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FINANCIAL SERVICES

2020 Global Market Outlook

We approach 2020 with caution.

Although the economic outlook for 2020 is slightly more optimistic than 2019, volatility is likely to persist.

2020 Summary: What to watch

Geopolitical Risks

Approach: Cautious

Trade wars, Brexit, Impeachment proceedings and the upcoming U.S. presidential election are some geopolitical risks that have the potential to impact the economy and the markets.

Economic Growth

Approach: Mixed

Economic growth has slowed down globally and is expected to remain subdued for the foreseeable future. The weakness in the manufacturing is countered by strong consumption. The U.S. consumer, in tight labor markets, is optimistic and keeps spending. Recently, the initial trade agreement between the U.S. and China has provided a stimulus to investor optimism.

Abating Recession Fears

Approach: Hopeful

The accommodative stance of Central Banks globally has contributed to abating recession fears and U.S. equity markets making new highs almost daily.

2020 Investment Approach

With equity market making all-time highs, credits spreads and interest rates near the low end, most asset classes seem expensive. Producing comparable results as in 2019 may prove difficult. In this late stage of the business cycle, the risk of a downturn is still real.

An adequate liquidity buffer that allows you to navigate through turbulent markets, reduces the necessity of selling investments in a downturn.

In Equities, we focus on high-quality assets with strong fundamentals, complemented with international and emerging markets equity exposure as well as increased allocations to traditionally defensive sectors with growth opportunities.

In Fixed Income, we favor high quality credit and exposure to international sovereign bonds.

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A Volatile 2019

As 2019 comes to a close we take a moment to pause, as there is much to be thankful for. It is also a time to digest where we have been and consider where we may be headed. Our 2020 Outlook leans on the past year as we aim to gain perspective on 2019 to help navigate the upcoming year. This outlook is not absolute, its objective is to evolve as the year progresses, to navigate risks and opportunities and adapt as uncertainties become realities.

2019 was a volatile year, oscillating between geopolitical risks, Trade War uncertainty/hopes on the one hand, and accommodative global monetary policy on the other hand. This market uncertainty is likely to continue in 2020. Although the current outlook for 2020 is slightly more optimistic than 2019, volatility is likely to persist and we approach 2020 with caution. With high stock and bond market valuations, the old age Bull and the uncertainty about the late business cycle, addressing the risk of a severe market decline or recession is still necessary. Hence the importance of continuing our analysis of potential drawdowns, in addition to the fundamental risk/reward trade-off. Over the next decade, we feel that equities will likely offer better expected returns than bonds, but in the event of a recession, equities will bear the brunt of the market volatility.

We continue to focused on high-quality assets with strong fundamentals, complemented with international and emerging markets equity exposure as well as increased allocations to traditionally defensive sectors with growth opportunities. In Fixed Income, we favor high quality credit and some international exposure.

In today's low rate environment and muted capital market assumptions, reaching retirement income goals is challenging. Diversification will be important in increasing the number, geographic and type of return sources. Investors with an income target in diversified portfolios may have to increase their exposure to riskier assets. Investors targeting a given level of risk, may need to accept lower returns as a price of the safety.

Stay invested, filter out the political noise and focus on the long-term strategic allocation. Identifying short-term liquidity needs and planning for those in safer Money Market funds or short-term bonds, will reduce the anxiety about short-term market downturns. That is why we recommend maintaining 18 months of a liquidity buffer in order to navigate market turbulence and reduce the necessity of selling investments at a loss to fund living expenses.

I. Economic Outlook

Markets will continue to pay attention to geopolitical risks in 2020. These include:

- U.S./China trade tensions may flare up again
- Brexit and Italy
- Impeachment Proceedings
- 2020 US Presidential Election
- Hong Kong /China conflict
- Middle East tension, including the September drone attack on Saudi oil facilities.

The U.S./China trade talks saga, as well as the economic pessimism and policy uncertainty, lead to declines in global trade and manufacturing. This economic uncertainty is likely to continue to dent capital expenditures and may spill over into the labor market with reduced hiring plans. Job openings have fallen in the last 18 months. If this trend spreads across more and more companies, we could see a self-fulfilling prophecy with consequently negative payroll reports feeding into a risk-off investor mindset.

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Many central banks opted for a more dovish stance, lowering rates and relaxing financial conditions. As these financial conditions have become more supportive of growth, global recession risks have abated. If trade pressures recede after the preliminary U.S./China trade agreement, global activity and capital expenditures may pick up and provide a stimulus to the global economy. Subsequent increases in industrial production may pave the way for cyclical assets to outperform. The implementation of conventional (low rates) and unconventional (QE and Repo market intervention) has the potential of lifting asset levels above their fundamental values, increasing the risk of a bursting asset bubble.

In the U.S., the FOMC "*judges that the current stance of monetary policy is appropriate to support sustained expansion of economic activity*"[1] and may translate in an unchanged Federal Reserve rate for 2020 as the lagged effect of the 2019 policy easing filters through the economy.

However, with rates already low, the effectiveness of the monetary policy tools to fight the next recession is being questioned and may prolong a potential downturn. The FOMC is internally investigating and evaluating its monetary tools and is expected to deliver a report in the middle of 2020 on possible changes or new tools as well as its goals.

Inflation is set to remain low, below the 2% target. However, there are some risks to upside inflation surprises with input cost rising as a result of the ongoing trade wars, deglobalization or strong demand in basic resources. Increased labor market tightness could also bring above trend wage growth and spur inflation.

As the U.S. Presidential Election approaches, it will most likely induce some extra volatility for stock markets and may affect certain sectors such as technology, energy, financial and healthcare as these may come under heightened regulatory scrutiny.

The impact of the U.S./China trade wars has also impacted international economies, especially the export-oriented economies, like Europe and Asia. The weakness in the manufacturing sector in Europe, the seemingly ineffectiveness of the central bank policy and the lack of unified fiscal policy, coupled with social unrest and demographic trends, dampened the GDP in Europe in 2019. The new ECB president, Christine Lagarde, will have to continue the expansionary QE and negative policy rates but may need the assistance of the European leaders in the form of fiscal stimulus to raise the GDP outlook and spur inflation.

II. Capital Markets Outlook

With Equity markets near all-time highs, credit spreads narrower and interest rates near the low end, most asset classes seem expensive and it will be harder to produce comparable returns as in 2019 without significant improvement in the global economy.

Thoughtful Portfolio Management for a New Decade: A strictly static approach becomes more challenging to maintain when expected returns are compressed and expected volatility is elevated. With global growth stabilizing and underlying and emerging trends becoming attractive alternatives we see opportunities emerging for diversification. A more dynamic approach to asset allocation can help investors take advantage of shifting global equity market leadership trends.

High quality dividend yield and dividend growth will likely be vital in a portfolio, as well as a diversified Fixed Income allocation. The inclusion of income-producing alternatives in the asset allocation will bring stabilization through low correlation with equity and fixed income as well as yield.

[1] Federal Reserve FOMC Statement, December 11, 2019

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II.I. Equity

A primary concern is the health of the underlying trends in the market and economy. While the S&P 500 has made new highs, the pace of the ascent has slowed, drawdowns have been more significant and volatility has risen. We are of the opinion that although the upward trajectory for stocks (at home and abroad) is likely to continue in 2020, it will not be in a volatility free environment. The emerging consensus is that the S&P 500 will see mid-size gains in 2020. We are preparing for the likelihood that deviation from that consensus will be to the downside vs. the upside.

Equity market returns may be restrained by earnings growth deterioration and high valuations. The lack of private investment growth, capital investments, owing to the trade uncertainty and rising labor and input costs will continue to put downward pressure on already slackening corporate earnings growth.

As profit margins come under pressure, firms may push the increased input costs onto the consumer, which may lead to higher inflation and eventually a hawkish Fed. Equity markets outside the US are valued more cheaply than the US and may reverse their underperformance of the past and outperform but are capped by the same barriers. Emerging markets may be a beneficiary of the global recovery and a temporary trade truce.

Crucial in this international outlook, is the valuation of the U.S. Dollar and the trade uncertainty. Part of the underperformance of international equities can be attributed to the U.S. dollar strength. A stable or weakening dollar, combined with global stable growth in a trade truce, could open the door for international equities to outperform.

II.II. Fixed Income

Interest rates are still (and again) historically low and are not expected to move significantly in 2020, given the FOMC stance and the base scenario inflation outlook. And they may stay low for longer. During this period of low rates in the last decade, companies have used debt issuance as the main source of financing (and even to fund share buyback programs) and thus increasing corporate leverage. Corporate credit spreads have tightened, reducing the expected total return of investment grade and junk bonds. Given the limited expected returns, coupled with increased default risk, we favor high credit quality bonds.

In a classic balanced portfolio, the allocation to safe haven assets (government bonds) could historically give the portfolio some resilience as they offer protection in a market downturn. The trade-off, was that the investor would have to forego some of the higher expected returns form a risky asset like equities in return for some lower “risk-free” return from bonds. With yields low or negative, the opportunity cost of bonds has risen as rates have come down. The expected return of bonds is so low that an income seeking investor has to look for other (and potentially riskier) sources of income.

We still believe that interest rate exposure will balance out portfolio returns and therefor investments in developed government bonds and high-quality corporate bonds will remain primordial in our investment strategy.

II.III. Alternative

As economic growth slows, and if inflation surprisingly jumps up (wage inflation combined with rising input cost being charged to the consumer), negative or low correlation between stocks and bonds may come under pressure. This could reduce the diversification characteristics of bonds in a portfolio. Hence the need for a new stabilizer in the form of alternatives may become necessary.

III. Responsible Investing and ESG

Recently, investors and asset managers are incorporating environmental, social and governance factors (ESG) into their portfolio’s due to the heightened awareness of responsible investing. We integrated ESG factors into our evaluative process. We feel that focusing on investment

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themes such as water scarcity, climate resiliency, alternative fuels and environmental awareness have the potential of adding alpha or mitigating risks (e.g. avoiding litigation). Given the change in demographics and the consumption pattern shift towards more sustainable products, companies providing responsible products and services could be met by increased demand and profitability.

Environmental technologies such as electric vehicles and renewable energy will be boosted by consumer preference and regulatory action. In Fixed Income, green bonds may prove a diversifier, with less exposure to cyclical sectors and a higher average credit quality than the broader investment grade market.

IV. Asset Class Views

Equity: Favor Defensive Late Cycle (health care/utility/staples) as well as quality/value dividend and dividend growth.

Health Care: US Healthcare could be disrupted or come under pressure in the election year but remain a long-term holding

Real Estate: focus on health care locations (aging population), data centers (5G and cloud), multi-family residential housing.

Technology: Technological disruption will continue to be a driver of growth and innovation especially in AI, robotics and cloud computing, digital media, cybersecurity.US elections (break up of big tech, privacy) and intellectual property rights in light of the trade wars and national security as well as the cyclical nature may cause some near-term volatility.

Trends in ESG:

Water scarcity: investing in companies that create products designed to conserve and purify water for homes, business and industries.

Renewable Energy: investing in companies globally that are providing goods and services in the wind and solar energy sector

International/Global Equity:

Developed Markets:

Europe: low valuations but risks due to ineffective ECB policy, Brexit and trade uncertainty. Fiscal stimulus may lift the outlook

Emerging Markets:

Stable to softer dollar, low valuations and good dividend yield make it an attractive segment.

EM central banks are expected to remain supportive of growth and equity markets, easing financial conditions.

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Fixed Income:

Taxable Bonds:

Favoring high credit quality and liquidity combined with longer duration.

Continued exposure to international Sovereign bonds

Municipal Bonds:

Favoring long duration/higher credit quality in a technically supported market with strong demand and low supply, as well as sound credit quality overall.

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