From robust to fragile growth

2019 Investment Outlook

Triodos Investment Management

**‘The long run is a misleading guide to current affairs.
In the long run we are all dead.’**

- John Maynard Keynes, A Tract on Monetary Reform -

About this outlook

In this investment outlook, we present our short-term outlook for the global economy and financial markets. The tactical asset allocation (TAA) for our SRI funds is based on these short-term expectations. With our TAA we exploit short-term opportunities for generating excess financial return. Doing this does not imply that we only focus on financial returns, or that we only focus on the short term. If we did that, we would fail in our mission as Triodos Investment Management. After all, we invest for the long term with the intention to generate social and environmental impact alongside a healthy financial return. We choose to invest for positive change and have been doing so for the past 30 years.

Our planet and society face many interconnected challenges: pressures on our environment and our social infrastructure stem from an economic system measured one-sidedly by output and growth. Countering these challenges and making our environment and our social and economic system future-proof requires a radical transformation. The challenge is not to pursue more economic growth and higher financial return, but to develop a sustainable system that respects our environment and works for the benefit of all.

We aim to serve as a catalyst in the transition to a sustainable economy where natural and human capitalare truly valued. We invest only in companies thatcontribute to a sustainable society through their products, services and business practices. In our white paper ‘Impact investing through listed equities and bonds’ we explain how we do this.

This short-term outlook serves as a reference document for us as an asset manager and for clients as investors in our SRI funds. We will update our short-term outlook on a quarterly basis, in combination with the performance of our SRI portfolios.

We deliberately present our short-term and our long-term economic outlook in separate publications, even though they are closely connected. Whereas our short-term outlook drives our TAA to exploit short-term opportunities for generating excess financial return, our long-term outlook - ‘The return of transitions’ - reflects Triodos Investment Management’s investment philosophy. The long-term expectations are the basis of the strategic asset allocation (SAA) for our SRI funds, the investment mix that provides an optimal balance between expected risk and expected return in the long term for each risk profile.

The standard Business-as-Usual scenario gives long-term returns based on standard assumptions for growth and inflation, which can be compared with other asset managers. Based on our conviction that the current growth model is untenable and given that the ‘standard’ approach does not take the ecological and social effects of economic growth into account, we describe two transition paths to a sustainable economy. These transition paths are not so much about probabilities and risks, but rather about necessities and opportunities.

Our short-term and long-term outlook come together in our investment selection. We make an active choice for shares and bonds of companies that offer concrete solutions for the necessary sustainable transition. By selecting these companies, we are convinced that we invest in the winners of the future.

Summary

Triodos Investment Management's short-term outlook

No global economic downturn in 2019, but risks will continue to build up.

Economic outlook
We expect the global economy to move slowly towards the end of the cycle. Although we do not foresee a global economic downturn for 2019, risks will continue to build up. Risks to growth are tilted to the downside, while inflation risk are tilted to the upside. Therefore, it cannot be ruled out that a recession may start earlier. While the next economic downturn will probably be less deep than the last one, it will be more difficult for policymakers to pull the economy out of the doldrums. Counter-cyclical fiscal policies, such as those successfully carried out at the start of the last crisis, will hardly be an option for any subsequent recession in many countries.

We expect that economic growth in developed countries will gradually fall back to trend level. Some emerging economies will continue to perform well in 2019, but this cannot prevent a likely decline in growth for the group as a whole. Following an increase in commodity prices, inflation rose worldwide. The effects of this will fade out next year, which is likely to bring down headline inflation again. With large differences between regions, core inflation continues to rise in developed countries.

Investment outlook
As stated in our economic outlook, we think the end of the cycle is imminent. The mounting risks, in combination with a change in cycle, will lead to an increase in volatility on the financial markets. Whereas US capital market rates will rise further in combination with higher inflation, European capital market rates will only rise slowly. For the time being, we maintain a neutral position in bonds.

In the longer term, we are negative because of the expected further rise in interest rates and the slowdown in growth. We expect credit spreads to rise across the board.

Equity valuations remain high, especially in the US. Given our economic outlook, we do not expect the current high price-earnings ratio to be sustainable. We therefore remain negative about US equities. Growth prospects for the eurozone are slightly better. We are mildly positive about European equity, even though political risks may hold European stock markets back in the short term. Given the economic outlook and their relatively cheap valuation, we remain positive about Japanese equity.

Short-term economic outlook

There is no denying that the current global economic cycle is in an advanced stage. This is not surprising given the record length of the current expansion phase. However, this is a worrying observation when we consider the following issues: the fact that many people have not yet, or hardly benefited at all from the economic recovery, the highly accommodative monetary stance, and the high levels of global debt.

Global: growth peak is behind us

Although the global growth peak is behind us, we expect the global economy to continue growing above trend in 2019. Growth will be less synchronised.
In many developed countries, the output gap - the difference between the actual output of an economy (as measured by GDP) and the potential output - has (almost) closed. These countries are close to their capacity utilisation rates, which will ultimately limit production. We therefore expect that economic growth in these countries will gradually fall back to trend level. First in the United States and later in the eurozone and Japan.

Some emerging economies will continue to perform well in 2019, but this cannot prevent a likely decline in growth for the group as a whole.

Following an increase in commodity prices, headline inflation rose worldwide. The effects of this will fade out next year, which is likely to bring down headline inflation again. Core inflation continues to rise in developed countries. In the US, headline inflation is expected to exceed the central bank's target, but this is not the case in the eurozone and Japan for the time being. Inflation divergence is even more pronounced within the large group of emerging countries. This is partly down to differences in cyclical positions, differences in inflation targets in place, and differences in the anchoring of inflation expectations at levels consistent with inflation targets.

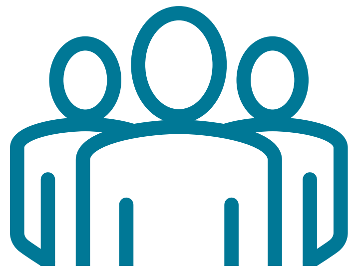
We expect the global economy to move slowly towards the end of the cycle. Any catch-up growth after the 2008 recession is now over. We also do not foresee an economic impulse from monetary or fiscal policymakers. However, we do not expect a global economic downturn for 2019. That being said, risks continue to build up. Risks to growth are tilted to the downside, while inflation risk are tilted to the upside. Therefore, it cannot be ruled out that a recession may start earlier.

While the next economic downturn will probably be less deep than the last one, it will be more difficult for policymakers to pull the economy out of the doldrums. Central bankers have their backs against the wall. There is less ammunition for monetary policy to combat a recession and the weapons in the arsenal are not as sharp as they were. Policy interest rates are still low, as is inflation, while liquidity is abundant. At the same time, the fiscal space for governments is limited. Counter-cyclical fiscal policies, such as those successfully carried out at the start of the last crisis, will hardly be an option for any subsequent recession in many countries.

Near-term risks to economic growth

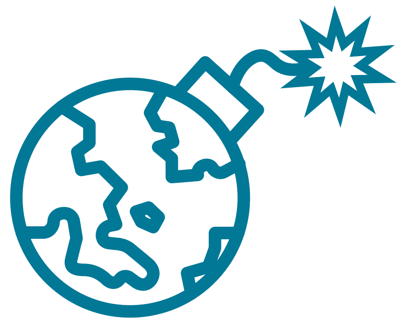
Environmental

1. Extreme weather events; negative effects on value chains, harvests and production
2. Ongoing deforrestation and pollution; loss of biodiversity



Social

1. Impact of wage inequality on growth
2. Migration flows
3. Populism and social unrest

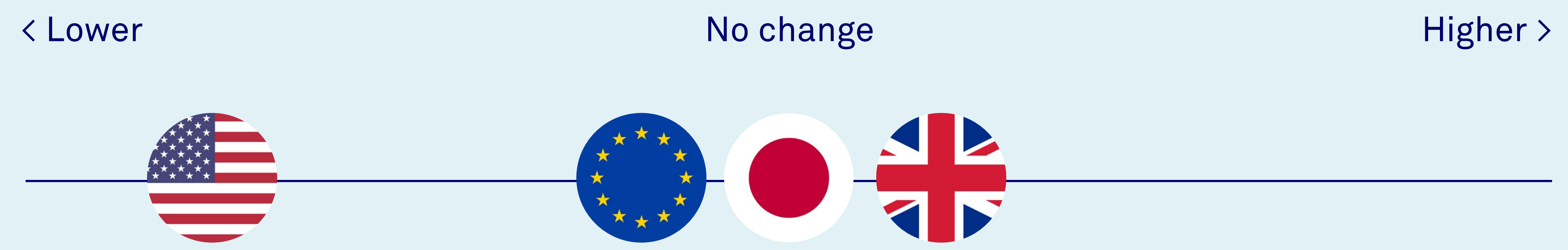


(Geo) Political

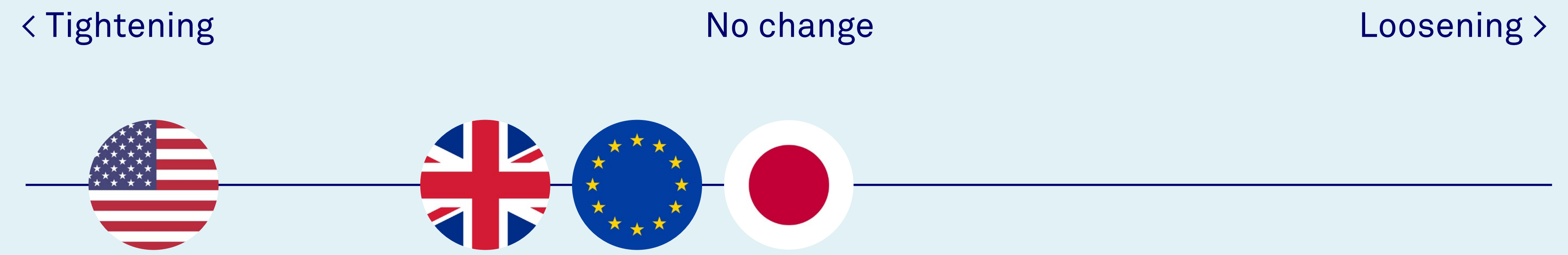
1. Full blown trade war
2. Italeave
3. Brexit

Lower economic growth, tightening of monetary policy

Economic Growth



Monetary policy



United States (US)
From tailwind to drizzle

Economy: sharp slowdown in growth
Inflation: headline inflation will exceed 2%
Monetary policy: one interest rate hike in December 2018 and two additional steps in 2019

US economic growth is high. To prevent the US economy from overheating, the American central bank, the Fed, has taken its foot firmly off the accelerator. Interest rates have been raised three times so far in 2018. Another rate hike is expected in December. The gradual tightening of monetary policy is slowly but surely increasing interest costs for households and businesses, slowing down consumption and investment growth. This is not yet reflected in the figures because the tax measures taken by the US authorities at the beginning of the year are giving the economy a boost. The effects of the tax relief will fade over the course of 2019. Due to a lack of new stimuli, economic growth is likely to slow down. The negative economic impact of the trade tariffs that were announced and implemented is expected to remain limited.

As a result of the economic upturn, there is no longer overcapacity in the economy. The underlying price pressure is therefore increasing. The Fed will likely continue to apply the brakes in 2019. The size of the Fed balance sheet is expected to decline further in the coming year as maturing bonds, which were purchased during the various bond-buying programmes, are no longer reinvested. In addition, the Fed will probably hike its policy rate two times in 2019. Experience shows that the Fed will keep hiking until something breaks. Usually this is a US recession, sometimes a crisis in emerging markets. Fed-Chair Jerome Powell has already indicated that the latter is no reason for him to stop tightening. We anticipate a (mild) recession in 2020, a presidential election year. The question is how voters will react when the economic tide turns. They have not materially benefited from the economic recovery over the last ten years. In addition, the monetary space for the Fed to stabilise the economy will be limited. With a current, unprecedented level of government debt, the budgetary room is also restricted. The US government would have been better off keeping its money for these rainy days.

Eurozone
Doing well, but not better

Economy: Marginal growth slowdown
Inflation: 2% inflation target remains out of sight
Monetary policy: bond-buying programmes will be discontinued, first interest rate hike in second half of 2019.

Economic growth in the eurozone also seems to have peaked. However, the economy is expected to perform only marginally worse in 2019 than in 2018. Ongoing credit growth and an improving labour market support growth in consumer spending, while higher corporate profits boost investment volumes. Economic growth is likely to remain above trend, which will gradually further reduce the remaining overcapacity in the European economy.
Differences within the eurozone remain as large as ever: in the core countries, the economy has overheated considerably, while Greece has barely recovered from the crisis and austerity measures are still in place. There are several risks for growth in the eurozone, such as a hard Brexit, an escalation of the Italian budgetary issue and an upsurge in trade tensions with the US. However, we do not think that these risks will undermine the relatively positive sentiment in the eurozone. The evidence we provide in support of this are the developments of recent years; major political uncertainty has not structurally destabilised the eurozone economy. Should any of these risks materialise, however, then this could seriously affect growth. And if major incidents occur, the room for economic stimulus by both the European Central Bank (ECB) and governments is limited. Monetary policy remains very loose and governments on average have less fiscal room for manoeuvre than before the financial crisis.

Although inflation rose to above 2% in 2018, this was mainly due to higher commodity prices. In 2019, inflation is expected to fall below the ECB's inflation target of 2% again. Although core inflation will increase slightly, it remains far from the 2% target. Nevertheless, the ECB will gradually adopt a less loose monetary policy. The government and corporate bond buying programmes (QE) will stop in December 2018, but the proceeds from the maturing bonds will be reinvested for the time being. The ECB is likely to keep rates on hold until second half of 2019.

United Kingdom (UK)
Uncertainty persists

Economy: Slightly higher growth in the case of a soft Brexit
Inflation: Lower inflation due to subsiding currency effects and commodity price effects
Monetary policy: 1-2 interest rate steps

The outlook for the UK is only about one thing: Brexit. There is a great deal of uncertainty about the way the UK will leave the European Union on 29 March 2019. Negotiations about the 'divorce terms' are far from smooth. Contentious issues include the border between Ireland and Northern Ireland and what should or should not be covered by a possible free trade agreement. The economic outlook for 2019 is highly dependent on the outcome of these negotiations. Although the chance of a hard Brexit has risen to an uncomfortable level, we still assume that the outcome will be a soft Brexit. We believe that the UK and the EU will manage to achieve a last-minute deal, which will be shaped further over a transition period. During this transition period, EU rules will continue to apply to the UK.

A soft Brexit is the most favourable scenario for the British (and European) economy. Nevertheless, economic growth in 2019 in this scenario will not be much higher than in 2018. Even with a Brexit deal, the uncertainty will not disappear after 29 March 2019. This is likely to mean companies remain reluctant to invest, even though there is a squeeze on the labour market. Household spending will probably increase as imported inflation subsides, and nominal wage growth gathers pace. In this relatively favourable scenario, the Bank of England (BoE) will likely raise its policy rate once or twice to curb inflation. If, however, there is no Brexit deal, GDP could fall, and the sterling would probably weaken again.

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Japan
Stable and predictable

Economy: stable growth
Inflation: 2% inflation target remains out of sight
Monetary policy: no significant change

GDP growth is likely to pick up a bit in the coming year. The shortage in the labour market remains high, which finally seems to translate into stronger wage growth. This will support consumer spending, at least until the next sales tax hike planned for October 2019. Beyond that date, experience suggests that growth will slow abruptly once more. Given the tight labour market, business investment is expected to remain an important growth driver.

Although the Japanese economy has been growing above trend for some time now, the Bank of Japan (BoJ) is finding it difficult to reach the 2% inflation target. In 2019, this target will probably remain out of reach. We would not be surprised if the central bank lowers its inflation target or even abandons it completely (and replaces it with a nominal growth target). There is little chance of a material change in the policy from the BoJ. The BoJ is likely to continue the current monetary policy of quantitative and qualitative easing (QQE) over the next few years.

Through this programme, the BoJ not only buys Japanese government bonds, but also listed equity funds. We also expect the ‘yield curve control’ - with which the Japanese central bank aims to keep the ten-year yield on Japanese government bonds around a certain percentage - to remain in place. Although the percentage is likely to be gradually increased.

Emerging countries
Pressure increases

Economy: on balance a slowdown in growth
Inflation: on the rise
Monetary policy: devaluation of currencies, especially Chinese renminbi

Economic growth held up much better in 2018 than developments in financial markets in the emerging countries would suggest. Some economies will continue to perform well in 2019, but this cannot prevent a likely decline in growth for the group as a whole.

In 2018, Chinese policymakers were once again confronted with a slowdown in growth. Tried and tested methods were used to try to stimulate growth: encouragement through higher (local) government investments, fuelling credit growth, and monetary stimulation. Nevertheless, we believe that economic growth will continue to slow down in 2019. So far, the hit from US tariffs has been offset by the benefits of renminbi depreciation. But if tariffs are raised further next year in line with US threats, they could become a headwind. A number of domestic factors will also limit growth. Chinese policy is increasingly focused on the quality of economic growth rather than quantity. Due to this change of direction, credit growth has diminished, which has eliminated an important driver for economic growth. More attention is being paid to environmental pollution, income inequality and the mitigation of financial risks[1]. In this respect, China is taking significantly larger steps than many Western countries. A negative interpretation of this is that it is most needed in China. But we prefer to look on the bright side: a large-scale energy transition is seemingly possible, as long as it is well managed. We think that the slowdown in growth is structural.

The focus on the quantity of growth in the past has resulted in an explosive increase in the Chinese debt mountain. Countries that take on so much debt in such a short time usually encounter a hard landing. It is therefore not surprising that concerns about financial stability are increasing. We believe that Chinese policymakers can avoid a financial crisis. They have the administrative and financial resources to engineer a soft landing.

The weakness in China is likely to weigh on the rest of emerging Asia in the coming quarters. However, weaker external demand may be partly offset by a supportive fiscal policy. In emerging Europe, the growth trajectories diverge. Turkey has most likely gone into a recession, while growth in Eastern Europe will probably slow. The Russian economy is gaining momentum. In many countries in Latin America growth will probably accelerate. The outlook for Mexico is the brightest, thanks to the new trade deal with the US and Canada. The economic outlook for Argentina will probably remain bleak.

We believe that Chinese policymakers can avoid a financial crisis. They have the administrative and financial resources to engineer a soft landing.

[1] Banks are writing off more bad loans, several regulators have merged to boost monitoring, the shadow banking sector has been restricted, and new asset management rules have been introduced.

Growth projections 2018-2019

	GDP-growth			Headline inflation		
	2017	2018	2019	2017	2018	2019
US	2.2	2.75-3.25	2.0-2.5	2.1	2.25-2.75	2.0-2.5
Euro area	2.4	1.5-2.0	1.25-1.75	1.5	1.5-2.00	1.25-1.75
Belgium	1.7	1.25-1.75	1.25-1.75	2.1	1.75 - 2.25	1.75-2.25
Germany	2.2	1.25-1.75	1.25-1.75	1.7	1.75-2.25	1.75-2.25
Netherlands	2.9	2.5-3.0	1.75-2.25	1.4	1.25-1.75	2.0-2.5
Spain	3.0	2.25-2.75	2.0-2.5	2.0	1.5-2.0	1.25-1.75
UK	1.7	1.0-1.5	1.0-1.5	2.7	2.25-2.75	2.0-2.5
Japan	1.8	0.75-1.25	0.75-1.25	0.5	0.75-1.25	1.0-1.5

Short-term investment outlook

Increasing risks and the end of the Goldilocks economy will lead to increased volatility.

At the end of last year, the global economy was in a so-called Goldilocks scenario: a situation in which the economy is not so hot that it causes inflation and not so cold that it turns into a recession. Financial markets benefited from healthy profit growth and low interest rates. Stocks performed well. With hindsight, we can say that Goldilocks ran into the Bear family at the beginning of 2018. Above-trend growth is pushing inflation higher, while the Fed continues to tighten. Higher bond yields lead to lower equity valuations. The downside risks to global growth have risen, while upward inflation risks have also increased. Financial market volatility increased in 2018, although it is still relatively low.

The end of the cycle appears to be imminent. This brings us to the question which factors will be the cause of the next recession. Experience has shown that this is usually down to a combination of factors, rather than one specific factor. Such a combination is now largely in place. The global economy has become accustomed to an extremely supportive financial environment (ample liquidity, low interest rates) due to the extremely loose monetary policy of recent years. This environment has led to an increased appetite for risk and a search for yield. As a result, stock prices are deviating from their economic fundamentals. When risks are not adequately priced, and equity valuations are stretched, then the consequences of a sudden turnaround in market sentiment are potentially huge. Numerous factors can cause a reversal in market sentiment, such as a full-blown trade war, other (geo)political events or changing market expectations about the number of interest rate hikes implemented by the Fed. Given the risks, in combination with the end of the Goldilocks economy, we expect further increase in volatility.

Bond markets

The Fed is likely to continue to raise its policy rates in 2019. US capital market rates will rise further in combination with higher inflation. This will ultimately also happen in the eurozone, but later. Given the very gradual normalisation of monetary policy, we expect that the money market rates will rise very little in the eurozone in 2019. Savers should therefore not expect too much return on their savings over the next year. Due to relatively robust economic growth and gradually rising core inflation, European capital market rates will only rise slowly. The ECB's monetary policy will remain too loose for a strong rise to occur. Political risks also remain for the time being. This can occasionally lead to a flight to safety, which limits the rise in capital market rates in the core countries. For us, this is the reason to maintain a neutral position in bonds for the time being. We prefer an underweight position in the longer term because of the expected further rise in interest rates.

The extremely loose monetary policy of recent years has led to ever lower yields on corporate bonds and narrower credit spreads. With yields still well below the long-term average, corporate bonds have been expensive for years, both in Europe and the US. In view of their high valuation, corporate bonds have a limited ability to absorb higher interest rates. Even if credit spreads do not increase significantly, higher interest rates imply a rise in corporate bonds yields. Investors will not lose any sleep over this for the time being. Realised volatility remains relatively low. This complacency is a risk, especially in view of our macroeconomic forecasts. The expected slowdown in growth, combined with high interest rates and higher corporate debt positions will inevitably lead to losses. Credit spreads are expected to increase across the board.

Equity markets

Despite recent market movements, valuations remain high, especially in the US. Given the economic outlook, we do not expect the high price-earnings ratio to be sustainable. The effect of the tax reduction has already been taken into account by the markets. The abundance of liquidity is decreasing as the large central banks slowly rollback their extremely loose monetary policies. Moreover, we do not think that profit growth will continue. The consensus of expectations for economic growth are already high and profit growth limits the upward potential; put simply, it cannot easily be much better. As a result, sales expectations cannot be easily surpassed. The scope for further margin expansion also seems limited, given the increasing tightening on the labour market and rising credit costs. An alternative is to increase productivity faster, but this has generally proved difficult in recent years. We remain negative about US equity.

European equity markets have lagged behind US equity markets for many years. This was no different in 2018. In addition to the trading tensions, European equity markets have suffered from difficult Brexit negotiations, Italy's reckless budget plans and a currency crisis in Turkey. We believe that European equity can benefit from relatively favourable economic growth prospects combined with limited (wage) inflation and a loose monetary policy. Ongoing political risks may, however, prevent European stock markets from moving upwards in the near term. We remain (slightly) positive about European equity.

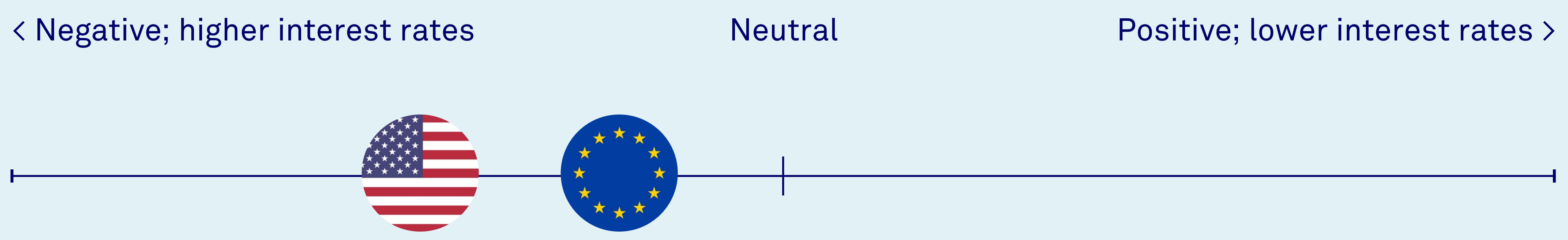
Japanese equity is relatively cheap. The Japanese central bank supports the equity market through its QQE programme and we do not expect that this programme will be terminated in the near term. In addition, the weak Japanese yen is good for Japanese stocks. Combined with the economic outlook, we expect profits to remain solid. We remain positive about Japanese equity.

Tightening of liquidity due to the normalisation of US monetary policy and a strong US dollar has led to problems in a number of emerging economies, such as Turkey and Argentina. This came as no surprise. The IMF and the Bank for International Settlements, among others, have been warning for years about the sharp rise in dollar denominated debt in emerging countries. Everyone knew that there would come a time when emerging countries with a high current account deficit and/or a large budget deficit would run into difficulties. These countries are, after all, heavily dependent on foreign investors to finance their high deficits. In their search for yield, many investors were willing to invest in emerging markets. With dollar liquidity now decreasing, investors are becoming more cautious.

In recent months, several emerging countries have faced capital outflows, which has led to a fall in equity prices. This has been good for valuations. Nevertheless, caution is still required. A more restrictive monetary policy in the US, a strong dollar, rising trade tensions, and/or country-specific risks continue to apply pressure to the profit forecasts. We do not think that the suffering is over yet. As far as we are concerned South Africa and India are the weakest parties, closely followed by Turkey and Argentina.

Market outlook

Government bonds



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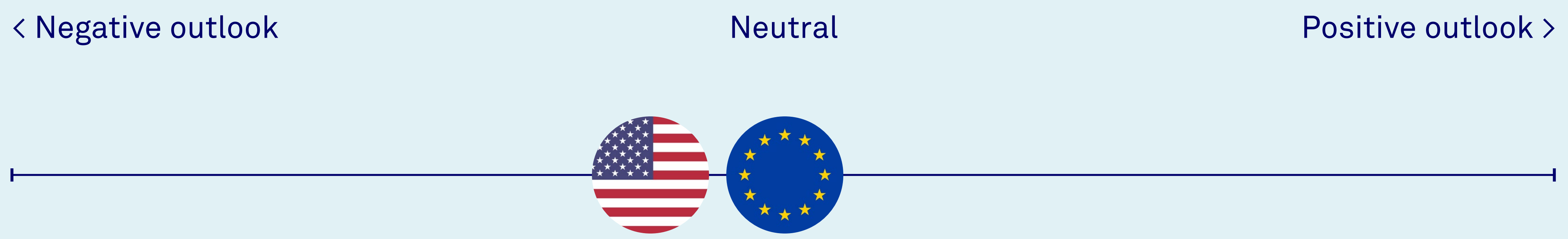
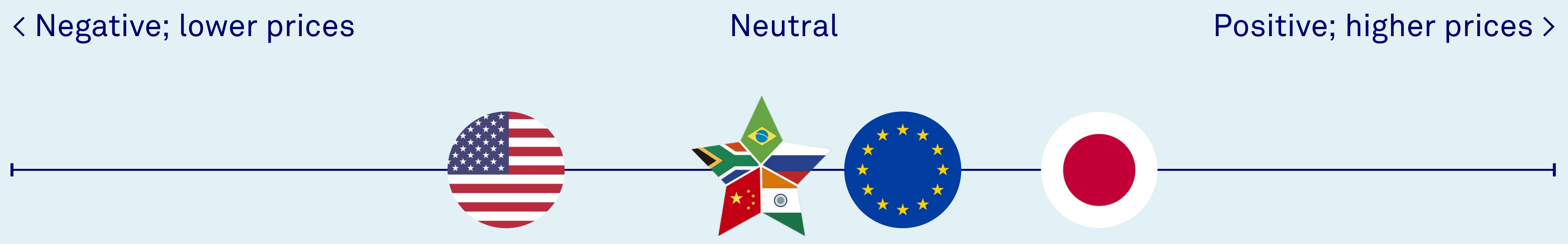


Equity



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With over 25 years of experience as a globally active impact investor, and as a wholly-owned subsidiary of Triodos Bank, Triodos Investment Management has developed deep sector-specific insights across Energy & Climate, Inclusive Finance, Sustainable Food & Agriculture, Sustainable Real Estate, and Socially Responsible Investing in listed equities and bonds. Assets under management as per 30 June 2018 amounted to EUR 4.2 billion.

Investing in positive change
For more information about the Triodos Socially Responsible Investment Funds, and other impact investment opportunities, please contact our Investor Relations team at:

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