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2020 Economic Outlook

A Long-Range Economic Look at the Year 2020

Economic Outlook

Economy

POSITIVES

- Inflation Subdued
- Accommodating Fed
- Residual Benefits Of Tax Cuts
- Confident Consumer:
  - Low Unemployment Rate
  - Growing Wages
  - Rising Household Net Worth

NEGATIVES

- Slowing Business Investment
- Contraction In Manufacturing
- Tariffs Disrupting Supply Chains
- Falling Executive Confidence
- Slow Global Economic Growth

A Tale of Two Economies:

We find a divergence between confident consumers and wary businesses. The consumer, buoyed by a low unemployment rate, decent wage growth, higher net worth, lower debt service and a rising stock market, continues to spend.

The business sector, on the other hand, has sharply pulled back on investment. Industrial production and the Institute for Supply Management (ISM) manufacturing survey are in territory usually associated with a contracting economy. At the same time job openings and manufacturing payrolls are slipping. Lastly, trade tensions and global economic weakness are undermining business confidence.

This tug of war will only end if the consumer can convince businesses to reverse their negativity as they did in 2015 and 2016. The other unfortunate possibility is businesses start cutting jobs which would erode consumer confidence.

While late in the economic cycle, worker's pay is still rising faster than consumer prices and almost everyone who wants a job has one. The outlook for the consumer sector remains solid. The manufacturing sector is facing some challenges because of tariffs and geopolitical uncertainties.

In the end, we believe the consumer will carry the day, so we are not likely to see a recession in the coming year. However, we expect sluggish economic growth here and abroad.

Stocks

POSITIVES

- Positive Momentum Is Our Friend
- Corporate Buybacks Still Strong
- Presidential Cycle Is Favorable
- Relatively Attractive International Valuations

NEGATIVES

- U.S. Gross Domestic Product (GDP) Growth Slowing
- Unprecedented Corporate Debt Levels
- Election Uncertainty

Bull markets rarely die of old age. This is good since the current stock market rally, which began in March 2009, is the longest bull market in history. It has also produced one of the highest 10-year total returns on the S&P 500.

As a result, valuations are now extremely elevated. Fortunately, the momentum of the stock market is still positive.

Corporate profit growth has stagnated since 2011, so corporations have been buying back shares to increase earnings per share. Corporate stock repurchases have amounted to $2.4 trillion over the past 10 years, one of the reasons the market had such strong returns. In addition, low interest rates have allowed corporations to issue debt to repurchase shares. Unfortunately, these extreme corporate debt levels pose a risk for investors.

Typically, this phase of the Presidential cycle is favorable for stocks. However, due to the uncertainty about the trade war and impeachment, stocks may have already enjoyed most of this benefit in 2019.

We are finding some relative value opportunities in the Finance and Energy sectors. Due to the lateness in the economic cycle and the popularity of passive investing, we believe large stocks should hold up but opportunities are rising in smaller stocks. International stocks have underperformed U.S. stocks for many years. We believe valuations are very attractive in some developed and emerging markets providing potential opportunities.

Overall, we anticipate modest gains in the market and we should see some rotation into unloved areas.

Bonds

POSITIVES

- Inflation Is Contained
- Continued Foreign Interest In U.S. Bonds
- Low To Negative Yields Around The World
- Aging Population

NEGATIVES

- 2019 Great Year For Bonds: Rarely Repeats
- Fed Balance Sheet Growing Again
- Fed Interest Rate Policy On "Pause"
- Economy Still Growing
- Record Corporate Debt Levels

In 2019, we saw a reversal of the rate hikes in 2018. This provided an opportunity in bonds as investors worried about the manufacturing slowdown. The delayed action from the Federal Reserve (Fed) caused the *Yield Curve* to invert and later forced them to cut rates as a "Mid Cycle Adjustment". All of this led to strong returns for bondholders, but as we have seen in the past, these are rarely repeated in the following year.

Due to issues with liquidity in the Money Market, the Federal Reserve started buying short-term securities. While not exactly *Quantitative Easing*, they have been purchasing $60 billion per month. The Fed has stated those purchases will continue well into the second quarter of 2020. Contrary to common belief, this action has often been a precursor to higher rates as opposed to falling ones.

Municipal bonds had a good year but became less attractive by late August. We cannot find much opportunity in muni bonds at this time, as they appear to be fairly priced. Corporate bonds have also done well but one area of concern could be the *contagion effect* from the low quality, *CCC bonds*. They have begun to lag other corporates which could be an early warning for higher quality bonds.

The economy is still growing albeit at a slower pace, and we expect some volatility and this could have a marked effect on bonds. The aging population and the lateness in the economic cycle should cause rates to remain low for a considerable length of time. We advise against chasing the "hot" trends in bonds.

Conclusion for 2020 Economic Outlook

FOR INVESTORS

Equities

- Anticipate modest gains in major stock indices even as risks rise
- Look for long term shifts in equity leadership
  - Growth to Value , Large to Small, Passive to Active
- Opportunities rising for International equities, especially deeply discounted ones in both developed and emerging markets
- Gold is fairly priced compared to stocks

Fixed Income

- Do not expect strong returns in bonds
- Trade and other issues will contribute to volatility
- Maintain modest durations and avoid excessive trading
- Muni bonds less attractive
- Heavily leveraged companies with the lowest quality bonds are at risk

WHAT COULD GO WRONG

- Trade wars intensify
- Substantial stock market correction
- Massive downgrade in corporate debt
- Recession in China and Europe

Quantitative Easing: *a course of action undertaken by the Federal Reserve to increase the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.*

Yield Curve*: a line that plots interest rates of bonds.*

Contagion effect: *a situation where a shock in a particular economy spreads out and affects others.*

CCC Bond: *Represents an extremely high risk bond or investment.*

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