Market Outlook
First Quarter 2019

First-Quarter Outlook
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Monetary policy normalization, mission accomplished.

2018 is on course to end with almost every major asset class delivering a negative return, an achievement rarely seen over the past century. Yet despite the broad-based carnage across global asset markets, the global economy remains in healthy shape. For 2018, global GDP growth is expected to be robust, led by strong U.S. economic growth, while global earnings per share growth should be strong, led by a significant increase in the U.S. where the tax cuts from the start of the year provided an extra boost to already strong underlying earnings. Despite such strong fundamentals, global equities (as measured by the MSCI ACWI Index as of December 27, 2018) were down over 12% year-to-date and 20% from the late January highs. The price-earnings ratio of equities is valued at only 12.6x expected 2019 earnings for global equities while U.S. markets, as per the S&P 500 Index, are trading at 13.7x next year's expected earnings, with an expected 8% growth in earnings per share. From highs of +10% in September, the U.S. market tumbled 20% by Christmas, following one of the worst Decembers on record.

What happened and what does it imply for 2019?

First off, I still believe investment returns over time will be driven by underlying fundamentals and that market behavior can lead to significant disconnects between the market and the underlying fundamentals. When they diverge, there are three potential outcomes to consider: First, is the market correct in signalling an upcoming deterioration in the underlying fundamentals (this is at the core of the efficient markets hypothesis and modern portfolio theory). Second, is the market being pushed around due to underlying market factors unrelated to the fundamentals, keeping in mind that 90% of turnover on any given day is driven by non-fundamental strategies. Third, can adverse market behavior become the cause of a deterioration in fundamentals (adverse wealth effect on consumption etc.)?

As we end 2018 in a sea of red that has certainly been more severe than expected, even as we reduced our equity exposures through the summer and fall, we are weighing each of the three possibilities outlined above in forming our views for 2019. As a base case, I reject the first scenario that the market is efficient in its forecasting ability (by any measure of common sense, 1,000-point days on the Dow Jones Industrial Average as seen on December 26, 2018 by itself should repudiate the efficient markets theory). The broad fundamentals remain reasonably robust. Yes, the U.S.

economy will slow as fiscal stimulus fades, but we still expect to see decent economic and earnings growth in the U.S. with the probability of a recession remaining low in the coming 12 months. Yes, there is the fear that a trade war with China could tip the U.S. over, but it is a fear, not a reality. The probability of an extreme outcome is only low to moderate in the near term, not the near full recession probability that is being priced into markets.

My base case remains that the robust underlying fundamentals will ultimately prevail, and that the current market selloff is predominately driven by either exaggerated or non-fundamental fears coupled with the unhealthy developments in underlying market structure. This leaves markets far more susceptible to pro-cyclical flows rather than the more orderly market maker structures that have been prevalent in the past. As we have argued, changes in underlying market structure should leave markets more prone to episodic volatility, as we are currently witnessing. While my base case is a version of the second outcome listed above, my fear is also that it has the potential to become the third, where the impact from the market selloff both tightens financial conditions as well as impacts both consumer and business confidence to bring about a self-fulfilling downturn in economic activity. While not my base case, as I mentioned, we will be monitoring for signs of such contagion in the real economy. It should also highlight that even as we lay out a base case outlook for asset prices into 2019 that favours risk assets, there are greater tail risks and hence a lower degree of confidence in that outlook. Much like the U.S. Federal Reserve (Fed), in 2019 we will be particularly data-dependent in assessing changes to our base case outlook.

The sum of all their fears

In my assessment, there are two key factors driving the current turmoil in markets. First, and most important, is monetary policy. Second, the politics of a dysfunctional Washington, and the laundry list of European political challenges. While both matter, the first is central to understanding the fundamental economic and market outlook and has a certain rationality that can be understood in framing a market outlook. The second, politics, is far more variable, volatile and hence challenging to predict the outcome and impact on the underlying fundamentals. From an investment perspective, as I have often stated, 80% of politics is drama and does not matter while 20% does matter. We spend a lot of time analyzing and seeking to understand which political aspects belong in the 20% bucket. However, for the purpose of this market outlook, I want to focus on the more important market driver: monetary policy.

In monetary policy terms, if 2018 was the year of normalization – mission accomplished.

2019 will be the year of Fed relent:

For now, the tightening cycle is complete (or fully priced into markets). The Fed may raise interest rates once more in 2019 but should also back down from balance sheet reduction being on auto pilot. I would argue the European Central Bank (ECB) has also finished its tightening cycle, having ended quantitative easing (QE) in December. The ECB's next policy move in 2019 will likely be to loosen monetary policy through an extended targeted longer-term refinancing operations (TLTRO) program and is unlikely to raise interest rates next year. If we are correct that developed economies are almost done with raising rates for the cycle, this could be the most significant market event in 2019 as markets shift from the current excessive fears of Fed policy error, to discounting that this is as good as it gets for interest rates. As long as the U.S. economy slows in an orderly manner, and there are no signs of accelerating inflation, the Fed will shift to talking about a pause in tightening, especially as recent inflation data and energy prices have both softened in recent months.

As markets discount the end of interest rate hikes and a slowing, but still growing above potential, U.S. economy, we expect to see further weakness in the U.S. dollar, which will in turn ease global and emerging financial conditions in 2019 rather than the tightening seen in 2018. The soft-landing scenario and topping out of U.S. 10-year rates below the recent highs near 3.25% will also be supportive of the outlook for credit, where the high-yield market has recently surpassed 8% yields – pretty good if rates aren't rising much further and the economy is not going into a recession soon.

My base case is that this is the path the Fed is on for 2019. But markets in recent weeks leading up to Christmas have been fixated on the fear that the Fed and Chair Jerome Powell are tone deaf to markets and will keep marching rates upward and the balance sheet downward. Two reasons I don't buy this and feel it is creating more of a buying opportunity in risk assets are, first, in my 30 years in the business, bond markets have always behaved in a manic-depressive fashion around Fed behavior and second, whenever there is a new chairperson at the Fed, there is a communication learning curve between how the chairperson speaks and how the market reacts that seems to take about a year to settle as both learn to dance together. This factor is clearly in evidence recently given Powell's not-so-great performance in press conferences and the near hysterical overreaction from some of the bond market talking heads I have heard. Take both with a common-sense grain of salt. Over the past month, the Fed has unambiguously blinked on the tightening path, even while some say, "Ya he blinked, but I want more!" The Fed has no desire to tip the economy over in 2019.

Market returns

Given our above base case of a Fed relent, and soft landing/extended economic cycle for 2019, coupled with the dramatic selloff of risk assets into year end, I want to own risk assets. While higher political risks, and hence lower confidence in the probability of our base case outlook unfolding demand higher risk premia, I believe the recent derating of equity markets to 12.6x globally and to below 14x in the U.S. now leaves room for multiple expansion. Not a call I generally make at this stage of the cycle, but it is rare to have seen the degree of derating witnessed over the past quarter. With strong earnings growth expected, it is possible we could see low double-digit returns from global equity markets in 2019, although not without some continuation of the volatility that returned to markets with a vengeance in 2018. By the same token, credit markets should be able to deliver mid-single digit returns as recent spread widening appears overdone versus our base case.

Key risk

While our base case paints a pretty sanguine picture for asset markets in 2019, I have tried to emphasize that our degree of confidence in the outcome is lower than usual, and that the tail risks of alternative outcomes is higher than usual. In particular, the adverse tail risk driven by a deteriorating U.S.-China trade war scenario and an increasingly erratic policy backdrop emanating from the White House are cause for concern. At a very minimum they will be drivers of increased volatility as markets react and overreact to often rapidly evolving and unpredictable narratives. But this is also part of our "A World in Transition" view that we have been talking about as the reality of the broader world in which we now live. It is not going to go away, and it makes investing for the future far more challenging. However, with structurally low real interest rates we have no choice but to find ways of navigating through the unsettled waters. As I mentioned in my last quarterly update:

"While we are certainly living in far more uncertain times, it is not the end of the world. It is merely the end of the world as we know it! The status quo no longer holds on many levels across the economic, political, social and investment spheres. Systems that were in functioning equilibria have become unmoored and disoriented over the past decade for many disparate reasons and have yet to settle into an equilibrium state consistent with new realities.

I am not an historian, but it is my sense that once long periods of relative economic and social stability end, it can take decades of elevated instability before we settle back into a new more stable economic, social or political pattern. 2008 may one day be seen as the end of a period of broad social economic and political stability and that 10 years later, we have merely recovered from the economic crisis era and are only starting to wrestle with the broader social, geopolitical and geo-economic aspects."

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