



2019 Market Outlook

January 2019

At the beginning of each year, we outline our expectations as we look forward. In July 2018, we raised a flag of caution with our [Five-Themes Mid-Year Update, Mounting Pressure](#). While we make no claim in our ability to forecast market conditions only six months forward, the end of the year did validate our warning to some degree and a more cautious risk-taking approach was prudent as economic expectations moderated.

2019 Outlook	Key Observation	Portfolio Impact
Growth Remains, but on Less Stable Footing	With fewer tailwinds, the pace of economic growth should wane, which may weigh on corporate earnings estimates.	Investors looking for a repeat of recent high returns and low volatility may need to reset their expectations to a more moderate return level and higher volatility.
Slowing Separation	With global policy divergence slowing, the U.S. dollar is less likely to continue its march higher.	U.S. fixed income and foreign assets become more attractive than they would be otherwise.
Volatility is Back	Asset prices will likely be more sensitive to incremental information, causing short-term volatility.	Low volatility may have lured some investors into believing their ability to tolerate risk is higher than it may actually be. Investors may consider revisiting their risk/return objectives with this in mind.
Be Cautious of Credit	The lower quality investment grade market today may not provide as much protection as expected and non-investment grade markets could struggle.	More tempered allocations to credit and thoughtful utilization of active bond managers to navigate the level of quality in today's market are prudent adjustments.
International Developed and Emerging Markets Remain Attractive	Foreign markets are more attractive today than U.S. based assets and offer an opportunity to enter or add to the asset class at reasonable valuations.	Thoughtfully add to allocations to take advantage of opportunities outside of the U.S.

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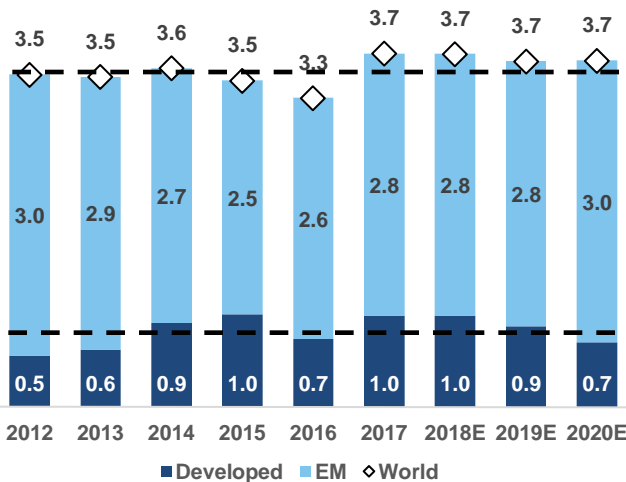


Growth Remains, but on Less Stable Footing

The sideways global economic growth trend in place since 2012 is likely to continue, however our expectations are that this occurs on less stable footing. As benefits from U.S. fiscal stimulus (tax reform) wane and global central banks signal less accommodation, equity growth will come to rely more on the earnings of companies than external factors. The global economic growth outlook appears resilient but with three primary headwinds mounting:

- 1) **Tighter Financial Conditions** – Rising U.S. short-term interest rates and the shrinking of the Federal Reserve balance sheet will both lead to tighter U.S. monetary and fiscal conditions which can weigh on global economic growth and create a more challenging backdrop for business activity.
- 2) **Trade Tensions** – While there are always winners and losers in trade negotiations, more tariffs result in lower economic growth and less consumption globally. After 10 months of negotiations, trade tensions between the U.S. and China remain largely unresolved. The duration of these trade disputes signals the distance between two largest nations and will result in greater uncertainty.
- 3) **Risk to Profit Margins** – Rising interest rates and wages can slow the pace of profit margin expansion and make it difficult for some businesses to sustain current profit margins. Nevertheless, falling margins do not mean negative growth, but rather a more tepid earnings growth outlook and tighter business conditions.

Sideways Economic Growth



Source: Bloomberg World GDP Growth

Profit Margin Growth



Source: Bloomberg S&P 500 Index Trailing 12-month Profit Margins

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Key Observation – With fewer tailwinds, the pace of economic growth should abate and may weigh on corporate earnings estimates and fuel bouts of short-term volatility as investors react more dramatically to companies missing or beating consensus estimates.

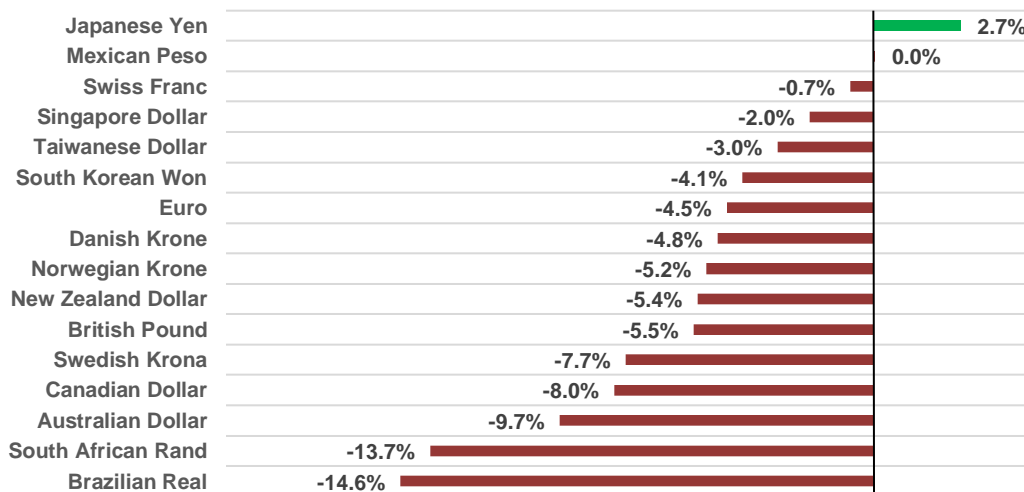
Portfolio Impact – Investors looking for a repeat of recent high returns and low volatility may need to reset their expectations to a more moderate return level and higher volatility more in-line with long-term history. While equities remain a key asset in portfolios, we do not recommend investors extend to riskier portfolios at this point in the cycle.

Slowing Separation

As outlined in our [2018 Mid-Year Update](#), we believed the persistence of divergent policies among central banks would decrease as global growth either: (1) accelerated and would force foreign central banks to tighten or (2) decelerated and would cause the Federal Reserve to pause its rate hike campaign. With global growth risks increasing to the downside and inflation within the Fed’s target range, we believe the latter is more likely and in process today. Consequently, we expect the Fed to slow or stop its rate hike campaign and/or reassess its balance sheet reduction program in 2019.

The differences in interest rate policies globally can impact the strength or weakness of the U.S. dollar. If U.S. interest rates are high compared to the rest of the globe, international savers will flock to U.S. markets and further strengthen the U.S. dollar. However, if that divergence slows or stops the likelihood of continued strength is lower.

The U.S. Dollar's March Forward



Source: Bloomberg, Trailing One Year Currency Returns Relative to U.S. Dollar

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Key Observation – With global policy divergence slowing, the U.S. dollar is less likely to continue its incessant march higher creating opportunities among various asset classes.

Portfolio Impact – The U.S. slowing or stopping its rate hike campaign has two primary impacts; both U.S. fixed income and foreign assets become more attractive than they would be otherwise. This provides the opportunity for investors to shade away from risk by owning more high-quality U.S. fixed income while also taking advantage foreign assets that have a more positive outlook than their U.S. counterparts.

Volatility is Back

Following a number of abnormally steady years for global equities, volatility rose materially in late 2018 to a more normal historical level. Looking into 2019, we believe there are two key reasons why volatility is likely to persist rather than dissipate:

- 1) **Scarcity of Growth** – If economic growth does in fact slow, investors will likely give more credence to incremental information impacting the growth outlook. News on trade negotiations, the Federal Reserve changing its stance on neutral interest rates and company earnings results are likely to become data points with greater focus potentially causing larger short-term swings.
- 2) **Political Uncertainty** – Brinkmanship between political parties in the U.S. resulting in the U.S. government shutdown, the European Union and Italian government on budget negotiations, ongoing Brexit debates and the yellow vest movement in France are just a few examples of political uncertainty that may adversely impact asset prices.

Frequency of Market Pullbacks (S&P 500 Index, 1928 - 2017)

Drawdown	Historical Frequency	Typical Occurrences Per Year	Typical Recovery Time
-2%	Often	18	1-4 weeks
-3%	Once per Month	11	2-6 weeks
-5%	Once per Quarter	5	2-3 months
-10%	Once per Year	1	8 months
-20%	Once per Market Cycle	0	20 months

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Source: Standard & Poor's. Returns are based on price index only and do not include dividends. For illustrative purposes only.

Key Observation – Asset prices will likely be more sensitive to incremental information causing short-term volatility. Short-term volatility should not be confused with a decline in asset prices, but should caution investors to avoid the temptation to react to short-term news.

Portfolio Impact – Low volatility of years past was an anomaly by historical standards and may have lured some investors into believing their constitution for risk was higher than it may actually be. Investors surprised by recent market volatility may take the opportunity to reassess return and risk objectives in their portfolio. Additionally, as asset price volatility rises and investors discriminate more amongst investments, such an environment should benefit more broadly diversified portfolios compared to those that are focused with fewer assets.

Be Cautious of Credit

Low interest rates and other unprecedented accommodative policies were used as a tool by global central banks to stimulate the global economy in 2008. However, this did not come without unintended consequences. One such outcome was the boom in the use of debt by corporations. While many high-quality borrowers rightly issued debt at very low costs to invest back into their businesses, many other once high-quality business took on much more debt to participate in mergers and acquisitions and lower quality borrowers had no issue refinancing or issuing new debt. Our word of caution for credit is centered on three primary factors:

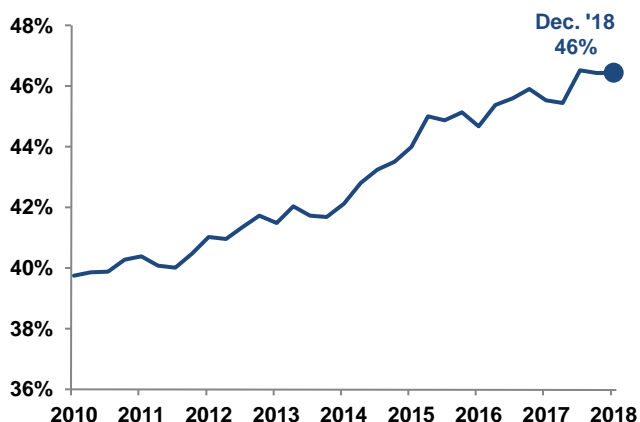
- 1) **More Debt** – Since 2015 the corporate bond market has grown by \$1.8 trillion dollars, which is a 45 percent increase in three years¹. While the economy has also grown over that time period, debt growth has outpaced economic growth as indicated below showing us the use of debt extends beyond a growing economy. This indebtedness of corporations is meaningful to investors because it may not only affect a corporation's ability to payback lenders, but in the instance of default it can affect the amount investors should expect to receive after bankruptcy proceedings. Each of these are important factors in building return expectations for non-investment grade debt.
- 2) **Quality Backslide** – Debt rating scales run from AAA (the highest) to CCC (the lowest) with the lowest investment grade rating being BBB. In the latest debt boom, an interesting pattern has emerged in which many companies issued debt, and by doing so likely lowered their credit quality. However, credit quality rating from rating agencies have piled up just short of non-investment grade status. Today 41 percent of all bonds are rated BBB, up from 27 percent 10 years ago. This tells us that the quality of the investment grade bond market as a whole has dropped and investors should account for this risk accordingly. We also believe that rating agencies have given greater latitude to companies and perhaps fallen prey to the same motivations that caused many issues with debt ratings leading up to 2008. For such a wave of debt to run right up to the line of non-investment grade but not over is significant in our view and improbable without relaxing standards.

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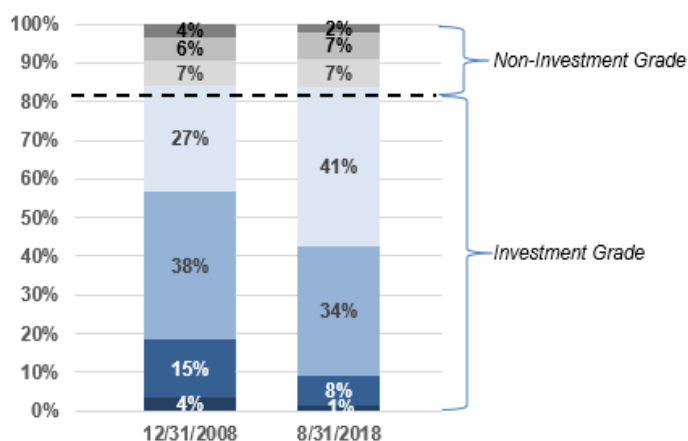
- 3) **Kicking the Can** – In the last decade, non-investment grade companies reaped the benefits of low-cost funding afforded to them by extraordinarily low interest rates and investor appetite for yield. Those benefits have begun to reverse as the Fed seeks to normalize monetary policy and these companies must roll outstanding debt at higher interest rates.

Debt Growth Outpaced Economy



Source: Bloomberg, U.S. Corporate Debt (percent of GDP)

The Migration of Investment Grade Debt



Source: ICE Data Services

Key Observation – With downside risks to economic growth emerging and higher interest rates, investment- and non-investment grade corporate debt, should be evaluated with greater skepticism. Today, lower-quality corporate bonds, within the investment-grade market, constitute a greater proportion of the investment grade market and may not provide less downside protection during volatile periods. The non-investment grade market may struggle to refinance debt at attractive interest rates given higher financial or operational leverage.

Portfolio Impact – More tempered allocations to credit and thoughtful utilization of active bond managers to navigate the level of quality in today’s market are prudent adjustments.

International and Emerging Market Equities Remain Attractive

Investor confidence in international, and in particular emerging markets, took a hit in 2018 as two years of double-digit returns reversed course sharply in 2018. Continued concerns over trade negotiations, strength in the U.S. dollar, political uncertainty and slowing global growth weighed on foreign stocks. However, we believe renewed allocations to international assets in the face of this uncertainty provide an opportunity for the following reasons:

- 1) **Valuation** – Emerging markets traded down nearly 15 percent in 2018 making them the least expensive they have been since December 2011. This is a strong case for inclusion or additional weight in a globally diversified portfolio for the long-term investor. As a result, our forward-looking assumption for emerging

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markets rose year-over-year and now stands as one of the most attractive global equity markets over the next 10 years.

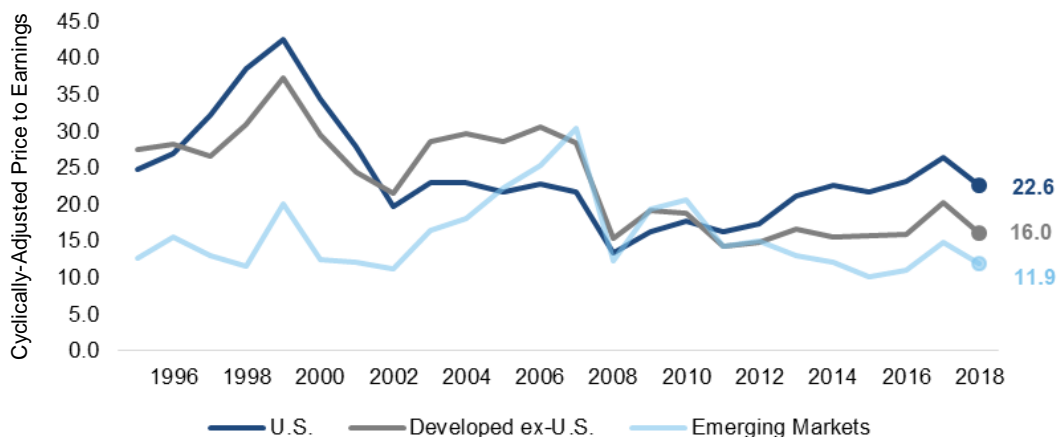
- 2) **Growth** – Over the last five years, emerging economies have accounted for approximately 76 percent of global economic growth² as their current state of development often leads to better demographic and growth profiles than developed nations. This relative benefit works to the advantage of long-term investors willing to allocate to these markets.
- 3) **U.S. Dollar Likely to Slow Advance** – The U.S. dollar has been a large headwind for investments outside of U.S. bonds. As we noted in our outlook regarding slowing policy divergence, we believe the likelihood of a repeat performance in the strength of the U.S. dollar is low and falling given the Fed’s slowing rate hiking campaign.

Asset Class	2018-2027 Expected Annual Return	2019-2028 Expected Annual Return	Change 2019 vs. 2018
U.S. Equity (All Cap)	5.9%	6.2%	0.3%
International Developed Equity	6.9%	8.0%	1.1%
Emerging Markets Equity	8.9%	10.3%	1.4%

Source: DiMeo Schneider & Associates, LLC 10-Year Capital Market Forecasts (2019-2018)

Current Equity Valuations

Lower valuations outside of the U.S. offer opportunity for long-term investors.



Source: Bloomberg. DiMeo Schneider & Associates, LLC 10-Year Capital Market Forecasts (2019-2018)

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Key Observation – Foreign markets are more attractive today than U.S. based assets and offer an opportunity to enter or add to the asset class at reasonable valuations. However, valuation, growth and currency movements are not short-term catalysts and should be considered with a long-term time horizon.

Portfolio Impact – We recommend thoughtfully adding to allocations to take advantage of opportunities outside of the U.S.

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