



## Investment outlook

Financial markets stumbled amid tightening financial conditions, rising protectionism and slowing global growth. While the expansion is facing a variety of challenges, our tempered outlook suggests the global economy will still grow close to its fastest rate in the post-crisis era.

### Global economy decelerates as headwinds mount and tailwinds fade

After enjoying solid and accelerating global growth in 2017 and the first half of 2018, momentum has waned and we expect this trend to continue into 2019. Financial conditions have worsened due to rising interest rates, widening credit spreads, falling stock prices and a stronger U.S. dollar. Moreover, the U.S. fiscal stimulus program will provide less of a boost in 2019 and could become a drag on growth in 2020. We therefore budget for slower growth going forward, much of which was already reflected in our forecasts last quarter, but we have lowered them slightly again this quarter to levels that are mostly below the consensus. That said, our forecast of 3.75 percent for global growth in 2019, down from the 4.00 percent forecast for this year and achieved in 2017, is still near the upper end of the range of growth rates experienced in the past seven years.

### Protectionism and several other risks threaten our base case of decent, yet slowing growth

European politics, rising interest rates, firming inflation and troubles besetting specific emerging-market countries are all threats to the expansion, but the largest macroeconomic risk today is protectionism, mainly with respect to the U.S.-China relationship. Tariffs exchanged between the world's two largest economies have ballooned in recent quarters and now cover several billion dollars of trade. While the economic damage from protectionism so far has been minor, further deterioration in the trade environment would be problematic. In North America, though, the risk from protectionism has actually diminished following the USMCA deal. The other two key risks to our outlook include slowing Chinese growth and the aging business cycle. The former is being addressed with increased stimulus measures in China, at the risk of reintroducing concerns about the country's massive debt levels.

### Business cycle is 'late' and advancing

Our assessment of 17 inputs situates the U.S. business cycle in its latter stages, which historically has been consistent with an expansion that has no more than a year or two left. The most obvious indication that the expansion is mature is that labour markets are extremely tight. There are now more job openings in the U.S. than individuals looking for work and the unemployment rate sits at its lowest level in nearly 50 years. Another classic late-cycle signal is that the yield curve is approaching inversion, though we recognize that the signal may be exaggerated given the absence of a term premium. Overall, our models suggest a low chance of recession over the next year, but the risk is rising.

### U.S. dollar is experiencing a prolonged topping process

We look for a moderation in U.S.-dollar strength given fading fiscal stimulus, less aggressive tightening by the U.S. Federal Reserve (Fed) and stretched positioning in the U.S. dollar. However, we note that the greenback hasn't reached extreme levels of overvaluation in the current cycle and we suspect the dollar can remain mildly expensive for longer than it has during prior cycle peaks. Our forecasts envision relatively modest fluctuations as the dollar navigates through an extended topping process. Against this backdrop, we think emerging-market currencies can outperform, particularly given political instability in Europe and Brexit uncertainty that could weigh on the euro and the pound. We expect further weakness in the Canadian dollar amid the recent drop in oil prices, competitiveness challenges and a slowing economy.

## Central banks respond to era of better growth and higher inflation

The macroeconomic backdrop has improved significantly from the initial years following the financial crisis, as sustained growth has eaten away at economic slack and rescued inflation from being dangerously low. Also contributing to higher inflation has been a meaningful rise in commodity prices since 2016, protectionism and the general tightening of economic conditions. We forecast slightly above-average inflation for 2019, but not to levels that would be problematic. Central banks have been responding by gradually dialing back the accommodative monetary policies that have been in place over the past decade. The Fed has been the most aggressive central bank, having raised rates beyond 2 percent, and it is now reducing its balance sheet. The Bank of Canada and Bank of England have delivered rate increases at a slower pace, and the European Central Bank has signaled an end to bond purchases this year, setting up for initial rate increases later next year.

## Government bonds rallied as investors sought protection

After rising earlier in the quarter, yields on government bonds slipped in all major regions as investors gravitated towards safe-haven assets against a backdrop of slowing global growth and a sharp decline in oil prices. Our models suggest that 10-year sovereign-bond yields in North America are near equilibrium, but that unsustainably low yields in other regions represent significant valuation risk. Over the longer term, we think that the potential for yields to rise stems from an increase in real interest rates to historical norms as investors demand higher after-inflation returns on their savings. However, this increase will likely be gradual and extend over many years and, with global economic growth slowing in the near term, any rise in real interest rates may be limited. As a result, we don't forecast much, if any, increase in bond yields in most major regions over our one-year forecast horizon.

## Market correction lowered valuation risk, but slowing profit growth may limit gains

Equities suffered steep declines in most regions in 2018, especially in emerging markets. Our composite of global equity markets situates stocks below our modelled estimate of fair value, but the valuation underpinnings differ largely across regions. Stock markets outside the U.S. are particularly attractive, whereas the S&P 500 is only slightly below fair value. While valuation risk has been reduced as a result of the correction, rising interest rates and firming inflation may restrain multiple expansion.

Rapid earnings growth has contributed significantly to the bull market of the past decade. However, earnings growth is expected to slow in the coming year, as tailwinds from tax cuts fade, economic growth decelerates and profit margins come under pressure. S&P 500 profit growth is forecast in the high single digits in 2019, down from the greater than 25 percent increase in 2018. That said, stocks still offer decent upside under reasonable assumptions, as long as earnings materialize as analysts expect.

## Adding to bonds and maintaining slight overweight in equities as cycle matures

Our asset mix reflects a view that the economy will continue to expand at a moderate, albeit slowing pace. Against this backdrop, central banks could moderate the speed at which they tighten monetary policy, and we remain underweight bonds as even a modest rise in rates will act as a headwind for fixed-income investments. However, yields are now sufficiently high that bonds should offer buoyancy in a balanced portfolio in the event of an economic downturn. We took advantage of the increase in yields earlier this quarter to add one percentage point to our fixed-income allocation. We have left our equity overweight unchanged, but it remains well below our peak exposure from earlier in the cycle. We have opted against adding to equities during the recent correction given a lack of positive confirmation from our technical signals, but maintain a mild overweight because we expect stocks to outperform bonds over our forecast horizon. For a balanced, global investor, we currently recommend an asset mix of 58 percent equities (strategic neutral position: 55 percent) and 41 percent fixed income (strategic neutral position: 43 percent), with the balance in cash.

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