Which cyclical and structural trends will drive markets in 2019?
Barings’ teams across public and private markets weigh in.

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INTRODUCTION

The past year has been a strange one for global growth as the recovery fell out of synch. The United States accelerated following large tax cuts and loosening government regulation. European growth was good, but stumbled under the political uncertainty around Britain’s exit from the European Union and Italy’s boisterous new challenge to bond markets. Japan offered some bright spots in corporate earnings and wage growth, but reflationary pressures remained weak. Meanwhile, China’s growth slowed as the government tried to puncture real estate bubbles. While there were no obvious signs of recession as 2018 ended, it is hard to make the case for a global acceleration in the months ahead. This has left most investors looking for attractive valuations and strong balance sheets, as they look for signs that GLOBAL GROWTH may fade.

Speaking of balance sheets, the long global recovery has brought with it RISING RATES AND HIGHER LEVELS OF DEBT, especially in the developed world. Amid broad agreement that quantitative easing proved indispensable after the financial crisis and has been a significant contributor to recent growth, the second part of the experiment has yet to play out. The asynchronous unwinding of large central bank balance sheets will be tricky, and investors will explore the implications of rising rates. The U.S. Federal Reserve (Fed) is furthest along, with Europe following behind. China’s central bank turned more accommodative toward the end of the year, while the Bank of Japan (BOJ) seemed likely to continue its loose monetary policy even as its economy showed signs of improvement. Vulnerable emerging markets were suffering the effects of rising U.S. rates and a stronger dollar, but careful investors were paying close attention to the affordability of debt everywhere.

President Trump’s talk of more AGGRESSIVE TRADE MEASURES against both allies and rivals seems to have triggered brief reactions in the U.S. markets, but it has been difficult to connect these with any broad impact on corporate profits. While agreements with Korea, Mexico and Canada made those trade relationships more predictable, the escalating tariffs on U.S.-China trade persisted amid even more acrimonious exchanges. The dialogue continued and both sides hinted at the possibility of more talks, but it was hard to imagine a durable solution. These added costs were not likely to undermine global growth on their own, but they had an immediate impact on some firms and sectors and created fresh investment risks amid rising uncertainty about the longer-term direction of the world’s largest bilateral trading relationship.

Amid these key cyclical trends, investors are also struggling increasingly to assess the impact of technological change and especially A DATA REVOLUTION THAT IS RESHAPING BUSINESS MODELS in the most unexpected sectors. There are already clear winners across both public and private markets, especially among firms that own valuable data sets and know how best to exploit them. Some of the losers are already apparent, but many more will likely materialize next year if they fail to understand the ways in which their value propositions can be undermined by cheaper, faster and better alternatives.

Demographic changes are slow but mostly predictable. Developed economies have been grappling with the CHALLENGES OF AGING POPULATIONS, and especially the costs of rising dependency ratios as fewer workers support more retirees. The macro challenges will likely contribute to expectations of lower growth and rising public debts. Yet increasingly, these policy challenges come with investment opportunities in more effective ways to deliver health care, more affordable options in senior housing and more creative ways of catering to retirees with savings to spend.
WILL GROWTH FADE NEXT YEAR?

TREND ONE

‘Steady as she goes’ remains perhaps the best bumper sticker for the global economy as the year ends, even if investors remain alert for signs of deceleration. The International Monetary Fund (IMF) is projecting global growth of 3.7% for 2019, which would match the growth rate for both 2017 and 2018 (Figure 1). Although global growth is expected to remain fairly stable, there are divergences among several economies. In the U.S., momentum is still strong as Fed tightening is offset by potent fiscal stimulus. Solid growth, low inflation and restrained labor costs continue to produce a favorable environment for strong corporate profit growth. In Europe, leading indicators point toward a modest slowing of growth momentum, with Purchasing Managers’ Indexes (PMIs) continuing to decline from cyclical highs reached in 2017 (Figure 2). Within the eurozone, trade protectionism concerns and Italian fiscal woes are weighing on the economy and impacting confidence. Similarly, the ongoing Brexit process continues to cloud the U.K. economic outlook. Among emerging market economies, initially the outlook of many energy exporting countries had brightened due to higher oil prices, but prospects have dimmed for countries like Argentina, Brazil and Turkey due to tighter financial conditions and domestic political concerns. China may also encounter weaker growth in 2019 amid the fallout from trade tensions, but policymakers have deployed bold measures to cushion the pain.

The year ahead will likely bring continuing headwinds: more rate hikes, more conflict on trade and more volatility in emerging markets. There are also countervailing forces that may offer support. Fiscal stimulus in the U.S. and China continues to work its way through the financial system. Aggressive easing by the People’s Bank of China (PBOC) should also eventually help boost global growth prospects. While the U.S. yield curve has flattened, global yield curves, especially in China, have steepened.

A key balancing act will be the unfolding policy handoff from monetary stimulus to fiscal stimulus and structural reform. The transition from a slower central bank balance sheet and money supply growth to higher money velocity will be key to maintaining steady growth, in our view. Although corporate earnings growth has been strong, the lagged effects of corporate tax reform could support future capital expenditure growth. If these offsets do not prove sufficient, investors will likely take a more cautious approach and focus on companies with strong balance sheets and reliable cash flows.
Debts have been rising and now they are getting more expensive. Global central banks continue to inject liquidity into the financial system. The Fed has signaled a continuation of the tightening cycle and expects to raise rates three times in 2019. The European Central Bank (ECB) is likely on hold for the next 12 months, and Bank of Japan (BOJ) rate hikes appear to be distant at best. While rising rates represent a return to normalcy and a partial validation of the unprecedented post-crisis monetary response, the expanding levels of debt will likely amplify the effect of rate increases. Data from the Institute for International Finance shows global debt levels swelled by $8 trillion in the first quarter of 2018 to over $247 trillion, or 318% of global GDP. In the U.S., total credit market debt outstanding ballooned 30% over the last decade to $70.2 trillion as interest rates hit historical lows. Over that time, however, we have had a significant risk transfer from the private to the public sector. Households deleveraged significantly and are arguably in their best financial position in decades. The aggregate level of corporate debt has increased, but we believe that measures such as debt-to-cash flow or debt-to-net worth suggest reasonable levels of leverage. Government sector debt, however, has more than doubled since 2008. This has resulted in more federal revenue going to interest expense despite record-low borrowing levels. As rates rise, this burden will likely become even more onerous.

Outside of the U.S., higher rates and a stronger U.S. dollar have exposed some of the weakest links in emerging markets. Recent selloffs and major currency depreciation have so far been limited to the more vulnerable economies—those with a combination of excessive short-term external debt, a large current account deficit and high domestic inflation. A stronger U.S. dollar and higher rates increase these countries’ debt servicing costs. Still, most emerging market countries appear more resilient. Even among the countries with current account deficits, the balance of payments has improved recently. Additionally, we have generally seen emerging market inflation rates converge toward developed market levels. Corporate fundamentals remain strong despite the increase in debt levels. Profit margins are near all-time highs and cash flow growth is robust. Despite their recent rise, spread levels are still well below average in both the investment grade and high yield corporate markets, an indication that investors feel adequately compensated for default risk. While duration has increased in the investment grade segment over the last decade, making those bonds more sensitive to rising interest rates, duration in the high yield market has remained fairly constant. Ultimately, the ability to digest a higher cost of capital will come down to whether or not the current growth environment enables companies to spend borrowing proceeds productively and generate the earnings required to service debt.
WILL TRADE RHETORIC FINALLY HIT PROFITS?

TREND THREE

The trade war expanded through 2018, but its impact differs across countries and sectors. From a macroeconomic perspective, even the expanding list of goods that have been subjected to tariffs is unlikely to alter the course of global growth significantly. U.S. exports account for only 12% of the country’s economy and China’s exports are barely 19%, with the actual Chinese contribution even smaller. In any event, trade volumes to the U.S. through the summer were actually expanding by 4%. While the IMF warned of the consequences of rising trade barriers, its forecasts only suggest a cumulative 0.3% reduction in global growth in 2019.

Yet the questions remain high on the minds of investors as they grapple with the potential impact of trade rhetoric on their returns. Average global tariffs have been steadily falling, from 8% in 1900 to roughly 2% today (Figure 5). But populist politics in many countries may stall further progress, and there will be winners and losers as a result.

Emerging markets that have grown along with expanding volumes of trade now face the consequences of this greater friction. Firms that have been increasingly dependent on complex international supply chains have been forced to reconsider the risks and potential costs. Even those that are more reliant on supplies closer to home can find themselves victim to ricochet effects—a foreign competitor shut out of the U.S. market by a tariff, for example, may redirect larger volumes to a market a U.S. firm had hoped to enter.

In some cases, tariff costs will be quietly passed along to the end consumer. In others, a stronger currency may help cushion the impact of what have become more expensive imports. Sooner or later, however, these costs will begin to erode corporate profits, an area we expect investors to be watching carefully over the next year.

Harder to assess is the added uncertainty around investment returns. Firms planning to expand production facilities will need to assess the likelihood that a fresh round of tariffs may shut them out of what they believe is a promising market. Rather than building one large plant, they may feel compelled to hedge their bets—at significantly greater cost. They may be forced to forego economies of scale for guaranteed market access. The early trends have been worrying with Foreign Direct Investment to the U.S. falling 24% (Figure 6) and to China rising 25%.

WHO IS LEADING THE DATA REVOLUTION?

TREND FOUR

Computing and storage costs have been falling for more than a century. Annual performance gains by some calculations topped 30% per year through the 1900s. More recent data suggests that the exponentially declining trend for computing costs has yet to abate and will likely continue well into the future (Figure 7). Together with cheaper storage and expanded mobile networks, this technology now supports complex algorithms to make better decisions on a range of activities from the operations of critical infrastructure to the behavior of consumers. In our view, while companies that own or control the data will enjoy a tremendous advantage, the real winners will be those who know what to do with it.

Perhaps one of the most important macroeconomic implications of the data revolution is its ability to greatly improve productivity across the entire economy, as robots, driverless cars and natural language processing systems all powered by this underlying data slash labor costs across a variety of tasks. An equivalent increase in output is also likely. Though the capital costs associated with any new technology tend to be high, the benefit achieved over the long term will likely be much more pronounced. As increased capex spending and technological integration flow through to increased productivity, we expect the improving fundamental picture to also be supportive of valuations. This should create a virtuous cycle of risk-taking, investment, productivity and growth.

The generation of new data will likely only accelerate (Figure 8). The greatest challenge, in our view, is how best to use the results for business decisions or operational gains. Another part of the challenge is implementing a business model that is unique and creative enough to take advantage of data and technology in ways that legacy competitors often cannot. Moreover, while media giants are able to harness consumer data and activity, these datasets are largely isolated from one another. Even within individual firms, large media players struggle to keep systems connected and operable across business units, which can prove a Herculean task. One final hurdle is that as the predictive quality and value proposition of raw data itself becomes a competitive advantage, management teams may be increasingly reluctant to share it publicly. Still, through the next year and beyond, we expect to see winners and losers across all industries, from health care to financial services to entertainment. Opportunities will also likely emerge around companies that are building the ‘picks and shovels’ of this next revolution, whether that be 5G networks, cloud storage or semiconductors.

Figure 7: The Falling Cost of Computing

Figure 8: The Exponential Growth in Data

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HOW WILL AGING SOCIETIES BEGIN TO AFFECT RETURNS?

TREND FIVE

Low birth rates and lengthening lifespans in developed nations are leading to an aging workforce and to stagnation in the size of the national workforce. Average life expectancy grew 5.5 years between 2000 and 2016, according to the World Health Organization, the fastest since the 1960s. While much of this is driven by better health care in developing countries, the ratio between the elderly and those of working age (15–64), has been steadily increasing globally. Nowhere is the story more advanced than in Japan, where the total number of elderly account for nearly half of all working aged individuals. Europe and China are not too far behind (Figure 9).

At the macroeconomic level, more people working longer and saving longer may help keep the natural rate of investment lower. There are broad consequences for individual savings and spending patterns, too. Workers can be productive for longer and many people will live to an age they thought unimaginable when they started saving for their pensions. Retirement is being pushed to a later date, as evident in the labor force participation rate of those between 60 and 64, which has seen a steady global increase since the start of the century (Figure 10). This is perhaps due to both individual choice and institutional and government decree.

For investors, an aging population means opportunities may arise from a greater number of elderly consumers. Among the more active, there are demands to fill leisure time with a wider variety of music, live entertainment and travel options. There will also be demand for new configurations of real estate designed specifically for older residents, ranging from more active communities to assisted-living facilities to intensive care. We expect to see more creative ways to deliver appropriate medical care, from simple clinics to hospices. There is also a potential role for artificial intelligence in the provision of elder care as firms develop robots that can provide 24-hour monitoring. Meanwhile, for elderly consumers who did not save enough during their lifetimes to fund their retirement, there will be an increased demand for creative retirement solutions such as reverse mortgages and life settlement agreements.
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