LPL RESEARCH PRESENTS
MIDYEAR OUTLOOK 2019
FUNDAMENTAL
HOW TO FOCUS ON WHAT REALLY MATTERS IN THE MARKETS
NEW EDITION—WITH—REVISED FORECASTS!
WHEN WE RELEASED our Outlook 2019: FUNDAMENTAL: How to Focus on What Really Matters in the Markets in December 2018, financial markets were in disarray. Global investors were scared by uncertain monetary policy, fiscal and legislative discord, slowing economic growth, and slackening corporate profits. Despite the increased volatility, we continued to believe that market and economic fundamentals remained generally sound.

Fortunately, the worst of these fears did not materialize, and consistent with our Outlook, the U.S. economy avoided a recession, global equities rebounded, and fixed income returns contributed to diversified portfolios. Economic and market fundamentals were the foundation for the market’s recovery from the December lows. Even as we face prospects for periodic volatility, we believe emphasizing fundamentals remains critical for making effective investment decisions.

At the halfway point of 2019, the U.S. economy has held steady, supported by the fiscal stimulus we have highlighted for two years, and corporate profits continue to grow. At the same time, trade tensions are increasingly weighing on the economic outlook, while slowing global growth and political uncertainty have forced global central bankers to extend extraordinary levels of support.

We are still navigating a challenging environment. Investing comes with uncertainty, and market volatility can be alarming, but we continue to encourage investors to look beyond short-term market stresses and consider the real drivers of investment returns, as we believe that mindset may be a key to achieving long-term financial goals.

Our Midyear Outlook 2019 provides our updated views of current fundamentals and the things that should persist as shorter-term concerns fade, and emphasizes our four primary pillars for fundamental investing—policy, the economy, fixed income, and equities. As the headlines change daily, look to these pillars and LPL Research’s Midyear Outlook 2019 to help provide perspective on what really matters in the markets.

Where We Are Now

Policy

We believe fiscal stimulus from the Tax Cuts and Jobs Act of 2017, along with decreased regulation and increased government spending, will continue to support the U.S. economy in 2019, and that the potential impact is both larger and more durable than consensus expectations. At the same time, uncertainty around global trade continues to dampen the benefits of fiscal support and may be discouraging productivity-enhancing capital investment.

We still believe self-interest is likely to bring the United States and China back to the negotiating table, but until we see progress, trade tensions remain the primary risk to our forecasts.

While fiscal policy has taken the lead, monetary policy grew more supportive in the first half of 2019. The Federal Reserve (Fed) indicated earlier this year that it would likely hold on raising interest rates for the rest of 2019, partly in response to the market’s poor reaction to last December’s rate increase. With inflation low, global growth slowing, and trade risk still present, monetary policy may be too tight for the current environment. Even if not fully justified by the data, the Fed may choose to lower rates later this year to provide a buffer against increased uncertainty.
Economy

DOMESTIC: U.S. economic growth in the first quarter was better than expected, with early readings showing gross domestic product (GDP) growth of 3.1%. Data have weakened in the second quarter but bright spots remain. Supported by strong labor markets, consumer sentiment remains upbeat and consumer spending continues to be an important driver of growth; manufacturing, however, has seen a larger negative impact from trade. We still believe fundamentals are supportive of moderate GDP growth this year. Again, progress on trade concerns is central to our growth projections, so we’ve slightly reduced our GDP forecast to 2.25–2.5%.

INFLATION: We believe the current pace of growth is consistent with an economy that is able to generate solid demand without adding excessive pricing pressures. Consumer inflation has slipped as global demand has softened, outweighing any broader price impact from tariffs. While headline inflation data remain sluggish, wages and wholesale prices continue to grow at a healthy clip. We expect core Consumer Price Index (CPI), which excludes food and energy prices, to grow 2–2.25% year over year in 2019, on pace with what it did in 2018.

EMPLOYMENT: Hiring has continued at an above-average pace for the expansion, with employment growth averaging around 200,000 jobs per month. Weekly claims for unemployment benefits have dropped to cycle lows several times this year, and this tight labor market will likely lead to increased wage growth in the coming months. Wages represent the largest cost for businesses, and it is difficult to have a sustainable inflation threat if wages are not climbing at a fast rate. Currently wage growth is just above 3%, suggesting hourly earnings are not yet a threat to the economy.

GLOBAL: We still expect emerging markets (EM) to continue to lead developed markets in economic growth, given the challenges in developed markets. Europe faces Brexit challenges, France is contending with “yellow vest” protests, Germany is battling weaker manufacturing, and Italy is struggling with difficult budget negotiations. In Japan, programs to increase government spending and reduce rates have supported growth, but true structural reforms remain elusive, and a value-added tax (VAT) increase is scheduled for the fourth quarter. We expect India’s GDP growth to outpace the rest of EM and Mexico to continue to lead growth in Latin America.

Fixed Income

Fixed income investors have benefited from falling rates due to subdued consumer inflation, a pause in rate hikes, and demand for U.S. Treasuries. Although a flattening yield curve has been troubling for some investors, we believe the flattening is due more to global investors searching for better yields than it is an indicator of looming recession. Considering the Fed, inflation, and our expectation for progress on trade, we now look for the 10-year Treasury yield to reach the 2.5–2.75% range in the next 6 to 12 months. Currently we favor an emphasis on investment-grade (IG) bonds in fixed income allocations, with a focus on a balance of IG corporates and mortgage-backed securities (MBS). We believe the extra yield in the MBS market given the degree of risk remains attractive and economic growth continues to support IG corporate bonds.

Equities

The overall U.S. economic picture has supported continued expansion. Modest inflationary pressures helped boost demand and support corporate profit margins in the first quarter. Given solid fundamentals, we continue to believe corporate profits will exceed the current consensus expectations.

The Fed’s decision to pause rate hikes boosted sentiment and increased demand for equities. Market technicals provided support for stocks’ rebound earlier this year, and historical patterns suggest the possibility for strength in 2019.

We have slight preferences for large cap over small cap, value over growth, and EM over developed markets. We continue to lean cyclically, favoring industrials, financials, and technology.

Market valuations remain favorable, with the S&P 500 Index’s forward 12-month price-to-earnings (P/E) ratio within historical norms. We reduced our S&P 500 earnings per share (EPS) forecast to $170 for year-end 2019, mainly because of trade uncertainty, and our year-end S&P 500 fair value estimate remains at 3,000. We will revisit this forecast if clarity on trade and monetary policy result in an improved outlook for corporate profits.
CENTRAL BANK–DRIVEN monetary policy and legislatively driven fiscal policy provide a constant backdrop against which businesses and consumers operate. Even though businesses drive much of their own success or failure, they’re always adjusting to policy environments. Consumers are also constantly nudged by policy, whether through interest rates, tax policy, or the overall job market.

Monetary policy has dominated much of this expansion, but over the last few years, fiscal policy increasingly has impacted businesses and the overall economy. Fiscal policymakers use four primary levers to support economic activity: taxes, regulation, spending, and trade. The first three levers remain tailwinds for economic growth and corporate profits. Trade, however, continues to dampen the benefits of the other levers.

Fiscal stimulus, via the Tax Cuts and Jobs Act of 2017, provided a boost to economic activity in 2018 through tax relief for consumers. We still believe that the fiscal support from the Act will exceed consensus expectations in 2019. Fiscal policy’s contribution to real GDP growth should be about 2.2% for 2019, higher than the 1.3% contribution in 2018 [Figure 1]. Reduced regulatory burdens have also increased business investment by energy companies, while looser capital standards have boosted the lending capacity of U.S. financial companies. Over the past year, U.S. corporations have repatriated approximately $750 billion of foreign-sourced profits, providing additional funding for shareholder distributions, hiring, and capital investment.

Trade, Tariffs & the Deficit

Unfortunately, the benefits of these fiscal measures may not fully materialize given heightened trade uncertainty. Too many businesses have faced questions about costs, logistics, and supply chain management to take advantage of incentives for capital investment.

Trade negotiations with China hit a stalemate in the middle of May, with the Trump administration responding by increasing tariffs to 25% (from 10%) on $200 billion in Chinese imports and threatening tariffs on the remaining $300-plus billion. China retaliated with additional levies of 25% on $60 billion in U.S. imports and threats of non-tariff barriers. In addition, the U.S. plan to impose tariffs on Mexican imports roiled markets in May but was quickly resolved. Nevertheless, businesses are increasingly concerned that a new front in the trade war could appear at any time.

In addition to trade, we remain concerned about the level of federal deficit spending. A glut of U.S. Treasuries has been
issued over the past year to fund government spending under the assumption that there will be a consistent bid for U.S. debt.

Although there is a strong bid for Treasuries now, that demand may wane as inflation nudges higher and global investors begin to demand more yield amid the rising federal budget deficit. We do not believe legislators or global investors fully appreciate the long-term risk of the rising deficit [Figure 2] to domestic rates and the value of the U.S. dollar, adding complexity to the policy outlook.

The Fed’s Role

In a perfect world, a transition of leadership from monetary policy to fiscal policy as the leading global economic catalyst would have gone smoothly. In the real world, a variety of challenges have surfaced, resulting in further reliance on accommodative global central bankers rather than feuding fiscal legislators.

Even in the United States, monetary policy is still part of the story. The Fed raised interest rates four times in 2018. In retrospect, three hikes probably would have been sufficient, given the market’s poor reaction to the fourth hike in December. Lesson learned: The Fed indicated earlier this year that rate hikes would likely remain on hold for the rest of 2019. Not surprisingly, investors in risk assets rejoiced at the Fed’s decision.

With inflation low and the yield curve indicating monetary policy may be too tight for the current environment, the Fed may go further and choose to lower rates later in the year to provide a buffer against rising risks from trade and geopolitical uncertainty, even if not fully merited by the data. Such a cut would be similar to midcycle “insurance” cuts in 1995 and 1998, which also occurred against solid growth backdrops. For now, the Fed remains data dependent and would probably need to see additional signs of economic weakness before making a move.

Though policy decisions can be confusing, they remain central to our economic and market outlooks. We continue to believe that economic (and political) self-interest will bring the United States and China back to the negotiating table. Until we see progress, though, trade uncertainty is the primary risk to all our forecasts.

![Twin Deficits: Budget & Trade](image)

**Twin Deficits: Budget & Trade**

Source: LPL Research, U.S. Treasury, U.S. Bureau of Economic Analysis, U.S. Census Bureau 05/31/19
FUNDAMENTALS HAVE CONTINUED to support steady but moderate economic growth in 2019. Financial markets were more skeptical at the end of 2018, and recession calls were among the loudest they’ve been all cycle. So far, though, that outlook has failed to materialize.

The U.S. economy grew at 3.1% in the first quarter, though some underlying weakness in the data may foreshadow some slowing later in the year. Net exports and inventories contributed nearly 1.6% to headline growth, but strength in both components typically weighs on GDP in future quarters. Nonetheless, domestic demand held up well in the face of a government shutdown and trade headwinds. Consumer spending was a modest contributor to GDP, while business investment slowed but still posted growth. With the Fed on hold and fiscal stimulus in place, we believe fundamentals are supportive of continued moderate GDP growth this year. However, progress on trade remains central to our growth projections. With negotiations stalling in the second quarter, we’ve slightly reduced our 2019 GDP forecast to 2.25–2.5% [Figure 3].

Inflation
We believe this pace of growth is consistent with an economy that is able to generate solid demand without creating excessive inflationary pressure—a situation that benefits investors while giving the Fed added flexibility. Year-over-year growth in consumer inflation ran just under 2% in the first half of 2019, well contained despite tightening labor markets. This disconnect has puzzled monetary policymakers, whose goal is to maintain low and stable inflation. We suspect several longer-term trends have kept inflation at bay, including globalization, retiring baby boomers, and a strong U.S. dollar. Wages and wholesale prices continue to grow at a healthy clip, showing us that pricing pressures are building underneath the surface. Based on these building pressures, we expect core CPI, which excludes food and energy prices, to grow 2–2.25% year over year in 2019. At that pace, consumer inflation would grow roughly at the same rate as it did in 2018.

Jobs & Productivity
Even if we should see growth slow, the U.S. job market continues to be a bright spot. Hiring has continued at an above-average pace for the expansion, and weekly claims for unemployment benefits have dropped to cycle lows several times this year. Strong job growth leads to higher incomes, stronger business and consumer spending, and improved corporate profitability. Productivity growth, though, is the key to sustaining this virtuous cycle. We saw a glimpse of this in the first quarter, as productivity grew at the strongest pace since 2010 [Figure 4].
Higher productivity becomes the primary driver of economic growth for an economy near full employment, and it lifts profit margins by boosting output and lowering labor costs. Trade uncertainty is becoming an increasing risk to productivity-supporting business investment, countering a boost from pro-growth deregulation and tax relief. If trade uncertainty or a failed negotiation dampens business investment, strong productivity growth may be difficult to sustain. On the other hand, trade clarity could motivate businesses to resume expansion plans and capital investment. If U.S.-China trade talks stall further or fail, we estimate the hit to confidence and business investment could subtract 0.5–0.75% from U.S. GDP growth over the next year.

Global Economy

Even if revised downward, U.S. growth expectations have been holding up relatively well compared with global growth prospects. While trade-related tensions have had some impact on global growth, we believe the repercussions have been small to date and that structural issues abroad have been the main culprit in the global slowdown.

Europe in particular still faces a variety of political and economic challenges. The United Kingdom’s Brexit process, messy from the start, continues to unravel; France is contending with the “yellow vest” protests; Germany is battling weaker manufacturing; and Italy is struggling with the difficult budget negotiations of an unsettled governing coalition. Trade concerns also remain in play for Europe, with important trade discussions with the United States on agriculture and autos still outstanding. These structural issues have also impacted the monetary policy outlook, with the European Central Bank (ECB) pushing back plans to raise rates and reduce the size of the ECB’s balance sheet.

In Japan, programs to increase government spending and reduce rates have supported growth. However, true structural reforms remain elusive. Consumer sentiment has also weakened ahead of the value-added tax (VAT) increase scheduled for the fourth quarter of 2019. Though Japan’s recent GDP growth has exceeded expectations, we suspect higher activity comes at the expense of growth in subsequent quarters.

We still expect EM to set the pace for global GDP. Beijing’s intervention has stabilized demand in China, but trade uncertainty continues to weigh on confidence and investment, suggesting the possibility for further stimulus. These policy efforts should support export growth in the rest of emerging Asia.

In India, we still expect GDP growth to outpace the rest of EM over the next few years, even as stimulus wanes following the Indian elections. Growth in emerging Europe remains weak, indicating the need for central bank accommodation in Turkey and Russia. We expect Mexico to continue to lead growth in Latin America, as Brazil struggles to gain traction.

We still see the United States as a growth leader in the developed world, but emerging markets continue to play an increasing role in the global economy, with the pace of growth leadership shifting from China to India.
BOND PRICES HAVE surged and yields have fallen this year due to four very powerful forces:

1. **INFLATION:** Consumer inflation has struggled to eclipse the Fed’s 2% target.

2. **RATE HIKE PAUSE:** Given the absence of a sustainable pricing threat, policymakers have signaled a rate-hike pause and indicated some flexibility to cut rates if trade tensions cause economic conditions to deteriorate.

3. **INVESTING IN U.S. TREASURIES:** Investors bracing for potentially slower economic growth and equity volatility have flocked to U.S. Treasuries as a perceived “safe haven” asset.

4. **SEARCH FOR INCOME:** Global investors have bid up prices of U.S. Treasuries as they search for income amid ultra-low rates on other sovereign debt.

In addition to falling yields, the flattening Treasury yield curve has garnered a lot of attention, especially from investors looking for recessionary signals [Figure 6]. However, we believe this global search for yield is the primary catalyst for the unusually narrow spread between short- and long-term rates. We are bound to have a recession sometime, but it has been difficult to see a case for one in the next year based on current conditions, although uncertainty around trade remains a risk.

Considering the Fed, inflation, and our expectation for progress on trade, we look for the 10-year Treasury yield to reach the 2.5–2.75% range in the next 6 to 12 months. While we see the potential for some pricing pressures to develop, the uncertainty around trade, geopolitics, and global growth could limit the ability of yields to climb in the coming months. This range reflects our baseline expectation of some meaningful progress on trade over time, but with continued headline volatility in the near term.
If we should see the resumption of U.S.-China negotiations and some rapid progress, we could push out of that range to the upside, while increased tensions with the potential for the Trump administration to broaden tariffs would pose downside risk.

**Bonds**

In this environment, we continue to favor a balance of high-quality intermediate bonds, with a preference for IG corporate bonds and MBS over U.S. Treasuries. The IG market would benefit from solid domestic fundamentals, while the extra yield in the MBS market given the degree of risk remains attractive in the current economic landscape. Tax-free bonds are a mixed bag to us, as we prefer higher-quality municipal issues relative to higher-yielding municipal bonds. Even though Treasuries may face headwinds from increased issuance and slightly higher inflation, they can provide diversified portfolios with income, liquidity, and ballast during periods of equity volatility.

We would continue to keep interest rate sensitivity below that of the broad Bloomberg Barclays U.S. Aggregate Bond Index. More rate-sensitive bonds have performed well as interest rates have fallen (bond prices go up when interest rates decline) and may provide diversification benefits, but with a flat yield curve, the yield advantage of longer-term bonds over shorter-term has all but disappeared. At the same time, we believe the current level of rates makes valuation for rate-sensitive fixed income expensive.

Fixed income investors must be selective when considering international bonds, given the various challenges in global policy and growth. Developed-market bonds appear expensive with extremely low yields, and they could ultimately face reckoning if the ECB and Bank of Japan ever decide to begin raising rates. EM debt offers better yield opportunities with favorable central bank outlooks, which is consistent with our EM economic outlook [Figure 5].

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**Yield Curve Inversion**

![Yield Curve Inversion Chart](chart.png)

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Source: LPL Research, Bloomberg 06/07/19

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Valuations remain favorable for U.S. stocks. The S&P 500’s forward 12-month P/E ratio is within historical norms, and P/E ratios relative to rates and inflation are both well below long-term averages. Given low rates and inflation, we think a trailing 12-month P/E ratio of 17.5 is appropriate. Combining this with our EPS forecast, we believe at year-end the S&P 500 would be fairly valued in the range of 3,000.

Historical Perspective

Historical patterns also forecast more strength through the end of the year. The S&P 500’s 13% gain in the first quarter was a rare event: The index has risen 10% or more in the first quarter just 10 times since 1950. Stocks’ strong start to a year usually has boded well for the rest of the year, as the index has historically risen an additional 6% over the rest of the year after a first-quarter gain of 10% or more.

Of course, stocks rarely climb in a linear fashion, as we’ve witnessed recently. We warned of a midyear stock pullback as early as March. Our call wasn’t an indictment of weakening fundamentals, but rather a recognition that a period of renewed volatility was increasingly likely after such a strong rally. Historically, when the S&P 500 has gained 10% or more in the first quarter, stocks have endured an average pullback of about 9% before recovering in the next three quarters. There also were some unresolved global risks present that we didn’t think stocks had adequately priced in yet. In fact, the S&P 500 ended up falling from record highs in May as trade tensions escalated once again.

The midyear market turbulence has been uncomfortable, and it may not be over. Several market risks are still present, including the geopolitical environment, the possibility of failed trade negotiations, and a potential monetary policy mistake. These risks could fuel periodic bouts of volatility, with trade central to our outlook [Figure 8].
We continue to believe in our year-end fair value estimate for the S&P 500 in the range of 3,000, and we would view any decline beyond 10% as excessive given current fundamentals on economic growth, corporate profits, inflation, and interest rates. We also would view potential weakness as an opportunity for suitable investors to rebalance diversified portfolios toward targeted allocations or for those investors with excess cash to build positions.

Our Positions

In late March, we went to market weight U.S equities, with a slight preference for large caps over small caps based on valuations, an aging business cycle, and an improved global trade environment. The beneficiaries of fiscal policies largely comprise the value space, but growth has widened its lead since the Fed paused on rate hikes.

Within equities, active strategies are most likely to benefit from the tailwinds of taxes, regulation, and government spending. To the degree that equity prices are driven by monetary policy and move together, active managers may continue to struggle.

Despite the length of this expansion, our sector positioning remains cyclical. We’re overweight in the industrials, financials, and technology sectors. Defensive sectors, including utilities and consumer staples, appear expensive with poor growth outlooks. Healthcare and real estate each offer dynamics that warrant market weights, including demographics and spending potential.

Our concerns about global policies, economies, and interest rates translate into our preference for EM stocks over international developed-market stocks. Fiscal deficits, populism, and exhausted monetary policies could weigh on sentiment, spending, and investment throughout Europe, while structural reforms and the looming VAT increase may pressure sentiment in Japan. Population growth, improved flexibility in production, economic momentum, and valuations all favor EM [Figure 7].

fig.8 Trade Uncertainty Increases Market Volatility

EPILOGUE  Even though the economic environment has become more challenging, the pillars of fundamental investing—policy, economy, fixed income, and equities—still appear sound to us. We will continue to monitor the impact of trade developments on the indicators we watch. For now, the odds of a near-term recession appear to remain low. U.S. stocks may endure periodic volatility as the bull market ages, but we encourage investors to focus on long-term trends instead of short-term noise. Volatility is the blessing—and curse—of long-term investing. During volatile periods, it can be tempting to make emotional, short-term decisions that could conflict with long-term goals. But we could also view bouts of volatility as opportunities, when suitable, to rebalance portfolios toward long-term allocations. By focusing on the fundamentals, we believe we all can make more prudent and effective decisions about how to achieve our long-term goals.
The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual security. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. Our recommendations are subject to change at any time based on market and other conditions. Economic forecasts set forth may not develop as predicted, and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. Information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy.

RISK DISCLOSURES
Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments. Investing in stocks includes numerous specific risks including the fluctuation of dividend, loss of principal, and potential illiquidity of the investment in a falling market. The prices of small cap stocks are generally more volatile than large cap stocks. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. Active management involves risk as it attempts to outperform a benchmark index by predicting market activity, and assumes considerable risk should managers incorrectly anticipate changing conditions. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond and bond mutual fund values and yields will decline as interest rates rise, and bonds are subject to availability and change in price. Bond yields are subject to change. Certain call or special redemption features may exist, which could impact yield. Municipal bonds are subject to availability and change in price. Interest income may be subject to the alternative minimum tax (AMT). Municipal bonds are federally tax-free, but other state and local taxes may apply. If sold prior to maturity they are subject to market and interest rate risk and capital gains tax could apply. Mortgage-backed securities (MBS) are subject to credit, default, prepayment, extension, market, and interest rate risk. U.S. Treasuries may be considered “safe haven” investments but do carry some degree of risk including interest rate, credit, and market risk. They are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. Investing in foreign and emerging markets involves special additional risks.

DEFINITIONS
Earnings per share (EPS) is the portion of a company’s profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company’s profitability. EPS is generally considered to be the single most important variable in determining a share’s price. It is also a major component used to calculate the price-to-earnings valuation ratio.

The price-to-earnings (P/E) ratio is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio. Price to Forward Earnings is a measure of the P/E ratio using forecasted earnings for the P/E calculation.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country’s borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

INDEX DEFINITIONS
All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The modern design of the S&P 500 stock index was first launched in 1957. All performance back to 1928 incorporates the performance of predecessor index, the S&P 90.