

# 2019 Global economic outlook

By Bob Baur and the Principal Economic Committee



## Economies grow; financial markets struggle

Three themes underlie the evolution of the world economy and financial markets in 2019. First, the world economic environment is vastly improved over any period from 2008 through 2016. So, monetary policy needs to be dramatically different from then. As central banks reverse ultra-accommodative policy, and long-term interest rates rise, financial markets that were long accustomed to an easy-policy elixir will struggle to adjust. The market tumult of this year will continue.

Second, there will be a persistent divergence between the real economy and stock and bond markets. The world economy is expanding, booming in the United States; but markets have been turbulent, with most world indices down for the year through November. Further policy changes will keep markets chaotic, but there are few imbalances to lead to a substantial slowdown in world growth. Economies may grow even as financial markets struggle.

Last, the passive investor's dream of a long, persistent uptrend in stock prices and downtrend in long-term interest rates is over. As the investment universe adjusts to this new setting, markets may be whipsawed by quick changes in trends. Investors may need a stopwatch since timing will be key to maintaining portfolio gains. We expand on each theme here as we consider prospects for world growth and global markets in the year ahead.

## 1. A radically improved economic environment

The 2008 financial crisis left a residue of fear: fear that the ugly economic phase from mid-2007 to mid-2016 was long-lasting; that the series of crises around the world would continue; that slow growth was inevitable; deflation a way of life. Central banks fought the crises with record low interest rates, easy credit, and bond purchases financed with central bank-created funds. This tsunami of liquidity washed over asset markets, raising prices of houses, real estate, and stocks and bonds of all domiciles just as former Federal Reserve (Fed) chair Ben Bernanke predicted. He also forecast that the wealth created by higher prices would translate into robust confidence and a surging economy. Nope: didn't happen.

### > 2019 global growth: Healthy, but divergences persist

The economic quagmire began to lift in mid-2016 after commodity prices troughed and the US dollar peaked. A synchronized world expansion began that gathered steam throughout 2017. Divergences appeared early in 2018, as US confidence and economic momentum soared while growth in Europe, Japan, and China decelerated. India is on a fast track with growth near 8%, the world's fastest. Over the last few weeks, the consensus view seems to be that global growth is slowing significantly and that a world recession may lie ahead. In contrast, we expect healthy but only mildly slower global growth in 2019. A significant trade conflict beyond present tensions would be negative for growth.

## ➤ US economy: Moderating mildly from red-hot

After two quarters of 4% growth, the US economy is off its peak gains. Still, the jobs market is smokin'. With robust job gains and accelerating wages, average hourly earnings should hit 3.5% by mid-next year. With another million or more workers to move into the workforce from the sidelines, there is still slack left in the labor market. Consumer confidence is near record and should keep consumption at or above 3% for several quarters. Capital spending was weak in the third quarter after six quarters of stellar gains. But, with aging capital stock and investment incentives in last year's tax reform, US capital spending should stay vigorous.

A prolonged investment cycle will raise productivity gains back to 2%, increasing potential growth. This will keep inflation tame, allowing faster real wage growth, so consumer spending will remain stout. We look for 3% gains in GDP through mid-2019 with mild deceleration the second half. With robust wage gains and slim evidence of imminent recession, this will be the longest expansion in history.

## ➤ Europe: Mild growth, a generous helping of political uncertainty

Third-quarter GDP growth in the Eurozone was weak partly because of short-term problems in German auto production. A rebound is coming, and GDP growth in currency union should be 1.5% to 2.0% this year and next. Unemployment keeps falling and good job growth is tightening the labor market. Wage gains are picking up, which will support continued healthy consumer spending; retail sales will maintain their broad upward trend. Business surveys are stabilizing. Capacity-use data suggests business slack is diminishing, so inflation should gradually edge above the latest 1.1% price rise over the prior year.

Political risk seems to never end in the euro area. Brexit negotiations gave way to an agreement that only has to be confirmed by the UK Parliament and the other 27 countries in the European Union...surely, not a problem! The budget discussion between Brussels and Italy is contentious, but may be resolved without real economic furor. History suggests an agreement will be reached, but only after worse outcomes are tested.

## ➤ Japan: The longest expansion in three generations

GDP gains in Japan this year and next will range from 1.0% to 1.5%. Ugly weather, earthquakes, typhons, and a sweltering summer turned third-quarter GDP negative; we expect a sharp rebound. Corporate profits keep hitting records, which bodes well for investment. Wage gains are picking up and employment keeps rising, a tough ticket for a country with a declining population. The female labor force participation rate is higher than in the United States and the jobless rate is an incredibly low 2.3%. Inflation should inch higher toward the Bank of Japan's (BOJ) target, so the BOJ will allow higher 10-year bond yields and slow its bond and stock purchases by mid-year. Higher yields should help Japan's banks and insurance industry. A key economic risk is a devaluation of China's currency; it could weaken a bit, but a substantial drop is unlikely. Next year's scheduled increase in the value-added tax may also become a late-year headwind.

## ➤ China: More deceleration

Growth in China is in the midst of a long, structural deceleration. Third-quarter GDP grew 6.0% annualized over the prior quarter, still fast, but well under prior quarters. Several factors are behind the slowdown. The three decades of a one-child policy will curtail labor force growth soon. Last year, officials tightened policy to slow the growth of debt to avoid a future financial crisis, causing infrastructure investment to slow to a trickle. Cutting pollution is also a goal but will be a drag on growth. The pace of GDP growth may fall to the mid-5% range in 2019. Such a growth slowdown would be a big headwind for other emerging countries that depend on China for their exports.

Officials are clearly worried about the slowdown: credit restrictions have been eased; taxes for businesses and households are to be cut substantially; the currency has been allowed to depreciate sizably; journalists have been ordered not to highlight negative growth statistics. The US tariffs on Chinese imports are also a meaningful headwind, more so than the China's tariffs on the United States. Since many developing countries depend on China for exports, China's growth slowdown will echo negatively throughout the region.

## ➤ India: Life beyond China

With positive changes and world-beating growth, India must be included in any roundup of economic and market trends. A new government took control in 2014 and changes didn't take long. Several will bring long-term gains, but include short-term economic drags. De-monetization (taking large denomination currency out of circulation) was designed to bring the underground economy into the open, let it formalize, and incentivize paying taxes. The sales tax changes streamlined product delivery across state lines. Forcing the banks to recognize non-performing loans restricted credit growth in the short-term, but was a first step toward fixing bank balance sheets. The new law on bankruptcy resolution is aiding this process. The slow credit growth led to the quarrel between the government and the central bank. The Indian currency plunged, and the stock market fell since mid-year, because India was caught in the contagion from credit stress in other emerging markets.

All these changes disrupted current growth, but India's long-term potential improved. Local investors recognized the eventual benefits as the stock market soared from before the election to this summer. Most of the fund flows into the stock market were from local investors and foreign inflows were miniscule. Even real estate may be on the verge of picking up; Mumbai housing is affordable compared to other world cities. While Indian stocks are still pricier than in other emerging markets, there is likely more value there. Inflation is under control and there is no reason for the central bank to raise interest rates. The demographics are the world's best. GDP growth should remain in the 7% to 8% range.

## 2. Main Street may prosper while Wall Street struggles

Stock markets surged for nearly a decade after the financial crisis. The average annual total return for the S&P 500 Index from the end of March 2009 to the end of 2017 was an astonishing 17.3%. The MSCI All Country World Index rose an average of 11.2% annually over the same period. Those huge gains came despite the fear and ugly economic environment during those years.

What propelled world stock markets to those terrific gains? It was the mathematics of easy monetary policy: central banks created oceans of liquidity and pushed long-term yields to super-low levels. Investors then discounted future earnings with those ultra-low interest rates and bid up stocks to a high present value. The stock market rally became an extension of monetary policy, a derivative of the central bank-inspired bull market in safe-haven bond yields. This process continued for so long that investors came to see this environment of easy policy, low interest rate, slow growth, and no inflation as permanent. But, it was not.

## ➤ Monetary policy reverses

World growth and its prospects vastly improved, and central banks are reversing policy, raising rates, and withdrawing liquidity. That which propelled the stock market is fading. That is what caused the extreme volatility and poor returns in 2018. The stock market downdrafts in February, March, and October were due to the change in the monetary environment. Pundits pointed to trade or geopolitics, but they were not the real market movers. Trade makes headlines, but liquidity makes markets.

Unfortunately, this process of policy normalization will likely quicken in 2019. The Fed should raise the fed funds rate in December. Another hike may come next March, but that's not yet assured. Long-term government bond yields will move somewhat higher, tightening financial conditions. The European Central Bank (ECB) is set to end its bond purchases in January and likely raise its official rate next fall. Negative official rates in euro area countries are inappropriate for today's growth pace. Governor Kuroda has noted the BOJ policy will soon have to turn less accommodative. Central banks in several emerging markets have raised official rates.

## > Will growth reverse too?

Stock and bond markets are in turmoil precisely because growth has been so robust. Will financial market struggles cause world growth to stumble next year? It's possible. And there are plenty of risks to consider: Italy's budget, Brexit, US and China trade issues, and US budget deficits. Still, the underlying fundamentals are mostly healthy; signs of recession are few. The tumult in financial markets will persist even as growth remains healthy.

## 3. Not a good time to be passive

Passive investing is very popular because investors were riding the long stock market rally higher for years. The long bull market in bonds from 1981 ended in July 2016, and the end of the stock market surge from 2009 is likely near. Don't expect many long, stable trends in 2019. Active investors may need a stopwatch for good timing. For most investors, it's a time to be cautious.

### > Stock markets

Stock markets have been under pressure this year as they adjust to an improved economy and less accommodative monetary policy. That pressure will likely continue in 2019 since adjusting to more normal interest rates will be a long process. However, there may be some upside yet in a traditional year-end rally. Monetary policy, while tighter, is still easy; interest rates remain relatively low. Company earnings were excellent again in the third quarter and world growth is healthy. Even Chinese stocks are trying to rally after a 31.7% peak-to-trough plunge from the January high on the Shanghai Composite. US stocks will do best if a rally comes. However, a move back to the mid-year highs is all that should be expected. Long-term yields would surely pick up concurrently and bring the rally to an end.

A significant bear market is a real possibility in 2019 as growth moderates, long-term rates make new cycle highs, earnings disappoint, and credit stress widens. If such a downdraft happens, US stocks would underperform world benchmarks, a reverse from recent years. Equity investors should think about defensive positions in sectors like utilities, consumer staples, and healthcare. Even after the downdraft ends, stocks may see little new upside for some time; that may be the price to be paid for the central bank-inspired rally after the financial crisis.

If, however, long-term interest rates stay around 3% or lower, a case could be made that stock markets would stay volatile within recent ranges. Expectations for earnings growth would come down and valuations would shrink a bit even without a nasty bear market. Once valuations de-rated some more, stock prices could simply rise with earnings growth. Unless US nominal growth falls back to the 3% range, the probability of interest rates staying near or below current levels is slim.

### > Bond markets

The real source of stock market turmoil is the rise in yields of long-term US Treasury bonds. At just over 3.0%, yields need to rise to correspond with potential nominal US growth, likely in the 4.0% to 4.5% range. But, a rise to those levels will only come in stages. First is a likely move in 10-year bond yields toward 3.5%. That would precipitate turmoil throughout the bond market like last year, only worse. Credit stress is already returning since spreads between corporate yields and Treasuries are widening, as are spreads between higher- and lower-quality credit. Pressure would increase on the next group of vulnerable emerging market countries after Turkey and Argentina. Central banks' super-low interest rates may have kept some companies operating that would have closed had rates been higher. Think Sears or GE. A large part of the investment grade index is just one notch above junk bonds. So, investor fears of default or downgrade are not unreasonable.

If 10-year US Treasury yields do hit 3.5%, those bonds might be a great buy for a trade; yields would likely fall along with the stock market, giving investors a capital gain on the bonds as well as a decent yield for the year. Long-term government bond yields could fall as investors rushed into safe havens. If the year-end stock market rally does not materialize, Treasury yields will already have seen the high for this cycle.

## > Currency

The US dollar strengthened throughout 2018 as US growth was surging versus the rest of the world and the Fed was regularly raising rates. We'd guess that trend has about run its course. The dollar could slide moderately next year if earnings disappoint, the stock market falls, and the Fed pauses. The yen and euro would be beneficiaries of dollar weakness.

## > Real assets

If a financial storm occurs, real assets might help limit one's losses. Commercial real estate might also offer somewhat of a port in a financial storm. Real estate straddles both financial markets and the real economy. Interest rates impact property prices, but the real economy affects rents. With a bit of inflation and reasonable growth, rents may still edge higher and provide an improving return even if property prices level out. In the short term, real estate investors will need to identify markets and properties that are less reliant on price appreciation and more reliant on income potential. The most desirable properties will be in metropolitan areas with the best job growth. Real estate investment trusts could be attractive if long-term US Treasury bond yields start to fall after hitting higher levels.

Commodities might also provide some downside protection. Prices in general are well off cycle highs. Even crude oil has plunged. Prices might suffer a bit more deflation if demand in China slows. However, decent world growth and a gradual pickup in inflation should limit the downside. The point here is to note the ratio of S&P 500 Index to a broad commodity index is as high as it was in 2000. Commodity prices may have less downside risk than stocks.

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