2019 Recession Unlikely and Stocks Could Rise Further If Fed Halts Rate Hikes And Quantitative Tightening, Analysts Say at CFALA Annual Forecast Dinner

LOS ANGELES – Three top Wall Street analysts delivered a mostly optimistic outlook for 2019 while cautioning attendees at CFA Society Los Angeles's (CFALA) 17th Annual Economics and Investments Forecast Dinner that Federal Reserve policy is the key to future economic growth and the path of the stock market.

Building on strong 2018 performance spurred by regulatory relief, tax cuts and business investment, the economy is primed to expand by around 2.5% in 2019, NatWest Markets Chief U.S. Economist Michelle Girard said, marking its seventh straight year of above-trend growth.

"Accelerating economic growth over the last four to six quarters has been driven by an expansion of the supply-side – rather than the demand-side – of the economy, which we believe sets the stage for sustained noninflationary growth in 2019 and a neutral, rather than restrictive, monetary policy stance," Ms. Girard said in remarks prepared for the dinner Wednesday at the Millennium Biltmore Hotel Los Angeles.

"In our view, those who see the strength of the economy in 2018 as a 'fiscal sugar high' are missing this point," she said. "Whereas individual tax cuts tend to boost demand temporarily as consumers spend their windfall, the economic lift from tax cuts that boost investment and, in turn, productivity can be more persistent."

Wages are likely to rise 4% or more in 2019 while inflation remains restrained by lower energy costs and improved productivity, Ms. Girard said, with core PCE inflation unlikely to move above the Federal Reserve's tolerance zone of "around" 2%.

NatWest expects the Fed to slow its rate raising program in 2019, with Ms. Girard noting that "the new FOMC leadership appears more open to the idea that wage growth does not necessarily lead to higher inflation. In our view, taking policy into restrictive territory – potentially endangering the expansion – will require justification in the form of a tangible rise in inflation," she said. "As we do not expect inflation to overshoot in 2019, we look for just two additional rate hikes next year, lifting the upper end of the Fed's target range to the 2.75-3% range, in line with the FOMC's median estimate of neutral. At that point, we look for the Fed to pause – perhaps for an extended period – until there is a clear need for action in either direction."

Risks to the NatWest forecast include higher inflation caused by tariffs, slower than expected productivity growth and companies becoming more cautious and cutting back on hiring and investing, Ms. Girard said.

A recession in 2019 is possible but unlikely, the Fed is finished raising rates for now and will probably end its balance sheet runoff (quantitative tightening) around June, Julian Emanuel, Chief Equity and Derivatives Strategist at BTIG, told attendees, adding that most of the damage to equities has already been done.

“Unlikely as it may seem now, new S&P 500 highs remain our base case in 2019,” Emanuel said in his prepared remarks. “Bull markets end on good news and ‘irrational exuberance’ – think housing prices in 2007 and tech stocks in 2000 – then the recession comes. We have yet to see this kind of sentiment in asset markets; it is likely ahead of us. Bull markets climb a wall of worry. This wall has been huge and both individual investors and professional investors have become fearful – and underinvested.”

Though sharp, the recent selloff in stocks is more akin to the shallow bear markets of 2011, 1998 or 1990-91 than a full-fledged bear market, Emanuel said, while warning that political instability could cause more market volatility that in turn might damage confidence among consumers and businesses and increase the possibility of a recession.

“We continue to view a recession in 2019 as unlikely but the politics-market-confidence feedback loop is powerful – raising the risks of a ‘self-fulfilling prophecy’ economic downturn,” he said. “However, the force of the market’s post-Christmas rebound off the S&P 500’s 10-year uptrend line leads us to view the bulk of the damage as past. Greed dominated at last year’s market turns in January and again in September. As 2018 ended and 2019 begins, fear is on full display. Counterintuitively, this fear is likely to reinforce the wall of worry that all bull markets eventually climb.”

Emanuel, who provides top-down analysis of broad market trends, sectors, valuation and volatility with a focus on U.S. equity markets, said modifications in central bank policy – already hinted at by Fed Chairman Jerome Powell – could prompt significant shifts in investment markets.

“The Fed could, in our view, help catalyze sector reversion with an end to hikes and/or balance sheet roll-offs, prospectively resulting in yield curve steepening favorable to cyclicals,” he said.

Although recent economic data in the U.S., Europe and China point to a slowing global economy, the key indicator in terms of a possible near-term recession is Federal Reserve policy, James Bianco, President and Macro Strategist at Bianco Research, said in his prepared remarks.

“How do we know if we are going to have a recession?” he said. “You do not need to bother with the economic data. What you need to watch is whether the Fed will kill the current economic expansion, and I think the odds are 40% to 50% that they will.”

Bianco pointed to what he termed “flip-flopping” between hawkish and dovish comments by Powell, adding that credit markets are signaling that interest rate hikes and balance sheet reductions by the central bank are warning of trouble ahead.

“The yield curve is telling us that the Federal Reserve policy is getting too tight, and that that Federal Reserve policy is a problem,” he said.

While Powell has said the Fed is prepared to be flexible and patient on policy, Bianco believes those comments were primarily a reaction to market volatility during the fourth quarter of 2018.

“What I'm getting from all of the Fed speak is, the markets acted like a petulant child, we had to kind of appease them to prevent them from blowing up – there’s no problem with our policy,” he said.

Despite economic uncertainties that include lowered expectations for corporate earnings and concerns about Fed policy, Bianco believes stocks will end 2019 in the black.

“The earnings numbers are coming down, the economy has been slowing, and this is going to limit any market rally as we move forward,” he said. “Even so, I think it's going to be an up year for the stock market. But before we get there – around the end of the first quarter into the second quarter – I think we're going to revisit the December 24, 2018 lows in both stocks and in yields. Then we'll bottom and we'll start up and no one will believe the rally.”

CFALA’s annual forecast dinner benefits the California Council on Economic Education (CCEE), which provides economic and financial literacy education to K–12 teachers and students to help them make better personal and financial decisions, improving students’ ability to succeed and compete in the global economy. Two teachers received Teacher of the Year awards from the CCEE at this year’s dinner: Jibin Parks of Los Altos High School and Connie Moore Kelley of the Hamilton High School BITA Academy.

Founded in 1931, CFALA is the local member society of CFA Institute, the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors’ interests come first, markets function at their best, and economies grow. For more information, visit www.cfala.org.

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