulus, the investment savings gap will widen and the US current account deficit must, in that case, also grow.

The key issue is that many of the goods which China produces cannot easily be substituted by US-produced goods. Over the course of the coming years, China has other markets it can turn to for sales of its goods.

Most notably, it is developing markets along the ‘new Silk Road’, a strategy which is now termed China’s Belt and Road Initiative.

The US, in turn, may look to alternative suppliers in, for example, Latin America. On this view of the world, three key trading blocs could emerge: one centered on the US in the Americas; one centered on China in Asia; and one covering a broad European region.

10a. China-US trade

10b. Three potential emerging trading blocs
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Frequency: Tuesday to Friday by 10.30 (GMT). Online only

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Global House View and Investment Perspectives; offering asset allocation guidelines, macro overview and investment ideas.
Frequency: Monthly

Infocus: Market Snapshot
An analysis of prevailing market events.
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