On top of the world looking over the edge

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What goes up must inevitably come down, so, in terms of managing expectations for 2019, I think it's important to consider how the unwinding of history's longest bull-run might play out.

My view is the US Federal Reserve will likely maintain the current pace of interest rate rises. Coupled with a still-strong dollar and continued trade tensions between the US and China, I see this as a classic policy error of central banks. Problems, when they come, will likely reach beyond the usual suspects and into emerging markets, in my view.

If this scenario does come to pass, what shelter is available to investors?

Arguably, the more defensive equity holdings are those that are not economically exposed. Here, the classic example is consumer staples – so shampoo, cosmetics, or washing powder, for example.

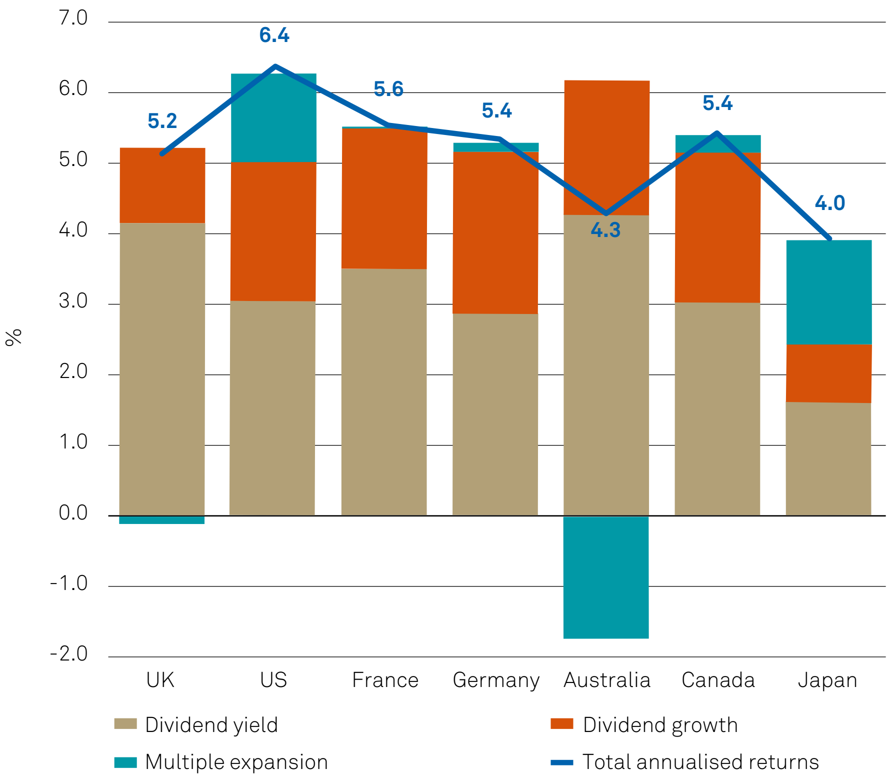
Near-term earnings visibility is helpful too. In a downturn, company growth is important but not as important as an ability to avoid decline. Strong balance sheets help. They provide flexibility (the contrast here is with highly levered companies, where the need to service debt often ends up dictating the actions of equity holders).

If the company also produces a decent and sustainable dividend yield, that then becomes a strong contributor to returns; if the yield is reinvested as the share price falls, capital losses can be recovered more quickly.

I think it's safe to say I have more confidence in predicting bright spots in 2019 at a company level: stable businesses with strong balance sheets that are not highly valued. Theory would suggest they could become more highly valued as people seek those defensive qualities, inviting the opportunity to then rotate into other areas 'after the flood'.

DIVIDENDS – HISTORICALLY THE BIGGEST DRIVER OF EQUITY RETURNS

Compounding effects of dividend yield dominates real returns in the long term (1970–Q2 2018)



For illustrative purposes only.
Source: Thomson Datastream, total annualised real return in local currency. 30 June 2018.

> A turkey is fed for 1,000 days by a butcher. Every day confirms to the turkey, and the turkey's economics department and the turkey's risk management department and the turkey's analytical department, that the butcher loves turkeys. Every day brings more confidence to the statement, but on day 1,001, there will be a surprise for the turkey...
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> **NASSIM NICHOLAS TALEB, ESSAYIST**

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