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“Stuck between a rock and a hard place.”

In 2018, the markets watched daily economic, political and inflation news that saw volatility return to global investing. In 2019, investors should expect more of the same, as the markets watch Central Bankers dance between growth (or lack of), inflation and trying to prepare for the next economic downturn.

By: Stephen Colavito Jr.
Chief Market Strategist
Lakeview Capital Partners

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A Look Ahead

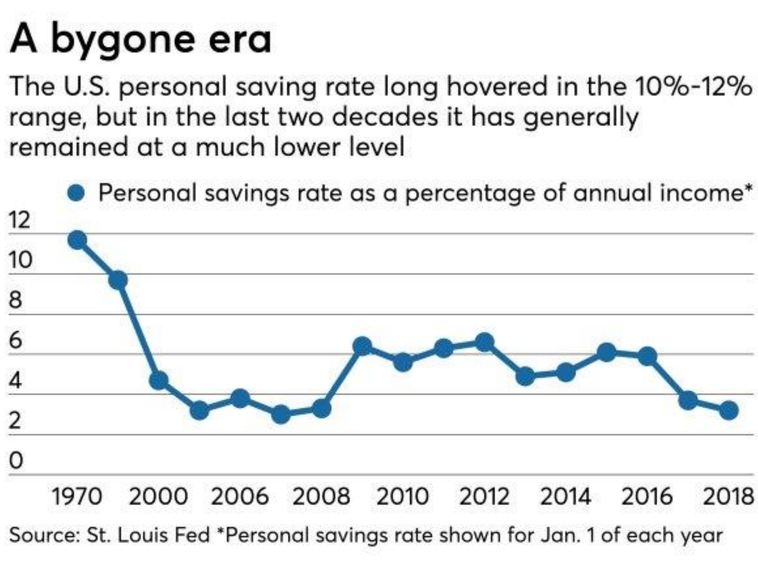
As we finish the last few weeks of 2018 and look forward to a new and hopefully prosperous New Year, there are several headwinds that limit our excitement about the markets next year.

First, it is our belief that the US economy will continue to grow in 2019, but at a slower pace than in 2018. The current median estimates are calling for GDP to grow at 2.6% in 2019 (source; Bloomberg). We believe that is a bit optimistic as our range is lower at 2.00-2.25%. Secondly, earnings revisions are likely to move lower as the economy slows. The current S&P 500 2019 EPS view is $174 which again, we believe is a bit high. Global breadth is now negative and weakening both in the US and overseas. Investors could see a deceleration in EPS towards the back half of the year and our estimate is between $165-170. Lastly, monetary policy will be put between a "rock and a hard place" as central bankers (particularly the Fed) will be under pressure with not to raise rates by both Wall Street and the White House, while trying to contain wage pressure and increasing the Feds ability to deal with a future economic down cycle.

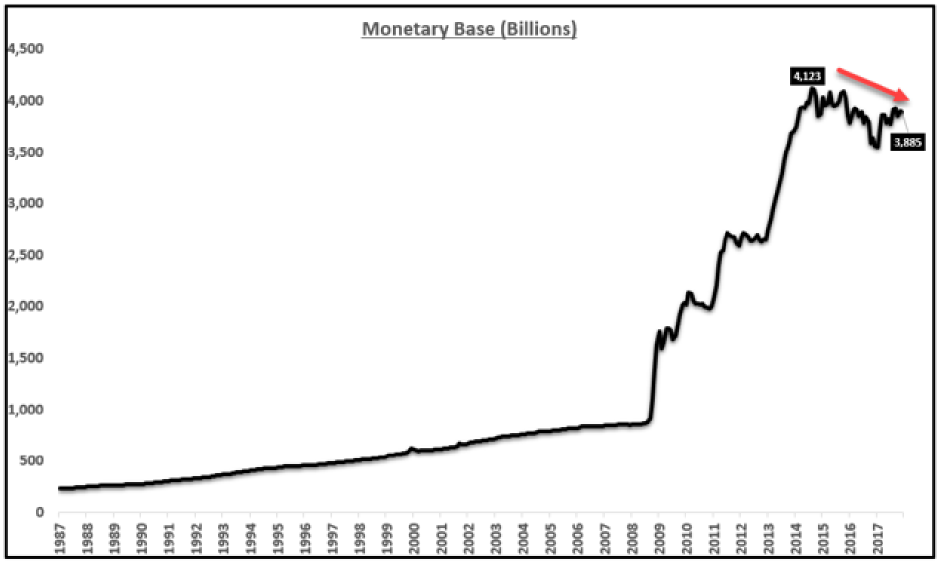
Slowing Growth

As of this writing, the US economy showed very nice growth in 2018 as the 2017 Tax Act helped give the US economy a boost that it needed. Current annualized growth in the 3rd Quarter of 2018 was 3.5% which followed 4.2% in the previous period. Upward revisions to nonresidential fixed investment and private inventory investment were offset by downward revisions to personal consumption expenditures (PCE) and state and local spending. The average historical GDP growth in the US has been around 3.22% (source: Trading Economics).

This year's growth is not likely to continue for several reasons. First, the initial impact of additional income in paychecks will wear off. Like a child eating a candy bar, the sugar rush will wear off and we are not likely to see consumers as confident as 2018. Secondly, consumer debt has continued to grow and is at an all-time high. Current US consumer debt (including real estate) is now above $13 trillion dollars and we believe consumers will focus on this issue in 2019. This problem is compounded by the fact that the US consumer saving rate is now at levels not seen since the mid-2000s.



Lastly, just as the Federal Reserve helped the economy with monetary stimulus via quantitative easing (QE). The Federal Reserve is now on a quantitative tightening (QT) cycle. This is done through raising Fed Funds as well as allowing some of their 4 Trillion-dollar balance sheet to roll-off back into the marketplace. Since we have a fractional banking system, this is likely to slow the money supply in the economy.



Source: Federal Reserve

Just as QE normally takes 12-18 months to increase M2 and hopefully create better economic conditions, QT generally takes the same amount of time to have the opposite effect. We believe the effects of QT start showing in the economy in early 2019.

These factors make us believe that the economy will still have growth, but we are not as optimistic as the street and our estimates are on the lower end of the range at 2.00-2.25% in 2019.

Under Pressure

Like the late David Bowie and Freddie Mercury use to sing earnings will be "Under Pressure" and a key theme in 2019. If our estimates are correct, then there would be small (but impactful) top-line pressure on earnings, but more importantly, pressure on the margin are likely going to make some estimates difficult to reach. Rising wages and higher financing cost are not going to allow companies to cut their way out if top-line growth slows.

There is good news as valuations are much more attractive than they were even a few months ago. However, often when the market hears of downward revisions (for whatever reason) momentum can lead other equities lower. We believe the US equity markets will still be one of the better performing equity markets, but expectations to total return need to reflect a challenging cycle.

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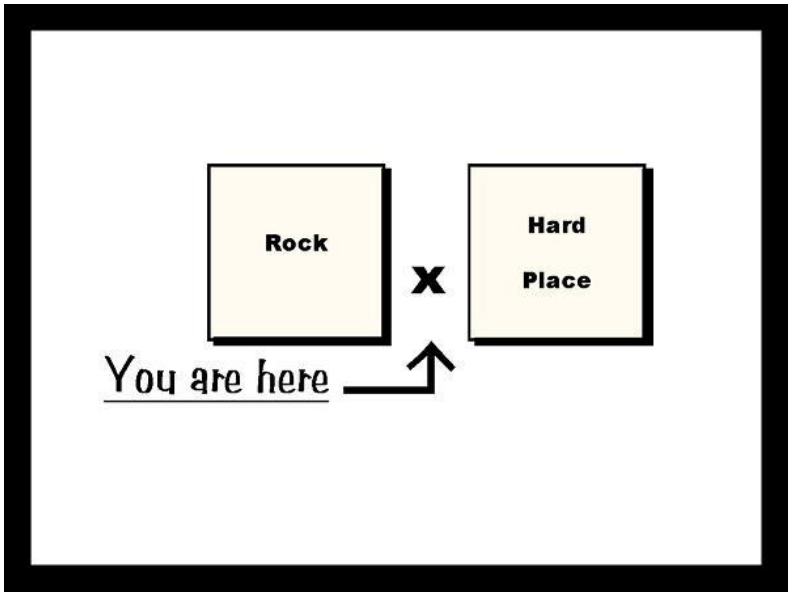
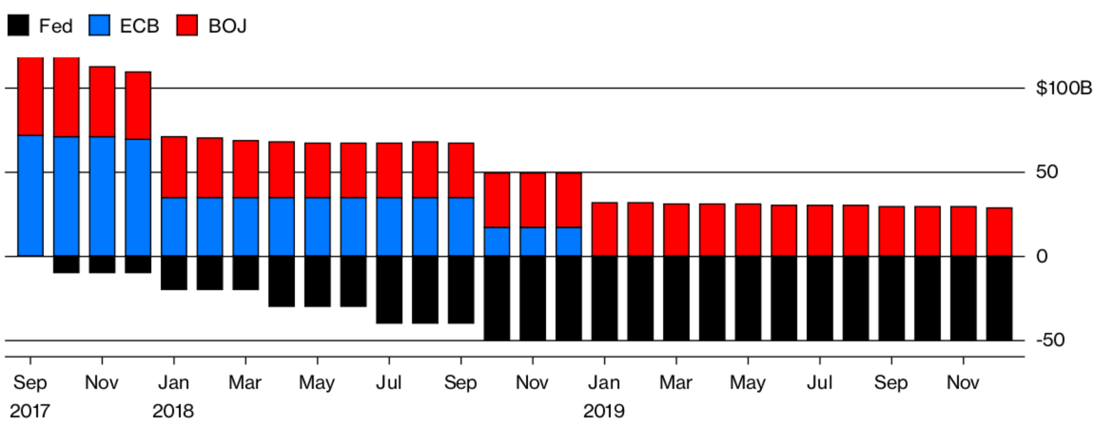


We don't envy the position the Federal Reserve will face in 2019. For one, the Fed will be acutely aware of the narrowing of the US versus the rest of world (RoW) growth prospects which will lead to a narrowing of central bank policy. The US has led the way to higher rates which has helped strengthen the US dollar (and hurt EM countries) but this is likely to pivot in 2019 as the ECB, BoE and BoJ seem increasingly committed to tightening (so long as data allows) as eurozone growth starts to improve. The Federal Reserve indicated it will start looking more at economic data and less focused on their internal "dot plots." This will help them to adjust to a weaker growth outlook and we believe causes them to pause after two additional hikes in 2019 (March and June).

Things Look Tighter Down the Road

Net asset purchases for the three major central banks have already fallen and are set to turn negative in 2019



Note: Fed estimates based on caps from FOMC. Runoff pace could be smaller, given limited amount of maturing securities

Source: Bloomberg Economics

This may not be what the market is looking for as there are already calls for the Fed to stop raising rates after this month. We believe the Fed will be less concerned about the markets so long as they trade in a range. This could become an issue and one that hamstrings the Fed if the market continues to show downward pressure or if there is a sell-off. This along with a White House that has been very vocal on their feelings about the Fed, put them in the position as illustrated above.

Even if the Fed pauses next year, we don't believe this will be a boon for US equities so long as the Fed sounds determined to keep a tightening bias, given the fact that financial conditions are still easy, and inflation and wages continue to climb. This will be a major challenge for US assets because should we get better than expected earnings, this is likely to mean even more Fed tightening. In essence, the good news is bad news and vice versa.

<u>The Trump Card</u>

The "X" factor to any and all estimates could also be called "The Trump Card." White House policy over the last two years has been unpredictable, to say the least. This year the markets have watched the Trump administration verbally threaten countries, remove the US from existing treaties and levy trade tariffs on countries not willing to renegotiate terms that the administration deems favorable. All promises he made during his campaign and a promise he is keeping.

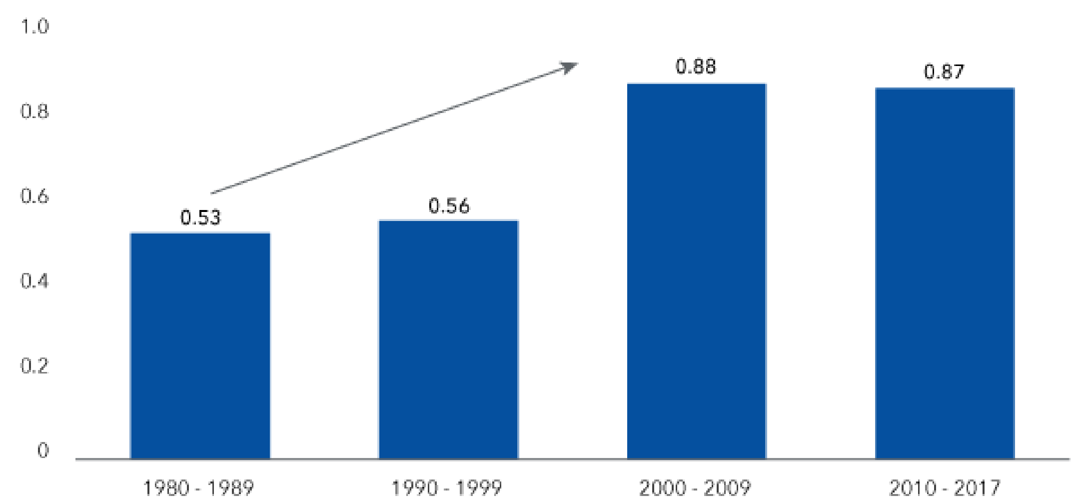
In 2019 we see this administration lowering the volume on the rhetoric, but we do not believe it will be the end of the trade war. We see China offering to buy US goods and services as an "olive branch." These are likely to be superficial as China will likely try and wait out the current administration in hopes of change in 2020. In turn, President Trump my delay additional tariffs in 2019 albeit at some de-stocking cost for 1Q19 US GDP (note: US exports to China have benefited from channel stuffing prior to expected Jan 2019 tariffs, but if the tariffs are delayed orders may fall in 1Q19 in response to excess inventories). It's our view that any goods bought by China would not offer long-lasting effects in trade balances, but one that is more style than substance.

Should the Chinese offer a trade deal and the administration accept that offer, we anticipate the markets to rally on that news as one part of the uncertainty puzzle has been (albeit temporary) lifted. However, we feel that any market rally would be an opportunity to rebalance as other bigger economic headwinds still exist.

Themes and Ideas for 2019

Even though 2019 looks challenging for investors, like most years we expect that opportunities will present themselves. Here are some of our early themes and ideas as we enter 2019.

- **Active will provide some alpha…again;** It has been said that the Stock Market is really a market of stocks, meaning that indexes don't have to go up for investors to make money. We believe active managers who are highly specialized in their various sectors can find alpha over their index or benchmark. This, in combination with some passive investing may be the best combination when building portfolios.
- **Companies with growing dividends could be used as a bond proxies if the economy slows;** If investors want to move into a more defensive posture, using sectors like Healthcare, Utilities, Telecom Services and Staples could see better performance reflecting defensive qualities in 2019. Their bond proxy attributes could make them attractive if investors see rates fall in a slower economic environment.
- **Correlations matter;** During periods of heightened volatility stocks tend to become more correlated, even if they are in different sectors. BlackRock recently did a study on US and EAFE (Europe, Australasia and the Far East) and noticed that correlations have moved to .87 between 2010-2017 from .53 between 1980-1989. So, we believe allocations need to truly be diversified among asset classes that have low correlations. Investors would be wise to look at non-traditional investments in addition to stocks/bond/cash.



Source: Morningstar: Data as of 12/31/17

- **Liquidity could be tested in 2019;** Research has shown (and you will see more research from us at Lakeview Capital Partners in the coming months) that liquidity of major financial markets substantially varied over time and that the unpredictability of market liquidity is an important source of risk for investors. We believe it could be a risk that is tested in 2019 as again, volatility in markets can exacerbate this issue along with issues like;
  - Dealers in corporate bond market have, in aggregate, reduced their capital commitment since the 2007 peak (source; SEC Access to Capital and Market Liquidity Report August 2017). This is consistent with the Volcker Rule and other reforms potentially reducing the liquidity provision in corporate bonds.
  - ETFs are untested as they have grown in popularity. As of January 2018, there was more than $3.5 trillion invested in ETF asset in the US, up from $498 billion in 2008 according to data compiled by research firm ETFGI. In the two "flash crashes" – one in May 2010, the other in August 2015, ETF prices did not trade in lockstep with their underlying assets (as they are supposed to do).
- **Do not fear volatility, use it;** As we wrote in November 2018, volatility is not something investors should fear in 2019, but one they should use to potentially add to the total return of their portfolio. Volatility has shown negative historical correlations to equities and there are investments that have used this index to the benefit of investors.
- **Cash is King…or maybe a Queen in 19;** Cash was one of the better performing asset classes in 2018 and we believe a larger than normal allocation to this asset class may be suitable for a lot of investors in 2019 as well. Current 3-month US Government Bills are paying a yield of 2.37% (as of mid-December 2018). With more Fed hikes likely, this rate is likely to move higher, thus paying investors a little yield while they wait.
- **Have a plan;** Let's face it, most investors probably made money from 2010-2017 because of easy monetary policy from governments and central banks. As that money has tightened, the markets have become a bit more of a challenge. Working with a trusted advisor who can customize a plan for you is going to be key in the coming years.

Don't Wait

History tells us that markets are very efficient in adjusting to economic conditions and 2019 is likely to follow in the same path. Its important for you to talk with your Lakeview advisor and have a plan to take advantage of opportunities as they present themselves. Whether its cash management, public or private equity, alternatives or fixed income, we offer high level thinking and investment ideas for your situation. Don't wait, call us today.