

## 2019 Investment Outlook

# Will We Alter or Confirm the Traditional Sequence of the Markets?

It appears we have transitioned to interchangeably utilizing the microscope and the telescope. Should the fear of a short measurable event be negated, we simply transition to a broader and bigger view that most assuredly affirms our current pragmatic opinion.

With increasing exposure to more economic and financial data and exponential interpretations of the data, we are not addressing the psychological component of what this does to herd behavior and the economic cycle. Let's take a look.

2018 was the year of "yes, but..." Considering the broadly positive domestic economic news, the countering fear was that this was peak earnings, peak unemployment, peak civility, and so on. (A quip about "peak peaking" might be appropriate, but it's a safe bet we will circle back to utilizing the ominous topping declarations again.) The "yes, but" hinges on acknowledging the positive but enlightening the speaker that their bliss is based on ignorance of some important facts that cannot be countered.

- Gross Domestic Product (GDP) was an annualized 3.00%, a year after 2017's calendar year growth of 2.50%, 1.90% in 2016 and 2.0% in 2015. Expectations are now ratcheting back as the GDP forecast is 2.89% as of this writing (11/14/18).
- We encountered a tightening labor market where the unemployment rate hit 3.70%, a level not seen since 1970. We have more job openings than people looking for work and continuing jobless claims hit a level not seen since 1970 as well. Average hourly earnings also rose to 3.10% on a year-over-year basis, a level not seen since 2009.
- Economic growth and the lagging impact of the tightening labor market on margins helped corporate earnings grow substantially. According to FactSet, the expected blended year-over-year earnings growth rate for the third quarter 2018 is 24.9%, above the original



Scott Colyer  
CEO & CIO



Matt Lloyd  
Chief Investment Strategist

estimate of 19.3%. FactSet also noted that if this were to occur, it would be the second highest level since the third quarter of 2010. Expectations for 2019 are for single-digit growth as the initial increase from the tax cut has been priced in and should be represented in year-over-year earnings.

- As earnings grew and markets reacted wildly about future expectations, the net worth of households and non-profits rose at an annualized 6.60% for the first half of 2018. This tracks with the long-term average of 6.90% over the last 73 years but exceeds the average growth rate of the last 20 years which stands at 5.35%. While this might surprise many, we have seen quite a bit of risk-off sentiment from investors during this whole expansion due to the impact of the financial crisis of 2007-2009.
- Sentiment numbers from consumers and small business owners are tracking at historic highs. This defies the mid-term election advertising blitz and confirms our belief that a negative bias focuses our attention and we tend to disregard positive events.
- Interest rates rose as the Federal Open Market Committee (FOMC) increased rates by 75 basis points through the end of October. A December rate hike looks likely due to the recent strong employment reports and increasing inflation pressures. Not-so-coincidentally, the 10-year U.S. Treasury yield increased from 2.40% at the beginning of the year to 3.21% as of 11/2/18. It was 2011 when the 10-year Treasury was last at this

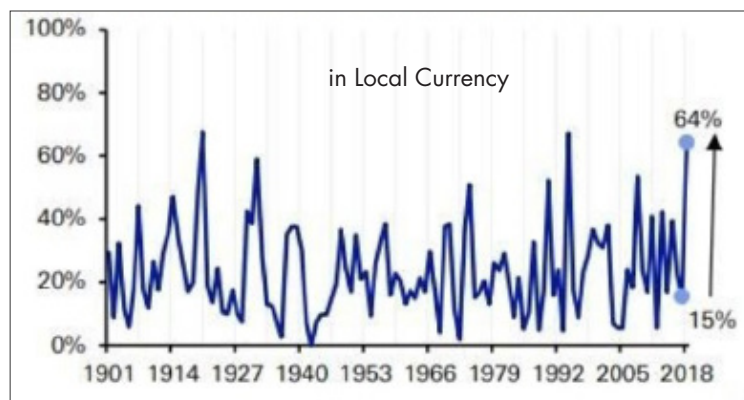
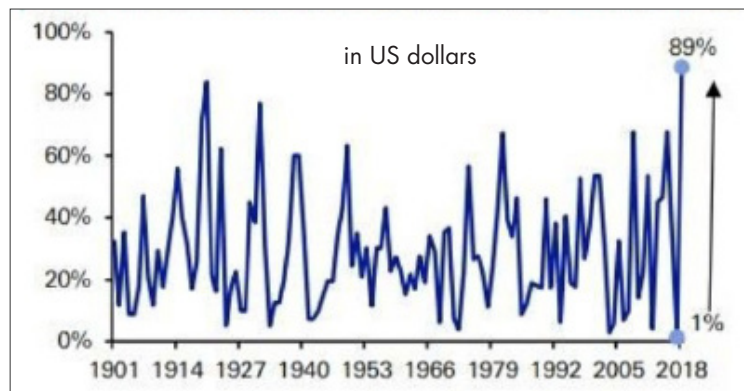
level. The 30-year Treasury yield rose to a current level of 3.45% from a beginning point of 2.74%.

- Perhaps the bigger events of the year were the hysteria surrounding the build-up to the mid-term elections and the trade skirmishes that were projected to unwind the positive economic developments. While a trade war would be problematic, we have experienced more of the saber rattling that typically occurs in years of unresolved tariff one-upmanship prior to a trade war. The new trade agreements with Mexico and Canada should be more of the template for investors in how trade agreements get worked out rather than extrapolating headlines into future certainties.

2018 was destined to be the yang to 2017's yin. Just as 2017 was defined by so little volatility, 2018 was just the opposite. Consider Deutsche Bank's striking research (below) showing that, in U.S. dollar returns, 89% of the assets they covered had a negative total return year-to-date through October 2018, the highest since 1901. This follows the all-time low of only 1% of assets having a U.S. dollar-denominated negative return in 2017.

### Percentage of Assets with a Negative Total Return

Source: Deutsche Bank, Bloomberg Finance LP, GFD. Total number of assets in 2018 is 70 versus 34 in 1901. Past performance does not guarantee future results.



One extremely important component of the charts above is the U.S. dollar returns on the top and the local currency returns below. It corroborates that the underlying assets

were vulnerable, but also emphasizes the positive correlation between asset prices and excess cheap money chasing assets with little regard to the cost of capital. There have been reports of various positive correlations unwinding after a historic run without a breach, however the problem with that was they were using assets denominated in U.S. dollars, which skews the metric. We have found that for those wanting to potentially mitigate volatility, our most preferred option is a broad-based investment in non-dollar denominated assets. In the last year, the U.S. dollar has traded in a 9.02% range, down as much as 6.50% and is currently 1.8% higher. Movement in the U.S. dollar has been a large factor in the diverging U.S. economic prosperity relative to Europe and China in particular.

As we embark on 2019, we expect some trends will continue, and some will wane. Here are some that we believe won't change.

- Markets discount future events, even if they are skewed by consensus optimism or pessimism. This inherent subjective probability not only obscures the likelihood of the event occurring but the ramifications of the event as well.
- The Federal Reserve, with access to all pertinent economic and market data, works in a methodical and data-dependent manner. However, it has always ultimately set forth a deleveraging or recession by being less accommodative as it tries to balance its mandates of stable prices and maximum sustainable employment. Though the mandates are broadly defined, with the increased politicization of the Federal Reserve over the last 40 years, it seems their responsibility and tools have morphed. You can generally count on a central bank to be a central bank and embark on certain patterns that have had repeating results, yet argue that the results will be more pleasant than the last cycle.
- "It's different this time" only assures one that it will be the same. The only difference is the description used to designate its uniqueness. We couldn't possibly make the same mistakes as our ancestors since we are so much more developed...
- The delineation between the majority and the minority has become more difficult with the proliferation of social media. Since the markets price in excess risk and excess optimism at certain times, this quest is one of the more fruitful efforts investors can partake in with outperformance the potential reward.
- Disregarding the previous results, the next election could be the most important in all of human history.

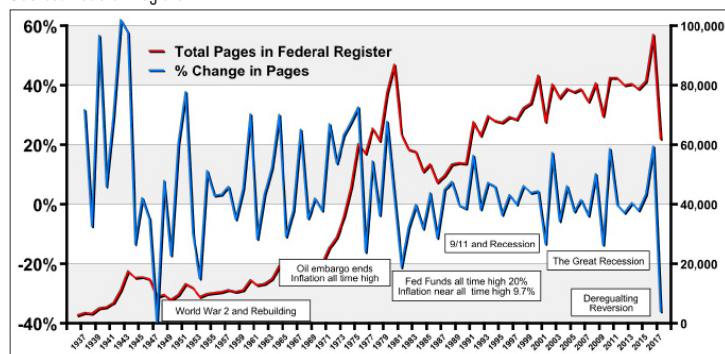
We see the continuation of the late-stage cycle for the U.S. economy. While recession risks are higher than they were a few years ago, we don't see the immediate warning signs (as of now) of a recession in 2019. In late-stage cycle investing, it's critical to scrutinize for more value-based metrics and be vigilant in monitoring changing conditions that could propel a recession.

Here are a list of traditionally accurate metrics we follow that are not denoting an eminent recession. Keep in mind that late-stage cycles are known for rapidly shifting conditions, while also understanding that these indicators can give false signals along the way.

- Though the yield curve is flat, it did steepen in the last few months. Two points: a steeper yield curve indicates a growing economy while an inverted one typically points to an economic slowdown. Even when the curve inverts, it typically takes 15 months or more before a recession begins. (Recall our prior note that the current byproduct of the massive quantitative easing done by the Federal Reserve, European Central Bank and Bank of Japan has potentially skewed the signal given from past inverted curves by being earlier than normal.)
- Deregulation is another positive factor that may extend this already historic expansion.

## Federal Register

Source: Federal Register



The average GDP rate since 1936 is 3.70%. Marking the six years when there was a large percentage decline in pages in the Federal Register, we see significant events surrounding them, however the four-year growth in GDP averaged 3.375%, below the average. How could this be if deregulation is a key stimulus? The answer is fairly easy when you look at corporate planning for expenditures and the regulatory outlook—corporate leaders are generally gun shy about increasing long-term investments if they feel the regulatory environment will increase. Regulatory pages have increased an average of 4.5% annually since 1936. In periods when there

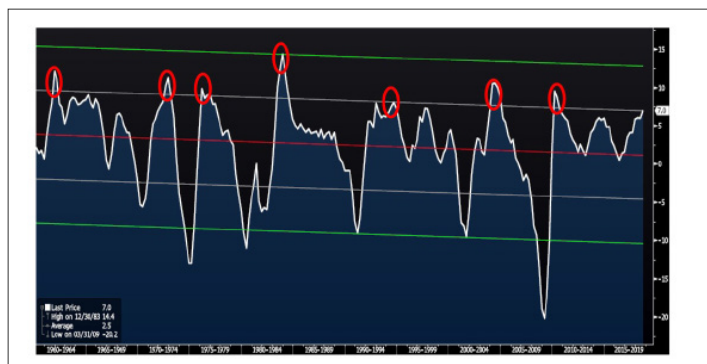
was a sizable reduction in pages, all but two years saw large increases in the following years. In the four-year period following consistent reduction in regulations, GDP increased 4.30% annually, well above the average over the last four decades. The impact of deregulation on corporate sentiment generally requires several years for business owners to continue investing in their business and expanding versus meeting increased regulatory requirements.

- The Leading Economic Index is 7.00% year-over-year, which is one standard deviation from its long-term trend line and only occurs roughly one third of the time. The current measurement is historically high and corresponds to continued economic growth.

## Conference Board U.S. Leading Economic Indicators (LEI)

Source: Bloomberg, year-over-year (YOY)

*Most one sigma tops in LEI YOY occurred shortly after recessions. However the lead time for the next recession was 61 months; the least amount of lead time was 16 months.*

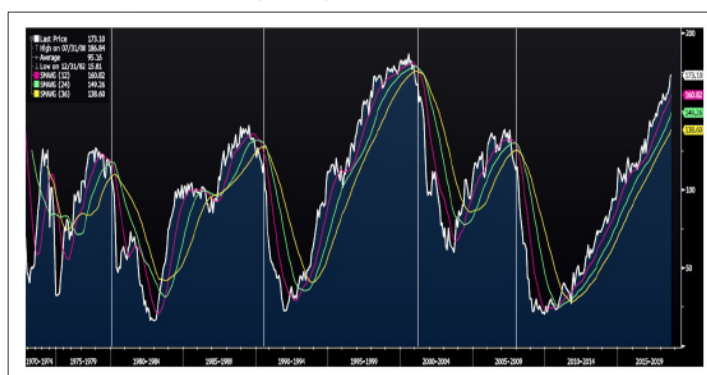


- One of the better mechanisms for the timing of a recession is the moving average of the Conference Board's Consumer Confidence number.

## Conference Board Consumer Confidence

Source: Bloomberg, year-over-year (YOY)

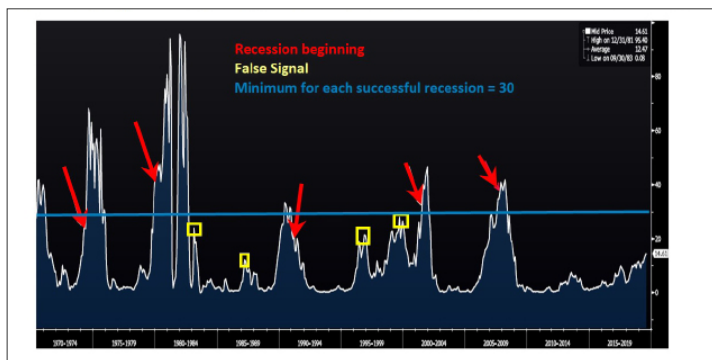
*Average lead time of five months when two-year moving average breached; high of seven months and low of four months; one false signal in mid-1980s. Russell 3000 peaks occurred after two-year moving average broke in all but 2001 recession with peak price in 2000.*



- If we take the Federal Reserve's recession indicator, we see a number that is well below the metric from which all past recessions were triggered, but many false signals as well.

## NY Federal Reserve—Probability of Recession in U.S. 12 Months Ahead Predicted

Source: Bloomberg, Past performance does not guarantee future results.



- The low pick up in High Yield's option-adjusted spread (OAS) to Investment Grade OAS is at a level that points to continued late-stage cycle growth. The spread as of 9/30/18 is 2.46% while the long-term average is 3.46%. A spread approaching 4.00% begins to send alarms. This indicator will most likely be one of the first to go off with the proliferation of lower investment grade debt during this cycle.
- Lastly, regarding timing, consider the receipts for the Treasury from Action Economics. Certain patterns have shown up prior to the last three recessions. Substantial declines occurred immediately prior to recessions beginning. Though we are coming off a decline, the most recent data shows a bounce, which resembles much of what we saw in 2015. We have often referred to 2015 as a stealth bear market and this and other data seem to corroborate it. The receipts also confirm to us that we are in the later stages of this cycle.

## U.S. Treasury Receipts

Source: Action Economics. Year-over-year growth. Past performance does not guarantee future results.



Though some may be shocked at the length of this recovery, there is a precedent. Consider the Great

Depression, the closest comparison to the Great Recession of 2007-2009. Leading up to the Great Depression, we had four recessions in the preceding 15 years. After the Great Depression we had two extremely long expansions. Although the recessions' lengths prior to the Great Depression and the two after were similar in length, the expansions were strikingly different. The expansions prior lasted on average only 25 months, while the two expansions after the Great Depression lasted an average 65 months. Here are the key points:

- The length of the average recession has declined over time while the average expansion has doubled in length – signs of a maturing economy and utilization of better tools to manage recessions and elongate expansions.
- There has clearly been a psychological impact on expansions that follow a severe recession where massive deleveraging created an over-active negative bias and an increased sensitivity to the natural ebb and flow of an economic expansion. In this environment, we tend to confuse cautious optimism for euphoria, which lends itself to mitigating bubbles before they grow too large.

## Business Cycles

Source: National Bureau Economic Research. Past performance does not guarantee future results

BUSINESS CYCLE REFERENCE DATES		DURATION IN MONTHS			
Peak	Trough	Contraction	Expansion	Cycle	
Quarterly dates are in parentheses		Peak to Trough	Previous trough to this peak	Trough from Previous Trough	Peak from Previous Peak
August 1918(III)	March 1919 (I)	7	44	51	67
January 1920(I)	July 1921 (III)	18	10	28	17
May 1923(II)	July 1924 (III)	14	22	36	40
October 1926(III)	November 1927 (IV)	13	27	40	41
August 1929(III)	March 1933 (I)	43	21	64	34
May 1937(II)	June 1938 (II)	13	50	63	93
February 1945(I)	October 1945 (IV)	8	80	88	93
November 1948(IV)	October 1949 (IV)	11	37	48	45
July 1953(II)	May 1954 (II)	10	45	55	56
August 1957(III)	April 1958 (II)	8	39	47	49
April 1960(II)	February 1961 (I)	10	24	34	32
December 1969(IV)	November 1970 (IV)	11	106	117	116
November 1973(IV)	March 1975 (I)	16	36	52	47
January 1980(I)	July 1980 (III)	6	58	64	74
July 1981(III)	November 1982 (IV)	16	12	28	18
July 1990(III)	March 1991(I)	8	92	100	108
March 2001(I)	November 2001 (IV)	8	120	128	128
December 2007 (IV)	June 2009 (II)	18	73	91	81

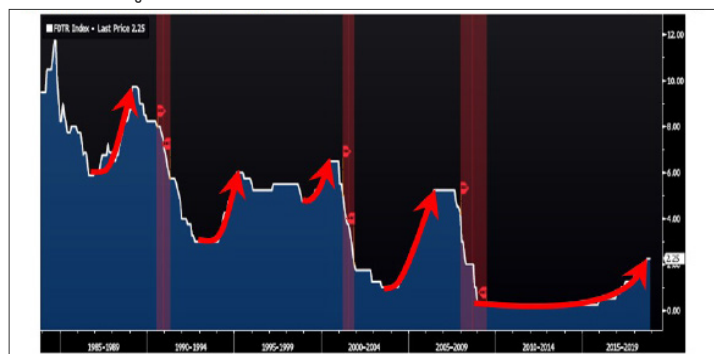
BUSINESS CYCLE REFERENCE DATES		DURATION IN MONTHS			
Peak	Trough	Contraction	Expansion	Cycle	
Quarterly dates are in parentheses		Peak to Trough	Previous trough to this peak	Trough from Previous Trough	Peak from Previous Peak
Average, all cycles:		17.5	38.7	56.2	56.4*
1854-2009 (33 cycles)		17.5	38.7	56.2	56.4*
1854-1919 (16 cycles)		21.6	26.6	48.2	48.9**
1919-1945 (6 cycles)		18.2 ↓	35.0 ↑	53.2	53.0
1945-2009 (11 cycles)		11.1 ↓	58.4 ↑	69.5	68.5

The current cycle appears to be rekindling a new lack of awareness that has been natural in the past. The markets

are used to more visceral moves in the Fed Funds rates, as compared to the “kid gloves” that the FOMC has been utilizing in the last decade. This explains the increased politicization of the Federal Reserve over the last 20 years as consumers’ net wealth has increased greatly combined with little understanding of the Federal Reserve’s past maneuvering and broadening social mandate. This chart accentuates the anemic pace of the current cycle’s increased rates compared to the past.

## Federal Funds Target Rate

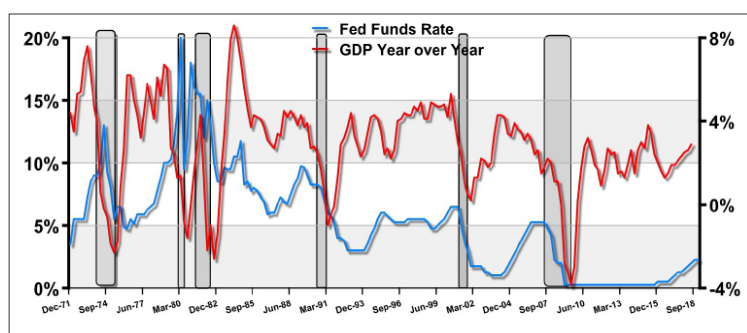
Source: Bloomberg



We continue to see growth for the U.S. economy as well as a rebound in both Europe and Emerging Markets. The Federal Reserve’s attempt to balance raising rates with economic growth will likely be a challenging task. As we can see below, the Fed Funds rate has seen two distinct periods in 47 years.

## Cycle: Interest Rates and GDP

Source: Federal Reserve, Bloomberg, Bureau of Economic Analysis

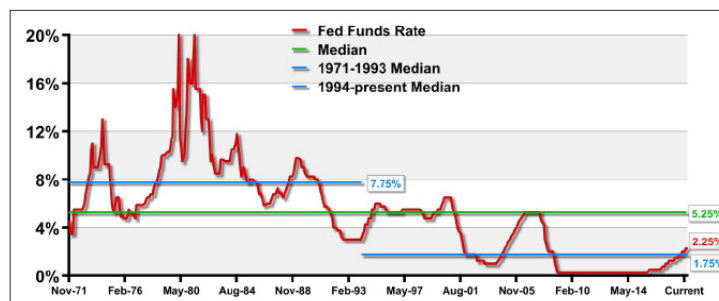


After the Great Recession, the Federal Reserve was also tasked with stabilizing liquidity in the many capital markets as well as the banking system. Things have changed in the century since the Federal Reserve was established in 1913 and, as we see from the chart above, one of the main mechanisms for executing their mandate is the use of short-term interest rates via the Fed Funds rate. This has been as high as 20% when hyperinflation dominated the economy to the recent all-time low of 0% in an attempt to return the economy, confidence and market liquidity to a more stable level.

Over the last nearly five decades, we can see two distinctively different periods in interest rates. This dynamic has set up some of the more pressing concerns for debt investors over the next 20 years as it appears the long-term bull market has hit its low point and a secular move up in rates may be in the cards. This requires investors in the credit markets be far more vigilant than they may have been over the last 40 years.

## Federal Funds: A Tale of Two Generations

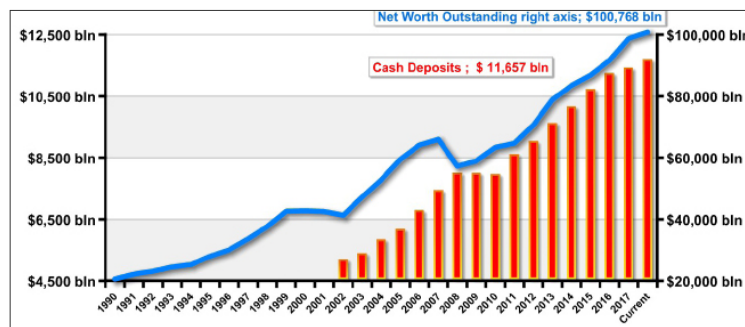
Source: Bloomberg, Federal Reserve



The U.S. consumer continues to experience a good tailwind from both their balance sheet and income statement. Though there are some initial signs of fatigue, it appears that some momentum will be maintained. Here are some of the key metrics we look at regarding the economy.

## Household Net Worth and Cash Deposits

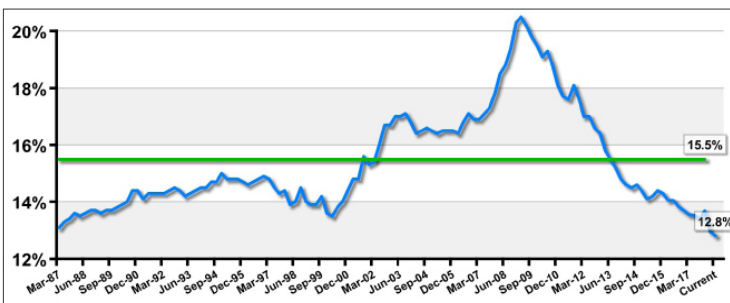
Source: Fed Flow of Funds



The amount of debt to assets has declined dramatically since its all-time peak in 2009.

## Household Debt as a Percentage of Assets

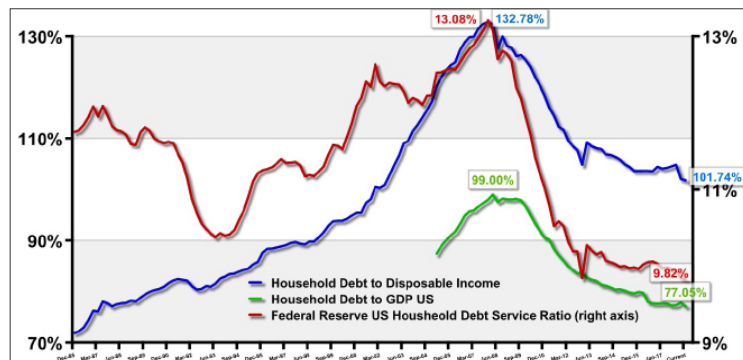
Source: Fed Flow of Funds



Another perspective is to view household debt relative to disposable income, GDP and the debt-service ratio. With interest rates rising, the debt-service ratio would be expected to rise, though it should take quite a bit of rate hikes and an increased debt load to return to previous highs.

## Household Debt Ratios

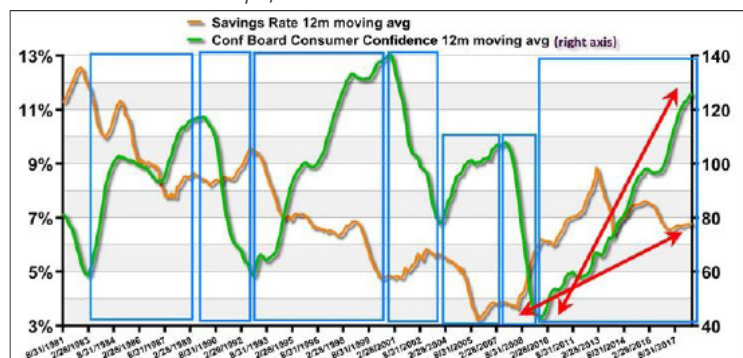
Source: IMF, Federal Reserve, Bloomberg



One dynamic that presented itself this year was the adjustment of how the savings rate is measured. For the first time in the last 40 years, savings rates have increased along with consumer confidence. From its bottom, the savings rate has doubled from 3% to 6.8%, although this may be explained by the idea that the savings rate could not go down much further based on demographics and the decline in interest rates paid on savings. However, it seems obvious that the last recession was so deep and broad that it impacted the emotions and fears across multiple generations. The chart below breaks down various trends in consumer confidence and the savings rate on a 12-month moving average.

## Savings Rate and Consumer Confidence

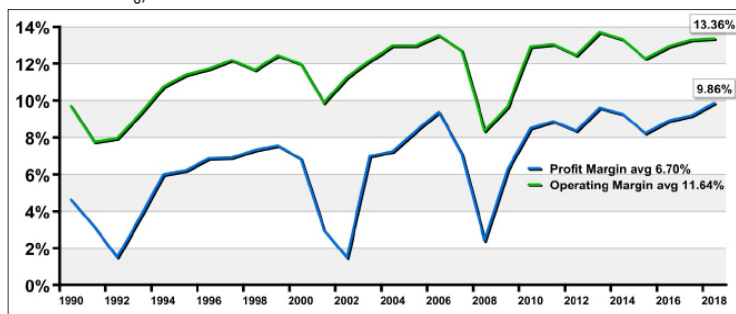
Source: Bureau of Economic Analysis, Conference Board



The corporate landscape has a bit more complexity when measuring potential vulnerabilities. Earnings margins have improved due to the tax plan and repatriation of dollars held abroad, which served to increase earnings per share (EPS) from a synthetic level. Though this should be mitigated a bit from some one-time gains and accounting measures, we still expect them to remain above average.

## S&P 500 Profit and Operating Margin

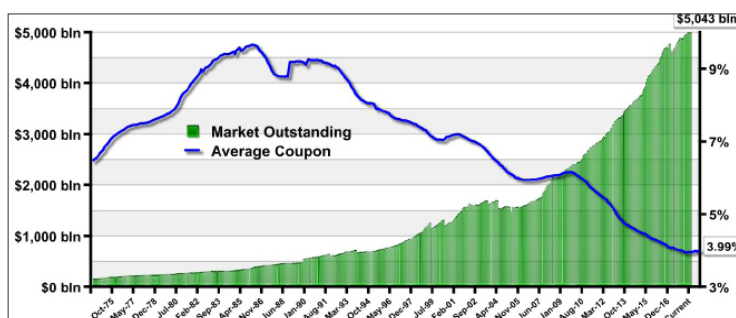
Source: Bloomberg, S&P



While earnings and cash flow have been good, there are a couple of key warning signs. The amount of debt has proliferated at an accelerated rate.

## Bloomberg U.S. Corporate Investment Grade Bond Market Index

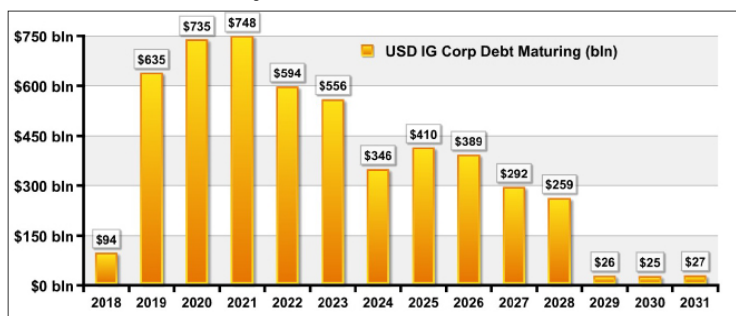
Source: Bloomberg Barclays



Aside from the debt proliferation and the fact that nearly 50% of the debt is at the lower end of the investment rating spectrum (BBB), 65% of the debt matures within the next five years. This timing may coincide with the end of the cycle, which could exacerbate the liquidity strains witnessed in the past.

## U.S. Corporate Investment Grade Bond Maturity

Source: Goldman Sachs, Bloomberg

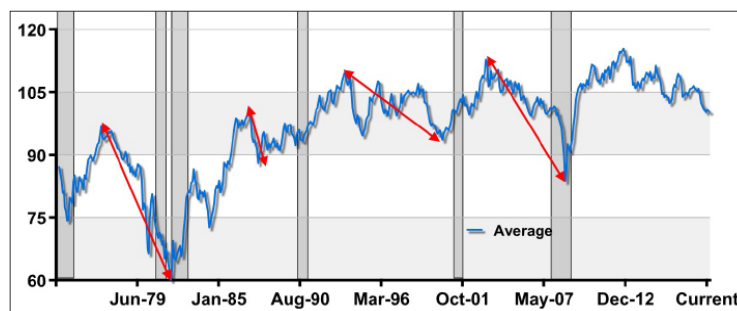


While this may point to a time of potential strained liquidity, it doesn't spell out massive defaults. However, the pricing of the debt corresponds to how severe the strains of the contraction. A simple look at the average price of the overall debt index is essential in estimating what might occur.

The gray boxes in the graph to the right denote recessions. The peak-to-trough price of the Bloomberg Barclays U.S. Corporate Investment Grade Bond price had an average decline in the last four periods of 22.55%. We have the benefit of being able to discern the price movement across two benign and two extreme recessions. The two anemic recessions saw an average decline of 13.3% while the two recessions that were above average had an average decline of 31.8% from their highs.

## Bloomberg Barclays U.S. Corporate Investment Grade Average Price

Source: Bloomberg, Barclays. Past performance does not guarantee future results.



## AAM's 9 for 2019

1. We continue to favor late-stage investments with an emphasis on Financials, Energy, Basic Materials, Consumer Discretionary and Industrials.
2. We expect higher volatility in the U.S. equity markets; larger cap value stocks may benefit as we anticipate the U.S. dollar to rally early and then decline by year-end. Due to shifts in industry classifications, potential outperformance may exist in the telecommunications equity class.
3. We expect the Federal Reserve to continue along its current path with an additional two or three hikes in 2019 given increased inflation and wage pressures, although they may be more data dependent and careful with timing.
4. We expect the yield curve to remain flat and potentially invert in 2019. However, with the unwinding of the Federal Reserve's balance sheet combined with higher budget deficits, we may encounter some brief periods of steepening. In light of these oscillating spreads in the yield curve, we still maintain the late-stage cycle investing theme and see the inversion as an affirmation of our economic and capital markets expectations.
5. We look for a healthy rebound in Emerging Markets (EM), particularly Asia as compared to Eastern Europe and South America, though still favor some broad-based exposure. We generally favor EM equities rather than debt though select debt may have some strong performance.
6. We also anticipate a rebound in Europe and Japan, as the processing of the election results and resolved trade talks begin to improve economics and ease the anxiety of investors. The United Kingdom may experience pressure in the first half of 2019, but we expect a rebound as the Brexit strategy becomes more clear.
7. We continue to emphasize the commodity sector, specifically Energy and Industrial Metals, as these areas tend to perform well during periods of inflation. The pressure that has pushed agricultural commodities lower may have some strong relative outperformance at points in 2019.
8. We have favored lowering duration in fixed income portfolios and now look to methodically increase credit quality as well. This can be done in several ways: via higher grade municipals, agency callable debt, certain agency floating rate structures such as fixed to float and/or Consumer Price Index (CPI) linked issues.
9. We see pressure on the U.S. dollar in the second half of 2019 as increased domestic budget deficits and global economic recovery may strain investors' appetite. We see gains in the euro, the pound and slight gain in the yen. The wild card is the Chinese yuan, determined by how quickly and to what degree trade tensions may be resolved.

This commentary is provided for informational purposes only. The indexes referenced in this publication are not available for direct investment. This publication is not an offer or solicitation of an offer to buy or sell any product or service. Unless otherwise stated, all information and opinions contained in this publication were produced by Advisors Asset Management, Inc. (AAM) and other sources believed by AAM to be accurate and reliable. **Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications.** All expressions of opinions are as of November 15, 2018 and are subject to change without notice.

All AAM employees, including research associates, receive compensation that is based in part upon the overall performance of the firm. AAM may make a market in or have other financial interests in any given sector or security with which this analysis suggests may be benefited from its conclusions. Investors should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed or recommended in this report and should understand that statements regarding future prospects may not be realized.

**Past performance does not guarantee future performance.**

The charts/graphs included in this publication do not reflect past or current recommendations made by AAM, should be considered an academic treatment of empirical data and should not be used to predict security prices or market levels. Any suggestion of cause and effect or of the predictability of economic cycles or investment cycles is unintentional. AAM's Investment Outlook was written using empirical research and analysis by highly experienced market observers and is designed for educational purposes only. This publication should only be considered as a tool in any broker's, dealer's or advisor's investment decision matrix. Investors should consult their financial advisor when applying the assumptions in this publication.

Not FDIC Insured. Not Bank Guaranteed. May Lose Value.

©2018 Advisors Asset Management, Inc. All rights reserved.

18925 Base Camp Road • Monument, CO 80132 • [www.aamlive.com](http://www.aamlive.com)

CRN: 2018-1126-7051 R

