# MARKET INSIGHT

December 2018

REYL
innovative banking

# THREE INVESTMENT TOPICS FOR 2019

The end of each year sees finance experts publish their forecasts for the coming year. After a 2018 full of twists and turns, what about 2019? We identify three major topics which will have to be taken on board and which will have a major impact on what the financial markets have in store for us next year.

**The end of American exceptionalism**
2018 was marked by the exceptionalism of the United States with respect to the rest of the world, from both an economic and a stock market standpoint. American growth has in particular been driven by the tax stimulus voted through in December 2017, boosting investor confidence and contributing about 10% growth in earnings per share of the expected 24.2%.[1] Next year the stimulating effect of the tax cuts will fade and financial conditions will continue to tighten, reducing the growth differential between the United States and the rest of the world. Strategists already predict a convergence in the growth of corporate earnings between the regions (with the exception of Japan) at around 8–10%.[2] The premise of a slowdown in the US economy is already starting to become apparent with a contraction in the housing market and decline in leading manufacturing indicators. The consensus expects a drop in GDP growth from 2.9% in 2018 to 2.6% in 2019 and 1.9% in 2020.

According to Goldman Sachs estimates, however, the US economy should remain relatively immune from the adverse consequences of the trade war with China.[3] In the Eurozone, though, economic conditions are already deteriorating and should turn the corner before long. In China, the authorities seem ready to support the economy in order to bring about a soft landing and a minimum growth rate of 6.1%.

**From political 'noise' to politics as a key driver of financial markets**
Investors in European assets have long been used to the political 'noise' which is fuelling uncertainties and weighing on returns. But we note that the political factor has intensified in Europe to the point of becoming a structuring force in financial markets. Political uncertainties have weakened confidence and sentiment and exacerbated the economic slowdown that began in Q1 2018. Next year we expect the political uncertainties to continue or even increase. The actual divorce of the United Kingdom (29 March), or the extension of the transition period, will undoubtedly generate episodes of stress on the markets. As regards the Italian populist government, the odds are it will not last the full year.[4] For the first time it is highly likely that the European parliamentary elections, to be held from 23 to 26 May, will see anti-EU parties win enough seats to significantly disrupt the legislative process. These elections are thus already emerging as a referendum on the European project and the ramifications could well extend beyond the assembly to European institutions and national policies. Finally, the appointment of Mario Draghi's successor as president of the ECB could be extremely important at a pivotal moment for European monetary policy.

In the United States, President Trump's main driving force seems to be his aim to secure a second term. His chances fundamentally rest on two factors: his popularity and the state of the economy at the time of the elections in November 2020.[5] Donald Trump will therefore do whatever it takes to sustain the economy and avoid a recession in the meantime. How this aim will affect the development of trade relations with China remains uncertain, however. On the one hand, continuing to take a stand against China enables the President to boost his popularity rating and, on the other, he wants to minimise any collateral damage done to the economy.

**Soft landing of the Chinese economy**
At the end of 2016 the Chinese authorities – determined to reduce excesses in the economy – put in place a number of measures aimed at slowing down credit and leverage. Credit growth thus began to slow down in 2017, curbing the money supply and ultimately the fixed assets investments underpinning Chinese growth. As these restrictive measures kicked in, growth fell from 6.9% in 2017 to 6.6% in 2018, a trend which should continue in 2019 with growth expected to be 6.2%. The trade war with the United States and its impact on confidence and sentiment has also helped exacerbate domestic weaknesses.

Being pragmatic and reactive, the Chinese authorities nonetheless rapidly saw the risks with which the economy was faced and in the second half of 2018 put in place a series of fiscal and financial measures designed to stimulate domestic demand. Though the objective of structural debt reduction is being maintained and a massive stimulus package is not on the cards, the Chinese authorities remain determined to support the economy. The 2016–2020 five-year plan is in fact based on average real GDP annual growth over the period of at least 6.5%, implying a minimum growth rate of 6.1% for 2019 and 2020 if this objective is to be achieved. While trade tensions with the United States are likely to continue and to become worse, the effect on growth will be limited to 0.5%, according to various estimates, and will be offset by the stimulus measures already put in place. Beijing will have the arduous task of preserving the fragile equilibrium between supporting the economy at the risk of leverage and cutting debt at the risk of dragging growth down. Should the economy slow down further, the Chinese government nonetheless has leeway to expand its accommodating policies.

**How should portfolios be positioned?**
In the United States, the combination of tightening financial conditions and the slowdown in the economic cycle is likely to weigh on heavily indebted companies and result in an increase of credit rating downgrades and a rise in default rates. We are thus cautious on US credit, particularly since US non-financial companies have a debt level (net debt/EBITDA) far higher than the pre-crisis peak in 2007. We are also cautious as regards US equities, which might struggle on account of the slowdown in earnings growth and their likely downward revision . The structure of the US market, heavily dominated as it is by cyclical sectors and growth companies, will also suffer in a more difficult economic backdrop. Exposure to high-quality companies with a robust balance sheet, stable margins, high buyback yield and low volatility might nonetheless enable portfolios to better navigate these troubled waters. In Europe, though we foresee an economic turnaround during the year, and though the relative valuations of European equities remain attractive, the political risk premium is putting us off. Emerging market equities will fluctuate depending on movements in the US dollar, the global withdrawal of liquidity, and Chinese macroeconomic policies. Great agility is therefore recommended and multi-asset class portfolio managers would do well to focus on tactical asset allocation next year.

[1] Sources: IBES, JP Morgan Equity Strategy, 10 December 2018
[2] USA 8.6%, Europe 9%, Emerging markets 9.9%, Japan 3.4%. Sources: IBES, JP Morgan JP Morgan Equity Strategy, 10 December 2018
[3] The cost is estimated in the worst case at 0.1% of GDP growth. Source: The Trade War: Bigger Numbers, Same Conclusion, Goldman Sachs Economics Research, 5 October 2018
[4] Italy has seen 60 governments since the Republic was proclaimed in 1946, lasting on average 361 days
[5] No president has attempted to be re-elected during a recession since 1980, the year Jimmy Carter was defeated by Ronald Reagan

**MARCO BONAVIRI**
SENIOR PORTFOLIO MANAGER

*“Multi-asset class portfolio managers would do well to focus on tactical asset allocation next year.”*

innovative banking

**IMPORTANT INFORMATION -** This content is being provided by REYL & Cie Holding SA or/and its affiliates (hereinafter referred to as "REYL") solely for information purposes, it shall be intended for internal use strictly and is not intended to be a solicitation or offer, recommendation or advice to buy or sell interests in any security or investment product mentioned in it, to effect any transaction, or to conclude any transaction of any kind whatsoever, in particular to any recipient who is not a qualified, accredited, eligible or / and professional investor. It is intended for the sole use of the recipient and may not be forwarded, printed, downloaded, used or reproduced for any other purpose. Whilst REYL shall use reasonable efforts to obtain information from sources which it believes to be reliable, REYL, its directors, officers, employees, agents or shareholders assumes no liability regarding this content and gives no warranty as to the accuracy, completeness or reliability of any mentioned data and thus assumes no liability for losses arising from the use of this content. This content is intended only for recipient who understand and are capable of assuming all risks involved. Before entering into any transaction, the recipients should determine if the relevant security or investment production mentioned in the content suits his particular circumstances and should ensure that he independently assesses (together with his professional advisers) the specific risks, the legal, tax, accounting consequences and eligibility requirements of any purchase of securities or investment products mentioned in the content. REYL makes no representation as to the suitability of the mentioned information, opinions or securities and investment products. Historical data on the performance of the securities and investment products or the underlying assets are no indication for future performance. The present content has been compiled by a department of REYL which is not an organisational unit responsible for financial research. REYL is subject to distinct regulatory requirements and certain securities and investment products may not be available in all jurisdictions or to all recipient types. The recipient should therefore comply with its local regulations. There is no intention to offer securities or investment products in countries or jurisdictions where such offer would be unlawful under the relevant domestic law.

**WWW.REYL.COM**