

ANTICIPATE

2019 Global Market Outlook

The late-late cycle show



Synopsis

U.S. Federal Reserve tightening, trade wars, China uncertainty, Italy's budget standoff with the European Commission and Brexit imply that 2018's volatility should continue into 2019. We believe that 2020 marks the danger zone for a U.S. recession, which gives equity markets some upside in the year ahead. However, late-cycle risks are rising—and monitoring these risks will be critical to avoid buying a dip that turns into a prolonged slide.

Key market themes

We believe 2019 will feature volatile equity markets that deliver mid-single-digit returns, with better potential in Europe and Japan than the U.S. We have an underweight preference for U.S. equities, mostly driven by expensive valuations. The market cycle is broadly neutral but is likely to be under downward pressure later in 2019. The sell-off in late 2018 has triggered some contrarian oversold signals, so there is scope for a tactical bounce. We expect the U.S. Federal Reserve (the Fed) to follow its December rate rise with three to four additional hikes in 2019, which will probably lead to an inversion of the U.S. Treasury yield curve.

In eurozone equity markets, we expect 8% growth in earnings per share in 2019, which would be a positive outcome for investors relative to what they have experienced over the past two decades. To achieve that profit increase, eurozone gross domestic product (GDP) growth needs to stay at or slightly above the long-run potential of around 1.5%, which we think is very achievable. The main risks to the benign cycle view are the budget conflict between Italy and the European Union, a disorderly Brexit and an escalation of the global trade war. Our base case is for these three risks to fade during the course of 2019.

As UK equities have effectively traded sideways over 2018, they continue to look slightly cheap on our scorecard moving forward. At 1.4%, 10-year gilts are still long-term expensive, and indeed more expensive now than this time last quarter given our higher forecast for the UK base rate.

In Asia Pacific, we foresee another solid year. We expect emerging Asia to deliver over 10% in earnings growth, while we view Japan as well-placed to exceed modest industry consensus expectations. Across the region, we think valuations are fair to attractive. Japanese and Chinese equities stand out as attractive, while Australian equities are close to fair. With inflation and wages gradually rising in Australia, and the labour market at full employment, we think the Reserve Bank of Australia will have the scope to raise rates once in 2019.

We see the downturn in Canadian commodity prices, led by oil in particular, as an ominous sign for future earnings growth. However, the cycle is still modestly positive and relative value is encouraging. Overall, we are slightly positive on Canadian equities, especially relative to U.S. equities, due to the sizeable valuation and yield advantage.

Economic indicators

- An important reason for the strength in the U.S. economy and corporate earnings in 2018 has been the Trump administration's fiscal stimulus. We believe that the peak economic boost from the fiscal stimulus will last into early 2019, before it becomes a drag on the economy in 2020.
- The current U.S. expansion will become the longest on record if it continues to July 2019, which seems likely. That said, we believe U.S. GDP and corporate profit growth will slow, while inflation pressures build.
- Japan and Europe aren't likely to grow faster than the U.S. in 2019, but we believe they have the potential to outperform pessimistic expectations.
- China's economy is on track for GDP growth of around 6.5% in 2018, its slowest since 1990. It faces headwinds from high indebtedness, slowing property construction, poor demographics and the trade war with the U.S. As a result, fiscal stimulus is underway, which should be enough to keep growth near 6% in 2019.

Asset class views

Equities: Broadly neutral

Our cycle, value and sentiment investment process results in an overall neutral view on global equities. While we are underweight U.S. equities, we're more positive on non-U.S. developed equities. We like the value offered by emerging markets equities, but the threat of trade wars, slowing economic growth in China and further U.S. dollar strength keeps us at a neutral allocation. A stronger contrarian sentiment signal that investors are turning negative on emerging markets would be a reason to increase allocations.

Fixed income: Fair value at 2.7% in the U.S.

We like the value offered by U.S. Treasuries. Our models give a fair-value yield of 2.7% for the U.S. 10-year bond. We see German, Japanese and UK bonds as very expensive, with yields well below fair-value. The cycle is a headwind for all bond markets as inflation pressures build and central banks tighten further, such as the Fed and Bank of England, or move away from extreme

stimulus, such as the European Central Bank and Bank of Japan (BOJ). High yield credit is expensive and losing cycle support, as is typical late in the cycle, when profit growth slows and there are concerns about defaults.

Currencies: Preference for Japanese yen

The yen is our preferred currency. It's significantly undervalued, getting cycle support as the BOJ becomes less dovish and has contrarian sentiment support from extreme market short positions.

The euro and British sterling appear undervalued as we move into 2019. The recovery in European economic indicators should support the euro. Sterling will be volatile around the Brexit negotiations, but should rebound if a deal is agreed with the European Union. We think it has more upside potential than the euro. We also believe that the U.S. dollar has modest upside potential.

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