Top 5 upside surpises for 2019

A conversational shift by midyear from ″synchronized global slowdown″ to ″synchronized global stimulus″ heads the list.

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In a recent TV appearance, I noticed the anchors were somewhat shocked that we are maintaining our 3,100 year-end forecast on the S&P 500—almost to the point of assuming I'd lost my marbles and should be handled with kid gloves. I took this as a very bullish sign. With market technicians projecting a roll over and "retest" of the Christmas Eve lows, and all the focus on global recession, China slowdown, unlikely trade deal and government shutdown, it is difficult for anyone who is bullish to appear credible. Note: it is conditions like this that sometimes, not always, presage outsized upside returns in the ensuing 12 months. So since most readers are fluent in the long list of what is or is not about to go wrong for the stock market, let me outline five of my most likely upside surprises for 2019.

1. **By midyear, the conversation shifts** from "synchronized global slowdown" to "synchronized global stimulus." Currently, many indicators suggest we are at least in a global soft patch. China trade, manufacturing and anecdotal data has been very soft, European numbers

are weak and some sectors of the U.S. economy, most notably autos and housing, are at best flat. Companies are guiding down earnings, and investors increasingly are worried that since we are already "late cycle," a softening would be the first step toward outright recession. This argument was stronger, in our view, when policymakers seemed oblivious to the soft patch, with Fed Chair Powell declaring in October that the Fed was still "a long way from neutral" and European Central Bank President Mario Draghi seemingly on the verge of ending quantitative easing (QE). Unfortunately for the bears, policymakers are seeing the same data we're seeing and, predictably, are reacting. Powell has put the Fed on hold and there are reports quantitative tapering (QT) may be near and end, too. Draghi, meanwhile, suggested yesterday that more QE may be in order. And the Chinese, sensing the slowdown, are expected to unveil tax and fee cuts totaling about $300 billion in March, on top of a series of rate cuts that have spawned a surge in bank lending. With all this stimulus underway or coming, by summer we should start to see signs the global economy is coming out of the soft patch. Imagine the turn in investor sentiment if the daily buzz on the business cable shows shifts from "global recession" to "global reflation."

2. **The China-U.S. relationship moves** from "generational conflict" to ″friendly cooperation.″ This is another big one. Currently, the narrative is that we and China are locked in an inevitable, generations-long battle for global supremacy that will sooner or later end in tears. We see this as completely wrong-footed. China and the U.S. are complementary economies that have been the two primary beneficiaries of the global expansion of the last three decades. China continues to have a vast population that is anxious to grow wealthy, willing to work hard and increasingly to consume higher-end products and services from the U.S. and elsewhere. It cannot produce these products and services on its own.

And we continue to have the world's largest population of middle-class consumers anxious to buy products produced by China. Yes, China would like to move up the value chain, as other emerging economies over the years have done. And it will. But U.S. companies, on top of the value chain, will continue to scale new heights that will benefit all. Which heights get scaled are harder to articulate because they are new, but surely the digitization revolution we've discussed elsewhere on these pages—a revolution that U.S. companies are leading globally—will figure increasingly in virtually all sectors of the global economy. By midyear, with a trade deal signed, we could move from the unpleasant negotiation phase to something far more cooperative and friendly, maybe even a honeymoon period.

3. **Oil moves higher to $90** a barrel. While concerns about global recession and demand played a role, the recent collapse in oil prices was spurred largely by a temporary supply glut when OPEC was caught over-producing because it thought that Iran's substantial oil output would be frozen out of the market by U.S. sanctions. The Saudis already have adjusted production back down to account for Iranian supply, and importantly need higher oil prices to fund their government and eventually to take their state oil company, ARAMCO, public. On the non-OPEC side, although shale production surprised to the upside last year, given the short cycle nature of these assets, we'd guess that upward surprises again in 2019 are unlikely. And given that oil capital expenditures (capex) suffered another blow with the 2018 problems in the oil patch, non-OPEC production outside the oil patch is likely to decline. If global recession/demand concerns ease as we expect, oil prices are likely to move higher. If you are wondering whether this would be a surprise or not, punch up the stock prices of the few remaining global oil-field services companies—most are trading near or below their 2008 lows.

4. **Treasury yields stabilize** between 2.5% and 3.0%. We're not sure if this would really represent a surprise at this point, but we include it because it certainly would feed the bullish setup we anticipate by midyear. With central banks now more likely to decrease QT (or even restart QE) than to accelerate balance-sheet tightening, the global shortage of risk-free assets relative to the global demand for such assets is likely to continue or even worsen. (Note: as of this morning, 10-year German bunds are yielding just under 20 basis points.) This should keep Treasury yields near their current levels even as the economy shows signs of re-acceleration. As this situation prolongs, we'd expect some of the interest-sensitive sectors of the U.S. economy to start showing signs of re-acceleration, as well. Think housing and autos—again two stock market sectors presently left for dead.

5. **The market cracks through the old highs** and a buying panic drives it to our 3,100 year-end forecast. Although a long way from where we are today (about 17%) and a full 31% above the market low on Dec. 24, if all of the other surprises listed above occur, 3,100's really not a reach. At that level, the market would be valued at 18 times the reduced consensus earnings forecast of $170 for 2019 and less than 17 times the likely outlook for 2020 earnings. This would look more than fair once the market realizes a recession is far off and, if anything, the soft patch was "the pause that refreshes," not "the beginning of the end." I'd note these kinds of mega-rallies are not unusual after a 20% drawdown that "forecasted" a recession that never happened. We've had six of these over the last 60 years, and the average return off the lows 12 months out was actually 27%. I'd add that the reaction of the semiconductor equipment stocks to this week's earnings news may be the canary in the coal mine for this upside move. Many of these stocks were down nearly 50% at the lows, with concerns about the chip cycle and economic cycle combining for a doomsday

> scenario for the stocks. The news this week was not great: a big capex cut here, a kitchen-sink earnings cut there, and reduced earnings and sales forecasts everywhere which, though down, were not the Armageddon some feared. This was enough to spark a 10-15% rally in many of these stocks. Tech cyclicals tend to be the first to move off their lows—even bears acknowledge that down the road, these companies' sales and earnings certainly will reach new highs. But the fact that they already are moving is worth noting.

We are continuing to recommend clients maintain healthy overweights to equities against their long-term neutral point, with a year-end S&P target of 3,100. Volatility is not dead but the trend in fundamentals looks positive and the surprises above may be coming sooner rather than later. Time may be running out for the bears.

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