Our 2020 vision: sustainable strategies may offer a path through volatile markets

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Allianz Global Investors

Key takeaways

- Expect wide "risk-on/risk-off" movements caused by US elections, trade developments and ample liquidity from central banks; risk management will be paramount
- Threats to the oil supply, food-security fears and growing US-China competition could create additional risks for portfolios
- Focus on the long-term sustainability of companies by incorporating ESG factors into investment decisions
- Choose carefully among over-owned US equities; consider undervalued European stocks and emerging-market debt; look to alternative investments for less-correlated returns; keep up the hunt for income against a backdrop of low yields
- Thematic investments offer access to stories with long-term global growth potential, such as artificial intelligence – they may be able to create value, and they resonate with investors' values and interests

In 2020, we expect markets to pivot between embracing and avoiding risk as they process muted economic growth, low rates and heightened political uncertainty. Consider managing risk actively rather than accepting volatile index returns, and think beyond the benchmark by investing sustainably and adopting thematic approaches.

We think 2020 will be characterised by muted global growth, a slower US economy and continued uncertainty about how monetary policy and politics will move markets. In this environment, investors should aim to keep their portfolios on track by having conviction and actively managing risk – not avoiding it.

Major political developments, including US President Donald Trump's bid for a second term in office, are on the horizon. This will likely contribute to wide "risk-on/risk-off" movements as sentiment swings between riskier and "safer" asset classes. We expect low beta returns for the overall market, which makes pursuing alpha – in excess of market returns – all the more important.

Central banks will remain a major market driver in 2020, even as their efforts to spark economic growth become less effective and today's ultra-low interest rates provide less room for manoeuvre. Rates have been negative in Europe and Japan for some time, and the US Federal Reserve (Fed) has resumed cutting rates that were already low. This approach has supported stocks and other financial assets, but it has also artificially inflated their prices – and contributed to wealth inequality – while not restoring enough economic growth.

Neil Dwane
Global Strategist

Investment implications

1 Active investing and good risk management will be paramount in 2020 as the market experiences what we expect will be wide risk-on/risk-off swings.

2 Focus on sustainable investing to help secure your future over the long term: integrated ESG, SRI, SDG-aligned investments and impact investments can help improve risk/return profiles.

3 Use thematic investments to align portfolios with evolving societal challenges and help create change in the world.

4 Choose carefully among US equities. The highly valued tech sector could come under pressure; value or income stocks could rebound.

5 Consider undervalued, unloved securities – European equities and emerging-market debt – and less correlated return sources such as alternative investments.

6 Keep up the hunt for income. Negative/low yields on traditional bonds may attract investors to higher-yielding bonds in the US and Asia, and to dividend-paying equities.

Facing dwindling options, central banks will likely continue offering additional stimulus with limited effect. Governments may need to shoulder some of the burden by increasing spending, reducing taxes or both.

Unless they want to chase index performance in this up-and-down environment, investors will need to address risk in a deeper, more holistic way – for example, by focusing on climate change and other risks that a company may face as it produces its goods and services. Incorporating environmental, social and governance (ESG) factors into investment decisions can help manage risks and improve return potential. So can thematic strategies that help investors align their portfolios with their convictions about how powerful long-term shifts – triggered by innovation or regulation – could create investment opportunities.

Five focus areas for 2020

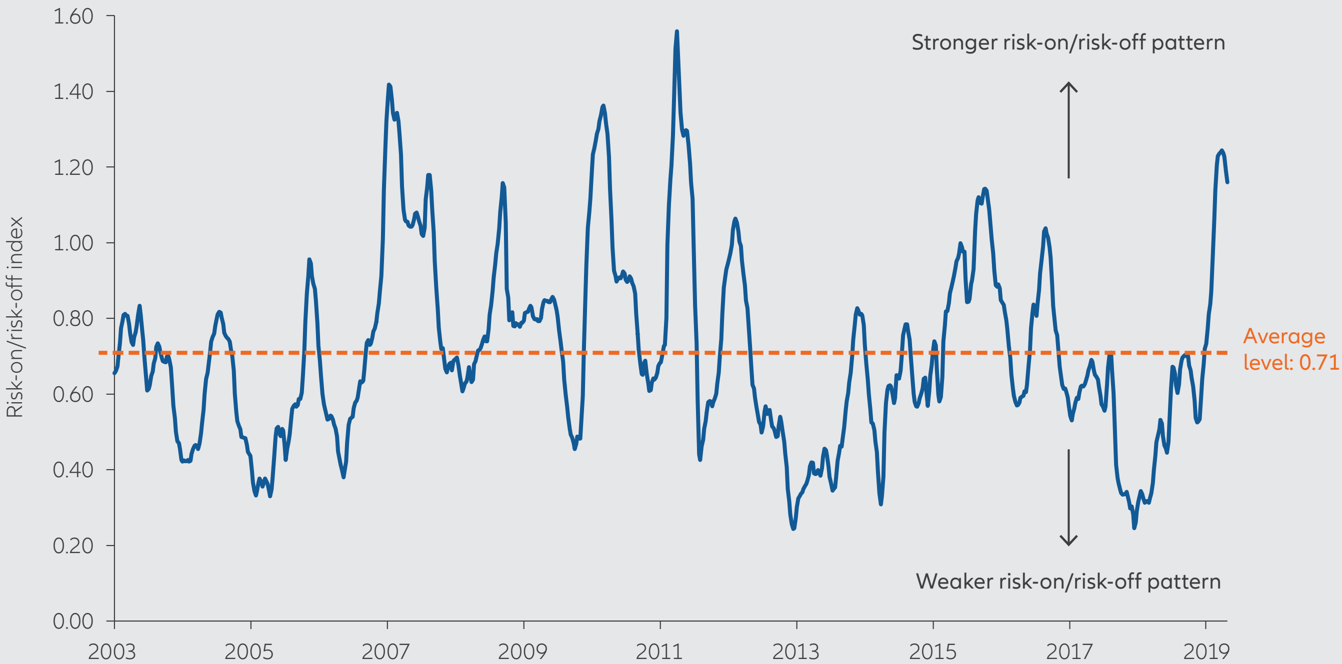
1. Risk-on/risk-off swings may mean flat beta returns

In recent years, headlines about interest rates, politics, trade, climate change and other critical issues have caused wide market swings. Given the upcoming US elections, continued trade wars and the late-cycle global economy, we expect markets could be even more sensitive to news flow. This will likely result in an increase in "risk-on/risk-off" trades – moving toward higher-risk investments when economic and policy indicators improve, and toward "safer" investments when they fall. As a result, beta could stay suppressed and volatile, which we believe will make active investment management and asset allocation increasingly important.

Takeaways for investors

- Be selective among highly valued markets while searching for opportunities in cheaper ones that also generate return potential from dividends or income. We could see attractive returns from less volatile dividend-paying stocks in value sectors such as energy, and from themes that capture global "megatrends" – powerful forces that could transform the way we live.
- Consider alternative investments such as private credit, infrastructure debt and equity, and absolute-return opportunities. These tend to be less correlated to equities over time, offering an additional source of diversification potential.
- Passive, index-based investments are backward-looking – their holdings are determined in the past – and can be buffeted about by news headlines. Rather than follow broad market swings passively, use active management to invest with conviction, pursuing alpha by aiming to stay ahead of market opportunities.

Risk-on/risk-off pattern is more visible again



Source: Allianz Global Investors Economics & Strategy; Bloomberg; Refinitiv; HSBC. Data as at 25 October 2019. Risk-on/risk-off index = average correlation between risky assets + average correlation between safe assets – average correlation between risky and safe assets (rolling 180-day correlations).

2. Consider sustainable investing as a core part of your approach

We believe the investment industry is at a tipping point, with sustainable investing no longer seen as a trend but rather an essential consideration in how portfolios should be managed. Sustainable investing incorporates non-financial inputs, such as ESG factors, with the aim of generating sustainable outcomes as well as strong financial returns. It's increasingly important for asset managers, companies and investors alike:

- Asset managers are driving capital towards sustainable companies and projects that address what investors view as some of the world's biggest challenges.
- Companies are finding that seriously addressing issues such as climate change and executive pay can help them improve their competitive positions.
- Investors are seeing proof that ESG investing can help them manage risk and improve return potential.

This widespread recognition of the importance of sustainable investing has translated into USD 12 trillion of sustainable investing assets in the US in 2018, according to the Forum for Sustainable and Responsible Investment – a rise of 38% over two years.

Takeaways for investors

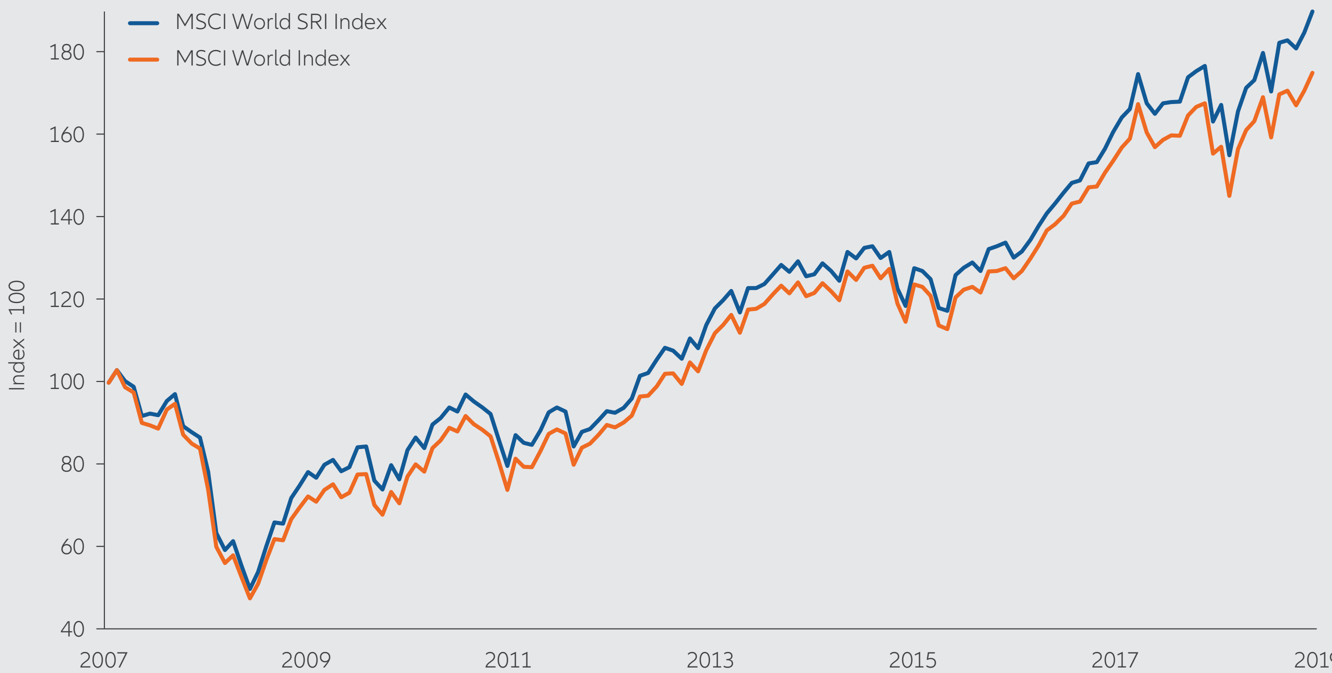
- There are many ways to make sustainable investing a core part of your approach: incorporate ESG risk factors into your decision-making; focus on sustainable and responsible investing (SRI); or invest for impact by using capital to address real-world issues.
- Aligning investments with the UN Sustainable Development Goals (SDGs) – which include promoting clean water, developing clean-energy sources and eliminating poverty – is also an increasing area of interest. Investors can direct their assets towards companies and governments that support the SDGs.
- Green bonds help fund renewable energy projects, public transportation and other areas that help fight the effects of climate change. They can also deliver reasonable income potential and have historically exhibited low correlation with the broader government-bond market, meaning the two asset classes tend not to move in tandem with each other. This can help a portfolio's overall diversification.

3. Strategic US-China competition is heating up

The US-China trade war has already contributed to the growth of a "tech cold war" that is giving rise to two distinct ecosystems. Tensions between the two nations

Sustainability and good performance potential can go hand-in-hand

MSCI World SRI Index vs MSCI World (9/2007-10/2019)



Source: MSCI. Data as at 31 October 2019. Start date based on oldest available data for the MSCI World SRI Index, a capitalisation-weighted index that provides exposure to companies with outstanding ESG ratings and excludes companies whose products have negative social or environmental impacts. The above chart is illustrative in nature and should not be considered a recommendation to purchase or sell a specific security, strategy or investment product. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

are also mounting over a range of other issues, including accusations of currency manipulation and objections to adding Chinese companies to benchmark indices. The growing rivalry between the US and China could force countries and companies all over the world to choose sides. This may further interfere with the supply chains of global tech and consumer-goods firms, many of which face already renewed regulatory scrutiny. Moreover, if the trade wars continue and China becomes less reliant on Western tech, its markets might even close to the West within the next five years. This would existentially change Silicon Valley's business model, which relies on low-cost manufacturing from China and other Asian nations.

Takeaways for investors

- The tech cold war and other US-China tensions could materially disrupt the global tech supply chain and consumer markets, creating new winners and losers. Index weightings would be slow to reflect these changes, but active managers can aim to capture related opportunities and mitigate risks.
- Big Tech firms are also grappling with other issues, including concerns about lax privacy safeguards and tax avoidance. Lawsuits and re-regulation could hurt valuations of these mega-cap stocks.

4. Threats to the oil supply and food security are growing

While oil prices have been relatively stable recently – hovering mostly in the USD 50-70 per barrel range in 2019 – geopolitical tensions in the Middle East could pressure the supply of oil. (The drone attacks at Saudi Arabia's state-owned oil-processing facilities are a prime example.) At the same time, climate change is pushing more investors away from fossil fuels, potentially reducing the capital the industry can access for growth and investment.

The food-supply chain is also more vulnerable than many realise due to trade tensions, abnormal weather patterns and disease outbreaks. Food-price inflation is one of the more serious "flations": in some instances, it slows economic growth through wage inflation; in the most serious cases, it endangers lives.

Takeaways for investors

- Renewable energy is attracting tremendous interest from corporations and investors alike, but there is a gap between the world's ability to deliver non-fossil-fuel solutions and the current global business model, which needs fossil fuels to function. New solutions like hydrogen fuel cells and nuclear fusion reactors could fill this gap, but for now they are high-risk investments – though the potential rewards may be high as well.
- Equities in general have also shown the ability to adjust when inflation is low to moderate, typically suffering more in periods of high inflation and deflation. Many companies can cope with higher levels of inflation – including food-price inflation – by dynamically adjusting their output prices when input costs rise. This may be good for some food suppliers' business models but doesn't address the issue of food affordability, which can be critical for millions of people.

The transition to a low-carbon economy could require USD 1 trillion in new investments every year, creating many new opportunities

Source: International Energy Agency

5. Thematic investing helps align portfolios with powerful long-term shifts

Investors are increasingly interested in areas of the economy that resonate with their values and interests – for example, developing new artificial intelligence (AI) technologies or managing resource scarcity. Thematic investments can help investors align their money with their convictions about how powerful long-term shifts – sometimes triggered by innovation or regulation – might provide not just investment opportunities, but new economic growth. Thematic investments aren't restricted to specific sectors, regions, market-cap sizes or benchmarks. This helps investors effectively capture disruptive companies and trends that could become tomorrow's market leaders – and helps them pursue alpha in excess of market returns.

Takeaways for investors

- Water is a critical investment theme. The world has a fixed supply of fresh, clean water, yet consumption needs are rising. Opportunities can be found in companies that improve water resource management and increase access to clean water.
- AI is a growth area that is also a broad investment theme. Investors can focus on firms that provide infrastructure for AI, and invest in non-tech industries – from farming to pharmaceuticals – that are using AI in new ways.
- Pet and animal well-being is an emotionally appealing theme that touches many industries – from financials (pet insurance) to consumer staples (pet food and household products).

Annual revenue for the global pet industry is projected to grow from USD 132 billion in 2016 to USD 203 billion in 2025

Source: Grand View Research

2020 regional outlooks

United States

Investors everywhere will be closely watching the 2020 US presidential elections, which will have major ramifications for markets and politics for the next decade. If President Trump survives his potential impeachment and wins re-election, we expect the status quo for the markets. If the Democrats win the presidency, we expect overall valuations and earnings to fall, given that several leading Democratic candidates' policies aim to lower corporate profits and increase taxation. Some candidates have also specifically targeted certain sectors with proposals calling for universal health care, greater regulation of tech and social media companies, and higher minimum wage levels. Importantly, the state of the US economy has historically been one of the biggest factors in how people vote in presidential elections, and the economy has already been slowing as the impact of Mr Trump's fiscal stimulus package fades. We see increasing risks that the US economy will fall into a recession within the next 12-24 months – perhaps by the end of 2020, just as voters are heading to the polls.

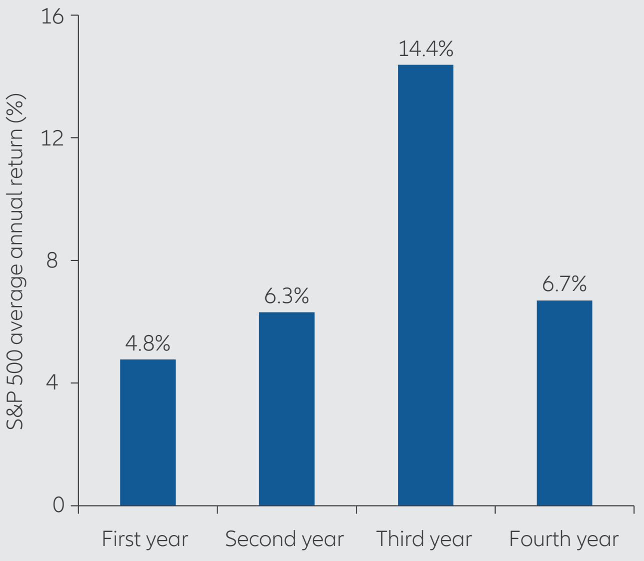
We will also be watching growing concerns about US dollar illiquidity – an issue that isn't widely discussed, but could severely impair global financial flows and investment. US dollar liquidity deteriorated markedly in 2019 when the Fed reduced the size of its balance sheet via "quantitative tightening" (selling its bond holdings). However, liquidity turned around when the Fed began temporarily increasing bank reserves by extending overnight "repo" funding operations. This shows that the markets need a surprising amount of US dollars to help provide financing and assist foreign-exchange swaps. The US dollar attracts 88% of all foreign-exchange transactions, according to the Bank for International Settlements, and demand for dollars still exceeds what the reserves of the US banking system can support.

China

For some time, China has been evolving its economy away from export-related manufacturing and towards consumption and services. This "rebalancing" approach has been more painful to China's economy than the US-China trade war, and China suffered a notable growth slowdown in 2019. Yet despite the anti-globalisation trend, the global economy is still interlinked, so China's pain has contributed to muted economic growth globally and created demand issues for major exporters such as Germany, Japan and South Korea. Beijing seems determined to do just enough to keep China's economy on track, pursuing economic growth of 5%-6%, with new growth targets to be announced in 2020. Amid the ongoing trade and tech cold wars, China will keep pursuing its "Made in China 2025" campaign, which aims to help China compete in advanced manufacturing by boosting domestic capabilities in artificial intelligence, robotics and other high-tech areas. We expect to see significant investment in China's health-care and tech industries as the country lessens reliance on Western suppliers. Investors can access these areas through China A-shares – Chinese companies listed on stock exchanges in Shanghai or Shenzhen, and available for purchase by non-Chinese investors.

US stocks have historically done well in final year of president's term – though not as well as year 3

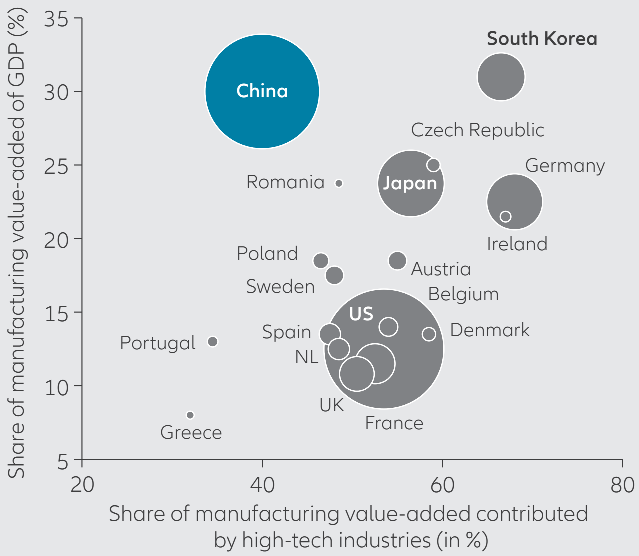
S&P 500 performance by year of presidency term (since 1936)



Source: FactSet; AllianzGI. Data as at September 2019.

China's economy is increasingly dependent on high-tech industries

Importance of high-tech industries vs dependence on manufacturing; size of circle indicates domestic R&D spending



Source for manufacturing data: Allianz Global Investors Economics & Strategy; European Chamber, China Manufacturing 2025 (data as at March 2017). Size of the circles reflects annual gross domestic R&D spending by the indicated country (source: OECD, data as at 2017 except Ireland, 2016; Portugal, 2018; and Sweden, 2018).

Europe

Europe faces a challenging year ahead. There will be plenty of political headlines to navigate, particularly given fractious politics within Spain and Italy. Core European Union (EU) countries are growing anxious about negative interest rates and additional quantitative easing from the European Central Bank. Faced with negative yields, European fixed-income investors will need to hunt for income elsewhere – perhaps in the US or Asia – and consider unloved but high-yielding equities. European markets appear set to continue their risk-on/risk-off trades as the region moves to the late stage of the economic cycle, but unloved European equities could be an attractive contrarian choice. Avoidance of a "no-deal" Brexit could help Europe by reducing economic uncertainty, enabling the EU to move forward with its own plans and potentially boosting its markets as the global economy stalls.

United Kingdom

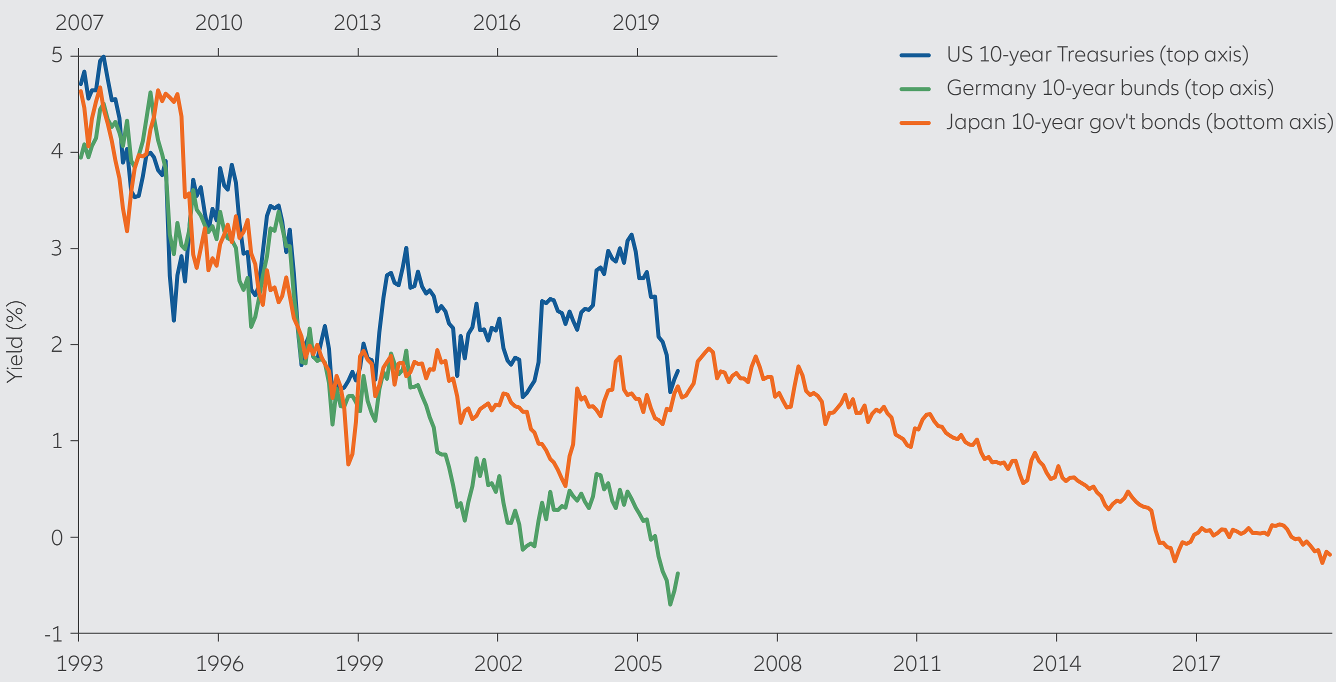
British and European lawmakers have struggled with Brexit since the 2016 referendum that sparked the UK's decision to the leave the EU. Additional delays in closing out Brexit would likely put more corporate investment on hold, while the British pound will be sensitive to the exact nature of the resolution. If the UK's currency were to weaken drastically, it could damage major exporters elsewhere – including Germany and its car sector – given the UK's value as an export market. Even if a Brexit deal is reached in early 2020, following the December general election, there will be many open questions about the UK's future trading relationships – though this scenario should ultimately be positive for domestic investors and others who have bypassed the UK amid long-running uncertainty. UK markets could rebound as pent-up investment is released, even if many investors aren't optimistic about the late-cycle UK economy.

Asia Pacific

Outside of China, we expect the Asia-Pacific region to offer reasonable economic growth potential overall, especially as India and Indonesia press on with further economic reforms and renewed investment. Nevertheless, much of the area remains disrupted by trade tensions – between the US and China at first, and now between Japan and South Korea. Japan never recovered from its 1990 financial and economic crisis, suffering through 30 years of low rates, low growth and low inflation – a phenomenon called "Japanification" that could strike Europe and possibly the US. Overall, we expect Asian economies to continue diversifying away from overreliance on trade with China and the US. Investors may want to take a closer look at potential growth areas such as cosmetics in South Korea, tourism and health care in Thailand, the services sector in the Philippines and the tech sector in Vietnam.

Post-crisis bond yields in Germany and the US resemble Japan's

10-year bond yields: US and Germany from 2007 (start of financial crisis); Japan from 1993 (first recession after bursting of Japan bubble)



Source: Refinitiv. Data as at 1 November 2019.