2019 Economic and Market Outlook: Not a Bad Place to Be

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As we approach year-end, we find ourselves in unfamiliar territory. Over the past several years, despite mounting worries about politics and other issues over the past several years, the economy—and the stock market—have kept growing. In the first half of 2018, the markets were moving higher, albeit with a few breakdowns, and economic growth was accelerating. People were increasingly confident, believing the worst was behind us. It seemed we had finally found a safe place after the heartaches and losses of the financial crisis.

Now, that story seems to be changing. Growth has slowed, and leading sectors—housing, in particular—appear to be rolling over. Spending growth has slowed as well, even though consumer and business confidence remain high. This slowing economic data has been accompanied by a decline in investor confidence, with an October market pullback that extended into November and December. The path ahead looks less clear than it did only a few months ago.

Although growth may be slowing, we *are* still growing. In fact, the most reliable leading indicators are signaling that we may keep doing so for the next several quarters—probably throughout 2019. When the fundamentals are solid, market volatility typically resolves quickly, as we have seen several times before in this cycle.

By the Numbers: 2019 Expectations

- GDP Growth: 2%–2.5%
- Inflation: 2%
- Federal Funds Rate: 3%–3.5%
- 10-Year U.S. Treasury Yield: 3.5%–4%
- S&P 500 Index: 2,900–3,000

There are risks, of course, but they are more political than economic. And even the real political risks have not been as damaging as feared. Turmoil in Europe—from both Britain and Italy—has so far failed to derail markets. Likewise, the political turbulence here in the U.S. has not prevented markets from reaching new highs. Similarly, despite all the worries about tariffs, strong economic fundamentals have allowed us to sail through the market storms, and this is likely to continue to be the case.

What, then, does this mean for the economy and markets in 2019?

Economic growth. For the economy overall, things have slowed a bit since the start of 2018. Consumers are still spending, but businesses are investing less. Also, while government spending growth is likely to continue, it won't accelerate, and trade is likely to be a drag. This should leave 2019 growth at around 2 percent to 2.5 percent on a real basis.

Inflation and interest rates. Despite continued economic growth, inflation has remained moderate through 2018, and the most recent data suggests that it is unlikely to accelerate much further in 2019. Current levels are slightly above but generally consistent with what the Fed considers acceptable.

With moderate inflation, the Fed is likely to keep raising rates in 2019 at the current steady pace. Expect one more increase in December 2018 and two to four more in 2019. Also, expect the Fed to continue reducing its asset base, now at a pace of $50 billion a month. Absent any surprises, the effects from higher rates and the unwinding of the balance sheet should be minimal, as they have been so far.

Longer-term rates should also rise somewhat. Given stable growth and ongoing low inflation, the rate on the 10-year Treasury can be expected to drift up from where it is now, to a level of around 3.5 percent to 4 percent by year-end 2019. The risk here is most likely to the downside, but this seems a reasonable target. Overall, monetary policy and interest rates should continue to normalize through the year.

Stock markets. This normalization means that stock markets are likely to trade on fundamentals such as revenue and earnings growth. Here in the U.S., both revenue and earnings growth were much greater than expected at the start of the year due to the 2017 Tax Cuts and Jobs Act, which reduced rates. While this is a trend that should moderate in 2019, revenue growth is expected to remain strong, at levels last seen in the immediate recovery from the financial crisis, which should support continued growth in earnings through 2019, at a slower but still healthy pace compared with 2018.

With solid fundamentals, the real question will be what stock valuations do. Historically, high levels of confidence have driven valuations higher, which is what we have seen through most of 2018. Recently, however, valuations have dropped to the lower end of the range typical of the past five years or so. As confidence levels moderate and growth slows, we can expect valuations to remain at the lower end of that range.

Given projected earnings growth and a resetting of valuations to levels prevailing through the past couple of years—to about 15 times forward earnings—the S&P 500 is likely to end 2019 between 2,900 and 3,000. There is upside potential if valuations recover to the high levels seen recently. But there may be more downside risk, as even a valuation of 15 is quite high historically. Still, this estimate is consistent with revenue and earnings growth projections and with overall economic growth.

What to watch for

None of this is guaranteed, of course. Things to watch include the apparent slowdown in U.S. and global economic growth, as well as rising interest rates. On the political side, we'll need to watch for potential investigations into the administration by the new Democrat-controlled House; the pending crises in Europe, including Brexit and Italy; and the situation with North Korea. Trade conflicts also have the potential to worsen.

Even if some of these risks come to pass, though, with job growth and confidence high, the economy is likely to keep growing, which should limit any damage. Overall, 2019 seems likely to be in line with many years of this recovery, with slow but steady economic growth, moderate market appreciation, and more normalization across the board. Despite the headlines, this is not a bad place to be.

broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks.

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