BNY MELLON
WEALTH MANAGEMENT

2019 Mid-Year Outlook

Navigating an Extended Cycle

A lot has changed in the last six months. Trade tensions between the U.S. and China have intensified, geopolitical tensions have increased, global bond yields have fallen and global growth has slowed to the point that major central bank policies are becoming more accommodative. Yet, despite these developments, all the major asset classes have delivered solid returns so far this year.

As we enter the second half of the year, we expect the global growth slowdown to persist, with some geographic divergence. A backdrop of lower rates, moderate inflation, and fiscal and monetary policy actions should help extend the long expansion. However, we remain focused on the downside risks related to trade disputes, European fragmentation surrounding Brexit and Italy, and other geopolitical developments (i.e., issues in South Asia, Gulf tensions) that may affect investor sentiment. Investors should expect more muted returns compared to the first six months of the year and the potential for increased volatility. As we enter the next phase of this global expansion, the transition to slower global growth and more modest return expectations require a balanced, active approach to return and risk within portfolios.

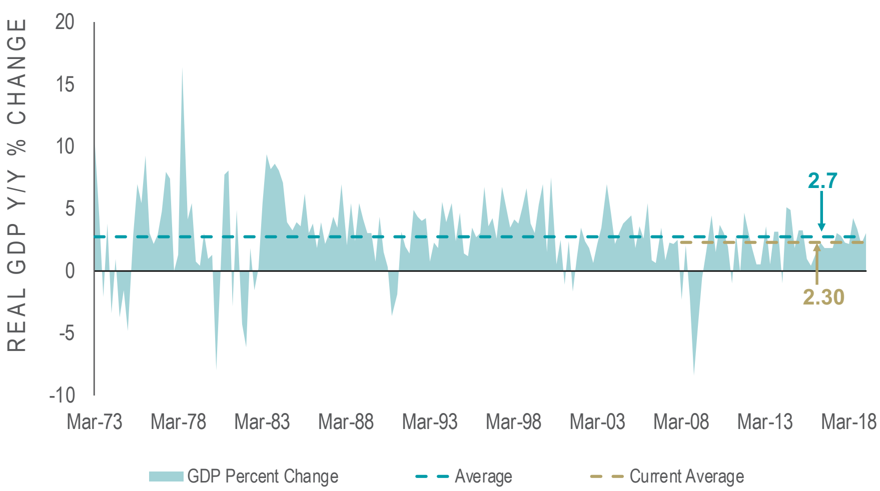
Key Takeaways

- Sustained slower global growth
- U.S. recession risk remains low
- Central banks seek to extend the long expansion
- Bond yields lower for longer
- Equities resilient, even in the midst of global trade headwinds
- Downside risks have increased, but investors likely to be rewarded for maintaining exposure

CYCLE EXTENDS; TRADE THE BIGGEST RISK

Strong labor markets, well-contained inflation and healthy consumer spending, especially in the U.S., should support the continued global expansion, though it will proceed at a slower pace. Our forecast is for a synchronized slowdown in growth. Global real gross domestic product is expected to slow to 3.3% in 2019, down from 3.7% in 2018, with the pace of growth in the U.S. decelerating to a near-trend growth of 2%, down from 3% in 2018. Still, the risk of a prolonged U.S.-China trade dispute could weaken our outlook.

Exhibit 1. U.S. Economic Growth Slows



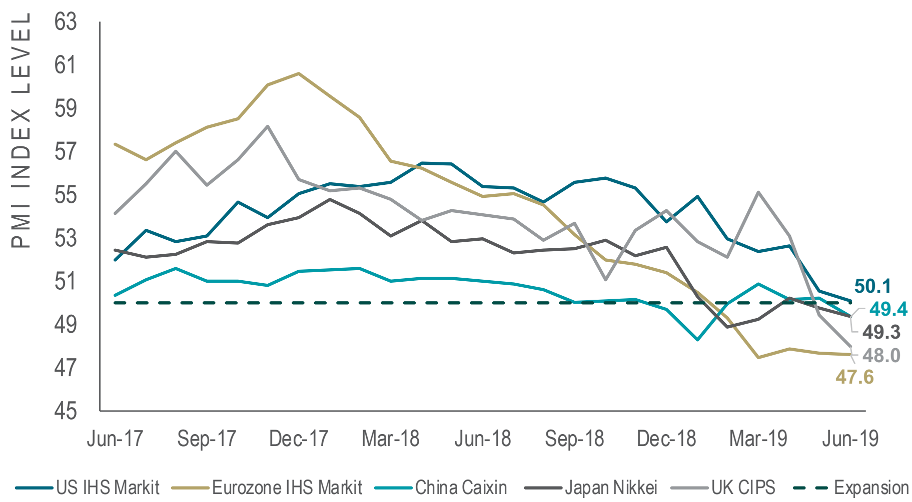
Source: FactSet

The current U.S. expansion is now the longest in U.S. history, though it has trailed the average expansion pace of 2.7% (Exhibit 1). After a strong first quarter annualized growth rate of 3.1%, we expect the pace of economic activity to edge toward a growth rate of between 1.5% and 2% over the next few quarters, and deliver an estimated real GDP of 2% for the calendar year 2019. U.S. unemployment is at 50-year lows and jobs growth slowed to an average monthly gain of 164,000 in the first five months of 2019, compared to 223,000 in 2018. Wage growth, largely stuck in neutral during this expansion, is moving modestly higher in part due to the minimum-wage increase and as a result of a tightening labor market. Average hourly earnings in May were up 3.5% from a year ago, below the 4% level that historically suggests an economy might be nearing the end of its cycle.

U.S. consumers are still quite healthy, with retail sales increasing at a seasonally adjusted 0.5% in May. Consumer confidence, though down from its peak, is still quite strong. The housing sector is also regaining some strength, aided by lower mortgage rates. We have started to see the impact of trade tensions on some parts of the economy, including manufacturing, auto sales, business sentiment and capital spending. Still, the risk of a U.S. recession seems unlikely in the near term.

Trade uncertainty is having a greater impact on other parts of the world, as evidenced by the downward trend in the Purchasing Managers indexes (PMIs), a survey measure of manufacturing activity. As seen in Exhibit 2, the Eurozone PMI has been on the decline since the start of the year and is in contraction (denoted by readings below 50) for the fifth successive month. Notably, the U.K. has seen a sharp decline amid the political uncertainty surrounding Brexit. Japan, an economy largely reliant on exports for growth, has also seen a sharp decline. China's manufacturing data fell below the level that denotes contraction for the first time in May, with new orders declining and export orders falling for the twelfth-straight month amid escalating trade disputes with the U.S.

Exhibit 2. Global Slowdown



As of 6/30/2019. Source: Factset.

As a result of weaker growth, trade stress, and political uncertainty in the U.K. and Italy, we expect the Eurozone to deliver weaker but positive growth. A strong labor market, an improvement in consumer confidence and an accommodative central bank should help stabilize growth. China's growth has slowed due in part to the prolonged trade tensions with the U.S. as evidenced by a slowdown in industrial production, a decline in fixed investment and softer manufacturing activity. Solid consumer consumption and Chinese stimulus measures have helped to stabilize growth thus far. As trade negotiations continue, however, China will need to balance its stimulative efforts with maintaining business and consumer confidence, so as not to exacerbate any slowdown in growth.

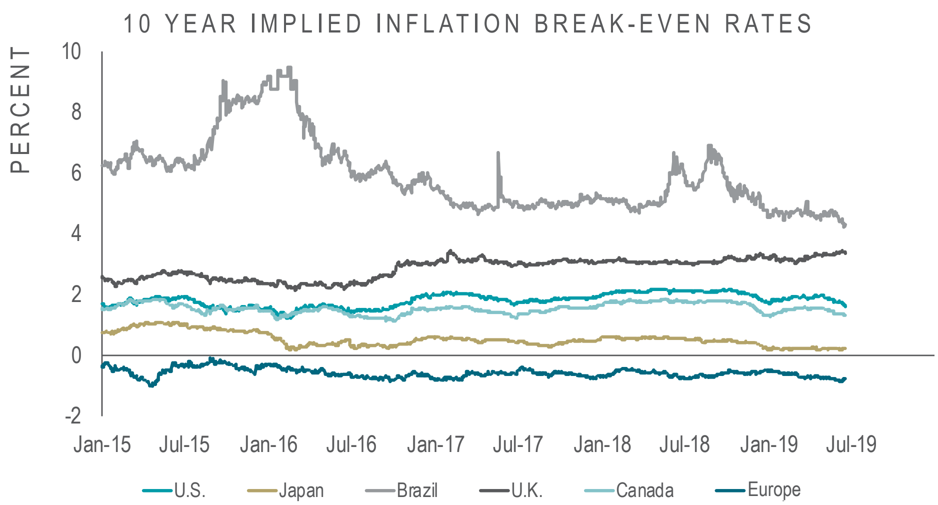
Trade remains the biggest risk to our economic outlook, with developments following the G-20 meeting likely pivotal for trade relations and the markets. As we expected, the summit produced a cease fire, with the avoidance of additional tariffs as negotiations continue. While renewed talks are welcomed, a worsening of trade tensions could increase the risk of recession given that additional tariffs may not only weigh on growth and corporate profits, but also affect business and consumer confidence as well. That is not our base case, however. In the end, both economies need to reach some type of deal for growth. We expect a modest deal will eventually be reached, but not without some shifts in market expectations over the coming months.

CENTRAL BANKS TURN MORE DOVISH

The Fed began the year by pivoting from being on autopilot in its tightening cycle to putting interest rate hikes on hold. As expected, the combination of slowing growth, tepid inflation and trade uncertainty caused the Fed to make yet another shift to its monetary policy at its June meeting.

The latest inflation data in the U.S. shows the core consumer price index, excluding food and energy prices, falling to a 14-month low in May to 1.8% year over year. More importantly, the Fed's preferred measure of inflation, the price index for personal consumption expenditures (core PCE), is at 1.6%, well below the central bank's target of 2%. Soft data is also feeding into longer-term inflation expectations. As illustrated in Exhibit 3, the 10-year break-even rate, a market-based measure of investors' expectations for the average annual rate of inflation over the next 10 years, has fallen in many parts of the world.

Exhibit 3. Inflation Expectations



As of 6/17/2019. Source: Strategas.

Consistent with our expectations, the Fed left the federal funds rate on hold and eased forward guidance. Without an actual rate cut, the easing in the Fed's forward guidance can limit the magnitude of a further weakening in business and market confidence now, while leaving the option to either ease or stand pat later. The market is now pricing in a 100% chance of a rate cut at the Fed's July meeting, with the odds leaning towards 25 basis points.

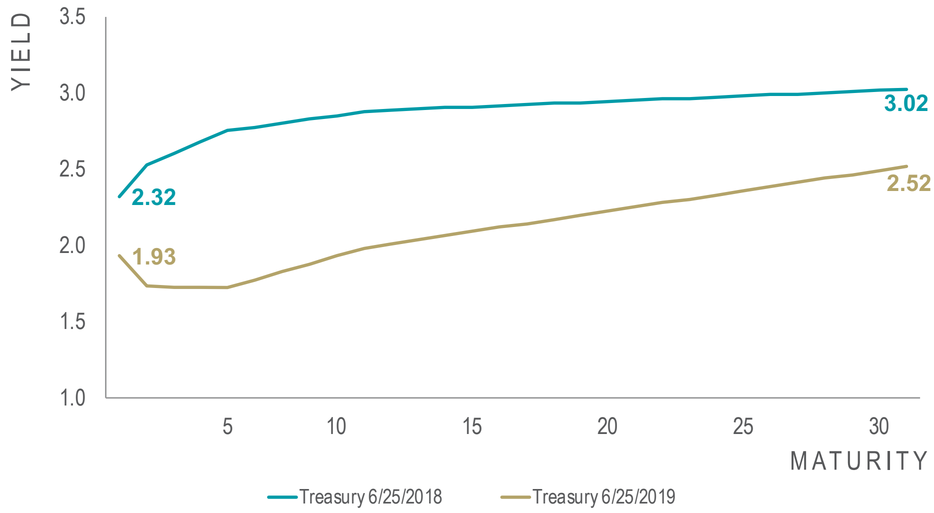
Weaker-than-expected inflation readings, as well as a decline in inflation expectations, have led major central banks around the world to shift to a more accommodative stance. The European Central Bank, Bank of Japan and the Bank of England all kept policy rates steady at their June meetings, but joined the Fed in signaling readiness to introduce new stimulus, including possible rate cuts, in the months ahead. The People's Bank of China continues to pump liquidity into the financial system and the government plans to boost demand for consumer goods such as automobiles, home appliances and consumer electronics. In its latest efforts to stimulate growth, the central bank has indicated a plan to accelerate the financing of infrastructure projects.

RATES LOWER FOR LONGER

The decline in global bond yields over the past six months is consistent with weaker-than-expected inflation data, slower growth and shifting central bank policy. German and Japanese 10-year bond yields are both below zero. Consequently, over $10 trillion in sovereign debt is offering negative yields, up from $6 trillion back in September of 2018. The yield on the 10-year Treasury note has fallen roughly 60 basis points since the start of the year, recently even piercing 2% for a short period — a level not seen since late 2016.

As a result, the U.S. Treasury yield curve is lower and flatter than a year ago, with parts of the curve inverting (where short-term rates are higher than long-term rates). Historically, an inverted yield curve has generally signaled a contraction in the U.S. economy. In examining the cause of this current inversion, the yield curve suggests that Fed policy is too tight. We could potentially see a steepening of the yield curve if the Fed does ease as the market is suggesting.

Exhibit 4. Yield Curve Shifts



As of 6/25/2019. Source: Bloomberg.

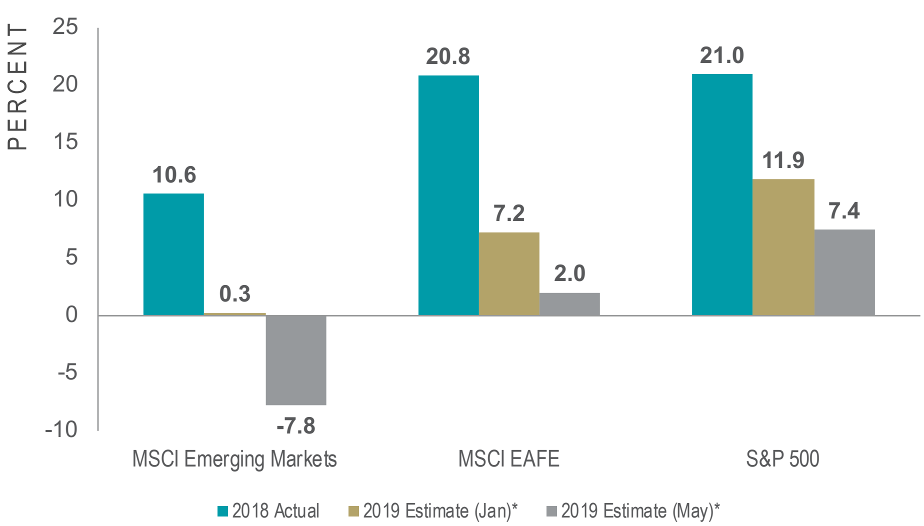
As long as global rates stay low, U.S. rates are likely to remain lower, as well. We could see longer-term rates in the U.S. move lower before moving higher if risk-off sentiment ensues following a further deterioration in trade negotiations and/or other geopolitical tensions. It seems plausible that interest rates stay in a lower range of 1.75–2.25% for the remainder of the year as they remain anchored by global rates.

EQUITY MARKETS RESILIENT

After strong earnings growth last year, slowing growth and trade tensions have resulted in a notable decline in consensus earnings estimates for 2019. In light of the potential impact to earnings and profit margins, we have lowered our year-over-year earnings forecast for the S&P 500 to the low single digits (3-5%), which should translate into an operating earnings range of between $160 and $170. Although many S&P 500 companies affected by the current tariffs have adjusted supply chains to reduce costs or pass them along to customers, further escalation could impact business investment decisions and profit margins.

Earnings estimates outside the U.S. have been affected by trade tariffs, softer global demand, and uncertainty around Brexit and Italy. After a strong year of earnings growth in 2018, one-year forward earnings growth estimates have come down across regions since the start of the year (See Exhibit 5). Importantly, earnings growth remains positive, except in emerging markets. If we see progress on a trade resolution, earnings have the potential to surprise to the upside.

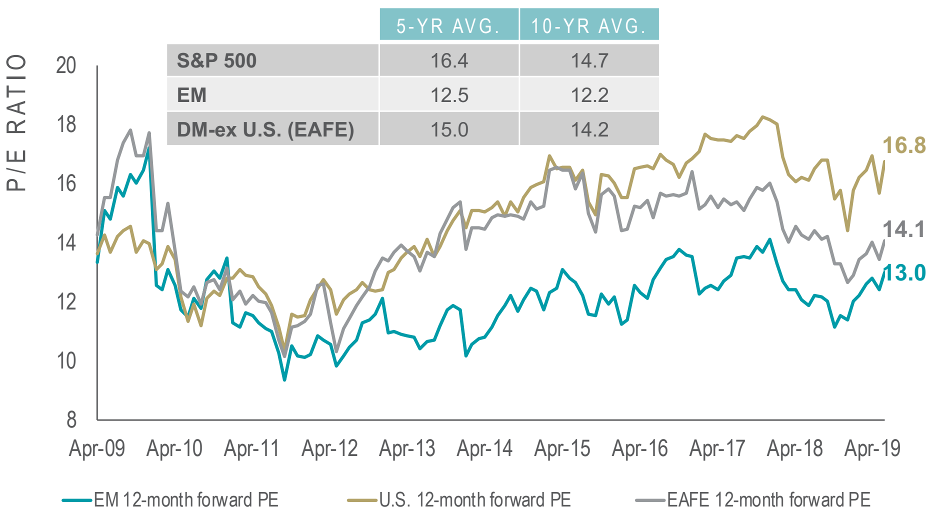
Exhibit 5. Earnings Growth and Estimates



As of 6/25/2019. *One-year forward earnings growth estimates.

Current valuations — the price investors are willing to pay — based on 12-month forward earnings are fairly valued based on historical averages. For example, as illustrated in Exhibit 6, the S&P 500 index is currently trading at a price/earnings multiple of 16.8x forward 12-month earnings, up from 15.4x at the end of last year and slightly above its five-year average. Emerging markets, as measured by the MSCI EM index, are also currently trading above their five-year average. Meanwhile, international developed equities, as measured by the MSCI EAFE index, are somewhat more attractive, trading at 13x.

Exhibit 6. Price/Earnings Valuations: Global Stocks Fairly Valued



MSCI EM and MSCI EAFE are used for EM and EAFE equity indices. Data as of June 25, 2019.
Source: FactSet and Bloomberg.

We are generally positive about equities given that earnings growth fundamentals remain intact, even in light of slower economic activity. Additionally, moderate inflationary pressure and loosening monetary policy should support equities moving higher. The ride is expected to be volatile, however, as risks and the potential range of outcomes have risen.

POSITIONING FOR AN EXTENDED CYCLE

In our view, the long expansion can continue, albeit at a slower pace, supported by a strong labor market, well-contained inflation, and more accommodative monetary and fiscal policy. Risks have increased in recent months with fits and starts to the U.S.-China trade negotiations, continued Brexit uncertainty, and emerging geopolitical risks. With such idiosyncratic risks difficult to forecast given the range of possibilities, it is important to maintain a balanced portfolio and be prepared for the volatility and potential pullbacks often associated with late cycles.

In this "lower-for-longer" rate environment, we continue to recommend a small underweight to fixed income. Total returns from the asset class are expected to be more modest than those generated in the first half of the year given the decline in rates and flatness of the Treasury yield curve. Investors should expect a return of capital rather than the price appreciation seen in the first half. We continue to recommend a high-quality portfolio of short-to-intermediate bonds, while still looking for opportunities to add yield to portfolios. We like U.S. credit with exposure to high yield corporate bonds, with a preference to fixed over floating rate. The municipal bond market's solid fundamentals of strong investor demand and tight supply should continue to provide positive, but more muted, after-tax returns. This combination should provide an important source of stability and allow investors the anchor needed to withstand the volatility in the equity markets.

We maintain a neutral posture to equities and favor the U.S. given its stronger economic outlook relative to other regions, moderate earnings growth, subdued inflation and the potential for further easing by the Fed. Global diversification remains important, but we continue to maintain a neutral weight to developed international equity given slower growth, political uncertainty in Europe and less monetary flexibility. We remain underweight emerging markets despite solid longer-term growth prospects and generally attractive valuations, as this asset class tends not to dominate this late in an economic cycle. A neutral position in equities allows us the flexibility to potentially lean in and add to risk if the market turns bearish or even be a seller into market strength, assuming no change to our constructive outlook for modest but positive growth.

With an expected increase in volatility, we continue to have a small overweight to diversifiers due to their low correlation to stocks and bonds. They help to smooth the ride. We favor incorporating absolute return strategies, as they offer less correlated returns with lower volatility. Long/short equity strategies are able to participate in further equity market gains, while offering some protection by shorting those companies expected to struggle more in a late-cycle environment. For investors who can take advantage of private investments, we advocate vintage-year diversification — investing across various points of an economic cycle. We currently see opportunities in the lower middle market, with a focus on industries with strong secular trends, as well as early stage venture capital companies driving innovation.

CONCLUSION

Our mid-year outlook assumes that the global economy will be able to muddle through, but between trade, the potential for a policy mistake, geopolitical tensions and political uncertainty, the markets will have a lot to digest. The road from here will certainly be more challenging, and investors should expect a more muted and volatile pattern of returns across asset classes. We'll continue to monitor developments on trade, inflation and central bank policy actions that may change our outlook. Maintaining a balanced, well-diversified portfolio and rebalancing toward those targets, if the market takes them off course, will be important for investors as we navigate this extended cycle.

ABOUT THE AUTHOR

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Leo Grohowski is chief investment officer of BNY Mellon Wealth Management. He leads all investment strategy and investment management functions for the wealth management organization.

Mr. Grohowski joined BNY Mellon in 2007 and has more than 30 years of industry experience. Previously, he was with US Trust, Bank of America, where he was chief investment officer, responsible for investment solutions and the end-to-end investment process, including portfolio management and investment strategy for Private Wealth Management clients. Prior to his role at US Trust, he was the chief investment officer for Deutsche Bank in the Americas, overseeing more than $250 billion in assets. From 1999 to 2002, Mr. Grohowski was chief investment officer of Deutsche Bank Private Banking, serving as chairman of the Global Markets Strategy Committee and Domestic Investment Strategy group, and head of Investment Products and Services for the DB Alex Brown unit. In 1996, Mr. Grohowski joined Bankers Trust where he served as a senior trust investment officer of the Private Bank and head of the U.S. Investment Strategy group. He was with HSBC Asset Management from 1988 to 1996 and was named chief investment officer in 1993, after heading the U.S. Equities group from 1988 to 1993.

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