CFA SINGAPORE INSIGHTS

By Praveen Jagwani

Watch out for geopolitical risks and slowing global growth in 2019

But some emerging markets may rise; EM equities seem to be perched on attractive valuations

AN OLD Danish proverb asserts: It is difficult to make predictions, especially about the future. Yet that has never discouraged, those of us in the business of studying financial markets, from making pronouncements, particularly at this time of the year.

With 2018 almost out the door, we can look back grimly, at what has possibly been the worst year, for broad market returns. In the 118 years since the dawn of 20th century, never before have 89 per cent of global assets delivered a negative return in US dollar terms. In local currency terms that figure is still a shocking 61 per cent.

The sustained expansion of global economy, we had witnessed since the Financial Crisis of 2008, seems to have finally run out of steam. In the past 9 years, all asset classes other than cash, generated positive real returns. The outlook for 2019 does not inspire a great deal of confidence and to produce investment returns, one will have to be very selective with markets and asset classes. Different countries are in different stage of the economic cycle and therefore investing in broad indices will not prove to be prudent in the months to come.

In 2019, the major themes likely to dominate are:

- Geopolitical risk:
  - Trade war between US and China
  - Stand-off between Italy and EU
  - Probability and shape of Brexit
- Slowdown in global growth
- Rise of select Emerging Markets

History has shown that when real rates are low, as they have been for the past few years, future returns on equities and bonds tend to be lower than the recent average. We expect the global economy to grow at slower pace next year. In the US, tighter monetary policy and declining impact of the tax cuts will start to drag on activity. China has already started to slacken despite additional stimulus from the People's Bank. Anecdotally, the decline in Macau casino revenues is also symptomatic of the growing despair enveloping the Chinese population. With total debt in excess of 300 per cent of GDP, the imbalances that have built up in China need to be scrutinised very carefully.

Trade war is beginning to hurt not just China and the US but also all countries knit together in the supply chain of major multinational businesses. While we have seen wage growth across most developed economies this year, the incidence of job losses is likely to pick up in the second half of 2019.

Overall trade war is likely to shave 0.4 to 0.5 per cent off the global growth in 2019-20. The decline in the price of oil despite Opec cuts is a testimony to the impending economic slowdown. Thus oil price is unlikely to spike any time soon.

Europe has had its share of drama with the ECB finally shutting down its long-running bond-buying stimulus programme. The next few months could see volatility increase in European markets with bonds, equities and the euro currency all at risk. Given the sharp fall in the price of Italian government bonds this year and the looming prospect of a disorderly Brexit, the Eurozone will have an existential crisis as it goes into the European Parliament elections in May. We think that the probability of the ECB hiking rates in such an environment is rather low.

After the rate hike in December, we expect that the Federal Reserve to hike interest rates only once next year and certainly not beyond the first half of 2019. With US growth slowing and inflation softening, the Fed may have to cut rates in 2020.

Impact of end of QE

As this scenario unfolds, the support for US dollar will diminish, thereby strengthening developed market currencies like the yen, euro and sterling. We don't think the markets have priced the full impact of a global withdrawal of easy liquidity (stoppage of QE programmes of US, ECB, Bank of Japan). Thus global equities could see further downside in the months to come. Credit spreads are likely to widen too as risk gets priced better. It would therefore be judicious as a bond investor to stay with US Treasuries and select EM sovereigns.

Equities in emerging markets after a devastating year in 2018 seem to be perched on attractive valuations with some countries reflecting a structural improvement. However the Emerging Markets are not a homogeneous mix.

The MSCI EM index is almost a proxy China play given the heavy weight that Greater China commands on the index. To isolate value, one must separate China and invest in countries with strong growth metrics. Historically, the time to buy EM is after the EM currencies have been battered and evidently 2019 offers a good entry point for EM assets.

The rise of anti-globalisation, anti-establishment, anti-immigration sentiment will keep most markets in an agitated and nervous state. Gold typically does well in periods of market volatility. Investing in passive instruments or index trackers is unlikely to yield returns as there is increasing divergence in central bank policies and economic cycles. Picking countries with a visible runway of economic expansion, those with large domestic consumption models and low debt/GDP are likely to generate relatively higher return for investors. Countries like Russia, India, Mexico, Brazil and Indonesia would be ideal hunting grounds for solid equity growth stories.

In summary, 2019 will be marked by greater market disruption and volatility which will require careful and deliberate selection of asset classes. In such an environment active management is likely to perform better than passive allocation to ETFs.

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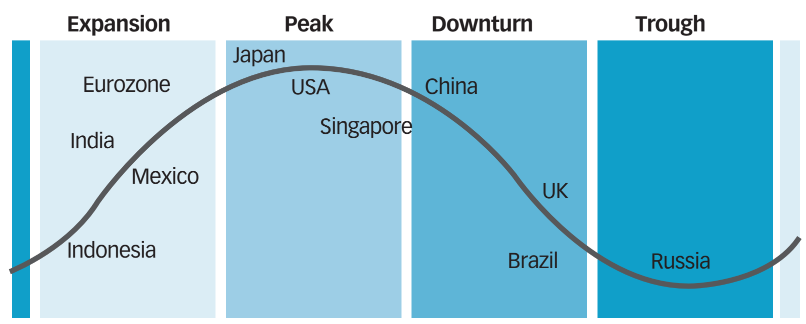
The economic cycle

Where markets stand now



Source: Praveen Jagwani

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