2019 outlook:

Investing in the twilight zone

The economic expansion of the last decade has been a consistent tailwind for financial assets. We see next year as the start of the twilight zone between expansion and an eventual downturn that will likely mark the end of the cycle.

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Twilight does not mean that darkness is descending immediately, but it's characterised by fading visibility as previously clear signposts melt into obscurity. Concerns about the fragility of financial markets will inevitably increase as the 'light' starts to fade.

2019 should see a slowdown in global growth, a rise in core inflation in developed countries and further rate hikes from the Federal Reserve (Fed). China is struggling to cushion its slowdown, geopolitical risks dominate, and European political cracks are widening. For UK investors, the shadow of Brexit looms large.

This late-cycle environment is tricky to navigate: market stumbles become more likely as the light fades but opportunities also present themselves when others are jumping at shadows.

The main danger for 2019 is a collision between tighter monetary policy, a cyclical slowdown and the structural headwinds of deteriorating demographics and high debt. However, previously lofty valuations in some equity and debt markets have started to normalise.

Those tensions have injected considerable volatility into financial markets this year. We think ongoing volatility, rather than a sharp bull or bear market is the likely regime for next year as well. In line with the old adage, equity investors are likely to be rewarded by being "fearful when others are greedy and greedy when others are fearful".

In line with our late-cycle playbook, we have seen the yield curve flatten and credit spreads widen in 2018. We agree with the view that our CIO Anton Eser provided in his 2018 market outlook: continued tightening of global liquidity conditions is likely to exacerbate market volatility. Equities have been volatile, which is typical of twilight markets. We expect this to continue into next year.

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INVESTMENT MANAGEMENT

2018: THE END OF UNINTERRUPTED SUNSHINE

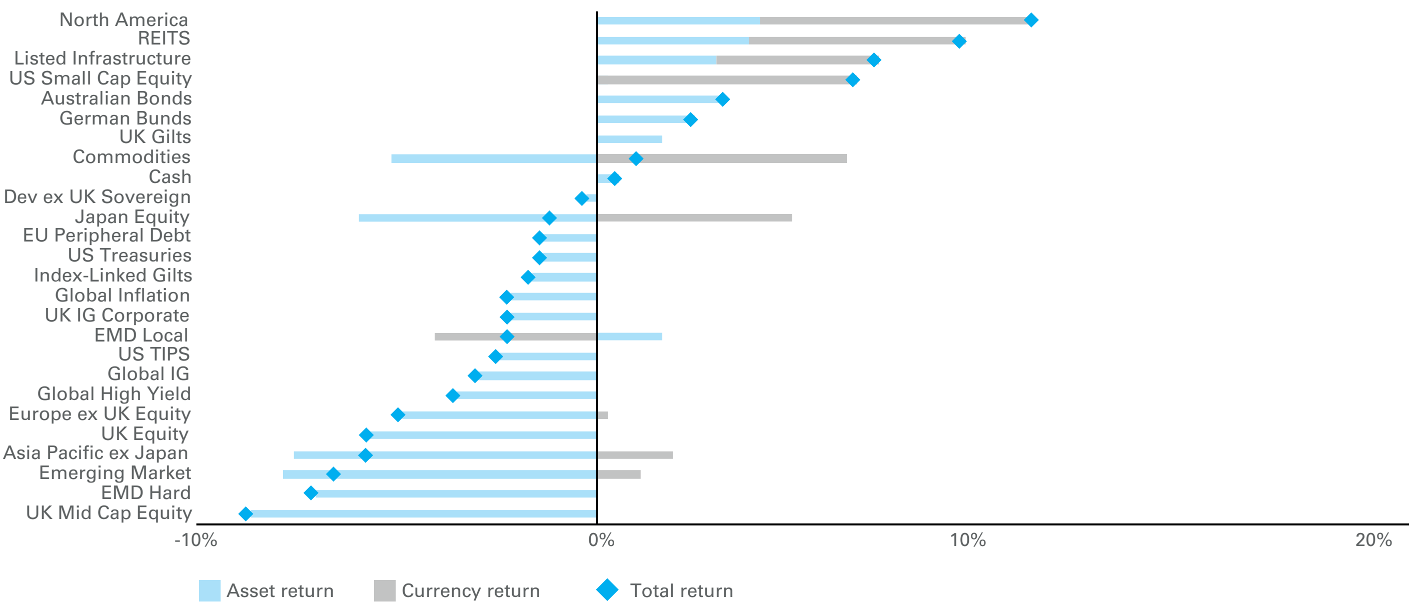
The US grew rapidly during 2018, aided by larger-than-anticipated fiscal stimulus. The labour market tightened further, which finally saw firmer wage growth. The Fed responded by shrinking its balance sheet and continuing a steady tightening cycle.

In contrast to the US, euro area sentiment deteriorated, exacerbated by unsustainable fiscal proposals from the new Italian coalition which drove sovereign spreads significantly higher. UK markets remained in thrall to the Brexit negotiations with further evidence that the British economy has slowed materially relative to its international peers.

Emerging markets were hit by the slowdown in China as the authorities were perhaps too successful in cracking down on leverage. The relatively smooth renegotiation of trading arrangements between the US, Canada and Mexico allowed the US administration to pivot to a more aggressive stance towards China. The ensuing tensions between the world's two superpowers repeatedly unsettled markets during the course of the year.

Equity markets suffered two corrections of around 10% in February and October, puncturing the tranquillity of the preceding year. As we write, equity markets remain nervous and close to their October lows. Credit spreads widened steadily since January. Government bond yields continued to diverge, with US rates rising to a multi-year peak and the European market anchored by negative policy rates.

Figure 1: Market performance across assets in 2018 for a GBP investor



Source: Bloomberg LP, LGIM. Performance from 31 December 2017 to 12 December 2018.

THE US: TWILIGHT BEGINS

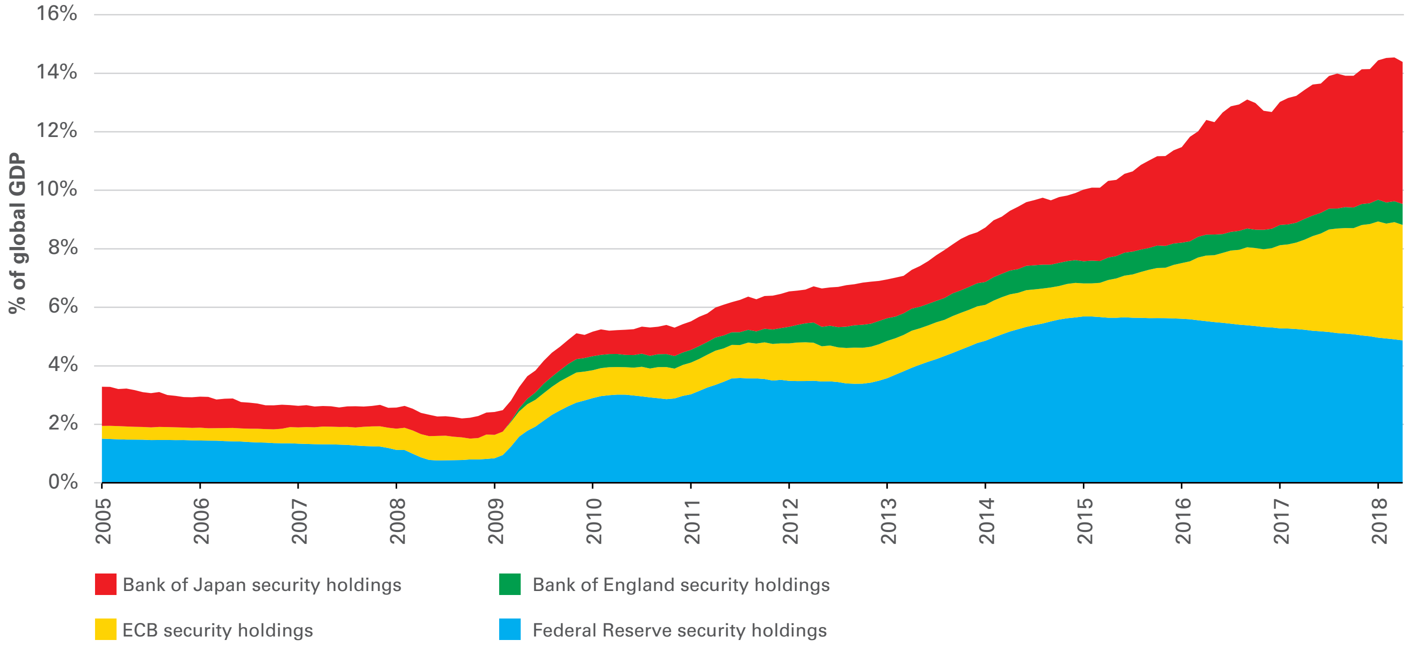
Although growth is beginning to slow, it should still remain above trend through most of 2019. Fiscal and monetary policies remain supportive in many parts of the world and banks appear willing to lend. The tightening of financial conditions via wider credit spreads and higher short-term interest rates is likely to have only a modest impact on the growth outlook.

In the US, risks to growth are skewed to the downside. Limited spare capacity in the labour market means that the Fed is unlikely to reverse course before there is clearer evidence of a significant slowdown in growth, unless financial conditions tighten significantly. However, there is also no clear need for policy makers to accelerate tightening in the absence of sharply rising inflation.

The probability of recession remains relatively low, though it is likely to increase towards the end of 2019 as the fiscal stimulus fades. Additionally, labour costs should start to increase more rapidly given unsustainably low unemployment. Moreover, even a mild slowdown in top-line growth can catch out the corporate sector given their fixed cost base.

The only long-term solution is stronger productivity to contain unit-labour costs and raise potential growth. This pick-up remains elusive, although there are a number of exciting developments across sectors.

Figure 2: Major central banks' balance sheets as a share of GDP incl. 2019 projection



Source: Bloomberg LP, LGIM

By the end of next year, we believe the US will be reasonably well-placed to fight the next downturn. Interest rates should be around 3% giving plenty of room to cut if needed, and balance sheet reduction will have reloaded the Fed's quantitative easing gun.

Watch out for: Rising core US inflation causing the Fed to raise rates more than expected

Left-field risks: A flair up of North Korean tensions if US negotiations are unsuccessful

EUROPE: ILL-PREPARED FOR NIGHTFALL

The European Central Bank (ECB) is set to end its asset purchases by the end of 2018. With growth having already slowed and core inflation only expected to drift up slowly, monetary policy will be on hold throughout next year.

Some of the recent growth weakness is likely to prove temporary. But more fundamentally the earlier tailwinds from a weaker currency, pent-up demand and low headline inflation are fading.

Europe's biggest problem remains an unwieldy and fractured financial system. Policymakers know that integration and risk-sharing are the answer, however, there is little popular support for such steps.

Populist pressures have come to the fore in Italy where higher debt interest costs are likely to more than offset any attempt to run a more expansive fiscal policy. The fragmented structure of the European debt market, rock-bottom interest rates and a political allergy to budget deficits mean that the **policy options*** in the next downturn are extremely limited.

Watch out for: As the sun sets on Mario Draghi's tenure at the ECB, investors will be fearful of a markedly hawkish successor

Left-field risks: Russia becoming increasingly aggressive towards other nations such as Ukraine

THE UK: THE LONG SHADOW OF BREXIT

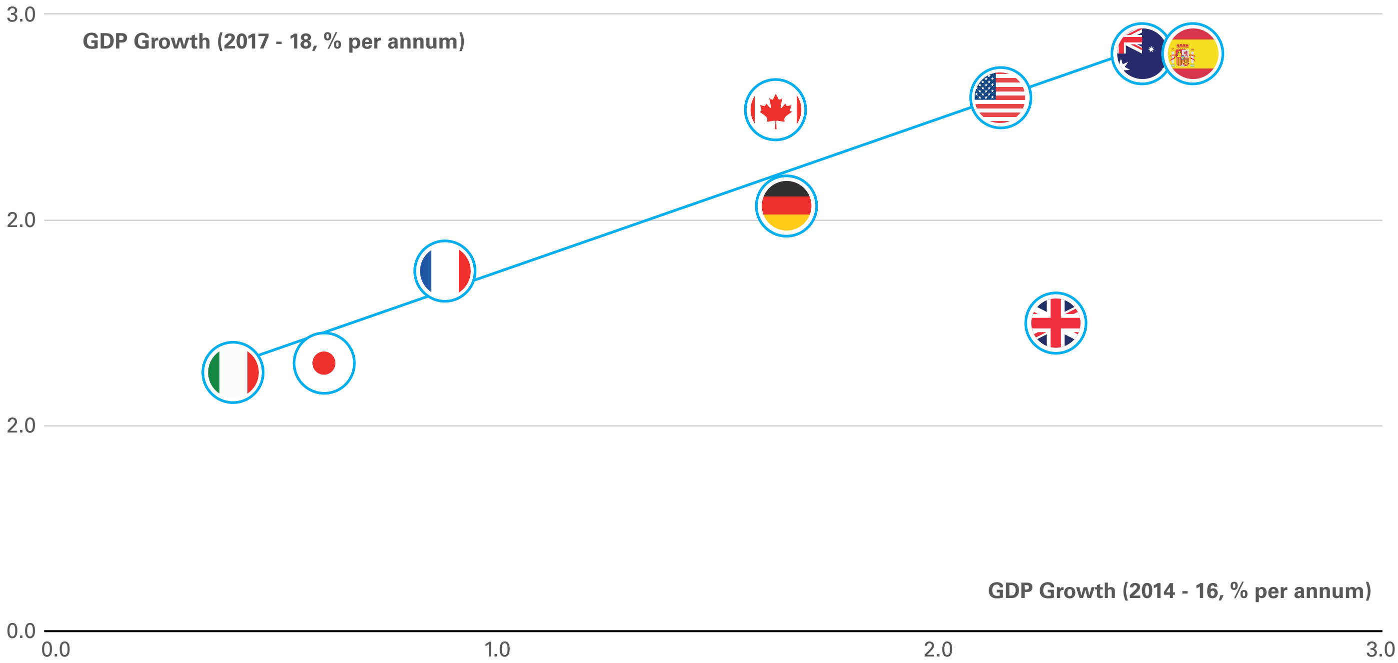
The UK economy was relatively stable during 2018. The labour market has strengthened, supported by a benign global growth backdrop, allowing the Bank of England (BoE) to raise interest rates for the first time in a decade. However it's clear that the UK has suffered a bout of idiosyncratic economic weakness since the middle of 2016 which has weighed on the exchange rate and interest rates.

The shadow of Brexit uncertainty has been pretty chilling for the UK. The outlook is similarly clouded by chronic political uncertainty.

Our base case is that Parliament eventually passes a Brexit deal which would moderate the uncertainty. But the magnitude of the political uncertainty means that any UK outlook is derived by peering into the fog through a kaleidoscope rather than looking into a crystal ball.

* http://www.lgim.com/web_resources/lgim-thought-leadership/Files/long-term_thinking_politics_and_policy_unconventional_policy_may_18_umbrella.pdf

Figure 3: UK economy – idiosyncratic slowdown post referendum vote



Source: Bloomberg LP, LGIM

But it is becoming clear that the impact of Brexit outcomes is looking increasingly binary. On the basis of a deal, we would anticipate higher interest rates, a stronger exchange rate, and a moderation in inflation expectations. No deal would see likely political turmoil, and sterling could fall sharply, leaving a monetary policy dilemma. With less spare capacity at present, we would not expect a repeat of the rate cut and quantitative easing which followed the referendum result.

Watch out for: Clues about Mark Carney's successor at the Bank of England

Left-field risks: England winning the UEFA nations league

THE EMERGING WORLD: TURNING ON THE LIGHTS

There were a number of idiosyncratic events in emerging markets during 2018 that impeded asset prices. However, the global themes at play were also important: higher funding costs for those with large US dollar liabilities and a slowdown in global manufacturing.

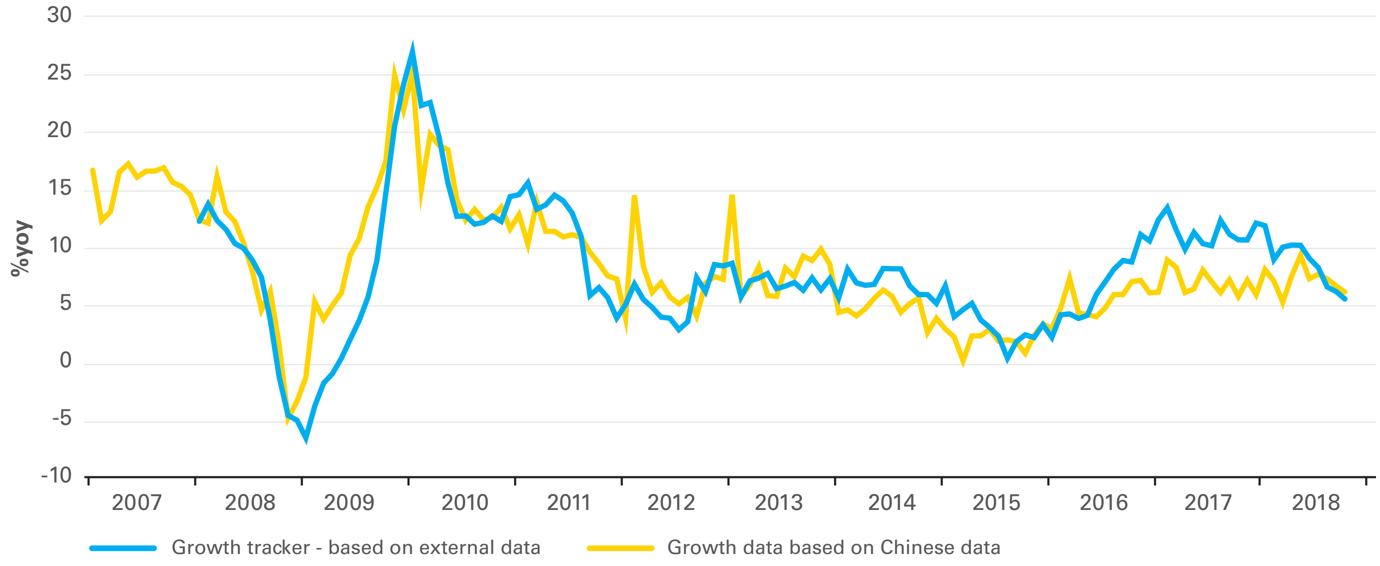
China is the big source of uncertainty. Its economy has slowed materially, but the authorities have responded by slowly ratchetting up fiscal and monetary stimulus. As twilight descends, the question is whether the country is turning on a pocket-torch or the macroeconomic floodlights. If it is successful in boosting credit growth, this should be positive for commodities and associated assets (e.g. debt issued by commodity producers, emerging market local debt and inflation-linked bonds).

Prospects for India remain bright, as earlier reforms underpin growth. The new government in Brazil appears committed to running a sensible budget policy and growth is expected to pick up in 2019. Russia is likely to remain sluggish, but avoid any crisis given its fortress balance sheet. Central and Eastern Europe are showing signs of being late cycle, but slower growth in the EU should prevent a further overheating.

Watch out for: A packed 2019 election calendar, including India and Argentina

Left-field risks: Heightened tensions between China and Taiwan

Figure 4: China growth trackers



Source: Macrobond, LGIM

MARKET OUTLOOK: EXPECT FIREWORKS

As the global economy enters the twilight zone, a point forecast for equities at the end of 2019 becomes increasingly useless. The market can trip-up on minor stumbling blocks, and recover just as easily as it becomes apparent that the stumble has not turned into a fall.

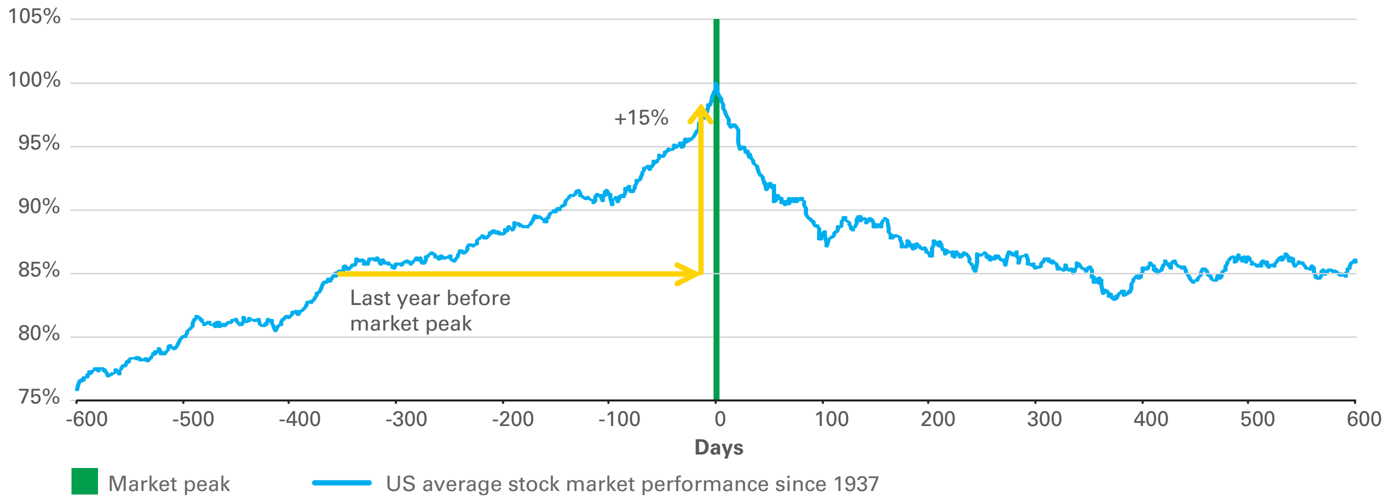
Our research on previous market cycles suggests that bull markets end with a bang not a whimper (see figure 5). Being six months too early in calling the peak can be just as damaging to performance as being six months too late. Although within equities we prefer Europe and Japan to the US, we also like technology and US energy. Those hoping for a return to tranquillity in equities are likely to be disappointed. We should expect fireworks as twilight descends.

Watch out for: A return to 'Trump the dealmaker' surprising investors positively.

Left-field risks: Increasing investor euphoria around the scale of technological breakthrough

The outlook for fixed income and currency markets is largely shaped by the policy options available to central banks. The rate differential between the US and other markets is likely to widen further, risking another bout of US dollar appreciation and yield increases in the first half of the year. However, we are sceptical about how much further US exceptionalism can run. Those moves are set to run out of steam by mid-year as focus switches to the 2020 Presidential election and beyond.

Figure 5: How bull markets die



Source: LGIM. The value of investments and any income from them may fall as well as rise, and investors may get back less than they invest. Past performance is not a guide to future performance.

Politics continues to be a threat for the euro as we head into 2019, with Brexit negotiations going to the wire, and the risk that the confrontation between the Italian government and the European Commission heads into the 11th hour.

One important twilight concern is the potential for a persistent change in the relationship between equities and bonds. In principle, the shock-absorbing capacity of bonds could disappear as an inflationary mindset takes hold. Instead of reducing portfolio risk, bonds could move with equities and exacerbate the problem. There's limited evidence of this so far, but it's a key risk to monitor in order to avert darkness descending upon multi-asset funds.

We expect the pressure on credit markets to continue. The large weight of relatively low quality issuers are vulnerable as uncertainty over future cashflows builds. However, the significant repricing seen in 2018 now provides a more sensible cushion against deteriorating fundamentals. Consistent with our constructive outlook for emerging market fundamentals, emerging market debt (both hard and local currency) looks increasingly interesting as we approach the end of the US tightening cycle.

Watch out for: Italy. It's the cheapest BBB rated sovereign credit, but has the greatest chance of creating a systemic crisis

Left-field risks: An unprecedented cyber-attack with possible geopolitical consequences

The key dynamic in late cycle is that changes in investors' recession probabilities become more likely. That can be very negative if short-term concerns about proximity to the cliff-edge spike higher. But anything which pushes out expectations for the next recession beyond 2020 would be a hugely positive market catalyst.

Twilight is *typically* the precursor to darkness, but not always. During a Scottish summer, for example, dusk runs straight into dawn the next day. The key to thriving in the twilight zone is to watch out for stumbling blocks and try not to jump at shadows. Both will be important in 2019.

Important Notice