LOMBARD ODIER
INVESTMENT MANAGERS

Global Perspective

Outlook 2019: Managing a "no recession, yet tricky" scenario

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November 2018

Executive summary

In our central scenario, we expect above-trend global growth with a low likelihood that any of the major developed market economies will enter recession. But it will still be far from plain sailing. We expect long-standing relationships between the main asset classes to come under pressure as markets become significantly more dynamic and volatile.

As such, we have dubbed 2019 a "No Recession, Yet Tricky" (NRYT) year.

Below is a summary of the key factors we expect will shape the global economy in 2019:

- **We expect US economic outperformance to reverse, US assets to underperform and the dollar to come under pressure** as late cycle dynamics take hold, the effects of tax cuts and repatriated profits begin to wane, the split Congress reduces the potential for further tax breaks, and the Federal Reserve becomes more measured in its approach.
- **We believe emerging markets are poised for a rebound** as trade tensions between the US and China ease and the Chinese government's efforts to stabilise its currency and equity market work through the system. Contrary to consensus, we think the ongoing stimulus efforts may lead to a positive growth surprise for China.
- **In Europe, we expect the Italians will back down** from their game of chicken with the Eurozone, but only in response to extreme market pressures, which means the road to Italy's breaking point is likely to be volatile. Meanwhile, **we expect Brexit will result in a 'cliff-edge',** last-minute deal, potentially creating a rally in Sterling, which currently looks cheap.

Global inflation overshoot remains a key risk to our central scenario as global monetary policy shifts into unified tightening mode.

At the more structural level, we also expect the global economy to come under pressure from two key areas:

- **Rising populism**, driven by increasing inequality, could mark the peak in central bank independence
- **Rising global leverage** implies lower resilience to shocks from rising rates or falling incomes

Key implications

In light of our 'No Recession, Yet Tricky' outlook, we believe investors should consider the following for the year ahead:

- A structural allocation to emerging markets using a multi-asset approach
- Downside protection, and a deeper focus on convexity
- A focus on quality in fixed income
- The relevance of uncorrelated strategies is likely to increase
- Sustainability factors will continue to drive risk and opportunity in 2019

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Introduction

In this year's outlook, we share our views on a number of macro themes which we think will be highly relevant in 2019 and their likely cross-asset implications. In our view, 2019 is likely to be a year which sees a further increase in dispersion in both global economic and market trends, leading to important investment implications.

We see 2019, as a **No Recession Yet Tricky** year (NRYT) as long-standing cross-asset relationships come under pressure. We also expect decoupling amongst economies, policies and market outcomes to become significantly more dynamic and volatile compared to the years following the financial crisis.

We expect trend or above trend growth in a number of major and key emerging countries next year and see the likelihood of a global recession as very low. That said, we expect that an "equilibrium" state, whereby global policy and the economy will appear in sync, is likely to remain elusive in 2019 as well.

Cyclical peak in US "exceptionalism"?

Receding policy support coupled with slowing buybacks

In the US, it is clear that the fiscal stimulus had a big impact on growth and was responsible for the economic outperformance in 2018, but this positive boost to the economy is now expected to fade gradually in 2019. Specifically, it is likely that the positive impact of the fiscal stimulus on both consumer spending and business investment will weaken in the coming quarters. Indeed, when we look at capital goods orders, there are already signs that business investment may be weakening. Similarly, the continued rise in interest rates is also causing a slowdown in the housing sector, likely creating a small headwind to growth next year. As such, our view for US growth in 2019 is close to consensus, but we believe that the risks are skewed to the downside.

In addition to the usual drivers of the positive economic growth impact as a result of the strong fiscal easing, share buybacks have been a strong technical factor in US equity markets. Any slowdown on this front starting early next year would represent an important new dynamic in the new year.

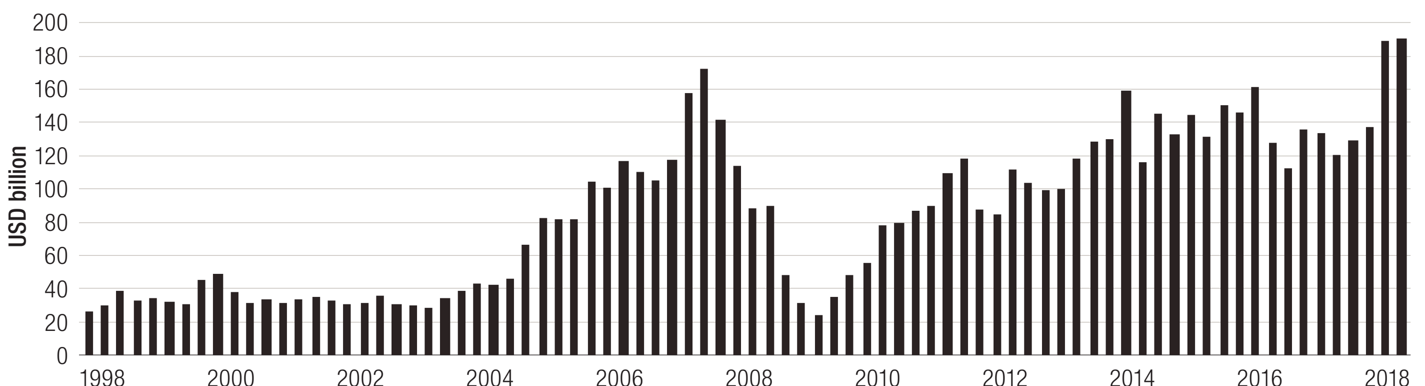
Specifically, the strong repatriation of foreign earnings is estimated to have reached about USD 400 billion by end of Q3 and supported business investment in the first half of the year. It has also boosted share buybacks, which are estimated to have reached USD 680 billion in the first half of 2018, representing the strongest two quarters of buybacks on record.

For financial markets, the question remains how markets will react to a normalisation in earnings growth, and to a reduction in the amount of share buybacks in coming quarters, as the repatriation of foreign earnings slows meaningfully. This is likely to mean an end to outperformance of the US equity market – a dominant trend of 2018.

When it comes to monetary policy, we believe the Federal Reserve will continue to tighten gradually. It has already signaled in its latest projections that it intends to hike rates by about 100 basis points (bps) between now and the end of 2019 and reduce the size of its balance sheet by USD 50 billion per month.

Given the continued increase in inflationary pressures, the Federal Reserve will need to continue to reduce the amount of policy stimulus. However, our expectation is that the Federal Reserve will hike rates by 75bp between now and the end of 2019 and keep the pace of balance sheet reduction unchanged. The Fed may raise rates less than is currently expected and/or slow the pace of its balance sheet reduction, given the distortions it is creating in the market. Already, recent commentary from key Fed officials, including Chairman Powell, shows increased sensitivity to rising headwinds facing the US economy and suggests a change in tone compared to the hawkish rhetoric which was being used in August. On balance, the tail risk to our central scenario remains overtightening (as reflected in the dot plot)[1] leading to a meaningful economic slowdown, especially in light of the fading fiscal stimulus.

FIG. 1 QUARTERLY BUYBACKS OF S&P 500 COMPANIES



Sources: Standard & Poors, LOIM calculations. November 2018.

[1] Dot plot refers to Fed Funds forecast by FOMC members that are regularly published by the Federal Reserve.

The dollar is also likely to give back some of the outperformance seen in 2018, as growth moderates and the rate differential narrows. A weaker dollar could provide a tailwind for global growth and certain assets. It would help improve the external debt position of EM economies and increase the attractiveness of local assets to foreigner buyers, while making assets denominated in dollars less attractive. A weaker dollar has historically been positive to global growth. A recent National Bureau of Economic Research paper[2] estimates that a 1% depreciation in the dollar against all currencies leads to an increase of 0.6%-0.8% in the volume of global trade.

A house divided
In addition to the fading fiscal stimulus, as discussed in our recent note, ‘no “blue wave” but gridlock arrives,’ the divided Congress is likely to be negative for the US dollar, as it is now less likely there will be a further increase in fiscal stimulus. In addition, the current configuration lessens the likelihood of confidence-sapping tail risks, such as impeachment and tax repeal, which should help reduce uncertainty.

On the geo-economics front, although the result doesn’t have a direct impact on the US/China relationship, it may indirectly affect President Trumps’ plans. Both fiscal and monetary policies are likely to become less supportive going forwards, which raises the potential of a deeper, negative confidence shock stemming from escalating trade frictions. Arguably, had the Republicans won both houses, the Trump administration may have taken an even tougher stance. As such, we see a divided congress as an issue for US domestic sentiment, especially the negative impact it could have on cliff-edge events such as the debt ceiling. There is a high likelihood we will see a showdown similar to those in 2011 or 2013.

Trade wars and emerging markets

Can China escape the Thucydides Trap?
Understanding the drivers of the current trade war remains key to understanding current and future asset market developments, especially in emerging markets (EM).

As discussed in our earlier note, ‘battered EM set for a rebound?,’ we think the growth damage priced into EM equity markets is out-of-sync with what the confrontation between US and China actually entails (under reasonable assumptions). This implies the severe decoupling we have witnessed this year between US and EM assets has scope to reverse in coming months as the catalysts necessary for such a reversal start to assert themselves.

China likely to offer concessions
The relationship between the US and China is perhaps the most important global dynamic of the century. In recent months, as trade tensions between the two countries have escalated, it has become increasingly clear the issues between the two global powers run deeper than trade.

So far, China has limited its retaliation to trade issues, but the US is widening its focus to include non-trade areas. It appears China currently has no source of support in Washington. A recent speech by Vice President Mike Pence summed up the extent to which US politicians are suspicious of China. It is unlikely the mid-term elections have changed the underlying dynamics of Capitol Hill, given the widespread skepticism. During the Obama era, China had support in Washington when it came to several multi-lateral engagements, including the Paris deal and on Iran, but all these initiatives have been reversed by the Trump administration.

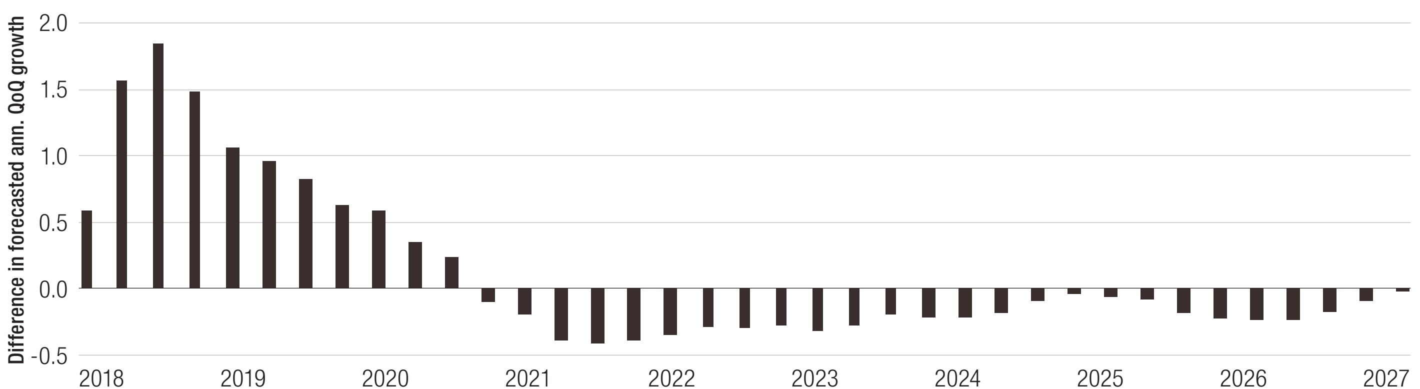
It is worth noting that the dominant view in international-relations circles remains that President Xi would like to avoid a “Thucydides Trap”, whereby a rising power clashes with the established order, at this juncture.

There is evidence to support this since China has, so far, remained focused on narrow economic issues in its retaliation against the US and the Xi administration has steered clear of widening its retaliatory response to include non-trade areas.

Although President Xi has talked tough in recent weeks, China has shown greater willingness to engage with the US and has talked more openly about issues that concern not only the US, but also other major trading blocs, such as intellectual property and access to China’s domestic market. We expect the upcoming G20 summit to be an important event and could lead to more meaningful discussions down the road.

It is unlikely all the issues that are creating a rift between the world’s two most important economic blocs will be sorted right away. However, tangible signs of reconciliation would be significant, especially given that fears of a fully-fledged trade war have started to be priced in to risky assets such as EM equities in recent months.

FIG. 2 DIFFERENCE BETWEEN CBO GROWTH FORECASTS BEFORE AND AFTER TAX CUTS PASSED



Sources: Congressional Budget Office, LOIM Calculations. November 2018.

[2] Boz, E, G Gopinath and M Plagborg-Moller (2017), “Global trade and the dollar”, NBER Working Paper 23988.

Mind the (valuation) gap

The valuation gap between EM and DM, which has opened up after a torrid 2018 for EM, looks inconsistent with underlying fundamentals.

We think Chinese equities' peak-to-trough fall reflects a growth hit of +1 percentage point (ppt), whilst the stimulus measures being planned may add 0.5 to 0.6ppt to growth next year. The broader stability of China and its currency are also likely to be an important positive tail wind for other EM countries, especially as countries prone to idiosyncratic risks – like Turkey and Argentina – show signs of stabilization following recent policy actions.

According to our estimates, the dividend yield differential between EM and DM equities – currently around 0.4% – is now similar to levels seen in September/October 2015 in the immediate aftermath of the yuan shock. In our view, this prices in a significant amount of stress. Similarly, price-to-book differentials are as extreme as they were in late 2015/early 2016, despite stronger growth and external fundamentals in a number of emerging markets. EM growth revisions are likely to turn positive in the coming months - led by China – and we think this discount will need to be reassessed by the market, and could potentially lead to a rebound going into year-end.

Beyond year-end, we expect EM assets, and especially equities, to be better supported than in 2018, although we continue to expect elevated levels of volatility as various market-shaping dynamics ebb and flow over the year.

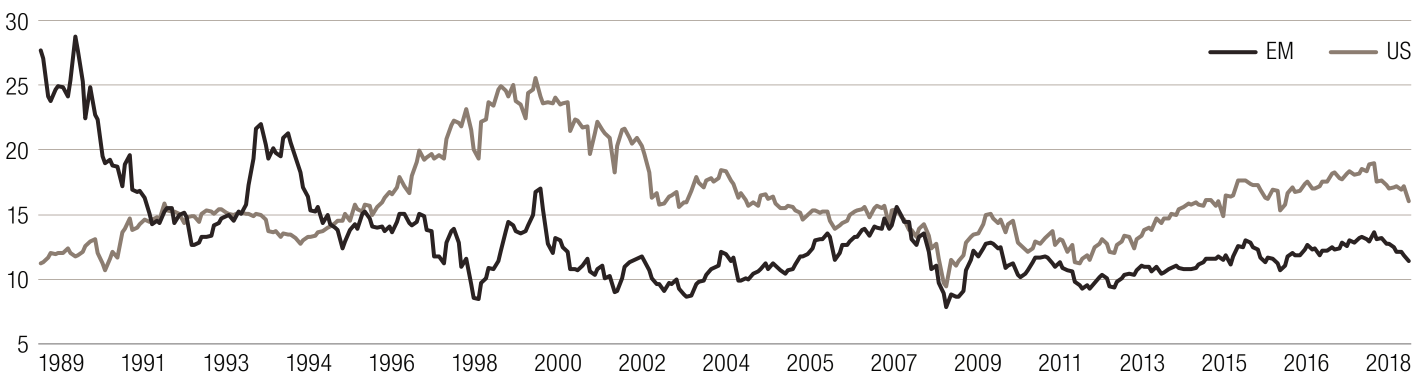
China Policy Stimulus – Key Backstop to Slowing Growth

When it comes to the Chinese domestic economy, we have seen a significant increase in targeted stimulus efforts by the government in recent weeks. For instance, the Chinese authorities have ramped up use of currency reserves in order to stabilise the currency. Recent data shows CNY 120 billion was used, which is the highest level since January 2017. In addition, we have seen significant rhetoric delivered by key individuals and specific policy actions aimed at stabilising the equity market. There has been a wave of nationalization when it comes to the weakest companies, which have been using shares as collateral, and direct government support for the equity market via proxy purchases.

Fiscal policy is another tool being used by China and, based on our estimates, the easing is now comparable to what we saw in the immediate aftermath of the global financial crisis. We expect the fiscal deficit to increase by 0.4 to 0.5ppt in 2018. Specifically, the tax reduction of CNY 1.3 trillion recently discussed by the Ministry of Finance may add 0.29ppt to next year's growth, according to various policy sources.

Focusing on the credit channel, recent data has been quite worrying as it shows a continued slowdown in credit deployment in China. Indeed, we think this will lead to a faster shift in credit policy in coming months, signs of which are already appearing. This indicates a rapid change in the government's stance (for example, explicit window guidance communicated by PBoC governor Yi Gang to key policy banks recently).

FIG. 3 12 MONTH FORWARD PE RATIOS: EM VERSUS US

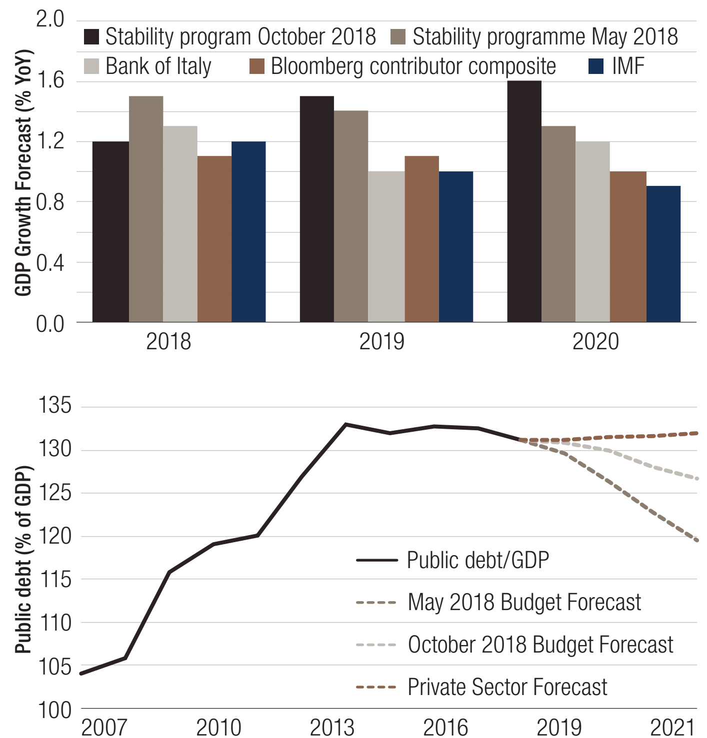


Source: Thomson Reuters Datastream. Forward P/Es calculated using Thomson Reuters estimates of forward earnings for the corresponding Datastream market sample. November 2018.

FIG. 4 MONETARY CONDITIONS LOOSENING TRAJECTORY AND MACRO DATA BEGINNING TO SURPRISE ON THE UPSIDE

Source: Bloomberg, National Bureau of statistics of China, LOIM calculations. November 2018. Increasing monetary conditions index signals loosening policy.

FIG. 5 ITALY'S OCTOBER BUDGET PROJECTIONS SUPPORTED BY OVERZEALOUS GDP GROWTH FORECASTS



Source: Bloomberg, IMF. November 2018. Private sector forecast is a simple average of multiple private sector institutions forecasts.

In terms of flow of current macro data, the Chinese economic surprise index is now showing signs of a more sustained upward trend having improved from -53 earlier this year to +2.7 currently. This implies data is starting to surprise on the upside. The latest export/import numbers were consistent with this trend, though some weakness is expected early next year as the tariffs come into play.

All in all, we are more optimistic than the consensus and think next year's growth in China is likely to surprise on the upside. This means that the 6.2% consensus growth forecast for 2019 may need upward revision as the impact of various policy moves start to show up in data in coming months.

Europe Remains Exposed to Political Risks

When it comes to growth outcomes in Europe, we expect trend growth dynamics and see the recent slowdown especially in Germany as temporary. Beyond cyclical factors, political risks in Europe, however, are likely to remain elevated going into 2019.

Italy plays chicken

Following the arrival of the populist government in Italy, we warned that Italian assets were at risk given the high likelihood of a confrontation between the Italian government and the European Commission (EC) over the budget plan.

Since then, Italian sovereign spreads have surged by about 200bp, sharply increasing the financing cost of the government. The Italian government plans to increase spending and lower taxes that will increase the fiscal deficit significantly in the years to come. However, it is clear when examining the growth assumptions underlying those estimates that the government is expecting a high fiscal multiplier from its stimulus. Those growth rates are about 0.5 percentage points higher than consensus and, as a result, private sector economists expect that the current fiscal plan will lead to a small increase in the debt-to-GDP of Italy.

The EC has rejected the Italian government plan, arguing that it is in breach of the Eurozone's budget rules, and has asked for a revision. This was met with defiance by the Italian government.

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Our base case scenario is that Italy will remain in the euro area and that the Italian government will back down and present a budget that is compliant with the EU rules (who may also offer some concessions). However, the road to this outcome will be volatile and risky, especially since we believe the Italian government will only back down in the face of extreme market pressures, as opposed to pressure from the EC.

Essentially, we think the Italian government could end up playing a high-stakes game of chicken with the EC. The populist government understands that if Italy were allowed to fall out of the common currency that could cause significant collateral damage to the rest of the Eurozone, and it is likely expecting the EC to back down first.

In our view, this means further increases in Italian sovereign spreads, and on the Italian banking sector, are likely in the coming months. Furthermore, the risk of an accident remains high and cannot be discounted. The situation is further complicated by the fact that there are also rising tensions within the Italian populist coalition, especially with the League gaining national support at the expense of the Five Star movement, and this could potentially lead to an early election in 2019.

Will Brexit Break Britain?

On 29 March 2019, the UK will leave the European Union. But this is where the certainty ends. It remains unclear whether the UK and the EU will have an agreement in place by that date.

The UK and the EU have recently reached a tentative divorce deal. The details available suggest that the UK will remain closely aligned with the requirements of the single market, preventing the establishment of a hard border in Ireland. It is not yet clear whether the deal will make it through parliament.

The domestic political risks in the UK remain elevated:

1. the hard Brexiteer wing of the Conservative party is standing ready to challenge Prime Minister May.
2. the Labour party is ready to vote down any Brexit deal to force an early election.
3. the DUP (Northern Irish party), which holds the balance of power in parliament, stands ready to vote down any agreement that reduces their link to the rest of the UK.

Recent political developments witnessed in the aftermath of Prime Minister May's push for a deal indicate that the above issues have not been resolved and uncertainty around Brexit has once again risen sharply as the 29 March 2019 deadline ticks down.

While at this stage, it is still unlikely a new referendum will be held – either on the EU membership itself or on the Brexit deal – the consequences of parliament voting against an agreement would be important and could derail the process.

We continue to think that ultimately a deal between the UK and EU will happen as all sides have an incentive to push the negotiations to the very end. However, the road to a deal is likely to see pressure on UK assets as they become a party to the 'chaos'. Indeed, if a sensible Brexit is delivered, we see GBP rising to 1.40 and potentially even higher next year with the possibility to be a big winner of 2019. That said, in the event of a "blindfolded" Brexit, we expect GBP to fall by another 10% as the currency adjusts to reflect the new uncertain reality facing the United Kingdom.

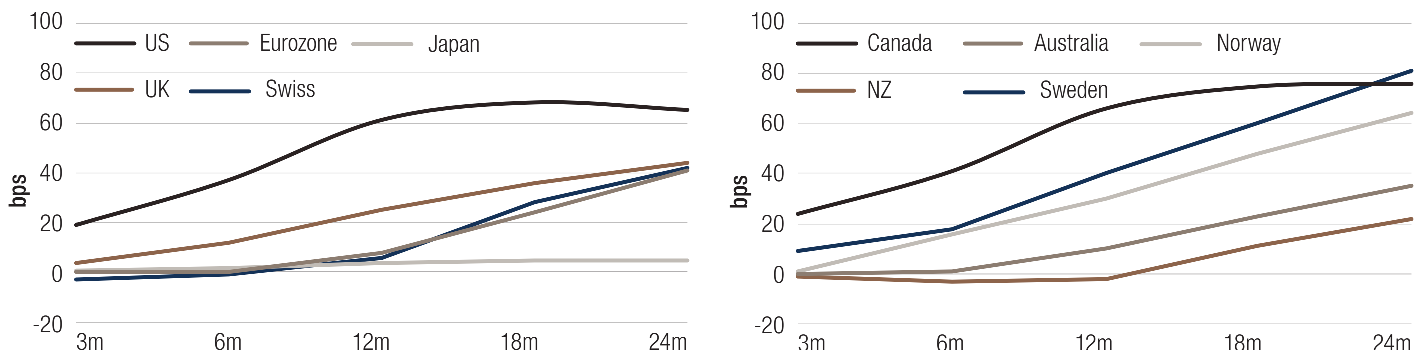
Global inflation overshoot remains a key risk

Monetary tightening goes global

Global inflation dynamics overshooting is a key risk to our central scenario of a "no recession, yet tricky" year in 2019 as central banks are likely to move into unified hiking mode across the globe and the liquidity pumped into the system post-financial crisis begins to gradually unwind.

It is not just the Federal Reserve that will remove some of the monetary stimulus in 2019. The European Central Bank (ECB), the Bank of England (BoE), Bank of Canada (BoC) and Sweden's Riksbank are likely to follow suit. A big unknown – and therefore risk – for investors is whether this involuntarily coordinated tightening of monetary policy could have an adverse impact on financial markets and growth. We believe the focus on tightening will remain strong in 2019, but we expect there will be an elevated sensitivity to overtightening, especially in the case of the ECB.

FIG. 6 GLOBAL MONETARY STIMULUS REDUCTION – EXPECTED CHANGE IN POLICY RATE



Source: Citi. Rate expectations based on OIS curve. November 2018.

On the positive side, the ECB has telegraphed its intentions very clearly and is widely expected to end its Asset Purchase Programme (APP) at the end of 2019, while a rate hike is unlikely to occur before the summer. In our view, September is the most likely starting point, with some risk of a delayed start.

However, some factors could force the ECB to revise its plan. Firstly, there are signs the economy could be slowing more than expected, which could mean the excess capacity will not disappear as quickly as the ECB expects. Secondly, an escalation of tensions with Italy could have a negative impact on monetary conditions and growth in the single currency area.

Next year is also going to bring about a change in leadership at the ECB and we expect markets to be watching very closely over the next few months as the next chairperson comes under scrutiny.

The path of the Swiss National Bank (SNB) policy is very much linked to the ECB's. As such, the SNB is very unlikely to hike ahead of the ECB, for fear of the impact it would have on the Swiss franc (CHF).

However, with a strong Swiss economy and a continued tightening of the labour market, inflationary pressures could force the SNB into an early hike. We believe the SNB will do everything it can to prevent this. One way to achieve that goal would be to allow the franc to appreciate in the short term to reduce imported inflation and offset some of the domestic inflation, affording the SNB some patience.

The Bank of Japan (BoJ) is likely the only major player that will not reduce the amount of policy stimulus in 2019. We believe, given the lack of sustained inflationary pressures, and with inflation remaining well below target, the BoJ cannot afford to reduce its amount of policy accommodation, leaving its QE programme and yield-curve targeting framework unchanged. Moreover, with the VAT increase scheduled for next autumn, it is very likely the BoJ would prefer the economy runs hot so it can better absorb the negative impact of the tax increase.

Nevertheless, we would not exclude the probability the BoJ tweaks its yield curve target because of continued upside pressures on Japanese government bonds as global long-term yields increase. But the impact such a change could have on the yen would likely prevent such a move.

For the BoE, if it was not for Brexit uncertainty, they would likely be tightening monetary policy already. As such, we expect the BoE to hike twice next year, in May and in November, conditional on a Brexit deal.

Structural trends to watch

On a longer term basis, we believe there are two key trends emerging that could play out in 2019. Firstly, as populism feeds a more aggressive form of rhetoric between governments and central banks, we may be beyond the point of peak independence for central banks. The result could lead to a rethink of their role in the economy, beyond the single objective of controlling inflation. Second, rising leverage could leave the world less resilient in the face of another shock, which could come from faster-than-expected rate hikes, or from a fall in income.

Inequality, populism and central bank independence

Populism, fuelled by rising inequality, is on the rise and continues to shape political outcomes in key economies. There is an argument that the policy actions taken by central banks in the aftermath of global financial crisis have been a strong contributor to widening the gap between the 'haves' and the 'have-nots' as rising asset prices is a key channel through which monetary policy works.

Notably, ex-Fed chair Ben Bernanke has been writing on this topic and, not surprisingly, defended the policy stance adopted 10 years ago. He argues the effects on inequality are not clear. Similarly, a recent study by the ECB concluded that the massive asset purchase programs helped reduce inequality by supporting employment growth. However, this topic has been a major source of debate, especially after Thomas Piketty's well-argued case showed that, contrary to traditional wisdom, developed economies don't automatically gravitate towards more egalitarian societies.

Central bank independence has likely peaked

An important side-effect of rising populism and its appeal, in our view, has been an increase in aggressive rhetoric being adopted by governments on central bank policy making. This was first evident in the Eurozone following the 2011/12 crisis, and now appears more widespread. President Trump has recently criticized Federal Reserve policy, breaking with presidential norms. Even in emerging markets, central bank independence is under pressure. In India, there is a serious clash between the Reserve Bank of India (RBI) and the government, and independence has completely reversed in countries such as Turkey.

In our view, monetary policy will need to be sensitive to factors that fan populism, and accept the impact of monetary policy on inequality. Even if policy makers can rightly claim that distribution of wealth is outside the scope of their mandate, the political outcomes inequality-shaped populism can generate have a huge influence on the functioning of the monetary policy regime. Central bank independence has been a dominant theme over the last 30 years, but, given rising populism and increasing skepticism about the value of expert-led institutions, we think we are now past peak independence in central bank policy-making in the developed world.

Consider, for example, the rise in populism evident in Germany, which is now shaping political outcomes, and could affect who is chosen as the next ECB chair. Meanwhile, in the US, it is totally conceivable that tensions between the president and the Federal Reserve will rise further if the US economy slows down. As the divided Congress limits the scope for further government spending or tax cuts, public pressure will begin to focus on monetary policy, particularly on the level of interest rates.

Overall, as populism continues to rise and multilateralism and globalization lose support, we think central banks need to reconsider their narrow focus on inflation and, in the case of the Federal Reserve, unemployment-based objective functions. This has clear parallels with the movement in the investment industry to rethink how global sustainability challenges, including rising inequality, are impacting the way we manage and assess assets across time and geographies.

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Are we ready for a shock?

Since the end of the financial crisis, the world has seen a dramatic increase in the amount of leverage in the non-financial sector. According to the Bank of International Settlements (BIS), debt in the non-financial sectors has increased by USD 71 trillion since the first quarter of 2007. This has been driven by an increase in both private debt (USD 40 trillion) and public debt (USD 31 trillion). As a result, the debt-to-GDP ratio has increased to almost 250%, up from about 210%, over the same period.

While the overall increase is important, the aggregate measures can mask what is really happening at the country level and also across sectors within a country. Some countries like Germany have actually reduced their overall amount of leverage over the period, while countries like China, Canada, France, and Singapore have increased greatly. In China's case, another dose of policy stimulus, which will once again use the credit easing channel, is most likely to draw attention to the heavy debt burden facing the economy.

Many investors are worried this increased leverage may be the cause of the next crisis. Our view on the subject is more nuanced. We believe increased levels of indebtedness make the economy more vulnerable to a shock, which, in turn, amplifies the impact of that shock on the economy.

Investors will be particularly focused on any uptick in interest rates as more debt, especially at the private level, means the economy can become more sensitive to changes in the cost of debt. This is important for monetary policy as it means that increased leverage reduces the neutral rate (rate at which the economy is thought to be in a demand and supply equilibrium, leading to stable inflation).

However, interest rate rises do not necessarily need to be destabilising. As long as the increases in interest rates are gradual, economic agents will adjust their spending, meaning weaker discretionary spending for households and weaker profits and investment for corporations.

The main risk is if interest rates jump suddenly higher or the speed of rate rises is faster than markets are expecting. Central banks in highly-indebted countries understand this and are likely to refrain from normalizing monetary policy too quickly. However, the risk could come if lending rates are linked to longer-term market rates and not the policy rate. This means that continued Federal Reserve tightening, or a sharp increase in US Treasury yields, could lead to a sharp increase in lending rates, by forcing up the level of global rates as the rate shock creates global spill-overs.

In addition, investors worrying about high levels of indebtedness often forget about the risk presented by a decline in income, which, in our view, has the potential to be more destructive. Any loss of income could have a dramatic impact on the capacity of the highly indebted to service their debt, leading to default. This scenario would require a negative exogenous shock, which could arrive in a variety of ways. In China, it could be through a dramatic loss of revenue for exporters following an escalation of the trade war, for example. Moreover, the real danger is that the increased default rate could create a negative feedback loop of weaker growth, prompting further income losses and defaults. As such, we don't think that 2019 would see negative implications of a big shock to a highly leveraged global system come the fore, however we do expect this issue to remain a key structural challenge as the current business cycle moves forward.

TABLE 1 GLOBAL LEVERAGE BY SECTOR AND COUNTRY

	LATEST DEBT-TO-GDP RATIO (2018 Q1)				CHANGE SINCE 2007			
	GOVERNMENT	CORPORATES	HOUSEHOLDS	TOTAL	GOVERNMENT	CORPORATES	HOUSEHOLDS	TOTAL
AUSTRALIA	37.7	75.4	122.2	235.3	29.5	-5	14.1	38.6
CANADA	70.4	114.3	99.4	284.1	21.3	28.4	20.7	70.4
CHINA	47.8	164.1	49.3	261.2	18.5	67.3	30.5	116.3
HONG KONG, SAR CHINA	70.3	234.8	71	376.1	49.4	109.1	19.8	178.3
FINLAND	59.8	113.5	66.7	240	25.8	19.4	15.6	60.8
FRANCE	97.6	134.1	58.6	290.3	33.1	30	12	75.1
GERMANY	62.5	54.1	52.5	169.1	-1.1	-1.8	-8.6	-11.5
ITALY	133.2	72.2	41	246.4	33.4	-2.4	2.8	33.8
JAPAN	200.4	98.8	57.4	356.6	55.5	-3.7	-1.3	50.5
SOUTH KOREA	38.5	99.1	95.2	232.8	16.1	10.5	22.9	49.5
NETHERLANDS	55.2	175.6	104.3	335.1	12.1	53.4	-5.3	60.2
NORWAY	36.1	142.9	101.6	280.6	-13	15	27.7	29.7
SINGAPORE	114.5	117	58.4	289.9	28.2	40.7	19.5	88.4
SWEDEN	37.9	154.6	87.7	280.2	-1.3	29	22.5	50.2
SWITZERLAND	29.5	113.1	128.3	270.9	-6.1	22.9	22.3	39.1
UK	85.7	83.9	86.1	255.7	44	-10.5	-6.1	27.4
USA	99	75.5	77.3	251.8	41.2	5.8	-21.2	25.8

Source: Bank of International Settlements, LOIM Calculations. November 2018.

Investing in a changing world

As we move into 2019, our central scenario of a “No Recession Yet Tricky” year is likely to deliver positive macro support for risky assets, but we are also likely to see more volatility along the way. We believe the scope for policy mistakes will be elevated next year as the monetary policy environment continues to shift, and both geo-political and geo-economic tensions remain high.

In terms of our specific recommendations, we believe investors should consider the following for 2019:

- This could be an opportune moment to consider a **structural allocation to emerging markets using a multi-asset framework.** We expect emerging market assets to rebound, especially equities, given the likelihood of a slowdown in US economic growth, the depreciation of the US dollar, and the ongoing policy stimulus in China. However, we are also mindful of increased volatility in local EM currencies caused by policy makers’ tendency to use domestic currency as a policy tool to protect foreign currency reserves. This is disrupting the dynamics across EM sub-asset classes. Historical performance patterns of hard, local currency fixed income and equities have started to diverge, which is why we believe a multi-asset approach is the more optimal way to harness the structural opportunities in EM.
- **Explicit downside protection, and a deeper focus on convexity,** could be a useful tool for harnessing the upside of a more volatile environment, while also controlling downside risk. Convertible bonds, for example, combine the characteristics of a corporate bond with the option to convert that bond into shares. This means they can offer an ‘asymmetric’ return profile because they are designed to capture upside potential similar to equities, but limit downside risk through the bond component. By finding convertible bonds with the most attractive asymmetric characteristics (convexity), we believe it is possible to maximize risk-adjusted returns in a “No Recession, Yet Tricky” environment. This is particularly relevant in the context of changing equity and bond correlations.
- **In fixed income, the focus on quality remains important in the context of rising leverage and fractured liquidity.** We continue to favour the BBB-BB segment of credit markets both in the US and Europe, which we believe offers a better balance between duration and credit risk. We believe the high yield segment faces a tricky challenge in 2019 given the continued rise in leverage in the corporate sector.
- Furthermore, **the relevance of uncorrelated strategies is likely to increase** as the global business cycle becomes more mature. This is especially pertinent where those strategies are designed to benefit from ‘alternative’ sources of information and actively avoid overcrowding.
- We believe **sustainability will continue to drive risk and opportunity in 2019 and beyond.** We are currently witnessing a new economic revolution, which will impact every region, every sector, every company and every asset class. This ‘Sustainability Revolution’ is driven by several structural mega trends, notably demographics, climate change, scarcity of natural resources, inequality and digitalization of our economies. We believe this will start to impact monetary policy going forward as central banks pass the point of peak independence as governments come under increasing pressure to address inequality in particular.

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