



Investment outlook

Central banks pivot to a dovish stance, dampening concerns over rising rates and providing support for risk assets. But headwinds from protectionism, fading fiscal stimulus and less favourable financial conditions continue to weigh on global growth trajectory.

Global growth decelerates to still-decent rates

After strong growth in 2017 and 2018, economic momentum has waned and we expect this trend to continue this year and next. The deceleration was largely incorporated into our forecasts from last quarter, but the hit to confidence from financial-market volatility, and the extended U.S. government shutdown, which was not part of our base-case a quarter ago, had negative economic impacts. Globally we look for 3.50 percent growth in 2019 and 3.25 percent growth in 2020, down from nearly 4.00 percent from the past two years. Further deceleration in 2020 seems likely as economic slack has diminished and the U.S. will encounter fiscal headwinds next year. The outlook for emerging markets is slightly better but, here too we expect a moderate slowdown, with 5.25 percent growth penciled in for 2019 and 5.00 percent growth for 2020. To be clear, we are expecting growth to moderate, but these rates remain quite good by post-crisis standards.

Risks to our outlook are constantly evolving

The three main risks to our outlook are protectionism, Chinese growth and the U.S. business cycle. Although protectionism is no longer actively deteriorating, the actions taken thus far are starting to inflict economic damage through slowing global trade. The U.S. is leading the charge on tariffs and we continue to budget for a negative scenario where most of the tariffs already in place remain active, with a possibility of further escalation between the U.S.-China relationship or in the auto sector. In North America, the USMCA deal that was struck last fall may still represent a challenge and we place a small chance that the deal is not ultimately approved. Moreover, moderating activity in China is a particular concern as the country is now the world's second-largest economy and biggest contributor to global growth. The Chinese government has announced a variety of fiscal and monetary measures to counteract slowing growth, but in doing so it has renewed concerns over potential debt problems.

U.S. business cycle is late and advancing

Our scorecard approach continues to situate the U.S. business cycle in late stage, with some underlying movements from last quarter. The 17 inputs in the scorecard rarely agree, but 'late cycle' is still the best guess. Interestingly, the second-best guess has shifted to 'end of cycle' from 'mid cycle' in the past quarter. Supporting the notion that the U.S. business cycle is in late stage is that the U.S. economy is now extremely tight, delinquencies on auto loans are at a high and still-rising level and the yield curve is extremely flat. The fact we are in late cycle doesn't mean investors should necessarily avoid risk-taking, but the risk-reward case is not as strong as compared to earlier points in the cycle, and volatility will likely be greater in this environment.

U.S. dollar strength likely holds

Several factors continue to support the U.S. dollar versus other key currencies. The U.S. economy remains robust relative to the rest of the world and interest rates are higher in America versus other major regions. Our model situates the U.S. dollar in overvalued territory, but not to an extreme degree that would call for significant economic adjustment in the near term. In addition, the U.S. dollar's safe-haven status means the currency generally appreciates when risk assets struggle. While many investors are questioning whether the U.S. dollar is due for a period of weakness after a nearly decade-long bull market, we think the dollar will likely follow a choppy topping process that may continue for a while longer.

Central banks on pause

Central banks are no longer actively tightening monetary policy amid a backdrop of slowing growth, less inflation and increased financial-market volatility. We don't expect rate hikes in any major region over the next year as economic growth decelerates, and also because we believe the neutral policy rate is toward the lower end of central banks' estimates. In addition, we think central banks will lean towards easier policies as they focus on stimulating growth rather than curbing inflation pressures. Dovish central banks reduce the risk of recession in the near term, but could encourage increased risk-taking which raises the chance of recession later on. In Europe and Japan, central banks are in an especially challenging situation as no monetary stimulus has been removed thus far. It now seems inappropriate to do so given the economic slowdown, presenting a risk that the European Central Bank and/or Bank of Japan won't have any room to deliver meaningful stimulus when this cycle eventually comes to a close.

Sovereign bond yields decline in all regions

Global sovereign bonds rallied in the past quarter, reflecting the downshift in economic growth expectations, slightly lower inflation and, perhaps most importantly, the fact that central banks are no longer set to raise rates. Yields on 10-year government bonds are now below our estimates of equilibrium in all major regions, particularly in markets outside of North America. While our models continue to suggest that interest rates are unsustainably low that the long-term direction for yields is likely higher, we recognize that slowing economic growth and tame inflation could limit upside pressure in the near term. As a result, we have lowered our forecasts for 10-year sovereign bond yields across major regions versus last quarter.

Equities rallied from depressed valuations following broad-based sell-off

Last year's equity-market correction moved stocks to especially attractive valuations, boosting total return potential and setting up the preconditions for the subsequent rally. The world's major stock markets suffered double-digit declines in 2018 and, as the sell-off intensified in December, our composite of global market valuations had fallen to its lowest level in seven years. The powerful rebound in stocks since the start of 2019 began from a point of reduced valuations and was fueled by the recent pivot by central banks and the fact that U.S. and China were

making progress toward a trade deal. Although stocks have had a good run so far this year, our models suggest that the rally can persist as long as earnings meet analysts' expectations. We recognize that the profit outlook for 2019 is less rosy than last year given the absence of another round of tax cuts and slower economic growth, but against a backdrop of moderate inflation and accommodative monetary policy, there is plenty of room for stocks to move up.

Maintaining slight overweight in stocks as economy progresses at a slower pace

Our base case looks for expansion in all major regions and, while growth is moderating, the degree of expected deceleration is quite mild. In this environment, central banks are unlikely to raise interest rates and bond yields will probably be contained. We maintain underweights to fixed income because, in our view, total returns for sovereign bonds are likely to be low for or even slightly negative for a long period. However, that underweight is less than it has been as yields are now at a level that could provide a cushion for returns on risk assets if the economy were to encounter a meaningful downshift. In our base case, though, economic growth should be sufficient to deliver moderate corporate-profit gains that would sustain mid-to-high single-digit increases in North American equities, and low double-digit returns in international and emerging-market stocks. Balancing the risks and opportunities and given these superior return expectations for stocks versus bonds, we feel that maintaining slight overweight exposure to stocks is appropriate. For a balanced, global investor, we currently recommend an asset mix of 58% equities (strategic neutral position: 55%) and 41% fixed income (strategic neutral position: 43%), with the balance in cash.

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