

## Plus ça change?



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The past year has been as rewarding for investors as it has been confounding for analysts. While economic growth weakened to its slowest pace since the global financial crisis, both equity and fixed income markets performed well. Market valuations sent contradictory signals regarding the outlook. An observer who has not followed markets closely might wonder if equities and bond markets are dominated by separate sets of investors that rarely commingle.

To form our expectations and investment strategy over the months ahead, it is instructive to review developments over the past year. Equities pointed to a sustained and positive economic outlook. Bond markets signalled a recession for most of the year. This signal was validated in credit markets where higher quality credits outperformed the high yield bonds that typically perform well during equity market rallies.

Most economic indicators pointed to a deceleration in activity through much of the year. The US-China trade war loomed large. Higher tariffs had a significant direct cost through lower employment in manufacturing and higher producer prices. Uncertainty regarding how the trade war will be resolved exacted a significant toll on decision making by companies. Investment spending declined in the manufacturing sector at a global level. Industrial production decelerated as well, spilling over into services.

While the main trade war protagonists are the US and China, Europe was particularly hard hit by the uncertainty. In part this is because Europe is more dependent on global trade growth than the US. Additionally, Europe struggled with its own – equally disruptive – uncertainties due to Brexit.

In emerging markets, economic growth disappointed as well. Global trade developments had a negative impact on export-oriented economies. But country-specific factors played a role as well. In Brazil, the vaunted reforms have had a bigger impact on market performance rather than the real economy. In India, Modi's re-election appears to have led to policy complacency. Within the span of 2 years, India has gone from a fêted success to an economy, where growth is sustained only by government spending.

Against this background, why hasn't the global economy slipped into recession? And why have the market developments been generally positive? There are two factors: employment, and monetary policy.

Manufacturing is no longer very labour intensive. Consequently, the deceleration last year has had little aggregate impact on employment. Employment growth remained robust in the US. In Germany, the unemployment rate reached an all-time post-reunification low, despite a recession in the manufacturing sector. Resilient employment, coupled with spending on nondurable goods, buoyed consumer confidence. This phenomenon was true in advanced economies, as well as emerging markets, where the decline in unemployment rates was less dramatic.

None of this would have materialised, had monetary policy not played a role. Unusually, the Fed changed course mid-cycle, while monetary policy was still within a neutral range. The ECB also loosened its monetary

stance, while substantial cuts were made by central banks in India, Russia, Brazil, and other emerging markets. Monetary conditions were loosened by all large economies.

Where does this leave our outlook for the months ahead? Has the global economy turned the corner? Has the US economy become “virtually recession proof” as economists at some venerable sell-side institutions are crowing? Our short answer is “no”. Here’s why:

Over the past year, we have been highlighting that the outlook has many high probability downside, and few upside risks. None of these risks have changed materially. There may be a respite from the US-China trade war, but trade issues are likely to remain a critical source of uncertainty for some time. US-European trade relations are looking vulnerable following the French/US dispute over the digital tax. The positive effects of the tax cuts on US economic activity is fading. Importantly, the US fiscal deficit is high, constraining fiscal policy options in the event of further deceleration. Consumer sentiment may be resilient, but there is a continuous rise in delinquency rates on personal loans. Geopolitical risks impacting oil prices have been rising steadily last year, spiking very recently.

Where could positive surprises outside the US come from? Europe’s growth is likely to remain below potential as businesses in the UK and elsewhere await greater clarity on the post-Brexit trade relations. Investor’s hope for some fiscal activism in Germany were dashed. Trade, demographic and investment trends suggest that China’s economy will continue to decelerate over the medium term. There is little evidence, that growth in other emerging markets can be a source of positive surprises.

This implies that while a recession has been averted, growth is likely to remain at or below potential in the foreseeable future. In the US this means a growth rate that is shy of 2%. In Europe, growth in Germany is likely to remain below 1%.

In this mature stage of the economic cycle, the environment for corporate earnings will remain challenged. Structurally higher costs of shifting global trade flows have already impacted margins. Tight labour markets will continue to do the same. Without catalysts to push economic growth above current levels, maintaining a positive level of earnings growth will be difficult.

None of this means that the outlook for equities is necessarily negative. The shift in monetary policy by the Fed and many other central banks around the world has shifted relative valuations in favour of risk assets. Although the Fed will likely pause further cuts in interest rates, the stage has been set for a more rapid phase of growth in the money supply. Continued share buy-backs can buoy the market for some time to come.

Markets can remain de-linked from fundamentals for some time. Or as Keynes memorably put it, markets can stay irrational longer than you can stay solvent. We recognise that being cautious last year has led us to miss some of the performance. Over the longer run, however, we believe it is best to keep one’s eye on fundamentals and the strategic asset allocation.

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