

2020 MARKET OUTLOOK

AN INTERVIEW WITH KELVIN BLACKLOCK



Kelvin Blacklock, Head of Investment Solutions, Eastspring Investments, Singapore, shares why he is turning more positive on equities in 2020. He, however, does not expect bond yields to rise sharply as the structural demand for bonds remains strong.

1 What is the team's global macro outlook for 2020?

There are signs that the cyclical weakness in the global economy may be coming to an end. Global economic sentiment appears to be stabilising on the back of greater policy support from global central banks and a temporary truce in US-China trade hostilities. The JPM Global Manufacturing PMI new orders index bottomed and momentum (3-month change) turned positive in October 2019. (See Fig. 1).

In the meantime, economic indicators in the US continue to surprise on the upside – US unemployment rate reached a 50-year low of 3.5% in September 2019. We note, however, that US economic outperformance has moderated. While the Federal Reserve (Fed) has signalled a pause in its rate cut cycle, its intention to grow the balance sheet again will support financial conditions. Notably, Japan's economic data has also started to beat expectations.

We are watching the prospects for fiscal easing in the new year. We believe that the probability has inched higher as low interest rates and quantitative easing has thus far failed to lift economic growth. Policy makers, especially in Europe, have also been increasingly vocal in calling for greater government spending.

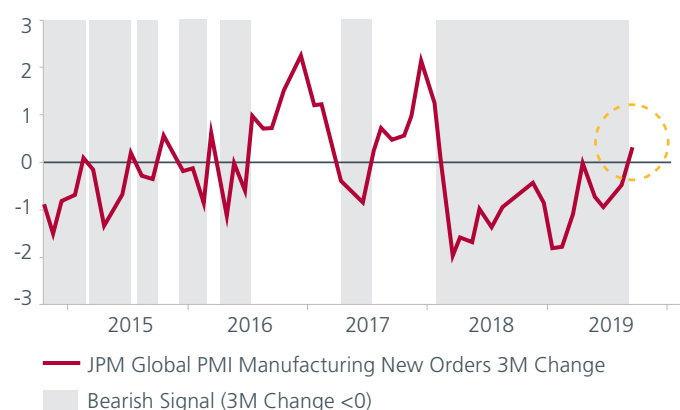
2 What does this mean for equities and bonds in the new year?

Signs of stabilising economic sentiment had already caused bond yields to rise modestly and Emerging Markets (EM) as well as value equities to outperform in the September to October period.

We believe that the economic recovery will continue because there is little evidence of a classic overinvestment bust or recession. The recovery will be good for equities which are more attractively priced than bonds. It will also be positive for corporate earnings, particularly in Asia, which have borne the brunt of the trade slowdown. We note that the trend of earnings revisions globally is improving. More aggressive fiscal policy, if it materialises, would also boost equities. Overall, we are turning more positive on equities.

Bond yields fell to very low levels in 2019 as investors turned more defensive on the back of recession fears. While investors bought bonds and

Fig. 1. JPM Global Manufacturing PMI new orders show a positive trend¹



sold equities, it created a viscous cycle where asset owners hedged the duration in their portfolios (by buying more bonds) as convexity kicked in. This in turn created a strong demand for “safe credit” which helped to contain corporate bond spreads.

The economic recovery is unlikely to lead to a huge rise in bond yields as most asset owners are still insufficiently hedged on duration and hence the structural duration hedging demand remains very strong.

Nevertheless, coming into 2020, we had neutralised the US and EU bond durations in our portfolios after a good run.

3 Within equities, what is the outlook for the US versus Emerging Markets?

The US economy remains in good shape with US consumption continuing to be supported by low interest rates and muted inflation. US economic data continues to surprise positively although the extent of the surprise has moderated. The US’ pace of innovation and creativity also gives investors attractive opportunities in the technology sector as well as other growth sectors in the US equity market. That said, we note that earnings sentiment in the US has been weakening during 2019.

Any weakness in the US dollar could be a trigger to unlock the huge valuation opportunity in EM and Asian assets. For now, the dollar appears supported by growth and interest rate differentials, particularly against the G10 currencies. The continued repatriation of overseas earnings by US companies will keep dollar liquidity ample in the US and scarce in the rest of the world. The improving global economic sentiment would however reduce safe haven demand for the dollar and temper its strength.

We are turning slightly more positive on EM as earnings sentiment and growth have improved. Outside of EM, Japanese equities will also be a beneficiary of the global growth recovery given how leveraged the Japanese economy is to the global economy. Japan’s economic indicators have

been improving and the market may finally reward its earnings outperformance if sentiment lifts.

A boost in capital spending, on the back of an uptick in global growth, would also be supportive.

4 High yields bonds have benefited from the search for yield. With the decline in yields, are investors sufficiently compensated for the risks?

US high yield corporate bonds have been de-leveraging over the past couple of years, and credit quality has improved. Meanwhile, Asian high yield bonds offer more attractive yields compared to their US counterparts with similar volatility.

Looking forward, with global rates remaining anchored, we can expect higher total returns from high yield bonds. Our expectations for lower rates and falling inflation in China, which accounts for more than 50% of the Asian high yield bond market, also supports our positive outlook for Asian high yield bonds.

Nevertheless, we remain prudent and continue to pair government bonds with high yield bonds in the US and Asia to generate income and stability in some of our income-focused portfolios.

5 With 10-year US treasury yields at historical lows and the crowded positioning in US treasuries, are they still an effective risk diversifier?

We expect US Treasury yields to remain low. Although the Fed has indicated a pause in its rate cut cycle, it stands ready to ease interest rates further or restart quantitative easing if a recession looks probable. This will bode well for Treasuries.

At the same time, while positioning may appear crowded, Treasury yields continue to look attractive compared to cash and other developed market sovereigns given low interest rates and little inflationary pressure. This suggests that the ongoing demand for yield, especially from European and Japanese investors, will limit how high US Treasury yields can rise in a correction.

Treasuries continue to exhibit low volatility and given its low long-term correlations to different asset classes, they remain an effective diversifier in multi asset portfolios.

6 Bonds and equities have rallied alongside each other in 2019. Does this mean that traditional market correlations have changed?

With the prevalence of quantitative easing in today's central bank playbook and the low probability of a recession, equities have enjoyed the economic benefits of lower rates. This has led equity and bond prices to rise together.

Equity and bond prices only tend to move in opposite directions during periods of elevated uncertainty (e.g. global financial crisis or recessions) when investors demand a higher equity risk premium relative to the term premium for bonds. It is this "flight to safety" that causes bond and equity prices to diverge. These situations provide opportunities for asset allocators to add value.

The long-term (~20 years) correlation between equity and bond prices has actually been slightly positive. Even with positive correlations, however, optimising the asset class mix in portfolios can improve Sharpe ratios and deliver better risk adjusted returns.

While short-term market correlations may change, for example, if quantitative easing is removed, long-term correlations used in strategic asset allocations are likely to stay the same.

7 With more muted returns from traditional assets, do you see alternatives playing a bigger role in a multi asset portfolio?

The optimal state for any multi-asset portfolio is to have numerous uncorrelated assets that generate positive returns. While alternative assets can be added to a multi-asset portfolio, they need to be structured and governed in a manner that makes them investible.

We remain cautious on the asset class, for now, as projected internal rate of returns (IRR) have come down with more investors chasing these investments and pushing up prices. Nevertheless, we continue to monitor market developments as we believe that there will be opportunities over the next few years to pick up attractively priced assets.

We continue to like real estate as low interest rates and inflation support valuations; in addition, this asset class should benefit from the growth of the global economy and the increasing wealth demographics in Asia.

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