2020 Economic and Financial Outlook – Muddling Through

Executive Summary

- Global real GDP growth fell to its slowest pace in 10 years but 2019 witnessed a strong performance in risk assets, propelled by central bank easing and the de-escalation of the U.S.-China trade war;
- Recession fears faded. In 2020, the global economic momentum is expected to improve marginally;
- Economic, geopolitical and climate risks, peak globalization and elevated leverage restrain the return of animal spirits in financial markets;
- Strong labour market fundamentals still favor consumer spending and the continuation of the U.S. relative outperformance. The big unknown is how consumers will feel as we move closer to the 2020 Presidential elections;
- Despite challenges in some emerging markets, fading drags from trade tensions and expansionary macro policies are poised to slightly improve the economic outlook in Asia, led by China;
- In Europe, broader trade uncertainty appears to be replacing Brexit uncertainty, preventing a long-awaited economic breakthrough;
- In Canada, most cyclical and structural factors are supportive for economic strongholds like housing, oil and the IT sectors;
- With the rise of ESG investing, the markets' perception of Canada increasingly depends on the ability of companies to adapt to a lower-carbon global economy;
- We expect a mid-single digit return on the TSX in 2020;
- In the absence of CPI reflation, we see no change to the BoC and Fed policy rates;
- The Canadian yield curve is projected to move from an inverted to a flat shape;
- We forecast WTI crude oil prices to stay close to US$63/bbl and the Canadian dollar to end 2020 a notch higher than the current US77 cents mark.

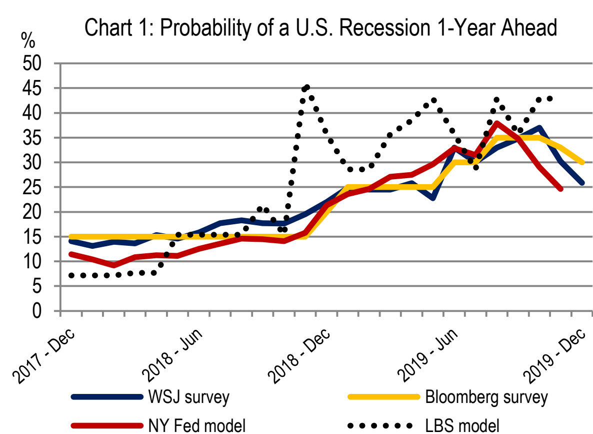
2020 Strategic Views	u		n		o
Equities				x	
Canada			x		
United States				x	
Other Developed Markets		x			
Emerging Markets				x	
Fixed Income		x			
Government Bonds		x			
Corporate Bonds			x		
Cash				x	

Notes: u: underweight, o: overweight, n: neutral. Relative to a balanced (neutral) portfolio.

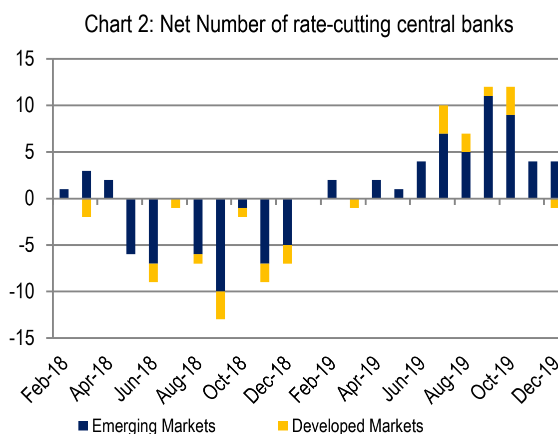
2019 Recap: Risk assets climbed in spite of a challenging economic environment

At the time of writing our 2020 Outlook, it is a notch easier to say that the worst could be behind us. Back in December 2018, there was no end in sight to the escalation in U.S.-China trade tensions. Credit spreads widened and the Federal Reserve's tightening went a few steps too far. The U.S. yield curve inversion exacerbated recession fears.

Fast-forward to January 2020. The odds of a U.S. recession declined in the later stages of 2019 according to most predicting models and economist-based surveys (chart 1). First and foremost, the U.S.-China trade war de-escalated with the "Phase 1" deal. Second, in response to trade tensions and low CPI inflation, almost three-quarters of the world's central banks, weighted by GDP, have eased their monetary policy stance during the second half of 2019 (chart 2). Third, the contraction in global manufacturing activity turned out to be shallow without generating the feared negative spillover effect to other industries. These encouraging developments reduced concerns about some tail risks and improved the economic and earnings outlook. North American equity markets reached new highs and the U.S. yield curve un-inverted.

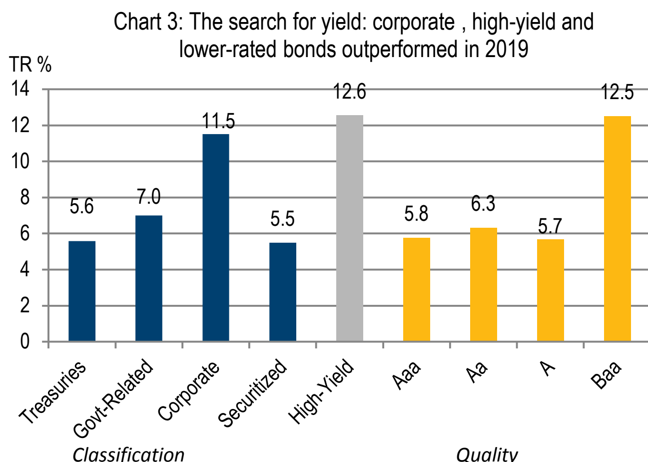


Source: Federal Reserve, Bloomberg, Wall Street Journal, LBS Econ. Research & Strategy.

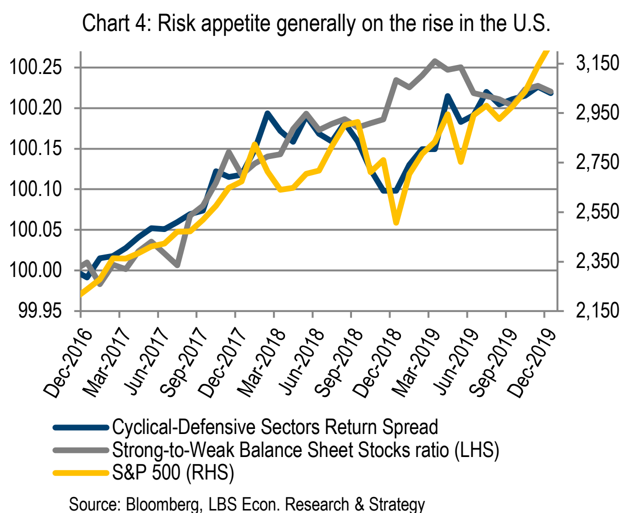


Source: Blackrock Investment Institute, LBS Econ Research & Strategy.

Another important feature of 2019 was that the continuous global search for yield led to a strong outperformance of riskier assets. For instance, global corporate bonds outperformed global risk-free government bonds by 4.5 percentage points (chart 3). Similarly, lower rated Baa bonds vastly outperformed better quality ones. High-yield bonds did even better. Companies took advantage of the investors' strong appetite by issuing about US$2.4T in 2019, close to the record high level reached in 2017. The risk appetite was also noticeable in the U.S. equity market: cyclical stocks outperformed defensive stocks and weak balance sheet stocks outperformed the basket of strong balance sheet companies (chart 4).



Note: TR: total return (unhedged) for 2019. For all series, global markets are used.
Source: Bloomberg Barclays Indices.



Source: Bloomberg, LBS Econ. Research & Strategy

2020 Global Outlook: The Muddling Through Economy

The year 2019 was marked by the slowest pace of global real GDP growth since the 2008 financial crisis. In 2020, the fading of the U.S.-China trade headwinds and the easing push from several central banks, particularly in emerging markets, are poised to translate into a modest acceleration in global economic momentum. A marginal acceleration in the business cycle is the best we can ask for in our world plagued by profound geopolitical tensions, peak globalisation, weak productivity gains, a big pile of debt, income inequalities and climate change challenges.

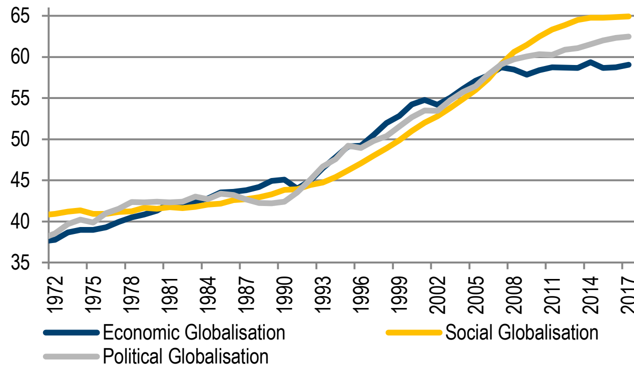
The purpose of our outlook is not to go deeply into all of these structural and unresolved issues. But let us begin 2020 with the main topic of 2019: U.S.-China trade tensions. The “Phase 1” deal provides additional relief to financial markets. Market uncertainty could re-surface at the start of the negotiations for the “Phase 2” deal focusing on contentious issues: intellectual property, technology transfer, the Chinese government subsidies of private and stated-owned enterprises and market access for foreign entities. Regardless of this new chapter in U.S.-China trade talks and the possible escalation of U.S.-Europe trade tensions, it worth reminding investors that the slowdown in globalisation (chart 5) started before the U.S.-China trade war, a persistent impediment for several multinational corporations.

The business environment is more challenging for U.S. companies…

Stretching the business cycle with ultra-low interest rates comes with the buildup of financial vulnerabilities, as highlighted by the IMF and the World Bank. First and foremost, in the U.S., the quantity of corporate debt soars and the deterioration of quality continues (chart 6). Also, U.S. banks’ lending standards for firms tightened at the end of 2019, a reliable leading indicator supporting our view that U.S. real GDP growth will fall below 2% for the first time since 2016 although it will still outperform its developed peers (chart 7). Another challenge relates to the inability of U.S. small and large companies to increase consumer prices in competitive markets. Thus, corporations have been cutting on job postings in order to protect their elevated profit margins. This should translate into weaker job creation in 2020, below the 2019 mark of 2.1M. Also, half of CFOs expect a recession in 2020 according to the latest Duke University quarterly survey, which does not bode well for capex spending and longer-term earnings growth. Finally, share buybacks on the S&P 500 have reached record levels in 2019. Combined to the fact that the free cash flow yield declined in

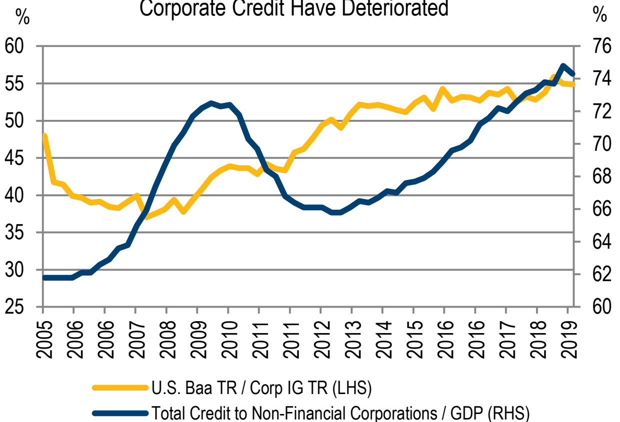
2019 in all industries, it is difficult to see how they could continue to creep largely higher in 2020. Buybacks are therefore more likely to provide weaker rather than stronger support to U.S. equities this year.

Chart 5 : Globalisation Slowing Down



Note: Economic globalisation includes trade and financial flows;
Social globalisation includes personal contact, information flows and cultural globalisation;
Political globalisation includes embassies ,international NGO's and participation in UN peacekeeping missions.
Source: The KOF Swiss Economic Institute Globalisation Index.

Chart 6: The Quantity and the Quality of U.S. Corporate Credit Have Deteriorated

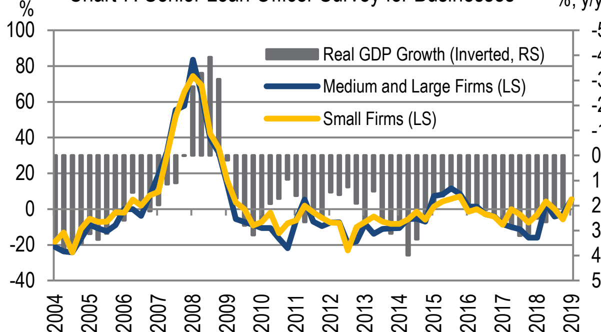


Note: the ratio represents the proportion of Baa-rated bonds in the aggregate Bloomberg Barclays Investment Grade Corporate Bond index.
Source: BEA. Bloomberg Barclays Indices / Bloomberg Finance L.P., FRED, and LBS Econ. Research & Strategy calculations.

… but the vibrant U.S. consumer supports the American relative economic outperformance

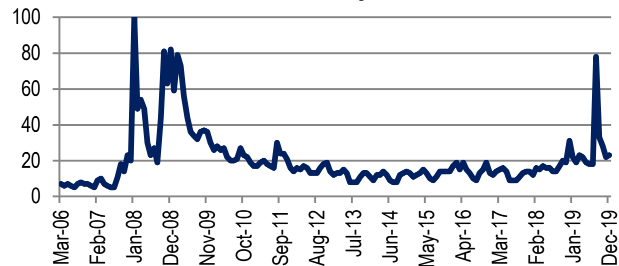
The U.S. economic success relies without surprise on the consumer. Consumer confidence is near a decade-high. After a brief summer blues tied to the Fed's first of three rate cuts, Americans are not concerned about a recession (chart 8). Investors will also find a great deal of comfort in labour market fundamentals. The unemployment rate stands at a 50-year low. The reliable wage growth tracker from the Atlanta Fed sits near a decade high, a key ally for U.S. consumer staples and discretionary sectors. Household consumption represents 70% of U.S. GDP versus 54% for the OECD average, offering a solid cushion against a recession in addition to better stability in earnings growth for the U.S. equity market. The real unknown is how consumers will feel as we move closer to the 2020 Presidential elections (chart 9). We have a stronger conviction about the other big house located in Washington: the Federal Reserve. Our base case scenario imbeds a Federal Reserve on hold throughout 2020. Powell will ease monetary policy conditions if U.S. economic growth and CPI inflation fall short of expectations. Stubbornly low inflation expectations, a crushed term premium and elevated private leverage cap the ability of longer term yields to comeback to previous peaks (chart 10).

Chart 7: Senior Loan Officer Survey for Businesses

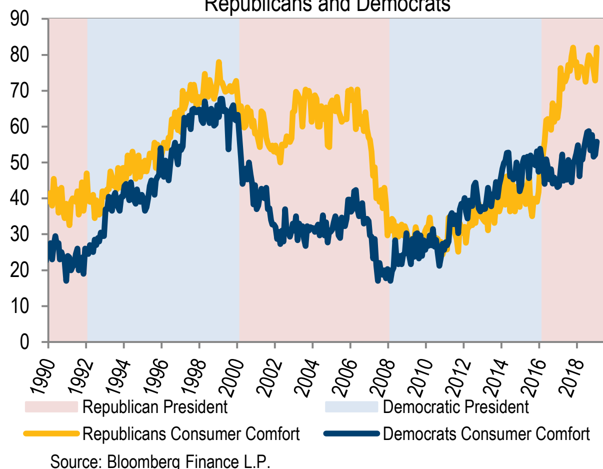


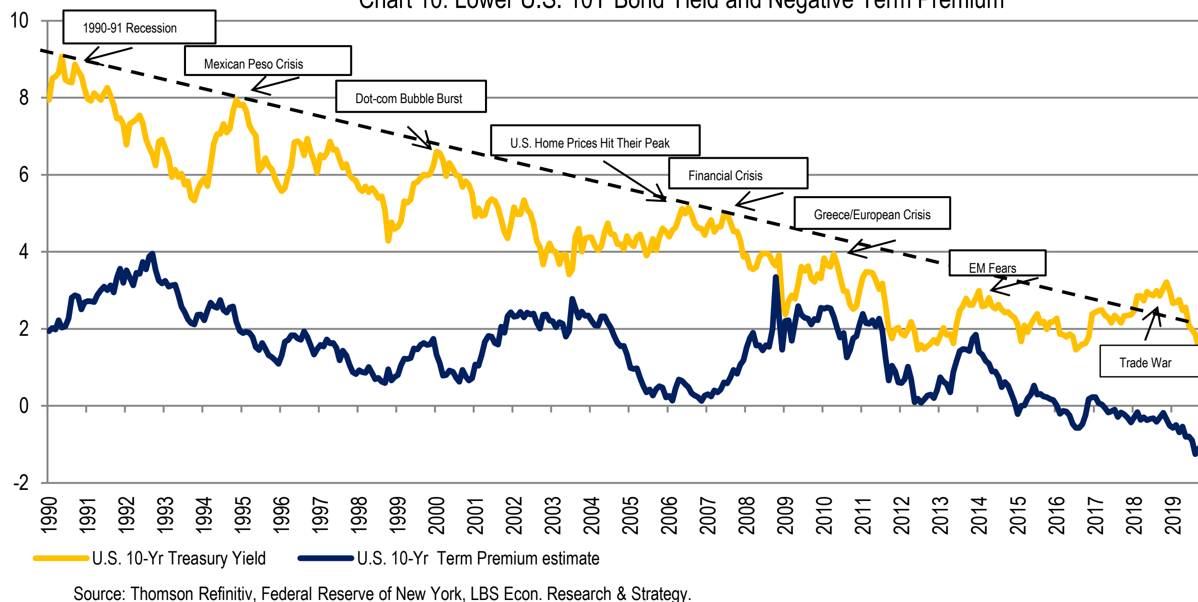
Note: Net % of respondents who report a tightening in lending practices for businesses.
Source: Federal Reserve, BEA/Thomson Refinitiv and LBS Econ. Research & Strategy.

Chart 8: Search Interest for the Word 'Recession' in the U.S. on Google Trends



Source: Google Trends, LBS Econ. Research and Strategy.





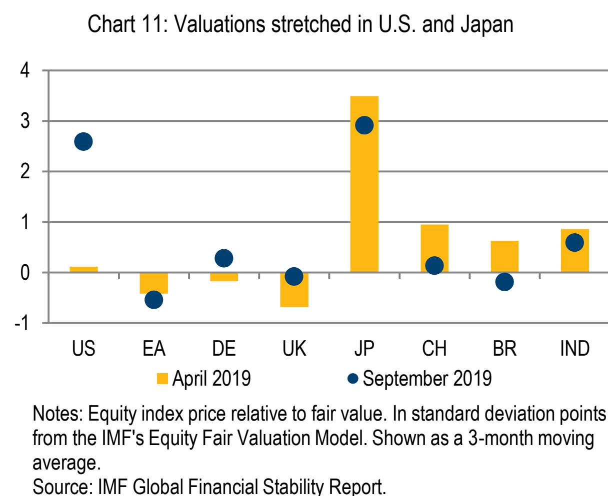
A better year ahead for China and the rest of Asia

39% of global real GDP growth was driven by China in 2019 even though the Chinese economy slowed to a greater extent than its structural downward trend because of the punitive U.S. tariffs. In response, Chinese authorities cut banks' reserve requirements ratios to their lowest level since 2007, reduced the value-added tax for manufacturers, cut personal income taxes and boosted credit growth. Granted, the effectiveness of these macro policies is diminishing. But altogether, China's economic growth is poised to edge down by only 0.1-0.2pp in 2020, in contrast to about 0.5pp in 2019. Outside of China, the emerging market outlook is mixed to say the least: social discontent in Latin America, fresh corporate tax cuts and a buffed infrastructure spending program in India, Turkey faces U.S. sanctions, etc. If the slightly better Chinese backdrop trickles down to peripheral economies in Asia during 2020, base metals prices should see better days after a challenging year 2019.

With intermittent unrest, limited upside in Europe

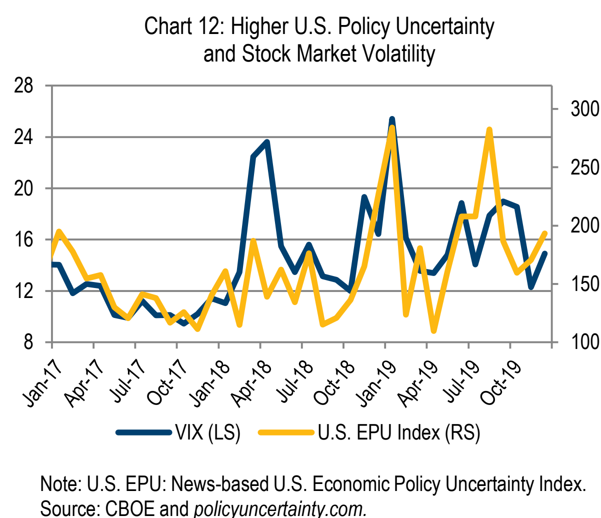
The outlook for the Euro area and the U.K. is mixed. Financial conditions in the Euro area eased according to the latest ECB bank lending survey, a reliable indicator of economic momentum going forward. Wages also accelerated to their fastest pace in a decade lately, reflecting the lowest unemployment rate on record since mid-2008. U.S. ETFs offering a broad exposure to European assets recently registered their biggest inflows in almost two years in late 2019. This being said, we do not think relatively cheap valuation in Europe will outweigh uncertainty and weak fundamentals in 2020 (chart 11). Indeed, real GDP growth will continue to underperform the U.S. Particularly, Germany flirting with a technical recession and dealing with a battling auto industry are apparently not enough for Chancellor Merkel to bring on fiscal stimulus. Also, the U.S. trade spat with Europe, particularly France, has intensified and could spread further in 2020. Meanwhile, in the U.K., the December 12th elections have given markets some short-term relief as the long-running Brexit saga has ended with Boris Johnson returning to power with a majority. On January 31st 2020, the U.K.'s legal exit date from the EU, trade negotiations will begin. If a deal is not reached by December 2020, then the U.K. will leave the EU without a comprehensive accord. Thus, Brexit uncertainty could be replaced by trade uncertainty during 2020, keeping the U.K. and Euro area economic momentum in the slow lane.

Chart 11: Valuations stretched in U.S. and Japan



Notes: Equity index price relative to fair value. In standard deviation points from the IMF's Equity Fair Valuation Model. Shown as a 3-month moving average.
Source: IMF Global Financial Stability Report.

Chart 12: Higher U.S. Policy Uncertainty and Stock Market Volatility



Note: U.S. EPU: News-based U.S. Economic Policy Uncertainty Index.
Source: CBOE and *policyuncertainty.com.*

Global Outlook Bottom Line

Slightly better economic pulse globally. Heavier structural issues. What does it mean for strategic asset allocation? After the surprising double-digit returns of 2019, we forecast a mid-single digit return on the S&P500 and TSX indices for 2020. The economic, geopolitical and climate risks restrain the odds of a breakout year. The odds of high single-digit returns are lower than a year ago in most development equity markets. The EM could lead the way due to improving trade dynamics and relatively more aggressive monetary easing. Holding extremely strong strategic trade convictions is hard as we peg the odds of our base case economic scenario at 45%, shy from the 50%-to-60% range of 2017 when the global economic recovery was synchronized. Also, risk assets are likely to evolve again around the roller coaster of media feeds and policy announcements that sparked market sentiment shifts and enhanced volatility during 2019 (chart 12). Under these circumstances, investors should keep some cash on hand as insurance. The U.S. relative economic outperformance remains supportive of higher earnings and equity returns.

2020 Strategic Views	u		n		o
Equities				x	
Canada			x		
United States				x	
Other Developed Markets		x			
Emerging Markets				x	
Fixed Income		x			
Government Bonds		x			
Corporate Bonds			x		
Cash				x	

Notes: u: underweight, o: overweight, n: neutral. Relative to a balanced (neutral) portfolio.

2020 Canadian Outlook: Traditional strongholds to improve economic reality and market perception

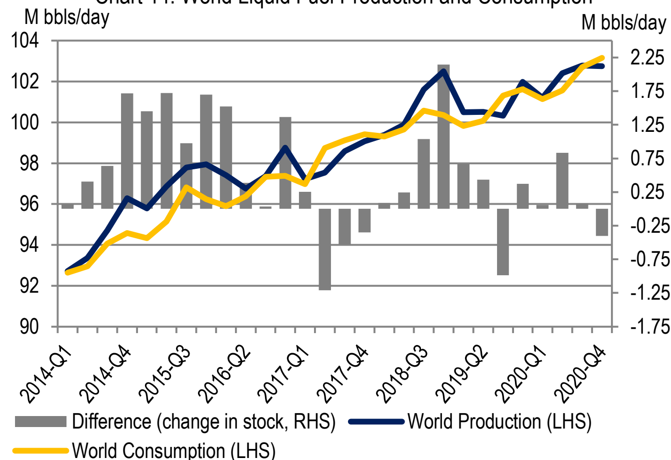
The TSX reached multiple new highs in 2019 and its valuation remains more cheap relative to the rest of the world (chart 13). The imminent ratification of the CUSMA dissipated any remaining pressure that North American trade uncertainty had on industrial and material stocks.

Our expectation of a mid-single digit return for the TSX in 2020 is based on the strengthening in global and domestic economic conditions as well as the end of oil pipeline congestion. The Canadian economy is expected to expand at a moderate pace again in 2020 on a real and nominal GDP basis. U.S.-China trade de-escalation eases the pain on commodities and manufacturing activity, more supportive for mining stocks and the TSX materials sector. Service-oriented sectors remain resilient, the IT sector is booming and the federal government is poised to announce further stimulus in the 2020 budget.

Chart 13: Ratio of the TSX/MSCI World P/E's

Source: Bloomberg, LBS Econ. Research & Strategy.

Chart 14: World Liquid Fuel Production and Consumption



Source: U.S. Energy Information Administration.

Canadian energy market: Improving transportation and ESG considerations

When it comes to Canada, oil is often the first topic brought up in a business conversation. Several factors will support global oil prices in 2020. First, U.S. shale companies, under increasing financial stress, are expected to produce fewer barrels. Second, OPEC and its allies decided last December to deepen oil production cuts to 2.1M bpd from 1.2M bpd until the March meeting at least. Third, global oil demand should slightly outpace supply by the end of 2020 if the U.S. Energy Information Administration's projection is accurate (chart 14). Fourth, renewed tensions between the U.S. and Iran and the possibility of supply disruption in Irak and through the Strait of Hormuz could generate spikes in the oil risk premium.

On top of this favorable global oil market, we expect the Canadian oil market to be in a better place twelve months from now even though it remains to be seen if the construction of the Trans Mountain pipeline will be halted by new legal challenges. Optimization of existing pipeline capacity and a ramp-up of crude-by-rail activity are valuable efforts. Most importantly, the full completion of the Enbridge Line 3 replacement in early 2021 should improve the financial markets' perception of Canada and end once and for all mandatory production curtailments. By assuming the completion of the TMX by the end of 2022, the completion of Keystone XL in 2024 and stable crude-by-rail shipments, total transportation capacity will exceed production by 1.5M bpd.

The WTI-WCS oil price differential is unlikely to improve in 2020 because new global rules limiting sulphur content in marine fuels became effective this January, restraining demand on Canada's heavy oil as it contains a higher concentration of sulfur. Carbon emission intensity from oil sands extraction is higher than conventional oil production, which brings us to the growing transition risk related to the adaption to a lower-carbon economy. Efforts by energy companies, the federal and the Alberta governments to promote lower CO2 emissions per barrel appear essential to improve the perception of Canadian energy in the context of a growing investor base looking for companies with strong Environmental, Social and Governance (ESG) credentials. This is the newest challenge for Canada's energy sector.

Canadian housing market: positive momentum to build-up further

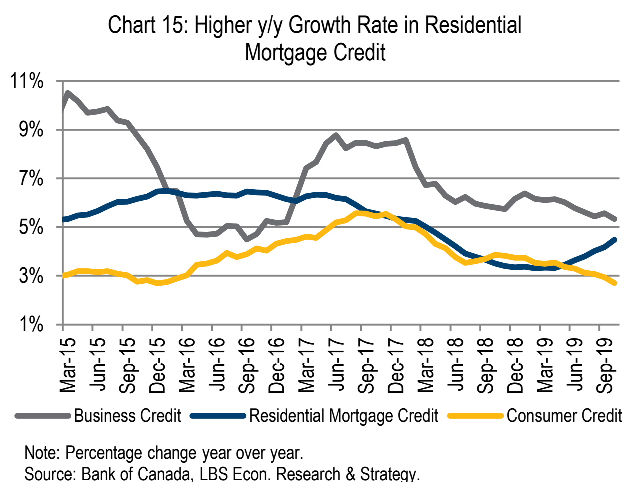
Besides oil, housing and banks are often on the front burner of Canadian-related market discussions. In our view, doomsayers about the Canadian housing market and the banking sector will continue to be proven wrong in 2020. First and foremost, Canada is home to one of the strongest household formation in industrialized countries, an overlooked factor underpinning credit activity, including mortgage demand. The lagged effect coming from robust full-time job creation in 2019, stronger disposable income growth and lower mortgages rates are poised to prolong the run-up in housing activity seen in late 2019, at least throughout the first half of 2020. The year-over-year pace of growth in mortgage credit outstanding is on the verge of becoming the fastest since the B20 stress test on uninsured mortgages was implemented in January 2018 (chart 15). Also, home price appreciation is poised to accelerate in most urban centres, thanks to the improving labour market integration of immigrants and the steady urbanization process. The risk is the return of frothy housing conditions. This brings us to the lingering housing affordability challenge. The number of Canadians owning a home will increase, but not the percentage of households owning a home. Too many millennials are either unable to buy or simply prefer to rent for longer. This contrasts with the situation observed south of the border. U.S. millennials just surpassed baby-boomers as the number one driver of housing demand, allowing the homeownership rate to increase. All in all, we forecast a mix of rental and ownership construction to bring Canadian housing starts close to the dynamic 200K mark in

2020. Tight housing conditions should preserve investors' interest in residential REITs and the TSX financial sector. The financial sector, home of an attractive P/E of 11.5, is also likely to benefit from our expectation of a steeper Canadian yield curve.

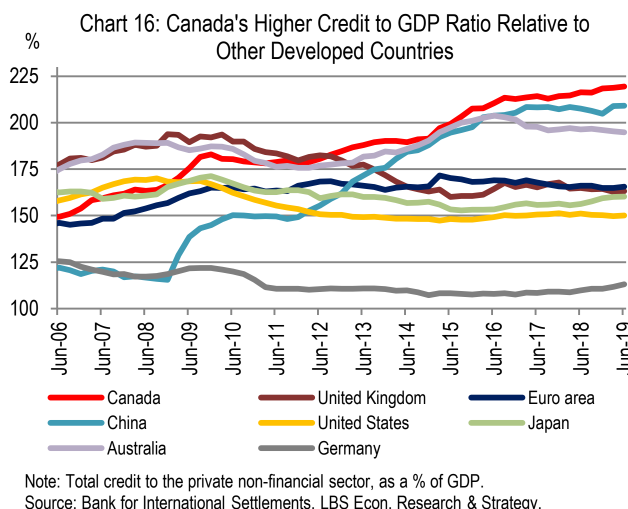
Besides credit demand, an additional pick-up in household disposable income coming from the increase in the basic personal amount is expected to increase consumer spending and savings. We calculate that this single policy measure is expected to add about 0.2% and 0.1% to household consumption and real GDP in 2020, respectively.

Canadian Interest Rates: Improving economic landscape to support a flatter yield curve

In the context of a muddling through economy, the bar remains high for the BoC to embark on a new round of easing or tightening. First, the BoC likely took lessons from the Federal Reserve that raised its policy rate too close to the neutral rate now lower than before. Second, the 1.75% overnight rate target is still stimulative removing the 2% CPI inflation rate. We forecast total CPI inflation to only edge down from 2.0% in 2019 to 1.9% in 2020 and core CPI metrics to slip by 0.2ppts to average 1.8%, clearly not low enough to make a case for easing. Third, BoC officials put more emphasis on long term considerations relative to elevated household and corporate debt levels and the preservation of financial stability (chart 16). In our view, the economy would need to go through a severe unexpected negative shock to seriously consider policy rate cuts. Altogether, we see no change to the overnight rate target in 2020. The only material change at the BoC concerns the Governor position. Stephen Poloz will end his 7-year term in June 2020 and markets will find out who the next governor is this spring.



Note: Percentage change year over year.
Source: Bank of Canada, LBS Econ. Research & Strategy.

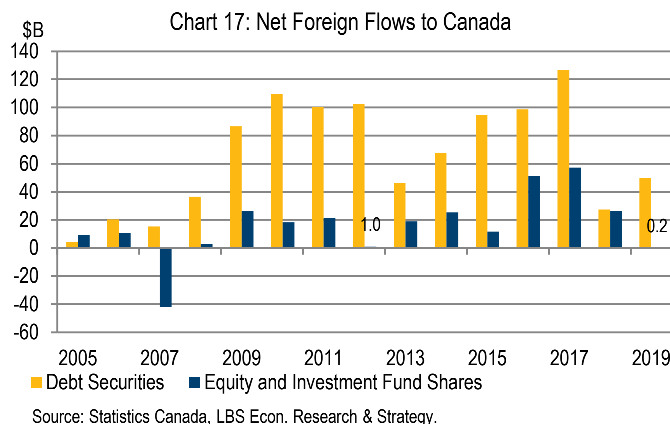


Note: Total credit to the private non-financial sector, as a % of GDP.
Source: Bank for International Settlements, LBS Econ. Research & Strategy.

We've been expecting no change in the BoC policy rate for a very long time and the bond market has finally abdicated in late 2019 by eliminating most of the pricing in policy rate cuts. Canadian federal 2Y yields are poised to stick close to overnight rate target. The absence of the reflation trade will also limit the magnitude of potential increases in Canadian 5Y and 10Y yields. At best, cyclical global and domestic improvements have a fair shot of bringing up 5Y and 10Y government bond yields close to the 1.75% policy rate during 2020, barring any major economic or geopolitical incident. The move from an inverted to a flat yield curve is part of our base case scenario.

Canadian Dollar: About Oil and Market Perception

With higher yields than most other developed markets, a solid AAA rating at the federal level and efficient liquidity, Canada offers value in this global search for yield environment. Net foreign flows into Canadian fixed income products could improve in 2020 after a timid 2019. Also, the net flows for Canadian securities and mutual funds started to stabilize at the end of 2019 after posting their worst performance since 2012 (chart 17). If our forecast for WTI crude oil prices to stay close to US$63 is right and that financial markets' perception of Canada moves in tandem with the improving economic reality, the loonie could end up a notch higher than the current US77 cents level at the end of 2020 without surpassing the US80 cents mark.



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Financial Forecasts

	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q4
Canada										
Overnight Rate Target	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**
3-Month Treasury Bills	1.65	1.66	1.65	1.65	1.65	1.65	1.70	1.70	1.70	1.70
2-Year Bond	1.86	1.54	1.47	1.58	1.70	1.65	1.70	1.75	1.80	1.80
5-Year Bond	1.88	1.51	1.39	1.39	1.68	1.62	1.65	1.75	1.80	1.80
10-Year Bond	1.96	1.61	1.46	1.36	1.70	1.65	1.75	1.85	1.90	1.90
30-Year Bond	2.18	1.89	1.68	1.53	1.76	1.70	1.75	1.85	1.90	1.95
United States										
Federal Funds Rate Target*	**2.50**	**2.50**	**2.50**	**2.00**	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**	**1.75**
3-Month Treasury Bills	2.40	2.35	2.08	1.84	1.52	1.65	1.65	1.65	1.65	1.65
2-Year Bond	2.51	2.29	1.76	1.66	1.58	1.60	1.65	1.70	1.75	1.80
5-Year Bond	2.50	2.23	1.76	1.54	1.68	1.70	1.75	1.75	1.80	1.90
10-Year Bond	2.69	2.42	2.00	1.67	1.92	1.90	2.00	2.10	2.10	2.10
30-Year Bond	3.02	2.82	2.53	2.11	2.39	2.35	2.45	2.55	2.55	2.55
Canadian Dollar (US$/C$)	**0.73**	**0.75**	**0.76**	**0.76**	**0.77**	**0.77**	**0.78**	**0.78**	**0.78**	**0.78**
S&P 500 Index	2507	2834	2942	2977	3231	3260	3300	3375	3455	3555
TSX Index	14323	16102	16382	16659	17063	17300	17500	17650	17900	18400
Oil WTI (US$/barrel)	45	60	58	54	61	63	63	62	62	60

Quarter-end data

Updated:January 2020 * Upper bound of the Fed's target range

Canadian Economic Outlook

	(q/q % change, at annual rate)									annual average			
	18Q3	**18Q4**	**19Q1**	**19Q2**	**19Q3**	**19Q4**	**20Q1**	**20Q2**	**20Q3**	**2018**	**2019**	**2020**	**2021**
Real GDP	2.5	1.0	0.8	3.5	1.3	0.3	1.8	1.5	1.9	2.0	1.6	1.5	1.7
Consumer Spending	2.9	1.0	2.5	0.5	1.6	0.3	1.6	1.6	1.6	2.2	1.5	1.3	1.5
Business Investment	-12.6	-4.2	10.8	-5.0	9.1	2.7	3.0	3.2	4.2	1.7	0.3	3.4	3.8
Non-residential structures	-7.2	-4.4	4.2	4.4	11.1	2.0	3.0	3.5	4.0	-0.6	1.1	4.2	3.9
Machinery and equipment	-25.4	-5.4	42.1	-21.8	7.0	1.0	2.0	2.0	4.0	4.7	0.9	1.1	3.2
Residential Investment	-4.0	-10.4	-2.7	5.5	13.3	4.0	3.0	2.3	1.5	-1.6	-0.4	4.1	1.4
Government Spending	2.2	0.4	3.3	0.9	1.8	2.0	1.6	1.6	2.5	3.4	1.8	1.8	1.8
Exports	0.6	-0.4	-3.3	12.9	-1.5	-7.1	3.7	2.1	3.0	3.1	1.5	1.0	2.5
Imports	-7.2	-1.3	8.1	-3.5	0.1	-2.9	3.8	2.2	2.6	2.6	0.3	1.1	2.6
Total CPI Inflation *	2.7	2.0	1.6	2.1	1.9	2.2	2.1	1.7	1.7	2.3	2.0	1.9	1.8
Unemployment rate (%)*	5.9	5.7	5.8	5.5	5.6	5.9	5.9	5.8	5.8	5.8	5.7	5.8	5.7
Employment	1.3	2.2	2.9	3.0	1.2	-0.8	0.8	1.0	0.8	1.3	2.0	0.7	0.8
Housing Starts (in 000s)*	197	217	187	224	223	210	215	200	195	187	211	201	193
Res. Transactions (units, 000s)**	117	115	112	118	127	--	--	--	--	458	486	522	535
Res. Housing Prices (yoy %)	1.8	-0.6	-0.7	0.2	1.7	--	--	--	--	7.6	--	--	--
Nominal GDP	4.5	-2.6	5.6	8.1	1.6	3.2	3.3	3.5	3.8	3.9	3.5	3.5	3.5

*Average for the period. **total for the period

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