The Globalist

7. January 2019

2019 holds opportunities on financial markets

by Michael Heise

2018 was not a good year for savers. Not only did the global equity markets end the year with losses, there was also little money to be made from investments in commodities, gold or high-yield government and corporate bonds. Two simple lessons can be learned. First, that the valuation of equities and other risk-weighted assets depends primarily on the expectations of market participants concerning the growth of the economy and corporate profits. As long as sustained growth is expected, political risks are put aside, as was the case in 2017. However, when doubts about the strength of the economy or even fears of recession arise, political uncertainties or even moderate monetary policy changes, as recently in the USA, can lead to huge setbacks. Secondly, we should again be reminded that following majority opinions among analysts and market participants does not guarantee investment success at all. The widely held view that US markets – although already highly valued – will continue to outperform is likely to have caused considerable losses for many investors in recent months. With the latest signs of a moderate economic slowdown in the USA, US stocks have drastically lost value. On Wall Street, 2018 has seen the worst December performance since 1931.

What will happen in 2019 and what is the risk of a recession? Current business cycle data does not indicate an economic downturn at the moment. Important indicators have declined significantly, but they are still at a relatively high level. We know, however, that economic indicators can change very quickly and that they only provide a snapshot of the situation. It is therefore important to investigate whether there presently are parallels to earlier downturns. In the past, it has often been financial market crises after phases of exaggerated valuation gains and strong debt increases that have led to real economic crises - partly very strong ones, as after the so-called subprime bubble in 2007, partly less strong ones, as after the dotcom bubble at the end of the nineties. In contrast, the current situation appears to be much more stable. After the price corrections of the past months for shares and corporate bonds, it is hardly possible to speak of gross mispricing across the board of markets. In addition, banks are much better capitalized. Corporate indebtedness is a particular concern in the US and some emerging markets, but it is not at a critical level in Europe.

However, economic crises can also be triggered by adverse developments in the real economy, irrespective of the financial market cycle. In the late phase of a cycle, capacity utilization is often very high, which dampens productivity gains and pushes up unit labor costs. Inflationary pressures then arise, prompting monetary policy to step on the brakes with higher interest rates. Looking ahead to 2019, however, this is not a very plausible scenario. Monetary and fiscal policy will tend to remain expansionary in most important economies including the USA. Therefore, the year 2019 might well be significantly better for the economy and for the financial markets than recent asset price performance signals. Actually, a significant amount of skepticism has been priced into markets, leaving some room for some positive surprises. For that to happen, however, policy makers would also have to help by contributing some positive news from the hotbeds of conflict in trade policy or from the Brexit process. Let`s see what comes.