

Market and Economic Insights

Quarterly review and outlook



Stop the madness: Closing out March (and the first quarter) with some clarity

Despite the elevated volatility that investors experienced in late 2018, our 2019 outlook remained relatively optimistic. We expected the new year to bring some clarity to the global picture for investors and remained overweight risk assets (particularly U.S. equities) as a result. During the first quarter, we received a clear answer to one of the underlying questions that had vexed markets (global central bank policy) and saw some progress on another (trade policy).

While these were positive developments for equities, risk assets still busted quite a few brackets in the first quarter. The S&P 500® rose 13.1%, its best quarter since 2009 and best start to a year since 1998. This exceptional performance occurred in spite of a yield curve inversion in the U.S., which has typically indicated recession concerns. These concerns underpin the consensus view regarding the end of the business cycle. We continue to diverge from this view and believe the cycle still has legs, which supports our overweight to equities. Though forecasts of corporate earnings growth have been sharply reduced, we believe these estimates have swung too far to the negative. We think an upside surprise could be relatively easy to achieve, especially in the U.S., where the economic backdrop remains solid.

Powell's "put" and the song of the dove

A sharp dovish turn from the Federal Reserve (Fed) in January led to speculation about a "Powell put" and echoed the expectations once placed on Janet Yellen, Ben Bernanke and Alan Greenspan (i.e., that the Fed would step in if equity markets fell sharply). In December, Fed chairman Jerome Powell was singing the economy's praises and suggesting the Fed's balance sheet runoff was on "automatic pilot." By January, he was highlighting slowing global growth and indicating flexibility in the effort to reduce the balance sheet. The change of course culminated in a very cautious March meeting, where Fed members conveyed their expectation for no further rate hikes in 2019.

This was particularly fascinating because the conditions used to justify the January shift were largely the same conditions faced in December. Specifically, Powell emphasized tightness in financial conditions. In fact, financial conditions had eased in early January. Similarly, while the Fed's growth expectations were revised down in March relative to December, these minor adjustments ordinarily would not warrant such a dramatic tack.

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The Fed wasn't the only central bank to change its tune. The European Central Bank (ECB) also surprised on the dovish side at its March meeting, extending forward guidance and announcing that another round of financing to banks called targeted long-term refinancing operations, or TLTROs, would begin in the fall. Markets responded in a risk-off fashion with the euro selling off, European government bond yields falling and eurozone bank stocks dropping by nearly 5%. This was partially due to the ECB sharply marking down its growth and inflation forecasts and also the perception that the central bank was behind the curve in dealing with slowing growth.

The Bank of Canada (BOC) joined the dovish chorus in March as well, dropping its pledge to continue raising rates into a neutral range while noting that the slowdown in the global economy has been "more pronounced and widespread" than the BOC had forecast. The Canadian economy grew just 0.4 percent in the fourth quarter, providing more evidence for those arguing that the BOC was out of tune with the slowdown.

The U.S. and China are getting closer, but to what exactly?

The early December trade truce agreed to by President Trump and President Xi Jinping was extended past the original target date of March 1. However, a mid-March summit at Mar-a-Lago failed to materialize and it now looks like any potential agreement will be pushed back until at least April and possibly June, though timing remains highly fluid.

Potential features of a U.S.-China trade deal



Additional purchases of U.S. goods by China

- Goal of reducing the bilateral trade deficit
- Soybeans and natural gas are likely commodities

Ending currency manipulation

- Including language by which China agrees to stop weakening its currency to boost competitiveness
- Opening several markets to global competition
- Financial services, insurance, automobiles

Possible impediments to a deal

- China's state subsidies to corporations
- Forced joint ventures/technology transfers
- Intellectual property protection

Procedural questions remain for the U.S. relative to existing tariffs, which currently affect \$250 billion in goods. The U.S. may remove the tariffs while maintaining the threat to reinstitute them if China does not accomplish certain reforms, or it may seek to maintain the tariffs until the reforms are in place. While we expect an agreement in the short-to-medium term, the role of tariffs in the negotiations and ultimate deal is likely to cause continued uncertainty.

The European Union may be the next target for the U.S. administration's aggressive trade renegotiation strategy. After China, the EU has the largest trade surplus with the U.S., and President Trump has made it clear he wants to focus on European autos and auto parts. Now, with the blessing of the Commerce Department, he has the leeway to impose — or more likely, threaten to impose — tariffs on this industry. While we do not expect the U.S. to enact these tariffs, the threat alone could roil markets in the coming months.

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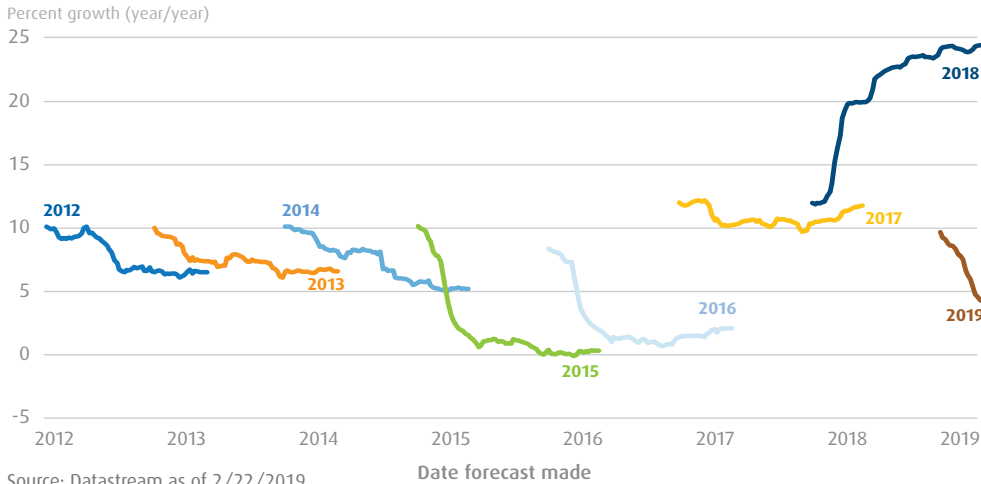
The European Union may be the next target for the U.S. administration's aggressive trade renegotiation strategy.

Equity earnings: Expectations take a tumble but have they fallen too far?

While equity investors have grown accustomed to +20% earnings growth over the last few quarters, this figure will likely come back to earth in the first quarter. With negative earnings growth expected in the quarter (and very slight positive earnings growth expected in quarters two and three), investors may fear a repeat of 2015–2016, when the U.S. saw negative earnings growth for six consecutive quarters.

First-quarter earnings expectations for U.S. companies have been downgraded by 6.6% since the end of 2018, a steep drop that is much larger than the average decline.

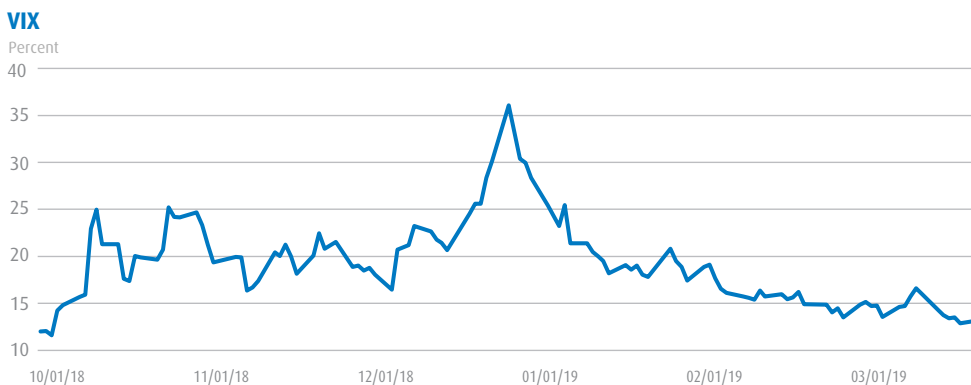
MSCI U.S. earnings growth forecasts



While we recognize the negative momentum behind earnings estimates, we think expectations have cratered to a point where it will not take much for companies to deliver an upside surprise. Moreover, U.S. companies should continue to benefit from an economic backdrop that remains solid. Wage growth has buoyed the confidence of the American consumer but has not risen to levels that would materially erode corporate margins. This wage dynamic has led to the current happy equilibrium where consumer spending and business profits can coexist at healthy levels.

Volatility has a wicked crossover

Coming into 2019, the expectation that volatility would remain elevated was very much a consensus view. In fact, volatility wrong-footed just about everyone in the first quarter by declining sharply and dipping to lows reached near the market peak last fall.



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Part of the explanation here is likely the clarity that investors received on key risks, as noted above. Additionally, economic growth is expected to pick up in the second half of 2019 and financial conditions have eased. Measures of consumer and business confidence in the U.S. have recovered from lows reached early this year. While some uncertainty around a trade deal persists, policy easing in China has also contributed to the volatility decline, as policymakers there have taken a number of measures to stimulate growth, including lowering tax rates and reducing banks' reserve requirements. While the first quarter's drop in volatility was a surprise to many, we do not expect a consistent stretch of placidity such as we saw in 2017. This year is more likely to resemble 2018, with longer periods of low volatility interrupted by bouts of high volatility. Uncertainty about the U.S. business cycle, trade policy, the start of the 2020 U.S. election cycle and Brexit all continue to loom over the market.

Conclusion

The dovish shift by global central banks, combined with some positive developments on trade, supports our overweight to equities. We remain underweight to credit as a partial balance to this position. Additionally, we hold a small cash position in our portfolios. Cash has become more attractive given the flat yield curve and our desire to keep some "dry powder" available to deploy quickly as opportunities arise. The sudden selloff in the fourth quarter of 2018 illustrates how rapidly investor sentiment can change and highlights the benefit of holding cash during these periods.


Developments in wage inflation and corporate earnings are likely to be among the most important factors in the coming quarters. The path of wage inflation will largely determine the Fed's actions and positive corporate earnings will have a significant influence on investor sentiment.

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