Market Outlook 2019
New Castle Investment Advisors, LLC

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OVERVIEW

As you likely notice, I have been updating clients more this year than any other time in the past decade. The reason is market volatility drives investor angst—which you undoubtedly feel this month in particular—and I have been trying to put the market sell-offs this year in a broader context. I said the market would get better after the election. I still believe this and feel my bullish sentiment this fall will be pushed forward into 2019.

The last five trading days of 2018 are likely to be volatile because trading volumes are light the last week of December, setting up an environment of heightened volatility. Pent up losses will also likely cause some traders to sell positions for tax reasons.

Where Are We Now—Extreme pessimism. Investor sentiment as gauged by the American Association of Individual Investors (AAII) is now approaching 50% bearish—its highest level since 2013. Furthermore, only 17% of U.S. investors as measured by the AAII feel stock prices will rise in value over the next six months—the lowest level since June 2016. Investors are now responding in kind. Weekly outflow from U.S. mutual funds ETFs in December are at record highs. Investors feel, "let me sell, stop the pain…"

Historic evidence shows bearish sentiment is not a leading predictor of future returns. It typically is a contra-indicator, meaning individual investors predictably buy when the market is already going up and sell when it is going down, leading to sub-par portfolio performance. Of late, it's been an unusually difficult time for stock investors, but I believe recent volatility has the classic underpinnings of a short-term, emotionally-driven correction. When volatility hits hard, this fast, it can be interpreted as a bearish trend within a bullish cycle. Typically, when a secular bull market turns into a long-term bearish one, the trend is not as violent as the period we are now witnessing—it rolls downward over many months.

The current bearish trend should be characterized as a cyclical bearish trend in a longer-term bullish cycle. Such sell-offs are typical in a long-term bull market. Historically, in situations like we are now witnessing, it is better to remain calm, focused on the long-term. Periods of extreme investor pessimism are usually followed by above-average market returns 6-12 months out. I cannot tell you what the bottom will be but I can tell you the market should be higher next year at this time. Your patience will be rewarded.

Economy/Market Today

I can present pages of statistics, weighing both the positives and negatives of the economy and market—politically, economically, etc.—but consider we have strong job growth in the U.S., inflation is at bay, savings rates remain high, consumers are spending, corporate and bank balance sheets are strong, earnings growth while slowing is still increasing.

But we have trade tariff concerns, Brexit, Italy, FED rate hikes, government shut-down, Mueller-Trump—the news is constant, unrelenting and mind-numbing. The facts remain U.S. GDP grew at an annual pace of 3.5% during the 3rd quarter; the job market is strong, with the economy adding 155,000 jobs last month--monthly job growth averaging a strong +200,000 the past six months; wage growth is accommodating increased consumer behavior; interest rates have increased at a rapid rate the past three years, but real interest rates remain historically low and the FED has likely stopped raising rates for the foreseeable future.

There is little doubt chaos is now extreme in the Trump White House. But in a historical context, a Democratic House should help to constrain some of the Trump impulses. Furthermore, looking back almost 100 years, the third year of a presidential term is typically a strong year, up about 17% on average. In fact, looking back almost 100 years, market returns following the mid-term election of the third term of a presidency have been positive over 90% of the time.

Yes, one can argue President Trump is (to say the least) an unusual president—and if 2019 is a negative year market-wise, it will likely be because of the president's mercurial style—but using history as our judge, it would seem imprudent to over-react to today's extreme market sentiment and let it be the determinative factor in portfolio construction.

2019 Market Forecast

The forward-looking P/E for the S&P 500 is now below 14, lower than its historic average. S&P 500 earnings next year should be around 175, with the index finishing 2019 at least 2850 and likely higher, meaning returns of 15-20% higher from here.

Market-wise, 2019 should be much better than 2018. While the year is likely to start with U.S. and global stocks continuing their current short-term cyclical bearish trend, the lows should be reached by the end of the first quarter. Expect continued volatility and wide daily swings. This is happening for two predominant reasons: first, the FED and other global central banks are unwinding the liquidity injected into the economy for most of the past decade, and the change can be disruptive The second reason—in my judgement—is the unusual and unpredictable political moves of President Trump. The U.S. remains the powerhouse when it comes to the global economy, but tariff wars, policy upheavals, presidential tweets, and military moves, etc., all create doubt and doubt is not what the market likes.

Unlike past bearish sell-offs post the Great Recession, the magnitude and scope of the current one could result in increased investor panic and selling capitulation. What does that mean? It means there are now more sellers than buyers and the sellers have to "capitulate," meaning those who have been contemplating selling do so, leaving an even more over-sold market and only buyers remaining.

What will likely be the catalyst(s) to bullish sentiment? Policy-wise it could be a combination of Brexit resolution and China-US trade resolution (of some sort), but the actual catalyst will likely be the one factor that beyond all others drives the market: corporate earnings. The late December 2018 tax cuts led to US corporate earnings growth exploding over 20% in 2018—highly unusual, particularly this late in an economic cycle—earnings growth should slow to a growth rate more like 5-8% in 2019. Certainly, higher wage rates and debt costs will impact corporate profit margins but share buy-backs and an improving world economy (back-loaded to the second half of 2019) should offset relative slower corporate earnings growth.

Expect uncertainty and volatility to continue into 2019, and it could well get worse before getting better, irrespective of short-term market rallies. Expect mid-range double digit returns for 2019. Oil prices will remain low. Brexit and global trade issues are certainly outliers and a negative outcome in either or both will roil the global economy, placing this outlook at risk.

Having said that, probability should dictate mild resolution in both. Consider that one of the prime reasons the third year of a presidential year is above average in return is the incumbent has already undertaken what policy initiatives was intended from the campaign, and 2016-2018 witnessed a Republican majority in Washington—2019 will be different politically and there is every incentive for the current administration to resolve the current China tariff issue. Not doing so, would likely lead to a recession, causing the president not to be re-elected. Policy risks/mistakes were likely the main cause behind the 4th quarter market sell-off. Not only the president (particularly his handling of trade issues) but also the Federal Reserve, most pointedly Chairman Powell, who made substantive verbal gaffes—somewhat typical of a newly installed FED chairperson. Powell's October comment on interest rate increases not being near done set the tone for the fall market sell-off. You will recall my email Tuesday of last week about the FED's interest rate announcement of December 19th. In my judgement, not only was a rate increase unnecessary at this time but more importantly he did not take a more "dovish" view of interest rate increases in 2019. His remarks and lack of full clarity resulted in the huge market sell-off Wednesday afternoon-Friday.

I see U.S. GDP slowing in 2019 to 2.8%. Global GDP will likely be in the range of 3.5%. Value stocks will do relatively better the first part of the year, but growth-oriented equities will once again kick into gear—think technology. Health care stocks will also likely outperform on a relative basis. Large cap stocks will outperform smaller ones, but mid and smaller cap equities should remain in most client accounts.

The developed world, particularly Europe, has underperformed this year but international stocks are now undervalued relative to their U.S. counterparts and in economic parlance should "mean revert,' or increase more than U.S. stock valuations over the next 18 months.

Emerging market equities (and debt) are historically very under-valued and now present buying opportunities for many client accounts. I will keep emerging market equities in most accounts but even though EM debt looks tempting, the volatility is too pronounced for most clients at this time.

The credit markets will also remain volatile. For example, it was only late last summer that 10-year treasuries started approaching 3.25%. Such rates are now down some 50 basis points as of this writing—that is a big shift in such a time frame, largely driven by increased market anxiety as well as the parallel feeling we all must be missing something and the world economy is about to tank. Putting aside my own view there should have been a pause last week in interest rate increases, the FED has more access to global economic data than any other financial institution, and the fact short-term rates went up once again is indicative the FED at this juncture feels there is likely a greater risk of the economy overheating than stalling or falling.

Expect the 10-year U. S. Treasury to hit 3.25-3.50% next year. The yield curve will likely remain relatively flat, with short term rates increasing at a faster rate than longer-term debt. It is possible at various times in 2019 the curve could actually "invert," whereby short-term rates could be higher than longer duration dated debt, but such an occurrence would likely be in the 1st quarter 2019. If it does happen, TV talking heads will say that means we are headed for a recession. Yes, in most instances when the yield curve inverts that leads to a recession a year or so down the line, but it has to stay in that mode for a period of time for it to be of predictive value and it will be the ten year treasury inverting, not shorter duration bonds.

In the near future, I intend to keep raising some cash and going further into bonds and CDs. I have kept bond durations lower, meaning 1-3 years out, because yes, in the short run, longer dated bonds could present opportunities, but with short term rates relatively good relative to say 20- or 30-year bonds, the yield differential does not warrant longer term exposure at this time. I would rather have cash or near-cash so as to be opportunistic when the time warrants. Also, I think it also better to be cautious when judging a one-year bond to say a 30-year bond, particularly when the current bond bull market started some 40 years ago, and we remain in an increasing yield environment.

Conclusion

Don't panic. And don't overact to the news, the president, whatever the issue of the day. We have been in market downturns before, but consider the market has been up over 70% of the time. The sky is not falling. Yes, it is possible a serious policy mistake—like trade—could mean another down year but your portfolio has dividend paying stocks, it's diversified and not concentrated in sectors or individual stocks.

In concluding, think about this presented by the Washington Post last week: Between March 2009-September 2018, the largest 500 U.S. companies grew some $19 trillion in market value and paid out over $3 trillion in dividends. Together, that is about the current level of U.S. federal debt of $21.9 trillion. In the past three months, the S&P 500 has lost some 16% in value, or $3.7 trillion. Had you been in cash the past ten years or even bonds, you would not have the market value you now have. Also, in the past ten years, there have been market sell-offs, economic slow-downs, and policy mistakes. Your portfolio is not a measure of today's news or angst. It is long-term looking.

A new short-term cyclical bull market will likely kick in sometime during the first half 2019 and be a countenance of the longer-term secular bull market that started in March 2009.

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This Market Outlook is not a recommendation to purchase or sell any securities or investments and is the opinion of its author at this time.