momentum
investments

in the
moment

Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

Roberta Noise
Economic Analyst

Financial market outlook for 2020: Global hard or soft landing?

Highlights

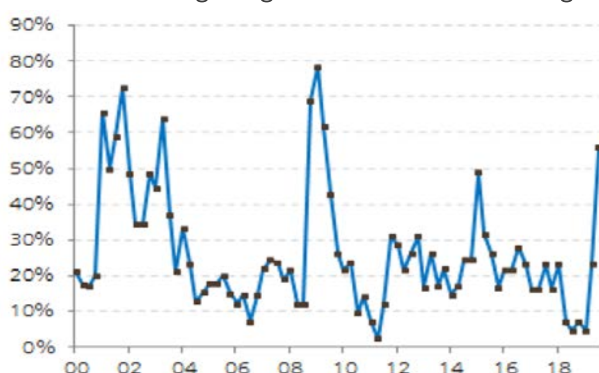
- The expected determining factor for the outcome of global financial markets in 2020 is whether the global economy will experience a hard or soft landing. This will largely be shaped by the interplay between the negative growth effect of trade tariff increases and the positive growth effect of policy stimulus measures.
- Whereas growth assets like equities, credit and property are likely to experience meaningful drawdowns in case of a hard landing for the global economy, defensive assets such as government bonds and gold are likely to flourish in absolute and particularly relative terms in such an outcome.
- In contrast, if policy makers are successful in engineering a soft landing for the global economy through their combined policy efforts, the more risky asset classes are likely to perform better.
- While either the hard or soft landing scenarios unfold in 2020, financial market volatility is likely to rise in line with the ebb and flow of market sentiment across the asset classes. This could be enhanced by the additional uncertainties typically associated with events in a United States (US) election year.
- From a valuation perspective, none of the main global asset classes look cheap compared to the past. However, on a relative basis, equities look cheaper than credit and particularly government bonds.
- While a soft landing in the global economy is expected, we acknowledge the meaningful risk for a more adverse growth outcome. We thus think it is prudent to use exposure to defensive asset classes as part of our diversified portfolio mix, while also providing some protection for portfolios where appropriate.
- History shows that the recent (lack of) returns from South African (SA) equities may be a good indicator of better future returns and that the state of the SA economy had little bearing in the past on the returns from the SA equity market. This is testament to the global nature of the SA equity market. Attractive valuations also provide some margin of safety for SA equities against a weak local growth environment. The main near-term risk for local equities is a hard landing for the global economy, as the SA equity market typically performs poorly around the onset of a US recession.
- In a yield-deprived global environment, SA fixed income investments continue to offer very attractive real risk-adjusted returns to more than adequately compensate investors for investment risk. Vanilla bonds offer real yields of 4% to 5%, inflation-linked bonds (ILBs) have yields of around 3.75% and cash yields a real return of around 2.75%.
- While the operating environment for listed property shares remains tough against the backdrop of a weak local economy, low valuations show that this is already well discounted. As a result, the risk-return profile for listed property is now asymmetric, with more upside than downside.

Hard or soft landing for the global economy is the deciding factor for financial markets in 2020

In our view, the over-arching deciding factor for global financial markets in 2020 is whether the global economy will experience a hard or soft landing. This will largely be shaped by the interplay between the negative growth effect of (previous and potential future) trade tariff increases and the positive growth effect of policy stimulus measures or the rolling back of some of the previously instituted tariffs.

With inflation below target in two thirds of countries, global central banks have the leeway to ease monetary policy further, by cutting rates or adding additional quantitative easing measures. Already, more than half of central banks are easing rates in an attempt to counter the slowdown in global growth (see chart 1). By contrast, very few central banks were cutting rates at the beginning of 2019.

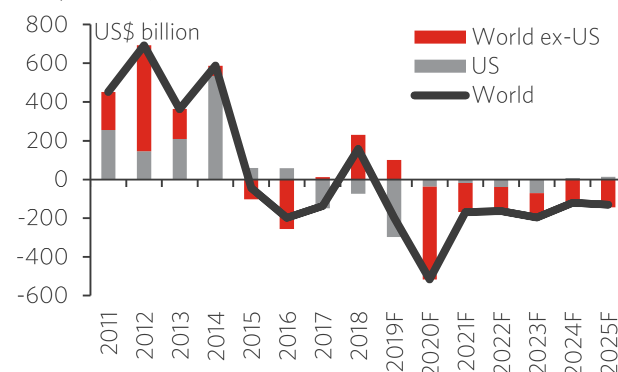
Chart 1: Percentage of global central banks easing



Source: UBS

But with interest rates already very low in many developed countries, there is a diminishing stimulus effect from monetary policy. Fiscal policy will thus have to supplement monetary policy to counter the global growth slowdown effectively. Although debt levels have generally risen since the global financial crisis (GFC), the cost of debt has fallen due to the rapid decline in borrowing costs. There is thus leeway for meaningful fiscal stimulus, with the International Monetary Fund (IMF) estimating the global budget deficit will rise by around US$500 billion in 2020 – the biggest likely rise since the global financial crisis. (see chart 2).

Chart 2: Change in global fiscal balances (US$ billion)



Source: IMF, RMB Morgan Stanley

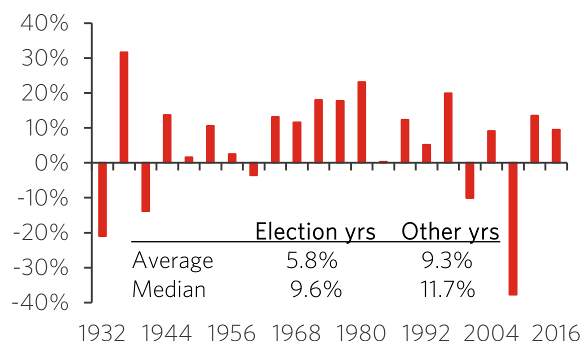
A hard or soft landing in the global economy induces a binary outcome for asset class returns. Whereas growth asset classes like equities, credit and property are likely to experience meaningful drawdowns in case of a hard landing for the global economy, defensive asset classes such as government bonds and gold are likely to flourish in absolute and particularly relative terms in such an outcome.

In contrast, if policy makers are successful in engineering a soft landing for the global economy through their combined policy efforts, the more risky asset classes are likely to perform better.

Within equities, a more benign economic growth scenario would be more beneficial to value and small-cap shares, while quality and large-cap shares should show better relative returns in a hard-landing scenario, although absolute returns would be under pressure.

Furthermore, the US election campaign could induce lower and more volatile equity returns in 2020. US equity returns have been lower historically in election years than in other years (see chart 3).

Chart 3: S&P 500 returns in US presidential election years



Source: Iress, Momentum Investments

Yield curve inversion is often seen as a reliable leading indicator for the probability of a recession. However, history has shown that the US equity market only peaks roughly one year after yield curve inversion on average, with the economy entering recession on average six months later (see table 1).

Given that the US 10-two year section of the yield curve inverted in August 2019, history would indicate a rough timeline of a US equity market peak around the middle of 2020, with the US economy entering a recession around the end of 2020.

If curve inversion again turns out to be a trustworthy indicator of eventual recession this time around, the above timeline would favour risky asset classes in the first half of 2020 and defensive asset classes towards the latter part of the year.

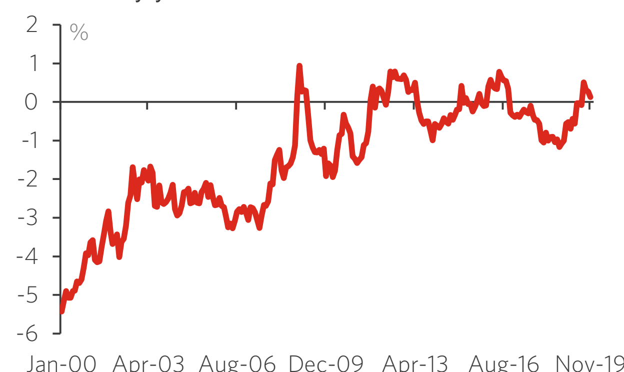
Table 1: Yield curve inversion as a leading indicator for US recession and equity returns

Start of US upcycle	Date of 10-2Y curve Inversion	Date of S&P500 peak	Start of US recession	# of months b/w curve inversion & SPX peak	# of months b/w SPX peak & recession	# of months b/w curve inversion & recession	% of cycle when curve inverts	% of cycle when SPX peaks	Perf b/w curve inversion & SPX peak
Mar-61	Dec-67	Nov-68	Dec-69	11	13	24	77%	88%	12%
Dec-70	Mar-73	Sep-73	Nov-73	6	2	8	77%	94%	-3%
Apr-75	Aug-78	Jan-80	Jan-80	17	0	17	70%	100%	11%
Jul-80	Sep-80	Nov-80	Jul-81	2	8	10	17%	33%	12%
Dec-82	Dec-88	Jun-90	Jul-90	18	1	19	79%	99%	29%
Apr-91	Feb-00	Aug-00	Mar-01	6	7	13	89%	94%	11%
Dec-01	Aug-06	Oct-07	Dec-07	14	2	16	78%	97%	19%
Average				11	5	16	70%	86%	13%

Source: Barclays

From a valuation perspective, none of the main asset classes look cheap against history. Equities look fairly valued on a forward price-earnings basis against the last 20 years, credit spreads seem somewhat expensive and government bonds are very expensive at current real yields. The relative attractiveness of equities over bonds is also highlighted by the S&P 500 dividend yield trading above the 10-year treasury yield (see chart 4). Research from Bank of America Merrill Lynch shows that in 94% of the past occurrences, equities outperformed bonds in the subsequent year. Furthermore, they also note that this is a widespread phenomenon, with 60% of US stocks on a dividend yield above the 10-year yield.

Chart 4: S&P 500 dividend yield minus the 10-year US treasury yield



Source: Iress, Momentum Investments

Meanwhile, US corporates face a similar asset allocation reality in a low-interest rate environment, with the rising differential between company earnings yields and corporate credit yields providing the necessary return incentive to induce renewed appetite to use cheap available debt financing to do share buybacks. It is only already-high leverage ratios that temper the appetite for overly aggressive share buybacks.

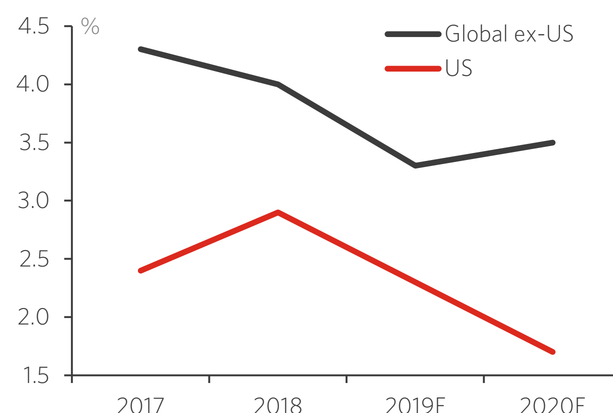
Equity and credit valuations indicate that these asset classes do not discount a recessionary outcome, while government bond valuations do not discount a soft landing outcome. Either the growth or defensive asset classes will be negatively surprised by the actual global growth outcome in 2020.

As either the hard- or soft-landing scenarios unfold in 2020, financial market volatility is likely to rise in line with the ebb and flow of market sentiment across the asset classes. This could be exaggerated by the additional uncertainties typically associated with events in a US election year.

Regional equity returns will also directly reflect the economic outcome in 2020. While an economic hard landing and the resultant flight to safety should benefit the more defensive US equity market over non-US regions, a more benign economic result should favour non-US equity destinations like Europe, Japan and emerging markets (EMs), with EMs additionally benefiting from the related likely US dollar weakness in a soft-landing scenario. Most forecasts reflect an increasing economic growth divergence between the rest of the world and the US in 2020 (see chart 5), which should benefit non-US equity regions, as long as a recession is avoided.

While a soft landing in the global economy is expected, we recognise the meaningful risk of a more adverse growth outcome. We thus think it is prudent to use exposure to defensive asset classes as part of our diversified portfolio mix, while also providing some protection for portfolios where appropriate.

Chart 5: US and global ex-US GDP growth



Source: BofA Merrill Lynch

SA equities – will 2020 be the year they bounce back?

Strange as it may seem at the outset, SA equities' recent (lack of) returns may be a good indicator of better future returns. In the past, when five-year trailing returns from SA equities were as low as is currently the case, subsequent returns from this asset class turned out to be very strong regardless of the prevailing macro environment at the time (see table 2). This is very much in line with international empirical findings that the initial price an investor pays for an asset (its valuation thus) is almost the sole determinant of the longer-term returns generated by that asset.

Table 2: **Subsequent Alsi annualised index returns (%) when trailing five-year returns fell below 3.5%**

		One year	Two year	Three year	Five year
Full period (11 times)	Average	27.2	26.1	25.0	18.6
	Median	26.6	27.8	25.8	18.2
Since 1984 (five times)	Average	45.3	30.9	25.8	19.5
	Median	39.2	31.6	25.8	18.2

Source: Iress, Momentum Investments

The state of the SA economy historically had little bearing on the returns of the SA equity market, with equities providing similar favourable returns in high-growth (above 4%) and low-growth (below 1.5%) economic periods (see table 3).

This is testament to the global nature of the SA equity market over time, firstly due to the high commodity component of the local equity market in years past and, more recently, due to the dominance of the local exchange by large globally-driven companies such as Naspers/Prosus, Richemont, AB InBev and British American Tobacco, which have limited links to the SA economy.

Table 3: **Alsi annualised index returns during low and high SA economic growth periods**

GDP <=1.5%	Average	21%
	Median	13%
GDP >= 4%	Average	20%
	Median	23%

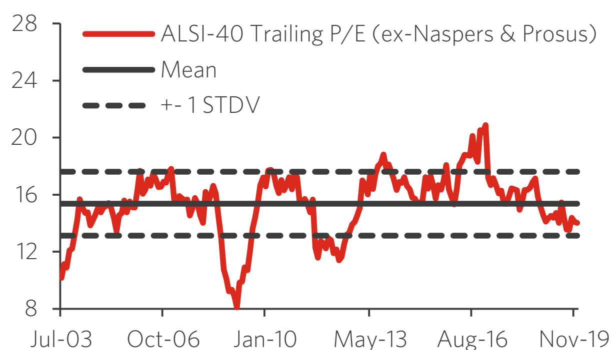
Source: Iress, Momentum Investments

The overall SA equity market trades around its 20-year average forward price-earnings valuation and looks cheap on a trailing price-earnings basis when the high Naspers valuation is excluded (see chart 6).

Therefore, there is a margin of safety for SA equities against a weak local growth environment. Even if a very bearish case of 0% profit growth for 2020 is assumed for SA companies, the local equity market is trading at less than a half standard deviation above its 20-year forward price-earnings average.

Similar to global equities, the main near-term risk for local equities is a hard landing for the global economy, as the SA equity market typically performs poorly around the onset of a US recession. However, in the longer run (three years and longer), US recessions don't matter for equity returns.

Chart 6: Alsi-40 trailing p:e excluding Naspers and Prosus



Source: Iress, Momentum Investments

SA fixed income – still very attractive risk-adjusted real returns available

Decent-yielding fixed-income investments have become a scarce commodity globally, as there has been an ever-increasing amount of corporate and government debt in the developed world trades at negative nominal yields and even larger negative real yields. This has enticed global fixed-income investors to look outside their normal developed market sample range towards debt where yield differentials with the developed world are high enough to more than compensate investors for higher investment risk (see table 4).

Table 4: Real 10-year bond yields (on latest available inflation)

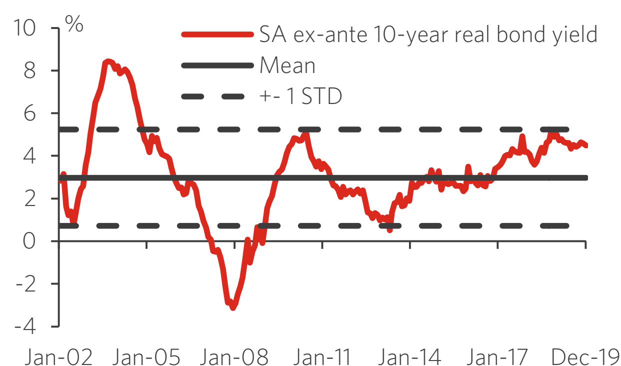
Developed markets		Emerging markets	
United States	0.0%	South Africa	5.5%
Japan	-0.3%	Brazil	4.4%
United Kingdom	-0.8%	Mexico	4.2%
Europe	-1.3%	Turkey	3.5%
		Russia	2.6%

Source: Iress, Momentum Investments

Within the EM debt universe, SA government bonds provide investors with the highest real yields available based on current inflation. Alternatively, assuming that SA inflation averages 5% in the long term, current 10-year SA bond yields offer investors a real return of more than 4% over the tenure of the instrument and around 4.5% based on our expected average inflation rate in the next year.

The latter is around 1.5% higher than the historical average real yield available from SA bonds since the advent of inflation targeting in SA in the early 2000s (see chart 7). The high relative real yield of SA vanilla bonds more than compensates investors for the fiscal risks prevalent in the country. In our view, the main risk to the SA bond market would be a global risk-off event that causes portfolio outflows from EMs. In this scenario, the relatively high foreign ownership of SA bonds could be a threat to the asset class.

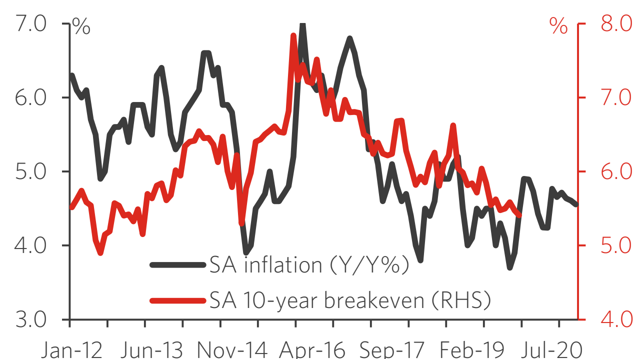
Chart 7: SA real 10-year bond yield



Source: Iress, Momentum Investments

While lower than nominal bonds, SA ILBs also provide investors with an attractive real yield of around 3.75% at the moment and is expected to receive near-term fundamental support from a rising inflation trend into the first quarter of 2020. However, this support is likely to disappear with falling inflation, as 2020 progresses (see chart 8).

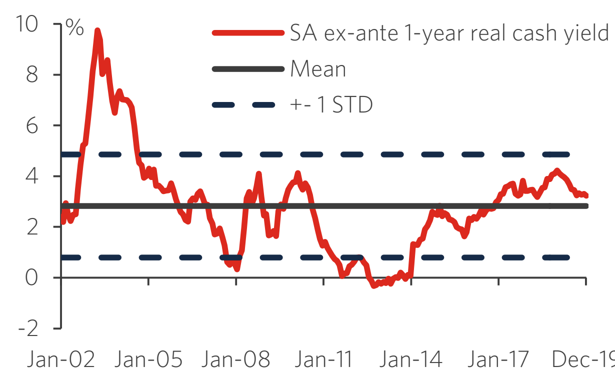
Chart 8: SA 10-year breakevens and inflation



Source: Iress, Momentum Investments

Although the available real SA cash yield of around 2.8% may not be as enticing as those available from local bonds and are only in line with their historical average, its relative risk-adjusted return profile still looks respectable (see chart 9).

Chart 9: SA real cash yield+-



Source: Iress, Momentum Investments

Listed property – tough operating environment well discounted

The operating environment for listed property shares remains tough against the backdrop of a weak local economy. This has culminated in rising vacancies, below-inflation rental increases and negative rental reversions in the sector. Combined with higher property costs from rates and taxes and electricity prices as well as a concerted effort to reduce gearing levels, there has been significant downward pressure on distribution growth, with many property companies struggling to maintain distribution levels, let alone show growth.

However, the low valuation level in the sector shows that weak demand and supply fundamentals are already well discounted. As a result, at current attractive valuations, the risk-return profile for listed property is now asymmetric, with more upside than downside.

Reasonable steps have been taken to ensure the validity and accuracy of the information in this document. However, Momentum Investments does not accept any responsibility for any claim, damages, loss or expense, howsoever arising out of or in connection with the information in this document, whether by a client, investor or intermediary. The content used in this document is sourced from various media publications, the Internet and Momentum Investments. For further information, please visit us at www.momentuminv.co.za. Momentum Investments is part of Momentum Metropolitan Life Limited, an authorised financial services and registered credit provider, and rated B-BBEE level 1.