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2019
"V for Volatility"

Introduction

Forecasting will never be an exact science and even the most talented researchers can end up with egg on their face; just ask the European based analysts who had called for Bitcoin to hit US$60,000 - US$100,000 by the end of 2018… On top of this the outlook for the year ahead appears even harder than usual to predict, although one thing is clear and that is that volatility from both a financial market and geopolitical sense is likely to increase in 2019. Therefore in this piece we try to highlight what we perceive to be the key issues for investors to keep an eye on over the next twelve months.

The Global Economy & Trade Wars

Potential domino effect: The imposition of tariffs by the U.S. on its Chinese imports has developed rapidly and thus there is a risk that these trade tensions could deteriorate further during the course of this year (2019), creating a consistent source of market volatility and potential weakness for the global economy. Indeed, in late 2018, the IMF scaled back its macroeconomic outlook for global growth, attributing downside risk to the negative ramifications from the U.S./Sino trade dispute. It could also be argued that the escalation of the trade war experienced during 2018 had no precedent in recent history. While the U.S. began tentatively with tariffs on solar panels and washing machines, the breadth of penal pricing then grew to cover some $250b of U.S. imports from China by the end of last year.

In aggregate we would suggest the net effect of these actions is to create dislocations, raise costs, and increase macroeconomic uncertainty, all of which are inconsistent with World Trade Organization (WTO) rules. While we still expect a deal to be arrived at eventually, the standoff between the two sovereigns now requires one or both sides to capitulate. If not, the polemic will become ever more costly for all parties involved and potentially increasingly disruptive for global financial markets.

QE to QT

Shifting sands: World markets have experienced the beginning of a structural shift from quantitative easing toward quantitative tightening in recent quarters, albeit tectonic thus far, the ongoing rates market transition could be a key driver of elevated volatility during 2019. While central banks – led by the U.S. Federal Reserve – begin the process of balance sheet normalization, global growth assumptions now appear to be finely balanced in 2019, all of which could be a source of potential market volatility and investor uncertainty.

Indeed, with the shift from QE toward QT, the optimism of sustained future economic expansion that was felt at times during 2018 has quietly ceded ground to a picture of less synchronized and perhaps more modest growth over the coming quarters. The immediate and most direct implication of a higher yield structure as monetary accommodation is withdrawn would seem to lie in implied volatility across the lower end of the risk asset spectrum. Here we see weaker-rated, higher-yielding assets that have outperformed on the back of investors' hunt for yield and borrowers that have feasted on access to cheap funding and leverage in recent years, to be most at risk from the shift from QE to QT and the associated asset allocation implications.

Oil

Push & Pull: After a mostly bullish year the last few months of 2018 saw crude prices retrace sharply, inventories climb and long-positions reverse as concerns rose over the outlook for the global economy. However we are not convinced that the bull has become a bear just yet, especially if a US/China trade deal can be thrashed out during the first quarter of this year. Global spare capacity remains wafer thin whilst geopolitical risks such as those linked to Iran, Libya, Nigeria and Venezuela could also provide the oil market with some added support in the months to come. A further drop in prices would of course negatively affect all producers revenue streams although some countries are more exposed than others. According to IMF projections the estimated fiscal break-even crude oil prices for GCC exporters in 2018 were as follows: Bahrain (US$110), Kuwait (US$48), Oman (US$79), Qatar (US$49), Saudi Arabia (US$83) and the UAE (US$69). *You can read more on this topic in our annual Global Investment Outlook.*

US Politics

Tweets ahead: We ended 2018 with talk that the US President wanted to sack the Chairman of the Federal Reserve which in turn spooked global financial markets. Meanwhile the government is still partially shut down as a stand-off between congress and the White House over funding for Trump's Mexican border wall continues. On top of this the US Defence Secretary became the 25th senior government figure to step down from his or her post within the current administration. According to the Brookings Institution, Donald Trump has now had the highest turnover of key staff members of any of the past five US Presidents. At the same time although his overall approval numbers remain relatively low, they have not yet fallen off a cliff, and despite hopes by some that he could face impeachment proceedings this year, especially now that the Democrats control the House of Representatives, such an outcome is highly unlikely with the Republicans retaining a majority in the Senate, unless of course the Muller investigation releases evidence pointing directly at the President.

However Mr. Trump does face a much tougher year ahead. For example any major legislative bills are going to be difficult to pass, whilst a slowing economy and further scrutiny into his business affairs could force both his base and senior Republican Party members to begin to reconsider their faith in his Presidency. Issues that are not in doubt are; that the US domestic political environment will remain at its most polarized since the Vietnam War, that Trump will continue to dominate the media headlines and that his Twitter account will be extremely active again.

Brexit

Any which way but loose: The closer we get to March 29th 2019, the day on which the U.K. is scheduled to leave the European Union, the further Britain seems to be from agreeing the terms on which the divorce will be struck, if indeed the divorce does go ahead as planned. 'In', 'Out', 'Soft Brexit', 'Hard Brexit' or even 'No Brexit', the only certainty at this stage of the polemic seems to be that uncertainty will persist and dampen GBP investor risk appetite over the coming months.

However, as the clock ticks down, more than just the pure economic arguments for and against Brexit that have driven the narrative over the past two years, it is now political uncertainty that may weigh most heavily on U.K. risk asset and currency market sentiment in the opening months of the New Year and beyond.

Mrs. May survived the December vote of confidence in her premiership, but we would conjecture that the Brexit saga will continue to fuel GBP market uncertainty and volatility during at least the opening months of 2019. In our opinion, the threat of a future mutiny against the Prime Minister remains a clear and present danger for U.K. risk assets, with investor sentiment highly susceptible to headlines concerning her position in 10 Downing Street. As such, the path of least resistance for cable in 2019 may remain lower, having already seen a more than 10% decline from its 2018 high.

Populism

Look Left & Right: Populist movements are continuing to disrupt the status quo across Europe and elsewhere around the globe. These groups come from both sides of the political spectrum such as Italy's right-wing 'Northern League' and the left-wing 'National Regeneration Movement' party in Mexico. Calculating the actual level of support of populist parties in Europe could soon be revealed via the EU's parliamentary elections in May and which Italy's Interior Minister, Matteo Salvini has described as "*a referendum between the Europe of the elites, of banks, of finance, of immigration and precarious work versus the Europe of people and labour*". Whether or not the majority of Europeans feel the same way remains to be seen, but judging by the recent huge anti-government 'Gilets Jaunes' protests in France which have since spread to Belgium and Spain, unhappiness with the status-quo is growing across the continent.

In Latin America both Brazil and Mexico elected populist presidents last year and each face serious economic challenges. In Brazil, President elect Jair Bolsonaro wants to pursue some 'Trump-like' policies including a withdrawal from the Paris Climate Accord, easing restrictions on gun-ownership and allowing further commercial projects in the already fragile Amazon rain forest. On the plus side he has promised to privatize certain state-owned companies and reform the country's costly pension program, although the latter will be a particularly tough issue to resolve.

Meanwhile Mexico's new leader, President Andres Manual Lopez Obrador carries a socialist agenda and clashed openly with domestic business leaders during his campaign. Thus under his stewardship government spending is set to rise especially on social projects. At the same time however his early policy steps have an air of pragmatism; He has just about sealed a new trade agreement with the US and Canada, promised to retain some fiscal discipline, continue to protect investors and crackdown on corruption and violent crime.

Iran, Syria & North Korea

New conflicts on the horizon? : A US sanctions waiver agreement with eight of Iran's key oil export destinations expires in April 2019. It's hard to see the current US administration extending this agreement as such a decision would undermine Trump's publically stated plan to squeeze Tehran as hard as possible. The JCPOA accord is still alive but on life-support, whilst the Iranian economy is already under severe pressure. Public discontent with the rising cost of living could become more vocal this year and hardliners within the regime will no doubt be looking for ways to distract such unhappiness. This in turn could see an increase in disruptive activity by Iranian proxies within the region together with a more combative stance towards the US and its allies by the IRGC, such as the potential harassment and/or blockade of naval and commercial ships sailing through the Strait of Hormuz.

Meanwhile the surprise, albeit staggered withdrawal of US forces from Syria, opens up the risk of a direct confrontation between the Kurds and Turkey there. There is also a growing concern over Hezbollah's continued build-up of its missile-related arsenal which in turn could persuade Israel to conduct a more expansive offensive against the militant group in Syria and/or Lebanon.

In Asia progress towards the denuclearization of the Korean peninsula appears to have stalled. Trump's and Moon Jae-In's face to face meetings with Kim Jong-Un last year gleaned plenty of media attention but few real changes on the ground north of the 38th parallel. The US administration's ongoing trade dispute with Beijing complicates this impasse even further and there is a risk that unless Pyongyang receives its demand for sanctions relief, it could easily revert back to its long history of 'saber-rattling.'

Elections

Polls to ponder: There are a number of elections scheduled to take place this year and many of these will be held in some of the world's key emerging markets:

1. Nigeria will hold a general election on February 16th 2019 when voters will also be asked to select their next President. While there are only two main front-runners for the top post, there is a risk that militants will attempt to use this high profile event to advance their own agendas, especially in the country's oil-rich Niger Delta region.
2. Thailand's military government lifted a four year ban on political campaigning in December last year as the country prepares for a general election on the 24th of February. This will be the first nationwide poll to be held under the reign of King Vajiralongkorn and under an amended constitution that was approved via a public referendum in 2017. These amendments also gave the military the right to directly or indirectly appoint all of the upper house's senators.
3. Ukraine will conduct a Presidential election on March 31st and there are currently three primary contenders: The incumbent Petro Poroshenko, an ex-Prime Minister Yulia Tymoshenko and the actor Vladimir Zelensky. The average voter does not appear to be too enthusiastic on any of the main candidates, but expect a ratcheting up of nationalist rhetoric ahead of the poll especially with the recent worsening in diplomatic relations between Kiev and Moscow.
4. India, the world's largest democracy, is due to hold general elections during the first half of 2019 although an exact date is yet to be announced. All eyes will be on the performance of Prime Minister Narendra Modi's ruling BJP party which was recently defeated during state ballots in three of its former strongholds, including Rajasthan and Chhattisgarh, by the main opposition Congress party which is led by Rahul Gandhi, the son of a former Prime Minister Rajiv Gandhi.
5. Some of Algeria's opposition candidates have been calling for the country's Presidential election, (which is due to be held in April this year), to be delayed until it becomes clear whether President Abdelaziz Bouteflika who is suffering from poor health, will be physically able to stand for a fifth term in office or not. However all the main political parties within the 'pro-government bloc' have already given their approval for Bouteflika to remain as their prime Presidential candidate.

6. Indonesian voters will cast their ballot in Presidential and parliamentary elections on April 17th. In the race for the top job the incumbent Joko Widodo, will face off against Prabowo Subianto a former senior army officer who has appointed a very conservative Muslim cleric as his running mate. Widodo remains a popular figure, but the outcome of recent governorship polls suggests we may see a much closer contest between these two Presidential candidates than currently predicted.

7. South Africa's ruling African National Congress led by its new President Cyril Ramaphosa face general elections in either late May or early August this year. The ANC has an uphill task in rebuilding its image, after the Zuma years saw allegations of high level corruption and nepotism severely tarnish its brand, but will still likely succeed in holding onto power. The big question will be the size of the ANC's majority, a sharp drop in support could force the President to adopt more aggressively populist and less market-friendly policies.

8. As the European Union's political institutions continue to try and combat the rise of anti-establishment parties, populism could well play a key role in which MPs are elected to the European Parliament, in a vote that is due to take place from the 23rd to 26th of May.

9. Tunisia will hold Parliamentary and Presidential elections in November but political risk is already rising again in this strategically important North African country. Tensions between President Essebsi and Prime Minister Chahed have hamstrung the government's economic reform program, as has the ongoing opposition to further austerity measures by the country's main trade unions. In the meantime rising unemployment and high poverty levels triggered violent protests in December 2018 and this situation could worsen in the months ahead.

10. Afghanistan was due to conduct a Presidential election in April this year, but that has now been delayed for several months after the country's electoral commission asked for more time to verify voting lists and train their staff on a new biometric identification system. A new date is yet to be confirmed. This decision comes as diplomatic efforts towards starting a formal peace process between the government and the Taliban have reportedly been picking up pace.

Electronic Trading Platforms

Rise of the machines: While the evolution of electronic trading platforms and the use of algorithms to trade through economic cycles have been heralded in recent years as a sign of development, maturity and sophistication for financial markets, we suggest that such automation could in fact be another exacerbating factor for market volatility in 2019.

At a time when global rates are shifting from QE toward QT and the so-called central bank safety net for risk asset investors is gradually withdrawn, we believe that macro fundamentals should be ascribed a much greater weighting within asset allocation investment strategies. But, by definition, electronic trading systems are generally unable to incorporate such analytical sensitivities into their algorithms. Sharp downward price movements resulting from rates market sell offs could therefore be more likely to trigger 'stops' on electronic trading systems, resulting in further selling, than being able to trigger 'buy' recommendations founded on relative value propositions. We would therefore conclude that the increase in trading automation over recent years could actually have an intensifying effect on asset price volatility during this year, the inverse of what, theoretically, such systems were designed to do in the first place.

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