January 2019

Global Equity Outlook for Q1 2019

Going into the 4th quarter of 2018, the S&P 500 had turned in a positive performance for the first nine months of the year while many of the other global markets struggled. Then the 4th quarter hit and the U.S. market reversed. For the quarter, the S&P 500 was down 13.5% while non-U.S. developed markets and the emerging markets continued their slide, although not quite as dramatically as the U.S. The MSCI EAFE Index and MSCI Emerging Markets Index were down 12.5% and 7.5%, respectively, for the 4th quarter.

The questions which might be asked: 1) why did the U.S. and other global markets perform so poorly during the quarter and 2) what do we expect to happen in 2019? As to the first question, there are a number of reasons why the U.S. and other global markets performed so poorly.

One of the fundamental explanations for the performance in the U.S. is that 4th quarter earnings growth will in all likelihood be less than half the growth earlier in the year. In the first 3 quarters of 2018, S&P earnings rose about 25% from a year earlier, helped by the U.S. corporate tax cut. For the 4th quarter of 2018, the estimated earnings growth rate for the S&P 500 is 11.4%*. In 2019, corporate earnings growth is expected to be 9%. Outside the U.S., earnings growth is forecasted to slow as well in 2019 to 7%.

Also during the 4th quarter, there were more indications that global economic growth was slowing. For Japan, GDP forecasts for 2018 dropped to 1.0% in December 2018 from 1.3% in January 2018. For Germany, GDP forecasts for 2018 dropped to 1.8% in December 2018 from 2.2% in January 2018. For both Japan and Germany, GDP contracted in the 3rd quarter of 2018. During the 4th quarter, China's economy grew at 6.4% which was the slowest annual rate since 1990.

Additionally, the U.S. Fed continued increases in interest rates during the 4th quarter. The Fed raised interest rates four times in 2018 with the latest increase in December. With interest rates close to 2.5%, cash became an alternative to stocks. Also, higher interest rates increased the cost of capital for corporations. In Europe, the ECB confirmed it would end its $3 trillion bond-buying programs.

Further, erratic and uncertain politics continued all over the world. For example, U.S. and China are in a trade dispute and, as of this writing, Brexit uncertainty came to a head on January 15th with the defeat in Parliament of the deal for exiting the European Union.

*Factset Research

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As to item (ii), what do we expect to happen in 2019? Will this be another 2008 or more like 2011 when the global markets went down 20 % from peak to trough and later recovered?

Our view is that unless there are events which pull the world into a recession, such as a bitter trade war or central banks overshooting monetary tightening, the upward trend in equities can continue. As of this writing, global GDP growth remains positive with global GDP growth forecasted to be 2.6% in 2019. Earnings growth is forecasted to be positive in the high single digits. There is little or no inflation acceleration, and the end of the U.S. Federal Reserve interest rate tightening may be in sight.

In terms of our equities positioning for 2019, we are modestly underweight in Continental Europe since GDP forecasts are being revised downward for many of the markets, beta risk which is a combination of volatility and correlation with the world markets is high for many countries. In addition, sovereign spreads have widened for some of the markets, including Belgium, Finland, Ireland, Italy, and Spain.

Within Continental Europe, some of our allocations have shifted somewhat due to improving terms-of-trade (export prices relative to import prices) for many markets due to declining oil prices. We have increased our allocations in Italy and Germany due to cheap valuations and improving terms-of-trade . Sweden is another market in Europe which we favor with attractive valuations, an undervalued exchange rate, and declining sovereign spreads over the last 24 months. On the other hand, our allocation to Norway has decreased. Norway could be hurt by the decreases in the price of oil.

In Developed Asia, Japan remains overweight. Japan's forecasted 2019 price-to-earnings of the market is 13x which is reasonable, its GDP forecasts are not being revised downward as in the case of many European markets, and its beta risk (combination of low volatility and correlation with the world markets) is low. Singapore is also overweight with attractive valuations, including a dividend yield of 4.3%, and low beta risk.

We continue to be overweight in emerging markets since many of the markets have attractive valuations. Brazil has become overweight. Although Brazil's terms-of-trade trend is negative, consensus GDP growth forecasts have begun to stabilize, and year-over-year price momentum is positive. Taiwan remains the top-ranked market in Emerging Asia, with favorable valuation, growth, and risk indicators.

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