Economic Insights: **A powerful equity rally**

Monthly update: January 2019

Commentary by Bob Baur, Robin Anderson, and the Economic Committee

A powerful equity rally: Yes, but, will the post-Christmas stock market surge continue? Let's consider the environment. The stock market collapse in December was historic. From the December 3rd peak to the Christmas eve trough, the S&P 500 Index (the Index) plunged 16.0%. Even with the yearend upswing, the Index lost 9.2% for the month, the worst December performance since 1931. Credit markets cratered too, with the yield on Barclay's US High Yield index rising nearly 1% to over 8%.

Most world markets outperformed those in the United States during December. The MSCI All Country World ex US Index lost 4.7%; the MSCI Emerging Market Index fell only 2.9%. The tech darlings that led US markets to many months of outperformance failed in December.

Markets led; the Fed followed: US markets groaned when Federal Reserve (Fed) Chair Powell implied the shift to normal monetary policy was on "autopilot." Expectations for several 2019 rate hikes, in spite of a slowing world economy and tighter financial conditions brought the final collapse.

The Fed lags. Fed governors heard the message in the market nosedive and suddenly were promoting a pause in normalizing policy. Even the most hawkish governors got on board. It was the monetary ceasefire that brought the massive rally.

After such a devastating market collapse, the sudden change of heart by the Fed made the huge upswing since Christmas almost inescapable. Besides, recession fears were overdone. The US economy is still robust; retail sales stay strong; the job market is excellent; and wage growth is picking up.

Interest rate outlook:

Markets like a dovish Fed

Markets reacted intensely to Fed Chair Powell's press conference and policy statement after the recent Fed meeting: stocks and gold soared; yields on 10-year US treasury bonds and the US dollar fell. The policy statement dropped language calling for "some further gradual increases" in the fed funds rate and implied the next move could be either up or down. Also, in an unusual separate statement, the Fed said it is "prepared to adjust any of the details for completing balance sheet normalization" dependent on future economic and financial conditions. Clearly, with inflation quiescent, the central bank wants to let the economy blossom.

None and done

So, we see no chance of Fed rate hikes in the first half of 2019. And whether the Fed even raises rates in the second half is highly questionable. Having been chastened by the December market collapse for being too hawkish, we'd guess the Fed will err on the side of patience, especially with only modest inflation. If stock markets rally hard in the second half, another rate hike late this year could happen. Still, the upper range of the funds rate at 2.5% is near many estimates of neutral. And with some slack left in the labor force and capacity use well below past business cycle peaks, there's no reason for the Fed to try to restrain the economy.

Whither long rates?

Near-term caution is still advised as yields on 10-year US treasury bonds could be weak over the next few months. If the stock market has another downdraft, we could see 10-year US treasury bond yields fall below 2.5% before mid-year. If that happens, borrowers should use the opportunity to lock in interest rates on all one's borrowing needs for some time. If US nominal growth stays in its current 4% to 5% range, long-maturity US treasury bond yields should eventually push toward that subdivision. Deflation worries are over and modest inflation is ahead. Inflation and real economic growth each at 2% suggests a 4% yield expectation on 10-year US treasury bonds at some future point is not unreasonable.

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Is the bear market over? With the Fed on hold, can the rally persist? Possibly, but, maybe not. Two key drags. First, central banks are unwinding a decade of financial repression and suppressed interest rates. Acclimated to years of capital subsidization, markets had to adjust to this new environment, which brought last year's volatility. And while the road to tighter policy may be stymied for a bit, tougher financial conditions may require more adjustment. Debt costs are higher; credit spreads are wider; and stock markets have been range-bound.

Second, robust earnings expectations may not pan out. After a year of 25% earnings growth, low double-digit forecasts became common. Estimates have fallen dramatically, but are still over 8% by Standard and Poor's forecasts of $169 for the 2019 S&P 500 Index. With world growth slowing, especially in China, we'd guess those projections are still too high. Several companies have already downgraded guidance: Apple, Macys, and Cat among others.

Given the shellacking individual stock prices receive when guidance is lowered, there seems real potential for another downdraft. The fact that long-term interest rates have not surged alongside stocks suggests the rally may be peaking. Further, if stocks do run higher, rate hikes would come back into view, reversing the Fed's shift to pause. Nevertheless, such a retest of the December lows or beyond would likely be a significant buying opportunity.

Market outlook

Earlier in the commentary we made the case for another stock market downdraft ahead based on tighter financial conditions and potential earnings downgrades. So, financial markets could see a tough first half of 2019. As a result, we still suggest investors stay cautious the first half. For bond investors, that means short maturity, high quality corporate bonds. Stock investors could stick to defensive sectors like consumer staples, healthcare, and utilities.

If a stock market downdraft does happen, we would suggest using it as a buying opportunity. While earnings forecasts may be too optimistic given modestly slowing growth, worries about a US recession later this year are overdone. Our proprietary recession dashboard shows few signs of an impending slump.

The same is likely true for the Eurozone and Japan, indeed, most of the developed world. The global slowdown is centered in China and the countries that depend on Chinese imports of goods and commodities. But, households in developed countries should not be impacted much by the slowdown. Wage growth is picking up in the United States, the Eurozone, the United Kingdom, and Japan. Labor markets in those countries are robust; US and Japanese jobless rates are the lowest in decades and by a decade in the Eurozone. So, household incomes and consumer spending should stay healthy and prevent a broad-based recession.

Main Street prospers; Wall Street struggles: So, the divergence between the real economy and financial markets that shaped 2018 will likely persist the first of this year. But, because the developed world should avoid a recession, any stabilization of growth in the second half should bring a gradual rebound of stock markets.

That dichotomy between households and financial markets suggests that real estate, and maybe real assets in general, could avoid first half financial struggles and provide decent returns for the year. With a little inflation and a decent economy, rental income from real estate may edge higher. Even commodity prices have not experienced as much downside volatility as financial markets. And with the US dollar likely having peaked and the Fed on hold, commodities could offer some stability and opportunity as the global economy steadies toward yearend.

Regional economic updates

The global growth slowdown from last year will continue in 2019. But, fears of a global recession are unconvincing. In fact, global recessions are extraordinarily rare. Using the International Monetary Fund definition, there have been four since 1945: in 1975, 1982, 1991, and 2009. The growth divergence between the United States, Europe and Japan will hold, but with the US economy set to decelerate a bit, the growth differential will be less extreme. In China, weaker growth will persist; the question is whether stimulus keeps a hard landing at bay.

United States: A long-lasting and robust US expansion will help keep the global economy out of recession. The imbalances that typically bring a slump are just not evident. Consumer balance sheets have improved dramatically. Cyclical spending, i.e., durable goods

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and investment, usually peaks before a recession, but it's still well below prior-cycle highs. Profit margins are still improving, opposite of the usual tell-tale recession sign. US corporate debt is high relative to history, but low compared to Europe and Japan.

Economic growth likely decelerated to near 2% in the fourth quarter, but the strength in retail sales suggests consumer spending growth steadied at a robust 3.5%. Less inventory accumulation and weak capital spending likely drove growth lower.

Looking ahead: Growth may decelerate from a strong 3% in 2018 to the mid-2% range this year. The shutdown could take a half percentage point from growth in the first quarter, but will bring a nice rebound in the second quarter. Consumer spending should stay very healthy this year, hovering near 3%. The labor market is showing remarkable strength despite the age of the expansion. Wage growth is picking up and will surely accelerate more. Modest inflation pressures mean faster wage growth will bring higher real incomes, a solid base for household spending.

The investment outlook is mixed. Capital spending plans from business surveys, a leading indicator of spending, worsened with the negative sentiment and market plunge in December. Credit spreads on corporate bonds, the yield difference between corporate and government bonds, are still high versus last year's low. So, corporate debt costs are higher even though US Treasury bond yields are lower. Other leading indicators for investment, profits and lending standards, are very supportive.

Housing should improve from last year's soft patch because the fundamentals are strong. Mortgage rates are lower and mortgage applications are rising over the prior year. Home builder sentiment improved a bit recently after hitting a three-year low. Household formation is rising and the home ownership rate is well up off the lows.

With no recession in sight, this will surely be the longest US expansion in history. And with the labor market so strong, it has the potential to be longer than most forecasters believe possible.

Europe: The industrial sector has still not found the bottom of the downturn. Manufacturing surveys for January were terrible. November industrial production contracted month over month, with German output off nearly 2%. The problems in Germany seem short and atypical, ranging from new auto emission standards to low Rhine river levels. And the yellow vest protests in France are likely driving weaker numbers. But slowing global growth, particularly from China, is another culprit.

Looking ahead: Despite the weakness in manufacturing, the Eurozone should avoid recession. Growth will be modest, hopefully near 1.5% for the year. France avoided a fourth-quarter contraction despite the protests. Labor markets are in good shape with the unemployment rate falling below 8%, the first time in a decade. Wage growth is picking up; that will support consumer spending, which has been the driver of growth. With downside risks to European growth, the European Central Bank will remain cautious. Any rate hike this year has become less likely and another round of long-term bank refinancing is more likely.

Japan: The economy should grow around 1% or a bit more this year. Data have been somewhat mixed with the January business survey slowing to 50.0, the breakeven between expansion and contraction. December exports fell more than expected. But, the labor market is the best in decades. Despite a declining population, total employment is growing robustly, up 2.4% over 2017, as more women and older workers find jobs. With an ultra-low jobless rate of a miniscule 2.5%, wage growth is accelerating.

China: Economic growth hit the slowest pace in 28 years last year as auto sales declined for the first time since records began. December retail sales and industrial production did improve sequentially, suggesting some stabilization. Other data stays weak. The Caixin survey of manufacturing companies dropped below 50.0, an indication of retrenchment. Imports declined 7.6%, the lowest pace since summer 2016 signaling concerns about domestic demand. Producer price inflation weakened, implying potential deflation and falling corporate profits. In fact, industrial profits declined for the first time since 2015. China has put a lot of stimulus into the system, especially lower income taxes. But, if the money supply and loans don't grow because of concerns about rapidly rising debt burdens, China may not be able to do enough to stabilize growth.

Emerging markets: With the Fed on hold and the US dollar weakening, this may be a better year for emerging countries than 2018. In fact, we expect emerging market assets to outperform those in the US for much of 2019. But a Chinese slowdown remains a key risk to its closest trading partners and commodity exporting countries.

Baseline Economic Forecasts for 2018 - 2019

A. Growth in Real GDP - Qtr-Qtr (% Change, Annualized):

	1st Quarter 18 Actual		2nd Quarter 18 Actual		3rd Quarter 18 Actual		4th Quarter 18 Forecast		2016 Actual		2017 Actual	
Real GDP	**18,324.0**	**2.2%**	**18,511.6**	**4.2%**	**18,665.0**	**3.4%**	**18,760.2**	**2.1%**	**17,659.2**	**1.6%**	**18,050.7**	**2.2%**
Personal Consumption Expenditures	**12,722.8**	**0.5%**	**12,842.0**	**3.8%**	**12,953.3**	**3.5%**	**13,063.9**	**3.5%**	**12,248.2**	**2.7%**	**12,558.7**	**2.5%**
Durable Goods	1,628.2	-2.0%	1,662.3	8.6%	1,677.4	3.7%	1,698.0	5.0%	1,476.8	5.5%	1,577.9	6.8%
Non-Durables	2,858.6	0.1%	2,886.7	4.0%	2,919.2	4.6%	2,944.4	3.5%	2,763.9	2.7%	2,822.0	2.1%
Services	8,267.9	1.0%	8,329.8	3.0%	8,394.9	3.2%	8,444.8	2.4%	8,022.5	2.3%	8,184.5	2.0%
Gross Private Domestic Invest.	**3,321.0**	**9.6%**	**3,316.7**	**-0.5%**	**3,436.2**	**15.2%**	**3,428.6**	**-0.9%**	**3,050.5**	**-1.3%**	**3,196.6**	**4.8%**
Bus. Fixed Invest.	2,654.0	11.5%	2,710.1	8.7%	2,727.0	2.5%	2,758.4	4.7%	2,411.2	0.5%	2,538.1	5.3%
Structures	533.3	13.9%	551.7	14.5%	546.9	-3.4%	551.0	3.0%	494.7	-5.0%	517.5	4.6%
Equipment	1,250.9	8.5%	1,264.9	4.6%	1,275.6	3.4%	1,288.2	4.0%	1,116.2	-1.5%	1,183.7	6.1%
Intellectual Property Products	875.7	14.1%	897.9	10.5%	910.2	5.6%	923.6	6.0%	803.9	7.5%	841.1	4.6%
Residential Invest.	615.3	-3.4%	613.2	-1.3%	607.7	-3.6%	612.2	3.0%	591.3	6.5%	611.1	3.3%
Change in Inventory	30.3	-	-36.8	-	89.8	-	35.0	-	23.4	-	22.5	-
Net Exports	**-902.4**	**-**	**-841.0**	**-**	**-949.7**	**-**	**-956.1**	**-**	**-786.2**	**-**	**-858.7**	**-**
Exports	2,517.8	3.6%	2,574.2	9.3%	2,542.2	-4.9%	2,561.7	3.1%	2,378.1	-0.1%	2,450.1	3.0%
Imports	3,420.1	3.0%	3,415.2	-0.6%	3,491.9	9.3%	3,517.8	3.0%	3,164.4	1.9%	3,308.7	4.6%
Gov't Purchases of Goods & Services	**3,152.2**	**1.5%**	**3,171.8**	**2.5%**	**3,192.0**	**2.6%**	**3,203.1**	**1.4%**	**3,132.5**	**1.4%**	**3,130.4**	**-0.1%**
Federal	1,213.1	2.6%	1,224.0	3.7%	1,234.7	3.5%	1,237.9	1.0%	1,187.8	0.4%	1,196.4	0.7%
National Defense	722.8	3.0%	733.3	6.0%	742.2	4.9%	744.0	1.0%	709.2	-0.6%	713.8	0.7%
Non-Defense	489.5	2.1%	490.1	0.5%	492.0	1.6%	493.2	1.0%	478.0	1.9%	481.9	0.8%
State & Local	1,937.7	0.9%	1,946.6	1.8%	1,956.3	2.0%	1,963.6	1.5%	1,942.8	2.0%	1,932.3	-0.5%
Final Sales of Dom. Product	18,274.4	1.9%	18,515.9	5.4%	18,562.1	1.0%	18,706.5	3.1%	17,617.5	2.1%	17,769.1	0.9%
Final Sales to Dom. Purchasers	19,141.3	1.9%	19,330.8	4.0%	19,471.6	2.9%	19,638.2	3.5%	18,387.2	2.3%	18,550.0	0.9%
year-over-year	2.6%		2.9%		3.0%		2.9%					

	1st Quarter 19 Forecast		2nd Quarter 19 Forecast		3rd Quarter 19 Forecast		4th Quarter 19 Forecast		2018 Forecast		2019 Forecast	
Real GDP	**18,869.1**	**2.3%**	**19,002.0**	**2.8%**	**19,119.7**	**2.5%**	**19,232.5**	**2.4%**	**18,565.2**	**2.9%**	**19,055.8**	**2.6%**
Personal Consumption Expenditures	**13,138.7**	**2.3%**	**13,243.0**	**3.2%**	**13,330.4**	**2.7%**	**13,412.6**	**2.5%**	**12,895.5**	**2.7%**	**13,281.2**	**3.0%**
Durable Goods	1,708.5	2.5%	1,725.3	4.0%	1,740.2	3.5%	1,753.1	3.0%	1,666.5	5.6%	1,731.8	3.9%
Non-Durables	2,962.6	2.5%	2,995.4	4.5%	3,021.3	3.5%	3,043.7	3.0%	2,902.2	2.8%	3,005.8	3.6%
Services	8,490.9	2.2%	8,545.6	2.6%	8,592.2	2.2%	8,639.0	2.2%	8,359.4	2.1%	8,566.9	2.5%
Gross Private Domestic Invest.	**3,460.3**	**3.8%**	**3,484.2**	**2.8%**	**3,509.9**	**3.0%**	**3,534.1**	**2.8%**	**3,375.6**	**5.6%**	**3,497.1**	**3.6%**
Bus. Fixed Invest.	2,785.6	4.0%	2,809.9	3.5%	2,831.0	3.0%	2,855.6	3.5%	2,712.4	6.9%	2,820.5	4.0%
Structures	555.0	3.0%	559.2	3.0%	563.3	3.0%	567.5	3.0%	545.7	5.4%	561.2	2.8%
Equipment	1,297.7	3.0%	1,304.2	2.0%	1,310.6	2.0%	1,320.4	3.0%	1,269.9	7.3%	1,308.2	3.0%
Intellectual Property Products	937.1	6.0%	950.9	6.0%	961.4	4.5%	972.0	4.5%	901.8	7.2%	955.3	5.9%
Residential Invest.	616.7	3.0%	621.3	3.0%	625.9	3.0%	630.6	3.0%	612.1	0.2%	623.6	1.9%
Change in Inventory	35.0	-	30.0	-	30.0	-	25.0	-	29.6	-	30.0	-
Net Exports	**-961.5**	**-**	**-966.9**	**-**	**-971.2**	**-**	**-972.8**	**-**	**-912.3**	**-**	**-968.1**	**-**
Exports	2,580.7	3.0%	2,599.8	3.0%	2,618.5	2.9%	2,634.7	2.5%	2,549.0	4.0%	2,608.4	2.3%
Imports	3,542.2	2.8%	3,566.7	2.8%	3,589.7	2.6%	3,607.5	2.0%	3,461.3	4.6%	3,576.5	3.3%
Gov't Purchases of Goods & Services	**3,210.8**	**1.0%**	**3,220.9**	**1.3%**	**3,229.9**	**1.1%**	**3,237.9**	**1.0%**	**3,179.8**	**1.6%**	**3,224.9**	**1.4%**
Federal	1,240.7	0.9%	1,245.9	1.7%	1,250.0	1.3%	1,253.1	1.0%	1,227.4	2.6%	1,247.4	1.6%
National Defense	746.8	1.5%	749.6	1.5%	752.4	1.5%	754.3	1.0%	735.6	3.1%	750.8	2.1%
Non-Defense	493.2	0.0%	495.7	2.0%	496.9	1.0%	498.1	1.0%	491.2	1.9%	496.0	1.0%
State & Local	1,968.5	1.0%	1,973.4	1.0%	1,978.3	1.0%	1,983.2	1.0%	1,951.1	1.0%	1,975.9	1.3%
Final Sales of Dom. Product	18,815.3	2.3%	18,953.2	3.0%	19,071.0	2.5%	19,188.8	2.5%	18,514.7	4.2%	19,007.1	2.7%
Final Sales to Dom. Purchasers	19,752.4	2.3%	19,895.7	2.9%	20,017.8	2.5%	20,137.2	2.4%	19,395.5	4.6%	19,950.8	2.9%
year-over-year	3.0%		2.6%		2.4%		2.5%					

Source: U.S. Dept. of Commerce, Bureau of Economic Analysis; Principal Global Investors

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