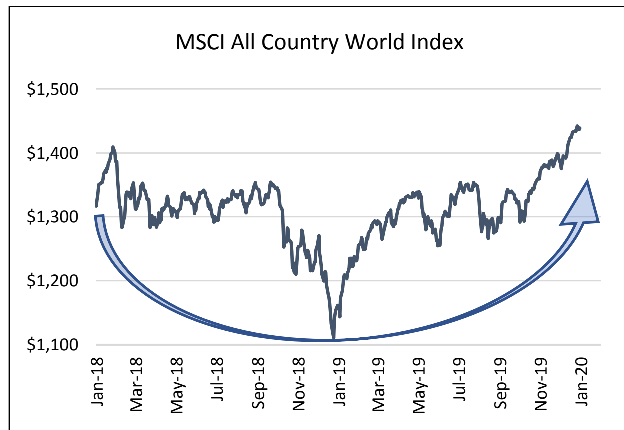
2019 Year in Review

With a sharp adjustment in global risk assets well underway at the end of 2018, we believed that the markets were finally recognizing the risks of rising deficits, high corporate leverage, and the folly of populist nationalism. Almost all major developed and emerging markets finished the year down sharply.

Shift gears and proceed full speed in reverse, and you have the story of equity markets in 2019. The Fed pivot from tightening to easing, combined with central bank measures that drove $17 Trillion in negative yielding debt (mostly in Europe), benefitted risk assets.



Source: MSCI

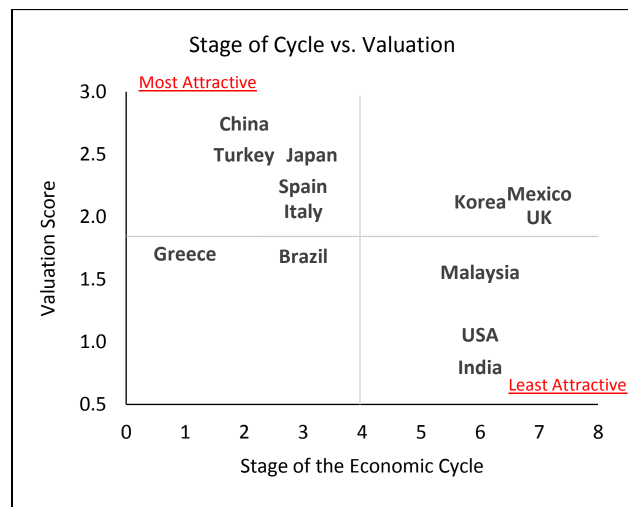
After falling 21% from its 2018 peak, the MSCI-All Country World IMI Index rose 26.4% in 2019, led by a 29.1% return in the U.S equity market. Fixed income markets posted strong gains as well, as interest rates and credit spreads fell. Global bonds rose 6.8%, led by U.S. high yield and emerging market debt, which returned 14.3% and 13.1% respectively. Commodity returns were mixed as oil rose 31% and gold gained nearly 18%, but industrial metals and agriculture products were weaker due to tariffs and softer global demand.

2020 Market Outlook

Given muted global growth prospects, elevated valuations, pressure for additional liquidity, and lower rates from central banks, what risks and opportunities are we facing, and how synchronized are they with the economic outlook?

Equities: There is an interesting degree of synchronization between valuation and stage of the economic cycle across global equity markets as seen in the next chart, which maps our proprietary valuation metric against cycle stage.

Countries that are in the early stages of their economic cycles and are also valued attractively include China, Japan, Turkey, Greece, Italy, and Spain. Economies exhibiting late-cycle behavior and therefore are less attractive to us from a risk perspective include the U.S., Eurozone, as well as select Asian economies including Korea. Very late-stage economies such as the U.K., and the European financial sector are interesting to us on a USD basis because we believe that impending recession and Brexit uncertainty have already been priced into valuations with the possibility of significant upside ahead. Within emerging markets, Mexico, Malaysia, and even India are gaining our attention as well for the same reasons.



Source: ACIMA Private Wealth Research

Fixed Income: We remain overweight bonds in general. Though our forecasts for lower interest rates came to fruition (and then some) during 2019, we believe that given the evolution of global economic cycles and the continued monetary easing around the world, bonds should be bought on any reasonable technical correction.

In the U.S. we continue to believe that fair value for the 10-year Treasury is in the low-to-mid 2.0% level, but believe economic weakness and further interest rate cuts from the Fed will make fair value an unsustainable target for the foreseeable future. While we did shorten the duration of our portfolios in 2019, we look to add duration on any technical correction. Given the macro backdrop, we prefer the investment grade sector over high yield in the US, and we

anticipate rising default risks to spur spread widening in the coming twelve to eighteen months.

Our forecast for a weaker dollar makes international fixed income another area of focus for us. Within this, emerging markets are attractive from a total return and risk/reward perspective, and Latin America remains a favorite region. Within developed market fixed income, our favorite regions include early-cycle economies such as Australia and Japan, and select opportunities within late-stage economies, such as the European financial sector.

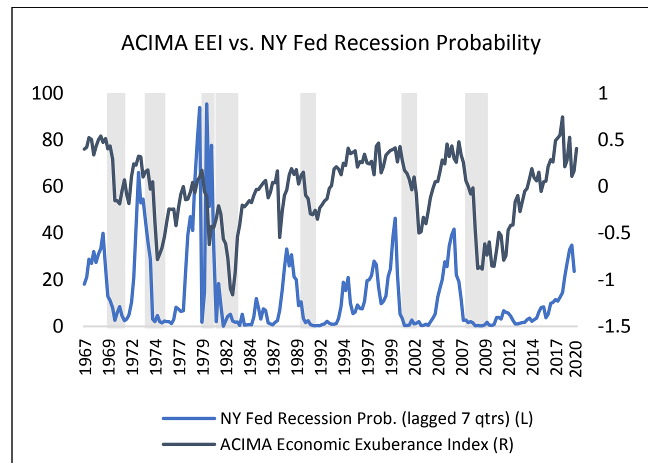
Commodities: While our expectations of a weaker USD did not materialize in 2019, we remain constructive on commodities as global uncertainty persists, central bank easing continues, and expect the USD to depreciate thereby creating global purchasing power parity for commodities.

Key Investment Themes

Unsynchronized World Economy: Our forecast for real global growth is 2.4%, a modest gain after last year's significant weakness. Developed markets have struggled with low inflation, falling growth rates, and soft outlooks which have been key drivers to central banks lowering rates. The global stabilization of growth will be attributed to gains in emerging markets but not broad based. We continue to underweight and reduce risk in late-cycle economies such as the U.S. and Korea, and remain overweight within early and mid-cycle economies such as Spain, Italy, China, Russia, Turkey, and Greece.

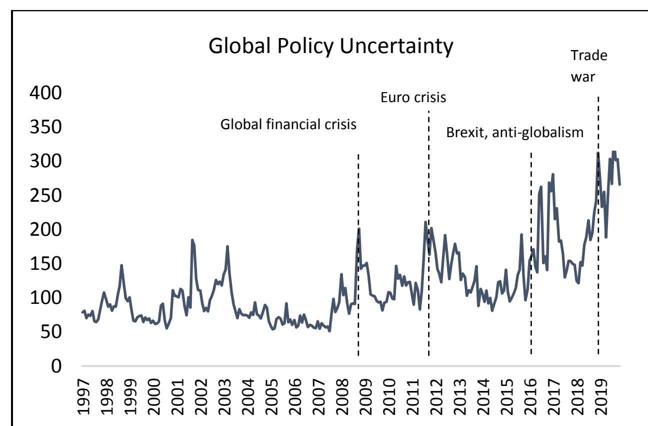
Source: World Bank

Rising Risk in the U.S.: Growth has decelerated, reflecting slowing investment and the drag on growth since the tax cuts. Notwithstanding the recent Phase 1 trade deal with China, higher tariffs have increased trade costs, and policy uncertainty will continue to weigh on confidence. Our forecast for real U.S. growth in 2020 is 1.5%. Despite a steepening yield curve, recession risks remain. We expect continued slowing in payroll growth, which will eventually affect consumer confidence. Manufacturing may already be in recession. Strong 2019 returns driven by Fed easing, P/E multiple expansion, and stock buybacks have reduced our expectations of future returns, which must be driven by earnings growth to be sustainable.



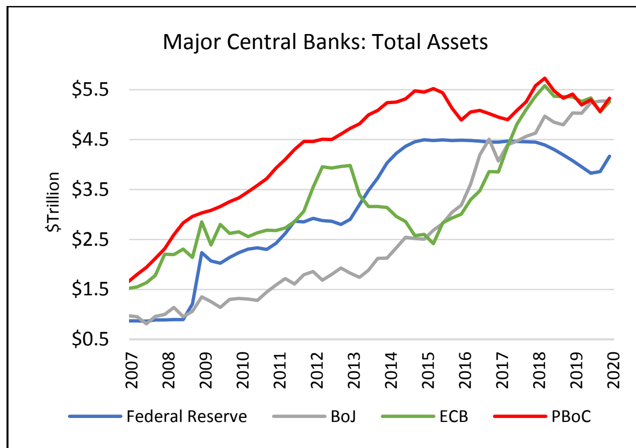
Source: NY Fed, ACIMA Private Wealth Research

Unprecedented Uncertainty: 2020 will have more than its share of uncertainty due to tariffs, trade wars, prolonged Brexit negotiations, geopolitics, elections, and more. An increasingly unpredictable policy environment will undermine economic activity globally through postponed investments and declines in productivity.



Source: Macroeconomic Review

Accommodative central banks: In the face of the deteriorating growth outlook and low inflation expectations we believe that the Fed will continue to reduce interest rates through 2021 and that the Fed's balance sheet will continue to increase. While zero interest rate policy (ZIRP) is embraced by the BoJ and ECB, we expect further monetary easing in many developed economies. These policies are bullish for emerging markets. Risk assets benefit in the short run; going forward, true economic and earnings growth drive returns.



Source: Bloomberg

Bubbling Corporate Debt: In addition to trillion-dollar annual fiscal deficits in the US, corporate debt is rising and credit quality is declining. The use of corporate debt to finance stock buybacks benefits earnings and stock prices in the short run, but the increasing use of leveraged loans and "covenant-lite" debt increases default risk, posing a systemic risk to the economy. We remain overweight investment grade bonds and underweight high yield.

Source: Federal Reserve

IN SUMMARY

- *A global economic narrative centered around early/mid cycle accelerations in Asia and late cycle slowdowns/recessions in the North Atlantic will pressure global growth.*
- *Historically high valuations, rising recession risks, and depreciation of the dollar should lead to the underperformance of U.S. risk assets vs. global risk assets.*
- *Trade wars, tariffs, Brexit, geopolitics, and 2020 elections could lead to elevated volatility.*
- *Tame inflation leads to ever-accommodative monetary policy by global central banks, increasing the risk of asset bubbles.*
- *Rising government and corporate debt, declining credit quality and financially engineered earnings growth could pose potentially systemic risks.*

In our view the 2020 story will be about uneven global recoveries colliding with uneven valuations. The opportunity is to be more aggressive in attractively valued markets with early-cycle upside and more defensive in pricey markets with less room to run.

As always, we endeavor to protect our clients' assets from the risks that we see while remaining flexible in order to capitalize on opportunities as they arise.

The ACIMA Private Wealth Team
January 2020

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