The Marathon Economic Expansion Is Slowing

2019 Annual Outlook

Marathons are often used as an analogy for investing, and for 2018, it's more than appropriate. We are currently in the second-longest economic expansion in history—the longest if it continues to mid-2019—and the longest equity bull market run ever. Both were well paced for the long distance, though the tempo has picked up in recent years. Some highlights from the race so far:

- Equity markets, generally a leading indicator of economic growth, jumped in 2017 on the possibility of new tax legislation.
- In 2018, as a result of lower taxes we saw corporate earnings soar nearly 20%.
- Real GDP growth also strengthened and could finish the year over 3%, nearly a percent higher than the average we have seen over this slow growth expansion.

But even with this great year economically, stock market returns were weak. Investors have their sights on 2019 and beyond, and fears that growth may be returning to a slow pace—and eventually stopping—have depressed returns.

Key Takeaways:

- The U.S. economy is expected to slow from its current pace, but we do not anticipate a recession next year.
- Equity markets entered 2018 with high valuations. The stock market pullback late in the year pushed down price to earnings (P/E) ratios and other valuation metrics to more average levels.
- We expect bond returns to be better in 2019, but not spectacular. Yields are higher and could help buffer price declines. We are cautious on the more credit sensitive parts of the market.
- Risks in markets continue to build. We will continue to pay attention to trade negotiations between the U.S. and China, geopolitical risks (especially in Europe) and the Federal Reserve.

While the economy is expected to slow, we do not foresee a recession in 2019. The chances of negative GDP growth are low, considering the fundamental strengths in the economy. Labor markets are strong, making for a strong consumer, which in turn should support corporate earnings. However, we will be watching closely for wage inflation, rising rates, and increasing input costs due to tariffs. These can all chip away at company bottom lines.

In 2018, it did not take long for market volatility to return. Stocks seesawed on news around tariffs, the Federal Reserve, and a potential earnings slowdown. We expect these themes to bleed into next year. We do feel China and the United States will eventually come to an agreement, but it's hard to gauge when this will happen. The Federal Reserve will be watching inflation data and markets closely, trying to hike rates if the opportunity presents itself.

Earnings growth, which tends to drive long-term equity market performance, is expected to weaken in 2019. Valuations such as (P/E) ratios have also come down due to the pull back in equity prices late in the year. Going into 2018, valuations (near 15-year highs) were a concern, so lower valuations could provide investors with a better entry point.

Many bond investors experienced losses in 2018, although they were generally moderate. We expect next year to be challenging for bonds but results likely will be better because higher yields buffer price declines. Another positive is that we could be getting near the Fed's terminal rate, and there may be fewer rate hikes than expected.

Based on GDP growth, expected corporate earnings growth, inflation expectations, and dividend yields, our baseline 2019 market expectations is for large cap U.S. stock returns to be positive, in the mid-single-digit range. We expect large cap stocks to perform slightly better than small caps, as they tend to be more stable during the volatility of late economic cycles. This excludes any positive or negative effects of multiple expansion or contraction. In the bond markets, we expect returns for intermediate term bonds to be flat to low single digits. This is based on current yields with some potential yield curve flattening, or inversion as rate hikes continue; it doesn't take into account impacts from any credit spread tightening or widening.

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Glossary
Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.