WEALTH MANAGEMENT MADE SIMPLE

nine points investment management

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Nine Points Investment Management (NPIM) Market Commentary
by CIO Clifford T. Walsh, CFA

2019 WAS A banner year for investors. It started off much like 2018, off to the races to start the year, but thankfully finishing quite differently. It was the best year for the equity markets since 2013, with all major U.S. equity asset classes up more than 25 percent with the S&P 500 leading the way, up 31.5 percent. Small caps lagged, up "only" 25.5 percent. The equity markets recovered from the late 2018 swoon, approaching and then braking above all-time highs in the first half of the year, but hovered pretty close to that top for most of the year—until the decisive breakout in October that drove the market well into new high territory.

The Federal Reserve (the Fed) took a much more dovish tone in 2019 than we anticipated. While we did not believe that the Fed would raise interest rates 3 to 4 times last year, we were surprised by the unusual late-cycle reduction of rates. This was a huge buoy for the financial markets and should be a tailwind for economic growth in 2020, but not necessarily financial market growth.

In our view, the downside surprises of the past year were pretty significant, as we experienced a multiple-quarter string of S&P earnings contraction, as well as a turndown in CapEx and manufacturing activity. However, it was muted by the cushion effects of lower interest rates and phase one of the U.S./China trade deal. We find it interesting that the entire 31.5 percent return of the S&P 500 was driven by multiple expansion with earnings down slightly.

The international equity markets lagged, as per usual, with developed equity up 22 percent and emerging market equity up 18.4 percent. Slower growth in developed markets, concerns over Brexit and a less central bank activity relative to the U.S. were likely the main drivers behind the lower performance.

When looking at the broad fixed income indices, it was the best year since 2002, with the U.S. aggregate bond index up 8.72 percent. Long-duration bonds and high yield led the way, with 18 percent and 14 percent returns, respectively.

U.S. GROWTH TO REBOUND?

Our view for 2020 economic activity in the U.S. is for the recent slowdown to bottom and begin to rebound, albeit modestly, in the middle of the year. Recession risks, which grew significantly throughout most of 2019, have recently diminished. This is due to Fed rate cuts and support of the repo market, along with

easing trade tensions with China as tariffs have likely peaked. Barring an external shock, it appears as if the start of a recession has been pushed out.

We do wish to point out, however, that given less cushion from lower interest rates and the recent rally in safe-haven assets like long-duration bonds and gold, we think the downside in the financial markets during the next recession will be greater than average.

There are few signs of the economy overheating, as it has in most late cycles throughout history, and the Fed has been very accommodative; so, unless inflation heats up and forces the Fed to act, we do not see them as the cause for the end to this cycle. It is more likely to be something like a reduction in purchasing power by consumers and/or corporations as debt limits are reached, which would be a more gradual decaying of the economy; or, something more binary, like the upcoming 2020 elections. Should the current administration fail to win re-election, we believe a rollback in regulations and tax cuts is possible and would weigh on corporate profits and household income.

THE FED VS. FUNDAMENTALS

The stock market's correlation to GDP has been quite low this cycle, as multiple expansion and share buybacks have driven equity returns during a low GDP growth environment, making it difficult for fundamental investors. The economic expansion since the bottom of the Great Financial Crisis has been the weakest and lowest quality expansion on record, fueled by debt and Fed actions. The correlation between GDP expansion and financial market performance has been less than 10 percent during this cycle, while the correlation between the markets and Fed actions is closer to 70 percent. It's been significantly more performance enhancing to ride the Fed waves of quantitative easing than to profit or avoid losses from swings in economic growth.

We expect this to continue for some time, but we think the Fed's impact on the financial markets could be muted in 2020. As we look at 2020 and the Fed's potential interest rate moves, the "wait and see approach" is likely to persist, in our view. A change in rate policy appears unlikely at the current moment, only probably taking place if there were substantial surprises, either good or bad.

This appears to be the case in most developed markets. Emerging markets appear to have the most "dry powder" from a central banking perspective.

We think inflation is an underappreciated risk in the markets today, which could cause the Fed to raise rates. Productivity gains have been solid given the deflationary effect of technology, but with the Fed reducing rates and providing liquidity, it is possible we see inflation. Low unemployment rates and high-capacity utilization rates due to low CapEx spending could fuel wage growth and corporate price increases.

Overall, we believe it is likely that Fed prefers letting inflation "run hot" rather than stifle growth through rate hikes, and perhaps putting pressure on the highly-levered credit markets; but, should inflation rise significantly, the Fed will have to act. If this happens while growth slows, we see a scenario that would lead to pressure on both fixed income and equities. With current low yields, bonds would provide less of

a cushion than in past drawdowns. We would, however, favor U.S. bonds over the likes of Europe or Japan.

INTERNATIONAL MARKETS

We expect economic activity in the Eurozone to continue on its lackluster path. Real GDP growth of around .75 percent to 1.25 percent seems like a good target to us, with inflation increasing at a similar rate. Germany is showing signs of recovery and, while not a major beneficiary of the U.S.'s trade deal with China, stronger trade partners likely means there will be a positive spillover effect in Europe. Brexit remains the key downside risk to this already-weak forecast. Should the exit be more difficult than is currently expected, the fallout could be significant.

Japan is likely to see continued lackluster economic activity as increased government expenditures is offset by a VAT tax hike implemented last year. Given negative interest rates and the massive amounts of quantitative easing efforts that have taken place in years past make, it appears as if there is little the Bank of Japan can due to stimulate the economy.

While we see China's growth slowing in 2020 and expect a lower growth rate to persist in the long term, we believe a U.S. trade deal will be a positive boost for China and other Asian emerging markets. In China, we expect central bank policies to be neutral with the potential for modest rate increases over time offset by support of the shadow banking system with capital infusions and the broader economy through exchange rate adjustments. Broader emerging markets appear stronger than they have in a few years with solid balance sheets and inflation at an all-time low and more central bank ammunition than China or any developed market. This has us cautiously optimistic that the emerging markets could outperform the broader indices in both equity and debt.

GEOPOLITCAL RISK

As of this writing, tensions in the Middle East have de-escalated, but we do not see issues with Iran resolved any time soon, if ever. Our forecasts could see downside if tensions rise again.

With phase one of the trade deal signed, we see the risk of a trade war lessening and believe that both sides have incentives to make progress on additional phases before the U.S. elections. Should talks somehow break down or China back off, perhaps hoping to get a better deal from a democratic challenger, we would expect to shave some growth from our forecasts and see a pullback in the equity markets.

We believe the most important event of 2020 is likely to be the U.S. election for control of both the Presidency and the Senate. Regardless of which democratic candidate gets the nod to battle with President Trump, all of the major democratic frontrunners propose a reversal of the 2018 Tax Cut and Jobs Act, which dramatically cut federal corporate income tax rates. While we view legislation banning stock buybacks as highly unlikely in the event of an administration change, despite the rhetoric calling for it by some, a reversal of recent bank deregulation could take place. Other areas that could see increased regulation include the technology and health care sectors. The tech sector has more than doubled the return of the rest of the stock market in the past decade, which could weigh down the broader indices.

U.S. DOLLAR

In our view, the path for the dollar appears lower. Due to reduced tension between the U.S. and China, along with the Fed rate cuts and a softer Brexit, as well as the potential unwinding of a variety of long-dollar trades, the U.S. dollar faces a number of headwinds. Risks to our view include rising geopolitical tension with China and/or Iran, a hard Brexit and a recession, which could attract investors as a safe-haven asset, as it has in the past.

PUTTING IT ALL TOGETHER

A handful of pundits are calling for double-digit gains in the U.S. financial markets in 2020, citing renewed growth and a history of strong markets during election years. We see a path to a 10 percent return in the S&P 500 in 2020, but it appears a less-than-likely path, dependent on at least 10 percent earnings growth in 2020 and 2021 and no multiple contraction, all of which we view as unlikely.

We expect 2020 to be a below-average year for equity returns, certainly before the elections. Already-high expectations, rebounding but still muted growth prospects and less Fed ammunition all give us pause when considering our year-ahead market forecast.

Given all the U.S. uncertainty and high expectations factored into equity and bond prices, we are bullish on emerging markets. The developing markets carry higher growth rates and dividend yields, and more attractive valuations compared to their historical discounts. Emerging markets also still appear to have room for stimulus, unlike most domestic markets, unless central banks in developed markets go to even greater extremes than at present. Not to mention, with easing trade tensions between the U.S. and China and the likelihood for a weaker dollar, we believe there is significant opportunity for emerging market equity and debt in a time when most asset classes have been overinflated by the Fed's balance sheet and greedy sentiment. Given recent underperformance of the asset class, many investors are underweight emerging markets, leaving the potential for significant asset flows.

We favor the front end of the U.S. Treasury yield curve, given the dramatic run-up in long-duration assets, fueled by low inflation and lower interest rates. This segment would likely prove resilient in the event of steepening, caused by higher-than-expected growth, which we place on a low probability; or, higher inflation, which we place on a higher probability. We would avoid U.S. high yield and leveraged loans.

We see geopolitical risk, economic fundamentals and sentiment as being the key drivers of returns and volatility in 2020. Barring a recession or a surge in inflation, we see the Fed playing a lesser role than it has in years past. Have we seen the peak correlation between the Fed and financial markets? We're not so sure, but we do believe it will decline in 2020.

Overall, we view 2020 as more of a "stock pickers' market," with subsector and factor performance likely driving more divergences than in years passed.

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QUESTIONS AND COMMENTS

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Sources

[i]All index returns are total return figures accessed using Morningstar Direct on January 1, 2020. You cannot invest directly in an index. Index returns do not include trading or other investment costs.
[ii]FactSet Research
[iii]Morningstar Direct
[iv]Morningstar Direct
[v]FactSet Research
[vi]FactSet Research