Opening Bell **2019**

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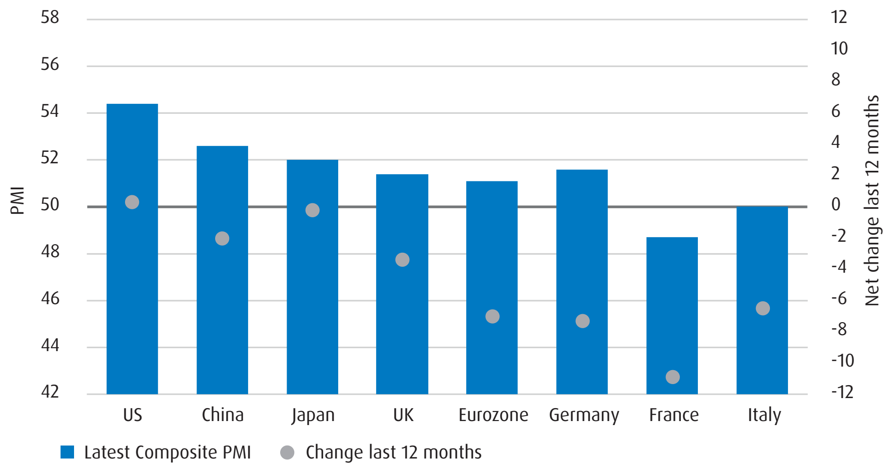
Our chief economist Steven Bell assesses the prospects for economies and markets in 2019.

State of play – is a recession likely?

This time last year we were enjoying a positive background for markets with synchronised global growth and a surge in profit expectations. Today the mood is very different. Growth has slowed, markets ended 2018 on a sour note and fears of recession are widespread. The data have certainly been soft. Global industrial production, a key driver of the economic cycle, has stalled. Does this imply a looming recession? We think not. Global PMIs suggest a pick up and a series of distortions such as inventories being built ahead of Trump's tariffs (later postponed) need to be considered. On balance, we expect a return to modest growth in the Spring.

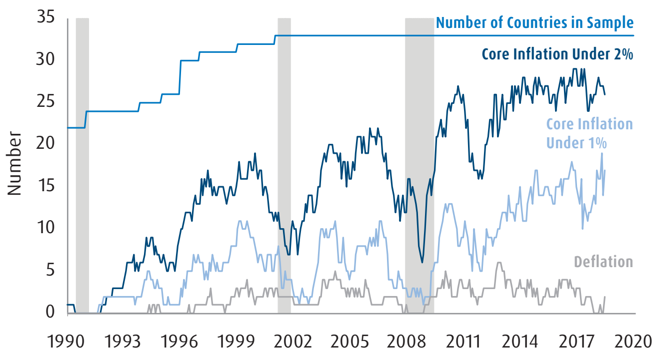
Key PMIs remain in expansionary territory, but there has been a marked deterioration in China and Europe.



Source: BMO Global Asset Management, Bloomberg as at 15 January 2019. PMI = Purchasing Managers' Index.

Inflation is major reason for believing worries over recession are overdone. We are still in a benign inflationary environment. The spectre of deflation has receded and for many countries inflation remains under 2%, which in turn limits the extent to which central banks need to hike rates.

Global inflation is not too hot, not too cold



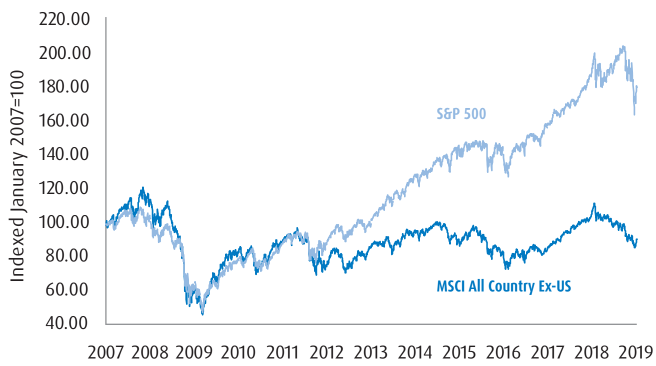
Source: Minack Advisors as at December 2018.

It is important, however, to acknowledge that risks have risen. Slowing growth, tensions around trade, populism and Brexit are all providing headwinds and uncertainty, triggering the moves we have seen in risk asset prices of late. These themes look set to persist, but with investors in a heightened state of nervousness, any surprise on the upside can have a big positive impact.

The US in focus

The outperformance of the US economy and its stock market has been a standout theme in recent years. However, with profits high and the labour market tight, many are beginning to question whether this can continue. The cost of labour is integral to assessing the prospects from here as it is a key determinant of both profits and the Federal Reserve's decision-making process. When assessing the evidence, wages are rising (unsurprising given low unemployment levels) but the level of appreciation remains relatively gentle. Of course, the data needs to be constantly monitored and the Fed's favoured measure, the Employment Cost Index, a quarterly series released later this month, should be examined closely.

Despite recent setback, the US has outperformed



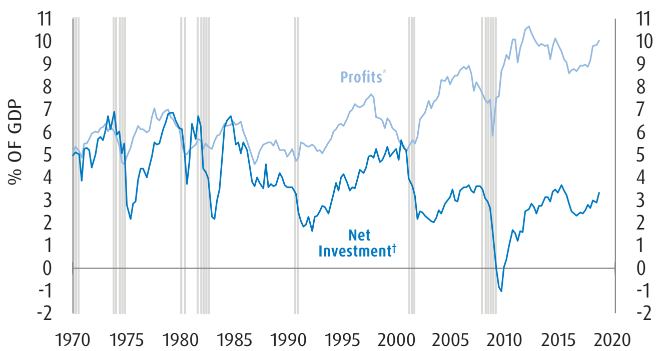
Source: Minack Advisors. BMO Global Asset Management as at December 2018

Perspectives on the yield curve

The yield curve, the difference between long and short-dated yields on government bonds is usually positive. With the US yield curve flattening, the prospect of an inversion – which in turn has been a reliable indicator of recession – has increased. A focus on some of the detail here, however, means we are not unduly concerned. The role of banks and their willingness/ability to lend is an important consideration. In a typical recessionary environment, margin compression results in banks cutting back lending. Currently, however, margins have been increasing which with banks being well capitalised, provides a significant positive going forward.

The investment environment also provides reassurance. Rather than being in a typical cycle characterised by overinvestment, squeezed margins and subsequent retrenchment in hiring and investment activity, we stand at a juncture in which investment levels remain relatively low. This supports our view that the cycle still has some way to run.

Profits are high but investment is low... may extend the cycle



*After-tax profits, CCA/IVA adjusted. †Business investment net of depreciation. Recessions shaded

Source: Minack Advisers. BMO Global Asset Management as at December 2018.

Quick views on the UK, Europe and China

- **Brexit uncertainty** – whatever the details of the eventual Brexit deal, the prospects for the UK are set to be uncertain for many years to come. In terms of politics, the Conservative Party is deeply divided and attention will soon begin to focus on what a Labour government could mean. The ever-important housing market reflects this backdrop, with London notably weaker in terms of activity. More generally though, the UK economy's emphasis on the service sector bodes well as many associated activities extend well beyond Europe.

- **Europe to improve?** – uncertainty is a theme on the Continent too, with social unrest in France, a coalition government in Italy and the need for ongoing reform all casting doubt on the long-term transition to a European super state. Europe's stock markets have significantly underperformed since the global financial crisis, with corporate earnings lagging behind those in the US. The performance of the European economy disappointed in 2018 but we do feel that there is scope for improvement in 2019.

- **China Crisis?** – another big disappointment has been the performance of China's economy. A combination of factors are at play. Huge borrowing levels provide a drag and mean that turning credit on to offset any slowdown isn't as effective – we don't, however, think a banking crisis is on the cards. Structural issues are also making themselves felt – economic 'miracles' typically slow when income levels reach around $7000 and there is an ongoing transition towards an economy with a more service-orientated composition. Expect the authorities in Beijing to step up their efforts to boost the economy.

Asset class takeaways

We entered 2018 with a cautious view on fixed income, wary on the prospects for bonds given valuations and the backdrop of rising interest rates and a reversal of quantitative easing. We maintain that stance, believing that whilst equity returns may be low in 2019, they look set to outperform bonds. Geographically, we are overweight the US, Japan and the emerging markets (ex-China), neutral on Europe and underweight China and the UK.

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Key risk

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

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