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 might be understandable as 2018 winds down, we see upside potential in certain regions and expect some of the issues underlying these risks to be clarified or resolved within the next year. Consistent with a more favorable outlook, our current positioning maintains an overweight to risk assets.

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U.S.: Continuing to grind higher

It is likely U.S. GDP growth in 2019 will 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. 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 2.5. Investors are likely to get skittish around the possibility of overtightening because the market is now pricing in less than one 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 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 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.

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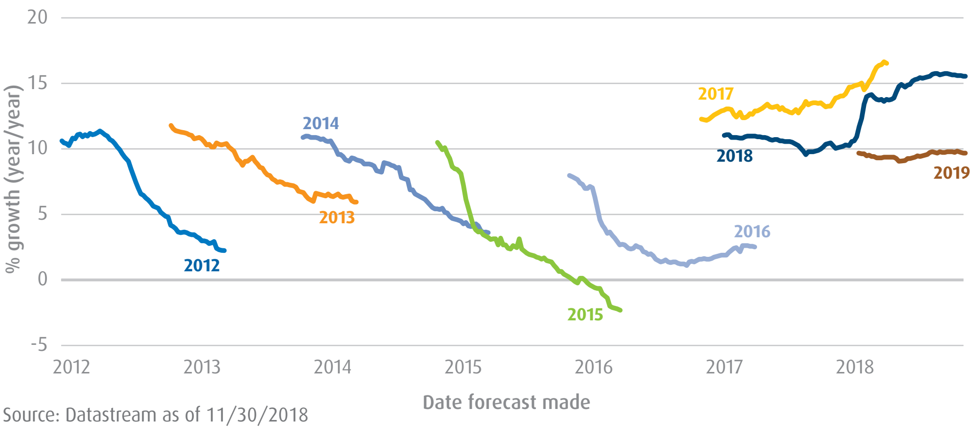
MSCI World EPS Growth Forecasts



Source: Datastream as of 11/30/2018

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.

Benchmark energy prices have taken a nose dive since peaking near US$77 in the fall. Canadian producers experienced further downward pressure with the collapse of the Western Canada Select (WCS) benchmark due to Canada's capacity-constrained distribution system. Although transportation capacity is expected to increase in 2019, the oil market is still subject to the poor supply and demand fundamentals that have recently emerged, keeping the outlook for oil prices quite grim. Record production in the major regions has elevated supply levels coincident with concerns of a slowdown in demand due to peaking global economic growth. Rock-bottom prices represent a significant headwind not only for the energy sector but the Canadian economy as a whole due to second-order effects throughout the country.

The second driver of performance is the path of monetary policy over the next year. The Bank of Canada has confirmed that it intends to raise the policy rate back to its estimate of the neutral rate, but consensus expectations 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. These challenges have also increased the likelihood that Canadian GDP will underperform consensus expectations for the year. The central bank may then be forced to shift policy guidance and back away from its more hawkish stance.

Depressed oil prices, rising interest rates and a leveraged consumer may elevate risks for a Canadian recession, but with a federal deficit at less than 1% of GDP, Canada has ample fiscal leeway for contra-cyclical policies. The government's recent fiscal update indicated this potential policy shift, with increased incentives for business investment.

Canadian equities look inexpensive on an earnings basis and in many cases should 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. On this basis, we do not see a catalyst for outperformance by Canadian stocks. Currency considerations further fuel the bias towards non-Canadian denominated equities, as any shift to a more dovish stance by the Bank of Canada will cause further weakness in the Canadian dollar. 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.

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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. 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.

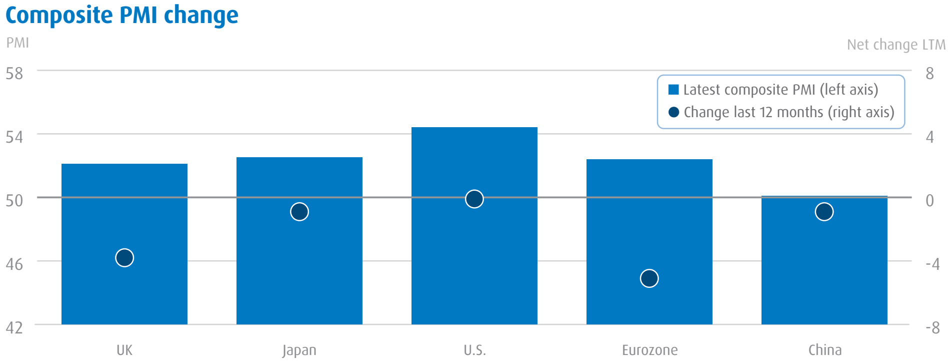
As for Italy, new elections are a possibility and the result may be a center-right coalition, which could introduce more pro-growth economic policies. This would be a positive outcome for both Italy and Europe, but getting there requires a sequence of events that remains difficult to predict.

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 EU. 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.

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.

"Muddle through" seems set to characterize European markets for another year.

Composite PMI change



Source: Markit

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."

MSCI EM Index – Trailing P/E ratio

Source: Bloomberg Financial, BMO Wealth Management

The U.S. dollar and U.S. interest rates are also important drivers of emerging market economies. Strength in the U.S. dollar has 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 across these markets. Over the course of the next year, we expect U.S. dollar strength to taper off as the Fed nears the end of its rate-hike cycle and this should in turn dissipate as a headwind for the region.

A final broad consideration is the tendency of EM equities to swing dramatically with risk-on and risk-off market sentiment. 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 level of uncertainty. Although this currently poses a near-term challenge for the region, resolution of some of these risks over the next year could lead to a more attractive environment for these assets. For now, ongoing risks remain, 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 across the global economy.

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Summary: A new year is upon us

As one year concludes, our focus naturally turns to the outlook for the year ahead. We are reminded that even when headwinds and risks appear plentiful, opportunities will also arise in the midst of these conditions. Many people may have resolutions on their mind — those that result in changes of habits or forming new ones. But it is another type of resolution that investors are really seeking — the resolution of some of the issues that have plagued the markets over the past year — trade, monetary policy, politics and inflation fears. As the uncertain becomes more certain, these risks will transform into opportunities and we look forward to participating along the way.

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