CASTLE ROCK
WEALTH MANAGEMENT

Registered Investment Advisor Firm

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The New Year brings many predictions about stock markets and global economies. I have condensed the various sources and present a few of them and some ways to prepare for the changing conditions.

We've already seen declining growth rates in 2018, and heading into 2019 there are signs that an economic peak and potential recession may be coming. Rising interest rates, declining liquidity, sluggish global growth and trade conflicts may weigh on economic growth and market performance in 2019. Investors should be prepared for increasing market volatility, and possibly even a bear market, in the coming year.

US Stocks and Economy

Corporate and consumer confidence may come under pressure from trade uncertainty, tightening financial conditions, slowing earnings growth as the impact of tax cuts fade and financial market volatility.

Tight labor market has put increased pressure on wage growth, which could dampen corporate profit margin and lead to higher interest rates. Additional US dollar strength and continued market volatility could further strain financial conditions.

Discipline around diversification and rebalancing will be important in 2019. Recession risk is rising, and stocks historically have posted their weakest performance during the six months leading up to recession.

Stocks historically strong post-midterm-election performance trend is a tailwind, but trade uncertainty and/or the political landscape could serve as offsetting headwinds.

Rolling bear markets – in which certain stocks or sectors fall into bear territory, even if the overall market isn't – may continue in 2019 as sectors and asset classes continue to reprice for declining global liquidity.

Global Stocks and Economy

Global growth may continue to slow in 2019 as the economic cycle nears a peak, with increasing drag from the worsening financial conditions combining with full employment and rising prices. Global stock markets may peak in 2019 if leading indicators signal a recession.

For global economies and markets, prognosticators aren't forecasting an imminent recession but a recession watch, in which conditions are favorable to a recession if a number of risk factors (e.g., trade, interest rates, inflation) deteriorate.

Watch the gap between unemployment and inflation rates, along with yield curve, for signs of a peak in economic growth ahead of a potential recession.

For all the concerns about trade policy, Brexit and other issues, 2018's big stock market declines generally were driven by inflation and interest rate concerns. These are the indicators investors should watch closely in 2019.

Historically, when unemployment and inflation rates have converged to become the same number – signaling an overheating economy – it has marked the beginning of a prolonged downturn for the stock market, followed about a year later by a recession. The gap between the unemployment rate and the inflation is close to one percentage point in countries like Germany, Japan, the United Kingdom and the US. Another leading indicator, the yield curve, also has shown a narrowing gap between short- and longer-term treasury yields. These gaps may close in 2019 and signal a peak for international stocks ahead of a global recession.

Consider rebalancing back to long-term asset allocations. Historically, long-term asset class trends have tended to reverse in the year prior to global recessions and bear markets. This may begin to favor international over US, value over growth and large- over small-cap stocks.

Fixed Income

The worst may be over for the bond bear market. After more than two years of steadily rising bond yields (and falling bond prices, which moves inversely to yields) research suggests that 10-year Treasury bond yields may have peaked for this tightening cycle at the 3.25% level. The Fed likely will continue to raise short-term interest rates to about 3% in 2019. Tighter global monetary policy, a strong US dollar and sluggish global growth exacerbated by trade conflicts are likely to weigh on economic growth and inflation, limiting the rise in bond yields. Volatility is likely to increase as markets adjust to tightening financial conditions.

Expect the dollar to stay firm until there is evidence that the Fed is done tightening and/or global growth picks up.

Expect the Fed to raise two more times, bringing the fed funds target to 2.75% to 3% in 2019. Because short- and long-term interest rates tend to converge at cycle peaks, the yield curve likely will flatten towards zero. Investors should gradually add to average portfolio duration when yields rise.

As the Fed normalizes rates and reduces its balance sheet, volatility may increase in riskier parts of the fixed income market – such as bank loans, high-yield and emerging-market bonds – due to issuers' high leverage. Investors should move up in credit quality and/or limit exposure to these asset classes. Municipal bonds may post solid performance in 2019, as demand appears strong for tax-exempt income and should be considered.

FED Watch

The Fed raised (as expected) its key interest rates to 2.25% to 2.5% at the December meeting. The language after the decision indicated that the Fed may be done raising for a while; there is even a slight possibility of a reduction in 2019. The Fed will also continue the process of reversing quantitative easing by allowing assets to mature off their balance sheets, rather than re-investing them.

Next meeting:
January 29th and 30th.

Castle Rock Wealth Management

Castle Rock Wealth Management is a Hybrid Advisory firm servicing the needs of clients across the United States.

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If you have questions or would like further information on this month's topics or any other financial or investment related subjects, please contact me by phone or through my email address at: bob@crwmadvisors.com