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2019 was a party to end the decade. What kind of hangover will 2020 bring?

Highlights:

- **2019 ended a decade of growth and buoyancy for stocks and bonds with a resounding bang. It was a welcome respite to the fraught "aughts" (2000 – 2010) which formed the cradle of the Great Financial Crisis, the worst economic crisis since the Great Depression, and two stock market collapses. [1]**
- **During the past decade the US did not experience a single recession, and as such it was the first decade to do so since 1850 (when good records became available). The S&P 500 saw 200 all-time highs during the decade the last time, which saw the decade return positive returns in 9 out of 10 years, and equities far outpaced all other asset classes (despite bonds showing a total return of 43% for the decade). Annual returns for US equities were 13.1% per annum. There was also not a single bear market (a loss of 20% or more) during this period.**
- **While equities and bonds boomed, commodities were a bust over the past decade. The Bloomberg Commodity Index lost nearly 45% during the decade, where the price of WTI crude oil fell by over 27%. Gold prices are up 20% for the decade but remain 25% below their peak (August 2011).**
- **The decade presented more political than economic or financial shocks – with 2016 as the peak of election shocks, containing Brexit and the Presidential election in the US that brought the disruptive force of Donald Trump. Increased protectionism, nationalism and a disruption of old alliances (particularly on trade) drove an aversion to Emerging Markets which lagged developed markets, which themselves were dominated by a handful of tech stocks.**

[1] https://awealthofcommonsense.com/2019/12/the-2010s-market-decade-in-review/

- **Central banks flexed their muscle as the decade's combined backstop, perhaps as a reaction to criticism that they had been slow to avert and then respond to the economic crisis of the decade fore. Only the US Fed was buoyed enough to start a rate rise cycle towards the end of the decade but reversed this in 2019 with three "insurance" rate cuts.**
- **Finally over the course of the decade climate change awareness reached the mainstream and every corner of world markets. Investors responded by elevating ESG concerns and stewardship issues to the forefront of their investment policies.**

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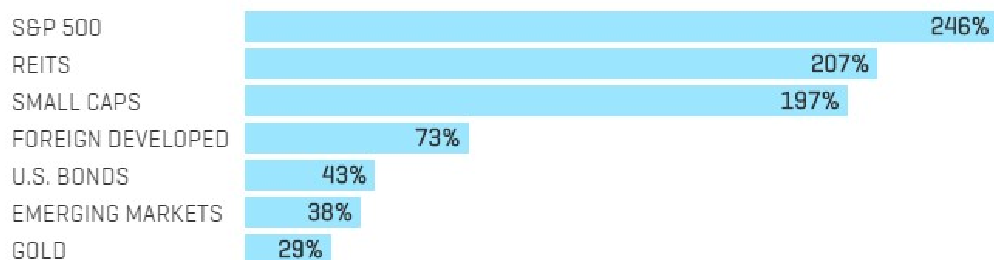
Current macro snapshot

Looking back to look forward? A decade of healing, now what?
2019 ended with the same animal spirits that characterized much of the year, and defied expectations of a recession and geopolitical and trade-driven upset. It brought to an end a decade of extraordinary equity market growth and record setting in which developed markets led the way, and Emerging Markets lagged even bonds. As noted above, the record-breaking nature of the equity market surge (with 200 all-time highs reached in the S&P alone) and soaring market caps in tech stocks in particular, points to an unstoppable momentum in which growth dominated value and equities dominated alternative asset classes which became popular in the aftermath of 2008. Bonds too defied expectations as interest rates remained in check thanks to Central Bank easing.



The decade was an ebullient response, therefore, to a previous decade of angst. Investor memories may be short, it may have brought some healing. But what now? Do Central Banks, having sampled negative interest rates in Europe, have any tools left in their monetary policy toolkit? Will a shift to fiscal policy be necessary to stimulate spending and growth? While Europe has been characterised by anaemic growth, even in the US, the engine of global markets this decade, growth has been lacklustre. As noted last quarter, in the US growth levels for the third quarter hovered below 2%, while in China growth expectations have been downgraded to closer to 5%, below the 6-6.5% target.

After a decade of lagging developed markets, will emerging markets receive more attention or will there be too many political surprises in developed markets for investors to even consider more peripheral options.

As of the end of the year the decade of excess may have led to an element of complacency. The end to the year was dominated by the post-election redux in the UK as the country moved inexorably towards Brexit, as well as the impeachment vote in the US House of Representatives. Neither event triggered markets much at all. Markets indeed seemed to be drunk on their own momentum as US bourses broke through key record levels in a Santa Claus rally boosted by the economy continuing to "hum".

The current decade (2020s) has seen more risk aversion as the year started on a sober note in its earliest days. Raging wildfires in Australia took on near catastrophic "unprecedented" proportions while the killing of an Iranian General Suleimani sparked new fears of geopolitical fallout. The field of Democrat candidates for US President was winnowed down, while the US House Majority Leader Nancy Pelosi withheld the articles of impeachment from the US Senate, based on fears of lack of impartiality. It is a particularly noisy start to the year, with a particularly large helping of the "unexpected" in terms of newsflow. This could lead to a variety of outcomes as the year unfolds.

After 2019 ended the decade with a bang, we are now dealing with the morning after. Whether the party continues or a reckoning is overdue remains to be seen.

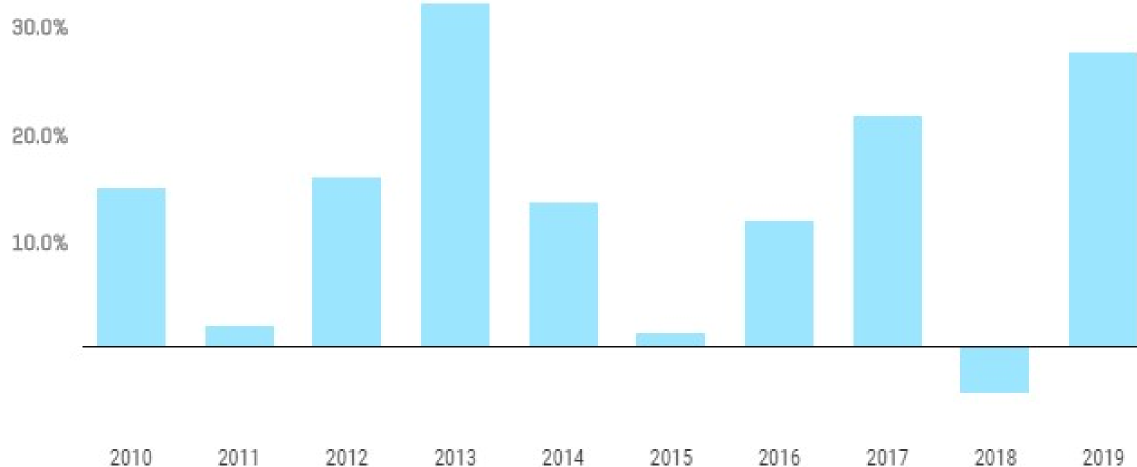
Individual Asset Class Performance

- Equities
- Fixed income
- Commodities
- Spotlight on Problem Credits

Equities: More records broken, but are investors getting queasy?

December delivered a robust end to a year characterized by broad-based strength and positive momentum. Despite the passing of articles of impeachment on President Trump, US markets were unphased and broke through new heights to return 3% for the S&P 500 and 3.6% for the Nasdaq, bringing the year to date figures to 31.5% and 36.7%, respectively. The news of progress towards Stage 1 of a US/China trade deal proved to be even more auspicious for China than the US, as the Shanghai Composite rose by 6.2% leading to a respectable 25.2% for the full year. Hong Kong was even more robust at 7% as protests there moved from the front page, although did not de-escalate much. Overall, emerging markets still lagged their developed counterparts in 2019 – the MSCI Emerging Market index added 7.3% in December to end the year up 18.6%, significantly behind Europe (DJ Stoxx +27.7%) but ahead of the FTSE 100 (+17.2%).

For the decade as a whole, annualized returns for US equities were 13.1% per annum, and there was not a single bear market during the period. The S&P rose in 9 out of 10 years, with only one negative year in 2018. Tech stocks denominated with the Nasdaq 100 rising by nearly 400%, and the stocks that dominated were the FAANGs (Facebook, Apple, Amazon, Google and Netflix). For the decade Apple, Amazon, Microsoft and Google saw their market cap rise from a cumulative $716 billion to over $4 trillion.



Fixed Income/Credit: how low can you go?

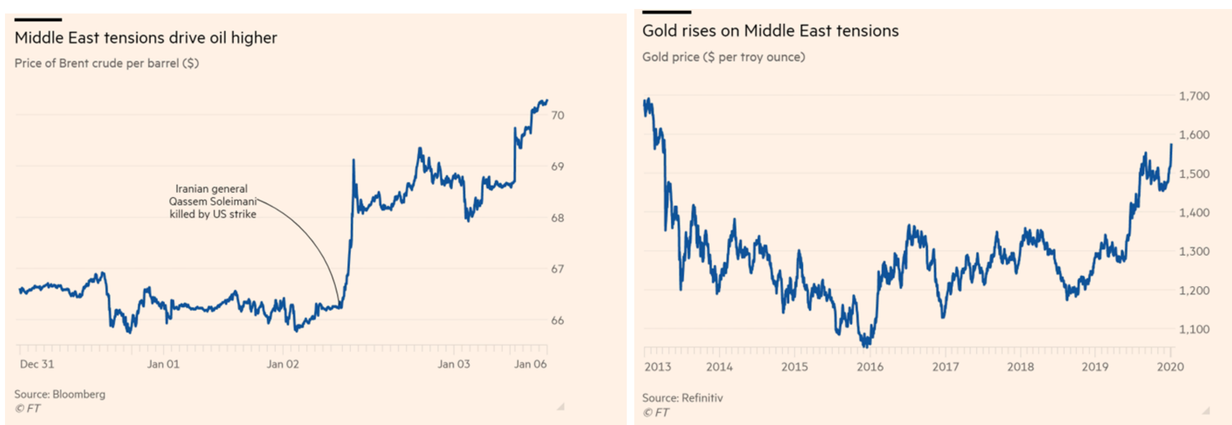
As noted already, fixed income has continued to perform strongly, particularly in the US, where high yield returned 1.9% in December to bring the year to 14.7%, and investment grade ended the year close to 14%. Government bonds were similarly robust, defying their roles as an insurance policy, with a strong performance in particular from US Treasuries (+5.9% for the year, UK Gilts up 7.1% and European sovereigns +6.7%). EM bonds too delivered a double-digit performance for the year with a particularly strong lift in Latin America in December.

Interest rates remained more or less range bound over the course of the decade as central banks honed their skills at managing market expectations and shoring up the economy. Unprecedented monetary easing failed to deliver run-away inflation, or a double-dip recession – in fact the only area with even modest inflation was the UK which experienced the inflationary effects of a weakened currency, driven off political concerns.

As an interesting aside, Sweden moved away from negative interest rates in December, out of an abundance of caution whereby it feared that negative interest rates would incentivize households to take on too much debt.

Commodities: a decade of bust but a recent pop in oil

It was primarily a lost decade for commodities, which had boomed during the previous 10 years. The Bloomberg Commodity Index lost nearly 45% during the decade, where the price of WTI crude oil fell by over 27%. Prices have, however, started to firm in the aftermath of rising Middle-East tension and in recent weeks exceeded $70 per barrel.

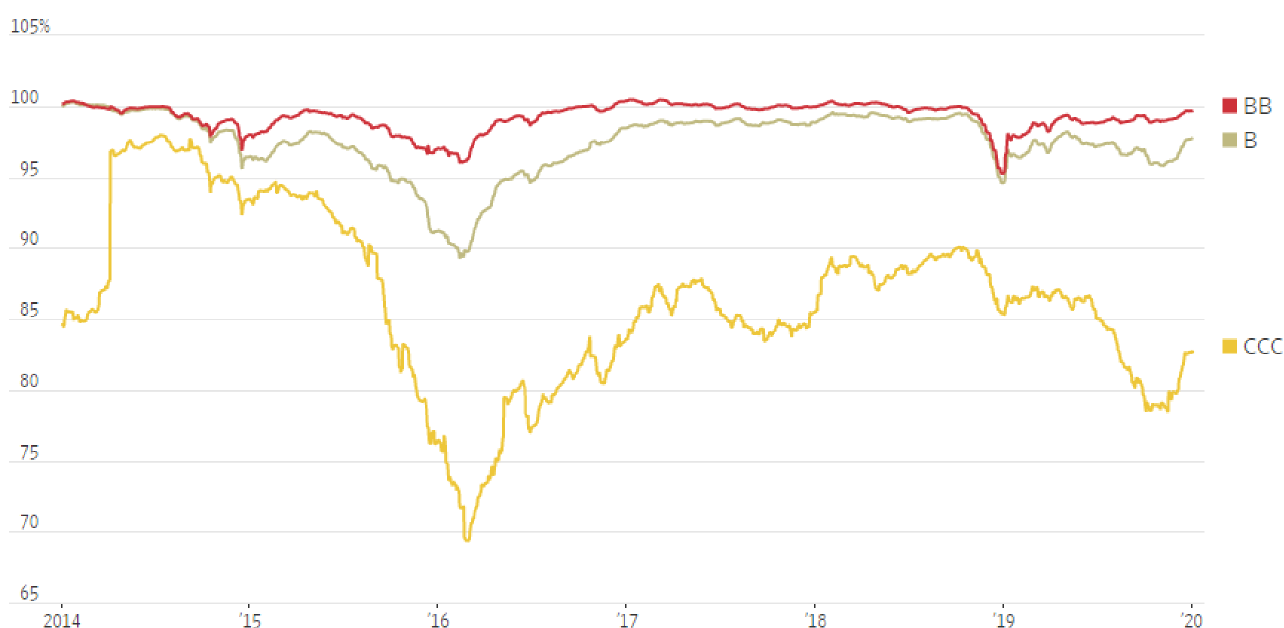


Gold prices are up 20% for the decade but remain 25% below their peak (August 2011). They too, responded positively to an increased perception of geo-political risk in recent weeks.

Spotlight on Problem Credits:

The 10-year long bull market in stocks and bonds has not seen full participation though and the lowest rated loans seem to be seeing some fall off in both valuations and demand. In December 2.5% of leveraged loans were trading at less than 70% of face value, which is the most since September. There was some pointing at lighter and looser covenants and a persistent understating of leverage ratios relative to earnings. There were also claims that borrowers were inflating earnings by including add backs of as high as 25% of EBITDA. Evidence suggests that the pace of deleveraging is rarely as swift as projected, and that the lack of covenant protection is accelerating a divestment of such stocks without much of a robust market to pick it up. Picking apart the add-backs may be done only erratically and the presence of transfer restrictions further constrains the potential demand for these loans. This all adds a layer of opacity which may obscure the true state of problem credits. If not a cause for concern, it is definitely a cause for heightened scrutiny.

As the chart below shows CCC rated loans persist in trading lower than more highly rated loans and more recently the pricing has been trending lower.



Outlook

So where do we go from here?

As we start the new year and a new decade we have carried over the recession-watching and forecasts of when the current bull cycle is likely to end. In the aftermath of the UK election all eyes will be on the Brexit process as steered by a new Conservative majority, while in global politics heightened tensions in the Middle East may cloud other developments such as on the trade front. In the US, the impeachment process will continue to compete for attention with the US/Iran tensions, and now that the Democratic field is narrowing the shape of the presidential election in 2020 will start to come into focus.

Looking ahead to the year to come, we have the following outlook:

- **The UK, its institutions, employers and investors are STILL in a waiting game.** With the election over, and a Parliamentary majority secured, the UK seems to be out of internal deadlock and into another waiting game – how the shape of a deal will be received by industry, markets and counterparts. In the absence of more actionable certainty we do not expect Sterling or UK markets to rally, and, indeed, in the first few weeks of the year Sterling broke through the $1.30 level on chatter of a further rate cut from the Bank of England.

- **Where next for the US as a distraction from impeachment process**? Last quarter we suggested that the distraction from the impeachment process by the US president would be the announcement of a trade deal or good news in order to boost markets at a strategically valuable time. It now seems that there has been a pivot to creating a national security crisis and increased defence spending as a means to shore up the incumbent, perhaps to distract from impeachment or other bad press. As noted above it remains an exceedingly noisy time. The pace of newsflow is at times overwhelming and salient economic data often gets lost in the volume of other news.

- **Beware the cracks in credit**. After a buoyant decade and the steady rolling back of credit protections it is inevitable that cracks are going to deepen and expose market frailties. It was interesting to note the reduced market for distressed debt given tightened guidelines for typical buyers such as CLOs. The absence of a working market may portend more volatility and more divergence between winners and losers. Just as the dominance of tech stocks have left other stocks in their wake, we expect more divergence within credit, leading to more fertile environment for active management perhaps, not just in credit but across the asset spectrum.

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January 15, 2020