2020 vision: Opportunities among the clouds

Going into 2020, investors face a number of risks. But we also see opportunities, particularly away from the US

A decisive result in the UK general election and progress on trade negotiations between the US and China in December have seen two of the dark clouds that have hung over markets clear. Others remain: weaker economic growth, an uncertain US presidential election, and trade tensions between UK and Europe to name just a few. This is all against a backdrop of low bond yields and above average equity valuations.

However, we are far from pessimistic going into 2020. Dark clouds and risks also provide opportunities – markets tend to rally on any signs of the outlook clearing.

Take global growth, for a start. Yes, the pace of expansion is modest, but the authorities have been on hand to offer stimulus, both monetary and fiscal. They are on high alert, and we would expect any signs of economic deterioration to prompt fresh measures.

We see scope for economic growth to become more broad-based across the globe. Consumer spending has generally held up well, and, with the corporate sector having drawn down inventories, we may soon see an uptick in industrial and manufacturing activity.

A stable to weaker dollar would be a positive development for risk taking and global growth in general.

Regional rotation

Any economic improvement would be advantageous to some of the more cyclical areas of the stock market that have been ignored by investors in recent years. Regionally, that means we are moving away from the US, instead rotating allocations towards emerging markets, Europe, Japan and the UK.

Among the sectors, industrials and materials should benefit, and perhaps even energy. We are also thinking more about value stocks, which are at some of the cheapest levels seen in the past half a century relative to growth stocks. Value companies are under-owned and, if we are half right about the global economy, value as a style should see outperformance in 2020. We are starting to position for that.

Investors' consciousness of environmental, social and governance (ESG) factors will continue to increase, and we would expect ongoing flows into companies who are at the forefront of this theme. In all likelihood with little attention to valuation.

Credit woes

In the fixed income universe, we see some potential in the areas of the sovereign debt market that still offer positive real yields – namely in the US and emerging markets.

On the flip side, we are concerned about the health of the credit market. The high equity risk premium, and therefore the cost of equity relative to the cost of debt, have served as an incentive for corporates to issue debt to buy back equity. As a result, net debt to EBITDA ratios for non-financial corporates have expanded to the highest level since 2009 in the euro area and since 2003 in the US.[1]

However, it isn't just the quantity of debt but also its quality we are nervous about when it comes to credit markets – more specifically the deterioration in creditworthiness, the steady erosion of covenant and other protections, and the growth of highly leveraged private debt raises questions whether investors are be properly rewarded for the risk they are taking.

Thirdly, we are concerned about the ability of market makers to provide liquidity in stress periods given the reduction in their inventories of corporate bonds relative to the amount outstanding. While default probabilities are more straightforward to assess and factor in, illiquidity premiums aren't. Moreover, credit pricing provides little room for default and recovery, let alone for hard-to-price liquidity risks.

Possible crunch triggers could come from the leveraged loans market or from emerging market debt, both of which have seen particularly heavy issuance in recent years.

One saving grace is that regulatory and demographic trends ensure that certain types of investors – such as insurers or pension funds – will likely continue to buy corporate debt, and that the realisation that they have received an uneconomic return will likely take years to materialise.

But, while a credit crunch may not be imminent, we think the risks are rising and the current pricing is too low to adequately compensate for them.

Overall in 2020 investors are unlikely to see a repeat of 2019's truly exceptional market performance. Instead, returns should be more reflective of the economic environment – which is modest but with scope for improvement. Earnings growth expectations have come down and the current cautious mood only increases the potential for future upside surprises.

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[1] Source: Refinitiv Datastream