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2020: Stock market/Economy, the great divide?

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2019 was an auspicious year for financial markets, but clouds gathered over global economic growth which was at its lowest since the 2009 financial crisis. Today, Western equity markets continue to reach new heights while the global economy is seeing sluggish growth. In an environment of ultra-low and even negative rates, the hunt for yield is driving stock markets up. Can the divide between the stock market and the economy continue to widen indefinitely?

2019 was an auspicious year for financial markets, but clouds gathered over global economic growth which was at its lowest since the 2009 financial crisis. The increase in customs tariffs (trade war between the US and China) coupled with a rise in uncertainties (Brexit, trade policies), led to a decline in corporate confidence and a marked slowdown in the manufacturing industry and global trade. At the same time, equity and bond markets, boosted by a new cycle of global monetary easing, have generated stellar performance.

Will 2020 see a growing divergence between markets and the real economy?

Investors have reason to be optimistic

Fears of an economic slowdown that would transform into a widespread recession--fears that shook financial markets in mid-2019--have dissipated over the past few months in an environment marked by:

- **Further monetary policy easing**: in the US, the federal funds rate was cut three times in 2019; in the Eurozone, the quantitative easing programme was reactivated while the deposit rate was lowered again, further into negative territory; and in China, the mandatory reserve ratio was lowered.
- **The calming of trade tensions between the US and China**, with, notably, the signature, on 15 January 2020, of a “phase 1” agreement under which the US will reduce its customs duties on certain imported Chinese products in exchange for Beijing's commitment to increase its purchases of US products by $200 billion over a period of two years.
- **Less likelihood of the prospect of a hard Brexit**, even if many steps and potential pitfalls remain in the divorce procedure between the EU and the UK.
- **Signs of a rebound in global manufacturing activity**: in November, the ISM Purchasing Managers Index registered for the first time since April a reading above the threshold of 50, which separates growth and contraction of activity.

In an environment of ultra-low and even negative rates, **the hunt for yield is leading investors towards riskier, and therefore more rewarding, assets**. Investors’ appetite for short-term yield is currently fuelling the market rally.

A stagnating global economy

If fears of an imminent global recession seem premature, the return to strong and sustainable growth is still out of reach: global growth will remain weak in 2020, driven by a small group of large emerging countries in the midst of economic recovery such as Turkey, while growth will likely slow down in a number of major countries including the US, China, Japan and Europe, that is, half of global GDP.

- In the **US**, the dissipation of the effects of fiscal stimulus measures, the tightening of the job market, the decline in corporate profit margins and the slowdown of investment growth point to an economy at the end of its cycle.
- In **China** (which accounts for nearly 40% of global growth), growth is at its lowest since 1992 and should continue to slow down, as stimulus measures launched by Beijing remain limited for fear of inflating the already massive debt.
- In **Japan**, the economy, grappling with the slowdown of the demand in China--a major buyer of its machines and components--is advancing at a snail's pace.
- The economy in the **Eurozone**, already nearly stagnant, will continue to slow down under the effect of the simultaneous deceleration of exports and the industrial sector.

The decline in growth in advanced countries reflects both a problem of demand, with notably the waning effects of fiscal stimulus measures in the United States, **and a problem of offer** tied to the decline in potential growth (weak gains in productivity, population ageing, rise in social inequalities, etc.).

And this time it's different?

The term "speculative bubble" often comes up in today's media, but not all increases in the price of an asset point to a bubble.

The standard model for determining the price of financial assets establishes that this price is equal to the present value of anticipated revenue flows (dividends). The rise in equities can be explained at least in part by the **anticipated increase in dividends** (in the short-, medium and long term). The **decline in interest rates** – which are used to discount the future dividend flows – is another explanatory factor.

It is impossible to precisely identify in the current levels of equity valuation--US equities in particular--whether a "bubble" component (not explained by fundamentals, i.e. firms' outlooks and dividends) **exists.**

Nearly all professionals currently diagnose a problem of overheating, and tend generally to protect themselves against shocks. But **there are always events that no one has foreseen, at a time that no one has anticipated**.

Central banks are now reaching the limits of what they can do to counter a potential recession, while **fiscal policy**, which is the prime economic policy instrument when interest rates are at zero, **remains subject to political and debt constraints.**

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