Weekly Market Flash

Our 2019 Market Outlook

January 4, 2018

In May 2018 the US economy achieved a milestone of sorts, outlasting the growth cycle of 1961 to 1969 to become the second-longest expansion in the country's history. In 2019 an even more auspicious accomplishment is in sight. If the economy does not experience a recession between January and July of this year it will become the longest-ever expansion, supplanting the decade of growth enjoyed between 1991 and 2001. From where we sit today, the odds appear rather strongly in favor of July arriving without a recession along the way. Indeed, for a recession to officially begin as early as July we would need to be experiencing nearly uninterrupted negative GDP growth between now and then – a possibility that would appear remote to the point of being negligible. Barring the catastrophically unexpected, this recovery looks set to claim the gold medal for longevity, if for nothing else.

What Have You Done For Me Lately?

Not that we should expect investment markets to be toasting the newly-minted longest-ever recovery with Champagne and noisemakers, though. Markets are forward-looking by nature, and they are already looking well past July in anticipation of when this economic cycle does turn. In some corners of the developed world outside the US, initial signs of the turn are already at hand. Five developed-market economies – Germany, Japan, Italy, Switzerland and Sweden – saw negative GDP growth in the third quarter of 2018. The IMF has lowered its outlook on global growth in 2019. At 3.7 percent the outlook is still relatively rosy, but the effects of slowing international trade, including the potential impact of a trade war yet to be actualized, give cause for concern. As the effects of fiscal stimulus in the US wear off, the persistent absence of meaningful growth in productivity – the one viable source of long-term growth – will come back into focus.

As the World Turns

There is a growing dissonance between markets and the economy based on deeper issues than headline macro data and other short-term sentiment drivers. There is a case to make that the world is in the early stages of a transition not unlike the unraveling of the Bretton Woods framework that guided the global economy's first quarter century after the end of the Second World War. By the late 1960s the US was losing its grip as the great stabilizing force of the world economy. The waning of US preeminence was underscored when then-president Nixon took the US off the gold exchange standard in August 1971. What ensued for the next decade was a period of great uncertainty, including four recessions of varying degrees of intensity with persistently high unemployment accompanied by soaring inflation. Equities fell in and out of bear market territory, finishing this miserable stretch more or less where they began it – in nominal terms, that is. On an inflation-adjusted purchasing power basis, an investor in a basket of S&P 500 stocks was much worse off at the end of this cycle than he or she was at the beginning.

Eventually the fog of uncertainty lifted and the era of what former Fed chair Ben Bernanke termed the "Great Moderation" began. Neoliberal politics and relatively unfettered global capitalism – known as the "Washington Consensus" – flourished as the dominant model for the next quarter century. That model got its comeuppance with the 2008 market crash and deep recession. The institutions emblematic of the

Washington Consensus have become increasingly strained. As in the early 1970s, there is a sense that what worked once is no longer working. And, likewise, a growing uncertainty about what comes next.

We believe heightened volatility will be the principal characteristic of asset markets in 2019. Volatility cuts both ways – up and down – meaning that predictions about market directional trends will be subject to high amounts of variability. Developments to which markets typically pay little heed – including political dysfunction and foreign policy crises – potentially will come under greater scrutiny. Outside the US, China and the EU may be sources of increased instability. Risk spreads are positioned to widen between benchmark government credit and various tiers of corporate, mortgage-backed and other debt types. The corporate debt market could be particularly tricky, and we will be paying close attention to trends in lower-investment grade paper. Central banks will be following these developments closely and may turn more dovish than expected in efforts to mitigate the impact on global markets. What central banks do – and do not do – will in turn influence investor sentiment back and forth between risk-on and risk-off. Currency and commodity markets will likely find themselves in the cross-winds of these sentiment shifts – again, volatile swings have the potential to impede the formation of durable directional trends.

Reasons (Maybe) to Smile

A prediction for heightened volatility does not necessarily translate into a doom-and-gloom outlook. For starters, we do not see compelling evidence of imminent financial risks on par with those that catalyzed the massive market sell-offs in 2000-02 (absurd asset valuations) or 2007-09 (overleveraged and intertwined credit markets). Valuations, in fact, are relatively attractive: the S&P 500 price-to-sales (P/S) ratio is currently below its 5-year average on both a twelve trailing months and forecasted basis. With the consensus forecast for FY 2019 sales still in the mid-high single digits, there are buying opportunities aplenty for investors willing to look past the short-term fury of the past two months.

Inflation – or rather its absence – could be another positive influence in the months ahead. The Core Personal Consumption Expenditures (PCE) index, which is the Fed's preferred inflation gauge, has remained fairly closely tethered to the central bank's two percent target in recent months, with little upward pressure thus far from continued tightness in the labor market. As long as inflation remains in check, the Fed will have flexibility to pause its monetary policy tightening in response to other potential developments, without increasing the risk of overheating the economy.

Finally, one wild-card boost to sentiment (though relatively limited in terms of real economic impact) could come between now and March if UK Prime Minister Theresa May's government manages to either succeed in bringing about a second referendum on Brexit (i.e. with the potential to avoid Brexit altogether) or at least push the March deadline for Article 50 down the road. As things stand right now the only viable options on the table are a deal loved by precisely nobody, or a hard crash out of the EU with potentially dire economic and social consequences for Britain. Popular support for a second referendum has grown markedly, offering at least some hope that Britons may wake up, breathe a sigh of relief and say "it was all just a bad dream."

The Big Unknown, Even Bigger

Any such positive X-factors as may emerge will, however, have to contend with plenty of negative possibilities. In our view the biggest of these resides at 1600 Pennsylvania Avenue. We say this with no regard whatsoever for ideological reasons or personal preferences, but simply as an assessment of the current power dynamics in Washington and sufficient existing evidence of a willing recklessness on the part of this administration with scant regard for consequences. Global trade, geopolitics and the independence of the Federal Reserve are examples of where and how what happens in Washington could matter to markets far more than is typically the case. Markets are used to political dysfunction as long as it stays within the sausage-making policy factory inside the Beltway. That assumption worked in 2017, but it has steadily unraveled since.

In conclusion: while the direction of risk assets in 2019 could plausibly end the year in either positive or negative territory, we believe the going will be bumpier than usual. If we truly are in the early stages of a tectonic shift in the socio-economic environment similar to what happened in the late 1960s, then there will potentially be an increased tendency to interpret new information through a glass-half-empty rather than half-full perspective. There will be opportunities, but it will be harder to capitalize on emergent trends in the presence of higher volatility – and this could well be equally true for equity, credit and alternative asset classes. In this environment we believe a more defensive position is warranted than one year ago, and that careful diversification among both riskier and low-risk portfolio segments can help buffer the impact of multiple cross-winds.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research