Investment Strategy

The Equity Strategist | November 27 2019

ADCB
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20 for 2020

- Next year is likely to see weak economic growth but no recession; thus making equity markets experience a 'comfortable unease'.
- In this note, we list 20 aspects of the financial/economic/political/policy landscape that we will be monitoring next year.
- Given the range of uncertainties and risks, we believe investors will find better risk-return trade-off in quality and defensives.

Exhibit 1: 20 for 2020: likelihood and impact on equity performance

S.No.	Things to watch	Likelihood	Impact
1	Fiscal policy turns easier at the margin	Likely	Positive
2	Manufacturing activity rebounds	Likely	Positive
3	Market realises that low inflation will not turn into deflation	Likely	Positive
4	Commodity prices rise sharply	Some what likely	Positive
5	Share buybacks remain strong in the US	Some what likely	Positive
6	Synchronous global upswing materialises	Some what likely	Positive
7	Global trade recovers	Not likely	Positive
8	Capital expenditures remain subdued	Likely	Neutral
9	Hong Kong protests worsen materially	Some what likely	Neutral
10	Chinese economy sees a hard-landing	Not likely	Negative
11	Consumption weakens globally	Not likely	Negative
12	Corporate defaults rise sharply in the US and China	Not likely	Negative
13	Monetary policy turns tighter	Not likely	Negative
14	Elizabeth Warren gets elected as US President	Not likely	Negative
15	Severe earnings recession materialises	Not likely	Negative
16	US-China trade stand-off spirals out of control	Not likely	Negative
17	US-EU trade/tariffs issue takes center stage	Some what likely	Negative
18	Regulatory crack-down on the US tech sector intensifies	Likely	Negative
19	Trump 2.0 starts to appear less equity market friendly	Likely	Negative
20	A major geo-political risk-off event	Not likely	Negative

Legend

Likelihood	Impact
Very likely	Positive
Likely	Neutral
Some what likely	Negative
Not likely	

Source: ADCB Asset Management

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2020: the year of 'comfortable unease' for equity markets

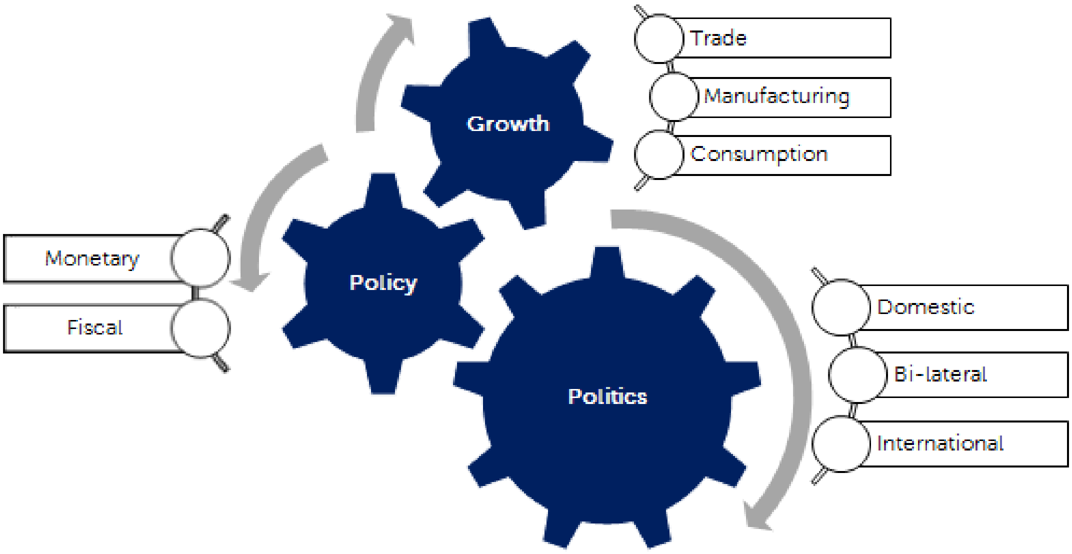
Next year, whilst markets are likely to experience unease with the weak growth environment, they are also likely to draw some comfort from an outright global recession not materialising. Against this backdrop we visualise equity performance next year to be influenced by an interplay of three different forces – growth, policy and politics.

On growth, we expect consumption to stay resilient with manufacturing activity recovering. However, we believe that trade will continue to be a drag on the economic performance. Overall, whilst the global growth is unlikely to turn negative over the coming year, we do believe that the growth rates will remain weak as the strength in consumption and a marginal recovery in the manufacturing will be offset by the weakness in trade.

We envisage an easier policy backdrop next year with fiscal policy becoming looser at the margin and monetary policy remaining accommodative.

The biggest risk to markets in our view is likely to stem from politics where domestic (US elections and China-Hong Kong), bi-lateral (US-China, US-EU and Japan-South Korea) and international (North Korea and Iran) political risks are likely to simmer in the background.

Exhibit 2: Three driver framework for global equities in 2020



Source: ADCB Asset Management

Risks to our rather relatively sanguine view are US consumer sector starting to come under pressure, geo-political risks escalating sharply and we 'talking' ourselves into a recession. Key vulnerabilities are lack of sufficient stimulants at the central banks, large debt pile of the global economy, building deflationary forces and a demographic drag.

Equity strategy considerations

Long-term: Our thesis is that while in aggregate, the equity market returns are likely to slow over the next ten years, we believe that there is significant scope for thematic investors to generate excess returns (for details and discussion see The Equity Thematician, February 2019). Further, our comparison of the current expansion in the US with that of 1990s showed us that a massive melt-up or melt-down in equity markets is unlikely in the near future (for details and discussion see The Equity Strategist, November 24 2019).

Near-term: As we had envisaged earlier (see The Equity Strategist, September 17 2019), fading trade uncertainty, stabilization of the manufacturing sector and a strong policy support triggered a pro-cyclical rotation over the last couple of months. In fact the recent strong performance of equities which came on the heels of volatility during summer, might leave the market participants wondering if this rally has now gone too far, too fast. In our view, this pro-cyclical rally has a bit further to run but the returns are likely to slow going into the year-end. The arguments of 'there is no alternative' (TINA) and 'fear of missing out' (FOMO) have gathered pace in the recent weeks and this is likely to underpin equity market performance in coming weeks. Cyclical data improvements are likely to provide further support. Valuations, sentiment and positioning are still not an impediment for performance ahead. However, some of the tail winds that propelled equities higher over the last two months are likely to fade. The impact of the yield curve steepening on equities might have played out to a good extent. The earnings season is largely concluded and therefore bottom-up drivers of equities are no longer in charge. Thus, the equity markets are now fully under the influence of macro drivers (trade, politics and policy). Overall, we believe that the current pro-cyclical rally seen over the last two months might have a bit further to go but as we approach the year-end, the returns are likely to slow.

2020: Given our economic outlook in which the global economy doesn't enter a recession but growth remains weak, we believe that for investors with sufficient caution and patience, opportunities do exist in equity markets. Moreover, we are not fully convinced that this pro-cyclical rally which we have seen since September this year, will last over a 12 month time frame. Therefore, in our strategic asset allocation (with a 12 month view), we retain our preference for US by region, defensive/non-cyclical growth sectors, large caps by size, growth as the style and quality as a factor.

Here are some considerations that investors should make while comparing the short-term pro-cyclical rally to the prospects of a pro-quality rotation in the medium term.

- If anything, we regard this sector rotation (from quality into value) healthy, also as a basis for quality consolidation and resurgence of quality themes.
- We believe that we are still in a late phase of economic expansion of the current cycle. Quality and defensive should continue to do well in such an environment.
- Also, global economic uncertainties can rise very quickly. As such we think the US and China are engaged in a prolonged trade/tech-war and the chances of intensification of the stand-off in the future (medium-term) remain rather high. Therefore, we see the recent attempts of reconciliation as only temporary.
- Even if a phase-1 of the trade deal is signed by both the US and China, focus could shift back very quickly to the enforcement of such a deal and here again, markets will remain influenced by deal-on deal-off sentiment.
- We think it is prudent to wait for an inflection in economic data before adding more cyclical/value exposure to strategic portfolios. At this point, while we are seeing some green shoots, a cyclical recovery is still not visible and remains heavily conditional upon the trade uncertainty fading.
- Going into next year, political risks should re-surface. Especially in the US, given the Presidential elections, markets are likely to remain influenced by the headlines of political developments, policy proposals and changing geo-political landscape.
- Therefore, after considering the risks and contemplating the trade-offs, we retain our preference for quality themes on a strategic basis.

Exhibit 3: Equity strategy summary of our 12M view

	Underweight (UW)	Neutral (N)	Overweight (OW)	Comments
Regions				
US			■	Higher quality, higher RoE/RoA
Canada		■		Stick with the benchmark
Europe ex UK	■			Selective OW Switzerland and Spain
UK		■		Stick with the benchmark
Japan		■		Prefer a cyclical tilt
Asia Pacific ex Japan	■			Structurally OW India; OW Australia and HK
EM LatAm	■			
EM EMEA	■			
GCC		■		Prefer KSA; regional banks
Global sectors				
Comm. Services			■	Prefer US exposure over rest of the world
Consumer Discr.		■		Prefer Consumer Services to Auto & Components
Consumer Staples			■	Prefer Household & personal products
Energy			■	Companies with positive cash flow to outperform
Financials		■		Prefer Banks with diversified business models
Health Care		■		Risks from US presidential elections
Industrials		■		Prefer Commercial & Professional Services
IT	■			UW Tech H/W and Semiconductor sub-sectors
Materials	■			UW Materials hedged with OW Brazil and SA
Real Estate		■		Prefer US exposure over Europe
Utilities		■		Stick with the benchmark
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			US small cap strained by leverage
Growth			■	Prefer non-cyclical growth
Value		■		Growth at a reasonable price (GARP)
Dividend yield			■	Prefer quality dividends
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Watch momentum for leadership change
Legend	*New* ■	*Old* □	*No change* ■	

Source: ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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