



2020 Market Outlook

Stabilization of fundamentals, continued election driven regulatory wins and the Fed provide a backdrop for equity returns in the high single to low double digits in 2020.

2019 started on the heels of an 18% December correction

In 2018 the world was binging on debt anew, and a supposed period of “Global Synchronized Growth” was upon us, for a time masking the slowing trend that allowed the Federal Reserve to tighten policy throughout most of 2018. Nevertheless, the Q3’18 earnings bar was too high, the Fed was perceived to be too hawkish and global growth began to show cracks in the last months of 2018. Then the market corrected 18% in December, with cyclical sectors especially punished, as the Fed continued to call for three rate hikes in 2019 that would never occur. A more pronounced change in leadership, from “value to growth”, than we had envisioned.

China trade concessions don’t trump global fundamentals

We wrote in early 2019 that trade tensions with China were subdued but likely to rise over the course of the year. Essentially, we were skeptical that Trump would placate markets by accepting symbolic concessions from China that allowed for a political victory. We also believed that economic data would weaken throughout the year, coming off post tax reform highs.

Indeed, economic indicators of activity and sentiment continued to weaken in 1H’19 –first in China and the Eurozone then in US manufacturing. Markets rallied as they began to discount rate cuts in the second half. Trade tensions ratcheted notably higher in August just as recession fears were mounting amid outright contraction in US manufacturing. At the time we wrote,

“If the slowdown we are experiencing is indeed a recession we would expect employment to be the next shoe to drop, however, that is not our base case. While manufacturing is certainly struggling, we have seen this before in 2015-2016 and in aggregate, manufacturing is a small piece of the US economy. In order for the slowdown to have a measurable impact on unemployment growth (recession vs slowdown signal) weakness in the Services economy would need to become more pronounced.

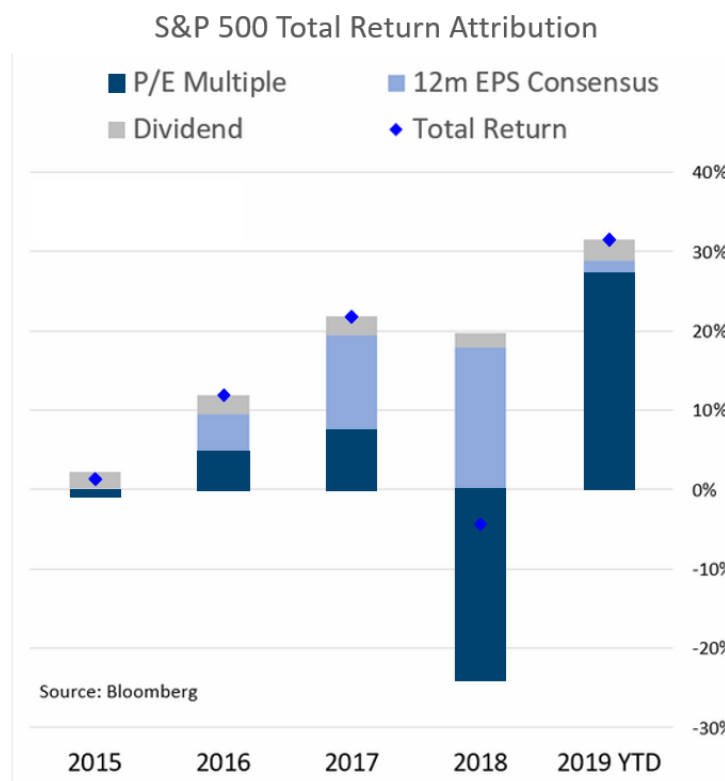
Rather, amidst easing global financial conditions, uninspired valuations, conflicting MARKIT versus ISM PMI readings, already pessimistic sentiment and cautious positioning; we expect the US to dodge a recession. However, while a recession isn’t our base case, we do expect economic data to continue deteriorating into year-end before improving sometime next year as the Federal Reserve continues to cut rates and hinder the dollars ascent (“Soft Slowdown”). In the interim, markets will remain volatile and particularly vulnerable to external shocks, which the geopolitical backdrop remains increasingly willing to provide (Iran, North Korea, Turkey, Syria, Saudi Arabia, Yemen etc.)”



Extra Ordinary 2019 returns driven by Multiple expansion

It was against this backdrop of easier financial conditions, uninspired valuations, a forthcoming trade deal, pessimistic sentiment and cautious positioning that markets rallied, led by cyclical stocks, into year end and all-time highs. Quite a contrast to year end 2018 and another change in leadership, from “growth to value”.

Interestingly, almost all of the return on broad indexes in 2019, can be explained by multiple expansion and dividends, rather than profit growth. In fact, the S&P 500 is likely about to post its fourth consecutive quarter of negative EPS growth in Q4'19. So where profits fell short, the easing Fed drove multiples and returns in 2019. You can see this dynamic in the graphic below:



As we look out into 2020, we see a dichotomy at play between the immediate term and medium term outlooks. The change in leadership or, “rotation into value” that began in Q3'19 picked up steam in the final months of the year and has continued in the first weeks of January.

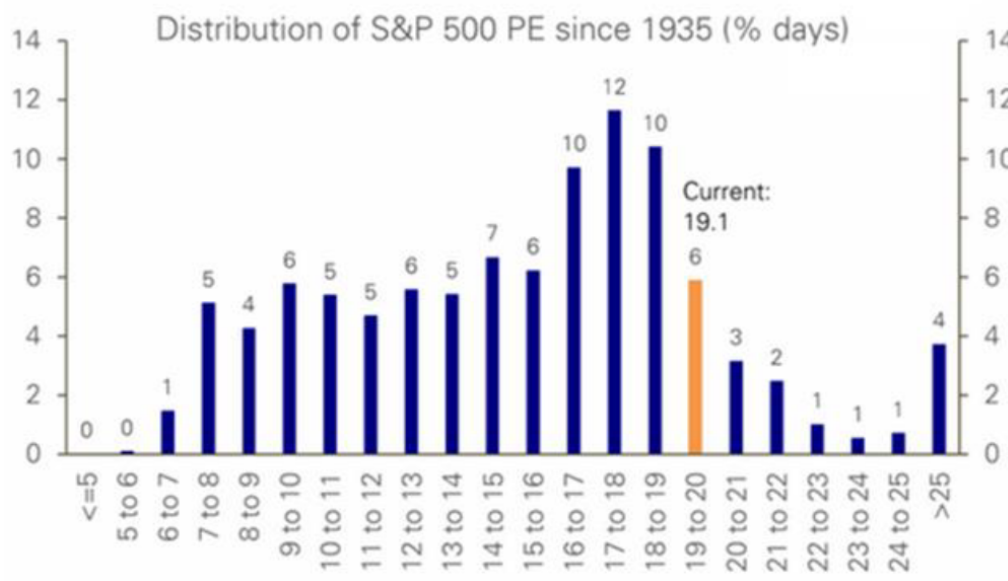
However it is this rapid rally that pits our immediate term caution against our *relatively* more sanguine medium term outlook. In Q3'19 we wrote about a favorable setup for equities. Five months later the setup is less ideal. Sentiment is decidedly bullish with little open portfolio insurance, positioning by market participants has reached extremes and the forward multiple on the S&P 500 is 19x. Furthermore, while we do believe that the US will dodge a recession we continue to believe that there will be some lingering weakness in the data over the coming months. In the immediate term, we are wary that the markets maybe somewhat ahead of the economic reality and prone to correct.



Renewed tailwinds justify stretched multiples

While sentiment and positioning are clearly stretched at present, they provide short term signals. The medium term issue is the forward multiple on the S&P 500 at 19x, which is getting a lot of attention currently because the multiple rarely holds, much less increases from this level as we can see displayed below:

The S&P 500 P/E multiple has traded lower around 90% of the time over the last 85 years (outside of the late 90s equity bubble)



Source: Bloomberg Finance LP, DB Asset Allocation

That said, we are less concerned about valuation given the materially altered backdrop; lower taxes, less regulation, trade détente, three rate cuts and a Fed policy framework reevaluation in 2020. That is not to say we are forecasting another year of extreme multiple expansion, rather, we think for better (growth) or worse (contraction) earnings will be the driver of equity performance in 2020.

The earnings outlook is thankfully a company by company consideration but nevertheless, on the whole it is not abundantly clear to us that 2020 will be an easy year. The labor market has continued to tighten and wage growth has been firming, putting margins in question. Global demand should stabilize but it is difficult for us to envision a marked acceleration that would put us at above trend GDP. The good news is that 2020 will have easy comparisons given negative earnings in 2019. It is rare for earnings to be negative two consecutive years.



As we look further out into 2020 we see economic conditions stabilizing then gradually improving despite elevated uncertainty given the US election cycle and the second order effects that coincide with it, both domestically and internationally.

Our thinking on the election is that it will be an extremely contentious, come down to the wire and likely be widely contested but that Trump will be reelected. However, the odds of Trump being reelected are currently elevated and will fall in the coming months before fluctuating with the competitive puts and takes of the general election. This will create opportunities throughout the year in sectors subject to policy uncertainty (Energy, Healthcare, Financials etc.) admittedly against what we believe will be steadily increasing geopolitical tension. Ultimately, we see a scenario where markets could enjoy either outcome, with a preference for the status quo.

Election uncertainty raises geopolitical risks as our allies, frenemies and adversaries evaluate their competitive stances with US interests and more seriously evaluate their actionable options, which we surmise will increase in number and viability as Trump's reelection odds decline from their currently elevated level. We suspect that adversaries are seriously analyzing an altered—possibly subdued—response mechanism of the Trump administration during an election cycle against the plausibility of outsized response should Trump indeed be reelected. We suspect there will be asymmetric returns to actions against US interests and we are keenly interested in China and Iran.

China trade fades into the background, geopolitical threats abound

First on China, we were correct that tensions would escalate in 2019 but while an agreement was signed, we believe that a deal that doesn't involve IP protections is superficial in nature and a "deal" where the underpinning is a commodity purchase program doesn't reflect the real objectives of US policy and is therefore not a deal. With a phase one deal we have entered a relative trade détente that we suspect will hold despite some mild violations of the agreement related to agriculture purchases by the Chinese. If not for the review of remaining tariffs on October 15th, (right before the election) we would be more inclined to say that the Chinese are not willing to implicitly support Trump's reelection by subsidizing the farm belt. Trump could reignite tensions post-election, but we think the agreement has put a "floor" on negotiations. So we think China trade, the headline of 2019, fades to the background in 2020 with the risk of rapid re-entry.

Moving on to Iran, we were highly surprised by the rapid response to the assassination of General Soleimani. We were not surprised by the calculated nature of the attack, but figured the regime would wait and "pick its spot". We are in store for another calculated response, likely further out the risk spectrum, that will test the US Administration, in our opinion. Increasingly, we wonder if the regime has calculated that cyber-attacks, rather than conventional kinetic means, provide a better degree of asymmetry. We foresee a blend of both options in 2020 with elevated risk of miscalculation. While a rapidly devolving trade war was the tail risk of 2019, a hot war is unlikely, but more plausible than is widely believed in 2020.



Fed, Election and Stabilizing fundamentals provide optimism into the 4th quarter of 2020

There are reasons to be constructive on the market over the medium term while certain aspects are causing us to be more cautious in the immediate. Valuations are well above their averages, but earnings growth will likely return in 2020 with a backdrop of low interest rates and improving economic data. While the months preceding the US election in November may create volatility, Trump will attempt to 'juice' markets with positive trade headlines and promises of further fiscal stimulus. Additionally, the high likelihood of a Trump or centrist win, provides certainty and is a positive for markets in our view. Geopolitical tensions are heightened, and will probably remain so throughout the year with foreign leaders testing Trump's nerve while he's campaigning, but we view significant military conflict beyond what has previously occurred as unlikely, at least until after November. Near term, current investor positioning increases the likelihood of a pullback in the next few weeks. Yet, the one main takeaway from this economic cycle is 'do not fight the Fed.' This is truer in 2020 than even in years past. The FOMC lost a hawk this year (Esther George) and replaced her with a dove (Neel Kashkari), making the balance of the committee slightly more accommodative as they review their framework (likely switching to a symmetric inflation targeting regime.) Incentives for Trump and the Fed are aligned, giving us reason to believe there are opportunities for high single to low double digit equity returns in 2020.

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