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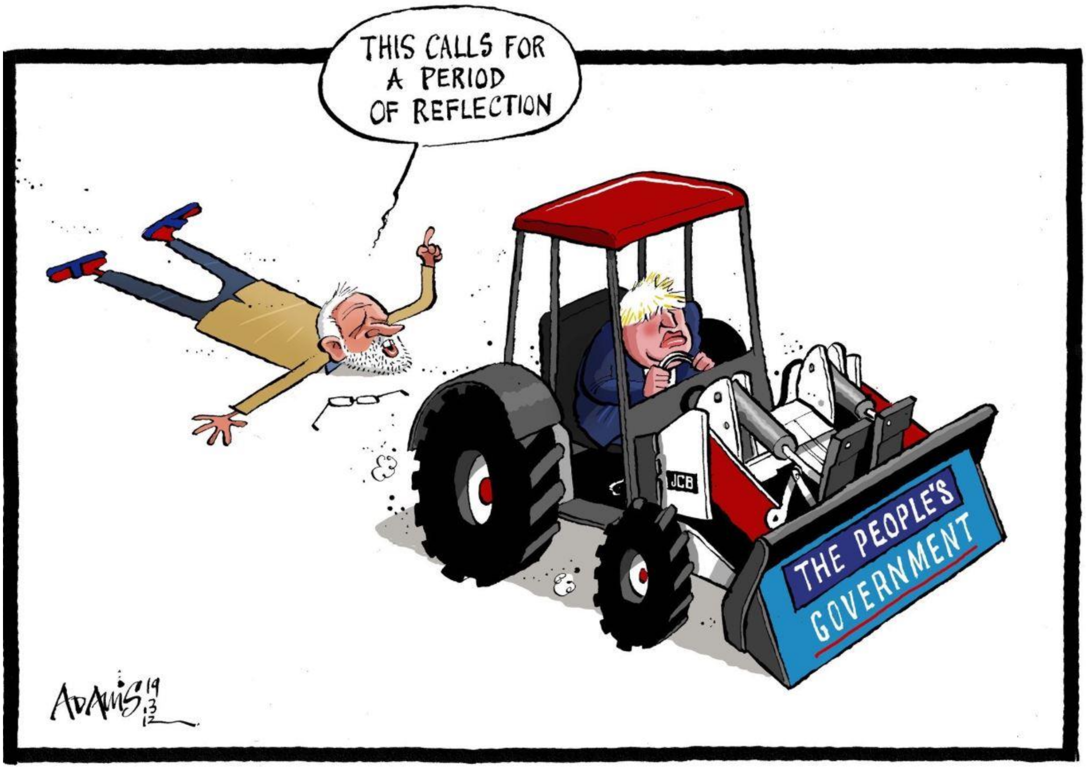

Source: Christian Adams' take on the GE2019 outcome, 13 Dec 2019

Brightening horizons

Cambridge Weekly recipients will have already seen our comment on the election outcome on Friday and so we will not rerun those comments here – please refer to the email from Cambridge Investments Ltd which you should have received shortly after noon.

After a wobbly start to the last month of the year, sentiment has improved over the last week and not just on the decisive UK election outcome. Boris Johnson has the necessary majority to end the prolonged period of Brexit uncertainty that has held back business activity and much needed business investment. However, this still means that the UK will create some distance between it and its nearest and largest trading partners. We can expect an initial economic activity bounce, spurred by pent up business investment, but the longer-term perspective on post-Brexit Britain will depend on its future relationship with the EU.

As we wrote last week, a stable majority government with the urgency for progress that Johnson's administration displayed during its first 100 days, bodes well for a more pragmatic approach to Brexit. This will offer the opportunity to overcome the divisions in the UK society that have taken hold of the country since the Brexit referendum and the closer the UK remains to the EU's economic area the less likely should be a break-up of the Union.

The reason however that stock markets around the world surged upwards on Friday had more to do with US president Trump announcing (via his notorious Twitter account) that the first phase of a trade deal with China had been agreed 'in principle'. After some confusion as to what this might entail, markets were reassured by a confirmation on Friday afternoon from the Chinese side that a phase one deal had indeed progressed to signing stage.

Recent economic data shows that the global economy is no longer slowing, and businesses – across Europe in particular – are looking more optimistically into the future. This has led to a more positive outlook to 2020 than seemed possible just a few months ago.

The global economy is not out of the woods yet, but stock markets have already priced in corporate profit growth between 5 and 10% for the coming year. This makes the starting point for 2020 slightly uncomfortable. However, the general outlook has become far less fractured than it had been over the past two years.

In 2018, the economy and corporate results were on the up, but stock markets threw another tantrum over inflation and bond market fears. In 2019, the economy and corporate results plunged back to stall speed as the manufacturing sector experienced another midcycle slowdown. Yet, stock markets only seemed to care about whether central bank intervention had put the fear 'genie' of a bond market collapse 'back in the bottle', rallying back to their previous valuation levels and providing investors with handsome returns in compensation for the 2018 year-end upset.

So, a reasonable prediction is that, after this roller coaster ride between economic fundamentals and market action, 2020 may see us entering calmer waters. We would generally agree, but for the time being, even with more certainty on the trade front, we are not yet looking at a barnstormer year ahead. In our 2020 outlook, we suggest that there is every reason to be cautiously optimistic. However, a more bullish outlook would need some significant additional catalyst for growth: perhaps a concerted global initiative towards CO_2 emission-reducing technologies, or some form of follow-on from the last two decades of the spoils from 'the internet of things'.

2020 Outlook

We go into the end of the year with almost a mirror image of where we were at the beginning. At the fractious end of 2018, there were flickering signs that global economic growth was set to slow. Capital markets decided to take these signs as warnings of the oncoming apocalypse: asset valuations sunk to levels that implied a global economic recession was imminent, as risk appetite seemed to evaporate. We wrote then that such excessive pessimism presented a buying opportunity – as economic data was middling but not miserable. We were right: global growth did indeed slow throughout the year, but only to the lethargic levels we have mostly become accustomed to in the post financial crisis era. When investors realised the end was not nigh, risk sentiment returned and markets rose (aided by a generous dose of central bank liquidity).

The last few months have seen a significant rally in risk assets, with the US market's S&P 500 index hovering close to its all-time high. Equity valuations have recovered to levels not seen since the heady days of late 2017. Markets seem to be pricing in a healthy rebound in global growth next year. But just like a year ago, the actual economic data does not yet back them up. There are signs, to be sure, but a growing number of investment professionals are worried that markets are running on hot air.

As we head into 2020, the crucial issue is whether investors have once again become out of sync. with economic reality – and are therefore in for a disappointment. Given this, we thought it would be best to pose ourselves some 'Hard Questions for (potentially) Hard Times':

Is the global economy headed for a recession?

The short answer is "probably not". On most indicators, recession fears have faded over recent months. Investors became fearful earlier in the year when yield curves around the world – the difference in yield between government bonds at different lengths of maturity – turned negative. In the past, this has usually been a good indicator of recession, in the US at least. But the yield curve has steepened over the last few months, with other financial indicators also pointing to a lower probability of recession.

Indicators based on actual economic conditions have not come in, however – quite the opposite. Economic data now suggests a higher chance of recession next year than implied by financial conditions. It is still not in the 'likely' territory, but it adds to the sense of fear that markets are outpacing economic fundamentals – a mismatch which will have to be corrected one way or the other.

The flipside to this is that, given how important financial conditions are to overall economic growth, market positivity could well be the thing to drag the economy out of its growth slump. Improving credit conditions – aided by a loosening of central bank liquidity – will help businesses and consumers.

Are easier financial conditions enough to trigger higher growth?

Potentially. By some measures, investors have displayed more risk aversion than justified by the relatively stable economy. Easing financial conditions encourage businesses to borrow to build new productive capacity, and reduce consumers' incentive to (over)save. However, if overall demand does not catch up soon to justify elevated asset prices (if businesses and consumers don't put their mouths where their money is) the prospects for risk assets become shakier. Fortunately, signs are that a sentiment rebound is occurring at the same time (and perhaps because of) a turnaround in manufacturing inventories.

Manufacturers have faced difficulties throughout the year, with weak demand leading to overcapacity. Now that cycle seems to have turned around. Inventories have run down to levels where manufacturers are now seeing positive demand. This feeds back into capital markets by giving investors something to get excited about. The increased capex investment that comes from this is then beneficial for overall growth.

But will the manufacturing sector recover?

There are signs that it already is recovering. The tough times for manufacturers were largely centred around the struggles of the autos sector. The sector was hit by a variety of combined ills – slowing global growth, weak Chinese demand, new emissions standards, etc. But auto manufacturers will also be beneficiaries of the inventory cycle, and the growth of the electric cars market could be a boon.

Manufacturing's inventory rebound seems to already be a fair way through in Asia, where autos inventories are pretty much in balance. There are still problems, but a productive upswing seems likely – particularly in Asia and Europe (which is sensitive to Asian demand).

The main caveat to this is the situation for global trade.

How bad is the trade war?

The global economy is still fragile, at least until solid data underpinning recovery hopes comes through. As we see it, Trump's trade war is possibly the biggest threat to the slowly recovering global growth picture. The green shoots of recovery will have little chance to blossom if flattened under a heavy tariff regime.

The US-China trade war is likely to continue to rumble on, despite the advent of "phase 1" as announced in one of the US President's tweets on Dec 12th. The initial agreement may signal an extended truce, but progress is needed in the next stages if global trade is not to sink further.

Global manufacturers have started to focus on building local supply and distribution chains but a rise in tensions would still hurt. This is particularly true for the US, where the inventories remain relatively large at the wholesale level.

Will it be resolved?

The state of play in US and Chinese politics makes that difficult. We have seen many false dawns during Trump's time in the White House, and the current move towards phases of agreement might just prove to be another. The fact that both sides are currently happy with a piecemeal approach to tariff removal is a positive, since a comprehensive agreement has proved impossible.

But the US Congress' recent legislation against Chinese human rights abuses has led to a sense of general anti-China sentiment across both political parties. Beijing has always stressed that economic issues are separate from those of sovereignty, but it seems clear that American politicians don't see it that way. With an election coming up next year, Trump's need to play the strong man on China could outweigh the need for short-term economic relief.

Businesses and investors may have accepted this situation, however. If things stay roughly as they are, at least some certainty is provided. One thing that hampers business investment is uncertainty (as we have seen here over the last few years), and so a stable environment – even a less-than-ideal one – could help sentiment.

What else worries you?

Company profitability has been one of the main issues of late, with Producer Price Inflation (a proxy for businesses' profit margins) sinking throughout the year. There are recent signs that this may be picking up, but it is too early to tell if this will hold out. That could be a problem for companies facing rising wage costs – with businesses increasingly reporting a squeeze on their margins. For small and medium sized businesses this could hit the hardest.

The expected global economic recovery is not a given, and it could well be that we once again fall back into stall speed – which would drain market optimism. This could happen in the US, where the cycle is not as far through as it seems to be elsewhere, which could mean increased weakness heading into next year.

Other danger spots include the possibility that government bond returns will be negative. Oddly enough, this might be because central banks are likely to keep markets awash with liquidity and not raise short-term interest rates. Throughout 2019, inflation expectations have fallen across the world (perhaps with the exception of the UK), imperilling financial systems if global growth continues to decline. One remedy is to allow inflation to "run hot" (i.e. to rise well above inflation targets) in growth periods. Such a policy could lead to a highly volatile outcome for long-maturity bonds, with investors becoming much less sure about what the targets actually mean.

China's ability and/or willingness to halt its economic slowdown also brings multiple risks to the global economy and to the political environment.

All of these downside risks have their upside counterparts, however. Which brings us to…

Are there reasons for positivity?

As things stand, investors are allowed a cautious optimism for 2020. Inflation seems to have bottomed in most of the world, partly due to the aforementioned inventory cycle. The other part to that is rising wages, the result of tight labour markets across the developed world. While this may hurt businesses in the short term, overall it points to a positive environment.

Increased demand will be a boon for the economy. What's more, with labour costs rising, businesses will be incentivised to put more money towards productive investment in the form of capital expenditure investment (CAPEX). Central banks are still providing markets with plenty of cash stimulus, meaning that there is plenty of money to put towards investments which should increase productivity.

Despite rising bond yields increasing the cost of credit, this is a positive for the economy. If China follows through on its tentative signs of recovery, the resultant increased global demand will be a plus. And if we are right that the US will be slower to recover than the rest of the world, then the value of the US Dollar should fall. That will help emerging markets with large dollar-denominated debts and is always a stimulus for global trade.

Following on from the Q&A style economic outlook for 2020, we will now continue with the investment outlook for 2020:

Themes

Global Politics

Developed world politics will continue to be fragmented, with politicians focusing on their domestic agendas rather than the global picture. We suspect the US election will dominate global headlines, especially during the second half of the year.

Trump's trade wars top the list of investor concerns. But reforming global trade is a positive for the long-term if the system becomes freer and fairer. It will, however, continue to be a flashpoint for markets if naked self-interest dominates dialogue.

Fiscal policy expansion has been much discussed this year, with climate change as the spur, but we suspect the cheap talk will continue without too much actually occurring in 2020.

Trump has undermined cool diplomacy, which may have consequences ahead of the US election. We note with disquiet, for example, that North Korea is working its way back into the limelight. Meanwhile, the rise of confrontation as a negotiating ploy means mistakes will happen. Turkey and the Middle East also remain fragile (with the risk of bringing nations like Greece into arguments).

We expect that in 2020 politics will at times trigger market volatility but in general be less disruptive to the medium to longer term prospects of investors.

Monetary Policy

Monetary liquidity should remain abundant for markets, with low interest rates staying that way pretty much everywhere. If shocks do happen, the central banks are unlikely to step in in the way we would have expected in 2018-19.

Discussions of how central banks should react to changes in the economy and markets will be about the 'boundaries': how high will inflation go before the start of a rate cycle? How much pain are they willing to take in order to encourage a fiscal response?

In summary we expect the central banks to remain supportive with their monetary policy and as such not pose a particular risk to investor returns as they did in 2018.

Regions

UK

The UK economy looked awful for a lot of 2019. This was reflected in the undervaluing of Sterling assets, which carry higher yields than other regions. A positive Brexit scenario (along the lines of a fairly soft deal) could therefore lead to a bump up in British assets.

However, the currency rally may not be able to run too much further, as it will be subject to the unknown future trade deal with the EU. Overall, a combination of stronger global growth and decreasing pessimism could release a positive dynamic through at least the first half of next year.

US

The US economy has been the strongest and most stable in the world – to the benefit of US asset markets. But, the unremitting strength of the labour market has created a supply-side constraint which may hold the US back compared to its global peers. For example, despite weakness in manufacturing, freight transport and other areas, employment has actually increased – with rising labour costs now eating into company profitability.

Pay is now stable but has become responsive to growth, suggesting that there is no longer an excess of workers. This means wage growth may strengthen, which would likely lead to increased business spending on machinery – thereby increasing productivity – and much needed demand on the manufacturing side.

This is late-cycle behaviour but one that could run for some time if not held back by rising short-term interest rates. Liquidity in the US, like everywhere else, is still ample. Corporate cashflow has been strong but has been used to buy back stock and increase dividends, so companies are sitting on smaller cash piles than in 2018/19.

Profit growth is also relatively tepid, with margins coming under pressure, and leverage is high, particularly among those companies that already employ the most. So, having boxed itself into a corner, the private sector could find profit growth disappoints.

While the US stock market has been the provider of some exceptional returns over the past two years as the rest of the world suffered more under the manufacturing slowdown, it is not a given that this will continue. The rest of the world starts 2020 with more 'bounce-back' potential than the US, which may finally be hitting the limits of growth.

Europe

Europe's economy has, without a doubt, had a tough year. Many of the negatives we highlighted at the beginning of last year materialised, while few of the positives did. The upside to that is that, with such a low base, the prospects for recovery look good.

Sure enough, leading indicators for Europe are the best anywhere in the world. Germany – the traditional powerhouse but 2019's laggard – still has inventory issues, particularly around the all-important auto manufacturing sector. But it too should benefit from the upturn in the inventory cycle, and domestic European demand for cars is better than in Asia or the US.

Europe is an export-led economy, which is part of why 2019 was so hard, but the expected rebound in global demand – particularly in Asia – will help. Northern Europe and Germany have the most fiscal headroom of any regions in the world, however hopes of fiscal expansion are likely to be dashed as per usual. Fortunately, it may well not be needed. An end of uncertainty – Brexit or otherwise – could unleash an avalanche of business investment catch-up (CAPEX), fuelling growth through the added demand.

City property (both residential and commercial) across the Channel currently has significant upward momentum, driven by ample lending. The good news here is that this is likely to continue until the ECB raises interest rates – which may not be until 2021.

Japan

The Japanese government have announced a fiscal expansion which will add about 1-1.5% to GDP. However, Japanese growth has had a sharp step down in the second half of 2019, ahead of a rise in consumption tax. A lack of demand from Asia has hurt them considerably, with weakness centred around machinery and slow demand for autos.

Still, like in most places, employment remains strong even if it has just weakened slightly recently. From the current low level, it will not take much for Japan to regain some liveliness into the new year.

China

China weakened through the second half of 2019, despite some state support. The key issue has been the government's inability to effectively provide stimulus for the private sector.

Officials want to avoid a repeat of 2015/16, where unfettered financing led to the creation of a credit bubble. That has led to a credit crunch for most companies, with state-related companies being the only ones with access to finance. Even those on the periphery (such as local government-owned enterprises) are finding access to funds being removed.

Government-led construction will continue, but the health of the private sector is poor and there is little sign of change. China is showing signs of having drawn down inventories, at least in relation to goods produced for overseas. This will mean less deflationary impact on the rest of the world – to the benefit of global producers. There are signs of increased demand for raw materials for China's own investment and consumption, but nowhere near the stellar levels seen in 2010 and 2016.

The main issue for global investors is still China's trade war with the US. And the likelihood of return to friendly relations there is low. While trade deals may be agreed, the scope and impact will not return trade to anything like previous levels. Indeed, China's relations with the major powers could give the world a negative shock – if it turns into authoritarianism vs liberal democracy. How the US election affects this will be a key point for markets.

In summary: We do not expect particularly positive overspill effects for the global economy from China in 2020, but the stabilisation of demand should nevertheless be a positive for global trade and Europe in particular.

Capital markets

Currencies

Our main currency call for 2020 is a weakening of the US dollar relative to its global peers.

Central banks have provided ample liquidity for markets throughout the year, which has helped sentiment. We expect this to continue, along with stable short-term interest rates, which should allay credit crunch fears. This will help banks and financial institutions.

It should also help economic growth in regions outside the US. If this recovery is not matched in the US (which we expect to lag others) this will lead to an imbalance whereby the value of USD should be expected to fall. In fact, even if it just matches US growth levels, the USD is expensive enough on a PPP basis to see a move back towards fair value.

Equities

Equity valuations (price-to-earnings ratios) have become stretched on an overall basis, given that profits have been declining through 2019 across the world. Markets now embed 5-10% growth, with the highest positivity in the US. The US may find it difficult to outperform if global growth does step up.

Corporate leverage is stretched enough to mean that CAPEX will be constrained by rising near-term cost pressures, even though revenues will be healthy and operating margins should be stable. This is a healthy environment for banks, with steepening yield curves, good liquidity provision and rising yields on corporate bonds.

There are threats that could derail market optimism - given the political environment, corporate taxes could be expected to rise after 2021 and Trump's trade wars remain a key risk for companies. As such, the 2020 US election will be a key event for markets.

Government Bonds

Rising nominal growth estimates for 2020 and beyond could cause some pain for investors in long-term bonds. Yield curves should steepen (rising yields for longer maturity bonds), driven by central banks keeping short rates stable while allowing long rates to rise. This would be exacerbated by a change in longer-dated term-risk premia, which will be reduced from the current levels of around -90bps, to around -25bps.

Inflation break-evens could also move out from current very low levels, especially if central banks allow US and EU wage inflation to run hot – this would add to the upward yield pressure discussed above. If growth shocked to the downside, inflation-linked bonds could still perform well, although to a lesser degree than in the positive growth scenario.

Credit

Credit spreads (the amount by which they yield higher than government bonds) have some room to tighten – which drives up the bonds' value. But if they tighten too much, we would expect investors to gravitate towards equity, holding back some spread compression. Overall, corporate bonds already discount low default probabilities. But this hides a risk of idiosyncrasy: in a rising inflation environment, we would expect small and medium sized businesses to default more often than large businesses. This could be true even if overall growth is rising. Emerging market credits (amongst commodity producers) look relatively better value.

Commodities

Commodities have come under pressure this year, but we expect them to see a turnaround in 2020. Lack of investment in production and the likely rise of infrastructure spending and CAPEX suggests some decent upside for industrial metals, especially in copper, which has been a relative laggard. It isn't all good news however, with high asset values and rising maintenance costs continuing to hurt resource sector stocks' profitability.

Property

A stable but low interest rate environment should support property values. Property has struggled over the last few years, but if consumption remains stable and the tightness of the labour market continues, we should expect demand for residential property to increase – helping prices.

The picture is less clear for commercial property, which is hampered by the struggles of retailers throughout the developed world. But stable employment and rising wages should help in this regard. We may see some upside throughout the year.

Global Equity Markets

Market	FRI 15:43	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7392.6	2.1	152.9	→	→
FTSE 250	21546	2.9	613.4	➚	⬀
FTSE AS	4113.5	2.2	90.3	⬀	→
FTSE Small	5722.0	2.0	109.7	➚	→
CAC	5937.5	1.1	65.6	⬀	➚
DAX	13327.9	1.2	161.3	⬀	➚
Dow	28148	0.5	132.9	➚	➚
S&P 500	3173.7	0.9	27.8	➚	➚
Nasdaq	8487.0	1.1	89.6	➚	➚
Nikkei	24023.1	2.9	668.7	➚	➚
MSCI World	2309.4	0.6	13.0	⬀	➚
MSCI EM	1070.7	2.1	21.8	⬀	→

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.9	17.9	13.7	13.2
FTSE 250	3.7	25.4	15.8	14.2
FTSE AS	4.6	19.0	13.9	13.4
FTSE Small	3.4	314.2	-	13.9
CAC	3.1	21.3	16.2	13.4
DAX	3.0	24.6	15.8	12.5
Dow	2.3	19.4	19.0	15.0
S&P 500	1.8	21.1	19.4	16.0
Nasdaq	1.0	26.5	23.3	18.0
Nikkei	1.9	19.1	18.4	17.3
MSCI World	2.4	20.1	17.9	15.2
MSCI EM	2.8	15.0	14.2	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
John Wood	17.1	Micro Focus Int'l	-4.9
Barratt Devts	13.8	Rolls-Royce	-3.6
Int'l Consol Air	12.5	Bunzl	-3.1
Berkeley	12.4	Spirax-Sarco	-2.7
Taylor Wimpey	12.0	Rentokil Initial	-2.5

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.332	1.4	Oil	64.85	0.7
GBP/EUR	0.836	0.7	Gold	1470.8	0.7
USD/EUR	1.11	0.7	Silver	16.89	1.9
JPY/USD	109.38	-0.7	Copper	277.8	2.5
CNY/USD	6.976	0.8	Aluminium	1775.0	1.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.8	0.1
UK 15-Yr	1.1	0.0
US 10-Yr	1.9	0.0
French 10-Yr	0.0	-0.0
German 10-Yr	-0.3	0.0
Japanese 10-Yr	-0.0	-0.0

UK Mortgage Rates

Mortgage Rates	Nov	Oct
Base Rate Tracker	2.57	2.54
2-yr Fixed Rate	1.44	1.50
3-yr Fixed Rate	1.59	1.61
5-yr Fixed Rate	1.69	1.71
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.28	4.28

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

For any questions, as always, please ask!

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16th December 2019

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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