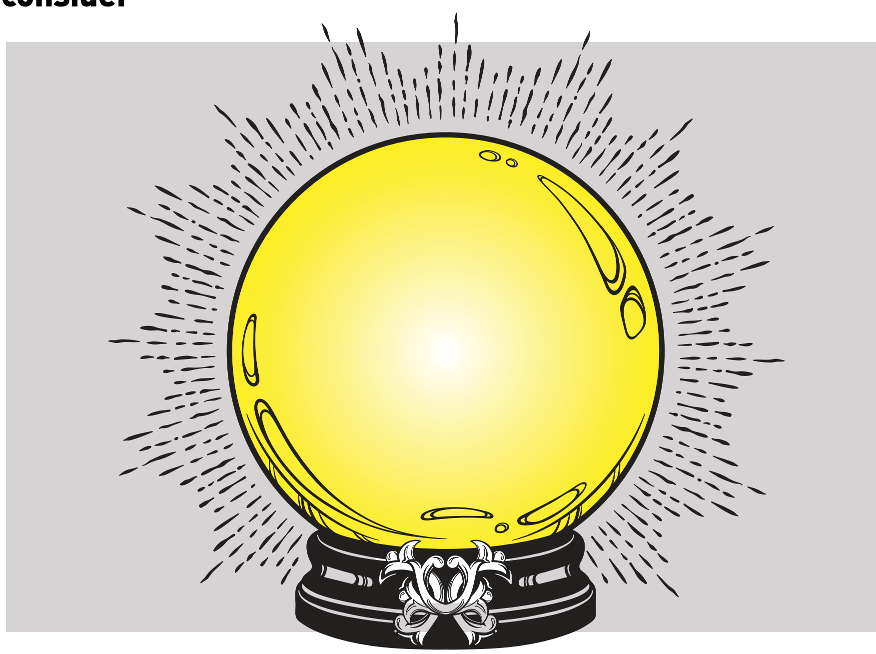
Summary
• Geopolitical tensions including Brexit and trade wars will continue to cast a shadow over markets, with experts predicting that 2019 could be even more volatile than 2018 for markets.
• Investors are advised to look through the short term and think about the long term, rather than just the next year.
• Emerging market equities are expected to make a comeback due to faster growth in China.
• Credit is still attractive but through industry and issuer selection.

Looking through the crystal ball

With experts predicting that 2019 will be even more volatile for markets than 2018, due to geopolitical events, Lynn Strongin Dodds looks at what the New Year might bring, and the asset classes pension schemes should consider



Crystal ball gazing is never easy but the general consensus for 2019 is that the year could be even more volatile than the end of 2018. Diverging interest rate policies, a potentially spluttering US economy, Brexit and other geopolitical tensions could continue to cast a pall and impact investment making decisions. Selectivity will be key going forward.

"My advice, especially to pension clients, is to look through the short-term political noise and think more about the long term and not the next year or so," State Street Global Advisors head of strategy and research Altaf Kassam says. "However, one of the problems with 2019 is that the short term is impacting the long term whether it is trade wars or the rise of populism. The outcome raises important questions for capital markets and the shaping of portfolios".

Amundi Asset Management group chief investment officer Pascal Blanque and his deputy Vincent Mortier also believe the tide is turning. Their research shows that from 2009-17, on average, 76 per cent of major asset classes including different regional government bonds, equity, inflation-linked currency and commodities recorded positive performances for each year. The story changed in 2018 with markets ratcheting up an unprecedented year in which less than 20 per cent of asset classes were in positive territory.

Although the future is uncertain, many fund managers agree with JP Morgan Asset Management managing director, chief market strategist for EMEA, Karen Ward, who warns investors not to be too over-reactive and dramatic. "For one, decisions and sentiment can change quickly," she says. "The US and Chinese authorities could yet return to the negotiating table and stem trade tensions. Indeed, the more that bad news builds in the near term, from either the economy or the markets, the higher the incentive for politicians to consider a more amicable conversation."

Against this backdrop, Ward says: "JPAM would consider relatively small changes to improve the resilience of a portfolio. Within equities, look for regional diversification and consider moving to larger cap stocks, with a bias towards quality and value styles over growth. Fixed income should play a greater role, but be selective and consider alternatives such as macro funds to add ballast to a portfolio."

Columbia Threadneedle Investments deputy global CIO and CIO EMEA, Mark Burgess, on the other hand, favours capital-light, high-return businesses on the equity front that are capable of growing market share and sustaining pricing. He also believes that the technology segment, which has taken a beating over the past few months, remains an attractive hunting ground but investors will have to take a wider view.

"While the technology sector has garnered much of the focus during recent years, this phenomenon is present across industries, with the profit dispersion between the highest quality companies and the lowest becoming ever more pronounced," he adds. "As value chains continue to evolve, traditional business models are challenged, and technology comes of age, those companies that are able to innovate should continue to grow."

The credit spectrum

It is also a transition year for credit, according to Schroders head of US credit Martha Metcalf and lead fund manager global Rick Rezek. They note that after nearly a decade of expansion, September marked the first time since the crisis that central bank balance sheets contracted. This is expected to continue as the ECB announced it was going to end its corporate bond-buying programme at the end of 2018 while other central banks are beginning to cut back asset purchases.

They both believe that credit fundamentals are strong heading into the New Year, while the likely decline in supply is a positive somewhat offset by uncertainty around demand. "We think attractive valuations and a strong macro backdrop, particularly in the US, could lure investors into corporate bonds across the credit spectrum, Metclaf and Rezek say. "Overall, we see idiosyncratic risk persisting and becoming more of a theme in 2019, bringing increased opportunity to generate returns through issuer and industry selection. That said, despite the broad improvement in valuation, it will be important to remain disciplined and selective to ensure adequate compensation for risk."

In general, many analysts are cautious on European peripheral sovereign credit as well as corporate risk due to the challenges posed by Italy's populist government as well as the longer-term threats of a recession to the Eurozone more generally. "Italy's political situation remains the biggest unknown," says Invesco chief strategist and head of multi-sector fixed income Rob Waldner. "However, while the situation continues to evolve, we assign a very low probability to Italy leaving the euro. As we move into 2019, we expect friction over Italy's budget deficit to continue to weigh on investor sentiment, likely creating bouts of market volatility but also presenting opportunities."

UK markets are also a cause for concern due to the uncertainty over Brexit. "Our base case for Brexit is that a deal will be agreed upon at the expense of a longer transition period," says Waldner. "Accordingly, we believe current valuations present opportunities in certain parts of the UK corporate bond market, namely among issuers with a strong international presence that may mitigate the potential growth challenges of a hard Brexit."

Ward adds that the challenge for UK investors is most acute. A good Brexit deal may be good news for the economy and coincide with a bounce in growth in 2019. But it will pose significant challenges for those in search of asset returns, because stronger sterling will likely drag on the FTSE's international revenues, while a faster pace of interest rate normalisation will weigh on government bonds."

As for the US, many economists expect the economy to slow as 2019 progresses and that the yield curve will continue to significantly flatten. In this scenario, floating rate notes such as leveraged loans or short duration strategies would be the best instruments to help minimise the risk of rising interest rates and inflation. If the curve inverts as some expect might happen by the end of the year, high quality global as well as taxable municipal bonds that have longer duration would help to protect against an impending downturn. The latter would also offer UK investors exposure to the US infrastructure story.

As for other investment strategies, fund managers are bullish on the prospects for emerging markets due to a confluence of factors – faster growth in China, the world's second largest economy, thanks to policy easing, a Federal Reserve pause in mid-2019, which dampen the dollar and perhaps some resolution to the U.S.-China trade war. Emerging market equities could be the main beneficiaries with JPMorgan Chase & Co. strategists among those projecting the MSCI index to climb, with a year-end 2019 call of 1,100 – a roughly 13 per cent hike on current levels. The gauge is down almost 16 per cent for 2018, the third-worst performance since the global crisis in 2008.

Real assets are also in favour. As Amundi Asset Management global head of real and alternative assets Pedro-Antonio Aria puts it: "The drivers for real assets in 2019 are set to remain broadly unchanged from this year. In a low-yield environment, especially in Europe where the ECB remains broadly accommodative, investors are structurally more inclined to invest in alternative asset classes that, thanks to their ability to capture illiquidity premia, can potentially deliver higher income and returns while diversifying risks".

He adds, real assets investments, in particular infrastructure and property, potentially act as a structural hedge against inflation, an important feature for investors since this remains a high probability in 2019. Brexit, of course is hanging over the UK and investors are currently standing by the side lines, particularly on the commercial real estate front. However, Aria believes "that the current economic outlook in Europe could favour real estate due to the demand for space and the expected increases in rent - expected to be the main driver of performance - as anticipated in France, Spain, Germany and Benelux."

Written by Lynn Strongin Dodds, a freelance journalist