Investment Report 2020
Navigating uncertainty

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Investment overview

In our 2019 report 'the Art of the Long View', we identified two main growth areas for equities in the coming decade – Tech stocks and Emerging Markets. We also recommended a balance between capital growth and dividends for those nearing retirement. Our 2019 predictions included:

- Emerging markets would continue to power global growth, contributing today 69% of GDP increase, and predicted to contribute 77% by 2023. Despite a slow down in the Chinese economy to 6%, India and Brazil are in strong positions to contribute to global GDP
- Technology stocks (especially FAANG, BATs and Unicorns) would continue to drive growth in developed and some developing economies, occupying an increasing share of S&P500 market value – now approaching 26%, and likely to be 50% by 2030
- Dividends from equities have never been more attractive in countries such as the UK where stocks are undervalued due to heightened risks of a BREXIT no-deal. The FTSE100 stands just above the level it did in 1999 (around 7,000). Current dividend yields are likely to reach an average of 5% in 2019

These predictions were partially proven true in 2019 with an exceptional spurt of Tech stocks reaching 40% gains over the year S&P Tech) and the NASDAQ hitting 9,000. Emerging markets were less attractive with only a 10% gain although the Chinese SSE was up by 21%. This contrasted sharply with a 25% decline in the MSCI EM index during 2018. Dividend yields held up in mature markets, with 4.3% in the UK against just 2% in the USA.

With the USA equity markets at an all time high (almost double those of Europe and Asia in terms of CAPE), we might expect a rebalancing to take place, especially in the UK where a strong election victory should encourage global investors to return to our shores. We continue to see Tech as the primary engine for growth given the inability of large incumbents to innovate their business models.

2020 could be a volatile year with US elections, continuing uncertainty over US/Chinese trade wars and Brexit negotiations. However we have confidence that Emerging Markets will continue to flourish relative to Developed regions given population sizes and demographics across countries such as China, India and Indonesia.

Look back on 2019

Yet again the global equity markets enjoyed a bumper year in 2019 similar to that of 2017. Despite a sharp fall in the fourth quarter of 2018, the markets bounced back in Q1, 2019 to peak by mid year. Thereafter worries about trade wars took their toll until a first step in resolution enabled markets to recover in the final quarter, reaching historic highs.

Figure 1 – Changes in the 2019 market indices

Market Index	*Change in 2017 (Jan-Dec)*	*Change in 2018 (Jan-Dec)*	*Change in 2019 (Jan-Dec)*	*Final level in 2019*
FTSE 100	+7%	-12%	+10%	7600
FTSE 250	+13%	-16%	+23%	22,000
AIM	+24%	-16%	+10%	960
S&P 500	+20%	-7%	+28%	3,270
NASDAQ	+27%	-9%	+33%	9,000
DAX	+12%	-18%	+23%	13,250
CAC	+12%	-12%	+26%	5,980
Nikkei	+16%	-12%	+18%	23,650

These figures confirm the strength of the US equity market in both S&P and NASDAQ. However a closer inspection shows that large incumbents increased their value largely by taking advantage of low interest rates to buy back stock. Most of the top line growth came from small companies and Tech stocks. Despite near recession and negative bank rates Europe surprised on the upside. Parliamentary paralysis over Brexit hit the UK markets hard until the December election victory by the Tories.

Outlook for 2020

Several issues will dictate the outcome of equity markets in 2020:

- Will investors return in full force to the UK markets despite uncertainty about Brexit trade negotiations? With the FTSE100 standing at 20-30% below benchmark rates it is likely to rise to 8,000 and beyond in 2020. A favourable deal could propel the index to 8,500 or even 9,000
- Can the EU avoid recession and begin to achieve growth? Given the near implosion of the German economy in 2019 (due in part to automotive factors), and exceptional levels of dept elsewhere (France, Italy), prospects do not look promising. Time to steer clear.
- Has the USA equity market run its course especially for large incumbents? We see a continuing polarisation between Tech and incumbents as the digital economy matures. NASDAQ may be due an adjustment as valuations reach new heights
- Where might the Emerging Markets be in the coming year and beyond? We suspect that China will continue to boost its economy and help to accelerate growth in Asia as well as Africa. Expect to see Asian dividends rise to western levels (+3-4%).

Overall, 2020 is unlikely to deliver another bumper year as per 2019 or 2017. However we see selective opportunities emerging that could deliver 5-10% portfolio growth.

Global perspectives for equity investors

We have enjoyed over a decade of stock market growth since 2008 – almost unprecedented in recent times. Much of this can be attributed to exceptionally low interest rates (entering negative territory) and a heavy dose of quantitative easing. The USA has benefited disproportionately over this period with the S&P advancing by 260% since 2010 compared to 60% in rest-of-world markets. USA equities have reached record peaks that may be unsustainable.

The caution for the coming decade is that the World no longer has a safety net should their be a major downturn. Low interest rates are likely to persist given the fragility of many national and regional economies – the USA, EU and Japan continue to pump $11 Trillion of quantitative easing into their economies. The Global growth in GDP is gradually shrinking from a healthy 3.5% down to just above 3%. Global debt now stands at $250 Trillion, up 25% since 2000. This is not a bullish picture.

The intriguing question is whether the World economy can continue to function on a diet of QE and low interest rates. Top line growth continues to be confined to Emerging Markets, Small Companies and Tech despite recent success elsewhere in some equity categories (USA and European incumbents).

With an accelerating transition from an industrial to digital economy there is every reason to expect surprises in the coming decade, especially amongst incumbents who seem incapable of changing their traditional business models or increasing the top line.

Closing the innovation gap

The real dilemma today is the innovation gap that exists amongst many industrial leaders such as automotive suppliers in Germany. A recent report (see www.rogercamrass.com) suggests that large incumbents have developed business models over several decades that deliver efficient production in a stable market environment. Given uncertainties attributed to the digital economy this scenario is no longer valid. *Instead the economic prize goes to those entities who can achieve continuous innovation based on speed and agility*.

Already whole sectors such as retail, media, IT, Finance and automotive have been disrupted by nimble newcomers some of which are now reaching trillion dollar valuations (Microsoft, Apple, Amazon). There is little real possibility that incumbents can change their core operating models in time to fend off digital disruptors. The only possibilities that exist here is to launch innovations outside the core – what we refer to as the ‘edge’. Some firms such as AXA, PMI and ROCHE have embarked on such high risk projects but there is little evidence yet that they can produce innovation at scale i.e. new multi-billion dollar revenue streams.

The conclusion here is that large incumbents will continue to produce healthy dividends as they fade gradually into oblivion (perhaps by 2030 when Gartner predicts the death of big banks). This will have an impact on regions such as Europe where innovation is sadly lacking (no digital leaders are evident here).

China, India and Brazil (members of BRIC) will be economies to watch in the coming decade. Given their young populations (50% of Indian population is under 25), the scope for growth and innovation is extremely high. China is creating waves in areas such as Retail, Financial Services, Telcom, and Healthcare. Chinese companies may become the major insurgents into Western economies over the coming decade, again threatening incumbents.

Recommended asset allocation for 2020

The asset allocations for 2020 will be much the same as 2019 with continuing emphasis on diversity across regional markets. Within asset classes we can be more specific about fund and company selections:

- USA – focus on Tech through NASDAQ and Tech funds (e.g. Scottish Mortgage). Also focus on smaller companies rather than large incumbents
- Europe and UK – also better prospects from smaller companies and opportunity funds such as Marlborough and Fidelity Special Opportunities
- Emerging Markets – placing strong bets on India and China (through Fidelity). Also looking at Africa as the next growth region
- Re-evaluating Japan as a possible resurgent economy especially amongst smaller companies (Leg Mason Japan has grown 730% over the last decade)
- Recognising that highest dividend yields will come from the UK, Europe and some emerging markets (3-5% against 2% in the USA)

Asset Class (SIPPs and ISAs)	2018 allocation	2019 allocation	2020 allocation	Rational
Cash/Short dated strategic bonds	25%	10%	5%	Keep cash reserves for market corrections
Bonds and property	10%	15%	10%	Alternative to cash with some up side
US Equities (S&P, NASDAQ)	20%	25%	25%	Strong dollar, growth expected to continue
European Equities	20%	5%	10%	Diminishing prospect of a full recession
UK Equities (FTSE100 and 250)	10%	20%	25%	Post Brexit uplift providing negotiations go well
Global/Asian Equities	20%	25%	25%	Powering global growth at 5-6% GDP

National and regional highlights

Large variations persist between countries and regions of the Globe. A broad-based investment strategy is advisable to catch market up-turns (China?) and reduce impact of down-turns (EU and USA?):

1. **USA**
   The USA economy continues to be buoyant, although the FED had to intervene mid year with a rate cut to avoid the possibility of recession. Stocks are at an all time high and thus unlikely to sustain hyper-growth with the exception of Tech which has been the engine of the bull market over the last decade (with trillion dollar valuations and growth rates of 20-33%). Debt now stands at over 100% of GDP. There is a dangerous resurgence of collateralised loan obligations (CLO). 2020 is election year which will bring volatility. Caution is required here.

2. **China**
   Finally the world (and in particular Donald Trump) has held China to account with its massive trade imbalance and theft of intellectual property. 25% import tariffs from the USA have damaged production and caused the government to focus on domestic infrastructure projects to boost growth. China's debt mountain has reached 250% of GDP sending warning signals to the rest of the world. However its strength in Tech matches that of the USA in companies such as Alibaba, Baidu and Tencent so we can remain optimistic that it will solve current problems.

3. **Eurozone**
   The EU has seen a steady decline in its global standing as an economic region, falling from 38% of global trade in the seventies to 15% today. It is likely to decline further to just 10% of world trade by 2050 illustrating a stagnation and inability to innovate. Germany, the historic engine of growth for the EU is now coping with severe disruption of its main sectors – engineering and automotive. Two thirds of the DAX is 'old economy' compared to 40% in the USA. France is the fourth most indebted country on the world (after USA, China and Japan). The European Bank has resorted to quantitative easing and negative interest rates to cure EU problems – hardly a solution for modern times.

4. **UK**
   Unprecedented levels of political uncertainty persisted through 2019/ Fortunately Theresa May resigned in June to give Boris Johnson a chance to break the impasse in Parliament. However it took a general election in December to achieve the desired result – with the strongest conservative victory since 1935. Faced with a Marxist regime led by Jeremy Corbyn the UK was fortunate to see such a decisive outcome. Despite this backdrop the country achieved the lowest unemployment rate in recent years (3.8%) and modest growth in GDP (1.5%). The UK generated several unicorns, especially in the FinTech area such as Resolute, Monzo, and Ocado in retail. The coast is now clear for a healthy recovery with a strengthening pound and resurgent stock market.

Tech trends

The last decade has been defined by what we refer to as Wave One technologies such as mobile, cloud, data analytics and social media. As we enter the new decade, we can expect a second wave of technologies to accelerate the development of the digital economy. These include:

- **5G and the Internet of Things** (IoT) that could have profound impact not just on consumer markets (e.g. smart phones and connected homes) but also on industrial supply chains such as utilities, logistics, energy and construction. This combination will open new transformational opportunities as well as stimulating a next generation of disruptors
- **Artificial Intelligence (AI) and Robotic Process Automation (RPA)** will help to automate many of today's jobs and could pose a serious challenge to employment levels. AI is also being employed in the consumer space, presenting a new era of 'Hyper-Personalisation' that will challenge many consumer goods companies
- **Blockchain and crypto-currencies** could end the monopoly of banks and insurance companies as peer-to-peer exchange of goods and services becomes the norm. Blockchain could also transform the way business is conducted between trading partners such as in the construction sector. It might hold the key to securing personal data.
- **Three-Dimensional printing** (3D) could change the face of manufacture and bring more jobs on-shore from China and India. It will enable factories to perform a multiplicity of tasks. It will also encourage the resurgence of a local craft industry as individuals design and manufacture in their villages and houses.

The task of exploiting the second technology wave will be linked directly to a nation's ability to innovate. The UK has proven successful in previous decades in exploiting new generations of technology and needs to rise to this unprecedented opportunity. As we see in California and other innovative areas of the world (especially Israel), the factors necessary to exploit technology include appropriate skills, access to markets and availability of capital. In this respect the UK is well placed relative to Europe and already attracts a disproportionate amount of private equity and venture capital.

The one concern for the coming decade is the monopolistic position of digital leaders such as Amazon who now controls 47% of the cloud market (via AWS),Microsoft in Cloud and Office, and Google, controlling a third of all online advertising. With no real competition from incumbents, these digital disruptors can claim the market for themselves.

Stock and Fund picks

Funds specialising in smaller companies and opportunities such as Marlborough Special Situations, Fidelity Smaller Companies in the UK and USA deserve more attention given stela performances over the last decade.

The growing influence of private equity suggests a renewed interest in companies such as 3I, KKR, Blackrock and Carlisle. A growing proportion of public companies are now being absorbed into private equity portfolios – with the possibility that public markets may begin to collapse over the coming decade.

ABOUT THE AUTHOR

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