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GLOBAL INVESTMENT COMMITTEE OUTLOOK 2019: TEMPERED POSITIVE VIEW

Global Growth Should Be Moderately Good

So many developments have occurred since we last met in September, but the major ones were the surprising collapse in oil prices mostly due to geopolitical factors, the U.S.-China trade and BREXIT conflicts becoming increasingly intractable, and that aspects of the global economy showed occasional signs of moderation. The major market debate is whether the 3Q GDP data weakness in various countries was mostly a function of temporary factors or a sign of a major downturn. Of course, everyone has long known that 2019 will be slower than the heady pace of 2018 and that central banks were slowly normalizing, but markets lost confidence very quickly when clear signs of such appeared. Indeed, there is a generalized concern about being at the end of an economic cycle, but we all know that this cycle is very different than all the others, so it is very difficult to predict. We, however, come down on the side that economies will not falter in 2019 and that the markets have over-reacted. Many on our Global Investment Committee think that the balance of potential risks is to the downside, but not strong enough to produce a significantly negative view. BREXIT plays a large role among these risks, and none of us are truly confident about the result, which would have major global implications, but assuming BREXIT does work out without major disruption, the G-3 and Chinese economies should grow decently through December 2019, approximately in line with the expectations of major economists, while we expect central banks to reduce their accommodation similarly to consensus expectations. With such as the backdrop, we expect bond yields to rise mildly, the USD to be flat in the 1H, but decline in the 2H, and equity markets to rise further, especially as we forecast that the multitude of other geopolitical risks will also remain under control. Clearly, there are significant downside risks, but obviously upside risks as well.

Through November 30th, MSCI World fell 5% from our September meeting date vs. our +6.9% expectation (although our targets were for end-December, so much depends on the coming weeks' news), defying our bullish stance at the time. We plainly did not accurately forecast the development of political and economic fears. All regions undershot their targets with negative returns in USD terms so far during the period. 10-year Bunds and JGBs moderately undershot our December target but Treasuries slightly exceeded our target. Our currency calls were basically correct, with the EUR and JPY only slightly weaker than we expected.

Despite the market conniptions, our GDP forecasts for 4Q18-1Q19 were relatively good, albeit from 3Q levels that were disrupted in Japan by weather disasters and in Europe by German auto production dysfunction. Relative to current consensus, the U.S. forecast was on target and Europe and Japan now have consensus estimates moderately lower than our forecast for 4Q18-1Q19, but our 2Q19-3Q19 forecasts match the current consensus. As for China, consensus now is just barely below our forecasts. Looking forward, U.S. GDP, at a 2.5% Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR) in 1H19 and 2.0% in 2H19, should match economist-consensus expectations. Growth should come from increased personal consumption and fixed asset investment, while net trade will likely be a very volatile factor, especially in the 1Q. Meanwhile, the Eurozone's and Japan's GDPs will likely both grow at 1.7% on a HoH SAAR basis in 1H19, and 1.8% and 0.6%, respectively, in 2H19, both also approximating consensus expectations. Japan's forecasted weakness in the 2H is due to the VAT hike scheduled in October. Lastly, China's official GDP should be approximately 6.0% and 6.4% HoH SAAR in the 1H19 and 2H19, respectively. Here too, personal consumption will likely lead the way, while fiscal stimulus will begin providing more support, as well. Overall, these results should re-assure risk markets, and corporate profit estimates should continue to show decent growth through 2019.

As for geopolitical issues, we still believe that such will be handled without crisis due to the strong economic incentives of all major players, but there are many situations that bear close monitoring, especially regarding China, the Middle East and BREXIT. Trade disputes with the U.S. and Europe, Canada and Mexico have settled down, but that with China has proven quite intractable. We assume 25% US tariffs on the $200BB tranche of Chinese exports to the U.S. will occur in the 1H but that the global economy can withstand such without too much dislocation. The conflict, however, has metastasized into sanctions and arrests related to national security, and into the real possibility of a break in supply chains and technological standards, which would be a large disruption to the world economy. This also increases the possibility that North Korea could become a hot issue again. In Europe, the Italian budget conflict has been ameliorated for now, but promises to be an occasional disruption in the future due to populist anger at slow economic growth, poor wealth conditions and immigration problems, neither of which are likely to be solved. France is suffering from these issues too now and the violence there is likely striking fear in governments throughout Europe. Lastly, the U.S. internal political situation is too difficult to predict, and while market uncertainty related to impeachment and recriminations by both sides may rise at times, the chance of a major political upheaval remain slim.

Central Banks: Normalization except Japan

Our Fed call for 25 bps hikes in both September and December certainly seem correct, although our forecast for a pause in the 1Q, followed by hikes in the 2Q and 3Q is unproven, though not too far to current economist consensus. We now expect 4Q, 1Q and 2Q hikes and then a pause. As we expected, the ECB still intends to end QE in December. We retain our call for quarterly 20 bps hikes starting in 3Q19, but there is a decent chance that such could be pushed into 2019. We also add that moderate-sized TLTROs will be issued in the 1H. In September we expected the BOJ to remain on hold except that it would taper ETFs, but clearly this latter factor is off the table for a while. We still do not expect any BOJ hikes for the next four quarters due to the VAT hike in October 2019. As for inflation, we expect U.S. Core CPI to be 2.2% YoY in June, and 2.1% in December 2019; and as we expect the Brent oil price to be $66 and $68 at those periods, we expect the headline CPI to be 2.2% and 2.3% respectively, which are basically perfectly on target for the Fed. Overall commodity prices should also move mildly upward in 2019, primarily led by a recovery in oil due to OPEC regaining better control of the market. Although global growth should keep global commodity demand quite firm, investment speculation in commodities should diminish.

Flat USD in 1H, weaker in 2H and Low G-3 Bond Yields

Given our scenario, we expect G-3 bond yields to continue rising slightly in the next few quarters. For U.S. 10Y Treasuries, our target for end-March is 3.15%, while those for 10Y JGBs and German Bunds are 0.15% and 0.40%, respectively. For June-end, we expect 3.15%, 0.15% and 0.50%, respectively, and in the 2H, the U.S. should decline to 3.0%, while JGBs should remain flat and Bund yields rise slightly. This implies (coupled with our forex targets) that including coupon income, the Citigroup WGBI (index of global bonds) should produce a -1.2% unannualized return from our base date of November 30th through June in USD terms, and -1.3% through December. Thus, we continue to maintain an unenthusiastic stance on global bonds for USD-based investors. For Yen-based investors, the WGBI index in Yen terms should be -0.1% and -3.5%, respectively, and as for JGBs, we target the 10Y to have a -0.6% total unannualized return in Yen terms through June and similarly through December.

Regarding forex, although Fed policy will tighten faster than the BOJ and ECB, global worries about U.S. budget and trade deficits, coupled with an uncertain U.S. political situation, should restrain USD enthusiasm, so we expect the Yen and Euro to be basically flat through June from our base date levels of 114 and 1.13, respectively. The Yen and Euro should, however, strengthen to 111 and 1.16 at end-December. Meanwhile, our call for the AUD:USD is for 0.72 at end-June and 0.74 at end-December.

Moderately Positive on Global Equities

Our new scenario is positive on global equities (as it has been for us during virtually the entire period since the Global Financial Crisis), as decent economic growth should bring good corporate earnings growth, while mildly rising interest rates should not curtail valuations much. The increasing realization that the Fed will pause, if not halt, its hiking cycle in the 2H, should help all equity markets. Meanwhile, relief on BREXIT and the U.S.- China trade war would also be a major positive for markets. Aggregating our national forecasts from our base date of November 30th, we forecast that the MSCI World Total Return Index will increase 6.6% (unannualized) in USD terms through June and 11.6% through December. Clearly, this suggests a reasonably positive stance on global equities for USD-based investors (and Yen-based investors, as well).

In the U.S., decent global economic growth, coupled with accelerating corporate operational efficiency, should more than offset the headwinds from mildly higher interest rates and political uncertainty, so the equity backdrop is positive, especially as SPX CY18 and CY19 EPS estimates have risen by another 1% since our September meeting and the PER based on 12-month forward EPS has fallen to 15.8 times from 16.8. A continued high level of share buybacks also will help support the market. Given all of this, we expect the SPX to hit 2884 (5.6% total unannualized return from our base date at end-November) at end-June, and 2957 at the end of 2019 (9.2% return).

European equities have been quite disappointing for the last three quarters, especially in USD terms. Some European macro economic data, especially exports and auto production, are still showing signs of deceleration, but GDP should be reasonably solid going forward, especially by mature-country standards. Political risk continued to haunt the markets, but fears of an Italian crisis have greatly decreased in recent days and better BREXIT conditions would greatly boost investor sentiment. Continued low interest rates and decent earnings increases from global economic growth should help its equity market rebound. Notably, rising oil and commodity prices, to which UK and European corporations are highly geared via multinational companies, should also boost corporate earnings after a very negative 3Q trend for such. Furthermore, the European PER on next-12-months EPS is low at 12.8 and will likely rise somewhat, so we see the Euro Stoxx index rising to 375 and the FTSE to 7500 at end-June, and to 380 and 7800 at year-end, which translates to 10.7% and 16.8% unannualized MSCI Europe returns in USD terms for those periods. Consensus EPS for CY18 and CY19 decreased 2% since our last meeting, but YoY growth for CY19 remains solid at 10% with a high dividend yield of 3.5%.

Japanese equities have also disappointed, falling significantly in USD terms during the reporting period, but now valuations are very low, at 12.5 times next 12-month EPS, and EPS growth is still looking positive ahead. Indeed, although consensus EPS for CY18 and CY19 decreased 2% since our last meeting, YoY growth for CY19 remains very good at 9%, with a dividend yield of 2.3%. Global trade disputes likely have played a key factor in reducing investor sentiment regarding the country, with Chinese demand for Japanese capex goods declining significantly. Japan's domestic economy also suffered from natural disasters in the 3Q, but the 4Q should rebound nicely. Companies still have high operational gearing to continued global economic growth, so our expectation for improved sentiment for the latter should lead to greater interest in Japanese equities. Meanwhile, corporate governance continues to improve (despite a few hiccups), with share buybacks continuing to be very supportive, so we expect TOPIX at end-June to be 1752 with 1862 through December for total returns of 5.1% and 16.8% in USD terms, respectively. There is some uncertainty about how volatile economic sentiment will be in the lead up to the proposed VAT hike in October 2019, as the last hike caused major disruption, but we think the bumps should be quite mild this time as the economy is now on much sturdier ground and consumers realized that they over-reacted the last time.

As for the Developed Pacific-ex Japan MSCI, it too has been disappointing due to trade fears, but we expect Hong Kong and Australian equities to perform well ahead, leading to an 8.4% unannualized return in USD terms through June and 18.3% through year-end. Better confidence in global growth, reasonable equity valuations, decent earnings growth and continued low global interest rates all play major roles in these expected returns. Hong Kong property prices are likely to decline, but this is greatly discounted in share prices already and any sense of an impending pause by the Fed should especially help sentiment there. Once again, the major risk is trade disputes, particularly between the U.S. and China, but that risk is greatly priced into the markets by now and the topping out of sanctions at 25% on the $200BB tranche would be a major positive for these markets.

Investment Strategy Concluding View

There is no doubt that geopolitical tail risks remain quite large, but the Global Investment Committee remains moderately positive because the net impulses for global economic growth and corporate profits continue to improve. Thus, similar to our meetings of the last decade, this justifies a positive stance on global equities. Meanwhile, global bond yields should rise slightly, so we maintain an unenthusiastic stance on global bond returns, especially compared to U.S. short term fixed income rates. Clearly, there are significant downside risks to global risk markets in 2019, but many upside risks as well.

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