2018 Investment Summit: Market and Economic Perspective for the Year Ahead

Edward Crotty, CFA – Senior Vice President, Chief Investment Officer and Portfolio Manager, Davidson Investment Advisors
Scott Haigh – Senior Vice President, Portfolio Manager, Director of Managed Assets Research
Mary Ann Hurley –Vice President, WM Registered Fixe Income Trading Associate
Gil Luria –Managing Director, Director of Institutional Research
Michael Meighan, CFA, CAIA – Vice President, Chief Investment Officer, Davidson Trust
James Ragan, CFA –Director of Wealth Management Research
James Rice –Senior Vice President, Taxable Fixed Income Trading Manager, D.A. Davidson Fixed Income Capital Markets

Our 2018 year-end Investment Summit was held in Seattle in early December. This annual event is an opportunity to bring together D.A. Davidson thought leaders across multiple departments to discuss financial markets, the state of the economy, and engage in a spirited discussion regarding risks and opportunities in the year ahead. At all Investment Summit meetings our "Group of 7" members give an individual estimate of future U.S. GDP growth, interest rates, and a target level for the S&P 500. The result is our D.A. Davidson "Dot-Plot," which is an average of those individual estimates**. The result from the December meeting was a 2019 outlook that we would characterize as modestly positive, but encompasses a relatively wide range for 2019 U.S. GDP and the S&P 500 index. Our average estimate for 2019 U.S. GDP growth was 2.47%, down from an expected 2.90% in 2018; our 10-year Treasury yield estimate of 3.38% compares to the 2.89% presently; and our S&P 500 mean estimate of 2,856, represents a gain of approximately 10.7% from current levels near 2,580.**

DA Davidson Investment Summit "Dot Plot"

Average Estimates 2019	Mean	Range	2018*
U.S. GDP Growth (2019)	2.47%	2.00% - 2.75%	2.90%E
U.S. 10-year yield (12/31/19)	3.38%	3.15% - 3.50%	2.89%
S&P 500 (12/31/19)	2,856	2,700 - 2,940	2,600

*2018 GDP is FactSet consensus estimate as of 12/14/18
U.S. 10-year Treasury yield & S&P 500 as of 12/14/18

As a group we agreed that market risks are rising, which is likely to lead to increasing volatility and challenges for investors in 2019. **Despite some differences of opinion regarding the level of 2019 GDP growth, inflation trends, and equity market potential, we believe that global financial markets remain healthy and that investors should commit to diversified strategies using domestic and foreign equities, bonds, and alternative investments.** 2018 reflected difficult markets across asset classes in 2018, but entering 2019 investment opportunities are numerous. The Investment Summit covered multiple topics of importance to investors, including equity markets, interest rates, the economy, earnings, global growth, and politics. Below is a summary of several potential market drivers and predictions for 2019. Not all of the predictions below achieved consensus among the group, but included our most "spirited" discussions. One thing that we learn from our Investment Summit meetings is that market and economic predictions can vary widely across investment experts, but having an investment plan that assumes volatility and a range of outcomes is important to achieve long-term investment success.

Equity investors are currently pricing in a 2019 slowdown. In 2018, S&P 500 EPS growth (+25% after three quarters) and U.S. GDP (estimated +2.9% for the full-year) surged to multi-year highs. Naturally, those growth rates are expected to come down as earnings growth was boosted an estimated 7% by tax reform and GDP growth would moderate as the economy nears full-employment. Since mid-year, the U.S. housing and auto markets have slowed, year-over-year wage growth in the U.S. has been at or above 3%, and economic data in Europe and China has weakened. This has created new headwinds for investors to navigate and equity markets appear to assume that 2019 EPS growth and GDP will fall short of current consensus for 8% (S&P 500 EPS) and 2.5% (U.S. GDP), respectively.

2019 Predictions

- **Value stocks could outperform growth stocks for the first time in three years.**
- **Surging wages could drive higher than expected inflation.**
- **Commodities prices could rebound in 2019.**
- **Emerging markets equities could outperform U.S. equities following 2018 weakness.**
- **Geopolitics in Europe (U.K., France, Germany, Italy, etc.) will cause global volatility.**
- **A China trade agreement is likely, but will take longer than 90 days.**
- **The Federal Reserve will be blamed for any negative outcome, inflation or recession.**

Value stocks could outperform growth stocks for the first time in three years. Through 12/7/18, the Russell 1000 index was down 1.8% in 2018 year-to-date (YTD). Within that index the Russell 1000 Growth component was up 1.3%, while Russell 1000 Value was down 5.1%. The last calendar year that value outperformed was 2016, and since the end of 2013 (nearly five years) the Russell 1000 Growth index has gained 58.7% on a price basis vs. just 25.1% over the same period for the Value index. Very recent market moves have favored value however, as from 6/30/18 – 12/7/18, while the Russell 1000 declined 3.6%, the Value component declined just 2.2% while Growth declined 4.9%. Value stocks can continue to outperform as sector leadership rotates away from growth-heavy Technology and Consumer, in favor of value-heavy sectors that include Financials and Energy.

Surging wages could drive higher than expected inflation. Headline inflation has receded from 2018 high levels in Q4 as both the Consumer Price Index (CPI) and Personal Consumption price index (PCE deflator) were recently reported below expectations. November CPI increased 2.2% year-over-year (y/y), below a rise of 2.9% y/y in June and July, and the October PCE deflator slipped to 2.0%. While price inflation appears tame for consumers, corporations continue to face upward pressure on wages, and Commerce Department data showed that average hourly earnings increased 3.1% y/y in both October and November, the highest levels of the year. Many companies have announced price increases to address these costs; continued waged gains will likely put upward pressure on consumer inflation in future periods.

Commodities prices could rebound in 2019. Major commodity prices have traded lower throughout 2018, led by fourth quarter weakness in oil and declines in the price of gold, silver, and copper. Price weakness has been attributed to concern regarding GDP growth in emerging markets as well as strength in the U.S. dollar. Trade issues have hurt the price of soybeans, corn, cotton and lumber, each either down for all 2018 or well below mid-year highs. A rebound in precious metals could be an interesting contrarian play, if continued market volatility, the rise of populism, and skepticism regarding accommodative central bank policies creates demand for gold.

Emerging markets equities could outperform U.S. equities following 2018 weakness. The MSCI Emerging Markets index was down 10.2% year-to-date through 12/7/18 compared to -1.5% for the S&P 500 index. Looking at various valuation metrics, the EM index trades at a multi-year discount relative to U.S. markets and also compared to its historical average. Against a backdrop of low expectations and the potential for improved relative performance, emerging markets could rebound in 2019. International growth managers are seeing opportunities in India, while value managers point to emerging countries in Asia as well as Russia.

Geopolitics in Europe (U.K., France, Germany, Italy, etc.) could cause global volatility. As 2018 comes to a close, Great Britain is struggling to approve Prime Minister Theresa May's Brexit plan with the European Union, and there now is a real possibility that Brexit happens on 3/29/19 with no formal agreement in place. This "Hard Brexit" scenario creates significant corporate uncertainty, creating headwinds for investors. In France, President Emmanuel Macron was forced to withdraw a planned carbon tax following national protests, but he appears to have survived a no-confidence vote on his presidency. Germany faces its own transition issues as Angela Merkel, Chancellor since 2005, announced her intent to step down when her fourth term expires in 2021. The battle for Germany's next leader, while not immediate, opens the door for a populist candidate and a potential change in European leadership.

A China trade agreement is likely, but could take longer than 90 days. A "win" on the China trade negotiations is important for President Trump's approval rating and reelection chances, suggesting that compromise is possible despite the President's confrontational style and mixed signals. The U.S.-China trade truce, first announced at the G7 Summit on 11/30/18, freezes U.S. tariffs on Chinese goods at 10% for 90 days and promotes increased China purchases of U.S. goods immediately. A deal to reduce the U.S. trade deficit with China appears doable, but the U.S. will fight for a level playing field for technology transfer and protection of intellectual property. Negotiation of those elements could take time and will potentially push a settlement beyond the 3/1/19 deadline.

The Federal Reserve will be blamed for any negative outcome, inflation or recession. The Federal Reserve has engineered a multi-year tightening path that has included eight fed funds rate hikes since December 2015, and the end of Quantitative Easing. But with the U.S. in the later stages of economic expansion, interest rates below what the Fed considers "normal" levels, and mixed inflation data, future Fed rate decisions will be intensely scrutinized. Additional fed funds increases (including a 25 basis point hike expected on 12/19/18) are vulnerable to criticism if the U.S. economy slips into recession, but also will be criticized if, as expected, GDP growth slows in 2019. On the other hand, if the Fed holds rates unchanged and accelerating wage inflation leads to overheating consumer prices, the Fed will be blamed for not doing enough to combat inflation. For the most part investors have given the Fed credit for managing full employment and stable prices and the U.S. economy appears positioned for slowing growth from 2018 levels and a soft landing.

James D. Ragan, CFA
Director of WM Research
(206) 389-8000
dadavidson.com