WEALTH MANAGEMENT INTERNATIONAL, LTD.

Proactive Investment Management & Financial Planning

Global Perspectives, December 2018: Outlook for 2019

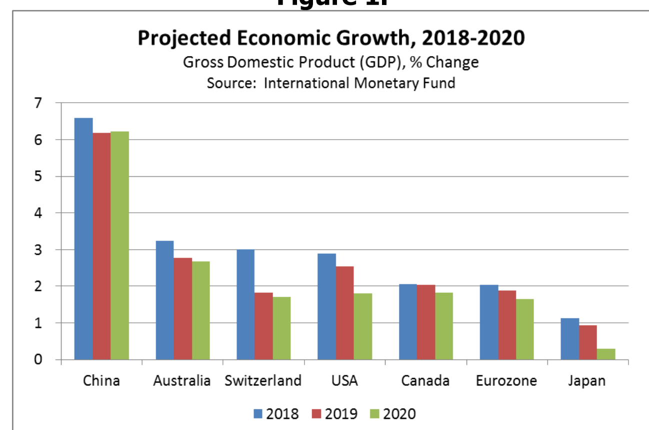
Over time, financial markets tend to reflect what's going on in the actual economy – the rate of economic growth or decline, the trend in price inflation, the looseness or tightness of fiscal and monetary policy, etc. However, as shown by the steep decline in the stock market during the fourth quarter of 2018, there can be periods when excessive excitement or fear can take over. The financial markets can occasionally become unmoored from economic reality, and it can become quite difficult to figure out where they're heading. All the same, we think a detailed, objective analysis of the economic and market evidence can help us gauge the markets' most likely path in 2019. As always, our goal is to craft a better investment strategy, or at least prepare for strategy adjustments that might help generate better returns or reduced risk.

Economic Overview

In our view, the actual trends in the global economy remain quite positive as we head into 2019. The International Monetary Fund (IMF) currently forecasts global economic output will grow by a healthy 3.7% in 2019, matching its 3.7% increase in 2018. Admittedly, it looks like growth will moderate in many key countries, especially in China and the advanced industrialized nations (see Figure 1). The expected slowdown reflects a wide range of issues, but protectionist trade barriers and tighter monetary policies are particular concerns. Nevertheless, because of the strong momentum built up in recent years, the slowdown in most countries is anticipated to be modest. With economic growth stable or slowing, it appears inflation will remain under wraps. The IMF believes average prices in the advanced countries will rise just 1.9% in 2019, compared with an increase of 2.0% in 2018. We therefore think the central bankers may soon become less aggressive in hiking interest rates and cutting asset purchases. The problem is that the cost increases and policy moves to date may have already done their damage, and there is a risk that an unexpectedly steep slowdown could already be baked into the global economy.

The dominant U.S. economy provides a great example of the kind of moderating growth that seems to be coming down the pike. The IMF currently forecasts that growth in U.S. gross domestic product (GDP) will moderate from 2.9% in 2018 to 2.5% in 2019. However, the projected growth rate would still be higher than the average annual rate of 2.2% over the last couple of decades. The U.S. economy remains in a well-established, self-sustaining expansion phase, in which increased demand spurs greater production and more hiring, which in turn prompts even further increases in demand, and so on. A major reason for the projected moderation in growth is simply that the stimulus from the 2018 tax cuts and government spending hikes is now petering out. In addition, the Federal Reserve has been gradually hiking its benchmark short-term interest rate and reducing its bond purchases, which is probably having some slowing impact, even as continued growth in recent years has eaten up spare production capacity and driven up costs. U.S. interest rates are still historically quite low, so we tend to think they're not yet a major impediment for the economy. However, many indicators suggest that the U.S. economy has become a lot less dynamic since the Great Recession of 2008-2009, and it could be that even today's low rates are having an outsized impact on the relatively enfeebled economy.

Figure 1.



U.S. Stocks

We think U.S. stocks may soon start to rebound from their late-2018 correction, and they could even rise to a new round of record highs in the first half of 2019. The key thing is that continued economic growth should keep

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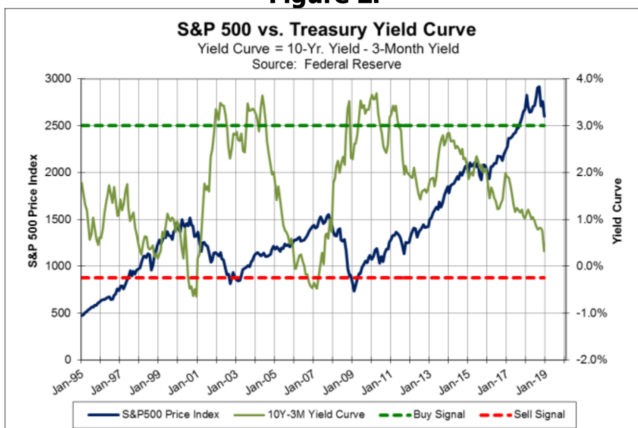
boosting corporate earnings. Profits are unlikely to keep growing as strongly as they did in 2018. In the third quarter, earnings per share among the companies in the S&P 500 stock price index were up an astounding 27.8% from the same period one year earlier! However, even with moderating economic growth, S&P's analysts predict earnings per share will rise by more than 10% in 2019. Our analysis of historical relationships indicates that would be more than enough to keep boosting stock values. The problem is that several economic and financial indicators are inching closer to the point where they would be signaling a near-term economic recession and a steeper, longer lasting decline in the stock market. Among the most important such indicators, short-term interest rates have risen almost up to the point where they equal longer-term rates. Such an inversion of the "yield curve" is often a solid warning sign of recession and falling stocks (see Figure 2). We therefore believe stock prices may peak around mid-2019, after which the chance of a bear market will tend to increase as we move toward the end of the year. If we're right that the economy and stock market could be getting shakier by late 2019, we think the best-performing stock sectors will be the "defensive" ones, especially healthcare, consumer staples, and utilities.

Figure 2.



Foreign Stocks

The developing slowdown in global economic growth first became noticeable in the major non-U.S. countries, so foreign stocks performed significantly worse than U.S. stocks in 2018. All the same, the tables could be turned in 2019. The relative resilience of U.S. stocks in 2018 means that investors could see foreign stocks as the better bargain and start to prefer them over U.S. stocks. In addition, the strong dollar that weighed so heavily on less-developed "emerging markets" during 2018 could reverse if the Fed slows its rate-hiking campaign. As long as global trade tensions don't increase too much, and as long as global commodity prices don't fall too dramatically, the emerging markets could perform well in the near term. In our view, the foreign countries with the most attractive stock markets in 2019 are as follows:

Switzerland. Economic growth has remained healthy in Switzerland in recent years, and even though growth is expected to cool in 2019, it is still anticipated to meet its long-term average of about 1.9%. More important, the well-managed Swiss economy in general, and its unique mix of relatively stable stocks, means that Swiss assets are often treated as safe havens in time of geopolitical, economic, or financial market volatility. As discussed above, we think the global economy will keep looking good in at least the first part of 2019, but the next downturn will eventually start to look more imminent. As investors start to pull back from risk, we think Switzerland's reputation as a safe haven will mean that Swiss assets will be less negatively impacted, and may even rise.

Hong Kong. Although Hong Kong isn't necessarily seen as a global safe haven like Switzerland is, it often plays the role of a regional safe haven for Chinese investors. In times of economic slowing or turmoil in the Chinese financial markets, Chinese investors often channel their funds into Hong Kong, driving up prices for the city state's assets. Indeed, as tighter monetary policy and U.S. trade barriers threatened to slow the Chinese economy dramatically in 2018, positive fund flows helped Hong Kong stocks preserve most of their value, even as other stock markets around the world were tanking. As economic growth continues to moderate in mainland China, and as the U.S. administration continues to pressure China over its trade policies, we think stocks in Hong Kong could continue to outperform in 2019.

India. Like most emerging markets, India's economy and Indian stocks can be volatile. Nevertheless, we believe Indian stocks will tend to benefit over time from the country's relatively high population growth and rapid increases in per-capita income. We also think the government's recent moves to reduce trade barriers, lower taxes, attack corruption, and bolster property rights could raise Indian companies' profitability in the coming years. India's developing national security relationship with the United States is also likely to have a positive impact on its markets. We therefore continue to include exposure to India in our more aggressive strategies.

Fixed Income

In our view, the primary role for fixed-income investments is to lend a measure of stability to a portfolio and produce a relatively secure stream of income. All our bond strategies therefore focus on U.S. fixed income. Nevertheless, it's important to remember that while high-

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grade bonds are historically more stable than stocks, they can indeed lose value, especially in periods of rising inflation and increasing interest rates. That's exactly the kind of environment that bonds faced in 2018, and the result was as anticipated. U.S. investment-grade bonds are on track to provide a negative total return for 2018, in spite of strong safe-haven buying in the fourth quarter.

With the U.S. economy continuing to expand, we think inflation pressure will remain a concern, and the policymakers at the Fed are likely to tighten monetary policy at least a bit further in 2019. Not only do we think the policymakers will raise their benchmark short-term interest rates, but we suspect they will continue to let their holdings of longer-term bonds mature without buying replacements. In other words, we think bond prices will continue to face some downward pressure in at least the first part of the year, especially if the stock market starts to rebound as we anticipate and those bonds that were bought for safety's sake during the fourth-quarter correction start to get sold. Importantly, we suspect the bonds that are most susceptible will be those with longer maturities, greater exposure to rising inflation, and increased default risk because they are issued by companies with weaker finances. In contrast, we think the most attractive U.S. bond sectors in 2019 will be:

Shorter-Maturity Bonds. Even though we think the financial-market chaos of late 2018 could make the Fed policymakers slow their monetary tightening to some extent, we don't think they will end their tightening altogether. We therefore think it will still be best to concentrate our bond holdings in those fixed-income sectors that are historically less vulnerable to rising inflation and higher rates. The obvious sector is short-term bonds. Indeed, we began to re-orient our bond holdings to short-term fixed income in mid-2018, including a sizeable allocation to those ultra-short term "floating rate" obligations that tend to hold their value when interest rates rise. If the economy falters earlier than we anticipate and the Fed starts to cut interest rates, these shorter-term bonds would likely underperform their longer-term brethren. However, given that shorter-term bonds currently yield almost as much as long-term obligations, we think their reward/risk ratio remains favorable for the time being.

Inflation-Protected Securities. Even though inflation pressure has moderated a bit in recent months (perhaps because of the Fed's rate hikes to date), prices are still rising, and that's still having a negative impact on U.S. fixed-income investments. We think that dynamic will continue in early 2019, so we expect relatively good returns on both longer-term and shorter-term Treasury Inflation Protected Securities (TIPS). The principal and interest on TIPS is adjusted upward along with the rise in the consumer price index, so we think they will continue to be well insulated against further increases in inflation.

Alternatives

The "alternative" investments that we consider include a wide range of assets, such as publicly-traded real estate investment trusts (REITs), infrastructure, private equity, physical commodities, arbitrage strategies, and momentum strategies. All those asset types can be further divided into subcategories. For instance, physical commodities include everything from crude oil and soybeans to gold, copper, lumber, and cattle. Even though the main themes discussed above are continued but moderating economic growth and continued but moderating interest-rate hikes, the impact of those trends is likely to be quite different for the various types of alternative assets. Our goal with alternative investments is to exploit any opportunity they offer for good returns and risk-reducing diversification, but the trends discussed above will likely be negative for some of them. We think industrial commodities like crude oil and copper will be especially challenged now that more investors are focused on the likelihood of slower demand growth going forward, while the increased market volatility associated with today's slowing economy should make it harder to get good returns from trend-following momentum strategies. The alternative assets we think could perform best in the new year are as follows:

REITs. Not only have publicly-traded REITs historically provided strong returns (see Figure 3), but we think current conditions are particularly positive for them. One reason for that is simply the continued growth in the economy, which is likely to keep boosting the demand for real estate assets such as stand-alone retail stores, office buildings, apartment blocks, warehouses, hotels, data centers, and cell phone towers. Because of the special tax status of REITs, they tend to pay a large part of their profits in dividends and must rely on debt for growth capital. REITs therefore tend to fare poorly when interest rates are rising, and they have indeed struggled over much of the last few years. However, now that we seem to be in the latter stages of the Fed's rate-hiking campaign, longer-term bond yields have stopped rising, and REITs have started to perform better. As long as the economy keeps growing, we think stable-to-falling bond yields will allow REITs to perform well throughout much of 2019.

Infrastructure. Investing in infrastructure is similar to investing in real estate, in that the underlying asset is a physical structure. The difference is that infrastructure is often an essential community facility that generates user fees instead of rents. Investing in infrastructure such as

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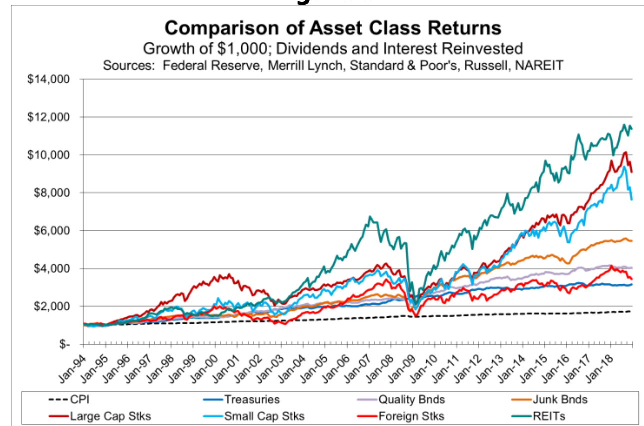
toll roads, airports, and other such facilities is often seen as a way to earn good income with relatively low risk. Like REITs, infrastructure can suffer when interest rates are rising rapidly, but we think they can perform well as investors continue to fret about slowing economic growth and as the Fed comes closer to the conclusion of its rate hikes.

Precious Metals. Against today's backdrop of moderating economic activity and the administration's aggressive approach to international security and trade disputes, we think investors will look increasingly to the safe-haven reputation of the precious metals. More specifically, we think gold could become especially sought after (since silver is used more heavily in industrial processes, it can perform more poorly when economic growth is slowing). On top of that, gold is often challenged when interest rates are rising, while it tends to do better when rates are stabilizing or looking like they are ready to stabilize. Those factors already seem to have helped push gold prices higher again in late 2018, and we think they could continue to do so in 2019.

Risks and Conclusion

We continue to believe that a key risk in 2019 is that relatively strong inflation pressure will prompt the Fed to keep raising interest rates to the point where they go too far and short-circuit the economy. However, there is also some risk that the Fed could spook the economy and markets by abruptly stopping its rate hikes without adequate explanation. Such a sudden stop in rate hikes could make some skittish investors think that economic conditions are deteriorating faster than commonly known, which would likely undermine confidence. Likewise, we think there are risks to the economy and markets if there are volatile, nontraditional moves in government policy related to national security, trade, regulation, taxes, and spending. All that's on top of the usual possibility of a completely unexpected national security crisis or natural disaster. And finally, we see substantial risk of a political crisis depending on the findings of the special counsel investigating ties between Trump administration officials and the Russian government.

Figure 3.



In spite of all the risks described above, all indications point to continued good growth in the economy and corporate profits in the early months of 2019. We therefore continue to believe the financial markets can recover from their late-2018 swoon and march higher again. We even think stock prices could rise to one more round of record highs. However, as we progress through 2019, we think the chance of a disruptive slowdown will increase, and we believe it will become increasingly important to keep reducing risk in our various portfolios. The moves we already made in late 2018 helped insulate our portfolios from the worst of the stock market decline of 2018's fourth quarter, but we stand ready to further cut risk as conditions warrant in 2019.

Patrick Fearon, CFA
Chief Investment Officer

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