SOLVING

FOR 2019

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CONFERENCE SUMMARY

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PRESIDENT AND CIO—EQUITIES

KEY POINTS

- Synchronized growth has given way to synchronized slowdown
- Can the U.S. achieve a soft landing, and can China's stimulus gain traction?
- Subdued inflation is giving central banks much needed flexibility
- Corporate earnings can grow modestly—as long as the soft landing is achieved
- Political risk remains high, especially around U.S. – China trade

THE YEAR AHEAD: OUTLOOK AND CHALLENGES

"What we are seeing, globally, is a late-cycle slowdown."

The synchronized global economic growth of 2017 turned into a synchronized slowdown during 2018, Joe observed. One by one, asset markets followed. Europe, Japan and the emerging markets suffered poor performance in the first half of the year, but the U.S. gave up much of its outperformance in a violent sell-off in the fourth quarter. In late September, investors were still worrying about the U.S. overheating and the Fed tightening too quickly. Just 10 weeks later, markets were pricing in rate cuts and signaling that the economy might fall off a cliff. By year-end, 2018 saw the most asset classes with negative real returns for decades, indicating higher correlations as well as poor performance.

Against that background, Joe asked: Will the economy achieve a soft landing? Will central banks make or break 2019? Will corporate earnings grow? Is corporate leverage too high? And will politicians mess things up?

Our central view is that the U.S. can achieve a soft landing. Joe surveyed a range of traditional forward indicators of recession and found very few warning of either an overheating or a stuttering economy. Among the causes of past recessions, he argued that the only one that looks like a current risk is the presence of financial imbalances and the threat of a bursting credit bubble. However, he cautioned that the most worrisome credit bubble is currently to be found in one of the world's most important economies: China. While our view is that, ultimately, China has the means to stimulate its economy without exacerbating this problem, it remains the most substantial risk to our soft-landing scenario.

When it comes to central banks, Joe acknowledged that the shift from quantitative easing to quantitative tightening is affecting market liquidity, but overall he observed that the recent slackening in inflation worldwide was giving policymakers more flexibility in their efforts to avoid over-tightening and inverting yield curves. The marked slowdown in euro zone PMI data suggests that the ECB might have missed an opportunity to make a start on policy normalization during 2017, however.

Joe noted that current analysts' expectations were for 8% growth in S&P 500 earnings this year, and while he anticipates realized growth to be slightly lower than that as margins are squeezed by slower nominal growth and rising wages, he does not regard them as overly vulnerable outside the technology sector. Ultimately, however, these views depend upon the central soft-landing scenario coming to pass: in the event of a more serious slowdown, earnings could contract and equities could sell off to reflect that.

Turning to the topic of leverage, Joe observed that government debt had climbed by 73% and corporate debt by 62% since 2008. Asking whether this might be the catalyst for a turn in the current cycle, he noted that, while gross leverage among investment grade borrowers is as high as it was before the two previous recessions, net leverage remains lower given the amount of cash that companies have on their balance sheets. Among high yield borrowers, issuance has moved from bonds to loans, and in doing so, a lot of the covenant protection normally associated with loans has deteriorated or disappeared altogether. Set against this worrisome trend, however, Joe noted that there was little immediate risk from borrowers having to refinance a large wall of maturities.

Joe wrapped up by addressing some of the political risks stalking markets. He acknowledged that the rising proportion of the populations in the developed world who feel disenfranchised by globalization and by technological disruption is a deep challenge that we will all face for the foreseeable future. The most immediate risk, however, comes from the U.S. – China trade dispute. Joe argued that, while the "transactional question"—what China will buy from the U.S. to help balance the trade deficit—is easy enough to resolve, the "transformational" change on questions such as protection for intellectual property and subsidies for industry, while a reasonable requirement, will be far more difficult.

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