

*Pushing Forward*

2019  
MARKET  
OUTLOOK



**Commerce Trust Company**

Wealth | Investments | Planning

# 2019 MARKET OUTLOOK



## POWERING THROUGH THE MARKET'S DIPS AND TURNS WILL REQUIRE INVESTMENT SAVVY

As we enter 2019, the financial markets have been unusually volatile. Volatility has been driven by fears of escalating trade/tariff conflict with China, weakness in European economies, tighter monetary policy from the major central banks, the political tensions of a divided Congress, and a sense that the U.S. economy is slowing. As investment managers, we realize that the global economy is amazingly complex and that domestic and international connections are such that a perfect forecast is not possible to create. So as always, it is most important to remain focused on the underlying fundamentals, as well as the associated risks.

### MARKET SUMMARY

- Solid fundamental underpinnings of the U.S. economy should support continued expansion into all-time record territory by summer of 2019. Data suggest little near-term recession risk.
- The foundation for sustainable demand appears to be in place across the major world economies. Employment is growing, nominal wages are gradually rising, and inflation remains low.
- The Federal Reserve (Fed) will likely slow the pace of its interest rate-tightening course this year, while support from fiscal stimulus, such as 2017's tax cut package, should decline.
- A weaker U.S. dollar is needed before international equity markets begin outperforming domestic equity markets.



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Moving forward into 2019, we expect a stabilization of global growth at a slightly slower pace than that of 2018 – 3.5% vs. 3.7% – rather than a continued downshift or even recessionary scenario.

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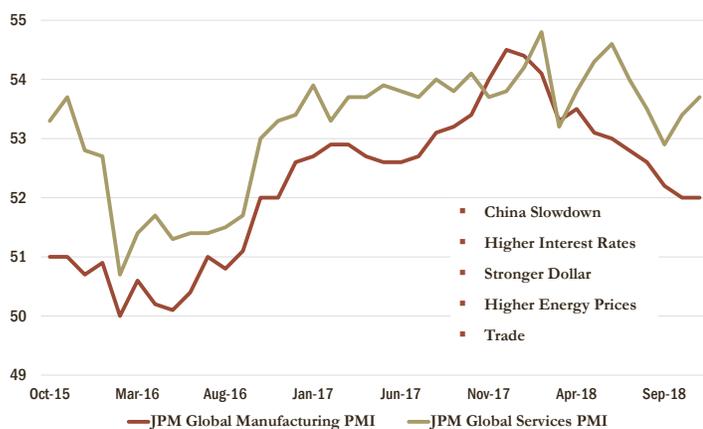
## ECONOMIC OUTLOOK

Looking back over 2018, no one could mistake it for anything but a challenging year. Following the synchronized global rebound in 2017, growth turned out to be lower in 2018 almost everywhere except for the United States. Yet the overall global economy did continue to expand at a 3.7% rate. However, Europe’s performance has been particularly disappointing. Growth in Japan and China has decelerated as well. Evidence of this slower growth can be seen in the global Purchasing Managers’ Index (Figure 1). Even more broadly, most emerging market economies had a difficult year.

Moving forward into 2019, we expect a stabilization of global growth at a slightly slower pace than that of 2018 – 3.5% vs. 3.7% – rather than a continued downshift or even recessionary scenario. The foundation for sustainable demand appears to be in place across the major world economies. Employment is growing, nominal wages are gradually rising, and inflation remains low.

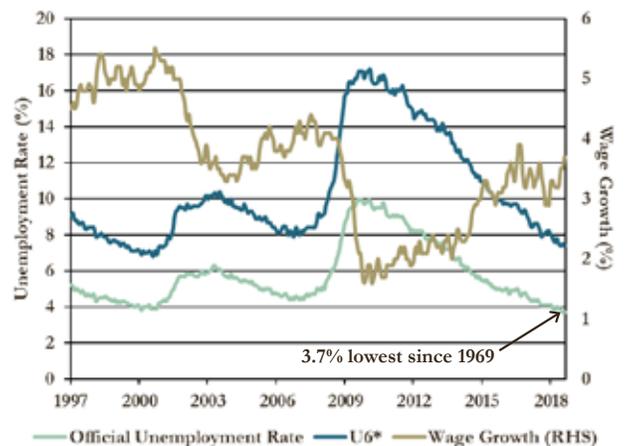
A closer look at U.S. employment reveals that job growth last year was stronger than in the previous year. Private sector job growth averaged 180,000 per month in 2017 and 200,000 in 2018, an 11% improvement.

### GLOBAL PURCHASING MANAGERS’ INDEX ROLLS OVER (FIGURE 1)



Source: Bloomberg

### UNEMPLOYMENT FALLS – WHILE WAGES RECOVER (FIGURE 2)



Source: Bureau of Labor Statistics, Bloomberg

# 2019 MARKET OUTLOOK



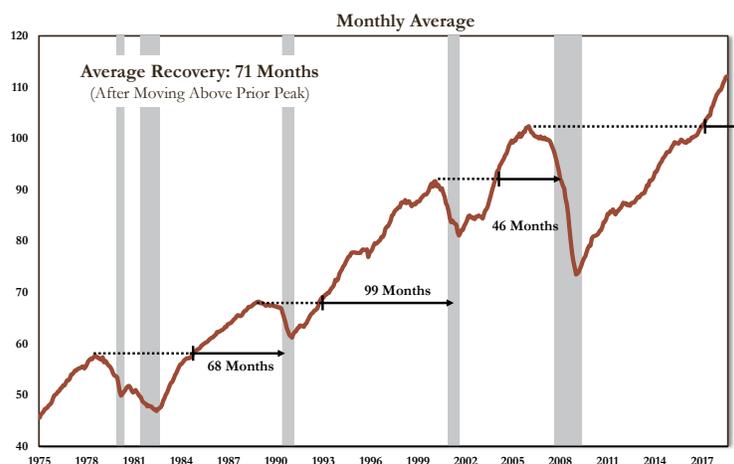
Unemployment is near a 50-year low, at 3.7%, and wages are continuing to rise moderately (Figure 2). Also, the annual growth rate of the labor force (the total of those working plus those looking for work) is running at 1.4%. This growth rate is significantly higher than the 0.5% average growth rate seen since the economy bottomed in mid-2009.

The Leading Economic Indicators Index (LEI) compiles economic factors that can give readings on significant trend changes in the economy (Figure 3). Historical economic cycles of this length would suggest the U.S. economy is in the later stages of the current expansion. But the most current release of the LEI data suggests no near-term recession risk. In the six-month period ending October 2018, the LEI index increased 2.6% (about a 5.2% annual rate), and the strength among the components remains widespread. More generally, on average, a recovery lasts another 71 months after the LEI index moves above its prior peak. Given the track record of this metric, the U.S. economy may have two to three more years of growth ahead.

A recent development weighing on the financial markets is the shape of the yield curve. The yield curve is relatively flat and moving closer to inversion for the first time this cycle (Figure 4). An inverted yield curve generally occurs as Central Banks hike interest rates to cool down a potentially overheating economy. Rising rates

## LEADING ECONOMIC INDICATORS

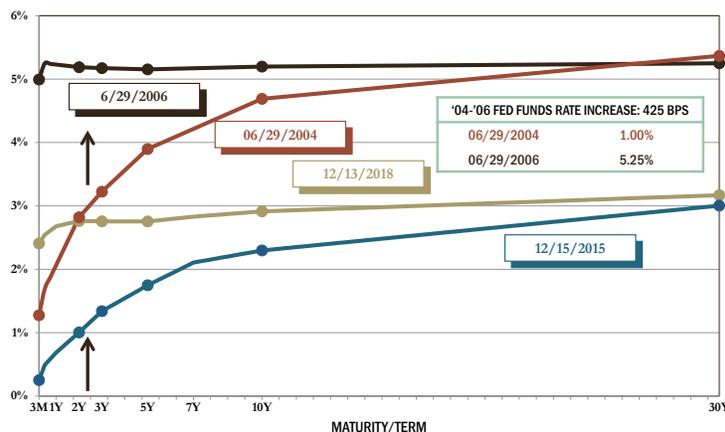
(FIGURE 3)



Source: Bloomberg

## TREASURY YIELD CURVE CHANGES

(FIGURE 4)



Source: Bloomberg



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The yield curve is relatively flat and moving closer to inversion for the first time this cycle... However, the curve shape should not be interpreted in isolation, but as a part of the broader macroeconomic landscape. Historically, economic expansions have continued for 1-2 years after an initial inversion.

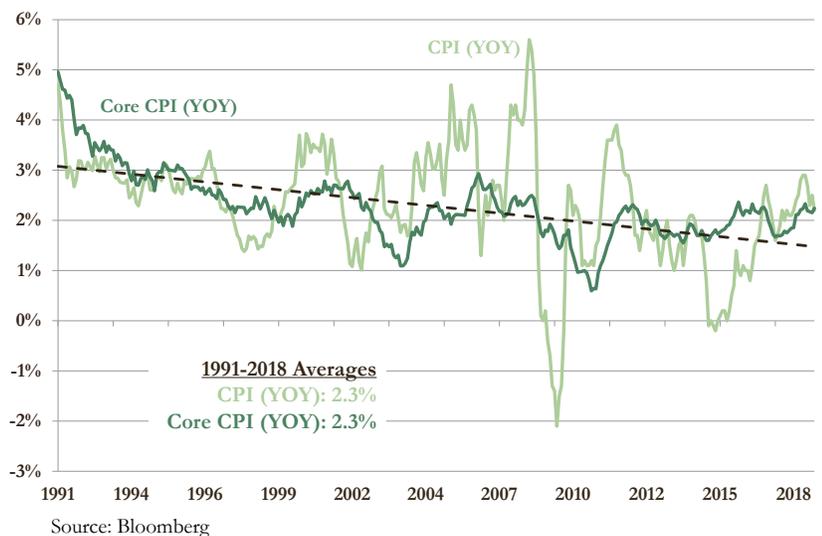
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may be expected to reduce business activity and inflation and could lead to recession. However, the curve shape should not be interpreted in isolation, but as a part of the broader macroeconomic landscape. Historically, economic expansions have continued for one to two years after an initial inversion.

Recent 12-month inflation rates for both overall and core CPI were near the Fed’s target of 2%. Both measures have gradually drifted up since last year, with some underlying forces likely to push inflation moderately above 2% next year (Figure 5). With labor markets tightening, there are signs of increases for wages and benefits. However, the more recent downturn in energy prices has caused “headline” inflation to dip below 2%. These modest pricing increases have allowed and will continue to allow the Fed to move very slowly with any Fed Funds rate increases going forward.

In summary, as the global economy enters its 10th year of expansion following the worldwide financial crisis, most indicators suggest growth will continue. However, the global economy is forecast to slow moderately over the next several quarters as U.S. fiscal stimulus fades. Even so, growth will continue to be led by a still solid United States (2019 GDP near 2.5%), but weaker activity in Europe, China and Japan. Again, while we see no

### INFLATION – BENIGN BUT TURNING UP FROM BOTTOM (FIGURE 5)



ECONOMIC  
OUTLOOK

U.S. GDP IN  
2019 UP

EMPLOYMENT UP

MODESTLY RISING  
INFLATION

# 2019 MARKET OUTLOOK



recession on the horizon, the outlook remains framed in part by the yet unresolved U.S.-China trade relations. Overall, we are still encouraged by the underlying economic fundamentals.

## EQUITY OUTLOOK

For the first three weeks of 2018, equities started off with a bang as the S&P 500 rose 8% on expectations of surging earnings from a corporate tax cut and a strong economy. As the year progressed, the equity market experienced two 10% corrections and ended the year with little to show in positive returns, whether in large-, mid- or small-cap stocks. While returns in 2018 were disappointing for investors, we do believe the pause in the market sets us up for somewhat stronger returns in 2019.

As we begin 2019, we note how valuations for the market have improved dramatically since last January. The S&P 500 median price/earnings ratio (P/E) hit 27 times on January 31, 2018, a level only surpassed in 2002 and 1999 (Figure 6). Fortunately, earnings have increased 25% over the last year, bringing down the median P/E to 21.4 times at the end of November. We have now moved out of the overvalued territory to more reasonable valuation levels. With a backdrop of moderate economic growth, we believe earnings will increase 6% to 9% in 2019.

Another problem the equity market faced in 2018 was an accelerating upward trend in short-term interest rates. Rising short rates have not been a problem since the beginning of this bull market in March 2009, at least not until early last year. Since then, the Fed increases in short-term rates have become a headwind for rising equity prices. Expectations for further multiple rate increases in 2019 have now diminished with the uncertainty in the financial markets and the subdued global economic growth outlook.

EQUITY  
OUTLOOK

GROWTH  
OUTPERFORMS  
VALUE

EQUITY VALUATIONS  
LOOK ATTRACTIVE

DOMESTIC STOCK  
OUTPERFORMS  
INTERNATIONAL

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Conservative hedge funds, which have lagged stock and bond markets since the 2009 recovery, may have their day as investors seek preservation of the wealth they have built over that time.

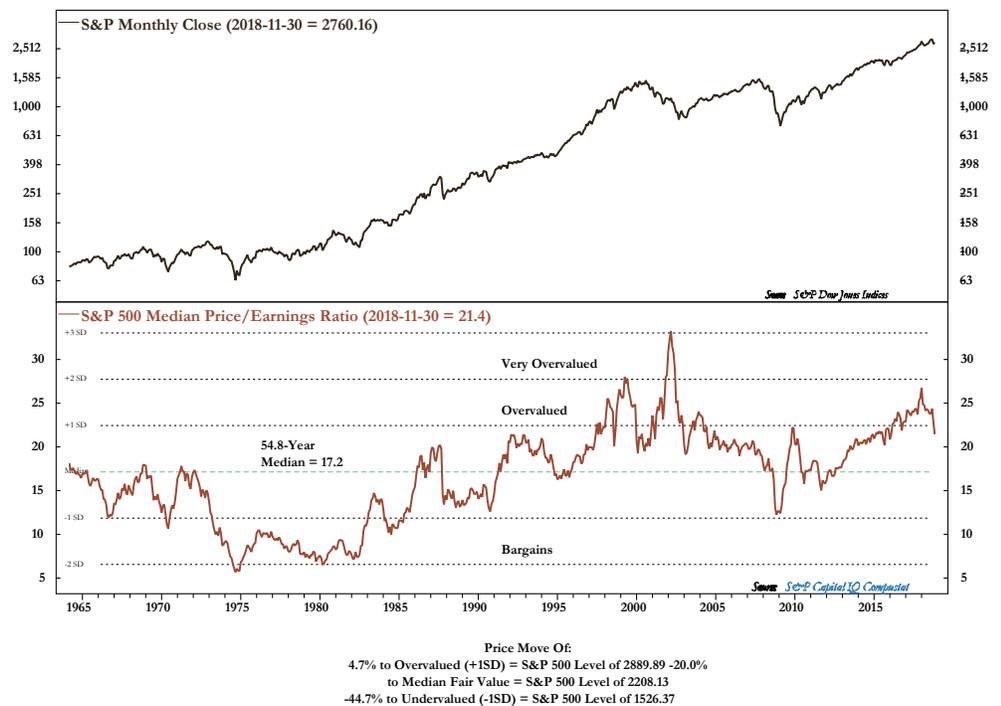
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The last positive factor entering into 2019 has been the shift in investor sentiment from one of buying every dip on the belief that the market always goes higher to one of a more cautious nature. Now, reports in the financial news are of a slowing global economy, inverted yield curve and the prospects for a bear market. Investors have increased their liquidation of equity funds, giving us some future buying power as the year has progressed.

While the domestic equity outlook is improving, is there any hope for a turnaround in the international equity markets? As we start another year we can say international developed and emerging markets look inexpensive on a valuation basis and offer attractive dividend yields. Of course, we could have said that for the last four years. In 2019, international equities need the U.S. dollar to stabilize and preferably decline against other world currencies. While we are hopeful the underperformance will end at some point, we remain underweight international versus domestic until we see a clear shift in the direction of the dollar.

## S&P 500 MEDIAN PRICE/EARNINGS RATIO

(NDR CALCULATION) MONTHLY DATA 1964-03-31 TO 2018-11-30 (FIGURE 6)



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## ALTERNATIVE INVESTMENTS OUTLOOK

Alternative investments include strategies such as hedge funds, real estate, energy master limited partnerships (MLPs) and commodities. We include them in many client portfolios to either reduce volatility or provide

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diversification. These investments have expected returns and risks that may be higher or lower than those of stocks and bonds, and they often do not move in sync with traditional markets. This may provide some protection from a sharp decline in stocks or a significant rise in interest rates.

Hedge funds represent an area where we emphasize strategies that may provide protection in a declining market or behave differently than stocks and bonds. We expect that higher market volatility will continue into 2019. Conservative hedge funds, which have lagged stock and bond markets since the 2009 recovery, may have their day as investors seek preservation of the wealth they have built over that time.

While the conditions that drive their prices may differ, real estate investment trusts (REITs) and MLPs are a subset of the stock market. These asset classes are sensitive to changes in interest rates. While bonds also suffer during periods of rising interest rates, REITs and MLPs may not offer the same level of portfolio protection as bonds.

Commodities tend to perform well in the late stages of economic expansions and early stages of recessions. With our view that the economic expansion has two to three years remaining, we are not allocating to commodities in a significant way.

## FIXED INCOME OUTLOOK

The fixed income market faced strong headwinds in 2018. Companies were situated in a mature economic cycle while confronting tighter monetary policy. Risk premiums (i.e., spreads) rose, more notably in the last few months of the year as concern grew about trade tensions and a global economic slowdown.

FIXED INCOME  
OUTLOOK

1-2 POSSIBLE  
FED FUNDS  
RATE HIKES

10-YEAR  
U.S. TREASURY  
YIELD UP

EMERGING  
MARKET DEBT  
VOLATILITY



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With an additional Fed rate hike anticipated in 2019, portfolio durations are expected to be maintained slightly short to neutral relative to their corresponding benchmarks.

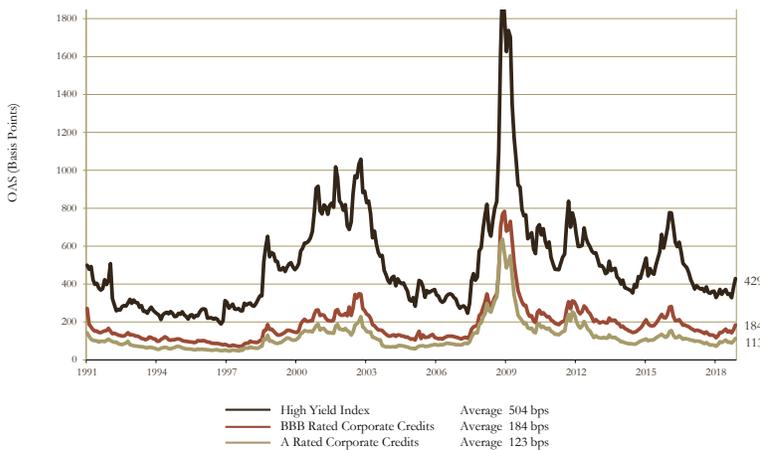
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The U.S. Treasury yield curve continued to flatten throughout the past year, partly attributable to the Fed’s four hikes of the Fed Funds rate. Treasury yields in the short end (1- to 5-year) rose more than longer maturity yields (10- to 30-year). Year-to-date the 2-year Treasury is up 88 basis points (100 basis points = 1.0%), from 1.88% to 2.76%, and the 10-year Treasury is up 47 basis points, from 2.41% to 2.88%. (Figure 4) Credit spreads widened as concern grew about trade issues and their impact on global economic growth. Not since 2011 have spreads widened to such an extent, resulting in a drag on bond performance (Figure 7). With interest rates rising and spreads widening in 2018, the bond market is on pace to have its first negative annual return year since 2013. The Bloomberg Barclays Aggregate Bond Index reported a -1.01% return (through December 13, 2018).

Unfavorable bond market conditions left nearly all fixed income sectors with flat to negative returns (through December 13, 2018). The high-yield sector benefited from a low default rate, ending the year nearly flat despite widening spreads. Mortgage-backed securities finished slightly negative as the Fed shrank its balance sheet and institutional investors picked up the slack. Asset-backed securities finished as one of the few sectors with a positive return for the period. The rising Fed Funds rate led to the emerging market debt sector ending the year as the worst-performing sector (Figure 8).

### CORPORATE CREDIT SPREADS

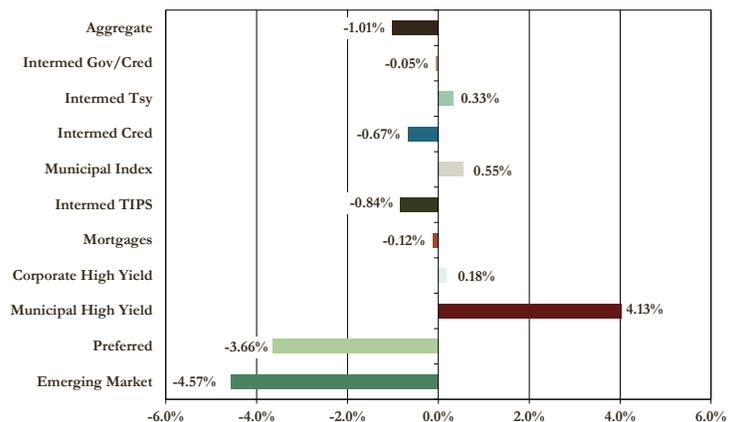
1/31/91 THROUGH 11/30/18 (FIGURE 7)



Source: BBG Barclays, ICE BofA ML

### FIXED INCOME – YTD RETURNS

AS OF 12/13/18 (FIGURE 8)



Source: Bloomberg

# 2019 MARKET OUTLOOK



The Barclays Municipal Bond Index is up 0.55% year-to-date (through December 13, 2018). State and local issuers have benefited from healthy tax revenues and a sound housing market. The credit outlook for states remains stable. Given the lower corporate income tax rate of 21%, banks and insurance companies continue to sell their municipal holdings. As holdings from these investors have been reduced, long maturity municipal bonds have moved back to fair value relative to Treasuries. Opportunities in the long-end of the municipal bond curve are likely to persist, given the absence of the institutional investors in this space and the lack of desire to extend portfolio durations in the current rising rate environment.

Bond returns for 2019 are anticipated to be in the low single digits, better than those realized in 2018. An additional Fed rate hike in 2019 and continuing trade tensions will hamper the upside potential for the various bond sectors. Some caution is warranted with corporates. Spreads widened significantly in 2018, and they are now near their historical averages. The high-yield sector is expected to benefit from a low default rate forecast for the coming year. A slower pace of U.S. Fed rate hikes in 2019, along with a weaker U.S. dollar, should help rekindle interest in emerging market debt. Overall, the U.S. economy should remain strong enough to support credit fundamentals.

Our fixed income strategy for broadly diversified portfolios suggests improving credit quality by raising exposure to mortgage-backed securities while lowering corporate bond holdings. Adding to Treasuries will help improve liquidity and provide some dry powder for when corporate spreads are trading wide to their historical average. With an additional Fed rate hike anticipated in 2019, portfolio durations are expected to be maintained slightly short to neutral relative to their corresponding benchmarks.

## CONCLUSION

Compared with the way 2018 started with plenty of early promise, the markets clearly disappointed investors by year-end. Ironically, as uncomfortable as that fact might be, the downward tumble in the stock markets over the last three months may have actually cleared the decks for more upward momentum in stocks in 2019.

In 2019, we expect to see the economic expansion grinding it out into record-length territory – with no recession signals in sight.



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So, we expect the Fed will likely make one more rate hike in 2019, and then take a “wait and see” approach on whether the economy is strong enough to support further rate increases in the balance of the year.

Our message during this uncertain market environment is to consult with your financial advisors on a regular basis and be prepared to rebalance portfolios as needed.

#### INVESTMENT POLICY COMMITTEE - DECEMBER 20, 2018

Disclosures: Past performance is no guarantee of future results, and the opinions and other information in the Market Outlook are as of December 20, 2018. The Market Outlook is a special report designed to provide investment information on economic markets for Commerce Trust Company's clients. It is intended to provide general information only and reflects the opinions of the Commerce Trust Company Investment Policy Committee.

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## KEY STATS

**2.5%**

2019 U.S. GDP GROWTH  
FORECAST

**3.0%**

2018 U.S. GDP GROWTH (EST.)

**-2.76%**

S&P 500 YTD\*

**3.7%**

2018 UNEMPLOYMENT

**2.88%**

10-YEAR U.S. TREASURY YIELD\*\*

**-1.01%**

BLOOMBERG BARCLAYS AGGREGATE  
BOND INDEX YTD RETURN\*\*

**0.55%**

BLOOMBERG BARCLAYS MUNICIPAL  
BOND INDEX YTD RETURN\*\*

\* AS OF 12/14/18

\*\* AS OF 12/13/18

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