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FINANCIAL SERVICES

2019 Global Outlook

At the end of 2018, we look back at a rollercoaster year in financial markets, marked by the return of volatility, fear of a hawkish Federal Reserve and geopolitical threats in global trade, tariffs, Italy and Brexit. Looking ahead, 2019 looks equally challenging for investors with global economic growth slowing.

Given the current asset valuations and late cycle bull market, returns for 2019 are expected to be lower than investors have experienced in the last decade. Volatility on the other hand, is likely to persist.

Investor focus should be on high-quality assets, selected based on strong fundamentals, coupled with international equity exposure as well as an increased allocation to traditionally defensive sectors with growth opportunities.

I. Economic Outlook

I.I Global Economic Outlook

The recent volatility in financial markets as a reaction to headline news has highlighted the common investor sentiment that the global expansion that started in 2009 may have run its course. Concerns about an imminent global recession have sprung up based on the assumption that the US expansion has entered the later stage of the business cycle and that a slowdown in growth is gradually under way.

Nevertheless, the global economy is expected to continue to grow, however at a slightly lower pace. The risk of a recession in 2019 is still low, but mounting. Geopolitical threats, such as trade conflicts, Brexit and the Italian budget deficit and the related Euro breakup risk, the fragility of the Chinese economy, global monetary tightening by central banks, and finally rising global debt levels, especially in Emerging markets are all concerns for the global economy and possible triggers for a downturn. This is perceived quickly by the return of volatility in the markets and likely to stay in 2019.

This does not mean a “risk-off” world for now, but enforces our view of being cautiously optimistic (for now).

I.II United States

GDP growth in the U.S. is expected to slow down driven by the fading of the fiscal stimulus boost, the restrictive Federal Reserve Policy and the continued geopolitical risks. The tight labor markets, housing slowdown, high asset valuation and threats to business and consumer confidence are clearly consistent with a slowdown in growth and exemplary of nearing the late stages of the business cycle. One of the leading indicators, and flashing light in the dashboard as a sign an economic contraction, will be the consumer and business activity confidence.
With wage pressures still subdued and with no visible effect from tariffs yet, core inflation should remain near or below 2%. As inflation approaches its target, unemployment rates indicating full employment and global risk rising, the Federal Reserve is expected to bring the policy rate to the 2.5% -2.75% range by mid-2019 based on what is priced in by the Fed Fund futures[1]. In doing so, the Fed is trying to steer the US economy to a soft landing. Soft landings have historically not been associated with 20% drops in equity markets, higher unemployment and falling interest rates.

The combination of a slowing U.S. economy, a slowing Fed and the beginning of tightening by international central banks, will limit the U.S. dollar strengthening and is likely to reverse some gains.

I.III Developed Non-US markets

Europe witnessed a sharp slowdown in 2018 driven by weak global demand for exports as well as a sharp reduction in car manufacturing and sales. As domestic demand remains resilient and with rates still at very low levels, economic growth in Europe is expected to stabilize slightly above trend while keeping monetary policy exceptionally accommodative. As inflation is slowly picking up, the European Central Bank is expected to end quantitative easing and start raising rates by mid to late 2019 albeit at a very gradual path. Economic risks to the downside have increased in 2018 with increased tensions between Italy and the European commission with regards to the 3% deficit ceiling. Although an "exit-italia" is highly unlikely, the situation warrants close attention. In the UK, the baseline Brexit scenario is still an orderly departure but multiple outcomes (no deal and new referendums, hard exit and no trade agreement, …) are equally possible and pose much more downside risk to the British and European economic growth and future of the union.

[1] CME Group Fed Watch Tool, Probabilities based on the Fed Fund Futures
https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html

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The rising trade tensions have slowed the Chinese economic growth in 2018. China will continue to face downward pressures despite the ongoing efforts to stabilize the economic growth by a financial deleveraging program. Even with hopes that a trade deal is imminent in Q1, the conflict extends in intellectual property rights, market access and industry policy, not to mention the announcement of the DOJ with regards to proof of state sponsored hacking of US companies. Hence the resolution process will be hazardous and prolonged.

I.IV Emerging Markets

Aggregate economic growth in emerging markets is expected to be 4.6% in 2019 but will be regionally mixed and dispersed. Asian economies will be exposed to the repercussions of the Chinese decline. The major risks for emerging markets are the US-China trade tensions and the Chinese slowdown. Additionally, the US monetary tightening has led to tighter financial conditions and with corporate leverage increased, mainly in nonlocal (USD) currency, credit and currency risks remain elevated at the moment. These markets may also benefit from a pause, if not a reversal, in the rising US dollar.

II. Markets Outlook

In the face of an unusual amount of uncertainty, investors need to focus on finding opportunities to buy and own high-quality assets without becoming too defensive. Facing increased volatility many investors instinctively want to sell to safeguard their hard-earned money. Volatility should be viewed as an opportunity to not only stay invested but to additionally buy while prices are depressed to lower one's cost base. Everybody loves sales but we need to be vigilant about lemons, sectors or stocks undergoing structural change, highly leveraged businesses that capitulate to debt constraints and poor cashflow management.
Fidelity Investments[2] compared the returns of retirement accounts for those who sold all their stocks in 2008 and maybe bought stocks again eventually versus those whose stayed invested. Ten years later, those who remained invested returned 240% versus only a 157% increase in account balances for those who sold.

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[2] Lessons Learned 10 Years After the Global Financial Crisis Serve as Powerful Reminders for Investors, Fidelity Investments, 2017

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Source: Fidelity

Remaining invested during a market downturn also means participating fully in the recovery as soon as it happens. And remember that investing is a long-term pursuit, tailored to a long-term financial plan and allocated according to your personal risk tolerance.

II.I Equity

"Past performance is no guarantee of future returns." This will likely hold especially true for 2019 as investors have been accustomed by 11% -12% annualized returns since the financial crisis. With higher asset valuations, the outlook for expected returns is significantly lower, ranging between 4% and 6%. Moreover, volatility levels experienced in Q4 of 2018 are likely to remain. The fear of rising interest rates, trade conflicts set the stage early in the year. Act 2 started at the end of the summer when threats of regulations and congressional hearing prompted investors to rethink the frothy valuation of growth stocks, FANG's and alike.

Lower expected returns but positive in a late cycle bull market that could extend to 2020 is still the base scenario, yet challenging. Earnings growth is slowing as the impact of tax reform fades. Without a clear impact of tariffs on profit margins visible yet, earnings growth should remain positive.

The expected returns for US equities are more subdued than for non-US equity markets, underscoring the benefit of global equity allocations at this point. The weakness and underperformance of non-US developed and emerging markets could prove to be a buying opportunity for long-term investors.

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II.II Fixed Income

Higher interest rates in the U.S. have pushed expected fixed income returns higher and improved the outlook for the asset class. However, in 2018, it led to negative returns in most fixed income markets. In the short term, the continued monetary tightening in the US joined by international central banks as well as the flattening yield curve, taxable bond exposure should be focused on shorter term bonds. In the second part of 2019, the Federal Reserve balance sheet reduction could result in an increase in the supply of Treasuries, aided by the Federal budget deficit and increased Treasury issuance. This could push up longer-term interest rates. Long-term treasury bonds would then offer an opportunity for investors seeking protection for an isolated event or recession.

Due to absence of inflation expectations and consequently low break-even inflation yields in TIPS, real returns remain very low. TIPS are consequently only a viable hedge for inflation sensitive investors.

Credit markets, being more correlated to equity markets, can be vulnerable to a global downturn. The removal of the cheap liquidity, increased leverage on corporate balance sheets and high levels of sub-investment grade issuance are grounded reasons to be cautious on corporate credit. Funds with an investment grade rating and lower maturities will remain favored. High-yield credit and loans spreads remain low, offering a low risk-reward.

Despite the flattening in the US Treasury yield curve, the municipal bond curve has steepened. Municipal bonds have proven more resilient than taxable bonds in 2018, mainly driven by moderate new issuance, longer term benefits of the tax reform legislation and improved credit quality on the back of sound municipal revenue. The steepness of the municipal yield curve makes the longer-term municipal bonds attractive. High yield municipal bonds are also expected to outperform in this favorable environment and we continue to hold our allocation in this segment.

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III. Highlights & Asset Class Views

- Global economic growth but slowing down
- Threats:
  - Geopolitical issues: Trade wars and protectionism, Brexit, EU and Italy
  - Global restrictive monetary policy by central banks
- Lower expected returns and higher volatility
- Focus on high-quality assets, carefully selected based on strong fundamentals
- Reduce exposure in select growth sectors in favor of traditionally defensive sectors such as health care, utilities and consumer staples.
- The defensive characteristics of agriculture and timberland in the late economic cycle warrants further investigation and possible investment.
- Real-estate opportunities including housing, e-commerce logistics, data centers and health care continue to offer value.

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