Market and Economic Insights

2019 Outlook

The only certainty is uncertainty: Looking for answers in 2019

The global growth slowdown, rising trade tensions, plummeting oil prices, monetary policy anxiety and restive European politics cannot help but leave investors with a raft of questions heading into 2019. While we can never be fully certain that we've reached "peak uncertainty," there is little doubt nearly every economy and market around the world must contend with risks related to these questions. As we look ahead to 2019, we assess the scope of these risks across key regions. Though a glass-half-empty view is understandable as 2018 winds down, we see upside potential in certain regions, especially if some of the issues underlying these risks can be clarified or resolved in the next year.

Table of contents

- U.S.: Continuing to grind higher
- Europe: Existential crisis still a headwind
- Canada: Proceed with caution — oil slick ahead
- Japan: Kaizen, but at a snail's pace
- Emerging markets: Persistent risks but worth watching in 2019

U.S.: Continuing to grind higher

U.S. GDP growth in 2019 will undoubtedly slow from the heights reached in 2018, but it should remain well supported by healthy consumer spending and a firm labor market. Fiscal spending remains a tailwind, and both business and consumer confidence are near all-time highs, supporting the case for the U.S. continuing to "decouple" from the rest of the world. We believe the economic cycle has more room to run, and the probability of a U.S. recession over the next 12 months is low.

While concerns around "peak earnings" are increasing, we think corporate earnings growth will remain in the mid-to-high single digits in 2019 *(Exhibit #1)*. Valuations are reasonable, particularly in the context of low interest rates and a benign inflation environment, and should provide upside support for equities.

The chorus of those encouraging the Federal Reserve (Fed) to pause its rate-hike cycle in 2019 continues to get louder. After a successful normalization process, the Fed finds itself nearing its own estimate of the longer-run neutral interest rate. Current Fed "dot plot" projections indicate a median of three more rate hikes in 2019, but an average closer to two and a half. Investors are likely to get skittish around the possibility of overtightening because the market is only pricing in about one more hike in 2019. Ultimately, we believe that the Fed's actions will be data-dependent and that inflation will remain sufficiently benign, allowing the central bank to ease back to one or two rate hikes in 2019 rather than three. The lifting of this cloud should provide some clarity to the equity markets. On the long end of the yield curve, we expect bond yields to move modestly higher but remain below historical norms.

With a split government over the next two years, we expect gridlock to prevail and significant policy initiatives to stall. Some believe President Trump may tack toward the middle and look for common ground on issues such as immigration reform and infrastructure, though we would place a low probability on any large-scale deals. The potential for a government shutdown over funding for a U.S.-Mexico border wall, as well as raising the debt ceiling, will continue to cause uncertainty, though we expect the effect on markets to be limited.

Tariffs and trade wars could have an outsized influence on markets in 2019. The disruptions and slowdowns caused by further escalation could dampen business sentiment, restrain growth, and, perhaps worst of all, inject inflation into the economy, which could result in a more aggressive Fed. U.S. trade discussions with both China and Europe are ongoing and difficult to predict. Positive developments, or simply an end to escalation, would likely be well received by the markets. With economic growth slowing around the world and tariffs moving toward more mutually harmful levels, de-escalation is a likely outcome, but with a good deal of uncertainty regarding the ultimate path toward resolution of the underlying trade questions.

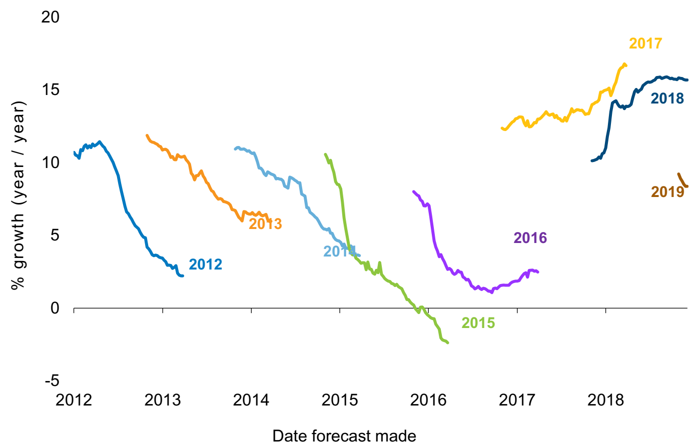
Europe: Existential crisis still a headwind

Elections to the European Parliament in May 2019 could bring a further transformation of the political landscape. A new European Commission will follow and must contend with two significant challenges: Italy's political situation and the future trading relationship with the U.K. (assuming Brexit goes ahead). At the macro level, there is relatively little uncertainty regarding the economic prospects for the rest of Europe. Growth slowed in the eurozone in 2018, but remained above trend. Core inflation picked up, albeit slowly. We expect both patterns to repeat in 2019 *(Exhibit #2)*. European equities have been restrained by lackluster earnings growth — especially when compared with the powerful performance in the U.S. The large financial sector has struggled in the face of ultra-low interest rates. The European Central Bank will stop expanding its version of quantitative easing, but may introduce a new version of its targeted refinancing operation, which provides liquidity to banks, in order to assist Italian banks. Yet the long-awaited increase in official interest rates is now unlikely to occur before the end of 2019.

As for Italy, new elections are a possibility and the result may be a center-right coalition, which could introduce more pro-growth economic policies. This would be a positive outcome for both Italy and Europe, but getting there requires a sequence of events that remains difficult to predict.

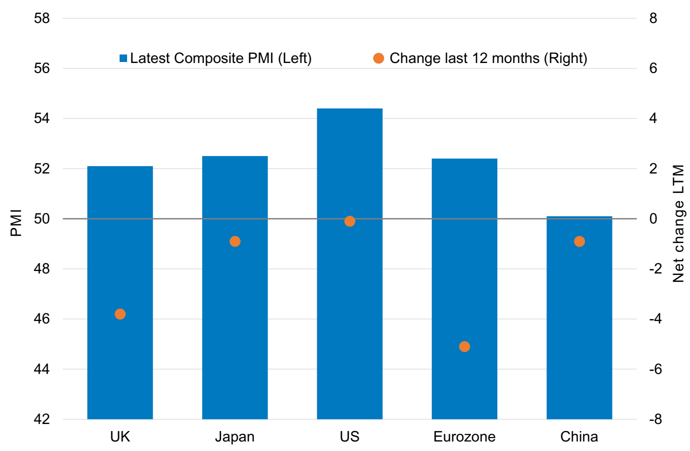
With Brexit, we can be confident that the economic and political uncertainty will continue. A smooth Brexit is still possible, but remains only one of a series of scenarios: alternatives include a no-deal Brexit or a second referendum. Yet even a smooth Brexit merely opens the way for negotiations on the future trading relationship between the U.K. and the E.U. Given the arguments, regrets, accusations and resignations that have dogged this process thus far, these talks are guaranteed to be controversial on both sides of the channel.

Exhibit 1 » MSCI World EPS Growth Forecasts



Source: DataStream

Exhibit 2 » Composite PMI Change



Source: Markit

Exhibit 3 » MSCI EM Index - Trailing P/E Ratio

Source: Bloomberg Financial; BMO Wealth Management Strategy

It seems highly unlikely that Europe will be the star performer in 2019. We think core bond markets will struggle, but equities should eke out modestly positive returns. "Muddle through" seems set to characterize this region for another year.

Canada: Proceed with caution — oil slick ahead

The current investment outlook for Canada will remain largely influenced by the performance of the commodity sector (specifically oil prices) and the monetary policy trajectory of the Bank of Canada. Record oil production in the major regions has elevated supply levels coincident with concerns of a slowdown in demand due to peaking global economic growth.

For monetary policy, the consensus expectation for Canada's central bank has recently decreased to one or two rate hikes for 2019. Given Canada's elevated level of household debt and the headwinds caused by lower oil prices, further interest rate increases may prove to be a policy error with negative consequences for the Canadian economy.

Canadian equities look inexpensive on an earnings basis and in many cases will continue to be beneficiaries of strong U.S. growth, but the headwinds of lower energy earnings and the ripple effects in other sectors make Canadian earnings vulnerable to downward revisions. Among Canadian asset classes, bonds have the greatest likelihood of outperforming, as the Bank of Canada moves to the sidelines in recognition of the real challenges facing the Canadian consumer and corporate sectors.

Japan: Kaizen, but at a snail's pace

Japan has provided a bastion of stability in 2018, with minimal policy-induced volatility over the course of the year. The Bank of Japan (BOJ) has continued its ultra-loose policy stance — albeit with a slight shift during the summer — while Prime Minister Shinzo Abe has maintained a tight grip on power. The path forward into 2019 looks markedly less clear. On the monetary side, Japanese inflation remains well below the BOJ's elusive 2% goal, despite very low unemployment and strong corporate profits. The patience of the BOJ will be tested and pressure may mount to scale back some of the stimulus, but we expect monetary policy to remain loose for the foreseeable future.

On the fiscal side, Japan is scheduled for a consumption-tax hike in October 2019, a full four years later than originally scheduled. Barring an unforeseen downturn, this tax hike will likely occur, but we expect the Japanese government to blunt the impact with other fiscal policy in order to avoid a repeat of 2014's disruptive tax increase. Above-trend economic growth, growing corporate profit margins and improving corporate governance keep us cautiously optimistic for the Japanese stock market in 2019.

Emerging markets: Persistent risks but worth watching in 2019

Emerging markets (EM) comprise a diverse set of economies and political landscapes, but there are a few key drivers that have an outsized influence on the overall direction of the asset class. First among these is China, which is by far the single largest market in EM and whose economy many other EM countries rely upon for their own growth. Like most of the world, China is experiencing a slowdown. In China's case, this means growth falling from the high 6% range to the low 6% range. To combat the slowdown, the Chinese government recently increased fiscal spending, enacted a large tax cut and loosened bank reserve requirements. Our baseline expectation is that China will have a managed slowdown with still-enviable growth. Risks to this outlook include the possibility of an escalating trade war with the U.S., an accelerated downturn in China's housing market and slowing retail sales growth. In terms of valuation, both China and emerging markets as a whole are attractive, though not necessarily at "rock bottom" *(Exhibit #3)*.

Other important drivers of emerging-market economies and markets are the U.S. dollar and U.S. interest rates. In the second half of 2018, the strong U.S. dollar put heavy pressure on countries with high levels of dollar-denominated debt, such as Turkey and Argentina. Additionally, higher U.S. Treasury yields tightened financial conditions broadly in EM. Over the course of 2019, we expect U.S. dollar strength to taper off and dissipate as a headwind for EM as the Fed nears the end of rate hikes. If the trade and tariff environment does not deteriorate in the meantime, EM could become gradually more attractive as the year progresses. Ongoing risks remain for now, but it is worth noting that overall current account balances in EM are in much better shape than in the years preceding the Asian financial crisis. Even in a downturn scenario, we do not believe that the risks in EM are systemic.

A final broad consideration is the tendency of EM to swing dramatically with risk-on and risk-off market sentiment. Some of the risks facing EM and the global economy will likely need further resolution before these markets can regain their footing. At present, risks around trade and tariffs, the global growth slowdown, interest rates and inflation, and European geopolitics all seem to be approaching a peak uncertainty phase that poses a near-term challenge for EM and risk assets overall. However, we have seen some signs of stability with respect to EM currencies in the latter part of 2018. Current risks point to a moderate EM allocation, but resolution of EM risks in 2019 could lead to a more attractive environment.

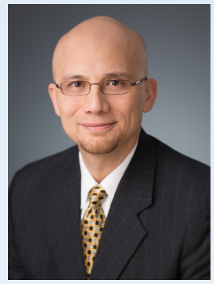
Michael Stritch, CFA®
Chief Investment Officer &
National Head of Investments
BMO Wealth Management - U.S.

Yung-Yu Ma, Ph.D.
Chief Investment Strategist
BMO Wealth Management - U.S.

Michael Stritch, CFA®
Chief Investment Officer & National Head of Investments BMO Wealth Management - U.S.

As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments for our Ultra High Net Worth group, and became National Head of Investments in 2015. In January 2018, Michael took over the role of Chief Investment Officer. With close to two decades of experience in money management, Michael has a deep background in economic analysis, portfolio construction and risk management.

Michael earned a BA in economics from Northwestern University and an MBA with distinction in finance and decision sciences from the J.L. Kellogg Graduate School of Management at Northwestern University in Evanston, Illinois. He is a member of the Beta Gamma Sigma International Honor Society, holds a Chartered Financial Analyst designation, and is a member of the CFA Institute, CFA Society of Chicago, and the Chicago Quantitative Alliance. He is also a graduate of the American Bankers Association – National Trust School.



Yung-Yu Ma, Ph.D.
Chief Investment Strategist BMO Wealth Management - U.S.

As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

Prior to joining BMO Wealth Management, Yung-Yu was a finance professor at Lehigh University, where he taught courses in fixed income, equities and derivatives. His academic studies have been cited in the *Wall Street Journal*, in leading finance journals, top law journals, the *Handbook of High Frequency Trading*, and in *Oxford Handbook of Corporate Governance*. During his tenure at Lehigh, he was awarded the Staub Outstanding Teacher Award, awarded to one faculty member by a vote of faculty and students. Prior to his academic career, Yung-Yu worked for a global consulting firm performing financial and market analysis for global companies with operations in Hong Kong, Taiwan and Mainland China. Later, he oversaw the operations at a Fortune 500 subsidiary in Taipei and Mainland China.

Dr. Ma earned his Ph.D. in Finance at the University of Utah and his B.A. in Economics and Political Science, *magna cum laude*, at Williams College.

Yung-Yu lives in Portland, Oregon with his wife and two children. He is a basketball fan and enjoys cheering on his children's teams.

To view this piece, and other articles online, please visit us at **wealth.bmoharris.com/insights/**

C-11# 7970564
Written: December 06, 2018