# Q4 2018 OUTLOOK & REVIEW

QMA's Global Multi-Asset Solutions Group

KEY POINTS

## Economic Outlook

- The global economy enters the last quarter of 2018 with good momentum; however, growth has become less synchronized, more uneven and less robust than in 2017, with economic activity accelerating in the US, moderating in the eurozone, UK and Japan, and slowing in China and other emerging markets (EM).
- In the US, consensus GDP growth forecasts for Q3 of 3% now look conservative, as the labor market and business confidence (especially small business) continue to get a boost from fiscal stimulus and strengthening capital spending.
- In Europe, rolling shocks, including the Brexit stalemate, Italian fiscal stress, and possible fallout from the Turkish lira crisis on European banks have weighed on growth. Japan appears to have rebounded smartly from its contraction in Q1, but still appears set to grow at a slower pace this year than last.
- Inflation shows a similar divergence, reaching central bank targets in the US and the UK, but lagging far behind in Europe and Japan. Thus, while policy normalization is the general theme, the major central banks remain at very different stages.
- Trade tensions and the ongoing crisis in emerging markets top the downside risks. Trade uncertainty has now seeped into the GDP and business confidence data for Europe and Japan, while the combination of trade tensions, fears of Turkish lira contagion, and Fed rate hikes have contributed to slowdowns in a number of EMs, including China.
- On balance: The near-term risk of a global downturn remains very low. But storm clouds are gathering.

## Investment Outlook

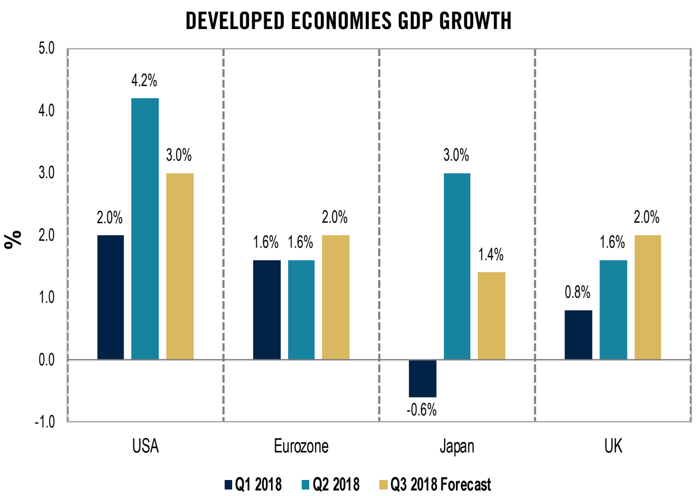
- In Q3, we rightly foresaw the outperformance of US equities, based on our expectation of superior economic and profit growth and that the US would paradoxically be seen as a safe haven from US trade tensions. We are sticking with that call—for now.
- Chief among the factors favoring a continuation of the trend is the breathtaking year-over-year 20% expected profit growth by S&P 500 companies in Q3 and Q4. We continue to be bullish on US small caps.
- Looking further out, however, we see the trend in 12-month forward earnings forecasts converging with other regions as the impact of US corporate tax cuts starts to fade.
- As we prepare for a possible rotation out of the US, we note the increasingly compelling valuations of non-US markets. The current double-digit return differential between US and non-US stocks is also highly unusual, suggesting US equities may be overbought.
- We now maintain a very slim overweight in global equities versus bonds. Excellent near-term conditions are balanced by building global macro risk factors, including continued Fed tightening, EM turmoil, escalating trade tensions, and the looming US mid-term elections.
- The mounting inflation pressures in the US have us carrying a healthy allocation to cash and sticking to the shorter end of the curve in Treasuries and US investment grade bonds.
- Among riskier fixed income segments, we are not yet tempted by wider spreads in EM hard currency debt.

## Economic Outlook:
## *Blue Skies Above, But Clouds on the Horizon*

The global economy enters the last quarter of 2018 with good momentum; however, growth has become less synchronized, more uneven and less robust than in 2017, with economic activity accelerating in the US, moderating in the eurozone, UK and Japan, and slowing in China and other emerging markets (EM). In aggregate, global growth appears to have slowed a bit in Q3, after expanding by a robust 4.3% annualized in Q2, according to Capital Economics.

The United States continues to lead the developed world in economic growth (Figure 1), benefitting from strengthening business investment and from fiscal stimulus this year and next.

### 1/ Growth Trends Less Synchronized, More Uneven




As of 6/30/2018.
Source: QMA, Bloomberg.

The US labor market continues to generate solid job gains, and business confidence remains robust, with readings around 60 on both the manufacturing and the services indexes from the Institute for Supply Management (over 50 is considered expansion territory). Small business confidence is also at an all-time high. Indeed, consensus GDP growth forecasts of 3% for Q3 may be too conservative as the GDP Now tracker published by the US Federal Reserve Bank of Atlanta was tracking at 3.8% as of September 29.

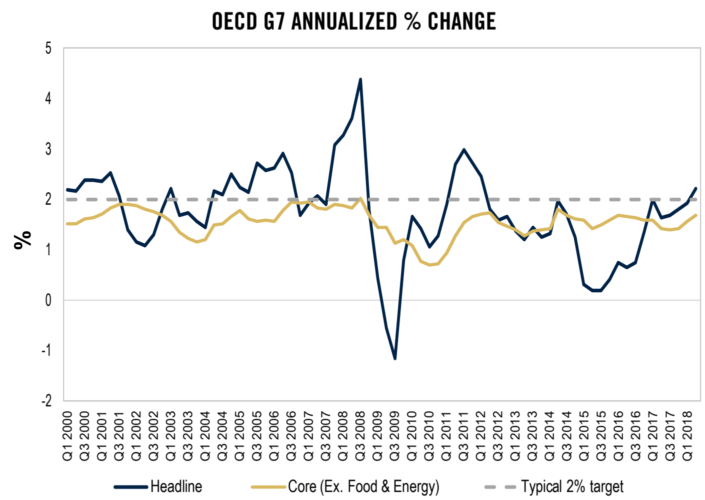
Given the length of the current expansion, the second-longest in the post-World War II period, there are nagging concerns about the end of the cycle. Recession risk is likely to build going forward, as more robust wage growth, increased inflation pressure and continued policy tightening raise the risk of a policy-induced slowdown (see our recent Market Pulse, "Help Wanted: Why Inflation Fears Might Actually Be Right This Time"). Nevertheless, while there is little doubt that the economic expansion is mature, the key economic and financial indicators that we monitor still suggest the risk of a recession in the near term is low.

While eurozone growth surprised to the upside last year, this year it is more modest and closer to trend. Growth on the continent has been weighed down by a rolling series of shocks, including the immigration crisis that threatened to bring down Angela Merkel's government in Germany, Italian political and fiscal drama, trade tensions with the US, a Brexit stalemate, and the Turkish lira crisis and its lingering threat to European banks. The UK economy (with growth near 1.5%) remains weighed down by the Brexit uncertainty, which increased over the summer as negotiations between the UK and EU stalled and the October deadline approached, raising the risk of fresh elections and/or a hard Brexit.

Japanese growth rebounded sharply in Q2 after contracting in Q1 and is expected to remain above potential in coming quarters (around 1.5% in Q3), albeit at a slower pace than last year.

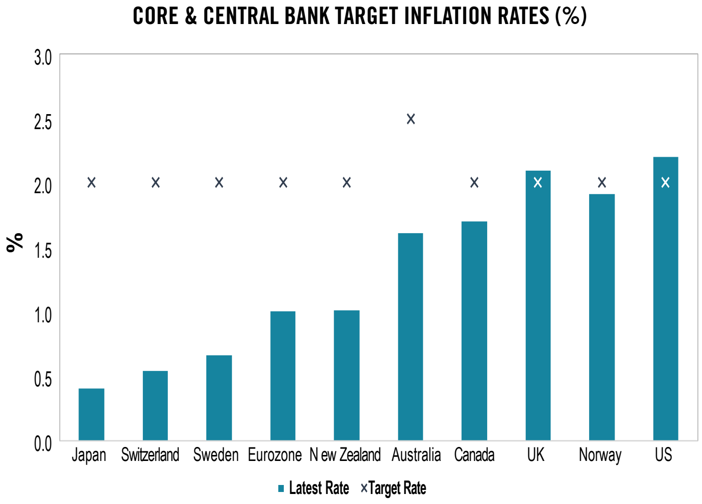
While inflation has risen on average across the developed economies (Figure 2) as economic slack has been absorbed, inflation risk is really a concern just for the US and the UK, especially when compared to Europe and Japan (Figure 3). Thus, while policy normalization is the general theme, the major central banks remain at very different stages. The US Federal Reserve (Fed) hiked rates again in September and remains on track to hike for the fourth time this year in December and potentially multiple times next year. Likewise, the Bank of England raised rates in August and is likely to hike again in Q4. The European Central Bank is set to halve its quantitative easing (QE) asset purchases and plans to terminate them at the end of the year if the economic data allows, but it has assured markets that rates will be unchanged "at least through the summer of 2019." Pulling up the rear, the Bank of Japan (BoJ) has pledged to continue QE buying and to keep rates low for an "extended period," given that inflation is still well below the BoJ's target.

### 2/ Developed World Rising Inflation Trend...




As of 6/30/2018.
Source: QMA, OECD, Thomson Reuters Datastream.

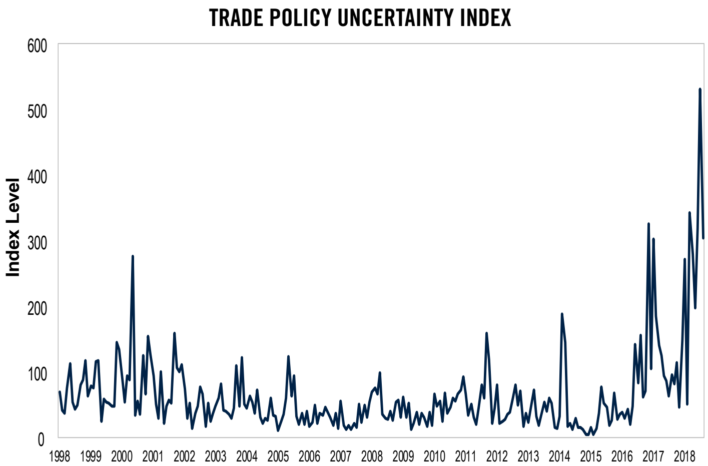
### 3/ …But Not a Concern Everywhere




As of 8/31/2018.
Source: QMA, Thomson Reuters Datastream.

Trade tensions remain a big risk to growth and have not de-escalated materially (Figure 4). The impact of this uncertainty appears to be seeping into the economic data, adversely affecting global trade data as well as GDP growth and business confidence in both Europe and Japan.

### 4/ Trade Conflict Endures



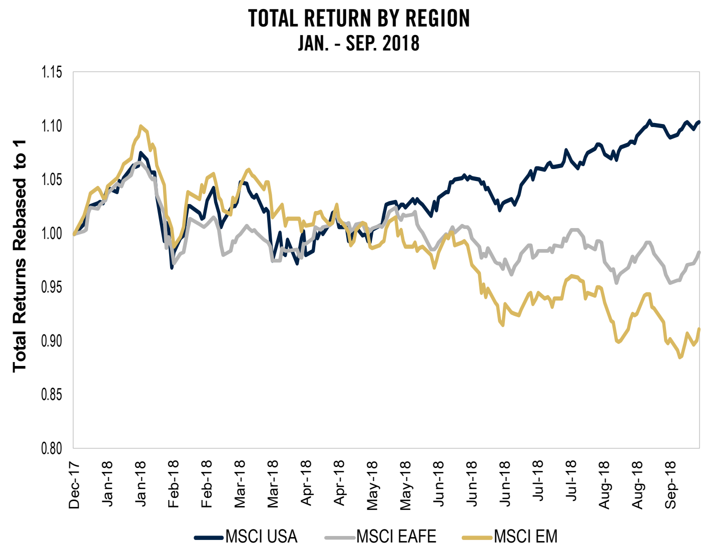

As of 8/31/2018.
Source: QMA; Bloomberg; Baker, Bloom & Davis.

Meanwhile, emerging markets face increased growth challenges (see sidebar, page 5). The US-China trade skirmish, fears of contagion from currency crises in Turkey and Argentina, Fed rate hikes and dollar strength have contributed to slowdowns in several EM economies, including China. EMs face further financial pressure from high and rising debt levels, and political uncertainty around elections. Weaker currencies combined with higher oil prices are also increasing inflation, forcing central banks to hike interest rates, adding to the economic difficulties.

## Investment Outlook: *Continued Divergence or Rotation and Convergence?*

A key theme of our Q3 Outlook involved the continued likely outperformance of US equities versus international (i.e., EAFE) markets, given our expectation that the US would deliver superior growth and that ongoing trade tension would favor the US as a relative safe harbor. And as it turned out, US equities increased their dominance over other major markets during the quarter (Figure 5).

### 5/ A Great Divergence




As of 9/19/2018.
Source: QMA, FactSet, MSCI.

**Past performance is not a guarantee or reliable indicator of future results.**

The operating performance of S&P 500 companies through the end of Q2 was simply breathtaking, with 25% profit growth and 9.5% revenue growth year over year (YoY) thanks to the corporate tax cuts, 4.2% GDP growth in Q2, and the lagged impact of the weaker dollar seen through the spring of this year. Buybacks, one of the uses of cash repatriated since the December 2017 tax cuts, increased by 60% in Q2, providing additional support for US equity performance.

Having gotten this call right (and given the recent margin of US outperformance), we are now faced with the dilemma of whether to stay with what has worked year to date or to change horses. So, will it be more of the same for Q4 or are we approaching a turning point?

We are sticking with our overweight in the US for now but could make a shift toward non-US markets during the fourth quarter depending on how the following factors shake out.

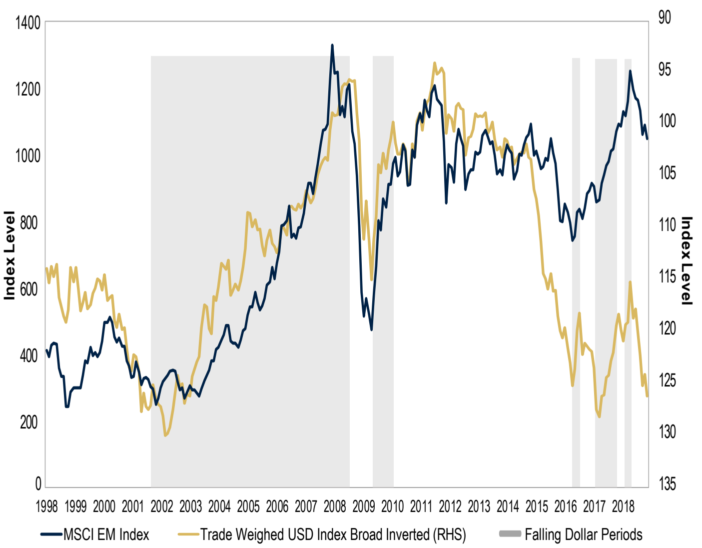
**Factors that favor (or would favor) continued US outperformance:**

- Expected YoY US earning growth around 20% for the next two reporting quarters
- Continued US economic strength and sluggish growth in the rest of the world
- Further escalation of trade tensions
- The spread of EM crises to the developed markets
- Resumption of US dollar strength (Figure 6)
- Hard Brexit or escalation of Italian fiscal stress and/or political uncertainty
- Less disruptive outcome of the US mid-term election resulting in split government

**Factors that favor (or would favor) a shift to "go global":**

- Over the next 12 months US earnings growth converging with other regions as impact of the tax cut on US earnings growth fades (Figure 7)
- Double-digit gap in return differential (highly unusual), suggesting US stocks are overbought
- Compelling valuation of non-US markets (Figure 8)
- Stabilization or weakening of US dollar from here
- Dovish signals from the Fed
- Easing of trade tensions as more countries/regions agree on bilateral deals with the US
- Roll off of positive impact from fiscal stimulus next year slowing US growth more than expected

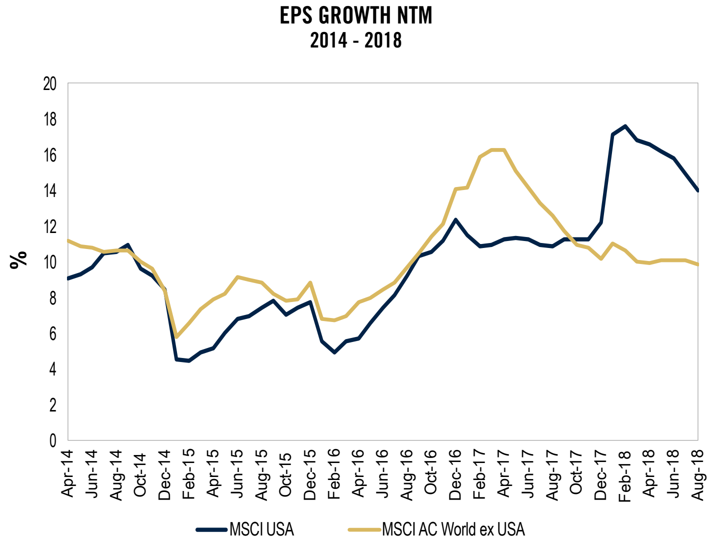
### 6/ USD and EM: Joined at the Hip




As of 9/1/2018.
Source: QMA, Thomson Reuters Datastream. An investment cannot be made directly in an index.

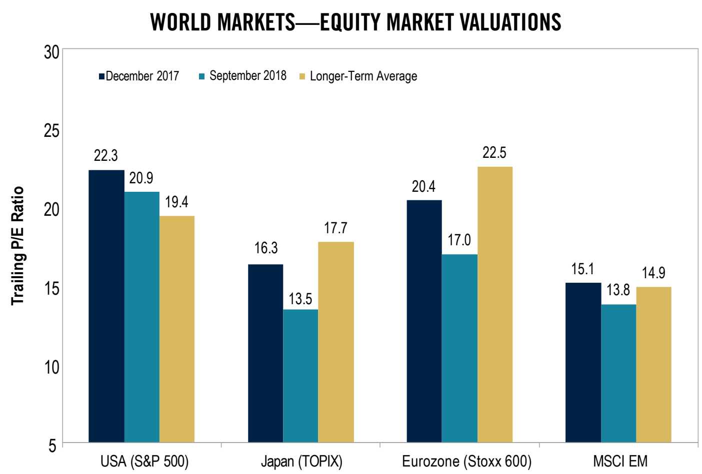
**Past performance is not a guarantee or reliable indicator of future results.**

### 7/ US Earnings Growth Expectations Falling Back to Earth




As of 8/31/2018.
Source: QMA, FactSet.

### 8/ Value Favors EAFE/Emerging Markets




As of 9/10/2018.
Source: QMA, FactSet. Long-term average over last 20 years except TOPIX (3/31/2004-present).

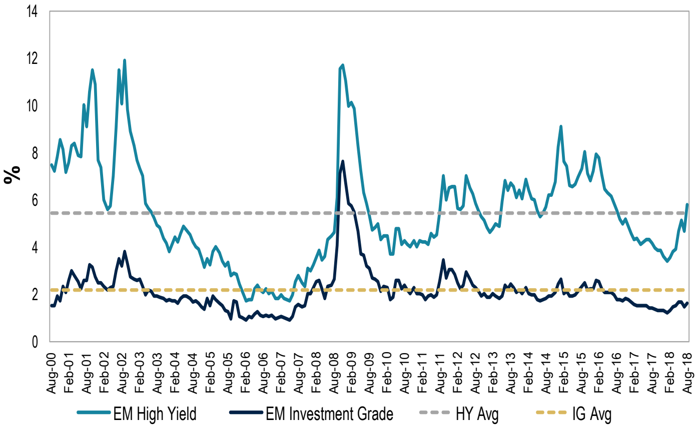
**Past performance is not a guarantee or reliable indicator of future results.**

In September, we dialed back risk a bit more in our portfolios and now maintain a very slim overweight in global equities relative to our policy benchmarks. Economic uncertainty may increase with continued Fed tightening, EM turmoil, escalating trade tensions, and the US mid-term elections looming. Further, the earnings yield gap (the difference between the earning yield on the S&P 500 and the yield on Treasury bonds) has fallen to 2%, the lowest level since 2011. Our quantitative work suggests that US equities perform in line with Treasuries at this level of spread. In light of this, and given that bond yields have moved back up above 3%, we have taken some profits off the table in US stocks, bought some Treasuries on the margin and increased our allocation to cash.

As inflation returns and central banks phase out hyperstimulative monetary policy or signal their intention to do so, we expect long rates to move up more, and that's another reason we carry a healthy allocation to cash and are sticking to the shorter end of the curve in our allocations to Treasuries and US investment grade bonds. Within the US government bond space, we are overweight TIPS as potent protection from rising inflation. We are underweight commodities as there is a high chance the US dollar has further upside and China's growth slows further. EM hard currency debt has cheapened, but is still not cheap. As shown in Figure 9, all of the spread widening has occurred within non-investment grade countries. So we are sticking with our underweight position for now.

### 9/ EM Sovereign Bond Spreads Widen but Are Still Not Cheap

EM HIGH YIELD VS. EM INVESTMENT GRADE SPREADS




As of 8/31/2018.
Source: QMA, Barclays.

**Past performance is not a guarantee or reliable indicator of future results.**

We maintain our positive outlook on US small cap stocks (see our June 2018 Market Pulse, "Small Caps' Turn"). Tax reform is a boon for this more domestically oriented asset class as its effective tax rate has come down by some 10%, according to J.P. Morgan.[1] Moreover, smaller companies are likely merger & acquisition targets as multinationals look for the best use of repatriated cash. From a fundamental standpoint, small caps are attractively priced, trading roughly in line with their larger counterparts while expecting to deliver twice the earnings growth (45% vs. 22% for the Russell 2000® vs. Russell 1000®). One concern is that small caps carry large amounts of leverage on their balance sheets. Eventually, rising rates and widening credit spreads may spur fears of defaults in this space. For now, though, spreads are well behaved and we are comfortable with this allocation. Umbrellas at the ready, of course.

[1] J.P. Morgan Global Asset Allocation Monthly Research Report, 9/18/2018.
There is no guarantee this expectation will be achieved.

### 10/ QMA's Asset Class Views

| Asset Class | – | | Neutral | | + |
|---|---|---|---|---|---|
| **Stocks** | | | | ■ | |
| **Fixed Income** | ■ | | | | |
| **Real Estate** | | ■ | | | |
| **Commodities** | | ■ | | | |
| **Cash** | | | | | ■ |
| **Stocks** | | | | | |
| US | | | | ■ | |
| EAFE | | | ■ | | |
| Emerging Markets | | ■ | | | |
| **Fixed Income** | | | | | |
| US Core | | | ■ | | |
| TIPS | | | | ■ | |
| High Yield | | | | ■ | |
| Non-US Dev. Sov. Bonds | | ■ | | | |
| EMD | | ■ | | | |

■ October 2018

As of 9/30/2018.
Source: QMA. There is no guarantee this will be achieved. For illustrative purposes only. Positioning subject to change.

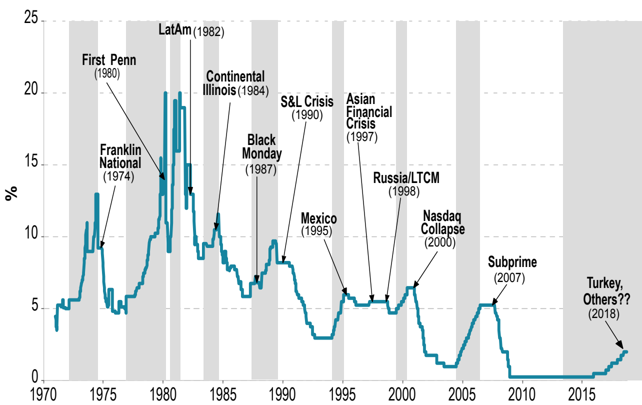
## EM: Déjà Vu All Over Again?

Tech stocks were soaring, the US economy was growing at a robust rate and a global expansion getting long in the tooth was beginning to wobble in the face of Fed rate hikes that had helped spark a major currency rout in Asia. These were the circumstances leading up to the Asian Financial Crisis of 1997, but if they sound eerily similar to the events surrounding the current crisis embroiling a widening swath of the emerging markets, it should not be too surprising. There is a saying that when the Fed taps on the brakes, someone flies through the windshield. In the summer of 1997, it was the heavily indebted Asian Tiger economies of Thailand, Malaysia and the Philippines. In the summer and fall of 2018, it has been Turkey, Argentina, Brazil and other EMs with high current account deficits and vulnerable currencies. Now, as then, the rising borrowing costs and foreign exchange (FX) pressures associated with a Fed tightening cycle are exposing the weakest links. The question, as always, remains whether the damage can be contained before it spreads more widely.

*(Continued on the next page)*

### 11/ When the Fed Taps on the Brakes, Someone Flies Through the Windshield

**FED RATE HIKE CYCLES AND CRISES**




As of 9/26/2018.
Source: QMA, FactSet.

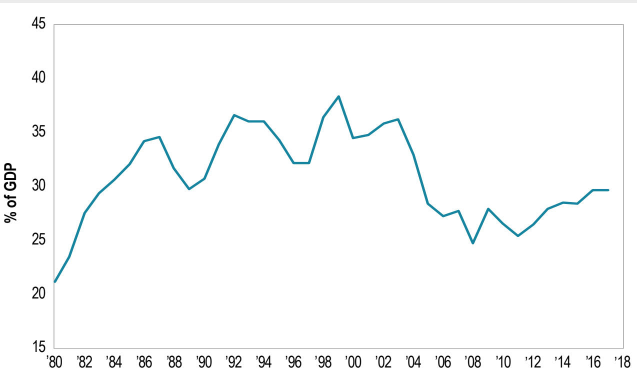
Given the still generally upbeat tenor of our outlook on the previous pages, it is obvious our answer to that question is still yes. We believe that the underlying strengths are such that the global economy can ride out the current stress emanating from EMs. But, as with so many of the factors we are watching, this is not a slam dunk. We break down the odds roughly as follows:

**Scenario 1: Asian Contagion Redux (30%)**

- Since the Global Financial Crisis, EM countries seduced by cheap financing have ramped up their levels of external debt to about 30% of GDP. While this is below the levels of the late '90s, the concern is that a large share of it is private sector debt denominated in hard currency, such as EUR and USD. And while most EM countries look much stronger compared to 20 years ago due to steady buildup of their FX reserves, anecdotal evidence suggests that most of the debt is poorly hedged, raising the risk of ballooning debt payments.

### 12/ On the Surface, Debt Load Not as Bad as in '97

**EMERGING ECONOMIES — EXTERNAL DEBT**




As of 4/2018.
Source: QMA, Bloomberg, IMF World Economic Outlook.

- Tighter financial conditions around the developed world have already triggered substantial EM currency depreciation, making servicing of hard currency debt even more challenging.
- Trade tensions worsen the pressures as they curtail countries' ability to export freely and replenish hard currency reserves.
- Rising oil prices put additional pressure on commodity-poor markets such as China and India, spurring more demand for FX reserves and the potential for a cycle of inflation and monetary tightening even in less indebted EM countries.
- EM troubles may spill over into the developed world, with EM corporate debt defaults hitting European banks.

**Scenario 2: Continued Stress but No Pandemic (70%)**

- Most EM currencies are free-floating and are no longer pegged to the US dollar. This exchange rate flexibility gives governments more latitude in managing their FX reserves, allowing for more gradual monetary adjustment that has less abrupt effect on their economies.
- China is a much bigger part of the EM complex than it was in '97, accounting for some 40% of EM GDP. China's debt is mostly internal, and foreign currency reserves are extensive, giving government substantial leeway for "doing whatever it takes" to maintain financial stability and economic growth.
- Most of the outstanding debt is corporate debt, limiting the risk of sovereign defaults. Corporate defaults transmit to EM banks, which are more likely to be rescued by governments.
- For all the distress seen so far, the EM economies are largely still growing, corporate fundamentals are sound, earnings expectations remain in the low double digits, and local currency returns on EM equity and debt are substantially higher than in hard currency terms, suggesting that so far the crisis has mostly been a currency one.

So, on balance, we see more reason to believe that EM stresses will not unravel into a full-blown debt crisis, although we continue to monitor the situation closely.

That said, it is worth noting another parallel to '97. When the Asian crisis flared, causing markets around the world to tumble, the Fed halted its tightening campaign, and a year later it cut rates in response to the Russian sovereign debt default and meltdown of hedge fund Long-Term Capital Management. In the short term, the move had the desired effect. Stocks recovered from a sharp sell-off and US economic growth stayed firm. But it also wound up turbocharging the next (and final) leg of the dot.com bubble, which led to the tech wreck of the early 2000s.

While it is hard to imagine the Fed would return to cutting rates any time soon, if the current EM crisis were to somehow trigger more widespread financial damage, the Fed's pace of tightening could very easily slow. Three or four hikes next year could turn into two. Or one. This, in turn, could prompt still-buoyant liquidity to flood markets segments with the strongest underlying fundamentals.

So, again, it's not our expected scenario. However, it's not beyond the realm of possibility that this bull market could end with the FAANG stocks going parabolic for a time before a major crash circa early 2022.

To cite another common saying, history doesn't repeat itself but it often rhymes.

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*As of 6/30/2018.

## NOTES TO DISCLOSURE

Sources: QMA; Capital Economics; Institute for Supply Management; US Federal Reserve Bank of Atlanta; Bloomberg; OECD; Thomson Reuters Datastream; Baker, Bloom & Davis; FactSet; MSCI; Barclays; J.P. Morgan; IMF World Economic Outlook.

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