Closing Bell

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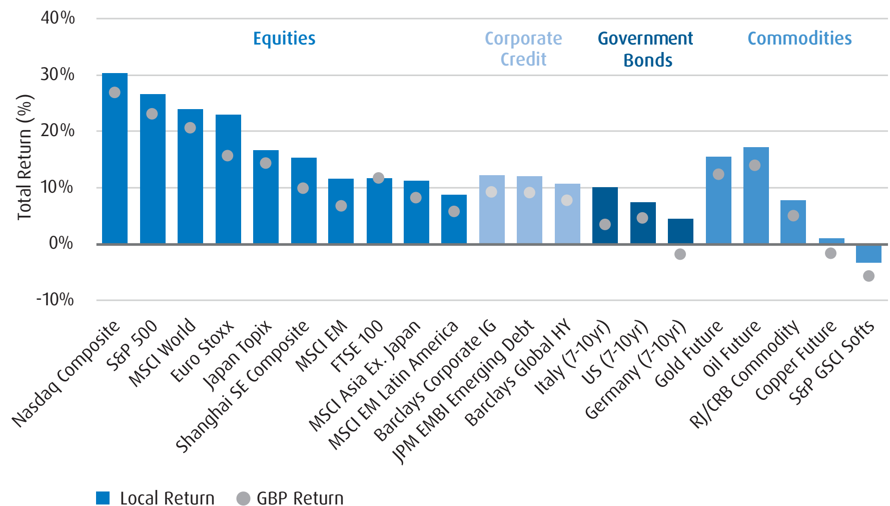
Central banks fuel strength in bonds and equities

- Extraordinary returns from financial assets as central banks around the world ease monetary policy
- All this despite a negative political background (Trump's tariffs, Brexit unresolved, civil unrest from Hong Kong to Chile to France), sluggish economies and weak corporate earnings
- 30% of global government debt now has a negative yield
- ESG considerations come to the fore

At the start of 2019, investors were nervous and confidence was fragile. But a few days later came the dramatic pivot by the US Federal Reserve. Their bias towards hiking interest rates was dropped and the market began to price in cuts. Ultimately, they delivered a total of 0.75% in interest rate reductions in three stages. With the European Central Bank also easing policy, the stage was set for central banks around the world to follow suit.

Chart 1: Asset performance year-to-date 2019



Source: Bloomberg, BofA Merrill Lynch, IG = Investment Grade, as at 4-Dec-19

Key risk

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

Continued

Greece outshines in bonds and manufacturing

With global economic growth sluggish and inflation low, bond yields tumbled. At the peak in August, 40% of developed market government debt had a negative yield. The bond market generated a long list of other remarkable statistics in 2019. We gasped when Italian 10-year yields fell below 1% in August and held our breath as they hit 0.5% a month later. Almost the entire Italian yield curve now lies below its US equivalent. But the prize for the best performer in the EU goes to Greece, a market that few investors would touch a few years ago as they restructured their debt and 10-year yields reached 35%. Today, Greek government bonds now yield just 1.5% at 10-year maturities, a decline of 2.8 percentage points year-to-date with a yield curve which also lies below that of US Treasuries. To top it all, Greece enjoys one of strongest manufacturing purchasing managers' index (PMI) whereas that for Germany is in recession territory.

Bond markets may have enjoyed a strong rally in 2019 but investors required nerves of steel or good fortune to make the most of the performance. The year-to-date return on 30-year German bunds hit 33% in August but they have since given back almost half of that and are now up 'only' 18%. Investors in the Austrian 100-year bond had an even more volatile ride: up 80% year-to-date in August and 46% now. By contrast, the UK gilt market was a sideshow.

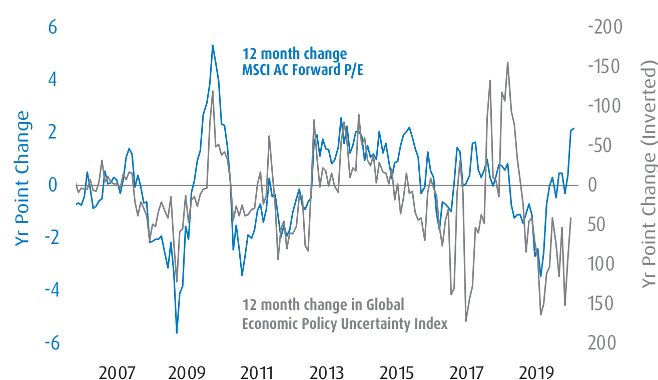
Growth stocks outperform

Tumbling interest rates provided the background for the strong performance in equity markets, led by the NASDAQ. This provides further evidence for the role of interest rates, as the index is weighted towards 'growth' or 'long duration' stocks that benefit most from lower interest rates. It certainly wasn't earnings' strength that pushed markets higher: most major markets look set for flat or negative growth in earnings in 2019. Indeed, one of the most powerful themes in equity markets in recent years – the outperformance of 'growth' versus 'value' – was propelled further by declining interest rates and, on some measures, now looks fundamentally overvalued.

Emerging markets have struggled

Emerging market (EM) equites produced decent returns in absolute terms but underperformed developed markets (DM) consistently over the year. It remains to be seen whether the significant interest rates cuts in EM generate a revival in 2020. China undoubtedly suffered from the tariffs imposed by President Trump, which went far further than expected by most market participants, including ourselves. But other EM markets delivered similar lack lustre performance. The FTSE-100 was one of the few DM indices that matched EM's underperformance. It is traditionally a defensive market but also suffered from being the biggest underweight in global portfolios according to most surveys due to Brexit uncertainty.

Chart 2: Earnings vs. Economic Policy Uncertainty



MSCI AC = index of world equity markets, covering 23 developed and 24 emerging markets.
Prospective PE = the ratio of current price to consensus earnings expected for the next 12 months.

Source: Datastream, Global Economic Policy Uncertainty Index (Baker, Bloom and Davis). As at 29-Nov-19

Political uncertainty and civil unrest are short-term headwinds

The broad-based rally in financial assets occurred despite an adverse political background. We have already mentioned Mr Trump's tariffs. His anti-business stance in 2019 contrasts with the market-friendly tax cuts and de-regulation that characterised the first half of his Presidency. Brexit uncertainty continues as the UK faces a general election under its third Prime Minister since the referendum in 2016. Civil unrest in Hong Kong has been front page news but it has also been evident in France, Chile, Lebanon and several other countries. Domestic markets undoubtedly suffer when uncertainty damages the macro economy, as in Hong Kong. Chart 2 suggests that market valuation is also sensitive on a short-term basis to political uncertainty. But for this year at least, the interest rate stimulus has dominated.

ESG considerations come to the fore

Another market theme that rose to prominence in 2019: ESG (environmental, social and governance) investing. This has long been a focus of BMO Global Asset Management, but it is now front and centre across our industry. As ESG-driven flows increase, their influence on individual equity performance will follow suit. Issues such as climate change may play out over decades, but markets are a discounting mechanism, which suggests that this and related ESG considerations are set to become powerful factors in shorter-term market movements.

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