The Weekly

Special Edition: Expectations for 2019

Peapack-Gladstone Bank, Peapack Private Wealth Management

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As of 01/11/2019

STOCKS	Close	Wk Net Change	Wk % Change	Div Yield	YTD % Change	12 Mos % Change
DJIA	23,995.95	562.79	2.40	2.37	2.87	-6.17
S&P 500	2,596.26	63.49	2.51	2.08	3.57	-6.19
NASDAQ 100	6,601.40	178.72	2.78	1.15	4.29	-1.60
S&P MidCap 400	1,763.62	79.28	4.71	1.81	6.05	-10.05
Russell 2000	1,447.38	66.64	4.83	1.56	7.33	-8.79

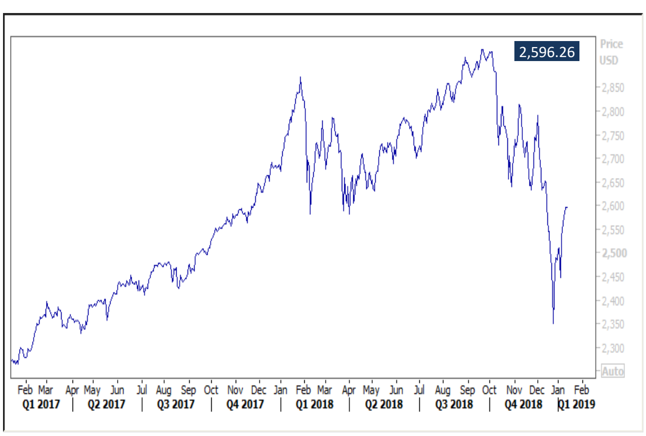
TREASURIES	Yield	FOREX	Price	Wk %Change
2-Year	2.54	Euro/Dollar	1.15	0.66
5-Year	2.52	Dollar/Yen	108.54	0.02
10-Year	2.70	Sterling/Dollar	1.28	0.94
30-Year	3.03	Dollar/Cad	1.33	-0.81

Source: Thomson Reuters & Bloomberg

Economy

Despite the worst December for U.S. equities in 50 years we are still confident the U.S. economy will post positive growth numbers in 2019. We are currently forecasting GDP growth to be approximately 2.0% - 2.5% in 2019 with the first half considerably stronger than the second half. This economic expansion currently ranks as the second longest in history and despite some storm clouds on the horizon we do not envision a recession beginning in 2019. Recession risk indicators we follow certainly have moved higher, but the Bloomberg consensus probability of recession 12 months from now is only 25%. The consumer enters 2019 on strong footing with the unemployment rate at 3.9%, and the U-6 measure of unemployment at 7.6% (topped out at 17.1% during the Great Recession). Average hourly earnings finished the year at +3.2% over the past twelve months and disposable personal income advanced by 4.7%. We will continue to closely monitor consumer debt, but at the moment these levels are manageable. Back in 2007 household debt came to 131% of disposable personal income, but today this figure stands at 98%. The housing market continues to soften with higher mortgage rates and a general lack of supply. Existing home sales declined for six consecutive months through October, but recently sales have turned positive. Over the past twelve months the price of an existing home rose to $257,700, and is up 4.2% versus a year ago. Business equipment spending will be a key component in 2019, as the fourth quarter showed flat spending numbers. Core capital goods orders and shipments have been below average during this expansion, and during November both of these metrics posted small declines. Without better capital expenditures and productivity growth the U.S. economy will struggle to achieve the upper end of consensus expectations in 2019. Finally the Federal Reserve, which originally forecasted three interest rate increases for 2019 has recently turned dovish and is now targeting one or two rate increases.

S&P 500



Equities

As we enter 2019, investors' nerves are raw after two major equity market corrections in 2018 and the historic December drawdown. The S&P 500 fell 13.5% in the fourth quarter and domestic equity investors experienced the first negative calendar year of -4.4% in 2018 in over a decade. Global equity markets were also extremely volatile last year with 50 trading days with over a 1% move in MSCI ACWI index. So, what will 2019 look like?

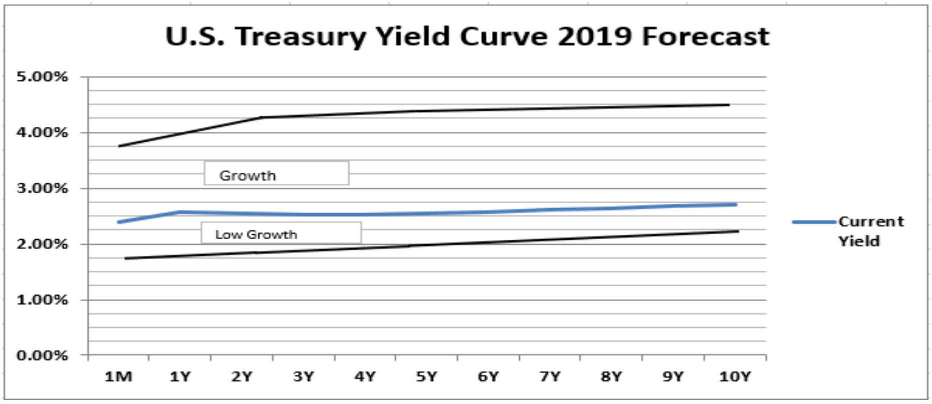
Although global economic growth is slowing, we do not expect a recession to begin in 2019 and generally the overall fundamentals remain reasonably constructive for equities. Domestic real GDP growth is expected to grow between 2.0 and 2.5%. Solid economic growth should support mid-single digit earnings growth for U.S. equities. Consensus expectations for earnings growth (9% y/y for the S&P 500) has drifted lower during the fourth quarter, but still appears too high. Corporate margins, which have expanded to historic highs and have been a significant contributor to earnings growth over the last few years, will likely contract. Operating leverage should modestly disappoint as the global economy slows. Rising wages and higher input costs will also negatively impact margins as well.

Market weakness at the end of 2018 coupled with robust earnings growth of approximately 22% last year dramatically reduced price-to-earnings multiples. The forward multiple on the S&P 500 dropped from 18.5 times at the start of 2018 to 14.4 times. At the beginning of 2018, the FPE multiple was almost a full standard deviation above the 25-year average of 16.1 times, but with the FPE now well below average it indicates that a lot of negative news has already been priced into the market. Valuations are compelling for both international and domestic equities.

Higher earnings (in 2019) and attractive valuations typically create a condition conducive to higher stock prices. Investors will continue to experience heightened levels of volatility because equity markets will be further buffeted by news flow regarding the trade and the Fed policy. Given recent financial market volatility and tightening financial conditions, we expect the Fed will be much more circumspect in regard to future rate increases. The bilateral trade dispute between the U.S. and China is likely to get resolved because a trade war is not in anyone's interest. The timing of a resolution is very difficult to predict because of the related political ramifications. There are other factors and events, such as Brexit, that are difficult to predict that will likely impact markets.

We expect global equity markets to work higher this year, however, the concerns that caused the fourth quarter selloff are real and significant. Our premise that the aging bull market will continue assumes that central banks do not make a major policy mistake and that global economies stabilize in a low growth path.

COMING UP NEXT WEEK		Est.
01/14 Construction Spending MM	(Nov)	0.2%
01/14 Factory Orders MM	(Nov)	0.2%
01/14 New Home Sales-Units	(Nov)	0.560M
01/15 PPI Final Demand MM	(Dec)	-0.1%
01/16 Retail Sales	(Dec)	0.2%
01/17 Housing Starts Number	(Dec)	1.250M



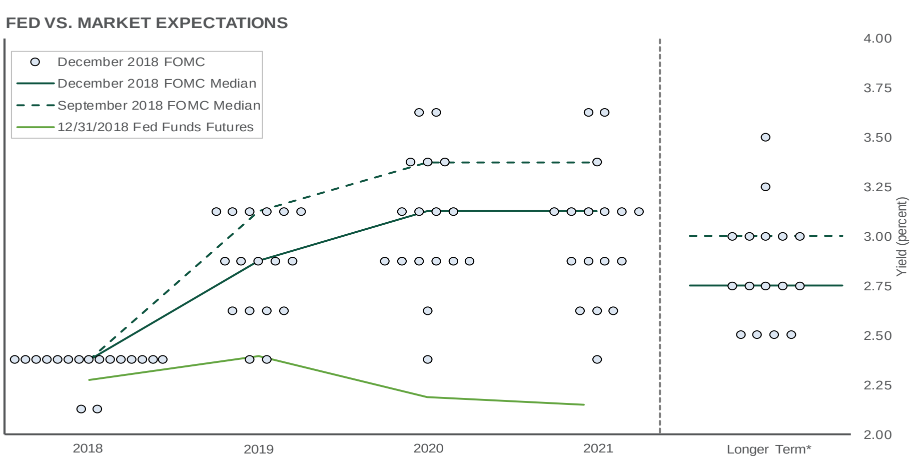
Fixed Income

Accommodative monetary policy was one of the main drivers that helped heal the global economy from the devastation of the financial crisis. In 2018, coordinated global growth allowed central bankers around the world to decrease their reliance upon monetary policy in hopes that their economies had enough forward momentum to continue expanding. Unfortunately, with escalating global trade tensions, rising populism and geopolitical risks, global growth began to decelerate over the course of 2018 which is making the removal of accommodative monetary policy extremely difficult. It is our belief that if global growth does not stabilize moving forward global central banks, particularly in Europe, China and Japan, will be unable to step away from their monetary policy stimulus.

If the U.S. economy progresses according to the FOMCs most recent projections, the Fed funds rate should end 2019 at 2.875%, which implies 2 rate hikes over the course of the year. The Fed funds futures market is not quite as optimistic and sees the Fed funds rate ending the year at 2.42%, which implies no additional rate hikes over the next twelve months. The next FOMC decision is scheduled for January 30th and the implied probability of a rate hike currently stands a 0.5%. The second FOMC decision of 2019 occurs on March 20th and right now it looks like there is also a 0.5% chance of a 25 basis point (bp) rate increase. Given the escalation of volatility and tightening of financial conditions since Fed Chairman Powell's December press conference we believe the Fed will reiterate a patient stance with respect to future rate hikes. If global growth does not decelerate too dramatically and inflation remains well anchored, we believe the Fed will be able to hike rates by 25 bps in the second half of 2019.

Historically, during periods of Fed monetary tightening, the U.S. Treasury yield curve tends to flatten. That trend continued in 2018 while the Fed increased the Federal funds rate 1.00%, cumulatively. During active monetary tightening cycles, the FOMC controls the front-end of the yield curve as market participants set clearing levels on longer-dated maturities. Without knowing where the long-term Fed funds rate will ultimately reside, the result is usually yield curve flattening. This was evident in 2018 when the spread between the 2-year and 10-year Treasuries decreased 32.6 basis points (bps) to close the year at just 19.5 bps. The flattening was even more pronounced at the 3-month and 10-year tenors as that spread compressed 70 bps from 102.4 bps to 32.4 bps. As noted above, the FOMC projection is calling for 2 rate hikes in 2019, whereas the Fed funds futures market is predicting no additional rate hikes. According to Bloomberg, the forward curve shows the spread between the 2-year and 10-year Treasuries increasing 13.6 bps to 29.6 bps, however, the 3-month and 10-year spread is forecasted to decrease 0.5 bps to 27.5 bps over a one-year horizon.

A host of factors including credit concerns, supply and demand dynamics, monetary policy, geopolitical risk, and the slowing of global growth caused corporate credit spreads to gap wider in 2018. Investment-grade 5-year AA, A and BBB – rated composites increased 38.6 bps, 42.9 bps, and 63.5 bps, respectively. The high-yield (HY) sector showed even greater signs of stress as 5-year BB and B – rated composite spreads increased 155.2 bps and 206.2 bps, respectively. The $2.5T BBB corporate debt market now represents almost fifty percent of total investment-grade debt outstanding. Investors are beginning to be wary of potential credit events that could cause portions of the BBB universe to be downgraded to high-yield ratings. Such an event would increase HY supply and widen credit spreads even further.



Source: Northern Trust Investment Strategy, Bloomberg, FOMC