

THREE KEY THEMES THAT WILL SHAPE 2019

07 February 2019: Last year was a challenging year for investors, with US equity and government bond markets both returning less than cash.

According to Keith Wade, Chief Economist & Strategist at global asset manager Schroders, two factors – namely disappointing worldwide growth and less cash flowing through the global economy– were contributing factors to this negative consequence.

He says that these factors – driven by three underlying issues -will continue to influence markets in the year ahead. “Poor global growth and tighter liquidity will continue in 2019 with the decline of cheap money, the reappearance of emerging markets and the many governments turning to quick fix policies to quail populist demands,” says Wade.

He says that while there is no guarantee of better performance in 2019, identifying these important themes gives investors an opportunity to manage these investment risks.

Wade unpacks the three key themes below:

Theme 1. Lower availability of cheap money exposes those reliant on borrowing

In 2019, the volume of money in the global financial system is expected to reduce according to Wade. “The main reason for this is a change in the activities of major central banks. After a period of buying government bonds, the US Federal Reserve (Fed) plans to sell back some of these investments, withdrawing some cash in circulation. The European Central Bank has said it will stop buying bonds. This leaves the Bank of Japan as the only major central bank still contributing to new money to the financial system (through the purchase of its government bonds),” says Wade.

He explains that this is important, because cheap, easy money encourages investors to take greater investment risks. “In recent years this has helped direct investment into peripheral eurozone markets (e.g. Greece, Portugal, Spain and Italy), some emerging markets and also lower grade corporate credit. As liquidity is withdrawn from the system, important support for these markets disappears. The early effects of this trend were already being seen in emerging markets in 2018. In 2019 they look set to intensify,” says Wade.

Theme 2. The return of emerging markets

Wade explains that given the above discussion it may seem odd, he believes that emerging markets can make a comeback in 2019. This is, however, one condition that

the US Fed's policy of interest rate rises comes to a halt. "Should this happen - and we forecast one more rate rise in June, taking US rates to 2.50-2.75% - there is a good reason to believe the US dollar will lose some of its strength. This would provide a welcome relief to those investors that borrow in dollars –a heavyweight of whom resides in the emerging markets," says Wade.

He explains that the positive effects from this development could more than offset the pressure from the withdrawal of money in the global financial system and escalating trade tensions. "Arguably, prices for emerging market assets may already be discounting the worst, with both equities and foreign exchange in those countries having fallen significantly, so there is room, following some good news, for a bounce," says Wade.

"Macroeconomic developments will be important as well though, and it may need more government spending and tax cuts from China before investors' confidence is more firmly restored. The worry of a US-China trade war remains a looming threat, but there is no reason to expect an outright contraction in overall trade as an activity should be diverted elsewhere."

Theme 3. Populist pressures mean governments turn to quick fix policies

Without the engine of US or Chinese demand, Wade warns that global growth tends to slow. "The US outperformed, in growth terms, in 2018 as a result of President Trump's tax-cutting agenda. Other leaders and governments have been taking note. In France, President Macron responded to weekends of riots by meeting populist demands for lower taxes. In the event of a hard exit from the EU, the UK is planning its fiscal boost. Japan may well be the exception, with an increase in a consumption tax scheduled for October 2019. However, even here measures are being taken to offset the impact," explains Wade.

"In any case, the key point is that governments seeking growth are no longer making economic reforms to increase competition or make labour markets more flexible. The approach today is to deliver a quick fix through a tax cut, increased public spending or regulation such as a rise in the minimum wage rate. Some of these measures are warranted and overdue, but others are a response by governments to populist pressure."

Wade believes that being aware of these risks allows investors to be better prepared. He concludes, "How are these themes likely to shape market performance in 2019? Much of the bad news is already priced in by the markets. This, of course, is no guarantee of positive returns in 2019, but it does mean that markets are better positioned for disappointment and hence potentially more resilient to shocks than they were last year."

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