Market Strategy and Macroeconomics
Group Investment Management
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Economic and market outlook 2020:

Fasten seatbelts

Source: iStock by Getty Images

Overview

As central banks try to avoid economic stall speed and fight the crosswinds of trade uncertainty, manufacturing contraction and political turmoil, it's time to fasten seatbelts and prepare for what could be a bumpy landing for the global economy and financial markets.

As we predicted last year, 2019 proved to be a year of fading growth rather than the end of the cycle, helped by a profound shift in monetary policy. However, time is running out and 2020 is likely to see economic activity flirt with recession. Most of the world's central banks cut rates aggressively this year as the US Fed had an epiphany, dramatically reversing course from tightening to easing. While this tectonic shift in global policy will certainly help prospects for the coming year and has resulted in a liquidity bonanza for financial assets, we suspect it is not sufficient in itself to alter the declining flight path for growth.

While much has been made of the need for fiscal policy to supplement monetary stimulus, not least by the ECB, the reality is that high debt levels will remain a difficult hurdle for governments to overcome, while surplus countries such as Germany remain reluctant to change course. This is unfortunate as interest rates are bizarrely low and some governments are being paid to borrow for as long as 30 years. With a fundamental need for investment in infrastructure, education, technology and decarbonisation, fiscal action should be forthcoming and focused on investment. In the decades to come this unique period will be seen as a tragic missed opportunity, as fundamental shifts in policy seem unlikely currently, despite some hopeful signs emerging in Japan. Consequently, monetary policy and the US-China trade relationship will again be the defining features of the year ahead.

In the Global section, starting on page 4, we delve into the forces at work, with trade still under severe pressure, and highlight the limitations of monetary policy. This comes against a backdrop of very benign inflation, with central banks continuing to miss targets by a wide margin.

Critical to our somewhat sombre outlook is the US economy, which we expect to have a mild technical recession following the longest recorded period of expansion. We explore the drivers in depth on pages 6 and 7. While growth has been robust, business and consumer sentiment are in decline and even the labour market is showing some warning signs, with a slide in hours worked and a peaking of wages. Business investment is also subdued given the uncertain global outlook, with rising corporate debt being used more for stock repurchases and higher dividends than for increasing productive capacity through capital spending. To be clear, we do not expect a 2007 style contraction, but it will be disruptive nonetheless and will require an agile Fed to keep it short and shallow.

The outlook for the UK is opaque as a result of continued Brexit uncertainty. We assess prospects on page 8, noting that the transition period will need to be extended beyond the end of 2020 as it is unlikely that the future trading relationship with the EU will be defined by then. This is one country, however, where fiscal spending is expected to be meaningful, though not sufficient to redefine lacklustre growth prospects. The rest of Europe is discussed from page 10, with Germany remaining under pressure from its industrial and export exposures, although stabilisation is expected in manufacturing. More broadly, Eurozone activity is likely to remain subdued, with Italy again disappointing and political risks never far away. Switzerland should hold up fairly well, supported by a diversified and resilient economy, but its highly cyclical exports will not be immune from the weaker global conditions or further currency strength.

The critical nature of China is assessed from page 18, where slower growth is again expected, ticking fractionally below the 6% level for the year. Importantly, the authorities will be balancing stimulus carefully to prevent any labour market disruptions and we do not expect a hard landing. Consumption is expected to be rather pedestrian, but a targeted policy response will keep it expanding, while there may be some improvement on the infrastructure side towards the end of next year as investment rises.

Prospects for Japan are underwhelming, despite the boost from the Olympics. The BoJ is expected to be on hold though, encouragingly, significant fiscal spending has been pledged. The ASEAN region will be part of the global slowdown, but idiosyncratic factors will be visible, with a bottoming in the semiconductor cycle helping those countries with IT exposures, while an ongoing shift of production away from China will bolster prospects in the region longer term. Australia will not be immune from the growth trends either, though a significant fiscal surplus and aggressive action from the central bank will provide some off-set.

Financial assets are expected to have a more challenging year, discussed in detail in the global and regional sections. The liquidity driven surge in 2019 has momentum, but as the move came through multiple expansion in the absence of earnings growth, stock valuations are becoming elevated. History suggests that even a shallow recession can cause equity drawdowns in excess of 20%, while the high leverage, fall in index quality and tight credit spreads imply that credit markets may well be the first to crack. Despite regional variations, should our economic outlook prove to be prescient, risk assets generally will be in for a turbulent ride, while bond yields could retest this year's lows before stabilising on recovery hopes. 2020 is likely to contrast sharply with the outsized gains of 2019, but periods of opportunity are still expected for the nimble investor.

Given the crosswinds that economies and financial markets face as policy and politics impact a mature and faltering cycle, it seems appropriate to fasten seatbelts.

Guy Miller
Chief Market Strategist
& Head of Macroeconomics

Contents

Global

Outlook

- Global growth is expected to fall further, led by the US and with few off-sets coming from the rest of the world
- Central bank actions will soften the slowdown, but global trade uncertainty remains a headwind
- Inflation is unlikely to become a problem amid benign wage growth and a weak economic outlook

Implications

- Core bond yields are set to remain capped, and a snap lower should be expected if growth falters
- Credit is likely to be resilient at the start of 2020, but a bear market is likely to unfold later in the year
- Equity momentum is currently strong, although a correction should be expected as US growth stumbles

Risks

- A rebound in growth fuels complacency and a renewed shift towards hawkish central bank policy
- A further escalation in the US-China trade dispute leads to a deeper, and more disruptive, global recession
- High corporate leverage and vulnerable European banks trigger a negative feedback loop in credit

Global growth slumps, led by past policy tightening and trade disruptions

Global growth has fallen sharply over the past year, down from 3.1% in 2018 to around 2.5% in 2019, which is well below its long-run average but not yet in recessionary territory. Despite recent policy loosening and tentative stabilisation in manufacturing activity, we fear that growth will fall further over the course of the coming year. This partly reflects our long-held view that the US is likely to see a recession in 2020, mainly as a result of a tight labour market and extended leverage in parts of the economy. Global headwinds to growth are also set to remain in place. The US-China trade conflict disrupted business confidence and spending, leading to a slump in investment and a contraction in global trade. While a near-term truce between China and the US is a possibility, longer-term questions around the emergence of China as a global superpower and the attempts by the US to contain it are unlikely to be resolved. This will have a longer lasting impact on the global economy.

Central bank stimulus is insufficient to sustainably improve the outlook

As a result of the sharp slowdown in growth, a synchronised rate cutting cycle has been kicked off, with almost all major central banks participating – including the Fed, the ECB and the PBoC. The extent of this policy shift has been significant. Just one year ago the Fed hiked rates – for the fifth time in a year – and signalled two additional hikes in 2019, which would have taken the Fed rate to 2.9%. Instead three cuts were delivered, leaving the Fed rate at 1.6%. This opened the door for emerging markets (EMs) to loosen policy. With inflation low and a negative output gap in many EM regions, there is room to expand. However, though the effects of this stimulus are yet to be seen, we suspect that major headwinds to demand and activity – including slowing growth and limited stimulus in China alongside trade disruptions and political and geopolitical uncertainty – will prevent a sharper rebound in EMs.

The mature economic cycle still justifies a base case with a US recession

While there is room to grow in EMs, capacity is constrained in developed markets (DMs). This is the main reason why we expect the US to enter a recession in 2020, despite the policy U-turn. The Fed's reaction function will be critical, however, in determining the timing and the depth of the slowdown. Elsewhere in DMs, conditions are not looking much better. Growth has been particularly weak in the Eurozone, as a result of external headwinds and a lack of domestic growth drivers. The ECB has loosened policy, but this is unlikely to make a meaningful difference to the growth outlook, as a lack of liquidity is not the issue facing the economy. Indeed, given interlinkages in the global economy, a US recession should be expected to have global implications, with limited potential for other regions to provide an offset.

Global growth is set to fall further, but at a more modest pace of decline

Summing it all up, we forecast a further decline in global growth in 2020, to around 2.2%. As a result of yet weaker growth, more policy loosening will be forthcoming, with rate cuts in many regions and potentially also a broadening out of unconventional policy measures, including central bank QE. This should limit the depth of decline. There is also the possibility of a shift towards more fiscal policy in some regions. For now, however, we only expect a patchy response to slowing growth. To improve the growth outlook more sustainably, a coordinated and pre-emptive response focused on investment would be required. This remains highly unlikely.

Weak inflation will remain a focus point for central banks

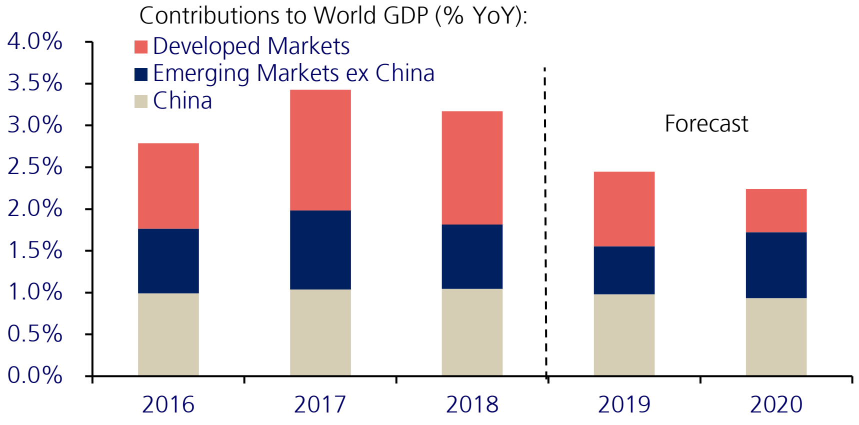
The outlook for inflation is set to remain weak over the coming year. Producer prices are in deflationary territory in many regions as a result of the industrial slowdown. This will work its way through the global supply chain, weighing on inflation more broadly. Although a further decline in growth is anticipated, it is still expected to be fairly shallow, which should provide some support for wages, with a broadly stable outlook for underlying inflation. Risks to inflation will be tilted to the downside in a slowing growth environment, however.

Bond yields set to revisit their recent lows if growth continues to falter

2019 saw global government bond yields slump as a result of recession fears, trade disputes and a repricing of central bank actions. Yields have retraced some of the move on hopes of a US-China trade deal and reduced recession fears. While improving sentiment and macro data could easily lead to a snap higher in yields, government bond yields are likely to be capped, reflecting a combination of extended debt levels and structurally weak growth and inflation. If the view of a US recession materialises, we would also expect Treasury and global yields to fall back over the course of the year. Given this, prospects for higher yields in Europe are also limited, particularly as policy rates will remain deeply negative for a long time to come.

In the European periphery, we expect spreads to remain relatively tight until we see more direct evidence of a further growth slowdown and a return of recessionary fears. At that point peripheral bond markets would be vulnerable to spread widening, especially if macro concerns are combined with political uncertainties. Italy looks particularly vulnerable in this respect, with weak

Global growth not yet bottoming



Source: ZIG, Bloomberg

underlying macro fundamentals, even before we enter the end of the economic cycle.

In credit markets, investor focus is likely to return to fundamentals

Driven by the dramatic shift in the global monetary policy stance led by the Fed, credit has had a strong performance in 2019, although performance was front loaded. In the beginning of 2020, we expect credit returns to be lacklustre but positive, with credit underperforming equities. Sometime around the middle of 2020, credit is likely to enter an outright bear market, as weak fundamentals begin to bite. 2020 is also likely to see a shift in investor focus from a liquidity driven search for yield to protection of capital amid poor fundamentals and tight spreads, which is already underway in weaker parts of credit.

Corporate leverage is highly extended, encouraged by cheap financing costs, and company managements are unlikely to change strategy from boosting shareholder returns at the cost of creditors. 2019 has seen debt growth pick up dramatically, which will erode balance sheets further as the cash finds its way into the pockets of shareholders through M&A, buybacks or dividends rather than being invested into increasing productive capacity.

The proportion of earnings used for servicing interest has been rising despite low interest rates, leaving companies vulnerable to a change in creditor sentiment. A higher cost of credit can cripple companies within investment grade credit, as is already happening in low quality segments of the high yield market. High yield and leveraged loans issued by the weakest companies are experiencing stress. The gap in spreads between CCCs and Investment Grade credit continues to rise. Default rates should pick up in 2020, as suggested by the tightening of lending standards seen in the Fed's lending surveys. Stress in credit is likely to be further exacerbated by weak earnings, especially if our expectation of a US and Eurozone recession were to materialise.

The above factors remain strategically supportive of a more favourable stance towards equities compared to credit during H1 2020, a strategy that is also supported by other factors such as typical late cycle underperformance of credit, relatively cheaper valuations of equities, and the over-owned nature of credit currently driven by a search for yield.

Within credit, we expect dispersion to take a toll on high yield and we also think BBBs within investment grade will be at risk as a perceived downgrade from Investment Grade will become expensive. Vigilance is warranted around European banks, with the market share of bail-in-able bonds likely to increase going forward. Cyclical sectors such as autos and industrials remain vulnerable, although non-corporate credit such as ABS, covered bonds and municipals are likely to remain resilient.

Downside ahead for stocks, as the bull market runs on borrowed time

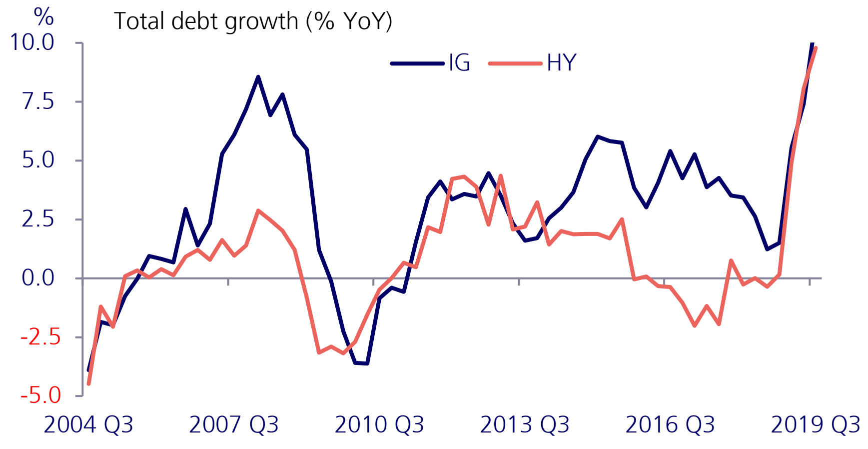
Equity markets proved to be stronger than expected in 2019, with most posting gains in excess of 20% YTD. The profound shift in global monetary policy overwhelmed poor earnings and the multitude of political and geopolitical issues that might otherwise have proven problematic. Indeed, the gains made in developed markets came almost entirely from multiple expansion as growth slowed and earnings languished. Interestingly, the rally came despite continued outflows from stocks into bonds, though corporate buying – M&A and stock repurchases – helped buoy markets.

As we look to 2020, momentum could persist for a little longer, particularly if economic data stabilise and the very recent flows back towards stocks gain impetus. However, we suspect 2020 will see the equity rally disrupted. A lot will depend upon whether our view of the US economy faltering proves correct and what the reaction function of the Fed will be. If history is any guide then caution is needed, as a slump in stocks of 20% or more is common, even in our mild recessionary scenario. Consequently, we envisage a year that will offer a period of potential gains for nimble investors, but signs of further economic deterioration should be treated as a signal that the mature cycle – the longest in US history – is ending and it is time to de-risk. Should our view prove to be wrong, and the economic cycle extends, the bull market is likely to have further to run, but will face new challenges, notably a switch back to fundamentals as a driver rather than liquidity, bringing with it higher volatility and greater dispersion between markets and sectors.

Idiosyncrasies may offer opportunities, but drawdowns will not be avoided

Given the downside we see for stocks, the US market is again expected to be a relative stalwart, though UK equities have potential once Brexit is clarified and the currency displays stability. Valuations are attractive and evidence of pent-up demand offers some support, but this will not be enough to provide immunity from a global sell-off. Eurozone and Japanese stocks offer some upside near term and the possibility of a weaker USD would lend support to the rather beleaguered Emerging Market universe, but these regions are unlikely to outperform over the course of the year if our de-risking forecast plays out. Consequently, despite the downside emanating from the US economy, US equites are again expected to offer relative performance in the context of lower global equity prices in 2020.

Corporates are on a debt binge



Source: ZIG, Bloomberg Note: Average of US and European median non-financial corporate debt growth, excluding commodity sectors.

US

Outlook

- Growth is expected to slow further as the economy reaches its capacity limits
- The economy is expected to dip into a mild recession in 2020
- Inflation remains subdued, giving the Fed room to further ease its policy

Implications

- Bond yields may rise in the short term, but the upside potential seems limited given our cautious outlook
- Credit to be resilient in early 2020, but a bear market is likely later in the year
- Equity markets look stretched and are vulnerable to further weakening in fundamentals

Risks

- The expected slowdown could lead to a negative feedback loop from corporate leverage, exacerbating the downturn
- As an upside risk to our view, the Fed could act more aggressively to boost growth and inflation expectations
- The strategic rivalry between the US and China intensifies with negative effects spilling over to the global economy

The economy is running out of steam as business sentiment falls

The US economy is currently enjoying its longest expansion on record and while the duration of an economic expansion is not necessarily a reason for it to stop, the current cycle is increasingly showing signs of reaching its end. Having peaked in the second quarter of 2018, GDP growth steadily slowed down to an annual rate of 2.1% in the third quarter of 2019, the lowest rate since the beginning of 2017. While the ongoing trade war with China is taking its toll on the US economy other forces are weighing on the outlook as well.

Business sentiment has significantly deteriorated over the course of the last twelve months. Peaking at 60.8 in August and September 2018, respectively, the ISM Manufacturing and Non-Manufacturing indices fell to 48.1 and 53.9 in the latest print in November 2019. While both surveys have ticked up recently from their lowest levels reached in Q3, the trend still does not look very promising. A partial trade agreement with China would most likely lift spirits in the short term, but we continue to believe that momentum will weaken further in 2020 with the US economy likely to tip into recession over the course of the year.

Signs of weakness in the labour market

The slowdown in momentum should not come as a surprise. Growth rates observed in late 2017 and the first half of 2018 were boosted by the corporate tax cuts and the dip in growth the year before. The labour market steadily tightened as more and more people were able to find a job. From the beginning of 2018 on there have been more job openings than unemployed workers, indicating that the economy is slowly but steadily reaching its capacity limits. This is also reflected in the increasing challenge that firms are having in filling open positions as shown by the NFIB small business survey's corresponding measure repeatedly touching a record high in 2019. Interestingly, the measure has eased to a 12-month low recently while hiring plans were at the same level as in January, though lower than a year ago.

In an environment where interest rates are at historically low levels, return on equity is reasonably high and the labour market is very tight, one would expect business investment to pick up. However, despite a seemingly positive environment, investment remains very modest and has even fallen in the past two quarters. Unless the outlook brightens significantly, and CEO and business confidence improve substantially, we do not expect a strong pickup in investment in the near term. Tighter credit standards for commercial and industrial loans are creating further headwinds to business spending.

Fiscal spending is also unlikely to boost growth in 2020 as the fiscal deficit is already very high and political support for stimulus in a divided Congress is unlikely, particularly in an election year.

Consumers become more cautious and are likely to reduce their spending

The burden to keep the economy afloat will, once more, be carried by the consumer. Currently, the solid labour market and decent wage growth support household spending. Although the unemployment rate ticked up slightly in the fourth quarter, it remains close to a five-decade low, and even the broader underemployment rate has fallen to the lowest level since 2000. However, some cracks are appearing, and several early signs indicate that the labour market could have peaked for this business cycle. Average weekly hours have ticked down since the beginning of 2019, as did average weekly overtime, both a signal that the demand for labour has fallen over the course of the year. Similarly, wage growth peaked at 3.4% YoY, the highest in a decade, in February 2019 and has since slowed down to 3.1%. As noted above, small businesses' difficulties to fill open positions seem to have peaked in 2019.

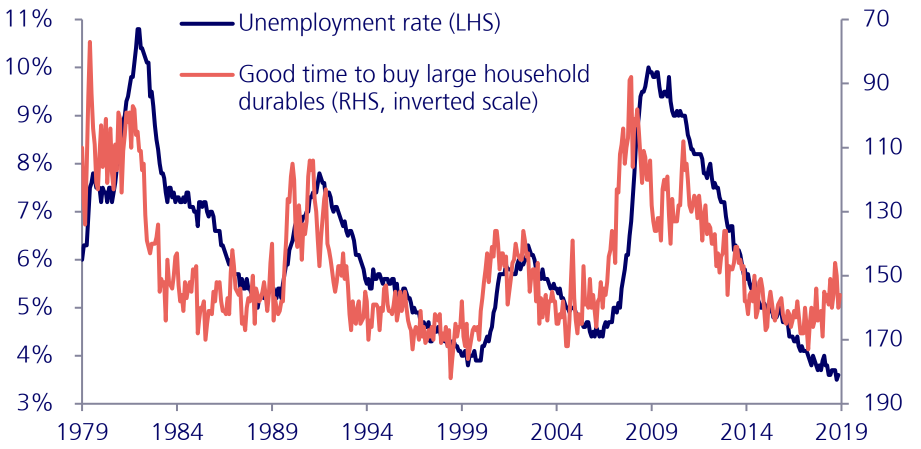
So far, the deterioration of the employment situation does not show a huge impact on consumer confidence and household spending, although auto sales peaked some time ago, for example. The housing market on the other hand has shown renewed strength recently, helped by a fall in mortgage rates after the Fed started to cut rates.

The Conference Board's Consumer Confidence Index stands at historically high levels, though lower than a year ago. Crucially, however, the gap between households' current perception and expectations has widened to the most extreme level since 2001. While this is not necessarily an indicator of an imminent recession, it shows that consumers are much more worried regarding their future than regarding their current situation. This is reflected in households being increasingly reluctant to buy big-ticket items like cars or large household durables. In the past, the deterioration in these indicators has been a good leading indicator of a deterioration in the labour market, followed by a pickup in unemployment.

The Fed 'un-inverts' the yield curve but needs to do more to boost growth

While a US recession in 2020 remains our base case, other scenarios are possible too, of course. Investors were spooked by the inversion of the yield curve which in the past has been a relatively reliable indicator of a looming recession as an inversion has occurred ahead of every single recession since the end of the Second World War. However, there have been cases where a yield curve inversion was not followed by a recession, and even if it was the period between the inversion and the recession varied widely.

Hesitant consumers indicate that the cycle is nearing its end



Source: Bloomberg

It would be too simple to just put aside the yield curve signal because the yield slope has risen back to positive territory. That was also the case when the inversion was followed by a recession. We do acknowledge, however, that the Fed did react relatively swiftly and more pre-emptively than in the past. The Federal Open Market Committee (FOMC) cut rates three times between July and October 2019 by a total of 75 basis points. That was just enough to 'un-invert' the curve, but it remains a relatively close call as longer-term Treasury yields failed to gain enough momentum to rise back to levels seen before the rate cuts happened. This can be taken as a signal that investors doubt that the Fed has done enough to reignite growth. The same can be said of the very modest pickup in inflation expectations in the aftermath of the rate cuts.

An upside risk to our cautious economic outlook would be a more aggressive Fed that is willing to act more decisively by further easing its policy, thus weakening the dollar and pushing up inflation expectations. Based on the latest FOMC statements this looks unlikely for the time being, however. Nevertheless, if growth momentum weakens further in 2020, as we expect, the Fed would respond by another series of rate cuts to support the economy. Our base case includes three more cuts over the course of the year.

Treasury yields are expected to fall back again to - and probably even dip below - recent lows once economic data deteriorate. In the near term, yields could rise a bit further, particularly if there is an agreement on a partial trade deal between the US and China. Given our cautious view on growth, subdued inflation and a hesitating Fed, the upside potential for yields seems limited, however.

Credit gives ominous signals through rising dispersion

We believe credit is likely to remain resilient but underperform equities at the beginning of 2020 and is likely to enter an outright bear market later on.

2019 has been a strong year for credit, although performance was front loaded with the last few months being lacklustre. Stocks reaching new records did not filter into credit with the weaker parts of the market underperforming significantly. The gap between CCC and Investment Grade credit spreads continues to widen. High yield energy sector spreads are also significantly wider on the year. We think this dispersion between stronger and weaker credits is likely to continue and is an ominous signal indicating that investor focus is returning to fundamentals.

Credit fundamentals remain weak, with corporate leverage at record levels. Despite low yields, the share of earnings spent on servicing debt has been rising due to high debt loads. However, we expect a continuation of shareholder appeasement through buybacks as debt financing is cheap. However, tightening lending standards in the Fed's bank lending survey are foreboding higher default rates from current low levels and have historically been a very good leading indicator. Rating downgrades are also gathering pace.

Looking into 2020, while the beginning of the year could see credit remaining resilient due to the benign liquidity backdrop, we think credit is likely to enter a bear market around the middle of the year. The focus on fundamentals, which are poor, along with a slowing macro economy are likely to cause stress in credit. Even at the beginning of 2020, we expect credit to underperform equities, as is typically the case in the late stage of the cycle, given the limited spread tightening potential at current levels.

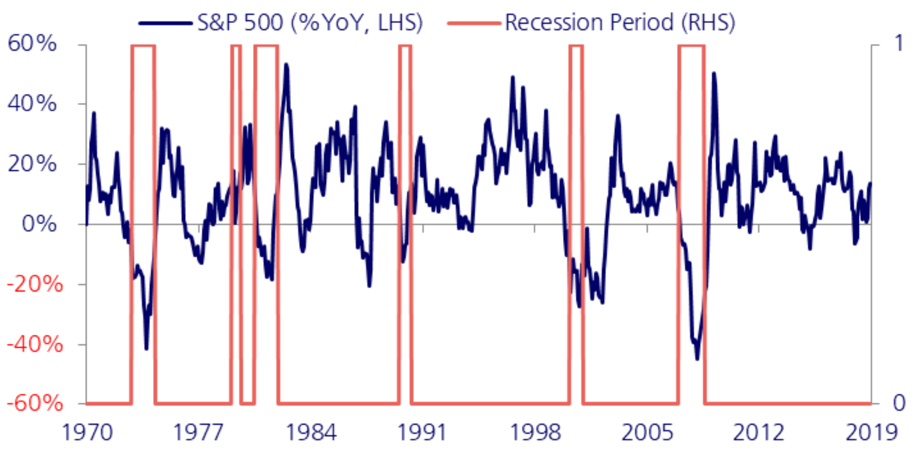
Within credit, we prefer investment grade to high yield, and we believe the BBBs could be at significant risk when the cycle turns, as the spread discount on a downgrade will rise significantly. We also think that cyclical sectors in industrials, such as autos would be at further risk along with energy, which is already seeing investor angst. Non-corporate credit such as municipals and ABS are likely to remain resilient, but spreads are already low in these and absolute excess returns to Treasuries will likely remain lacklustre.

Equity markets would slump if the economy dips into recession

Stock markets had a strong run in 2019 with all major US indices marking record highs despite the absence of significant earnings growth and slowing economic momentum. Equity investors are looking through the current weakness in fundamentals and seem to be betting on a solid growth rebound in 2020. The lack of earnings growth in combination with a strong market performance has boosted valuations with the forward price-earnings ratio of the S&P 500 rising to the highest level since the beginning of 2018, which was the highest since 2002 when investors still had to digest the fallout of the internet bubble. The strong performance in 2019 was fuelled by liquidity coming back to the market as the Fed shifted from its hawkish stance at the end of 2018 to an environment of monetary easing in the US as well as globally.

Equity markets now look stretched relative to fundamentals. Rich valuations do not necessarily imply a market correction in the near term, particularly if investors continue to buy the rally for fear of missing out. However, if we are right about the US economy tipping into recession in 2020 then the equity market will most likely suffer a major drawdown. While we would not expect a situation comparable to the financial crisis, a 20% drop in the S&P 500 is very probable in such an environment.

Recessions lead to major stock market corrections



Source: Bloomberg

UK

Outlook

- Growth stabilises but the economy faces further headwinds from Brexit and a weak global environment
- Increased fiscal stimulus will help to support economic growth in 2020
- The Bank of England will keep its dovish stance but is likely to remain on hold for now

Implications

- Bond yields are likely to stabilise as political risks recede, but the upside seems limited
- Credit should be resilient initially, but becomes more volatile later on, while outperforming European credit
- Equities are attractively valued but will continue to be impacted by a volatile Brexit process

Risks

- The economy faces a cliff edge if no trade deal is agreed and the transition period is not extended by the end of the year
- A significant deterioration of the global environment in addition to Brexit uncertainty drags the economy into recession
- The labour market suffers as more and more firms decide to leave the country given the uncertain future

Economic growth stabilises but faces further headwinds

The economic environment remains challenging, as indicated by modest business activity and the fall of industrial and manufacturing production in the third quarter at the fastest rate since 2013. GDP growth rebounded to 0.3% QoQ in Q3 after a drop in Q2, helped by stockpiling ahead of yet another delayed Brexit deadline. Nevertheless, despite the latest pickup, growth remains very modest at a rate of 1.0% YoY, a post-recession low.

Business investment fell for the second quarter in a row as firms remain reluctant to spend given the uncertain outlook and the global slowdown. Exports picked up, partially helped by foreigners increasing their stockpiles ahead of the - now delayed - Brexit deadline at the end of October. Meanwhile, consumer spending grew at a steady pace helped by a solid labour market. However, a fall in retail sales in October indicates that consumer spending has softened entering the fourth quarter.

Manufacturing is particularly hard hit by Brexit uncertainty and global slowdown

Brexit uncertainty remains a major drag on the UK economy, which is further exacerbated by a sluggish global growth environment. The downturn is particularly severe in the manufacturing sector. Markit's Manufacturing PMI fell to 47.4 in August, the lowest level since summer 2012 when the Eurozone crisis flared up and risked drawing the continent into another severe downturn. Firms reported weaker inflows of new business, particularly in the domestic market, with new orders decreasing six months in a row. The weakness was only compensated for in part by manufacturers building up stocks ahead of the October Brexit deadline. Weak business activity translated into further headwinds for manufacturing employment with job losses for seven consecutive months in October, when the rate of decline was among the steepest over the past decade. The manufacturing sector remains under pressure, despite the PMI's small pickup to 48.3 in November.

The service sector is struggling, too

Globally, services have been holding up much better than manufacturing so far, indicating that the UK manufacturing sector's weakness has been exacerbated by a general global downtrend. However, different to what is observable in many other regions, the UK service sector has also been facing headwinds through most of 2019, with the slowdown accelerating over the course of the year. In November, the Services PMI fell to 48.6, the lowest level since the brief dip after the Brexit referendum in 2016. New business in the service sector has fallen in eight out of eleven months, with the latest indication again being the weakest since July 2016, which was a post-recession low.

A tight labour market and low inflation boost real wages

While firms have been working down existing business, fewer new contracts and sharply falling backlogs led to a decline in workforce numbers. Overall, as indicated by the Composite PMI, employment was under pressure through most of 2019 with a dip in September to the weakest in a decade.

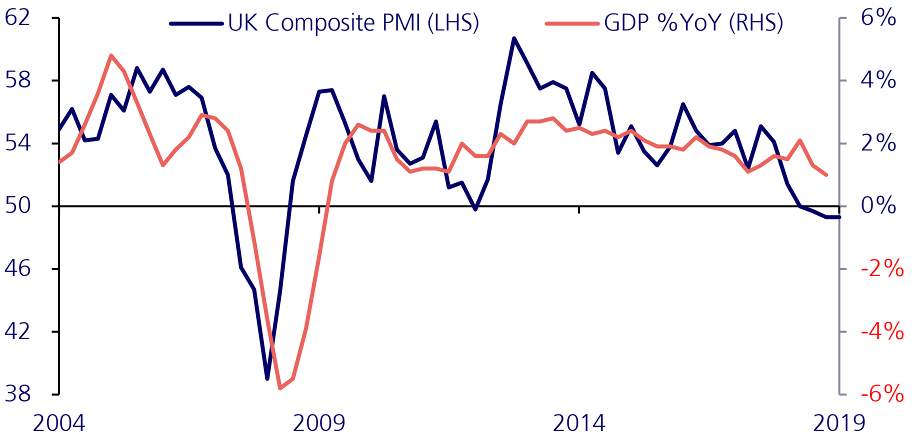
Despite the challenging environment the labour market has been holding up very well so far. The unemployment rate continues to hover around multi-decade lows, ticking back down to 3.8% in September. Despite the tighter labour market wage growth slowed down to 3.6% YoY from 3.8%, the month before and 3.9% at its peak in summer. However, the inflation rate also receded from 2.1% in July to 1.5% in October, the lowest in almost three years. This resulted in the strongest growth in real wages since the Brexit referendum when a weakening currency started to weigh on households' purchasing power. Inflation is unlikely to pick up significantly soon so consumers should continue to benefit from rising real wages. We therefore expect consumer spending to continue at a steady pace in the coming quarters unless there is a significant deterioration in the employment situation. Consumer confidence has been deteriorating in the aftermath of the Brexit referendum but has held up better than business sentiment. Depending on the election result and the reduction of the immediate risk of a no-deal Brexit, consumer sentiment is likely to stabilise in the first quarter.

No-deal risk expected to flare up again as the end of the transition period looms

With a solid lead in the polls it looks likely that the Conservative Party will win an outright majority in December's election. Based on this assumption we expect parliament to pass Boris Johnson's withdrawal agreement with the EU. That would mean the UK will formally cease to be an EU member at the end of January 2020 and will enter the transition period until the end of 2020 if it is not extended. In the short term, a clear Tory majority would remove uncertainty regarding the Brexit path, which should help to stabilise the currency and yields. However, the Tory manifesto pledges not to extend the Brexit transition period beyond 2020. Given that it is highly unlikely that the EU and UK will finalise a trade deal by the end of 2020, uncertainty will increase again as the proposed deadline to ask for an extension of the transition period approaches toward the middle of the year.

Although there may be some pickup in business activity and investment spending in the aftermath of the election, we do not

Further slowdown ahead



Source: Bloomberg

expect a substantial acceleration as the risk of 'no deal' remains in place until a clear path towards the future relationship between the UK and the EU becomes visible. It is therefore unlikely that business spending will provide a significant stimulus to GDP growth in 2020.

Increased fiscal spending will support growth in 2020

With consumption steady but relatively modest and business investment expected to be soft, an important swing factor to growth will come from fiscal spending. Indeed, based on the parties' manifestos, we expect a significant fiscal boost regardless of who wins the election. While the Tories have recently toned done the size of the fiscal boost somewhat, the announced spending increases would still add about half a percentage point of GDP growth in 2020, a sizeable lift given the latest annual growth rate of 1%. The fiscal boost would be significantly larger in the case of a Labour majority, but this seems unlikely given the Tories' lead in the polls as indicated above.

Crucially, the expected fiscal stimulus will likely start to have an impact only in the second quarter. If we are right in assuming that a Tory election victory would alleviate near-term uncertainty, and thus ignite some investment spending in Q1, the timing of the fiscal boost will help to smooth growth over the course of 2020.

The BoE will keep its dovish tilt

The announced fiscal boost and the removal of some near-term risks regarding Brexit and the election are the main reason why we expect the Bank of England (BoE) to keep its monetary policy unchanged in the coming months. The BoE has recently shifted to a more dovish stance as two members of the Monetary Policy Committee (MPC) surprisingly dissented from the majority and voted for an immediate rate cut at the MPC's meeting in November. The BoE slightly reduced its growth forecast for 2020 to 1.2% from 1.3% before. As indicated above, inflation has fallen steadily from its latest peak in late 2017. Producer input prices even fell at an annual rate of 5.1% in October, indicating that price pressure will remain muted in the coming months.

While the BoE is likely to keep its dovish bias entering 2020, we currently do not expect a majority to vote for a rate cut soon unless the situation deteriorates significantly in the near term. Gilt yields are likely to recover as near-term risks recede and fiscal stimulus is expected to prop up growth. However, given the still modest growth environment, the expected uncertainty around the end of the transition period and potential no-deal risks, the upside seems limited.

Credit to be volatile from mid-year, while outperforming the Eurozone

Credit tends to be much more correlated across geographies than equities, leading us to expect sterling credit to become volatile from the middle of 2020, in line with our view on global credit. That said, we expect 2020 is likely to start with resilient, although lacklustre performance, driven by liquidity.

We think global credit is at risk next year, as elevated corporate leverage, tight spreads and weak growth move investor focus away from the current liquidity driven search for yield, back to fundamentals.

Sterling credit spreads have some potential to tighten versus those of European credit, although we think this will be relatively marginal. The risk of a hard Brexit was not fully priced into credit in our view and hence a constructive outcome is also unlikely to provide much upside. We think financials may see more outperformance, however, as the downside and therefore the risk premium of a hard Brexit is still evident given the fragilities of UK banks.

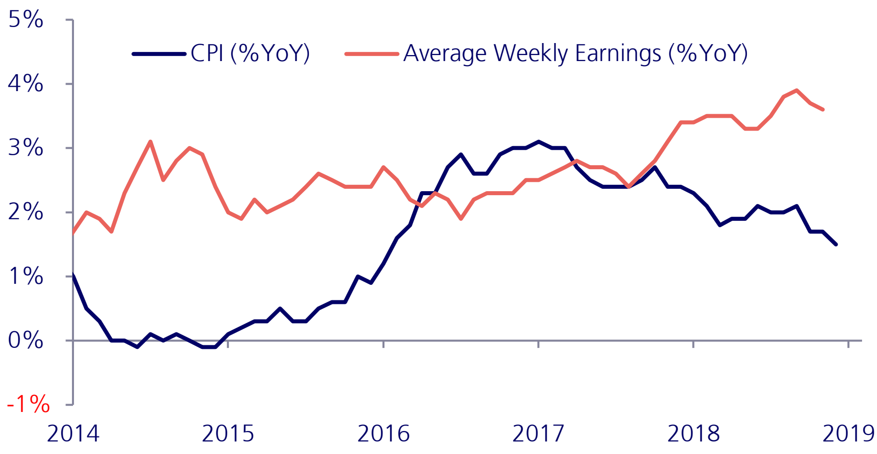
We believe ABS and covered bonds should be more resilient in 2020. We see some tightening potential for UK ABS spreads and remain constructive on senior tranches. The UK should remain the largest ABS market in Europe and we expect strong issuance, partly driven by banks and building societies that need to refinance their maturities within the BoE's Term Funding Scheme in 2020.

UK equities are attractively valued but will continue to be impacted by the volatile Brexit process

The FTSE 100 has been lagging most of its peers over the course of 2019 with the ebb and flow of Brexit uncertainty dragging and pushing the market relative to other regions. Despite the ever-present Brexit risks the market almost managed to keep up with the rest of the world in the first half of the year in local terms, helped by a weaker currency. However, with sterling strengthening and the imminent risk of a no-deal Brexit having receded after the EU granted an extension of Art. 50 until the end of January 2020, the FTSE 100 increasingly fell behind as global stock markets raced ahead. In line with the receding risk of a no-deal Brexit and the related hit to the economy, the FTSE 250, containing smaller capitalised and more domestically focused companies, started to outperform its large-cap equivalent in Q3.

The FTSE 100's underperformance in 2019 adds to the Brexit discount that has been building up since the referendum in 2016. Valuations are relatively cheap both regarding the market's own history as well as compared to other regions. Therefore, they offer attractive value as the currency stabilises, particularly for longer-term investors. Nevertheless, UK equities are not immune to a global downturn and will continue to be affected by the volatile development around the Brexit process and ongoing trade negotiations with the EU.

Lower inflation boosts consumers' purchasing power



Source: Bloomberg

Germany

Outlook

- The German economy will track around recessionary levels in 2020
- Manufacturing confidence is stabilising, but at weak levels, while the service sector will slow further
- A large fiscal stimulus would help, but there are important institutional and political impediments

Implications

- Bund yields are already pricing in an extremely negative economic scenario and have near term upside
- German equities have upside potential early in 2020, especially if manufacturing sentiment rebounds further
- However, Germany's equity market is heavily exposed to the global economy, which we expect to slow further

Risks

- Political uncertainty and paralysis that impacts policy making and business confidence
- Lack of fiscal stimulus despite continued weak growth
- An escalation in the trade dispute between the US and EU, especially if it spreads to the auto sector

A perfect storm

The past few quarters have been a perfect storm for the German economy with a ratcheting up in global trade tensions, many specific problems in the auto sector and ongoing structural changes in the financial sector all weighing on growth. Industrial production has been in contraction on a YoY basis since October 2018 and the latest available data showed that output declined -5.3% YoY in October this year, the steepest pace since the Global Financial Crisis (GFC) ten years prior. Manufacturing makes up around 22% of total economic output in Germany and the sector employs around a quarter of the workforce, compared to equivalent figures for the Eurozone of 16% and 15% respectively.

Demand for capital goods, in which Germany specialises, has been affected by weak EM growth and exacerbated by trade tensions that have created uncertainty for global businesses and affected their willingness to invest. In the auto sector, a change in diesel emissions standards in late 2018 created enormous disruption to production, while weaker demand from China and other large export markets and increasing competition from electric vehicles (EVs) have all weighed heavily on the sector as well.

The overall impact from all these headwinds is that growth in 2019 was extremely weak. In fact, Germany only narrowly avoided a technical recession—defined as two successive quarters of negative growth—with GDP contracting by 0.2% QoQ in Q2 but managing to eke out a modest 0.1% QoQ expansion in Q3.

Are the initial shocks over?

As we enter 2020, global trade tensions persist and the ongoing rise of EVs is now forcing German auto makers to invest billions of euros in R&D, as they play catch-up, whilst profitability in the sector has also declined, forcing steep job cuts.

Forward-looking indicators such as factory orders and PMI data suggest the contraction in the manufacturing sector will continue at least into early 2020. However, these leading indicators also suggest that the pace of contraction should diminish or at least stabilise in the coming months.

Various other surveys of investor and business sentiment (such as the ifo expectations component and ZEW survey) also appear to have tentatively stabilised. Indeed, after a year and a half of weak growth and economic shocks, companies seem to be gradually adjusting to the new operating environment.

In addition, some of the worst fears surrounding a trade war between the US and EU have, so far, not been realised. The US has not actually imposed extra auto tariffs on Germany or other European exporters for example, despite having designated auto imports from the EU as a threat to national security. However, one key risk is that the disagreement between the EU and US over how to tax technology companies could eventually lead to a tit-for-tat escalation in tariffs that affects the auto sector or other important German exports.

Service sector resilience has faded

Unfortunately, the weakness in the manufacturing sector has continued for so long that, unsurprisingly, it has now started to impact the service sector as well. Given that the service sector is the largest part of the total economy, this is a particular concern. Recent ifo surveys and PMI readings have indicated that while there has been some stabilisation in manufacturing confidence, there has been a sharp fall in service sector confidence at the same time, as well as a drop in companies' hiring intentions in both the manufacturing and service sectors. This will ultimately hit consumer confidence and spending, potentially creating a vicious circle in the service sector if there is no strong offsetting policy response.

In addition, domestic business investment in machinery and equipment, which has been surprisingly resilient in 2019, is also likely to weaken in 2020, acting as an additional drag on growth. The upshot is that similarly to the Eurozone as a whole, economic activity will remain weak going into 2020. Indeed, it may still prove to be the case that Germany did in fact enter a technical recession in Q4 2019, despite having narrowly avoided one in the middle of the year. The first estimate of Q4 GDP will be released on February14.

Fiscal policy to the rescue … eventually

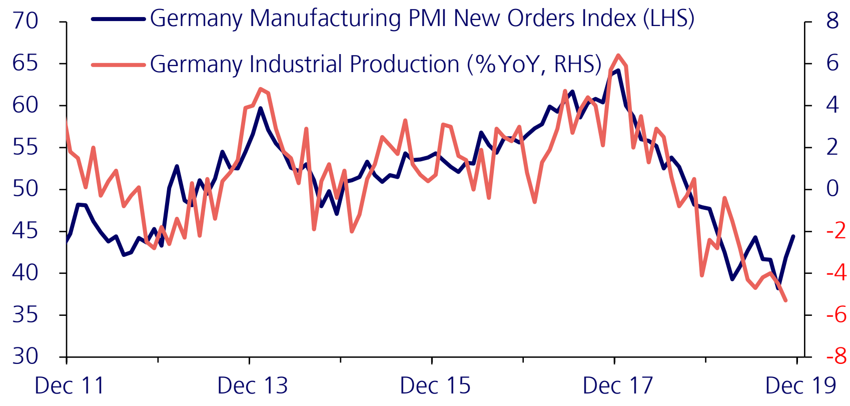
Given the weak trajectory of the German economy, and its strong fiscal position, it is often surprising to outside commentators that fiscal policy is not being used aggressively. In contrast to the rest of the Eurozone, Germany has been running a budget surplus since 2014. In 2019 the budget surplus will be around 1.5% of GDP, but a large discretionary fiscal boost is not planned in the budget for 2020 despite the poor economic conditions.

Admittedly, automatic stabilisers will kick in as growth slows, reducing the budget surplus in 2020 anyway The government also recently announced an environmental spending plan of around EUR 50bn to be spread over four years.

Various measures will be introduced to shift households and companies towards less environmentally impactful activities (e.g. subsidies and taxes to favour train travel over plane travel). One million charging stations for electric vehicles are to be installed by 2030 and a carbon dioxide emissions pricing charge introduced for traffic and buildings.

However, the offsetting revenue raising

The PMI survey points to stabilisation in manufacturing sector



Source: Bloomberg, Markit

measures and the fact that the plan is spread over several years means that the actual annual boost to economic growth in 2020 from the plan will be small.

Institutional impediments to fiscal stimulus

There are two institutional impediments to a substantial and sustained fiscal boost in Germany. The first is the 2018 coalition agreement between the CDU and SPD, which commits the government to run a budget surplus each year, the so called black zero ('schwarze Null'), and never a deficit, however small. This is simply a political agreement between two parties which could, and indeed should, be re-worked.

The second and most important impediment to a large and sustained fiscal stimulus is the so-called debt brake rule ('Schuldenbremse') as this rule has been enshrined in the German constitution since 2009. It commits the federal government to maintaining a budget in which a structural deficit may not exceed 0.35% of GDP in any one year. A deviation is allowed for emergency circumstances of up to 1.5% of GDP for one year, but any spending beyond that must be made up for in subsequent years. Given that Germany has been running structural surpluses recently, there is also a so-called reserve fund of around 1% of GDP which could be tapped into as well (the reserve fund is an accounting concept rather than an actual separate fund).

So in theory the government could choose to enact a one-off stimulus to the economy of up to two and a half percentage points of GDP in one year. However, to do anything more than that (for example a large investment plan over ten years) would be difficult as it would require a change to the German constitution, with a two-thirds majority in parliament needed.

We do think that in the near term some flexibility will be shown with respect to the schwarze Null limit and that eventually pressure will build for a one-off fiscal boost as well. However, it may require an actual technical recession (i.e. two successive quarters of negative growth) in order to generate sufficient political will and consensus for a large and continued fiscal stimulus.

Politics are extremely fluid

In this respect, the political situation in Germany is extremely fluid at the moment, complicating the process of a consensus emerging around the need for an aggressive fiscal stimulus.

The surprise election of Saskia Esken and Norbert Walter-Borjans as co-chairs of the SPD on the surface increases the chances of a fiscal stimulus as they campaigned for the SPD leadership on a mandate of a green fiscal stimulus, investment in infrastructure and increases in the minimum wage. However, for their policy aims to become reality they need to convince their larger government coalition partner, the CDU, to agree to such a change of course.

The SPD's bargaining position is limited, though, because they are trailing in third or fourth place in the polls, so any threat to walk away from the coalition and force new elections is not entirely credible. It is likely they will have to accept a substantial watering down of their proposals or wait until the CDU itself is motivated to adopt a fiscal boost as part of its own policies because of an economic recession.

If the present coalition does fall apart, then new elections are likely to be called, with a CDU/CSU and Green Party coalition government likely to emerge following elections. The Green Party is currently doing well in the opinion polls, second only to the CDU.

Another possibility if the current coalition collapses is that Chancellor Angela Merkel will try to stay on leading a minority government, at least until Germany's presidency of the EU (which runs in the second half of 2020) is complete. Overall, the political situation in Germany remains extremely fluid and complex, and a consensus around a large fiscal stimulus package still seems some way off. The key point is that things will probably have to get worse economically before there is enough pressure on politicians to act.

Bund yields have upside near term but will be capped by weak growth

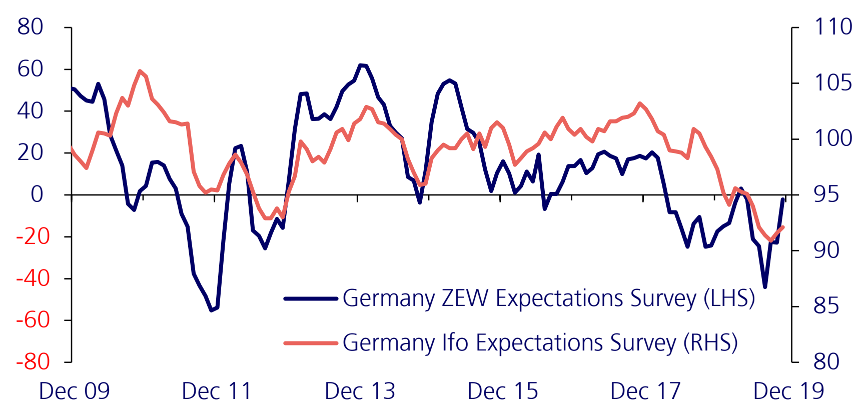
German Bund yields are understandably pricing in a very negative scenario with chances of further rate cuts by the ECB. However, if manufacturing data stabilise further there could be some short-term upside in core bond yields, especially if the debate continues to shift towards fiscal stimulus in Germany and away from negative rates on the ECB governing council.

Nevertheless, any upside to bond yields is likely to be capped by a still weak macro outlook, a long time lag before the government actually adopts a large fiscal stimulus package and a global slowdown led by the US that we expect to occur later in 2020. The upshot is that we expect core bond yields such as German Bunds will be rangebound over the year, though potentially trading within a wide range.

German equities can do well until the global slowdown is closer

On the flipside, German equities have upside potential in the near term, especially if manufacturing does stabilise. However, any gains are likely to be fragile, and exposed to a decline in investor sentiment as the year progresses and concerns about a global slowdown intensify. The other big risk for German equities in 2020 is an escalation in global trade tensions.

A modest improvement in the latest ZEW and ifo surveys



Source: Bloomberg

Eurozone

Outlook

- Weak growth leaves the region extremely vulnerable to further shocks
- The ECB will continue with QE asset purchases, but monetary policy is reaching the point of diminishing returns
- A large government stimulus would help, but is only likely to come if growth turns negative

Implications

- Eurozone equities could perform well early in 2020, but later in the year the outlook is likely to dim
- Credit should be resilient initially, but we expect mid-year to see a pickup in volatility
- Core bond yields are likely to be driven by the ebb and flow of risk appetite, but remain rangebound over the year

Risks

- A further escalation in the trade war either between the US and China or between the US and Europe
- An escalation of political risks within the Eurozone, for example in Italy if the new coalition government falls apart
- European bank vulnerabilities could amplify weakness in credit markets and the economy

Sub-trend growth as headwinds persist into 2020

In the Eurozone, 2019 was a year characterised by slowing growth, weakening business confidence and falling inflation expectations, eventually compelling the ECB to loosen policy in September and re-start QE asset purchases. Understanding the causes of the 2019 slowdown is crucial to understanding the outlook for the region in 2020.

The headwinds were both external and internal. Continued trade war uncertainty had an impact on global business confidence and willingness to invest, affecting demand for capital goods, of which Germany is a big exporter. Weak growth in China and emerging markets more widely also had a negative impact as did Brexit uncertainty in the UK, one of the Eurozone's biggest export markets. Domestically, structural problems in the auto and banking sectors weighed on growth. In addition, political uncertainty and crises flared up from time to time, for example in Italy with the collapse of the 5-Star/Lega coalition government and in France with the yellow vests protest movement.

Manufacturing weakness has finally transmitted to services

Given this long list of headwinds the Eurozone has shown resilience in its continued growth. Nevertheless, economic momentum has slowed to a below trend pace going into 2020, from an above trend pace at the beginning of 2019. While the service sector remained immune to the manufacturing slowdown in the first half of 2019 (see chart), helped by falling unemployment, confidence eventually ebbed in the second half of 2019, as company hiring intentions weakened.

The upshot is that the Eurozone is only likely to grow at a modest, below trend pace early in 2020, making it extremely vulnerable to any further shocks that come along during the year. Unfortunately, as we are predicting a US recession we expect this to transmit to the Eurozone at some point leaving growth close to flat over the year as a whole, with the chance of one or two quarters of contraction (i.e. a technical recession).

Admittedly, there are signs of stabilisation in the manufacturing sector, which had been at the epicentre of the slowdown in 2019, as companies have learned to gradually adjust to the trade war uncertainty. New orders in the Manufacturing PMI survey picked up in Q4 and companies appear to have worked down some of their excess inventories. Specific disruptions in the auto sector have also started to ease. However, a rapid rebound in the manufacturing sector is unlikely as trade uncertainties will persist in 2020, limiting businesses' willingness to invest.

Diminishing returns to monetary policy will limit the ECB's options

Given our expectation of anaemic growth in 2020, and possibly even some quarters of contraction, we do not expect underlying inflation to move materially higher. Rather core inflation is likely to continue to average around 1%, with risks to the downside.

Faced with weak growth and inflation, there will be pressure on the ECB to loosen policy further. The new ECB president, Christine Lagarde, has commissioned a strategic review of monetary policy objectives and tools. It is likely that the stated goal of targeting 'inflation below, but close to, 2% over the medium term' will be changed. One possibility is that the ECB makes the inflation target symmetrical around 2%, implying that even more action is needed to bring inflation back to target.

However, what further action the ECB could take and how effective it would be is debatable. Additional cuts in interest rates or QE asset purchases may be like pushing on a string, with diminishing effectiveness, and they could even be counter-productive. In particular, cuts in the deposit rate further into negative territory will increase distortions in the financial system. We hope any easing by the ECB in terms of cutting interest rates further into negative territory is extremely limited or does not happen at all. However, there is some scope for increasing the size of asset purchases, which we expect to continue through 2020, from the current pace of 20 billion euros a month.

Fiscal policy will have to do more

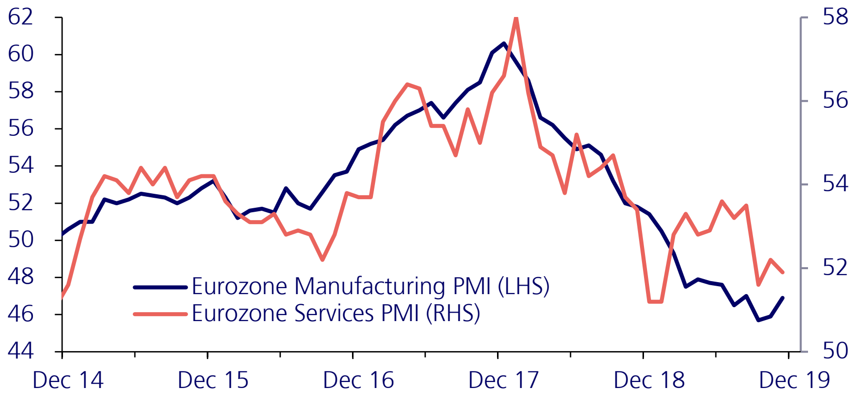
With further loosening in monetary policy likely to be ineffective, pressure will fall on governments to do more to support growth. The debate around the need for more fiscal stimulus has already started and there are plans for a modest amount of fiscal stimulus in 2020 of around 0.5% of GDP, similar to 2019. This is not insignificant, but in order for politicians to do more they will probably wait until clear signs of contraction/recession emerge. Given the time lags involved, any of their efforts will probably not have a measurable impact until late 2020 or even 2021.

France more resilient, Italy most exposed

By country, we expect France to be the most resilient amongst the big three Eurozone countries (Germany, France and Italy). Domestic demand remains reasonably strong and this momentum is likely to continue into early 2020.

The yellow vests protest movement has died down, and funding costs are low. Reforms introduced by the Macron government over the past couple of years have improved flexibility in the labour market and appear to be bearing fruit in terms of stronger employment growth.

Service sector confidence to soften further in 2020



Source: Bloomberg, Markit

However, there are challenges, including the planned pension reform that is creating significant opposition and could see a resumption of protests in 2020.

Italy will remain mired in stagnation/recession and is heavily exposed if we are right that there will be a global slowdown in 2020. Germany is also exposed to the global economic and trade cycle, though some stabilisation in 2020, specifically in the auto sector, should help at the margin (see the section on Germany for more).

Core bond yields will be rangebound

A subdued growth and inflation environment, with the possibility of further loosening from the ECB should be a supportive environment for core government bonds. However, at current yield levels of around -0.3% for 10yr German Bunds and 0.0% for French OATs (as of December 4) these markets are already pricing in a very weak macro environment. Therefore, as we go into 2020 core bond yields could rise higher initially, especially if there are further signs of manufacturing sector stabilisation early in the year before the recession we expect eventually hits, bringing yields lower.

Similarly, periphery spreads may remain tight early in 2020 until we see evidence of a more pronounced slowdown, and this macro weakness concerns investors. Italy looks particularly exposed in this regard because of its weak macro fundamentals and political fragilities adding to eventual pressure for spread widening.

Credit volatility to pick up around mid-year

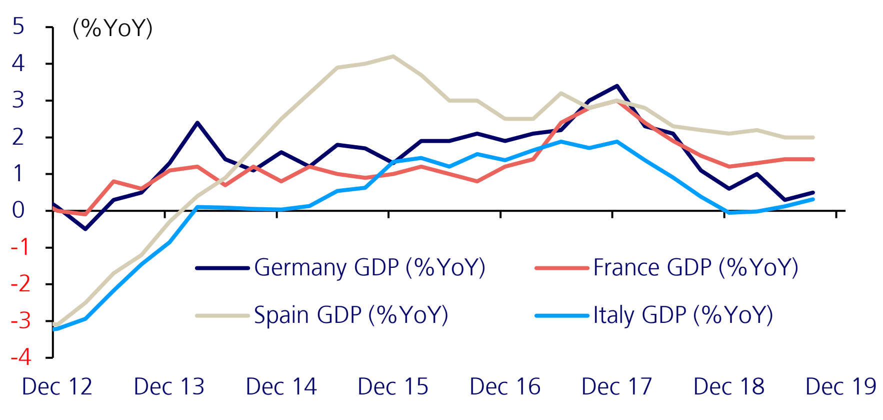
European credit is likely to remain resilient in the beginning of 2020, supported by a search for yield and ECB buying, although returns are likely to be muted relative to equities. Around the middle of the year however we expect more volatility and spread widening, with European bank credit warranting investor attention.

In 2019, credit has been well supported, largely due to a dramatic shift in global monetary policy stance, led by the Fed. Over the year, spreads have tightened notably, which along with a decline in government bond yields, has led to significant total returns, although some of this has been given up over the last few months.

We think the resilience of credit will continue for some time due to the strong supply/demand technicals, enhanced by ECB buying, but will eventually fade as higher volatility in 2020 emerges. We believe credit fundamentals are poor, with high leverage in the corporate sector and low profitability and stretched balance sheets in the banking sector. Debt issuance has picked up dramatically in 2019, with European Investment Grade credit markets seeing more than double the net issuance of compared to 2018. Together with the outlook for growth looking bleak, we think weak leveraged companies are particularly at risk if earnings were to decline further.

The dispersion between weaker and stronger credits is already rising and we believe that this is a leading indicator of a late stage in the credit cycle, which is also reflected in the tightening of lending standards in bank lending surveys from the Fed and the ECB. Both of these factors forebode higher default rates in 2020, which imply that current tight spread levels are reflective of a liquidity driven search for yield as opposed to fundamentals. We expect this to change in 2020 when investors start focussing again on fundamentals.

Slow growth leaves the Eurozone vulnerable to shocks



Source: Bloomberg

European banks have been a particular area of concern for us, where the large size, undercapitalisation, significant interlinkages and the increasing proportion of bail-in-able bonds are risk factors. While European banks continue to significantly underperform US banks and broader European companies in the equity markets, this is not the case in credit due to the search for yield environment.

All in all, we think European credit is likely to see higher volatility in mid-2020, although the beginning of the year shouldl see some resilience. Within credit, however, we expect covered bonds and ABS to remain more resilient than the corporate market.

Equities have upside early in 2020, but face drawdown risk later in the year

Eurozone equities still have the potential to rally early in 2020. Valuations are not particularly challenging compared to other equity markets and given that investors have been underweight in Eurozone assets for some time, they could have further upside over the next few months as we enter the late stages of the cycle. However, if our view of a global slowdown in 2020 is right, then eventually Eurozone equities are likely to correct substantially, especially as they are typically high beta and exposed to the global cycle. A significant peak to trough drawdown therefore seems likely at some point in 2020, especially as analysts` hopes for strong earnings growth are unlikely to be fulfilled, in our view, over the year as a whole.

Italian equities look particularly vulnerable because of domestic weaknesses, exposure to the global economy, a starting point of very weak growth and because they have done so well in 2019.

Spain on the other hand has lagged some of the other main Eurozone equity markets recently and could be due to catch up in 2020 on a relative basis. Spain trades on a trailing P/E ratio of 15 compared to 19.5 for the Euro Stoxx 50 (though this partly reflects the high proportion of financials in the Spanish index). Spanish equities rose just 8% in 2019, compared to 26% for Italy and 20% for the Eurozone overall (data as of December 4).

Switzerland

Outlook

- The economy is resilient and should continue to expand, albeit at a sluggish rate
- Inflation is set to remain low, with a strong currency and weak wage growth creating headwinds
- The SNB is prepared to cut rates further should pressure on the franc persist

Implications

- Bond yields are expected to remain low, anchored by weak inflation and persistently low policy rates
- The franc is likely to remain rangebound, with strong fundamentals and SNB interventions limiting more extreme moves

Risks

- An unexpected and disruptive change in SNB policy
- A surge in the franc triggered by a Eurozone crisis
- A further deterioration in US-China trade relations

The economy should continue to expand in 2020, but at a sluggish rate

Growth has slowed sharply in Switzerland, led by weaker external demand, particularly from the Eurozone, and a slump in investment. Global trade tensions have weighed on Swiss exports and the Manufacturing PMI, which reached an eight-year high in early 2018, then fell to a 10-year low by the middle of the year, ranking among the weakest regions globally. Going forward, headwinds are unlikely to dissipate. However, the economy is resilient and there are special factors that will help to boost headline GDP growth over the coming year. We therefore maintain our view of a continued, but sluggish, expansion, at around 1% in 2020.

A strong currency weighs on the economy, and headwinds will persist

Part of the slowdown in 2019 was justified as the economy was running hot in 2018. The slump was deeper than expected though, with annual growth down from over 3% in 2018 to 0.2% in Q2, though it has since rebounded and is now tracking at 1.1%. The weakness reflects the more challenging global environment, but a strong currency has been an additional headwind. The appreciation of the franc – up by close to 10% on a trade-weighted basis compared to the lows in 2018 – reflects renewed monetary easing from the ECB. As in 2014/2015, this has compressed interest rate differentials between Switzerland and the Eurozone and put upward pressure on the franc, adding to the woes of exporters.

The latest GDP data show that the economy is stabilising, with quarterly growth of 0.4% in Q3, following a 0.3% expansion in Q2. While this was stronger than expected, there was large divergence across industries, with the pharmaceutical sector providing a strong boost to the economy, offsetting weakness elsewhere. This confirms our view that challenges remain, and that a further acceleration is unlikely.

International sports events will help to boost headline GDP in 2020

Major sporting events have a significant impact on Swiss GDP statistics, as many international sports organisations are based in Switzerland and licensing fees from sports events are accounted for as Swiss services imports. This distorts headline GDP growth and injects significant volatility in the GDP statistics, unrelated to underlying economic fundamentals. The Winter Olympics and the Football World Cup boosted real GDP growth by close to 0.5pps in 2018, for example, and weighed on growth in 2019. For 2020, we expect the Summer Olympics and European Football Championship to provide a significant boost to headline GDP growth.

Swiss growth is resilient, with a well-diversified economy and exports

Looking through the volatile effects from sporting events, we also expect underlying growth to remain positive, despite a challenging external environment. A key reason for this is that the Swiss economy is resilient and the fiscal situation is sound should additional support be needed. Indeed, despite a collapse in German growth, a global trade slump and a stronger currency, the economy has continued to expand at a decent rate over the past year. Demand for Swiss exports tends to be sticky and less price sensitive, due to their specialised nature. The industrial sector is highly diversified, with exports ranging from pharmaceuticals and high-end optical and medical instruments to specialised manufactured goods and energy. Trade flows are also diversified regionally. While the Eurozone remains the key destination for Swiss exports, other markets have gained strongly over the past decade, with the US and China accounting for one third of Swiss goods exports, just a touch below the share for the Eurozone. This diversification has been helped by efforts to negotiate bilateral free trade agreements, now in place with around 40 partners, in addition to the EU. While this is important, and underpins our view of resilience and growth, Swiss exports are nonetheless highly cyclical, and prospects for the economy hinge on developments in the Eurozone and for global trade more broadly.

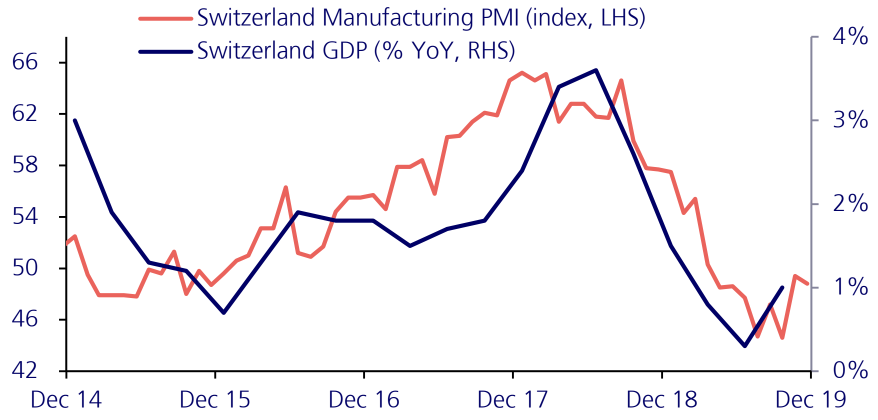
Swiss consumption is likely to remain subdued

Private consumption has expanded at a steady, but sluggish, pace of around 1% YoY over the past year. The lack of stronger momentum partly reflects downbeat household sentiment, influenced by a less buoyant labour market. While the official unemployment rate remains at a low 2.3%, hiring plans have been cut back, particularly in manufacturing. Retailers also face structural and deflationary headwinds, including cross-border and internet sales that weigh on growth. Indeed, retail sales volumes were down again in the first three quarters of the year and have fallen by over 5% since the end of 2014. As we have reiterated in the past, while producer prices have largely adjusted to a stronger franc, consumer prices are still highly misaligned, leading to a lack of competitiveness for the retail sector and consumption spending more broadly.

Investment has slumped on elevated uncertainty around global trade

Investment boosted growth in 2017 and early 2018, as businesses responded to a synchronised global growth upswing by expanding capacity. In the second half of 2018, investment collapsed, reversing prior gains. While volatile, the most recent data suggest a stabilisation, with equipment and software investment rebounding from recent

Growth stabilises, but a sharp upswing from here is unlikely



Source: Bloomberg

lows. The SNB business condition survey also reports that many businesses continue to face tight capacity, which helps to explain recent improvement. While tight capacity and ongoing investment needs should support activity going forward, a stronger investment boom is unlikely, however, given the challenging global economic environment.

Deflation returns to Switzerland, and weakness is likely to persist

Headline CPI inflation has slumped and prices are once again falling on a YoY basis. Part of the decline reflects lower energy prices and should wane over time. However, weakness is broad-based, with both imported and domestically generated inflation, as well as services and goods price inflation tracking at very low levels. While we expect inflation to rebound from current lows, it will likely remain below 0.5% in 2020.

This is a long way from the SNB's 2% reference point for inflation and well below Eurozone inflation and reflects very weak underlying price pressures. With consumer prices still misaligned, wages and prices are expected to remain under pressure going forward. Indeed, wage growth, which showed encouraging signs of picking up in 2018, has fallen back and is once again tracking at only 0.5% YoY. After accounting for positive productivity trends, this justifies stable, but not rising, prices. Indeed, Switzerland still suffers from deflationary headwinds, which is a concern for the SNB.

The SNB stays put, but prepares to cut rates further if needed

As we had expected, the SNB left rates unchanged in the September meeting, despite ECB policy loosening. Looking forward, two factors make us believe that the SNB is prepared to cut rates further, should pressure on the franc not dissipate—or even intensify. Exemptions for negative rates on excess reserves have been made more generous. This reduces pressure on bank profitability and makes it easier for the SNB to cut rates again. Moreover, the SNB revised down its inflation forecast in September, to only 0.2% for 2020 and 0.6% for 2021 – down from 0.7% and 1.1% previously. As this forecast is conditional on its current policy rate, this sent a strong signal that the SNB may consider it necessary to loosen policy further.

The franc has not weakened since the time of the September forecast. Domestic sight deposits, which proxy forex interventions, have risen, despite a broader risk-on rally in financial markets. This suggests that the SNB has made sizable forex interventions to offset pressure on the franc. The build-up in reserves is not at all as severe as in 2014/2015 but, should it continue, puts the SNB in a difficult spot given that forex reserves are already over 110% of GDP, with over 30% allocated to foreign equities and non-government bonds. Due to its size and composition, the balance sheet is a risky one, and this may make the SNB more vulnerable to political interference.

Unless conditions improve and the franc weakens over the coming months, we therefore do not rule out a further rate cut by the SNB. As we had feared, the window for higher rates has closed, with policy rates set to remain negative for years to come in Switzerland.

The housing market strengthens as negative rates are projected forward

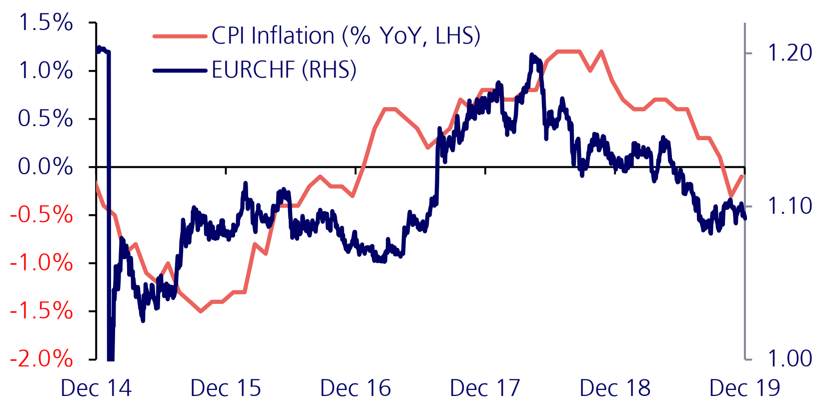
The global shift in monetary policy has amplified the search for yield by investors, particularly in Switzerland, where the whole government bond curve is below zero. This appears to be fuelling a late cycle recoil in the housing market. The UBS real estate bubble index shows that conditions warmed up in the third quarter, as lower mortgage rates led to a slight acceleration in mortgage lending and boosted interest in buy-to-let investment while home prices rose, putting an end to the downward trend of recent quarters. This left the overall index at the highest level since 2018 Q1.

While the low yield environment will continue to support the housing market, the banking sector has agreed to a range of self-regulation measures, set to come into force in January 2020. Additional measures to contain house price appreciation and mortgage lending should not be ruled out if the reacceleration continues. The SNB is rightly concerned about a further build-up in financial imbalances, as negative rates are now expected to remain in place for a long time.

Bond yields should stay negative, as hopes for rate hikes dissipate

We see limited upsides for global and Swiss government bond yields over the next 12 months. The economic cycle is in a late stage and underlying structural issues remain in the Eurozone, with the ECB set to stay on hold, or even cut rates further. This ties the hands of the SNB, likely ruling out rate hikes for years to come. The Swiss bond market is also tight, with government debt projected to fall further in 2020, to below 40% of GDP, and inflation remains weak. We therefore expect Swiss yields to stay broadly unchanged over the coming year.

Prospects for inflation hinge on the currency



Source: Bloomberg

Japan and Korea

Outlook

- Growth in Japan will barely be positive in 2020, but is also distorted by the negative overhang from 2019
- Structural capex and fiscal policy will spur growth, while exports are expected to be a drag
- The Bank of Japan is likely to keep monetary policy stable, but is ready to cut rates further into negative territory

Implications

- Our outlook for Japanese equities is constructive, even though a global correction would also hit Japan
- A resumption of net foreign buying, an earnings recovery and reasonable valuations make Japanese equities attractive
- We expect 10yr JGB yields to hover at the zero percent level

Risks

- A US-China trade war escalation would have negative implications for Japanese exports
- Japan's growth will suffer if our expected global recession turns out not to be as mild as projected
- A significant yen appreciation would be counterproductive to our resilient equity market view

2020: The year of the rat and the Olympics

In 2019, the year of the boar in the astrological calendar, attention towards Japan was focused on the consumption tax hike, the impact of the worst typhoon in sixty years and the Rugby World Cup. In 2020, the year of the rat, the focus will be the Tokyo Olympics and Paralympics.

The 2019 consumption tax hike will distort Japan's reported growth in 2020

The consumption tax hike from 8% to 10% on October 1, 2019 led to a similar rush demand and following drop in consumption as experienced in prior cases of tax hikes (see the chart on the next page). We expect a follow up impact in 2020 purely due to statistical reasons, called the 'negative overhang' from Q4 2019. To understand the impact, let's assume there will be zero change in economic activity in 2020. Still, annual GDP growth for next year will show a negative print purely due to this statistical effect. This is the reason why we will rather focus on the growth trend in 2020 than purely the annual number, which we expect to come in at about 0.2% for 2020.

In 2019, consumer sentiment tumbled due to the expected consumption tax hike and the difficult global trade environment. We believe the counter measures taken by the government, like exempting food from the consumption tax hike, a temporary reward points program for cashless payments and a free education package, has not been appreciated enough particularly by elderly consumers, even though the impact of these initiatives has compensated for the drag of the tax hike. We expect consumer confidence to recover in 2020, as it has usually done after prior consumption tax hikes. Some evidence of this is already visible in forward looking surveys. We also believe that the coming Tokyo Olympics should lift the downbeat mood among Japanese consumers in the second and third quarter. Furthermore, consumers will realise that firm labour market conditions, including record high female employment, and a steady, modest rise in disposable income are likely to continue.

How will the Olympics impact demand?

The impact of the Tokyo Olympics and Paralympics on growth will be more visible in specific consumer categories than in an overall boost. On the investment side, infrastructure capex already peaked in 2018 and will only have a minor impact in H1 2020. We do not expect a sudden fall after the Olympics, as a series of intended and necessary public infrastructure investments remain in the pipeline.

As for consumption, TV and camera producers may see a positive impact in H1, while the lodging and food segments will benefit during the Olympics. Overall consumption may benefit from upbeat consumer confidence before and during the event, however, consumption will probably also experience a drag as many households will refrain from consuming while watching sport events live or at home in front of their screens. As Japan has already been experiencing a tourist boom for some years, which was only recently interrupted by a steep drop in Korean tourists due to the conflict between both countries, we do not expect a significant surge during the Olympics. Potential visitors will probably refrain from visiting Japan during the event due to high hotel prices, fear of overcrowdings and the hot and humid weather conditions, while expenses per tourist will increase substantially.

Capex is likely to be underpinned by structural issues

We believe capital spending in 2020 may suffer in the short term but should be underpinned by structural aspects. These include investments to counter tight labour market conditions by further investing into process automation both in the manufacturing industries as well as in services (like check out machines in hotels, for example). Furthermore, new digital technologies such as Artificial Intelligence, 5G and the 'Internet of Things' require substantial new investments by companies, which should underpin our longer-term stable capex outlook.

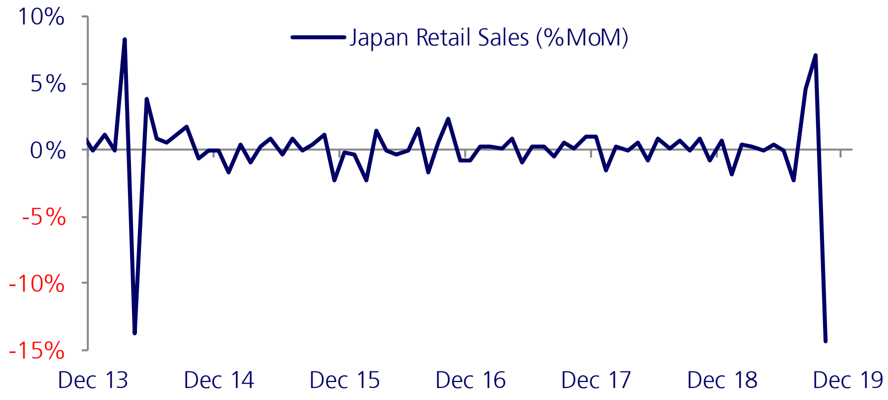
Growth will benefit from a fiscal boost

We believe domestic growth will benefit from a fiscal boost in 2020. The JPY 26tn fiscal stimulus package announced early December is unprecedented in times of solid growth and a strong labour market. While headline grabbing, we need to drill it down to a level that shows what impact it will have on GDP growth. Deducting loans and expected private sector contributions as well as spending under the Fiscal Investment and Loan Program leaves a 'fresh water' impact of JPY 9.4tn that sums up central and local government spending. Deducting the negative fiscal thrust, we believe the net contribution will still be positive, lifting growth in FY2020 to a range of 0.1–0.3 percentage points. However, Japan is facing difficulties in project execution of public work programs due to the tight labour market, particularly in the construction industry.

Lower exports are expected to be a drag on growth

The outlook for exports is less predictable than the one for domestic components of economic growth. It very much depends on

Retail sales plunge again following the consumption tax hike



Source: Bloomberg

the outlook for global trade in an environment of more protectionist policies particularly in the US and China. We also need to watch whether our scenario of a mild US recession with global implications in mid-2020 will develop as expected or can be averted. Our core scenario is that exports will be a drag on growth in 2020 due to the external headwinds mentioned, even though the recovery of the global semiconductor cycle should decrease the drag. Japan, as a leading auto exporter, will continue to suffer from the slump in global auto demand as consumers are delaying plans to buy a new car while the market transitions from combustion engines to electric transmission. Japan is a leading developer of hydrogen cars, but it will take at least a decade before this engine will play a decisive role in the global vehicle market.

No major additional boost expected by the Bank of Japan

The camp of economists is split between those expecting the Bank of Japan to expand monetary policy by channelling policy rates further into negative territory and those who expect the BoJ to refrain from doing so. We believe that the Bank of Japan will remain on hold, and that only some minor stimulus, like expanding ETF buying, may be an option. If our interpretation of the Bank of Japan's latest rather cryptic statement regarding forward guidance on policy rates is right, the BoJ seems principally willing to cut rates further below its current targets of -0.1% for the overnight rate and 0% for its 10yr JGB yields. We believe the Bank of Japan could cut its short-term rate target from -0.1% to -0.3% were the yen to appreciate significantly or the economy to suffer from a global synchronised recession. Unless that happens, the BoJ will favour keeping rates stable as it is aware of the negative implications for financial intermediaries, particularly regional banks. Even though the BoJ has recently paused buying ETFs, we think it could re-engage and even lift its JPY 6tn annual buying target in case the equity market was to suffer significantly.

Weakening price pressures

Until the fourth quarter 2020 consumer prices will remain distorted both to the upside, due to the consumption tax hike, and to the downside, due to free childcare measures. We need to look at underlying inflation tendencies and these suggest only minor inflation, with a chance of seeing even negative inflation prints by the middle of the year. If oil prices remain where they are now, energy inflation will be a drag in H1. Manufactured goods inflation is also going to fall unless the yen weakens significantly, while mobile phone tariffs will continue to exert downward pressure on consumer prices. Overall, inflation will not be a topic in 2020 in our view, even if consumer and business inflation expectations remain elevated. We expect Japan's core inflation to remain stable at a low level.

The equity market outlook depends on the global scenario

In 2019, Japanese equities underperformed their global peers in the first half of the year, stabilised over the summer, outperformed in September following a buying spree in futures by foreigners and have meandered sideways since then. We believe foreign appetite for Japanese equities has just started to re-emerge and has more room to recover in 2020. Index futures buying has recently been followed by net buying in the cash market, a sign that the conviction level of foreigners has improved. We also believe that the Bank of Japan will maintain its ETF buying program, even though it is lagging its 2019 target. Corporate buybacks will be another strong pillar of demand, following a surge in 2019. More companies have started to buy back their own shares, an important trend that is likely to continue. Meanwhile, domestic retail and institutional investors are likely to remain cautious.

Earnings revisions have been negative until recently, but we note that momentum is bottoming. We expect it to turn positive in 2020 and believe EPS to increase steadily next year, unless an external shock hits export related companies. Strong yen appreciation is another risk. Reasonable valuations leave room for upside surprises, while corporate governance reform is expected to underpin the market. However, if our base case of a substantial correction of US equities sets in, Japanese equities could initially correct even more.

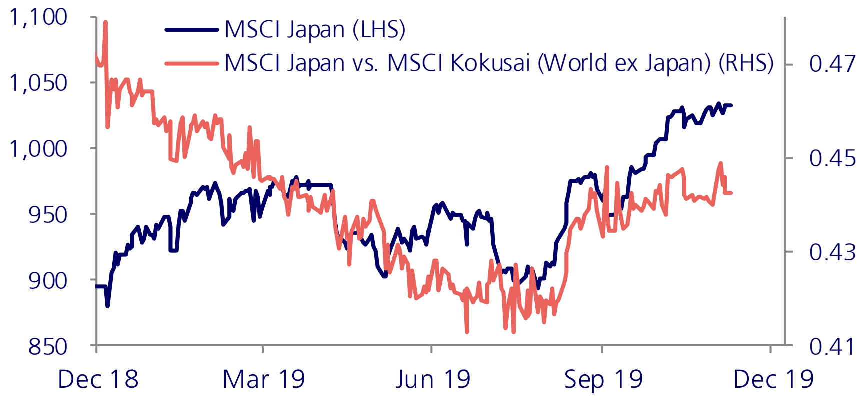
Headwinds for South Korea's growth outlook will remain, but monetary and fiscal stimuli should act as a cushion

In 2019, South Korea's economy fell into a downward spiral as private consumption, capital investment and exports took a beating, while increasing government expenditure helped to act as a countercyclical stabiliser. We expect sub-par growth to continue in H1, but the improving tech cycle should help to underpin a recovery in H2. There is, however, a risk that South Korea would suffer if our mild global recession scenario were to develop in H2. Both monetary and fiscal policy are expected to remain supportive of growth, independent of the outcome of the legislative election in April and the change of five out of seven MPC members at the Bank of Korea.

Macro-prudential tightening measures in the real estate market are likely to continue in order to put a lid on household debt growth, but leading construction indicators suggest that the worst is behind us.

The government has refrained from implementing another steep rise of the minimum wage, limiting it to 2.9% following the 30% rise over the last two years. This should help the labour market, even though employment growth will remain weak.

MSCI Japan reaches year's high and is outperforming after a slump



Source: Bloomberg

China and Taiwan

Outlook

- China's growth will be patchy in 2019, but no hard landing is expected
- Consumption growth is likely to remain lacklustre, while infrastructure investment is expected to pick up
- Long-term issues between the US and China will prevail despite short-term trade agreements

Implications

- We expect modest stimulus measures to be implemented both on the monetary and fiscal front
- The USDCNY should remain rangebound
- Decent earnings growth and fair valuations should support Chinese equities, with the 'A-H' performance gap narrowing

Risks

- The conflict with the US could deteriorate again
- Export growth could suffer once our global mild recession scenario kicks in
- Worsening labour market conditions could deteriorate significantly

The growth slowdown will continue

We expect China's growth to slow down further in 2020. As China's economy develops further and the ageing of its population continues, the momentum of growth is structurally weakening. In addition, there are other issues hampering growth like the global trade slowdown in general and the strategic issues with the US in particular. Following our estimated growth rate of 6.2% YoY for 2019 we forecast 5.9% for 2020, with the understanding that China's official GDP statistics are facing criticism for not fully reflecting China's effective growth rate.

China statistically needs to show growth rates of 6.15% YoY for both 2019 and 2020 to achieve its target of doubling GDP and income by 2020. We believe this will not be a critical issue, because the latest census showed that China's effective growth over the last eight years was stronger than previously published, allowing for weaker growth next year to achieve its ambitious target. We expect the official 2020 growth target, which will be announced during the National People's Congress in spring next year to be 'around 6%', down from 6%-6.5% this year. The decision regarding the growth target will already have been made during the Economic Work Conference in December 2019.

Again: No hard landing expected

Even though we assume that growth rates will continue to creep lower, this does - once again - not suggest a hard landing scenario, as China has enough tools to counter such a situation. In 2019, China refrained from major old-style broad-based stimulus, as the deleveraging process remains intact and budget constraints bite. Stimulus has become more targeted, favouring private high-tech and environmentally friendly industries, for example. Certainly, the government could be willing to shift its stance towards more broad-based stimulus in case the economy were to fall into a tailspin, but this is not our core scenario. A critical trigger point could be a significant deterioration in the labour market, which is difficult to confirm through official data, but rather more visible by anecdotal evidence or by focusing on the employment PMIs. The latter are hovering below the 'boom-bust' level of 50, which is a concern.

Mixed consumption outlook

We expect consumption growth to remain lacklustre in 2020 amid tougher employment conditions, a subdued housing market and the drag on real income due to higher pork prices. Indeed, pork prices have doubled because of African Swine Fever, hitting consumer sentiment particularly among low-income households, though the negative impact is expected to peak out in H1. Car sales have been a drag on consumption, falling since the summer of 2018, partly due to the end of subsidies, and it is difficult to envisage a significant turn for the better in 2020, unless some tax incentives are announced. Netting out car and fuel sales, retail sales growth has been more stable. Even though online retail sales growth has come down from its 50% YoY rate five years ago, it is still hovering in the mid-teen percentage range. Rising household leverage, mainly due to an increase in mortgage lending, as well as the lagging impact of trade disruptions on the manufacturing sector remain risks that need to be observed.

Will investment growth recover?

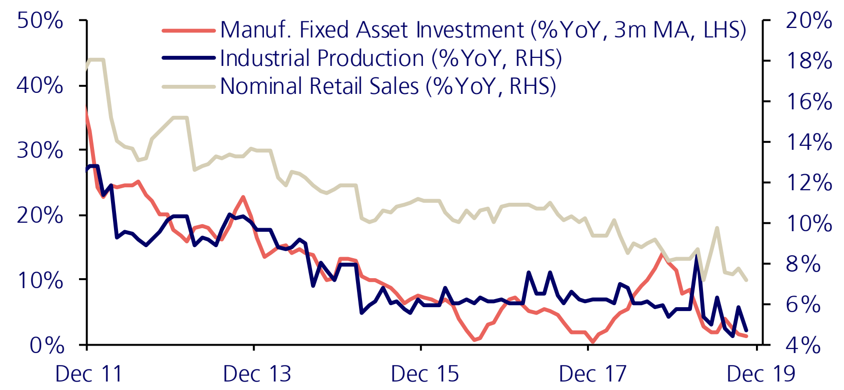
Fixed asset investment growth has tumbled from 30% to 4% YoY within the last ten years. Difficult funding conditions for the private sector, supply chain relocations to other countries like Vietnam, uncertainty amid trade issues and slower housing construction are all reasons that have played a role and will not disappear. A stabilisation on the trade front and an improving global semiconductor cycle could help create new incentives to invest more. Specifically, China's telecom industry is expected to increase 5G network investments further over the next two years. Property investment growth will probably not remain as resilient in 2020 as in 2019, not at least because falling land sales will go hand in hand with fewer real estate developments.

The bright spot is likely to be infrastructure investments, as local governments are frontloading the issuance of special-purpose bonds and are being urged by the central government to invest the proceeds in infrastructure projects instead of land. We expect a boost in Q2 once weather conditions improve. China's authorities need to find a solution to the problem of bureaucrats receiving lifetime penalties in cases of mis-investment. This measure was indeed necessary to handle excess investments by local governments without focusing on the return on investments. However, it has also made local government officials overly cautious about investing into public infrastructure even if funds are available. A more balanced investment approach is required.

Drag on exports will persist

On the US-China trade front we expect a Phase 1 deal to bring a solution that enables a permanent suspension of the 15% tariff hike from October and perhaps even a suspension of the planned 15% hike in December 2019. A rollback of existing tariffs, which has been brought to the agenda by Chinese negotiators, looks unlikely for now, but could become a topic in the Phase 2 negotiations. China could increase agricultural imports from the US and could further increase its control over intellectual property abuse. The existing tariffs, however, will have a negative impact on merchandise exports in 2020 and remain a drag on GDP growth. We also believe that

China's economic activity growth continues to decline



Source: NBS, Bloomberg, ZIG

partial trade deals will not change the broader picture of a deteriorating relationship between the world's biggest economies. There are risks on both sides. In a worst-case scenario of 30% tariffs on all US imports from China, GDP growth would slow significantly towards 5% even if domestic stimulus measures were to increase. This seems unlikely to us.

Stimulus will be aimed at stabilising, not fostering growth

We do expect modest fiscal and monetary stimulus in 2020. Local government bond issuance will expand further from 2019, with most funds spent on infrastructure projects, and issuance of 1 trillion yuan of the 2020 local government special bonds brought forward to this year. The amount equals nearly half of the 2019 quota. Restrictions on local government financing vehicles could also be eased somewhat. Turning to monetary policy we expect more reserve requirement ratio cuts in 2020. Once consumer price inflation has peaked in H1, the PBoC may be willing to incorporate modest cuts in the medium-term loan facility rate step-by-step, which then will also be reflected in the new loan prime rate. Overall, we expect aggregate credit to start expanding again on a YoY basis from 10.7% currently to around 11.5%, enabling a positive credit impulse.

Controlled yuan fluctuations

We believe the USDCNY will continue to hover in a 6.80 to 7.20 range. A sharp depreciation will be prevented in order to avoid capital flight, while the lower band may be reached, or even exceeded, if Phase 2 and Phase 3 trade negotiations were to result in a complete rolling back of previously installed tariffs on US imports from China, a scenario that is certainly not our baseline.

We are cautiously optimistic for Chinese equities

Chinese equities have clearly underperformed their global peers in 2019. Within the different categories, Hong Kong's Hang Seng index and China's Hong Kong listed 'H'-shares have barely gained at all and are the worst performers within major Asian equity markets along with the ASEAN markets and Korea, while China's domestic 'A'-shares have rallied 30% year-to-date. Hong Kong listed shares suffered from tighter financial conditions in China, the negative impact of US-China trade issues and the events in Hong Kong. 'A'-shares, meanwhile, benefitted from the MSCI index inclusion increase.

Our outlook for 2020 is cautiously optimistic, as earnings growth is expected to continue at around 10%, while valuations are fair. Funding costs will decrease as elaborated before, and stocks representing 'New China' show higher earnings growth particularly in the high-tech, media and consumer segments versus the 'old' industrial sectors. We believe 'H'-shares will narrow the performance gap to 'A'-shares, as another round of MSCI Index inclusion will take some time, while the 'southbound' flow from Mainland China to Hong Kong has some room to catch up. In the longer term, however, the 'A'-share story remains compelling for foreign investors. The development of the US-China relationship opens both upside and downside risks.

Taiwan's investment boom is likely to continue, while export growth could falter

GDP growth in Taiwan accelerated in the first three quarters of 2019, benefitting from strong exports of high-tech intermediate goods to the US, due to a shift from China to Taiwan based suppliers. This has overcompensated for weaker demand for these products from China. As we believe the first wave is over, and as China will become less dependent on Taiwan's supply, we expect export momentum to weaken in 2020. Taiwanese exports will also suffer if our global mild recession scenario unfolds.

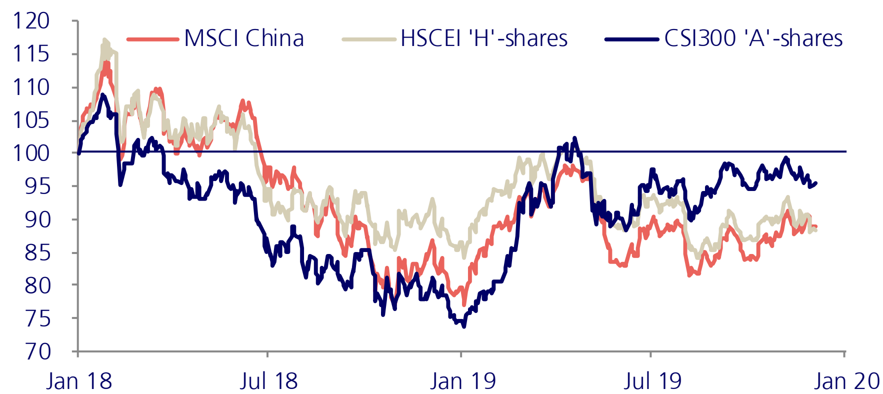
On the domestic side, strong infrastructure investment will not only prevail, but accelerate, as the government is planning to double its infrastructure spending, given that its debt-to-GDP ratio has fallen to a comfortable level of 30% over the last five years. There have been about 150 approvals for companies to return from Mainland China to Taiwan this year, and we expect significant private capital investments by these firms. Indeed, the government has doubled its target for investments by returning companies to TWD 500bn, with further increases expected.

We expect Taiwan's central bank, CBC, to keep its policy rate on hold at 1.375% with both headline and core inflation remaining far below its 2% target. However, we could envision a 0.125ppt cut later in 2020 in case the global economic trend deteriorates or if US-China trade issues were to worsen again.

On the political front both legislative and Presidential elections will be held on January 11, 2020, with polls suggesting that the incumbent party and president will win by a solid margin.

Taiwan's equity market has performed well in 2019 but valuations look now somewhat stretched on a forward basis, even if incorporating a decent earnings recovery and a solid dividend yield. Furthermore, Taiwanese equities will not be able to escape a correction in global equities.

All of China's major equity indices show negative two-year returns



Source: Bloomberg (Indexed to 100 on 1. January 2018)

ASEAN and India

Outlook

- The growth outlook is more constructive towards year-end but contingent on the trade and tech cycle momentum
- Further monetary easing is likely with limited support from fiscal policy
- A shift in production out of China should support foreign investment

Implications

- Equities are likely to lag amid weak corporate earnings and limited appetite for EM risk assets
- Regional bonds will be attractive as investors actively search for yield in a global environment of low interest rates
- Robust capital inflow and a recovery in exports will support currencies

Risks

- Trade escalation causes further disruptions in the regional supply chain
- Several countries are vulnerable to financial shocks amid high external debt and budget deficits
- A slippage in currencies de-stabilises the economies in the region

There is still room for growth

ASEAN and India's economies had been the world's growth engine during the last several years before slowing sharply in 2019 as a result of eroding exports, lacklustre manufacturing activity and subdued business investment. While we expect the economic slowdown to extend into 2020, there is still potential for growth.

First, most of the regional central banks have room for further easing. Benign inflation and high nominal policy rates will allow central banks to cut rates further while still maintaining a reasonable bandwidth between their interest rates and those in other advanced markets, avoiding capital outflow and currency depreciation.

Second, there is initial evidence that the global semiconductor cycle is bottoming out, providing ground for a recovery in electronic shipments. Singapore and Malaysia are the main beneficiaries, given their active participation in the semiconductor supply chain.

Third, a relocation of US and international companies out of China benefits the region. Given the competitiveness in labour and input costs as well as ongoing reforms to liberalise foreign investment, ASEAN and India seem to have the right elements to challenge China as a manufacturing hub.

Nevertheless, there are some risk factors to bear in mind. Fiscal deficits and high external debt to GDP ratios in some countries make the region vulnerable to external shocks. They also restrict the governments' ability to deliver further fiscal stimulus. Moreover, as an export-oriented economy, ASEAN is strongly linked to the global trade cycle and further disruptions in trade. Therefore, the global supply chain might weigh heavily on regional growth.

Risks and opportunities from the trade war

The trade dispute between the US and China has created both risks and opportunities for ASEAN and India.

In the short term, disruptions in the supply chain continue to put pressure on the exports of most countries as they are highly exposed to China's demand for materials, machinery and electronic parts. We expect Singapore and Malaysia's exports to be weak in particular as they are caught in a bottoming process of the global semiconductor cycle.

In the medium term, ASEAN and India will benefit from rising relocation needs of US and international firms moving out of China. In fact, before the tariff escalation took place, a gradual shift by international companies towards neighbouring countries had already begun. Since China is moving up in the value chain, its production costs are no longer so competitive. Certainly, this trend has been strengthened by the US-China trade spat, with Vietnam being the largest beneficiary so far. Going forward, we envisage other countries including Thailand, Malaysia, probably the Philippines and India gaining more traction from this trend.

Separately, ASEAN is also strengthening its position as an important trading partner of China, especially when trade flow between the US and China is expected to stall even if a trade agreement is reached.

Malaysia: A lack of fiscal support

Malaysia's growth stalled in 2019 with a pronounced weakness in exports. Business investment deteriorated sharply while private consumption held up well, partly balancing declines in other sectors. From a policy perspective, Bank Negara Malaysia (BNM) delivered a 25bps rate cut in May and has paused since then. The government was cautious about spending in an attempt to meet the 3% GDP budget deficit target, even though the actual figure edged up to 3.4% later.

The 2020 budget aims to achieve a deficit of 3.2%, an upward revision from 3% as a compromise given the subdued growth outlook. Nevertheless, the budget is still heading in the direction of tightening, although it is hoped that infrastructure investment moderately improves compared to 2019. Insufficient fiscal stimulus makes monetary policy the first line of defence. Therefore, we expect the BNM will ease its policy more decisively in 2020.

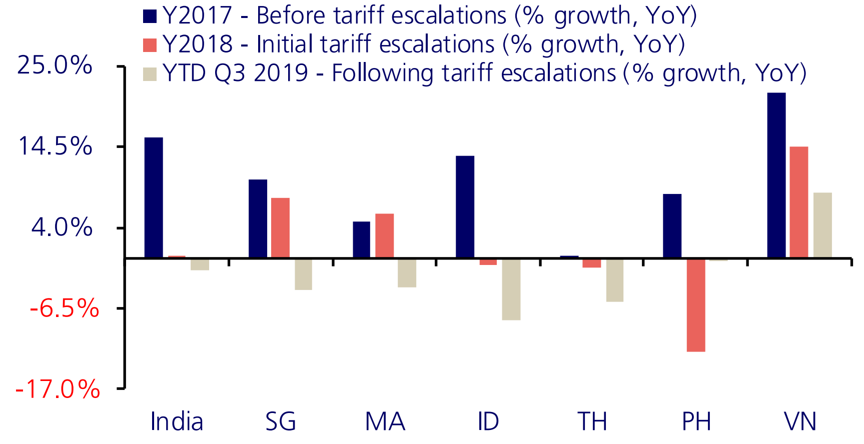
Subdued economic activity will be prolonged into next year with a potential pickup in H2 amid a recovery in the semiconductor cycle and a more visible shift of production out of China to Malaysia. However, a further escalation of trade disputes or a stronger than expected global slowdown will halt the recovery process.

Indonesia: Growth stagnates

Indonesian growth slowed modestly in 2019. Although the economy is more immune to trade headwinds when compared to its neighbours, lower oil prices and the global slowdown took a toll on growth. President Joko Widodo was re-elected, aiming to achieve 6% growth for Indonesia in his second term, a lower target than his 7% goal in the first term. However, it remains to be seen whether decisive steps are taken with regards to reforms and stimulus, as the process has been somewhat delayed so far.

Looking ahead, the Indonesian growth outlook remains stagnant. Growth will likely not escape the 5% trap and even edge lower amid challenging global macro conditions. We do not expect the country to benefit so much from the supply chain shift since its rigid business environment and labour laws make it a less desirable location for foreign

Trade tensions have uneven effects on ASEAN and India



Source: Bloomberg

investment. Even if further reforms come to pass, we will see more positive impact on sentiment, rather than on actual investment, as reforms take time to show an effect on economic activity.

On the policy front, fiscal stimulus seems limited as the 2020 budget aims to narrow the deficit to 1.8% of GDP, compared to a target of 1.9% in 2019. The reappointment of the Finance Minister, Sri Mulyani, also implies that the government will continue to adopt a conservative fiscal approach. Hence, the burden of easing will be mainly on the central bank's shoulders. Bank Indonesia (BI) was among the most active regional central banks in lowering interest rates in 2019. We expect more rate cuts to come in H1 2020 and the positive impulse of rate cuts is likely to be seen in H2 2020.

India: Credit conditions drag on growth

After an acceleration in the last few years, India's growth seems to have hit a wall in 2019. Even though India is not particularly sensitive to trade headwinds, the economy has its own troubles. The default of large non-banking financial companies (NBFCs) in September 2018 has pulled down the growth momentum. Indeed, shadow banking plays an important role in the economy as many firms seek funding through NBFCs, especially real estate developers. The collapse of several NBFCs and tightened lending standards following the defaults have caused a credit crunch, which weighs heavily on the construction sector and is causing rural stress given that many rural jobs are supplied by the construction industry.

Looking forward, there are a few factors that will hinder growth. The ongoing global slowdown in 2020 does not help exports**.** A credit crunch, a high level of non-performing loans and stretched corporate balance sheets are impeding investment growth. These issues might take a few years to be fully tackled, dragging heavily on the economy. On top of that, they also obstruct the transmission mechanism of monetary easing by the central bank.

Nevertheless, there are also positive impulses, which will counterbalance the setbacks. The effects of previous policy rate cuts and the corporate tax reduction should be realised in 2020. We expect more easing by the Reserve Bank of India (RBI) to come together with other measures to underpin the monetary transmission mechanism. Other than that, India is likely to benefit from the supply chain shift away from China. In addition to existing competitiveness in labour and input costs, ease of doing business has improved as the government took steps in labour reform, FDI liberalisation and corporate tax cuts. These measures will boost growth in foreign investment, encouraging economic activity and accelerating growth in the longer term.

Bonds are resilient while equities underperform

Our view on bonds is constructive. For investors seeking yield, government bonds in emerging markets like ASEAN and India are preferred to EM equities, especially when governments' default risks are low on the back of subdued inflation and a comfortable range of policy rates. Besides, resilient currencies and lower debt servicing costs provide investors with some confidence when considering putting money into government bonds.

In contrast, we expect equities to underperform their global peers backed on weak fundamentals and a flight-to-safety phenomenon during a gloomy time. Accordingly, lacklustre growth and weak exports are putting pressure on corporate earnings. Likewise, subdued business investment does not prepare the ground for a potential acceleration in earnings. Given a bleak macro picture, investors will tend to rotate from EM equities to safer asset classes such as gold, safe haven currencies and bonds. Hence, momentum will probably dip. This is particularly true for Malaysia, where equities have lagged for many years given the country's high sensitivity to external debt and investors' lack of confidence in the market performance.

Notably, Indian stocks traded higher in 2019, mostly decoupling from regional EM stock movements. Although we might see a continuation of the bull market in the short-term given the current robust momentum, risks of a rollover are high amid fading optimism post-tax cuts and uncertain growth prospects. Meanwhile, Vietnam's stocks have attracted more attention as the country is one of the biggest gainers of the trade war. However, a high barrier of entry owing to a limit on foreign shareholding imposed by the government is preventing foreign investors from having significant influence on the market.

Turning to currencies, we expect they will have a decent performance next year, supported by robust foreign investment. Also, as global growth troughs towards the end of 2020 following our base case, we envisage capital inflows into financial markets gradually increasing while exports will probably recover, supporting currencies.

ASEAN equities continue to underperform DM equities

Source: Bloomberg

Australia

Outlook

- The growth outlook is subdued with some signs of recovery towards the end of 2020
- An absence of price pressures from both supply and demand will keep a lid on inflation
- Labour market slack remains, paving the way for further monetary easing

Implications

- Bond yields will remain capped as interest rates are expected to stay low for longer
- Equities are likely to come under pressure on rising macro risks, but further monetary easing will provide support
- House prices should improve although upside will be limited given the high level of household debt

Risks

- Global macro and geopolitical headwinds intensify, weighing on sentiment and domestic conditions
- Lower interest rates and looser lending standards overheat the housing market, elevating financial risks
- High household debt coupled with rising unemployment trigger an economic downturn

A challenging year ahead

2019 marked the weakest growth level for the Australian economy since the global financial crisis (GFC). Subdued consumption and a sharp decline in business investment dragged on growth while buoyant public spending and resilient commodity exports helped to absorb some weakness. Several policy measures including policy rate cuts, looser lending standards and tax refunds to low and middle-income households have been implemented to support growth. However, we have not yet seen a meaningful pickup in broad-based economic activity. We believe there are two main themes that are going to shape Australia's growth outlook in 2020: global economic conditions and policy coping mechanisms.

First, the global macro environment remains challenging in 2020. While Australia is not directly tied to the semiconductor cycle and the Asian supply chain, the economy is highly linked to the global commodity cycle, China's economic performance and international capital markets. Therefore, a synchronised global slowdown, uncertainty around trade disputes and Brexit, as well as China's structural shift towards a service-oriented economy continue to have a great impact on the economic performance of Australia.

Second, policy responses matter. Australia has relatively better demographics than other developed economies with robust population growth and plenty of spare capacity in the labour market. While these conditions put pressure on the economy to create new jobs to keep up with the rise in population, it also means there is still room for policy stimulus to have an effect. On the other hand, the Reserve Bank of Australia's policy rate is approaching its lower bound, leaving less space for further rate cuts. Therefore, a good mix between fiscal and monetary measures is needed to boost economic activity and bolster the economy from external shocks.

Given that the current momentum is still very weak, and previous stimulus needs time to transmit and penetrate through the economy, we expect growth to slow further in 2020 and potentially recover towards the end of the year.

Muted inflation persists

Coupled with the economic slowdown is muted inflation across developed economies. Australia is not an exception. An absence of price pressures, from both the demand and supply side, is capping an upswing in prices. Subdued final demand amid lacklustre economic growth means a lack of demand-pull factors. From a cost perspective, low global oil prices keep domestic energy costs in check, while wage growth remains soft given rising unemployment.

The upside risks for inflation might be further depreciation of the AUD or natural disasters such as droughts putting pressures on food prices. However, these factors might not be strong enough to fully offset the weakness in prices.

Upward pressure on unemployment

Australia's population growth stands at 1.6% per annum as of March 2019 according to the Australian Bureau of Statistics. While robust growth in population fuels domestic demand for products and services, the employment gap tends to widen if job growth is weaker than an increase in the workforce, especially when the employment participation rate stands at a high level.

The rollout of the National Disability Insurance Scheme (NDIS), which provides financial support and services to people with permanent and significant disabilities, continues to boost employment growth in the healthcare and social assistance area. However, job growth in the business sector is expected to be subdued as economic activity and business sentiment remain downbeat, making companies cautious about expanding their workforce. That noted, we expect the unemployment rate currently at 5.3% to edge higher, drifting further away from the RBA's estimate of structural unemployment (NAIRU) at 4.5%, paving the way for further policy easing.

A housing boom is unlikely

A recovery in house prices during 2019 reduced fears of a housing crash, which was emerging at the end of 2018, but it is still too early to expect a strong boom ahead. While policy rate cuts and an easing of lending standards are boosting home loans and house prices, several factors will put a lid on a further acceleration in house prices.

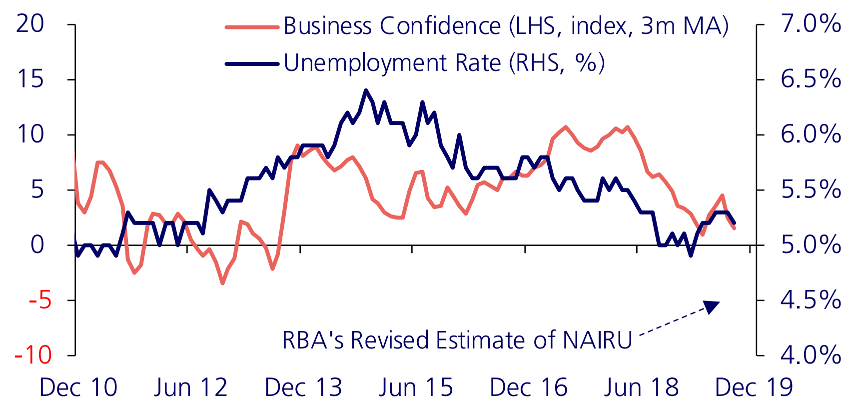
First, when it comes to taking new loans, Australian households are already quite stretched given the high levels of household debt to income and subdued wage growth. Second, while there is not yet a clear sign of stronger demand, investors remain vigilant for investment opportunities in the real estate market. Finally, the authorities are closely scrutinising dwelling activity as it plays an important role in the financial system.

Policy coordination is needed to lift growth

In 2019, the RBA and the government joined forces to provide stimulus amid rising global headwinds and weak domestic performance. We expect this to remain a tendency in 2020. However, there are a several matters that might limit policy impact in 2020.

Further cuts might not be as effective since lower interest rates have a diminishing effect or even negatively weigh on sentiment and banking profitability. Therefore, the RBA seems keener on an unconventional monetary

Labour market slack and weak sentiment prompt further easing



Source: Bloomberg

policy like quantitative easing (QE) than cutting rates into negative territory.

On the fiscal front, the government seems unwilling to jeopardise its current fiscal surplus. Thus, fiscal stimulus might not be the first card on the table unless economic data show sharper drops.

During a prolonged period of low interest rates when monetary policy loses its effectiveness and low interest rates might increase debt and elevate financial risks, fiscal spending plays an important role. Therefore, we believe a good mix between fiscal and monetary policy is needed to support the economy.

A weaker currency supports exports

While currencies in developed markets tend to strengthen during an economic downturn amid flights to safe-haven assets, the AUD has historically behaved more like a volatile commodity currency, largely driven by global commodity demand and prices. However, this relationship did not hold in 2019. The Aussie dollar dropped by almost 7% against the USD in 2019 despite a surge in iron ore prices. The reason behind this was probably a more aggressive easing by the Reserve Bank of Australia (RBA) compared to the Fed and other central banks of Australia's major trading partners. Besides, a weak currency also reflects weak underlying economic activity in 2019.

Looking forward, the Australian dollar is expected to remain subdued as the RBA continues cutting its policy rate to a lower bound and perhaps consider QE. Moreover, iron oil prices have come off the boil recently, relieving an upward pressure on the currency.

We expect a weaker currency to support shipments. In addition, China's infrastructure investment plan will remain buoyant in 2020, keeping iron ore demand from Australia resilient. That said, robust exports will be a silver lining amid lacklustre economic activity in other sectors.

Subdued bond yields driven by an extended period of low interest rates

Australia's bond market shared a similar trend with other advanced economies in 2019. Lower interest rates translate into lower bond yields, coupled with higher investor demand for DM bonds given rising macro risks and political uncertainty.

As the RBA's rate approaches a lower bound and the discussion on QE emerges, bond yields are expected to remain at historical lows in 2020.

Equity market: a ball game between bulls and bears

Australia's stocks had a decent year of performance, reaching new highs despite a fragile macro environment and global headwinds. Liquidity injection by the central bank through rate cuts and loosened lending standards have largely driven the climb. Other factors such as post-election optimism, improvement in the housing market and rising appetite for DM equities amid a global risk-off episode also played crucial roles. We expect market volatility to be high in 2020, moving in undecisive directions but QE is going to be a game changer. There are three main drivers behind this assumption: the global political environment, domestic conditions and monetary policies.

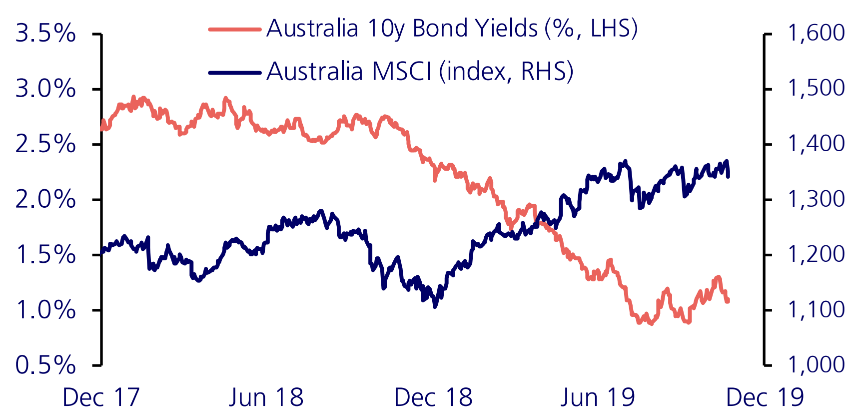
On the political front, despite some improvements in US-China trade dialogues and a potential Brexit deal, there are not yet concrete solutions. It might take years for these issues to be addressed and the US election will create more noise in 2020, driving up volatility in the market.

Domestic conditions are expected to be weak before they improve towards the end of 2020. As soft data persist and corporate earnings are further impacted, investor sentiment is likely to be downbeat, putting downward pressure on stock prices.

A counter-balancing factor is accommodative monetary policy, especially if QE is to be implemented for the first time in Australia. It will be a strong boost for risk assets like equities given that elsewhere in emerging Asia, equities are expected to lag amid a risk-off episode in global capital markets. On top of that, Australian bond yields are expected to stay low for longer and the property market is still taking its time to recover.

The performance of financial stocks is critical as they account for more than 30% of the ASX 200 index as of 2019. Although a pickup in home loans due to a recovery in the housing market lends support to banks, a low interest environment should put pressure on their profitability. Nevertheless, we expect the banking system to remain resilient, except if an economic downturn is more severe than we have expected, driving up the number of non-performing loans. This is a potential risk as households are already in highly leveraged positions.

Equities rally while bond yields are capped amid lower interest rates



Source: Bloomberg

Contact

Guy Miller
Chief Market Strategist
Head of Macroeconomics

guy.miller@zurich.com
+41 44 625 28 85

Julien Seetharamdoo
Head of European Market Strategy

julien.seetharamdoo@zurich.com
+41 44 625 39 53

Ha Nguyen
Senior Investment Analyst
Asia-Pacific

ha.nguyen@zurich.com
+41 44 628 56 45

Puneet Sharma
Head of Credit Strategy

puneet.sharma@zurich.com
+41 44 625 30 04

Charlotta Groth
Global Macroeconomist

charlotta.groth@zurich.com
+41 44 625 25 40

Thomas Liebi
Head of US and UK Market Strategy

thomas.liebi@zurich.com
+41 44 625 25 47

Håkan Hedström
Head of Asian Market Strategy

hokan.hedstroem@zurich.com
+41 44 625 31 93

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Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001631 (01/16) TCL

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