Invesco

Investment Outlook Series 2019

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Investment Outlook Series 2019

Each New Year brings the promise of a fresh start – but for investors, it's important to understand the global dynamics that have brought us to this point. How do yesterday's elections, monetary policy decisions and geopolitical developments affect tomorrow's opportunities? Working with our investment teams from across the globe, we've developed this 2019 outlook to provide insights that can help you position your portfolio for the future.

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Global economy expected to grow with low inflation in 2019

John Greenwood
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Key takeaways

- 2018 has been a year of turmoil, but, 2019 promises to be much calmer, in my view.
- I believe the Federal Reserve should be successful in positioning the US economy for several more years of expansion.
- Monetary policy invariably dominates fiscal policy in the determination of inflation.

2018 has been a year of turmoil with weakness in the bond markets and two significant sell-offs in equity markets. In between there were crises in Venezuela, Argentina and Turkey; ongoing Brexit negotiations; a strong rise in the price of oil; and disruptions created by US President Donald's Trump's repeated trade measures – all set against a backdrop normalising US interest rates. However, 2019 promises to be much calmer, in my view.

Though individually damaging, it is my view that these geopolitical events will prove to be no more than waves on the surface of the tide which is the record-breaking expansion of the US business cycle.

Consenus Economics	2018 Expected		Invesco Forecast	
	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	2.9%	2.5%	2.8%	2.5%
Eurozone	2.0%	1.7%	2.1%	1.8%
UK	1.3%	2.5%	1.3%	2.4%
Japan	1.1%	0.9%	1.1%	1.0%
Australia	3.2%	2.0%	3.3%	2.0%
Canada	2.1%	2.4%	2.1%	2.4%
China	6.6%	2.1%	6.7%	1.6%
India	7.4%	4.7%	7.4%	4.5%

Consenus Economics	2019 Forecast		Invesco Forecast	
	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	2.6%	2.3%	2.6%	2.0%
Eurozone	1.8%	1.7%	2.1%	1.8%
UK	1.5%	2.7%	1.8%	2.1%
Japan	1.2%	1.1%	1.1%	0.8%
Australia	2.8%	2.2%	2.8%	2.1%
Canada	2.0%	2.1%	2.3%	1.7%
China	6.3%	2.3%	6.6%	1.1%
India	7.5%	4.9%	6.3%	4.3%

Source: Consensus Economics, October 2018, and Invesco as of Oct. 15, 2018

2018 has been a year of turmoil with weakness in the bond markets and two significant sell-offs in equity markets.

United States

US monetary policy is becoming less accommodative, but the Federal Reserve (Fed) is not "tightening," only "normalising" policy. The current "normalisation" phase is analogous to the mid-course corrections in interest rates that occurred in 1994-95 and 2004-05. The important point about those episodes was that the business cycle continued to expand for several years after the completion of normalisation, and the equity and real estate markets also peaked considerably after these rate hikes were completed.

I believe there is a strong probability that the Fed will be successful in positioning the US economy for several more years of expansion after 2019 or 2020, when the federal funds rate is expected to reach the "neutral" level – i.e., the rate that is neither expansionary nor contractionary, but consistent with steady-state expansion. This would mean that by July 2019, the current expansion would exceed the longest recorded expansion in US financial history – the 10-year expansion of March 1991-March 2001.

There are two broad strands of thinking in the financial markets that run contrary to my view and imply that the US economy is on the cusp of overheating and a resurgence of inflation:

- The first theory points to tightness in the labour market - as indicated by the low rate of unemployment. These analysts rely on the "Phillips curve" to argue that when the unemployment rate has fallen in the past, wages have generally risen, and higher inflation has followed. The problem with this theory is that while it has worked sometimes in the past, it has not worked during the last three business cycles. The theory only worked when money growth was rapid, giving rise to overheating and inflation.

In recent years money growth has been low and stable,with the result that the economy is not overheating. Indeed, if we look at Germany, Japan or Israel, the unemployment rate is also at record lows, and yet these economies are not seeing wage or price inflation in any significant degree.

- The second theory claims that a big increase in the budget deficit due to an expansionary fiscal policy will also lead to inflation. But while Trump's tax cuts and the temporary 100% expensing of investment in a single year have boosted consumption and investment spending in the short run, monetary policy tends to dominate over fiscal expansion. This means there can be no assurance that there will be overheating and inflation.

I believe that, despite the low level of unemployment and Trump's fiscal stimulus, the course of the US economy will remain broadly consistent with the Fed's mandate to achieve full employment with 2% inflation. This, in turn, should limit the upside risk for interest rates and inflation. By the same token, it should limit the downside risk for the stock market and the bond market, in my view.

Turning to trade: The tariffs that have been put in place in 2018 are potentially damaging to trade volumes and will raise the cost of imports for US businesses and consumers. But the important thing to remember is that if domestic spending on consumption and investment is maintained, the damage from these trade measures should be minor. There are two reasons why:

- Trade enters the gross domestic product (GDP) growth calculation mainly from the change in the trade balance and the pass-through to domestic prices. The trade measures have not yet shown up in volume terms as Chinese and other exporters rushed to fulfill orders ahead of the increased tariffs, and the contribution of a change in import prices is small compared with the volume and price contributions of consumption and investment.

- The experience of the notorious Smoot-Hawley tariffs of 1930 has been exaggerated. In the past many historians and commentators wrongly blamed the tariffs for the Great Depression. However, the Smoot-Hawley taxes were imposed at a time when domestic demand was collapsing due to mistakes of monetary policy. The lesson: Provided central banks today ensure that money and credit continue to grow, there is no reason to fear a 1930s-style outcome.

If domestic spending on consumption and investment is maintained, the damage from tariffs should be minor.

Eurozone

Given that fiscal policies in the eurozone are expected to remain restrictive, that leaves monetary policy as the only possible source of macro-economic policy change. In this area, the key feature has been the European Central Bank's (ECB) tapering of its asset purchases (which are due to end in December) and the associated forward guidance on interest rates next year. ECB President Mario Draghi has said that interest rates are unlikely to increase before summer 2019.

However, it is worthwhile to remember that while quantitative easing (QE) describes monetary policy as it affects the central bank's balance sheet, and while market participants obsess about interest rates, what matters much more is the growth of money in the hands of the non-bank public. In principle, the key consideration for ending asset purchases or QE should be whether commercial banks are creating sufficient loans that bank deposits (on the other side of their balance sheets) or money growth can continue independently of ECB purchases. Here there is a problem because many eurozone banks are still nursing portfolios of non-performing loans while trying to build up capital, and consequently loan growth has been well below money growth. Terminating the ECB's asset purchase policy while European banks remain in a fragile condition means that the region will be vulnerable to another slowdown in nominal spending and poses the risk of inflation falling back towards deflation.

United Kingdom
Public debate has been dominated by the details of the negotiations for the UK's withdrawal from the EU. Although on the surface consumer spending seems quite normal, there has been a slowdown of investment pending the emergence of a clear agreement on the post-Brexit trading environment. House prices in the London area have been static since the start of 2018, and one of Jaguar Land Rover's factories in the West Midlands has announced that 2,000 staff will move to a three-day week, suggesting that Brexit could lead to a considerable drop in corporate investment.

Meanwhile economic growth as measured by real GDP has slowed from an average of 2.1% in 2015-16 to an average of 1.5% in the six quarters since the start of 2017, with most of the slowdown in business investment. Until business leaders obtain a clear framework for the environment in which they will operate after March 2019, their capital expenditure and hiring plans will remain at least partially on hold.

The same hesitancy has applied in the implementation of monetary policy. Having given clear signs earlier in the year that interest rates would be rising, the Bank of England's Governor, Mark Carney, and his Monetary Policy Committee voted not to raise Base rate in February and May, but finally raised it by 0.25% to 0.75% in August. However, money and credit growth have been slowing in the background over the past two years.

Japan
The Japanese economy continues to experience sub-par growth and sub-target inflation. Despite five years of aggressive QQE (quantitative and qualitative easing) by the Bank of Japan, little progress has been made in restoring growth and particularly inflation to normality. The economy continues to grow at a modest pace of 1.0-1.5%, due largely to the aging of the population which has meant that the workforce has been declining.

Also, QQE has made very little impact on the growth of banks' balance sheets and hence on money or credit growth, with the result that inflation has remained well below the Bank of Japan's 2.0% target. I expect little change in 2019.

China and smaller east Asian economies
China is confronting the challenge of deleveraging while attempting to maintain growth by intermittent easing of monetary policy (e.g. cutting reserve requirement ratios, relaxing macro-prudential controls on mortgage lending, and easing some money market interest rates). These moves to ease policy are best seen as a modest counter to the key policy priority of reducing leverage.

Meantime real GDP has slowed and is likely to slow further in 2019. Although some basic industries have recovered from their slump in 2014-16, housing and nominal fixed asset investment have slowed. In my view, none of this activity is likely to pick up significantly in 2019 unless the State Council's policy of deleveraging is revised. On the external side, the impact of Trump's tariffs has so far had only a minor impact as exporters have rushed to complete shipments ahead of higher tariffs being imposed from January. In 2019, I therefore expect exports to slow, with only single-digit growth of exports in US dollar terms.

Elsewhere in East Asia, domestic spending has been subdued while export growth has slowed. Looking forward, some smaller, low-cost economies such as Thailand and Vietnam may benefit from some re-allocation of Chinese manufacturing, but the overall outlook will be subject to heightened trade tensions and the "downside risks to global growth" predicted by the International Monetary Fund at its October conference in Bali.

Global markets

Three themes to watch in 2019

Kristina Hooper
Chief Global Market Strategist, New York

Key takeaways

- We believe economic growth divergence is likely to continue to some extent.
- Geopolitical disruption is leading to structural fragmentation.
- The debt problem is widespread and is becoming more burden some as rates rise.

As we look out to 2019, we believe there are three key themes that will persist into the new year.

Theme #1:
Divergence

While we expect economic growth to remain solid, there has been greater divergence in the past year in terms of growth. We believe such growth divergence is likely to continue, yet it will probably be constrained by the strength of US consumption and investment (as well as the strength of Chinese stimulus), which is likely to help boost growth in the rest of the world to at least some degree. We also expect some divergence in inflation in the coming year, with some economies experiencing upward pressure on wages as well as rising input costs.

Theme #2:
Disruption Monetary policy disruption

The US Federal Reserve (Fed) is very likely to continue on its path of regular gradual rate hikes. It would probably take a major downturn in economic data or a very severe US stock market correction to divert the Fed from that rate hike path at this juncture. In addition, the Fed is also conducting balance sheet normalization – a powerful tool in and of itself – at the same time as it is raising rates. The pre-set course calls for larger amounts of assets to be rolled off the Fed's balance sheet each quarter. which means a significant possibility of market disruption (we have already seen US monetary policy disrupt emerging markets in 2018). In addition, the European Central Bank (ECB) is due to begin winding down its own quantitative easing program from the end of 2018, which could contribute to further disruption in Eurozone bond markets, which are already experiencing renewed divergence. Plus there is the risk that, in October 2019, a more hawkish president could replace Mario Draghi as ECB President, which may in turn cause greater volatility for Eurozone stocks and bonds. In addition, more emerging markets economies are tightening – many doing so to keep up with the Fed – creating an overall environment that is less accommodative.

Geopolitical disruption

We have seen significant geopolitical disruptions in recent months, which threaten structural fragmentation in the global economy and are already contributing to divergence in global growth as well as creating significant volatility in financial markets. For example, the rejection of Angela Merkel's leadership in various German regions), the difficulty the UK has had in orchestrating its Brexit from the European Union and Italy's tensions with the EU over its desire to increase government spending in violation of Eurozone rules are contributing to volatility and pressure in European markets including the euro, government bonds and equities – especially bank stocks, and are likely to drag down growth in the UK, Italy and to some extent Europe as a whole. The US withdrawal from the Iran nuclear accord had contributed to a surge in oil prices because the hard line requiring sanctions compliance by many countries pointed to much tighter global oil supply, but the granting of many sanctions waivers has now lowered this risk contributing to a sharp oil price correction – all of which has affected currencies and markets in many oil exporting and importing countries. Of course, the greatest geopolitical risk is the potential for full-blown trade wars, which seems more likely than not at this juncture. This can place downward pressure on economic growth in a variety of ways: It increases economic policy uncertainty, which typically reduces business investment; it increases input costs, which reduces profit margins or is passed onto consumers, who in turn typically reduce their spending in other areas; or it results in demand destruction. Finally, it can disrupt supply chains and make economies less efficient and productive. There is hope for renewed negotiations, perhaps starting with a truce at the late-November G20 Summit, when Chinese President Xi and US President Trump are expected to meet. But we would caution that any relief rally could be temporary, because US concerns span many areas beyond trade, including intellectual property protection and national security.

Theme #3:
Debt overhang

The world is becoming increasingly indebted. In a recent Global Financial Stability Report, the International Monetary Fund warned about the growing debt overhang occurring in different economies. This problem is widespread — impacting households, companies and countries — and it becomes more burdensome as rates rise. For example, Canadian homeowners are showing signs of coming under pressure given that many have adjustable-rate mortgages. And the headwinds that many emerging market economies have faced in 2018 can be at least partly attributed to higher borrowing costs. As monetary policy normalization continues and accelerates in coming years, this pressure is likely to increase. In addition to the short-term effects of debt pressure, there is a long-term effect as well: More money spent on servicing debt means less money that can be used for consumption or for more productive purposes such as investment. That combination can negatively impact both growth in the current business cycle, as well as the growth potential of economies with high debt in the longer term.

Implications for markets

As monetary policy normalizes, we believe capital markets will normalize as well. That means an erosion of the support that Fed policy has given to US stocks. In this environment, we expect continued volatility and a continued reduction in correlations both across national financial markets, as well as among stocks within countries as fundamentals become more important. In addition, normalization of US monetary policy suggests that US asset markets are prone to mean revert over the course of this unusual cycle, with downside risks stemming from trade tensions and geopolitics. Mean reversion could result in somewhat higher bond yields and discount rates for corporate cash flow. And, it would probably be reflected in higher corporate credit and equity risk premia, while the potential for even partial fragmentation caused by geopolitical disruption would likely result in higher volatility and perhaps even reduced corporate earnings power if US firms have less access to global markets, including China – which has until now been expected to continue as a major driver of global growth and a major source of revenue and earnings growth for both US and other multinational firms.

Even with these downside risks and volatility, we would expect US bonds to perform relatively worse and US stocks to post modest gains because of their greater exposure to the US economy and structurally greater insulation from frictions in trade and geopolitics. In the eurozone and Japan, we expect continued support of risk assets because of more accommodative monetary policy, which in our view should result in modest positive stock returns for those regions despite relatively low economic growth. In emerging markets (EM), we expect the Fed-driven re-pricing to continue to spill over into global markets through a stronger dollar, higher US bond yields and tighter global financial conditions, pointing to more pressure on EM currencies, putting downward pressure on growth and upward pressure on inflation — a challenging scenario for EM equities, bonds and currencies. However, there is a significant possibility that by mid-year 2019, the Fed may moderate its normalization as economic growth slows, which should result in some moderation in the investment implications mentioned above, in our view.

We expect unusual behavior to continue across commodities with the trend toward a strong dollar, divergence between the US and the rest of the globe, and the risk of global growth downgrades pulling the overall commodity complex down. Base metals are among the commodities more exposed to these downside risks, driven by the deleveraging-led slowdown in China and the general downward pressures on global capex due to trade frictions. Against that, however, geopolitical risks and trade tensions hold out the prospect of continued divergences across commodities, notably in oil, where tensions in the Middle East may cause renewed upward prices pressures.

Soft commodities remain exposed to developments in US-China negotiations, with China's tariffs on US agricultural exports representing a potential bargaining chip in any negotiations that might lead to a reprieve or succumb to a new round of tensions or tariff increases.

In this environment, we believe exposure to risk assets is important for meeting long-term goals – especially given that we see a continued upward bias for stocks, although it is growing weaker. Mitigating against downside risk will be critical, and that includes being well-diversified within equities and fixed income, in our view. This is also important given the divergence in growth in different economies. And, perhaps most important during this period of uncertainty, we believe that exposure to alternative investments can help with diversification and risk mitigation. That may include strategies such as market neutral portfolios and other lower-correlating asset classes, especially ones with income-producing potential.

Asia ex Japan equities

Will optimism return to Asian equities in 2019?

Mike Shiao
CIO, Asia ex Japan
Hong Kong

Key takeaways

- We believe Asian markets may regain favor from international investors in 2019.
- Regional governments are expected to roll out pro-growth policies to support domestic economies.
- Asian companies are looking for opportunities to expand abroad, which represents an important change in mindset.

Contrary to 2017, when Asia ex Japan equities enjoyed a strong rally with extremely low volatility, 2018 has been a bumpy year. Global events, including rising trade tension and a stronger US dollar and yields, are preoccupying investors, masking solid economic growth from many countries in the region.

Will the tide turn in 2019? We believe there are good reasons that Asian markets will regain favor from international investors given:

- Solid economic growth, supported by strong fundamentals and supportive policies.
- Strong Asian companies, backed by dynamic growth drivers and expansion efforts.
- Compelling valuations, offering an attractive entry point for quality companies.

Healthy economic growth is obscured by near-term headwinds

Economic growth in Asia ex Japan is expected to remain strong despite mild moderation, (6.1% in 2018 and 5.9% in 2019). [1]

In China, we expect economic growth to achieve the government's target of around 6.5% in 2018 and to be between 6.0% and 6.5% in the medium term given the government's rebalancing efforts toward a consumption- and service-led economy. We expect continued innovation in the consumer and information technology sectors to address growing and more sophisticated consumer demand amid rising income and accumulated wealth.

In India, economic growth has been on a positive upward trend, and we expect it to gather further strength in 2019. We believe private consumption, particularly in the rural area, will remain the dominating growth driver, supported by strong expansion in per capital income, which is projected to increase at a compound annual growth rate of 10.2% between 2016 and 2025.[2] Elsewhere in Asia, economic growth is expected to remain steady, predominately driven by robust private consumption.

We believe Asian economies are well-positioned to withstand contagion risk from other emerging markets (in the case of continued strength in US dollar and yields) given their stronger trade balance, higher reserve adequacy and improving external debt profile. Asian countries are not like Argentina and Turkey, which are running current account deficits at around 6% of gross domestic product (GDP), and their overall external debt to foreign exchange reserve level is also much lower. [3]

Supportive policies to ensure stable outlook

We believe regional governments will roll out pro-growth policies to support domestic economies and remain committed to reforms to address structural bottlenecks.

In China, we believe policy responses are data dependent, indicating that targeted easing measures should continue in the near term. That said, we believe structural reforms, including deleveraging and supply-side reform, will remain a top priority given their paramount importance to long-term economic health.

In India, we expect reforms in areas including financial inclusion, housing for all and digitalization to continue, driving further productivity gains. In other parts of Asia, we believe the policy focus will be on sustaining domestic consumption and employment. In the Philippines and Thailand, public infrastructure projects will be another key development area that local governments push for.

1 Source: Bloomberg L.P. 2018 and 2019 GDP growth rates refer to Bloomberg consensus estimate as of Oct. 10, 2018.
2 Source: Deloitte and FICCI, estimate as of Oct, 2018.
3 Source: CEIC, Morgan Stanley Research.

Strength of Asian companies to extend thanks to dynamic growth drivers and expanding efforts

We believe Asian companies will extend strength thanks to the emergence of new and dynamic drivers in the technology and consumer-related sectors on top of existing ones in the traditional sectors that have been benefiting from reforms. We believe it was evidenced by the evolving composition of top Asian companies by market capitalization. Chinese internet giants Tencent and Alibaba have taken over the top two spots that were once occupied by PetroChina and Industrial and Commercial Bank of China. [4]

We believe it also shows that the investment universe of Asian equities is moving closer to the underlying structural drivers of the economy. With consumption and services growth across Asia contributing higher to overall GDP, we believe the underlying investment universe will get broader and deeper and have better quality too.

Besides riding on new growth areas, we also note that Asian companies are looking for opportunities to expand abroad.

We believe it represents an important change in mindset and expansion strategy, and illustrates the rising emergence of Asian corporates that can extend their success outside of their home market to be globally competitive.

Compelling valuation against solid earnings growth

Compared with developed markets, Asia ex Japan equities are trading at a much attractive valuation now. Its 12-month forward price-to-earnings ratio (P/E) stood at 11.1x as of mid-October, which is also one standard deviation below the historical average.[5]
We believe the market might have already priced in most negative events.

We believe earnings growth of Asian equities will remain healthy in both 2018 and 2019. In China, we expect earnings to be led by sustainable growth sectors including the consumer, internet and health care sectors; while in India, we believe earnings growth will continue to trend up in 2019. In addition to consumer-related sectors and retail-focused private financial institutions, we are also positive toward earnings growth of IT servicing companies. We believe they will benefit from a depreciating rupee and strengthening US economy.

Risks to watch in 2019

Despite a reduction in domestic risks given solid macro fundamentals and prompt policy responses, we believe external risks that were weighing on sentiment in 2018 will likely continue in 2019:

- **Trade tension.** We expect trade conflict to linger for a while, but given its complex nature and connection with US domestic politics, we expect things to turn quickly on either side (not excluding a substantial positive outcome).

  We believe the development on the Korean Peninsula provides a good reference to trade tension. Few expected back in 2017 that North Korea would hold a summit with both South Korea and the US in the following year.

- **Dollar strength and rising yields.** Stronger dollar and rising yields are historically negatively linked with Asian equities, and we believe it is worth continued monitoring, especially for countries running current account deficits.

- **Election.** We believe upcoming elections in India, Thailand and Indonesia in 2019 require close watch given their implications for domestic policies and equity markets. Despite the uncertainty, we believe investors should remember that elections do not always have an unfavorable impact on equity markets. We have seen positive market reactions following elections as well, especially in India.

4 Source: Factset, Invesco.
5 Source: Goldman Sachs Investment Research.

Conclusion

We believe the robust fundamentals of Asia ex Japan equities will likely draw renewed interest from investors in 2019. We believe the current valuation has already priced in most negative events. We believe Asian companies are on solid ground to extend strength given their investment into new growth areas and overseas markets.

What is in store for Chinese equities in 2019?

Mike Shiao
CIO, Asia ex Japan
Hong Kong

Key takeaways

- We believe Chinese equities represent some of the best structural opportunities across global markets.
- Following the correction in 2018, we believe the risk-reward picture has turned exceptionally favorable.
- We believe corporate fundamentals will remain strong given solid support from the domestic market.

There has been a disconnect between sentiment and fundamentals when it comes to Chinese equities in 2018. Market sentiment has been weak (driven by the changing relationship with the US and moderating growth), while economic fundmentals remained decent. China was on track to deliver its growth target despite moderation, widely known as a result of economic transitioning towards high quality growth.

Looking into 2019, our view on Chinese equities remains the same: We believe they represent some of the best structural opportunities across global markets, and the risk-reward is attractive now given:

- Economic growth that's expected to remain stable on the back of strong consumption.
- A solid and competitive domestic market to strengthen corporate fundamentals.
- Appealing valuation trading at close to a 10-year low.

Economic growth to remain stable in 2019

The Chinese economy continued its steady expansion in 2018 with gross domestic product (GDP) growth well on track to achieve the government's target of around 6.5%. We expect the economy to remain stable in 2019. China aspires to become a moderately prosperous society by 2020, with GDP doubling from its 2010 level. We believe China will set an appropriate growth target that will allow it to stick to its plan.

We expect consumption and services to keep gaining importance in driving economic growth thanks to rising income and growing household wealth. In the first three quarters of 2018, 78% of GDP growth was driven by consumption compared with 64% during the same period in 2017. [1]

We believe there remain structural needs for fixed asset investment, particularly infrastructure investment in China. We believe investors should bear in mind that even though China has made tremendous improvement, it still lags behind its developed peers on infrastructure as a developing country.

We expect the trade sector to face macro headwinds due to moderating global growth and rising tariffs, but we expect the impact to be limited as its contribution to GDP growth has been low in recent years.

Consumption to drive long-term economic growth

We have long been optimistic about consumption in China. First of all, we believe the Chinese government is deeply committed to promoting domestic consumption as a key growth driver as it not only leads to more balanced and sustainable growth in the long run, but also addresses the growing demand of Chinese people for better lives.

Secondly, Chinese private consumption as a share of GDP was only 39% as of 2016, much lower than global average of 58.4%. We believe it has great potential to keep rising going forward. [2]

Lastly, we believe a dynamic ecosystem in the consumer and technology sectors has been formed in China by structural trends, such as rising Internet penetration, an improving transportation network, and changing perceptions of Chinese consumers (e.g., young consumers spend more on leisure and sports and are more willing to use credit). We believe those trends will continue to drive strong growth of related companies, making consumption a highly investable theme within Chinese equities.

1 Source: JP Morgan research.
2 Source: Citi Research.

Solid domestic market to support corporate fundamentals
There have been concerns among investors that Chinese companies might not be able to extend their strength amid trade tensions. However, we believe corporate fundamentals will remain strong given solid support from the domestic market.

China is now the second-largest economy in the world. With a population around 1.4 billion, it represents a sizable market that encompasses many exciting opportunities.

We believe Chinese consumers are looking for upgraded and more sophisticated products as they are getting richer, which will lead to Chinese companies moving up the value chain to address the changing demand.

In addition, we believe the competitive landscape now is very different from the past when few state-owned enterprises dominated the market. There are more private companies now, in particular in the consumer-related sectors. We believe Chinese companies will keep pursuing innovation in order to stand out from the competition, and they will eventually become more mature in managing corporate affairs.

Continued reform efforts to tackle structural bottlenecks
2018 marks the 40th anniversary of China's economic reform and opening-up. We believe what China has achieved during the past 40 years is now widely acknowledged, but what is underappreciated is that it has never been a smooth journey to remain committed to reforms amid challenging times.

We believe the Chinese government's reform efforts will continue. In particular, we believe deleveraging and supply-side reform continue to be important. We believe China has made positive progress in stabilizing the growth of debt and expect deleveraging to remain important in helping support the sustainability of economic growth in the long run.

We believe supply-side reform will continue as well, and strengthened environmental policies will play a crucial role in supporting further reduction in overcapacity in the energy and materials sectors. Meanwhile, we believe the government will make a balancing act between launching reforms and maintaining economic growth, and we expect to see some easing measures continue in 2019.

Appealing risk-reward given valuation at close to 10-year low
Following the correction in 2018, we believe risk-reward has turned exceptionally favorable for Chinese equities. They traded at 9.9x 12-month forward price-to-earnings (P/E) as of mid-October, close to 10-year low. [3]

Given the appealing valuation, we believe investor confidence will eventually be revived once earnings growth is confirmed to remain on a solid ground. MSCI China companies achieved earnings growth of 17% in the first half of 2018, and market consensus expects it to remain steady in the second half of 2018 and 2019. [4] We believe the consumer, internet and health care sectors will lead earnings growth, as they can continue to benefit from structural economic growth drivers in consumption and services.

Trade tension warrants closer monitoring
Trade tension was a top issue that weighed on sentiment in 2018, and we believe it deserves continued attention from investors.

We believe China and the US remain in a negotiating process, and given the complex nature of the issue and its connection with US domestic politics, we expect things to turn quickly on either side (not excluding a substantially positive scenario).

We believe China remains competitive in the industrial sector. It plays a key role in the global supply chain that is difficult to be replaced thanks to its competitive advantages in land, labor and productivity, but it is undeniable that there is still ample room for the country to improve on the technology front.

3 Source: Goldman Sachs Global Investment Research. As of Oct. 15, 2018.
4 Source: Citi Research.

Conclusion

We believe the Chinese economy will maintain stable growth in 2019 on the back of strong consumption, providing a supportive backdrop for Chinese companies to deliver healthy earnings growth. We believe continued innovation will lead to rising competitiveness of Chinese companies, which makes them continue to be our top choice among Asian equities.

Fixed Interest 2019 Outlook

Stuart Edwards,
Paul Read,
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Fixed Interest,
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Key takeaways

- 2018 saw a re-pricing of some parts of the bond market, which has created some value.
- Fundamentals within the banking sector generally remain good heading into 2019.
- Challenges remain that could see further volatility and potential investment opportunities during 2019.

Stuart Edwards

As we look ahead to 2019, the US economy is, in my view, in pretty good shape. However, with the fiscal stimulus that has been such a driver of recent growth coming to an end and trade tensions an ongoing concern, economic growth has likely peaked and could now fade. Meanwhile, despite the structural arguments one could make for inflation to increase, we are, so far, yet to see any meaningful pick-up in the rate of inflation.

Against this backdrop, the US Federal Reserve is three years into its current hiking cycle. As US yields have adjusted to a higher Fed Funds rate, so too has the balance of risk and return for US government bonds. That is not to say that yields might not rise further than current levels – clearly, they could. Rather, the compensation for taking US duration risk has increased making the US a potentially competitive source of income. In turn, this has led investors to demand a higher premium to invest in more challenged areas of the fixed income market. At times over the past 12-months this re-pricing has created opportunities that we have sought to exploit.

As the challenges of tightening monetary policy and global trade play out over the coming year, I would expect further tactical and strategic investment opportunities to present themselves. The flexibility to be able to exploit such opportunities will, I believe, be important to delivering returns in what could be another difficult year for bond markets.

Paul Read

I think 2019 will initially be a continuation of what we have seen in 2018. The Federal Reserve look set to continue their policy of gradually tightening US monetary policy. Meanwhile, uncertainty over trade, the Italian government's budget deficit, Brexit and emerging markets remain potential catalysts of further volatility.

While I remain cautious, I am slightly more constructive on the asset class than I have been in previous years.

That said, I think we begin 2019 with bond markets better placed than they were at the start of 2018. The volatility of the past 12-months has seen some value come back into parts of the market and as a result there are now some relatively attractive yields that can be found. This not only helps when we're trying to get income for the funds, but it also means that there is now more of an income cushion during periods of price volatility.

One area where I believe the re-pricing has created some value is the AT1 market and I have, where appropriate, been seeking to add exposure. Elsewhere, the rise in US yields is a positive for US corporate bond markets. Currently, I think the best opportunities within this market can be found in bonds maturing in 7-10 years, but if US yields move significantly higher, then this could start to open-up opportunities further out the curve.

Summing up, I don't think we are yet at a point where we can say the market has become cheap, but I do think we can probably say that the market has become more rational. I think there is a sense that the balance has started to tip away from borrowers and toward us as investors. So, while I remain cautious, I am slightly more constructive on the asset class than I have been in previous years.

Julien Eberhardt – Financials

Our largest sector allocation in corporate bonds remains financials. Before thinking about the prospects for the sector in 2019, I think it is helpful to reflect on what has happened to financials over the course of 2018. At the start of the year, the financial sector was very popular with investors owing to the sectors attractive level of yield versus other parts of the market. After a strong start, a series of exogenous factors began to impact on the sector in late January/early February leading to significant re-pricing as the market sought to reposition.

Alongside concerns over US interest rates, trade, the Italian budget and Turkey were money laundering concerns within Nordic banks, uncertainty over the treatment of stamp duty in Spanish property transactions and whether or not banks should pay the charge, Deutsche Bank's profit warning and a change in its CEO, Aviva's threat to cancel preference shares it had previously described in marketing material as irredeemable, HSBC's reclassification of £2bn worth of discount perpetual floating rate securities (DISCO bonds) to tier 2 capital – a move which saw the bonds lose around 20% of their value and the ECB's commitment to not hike interest rates until at least summer 2019.

Despite all of this, fundamentals within the banking sector generally remain, in my view, good. Italian banks have continued to reduce the amount of non-performing loans (NPL) on their balance sheets. Meanwhile, asset quality within the banking sector has continued to improve. What the past twelve-months has done is to bring some value back into the market. AT1 bonds and Bank equity are now significantly cheaper and, in my view, offer value. From a top-down perspective, the sector should receive further support if the ECB maintains its current path and starts to tighten policy in 2019. But, Brexit and Italy remain two significant risks for the sector and are areas we are closely monitoring. As has been the case this year any further periods of volatility would, all else being equal provide an opportunity to increase exposure.

As the challenges of tighter monetary policy and tensions over trade play out over the coming year, I would expect further tactical and strategic investment opportunities to present themselves.

Emerging Markets equities

Emerging markets should be able to withstand a challenging environment in 2019

Ian Hargreaves
Co-Head of Asia & Emerging Markets Equities, Henley

William Lam
Co-Head of Asia & Emerging Markets Equities, Henley

Key takeaways

- Headlines have dominated negative sentiment – it is important to take a more fundamental long-term approach to European equities.
- Domestic demand continues to drive the European economy.
- Valuations are attractive in many sectors.

2018 has been a challenging year for both Asian and global emerging equity markets. The year began with upbeat earnings expectations and valuations above long-term historical averages. However, since the start of the year, valuations have contracted due to a number of factors. Firstly, we have seen a marked increase in the risk premium for emerging markets given increased uncertainty surrounding trade tensions and geopolitics. Secondly, this has led to greater concern about China where growth has already been slowing due to the government's deleveraging campaign. Lastly, the tightening of US monetary policy has led to a deteriorating US dollar liquidity environment with negative implications for emerging market equities and currencies.

This backdrop is likely to continue into 2019, but emerging economies are better placed to withstand these pressures than before, in our view. Valuations are also beginning to reflect the risks being faced, and are currently nearer the bottom end of their historical range.

Trade

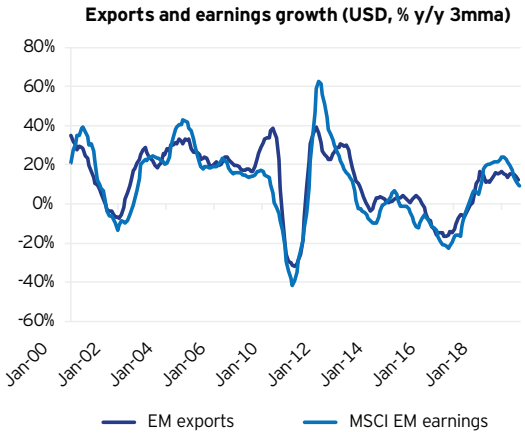
Escalating trade tensions between the US and its major trading partners have dominated the headlines in recent months and have accelerated the broader market's derating. Negotiations between the US and China have not yet yielded any results, with President Donald Trump happy to ratchet up the pressure by announcing further rounds of potential tariffs. The outcome is unpredictable, and there is a danger that tensions may escalate further. However, as the negative implications of tariff increases for the US economy become clearer, there is also a possibility that striking a deal becomes expedient. In the near term, we expect not only a direct impact on trade activity, but also an impact on corporate and consumer behaviour, with implications for investment and consumption. This would impact companies in different ways, and we are seeing more opportunities for investment where the market's reaction has been indiscriminate.

US monetary policy tightening

Although policy normalisation in the US has been well telegraphed, investors have been concerned about a potentially faster-than-anticipated rise in interest rates. As the risk free rate rises, so does the cost of capital, leading in theory to a valuation de-rating of long duration assets such as stocks. Also, a stronger US dollar has led to tighter global liquidity conditions and greater headwinds to global demand growth, which could impact emerging market earnings.

Earnings

Corporate earnings have so far been fairly resilient. However, leading economic indicators of global growth have declined, suggesting export growth is likely to slow from current double-digit levels. This is a key driver of earnings growth in emerging markets, as can be seen in the chart below.



Source: Emerging Advisers Group as at 21 November 2018

Secondly, China's economy has been slowing as a result of tighter policy settings. Initiatives to tackle excessive credit growth, reduce financial risk and improve environmental protection are all long-term positives in our view, as they address some of our biggest concerns, but in the near term we would expect a further weakening of economic growth in China.

Given the backdrop of slower global growth, it is likely that consensus earnings forecasts for 2019 are still too optimistic. Over the last six months earnings have been revised down 5% from the peak, and we would expect further downward revisions to the current 10% earnings growth expectations for 2019.[1]

Asia

In China, deleveraging efforts have led to an economic slowdown while trade issues have increased uncertainty in the outlook. The authorities are likely to be more tolerant of slower growth than they have been in the past, in our view, but they are keen to protect the downside risk to the economy. As expected, we have started to see some moderate easing measures such as reserve requirement cuts, increased export tax rebates, tax deductions on household income and support measures for SMEs in the private sector. At the same time, authorities will not want to see another significant leveraging up of the economy given that this is a major macroeconomic concern. The balance between avoiding a sharp slowdown in growth and avoiding excessive stimulus is becoming more delicate.

Elsewhere in the region, economies do not look particularly vulnerable. Current accounts are generally healthy and credit cycles are not extended. Where current account deficits do exist – Indonesia, Philippines and India – they seem manageable and growth forecasts have already been lowered. Those economies more sensitive to global demand, such as South Korea and Taiwan, are likely to be impacted by ongoing trade and Chinese growth concerns, but we believe their innovative companies have strong competitive advantages that should sustain them better than many fear.

Operational strength in Asia

Meanwhile, there have been some significant improvements at the corporate level in Asia over the last decade. As can be seen in the chart below, the region's capex/sales ratio has been steadily declining. In part, this reflects lower structural growth, but it also demonstrates that Asian companies are more cautious, focused and better managed than they were historically, and suggests that better returns on capital are sustainable. In a weaker growth environment, it is also positive that there are few industries with significant excess capacity risk.

Less capital-intensive companies have also been generating stronger free cash flow. The challenge has been how to better allocate that capital, with management facing growing pressure from minority shareholders to pay better dividends. While valuations and positive surprises in earnings are less likely to drive equity returns in the near term, there is an increasingly good dividend growth story in Asia.

Fig.1 Corporate capex discipline should support returns
- Asia ex Japan CapEx % Sales

Source: Worldscope, Factset, Citi Research as at 9 May 2018.

Latin America

Market volatility in Latin America has been exacerbated by politics and uncertainty over the North American Free Trade Agreement (NAFTA). Presidential elections in Mexico and Brazil have resulted in populist candidates from either side of the political spectrum gaining power. Markets have been buoyed by a reduction in political uncertainty and strengthened hopes that key areas of reform will now be addressed.

In Brazil, the pace of economic recovery has been sluggish. Plans to push ahead with pension and tax reforms would help reduce a large fiscal gap, and go some way to restoring investor confidence and promoting consumption growth and investment spending. Meanwhile, the prospects for Mexico are likely to be bolstered by the successful replacement of NAFTA with the US-Mexico-Canada Agreement (USMCA).

1 Sources: I/B/E/S, MSCI, JP Morgan as at 21 November 2018.

EMEA
Increased uncertainty over US-Russia relations may dampen economic growth, but the Russian economy is still expected to expand by 1.5% in 2019,[2] drawing benefit from recovering oil prices, strong consumer demand and prudent fiscal policy. However, aside from an easing in tensions with the US, the country needs to introduce further reforms for gross domestic product (GDP) to accelerate. Having said that, we still believe the status quo is a healthy environment in which domestically-focused companies can prosper. Unfortunately, our optimism is not being matched yet by market sentiment, which is currently being negatively affected by worries over the imposition of new sanctions.

Elsewhere in emerging Europe, countries such as Poland and Hungary are likely to enjoy healthy growth rates and low interest rates, in our view.

A bright medium-term outlook
Over the medium term, our outlook for emerging markets is cautiously optimistic. Economic and corporate fundamentals remain solid, and these economies remain the biggest driver of global growth. In particular, we are encouraged by the capital discipline being displayed by companies across emerging markets, with evidence of strong balance sheets and improving free cash flow generation. This is being reflected at the macro level too. Few countries are exhibiting signs of overheating – a far cry from the situation that prevailed in the run up to the global financial crisis in 2008. With valuations towards the low end of the historical range and at a significant discount to their developed market peers, the market appears too focused on short-term uncertainties and is ignoring the fundamental improvements that have taken place.

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

In emerging and developing markets there is potential for a decrease in market liquidity, which may mean that it is not easy to buy or sell securities. There may also be difficulties in dealing and settlement, and custody problems could arise.

2 Source: Bloomberg, L.P., as at 21 November 2018.

ETF strategies

Strategies for mitigating the new risks of the new year

Dan Draper
Managing Director,
Global Head of ETFs

Key takeaways

- We see new risks on the horizon for both equity and fixed income investors, but there are various exchange-traded fund strategies that we believe can help.
- We expect that a loss of profit momentum in 2019 could lead to increased volatility and correlations, and we believe that the Low Volatility and Quality factors may perform relatively well in such an environment.
- With the overall climate still tilting in the direction of higher rates in 2019, one way to potentially manage that risk is to build bond ladders using defined-maturity bond funds.

In the new year, we see new risks on the horizon for both equity and fixed income investors. Equity markets are anticipating a loss of momentum for corporate profit growth. And, for the first time in 12 years, fixed income investors are forced to wrestle with the challenge of navigating a multi-year upward trend in interest rates at both the short and long end of the bond universe. There are various exchange-traded fund strategies that we believe can help with both challenges.

Equities: Loss of profit momentum could support Low Volatility and Quality

Factors are measurable characteristics of a security that help explain its performance. Academic research has shown that different equity factors have the potential to outperform the broad market, but they have historically done so during different types of market conditions. So what trends do we believe could impact factor performance in 2019?

In 2019, corporate profit growth will face the headwind of difficult year-over-year comparisons to 2018, as we expect the impact of the Trump tax cut to dissipate, monetary tightening to continue, the inventory cycle to turn less constructive for output, and the lagged effect of dollar strength to eat into profitability. Additionally, the deterioration of housing affordability during 2018 is a harbinger of cyclical weakness, in our view, and rising labor costs and buoyant diesel prices due to fuel regulations have worked to squeeze profit margins. A wildcard for profitability will be Chinese-US trade tensions and tariffs.

We expect that a loss of profit momentum in 2019 could lead to increased volatility and correlations. In addition, we expect that the Federal Reserve's rate increases over the past few years could also exacerbate volatility (historically, changes to the federal funds rate have preceded equity volatility by about two years). Given this view, we believe that the Low Volatility and Quality factors may perform relatively well in such an environment. Additionally, as we move later into the cycle, we would expect the spread between growth and value to narrow, and we believe a factor combination of Value/Momentum may shine under those conditions.

In terms of emerging markets (EM), we believe that fundamentally weighted strategies have the potential to fare better than the overall market. 2018 saw a vicious EM sell-off, which priced in a bleak outlook for the asset class as a whole, but there are potential positives on the horizon: New political leadership in Brazil brightens the forecast for favorable economic reforms and privatization, China is working to stimulate its economy through fiscal measures such as tax cuts, any investors who fear the impact of sanctions have likely left the Russian equity market already, and Russia's fiscal house looks healthy (although geopolitical tensions remain).

Fixed income: Interest rate risk could spark interest in bond ladders

In some ways, the fixed income outlook for 2019 is more clouded than it was at the start of 2018, when well-established global growth trends were driving visibility in both equity and fixed income markets.

The rise of trade tensions between the US and China – and the ensuing tariffs – have softened global growth expectations, and thereby potentially eased, to a degree, the expected upward pressure on interest rates in both the US and Asia. On the other hand, solid US economic growth combined with improved wage growth and low unemployment in the US support the expectation that the Federal Reserve will maintain the gradual pace of short-term interest rate increases through 2019.

At the long end of the yield curve, we expect a continuation of 2018 – that long-term US interest rates may continue to move higher on the back of heavy issuance from the US Treasury, and that rates in Europe may gradually rise as the European Central Bank begins to slowly bring interest rate levels back above zero.

The main risk to this scenario, we believe, would be a meaningful further strengthening of the US dollar in 2019. While the dollar had begun to resume its longer-term downtrend in 2016 and 2017, the rise of trade tensions and the shift in US trade policy in the second quarter of 2018 triggered a sell-off in global equity markets that drove the dollar up significantly in the ensuing months. And since the global financial crisis, the fast-growing emerging market economies have become highly dependent on US dollar lending. A stronger dollar, therefore, would restrict growth in the emerging market economies by stressing the balance sheets of foreign borrowers as their debt burden and interest expense rise in local currency terms. Recent data has also clearly demonstrated that the availability of dollar-denominated credit growth weakens when the dollar is rising, presenting a double-whammy headwind to many emerging market economies that are dependent on US dollar-based credit growth.

Finally, a stronger dollar presents a headwind to both US corporate profits generated overseas and domestic inflation. With political risk in Europe as well as US-China trade tensions building into 2019, the risk of a countertrend rise in the dollar next year presents, in our view, the most visible risk to our forecast of higher short- and long-term interest rates in 2019.

With the overall climate still tilting in the direction of higher rates in 2019, one way to potentially manage that risk is to build bond ladders using defined-maturity bond funds, whether domestic or international. A bond ladder is a portfolio of bonds that mature at staggered intervals across a range of maturities. If rates continue to rise, proceeds from each maturing rung of bonds can be reinvested in longer-dated bonds at higher rates. Defined maturity ETFs can help investors build bond ladders quickly and easily, with a range of bonds that can help provide diversification to a portfolio.

Another way to help mitigate the impact of currency volatility on fixed income portfolios is to stick with US-dollar-denominated international bond portfolios.

European equities 2019 outlook

Jeff Taylor
Head of European Equities, Henley

Key takeaways

- Headlines have dominated negative sentiment – it is important to take a more fundamental long-term approach to European equities.
- Domestic demand continues to drive the European economy.
- Valuations are attractive in many sectors.

Equity investors, both in Europe and globally, have had plenty to deal with in 2018 – the first populist government in Italy, a political crisis in the UK, trade wars and generally weaker macroeconomic data. Consequently, European equities have been heavily sold off as investors reacted cautiously, ignoring by and large robust macroeconomic and earnings fundamentals.

Are things that bad?

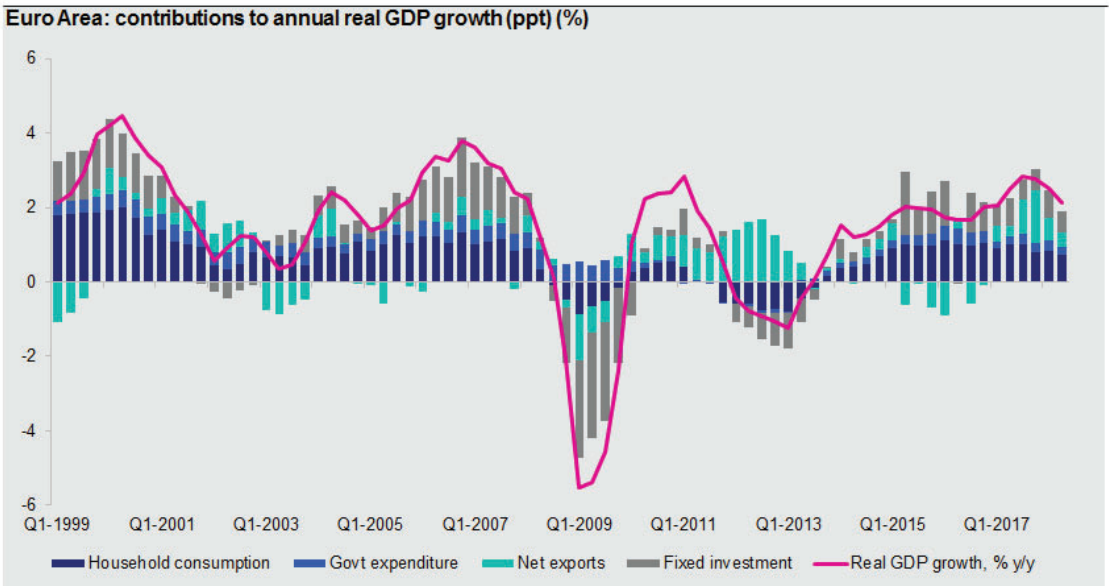
There's no getting away from how pessimistic investors have become. Tarnished by various crises in the last 10 years or so it's easy to be gloomy. What matters to us as fundamental, valuation based investors is to assess if the outlook is as negative as what's being priced in. Even if things are only 'less bad' there are opportunities to be had.

To us the outlook for domestic demand looks good as Europe recovers from the various crises of the last decade. Corporates are regaining their appetite to invest again whilst falling unemployment and rising wages are supporting consumption. So what about the macro weakness we've seen more recently? Q3 economic data has been distorted by the disruption caused in the auto sector from the introduction of new WLTP emissions regulations. This headwind should now fade if the more recent data is anything to go by.

Can trade tensions overshadow domestic demand? If there was an escalation of trade wars, this would almost certainly impact growth but we cannot ignore the strength of domestic demand. This should at least provide some mitigation in a very negative scenario and leave the economy better placed to bounce back afterwards. All in all Europe is still on track to deliver steady if unspectacular growth.

Another encouraging sign of Europe gradually returning to normal after various crises is inflation. Core CPI, the more relevant gauge, has been steadily ticking up for some time now. Wage growth, a key driver of inflation, is firmly on an upward trajectory not just in Germany but in the periphery too. With employment set to rise in 2019 the omens look good. Overall this should provide a solid economic platform – a combination of robust demand and improving pricing trends - for European corporates.

It's hard to ignore – despite the various political headwinds – how robust earnings are. Most indices – be they Pan European, Continental European or Eurozone – are on course to deliver mid to high single digit EPS growth in 2018. It's not all from Energy either. Banks and Insurers have played their part too.



Source: UBS, Haver as at 31 October 2018. Data as at 30 June 2018 (latest available.) Differences between the sum of the individual components and the total are changes in inventories.

If anything more of this growth is coming from those sectors directly exposed to economic trends. Based on our top down macro view and in the absence of any external shocks there seems little reason to believe this can't continue. All of this leads to a region in good shape, helpful for those European corporates more exposed to the economic cycle.

This view also questions the extent to which current monetary policy is required. Yes, support from the ECB is still necessary but would expect this to be gradually reduced over time given the current outlook for inflation and growth. Why is this important? For some time declining bond yields, in part due to ECB policy, have encouraged investors to favour long duration assets over other parts of the market. The valuation gap between these type of assets and other parts of the market is very extended to us. A change in interest rates would require investors to question this assumption.

Where are we finding the best opportunities?
When markets are as polarised as they currently are, you have to build portfolios which express a firm view based on fundamental analysis. Our approach has long been based on valuation: we look for mispriced stocks in all sectors of the equity market and we find that the disparities between stocks, sector and styles are particularly wide at present. Indeed, the most attractive valuations are currently to be found at the value end of the spectrum. 'Value' doesn't mean 'bad companies': we can find many high quality businesses to invest in in a wide range of sectors: financials, telecoms, energy, pharmaceuticals, food retail amongst others.

What could go wrong?
As with all things there are risks. Today most of these are political. Since the Global Financial Crisis we've approached such issues in the same way. We assess each situation and conclude what is the most likely outcome. For Italy the key question is if recent events are likely to lead to a European systemic crisis. For that to happen much would have to go wrong from here.

Looking at opinion polls there doesn't look to be much appetite for a referendum on the Euro – most surveys point to a firm majority in favour of the Euro. Yes, a complicated situation, but not as bad as some of the headlines occasionally suggest. What about the UK? Whatever the outcome – and difficult to know at this stage - is more of a domestic issue as opposed to having any material long term impact on the rest of Europe.

In conclusion we would point out the importance of focusing on fundamentals - which in general are robust - and not to get too hung up on some of the more scary headlines out there. If the outcome is not nearly as bad as current valuations suggest we believe the asset class can do well, even more so for the areas we are exposed to.

Fixed income

Gauging the ripple effects of softening economic growth

Rob Waldner
Chief Strategist and Head of Multi-Sector,
Invesco Fixed Income
Atlanta

Key takeaways

- In the US, we believe peak levels of growth are behind us and expect to see slowing in the second half of 2019.
- Outside the US, there are also signs of softening growth.
- Inflation is likely to increase somewhat, but we do not believe that wage inflation will be significantly passed through to consumer prices in 2019.

Global macro

In the US, we believe peak levels of growth are behind us, although we expect annual growth of around 2.75% to persist through the first half of 2019 before slowing. Fiscal stimulus is still having a positive effect on growth, but will likely wane in the second half of 2019. In addition, the positive financial tailwinds that have been driving the economy may turn more neutral as monetary policy continues to tighten. Therefore, while consumer spending will likely be additive to growth in the first half, as the boost from tax cuts winds down, the question is how much will the consumer want to spend thereafter? Consumption has grown at an unsustainably high level, in our view, over the last several quarters, driven by stronger consumer confidence and tax cuts. A meaningful slowdown in consumption could have negative implications for broader growth. These effects mean that risks to economic growth are higher in late 2019 than they have been in previous points in the cycle.

Inflation is likely to increase somewhat in 2019, supported by tariffs on goods prices. Aside from tariff-driven inflation, pressures are likely to be more subdued. However, labor prices are likely to continue their slow rise as employment markets tighten. We do not believe that wage inflation will be significantly passed through to consumer prices in 2019.

In the US, we believe peak levels of growth are behind us and expect to see slowing in the second half of 2019.

The combination of strong labor markets and strong growth make it very likely that the US Federal Reserve (Fed) will continue its slow hiking cycle through the first half of 2019. However, if the yield curve continues to flatten and financial conditions tighten, it might be more difficult for the Fed to hike twice in the second half of 2019.

The US Treasury market has undergone a significant correction, and valuations are now inexpensive relative to long-term fundamentals, in our view. However, large fiscal deficits will continue to cause the US Treasury to issue large amounts of debt. Increased supply combined with declining Fed purchases could create US Treasury volatility in the coming year.

US growth is attracting capital flows, and this is likely to continue until global growth paths begin to converge. In our view, this is likely to support the US dollar in the coming months. If there is a significant US slowdown next year, we believe it would likely be imported from China (not generated internally), if China is unable to ease itself out of the slowdown it is currently experiencing.

Outside the US, there are also signs of softening growth. In China, we have been penciling in lower-than-consensus 2018 economic growth since the start of the year. The current softness in economic momentum may be traced back to tightening regulations and deleveraging policies that took place in late 2017/early 2018, leading to a sharp slowdown in credit trends in mid-2018. Additional uncertainty has been generated by US trade policy. Chinese policy-makers have begun to ease again in response to these developments in growth. The success or failure of this easing program will likely have major implications for global financial markets.

Europe is proceeding at a slower pace than we expected earlier in the year, as the effects of stimulus delivered in 2015 and 2016 fade. In addition, several risk events on the horizon are likely to act as headwinds to both growth and markets: Italian politics and budget concerns, US-Europe trade tensions and Brexit uncertainty. On top of that, the European Central Bank is likely to begin its hiking cycle sometime in the fourth quarter of 2019. Due to these growth and political factors, we do not expect core European interest rates to move too far from current levels in the next six months.

Investment grade

The coordinated global growth conditions of 2017 appear to have softened in 2018 and may result in further economic dispersion across the developed world in 2019. Despite this headwind and the threat of tightening monetary conditions, corporate fundamentals continue to remain resilient. As a result, we expect corporate credit to outperform comparable sovereign debt due to the additional income available to corporate investors. Corporate spreads should also provide some buffer from the potential for higher interest rates.

A meaningful slowdown in consumption could have negative implications for broader growth.

The growth of debt markets, especially the BBB component of the US corporate space, is drawing considerable attention as a potential source of risk. While a combination of merger and acquisition (M&A) activity and credit migration has expanded the lower quality portion of the investment grade market, corporate leverage has tended to decline following such events. The M&A pipeline is the lightest we've seen in recent years, and investor surveys show a desire for US companies to de-lever.

We remain positive on corporate credit. However, the risk of unanticipated monetary tightening or a deceleration in global growth could result in deteriorating fundamentals. The number of "known" potential risks – from the impact of tariffs to geopolitical issues is on the rise, and any one of them could alter the trajectory of the current cycle. We also continue to monitor secular trends in technology, which have the potential for far-reaching impacts across industries such as retail and transportation. We believe sector allocation and security selection resulting from a sound credit process will be as critical in 2019 as it was in 2018.

High yield

Despite market fears of slowing economic growth, high yield has historically fared well in moderate growth environments. While there is some fear in the marketplace that corporate earnings have hit a near-term peak, fundamentals overall are robust enough for companies to generate free cash flow and reduce leverage. Reduced leverage generally means lower default risks, which can lead to tighter credit spreads. Negative returns in high yield are generally driven by recessions, as company earnings decline and defaults increase. We do not believe we are in that environment today, as the Fed and the European Central Bank have elongated the business cycle. Their actions have benefited credit markets and afforded many companies to reduce leverage.

As high yield investors, we are aware of duration risk and the volatility associated with interest rate movements. There are three reasons why rising rates by themselves may not be bad for most high yield bonds.

1. Normally, rates rise as the economy is expanding, which typically generates more profits for most companies and a greater ability of companies to service their debt.
2. High yield bonds may offer call protection. When rates rise, issuers often refinance their debt before rates go higher. If an issuer refinances its debt before maturity, it normally pays a penalty (call price) that varies between 102 and 105. This pre-payment penalty is added to the returns of the high yield bond.
3. The duration of high yield bonds is typically lower compared to investment grade bonds due to the comparatively short maturities and high coupons of high yield bonds.

While history demonstrates that recessions are a negative influence for high yield, we do not see an immediate cause for concern given the overall health of the US economy, the gradual pace of Fed tightening, and robust fundamentals among many high yield issuers.

Structured Agency mortgage-backed securities (MBS)
The primary driver of Agency MBS performance in 2019 will likely come down to the simple economics of supply vs. demand. The recent trend higher in interest rates should dampen mortgage supply to some degree, but we still expect a healthy US$225 billion of net supply to hit the market next year. That amount of supply is in line with historical norms, and one which the market can easily absorb. The problem is, the supply impact felt by the market may be nearly double that amount. The Fed has stopped reinvesting pay downs from its US$1.7 trillion mortgage portfolio, so prepayments that had previously been reinvested are now effectively increasing supply to the rest of the market. While nominal Agency MBS spreads have increased roughly 20 basis points in 2018 to accommodate this excess net supply, [1] we believe the market may need to cheapen by another five to 10 basis points, at current volatility levels, to clear the excess net supply and stabilize.

Residential mortgage-backed securities
Although recent housing data reflect some weakness in construction and sales activity along with affordability constraints, the limited supply of homes against the backdrop of a strong labor market underpins our positive outlook for home prices and borrower performance. Issuance volumes continue to fall short of legacy paydowns, resulting in heavy competition for floating rate and limited duration assets prevalent in the sector. Nevertheless, the flatness of the credit curve warrants a measure of caution with respect to below investment grade securities, with limited room for further spread tightening in these credits, in our view. We believe highly rated classes, on the other hand, offer compelling spread pickup versus other fixed income credit sectors. While we are cautious about non-investment grade spreads, our concerns about the ultimate credit quality of lower-rated classes remain limited.

As short-term interest rates continue to move higher, we see attractive opportunities in floating rate securities, including single-family rental securitizations and moderately seasoned Credit Risk Transfer bonds issued by Fannie Mae and Freddie Mac. Much of the growth in residential credit issuance will likely be linked to non-qualified mortgages, as the investor base broadens and the sector continues to mature.

Asset-backed securities (ABS)
As the US economy approaches late cycle, current strong fundamentals are expected to gradually move toward normalized levels in 2019. This remains a positive factor for the consumer and underlying ABS collateral performance. As the Fed continues to tighten and the yield curve flattens, shorter-term ABS should remain in high demand. As a result, we expect projected gross ABS supply to be easily absorbed by the market. While relative attractiveness of ABS versus corporate bonds has diminished somewhat, we are still finding attractive areas of value for reasonable yields and short maturity profiles. Additionally, ABS offer diversification from corporate bonds.

Commercial mortgage-backed securities
We expect commercial real estate rent growth and property price appreciation to continue, albeit at a slower pace as new supply dampens space absorption. In the retail property sector, we expect growth in e-commerce to remain a headwind. On the positive side, lending conditions remain very accommodative across property markets, despite slightly tighter credit standards and higher rates. Additionally, we expect modest new issuance volumes to be easily absorbed by investors. With a neutral outlook on spreads and a flattened credit curve, we prefer slightly seasoned credits that benefit from embedded property price appreciation and contracting spread duration. As we progress further into the real estate cycle, we believe commercial real estate debt that offers attractive carry and benefits from appreciation that has already occurred will become increasingly more attractive.

1 Bloomberg L.P., data from Dec. 31, 2017 to Oct. 16, 2018.

Global liquidity
Invesco Global Liquidity expects US money market yields to increase in 2019, as the Fed continues to push monetary policy rates higher. Even though the Fed has increased policy rates for three years in a row, current rates are considered to be in neutral territory and many market participants believe the Fed has more room to remove policy accommodation if needed. We expect at least two rate hikes in 2019. As a result, yields on money market securities and low duration investments may become even more attractive on a relative basis if the US Treasury yield curve maintains its five-year flattening trend. This may continue to drive asset flows into money market funds, ultrashort bond funds and exchange-traded funds (ETFs). We expect abundant supply of short-term US Treasury securities and demand for high quality assets to keep credit spreads at the lower end of recent ranges. Risks to credit spreads could come from an unexpected weakening of the US economy or late-cycle hints of a recession on the horizon.

Emerging markets (EM)
We believe EM growth has peaked and expect it to moderate into 2019. China, in particular, is slowing, although in a measured, managed way. Targeted easing will likely mitigate China's growth-related risks, but we cannot rule out periods of financial market disruption as authorities seek broad deleveraging. We expect the US dollar to weaken in 2019 as global growth re-couples, which should lend support to EM and commodities as it fosters capital inflows and improved terms-of-trade. That said, there are likely to be periods of US dollar strength and higher US yields, which could lead to bouts of market volatility. Escalation in global trade tensions may also continue to test markets. We expect volatility to rise in general in 2019 as major central banks gradually removal extraordinary monetary accommodation.

Risks to our view include a resurgence in US inflation, which would likely prompt policy tightening beyond what is priced-in, leading to a sharp deterioration in financial conditions via strengthening in the trade-weighted US dollar. Also, concerns related to Chinese growth may move to the fore, placing downward pressure on industrial commodities and broader risk sentiment, beyond concerns relating to trade disputes.

EM asset selection has become of paramount importance, particularly in the aftermath of a heavy election period in Brazil, Mexico and Turkey, and in advance of upcoming elections in Argentina and Indonesia in 2019. Sanctions risk is also elevated in Russia and, to a lesser extent, Turkey. EM currencies remain highly sensitive to US funding conditions, but scope for US dollar stability in 2019 will likely lend support, given the extent of the EM currency sell-off in the second and third quarters of 2018, and as US growth moderates. We tend to favor the currencies of commodity-producing countries, given valuations and the yield advantage. Although on the rise, we expect EM inflation to remain low, providing scope for the inflation risk premium in the longer end of selected EM yield curves to continue to compress. As with EM currencies, we favor commodity-producing local rate markets.

European fixed income
European economic growth moderated in 2018, from above-trend levels to a more sustainable pace, in our view. In 2019, we believe Europe's economic backdrop of robust growth, subdued inflation and accommodative monetary policy will likely support European fixed income. The forward guidance provided by the European Central Bank (ECB) is well documented, and although quantitative easing is drawing to a close, we do not expect interest rate hikes to occur until the fourth quarter of 2019. We believe the ECB's growth targets are overstated, but we are not concerned that this will have a material impact on the broader European fixed income markets.

Europe is earlier in the credit cycle than the US, with stronger corporate de-leveraging trends underway and more conservative discretionary cash flow behavior, which is generally positive for bondholders.

Our main concerns for the region revolve around political uncertainty.

- Italy's political situation remains the biggest unknown. However, while the situation continues to evolve, we assign a very low probability to Italy leaving the euro. As we move into 2019, we expect friction over Italy's budget deficit to continue to weigh on investor sentiment, likely creating bouts of market volatility but also presenting opportunities. We believe valuations are attractive in Italy, but we remain concerned about the political outlook and the country's long-term debt sustainability, especially in light of its low growth prospects and the removal of ECB monetary stimulus.

- Our base case for Brexit is that a deal will be agreed upon at the expense of a longer transition period. Accordingly, we believe current valuations present opportunities in certain parts of the UK corporate bond market, namely among issuers with a strong international presence that may mitigate the potential growth challenges of a hard Brexit.

Overall, we believe solid European growth, low inflation and accommodative monetary policy are supportive of riskier assets in the region. That said, as the ECB pursues its path of policy normalisation and as European – and global – political uncertainty remains elevated, we believe caution is warranted.

US municipals

Much of our 2019 outlook for the municipal asset class hinges on our expectations for new issuance. Total new issuance in 2018 looks likely to fall below previous years due largely to the elimination of advance refunding issuance under the Tax Cuts and Jobs Act (TCJA) of 2017. This change caused issuers to bring issuance forward into 2017, resulting in reduced 2018 supply. While the repeal of advance refunding issuance directly affected the tax-exempt market, it remains readily available (though rarely used) in the taxable municipal market. This may add to potential issuance in 2019. However, even with this possible boost, we do not expect municipal supply to exceed 2018 levels by much – a net positive for municipals, in our view.

On the demand side, we expect individual investors to play a larger role in the municipal market going forward. Their participation may increase during the early 2019 tax season, as tax cuts under the TCJA potentially end up smaller-than-expected. This may be especially true for investors in high-tax states. Municipal securities should also continue to offer diversification benefits, since they have historically exhibited low correlation to other asset classes, such as equities, corporate bonds and US Treasury securities.

With the US midterm elections behind us and the Democratic win in the House, we believe "tax reform 2.0" is less likely. Infrastructure spending, one of the only areas with bi-partisan support, may see a rise in 2019, but we believe it is unlikely. Rather, we believe Democrats will likely pursue infrastructure as part of their 2020 campaign platform, with more immediate resources put toward health care and immigration policy. Once decisions are made on infrastructure, we expect funding to be accessed via the municipal market. However, we expect the pace of issuance to be measured.

Indian fixed income
The Indian fixed income market cheapened in 2018 due to fears of a rate hike amid a rise in domestic inflation and a depreciating rupee. However, we expect a rebound in 2019 as headline inflation likely remains under 4% for most of the year and expectations of future rate hikes, which were previously priced into bond yields, potentially retreat in the coming months.

The rupee's decline has also been an important driver of upward pressure on bond yields in 2018. Trade war concerns, higher oil prices leading to a higher current account deficit and general risk aversion toward emerging markets all pressured the rupee lower in 2018.

We expect some recovery in the rupee as oil prices stabilize and if "risk-off" sentiment subsides in 2019. The contraction in the differential between Indian and US inflation may also help limit the rupee's long-term depreciating trend. Additionally, the liquidity-enhancing measures of the Reserve Bank of India, through open market operations (gilts purchases), have resulted in net positive demand for gilts. Overall, we expect 2019 to be additive to bond performance due to the positive combination of a retreat in bond yields and consolidation in the rupee.

Asian fixed income
We are constructive on Asian fixed income on the back of stabilizing Chinese growth and our outlook for increased foreign direct investment in the region. Geopolitical risks will likely remain on the forefront, however, as the US is poised to increase tariffs on Chinese exports in 2019 and impose additional tariffs. Indian and Indonesian general elections are slated for the first half of 2019, which are bound to generate headlines and potential volatility.

We are sanguine about China, as policy easing measures appear to support economic growth after a deceleration in the beginning of 2018, attributed to weakening domestic consumption and the impact of de-leveraging. Improved liquidity in the system is expected to boost economic growth and neutralize part of the negative impact of trade disputes. Looking to 2019, we favor bonds with short maturities and attractive yields issued by solid credit quality names. We are monitoring two variables closely: 1) the extent that increased liquidity flows into the private sector and 2) the USD-renminbi exchange rate. We are especially watching Chinese issuers who are more vulnerable to the exchange rate's performance.

Outside of China, we favor markets that are likely to benefit from increased US and Chinese direct investment. The Chinese government is expected to put significant capital to work in the region through the Belt and Road Initiative, which would be positive for recipient countries. The US and other countries are also likely to increase investment in the region as a counterweight to China's program through initiatives like the US-led Indo-Pacific Alliance with India and Mongolia and via the International Development Finance Corporation, which invests in developing country projects. We are watching two key risks: 1) environmental, social and governance (ESG) factors to avoid potential disruption caused by social unrest, corruption and/or environmental disasters, and 2) potential financial distress that could be caused in some Asian countries by a strong US dollar, especially those with substantial US dollar debt relative to their GDP.

Global equities

A decade after the global financial crisis, a mixed bag of growth

Nick Mustoe
Chief Investment Officer, Henley

Key takeaways

- The overvaluation of structural growth stocks, such as technology stocks, is unsustainable, in our view.
- For markets used to easy money, the transition to a more 'normal' period for central banks is likely to pose a challenge.
- The European market looks a lot more attractively valued than the US, especially those stocks more sensitive to the direction of the economy, such as banks.

The outlook for global growth has become more mixed. While the synchronised economic expansion that I discussed in this piece last year is less widespread today, it should still be sufficient for corporate earnings to grow. Amid continued regime change – quantitative easing has given way to quantitative tightening, and interest rates are rising – the US continues to press ahead, while there is less momentum elsewhere.

In the 10 years since the global financial crisis, what does this mean for global growth? We see the US continue to be propelled by fiscal stimulus and still-supportive domestic financial conditions. Europe and Japan are following at a still-healthy but clearly decelerated pace. In the meantime, China's economy is losing steam and it is unclear how successful attempts to reinvigorate activity through renewed credit and fiscal stimulus can be against the backdrop of leveraged balance sheets and trade tensions with the US. The uncertainties over global trade, combined with the tightening of dollar liquidity, are weighing on emerging market economies across regions, even if to different degrees.

We're clearly in a phase of transition now that we are entering a more 'normal' period for central banks globally. For markets used to easy money, it's unlikely to be an easy transition. Expect bouts of volatility along the way. Even the two-day rally at the close of October 2018 couldn't rescue global stock markets from a dismal reality: It was their worst month in more than six years (since May 2012). Discouraging earnings forecasts from some of the world's largest technology groups had triggered a wider sell-off, reigniting fears that the longest bull market in history had come to a halt.

Overall, it's a positive story for most equity markets, and third quarter corporate earnings on both sides of the Atlantic have offered some reassurance. However, financial markets have been beset by worries for some time over rising interest rates and a slowing global economy. At the top of the list are concerns that the US/China trade relationship is likely to continue to worsen into year's end; that US tariffs on Chinese goods are set to move higher in a few months; and that trade talks have broken down.

The transition could be all the more stark for the US equity market given that it was supported in 2018 by a one-time repatriation of earnings held abroad by US corporates, with much of the money used to buy back stock or increase dividends. As we go into 2019, however, it is unlikely that the US equity market will remain as well-supported on this measure as in the previous year.

Anticipating the end of the business cycle

The US equity market is clearly anticipating the peak of the business cycle and, consequently, it fears that a recession may come soon. That has influenced recent flows into the more favoured structural growth stocks, such as technology. We still see this sector as overvalued. In our view, the real investment opportunities lie outside of the US as we look to exploit the valuation disparities between the US and the rest of the world.

The US equity market has never been more expensive compared to other regions, skewed by technology stocks. The so-called FAANMG stocks (Facebook, Amazon, Apple, Netflix, Microsoft and Google's parent company Alphabet) have dominated market performance this year, seeming to promise relentless growth based on society's digital revolution. Tech company growth rates have been considered relatively resilient to escalating trade tensions as well. The market has continued to narrow with its focus on growth, while paying little regard to valuations. These six technology-related stocks have contributed around two-thirds of global equity returns so far this year. In my view that isn't sustainable.

The US equity market is clearly anticipating the peak of the business cycle and, consequently, it fears that a recession may come soon.

I remain focused on valuations and the potential for markets to generate sustainable returns over the long-term. As such, I am more constructive on the prospects for European, UK, and Asian markets over the next few years in regard to their ability to generate returns. Europe, for example, currently offers some of the best investment opportunities, in my view. On the whole, the European market looks a lot more attractively valued than the US, especially those stocks more sensitive to the direction of the economy, such as banks.

We are seeing strong companies trading at significant discounts to their intrinsic worth. With the era of easy money coming to an end and interest rates rising, the pendulum could swing in favour of cheaper sectors such as financial services stocks, which tend to benefit from rising interest rates. Given the concerns around Brexit, the UK stock market looks incredibly undervalued. A lot of UK-domiciled stocks are trading at very low valuations relative to their global peers, suggesting that much of the 'bad news' has already been priced in.

Amid a slower period of economic growth than in 2017, we can assume that markets will continue to worry about the end of the cycle going into next year.

Meanwhile, there are signs that a rotation could be underway from growth to value stocks given the recent downturn. Major revenue shortfalls reported by both Amazon and Alphabet triggered their largest share price falls in years, creating a gap for other sectors to perform, such as energy and health care.

While the US macro picture has not worsened since early October, there has been a steady drip of disappointing news from elsewhere. At the time of writing, Brexit negotiations are still ongoing, and there remains the risk that the UK Parliament could vote down any eventually agreed-upon deal, in which case there might not be enough time (or willingness on the part of the EU) to negotiate a new one before next April. The Italian government's face-off with European authorities has not been resolved, and China and the eurozone have slowed more than expected this year.

Amid a slower period of economic growth than in 2017, we can assume that markets will continue to worry about the end of the cycle going into next year. However, we believe that over the medium term economic growth will be sufficient for most equity markets to deliver decent returns.

Global Multi-Asset

The prolonged global expansion could continue if fiscal and monetary policies remain supportive

Clive Emery
Product Director,
Multi-Asset,
Henley

Key takeaways

- We take a two- to three-year view of the world when building our central economic thesis.
- We believe it is vital to consider both cyclical and structural forces in building this thesis.
- We must believe that all of our ideas can make a positive return in our central economic scenario to ensure we have ideas that can excel in various economic conditions. However, it is important to note that our ideas do not derive from it.

2018 has been a relatively volatile year, however this has been limited to bouts of volatility while, rather surprisingly, levels of market volatility overall have remained fairly subdued.

Throughout 2018, we have seen a blow-up of exchange traded funds (ETFs) that were designed to benefit from falls in the VIX index, a large election surprise in Italy, further US sanctions on Russia, another International Monetary Fund bailout for Argentina and more general pressure on emerging markets (EMs) from the strengthening of the US dollar and increasing US interest rates. There has also been heightening rhetoric around trade and we have seen the beginning of tariffs, which could potentially lead to trade wars. The populist theme has also played out in the raft of elections across the globe, which while there have not been many huge surprises, the rise of populist share of the vote has caused some market worries.

Despite this, the US economy has continued to grow more quickly as the year has gone on and generated enough inflation to keep the US Federal Reserve (Fed) comfortable hiking rates. Growth in the rest of the world has moderated from the peak seen at the end of 2017 into 2018 but most regions are still probably growing above potential. During 2018, headline inflation globally has picked up, mainly from the increase in the oil price, while core inflation remains subdued.

What is our central economic thesis looking forward into 2019?

Our central economic thesis is our two- to three-year outlook for the global economy, we update this every month and will re-visit the thesis in times of extreme market stress. However, as we approach 2019, we summarise our views below:

Trade-off between cyclical factors and structural vulnerabilities

- US momentum and Chinese policy are key to extending the current economic cycle
- A stronger USD and trade disruption unveiling weaknesses in emerging economies
- Becoming increasingly difficult for current policy to offset balance sheet strains

Inflation is likely to remain contained

- Positive real wage growth could test policy makers' resolve
- But a lack of pricing power and debt overhang will keep inflation low versus history
- Core bond yields ultimately capped by structurally lower nominal economic growth

'Price discovery' by Central Banks supports only a gradual change in policy

- US policy versus rest of the world - spread will eventually narrow
- Global liquidity is grinding lower, capping the upside for credit growth
- Political populism will continue without a self-sustaining recovery and policy change

Risk assets require a selective approach, particularly in EM

- Regional drivers matter from here, e.g. the euro, US corporate cash, EM local debt
- Credit is still vulnerable; equity returns determined by earnings growth and income
- Diversified alpha an additional source of value

Volatility to reset at higher average levels

- Fixed income and currency volatility sensitive to Central Bank action
- Market volatility impacted by investor behaviour (e.g. search for yield)
- Sporadic bouts of volatility emanating from developed markets (DM) or EM may be linked

How has our thesis evolved throughout 2018?
At the turn of the year, we amended our central economic thesis to acknowledge that cyclical factors were driving the global economy and the structural vulnerabilities had been moved into the background. While we made this acknowledgment, our forward-looking view could be described as the economy "bumbling along" as opposed to our previous "cautious optimism". As the year has progressed, some of these structural vulnerabilities have come back to the fore, while the cyclical drivers have weakened somewhat. Our current thesis touches on the trade-off between both going forward, which will likely lead to more bumps along the road.

We acknowledge that this prolonged cycle can continue while monetary and fiscal policy is supportive, but going forward it is likely to rely primarily on US momentum continuing and China being the marginal player. However, the recovery could be derailed by continued monetary tightening in the US. This is starting to put pressure on EMs and, while the Fed often comments that they are only focused on the domestic macro, if they over tighten they could end up tripping themselves up.

There is also a fine balance to be struck in China, where it feels that further easing measures are needed to keep the Chinese growth machine churning. While growth would likely then continue, this will further add to the imbalances being built up. China and the rest of Asia are also especially vulnerable to the trade war rhetoric coming from the US administration, which is an obvious risk over our time horizon, especially if it escalates.

We have always believed in being selective across the EM complex, but this is something that is even more important now given the aforementioned external influences at play. The current debate is around whether the countries that have seen stresses are idiosyncratic stories or whether these external pressures are revealing more systemic frailties. Thus far, it has generally been high yielders with current account deficits that have been the hardest hit (namely Turkey, Argentina, India, Indonesia and South Africa). This year, we have reduced our overall EM exposure. However, as always, it has not been an asset allocation decision rather via a few individual idea views. We still believe there are constructive emerging market stories available but we are likely to approach them with more caution than previously.

Where does our thesis remain the same?
The team continues to feel that inflation globally remains contained and while wage growth and trade disruption remain as risks, it is more likely that profit margins will be squeezed as opposed to large price increases being passed on to consumers. Equity profit margins currently are fairly healthy and, while labour markets appear tight, current wage growth is rather subdued. This means that companies can afford to absorb the increased costs on their books.

With inflation contained and structural levels of gross domestic product lower than previously, we maintain our belief that global bond yields will remain capped. Also, while there has been divergence between policy rates in the United States and the rest of the world, we are not convinced that this will continue over our time horizon.

Whether this divergence is reversed due to the Fed changing tack and loosening policy over the next two to three years or the rest of the world's central banks hiking rates, it seems clear that global liquidity is grinding lower as most central banks have started some form of quantitative tightening. This will make it difficult for most economies to continue the above-potential growth path they have enjoyed over the past 18 months, which will add further complexity to policy makers' decision making.

We remain of the belief that market volatility should reset at higher levels. This is a long-held view of ours on, which we have previously got wrong and, while the last year has seen levels of volatility stabilise from a seemingly everlasting decline, as mentioned previously we are yet to see them really pick up. We now have outright volatility views in currency and equity, as well as taking advantage of low levels of volatility to buy options or create option structures within some of our currency, equity and interest rate ideas.

More recently, we have been asked about our time horizon and whether we will look at changing our return or volatility targets. However, we will always look forward over the next two to three years – it would be imprudent to overrule this view in order to try and boost short-term returns, especially given current market uncertainty.

We firmly believe that it is important to not succumb to this type of pressure as while it is very difficult to accurately predict a change in regime, it is important to consider that one could come at any time. We continue to scenario test around a number of market environments so that we can build a robust portfolio, which has the potential to work in our central scenario, participate more fully in upside scenarios and remain robust in case of potential market shocks.

Global Solutions

Heading into an uncertain 2019, diversification must be top-of-mind

Duy Nguyen
CIO and Head of
Global Advanced Solutions

Key takeaways

- The road ahead is expected to be challenging due to a variety of factors: rising global interest rates; increased volatility; diverging global monetary policies; and heightened geopolitical tensions around trade and tariffs.
- Our forecasts for returns are tepid across the major asset classes.
- There remain pockets of opportunities within asset classes.

Heading into 2019, the market's resiliency is likely to be tested by evolving geopolitical tensions and questions regarding the ability of a late stage economy's ability to grow. Volatility is expected to remain elevated as the markets seek additional support for increasing asset prices beyond continued earnings growth and the perceived positive impact of tax cuts.

However, the road ahead will likely be more challenging to navigate. While the economy, as measured by Gross Domestic Product, continues to expand, and US equities are experiencing their second largest expansion in recent history, there are numerous challenges for investors to navigate going forward, including:

- Rising global interest rates
- Increased volatility
- Higher correlations among traditional asset classes
- Diverging global monetary policies
- Heightened geopolitical tensions around trade and tariffs

In short, the landscape for investors is increasingly complex, and our estimates for returns across asset classes remain tepid. In our 2018 Outlook last year, we talked about blind spots, particularly with respect to the benefits of diversification across and within asset classes. This year, we are focusing on how to avoid those blind spots in the uncharted markets ahead. Fortunately, the investment tool kit available to investors has expanded over recent years, particularly for those seeking diversification; ongoing areas of development in the financial marketplace include factor-based strategies, private market investments and multi-asset outcome-oriented solutions.

> The landscape for investors is increasingly complex, and our estimates for returns across asset classes remain tepid.

Asset Class Forecasts

Our capital market assumptions which reflect ten-year and five-year forecasts for the behavior of asset classes, suggest that return estimates across asset classes remain low. Differences in growth and inflation estimates for major economies are now driving diverging expectations of performance among asset classes globally:

- **Equities**
  Elevated valuations continue to factor into lower long-term return estimates. Reflecting the late-stage business cycle, estimates over nearer-term are even less bullish, with lower US equities return estimates relative to international developed markets. Our near-term view slightly favors emerging market equity, given recent underperformance, although emerging market equities tend to face headwinds in many of the above-mentioned market challenges. Within US equities, CMAs reflect a better outlook for the small- and mid-cap equities, given recent underperformance.

- **Fixed Income**
  With higher expected inflation, rising short-term interest rates and narrowing credit spreads, a diversified bond exposure appears more attractive relative to pure credit exposure or long duration. Our outlook for credit is cautious given the historically narrow credit spreads and vulnerabilities of lower-rated credit in late-stages of the business cycle. Our outlook also favors investment grade over high-yield and floating rate bonds.

- **Commodities**
  Our view is for higher returns from commodities buoyed by higher cash rates and rising inflation expectations.

In summary, we see attractive relative value opportunities in emerging markets vs. developed, Europe vs the US, shorter duration investment grade versus longer duration government, and investment grade vs. high-yield.

The Key: Stay Focused on Diversification
In an environment where returns are compressed, volatility is expected to be higher and correlations across asset classes are higher. It is very important to be well-diversified.

We also remain optimistic that innovation within alternatives may enhance the potential for diversification beyond increasingly-correlated traditional assets. Particularly with considerable macroeconomic and geopolitical headwinds poised to challenge the market's resilience and increase its overall volatility, we believe investors should consider turning to alternative investments to seek enhanced risk-adjusted returns and diversification benefits.

- **Non-directional diversifying alternatives** struggled early in the fourth quarter due to leverage, momentum factors and interest rate exposure. While recent performance has disappointed investors, our view remains that the potential diversification benefits and downside mitigation provided by non-directional alternatives during a volatile prolonged downturn secure their place in a diversified portfolio.

- **Multi-factor alternative strategies** are an increasingly mainstream tool for portfolio diversification, as different factors are expected to outperform or underperform in different market environments. In highly volatile markets where risky assets are underperforming, for example, we would expect low volatility and quality to outperform and momentum to underperform. When equities rise rapidly, we might instead expect value and momentum to outperform and low volatility to underperform. We view systematic harvesting of risk premiums from long/short factor investments as an effective potential diversification approach that may also capture consistent risk premiums across market cycles.

- **Private market investments** are attractive on an uncorrelated, risk-adjusted return basis, in our view; while investors should be mindful of their corresponding potential complexities, risks, and liquidity considerations, we expect that private market investments will play an important role in incrementally capturing growth and income while providing diversification beyond traditional asset classes.

The good news is that while we are cautious of the market environment heading into 2019, we are also confident that these challenges will continue to drive new areas of innovation and opportunity that have the potential to help investors meet their financial goals.

Investors should consider turning to alternative investments to seek enhanced risk-adjusted returns and diversification benefits.

A brighter outlook for international earnings

Clas Olsson
CIO, International and Global Growth

Key takeaways

- Despite the soft patch in certain macro indicators, there is a broad expectation that most major regions may deliver solid earnings growth in 2019.
- We believe equity valuations remain vulnerable to higher bond yields and discount rates, particularly among the technology names.
- Trade and geopolitical tensions are the primary threats to the growth outlook.

As 2018 draws to a close, strong US corporate cash flow has been well-supported by tax cuts and increasing fiscal spending. This may continue to underpin reasonably healthy capital expenditures and support economic growth and earnings delivery in the US – but the big question is, will growth pick up around the world?

The big picture: Earnings and valuations

Earnings

In late 2018, key regions outside the US have seen a softening in gross domestic product expectations, industrial production and purchasing manager indices. There are many moving parts here: higher oil prices, higher US interest rates on dollar-denominated debt, weaker currencies, trade tensions undermining confidence, etc. And yet, despite the soft patch in some of these macro indicators, there is a broad expectation that all major regions around the world (with exception of Japan) may deliver high-single-digit to low-double-digit earnings growth in 2019.[1] The region that stands out the most is the eurozone, with consensus expectations for earnings growth to pick up from about 6% this year to 10% next year.[2] On the other hand, expectations are for US earnings growth to decelerate from more than 20% this year to about 10% next year.[2]

Valuations

Despite the stock market sell off in early October, we believe equity valuations remain vulnerable to higher bond yields and discount rates, particularly among the technology names. US stocks continue to trade at a premium to non-US stocks, a fact which many have come to dismiss given relative earnings progression of the past several years. And yet, non-US markets indices have been trading at discounts on earnings and book multiples not seen in 15 years, with emerging markets (EM) discounts pushing to new extremes in late 2018 and the International Monetary Fund downgrading growth in many EM markets. Yet, specific names are starting to look appealing to long-term investors like ourselves.

Regional highlights

Europe

- Eurozone growth has moderated, but is still near a decade high, and it feels like expectations are low.
- In Europe, there is a reasonable possibility we could see accelerating earnings growth in 2019 despite lower GDP growth because of pent-up demand growth.
- We started to see a mild breakdown in expensive momentum names in the third quarter, which makes us more constructive on our quality growth holdings.

China

- Although the outlook can change quickly, at this point there has been no break-through in regard to US-China trade tensions.
- Expectations are that the Chinese authorities will continue to provide stimulus to keep the economy and the consumer on track.
- Now that stock prices and valuations have come down, we are evaluating some of the high-quality names that are now more attractive from a valuation perspective.

Emerging markets

- Emerging markets clearly have been weak in 2018, with some disparity among regions. For example, Brazil and Mexico have started to strengthen, while China is weakening and Turkey looks to be bottoming.
- The weak appetite for risk has led to weaker markets as well as currency pressure dampening US dollar returns. However, this is as much a function of the US being in a hiking cycle versus country weakness.
- Our outlook for EM equities is mixed. Unfortunately, the trade dispute between the world's two largest economies adds a degree of unpredictability.

1 Source: FactSet Estimates, as of Oct. 15, 2018.
2 Sources: FactSet Estimates, MSCI, as of Oct. 15, 2018. Non-US stocks represented by the MSCI EAFE Index, US stocks by the S&P 500 Index, and emerging markets stocks by the MSCI Emerging Markets Index.

Three points to consider

- In our view, the high growth/high momentum reset is healthy. The October correction has so far inflicted the greatest damage to the share prices of high growth/high momentum areas of the market – particularly technology, where our team has chosen not to chase performance and high valuations. To the extent that some of these businesses continue to de-rate, we would expect to avoid much of the pain and potentially find some good long-term opportunities.
- The recent rise in the 10-year Treasury yield is positive in the near term, in our view, so long as inflation remains subdued. The rise in bond yields (discount rates to equity cash flows) has been driven primarily by higher real growth expectations from still low levels in the US. At the same time, weaker currencies relative to the dollar coupled with still negative real yields abroad remain stimulative to global growth.
- Trade and geopolitical tensions are the primary threats to the growth outlook. Ongoing trade/tariff disputes between US and China are problematic, as is the uncertainty that remains around Brexit, Turkish prospects and the disruption imparted by the new Italian government's fiscal spending intentions, to name a few. China is the wildcard and is more difficult to handicap given the uncertainty associated with the Chinese leadership's unwillingness to be seen as weak in the face of tweets from Trump and aggressive tactics from his administration. At the same time, we should not dismiss the probability that the US administration may negotiate hard on the front-end with China, only to reach agreement in the final hour as was done with Canada and Mexico in the early-October USMCA trade deal.

In conclusion

Our team takes a three- to five-year view of Earnings, Quality and Valuation (EQV). And yet, given that we're in a momentum market that reminds us of the late 1990s, we feel a stronger-than-normal need to have confidence in short-term earnings. That's because we are witnessing more violent moves in shares when companies just slightly miss expectations. In an environment where US growth might be peaking, we believe our quality growth style is moving back into favor.

Real estate

The outlook for real estate fundamentals is positive, but risks remain

Tim Bellman
Head of Global Research, Real Estate

Joe Rodriguez
Head of Real Estate Securities and Managing Director, Real Estate

Key takeaways

- Risks today are crystallizing; many are more global in nature.
- Pricing remains attractive; however, yield/cap rate compression is largely behind us.
- Total returns in 2019 are likely to be driven by net operating income growth.

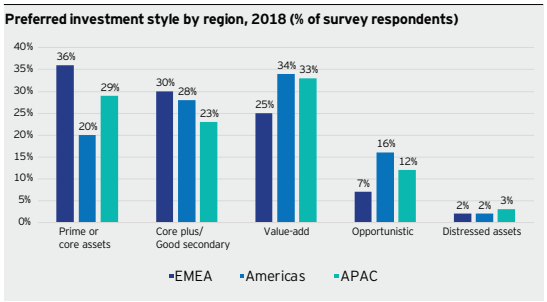
Strong growth in developed economies should continue to support favorable real estate fundamentals in the near term. The baseline scenario remains very positive, and global real estate securities earnings yields are providing a positive spread over local government bonds, a sign that real estate is still fairly priced. Yet macro risks to the outlook are perhaps now greater today than in prior years; many are increasingly global in nature. They include rising populism, an escalation of the US-China trade war, a monetary policy normalization misstep, a disorderly Brexit or a China debt crisis. Should any one of them materialize, it would have the potential to derail the global growth outlook to a measurable degree.

Global opportunities

Investor surveys in recent months reflect an increasing appetite for real estate, with allocations to the sector expanding to more than 10% of institutional portfolios. [1] While greater in the US and Asia Pacific than in Europe, many investors are seeking to leverage value-add platforms to enhance returns, likely in response to expectations of limited future cap rate compression (Figure 1). In Europe, there is a greater appetite for core strategies, given real estate's attractive pricing relative to long-term government bonds. We envisage the next few years will be marked by the emergence of new regionally focused offerings that can cater to these changing investor preferences.

Figure 1: Investment style appetite by region

Investors are increasingly interested in European core, Asian and US value-add.



Source: Invesco Real Estate using data from CBRE ResearchGlobal Investor Intentions Survey, 2018

> Risks today are greater than they have been in prior years, and are increasingly global in nature.

Regional investment themes

Differences in the regional total return outlook are driven in large part by our expectations of growth, with various local and regional nuances:

- **Asia Pacific**
  Over the last few years, Asia Pacific returns have surprised to the upside. There have been strong market-level returns, and the region has been the strongest component of the MSCI IPD Global Property Fund Index. Going forward, our total return forecasts for the region are projected to maintain a stable growth profile, driven in part by greater net operating income potential. We favor market-sector combinations benefitting from either cyclical upswings, such as Singapore offices, or long-term secular trends (aging, e-commerce, and technology).

- **Europe**
  Prime rental growth is becoming increasingly broad-based amidst ongoing economic growth in Continental Europe. Despite Brexit uncertainty, UK real estate fundamentals and capital markets have thus far remained resilient, but peak uncertainty is likely still to come. Limited development pipelines and structural demand growth make logistics and hotels of particular interest. A nascent institutional-grade multi-family housing market presents additional opportunities to participate via forward-funded developments.

1 Source: Oxford Economics as of September 2018

■ **United States**

The US is probably furthest along in its real estate cycle relative to the other regions, although thus far it has maintained its robust pace of growth. The near-term outlook remains positive, although labor constraints could start to weigh on sustained growth. We anticipate a tapering in real estate returns in 2019-2021 after a strong 2018. Given it is in a later stage of the economic cycle, we intend to lean into markets and sectors that have historically offered enduring value and stable income, while supplementing with selective growth-oriented opportunities.

Two global risks

At present, the risk that seems most concrete is the continued disruption of the retail sector by e-commerce. While not a new trend, the potential for further e-commerce penetration worldwide may be greater and faster than previously anticipated. Changes in consumer behavior, led by increased spending power of the millennial and Generation Z cohorts, has accentuated the shift from offline to online, in turn creating greater divergence of retail asset performance. Once one of the best-performing real estate sectors in most countries, this convergence of technological and demographic influences is changing the profile of retail real estate. In our view, this divergence is creating a wider chasm between the best retail assets and the rest, and this warrants a direct strategic response going forward. Public markets have responded to the shift, pricing mall and strip center REITs at a sizable discount to gross asset value (GAV), particularly in the US, which is arguably the most impacted region given its outsized provision of retail space per capita.

A US-led trade war poses a key threat to the global outlook today. The US has thus far announced tariffs on Chinese imports totaling roughly half of the US's $506 billion total import volume from China in 2017.[1]

China has reciprocated in kind, announcing tariffs on $110 billion of US goods, nearly 85% of Chinese imports from the US in 2017. [2] Of the two countries, only the US has much remaining capacity to impose greater tariffs, yet both countries could increase tariff rates, extend tariffs to services or impose broader capital control measures. Given that the US and China combined are expected to contribute 42% of global economic growth over the next several years, [2] a broad-based escalation of their trade war could impact both real estate fundamentals and capital markets.

> The period of cap rate compression appears to be in the rear-view mirror; as such, income growth is likely to become an even more important component of total returns going forward.

Pricing and timing

One concern over the next 12 months is the potential impact that interest rate normalization could have on real estate values. With the US Federal Reserve in the vanguard, more central banks around the world are starting to withdraw monetary policy stimulus. This winding down of quantitative easing (QE) and normalization of interest rates is an unprecedented and delicate process.

What might be the impact? As interest rates rise, there may be some upward pressure on real estate yields/cap rates as investors reassess relative pricing. Historically, however, the relationship has been far from one-to-one. Much depends on the outlook for real estate fundamentals. The period of yield/cap rate compression appears to be in the rearview mirror; as such, income growth is likely to become an even more important component of total returns going forward. Indeed, to some degree, growth in net operating income can offset changes in real estate yields/cap rates.

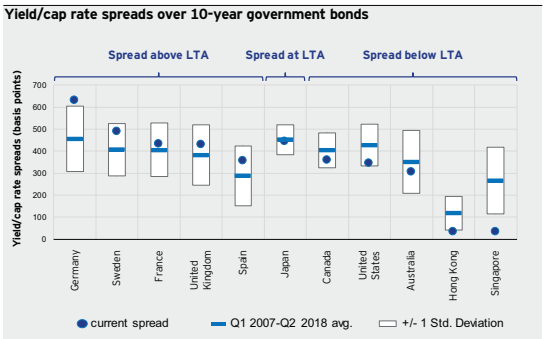
1 Source: Oxford Economics as of September 2018
2 Source: Oxford Economics as of September 2018

A useful mechanism for measuring price attractiveness in real estate is to compare real estate yield/cap rates spreads to long-term government bond yields. Two-thirds of the time, the yield/cap rate spread over long-term bonds is within plus or minus one standard deviation of the long-term average. Broadly speaking, when in this range, real estate may be considered to be fairly priced. Often, markets where strong growth is expected are found at or below minus one standard deviation.

As we see in Figure 2, yields/cap rates today broadly suggest that most markets are priced within the lower end of normal bounds. Europe is the main exception, as long-term government bond rates are very low, thus making real estate an attractively priced asset class; however, given the European Central Bank's anticipated wind-down of its QE program in the near term, these spreads may change.

Figure 2: Cap rate spreads over 10-year government bonds

Most markets are priced within the lower end of normal bounds.



*Please note that data for Singapore is current as of Q1 2018.

Note: current spread is calculated as the spread between the Q2 2018 cap rate and the September 10, 2018 10-yr bond rate. Countries are ordered from left to right by current spread value after sorting by relative distance from Long Term Average (LTA). Spreads at LTA are within +/-25 bps of LTA.

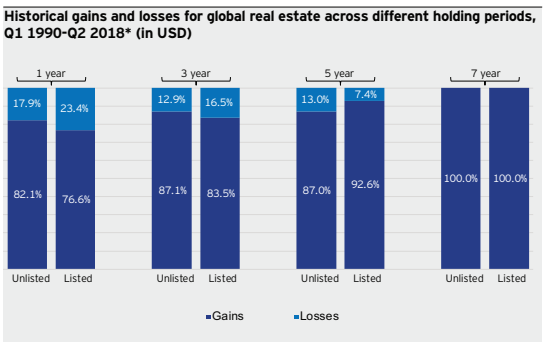
Source: Invesco Real Estate using data from Real Capital Analytics and Macrobond as of September 2018

Standard deviation is a statistic used to measure dispersion in a data set. It is calculated as the square root of the mean of the squares of the deviations from the arithmetic mean of the distribution. In a normal distribution, one would expect approximately two-thirds of data points to lie within +/- one standard deviation.

Given pricing pressures, investors may inquire whether now is a good time to be investing in listed and unlisted real estate. An exercise in comparing the asset class's tendency for gains and losses over different hold periods may yield one potential answer (Figure 3). Historically, there have been many more periods of gains than losses over the longest historical periods available – this suggests that regardless of entry point, the propensity for gains increases the longer the hold period. For many investors, time *in* the market may be more relevant than *timing* the market.

Figure 3: Historical frequency of gains and losses for listed and unlisted real estate

The longer the hold period, the greater the proportion of periods yielding gains.



Note: *Historic data series for global unlisted real estate represented by MSCI IPD GPFI and reflect the time period from 1Q2008 to 2Q2018, the longest time period available.
Global listed real estate is represented by the FTSE EPRA/NAREIT Developed Index reflects the period from 1Q1990 to 2Q2018, the longest time series available.
All returns shown in USD.

Source: Invesco Real Estate based on data from MSCI IPD, Bloomberg Barclays, and Macrobond as of September 2018

The MSCI IPD Global Property Fund Index is an index of unlisted, open-ended core funds that invest in a single country or cross-border. The index is used as a proxy for global core real estate performance.

Conclusion

Against the backdrop of global risk factors, the outlook for real estate fundamentals and returns remains broadly positive. In the more than 200 market-sector and 2,000 sub-sector combinations that Invesco Real Estate monitors globally, we expect rental growth in over 90% of these areas in 2019, with a slightly higher share in Asia Pacific and the US than in Europe.

Energy tops our list of 2019 opportunities

Kevin Holt
CIO, US Value Equities

Key takeaways

- Equity markets have been negatively impacted by global trade war concerns, and investors are also worried about the prospects of slowing economic growth given tighter monetary conditions.
- In particular, opportunities exist in select cyclical sectors as many are discounting a sizable economic slowdown commensurate with a recession.
- In our view, historically low volatility sectors are expensive, and in some cases structurally challenged versus history.

Equity markets have moved meaningfully higher with little disruption since the presidential election in 2016. Absent an unexpected downturn, I believe the US economic backdrop is relatively strong and supportive of higher equity prices in certain sectors as we transition into 2019. The benefits of fiscal stimulus combined with aggressive deregulation should continue to be felt in the coming year, in my view. That said, this outlook is not without risk and investors have no shortage of issues to worry about – trade tensions (most notably between the US and China) and concerns about the current level and trajectory of interest rates have both cast a shadow on the stock market.

Trade wars have historically been a lose-lose scenario, which makes a timely resolution even more important. The longer the conflict continues, the greater the potential for higher inflation, slower economic growth and disruption in the stock market. While the bottom-line effects are hard to accurately quantify, companies have been commenting more frequently that ongoing trade wars are negatively affecting corporate profits as 2018 comes to a close. A global power management company is anticipating US$110 million in tariff-related costs in 2019, which could likely be passed through to consumers in the form of higher prices. A large industrial company noted in October that higher input costs, while not all trade-related, outstripped price increases by US$50 million in the third quarter. I believe that a favorable trade-related outcome should help alleviate many of the concerns surrounding more economically sensitive companies.

We're optimistic about energy

In our view, energy stocks represent the largest opportunity for fundamental improvement in the market today. Following the largest downturn in oil prices in decades, major energy companies cut capital expenditures about 50% since 2014.[1] The cuts had a significant impact on future production as many of the oil projects are long-tailed and can take three to five years to bring on.

The combination of underinvestment and growing world consumption has resulted in a supply-demand deficit environment with the lowest spare oil capacity on record. Absent a material decline in demand, global consumption should continue to outstrip supply for the foreseeable future.

It's also important to note that energy companies have been changing the way that CEOs are compensated. Corporate energy boards are now prioritizing profitability over production, and are funding only those projects that generate an acceptable return on investment capital. This recent shift has led to healthier balance sheets, more attractive free cash flow generation and, in many instances, stock repurchases of shares that are at historically inexpensive valuations.

And yet, these improved fundamentals have done little to convince investors that energy companies represent a compelling opportunity. The question is: Will companies revert to their bad habits of overspending, or will capital discipline remain? In our view, the market entered November with energy stocks reflecting an oil price of US$50 per barrel, and long-term price expectations averaging US$60 to US$70. This indicates the potential for substantial upside for energy stock prices, in our view.

We're cautious about consumer staples

Conversely, we remain cautious of those traditionally defensive segments of the market that were used as bond proxies and perceived "safe havens" over the course of the past decade. Flat to negative revenue growth in consumer staples, combined with historically unattractive valuations, warrants additional caution, in our view. We expect this to be further exacerbated by price-cutting activities from big-box retailers as competition heats up.

1 Source: Bain & Company, "Accelerating Capital: 2018 Oil & Gas Industry Planning Outlook," Nov. 22, 2017. Oil majors cut capex spending from $215 billion in 2013 to $118 billion in 2016.

We believe many of the food and consumer products companies have driven operating margins to unsustainable levels by underinvesting in their businesses. Many of these companies are also highly correlated with bond prices, which could make them a risky bet in a rising interest rate environment. That said, if the trade fears persist, I would expect these stocks may outperform as investors seek out more conservative alternatives relative to cyclical stocks in the short-term.

Conclusion

Looking ahead into 2019, we find ourselves in an environment where valuations have taken a back seat to growth stocks and low volatility stocks. Instead of growth versus value, stock market moves have been largely characterized as risk on/risk off due to the proliferation of factor and quantitative-oriented strategies. I believe that a meaningful shift to value, which includes areas that are more sensitive to the macro environment, may take place once investors begin to feel comfortable with the key issues highlighted above.

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