



Five Trends Shaping Markets In 2020— And How to Respond

Asset allocation ideas to help position your portfolio for the challenges and opportunities ahead.

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KEY INSIGHTS

- The year ahead will likely bring slowing growth, negative interest rates, steep valuations and geopolitical concerns.
- Effective strategies to navigate this environment may include diversifying risk, going long duration, and overweighting emerging markets.
- Other ideas include seeking multiple sources of income and treating market corrections as buying opportunities.

Looking ahead to 2020, investors face a range of challenges as well as opportunities: a slowing global economy in a mature economic cycle, central banks stimulating or preparing for stimulus, low or negative interest rates, steep valuations, and myriad geopolitical concerns, including ongoing technological disruption, shifting demographics and piling global debt. It is easy to get scared.

We have narrowed these down to five key trends that we believe will continue to dominate headlines and drive the performance of financial assets over the short term. For each of these trends, our EMEA Multi-Asset Solutions team has outlined a range of investment ideas to help investors position their portfolios for the period ahead.

1. Slowing Economic Growth, the End of the Cycle: Finding Growth in a Low-Growth World

This current expansionary stage of the economic cycle is the longest on record.

Mature cycles do not just end because of old age, but rather because one of the following has occurred: significant imbalances in the system, rising inflation and aggressive central banks, or a confidence shock leading to a collapse in demand. While we cannot be certain we have any of the above, predicting the end of cycles and the beginning of recessions are notoriously difficult.

Economies across the globe are slowing down; debt levels are high and rising; inflation remains stubbornly low, although the labour market is tight; short-term and long-term interest rates are low or negative; and corporate earnings are losing steam after a roaring 2018. As time goes by, investors are increasingly concerned about an economic contraction.

We have yet to identify any clear signals that a recession is imminent. The cycle could continue for another 12 to 24 months, or perhaps longer with the help of policymakers. Investors who need their



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Investment Trend No. 1: Slowing Economic Growth

Investment Idea	Diversification	Defense	High Growth, High Yield
	Diversify risks because we don't know when the cycle ends.	Include investments that should do well when equity markets do not.	Overweight investments offering potential for high growth and high yields.
Rationale			
	<ul style="list-style-type: none"> Multi-asset portfolio, investing across global equity and bond markets. Active management, aiming to reposition portfolio based on developments. 	<ul style="list-style-type: none"> High-quality, long-duration government bonds. "Safe-haven" currencies (e.g., U.S. dollar, Japanese yen). Defensive derivative strategies. 	<ul style="list-style-type: none"> Emerging markets equity and debt. Global high yield bonds. Growth equities.
Examples			

“Negative yields are not a new normal—they are abnormal.”

portfolio to generate returns must invest—they do not have the privilege of pulling out, risking missing on a potential final upward-leg in equities, in particular when cash and government bonds offer much lower returns. Nobody wants to be the one who stops dancing before the music stops.

The three investment ideas here are: to maintain diversification, to maintain exposure to defensive investments (because we don't know when recession hits), and to favour investments offering growth and income potential because they are likely to be attractive in a low-growth, low-yield environment.

2. Monetary Policies: Global Synchronised Stimulus

While the U.S. Federal Reserve (Fed) has cut its policy rates three times, and is on pause, an easing cycle may still ensue, depending on data. Never in modern history has an easing cycle begun with the U.S. 10-year Treasury yield so low. Meagre inflation, political pressure, and the fear of a recession are all potential reasons for the Fed to ease—no group of Federal Open Market Committee members wants to go down in the history books as the one that derailed the global economy. Meanwhile, across the Atlantic, the European Central Bank (ECB) has not only cut its deposit rate from -0.40% to -0.50%, but it has also reintroduced its quantitative easing (QE) programme. A lot is at stake.

The situation is different for other major central banks—the Bank of Japan (BoJ), the Bank of England (BoE), and the People's Bank of China (PBoC). While the PBoC must rebalance a weakening economy with de-risking the financial sector and controlling debt—and so might not offer stimulus at full throttle—many central banks in emerging markets have room to cut rates. They have not had the opportunity to begin a hiking cycle, yet they are already considering easing once again. Just as we thought that markets were beginning to get over their addiction to QE, easy money, and stimulus, they relapse. Policymakers do not want the economic cycle to end under their watch.

The three investment ideas here focus on currencies, high-quality fixed income, and risk assets. Global synchronised stimulus may have a profound impact on all these asset classes. The risk is now that the markets expect policymakers to act; if central banks fail to deliver, the disappointment could lead to a sell-off. In other words, central banks are the knights in shining armour and without them, confidence might be severely dented.

3. Fixed Income: The New Abnormal and the Role of Bonds

We are truly in uncharted territory. Not only have some equity markets (once again) reached all-time highs, but the yields of some government bonds have also (once again) recently reached

Investment Trend No. 2: Global Monetary Stimulus

Investment Idea	Currencies	Investment-Grade Bonds	Risk Assets
 Rationale	Fed ready to ease, with more room to cut rates than other central banks, and relatively slower U.S. economy, may lead to a weaker U.S. dollar.	High-quality government bonds and investment-grade credit may get a boost from falling rates in a low inflation and slow-growth environment.	As rates fall, the discount factor falls and the prices of assets may rise further. As long as the economy does not derail, risk assets could benefit.
 Examples	<ul style="list-style-type: none"> Emerging markets currencies. Japanese yen. 	<ul style="list-style-type: none"> U.S. Treasuries, UK gilts. Global investment-grade credit. 	<ul style="list-style-type: none"> Equities. High yield bonds, emerging markets debt.

all-time lows. The German 10-year bund yield has reached a level below -0.70% for the first time in history. Some investors need safe-haven assets to hedge liabilities so much that they are willing to pay the German government to keep their cash, instead of earning an interest on it. The yield of French 10-year government bonds fell below zero for the first time. Now, investors who lend money to the French government get paid back less than they have lent. The yields on 10-year Greek bonds reached over 25% in the 2011 eurozone debt crisis. Now, the 10-year Greek yield is lower than the U.S. 10-year Treasury yield.

The “new normal” for government bonds was supposed to be “lower for longer” rates. Globalisation, technological disruption, debt that

“borrows” growth from the future, and demographics can explain a world with modest inflation and modest economic growth, justifying low government bond yields. But negative yields are not a new normal—they are abnormal. With central banks pivoting to easing policy, economic growth slowing down, and inflation remaining low, the negative yields can turn even more negative. The caveat is that if the U.S.-China trade war and Brexit reach a healthy resolution, combined with easier global monetary policy, the economy may improve and rates may move higher, not lower.

The three investment ideas here focus on the role of high-quality bonds in multi-asset portfolios. The traditional roles of bonds were to generate income—which doesn’t work so well

Investment Trend No. 3: Fixed Income

Investment Idea	Uncorrelated Strategies	Income Strategies	Unhedged U.S. Treasuries
 Rationale	Seek uncorrelated strategies to diversify equity risk when government bonds have limited “fire power” to generate returns when equity markets fall.	When bonds do not provide income, add multiple sources of income to portfolio (coupons, dividends, option writing).	While typically the currency exposure of foreign bonds should be hedged, U.S. Treasuries could play a protective role in portfolios given their yields and U.S. dollar exposure.
 Examples	<ul style="list-style-type: none"> Active investment strategies with proven low correlation with equity markets. Derivatives to hedge against equity sell-offs (e.g., options) and dynamically change equity exposure when risk rises (e.g., managed volatility overlay). 	<ul style="list-style-type: none"> Multi-asset income (developed and emerging bonds, global equity, REITs, option writing). 	<ul style="list-style-type: none"> Long-duration U.S. Treasuries—expect relative high volatility because of currency exposure when portfolio’s base currency is not U.S. dollar.

“Regardless of how the Brexit saga ends, the mere fact that it ends will remove some uncertainty.

with negative rates—and to diversify equity risk. Protection from bonds is limited when rates are low (how much further can they fall?), and it is expensive to pay interest on bonds rather than collect interest from them. Safety has become expensive.

4. Valuations: When Expensive Is Too Expensive

Many financial markets are close to historical extremes—either highs or lows. Years of unconventional monetary policies have pushed interest rates lower and asset prices higher. Valuations mostly matter over the long term—although they can impact short-term sentiment—and at extremes. Public stocks are arguably not overvalued because earnings have kept up with prices, and they are not as expensive as bonds. However, it is difficult to argue that bonds are not overvalued when rates are so low and spreads are so tight. Higher prices today mean lower returns tomorrow. Excess returns—alpha—from active management could become more precious when market returns are modest.

At times like these—with rich valuations, a mature economic cycle and geopolitical uncertainties—investors tend to become increasingly nervous, and investor behaviour can become paramount. Moreover, when the bond market implies one thing—low/negative

10-year bond yields reflect expectations for negative economic growth and/or deflation—and the equity market implies the opposite—swinging from one record-breaking high to another—this is not time to be too brave. Our three investment ideas focus on how investors should behave during these stressing times. Uncertain times require a diligent and clear head, calmness in the face of volatility and the unknown, and not being too brave.

5. Geopolitics: Politics, Populism and Policy

During normal times, geopolitics can create a lot of noise—but it usually has limited impact on the long-term performance of financial markets. We are not living in normal times.

We are living through a number of secular shifts in society: a digital revolution, a political revolution, and a demographics revolution. Technology impacts nearly every aspect of our lives—the way we work, shop, bank, commute, communicate, and so on. Populism seems to have changed Western politics and our values. An aging population may mean that the Japanification of Europe will follow. Fiscal policy needed to fund more populist campaign promises will likely contribute to ever-growing debt bubble for many countries. Things are changing, and they are changing fast.

Investment Trend No. 4: Valuations

Investment Idea	Buy on the Dips	Stay Calm and Carry On	Don't Be a Hero
 <p>Rationale</p>	<p>If you believe there is another upward leg in equity markets, assess pullbacks to potentially buy on the dips.</p>	<p>Markets are likely to be increasingly volatile, especially after years of low volatility. Volatility is not a risk per se, unless you are a forced seller.</p>	<p>When valuations are stretched, it is not the time to take large bets against the benchmark or policy.</p>
 <p>Examples</p>	<ul style="list-style-type: none"> When equity markets correct, consider buying and resist selling at possible lows. 	<ul style="list-style-type: none"> Do not panic because of volatility. Be cautious and try to assess when rising volatility is not leading signal to the end of the economic cycle. 	<ul style="list-style-type: none"> Stay close to the benchmark. Use a good active manager to help you navigate treacherous conditions and generate precious alpha.

Investment Trend No. 5: Geopolitics

Investment Idea	Export-Oriented Markets	Europe	Natural Resources
 Rationale	Consider markets that have suffered because of trade wars and can benefit from a resolution.	Uncertainty in Europe holds the markets back. Once some uncertainties are cleared—with either good or bad outcomes—markets may have a relief rally after recovering from the initial shock.	A war with Iran might cause oil prices to jump.
 Examples	<ul style="list-style-type: none"> Japan equity, emerging markets equity. 	<ul style="list-style-type: none"> European equity. 	<ul style="list-style-type: none"> Natural resources equity.

Global trade disputes between the U.S. and China are set to continue impacting the global economy, manufacturing, supply chains, and corporate earnings. With the impeachment process and the 2020 U.S. general election on the horizon, we believe President Trump is likely to try to reach a deal with the Chinese. European politics—Brexit, the need for decisions on fiscal stimulus—are likely to have a major impact. Regardless of how the Brexit saga ends, the mere fact that it ends will remove some uncertainty—and markets hate uncertainty. Another geopolitical

risk is an escalation of tensions in the Middle East. Although the oil price is no longer as sensitive to the situation in the Middle East because new technologies offer abundant energy sources in the U.S., a war could still impact oil prices. With the amount of global debt in the system, a spike in inflation due to higher energy prices in a world running on fossil fuel could be damaging.

In this complex environment, our investment themes focus on what can go wrong in case of deterioration and what can go right in case of resolution.

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