2020: May You Live in Interesting Times

By Drummond Brodeur, Senior Vice-President and Global Strategist
January 14, 2020

A new decade begins: Welcome to the 2020s

There is little doubt that both 2020 and the 2020s will prove to be interesting times. Almost everything we have known from a global economic, market, political and social perspective seem to be in a state of flux vs. the broad norms that have existed for the better part of all of our lives! The geopolitical backdrop and institutions of the multi-lateral, rules-based global economic order that were established in the post-world war era – and that have underpinned some of the most politically stable and prosperous decades in human history – are going into reverse. I first outlined the concept of the coming Geopolitical Recession last July (Winter is Coming: The Geopolitical Recession Begins Now), and it remains a key macro driver as we enter the 2020s. Deglobalization is replacing globalization. Bilateral agreements are replacing multi-lateral ones. "Might-makes-right" is replacing the rule of law. Great power competition and cold war mentalities are replacing multi-lateral collaboration and cooperation. Managed trade is replacing free trade. Capital and currency controls are hindering capital flows, tariffs and export controls are hindering trade flows. Zero-sum and even negative-sum outcomes are replacing positive-sum outcomes.

The geopolitical turmoil will continue to unfold in the coming decade at the same time that technological advances continue to accelerate and to disrupt old ways of doing almost everything. Technology is opening up new approaches and new opportunities in nearly every aspect of our personal and business lives. Autonomous driving and electric vehicles, smart cities, and amazing medical breakthroughs are all on the table in the coming decade. If fourth generation (4G) mobile technology ushered in the sharing economy with services such as mobile e-commerce, Uber and Airbnb in just the past decade, what can we expect by 2030 as we roll out 5G, with over 100 times the data speeds? Entire new industries, applications and businesses will emerge, some already in their infancy today, but many others yet unimagined.

Yes, the 2020's will be an extraordinary time of change. But there is no sense in lamenting the past, there is no going back, nor of wishing for a different future. In life as in investing, the objective must be to understand how the future is unfolding, to embrace it, to adapt and to adjust to likely outcomes. Change is not all bad. Accelerating change may drive chronic uncertainty, which is a pain, but it also offers new and different opportunities. While ongoing global geopolitical tensions, and the crumbling of the existing global order make for depressing day-to-day headlines, bear in mind that most of it is still just noise, played loudly and exaggerated by the media. So while there will be significant challenges in both the near and longer term (I haven't even mentioned climate change!), it has generally not been a good idea to bet against human ingenuity and the path of progress.

The biggest investment challenge in the next decade

The world marches on, and we must march with it. For investors, opting out or moving to the sidelines is not an option, as global interest rates are at 5,000-year lows and are negative (this still seems crazy!) across much of Europe and Japan. The so-called real risk-free rate of return that risk-averse investors can expect to receive for "sitting out on the sidelines" is negative across the developed world. (The real rate of interest is the nominal rate one receives, less the rate of inflation. It is the rate required to protect the purchasing power of your savings against erosion from inflation.) This is an unprecedented challenge for most investors today, as it implies that hiding your savings under the proverbial mattress risks a modest to severe loss of purchasing power as inflation gradually but persistently eats away at the value of those savings. Negative real interest rates, or financial repression as it is termed, is a tax on savings and a deliberate transfer of wealth from savers (you) to borrowers (governments). But it is also a voluntary tax; you do not have to pay it. In effect, savers today have no choice but to engage risk assets and to craft a strategy to navigate through what will be a decade of volatile markets to both protect the value of their hard earned savings and to earn a reasonable real rate of return over and above the rate of inflation (for more on the challenges of negative real rates see my fourth quarter outlook: Modern Portfolio Theory, RIP.

For investors, the path must be to build a framework for understanding unfolding events, their potential outcomes and investment implications with the aim of navigating what will be a challenging and turbulent decade. In the coming year and in the coming decade, I believe that Signature's team-based investment approach with over 50 global analysts, PM's and strategists covering all major asset markets and geographies can play an important role in helping you achieve your investment goals.

Looking ahead with little anticipation

As we enter 2020 the economic landscape can best be described as Meh, or uninspiring. We see lots of ongoing political flashpoints, excitement and fireworks, but with limited incremental implications for the economic outlook. We also see a slowing global backdrop as the economies of both the U.S. and China continue to decelerate. My expectation of a global recession by mid-2020 (see Winter is Coming), in which, "a recession is defined as a significant slowdown in aggregate demand, which is highly likely in the next year," is now clearly underway. A global recession is not about negative GDP growth, it is when the global economy slows to 2.5% growth and we are getting close to that. The latest IMF forecast for global growth, issued in October, saw its fifth consecutive downgrade to just 3% in 2019, down from 3.6% growth in 2018, and 3.8% in 2017. I expect a further modest deceleration into early 2020. Growth may dip as low as 2.5%, or maybe not. Either way, the slowdown (from 3.8% down to 3.0%) is already well underway. We expect the global economy to stabilize and bottom over the course of 2020, effectively delivering a soft landing, but we don't see signs of significant reacceleration. In and of itself, having the global economy stabilizing at a slow pace is not a bad thing. It may be mildly problematic for investor expectations, as following the recent equity market rally markets appear to be discounting a more robust economic and earnings reflation than we think likely. But while earnings may disappoint in a slow growth global economy, inflation is also unlikely to become an issue, allowing the current historically low interest rate structure to remain in place. This in turn provides support for current valuation levels across the risky asset spectrum from credit to equities.

2019 surprises and 2020 market implications

Looking back on 2019, the two biggest surprises versus our expectations were first, the degree of the economic slowdown as the U.S.-led tariff war with China escalated and drove the global industrial sector into a significant recession. Second, while our central case going into 2019 was that the U.S. Federal Reserve (Fed) would pivot away from monetary tightening, which they did in January, we had not expected the subsequent trade-driven slowdown would further force the Fed back into an easing mode. But it certainly did, resulting in three rate cuts through the back half of the year. The rate cuts, as well as an end to quantitative tightening, drove a significant asset market reflation but has not, at least so far, offset the industrial recession playing out globally. While looser monetary policy certainly helped to cushion the impact, I expect it will be less effective in driving economic reflation than in previous easing episodes.

While the Fed action was by far the biggest positive market surprise for 2019, it will not repeat in 2020. We expect the central bank to stay on hold in 2020, unless the actual economic data turns, one way or the other. We expect future policy moves will be asymmetric, with a quick trigger to loosen, but slower to tighten as the fear of Japanese-like deflation influences their reaction function. The U.S. election in November 2020 adds another dimension to the Fed's desire to remain on the sidelines. Only a significant slowdown is likely to see any Fed activity beyond ongoing liquidity management. Our 2020 base case is that there will be no further cuts to interest rates and the 10-year Treasury bond yield will likely bounce along in the current range of 1.5-2%, (effectively 0% real yield), but rates will be cut if significant signs of further economic slowdown emerge.

Looking into 2020 from an equity perspective, it is also hard to get too excited. My target level coming into 2019 was 3,000 for the S&P 500 Index, and the latest rally appears to be getting ahead of the underlying fundamentals. The rally has been driven primarily by looser Fed policy, and the anticipation of re-acceleration in 2020. We are not as optimistic. Earning growth in 2019 was effectively zero, so the market's 25% advance means that it is 25% more expensive vs. a year ago. In fairness, the first 15% was merely a rebound from the selloff in December 2018, so I view the current market as being up about 10% in anticipation of better earnings in 2020. Current consensus estimates are still about 10%, but the reality will likely end up closer to 5%, so some disappointment may lie ahead (as is usual at this time of year). At this point, with the S&P 500 close to 3250, a trading range of 3000-3500 seems a likely outcome. Following the returns of 2019, a flat-to-modestly higher equity market, along with dividends, offers a reasonable expectation of a mid-to-high single-digit equity return in 2020. Albeit, we also expect a few bumps along the way.

The Geopolitical Recession continues

The Geopolitical Recession concept I outlined in my July commentary remains alive and well in 2020. The recent short-term resolution of Brexit and the U.S.-China Phase 1 trade deal have not actually addressed the key underlying uncertainties. The U.K. election resolves the question over whether Brexit will happen, but not what Brexit is. Certain aspects are resolved, ie. there will be no second referendum and no Corbyn-led labour government (a huge tail risk gone), but that merely moves the U.K. into a transition period. We will spend another year trying to figure out what Brexit will look like, and hence what the ultimate economic impacts will be post-2020 or 2021.

Meanwhile, details on the U.S.-China Phase 1 trade deal are sparse, but it appears the agreement was closer to the skinnier end of expectations. It did eliminate the impending December 15 tariffs (that no one thought the U.S. could afford to go ahead with), but it also serves to cement the notion that China must continue to pursue technological independence from the U.S. The U.S. has effectively declared an ideological war against China that will last for the foreseeable future. Tariffs were always a sideshow to the main ideological and technological aspects of the conflict, and even as the trade and tariff rhetoric may subside, we do expect to see continued escalation in other areas going forward. None of this is positive for the long-term economic outlook, but non-tariff aspects have the potential to be less disruptive to markets and economies in the short term, even as they undermine longer-term outcomes.

2020: A year of "three halves"

For 2020, slow growth and low rates may be unexciting, but it is not a terrible backdrop for risk assets such as equity and credit. I expect a year with more market volatility than we saw in 2019 and foresee 2020 as a year of "three halves." The first half of the year should see markets driven primarily by unfolding economic data and corporate earnings that help confirm or refute the markets' anticipation of a reacceleration. The political hijinks around impeachment in the U.S. will provide significant news noise but with minimal direct economic or market impact. Do, however, be mindful of the potential for damaging policy moves, launched via Twitter, that may escalate real trade tensions with China, Europe or others. By mid-year through to the November U.S. elections I expect market volatility to reflect U.S. election concerns and uncertainty. The "third half" of 2020 will likely see a post-election rally into year-end as the election uncertainty fades. While the last two halves dance more to political music, we are assuming a broadly stable economic backdrop; any material change in the economic outlook will also clearly have an impact on our outlook.

There are no major recent changes to our recent asset allocations. We remain cautious and slightly underweight in equities, maintain exposure to gold, and have added some carry/income exposures through credit/real assets. (For representative positioning purposes, see the Signature Global Income & Growth Fund commentary for December 2019).

Sources: Bloomberg Finance L.P., World Bank and Signature Global Asset Management, as at January 9, 2020.

Published January 14, 2020