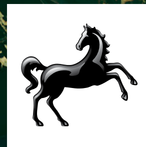
Private Banking

OUTLOOK

WHAT'S IN STORE FOR INVESTORS IN 2019?



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The key phrase for 2018 has been volatility. The prices of stocks and bonds have fluctuated significantly as investors tried to digest a range of political and economic uncertainties.

While we foresee economic growth and profits in the US and UK coming under pressure in 2019 as a result of these factors, the fundamental economic indicators don’t seem to be pointing to an imminent recession.

In the following short outline, we set aside the emotions and consider the realities of what 2019 could bring, and the sort of perspective that we feel is most likely to best serve investors.

Markus Stadlmann
Chief Investment Officer

What's worrying **INVESTORS?**

There are plenty of reasons for investors to be cautious at the moment, but much of the concern is driven by emotion as opposed to underlying data. Before we consider the fundamental realities of the investing environment, let's take a quick look at the many issues that are currently undermining confidence.

International trade disputes are contributing to a reconstruction of trade barriers, while the implications of Brexit will have to be ironed out.

In the meantime, inflation has been picking up from its historic lows across the globe and is above target in the US and the UK. That is prompting central banks to reduce or even reverse the measures that they have been using to support economic growth. These measures include managing key underlying interest rates which, in the US, have moved from 0.25% in 2016 to 2.25% in late 2018.

These developments are occurring just as corporate profits in the US appear to have peaked. By contrast, there is the potential for China and some emerging markets to replace the US as the main driver of growth in 2019.

So it is reasonable to ask if the level of concerns being conveyed by some is justified.

The FACTUAL REALITY

In order to find out, we need to set the emotions aside and look at the data. One of the more reliable indicators of a potential recession on the horizon can be found in the yields that investors receive for holding bonds.

In an economy that is seen as stable or growing, bonds with a relatively long life span tend to pay investors a higher yield than those with a shorter lifespan. This is because there are greater risks associated with holding a bond that has longer to run.

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Most bonds pay a fixed annual return, known as the coupon. If the face value of the bond (i.e. the amount the investor will get back when the bond expires) is £100 and the coupon is £5, then the annual yield is 5.00% (£5 ÷ £100).

But if investors expect interest rates to go up, then a savings deposit that provides a variable interest payment might increase the interest that it pays to savers. Most bonds cannot do this because the coupon tends to be fixed – the £5 in the previous example would remain at £5 no matter what happens with interest rates.

That contrast could tempt bondholders to sell bonds and invest money in a savings account instead. This, in turn, would reduce the demand for many bonds, pushing their prices in the open market down from £100. By way of example, if the price fell to £95, that would push the yield up to 5.26% (£5 ÷ £95).

We generally expect the rates of return on 3-Month Treasuries (very short-term US government bonds) to be lower than the 10-year equivalents. But with investors anticipating rising interest rates, the returns on these two bonds have been converging (see Chart 1).

On many occasions in the past, when those two returns reverse, i.e. the rate on the 3-Month Treasury rises above the yield on the 10-Year Treasury, a recession has followed.

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However, the average time lag between the two yields coming within 0.5% of each other and a subsequent recession in the US tends to be around 20 months. If they don't get that close, then recessions are far less likely to follow.

These yields were around 1.0% apart in the Autumn of 2018, so the 20-month countdown could not begin. In short, if this indicator is to be trusted, then a recession appears unlikely in the near future.

CHART 1: 3-MONTH AND 10-YEAR TREASURY RETURNS CONVERGING

The graph shows how the rate of return on 3-month Treasuries and the yields on 10-year Treasuries have been converging over recent years.

Source: Lloyds Bank plc/ Bloomberg October 2018.

The

LIKELY IMPLICATIONS

While rising wages, rising import costs and solid economic growth have driven interest rate rises in the US, these factors could slow in 2019. Meanwhile, the European Central Bank, faces a more difficult immediate future.

The Italian government has promised its electorate that it will reduce taxes and increase spending. To do this it will probably need to issue more bonds i.e. to borrow more from investors. It has had its initial budget proposals rejected by the European Commission for being too profligate, and had its national credit rating downgraded by at least one major rating agency.

These factors push borrowing costs up for the country's government, companies and private individuals. By making mortgage and debt repayments more expensive, the "populist" government could risk making itself decidedly unpopular. So we would not be surprised to see the stand-off between Italy and the European Union (EU) grind towards a compromise whereby the Italian government saves some face, but ultimately accedes to financial reality by delivering a more prudent budget. This, combined with relatively low inflation across the EU, will offer little scope for the European Central Bank to increase interest rates.

Of greater significance is the rising value of the dollar relative to other currencies. For example, the eurozone's key underlying interest rate is 0.00%, while that of the US is 2.25%. Therefore, holding dollars pays a better return than would holding euros. As a result, demand for dollars has increased of late, sending their value higher relative to a broad range of currencies. This could continue into the first half of 2019, but might tail off after that. While it does occur, it has significant implications.

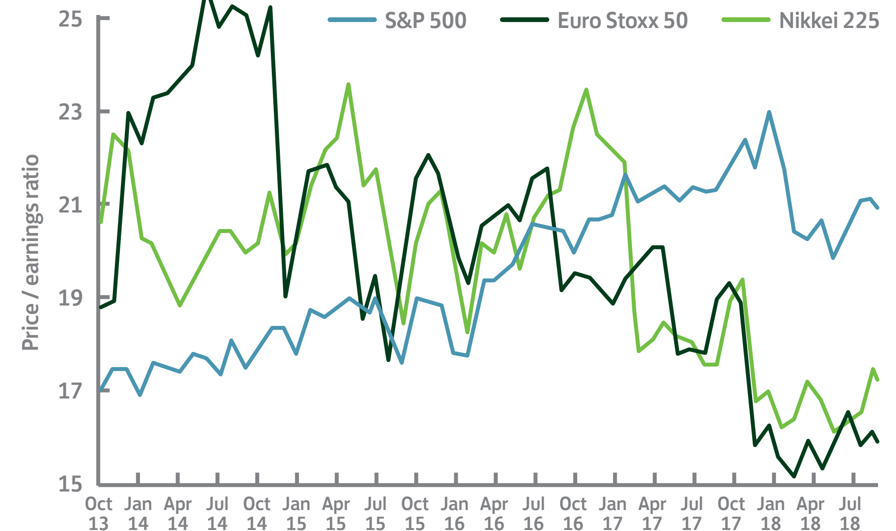
Firstly, it makes US exports more expensive for overseas customers to buy while reducing the value of overseas revenues that are repatriated into dollars. Secondly, it presents a problem to non-US governments and companies that have borrowed heavily in dollar-denominated debt.

A rising dollar makes the debt burden in the respective local currency more expensive. That means more money is needed to meet interest payments, money that can no longer be used to invest in growth or to buy goods and services.

Argentina and Turkey are having a particularly tough time. For example, the latter's currency has fallen from $0.50 to the Turkish lira in September 2013, to as low as $0.14 five years later.

Other emerging market countries are less vulnerable. The likes of India, Thailand and the Philippines have reduced their reliance on dollar-denominated debt. At the same time, the amount of trade that Asian countries conduct with each other has risen from around 47% of their total output in 1990 to around 58% today. So a slowing of growth in the US is likely to have less effect on the increasingly self-sufficient Asian region.

What's more, asset prices (such as company shares) are more attractively priced in emerging markets when compared with those of the US (see Chart 2).



This chart shows how the prices of US company shares have increased in relation to the profits generated by the underlying companies, while those of emerging markets have not kept up.

Add to this the likelihood of Chinese authorities providing financial stimulus to their domestic economy, and it would be reasonable to anticipate Chinese growth replacing that of US as the main global driver in 2019.

A similar story could unfold in Japan (see Chart 3). As well as having attractively priced company stocks, the world's third-largest economy is pushing through a series of corporate reforms on the back of a sustained programme to boost inflation and economic growth.

So, while the US might cease to be the main driver of global growth in 2019, it could be replaced by China. However, it will be more difficult for global stocks to continue the 10-year run of overall rises in the coming months. Relatively expensive US stocks, in particular, look as though they would struggle to rise much more.

Brexit

POTENTIAL OUTCOMES

Once the dust has settled on 2018, we should be some way closer to an idea of how to react to the final act of Brexit. At the time of writing, uncertainty continues to reign. Depending on whom you ask, the implications for economic growth were estimated to be between around £20bn and £250bn in costs and lost economic growth.

But investors can take some comfort in the natural counterbalances that have already provided a degree of benefit as a direct result of the vote to leave the European Union, even if they have been somewhat fortuitous.

These benefits relate largely to the value of the pound. When the outlook for the UK economy worsens, the number of people wanting to invest in the UK and needing pounds to do so, falls. That leads to more people selling than buying the pound, pushing its value down relative to other currencies.

A lower value to the pound is good news for companies that generate most of their revenues overseas. This is because it either reduces how much those customers have to pay for the relevant goods and services, or it increases the value of profits that are repatriated back into pounds.

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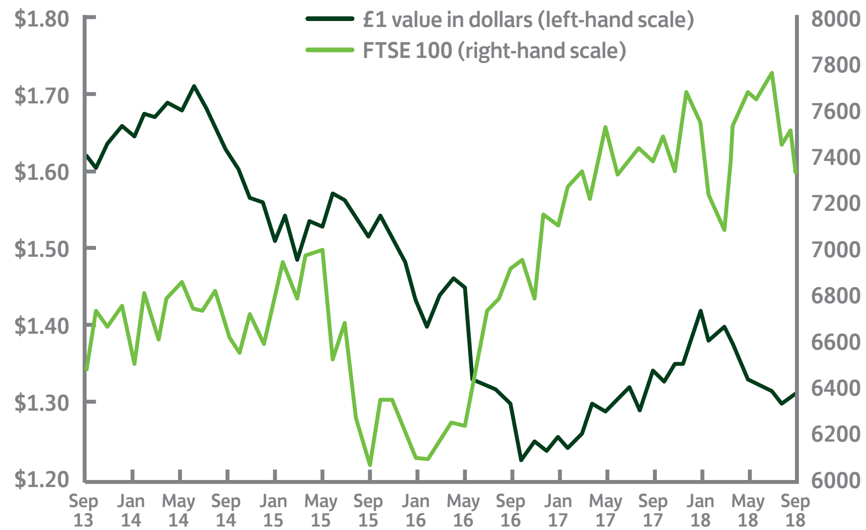
Around two-thirds of the revenues generated by FTSE 100 companies come from abroad. So when the value of the pound goes down, the value of the FTSE 100 tends to rise, as Chart 4 shows.

This does not apply to the more domestically focused companies such as those that tend to be found in the FTSE 250 index (the next 250 biggest companies listed on the London Stock Exchange after the top 100).

However, UK investors can get a further benefit from a falling pound. If they own non-UK assets such as stocks or bonds of US or European companies, the value of those assets, in terms of pounds, is effectively boosted by the lower value of the UK currency.

While that might not counterbalance all of the risk, it has benefited a number of investors in a considerable way.

CHART 4: THE FTSE 100 TENDS TO RISE WHEN THE POUND FALLS



This chart shows how the value of the pound influences the overall prices of shares listed on the FTSE 100 index.

Source: Lloyds Bank plc/ Bloomberg October 2018.

IMPLICATIONS for investors

So where do these points leave us?

Starting with the positives, we foresee a promising outlook for Japanese and emerging market equities. Assets there are attractively priced and backed by the benefits of rising inflation, high productivity and policies designed to encourage growth. In Europe, political instability could work to the advantage of equity investors as we expect central bank policy to have to remain accommodative there as well.

Other positive asset classes include cash and US government bonds. Both could become more popular among investors as economic growth in the US slows and investors look for lower-risk rated assets.

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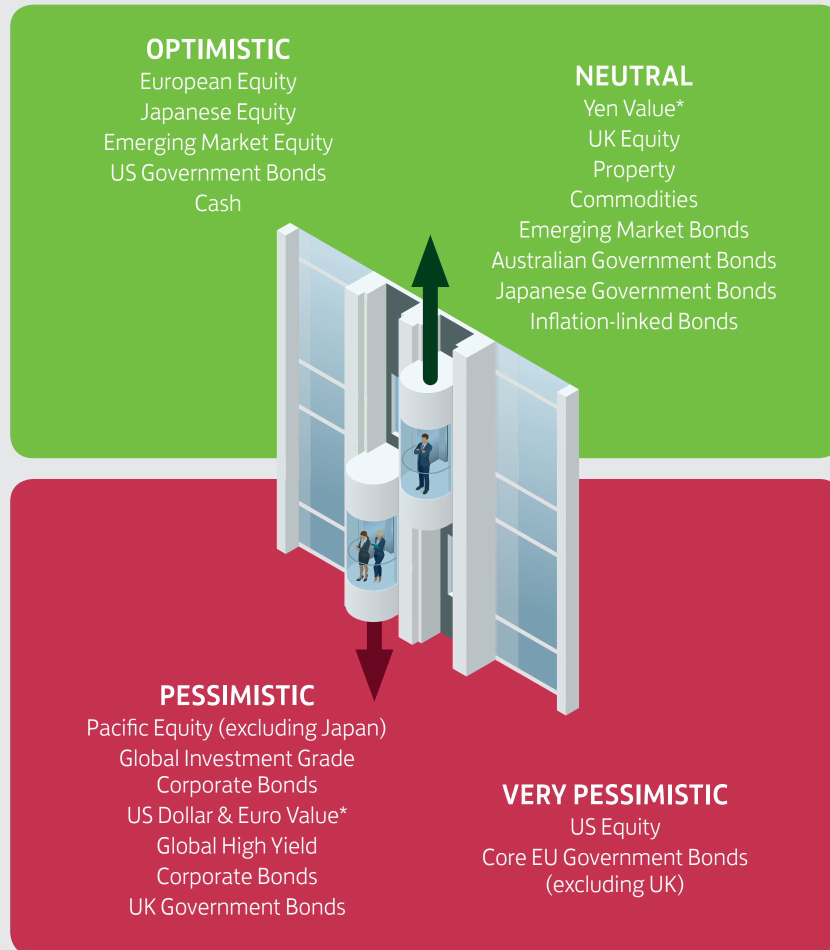
In contrast, profit growth in the US appears to have peaked, so the optimism of rising profits boosting share prices there is likely to run out of steam, with investors moving money into other opportunities. This is also likely to have a negative effect on the value of the dollar.

Meanwhile, the maintenance of low interest rates in Continental Europe could make French and German government bonds unattractive relative to higher-risk rated opportunities such as company shares.

The expectation of rising interest rates and less bond-buying by the Bank of England could combine to make government bonds with their relatively low, fixed returns unattractive. We expect the demand for global bonds to recede as investors have to be more particular about the asset classes and regions in which they invest.

Finally, the value of the euro could be subject to falls as investors weigh the implications of Italian populism and the UK's exit from the EU. This could be counterbalanced by the European Central Bank reducing its bond-buying programme which will reduce the flow of new cash into the financial system – a process that puts downward pressure on the value of the euro.

OUR CURRENT ASSET CLASS PREFERENCES



These are our preferences towards different broad asset classes over the near future (as at the time of writing in November 2018). This is designed to act as a visual aid to understanding our thinking about the economic and political scenario as explained throughout this document.

Forecasts are opinions only, cannot be guaranteed and should not be relied on when making investment decisions. The forecast of future performance is not a reliable guide to actual future results.

* These are our views on currencies in relation to their value against sterling.

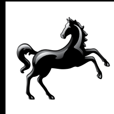
In summary then, we anticipate that China will take over from the US as the main driver of global growth in 2019. Japan and some emerging market economies could also deliver a rebound in domestic stock prices due to a combination of resilience and support from policy-makers.

Profit growth in the US appears to have peaked, and that is likely to combine with higher inflation and interest rates, as well as ongoing trade tensions to impede the rise in stock prices there. While this might be storing up recessionary pressure in coming years, we do not foresee a complete reversal of growth in 2019.

At the time of writing, uncertainty over Brexit negotiations make it difficult to know what the outcome will be. In the meantime, we retain our long-term perspective of around 10 years, married with an appropriately diversified portfolio of investments. We believe that this goes a long way to retaining a focus on protecting and growing value while not being overly distracted by short-term noise.

More information

To find out more about our thinking, ask your Private Banking and Advice Manager for a copy of the full 2019 Outlook document.



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Important information

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