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INVESTMENT MANAGEMENT

Our market outlook for 2020

January 2020

Our sub adviser Brewin Dolphin, looks ahead to what 2020 may bring for investors.

Just over a year ago, in the final quarter of 2018, we were witnessing a synchronised slowdown in global growth and a concurrent downturn in equity markets, which meant investors were entering 2019 in a downbeat mood.

Nevertheless, we still expected that equities would outperform cash and bonds over the year, due to attractive equity valuations and a US president determined to boost the US economy.

Happily, this was the case. It has been a bumpy ride in some markets but the UK's FTSE100 ended the year up by 12%, while the FTSE250 had a particularly good year, up by 25%. The US market continued to hit record highs – its S&P500 index rose by 29% – while China's Shanghai Composite Index rose by 22%, even as its economy slowed and the trade war hit its exports.

Despite strong returns from equity markets, 2019 was a mixed bag in terms of economic growth with a manufacturing slowdown weighing on growth in the US and more severely in Germany and China. The year ended, however, with signs of life returning to that part of the market, which we expect to gather pace as 2020 progresses.

Geopolitical tensions

Perhaps the most important factor for the year ahead is the possible resolution of the trade dispute between the US and China. Markets reacted enthusiastically to news in December that a partial trade deal had been struck, although it has yet to be signed. If completed, it will be good news for the global economy as it reduces uncertainty and should boost investment and hiring.

But we should not get carried away with hopes that a "phase two" deal will be struck this year, as there are still significant hurdles to overcome. One tough issue is Chinese subsidies. As part of its Made in China 2025 plan, Beijing aims to use government subsidies to help Chinese companies buy intellectual property that will give them an edge against Western competitors, particularly in fields such as 5G. The US wants these eliminated.

Even the schedule for the "phase two" talks is uncertain. America says negotiations will begin immediately, but China may want to wait until after the US elections in November, when there may be a more amenable incumbent in the White House.

However, this does not mean progress cannot be made. Our base case view remains that the trade war between the US and China will not escalate to the extent that it results in a serious growth downturn, and President Trump will want the US economy to be in good shape to boost his chances of re-election in November.

But just as it seemed that progress was being made on the trade war, President Trump has created another geo-political flashpoint by ordering the air strike that killed one of Iran's most senior military leaders. The obvious concern is that it may escalate into a conflict that could drag in other countries and involve some of the world's biggest oil producers. It is a situation that will need close monitoring as it develops during 2020.

China

Some tentative signs have emerged that growth momentum in China is stabilising on the back of stimulus efforts late last year. A raft of economic data released in December beat expectations, although it is still not clear whether China's slowing economy has bottomed out.

Encouragingly, China has started the year in an assertive manner, with more measures to stimulate economic activity. It has cut the capital reserve requirement for its banks, which Chinese authorities said would have the effect of injecting 800bn yuan (£88bn) of liquidity into its financial system, freeing up cash to lend to businesses and consumers. It also changed a key benchmark interest rate to lower borrowing costs for businesses, which should boost investment and hiring.

The US

Not long ago, investors in the US were obsessed with the prospect of a recession. While this possibility has not disappeared, evidence suggests that the current expansion could continue for some time yet. The US Federal Reserve cut interest rates for the third successive month in October as a "preventative strike" against a downturn in the manufacturing sector spreading to the broader economy.

When assessing the outlook for the US economy, accurately predicting how the housing market will perform is extremely helpful. This is because when the housing market does well, it not only boosts employment through an increase in housebuilding and construction, it also leads to an increase in consumer spending on home improvements and other purchases associated with housing activity such as spending on furniture, household appliances and home improvements.

In addition, an improving housing market creates what is known as a "wealth effect", which means consumers feel richer, so they spend more. For an economy like the US, where consumer spending accounts for around 70% of GDP, anything likely to boost the wealth effect is a key leading indicator.

The three cuts in US interest rates last year will help boost the housing market in numerous ways. They have already led to lower mortgage rates, which boosts both demand and housebuilding activity. Affordability is also historically attractive thanks to recent weak house-price growth, low mortgage rates and rising household incomes. All in all, the backdrop for the housing market is healthy. This should help the US economy to continue its record-setting expansion.

Eurozone

Germany, Europe's largest economy drives the region's growth. While heavily reliant on manufacturing and exports, it narrowly avoided recession by posting positive economic growth in the third quarter of 2019. The latest business surveys suggest a recovery in new orders for German businesses and give us grounds for cautious optimism about the outlook.

Key to this improvement is a pickup in the global automobile sector. The ratio of global new orders for cars relative to inventories has rebounded, which is good news for Germany given its large exposure to this sector.

Germany also has some insurance in place; following years of prudence, the German government runs a large structural budget surplus, which gives it ample ammunition for stimulus (such as tax cuts) to counter any downturn.

That would follow the example set by the Eurozone's second largest economy France, which has adopted an expansionary fiscal policy (meaning lower taxes), with more tax cuts promised in its 2020 budget. The stimulus has bolstered household confidence and suggests consumer spending growth has room to accelerate further.

UK

In the UK, the end of the era of austerity, as promised in the Conservative manifesto, will provide some support to the economy, but there is still uncertainty around Brexit despite the threat of a second referendum being removed. Boris Johnson's refusal to allow an extension to the negotiating period increases the risk of a no-deal withdrawal before the transition period expires at the end of 2020.

This has already led to a sharp drop in the pound, although this in itself is a mixed blessing; with a large share of the revenues of UK companies coming from overseas, many stocks benefit when the pound falls, providing some offset to the rise in living costs that the weak pound causes. However, the spectre of a disorderly Brexit may still deter investment in the UK, both by UK companies and by foreign investors.

Looking ahead, the outlook for the traditional elements of economic growth are mixed. The household sector is by far the biggest part of the UK economy and house prices have historically been an important driver of retail spending. National average house prices are still rising, but only just. If the past is a good guide, retail sales growth will fall.

So, while we see a positive outlook for UK equities, we don't believe that the Boris Bounce makes them more attractive than other markets.

In summary

There are enough positives as we enter 2020 for equities to outperform bonds and cash once more. While some notable risks remain, we are alert to the opportunities and challenges that these present. That is why we manage diversified portfolios of asset classes and geographical regions which can capture the opportunities that are thrown up by any market corrections or price shifts in particular assets, creating selective buying opportunities for our clients.

Following such a strong year in 2019 we have to be realistic about the prospects for 2020 but that doesn't mean being pessimistic. As legendary investor Peter Lynch pointed out:

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team, providing recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. He is a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.

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