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Positioning Your Portfolio for 2019

FIVE THEMES SET TO DOMINATE THE YEAR AHEAD – AND HOW TO PREPARE

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As we approach the New Year, a range of disruptive forces present distinct challenges for investors – playing out in the geopolitical arena in the form of trade wars, on the policy front in the form of divergent monetary policies, and on the economic front as countries contend with a late cycle environment.

We've narrowed these down to five key themes that should continue to dominate headlines and drive the performance of financial assets in 2019.

At a time when many investors review their portfolio positioning, our Asset Allocation team outlines its investment ideas to help navigate the environment ahead.

THEME 1: Global trade wars – can China avoid a crisis?

The trade conflict between the US and China has been escalating – and it might get worse before it gets better if the two sides continue to play a game in which neither side is willing to yield first.

A deterioration in the relationship between the world's two superpowers might have far reaching consequences, such as a weaker yuan and stronger US dollar, rising geopolitical tensions and slowing global economic growth. A less visible but potentially greater risk is the impact on US inflation – higher prices caused by tariffs could lead to an upside surprise in inflation data and a subsequent sell-off in US rates and equities.

Although the direct impact of a trade war on the US economy could be marginal, China's economic growth could lose nearly 2% in the next two years, according to the International Monetary Fund, creating a serious drag on the global economy. China has been considered a major risk for years and, with imbalances building, this could finally materialise – indeed, trade tensions have already sent the Chinese stock market plunging in 2018. After the 2008 Global Financial Crisis, China was the economic locomotive that helped to pull the rest of the world out of recession; it might lack the necessary power to do so again next time.

If the trade conflict is resolved, however, Chinese assets could offer a buying opportunity at bargain prices.

Investment Ideas

US Dollar	High-Quality Government Bonds	Emerging Markets (EM)	China and Japan Equities
Consider taking advantage of potential currency uplift and as a safe-haven currency	Maintain US long-term Treasuries – defensive qualities could prove supportive if global economy slows	Separate China allocation from EM – China may underperform other EM countries	Be prepared to consider Chinese and Japanese equities at attractive valuations if the trade conflict fades

THEME 2: Fixed income – a bias towards rising bond yields?

Since the 2008 credit crisis, government bond yields have declined significantly, partly due to quantitative easing (QE) and partly due to subdued expectations about future short-term rates, inflation and economic growth. These expectations are reflected in the flat yield curve. With the tapering of QE and the beginning of the hiking cycle, we are now at a turning point, which could have significant consequences for bonds as well as all major asset classes.

The key risk is a surprising jump in inflation, leading to a realisation that central banks are behind the curve and raising expectations of faster tightening. In this scenario, a correction in both equities and bonds could occur. This would be problematic for portfolios relying on a negative equity/bond correlation for diversification. Higher US yields could also mean a strong US dollar, providing some protection to clients exposed to US assets.

Tightening is dependent on continued economic strength; but if the economy slows, bonds may have another good year and could outperform equities.

Investment Ideas

Short Duration	US Treasuries	High Yield (HY) Bonds	Value and Growth in Equities
Shorter duration could outperform longer duration in a rising rate environment. But consider some long duration in the portfolio as it can offer protection	US Treasuries offer better value over cash and can play a defensive role in portfolios	HY could outperform investment grade when rates are rising due to positive correlation with economic growth and shorter duration	Maintain a balance between value (short duration) and growth (long duration). Banks may benefit from a steepening yield curve

THEME 3: Emerging markets – risk or opportunity?

Higher US interest rates may attract capital flows away from emerging markets (EM) as the opportunity cost of being in safer US assets decreases. In addition, a combination of higher US rates with stable non-US rates should strengthen the US dollar, making it more difficult for EM countries to repay dollar-denominated debt, while there is also the potential for intensifying protectionism and global trade wars.

Each of these factors by themselves, or even in combination, may not necessarily lead to an EM crisis; however, the weight of some idiosyncratic country-level problems, such as those we have seen in Argentina, Turkey or Brazil, could lead to contagion, which in turn could be amplified by indiscriminate selling from ETF investors.

Overall, however, the fundamentals of many EM countries are sound. The valuations of EM equity and bond markets look attractive after lagging their developed markets counterparts in 2018, particularly US equities. If an EM crisis doesn't materialise, it may be a buying opportunity.

Investment Ideas

Selective EM	Barbell Allocation	Equity Diversification	EM Debt
EM is not a homogenous opportunity set – it will pay to be selective	Use a barbell strategy combining EM assets with defensive assets (e.g. US dollar, US Treasuries)	Diversify EM equity exposure across Asia, Europe, Latin America and frontier markets	Blend EM debt exposure across hard currency sovereigns, local currency sovereigns and corporate issuers

THEME 4: Global stock markets – another year in the long bull cycle?

President Trump will do everything he can to keep the US economy strong because the success of his presidency relies on it, although his hands might be somewhat tied following the US midterm elections. While the current economic cycle has become one of the longest in history, we see no immediate warning signs that it is likely to end soon. As such, unless unforeseen significant risks materialise to derail the US economy, we may have another strong year for equity markets despite concerns over valuations. The policy of 'America first' with respect to trade negotiations may help push the value of American assets higher.

But there is a risk here. America still relies on the rest of the world as much as the rest of the world relies on America – attempting to reset the terms of global trade too hard in America's favour might derail the economies of other countries.

Investment Ideas

US Equities	Bonds	Cash	Currency
Maintain an allocation to US equities as they may deliver another year of outperformance	Balance equity exposure with an allocation to bonds to diversify equity risk and include as many independent sources of return in the portfolio	Keep some cash in the portfolio to be able to quickly invest in opportunities as they arise	Overweight the US dollar or simply do not hedge the dollar exposure of US assets (although hedging the currency of foreign high-quality bonds and cash should be a golden rule of thumb)

THEME 5: Europe – can it push through harder tests to come?

The European Union (EU) faces a number of challenges in 2019, including the ongoing Brexit process, further tensions with the Italian government and the continued rise of populism, anti-immigration, anti-establishment and separatism movements. A weakening European economy (real GDP has decelerated in 2018) could exacerbate the issues.

On the other hand, any favourable resolutions could lead to economic acceleration and a relief rally. In addition, European earnings growth has lagged European economic growth – a recovery in earnings may provide a boost to European equities.

Investment Ideas

High-Quality Government Bonds	European Equities	UK Equities and British Pound	Active Management
Include US long-term Treasuries – defensive qualities could prove supportive if global economy slows	Maintain exposure as favourable resolution to political concerns could provide support	Be prepared to add to allocations at attractive valuations if a favourable outcome for Brexit becomes likely	Political uncertainty may lead to volatility – a constructive environment for good active managers to add value

More on Disruptive Forces

The T. Rowe Price Global Market Outlook for 2019, *Navigating Global Disruption*, is released in December. The report provides a global perspective on the range of disruptive forces set to impact markets and economies in 2019. Featuring key insights from our Global CIOs, it's an essential resource as you prepare your investment strategy for the year ahead.

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