We may now be in 2020 but when it comes to financial markets, perfect vision is impossible. This time last year, markets had endured their worst December since 1970 and investors were bracing themselves for recession. By March, the US Federal Reserve (Fed) had altered its plans for higher interest rates. All of a sudden, the challenges of the fourth quarter seemed like a distant memory.

At this stage of the economic cycle, the mood of financial markets can be prone to sudden change. In 2019, episodes of volatility resulted from flashpoints in US/China trade tensions, fears of a global slowdown and, at home, the threat of a no-deal Brexit. None of these issues are firmly resolved and they look set to remain among the dominant storylines as this year progresses.

NO FED SURPRISES

In January of last year, US Federal Reserve Chairman Jerome Powell confirmed that his Committee had reversed course on its programme of interest rate hikes, to counter slowing economic growth. As recently as September 2018, the Fed had been forecasting three increases for 2019. Instead, the opposite happened and the Committee completed its about-turn by cutting interest rates in July, September and October.

The result was good news for the market. As the world’s largest economy, what happens in America has implications globally and the return to easier monetary policy was a key driver of last year’s gains. It was also good news for the consumer, with lower interest rates helping to fuel wage increases and household spending. This allowed the US economy to fend off the worst effects of a deepening recession in manufacturing.

At their latest meeting in December, the Fed indicated that there will be no further changes to interest rates until 2021 and such expectations are now priced into markets. If economic forecasts should deteriorate unexpectedly, the Fed may be forced to act. But without the kind of policy surprise that the Committee delivered last year, returns are unlikely to be as generous as they were in 2019.

GEOPOLITICS WILL REMAIN IN FOCUS

One man who particularly approved of the Fed’s interest rate cuts was Donald Trump, with the President an outspoken critic of the previous approach. Trump will be hoping to get his way again, this time in November as he attempts to secure a second term in the Oval Office.
The legacy of Trump’s early tenure has been an unusual one. The President has supervised a record economic expansion (by length) that has proved more resilient than many predicted. It has been both helped (through tax cuts) and hindered (by trade wars) as a result of his own initiatives. No President who has enjoyed unemployment of less than 7.4% has ever failed to be re-elected, and the US figure is currently 3.5%, its lowest level since 1969. Equally, none of them faced the threat of impeachment.

The Presidential election will be a key determinant of the path of global markets in 2020 and another four years of Trump may, surprisingly, be investors’ preferred outcome. The race for the Democrat nomination still comprises a broad range of candidates, with politics ranging from the far left (Elizabeth Warren) to centre (Joe Biden). One area that they agree on is that many of Trump’s pro-growth agendas have adversely impacted the middle classes. In the event of a Democrat win, tax cuts would likely be removed for large corporations.

A related issue is the trade war with China, which was the biggest driver of market uncertainty in 2019. It’s clear that tensions run deep, with the US aiming to protect its position as the dominant global superpower in the face of unprecedented Chinese expansion. As a result, the issue is likely to extend to this year’s presidential election and beyond. However, for all of the rhetoric, it’s clear that both sides are cautious about the impact on growth. Trump tends to save his most aggressive tactics for when markets are at record highs, while the most significant tariffs (those that would impact the consumer) have been nullified by a “Phase One” deal.

From the UK investor’s perspective, the other major issue that refuses to disappear is Brexit. In December, the market enjoyed its best day in three years following the General Election, and the new Government has wasted little time in attempting to “get Brexit done”. But for all of the optimism, a Withdrawal Agreement is just the beginning. Discussions to follow – on trade and the nature of any future relationship with the EU – will be complex and have been made even more so by the Prime Minister’s timescales. The outlook is a little bit clearer, but the uncertainty is not yet over for UK companies.

A BRIGHTER OUTLOOK IS BETTER FOR EQUITIES

Last summer, many predicted that the bull (or rising) market was finally coming to an end. Evidence was building of a recession in the manufacturing sector and the “FAANG” stocks (Facebook, Amazon, Apple, Netflix, and Google parent company Alphabet), which for so long had trended in one direction, began to fall. However, with news of a preliminary trade deal between the US and China, combined with expectations of a more orderly Brexit, economic forecasts have been revised upward. The bull market rumbles on.

Despite the brighter outlook, earnings expectations in the equity market remain cautious. In the UK, reduced risk of a “no deal” scenario helps to alleviate the uncertainties that faced UK businesses last year, while a trade truce is good for exporters. If earnings are higher than anticipated when share prices rise, it should be supportive for equity markets. Share buybacks also remain close to record levels.
RISKS IN THE BOND MARKET ARE GREATER

In the UK, government bond funds have outperformed equity funds over the past two years as a mixture of economic uncertainty and investor demand has driven yields to historically low levels. More than 30% of all investment grade debt globally now comes with a negative interest rate.

The demand for income is as strong as ever. A recent offering of 48-year Italian government debt was six times oversubscribed on the basis that it offered a yield in the region of 3%, despite the country being close to bankruptcy. However, investors may be wise to look elsewhere for their income in 2020. Yields moved sharply in response to the improving outlook and any further improvements, particularly on the trade front, could lead to a sustained sell-off.

Of course, things can change quickly and as the bull market reaches its 11th birthday, it’s important for investors to diversify. Valuations in some areas are expensive and there are only so many levers that Central Banks have left to combat further weakness. The outlook for 2020 is like a summer’s day in Scotland – reasonably bright, but you can never be sure it isn’t going to rain.

Please remember that past performance is not an indicator for future results. Investment markets and conditions can change rapidly and, as such, the views expressed in this update should not be taken as statements of fact nor be relied on when making investment decisions. Forecasts are opinions only, cannot be guaranteed and should not be relied on when making investment decisions.