Brewin Dolphin's Outlook for 2019

Markets have entered 2019 in a wary mood following the worst year for global stocks since the financial crisis. This time last year we cautioned that markets could be more volatile in 2018, but as the year progressed the scale of the volatility was greater than anticipated.

Many of the events we thought would happen last year did. President Trump's business-friendly tax package, kept the US economy booming. We said that Brexit and more US rate hikes in 2018 could cause nervousness, and that is what we saw.

The hardest factor to anticipate in 2018 was the extent to which the Chinese economy would slow down. Most of the pain came from local efforts to reduce borrowing within the economy but these were compounded by the escalating trade war. The sum of these factors was a sharper slowdown in growth than we expected. As the year progressed volatility increased as, in addition, oil prices fell and people began to mutter about the threat of recession. What was expected to be another decent year for stock market returns proved anything but.

As 2018 ended, all major stock market indexes were down. China languished at the bottom of the league table1, down more than 25% over the year. Other emerging market indexes also saw out the old year in bear-market territory, being down more than 20% from their 52-week highs. The FTSE 100 dropped more than 12%, more than offsetting the dividends of around 4%. Even the S&P 500 lost 6% despite the strength of America's economy so, from a sterling investor's perspective, was down around 1% after the impact of
the stronger dollar and dividends.

Declining growth

As we enter 2019 the world looks very different from where it was 12 months ago. Back then developed and emerging markets were enjoying an economic upturn, growing together for the first time since the financial crisis. Now the global economy is undergoing a synchronised downturn. Even the US, which last year stood out as a beacon of economic strength, is expected to slow in 2019 (although for now it is still defying the sceptics). A slowdown in Chinese growth has proved of particular concern in the opening days of the new year. China's privately-owned manufacturing sector contracted for the first time in 19 months in December, the latest sign of how weakening domestic demand and US tariffs are putting pressure on the world's second-largest economy.

Europe remains a potential trouble spot, even ignoring the uncertainty around Brexit. Towards the end of last year, we had the apparent resolution of the Italian and EU budget standoff. But concerns about the stability of Italian banks continue to cause jitters. The European Central Bank has been forced to appoint temporary administrators for Banca Carige after it missed a deadline to improve its financial position – which doesn't say much for the health of Italy's banks.

Equities to outperform

There is plenty to fret about as 2019 begins. Even so, we believe the global outlook would have to significantly worsen before investors would be better off in cash or bonds than equities. It could be a bumpy ride for stock market investors as the volatility we saw in 2018 continues. However, it is worth remembering that while heightened volatility can be unnerving it can also be a friend to investors with strong nerves. It can offer the chance to pick up quality stocks, or add to existing positions, at more attractive valuations.

Last year's downturn means that stock markets are looking much better value than they were. Indeed, we believe that some of the stock markets that have been most bruised could be bright spots as the year progresses.

One of our central assumptions for 2019 is that the US dollar will weaken later in the year. This alters our view of recent years that the US is the best investment destination in the world. The attraction of holding assets in other markets, particularly riskier emerging markets, increases as the dollar weakens.

US – no recession

Yet, even if we expect its currency to weaken, one event we don't expect to see in the US in 2019 is a recession. As the impact of Trump's tax cuts lessen, we expect US growth to slow. However, the fall in the oil price will take up some of the slack:

initially lower oil prices are treated as quite negative by the market, but, ultimately, they are shown to be a boon to economic activity. The fall in US long-term bond yields, which means mortgage rates have dropped, should also support US growth as the tax impact fades.

The market's recent volatility partly reflects investors' fears that the risk of a US recession has moved closer. Our contrary view is that recession risks have shifted further away. However, we expect to move some money out of America as the dollar starts to weaken – though it could be the second half of the year before that happens.

Asia, emerging markets and the China slowdown

There are a whole host of trades that will benefit once this negative dollar trade starts to come through. We expect, for example, to see a significant pick up in Asia and emerging markets, which, following a torrid 2018, stand out as the cheapest equity asset classes. Indeed, our expectation is that emerging markets will do better than developed markets in 2019.

However, a sharper than expected economic downturn in China would put that recovery at risk. Recent Chinese economic data has pointed to strong downward pressures and the Beijing authorities have introduced a range of stimulus measures to revive the economy. Only time will tell whether those measures are effective and, in the meantime, we are anticipating a significant soft patch for Chinese exports in the early part of the year. That is because export orders were bought forward ahead of an increase in US-China tariffs that was supposed to kick in over the new year.

In the end the tariff increases were postponed, and could even be cancelled, but the fact that the orders have already been brought forward could make the early part of 2019 a difficult one for China and the surrounding Asian region. The Chinese economy will need to get through that soft patch before any impact of stimulus will really be seen. However, we are currently expecting a bounce in Chinese economic activity later in the year, a development that will be positive for output in the wider Asian region and global growth as a whole.

Europe – reliant on exports

Europe could be one of the prime beneficiaries. Over the past year domestic demand has been stable in Europe but the European economy has materially slowed as exports have dropped. It has been a demonstration of how reliant Europe has become on overseas exports. The region generates so little of its own domestic demand it is heavily reliant on China and the Asian region to provide marginal demand to boost economic growth.

Consequently, if the dollar weakens and Asian growth picks up, Europe should become more attractive from an investment point of view. That said, there remain plenty of reasons for caution. As we highlighted above, risks such as the potential fragility of Italian banks continue to cause nervousness. Other possible destabilising factors include Angela Merkel's replacement as German Chancellor and an intensification of the gilets jaunes protests in France.

Brexit - upside for sterling

Of course, we can't go without mentioning the 'B' word and the ongoing developments around the various deal or no deal scenarios.

Nobody really knows what a no-deal will mean but the stresses in the economy are likely to be significant. Even for large companies, with substantial resources, the challenges of preparing for no deal are immense. Many companies operate on 'just-in-time' processes, which means they don't have space to stockpile a great deal more. Dealing with that problem by, say, building more warehouses is an impossible thing to do in such a short time period and would be a colossal waste if they were not then needed.

For small businesses, which account for half of all UK employment and a third of turnover, there simply aren't the resources to prepare for a no deal, particularly ahead of the 29 March deadline. Under any circumstances it would be very difficult to get the economy ready for a no deal. The European economy would also be hit hard if Britain crashes out of the European Union without an agreement that keeps trade flowing.

As a result, we still think no deal remains unlikely, but the Prime Minister is currently engaged in simultaneous games of chicken with the European Union and the various lobbies wanting to either leave with no deal, remain, or have a second referendum. Currently none of the parties are budging meaning that the first time parliament is allowed to vote on the withdrawal agreement it will look very much like the one which was shelved to avoid embarrassment last year. That means there is a high chance that they will reject it, assuming this bravery will earn them more concessions from the EU when the deal comes back in a subsequent vote – a risky strategy indeed.

The most likely outcome is that a deal gets done (eventually). That would provide a boost for sterling which would be a fillip for many retailers whose stronger pounds would go further when buying stock from overseas and selling them to consumers who would feel wealthier too. The opposite would be true for many food and beverage companies who sell their wares internationally. There are other companies which are clearer proxies for the economic health of the country such as housebuilders and construction companies. These would also benefit from a Brexit deal being secured. Investors are naturally wary of them while the issue remains unresolved.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team ensuring that a rigorous and exhaustive investment process is employed. He also provides recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. Before joining Brewin Dolphin in 2006, Guy was an Investment Director at Hill Martin (Asset Management). Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.

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