The Perspectives Podcast
Outlook 2019
Episode Six

with
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Newsclip: (A quarter of a million new jobs, a wage boost that's the best since 2009, and unemployment rate at its lowest in almost 50 years; We saw the Dow fall 400 points then 500 points then 700 points. Even hardy stock traders on the floor couldn't believe the volatile swings. The biggest issue facing the market is the trade negotiations with China. The bottom line is the GDP numbers are going well and that matters...)

Candace: That's just a taste of the dynamics we've seen in 2018 and they're likely to continue in 2019. There are some real mixed signals out there. If you look at the big picture the U.S. economy is in the best shape it's been in for decades with low unemployment robust growth and even finally a slight uptick in wages. But yet after a year of stock market ups and downs investors might feel like they're pretty much back where they started at least in the U.S. markets. And external factors like trade disputes and gridlock in Washington could potentially put the brakes on economic growth. So how can we make sense of all these signals?

On today's episode we'll explore what 2019 might look like for investors. We'll take a look at the economy, policy and the markets— where we've been and our outlook on where we could be going. And we'll share insights on what this might all mean for your financial life.

You're listening to the Perspectives podcast. I'm Candace Browning, head of BofA Merrill Lynch Global Research. And with me is Michael Hartnett, chief investment strategist for BofA Merrill Lynch Global Research.

Michael: Hi, Candace

Candace: And Chris Hyzy, chief investment officer for Merrill Lynch and U.S. Trust.

Chris: Hello Candace.

Candace: So Michael and Chris, let's start with your big picture on how things went in 2018. Did they generally go as expected or did investors really get thrown some curveballs and surprises.

Michael: Well, I think if you're a U.S. based investor, 2018 has been okay in that the equity market is flat to slightly up, bond markets are flat to slightly down. So it certainly hasn't been a disaster. But at the same time it's being very different from what we've been used to for much of the past 10 years, which is you know nice big fat returns from both corporate bonds and corporate equities, so it's definitely had a different flavor to it. And I think part of that's really interest rates moving up, which is a new thing for a lot of investors.

The good news for the U.S. is, thanks to the tax reform, the profit story has been good. But yeah, I guess it just hasn't quite been enough and that's why I think looking into 2019 people are like well if interest rates are going to continue to go up we really what are we going to do with profits looking as they're starting to decelerate.

Chris: So now the question is how much are interest rates, as Michael said before, going to go up relative to where we are right now? How much is growth going to slow down, and what's the appropriate price you pay for that? When you think about the economy heading into next year, it's important to go back to the basics: What's the health of the consumer, what's the health of corporate America. What's the health of the economies outside the United States and what is the negative or potential positive shock to that base story.

Candace: Okay, so let's delve into what the outlook for 2019 really is, and let let's start with the U.S. economy. So in many ways it's been a real bright spot globally, but we are starting to hear a little bit the R word, recession. Let's hear what Larry Kudlow the head of the Trump administration's economic council had to say about it this past November.

Newsclip: "The economy, the basic economy, has reawakened. And it's going to stay there. I mean I'm reading some of the weirdest stuff how recession is around the corner. Nonsense. My personal view, our administration's view, recession is so far in the distance I can't see it." (*Larry Kudlow, Nov. 20, 2018*).

Candace: So Michael what do you what do you make of that. Do you think there's a recession not that far away?

Michael: I don't think you can be too dismissive of the risk of recession. You know we're nine years into an economic upswing in the U.S. So I think most investors think that at some point in the next year or two there is going to be a slowdown. I think the question is A, is it a just a slowdown; B, a profit recession, where profits actually decline in year-on-year terms. Or you know, is it the big R? You know you really do get a recession. I think what the equity market has discounted thus far is a slowdown. And if it is just a slowdown then, you know, 2500 on the S&P, it's not going to get a lot lower than that, but it could go lower than that if you get either a profit recession or an actual, real recession.

Candace: Well, let's talk about what are some of the forces that could bring about a larger profit recession or a real recession. What do you see as some of the risks out there?

Michael: **T**he one that is still the missing link is inflation, and particularly wage inflation. If wage inflation is going up, number one, profit margins are going down, all other things being equal. And number two the Fed can't cut interest rates if they need to. So, it's that double whammy. If life as it always is, in the markets, is about earnings and interest rates, the one thing that makes earnings go down and interest rates go up is wage inflation. So that's one missing link thus far.

Chris: Yeah, to consider a contraction in growth,-you would have to have a negative shock to the system. That shock is generally interest rates they go up too much.-And the second thing, quite frankly, is it could be a pretty sizable geopolitical shock out there that would affect the level of global economic growth, and then those winds would blow over into the United States.

And then, last but not least, as Michael said, if investors are forecasting a so-called hard landing, or where growth goes significantly below around 2 percent in the United States, that could affect earnings growth significantly. And then you not only see negative profit revisions, you actually start to see a profit recession that affects not just the equity market, the credit markets overall. Do we see that right now? No. But it's important to have those concerns ready if you start to see that unfold.

Candace: So, we have brought up the words geopolitical risk but not really delved into it very much. Let's talk a little bit about China, which I think is the primary geopolitical risk out there. Why is it so important?

Michael: Well it's the second largest economy in the world. It's also you know got a tremendous amount of savings, so the impact that it has on currencies, via capital flows, is immense. And China matters because they can affect U.S. interest rates because they are such a huge holder of U.S. Treasuries. So, you've just got to hope I think, that the relationship between the U.S. and China can be managed in a way that doesn't cause temper tantrums on both sides because the impact that it can have on trade, on capital, you know can really have an impact on asset prices.

Candace: And it seems that one of the most difficult things about the trade situation with China is in intellectual property. And how do you thread that needle?

Michael: I don't think you can. I mean I just don't think you can. You just have to use as much pressure as you can, you know, to prevent the acquisition of that intellectual property. And I think that's what the U.S. administration is doing. If you go to you know D.C. right now everyone is in this: We are going to prevent China from becoming a military, technological, and geopolitical partner.

Chris: Intellectual property and the race towards innovation is absolutely the goal here, predominately from China, and then the U.S. trying to slow that down. So we'll see how this ultimately plays out. But from a truce to a long-term agreement could be years in the making versus it's going to happen in 2019.

Candace: So we've talked a little bit about China. Let's actually talk about Washington, D.C. What does gridlock potentially mean? What's your outlook on an infrastructure bill? How important do you think that is? What do we see in Washington in 2019?

Michael: If the economy needs it next year the likelihood of an infrastructure bill is very, very high. I think what we were saying earlier on in terms of interest rates, the Fed, and the markets. That sounds good, you know because you spend money, you spend it on infrastructure, growth goes up, earnings goes up. The problem this time around are interest rates, and is the bond market going to allow that spending, you know to take place, or is it going to charge the politicians more money for it. And that I think will be a big deal for markets next year.

Candace: Well the Fed Chair Powell recently made some comments in late November that were pretty revealing on what the Fed's current stance is.

Newsclip: **"**Interest rates are still low by historical standards and they remain just below the range of estimates of that level that will be neutral for the economy—that is, neither speeding up or slowing down growth." (*Jerome Powell, Nov. 28, 2018*)

Candace: So what do you think is the neutral level for interest rates?

Chris: Wow. I say wow because that is the comments coming in late November, I wouldn't say are completely opposite of the comments on October 3rd which went something like "we are far away from the neutral rate," comma, "probably." But that neutral rate is going to depend on the overall level of rates, inflation, et cetera, so if you use 3 percent as your neutral rate we're three hikes away from the so-called neutral rate. Having said all that what's really interesting about all of this is that the Fed can go four times next year. They can go five times the next year. They can go one time. It's all on the basis of what the appropriate level of interest rates is, all things considered, employment inflation the level of growth what happens overseas. So do we really know?

Michael: I think it's definitely two and a half to three and a half. But again I come back to it, if you get a pickup in inflation, that's going to be the biggest bugbear for the market just in the very short term, if suddenly inflation out of nowhere just reached its head that really would be a big surprise and be quite a negative surprise for the markets. Let's hope that doesn't happen.

Candace: So that's a perfect setup for switching from you know talking about the economic backdrop, policy, interest rates to what do you actually expect to see in the markets in 2019.

Chris: I think we're setting up very well for the year of realism — on the basis of what interest rates actually are, the level of inflation, the level of earnings, and setting back down to, dare we say, normalcy, where volatility goes from where we were, record low levels when we closed 17. So volatility should pick up, earnings growth should reset to a more normal level, think 5, 6 percent. And one mechanism could drive your overall portfolio construction theme in 2019, which is the dollar. Where does the dollar go, does the dollar weaken for the first time in a while? If that's the case, Michael's view that he's been discussing about the non-U.S. market place becomes a lot more attractive.

Michael: For sure. And I think that if you can create a narrative of peak dollar, because at some point you're going to get peak interest rates and peak GDP in the U.S., Emerging Markets, Europe, resources, value, a lot of areas that you know have just being shunned, or you know people have dipped their toes in but sort of regretted that they had and had to pull back. You know that becomes much more of an option on an 18 month view.

Candace: Well then, let's delve into some of the sectors and let's start with tech. So clearly a lot of the market's growth over the past several years has been driven by the tech sector. Could that actually be changing? And if it is changing, what do we think some of the new market leaders could be?

Michael: Well, I think very broadly it is changing. You can't expect you know 25 percent from technology stocks every year. And what we found in 2018 was unfortunately just too many people expected 25 percent every year, and everyone was crowded into the same stocks, and then you know only takes one person to sell and then it moves the other way.

Chris: Tech is now not as interesting as it was in the past few years as a completely big sector but parts of it still very are. There's an enormous amount of the health care sector that has technology and innovation in it, and that's the new switch, to go from inexperienced tech to experienced technology companies and then healthcare.

In addition, the significant discount that some of the industrial sector has traded at given what we all went through with trade, et cetera, looks to be, have a big opportunity set to it.

Michael: Clearly momentum to quality is one leadership shift. Maybe it's U.S. to non-U.S. is another shift that people will think about. You know I think the key is whether people can genuinely go to value. Because there really is great value.

Candace: And what do we see for some of the other sectors we haven't talked about like financials, consumer, materials.

Chris: Part of the financial story is also that in 19 and 20, barring no recession, and even in the out years after that, the financials are more of an investment around leveraging the pickup in lending in the millennial space. And we had a major stall in the housing market and the auto market in 2018 and demographics can tell us that that begins to switch in the middle part of 19 into 20, where the millennial age now gets up to an age four or five years later than most of us bought our first home. So it will be a combination of who's leveraged to the consumer and Main Street and who's leveraged to the millennial pickup in lending towards housing and housing development.

Michael: I mean those would be the other two points. Housing had an awful year in 2018 and I think that if the Fed is going to stop raising interest rates at some point next year, housing will have a better year, unquestionably. I think the other story there is, you know, the cyclicals which you know a lot of those were harmed by what was happening in terms of interest rates.

Candace: So Chris let's talk about portfolio guidance for 20 19. Is there anything that investors should do differently in 2019 than they did in 2018?

Chris: For us, heading into 2019, raising the level of diversification makes sense. The second thing is, when you do that it's not just at the allocation level — it's also below the allocation level, when you're thinking about themes. And start to think about as you end this cycle and start a new one, what are the larger themes to build a longer-term portfolio that makes sense that you are underexposed to.

And if we do get any further movement on a positive basis out of the Fed as it relates to a potential pause and the trade truce turns into something that is a little bit more unexpected—which is some components of a framework for a longer-term agreement, then you start to get more interesting returns in areas that have not performed—again, non-U.S., value, cyclicals, in those areas. For the time being, being exposed to quality, as Michael said before, versus momentum, and being a little bit more exposed to value makes sense to us.

Candace: Would you suggest perhaps given all this uncertainty that investors maybe should have a higher level of cash?

Chris: That's a great way to put it, because in 2019 everything that we've discussed, you could basically say that it's a "year of high event risk." And if you have that as your thought process, having a higher level of cash, yes, makes sense. It's going to depend on, quite frankly, where we are as we head through the year. But as we get into 2019, where yields are at the cash level and even in short-term fixed income, having a higher allocation there does make sense.

Candace: Michael?

Michael: You do have a lot of people and you know it hasn't been the wrong call, going into 2019 saying look, look at T bills, I mean, they're 2, 3 percent it ain't so bad. But what I've got to tell you is that you look at emerging market dollar yields now you're up at 7, 8 percent. You know, you look at investment grade Triple B you're up 5 at percent. I mean, I think one of the things we mustn't forget is that there has been a big move up in yields, and at some point, again, if the Fed is heading towards a pause that stuff is going to become very, very attractive.

I would also say you know, just have a shopping list. I mean you know 2018, 2019, it will provide moments where you're really going to be able to buy what you want to own in the next five years at, you know, a pretty good price. And so I think that always you've got to be disciplined. But when the opportunity comes sort of execute on that. So I think having a shopping list for the next couple is very important.

Chris: And Michael brings up a very good point there, which is emotion, and getting too excited or getting too high or too low. Market timing requires two decisions: When you get out and when to get back in. And it's very difficult to do. So for the long-term investor, look away from the market timing type of approach and think about building that shopping list.

It could be about accessing a particular yield. It could be about exposing yourself to areas that have significantly underperformed and over the next business cycle start to revalue themselves upward. Whatever it is for the objective or the long-term goal of that individual, that family, that institution. That's how you build a portfolio versus trying to second guess or outguess the totality of the market.

Candace: Well great. Thank you very much for listening to this Outlook 2019 Perspectives podcast. My cohosts are Michael Hartnett and Chris Hyzy. I'm Candace Browning.

As you think about your goals for the coming year it's important to stay focused on what you're investing for. It's easy to get distracted by daily news and headlines, not to mention the market's actual daily moves. But knowing what's most important to you and having that shopping list and a well-rounded investment strategy is a good way to tune out the noise. And working with someone like a trusted adviser can help you come up with a plan that's right for you.

For further insights, listen to other episodes in the Perspectives podcast series. Thanks for listening.