

A good year lies ahead – and a weak decade

The investment prospects for next year aren't bad. But the next decade doesn't look anything like the past one.

“ We do not expect an economic or a market slump, though we can't completely rule it out either. We therefore enter the new year with cautious optimism. ”

Stefan Kreuzkamp
Chief Investment Officer



A new year begins and also a new decade that will bring fresh uncertainties and challenges. One thing that looks certain is that the pace of change will increase in technology, in the economy and perhaps in politics, too. We believe technology will also be a prime mover of change in our industry, not only changing the way we work but also bringing a raft of additional regulatory changes. Our core business, responsible asset management, has been challenging in this past decade dominated by low inflation, quantitative easing, low bond yields and inflated asset prices. Now we have to ask ourselves what growth potential the world and its different regions may have over the next ten years, where interest rates, inflation and markets will head, and where, too, the world is heading socio-politically.

The uncertainties are great and we want to make clear that our expectation is that the conditions that have proven so favorable to financial assets in the past decade are unlikely to persist. In the next decade, we do not expect to be able to achieve as good returns as in the past one.

Here in the Quarterly CIO View, however, our focus is only on the next one to two years. The "only" is not intended to suggest that even this relatively near-term forecast is at all easy, though.

The past year is set to become one of the best for investors in a long time. We had not expected that but we were right to be concerned about how Brexit, the U.S.-China trade dispute and U.S. corporate earnings would play out. Corporate earnings are, in fact, beginning to look even worse than we predicted: and by year-end there could well be zero year-on-year growth for 2019 and consensus earnings estimates for 2020 are still being revised down further. The S&P 500's upward move by nearly a quarter since the beginning of the year¹ might therefore be due to three particular factors:

1. Fears of recession, which had been fanned by the inversion of the yield curve (between 2-year and 10-year U.S. government bonds) in August, subsided in late autumn.
2. Political fears have also eased a little as the year comes to a close with the risk of a disorderly Brexit declining and the U.S.-China trade dispute at least not looking likely to get worse.
3. The decisive factor, however, was probably the surprisingly loose U.S. Federal Reserve (the Fed). The Fed didn't just refrain from further interest-rate hikes, it cut rates. In addition, it announced in March that from September onwards it would not let its balance sheet shrink further. And in the wake of September's repo-market turmoil, it even injected fresh billions into the system. Other central banks, such as the European Central Bank (ECB), also became more expansionary.

¹ As of 11/19/19

Therefore cynics could easily say that their suspicions have been confirmed this year: an over-indebted world just can't take higher interest rates and the central banks are there again, ready and willing to bail out the global economy or capital markets should either begin to get the shakes. Given the strength of the U.S. dollar and very low U.S. government-bond yields, another cynical view might also be gaining ground: that the U.S. can live beyond its means and pile up as much debt as it wants. It just doesn't matter because America doesn't have to pay its way, it can always print the money it needs to meet its obligations. This argument, however, though it may work in the short term, looks highly questionable in the long run. And trust in the invincibility of the dollar and Treasuries looks all the more dubious given the current protectionist policies of the U.S. administration, which continues to break away from multilateral agreements. But predicting just when the dollar will begin to weaken as a result of deteriorating foreign policy and twin budget and trade deficits can be just as difficult an art as forecasting when the years of monetary expansion may produce inflation. Predicting one or the other can leave you looking foolish for a long time – before history finally vindicates you.

We are not predicting either dollar weakness or soaring inflation in 2020. Instead, we believe the central banks will keep the music the same and investors are likely to continue to dance to the loose money waltz. But not quite as quickly. In our view, markets won't do as well as in 2019. After all, investors have been dancing to the same tune for a very long time and are getting tired.

Next to easy money it is, however, global economic growth that might help to keep them on the dance floor. We expect growth to be at the same level in 2020 as in 2019 – 3.1%. But we expect returns to drop into the single-digit range in the next twelve months, a level similar to the one we expected a year ago for 2019. Since then, however, equities have become

more expensive, after double-digit price increases despite flat earnings growth. And it is unlikely that central banks can come up with the same positive surprises again in 2020.

Politically, meanwhile, the picture is changing, and probably not for the better. The U.S.-Chinese trade dispute may not have become worse but little real progress has been made. The escalation of the protests in Hong Kong add further complexity. And however the UK election goes, Brexit, or its consequences, will remain on the table in 2020. The consequence of all these uncertainties on both sides of the Atlantic is a growing tendency for companies to put off investment plans. We doubt that states will compensate by implementing fiscal packages. We feel Germany, certainly, is unlikely to, nor do we see the investment gap being filled by China, whose overall economic growth we expect to fall below six percent.

Asia should remain the world's growth engine, and one of our preferred regions, in the coming year, both for equities and bonds. The hunt for bond yield should again drive investors deeper into emerging markets and corporate bonds. In the Eurozone, the ECB, a price-insensitive buyer, is back and should keep demand constantly high.

Given the continuing high level of risk we will incorporate some hedging in our portfolios in 2020, using for example longer-term U.S. government bonds or gold. Irrespective of the strategic asset allocation in our individual portfolios, we will more closely align investments to environmental, social and governance (ESG) criteria in 2020. Our early focus on this issue paid off in 2019, when environmental issues dominated the headlines worldwide. We will continue to expand our ESG efforts, as we cannot and will not ignore the "how" of generating returns.

Look at our forecasts to see our 12-month outlook in numbers.

GLOSSARY

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The **European Central Bank (ECB)** is the central bank for the Eurozone.

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

A **hedge** is an investment to reduce the risk of adverse price movements in an asset.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

An expansionary monetary policy is a type of macroeconomic monetary policy that aims to increase the rate of **monetary expansion** to stimulate the growth of the domestic economy. The economic growth must be supported by additional money supply.

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

A **repurchase agreement (repo)** is a form of short-term borrowing, whereby a dealer commits to repurchase the security shortly after it is sold. The dealer pays the repo interest as remuneration.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The **U.S. Federal Reserve**, often referred to as "the Fed", is the central bank of the United States.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

A **yield-curve inversion** is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.

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