

# Investment Outlooks 2019



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# Welcome to

# Schroders Investment Outlooks 2019

**Schroders Investment Outlooks 2019 brings together the views of Schroders' global experts as they share their thoughts on the coming 12 months.**

We hope that these outlooks will provide an informative snapshot of what to expect in 2019 and beyond.

For more articles, please visit [www.schroderstalkingpoint.com](http://www.schroderstalkingpoint.com)



# Outlook 2019:

## Why 2019 might be a better year for investors

### Author

**Peter Harrison**  
Group Chief Executive



## After the disappointment of 2018, Chief Executive Peter Harrison rounds-up the factors our fund managers think could lead to a brighter year ahead.

2018 has been a disappointing year for most investors. Almost all markets, both stocks and bonds, have fallen in value this year, under pressure from rising interest rates, political developments such as Brexit, and the trade dispute between the US and China. With hindsight, markets were priced for perfection at the start of 2017 and were vulnerable to bad news - and there has been plenty of that.

It is easy to be influenced by the pessimism now affecting markets. We accept that there is likely to be more bad news in 2019 - and I would pick out the trade dispute between the US and China as showing no sign of resolution and with the potential to damage economic growth around the world. But there are signs that market returns may be more positive in 2019.

Greater realism has arrived with falls in stock markets, particularly since September. Markets are pricing in at least some of the risks we have identified.

Schroders' economists expect a gradual slowdown in growth in the US in 2019 and 2020. The emphasis is on the word gradual: we do not see a recession as likely in 2019 (although not inconceivable in 2020) as many of the forces that led to a strong year in the US in 2018 are still in play. The slowdown, however, means that an end to the cycle of rising interest rates is in sight. If we are right that interest rates rise no further than 3%, that is a modest peak compared to past economic cycles.

Our equity fund managers all point to slightly higher inflation next year as helpful to those companies that have strong market positions and the ability to raise prices. They also see more attractive valuations for many companies. Even in Europe and the UK, where growth has been disappointing, the income return from dividends alone looks more attractive compared to cash or bonds than for some time. Equities do, of course, carry greater risk along with potential for higher returns though.

Weaker growth in the US is also likely to lead to the US dollar losing ground against other currencies. This is good news for emerging stock and bond markets as a strong dollar sucks money away from these markets. Emerging markets, including China, have suffered particularly badly in 2018 and we would not be surprised to see them recover in 2019. Our multi-asset team describes their valuation as "provocatively low".

Our bond managers are not so comfortable about the outlook, with the central banks, who have been huge buyers of government and other bonds, steadily departing the field. Corporate bonds, however, have become cheaper in recent months and, if we are right about a limited slowdown in the US next year, will be supported by strong fundamentals.

2018 was the year in which the long term sustainability of business models started to influence how the market prices companies. We have seen criticism of some practices of large technology companies leading to falls in their stock prices, and increasing physical damage caused by climate change; inequality between generations has led to political turmoil in several European countries. Across our investment decision-making an eye on sustainability is becoming more and more critical.

We recently published a 10-year outlook for markets, Inescapable investment truths for the decade ahead. This highlighted the modest return prospects from public markets, given lower rates of economic growth than in the past and the low level of bond yields. 2019 will fit that pattern, with positive returns likely, but investors having to work hard - both through asset allocation and security selection - to augment low headline market returns.

I also continue to believe that private assets such as private equity and real estate will, as part of a diversified portfolio, help investors achieve their goals.

On this basis, 2019 should be a better year than 2018.

“  
Across our investment decision-making an eye on sustainability is becoming more and more critical.  
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# Outlook 2019: Asian bonds

## Authors

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**Julia Ho**

Head of Asian Macro



- The Asian bond market has been hurt in 2018 by robust US growth and a more hawkish Federal Reserve, but this headwind should fade in the coming year
- The ongoing US-China trade war remain a risk to watch but opportunities are still present as Asia is not a homogenous region; country and credit differentiation will be key
- Corporate bonds from a number of robust issuers with strong balance sheets have sold off aggressively this year, and this provides a number of opportunities

**Angus Hui**

Head of Asian & Emerging Market Credit



**We expect that the US dollar's strength should fade in 2019 as the pace of US rate hikes begin to slow, which will ease the pressure on bonds next year.**

The US spent much of 2018 exceeding expectations. Growth in the US economy was stronger than expected. Interest rates rose more rapidly than expected, leading to a stronger-than-anticipated US dollar (USD). In combination, these factors have created much angst for Asian bond markets, resulting in negative performance.

At the same time, the region has had to grapple with a slowing Chinese economy, mostly as a result of the country's efforts to reduce debt in the financial sector over the past two years. That is to say nothing of the trade war with the US, which has weighed on domestic business confidence and dominated headlines. Asian currencies and higher yielding bond markets - such as Philippines, India and Indonesia - are more vulnerable to USD funding, took the brunt of the repricing. Consequently, while valuations for the region have become more attractive, fundamentals have remained solidly intact.

Going into 2019, we expect the USD strength to wane, easing pressure on Asian currencies. This is especially true for India, Indonesia and the Philippines, that have struggled the most this year, even though the outlook on global growth remains uncertain and China may slow further still. The pause in the upward USD trend should provide breathing space for the central banks in Asia to adjust monetary policy to limit any further downside to growth or currency weakness. With regards to China, we believe it would be positive for the Chinese bond market if policymakers continue to engage in further reserve ratio requirement (RRR) cuts and provide further targeted stimulus to stabilise growth. We expect these policy actions - such as further RRR cuts - would support the Chinese economy in early 2019, and this should in turn be a positive for other countries dependent on trade with China in the region.

## Trade war ceasefire?

The ongoing trade war between US and China is not likely to see a resolution soon. However, tensions appear to have eased slightly. Both sides seem eager to limit the trade wars' negative impact on growth of their respective economies. We believe this paints a constructive backdrop for Asian currencies and local currency sovereign bond markets, as markets are still pricing in a deterioration of the situation.

In terms of USD denominated (hard currency) credit markets, trade related tensions may have slowed the strong economic growth witnessed last year, but it is worth noting that a large part of the Asian USD denominated credit universe comprises issuers that do not have export driven businesses. We expect domestic conditions across a large swathe of the emerging Asian universe – China, India, Indonesia, Philippines and Thailand - to continue to power ahead in 2019. The flip side of this is of course that the more export oriented economies of Hong Kong, Singapore, South Korea and Taiwan could experience a slowdown. Hence, performance is likely to be differentiated amongst countries in the region given the differing economic dynamics. With less pressure from a rising USD and the likelihood of much more gradual US monetary policy normalisation from here, regional Asian central banks are likely to ease off on their monetary policy tightening bias thereby easing cost of funding pressures for corporates in their local markets.

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**Asian bonds provide fertile ground for investors seeking high quality capital gain and yield in 2019.**  
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## Fundamental strength key to returns

Credit fundamentals of investment grade Asian economies continue to be robust, with strong reserves and fiscally prudent policies that should enable them to continue to weather volatile macroeconomic conditions. Similarly, we expect credit fundamentals for USD denominated investment grade corporate bonds to remain robust with South East Asian companies likely to hold up better than their North Asian counterparts. Across both the investment grade and high yield space, credits with solid fundamentals have seen a significant weakening in prices due to numerous factors (the oil price, Fed guidance, policy risk etc.) and could be a good place for investors to look for positive medium to long-term returns.

We see a number of opportunities currently in Indonesian and Chinese high yield companies. Within the USD denominated high yield universe, Chinese property issuers constitute the largest part of the market and we expect to see a divergence in credit fundamentals amongst these issuers as a tougher operating environment separates the strong from the weak due to refinancing concerns. However, increasing evidence of Chinese policy support to address these concerns should help boost investor confidence and see sentiment improve as we progress through 2019.

The realities of quantitative easing in Europe ending means investors are likely to remain relatively cautious in the New Year. That said, we also doubt an extreme “risk off” scenario will develop, as signals that portend a global recession remain largely absent.

In the coming year, our focus will be to emphasize selectivity and pick countries and companies with robust balance sheets that have wide access to financing channels. With yields ranging from 2% to 9% across the credit quality spectrum in USD and Asian currencies, and the increasing possibility of a peak in US rates, we believe that Asian bonds provide fertile ground for investors seeking high quality capital gain and yield in 2019.

# Outlook 2019:

## Asian ex Japan equities

### Authors

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#### Toby Hudson

Head of Asian  
ex Japan Equities



#### Matthew Dobbs

Fund Manager,  
Asian Equities &  
Head of Global  
Small Cap



#### Robin Parbrook

Co-Head of Asian  
Equity Alternative  
Investments



#### Lee King Fui

Head of Asian Equities  
(Singapore)



- Asian equities have cheapened providing selective buying opportunities
- There are promising opportunities across various areas including businesses benefiting from long-term regional trends, domestic-oriented companies, exporters and banks
- Uncertainty related to China, as well as a stronger US dollar and higher US interest rates are key risks to the region

**A tumultuous 2018 has left Asian equities significantly cheaper and presenting selective opportunities, but investors need to tread carefully. Three of our Asian equity managers explain why.**

It's been a poor 2018 for Asian equities. Hampered by trade tensions, central bank tightening and a strong US dollar, the MSCI AC Asia Pacific ex Japan Index has fallen 11.3% (in USD to end of November). Can the tide turn for the region in 2019? Here, three of our Asian fund managers share their different perspectives.

#### Toby Hudson

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The outlook for Asian growth has deteriorated due to four factors:

1. The slowdown in China
2. The impact of higher oil prices.
3. Rising interest rates in markets like India, Indonesia and the Philippines.
4. The escalating trade war between the US and China.

In the near term, market performance is likely to remain dominated by the interplay of these same factors.

On the positive front in China, the authorities have moved to a slightly more pro-growth stance, with recent cuts in reserve requirements and encouragement for the banking sector to lend. Meanwhile, expectations are increasing for further cuts in taxes and also a pick-up in infrastructure spending. This slightly looser policy will take time to show up in the macro data, with headline growth still expected to slow in coming months, but the change in signalling from the authorities to support growth is still important for markets.

Oil prices have also retreated from their recent highs, which alleviates some of the pressure on the more fragile emerging economies and will reduce the drag on consumption.

At the same time, US bond yields and interest rate expectations have moderated slightly in the last few weeks, partly in response to the crack in the US stock market and also due to the ongoing slowdown in growth outside the US. All of this is helping to stabilise sentiment towards risk assets.



Much harder to read is the outlook on the trade front. The recent truce apparently reached between the US and Chinese presidents at the G20 meeting at the end of November was well-received by markets. But there is little confidence that this is the end of the trade frictions, given the longer-term concerns held by many in the US over China's threat to US national security on different fronts.

Given this difficult backdrop, we continue to tread carefully in equity markets and have not moved to significantly increase risk recently despite the correction.

As bottom-up investors, our focus remains on those businesses best-equipped to survive the current slowdown and also exploit the favourable longer-term trends we continue to see in the region. These trends include the continued growth in domestic consumption and growth of service sector industries in countries like India, Indonesia and China. Other themes include the technological leadership of Chinese players in the online space, or the growth potential for industry leaders in the Korean and Taiwanese tech hardware sectors

## Matthew Dobbs

On the valuation front, Asian equities in aggregate now trade close to the levels seen during the last period when regional markets experienced a downdraft in late 2015 and early 2016. At this level, they are beginning to offer some value.

Despite the trade issues, we are still finding a number of good opportunities among selected Asian exporters. We like companies that deliver a high level of added value with their products and that have complicated supply chains. This makes it is very difficult to source alternatives for their products elsewhere.

Promising investment opportunities are also showing up among a number of domestically-focused growth stocks in sectors like leisure, healthcare, internet services and education. Following the market falls of 2018, these have come back to attractive levels.

We also still like a number of the banks across the region. These are very strongly capitalised, meaning they look capable of absorbing losses if they need to. We don't expect to see a significant increase in losses due to non-performing loans, when payments are being missed, but an attractive combination of solid growth and undemanding valuations.

Given the uncertain environment, Asian management teams are generally being selective in their capital spending decisions at a time when balance sheets (at least for companies we prefer) look robust. Consequently, free cash flow generation is running at historically high levels, which should underwrite resilient dividends.

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**Promising investment opportunities are also showing up among a number of domestically-focused growth stocks.**  
”

## Robin Parbrook and Lee King Fuei

With global equities teetering on the brink of bear market territory (a 20% decline), the braver contrarian investors invariably ask, “Is it time to buy?” Well, to answer that I always turn to valuations.

For this, we use two main indicators: one focused on the top-down, a broad assessment of the stock market across the region as a whole, and one on the bottom-up, looking at individual businesses and stocks.

Looking at the former, the sharp drop in the regional index in October has brought us just a short throw away from the level that has typically caused us to turn more positive on Asian equity markets. Unfortunately, our bottom-up valuation indicator is not sharing the same level of enthusiasm. Despite outsized declines in some individual stocks, only 58% of the stocks covered by our analysts are currently showing upside to their fair values. This number sits just slightly above its long-term average and remains some distance away from the 70% that we look for to signify an abundance of positive absolute return opportunities. Based on our calculations, a further 14% correction in stock prices from here, all else being equal, will be required to get us there.

However, valuation measures relate the share price to an underlying fundamental variable, whether that is earnings, dividends, sales or something else. While the price component remains the more dynamic part, the fundamental portion can shift over time too. Today's cheap markets can look expensive tomorrow – even if prices are unchanged – if the fundamentals deteriorate significantly.

Compared to previous earnings downgrade cycles – including the global financial crisis and the eurozone debt crisis – the current one looks to be still in its infancy in terms of both magnitude and duration.

At its worst around the time of the Asian crisis, Asian earnings almost halved over a period of four years.

China is increasingly finding itself in an economic quagmire, with the risks of either a currency devaluation or an economic recession rising. While neither is a base case scenario for us, if one or other does materialise it will be painful for Asia. Given the size of the Chinese economy today, and the amount of intra-regional trade, the region will be lucky to escape with just a cold, and not something a lot worse, if China sneezes.

Given this backdrop we recommend investors tread cautiously and watch economic trends in China very closely. Assuming the tail risks highlighted above do not materialise, we will continue to gradually add to our favoured names on weakness. These are primarily in those markets offering the most upside on our long-term valuation models - Australia, Hong Kong and Singapore.

# Outlook 2019: China equities

## Author

**Louisa Lo**  
Head of Greater  
China Equities



**We are taking a defensive stance, staying underweight to the technology sector, while emphasising domestically-focused areas of the market and those with long-term growth trends.**

Following a cyclical recovery in 2017, driven by robust domestic demand and supply-side reforms, the emphasis in China has since shifted to the quality of economic growth.

With political power consolidated under President Xi, this focus on quality growth as well as economic and social stability brought renewed efforts to shrink the shadow banking sector. The government's effort to deleverage the economy and increase regulatory oversight led to concerns around economic growth coming into 2018. Indeed, we saw credit conditions tighten on the back of reduced shadow banking activity. Tighter credit led to a rise in credit defaults this year, while areas including industrial production and fixed asset investment also lost momentum.

Against the backdrop of a slowing economy and escalating trade tensions with the US, China has introduced various measures to help support the economy:

- The delayed implementation of regulations on wealth management products
- Cuts in banks' reserve requirement ratio (RRR)
- The accelerating issuance of local government bonds
- The encouragement of banks to increase lending to small and medium enterprises
- The State Council's guideline to support domestic consumption
- Changes to the income tax scheme for individuals.

We believe that these policies are aimed at cushioning the economy on the downside rather than providing large scale stimulus. A weak renminbi and high debt levels also limit the ability of the government to stimulate aggressively. The government will need to continue to balance its agenda for deleveraging and introducing structural reforms, whilst maintaining reasonable economic growth.

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**The government will need to continue to balance its agenda for deleveraging and introducing structural reforms, whilst maintaining reasonable economic growth.**  
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## Trade dispute

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On the trade front, our base case remains that a wide-ranging destructive trade war is not in anyone's interest. The risk to Chinese and Asian earnings remains hard to gauge given the announced tariffs to date are relatively narrow in scope and will have little impact on the listed corporate sector. We see limited scope for Chinese manufacturing to be re-shored to the US, or substitution of US goods in place of Asian imports. However, it is the second order impact on capex and investments, and potentially on consumption, that is harder to measure.

The renminbi is an unlikely tool should trade tensions continue to escalate given the risks of inciting capital flight, but currency weakness may be seen as a result of US dollar strength.

The risks of a full-scale and protracted trade war are longer term in nature, with China's strategic industrial policy blueprint and a Sino-US technology arms-race at the heart of the issue. China has shown its willingness to negotiate and compromise on trade issues to narrow the trade deficit, reduce import barriers and further liberalise its domestic market. However, China is unlikely to move on its strategic vision to transform itself into a technology leader.

## Defensive stance, though value is emerging

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Earnings-per-share growth is currently forecast to be in the mid-teens, but we think that is likely to moderate going into 2019. Margin pressure for mid-stream consumer and industrial companies remains high, especially for those who are unable to pass on higher costs.

We remain relatively defensively positioned going into next year given the current environment, with most of our exposure concentrated in domestically-focused names and sectors showing long-term growth trends. We remain underweight to technology stocks given uncertainties brought about by regulatory headwinds. We prefer the energy sector given discipline on the supply side and on pricing. We also favour Chinese insurance companies, and names benefiting from domestic consumption, where we are seeing a pick-up in offline consumer activity.

Valuations for China equities have become more attractive and suggest upside for investors over the medium term. However, investors are likely to remain cautious in the near term given the likelihood of further cuts in earnings forecasts, continued uncertainty on the trade front, and continued increases in US interest rates in the next few months.

As bottom-up investors, our focus remains on those businesses best equipped to navigate the current slowdown and also exploit the favourable longer term trends we continue to see in the market.

“  
Valuations for China equities have become more attractive and suggest upside for investors over the medium term.  
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# Outlook 2019: Commodities

## Author

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**Mark Lacey**  
Head of Commodities



**James Luke**  
Fund Manager,  
Metals



- **Restrained supplies should support major commodities in 2019 despite demand worries**
- **Deep market deficits are apparent in key energy, metals and agricultural markets**
- **Fading US economic outperformance, inflationary pressures and a potentially weaker dollar create a strong backdrop for real assets**

**We look across the range of commodities and find that supply and demand dynamics should mean elevated anxiety levels can be overcome and drive positive returns in 2019.**

Commodities have been faced with a wall of worry recently. Fear of trade wars and slowing global growth have gnawed away at investor confidence. You can't dismiss such fears lightly, but we think the outlook for commodity returns in 2019 is positive.

Looking ahead, there is an obvious contrast between tight supply and demand balances and macroeconomic worries.

For example, the global crude market looks set to draw on inventory (ie its stored product) in 2019 despite recent volatility. In metals, London Metal Exchange (LME) aluminium inventories have more than halved since early 2017 and production cuts are likely to accelerate.

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**Looking ahead, there is an obvious contrast between tight supply and demand balances and macroeconomic worries.**  
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Other macro factors are also supportive for commodities, in particular:

## Inflation risk

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Markets are focused heavily on the potentially damaging links between trade wars and global growth. Far less focus has been on the inflationary impact of trade wars and the inflationary effect of loose fiscal policy from governments in the EU and China.

## The US dollar

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The US dollar has been strong in 2018. However, the impact of tax cuts fading and rising interest rates affecting sensitive parts of the economy, the likelihood of a strong dollar headwind being removed from commodities in 2019 is high.

Below we take a look at our core views in each of the major commodity sub-sectors.

## Energy

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Energy markets have seen a rapid turnaround in positioning, as an arguably overbought market met a series of negative catalysts: the Organization of the Petroleum Exporting Countries (OPEC) and the US ramped up production faster than expected and less severe sanctions resulting in an oil surplus at a seasonally weak period for demand.

Our fundamental outlook for oil is bullish over the next 12 months, as we expect the market to retighten in 2019.

Demand numbers continues to be strong and spare capacity (apart from Iran) is at historical lows. International oil companies continue to demonstrate and express a desire to maintain discipline in their use of capital.

Looking to North America we think expectations for production growth are overblown. Pipeline constraints from key basins will only be alleviated towards the middle of the third quarter of 2019, and Canadian production has started to be shut because of weak local crude prices.

Even assuming weaker oil demand growth in 2019 and significant production growth from North America, we still think demand will be beyond what OPEC is able to produce. We believe the market will have to draw on inventories in the second and third quarter.

We expect such inventory draws to drive the oil price up, with potential price spikes if precarious producers, such as Libya, Iraq, Nigerian and Venezuela, were to suffer disruption of their supply.

## Metals

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As a group we don't expect to see major outperformance from base metals in 2019. The exception is where there are obvious supply catalysts ahead. Aluminium stands out. Prices are extremely low relative to costs and a large deficit will likely drive prices higher.

Longer term we continue to see significant potential for the nickel market based on limited supply growth and strong incremental demand from Li-ion batteries.

Precious metals are currently very out of fashion. Focus on short-term issues, such as extreme short positioning and strong Indian buying, misses the most important question for gold. Namely: when will the weight of higher interest rates on a highly leveraged US economy, as well as the impact of weaker emerging markets growth, weaker equity markets and the uncertainty of an aggressive trade posture finally spill into US economic data?

If this occurs the negative impact on rates expectations and the dollar could be profound. Timing such a scenario is difficult. Patience will be required, but 2019 is likely to yield such a turning point and would be a major positive catalyst for precious metals markets.

## Agriculture

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Fundamentals currently differ significantly between the five agricultural sub-sectors that we cover. The political and economic uncertainty resulting from trade wars and emerging market currency volatility has weighed heavily on agricultural markets.

However, markets such as grains and feedstock stand-out as positive given our expectation that global production and stocks will continue to tighten in 2019.

Likewise, cotton markets look promising as the demand for natural fibres worldwide remains strong whilst high quality cotton is in short supply.

Conversely, we are negative on oilseeds over the next 12 months, with the soybean complex looking particularly negative.

Finally, soft commodity markets like cocoa, coffee and sugar appear to be close to ending their long-term bearish trend. Coffee and sugar prices have tumbled since 2011 and fully reflect the importance of global inventories. While a catalyst is still missing the downside is limited and they represent an interesting long term investment opportunity.

# Outlook 2019:

## Emerging markets debt relative

### About the author

**James Barrineau**  
Head of Emerging  
Markets Debt Relative



- Emerging markets debt absolute yields are at levels that will rival reasonable forward expectations for equity returns
- A true catalyst for additional price gains will likely be a lower US dollar, either from slowing US economic growth that converges with the sluggish eurozone, or more clarity on the end of the Fed hiking cycle
- We find shorter duration non-investment grade dollar bonds attractive. The most stressed countries in EM have made large strides towards fundamental stability. Although growth will be slower, it is unlikely that macroeconomic imbalances threaten a recovery in asset prices

**Emerging markets debt yields are at levels which rival reasonable forward expectations for equities in 2019. In our view, a true catalyst for additional price gains will likely be a lower US dollar.**

Yields on US dollar emerging market debt are approaching 7% for the major indices, comparable to peak levels during the 2014-early 2016 emerging markets (EM) sell-off (see chart). Of course, with the risk-free rate rising, investors may not be comfortable even at those levels until there is greater clarity on where the terminal policy rate for the Federal Reserve (Fed) will be during this cycle.

With perhaps the best of US growth behind us in Q2 of 2018, the outlook for Fed policy should become clearer in 2019, enhancing the probability that the asset class will outperform a rare negative year across all major dollar and local currency indices. Significant strife emanating from within the asset class that would derail a price recovery is a low probability for 2019 in our view.

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Emerging markets enter 2019 well on the way to recovering from the negative effects of a stronger dollar and outsized US growth.  
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## J.P. Morgan EMBI Global Diversified Blended Yield



Source: Bloomberg 26 October 2018.

### EM recovery well underway

Emerging markets enter 2019 well on the way to recovering from the negative effects of a stronger dollar and outsized US growth. These effects shifted liquidity away from the asset class, much as in the 2014-2016 period when the Fed first began ending quantitative easing and raising interest rates. Like that period, currencies have been the adjustment mechanism of choice for stressed countries.

So while local returns were deeply negative, countries for the most part avoided spending precious foreign exchange reserves in a futile search for currency stability. Thus, when the smoke begins to clear, countries generally find that creditworthiness has not deteriorated significantly, dollar debt is not perceived to be seriously at risk of default, and a slow recovery of growth can begin. Broadly, that is where the asset class finds itself.

In 2018, Turkey and Argentina were the most severely stressed countries but both seem to have done enough to stabilise currencies and external deficits at levels that markets are now comfortable with. In other less vulnerable countries like Indonesia and Mexico, interest rates have been increased but not to levels that would cause significant slowdowns into 2019. Growth in the asset class should recover slowly and major recessions in key countries are unlikely.

### EM dollar debt outlook favourable but local currency bonds remain challenged

We see the prospects for dollar debt in EM as being very favourable. Yields on non-investment grade debt have steepened considerably faster than those of investment grade. As pressures on the asset class ease, historically that has reversed fairly quickly. Even if one assumes a slower recovery for prices, yields at 8% and above on average offer investors a cushion not available in other liquid fixed income asset classes.

Until the dollar definitively heads lower, local currency bonds as a whole will be challenged to deliver returns comparable to dollar bonds. Yields on the local currency index are now roughly flat to dollar index yields, whereas the historical average is about a 100 basis points yield differential for local debt. Though yields indeed rose in local bonds, they did not rise as quickly in aggregate, as many countries in Central Europe, Asia, and Latin America did not feel pressured to raise interest rates to help defend currencies.

It will take a quite unambiguous turn in the US dollar to allow investors to benefit from sustained currency rallies across the asset class in our view. If the Fed remains on the current hiking path, that may be an event beyond 2019.

# Outlook 2019:

## Emerging market equities

### About the author

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**Tom Wilson**  
Head of Emerging  
Market Equities



- Valuations in aggregate are attractive and reflect a cautious growth and earnings outlook, while many currencies look cheap
- Further escalation in the US-China trade conflict is a risk, but is increasingly priced-in
- We expect moderate US dollar depreciation in 2019, which should act as a catalyst for emerging markets equities

**Key potential catalysts for emerging markets performance in 2019 are US dollar weakness, a better-than-expected outcome in US-China trade relations and an easing in Chinese growth concerns.**

The MSCI Emerging Markets Index has fallen more than 10% in 2018, and more than 20% from its peak in January. US monetary policy normalisation and a rising growth differential have driven a strong US dollar, negatively impacting emerging markets (EM) currencies and financial conditions.

Although the US has delayed implementation of tariff increases on \$200 billion of Chinese goods, we expect the trade conflict between the two countries to resume. In addition, a negative credit impulse in China and rising uncertainty on the trade outlook has affected Chinese growth and global trade. Sentiment is now cautious and valuations have de-rated.

To what extent is this a buying opportunity, or should we remain cautious about the future?

### Valuations

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Aggregate valuations are attractive, with both price-book and price-earnings ratios below their long term averages, as highlighted in the chart below. Sentiment is cautious, but investor allocations remain elevated following significant inflows into EM funds in 2017.

Valuation multiples price in a cautious earnings outlook. Earnings per share revisions have been negative and may remain so, which may act as a headwind to a multiple recovery.

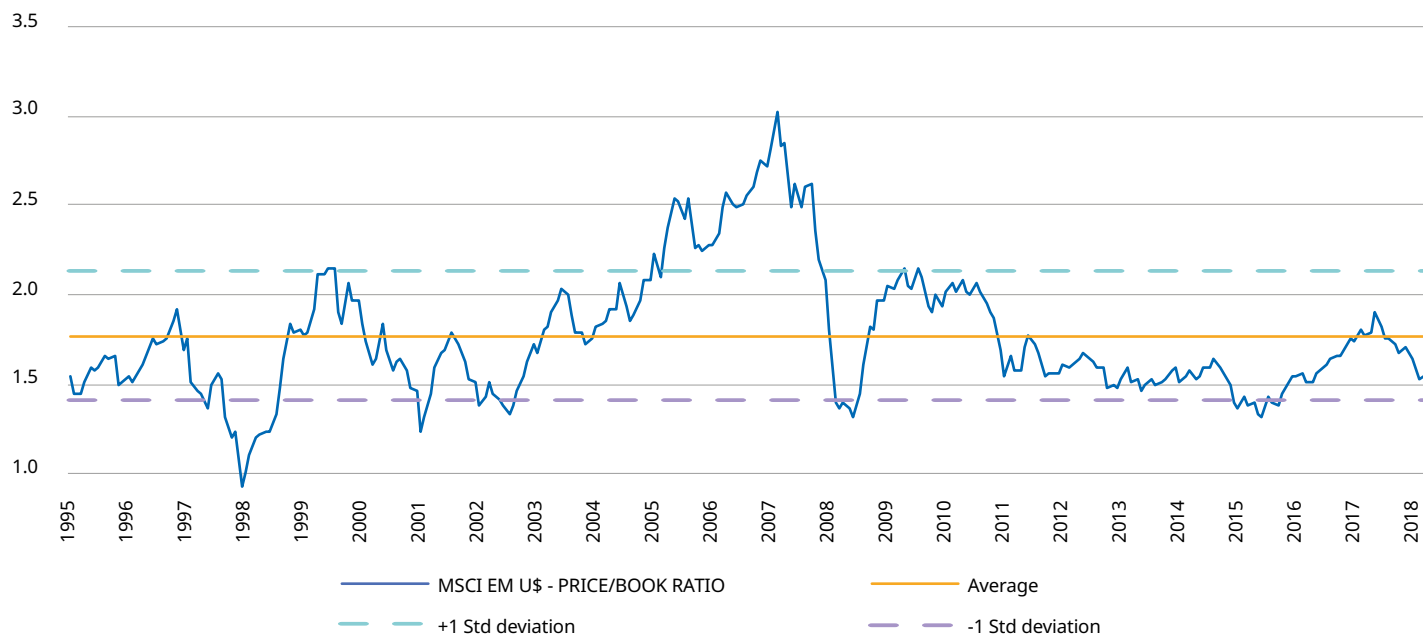
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**Aggregate valuations are attractive, with both price-book and price-earnings ratios below their long term averages.**

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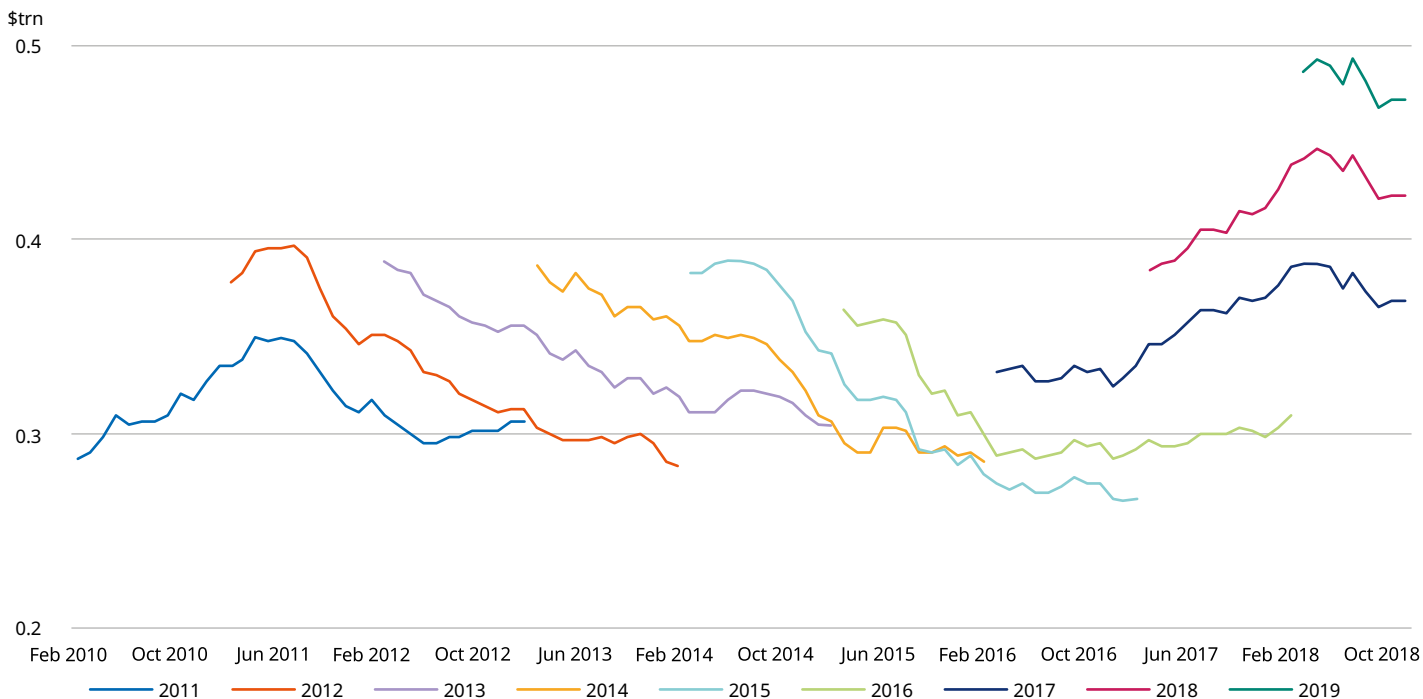


### MSCI EM Price / Book



Source: Refinitiv, Thomson Reuters, MSCI. Data as at November 2018. Historical trends are not indicative of future trends

### MSCI EM earnings expectations



Source: Schroders, Factset. Data as at November 2018. The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. We accept no responsibility for any errors of fact or opinion and assume no obligation to provide you with any changes to our assumptions or forecasts. Forecasts and assumptions may be affected by external economic or other factors.

## Trade conflict

The announcement of a delay in US tariff rises on \$200 billion of Chinese goods, previously scheduled for 1 January, is welcome. However, the dispute is as much concerned with issues such as technology transfer as it is simple trade volumes. The US is likely to demand concessions which China may regard as designed to contain its economic aspirations and global influence. Consequently, we expect a resumption in trade tensions in 2019.

In addition to potential tariff increases, it is also possible that further tariffs are introduced on the remaining \$270bn of Chinese exports to the US, though this may have a more visible inflationary impact on US consumers. The trade conflict potentially creates supply chain disruption for a wide range of industries and is likely to impact corporate confidence and investment as well as trade. Renewed escalation would further suppress sentiment and create uncertainty.

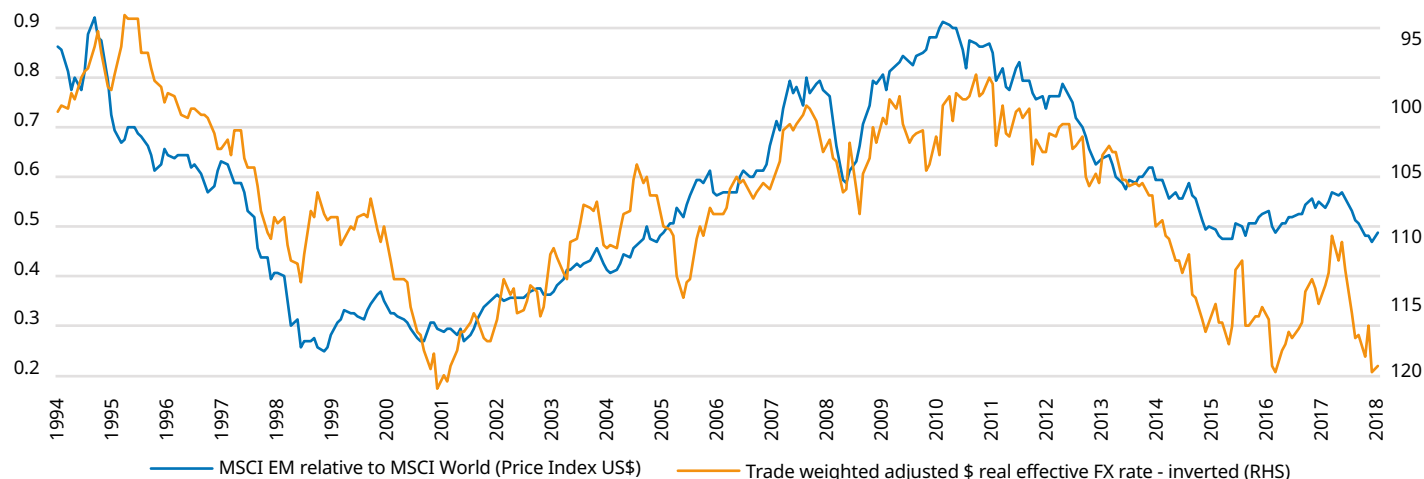
Despite an initial positive reaction from markets, sentiment remains cautious regarding further escalation and there is a degree of risk asymmetry. We do not believe an easy resolution will be found, but should the current truce hold and further escalation stall, this would likely be positive for markets, especially if this comes in conjunction with ongoing Chinese stimulus and US dollar weakness.

## China

In China, regulatory tightening has driven a negative credit impulse, while the government has also focused on prioritising the quality of growth. This has caused economic momentum to slow. In the second half of 2018 we have seen the re-initiation of monetary, fiscal and infrastructure stimulus, in addition to a degree of regulatory forbearance.

We think that stimulus will remain relatively constrained in comparison with prior episodes: regulatory tightening in the financial sector is designed to improve risk in the financial system and will likely remain a priority; a large stimulus may also affect the current account, which moved negative in the first half of 2018, and pressure the currency.

## US dollar vs. emerging equities relative performance



Source: Refinitiv. Data as at November 2018. Historical trends are not indicative of future trends. Performances shown is past performance. Past performance is not a guide to performance. The value of investments can go down as well as up and is not guaranteed.

## US dollar

The US dollar is strongly inversely correlated with EM equity market performance. The dollar is the external funding currency of choice for EM and impacts EM financial conditions. We expect the dollar to depreciate modestly in 2019. The currency is expensive and we anticipate US economic momentum will slow, given fiscal fade and the lagged impact of monetary tightening. If the dollar declines and we have passed peak yields for the US 10-year Treasury then EM currencies, economies and markets are likely to see relief. This is an important catalyst.

## Identifying the opportunities within EM

Disaggregating EM equities, we see opportunities in terms of growth, valuation and earnings. We favour Korea, which is exposed to global growth, but where valuations in certain cases now price in a negative earnings outcome. Russia offers compelling value including on cash flow, yield and currency. In Brazil, political risk remains, but the new president's anticipated economic policy framework could support a recovery in growth. The outlook in Poland and Hungary is also favourable, given the positive earnings outlook and attractive valuations.

## Valuations supportive but risks bear monitoring

Overall EM valuations are supportive and we continue to monitor the extent to which the risk of further trade escalation is already priced in; the potential for US dollar weakness in 2019; and whether Chinese stimulus will ease growth concerns. These factors might act as a catalyst for EM market growth performance in 2019. However, the strength of a potential recovery is tempered by a more cautious global growth outlook, as the US is late in its economic cycle and well advanced in its monetary tightening cycle, and we expect Chinese growth to be slower on a medium term basis.



# Outlook 2019:

## European commercial real estate

### Author

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**Duncan Owen**  
Global Head of  
Real Estate



- Length and strength of upswings differ by city and sector
- Rents are rising as occupational demand outstrips supply
- Price corrections may offer some opportunities

## Demand for European commercial real estate is underpinned by an increase in technology and professional service jobs

European commercial real estate markets have performed strongly. Prices in Europe's major cities have risen on average by 40-50% since 2013 (source RCA) and except in southern Europe, they are now 10-20% above their previous peak before the global financial crisis (GFC).

### Cycles vary enormously

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Intuition suggests that markets are due a correction, but it would be wrong to assume that real estate cycles are fixed like the tides. History shows that the length and strength of upswings has varied enormously across different cities and sectors over the last 50 years. For example, e-commerce is currently driving a wedge between the retail and industrial sectors and whereas industrial capital values in the UK rose by 10% over the first 10 months of 2018, shopping centre values fell by 7% (source CBRE).

European commercial real estate faces two main risks. Firstly, the growth of populist parties across Europe has increased the chance of radical shifts in economic policy. The obvious example is Brexit, which poses a threat to financial services and office rents in the City of London and the Docklands. Conversely, this has given a modest occupational boost to office demand in Frankfurt and Paris. In addition, Catalonia's declaration of independence has raised a question mark over assets in Barcelona, while the Italian government's budget dispute with the EU has hit foreign investor interest in Milan and Rome.

The second clear risk is higher interest rates. Schroders expects the Bank of England and the European Central Bank to raise base rates and the refinancing rate to 1.75% and 1% respectively by the end of 2020. Yet, despite textbook theory that real estate yields should move in parallel with government bond yields, we think that the increase in office and logistics yields over the next 2-3 years will be limited to 0.25-0.4%. Retail could be the one sector where yields rise and capital values fall more sharply.

## Generous yield gap

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We do not expect a bigger increase in office and industrial yields, partly because there is still a generous gap of over 3% between average investment grade real estate and government bonds. The long-term average is only 2%. Globalisation, particularly at the prime end of the market is also a factor. Asian, North American and Middle Eastern investors, with varying costs of capital, together accounted for a quarter of European investment deals by value in the first nine months of 2018, compared with 17% a decade ago.

However, the key reason is that real estate is not a fixed income asset and office and industrial rents are rising, as occupational demand outstrips supply. Office rents are rising as the increase in technology and professional service jobs lifts demand and as new, tighter bank regulations introduced after the GFC hold down speculative development. UK industrial rents are growing by 3-4% p.a., supported by both the growth in online retail and loss of supply because a lot of estates have been converted into housing. There are also signs of an upturn in industrial rents in the more supply-constrained parts of France and Germany (e.g. Hamburg, Munich, Paris, Stuttgart).

The catch, however, is that yields at the prime end of the market have compressed to record low levels and all of the good news on future rental growth is in the price. In most big European cities prime office yields in the central business district (CBD) have fallen to 3.0-3.5% and prime industrial yields are between 4.0-4.5%. So where do we see value?

In the office market we have a two-pronged strategy in big cities. We seek to add value by re-developing older buildings in the CBD. We also look at adjacent areas where yields are higher and which are being transformed either by a technology, or life sciences clusters, or by new transport links, or other regeneration and new infrastructure. Examples include the ArenA in Amsterdam; Kreuzberg-Friedrichshain in Berlin; Bloomsbury and Waterloo in London; Boulogne-Billancourt, Clichy and Montreuil in Paris and Solna in Stockholm.

We also like multi-let offices in smaller “winning” cities which have good universities and a diverse economy (e.g. Cambridge, Leeds, Leipzig, Lyon, Manchester, Malmo, Mannheim and Utrecht). In the industrial market we favour multi-let estates and smaller distribution warehouses, where it is still possible (except in London and the South East) to buy good quality assets on yields of 5.25%, or higher.

Looking further afield, we also see value in other sectors such as self-storage and hotels, specifically hotels with management agreements. Both segments are benefiting from structural change – urbanisation and people spending more on experiences, respectively – and while they each involve operational risk, this can be controlled by skilled asset management and yields are relatively high.

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We also see value in other sectors such as self-storage and hotels, specifically hotels with management agreements.

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## Potential retail opportunities

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Is now time to go back into the retail sector given that the transition to omni-channel retailing still has a long way to go? Projections suggest that the internet’s share of UK retail sales, for example, will almost double from 17% to 30% over the next 10 years. Unfortunately, that suggests that the recent wave of retailer failures and store closures in northern Europe will continue and that there will be a sustained fall in rents. At present, that reality is not reflected in current valuations and retail yields.

However, looking forward, if most investors shun the sector and yields jump over the next 12 months, then there could be some interesting opportunities to buy defensive retail assets (e.g. dominant shopping centres, convenience stores). There may also be opportunities in town centre buildings which can be re-modelled into mixed-use schemes incorporating apartments, offices, medical clinics, places of worship.

In conclusion, we continue to see value in parts of the European commercial real estate market. The upswing in office and industrial rents has further to go in most winning cities and some segments such as hotels where management agreements are attractive. The big concern is the current economic and market cycle. Whilst we may not be at the peak of market pricing, no one would be surprised in a year’s time if we discovered we are in reality there now. Therefore, 2019 could be a year of price corrections which may offer some good opportunity for investors who are well capitalised. There is more than one real estate cycle in Europe.

# Outlook 2019: European equities

## Authors

### Rory Bateman

Head of UK and European Equities



### Martin Skanberg

Fund Manager, European Equities



### James Sym

Fund Manager, European Equities



- After a poor 2018, European equities are lowly valued, balance sheets look healthy and we see the dividend yield as attractive
- Sectors such as tech hardware and autos are priced at recessionary levels but the economy continues to expand
- The return of inflation is a structural pressure that could benefit previously out of favour sectors such as telecoms and financials

**European equities may remain volatile in 2019 but this can open up opportunities for investors seeking out under-valued companies.**

### Rory Bateman

The global economic picture for 2019 looks more challenging as we approach the closing stages of this economic cycle. The equity market has already factored in the slowdown, leading to disappointing returns across most regions in 2018.

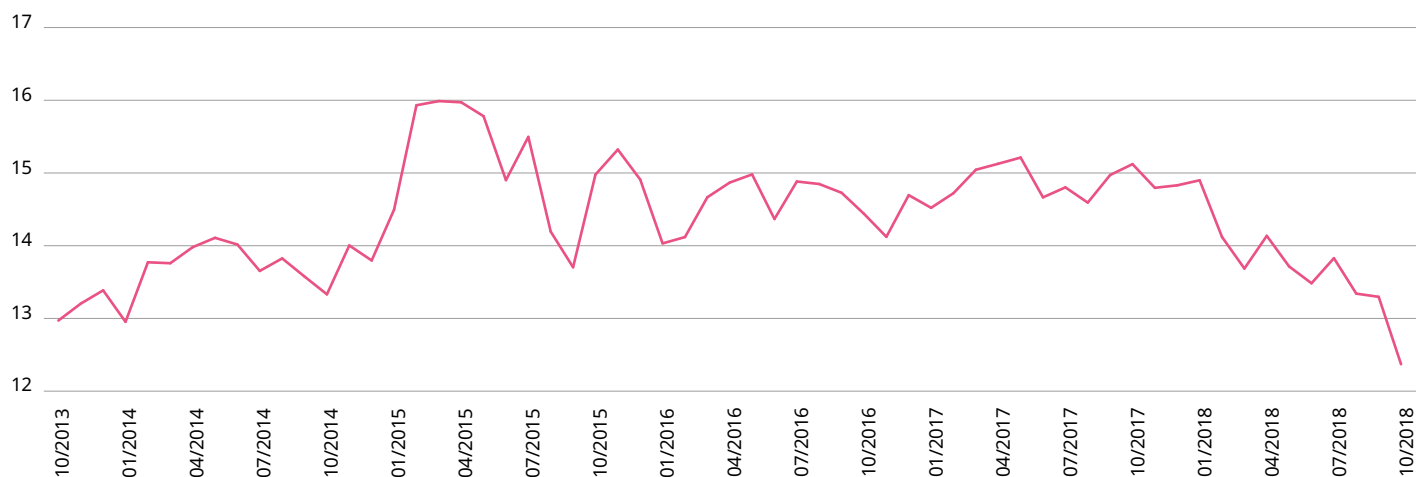
We believe Europe's economy should enjoy above trend growth in the year ahead given the later post crisis recovery compared to the rest of the world and the continuing domestic consumer expansion. Investors can access European equities at a five-year valuation low<sup>1</sup> (see chart 1) following the market decline experienced during 2018.

Over recent months we have seen higher global volatility due to trade wars, rising interest rates in the US and the progressive withdrawal of quantitative easing in Europe.

In addition Germany in particular has grown below expectations. This is largely due to changes in diesel emissions regulations for the auto industry. However, our sense is that the German industrial issue is temporary therefore helping to ensure positive corporate earnings growth in 2019 (see chart 2).

<sup>1</sup> The charts shows the price-earnings ratio (P/E ratio) which is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

**Chart 1: MSCI Europe price-to-earnings ratio**



Source: DataStream, 31 October 2018. Chart shows the price to 12-month forecast earnings of the MSCI Europe index.

The chart shows positive earnings growth for 2018 and realistic expectations for 2019.

We often discuss the valuation differential between the US and Europe. At this particular moment the European price-to-earnings (P/E) discount appears extreme. While European companies have not benefited from the share buyback<sup>2</sup> bonanza experienced in the US, the dividend yield on European equities is a very healthy 3.7% (MSCI Europe, as at 31 October 2018) and overall corporate balance sheets are in rude health.

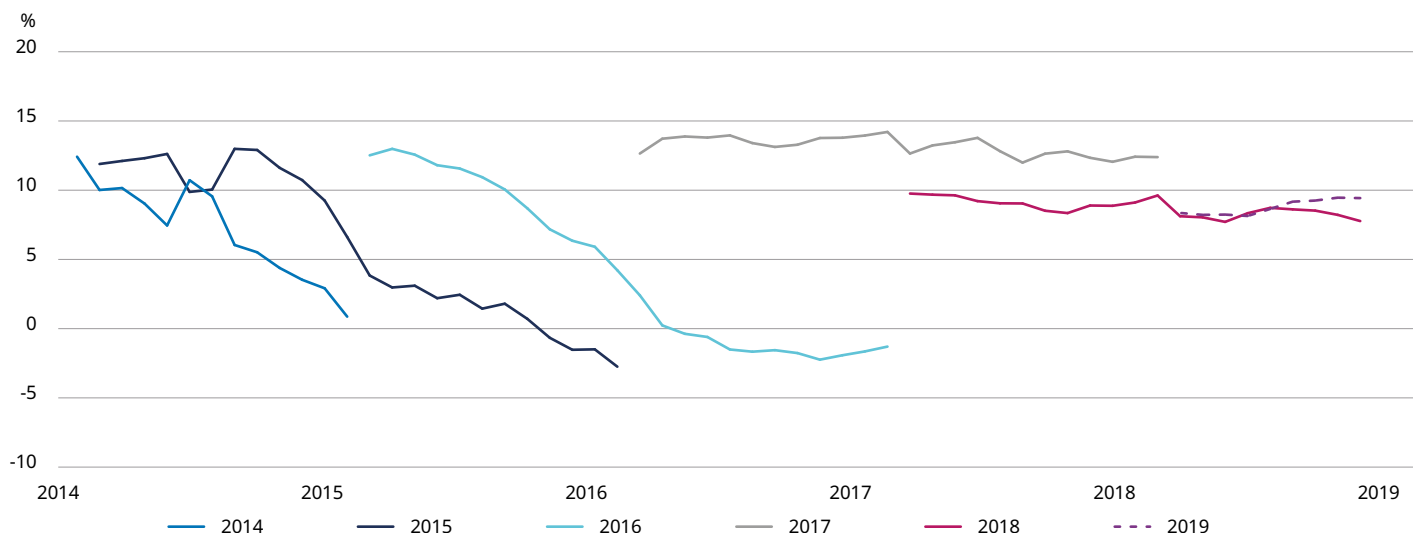
Chart 3 below shows the US versus European market current P/E multiple (blue line); the US is trading at a significant premium to Europe - close to historic peaks. The orange line illustrates the significant underperformance of the European market compared to the US (both in US\$).

<sup>2</sup> A buyback, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available on the open market.

We expect the inevitable political uncertainties in Europe to present investors with opportunities to buy select stocks at attractive levels. International sentiment towards European equities is currently extremely sceptical given Brexit and Italian budget concerns. Stock market history shows that such times of extreme sentiment can be a good opportunity to take a contrarian approach. Some investors may therefore consider making a tactical near-term allocation to European equities.

Having said that, timing is always difficult. Our expertise is in identifying under-valued companies that we expect to deliver strong returns during the medium to long term. We are currently exploring heightened numbers of attractive stocks given compelling valuations and increased levels of volatility.

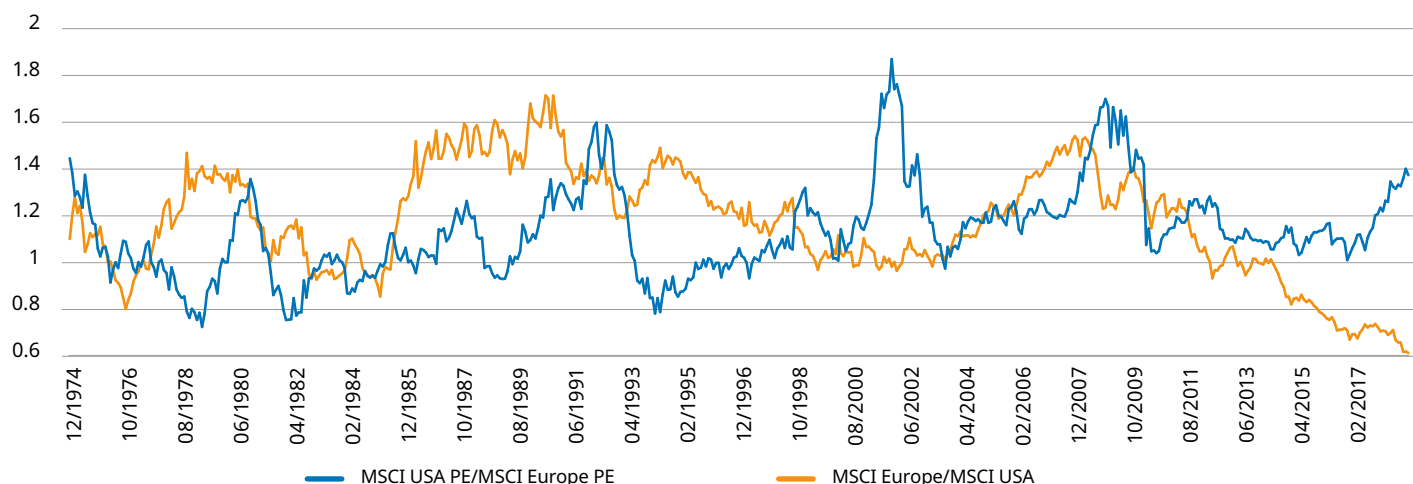
### Chart 2: Earnings revisions in Europe



Source: Barclays Research, DataStream, MSCI, IBES, as at 22 November 2018. Chart shows the trajectory of consensus earnings revisions for the MSCI Europe index.

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Forecasts and assumptions may be affected by external economic or other factors.

### Chart 3: Europe has underperformed the US



Source: DataStream, 31 October 2018.

## Martin Skanberg

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There are clouds on the economic horizon as we head into 2019 and this has resulted in exaggerated market volatility recently. Positioning in markets has become very defensive, with investors favouring the perceived safety of sectors such as consumer staples over those more closely linked to the economic cycle, such as industrials.

At a time of fear in the market, it is anti-consensual to favour these more economically sensitive sectors and stocks but they are the ones we think, if chosen correctly, have the ability to outperform the most in any rebound. We are seeking out areas of the market where we see value as well as sensitivity to the economic cycle.

For example, sectors such as tech hardware or the automotive space are valued at levels that imply we are in a mild recession. Yet the US economy is performing well and the eurozone economy continues to expand, albeit more slowly than at the start of 2018. The current very defensive market positioning could quickly unwind.

At the same time, we look for stocks that can deliver growth and/or a share price uplift irrespective of the general market environment. This leads us to focus on corporate change stories. Examples include businesses that are under-earning versus peers, or where the corporate structure is overly complicated and therefore the market awards the business a discount valuation. Such opportunities are always interesting, as long as we feel there is a credible strategy to unlock this value and the share price does not already reflect the opportunity.

## James Sym

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Investors face a changing market environment as we head into 2019 and a key feature of this is the return of inflation. Anecdotal evidence tells us that many European companies are facing an increasingly tight labour market, so they need to pay higher wages to attract and keep employees. Meanwhile, underinvestment since the global financial crisis combined with steady economic growth means many companies now find themselves with full factories, so they need to invest in new capacity.

Both of these factors are inflationary, and could weigh on the kinds of companies that fared well in the low rate and low inflation environment. Can a company still grow if it is unable to add new workers or new capacity? We think investors will need to look at a different type of company as higher inflation becomes embedded.

Financials could benefit from the new inflationary environment because they can re-price the rate they charge on loans and other products. Revenues should rise more quickly than staff costs, and financial firms benefit from volume growth as the economy continues to expand. Within financials, we prefer insurers; it remains important to be selective when investing in European banks.

The telecoms sector is another that should benefit from higher inflation. The infrastructure is already there and rising wages mean consumers are able to bear higher prices. Similarly, consumer cyclical sectors – like the carmakers – are currently very cheaply valued and could benefit from a more confident consumer in 2019.

We see this return of inflation as an embedded structural factor - the result of years of underinvestment and pressure on wages. The important thing, as investors, is to identify this changing environment early before it becomes obvious to the whole market.

The opinions above include forecasted views, there is no guarantee than any forecasts or opinions will be realised, they should not be relied upon. Nothing in this material should be construed as advice or a recommendation.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

Equity prices fluctuate daily, based on many factors including general, economic, industry or company news.

Investments concentrated in a limited number of geographical regions, industry sectors, markets may result in large changes in the value, both up or down, which may adversely impact the performance.





# Outlook 2019: Global bonds

## Author

**Bob Jolly**

Head of Global  
Macro Strategy

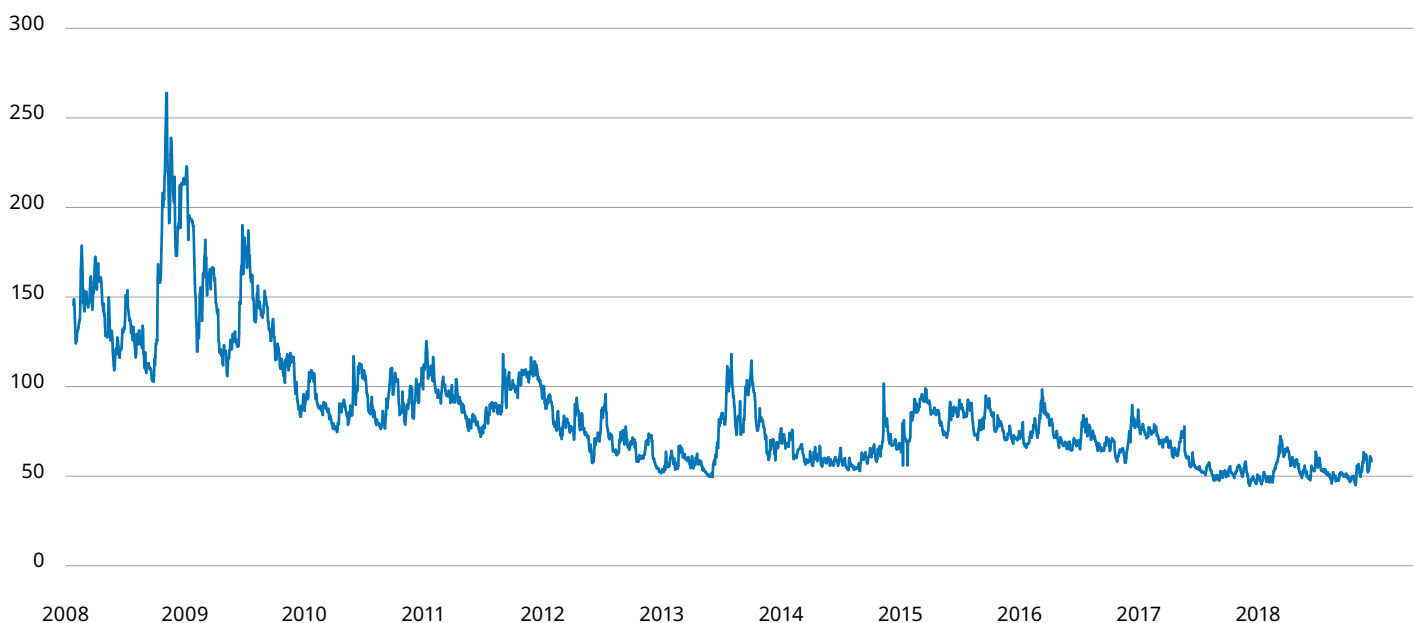


- The post-2008 low volatility sea of tranquillity is being disrupted by monetary policy adjustments and geopolitical factors
- We see a mixed picture: the US expansion has further to run (good), red flags such as excessive consumer borrowing remain absent (neutral), but market gains are likely to moderate (negative)
- Countries and companies with a lot of debt may be vulnerable and we see the shifting environment resulting in opportunities for active investment approaches

**The storm clouds are gathering for fixed income investors who may soon have to leave behind the quiet life which they have become accustomed to post-2008.**

For most of the post financial crisis period, fixed income markets have been a relative sea of tranquillity, with volatility (the degree to which prices fluctuate) declining at first precipitously before stabilising at a historically low level (see chart).

### Post-crisis sea of tranquillity in US Treasury yields



Source: Bloomberg. Merrill Lynch Option Volatility Estimate (MOVE) Index as at 21/11/2018 (measuring the volatility of US Treasury yields, the level of fluctuation in yields, using one month options contracts).

Past performance is not a guide to future performance and may not be repeated.

How to explain this? Central banks have been extremely influential in driving down volatility and until now, suppressing any periodic upticks in market fears. Interest rates have been lowered to unprecedented levels, with central banks adding to the stimulus by expanding their balance sheets with quantitative easing (QE), where money is printed in order to buy bonds in the open market.

Money has been freely available and central banks have been offering apparently unlimited economic support through the printing presses. It is perhaps then no surprise that any political or economic shocks have failed to generate any real escalation of concern you would normally associate with a pick-up in market volatility.

However, enough of history, time to dust off the crystal ball for 2019.

First, what has changed?

**1. What was, post the Global Financial Crisis, a problem of meaningful underemployment of labour is now verging on a global shortage.** US unemployment is now around 50 year lows, in Japan the job vacancies to applicants ratio is at 45 year highs and even with the ongoing Brexit fears UK unemployment is the lowest since 1975.

**2. Central banks seem increasingly convinced QE has had its day and interest rates need to rise.** Having fretted over the potential for inflation to fall into deflation (falling prices), central bankers are willing to say such risks have receded enough to take away some of the QE punchbowl. Even in Europe, which lags the rest of the world's economic recovery, the central bank has announced the probable end of its QE programme.

**3. Governments are loosening the purse strings.** Whether it be the more spectacular fiscal splurge of Donald Trump, in the form of substantial tax cuts, or the more measured 2018 budget announcement from the UK government, billed as marking the end of several years of austerity, governments are taking steps to make life easier for their electorates, pretty much globally. Whether it be caused by a rise in populism or improved government finances, fiscal policy is more of a global economic tailwind.

**4. The rise in protectionist tendencies.** US President Donald Trump characterises his administration as "America first". His decision to impose tariffs on imports from China has had a detrimental impact on economic sentiment in Asia. The region, together with the majority of emerging markets, has suffered for the majority of 2018. The outlook for global trade remains uncertain. President Trump's stance towards China and trade more generally will remain a key factor in determining the future path of the global economy and markets.

## Where from here?

After a decade of extreme monetary policy accommodation, it's hardly surprising there is a degree of market turbulence as central banks begin the gradual removal of these policies. Markets are acclimatising to the shift and some of the more inflated riskier assets, equities notably, have recently suffered. From here we see a mix of both good, neutral but also some negative developments.

**The good news:** the US expansion looks more durable than most commentators suggest. Our analysis suggests productivity (often measured as amount of economic output, or GDP, per amount of input, usually hours worked) could rise going forward. While this may involve interest rates ultimately settling at a higher level, it also suggests a stronger level of growth. The positive developments in terms of higher productivity could also extend beyond the borders of the US.

**The more neutral news:** domestic economic activity in most parts of the world is moving ahead nicely, consumers are mostly living sensibly within budgets and many of the excesses which can often appear after a long period of economic expansion and as the economic cycle starts to mature, are still largely absent. For the most part, employment and average wage earnings growth are reasonable rather than excessive.

Inflation, while nudging higher, is again not flashing any real warning signals of excess. While monetary policy accommodation (QE, low interest rates) may be removed, should the above backdrop continue, central banks can continue to remove it gradually without risking choking-off economic activity.

**The bad news:** asset prices are unlikely to continue to rise at the speed and consistency they have been for much of the last five to 10 years. As monetary policy returns to a more normal level, many assets will need to be priced without the meaningful support provided by the world's central banks. For some this could mean significant adjustments.

Markets are likely to be more volatile going forward. We may see higher levels of company defaults (companies missing interest payment on bonds) as a result. Risk will need to be stringently and realistically priced, which means it could be time to throw away the rose tinted spectacles, especially in parts of the world where debt has quietly been increasing to record levels.

While this doesn't have to be disastrous for asset prices, it could suggest the days are numbered for buy and hold type tactics, holding stocks and bonds and riding a fairly smooth upward trajectory. We envisage substantive opportunities arising for more active approaches, not just in fixed income, but potentially across asset classes.

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. This information is not an offer, solicitation or recommendation to buy or sell any financial instrument or to adopt any investment strategy.

We cover many of the issues discussed above in our recent paper: inescapable investment truths for the decade ahead. [www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/](http://www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/)

# Outlook 2019: Global cities

## Author

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### Hugo Machin

Co-head of Global  
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### Tom Walker

Co-head of Global  
Real Estate Securities



- Fundamental shifts in demand will impact on how we use land and buildings in global cities
- The demand shift is already evident in retail, with surging demand for well-located warehouses
- Locations in strong cities close to great transport links have enduring value and will benefit from the disruption revolution, as people cluster together to monetise new ideas

## Global cities look set to benefit from a technological revolution in 2019 as investors place a higher value on knowledge than manufacturing.

### Disruption revolution

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In our view, 2018 will go down as a 'Goldilocks' year; not too hot and not too cold. While there have been world events that, fleetingly, seem important, we see fundamental shifts in demand as having a greater long-term impact on markets.

Our outlook for 2019 is influenced more by these demand shifts, than by headlines.

The industrial revolution was an inflection point where technological advancement fundamentally changed people's lives. Western economies moved in Victorian times from being agrarian-based to manufacturing-based. We think the current rate of technological advancement is similar.

The ability of technology to disrupt and disintermediate means today's economy is moving from being manufacturing-based to knowledge-based. Simply put, higher value is in idea monetisation; lower value is in manufacturing, which is increasingly automated.

### Ideas trump manufacturing

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This is great for cities. Idea monetisation is what cities do best; human proximity leads to greater idea generation and sharing. This is why cities are becoming so important and why certain cities, given their scale, cultural and educational reach, are pre-eminent.

We see demand as shifting in two ways. First, to cities where the highest value economies are; and second, to certain land uses in those cities. If we take the importance of cities as given, it is the changing demand for land use in cities, reflecting broader disruptive trends.

Land is an economic instrument and land use is shaped by economic demand. The demand shift in land use has transformed areas of the market, leaving clear winners and clear losers.

The most obvious example is the disruption to the retail market, leaving shopfronts boarded up but huge demand for warehouses close to cities.

E-commerce has shifted demand, irreversibly in our view, from the High Street to the home. There are, however, pockets of optimism and we wrote about them in a recent blog<sup>1</sup> about the reinvention of the high street. Nonetheless, technology has wrought structural change on the market.

<sup>1</sup> <https://www.schroders.com/en/insights/economics/how-the-high-street-is-being-reinvented-in-global-cities/>

This demand shift will have a profound impact on the most important global cities. Areas that we see demand increasing are in warehouses, data centres, student accommodation and flexible office space.

We see demand continuing to wane in retail as commoditised offerings, particularly apparel, move almost entirely online. Even the white hope of the leisure segment – cinemas and restaurants – are struggling, as streaming giants take market share and oversupply of “casual dining” impacts restaurateurs’ profitability.

As we peer into 2019 through the news cycle of Brexit, mid-term elections and Trumpian trade wars, enduring “truths” of global cities and well-located land can prevail, regardless of how disruptive technology changes the face of economic demand.

### What does this mean for investment markets?

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The “disruption revolution” is changing the way we use land, just as it is changing way we shop, socialise, travel and work.

There is no facet of our lives that technology is not impacting. Real assets - buildings and land - reflect that. We see certain cities and certain land uses in those cities becoming more important. This means well-located land will continue to benefit from economic demand, despite the changing pattern of that demand.

As demand shifts, there are still some enduring truths in investment markets when it come to real assets. The first is that the knowledge economy is thriving in cities where there is already critical mass. The second notion is that investing in land located close to transport may provide more attractive opportunities than is currently understood. This is why we worked with our DIU team to develop a transport score<sup>2</sup>.

As we peer into 2019 through the news cycle of Brexit, mid-term elections and Trumpian trade wars, enduring “truths” of global cities and well-located land can prevail, regardless of how disruptive technology changes the face of economic demand.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

<sup>2</sup> <https://www.schroders.com/en/schrodersglobalcities/blog/blog/the-transport-freebie-the-benefit-of-land-ownership-next-to-mass-transit/>

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# Outlook 2019:

## Global convertible bonds

### Author

**Dr. Martin Kuehle**  
Investment Director,  
Convertible Bonds



- Overall market volatility will remain high and convertibles look prepared to protect against further set-backs in 2019
- Convertibles are fairly priced with attractive valuations in Japan and Asia ex-Japan
- Solid fundamentals and stable BBB+ credit rating puts convertible bond universe on solid footing against any pick-up in default rate

## Convertible bonds currently appear fairly defensive relative to history and valuations are attractive particularly in Asia.

October 2018 clearly reminded equity investors of the risks in stock markets. After a prolonged period of abundant positive returns and low volatility, macro and political risks are again forefront of investors' minds:

- US interest rates are higher and rising – negative outcomes are likely for bond investors. It's not too surprising that 2018 has been one of the worst years for bond markets, in aggregate, since the mid 1970s.
- Higher US rates have had a strengthening effect for the US dollar, creating concerns for emerging market countries and companies with a large amount of dollar-denominated debt. This looks set to continue in 2019.
- The US anti-trade agenda and higher tariffs is now a firm fixture for markets. It has been, and will likely continue to be, a continual background noise nagging at investor sentiment. The hope is that, on balance, tensions are unlikely to escalate significantly, as both the US and China have threatened.
- Italy's weak economy, problems for the country's banks (surging "Target2" balances particularly), Italian deficit "negotiation" tactics and a powerless "retaliation" by Brussels once again highlight the flaws with the current design of the euro single-currency system. On the other hand, neither ground-breaking reforms including Eurobonds or the mutualisation of debt, nor a break-up of the euro should be on the cards for 2019. It will likely prove to be another reason for further volatility though.
- An overall slowing down of economic growth led by fear of slower growth in emerging markets.

All these risk have one thing in common: they are known – and in fact have been around for months if not years.

“  
The rich valuation levels in the US and in Europe have come down significantly while Japan and Asia ex Japan continue to offer discounts to fair value.  
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## What is going to change in 2019?

2018 marked a special occasion: the US equity market saw two set-backs of 10% losses for the first time since 1960. While history tells us this is unlikely to repeat next year, the easy part of any outlook for 2019 is to state that volatility will remain high.

Central banks are moving away from quantitative easing to a process of gradual tightening. The US Federal Reserve (Fed) has hiked eight times since late-2015. The likelihood is this will weigh on demand for bond investments. In addition, US companies will slow down their stock buyback programmes. In 2018 US businesses moved a vast amount of money back to the US due to incentives under the tax reform. This will slow down in 2019. Together these shifts could result in a buyers' strike for bonds and equities and a serious shift in the demand and supply ratio.

Amid this changing backdrop, we see scope for convertible bonds to continue to assert the following core characteristics:

**Protection against sudden and volatile equity market set-backs.** 2018 demonstrated the relative stability of convertibles once more. The overall level of volatility on the global equity markets rose to 10%, compared to 5% for convertible bonds, based on monthly observations of the MSCI World equity index and the Thomson Reuters Global Focus convertible bond index. Similar protection was seen in peak-to-trough downside participation where convertibles protected 57% of the equity losses in February, and 59% of the equity losses in October. The characteristics of the asset class suggest it can continue to provide a similar level of protection in 2019.

**Protection against credit blow-outs** and possible jump in defaults. It will become more apparent that long-term ultra-low/zero interest rates have resulted in market inefficiencies, artificially low default rates, and zombification, allowing weak companies to survive. The default risks have been increased by large investment flows into exchange-traded funds (ETFs) and a potentially crowded

trade in lower investment grade (IG) companies. Once companies face higher refinancing costs, they may be downgraded, triggering a vicious cycle of selling pressure and illiquidity. Convertible bonds are not immune to default risk, but the investable universe is dominated by strong companies with an implied IG rating.

In general, the degree of possible protection from convertible bonds depends on several factors: the amount of equity exposure, the distance to the bond floor (the safer fixed income element of convertible bonds), the credit risk or estimated risk the company will default and valuation.

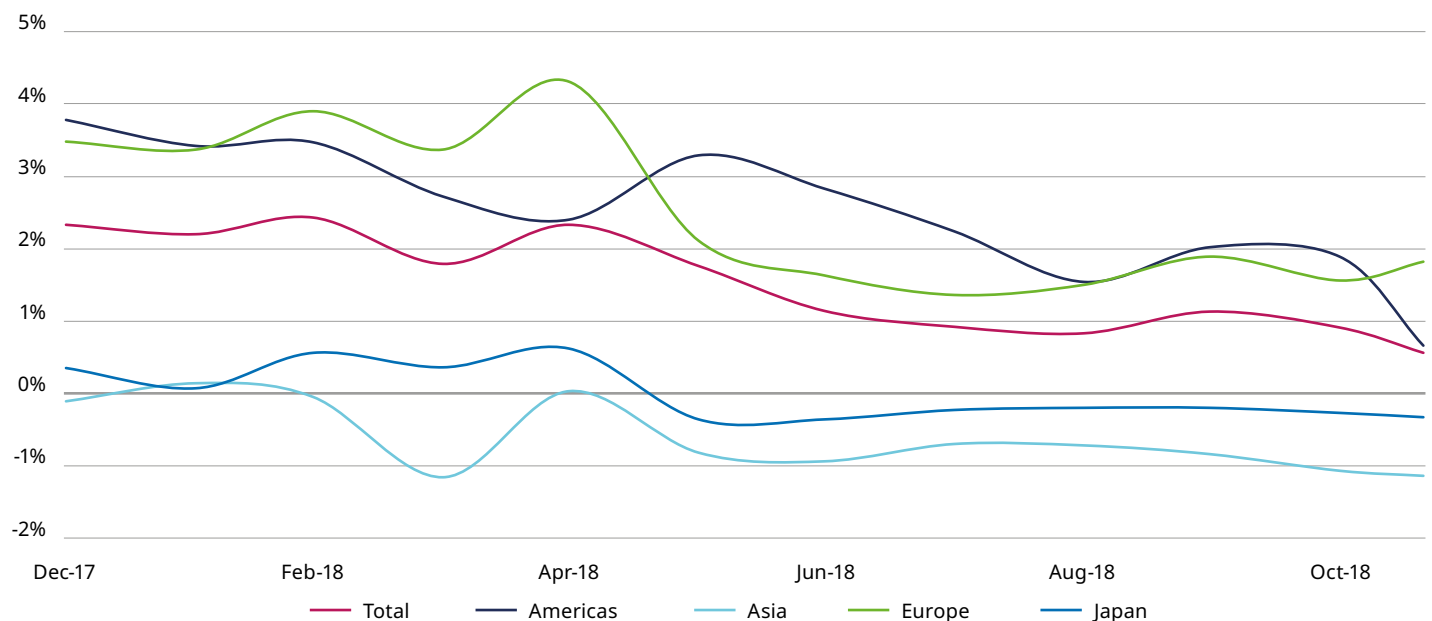
The convertible universe currently exhibits notably protective characteristics compared to history. The overall equity exposure sits at a low 36% with a high 88% bond floor, the fixed income value of the convertible bond. Assuming the issuer survives and pays back at maturity, this is the protective element for the capital invested, and theoretically, the lowest market value the security can fall to. The overall credit rating is a stable BBB+ average (Thomson Reuters Global Focus Index) suggesting these companies can weather more difficult conditions.

Crucially, the asset class is fairly-priced. The rich valuation levels in the US and in Europe have come down significantly while Japan and Asia ex Japan continue to offer discounts to fair value.

Finally, the market structure has changed following summer 2018 primary market issuance. Previously lacking interesting disruptive business models, the universe now offers highly balanced names with a dynamic growth tilt. IT remains the dominant sector, particularly cloud businesses, app services, and payment solutions providers. With the October set-back, many of these structures are trading much closer to par value with significant upside.

Given the current fundamentals of convertible bonds, we think the investment question for 2019 may not be whether to have an allocation to the asset class, but how much to allocate.

## Valuations of convertible bonds



Source: Schroders 20 November 2018.

# Outlook 2019: Global credit

## Authors

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**Martha Metcalf**  
Head of US Credit



- With the removal of extraordinary central bank support measures, 2019 looks set to be a transitional year, not just for corporate bonds
- Credit fundamentals are healthy, but the outlook for demand and sentiment is uncertain with rates rising and the credit cycle maturing
- Tougher markets in 2018 have resulted in attractive corporate bond valuations, while defaults and new supply are expected to remain low

**Rick Rezek**  
Global Credit  
Fund Manager



**Valuations have become more attractive and fundamentals are reasonably positive. But a period of transition looms, with central bank support being withdrawn and government bonds now offer a more compelling alternative than they have in many years.**

The past year has been challenging for most areas of the credit markets, not least due to a transition from quantitative easing to quantitative tightening. This, among other things, has the potential to weigh on markets again in 2019.

The outlook for credit is finely balanced. Fundamentals are healthy across investment grade (IG) and high yield (HY) issuers while the macro backdrop in the US remains strong. This is offset by declining demand and sentiment as rates rise and the end of the credit cycle approaches.

### **Solid credit metrics and low default rates persist**

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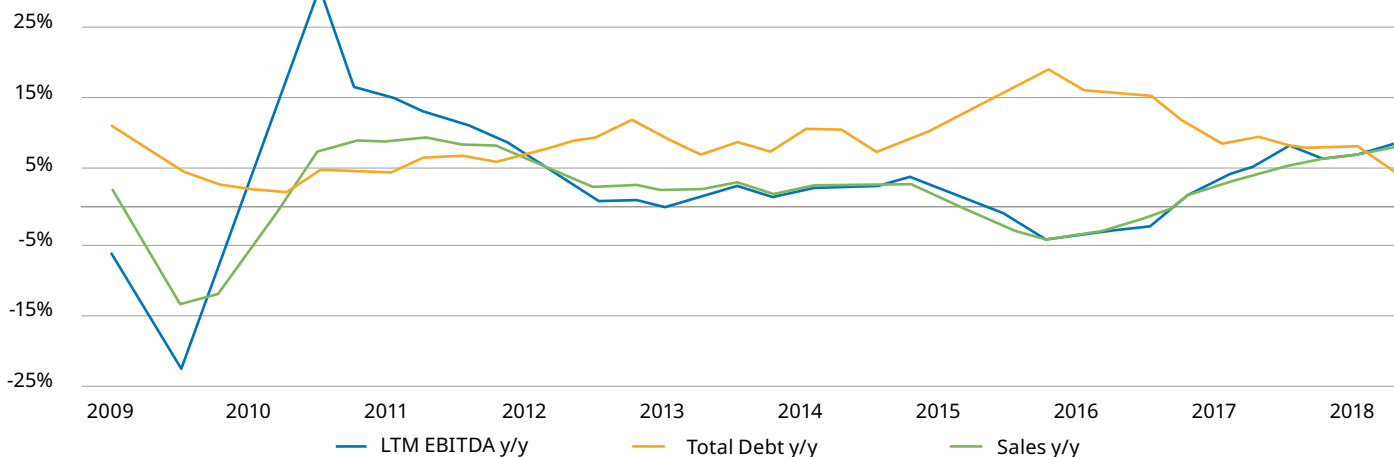
Within investment grade, revenue growth remains positive, but recent results indicate that the pace of growth has moderated as the benefits of US tax reform fade. However, earnings growth continues to outpace debt growth which has led to an organic improvement in leverage metrics (see chart below). This is expected to continue for the next few quarters. Overall, IG corporates are in good shape fundamentally but starting to show signs of late-cycle behavior.

High yield (HY) companies have posted solid earnings growth, on aggregate, throughout the year with balance sheets remaining relatively healthy. Due to the strong economic backdrop, particularly in the US, and healthy earnings, the Moody's trailing 12-month global default rate remains close to historical lows. It is also expected to fall from 2.6% at the end of October 2018 to 2% in late 2019. The distressed ratio, an indicator of defaults six to nine months in advance, also remains subdued, while ratings trends are favourable.

Two areas of concern include the growth in BBB-rated IG as well as the tremendous growth of the leveraged loan market within sub-investment grade. BBB-rated companies now constitute half of the IG market (Bloomberg Barclays US Corporate Index), up from 35% a decade ago. A significant percentage of this growth has, however, come from more defensive companies migrating from A-rated down to BBB following a merger and acquisition (M&A) event. The leveraged loans market could be vulnerable to dislocations should economic conditions deteriorate, potentially impacting the broader corporate bond market.



### Year-over-year investment grade EBITDA, sales & total debt growth



Source: Morgan Stanley

### Supply to remain supportive but demand uncertain

New investment grade issuance is expected to decline between 5-10% in 2019 after falling by nearly 10% in 2018. About 20% of issuance this past year has been to finance M&A transactions. This is expected to fall next year as higher all-in yields, increased equity volatility and recent tax changes are likely to deter such activity.

In HY, negative net supply (see chart below) has provided a key technical support, as in 2017. Gross new issuance is down nearly 40% year-over-year as opportunistic refinancing is less attractive, rates have risen, and with the shift in issuance from bonds to loans. The HY bond supply deficit is the highest in over a decade, according to JP Morgan, and we expect this key technical support to continue.

From a demand perspective, corporate bond mutual fund flows turned negative towards the end of 2018 after three solid years of inflows. Investors have been concerned by rising rates,

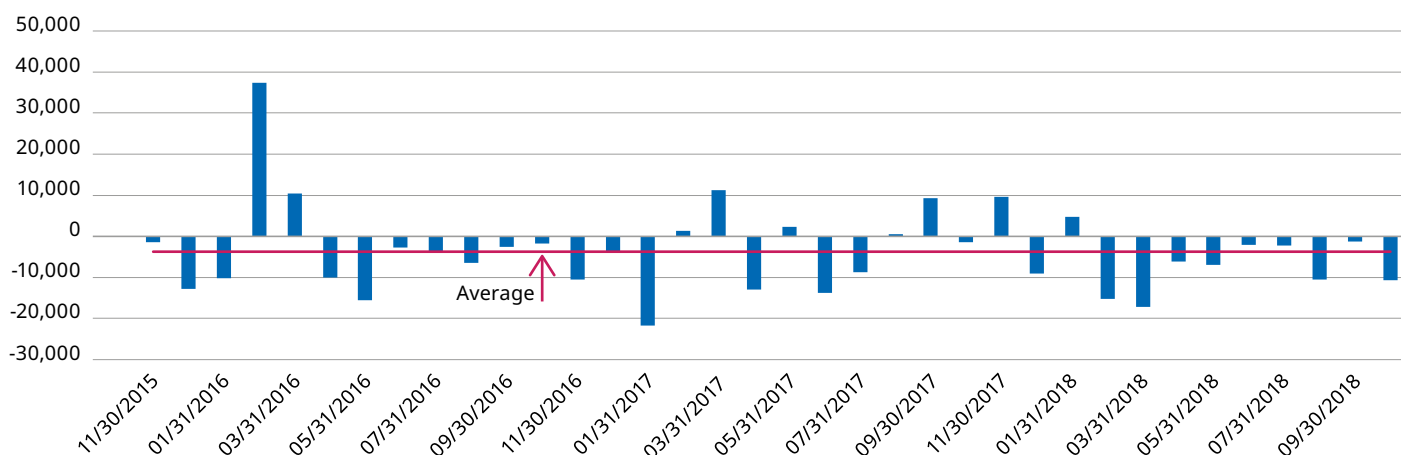
trade-related fears and higher hedging costs. The withdrawal of accommodative policy by central banks will likely result in lower demand for corporate bonds.

As rates increase, those investors who moved down the credit quality spectrum to achieve return goals amid the low rate environment will no longer need to do so. One potential mitigant is demand for long-dated corporate bonds from US pension plans, which are on average 90% funded, and may look to de-risk by rotating from equities to bonds.

Unlike IG, the HY market was never a big beneficiary of foreign demand, but still managed to perform well in 2018. This occurred despite steady outflows through 2018, primarily due to a dearth of new supply.

The recent market weakness has made valuations more attractive. We see scope for investors to re-evaluate HY and possibly add to allocations given strong fundamentals, attractive yields and the positive supply dynamic.

### US high yield net supply in USD millions



Source: Bank of America Merrill Lynch

## Credit valuations attractive once more

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With sentiment shifting amid increased equity volatility, declining oil prices and geopolitical concerns, credit valuations have become more attractive. Global investment grade yields are at levels not seen since mid-2012 while spreads are 50 basis points (bps) higher than the post-2008 lows recorded earlier this year. Given solid fundamentals and expected decreasing supply, we see this as an attractive buying opportunity.

For HY, valuations posed a challenge for much of the year. Spreads remained in a tight range, primarily due to the lack of new issuance, even as other risk assets hit turbulence. HY also benefited from its shorter duration, so was less affected by rising rates, as well as less exposure to trade concerns given the domestic nature of the majority of HY companies.

As in the IG market, HY spreads began to widen in the fourth quarter, due to weakness in oil prices and equity volatility. They are now well above the cycle tights seen earlier in the year. Current pricing looks attractive enough to draw investors back, especially given the benign backdrop for defaults.

## 2019 a year of transition for credit

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After nearly a decade of expansion, September marked the first time since the crisis that central bank balance sheets contracted. We see this continuing with the European Central Bank (ECB) expected to conclude its corporate bond-buying programme at the end of 2018 and other central banks beginning to cut back asset purchases. We will monitor the impact on corporate bonds closely.

Credit fundamentals are in good shape for the new year while the likely decline in supply is a positive somewhat offset by uncertainty around demand. We think attractive valuations and a strong macro backdrop, particularly in the US, could lure investors into corporate bonds across the credit spectrum.

Overall, we see idiosyncratic risk persisting and becoming more of a theme in 2019, bringing increased opportunity to generate returns through issuer and industry selection. That said, despite the broad improvement in valuation, it will be important to remain disciplined and selective to ensure adequate compensation for risk.

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Credit fundamentals are in good shape for the new year while the likely decline in supply is a positive somewhat offset by uncertainty around demand.  
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# Outlook 2019: Global economy

## Author

**Keith Wade**  
Chief Economist  
& Strategist



- We forecast a more stagflationary environment in 2019 with global growth set to slow and inflation to rise
- We expect US interest rates to peak at 3% in mid-2019 but other central banks will continue to tighten monetary policy
- The US dollar looks set to weaken, which could benefit emerging market assets

## We forecast global growth to slow in 2019 and the dollar looks set to weaken with US interest rates peaking mid-year.

The world economy continues to expand but there are signs that growth has peaked as the US, European and Asian economies slow. We expect trade tensions between the US and China to persist well into next year with higher tariffs creating a more stagflationary environment of lower growth and higher inflation.

### Global GDP growth to slow

Our forecast is for global economic growth to slow to 2.9% in 2019 from an estimated 3.3% in 2018. This is below consensus (3.1%) and largely reflects our more pessimistic view on the US. We see US GDP growth at 2.4% in 2019, as the boost from tax cuts fades while interest rates move higher and the effects of a prolonged trade war with China are felt. While the recent 90-day truce is welcome, we remain sceptical on the prospects for a longer-term agreement on issues such as intellectual property rights. We see a further slowdown in global growth to 2.5% for 2020.

In the eurozone, we forecast growth to slow further in the first half of 2019 due to the effects of the trade war between the US and China. Our forecast has GDP growth slowing from 1.9% in 2018 to 1.6% in 2019. Assuming Brexit goes smoothly, the UK should see an improvement in growth in 2019; we forecast GDP growth of 1.4%.

For Japan, we see GDP growth of 1% in 2019, little changed from 2018. The start of the year looks set to be robust, helped by reconstruction spending after the damaging earthquakes, floods and typhoons of 2018. However, VAT is due to rise to 10% from 8% in October and previous VAT hikes have had a significant impact on economic activity.

The picture in emerging markets is mixed, with China and the wider Asian economies under pressure from trade tensions and lower demand in the technology sector. We forecast Chinese growth to slow to 6.2% in 2019 from 6.6% in 2018. Latin America may be a bright spot within the emerging markets as Brazil's economy looks set to strengthen now the elections are over.

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Latin America may be a bright spot within the emerging markets as Brazil’s economy looks set to strengthen now the elections are over.  
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### Inflation on the up, driven by emerging markets

Despite cooler economic growth and lower oil prices, our global inflation forecast has increased to 2.9% for 2019. This is a result of higher inflation in the emerging markets, where currency weakness is pushing up import prices.

In the advanced economies, we have trimmed our inflation forecast as a result of downgrades to Japan and the UK. For Japan, the lower forecast includes special factors such as a 20% cut in mobile phone charges. For the UK, we forecast inflation to fall from 2.5% in 2018 to 1.8% in 2019. This is due to softer oil prices as well as expectations that sterling will strengthen against most currencies in the event of an orderly Brexit.

For the US, we see inflation remaining elevated in 2019 at 2.7%. Our projection reflects the tighter capacity typical of this late stage in the economic cycle as well as higher import tariffs as the trade war continues.

### US rates to peak in mid-2019

We anticipate three more interest rate increases from the US Federal Reserve (Fed), taking the Fed funds policy rate to a peak of 3% in June 2019. We assume that the Fed will “look through” above-target inflation in 2019 and will pause to take account of the effects of slower growth on future price rises. We then expect rate cuts in 2020 as the US economy cools further.

For the Bank of England, we look for two rate rises next year, although this is dependent on a smooth exit from the EU with a transition period for the economy.

Meanwhile, the European Central Bank (ECB) is expected to end its asset purchase programme in January 2019 and to raise interest rates in September. This would be the first increase during ECB President Draghi’s tenure and would also be his last given he steps down from the post in October. Although eurozone growth is expected to be weaker next year, it will still be above trend and sufficient for a central bank keen to start raising interest rates from ultra-low levels.

- For more on the longer-term outlook for growth, inflation and other economic forces, please see our Inescapable investment truths for the decade ahead<sup>1</sup>

<sup>1</sup> [www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/](http://www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/)

### Weaker dollar could be silver lining for emerging markets

We expect the combination of a peak in US rates and the start of tighter monetary policy elsewhere to result in a weaker US dollar in 2019. Although the difference between US interest rates and those elsewhere will remain in favour of the US, currency markets are likely to have priced this in already. We think currency markets will increasingly focus on the growing budget and current account deficits in the US, which will drag the currency lower. The current account is a nation’s transactions with the rest of the world, including net trade.

For the emerging markets, a weaker dollar could be the silver lining in the outlook. Although an escalation of the trade wars and the prospect of slower global growth does not bode well, a weaker dollar would help ease pressure on the region. In 2018, rising US interest rates and a stronger dollar squeezed dollar borrowers outside the US, put pressure on emerging market currencies and forced local central banks to tighten monetary policy. Dollar strength also weakened commodity prices and hurt world trade. In 2019, there is scope for some of these factors to unwind, thereby easing financial conditions and supporting emerging market assets.

For the eurozone this scenario is less favourable as a stronger euro will tighten financial conditions, while the slowdown in the US is dragging on global growth. Both factors make it harder for the ECB to keep raising interest rates. There is a strong possibility that the ECB has left it too late to normalise interest rates and will look back on the past year as a missed opportunity. The region could become stuck with low rates and with little monetary firepower to fight the next downturn.

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. We accept no responsibility for any errors of fact or opinion and assume no obligation to provide you with any changes to our assumptions or forecasts. Forecasts and assumptions may be affected by external economic or other factors. The opinions/forecasted views above should not be construed as advice or recommendation.

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For the emerging markets, a weaker dollar could be the silver lining in the outlook.  
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# Outlook 2019: Global equities

## Authors

### Alex Tedder

Head and CIO of Global  
& US Large-Cap Equities



### Simon Webber

Lead Portfolio Manager



- In general, markets are moving into a new phase in which inflation is on the rise and central banks are offering less support to markets
- There is plenty of complacency in equity markets about the risks from higher interest rates and elevated corporate debt
- We believe that some of the best investment opportunities are to be found where industry disruption is significant, such as in the transition to renewable energy

## We are seeking out companies investing for change in 2019, while increasingly wary of those that have borrowed excessively.

In 2018, global economic growth remained broadly stable, but in contrast to 2017, it is no longer so closely synchronised. The US continues to expand robustly, while data from the eurozone and China has cooled. Japan has also failed to keep pace with the US, while UK growth remains sluggish and any improvement in business confidence remains contingent on Brexit outcomes.

At the same time, global monetary policy is tightening as central banks step back from their long-standing market support. This trend has been clearly telegraphed, but after nearly a decade of exceptionally low interest rates, there is plenty of complacency in equity markets about the risks from higher rates and elevated corporate debt. Indeed, this is one of Schrodgers' "inescapable investment truths"<sup>1</sup> for the decade ahead.

### The best laid plans...

Higher borrowing costs are not the only risk to profitability and valuations. Labour, energy and other business costs are generally rising. At the same time, a trend towards protectionism is creating less efficiency in the sequence of processes needed to create goods, also known as the supply chain. An era of low costs has been one of the outstanding features of the longest US bull market<sup>2</sup> in history – but we are beginning to see clear signs of wage and cost pressures. Amazon's wage hike to \$15/hr, and Caterpillar's recent guidance on higher raw material costs appear closely linked to tariff and trade effects, are milestones in that respect. It would seem likely that US profitability in particular will start to fall back to longer-term averages during 2019/2020.

It is an unusually difficult environment for companies to plan, and we expect there to be more profitability surprises in the year ahead. The aggressive trade stance that the US has struck since the start of the year remains a significant threat to smooth economic function and the frictionless flow of goods around the world. Companies with a supply chain heavily reliant on China could be faced with 25% tariffs on exports to the US in 2019. We could, equally, see a trade deal with lower barriers than we had before. These are clearly two very different cost and business environments and makes planning extremely hard for companies.

In many cases, supply chains cannot be moved quickly, given how long it takes to assess suppliers properly or construct factories in new places. A premium could well be placed on those companies that have invested to avoid or limit supply chain disruption. All of this makes for a more uncertain profit outlook than usual.

<sup>1</sup> [www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/](http://www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/)

<sup>2</sup> A bull market is broadly defined as one that rises over time without falling more than 20% from its peak during the period.

Arguably, the market correction in early Q4 indicates that investors are no longer as complacent around trade concerns as they have been. Equity valuations have fallen to or below their longer-term averages as measured by headline price to earnings (P/E)<sup>3</sup> ratios. However, P/E ratios are not the only valuation measurement. If the ongoing trade conflicts or a recession tip earnings into a downcycle, more attractive P/E ratios now will be of little comfort. In such an environment, the debt encumbered companies we referred to above could be badly hurt.

We are generally cautious towards companies with high debt levels or those that cannot raise prices in order to offset the higher costs they face. We think telecoms is the best example of such a sector just now.

## Disruption and opportunity

Identifying the companies best prepared to weather - or indeed prosper - from the new phase of the business and economic cycle, will require an active approach and thorough understanding of company fundamentals.

We believe that the current period of disruptive change across many industries presents significant investment opportunities. We favour many of these exciting disruptor companies and think the consistent in the stock market to factor in the true long-term growth prospects of high-quality growth businesses continues to make many of these stocks attractive.

It remains critical for businesses and investors alike to ensure that they are on the right side of the disruption. We focus on identifying those businesses that are willing to invest for the long-term, are prepared for change, and can create sustainable growth from their business models.

Take the shifting demand between fossil and renewable energy sources. Fossil fuel energy prices have - until a recent correction - been rising, as industry investment in 2015-2017 was lower as a consequence of weaker energy (and other commodity) prices earlier in the decade. The rise in fossil fuel prices and improvement in renewable energy economics means alternative energy technologies are increasingly competitive. We expect demand to strengthen for both renewable power and electric vehicles. We continue to look for good companies that can participate in this long-term growth, while avoiding the most competitive parts of these industries and companies that do not offer a unique service.

We also favour a number of consumer and technology stocks. The competitive landscape in content and media consumption is changing rapidly, making for a rich source of opportunity, particularly in social media, music and gaming. In some instances, valuations in these areas look high, but we think the market underestimates the ability of a number of companies to expand their business activities and/or monetise content to support long-term growth trajectory.

<sup>3</sup> A ratio used to value a company's shares. It is calculated by dividing the current market price by the earnings per share.

The opinions above include forecasted views they should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. Forecasts and assumptions may be affected by external economic or other factors, they should not be taken as advice or a recommendation to buy and/or sell.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

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The competitive landscape in content and media consumption is changing rapidly, making for a rich source of opportunity, particularly in social media, music and gaming.  
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# Outlook 2019:

## Income

### Author

**Rupert Rucker**  
Head of  
Income Solutions



- Investors continue to aim for ambitious levels of income
- Interest rates are rising in many developed economies but look set to remain below pre-crisis levels and often below inflation
- Investors seeking sustainable higher income may need to invest for the longer term and accept that their capital is at risk

## Sustainable higher income remains a top priority for investors in 2019 but will still be hard to find, even as interest rates rise.

Income looks set to remain a primary focus for investors as we head into 2019. Results from the most recent Schroders Global Investor Study show that the average level of income investors are seeking from their investments has increased from 9% to 10%<sup>1</sup>. This is an ambitious target.

The challenge for the foreseeable future is that traditional sources of income cannot fulfil investors' needs. In the past, investors could earn decent levels of income with limited risk to their capital by depositing their savings in banks and government bonds.

That has changed since the financial crisis, and returns on lower risk assets such as cash and some western government bonds are much lower than they were before 2008. This has resulted in a mismatch between investors' expectations and the reality of the current investment landscape.

It is true interest rates are rising or may at least have bottomed across many developed economies. However, we have made a long-term broad assumption for our income solutions that interest rates globally will not revert to pre-crisis peaks. We foresee they will settle at levels which will still make bank deposits and government bonds an unattractive source for income for some investors.

- For more on the long-term outlook for interest rates, see Inescapable investment truths for the decade ahead<sup>2</sup>

This is not without historical precedent. Indeed, the anomaly is the spike in interest rates in the 1970s. This chain of thought is based on persistent structural disinflation from new technology, globalisation and demographics, on top of the huge debt piles that persist in many economies.

As a result, investors may find that traditional income providers offer a risk profile that meets their needs in terms of keeping their money safe but cannot in return give them the meaningful income which they are seeking, even if they lock their money up for a long time. If they adjust for inflation, their return could be next to zero or even negative in some cases.

For example, in the UK there has been a lot of noise about Goldman Sachs launching their retail bank called Marcus, offering a deposit rate of 1.5% to lucky depositors. We need to remember that inflation is currently 2.4% in the UK. It is rare to find so much excitement over an opportunity to, in effect, 'lose money' as inflation will still erode the real terms value of their savings.

1 [www.schroders.com/en/insights/global-investor-study/investors-seek-minimum-income-of-10.1/](http://www.schroders.com/en/insights/global-investor-study/investors-seek-minimum-income-of-10.1/)

2 [www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/](http://www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/)



Cash and other assets such as government bonds are therefore not the answer for some income investors, in our view. Yet the same Global Investor Study referred to above revealed that investors are still holding 20% of their assets in cash<sup>3</sup>.

What are the alternatives? For investors looking for higher income, the investment journey has become a lot more complicated. They now need to look for other investment sources to meet the income they seek. There are many investment options for them to research and understand. This is stressful.

They now have to make a choice between handing over their money to investment experts or trying to invest themselves. In both cases, the value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. In addition, there is suddenly a huge choice of investment opportunities offering much higher potential returns but these come with (in general) much higher risk. And how do they know which ones will suit their needs?

They could reasonably decide to invest themselves. This is entirely viable but they may be restricted to a narrow list of choices and possibly lack expertise in conducting sufficient analysis.

The search for income is also a question of expectations. Investors may need to dial down their income ambitions in this world of lower interest rates and returns. For example, the dividend yield on global equities is around 2.5% (as of November 2018). Earning sustainable higher income will involve taking on more risk (particularly in terms of the volatility of day-to-day changes in the value of their capital). Investors will need to remain invested for a long period of time, as that is the only way that short-term declines in capital values can be restored and income earned.

For investors who can make that commitment, the Schroders Income strategic capability has a range of potential solutions. It covers a global set of opportunities across a wide range of asset classes including shares, bonds, multi-asset, real estate and more.

In short, while interest rates might be on the rise in 2019, investors may need to look beyond cash savings to achieve their income goals.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. This information is not an offer, solicitation or recommendation to adopt any investment strategy.

<sup>3</sup> [www.schroders.com/en/insights/global-investor-study/2018-findings/investing/](http://www.schroders.com/en/insights/global-investor-study/2018-findings/investing/)

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# Outlook 2019: Japanese equities

## Author

**Ken Maeda**  
Head of  
Japanese Equities



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Japan’s economy is gradually improving under a stable domestic policy environment, but external risks and trade friction could continue to affect investor sentiment in 2019.  
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- Stable domestic policy environment could be offset by external risks
- Japan has continued to see a gradual improvement in domestic economic conditions
- Corporate profits responding positively to the improved domestic backdrop

**Japanese companies continue to respond positively to the improving domestic conditions as they begin to regain some pricing power after almost two decades of deflation.**

Japan’s economy is gradually improving under a stable domestic policy environment, but external risks and trade friction could continue to affect investor sentiment in 2019.

### Domestic policy environment to remain stable in 2019

After his reappointment as governor of the Bank of Japan in April, Governor Kuroda has continued to pursue an aggressive monetary policy stance with the aim of achieving a sustainable exit from deflation. However, since July, there has been considerable debate generated by Kuroda’s attempts to fine-tune the implementation of these policies without changing any of the headline objectives. Although this has been portrayed as a necessary transition to a more sustainable version of the same policy, these moves can also be interpreted as containing elements of tapering from the highly accommodative stance.

Following the Liberal Democratic Party’s (LDP) victory in a snap general election in October 2017 and his subsequent re-election as party leader in September 2018, Prime Minister Abe can now continue in his position, should he choose to do so, until 2021. In the process, he would become Japan’s longest serving prime minister.

### Consumption tax to increase in October 2019

Shortly after the end of September, the government confirmed that the next increase in consumption tax would go ahead, as planned, in October 2019. The final decision on this had not been expected for several more months but the early announcement may simply be a reflection of the complexity of the implementation this time, rather than carrying any particular political message. In addition to a range of exemptions from the new higher rate, the government is also planning a series of stimulus measures designed to mitigate the extent of economic dislocation seen around previous tax increases. At this stage, it is unclear what the net impact to the economy of all these measures might be.

Meanwhile, although we expect no substantive change to monetary policy in the near future, there is a chance that the Bank of Japan may choose to act earlier than strictly necessary in order to avoid making any change around the same time as the tax increase.

Beyond October 2019, long-term equity investors should be considering the possibility of an exit from current monetary policies within their time-horizon. If the authorities are able to declare a sustainable exit from deflation, this could dovetail well with the final stages of Prime Minister Abe's tenure. Although these appear to be largely political considerations, they reflect the underlying improvements in the real economy which are, in turn, driving the corporate profit growth we are expecting over the next couple of years.

### Gradual improvement in domestic economy

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Japan has continued to see a gradual improvement in domestic economic conditions despite some short-term weakness in headline GDP in the first quarter of 2018.

Meanwhile, the labour market has continued to show sustained improvement, which is maintaining upward pressure on wages. The extent to which higher participation rates have offset Japan's known demographic issues continues to be widely under-reported, but should properly be regarded as a key success for government policy. Although this particular trend must reach a natural peak soon, the tightness of the labour market is capable of sustaining the recent upward pressure on wages. This will ultimately feed through to inflationary expectations which will, in turn, generate better pricing power for domestic-oriented companies.

Capital expenditure is also running well ahead of companies' earlier expectations. This is partly a rational response to the macro impact of labour shortages but is also a reversal of the long-term trend of underinvestment, especially in technology and systems, through the period of deflation.

### Japan has avoided confrontation with the US, for now...

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Against this domestic stability, considerable uncertainty has been generated by the rapid escalation of trade issues between the US and China. Japan has avoided a focus on its own trade surplus with the US but the persistent imbalance in autos, in particular, remains a potential easy target for the Trump administration. The secondary effects of the US dispute with China could also become more significant for Japan over the next twelve months.

### Foreign investors remain unconvinced

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Overseas investors have continued to take a relatively fickle approach to Japanese equities. In aggregate foreigners tend to be influenced by market momentum, appearing as sellers into market weakness and buyers into strength. The result is that we have seen no follow-through from the improved visibility on corporate profits and the recent market setback has led to further de-rating of market valuations.

Meanwhile, the Bank of Japan remains a large consistent buyer of equities via ETFs. Although this may be an effective route for its asset purchase programme, it also carries an increasing risk of distorting market prices. For 2019, however, there is no reason to expect the scale of buying to fade, and it is definitely much too early to worry about the potential impact of the central banks holdings being unwound.

### Corporate profits responding to economic improvements

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While a modest pick-up in inflation and wages will imply some higher costs, corporate profits are generally responding positively to the improving domestic conditions as companies begin to regain some pricing power after almost two decades of deflation.

While investors seem destined to live with higher levels of external risks, especially on trade, some of the domestic risks have receded in recent quarters and we should therefore have more conviction in our view of current Japanese equity market valuations.

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Japan has continued to see a gradual improvement in domestic economic conditions despite some short-term weakness in headline GDP in the first quarter of 2018.  
”

# Outlook 2019: Multi-asset

## Author

Johanna Kyrklund

Global Head of  
Multi-Asset  
Investments



- The economic backdrop looks more challenging and there is a risk of US recession in 2020
- Markets may prove volatile and government bonds can be a useful diversifier
- There are still opportunities for positive returns; we highlight low emerging market valuations

**The traffic light for investing is turning from green to amber, but it's not time to slam on the brakes just yet.**

We move into 2019 in a sombre mood after a year of challenging markets. Whilst it is tempting to blame the political headlines, the reality is that economic growth outside of the US has been disappointing. Combined with rising rates in the US, this has led to weaker prices pretty much across the board.

### Economic cycle is turning more challenging

Based on the indicators we track, there is now a reasonable probability of a US recession in 2020 as the impact of fiscal stimulus fades. We are cognisant that we are moving into a more challenging phase of the cycle. Growth in Europe and Asia remains dependent on an acceleration in global trade, which we view as unlikely. At the same time, the best we can hope for from the major central banks is that they step back from their planned withdrawal of liquidity.

### Still opportunities for positive returns

However, against this backdrop, we still see opportunities to generate positive returns, however. The US 10-year yield is sitting quietly around 3% and we expect only a couple more rate hikes from the Federal Reserve in 2019. This should underpin equity valuations and provide diversification benefits from bonds in a multi-asset portfolio. Lower oil prices should support consumption and put a lid on inflationary pressures. Emerging market valuations are provocatively low and provide a cushion to political concerns.

### Caution needed amid likely volatility

In 2019, we expect markets to oscillate based on an assessment of the probability of US recession. The traffic light is turning from green to amber, we would emphasise more cautious investments, but we don't need to slam on the brakes just yet.

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. Forecasts and assumptions may be affected by external economic or other factors. Forecasts should not be taken as advice or recommendation.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

“  
Emerging market valuations are provocatively low and provide a cushion to political concerns.  
”



# Outlook 2019: Multi-manager

## Authors

### Marcus Brookes

Head of  
Multi-Manager



### Robin McDonald

Fund Manager



- Slowing US growth in 2019 should not come as a surprise as the fiscal impulse fades and the effects of higher interest rates strike the economy
- For now, we think the Federal Reserve will continue hiking rates until the economy slows below trend, which may not appear obvious until the second half of 2019
- In the meantime, markets are left discounting a tricky combination of slower global growth, higher interest rates, quantitative tightening and falling profit margins

## Avoid the crowds in 2019; focus instead on value, gold and maybe even the UK.

Capital preservation has been the name of the game so far in the fourth quarter of 2018, and we expect that to remain the priority for much of 2019 too. To that end, we are deploying four main strategies:

1. Taking advantage of lopsided positioning by leaning against crowded trades
2. Emphasising value over growth
3. Giving precedence to defensives over cyclicals
4. Owning gold for when the Federal Reserve (Fed) eventually turns dovish

### Bonds behaving badly

An obvious omission from the above list is going long government bonds. To be clear, in more normal times, we would be long the asset class by now. Equally, in pretty much any other cycle before this one, government bonds would be behaving far better than is currently the case. Historically, as the economy slows, the fundamental argument for owning core government bonds improves. The problem however, as mentioned in our recent quarterly<sup>1</sup>, remains principally one of price.

Before the financial crisis, a country's 10-year yield traded roughly in-sync with its trend rate of nominal GDP growth. This relationship broke down with the advent of quantitative easing (QE). The table below, with data courtesy of the OECD, presents where we are today:

Country	Forecast 3-yr average nominal GDP growth (2018 - 2020)	Current 10-year bond yield	Yield discount to 3-yr average nominal GDP growth
US	4.9%	3.1%	1.8%
UK	3.1%	1.4%	1.7%
Germany	3.7%	0.4%	3.3%
Japan	1.4%	0.1%	1.3%

<sup>1</sup> <https://www.schroders.com/en/sysglobalassets/digital/insights/2018/pdf/multi-manager-quarterly-view-web.pdf>

Admittedly, QE is not the only reason why this unnatural gap now exists, but it is the most significant one in our view. This policy is now being unwound in the US, is dormant in the UK and ending in Europe and Japan. That means there is a meaningful counterbalance to the forces that would ordinarily see bond yields decline and prices rise (another is boosting the fiscal deficit to over \$1 trillion at a time of full employment). To our mind, this goes a long way to explain why bonds scarcely helped investors in October when equities tumbled.

While we are not ruling out buying government bonds next year, we prefer at present to compensate for the role they would have traditionally played via other means. The Fed turning justifiably more dovish is one reason we would reassess this stance. Equities falling and the oil price crashing have yet to really move the needle.

## The political playbook

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Clearly, geopolitics will continue to have a sizable impact on sentiment both domestically as well as internationally.

How will Brexit evolve? Will there be a trade deal between the US and China? What are the implications of a Democratic House on Trump's presidency? The answers to these questions will inevitably have a profound bearing on how the year ultimately pans out. The impact of a rising cost of capital on US buybacks will also be important.

“  
**Not that we are convinced of a favourable Brexit outcome necessarily, more that we consider an unfavourable outcome as being already reasonably discounted.**  
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## Avoid the crowds

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Something we have felt for some time is that in spite of the outlook appearing unusually uncertain, investors have seemed pretty sure about which assets would outperform. The extreme degree of capital concentration in a shrinking number of securities was testament to this view.

We have written before of how US assets this cycle have re-rated against all others to such an extent that they represent more of a risk than an opportunity today. In the long-term, that stands in meaningful contrast with assets both in the UK and internationally outside the US. We continue to position the portfolios for capital dispersion as opposed to further capital concentration in the US, not least as its growth rate, one way or another, is likely to converge somewhat with the rest of the world over the next 12 months. In summary, markets everywhere are in the process of repricing for a classic period of late-cycle stagflation. We think this is appropriate. How the Fed responds will inevitably be important, as will the investor response to the Fed. To be clear, pausing on rate hikes will be as good as it gets in our view. This is absolutely not an environment that justifies a rate cut or further QE. The unemployment rate is simply too low and deflationary pressures non-existent. Furthermore, the Fed under Jerome Powell's leadership seems far less responsive to market volatility than under his predecessors Yellen, Bernanke or Greenspan.

## A sterling effort

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For the time being, we expect crowded trades to remain under pressure as extreme positioning is unwound. For UK investors, the performance of sterling adds a further layer of complexity to asset allocation. On conventional measures such as Purchasing Power Parity (PPP), sterling is c.20% cheap relative to the dollar. That implies a 25% move to reach fair value, assuming it doesn't overshoot. This highlights an additional risk to owning unhedged assets overseas when your domestic currency is one of the cheapest around. We currently have little exposure to the US in part for this reason.

Not that we are convinced of a favourable Brexit outcome necessarily, more that we consider an unfavourable outcome as being already reasonably discounted. We anticipate increasing our exposure to the UK over the course of the year.

For more on our views regarding some of the other themes outlined above, please refer to our recent quarterly 'Rising yields don't matter...until they do'<sup>2</sup>.

<sup>2</sup> <https://www.schroders.com/en/sysglobalassets/digital/insights/2018/pdf/multi-manager-quarterly-view-web.pdf>

# Outlook 2019:

## Securitised credit and asset-based lending

### Author

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**Michelle Russell-Dowe**

Head of  
Securitized,  
US Fixed Income



- We are expecting asset prices to remain stable and performance reasonable in 2019, albeit below 2018 levels
- Securitized credit offers a respite from overcrowded corporate credit
- Today, investors must work harder to identify markets that are inefficient or offer more material compensation for risk

### The securitized sector offers respite from overcrowded corporate credit markets and inefficiencies continue to create opportunities.

The conditions framing 2018 will persist into the New Year, governing value through 2019, namely:

1. Fed interest rate policy and QE
2. Persistence of regulation of banks and insurance companies globally
3. Lack of affordable housing supply

The Federal Reserve (Fed) is the first major provider of quantitative easing (QE) to substantially reverse course. While QE and low interest rates have supported investment returns, it has also led to many markets becoming crowded. However, securitized credit, excluding Agency mortgage-backed securities (MBS, guaranteed by government-sponsored entities), has received far less benefit and is less exposed to an unwinding.

Securitized credit offers a respite from overcrowded corporate credit, as – other than Agency MBS – it sits outside of major benchmarks and does not feature in ETFs.

### Securitized's strong 2018

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Securitized was one of the best performing credit sectors in 2018. The table below shows how various sectors compare with traditional government, corporate and high yield bonds. It benefited from a combination of limited supply, high spreads, strong fundamentals, and more conservative lending standards. Tighter banking regulation is behind that last point. All of these conditions look set to persist in 2019.

However, securitized markets have recently seen some of the yield spread compression that has occurred across the credit universe. This has even happened in some private markets. The illiquidity premium has declined, especially within markets for larger loans or trades that are more scalable. Today, investors must work harder to identify markets that are inefficient or offer more material compensation for risk.



## 2018 Year to Date

	Total Return	Excess Return (vs. Swaps/LIBOR)	Current Spread
<b>Legacy Non-Agency MBS</b>	2.7%	0.9%	123
<b>CLO</b>	2.5%	0.2%	176
<b>Floating-rate ABS</b>	2.4%	0.1%	61
<b>Fixed-rate ABS</b>	1.4%	0.4%	49
Corporate High Yield	-0.1%	0.2%	418
<b>CMBS</b>	-0.3%	0.7%	82
<b>Agency CMBS</b>	-0.7%	0.3%	44
<b>Agency MBS</b>	-0.8%	-0.3%	38
US Treasury	-1.4%	0.2%	N/A
Corporate Inv. Grade	-3.7%	-1.6%	139

Data to 30 November 2018. Source: BAML, Palmer Square, Bloomberg.

MBS= Mortgage Backed Securities; ABS= Asset Backed Securities; CMBS= Commercial Mortgage Backed Securities; CLO= Collateralized Loan Obligations. Excess returns are measured over swaps for fixed rate assets and LIBOR for floating rate assets.

Regulation of banks and insurance companies has been critical to strong performance. Regulations, such as Solvency II and Basel III (and soon IV), have resulted in pressure on banks and created opportunities to access a diverse set of assets. Investors have been able to step in and replace community banks in real estate transactions and new opportunities have emerged to finance capital relief transactions for the banks. We do not see regulatory relief in sight and expect these inefficiencies to continue to create opportunity next year.

### Agency MBS: an attractive diversifier

The nearly \$8 trillion Agency MBS sector is one where net supply is increasing. With heavy bank regulation in the US, the bulk of US mortgage financing still sits under the government umbrella. The Fed itself is also a substantial owner of Agency MBS through its QE programme. However, it is running down this portfolio, which is increasing net supply and cheapening prices.

Agency MBS offer value now that we have reached the monthly cap in the Fed's "run off" programme. Additional support comes from the current mortgage rate being higher than the bulk of the outstanding mortgage market (the coupon on the index), which mitigates extension risk. We view Agency MBS as an attractive diversifier against traditional corporate credit risk and expect that to remain true next year.

With boosters like the Trump tax package, the US economy has grown more than other developed markets in 2018. The US consumer is strong, household balance sheets are healthy, and debt service costs (mostly fixed-rate) remain low. These factors are all strong fundamental supports for US asset-backed securities (ABS) and MBS.

### CLO clouds gather

At more than \$1.3 trillion outstanding, the market for leveraged loans is a growing example of a crowded market. Half of the US leveraged loan market is financed via Collateralized Loan Obligations (CLOs) and this is one of the markets where we see clouds on the horizon.

Typical investor protections, such as loan covenants, have been shed. This is already resulting in below average recovery rates when loans default. We believe that investors are not compensated for this increasing risk and should remain in the most senior levels of CLO capital structures. Additionally, external pressures could increase refinancing demand, while limiting refinancing options for outstanding leveraged loans, a typical precursor to higher default rates.

### Continued demand for floating rate assets

One of the conditions creating demand for leveraged loans is increasing US interest rates. Their floating-rate nature has provided credit exposure without detrimental exposure to rising interest rates. We believe this will continue to play a part in 2019.

Floating rate exposure is also a feature of much of the global securitized credit market, excluding Agency MBS. In addition, assets like consumer ABS and MBS are backed by loans from sectors that are more regulated and have not re-leveraged as dramatically as the corporate market.

## US rental housing as a defensive asset

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Mid-term elections in the US are settled, with the House and Senate controlled by different parties. US legislative changes such as tax plans or regulatory shifts are hence now much less likely. This reduces the chance of constrained residential mortgage lending abating.

This time around, the US lending landscape excludes the “affordability products” prevalent prior to the financial crisis. The vast majority of existing home loans are now fixed-rate. As such, existing mortgagors are unlikely to be challenged should mortgage rates rise.

Affordability, for a new home buyer; however, makes for significant headlines given the importance of housing as a basic need for nearly everyone. On one hand, rising home prices, as we’ve seen over the last several years, increase homeowners’ equity and provide protection for investors in earlier securitisations. On the other hand, with low supply of homes and rising mortgage rates, new home-buyers may be priced out. With lower availability of smaller square footage housing or affordable apartments, home prices in many markets are likely to be well supported. But something has to give as mortgage rates rise and we believe demand for rental housing is likely to rise. We view this as an important trend to monitor and a potentially defensive asset to own or lend on.

## Contrasting fortunes for auto and student loans

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Other types of lending, such as auto lending, have seen standards tighten and the benefits of recent declines in oil prices. We see this sector as priced fairly, even given the increased leasing activity seen in recent years.

In contrast, student loan debt has been the growing pariah of the consumer debt space, likely driving some of the delays in household formation and home buying. This continues to be a sector where we see higher levels of political risks.

## US resilience in 2019

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Despite some risks, we generally expect US ABS and MBS to have a lower correlation to downdrafts than other markets and continue to exhibit more attractive return per unit of duration, or price volatility. That said we still highlight the potential for changes in areas where credit or pricing has got ahead of itself, such as for leveraged loans or more subordinated Commercial Mortgage-backed Securities

We expect the Fed will focus on the consumer, housing and inflation as decision tools when evaluating rates. As a result, we are expecting asset prices to remain stable and performance reasonable in 2019, albeit below 2018 levels.



# Outlook 2019: Sustainability

## Author

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**Jessica Ground**  
Global Head of  
Stewardship - ESG



- With a growing number of extreme weather-related events in the years ahead, certain sectors are at risk of suffering damage to physical assets and rising costs
- Governments are likely to look to corporates to help them tackle the imbalance between generations
- Companies with too much debt are vulnerable to a rising interest rate environment

**The next few years will see rising physical losses from climate-related events, higher taxes to combat intergenerational inequality and tougher conditions for over-levered corporates.**

Usually sustainability experts avoid having to pen market outlook pieces; it's all about the long term after all... But our thesis at Schroders is that environmental and social change is accelerating, generating an ever-stronger headwind for companies to navigate.

2018 has provided ample evidence of this, with populism continuing to rise alongside global temperatures. Increasingly, there is nowhere to hide for companies who don't operate in a sustainable way: technology companies, which in the past seemed almost untouchable, have seen more taxation, regulation and a number of uncomfortable moments in front of Congress.

Against this backdrop, environmental, social and governance (ESG) analysis and forecasting has never been more important for investors. This is one of Schroders' inescapable investment truths for the decade ahead<sup>1</sup>.

### Environmental: the physical risk of climate change

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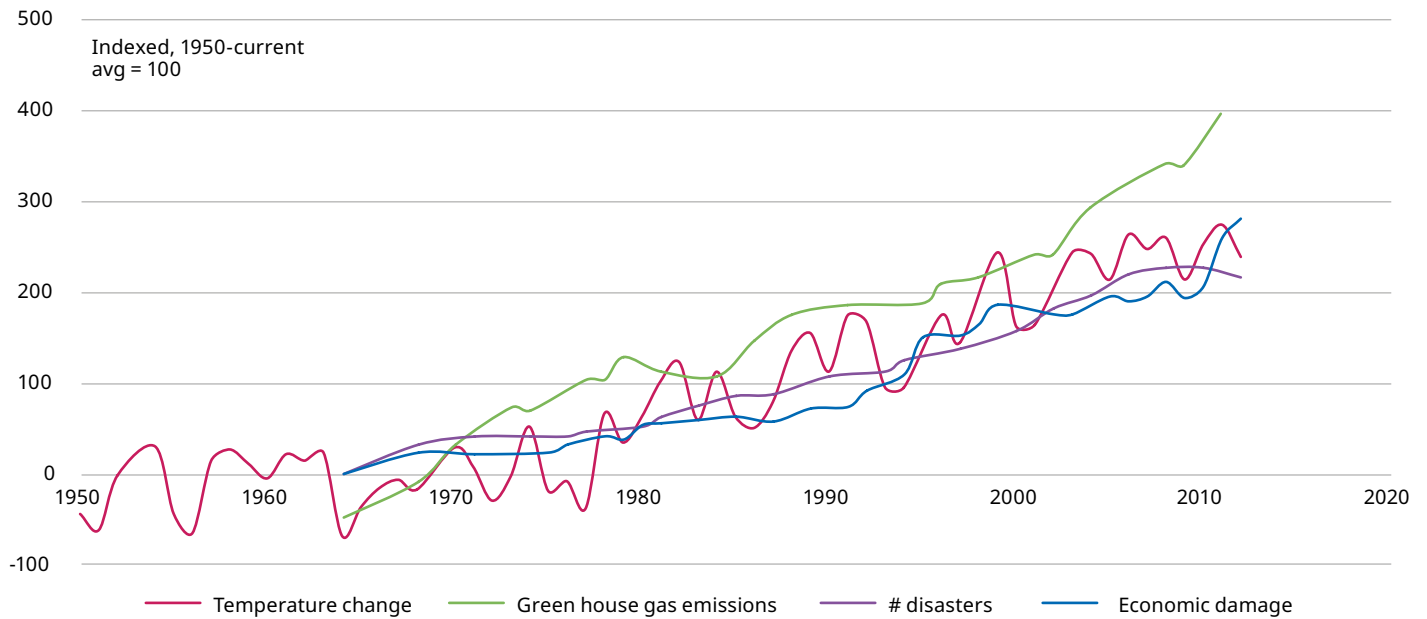
Surely climate change is the ultimate long-term issue, most of you will be thinking. So much of the analysis in this area is about far-off risks and talk about action that needs to take place by 2030; a lifetime for markets.

However, one aspect of climate change is here and now: as temperatures climb so the physical losses from extreme weather events are expected to do so too. This could be especially pertinent in 2019 given that experts expect an El Nino weather pattern to develop, causing warmer temperatures and increasing the possibility of severe weather around the world.

Investors often neglect to thoroughly understand just how vulnerable a company's physical assets and infrastructure are to severe disruption and damage as a direct result of drastic weather patterns. Recognising this, we created a physical risk framework which we applied to over 10,000 companies globally. It calculates the amount of insurance businesses would have to pay to protect their physical assets against weather-related hazards.

<sup>1</sup> [www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/](http://www.schroders.com/en/insights/economics/inescapable-investment-truths-for-the-decade-ahead/)

## Rising temperatures, emissions, natural disasters and economic damage



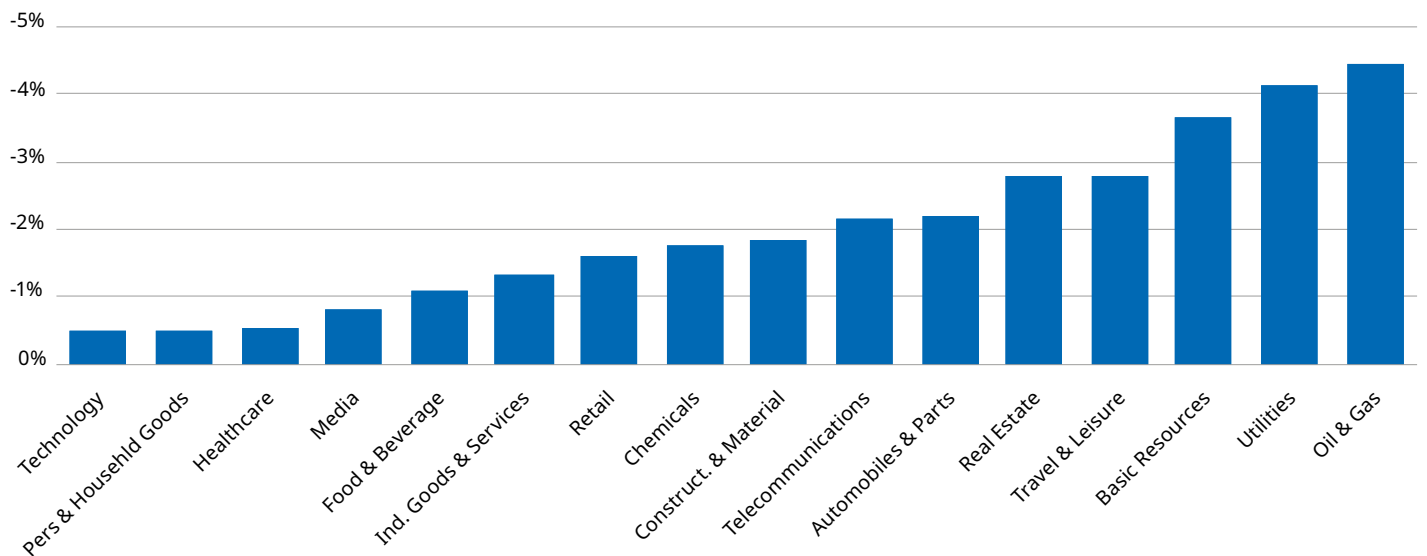
Source: EM-DAT, NASA, Schroders and UN FCC. Based on most recent data available in May 2018.

We identified oil & gas, utilities and basic resources as the sectors most exposed to the physical impact of climate change<sup>2</sup>. The potential cost of insuring their physical assets equates to more than 3% of their market values. The sectors least at risk are technology, personal & household goods and healthcare.

There is growing evidence that climate change is exacerbating natural weather systems and that going forward we are likely to see harsh weather materialise more frequently. This doesn't just apply to 2019 and its possible El Niño event, but to future years as well. This may have important investment implications.

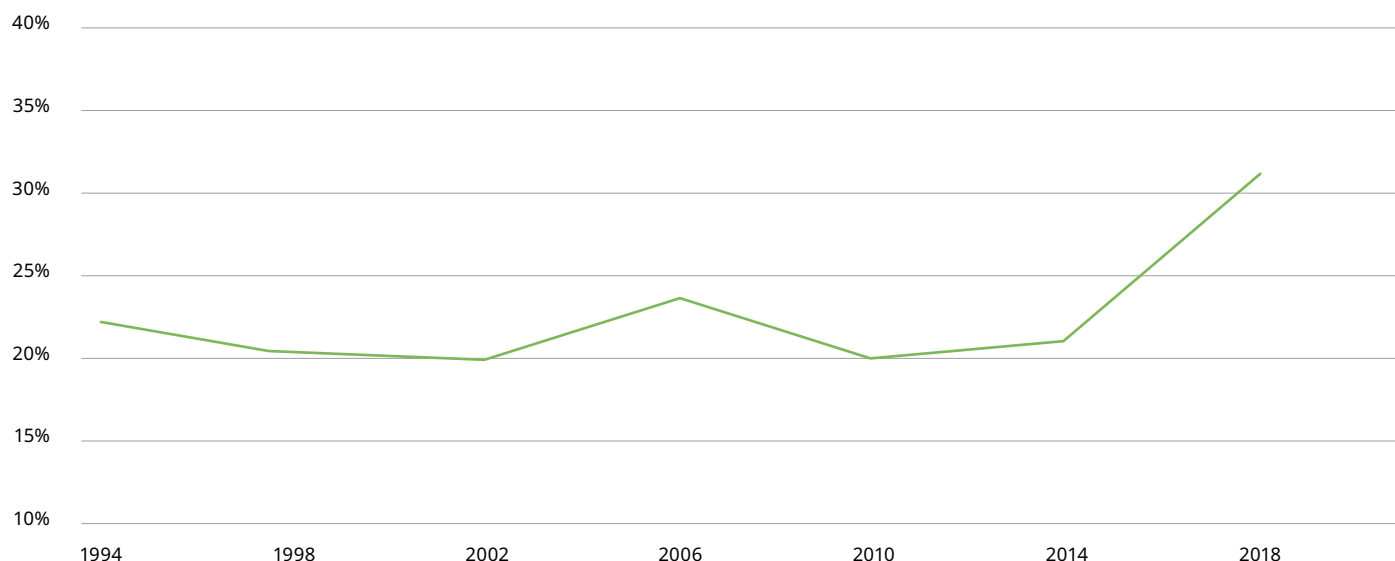
<sup>2</sup> [www.schroders.com/en/insights/economics/how-will-physical-risks-of-climate-change-affect-companies/](http://www.schroders.com/en/insights/economics/how-will-physical-risks-of-climate-change-affect-companies/)

## Enterprise value adjustment for physical climate risks (%)



Source: Schroders based on latest data as of June 2018. Based on calculations using data from Thomson Reuters, Germanwatch, MunichRe and SwissRe.

## High youth turnout in 2018 US midterm elections (ages 18 – 29)



Source: The Conversation, The Center for Information and Research on Civic Learning and Engagement, November 2018.

### Social: Corporates to bear the brunt of the youth challenge

Many think that the “S” of ESG is the most difficult part of the acronym to analyse. Yet it is the area in which we have had the most success: we forecasted the growth of living wages in 2014, the advent of sugar taxes in 2015, and the impacts of rising protectionism on global supply chains in 2016. So we would like to think our track record on social predictions is pretty compelling, which makes the bar high.

One major challenge that we see looming is intergenerational inequality. Developed world populations are getting older, and this is becoming expensive. Related costs like healthcare and pensions are rising almost exponentially. Asset price inflation and low rates have created “generation rent” (so called because of the difficulties many young people face in becoming homeowners). However, given that younger generations have historically largely abstained from voting, policymakers haven’t always grappled with these issues. Recent elections have pointed to a reverse in this trend and as a result, we expect to see increasing pressure on governments to act.

Given the current state of many governments’ finances, providing solutions for younger voters will be a challenge. We can expect companies to have to shoulder more of the burden, which will likely mean higher pension contributions, more support of housing for younger workers, and greater training demands.

We continue to think that companies and consumers face rising taxes on many fronts. For example, carbon taxes continue to increase, although not at the rate we believe is effective enough to really combat climate change. It doesn’t feel as if the world is quite going to be ready for meat taxes in 2019, but given the benefits for health and the environment we wouldn’t rule it out over the medium term.

### Governance: Debt could come back to haunt us

We were somewhat surprised this year when we looked at debt data to find that the share prices of companies with relatively high levels of debt hadn’t been penalised. The current credit and economic cycle has been running for quite some time. This means that few of the current cohort of managers and boards can remember what a bind high levels of borrowing can be when the interest rate or operating environment changes.

Research from Bernstein (24 October 2018), paints a rosy picture of companies’ debt positions. It shows that fewer and fewer companies are struggling to service their debt because their operating income comfortably covers their interest expenses. However, the next three years will see 25-45% of this debt rolling over (ie when existing borrowing arrangements mature and need to be renewed). Against a backdrop of rising interest rates, this could be a challenge.

Yes, more debt is long-term than ever before, but for some companies rates don’t have to rise much nor operations decline a great deal, for things to become markedly tougher.

### Conclusion: sense of urgency

While many of the issues we’ve raised here are long-term in nature, a number of them pose a more immediate threat to companies than most investors appreciate. Rapid and large-scale environmental and social change is likely to see companies across the board come under increasing pressure from a variety of sources, whether environmental-, social- or governance-related. In light of this, we think ESG analysis and forecasting will continue to rise in importance for investors the world over.



# Outlook 2019:

## UK equities

### Author

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**Sue Noffke**  
Fund Manager,  
UK Equities



- The possibility of a “no deal” Brexit has created uncertainty
- Investors have shunned UK stocks as a consequence of Brexit
- Stock selection will remain key
- The longevity of the current bull market is a potential source of concern

**Andy Brough**  
Head of  
Pan-European  
Small Companies,  
UK/Euro Small Cap



**Investors have shunned UK equities as a result of uncertainty related to Brexit. Against this backdrop, UK equities fund managers Sue Noffke and Andy Brough explain how they’re looking at the market heading into 2019.**

### Introduction

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More often than not, global developments set the tone for UK equities and the market gyrations seen in the fourth quarter of 2018 are a timely reminder of this. The major domestic issue of Brexit has taken a back seat. Instead, the driving forces are international; including US-China trade tensions, European political uncertainty, and the end of quantitative easing/rising interest rates.

Global trends like these will continue to be crucial. But so will Brexit, with many potential pitfalls in the run up to and beyond the UK’s scheduled departure from the EU on 29 March 2019. The UK government has negotiated a “withdrawal agreement” with the EU. However, if parliament rejects the deal, and a delayed Brexit is not agreed the UK will be leaving the EU on 29 March 2019 without a deal, with the risk of a UK recession.

Against this backdrop, two of our fund managers who cover different areas of UK equities explain how they’re looking at the UK stock market heading into 2019.

### Sue Noffke

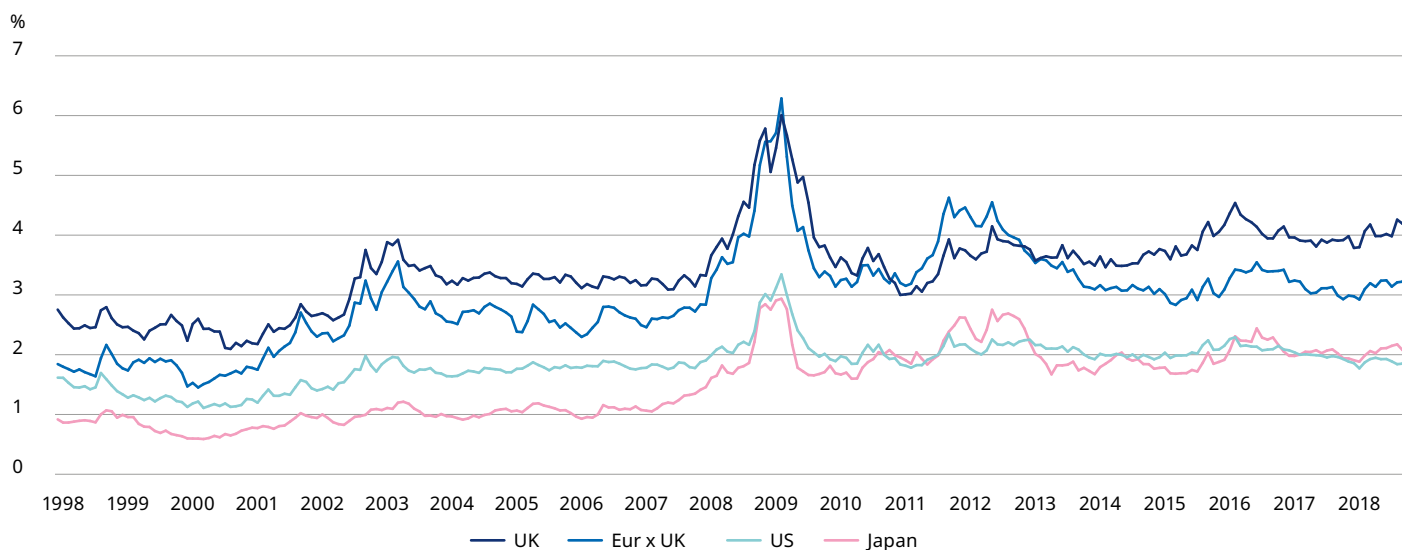
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As a consequence of Brexit, UK domestic-focused companies have significantly underperformed those companies which generate their earnings overseas. Sterling weakness has been a major driver of this as overseas earnings become more valuable when brought back to the UK when the pound is weak. However, the underperformance has also been in large part due to UK domestic companies suffering a “de-rating” (see below for explanation) amid fears the UK economy would grow at a lower rate outside the EU.

When I look at the dividend yield of the UK stock market at 4.5% (see chart below) I see it’s at an equivalent level to that seen before and after the peak of the global financial crisis (GFC) in 2008/09. However, I don’t believe we are likely to see a recession in the order of magnitude experienced following the GFC. If we do see a recession, I would expect it to be local to the UK (possibly the result of a “no deal” Brexit), rather than global, albeit world economic growth looks set to moderate in 2019. This gives me a degree of comfort that this elevated yield is sustainable (rather than a signal of impending distress) as the large majority of UK stock market dividends derive from overseas.



## UK dividend yield versus its history and other regions



Source: Citi, October 2018

### Past performance is not a guide to future performance

The extreme level of pessimism towards the UK stock market also becomes apparent when you study the dividend yield gap between UK and global equities. The UK stock market has historically offered a higher yield than other regions, however the premium is now at its most elevated in almost 20 years, at a level not seen since the 1999/00 dotcom bubble (see chart below).

As 2018 comes to a close many market commentators are rightly drawing parallels to previous occasions when the market cycle and “business cycle” were in more advanced stages. The pick-up in volatility certainty reflects a growing nervousness around the outlook.

Again, however, I take some comfort in the fundamentals. The short-term outlook for underlying UK dividend growth (excluding both special dividends and exchange rate movements)

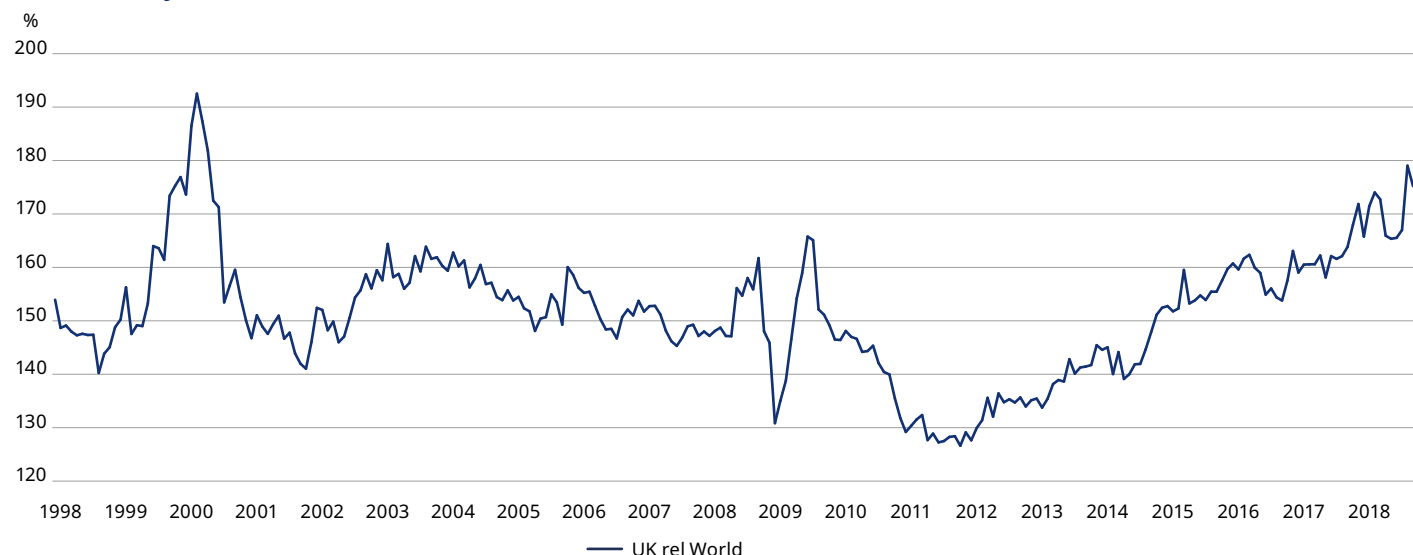
1 The period of time in which an economy moves from a state of expansion to one of contraction, before expanding again is known as the economic, or “business cycle”.

has improved, due to the strengthened pay-out ratios resulting from rising commodity and oil producer profits. Meanwhile, that other big driver of UK dividends, the banking sector, is finally returning to form 10 years after the GFC.

Should a “no deal” Brexit be averted, there would likely be an upwards movement in sterling and a re-rating of the market. This would be particularly beneficial to those UK domestic companies that have suffered a severe de-rating<sup>2</sup> over the last two and a half years. UK-focused banks, property companies, housebuilders, consumer discretionary areas (general retailers and leisure companies), food retailers, media agencies and utilities are all trading on depressed ratings. This is clearly seen in a range of valuation metrics, including price-to-earnings (P/E) ratios, which for some of these sectors are now in single digits.

2 The rating of a sector or an area of a stock market is a measure of how highly, or lowly, investors value it. It can be expressed by a variety of valuation metrics, such as the price-to-earnings (P/E) ratio. The P/E of a sector/area is its current level divided by its expected aggregate future earnings – when the P/E falls, the sector/area is said to have suffered a de-rating.

## UK dividend yield relative to the world



Source: Citi, October 2018

## Andy Brough

With the plethora of forecasts since the EU referendum, what has actually happened to the UK economy since June 2016? Well, the economy has continued to expand at a steady pace (and ahead of expectations) against the backdrop of a very low unemployment rate and rising wages. The country's fiscal position has also recovered as tax revenues have picked up, further underlining the resilience of the UK economy. We are, therefore, cautiously optimistic about the future.

The chancellor significantly loosened the purse strings in the Budget, in what the Office for Budget Responsibility has described as the "largest discretionary fiscal giveaway" since the economic advisory body was created in 2010. This comes at a time when nominal wages have continued to rise (up 3.2% in the three months to September, the fastest rate since December 2008), while a moderation in inflation has seen the return of real wage growth.

Historically there has been a positive correlation between real wage growth and real retail sales, as illustrated by the chart below.

It is telling to us that, despite their depressed levels of confidence in the general economic outlook, the surveys reveal that consumers remain positive about their personal financial situation. We certainly see evidence from our portfolio holdings of consumers willing to spend. The key challenge remains identifying the beneficiaries of the increased spending, at a time that structural changes impacting the UK high street and other consumer-facing sectors now seem to be accelerating.

In this regard, it's our view that the odds could be skewed in favour of investors in UK small and mid-cap (smid) companies. This is an area of the market packed full of companies taking advantage of new technologies and the internet to drive growth, disrupt and take share from sector incumbents. In a fast-evolving world, smids are generally better able than large caps to capitalise on the opportunities as they tend to be more dynamic, and have a small base from which to achieve growth.

We have identified a number of specialist retailers that are bucking the decline in the UK high street. They encompass a whole range of sectors, from cutting-edge "athleisure" fashion to homewares retailing. Many of them are in the foothills of "multi-channel" strategies, as they discover the right mix of in-store and online experience to maximise growth. Others take in niches such as pet supplies or casual dining, where management teams are seizing the initiative, making changes and turning performance around. And there are plenty of companies benefiting directly from the travails of sector peers.

At the same time it should not be forgotten that the revenues of the FTSE 250 are evenly split between overseas and domestic sources, so smid investors stand to benefit both from exciting overseas growth opportunities, and the highly depressed sentiment towards UK domestics. Given the growing divergence between the best and worst-performing shares the environment is changing in favour of the active stockpicker or active asset manager who picks correctly, creating scope to outperform the market.

The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. Our forecasts are based on our own assumptions which may change. Forecasts and assumptions may be affected by external economic or other factors.

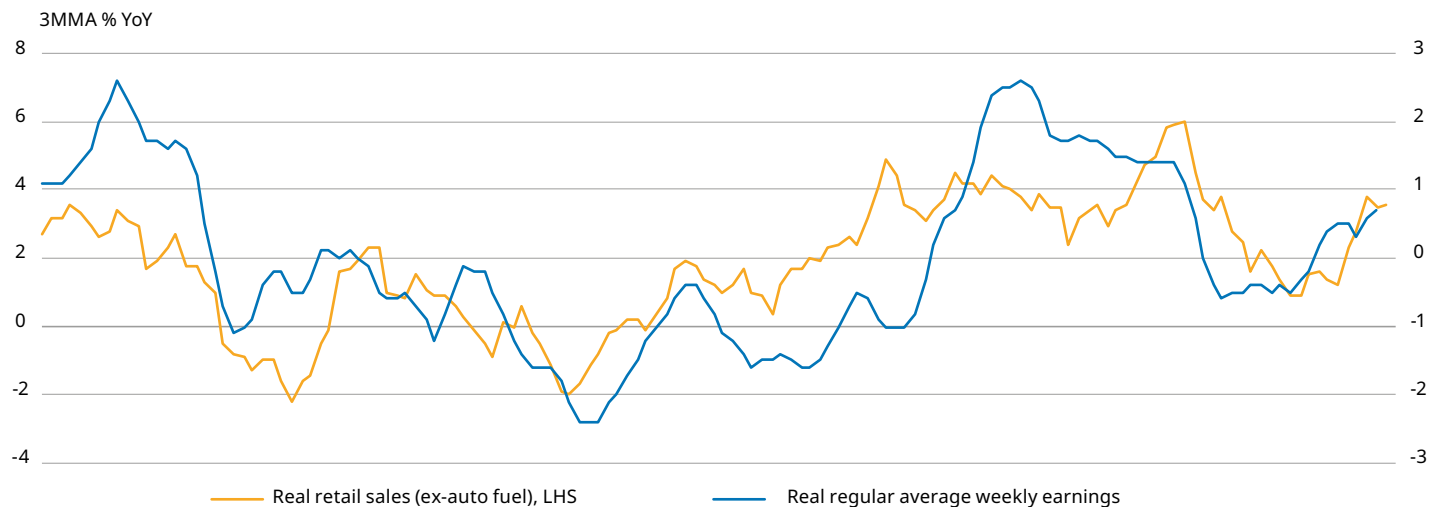
### Risk considerations

The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested.

Investments concentrated in a limited number of geographical regions, industry sectors, markets and/or individual positions, may be subject to higher volatility resulting in large changes in value, which may cause an adverse impact.

Equity prices fluctuate daily, based on many factors including general, economic, industry or company news.

## UK retail Sales (ex-auto fuel) vs real wage growth



Source: Datastream



# Outlook 2019: US equities

## About the authors

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- The US economy has outperformed other developed markets in 2018 and we believe it will remain comparatively stable in 2019
- We believe that earnings growth may slow as interest rates rise and wage inflation picks up
- The combination of slowing earnings growth along with severe cost pressure should provide an fertile environment for active investors next year

**We believe that US earnings growth will slow in 2019, but we believe the more challenging corporate environment may provide a rich backdrop for stock pickers.**

## US small and mid-cap equities

### Robert Kaynor

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In 2018, although growth in some global economic powers such as the UK, Germany and France slowed, US expansion remained robust. In particular, the US labour market stayed strong. An average of ~200,000 jobs were created per month while, at 3.7%, unemployment has hit its lowest point in almost half a century.

The labour market's strength is the main cause of a nascent increase in inflation, as wage pressures are beginning to build, particularly in the service sector. We have been hearing about this wage inflation for three years, even if it is only now visible in official data. We believe inflation should be manageable if the Federal Reserve (Fed) stays on track with its "dot plot" (the US central bank's forecast pace of interest rate normalisation).

We believe the economy is therefore likely to deliver stable growth next year, but that the return of interest rates to more "normal" levels and higher inflation will probably weigh on earnings growth. We are already beginning to see companies with large debts suffering due to rising interest rates. Meanwhile, those companies unable to raise their prices (i.e. lacking "pricing power") are struggling to offset higher wage bills. Also, 2018's strong earnings growth was partly attributable to tax reforms and other fiscal stimuli, both of which will fade in 2019.

As a result, our overall view is that early estimates for 2019 earnings growth are likely too optimistic. However, provided investors are aware of their exposure to these factors, we believe that the environment could provide favorable opportunities for active investors next year.

This far into an economic recovery, with the Fed raising rates to preempt inflationary pressures, there is considerable debate around the timing of the next recession. We cannot tell you when the next recession will occur, but we are confident that the herd of strategists calling for it in 2020 will most likely be proven wrong.

Recession speculation aside, the market must continue to digest the reality of slowing corporate earnings growth, continued inflationary pressures, and a less market-friendly fiscal policy backdrop.

Through the market turbulence at the start the year, growth and large cap stocks have continued to be seen as relative "safe havens". Although "micro-cap" stocks outperformed significantly as risks around trade disputes reached fever-pitch in the second quarter, market participants have spent most of the year favouring the growth companies that do best when the economy is strong.

Will this persist? It seems likely, given the earnings pressures we are anticipating.

Debt levels amongst US companies overall are high, but particularly so in the small and mid cap space. One way to measure a company's debt level is the debt/EBITDA<sup>1</sup> ratio (which compares a company's debt to its gross earnings). For the larger companies that constitute the S&P 500 index, the ratio is 2.3 times earnings. For the companies in the small and mid cap Russell 2000 index it is over 4 times.

Earnings may wax and wane along with the economic cycle, but debt does not. What this means is that when earnings falter, company borrowings stay the same size while interest rates continue to move higher. Debt burdens become heavier. The solution is for companies to pay down debt.

In the US small cap space a significant proportion (in excess of 40%) of total debt is on a "floating rate" (ie the interest rate payable on it changes or "floats" over time), in contrast with large cap companies (17%). Typically, companies with higher percentages of floating rate debt are more likely to have problems as interest rates rise and earnings falter.

We have made a concerted effort to make sure companies in our portfolios have lower levels of floating rate debt than their peers.

From a valuation perspective, we think companies in the consumer discretionary and industrials sectors look attractive relative to the index. In general, we will continue to look to invest in companies balancing shareholder interests with company growth.

<sup>1</sup> EBITDA stands for earnings before interest, tax, depreciation and amortisation (EBITDA)

## US large cap equities Frank Thormann

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Without doubt, one of the main contributors of the strength and length of the US equity bull market has been the resurgence of corporate profitability to historically unprecedented levels. In particular, the country's unique position as the global leader in technology and innovation has been a real source of strength. Silicon Valley is often described as the global "cradle of innovation", and is home to some of this world's most innovative as well as profitable companies.

In addition, the US has been particularly successful in repairing its banking sector, resulting in US bank profitability far exceeding European peers. Further, the US is home to a resurgence in oil production driven by a revolution in fracking technologies. Its relatively stable economic and political environment has attracted large capital inflows, resulting in a surge in the dollar. The icing on the cake was the significant tax cuts announced in 2017.

For 2019 we envision a change in market leadership. 2018 was marked by fast revenue and earnings growth across the board and the rising tide has lifted most boats. 2019 is likely to be a year of a fairly sharp slow down in earnings growth.

Consensus expectations call for 9% earnings per share (EPS) growth for the S&P500 in 2019 after +25% growth in 2018. We think even these expectations may prove optimistic. In light of this slow down, we believe that attractive returns may be earned by focused stock picking and emphasising strong pricing power, relative insulation from rising cost pressures and company-specific catalysts which will allow them to sustain above-average growth.

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