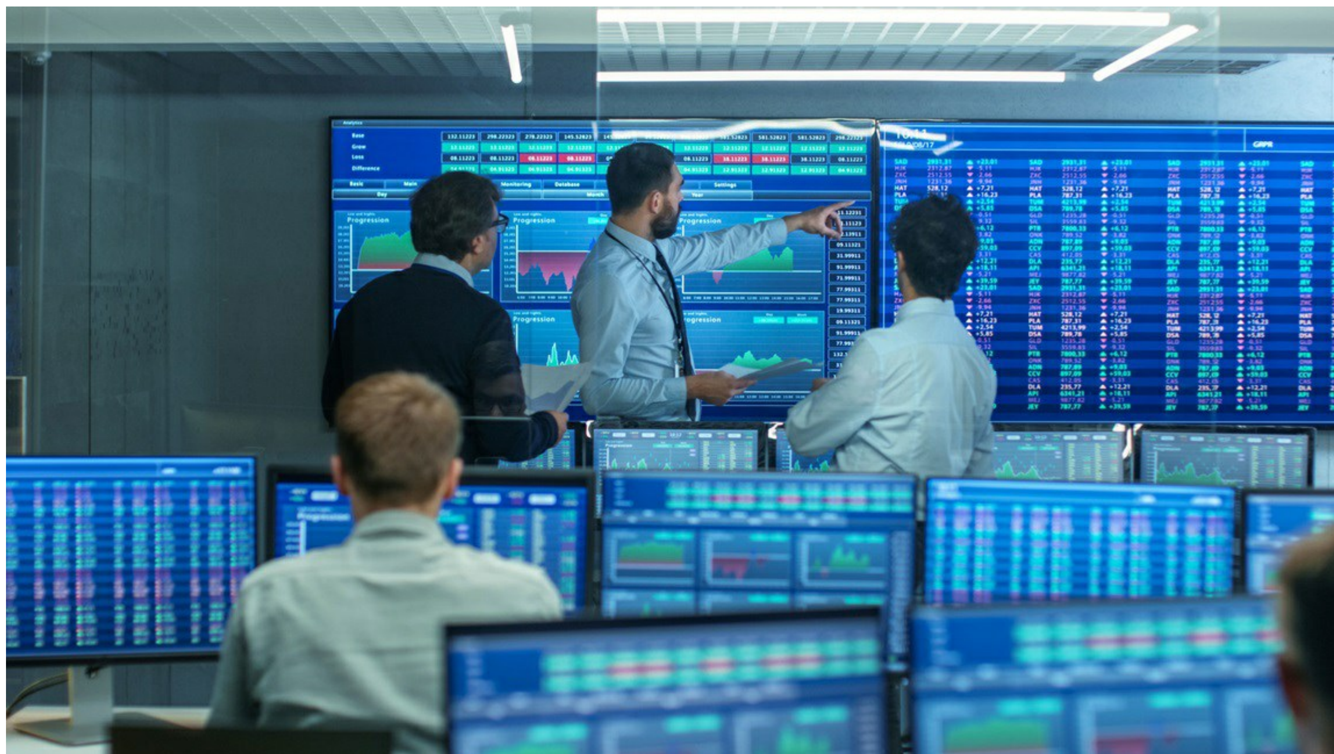
Investment Themes & Strategy

The bull market is losing steam

Mona Mahajan | 06/12/2018



Summary

At the start of 2018, investors were concerned about overheated markets: US tax reform had just been passed, the global synchronised growth story was intact and the S&P 500 index had gained 7.5% by the end of January. What a difference a year makes.

Key takeaways

- 2018 proved to be quite a difficult year for most investors globally; in 2019, we expect modest US market returns and volatility to remain elevated
- Key themes for 2019: the Fed nearing the end of its rate-hiking cycle; a global slowdown and US recession watch; and potential volatility from uncertainty in trade, politics and consumption.
- With expectations for lower S&P 500 earnings growth and contracting multiples, markets are better-poised for upside surprises in upcoming quarters

A look back at 2018

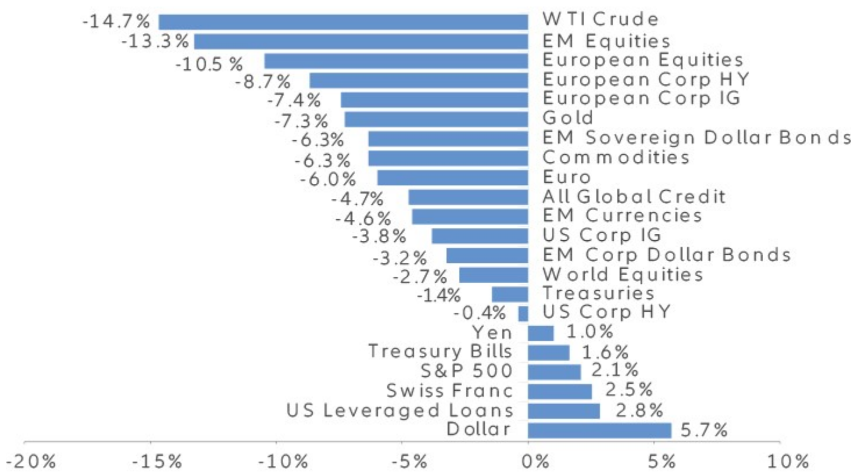
Some key themes that drove market exuberance at the beginning of 2018 have since faded.

- **Global growth slowed:** The global synchronised growth story has slowed, driven by softness in Europe – including uncertainty surrounding Italy and Brexit. This was followed by rollover in China and emerging markets broadly, exacerbated by a stronger US dollar and trade tensions.
- **Some cracks emerged in the US economy:** While the US economic picture remained solid in 2018, a look beneath the surface told a more mixed story. The Federal Reserve seemed determined to continue its normalisation path, deficits were rising and the US dollar moved higher as trade tensions remained escalated. Higher rates hurt rate-sensitive sectors like housing and automobiles, while corporate credit began to look worrisome – particularly as valuations remained rich.
- **Market performance faded:** As a result of these factors, the market euphoria from early 2018 faded as the fourth quarter approached. The US markets had outperformed global markets for much of the year, driven by the technology, consumer discretionary and high-yield

sectors. But they eventually showed signs of strain, with a second 10% correction hitting in October. Investors began profit-taking in some of the most crowded trades – for example, the FANG stocks (Facebook, Amazon, Netflix, Google) – and rotated to defensive areas of the markets.

All told, 2018 has in fact proved to be quite a difficult year for most investors globally, with only a handful of asset classes – some US-centric – offering modestly positive returns **(Exhibit 1)**.

Exhibit 1: Returns of global asset classes year-to-date



Source: FactSet. Data as at 30/11/2018.

Three themes for 2019

As we look towards 2019, three themes seem to be driving US market sentiment and returns.

1 The Fed's rate-hike cycle is nearly complete

The Fed has already raised rates eight times in this cycle, starting in December 2015. We believe it will raise rates again in December 2018, bringing the total to nine hikes for this cycle and resulting in a fed funds rate of 2.25%-2.50% **(see Exhibit 2)**. Beyond 2018, our expectation is that the Fed will likely raise rates one or two times, and then perhaps pause to assess the economic data and impact. The market expectation for 2019 is currently for one more rate hike, while the last set of Fed median estimates indicates three more rate hikes in 2019.

Regardless of which camp is correct, the key point in our view is that the Fed's cycle is close to the end: nine rate hikes have been completed, and there may be between one and four left. As a result, the majority of the market's adjustments are behind us. While it is true that, historically, Fed cycles have often led to recessions (10 out of the last 13 cycles since the second world war), recent commentary from Fed officials, including Fed Chairman Jerome Powell, indicate that this Fed will be prudent and data-dependent, proceeding cautiously as it winds down this cycle.

Exhibit 2: Fed funds rate (upper bound),%

Source: Bloomberg. Data as at 30/11/2018.

While the rate-hiking portion of normalisation is nearly complete, balance-sheet normalisation is ongoing. The Fed so far has reduced its balance sheet by approximately USD 400 billion, from USD 4.5 trillion to USD 4.1 trillion[1] , and estimates are that it will ultimately cut its holdings by another USD 1.0 trillion to USD 1.5 trillion.

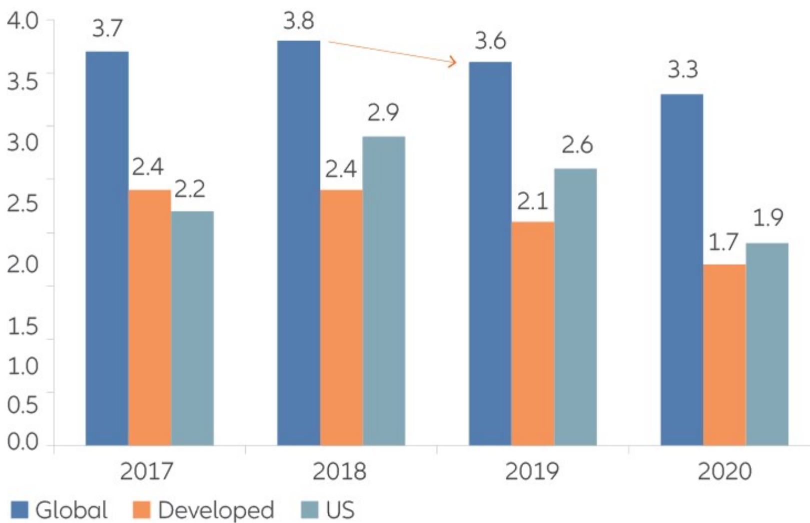
As a result, with more Treasuries coming to market over the next few years – and with rising deficits in the US – we are closely watching changes in long-term Treasury yields, which may be pushed upwards by these two forces over time. (However, bond yields have most recently been falling, as growth concerns have become prevalent.)

2 A global slowdown has begun; the world is now on US recession watch

The global economy has shown clear signals of slowing, with Bloomberg forecasts putting 2019 global GDP growth at 3.6%, down from 3.8% in 2018; similarly, developed-market growth is predicted to fall from 2.4% to 2.1% **(see**

Exhibit 3). In the US, 2018 will likely be a peak year in terms of both real GDP growth and earnings growth. On a quarterly basis, the GDP growth rate likely peaked in the second quarter of 2018 (at a 4.2% annualised rate). We expect GDP to decelerate to less than 2.0% by the fourth quarter of 2019.

Exhibit 3. Real GDP growth rate forecasts (% year-on-year)



Source: Bloomberg. Data as at 30/11/2018.

As we move through next year, keep in mind the confluence of factors that, working together, may create headwinds for the US economy:

- The fading impact of fiscal stimulus and tax reform, which will have anniversaries in the first quarter of 2019.
- The headwinds to global corporations stemming from a strong US dollar in 2018.
- Higher wages and material costs pressuring margins.
- A slowing global economy, from which it may become harder to decouple as fiscal stimulus fades.

While our base case for 2019 does not call for a recession in the US – in fact, our recessionary indicators generally still seem relatively healthy – we and the rest of the world will carefully assess the impact of the Fed's rate hikes, particularly on the US Treasury yield curves and the US credit markets. These could be leading indicators of an impending US slowdown.

3 Black swans abound

Just like in 2018, several unknown factors – "black swans" – could spark market volatility in 2019. These include ongoing trade negotiations, elevated oil price volatility, geopolitical tensions, worries about US corporate leverage and concerns about rate-sensitive portions of the economy – such as housing and autos.

On the subject of trade, US President Donald Trump's recent meeting with Chinese President Xi Jinping at the G-20 summit resulted in a seemingly positive step towards a trade resolution. Mr Trump agreed to hold off on increasing the tariff rate from 10% to 25% on USD 200 billion of Chinese goods, and China has agreed to increase US imports in areas like agriculture, energy and industrial products in an attempt to reduce the widening trade imbalance between the two economies. Importantly, over a 90-day period, the countries will also try to address China's violation of intellectual property rights and its technology-transfer practices. Although we have already seen volatility around the timeline and goals of these trade talks, we believe that both parties have a vested interest – both from an economic and financial-markets perspective – to come to a trade resolution.

While there is certainly potential for negative risks to emerge in 2019, there could also be upside surprises in the US economy – in addition to trade progress.

- We could see elevated consumer and small-business confidence: lower oil prices and a stronger dollar are both supportive of the US consumer, and consumption is a key driver of US GDP.
- And as President Trump's focus shifts towards the 2020 presidential elections, he may work rigorously to avoid having the US economy slip into recession. This could result in additional legislation or stimulus, enacted unilaterally or with the support of Congress, that could be positive for the economy.

Expect another modest year in 2019

Look for modest returns and elevated volatility

All in all, we expect 2019 to be another year of modest returns and elevated volatility in US markets. The good news for US investors is that the bar for earnings growth has come down, with year-on-year growth rates now expected to be 8.8% in 2019, down from 10.2% at the beginning of the year. In addition, price-to-earnings multiples have compressed, with the S&P 500 Index's forward multiple going from 23.3x at its peak to 18.8x – a reduction of 19%[2] . As a result of these factors, markets could be better poised for any upside surprises the coming quarters hold.

Using our own 2019 earnings-growth expectation of 5%-7%, with limited further multiple compression, we anticipate a low-single-digit return for the S&P in 2019. Add to this an average dividend yield of approximately 1.8%, and total returns could reach mid- to high single-digit territory. This would still be attractive compared with many other asset classes **(see Exhibit 4)**.

We also expect volatility to remain elevated in 2019 – keeping in mind the two 10% corrections in 2018 and an average VIX (CBOE volatility index) of 15.9, which is well above the 2017 average of 11.1[3] . Investors should be prepared for similar choppiness as we get closer to the end of the Fed tightening cycle and as US recession watchers remain on high alert.

Exhibit 4. Modest return expectations for 2019

Indicator	2017 actual	2018 to date	2019 expectation
US Equities (S&P 500)	19%	2.40%	Single-digit returns
US Rates (10-Year Yield %)	2.41 (2.04 – 2.63 range)	3.02 (2.41 – 3.24 range)	3.00 – 3.40
US Real GDP Growth	2.20%	2.90%	2.50%
US Inflation (Core PCE)	1.60%	2.00%	2.0% - 2.2%
Fed rate hikes	3 hikes	3 hikes (+1 in Dec, 2018)	2 hikes (with a pause after 1-2)
Volatility	All-time lows	Increases in spurts	Increases in spurts

Source: Allianz Global Investors. Data as at 30/11/2018.

Portfolio positioning: Four to watch

We continue to believe that equities generally offer the highest potential as an asset class, but we still favour a generally more-defensive positioning across portfolio allocations.

1. **US equities:** We believe investors would be prudent to focus on higher quality while applying a barbell approach to sector positioning. We still are looking to participate in the long-term investment theme we call "winners from disruption" – including areas like cloud computing, cyber-security and electronic payments. But we believe investors should balance these with defensive sectors like health care and consumer staples, which can hold up even in a slowing economy. We generally prefer investing with companies with strong balance sheets and free cash-flow metrics at this point in the cycle, since they can better withstand rising rates and a decelerating economy.

2. **Global investments:** We also see another barbell forming from a global perspective. We view China and emerging markets as offering more potential upside for investors, particularly if the US dollar stabilises or weakens in 2019, and if we get a meaningful resolution on trade. The other end of this global barbell remains the US, as its economy will continue to be a relative outperformer in the developed world. In our view, Europe remains uncertain, and until we get more clarity around Brexit and the situation in Italy, it may be difficult to find incremental returns in this region. However, valuations have become more attractive and, notably, Europe may ultimately provide an important source of yield. Dividend yields in the Euro Stoxx 50 and FTSE 100 indexes average 3.7% and 4.6%, respectively – well above the S&P 500's yield of 1.8%.

3. **US fixed income:** We are positive on shorter-duration fixed income and incrementally more cautious on high yield; we believe active management is critical for this space. We also believe convertible bonds could benefit from elevated volatility. We remain comfortable with an allocation to US Treasuries, which remains a flight-to-safety asset class and can be a good place to tactically park assets while awaiting market opportunities.

4. **Alternatives:** As we get later cycle in the US economy, we believe there should be more room for alternative assets in an investor's portfolio. This may come in the form of private equity or credit, as well as areas like infrastructure debt and equity. Both remain less correlated to both public equities and fixed income, and as a result offer a good source of potential portfolio diversification.

[1] Source: Bloomberg. Data as at 30/11/2018.

[2] Source: Bloomberg. Data as at 30/11/2018.

[3] Source: Bloomberg. Data as at 30/11/2018.

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