DEVELOPED MARKETS OUTLOOK 2019

Shakespeare once said, “present fears are less than horrible imaginings.” As we come to the close of 2018, we have observed equity markets turn double-digit returns to losses, an aggressive rise in interest rates and a modest increase on the perception of escalating tensions surrounding the world’s two largest economies. The fact remains that the US in on the verge of its longest post WWII expansion in history, with an underlying backdrop of positive global GDP growth as well. While we expect central banks to moderate either the pace of hikes or the tone of guidance, the increased volatility toward the year-end has re-introduced a more robust risk-premium into the market. We believe this will provide a catalyst for increased potential for returns in 2019, on the backdrop of wider credit spreads and lower equity prices. Additionally, we think the resilient economy will continue to provide headwinds for longer-term interest rates, albeit at a relatively moderate pace compared with last year’s normalization of interest rates.

Europe Outlook

Political risk in Europe will remain a continuing theme into 2019. The elections to the European Parliament will take place in mid-2019 and will potentially be seen as a market event for the first time. Several national elections will also take place for EU member states in 2019. Populism has been and will remain an ongoing force for European elections. Populists will further contribute to risk premiums in European markets, limiting reform efforts on deficit reduction and the banking sector, while promoting increased segregation in lieu of integration. The risk of snap elections will remain a persistent threat to market stability, with several fragile coalition governments at risk to populist agendas.

Elsewhere, Brexit stills weighs heavily on the outlook for the UK, where the implications of the UK leaving the European Union have yet to be settled. The position of Theresa May as PM seems confirmed for now, however what is yet to be confirmed is the nature of the exit, and whether the deal May’s government agreed with the EU will pass in the UK Parliament. We expect a deal to eventually come to pass but there will be more challenges along the way. The chances of a delay in leaving on 29 March will increase until she is able to get the number of votes needed to pass in Parliament and additionally a second referendum could transpire. With the assumption of a deal, we expect there to be upside in Pound Sterling, which could reach 1.40 GBP/USD. But if there were to be an exit with a no deal, the range will be 1.15 or lower.

The fluctuating Brexit negotiations make it harder to make a prediction on the course of the BOE. If a deal is agreed, we look for two further hikes in May and November 2019, making the Bank Rate 1.25%. The obvious risk is if Brexit negotiations collapse and economic growth stalls, that would prevent any rate hike and the potential need for further stimulus from the central bank. Conversely, a clear Brexit deal could bring a positive spillover to the economy and bring forward the timetable.

On a much broader view, we think the Eurozone will continue to generate moderate growth with subdued inflation. We note that Mario Draghi’s term as president of the ECB ends in October 2019, and there is no clear favorite for his replacement. Whomever the successor, they will likely have to maintain a dovish tone with no expectations of a rate hike until 2020 at the earliest. While the end of QE will occur as 2018 closes, we think the ECB will be apt to maintain its balance sheet for the foreseeable future, akin to the Fed’s four-year balance stability that ended in October 2017. Given the large maturity concentrations, especially within the ECB’s holdings of German assets, we expect the ECB needing to focus on diversification, as it reinvests maturing in bonds. We think it more likely that the ECB will institute an operating twist, spurring continued flattening in core and semi-core curves.

US Outlook

Across to the US, we think the Fed will likely move away from its regimented quarterly tightening pace, driven by increased data dependency and tempered by political risk from the US-China trade-war, as well as moderating economic growth. We think the US yield curve will likely approach inversion in the first half of 2019, based on slowing inflation data and growth outlook, but expect the curve to steepen in the second half of 2019, driven by a pickup in energy prices and the knock-on effects of the capex spending pick-up in 2018. The resurgence of volatility and data dependency will continue to define the US market going forward as the Fed will become increasingly cautious given growing uncertainty surrounding its economic outlook. The main risk here is that either the Fed, or market is wrong on the terminal Fed funds rate, our confidence lies in the market.

The US economy is enjoying the second-longest growth cycle in history and is on the way to becoming the longest on record. The duration of this cycle has surfaced the debate regarding when it will end. The Fed has raised interest rates eight times since December 2015 in an effort to normalize monetary policy from the emergency levels set after the financial crisis and this has added to the debate about when the current growth cycle may end. Although there are some imbalances appearing in the US, we see more positive signs that support a continued growth cycle than we do risks of recession over the next 12 to 18 months. The NY Fed's own recession probability model has risen in recent years but stands at 14.5%, which is relatively low, given historical levels ahead of actual recessions.

The flattening of the yield curve in the US has added to concerns about the economic cycle. The 2's 10's spread has declined from 260bps in 2014 to around 25 basis points. Recessions tend to be preceded by a Fed hiking cycle and an inverted yield curve. The Fed has downplayed this concern recently owing the low level of longer term rates due to a lack of term premium caused by quantitative easing and demand for duration. We agree with this view however, we think the potential for the curve to steepen or at least stabilize and not invert has increased recently. The current supply dynamics in the US, reduced demand caused by the ECB's intention to stop balance sheet expansion at the end of this year and the BOJ's recent decision to reduce QE purchases should put pressure on the long end of the curve. The combination of these events may influence investors to demand a higher term premium and therefore we may see longer duration underperform and a steeper curve.

There are many reasons to believe recession risk is low and for continued growth momentum in the US economy. Some of the key factors are the current strength in the labor market, very strong capex investment, and moderate inflation. Furthermore, despite the Fed's tightening cycle, broader financial conditions remain very easy in the US. Additionally, on the fiscal side of the equation government spending has increased and the regulatory environment continues to improve. While these conditions are supportive of growth they are also the reason US corporate leverage is now at record levels over $9 trillion, on the other side, corporate revenues have never been stronger. While we have observed spreads widen in the corporate space towards the end of 2019, we think this provides an opportunity to add to credit risk as spreads have now approached levels commensurate with positive long-term excess returns. With a limited probability of recession, we think the added carry offered by the corporate sector will defray some of the risk of higher underlying yields in the US.