Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

2019 Economic and Financial Outlook: Living through the ups and down of a tightening cycle

Towards the end of last year, we thought market participants to be too optimistic about the economic outlook. At the time, the IMF had revised its global economic growth forecast from 3.7% to 3.9% and many observers were calling for major central banks to increase their tightening bias. For our part, we called for already timid central banks to remain prudent during the course of 2018, as they were soon to realise that outside the U.S., economic growth would not be as strong as expected. We also called for the U.S. dollar to appreciate as we estimated that the Fed would remain the most upbeat major central bank globally.

In December 2017, we wrote in our 2018 Outlook: "On the one hand, the ECB remains timid in its intentions to scale down bond purchases (it is buying less assets but has extended the buying period further into the future), the Bank of Canada recently announced that it will remain prudent given the low inflation outlook and the numerous risks ahead (NAFTA being the elephant in the room) and the BOE, while inflation is creeping up, is stuck dealing with the risks that Brexit will slow down the UK economy. On the other hand, the Fed is largely expected to raise short term rates in December and it has started to shrink its balance sheet in the context of strong growth, tightening labour markets and potential tax cuts, which could further boost growth."

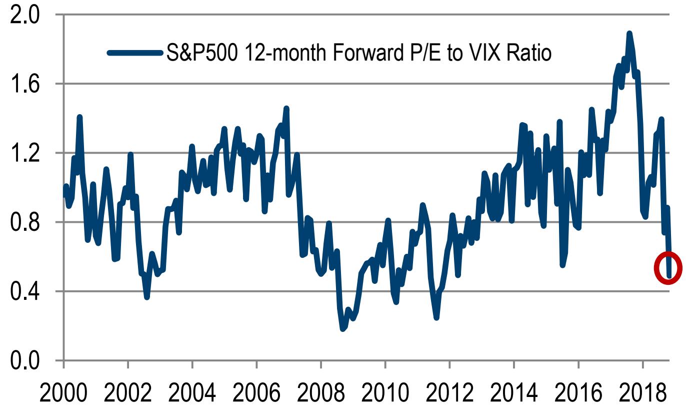
While we were right about the strengthening of the U.S. dollar and the Fed being less accommodative than other central banks, all major central banks proved to be much more hawkish in 2018 than we had expected them to be. However, during the last two months of 2018, their tone finally changed and both central banks and market participants are now acknowledging that the global economy is weakening, and risks to the outlook are higher than initially forecast. In particular, the threat of a deteriorating U.S.-China trade conflict has been hanging over the global growth outlook since last Summer and, accordingly, less than an a year after having raised their economic growth forecasts, both the IMF and the OECD, as well as most major central banks, have since revised them back down.

While both American and European equity markets were generally too optimistic up until a few months ago, on the back of Trump's generous tax cuts, faster U.S. growth, and the hope of a resilient recovery in Europe, pessimism has set in during the last quarter of the year. Now, the effects of the U.S. tax cuts and the fiscal stimuli are tampering. Moreover, European growth is slowing as many countries in the E.U. are dealing with crises; the U.K., France, Italy and, to a certain extent, Germany to name only the most obvious ones. As such, our complacency index, measured as the ratio of the S&P 500 forward P/E to the CBOE VIX Index, has declined from a record high in recent years to almost a seven-year low in December and is now getting closer to its 2008 Financial Crisis trough (see chart 1). In short, markets are no longer complacent.

We are also finally seeing signs that the monetary tightening of the last two years is finally biting. Increasing short term interest rates, higher long term rates, reverse QE in the U.S., reduced bond purchases elsewhere, a stronger US dollar, higher oil prices, widening credit spreads, lower earnings growth forecasts, new tariffs and higher global trade uncertainty are all contributing to a tightening in financial conditions worldwide. For instance, in the United States, the Goldman Sachs financial condition index is currently at its highest level in two years after reaching a 17-

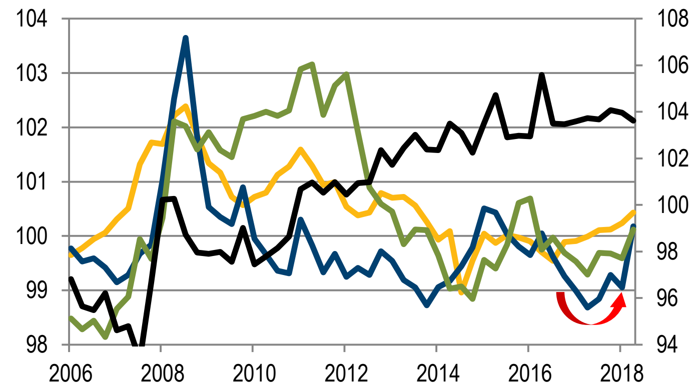
years low in mid-2017. In China, financial conditions have been on a tightening trend since the end of 2010 (see chart 2).[1]

Chart 1: Complacency Index hit multi-year bottom



Sources: Thomson Reuters, Bloomberg Finance L.P., LBS Econ. Res. and Strategy.

Chart 2:Global Financial Conditions Have Tightened



G.S. Economics Research selected financial conditions indices:

Eurozone U.S. Japan China (RS)

Source: Goldman Sachs / Bloomberg Finance L.P.

Leading indicators have now also reversed course and point towards lower growth for next year, confirming the September IMF and October OECD downward global growth revisions. Moreover, market participants seem to be anticipating the possibility that these forecasts could be lowered again in the near future. Accordingly, long term bonds (which had recently seen yields reach new highs) have recently rallied (yields are now at year lows) and equity markets have retraced dramatically in the last months. For instance, the U.S. 10-year bond yield, which reached 3.25% as late as early November, sits at 2.76% as of December 28th, while the S&P 500, which had briefly topped 2940 at the end of September, also briefly traded below 2350 three months later on December 24th; a 20% correction from peak to through.

It would be fair to say then that the reversal in market sentiment has been abrupt and brutal. Yet, it is precisely because central banks will most likely react if the reversal in financial markets were to truly signal a deteriorating economic outlook that we expect market dynamics in 2019 to follow the reverse scenario that played out in 2018. In other words, rather than seeing market participants start 2018 with an overly optimistic scenario, excess pessimism is likely to mark the beginning of 2019 and linger until real progress is made on the global trade front. Incidentally, central banks communication related to future monetary tightening have become more dovish in recent weeks to allow such repositioning if it were to become necessary. We expect these negative sentiments to persist until market participants' fears are assuaged. Only then will central banks become less accommodative as they become less concerned with the economic outlook. At this point, we expect markets to recover strongly from their current depressed levels. It remains difficult to pin point the exact timing of such a change in sentiment but we think it is most likely to occur towards the end of the second quarter of 2019.

The U.S. Dollar

As such, we expect the current appreciation of the U.S. dollar versus other major currencies to persist until then. In the short run, the appreciating U.S. dollar could thus lead to more tightening in global financial markets. This, in turn, could have significant negative impacts on U.S. growth and on the American trade deficit. It could also potentially

[1] A higher financial condition index indicates tighter financial conditions.

create financial instability in countries heavily indebted in the U.S. dollar, as well as incite the Trump administration to increasingly favour protectionist policies.

For precisely these reasons, we believe that the Fed as well as other major central banks will continue to tamper or postpone their tightening bias. We expect at most two more hikes in 2019 from the Fed and we expect these hikes to only occur towards the second half of 2019. We also expect that the reverse QE targets might be revised lower early in the New Year. This would be necessary to avoid provoking further financial tightening, another disproportionate US$ appreciation, global economic uncertainty and political backlash against free-trade at a time when market participants are skeptical about growth and the prospect that the Trump Administration will contain its unfriendly trade measures against China.

However, as we expect these negative trends to reverse in the second half of the year as the Fed and other major central banks fend off the danger, we foresee a weakening US$, rising commodity prices (including oil, gold and copper prices) and an outperforming equity market in the second half of 2019.

Stocks now appear cheap relative to bonds. While, it might be too early to fully take a plunge into the equity market, at current levels, equities have started to become attractive, in our view justifying the rally of the last few trading days of the year. High quality stocks should thus be on investors' preferred Christmas list. Also, corporate bond spreads, in tightening mode for most of the year until recently, should continue to widen at least until the financial and economic outlook improves. Therefore, accordingly, we endorse maintaining an underweight position in such assets as we have been recommending since November.

Commodities

In line with the views expressed above, we expect commodity prices to suffer in the first quarter of 2019, and to pick up some momentum after that. In the oil sector, WTI oil prices, which had been above US$ 60 for most of the year but have fallen sharply since November, are expected to recover relatively quickly in 2019. WTI stands marginally above US$ 45 as of December 28th. Yet, we still forecast them to reach $US67 per barrel by year-end 2019. Our positive oil outlook for 2019 is predicated on OPEC and Russia's recent decision to extend their production cuts to rapidly eliminate excess inventories. This should be supportive of higher oil prices in the early part of next year. In turn, rising oil prices should contribute to the outperformance of Canadian equities and the Canadian dollar in the second half of 2019 as Western Canadian Select benefits from both raising WTI prices and a tightening of the WTI-WCS discount.

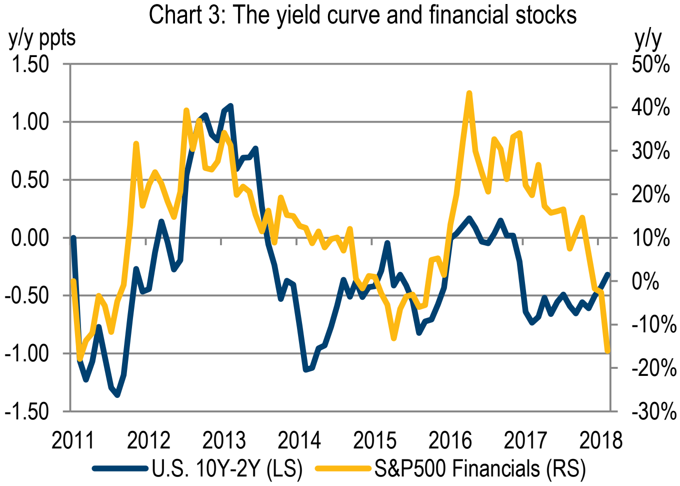
We are ambivalent on gold prices. Geopolitical uncertainty could attract investors towards gold in the first half of the year. The Fed slowing its tightening of monetary policy would also normally allow inflation expectations to rise, supporting gold price. However, the lack of structural inflationary pressure and a rising U.S. dollar should not favour gold until expectations of a slowdown disappear in the later part of the year. As such, in the second half of 2019, a pickup in investors' sentiment and a renewed optimism towards emerging markets could lead the US$ to give up some of its gains and finally favour gold prices if central banks, as we expect, do not become overly preoccupied with inflation.

After 3 bad years in a row, fertilizer stocks somewhat recovered in 2018 amid strong demand for their products. They recently weakened. The outlook should remain uncertain in the first half of the year until the global economy picks up some steam.

While we repeatedly caution investors against REITS in a monetary policy tightening environment, the sector still provides excellent protection against inflation risks and yields on these securities are expected to remain higher than that of long term government bonds. We again recommend establishing positions in the REITS sector on weakness and as a diversifying strategy. The summer of 2017 and last February provided excellent opportunities to do so. The situation may present itself soon again this year.

The U.S. and Canadian financial sector figured among our top overweight sectors last year. Their relative valuation appeared attractive and 2018 expected earnings growth were higher relative to other sectors. Accordingly, financials stocks outperformed in early 2018 in a steepening yield curve environment. However, in the second half, the flattening of the yield curve and concerns about the health of the corporate sector penalised stocks in the sector (see chart 3). Today, these stocks trade at the same level as last year, even though their earnings are higher due to the corporate tax cuts (reduced from 35% to 21%) and improved outlook. The flat yield curve currently makes them attractive as we believe that the yield curve will steepen in the latter part of 2019.

Chart 3: The yield curve and financial stocks



Sources: Bloomberg Finance L.P. and LBS Econ. Res. and Strategy.

We expected the global economic recovery and rising technology capex spending to benefit both the U.S. and Canadian technology sector. They had until recently. The recent correction, triggered by diverse factors, creates, in our view, an opportunity for patient investors. We also expect defensive sectors, such as consumer staples in the U.S. and Canada and health care/pharmaceuticals in the U.S., to outperform in the first half of 2019, but the trend to reverse in the second half.

Risk to the outlook

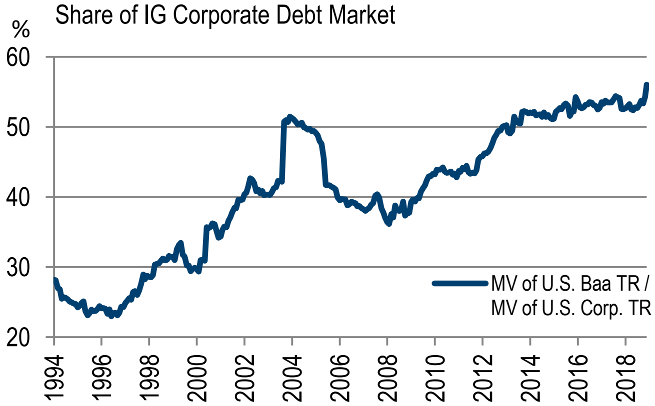
One thing appears clear to us at this juncture: volatility should persist in the next year at least as long as the uncertainty around the outcome of U.S./China trade negotiations lingers. Moreover, as measured by the CBOE VIX, the record low volatility experienced in 2017 was much more of an anomaly than was its abrupt reversal in 2018. Finally, much more than in the past, market movements are determined by geopolitical dynamics which remain highly unpredictable, especially when the global institutional framework (i.e. the rules of the game) are subject to change in coming years.

We nevertheless expect the USMCA to be ratified by Congress in the second quarter of 2019 and the United States and China to bury the trade hatchet in the summer. We thus remain optimistic. However, it is worth remembering that the road to prosperity might be fraught with obstacles. As in previous years, we caution readers that there are risks to the above economic perspectives and market forecasts. First, global growth could falter if the U.S. intensifies its trade war with China. Aside from a quick capitulation from China (which we have a hard time imagining), we do not foresee an optimistic outcome if this scenario prevailed.

Second, corporate debt continues to be a concern. In developed markets, the declining quality of credit at the fringes of the High Yield (HY) grade segment of the market could become a problem as rising interest rates and high refinancing schedule starting in 2019 could hurt companies' access to vital capital. For instance, the share of BBB-rated debt in the overall U.S. corporate debt market reached a record-high 56% in December. This is a staggering 3.6 percentage point increase in only 6 months (see chart 4). Moreover, Bloomberg news reported that several companies rated BBB have pushed their leverage ratio above the threshold that is generally viewed as a criterion to be rated HY by ratings agencies. In many cases, this was due do mergers and acquisitions. There is therefore a risk that the current composition of the Investment Grade market does not accurately reflect the risk associated with its components.

In any case, a crisis related to either the U.S.-China relationship or corporate debt would likely cause flights to quality and safe-haven assets, making U.S. based assets and the U.S. dollar one of the only places to hide.

Chart 4: Lowest-Rated Tier Debt Make up Record-High Share of IG Corporate Debt Market



Notes: IG: investment grade. MV: market value. TR: total return index.
Source: Bloomberg Barclays Indices / Bloomberg Finance L.P.

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