BERNSTEIN

OUR 2019 OUTLOOK

2018 started with the continuance of a 14-month market uptrend and extreme calm. Now with just one month left in the year, we've seen a change; there's been a resurgence in volatility and a market sell-off of over 10% since the S&P 500 hit an all-time high in mid-September. As we think ahead to 2019, we consider the factors that will influence the financial markets and answer the question on the minds of many investors: Will 2019 bring the agitated markets of the fourth quarter, or a return to January's calm?

FORMULATING OUR EXPECTATIONS

In forming our thoughts for next year, we gathered forecasts from across our firm—perspectives from our economists, portfolio managers and analysts on the expected key market drivers for the next 12 months. Before we discuss these factors, it's important to point out that our investment thesis does not change when we ring in a new year. Our expectations are continually formulated and adjusted based on a long-term time horizon; we do not invest nor do we base our strategic asset allocation on a one-year time frame. With that said, we do take into account short-term outlooks and may make tactical changes based on these beliefs.

RINGING IN 2019 WITH SLOWING GLOBAL GROWTH AND HIGHER VOLATILITY

Our expectations for the global economy continue to be decelerating growth and more volatile financial markets. This viewpoint stems from continued, steady increases in inflation, modestly higher interest rates in the US, and further trade uncertainty. Let's discuss each in turn.

Bracing for higher prices

When the economy is doing well, prices for finished goods, raw materials, and labor, among others, tend to rise.

Concern about inflationary pressures has prompted the Federal Reserve to increase interest rates with the objective of staving off significant price inflation. This is a normal response to a strong economy. Inflation, as measured by core CPI, has been gradually increasing over the last 12 months (*Display 1*), and we expect it will continue to rise moderately next year. We forecast inflation will increase to around 2.5% by the end of 2019. This is a modest increase, and by itself, is not worrisome. But as we mentioned, the Fed is extremely focused on keeping the economy and inflation on a steady trajectory.

Rate hikes forge ahead

With inflation increasing at a moderate, yet steady rate, we expect the Fed will stay on their rate hiking path. We are forecasting four rate hikes in 2019 in addition to one later this month. Our four-hike projection for next year is above many forecasts; in fact, the market is pricing in one to two hikes, and the Fed has, as of their latest projection, suggested three for next year. Our more aggressive forecast is grounded in our belief that steadily rising inflation will necessitate a stronger response. That said, with the recent decline in oil prices, we think the risk to our forecast is to the downside with four being the upper end of the likely range.

Display 1

CORE CPI HAS MOVED STEADILY HIGHER RECENTLY

Year-over-Year Percent Change

Through October 31, 2018
Source: Bloomberg

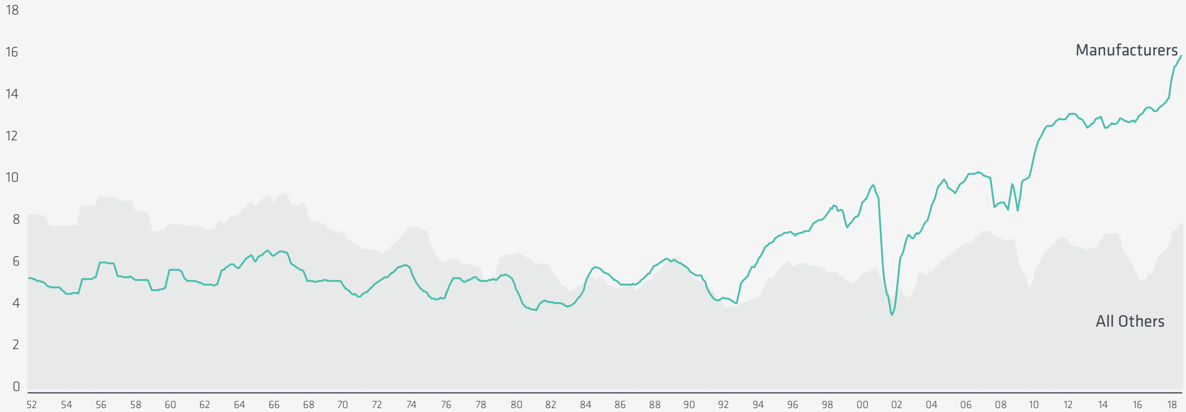
But this Fed action only targets short-term interest rates. We believe long-term rates will also rise next year, but to a lesser extent. Today the 10-year Treasury is yielding around 3.0% and we think it will move up to around 3.75% by the end of 2019.

These higher interest rates across the entire yield curve, in part, will tighten financial conditions in the US. While tighter financial conditions will hinder the ease with which transactions across businesses get done, we don't believe they will be restrictive enough to push the US into recession—just merely slower growth. Our GDP forecast for 2019 is 2.25%, down marginally from the 2.5% expected this year.

Display 2

PROFIT MARGINS MAY HAVE PEAKED

S&P 500: Net Profit Margins* (Percent)



Through September 30, 2018

*Based on trailing four-quarter data excluding financials. Smoothed on a trailing three-month basis.

Source: Corporate reports, Empirical Research Partners analysis

Trade disputes persist

Despite this weekend's seemingly fruitful discussions at the G20 meeting, we believe investors should ready themselves for prolonged trade disruption. The uncertainty that accompanies this disruption will not ease any time soon, in our opinion, as we expect populist movements to remain for years to come. By extension, the benefits of globalization may have peaked.

Populism, as a political ideology, is gaining traction all over the world, not just here in the US. And populism tends to be more insular than integrated. This attitude should cause a turnabout from the globalization movement that characterized markets for the past few decades. Now, instead of finding the cheapest or most efficient source of raw materials, labor, or transport worldwide, this sourcing arbitrage will be challenged. Populism affects trade, but more importantly, it impacts profitability for corporations.

Profit margins have expanded since the early 1990s, particularly for manufacturers—a big part of that due to globalization, and the ability to procure the lowest-cost provider of some good or service (*Display 2*). Disruption to this globalization framework as populism rises should be margin diminishing.

SO, WHAT'S IT ALL MEAN?

The confluence of higher inflation, rising rates, and trade tensions together with fading positive market drivers from this year will reduce earnings growth in the US next year. Earnings growth for US companies in 2019 is expected to be around 9%, down from around 20% in 2018, a pace more in line with expectations for companies outside of the US.

Keep in mind, though, that the US economy and economies throughout the world are still solid and will continue to grow next year. While there are challenges (there always are), the data do not suggest a recession is on the horizon. Returns for any short period, like 12 months, are always impossible to forecast accurately with consistency, but the conditions we've laid out above lead us to conclude that financial markets should remain somewhat volatile. It's in this environment that greater-than-normal diversification is warranted and thoughtful research is rewarded.

CAPITAL MARKETS UPDATE

US and Emerging Markets Bounce in November

Stocks	**November 2018**	**YTD**
US	2.0%	5.1%
Int'l Developed Markets	(0.1)	(9.4)
Emerging Markets	4.1	(12.2)
Bonds		
Municipal	0.6%	0.4%
Taxable	0.6	(1.8)
Alternatives		
Hedge Funds	(3.0)%*	(2.1)%*
Commodities	(3.3)	(5.9)
Real Estate	3.7	(0.1)

Past performance is not necessarily indicative of future results.
There is no guarantee that any estimates or forecasts will be realized.
US stocks are represented by the S&P 500 Index; international developed-market stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of developed markets in Europe, Australasia, and the Far East; emerging-market stocks by the MSCI Emerging Markets Index; municipal bonds by the Lipper Short/Intermediate Blended Municipal Fund Average; taxable bonds by the Bloomberg Barclays US Aggregate Bond Index; hedge funds by the Hedge Fund Research Inc.'s (HFRI) Fund of Funds Composite Index; commodities by the MSCI ACWI Commodity Producers Index; global real estate by the FTSE EPRA/NAREIT Developed Index. An investor cannot invest in an index. These figures do not reflect the deduction of management fees and other expenses an investor would incur when investing in a fund or separately managed portfolio. See "Information About MSCI" at the end of this report.
*October 31, 2018
Source: Bloomberg Barclays, FTSE, HFRI, Lipper, MSCI, S&P, and AB

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