ECONOMIC GROWTH AND EQUITY MARKET LEADERSHIP

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With the notable exception of the current investment cycle that began in 2009, value stocks have outperformed growth stocks coming out of recessions in virtually all cycles dating back to 1960. Growth stocks and growth managers have massively outperformed value stocks and value managers since 2007, an unprecedented winning streak. The superior performance of growth stocks during the current equity bull market can be explained by persistently heightened investor fear and uncertainty regarding the future strength of the economy and company earnings, encouraging a sustained flight to safety.

Summary and Major Conclusions:

- The outbreak of the coronavirus late last year has been a game changer for the world economy. As such, I have revised my forecasts for GDP in all the major economies, most notably for that of China, but also modestly for that of the US.

- The impact on China is by far the greatest. The epidemic is acting as a freeze on commerce in China. Retail stores have closed, factories have shuttered, real estate transactions have plummeted, and transportation both into and out of China has been curtailed.

- I have reduced US GDP growth in Q1 to an annual rate of 1.5%, down from 2.2% for all of 2019. Downward revisions to China's GDP are far greater. First quarter GDP growth could decline by 50%, from 6% in 2019 to only 3%.

- Assuming that the epidemic is contained during the spring months, world economic growth could rebound strongly during the second half of the year. Fourth quarter US GDP could grow at a 3.5% annual rate, while China's GDP could expand at a temporarily above-trend pace of 7.5%.

- In the US, second half GDP growth should benefit from the lagged effect of monetary stimulus, a resumption of production at Boeing, a restoration of depleted business inventories, and continued strength in consumer spending and housing.

- Corporate debt issuance has increased at a rapid pace in recent years, pushing the debt-to-GDP ratio to an all-time high. However, a significant portion of borrowing has been opportunistic and motivated by a record-low cost of debt capital, with market yields declining to an all-time low of 2.52%.

- Moreover, corporations have appropriately extended the duration of their debt to an average of eight years, the longest average maturity in 40 years. These longer maturities allow companies to lock in record-low borrowing costs for many years.

- Credit quality in the corporate sector should remain benign until there is a sharp rise in interest rates, a decline in corporate earnings and cash flow, and a sharp pullback in bank lending.

- Conditions for bond investors are far less favorable. High-grade corporate bonds are grossly overvalued: With current yields to maturity only slightly above the inflation rate, bond investors are virtually assured of a loss of principal in coming years.

- Although the upcoming election is likely to have only a modest economic effect this year, its impact on financial markets could be considerable. Moreover, the actual outcome of the election will likely have an enormous effect on both the economy and the financial markets in 2021.

- Prior to the election, the equity market will ebb and flow along with the perceived likelihood of a Trump victory. The widely divergent economic policy priorities of the two parties imply that the direction of the equity market in 2021 could be vastly different depending upon the election outcome.

- If reelected, President Trump is expected to double down on the policies of his first term. This could mean additional deficit-financed tax cuts and new spending initiatives; further restrictions on immigration; a further pullback in regulation; and an anti-globalization mindset, with a high risk of more tariff wars.

- The economic priorities of the Democratic party are diametrically opposed to those of Trump. A Democrat in the White House would likely mean higher taxes on upper-income families along with a shift in government spending from the defense department to social programs.

- A Democratic administration would also push for increased government involvement in the health insurance system and a reversal of both immigration and regulation policies, with an emphasis on legislation to address climate change.

- Growth stocks and growth managers have outperformed value stocks and value managers since 2007, a truly unprecedented duration. Moreover, the gap between growth and value widened during the first two months of this year.

- History reveals an alternating pattern between growth and value stock leadership every four to six years. Value stocks tend to outperform growth stocks during periods of rapid economic growth, rising interest rates and inflation, and US dollar weakness.

- My investment conclusion is that an extended period of relative strength in value stocks is long overdue and a matter of when, not if. The catalyst will be a strong rebound in world GDP along with a sustained acceleration in corporate earnings to an above-trend pace — all of which is unlikely to occur until the second half of this year.

This week's *Economic Perspective* addresses key issues with respect to GDP growth in the US and China over the next year, with important implications for global economic growth. The strength of the world economy is the most important catalyst for a shift in equity market leadership from growth to value stock groups.

HAVE YOU REVISED YOUR ECONOMIC GROWTH FORECAST FOR 2020?

The outbreak of the coronavirus in China late last year has been a game changer for the world economic outlook. As such, *<u>I have revised my forecasts for GDP in all the major economies, most notably that of China, but also modestly for that of the US</u>*, which is somewhat insulated but not immune to the virus. The impact on the US economy is concentrated in services exports.

GDP accounting principles treat tourism — and all foreign travel into the US — as an export of services, and China is among the countries with the most tourists traveling to the US. More than three million Chinese tourists visit the US each year, and each spends 50% more than a typical foreign traveler. I have reduced US GDP growth in Q1 to an annual rate of 1.5%, down from 2.2% for all of 2019.

A portion of the Q1 downgrade derives from the temporary suspension of production of the Boeing 737 MAX. I have also reduced my Q2 growth rate to 2%. However, assuming a strong rebound later in the year, I have maintained my full-year GDP growth estimate at 2.5%. Fourth quarter GDP could expand at a rate of 3.5%.

The impact on China is far greater. The epidemic has frozen commerce within the country. Retail stores have closed, factories have shuttered, real estate transactions have plunged, and transportation both into and out of China has been curtailed. First quarter GDP growth could decline by one half, from 6% in 2019 to only 3%. However, growth could improve somewhat in Q2 and rebound strongly in Q3 and Q4. Full-year GDP growth could be only slightly lower than previous forecasts, at 5.5%.

WHY DO YOU EXPECT A STRONG ECONOMIC REBOUND DURING THE SECOND HALF OF THIS YEAR?

It is important to point out that the world economy had begun to exhibit preliminary signs of a bottoming process in the final months of last year, leading to market optimism for a sustained recovery during 2020. *Absent the outbreak of the coronavirus, the world economy was expected to show good progress in the first quarter, setting the stage for a solid 2020*. Instead, I have downgraded my forecast for GDP for all major economies, and most significantly for that of China.

A strong economic rebound in the second half of this year explicitly assumes that the coronavirus will be contained during the spring quarter and that the world economy will resume its recovery by the middle of this year. Global economic growth should be led by China and the rest of Asia, as considerable pent-up demand for travel and consumer spending will spark a sharp recovery in aggregate output. Furloughed construction projects should also resume. Finally, these natural market forces will be reinforced by aggressive monetary and fiscal stimulus already in the pipeline. Tax cuts and increased public spending have been announced in China, Germany, India, and the UK.

In the US, second half GDP growth should benefit from the lagged effect of sustained monetary stimulus, a resumption of production at Boeing, a restoration of depleted business inventories, and continued strength in consumer spending and housing. Government spending is always stronger in an election year and should also add to GDP growth.

COULD YOU PROVIDE AN UPDATE ON US CORPORATE DEBT?

There are numerous crosscurrents in the US corporate debt market, for both issuers of debt and bond investors. Corporate debt issuance has increased at a rapid pace in recent years, pushing the debt-to-GDP ratio to an all-time high. However, *a large portion of borrowing has been opportunistic and motivated by a record-low cost of debt capital*. Average yields on investment-grade bonds have plunged to an ***all-time low*** of 2.45% in late February.

Moreover, corporations have appropriately extended the duration of their debt to an average of eight years, ***the longest average maturity in 40 years***. These longer maturities allow companies to lock in record-low borrowing costs for many years. *Credit quality in the corporate sector should remain benign until there is a sharp rise in interest rates, a decline in corporate earnings and cash flow, and a sharp pullback in bank lending*. ***Corporate sector debt is unlikely to act as a headwind for GDP growth over the next 12 months***.

Conditions for bond investors are less favorable. *High-grade corporate bonds are grossly overvalued*: With current yields to maturity only slightly above the inflation rate, bond investors are virtually assured of a loss of principal in coming years. Bond prices could decline significantly when interest rates are in a sustained uptrend, in combination with a rising trend in both inflation and default rates.

HOW SHOULD INVESTORS FACTOR IN THE PRESIDENTIAL ELECTION?

Although the upcoming election is likely to have only a modest economic impact this year, its effect on financial markets could be considerable. Moreover, *the actual outcome of the election will likely have an enormous effect on both the economy and the markets in 2021*. The reason is that the economic policy agendas of the two parties differ radically.

Between now and the election, the equity market will ebb and flow along with investor perceptions of the likelihood of a Trump victory. In addition, the direction of stock prices has exhibited a positive correlation with the success of Senator Bernie Sanders — based upon the assumption that the odds of a self-proclaimed socialist becoming president of the United States are extremely low.

The widely divergent economic policy priorities of the two parties imply that the direction of the equity market in 2021 could be vastly different depending upon the election outcome. If reelected, President Trump is expected to double down on the policies of his first term. This could mean additional deficit-financed tax cuts and new spending initiatives; further restrictions on immigration; a further pullback in regulation; and an anti-globalization mindset, with a high risk of more tariff wars. It is *generally agreed* that a Trump reelection would be favorable for financial markets.

The economic priorities of the Democratic party are diametrically opposed to those of the Trump administration. A Democratic president would likely propose higher taxes on upper-income families; oversee a shift in government spending from the defense department to social programs; and push for greater government involvement in the health insurance system. There would also likely be a reversal in both immigration and regulation policies, with an emphasis on legislation to address climate change and the environment. It is *widely believed* that a Democratic victory would negatively affect financial markets.

WHAT IS THE LIKELY CATALYST FOR A SHIFT IN EQUITY MARKET LEADERSHIP FROM GROWTH TO VALUE STOCKS?

Growth stocks and growth managers have massively outperformed value stocks and value managers since 2007, an unprecedented winning streak. Moreover, the gap between growth and value ***widened*** during the first two months of this year. *Compared with a total return of 3% for the S&P Growth Index, the S&P Value Index **declined** by 3%*. When might value stocks (and value managers) begin to outperform growth stocks (and growth managers)? History offers two likely possibilities:

1. Near the conclusion of the next recession. For obvious reasons, the rebound in earnings for cyclical stocks coming out of recessions tends to massively exceed the consistent 10% growth rate for the growth sector. The equity market will discount this trend in advance, as it always does. However, my forecast continues to assume that a recession is not imminent, and could be as long as two years away.

2. Assuming the absence of recession, widespread investor expectation of a healthy and sustained rebound in the world economy from the current protracted economic slowdown — as occurred in 2016 and 2017. Once again, overall earnings could rebound strongly later this year and in early 2021, with the profits of cyclical stocks expanding by more than 25%, well ahead of the consistent 10% trendline growth for growth stocks. ***Relative earnings growth generally dictates relative stock performance***.

History reveals a relatively consistent rotation between growth and value in four-to-six-year intervals. Value stocks tend to outperform growth stocks during periods of *rapid economic growth*, rising interest rates and inflation, and US dollar weakness. Growth stocks tend to perform best during periods of *moderate growth in GDP and company earnings* and very low inflation and interest rates. Value stocks also tend to perform best during the first several years of a business cycle expansion, whereas growth stocks perform best during times of rising recession fears.

With the notable exception of the current investment cycle that began in 2009, value stocks have outperformed growth stocks coming out of recessions in virtually all cycles dating back to 1960. *The superior performance of growth stocks during the current equity bull market can be explained by persistently heightened investor fear and uncertainty regarding the future strength of the economy and company earnings*, encouraging a sustained flight to safety.

Growth stocks provide investors with a certain degree of comfort with respect to earnings visibility — an ingrained belief that the sales and earnings of high-quality growth companies can increase on a quarter-to-quarter basis with consistency and dependability. Conversely, because they tend to be concentrated in economically sensitive sectors, value stocks are less attractive during periods of economic uncertainty and expectations for sluggish growth in company earnings and GDP.

Relative equity market valuations between growth and value continue to diverge. Compared with a price-to-earnings (P/E) ratio of 15x for the value index, the growth index is valued at 24 times forward 12-month earnings per share (EPS). Value stocks also offer a dividend yield of 2.7%, versus only 1.1% for growth stocks. My investment conclusion is that an extended period of relative strength in value stocks is long overdue and a matter of when, not if. *The catalyst will be a strong rebound in world GDP and a sustained acceleration in corporate earnings at an above-trend pace* — all of which is unlikely to occur until the second half of this year.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

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.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

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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