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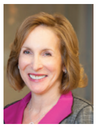
2019 Outlook: Down but not out

Insight from sub-adviser Wellington Management



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Key Points

Based on fundamentals (slowing but solid), fiscal and monetary policy (a little tighter), and valuations (enticing but not extreme), we would consider the following:

- Reduce but don't abandon risk; favor equities over bonds but move to more defensive sectors
- Favor US equities relative to Europe, Japan, and EM
- Favor bank loans, short duration, and higher-quality securitized products relative to other areas of credit
- Our differentiated views:
  - US equities over other regions
  - Rotation into defensive equity, away from technology
  - Broad commodities exposure, including precious metals, as a potential hedge against higher inflation and potential lower growth
- Risks: Trade war, aggressive Fed tightening, material global growth slowdown

SOME INVESTORS SEE A DIFFICULT CHOICE: ACCEPT THE MARKET'S WARNING SIGNS OF A DOWNTURN AND POSITION DEFENSIVELY OR DEFY THE MARKET AND EMBRACE RISK AMID CHEAPER VALUATIONS. We anchor our 2019 views to fundamentals, policy, and valuations. Global economic fundamentals are turning weaker but should be solid enough to support modestly higher inflation and interest rates; fiscal and monetary policy are likely to be a little tighter; and valuations are enticing but not yet at extreme levels. Return expectations need to meet a higher bar, in our view, given that US cash now yields around 2.5%.[1] We think this adds up to a case for compromise: positioning portfolios defensively without abandoning risk.

We would consider favoring equities (over bonds), shorter-duration credit, and commodities, but also reducing risk in each asset class. Within equities, we would consider the US over other markets, given our view that the US economy is strongest and US equities are least exposed to changes in global growth. From a sector standpoint, we would consider leaning into defensives, such as consumer staples, health care, telecommunications, and utilities, which, despite their rate sensitivity, may offer steady income and some market upside. Within credit, we would consider the relative stability of bank loans over high yield, and have softened our bearish view on investment-grade credit as spreads have widened and companies with healthier balance sheets look more attractive. We see potential for commodities to play the dual role of a hedge against rising inflation and slower growth, and thus would consider energy and precious metals.

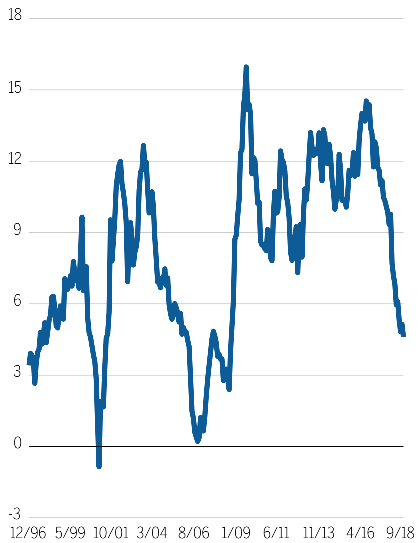
Growth, rates, and inflation

We think the global economy should expand at a slower pace in 2019 than in the past several quarters, yet remain strong enough to reduce excess capacity and drive modest increases in inflation and interest rates. Monetary policy has become less supportive (**FIGURE 1**), but we expect policy makers to be cautious in further reducing accommodation given slower global growth and poor market performance.

We think the US Federal Reserve (Fed) will hike rates in December but will revisit its forecast of three hikes in 2019 as growth slows and financial conditions tighten. We expect the European Central Bank to end its asset purchase program by the end of 2018 but also become more dovish in its forward guidance on rates as growth slows and inflation signals remain benign. We think the Bank of Japan will remain committed to its accommodative stance despite allowing a wider band

[1] Source: Bloomberg, December 10, 2018

FIGURE 1
Easy monetary conditions are moving in reverse
GDP-weighted M1[2] money supply, y/y % change*



[2] M1 is the money supply that includes physical currency and coin, demand deposits, travelers checks, other checkable deposits and negotiable order of withdrawal (NOW) accounts. * Includes US, Europe, Japan, and China | Sources: Bloomberg, Wellington Management | Chart data: December 1996 – October 2018

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in which the yield on the 10-year Japanese government bond can trade. In China, despite growth concerns, authorities remain intent on reducing supply in heavy industries, which we think will help lift global inflation and rates.

We expect modest appreciation in the US dollar because the Fed is the least accommodative major central bank and the dollar tends to play a defensive role when growth slows.

Country and regional equity fundamentals

US

We expect the US economy to continue outpacing its developed market peers but to slow some as fiscal stimulus fades and higher interest rates dampen demand in areas like housing. However, US consumers continue to power the economy and are supported by a strong job market and higher wages. Despite falling in the wake of this quarter's stock market sell-off, consumer confidence remains at healthy levels.

Capital expenditures may not fulfill the hopes for a stimulus-fueled bump as trade concerns increase uncertainty for businesses, but should still add to growth in coming quarters. We sense that the US administration could capitulate on its most severe trade threats given softer growth and weaker equity markets.

Based on our more favorable outlook for the US economy relative to other developed markets, we would consider US equities over their higher beta peers. US valuations are still relatively high, but that is a lesser concern over our 6 to 12 month horizon.

Europe

European economic growth continues to disappoint, and leading indicators point to further sluggishness in coming quarters. Business cycle indicators are soft, and recent data suggests that Europe's bright spot, consumers, could start to be affected. Politics are likely to impact business and market sentiment, including Brexit and Italy's budget woes, which risk spooking the bond market. European companies also derive a substantial portion of their revenues from overseas, which makes them susceptible to changes in global growth (**FIGURE 2**).

While our opinion of Europe's economy is generally negative, we remain optimistic that consumers will continue to enjoy a strong job market and can help Europe avoid a more material slowdown in 2019. In addition, equity valuations look attractive and margins have ample room for expansion, so we are maintaining a neutral stance.

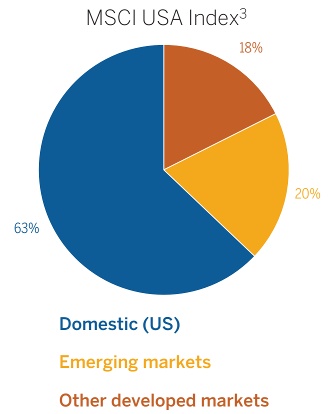
Japan

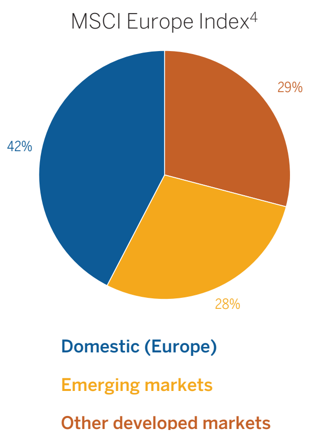
Japan's economy continues to muddle through at a reasonable pace but lacks a catalyst for meaningful expansion. Consumers are benefiting from a historically tight labor market, while companies are turning record profits and cash balances are high. However, we are concerned that Japanese stocks are highly sensitive to changes in the global economic cycle and that the yen is at risk of appreciating during bouts of global market weakness. Despite attractive company fundamentals and cheap valuations, we are neutral on Japanese equities given the slowdown we expect in global growth and rising geopolitical and economic risks.

FIGURE 2

Europe is more globally exposed

Revenue exposure by market (%)





As of November 30, 2018 | Source: MSCI

Emerging markets (EM)

We continue to hold a neutral view on EM equities but are closely watching the impact of China's recent policy loosening. Thus far, China's structural deleveraging campaign is continuing to depress money supply, and we suspect a soft landing in 2019 is in order. Looking across the breadth of EM, we acknowledge that performance will vary and some markets may outperform meaningfully, but at the index level we fear that a step down in global growth will restrain returns.

Taking the long view

Our views are based on a 6 to 12 month time frame, and thus we focus more on economic fundamentals and policy than on equity valuations, which have tended to be better predictors of returns over longer periods. Over a longer time horizon, we would consider leaning into developed and EM that have lower equity valuations than the US. What's more, we believe that longer-term growth prospects are brighter for EM, which have superior demographic profiles.

Commodities

Changes in inflation can have a meaningful impact on a portfolio, and commodities are the only asset class that have historically had a high beta[5] to those changes. The supply backdrop continues to support commodity prices in areas such as industrial metals, where China has reduced investment, and oil, where shale bottlenecks may crimp output in the first half of 2019 and major oil company investment has lagged. We would also consider precious metals as a potential hedge against a softer growth outcome than anticipated, as well as a plethora of geopolitical risks.

Better valuations in credit

Cheaper valuations may offer an opportunity to upgrade the quality of credit portfolios. Idiosyncratic risk stemming from the struggles faced by General Electric and Pacific Gas & Electric Company, plus the pressure on energy companies from the decline in oil prices, contributed to wider spreads in investment-grade and high-yield bonds in November. Spreads[6] in both markets are now above the historical median (since inception).[7]

We are moderately bearish on investment-grade credit given high leverage and the dominance of lower-quality names in the Bloomberg Barclays US High Yield Bond Index. However, cheaper valuations and a more benign interest-rate outlook mitigate these negatives somewhat, and we think wider spreads offer an opportunity to upgrade from highly levered BBB names to less levered, higher-rated names that may be more insulated from a downturn. We also think a flat corporate yield curve supports shorter-duration[9] credit.

We remain neutral on high yield. The yield on the index is about 7.25%, and we see the strongest potential in the US-oriented revenue sources of high-yield companies.[10] We also think the high-yield sector is supported by structural changes: Over the past 20 years, we believe it has become a larger, better-diversified sector with an improved average credit quality, as well as a source of permanent funding for more public companies.

[3] MSCI USA Index is a free float-adjusted market capitalization index that is designed to measure the performance of the large and mid cap segments of the US market.

[4] MSCI Europe Index is a free-float adjusted market-capitalization-weighted index designed to measure the equity market performance of the developed markets in Europe.

[5] Beta is a measure of risk that indicates the price sensitivity of a security or a portfolio relative to a specified market index.

[6] A spread is the difference between the bid and the ask price of a security or asset.

[7] Source: Bloomberg, December 10, 2018

[8] Bloomberg Barclays US Corporate High-Yield Bond Index is an unmanaged broad-based market-value-weighted index that tracks the total return performance of non-investment grade, fixed-rate, publicly placed, dollar denominated and nonconvertible debt registered with the Securities and Exchange Commission.

[9] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[10] Source: Bloomberg Barclays US High Yield Bond Index, December 10, 2018

Our multi-asset views

Asset class	View	Change
Developed market equities	**Moderately bullish**	—
US	Moderately bullish	—
Europe	Neutral	—
Japan	Neutral	—
Emerging market equities	**Neutral**	—
10-year govt bonds	**Moderately bearish**	—
US	Moderately bearish	—
Europe	Moderately bearish	—
Japan	Moderately bearish	—
Credit	**Neutral**	⬆
Investment-grade	Moderately bearish	⬆
High yield	Neutral	—
Bank loans	Moderately bullish	—
Emerging market debt (external)	Neutral	⬆
Commodities	**Moderately bullish**	—

Change is from previous quarter. Views expressed have a 6 to 12 month horizon and are those of the authors. Views are as of December 2018, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

[11] S&P/LSTA Leveraged Loan Index reflects the market-weighted performance of institutional leveraged loans based on real-time market weightings, spreads, and interest payments.

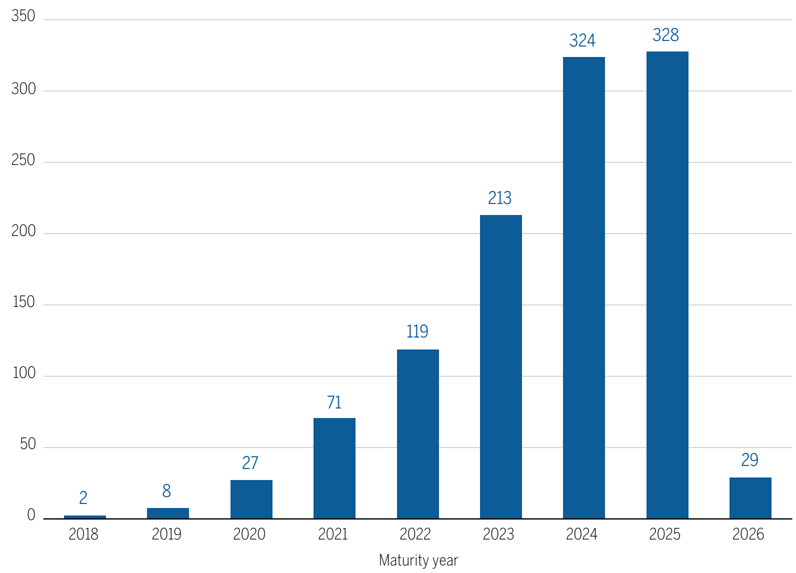
[12] A collateralized loan obligation (CLO) is a security backed by a pool of debt, often low-rated corporate loans.

We maintain our moderately bullish view on bank loans given our expectation that interest rates will rise and given the sector's low default rates, strong interest coverage, and low level of maturing debt until 2023 – 2024 (**FIGURE 3**). Huge growth in the sector and the proliferation of "covenant lite" issuance are legitimate concerns, but we think they call for moving up in quality and being more selective, especially in new issues.

FIGURE 3

No bank-loan maturity wall in the next few years

Maturity breakdown of S&P/LSTA Leveraged Loan Index[11] as of November 30, 2018 (US$ billions)



Source: S&P

Another way to potentially move up in quality in credit is to increase exposure to securitized credit, which may offer diversification and structural credit enhancement. We would consider high-quality collateralized loan obligations (CLOs),[12] which may have more call protection than bank loans and provide more diversification. We also find structures related to residential housing attractive, as consumers are benefiting from higher wages and low oil prices.

We have upgraded our view on EM external debt (USD-denominated) to neutral from moderately bearish. While this may seem counterintuitive given the potential for slowing global growth, many EMs have already gone through the painful foreign-exchange adjustment process that allows a country's finances to improve via the current account, which is likely to benefit debt relative to equities. In addition, EM spreads are wide on an absolute and relative basis compared to US high yield.

About the authors

Nanette Abuhoff Jacobson consults with clients on strategic asset allocation issues and works with investment teams throughout the firm to develop relevant investment solutions across asset classes.

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Any views expressed here are those of the authors as of the date of publication, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients.

Downside *and* upside risks

The recent sell-off in risk assets reflected many of the risks we have discussed in the past: trade tensions, higher rates, global populism, and crowded trades in technology. In fact, given the extent to which these risks have been priced into the market, we are mindful of upside risks that could spark a sharp rally—if, for example, the Fed backs off from its hiking path or there's a positive political turn of events in the UK or Europe, or in US/China relations. In such a case, we would expect the riskiest assets to rally most, including EM equities and commodities.

That said, the global economy is slowing, the bull market is 10 years old, and US equity valuations are relatively high, leaving little cushion against adverse news in fundamentals, policy, or politics. We maintain that more restrictive trade policies are the biggest risk for the global economy, with the potential to dent business confidence and investment, and to raise prices for manufacturers and consumers. For now, an increase in tariffs on US$200 billion of Chinese goods from 10% to 25% has been postponed until March, avoiding the worst-case scenario of an all-out trade war. However, there is still the threat of tariffs on the remaining US$267 billion of Chinese exports to the US, which would affect most consumer goods, and the possibility of a 25% tariff on European autos is back in the headlines.[11] Another risk is that higher-than-expected inflation puts the Fed on a more aggressive hiking path than the market anticipates, a scenario that is not our base case but could cause higher rates, lower growth, and a severe market sell-off.

Investment implications

Equities over bonds—While the global backdrop may be weaker in 2019, we think growth will be strong enough to consider equities over bonds.

US equities over other regions—We continue to think the US stands out as the strongest economy and would consider favoring US equities, which may be least exposed to a broader global slowdown.

Defensive sectors—Stable earnings and cash flow are the key characteristics of defensive companies. Sectors with these features typically include consumer staples, health care, telecommunications, and utilities. Value-oriented or cyclical sectors that are at depressed valuations, such as natural resources, may also represent opportunities. Technology companies are likely to face continued headwinds on the regulatory front.

Commodities as a dual hedge—We think commodities could be additive to a portfolio in the event of a rise in inflation (e.g., energy) and/or slower-than-expected economic growth (e.g., precious metals).

Credit upgrade—Wider spreads may provide an opportunity to shift corporate exposure into companies with less leverage or cyclicality, shorten duration, or move into securitized products that offer more potential diversification and credit enhancement.

Seek out idiosyncratic stories—Idiosyncratic stories that rely less on a rising tide of strong global growth and easy monetary conditions may offer downside protection amid higher volatility.

[11] Source: Bloomberg, November 28 and December 4, 2018

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