The nine things to watch in 2020

Summary

Last year, investors were worried that a large correction in equity markets might trigger significant growth slowdowns—perhaps even recession—in the US, Europe and Asia. This year, in contrast, investors are generally quite optimistic, looking forward to stronger growth, supportive policy settings and less policy uncertainty around trade and investment.

The nine things to watch in 2020 lists the factors that we think will be critical to whether the market consensus proves accurate or misguided and also provides our thoughts on how they will evolve.

Globally, we do expect growth to be stronger in 2020, but only modestly so. This should be reflected in a moderate improvement in manufacturing Purchasing Manager's Indexes (PMIs) that may disappoint investor expectations. This is partly because we think firms will remain cautious despite the Phase 1 trade deal between the US and China and the Brexit Withdrawal Agreement, and we do not expect much progress to be made on a Phase 2 deal. Also, we expect slower US jobs growth and only a modest improvement in US earnings. This outlook, however, may enable the US Federal Reserve (the Fed) to ease monetary policy, while the other positive news is that we do not expect oil prices to rise substantially in spite of geopolitical concerns.

Domestically, many analysts have been calling for more fiscal stimulus to support the efforts of the Reserve Bank of Australia (RBA) to boost growth. We do not however, expect a significant fiscal boost, which suggests Australian growth will remain mediocre. That will put more pressure on the RBA to cut rates to its effective lower bound of 0.25 per cent and explore unconventional monetary policy options. Lower rates, in turn, could sustain very brisk house price growth, although we suspect that an increase in the number of properties for sale will result in a moderation of house price gains.

By listing the nine things we think are most critical to the global economic outlook and how we expect them to evolve, we can monitor how our views are tracking over time and whether—and in what direction—we might have to revise our forecasts. We will also revisit these forecasts from time to time to see how they are performing and whether the variables have diverged sufficiently from our baseline to warrant a shift in our overall view, or whether we are just seeing noise around our estimated trend.

Table 1 – The nine things to watch in 2020

Item		Forecast
1.	Global manufacturing growth	Moderate improvement
2.	US jobs growth	Slows to 130,000 per month
3.	US earnings growth	+6%
4.	US Federal Reserve eases monetary policy	-25bps
5.	No Phase 2 US-China deal	Tensions persist
6.	Oil price remains steady	~US$65 per barrel
7.	Australian fiscal policy fails to boost private spending	Modest stimulus
8.	Australian house price growth	+5%
9.	Reserve Bank of Australia eases monetary policy	-50bps

Source: TCorp

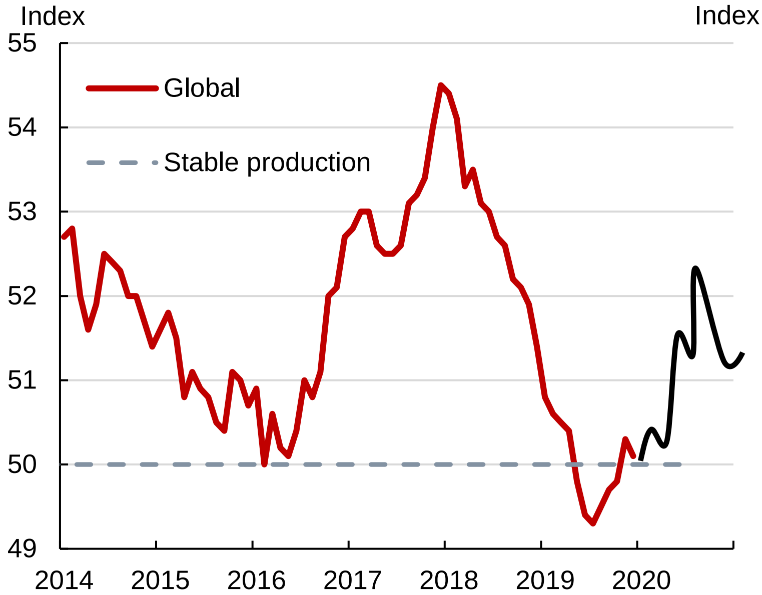
1. Global manufacturing growth has subdued recovery

Global manufacturing activity fell significantly in the middle of the year as the US-China trade dispute and the ongoing Brexit negotiations prompted firms to freeze investment until the uncertainty dissipated.

"We expect the manufacturing sector to be stronger in 2020 than it was last year."

Now, however, that the US and China have signed the Phase 1 trade deal and a convincing electoral win for the UK Conservative Party has made Brexit an inevitability, many analysts are hoping firms will unleash a flurry of spending to make up for lost time. And if that were to occur it would result in a vibrant rebound in global manufacturing.

Chart 1 - Global manufacturing activity 2014 - 2020



Source: Bloomberg

"While manufacturing should improve in 2020, we don't anticipate a repeat of 2017 where there was strong synchronised manufacturing pickup."

We expect the manufacturing sector to be stronger in 2020 than it was last year. As is well known, the inventory cycle tends to exaggerate manufacturing production cycles. That is, when demand falls, it usually takes a while for firms to recognise that demand has fallen and then reduce production. In the meantime, of course, inventory levels build up, which means the producer has to trim production levels further until inventories have been reduced. In our view, this describes the year that was in 2019.

"We should also add that the outbreak of "the coronavirus in China could temporarily affect the recovery in production, but the evidence from similar occurrences in the past is that it will not have a lasting impact."

In 2020, that process is likely to go into reverse. The important question though, is whether the underlying level of demand will be much stronger in 2020 than in recent years. In our view, there are still sufficient uncertainties, including the US Presidential election, negotiations around a possible Phase 2 trade deal and whether the UK and European Union can agree on a new trade deal – for firms to remain cautious in 2020.

We should also add that the outbreak of the coronavirus in China could temporarily affect the recovery in production, but the evidence from similar occurrences in the past is that it will not have a lasting impact.

Bottom line: While manufacturing should improve in 2020, we don't anticipate a repeat of 2017 where there was strong synchronised manufacturing pickup.

2. US jobs growth slows

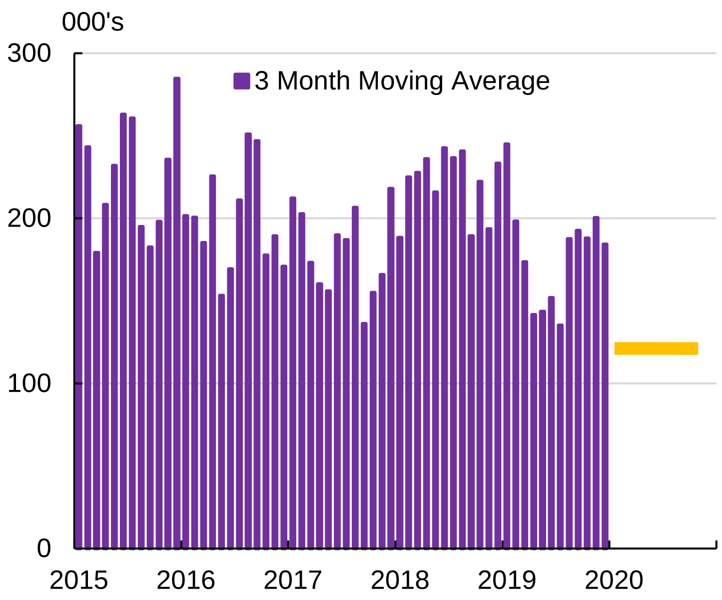
US monthly employment growth averaged 176,000 over 2019. The consistently strong growth in employment has meant that household income growth has been reasonable despite moderate wages growth. In turn, that has underpinned healthy consumer spending. In addition, the resilience of household spending during 2019 was the critical factor that prevented the downturn in manufacturing activity from spilling over into the broader economy.

"…the resilience of household spending during 2019 was the critical factor that prevented the downturn in manufacturing activity from spilling over into the broader economy…"

A key reason for the ongoing strength of employment has been an increased willingness of Americans to seek work. This is evident in the participation rate which measures the proportion of the working age population that either has a job or is looking for work.

The employment to population ratio is driven by a combination of cyclical and structural factors. For example, when the labour market is tight and wages are rising, people that were previously not looking for a job will be tempted to seek one which would boost participation. On the other hand, because people tend to work less as they get older, an ageing population will tend to depress the participation rate.

Chart 2 - US nonfarm payrolls 2015 - 2020



Source: Bloomberg

Immediately after the Global Financial Crisis, the participation rate collapsed as the cyclical factors reinforced the negative structural trends. Over the last six years however, the positive cyclical factors have outweighed the negative structural drivers of labour market participation.

In our view, however, the participation rate has now recovered to a level that is consistent with its underlying determinants. This suggests that the participation rate might move sideways over 2020 in which case monthly employment gains could fall back to around 130,000 per month.

"Slower jobs growth triggered by weaker labour supply rather than demand, might result in an acceleration of wages growth. In the absence of that, weaker employment growth would likely result in softer consumer spending."

<u>Bottom line:</u> Slower jobs growth triggered by weaker labour supply rather than demand might result in an acceleration of wages growth. In the absence of that, weaker employment growth would likely result in softer consumer spending.

3. US earnings grow at low single digit pace

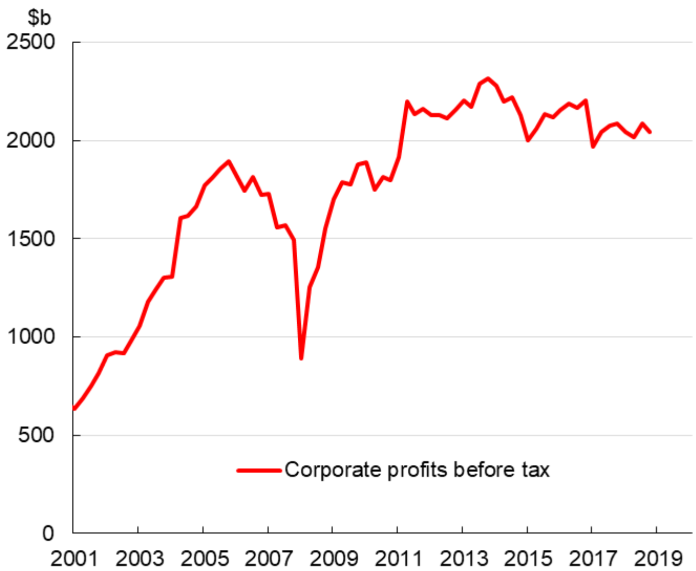
The optimistic case for earnings begins with an expected rebound in global growth in 2020. Combined with a reduction of uncertainty following the Phase 1 trade deal between the US and China and the UK Conservative Party's convincing election victory—which has paved the way for a clean Brexit—business investment should improve. Meanwhile, central banks appear committed to keeping interest rates at very low levels. Given this benign backdrop, many analysts expect earnings to grow by around 10 per cent in 2020.

> *"US earnings growth should be good but not great in 2020. While the expected pick-up in economic growth provides a supportive backdrop, there are also a range of factors that may hinder corporate profit growth"*

While that is a plausible scenario, we expect a more modest rise in US earnings. As discussed previously, we anticipate a moderate recovery in manufacturing activity rather than a rapid bounce back. In addition, while investors have reacted very positively to the Phase 1 trade deal between the US and China, we think businesses will be more cautious as the majority of US tariffs remain in place and there is no certainty that they won't be increased further. Of course, the tariff themselves—some of which only came into effect in September 2019—will also be a drag on earnings for some US firms.

Furthermore, some of the tailwinds that have supported earnings in recent years, such as falling corporate tax rates and declining interest rates also appear to be abating. Economic profit earnt in the US (see Chart 3 below) has stalled in recent years.

Chart 3 – US economic profits 2001 - 2019



Source: Bloomberg

While these considerations are likely to restrain earnings growth, they shouldn't be sufficient to prevent an improvement. In our view, earnings growth is more likely to be around 6 per cent than 10 per cent.

<u>Bottom line:</u> US earnings growth should be good but not great in 2020. While the expected pick-up in economic growth provides a supportive backdrop, there are also a range of factors that may hinder corporate profit growth.

4. US Federal Reserve eases monetary policy

Wayne Gretzky, former Canadian ice hockey star and head coach attributed his success to his father's advice to "skate to where the puck is going, not where it has been." In a similar manner, best practice for central banks over the past 25 years has been to set policy for where the economy will be in 18 months' time, not where it is today.

"Policymakers are becoming impatient with their inability to get their preferred inflation gauge back to target. If the US economy's performance in 2020 is similar to 2019, a rate cut would appear more likely than a rate hike, even if risks have abated."

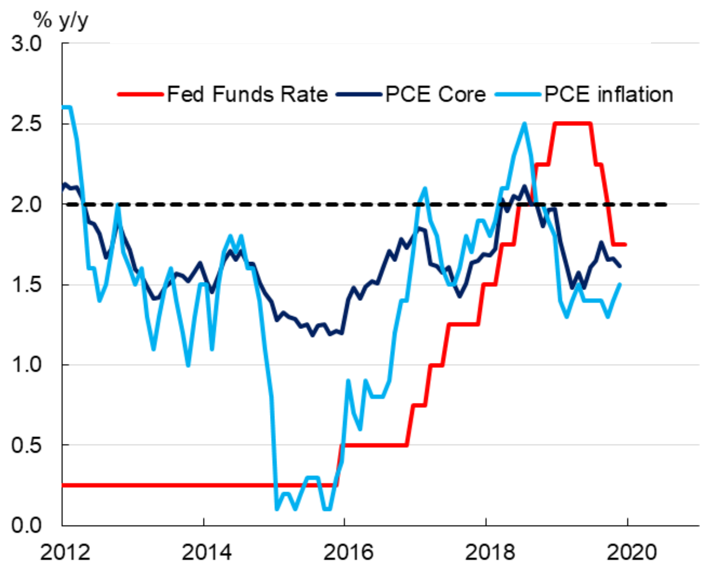
In 2019, however, central banks began to argue that this 'pre-emptive' policy strategy may no longer be appropriate. At the moment, both the Fed and the European Central Bank are reviewing their monetary policy strategies. In the US, the notion of achieving an 'average' 2 per cent target is becoming more popular, in which periods of sub-2 per cent inflation would be offset by periods of above 2 per cent inflation.

This idea has been most clearly articulated by Lael Brainard, member of the Board of Governors of the Federal Reserve System who said in late 2019:

> *"As we saw in the United States at the end of 2015 and again toward the second half of 2016, there tends to be strong pressure to "normalize" or lift off from the ELB (effective lower bound) pre-emptively based on historical relationships between inflation and employment. A better alternative would have been to delay lift-off until we had achieved our targets."*

Currently, Fed policymakers suggest that the next move in rates is likely to be up, but probably not until 2021. If, however, policymakers adopt the new approach, then they would only contemplate lifting rates a year or so after inflation has surpassed 2 per cent. And if inflation fails to reach 2 per cent in 2020, then the only logical move for the Fed would be to ease policy.

Chart 4 – US inflation and policy rate 2012 - 2020



Source: Bloomberg

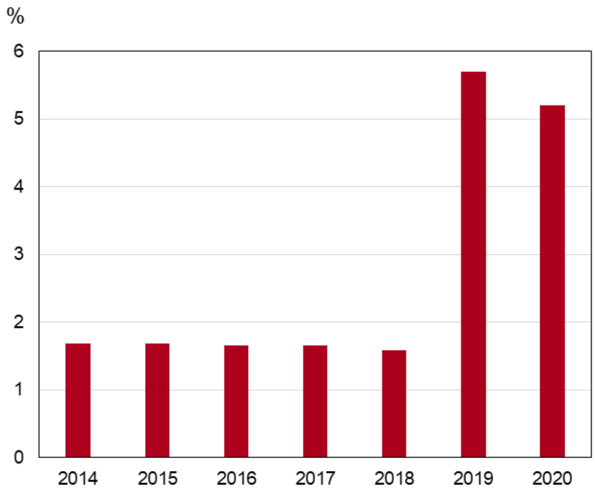
<u>Bottom line:</u> Policymakers are becoming impatient with their inability to get their preferred inflation gauge back to target. If the US economy's performance in 2020 is similar to 2019, a rate cut would appear more likely than a rate hike, even if risks have abated.

5. US and China fail to reach a Phase 2 trade deal

Phase 1 of the US-China trade deal resulted in the US deciding not to proceed with the tariffs that were scheduled to come into force in December 2019, while the US also halved the tariff rate from 15 per cent to 7.5 per cent on the US$160bn of Chinese exports that commenced in September 2019. In exchange for that, China agreed to purchase an additional US$200bn of goods from the US over the next two years, respect intellectual property rights and open its domestic financial market to US firms. It is clear in Chart 5 below, however, that the US has only made a modest concession so far.

"…faced with a choice between maintaining tariffs on China and overseeing a strong equity market, US President Donald Trump will ultimately opt to do a deal with China and support the equity market. If this is the case, then a Phase 2 deal becomes quite plausible as long as the president believes it will boost stock prices. …"

Chart 5 – US effective tariff rate, 2014 - 2020



Source: Bloomberg

"…while the tariffs dominate the headlines, we believe that the US-China trade dispute is actually about technological leadership in a range of key sectors including biotechnology, artificial intelligence, renewables and robotics…"

The Phase 1 deal has frequently been described as heralding a 'truce' in the trade dispute between the US and China rather than the onset of peace. Markets, however, have reacted very positively to the development since it was first rumoured in late 2019. This optimism seems based on the notion that US President Donald Trump views the performance of the stock market as an important measure of his economic policies and will do anything to support share prices.

Thus, faced with a choice between maintaining tariffs on China and overseeing a strong equity market, President Trump will ultimately opt to do a deal with China and support the equity market. If this is the case, then a Phase 2 deal becomes quite plausible as long as the president believes it will boost stock prices.

"It took much longer for Chinese and American negotiators to arrive at the Phase 1 deal than anticipated. Phase 2 will be much more complicated and appears unlikely to be achieved this year."

But while the tariffs dominate the headlines, we believe that the US-China trade dispute is actually about technological leadership in a range of key sectors including biotechnology, artificial intelligence, renewables and robotics. This disagreement is not simply between the current leaders of China and the US, but between the broader governments and corporate sectors. Without a complete capitulation by one of the two adversaries, it is difficult to see how a Phase 2 deal could be achieved.

<u>Bottom line:</u> It took much longer for Chinese and American negotiators to arrive at the Phase 1 deal than anticipated. Phase 2 will be much more complicated and appears unlikely to be achieved this year.

6. Oil price averages US$65 per barrel over 2020

Tensions between the US and Iran escalated in early 2020 following the assassination of Iranian general Qasem Soleimani. This has once again raised questions on whether an escalation of these geo-political concerns could undermine the global economy. In our view, the key question is whether these ongoing tensions are reflected in a sharp rise in the price of oil. Of course, oil prices could also rise if OPEC (together with Russia) successfully curtailed production.

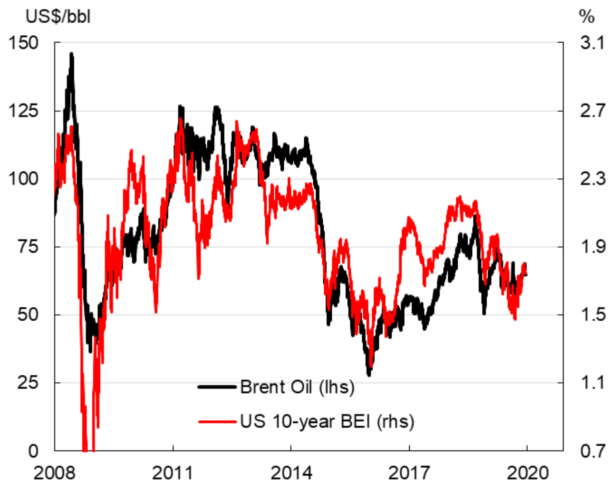
A sharp rise in oil prices—towards US$100 per barrel—is one of the key risks to US consumer spending, which otherwise appears fairly well supported. Over the course of 2019, US business investment was subdued as firms placed expansion plans on hold against the backdrop of rising tariffs and other regulatory changes. Consumer spending, however, remained solid, which ensured that the overall economy managed to grow at a decent clip.

> *"…while higher oil prices are a risk, we continue to think that US oil production can play a key role in ensuring prices remain fairly stable…"*

If, however, subdued business investment was accompanied by weaker consumer spending, then the US economic outlook would be much gloomier. Of course, those emerging markets which are large oil importers would also come under pressure as import bills surged, inflation picked up and the government's budget situation worsened.

While higher oil prices are a risk, we continue to think that US oil production can play a key role in ensuring prices remain fairly stable. Were prices to spike higher, it should incentivise marginal US producers to ramp up production and gain market share. This restrains how far OPEC can sustainably restrict its production and keep prices elevated.

Chart 6 – Inflationary expectations and oil 2008 - 2020



Source: Bloomberg

Much higher oil prices would of course directly affect financial markets. Chart 6 above shows the relationship between oil prices and the market's implied expectation of inflation. It suggests that if the oil price was sustained at around US$100 per barrel, that expected inflation—which is one component of bond yields—would be around 2.3 per cent.

<u>Bottom line:</u> We expect oil prices to remain range-bound, but if prices did surge it would result in weaker US growth, profits and equity markets, but higher inflation and bond yields.

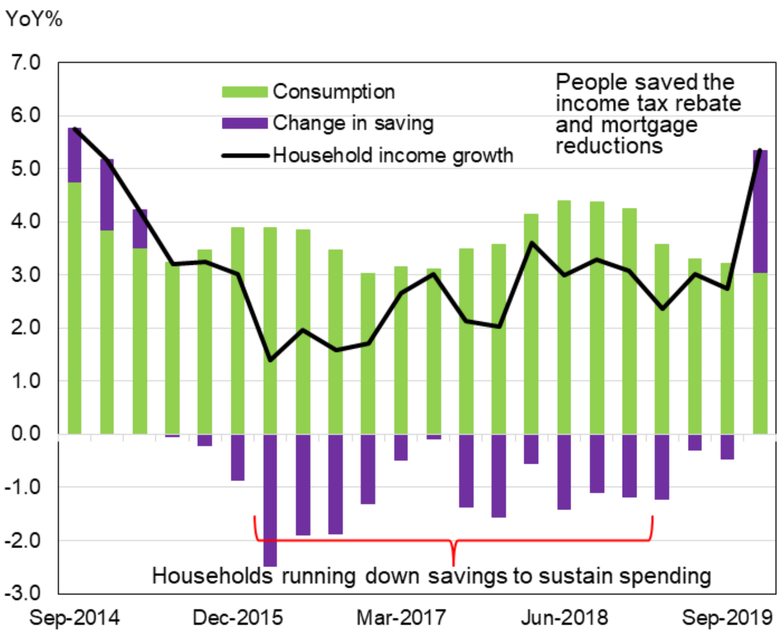
7. Australian fiscal policy fails to boost private spending

Around the world, central banks are conceding that monetary policy is becoming less effective in supporting growth and that it would be helpful if fiscal policy also played its part. Australia is no exception to this trend, with Philip Lowe, Governor of the Reserve Bank of Australia imploring the government to use fiscal policy to stimulate the economy and consider productivity boosting reforms.

> *"The government's commitment to a budget surplus in 2019-20 appears however, to have weakened in the wake of the horrific bushfires that struck large parts of Australia during summer. This raises the possibility that fiscal policy might become a bit more supportive of growth than previously seemed likely."*

While the federal government delivered some income tax relief to households in 2019, it has so far resisted calls to bring forward the additional tax cuts slated for 2021. Similarly, it has made it clear that it doesn't believe the economy requires further support and regards attaining a budget surplus as a priority.

Chart 7 – Australian household income and spending September 2014 – September 2019



Source: Bloomberg

> *"While the federal government is likely to open the purse strings a little, it won't be sufficient to revive consumer spending."*

The government's commitment to a budget surplus in 2019-20 appears however, to have weakened in the wake of the horrific bushfires that struck large parts of Australia during summer. This raises the possibility that fiscal policy might become a bit more supportive of growth than previously seemed likely.

Even if, however, more stimulus is forthcoming, will it revive consumer spending? Chart 7 above illustrates that while the 2019 income tax rebate did boost household income, consumers saved, rather than spent it. In our view, this doesn't mean that fiscal stimulus is ineffective, but merely that any fiscal stimulus needs to be better designed, and larger, than the 2019 tax rebates. And while we do think that the government will deliver more support to the economy in the 2020 budget, we do not think it will be sufficient to significantly alter the momentum of consumer spending.

<u>Bottom line:</u> While the federal government is likely to open the purse strings a little, it won't be sufficient to revive consumer spending.

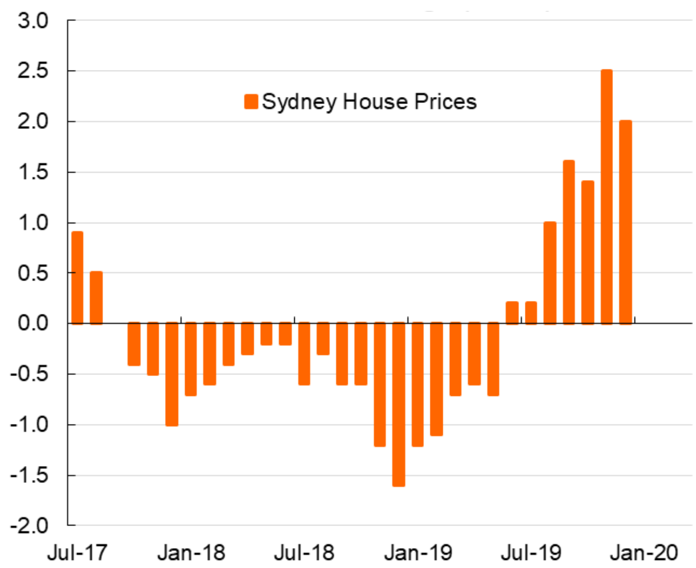
8. Australian house prices rise another 5 per cent

One of the most remarkable stories of 2019 was the speed of the turnaround in housing prices. As shown in the chart below, Sydney house prices were growing by 1.5 to 2.5 per cent per month towards the end of 2019. The question now is whether house prices can continue to grow at such a pace in 2020 or whether prices will bounce back to their recent highs and then stabilise from there.

> *"Our base case is that price growth moderates substantially over 2020 from the frenetic pace in late 2019…"*

There were three triggers for the rebound in house prices. First, the re-election of the Liberal-National Coalition government at the May federal election, which maintained policies such as negative gearing and the capital gains tax discount that support investors. Second, regulators loosened macro-prudential lending policies. Third, the RBA cut interest rates three times. Looking ahead, overall regulatory policies are likely to remain supportive, while the RBA may well cut interest rates further in 2020 which could boost prices further.

Chart 8 – House price change (m/m%) July 2017 – January 2020



Source: Bloomberg

Our base case is that price growth moderates substantially over 2020 from the frenetic pace in late 2019. This partly reflects affordability issues, particularly in Sydney and Melbourne. While it is possible that prices could climb back to previous highs reached in 2017, given the modest pace of wage gains since then, it seems more difficult for prices to keep rising quickly above that level. In addition, the rapid pace of house price gains in late 2019 also occurred when there were few properties for sale. We think that prospective sellers will be more likely to put their property on the market now that prices have recovered. And as the equilibrium of supply and demand is restored, that should also result in slower price growth.

<u>Bottom line:</u> Continued rapid house price growth over 2020 would bring forward the recovery in housing construction as new property development activity becomes profitable. It would also, however, increase the risk of a 'boom-bust' cycle as another year of booming prices would bring into question the quality of lending and could see regulators reinstate the controls that they have only recently abandoned.

9. RBA cuts its policy rate to 0.25 per cent, takes tentative steps towards quantitative easing

The RBA experienced an epiphany in 2019. For the last couple of years it proclaimed the economy was imminently poised to accelerate with rising wages growth and inflation back at target which would justify higher interest. In 2019, the RBA finally conceded that wages growth was stuck at around 2 per cent and that inflation would remain below 2 per cent.

Moreover, the RBA pivoted away from a singular focus on its inflation target and placed more emphasis on getting unemployment down. The RBA also conceded monetary policy had limitations, and that without more supportive fiscal policy the economy's performance would remain mediocre. Finally, the RBA highlighted the importance of the Australian dollar in determining the economy's performance and how unhelpful it would be if the currency appreciated. And of course, it cut its policy rate three times in 2019.

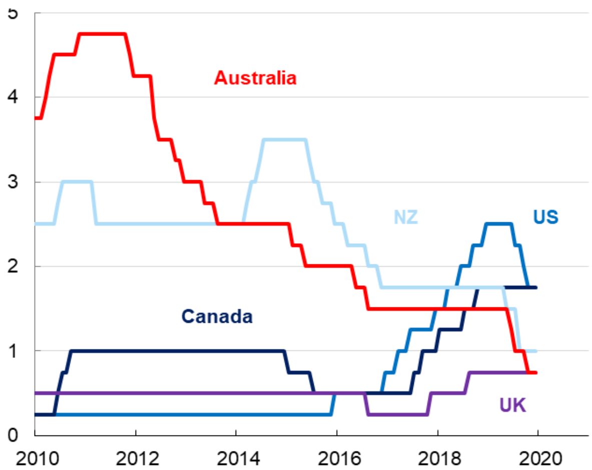
> *"In our view, without a significant fiscal stimulus, the RBA will continue to struggle to make progress on its goals for both inflation and unemployment. Hence, further easing seems likely."*

So what will the RBA do in 2020? In our view, without a significant fiscal stimulus, the RBA will continue to struggle to make progress on its goals for both inflation and unemployment. Hence, further easing seems likely. While it can be debated whether cutting interest rates from very low levels to even lower levels is effective, the RBA's belief seems to be that if it can do something, it should. That suggests it will cut the cash rate to 0.25 per cent in the second half of the year. And if the economy is still flat-lining after that, the RBA will take a tentative step towards quantitative easing by signalling its intention to commence buying government bonds.

While we don't think that lower rates will suddenly boost the desire of firms to invest—or consumers to spend—we suspect that the RBA hopes it will help weaken the exchange rate. And a lower Australian dollar would flow through to stronger profits and an improved competitive position for Australian firms. Chart 9 below shows how Australia has gone from having the highest policy rate in the English-speaking world to the lowest. The decision to adopt quantitative easing would be an extension of this.

<u>Bottom line</u>: The RBA fears it will lose its independence if it admits it can't meet its inflation target, and so will likely continue easing policy in 2020.

Chart 9 – Anglo-American democracy inflation rates – 2010 - 2020



Source: Bloomberg

Reflecting on 2019

Our prognostications have had a good success rate in recent years, however that cannot be said of 2019 when central banks proved to be far more dovish than we expected.

On the positive side, our forecasts for economic growth in the US, Europe and China were mostly on track. The US economy did not stall as many people feared and growth is likely to have accelerated into the end of 2019. Similarly, Europe appears to have grown at around its trend rate over 2019 despite very weak manufacturing and China's economic growth also tracked just above 6 per cent. Our expectation that US-China trade tensions would persist, and that China would only make token concessions to the demands of US negotiators, also proved close to the mark.

In contrast, our forecasts for central banks were wrong. In Australia, we thought the RBA would resist the pressure to ease policy due to its upbeat view on growth. By April, however, it was clear to us that the RBA would cut rates, as it did in June, July and October. Lower rates, combined with the relaxation of macro-prudential lending policies then revived mortgage borrowing in the second half of 2019. Until then, house prices were on track to fall around 7 per cent over 2019 (which was our expectation), but the subsequent rapid rebound in prices saw them end 2019 up 3 per cent.

Similarly, the Fed had no tolerance for even the risk of slower growth. The shift in the Fed's pivot—from expecting to raise rates three times to actually cutting rates three times—was a key reason why US 10-year yields rallied strongly through the first nine months of 2019, whereas we expected them to edge sideways. While the dovish pivot of the Fed would usually weaken the US dollar, the relative weakness of European manufacturing and the European Central Bank's decision to resume quantitative easing prevented that from occurring. As a result, the US dollar did not weaken as we thought.

For us, the key lesson from 2019 is how central banks abandoned the notion that they should pre-emptively address inflation. In our view, that also has implications for this year and the years to come.

Table 2 – The nine things to watch in 2019 – forecast vs actual

Item	Forecast for 2019	Actual (year-end)	Outcomes
US growth	Stronger H2	Likely improved	US growth hit 4.1% in Q2 and is expected to be 2.8% for Q4
US policy rate	2½-2¾%	1½	Fed cut rates three times
US$ index	-10.0%	+0.2%	US$ was mostly stronger over 2019
US-China trade war	Token concessions from China	Token concessions from China	China agreed to purchase additional rural goods from the US
US 10-year bond yield	2.75%	1.92%	10-year yields rallied strongly over 2019 before late sell off
RBA cash rate	1.5%	0.75%	RBA cut rates in response to falling house prices and low inflation
European growth	¾-1%	¾-1%	Manufacturing activity was weak but a resilient consumer supported growth
Australian house prices	-7%	+3%	Prices fell 4% over the first six months, but surged 7% after August as the removal of macro-prudential controls boosted lending
Chinese growth	>6%	Likely >6%	Market expects the Chinese economy grew by 6.2% in 2019

Source: TCorp

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