Allocation insight

11 January 2019

Market themes for the next 12 months

First the good news. A year ago, the return expectations on liquid investments were very low, US monetary policy was tightening and the mood of investors was, on average, very positive concerning the new year's investment outlook. As the set-up was not especially positive for investors, the positioning of our portfolios was cautious. Now, following the autumn's market plummet, the return expectations on equities and corporate bond investments have risen and an increase in key interest rates is no longer self-evident. This increases the likelihood that this year will turn out to be better for investors than last year.

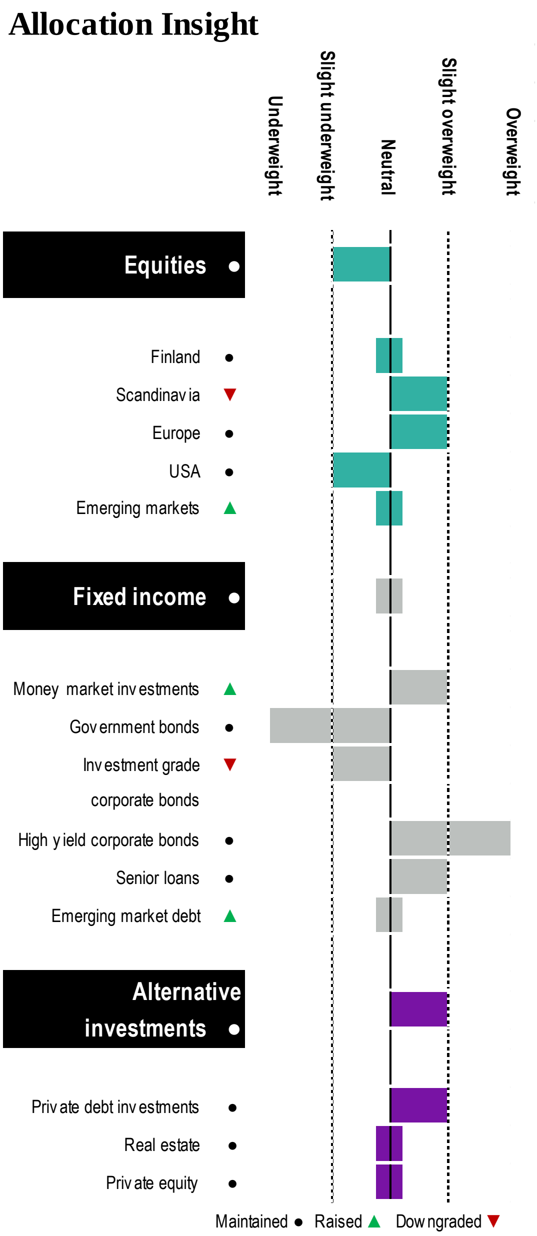
There are still concerns. The slowing down of economic growth weakens the accuracy of economic and earnings forecasts and raises the possibility of monetary policy errors, at the same time as the global economy's debt level is record-high. The trade war between the US and China creates disturbances in global supply chains and reduces companies' investment appetite in an already uncertain environment.

The investment year holds an unusual number of possible development paths, which encourages us to be patient, but at the same time to be opportunistic when opportunities emerge. We will sift through the possible scenarios by reviewing the factors most likely to impact the investment markets and our allocation decisions.

Concerns are not in short supply although the conditions for a better investment year are there

Economic growth is slowing and China's role is critical

The slowing of economic growth is clearly visible in different parts of the world. The PMIs depicting China's economic activity show dwindling economic activity, in Europe the decline in PMIs was exceptionally strong in the second half of last year and the figures published in the US in December/January show similar trends.



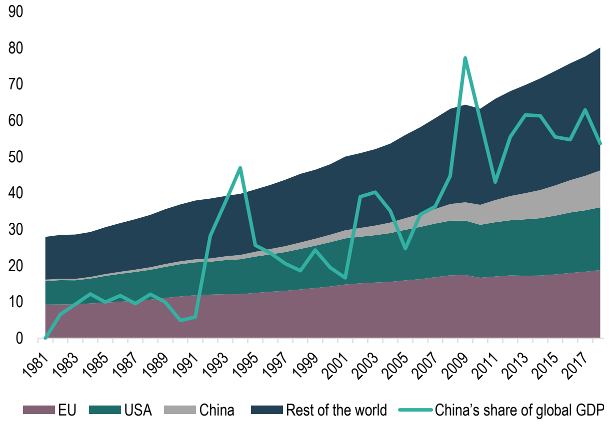


Figure 1. Global GDP development by region 1980–2017, billion US dollars (left axis) and China's share of the world's GDP growth (right axis).
Source: World Bank

The reasons behind the slowdown are many and their effect, alone or together, will pretty much determine how deep and long-lived the current shift in the economic environment will be. The earnings potential of companies is tied to the development of the economic environment, which makes this a critical factor in terms of equity market development.

Due to China's strong position as a driver of global economic growth, both directly and indirectly (Figure 1), its role in global economic development is significant. Just over a year ago, China's government laid out the key changes in the country's economic structures for the next five years. These were the reduction of polluting basic industry, increasing the share of the service sector and curbing the rise in housing prices. Over the past decades, China's economic growth has leaned heavily on basic industry and on the increasing affluence generated by the rise in housing prices and urbanisation. The changes targeted in the five-year plan would thus be significant. In addition, the traditional numeric economic growth target was removed, which shows that the country's leaders are ready to accept greater annual volatility in economic growth in order to achieve the targeted changes.

China's economic growth slowed down clearly during the autumn and the development of housing prices in the major cities has taken a slight downward trend. The government reacted to the situation by increasing the banking system's liquidity, but the general impression that China can, at will, quickly and easily stimulate its economic growth with infrastructure investments is outdated. In terms of global economic growth, this is a risk that the investment markets have not factored in.

The slowing of China's economic growth and trade policy uncertainties have had a negative impact, not only on the local equity market, but also on the country' trade partners. The clear slowing down of Germany's, and thus the entire euro zone's economy, in the second half of last year was mostly linked to dwindling demand for exports and specifically the automotive sector in the German automotive sector's key growth area in China.

The year-old tax reform in the US led to a consumption and investment frenzy last year, the impacts of which died down over the autumn, however. The negative impacts of trade policy measures on companies' business have also strengthened. Signs of this have showed up in the profit warnings of some technology sector companies. In addition, the cost structure of US companies is burdened by rising payroll and financing costs. Simultaneously, the cooling down of the housing markets is reducing consumption appetite. The overall debt level of the corporate sector is record-high, the need for refinancing in upcoming years is large and companies' sensitivity to a rise in the interest rate level is high as a result.

The slowing down of global economic growth is thus linked to many risk scenarios that can materialise in a number of ways. One key question is, however, whether China and the United States can come to an agreement on trade policy. The first hard deadline for the negotiations is March 2nd. If trade policy tensions can be alleviated, the way will be open to a more positive scenario from investors' viewpoint. The greatest benefit in this situation would go to the parties that have suffered the most from the situation, primarily European export companies' equities and bonds.

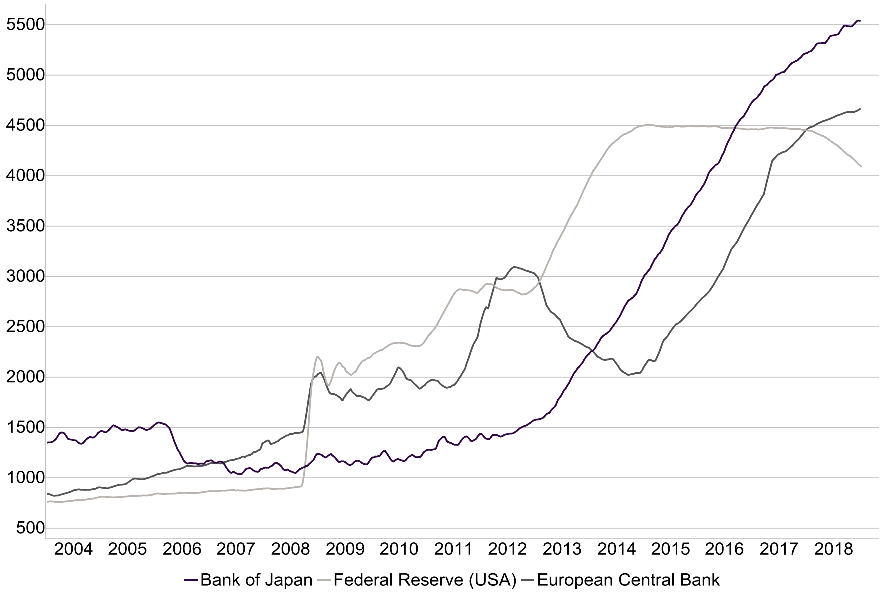


Figure 2. Development of the main central banks' balance sheet 2004–2018 (Source: Macrobond).

Key interest rate hikes not to be taken for granted

Over the next year, monetary policy will tighten globally even if none of the central banks were to raise their key interest rate. The Fed will be likely to reduce its balance sheet at a rate of some USD 50 billion per month, in other words, it will allow this amount of the bonds it owns to mature without purchasing new ones in their place. At the turn of the year, the ECB wound down its monetary stimulus programme and is planning an interest rate hike for the latter part of the year. This will prove to be a very challenging target unless the economic outlook improves significantly. In Japan, the central bank will probably reduce its massive government-bond-buying programme. The combined effect of the measures will be the leeching of money from the global financial system over the next year at a rate of around USD 20 billion a month (Figure 2). China's central bank is the only major central bank that is currently increasing monetary stimulus.

In an environment where economic activity is slowing anyway and inflationary forces do not appear to be accelerating, this means a fairly significant global change diminishing the supply of money. Especially operators outside the US that are dependent on dollar financing are finding themselves in a difficult position. If we can avoid a downturn scenario, future dollar-denominated financing costs will most likely rise further.

Our approach to the new investment year includes a substantial cash position, still favouring corporate bonds over government bonds

In the autumn's market decline, we got a taste of how the operators with the most debt fall out of favour with investors in an environment where the supply of debt is falling and risk is being repriced. This type of situation often creates opportunities that can only be seized by actors with a good level of liquidity. Our approach to the new investment year includes a substantial cash position, still favouring corporate bonds over government bonds.

More favourable investment environment than last year, if we avoid a downturn

The valuation levels of liquid investments fell last year as the real interest rate rose in the US. The slowing down of economic activity strengthened this movement. While the return levels of the US equity market were on average five per cent at the start of last year, they have risen, at the moment, by just over one percentage point (Figure 3). The corporate bond market has also experienced major movements. For instance, the credit risk premiums of higher risk corporate bonds widened in the euro zone by some two and a half per cent during last year. Similarly, the decline in government bond rates in both the US and Europe has further reduced the relative attractiveness of safe haven investments.

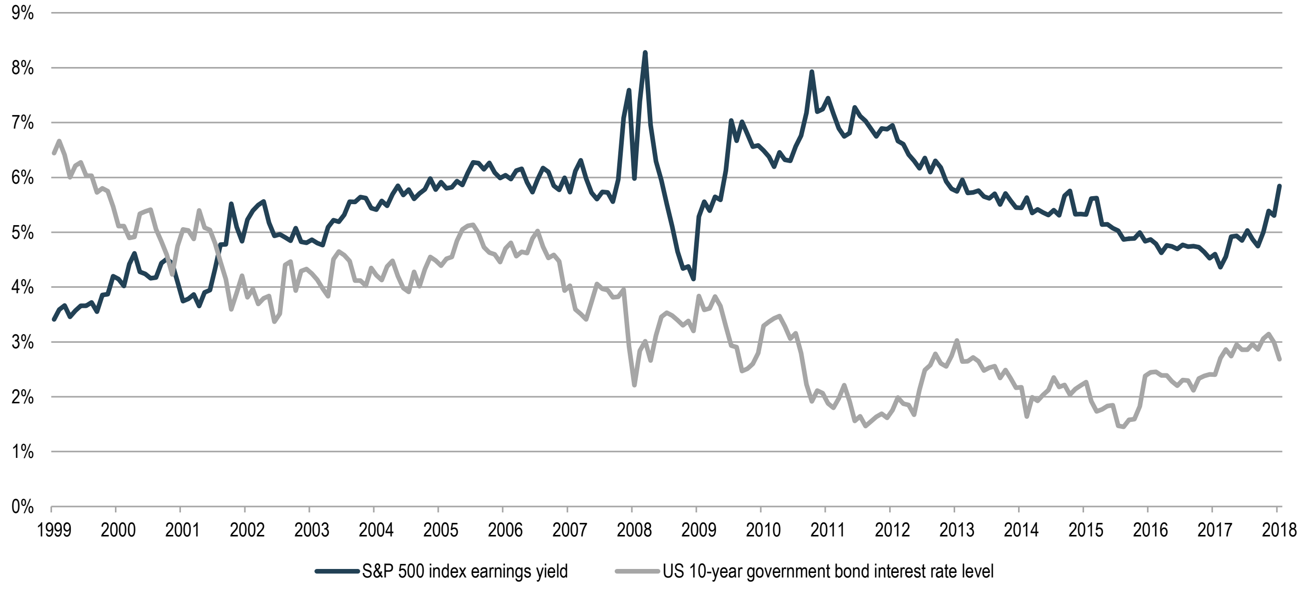


Figure 3. The S&P 500 index earnings yield, i.e. the total earnings of the index companies divided by the total market value, and the development of the US 10-year government bond interest rate level 31 Dec 1999–31 Dec 2018. Source: Bloomberg.

The big picture is, however, blurred by a decline in the changes in companies' earnings forecasts, resulting from slowing economic growth (Figure 4). This has also been the main reason behind the gradual downgrading of our equity investments over the past year to moderate underweight. Behind this earnings development has been the moderation of the earnings forecasts of tech companies in particular from their overly optimistic levels and the reflection of oil price decline on the earnings of energy companies. In a situation in which the slowing down of economic growth would continue, the decline in earnings forecasts would extend to other sectors also.

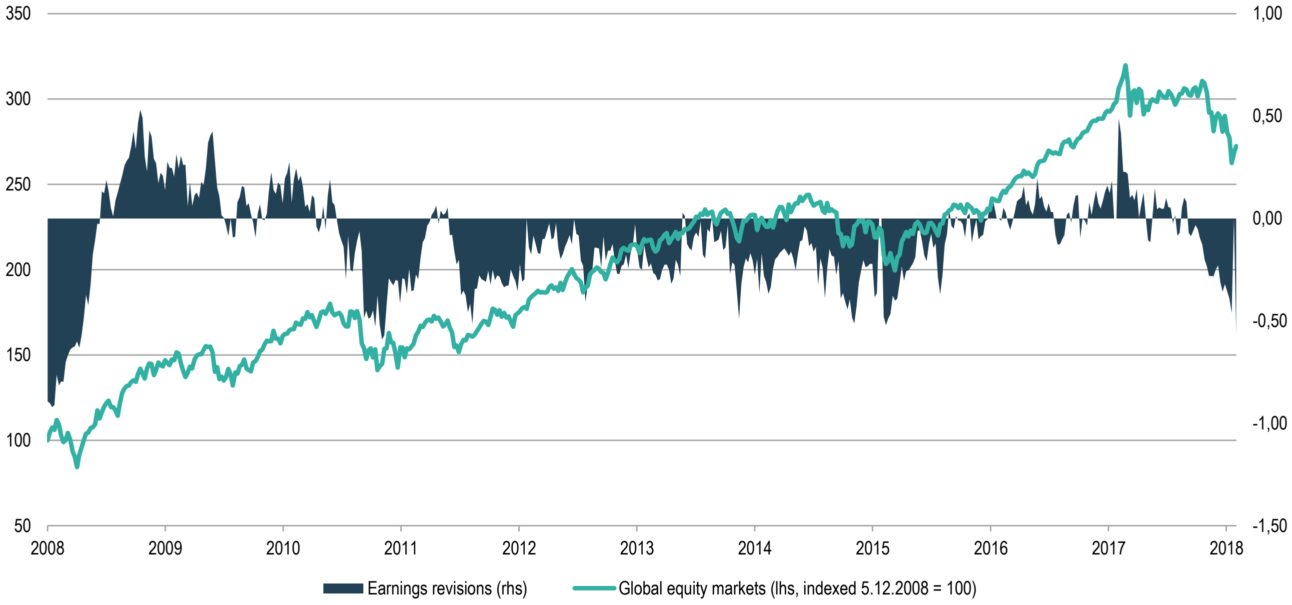


Figure 4. World equity markets total return and global earnings revisions 5.12.2008-4.1.2019. Source: Bloomberg.

Even if we were to avoid a downturn, which appears to be the most likely scenario at the moment, the situation is not problem-free for investors. The recent decline in equity investment valuation levels raises the future earnings expectations of a balanced investment portfolio, but the fixed income environment will most likely remain low, forcing us to take a critical look at asset class allocation. Keeping alternative investments as a permanent part of a well-diversified investment portfolio is warranted, both in order to defend future earnings expectations and improve the portfolio's risk profile. Alternative investments will remain at moderate overweight in our allocation insight.

Carolus Reincke

Head of Multi-Asset Solutions and Responsible Investing

Topias Kukkasniemi

Portfolio Manager, Multi-Asset Solutions and Responsible Investing