BNY MELLON
WEALTH MANAGEMENT

2019 Outlook: A Year of Transitions

By Leo P. Grohowski
Executive Vice President
Chief Investment Officer

Highlights

- Slowing global growth but no recession in 2019
- Continued removal of financial liquidity
- Drift higher in inflation and rates flattens yield curve further
- Moderate equity return expectations
- Volatility persists amid trade, growth and political worries
- Diversification, discipline and flexibility critical

Trade, higher interest rates and politics dominated financial markets in 2018, resulting in a volatile and challenging year for investors. After a strong run, global equity markets corrected, adjusting to a new environment of higher rates and a less accommodative Federal Reserve. Even fixed income provided little reprieve for investors as a drift higher in interest rates delivered little in the way of return.

We believe 2019 will be a year of transitions. Unlike the start of 2018, when economies around the globe were delivering synchronized growth, we expect the long global expansion to endure but transition to a slower pace. The relative deceleration in growth is due in part to the fading of U.S. fiscal stimulus and the reduction of financial liquidity as other central banks join the Fed in tightening monetary policy and winding down quantitative easing programs. But with inflation expected to remain contained and our projection of interest rates moving only modestly higher, solid earnings growth should support equity markets.

We do not expect a smooth ride, however. The market volatility that appeared this year should continue, as uncertainty around monetary policy, trade, and potentially disruptive geopolitical events persists. The transition to slower global growth, the fading of financial liquidity and more modest return expectations require a more balanced and active approach between return and risk within portfolios as we enter the next phase of this long global expansion.

The Long Expansion Slows

While the global expansion is set to slow and risks are emerging, we do not expect these forces to threaten the broader expansionary theme in 2019. BNY Mellon Wealth Management forecasts real global gross domestic product (GDP) to slow from 3.7% in 2018 to 3.5% in 2019. In the U.S., growth will likely moderate from the projected real GDP growth of 3.0% in 2018, to trend growth of near 2.0%.

The U.S. economy remains healthy. The labor market is strong, with the unemployment rate at 3.7%. Jobs growth is robust. The U.S. has added an average of over 200,000 non-farm payroll jobs per month over the prior 12 months. Consumers are spending, as evidenced by solid retail sales growth of approximately 4–5% year-over-year. However, concerns about the sustainability of spending are beginning to emerge, with housing growth under pressure as mortgage costs rise and auto sales slow. Nevertheless, we believe the U.S. economy will continue to grow albeit at a slower pace in 2019, as the boost from the corporate and personal tax cuts begins to fade and higher interest rates weigh further on sensitive areas.

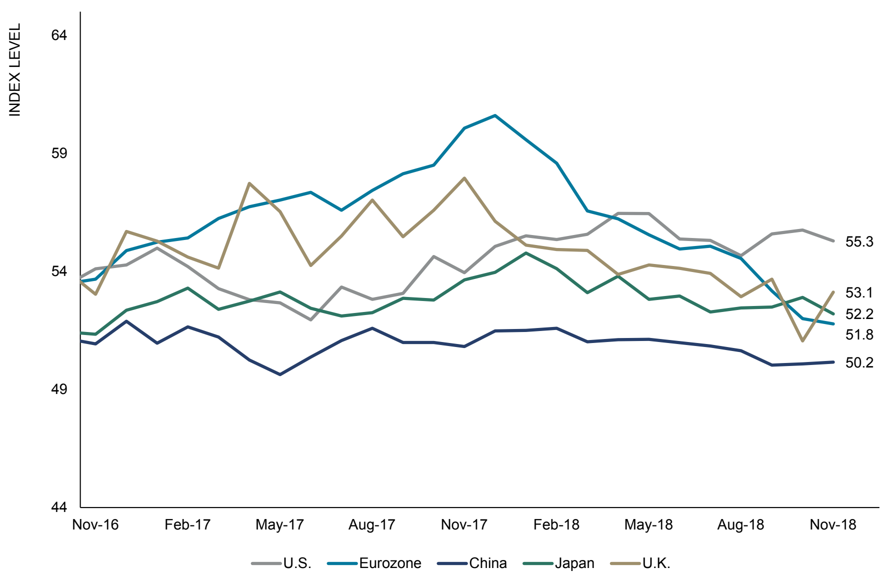
Europe, China and some emerging market economies have seen a softening of data in 2018, pressured by tighter financial conditions, political risk and ongoing trade tensions. Low interest rates and strong consumer demand is expected to sustain the Eurozone's economic growth next year. However, political uncertainty regarding budget challenges in Italy, the terms of the United Kingdom's exit from the European Union and leadership changes in Germany could all pose risks to growth for the region. Japan's GDP, which has been nearly flat, is expected to deliver 1% growth next year.

Consistent with consensus estimates, we expect China's growth should moderate to about 6% in 2019. As trade negotiations continue into the new year, China will need to try to balance its stimulative efforts while maintaining business and consumer confidence so as not to exacerbate any slowdown in growth. Other emerging market countries have seen slowing growth as well, as a result of tighter financial conditions, a strong U.S. dollar and a decline in consumer spending. Despite these challenges, we expect most developing countries will expand in 2019. However, more vulnerable countries with current account deficits, like Turkey or Argentina, could face additional headwinds if the dollar continues its upward path throughout 2019.

We regularly monitor country- or region-specific Purchasing Managers' indexes (PMIs), which can serve as a leading indicator of economic health (see Exhibit 1). The U.S. continues to show a positive trend as business confidence, employment and new orders remain strong. The Eurozone and U.K. PMIs remain weak, although they still denote expansion, with readings above 50. China's latest manufacturing data declined to its lowest level in over two years, with new export orders in contraction for the sixth straight month. Additionally, industrial production is confirming these trends in economic activity, with Eurozone activity declining from nearly a 4% annual pace at the start of the year to 1% more recently. U.S. industrial production remains robust at a 3.9% annual pace, moderating from strong midyear numbers. Meanwhile, output activity in Japan has been flat year-over-year, but readings have been volatile and trending down.

Exhibit 1. Global PMIs

Regions/Countries at Differing Points in The Business Cycle



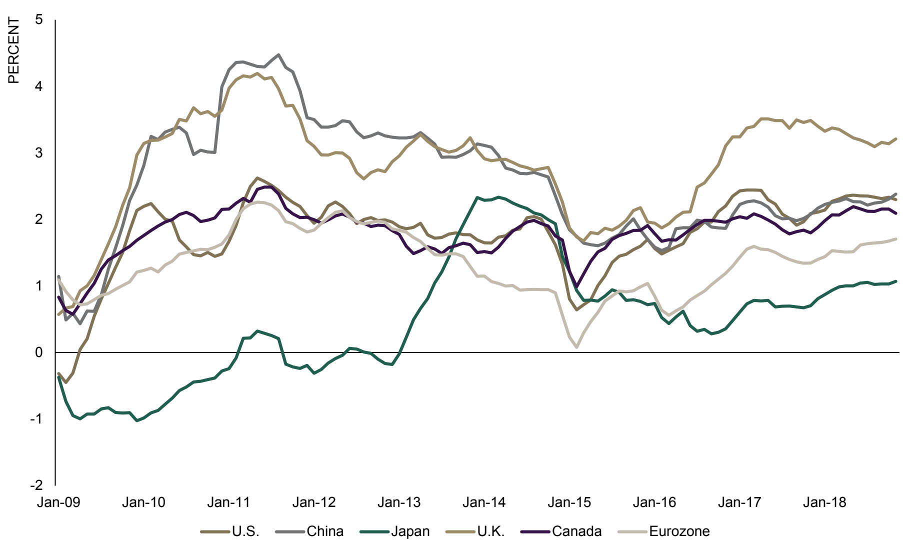
As of 11/30/2018. Source: FactSet.

Central Banks Continue Monetary Tightening

The sustainability of the long-lived global expansion will undoubtedly be impacted by the actions of central banks. Despite well-contained realized inflation to date, our expectation is for a drift — but not a spike — higher in inflation. A pickup in U.S. economic activity, low unemployment and near 2% inflation has allowed the Fed to continue its tightening in 2018. As expected, the Fed raised the federal funds rate by 25 basis points at its December meeting and trimmed its forecast in 2019, from three to two hikes. The Fed's shift in projections aligns with our expectation of a pause next year with only two, or possibly fewer, rate hikes.

The European Central Bank formally ended its bond buying program at its December policy meeting and confirmed that it will begin to raise its policy rates in the second half of 2019. The Bank of England will likely continue its normalization next year, subject to the ultimate outcome of the imperiled Brexit negotiations. Meanwhile, the Bank of Japan has stated that it will keep rates at zero given the slowdown in growth and lack of inflationary pressures with core consumer prices at 0.4% year-over-year. The Bank of Canada is expected to continue raising rates in 2019 given that core inflation is near its 2% target rate. The Peoples Bank of China has been easing monetary policy by bringing down market interest rates and cutting bank reserve requirements and we believe will likely ease policy further in 2019 to help offset China's slowing economic growth and trade uncertainty.

Exhibit 2. Inflation Expectations Drifting Higher



As of 11/15/2018. Source: Thomson Reuters.

Dynamics Within Fixed Income

Global bond yields remained low in 2018, while U.S. government bond yields moved higher for much of the year. As was expected, the U.S. Treasury yield curve flattened as illustrated in Exhibit 3. The short end of the yield curve has increased more than the long end, as inflation expectations remained generally muted and bond markets seemed to begin to price in slowing economic growth in 2019. Credit spreads remained at historically tight levels throughout the year until the fourth quarter when concerns about a growth slowdown increased.

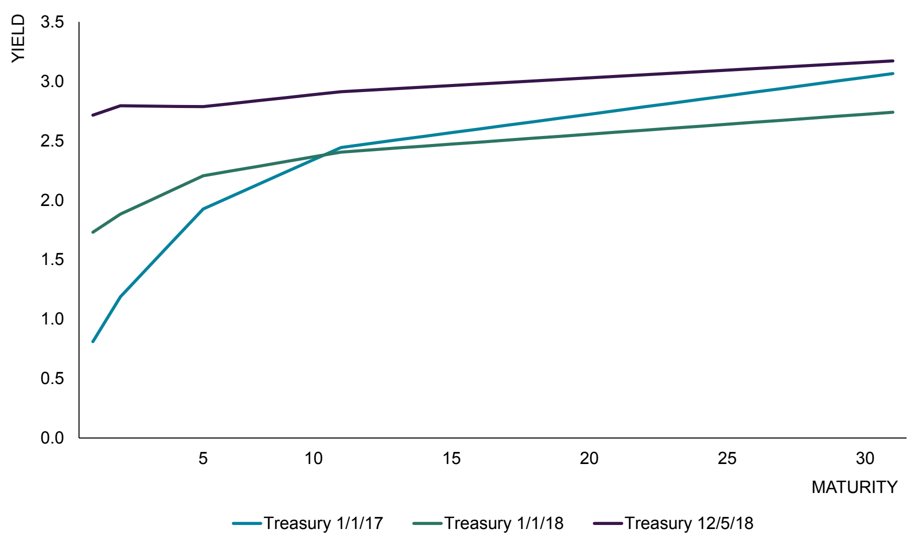
We expect a similar pattern to unfold in 2019: a gradual increase in rates and a further flattening of the yield curve, with the long end of the curve moving up less than the short end. Our projection for the 10-year Treasury note yield is a range from 2.25% to 3.5%, but, similar to what transpired this year, long-term yields are likely to peak before retreating lower by the end of 2019.

We also expect a modest widening of credit spreads. Global bond yields in Europe and Japan should only drift slightly higher from their low levels given modest inflation expectations currently estimated at 1.5% and 0.9%, respectively.

The shape of the yield curve remains a useful barometer of what's ahead for the economy. Historically, when the yield curve inverts (that is, when short-term rates are higher than long-term rates) it is thought that an economic recession can be expected to occur roughly two years later. If the Fed follows through with its forecast of two rate hikes in 2019, we would most likely see an inversion in the yield curve. However, should the inversion occur, that doesn't mean there is a recession around the corner. It is more likely several years away.

Fixed income returns should see a slightly better 2019, as we are starting the year at higher yields. Our forecast of "coupon minus" returns for fixed income has been accurate this year, and investors should expect similar returns in 2019. Yield will continue to be important in portfolios, so we expect to focus on income-producing bonds, and advocate diversification and due diligence in security selection. Credit fundamentals are still solid, with corporate bonds still benefiting from strong earnings and lower supply. We have recently moved to a neutral weighting from an overweight in high yield corporate bonds, as this asset class can be more volatile as the cycle matures despite still solid corporate fundamentals. Municipal bonds should deliver modest returns benefiting from a favorable supply/demand environment with a solid credit outlook.

Exhibit 3. Yield Curve Shifts
A Situation We Are Monitoring



As of 12/5/2018. Sources: Bloomberg.

Equity Returns Moderate

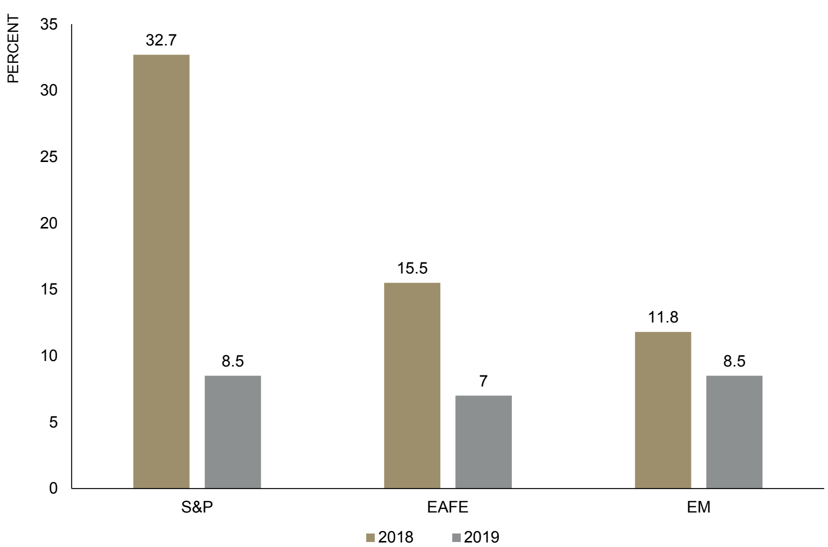
Corporate earnings growth for 2019 is expected to slow as tax benefits fade and companies manage higher input cost and wage pressures. Trade is also a risk to earnings and profit margins. Although many S&P 500 companies impacted by the current tariffs have been able to make supply chain adjustments to reduce costs or pass them along to customers, a further escalation could impact business investment decisions and profit margins.

As illustrated in Exhibit 4, U.S. consensus earnings estimates are expected to see the biggest decline given the one-time tax cut benefits that were built into 2018 estimates. Our forecast is for S&P 500 companies to still deliver a solid year-over-year earnings growth rate of 5-10%, which should translate into an operating earnings range of between $165 and $175. Earnings estimates outside the U.S. are expected to decline but to a lesser degree due to other factors, such as slower global growth, uncertainty around Brexit and Italy, and idiosyncratic factors in emerging markets (i.e. Russian sanctions) are also negatively impacting global earnings for the year ahead.

Current valuations — or the price investors are willing to pay — based on 12-month forward earnings have reset this year and are now more in line with historical averages. For example, the S&P 500 index is currently trading at a price/earnings multiple of 15.4x forward 12-month earnings and provides a dividend yield of approximately 2%. Meanwhile, international developed and emerging markets are trading at 12.7x and 11.0x, respectively. We expect little in the way of P/E expansion next year.

We continue to believe that the secular bull market in the U.S. remains intact and that earnings, rather than multiples, should continue to support equity markets, especially in light of mostly benign inflation. However, investors should expect a more moderate and choppier pattern of returns moving forward given rising rates and the later stage of the cycle. In fact, volatility has picked up in the fourth quarter of 2018. The Chicago Board of Options Exchange Volatility Index (VIX)—a closely watched gauge of investor fear—has jumped from a prolonged period in the low teens to the mid-20 level (above its 20-year average of 20).

Exhibit 4. Slower U.S. Earnings Growth
Consensus Earnings Growth Estimates



As of 12/18/2018. Source: Bloomberg, earnings growth estimates in local currency.

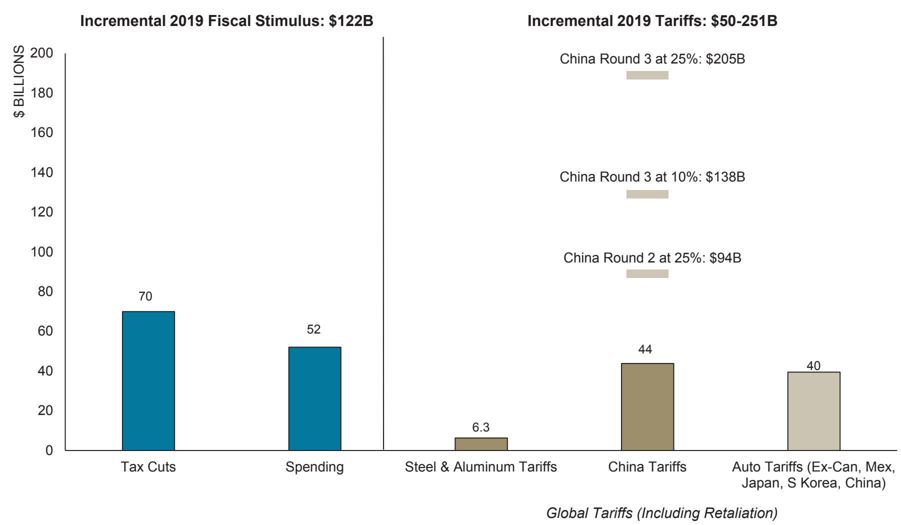
Risks to Our Outlook

Risks to our outlook include deteriorating U.S.-China trade relations, an unexpected increase in wage growth and a change in the Fed's policy stance. While the impact of tariffs on the U.S. economy has been small so far, the potential negative implications grow the longer the issue of trade and tariffs goes unresolved. The agreement for a trade truce between President Trump and Chinese President Xi Jinping at the G20 Summit was initially a positive development for the markets, but sentiment quickly turned as investors realized nothing had yet been resolved. As illustrated in Exhibit 5, fiscal stimulus of approximately $122 billion currently outweighs the tariff costs. But the scale could easily tip to the negative if increased tariff rates are imposed or additional retaliatory actions are taken.

While it is difficult to predict the outcome with any high degree of certainty, we believe both presidents want to reach a mutually agreed upon deal in the end. Nevertheless, investors should expect more periods of volatility as trade negotiations continue.

Exhibit 5. Will Tariffs Outweigh Fiscal Stimulus in 2019

Breakdown of Calendar Year 2019 Tax Cuts, Stimulus & Tariffs



As of 12/3/2018. Source: Strategas.

While inflation has been largely contained, we expect prices to drift higher, though not to a degree that would compel central banks to be more aggressive and raise rates faster. The Fed's preferred measure of inflation, the Personal Consumption Expenditure Price index excluding food and energy, rose 1.8% on a year-over-year basis through October. But with oil prices declining over 35% during the fourth quarter, we expect inflation may decline in the near term but then modestly drift higher over the course of 2019. Wage inflation pressures, however, could surprise to the upside. Thus far through this recovery, wage growth has been muted as a rising working-age population put downward pressure on prices. But as unemployment levels continue to drop and companies have a more difficult time finding quality workers, pressure on wages should increase. This is a global trend, with wages having increased approximately 3% in the U.S., 2.4% in Europe and 4% in Japan.

The Fed has recently conveyed that interest rates are close to neutral and trimmed its rate hike forecast, diminishing the risk that it might move too aggressively. However, a faster-than-expected increase in inflation caused by higher wage growth or trade developments could lead the Fed to reverse its more cautious policy stance and increase the pace of tightening.

More Balanced Positioning Provides Flexibility

Overall, we are generally optimistic about the macroeconomic backdrop of slower growth, contained inflation and modestly higher interest rates, and see little sign of recession over the next 12-18 months. Although we expect the pace of corporate earnings growth to moderate, we believe the overall environment still favors equities over bonds. (See Exhibit 6 below, which illustrates our current asset class positioning.)

Exhibit 6. Asset Class Positioning

	Underweight	Small Underweight	Neutral	Small Overweight	Overweight
EQUITY			◇		
Large Cap				◆	
Mid Cap			◆		
Small Cap			◆		
International Developed Large Cap			◆		
International Developed Small Cap			◆		
Emerging Markets		◆			
Private Equity			◆		
Private Equity-Real Estate			◆		
FIXED INCOME		◇			
Treasuries	◆				
Investment-Grade Corporate	◆				
Tax-Exempt		◆			
High Yield			◆		
DIVERSIFIERS				◇	
Real Estate (REITs)		◆			
Long/Short Hedge				◆	
Absolute Return Hedge				◆	
Managed Futures					◆
Commodities	◆				

As of 12/5/2018.

This mid-to-late cycle stage now calls for a more balanced approach to portfolio positioning that allows for flexibility given the increased risks. We have been moderately trimming equity exposure since the summer of 2018 to get to a neutral policy stance in equities. We continue to favor domestic over non-U.S. equities. Global diversification remains important, but slowing growth, political risks and the promise of tightening on the horizon cause us to hold a neutral weight to developed international equities and a small underweight to emerging market equities despite attractive valuations. While our domestic bias has served portfolios well over the years, we will continue to monitor non-U.S. growth, valuations and currency markets as we evaluate potential shifts to our regional equity exposure.

While we believe bonds provide a necessary source of income and diversification, we have modest return expectations for the asset class as a whole given our call for a drift higher in rates. Because of that, we have a small underweight to fixed income, with a focus on income-oriented bonds within a well-diversified portfolio. As rates move higher, you can expect us to move from slightly short to a neutral duration, increase our quality because of spread widening, and have less emphasis on a barbell yield curve position given the amount of yield curve flattening that has already occurred.

Our slight overweight to diversifiers (investments that don't move in the same general direction as stocks or bonds) has provided a buffer to market volatility without the interest rate sensitivity of fixed income and should continue to play a role in portfolio diversification. Customized hedging solutions may also provide a complement to a well-diversified portfolio, especially for investors who have additional capital to put to work but who desire more downside protection.

Conclusion

Even with the challenges of trade, an uncertain monetary tightening path and potential geopolitical tensions, the current economic expansion (now the second longest in history) should continue, although at a slower pace. At the same time, central banks are becoming less accommodative, removing liquidity from the market. This less-accommodative posture has two effects: it increases borrowing costs and makes market participants reassess what they are willing to pay for assets, a process that leads to an increase in market volatility. Nevertheless, we believe financial markets should be able to deliver moderate returns amid the volatility, given our continued expectations for solid earnings growth and only a drift higher in interest rates. While the later stage of market cycles require a more balanced and diversified approach to investing, they can still be modestly rewarding for investors willing to withstand the higher volatility that often accompanies them. With that said, investors should ensure that their long-term investment plan aligns with their risk profile and what they want to accomplish with their wealth.