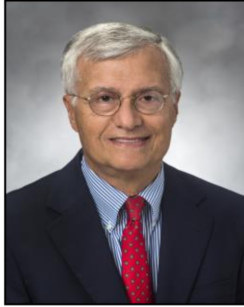

CENTRAL INVESTMENT THEMES FOR 2020

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Summary and Major Conclusions:

Current valuations for US common stocks and bonds are vastly different from one year ago. Compared with deeply depressed valuations at the beginning of last year, current valuations are elevated in all asset classes. The price-to-earnings (P/E) ratio for the S&P 500 has risen from 14x very early last year to 19x, the highest level in many years. The current yield to maturity for high-yield corporate bonds has declined from 8% one year ago to an uninspiring rate of only 5.5%. The 1.60% market yield on ten-year US Treasury bonds and the 2.5% yield on high-grade corporate bonds are near all-time lows.

- World financial markets are expected to behave differently this year when compared with 2019. Economic, financial, geopolitical, and policy conditions are also likely to differ from those of last year.
- Economic and profit growth should accelerate during the year. Inflation and borrowing costs are likely to move gradually higher, while the US dollar could decline.
- Despite an improving economic outlook, investment returns are almost certain to trail those of 2019, since most of the spectacular market gains of last year occurred in anticipation of improving economic conditions this year.
- The biggest surprise this year could be a better-than-expected rebound in foreign economies. World GDP growth could exceed 3%, up from 2.5% in 2019. Earnings growth for companies outside the US could exceed that of the domestic economy on a rate-of-change basis.
- Risk asset returns should exceed those of defensive assets for much of 2020 in an environment of improving prospects for economic growth worldwide and growing investor optimism.
- However, investment returns will likely be constrained this year because of elevated valuations in all asset classes.
- Monetary conditions should provide a continued tailwind for risk assets through most of the year. The Fed is determined to achieve faster growth and rising inflation, a bullish prescription for the equity market.
- US equity market returns exceeded 30% last year in the context of roughly zero growth in company earnings. Equity returns in 2020 are unlikely to exceed the growth rate in company earnings.
- World equity markets should outperform global fixed-income markets. Rather than decelerating as in 2019, world economic and profit growth should accelerate throughout the year, exerting upward pressure on interest rates.
- Common stocks almost always outperform bonds when economic growth is accelerating within a framework of stable inflation, accommodative monetary conditions, expansionary fiscal policy, and rising corporate earnings.
- Total returns on US equities in 2020 could be within a range of 5% to 10%. Within the context of modest returns on the overall equity market, significant divergences among sectors of the market are likely, with many distinct winners and losers.

- Following four quarters of weakness, US company earnings should resume growth this year. Earnings growth outside the US could exceed that within the US, benefitting non-US firms and US multinationals.

- Compared with deeply depressed valuations on US financial assets at the beginning of last year, current valuations are elevated in all asset classes. Price-to-earnings (P/E) ratios have risen from only 14x one year ago to 19x currently.

- Following ten years of underperformance, international equities could outperform those of the US, led by European and Asian stocks. Non-US equities should benefit from improving business conditions, more expansionary policy settings, and significantly more attractive valuations.

- Receding investor fears of recession should work to the advantage of value stocks. Similarly, economically sensitive stock groups should outperform defensive stocks and bond substitutes.

- The next 12 months will likely be challenging for bond investors, with most segments of the fixed-income market generating negative rates of return, led by long-duration US Treasury securities. Corporate bonds are significantly overvalued and have minimal investment appeal.

- Following an extended period of inversion, the yield curve should be positively (upward) sloped for all of this year. A positively sloped yield curve is a manifestation of benign underlying economic and financial market conditions.

- Looking beyond a generally prosperous 2020, the US economy is likely to enter another slowdown phase during 2021, with rising odds of recession in 2022. As a forward-looking indicator, financial markets could begin to discount deteriorating 2021 fundamentals during the latter months of this year.

- Domestic politics and geopolitics could affect world financial markets this year to an even greater extent than in 2019. Although trade tensions between China and the US will likely be on pause, the months leading up to the US presidential election could witness increased financial market volatility.

The investment landscape in 2020 could be vastly different from that of 2019, with important implications for financial market returns. This week's *Economic Perspective* provides a summary of my central investment themes for the new year.

[1] World financial markets are likely to behave differently this year when compared with 2019. Economic, financial, geopolitical, and policy conditions are also likely to differ from those of last year. Economic growth should accelerate during the year, corporate profitability should improve as the year unfolds, inflation could move slightly higher, borrowing costs should be in a modest uptrend, and the US dollar could decline.

[2] The US economy should perform better this year, as continued strength in consumer spending and housing is augmented by a moderate recovery in the manufacturing and capital goods sectors. Compared with 2.2% growth in 2019, US GDP could expand at a 2.5% annual rate. However, investment returns are certain to trail those of 2019, since most of the spectacular market gains last year were in anticipation of improving economic conditions this year.

[3] The biggest economic surprise this year could be a faster-than-expected rebound in foreign economies. World economic growth should accelerate during the year, sparked by massive global monetary stimulus, an end to inventory liquidation in Germany, improving domestic demand in China, and resumed growth in world trade.

[4] Emerging market economies should benefit from a decline in the US dollar and a rise in world trade. World GDP growth could exceed 3%, up from 2.5% in 2019. Earnings growth outside the US could exceed that of the domestic economy.

[5] Risk asset returns should exceed those of defensive assets for much of 2020, in an environment of improving prospects for economic growth worldwide and growing investor optimism. Economic, financial, and policy trends should support another year of positive returns for global equities.

[6] However, rates of return will likely be limited this year because of elevated valuations in all asset classes. Valuations on government and corporate bonds and domestic equities have risen to the highest levels in many years.

[7] Monetary conditions should support risk assets through most of the year. The Federal Reserve should remain highly accommodative, holding its policy rate at 1.75% throughout the year. The Fed is determined to achieve faster growth and rising inflation, a bullish prescription for the equity market at the expense of the fixed-income market. The Fed's balance sheet should continue to expand in coming months.

[8] Financial markets outperformed a sluggish economy in 2019. The opposite is likely to be true in 2020: The economy should perform better than financial assets. US equity market returns exceeded 30% last year in the context of roughly zero growth in company earnings. Equity returns in 2020 are unlikely to exceed the growth rate in company earnings.

[9] World equity markets should outperform global fixed-income markets. Rather than decelerating as in 2019, world economic and profit growth should accelerate throughout the year, exerting upward pressure on bond yields. Global monetary and liquidity conditions will likely remain highly expansionary.

[10] Common stocks almost always outperform bonds when economic growth is accelerating within a framework of stable inflation, accommodative monetary conditions, expansionary fiscal policy, and rising corporate earnings. Total returns on domestic equities in 2020 could be within a range of 5% to 10%.

[11] Within the context of modest overall equity market returns, significant divergences among sectors of the market are likely, with notable winners and losers. All 11 sectors of the S&P 500 posted positive returns in 2019, an unlikely occurrence in 2020.

[12] Several stock groups could generate returns well in excess of 10% while others could be in negative territory. As a generalization, the worst-performing sectors in 2019 could be the leaders of 2020, and vice versa.

[13] Stock market volatility is also likely to increase significantly in 2020. The domestic equity market suffered three sell-offs of greater than 5% last year and declines of 10% and 20% in 2018. Investors should be prepared for periodic setbacks throughout the year.

[14] Following four quarters of weakness, US company earnings should resume growth this year. Earnings are highly leveraged to industrial production, business capital investment, and trade; profound weakness in each of these areas contributed to profit weakness in 2019. A sustained recovery in these sectors could result in a disproportionately large increase in company earnings relative to growth in nominal GDP.

[15] US company earnings are also leveraged to the global economy, world trade, and the US dollar. An anticipated revival in world trade would be especially beneficial for earnings of foreign companies and US multinational firms. A sustained period of US dollar depreciation should also support corporate profitability worldwide.

[16] Current valuations for US common stocks and bonds are vastly different from one year ago. Compared with deeply depressed valuations at the beginning of last year, current valuations are elevated in all asset classes. The price-to-earnings (P/E) ratio for the S&P 500 has risen from 14x one year ago to 19x. The current yield to maturity for high-yield corporate bonds has declined from 8% one year ago to an uninspiring rate of only 5.5%. The 2.5% yield on US investment-grade corporate bonds is the lowest on record.

[17] Following ten years of underperformance, international equities should outperform those of the US, led by European and Asian stocks. Non-US equities should benefit from improving business conditions, more expansionary policy settings, and significantly more attractive valuations.

[18] The correlation among the component stocks within the S&P 500 should decline this year to levels below those of recent years. Individual stock and economic sector selection will likely prove to be the primary determinants of relative portfolio performance during 2020.

[19] Receding market fears of recession should work to the advantage of value stocks. Similarly, economically sensitive stock groups should outperform defensive stocks and bond substitutes. Leading equity market sectors in 2020 include financials, industrials, energy, and transports; lagging sectors include utilities, consumer staples, and real estate.

[20] Following spectacular gains in 2019, technology stocks could generate only moderately positive returns this year. Elevated valuations and more aggressive government anti-trust initiatives against the giant tech companies could limit gains over the next 12 months. Compared with total returns in excess of 50% last year, the S&P 500 Information Technology sector could generate total returns of less than 10% in 2020.

[21] The outlook for the fixed-income market is poor. The next year should be a significant challenge for bond investors, with most segments of the fixed-income market generating negative rates of return, led by long-duration US Treasury securities.

[22] Both investment-grade and high-yield corporate bonds offer little investment appeal at current market yields of 2.5% and 5.5%, respectively. Credit spreads are extremely narrow, increasing corporate bond vulnerability to a rise in default rates later this year and in 2021.

[23] Following an extended period of inversion, the yield curve should be positively (upward) sloped for all of this year. A positively sloped yield curve is a manifestation of generally favorable underlying economic and financial market conditions.

[24] Looking beyond a generally prosperous 2020, the US economy could enter another slowdown phase during 2021, with rising odds of recession in 2022. The classic late-cycle pressures that typically emerge as business cycles mature could be evident later this year and in 2021. *As forward-looking indicators, financial markets could begin to discount deteriorating 2021 fundamentals during the latter months of this year*.

[25] Domestic politics and geopolitics will affect financial markets once again this year. Trade tensions between China and the US will likely be on pause, and the odds of an orderly Brexit of the UK from the European Union have improved significantly. However, relations between the US and Iran, North Korea, and Russia could deteriorate further over the next 12 months.

[26] The US presidential election in November is a wild card in the outlook. It is likely that financial market volatility could increase materially during the months leading up to the election. The domestic equity market is especially vulnerable to a sustained swing in voter sentiment favoring the Democratic candidate.

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MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

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Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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