2020 outlook: Less yin (dark), more yang (light)

Our 2019 outlook, “The only certainty is uncertainty: Looking for answers in 2019,” took a glass-half-full perspective despite volatile markets in late 2018. We expected continued U.S. strength, which was largely accurate, judging from the impressive equity market performance this year, even amid lackluster corporate earnings growth. We also acknowledged the continuing influence of tariffs and trade wars on investor sentiment. While trade tensions eased recently following the announcement of a “phase-one” agreement between the U.S. and China, last year, we were perhaps too optimistic for genuine calming of trade headwinds. Finally, our “muddle-through” outlook for the European economy was largely correct, but equities across the continent performed better than anticipated despite weak growth and Brexit overhang.

For 2020, we expect a continued global expansion underpinned by three economic drivers: labor market strength, accommodative monetary and fiscal policy, and stabilization in the manufacturing sector. A fourth driver of markets, and perhaps the least predictable, will be political developments in 2020. Globally, each region will have different exposure to these four key factors, but relative market performance will likely be dependent on their outcomes. Our base case calls for relatively stable interest rates and additional upside for global equities.

Labor markets: The economic bedrock

Strength in the labor market is a key source of economic stability in larger economic regions such as North America, Europe and Japan. In a recent salary forecast report, consulting firm Korn Ferry predicted global wage growth at 4.9%, well ahead of global inflation expectations of 2.8%. We believe labor market strength will be an ongoing driver of global economic growth and consumer confidence.
Downside risks associated with the labor market in 2020 include wage growth accelerating in the second half of the year to the point that it squeezes profit margins. Conversely, if growth slows due to persistent business uncertainty or other headwinds, the employment framework could ultimately weaken and erode the economic foundation. Despite these risks, our base case is that the labor market remains a key element of economic stability and an important pillar of support for risk assets.

**Monetary and fiscal policy: A reliable wind at our backs**

Compared to previous economic cycles, both the U.S. Federal Reserve (Fed) and the European Central Bank (ECB) have responded more pre-emptively to slowing growth in an effort to extend the economic expansion. China also adopted monetary easing measures in 2019 that should support 2020 growth. While global interest rate levels look broadly appropriate at this time, the backdrop of slowing global growth, lingering trade uncertainty and muted inflation points to potential monetary policy adjustments and short-term interest rates being slightly skewed to the downside. The benefits of the past year’s interest rate cuts continue to work through the economy but are likely to fade throughout 2020. In the U.S., low interest rates have freed up spending power and pushed mortgage debt servicing to historic lows as a percentage of disposable income — just over 4% today versus over 7% prior to the financial crisis.

While central bank actions directly affect their home nation or region, interest rate dynamics also have a global component. This means that even countries where central bankers have not cut benchmark rates recently, such as Canada, have seen downward rate pressure due to actions by the Fed, the ECB and the Bank of Japan. Overall, monetary conditions and central banks’ willingness to act support our expectations for sustained growth in 2020 and relatively modest odds of a recession.

Across many regions, one common theme is a willingness to accelerate fiscal stimulus should a downturn develop. While such a backstop is comforting, our base case for fiscal stimulus is more modest. Germany has the capacity to stimulate but places greater emphasis on a balanced budget. China is reluctant to step on the fiscal pedal due to concerns that this will cause greater imbalances in the financial sector. Japan, however, will likely continue to issue zero-interest-rate paper to finance fiscal spending. Though the minority government in Canada has committed to expanding fiscal spending, the scope may be limited due to a tight labor market.
One positive fiscal spending development is that sustainable or “green-focused” investments such as renewable energy are gaining momentum. This is an area where Germany, China, Canada and others are certain to increase investment. Overall, we expect that fiscal policy will provide an element of underlying support to the global economy in 2020.

**Manufacturing: In a hole, but no longer digging**

Manufacturing weakness across the globe has shown early signs of stabilization according to forward-looking survey measures. We believe the worst is over for the sector, and that stabilization in the first half of 2020 is likely to lead to moderate acceleration in the second half of the year. End demand remains supported by a strong labor market, and U.S.-China trade negotiations have taken a positive turn, alleviating some of the sector’s headwinds. In addition, the moderate level of investment during the current cycle implies that the manufacturing sector does not suffer from significant imbalances that would require unwinding.

In developed economies, the manufacturing sector constitutes a relatively modest portion of GDP, but it can be an important swing factor nonetheless. A stabilizing manufacturing sector will help support global growth and should aid risk assets by reducing recession concerns.

**Global manufacturing PMIs**

![Chart showing global manufacturing PMIs for various countries.](chart.png)

Source: Markit, Bloomberg

**Politics: Anything could happen, but it probably won’t**

With the U.S. presidential election in November 2020, politics are likely to play a more prominent role in market developments this year. Further progress relating to U.S.-China tariff reductions and trade negotiations could also be the difference between a global economy that just muddles through and one in which previously cautious business spending becomes more assertive.

Recent U.S.-China trade negotiations led to a “phase-one” deal that could be officially signed in January. While the exact terms of the deal are not yet known, early reports suggest that the U.S. agreed to hold off on new tariffs and roll back a portion of existing tariffs, while China agreed to increase purchases of U.S. agriculture and other goods, provide greater market access and strengthen intellectual property protection.
President Trump may use tariffs as a threat or policy in other targeted instances outside of the U.S.-China relationship, but we do not expect him to open additional trade-war fronts as this would distract from his dual priorities in 2020: the presidential campaign and the domestic economy. The pivot to domestic issues should be marginally positive for business confidence and risk assets.

Markets will also likely focus on the possibility of U.S. policy shifts, given that Democratic candidates are split between moderate and progressive platforms. Such shifts could include rolling back the 2017 tax cuts and/or implementing additional taxes and regulation. We believe the likelihood of a more radical agenda becoming actual policy is slim. Even if a candidate from the more progressive wing of the party secures the Democratic nomination and wins the election, a wide-ranging legislative agenda will likely still face a Republican majority in the Senate, as only a small number of those seats appear to be in play in 2020. Though the probability of dramatic policy shifts is relatively low, we still expect the fear of potential political outcomes to create volatility and generate buying opportunities.

In the U.K., Boris Johnson’s decisive general election victory removes some major uncertainties and clears the way for Brexit to be delivered by January 31. While this is positive for sterling and risk assets in the U.K., we do not expect U.K. outperformance in 2020. The future trading relationship with the European Union, its main trading partner, has yet to be agreed upon and economic headwinds such as low investment continue to pressure the economy.

In summary, our outlook for 2020 is relatively positive for risk assets. Uncertainties remain, but some of the clouds have lifted and the economic landscape looks reasonably good. As winter settles in, a little more daylight is certainly welcome.
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