WM Research Market & Economic Outlook – 2019

Major Indices 2018 Returns*	Value	Price Return	Total Return	All-Time High	% from High
S&P 500	2,506.96	-6.23%	-4.43%	2,930.75	16.9%
Dow Jones Industrial Average	23,323.66	-5.65%	-3.50%	26,828.39	15.0%
NASDAQ Composite	6,636.83	-3.86%	-2.84%	8,109.69	22.2%
Russell 2000	1,349.23	-12.13%	-11.05%	1,740.75	29.0%
MSCI EAFE (USD)	1,740.55	-11.74%	-8.89%	2,388.74	37.2%
MSCI Emerging Markets (USD)	967.65	-12.00%	-9.73%	1,338.30	38.3%
Bloomberg Commodity Index	79.96	-9.31%	-7.57%	237.95	197.6%
Barclays U.S. Aggregate Bond	99.94	-3.04%	-0.23%	111.03	11.1%

**Through 12/19/2018* *Data Source: FactSet*

Outlook Summary:

Volatility returned to the equity markets in 2018, as investors endured two double-digit percentage market corrections, both preceded by market rallies. This created a tale of two markets in 2018. The year's first market, from January to September, included a January surge to new highs followed by a 10% correction in early February. By late September, on the back of impressive U.S. GDP and earnings growth, the S&P 500 rallied to new highs and a year-to-date (at the time) gain of 9.6% at its peak. At that point, the year's second market kicked in with the beginning of a more severe correction that remains underway and includes the S&P down 13.5% from its September high. Investor sentiment has turned decidedly negative due to fears of economic slowdown in the U.S. and internationally, an uncertain deceleration in earnings growth, an escalating trade dispute with China, and Fed tightening that many believe is overly aggressive. These fears should not be dismissed and are likely, in our view, to drive continued volatility in 2019. However, with the S&P 500 down 2.8% year-to-date, despite 25% earnings growth, equity market valuations are much lower today than one year ago and appear to be pricing in economic headwinds that may not fully materialize. **This valuation support, along with expectations for 2019 growth in U.S. GDP and corporate earnings, leads us to conclude that equities can move higher in the year ahead. Our target for the S&P 500 at year-end 2019 is 2,900, which represents an approximate 16% gain from recent price levels. Adding to that an estimated dividend yield of 2% for the index produces a total return expectation of 18% for 2019.** While our target appears aggressive given the ongoing market correction, our price target is below the market highs of September 2018.

Our price target represents a P/E of 16.7x the current FactSet consensus 2019 EPS estimate for the S&P 500 of $174. This is slightly above the 20-year average S&P 500 P/E of 15.7x, which we view as reasonable given that long-term interest rates remain well below long-term averages. The 2019 EPS estimate reflects a year-over-year (y/y) increase of 8% from 2018 estimated earnings, which (with Q4 still to report) are expected to grow 22% from 2017. We estimate that the Tax Cuts and Jobs Act (enacted at the end of 2017), which lowered the statutory U.S. corporate tax rate to 21% from 35%, added approximately 7% to S&P 500 earnings growth in 2018. While the lower tax rates and positive contribution to earnings will continue in 2019, the percentage boost to the growth rate will not. Excluding the tax reform benefits, we estimate that S&P 500 earnings increased 18% through Q3 and will grow 15% for the full year, reflecting strong corporate performance and full-year results well above prevailing estimates in early 2018 (in April 2018 the S&P 500 consensus EPS growth estimate was 18%). In our 2018 Market Outlook, we published a 2018 S&P 500 target of 2,850; we subsequently raised that target to 2,975 after GDP and earnings trends were exceeding expectations. The market peaked at 2,931 (closing price) on 9/20/18, and since has endured a steep correction of greater magnitude than we expected. Through 12/14/18, the S&P 500 year-to-date (YTD) decline was 6.2% on a price basis and -4.40% including dividends. In Q4 alone, the S&P 500 price decline is 14.0%.

(S&P 500 price divided by 12-months forward EPS estimates)

Data source: FactSet through 12/19/18.

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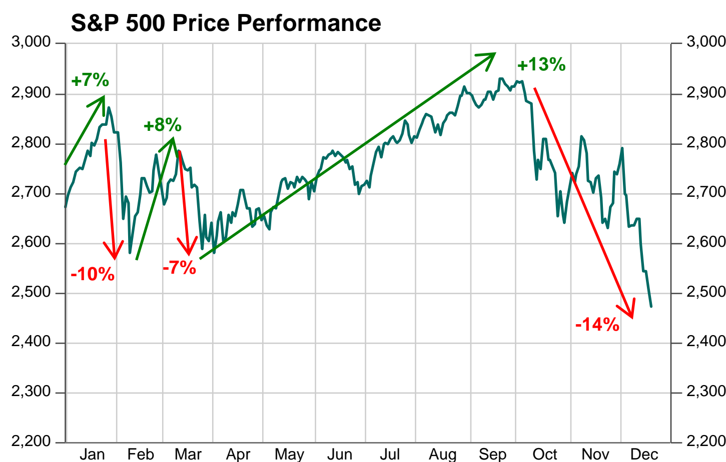
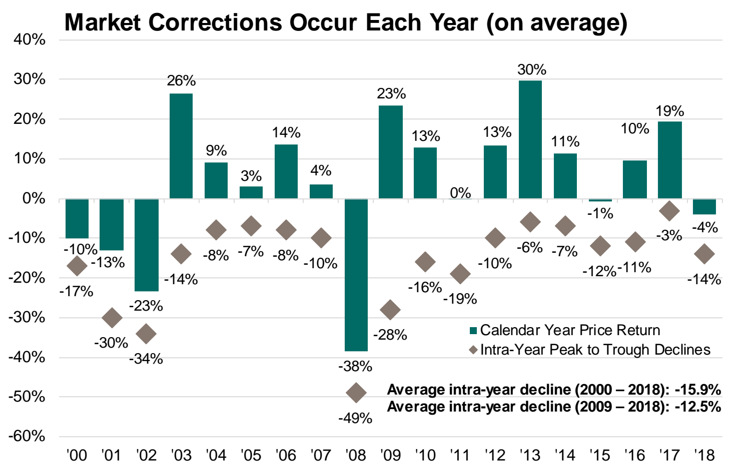
2018: The Return of Market Volatility

On average, the S&P 500 experiences a correction each year. It did not take long in 2018 for investors to be reminded that equity prices can be volatile and that market corrections are possible. After setting 15 new record highs in January, the S&P 500 peaked on 1/26/18 then declined 10.2% over eight days due to fears of surging interest rates and the threat of tariffs. After 2017 included only a 2.5% peak-to-trough decline in the S&P 500 and just ten days of daily moves up or down of at least 1%, we argued that investors should expect annual market declines of 10% or more, even in bull markets. Following the February decline, the S&P 500 needed 28 weeks to recover those losses by August. After a late summer rally that peaked on 9/20/18, the second 2018 market correction has persisted for thirteen weeks, and remains under way.

Over the 19-year period 2000-2018, the average annual calendar-year peak-to-trough decline in the S&P 500 was 15.9%; yet the average annual S&P 500 gain was 4.5%. Over the 10-year post-Financial Crisis period of 2009-2018, the average decline was 12.5%, while the annual price return for the index was 12.5%. Given our view that economic fundamentals remain positive despite slowing growth rates and ongoing headwinds, we believe that U.S. equities are currently undervalued. **While the recent market declines are painful and create significant anxiety, we advise clients to remain focused on their long-term goals, which typically includes building a diversified portfolio across sectors and asset classes according to individual risk tolerance and investment parameters. An increase in market volatility should not negatively affect the ability of investors to reach those long-term goals.**

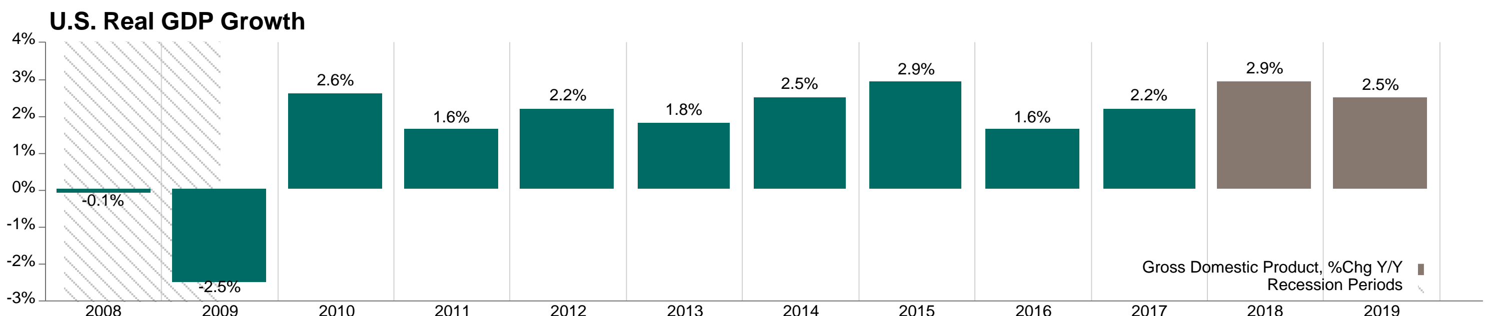




Data Source: FactSet, as of 12/19/18

The U.S. Economy was a 2018 Bright Spot

The U.S. economy has sustained GDP growth above expectations in 2018, while growth rates in Europe, China, and emerging markets have disappointed. Looking forward, growth expectations for 2019, including the U.S., have moderated, although remain well above growth trends in 2016 and 2017. The current growth cycle has been driven by healthy consumer spending and business investment. In October, the International Monetary Fund (IMF) reduced its 2018 and 2019 global GDP growth forecast to 3.7% from its +3.9% outlook in April. The modestly lowered outlook was attributed to trade concerns in the U.S. and weaker growth rates abroad. While we characterize a 3.7% global GDP growth potential in 2019 as relatively healthy, the IMF sees the balance of risks to the downside as monetary policy tightens, fiscal stimulus fades, and protectionism gains sponsorship around the globe. We look for 2019 U.S. GDP of at least 2.5% and believe that European GDP could stabilize after lower than expected growth in 2018.



2018 & 2019 data are the consensus estimates as of 12/19/18.

Data Source: FactSet

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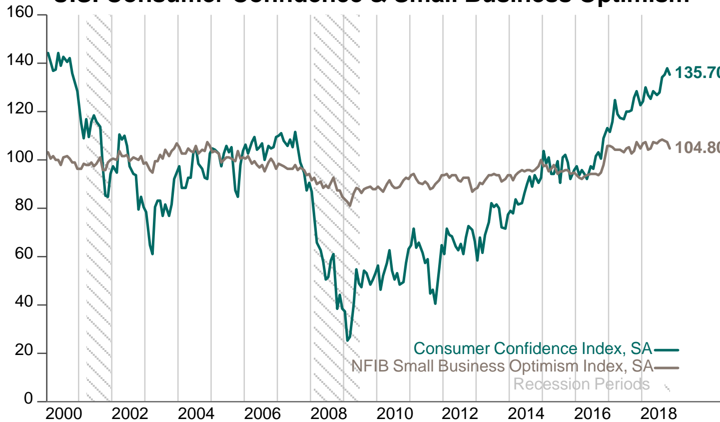
Global GDP Estimates

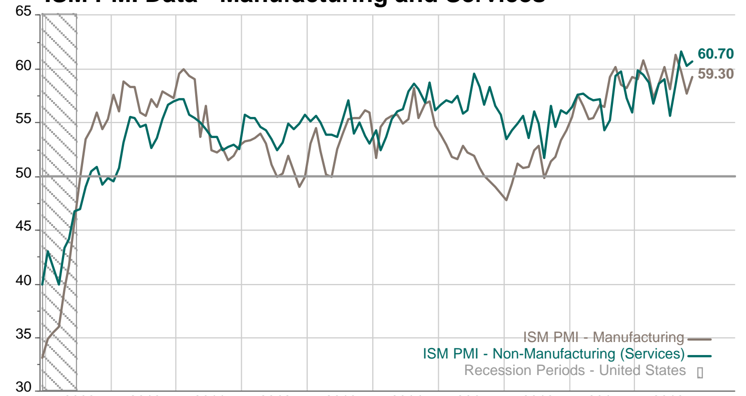
	2017A	2018E	2019E
Canada	3.0%	2.1%	1.8%
Germany	2.5%	2.5%	1.8%
United Kingdom	1.7%	1.3%	1.5%
France	2.3%	1.6%	2.2%
Italy	1.6%	1.0%	1.0%
China	6.9%	6.6%	6.2%
Japan	1.9%	1.0%	1.0%
South Korea	3.1%	2.7%	2.6%
Mexico	2.1%	2.1%	2.1%
Brazil	1.1%	1.3%	2.4%

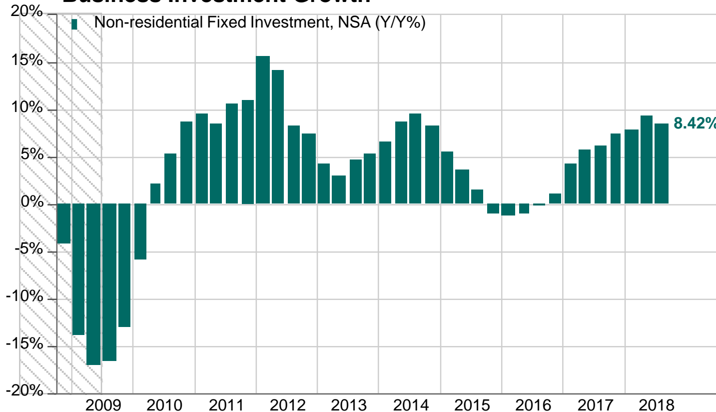
2018 & 2019 data are consensus estimates as of 12/18/18.

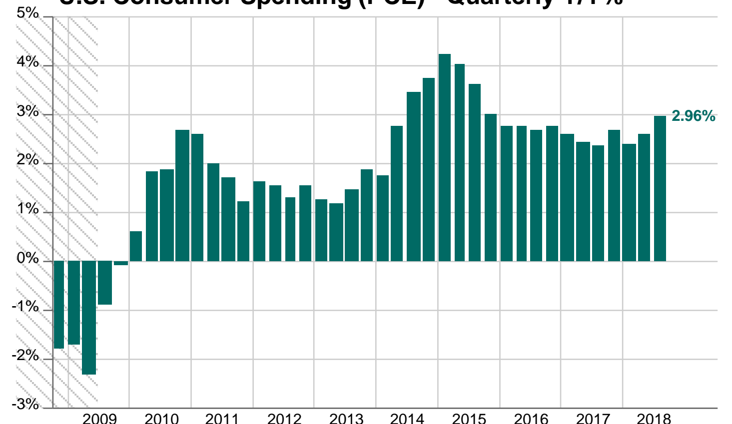
Data Source: FactSet

U.S. consumer and business confidence, purchasing manager surveys, consumer spending, and business investment remain at high levels. There has been much discussion in late 2018 about the potential for substantially slower GDP growth than the +2.9% expected in 2018. As of 12/19/18, the FactSet economist consensus estimate for U.S. 2019 GDP growth is 2.5%, and is actually up from +2.4% in September. While admittedly 2.5% growth would be lower than 2018, it is well above the anemic growth rates of +1.6% and +2.2% in 2016 and 2017, respectively. Despite a wide range of expectations for 2019 (even our D.A. Davidson Investment Summit Group's range was 2.0%-2.75%, which we discussed in our 12/18/18 Investment Summit note), we believe that 2.5% or higher is quite possible. This is supported by solid data including consumer confidence that has remained at decade-high levels, small business optimism that has levelled off at multi-year high levels, and manufacturing and services ISM PMI (surveys business intent of purchasing managers) which still suggests expansion. In addition, two of the major contributors to GDP: Consumer Spending (68% of GDP) and Business Investment (14% of GDP) have accelerated in 2018 and should continue to drive positive GDP data in 2019. Consumer spending drivers include employment gains (average monthly new jobs in 2018 of 206,000 vs 170,000 in 2017) and average hourly earnings up 3.1%, compared to +2.5% at the end of 2017. This has more than offset a drag from housing and automobile sales. Business spending growth is expected to moderate from 4-year high levels in 2018, but in our view will drive GDP growth due to business optimism and investment-friendly tax policy.









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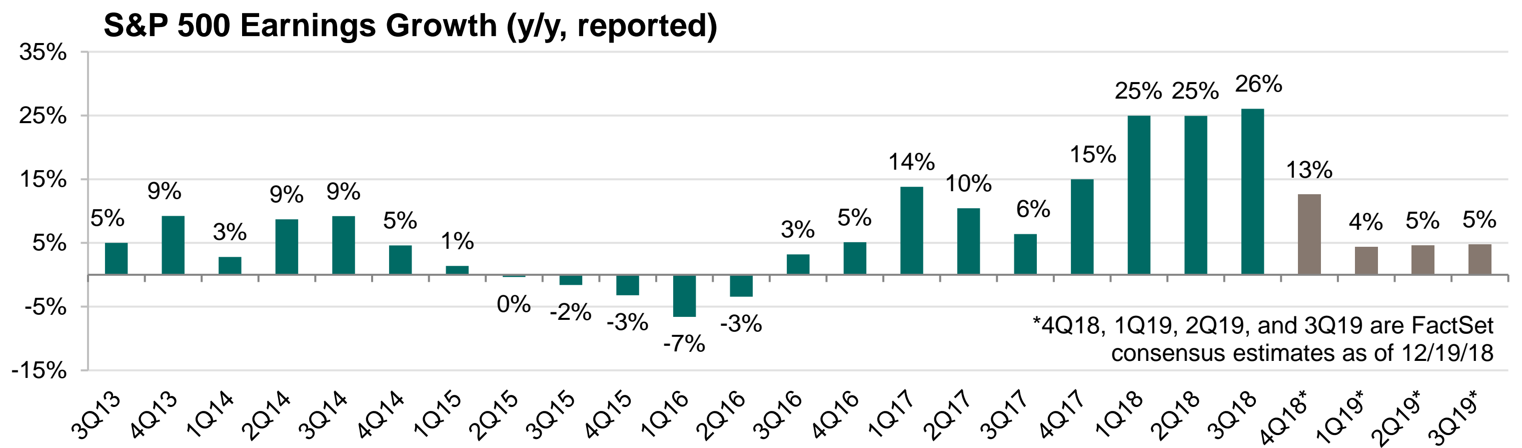
Double-Digit Percentage Earnings Growth Unlikely to Continue in 2019

S&P 500 y/y earnings growth increased 25% in Q1, 25% in Q2, and 26% in Q3 of 2018 as revenue and margins exceeded expectations and U.S. corporate tax reform added an estimated 7% to the growth rate. We expect continued earnings growth in 2019, but 2018's level of growth is not sustainable due to comparison against the huge 2018 numbers, moderating global GDP growth outlooks, and headwinds from a stronger U.S. dollar (a drag on foreign earnings) and lower oil prices. Earnings estimates have declined in recent weeks, both for 4Q18 and 2019. The FactSet consensus estimate for 4Q18 earnings growth is now 13%, compared to +17% in October and full year 2019 earnings are currently estimated to grow 8%, down from +11% in October, as analysts have lowered estimates due to both a more conservative view of global growth potential, and increasing cautious commentary from corporate executives. Earnings growth of 13% in Q4 would reflect the fifth consecutive (and seven of the last eight) quarters of double-digit growth. All eleven S&P 500 GICS sectors are expected to report higher y/y earnings growth in Q4 led by Energy, Financials and Industrials. Lower earnings estimates can be attributed to normal analyst estimate revisions, the accounting impact of a stronger U.S. dollar index (DXY) that is 5% higher since year-end, and the Q4 collapse in oil prices that will likely become a modest EPS headwind in 2019.

We acknowledge that the decline in earnings expectations is a negative for investor sentiment because in a pessimistic scenario, future earnings growth could turn negative. While we assign a low probability of negative earnings growth in 2018, it is possible that growth could fall short of already reduced expectations. A 4% earnings growth rate (rather than 8% expected) would take the S&P 500 forward P/E ratio, currently at 14.4x, to 14.9x, still below the long-term average, and supportive of higher equity prices in our opinion. Given our expectation for growth in S&P 500 earnings in future periods, we believe that U.S. equities are undervalued for long-term investors.



Trade Uncertainty and Tariff Threats Remain a Market Headwind

2018 was an active year for U.S. trade disputes as President Trump held active negotiations and threatened tariffs with Mexico, Canada, Europe, and China. China has been the most complicated due to its key role in the U.S. supply chain and large size as the 2017 U.S. trade deficit with China of $375 billion comprised 46% of the U.S.' total goods deficit. Despite several positive developments throughout the year, including a new U.S. Mexico Canada Agreement to replace NAFTA that should benefit the U.S. auto industry, and a truce with Europe regarding auto tariffs, the fear level for investors has remained high as the China dispute is unresolved and corporate CEOs have increasingly cited trade uncertainty as a threat to growth plans. The U.S. and China also agreed to a tariff truce, following a meeting between President Trump and President Xi at the G20 Summit in Buenos Aires. The truce will last 90 days, until 3/1/19, during which time existing U.S. tariffs on China goods will be held at 10%, and China agreed to reduce tariffs on U.S. cars, and begin purchasing more U.S. agricultural and industrial products. All of that sounds like good news, although investors are skeptical of meaningful progress in just 90 days and deeper discussion that are demanded by the U.S. to protect U.S. technology innovation and intellectual property. All of this was complicated by the early December arrest in Canada of a prominent Chinese corporate executive. The arrest was made at the request of U.S. officials for violating U.S. sanctions against Iran. It is unsure at this point how much this legal case could disrupt trade negotiations, but we view it as an additional headwind.

We believe that no parties want a full-blown trade war, but countries will fight to protect their interests and harsh rhetoric from President Trump will likely be matched by our trading partners. The President is aware that a tariff-driven trade war will punish many industries, possibly driving reduced capital investment, and he must know by now that an extended fight can damage investor confidence in a decelerating economy. But he also believes that the U.S. has the upper hand with most trading partners due to the size of the U.S. economy. Because of this we believe that the President is willing to let a trade war develop as it may increase his view of potential for a favorable agreement. The preferred outcome for the U.S., however, is a negotiated trade agreement with China, and we believe that remains the most likely result. A positive outcome with China represents a potential 2019 catalyst for equity markets.

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The Federal Reserve Raised its Fed Funds Rate Four Times in 2018

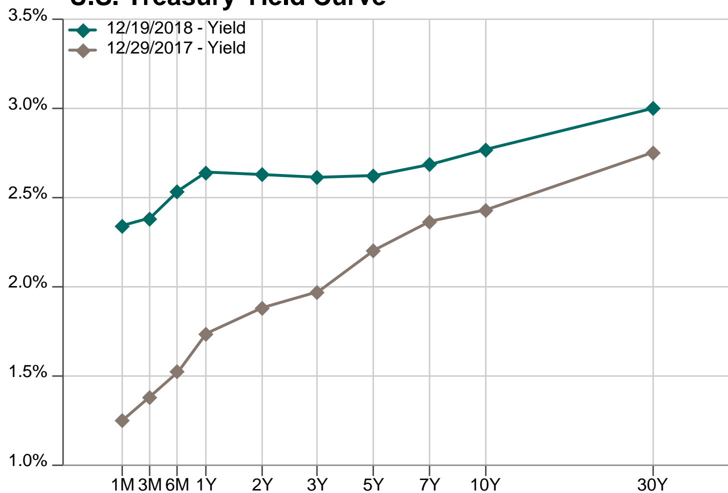
On 12/19/18 the Fed's Open Market Committee (FOMC) raised its fed funds rate by 25 basis points (bps). This was the fourth consecutive year of a December rate hike, but in 2018 the Fed raised rates four times, compared to three times in 2017, and one each in 2016 and 2015. This has represented a multi-year quest to "normalize" short-term interest rates following the zero percent level of rates enacted to combat the Great Financial Crisis of 2008. After nine 25 bps rate hikes since December 2015, the fed funds target range is 2.25%-2.50%, still very low by historical standards, and barely above the rate of inflation currently at 2.0%. The Fed also released its individual median estimates of expected GDP growth, inflation, and future rate increases and each was lower than the September 2018 meeting, the Fed's last projections update. The Fed also lowered its expectations for 2019 rate increases to two more, from three at the September meeting. This most recent meeting was one of the more eagerly anticipated meetings by investors in recent memory, because the current S&P 500 downturn intensified in early October after Fed Chair Jerome Powell said the short-term interest rates were "far from neutral," indicating that the Fed would follow a pre-planned rate increase path that would not adequately consider slowing economic data. In early-December Mr. Powell walked back those comments, stressing that rates were "just below neutral" and future hikes would be data-dependent (the "neutral" rate is the estimated rate that is neither expansionary nor restrictive to the economy). One question asked by investors after the latest hike, why did the Fed raise its fed funds rate if it sees lower GDP growth and lower inflation than it did previously?

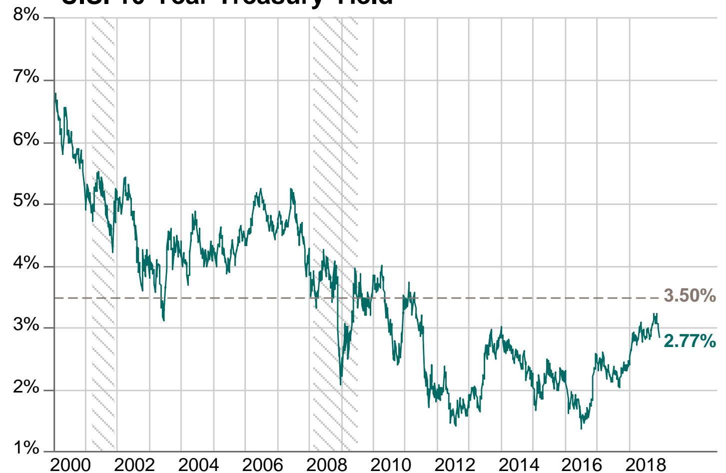
Investors' immediate reaction to the FOMC announcement was to sell equities and purchase long-term Treasury bonds. This resulted in significant volatility, including a 1.6% decline in the S&P 500 index and rally in U.S. 10-year Treasury bonds, driving the yield to 2.85% from 2.90%. Although the Fed largely telegraphed the December hike, many investors wanted a more dovish stance regarding 2019. The fed funds futures market is currently pricing in zero rate hikes in 2019, clearly below the two estimated by the Fed. Additional interest rate hikes in a rapidly decelerating economy could contribute to a recession, which is clearly the fear contemplated by investors. The combination of lower equity prices, higher short-term interest rates and lower long-term rates reflects the view that future GDP growth will be lower than the Fed's projections (+2.3% in 2019) and that short-term interest rates must be lower to stimulate growth. The Fed appears to be betting that the markets are wrong, and that GDP growth will remain robust. We also share that view, driven by an outlook for healthy consumer spending and business investment.

Federal Reserve "Dot Plot" as of 12/19/18 *

	2018	2019	2020
U.S. GDP Growth	3.0%	2.3%	2.0%
September projection	3.1%	2.5%	2.0%
Unemployment Rate	3.7%	3.5%	3.6%
September projection	3.7%	3.5%	3.5%
Core PCE Inflation	1.9%	1.9%	2.1%
September projection	2.1%	2.0%	2.1%
Year-End fed funds rate	2.4%	2.9%	3.1%
September projection	2.4%	3.1%	3.4%

**reflects the median estimates from Federal Reserve Board members and Federal Reserve Bank presidents* *Data source: U.S. Federal Reserve*





Data Source: FactSet as of 12/19/18

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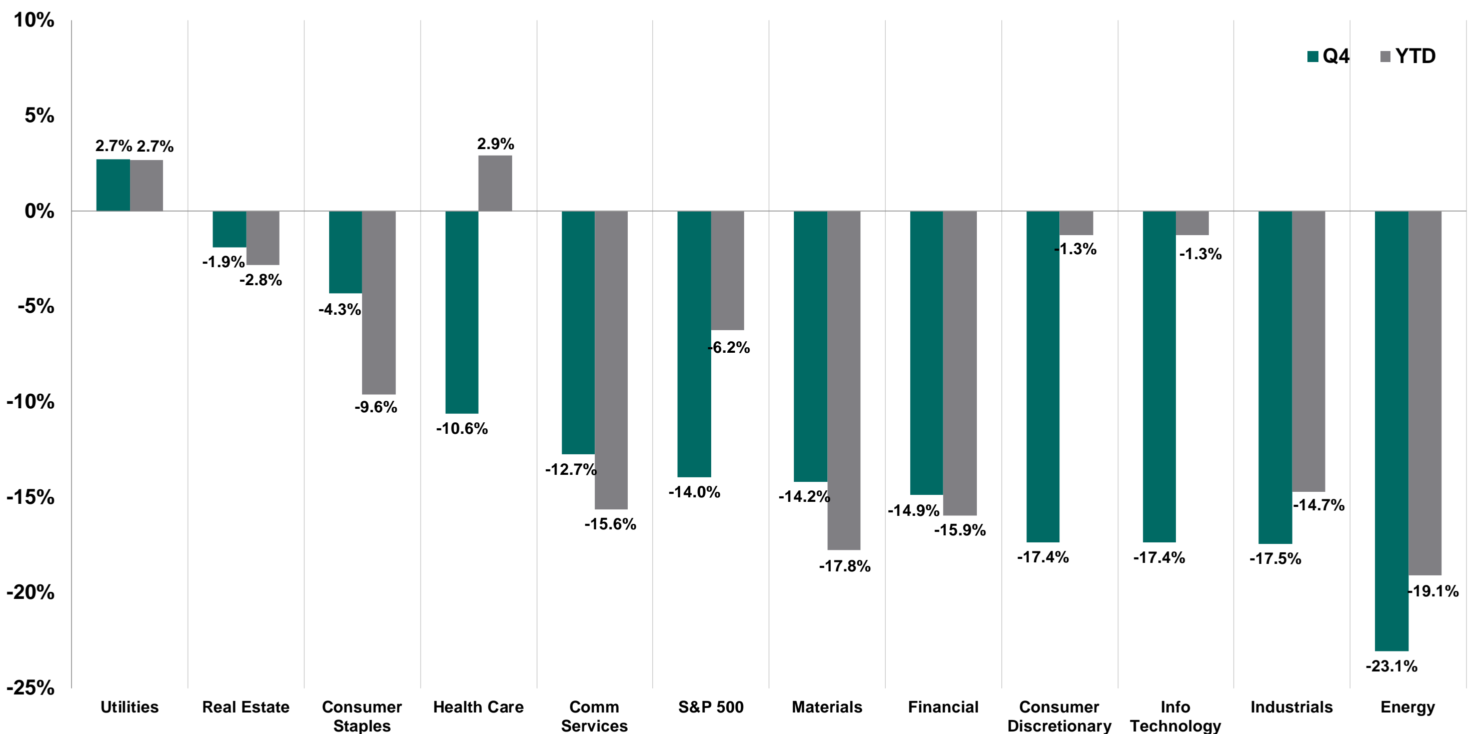
Interest Rates Were Higher in 2018; the Treasury Yield Curve Flattened

As of 12/20/18, the U.S. 10-year treasury yield was 2.77%. That compares to 2.43% at year-end 2017, and well below the 3.23% yield as recently as 11/8/18. Since that time, fixed income investors have become concerned about the future trend of U.S. GDP growth, and potential damage to the economy from continued Fed interest rate hikes. That has caused a continuation of the flattening yield curve that began in 2017. One year ago, the spread between the 2-year and 10-year Treasury yields was 52bps. As of 12/20/18 the spread has compressed to 12 bps (the 2-year yield of 2.65% and the 10-year at 2.77%). While the 2-year yield remains below the 10-year yield, it has traded modestly higher than the 3- and 5-year yields, stoking some investor concern, as historical yield curve "inversions" have accurately signaled future recessions. However, we are more concerned with inversions at the long and short-end of the curve, and a flat yield curve between 2-years and 10-years has a few times in the past persisted for many months without inverting. Despite the flat curve, many investors appear to dismiss the benefits that come from current rates that remain at historically low levels. We don't believe that a fed funds target rate of 2.25%-2.50% should put the brakes on GDP growth, and the 10-year yield of 2.75% remains significantly below the average yield since 2000 of 3.5%. We believe the current interest rate environment remains conducive to growth and to higher equity valuations. We also believe that if economic data does begin to decrease faster than expected, the Fed will follow its "data dependent" commentary and adjust its interest rate policy.

Double-Digit Declines in Cyclicals Headline Q4 Equity Returns, Defensives Offer Some Relief

With the S&P 500 index down 14.0% in Q4, there have been very few places to hide for equity investors. Defensive sectors, although down in December, have held their own in Q4, led by a 2.7% gain in Utilities, and a relatively modest 1.9% decline and 4.3% decline for REITs and Consumer Staples, respectively. Eight of the eleven S&P 500 sectors have dropped at least 10% in Q4, including a stunning 23% decline for Energy. For 2018 year-to-date (YTD) through 12/19/18, five sectors are down at least 15%, and Health Care and Utilities have remained positive. The Technology and Consumer Discretionary sectors have both declined over 17% in Q4, however but were down just 1.3% YTD.



Data Source: FactSet as of 12/19/18; price returns

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S&P 500 Sector Recommendations - 2019

GICS Sector	S&P 500 Weight by Market Cap	WM Research 2019 Outlook	Notes
Technology	19.9%	marketweight	diversify across sectors, consider value names
Health Care	15.8%	underweight	2017 was good, but we expect ramping political headwinds
Financials	13.7%	overweight	low valuations, strong balance sheets, patience required
Consumer Discretionary	9.9%	marketweight	consumer trends positive, but investors should remain diversified
Communications Services	9.9%	marketweight	be selective, some companies to face regulatory scrutiny
Industrials	9.4%	overweight	attractive valuations, could rally on positive trade news
Consumer Staples	7.4%	underweight	strong defensive appeal, could lag if GDP growth surprises higher
Energy	5.4%	marketweight	low valuations, stick with quality, would like to see oil turn
Utilities	3.1%	marketweight	strong defensive appeal, valuations rich
Real Estate (REITs)	2.9%	marketweight	vulnerable to rising rates, but rates have remained low
Materials	2.6%	overweight	attractive valuations, like companies with some pricing power

Data Source: D.A. Davidson Wealth Management Research

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