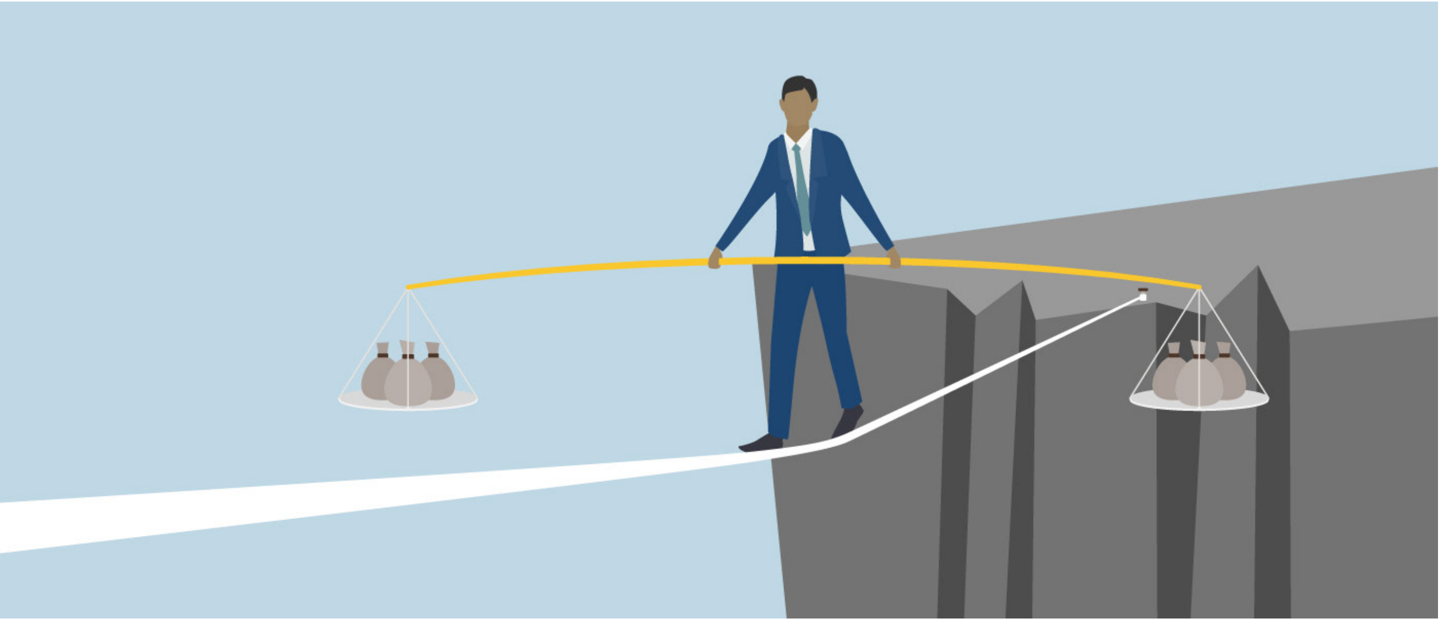
The investment outlook for 2020

Balancing risks, building resilience

Europe | December 2019



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IN BRIEF

- The economic map for 2020 is far from clear. The early months of the year may see a small reprieve in manufacturing activity, but overall global growth is likely to remain constrained by geopolitical uncertainty.
- Risk assets had an optimistic 2019, but stagnating earnings growth means valuations now look less supportive. Given pressure on margins, we struggle to see a significant reacceleration in earnings growth in 2020.
- Central banks are likely to remain a key pillar of market support, given their demonstrated willingness to push deeper into uncharted policy territory to keep the expansion going.
- Against this backdrop, we favour a regionally neutral, defensive equity allocation. Government bonds still have a role to play as insurance, despite low yields, but we believe investors should also consider other diversifiers, such as infrastructure and macro funds.
- Given the binary nature of some of the political risks, investors may wish to consider some allocation to assets in emerging Asia that are likely to benefit if trade uncertainty resolves.
- Inflation appears to be off the cards for now, but any resurgence would likely upset the price of both stocks and bonds, so real assets could provide a useful portfolio buffer.
- We expect the focus on sustainability to continue to grow, with potential regulatory and policy responses having wide-ranging investment implications.

J.P.Morgan Asset Management

WHERE ARE WE IN THE CYCLE?

A view on asset allocation is often rooted in an assessment of where we are in the cycle. Early in the cycle, valuations are cheap, policy accommodative and the economy has ample spare capacity to grow. It's often a good time to take risk.

Conversely, late cycle is usually a good time to take chips off the table. When the economy is displaying signs of exuberance or overheating, higher interest rates usually put an end to the party.

It's proving much harder to navigate markets today based on an assessment of the cycle. The map is far from clear. Unemployment rates – often a key navigation tool – are near record lows in most parts of the developed world, suggesting the economy is very late cycle. However, there are very few other signs of classic late-cycle economic exuberance. Neither business nor consumer spending looks toppy. Indeed, the US consumer is looking remarkably prudent: the savings rate, which often falls sharply late in the cycle, is pretty high (Exhibit 1).

And inflation is certainly not suggesting the global economy has reached its limits. In fact, central banks are preoccupied with the idea that inflation remains too low and may be getting stuck. Rather than trying to tame the expansion, the primary focus for central banks is how to gee it up.

This makes it very hard to say confidently how much time is left on the economic clock.

A resolution in the US-China trade conflict, a Brexit solution, and an easing of tensions in Hong Kong, Chile and Turkey could fuel a turnaround in business sentiment and a reacceleration in activity in 2020. Against a backdrop of muted inflation, interest rates could stay low. This would be a good environment for risk assets.

But it is more likely, in our view, that geopolitical risk will linger. We think the trade conflict is unlikely to be fully resolved. Surveys suggest the US electorate believes the president is right to address unfair trade practices, while on certain areas of the disagreement – such as China's state-led subsidies for its tech sector – there is seemingly no common ground. China believes in industrial policy, the US does not.

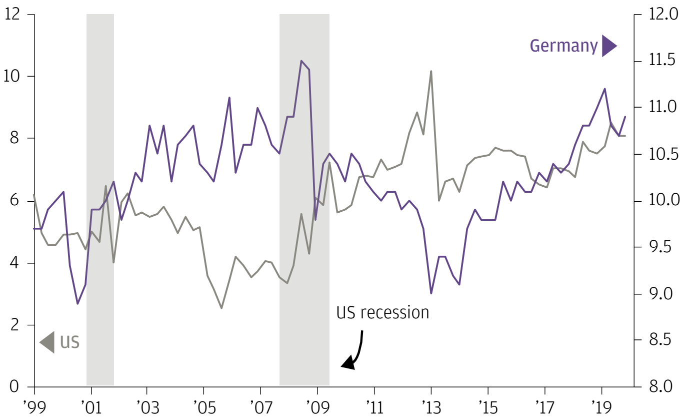
The US administration does seem to appreciate that it needs to get the balance right between keeping the agenda alive and not damaging the US expansion, hence the recent more conciliatory tones. We'll see in the coming months whether this more measured approach does much to boost corporate sentiment. Companies have been spooked, and are likely to remain reluctant to invest, which will limit the extent to which manufacturing bounces back through the course of 2020. This reluctance appears to be filtering into hiring intentions.

If geopolitical tensions linger but don't re-escalate, we should be facing a slowing rather than a stalling economy. But that is a big 'if'. Our newly established health monitor (Exhibit 2) highlights the key indicators of US economic activity and will help us track the risks in the coming months.

EXHIBIT 1: HOUSEHOLD SAVING RATES AND INFLATION EXPECTATIONS

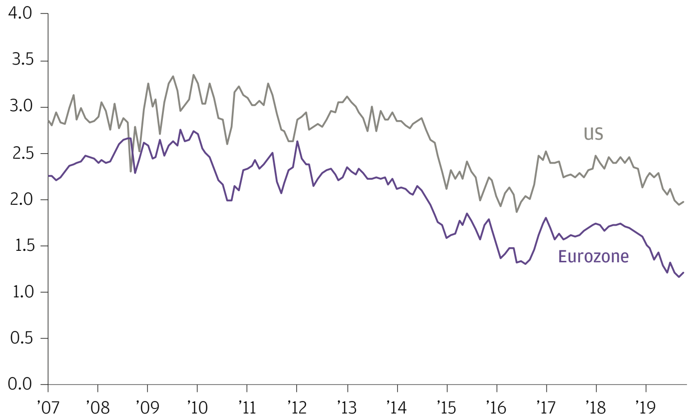
Household saving rates

% of disposable income



Market-based inflation expectations

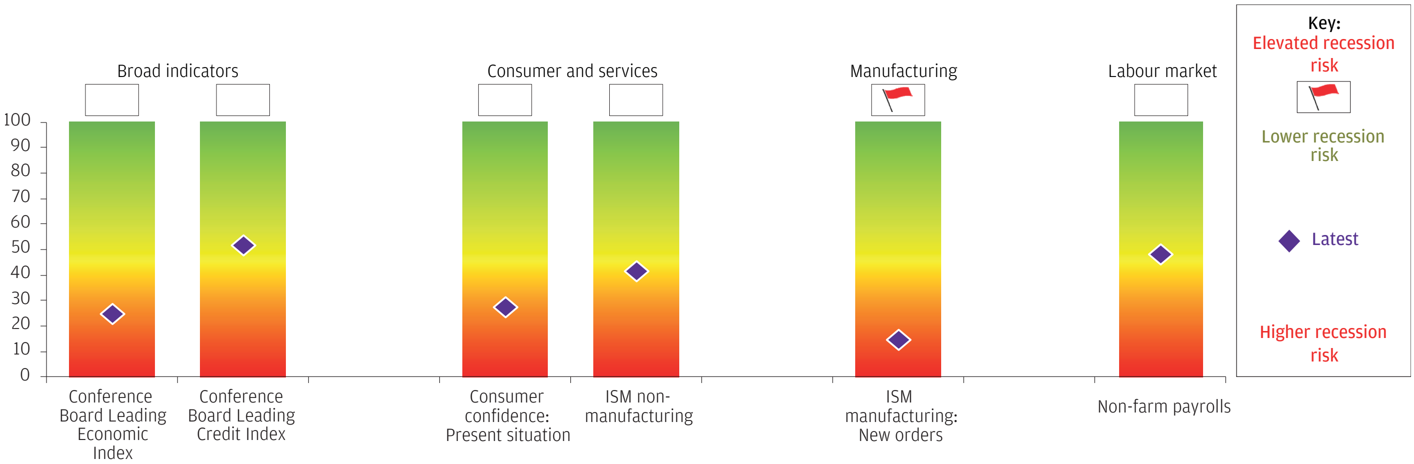
%, 5y5y inflation swap



Source: (Left) BEA, Deutsche Bundesbank, Refinitv Datastream, J.P. Morgan Asset Management. (Right) Bloomberg, J.P. Morgan Asset Management. 5y5y inflation swap represents the market's expectation of five-year average inflation, starting in five years' time. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Past performance is not a reliable indicator of current and future results. Data as of 25 November 2019.

EXHIBIT 2: US ECONOMIC HEALTH MONITOR

Percentile rank relative to historic data since 1990



Source: BLS, Conference Board, ISM, Refinitiv Datastream, J.P. Morgan Asset Management. Elevated recession risk flags are shown when the underlying indicator is at a level consistent with the onset of any of the past three US recessions, as determined by NBER. Transformations used for each of the indicators are: % change year on year for the Leading Economic Index and consumer confidence present situation, index level for Leading Credit Index, ISM non-manufacturing and ISM manufacturing new orders, and three-month moving average of monthly absolute change for non-farm payrolls. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 26 November 2019.

HOW WILL THE US ELECTION AFFECT MARKETS?

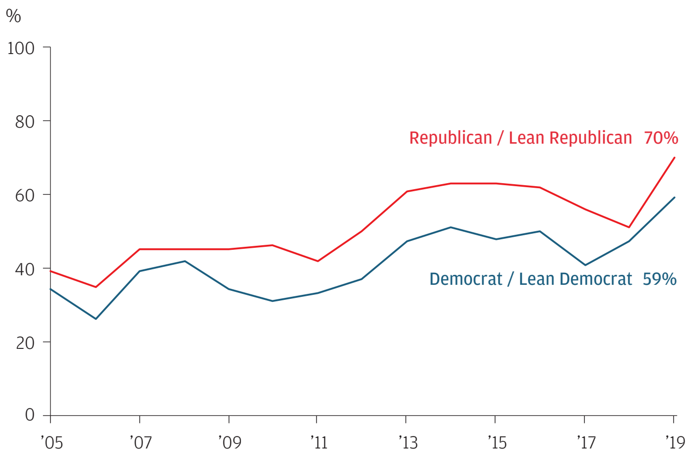
The political event of the year will be the presidential election on 3 November. While it seems highly likely that Donald Trump will have the Republican nomination, there is much less clarity over who will lead the Democrats. There are currently three frontrunners for the nomination: Joe Biden as the more centrist candidate, and Elizabeth Warren and Bernie Sanders from the left wing of the party. Warren and Sanders are advocating some radical policy changes, including an overhaul to the health care system, breaking up big banks and tech firms, banning fracking, and imposing wealth taxes and higher corporate taxes. Biden's proposed policies are comparatively moderate, but still include reversing the 2017 tax cuts. Pete Buttigieg and Kamala Harris, two other candidates, are currently less favoured, but worth watching. And it is not yet clear exactly how the late entry of Michael Bloomberg may influence the race for the Democratic nomination. Support can swing wildly during the process – for example, Barack Obama overturned a significant lead in the polls for Hilary Clinton to win the Democratic nomination and ultimately the 2008 election.

We should have a much clearer picture of who the Democratic nominee is likely to be by the end of March, when two-thirds of the primary results (by the number of delegates) are known. The primaries are followed by the respective party conventions, when the candidates are officially selected. Then it's to the presidential debates in September and October, before the US electorate finally casts its votes on 3 November (see **Exhibit 3** for a timeline of key events).

Who is likely to win? History strongly favours the incumbent: three-quarters of sitting presidents have been re-elected, looking at elections going back to 1932. An incumbent president has never failed to win re-election unless a recession has occurred during their time in office, which perhaps explains the president's more conciliatory recent tone on trade. But President Trump's approval ratings are lower than those of other re-elected presidents were at this point in the election cycle.

It is worth bearing in mind that the impact that any president can have on the economy and market depends on their ability to enact legislation. To be able to put in place more controversial policies, control of both the House of Representatives and the Senate is necessary. It is difficult to see President Trump regaining control of the House of Representatives, were he to win. Similarly, it is difficult to see the Senate shift to a Democrat majority. And so a divided Congress appears the most likely outcome. While political gridlock is not an ideal scenario, it may comfort investors to know that it could act as a considerable restraint on some of the more radical proposals on both sides. Regardless of the election outcome, it seems unlikely that the trade conflict with China will be fully resolved – surveys suggest that there remains widespread support among the US electorate to address unfair trade practices (**Exhibit 4**).

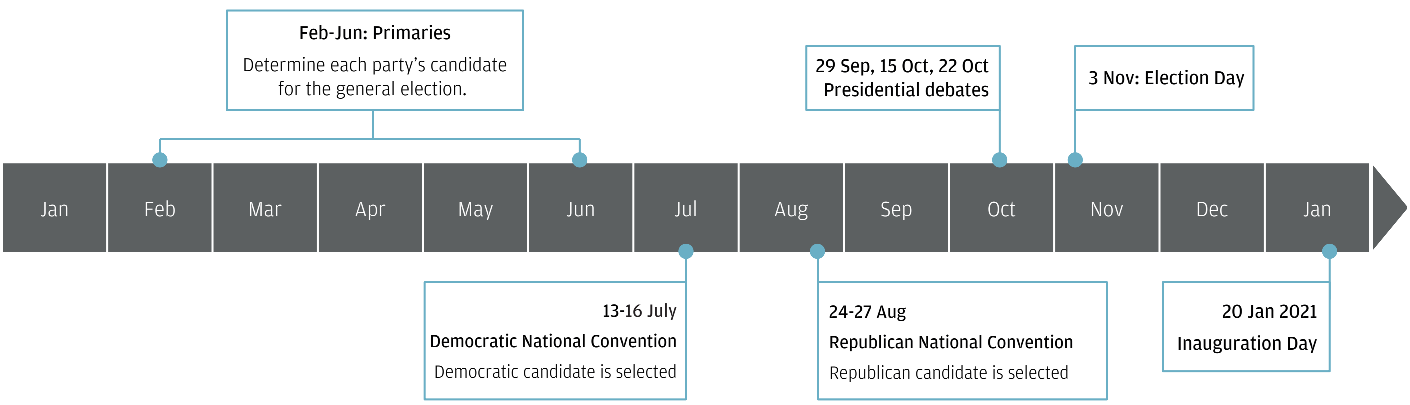
EXHIBIT 4: US VOTERS WHO HAVE AN UNFAVOURABLE OPINION OF CHINA



Source: Pew Research Center (Spring 2019 Global Attitudes Survey), J.P. Morgan Asset Management. *Guide to the Markets - Europe*. Data as of 25 November 2019.

It is hard to say anything concrete about the likely impact of the election on markets. Historically, S&P 500 volatility has typically been higher in election years than in non-election years, as markets frequently reprice the probability of the future administration's policies. Markets have also tended to react more positively in the immediate aftermath of the election of a Republican president, as the party's policies are broadly thought of as more market friendly. But it is important to note that this is by no means a strong rule of thumb, and that other significant geopolitical and economic events may carry more influence over the market's direction.

EXHIBIT 3: US ELECTION 2020 KEY DATES

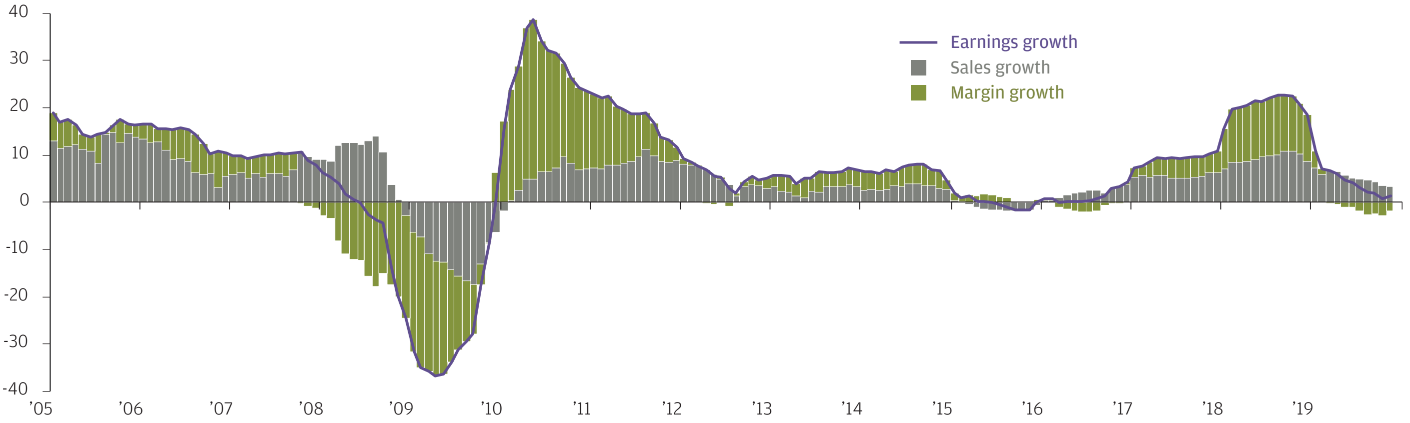


Source: J.P. Morgan Asset Management. As of 25 November 2019.

VALUATION AND MARGIN HEADWINDS

EXHIBIT 5: S&P 500 EARNINGS PER SHARE GROWTH BREAKDOWN

% change year on year, EPS estimates over next 12 months



Source: IBES, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. EPS is earnings per share. Earnings growth breakdown is calculated using IBES consensus estimates for next 12 months' EPS. Past performance is not a reliable indicator of current and future results. Data as of 25 November 2019.

Risk assets appear to be taking a more optimistic view of the world. Most markets have recovered the declines seen late in 2018.

At the same time, earnings have stagnated in most geographies. As a result, valuations, on a forward price-to-earnings basis, are considerably less supportive than they were as we entered 2019, and credit spreads considerably tighter (**Exhibit 6**).

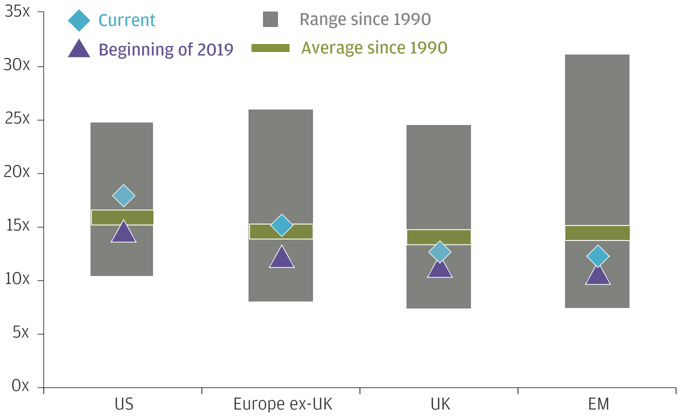
Is earnings growth likely to reaccelerate in 2020? We struggle to see it. Our overall assessment is that corporate earnings will hold up in 2020 in most major regions, but we shouldn't expect too much growth. A key global problem is that tight labour markets are pushing up wage costs, but companies still have little top-line growth as pricing power remains elusive in most industries. As a result, margins are under pressure (**Exhibit 5**).

The risks to this outlook for earnings appear broadly balanced. A re-escalation in trade tensions or margin pressures may lead firms to cut jobs, and the global economy could take a turn for the worse. But we are also mindful that the higher wages that have been squeezing profits in 2019 could in turn lead to higher sales. Declining interest rates may also help ease margin pressures and boost sales. This prevents us from getting overly bearish.

EXHIBIT 6: EQUITY AND CREDIT MARKET VALUATIONS

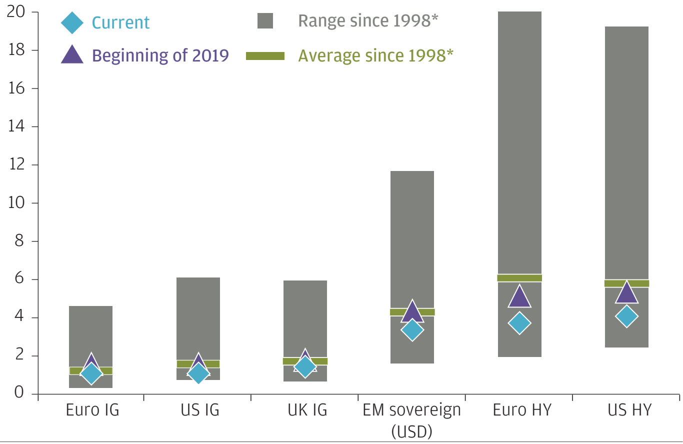
Global forward price-to-earnings ratios

x, multiple



Fixed income spreads

% option-adjusted spread

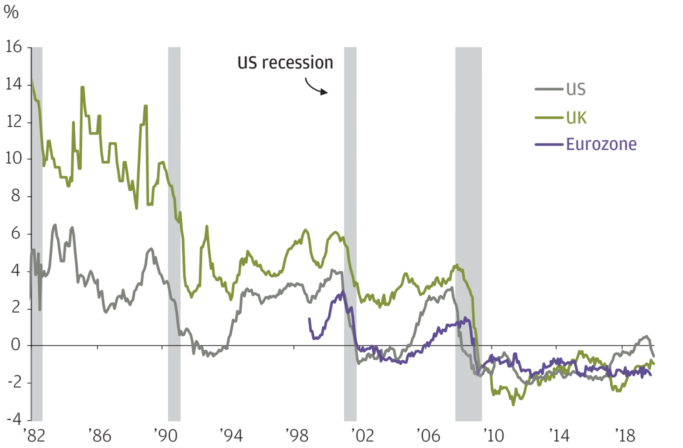


Source: (Left) IBES, MSCI, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. MSCI indices are used for all regions/countries, except for the US, which is represented by the S&P 500. (Right) Bloomberg Barclays, BofA/Merrill Lynch, Refinitiv Datastream, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Euro IG: Bloomberg Barclays Euro Agg. - Corporate; US IG: Bloomberg Barclays US Agg. Corporate - Investment Grade; UK IG: Bloomberg Barclays Sterling Agg.- Corporates; Euro HY: BofA/Merrill Lynch Euro Non-Financial High Yield Constrained; US HY: BofA/Merrill Lynch US High Yield Constrained; EM sovereign (USD): J.P. Morgan EMBI Global. *Ranges and averages are from the beginning of 1998, except for Euro IG and US HY, which are from November 1998 and January 2000, respectively. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 25 November 2019.

DON'T FIGHT THE FED (AND THE ECB, THE BOJ, THE BOE...)

While geopolitical risk has weighed on growth and corporate earnings, central bank activism has helped push risk asset prices higher. Indeed, the central banks have recast themselves from the investor's foe to the investor's friend. In past expansions, the central banks tended to be the recovery-slaying baddies - the players responsible for killing off economic exuberance, and, in turn, expansions (**Exhibit 7**). But it's hard to blame the central banks for the recent slowing in activity. Real policy rates remain deeply negative.

EXHIBIT 7: REAL POLICY RATES



Source: Bank of England, BEA, European Central Bank, Eurostat, ONS, Refinitiv Datastream, US Federal Reserve, J.P. Morgan Asset Management. Real policy rates are calcualted as the nominal policy rate minus the annual rate of core inflation. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Data as of 31 October 2019.

Indeed, central banks are determined to do whatever it takes to keep the expansion going. Having cut interest rates by 75 basis points and injected liquidity to calm tensions in the repo market, the Federal Reserve (Fed) has indicated that policy will pause while the dust settles. The European Central Bank's (ECB's) sizeable package of stimulus included an open-ended commitment to purchase government and high-grade corporate bonds.

The Bank of England (BoE) has been caught in the Brexit headlines for some time, but has indicated some inclination to lower interest rates should the outlook deteriorate. However, an almighty fiscal expansion may end up doing much of the heavy lifting to support the UK economy in 2020.

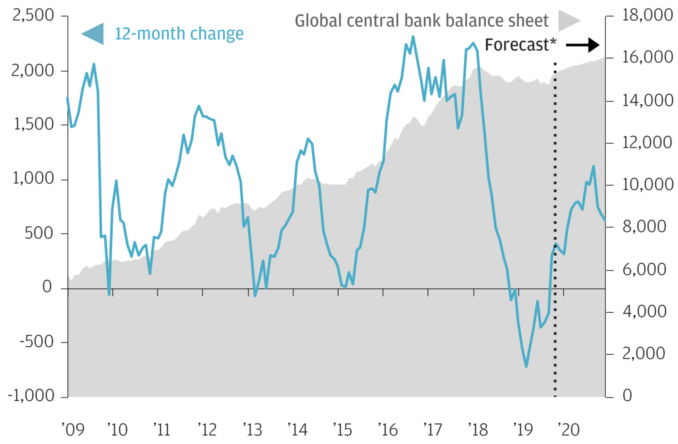
The message to investors from the central banks is clear: should further stimulus be required, it will be delivered. The Fed is under particular political pressure to demonstrate that it is a 'national champion'.

The central banks do not believe they are out of ammunition. They have new innovations up their sleeves. Quantitative easing has now been accepted as a 'normal' tool. Ambitions to return assets to the public markets seem to have been abandoned and central banks have accepted permanently larger balance sheets. Indeed, some are happy to take an increasing share of risk markets. With such large holdings of government and corporate bonds, the Bank of Japan is increasingly focusing its balance sheet expansion on the purchase of corporate equity (**Exhibit 8**).

EXHIBIT 8: GLOBAL CENTRAL BANK BALANCE SHEET AND BANK OF JAPAN EQUITY PURCHASES

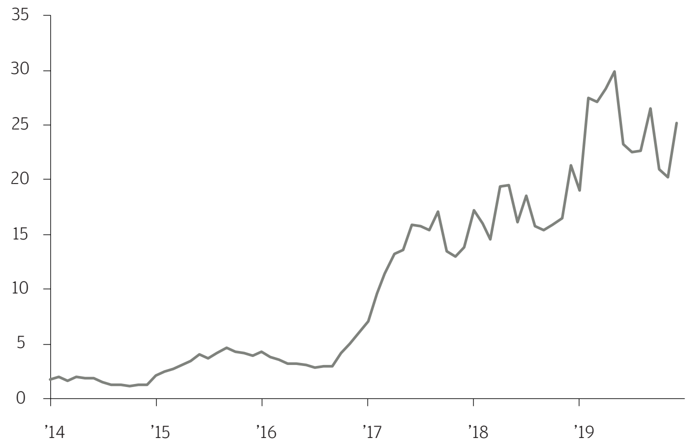
Global central bank balance sheet

USD billions



Proportion of Bank of Japan asset purchases in equities

% of total monthly asset purchases, six-month moving average



Source: (Top) Bank of England (BoE), Bank of Japan (BoJ), European Central Bank (ECB), Refinitiv Datastream, US Federal Reserve (Fed), J.P. Morgan Asset Management. Global central bank balance sheet is the sum of the balance sheets of the BoE, BoJ, ECB and Fed. *Balance sheet forecast assumptions: BoE to have zero net asset purchases over the forecast period; BoJ to have an annualised net asset purchase pace of 20 trillion yen over the forecast period; ECB to have net asset purchases of 20 billion euros per month over the forecast period beginning in November 2019; Fed to increase assets by 70 billion US dollars per month until January 2020, after which assets rise 10 billion US dollars per month over the rest of the forecast period. (Bottom) Bank of Japan, Bloomberg, J.P. Morgan Asset Management. Equities includes ETFs and shares. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2019.

There is also a growing consensus that zero is not the lower bound on interest rates. In theory, this is simply an extension of normal interest rate policy; interest rates are cut to entice savers to spend, but negative interest rates have the added sting in the tail that savers will be penalised if they persist in their prudence. Christine Lagarde, the new president of the ECB, may have little choice but to pursue negative rates further if European activity and inflation fail to pick up. We suspect, however, that her greatest contribution will come from her diplomatic skills, which will be necessary to advance the discussion among policymakers and politicians on the need for both fiscal expansion and further integration.

Whether negative interest rates serve to boost private sector spending remains to be seen. But this may not be the primary channel of transmission. Low interest rates are an enormous cash windfall for governments, and could encourage governments to turn on the fiscal taps. This certainly seems to be playing out in the UK, where austerity has been well and truly declared over.

PORTFOLIO CONSTRUCTION: BALANCING RISKS, BUILDING RESILIENCE

In summary, geopolitical risks are likely to continue to weigh on global corporate earnings, which, from these valuations, is likely to limit the extent of further upside in risk markets. At the same time, central banks are likely to remain active to limit the downside.

Given this backdrop, investors may wish to consider:

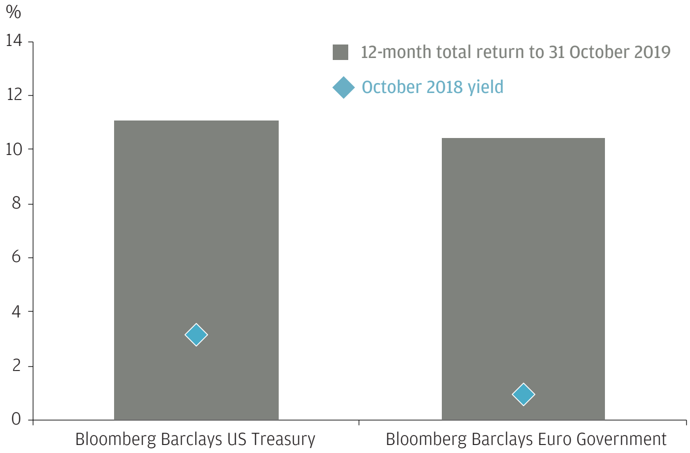
1. An equity allocation that is neutral but inclined towards more defensive stocks

In our view, an equity portfolio more focused on large cap, quality stocks is likely to prove more resilient should the downside risks materialise. Perhaps more controversial is our view that value stocks will also prove more resilient. This is less about value stocks suddenly getting uprated, which would require a reacceleration of growth and the prospect of higher interest rates to lift the financials. Instead, it is our assessment that tech-heavy growth stocks may prove more cyclical than currently expected and thus more vulnerable to a downgrade in earnings expectations. However, if economic growth remains positive but sluggish, then the scarcity of growth may continue to favour the tech-heavy growth markets. Given this two-way risk, and the fact that the US market is tech-heavy, we don't see an argument for a particular regional bias in 2020. It seems more likely that global factors will either lift all boats, or provide equal challenges.

2. A broader approach to diversification

Despite historically low yields, we believe government bonds will still serve their purpose in a portfolio, which is to go up in price when stocks are falling. One of the key lessons of 2019 was that government bonds can still offer robust returns even when the starting yield is low. In October 2018 the euro government bond index yield, at 0.9%, was 2 percentage points lower than the US, but offered a similar return over the coming year (**Exhibit 9**). The 1% yield on the Austrian one-hundred year government bond is the clearest reminder to challenge ourselves when we think yields can't possibly get any lower.

EXHIBIT 9: YIELDS AND TOTAL RETURN OF US AND EURO GOVERNMENT BOND INDICES



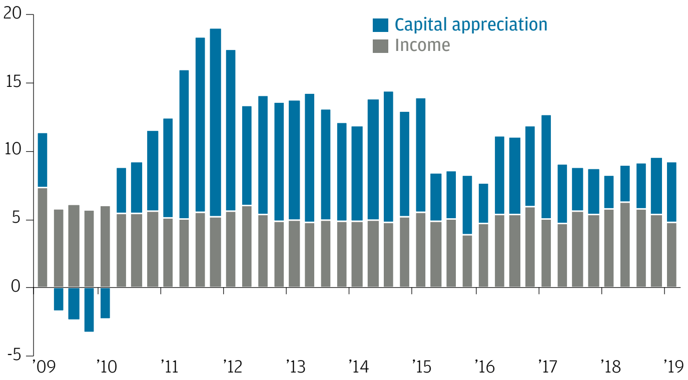
Source: Bloomberg Barclays, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 31 October 2019.

While government bonds still provide insurance, they no longer provide real income. Indeed, negative yields in much of the core market in Europe mean that investors have to pay for the insurance core bonds provide.

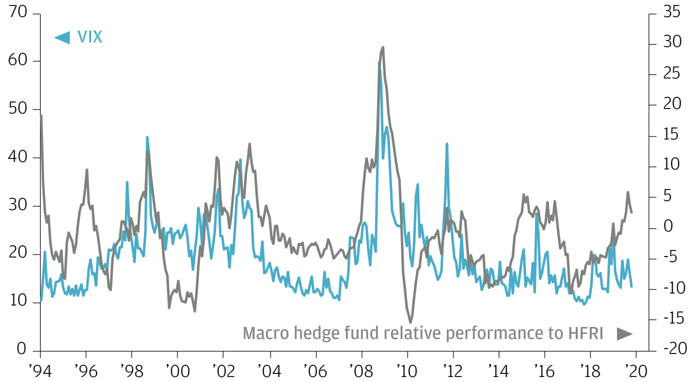
This leaves investors in a difficult quandary. Higher yields can be found, but only with increasing risk. On this basis it is noteworthy that the income on offer in core global infrastructure has remained robust, while yields on investment grade and high yield bonds have been compressed. The income from infrastructure investments has a better chance of cushioning total returns in a downturn, although investors do have to accept the liquidity risk that comes with real assets. Macro hedge funds may also have a role to play in portfolio diversification, given that their dynamic nature means they tend to adapt well in periods of heightened volatility (**Exhibit 10**).

EXHIBIT 10: ALTERNATIVE ASSETS

Global core infrastructure returns
%, rolling 4-quarter returns from income and capital appreciation



Macro hedge fund relative performance & volatility
Index level (LHS); % change year on year (RHS)



Source: (Left) MSCI, J.P. Morgan Asset Management. Infrastructure returns represented by the "low risk" category of the MSCI Global Quarterly Infrastructure Asset Index. Data show rolling one-year returns from income and capital appreciation. The chart shows the full index history, beginning in the first quarter of 2009. (Right) CBOE, Hedge Fund Research Indices (HFRI), Refinitiv Datastream, J.P. Morgan Asset Management. Macro hedge fund relative performance is calculated relative to the HFRI fund weighted hedge fund index. VIX is the implied volatility of S&P 500 Index based on options pricing. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 31 October 2019.

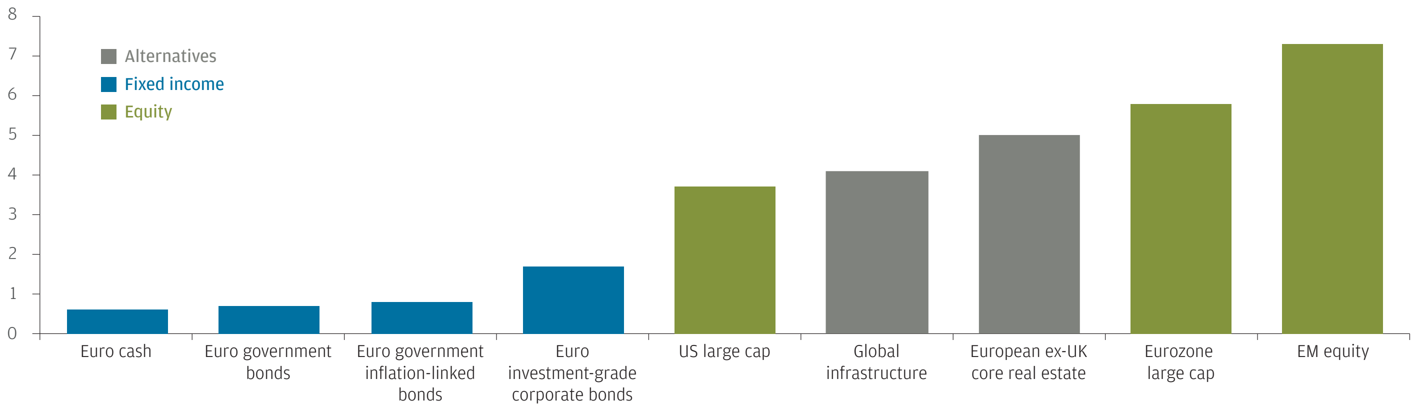
3. An eye on the upside

While our base case is more pessimistic, it is not outside the bounds of possibility that the geopolitical backdrop could improve in 2020. In which case, it makes sense to have some allocation towards areas of the market that would be the biggest beneficiaries (much like how an allocation to core bonds would work if the downside risks materialised). In our view, emerging Asia would see the most significant upside in the event of a trade resolution.

Even if this short-term view doesn't play out, investors may need to consider the investment opportunities in parts of the emerging world to bolster long-term returns. Quite simply, very few parts of the developed world have the capacity to deliver growth in excess of 2% because of demographic headwinds. The emerging world – particularly China – is not exempt from population pressures, but incomes are rising more rapidly and increasing numbers are reaching middle income status. More households are buying their first homes, cars and appliances, and using financial services. Investing in emerging economies requires careful selection, and even then investors should expect more volatility. But our assessment, as seen in our Long-Term Capital Market Assumptions, is that the emerging world offers returns well in excess of those seen in the developed world (**Exhibit 11**).

EXHIBIT 11: 2020 LONG-TERM CAPITAL MARKET ASSUMPTIONS EXPECTED RETURNS IN COMING 10-15 YEARS

%, annualised returns in EUR



Source: 2020 Long-Term Capital Market Assumptions, November 2019, J.P. Morgan Multi-Asset Solutions, J.P. Morgan Asset Management. Returns are nominal and in EUR. The projections in the chart above are based on J.P. Morgan Asset Management's proprietary long-term capital market assumptions (10-15 years) for returns of major asset classes. The resulting projections include only the benchmark return associated with the portfolio and do not include alpha from the underlying product strategies within each asset class. The assumptions are presented for illustrative purposes only. Past performance and forecasts are not a reliable indicator of current and future results. Data as of November 2019.

4. How inflation could upset returns in 2020

Many of the key geopolitical risks have been discussed. But there is one scenario not yet mentioned that could truly upset the applecart in 2020: the return of inflation. While this isn't the most likely risk we face in 2020, it is worth considering because it would limit the ability of the central banks to continue to pursue aggressive pre-emptive supportive monetary policy. If you believe, as we do, that central bank activism has been the rising tide that has lifted all boats, then a return of inflation would be analogous to the tide going out. This would leave us in the worst of all worlds: one in which bonds and equities are falling in price. For this reason, we will be especially vigilant for any signs of returning inflation. This could be another reason to consider some allocation to global infrastructure or other real assets, which not only provide favourable income and diversification characteristics, but also offer a buffer against inflation risks.

AN INCREASED FOCUS ON SUSTAINABILITY

It seems likely that 2020 will see an increased focus on sustainability within the investment community. Savers are increasingly interested in how their money is being put to work, while numerous sustainability issues are high on policymakers' agendas. The changes in regulations and policy that could ensue have the potential for far-reaching effects on asset valuations. Consider the following examples:

- Artificial intelligence is increasingly driving sales revenues. A change in **data privacy** laws could significantly affect the use of personal information and the outlook for earnings in certain tech and consumer discretionary sectors.
- The political backdrop is expected to remain volatile in many countries. Companies will be under increasing political and social pressure to demonstrate **responsible capitalism**, which could have a significant impact on wage costs and profit margins.
- Policies to reduce **CO_2 emissions** are coming through thick and fast as governments attempt to meet the targets set out in the Paris Agreement. This creates challenges for some sectors and companies, as well as opportunities in others that are part of the decarbonisation solution.

Investors not accounting for the changing nature of the political and regulatory agenda around sustainability may be caught out. There are a range of ways in which environmental, social and governance (ESG) information can be incorporated into investment strategies. Those looking to lean heavily into a specific theme may look to thematic strategies, for example. But in our view, ESG integrated strategies, in which the information is available and evaluated alongside other traditional financial metrics, will serve as a base requirement. Keep an eye on our *On the Minds of Investors* series for more information on the impact of sustainability on the investment landscape.

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