2020 INVESTMENT OUTLOOK

The stock market capped off 2019 as a mirror image of the prior year, finishing near all-time highs on the heels of global central bank easing and the cessation of some short run risks in the final month of the year. The Federal Reserve cut its key policy rate on three occasions throughout the year and nearly 60% of global central banks finished 2019 cutting interest rates in some fashion, the most synchronized easing since the beginning of the global financial crisis more than a decade ago. Central bank balance sheets also began to grow again with the European Central Bank (ECB) re-starting its bond buying program in response to the industrial contraction and the Federal Reserve supporting short-term funding markets with liquidity. The actions by the Federal Reserve are an about-face compared to its policies to end 2018 when it was raising interest rates and reducing its bond portfolio, which led to a sharp fourth quarter correction.

The liquidity-driven rally of 2019 was also supported by the apparent de-escalation of trade tensions between the U.S. and China via a first phase trade deal as well as the outcome of the U.K elections, which could lead to a negotiated Brexit rather than a hard exit without any free trade agreement. Such conclusions have further fed the bullish sentiment that gained momentum in equity markets throughout the fourth quarter. Various measures of optimism show investors to be the most bullish about the stock market in many years. This combination of both rising liquidity and bullish sentiment could be very potent in the short run, leading to an overshoot in stock prices which causes a misperception of the fundamental growth that could ultimately follow.

Full year earnings growth is expected to be just 1-2% in 2019 for S&P 500 stocks once companies report fourth quarter results in the coming weeks. Thus, the stock market's extraordinary advance was almost entirely due to valuation expansion. The forward P/E ratio of the S&P 500 ended the year at 18.4x earnings, among the highest levels of the past 50 years ignoring the late 90s bubble. This is an incredible reversal from the prior year-end when the market's valuation contracted to 14.6x earnings in the face of a tighter Fed and rising economic uncertainty. The onus will now be on fundamental growth to accelerate in 2020 to justify the strong advance of 2019.

Nonetheless, U.S. stocks ended the decade of the 2010s achieving the highest risk-adjusted return of any decade since the 1950s, according the Bloomberg data. The so-called Sharpe ratio, which takes into account the return above Treasuries as well as stock market volatility, shows equities realized 1.01% excess return above T-bills for each percentage point of risk. Such performance was even slightly better than the decade of the 1990s, which saw higher absolute returns but was a period of higher interest rates and higher stock market volatility. Amongst the biggest surprises to market pundits in the 2010s was the persistent decline in both interest rates and stock market volatility relative to prior decades despite increasing levels of economic policy uncertainty. Such a divergence will likely resolve itself in the coming decade.

160 FEDERAL ST., 22nd FLOOR ¤ BOSTON, MASS. 02110 ¤ TELEPHONE 617-951-9969 ¤ FAX 617-951-0773
WWW.WILKINSINVEST.COM

Equity Markets – 12/31/19

	Index Price Level	2019 Total Return
Dow 30 Industrials	28,538	25.3%
S&P 500	3,231	31.5%
NASDAQ Composite	8,973	36.7%
MSCI All Country World Index ex-USA	302	22.1%

Outlook

While most financial markets are starting the year near cycle peaks, the underlying economic measures are more mixed. Growth in the U.S. continues to be led by the service economy, buoyed by a consumer who is experiencing better job prospects, higher wages, and a stronger balance sheet relative to the past. Global manufacturing and trade flows, however, are at cycle lows in terms of activity momentum and various end markets failed to realize the stronger second half that many management teams suggested last spring.

Nonetheless there are some green shoots that can be seen in some of the monthly purchasing manager index (PMI) data as well as the hard economic data released by governments. Global PMI new orders have started to move higher relative to inventory de-stocking, which is often a sign that manufacturing end markets are bottoming. Semiconductors and electronics, for example, have already experienced a long inventory correction over the past 15 or so months yet emerging technologies such as 5G and IoT continue to rapidly advance, which should eventually lead to a pickup in fundamentals for the electronics industry. Auto end markets, on the other hand, are likely to remain stagnant in the near term as the mix shift towards electrification is facing lower Chinese subsidies and longer lead times on battery development, putting the recovery in the industrial sector on more precarious terms.

Although manufacturing is a smaller part of the global economy than the service sector it is prone to more cyclicality, thus its second derivative of growth can have a greater impact on the momentum of total GDP growth. With global PMI indices currently at similar trough levels experienced in both 2012 and 2015 and activity showing signs of bottoming once again, there is the potential for manufacturing to experience its third rebound within the current economic expansion and at a minimum stabilize global growth through the first half of 2020. Moreover, the U.S. has never experienced a recession when the Conference Board's Index of Leading Indicators is growing on a year-over-year basis as it still is. Most U.S. recessions see declines of 10% or more in this index and it appears to be rounding out a bottom alongside the manufacturing data. Thus, the downside momentum in economic growth experienced throughout 2019 in many economies appears to be subsiding. In fact, Citigroup economists forecast the number of economies slowing to drop to 45% from 70% in the coming year. A strong cyclical rebound is not expected, however. Transportation stocks, which normally lead the market higher in more traditional recoveries, have actually declined since early November and have meaningfully underperformed the stock market the past two months, hardly a vote of confidence.

The easing of financial conditions throughout 2019—lower interest rates, tighter credit spreads, and higher stock prices—may continue to flow through the economy in 2020. Monetary policy has historically worked at a 2-3 quarter lag. Thus, the effects of cutting interest rates three times last year should continue to support growth through at least the first half of this year. One beneficiary of the recent decline in interest rates has been the housing market, which has seen the 30-year fixed rate mortgage fall more than 125 basis points over the past year to under 4%. Residential investment had been in a steady decline over the past two years before resuming growth in the third quarter of 2019. Data on housing permits indicates this momentum should continue as 2020 commences. Building permit activity, a leading indicator of construction, is up 20% on an annualized basis since June and ended the year at a cycle high.

Previous mid-cycle recoveries in 2012-13 and 2015-16 were associated with a sharp pickup in credit creation and massive stimulus in China, which significantly impacted the magnitude of the global GDP growth rebound that followed. Currently the level of stimulus and rate of money growth in China is far less accommodating than prior slowdowns, however. Leadership continues to emphasize financial stability and the transition to a more balanced economy, although construction activity spiked to end the year.

While the U.S.-China phase one trade deal is a welcome pause to the ongoing dispute and is supportive of the fundamentals of agricultural-related industries, some pundits question whether the Chinese can actually meet the agreed upon export commitments. There is also the risk of backsliding. We don't anticipate a major upswing in capital investment as a result of the trade deal despite the rising business confidence captured in several closely-followed surveys to start the year. Companies are likely to continue to favor investment in intellectual property products like software and R&D, which has grown at a 6.7% annualized rate the past five years compared to equipment and structures growth of just 1.7%. Such investments support ongoing productivity programs and innovation rather than adding new capacity in a slow demand environment. Trade will remain a longer term risk for the global economy as the U.S. and China will continue to be strategic geopolitical adversaries due to significant differences in the two economic and political systems. The era of peak globalization also seems to be behind us as the results of recent elections have shown.

Credit market excesses continue to build and are an increasing risk to the outlook whenever spreads eventually widen. Investment grade issuer net leverage of more than 1.9x cash flow stands at an 18-year high and high yield net leverage of nearly 3.7x cash flow is at a multi-decade high even when excluding highly leveraged energy companies. Furthermore, the size of corporate debt one level above junk has never been greater. The rise in negative yielding debt across the globe has pushed many investors out the risk curve, leading corporations to take advantage of such accommodation to refinance debt, support M&A, and repurchase stock. Generally, the growth rate of debt across the globe continues to significantly outpace GDP growth, which is an unhealthy trend amidst a global slowdown. Eventually such diminishing returns from incremental debt will come home to roost.

Interest rates are likely to remain anchored near ranges that persisted during the second half of 2019. Following the latest Federal Reserve meeting in December, Chairman Powell said that he would prefer to let inflation rise and then hold above the central bank's 2.0% target (core PCE price index) before considering future rate hikes. "In order to move rates up, I would want to see inflation that's persistent and that's significant," Powell said. However, inflation has averaged less than 1.6% on a trailing 12-month smoothed basis over the past decade, exemplifying the strong secular forces at play containing it such as demographics, globalization, and technology. Such forces seem unlikely to shift in the near term, preventing the central bank from achieving its inflation mandate any time soon. Thus, the Fed is likely to remain on hold until the next slowdown arrives, when it would likely resume cutting rates once again. In the meantime, favorable U.S. interest rate differentials, higher private sector savings both within the U.S. and abroad, and a resumption of central bank buying could continue to keep a lid on interest rates and sufficiently finance the growing federal budget deficit for now (which remains a long run concern).

The medium-to-long term trend of stock prices ultimately follows the rate of corporate earnings growth. Although Wall Street analysts are forecasting nearly 10% growth for S&P 500 profits in 2020, roughly 75% of buyside investors consider that projection optimistic based on a recent Citigroup client survey. Full year earnings probably progress closer to a 4-5% rate considering the muted demand environment, rising compensation costs, and moderation in share repurchases. Forecasts for global GDP growth call for a slight acceleration in 2020 over the prior year but far from a sharp inflection higher. The World Bank is forecasting 2.7% global GDP growth in 2020 (measured at market exchange rates), up from 2.5% in 2019 but still well below the 3.0%-3.1% growth of 2017-2018. The IMF, which gives more weight to emerging economies in its forecast since it uses purchasing power parity rates instead of market exchange rates, is projecting 3.4% GDP growth in 2020, up from 3.0% the prior year but still meaningfully lower than the 3.8% achieved in 2017.

Financial market volatility, which has moved to historic low levels, has decoupled from rising economic policy uncertainty and geopolitical risk. Such a divergence is unsustainable. The upcoming Presidential election will bring these risks to the forefront but is unlikely to resolve them given the degree of division within the country. Some proposals like taking the corporate tax rate back to 35% would lead to a meaningful corporate profit recession, likely causing a significant stock market correction at a minimum, and making U.S. companies less competitive on the global stage. Other proposals such as impediments to global trade, strict immigration practices, and a wealth tax seemingly go against the tenets of capitalism that have made the U.S. economy the preeminent creator of wealth, according to pundits on both sides of the political aisle.

As *Foreign Policy* recently opined, “There is little systemic thinking about how to deal with automation, the backlash against globalization, and the structural factors against nativistic populism. If this were merely a local problem, whether in the United States or Europe or elsewhere, that would be one thing. But such political upheavals also threaten many of the very economic sinews that have driven broad-based prosperity since the end of World War II. Populism doesn’t trust markets. If you have a structural driver away from markets, you have a long-term economic problem.”

Geopolitical tensions have also inflected higher to start the year following the airstrike that killed the Iranian General Qassem Soleimani, head of Iran’s elite Quds Force, a U.S.-designated terrorist organization directly linked to the killing of hundreds of American troops in the Middle East over the past two decades. The killing is a crushing blow to Iranian military leadership and the regime’s expansion throughout the region in various forms, and Iranian leadership is almost certain to exact revenge.

Investment Conclusion

According to a recent Bloomberg study, good stretches in stocks are rarely followed by bad ones as it is unusual for the economy to recess immediately after a large rally. Since 1930 there have been 17 calendar years in which equities gained 25% or more and only on three occasions did the economy fall into recession the year after—1990, 1981, and 1937. Also, when stocks have gained at least 20% in a given calendar year there have been positive returns in the next one two-thirds of the time with an average advance of 6.5%. However, rarely have valuations been so high alongside record low volatility, negative interest rates, and rising policy uncertainty. This raises the risk of a significant correction. While the broad investor class is moving out the risk curve despite the lack of proper compensation, we continue to protect client capital in such an environment. The tax calendar has favorably turned as the market touches new highs, giving us the opportunity to trim holdings where appropriate and patiently wait for more attractive buying opportunities in the future. We would agree with market strategist Ed Yardeni’s succinct view of the current investment backdrop. “Bull markets do best when you’ve got a wall of worries. What I’m worrying about is nobody is worried anymore.”

January 3, 2020