2019 Outlook

In this issue of ‘Perspectives’, we offer our thoughts on the year ahead.

Domestic Outlook

US real GDP growth is expected to slow in 2019 to 2.2%, down from 3.1% expected for 2018. Growth in 2019 is expected to gradually moderate throughout the year as monetary policy becomes less supportive, the benefit from lower tax rates for individuals and businesses continues to fade, higher interest rates become more of a headwind, and trade policy, which has thus far had a limited impact on growth, possibly leads to a more noticeable drag on GDP depending upon the direction of trade policy and magnitude of any new tariffs. Additional factors expected to contribute to the slowdown in growth are lower growth in Europe and Asia and elevated geopolitical uncertainties domestically and abroad.

Risks to the outlook include: increased uncertainty about US trade policy and escalation of trade tensions beyond what is already incorporated by the market and into forecasts; greater than expected slowdown in China’s economy; missteps as central banks unwind extraordinary monetary stimulus and the impact from increasingly tighter financial conditions takes a larger share from corporate profits and consumer disposable income; stronger USD, which would weigh on top-line growth of exporters and multinational corporations and lead to capital outflows from emerging market economies and reduce the capacity of these countries to service their USD denominated debt; renewed market volatility and pronounced weakness, which could weigh on business confidence and activity, as well as consumer spending; and inflation expectations surprise to the upside driving interest rates higher as investors demand compensation for declining real return. Although we recognize these risks to the outlook, they are not part of our base case expectations.

Consumer spending has been a source of strength, running at a pace of 4% (annual rate) for much of 2018, a strong level that can be traced to strong jobs growth, low unemployment, and modest real wage gains. We believe consumer spending will remain relatively strong in 2019, but some moderation is expected as the benefit from last year’s tax cuts wanes, higher interest rates, and potential for weaker consumer confidence that could result during a period of elevated volatility and prolonged market weakness.

EXHIBIT 1: Sentiment is weakening, but coming off very high levels

Inflationary pressures thus far remain muted and inline with the Fed’s 2% target. However, inflation could rise at a slightly faster pace in 2019 given the strength of the labor market, narrowing of the output gap and advanced stage of the US recovery; although we do not believe inflation will move materially higher than the Fed’s 2% target. In the event inflation catches the Fed off-guard, we would expect the Fed to respond quickly with more restrictive monetary policy, which could lead to increased market weakness owing to fears that higher interest rates could curtail growth, pulling forward the end to the business cycle sooner than currently expected.
Business investment spending grew strongly during the first half of 2018 but faded during the third quarter, perhaps owing to the uncertainty created by the tariff dispute with key trade partners. Both manufacturing and non-manufacturing Purchasing Managers Indices (PMIs) remain at elevated levels consistent with moderate GDP growth, but both have declined from their recent highs. However, real business equipment spending growth has slowed (4.4% annual rate) compared to 2017 (9.6%) and in all major categories, which is a key factor in our expectation of lower GDP growth in 2019.

Foreign Outlook
The global expansion is expected to continue this year but at a slower pace than 2018. The International Monetary Fund (IMF), in its January 2019 World Economic Outlook, projects the world economy to grow at 3.5% in 2019, down from their 3.7% estimate for 2018. Partly driving the IMF’s weaker forecast includes lower growth in Germany, Italy and France. Additionally, The IMF projects China’s economy to slow to 6.2% in 2019 from 6.6% estimated in 2018 due to the combined impact of financial regulatory tightening as the Peoples Bank of China (PBOC) seeks to rein in private-sector credit growth and new tariffs and trade tensions with the US. Key sources of downside to the outlook include weaker than expected growth in China and the ultimate outcome of the United Kingdom’s potential withdrawal from the European Union planned for March 2019.

Corporate Sector
Conditions for corporate credit have been healthy based on solid global GDP growth, strong, broad-based corporate revenue and earnings growth, and a benign default environment. Looking forward, while conditions for corporate markets are more likely to become less favorable than more favorable as GDP growth gradually slows and corporate revenue and earnings growth rates decelerate, there remains a solid backdrop for credit fundamentals. One of the more-watched themes, and key sources of downside risk, continues to be the high leverage many non-financial issuers have during this late stage of the credit cycle.

Corporate revenue and earnings estimates for 2019 are solid at 4.9% and 7.7%, respectively. However, even if these levels materialize, they will represent a marked deceleration from the strong growth of last year. In 2018, earnings were driven by US growth, lower tax rates, steady consumer spending, overseas GDP growth, and higher commodity prices. This year, corporate earnings are expected to slow as higher wage inflation and benefits expense will pressure the profit margins of most companies and a stronger US dollar will weigh on the top-line growth of exporters and multinationals.

As we monitor credit quality going forward, we are mindful that there is more concern the economic recovery may be nearing an end and we will see the credit cycle turn down in the next 12 to 24 months. Accordingly, an important area of focus is monitoring the elevated leverage and the amount of BBB-rated debt outstanding. BBB-rated debt outstanding has grown 227% since 2009 and now accounts for 50% of the Bloomberg Barclays US Corporate Index. As a result of this growth, the BBB-rated market is now 4.3x the size of the BB-rated market, compared to 2.0x as large 10 years ago. This means the high yield market might struggle to absorb fallen angels en masse should a downturn occur. That said, the outlook for growth and corporate earnings suggests elevated leverage will be manageable up until the time that earnings recede. In addition, some strategists believe high grade issuers have significant financial flexibility with the capacity to improve balance sheets meaningfully with lower payouts to shareholders, if
and/or when needed. However, the challenge with this line of thought is that corporate managers generally overestimate how long a business cycle will last and tend to reduce payouts to shareholders only after corporate performance has shown signs of weakening.

The pace of M&A activity is expected to slow in 2019, which should be helpful in reducing new issuance and since many large debt-financed M&A transactions have contributed to the rise in high grade non-financial leverage and growth of BBB-rated debt outstanding, a reduction in activity should act as a positive influence on credit metrics, all else being equal. Several factors are behind the outlook for lower M&A activity including: 1) reduced appetite for cross-border deals due to US trade policy uncertainty, 2) higher after-tax cost of debt funding because of higher bond yields and lower corporate tax rate, and 3) increased risks of being this late in the cycle makes management less bullish in embarking on these transactions to some extent.

We expect to focus on the following attributes as we evaluate new investment opportunities in 2019:

- Historically defensive non-financial sectors
- Banks based on lower supply and more robust fundamentals
- Issuers after their M&A credit event based on demonstrated progress toward successful integration and deleveraging
- Quality defined by the most liquid issues in strong credits with low refinancing and event risk
- Up-in-quality trades considering more compressed spreads by rating
- Favorable issuer selection as an opportunity to add exposure during periods of broad-based, indiscriminate market weakness

**Municipal Sector**

Expectations for solid economic growth driven by strong corporate fundamentals, increased tax collections, low unemployment, a sturdy consumer, and steadily rising property values support a continued allocation to the municipal sector. In addition, many state and local governments have maintained fiscal discipline with growth in tax collections outpacing that of tax-supported debt. Of note, credit quality remains mixed as some issuers have done a better job rebuilding reserves in the years since the financial crisis and should be better positioned to weather the next economic downturn.

Unlike other sectors, core challenges in the municipal sector are long-term in nature and require long-term solutions. Specifically, rising costs of entitlement programs continue to grow as a percentage of state and local government budgets, crowding out spending for infrastructure, and pressuring education funding, though most states continue to prioritize education over other expenses. Changing demographics coupled with rising Medicaid costs and the threat of reduced federal funding also strain state budgets, while volatility in energy prices creates budgetary fluctuations for energy-producing states.

The Tax Cuts & Jobs Act (TCJA) of 2017 had a significant impact on how we invest in the municipal market. While tax-exempt securities provide an attractive tax-mitigating strategy, we remain focused on our relative value framework, namely whether the taxable equivalent yield on tax-exempt securities is favorable to other taxable alternatives.

TCJA reduced the corporate income tax rate from 35% to 21% and lowered the top individual tax rate from 39.6% to 37%. Whereas the corporate and top individual tax rates were relatively similar in past years, the divergence between the corporate rate and the top individual rate created two very different outcomes for each investor. The value of the tax exemption is significantly higher for individual investors because of their higher income tax rate. With approximately 60% of the municipal buyer base represented by retail investors (mutual funds, high net worth individuals), relative value reflects their tax status and as such, remains unattractive for corporate entities who receive a lower benefit.

Maintaining an allocation to municipal bonds within a fixed income portfolio enhances diversification through exposure to different risk factors, improves overall portfolio quality, and provides an alternative method of capturing yield. In 2019, we will remain thoughtful in our approach and adhere to the following strategies in the municipal sector:

- Maintain skew toward the revenue sector given dedicated revenue sources for debt service payment that have fared better in rare bankruptcy proceedings and are ring-fenced from state and local entitlement program liabilities
  - Continue to favor essential services such as electric power and water and sewer
- For general obligation bonds, the focus remains on states and local jurisdictions that have:
  - A large and growing tax base, diversified economy, favorable wealth and employment metrics, low taxpayer concentration, and manageable retiree benefit obligations
  - Historically demonstrated responsible management of municipal finances in the form of structurally balanced and timely budgets, as well as good transparency
Diversify by region, sub-sector, and issuer to the extent possible recognizing that debt issuance is driven by demographics, tax policy, constitutional limits and other regional factors.

Avoid issuers with heavy reliance on short-term debt, off-balance sheet contingencies, substantial derivative exposure and bond issues with extraordinary structural features.

Securitized Sector

Residential Mortgage Backed Securities
During 2018, the Fed continued the process of reducing the size of its balance sheet. As of 3Q18, the Fed raised its reinvestment cap for the final time to $20B per month which, based on current market prepayment speeds, is expected to completely remove the Fed from purchasing RMBS in the open market. This process has been smooth and has had minimal spread impact until 4Q18 where the combination of the technical headwind created by the Fed actions, rising interest rates, and macro factors pushed RMBS spreads wider along with other risk assets. Money managers were the largest driver of MBS purchases in 2018 as banks were largely on the sidelines and will likely be needed to pick up the slack in 2019.

With the big move in rates last year, over 80% of outstanding mortgages are out-of-the-money and therefore mortgages are fully extended, which means the risk is skewed more to a decline in rates and an acceleration in speeds. Following the widening in 2018, RMBS spreads are beginning to look attractive relative to historical levels and relative to corporate spreads. However, the technical headwinds are mounting with no signs of abatement in the near-term. Therefore, we believe there is potential for some modest widening from current levels and no clear catalyst for spread tightening in the face of these technical pressures. At the moment, this leaves us neutral on the sector outlook with no clear plans to add exposure, but some additional investment may be prudent if our outlook for corporate bonds deteriorates.

Commercial Mortgage Backed Securities
Even though the commercial real estate market is in the late cycle, rental rates, vacancies, and pricing remain strong with some individual markets reflecting softness for one or more property types. Underwriting standards are also significantly stronger now compared to the last downturn. Therefore, we expect to continue to find value in this segment in 2019.

Asset Backed Securities
The US consumer balance sheet remains healthy, with auto loan and credit card debt growing at a reasonable mid-4% rate year-over-year, slower than in 2017 (mid-7% range) and closer to the rate of GDP growth. Total household debt is equivalent to 87% of disposable personal income, down from pre-crisis levels in the high-90% range. Concern exists regarding the pace of growth in student loan debt, which has grown to over 10% of the household balance sheet (from 4% pre-crisis); however, we have avoided student loan ABS in favor of auto loan, lease, and credit card securitizations.

Spreads have widened somewhat in the sector, in line with corporates though at a fraction of that magnitude, a trend we also expect to continue into 2019. We expect to remain interested in adding to ABS given the improved relative value combined with the benign credit outlook.

Closing Comments

Key risks that we are monitoring are the uncertainty of US Trade policy, greater than expected slowdown in China’s economy, potential mis-steps as central banks unwind extraordinary monetary policy, and Brexit. We expect the economy to continue growing, albeit slower than it did in 2018. Favorably, the investment environment will be supportive of incremental income given modestly higher rates year-over-year and valuations that are more attractive in credit and securitized sectors.

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