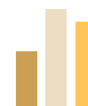
December 2018

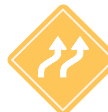
2019 outlook: Steady as it goes for U.S. growth

The U.S. economy continued to hum along at a strong pace in 2018 with not many hiccups to slow it down. After such a good run of economic growth, it wouldn't be surprising to see the pace of expansion moderate in the coming year. Even with continued economic strength and a healthy earnings environment for U.S. businesses, financial markets are worried about how much gas remains in the tank. For 2019, we see the potential for U.S. stocks to appreciate and international markets to narrow the gap, while rising short-term rates exert pressure on longer-term bonds.

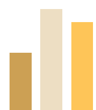


U.S. economic growth is expected to cool but remain strong through 2019.

Business conditions should remain favorable, likely helping stocks advance through the upcoming year.



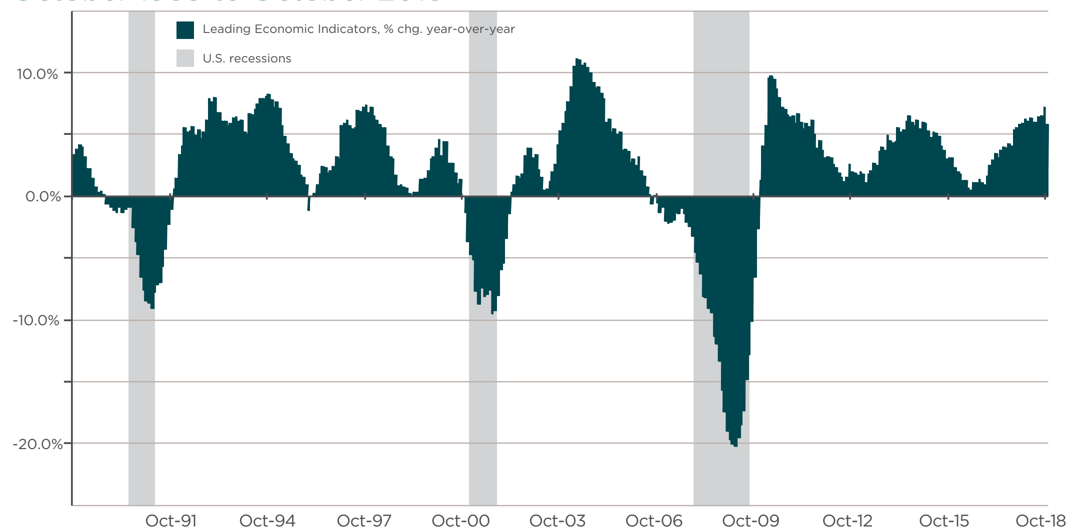
Primary risks to our outlook include increasing margin pressures and uncertainty around trade.



U.S. economic growth is expected to cool but remain strong through 2019.

- The U.S. remains in the maturation phase of the business cycle, but we do not anticipate a recession arriving in the next 12 months.
  - The trend in U.S. leading economic indicators is well into the positive range as 2018 ends; this signal has historically turned negative in advance of previous recessions (see chart below).
- Real GDP growth in 2019 should slow down from this year's approximately 3.0% pace but is likely to remain above its long-term trend.
  - Higher interest rates from Federal Reserve tightening and rising inflation, the lessening impacts of tax cuts and increased federal government spending, and slower growth abroad should combine to cool economic activity.
- Nationwide Economics projects the unemployment rate to drop further during 2019 — potentially to levels not seen since the 1950s — while wage gains should continue to accelerate.
- Inflation is expected to edge higher in 2019 as labor and product markets continue to tighten, moving the annual pace of price increases further above the Fed's 2.0% target.
- The Federal Reserve should stay on track toward rate normalization; we anticipate three quarter-point rate hikes in 2019, bringing the federal funds rate up to a range of 3.0% to 3.25% by year-end.

Chart 1: Conference Board Leading Economic Indicators, % change year-over-year
October 1989 to October 2018

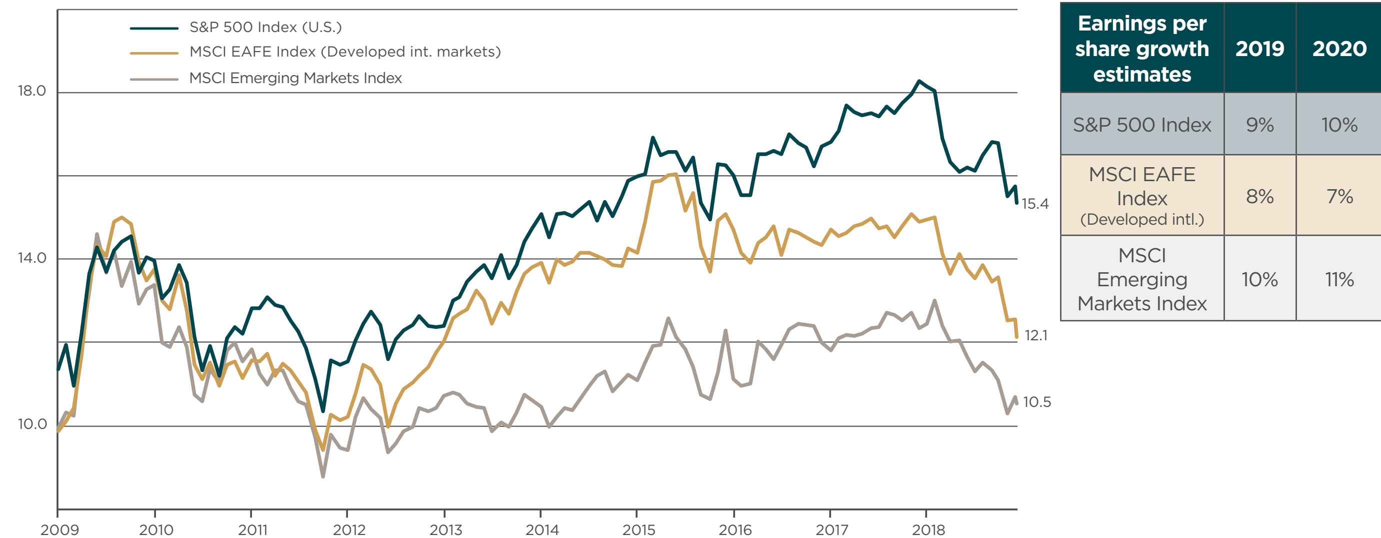


Source for data: The Conference Board (Leading economic indicators); National Bureau of Economic Research (Recession dates)

Business conditions should remain favorable in 2019, likely helping stocks advance through the upcoming year.

- The consensus estimate for 2019 earnings growth for S&P 500 firms is around 9%, with 5% estimated for annual sales growth.
  - Bear markets are rare in periods when earnings and sales growth are both so strong.
  - While U.S. stocks may avoid slipping into bear market territory in 2019, we expect the current spell of market volatility to continue in the new year.
- Stock market valuations (as measured by the price/earnings ratio of the S&P 500 Index) were reset in 2018, falling from 18.5 times earnings in January to 15.5 times earnings in December.
  - The current P/E ratio for the S&P 500 is lower than its 20-year average of 15.8 times earnings.
- In international markets, growth slowed and equity indexes slipped in 2018, highlighting the gap between the U.S. and the rest of the world, but there is potential for stock markets to recover in 2019.
  - Valuations in international markets currently appear more attractive on a relative basis, with earnings growth in developed and emerging markets on par with the U.S. (see chart below).
- Given where we are in the business cycle, it's not unusual to see interest rates rising across the board, but as long as business activity and fundamental performance remain strong, the pressure on investment-grade bonds is likely to stay in place.

Chart 2: Price/earnings ratios of U.S. and international stock indexes
January 2009 to October 2018



Earnings per share growth estimates	2019	2020
S&P 500 Index	9%	10%
MSCI EAFE Index (Developed intl.)	8%	7%
MSCI Emerging Markets Index	10%	11%

Source for data: FactSet Research Systems

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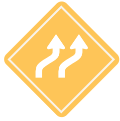
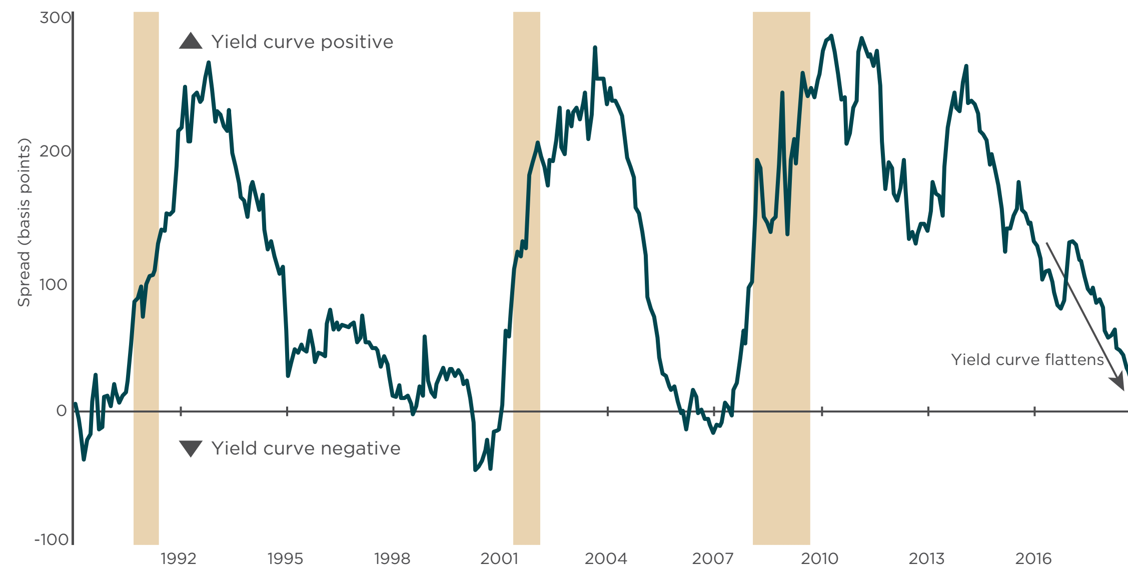


Primary risks to our outlook include increasing margin pressures and uncertainty around trade.

- U.S. businesses may start to feel a squeeze on margins due to rising interest rates, a stronger U.S. dollar, tight labor markets and higher wage pressures; this could contribute to a slowdown in earnings growth in 2019.
- Companies and sectors should continue to feel the ripple effects of President Donald Trump's trade policies, from higher tariffs on select imports to uncertainty around the outcome of continuing trade negotiations between the U.S. and China.
- The yield curve is likely to remain flat and be poised to invert as Federal Reserve rate hikes push up short-term interest rates and spreads between long- and short-term rates stay narrow.
  - Historically, the yield curve has tended to be flat at this point in the business cycle.
  - On average, there has been about one year of lag time between when previous yield curves have inverted and the start of the subsequent recessions.
  - If the yield curve does invert, the expansion may continue to show strength and equities may perform well before a potential recession.

Chart 3: Spread (difference) between 10-year and 2-year U.S. Treasury rates
January 1989 to October 2018



Source for data: FactSet Research Systems (Treasury rates); National Bureau of Economic Research (Recession dates)

Key takeaways

U.S. investors continue to ask how much farther can the current expansion and stock market rally go. We may be closer to the end than the beginning of the cycle as of the end of 2018, but there still may be opportunities for growth and return for prudent investors to uncover. We may be in a transition phase right now as momentum stocks start to wane and quality stocks rise to prominence. This would be expected at this point in the business cycle. There's room for the expansion and the stock rally to continue, but investors must also be prepared for the risks.

- Focus on the investment plan you created with your financial advisor to help you stay on track toward your goals.
- Stay invested in the financial markets according to your risk tolerance in order to capture opportunities for return as they appear.
- Reassess your risk tolerance with your financial advisor to ensure you're not overexposed to risks you're not comfortable with.
- Tune out the noise around news headlines and political events to avoid emotional reactions and decisions within your investment portfolio.

For more help or information, contact your financial advisor.

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MSCI EAFE® Index: An unmanaged, free float-adjusted, market capitalization-weighted index that is designed to measure the performance of large and mid-cap stocks in developed markets as determined by MSCI; excludes the United States and Canada.

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