Weekly Digest

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2020 Vision

I have a chart on my desk which reins in any potential complacency in my own abilities to forecast investment outcomes. It shows the US 10-year government bond yield going back to 1993 overlaid with economists' forecasts at the beginning of each year showing where they thought the yield would be twelve months later. In only three of twenty-seven years has the outcome fallen within the range of the top and bottom quartiles, with 2019 being one of the biggest misses on record. As the old saw goes: "It's very difficult to make predictions, especially about the future". Which makes one wonder just how well I have utilised my time reading any number of year-ahead reports, as well as attending meetings with several strategists. Many have pinpoint accurate forecasts for where certain equity indices are going to stand at the end of December, but I think we all acknowledge that it would be sheer luck to hit one of them. The key thing is to understand the components that make up the target and to be aware of the general underlying trend.

One feature of the last decade is that investors, scarred by their experiences in 2000 and 2008, when equity markets fell around 50%, have remained fearful of a repeat performance. I describe it as "waiting for the other shoe to drop". It has meant that many private investors have failed fully to participate in what is by many measures the longest bull market in history. And, of course, the longer it becomes, the greater the fear that the end is just around the corner. But longevity per se is not a useful predictor of the imminent future. Indeed, in the post-financial crisis world of repressed interest rates, bond yields and volatility, many of the old rules of thumb based on historical averages no longer seem to apply.

So what are the expectations for this year? And what are the risks to those expectations? The consensus forecast (compiled by Bloomberg) for the US 10-year bond yield - the key global benchmark - for the end of this year is 1.94%, which is not far above the current yield of 1.82%. That tells its own story, suggesting no expectation of either a much weaker economy or an outbreak of higher inflation. But is it probable that the consensus is going to be accurate? What if I tell you that at the start of this year the 10-year yield was 1.92% and the December 2020 forecast was 1.93%? In all of those years going back to 1993 the smallest annual yield shift

was 2 basis points (0.02%) in 2004. Admittedly the yield volatility (at least when measured on an annual point-to-point basis) has been lower in recent years. If I look at averages, the twenty-seven-year average move is 83 bps, the ten-year average is 60 bps, while the five-year average falls to 32 bps, although the annual ranges have obviously been higher. And last year's 77 basis point move (and 126 bp range) prove that bond market volatility is far from dead. Furthermore last year also saw one of the biggest misses relative to expectations, with the consensus forecast of 3.1% at the start of the year comparing very badly with the final outcome of 1.92%.

We are not sufficiently brave (or foolhardy!) to venture our own precise forecast, but, for the record, we believe that the greater probability is that the yield will drift upwards in response to a more constructive economic environment. It is possible that US inflation will break higher, taking yields with it, but this has long been predicted without happening. The opposing forces of a tighter labour market on the one hand and the influence of demographics and technology on the other appear to be cancelling each other out for now, and there is certainly no consensus in the economics community about how this will be resolved.

So what are the implications for equities? At the most basic level, the performance of equities in the shorter term is driven by three factors: earnings growth, the discount rate and the risk premium. The first two are easily observable; the latter is something of an ethereal concept only truly measurable on an ex post basis. If the consensus is right on bond yields, then the discount rate factor is going to play little part in this year's equity performance. If the expectations turn out to be on the low side, it could depress equity valuations, but this should be counterbalanced by more robust earnings. It would also suggest a better performance for the Value style relative to Growth. Should yields turn lower, there is an asymmetric downside risk owing to the risk of falling into recession and the negative effect of operational leverage. My experience is that analysts always underestimate this phenomenon in a downturn. This scenario would also suggest an increased crowding into those companies that can continue to demonstrate resilient growth.

The current consensus bottom-up forecast for global company earnings growth this year is around 9% (IBES data), although our feeling is that this is a little high. Even so, growth in the 5-7% range combined with a dividend yield of around 2.5% suggests the potential for high single-digit equity returns, and we are happy with that as a central view – although not a precise forecast as such! It remains hard to see the global economy accelerating in a synchronised manner sufficiently to push earnings growth considerably higher, and valuations would have to move into decidedly nose-bleed territory if they were to be the source of much stronger returns. Where could things come unstuck? It appears that central banks are hell-bent on keeping the economic train on the rails, so it is politicians (well, one in particular), who represent the most risk, notably with the potential for military conflict or escalating trade wars. A pragmatic view is that neither suit the current agenda, but you can see what will make investors jumpy.

Last week's Economic Highlights

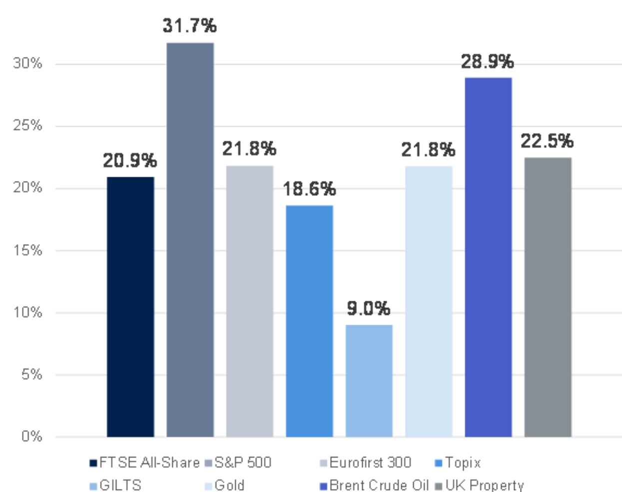
FTSE 100 Weekly Winners

NMC Health PLC	15.4%
Centrica	8.3%
Taylor Wimpey	7.5%
Evraz	7.1%
Persimmon	6.8%
United Utilities	6.0%
Ocado Group	6.0%

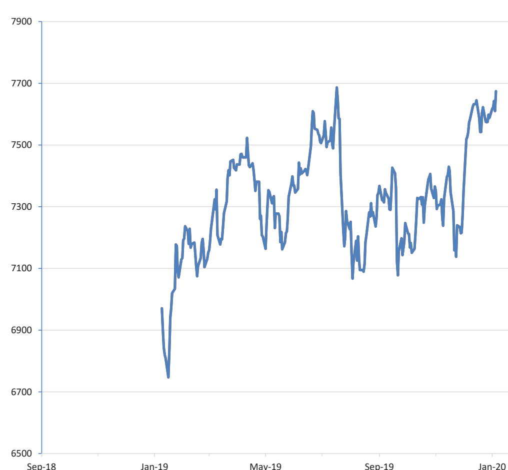
FTSE 100 Weekly Losers

Pearson	--6.2%
DS Smith	-4.6%
RBS	-4.5%
Mondi	-4.4%
Prudential	-4.3%
BT Group	-4.2%
TUI AG	-4.1%

Year to Date Market Performance



FTSE 100 Index, Past 12 Months



Source:FactSet

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