The Wall of Worry
THE GLOBAL ECONOMY CONTINUES TO GROW DESPITE RECENT UNCERTAINTY

From China trade tariffs, to higher interest rates, to a lack of enthusiasm for record corporate earnings, there’s been no shortage of uncertainty in 2018. Together, these concerns have formed a “wall of worry” for U.S. markets. Ever since stocks fell 10% from their January highs, investors have started to wonder, “Could this be the end?”

While the U.S. expansion is likely in its final innings, we think it’s too early to declare that the game is over. Future bumps are to be expected at this late stage of the cycle, but strong global growth and well-behaved interest rates paint a positive picture for risk assets in 2018. Upon closer inspection, it seems the “wall of worry” may not be as formidable as some investors fear.

Here are three developments we’re watching:

1. U.S. – China Trade Tensions
The current administration is taking China to task for what it considers unfair trade practices. It remains highly focused on China’s “Made in China 2025” plan, which threatens U.S. leadership in high-tech sectors such as artificial intelligence, robotics, aviation and new energy vehicles. The recent tariffs announced between the two countries have unsettled markets and caused investors to worry that a positive deal could remain elusive for some time.
While full-scale trade wars are generally bad for everyone, so far we would characterize the proposed tariffs as more of a trade “skirmish,” affecting only a tiny portion of total U.S. imports (see chart). While this will likely be a long process, the two countries have begun negotiating, and the more positive tone of recent discussions suggests that more communication will take place. At this stage, announced tariffs don’t undercut global growth or market fundamentals, though the situation bears monitoring.

2. Higher Interest Rates
The ability to borrow money is like oxygen for the economy. Most companies don’t build factories with only cash on hand, and most consumers don’t deplete their savings to pay for a new home in full. They borrow to pay some of the bill. So when interest rates go up, the higher cost of borrowing may discourage them from investing and, in turn, slow down the economy.

Although rates remain low compared with history, the Federal Reserve continues to gradually raise rates (see chart). While we believe the Fed is responding to a healthier economy, any future rate hikes could lead some investors to reevaluate stock prices and growth expectations.

Today, borrowing costs remain well below investors’ expected return. Therefore, we don’t believe current interest rates are at levels that are harmful to growth and should continue to encourage borrowing, investment and further economic growth.

Despite recent hikes, U.S. interest rates (green line) remain historically low and should continue to support economic growth (gray line).
3. Fear of an Aging Cycle

As the U.S. expansion is in its ninth year, investors wonder how much longer it can last (see chart). Despite record earnings expected in 2018 on the heels of tax reform, investors have become wary of what could happen after the “sugar high” from fiscal stimulus has faded. We expect strong earnings growth of roughly 22% in 2018, followed by a year of more normalized growth in 2019 (about 7-10%). Beyond that, the outlook becomes less certain.

While it’s hard to predict what will happen to the U.S. economy beyond 2019, it’s important to remember that late-cycle investing can still be fruitful. We expect risk assets to continue moving higher in 2018, as investors get more clarity on earnings and existing concerns begin to ease. Returns will likely be lower in 2019 and beyond, as we head into the later innings of the cycle and investors determine what a slowing earnings stream is worth. This dynamic will likely lay the groundwork for international markets to carry global growth forward. International economies, such as Europe and emerging markets, are much younger in their economic cycles.

The current expansion is now the second longest in U.S. history and will likely continue into the foreseeable future.

CLIMBING THE “WALL OF WORRY”

Although this “wall of worry” has caused market disruptions in 2018, investors should keep in mind that volatility is normal. The S&P 500 has experienced declines of 10% or more in 21 years since 1980. Yet the final market return was positive in 29 of those 38 years, suggesting that staying invested over the long run has paid off.

We were spoiled by lower-than-average volatility in 2017 with only a -3% decline (compared with 2018’s -10% decline). The market now appears to be climbing a “wall of worry,” as strong earnings, driven in large part by tax reform, should support higher stock prices as uncertainty fades.

We expect interest rates to remain well-behaved and earnings growth to continue. If we’re right, we anticipate a positive year for U.S. stocks, with some volatility likely along the way. We think interest rates on 10-year U.S. Treasury bonds will gradually rise to 3.1% this year due to further Fed hikes, strong growth, firming inflation and increased Treasury supply. These developments will lay the groundwork for the eventual end of the U.S. cycle, while international markets will likely continue to grow.
WHAT THIS MEANS FOR YOU

While the “wall of worry” needs to be monitored in the months ahead, we believe 2018 is a year to stay invested. Diversification is critical at this point in the cycle, and you should be aware of how sensitive your bond portfolio is to rising interest rates. Global growth is for real, and we expect stock indices around the world to move higher this year. Because the growth baton is being passed to non-U.S. economies, we favor global stock market exposure to capture the opportunities.