Our predictions and preferences
Review of 2019 Outlook

Each December, we review the Outlook we presented a year earlier. In 2019 our predictions proved to be sound. Overall, with two judged ‘partly correct – a half mark’ we scored 9/10.

Global growth continues; no recession in US or other developed economies
We expected that global gross domestic product (GDP) growth would continue in 2019 and that the US and other developed economies would not head into recession. Some countries were close to recession – notably the UK and Germany – but it was avoided. So, once again, the global expansion continued.

Trump: all out for growth
We expected President Trump to do all he could to stimulate US growth, but recognising the limits to what could be done we thought “the emphasis will be on the maintenance of growth”. In particular, we thought his criticism of the Fed would lead to “interest rates not rising as far and as quickly” as the market was expecting in late 2018. That, indeed, proved to be the case, with previous rate increases reversed from July 2019 onwards.

Emerging markets recover
We thought emerging markets would grow faster than developed markets in 2019, which they did. However, they did not grow as fast as in 2018. According to IMF estimates, GDP growth in emerging markets was 3.9% in 2019, weaker than the 4.5% recorded in 2018. However, emerging market bonds did well in the year (with a total return of 12.3% in the year to 13 December 2019). Emerging market equities, however, underperformed developed markets (total returns of 15.6% compared to 26.2%, in the year to 13 December 2019)*.

* Sources. Emerging Market Bond returns: Bloomberg Barclays EM USD Aggregate Total Return Index; Equity Market Returns MSCI World and Emerging Market indices in US$ Total Return terms.
Sterling rebounds
We thought that sterling would rebound against the US dollar as Brexit uncertainty receded. It took longer than we expected but sterling made gains – from US$1.27/£ at the end of 2018 to US$1.33/£ on 13 December 2019.

Value in US corporate bonds
We thought that US investment grade corporate debt offered good value and would produce positive returns in 2019. Indeed, the sector produced very good returns: 15% in total return terms in the year to 13 December on the basis of the ICE BofAML US BBB Corporate Bond Index.

Real rates stabilise or fall
We thought that the rise in real interest rates in the US, measured by the yield on Treasury Inflation-Protected Securities (TIPS), would “stabilise or maybe even fall”. The real yield on 10-year TIPS fell from 1% at the end of 2018 to just 0.12% on 13 December 2019.

Healthcare disruption
We thought the healthcare sector was ripe for disruption, particularly with the development of new types of digital technology and that the trend would be seen first in the US. We said we were “actively seeking ways of gaining exposure” to innovative companies using digital technology. Although the healthcare sector underperformed the S&P 500 index, the healthcare equipment sector, which is focussed on disruptor companies did well, slightly outperforming the S&P 500 index.

Europe: another crisis averted
We thought that the latest crisis – centred on Italy – would ease. We expected concerns about Italy’s credit standing to recede and that “the yield spread between Italian and German government bonds should narrow”. That did, indeed, happen: Italian 10-year yields fell from 3% in late 2018 to just over 1% in late 2019, with the yield spread over Germany almost halving from 300 to 150 basis points.

China-US cold war
We thought that tensions between the US and China could ease to some extent in 2019, but that there was very unlikely to be a big reduction in China’s trade surplus with the US. Longer-term, we expected China would pivot towards the rest of Asia. China’s trade surplus with the US did narrow a little but its overall trade surplus expanded significantly.
Global growth continues; world trade recovers

We see global growth continuing at a reasonable pace (just over 3%) in 2020.¹ This will be helped by a recovery in world trade, after stagnation in 2019. Some economies, notably the eurozone, will be on the brink of recession but, even there, it will be avoided.

We see the US economic expansion reaching its eleventh anniversary in summer 2020. It will be the longest expansion since records began in 1854.² It will comfortably exceed previous records: the 120-month long expansion (from March 1991 to March 2001) and the 106-month expansion (from February 1961 to December 1969). Yet, one important reason for its long duration is that it has been subdued.

The UK expansion has been even more subdued but has now lasted as long as that in the US. The eurozone and Japanese expansions are positively youthful in comparison (see Figure 1a).

Fears of a US recession were widely cited in 2019. Leading indicators of such a dip, especially the slope of the yield curve, were closely, indeed somewhat obsessively, watched in financial markets. That nervousness will continue, even though we think it is a misplaced worry.

The main reason is that shrinking world trade was one of the main causes of a slowdown in world GDP growth in 2019 (see Figure 1b). That, we think, will rebound as the first phase of a China-US trade deal and other less-well noticed trade deals move ahead.

These include the RCEP, Regional Comprehensive Economic Partnership, in Asia; the AfCFTA, African Continental Free Trade Agreement.

We think that attention will start to shift from US-China relations to trade deals that help the more open economies, especially as the world evolves into regional trading blocs. Furthermore, outside the US, especially in emerging economies, interest rates have come down; and greater fiscal stimulus is being seen in many economies.

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¹At Purchasing Power Parity exchange rates; that is broadly in line with the IMF’s October 2019 forecast of 3.4%.
²Source: NBER. [https://www.nber.org/cycles.html](https://www.nber.org/cycles.html)
Workers catch up

The gap between CEO pay (their pay is often linked to their company’s share price) and that of ordinary workers may not narrow much in 2020. But pressures in many countries will be for higher wages for normal workers.

Around the world, the pay of ordinary workers has lagged in two clear ways. A catch-up is long overdue.

First, the pay of ordinary workers in many countries has not kept pace with the rising cost of living. That is clearly seen in the US, for example: in real terms the minimum wage is almost half what it was in the late 1960s (see Figure 2a). In the UK, there is broad support for increases in the minimum wage and, recognising that this is still low, for a ‘living wage’ especially in (expensive) London.

In emerging economies, where their competitiveness often relies on low pay rates, wages will increasingly catch up as productivity and living standards rise.

Second, the gap between the pay of normal workers and CEOs is more than ten times wider than it was in the 1960s. Much of that difference is accounted for by CEO pay having a large component dependent on their employer’s stock market performance (demonstrated by its high volatility, see Figure 2b).

Although we do not expect CEOs to sacrifice their generous packages, policy makers in many economies will act to start closing the income gap.1

Increasing wages may have some impact on corporate profit margins, but we do not think the threat is great. With many economies operating close to full capacity wage increases can more easily be passed on in selling prices.

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1 Measuring the extent of the pay gap is not straightforward. The measure used in Figure 2b uses stock options realised, not granted. The Economist, 28 November 2019, has a useful briefing on the matter. https://www.economist.com/briefing/2019/11/28/economists-are-rethinking-the-numbers-on-inequality
Austerity is over

Austerity, restrictions on government spending, will be over in 2020. The emphasis will be on more, not less, spending. But don’t expect too much: after years of belt-tightening, caution will be in order.

After the financial crisis of 2008/9, as recessions set in and banks were bailed out, government spending (see Figure 3) and budget deficits ballooned. Bringing these deficits back under control became the emphasis around the world. ‘Austerity’ was the new mantra.

Although it was expressed in different ways – from Germany’s ‘black zero’ to eliminating the deficit in the UK to troika-imposed measures in the eurozone – austerity meant essentially the same thing everywhere: a reduction in government spending and, often, tax increases.

Those measures have been, by and large, successful in cutting government deficits. But the US notably abandoned austerity policies in 2017/8, with large tax cuts and increased government spending. The government fiscal deficit is now running at US$1 trillion a year, similar to that in the 2012 fiscal year.

Other countries are now set to follow. Improvements in public services, increased pay for public sector workers and variations on the theme of a Green New Deal (see next section) will be the key trends.

In Germany, the change of leadership of the SPD increases the likelihood of a material shift towards deficit and off-balance sheet financed green investment at the national and EU level in coming years. Japan has recently launched a substantial new infrastructure spending plan.

In the UK, more spending on the health service and infrastructure are key aspects of the new government’s plans.

Announced extra spending plans include: €54bn in Germany on emissions reduction; £34bn a year in the UK on the National Health Service; and ¥26 trillion in Japan (expected to boost GDP by 1.4 percentage points).

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3. Austerity over?

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Source: Refinitiv. Data as at 10 December 2019.
A big theme for 2020 will be more spending on green initiatives. Tackling climate change will move to the top of the agenda around the world.

The realisation that action on climate change is needed is rapidly moving into the mainstream. It will be a key theme of 2020. Acceptance of the fact that greenhouse gas emissions cause global warming and that these need to be curbed will become (almost) universally accepted.

Without substantial mitigation of greenhouse gas emissions, global temperatures are projected to rise by 4°C above pre-industrial levels by 2100 (they have already increased by 1°C since 1900). Emissions of greenhouse gases will need to be cut significantly if global warming is to be restricted to 1.5-2.0°C (see Figure 4a).

Carbon dioxide (CO₂) emissions from burning fossil fuels account for almost two-thirds of global greenhouse gas emissions (see Figure 4b) and are the most immediately practical to control. A switch from fossil fuels to solar and wind energy, investment in carbon capture and storage technologies; and a phasing out of subsidies on fossil fuels will be the key elements.

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The latter amount to as much as US$5 trillion (6% of global GDP) and are largest in emerging economies. We think that Europe will be at the forefront of this green move in 2020.
Fixed income: capital preservation is key

The major developed world central banks are set to keep interest rates at or below their current levels in 2020. That will make for a tough environment for fixed income markets in the developed world. Investment grade corporate bonds offer one of the safest places.

Frozen 2, one of the box-office hits of the winter, could well describe the predicament of central banks in 2020. Their interest rates first hit zero or sub-zero in the aftermath of the global financial crisis. After a few attempts to break away, notably by the Fed, were dashed, rates are set to be frozen again in 2020.

Growth is simply not strong enough and inflation pressures not sufficiently intense for anything else to be seriously contemplated. We see the Fed, ECB, Bank of Japan and Swiss National Bank leaving their policy rates on hold in 2020. The Bank of England may raise rates if economic dismay turns to over-exuberance after a successful Brexit; but that is more Disney fantasy than likely reality. All this makes for a tricky environment for fixed income investors. German government bond yields along the maturity spectrum remain negative; UK 10-year gilt yields are not much above recent multi-century lows; and in this environment US 10-year Treasury yields of almost 2% look somewhat generous.

There are opportunities for yield pick-up in, for example, investment grade corporate bonds (see Figure 5). Yield spreads over Treasuries could compress a little, generating capital gains, making this one of the best areas on a risk-adjusted return basis. But, overall, 2020 will be a tricky year for developed market fixed income.
Value in emerging market bonds

We see value in emerging market local currency debt. With subdued inflation and the US dollar stable, emerging market interest rates can be cut further in 2020. This should set the scene for local currency-denominated debt to do well.

In contrast to the main developed markets, where there are limited prospects for further interest rate cuts and lower bond yields, emerging markets are in a much better position. Inflation rates continue to trend down across emerging economies (see Figure 6a) and this means there is a domestic case for lowering interest rates. That has not been the case in all emerging market countries – as the particular problems of Argentina and Turkey demonstrate – but most emerging economies are now on a relatively firm footing as far as domestic growth and inflation are concerned.

A key risk to investing in emerging market local currency debt in the past has been local currency weakness, often as a result of generalised US dollar strength. With the US dollar generally highly valued, however, we think that is less of a risk in current circumstances.

Two other key factors lend support to emerging market local currency debt. First, corporate debt levels have generally been reduced relative to GDP in recent years, so this risk of excess leverage is much lower, we think, than in the past.

Second, there is a broader recognition of the risks associated with borrowing in foreign rather than local currency. Such foreign currency borrowing proved to be a particular problem in Argentina and Turkey in their recent crises. Local currency borrowing will now, we think, be favoured – giving such markets more depth, breadth and investability. So, after a good year for emerging market local currency returns in 2019 (see Figure 6b), we see another solid year in 2020.

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6a. Inflation in emerging and advanced economies

6b. Emerging market local currency bonds performance

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Inflation rates continue to trend down across emerging economies and this means there is a domestic case for lowering interest rates.

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Note: The G-7 comprises: Canada, France, Germany, Italy, Japan, UK and US. The EM-7 comprises: Brazil, China, India, Indonesia, Mexico, Russia and Turkey. Source: Refinitiv. Data as at 10 December 2019.

We like the bank sector. It has historically offered a high dividend yield; it has been out of favour for a long time; but its post-crisis repair is now well-advanced. Cost cutting and the move from branch-based activity to online platforms could start to bring rewards.

The bank sector has been under pressure for many years (see Figure 7a). Financial innovation has seen the rise of challenger banks with new technology; many banks have been slow to rid their balance sheets of the bad loans of the crisis era; and a public dislike of banks has been slow to clear.

That seems to us to be changing. Mainstream banks are now, in many cases, very effectively using new digital platforms to bring big benefits to their retail customers. That enables branch networks to be pruned, generating cost savings. And more aggressive balance sheet adjustment – writing down the bad loans of the crisis era – is now coming to the banks who were laggards in this process. In 2020, European banks will be allowed to buy back their equity and we see a number of banks being quick to do this.

In emerging markets, banks have often been tainted by the woes of their developed world counterparts, but their business case remains strong. Generally, bank profit margins are improving (see Figure 7b). So, after many years of underperformance of the wider global equity market, we think the bank sector is due for a catch-up in 2020.

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**7a. Banks’ underperformance**

![Graph showing banks' underperformance](source)

**7b. Banks’ net profit margin**

![Graph showing banks' net profit margin](source)
Small caps recover

Small cap companies are due a catch-up. In the US, the sector has lagged large caps in four out of the last five years.

Much of the work on long-term stock market returns has identified a ‘small cap’ premium. That is, such companies produce excess returns, largely in compensation for their higher risk. However, such ‘factor premia’ have a disturbing tendency to vanish once identified. In the US, small caps have underperformed large caps in four of the last five years (see Figure 8a). This has meant that the gap between the market capitalisation of large cap and small cap companies has widened significantly (see Figure 8b).

Stronger gains have been made in the large cap S&P 500 index than in the small cap Russell 2000 index. The difference between the two indices is significant: the median market capitalisation of companies in the S&P 500 is US$23bn with two companies (Apple and Microsoft) valued at over US$1tr.

The largest market capitalisation in the Russell 2000 is US$16bn, with a median value of US$800m.

The S&P 500 is heavily weighted in the technology sector, while the Russell 2000 is more heavily weighted in financial services. Within sectors, however, the performance of big and small companies can diverge sharply: large cap technology stocks have recently produced better returns than small cap companies, for example.

There are four main reasons why we think this gap in performance is due to reverse, with small caps doing better.

First, big technology companies are increasingly being scrutinised with the result that their business models may not be as sustainable in the future. Their valuations may suffer if this realisation takes hold.

Second, there is every reason to think that innovation will still be a strong feature of small cap companies: after all, today’s large cap tech companies started out small (stereotypically ‘in a garage’).

Third, societal and environmental changes mean that big cap companies often attract widespread criticism, including pressure for divestment. Companies that are ‘boutique’, ‘specialist’, ‘independent’ and offer ‘hand-crafted’ products are the preferred choice of the millennial generation. Small, for many, is still beautiful.

Finally, we think small cap companies could well be the target of the large amount of ‘dry powder’ accumulated by private equity companies, which has proved difficult to employ in non-listed companies. Small cap companies could well be the ‘new private equity’.

8a. Small cap versus large cap returns

8b. Large caps have outperformed small caps

Brexit boost

After three and a half years of Brexit uncertainty, we see the UK as set for a rebound. Sterling is cheap, the UK equity market has been out of favour and gilts offer a reasonable yield.

Sterling, the UK equity market and UK property have all been, very much, out of favour since the referendum vote in favour of Brexit in June 2016.

Finally, we think, the fog about the UK’s future relationship with the EU will lift in 2020. A formal Brexit will, we think, take place at the end of January. If the UK and EU can find a satisfactory way of working together to iron out the technical complexities which remain to be settled, attitudes to the UK could well change significantly by the end of 2020.

Sterling remains undervalued (see Figure 9a) and could well recover to the US$1.35-1.40 rate. UK equities are cheaply valued, both in an absolute sense and relative to government bonds – where the gap between equity and bond yields is higher than at any time since World War 2.

Aligned with the previous theme-favouring small caps - UK small cap companies are also cheaply valued relative to large cap companies (on a forward price/earnings multiple of 11, compared to 12.5 for large caps).5

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5 Source: Factset, as at 6 December 2019.
A tripolar world

Although the trade war between the US and China will continue, the world is evolving towards a tripolar arrangement. That trend will become clearer in 2020.

Late 2019 saw the prospect of a ‘Phase 1’ of a trade deal between the US and China appear tantalisingly close; fade away; and then finally be agreed before new tariffs were due to be imposed on 15 December (see Figure 10a). That pattern, of course has been characteristic of the negotiations for some time.

The reality is that US tariffs on China and China’s retaliatory tariffs on the US are unlikely to be completely reversed. Furthermore, the risk to China’s industries from erratic changes in tariffs has contributed to ‘de-Americanisation’ – an increasingly heard (albeit ugly) word in late 2019.

It has a number of aspects. Asian economies, notably China, are now seeking out local suppliers as an alternative to American companies. Japanese companies, for example, may well be suitable alternative suppliers in the electronics industry. And Beijing has ordered Chinese companies to remove their foreign (not just American) PCs and software within three years.

We think these are just the first signs of the emergence of a tripolar world: North America with its (relatively free) trading bloc – the USMCA (the ‘new NAFTA’); Europe, anchored by the EU and eurozone; and Asia, dominated by China and now extending its influence across Eurasia and, indeed, further.

These changes will benefit some economies – exports from Vietnam, for example, are booming – but the more important point is that there is a fundamental change in the pattern of world trade and growth taking place.
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