Deciphering financial markets in 2020

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Author(s)
Didier Saint-Georges

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A good place to start before thinking through investment prospects for 2020 is a clear understanding of how financial markets got to where they are today is in orde**What exactly were the dynamics at work? They resulted from the combined impact of three key drivers:** a shifting economic landscape, investor sentiment and changes in available liquidity.

The economic landscape has been characterised over the past decade by low, but positive growth rates. The world economy has gone through a series of mini ups and downs (an upturn in 2012–2013, a downturn in 2014–2015, another upturn in 2016–2017 and then a slowdown in 2018–2019). **The crucial question in 2020 is whether we'll be seeing yet another mini-upswing or a continuation of the slowdown.**

Investor sentiment obviously reflected how investors perceived those mini-upturns, but it also moved in response to such spikes in political uncertainty as Donald Trump's belligerent trade policies and the risk of a no-deal Brexit. **The big question in 2020 is what might impel investors to shift out of their current positioning.**

Lastly, **monetary policy**, though essentially dovish over the past decade, was instrumental in shaping the mini-upturns referred to above. After a hawkish turn in 2018 that conjured up recession fears, the Fed's decision in early 2019 to ditch its tightening agenda was a major driver of the ensuing stock-market rally. **In 2020, policy shifts by central banks, particularly the Fed, will be of paramount importance.**

Taken together, these three drivers of financial market movements suggest that markets in 2020 could still trend upwards, but most likely with a number of jolts along the way.

Headwinds to a cyclical upswing

The economic data available to us as the new year gets going bear out our belief that the two primary global growth engines – China and the United States – are still sputtering.

In China, the latest domestic economic indicators point to a mild levelling off in output. GDP growth should be substantial enough to encourage companies to restock, but too weak to kick-start a lasting global upswing. Beijing has moreover decided against both massive fiscal spending and a western-style monetary policy. Xi Jinping views reining in private-sector leverage and getting capital flows under control as strategic issues that take precedence over economic stimulus.

The trade agreement with the United States will likely help the government achieve those goals and bring support to the renminbi**China is in fact where we currently see an expanding range of equity investment opportunities.**

In the United States, the recent powerful equity-market rally will lift sentiment further and support consumer spending, an essential contributor to GDP growth. But the attendant wealth effect won't raise the country's growth potential, which in our view is 2% at most, due to insufficient productivity gains. As in China, the latest economic indicators show a weakness in US manufacturing that is now in danger of spreading to the service sector, which has so far held up well. The US-China trade agreement should enable output to steady, but we feel that this is still a far cry from the growth spurt we saw in 2016 and 2017.

In Europe, the economy stands to benefit, in the short run, from the overall improvement we expect but is unlikely to score significant gains on such a modest uptick. This outlook encourages us to keep our equity portfolios overweight growth stocks with predictable earnings prospects.

The bewildered investor

Even leaving aside the new front of uncertainty created by the Trump administration in the Middle East (based on a calculus that is anything but risk-free), the broader political agenda in 2020 may well put investor sentiment to the test several times. The UK and the EU will be initiating tough trade talks, the US and China will be entering the second leg of theirs, and the upcoming US presidential election will be a crucial variable for financial markets.

We expect skilful management of portfolio risk arising from exposure to overall market movements to play a greater role in generating performance than in 2019.

Central banks caught between interventionism and moral hazard

In addition to the ECB's resumption of its asset purchase programme, the main central-bank highlight of 2019 was the extraordinary interventionism displayed by the Fed – injecting over $400 billion into the US financial system since September. **One of the keys to how financial markets will shape up in 2020 is therefore whether this colossal injection of liquidity will continue or not.**

This underscores the tremendous importance of the conclusions the Fed will draw from its 2019 strategic monetary policy review. The Fed certainly doesn't want to relinquish its claim to independence by openly agreeing to directly finance the Trump administration's fiscal policy. But recent events have driven home a key point to even the most sceptical observers: it is technically impossible for the Fed to scale back its support for financial markets without creating major turmoil. Furthermore, with inflation expectations still low, the US central bank retains considerable leeway for further action. **In 2020, maintaining an increasingly precarious balance between active intervention and the desire to avoid accusations of moral hazard will likely emerge as a more pressing issue – one that could well prove damaging to the greenback.** We have already factored in that risk, as demonstrated by the forex hedges set up over the past several months on our dollar-denominated assets.

Conclusion

Our analysis leads us today to believe that the interplay among these three key drivers of market movements will produce much less binary outcomes in 2020 than in the preceding two years. Investors are still giddy from the market rally at the end of last year, and thus increasingly vulnerable to missteps by policymakers, including – but not limited to – those at central banks. **We therefore maintain that in contrast to 2019, this year investors would be wiser to follow a truly active asset management approach as opposed to a trend-based one.**

Source: Carmignac, Bloomberg, 31/12/2019

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