2019 Investment Outlook

We're Moving On Up

"Fish don't fry in the kitchen, beans don't burn on the grill, took a whole lotta tryin', just to get up that hill."

The Jefferson's Theme Song

"Patience is one of the most valuable attributes in investing."

Marty Zweig

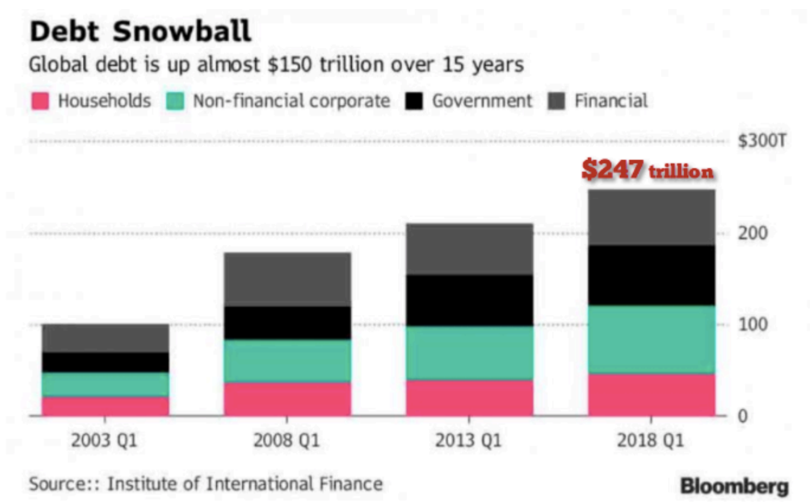
"If I owe you a pound, I have a problem; but if I owe you a million, the problem is yours."

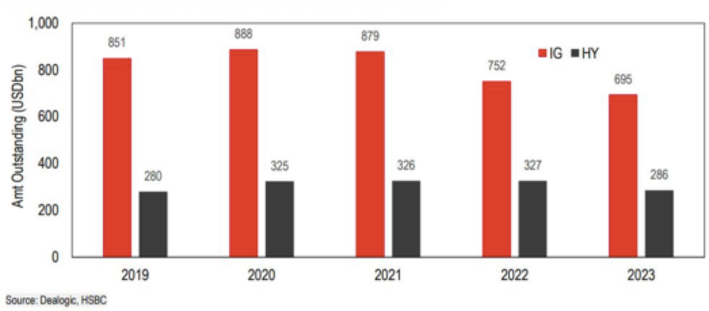
– John Maynard Keynes

In America, anything is possible to anyone, anywhere, regardless of economic background. Moving on up the economic ladder is one of America's most enduring qualities. It's called achieving the American Dream or getting a piece of the America Pie. This concept was captured in the theme song from the 1970's comedy show The Jefferson's. The lyrics cleverly captured the upward mobility dreams of every American and it was a catchy theme song too. Black upward mobility was a new topic on TV in the mid-1970's but great humor transcends nationalities and ethnic groups and the show was a big hit. At its heart, The Jefferson's was a great comedy show with great character actors much like Taxi, Barney Miller, Cheers, and Friends. George Jefferson was a bit part on the All In The Family TV show until George moved out of Archie Bunker's Queens neighborhood to relocate to the Upper East Side of New York City and into a deeeeluxe apartment in the sky. The Jefferson's did well enough to have a maid, the sassy mouthed Florence, who always gave George a run for his money and added to the laughter. The Jefferson's ran for 11 years from 1975 to 1985, about as long as our current economic up cycle coming out of the 2008 Global Financial Crisis. George and his wife Weezy most likely would not be running the dry cleaner business today due to the ridiculous escalation of real estate prices and rents in New York City. On a future visit to mid-town Manhattan, observe how many retail storefronts sit empty in the heart of tourist district and consider the fact that we're not even in a recession yet.

Until the large stock market sell-off during the fourth quarter of 2018, both U.S. stocks and bonds were considerably overvalued. While U.S. stocks are not yet truly cheap, a large chunk of the froth was knocked off of U.S. stock valuations with the recent mid-teens double-digit declines. On the other hand, bonds remain an Achilles Heal to financial markets given the explosive growth of debt over the past two decades. Monetary policy decisions made by central banks since the Global Financial Crisis in 2008 have caused global debt issuance to explode due to artificially suppressed interest rates. As shown in the top chart on the next page, global debt has grown nearly $150 trillion (that's a t, not a b) since 2003. Governments globally have consistently run large fiscal deficits. The U.S. deficit alone is now over $1 trillion per year and our national debt is $22 trillion. Corporate debt has also grown sizably in part to repurchase company shares in order to boost earnings and stock prices. According to economic research firm Macro Mavens, share buybacks have increased six fold since 2011 and totaled $1 trillion, representing nearly 50% of stock market gains since 2011. There was $760 billion of BBB rated U.S.

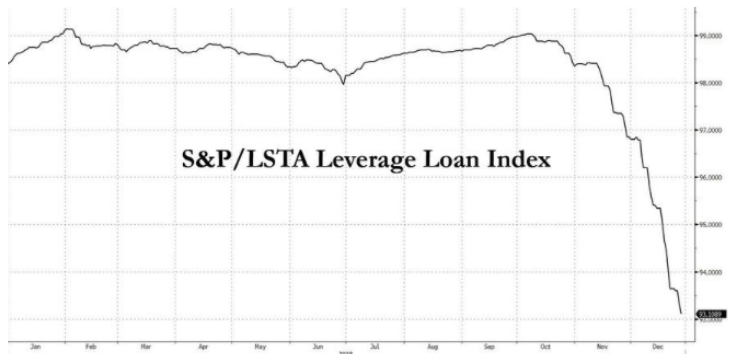
corporate bonds as of year-end 2007 and today there is $3.15 trillion. The second chart below shows just over $3 trillion of corporate debt maturities need to be refinanced over then next five years.





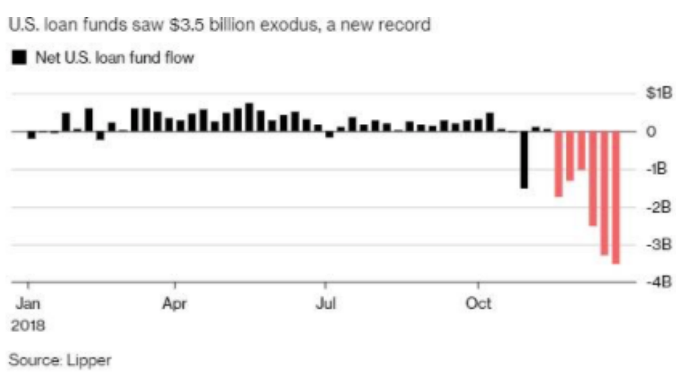
Corporate bonds set to mature over the next five years

Since 2009, both governments and corporations have been able to easily sell this debt due to the ravenous appetite of investors desperate for fixed income investments offering higher yields in a low yield world created by the artificially suppressed interest rate policies of global central banks. More recently, cracks are beginning to show in the U.S. debt foundation, which is not the right kind of foundation on which to build a sound economy. The following chart shows the S&P/LSTA Leverage Loan Index went straight down from November 1st through the XMAS Eve. That's nearly two straight months of not a single positive daily return, an unprecedented string of negative returns for a fixed income benchmark.



Source: Bloomberg

The cause of the declines was investors fleeing the space as captured in the chart below, showing record amounts of withdrawals from loan funds. In a low interest rate world, income investors rushed headlong into these types of bonds in order to earn higher yields since both cash and short-term bonds barely offered any yield for most of the past decade. Unfortunately, bank loans and leveraged loans are an illiquid market to begin with so when investors' head for the exits all at once and there are no other buyers willing to take the supply, then prices quickly reset lower. The outflows from loan funds became a stampede towards the end of 2018.

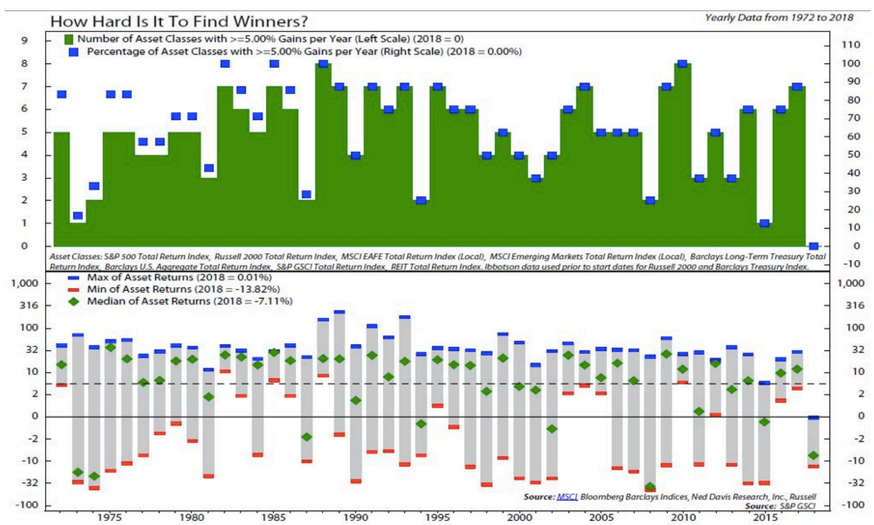


There is a large hill to climb for debt holders and issuers over the next several years, particularly in the corporate investment grade and high yield debt sectors. In the absence of having the cash to pay off the debt, many companies will need to refinance their debts. The difference this time is that market yields are now much higher than several years ago. As yields go higher, the cost of refinancing this debt gets more expensive for these companies (many are referred to as zombies) and at a time that the economy is at the tail end of its current expansion (2^{nd} longest in U.S. history) and overdue for a recession. The global debt situation is a yellow caution flag for investors looking ahead. Maintaining a higher quality bias in a fixed income portfolio, even if accepting lower yields for doing so, is a prudent position to take in front of this large debt-refinancing wave coming over the next five years. Importantly, many of these leverage companies are publicly traded, and will face higher interest expense when they refinance their debts, which will create a greater headwinds to corporate earnings as well.

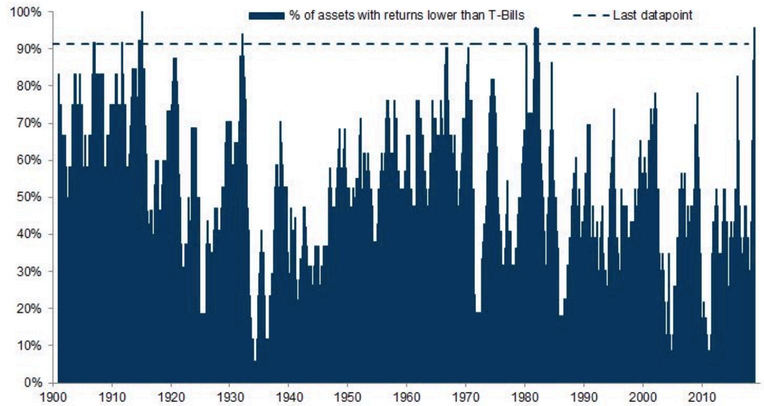
When thinking about your investment portfolio in the year ahead, remember George and Weezy moving on up from middling Queens to the snazzy Upper East Side of Manhattan. During 2019, investors should consider moving on up the quality curve in both stocks and bonds as a means to hedge against a deteriorating economic outlook and to protect against more outsized losses such that occurred during the fourth quarter of 2018. It took a whole lotta tryin' to flourish in the decade post the Global Financial Crisis and now its time to emphasize preservation of capital and risk management as a means to survive until the next fat pitch investment opportunity arrives. After a decade of robust returns, adopting a higher quality bias in both stock and bond portfolios should serve investors well and keep them on the path of attaining (or retaining) the American Dream.

2018 In Review

After an almost perfect 2017 of higher returns and low volatility, markets became extremely volatile and experienced significant declines towards the end of 2018. As shown in the chart below, 2018 was the first year in 46 years that no major asset class delivered at least a 5% return. It is an extremely rare event when absolutely nothing is working to the upside. Since 1972, there have been only seven other years when the median asset class return was negative. 1973, 1974, 1987, 1994, 2002, 2008, and 2015. Normally, in a bad year for stocks, bonds provide the ballast to an unstable ship but even in 2018 bond returns were mostly negative except for very short-term bond funds that represented a cash+ option.



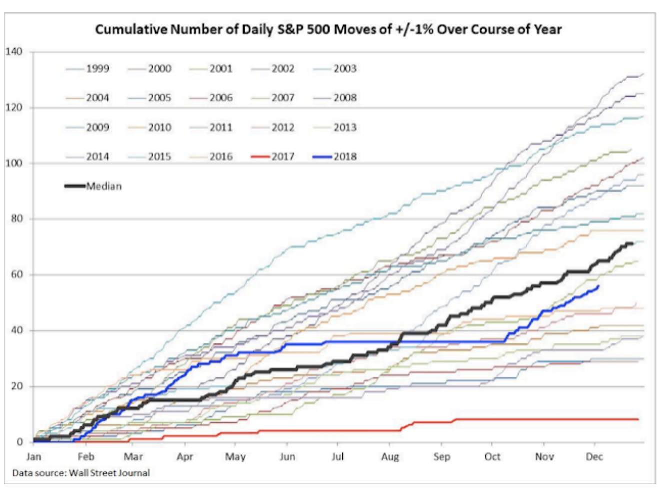
Speaking of cash, it was the best performing asset class during 2018, another rare outcome. As noted in the next chart, cash outperformed 93% of all other asset classes. The last time cash outperformed so many other asset classes was in the early 1980's and before that it was the middle of the 1910-1919 decade. 2018 wasn't the worst year in terms of absolute negative returns (2008 takes that title) but it was one of the worst years for investors with balanced accounts where a vast majority of asset classes except cash offered no shelter from the brewing storm.



Source: GFD, Datastream, Goldman Sachs Global Investment Research

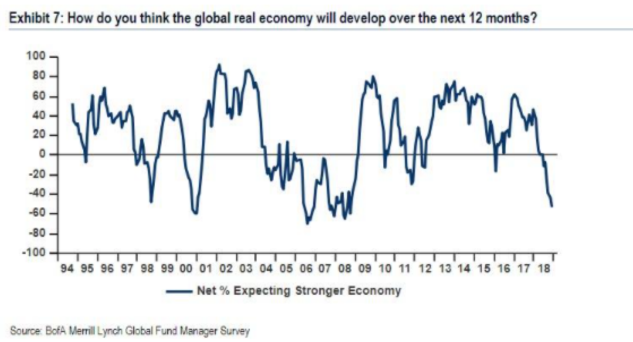
Volatility of Daily Returns

2018 was much worse than 2017 in terms of stock market volatility. However, 2018 was more normal in the context of typical stock market price volatility in any given year. 2018 just felt worse because of the 2017 was the lowest level of daily price volatility of the past 20 years. The next chart below shows the cumulative number of +/- 1% daily price moves in the S&P 500 Index each year from 1999 to 2018. In the latter part of 2018, daily volatility rocketed higher as there was a significant increase in the number of daily moves greater than +/- 1%. The blue line captures 2018 through early December and volatility only got worse into year-end. The solid black line, which captures the median daily price volatility experience of the 1999-2018 time period, was actually slightly higher than 2018 up to early December but 2018 eventually caught up. 2018 saw higher daily volatility from late January through May, with a long pause through the middle of the year, following by another bout of daily price volatility into year-end. Compare the 2018 experience to 2017 (bottom red line), which was like a patient in a medically induced coma, with the lowest price volatility profile of the last 20 years. Also note that there were many years over the past 20 that had more cumulative price volatility than 2018. Yes, 2018 felt a lot more volatile, especially compared to 2017, but it was not an outlier year for volatility. The early trading action in the first two weeks of 2019 indicates investors could be in store for a higher level of daily price volatility this year compared to 2018.

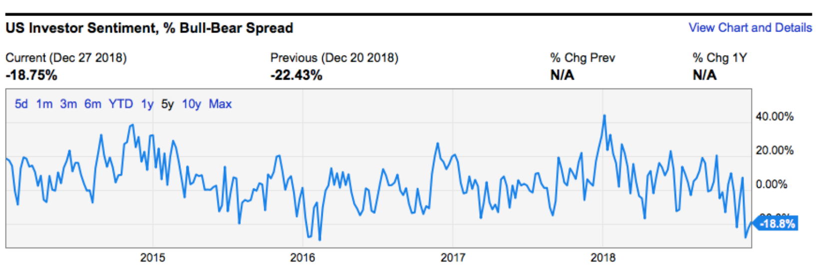


Investor Pessimism Prevails

The term dour perfectly describes the mood of the investors, both institutional and retail investors, at the start of 2019. The forward outlook from both groups became increasingly negative as 2018 unfolded. The first chart below is from the December survey of global fund managers conducted by BofA Merrill Lynch and shows negative expectations for the global economy over the next 12 months is approaching 2008 levels.

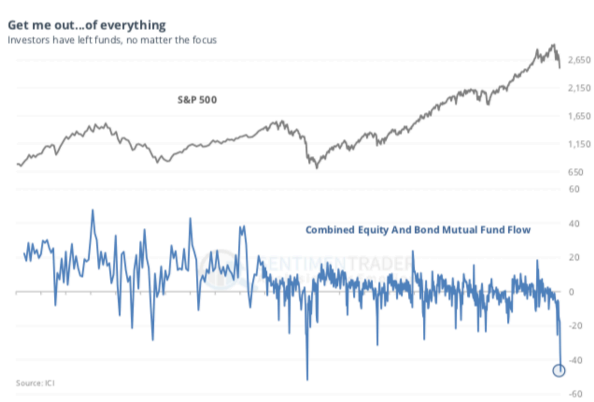


As shown in the next chart below, a similar story unfolds in a survey of retail investors by AAII, which plots the number of investors with bullish expectations minus the number of investors with bearish expectations. Note that coming into 2018, investors were rampantly bullish but by the end of 2018 that bullishness had plummeted into outright bearishness.



Source: YCharts, AAII

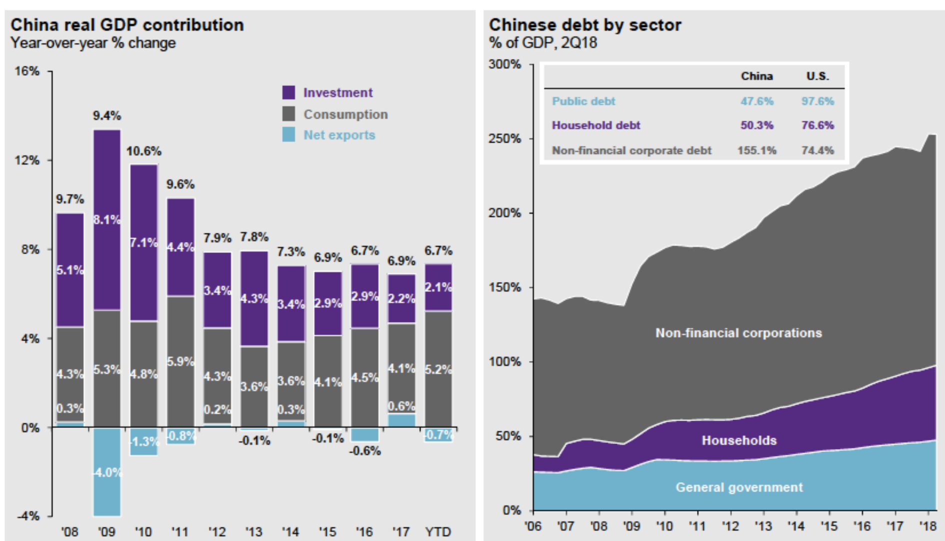
This extreme negativity was reflected in massive outflows from mutual funds towards the end of 2018.



It's important to note that sentiment indicators are more short-term in nature and the setup into early 2019 suggests extreme negative sentiment prevails. As such, and with the stock market having experienced a dramatic and rapid decline in the last three months of 2018, it's not completely unexpected the stock market has had a short-term snapback rally in early 2019. However, there is no guarantee this rally will hold up given the large macro uncertainties facing the world. At the top of the list is the U.S./China trade war that has a 2/28/19 deadline to be resolved or the Trump Administration will increase tariffs from 10% to 25% on a large amount of Chinese imports. If the U.S. and China fail to work out a trade deal, the global economy will undoubtedly take another step towards lower global growth in 2019. There is also the U.S. government shutdown and U.K.'s Brexit vote to get past in early 2019.

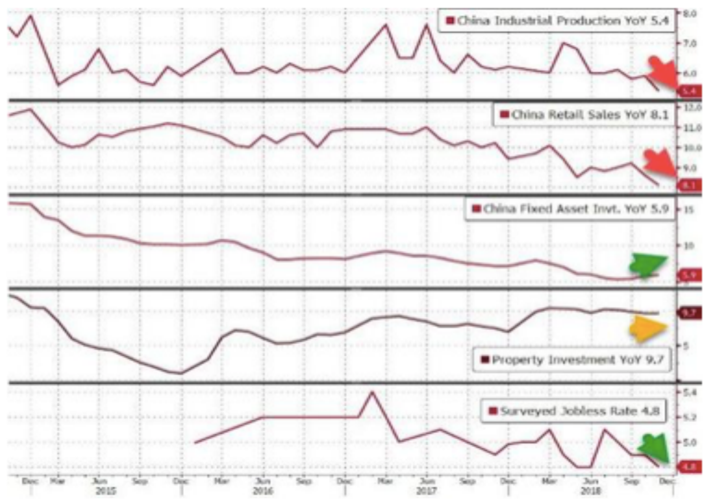
China

It's impossible to understate the importance of China's economy to supporting global economic growth. The left side chart below shows China's real GDP growth profile over the past 11 years has averaged 8.1% compared to the rest of the developed world, which struggled to exceed 2% real GDP growth. The right side of the chart shows that China's debt profile, like the rest of the world, has increased significantly since 2006, and has been a big factor supporting China's GDP growth rate and its centralized State Owned Enterprise economy. China has had strong growth, but increasingly of a lower quality profile given the rising importance of debt used to support economic growth.



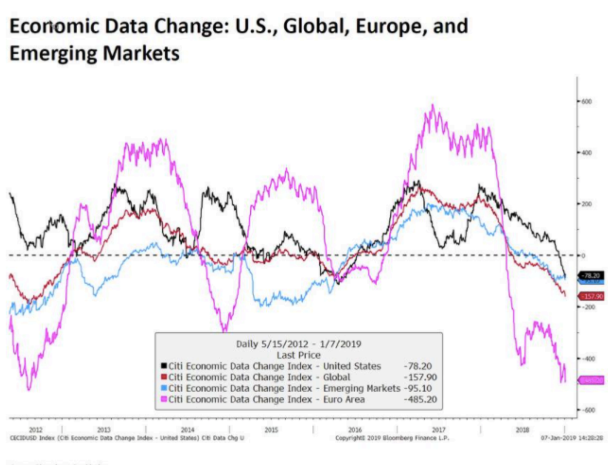
Source: FactSet, J.P. Morgan Asset Management; (Left) CEIC; (Right) BIS.

As 2018 played out, the economic data out of China continued to deteriorate. It is fair to say the trade war initiated by Trump is taking a direct toll on China but it is also taking an indirect toll everywhere, especially on Europe since China is Europe's most important export market. Slower China growth means slower European growth, as has been seen in European economic data during the second half of 2018. The top chart on the next page shows key Chinese economic data going back to 2015 and captures the deceleration in the Chinese economy on the right side of the chart. Both industrial production and retail sales are decelerating. The slowdown in the Chinese economy coincided with the ratcheting up of the trade war by the U.S. The Chinese government is beginning to introduce more stimulus measures to stabilize its economy including weakening the Yuan and cutting bank reserve requirements.



Source: Bloomberg

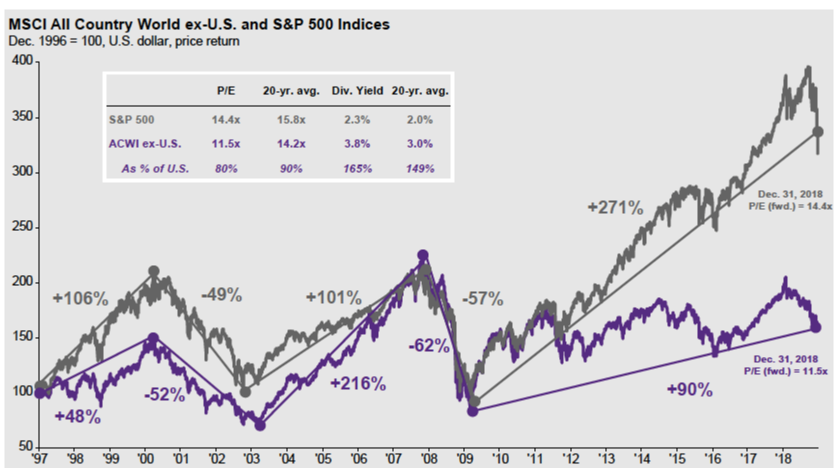
The next chart shows how the trade war is negatively impacting global growth in all major regions of the world.



Unless the trade war situation stabilizes or if there isn't a meaningful deal worked out between the U.S. and China by the end of February, then 2019 global growth has limited prospects for stabilizing and recovering in the back half of 2019. The trade war has significant ramifications for the earnings outlook for U.S. stocks since market expectations are currently for 7% earnings growth in 2019. Apple's recent negative preannouncement of its fourth quarter 2018 revenues (mostly due to sizable declines in its China IPhone sales) was a major surprise to global markets. It suggests the Chinese economy is slowing more than expected and the Chinese consumer to some extent is boycotting American goods due to the trade war. With U.S. housing and auto sales already showing signs of weakness, consumer confidence declining, and oil having fallen 40% since October 1st, the economic growth and earnings outlook for 2019 looks much more uncertain. The setup entering 2019 is certainly weaker than the setup entering 2018 when the tax cut bill had just passed and the China trade war was in its infancy. How the U.S./China trade war resolves itself is one of the most important variables in determining how 2019 will play out and financial markets should have a better handle on that subject by no later than the end of February.

International vs. U.S. Stocks

A key source of underperformance for balanced portfolios in 2018 was the poor returns from international stocks. The return spread between U.S. stocks and developed international stocks during 2018 was 9.4% to the favor of large cap U.S. stocks as measured by the S&P 500 Index. Coming into 2018, international stocks were cheaper and leaving 2018 they were trading at an even greater discount. The next chart shows the performance of the S&P 500 Index and MSCI All Country World Ex U.S. Index (includes emerging markets) going back to 1995. From the Global Financial Crisis low in March 2009, U.S. stocks outperformed international stocks by a significant margin. As indicated in the table, as of 12/31/18, the MSCI ACWI Ex U.S. Index traded at 11.5X PE multiple compared to the 14.4X PE multiple for the S&P 500 Index on a 12-month forward earnings basis. Non-U.S. stocks are trading at 80% of the multiple of S&P 500 Index compared to their 20-year average of 90%. In addition, the dividend yield on non-U.S. stocks is 65% higher than the dividend yield offered by the S&P 500 Index and compared to the 20-year average of 49%. At the start of 2019, non-U.S. stock markets offer cheaper valuations and higher dividend yields. No one can predict exactly when this situation may reverse. However, non-U.S. stocks are discounting global risks to a greater degree than U.S. stocks and compared to the past 20-year relationship between these two important asset classes.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

Earnings and Fair Value of U.S. Stocks

Let's next look at the prospects for the U.S. stock market's return for 2019. It's helpful to review current 2019 earnings forecast for U.S. stocks (using the S&P 500 Index) to determine a fair valuation range for them. Ultimately, the stock market's price level is really determined by two key factors. The first is corporate earnings and the second is the PE multiple investors are willing to pay for those earnings.

Calendar year 2018 S&P 500 Index operating earnings are forecast to be $162.51/share. In that figure there are three quarters of actual earnings with the fourth quarter earnings estimated and to be determined over the course of the next several weeks as companies report actual fourth quarter results. With the S&P 500 Index at 2,507 as of 12/31/18, the S&P 500 Index was trading at a 15.4X multiple (2,507/162.51) using calendar year 2018 earnings estimate. As of 1/5/19, the S&P 500 Index earnings estimate for 2019 stands at $174.61/share or a +7.4% year over year earnings growth forecast for 2019. Applying the current 15.4X multiple to the current $174.61/share 2019 earnings estimate would equate to a 2,689 price target for the S&P 500 Index or +7.4% from the 2018 closing level. However, given Apple's recent negative earnings announcement plus more recent macro data showing more signs of slowing global growth, the current 7.4% earnings growth estimates is likely too high. What if earnings growth gets marked down over the course of the year (earnings estimates typically decline 3.5% each year from start to finish) such that S&P 500 operating earnings only grow 5% in 2019 and the S&P 500 operating earnings estimate is $170.63/share instead of the current $174.61/share estimate. Maintaining the same 15.4X multiple, then fair value for the S&P 500 Index by year-end 2019 would be 2,628 or +4.8% of potential upside from the year-end 2018 S&P 500 Index level. If the U.S./ China trade negotiations fall apart and the Trump Administration raises tariffs to 25% and the global macro outlook worsens, then zero to possibly negative earnings growth becomes a stronger possibility for 2019. Obviously, should that happen, the S&P 500 Index has more downside risk from the 12/31/18 closing level of 2,507. However, if you are an eternal optimist, and believe the U.S. and China will work out a deal and global growth stabilizes and improves in the back half of 2019 as a result, then investors may be willing to pay a higher PE multiple than 15.4X and more upside return opportunity exists in U.S. stocks than presented above. However, the odds favor the risks more so than the rewards and investors should likely keep their expectations in check as a result. A mid-single digit return outcome from U.S. stocks in 2019 might be the decent outcome based on where things stand entering the New Year.

Summary

A much more challenging outlook faces investors at the start of 2019 than a year ago. The U.S. tax cuts are now fully baked in and no longer a tailwind for the U.S. economy. PMI readings globally are decelerating with the U.S. PMI reading in December for both the manufacturing and services sectors moving lower. The trade war and debt issues are creating stress in China's economy, an important engine of world growth. The debt situation globally is a major overhang and could become a bigger risk should the global growth outlook worsen. U.S. investors experienced a decade of above average returns and one of the longest periods of sustained economic growth (albeit low growth) on record, in large part due to central bank policy decisions. However, 2018 marked a major turn in central bank liquidity support, which had a tremendously positive impact on financial asset returns over the past decade. The preponderance of evidence suggests we are closer to the end of the current economic up cycle. From here, a prudent investor should consider a George and Weezy type move in their investment portfolio. Moving on up the quality curve in both stocks and bonds will offer some (but not total) protection against more adverse outcomes. A cautious approach is easily justified and there ain't nothing wrong with that so consider moving on up.

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