As we enter 2019, the road looks rockier, and you may be asking whether we’ve passed the peak. In our view, we’re still climbing, but growth rates have peaked as the effects of one-time changes fade.

Continuing modest economic and earnings growth should support rising stock prices and the global bull market. Slower growth can make financial markets more sensitive to uncertainty and changes in the outlook. Although global growth has decelerated, market expectations have fallen faster, creating opportunities for investors.

As we move through the later stages of the global market cycle, be prepared for frequent predictions about its end. Such predictions are mostly wrong, but downturns can happen without warning. We’re watching the indicators closely and don’t see signs of a recession or an associated stock market decline ahead.

This cycle has been lengthy, and we think the later stages could extend longer than many expect. Here are a few common late-cycle characteristics to help you prepare:

- Higher market volatility that lasts longer
- Decelerating economic and earnings growth
- Higher bond market volatility and somewhat higher interest rates as the Federal Reserve and other central banks remove monetary stimulus
- A flatter yield curve, which makes short-term fixed income more attractive – rates on short-term bonds are close to long-term bond rates without the additional interest rate risk.

Disappointed by Past Performance?

If you were disappointed because your portfolio’s performance lagged the market at times in 2018, you may want to reconsider how much risk you’re comfortable taking. Most investors don’t want to stomach as much volatility as stocks offer. For perspective, remember that over the past 20 years, the one-year return on the S&P 500 has ranged from a loss of 37% to a high of 32%.*

- Bonds can help reduce swings in portfolio values because their prices frequently move in the opposite direction from stocks, or fall less when both decline. And similarly, when stocks are rising, portfolios with bonds don’t perform as well as those with stocks alone.
- Better-diversified portfolios – including bonds, international stocks and smaller companies, as well as large-cap U.S. stocks – are designed to provide less portfolio volatility. A portfolio with 65% in equities and 35% in fixed income had a narrower range of one-year returns than the S&P 500 – the biggest loss was 25%, and the highest return was 21%.

Your asset allocation is designed to help you stay invested when stocks drop sharply, which they can do from time to time. Make sure you have realistic expectations for how market volatility can affect your portfolio. You may need to rebalance by adding fixed income and international equities to return it to the right mix of investments for your comfort with volatility, time horizon and goals.
Returning to Modest U.S. Economic Growth

U.S. economic growth accelerated in 2018 due to the tax cuts and higher government spending. As those effects fade in 2019, we expect growth to decelerate from near 3% to about 2.5% – a pace that’s still faster than the average in this long-running expansion. Expansions don’t die of old age; they’re usually killed by a rapid increase in interest rates or an unexpected shock.

We think the expansion is well-positioned to become the longest since the 1920s, with the following sources of growth:

1. **Job growth remained robust in 2018**, pushing the unemployment rate down to 3.7%, the lowest since the late 1960s. We expect slower but still-solid job growth in 2019 to support rising consumer spending, which is about 70% of the economy.

2. **As the unemployment rate falls further, wages are likely to rise a little more quickly**, and companies will try to improve productivity. Business spending should increase as companies invest higher profits.

3. **Federal government spending is projected to continue to rise.**

U.S. Earnings Decelerate due to Rising Costs

Companies started to report faster-rising costs and occasional shortages toward the end of 2018 as overall wages rose by more than 3% and tariffs pushed prices up. While companies can raise prices as their costs increase, tough competition and disruptive competitors may impose limits, squeezing margins but keeping overall inflation contained near the Fed’s 2% target.

In addition, sales growth is likely to slow modestly from nearly 9% in 2018 to 5% in 2019, according to FactSet. As a result, we expect corporate earnings to decelerate from more than 25% in the first three quarters of 2018 to less than 10% in 2019. Slowly rising earnings still provide support for higher stock prices over time.

Solid Fundamentals Support the Aging Bull Market

Earnings reported by S&P 500 companies rose faster than stock prices in 2018, bringing the price-to-earnings ratio (P/E) down near its long-term average of 16.7 and indicating stocks are no longer expensive. If stocks rise in line with earnings in 2019 and beyond, we believe long-term returns on large-cap stocks are likely to average 7% to 8% annually. That’s well below the S&P 500’s 14% rate of return over the past five years.

Prospects for slower economic growth hurt the performance of mid- and small-cap stocks in late 2018, making them more attractively valued compared to large-cap stocks and their own history. As a result, we think mid- and small-cap stocks are opportunities for investors, with higher expected returns than those of large-cap stocks to compensate for their higher expected volatility over time.

Interest Rates Edge Higher

We expect the Fed to continue slowly raising short-term interest rates, pausing during 2019 unless inflation rises well above its 2% target. With the pace of economic growth expected to decelerate modestly in early 2019, the data-dependent Fed may want to wait, trying to avoid crimping growth further unless inflation becomes a bigger risk. Longer-term rates are also likely to increase slightly. As a result, we think short- and long-term rates should rise in tandem, keeping the yield curve relatively flat and consistent with modest economic growth.

We recommend adding cash and short- and intermediate-term investment-grade bonds to help reduce portfolio volatility. Shifts toward tighter monetary policy around the world are likely to raise bond volatility, with bigger price moves (both up and down), and modestly rising interest rates could mean low bond returns, particularly for longer maturities. A well-diversified and laddered bond portfolio can smooth the impacts of slowly rising interest rates and help buffer your portfolio when stocks move sharply.

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**Rising Earnings Support Rising Stock Prices over Time**

![Graph showing rising earnings support rising stock prices over time.](source: S&P, 11/30/2018. Estimated earnings are based on Capital IQ consensus estimates. The S&P 500 is an unmanaged index and is not available for direct investment.)
International Prospects: Down but Not Out

The synchronized upswing among global economies that took shape in 2017 stalled in 2018 as the European expansion waned and China continued its path of decelerating growth. We expect world gross domestic product (GDP) growth to fade a bit more in 2019, but we think investors have become overly pessimistic, and international equities are trading at sizable discounts to U.S. stocks. Reasonably positive fundamentals, mixed with policy and trade risks, support our expectation for better performance and our recommendation to diversify your investments internationally.

- **Past the peak, but more growth** – We expect slightly slower world economic growth in 2019, driven mainly by decelerating growth in the U.S. and China. Expansions in Europe and Japan faded last year, but more recent economic readings suggest they might be finding some footing. China announced tax cuts will start in early 2019 to provide additional stimulus, suggesting policymakers will keep working vigilantly to stabilize the economy. In our view, slower global growth can extend the cycle without signaling its end. On average, world GDP growth peaked more than two years before the start of a recession over the past three decades.

- **Same cycle, different drivers** – Historically, the U.S. and global markets have cycled broadly together, with local factors driving timing differences. For example, while the Fed is increasing U.S. interest rates, foreign rates remain low, and monetary policies are still designed to boost economic growth in Europe and Japan. Low unemployment rates help improve economic growth, and profit margins are rising, suggesting accelerating earnings growth internationally, in contrast to decelerating U.S. earnings. And international stock valuations reflect a pessimistic outlook, as relative P/Es have declined for developed- and emerging-market equities, as shown in the graph above.

In addition, the 5.5% rise in value of the U.S. dollar was a sizable headwind in 2018 for international equity returns and for some emerging markets with high U.S. dollar debts. We don’t expect the dollar to rise as much this year, potentially helping improve emerging-market growth prospects and the performance of international investments.

Many international risks could contribute to a bumpier market in 2019, but we don’t think they’re likely to trigger the end of the bull market. In addition to Brexit and Italian debt worries, the European Central Bank will likely begin to wind down its stimulus later in the year. Similar moves by the Fed in 2015 prompted short-term market anxiety. And U.S.-China trade tensions are unlikely to be resolved immediately. Although we don’t expect a full-blown trade war, lengthy negotiations mean additional volatility is likely.

- **Opportunities in the aging cycle** – U.S. stocks have outperformed international developed-market stocks in seven of the last 10 years.* Historically, performance rotates, and as the cycle ages, we think the global cycle is positioned to last longer and consider international markets attractive. Possible catalysts for better performance include stabilizing global economic growth, easing trade tensions with China or the resolution of some of Europe’s political uncertainties. We recommend adding broad-based developed-market and emerging-market equity investments if appropriate.
What Could End the Bull Market?

Most bull markets end when tighter monetary policy pushes the economy into recession. One indicator to watch is the yield curve: It has become negative before many past recessions. We expect it will remain relatively flat, which is consistent with modest growth ahead. In addition, past recessions have begun after the unemployment rate has started to rise; we expect it to fall in 2019.

Two other potential recession triggers are:

1. **Accelerating inflation**, which could cause the Fed to raise rates more aggressively
2. **The onset of recessions in the rest of the world** due to a slump in China, higher tariffs or political risks

Our outlook for 2019 suggests these indicators should also remain consistent with modest economic growth, rather than a recession.

Preparing for a Rockier Road Ahead

Stocks became more volatile in 2018 as investors reacted to greater uncertainty about the outlook and worried about prospects for slowing global growth, higher interest rates, slower earnings growth and rising international tensions, including higher tariffs. We don't think any of those concerns will vanish in 2019, which is why we expect higher volatility to continue.

As long as the underlying fundamentals of economic and earnings growth remain positive, we believe pullbacks can be opportunities to add quality investments at lower prices. Over the past 26 years, the S&P 500 has dropped by more than 10% about once a year, with an average decline of 14%, which made buying the dip an attractive strategy. And in 75% of those years, the S&P 500 ended with positive returns for the year because stocks continued to rise.*

Stocks usually outperform bonds as the cycle lengthens, which is why we don’t recommend reducing your allocation to equities. A rockier road may mean more opportunities to buy the dips, based on our positive outlook for the fundamentals of economic and earnings growth.

To help address higher market volatility, we recommend rebalancing your portfolio and improving its diversification. Consider adding:

- **Short- and intermediate-term investment-grade fixed-income investments** to rebalance to the appropriate mix of stocks and bonds based on your comfort with risk and long-term goals. Check whether you have enough cash to cover short-term spending requirements.
- **Small- and mid-cap U.S. stocks**, as well as **large-cap stocks** – the late 2018 pullback lowered valuations, and they could benefit from solid earnings in 2019.
- **International equity investments in developed and emerging markets** – political conflicts, slower economic growth and trade tensions have made investors pessimistic about international equities and reduced valuations, creating an attractive opportunity, especially if some of the growth and trade concerns are resolved more quickly than expected.

Past performance is no guarantee of future results. Diversification does not guarantee a profit or protect against loss in declining markets. Investing in equities involves risks, therefore the value of your shares will fluctuate and you may lose principal. Small and mid-cap stocks tend to be more volatile than large company stocks. Special risks are inherent to international investing, including those related to currency fluctuations and foreign political and economic events.

This cycle has been lengthy, and in our view, slower growth rates could help extend the later stages – they could last longer than many expect. Don't let a rockier road deter you from taking appropriate actions or darken your outlook.

*Source: Morningstar Direct, Edward Jones calculations

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**Bear Market Tied to Recession**

<table>
<thead>
<tr>
<th>Possible Triggers</th>
<th>Indicators to Watch</th>
<th>2019 Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tight monetary policy</td>
<td>Inverted yield curve</td>
<td>Flat yield curve, consistent with modest growth</td>
</tr>
<tr>
<td></td>
<td>Rising unemployment rate</td>
<td>Falling unemployment rate</td>
</tr>
<tr>
<td>Accelerating inflation</td>
<td>Faster wage growth and price acceleration</td>
<td>Below 3% (near the Fed's 2% target)</td>
</tr>
<tr>
<td></td>
<td>Oil spike; rising commodity prices</td>
<td>Flat to falling prices</td>
</tr>
<tr>
<td>Global downturn</td>
<td>Purchasing Managers’ Index (PMI) data</td>
<td>Expansion</td>
</tr>
<tr>
<td></td>
<td>China recession</td>
<td>Measured slowdown</td>
</tr>
<tr>
<td></td>
<td>Geopolitical tensions</td>
<td>Trigger volatility</td>
</tr>
</tbody>
</table>