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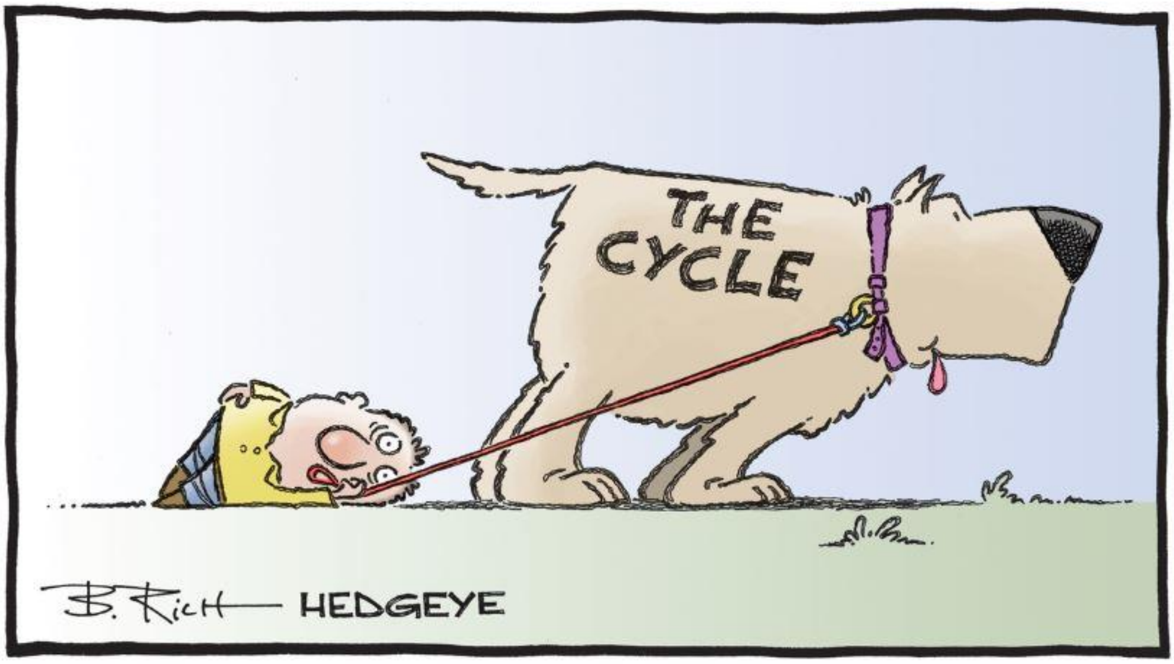


Hedgeye, Keen cycle, 19 December 2019

2020 will be interesting

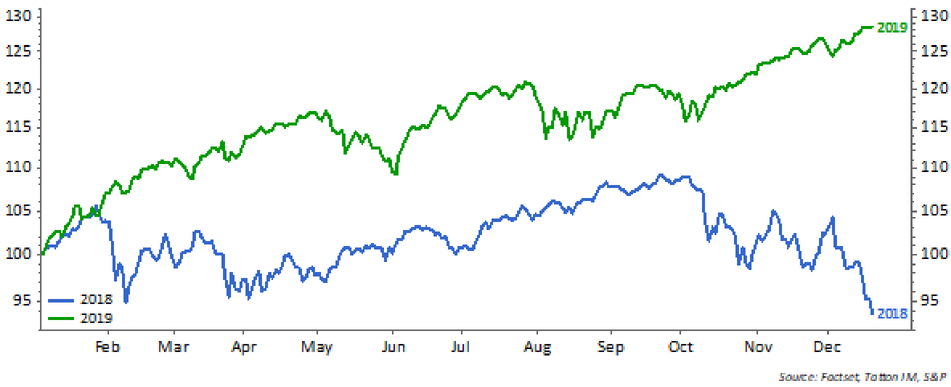
Christmas, New Year and even a new decade are all approaching fast and so to close the year of Cambridge Weekly's with this final 2019 edition, we will reflect on the changes of the last 12 months and indeed the past decade, and what that might tell us about likely developments over the coming year and decade.

The fourth quarter of 2019 has felt like a mirror-image of 4Q 2018. Liquidity was tight then, and is abundant now, particularly since the US central bankers restarted their purchases of US government bonds. Previous rounds of quantitative easing (QE) were aimed at bringing down longer term lending rates to stimulate the economy. But this time the Federal Reserve is buying assets in order to ease strains in New York's short-term interbank lending markets. This may be an important point of principle for economists. However, it appears to make no difference to stock markets: they have rallied over the quarter as any fears of credit market stresses have receded further, even though the causes of such stress from a slowing economy have arguably increased.

The economy was strong 12 months ago but seemed to be weakening. Now, decidedly weak it looks to be strengthening for the coming quarters. Markets (especially the US equity markets) have behaved in the reverse way, as the chart below shows.

US Equity Market

S&P 500: 2018 and 2019



The start of 2019 saw a reversal of the market rout at the end of 2018, as it became clear the Fed was reversing course.

This time around, we do not think the Fed will reverse its liquidity injections meaningfully but there may be less headroom if further monetary stimulus was called for in face of a deteriorating environment. Meanwhile, expectations of an economic rebound could take some time. The release of Q4 2019 earnings during January will be watched closely for directional signals, but are likely to be underwhelming, showing no – or even negative – growth. That will stretch valuations in US markets further at a time when they are already trading at the very lofty heights of almost 19 times annual earnings. The last time we reached those levels was in January 2018, when they were accompanied by talk of 'irrational exuberance' and were corrected downwards considerably over the further course of 2018.

This will make markets nervous, but the notable difference between then and now is the most likely direction of travel of the global economy. Back then, it was feared to be coming off a synchronous high. Now, there is every expectation that it is improving from a synchronous low in growth rates. The evidence for this actually happening imminently is still feeble, with the strongest evidence of a turnaround once again – and somewhat surprisingly - coming from China, while the data flow from Europe, the US and Japan can at best be described as mixed.

Still, if there is a dip, many investors who have missed this quarter's rally will be itching to buy at lower prices. The real danger is if there is a shock, and the most likely source remains US-China trade negotiations. These are on-going, and phase 1 was a very small win for the two sides. The rhetoric got a little more confrontational again this week, and phase 2 game playing is just starting. 2020 will be interesting.

2010/2020 - a decade back, one forward - Endings and Beginnings

Another day, another decade. As we come to the end of the only decade that is so far without a catchy nickname (how about 'the Teenies' to follow the Noughties' of 2000-2009?), we thought it appropriate to look back at the themes and events that shaped the last 10 years – and dare to look forward to what might shape the next.

Looking Back

The 2010s started with diverging opinions on what was in store. In economic and financial terms, the 2000s ended about as badly as they could have. But after the horror years of 2008 and early 2009, initially it seemed as though the global financial crisis and ensuing great recession would prove to be just another short – even if very severe – recessionary blip after which things would return to the previous 'normal'. By the start of the decade, asset values had mostly recovered, banks had recapitalised, the financial system no longer seemed dysfunctional, and the global economy had staged a remarkable growth recovery. Optimists (some on our own team) thought this rekindled stability would underly a return to strong global growth and put the nightmare behind us.

Pessimists disagreed, suggesting that the ghost of crises past would stay with us, ushering in a 'lost decade' of Japan-style stagnation. In a way, they were right. The extraordinary monetary stimulus from central banks managed to avoid a repeat of a disastrous 1930s-style depression, but over a decade since the crash, those 'short-term' crisis measures are still with us. Historically low interest rates, massive central bank asset purchase programs, and – crucially – sluggish economic growth have been the hallmarks of the last decade.

In the financial world, monetary policy has taken centre stage unlike ever before. Central bank guidance and policy meetings (such as the annual Jackson Hole conference) have become the centres of attention for global investors. Few could argue that support was needed to bolster the return of confidence in the financial system, but the trillions of dollars of liquidity provided by central banks have undoubtedly had a distorting effect on capital markets. Bond yields have sunk and remain below 0% for vast amounts of public debt, and elsewhere at least only around the rate of inflation. Volatility has been crushed and asset prices have become highly correlated, regardless of the quality and likely sustainability of their underlying profit streams.

Such long exposure to monetary intensive care – like any strong medication without sufficient rehabilitation measures – has had some uncomfortable side effects. If the rising tide lifts all boats, it does not matter which one you are on, and so high asset correlation prompted an exodus from active fund management into passive index-tracking funds. However, the lack of dispersion and the dropping away of active fund managers has meant that, when the market mood turns sour, there is no one to step in – leading to sharper price falls than we would have expected under similar circumstances in the past (as we saw at the end of 2018 and the beginning of 2016).

Sinking returns on 'risk-free' assets caused money that would otherwise have been seeking less risky sources of positive returns to pile into speculative investment opportunities – creating cohorts of 'reluctant investors' who are much more prone to 'crashing out' again at the slightest hint of a market turn. The commodities bubble in 2014 was a prime example. 'Reluctant investors' were seeking investment returns in what they perceived as an asset class untainted by the aftermath of the financial crisis, but independently driven by the relentless catch-up in growth and natural resources demand of the world of emerging economies.

The unwinding effects of these false price signals to the resource industry became a key theme of the middle part of the decade as they caused the first mid-cycle slowdown in the demand for manufactured goods. Booming property prices, despite stagnant fundamentals (i.e. low wage growth), was another. Amidst investor resignation that low growth will be the norm we have seen high-growth technology stocks become the only game in town, leading to some extreme equity valuations as any form of meaningful growth becomes addictively attractive.

Financial distortion has also created economic distortion. Central bank policy has underpinned a broad-based and substantial recovery in asset prices – to the benefit of asset-holders. Meanwhile, wage growth has stagnated in the developed world, leading to a significant increase in actual as well as perceived wealth inequality. Those without prior capital stock – typically the young and/or low earners – have seen low or non-existent growth in living standards, while the older and better off have enjoyed some of the best returns in recent memory. This created populism amongst the not capital rich disenfranchised and subsequent geopolitical destabilisation in a way not seen since the 1930s. Accelerating climate change and loss of economic perspective motivated the younger generation and created fractions across western societies, with many worried about the longer-term consequences.

What caused that wage stagnation? Globalisation has been ongoing since at least the 1980s – but it accelerated in the 2010s. Though there has been pushback in recent years, the last decade was marked by a rise in global labour competition. This is not to do with the increased global migration of labour, but rather the ease with which production of 'hard' and 'soft' goods can be shifted to where capital and labour generates is most cost-effective. This has created a disconnect in the old industrialised world between scarcity of labour and wage dynamics. As a result, the past decade witnessed record low levels of unemployment without the historic upward pressures on wages.

Businesses, on the other hand, have benefited from these new global dynamics and have been able to substantially increase their profit margins, without sharing anything like the same amounts of their revenues with their employees. Over the decade this has had at least two important consequences: Firstly, large global companies have had a big advantage over smaller companies, which is why the more nimble small cap sector has not been able to outperform the more sluggish large cap sector – which in turn was an important contributing factor to the struggles of active stock pickers versus large cap-driven index trackers.

The second consequence of below average growth participation of labour is that it has led to a chronic shortage of consumer demand growth in the western world. These economies increasingly relying on demand growth from emerging economies like China, or make desperate attempts to 'steal' demand from elsewhere - either through artificially low exchange rates (E.g. Germany benefiting from a weaker Eurozone) or through protectionist trade policies (US-China trade wars). Meanwhile the public sector also removed domestic demand contributions as most western nations engaged in repairing domestic balance sheets through spending cuts through austerity policies.

All this provides some insight into why – even though the global recession now lies more than 10 years behind us – rates of economic growth amongst western economies have still not recovered.

The other sea change of global economic dynamics over the past decade came in 2014. China overtook the US as the world's largest economy. It still has some way to go in nominal terms, but in the last decade, the country firmly established itself as a major economic, technological and political power. China is no longer playing catchup in its tech 'arms race' with the US: it is at the forefront, as the ongoing battle over 5G technology shows.

China's growth has undoubtedly had some deflationary impacts on the rest of the world, but the country is now a critical element of the global economy. The government's 'Belt and Road' Initiative, as well as the huge amount of outward investment from large Chinese tech companies, has already had a profound effect on global markets. Its contribution to global growth is more important today than for the last 200 years. In 2016, it was Chinese demand – spurred by the government's infrastructure push – that led other emerging markets and the global economy forward.

With this increased importance comes increased reliance. Europe is now particularly reliant on demand from the 'middle kingdom', as the struggles of the autos sector have shown. China's burgeoning credit pile – and Beijing's response to it – is a key concern for global investors. Ever since Donald Trump took office three years ago, the US-China trade war has topped the list of market fears.

The trade war is just the latest political backlash against a rapidly growing China – back in 2009 Barack Obama's announcement of the US's 'pivot to Asia' was interpreted by Beijing as an indirect threat. Direct confrontation between the two global powers never looked likely over the last decade, but not since the USSR's technological prowess in the 1950s has the US faced an economic and technological rival like it does now.

Given the developed-world factors, it would be a stretch to say that China's stellar growth came at the expense of the West, but. by the same token, it would be difficult to argue it had no effect. So, were the pessimists right about the 2010s or was it the optimists? In some ways, both. The growth of asset prices (and therefore investment portfolios) has been matched only by the growth of living standards in countries that were called "emerging" 10 years ago. Of course, none of that will be of much help to workers in developed countries who have seen little improvement in a decade: "It was the best of times, it was the worst of times".

Looking forward

Saying what will come out of the next decade is (obviously) much more difficult than saying what came out of the last. As any good investment professional knows, you should always be careful about extrapolating the future from the past, but without veering into Back-to-the-Future speculation, we will say a little about what the 2020s may have in store.

For starters, it is clear that the extreme monetary environment of the last decade cannot continue indefinitely. Central bankers have been saying as much for some time. They are fully aware of the distortional effects and collateral damage of low interest rates and quantitative easing and have recently begun urging governments to finally throw their fiscal weight behind monetary policymakers. Central bankers know that they cannot – and should not – cut interest rates any further over the long term. To do so would be to hurt the banking system which facilitates lending and creates the liquidity needed for a functioning economy – as well as all the other negative side effects we have discussed.

That is not to say that they will not perform any more short-term interventions. Heading into next year at least, a sudden removal of central bank liquidity – while highly unlikely - would prove disastrous for a global economy perilously close to stall-speed rates of growth - QE is not a long-term solution. Whereas they were the saviours of financial stability over the last decade, central bankers will hope they can take a more backseat role.

With yields still lingering around historical lows across all maturity bands, we start the decade with low expectations for returns on government bonds. One thing to emerge from the changing monetary environment is that it is now unclear what would constitute a stable long-term premium. The value of money needs to be stable over the short term, but if it increases in value it provides a disincentive to use it in transactions. On that basis, the natural rate of short-term deposit interest should ideally be related to inflation, with a real rate of around 0%. Likewise, the yield on longer maturity bonds should reflect (and historically has reflected) the expected economic rate of growth for those respective periods to maturity. At the moment central bank action has driven yields close to zero, a disconcerting, if misleading signal to investors. For these reasons, we would expect that – as they have begun to – central banks will be more focused on providing liquidity than on supressing long-term investment returns.

The rise of populism is in part a backlash against the growing sense of inequality. To rectify that inequality, the have-nots need to catch up with the haves. And to ensure that, the return on capital cannot be higher than the return on labour. On that front, the recent historic tightness of the labour market does seem to finally be pushing up wage growth. If this continues, it will be to the detriment of company profit margins (in the short term at least). But it will be necessary to avoid worse political outcomes.

There will likely be increased pressure on margins from the political side either in the form of increased tax or increased regulation. Already we have seen anti 'big tech' sentiment gain popularity across the political spectrum (in the US at least) and we expect that pressure will only increase. The first 20 years of the new millennium was somewhat of a 'wild west' for large tech companies. That they are subject to increased regulation is not something to be feared – though it may mean that the high-growth model becomes unsustainable.

Such pressures on corporate profit margins can be to the detriment of investors but does not necessarily have to be. If the wider distribution of the spoils of corporate activity leads to a recovery from the anaemic demand growth of the past decades, then profits can grow even faster than before on increased volumes, even if the actual margins no longer expand. Were this to happen, then we would at long last have experienced the end of the 'new normal' and the return of the 'old normal'. As welcome as this may be, it would also mean the return of the 'old laws' of economic cycle dynamics. The current cycle has most likely been as long lasting and enduring as it has proven to be because there has been very little opportunity for a conventional end to it by overheating. Should the old wage/demand dynamics return, this would no longer be the case.

On the technology front, there is plenty to be excited about for the upcoming decade. Electronic driverless cars and superfast 5G networks are already on the way and could prove to be transformative. There are also plenty of other avenues where technological improvement looks promising: Quantum computing, AI/Machine learning, blockchain etc. New technologies have historically been the spur for increases in aggregate demand and productivity – which have been so sorely lacking over the last decade. So, one need not be a devoted futurist to be optimistic about the economic prospects that could come from the demand stimulus potential of these.

There are of course plenty of risks. The effects of climate change will continue to be felt, and populist politics show no sign of going away just yet. As of now, it looks like the barriers to international trade being erected in the US and the UK will be long-term features and may even be added to by other countries. Whereas the 2010s saw an acceleration of globalisation, the 2020s could well see a reversal. The potential effects of that are unclear.

The slow breaking up of the global trade order would not be good news for China, but it would not stop its rise. It has now reached a size and maturity which allows it – like the US – to rely more and more on domestic demand. Regardless of the global trade picture, we would expect Chinese economic rate of growth to slow from its recent pace over the long term – if only for demographic reasons. The country's place in the global economic order is entrenched. We expect this to lead to increased confrontation between the US and China, particularly if populism prevails in the former.

The 2020s bring promises and risks, like any new decade. Themes that have been ongoing for decades (globalisation, financialisation, environmental degradation, etc.) could well be set in reverse. But we are wary of predictions of wholesale changes. In the apocryphal words allegedly spoken by Mark Twain: "History doesn't repeat, itself but it often rhymes".

Global Equity Markets

Market	FRI 12:10	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7590.3	3.2	236.9	⬀	⬀
FTSE 250	21587	0.4	79.7	↗	↗
FTSE AS	4205.9	2.7	110.9	↗	⬀
FTSE Small	5865.6	2.5	140.3	↗	⬀
CAC	6007.8	1.5	88.8	↗	↗
DAX	13307.8	0.2	25.1	⬀	↗
Dow	28377	0.9	244.9	⬀	↗
S&P 500	3205.4	1.2	36.8	↗	↗
Nasdaq	8641.3	2.1	174.4	↗	↗
Nikkei	23816.6	-0.9	-206.5	↗	↗
MSCI World	2340.7	0.9	20.9	⬀	↗
MSCI EM	1106.6	1.8	19.7	↗	⬀

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Scot Mtge Inv Trust	9.3	NMC Health	-50.9
Brit-AM Tobacco	7.9	Persimmon	-7.1
Rentokil Initial	7.8	Pearson	-5.4
AstraZeneca	7.4	Land Securities	-5.1
Evraz	7.3	Berkeley	-4.7

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.303	-2.3	Oil	66.28	1.6
GBP/EUR	0.852	-2.1	Gold	1478.3	0.1
USD/EUR	1.11	-0.2	Silver	17.08	0.8
JPY/USD	109.36	0.0	Copper	280.9	1.0
CNY/USD	7.009	-0.5	Aluminium	1797.0	1.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.8	0.0
UK 15-Yr	1.1	0.0
US 10-Yr	1.9	0.1
French 10-Yr	0.1	0.1
German 10-Yr	-0.2	0.1
Japanese 10-Yr	0.0	0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.7	18.4	14.0	13.2
FTSE 250	3.7	25.5	15.9	14.2
FTSE AS	4.5	19.5	14.2	13.4
FTSE Small	3.3	240.9	-	13.9
CAC	3.0	21.5	16.5	13.4
DAX	3.0	24.6	15.7	12.5
Dow	2.2	19.5	19.2	15.0
S&P 500	1.8	21.4	19.6	16.0
Nasdaq	1.0	27.2	23.8	18.0
Nikkei	1.9	19.0	18.4	17.3
MSCI World	2.4	20.4	18.1	15.2
MSCI EM	2.7	15.4	14.6	11.9

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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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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