2020 – The Year of Choices

In 2019, global economic growth looks to have fallen to a post-financial crisis low due to slowdowns in the US, Europe, and China. Although the labor market and consumption remained relatively healthy, fixed investment and trade growth weakened as the US-China trade conflict impacted business confidence.

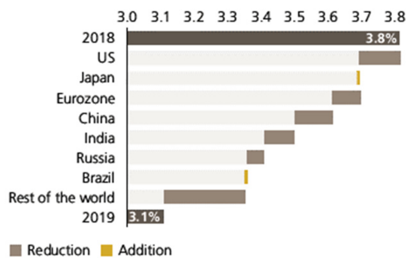
In our base case, we expect sub-trend growth to continue into 2020. But in a Year of Choices – for policymakers, electorates, and investors alike – the two-way uncertainty around our base case is greater than usual. We see three key "choices" defining outcomes:

1. Stick or twist?

Elections will take place in the US and, in December 2019, the UK. The issues up for grabs include how to structure a healthcare system for an aging population, growing income inequality, the role of the nation-state in an interconnected world, technological change, and who pays for environmental damage. The polarization between candidates, magnitude of issues, and market capitalization of the US and UK markets make these elections relevant for investors around the world. How each issue is decided will shape global trends and define sectoral winners and losers.

Global growth slowed in 2019…

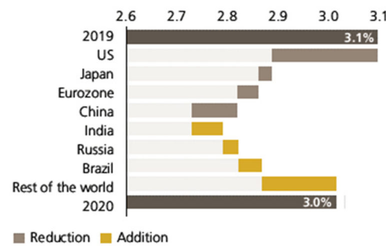
Change in global growth, attributed to select regions



Source: Haver, CEIC, national statistics, UBS, as of 11 November 2019

…and looks to remain slow in 2020

Change in global growth, attributed to select regions



Source: Haver, CEIC, national statistics, UBS, as of 11 November 2019

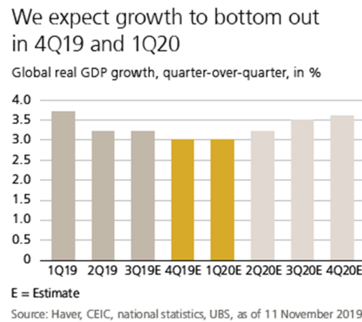
2. Deal or no deal?

China's competition with the US in the economic, technological, and geopolitical spheres creates an ongoing challenge to the previous world order that will not be easily resolved. In an era of "deglobalization," the trade turmoil between the two nations could flare up again in 2020, even if an interim deal is reached soon. But, equally, both sides have key influencers who would prefer to curb tensions. A deal to reduce or remove existing tariffs and a pledge to stop adding more could dramatically reduce global economic uncertainty, unlock pent-up investment demand, and enable US President Donald Trump to "declare victory" in an election year.

3. Monetary or fiscal?

With interest rates already close to, at, or below zero, the effectiveness of traditional monetary policy is now diminished, leaving us to consider the role of fiscal policy in stimulating growth. Given a divided US Congress, Eurozone budget constraints, and China's concerns about managing leverage, meaningful fiscal stimulus in 2020

appears unlikely, in our view. But low inflation and interest rates do provide the leeway to take a fresh look at the role of government spending, and coordinated fiscal and monetary action could offer material upside to our growth expectations, even if it might require a "mini-crisis" to force policymakers to reassess their current approach.



EQUITIES

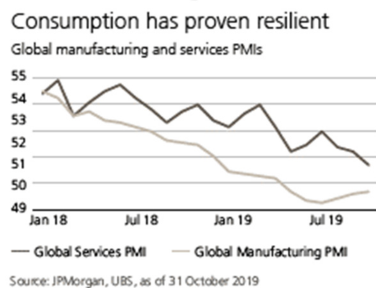
Global equities have delivered positive returns over the past 12 months against a backdrop of slowing growth and falling interest rates. Our base case, as we enter 2020, posits muted stock market performance for the year, but we note the two-way uncertainty in our Year of Choices. In this environment, we seek more reliable returns by focusing on quality and yield, domestic exposure, and consumer spending.

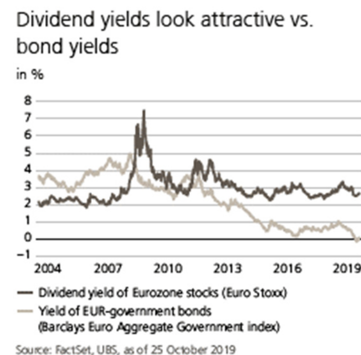
In 2020, we forecast equity earnings to increase by around 5% in the US and 6% in emerging markets, and to contract by 3% in the Eurozone. Meanwhile, with global central banks having cut rates to prolong the expansion, investors are likely to continue to hunt for yield.

In this environment, we think investors should prioritize both quality and dividends:

- **Globally,** we prefer quality companies with higher profitability, lower financial leverage, and less earnings volatility than the overall index. Such companies tend to perform relatively better during periods of economic slowdown and recession.
- **In the US,** we position our Dividend Ruler strategy with a bias toward higher-yield, higher-quality companies compared to the overall market. We continue to believe this focus on high-quality companies should provide some downside protection if economic risks rise.
- **In Asia,** dividend yields are higher than their historical average, and we see scope for dividend growth. We like high dividend yielding stocks in markets where the dividend yield on stocks is higher than the yield on government bonds, particularly in Singapore, Hong Kong, Thailand, and Taiwan.
- **Within the Eurozone,** dividend plays are appealing, given the near record-high gap between dividend and bond yields in the region. We seek stocks with high sustainable dividend potential.
- **In Switzerland,** there is a similarly wide gap between dividend and bond yields. The overall MSCI CH has an average yield of around 3%, versus zero or even negative for Swiss bonds. We look for defensive names that boast attractive valuations and dividend yields, as well as robust earnings growth relative to the wider market.

- **In emerging markets,** we believe an attractive way to improve the quality of your equity portfolio is to invest in companies highly rated according to environmental, social, and governance criteria (“ESG leaders”). Emerging markets (EM) face some major challenges in the coming years, which will put stress on resources like water, food, and energy, and may result in increased environmental and social risks. Although regulation in EM is often less robust than in developed markets, we believe it will continue to tighten, and, consequently, EM companies with higher ESG standards may deliver more sustainable financial performance with lower downside risk. The MSCI EM ESG Leaders index has already outperformed the broader MSCI EM index on average by more than 3% annually (end-of-September 2007 – end-of-September 2019).





Go domestic over global
Companies exposed to global trade are likely to be dependent on a favourable political climate in the year ahead, and so could experience higher volatility. We prefer stock markets that rely more on domestic spending.

- **We prefer US stocks to Eurozone equities.** 69% of US company revenue is generated domestically compared with 47% for Eurozone firms, while 58% of US revenue is derived from the consumer compared with just 36% in the Eurozone. Within Europe, we recommend focusing on the more domestically oriented financials and utilities sectors.
- **We like China within EM equities.** Chinese stocks may appear vulnerable to trade tensions with the US, but in fact the country’s listed companies generate only 2% of their sales in North America, and 86% domestically – making the market among the least exposed to trade within EM. Chinese authorities have also stimulated their economy in response to the trade dispute.

Choose consumer over business
Even in the event of an interim US-China trade deal, policy uncertainty will likely continue to weigh on business investment. We expect consumer-facing sectors to prove more resilient thanks to vibrant labor markets and healthy wage growth.

- **In the US,** we overweight the consumer discretionary sector, which should benefit from relative strength in the US labor market. In particular, we are attracted to strong brands with pricing power and companies aligned to the needs of millennial consumers that should drive consumption trends for years to come.
- **In Asia,** we focus on Chinese internet and 5G beneficiaries, which should gain from consumer adoption of 5G smartphones.
- **Our least preferred global sectors** include materials and information technology, both of which are more exposed to business than consumer spending.

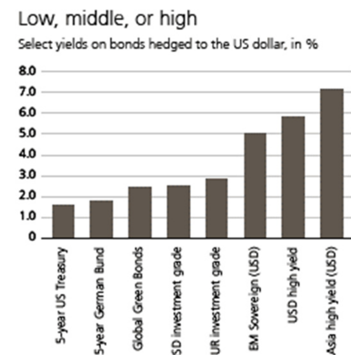
FIXED INCOME

Bond yields fell sharply in the past year, and the outstanding supply of negative-yielding debt now totals as much as USD 12trn. We doubt yields will move much lower, but also see little to suggest that the yield environment will improve. Low yields might tempt investors to turn to riskier instruments. But corporate credit fundamentals at some high yield companies are showing signs of deteriorating. We recommend choosing fixed income investments in "the middle lanes," avoiding the safest and the riskiest issuers, and looking for sustainable alternatives.

Choose the middle lanes

Limiting exposure to negative-yielding debt and increasingly risky high-yielding credit means fixed income investors should look to drive in the middle lanes.

US dollar-denominated emerging market sovereign bonds offer a yield of 5% (EMBIGD index). It remains a well-diversified asset class with over 70 countries in the index, which helps investors limit exposure to idiosyncratic issues. Emerging market growth also remains structurally higher than developed markets – China alone will make up 6% of broad global bond indexes by the end of 2020, and EM 13%.



- **Within US fixed income,** we favor senior loans over high yield bonds. They offer comparable carry to high yield, but with a secured structure. We expect the underperformance of floating rate assets during 2019 to fade in 2020, as the rush into fixed rate securities ebbs. We think defaults will be low and recovery rates on secured loans high.

- **In Asia,** we look for good-quality names in the high yield space, and prefer BBB within investment grade. We favor investment grade bonds, which can provide enough spread cushion to withstand the volatility in rates, including Chinese government-related issuers and select corporate bonds issued by Indian privately-owned companies. China property remains our preferred sector in high yield.

- **In Europe,** we look for select investments in the "crossover zone" between investment grade and high yield. The ECB is buying bonds, so corporate spreads should be relatively contained, and investors able and willing to stomach the potential volatility of "crossover credit" investments can earn potentially significant alpha if key rating agency action is anticipated correctly.

CURRENCIES

Choose barbells over greenbacks

We expect the US dollar to weaken over the course of 2020. In recent years, high interest rates, risk aversion stemming from the downturn in global trade, and support from earnings repatriation have supported the USD. But over the coming year(s) US growth and interest rates will be closer to those elsewhere in the world, and uncertainty ahead of the US election and the waning effect of tariffs suggest a weaker greenback is likely.

The dollar's exclusive position in recent years as a relatively high-yielding currency with safe-haven characteristics will be hard to replicate. But we think it can be approximated through a barbell approach that combines relatively stable low yielders with promising high yielders. In an uncertain environment, we think the Japanese yen and the Swiss franc will benefit from safe-haven flows. Meanwhile, the "hunt for yield" is likely to benefit select emerging market currencies. In particular, those countries enjoying rising GDP growth, investment, productivity, and fiscal stimulus are likely to find their currencies in demand. Currently, we like the Indian rupee and Indonesian rupiah.

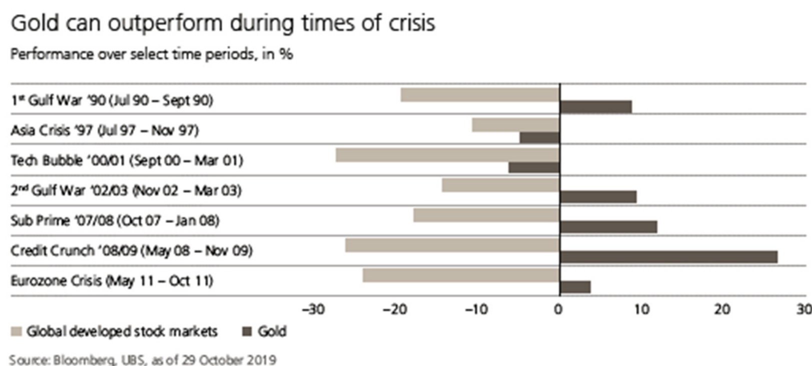
COMMODITIES

Go precious over cyclical

We see gold appreciating in 2020, albeit at a slower pace than in 2019, when it was up 18% in the year to October. Muted economic growth and now lower interest rates reduce the opportunity cost of holding gold, which does not offer a yield. Political uncertainty could send safe-haven flows into gold. And since gold is priced in USD, a weaker dollar would in turn push gold prices higher.

In contrast, ongoing economic concerns dampen the outlook for cyclical commodities. In the absence of a broader recovery in manufacturing and investment activity, the conditions are building toward market surpluses both in industrial metals and in oil.

Of course, sudden changes in the outlook are possible, and investors should remain vigilant. In oil, OPEC supply remains a wild card. Price declines to USD 55/bbl or lower could offer an opportunity to buy, while price setbacks in copper and aluminium could also offer a chance to go long. In precious metals, investors should bear in mind that insurance-like qualities do not come for free. If geopolitical tensions ease or the economy recovers more quickly than we expect, performance would likely suffer.



REAL ESTATE

Picking late-cycle winners

Prices of both residential and commercial real estate have been inflated by years of low borrowing costs, affecting the choices that investors should make in coming years.

Risks in the owner-occupied housing market are elevated in a range of major cities, with a heightened danger of price declines in Paris, Munich, and Vancouver. Regulatory interventions to improve affordability have become a growing issue. However, pockets of relative value remain, including in Chicago, Milan, and Dubai. Residential investors should therefore choose their locations carefully. A diversified property portfolio in such fairly valued or undervalued cities would improve the potential for an attractive risk-adjusted rate of return over coming years, in our view.

In commercial real estate, we advocate an active management strategy. Skilled managers can still unlock value, even in periods when overall returns are likely to be modest and transaction volumes are falling. Investors should choose investments based on long-term structural trends, such as the growth of e-commerce, urbanization, and aging societies. For example, urban logistics real estate, like small warehouses and distribution centers that facilitate the last stages of the delivery process, stands to benefit from the rise of e-commerce, while secondary retail assets are coming under pressure and should be avoided.

Source : UBS House View / YEAR AHEAD 2020