Living in a castle in the air

Low growth, inflated markets

Outlook 2020

‘The conventional view serves to protect us from the painful job of thinking.’

- John Kenneth Galbraith -

About this outlook

In this outlook, we present our expectations for the global economy and financial markets for 2020. It serves as a reference document for us as an asset manager and for clients as investors in our impact equities and bond funds. We update our short-term outlook on a quarterly basis, in combination with the performance of our impact equities and bond portfolios. The tactical asset allocation (TAA) for our impact equities and bond funds is based on these short-term expectations. With our TAA we exploit short-term opportunities for generating excess financial return. Doing this, however, does not imply that we only focus on financial returns, or that we only focus on the short term.

We invest for the long term with the intention to generate social and environmental impact alongside a healthy financial return. Our short-term outlook and long-term horizon come together in our investment selection. We make an active choice for shares and bonds of companies that offer concrete solutions for the necessary sustainable transition. By selecting these companies, we are convinced that we invest in the winners of the future. In our white paper 'Impact investing through listed equities and bonds' we explain how we do this.

Economic transformation

Nowadays, it is widely acknowledged that our planet and society face many interconnected challenges: pressures on our environment and our social fabric stem from an economic system measured and steered one-sidedly by output and growth. Countering these challenges and making our environment and our social and economic system future-proof requires a radical transformation.

Until now, economic growth still is the primary goal of economic policy, as it is assumed that other objectives, such as wellbeing, will automatically flow from an increase in GDP. Material consumption serves as a proxy for progress and development.

In our view, the challenge is not to pursue more economic growth and higher financial return per se, but to develop a sustainable system that respects our environment and works for the benefit of all. We therefore need to rethink our economic theory and change our current system. In a new whitepaper, to be published in December, we will present contours on what a new economic model could look like, in line with our bottom-up investment approach.

Rethinking economic theory and transforming our economic system requires time. It is an evolutionary, rather than a revolutionary process. Even though we must make radical choices, it is not a matter of replacing one system by another overnight. Triodos Investment Management is part of this evolution, but also of our current system. As an impact investor, we make radical choices in the way we invest. Allocate capital towards achieving the SDGs and towards a low-carbon inclusive economy. But we also must be transparent in our investment choices, our impact and the limitations we face. This split-up is reflected in this outlook, which is largely based on the conventional theory we need to step away from.

Economic outlook

The decade of elevated worldwide economic growth that started after the Great Financial Crisis (GFC) is coming to an end. Global gross domestic product (GDP) has been growing below trend in 2019, indicating that we have entered the final stage of the economic cycle. For 2020, we expect a continuation of weak global growth, with risks remaining skewed to the downside. In combination with the highly accommodative monetary stance of the world's main central banks and elevated levels of global debt, this puts the world economy in a fragile state. As we expect a continuation of the undirected ultra-loose monetary policies and possibly additional fiscal stimulus, it is not unlikely that this unsustainable status quo will persist for some time. A worrying observation, as in the short term this might leave limited room to address major challenges at hand for current and future generations: social inclusion and climate change.

Global economy: slow growth and downside risks

In our outlook for 2019, we expected a further normalization of monetary policy. Looking back, we completely underestimated the quick turn in monetary stance following the market turmoil at the end of 2018. Despite this renewed dovish bias, it is very disappointing that 2019 will likely mark the slowest global economic growth rate since the global recession in 2009. According to International Monetary Fund (IMF) projections, the growth rate of the world economy will decrease from 3.6% in 2018 to 3.0% in 2019, with developed economies growing at a rate of 1.7% and emerging and developing economies at a rate of 3.9%. Especially for developed economies, this growth seems merely fabricated to allow investors to keep on living in their air castles. These 'strongholds' are kept afloat by measures that intend to stimulate economic growth, but in the end only sustain the ongoing inflation of asset prices and the further financialization of the economy. Growth is less and less based on real, 'earthly' activities. This trend is likely to continue in 2020.

Overall, we expect that developed countries will continue to experience subdued growth at around 1.7%. The economies of the United States (US) and Japan are expected to slow to 1.7% and 0.5% respectively, and the eurozone is expected to stay in its current low-growth gear of around 1.2%. Aging populations, low productivity growth and closing output gaps are causing a growth slowdown in developed countries towards long-term potentials. We can conclude that the structural growth potential in the global economy is decelerating, and that most economies have never regained the growth potential that was lost during the GFC. Some emerging countries have potential to improve growth performance in 2020, since a small improvement from current lows is not unrealistic. However, a further slowing of the Chinese economy will likely offset most of these gains, resulting in an overall economic growth rate for emerging countries of 4.0% to 4.5%.

Resilient services sector

Even though the most imminent current geopolitical tensions are likely to remain a headwind for the global economy, we do not expect a global economic downturn in 2020. Escalation of current conflicts remains possible, and this could potentially be the spark that ignites a recession. However, recent developments such as the preliminary Brexit deal between the UK and the EU and the anticipated phase-1 trade deal between the US and China point to a deflation of tensions in 2020. This would reduce the risk of a more severe slowdown in developed countries and would increase the upward potential for some emerging countries.

Currently, the slowing manufacturing sector is the weak spot of the world economy. The main driver of the manufacturing slowdown has been the decline of the automotive industry, which in 2018 shrank for the first time since the GFC. This downturn was mainly due to a reduction of consumer subsidies in China and the disruption caused by the rollout of new emissions tests in Europe. Also, car purchases declined or were postponed because of rapidly changing standards and increased options for car-sharing. However, recent data indicates that the manufacturing slowdown might have bottomed out. The sector will remain in contraction mode for some time though.

So far, there has been limited spillover to the services sector, with the global services purchasing managers' index (PMI) dropping to below 52 in the second quarter of 2019, but until now remaining above the contraction level of 50. As the slowdown of the manufacturing sector may have come to an end, we do not expect a more substantial spillover any time soon. Current strengths in most developed countries, such as low unemployment rates and robust domestic demand, are not likely to deteriorate substantially in the short term.

Accommodative central banks and fiscal stimulus may provide enough fuel to continue the unsustainable status quo of lower global growth and further inflated asset prices. However, going forward, this might also be the main threat to the global markets. Air castles tend to disappear into thin air. We do not know when and how but are convinced it will happen sooner or later.

Modestly rising inflation insufficient to reach targets

In 2019, a softening in commodity prices and a global growth slowdown decreased headline inflation worldwide. The IMF projects a headline inflation of 1.5% for developed economies in 2019, with inflation in the US, the UK, Japan and the eurozone staying below the respective central bank targets. For 2020, we expect slight upward pressure from accommodative monetary and fiscal policies. Tight labour markets might result in a modest rise in inflation in most developed economies, with US headline inflation approaching the Federal Reserve's (Fed) 2% target. For the eurozone and Japan we expect inflation to stay below target. Inflation in emerging countries is expected to diverge but will likely continue to stay below historical averages in most countries, as inflation expectations are moving closer to central bank targets and the effects from previous currency depreciations are fading.

Loose monetary policies and fiscal stimulus

In response to the economic growth slowdown and persistent geopolitical risks, there has been a synchronized move across developed and emerging countries towards looser monetary policies. We expect that the monetary stance will even be more accommodative in 2020, with policy rates at historic lows and additional measures like bond-buying programs scaled up significantly in both the eurozone and the US. The question is how effective these measures are in the current low-growth, low-interest rates, low-inflation environment. So far, the excessive easing has led to financial market returns not matched by underlying real performance, thus only benefiting investors and multinationals. In the longer run, these elevated valuations are not sustainable, although it is impossible to predict how long that long run will be.

As currency devaluation is one of the effects of looser monetary policies, we expect that ongoing worldwide easing measures will increase the probability of a global currency war. US president Donald Trump has already accused both the European Central Bank (ECB) and the People's Bank of China (PBoC) of currency manipulation. Any retaliation effort could induce a downward spiral and increase global uncertainty and tensions, thereby hurting business investment, productivity and employment growth.

At some point, the negative side-effects of accommodative monetary policies, like feeding inequality, excessive risk-taking and the creation of zombie firms, outweigh the presumed economic benefits. In our view, we have reached that point. Targeted green monetary and fiscal policies are now required to secure sustainable economic development.

Environmental risks should be the top priority of these policies, as both the likelihood and potential impact of environmental risks have severely increased during the last decade, according to the World Economic Forum. The likelihood and potential impact of conventional economic risks have on the other hand decreased. It is hopeful that governments are indeed likely to turn to fiscal policies to sustain economic growth, even though measures would only make sense it they indeed steer towards a more sustainable economy. Undirected fiscal policies would just continue the status quo, thereby further weakening the fragile state of the economy.

Environmental

1. Extreme weather events: floods, droughts, hurricanes, earthquakes
2. Failure of climate change mitigation and adaptation by governments and businesses
3. Ongoing activities leading to biodiversity loss and ecosystem collapse

Social

1. Impact of wealth and income inequality on growth
2. Migration flows
3. Populism and social unrest

(Geo) Political

1. Continued trade tensions
2. Continued Brexit uncertainty
3. Escalation of frictions in the Middle East

Long-term financial asset returns – business as usual

The expected long-term financial asset returns determine our strategic asset allocation. We use the 'business as usual' scenario to calculate these returns. This scenario does not consider the negative effects of our current economic growth model for people and the environment, or the unsustainability of certain developments. It therefore is synonymous with an unsustainable world. However, until the world transitions to a more sustainable economic system, we have to account for the current situation by basing our estimations upon this scenario.

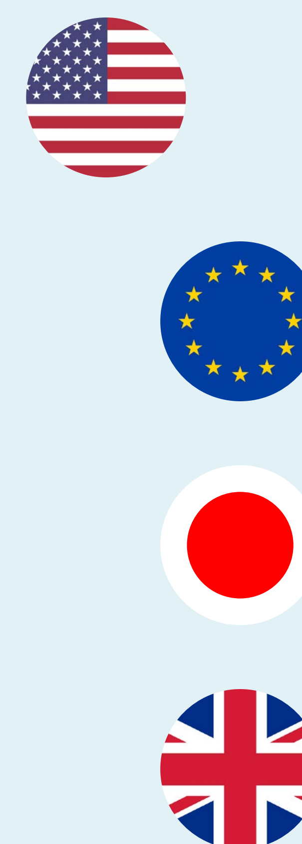
Financial asset returns are determined by the long-run fundamentals of the economy. It is widely accepted nowadays that these fundamentals in the 'business as usual' scenario are two-fold, namely output growth and inflation. In the long run, business cycle fluctuations average out. Output should then converge to so-called potential output, while long-run inflation depends on the ability of central banks to control the inflation expectations of economic agents.

Based on this standard approach, we conclude that potential output will probably remain low over the next decade or so. Demographic factors are likely to act as a brake on growth in many advanced economies, as populations age and workers retire. Therefore, potential employment growth and total factor productivity growth are expected to slow down. Inflation will likely settle around the targets set by central banks in most advanced economies, except in Japan, where inflation is likely to remain below target. These findings imply that living standards may improve, but more slowly, in the future.

Together with asset class valuation, this economic outlook determines our expected returns for equities and bonds. Expected returns on government bonds, corporate bonds and equities are low from a historical perspective. Within government bonds, the calculated expected returns of US Treasuries are the highest and closest to their historical returns when compared to UK gilts, government bonds from eurozone countries and Japanese government bonds. In comparison to government bonds, the calculated expected returns for eurozone investment-grade credits are even further removed from their historical returns. Within equities, the calculated expected returns of UK and Japanese equities match their historical returns. Expected returns of European and especially US equities stay far removed from their historical returns. All in all, risk taking is only mildly rewarded. Because of the above, we adopt a neutral risk attitude for the long term.

Economic growth 2020

‹ Lower | No change | Higher ›



Monetary policy 2020

‹ Loosening | No change | Tightening ›

United States (US)
Still solid, but slowing

Economy: further growth slowdown
Inflation: core inflation will approach and possibly exceed 2% target
Monetary policy: continued easing, two additional interest rate cuts in 2020

Although still in solid shape, the US economy is clearly slowing down. The global growth slowdown and the trade war with China are gradually faltering the US economy, which has blossomed for more than a decade. The manufacturing sector has moved into contraction and business confidence is sliding, leading to stalled capital investments. The services sector has long held firm but is now beginning to show a downward trend. Positives are the historically low unemployment rate and strong consumer spending. However, sluggish profit growth and depressed business sentiment could affect the health of the labour market. In addition, a continuation of the trade war, in our view still a realistic scenario despite recent news on de-escalation, could lead to job losses and decrease consumer spending, given that potential new tariffs would likely focus more on consumer goods.

In response to the downside risks, the Fed has stopped shrinking its balance sheet and cut interest rates three times in 2019, the first rate cuts in over a decade. Fed-Chair Jerome Powell explained this shift in monetary policy as insurance against increasing global uncertainties, while indicating that it is not the intention to start a lengthy rate-cutting cycle. In our view, heightened market anticipation and slowing global data will force the Fed to make at least two more rate cuts in 2020. This could be accompanied by expansion of the Fed's balance sheet, as new prolonged bond-buying programmes are likely. The Fed has already restarted its Treasury bills purchasing scheme of USD 120 billion a month, although it stressed this was not intended as an additional easing measure. We expect core inflation to approach and maybe break the Fed's inflation target, as future easing measures will counter the possible cooling of the labour market.

The presidential election of 2020 will be a reason for Trump to keep the economy going at all costs. Apart from pursuing a supportive fiscal policy – and increasing government debt in the process - this will probably include putting (more) pressure on the Fed to support the economy. We therefore expect that a recession will be avoided in 2020, but the growth rate will likely slow down to below the level of 2019. For 2019, the IMF predicts an economic growth rate of 2.4%. We expect GDP growth to further slow to around 1.7% in 2020. At lower structural growth levels, however, a recession is more imminent should any of the risks materialize. With interest rates at already very low levels and a weak fiscal position of the US government, the newly elected president – either President Trump or his Democratic opponent – does not have much ammunition left to counter a recession.

Eurozone
Victim of slowing global trade

Economy: stable, subpar growth
Inflation: 2% inflation target remains out of sight
Monetary policy: continuation of quantitative-easing scheme, one additional interest rate cut in 2020

The slowing of economic growth that began in 2018 continued by shifting into an even lower gear in 2019. The IMF predicts a GDP growth rate of 1.2% for the eurozone in 2019, and we expect it to stay at this subpar level in 2020. The structural growth level has come down over the past ten years. Partly this reflects demographic changes, for another part it reflects the lower productivity growth in many (Western) countries. Lower structural growth implies that any (unavoidable) temporary weakness can turn into a recession. Global trade weakness is the main reason for the eurozone's current slowdown, as the dichotomy between increasingly weak external demand and resilient domestic demand persists. Prolonged weakness in the manufacturing sector and growing signs of a spillover to the services sector pose a risk to household spending. So far, the continuing decline in unemployment has helped to keep household confidence high. However, the overall unemployment rate is approaching historic lows, and a further decline seems unlikely.

The engine of the eurozone economy, Germany, is experiencing an industrial recession, and other core countries are also showing manufacturing weakness. Important factors that caused the downturn are the global trade tensions, Brexit uncertainty and the slowdown in China. We foresee a continuation of indirect negative impact from the tariffs war between the US and China, and a strong possibility of direct negative impact due to tariffs imposed by the US on European goods. No matter the outcome, the Brexit saga will also hamper eurozone economic growth. On top of that, internal struggles such as the discussion on the Italian budget could easily flare up again, as the current status quo remains fragile.

In this light, the ECB in September cut interest rates for the first time since 2016, announced the restart of its quantitative-easing scheme, and eased lending terms for eurozone banks. The problem for the ECB is that economic developments in the eurozone diverge. North-western eurozone countries such as Germany and the Netherlands do not need extra monetary stimulus. For them, this results only in a further inflation of asset prices. Southern European countries, on the other hand, and for different reasons, could use some support. This causes frictions within the Governing Council of the ECB, which increases tensions between eurozone countries. The current accommodative monetary stance may help to mask the structural political and economic problems of the eurozone and keep things going in short run. At the same time, however, it also prevents politicians to solve the underlying problems.

In addition to addressing the global growth slowdown and looming downside risks, the recent ECB measures were mainly intended to support the convergence of inflation towards the medium-term aim (below but close to 2.0%). The ECB expects headline inflation to be 1.2% this year, and 1.0% in 2020. We agree that inflation will not reach the target and therefore foresee a prolonged period of extremely loose monetary policy, with likely one more rate cut in 2020 and continued quantitative easing. Mario Draghi, the ECB's resigning president, called upon governments to take charge through fiscal policies. There are already some signs that governments will act upon this request, which could help to partly offset a further deterioration of growth. However, possible effects are not expected to show before the second half of 2020 and will not outweigh the stalling forces at hand.

United Kingdom (UK)
When and how?

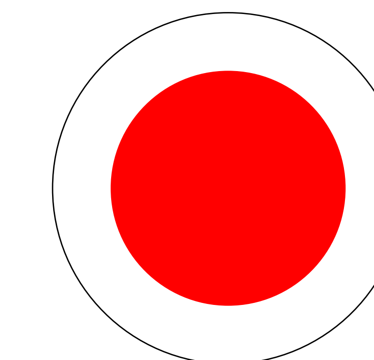
Economy: continued Brexit uncertainty sustains slow economic growth
Inflation: little below 2% target in case of orderly Brexit, otherwise above 2%
Monetary policy: interest rate cut in first half of 2020

One year and several deadlines further, the UK is still a member of the EU. As it stands, the EU agreed to postpone the Brexit deadline to 31 January 2020, and British parliament subsequently voted in favour of a general election on 12 December 2019. Thus, a possible Brexit deal now depends on the election results. A clear majority for Boris Johnson's Conservative Party may result in an approval of the current withdrawal deal with the EU by British parliament at the beginning of 2020. Any other outcome is likely to increase the uncertainty again, and thus the chance of a no-deal break.

Even if a deal is agreed upon, tensions will remain. Once a withdrawal deal has been signed, a transition period will begin, in which a trade deal must be negotiated. We expect a Conservative government to take a tougher line with the EU in this phase, which increases the likelihood of an eventual no-deal scenario at the end of 2020. No matter the outcome of the British elections, the Brexit saga will therefore remain a severe headwind for both the UK and the EU.

The UK economy could in 2020 potentially benefit from Boris Johnson's announced tax cuts, public investment increases and public services expenditures. It is more likely, however, that ongoing uncertainty will continue to suppress economic confidence. This might ultimately (further) impact the so far low unemployment rate, robust wage growth and solid consumer spending. Although we do not expect these strongholds to deteriorate quickly, the slow economic growth pace of 2019 (1.2% according to IMF predictions) is likely to continue in 2020.

We expect inflation will be a little below the Bank of England's (BoE) 2%-target next year in case of a somewhat orderly Brexit. If the UK leaves the EU without a deal, a weakening of the sterling likely results in higher inflation. The BoE has indicated that its policy interest rate could move either way, but there seems to be a bias towards rate cuts. Rate hikes are an option in case of an orderly Brexit and an improvement in global economic growth. As we expect at least some uncertainty to persist, we expect a rate cut in the first half of 2020.



Japan
Low growth continues

Economy: even lower economic growth
Inflation: 2% inflation target remains out of sight
Monetary policy: interest rate cut in first half of 2020

The years of low economic growth are likely to continue in 2020. The IMF expects an economic growth rate of 0.9% for 2019, and we think the GDP growth rate will move even lower in 2020. The most important reasons for our low growth expectations are the global growth slowdown, the negative effects of the US-China trade war on Asian supply chains, Japan's trade dispute with South Korea and the recently imposed sales tax increase.

The tight labour market, reflecting Japan's ageing population, will continue to support wage growth and thereby consumer spending. It will also force companies to account for this shortage by making capital investments. However, the sales tax hike is expected to drive down consumer spending and and continued slow global growth and trade uncertainty will decrease profits and investment appetite, especially in the already pressured manufacturing sector. Exports will be hindered by a strong yen and a growth slowdown in China, Japan's largest trading partner.

The Bank of Japan's (BoJ) monetary policy remains ultra-accommodative, with the quantitative and qualitative easing (QQE) to be continued over the next few years. Through this programme, the BoJ not only buys Japanese government bonds, but also listed equity funds. We also expect the 'yield curve control' – with which the Japanese central bank aims to keep the ten-year yield on Japanese government bonds around a certain percentage - to remain in place.

However, against a backdrop of slowing overseas growth, the downside risks from the sales tax hike and a rate of inflation that is far removed from its 2%-target, the BoJ has hinted at even more easing. We expect new measures will eventually follow through, as inflation is likely to stay between 0.5% and 1.0% in 2020. We pencil in an interest rate cut in the first half of 2020. The BoJ will be careful, however, as some fear that further easing could hurt inflation rather than support it. Possible economic stimulus by the government will also influence the BoJ's future decisions. The government is monitoring the impact of the sales tax hike on the economy and could compile a supplementary budget. We do not expect this budget to be available before early next year, however.

Emerging economies
Moderate outlook

Economy: modest rise in growth
Inflation: no substantial overall change
Monetary policy: move towards more easing

In line with our general outlook, the growth potential for developing and emerging countries is also limited. With the peak of globalisation possibly laying behind us and the continuation of China's slowdown, the main growth drivers of the past are faltering. There is still some opportunity for a modest rise in the overall growth rate in 2020, but this largely depends upon the recovery of key economies such as Argentina, Brazil, Iran, Mexico, Turkey and Russia, which all performed below par in 2019. As this recovery, in some cases, depends upon both domestic improvement and an upswing of the global trade environment, overall growth for 2020 is likely to be modest. The IMF predicts economic growth for developing and emerging countries to be 3.9% in 2019. We expect the overall economic growth rate to range from 4.0% to 4.5% in 2020.

We expect that Asian countries will continue to be the most important global growth engines, even though its largest economy, China, goes through a structural slowdown that may continue for some years. We expect the slowdown of China will be (partly) offset by the recovery of the Indian economy, which we feel will pick up due to a reduction of the corporate tax rate and monetary easing. The Chinese slowdown is caused by a decline in the growth of the labour force and a shift in the country's focus from quantitative to qualitative economic growth. This policy shift aims to increase the role of private consumption as key economic driver and diminish credit-fuelled investment, thereby also trying to reduce the huge amount of government debt.

This policy shift will, at least initially, limit Chinese growth, and global headwinds such as the ongoing trade war with the US and weaker global demand will accelerate this growth slowdown. The US-imposed tariffs on Chinese goods are already taking their toll on exports, and this will continue to be the case in 2020, as we do not expect that US president Trump will completely remove current tariffs. Depreciation of the renminbi is expected to only partly offset this effect. Therefore, we expect a further slowdown of Chinese economic growth in 2020. The PBoC will try to soften this slowdown by a further easing of its monetary policy. It has already made a start by loosening the reserve requirements for Chinese banks, thereby increasing their ability to lend. Fiscal policy will also continue to support activity, providing stimulus if necessary.

Growth in Emerging Europe was subdued in 2019, but we expect it to pick up somewhat in 2020. The main reasons for this are the recovery in Turkey due to monetary easing and the improvement in Russia due to the unwinding of past fiscal and monetary tightening. Overall growth in Latin America has slowed considerably in 2019, mainly because of mining supply disruptions in Brazil and political uncertainty in Argentina and Mexico. In 2020, we expect that strengthening of the Brazilian and Mexican economies and softening of the contractions in Argentina and Venezuela will accelerate growth. In the Middle East, current frictions are likely to remain in 2020. The recovery of one of its key economies, Iran, depends to a large degree on the easing of tensions with neighbouring countries and the US.

Investment outlook

Growth projections 2019-2020

	GDP growth			Headline inflation		
	2018	2019	2020	2018	2019	2020
US	2.9	2.00-2.50	1.25-1.75	1.8	1.50-2.00	1.75-2.25
Euro area	1.9	0.75-1.25	0.75-1.25	1.4	1.00-1.50	1.00-1.50
Belgium	1.4	1.00-1.50	1.00-1.50	2.3	1.00-1.50	1.00-1.50
Germany	1.5	0.25-0.75	0.50-1.00	1.9	1.25-1.75	1.25-1.75
Netherlands	2.5	1.50-2.00	1.25-1.75	1.6	2.25-2.75	1.25-1.75
Spain	2.4	1.75-2.25	1.50-2.00	1.7	0.50-1.00	0.75-1.25
UK	1.4	1.00-1.50	1.00-1.50	2.5	1.75-2.25	1.75-2.25
China	6.6	5.75-6.25	5.50-6.00	2.2	2.25-2.75	2.25-2.75
Japan	0.8	0.50-1.00	0.25-0.75	1.0	0.50-1.00	0.50-1.00

2019 has so far been characterized by rallying bond and equity markets. Bullish investor sentiment, abundant liquidity and ongoing corporate share buybacks have pushed up stock prices, whereas safe-haven appetite drove down bond yields. As the world is experiencing a synchronized economic slowdown that is accompanied by severe geopolitical uncertainties, one would have expected at least some form of market correction. The absence of this correction and a general lack of volatility show investors are relying on central banks to do whatever is necessary to sustain economic growth. Although we think this situation in the long term cannot hold, for 2020 we expect monetary policies and fiscal stimulus will satisfy investor expectations, thereby preventing financial markets from coming down.

The current economic growth slowdown and the expected continuation of weak growth in 2020 suggest we have entered the final stage of the business cycle. Profit growth has deteriorated, and earnings revisions have been negative for most equity markets. On top of that, geopolitical uncertainty has increased, fuelled by the escalating US-China trade war, the continuing Brexit-saga, and social and political unrest in Hong Kong and several countries in the Middle East and Latin America. However, financial markets have been remarkably resilient, showing an upward trend without substantial volatility. This is largely due to extremely loose monetary policies that have inflated bond and equity prices and drove investors higher upon the risk curve. The easing measures did not lead to the desired increase in consumer prices, but only further inflated the financial assets bubble. Financial asset prices are becoming more and more detached from their underlying values.

Despite this seemingly unsustainable situation, we think that financial markets might be able to keep their resilience until the next economic cycle, when outlooks will start to improve again. The recent statements of central banks are instrumental here. Nevertheless, in the current environment where risks are not adequately priced, with stock prices deviating

from their economic fundamentals, the consequences of a sudden turnaround in market sentiment are potentially huge. Therefore, caution is required. This means we remain slightly underweight in equities and neutral in bonds. Central bank policies not living up to investor expectations are a key downside risk, next to a prolonged trade war that will further weaken the manufacturing sector and may eventually lead to a more severe spillover to the services sector.

Bond markets

In 2019, safe-haven appetite and central bank policies resulted in historically low government bond yields. Both the Fed and the ECB are expected to continue to lower their policy rates in 2020. This will likely result in even lower capital market rates in the US and the eurozone. Given the continuation of easing measures, money market rates are likely to follow a similar trend. Savers should therefore brace for a further decrease in the returns on savings over the next year. As inflation is not expected to reach the ECB's target for quite some time and eurozone economic growth remains subdued, the prospect of a prolonged accommodative monetary stance will keep European capital market rates low for longer.

Political risks also remain in the eurozone, with the Brexit-saga and the current fragile political status quo in Italy being just two examples. In combination with other geopolitical issues, this may occasionally add to the appetite for safe-haven investments and trigger a further decrease in the capital market rates in the core eurozone countries. However, normalization of some risks might occur in 2020, thereby somewhat tempering the likelihood of a downward push. Overall, these are enough reasons for us to maintain a neutral position in bonds, for the time being.

The extremely loose monetary policy of recent years has induced a search for yield that resulted in lower yields on corporate bonds. For investment-grade credits, strong corporate fundamentals and low default risks also drove down credit spreads. Spreads are not at their tightest levels ever seen, but the ever lower and often negative yield on government debt has led to historically low yields on investment-grade corporate bonds as well. Although a prolonged economic slowdown would normally increase the default risk and thereby widen credit spreads, it seems that the current investor landscape focuses predominantly on central bank measures. This means the 2020 outlook of lower interest rates and central bank bond purchases would imply a further drop in corporate bond yields. Although the increase in central bank liquidity makes defaults less likely, slowing growth makes us prefer high-quality credits with strong balance sheets.

Equity markets

The US equity market remains relatively expensive, both versus other regions and from a historical perspective. In our view, the current high valuations do not reflect underlying fundamentals. Slow global economic growth and a further slowdown of the US economy will keep earnings revisions and corporate profit growth in negative territory in 2020. Trade concerns will persist and might widen if president Trump decides to also focus on other countries. This could affect the currently robust consumer spending, which makes us think current sales expectations cannot easily be surpassed. Therefore, the continuation of the upward trend in US equity markets mostly depends on additional easing measures from the Fed. Although the Fed is likely to further loosen its monetary policy, a failure to meet high investor expectations could trigger a change in sentiment. The 2020 US presidential elections will also come into play, adding to the political uncertainty about future trade and taxation policies. Taking all the above into account, we remain negative about US equity.

In 2019, European equity markets followed the overall upward trend of US equities, albeit at a slower pace. Besides the worldwide trade tensions, the possibility of a no-deal Brexit has been the main reason for market concern. Now that the likelihood of a hard Brexit has somewhat decreased and Italy has also found a (fragile) political status quo, it seems eurozone political risks have somewhat diminished, although trade uncertainty remains a severe risk. The ECB's recent easing measures will likely be followed by more easing in 2020, creating an extremely loose monetary environment. Several core countries are also considering fiscal measures to stimulate the economy. As we believe the eurozone economic growth slowdown has nearly bottomed out and will not further decrease next year, European equities could benefit from accommodative monetary and fiscal policies. Because European equities are also relatively cheap compared to their US peers (although still expensive in absolute terms), we remain neutral to slightly positive about European equity.

Japanese equities are relatively cheap compared to their US and European counterparts. Equity markets also followed an upward trend in 2019, on the back of lagging economic growth in comparison to other developed countries. The recently implemented sales

tax hike is expected to drive down Japanese consumer spending and the the coninued slow global growth and trade uncertainty will decrease profits and investment appetite, especially in the already pressured manufacturing sector. Exports will be hindered by a strong yen and a growth slowdown in China, Japan's largest trading partner. However, the BoJ will continue to support the equity market through its QQE programme and we do not expect that this programme will be terminated in the near term. The BoJ also hinted at additional easing measures, while the government is monitoring the impact of the sales tax hike on the economy and could compile a supplementary budget. In combination with attractive valuations, this keeps us positive about Japanese equity.

The global trend towards monetary easing and the softening of major geopolitical tensions could benefit emerging markets going into 2020. More liquidity and lower interest rates could make investors turn to riskier financial assets, and reduced trade tensions could stimulate investor confidence. Both would result in increasing capital inflows for emerging countries. However, a strong US dollar might continue to cause problems for distressed countries with large amounts of dollar-denominated debt. Countries with a high current account deficit and/or a large budget deficit are heavily dependent on foreign investors to finance their deficits. Many countries have, in fact, somewhat reduced their current account deficits. This creates more room for these countries' central banks to loosen monetary policies without directly triggering severe currency depreciations.

In 2019, Argentina, Iran, Turkey and Venezuela have all faced or are still facing severe economic difficulties. We anticipate that the problems for these countries might ease a little in 2020, although they certainly will not be solved. Political stability will be key. Economic growth in Brazil, Mexico, Russia and Saudi Arabia is expected to somewhat pick up in 2020, after a slowdown in 2019. We expect that China's soft slowdown will not result in a substantial drag on financial markets, as China's expected monetary and fiscal measures will likely comfort investors. India's fiscal stimulus and central bank easing is expected to increase economic growth, the prospect of which will likely provide fuel for domestic financial markets. In combination with overall relatively cheap valuations for emerging markets, the above makes us cautiously optimistic about emerging market equity performance in 2020. However, much depends on diminishing country-specific risks, reduced geopolitical tensions and a continuation of global monetary easing measures.

Tactical asset allocation

Asset class	Valuation	Cycle	Sentiment	Total
Government bonds	**–**	**0**	**+**	**0**
EMU government bonds	–	0	+	0
UK Gilts	–	0	+	0
US Treasuries	–	0	+	0
JP government bonds	–	0	+	0
Credits	**–**	**-/0**	**+**	**0**
Euro IG corporate credits	–	-/0	+	0
Equities	**–**	**–**	**+**	**-/0**
Europe ex UK equities	0	–	+	0
UK equities	+	–	-/0	0
US equities	–	–	+	–
Japanese equities	+	-/0	0/+	+
Emerging equities	+	–	0	0/+

+ = positive 0 = neutral – = negative

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