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As 2018 draws to a close, the investment team at Roosevelt is engaged in the annual exercise of debating which critical factors could determine U.S. equity market performance in 2019. In recent years, we have generally approached each upcoming turn of the calendar with optimism, underpinned by our expectations for U.S. economic growth, corporate earnings growth, and an accommodative central bank. Last year we anticipated an additional boost from fiscal stimulus. This time around, our level of optimism is reduced but not extinguished.

As we see it, the key difference relative to the prior few years is that financial conditions have tightened. As compared to a year ago, U.S. Treasury yields are higher. Corporate credit spreads are wider. The U.S. dollar is stronger. And commodity prices are lower across crude oil, industrial metals and agriculture. On balance, these conditions make it more challenging for U.S. businesses to invest, which we expect to weigh on the U.S. economy and corporate earnings growth.

Moreover, we anticipate the Federal Reserve will transition U.S. monetary policy from accommodative to neutral, both by raising its benchmark interest rate and reducing the size of its balance sheet. Fiscal policy may provide a modest offset as the deficit widens, but far less than the 2018 tax reform. And uncertainty related to funding the government or raising the debt ceiling could weigh on capital markets next year, following midterm elections that have returned the nation to divided government.

Unfortunately, we do not expect these headwinds in the U.S. to be offset by improving conditions abroad. The European Central Bank has communicated its plans to reduce accommodation, by first eliminating its asset purchase program and then raising its benchmark interest rate for the first time since 2011. There will also be several important European political developments, including whether the U.K. can achieve an orderly exit from the European Union, and if Italy and the E.U. can reach a budget agreement.

The U.S.-China trade dispute is also likely to have global reverberations, especially as China balances its shift toward a consumer-driven economy with its need for stimulus and the burden of substantial system-wide debts. Furthermore, the strengthening U.S. dollar raises the risk of capital flight from emerging markets, particularly those with large current account deficits and dollar-denominated debts. The record \$57 billion IMF bailout of Argentina this summer was one such event, and additional economies may be vulnerable. Overall we have witnessed a shift from synchronous global growth in 2017, to more divergent paths in 2018, to what may potentially be a synchronous global slowdown in 2019.

While there are many risks to be concerned about, we still anticipate market appreciation in 2019. The U.S. economy may slow from its 2018 pace, but we still expect it to grow above potential. The consumer is the engine of the U.S. economy and it continues to run well. Consumer confidence is at cycle highs. Unemployment is at peacetime lows. Job creation is

healthy. And wage growth is in excess of inflation. We expect a strong holiday shopping season, though not without significant promotional activity. In the coming months, gasoline prices are expected to follow crude oil prices lower, and tax refunds could surprise to the upside due to tax reform, providing further support to the consumer. Housing is a notable exception, as higher mortgage rates have weighed on affordability and activity has slowed. However this malaise has not yet spread to autos, where sales have plateaued at a historically high level for several years now, with declines limited to the passenger car segment.

Similar to the U.S., the slowdown in Europe is also beginning from a position of strength, such that growth may persist at or above potential next year. Moreover, over the course of this cycle, European politicians have time and again demonstrated their ability to come together at difficult times and at least kick the can down the road, so to speak. We expect the current U.K. and Italian challenges will prove no different. In China, the leadership has been managing a gradually slowing economy for many years now. Though Beijing did stumble in early 2016, it has yet to collapse, and its \$3 trillion in foreign reserves suggests it has the wherewithal to stimulate growth or shore up its banking system as needed.

In our view, the U.S.-China trade dispute is a wildcard. The U.S. has reached revised trade agreements with Canada and Mexico as well as South Korea, and its negotiations with the E.U. have progressed sufficiently to abate any further protectionist actions. So, tough talk from the U.S. administration may simply be an 'Art of the Deal' style tactic that does not preclude an eventual settlement. However, China may prove different, because the dispute encompasses trade practices whose resolution appears more intractable, and it may also be part of a larger geopolitical struggle. The recent G-20 agreement to delay further tariffs is a positive sign, but a permanent deal still appears far off. We expect developments from this ongoing dispute to continue to generate capital market volatility, and are reluctant to make a call on how it may ultimately turn out.

Overall we expect slowing but adequate growth across the major economies to drive U.S. corporate earnings growth in the mid-single digits. While consensus forecasts from Wall Street strategists may be slightly higher than this, it is the normal historical pattern for these to be revised down over time. The recent market correction has left U.S. stocks broadly valued in line with historical precedent, and therefore in our view not unduly vulnerable to further compression. Thus we arrive at our expectation for modest equity market appreciation in 2019.

At the same time that our return expectations have moderated, our volatility forecasts have increased. In the latter stages of a bull market, as the Federal Reserve raises interest rates and the yield curve flattens, investor sensitivity to the risk of recession grows markedly. We are on the lookout for signs of heightened recession risk, such as reduced payroll additions, rising unemployment, slowing freight flows, weakening consumer credit, tightening bank lending standards, and widening credit spreads. As U.S. gross domestic product grew 3.5% in the third quarter, and these data sets broadly do not suggest much more than a modest slowing, we do not expect a recession or bear market in 2019.

In 2018, there have been two market corrections to date, which is the average of what

investors have experienced in a typical year over the past few market cycles—though it may have felt more severe this time following a near-record year of calm in 2017. Because of the late cycle environment and its attendant recession risks, we expect there could be similar bouts of volatility in 2019 to those experienced in 2018. We believe the combination of average volatility with more modest returns suggests that the risk to reward ratio of investing in U.S. stocks may moderate somewhat in 2019.

Our portfolio positioning reflects this later-cycle view. We hold a little more excess cash than is typical, and we have continued to shift our holdings toward more recession-resistant stocks. These are stocks that we expect to outperform in corrections that are sparked by recessionary fears, or in the bear market that we believe will ultimately arrive in advance of the next recession, whenever it occurs. That said, we hope and expect our portfolio to at least keep pace with the modest market appreciation that we forecast for next year, while our slightly more defensive positioning should provide ballast for our clients in the event of future periods of market volatility.