2020 Strategy Outlook:
Five themes that will shape markets

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As we move into 2020, these are five themes which Principal Global Investors believes will shape markets in the next 12 months.

Central bank and government role reversal, increasing risk velocity

The era of hands-on central banks and hands-off governments is being overturned. Since the financial crisis, central banks have been proactive, maximising their monetary policy toolkits to ward off economic perils through quantitative easing and historically low rates. Conversely, over this same time period, Western governments have typically preferred a conservative approach to fiscal measures designed to move the economic needle.

2020 will be the year we see a role reversal of sorts between governments and central banks. The result will be greater room for surprises to be sprung on investors, and consequently an environment where risk velocity—the pace at which risks can transition from a threat to a real portfolio impact—is elevated further.

Central banks have been reconsidering the wisdom of negative policy rates. Slashing rates has distorted financial markets, crippled bank lending, and threatened pensions systems worldwide. So, while the still-sluggish economic backdrop means central banks won't withdraw monetary stimulus, they will increasingly look to fiscal policy to add the required additional economic stimulus.

Central banks will effectively become mediators between—and negotiators with—governments to encourage necessary fiscal changes. This will be most evident in Europe. Christine Lagarde has brought much of the IMF's agenda into the ECB, and the Euro area's fiscal stance is likely to be mildly expansionary next year.

In the U.K. too, while the Bank of England likely holds fire, the new government is set to indulge in fiscal spending. In the United States, President Trump has already been a more active, interventionist government. If he is voted President again, for a last term, he will likely adopt an even more direct approach, unencumbered by the need to consider re-election. By contrast, the Federal Reserve is already indicating that the bar to either lowering or raising rates is very high.

Our research has indicated that markets react more sharply and rapidly today than a decade ago in response to central banking and geopolitical surprises. We don't foresee a recession in the next 12 months, so there is no reason to take risk off the table. Yet, investors will increasingly need to be nimble and actively seek out opportunities, whilst also retaining a largely defensive positioning, in this low return, high risk world.

Onset of equities vertigo

2020 could be the year that "equities vertigo" begins to kick in. Persistent central bank liquidity will continue to fuel stocks. But diminishing monetary effectiveness means this will be delivered via multiple expansion, not earnings growth.

Central banks have provided significant stimulus this year but, as rates get closer to zero, the marginal impact on households and corporates has declined. Earnings per share growth in Q3 2019 was the lowest in three years in both the United States and Europe. Yet despite some notable profit warnings, stocks that were missing estimates were not being penalized as severely as they were in past quarters by the market. It appears that the amount of capital in the system, thanks to the liquidity that has been injected into the market, is creating a buoyancy effect.

How long can this wide and growing disconnect between lacklustre earnings on one side and valuations on the other be sustained? We expect the global economy to stabilise in early 2020, but we don't anticipate a strong upturn, so central banks will maintain the monetary sugar rush to financial markets.

Against that backdrop, this record-high equity market will likely remain range-bound but also occasionally be ravaged by bouts of volatility as stocks react more sharply to corporate, political, and economic news. Large cap momentum stocks, which have not quite reached the multinational mega-cap level, could find themselves most vulnerable to these top-of-market wobbles.

Equities continued to look relatively resilient in 2019, but the gap between valuations and underlying economic fundamentals is growing wider. The bar to beat estimates gets higher each earnings season. It is difficult to see how equities will not start to look downwards with a feeling of rising nausea as we move through the year.

A pendulum swing towards value

Linked to the onset of equities vertigo is the pendulum swing that we see reappearing in 2020—from momentum to value. Value stocks—so unloved over the last decade—will finally become temporarily fashionable again.

Over the past year or so, most of the S&P 500 gains have come from defensive sectors and growth stocks. But valuation extremes and overwhelmingly bearish investor positioning had rendered the market vulnerable to rotation and we saw evidence in the latter part of 2019 that this was beginning to occur. In September 2019, we saw one of the largest three-day rotations from momentum to value in over 30 years.

Yet, there is still further to go.

The dislocations between sectors and styles remain at fairly extraordinary levels, even after the September rotation. According to some estimates, the rotation from momentum to value isn't even half way done, while some defensive sectors, such as healthcare, are yet to register any notable rotation yet.

There are opportunities if investors are brave enough to tactically position for it and 2020 may well be the year when we witness a major shift in style preference from global asset allocators. Indeed, there is a growing sense that, at these prices, it would be almost rude not to have some value exposure—and a corresponding sense of "FOMO" that when a value rebound happens it could be extremely sharp, and unexposed investors could be left behind.

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Does this mean investors should dump momentum en masse? No. The initial part of the rotation was largely technical and, with the dislocation still elevated, the next phase of the rotation will also be technical in nature. For there to be a fundamental and sustained shift from momentum to value will require a stronger upturn in global economic activity than we are anticipating for 2020, while trade negotiations can be undone at any moment. But partially reducing exposure to momentum to fund some exposure to value appears a prudent course of action at this juncture.

CoCo-colonization

Global issuance of convertible bonds looks set to surge in 2020. Globally, conditions look primed for a CoCo boom.

Whilst central banks will make a huge effort to move away from negative yielding debt, we are in a low yield environment for the foreseeable future. Investors have been drawn to the yields available in the convertible bond universe. In Europe, investment grade corporate bonds offer an average yield around half a percent, whilst AT1s are returning almost 5%. Regulatory changes coming into effect in 2020 in Europe mean that tier one capital needs to be bolstered significantly. As a result, some industry estimates are for AT1 issuance to grow by around €25 billion.

The outlook looks similarly favourable in the U.K. CoCos effectively switch the liability of bank bailouts from taxpayers to bondholders. With the threat of an ultra-hard Brexit periodically placing question marks over the U.K. banking sector during the last three years, a Brexit resolution early in the new year should see the asset class begin 2020 in buoyant fashion.

At this point, the most economic damaging Brexit outcome—No Deal—looks remote. Even if the U.K. economy takes a hit as post-Brexit reality begins to bite, U.K. banks look exceptionally resilient. The regulatory response to the financial crisis and the hugely increased amount of capital that banks now need to hold has meant that banks look well-equipped to weather even the worst economic storms.

The proliferation of convertible bond supply and demand is not only a European phenomenon. In October 2019, the convertible bond issued by Shanghai Pudong Development Bank was more than 140 times oversubscribed, with more than $1 trillion of orders placed. More than $40 billion of CoCos were issued in China in 2019, an 80% increase on the prior year; the theme should continue in 2020. A de-escalation of U.S./China trade tensions would create a further tailwind for the asset class.

In a low-growth, low-return environment, and with high-profile issuance continuing to deliver successfully, global investors are likely to increase their portfolio exposure to convertibles. "CoCo-colinization" could be a major investment narrative over the next 12 months.

A late cycle bounce for emerging markets

As we approach 2020, the pieces for emerging market assets are slowly coming together. Global growth appears to be stabilising and should start a shallow recovery in Q1 2020, while global investor sentiment is being supported by expectations for a likely reprieve in trade tensions, setting the scene for a more constructive year for emerging markets.

Macro stability in recent years has given many emerging economy central banks the space to cut policy rates further in 2020, and some governments will also be able to add fiscal stimulus to the policy mix. This enviable policy space means that global growth should be weighted towards the emerging economies, paving the way for a modestly weaker U.S. dollar.

Emerging market debt valuations appear more attractive relative to developed market debt, with Latin America the cheapest region and benefitting from being somewhat insulated from the U.S./China trade tensions. Yet, this also implies that an easing of U.S./China trade tensions would benefit Latin America less than other regions. Emerging Asia, on the other hand, stands to gain the most.

A U.S./China trade resolution, even just a partial deal which stops further tariffs, will reinforce the wealth of China's stimulus measures introduced over the past year, stabilising the economy and thereby lifting the emerging Asia region. Increasingly too, Asia is more than just China. Structural reforms to take advantage of supply chain diversion and elevate long-term growth prospects should be noticed by investors.

Yet, while the macro backdrop appears supportive for emerging market assets, the late-cycle bounce still requires investors to carefully pick their allocations. Markets will likely penalise governments who flagrantly reflate their economies without regard for already-sizable debt piles and/or inflationary risks.

Political risks are likely to become more pertinent in 2020, as pockets of social unrest become more widespread, putting prudent macro policies in danger of being thwarted by nationalistic priorities.

Asset class picks for 2020

Central banks may be reconsidering negative interest rate policies but, with growth set to enjoy only a mild recovery in 2020 and inflationary pressures remaining muted, the low interest rate environment will persist.

Investors should remain fully invested, actively seeking out opportunities that offer positive returns but also limit portfolio risk, as well as markets that may have underperformed in 2019 but are now set to improve in 2020. The fragility of the geopolitical outlook, particularly with regards to U.S./China trade tensions, also argues for retaining some essentially defensive, nimble positioning.

In equities, we believe it is prudent to have a core allocation to **U.S. mega cap stocks** which should prove more resilient than large cap peers to late cycle shocks, and focus on those companies with demonstrably strong balance sheet quality. At the same time, we favour building a tactical allocation to **value stocks** given the potential upside available—in particular, in financials which have robust balance sheets and are well positioned to benefit from a hiatus in Brexit uncertainty and de-escalation in trade tensions.

In fixed income, we take the view that market conditions make **convertible bonds** and **emerging market debt** attractive sources of yield. Against a backdrop of very low corporate bond yields, both offer investors greater potential returns at a time when market conditions should be increasingly supportive of the risk profile of the asset classes. However, we would advocate the merits of active management in both cases as unpredictable geopolitics and domestic political hotspots are likely to create clear winners and losers over the course of the year.

As part of a defensively-positioned portfolio, we continue to favour an overweight position in **Real Estate** across public equity (REITS), public debt, private debt and private equity. As a long-term asset class with different drivers and dynamics to global equity markets, real estate (especially private real estate) is somewhat sheltered from downside risk and sudden market selloffs. As domestic assets, they tend to be somewhat insulated from global supply chains and geopolitical concerns and, in a low growth, low rate environment, still have the potential to deliver positive returns.

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