GLOBAL riskupdate
The quarterly independent risk review for banks and financial institutions worldwide

2019: A Year of Turmoil

by Dennis Cox, CEO, Risk Reward

Insights from a Global Risk Expert on Politics, Economic Growth, Interest Rates, the Oil Price, Equity Markets, the Housing Sector, and what is means to business

Risk Reward's CEO Dennis Cox predicts 2019 as a Year of Turmoil

As always, we start our first quarter at Risk Reward Limited with our predictions for the coming year. While this is always difficult, 2019 and 2020 pose perhaps our greatest challenges since our business began trading in 2002. If that does not sound optimistic, with regret 2019 is unlikely to be a great year and 2020 could easily be worse.

Let's first think about the year that has just passed. As we predicted last year UK banks did receive permission by the Bank of England to increase interest rates, but these were as benign as we then proposed. Sterling weakened because of Brexit and the oil price fell due to a reduction in future demand expectations. Property prices at best froze and the stock market went nowhere. Not a great picture, but the interest rising economic environment is never a great time for economic growth. And as I am writing this, the US government closed again due to a failure to agree a budget with an intransigent President, together with a variety of US driven trade disputes. That is the context in which we are looking at what is most likely to happen this year and next.

Generally, the next few years are not going to be great for the stock market or for fixed income bonds either. My continued negativity on oil prices is not only due to the economic environment but also due to reducing demand and excess supply. I did say that if you thought 2018 was bad, just wait for 2019 and 2020 – a view I still hold. At its most basic the world is entering the negative economic cycle of rising interest rates with far too much government borrowing, too little of the excess funds effectively recycling through the banking sector and too many governments running deficits that are unsustainable. This is building up pressures which has already resulted in the unrest we are currently seeing and protectionist policies appearing globally.

A consequence of this is that 2019 will see many long-established politicians departing the global stage. This will affect countries as disparate as Israel, Germany, the UK and probably the USA.

Politics in 2019

If you back in history in terms of where we are in the economic cycle this is roughly 1968. That was a year of major change and unrest with groups of people looking for solutions in various places. Flower power was one of the consequences of people wanting a different world. Student rioting was another consequence and broke out in many countries. Wars were continuing, and anger was brewing. Governments borrowed without necessary restraint building up the problems which were to follow. In the last cycle in 1968 there were choppy economic waters, but it would be another two years before we would see a bridge (over troubled waters). It ended up with Anarchy in the UK in 1977 and the Savings and Loan or LDT crisis in 1979. That was a crisis of smaller banks based on banks being too small to succeed, rather than too big to fail. That led to the peak of interest rates in 1982 and the horrible accompanying volatility.

It will be hard to keep any population confident in their rulers. This statement knows no boundaries, but a series of popular leaders are likely to be elected and then rejected. Predicting exactly what will arise and where would be at best foolish. However, I am expecting a series of populist leaders to appear some of which will not be well known at present. Their lack of experience will make solving global problems more complex and I can assure you we will have global rather than local problems.

Still, as I put pen to paper the UK is still arguing over Brexit and no solution would achieve a majority in Parliament. I have stated before that my expectation is that after all the bloodletting the ultimate position will look much like life did before the referendum. Indeed, the current deal with minor modifications will probably be where we will end up. Brexit is a sideshow – not the main event for 2019.

So, there is going to be political turmoil not least in the USA where the conflict of different parties overseeing the two houses and a President that does not always appear to take advice will become unsustainable during 2019.

Global Economic Growth

There will not be any global growth in 2019, or 2020. Indeed, I would be surprised if there was any real growth globally in the next decade. That is not just due to interest rates but also due to sociological and technological changes impacting trading patterns. Changing ways of working will cause a reduction in opportunities particularly for those unable to operate effectively in the knowledge economy. The false dawn of on-line retailing will also become clearer with the consequent fragmentation continuing to take out major names. However on-line retailing will not grow at its historic rate, but it will reduce global activity. You buy less on line then you would have bought from a bricks and mortar retailer. That means this is a battle with only losers.

Interest Rates

Interest rates are on an upward cycle and the US decisions will drive rates globally, not least due to commodities continuing to be priced in USD. The upward cycle of interest rates in the US is likely to continue during 2019 and 2020 even though this creates problems.

The US budget deficit needs to be funded and these funds must come from outside of the US. Consequently, US rates are likely to remain above those of many of their major trading partners throughout this period. The inverted US yield curve warns that a US recession is coming, and we would expect the US to be in recession in Q3 2019. Our central expectation is that interest rates in the US will rise by 1.25% in 2019 and a further 3% in 2020. UK rates will rise by 0.75% and 1.25% in the same periods if Brexit will be resolved by some form of agreement.

Oil Prices

Oil prices will remain under continual pressure as alternatives really start to bit into demand leading to excess supply. The floor for world crude at USD 42 will be challenged in Q1 2019 and we could easily see USD 36 without any real prospect of recovery. I know some people are predicting prices down to UD 24 but that would in our opinion require a level of reduction in global GDP which we consider plausible but unlikely.

Equity Markets

I can so no reason for equity markets to maintain their current reduced levels in 2019. I am anticipating a tech stock sell off as the eye watering multiples reduce. Our central expectation is a 7% reduction in 2019 and a 2% rise in 2020.

Bond Markets

Long dated fixed income is not a product for 2019 or 2020. As interest rates rise there is never a right time to buy, resulting in a disappearance of this asset class. It will also mean that yield curves will become distorted and unreliable beyond five years. Shorter dated fixed income will still be fine so long as the US continues to refinance these assets. The redemption value has the effect if anchoring the bond value and maintaining the liquidity of the money markets.

But I am sure you are wondering how indebted governments will fund themselves. Can they do this with money market instruments? Will the market for floating rate instruments broaden even though these instruments do not float but step in arrears?

I have no doubt that increases in taxation and protectionist policies will be a consequence and these will have a negative impact on economic activity.

The Housing Market

When interest rates were falling people would refinance their fixed rate housing loans to take advantage of lower rates. People on floating rates saw their repayments fall. All good for the housing market. However, in an interest rate rising market nobody with a fixed rate loan refinances since the replacement product would be at a higher rate. This results in a declining housing market, unemployment and unfilled vacancies as well as negative equity.

Clearly property is not a global market and local factors lead to massive differences. Generally, if we were to give a percentage, we would expect property prices to reduce by around 10% in 2019.

Conclusion

As you can see nothing is pointing to a positive outlook in 2019 and that is a cause for concern. As individuals and businesses will try to degear and be even more conservative opportunities will be limited. As always, some firms and individuals will do really well – but at what cost to the rest of us?

This is just a summary of our current thoughts. Do contact us if you want further information on any of this. Have as good a 2019 as best possible given the headwinds that clearly exist.

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