Voya Global Perspectives

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2019 Forecast

The Storm Before the Calm

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Executive Summary

- Exceptionally strong economic growth has prompted the Fed to raise interest rates, reduce the balance sheet and generally to "Rip the Bandaid Off" from a zero rate environment.
- The subsequent surge in volatility is cleaning house from rampant speculation that needed to be unwound - setting the stage for a healthier and calmer market in the future.
- Two of the "Big 3" — China and the Eurozone — are struggling for geopolitical reasons but also due to the U.S. regaining its ranking as the most competitive country in the world.
- Investors should prepare for the "storm" of tighter monetary conditions and greater geopolitical uncertainty but not at the expense of losing sight of our forecasted "calm" outlook.
- Diversify, be disciplined and do not forget your ABCs — which in our 2019 forecast extend all the way to J-Jobs.

Introduction

In 2019 we expect, and prudent investors should prepare for, "the storm before the calm" — tighter monetary conditions, uncertainty that includes a "disorderly Brexit" and increasing tensions between China and the United States on multiple fronts. We expect a storm though, nothing more. These conditions pale in comparison to what we consider the best economic backdrop in 30 years, which we believe will result in the "calm" that investors potentially can take advantage of across markets and around the globe.

The Federal Reserve is ground zero for storms. The U.S. dollar is the global reserve currency, and whether or not the Fed cares about the impacts of its policies outside the U.S., there is an incontrovertible feedback loop to U.S. markets. Policy overshoot can wreck global markets, which in turn can wreck the overseas earnings of U.S. companies.

We all know from experience that ripping the Band-Aid off produces sharp, quick pain but beats the slow, endless tugging that ends up delaying healing. The eight interest-rate increases the Fed effected in the short span of two years "ripped the Band-Aid off" the economy, instead of taking the go-slow approach, but coincided with the first 3% GDP growth rate in a 12-month period in over a decade — no small feat. Add to that record levels of employment, record corporate earnings and a manufacturing renaissance; and you have sown the seeds for a market with resilience like a palm tree, which bends in the wind but swiftly recovers after the storm passes.

The Fed's fast-paced rate increases have had the remedial impact of removing speculative excesses. For example, in the last three months at the time of this writing Bitcoin is down -44.7% and the FAANG stocks — Facebook, Apple, Amazon, Netflix and Google — are living up to their acronym down -19.8% as they rip speculators apart. The good news is that it is far better going through a correction than another 2008-style credit crisis. By the way, the Fed is practicing something called "macroprudential" policy — an approach to regulation that seeks to mitigate the risks of the financial system as a whole. It is good policy and we should be thankful the Fed focuses on it. Fed Chairman Jay Powell gave the market a boost at year-end 2018 by saying he thought interest rates were close to "neutral" — the level that neither inhibits economic growth nor encourages inflation — implying that the pain of dealing with tightening monetary policy may be almost over. That is good news and an important insight for maintaining calm in 2019.

Because there is much to think about in the coming year, our 2019 forecast expands our usual ABCs all the way to J, as detailed below.

Figure 1. Global Perspectives Outlook for Markets, Rates and Sectors in 2019

Rate/Sector/Metric	2019 Forecast
S&P500 EPS	$178
S&P500 Index Level	2850
Oil	$60/bbl
10 Year UST Yield	3.00%
Global Growth	3.60%
U.S. GDP Growth	2.60%
Gold	$999/oz

Source: Voya Investment Management. Forecasts are subject to change.

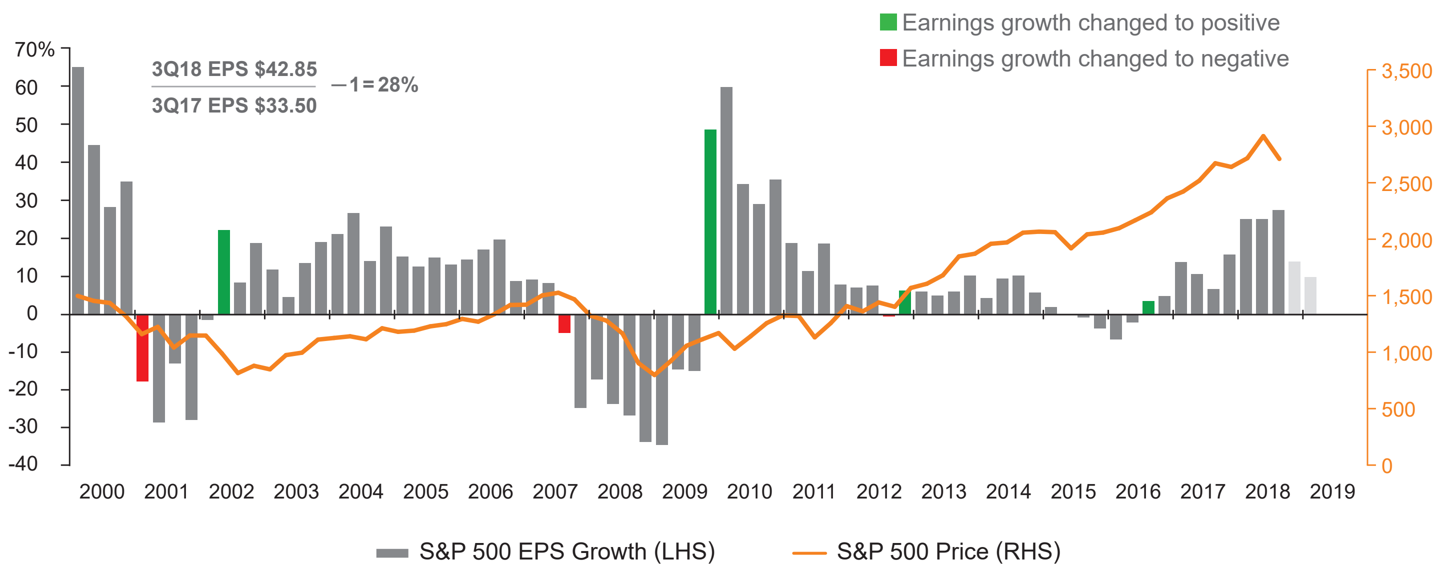
A – Advancing Corporate Earnings

Corporate earnings growth has been on fire over the past four quarters, accelerating to nearly 30% year-over-year growth in 3Q18. It is clear that corporate earnings will not grow forever at this incredible pace, but in our view, talk of "peak earnings" is way off base. We expect corporate earnings to grow through this year and with that, equity prices will follow.

- 2019 forecast — S&P 500 price level 2850, 16 P/E
- Sector recommendations — consumer discretionary, financials, energy and industrials
- The earnings growth of the full year 2018 is projected at 20.6% with revenue growth of 9.0%. This has been a stellar year for earnings and revenue which was triggered by the extraordinary tax cuts and deregulation.
- In 2019 earnings are expected to grow between 8% – 10% with revenue forecasted to grow around 6%. This growth will put earnings and revenues at all-time record highs and is a sign of U.S. and Global growth.

Figure 2. Corporate Earnings Growth is a Barometer of Global Economic Health

S&P 500 Index: Estimated Quarterly YoY Earnings Growth

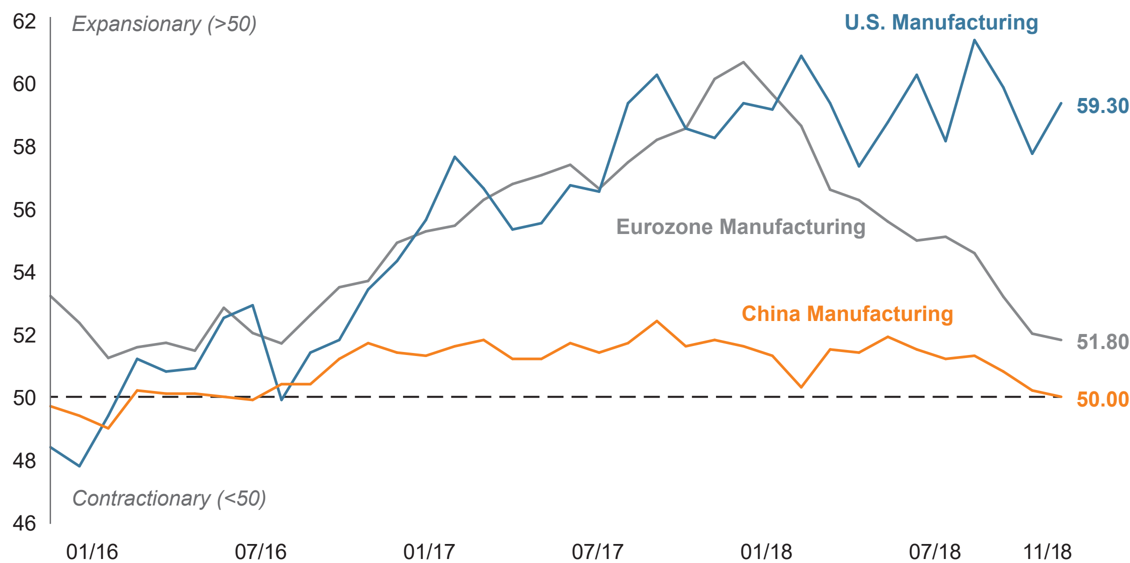


Source: FactSet, Voya Investment Management. Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. The S&P 500 index is a gauge of the U.S. stock market that includes 500 leading companies in major industries of the U.S. economy. **Past performance is no guarantee of future results.** Indices are unmanaged and not available for direct investment.

B – Broadening Manufacturing

- The latest U.S. manufacturing PMI hit 59.3, up from 57.7. Employment continued to hum along at 58.4 and new orders made a big comeback to hit 62.1, interrupting a slide
- Tax cuts, transportation costs and technologies that reduce labor cost differentials have increased the appeal of U.S. manufacturing reshoring
- Globally, the manufacturing sector is showing signs of stabilizing especially among the emerging markets. Russia, Brazil and India are moving up and Europe may be stabilizing

Figure 3. Global Manufacturing Reports Indicate Expansion



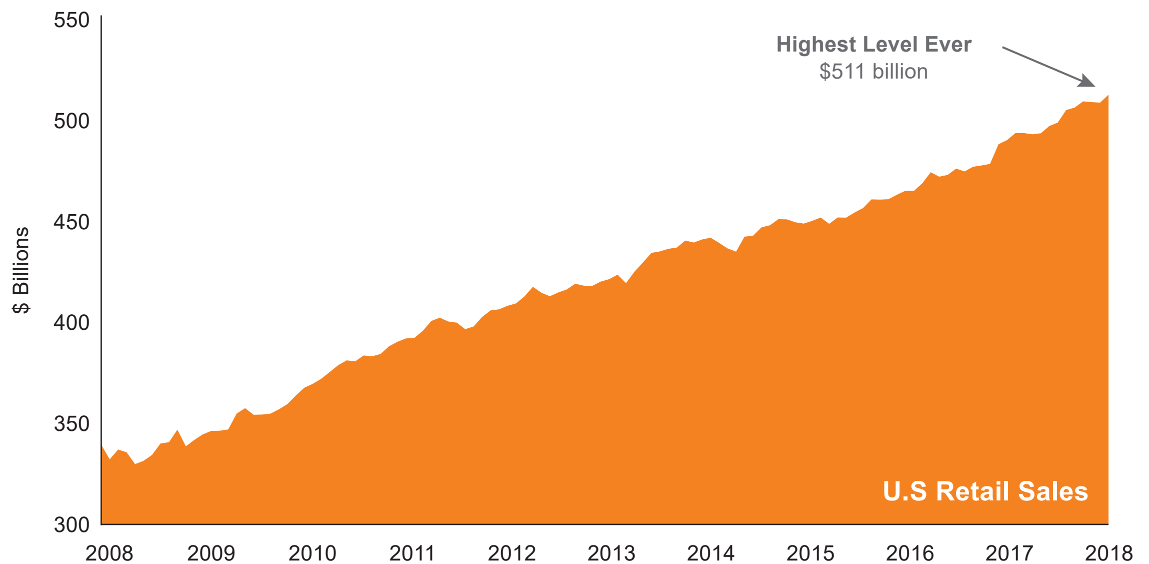
Source: Institute of Supply Management, FactSet. The Purchasing Managers' Index (PMI) is an indicator of economic activity in the manufacturing sector. Measures above 50 indicate economic expansion, measures below 50 indicate economic contraction. Data as of 11/30/18.

C – Consumers, the Game Changers

Just as last year's calls for the demise of many consumer discretionary stocks were premature, so we believe is the call for a marked slowdown in consumer spending. We believe the following factors will provide support for the biggest contributor to the U.S. economy:

- Higher tax refunds will fuel consumer purchases, especially in 1Q19
- Wages are increasing 3.1% year-over-year after many years of stagnation
- Inflation — both core and headline — has been falling
- Gas prices are lower
- Consumer confidence remains near 18-year highs
- The labor market is continuing to add about 200,000 jobs per month

Figure 4. At about 70% of gross domestic product (GDP), the U.S. consumer is the game changer in economic growth



Source: U.S. Department of Commerce, U.S. retail sales as of 010/31/18.

D – Diversify Globally into Multi-Asset Portfolios

- A pillar of our global perspective has been recognizing the "folly of gaming diversification," i.e., when investors abandon diversified positions seeking to sidestep impending risks or to crowd into areas of strong returns
- We recommend investors spread their exposure across multiple asset classes and sectors to mitigate concentration risk. This approach also has the remedial effect of increasing exposure to areas of higher return potential
- "D" also stands for the discipline to maintain positions when it seems all is lost or the grass is greener on the other side

E – Emerging Markets Show Encouraging Fundamentals

China is one of the "Big 3" that we follow closely for directional trends in global economic growth. It is still considered an emerging market, not because of its size but because it lacks open markets. China is slowing, though, mainly due to the lagged effects of tightened monetary policy implemented more than 18 months ago.

- The credit contraction from late 2016 through the first quarter of 2018 is the tightening that is affecting China's current growth
- China's aggressive economic stimulus for the past six months is not likely to have an effect until the third quarter of 2019
- The U.S.–China trade dispute has created a severely asymmetric distribution of "pain" tilted toward China rather than the U.S. In our view, this is probably a big part of why easing has proven ineffective in 2018
- Other emerging markets such as Singapore, Malaysia and Vietnam are directly tied to China and will respond positively when stimulus kicks in

F – The Fed is the Elephant in the Room

The Federal Reserve has been central to our market outlook. We expect that the Fed may downgrade the "dots," that is, expected interest-rate hikes, to two in 2019 based on the following:

- Fed Chairman Powell said in November that rates are "just below estimates of neutral," walking back somewhat his comments from October that the Fed has a long way to go
- Inflation is not a threat — expectations are grounded, oil prices are down and the U.S. dollar is up, implying the Fed will only hike two times in 2019
- Market indicators, including current expectations, are signaling that the Fed already has done enough. If the Fed heeds those signals, it could alleviate pressure on the emerging markets, the U.S. dollar and high yield bonds (less pressure on commodity producers)
- U.S. Treasury rates are likely to move higher barring a recession. With the Fed increasing interest rates and nominal GDP growth likely to reach 4% or higher, the 10-year Treasury yield seems ripe to move above 3%

G – Global Growth Divergence

Last year's theme was global, synchronous expansion. This year has been a year of desynchronizing, with the U.S. growing at its fastest pace in a decade and other global economies faltering.

- While there has been a pickup in 4Q18 activity, the 2019 outlook depends on the effectiveness of China's stimulus, especially for export-driven economies such as Japan and Germany
- Japan and Germany posted negative GDP in 3Q18; even an orderly Brexit is expected to take a toll on UK GDP
- Regional demand for goods has dropped and world export growth has slowed as U.S.–China trade tensions shake up global supply chains. The auto sector has been particularly hard hit
- Trouble continues to brew in Italy with its rising debt to GDP (currently 130%) and the clash with European Union financial discipline increasing the chances of recession
- Plans for rate hikes in the Eurozone will not begin until mid-2019 at the earliest, whereas Japan will continue to expand its balance sheet with more "helicopter" money

H – Housing Headache

The housing market has slowed throughout 2018 because of supply constraints, which have pushed up prices and strained affordability, especially for first-time buyers. Throw in higher mortgage rates and the negative housing headlines are not surprising.

- The U.S. housing market will not crash but will not be an economic tailwind
- Prices will continue to rise in 2019 but the rate of increase will slow. Realtor.com anticipates price appreciation of 2.2% while Case/Shiller forecasts a 3.7% increase in its 20 metro area index
- Higher mortgage rates, low inventories and continued price appreciation, in conjunction with a predicted tepid 8% increase in new housing starts, will result in a 2% decline of existing home sales in 2019
- Housing prices have been rising at 5%, faster than inflation, but with only 1.2 million starts in 2018 vs. 2.3 million starts in 2006, housing is not a bubble

I – Inflation in Short Supply

- Investors as well as the Fed have been on inflation watch all year, but inflation likely peaked in July when the consumer price index (CPI) registered 2.9% YoY. Headline inflation has since ticked down to 2.5% YoY. Core personal consumption expenditures, the Fed's preferred inflation measure, is 1.8% YoY, below the Fed's 2% target
- Looking at inflation-sensitive market indicators, we see a rather consistent story that inflation is unlikely to break out to the upside. Market indicators such as the surge in the U.S. dollar and the precipitous drops in the prices of gold, oil and other commodities imply that the Fed has already done enough
- With inflation as low as it is currently, and the expectation that growth will be ebbing, the potential for further dollar appreciation is constrained but not extinguished

J- Jobs, Jobs, Jobs

A pro-business backdrop has created a record number of job openings in the U.S. and a situation where there are more openings than job seekers.

- Hourly earnings exhibited their biggest increase since April 2009 with a 3.1% jump in wages. Wage increases need not be inflationary if productivity rises. Third-quarter productivity was up 2.3%. A 3.1% increase in hourly wages coupled with a 2.3% surge in productivity is effectively a 0.8% cost increase for employers
- The recent jump in capital expenditures or business investment, (7.5% in the last four quarters vs. near zero in the prior four quarters ending in 2016), is helping to spur productivity. In our view, the lack of productivity gains over the last decade holds the blame for below-trend GDP and stagnant wages

Risks to 2019 Outlook

The Federal Reserve

The Fed has a reputation for bringing the U.S. into recessions due to aggressive policy overshoots when raising interest rates.

- In the fourth quarter of 2018, we have seen this risk play out and it is real. The zero-bound Fed funds rate was a risk, but with the Fed funds rate now more than 2% and core CPI near the same level, this risk is essentially gone
- The Fed funds rate is a fulcrum of asset valuation. If it continues to go up, even slowly, it will be disruptive – maybe severely – to U.S. and global markets
- Our base case is that the Fed will pause earlier than the markets have priced in

Cyberattacks

- A 2018 World Economic Forum study revealed that advanced economies see cyberattacks as the biggest threat to doing business
- The rise of state-sponsored hacking raises the likelihood that cyberwarfare will be central to the next significant global conflict
- The U.S. economy and national security depends on a secure electric power grid critical for key infrastructure including transportation, finance, energy, water, and communications

"No Deal" Brexit

- If Britain leaves the European Union without an EU trade deal in place, it would be a worst-case scenario
- There are now rumblings of a possibility of reversing "Article 50" the democratically decided decision to leave the EU
- Rating agency Fitch warned that a "no deal" Brexit could lead to a further downgrade of its sovereign credit rating

Italian Recession Triggered by EU Clash

Europe is one of our Global Perspectives "Big 3" of the world economy that determine global growth. With the uncertainty and slowing growth in Italy and the U.K., Europe is on watch for downside risk.

- Italy is no Greece, it is worse. Greece was practically insignificant but Italy is the fifth largest debtor in the world and its debt is 130% of GDP. The recent clash with the EU over budgets could escalate
- European banks depend on Italian stability. Currently, there is a fight waging with the EU over its budget, pushing its economy to the brink of recession
- No one is yet predicting a Brexit-like event for Italy, however, the situation just adds to the disruption in Europe

Conclusion

The Global Perspectives "Big 3" serve as our bellwether for global growth; with financial conditions tightening, the story is not as robust as last year. As central banks, the Fed in particular, reverse years of excess in monetary policy, this "storm before the calm" is to be expected. The storm that hit in 4Q18 is scary, yet the global macroeconomic backdrop is better than it has been for a decade. It is even better in the U.S., the largest and most competitive economy on the planet, which we think reflects pro-business policies that are working.

As we have discussed, there are risks for 2019 but they are more about unwinding "errors" of the past that we believe will create a healthy, prosperous and balanced future. Diversify, do not concentrate positions, be disciplined and do not forget your ABCs.

Figure 5. Effective Diversification Casts a Wide Net Across Global Equity and Fixed Income

Index	Wgt	Nov 18	YTD	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	3 years	5 years	10 years	15 years	20 years
Equity																		
S&P 500	10%	2.0	5.1	21.8	12.0	1.4	14.9	32.4	16.0	2.1	15.1	26.5	-37.0	12.2	11.1	14.3	8.8	6.4
S&P Midcap	10%	3.1	0.3	16.2	20.7	-2.2	10.3	33.5	17.9	-1.7	26.6	37.4	-36.2	10.5	9.3	15.6	9.9	10.3
S&P Smallcap	10%	1.5	4.1	13.2	26.6	-2.0	5.5	41.3	16.3	1.0	26.3	25.6	-31.1	12.4	9.4	15.8	10.3	10.4
Global REITs	10%	3.8	0.7	11.4	5.0	0.1	16.5	4.4	28.7	-5.8	20.4	38.3	-47.7	5.9	6.5	12.2	8.3	8.8
EAFE	10%	-0.1	-9.0	25.6	1.5	-0.4	-4.0	23.3	17.9	-11.7	8.2	32.5	-43.1	4.6	2.3	8.0	6.1	4.4
Emerging Mkts	10%	4.1	-12.0	37.8	11.6	-14.6	-2.4	-2.3	18.6	-18.2	19.2	79.0	-53.2	9.8	2.3	9.5	9.0	8.9
Average		2.4	-1.8	21.0	12.9	-3.0	6.8	22.1	19.2	-5.7	19.3	39.9	-41.4	9.2	6.8	12.6	8.7	8.2
Fixed Income																		
Corporate	10%	-0.2	-3.9	6.4	6.1	-0.7	6.7	-1.5	9.8	8.1	9.0	18.7	-4.9	2.5	2.9	6.5	4.6	5.2
U.S. Treasury 20+	10%	1.9	-7.2	9.0	1.4	-1.6	25.1	-13.9	3.4	33.8	9.4	-21.4	33.7	0.9	4.8	4.1	5.9	5.9
Global Aggregate	10%	0.3	-3.2	7.4	2.1	-3.2	0.2	-2.6	4.3	5.6	5.5	6.9	4.8	2.2	0.6	2.9	3.4	3.8
High Yield	10%	-0.9	0.1	7.5	17.1	-4.5	2.3	7.4	15.8	5.0	15.1	58.2	-26.2	7.1	4.4	12.2	7.3	6.7
Average		0.3	-3.6	7.6	6.7	-2.5	8.6	-2.6	8.3	13.2	9.8	15.6	1.9	3.2	3.2	6.4	5.3	5.4
Overall Average		**1.6**	**-2.5**	**15.6**	**10.4**	**-2.8**	**7.5**	**12.2**	**14.9**	**1.8**	**15.5**	**30.2**	**-24.1**	**6.8**	**5.4**	**10.1**	**7.4**	**7.1**

Source: FactSet, FTSE NAREIT, Voya Investment Management. The Overall Average model allocation includes 10 asset classes, equally weighted: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI BRIC Index, Bloomberg Barclays U.S. Corporate Bonds, Bloomberg Barclays U.S. Treasury Bonds, Bloomberg Barclays Global Aggregate Bonds, Bloomberg Barclays U.S. High Yield Bonds. Returns are annualized for periods longer than one year. **Past performance is no guarantee of future results. An investment cannot be made in an index.**

General Investment Risks:

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. All security transactions involve substantial risk of loss.

Domestic Equity: Exposure to financial and market risks that accompany investments in equities. Markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market or economic developments. Small cap stocks may be more volatile and less liquid than stocks of larger more established companies.

Fixed Income: Exposure to financial, market, prepayment, credit and interest rate risks. The value of an investment in a fund is not guaranteed and will fluctuate. Higher yielding bonds are subject to greater volatility and credit risks. A fund may invest in securities guaranteed by the U.S. Government as to timely payments of interest and principal, but a fund's shares are not insured or guaranteed. Bonds have fixed principal and return if held to maturity, but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates.

International: In addition to the general risks of investing in equities and fixed income securities, investing in foreign securities poses special risks, including currency fluctuation, economic and political risks not found in investments that are solely domestic. Risks of foreign investing are generally intensified for investments in emerging markets.

REITs: Real Estate Investment Trusts may be sensitive to factors such as changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and credit-worthiness of the issuer. REITs may also be affected by tax and regulatory requirements.

Non-Diversified Strategies: Due to the concentrated nature of non-diversified and sector funds, they may experience greater volatility than funds with a broader investment selection/strategy.

Diversification does not guarantee a profit or ensure against loss. **Past performance is no guarantee of future results.**

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