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2019 – a list of lists regarding the macro investment outlook

Key points

- Despite continued volatility, 2019 is likely to be better for diversified investors than 2018 was.
- Recession is unlikely and so too is a long and deep bear market in shares.
- Watch the US trade war, the Fed, global business conditions indicators, Chinese growth, politics and the Sydney and Melbourne property markets.

Introduction

2017 was a great year for well diversified investors – returns were solid (balanced super funds returned around 10%) and volatility was low. So optimism was high going into 2018 but it turned out to be anything but great for investors who saw poor returns (average balanced super funds look to have lost around 1-2%) and volatile markets. As a result, and in contrast to a year ago, there is much trepidation about the year ahead. Having just written lists for Christmas presents and New Year resolutions, I was again motivated to provide a summary of key insights and views on the investment outlook in simple point form. In other words, a list of lists. So here goes.

2019 – a list of lists regarding the macro investment outlook continued

Five key things that went wrong in 2018

In 2018 global growth was good, profits were up, inflation was benign and monetary conditions were relatively easy. It should have been good for markets. There were five reasons it wasn't:

- Fear of the Fed – the Fed didn't really surprise but investors became increasingly concerned that it would overtighten. This reached a crescendo in late December.
- US dollar strength – a rising US dollar is a defacto global monetary tightening and this weighed particularly on emerging countries and US earnings expectations.
- Geopolitics – President Trump's trade war hit confidence from March and morphed into fears of a broader Cold War with China. Other worries around Trump (with ongoing turmoil in his team, fears of impeachment as the Mueller inquiry progresses and a return to divided government) along with the populist government in Italy also weighed.
- Global desynchronisation – US growth was strong, but it slowed everywhere else.
- In Australia, tightening credit conditions (with fears of a credit crunch due to the Royal Commission) and falling house prices weighed on banks & growth expectations.

Five lessons from 2018

- Global growth remains fragile with post GFC caution lingering. This and technological change are helping to keep inflation down. Trade war fears didn't help. Amongst other things this means central banks need to tread carefully in normalising monetary policy.
- Investors continue to find it easy to fear the worst – this has been evident in three major circa 20% sharemarket declines since the GFC – in 2011, 2015-16 and now 2018.
- Geopolitics remains a significant driver of markets and economic conditions.
- Government bonds remain a great diversifier – they rallied when shares plunged.
- Stuff happens – history tells us markets have periodic setbacks. 2018 was just another example.

Five big picture themes for 2019

- Policy pause and stimulus – the turmoil in markets and threat to global growth is likely to drive a policy response early this year with the Fed pausing, China providing more stimulus and the ECB providing cheap bank financing. There may also be some fiscal easing in Europe.
- While global growth is likely to weaken a bit further in the coming months, it's likely to stabilise and resynchronise as the year progresses helped by policy stimulus, an easing in the $US and by the late 2018 plunge in energy costs.
- Global inflation is likely to remain benign helped by the 2018 growth slowdown and fall in energy costs. In this sense the malaise of 2018 by forestalling inflation and hence monetary tightening has arguably helped extend the economic cycle. The US remains most at risk on the inflation front though given its still tight labour market.
- But expect volatility to remain high given the lower level of spare capacity in the US and ongoing political risk.
- Australian growth is expected to be sub-par as the housing downturn detracts 1-1.5 percentage points or so off growth.

Key views on markets for 2019

- Global shares could still make new lows early in 2019 (much as occurred in 2016) and volatility is likely to remain high but valuations are now improved and reasonable growth and profits should see a recovery through 2019 helped by more policy stimulus.
- Emerging markets are likely to outperform if the $US is more constrained as we expect.
- After a low early in the year, Australian shares are likely to do okay, recovering to around 6000 or so by year end.
- Low yields are likely to see low returns from bonds, but they continue to provide an excellent portfolio diversifier.
- Unlisted commercial property and infrastructure are likely to see slower returns over the year ahead. This is likely to be particularly the case for Australian retail property.
- National capital city house prices are likely to fall roughly 5% led again by 10% or so price falls in Sydney and Melbourne off the back of tight credit, rising supply, reduced foreign demand & possible tax changes under a Labor Government.
- Cash and bank deposits are likely to provide poor returns as the RBA cuts the official cash rate to 1% by end 2019.
- Beyond any near-term bounce as the Fed moves towards a pause on rate hikes next year, the $A is likely to fall into the $US0.60s as the gap between the RBA's cash rate and the US Fed Funds rate will still likely push further into negative territory as the RBA moves to cut rates.

Six things to watch

- The US trade war – while it may now be on hold thanks to negotiations with China, Europe and Japan these could go wrong and see it flare up again. US/China tensions generally pose a significant risk for markets.
- US inflation and the Fed – our base case is that US inflation remains around 2% enabling the Fed to pause/go slower, but if it accelerates then it will mean more aggressive tightening, a sharp rebound in bond yields and a much stronger $US which would be bad for emerging markets.
- Global growth indicators – if we are to be right, growth indicators need to stabilise in the next six months.
- Chinese growth – a continued slowing in China would be a major concern for global growth and commodity prices.
- Politics – political risks abound in the US with the Mueller inquiry getting ever closer to President Trump and a return



2019 – a list of lists regarding the macro investment outlook continued

to divided government leading to risks around raising the debt ceiling and Trump adopting more populist policies. In Europe the main risks are around Brexit, Italy and the EU parliamentary elections in May. Australia's election risks are more interventionist government policy and tax changes.

- The property price downturn in Australia – how deep it gets and whether non-mining investment, infrastructure spending and export earnings are able to offset the drag from housing construction and consumer spending.

Three reasons why global growth is likely to be okay

Global growth indicators are likely to weaken further in the next few months but then stabilise, resulting in okay global growth of around 3.5% this year:

- Global monetary conditions are still easy. While the flattening US yield curve is a concern all other measures of monetary policy show it to be easy – particularly globally.
- Market volatility and associated uncertainty are likely to drive a policy response with the Fed pausing, other central banks easing and possible fiscal stimulus in Europe.
- We still have not seen the excesses – massive debt growth, overinvestment, capacity constraints or excessive inflation – that normally precede recessions.

Three reasons why Chinese growth won't slow much

- The Chinese Government's tolerance for a sharp slowing in growth is low given the risk of social instability it may bring.
- Monetary and fiscal policy is being eased.
- In the absence of much lower savings (the main driver of debt growth), rapid deleveraging would be dangerous, and the Chinese Government knows this.

Four reasons Australia still won't have a recession

A downturn in the housing cycle and its flow on to consumer spending will detract around 1 to 1.5 percentage points from growth, and growth is likely to be constrained to around 2.5-3%, but recession is still unlikely:

- The growth drag from falling mining investment (which was up to 2 percentage points) has faded.
- Non-mining investment & infrastructure spending are rising.
- Interest rates can still fall further, and the RBA is expected to cut the cash rate to 1%.
- The $A will likely fall further providing a support to growth.

Three reasons why the RBA will cut rates this year

- The housing downturn will constrain growth to at or below potential.
- This will keep underemployment high, wages growth weak and inflation lower for longer.
- The RBA may ultimately want to prevent the decline in house prices getting so deep it threatens financial instability.

Three reasons why a grizzly bear market is unlikely

Shares could still fall further in the short term given various uncertainties resulting in a brief ("gummy") bear market before recovering. But a deep (or "grizzly") bear (where shares fall 20% and a year after are a lot lower again) is unlikely:

- A recession is unlikely. Most deep grizzly bear markets are associated with recession.
- Measures of investor sentiment suggest investors are cautious, which is positive from a contrarian perspective.
- The liquidity backdrop for shares is still positive. For example, bank term deposit rates in Australia are around 2% (and likely to fall) compared to a grossed-up dividend yield of around 6% making shares relatively attractive.

Seven things investors should allow for in rough times

Times like the present are stressful for investors. No one likes to see their wealth fall and uncertainty seems very high. I don't have a perfect crystal ball, so from the point of sensible long-term investing the following points are worth bearing in mind.

- First, periodic sharp setbacks in share markets are healthy and normal. Shares literally climb a wall of worry over many years with periodic setbacks, but with the long-term trend providing higher returns than more stable assets. The setbacks are the price we pay for the higher long-term return from shares.
- Second, selling shares or switching to a more conservative strategy after a major fall just locks in a loss. The best way to guard against selling on the basis of emotion is to adopt a well thought out, long-term investment strategy.
- Third, when growth assets fall they are cheaper and offer higher long-term return prospects. So, the key is to look for opportunities that pullbacks provide.
- Fourth, while shares may have fallen in value, the dividends from the market haven't. The income flow you are receiving from a diversified portfolio of shares remains attractive.
- Fifth, shares often bottom at the point of maximum bearishness. So, when everyone is negative and cautious it's often time to buy.
- Sixth, turn down the noise on financial news. In periods of market turmoil, the flow of negative news reaches fever pitch, which makes it very hard to stick to a well-considered, long-term strategy let alone see the opportunities.
- Finally, accept that it's a low nominal return world – low nominal growth and low bond yields and earnings yields mean lower long-term returns. This means that periods of relative high returns like in 2017 are often followed by weaker years.



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