John M. Longo, PhD, CFA
Chief Investment Officer,
Beacon Trust
jlongo@beacontrust.com

A LOOK AT THE YEAR AHEAD: Ten Investment Forecasts and Four Strategic Wealth Management Themes to Capitalize on Them

December 2018

As we acknowledge each December in presenting our outlook for the coming year, no one can know the unknowable or predict the unpredictable. But, as wealth managers, it is our job to analyze the world around us and invest in the context of the short- and intermediate-term economic landscapes. We have never believed in a "one size fits all" portfolio and have always provided custom tailored advice to our valued clients based on their personal goals and risk tolerances. With this in mind, we would like to share with you our perspective and predictions about some significant events that we believe are likely to unfold in the year ahead.

Beacon's Ten Investment Forecasts for 2019

1. U.S. stocks will deliver another positive year as earnings growth continues in a slowing economy.
2. The slowing economy will result in the Federal Reserve increasing interest rates 2 times or less in 2019 to reduce the risk of tilting the economy into a recession because of an inverted yield curve.
3. Bond indexes will provide muted returns again in 2019. Cash equivalent investments remain attractive on a risk-adjusted return basis.
4. Real estate prices will increase at the national level, but at a slower rate versus 2018 as rising interest rates and recent tax law changes limit price appreciation.
5. The current economic expansion will become the longest in U.S. history.
6. The U.S. federal budget deficit will exceed $900 billion in fiscal 2019 helping to keep the 10 year U.S. Treasury note above 3.0% for the bulk of the year, despite a slowing economy.
7. The U.S. dollar will temper its rate of appreciation resulting in positive returns for broad international stock indexes, such as MSCI World (ex-U.S.).
8. The municipal market will outperform most fixed income sectors, except for cash, in 2019.
9. High quality investments will outperform low quality investments in 2019.
10. Crude oil prices will increase as production cuts and modest global growth offset fears of oversupply and a slowdown in China.

Beacon's Four Investment Themes for 2019

Beacon's 2019 Investment Themes echo our forecasts for the coming year and reflect our best thinking to protect capital and improve returns:

1. The aging bull market for U.S. stocks continues on.

2. Global economic growth slows.

3. Interest rates continue to increase modestly.

4. Diversification and quality will add value once again.

A Glance Back on the Year That Was

U.S. stocks have generated positive returns for the 10th consecutive year, with the S&P 500 up roughly 1% as of this writing. Despite their gains, stocks navigated a very choppy year, with not one, not two, but three corrections. The current bull market, which began in March, 2009, is now officially the longest on record in U.S. history. Bonds delivered mixed results in 2018, with most short-term, floating rate, and municipal indexes delivering small, but positive returns, while most other segments of the bond universe generated modest losses.

Before we look ahead to 2019, it seems only fair to look back on our 10 forecasts for 2018. What did we get correct and where did we go wrong? In our view, four of our ten predictions were correct and two were partially correct. Four predictions were incorrect, albeit with a couple of near misses. This performance lags the seven to eight forecasts that historically we assessed to be correct in most of our prior reports.

Let's start with our mistakes. Small cap stocks started out 2018 very strongly, but ultimately lagged large caps as the year came to a close. Infrastructure stocks also lagged the S&P 500 as a major federal spending package failed to emerge. Their prospects may be better in 2019 as Democrats and Republicans wrangle over a budget deal as the year comes to an end. International stocks lagged U.S. stocks, partially due to the strong U.S. dollar, which trims net returns to U.S. based investors. Commodities also started out strong, but ultimately most indexes in this segment ended lower. Let's move on to what we got right in 2018.

As noted above, U.S. stocks delivered positive returns for their tenth consecutive year, but given the volatility in the market, the gains are at risk for evaporating by the end of the year. We had not only one correction, but three in 2018. Real estate had another good year, with the Case-Shiller Home Price Index increasing about 5.5% in 2018. The supply of municipal bonds was down about 20% in 2018, resulting in a net positive return for most municipal bond indexes.

In terms of our partially correct forecasts, we predicted that bond yields would increase, but that the Barclay's Aggregate Bond Index would wind up in (very low) positive territory. Yields did increase but the Barclay's Index is down less than one percent so far in 2018. Speaking of rising yields, we forecast that the Fed would increase rates 3 times or less on 2018. So far this prediction is true, but it appears likely that the Fed will raise rates in December, which would move this prediction into the incorrect column. **Table 1** provides a summary scorecard for our 2018 forecasts.

Table 1: Review of Beacon's 2018 Financial Forecasts

Forecast	Assessment	Rationale for Assessment
Stocks to deliver positive returns *	Correct	The S&P 500 is up roughly 1% YTD as of this writing
Fed to raise rates 3x or less	Partially Correct	The Fed raised short-term rates 3x so far in 2018 *
Bond yields to move up slowly *	Partially Correct	Yields increased, but the Barclays Agg fell < 1%
Real estate prices to rise single-digits	Correct	Case-Shiller Home Price Index increased about 5.5%
U.S. stocks to experience a correction	Correct	Corrections occurred in January/ February / October
International to outperform domestic equity	Incorrect	MSCI deceased while the S&P 500 increased
Small Cap stocks to have a good year	Incorrect	Small cap stocks started strong but ultimately lagged
Supply of tax exempt bonds to decline	Correct	Tax exempt issuance was down roughly 20% YOY
Commodities to increase in value	Incorrect	Modest decreases, partially impacted by strong dollar
Infrastructure stocks to outperform market	Incorrect	Infrastructure stocks lagged

**There is a high likelihood that The Federal Reserve will increase rates at its December 18-19, 2018 Federal Open Market Committee meeting. If so, it would move this prediction from partially correct to incorrect. Stock returns are modestly positive and bond returns are modestly negative as of mid-December. The results from these 2018 forecasts may also change by the end of the year.*

A Closer Look at Beacon's Ten Investment Forecasts for 2019

There is an element of risk in offering predictions, since the future is uncertain. We can state with confidence that some forecasts we offer for 2019 are likely to be correct, some incorrect and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major events of 2019 are neither on our list, nor on anyone else's. For example, although many analysts thought that the price of Bitcoin was at bubble levels, few forecast the massive 80% drop that occurred in 2018. The apparent denuclearization agreement between the U.S. and North Korea also represented somewhat of a shocker on the geopolitical front. It is often the events that few investment strategists are talking about that result in the most extreme market movements. As noted in our Executive Summary section, Beacon portfolios are custom tailored to each client's unique risk tolerance. Hence, our investment ideas may be appropriate for some clients, while not consistent with the goals and objectives of others. With these important caveats in mind, we humbly offer you some color around our top ten investment forecasts for 2019.

1. **U.S. stocks will deliver another positive year as earnings growth continues in a slowing economy.**

   We believe in the Wall Street expression, "Bull markets don't die of old age." In most cases, they end due to a forthcoming recession. Although we expect the economy to slow in 2019 versus its strong 3.0%+ GDP pace in 2018, we nevertheless expect positive growth. Earnings growth is driven largely by economic growth. Analyst consensus earnings estimates for the S&P 500 suggest 8%-10% earnings growth in 2019. It may be challenging to reach double-digit returns with a backdrop of rising interest rates and Fed balance sheet shrinkage, but we expect to see an eleventh consecutive year of positive returns for the S&P 500 when 2019 comes to a close.

2. **The slowing economy will result in the Federal Reserve increasing interest rates 2 times or less in 2019 to reduce the risk of tilting the economy into a recession because of an inverted yield curve.**

   The "Dot Plot" is a tool that the Federal Reserve uses to graph the estimated Federal Funds Rate forecasted by voting members of the Fed's Open Market Committee. The current plot is showing a quarter point increase in December, three quarter point increases in 2019 and one in 2020. An aggressive rate hike path may result in an inverted yield curve, historically a harbinger to a recession. Given the slowing economy and some backpedaling on prior hawkish comments by Fed Governors, including Chairman Jay Powell, we think the Fed will go slow in 2019, with one quarter point increase as the most likely scenario.

3. Bond indexes will provide muted returns again in 2019. Cash equivalent investments remain attractive on a risk-adjusted return basis.

From 2009 to a little over a year ago, short-term interest rates were close to 0%. Now with the Fed slowly, but surely, exiting from “emergency rate” levels, cash yields in excess of 2% are fairly attractive. Certificate of Deposit (CDs) with a two year maturity may provide yields of around 3%. We believe the deck is stacked towards a gradual rise in interest rates, with a still growing economy and a huge supply of new federal government debt that must be absorbed. This dynamic may result in a bond market scenario similar to what unfolded in 2018. Namely, muted returns for most bond indexes and cash-like investments that provide attractive risk-adjusted returns.

4. Real estate prices will increase at the national level, but at a slower rate versus 2018 as rising interest rates and recent tax law changes limit price appreciation.

Real estate prices tend to rise at the national level, unless there is a deep recession. However, substantial variation in home price changes exists across the United States each year. For example, high tax states, such as those in New Jersey, New York, Connecticut, and California, may see more muted price increases as recent federal tax law changes, which limit state and local deductions to $10,000, act as an anchor on price appreciation. Combined with a backdrop of rising interest rates, we think residential real estate will be hard pressed to match last year’s solid 5.5% increase in the S&P Case-Shiller Home Price Index.

5. The current economic expansion will become the longest in U.S. history.

The U.S. economy has expanded for 114 consecutive months since the end of the Great Recession, which officially ended in June, 2009. The longest expansion in U.S. history was from March, 1991 to March, 2001, or 120 months. Therefore, if the U.S. economy can get to July of next year without entering a recession, it will be the longest on record. We think the odds are good that it makes it there and beyond, given that most economic indicators point to continued growth. The current recovery, in terms of its average GDP growth rate, has been more tepid than prior ones, so “lower for longer” may be the theme of the current recovery. As with bear markets, there is no magic number that must push the economy into a recession. Australia has not gone through a formal recession since June of 1991 and China has not experienced one since at least 1990, according to official government supplied GDP numbers.

6. The U.S. federal budget deficit will exceed $900 billion in fiscal 2019 keeping the 10 year U.S. Treasury note above 3.0% for the bulk of 2019, despite a slowing economy.

The U.S. federal budget deficit exceeded $750 billion in fiscal year 2018, which ended on September 30th. Given the recent individual and corporate tax cuts and a slowing economy, the deficit is likely to increase in fiscal year 2019. Rising interest rates versus last year’s levels make the U.S. Treasury’s national debt of $21.8 trillion more expensive to carry. Therefore, we think a federal budget deficit of at least $900 billion is likely this year. Why does the deficit matter, other than the obvious fact that it must be repaid someday? The main impact is on interest rates. The U.S. government has to compete with other borrowers in order to raise the money necessary to finance its deficits. The Federal Reserve also continues to reduce its balance sheet by $50 billion a month, a modest tightening action. This confluence of factors suggests to us that interest rates will be biased towards rising across the maturity spectrum, with the benchmark 10 Year U.S. Treasury Note to remain above 3.0% for the bulk of the year, despite a slowing economy.

7. The U.S. dollar will temper its rate of appreciation resulting in positive returns for broad international stock indexes, such as MSCI World (ex-U.S.).

The U.S. dollar has been on a multi-year run, versus a basket of currencies around the world, based on its rising interest rates, strong relative growth, and longstanding safe haven status. However, with the Fed near the end of its tightening cycle and better valuations around the world, investors may look outward for a change.

International equities may add to performance in 2019, rather than the uncomfortably large drawdown experienced by most foreign equity markets this year.

8. **The municipal market will outperform most fixed income sectors, except for cash, in 2019.**

   In our view, municipal bonds will continue to be a safe haven and tax efficient investment opportunity for most high net worth investors. The demand from these investors for high quality investments will likely remain robust amid macroeconomic uncertainty. Additionally, investors in high tax states such as New Jersey, New York and Connecticut will continue to have more incentives to invest in tax-exempt bonds as tax reform last year capped state and local tax (SALT) deductions at $10,000.

9. **High quality investments will outperform low quality investments in 2019.**

   Quality may be measured in a number of ways. For example, in the fixed income area, bonds with high credit ratings are viewed as being of higher quality than bonds with below investment grade or “junk” ratings. In the equity universe high quality firms are those with consistent, positive earnings and strong balance sheets, while low quality firms are often losing money and/or overleveraged. Any way you slice it, we believe that investors will be more discriminating with their investments as they try to navigate the longest bull market and economic expansion in U.S. history.

10. **Crude oil prices will increase as production cuts and modest global growth offset fears of oversupply and a slowdown in China.**

    Crude oil has plunged from $75 a barrel to roughly $50 a barrel in the past three months on fears of a slowdown in China and continued strong production from the mid-continental United States. Despite the growth in solar and other forms of alternative energy, oil consumption typically moves in line with economic growth. Growth will occur not only in the U.S., but also in most emerging markets around the world that comprise the bulk of the world’s population. Furthermore, sport utility vehicles (SUVs) are poised to overtake sedans as America’s vehicle of choice, despite inroads made by electric vehicles. The “Amazon and Uber economy” has also created enormous demand for home delivery of many products and services, which are bullish for oil demand. Net-net, by the end of the year we expect oil to be above $50 a barrel.

Beacon’s Four Strategic Wealth Management Themes for 2019

Investment forecasts in and of themselves are interesting, but of little direct value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Forecasts we offer Four Strategic Wealth Management Themes for 2019, which are often tied to the specific investment in your portfolio.

1. **The aging bull market for U.S. stocks continues on.**

   When we look across the investment landscape, equities still appear to be “the best house in a bad neighborhood.” Consider that taxable investment grade bonds are yielding 2%-3% in an environment where inflation exceeds 2%. Hedge funds, with their high fees and lackluster returns, have long been a disappointment. Gold, despite its safe haven status, pays no cash flow and lost money in a tumultuous 2018. And let’s not get started on Bitcoin. This perspective especially rings true when you consider that earnings are still poised to rise and the dividend yield on many high quality equities exceeds 3%. We think investors will come around to our line of thinking and vote with their dollars for both U.S. and international equities in 2019.

2. **Global economic growth slows.**

   The recent tax cuts and rollback in business regulations did have a demonstrable short-term impact on U.S. GDP. The long-term effect, of course, is unknown thus far. Nevertheless, the 4.2% GDP growth experienced in 2Q 2018 and 3.5% in 3Q 2018 are likely not sustainable. China’s GDP “slowed” to about 6% and Europe and Japan continued to experience tepid, but positive growth. Most central banks around the world are exiting from stimulus packages that were instituted in the midst of the Great Recession. The threat of a global trade war, especially between the U.S. and China, remains at the forefront of most investors' minds. However, slow growth doesn't mean no growth. In a fast growth environment almost all firms benefit. As growth slows, we think investors should be more discriminating and the wise selection of individual stocks and funds may make all the difference in the year ahead.

3. **Interest rates continue to increase modestly.**

Fixed income investors have largely been spoiled over the past 35+ years since the general trend in interest rates was down. This glide path, of course, created a largely bullish backdrop for most fixed income securities since the early 1980s. Now the sledding is a lot tougher, especially on an after-tax and inflation basis. As we noted in our Ten Investment Forecasts for 2019, we think the Fed is almost done with its rate hike program and that long-term rates may continue to edge up with a shrinking Fed balance sheet and expanding federal budget deficit. In our view, this creates an environment for bonds marginally better than that experienced in 2018. Why hold an investment that provides only a 2% -3% yield and minimal capital appreciation potential? This was a worthwhile question asking when stocks were up 8% in mid-January, 2018 alone. But the corrections in late January, February, and October-December of 2018 provide ample evidence of the valuable role that bonds may play in most portfolios. Not only do they often provide positive returns in down equity markets, but they often give investors the fortitude to stay the course and remain invested when the equity rebound eventually occurs.

4. **Diversification and quality will add value once again.**

This past year has been quite anomalous, with large cap U.S. equities, certain cash equivalent investments, and select municipal bonds earning positive returns. Most international equities, small cap U.S. equites, commodities, hedge funds, and taxable bond funds lost money in 2018. Quite simply, diversification didn't work for most investors. We are not ready to throw time tested investment principles into the financial dustbin after a short-term period of underperformance. Rather, the underperformance of many of these segments of the financial universe may increase their long-run attractiveness. The strong U.S. dollar and well above average stock volatility in 2018 contributed to some of the varied results. As things normalize somewhat, we expect traditional relationships between risk and return to re-establish themselves. Nevertheless, given the late stage bull market and economic cycle, we suggest investors err on the side of high quality across the spectrum of their investments.

We at Beacon look forward to the opportunity to discuss our Ten Investment Forecasts with you, as well as the ways in which our Four Strategic Wealth Management Themes can be custom tailored to your personal situation. As always, we close by thanking you for your loyalty and support. We consider our relationship with our clients a true partnership, and our sole mission as a firm is to add value to our clients in any way we can. It is with the fulfillment of this mission in mind that each of us at Beacon is focused on individual and collective improvements each day.