

Schroders

Economic and Strategy Viewpoint

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2018 review: A tough year for investors



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- We look back at a year full of challenges for investors as trade wars came into effect and Europe endured a mini Italian debt crisis, while parts of the emerging markets were hit by tighter dollar liquidity and political risk.
- 2018 was a poor year for investors as both US equities and Treasuries underperformed cash – a very rare event. Away from the US, there were places to hide in other developed market government bonds, along with safe haven currencies like the Japanese yen and the Swiss franc. The Mexican peso was also an unlikely winner in 2018.

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Three themes for 2019 and some black swans



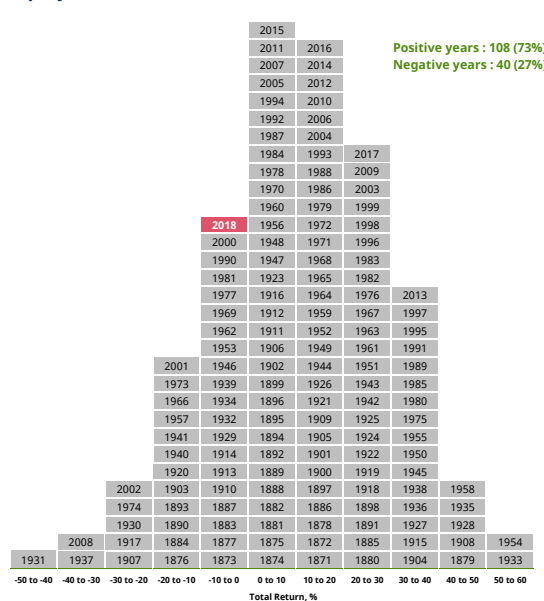
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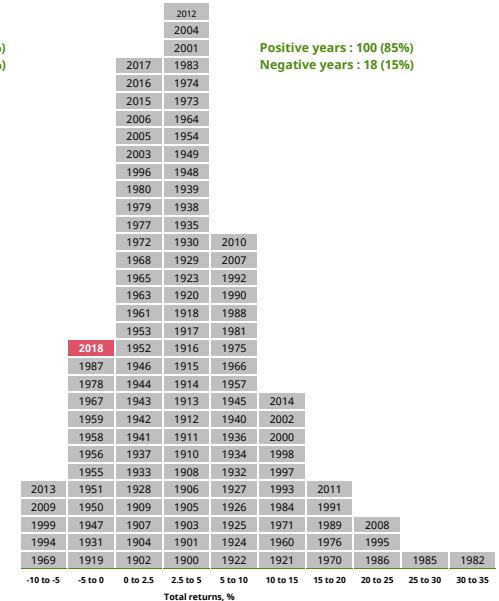
- Growth concerns and tightening liquidity weighed on markets in 2018 and look set to continue in 2019. As the European Central Bank ends QE, we estimate that global liquidity will contract further this year, keeping pressure on some of the riskier areas of finance.
- Investors will look for governments to boost growth through fiscal policy and in emerging markets will seek relief from a stronger dollar as the Fed brings the tightening cycle to a close. We also note that following the de-rating at the end of 2018, equity markets are better positioned for disappointment than a year ago.
- Black swans include another eurozone crisis, the UK remaining in the EU, military action and Trump not running for re-election.

Chart: Both bonds and equities underperformed in 2018

Equity returns distribution



Bond returns distribution



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Note: Equity total returns using S&P500 from 1873, and bond total returns taken from US 10-year Treasuries from 1900. Source: Thomson Reuters Datastream, Global Financial Data, Schroders Economics Group, 2 January 2019.

2018 review: A tough year for investors

“If you can look into the seeds of time, and say which grain will grow and which will not, speak then unto me.”

Banquo in Macbeth by William Shakespeare, 1606.

At this time of year, we like to take a step back and review the performance of markets and the lessons we can learn for the coming year. 2018 began much as 2017 had ended. Risk assets continued their march upwards, while government bonds continued to see selling and rising yields. Though there had been plenty of political noise in 2017, investors managed to navigate the Twitter minefield and continue to push equities higher.

However, by February of last year, investors started to lose their nerve. Political noise was turning into action, notably with the introduction of tariffs which marked the start of the US-China trade war. It was a poor year for investors who held almost anything other than cash. Both equities and bonds generated negative returns, which has only previously happened twice before since 1900.

Green shoots withered in spring

The year started with a US federal government shutdown, followed by around of tariffs started by the US

The year began with the US federal government shutdown for two days as a result of a dispute over Deferred Action for Childhood Arrivals. A risk that is still live today for early 2019, and still linked to migration though this time through the infamous wall.

A pugnacious US appeared willing to take on all comers, with trade tariffs applied to steel, aluminium, solar panels and washing machines early on. The EU, Canada and China responded in kind. This would, however, prove only a taste of things to come, with Washington releasing its first list of proposed China specific tariffs in April.

Elsewhere in the world, after months of negotiations, Angela Merkel's CDU/CSU coalition agreed to re-establish their previous coalition government with the Socialist party (SPD) following a failure to agree terms with the Green party and the centre right Free Democrats (FDP). However, the reformation of the previous government, which had performed so poorly in the 2017 election, led to a further deterioration in poll ratings.

In emerging markets (EM), Jacob Zuma resigned as president of South Africa after nine years in power after intense pressure from his own ANC party over corruption allegations. His deputy, Cyril Ramaphosa, took over and helped to boost optimism, supporting South African equities and the rand. However, it did not take long before populist rhetoric about land expropriation started to hurt sentiment.

Russia saw fresh sanctions in response to assassination attempts in the UK

Hopes that a Trump presidency might ease pressure on Russia were dealt a blow as the country saw fresh sanctions. The botched assassination attempt of former Russian double agent Sergei Skripal and his daughter Yulia led to chaos in the small English city of Salisbury, and later, the tragic death of a member of the public.

Finally, the ominous beginnings of crises in Argentina and Turkey were apparent by April, with currency weakness building as concerns mounted over government policy.

Summer sizzled with political heat

In May, after 88 days of negotiations, a new populist coalition government took power in Italy. The right wing League party joined forces with the far left Five Star Movement under an agreement to reverse recently introduced pension reforms, to reduce migration, and to dramatically expand fiscal policy. Investors took fright, causing Italian bond yields to rise sharply and Italian equities to fall in value.

Italian politics was heating up by the summer, while North Korea was coming in from the cold

June saw the first ever meeting between the leaders of the US and North Korea, at a summit in Singapore. The summit resulted in a statement agreeing to the denuclearisation of the Korean peninsula, new peaceful relations, and follow up talks. Talk of the Nobel Peace Prize followed, though President Trump would ultimately be disappointed.

Over the summer, Japan was struck by a series of natural weather disasters. A combination of earthquakes, heavy flooding, extreme heat and typhoons caused hundreds of casualties and economic activity to contract in the third quarter.

Mexico's election saw left wing populist Andres Manuel Lopez Obrador (AMLO) emerge victorious. Earlier in the year concerns over an AMLO victory had weighed somewhat on Mexican assets, but these worries seemed to have been set aside by election day, with the stock market rallying on the back of the result. It was possibly, optimism that AMLO would be more pragmatic than originally feared that drove the rally, though events since then would suggest this was misplaced.

Autumn sees mixed trading and news

The UK government finally decided on what it wanted from the EU as part of its Brexit negotiations. Dubbed the Chequers Agreement, Prime Minister Theresa May's plan was meant to be a compromise between a soft and hard Brexit. However, few people liked the plan (including the EU), leading to several high profile resignations from her cabinet.

Australia's former prime minister Malcolm Turnbull resigned from parliament at the end of August, having lost support in the Liberal party. A week later, Scott Morrison, the treasurer, won a close internal ballot and became the new prime minister.

In Europe, new emissions standards were introduced following the diesel emissions scandal, applying to all new cars sold in September. This caused a huge backlog of supply for manufacturers, with anecdotal evidence suggesting testing times taking twice as long. European industrial production and retail sales slumped as a result, causing more concerns over the state of the economy.

In Japan, Prime Minister Abe won his ruling party leadership election, keeping him on track to become the longest serving PM in Japanese history. He reaffirmed his plan to hike VAT to 10% in 2019, alongside announcing several measures to soften the blow.

The crises in Argentina and Turkey reached their denouement, with the former turning to the IMF for assistance and the central bank in the latter capitulating, with a return to orthodox, and aggressive, monetary policy. Concerns do however remain about the policy intentions of Turkey's President Erdogan.

In a rare piece of good news, the replacement for NAFTA, called the USMCA, was agreed on 1 October, ending months of uncertainty and putting to rest fears that trade barriers would be erected between the North American nations.

An eventful winter puts risk assets in a deep freeze

As winter was beginning to set in, Italian politics returned to the fore. The coalition government submitted its draft budget to the European Commission which included a modest fiscal easing programme. The 2019 deficit target was lower than initially thought in the summer, but still above the tolerance levels of the budgetary rules. The Commission rejected the budget proposal and threatened to begin the process that would eventually lead to penalties for Italy. However, just as the year was drawing to a close, the Italian government sheepishly backed down and reduced the deficit target to comply with the Commission.

Argentina and Turkey returned to the spotlight for the wrong reasons

By winter, Italy was rowing with the European Commission, Macron was facing the “gilets jaunes”, Theresa May was fighting for survival

The “Trump of the Tropics” stormed to victory in Brazil, as the actual Trump lost control of the House of Representatives

Central banks were a rare source of stability and consistency in 2018, even if they were tightening policy

Elsewhere in Europe, President Macron hit a new low in opinion polls as the French population fell out of love with the modern centrist reformer. Dubbed the “Emperor of Europe”, his critics complained of a leader that was only interested in helping the rich. Tensions rose and spilled over into huge national protests under the “gilets jaunes” (‘yellow vests’) movement, which were initially sparked in reaction to fuel duty increases, but became a symbol of a greater populist revolt. Demonstrations and strikes disrupted output and hit tourism in the final quarter, but the damage will not be clear until the new year.

Across the border in Germany, the historic moment came when Chancellor Angela Merkel announced that she would step down as CDU party leader, and that she would not contest the next federal election. An internal contest followed which resulted in the election of Annegret Kramp-Karrenbauer as the new leader and default favourite to become the next chancellor. Often referred to as “mini-Merkel” due to her close relationship with the current chancellor, she is expected to allow Merkel to see out her term, but begin to form a new vision for her potential leadership.

The frost melted away in the Brexit negotiations as the UK and EU agreed on the terms of the Brexit divorce. The deal would lead to a transition period until the end of 2020, with the future relationship yet to be negotiated. A backstop agreement was bolted on to temporarily solve the Irish border issue; however, the clause which requires a ‘mutual review mechanism’ to end the backstop met a frosty reception in Westminster. So much so that Theresa May faced (and won) an internal party leadership challenge, and in the end was forced to delay the parliamentary vote on the agreement until the new year.

Another market positive election in the Americas saw Jair Bolsonaro romping to victory in Brazil's October election as the far right candidate defeated the establishment parties on an anti-corruption platform. Markets are hopeful he will deliver much needed pension reform, but time will tell whether he can build the political alliances necessary in a highly fragmented legislature.

The US mid-term election results were largely as expected. The Democrats took control of the House, but the Republicans retained control of the Senate. The result meant that future fiscal easing is less likely unless it benefits Democrat supporters or policies. A preview of the fight likely in 2019 began with yet another federal government shutdown as Trump was denied funding for his “border wall”.

Just after the mid-term elections, President Trump sought a political ‘win’ on the international stage at the G20 summit in Argentina, in the form of a temporary trade truce with China. This delayed further tariff escalation by 90 days while the two sides conduct further talks; existing tariffs remain in place. While a positive for market sentiment, it was not immediately clear whether a compromise was feasible.

Central banks continued to tighten policy gradually

Monetary policy continued to be tightened over 2018 as the US Federal Reserve (Fed) raised its interest rate target range four times to between 2.25-2.50%. Appointed in February, new Fed chairman Jerome Powell continued along the same path as his predecessor, despite complaints from President Trump in the second half of the year. In the last meeting of 2018, although the Fed lowered its forecast for future rate increases, investors had been looking for a more soothing tone from its chairman. Equity markets sold off sharply as Powell said in his press conference that he did not see the central bank changing its “autopilot” policy in reducing the size of the Fed's balance sheet.

Meanwhile, the European Central Bank (ECB) decided to taper its quantitative easing programme through 2018, with an end to purchases in December. Though interest

The People's Bank of China bucked the trend by loosening policy, though not by cutting rates

rates remained unchanged, the Bank issued forward guidance that it expects interest rates to remain unchanged at least through the summer of 2019. Watch this space.

The Bank of England managed to hike once this year, but uncertainty over Brexit clouded the outlook. As for the Bank of Japan, policymakers widened the targeted range of the 10-year government bond yield driven by concerns about the side effects of prolonged monetary easing.

The People's Bank of China went against the global trend and eased policy, not by cutting rates but through further reductions in the reserve requirement ratio, which it cut 250 bps over 2018, and through open market operations.

Most other emerging market central banks enacted rate hikes during 2018, in part as a reaction to the tighter policy emanating from the Federal Reserve. Deserving of a special mention though is Turkey, where rates were hiked 1425 bps to 27% over the course of the year, as the country's crisis escalated. In India, rates saw modest hikes but the bigger news was the resignation of the central bank governor Urjit Patel in December for "personal reasons" following disagreements with the government over the transfer of central bank funds to the government's coffers and the central bank's tough stance on asset quality issues across the financial sector.

Finally, there was a late surprise for investors as the Swedish Riksbank announced that it would raise its main policy rate from -0.50% to -0.25% in January. Most economists had not anticipated the move, but the policy committee noted that the global economy is now entering a phase of more subdued growth and signalled that it is in no rush to lift the rate into positive territory. Clearly it is still waiting for the ECB to make its move.

Cross-asset performance comparison

Looking across the major asset classes, only US cash made a positive return (2%) in 2018. Yet again, commodities were the worst performing asset class (-11.2%), though closely followed by the MSCI World equities index (-8.2%). The best non-cash asset class was US Treasuries, although they too failed to generate a positive return as interest rates rose (-0.1%).

With sentiment clearly poor, it was strange to see the lower risk investment grade credit bonds (-3.5%) underperform their lower quality and riskier counterpart – high yield bonds (-3.3%). It seems that reduced issuance by those companies that fall into the high yield category helped support the asset class relative to investment grade credit.

Lastly, gold also had a poor year as rising real interest rates sapped demand for the precious metal (-1.7%).

2018 was a tough year for investors as cash was the only major asset class to provide a positive return

Chart 1: 2018 Cross-asset performance (USD)



Source: Thomson Datastream, Schroders Economics Group. 2 January 2019.

The usual seasonal patterns failed to materialise in 2018. “Sell in May and go away, come again on St. Leger Day” (12 September) has often helped investors avoid summer sell-offs, which are often linked to a lack of liquidity during a quieter trading environment. However following the old adage would have cost investors a further 3.5 percentage points loss on holdings in the MSCI World equity index (in addition to the actual 8.2% loss).

Moreover, many investors were left disappointed in December as the “Santa rally” also failed to materialise. In fact, December 2018 was the worst December performance for the MSCI World equity index on record (since 1970). Had investors simply sold at the end of November, they would have avoided the 7.6% loss that followed. The next biggest December decline was in 2002 (-4.8%). Paying greater attention to events rather than seasonal patterns would have helped greatly last year.

When comparing the performance of US equities and Treasury bonds against their history, the S&P500 posted a negative and below average return (data since 1873 – see chart on front page) while Treasuries also had a negative and below average year (data since 1900 – chart on front page).

Though there were both optimists and pessimists at the start of 2018, we doubt anybody predicted that both equities and government bonds would have generated negative returns. In fact, 2018 was only the third year since 1900 where both equities and bonds underperformed cash. The previous two occasions were in 1931, towards the start of the Great Depression, and in 1969, the year of the start of the Vietnam war and the last time there was a big fiscal stimulus during a period of expansion.

Comparing equity market performance

2018 was a poor year for equity investors, with all major indices netting a loss when cast in both local currency and US dollar terms. The best performer was the US NASDAQ index (-2.8%). This came despite a strong start to the year thanks to what seemed to be the unsinkable FAANG stocks (Facebook, Apple, Amazon, Netflix, Google – now Alphabet). A simple average price index of the five tech giants was up 43.4% on 30 August, but ended the year only up 6.9%. Data breaches and flagging sales hit the five, which were trading on gravity defying multiples to begin with.

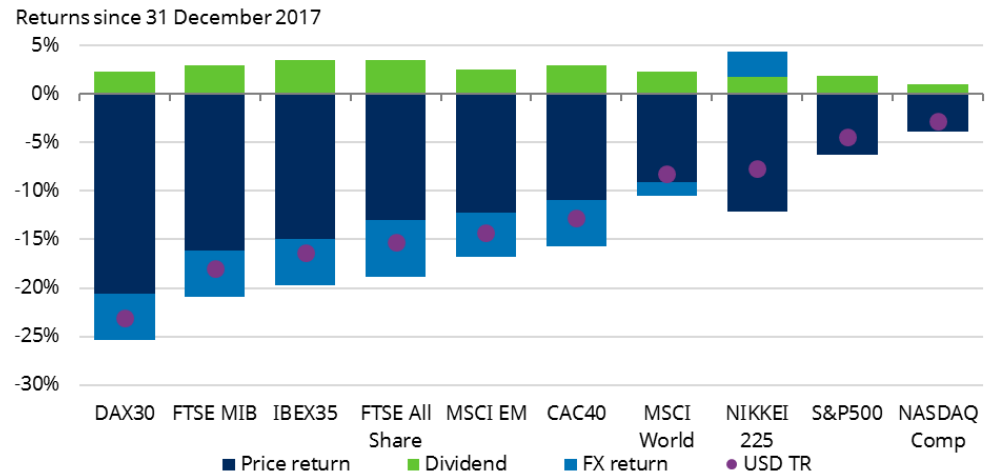
The worst performer of all was the German DAX30 index, down -18.3% in local currency and -23.1% in US dollars (USD). The German index suffered from being both a cyclical index, but also by having a relatively high level of exposure to Asia, which was suffering from the trade war.

The less cyclical European indices fared better, including the French CAC40 (-8% in local currency and -12.8% in USD) and the UK FTSE All-Share (-9.5% in local currency and -15.3% in USD).

2018 was only the third year since 1900 where both US equities and Treasuries generated a negative return

In equity markets, the US NASDAQ was the best of a poor bunch, but the German DAX was the worst performer

Chart 2: Equity markets performance (total returns in USD)



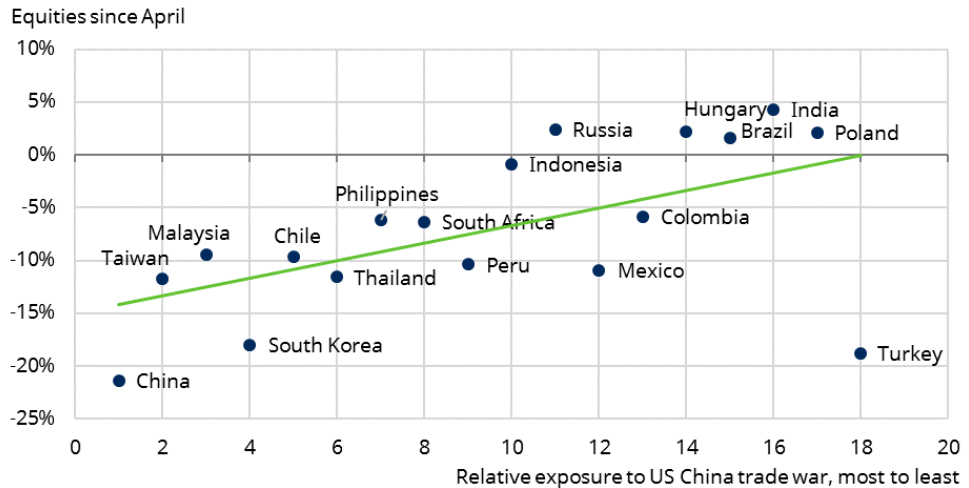
Source: Thomson Reuters Datastream, Schrodgers Economics Group. 2 January 2019.

In emerging markets (EM), while the overall index was down 14.3%, this masked considerable dispersion, particularly in dollar terms. Turkey was the year's worst performer, thanks to a collapse in the lira, with equities losing investors 57.6% in dollar terms. The best performing market, Brazil, was still down for the year, but only just at a less painful 0.2%.

The dominant common theme for EM equities in 2018 was trade wars, as demonstrated by chart 3 below. Taking April, when the US first mooted China-specific tariffs, as a starting point, there is a striking correlation between equity performance in EM and a country's exposure to the US-China trade war, as measured by value added to China-US trade. Less exposed economies managed to eke out small positive price gains, though as discussed currency moves still saw a negative overall return in dollar terms.

Chart 3: Trade war fears came to dominate EM equities

In EM, markets with high exposure to the US-China trade war were the hardest hit



Source: OECD, Thomson Reuters Datastream, Schrodgers Economics Group. 2 January 2019.

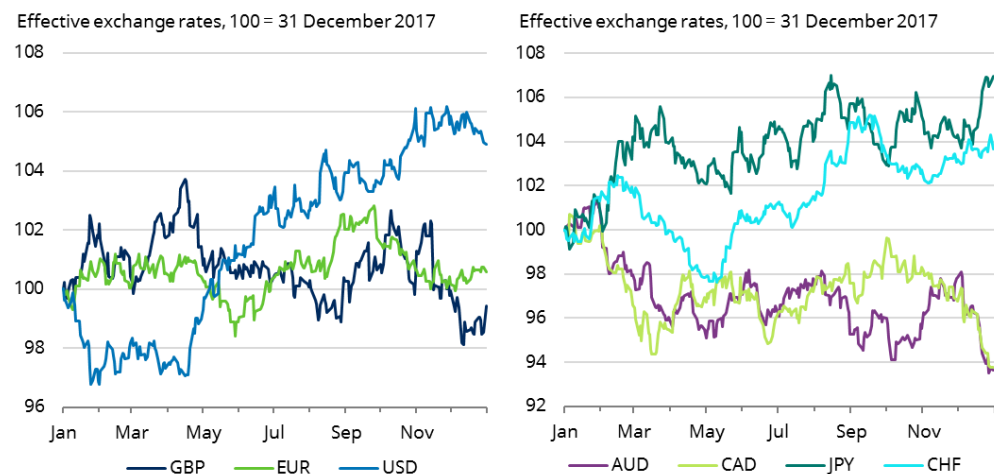
Comparing currency market performance

Currency markets ended 2018 largely reflecting the anxieties of investors. The US dollar started the year weaker, helping to boost risk assets, however by April the greenback was on the rise once again, ending the year up on a nominal trade weighted basis (+4.9%). The initial rise over the summer reflected the stronger US economy, however by the autumn, the strong US dollar started to reflect concern in the global economy (chart 4).

2018 was another strong US dollar year, as safe haven currencies did best, while commodity currencies fared worst

The euro had a reasonably steady year, with a temporary dip coinciding with the Italian elections. Overall, the euro finished 2018 slightly up (+0.6%). As for the British pound, it was a volatile year with some upside support from the Bank of England raising rates, but sterling ended 2018 with a slump caused by the lack of resolution on Brexit (-0.6%).

Chart 4 and 5: Currency performance in developed markets



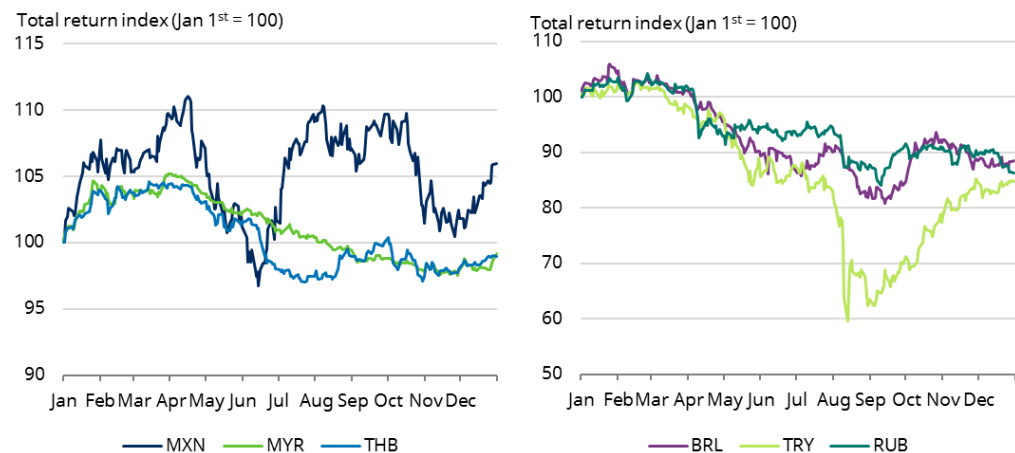
Source: Thomson Reuters Datastream, Schroders Economics Group. 2 January 2019.

There was a clear trend of investors favouring safe haven currencies, while shunning commodity driven currencies (chart 5). The best performing currency (including versus the US dollar) was the Japanese yen (+7%), while the Swiss franc also performed well (+3.7%). The worst performing major currency this year was the Australian dollar (-6.4%) followed by the Canadian dollar (-6.2%) – both heavily reliant on commodity exports, which suffered in 2018.

In emerging markets, the strength of the dollar combined with some idiosyncratic risks, meant that even after including carry very few currencies generated a positive dollar return. Chart 6 shows the three best performing currencies, and of those only the Mexican peso ended the year in positive territory with a return of nearly 6% against the dollar. Malaysia and Thailand were the best of the rest, losing investors only 1% or so. Mexico's good year arose chiefly from improving political sentiment as investors took an optimistic view of the prospects of an AMLO presidency, and as NAFTA uncertainty was reasonably favourably resolved with a new trade deal.

Charts 6 and 7: Best and worst of EM FX

The Mexican peso was the best performing EM currency, with Turkish lira providing the scares for the year



Source: Bloomberg, Schroders Economics Group. 2 January 2019

Turning to the worst performers (chart 7), the Turkish lira had a particularly painful year, though it managed to erase much of the losses with a year-end rally. The currency's rollercoaster ride was heavily linked to central bank action (and lack of it) amidst fears of political interference. Comments from President Erdogan proved as catalytic for Turkish assets as those of his American counterpart did for US investments.

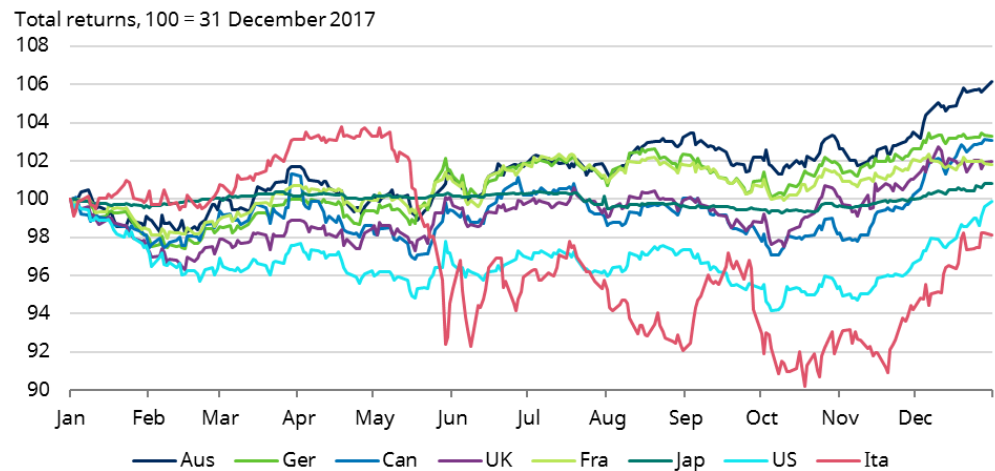
Comparing debt market performance

While US Treasuries failed to generate a positive return in 2018, a number of other government bonds managed to remain in the black (chart 8). 10-year Australian government bonds returned +6.2%, thanks to the high yield on offer at the start of the year.

German Bunds were the next best performers (+3.3%), helped by the mini crisis in Italy. Speaking of which, Italian BTPs had a wild and volatile year as shown in chart 8. Despite ending the year only down 1.9%, at the peak of the crisis in October, BTPs were down -9.8%! Regardless of the rebound since, BTPs were the worst performing major government bond market of 2018.

Chart 8: Government debt returns

Though US Treasuries were down on the year, other DM government bonds shielded investors from the malaise in risk assets



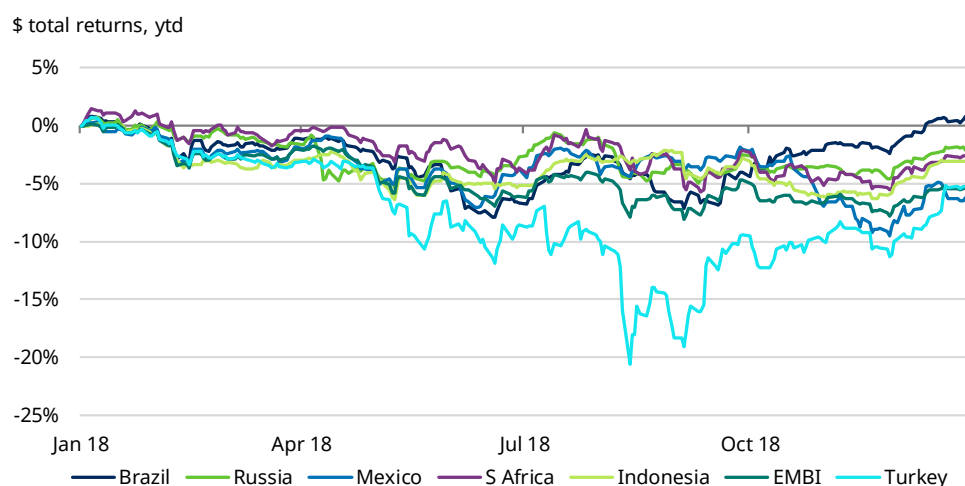
Source: Thomson Reuters Datastream, Schroders Economic Group. 2 January 2019.

Canadian bonds (+3%), UK gilts (+2%), French OATs (+1.8%) and even Japanese government bonds (+0.8%) all managed a positive return. This suggests that government bonds broadly still have a place in portfolios as hedges for risk assets, although greater care is required in making those investment choices.

EM dollar denominated sovereign debt as a whole had a bad year, with the EMBI index losing 5.3% for investors. The only sovereign offering a positive return was Brazil, which rallied after the election to squeeze out a 0.8% gain for 2018. For much of the year Turkey was the definite laggard thanks to its economic and currency crisis, at one point losing more than 20%, but a strong second half rally erased much of the losses to leave returns down 5.3% for the year.

Only Brazilian government bonds (USD) generated a positive return in EM debt space

Chart 9: An uninspiring year for hard currency EM debt



Source: Thomson Reuters Datastream, Schroders Economics Group. 2 January 2019.

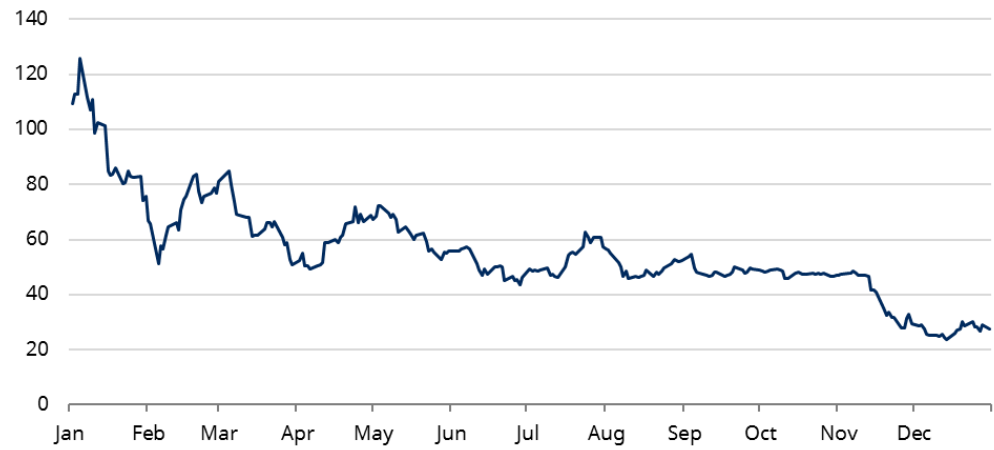
Lessons from 2018

Having reviewed events and performance of markets over the past year, we highlight a few lessons worth considering for 2019:

- While central banks care about markets, they do not set policy for the sole purpose of pleasing investors. Sometimes, markets are too expensive, and central bankers will see a correction as normal, rather than a signal that something is “wrong”.
- Trade wars have far-reaching effects that will only be fully appreciated many years after the fact. Not only is intermediate trade being impacted, but eventually we will see trade substitution which will benefit some of the trade competitors to the US and China.
- Investors should pay more attention to fundamentals and events rather than seasonal patterns for stock markets. Selling in May would have hurt portfolios in 2018, while the “Santa rally” turned out to be the worst December performance for global equities since 1970.
- Government bonds are still useful for hedging against downside risks. However, investors must look beyond US Treasuries to find the best returns, particularly in the new political environment. Other safe havens, like the yen, Swiss franc, and Bunds, are worth a second look.
- Political risk is still as important as ever for investor sentiment. It can cause short-term downside risks such as Italy and Turkey, or longer-term shifts such as the US-China trade war. It can also provide upside risk as seen in Brazil.
- Finally, Bitcoins still have no place in an investor's portfolio (see our comments in last year's edition). The crypto currency is down -72.5% in 2018, despite a significant increase in participation from reputable financial services institutions.

Chart 10: Was 2018 the nail in the coffin for Bitcoin?

USD\$ per Bitcoin index (100=31 December 2017)



Source: Thomson Reuters Datastream, Schroders Economics Group. 2 January 2019.

Three themes for 2019 and some black swans

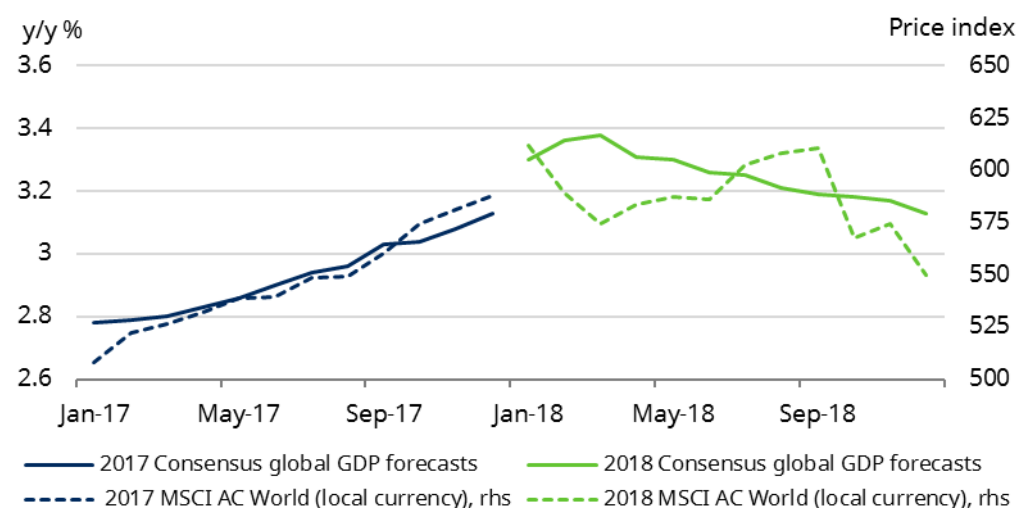
Our review of the past year makes for sobering reading, with US equity and government bond markets both returning less than cash. Such an outcome has only been registered on three previous calendar years since 1900 and highlights the challenge for investors in the current environment (see chart front page). Two factors have been important in delivering this outcome and will shape market performance in 2019.

Growth concerns

Global growth disappointed in 2018

First, global growth disappointed and remained a concern as trade tensions escalated. At the start of 2018 expectations were high as a result of the synchronised recovery in global activity in 2017. As we noted at the time though, the hurdle for positive macro surprises in 2018 had become greater, making the potential for gains more limited for equity markets. Whilst the actual outcome for global growth in 2018 is likely to be similar to that in 2017, relative to expectations, 2018 was a disappointment (see chart 11). Although the shortfall was not great, equity markets had become priced for a continuation of positive news judging from the level of market valuations and this stacked the odds against equities.

Chart 11: Global growth expectations and the equity market: 2018 vs. 2017



Source: Thomson Reuters Datastream, Schroders Economics Group, 17 December 2018.

As we went through the year, the world economy experienced a slowdown in export growth in part related to the threat from the trade wars, but also linked to the strength of the US dollar in our view. Economists produced a wide range of estimates for the impact from the US-China trade dispute and whilst we disagree with the more extreme numbers, there is evidence that the damage will extend beyond exports with capital spending also affected by the increased uncertainty associated with trade tensions.

Of course, the disappointment on global growth does not account for the underperformance of sovereign bonds for which we would look at the second factor: the tightening of global liquidity.

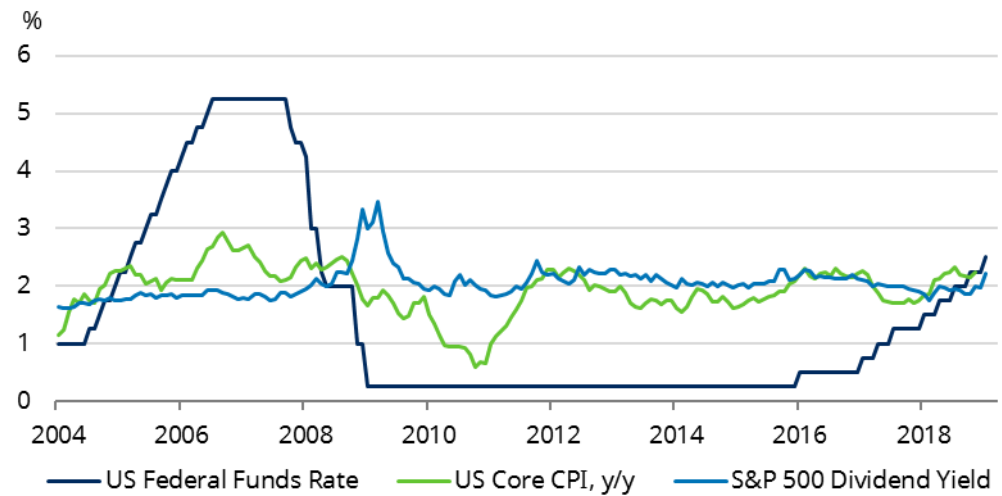
Tightening liquidity

And liquidity tightened

The US Federal Reserve (Fed) raised interest rates four times in 2018 taking the Fed funds target range to 2.25 to 2.50% and, although the yield curve has flattened, bond

yields are higher as a result of the rise in short-term rates. Furthermore, for the first time in ten years, cash yields more than underlying inflation and thus holds its value in real terms (chart 12).

Chart 12: Cash rates rise above inflation and equity yields in the US



Source: Thomson Reuters Datastream, Schroders Economics Group, 2 January 2019.

Cash has become more attractive in real terms and relative to equity

Cash is also attractive relative to equity, with the interest rate rising above the dividend yield on the S&P 500 for the first time since 2008 (Chart 12). Whilst this does not mean that equities are expensive (as dividends can be expected to grow in the future), it does reduce the search for income which has been driving investors into risk assets since the financial crisis and the collapse in interest rates.

The rise in US rates has had a wider impact through the effect on dollar borrowing costs. Recent analysis from the Bank for International Settlements (BIS) highlights the increased importance of dollar funding since the global financial crisis. Dollar strength has clearly squeezed liquidity in Asia and Latin America where dollar rates drive funding costs.

In addition to the rise in short rates, liquidity has been withdrawn via the Fed's programme of reducing its balance sheet, often referred to as quantitative tightening (QT). According to the BIS, the Fed's holdings of US Treasuries fell by more than two percentage points, to 15% of total marketable securities in 2018, about five percentage points below the 2014 peak.

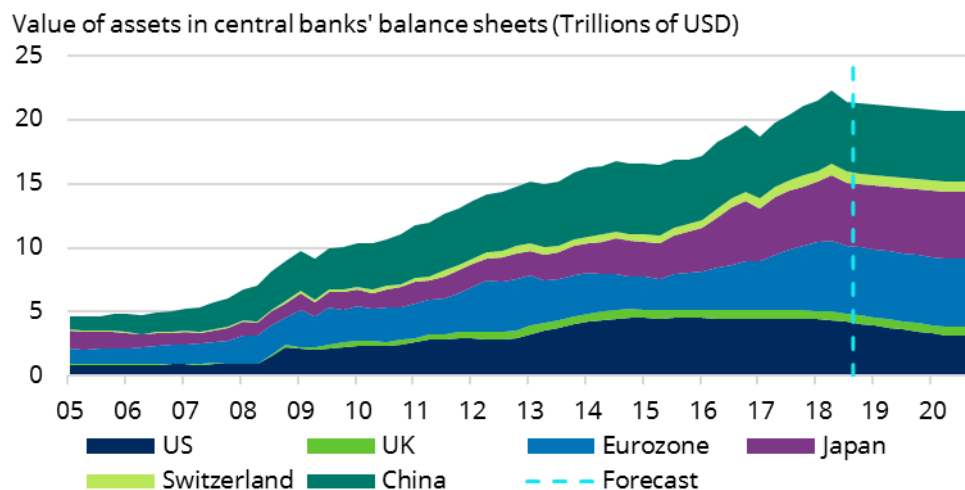
We discuss our outlook for equities below, but first highlight some key themes for 2019.

Theme 1. Liquidity ebbs and exposes the over-leveraged

Going forward, global liquidity is likely to slow further as, alongside a continuation of the Fed's QT, the European Central Bank brings its asset purchase programme to an end, as confirmed at its last policy meeting. These moves mean that the Bank of Japan is the only central bank actively engaged in QE in 2019. Intervention by the People's Bank of China and the Swiss National Bank in foreign exchange markets may continue, but the net result is that the overall level of liquidity is set to ebb in 2019 (see chart 13).

Central bank liquidity to peak

Chart 13: Global liquidity set to fall



Source: Thomson Reuters Datastream, Schroders Economics Group, 20 December 2018.

The question is how much impact will this have on bond yields? We never expected bond yields to return to pre-QE levels given the changes in the world economy since the policy began. The slowdown in productivity and greater regulation of the banking system mean equilibrium real rates will be lower. Furthermore, central banks will still have some control over the curve via short-term policy rates and forward guidance.

Nonetheless, we had expected a greater impact from Fed QT in 2018 and as US Treasury yields rose earlier in the year this appeared to be playing out. However, more recently Treasury yields have fallen back and although higher than at the start of the year, with 10-year yields currently below 3% the impact has been less than we expected.

The flow of funds data suggests that this reflects increased demand for Treasuries from households, private sector pension funds and government retirement funds. Overseas buyers have also contributed. Higher yields have no doubt helped, but the appetite for Treasuries has proved greater than expected particularly from those with long-term liabilities.

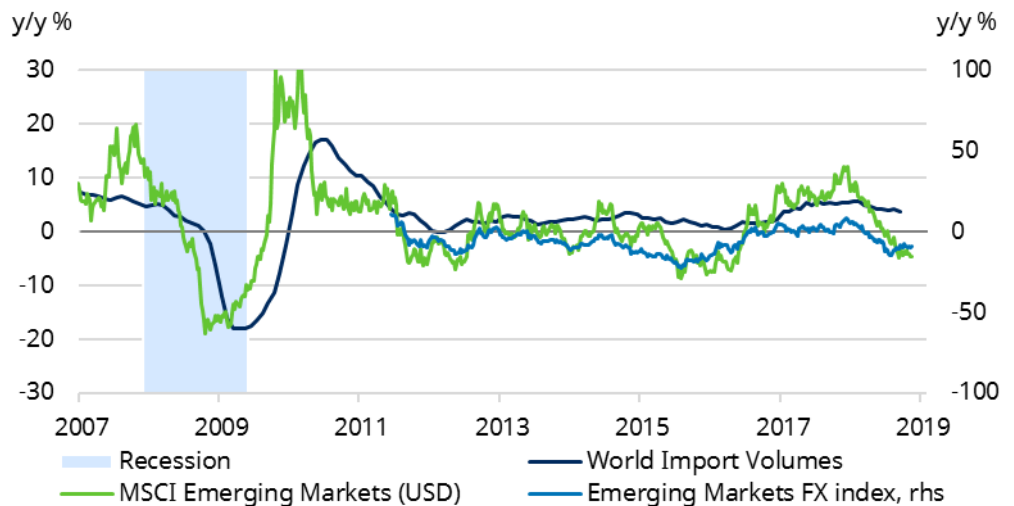
The end of the ECB's asset purchase programme will be another test for the bond markets as the central bank has had a significant impact, in markets where it was by far the largest buyer. We would expect upward pressure on yields; however, it would seem that the impact would be felt most by those outside the region, who benefited from the original asset purchase programme as investors moved out of core European markets. That means peripheral eurozone, some emerging markets and also lower grade corporate credit. The riskier areas tend to suffer as liquidity tightens as we have seen in emerging markets in 2018: as Warren Buffett said "It is only when the tide goes out that you discover who's been swimming naked".

Theme 2. The return of emerging markets

It may seem odd following on from theme 1, but emerging market assets can make a comeback in 2019. Tightening global liquidity and trade wars will not help; however, if our forecast is correct and the Fed decides to pause the tightening cycle in June 2019, there is a good argument to be made for the dollar to weaken. This would relieve the pressure on dollar borrowers and emerging markets. Arguably, those markets may already be discounting the worst, with both equities and foreign exchange having fallen significantly (chart 14).

Emerging markets are discounting a slower environment

Chart 14. Emerging market assets are pricing a weaker trade environment



Source: Thomson Reuters Datastream, Schroders Economics Group, G0008, 2 January 2019.

Macro developments will be important though and it may well need another bout of monetary and fiscal stimulus from China to be the catalyst for investors to return to the region. This would help to alleviate concern over another collapse in global trade as seen in 2007-08. However, whilst US-China trade will slow, unless the trade war goes global there is no reason to expect an outright contraction in trade as activity should be diverted elsewhere.

Theme 3. Populist pressures means governments turn to fiscal policy

The past year has reminded us how weak underlying growth in the world economy has become. The phrase “secular stagnation” is being heard again. Without the engine of US or Chinese demand, global activity tends to slow to a pace well below pre-crisis norms. Europe and Japan tend to blow with the global trade winds rather than generate their own domestic demand.

The US outperformed in growth terms in 2018 as a result of President Trump's fiscal policy stimulus. Others are taking note. The most striking example has been in France, where President Macron caved in to populist demands for lower taxes after several days of riots. Italy has been subject to more rigour from the European Commission, but has now gained agreement for a more expansionary budget in 2019. The UK is planning a fiscal boost in the event of a hard exit from the EU. Meanwhile, as mentioned above, look out for more fiscal policy stimulus in China. Japan may well be the exception with an increase in the consumption tax scheduled for October 2019. However, even here measures are being taken to offset the impact and following the announcement of the FY19 budget it looks like increased spending will offset the extra revenue.

The key point is that governments seeking growth are no longer making economic reforms to increase competition or make labour markets more flexible. The approach today is to deliver a quick fix through a tax cut, increased public spending or regulation such as a rise in the minimum wage rate. Some of these measures are warranted and overdue, but governments are no longer strong enough to withstand populist pressures for a fiscal solution. This will mean greater public borrowing as the US is already finding with the budget deficit approaching 4% of GDP this year, which is remarkable for an economy with its lowest rate of unemployment since 1969. At this stage of the cycle the budget should be close to balance if not in surplus.

Governments looking for a quick fix are turning to fiscal policy

How are these themes likely to shape market performance in 2019?

Coming back to our review of the factors behind the weakness of markets this year: growth concerns and tighter liquidity. Clearly we still have concerns about the latter (theme 1), but recognise that governments will look to offset the macro effects through fiscal policy (theme 3).

On the growth front, our base case forecasts for 2019 are slightly below consensus and we see trade tensions rumbling on, suggesting that concerns over activity will persist. However, markets may already be pricing in much of the bad news with historic price earnings multiples now below their rolling averages (chart 15). This of course is no guarantee of positive returns in 2019, but means that markets are better positioned for disappointment and hence potentially more resilient to shocks than this time last year.

Chart 15. Equity markets have de-rated

Global equity market PE (MSCI)



Emerging Markets PE (MSCI)



Source: Thomson Reuters Datastream, Schroders Economics Group, G0042, 2 January 2019.

Black swans

This is an opportunity to think the unthinkable. We already use scenario analysis to calibrate the known unknowns. Black swans, however, are the unknown unknowns. By definition, we cannot anticipate them. However, we can think of four events which are plausible, but not being given much weight by markets.

Eurozone crisis 2

As argued above, the single currency area will feel the effect of tighter liquidity as the ECB ends QE. The worst outcome would be another Greek-style crisis. However, it is not clear that Europe has the mechanisms to prevent such an occurrence as it is yet to complete the banking union and is not a fiscal union. President Macron has proposed a fund to support growth in such circumstances, but this has yet to be created.

Peripheral bond markets have breathed a sigh of relief with the recent agreement on the Italian budget for the coming year, but the drama is likely to play out again in 2019 given the aims of the populist coalition. Any signs of crisis would cause the ECB to delay rate rises and even restart QE, but remember that it is often only through a crisis that the EU makes progress by creating the necessary support for reform.

The eurozone does not have the mechanisms to contain a crisis

Trump may have other plans

No Brexit

This seems inconceivable given the time and energy currently being poured into sorting a withdrawal agreement. However, “no Brexit” is the only outcome that will not require a vote and with MPs seemingly hell bent on rejecting the current deal on offer and the EU refusing to talk further, there must be a possibility that the government cancels Article 50 and stays in the EU. It could certainly become a bargaining chip if PM May needs to win over the Commons.

Military action

There are plenty of hot spots which could ignite in 2019. The proxy war in the Middle East could become an actual war between Saudi Arabia and Iran. China has ambitions for Taiwan and across the region. The recent departure of defence secretary James Mattis indicates a more isolationist US, creating opportunities for others to fill the void. If Trump was to fully destabilise the UN, then Russian adventurism could return.

Trump does not run for re-election in 2020

Although it is often difficult to read the president's intentions, he appears to be constantly campaigning and setting himself for a second term. However, he will have to see off the Mueller investigation on involvement with Russia in the 2016 election. Furthermore, he is already the oldest person to be elected president, taking office at the age of 70 and would be 78 if he served a whole second term. Health may be a factor. Or, he could simply decide to do something else: there has been talk of him founding a media empire – Trump TV anyone?

Schroders Economics Group: Views at a glance

Macro summary – January 2019

Key points

Baseline

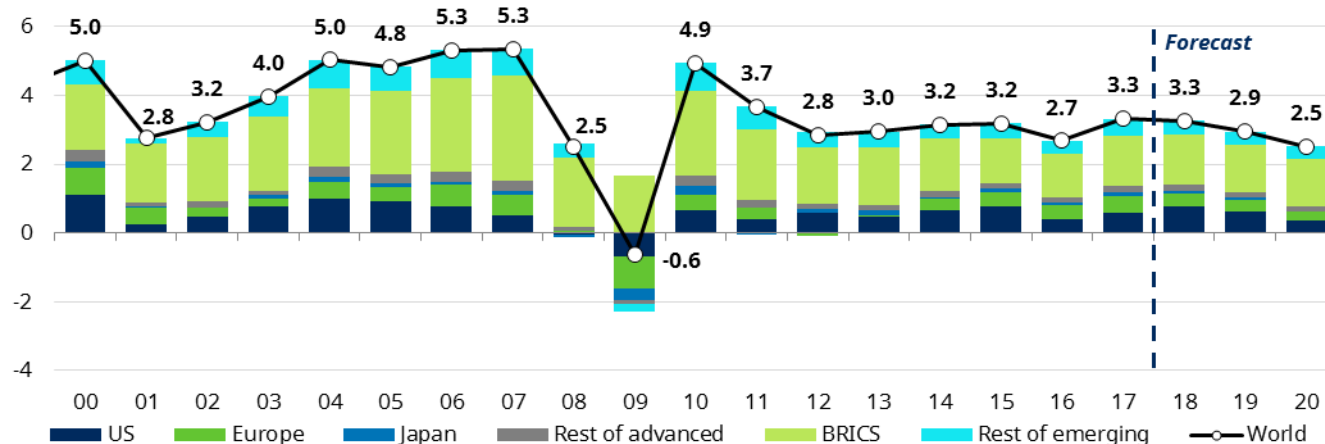
- Global growth is expected to reach 3.3% in 2018, before moderating to 2.9% in 2019 and 2.5% in 2020. Inflation is forecast to rise from 2.3% in 2017 to 2.9% in 2018 and 2019, then falling to 2.7% in 2020. Meanwhile we continue to expect an escalation of the US-China trade war next year.
- US growth is forecast at 2.9% in 2018 and 2.4% in 2019. With core inflation rising, we expect two rate hikes in 2019, taking the Fed funds to a pause at 3% by mid-2019. However, as US fiscal stimulus fades and the economy slows to 1.3% 2020, the Fed is forecast to cut rates twice. The Fed should halt quantitative tightening in 2020.
- Eurozone growth is forecast to moderate from 1.9% in 2018 to 1.6% in 2019 as the full effects from the US-China trade war hits European exporters. Inflation is expected to remain under 2%, with higher energy price inflation in 2018 replaced by higher core inflation in 2019. The ECB is likely to end QE this year, before raising interest rates twice in 2019 and twice again in 2020. The refinancing rate is forecast to reach 1% and the deposit rate to reach 0.5% by the end of 2020.
- UK growth is likely to pick up to 1.4% and 1.5% in 2019 and 2020 from 1.2% this year. The risk of a no-deal Brexit should mean that the deal passes parliament ahead of a transition period that preserves the status quo of single market and customs union membership. Inflation is expected to fall to 1.8% in 2019 thanks to an expected rise in sterling, but stronger growth is expected to push inflation up to 2.1% in 2020. Meanwhile, staying on hold for the rest of 2018, the BoE is expected to hike twice in 2019 and twice in 2020 (to 1.75%).
- Growth in Japan should stay fairly constant in 2019 at 1% from 0.9% this year, however activity should be volatile owing to the consumption tax hike. A slow recovery should follow resulting in no growth in 2020. Despite or expectation for much lower inflation in 2019, we expect the BoJ to make another tweak to yield curve control next year and ultimately raising rates to 0% at the end of 2020.
- Emerging economies should slow to 4.5% in 2019 and 2020 from 4.8% this year. We are optimistic that for most of the BRIC economies domestic factors can outweigh global problems in 2020. But China should continue its secular decline, exacerbated by trade wars and the PBoC should continue to ease.

Risks

- Risks are tilted toward stagflation with the highest individual risk going on the deflationary US recession 2020 scenario where the Fed overtightens in 2019. An outcome which would probably see a vacancy for the chair of the Fed.

Chart: World GDP forecast

Contributions to World GDP growth (y/y)



Source: Schroders Economics Group, 26 November 2018. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2017	2018	Prev.	Consensus	2019	Prev.	Consensus	2020
World	100	3.3	3.3	(3.3)	3.2	2.9	↓ (3.1)	3.0	2.5
Advanced*	61.4	2.2	2.3	(2.3)	2.3	1.9	↓ (2.0)	2.0	1.3
US	26.5	2.2	2.9	↑ (2.8)	2.9	2.4	(2.4)	2.6	1.3
Eurozone	17.2	2.4	1.9	↓ (2.0)	1.9	1.6	↓ (1.7)	1.6	1.2
Germany	5.0	2.5	1.6	↓ (1.9)	0.0	1.4	↓ (1.7)	1.5	1.3
UK	3.6	1.7	1.2	(1.2)	1.3	1.4	↑ (1.3)	1.5	1.5
Japan	6.7	1.7	0.9	↓ (1.0)	0.9	1.0	(1.0)	1.1	0.0
Total Emerging**	38.6	5.1	4.8	↓ (5.0)	4.8	4.5	↓ (4.8)	4.6	4.5
BRICs	25.3	5.7	5.7	↓ (5.8)	5.7	5.5	↓ (5.6)	5.6	5.4
China	16.7	6.9	6.6	(6.6)	6.6	6.2	(6.2)	6.3	6.0

Inflation CPI

y/y%	Wt (%)	2017	2018	Prev.	Consensus	2019	Prev.	Consensus	2020
World	100	2.3	2.9	↑ (2.8)	2.9	2.9	↑ (2.7)	2.7	2.7
Advanced*	61.4	1.7	2.1	↓ (2.2)	2.0	2.0	↓ (2.1)	1.8	1.9
US	26.5	2.1	2.6	↓ (2.8)	2.5	2.7	↑ (2.6)	2.1	2.4
Eurozone	17.2	1.5	1.8	(1.8)	1.8	1.6	(1.6)	1.6	1.5
Germany	5.0	1.7	1.9	(1.9)	1.9	1.8	(1.8)	1.9	1.7
UK	3.6	2.7	2.5	↑ (2.4)	2.5	1.8	↓ (2.2)	2.1	2.1
Japan	6.7	0.5	1.0	↑ (0.9)	1.0	0.5	↓ (1.3)	0.9	1.1
Total Emerging**	38.6	3.3	4.2	↑ (3.7)	4.2	4.2	↑ (3.7)	4.0	4.0
BRICs	25.3	2.2	2.7	(2.7)	2.8	3.3	↑ (3.2)	3.0	3.0
China	16.7	1.6	2.2	↑ (2.1)	2.2	2.6	↑ (2.4)	2.3	2.4

Interest rates

% (Month of Dec)	Current	2017	2018	Prev.	Market	2019	Prev.	Market	2020	Market
US	2.50	1.50	2.50	(2.50)	2.80	3.00	(3.00)	2.66	2.50	2.51
UK	0.75	0.50	0.75	(0.75)	0.91	1.25	(1.25)	1.10	1.75	1.23
Eurozone (Refi)	0.00	0.00	0.00	(0.00)	-0.31	0.50	(0.50)	-0.25	1.00	-0.04
Eurozone (Depo)	-0.40	-0.40	-0.40	(-0.40)	-0.31	0.00	(0.00)	-0.25	0.50	-0.04
Japan	-0.10	-0.10	-0.10	(-0.10)	0.05	-0.10	(-0.10)	0.08	0.00	0.09
China	4.35	4.35	4.35	(4.35)	-	4.00	(4.00)	-	3.50	-

Other monetary policy

(Over year or by Dec)	Current	2017	2018	Prev.	2019	Prev.	2020
US QE (\$Tn)	4.2	4.4	4.0	(4.0)	3.4	(3.4)	3.1
EZ QE (€Tn)	2.4	2.2	2.4	(2.4)	2.4	(2.4)	2.4
UK QE (£Bn)	435	435	445	(445)	445	(445)	445
JP QE (¥Tn)	545.5	521	552	↑ (549)	572	↑ (563)	592
China RRR (%)	15.50	17.00	14.00	↓ 15.00	12.00	↓ 14.00	11.00

Key variables

FX (Month of Dec)	Current	2017	2018	Prev.	Y/Y(%)	2019	Prev.	Y/Y(%)	2020	Y/Y(%)
USD/GBP	1.27	1.35	1.35	↑ (1.30)	-0.2	1.42	↑ (1.35)	5.2	1.38	1.4
USD/EUR	1.14	1.20	1.16	↑ (1.14)	-3.4	1.21	↑ (1.18)	4.3	1.25	1.2
JPY/USD	109.7	112.7	112	↑ (110)	-0.6	110	↑ (108)	-1.8	108	-1.8
GBP/EUR	0.90	0.89	0.86	↓ (0.88)	-3.2	0.85	↓ (0.87)	-0.8	0.91	0.9
RMB/USD	6.87	6.51	7.05	↑ (6.90)	8.3	7.20	↑ (7.00)	2.1	7.40	7.0
Commodities (over year)										
Brent Crude	53.1	55	73.6	(73.6)	34.1	71.7	↓ (73.2)	-2.5	68.1	-5.1

Source: Schroders, Thomson Datastream, Consensus Economics, January 2019

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data as at 31 December 2018.

Current forecast updated November 2018. Previous forecast refers to August 2018.

* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

** **Emerging markets:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

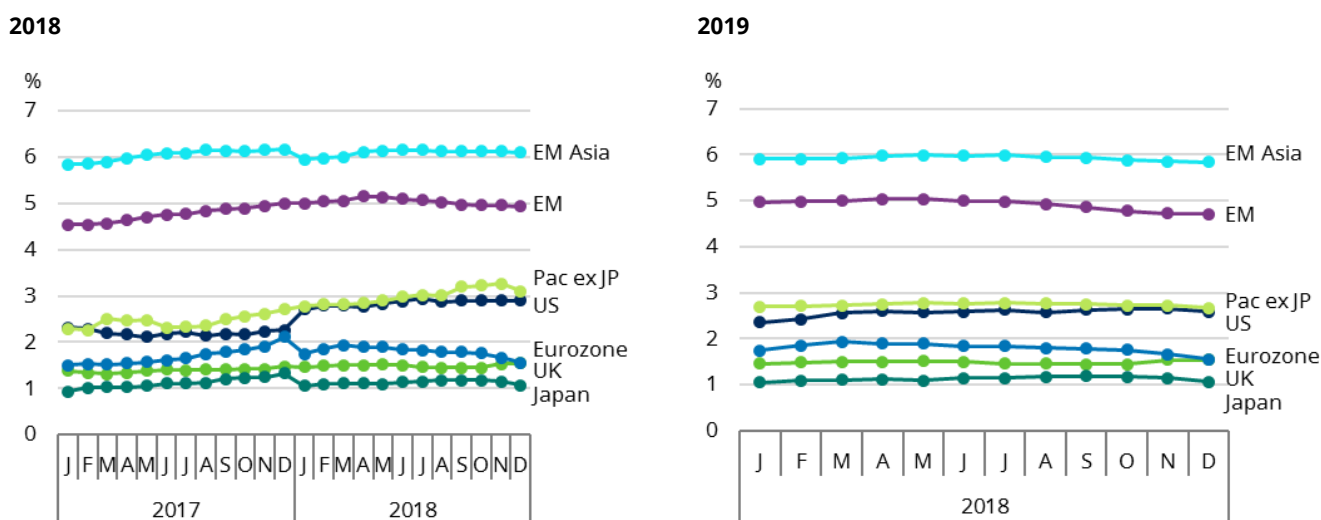
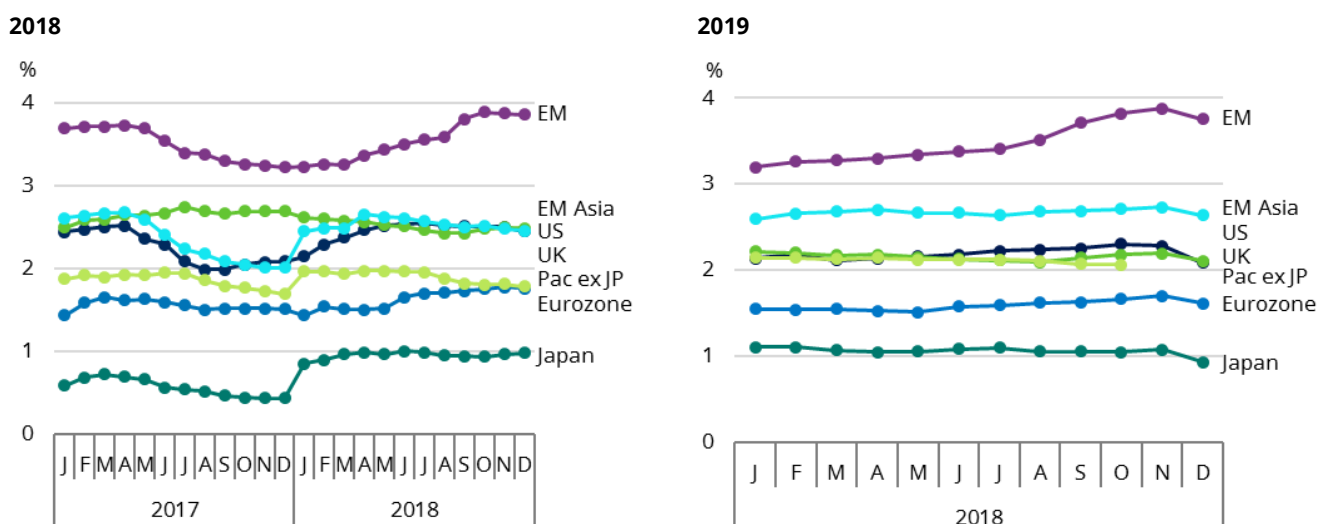


Chart B: Inflation consensus forecasts



Source: Consensus Economics (2 January 2019), Schroders.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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