STATE STREET GLOBAL ADVISORS

2019
Global Market Outlook

CIO's View

Not Over Until It's Over

Bumpy global markets and increased risk mean investors should assume a more defensive posture and prepare to reposition away from the US in 2019.

Richard Lacaille
Global Chief Investment Officer

While global growth is expected to slow in 2019, with the balance of risks to the downside, we expect investors will still be able to find attractive opportunities in certain parts of the markets where fundamentals remain strong, especially US equities. Although the S&P 500 marked its longest bull run in August 2018, a severe correction in October reminded us that we are closer to the end of the cycle than the beginning and that investors should be prepared for heightened volatility. Still, we see sufficient economic strength and earnings momentum in the US to drive equity outperformance, at least in the short to medium term.

Despite rising inflation pressures, our base case does not anticipate excessive wage growth in 2019 or other imbalances that might tip the global economy into recession in the coming year. But elevated geopolitical and policy risks might easily unsettle markets, especially in the second half of the year.

Moreover, the maturity of the current cycle would suggest a more cautious return-seeking position in 2019, with a diverse combination of defensive equities, high-quality credit and emerging markets selectively across equities and local-currency bonds.

US Expected to Outperform

In the US, there are a number of levers that should send equities higher, including increased capital expenditure intentions as well as higher government and consumer spending. With the Democrats in control of the House of Representatives again, there is at least the potential for renewed focus on infrastructure spending. Earnings growth for US companies is forecast to remain strong in 2019, a year in which we expect investors will pay a premium for quality stocks. The US is leading other regions in earnings per share and sales growth expectations.[1]

The two biggest downside risks to this view are a policy mistake and a doubling down on tariffs with China. The Federal Reserve (Fed) faces a more challenging year in 2019. Having admitted uncertainty over where the neutral rate is, Fed Chair Jerome "Jay" Powell has said the central bank will remain data-dependent and move cautiously.

We have tentatively penciled in three rate hikes for 2019 though the Fed might slow the pace of tightening from every three months to every four or five months depending on the trajectory of growth and inflation. We should have more visibility halfway through the year on whether US fiscal stimulus can extend economic expansion beyond 2019, even as Fed moves to further tighten monetary policy and unwind its balance sheet weigh on global liquidity.

In the US-China trade dispute, one can only hope that cooler heads prevail, since the potential costs of a downward spiral in retaliatory measures are high. Research suggests that increasing tariffs to 25% on all goods traded between the two countries could shave as much as a full percentage point off global growth and more than two percentage points off US and Chinese growth.[2] President Trump still has broad discretion over tariffs even in the wake of a divided Congress. However, with the midterm elections now behind him, Trump's ambitions for re-election in 2020 might lead him to try to accelerate trade deals with both China and the European Union (EU).

1 According to MSCI forward EPS estimates, State Street Global Advisors, Bloomberg, as of September 2018.

2 Stephen Letts, "Trade war escalation could smash global economy and equities: UBS," July 12, 2018.

Politics Dampen European Sentiment

More than cooler heads will be required to restore investor confidence in European markets as the March deadline for the UK leaving the EU approaches. Brexit uncertainty weighed on UK markets for much of 2018, as a negotiated exit continued to elude the May government. Meanwhile, the EU faces more existential dissent from the populist government in Italy determined to ignore EU rules on budget deficits, as well as additional populist challenges from across the continent.

In the latter part of 2018, the spread between Italian and German bonds neared its widest in five years.[3] Both the euro and sterling have been driven lower by growing uncertainty, with the two staunchest defenders of the European project, Germany's Angela Merkel and France's Emmanuel Macron, entering 2019 politically weaker at home. Chancellor Merkel has already announced her departure from the political stage by 2021 after 13 years in office.

3 Bloomberg, Reuters, as of October 17, 2018.

Emerging Markets Opportunities

We believe the guilt-by-association sell-off in emerging markets (EM) in 2018 has created some attractive buying opportunities. While EM equity valuations are roughly at their average level since 2003, their valuations relative to other markets are at all-time lows. In particular, EM consumer-related and tech sectors are much cheaper than their developed market counterparts. In EM bonds and currencies, the severe pullback in 2018 has also created attractive relative valuations.

China Matters Most

We expect all eyes will be on China in 2019, and not just because of its trade dispute with the US. The Trump administration has signaled that it is fundamentally shifting its position toward China, away from the "constructive engagement" of previous administrations toward "strategic containment." This switch seeks to prevent China from increasing its competitive advantage in growth areas like artificial intelligence, quantum computing and biotech. While investors appear to have already priced in a particularly harsh trade environment for China and related emerging markets, we believe markets are only beginning to digest what a fundamental shift in relations between the US and China might mean.

Tariffs now appear to be just a first step toward reconfiguring supply chains that have become more intertwined and global since China joined the World Trade Organization in 2001. Five years after China joined the WTO, the US economy was still five times larger (in today's dollars) than China's; by 2017, the US economy was just 60% larger.[4] Still, the world's second-largest economy must navigate a delicate balance between managing an orderly deceleration and deleveraging process while maintaining social stability at a time when Chinese consumers are struggling with rising food and housing prices.

We still believe that China's long-term, consumer-driven growth story is intact, but a sharpening of competition with the US is likely to insert more event-driven volatility into markets. For global investors, the coming year will be especially significant, as major EM equity and debt indices begin to include Chinese securities. Given the growing importance of China in global capital markets and its outsized impact on EM indexes, we think investors should consider a stand-alone allocation to Chinese equities combining both onshore and offshore exposures in order to better manage risk.

4 The Economist, October 18, 2018.

Prepare to Change Course

Going into 2019 there is so much bad news embedded in European and some EM equities that, if the worst outcomes are averted, we could see attractive upside opportunities toward the second half of the year. Indeed, Europe could stabilize or accelerate at the same time as the fiscal stimulus in the US is starting to fade and higher interest rates are beginning to apply the brakes on growth. Investors should therefore be prepared to reposition equity exposures into other regions at some point in 2019.

Reducing Risk in Fixed Income

Caution and quality are the watchwords for fixed income investors in 2019. With many of the advanced economy central banks expected to tighten and the Fed continuing to normalize its balance sheet, investors will need to proceed carefully. US rates are near a cyclical peak and the yield curve will continue to flatten as the Fed continues hiking. Pricing action in the market suggests caution in credit. Against this backdrop, we believe investors should begin to balance their overall risk posture, look to the front end of the US yield curve for opportunities and explore EM bonds and currencies for value.

Defensive Positioning for Extra Innings

Heading into 2019, we maintain our largest overweight in US equities in our tactical portfolios. We also favor the US dollar, short-duration bonds and higher-quality credit as well as local-currency EM debt and EM currencies. For investors with a longer time horizon, we recommend using pullbacks to add to positions in EM equities. Within Europe, there might be attractive trading opportunities at a micro level within countries and sectors, depending on how they are affected by ongoing trade disputes.

Amid so much geopolitical and policy uncertainty, investors should consider dry powder in the form of cash in order to be more opportunistic, especially in the US where three-month Treasuries are now yielding more than the dividend yield on the S&P 500. Now is the time to add flexibility to portfolios and diversify across regions and sectors. Seek defensive securities that protect on the downside and consider when it makes sense to hedge currency exposures. While the cycle isn't over until it's over, building in strong defenses now will help navigate late-cycle volatility and uncertainty.

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