8 Key Investment Themes for 2020

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Rick Rieder, Russ Brownback and Trevor Slaven contend that eight major market influences are likely to dominate the investment environment in the year ahead and that the proper portfolio mix will be instrumental in delivering a successful outcome.

In our industry, we can safely rely on the turn of the calendar year to bring with it an overflowing inbox of "bold calls" for year ahead. Through the barrage of 2020 predictions, sector bets, benchmark target revisions, and the like, we are struck by the sobering reality that it will be incredibly difficult for asset markets to repeat the heroic returns of 2019 this year. Notwithstanding a fundamental environment that appears to be stabilizing, more dovish global central banks, and a meaningful reduction in trade tensions, fulsome market valuations abound, leaving less room for upside and little margin of safety should any of these influences reverse, or should unforeseen new risks arise.

As such, we think a 4% to 5% returning portfolio would be a winner in fixed income in 2020. Our "Drive for 5(%)" centers around building a barbell portfolio, underpinned on one side by high quality fixed income, with carefully selected equity and alternative assets on the other. This portfolio mix will be instrumental in successfully navigating a macro environment that is likely to be dominated by eight major influences:

1) Global Liquidity is vital in determining the investment opportunity set

Global liquidity is the most dominant, yet underappreciated, influence in contemporary global macro analysis. Central banks allowed liquidity to contract in 2018 and in early-2019, but they pivoted sharply over recent months. Liquidity injections in the fourth quarter of 2019 retraced more than half of the 2018-19 contraction. Further, we forecast that global liquidity will grow by an additional $1 trillion this year, providing important support for the economy and financial markets. Through 2020, there is a risk that liquidity is actually oversupplied and that central banks ultimately intervene verbally, to slow the momentum of liquidity-fueled risk rallies.

2) A yawning supply/demand imbalance in global assets will continue to be immensely powerful

We're astounded by the massive capital flows seeking out the inherent stability of bonds and cash, as well as the record amounts of corporate stock buybacks. Both these actions are presumably being pursued by investors due to a perceived lack of attractive investment alternatives for cash. These phenomena are exacerbated by the crowding-out effect that surging global liquidity intentionally creates. Central bank asset purchases, combined with companies that are simply rolling existing debt without adding new borrowing, means that the net new supply of fixed income assets is likely to be some $400 to $500 billion lower than last year. Supply is not only contracting; it continues to be insufficient to match the demand from a global demographic transition of people that are heading into retirement in 2020 and the next decade – a cohort bringing with them into their golden years an intensifying bid for yield against a shrinking pool of available income (see graph).

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3) 1.8% will be a guidepost for navigating financial and real economy ups-and-downs

Unlike some market commentators' more dramatic predictions for 2020, we see a more moderate path for both U.S. growth and inflation this year, at about 1.8%. Today's service-oriented economy, driven by technology, health care and consumer services, is largely insulated from the traditional cyclical influences that are more the hallmarks of an industrial economy. In fact, we wonder whether a traditional business cycle exists in precisely the same way anymore. Demographic headwinds are shifting global demand curves to the left and are driving equilibrium economic growth rates lower. With "muted" economic stability around 1.8%, global liquidity becomes the tail that wags the dog in the absence of big "macroeconomic imbalances." We are prepared to fade extreme price moves when markets inevitably adopt more extreme views (in either direction) over the course of the year.

4) Inflation could have its best year of the post-crisis era, but still not average greater than

2.0%

While we foresee a cyclical rebound in inflation during the first half of 2020, we're skeptical that it will either be sustained, or resemble traditional "econ 101-type inflation," or "demand-driven inflation." Temporarily elevated readings will simply be the result of a weaker USD, favorable base-effects, and a cyclical upswing in commodity prices. So, while Treasury yields may rise on the back of this inflation increase, any rise in yields will be met by unprecedented demand for yielding assets, limiting the impact.

5) Fiscal policy is a right-tail risk (not left-tail) in 2020

Developed market (DM) economies (ex-U.S.) have not enjoyed the tailwind of fiscal stimulus for many quarters, but that may change this year. In Europe, for instance, new leadership at the European Central Bank (ECB) and questions around the efficacy of the negative interest rate policy/zero interest rate policy (NIRP/ZIRP) could result in evolving policies that focus more on targeted growth, rather than fruitless efforts to generate inflation. Indeed, the Riksbank recently provided an example of how Euro-area policy might shift in 2020, when it de-emphasized NIRP in favor of fiscal expansion. In the U.S., both sides of the presidential debate will put forth stimulus plans for households, while China looks to have increased its reliance on fiscal policy within its overall policy mix.

6) Negative yields in the EU and Japan may turn to negative returns this year

In 2019, we saw a marked resurgence of negative yielding debt, to the tune of $17 trillion in August (which has since fallen by a third), mostly in Europe and Japan. These assets face a huge task in generating positive returns in 2020. Core front-end European rates still trade below the ECB policy rate, which is unlikely to be lowered further, yield curves are as flat as they have been in a decade, mitigating roll-down benefits, and European 10-Year yields sit well below all other "crisis" moments of the last decade. The combination of stabilizing growth and inflation, lagged benefits of 2019's Federal Reserve (Fed) easing, ongoing global liquidity injections, and a potential boost from new fiscal initiatives can combine to catalyze a drift higher in DM yields and term premia, which may generate negative returns for the negative-yielding universe.

7) U.S. Treasury yields will trade in a tighter range in 2020, relative to 2019

Last year we also saw an historic pivot by global central banks toward unexpectedly dovish policies, leading to tremendous rate market volatility. In contrast, with DM rate policy now firmly entrenched in a stable equilibrium, a stable real economy and overwhelming demand for yielding assets, U.S. Treasuries will likely be range-bound during 2020, with the potential for a somewhat steeper yield curve. We envision a 1.75% to 2.25% range on the 10-Year U.S. Treasury note, barring temporary spikes, if the perfect storm of higher equity markets, weaker USD, and higher commodity prices spark inflation fears among one-word headline watchers. As a result, we like the front end of the curve, anchored as it is likely to be by Fed policy rates that aren't anticipated to budge much this year.

8) Long global equity and long equity volatility will be good tactical opportunities in 2020

We think that tactical investment opportunities will likely arise from the laggards of the past decade, namely: the FTSE, Hang Seng, Nikkei and European bank stock indices. Well-known political risks, heavy ties to manufacturing, and perpetually low growth potential have weighed on these benchmarks, but policy pivots, benign valuations and increasingly enticing dividend yields (especially relative to fixed income alternatives) could provide the spark for a rally. The demand for yield will eventually trump structural headwinds in these areas of the market, in our estimation. With that in mind, we still believe that U.S. equity markets offer a best-in-class "fundamental" backdrop, with gains likely to be primarily driven by world leaders in innovation, high-returning research and development spenders and firms with solid and sustainable profitability levels; i.e. the fast rivers of cash flow. These segments of the U.S. market will also witness additional technical market support from the hundreds of billions of dollars in share buybacks expected to be undertaken this year.

Portfolio Positioning Considerations

We think markets will perform well at the outset of 2020, but anxiety will rise as valuations become increasingly stretched as the year evolves. In our "Drive for 5(%)," we like liquid portfolios oriented around high-quality yield with upside potential through the equity market. And we like using cheap volatility as a tool for hedging. Our "Drive for 5(%)" may sound pedestrian when compared to the 5% average return for the U.S. Aggregate Index over the past 20 years (though it's been closer to 4% post-crisis), but on the heels of a stunning 9% return for that index in 2019, along with yields in most sectors that are currently near all-time lows, attaining this traditional 5% return will actually be extremely challenging. For the Aggregate Index to attain a 5% return in 2020, yields and spreads would have to fall about another 20% from already-low levels, to new all-time lows, which is implausible in our view.

Therefore, given the ubiquitous, already realized, spread compression we've witnessed in credit sectors, the bar is high to justify extending down the credit spectrum for yield. Similarly, with yield curves so flat, there is little rationale to extend duration. As a result, we're focused on high quality securitized assets with LIBOR + AAA/AA spreads, European investment-grade (IG) debt swapped back to USD, front-end U.S. IG credit, the mortgage-backed securities basis, and commercial mortgage-backed securities bespoke assets. When we do reach for a bit of yield, it will be selective and could likely focus on emerging markets (EM) local currency credit, bank loans and BBB rated collateralized loan obligations, alongside tactical positions in some U.S. high yield debt.

Further, as mentioned, we're concentrating equity risk exposure within the "fast rivers of cash flow" that we mentioned previously, while attempting to avoid dead-weight names and value traps. We also favor EM equities and high dividend European equities. We think a well-constructed equity portfolio can potentially return 8% to 12% in 2020. Among alternative assets, we like bespoke expressions that encompass an optimal mix of high yields, quality collateral and upside potential. We expect a successful alternative portfolio to return roughly 10% to 14% in 2020. Managed together, a barbell portfolio such as this can reward investors appropriately for taking risk in a year that will, in retrospect, likely be described as more challenging than usual.

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