NEWTON
Investment
Management

January 2019
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# MARKET OUTLOOK

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Global Strategist,
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**At the start of 2018, optimism reigned among policymakers and market participants, as it appeared that the synchronized global growth of 2017 marked the point at which the global economy had finally left behind the period of rolling crises that began with the global financial crisis back in 2007.**

With the economic volatility of the post-crisis period behind us, a serene economic expansion was seen as likely to deliver healthy returns for risk assets. However, that optimism proved misplaced: the Crisis, Response, Improvement, Complacency (CRIC) framework we have found useful for navigating the ebb and flow of markets post-financial crisis remained relevant in 2018.

The synchronized global growth of 2017 led to 'complacency' among policymakers, which in turn led to policy tightening – both by central banks and by authorities in Beijing. Last year saw a sharp slowdown in credit creation from both central banks and the private sector and, as a result, 2018 was the year that global money growth stalled. The reversal of the 2016/17 credit surge has led to renewed asset-price declines and waning economic momentum.

## HERE WE GO AGAIN

So, with respect to the outlook for 2019, did 2018 constitute another crisis to which we will see a renewed response from policymakers? Over the course of 2018, in reaction to flagging economic momentum and ailing markets, a slew of measures were announced to stimulate the Chinese economy, particularly in the second half of the year. However, it appeared that policymakers were still prioritizing financial stability over economic stability; credit growth remained subdued by Chinese standards and the shadow-banking sector remained in shutdown mode. With China's economy continuing to slow towards the end of the year, and with data suggesting its manufacturing sector had contracted for the first time since 2016, have policymakers begun once again to prioritize economic stability?

2019 has begun with a raft of further easing measures in China, and the modest return of optimism has been aided and abetted by a less hawkish tone from the US Federal Reserve (Fed). As recently as December's meeting, the Fed's Federal Open Market Committee (FOMC) appeared resolute in the face of US equity and credit-market declines: interest rates would move higher and quantitative tightening (QT) would remain on autopilot.

However, when joining a panel discussion at a meeting of the American Economic Association in Atlanta (on January 4, 2019), Fed Chairman Jerome Powell struck a decidedly more dovish tone, intimating a pause in further rate hikes and a new found flexibility with respect to QT.

# IS IT ENOUGH?

Certainly, Powell displayed greater empathy to the plight of financial-market participants than he had been willing to show up until that point. At the same time, it seems likely that monetary and fiscal policy in China will provide more support in 2019 than it did through 2018. The burning question remains whether all this will be enough to turn market fortunes around, and whether we will see a repeat of the 2016/17 reflation story?

While markets and economies differ today from late 2015, (the point at which the last policy-driven reflation of the global economy and financial markets began), it is worth reminding ourselves what that collective effort looked like.

After increasing interest rates in December 2015, for the first time since the global financial crisis, the Fed paused in much the same way that Powell has suggested the Fed will do today. However, in stark contrast to today, the second half of 2015 saw global central banks begin the largest combined intervention effort in history, to the tune of over $5 trillion of asset purchases between 2016 and 2017, spearheaded by the European Central Bank and Bank of Japan. Meanwhile, in China, the largest bank bailout in history paved the way for the biggest debt-fuelled stimulus program ever seen.

At the start of 2019, we are not faced with a repeat of the combined global stimulus that reflated the global economy and markets in 2016 and 2017. Perhaps the cavalry will come once again, but it now remains somewhere just over the horizon.

# 2019: A YEAR OF TWO HALVES?

As we look to the year ahead, markets are likely to remain volatile, and, as we survey the landscape, it appears that 2019 could be a year of two distinct halves. Right now, market participants appear willing to back the idea that policy easing will ensure continued economic expansion and an extension of the bull market. Rallying risk assets engender optimism and, as always, upside volatility re-energizes bullish market sentiment.

However, this optimism sits uncomfortably against a backdrop of forward-earnings downgrades and continued economic slowdown. To this end, recent developments in credit markets serve as a warning.

Last year saw a steady rise in credit spreads globally – an ominous development for corporate financial health in 2019. While earnings growth is likely to remain positive over the course of the year, on balance we believe the easing measures announced thus far are unlikely to arrest the ongoing deterioration in corporate earnings. Moreover, while the bulk of equity-market weakness in 2018 was driven by declining valuations, in our view the biggest risk to fragile equity markets in 2019 remains the continued deterioration of corporate earnings. Markets, after all, have a habit of leading the economy.

Over the course of the year, we see the market as likely to reward balance-sheet strength and stability of cash flows above other attributes, and, with a decade of financial excess now behind us, the risks appear to be skewed very much to the downside.

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**Paul Markham**
Portfolio Manager,
Global Equities

# GLOBAL EQUITIES OUTLOOK

## CHINA, THE US AND TRADE WARS

All else being equal, we believe the overall near-term trade-war winner is likely to be the US, but recent comments from Chinese President Xi Jinping in which he warned outside influences not to dictate to China what it should do are significant because he has set them in the context of the long term. China has fluctuated between being the world's biggest world power a few hundred years ago, to an economic minnow as late as the 1970s, to a global superpower today; so it seems fair to say that the country has a long-term view on achieving economic pre-eminence on the global stage. In the near term, China may have lost the battle with the US over trade sanctions, but it might still win the war on trade over a longer time horizon. We would expect market noise around US-Sino relations to remain prominent in 2019.

The fact that the US economy is starting to lose momentum will not slow the US president down. If anything, US President Donald Trump is likely to become even more strident. It is possible that his 'Art of the Deal' approach – i.e. to push for more than he can reasonably achieve – will define the narrative around US-Sino trade negotiations, so for now the noise will rumble on, with any Chinese goods either entering or leaving the US likely to suffer in the near term. The US has the wherewithal to produce all of the items it has been importing from China, but the pertinent question remains how much such a move will end up costing the US consumer. There will be a question mark over US companies' profitability if growth is sluggish while costs are rising. If US prices incurred by the increased cost of producing goods domestically are passed onto the US consumer without companies justifying the rise, we could see the onset of a 'stagflation' scenario in the US. If the perception grows that the US president is losing his positive impact on the economy, it is quite feasible that we will see greater urgency from his political opponents in relation to the political and legal issues that currently surround him.

## EUROPE

For Europe, there is the very real prospect that the rate cycle may start to reverse in the US before it even begins in earnest in the eurozone. The French government's reaction to the 'gilets jaunes' protests appears to be a signal that the European Union (EU) is going to have to contend with upward pressure on its fiscal deficit – which will not be easy considering its current commitment to a process of fiscal tightening. This story may run on for some time against a backdrop where European economic data has continued to be uninspiring. It is increasingly easy to see Europe undergoing 'Japanization': the poor demographics and low-interest-rate trap that enveloped Japan over two decades.

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## BREXIT

The Brexit saga continues to rumble on, much to the growing chagrin of the UK population, and serves as proof, if any were needed, that the EU continues to hold up the UK as an example to act as a deterrent to others that may be tempted to exit the bloc. UK Prime Minister Theresa May's precarious position, and ensuing domestic political instability, make the task of delivering Brexit even more fraught, and we will still see various twists and turns ahead. So far, it has paid to be hedged out of sterling and focused on overseas earners in the UK market. At some point over the coming months, UK domestic stocks may present attractive valuation entry points if the uncertainty takes a further toll on current price levels.

## JAPAN

After outperforming for much of 2018, Japan sold off significantly in the fourth quarter as global risk aversion hit the market hard. The country is far from immune from global economic forces; but with valuations now at multi-year lows, corporate governance continuing to steadily improve and the Bank of Japan showing no sign of changing direction with its very loose monetary policies, we continue to find attractive opportunities in Japanese companies.

**Paul Brain**
Investment Leader,
Fixed Income

# FIXED INCOME OUTLOOK

**There will be a number of factors influencing bond markets during 2019, but perhaps two might prove to be the most significant: first, the prospect of the Federal Reserve having reached a plateau in its interest-rate policy and, second, a potential rise in default rates.**

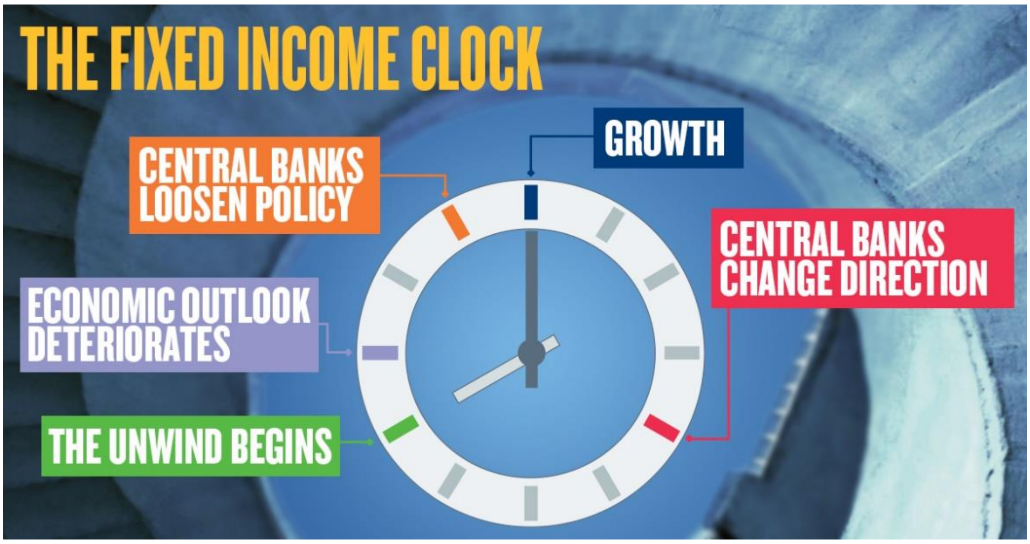
During 2018, the US Treasury market had to adjust, initially by selling off against the backdrop of a hawkish Fed in the first half of the year, and then by responding to the demise of risk assets and a government-bond rally into the year end. The fourth quarter confirmed the suggestion we made earlier in the year via our referencing of a fixed-income 'clock', that tightening by a central bank is eventually more painful for the risk assets that have been inflated by previously loose monetary policy than for the government-bond market. Further tightening when the economy is past its best could lead to more problems for risk assets and greater demand for safe-haven government bonds.

The gap between bond yields and cash rates has narrowed to the point where the market appears to have reflected this state of affairs. Strong economic growth will not necessarily result in a significant rise in risk assets (beyond an over-sold bounce), as this may bring about a hawkish response from the central bank that in turn will dampen risk-asset performance. Meanwhile, the economy continues to grow and the Fed reduces its balance sheet as part of a less public tightening policy.

In China, the authorities play a game of withdrawing previous sources of liquidity and adding to others to maintain economic growth at close to 6%, while removing some of the previous excesses. This is going to be a very delicate balancing act and one that will, at best we think, benefit the domestic economy rather than the global economy. Any rapprochement in the ongoing US-Sino trade negotiations will perhaps offer some reprieve to the outlook.

In the near term, the Fed's stance will dictate the total return of markets, and owing to their safe-haven nature, that of government-bond markets. On balance, however, we may have reached a short-term equilibrium.

Later in 2019, we continue to believe that the higher borrowing and production costs weighing on companies (especially in the US) will act as a drag on investment and lead to slower growth and higher default rates. As the bond-market cycle clock ticks on (see below), the high-yield bond markets will need to adjust further owing to the extent of leverage in the asset class, and, consequently, the government-bond rally could resume.




We would expect the performance of investment-grade corporate bonds and emerging-market sovereign bonds to lie somewhere in between the two previously mentioned bond asset classes over the course of 2019.

**Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.**

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