Invesco

Stronger growth prospects clouded by coronavirus

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The fourth quarter of 2019 marked another period of weak global growth. This was led by manufacturing as trade in automobiles and electronics posted more disappointing results. Policymakers responded by easing monetary policy in almost every major global economy, in moves that were largely anticipated. The US Federal Reserve (Fed) delivered the last of its three interest rate cuts, the European Central Bank (ECB) restarted its quantitative easing (QE) programme and several emerging market (EM) central banks reduced interest rates, including Brazil, Russia, and India.

What were the macro drivers in Q4?

The economic narrative did not change much from the third to the fourth quarter. The global economy continued to lose momentum, driven by weakness in global manufacturing and trade. While more domestically oriented economic sectors remained resilient, spill over effects began to emerge from elevated trade tensions through the quarter that only began to dissipate toward the end, as did tail risks related to Brexit and US funding markets.

As more global central banks eased monetary policy, global growth appeared to stabilise. Risk assets generally performed well, finishing the year with strong returns.[1] The fourth quarter capped 2019 as the year when easier US financial conditions provided a boost to asset prices, even as growth momentum faltered.

1 J.P. Morgan GBI-EM Global Diversified Index (bonds) returned 13.5% in 2019 The MSCI World Index (equities) returned 28.4%. All returns in US$.

Developed markets (DM)

Global economic growth peaked in 2017 and slowed for nearly two more years but began to stabilise in the autumn of 2019. While economic activity data do not yet suggest acceleration, global forward-looking surveys point to a gradual pick-up in activity. In DM, domestically oriented sectors have been resilient, despite weakness in manufacturing.

In the US, strong labour markets, income growth and high levels of consumer confidence supported Q4 consumption. We expect the US economy to slow to its potential rate of just below 2% in 2020, due to waning fiscal stimulus that has supported the economy over the past two years and an increasingly tight labour market that could decrease the pace of job and aggregate income growth.

Investment was a drag on growth last year and we do not expect a strong rebound this year. However, reduced trade uncertainty and an anticipated recovery in global trade should stabilise investment. A housing recovery, supportive monetary policy, and consumption growth should also underpin the expansion. Inflation is still below the Fed's target and we expect it to increase gradually. Given the Fed's emphasis on the symmetry of the inflation target, and its higher tolerance for inflation to overshoot the target compared to the past, we expect the Fed to be on hold this year, barring unforeseen shocks.

In the eurozone, we expect growth to stabilise, thanks to receding headwinds from global trade plus modest fiscal and monetary stimulus. The major negative swing factors in Q4 eurozone performance were the external and auto sectors. The synchronised global growth that peaked in late 2017 led to above-trend eurozone growth, given its strong export-oriented sectors. As world trade lost momentum, so did the eurozone economy, especially manufacturing.

The important auto sector is also experiencing challenges from new emission standards on top of global trade issues. We expect these headwinds to abate in the coming quarters and support stabilisation of eurozone growth. Eurozone inflation has been below target, but stable. We expect inflation to increase slightly in 2020 but remain well below target. We expect the ECB to continue its modest QE programme throughout 2020, with possible changes communicated toward the end of the year as it concludes its review of monetary policy.

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China and Asia emerging markets (EM)

The Asian economies are showing green shoots of recovery. Purchasing manager indices (PMI) have finally entered expansionary territory and export growth, although not yet positive, has begun to stabilise. There are some signs that the new mobile phone cycle and 5G roll-out may support the electronics cycle in 2020, but global manufacturing weakness (dominated by autos and electronics) has not shown signs of abating yet.

The Phase I trade deal between the US and China, easier financial conditions on the back of recent monetary easing in the region and Fed signals that it has paused should boost confidence. Several Asian countries, including China, India, Korea and Indonesia, have also announced growth-supportive fiscal policies.

Nonetheless, a continued structural slowdown in China and its rebalancing from an investment-led to consumption-led growth model will likely diminish the stimulus to EMs and commodity prices going forward compared to the past. In addition, the Phase I deal is not likely to end geopolitical tensions between China and the US and we foresee potential complications as more difficult issues are brought to the table, either in the implementation of the Phase I deal or with a Phase II deal.

Against this backdrop, we expect a mild and gradual recovery in Asia in 2020. Besides structural headwinds, the coronavirus is rapidly becoming a substantial downside risk for Q1 and potentially Q2 growth in the region. In China, the epicentre of the virus, Q1 growth could take a substantial hit, but we hope better preparedness than in the 2003 SARS epidemic and authorities' policy response, will allow for recovery later in spring, once the virus is hopefully contained.

Latin America

We expect meaningful recovery in Latin America as major economies such as Argentina, Brazil, and Mexico show signs of rebounding. Brazil is a bright spot with strong momentum in domestic demand-led growth and its structural reform agenda, amid low inflation and low interest rates. Mexico is expected to emerge from no growth to displaying signs of expansion, supported by the construction and oil sectors.

Argentina is likely to be in the headlines due to its debt restructuring process and economic regime change but may still contract this year after posting declines in three of the last five years. We do not expect contagion to the region from Argentina's woes, given its generally constructive macro background of low inflation and interest rates along with moderate fiscal and external balances. We are monitoring the potential for social unrest, but it has abated somewhat and has been largely due to idiosyncratic factors.

The largest economies - Brazil and Mexico - are unlikely to experience unrest due to the popularity of their presidents. We expect Chile to bear the largest cost in terms of growth from prolonged uncertainty surrounding a new constitution to satisfy social demands.

In the absence of generalised structural reforms, especially given politically charged conditions in the region, growth outcomes or improved sentiment in the developed economies or China could improve the outlook for the region. Most regional central banks (Mexico being the exception) have lowered policy rates to accommodative territory and are comfortable with the benign inflation outlook, even in the context of weaker exchange rates.

Outlook

Recent economic data have begun to confirm our expectation that green shoots will spread across the global economy. Trade has shown signs of stabilising, led by the electronic cycle and a slowing decline in global auto sales. We expect global growth to be stable to marginally higher over the next two-to-three quarters. The coronavirus could impact this expectation due to China's contribution to global growth.

Several tail risks that were embedded in the markets in Q4 have receded materially, in our view. The Phase 1 trade deal between the US and China reduces the potential for an escalation of the trade war in an election year and may provide a tail wind to global growth. Greater clarity on Brexit could help stabilise sentiment in Europe and the Fed's actions to smooth the US repo market should improve the functioning of US dollar funding markets. While the debate over the Fed's balance sheet expansion and its impact on markets continues among market participants, perception may be more important than reality, and when combined with the reduction of other risks, should be helpful to risk assets, in our view.

We expect better growth in 2020 than last year as growth rates could trend upwards, driven by our slightly optimistic outlook on China, which has recently been challenged by the coronavirus breakout, and our more optimistic outlook on Latin America as outlined above. This should leave the major global central banks on hold. However, the impact of the coronavirus could influence them. For the Fed, we believe the bar to raising interest rates is higher than lowering them further if growth falters. In EM countries, we believe there is still room for lower policy rates.

While discussion about the use of fiscal policy to combat low growth intensified in Q4, we do not expect major global fiscal stimulus at this juncture. We believe Germany should engage fiscal policy to help its manufacturing-heavy economy become more flexible, but the debate is at the very early stage and we do not expect policy changes in 2020.

Portfolio implications

The outlook for global growth is clearer and more positive, in our view, with reduced downside risks. We expect non-US growth to improve relative to US growth and, therefore, do not expect US financial conditions to tighten. Our base case is for the latter to remain at very easy levels or ease further. However, the room for error for some asset classes, such as US credit markets, is low, in our view, given high valuations.

We continue to favour EM interest rates over those in DM. Other than US Treasuries, we do not see value in DM duration and continue to focus on relative value trades to generate alpha. We remain overweight EM interest rates for both carry and capital gains in select countries such as Mexico, Indonesia, and Russia.

We continue to expand our risk budget allocation to currency risk, where a slow slide in the dollar is likely to continue unless US growth falters, in which case, we could see a more significant sell-off. We are focused on carry in several EM currencies such as the Indian rupee, Indonesian rupiah, Mexican peso, and Russian rouble. We are focused on DM and some EM currencies for capital gains, including the Norwegian krone, the Brazilian real and Japanese yen, as we expect US dollar depreciation.

In our view, the asset class with the largest downside potential, if risks to our outlook materialise, is credit. In our base economic case, credit should continue to deliver carry. However, given current valuations, we favour a marginal reduction in allocation and favour European structured credit.

Coronavirus and impact

As we finish writing our outlook, we are faced with a black swan event in the outbreak of the virus linked to the Wuhan wet market. The impact of this global scare will likely be to lower growth in the near term. However, its medium-term impact on markets is still unclear as we await an economic policy response. While we do not expect to make immediate changes to our portfolio, we are evaluating certain country level exposures.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested.

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