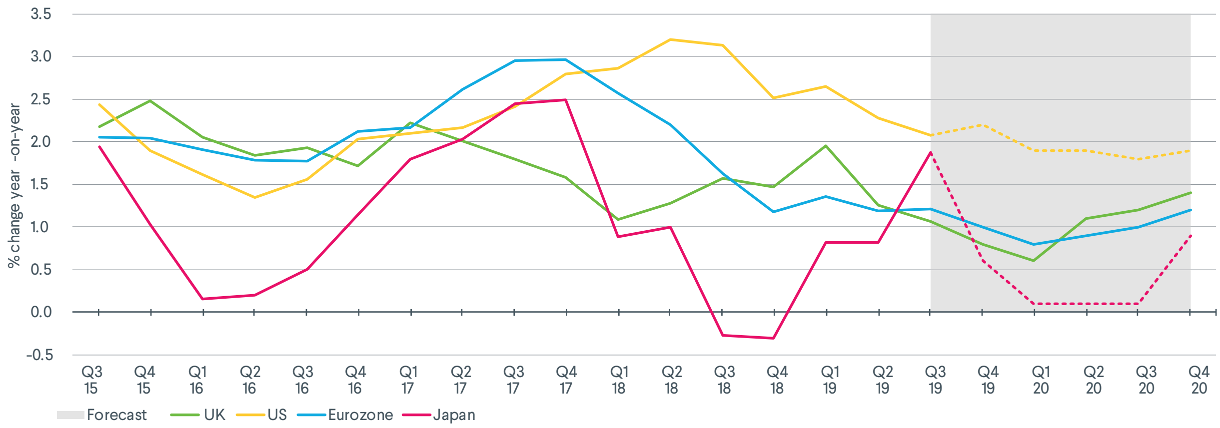
Capital markets update

2019 was a strong year for most markets. Global equities, led by the US, delivered stellar returns, with returns from global equity indices close to 30% in local currency terms. Bonds also rose over the year, although yields drifted higher from the extremes of the third quarter. Oil and gold also rose, by 23% and 19%, respectively.

Growth decreased across most economies in 2019, resulting in the slowest pace of global growth since 2009. Trade tensions, political uncertainty and an acute slowing in European manufacturing production all contributed. There are signs the worst of the slowdown may be over as the global manufacturing Purchasing Managers Index (PMI) moved back in to expansionary territory in November. Although manufacturing PMIs suggest the industrial sector will continue to weaken in the major advanced economies, remaining at levels consistent with contraction, the latest figures provide a more encouraging, albeit diverse, outlook for emerging economies. Beyond manufacturing, Services PMIs have generally been more positive and in the US and Europe picked up in Q4. In advanced economies domestic demand has been underpinned by labour markets which weathered 2019's weakness in manufacturing fairly well: overall employment was resilient and wages were rising. Though tariffs remain on two thirds of US imports from China, the signing of an initial US-China trade deal has also helped quell growth fears. As a result, consensus forecasts see world GDP growth reaching a low in the first half of this year, before picking up, leaving growth for 2020 unchanged from 2019 at 2.5%.

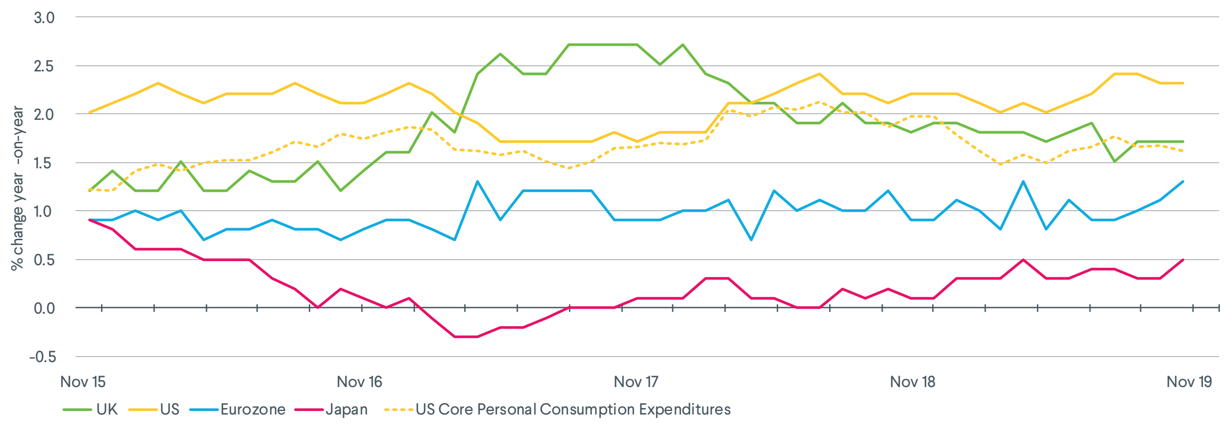
Although GDP growth is slowing in the US, it has continued to outperform other major developed economies and third-quarter growth did surpass expectations. The slowdown in the Eurozone has developed more acutely than forecast, particularly in Germany, where falling external orders led to industrial production falling sharply. China has also slowed as export and investment momentum has weakened. UK GDP growth has also been anaemic in the first three quarters and is expected to be flat in Q4; businesses have contended with potential no-deal Brexits in March and October, leading to an extremely weak period of business investment. Particularly worrying, given the sector's dominance in the UK economy, the Services PMI slipped in to contractionary territory in November, though early estimates suggest a rebound in January. Continuing uncertainty suggests sluggish UK GDP growth in 2020, though full-year forecasts mask a pick-up in quarterly growth rates, driven by looser fiscal policy and strengthening household spending power.

Chart 1: Year-on-year realised and consensus forecast GDP growth



Source: Datastream and consensus forecasts

Chart 2: Core CPI inflation



Source: Datastream

Inflation in most advanced economies, both forecast and realised, remains persistently below target. In the US, Eurozone, and UK unemployment rates are historically low and wage growth is rising modestly in real terms, but inflation continues to surprise to the downside. Consensus forecasts largely see inflation in the major advanced economies moving sideways over the coming year, although trade tarifffs, escalation of tensions in the Middle East, or a deferred effect from tight labour markets could be sources of some upward pressure.

This lack of inflationary pressure has allowed central banks to turn more accommodative – the US Federal Reserve (Fed) cut rates for the third time in three months at its October meeting, while the European Central Bank cut rates to -0.5% and announced the restart of quantitative easing in November. Brexit, and its potential impact on the balance between supply and demand, has played a part in keeping the Bank of England from cutting in 2019. However, subdued growth and inflation well below target in December has sharply increased market-based expectations of a near-term rate cut.

Government bonds

For most of 2019, government bond yields followed deteriorating macroeconomic data and manufacturing surveys lower, with the value of global negative yielding debt peaking at $17 trillion in August. However, the fourth quarter saw sovereign bond markets give back some of their gains as sentiment improved on the economic outlook.

UK nominal yields moved higher in line with global comparators, but index-linked gilt yields, particularly at the very front end of the curve, rose more as sterling strengthened. As a result, gilt-implied inflation has returned towards longer-term average levels (Chart 3). Medium-dated conventional gilts continue to look more attractive for hedging inflation while ultra-long-dated index-linked gilts offer better relative value. However, the government will beign a consultation in March that might reduce RPI inflation closer to CPI infaltion, posing a risk to current valuations of longer-dated index-linked gilts.

Chart 3: Spot gilt-implied inflation

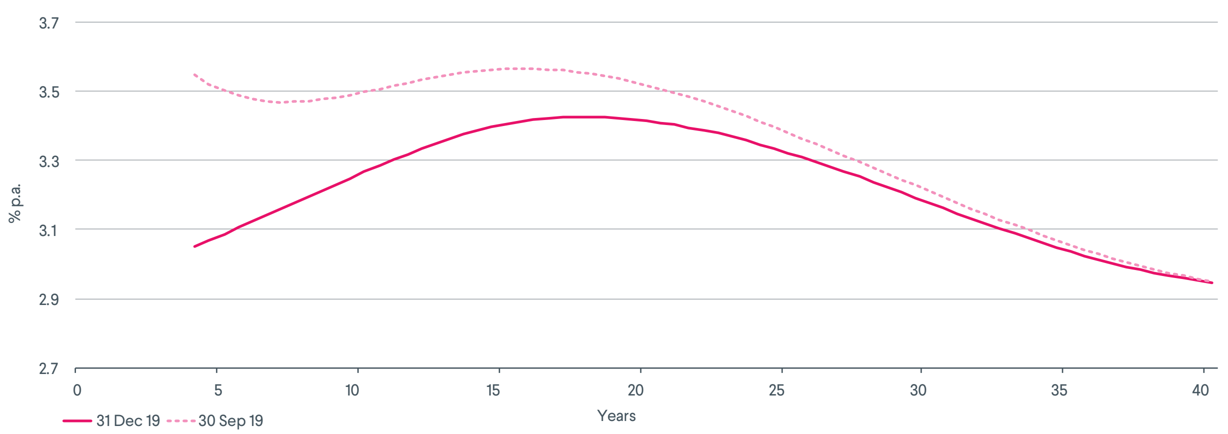
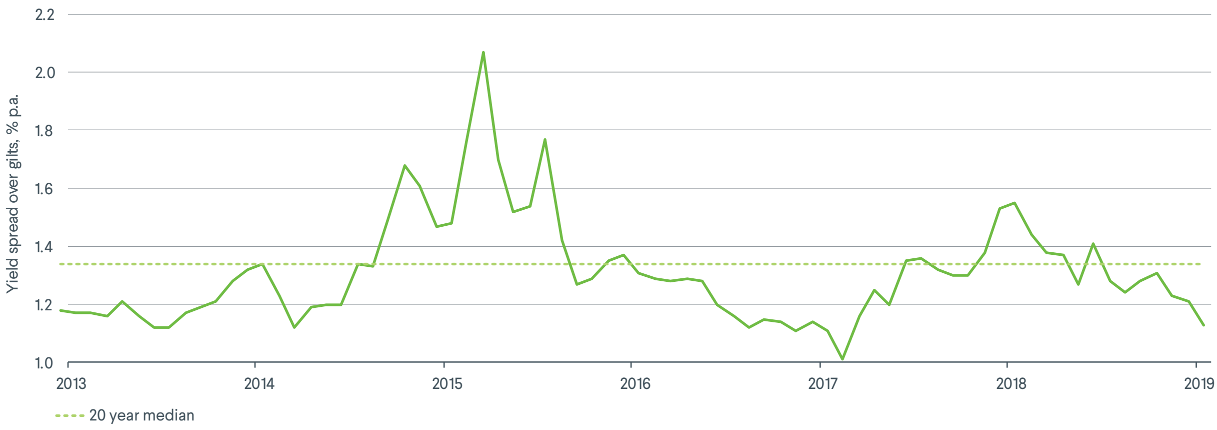


Chart 4: Sterling A-rated corporate credit yield spreads



Credit

Global credit spreads continued to tighten in the fourth quarter, as they have done for much of 2019. Speculative-grade credit spreads outperformed their investment-grade counterparts over both the quarter and year to the end of 2019. In addition to the very low level of underlying yields, which will limit absolute returns, sterling and global investment-grade credit spreads have moved further below long-term median levels (Chart 4).

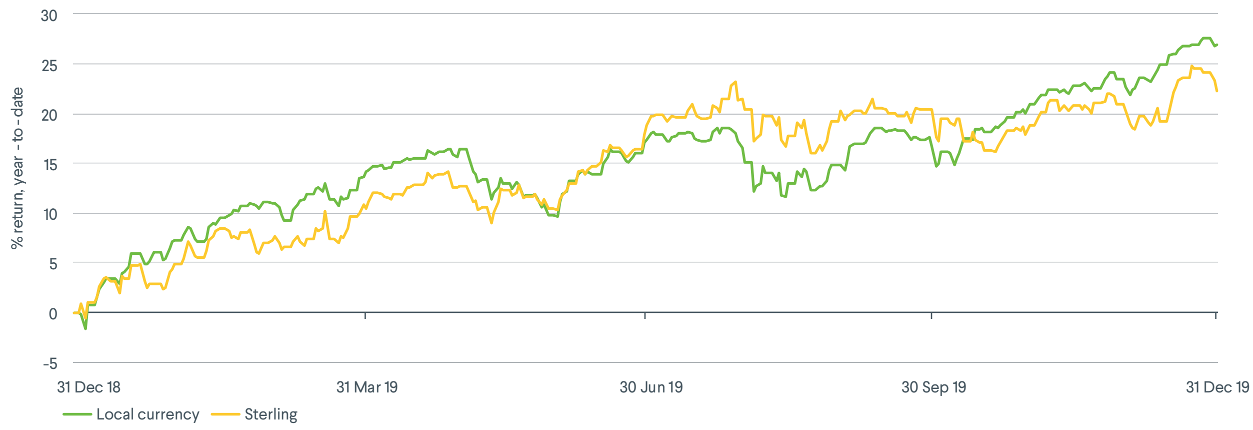
Speculative-grade credit spreads, particularly in the higher quality portions of the high yield bond market, are touching levels they have rarely ventured below. At the same time, the affordability of debt for high yield companies, as measured by the number of times earnings cover interest payments, has drifted lower over the 2019. Though leveraged loan spreads retraced some of the spread widening over 2019 in the fourth quarter, loans continue to offer better relative versus high yield bonds.

Equities

Despite deteriorating industrial data over the course of 2019, the FTSE All World Index returned 27% in local currency terms (Chart 6). These returns were largely delivered in the first quarter - when equity markets bounced back from a sharp sell off at the end of 2018 - and in the final quarter of 2019. The strong fourth quarter rally followed indications of progress in the global trade disputes, a third quarter earnings season that was generally better than feared and some improvements in macroeconomic data.

At the same time, earnings growth in 2019 was minimal, pushing global equity valuations slightly above longer-term average levels. The relative valuation is more extreme in the US, a market which remains at a significant premium to global equities. Overall, we are sceptical the strong equity market rally will continue throughout 2020, unless there is a substantial acceleration in earnings growth. Whilst consensus earnings growth expectations for 2020 currently point to sharp rebound of around +9% for global equities, we believe these forecasts look optimistic, unless economic data continues to improve and the recent progress in global trade negotiations leads to a sustained easing in the trade tensions.

Chart 5: FTSE All World Index, total return



Property

Annual capital value growth turning negative during 2019, and the pace of the fall continued to increase in the fourth quarter. Total return remains positive due to income but has slowed to its weakest pace since Janaury 2013. The slowdown is primarily rooted in acute weakness in the retail sector, even though that represents under 30% of the traditional UK commercial market. Impacted by Brexit-related uncertainty, transaction voumes were significantly below historical averages over 2019.

Net initial yields (based on actual income receipts, rather than notional rental values) remain low versus history, at or around 5.0% p.a. With annual rental growth continuing on a downward trend, slowing to just above zero in November, and little sign of any revival in the retail sector, we expect muted returns from UK commercial property over the short to medium term.

Conclusions

The slowdown in global growth is forecast to abate in 2020, though any potential rebound is expected to be modest. While industrial momentum remains weak, labour markets, and hence consumers, have remained relatively resilient. Risks of an escalation in trade tensions between the US and China have eased, but uncertainty is likely to remain high and re-escalation represents a major downside risk to the outlook. Geopolitical risks have also increased as relations between the US and Iran deteriorate.

Valuations in equity and credit markets continue to look more optimistic than this outlook warrants. Risk assets could continue to drift higher amid globally accommodative monetary policy and a partial easing in trade tensions, but further evidence of a global industrial recovery might be required for a more sustained rise. Even if the downturn in global growth may soon be over, we retain a degree of caution, holding a little more cash than usual as a result. We continue to prefer equities to property in growth-orientated portfolios and would advocate diversifying credit portfolios, potentially by trimming speculative-grade exposures.

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