US Private Wealth Management
U.S. Bank

4Q 2018 investment views: Positive domestic momentum heading into an action-packed conclusion to the year

Quarterly outlook

Contributors from U.S. Bank Wealth Management:

Eric J. Freedman
Chief Investment Officer

Thomas M. Hainlin, CFA
National Investment Strategist

Robert L. Haworth, CFA
Senior Investment Strategy Director

William J. Merz, CFA
Senior Research Analyst,
Fixed Income

Terry D. Sandven
Chief Equity Strategist

Kurt W. Silberstein, CFA
Head of Alternative Investments

Kevin T. Weigel, CFA
Senior Research Analyst,
Real Assets

Executive summary

As we enter the year's final quarter and contemplate the path forward, we find ourselves at an interesting juncture. Our analysis suggests that the global economy remains on firm footing, although we are seeing mild deterioration, particularly outside of the United States. However, relatively favorable asset performance has demonstrated some momentum inconsistent with softening economic data. What is an investor to do? Do you anticipate that potential further economic weakness may result in asset prices following suit or stay the course after over nine-and-a-half years into a global equity market bull market?

We continue to advocate a slight pro-growth portfolio orientation in the current environment. While economic growth is showing signs of slowing, that slowdown comes from a favorable base built up over several years and for much of 2017 and early 2018 in a globally synchronized fashion. Further, corporate profits remain robust, credit conditions are favorable and global central banks remain, on balance, prone to easier money policies versus more restrictive ones.

Risks remain and several key catalysts await in the fourth quarter. The domestic central bank — the U.S. Federal Reserve (Fed) — hosts key meetings that will provide guidance on where it may steer policy into 2019, with markets concerned about the potential for a Fed that could transition to a faster pace of interest rate increases than is currently discounted. The U.S. midterm elections will also prove noteworthy, with markets anticipating some legislative movements, but room for surprises always exists. Finally, trade negotiations, which to date have driven considerable media attention yet a minor capital market response, may escalate to levels where markets may react. We will keep you apprised of our views and hope the content that follows helps guide you into the fourth quarter and beyond.

Important disclosures provided on page 9.

Global economic views

We think the U.S. economy is the best house in the neighborhood, but growth may slow to finish the year

U.S. economic growth remains among the most solid in the world, although recent weaker data indicates to us that we may have passed the peak for now. Tax cuts and easier global monetary policy continue to be a tailwind to growth while growing tariffs and trade war issues could be a meaningful headwind next year. Inflation is also likely to subside in the coming months, reflecting weaker food prices and flat energy prices. Accelerating wage growth could provide some boost to inflation, although it may be insufficient to stem the moderation.

- U.S. economic growth accelerated to the fastest pace in three years at 2.9 percent year over year as of June 30, 2018. A robust labor market is likely to continue to support growing consumer spending. The unemployment rate is touching the lowest levels since 2001 and July job openings (6.9 million) exceeded total unemployed for the first time in the history of the job openings data (inception March 2001).
- The Fed's preferred inflation measure, core (excluding food and energy) personal consumption expenditure (PCE) prices, reached the Fed's stated target (2 percent) to start the third quarter. Core prices have been boosted generally by growth in housing and transportation costs. Energy prices have been a primary driver of the higher gains for headline price indices.
- The Fed has continued to remove monetary accommodation, in contrast to central banks in Europe and Japan. The Fed has reduced balance sheet holdings of bonds by 4 percent for the year ended in July and increased interest rates four times in the past year. Financial conditions in the United States remain relatively accommodative for now despite the recent changes in policy.

Europe and Japan appear to be past their respective growth peaks

The economic momentum story across major developed market economies outside the United States, especially Japan and the eurozone, has been somewhat disappointing and we expect this trend to continue well into next year. Business and consumer sentiment surveys have softened and inflation trends have moderated. Central bank policies remain accommodative, with the European Central Bank (ECB) and Bank of Japan (BOJ) continuing asset purchase programs at least through year-end. We estimate that a recession in the near term is unlikely in either region due to continued monetary stimulus. However, unlike the United States, there is likely little fiscal stimulus in the pipeline to provide a catalyst for additional acceleration.

- Gross domestic product (GDP) growth in Europe and Japan has rolled over, with peak year-over-year growth in both economies achieved in the third quarter 2017. Business and consumer sentiment surveys have rolled over, and with little prospect of fiscal stimulus growth, are likely to continue to slow.
- Inflation trends in Europe and Japan have begun to soften despite the continuing monetary stimulus. Softer food prices, combined with weaker business and consumer sentiment, leads us to believe inflation trends are likely to remain weak.

Emerging market growth continues to slow in the face of weaker currencies

U.S. dollar strength remains a challenge for emerging market growth. Tighter U.S. monetary policy appears to be straining emerging market currencies and rates. The momentum of economic growth is likely to continue slowing across this segment. While some economies are amid crises, such as Turkey, Venezuela and Argentina, we believe most are likely to avoid recession for now. Major economies, such as China and India, continue to post very solid overall growth, though at somewhat slower levels. Potential tariffs from the United States remain a modest risk to overall economic activity for now.

Equity markets

We expect U.S. equities to trend higher into year-end, albeit with greater volatility and at a more subdued pace

U.S. equities are beginning the fourth quarter amid a generally favorable fundamental backdrop, spurred by strong earnings growth while the degree of investment difficulty has risen. On balance, we expect equities to trend higher into year-end, absent ramping inflation and a looming recession. Our year-end 2018 and 2019 price targets for the S&P 500 are 3,000 and 3,325, respectively.

The fundamental backdrop of rising earnings, non-problematic inflation and still relatively low interest rates provide valuation support while serving as the basis for stocks to trend higher

Consensus earnings estimates for 2018 and 2019 are approximately $160 and $175 as of the end of the third quarter, according to Bloomberg and FactSet. This reflects year-over-year earnings growth of roughly 20 percent and 10 percent, respectively. Rising earnings typically equate to rising stock prices. The projected slowing in the rate of earnings growth in 2019 over 2018 levels while looming on the horizon, seems well telegraphed.

Valuations, although elevated, are short of extremes, implying continued support for stocks. The S&P 500 ended the third quarter trading at roughly 18.1 times 12-month forward estimates, modestly above the 25-year average of 17.1, according to Bloomberg.

The degree of investment difficulty has increased, a potential headwind for future performance

Factors impacting sentiment appear to be increasing, thus warranting a cautious near-term bias.

- Year-to-date performance leadership is narrow, with the Information Technology, Consumer Discretionary and Healthcare sectors leading all other sectors by nearly a three-to-one or higher margin. Narrow performance leadership is typically indicative of deteriorating market fundamentals and/or investor angst.
- Inflationary pressures, while not widespread, are more prevalent. The pace of inflation is important because price-earnings multiples are apt to trend lower, commensurate with the pace of rising inflation. Relatedly, it is difficult to envision price-earnings multiple expansion serving as a lever for higher stock prices in an environment where inflation may be surfacing and the pace of earnings growth is projected to slow.
- Interest rates are on the cusp of change. Rising interest rates present increased competition for equities as the yield curve continues to flatten. In September, the difference between the 10-year and two-year U.S. Treasury notes reached the lowest level in more than a decade. Should the two-year rate exceed the 10-year rate, resulting in an inverted yield curve, sentiment is likely to wane in anticipation of a potential corporate credit crunch, resulting in a shift toward more defensive sectors and companies.
- Tariff-related activities have the potential to damage business confidence, interrupt the global supply chain, negatively impact company earnings and weigh on stock prices. The implications of tariffs remain a work-in-progress, with timing and magnitude being unknowns.
- Midterm elections add to political and business uncertainty. A change in House and/or Senate control following the November elections could imply that many of the items that have helped propel equities higher over the past two years may be subject to change. At a minimum, a change in control would likely spur rotation among sectors and companies.

Neutral outlook for foreign developed equities as slowing momentum offsets healthy earnings growth

We view opportunities for foreign developed market equities as fairly balanced for the remainder of 2018 and looking into early 2019. Current economic conditions in Europe and Japan are healthy and provide a generally positive backdrop for equities. Corporate profits across foreign developed markets are estimated to grow at a healthy 19 percent over the full year in 2018, led by a strong earnings recovery in the United Kingdom. Valuation of foreign developed equities has moderated and is at or near 20-year lows relative to U.S. equities. Finally, monetary policy is expected to remain supportive for risk assets throughout developed economies. While the ECB is looking to end its asset purchase program after 2018, they have indicated that interest rates in the region would likely remain at current low levels well into 2019. The BOJ remains committed to both asset purchases and low interest rates as inflation and growth in that country remain below the central bank's targets.

Tempering our positive outlook, economic momentum in Europe appears to have moderated based on our analysis of a broad range of macroeconomic indicators. The Japanese economy has also decelerated in the first half of 2018. Corporate profit growth is expected to also decelerate to a still healthy but slower rate of growth of 8 percent. Despite notable improvements in corporate profitability of "Japan, Inc.," foreign investors remain skeptical toward Japanese equities, as evidenced by net outflows of investor funds in 2018. Finally, price momentum, or the trend in stock price movements, for foreign developed equities remains weak and in sharp contrast compared to positive U.S. equity price trends.

Balancing improved valuation, healthy earnings and supportive central banks with softening macroeconomic data, decelerating earnings growth and weak relative price trends, we maintain a neutral outlook on foreign developed equities.

Neutral outlook for emerging market equities remains despite challenging market performance

We also view opportunities and risks in emerging market equities as fairly balanced for the remainder of 2018 and into 2019, and retain our neutral outlook. An environment of rising U.S. interest rates, a rising U.S. dollar relative to other currencies and rising oil prices has persisted into the second half of 2018. This combination creates one of the most challenging macro environments for emerging market countries. In particular, rising U.S. interest rates increases the competitiveness of U.S. Treasury yields to other riskier investments, such as emerging markets equities. Of note, the interest rate on the two-year U.S. Treasury note is equivalent to the dividend yield on the emerging market equity index.

In addition, uncertainty regarding ongoing trade negotiations between the United States and China, the world's two largest economies, has also served to increase the "premium" that investors demand for riskier assets, such as investments in emerging market equities. Finally, Turkey and Argentina, two emerging market countries highly dependent on foreign capital for investment, are experiencing near-crisis financial conditions due weak economic fundamentals and spiraling inflation (34 percent in Argentina and 18 percent in Turkey).

The confluence of all of these factors has led to significant underperformance of emerging market equities relative to U.S. equities in 2018. Despite the challenging environment and negative price momentum of emerging market equities, the global economy remains healthy and most emerging market countries are in solid fundamental shape. China's policymakers have recently enacted a variety of measures to stimulate the economy in order to offset trade-related uncertainty, including monetary easing, middle-class tax cuts and regulatory reforms. Corporate earnings in emerging market equities are estimated to rise an estimated 10 percent in 2019. Valuation of emerging market equities has moderated and is at a substantial discount relative to U.S. equities. And within emerging market equities, we continue to have a positive view of "thematic" approaches that focus on China's maturing economy (areas such as healthcare, the environment and infrastructure that connects China to the world) and the growing ranks of middle class consumers in emerging markets.

We remain neutral on emerging market equities, balancing country specific risks and trade uncertainty with Chinese policy stimulus, still healthy earnings growth and relatively moderate valuations. While recent price declines present an appearance of value, we continue to watch for a reversal in the challenging macro conditions described above and a commensurate decline in risk "premium" before adjusting our forward view.

Fixed income markets

Yields likely rise modestly based on Fed policy, inflation and strong Treasury bond issuance

Bond yields are still low by historical standards. We expect yields to continue to trend higher, which is a negative headwind for bond investors since rising yields equate to falling prices. Catalysts for yields to trend higher include further Fed interest rate increases, rising inflation expectations, stable U.S. growth, increased U.S. Treasury debt issuance (due to a rising fiscal deficit) and softer foreign investor demand for U.S. Treasuries. Outside the United States, central banks are gradually removing policy accommodation via rate hikes and slowing central bank asset purchases, which further leads to upward pressure on yields.

Investment grade and high yield credit valuations are expensive by historical comparisons, but strong corporate fundamentals, a robust domestic economy and still-supportive monetary conditions justify a continued neutral allocation.

- Core inflation measures appear to be stabilizing, though a strong job market and rising wages may yet put upward pressure on prices. As it currently stands, a modest degree of re-pricing in inflation expectations should apply incremental upward pressure to bond yields.
- We expect four total interest rate hikes from the Fed in 2018, which includes one more increase at the December meeting. This is in line with the Fed's median forecast. In 2019, the median forecast is for three hikes. Market-based odds call for one more this year (December) and two next year, which we believe underappreciates the Fed's likely path. Treasury yields should move modestly higher as the market further acknowledges the Fed's resolve.
- We expect the Fed to continue unwinding its balance sheet at a modest and deliberate pace. On a net basis, global central banks are still injecting liquidity into markets via asset purchases, though we expect net purchases will continue to fall as we approach 2019.
- Later in 2019, monetary policy could become slightly restrictive if growth trends weaken. While this may eventually put pressure on corporate bonds (and economic growth in general) domestic credit and economic fundamentals appear robust for the time being.
- Ongoing deficit spending should necessitate elevated U.S. Treasury issuance for the foreseeable future. This should contribute to upward pressure on bond yields as investors digest increasing supply.

Maintain shorter-than-normal bond maturities

We advocate for shorter-than-normal bond portfolio maturities due to the current limited give-up in yields and our expectation for higher rates. Treasury bonds, particularly those with shorter maturities, offer increased competition and a more balanced risk/reward versus riskier income-producing assets.

Balanced risk/reward between corporate credit and U.S. Treasuries

Incremental yields for investment grade corporate bonds relative to U.S. Treasuries remain near historically low levels. A constructive economic backdrop and strong corporate fundamentals mean this relationship may remain near these low levels despite deceleration in global growth and monetary policy.

High yield bonds offer incremental yield relative to investment grade corporates and U.S. Treasuries, but rich valuations leave little room for error. Limited supply has been a major contributor to the resilience of high yield bonds throughout 2018 despite volatility early in the year. While bank loans have historically offered lower risk and lower return alternative to high yield bonds, deteriorating issuance quality is likely to result in credit losses that surpass investor expectations when the credit cycle eventually ends. We strongly advocate for active management within the high yield space, reflecting the higher risk and diverse nature of the market.

Balanced view of municipal debt, with elevated valuations offset by limited supply

Like corporate credit markets, municipal bond valuations are richer than historical averages. However, limited supply continues to support prices and municipal bonds may provide value for taxable investors in higher tax brackets. Longer term, legacy liabilities, such as underfunded pensions, increased healthcare spending and deferred maintenance on infrastructure, may pose risks to certain segments of the municipal bond market. For nontaxable or low-tax investors, municipals with longer maturity profiles may offer more compelling value relative to longer maturity Treasury and investment grade corporate bonds.

Risks in non-U.S. bonds leads us to prefer currency hedged or U.S. dollar-denominated investments

Yields in developed markets remain quite low, though like U.S. yields, are trending higher. Some countries are still experiencing bond yields below zero. Monetary policy outside the United States remains in the early stages of removing accommodation, which should push yields higher. Coupled with risks from currency volatility, we believe exposure to foreign developed market bonds is unattractive, especially for bonds denominated in foreign currencies. On a currency-hedged basis, the investment picture is mixed, but with higher rates and lower central bank liquidity likely ahead, we prefer U.S. markets.

For investors with higher-than-average risk tolerance, emerging market debt remains an opportunity for diversification, though ongoing volatility is likely

Emerging market debt has begun to recover slightly in the third quarter, though returns are still negative for the year. Weakening emerging market currencies and crises in a small number of countries have fueled negative returns. Continued volatility is a clear risk, driven by currency risk and potentially exacerbated by additional Fed rate hikes. However, valuations are near long-term medians, unlike the historically rich levels witnessed in most other segments of the global bond market. We remain neutral on emerging market debt and continue to recommend active management. Like non-U.S. developed markets, incurring emerging market foreign currency risk has often resulted in uncompensated price volatility. As such, we advocate for U.S. dollar-denominated bonds within the emerging market bond category.

Real estate markets

Real estate providing solid income while rising rates creating headwinds

Centrally located, Class A property prices have generally been flat for the better part of two years now. Vacancy rates appear to be rebounding from recent lows and property income growth has come under pressure. We expect the deceleration in income growth to continue as more supply continues to grow, on average. Valuations remain rich, with incomes relative to property values near all-time low levels. Rising U.S. Treasury yields, especially relative to real estate market incomes, are likely to provide future pressure on prices.

Furthermore, commercial mortgage interest rates are now only 0.25 percent below the average earnings rate for centrally located, Class A properties. As the Fed continues to raise rates and inflationary pressures build, the spread between mortgage rates and property income yields could compress further. Historically, prices have come under pressure as commercial mortgage rates reach the level of the property market's earnings yield. While current levels of mortgage rates relative to earnings is indicating caution, we believe investors are likely to at least earn the current income of real estate investments. We remain tactically cautious on real estate since Fed interest rate increases could dislodge valuations from historically expensive levels, causing price declines in commercial real estate.

Commodities markets

Trade wars and emerging market turbulence pressure commodity prices

Commodity markets from grains to industrial metals and oil have come under pressure over the past few months. Trade wars, Fed tightening and economic crises in several emerging market countries (Venezuela, Argentina, Turkey) have all contributed to the broad weakness in commodity prices. In general, most global commodity markets remain well supplied. Spare capacity was built when prices were at all-time highs five years ago. This spare capacity was being worked off amid a synchronized global economic recovery. However, increased tariffs could reduce global trade and, potentially, global GDP. This lessens the risk of unanticipated supply shocks. Furthermore, higher growth prospects and a more active central bank in the United States has led to increases in the dollar, which should continue to pressure commodities for the remainder of the year.

Alternative investments

Opportunities in alternative investments remain favorable but require caution

As we head into the fourth quarter, it is easy to be both optimistic and pessimistic. The optimism is due to the third quarter rewarding investors as markets reacted favorably to company earnings and guidance while the United States side-stepped geopolitical pitfalls. Pessimism can be attributable to the escalation of trade tariffs, U.S. midterm elections and trouble in emerging markets that may extend into the fourth quarter and beyond. Despite the conflicting outlook, when appropriate, opportunities in alternative investments remain favorable but require caution. Hedge funds should be able to take advantage of the increasing volatility and price dispersion among companies, regions and asset classes. Demand for private capital remains strong due to the higher expected returns over traditional stock and bond portfolios. However, prudence is required due to the large amount of capital raised for both private equity and private debt over the past few years.

The path to outsized returns is oftentimes that less traveled

We find that the greatest dispersion between winners and losers in the public markets is within: 1) technology and healthcare stocks, 2) high yield bonds, 3) global structured credits and 4) distressed debt within emerging markets. Dispersion can be due to either a lack of research in the space or the velocity of change within the market or sector. In the Technology and Healthcare sectors, we believe alternative managers are uniquely positioned to potentially profit by differentiating between innovators and followers. In certain high yield and structured credits markets, we see increased use of leverage and weakening bond covenants, with credit prices being driven less by fundamentals than by the supply/demand imbalance between minimal new issuance and the insatiable demand for yield. An experienced fund manager can identify securities with prices detached from economic reality by buying securities that are financially sound and selling securities expected to trade lower due to poor financial condition. The possible advantage to investing in these markets through a private capital fund is the longer investment period to deploy capital as events unfold since it is difficult to time when a market is at the bottom.

Emerging markets are a different story. Three countries, Brazil, Argentina and Turkey, are in various degrees of financial distress. Investors' first reaction is often to sell out of emerging markets and wait until the dust settles. This year, selling pressure has pushed some emerging market equity indices down 20 percent as of early September. The indiscriminate selling provides attractive investment opportunities, but timing when to invest is difficult. As stated by one emerging markets hedge fund manager, "it is akin to catching a falling knife." History shows emerging markets recover from these selloffs and can reward managers with outsized returns depending on the ability to identify and invest in undervalued assets before an "all clear" signal is given.

Below are a few of our thoughts on hedge funds and private capital investment opportunities.

- **Hedged equity:** We have a favorable outlook for the Healthcare and Technology sectors. There is constant innovation and frequent turnover among winners and losers in these sectors. Funds profit from "creative destruction." For instance, a firm with a new drug treatment showing greater efficacy over a competing company's drug can render the drug obsolete in a matter of months. This is observed by the abrupt price declines and increases (plus/minus 25 percent) of biotech stocks reacting to favorable/unfavorable FDA rulings or drug trial results. Disruption among technology companies can be attributable to a new application that changes how we use our smart phones to communicate, shop, monitor our exercise habits, etc. The result is a recalibration of companies leading the charge and those left behind.
- **Hedged fixed income:** Our highest conviction strategies continue to be high yield, structured credit and distressed debt in emerging markets. Securities in these markets have a low sensitivity to rising interest rates since credit quality is the key driver of investment return. We believe having exposure to high yield and structured credit funds can generate superior returns with less risk than traditional long-only funds. Most important is the ability of the funds to understand the dynamics between fundamental analysis and the trading activity in the markets, or "technicals" driving bonds prices. Not being deceived by opportunities that appear to look good on the surface is the key to success in these markets. Knowing the full extent of a security's weak covenants and its financial stability helps to avoid the significant drawdowns resulting from shoddy analysis.
- **Private equity:** An area of interest is light industrial real estate (LIRE). Demand for LIRE is driven by the growth in e-commerce and storage for the vast number of servers required for all our pictures and documents stored in "the cloud." E-commerce is approximately 10 percent of total retail sales in the United States and growing three times faster than brick and mortar sales. That is not a surprise to many of us. What most of us do not know is the e-commerce supply chain requires up to three times more warehouse and logistics than the traditional brick and mortar supply chain. This is due to customers expecting e-commerce to deliver a nearly infinite number of choices very quickly. Fast delivery requires the "last mile" distribution network, which is driving strong demand for LIRE.
- **Private debt:** Finding funds that do not accept too much capital is a challenge. Private debt funds are awash in capital looking for loans to make. This makes us wonder about the credit quality of the loans being made and what will happen when there is an economic slowdown. That said, we have been able to identify a few funds that are adhering to sound and conservative underwriting standards. Overall, it is a market where we remain very selective. This is captured in the traders' adage, "sometimes the best trades are the ones you don't do."

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