Perspectives

المال كابيتال
Al Mal Capital

January **2020**

Global Market Outlook 2020

"Expect the best, plan for the worst, and prepare to be surprised" – *Denis Waitley*

2020

2019 Market Review: The year of buying everything

Global Market Outlook 2020

Investment Themes for 2020 and Beyond

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Welcome to the 32nd edition of Perspectives.

2019 will be remembered as one of the best years ever for investors with every major asset class in the black. Despite an early backdrop of heightened volatility, escalating trade tensions, Brexit uncertainty, and calls for a recession, the year progressed in an unexpectedly pleasant fashion as the Fed used its limited arsenal to provide additional stimulus.

In this publication, we first review the market action in 2019, "the year of buying everything". We discuss in detail what we identified as the 10 most relevant financial market stories in 2019.

In the second part, we share our global investment outlook for 2020. On an aggregate basis, the context remains favorable to equities. We explain why investors should even consider tilting their portfolios towards more cyclical exposure. But while our base case scenario argues in favor of an overweight stance in risk assets, we also outline an alternative scenario which could trigger a major correction in stocks and credit. So while investors can be positioned for the best outcome, they also need to plan for the worst and prepare to be surprised.

In the final section, we review our 10 favorite themes for 2020 and also highlight five Mega Trends to watch in the long run.

We hope you will enjoy this issue.

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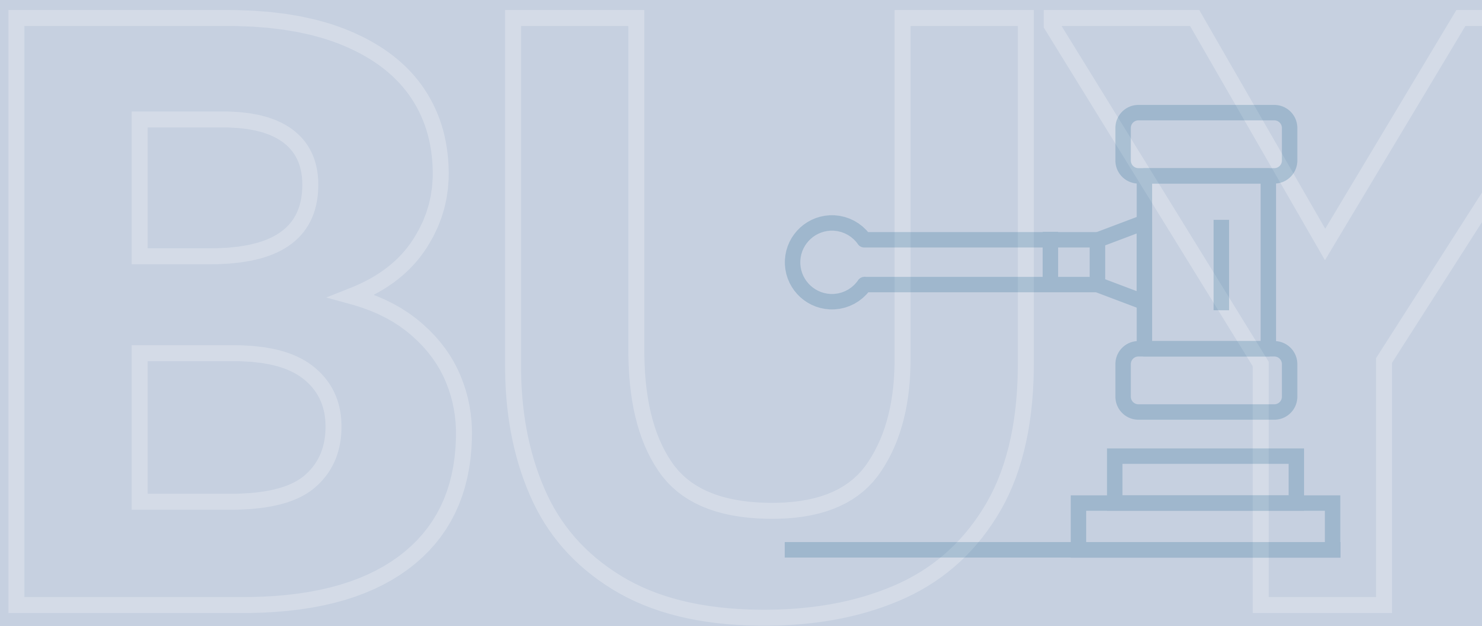
2019 Market Review: The year of buying everything



2019 was quite the turnaround story for investors. Despite an early backdrop of heightened volatility, escalating trade tensions, Brexit uncertainty, and calls for a recession, the year progressed in an unexpectedly pleasant fashion. The Fed used its limited arsenal to provide additional stimulus, and global markets soaked it up to extend the decade-long bull run. 2019 will be remembered as one of the best years ever for investors with every major asset class in the black. Overall, the global stock and bond markets added $24 trillion in market value ($17.5 trillion in stocks, $6.5 trillion in bonds).

Interestingly, 2019 proved to be almost the exact opposite of 2018:

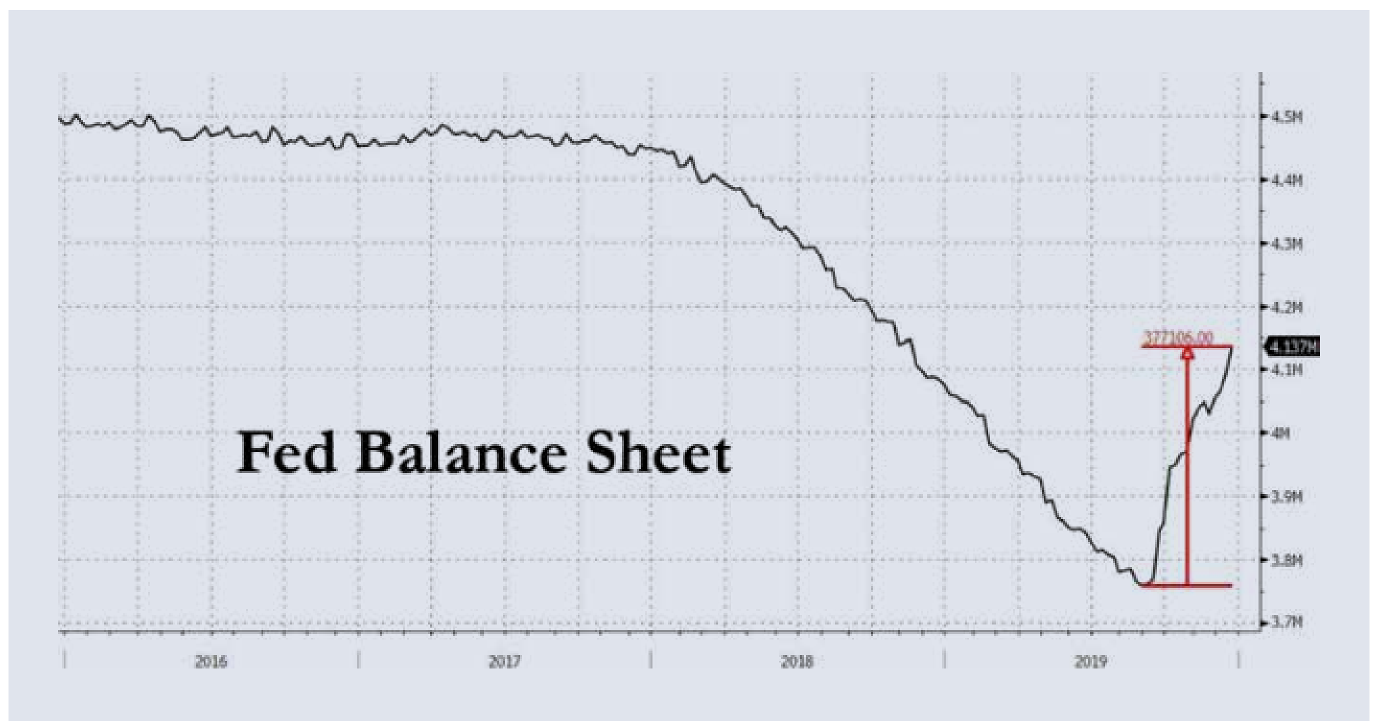
- US economy struggled in 2019; US economy was strong in 2018;
- In 2019, US earnings growth had been slightly negative; US earnings were growing at double-digits in 2018;
- Fed decreased rates 3x in 2019 and started to expand the size of its balance sheet (again); in 2018, Fed increased rates 3x in 2018 and reduced the size of its balance sheet;
- P/E multiples expanded in 2019; P/E multiples contracted in 2018
- All Asset classes were up in 2019, while 95% of asset classes were down in 2018 (see chart below)

Selected asset class performance in 2019 vs. 2018 (Total return)

Indeed, after a pause in Q3, the 4th quarter of the year proved to be a very decent one for risk assets. The Nasdaq index posted another strong quarter (+12%) just ahead of Emerging Markets equities (+11.4%). After a disappointing first half of the year, hopes of a "Phase 1" Trade deal between China and the US benefited emerging and frontier markets. After a volatile 3rd quarter, WTI Crude Oil ended the year on a strong note (+11% in Q4) while Gold posted a small gain (+3% over the quarter). Long-term US Treasuries (-5.3%) and US REITs (-1.8%) were the two worst performers in Q4.

Hopes of trade deal "Phase I", strong US consumer data and stabilization in global manufacturing PMIs all acted as tailwinds for the market. Importantly, the Fed's decision at the end of September to pump $500bn into the repo market – short-term borrowing for dealers in government securities – added more fuel to the market fire and acted as a kind of backdoor stimulus. By January the Fed's balance sheet will surpass what it was at the height of the massive quantitative easing program instigated after the global financial crisis in 2008, leading some to dub the current expansive policy as "stealth QE". Since October 2019, a 1% increase in the Fed balance sheet has been associated with a 0.9% increase in the S&P 500.

The Fed's balance sheet is now up over $377 billion since September



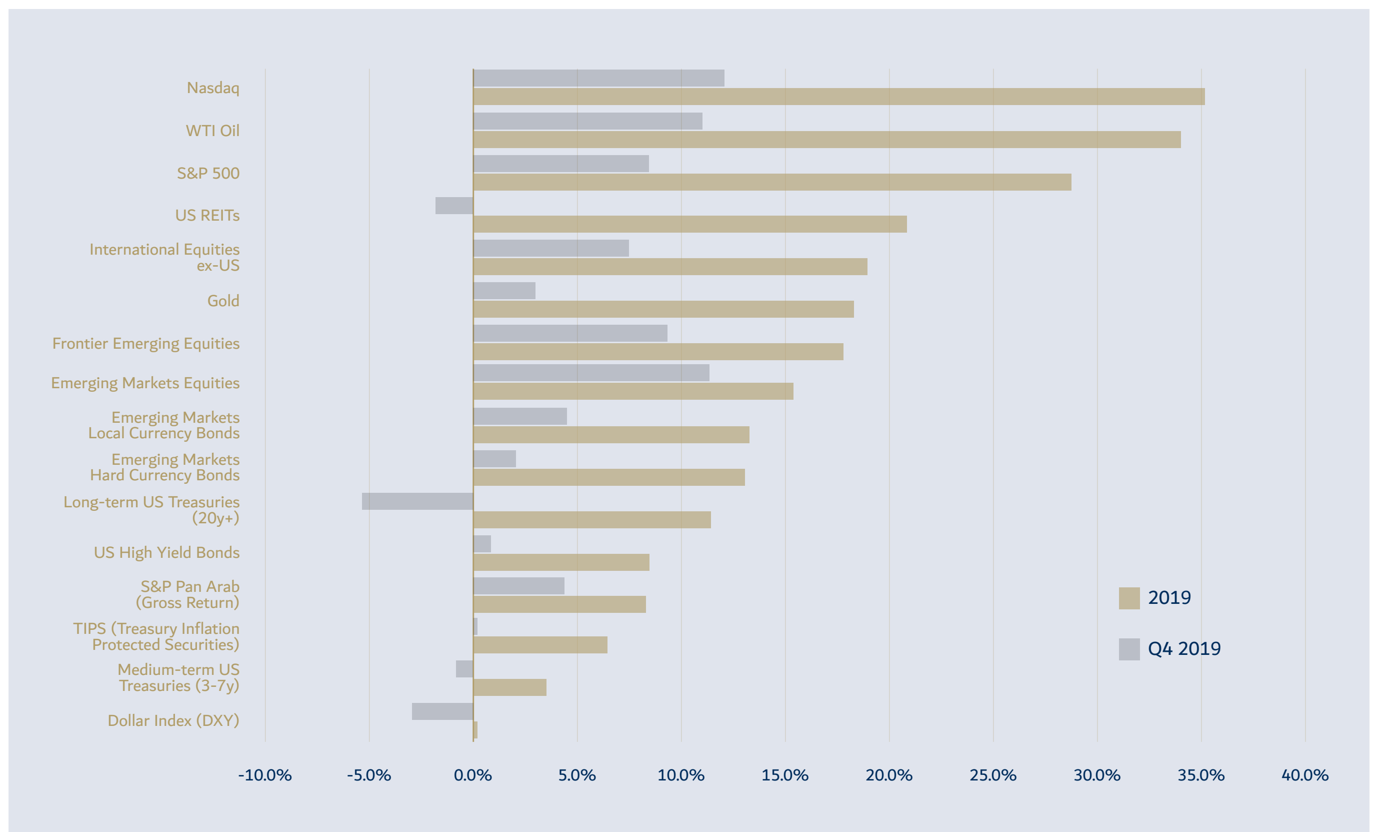
Coming back to the full-year performance, the most remarkable feature of 2019 is that **every major asset class had a positive return for the year – a very rare event. The only real difference lies in the magnitude of that positive return.**

The Nasdaq was the best performing major index in 2019. However, the winning asset class was a surprising one: crude oil. The WTI oil price started the year at about $46/bbl and it closed the year at over $61/bbl, which is a 34% gain.

Gold also had a remarkable year with an 18% gain, which is in-line with the price return of the MSCI World ex-US. Global Equities, Crude Oil and Gold outperformed bonds and cash over the period, although long-term US Treasuries (20y+) generated double-digit returns as well (+11%). We note the strong performance of Emerging Markets Bonds (in $) which are up +13%, outperforming US High Yield (+8.4% in 2019).

A simple multi-asset portfolio invested 60% into US large-caps stocks and 40% into a diversified bond portfolio was up nearly +22% in 2019, the best performance since 1997.

Q4 and YTD 2019 returns (in $) for selected asset classes



Within equities, US equities outperformed the rest of the world as Emerging market equities lagged (+15.4% for the MSCI Emerging Markets versus +28.9% for the S&P 500).

Still, 2019 will be a year to remember for many regional markets. In a nutshell:

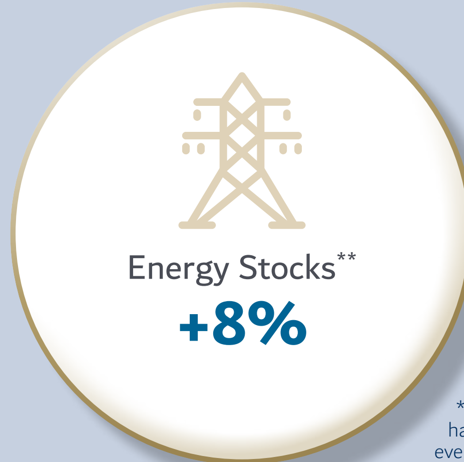
- The S&P 500 had its best year since 2013;
- The MSCI World had its best year since 2009;
- The FTSEMIB (Italy) had its best year since 1998;
- The CAC 40 (France) had its best year since 1999;
- The DAX (Germany) had its best year since 2012;
- The Shanghai Composite (China) had its best year since 2014;
- The FTSE (UK) had its best year since 2016

Beyond the main market indices, it is also worthwhile to highlight some of the biggest winners and (relative) losers of 2019:

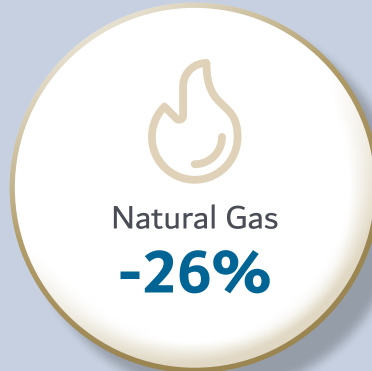
Winners (2019)

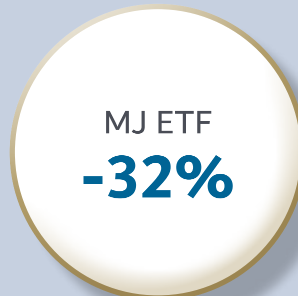
*Since May IPO

Losers (2019)



**Even though they had a positive return, evergy stocks were the lowest performing sector overall





MJ ETF (ETFMG Alternative Harvest ETF)

VXX ETN (iPath Series B S&P 500 VIX Short-Term Futures)

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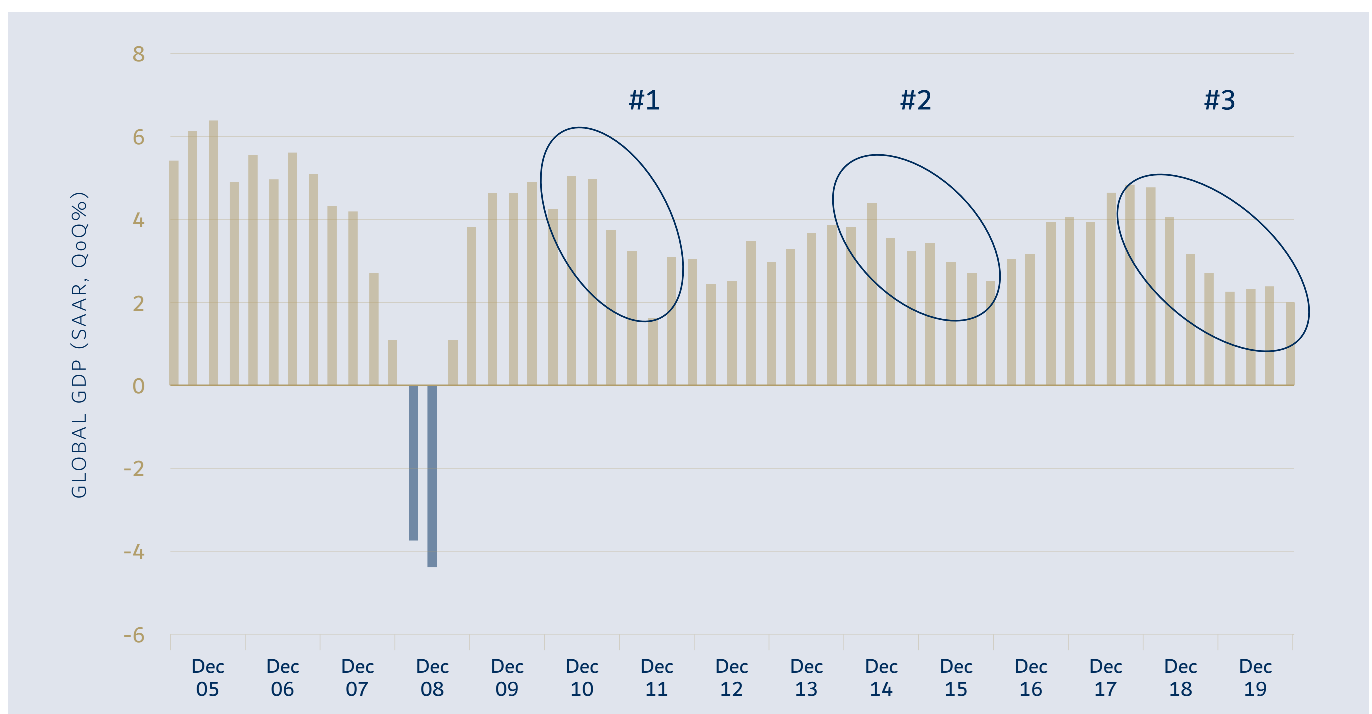
Below, we discuss in more details what we identified as the 10 most relevant financial market stories of 2019.

Story #1: A Weaker Global Economy

In 2019, global growth recorded its weakest pace since the global financial crisis a decade ago, reflecting common influences across countries and country-specific factors.

This is the 3rd "soft patch" since the start of the global economy recovery in 2009 (see chart below).

Global GDP and the 3 soft patches of the current economic cycle / source: IMF



Rising trade barriers and associated uncertainty weighed on business sentiment and activity globally. In some cases (advanced economies and China), these developments magnified cyclical and structural slowdowns that were already underway.

Further pressures came from country-specific weakness in large emerging market economies such as Brazil, India, Mexico, and Russia. Worsening macroeconomic stress related to tighter financial conditions (Argentina), geopolitical tensions (Iran), and social unrest (Venezuela, Libya, Yemen) rounded out the difficult picture.

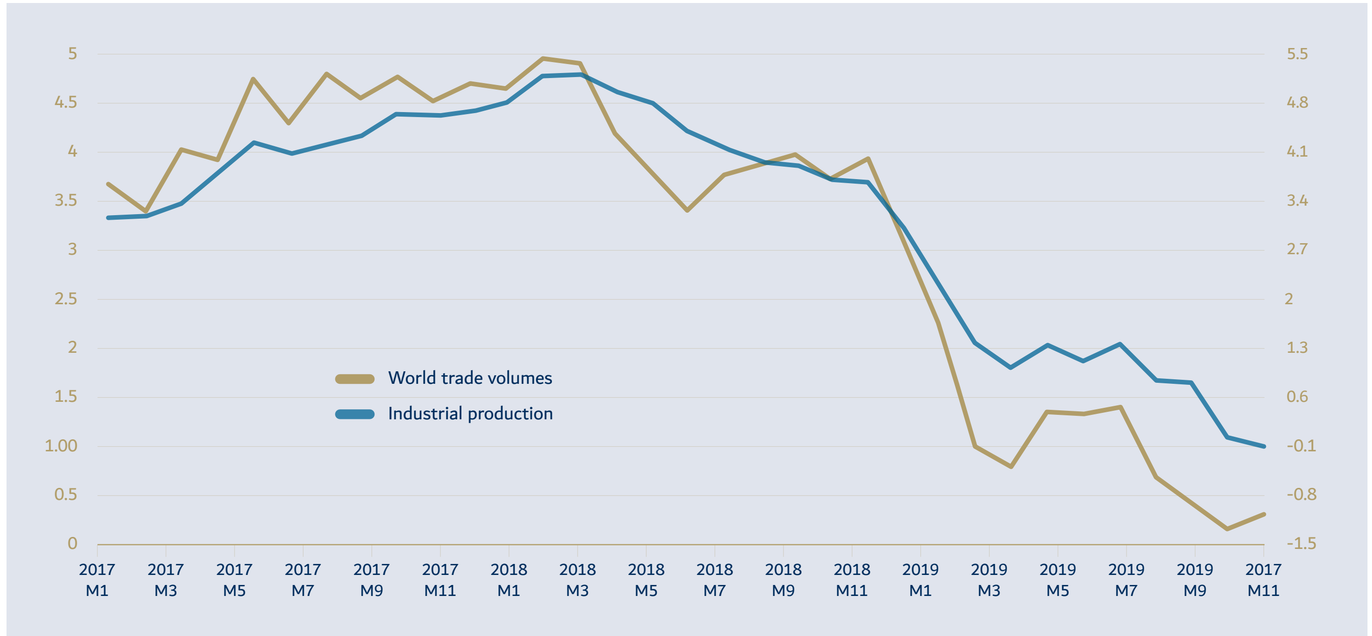
The strength of the US consumer remains to be the key drivers of global economic growth (source: Richardson GMP).

But with the economic environment becoming more uncertain, firms turned cautious on long-range spending and global purchases of machinery and equipment decelerated. Household demand for durable goods also weakened, although there was a pick up in the second quarter of 2019. This was particularly evident with automobiles, where regulatory changes, new emission standards, and possibly the shift to ride-shares, weighed on sales in several countries.

Faced with sluggish demand for durable goods, firms scaled back industrial production. Global trade—which is intensive in durable final goods and the components used to produce them—slowed to a standstill.

In 2019, global growth recorded its weakest pace since the global financial crisis a decade ago.

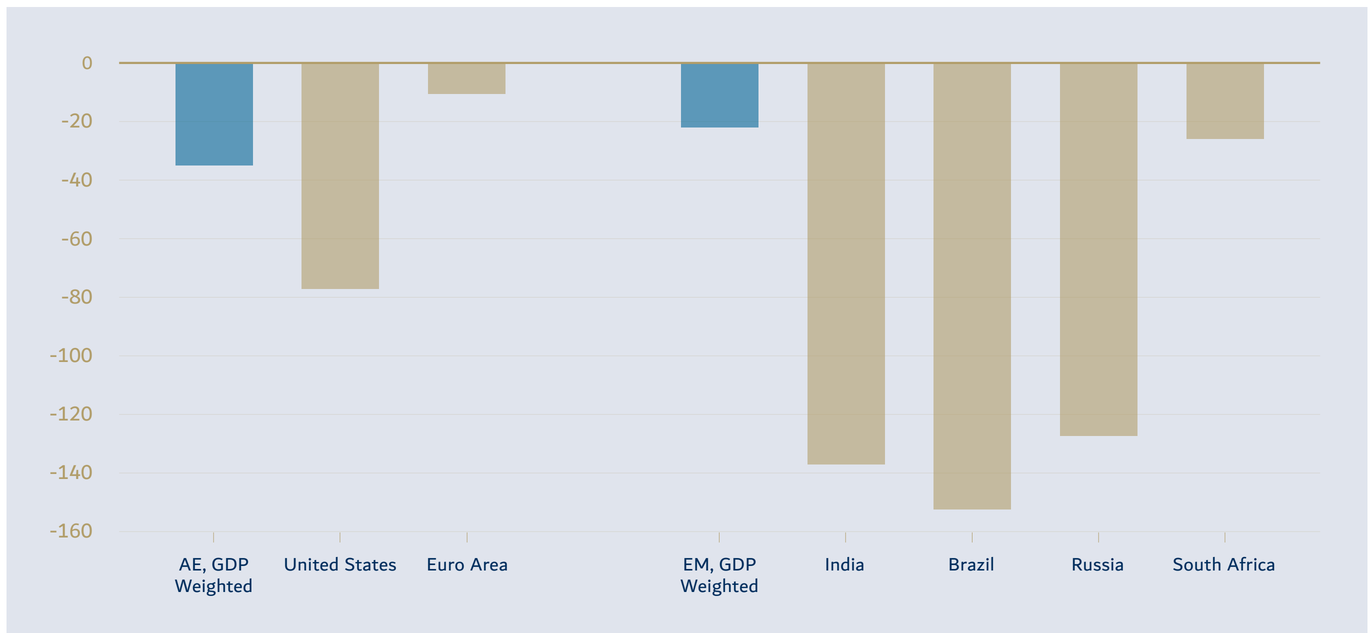
Over the past year, there has been a significant slowdown in global industrial activity and trade (annual percent change) / source: IMF



Story #2: Central Banks Came To The Rescue

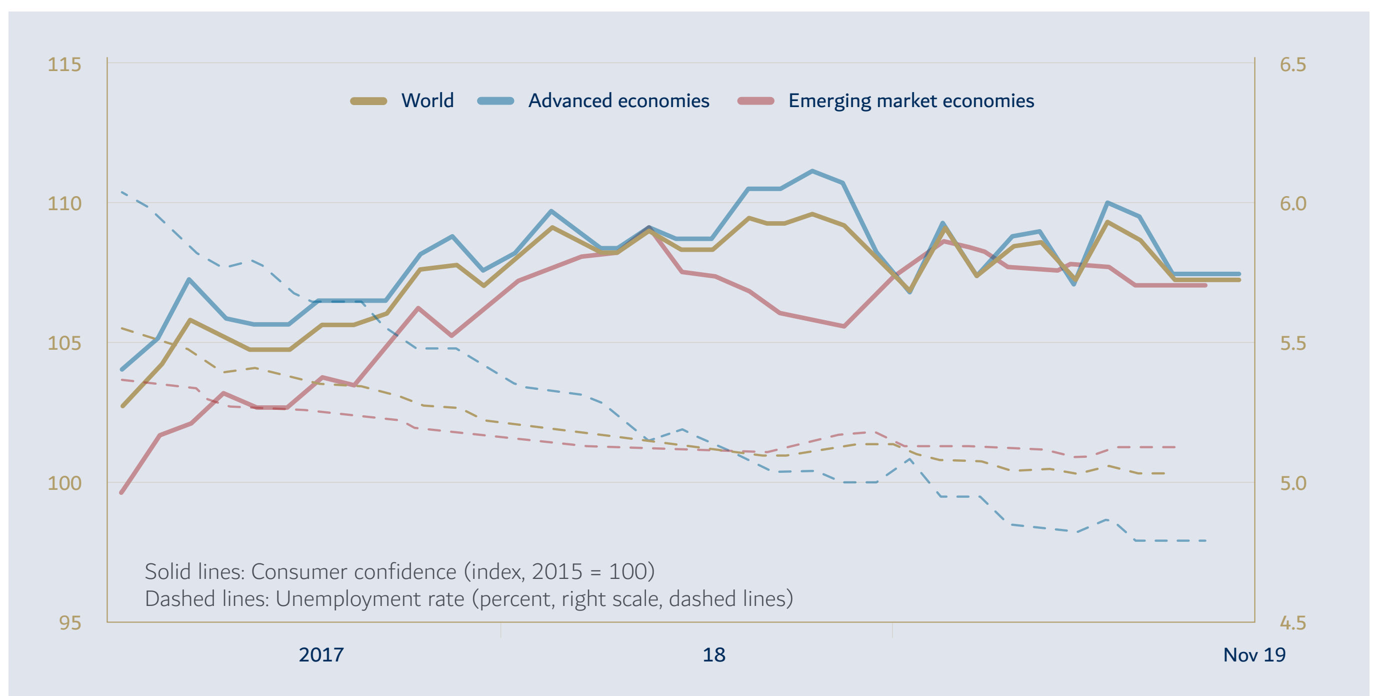
Central banks reacted aggressively to the weaker activity. Over the course of the year, several — including the US Federal Reserve, the European Central Bank (ECB), and large emerging market central banks — cut interest rates, while the ECB also restarted asset purchases. During the 4th quarter, the Fed had also been pumping billions into the financial system after the mid-September tumult in very short-term lending markets (Repo). This was interpreted by the markets as an expansion of the Fed's balance sheet and thus as a "Quantitative Easing" equivalent (the equivalent of a "risk-on" signal – see next story).

Large central banks have cut policy rates in response to weaker growth (2019 policy rate reductions in 2019) / source: IMF



These policies averted a deeper slowdown. Lower interest rates and supportive financial conditions reinforced still-resilient purchases of nondurable goods and services, encouraging job creation. Tight labor markets and gradually rising wages, in turn, supported consumer confidence and household spending.

Confidence boost - the continued resilience of spending on nondurable goods and services has meant steady job creation, which has supported consumer confidence / source: Haver Analytics & IMF



Story #3: Liquidity Boosted Financial Assets

Despite earnings going nowhere in 2019, equity markets performed strongly thanks to 2 major tailwinds:

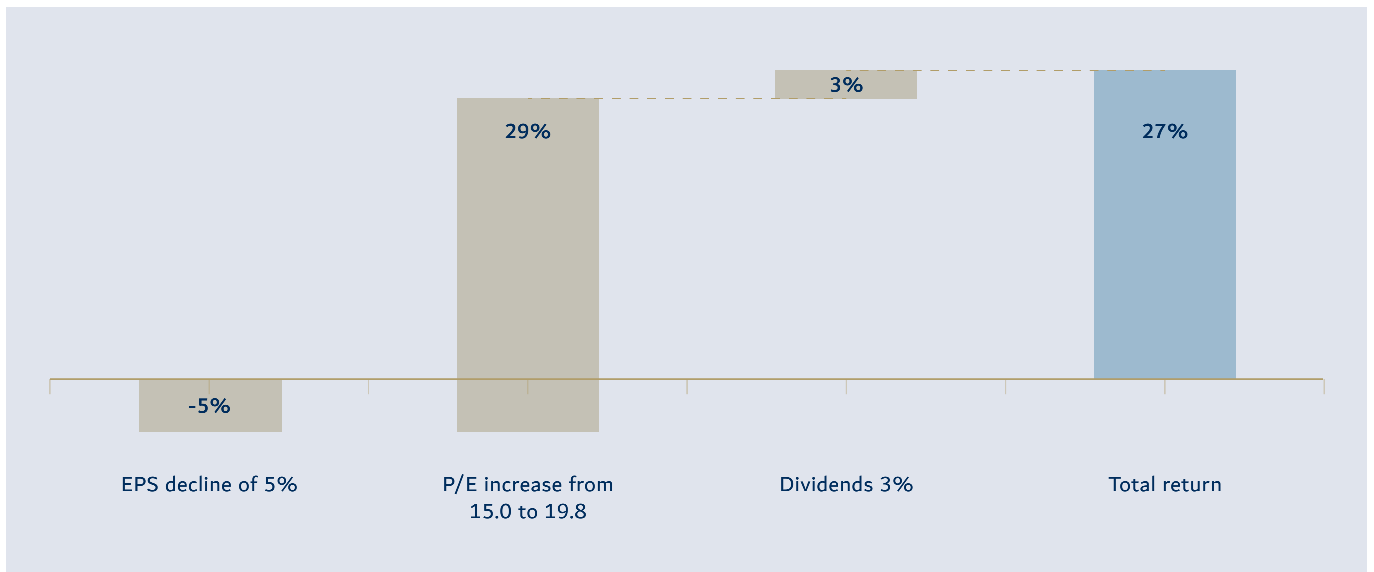
1. The Fed adjusted their 2018 "monetary policy mistake" by cutting rates and expanding central bank balance sheet – global central banks followed with the fastest rate cut since the 2008 Global Financial Crisis.
2. Trade deal "Phase I" created "melt-up" conditions in Q4.

Global liquidity has been driving global stocks upward in 2019

Story #4: Equity Markets Driven by Multiple Expansion

While 2019 has been a stellar year for equity markets, it is important to recognize that this year's ascent has been primarily driven by multiple expansions, as global earnings growth is expected to be slightly negative for the full year (see below).

MSCI All Country World Total Return – 2019 – Performance contribution



As mentioned earlier, 2019 is the exact opposite of 2018 which saw equity markets declining while earnings grew doubled—digits. That said, while valuations were the main driver of returns, if the past two years are viewed in isolation, when taken together, earnings have actually been responsible for equity market gains.

As shown on the chart below, over the last decade SP&500 stocks have gone up 2.8 times, while the index's underlying EPS are up 2.7 times (source: Bloomberg). The key takeaway for investors is that equity markets are driven by earnings growth over the long-run and returns are not constrained by the calendar.

Since 2010, the S&P 500 has kept a moderate slope in line with EPS growth

Story #5: Intra Asset Classes Return Dispersion

Despite a broad bull market involving all asset classes, we have observed some major intra asset classes divergences.

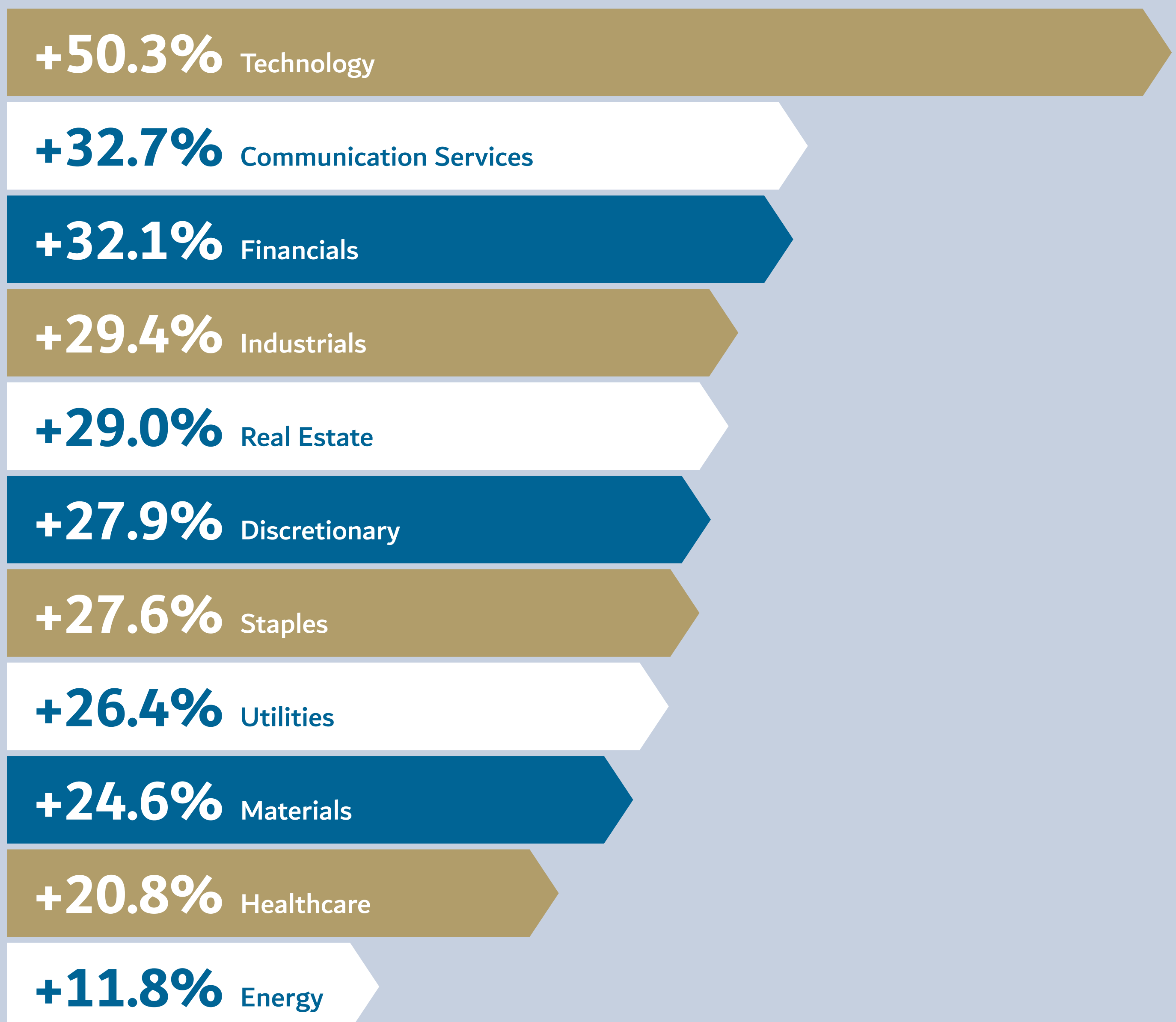
This was particularly the case with equities. For instance, the S&P 500 return in 2019 is almost twice the performance of the MSCI Emerging Markets. Within US equities, defensives slightly outperformed cyclicals, which is rather unusual when the main index advance is as strong as it was in 2019. We also note that US large-caps outperformed US small caps by 900 basis points. Still in the US, it is remarkable to see that just 2 stocks accounted for nearly 20% of the S&P 500 entire 2019 return (see table below).

"Superstar" firms made the largest positive return contributions in 2019 (source: Goldman Sachs)

Ticker	Company	Market cap weight		Total return	Fwd P/E	Consensus 2020 growth		Contribution to SPX return
		Dec 18	Current			EPS	Sales	
AAPL	**Apple Inc.**	**3.4%**	**4.6%**	**88%**	**23x**	**11%**	**6%**	**303 bp**
MSFT	**Microsoft Corp.**	**3.8%**	**4.5%**	**57%**	**29x**	**13%**	**11%**	**217**
FB	Facebook Inc.	1.5%	1.8%	57%	23x	36%	22%	86
GOOGL	Alphabet Inc.	3.0%	3.0%	28%	26x	15%	18%	86
JPM	JPMorgan Chase	1.6%	1.6%	46%	13x	2%	NM	72
AMZN	Amazon.com Inc.	3.0%	2.9%	23%	80x	26%	18%	69
BAC	Bank of America	1.1%	1.1%	46%	12x	10%	NM	50
MA	Mastercard Inc.	0.8%	1.0%	59%	35x	18%	14%	49
V	Visa Inc.	1.1%	1.2%	43%	30x	15%	11%	48
T	AT&T Inc	1.0%	1.1%	44%	11x	2%	0%	44
Top 10 Contributors		**20%**	**23%**	**50%**				**1023 bp**
S&P 500		**100**	**100**	**31**	**19x**	**9%**	**6%**	**3149**

Looking at sector performance within the S&P 500, all of the 11 Level 1 sectors posted positive performance in 2019. However, rising oil prices did not do enough to buoy energy stocks — the poorest performing S&P 500 sector. Although oil was up on the year, natural gas actually fell in price by about 26% in 2019. This effectively cancels out the gains made by oil, putting energy producers at the bottom of the list.

Technology stocks excelled in 2019 led by a big bounce-back from Apple, a big winner that gained more than 80% over the course of the year. Other strong sectors in the benchmark U.S. index included communication services and financials.



Outside of equities, there was also some divergence with fixed income as higher quality Junk spreads tightened while lower quality Junk spreads widened.

One possible explanation for the striking underperformance of hedge funds in 2019 despite one of the best returns for the S&P 500 in history is the underperformance of the “bullish” strategies (small caps, cyclicals, low quality junk bonds, etc.).

Story #6: A Strong Year for Bond Markets

Despite the strong gains recorded by equity markets, 2019 proved to be a remarkable year for fixed income investors as the US 2-year yield fell their most since 2008 while the US 30 year yield the most since 2014.

While the US 2y–30y yield curve was close to being flat in September, it steepened by 29 basis points over the full year, which means that 2019 is the first year the curve has steepened since 2013.

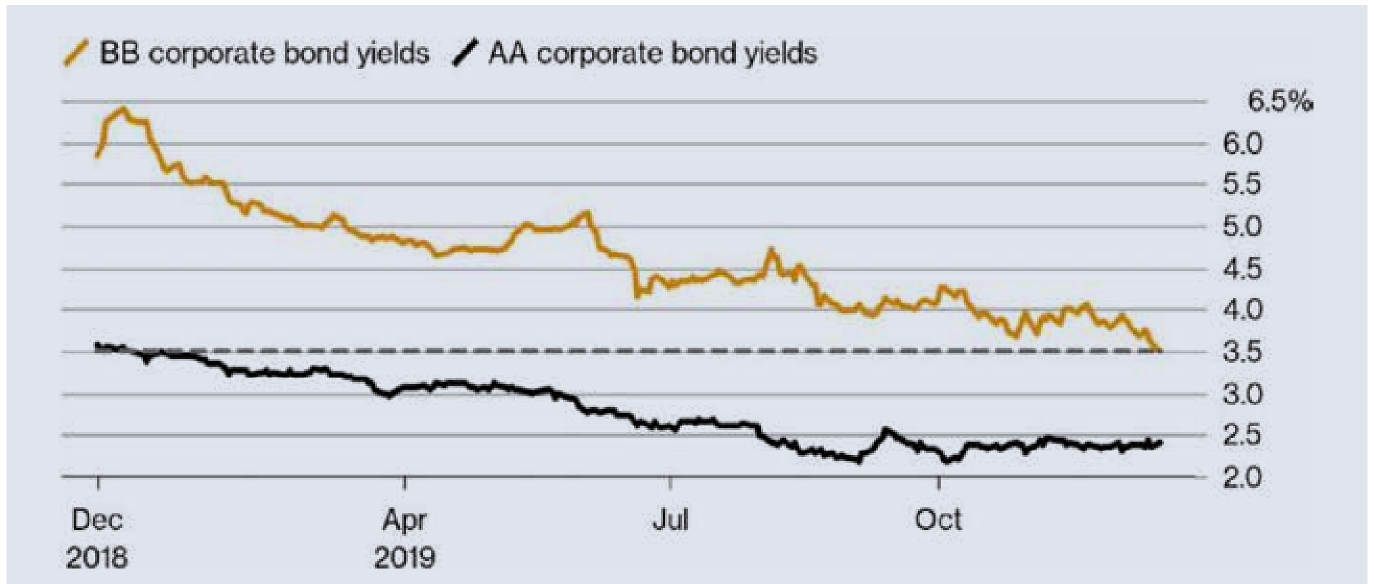
US Treasury 2y-30y yield curve (source: Bloomberg)

European government bonds performed strongly as well even at the lower end of the quality spectrum. We note that the US 10- year Treasury is now yielding higher than the Greek 10-year bond. Emerging market bonds had one of their best years ever with a 13% total return for both the Hard and Local currency indices.

Within credit, US high yield spreads (versus US Treasuries) dropped below 300 basis points again. The average BB-rated bond now yields just 3.5%, which was the yield of AA bonds at the end of 2018 (see chart below). We note that the spread between BBB and BB credits is close to all-time low. As mentioned in the previous section, the lower quality segment of high yield underperformed. For instance, B-rated loans have been under meaningful selling pressure as downgrades mount. While CLOs (Collateralized Loan Obligations) are the largest buyers of leveraged loans (about 50%), leveraged loan mutual funds and ETFs are the 2nd-largest buyers comprising around 30% of the demand. Funds and ETFs offer the promise of daily liquidity, yet the underlying asset is fairly illiquid and the time to sell could be lengthy, increasing the risk of freeze redemptions "à la Woodford". Cascading redemption freezes would likely reverberate through the entire leveraged loan markets including CLOs and thus lead to a full-blown credit crisis. Central banks have thus far been able to postpone a potential credit crisis. But by not allowing the business cycle to function – keeping zombies alive – central banks are crafting the conditions for more leverage to pile up. It is interesting to see that equity investors are more worried by B/CCC weakness than fixed-income investors are.

Despite the strong gains recorded by equity markets, 2019 proved to be a remarkable year for fixed income investors.

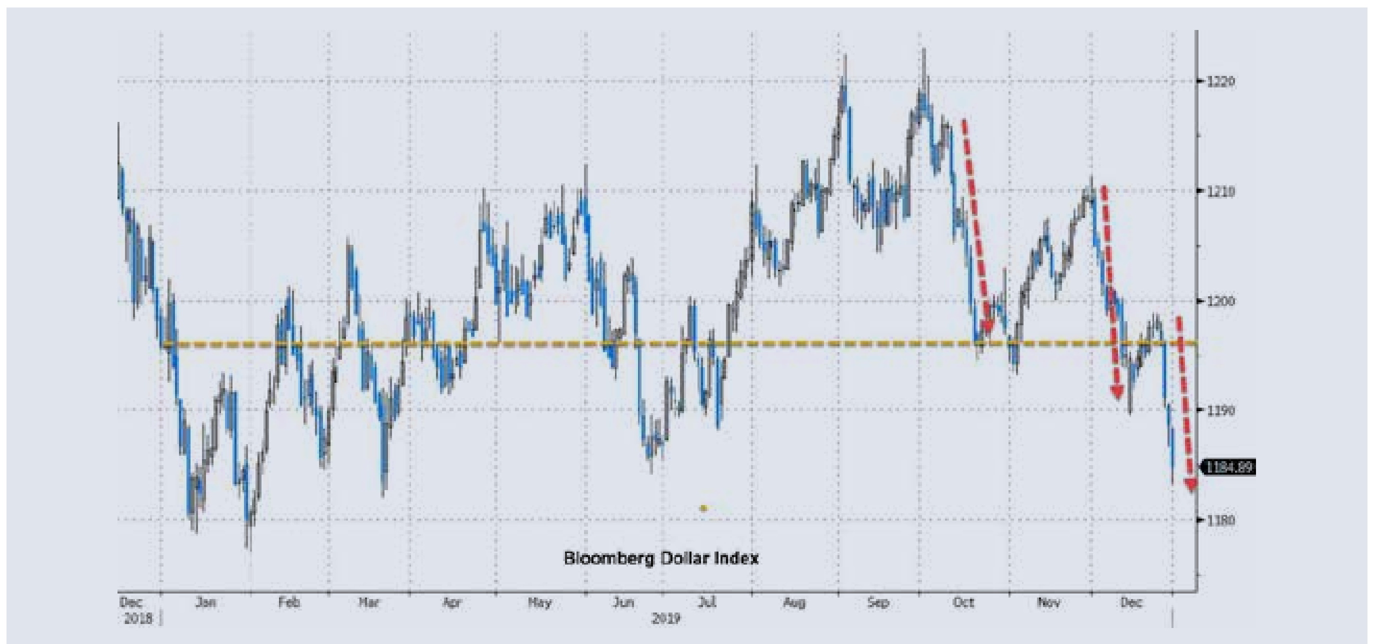
A year ago, double-A rates bonds yielded what double-B bonds yield today (source: Bloomberg)



Story #7: Currency Volatility Dropped to a 6-year Low

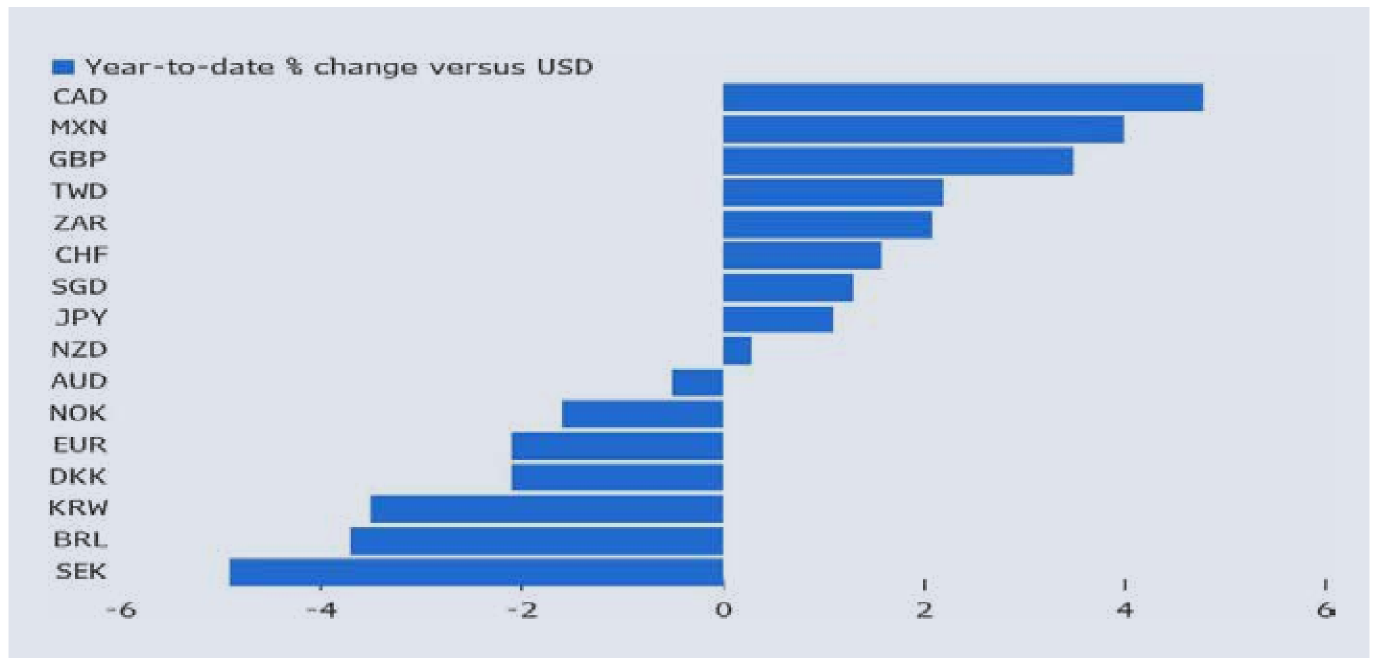
There was not much to be excited about within the Forex land in 2019. Indeed, the JPMorgan Global FX volatility index dropped to 6-year low levels with the euro's trading range being the tightest over the last 20 years. The Trade-weighted dollar index was nearly unchanged last year as it tumbled into year-end, erasing its earlier gains. We note that the three legs lower all started as the "Phase One" deal with China was announced to be 'completed' (see chart below).

Bloomberg dollar index in 2019 (source: Bloomberg)



The biggest currency mover on the year was the Loonier (Canadian dollar), which jumped over 5%, partially thanks to rising oil prices. Meanwhile, the euro fell over 2% against the U.S. dollar. The Swedish Krona was the worst performer within the major currencies (see chart on the next page).

Bloomberg dollar index in 2019 (source: Bloomberg)



Story #8: A Mixed Year for Commodities

The S&P GSCI Commodity index was up +8.7% in 2019 and thus underperformed both global equities and broad bond indices.

Nevertheless, there were some bright spots: Gold (+18%) had its best year since 2010 while Silver (+15%) had its best year since 2010. Both precious metals were driven by safe-haven buying fueled by rising geopolitical tensions and quantitative easing by major central banks. while. But Palladium was the year's big precious metal winner with a 53% gain (see chart on the next page). Over the past 5 years, Palladium has been the best performing precious metal, generating triple-digit returns, almost 5 times higher than gold.

Selected precious metals performance in 2019 (source: Bloomberg)

Within Energy, WTI Crude Oil (+34%) had its best year since 2016 on the back of crude oil export cuts by the Organization of the Petroleum Exporting Countries (OPEC) and expectations for improving demand outlook in 2020.

Natural Gas was the biggest loser in 2019 with a -26% decline in price. A record volume of new supply entered the market in 2019 just as the global economy slowed, curbing demand for the cleaner but comparatively more expensive fuel for power generation.

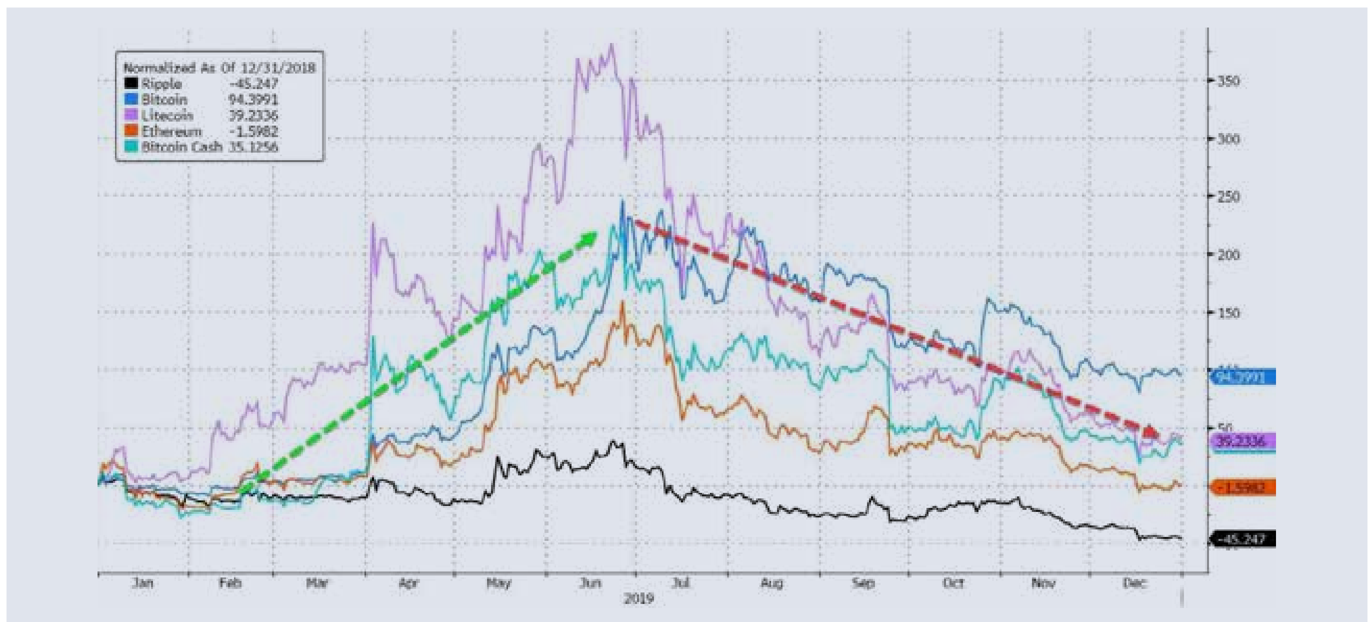
Within the broader Commodity complex, Iron ore was best performing commodity, up 140% for the year, with prices hitting a record in July before retreating as supplies increased. A ban on nickel ore exports by top miner Indonesia lifted London prices more than 30% this year. But copper, widely used in power and construction, gained less than 7% as Sino-U.S. trade relations capped gains.

Within soft commodities, Chicago soybeans and corn futures ended the year with little change, with the focus on Brazilian supplies entering the market early next year and slowing demand in China in the aftermath of African swine fever. Malaysian palm oil was up more than 40% in 2019 given concerns about lower production early next year as dry weather curbs yields across Southeast Asia. Arabica coffee was also among the gainers.

Story #9: A Tale of Two Halves for Crypto-Assets

Cryptocurrencies had an outstanding year in 2019, but it was a tale of two halves with gains halved after peaking around late June. Bitcoin is up +94% in 2019 while Litecoin is up "only" +39% after collapsing in the second half of the year. Ethereum ended the year almost unchanged while Ripple is down -45%.

Major crypto assets performance in 2019 (source: Bloomberg)



In terms of news flow and development, 2019 was overall a positive year for Bitcoin and crypto-assets. The rebound of the Bitcoin price, the announcement from Chinese President Xi Jinping that he would like to see China embracing blockchain technology and the start of the Libra project by Facebook were the key highlights of the year. The Libra announcement was probably the most seismic shift as it successfully goaded central banks around the world to start having a serious conversation about the digitization of currencies.

2019 was the year that kept crypto-assets and blockchain in the headlines of the mainstream media. It was no more a question of what or why — it became a question of when crypto-assets would gain prominence, and potentially lead the way.

There were also some big technological developments in terms of infrastructure for traditional institutions looking to trade digital assets. We have seen improvements in custody, execution, data and more. The biggest milestones were the launch of Bakkt and Fidelity Digital Assets. It is also important to note the continued development of the Lightning Network within the ecosystem.

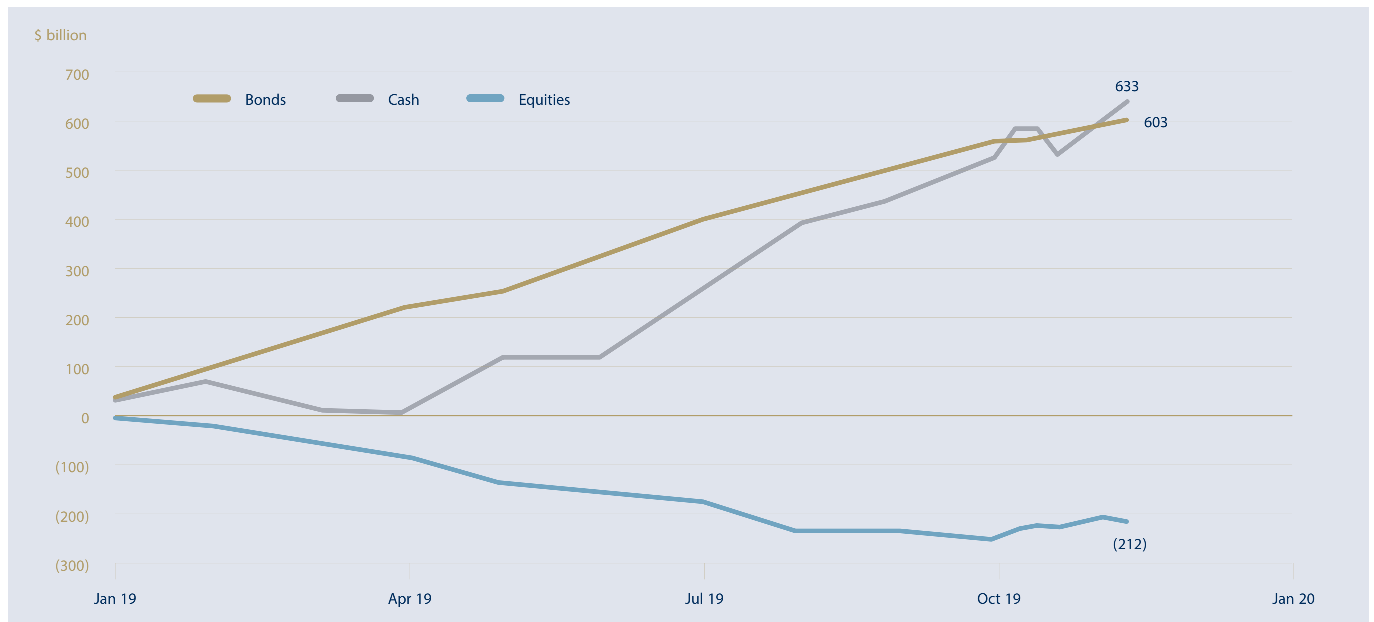
Last but not the least, 2019 was also the year of mining. The hashpower steadily increased throughout the year to reach an all-time high of 100 exahashes, a record for Bitcoin. The hashpower increased even though the price fluctuated wildly. This seems to indicate that cryptocurrencies, and more specifically Bitcoin, are here to stay.

However, 2019 was also characterized by a sharp decline in retail interest and disappointing institutional involvement. A major setback has been regulatory uncertainty in the United States.

Story #10: Fear of a Recession Has Led to a Record Equity Outflows

While global equities performed very well in 2019, it is remarkable to see that equities mutual funds and ETFs combined flows were in the red last year as negative geopolitical headlines and fears of recession pushed investors towards safer instruments such as bonds or cash (see chart below).

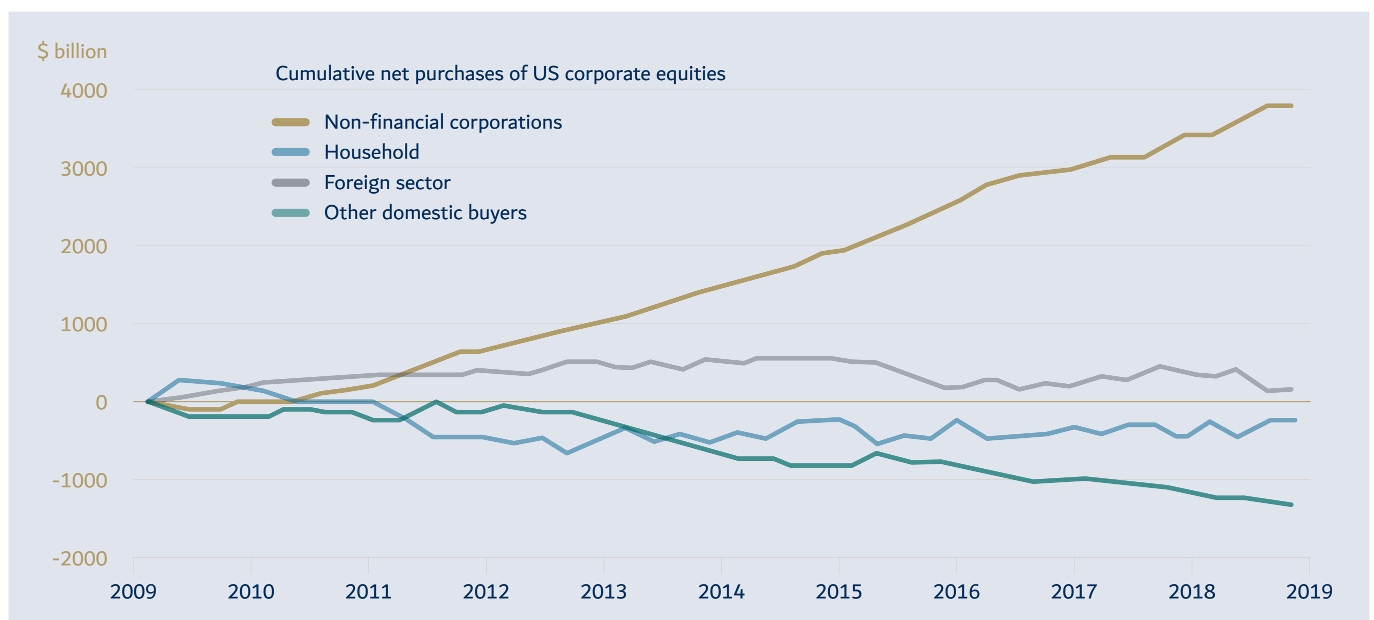
2019 was a year of record equity outflows (source: Goldman Sachs)



From a contrarian perspective, this is rather a positive development as it demonstrates that despite the extended bull run there is no sense of euphoria (this is usually the case at market peak). However, it does question mark what are the main drivers behind the equity rally?

As shown on the chart below, share buybacks have been the main driver behind equity gains since the 2019 market bottom.

Buybacks are the main source of the rally since 2009 (source: Deutsche Bank)



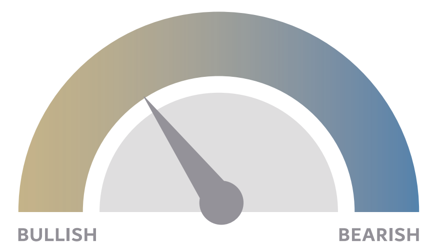
Global Market Outlook 2020

Our view on risk assets and equities in particular is guided by the changes and developments in the weight of the evidence.

On an aggregate basis, the global context remains favorable to risk assets. The evidence improved over the course of 2019 and has a slightly bullish bias as we prepare this outlook. While we expect more corrections and volatility down the road, we also believe that a globally-based, broadly supported cyclical bull market could unfold. With central bank easing and expansion in valuation multiples behind us, we expect a growth uptick to take over as a key support and argue in favor of a tactical tilt into more cyclical exposures, including Emerging Markets.

The scenario above is our base case. There is an alternative scenario under which global manufacturing does not pick up and instead cause spillovers to other sectors like services. Corporate earnings would weaken further, causing defaults and credit spreads widening. While the use of additional monetary stimuli would make a recession considerably less severe than in 2009, we would still expect a major decline in risk assets to unfold.

Global Equity Outlook: The Weight of the Evidence is Slightly Bullish



Macro Economic Cycle (Bullish)

The global economic cycle is likely to be extended just slightly more in 2020. Signs that manufacturing PMIs are stabilizing and will improve further out have increased, and financial conditions will remain favorable. This is mostly due to the continuous loose monetary policy by central banks around the globe.

We expect that the two major political headaches that dominated most of 2019 – the US-China trade war and Brexit – to have less impact in 2020. We do believe that the hard Brexit scenario will be avoided and what happens in the meantime should be considered noise. On the Trade war front, we anticipate a de-escalation in trade disputes although we do not bet on a comprehensive trade deal. Still, any slimmed-down version should be enough to bring back some business confidence and hence capital expenditures. In terms of economic policies, monetary stimuli are close to reaching their limits and a switch to some fiscal stimulus is a likely development.

Overall, our core scenario is for a cyclical strengthening to prolong the growth cycle, with global GDP growth in 2020 to be broadly in line or slightly stronger than in 2019 (+2.6% in real terms).

US – No Recession, Room for Further Easing if Necessary

The US economy is unlikely to slip into a recession next year as employment, consumer spending and services remain resilient. We expect the ISM manufacturing index to recover along the way, digesting the inventory overhang and moving back above 50. Contrary to the ECB and BoJ, the Federal Reserve has the ability to ease significantly, but will only do so if economic circumstances deteriorate. With monetary policy already pretty loose, however, this should not hamper growth. With 2020's slow start, US GDP growth is likely to be lower (<2%) than in 2019. We expect Trump to remain US president after the elections because the incumbent party tends to win whenever the economy is improving. We acknowledge, however, that the 2020 US presidential race looks open and is likely to be a source of volatility.

China – Lower Growth, No Collapse

Unsurprisingly, China's GDP growth is set to slow further due the economy transition from an investment-driven to a consumption-driven structure, the attempt by the government to bring a large debt burden under control and unfavorable demographics. China has used the ongoing trade dispute with the US as an excuse for this lower growth, and without a significant trade deal on the horizon, this is likely to remain the case. Like the US, China has room to stimulate the economy further if needed but will only do so reactively. However, things need to get worse before the government decides to provide heavy stimulus measures to boost short-term growth.

Europe – Waiting in Vain for Fiscal Stimulus

The outlook for GDP growth remains subdued. Germany is struggling with the global manufacturing slump and lower export growth, partly related to the US-China trade war. As a result, GDP growth in 2020 will be below 1%. Other major Eurozone economies, like France and Spain, will record better growth, albeit below trend as well. The ECB will not deliver any material additional monetary easing, unless economic circumstances turn ugly. A loosening of fiscal policy has the potential to reduce pressure on the ECB. The new political leadership at the European Commission (Mrs. von der Leyen) and the EVB (Mrs. Lagarde) shows more openness o expansionary fiscal policy, at the expense of austerity. However, we do not expect major fiscal stimulus. Indeed, Germany and the Netherlands are the two main contributors to additional government spending but are expected to record another government budget surplus next year. As mentioned earlier, we assume no hard Brexit, which should lift business sentiment for the whole of Europe, opening-up room for some lost capex spending.

Countries stand at a different stage of the economic cycle (source: Moody's analytics)

The Alternative Scenario

While our base case is for a cyclical strengthening in 2020, there is also a bear case with global economic growth flirting with recession and political tensions reaching a boiling point. In this alternative scenario, global manufacturing does not pick up and instead causes spillovers to other sectors, like services. Corporate earnings weaken further, causing defaults, first among the lowest-quality companies, especially those with large amounts of debt, and will spread out from there. Unemployment would start increasing and consumer spending would drop, causing GDP to shrink. In this scenario, we expect central banks to ease as much as possible and become even more creative. While the use of monetary policy would make a recession considerably less severe than in 2009, we would still expect a major decline in risk assets to unfold given the amount of leverage and excesses which have been created over the last few years.

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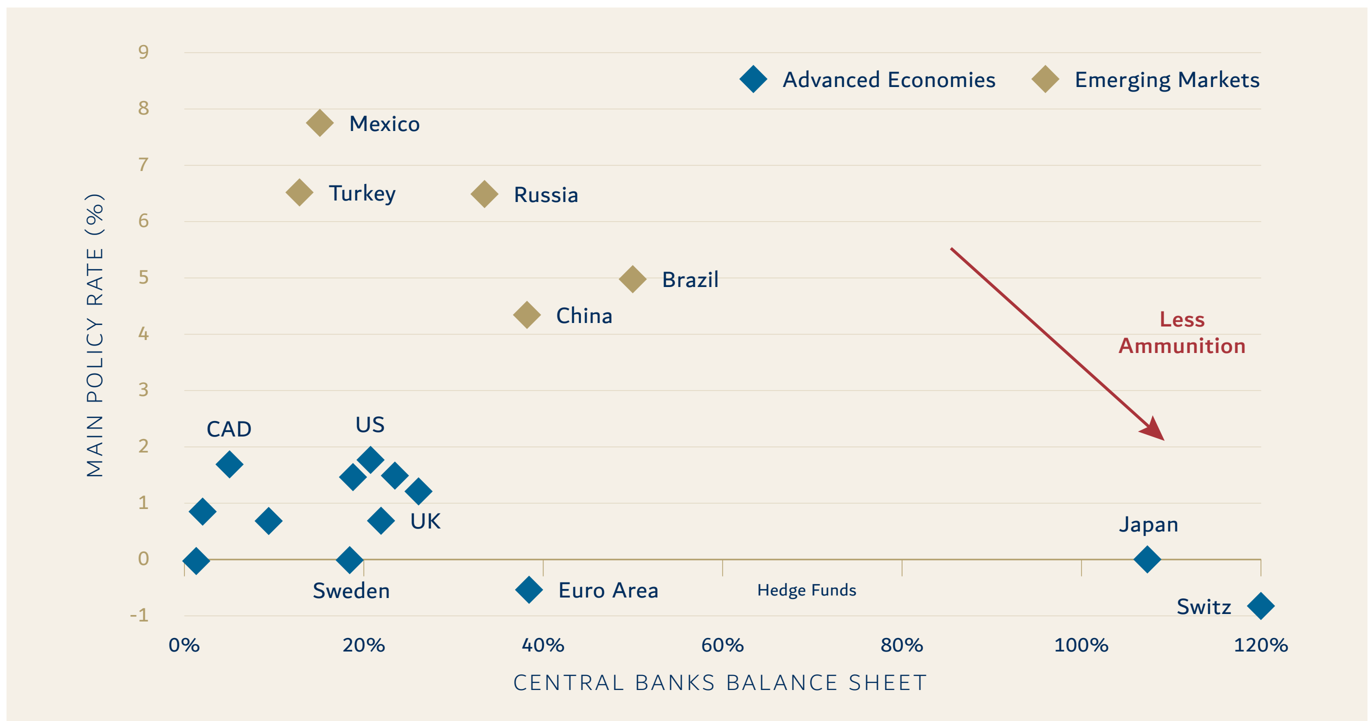
Monetary Policy (Neutral)

We see economic fundamentals driving markets in 2020, and less scope for monetary easing and other policy surprises. In the US, data from CME shows an expectation for at least one rate cut in 2020. But the bar for further easing by the Federal Reserve looks to be high — with no policy action barring a significant growth slowdown or an unwanted tightening in financial conditions. A downside risk on the US Monetary policy side is what it will take for the Fed to withdraw from its daily liquidity operations in the $2.2 trillion market for repurchase agreements, or repos - after it became a dominant player in a short three months. Another challenge for Fed officials would be to decide just how big the central bank's balance sheet, which is currently about $4 trillion, should be.

Elsewhere, the European Central Bank (ECB) and the Bank of Japan (BoJ) may deliver further monetary easing given persistent inflation undershoots. Both central banks have limited policy space left, however, and the side effects of negative rates – particularly on banks' profitability and ability to lend – increasingly undermine their policy efforts. As such, renewed monetary policy is likely to be limited to asset purchases – although they seem to have reached their limitations and created overvaluations in the sovereign bond market. The policy debate might increasingly focus on a potential hand-off from monetary to fiscal stimulus although the scope appears limited.

Overall, we believe the dovish pivot by global central banks is largely behind us as their ammunition is scarcer today. However, Emerging markets do have some room for further monetary policy action (see chart below).

Central banks ammunition is scarcer today although EM still have room (source: BofA Merril Lynch)



We believe the dovish pivot by global central banks is largely behind us as their ammunition is scarcer today. However, Emerging markets do have some room for further monetary policy action.

Earnings Growth (Neutral)

As mentioned in the macro cycle section, our base case scenario is for global GDP growth in 2020 to be broadly in line with 2019 as concerted monetary policy loosening ensures a cyclical strengthening. Based on these assumptions, we expect high single-digit earnings growth in developed markets based on slight margin improvement and revenues being in line with nominal GDP growth. The upside risk could come from easy monetary conditions which could trigger an improvement in manufacturing activity but also facilitate more share buybacks. From a regional perspective, we expect earnings growth to be more balanced in 2020 than last year. We note that bottom-up earnings expectations anticipate much higher growth for the cyclical segments of the market (versus defensives).

Within emerging markets, an acceleration of growth momentum in 2020 is likely to translate into higher earnings growth. The MSCI Emerging Markets earnings are expected to grow by 14.6% in 2020 (coming from a lower base), which compares with 9.1% earnings growth for the MSCI World. This is in line with emerging markets GDP growing faster than in the developed world.

While global earnings momentum is likely to be positive is 2020, we are also cognizant that current estimates may prove to be too robust. Expectations for a rebound of earnings rely heavily on improving economic conditions – hence the downside risk. In the US, we note that labor costs are rising at a faster pace than pricing. This creates downside risk on profit margins as well.

Valuations (Neutral)

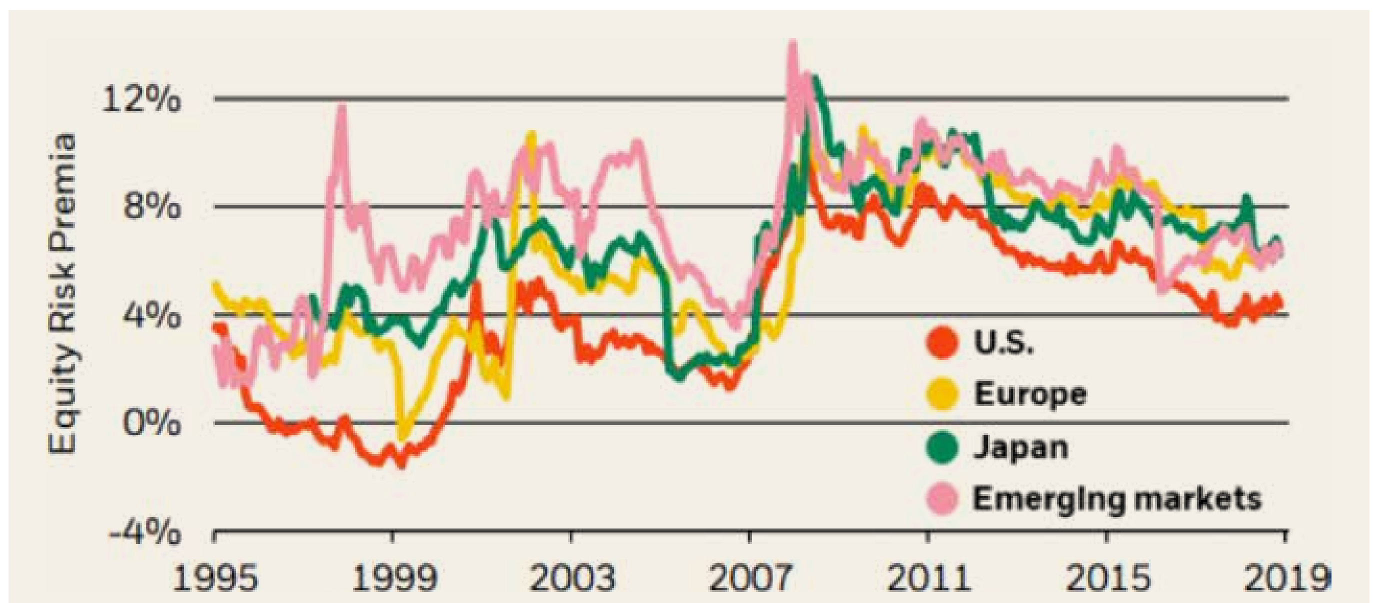
Price gains for stocks have outpaced fundamental improvements in 2019. Using either trailing or forward earnings data, Price/earnings ratios (P/E) are historically elevated. While valuations are not trustworthy short-term indicators, they do a great job in assessing the potential downside risk for stocks. Current P/E ratios have been associated in the past with sub-par returns. Elevated valuations put pressure on earnings to come through – and as mentioned earlier, earnings growth estimates could disappoint in 2020.

While absolute equity valuations ratios look lofty, stock markets do not look expensive in a multi-asset world. The equity risk premium has been consistently high in recent years as global bond yields continued to fall. Today is no different, with the equity risk premium still firmly above the historical average (see chart below). Historically, on an annual basis, equities have realized the best returns when the equity risk premiums have been the highest.

Within global equities, the rest of the world still look cheap versus the US. Some re-rating is likely in 2020.

Within sectors, defensives such as consumer staples, utilities and real estate trade at a premium to historical; average levels while cyclical sectors such as industrials, materials and financials trade at a discount to the norm. Against a backdrop of a global economy which is bottoming out and fading recession we see some scope for a rerating for cyclical sectors.

Equity risk premia 1995-2019 (source: Blackrock research Institute)



Investors Sentiment (Neutral)

As John Templeton once put it, "Bull markets... die on euphoria". Throughout 2019, we had been far away from a euphoric state of equity markets. Cash positions of global fund managers remained significantly above average, which is a contrarian bullish signal for stocks. In general, investor positioning was defensive with net outflows in equity mutual funds and ETFs (see first section of Perspectives).

However, shorter-term sentiment indicators have been shifting towards more optimism lately, though it is neither widespread nor excessive enough to weigh on stocks. Moreover, optimism has been quick to dissipate on any stock market pullbacks.

Still, a false sense of security seems to unfold after a decade of historically remarkable gains for US large-caps. For instance, the short interest on the largest S&P 500 ETF is at the lowest since October 2018. BofA Fund Manager Survey shows cash levels at 4.2%, the lowest cash balance since March 2013. This complacency can lead to unwise risk-taking by adding to crowded assets (with the view that time in the market is all that matters) at the expense of relatively unloved assets (including cash). A historical note: forward returns for equities tend to be inversely correlated to household exposure to equities and according to data from Ned Davis Research, current household equity exposure is in the top 10% of all readings in the past 70 years.

Overall, we would thus rate investors sentiment to be neutral (versus being a positive factor last year as investors were too pessimistic - which is positive from a contrarian point of view).

Seasonality and Other Market Cycles (Neutral)

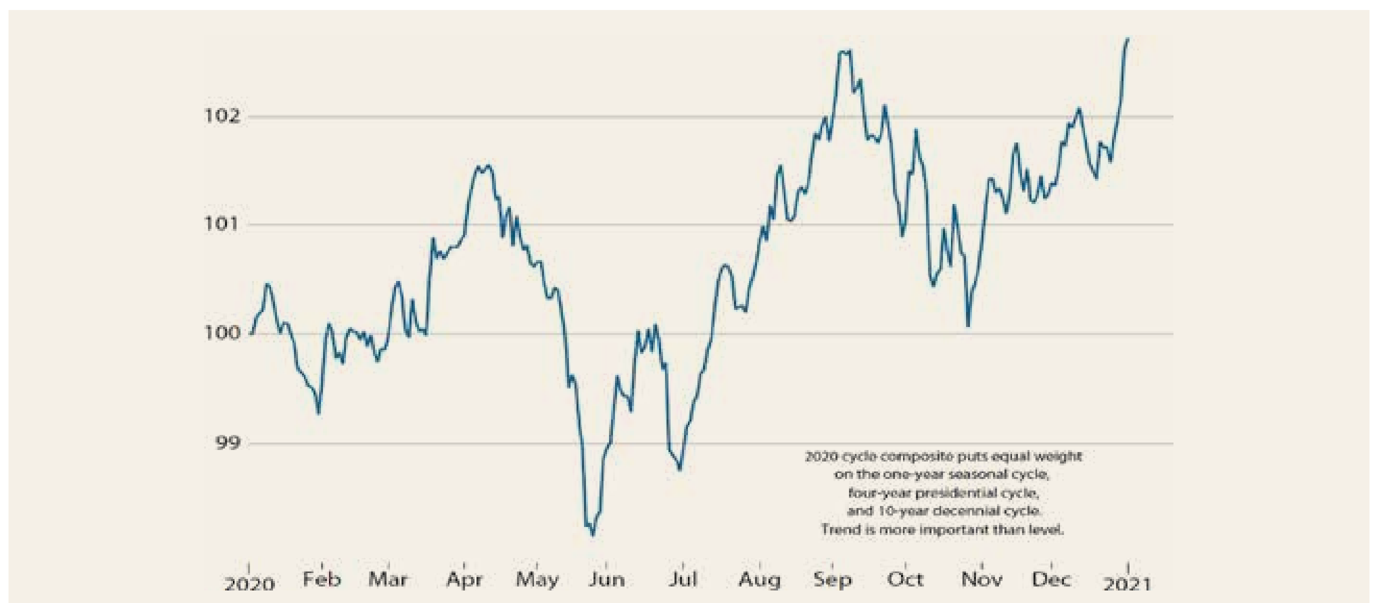
US Presidential election years since World War II have tended to see stocks struggle early, rally late (after election uncertainty subsides) and finish with an average gain of nearly 7%. The prospect of a presidential primary campaign and a Senate impeachment trial in the first quarter of 2020 is likely to exacerbate the tendency for early-year volatility. If President Trump's approval rating in the Gallup poll remains above 35% or so, the impeachment effort is unlikely to go anywhere and its conclusion could turn the market's attention more squarely on the election. Either way, 2020 is shaping up to be noisy and full of political conflict and uncertainty.

While seasonality (one-year cycle) remains favorable until April, the best opportunity for a seasonal tailwind may be closer to the actual election (i.e October - November).

Looking at the 10-year cycle, years ending in zero (depending on your accounting either the first year of a new decade or the last year of an old decade) have seen an average decline of 3% over the past century.

Using a cycle composite (which puts equal weight on the one-year cycle, four-year presidential cycle and the 10-year decennial cycle), the S&P 500 is expected to be volatile during the first half of the year, rally ahead of the US Presidential election and then exhibit some volatility again in the 4th quarter.

Cycle composite for the S&P 500 in 2020 (source: S&P Dow Jones Indices)



Technicals (Bullish)

The improving broad market backdrop over the course of 2019 provides support for the view that a new cyclical bull market has emerged. Early year breadth thrusts helped fuel the recovery from the 2018 lows, and additional breadth thrusts have helped sustain the rally (see chart below).

S&P 500 index and number of stocks with New 52w Highs

There is still room for improvement. Indexes that track the performance of the median stock have been more uneven. Taken all together, however, the late-2019 new highs on the S&P 500 have been accompanied by improving domestic and global trends and that is a meaningful improvement over the new highs that were seen in early 2019 and mid-2018. We note that the percentage of global markets with positive y/y change keeps growing which suggests that a new bull market is underway in global equities. The outperformance of cyclical and non-US equities during the fourth quarter was an encouraging development. From a cross-assets point of view, we like the fact that credit spreads have remained tight.

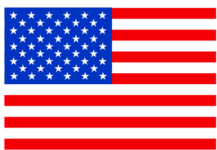
Bottom line: The weight of evidence remains slightly bullish and thus favorable for risk assets. While 2019 earnings growth has not been favorable for equity markets, concerted monetary policy loosening should enable a cyclical strengthening in 2020 and spur an acceleration of earnings growth. While central banks ammunition is scarcer today, monetary conditions remain supportive. Equity valuations are not cheap but remain attractive versus bonds. We also note that market sentiment is not too euphoric despite a record year for equity markets. US Presidential election years have been volatile in the past but generated decent equity returns on average, especially when the incumbent wins. Last but not least, the technical picture is favorable with breadth improving as more markets and sectors are participating to the upside.

We thus continue to favor equities over fixed income but expect some volatility in the months ahead. Investors should prepare accordingly and avoid extreme tactical bets.

Indicators Review Summary (+2)

Fundamental Factors (Leading Indicators)	Market Factors (Coincident Indicators)
Macro Economic Cycle: Bullish (+1)	Investors Sentiment: Neutral (=)
Monetary Policy: Neutral (=)	Seasonality & Other Market Cycles: Neutral (=)
Earning's Growth: Neutral (=)	Technicals (Trend, Breadth, Credit Spreads, etc): Bullish (+1)
Valuations: Neutral (=)	

Below, we highlight our preferences for the main regional equity markets.

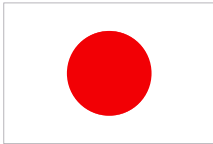


U.S: NEUTRAL

The outperformance of the US market over the last 10 years can be explained by its high exposure to growth stocks (Technology, internet and biotech) and under-exposure to Financials. While the outperformance trend versus the rest of the world might persist in the medium to long-term, we see a window of opportunity for international ex-US to outperform in the coming months on the back of a global cyclical improvement. This does not mean that we are negative on US equities. A slowing but still growing economy is a positive macroeconomic context for U.S equities. We believe the potential for multiple expansion is capped but expect earnings growth to improve in 2020. We prefer quality companies with strong balance sheets in a late-cycle environment. Technology and Health care are among our favored sectors, although the valuation multiples for the former are rich. Should the "growth scare" start fading, some cyclical / value stocks could be attractive as well (we note that Value is trading at a 45% discount to Growth on a forward P/E basis). Small & Mid-caps have been lagging as well and now look attractive from a relative valuation standpoint. Over the coming years, we expect US small caps to generate mid-teen earnings growth. Overall, we maintain a neutral stance on US equities as we believe that emerging markets equities currently offer more value, especially if the Fed maintains its dovish stance and if the dollar starts to weaken.

EUROPE: NEUTRAL

European equities performed well last year as markets have priced in the ECB's easing. While valuations remain attractive, we see no catalyst for relative performance in the foreseeable future. While eurozone equities could benefit from a recovery of the financials, industrials and materials sectors, we do see greater upside in cyclical exposures elsewhere – hence our NEUTRAL rating. For 2020, we expect high single-digit earnings growth for eurozone equities, broadly in-line with the rest of developed markets.



JAPAN: NEUTRAL

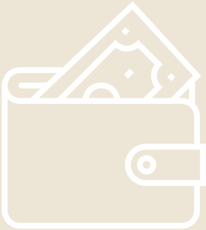
Japan has been the best performer in major equity markets since midyear as perceived easing in U.S.-China trade tensions led to a shift by investors into unloved assets such as value equities, including beaten-down Japanese stocks. We do not see this rotation having staying power though as trade negotiations will soon enter in Phase 2, which is much more challenging than Phase 1. Moreover, Japan is facing a number of domestic challenges (e.g recent sales tax increase could weigh on consumer spending and growth, the Bank of Japan may be running out of policy space, etc.). Still, should a prolonged trade truce between the U.S. and China take place and global manufacturing activities bottom out, we would need to reassess our view on Japanese equities. Another positive in the background: Japanese firms are gradually improving their corporate governance, reflected in increased payouts to investors in the form of dividends and share buybacks.

EMERGING MARKETS: OVERWEIGHT

The trend towards de-escalation in the trade tensions and an improvement in the global economic backdrop should help emerging market equities to outperform. After 15 months of decline, the global manufacturing purchasing managers' index (PMI) has rebounded from trough levels, led by an improvement in emerging economies. Historically, when the global manufacturing PMI rebounds from trough levels, emerging market equities outperform by 8% on average. Moreover, EM central banks (outside China) are likely to stay on their easing paths, supporting growth and equity markets. Valuations are attractive, particularly in Asia, while relative earnings revisions are at a seven-year high. We have a positive view on China, Emerging Asia and Brazil.

We believe the potential for multiple expansion is capped but expect earnings growth to improve in 2020. We prefer quality companies with strong balance sheets in a late-cycle environment. Technology and Health care are among our favored sectors, although the valuation multiples for the former are rich.

Our view on the other asset classes



FIXED INCOME

We maintain an under-weight stance on Fixed Income as we believe a "baby bear market" is a possible event in 2020 with government bonds being the most impacted segments. Indeed, major central banks are likely to keep policy mostly on hold in the near-term, even as growth and inflation firm somewhat.

The above tilt risk towards a steepening of the yield curve. We thus prefer shorter-term maturities in US Treasuries as well as exposures to inflation-linked (TIPS) debt amid rising US wage pressures and potential for supply shocks that could firm inflation beyond expectations.

We prefer global credit over government bonds. The income potential of Emerging Market debt – particularly local currency – looks especially attractive. With global growth expected to pick up, we favor high yield over investment -grade corporate bonds.

Indeed, after a long rally, High-quality US Investment Grade bonds now pose greater risk than many may realise. The duration of this class of assets has increased to near-record highs, while spreads over the yield of equivalent Treasuries have fallen to near record lows. A pick-up in interest rates, depending on its speed and longevity, could significantly push down prices across the market, which totals over $7tn, accounting for just over a quarter of the total US bonds outstanding. That could happen even without a deterioration in credit quality. Historically, the duration of the investment-grade universe has hovered around 6 years; it is now over 7.6 years. At this level, a 1 per cent increase in either spreads or Treasury rates would push prices down by 7.6 per cent. Historically, Treasury yields and investment-grade corporate spreads had a negative correlation. But this relationship has broken down. Over the past couple of years, Treasury yields and corporate spreads have displayed a positive correlation. In other words, rates and spreads have moved in the same direction: lower and tighter in 2019, and higher and wider in 2018. Investors should pay attention and consider either reducing the duration of their investment-grade corporate holdings or moving to corporate bonds with wider spreads.

Should the alternative scenario (see earlier) become more likely, we would re-consider the whole fixed income positioning favoring long duration government bonds and higher quality investment grade over the other segments.

CURRENCIES

The greenback became the winner by default over the past two years thanks to an interest rate advantage, US growth superiority and the safe-haven properties of the USD. These factors helped the US currency to resume its appreciation trend after a noticeable correction in 2017, when global growth was accelerating.

Going forward, we believe that an improving cyclical backdrop and decreased demand for safe havens could challenge the dollar strength. European cyclical currencies such as the euro (EUR), the British Pound (GBP) and the Swedish Krona (SEK) should benefit from a pick-up in global growth. Indeed, the Eurozone, the UK and Sweden are slowly shifting away from austerity towards expansionary fiscal policy while the US seems to have somewhat exhausted fiscal policy ammunition.

Despite our expectations for a cyclical improvement in 2020, we believe that the growth acceleration will not be strong enough to support commodity-sensitive currencies such as the Australian Dollar (AUD) or the New Zealand Dollar (NZD). Other commodity currencies such as the Norwegian Krone (NOK) or the Canadian Dollar (CAD) can count on rather hawkish central banks.

High-yielding emerging market currencies should benefit from both their interest-rate carry and stronger risk appetite. We expect the Chinese Yuan (CNY) to face less pressure in 2020 than last year thanks to a de-escalation of the trade war, less negative pressure stemming from the manufacturing recession and calibrated monetary policy easing.

Should our base case scenario unfold, safe-haven currencies such as the Swiss Franc (CHF) and the Japanese Yen (JPY) are unlikely to appreciate. However, the US Presidential election, uncertainty on Trade deal phase II and tensions in the Middle-East should keep safe-haven currencies in high demand.

OIL

There are 3 major drivers of oil prices to watch out going forward: **OPEC+ supply restrictions, the US shale boom and the strength of global growth** (which affects demand).

In 2019, **OPEC+** policy delivered most of the headlines but had limited impact on prices. The downward adjustment of the quotas which was decided at the last meeting of 2019 in early December was basically an alignment with reality. Saudi Arabia continues to shoulder the largest supply curtailments on behalf of the other members of the OPEC+. This extra effort is basically offsetting soft global demand and continued US production growth. In 2019, the way the oil market was able to absorb the shortfall of Iranian oil and the temporary disruptions following the Saudi attacks shows there is enough supply to absorb unexpected shocks.

When it comes to the **US shale boom**, the broad market context is unlikely to change in 2020. Whenever OPEC+ supply restrictions produce their desired effect in maintaining oil prices at reasonably high levels (WTI Crude Oil around USD 60-65), the US shale business' prospects start brightening and new supply comes to the market – which is not the outcome aimed by OPEC+. This means that the oil price upside potential is capped, unless the economy strengthens more than expected and demand tightens the oil market balance to an extent that supply restrictions bite. Still, some market observers warn that US oil production growth is grinding to a halt as capital markets closed for some producers with investors turning more cautious. However, completion activity seems to hold up well as the majority of the oil business still get or do not need external funding. Let's keep in mind that the oil majors are expanding their presence with a cost and funding advantage. Thus, US oil production should continue to grow and likely still meets half of global oil demand growth in 2020.

On the **demand side**, it is unsure if last year oil demand growth slowdown is due to cyclical or structural reasons. While the global manufacturing slowdown and Trade war had an impact on demand, the fast-changing demographics, declining car sales and rising electric mobility shares suggest that structural factors should not be dismissed. In sum, surprises in oil demand growth would rather come from emerging markets including Latin America or India.

The outlook beyond 2020 gets more interesting. There is a possibility that both Iran and Venezuela return to the oil market over the coming years, with Mexico too potentially reaping the benefits of the energy reform. This means that oil prices could come under heavy pressure beyond 2020 as rising oil supply could coincide with a recession-related demand slump and increased pressure from electric mobility.

Overall, we expect Brent oil to trade within a USD 60-70 range in 2020 with some long-term downside risk.

GOLD

Gold benefited from its status of safe-haven in 2019 as gold price increased alongside the rise of the amount of negative-yielding bonds. Looking forward, a re-acceleration of global economic growth is likely to cap the gold bull-market. However, as global growth is still on shaky grounds and as the trade tensions should remain a source of uncertainty for financial markets, in particular as the United States and China are still worlds apart in some important areas, we believe gold demand should stay sound and prices should remain supported

Meanwhile, emerging market central banks are likely to remain strong buyers of gold in order to diversify their currency reserves, providing support to the physical market. Adding in a somewhat softer US dollar, we see further upside for gold over the next two years. We stick to our constructive view on the yellow metal and suggest using Gold as a portfolio diversifier.

Key Takeaways and Our Asset Allocation Recommendations (one-year time horizon)

Heading into 2020, we continue to favor **equities over fixed income**. We expect moderate but positive returns for **equities** on a one-year time horizon. While valuations are more demanding than at the start of 2019, earnings momentum is expected to re-accelerate this year. Financial conditions remain supportive and the sentiment is not euphoric. To the contrary, we believe that the average investor continues to hide into two extreme segments of the market: long-duration bonds (as investors are underpricing global growth rate in 2020) and hyper-growth stocks (because the global growth environment is weak, and because there is no inflation, investors are ready to overpay for earnings growth).

With global growth picking up, we believe this "barbell" portfolio could break down paving the way for outperformance by the undervalued segments of the market such as international ex-US equities, US small & mid-caps and cyclicals. Actually, a marginal improvement in global growth expectations and a weaker dollar could even open the door to a broader cyclical equity bull market.

We continue to be cautious on Fixed Income. With nearly $14 trillion of bonds still trading in negative yield territory, the asset class remains too expensive – especially long-duration sovereign bonds. We favor US high yield bonds as well as Emerging Markets debt. We also continue to favor alternative fixed income such as trade finance funds.

Amid so much geopolitical and policy uncertainty, investors should consider being more opportunistic. We are at the stage of the cycle where investors need to add flexibility to portfolios and take advantage of alpha opportunities through **actively managed funds**.

Within **real assets & illiquids**, we are constructive on real estate as the search for yield is likely to stay intact. We also believe that hedge funds will deliver better returns going forward as they should take advantage of the rise in volatility and a more selective context. Private equity has become overcrowded with the amount of "dry powder" reaching record levels. Nevertheless, there are some attractive direct co-investment growth opportunities. Gold should be considered as useful portfolio diversifier in the current context.

On the **currency** side, we believe that the dollar will be under pressure but is unlikely to decline meaningfully. Emerging Markets currencies are expected to perform well. The Swiss Franc and the Japanese Yen can be used as a portfolio diversifier, i.e it should do relatively well in case of market turmoil.

Asset Allocation Matrix

	Asset Class View	Bullish	Neutral	Bearish
Equities	Overweight	Emerging Markets U.S Small and Mid Caps	U.S Large Caps Japan U.K Europe	
Fixed Income	Underweight	Trade Finance U.S High Yield Emerging Markets Debt (in $) Emerging Markets Debt (in local currencies)	U.S Investment Grade Corporates	Sovereigns
Real Estate/ Illiquids	Neutral	Real Estate Gold	Hedge Funds Energy Industrial Metals	Private Equity Agriculture
Cash		Emerging Local Currencies Euro ▲ British Pound ▲	U.S $ Yen Swiss Franc	

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Key Risks to Our Core Tactical View

Our core market view is to stay overweight in risk assets as growth concerns will progressively fade, paving the way for a global, broadly supported cyclical bull market.

That being said, we are aware that some key risks could challenge this "base case" scenario. As mentioned earlier, there is an alternative scenario under which global manufacturing does not pick up and instead cause spillovers to other sectors like services. Corporate earnings would weaken further, causing defaults and credit spreads widening. While the use of additional monetary stimuli would make a recession considerably less severe than in 2009, we would still expect a major decline in risk assets to unfold.

1. Return Of Inflation

The current market consensus is that inflation will remain muted and that central banks are more likely to cut, not hike, rates in 2020. There is risk is that inflation surprises to the upside and forces central bankers to raise interest rates more than expected. This outcome has ended many past economic and market cycles.

2. Trade Tensions Don't Fade

Markets have responded positively to the "Phase One" deal between the U.S. and China, seeming to believe 2019 was the peak in trade tensions and that 2020 will see them fade. However, while the "Phase One" trade deal stops the escalation of tariffs (at least temporarily), it does nothing to restrict use of other legal and political tools to try to constrain technological advances. As the U.S.-China strategic conflict becomes more focused on technological leadership, it may impact stocks in the technology sector which led the global stock market higher in 2019. There is also a risk for Trade tensions between the U.S. and European Union to heat up following WTO-approved tariffs in response to illegal support for airplane makers and France's new digital services tax on U.S. tech companies.

3. Brexit Ends Badly

The Brexit deal being passed by Parliament helps set the stage for the U.K. to leave the EU on January 31, 2020. However, this isn't the end of Brexit. During the transition period that runs until the end of 2020, the U.K. and the EU will need to negotiate a new trading agreement. As the year goes on, there should be indications as to the success of these negotiations. If evidence points to no agreement, the year-end split with the EU could have similar economic impacts to a no-deal Brexit. The markets may begin to price in the risk of disruptive economic consequences.

4. Rising Costs Prevent Earnings Rebound

Despite a weak revenue picture, analysts expect a 9-10% rebound in earnings per share in 2020 for the global companies in the MSCI World Index, which saw no growth in 2019. This expectation could be threatened by a rise in costs. Labor is the biggest cost for most companies and record low unemployment rates combined with weak productivity could mean pressure on wages to rise, squeezing corporate profit margins and resulting in weaker than anticipated earnings. After a rise in valuations lifted stocks around the world in 2019, an earnings recovery may be needed to cement or build on last year's gains.

5. Manufacturing Recovery Fail

After a 15-month long global manufacturing downturn, a four-month rebound began in August 2019. However, this could be another false start, with manufacturing running out of steam just as it was about to start growing again. This is one of the potential triggers for our "Alternative scenario";

6. Geopolitical Conflict

The markets have been largely immune to geopolitical incidents of the past two years. It showed little response to terrorist attacks in the Strait of Hormuz, the attack of Saudi oil processing facilities which temporarily cut Saudi oil production in half, the protests in Hong Kong ignited by a controversial extradition bill, etc. A number of geopolitical concerns for 2020, including those with North Korea and Iran, could very well interrupt the market's complacency.

7. Surprise US Election Outcome

The biggest global political event in 2020 is the U.S. election. For now, markets seem to be unresponsive to the candidates' rise and fall in the polls. But, as the election draws closer, the markets may start to price in the potential for sweeping changes with uncertain impacts for legislation-sensitive sectors like financials, health care, and energy.

8. Ineffective Monetary Policy

Market participants exhibited a high degree of confidence in central bankers' powers to manage the global economy in 2019. Yet, monetary policy may be nearing the end of its usefulness in stimulating global economic growth.

9. The "Bond Bubble" Could Come To An Abrupt End

This would lead to a top in credit and equities multiple, causing Wall Street to deleverage and pushing Main Street towards recession;

10. A Disorderly Rise In The Us Dollar given US policy divergence could create a potential liquidity crisis in Emerging markets over the course of 2020.

Some Upside Surprises

Of course, it's not all negative. There may be upside surprises in 2020 as well, such as: meaningful fiscal stimulus by world governments, a rebound in business spending, and a reacceleration in China's economy. With the latest reading for the OECD's global composite leading indicator ticking up for the first time in two years, perhaps global growth may pickup in 2020, rather than merely stabilize. As we consider unexpected positive impacts, it's worth noting that European economic data has been surprising on the upside in recent weeks, after disappointing economists in both 2018 and 2019.

Be Prepared

Whether or not these particular surprises come to pass, a new year almost always brings surprises of one form or another. Distinguishing between news and noise is likely to be even more difficult than usual in the months to come. We will continue to monitor the weight of evidence and the aforementioned risks very closely. Having a well-balanced, diversified portfolio and being prepared with a plan in the event of an unexpected outcome are key to successful investing. ***In the next section, we review our favorite themes for 2020.***

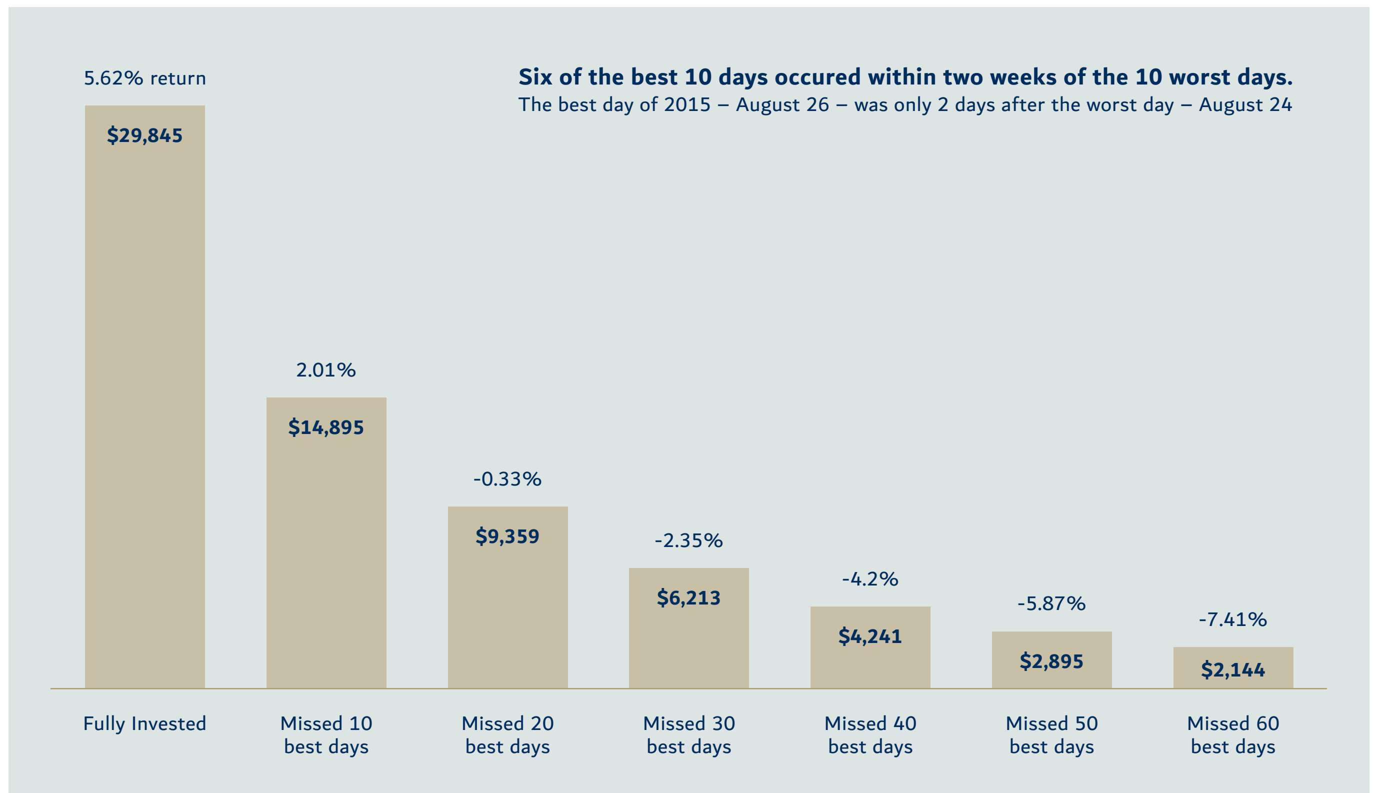
Investment Themes for 2020 and Beyond

Theme 1: Stay Invested Into Risk Assets

As mentioned earlier, our base case macro scenario is favorable to risk assets. While we expect more corrections and volatility down the road, we also believe that a globally-based, broadly supported cyclical bull market could unfold.

Maintaining an overweight stance to equities after such a rally is never an easy task. Investors are also forewarned that volatility (and the likelihood of correction) is likely to increase going forward. But this will be the price to pay to stay allocated to equities in the next couple of months. As it has already been well documented, timing the market is a very difficult and potentially costly task. As shown on the chart below, investors who stayed invested across the full cycle sharply outperformed those who unfortunately missed market recovery phases as they stayed on the sideline for "safety" reasons.

Performance of a $10,000 investment into the S&P 500 depending on exposure



Investors who stayed invested across the full cycle sharply outperformed those who unfortunately missed market recovery phases as they stayed on the sideline for "safety" reasons.

Theme 2: US Elections

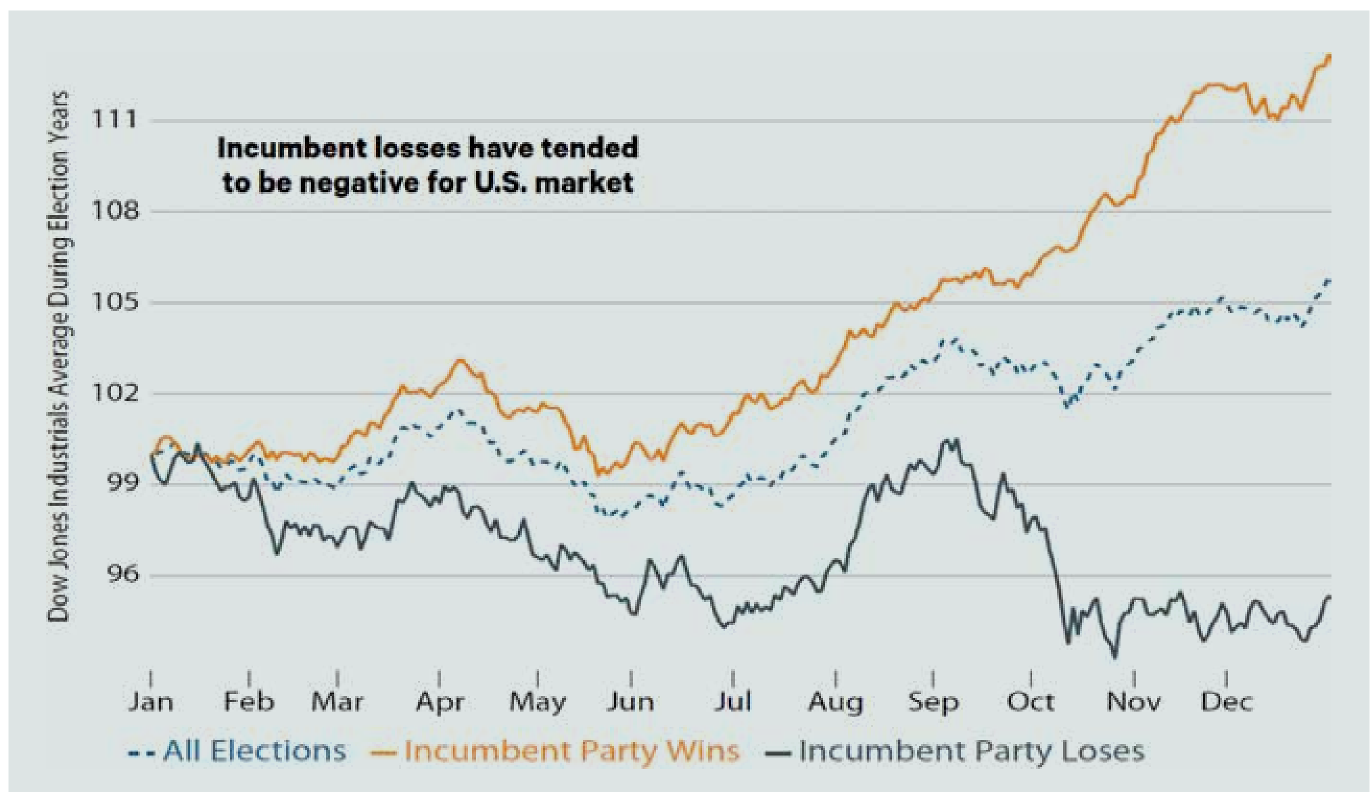
Heading into 2020, the U.S. presidential election is top of mind for investors asking how it might impact their portfolios. While national elections generally don't substantially affect global investors, the U.S. election is an exception to that rule. Indeed, investors both in the U.S. and abroad should pay attention in the run-up to the election and monitor the debates for a number of key issues and this for at least two reasons.

First, a win by the incumbent party historically had a positive impact on the US equity market (see chart below). Investors are thus likely to monitor election polls very carefully throughout the year. The Democrat party nomination outcome might also have an impact on market volatility as "leftwing" democrats such as Elizabeth Warren are not seen as market-friendly.

Second, there are numbers of themes which will be debated ahead of the elections by the candidates. Some of them could create some uncertainty among investors and thus have a major impact on market performance and volatility – for instance:

- **Corporate taxes: If a Democratic candidate prevails in 2020, there could be sweeping changes to corporate taxes while tax rate is likely to remain unchanged if Mr Trump wins;**
- **Trade policy: Mr Trump could become more adversarial with China if he is reelected;**
- **Technology: Investors should be prepared for greater scrutiny of big tech (whoever wins);**
- **Wealth inequality: If President Trump is reelected, he might push to make the personal tax cuts from his Tax Cuts and Jobs Act in 2017 permanent. But under a Democratic president, income tax rates for the wealthy would likely increase;**
- **Healthcare is a huge debate topic in the lead-up to the 2020 election. President Trump has weakened the Affordable Care Act, but a Democratic president would likely strengthen it;**
- **Environmental legislation: President Trump has loosened environmental regulations, but if a Democrat wins in 2020, they would almost certainly retighten them. This could put pressure on the carbon-based energy sector.**

S&P performance during election year depending which candidate wins



Theme 3: The Return Of The Underdogs

We have been through an extraordinary period of value factor underperformance over the last 15 years. There were only two periods of extreme divergence in style performance over the last 30 years: the "Tech Bubble" (growth outperformed sharply between 1994 and 2000) and the pre-GFC (Value outperformed sharply between 2000 and 2008). Historically, a brutal style rotation took place in each of the two previous extreme periods (see chart below).

The record outperformance of MSCI Growth vs MSCI Value (source: Goldman Sachs, Datastream)

But after a very long period of underperformance, the value style has made a slight comeback since early September 2019. Interestingly, the return of value has also coincided with the US equity market underperformance versus Japan, EM and Europe. The one common thread is that both value and non-US equities have both been underdogs. What the recent outperformance of value and non-US equities shows us is that equity investors are increasingly uncomfortable overpaying for arguably crowded trades, whether from a style or regional perspective, and are ready for a change. They just need a trigger. The resumption of the US-China trade negotiations provided such a trigger in early September. For this return of the underdogs to continue, we need a cyclical improvement in global growth which is basically our base case scenario. As of now, the key risk for investors would be to fall into a "value trap." i.e value stocks get even cheaper as fundamentals continue deteriorating. But some quantitative research shows that in the last 18 months we have actually seen an improvement in fundamental earnings for value stocks (while valuation kept deteriorating). This combination is unprecedented and thus suggest that the value style could be on the brink of an extraordinary bounce-back.

Within Value, we like in particular the banking sector. It has been out of favour for a long time but its post-crisis repair is now well-advanced. Cost-cutting and the move from branch-based activity to online platforms could start to bring rewards. In 2020, European banks will be allowed to buy back their equity and we see a number of banks being quick to do this. In emerging markets, banks have often been tainted by the woes of their developed-world counterparts, but their business case remains strong. Generally, bank profit margins are improving. So, after many years of underperformance of the wider global equity market, we think the bank sector is due for a catch-up in 2020.

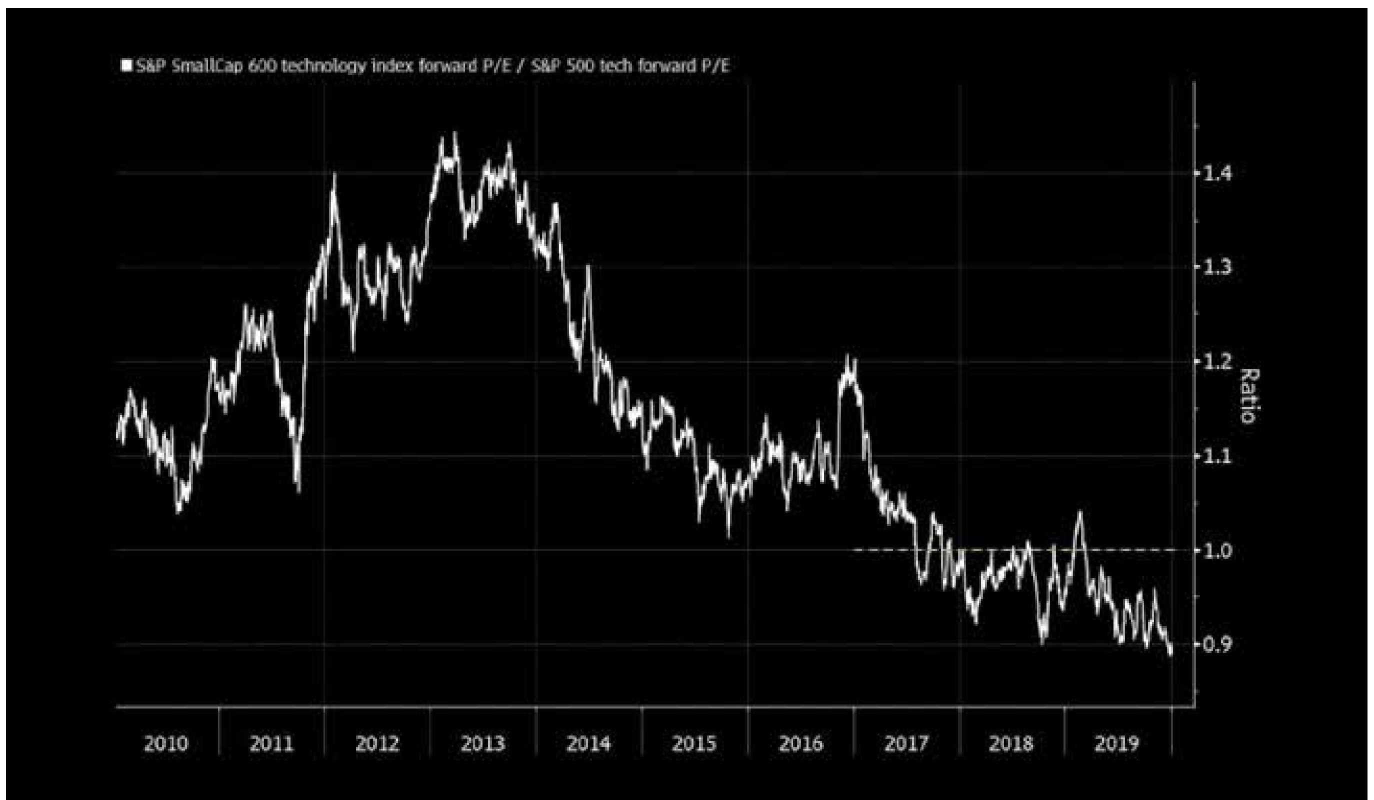
Clearly, in our alternative (and less likely) scenario, investors would return to seeking what is likely to become even more scarce growth among equities, the more visible the better, and willing to pay a premium for it.

Theme 4: US Small-Caps

US small cap companies have also been among the "underdogs", lagging large caps in four out of the last five years. We believe they are due a catch-up.

Academic research has demonstrated the existence of what is known as the "size" or "small-cap" premium, i.e smaller capitalization stocks historically produced excess returns, largely in compensation for their higher risk. But over the last few years, stronger gains have been made in the large-cap S&P 500 index than in the small cap Russell 2000 index. One of the reasons for this underperformance by small-caps is the fact that the S&P 500 is heavily weighted in the technology sector, while the Russell 2000 is more heavily weighted in financial services. Within sectors, however, the performance of big and small companies can diverge sharply: large-cap technology stocks have recently produced better returns than small-caps companies (see chart below).

US small-cap technology index fell to its lowest relative valuation since 2001



But there are reasons to think that this gap in performance is due to reverse, with small-caps doing better. First, big technology companies are increasingly being scrutinized with the result that their business models may not be as sustainable in the future. Their valuations may suffer if this realization takes hold. Second, there is every reason to think that innovation will still be a strong feature of small-cap companies: after all, today's large cap tech companies started out small. Finally, we think small cap companies could well be the target of the large amount of 'dry powder' accumulated by private equity companies, which has proved difficult to employ in non-listed companies. As recently mentioned in EFGAM research, small cap companies could well be the 'new private equity'.

Large-cap technology stocks have recently produced better returns than small cap companies.

Theme 5: Brexit Boost

After three and a half years of Brexit uncertainty, we see the UK as set for a rebound. Indeed, the Sterling, the UK equity market and UK property have all been out of favor since the referendum vote in favor of Brexit in June 2016.

To our opinion, a formal Brexit will, we think, take place at the end of January. We also believe that the UK and EU will find a satisfactory way of working together. This could lead to a significant improvement of investors' sentiment towards the UK by the end of 2020.

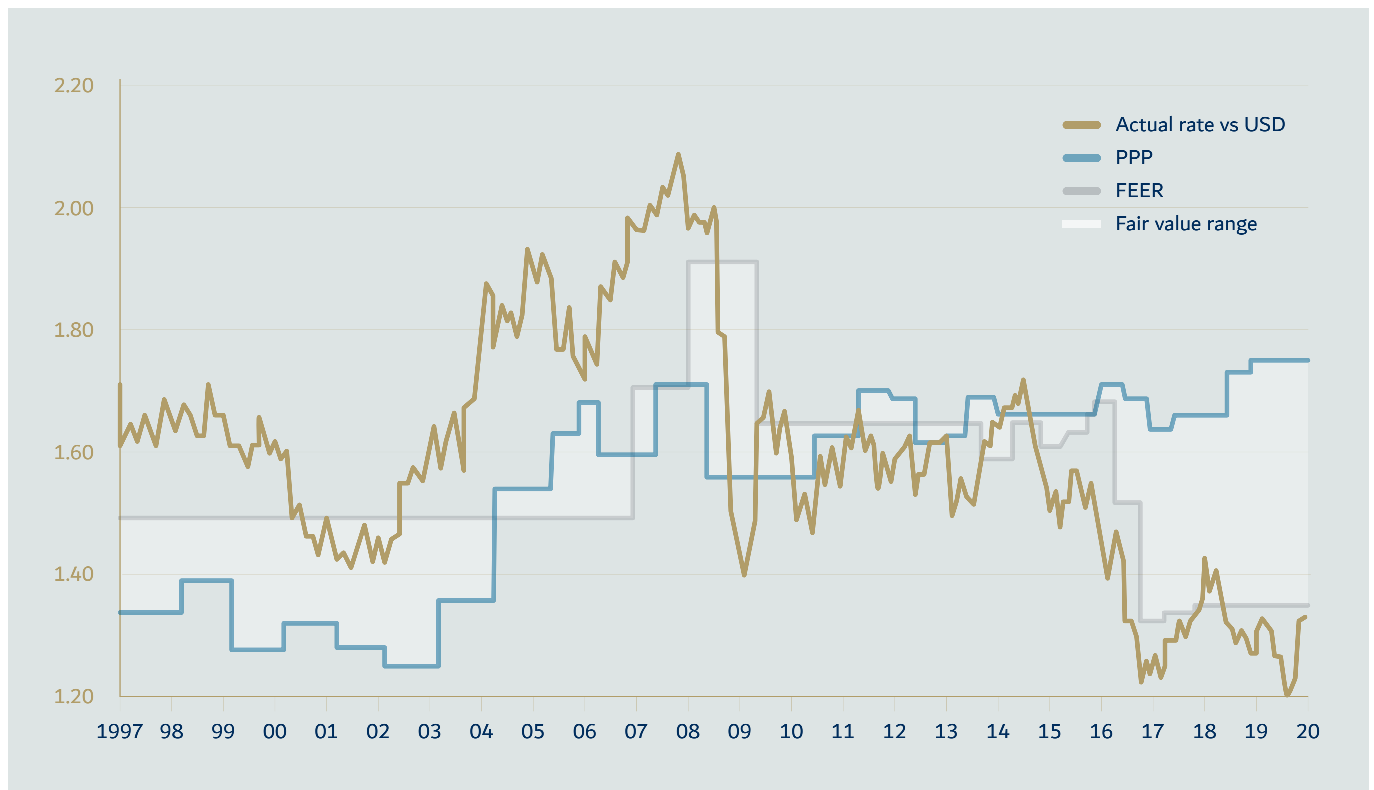
Indeed, UK Prime Minister Boris Johnson has a powerful incentive to avoid the economic disruption that a no-deal Brexit would produce. A soft Brexit is also in the interest of the European Union.

Sterling remains undervalued (see Figure 9a) and could well recover to the US$1.35-1.40 rate. UK equities are cheaply valued, both in an absolute sense and relative to government bonds – where the gap between equity and bond yields is the highest since World War 2.

Aligned with the previous theme favoring small caps, UK small cap companies are also cheaply valued relative to large cap companies as they trade on a forward price-earnings multiple of 11x compared to 12.5x for large-caps.

UK equities are cheaply valued, both in an absolute sense and relative to government bonds – where the gap between equity and bond yields is the highest since World War 2.

The Sterling remains undervalued (source: EFGAM)



Theme 6: Emerging Asia

As already discussed in the 2020 Global Outlook section, we are positive on emerging markets equities including Emerging Asia. More specifically, we do have a positive view on the three following countries:

Indonesia

2019 has been a poor-performing year for Indonesia, with almost a flat return. This has been primarily due to earnings disappointment leading to foreign capital outflows. On almost all valuation metrics (P/E, P/B, etc.), Indonesia looks relatively cheap against its own history while ROE has remained above 10%. 2020 earnings are estimated to grow at 11% y/y from low single-digits in 2019. With elections behind them, a stronger government coalition should be a game-changer. Jokowi's second term is backed by a 74% parliamentary majority vs 37% in 2014. This should help drive reforms for the next five years. Should reforms gain traction, foreign flows should come back, leading to a re-rating of the market (especially banks).

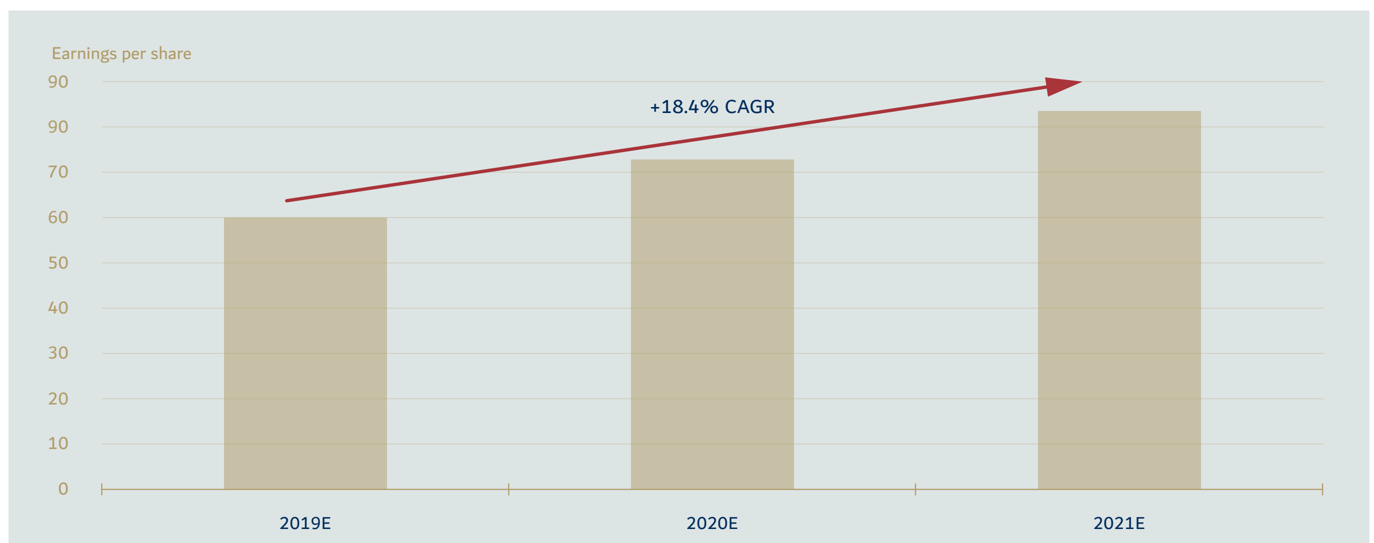
Philippines

Similar to Indonesia, Philippines equity performance was disappointing in 2019 with mid-single-digit returns. This underperformance (vs. MSCI EM index) can be explained by the delayed approval of the 2019 national budget, resulting in substantial underspending in the first semester of 2019. In 2020, public spending is expected to rebound while a dovish central should encourage private corporate investment. On almost all valuation metrics, the Philippines is very cheap while 2020 earnings are estimated to grow around 10% year-on-year. Sectors such as consumers and property, which benefit from lower interest rates and higher liquidity, are expected to outperform. Materials could also benefit from the government's infrastructure spending. With a fiscal deficit of 2.5% of GDP, there is some room for government spending.

Vietnam

Vietnam stocks continued to underperform in the second half of 2019, as US-China trade tensions dampened market sentiment. Vietnam's P/E is currently below its five-year average despite the fact that Vietnam is the only country within Asia whose GDP growth forecast has been revised upwards. Vietnam still has a massive growth potential, driven by supply chain shifts, a surge in urban population, favorable developments in labor market trends and an upswing in foreign investments. The removal of foreign ownership limits on listed companies, which is now capped at 49% for most companies (select sectors such as banking and aviation are limited to 30%), should further enhance its ability to sustain rapid growth. It should also provide a liquidity boost and could see Vietnam being upgraded by MSCI from Frontier to Emerging Markets status.

Earnings in Vietnam is projected to grow at a 18.4% CAGR – Source: Julius Baer, Bloomberg



Theme 7: Greater China Equities

Due to downward pressure on the Chinese economy, policymakers in China recently shifted to a modest monetary easing stance. This should help in boosting market sentiment on Chinese equities, hence our positive view on Greater China. While Taiwan looks expensive after the 5G Theme driven rally in 2019, we believe that Mainland China and Hong-Kong stocks offer investors with attractive upside potential.

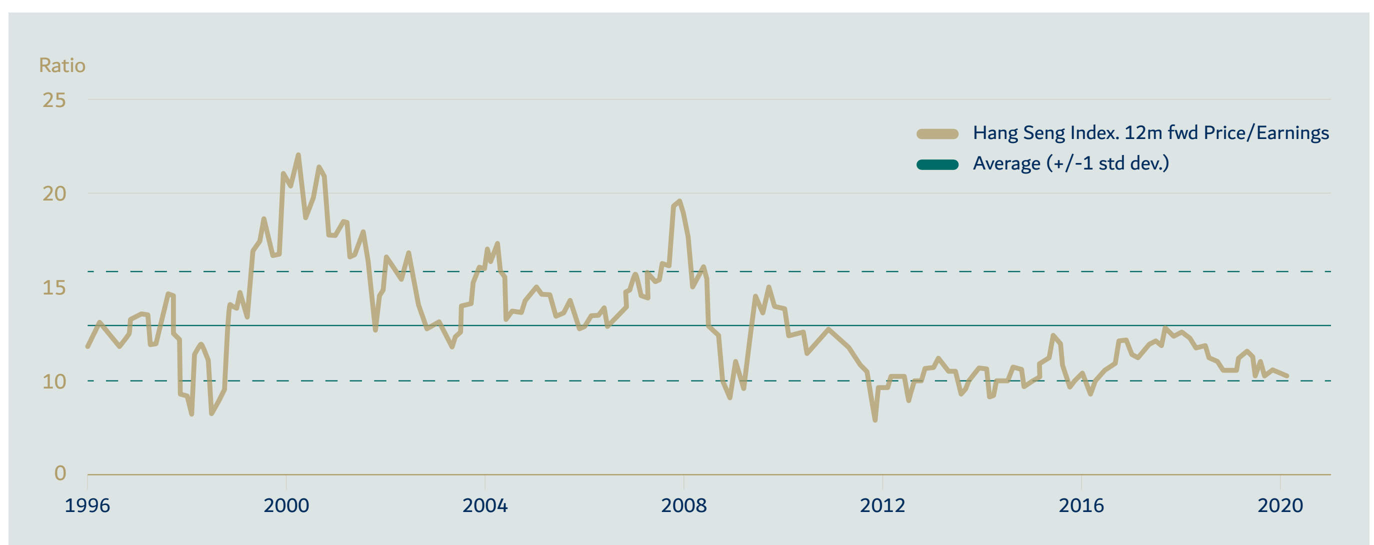
Mainland China

The inclusion of A shares into the MSCI regional benchmark is a very important milestone, as it is "forcing" international investors allocating to mainland Chinese stocks, which is becoming an asset class by its own. From a cyclical perspective, we believe that monetary easing, accelerated infrastructure investments through fiscal easing and some fine-tuning on local property purchase restrictions will drive a profit recovery in 2020. When it comes to offshore equity, the expected rotation from growth to value might benefit China which is by itself a value trade. We do see two types of opportunities within China equities. First, the "old economy" names can be bought tactically as they should benefit from a stabilization of economic growth while they trade at attractive valuations. The other opportunity set can be found within the "new economy" – indeed, the internet, healthcare and consumers names benefit from secular trends such as e-commerce, aging demographics and consumer upgrade.

Hong-Kong

Social tensions are pushing Hong-Kong towards recession. In October, retail sales declined 24% and exports fell 9% compared to 2018. The PMI index dropped to its lowest level since 2003. However, nevertheless, a lot of investors' concerns seem to be priced in. The Hang Seng Index is trading at 10x forward price/earnings, which is close to its historical low (see chart below). Meanwhile, the social tension has recently shown some signs of abating, although visibility remains low. The Hong Kong stock market is comprised of roughly 70% offshore Chinese companies and 30% domestic Hong Kong companies. While the former should benefit from a more favorable macro policy backdrop in China, the domestic Hong Kong companies are facing the headwind of an economic recession in the city. In her policy address in October, Chief Executive Carrie Lam unveiled several economic initiatives, with the key focus on housing. A featured policy is the relaxation of loan-to-value requirement, which in our view will benefit the Hong Kong residential developers. Last but not least, Banks currently trade on attractive dividend yield.

The Hang Seng Index is trading close to its historical low – Source: Julius Baer, Bloomberg



Theme 8: Green Investing

2019 will be remembered by many as the year the world woke up to climate change. Going forward, tackling climate change will move to the top of the agenda around the world. Acceptance of the fact that greenhouse gas emissions cause global warming and that these need to be curbed will become (almost) universally accepted. The realization that action on climate change is needed is rapidly moving into the mainstream.

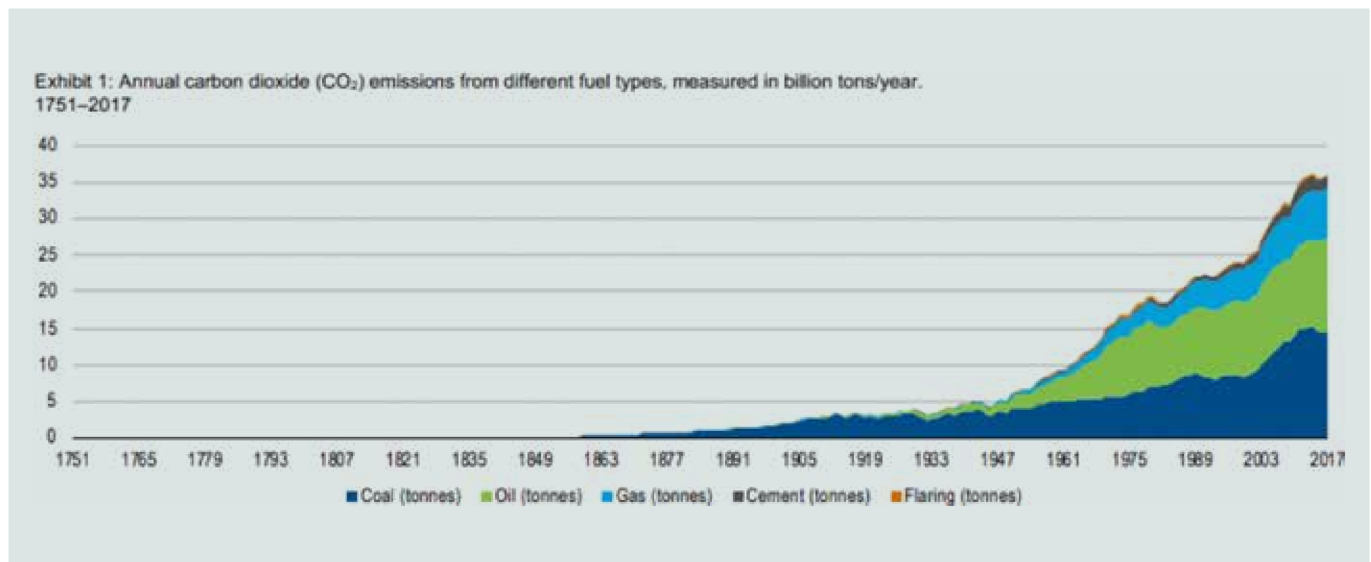
A big theme for 2020 will be more spending on green initiatives. Indeed, emissions of greenhouse gases will need to be cut significantly if global warming is to be restricted to 1.5-2.0°C. Carbon dioxide (CO2) emissions from burning fossil fuels account for almost two-thirds of global greenhouse gas emissions and are the most immediately practical to control. A switch from fossil fuels to solar and wind energy, investment in carbon capture and storage technologies and a phasing out of subsidies on fossil fuels will be the key elements.

The latter amount to as much as US$5 trillion (6% of global GDP) and is the largest in emerging economies. We think that Europe will be at the forefront of this green move in 2020.

From an investment point of view, the companies best positioned to manage the risks and capitalize on the opportunities associated with climate change are of two basic kinds:

1. Those providing services and solutions to help others reduce emissions and increase energy efficiencies, and
2. Those more adaptable and resilient companies working to "future-proof" their business models by reducing emissions and resource use faster than their competitors.

Global CO2 Emissions by Fuel Source – Source: Templeton, GCP, CDIAC



Theme 9: Capital Preservation Within Fixed Income

As mentioned in our Global Outlook section, our base case is for a cyclical improvement in 2020. We expect the major developed world central banks to keep interest rates at or below their current levels in 2020. That will make 2020 a tricky year for developed market fixed income. Indeed, German government bond yields along the maturity spectrum remain negative while the US 10-year Treasury yields of almost 2% look somewhat generous. A "baby bear market" in bonds is likely should the global economy start to re-accelerate.

The best way to preserve capital and "clip" a decent coupon is to look for value within credit markets. For instance, we see value in emerging market local currency debt. With subdued inflation and the US dollar stable, emerging market interest rates can be cut further in 2020. This should set the scene for local currency-denominated debt to do well. While some emerging market countries still face some headwinds (this is the case in particular for Argentina and Turkey), most emerging economies are now on a relatively firm footing as far as domestic growth and inflation are concerned. With the US dollar generally highly valued, however, we think the currency risk is lower than before.

There are also opportunities for yield pick-up in US High Yield. In addition to a higher coupon than investment-grade bonds, there is still room for spreads over Treasuries to compress a little, generating capital gains and thus making this segment as one of the best areas on a risk-adjusted return basis.

Theme 10: Buying Gold And Bitcoin As Portfolio Insurance

In the global outlook section, we included an alternative scenario under which global growth will fail to re-accelerate which would lead corporate earnings to weaken further, causing defaults, a rise in unemployment rate and consumer spending, altogether causing GDP to shrink. In this scenario, we expect central banks to ease as much as possible and become even more creative.

Should this alternative scenario unfold, there is a risk of a sudden crisis of confidence in fiat currencies, including the dollar. In 2019, gold performed strongly while bitcoin became the world's 8th largest "currency" in market value. We view these two assets as the ultimate portfolio diversifiers in case of a further money printing leading to a "hyper-inflation" scare.

Indeed, traditional currencies, be it the US Dollar, Euro, Yen or Pound are all inflationary in nature, due to the very fact that central banks can print them at will. This means that fiat money is losing value every day as its purchasing power is reduced.

One of the most common hedges against inflation is gold, due to its limited supply and scarcity. Even though gold is not an ideal investment (no earnings and no dividends), it does retain value better than fiat currencies and is fairly tradable.

During times of economic crises, most people pull their wealth out of fiat currencies and into precious metals, to preserve its value, at least until the economy recovers.

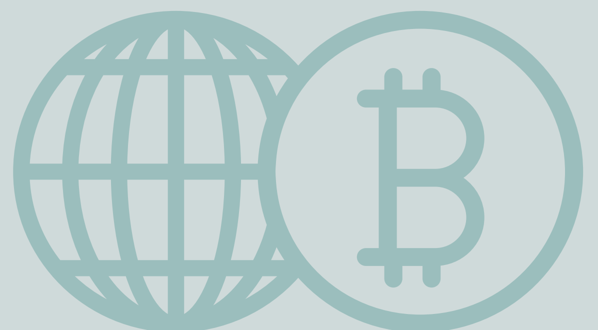
Bitcoin shares many of the characteristics of gold, most notably that it is a scarce and limited resource. There can only ever be 21 million Bitcoins in existence and not a single coin can be created arbitrarily — this makes Bitcoin a deflationary currency, theoretically increasing its purchasing power every day.

Bitcoin also has some key advantages over gold:

- It can be held, moved and managed easily and cost-effectively
- It can be traded or exchanged almost instantly
- It virtually crosses all physical and geographic boundaries
- It can be spent effortlessly in daily use

However, Bitcoin's volatility is a major factor which cannot be ignored. As such, any investment in bitcoin as a portfolio hedge should be limited to a very small percentage of a global portfolio.

In 2019, gold performed strongly while bitcoin became the world's 8th largest "currency" in market value.



5 Megatrends to watch in 2020 and beyond

One way investors can structure their portfolios is around "Megatrends", i.e secular themes that capture the major societal shifts underway. The idea is that businesses involved in these shifts are expected to benefit disproportionately as demand is expected to span decades.

#1: The Rise of Robot and Artificial Intelligence (AI) in Boosting Productivity

In terms of technology at the service of humans, innovation and application development is endless. Growth in digital data usage is massive.

Thanks to increasing computing power and big data, artificial intelligence (AI) has been expanding at a fast pace in many industries, with major advances in the fields of natural language processing and computer vision. The development of the Internet of Things could give another massive boost to AI applications over coming years. With this, smart cars, smart homes and smart factories (Industrial Internet of Things) could become reality sooner than expected. 5G will enable more intensive use of data for artificial intelligence, virtual reality, and digital health and the use of technology to deliver financial services.

Automation is the number one priority for a vast majority of companies across several sectors and Artificial Intelligence is to play a key role. Robots (collaborative most notably) adoption should benefit from falling costs and from increasing labor costs in emerging markets that make them an attractive ROI proposition.

Companies well positioned to benefit from these trends can be found within Semiconductors & equipment, Enterprise Software, Electronic equipment & components, internet platforms, cloud computing, robot manufacturers, and bio-tech utilising big data to develop targeted drugs etc.

#2: Wealth and Income Inequality in a Multipolar World

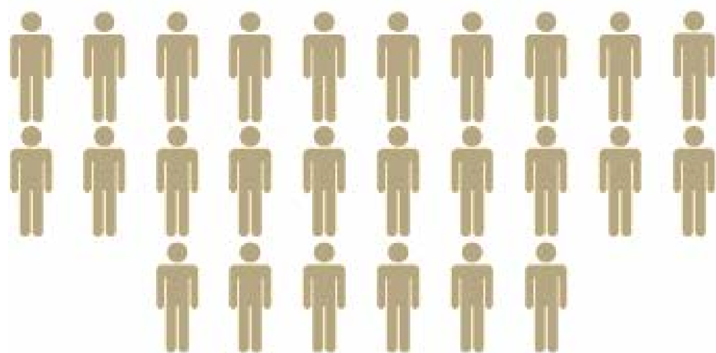
The Global Financial Crisis of 2007-08 was a period of intense uncertainty but, for the most part, that distress was confined to governments, boardrooms and the offices of international lending institutions.

In 2019, the story has shifted dramatically. Mass protests over the skewed benefits of globalisation accompanied by a loss of confidence in the democratic model are challenging the assumptions on which the Western liberal capitalist system has rested. Local protests against the established order took place across the globe in places as far apart as France, Chile, Bolivia or Lebanon.

If there is a defining issue that is driving popular unrest more or less across the board, it is that people do not feel they are sharing the benefits of an extended period of global economic expansion.

In January, Oxfam reported that the world's 26 richest individuals owned as much wealth as the poorest half of the global population. Billionaires grew their combined fortunes by US$2.5 billion a day in 2018, while the relative wealth of the world's poorest 3.8 billion people declined by US$500 million a day.

The world's 26 richest people now hold the same wealth as the poorest half of the global population



A rich-poor gap is widening across the world to the point where it is no longer possible to argue that an economic growth model that advantages the few is lifting all boats.

The medium and long-term **macro consequences** of this megatrend could be a further rise of populism (and thus macro and market volatility), more protectionism and even more aggressive monetary and fiscal policies.

At the **micro-level**, we might see a higher tax rate and pressure on profit margins stemming from labor costs (as employees claim a higher share of profits). Corporate governance is also expected to play a bigger role.

Companies set to do well in this environment are domestic manufacturers and brands, also security and defence. We also expect cybersecurity companies to perform well in the next decade.

#3: The Need for More Infrastructure

Infrastructure needs to be built in developed and developing nations. It improves productivity, competitiveness and the standard of living.

There is a funding gap between developed and emerging markets which needs to be filled. An example is the Chinese "One-road, one-belt" plan. Investment markets are also driving demand for infrastructure investment as bond yields are low, making the steady cash flows from infrastructure very attractive.

Beneficiaries of this trend are companies owning and building the infrastructure such as pipelines, roads and airports. Renewable energy infrastructure is also attracting massive investment.

#4: Millennials – Who Are Tech-savvy and Care About Sustainability and Life Experiences

50% of the world's population is below 35 and most of them are in emerging markets.

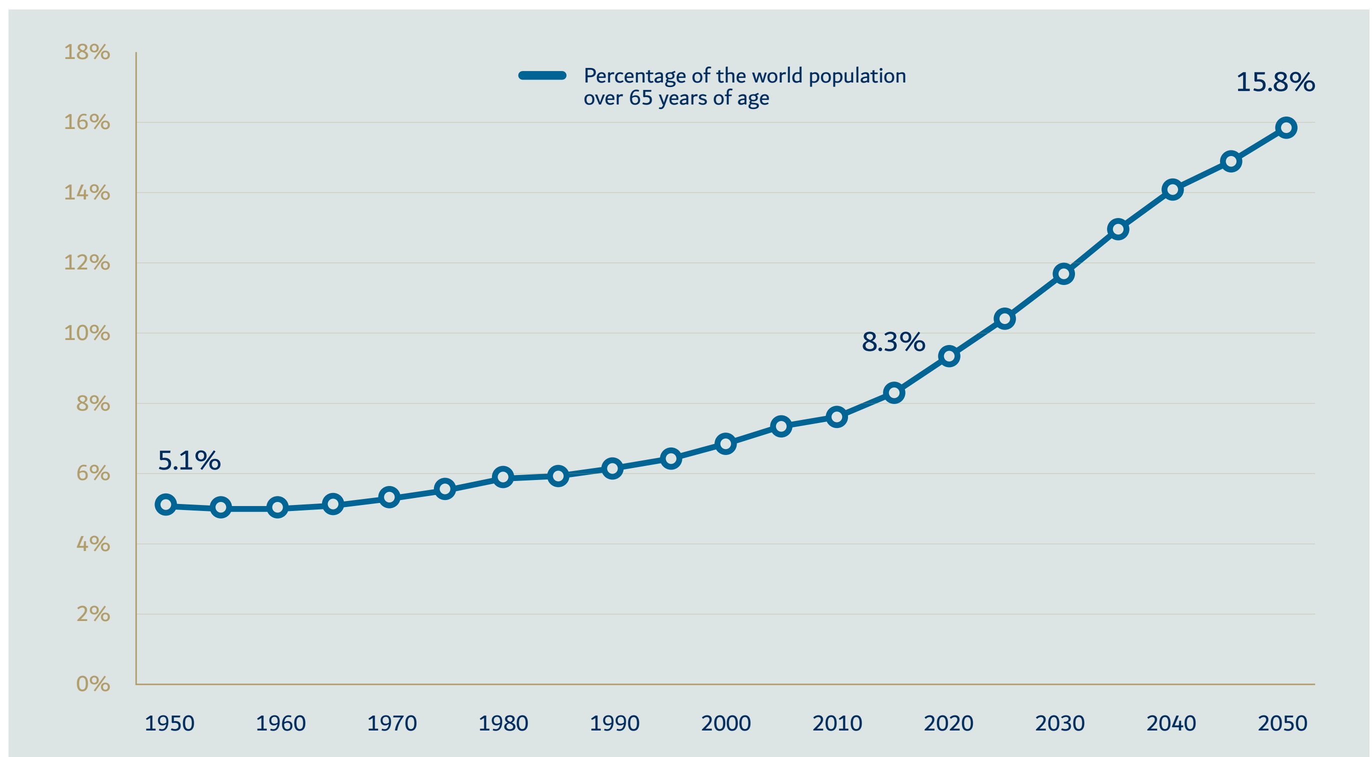
They are digital, tech-savvy, mobile, and want convenience and quick gratification. They are also concerned about the environment, as well as social and governance issues.

They will favour investments in sustainable businesses, clean energy, technology brands, smart mobility, education technology and fun and health.

#5: The Silver Economy – A Growing Share Of The Population Requiring Healthcare And Also Leisure Services

The global population is ageing. In a country such as Japan, deaths outnumber births and immigration does not feature. As a consequence, the percentage of the world population over 65 has been increasing since the war (see chart below) and has created what is known as the silver economy.

Percentage of world population 65+ (1950-2050) – source: United Nations, Department of Economic and Social Affairs, Population Division (2017)



The elderly consume a disproportionate amount of healthcare resources. They also have more time to travel.

Key beneficiaries are bio-tech companies targeting age-related disease, such as diabetes, arthritis and heart. Companies involved in tourism and leisure should also benefit.

These Megatrends are not set in stone and will change over time as technological innovation evolves and society changes. Still, it is possible to take a proactive approach by identifying the relevant long-term investment themes and integrate them within a global portfolio to enhance returns.

As highlighted in this special edition of Perspectives (Global Market Outlook 2020), the weight of evidence remains slightly bullish and thus favorable for risk assets. While 2019 earnings growth has not been favorable for equity markets, concerted monetary policy loosening should enable a cyclical strengthening in 2020 and spur an acceleration of earnings growth. While central banks ammunition is scarcer today, monetary conditions remain supportive. Equity valuations are not cheap but remain attractive versus bonds. We also note that market sentiment is not too euphoric despite a record year for equity markets. US Presidential election years have been volatile in the past but generated decent equity returns on average, especially when the incumbent wins. Last but not least, the technical picture is favorable with breadth improving as more markets and sectors are participating to the upside.

We thus continue to favor equities over fixed income but expect some volatility in the months ahead. Investors should prepare accordingly and avoid extreme tactical bets.

While our forecasts and views are always subject to changes, our commitment to serve our clients is not.

We remain at your full disposal for any specific issues you would like to discuss, so please do not hesitate to contact us.

Asset Management Team

Charles-Henry Monchau, CFA, CMT, CAIA
Managing Director – Asset Management
charles.monchau@almalcapital.com

Sherif El-Haddad
Executive Director – MENA Equities
sherif.haddad@almalcapital.com

Vrajesh Bhandari, CFA
Senior Portfolio Manager – MENA Equities
vrajesh.bhandari@almalcapital.com

Tamara Tannir, CFA
Senior Portfolio Manager - MENA Equities
tamara.tannir@almalcapital.com

Jai Andrew Lawrence
Analyst
jai.lawrence@almalcapital.com

Ridhima Dudi
Analyst

www.almalcapital.com