January 2019

Global Macro Views

Five Economic Essentials for 2019

In Focus

U.S. Leading Economic Indicators

While U.S. economic growth is likely to slow from 3.0% to 2.5% in 2019, we expect GDP to grow above trend

U.S. Dollar

We think Fed policy will have a larger influence on the dollar, and the dollar will rally further, albeit within a range

Federal Reserve Policy

Estimates on the number of forthcoming hikes are declining, and we now see two more in 2019 before a pause in the Fed hiking cycle

Global Growth

Growth remains above potential and recession risks appear relatively low for 2019 across the U.S., Eurozone and Japan

Keep an eye on: Italy

Despite the substantial, recent sell-off in Italian assets, we believe there is room for additional weakness before a subsequent recovery

Executive Summary

- Leading economic indicators suggest that economic growth has peaked, though a recession remains in the distance. We expect that the current, above-trend growth rate could prove to move the economy to a higher trend rate. The U.S. dollar is up from early-2018 lows against a backdrop of emerging markets outflows and European political risks
- We think Federal Reserve policy will affect the dollar in 2019, with room to the upside, albeit within a range. Our view is that U.S. inflation will remain on target but growth could beat expectations. If so, we believe the Fed will have room to hike rates two times by the end of 2019. Despite slower growth rates, growth remains above potential
- Looking ahead to 2019, recession risks still appear relatively low in the United States, the Eurozone and Japan. Emerging markets growth is expected to remain at current levels and a bit above trend
- Tough times in Italy are reflected in hard data and falling sentiment, as well as fractures within the coalition government and with the European Union. Despite the substantial recent sell-off, there is scope for further weakness before a recovery

Asset Class	Outlook
Equity	Underweight / Neutral / Overweight
U.S. Equity	Overweight
International Developed Equity	Underweight
Emerging Market Equity	Overweight
Total Equity	Overweight
Fixed Income	
Developed Sovereigns	Underweight
Developed Corporates	Overweight
Emerging Market Debt	Overweight
Total Fixed Income	Underweight

Based on a hypothetical model 60/40 portfolio. Recommendations are for informational purposes only and not intended to represent the tactical and strategic asset allocation of Voya's Multi-Asset portfolios.

U.S. Leading Economic Indicators

Main Conclusions

Trends among the array of leading economic indicators suggest that economic growth has reached a localized peak, though growth could still reinvigorate and an end to the economic cycle is still distant

The eventual roll-off of fiscal stimulus and the lagged effects of monetary policy will slow growth in 2019, with trade tensions potentially weighing further on it

Nonetheless, the slowing will be contained, with the current, above-trend growth rate converging toward a higher level of potential growth

Update on LEI Trends

- The Conference Board Leading Economic Index (LEI) consists of the following four main categories: labor market indicators, manufacturing and housing activity, equity prices and credit conditions
- In aggregate, the year-over-year change in the LEI index remains healthy at 5.2% but it has dipped from its most recent peak of 7.1% in September 2018. When assessed relative to the post-crisis period, growth in the LEI has ebbed and flowed with fluctuations generally tracking movements in Treasury yields. The index currently resides in the middle of the post-crisis range and remains at a healthy level
- Among the LEI components, recent weakness has been most evident within housing, new orders, equity market and jobless claims. The S&P 500 has declined about 15% from its September peak, and was briefly down 20%. New home sales growth has slowed from a 15% pace at the beginning of the year to -12% in October. The ISM manufacturing new orders index fell 10 points in December to a level that suggests minimal expansion. Other measures of goods orders also suggest slowing in the manufacturing segment of the economy. Initial jobless claims bottomed at 202,000 in mid-September and have been oscillating a bit higher
- Among other components, interest rate spreads have flattened meaningfully, but the leading credit index signal remains favorable despite recent spread widening. Consumer expectations for business conditions also remain resilient but have eased from elevated levels
- Business investment growth remains solid and should slow with softer sales growth, but we expect lagged improvements to productivity growth to aid potential growth along with a cyclical bump in the labor force participation rate
- Some of the weakness in LEI growth reflects uncertainty regarding trade frictions and Fed policy, concerns which might ultimately abate. Housing has shown clear sensitivity to higher U.S. interest rates, although rates have recently eased. Tax reform has been a potential aggravating factor for housing on the East and West coasts. Household formations, employment and income growth remain supportive for housing and for the broader economy
- Slowing in manufacturing reflects trade frictions and exposure to slowing global growth; although a lagging indicator, service sector activity, has remained robust

U.S. Dollar Outlook

Main Conclusions

Range-bound over the next three months, with a bias for U.S. dollar strength

We think Fed policy will impact the dollar, and the dollar will rally further, albeit within a range

The market is pricing only one or two hikes in 2019 and there is not a lot of room for repricing lower

Background

- The dollar peaked during 2016, accompanied by a U.S. rates sell-off after the elections
- Throughout 2017, the dollar sold off due to surprisingly strong growth in the Eurozone, followed by an early 2018 bid for risk assets
- The dollar rallied from a low in early 2018, accompanied by outflows from emerging markets and rising political risk in Italy

Dollar Outlook: Positive Drivers

Central Bank Policies

- The Fed is likely to take a less dovish monetary stance than the European Central Bank (ECB) or other G-10 central banks. Bond markets in the United States are underpricing the number of Fed hikes we expect in 2019 and 2020
- The ECB's stated course is on shaky ground. Markets are pricing a 50% chance of higher deposit rates in 4Q19. The combination of low inflation/low GDP growth means the ECB may not raise deposit rates

Political Risk in Europe

- The Brexit outcome is still uncertain; political tensions are rising in Italy, Germany and France

Risk-Off Trades are Likely to Favor the U.S. Dollar

- Lower oil prices, risk-off trades and rising volatility since September have supported the dollar. Uncertainty from tariff negotiations and monetary policy should lead to further, intermittent risk-off trades

Slowing Growth in China

- Slower growth has weakened the yuan (CNY) against the dollar. We think this trend will continue, and we should not be surprised to see the yuan weaker than CNY 7/$ by early 2019

Dollar Outlook: Negative Drivers

Fed Ends Tightening Cycle Sooner than Expected

- If this happens, we could see a dollar sell-off. We do not expect this: the Fed is saying it will be data-dependent going forward

Carry

- The dollar is a more expensive currency to borrow than the euro. International investors likely will not favor dollar-denominated investments, now that the U.S. yield curve is flatter than in other currencies

Federal Reserve Policy

Main Conclusions

We expect the Federal Reserve will proceed with caution as equity markets are fragile, but still deliver two rate hikes in 2019. This is an out of consensus view as the forwards market has now priced in a rate cut for the full year

Economic momentum in the U.S. is still above trend GDP growth and the Fed's gradual approach means a slowdown is likely to unfold over a multi-year period

Background

- Equity and bond markets have been reacting meaningfully to FOMC member communications since Chairman Jerome Powell made relatively hawkish comments in early October, stating that the Federal funds rate is a long way from neutral. Powell countered that statement with a more dovish stance in December
- Conflicting official statements on the path of policy rates have driven some of, but certainly not all, the volatility in financial assets. In our view, the Fed has pivoted its focus from the inflation rate to the decline in the unemployment rate, which is moving toward levels that could drive wage instability. As a result, we expect the Fed will proceed with caution as equity markets are fragile, but still deliver two rate hikes in 2019. This is an out of consensus view as the forwards market has now priced in a rate cut for the full year
- Market participants are concerned that the Fed may be overdoing it on the rate hikes. Cyclical parts of the economy such as housing and autos are showing signs of fraying under the weight of tighter monetary policy. This was broadly reflected in the fixed income markets as 10-year U.S. Treasury yields steadily declined through the fourth quarter
- Threading the needle of an economic soft landing is a difficult task for the Fed, as it does not have a broadly successful record of accomplishing that outcome. A soft landing is further complicated by high debt levels, which feel the pinch of higher financing costs as an indirect effect of tighter monetary policy. However, economic momentum in the U.S. is still above trend GDP growth and the Fed's gradual approach means a slowdown is likely to unfold over a multi-year period. This continues to be a hallmark of this expansion, that movements in economic growth are taking longer to the up and downside

Global Growth

Main Conclusions

U.S. economic growth is likely to slow in 2019 from 3.0% to 2.5%. The two main factors behind the deceleration are tighter financial conditions and fading fiscal stimulus

Nonetheless, growth remains above potential and recession risks appear relatively low for 2019 across the U.S., Eurozone and Japan. We expect growth to be above trend in 2019

The International Monetary Fund (IMF) forecasts emerging markets will grow 4.7% in 2019 and 4.9% in 2020. This would be slightly above estimated potential EM GDP growth

Investment Implications

- We expect U.S. unemployment to fall further as growth continues above trend, though the composition of third-quarter GDP was less supportive of future growth, with final sales revised lower and inventories higher. The continuation of above-trend growth should lead to higher wage growth but no significant impact on inflation. We expect one to two Fed rate hikes in 2019 until policy reaches a neutral stance with the Federal Funds rate just below 3%. For financial markets, the combination of less growth and more rate hikes than currently expected would be challenging
- Eurozone growth weakened in 3Q18. The budget crisis in Italy continues, and despite the prospect of the ECB's stimulus withdrawal, credit conditions remain supportive based on the ECB bank lending survey. The IMF forecasts growth of 1.9% in 2019 and further deceleration to 1.7% by 2020 from 2% in 2018
- The new environmental rules impacting German activity explain a sizeable component of the Eurozone slowdown, but their effects seem temporary. The ECB is likely to start hiking in 4Q19 or later
- The Italian government's growth forecasts are probably too optimistic, given flat 3Q18 GDP. The trade linkages with Italy are sizable within the Eurozone but small outside it. An Italian slowdown therefore is likely to have significant effects only within Europe. Given this environment we expect European equity markets to remain volatile
- Growth in Japan is expected to slouch back below 1%
- The IMF expects China's slowdown to continue, with growth at 6.2% in 2019 and 2020, down from 6.6% in 2018. The government has cut the reserve requirement, the currency has depreciated and credit contraction has stabilized
- Given that many EM countries outside China are early in their economic cycles, if growth outside the U.S. modestly improves, EM risk assets can deliver positive returns. Despite the fact that Fed hikes are a headwind to EM, the market is currently pricing no more hikes. Furthermore, EM valuations now appear somewhat cheap relative to history. As a result of this macro backdrop we expect modest gains in EM equities in 2019 but also elevated volatility

Italy

Main Conclusions

Despite the substantial, recent sell-off in Italian assets, we envisage scope for additional weakness before a subsequent recovery

Recent trends in key economic indicators for Italy have been mixed; sentiment has consistently deteriorated over the course of the year

Outlook

- ***Unemployment:*** Italy's unemployment rate, while still elevated relative to its Eurozone counterparts, has steadily declined since 2014
- ***Inflation:*** Pricing pressure has remained stagnant at best, with core HICP exhibiting disinflation. This past summer's boost in negotiated wages may push inflation somewhat higher in coming months
- ***Growth:*** GDP effectively flatlined over 3Q18, but we expect a modest recovery. Still, the path forward is not promising with respect to waning domestic consumption and investment
- ***Debt-to-GDP:*** Fundamentally, Italy's stagnant growth over the past several years can be attributed to subpar innovation, a dysfunctional educational system and unfriendly business conditions. Therefore, we do not foresee substantial improvement in the debt-to-GDP ratio, currently over 130%
- ***PMI:*** Italy has been experiencing a downward trend in PMIs across both the manufacturing and services sectors. The recent readings, now in contractionary territory, reflect multi-year lows and potential recessionary risk
- ***ESI:*** The economic sentiment indicator fell to a 16-month low in November. This generally functions as a reasonably strong indicator for medium-term shifts in GDP, thus clouding our outlook for growth
- ***Domestic Politics:*** The current populist coalition government developed a unified anti-establishment message. Though the government is fractious, the short-term risk of upheaval appears contained
- ***International Politics:*** While the European Commission has tentatively agreed to a 2% budget deficit with Italy, the growth assumptions embedded within this figure are questionable. Moreover, France's recent domestic turmoil has emboldened Italy's populist coalition to hold firm on its planned expenditures for the coming year
- ***Sovereign Spreads:*** The inefficient government budget plan has rattled investors, with markets pricing in uncertainty on Italy's debt sustainability. We do not expect a crisis, but believe additional weakness is coming. The ECB's imminent termination of QE could remove a long-standing tailwind for Italian bonds
- ***Credit Spreads and Equities:*** Nearly all Italian companies will experience higher borrowing costs as a result of upward pressure on corporate credit yields. Most notable are the Italian banks, which are susceptible to a "doom loop," i.e., a vicious downward cycle between banks and sovereign bonds, ultimately creating liquidity concerns. Thus, we expect private sector risk premia to remain elevated in coming months

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