MAERKI BAUMANN & CO. AG

PRIVATBANK

A first look into 2020

Market Comment, December 2019

Any initial outlook for the impending 2020 economic year must remain provisional for the time being, as a great deal will depend on the details of the planned trade agreement between the US and China, which is not yet in the bag. The financial markets are optimistic that trade tariffs will be reversed, but perhaps it will just be a case of no additional tariffs being imposed. Accordingly, we are seeing a few – albeit hardly conclusive – signs of stabilization in global manufacturing activity. That said, this sector remains very much dependent on a convincing trade agreement. Another important question is whether the global services sector and consumer spending, both of which have proved robust up until now, can retain their momentum. We would not be surprised if global economic growth were to continue to lag behind its historic potential and trend sideways for a while.

Over the last few weeks there have been a number of signs of a certain stabilization of global manufacturing momentum. We have seen an improvement in manufacturing indicators in China, India, Brazil and Mexico. The decline of industrial activity has slowed in the UK as well as in the Eurozone, yet as things stand we are still not in expansion territory. Companies are starting to react accordingly and cut headcount, with the German automotive sector being an obvious case in point.

This also gives us some idea of the main risk in 2020 too, namely that historically well below-average global industrial activity will gradually start to impact negatively consumer spending and services, which are the more important components of gross domestic product. These sectors have held up surprisingly well in 2019, but are fairly sensitive to changes in the labour market. Another aspect not to be underestimated is the significant process of structural change apparent in sectors such as automotive and retailing, which is forcing companies to deliver efficiency improvements and make high-risk investments.

As wage levels are increasingly creeping up in both the US and Europe due to the sharp decline in unemployment rates (a feature typical of the late stage of the economic cycle), companies are having to make adjustments to prevent profit margins from coming under pressure. Furthermore, major companies in Japan and Europe face an additional risk to sales unless their economies are performing better. The former regions are also reacting more sensitively to a possible trade agreement, as they are much more export-oriented than the US.

> "A key question for the equity markets in 2020 is how well multinational companies can defend their profit margins."
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> Gérard Piasko, Chief Investment Officer

In the event of a trade agreement being concluded, it will be very much a case of "the devil lies in the detail". China is hoping (and demanding) that the punitive tariffs levied by the US so far are rescinded, and that no further such tariffs are imposed. An aspect that remains crucial for the US is whether China will cease insisting on technology transfer from Western companies doing business in China and respect intellectual property, above all in technology. However, such a concession would hardly be compatible with the long-term strategy laid out by Chinese President Xi, namely to make China a leading technology power. The financial markets are therefore likely to be once again dominated in 2020 by the increasing political rivalry between the US and China, which has also manifested itself in the support for Hong Kong expressed by both US Congress and the White House.

For political reasons, the lower levels of volatility that we have seen in all financial markets in recent weeks can be expected to pick up in 2020. While it is true that the prospect of a "no-deal" exit of the United Kingdom from the European Union has receded following negotiations between Boris Johnson and Brussels, there is still plenty of uncertainty over the transitional phase, and the British pound has now factored in a positive outcome to a considerable extent.

What's more, 2020 will also see the U.S. presidential election along with congressional elections at the start of November. The majority of candidates vying for the Democratic nomination are laying out less than business-friendly policies, while at the same time indicating higher taxes. For incumbent President Trump, meanwhile, the ongoing impeachment proceedings could lead to a decline in popularity ratings. The well below-average level of volatility apparent in U.S. financial markets could therefore rise for political reasons.

The prospects of a significant pick-up in inflation are low as long as the global economy remains on a below-potential growth trajectory on the one hand, and a sufficient global supply of oil keeps oil prices in check on the other. Where the latter is concerned, a sharp fall in the oil supply for political reasons, e.g. due to developments in the Middle East, remains a threat. The historically low level of inflation is likely to prompt global central banks to remain on their guard, i.e. in case of doubt they are likely to opt for a more rather than a less expansionary monetary policy. This in turn should mean a continuation of support for bonds despite low yields – and, in the Eurozone, due in particular to the resumption of the bond-buying programme by the ECB. Like corporate bonds, equities should be supported by the looser monetary policy of central banks on the one hand, but could face at least some headwinds due to political (and therefore also economic) uncertainties on the other. Given the strong rise in equity valuations in many regions, a crucial question in 2020 will be how successfully multinational companies can defend their profit margins. As margins are already fairly high in a long-term comparison, innovation and efficiency will once again be key.

All in all, and given the ongoing phase of economic and political uncertainty, we believe that a well-diversified spread of asset classes would be a sensible approach in 2020 too.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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