INVESTMENT STRATEGY UPDATE

December 28, 2018

2019 – THE YEAR AHEAD

The year just ending was everything the previous year was not. Instead of steady double-digit returns in the U.S. stock market, investors saw returns evaporate, accompanied by a dramatic increase in volatility.

After starting the year with a bang in response to positive expectations about corporate tax law changes, the stock market pulled back sharply in February as tariff fears surfaced, followed by a steady climb to all-time highs in the early fall. Then, as further concerns over trade and economic growth both here and abroad took hold of investor imaginations, the stock market incurred an even bigger correction into year-end, erasing all of the gains built up over the course of the year, and then some. Many investors even fear that the current cycle is now over and that the next bear market is upon us.

Meanwhile, in the real world, the U.S. economy continued to grow on the back of increasing employment, consumer spending, and business sentiment. Corporate profit growth accelerated, aided by lower and simpler business tax rates from the Tax Cuts and Jobs Act of 2017. Interest rates continued to move gradually upward as the Fed gradually pulled in its monetary stimulus.

What to make of the seeming disconnect between financial market volatility and a nicely growing economy? In *2019 – THE YEAR AHEAD* we discuss the issues around this contradiction. Here at BTR, we still do not think that the current economic cycle, while nearly a decade old, is necessarily finished, but are alert to signs that would point to its demise. Meanwhile, lower valuations resulting from the recent correction provide a launching point for positive stock market returns next year.

The Economy

Economic growth in the U.S. accelerated in 2018, with real GDP growth of about 3% for the full year, compared with an average rate of around 2% over the prior years of the current cycle. Consumer spending grew nearly that fast as well, and business spending continued to pick up, although at a more moderate rate later in the year. Already low unemployment declined still further, down to 3.7% late in the year, below what many economists already believe to be “full” employment.

We think that as long as employment remains strong, consumer spending will continue to grow in 2019 at a pace similar to 2018. Wage growth should finally accelerate as low unemployment forces business increasingly to compete for available labor. While consumer debt has also been growing, consumer balance sheets are in fairly good shape, as debt-to-income ratios are not near previous peaks and consumers have continued to save at a healthy rate of over 6%, even while increasing their spending. Positive consumer sentiment surveys, so far, also support continued growth, perhaps partly because the average American has relatively little direct exposure to the stock market.

In spite of a gradual pickup in business spending over the last couple of years, U.S. manufacturing plant and equipment continues to age, and has been estimated to be at its oldest average since 1963. With aging infrastructure and rising wages, we see business as having no choice but to increase its investment spending in factories, buildings, machinery and productivity-enhancing technology. Fortunately, growing corporate profits provide the capability to do so. This pickup is occurring even though no specific fiscal legislation has yet been passed to encourage business infrastructure spending, and passing any such bill would only further support more investment. Productivity growth has already picked up, and should continue to increase as a result of more capital spending.

Government spending has increased somewhat as a result of stimulus packages, but the biggest increase in the federal budget deficit has been the result of lower tax revenues not fully offset by higher economic growth, at least so far. While there are troubling long-term implications to these deficits, they are not likely to affect the rate of economic growth further over the next year.

Housing and automotive spending are the laggards at this point. The supply of new homes has not yet grown enough this cycle to even keep pace with population growth. Many builders went out of business in the economic crisis of 2008, skilled tradespeople left for other fields, credit for land purchases became harder to obtain, and building regulations became stricter in many markets. The resulting imbalance between supply and demand has pushed housing prices up to levels that are unaffordable to many would-be buyers across multiple markets. However, we think this price surge has mostly run its course, and a gradual increase in supply, especially in multifamily homes, should continue. Automotive spending, while still strong, has inevitably plateaued after the vigorous catch-up from the last recession.

A big concern for U.S. economic growth is trade and the possible effects of tariffs. While the administration has settled its issues with Canada and Mexico, and appears likely to reach agreement with European partners, China still remains a risk. The tariffs that both countries have already imposed or are threatening are significantly larger than those of the other trade conflicts. Moreover, China has clearly been stealing U.S. technology and possibly national security secrets. Because these concerns have been wrapped up in the trade issue, the Trump administration is likely to be willing to incur more economic pain to achieve other objectives.

We are optimistic that the pressure on both sides will ultimately lead to a resolution, but will remain on the lookout for any failure of efforts to compromise. There are already indications that China is making some concessions. In any event, while a trade war with China could slow U.S. economic growth, it would not have a large enough effect to single-handedly throw our economy into a recession, as U.S. exports to China make up less than one percent of U.S. GDP.

Meanwhile, other economies are still growing, although not as fast as the U.S. Several have seen some slowdown in the second half of 2018, but there is still evidence of continued international growth. Employment in Japan is finally growing, while investment spending in the Eurozone is increasing. It does not seem to us that these economies will soon tip into recession.

Overall, we are looking for U.S. real GDP growth to slow somewhat from the tax-law aided 3% to something like 2.0-2.5%, still a robust number. The unemployment rate could creep still lower to 3.5% or less, while the debate on the true size of the labor pool continues. Slower employment growth might lower consumer spending growth a bit, but capital spending should pick up some of that slack. Trade already appears to have slowed some as a result of tariff issues, and this may end up being the biggest factor in pulling GDP growth toward its longer-run average.

<u>Inflation, Interest Rates, and the Bond Market</u>

Inflation was again less than we might have expected in 2018, as wage increases began to slowly pick up later in the year and commodity costs remained under control. With headline unemployment now at cyclical lows, some increase in wage inflation seems inevitable. At the same time, lower commodity prices will continue to have a downward effect on the Consumer Price Index numbers for at least the near term. Case in point, oil prices fluctuated dramatically in 2018. West Texas Intermediate crude oil hit a high of over $75 per barrel in early October, and subsequently dropped to under $50 in December. Many other commodities have also been weaker of late. So, we think inflation will likely stay around a 2% rate, perhaps gradually picking up in the second half of 2019.

Interest rates moved slightly higher during 2018. The Fed funds rate was raised four times by a total of one percent, to a current range of 2.25-2.50%, which takes the rate to near the bottom of the Fed's stated range of what it thinks "neutral" policy is. Bond market interest rates rose also, but by a lesser amount, as the ten-year U.S. Treasury benchmark note yield went from 2.4% at the beginning of 2018 to a high of over 3.2% in the fall, before falling back to a level around 2.75% as concerns about slowing economic growth and stock market selling took over. The Fed also continued to gradually shrink the size of its balance sheet, buying fewer U.S. Treasury bonds as part of its plan to unwind the "quantitative easing" program implemented to help the economy recover from the Great Recession.

The Federal Reserve signaled at its December meeting that it may raise the Fed funds rate twice next year in quarter-percent increments. This forecast is down from its earlier view that it would likely raise that rate three times. Many bond market participants think it will be one increase at most. Whatever happens, the Fed has indicated that it will be "data dependent" and adjust its policy as its sees economic developments unfold over the year. We think that in this environment the Fed will be unlikely to overshoot on tightening monetary policy just to have room to lower rates later.

The so-called "yield curve" of interest rates for each maturity in the bond market continued to flatten in the latter part of 2018 as rates on longer-maturity bonds came back down while the Fed funds rate was being gradually increased. An inverted curve (short rates higher than long rates) has been a reliable indicator of coming economic recessions. While flatter than a year ago, the curve from three-month Treasury bills or two-year Treasury notes to the ten-year benchmark is still positive, so this indicator has not yet raised a red flag (yellow, perhaps). The current curve is actually in a range historically consistent with relatively strong stock market returns.

Because we do not see the economy slowing enough to move into a recession during 2019, and because inflation will ultimately start to pick up before the end of next year, we think that bond market interest rates could move back up somewhat once current stock market selling subsides and investors observe continued decent economic reports. Therefore, we are keeping maturities relatively short in the bond portions of our clients' portfolios.

As the ultimate end of the economic cycle approaches, we also plan to move out of a portion of our corporate bonds and into more U.S. Treasury and agency securities. Corporate debt has grown substantially this cycle, increasing the chances of some challenges in refinancing in a more difficult economic environment, and therefore a likely widening of rates on corporate bonds relative to Treasuries. As rates increase, we will look to extend bond maturities to lock in the higher yields near the peak of the cycle. We will also continue to look for higher quality taxable municipals. For clients in high tax brackets, we will continue to emphasize quality and shorter maturities for now in tax-free municipal bonds as well.

The Stock Market

As noted, the stock market in 2018 saw big swings in sentiment and prices, ending with a thud as a major correction fed on investor fears that the current economic cycle is already ending. Cyclical sectors like industrials, energy, and financials became the laggards and were down for the year. Defensive sectors such as utilities and real estate investment trusts moved into the lead as a result of the market's decline, and healthcare was relatively strong all year. Technology stocks, led by social media and "new" tech, gave up most or all of their strong early performance. Small-cap stocks got hit harder in the correction than large-caps, and international markets continued to lag the U.S.

Is the recent stock market action signaling the end of this economic cycle and the start of tougher times? We don't think so, at least not yet. Recent economic data are not consistent with patterns that have predicted previous downturns. Both consumer spending and productivity are still growing or even accelerating, and these indicators have historically already slowed down before a recession begins. Corporate profit margins also usually start to decline, but in 2018 they actually improved, even after adjusting for the benefits from tax cuts. We know that a stock market decline can itself have a negative impact on business and consumer sentiment. But unless such a decline lasts for an extended period of time, we do not think it will be enough to cause an actual economic downturn.

Economic expansions don't just peter out. They are usually stopped by overly tight monetary policy as the Fed takes away the proverbial punchbowl and lowers the money supply to the economy. The flattening yield curve is one indicator to watch, but it typically inverts well before a recession starts, and it has not even done that yet. Although monetary policy is not as stimulative as it was a few years ago, and the reduction in quantitative easing bears watching, it is not yet anywhere near restrictive. Only the already-lagging housing sector has begun to feel any direct impact, and that is as much a result of high prices as it is higher mortgage rates.

Many investors seemed spooked by the Federal Reserve's apparent disregard for recent market volatility at its December meeting, but Fed Chairman Powell's comments all along have indicated that the Fed is sensitive to the economic implications of tightening too fast. As long as inflation does not increase too quickly, the Fed is unlikely to feel forced to move along any faster than it has already.

Another positive for stocks is investor sentiment itself. That of both individual investors and large money managers has quickly turned from somewhat optimistic to quite pessimistic during the course of the correction. Again, bear markets usually start in a euphoric, even bubble-like environment, and we have never reached that point during the current cycle. A lot of money is traded by large investors, such as so-called hedge funds, with short time horizons and substantial pressure to produce outsized investment performance. Still more trading is done by quantitative models and passive index funds, which pay no attention to the fundamental outlooks of individual companies. When many of these investors head for the exits at the same time, market volatility can be exacerbated.

The recent correction has brought stock valuations back to reasonable levels. At the end of 2017, the Price-to-Earnings (P/E) ratio of the S&P 500 stock index on 2018's expected earnings was over 17. Currently, the P/E on estimated earnings for 2019 is around 14, now below the long-run average of over 15. Earnings have continued to grow while stock prices have declined. This repricing gives the stock market a better opportunity to grow along with earnings.

A reasonable fear on the part of many investors is that the other economies of the world are slowing and might drag the U.S. down with them. After all, we depend on trade for part of our economic growth. However, the U.S. is a more closed economy than most in Europe and Asia; that is, we trade more with ourselves internally than with other countries. U.S. exports to all other countries are only about 12% of GDP. Thus, while slowing trade can slow our GDP growth, it is unlikely enough of a factor to turn it negative. Even a slowdown in China would not be enough to do this, and China's economic policy continues to be accommodative to try to offset a recent slowing of growth. While growth has slowed for a number of economies in the second half of 2018, none of them are currently in recession. Headlines will continue to be made around Brexit, Italian financial solvency, and French tax riots, but none of these will wreck our economy.

So, we expect the U.S. stock market to turn up at some point in 2019, driven by continued earnings growth and now-cheaper valuations that no longer fully discount that growth. While earnings growth will not be a headline-grabbing figure like the 25+% in 2018 as a result of the corporate tax rate cut, we think 5-10% growth is very achievable if real GDP growth continues at a rate of over 2%.

A P/E of 16-17 before the end of 2019 on the following year's earnings is not unreasonable in a 3% interest rate environment, perhaps on the low side of that range if one were finally to become concerned about the economic cycle toward the end of the year. That would imply stock prices could be at least 10-15% higher sometime next year than they are now. Add in a 2+% dividend yield, and total returns for 2019 could be quite interesting.

If the economy continues to grow through next year, it is likely that the selling in the more cyclical sectors will be seen to have been overdone, so areas like industrials and materials look promising for a rebound. Energy stock prices are likely to bounce at least somewhat during the year as demand for oil continues to grow and supply is constrained by the latest OPEC agreement, sanctions on Iran, and production problems in countries like Venezuela. Financial stocks have been penalized by the flattening yield curve, but if it does not invert and loan demand continues to grow, those stocks should do better.

Conversely, relatively good performance recently from the more defensive sectors has taken their relative valuations to high enough levels that their outperformance is likely to end soon. We still like the healthcare sector for its demographic tailwind and the technological advances occurring on a regular basis, but selectivity will be important as valuations have expanded for this group.

Many technology and social media stocks have come down sharply in recent months, raising the possibility that many of them might now be buyable. While valuations are less unreasonable, many are still priced at levels that would make them vulnerable if we are too optimistic about the economy's growth prospects.

At the end of 2017, overseas economies appeared to be starting to grow faster along with the U.S. During the course of this year, however, several European economies have seen growth again soften, while China's slowing growth is pressuring that of emerging market economies. Thus, while valuations have gotten even cheaper for international markets, we are not yet tempted to substantially increase our portfolio exposure to them.

Conclusion

The investment outlook for 2019, while still subject to increased volatility, looks better to us than the recent stock market sell-off would indicate. We have made the case that U.S. economic growth, although possibly slowing in the coming year, will not stop just yet. Both consumer and business spending should increase enough to keep the current cycle going a bit longer. Inflation could gradually start to pick up, but not right away. Tariff issues will cause continued worry, and should not be minimized, but are unlikely to be severe enough to push our economy into recession.

Interest rates are likely to continue increasing gradually as the Fed monitors inflation and employment. The Fed funds rate may be hiked one or two more times, depending on the level of economic growth, and longer-term bond market interest rates will likely also rise somewhat, particularly in response to any pickup in inflation. We continue to maintain shorter-than-average maturities in bond portfolios, while shifting to ever-higher average quality.

The late-year correction in the stock market should provide an opportunity to realize potentially significant positive returns at some point in the coming year as the market recovers. Valuations have come down to below-average levels while corporate earnings should grow at least at a moderate rate. That growth, combined with some re-expansion of valuations as investor fears subside, should produce a better stock market result than that of 2018.

We wish all of our friends and clients peace, joy, health, and prosperity in the New Year, and for many years to come.