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CIO Investment Outlook

Brace for a credit squeeze

Unfortunately for markets, our bearish outlook for 2018 came to pass. For 2019, the key question is how tightening financial conditions will impact heavily indebted borrowers – and whether this raises the risk of recession.

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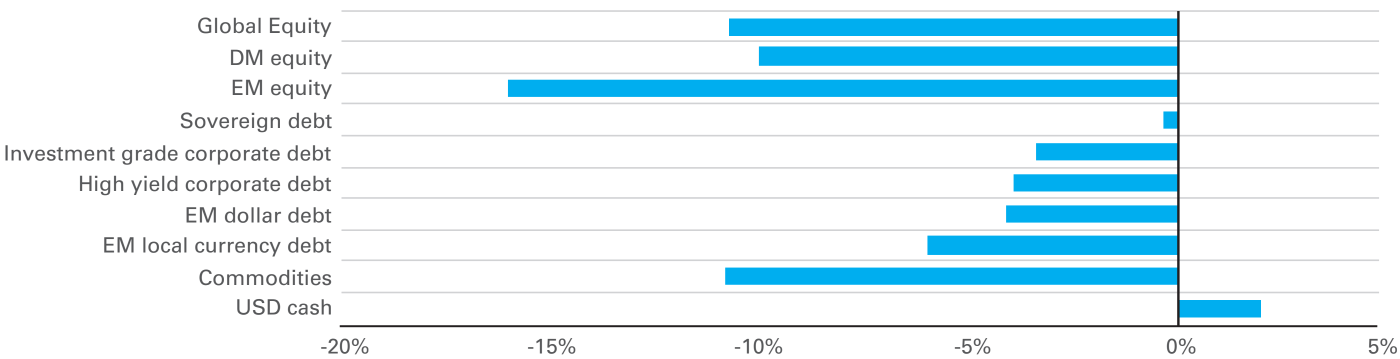
This time last year, I wrote about quantitative tightening, and how the liquidity tide going out would likely reveal structural problems associated with excess debt, deteriorating demographics and poor productivity – ultimately weighing on markets.

The first casualties were emerging markets, which suffered from a stronger dollar and higher bond yields. In second place were European borrowers, highly sensitive to the European Central Bank (ECB) slowing its asset purchases – weakening growth and political fragility is not a good mix to face without massive central bank support. US domestic assets had a good first half of the year, boosted by US President Donald Trump's tax cuts, with the S&P 500 near the highs and US credit spreads close to the tights of the year as recently as October. But this relative strength dramatically evaporated in the final weeks of 2018.

Figure 1: Total returns in 2018



Source: Bloomberg L.P., Barclays, MSCI, JP Morgan, Deutsche Bank

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Figure 7: US wage pressure continues to build (% YoY)

Source: Macrobond, as at 1 January 2019

The key constraint here is wage pressure (Figure 7). I suspect they would be unlikely to engage in another round of quantitative easing with such a tight labour market. But that suggests the need for rising unemployment, often associated with a recession. In other words, things would probably need to get worse before the Fed steps back in.

TAIL RISKS

There has been a cacophony of noise surrounding a number of geopolitical stories in 2018 – from European populism to global trade wars. Even if the underlying market driver continues to be tightening liquidity conditions, rather than these idiosyncratic headlines, they remain a focus for many investors. As a result, positive developments could catalyse periods of relative calm, but this would again encourage central bankers to keep their tightening policies in place.

We are more concerned with the downside risk. Further geopolitical upheaval has the potential to cause significant price dislocations, with investors and market makers pulling back all at once. This could be the time to deploy portfolio liquidity to pick up potential bargains.

MARKET IMPLICATIONS

Interest rates are likely to remain very low in Europe, Japan and the UK thanks to lacklustre economic growth. While the Fed will initially want to keep hiking interest rates, weakening growth prospects should keep a cap on longer-term yields, leading to more curve flattening. As growth concerns build, we expect the US Treasury curve to bull-steepen eventually.

Given liquidity tightening and mounting downside growth risks, a cautious approach to **equity** exposure makes sense, in our view, reducing risk on rallies.

Credit is also likely to remain under pressure in general, but there should be opportunities to invest in viable entities at distressed levels.

The outlook remains structurally **dollar**-bullish as liquidity conditions tighten. In the context of a cautious credit outlook, this is generally more positive for dollar-denominated **emerging market** debt versus local currency paper.

There are obvious downside risks for sterling and growth-sensitive **UK assets**, but valuations are more aligned to this observation than 12 months ago.

Commodities would likely be impacted by economic growth disappointments, but a new stimulus programme from China would clearly be very positive.

WHAT DOES THIS ALL MEAN FOR INVESTORS?

Against this backdrop, we are focused on managing risk to achieve long-term financial goals. We seek to enable defined benefit pension schemes to reduce inflation and interest rate risk, while managing allocations to growth assets. And of course 'growth' assets can range from pure equity exposure, to buy and maintain credit, to multi-asset target return strategies.

And we provide a number of similar solutions to defined contribution (DC) pension schemes, with a focus on multi-asset strategies.

Market volatility should matter less for investors in the 'accumulation' phase ahead of retirement, be they retail or DC scheme members. But we do offer solutions that are aimed at managing market risk at the same time as providing an income, for investors closer to retirement, and in line with their appetite for risk.

Meanwhile, we continue to integrate environmental, social and governance factors into our investment processes, as we believe that by doing so we can help to mitigate a wide range of risks for investors other than those posed by the macroeconomic outlook.

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