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2020 – THE YEAR AHEAD

The last twelve months saw a strong resumption of the bull market for U.S. stocks, calming investor fears that 2018's late sell-off foretold the end of the current economic cycle. With the exception of a few 5-7% pullbacks in the middle of the year as investors digested earlier gains and fretted about continuing trade war issues, U.S. stock indices moved steadily higher, and they now sit around all-time highs.

The current U.S. economic expansion is now the longest in history. Employment and consumer spending continued to grow, despite cautious business investment as managements watched the trade conflicts, especially with China, continue to unfold. Corporate profit growth slowed, however, as overall economic growth gradually moderated and the benefits from the Tax Cuts and Jobs Act of 2017 diminished. Somewhat surprisingly, interest rates dropped during the year as the Fed reversed course and again lowered the Fed funds rate.

Will economic growth, and with it the stock market, continue further into record territory, or are we finally reaching the end of this cycle? In *2020 – THE YEAR AHEAD* we examine this question and conclude that the party is not quite over. While some economic indicators are flashing yellow, we think that moderately good returns can still be achieved, at least when looking in the right places.

The Economy

The U.S. economy grew at a somewhat slower rate through 2019 than it did the previous year. After a strong first quarter aided by continuing benefits from the tax law changes, real Gross Domestic Product (GDP) growth settled back to around the 2% annual rate typical of much of this current economic cycle. For the full year, it looks like real GDP growth for our economy will have come in at just under 2.5%. Consumer spending continued to be the leading engine of that growth, aided by further gains in employment. Business investment slowed down as the tariff war with China heated up. The Federal Reserve continued to support the economy by first halting further Fed funds rate increases early in the year, then cutting rates in the second half.

The consumer is likely to continue driving economic growth in 2020. With the official unemployment rate down to 3.5% and average wages increasing around 3% annually, the strong job market continues to provide spending power. Low interest rates support consumer credit, and the consumer does not yet appear overextended, as the savings rate has increased over the year to nearly 8% of income. The housing market gained momentum in 2019 and should continue to grow in 2020 if mortgage rates do not increase too rapidly. Consumer sentiment surveys indicate that, while consumers have become more concerned about trade and political issues, overall sentiment remains positive and near cyclical highs. So, we think consumer spending could continue growing at a 3% annual rate or better.

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We have written before about aging U.S. capital stock, and the need for increased business investment as a result. This need has not gone away, but American business appeared to put off that day still further as capital expenditures slowed sharply in 2019 from the pace of the previous year, to an annual rate of only 0.2% for the first three quarters of the year. It seems that many CEOs have decided to err on the side of caution given the uncertainties presented by the ongoing trade issues. The manufacturing slowdown may have run its course, however. Purchasing manager surveys, after dropping into territory consistent with zero growth, appear to be bottoming, and any improvement in trade disputes would likely help. The commercial and industrial loan environment also remains positive. We think that corporate investment will pick up somewhat in 2020, especially if further progress is made on the trade front.

The Federal government has lately been running a program of deficit spending which appears likely to continue in 2020 based on recent budget bills. While tax receipts have been growing with the economy, they have still not risen to a level sufficient to offset the current rate of spending. So, in the near term at least, government fiscal policy will continue to be stimulative to growth as well.

Trade has been the big wild card in economic forecasting over the last couple of years. The U.S. government imposed additional tariffs on more Chinese goods during 2019, which were met with Chinese retaliation. But in December, a so-called Phase One deal to reduce some of these tariffs was negotiated, and this should help improve business and export-related parts of our economy. A revised trade agreement with Canada and Mexico has also obtained Congressional approval. And there is certainly incentive to continue to improve trade relations in a presidential election year and reach further agreements with China.

The trade war with China has actually had a bigger impact on other economies, particularly those in Europe and the Asia Pacific region, as trade makes up a larger part of their economic activity than that of the U.S. Chinese economic growth has slowed, partly as a result of tariffs, and this has impacted imports from its trading partners. As a result, the Eurozone economies again fell back to near zero growth during 2019. This relapse occurred despite continued monetary stimulus by the European Central Bank and other monetary authorities. There are some initial indications that the slowdown in growth may have bottomed in both Europe and China. Renewed growth would also likely help strengthen their currencies, which have weakened against the U.S. dollar as of late, in turn aiding U.S. exporting industries.

In total, we expect U.S. GDP growth to continue to run at about a 2.0% annual rate in 2020. This economic expansion, while the longest, is only the fourth largest, and still has plenty of room for further growth. The current headline unemployment rate of 3.5% is unlikely to go much lower, but job growth should be enough to bring additional people into the work force and support continued consumer spending growth. Capital expenditures should rebound a bit from 2019's depressed levels if progress continues to be made on trade issues. Federal Reserve monetary policy has become more accommodative, likely extending the current cycle for at least another year. A few indicators, like manufacturing purchasing manager indexes and the index of Leading Economic Indicators published by the U.S. Conference Board, have been in cautionary territory, but have not yet dropped to a level that would predict recession.

Inflation, Interest Rates, and the Bond Market

Moderate inflation continues to accompany moderate economic growth. As we have noted in the past, we would have expected wage growth to pick up more as unemployment declined to such low levels. However, after some acceleration in 2018, wage increases last year remained rather steady at a little over 3%. There are numerous theories as to why, but it is likely a combination of technological advances, current economic uncertainties around the trade war, and the relatively large number of part-time workers in the labor pool providing additional capacity. We expect gradual increases in wage growth, but not enough to raise Federal Reserve concerns about overall inflation. Meanwhile, prices have risen for some commodities, like oil, but many others have remained in ample supply. Overall inflation as measured by the Consumer Price Index is unlikely to rise much above 2% this coming year, after increasing by a similarly benign amount during the past one.

In 2019, interest rates reversed 2018's gradual upward course. The Federal Reserve, concerned about financial market volatility at the end of 2018, as well as economic growth slowing due to trade conflicts, put on hold its plan to raise the Fed funds rate gradually to more "normal" levels and head off any potential late-cycle inflation. It then lowered the Fed funds rate three times in quarter-percent increments during the second half of 2019 as further insurance. The Fed has clearly stated that it is now inclined to let inflation pick up to a level greater than 2% before raising rates again and it has no plans to increase the Fed funds rate in 2020 from the current range of 1.50-1.75%. The Federal Reserve has become much more transparent in recent years, and so we are inclined to believe them. If the rate remains unchanged over the course of the year, it should be enough to help support continued economic growth.

Longer-term interest rates also continued to fall through much of the year, despite a recovery in the stock market, from about 2.7% on the benchmark ten-year Treasury bond at the beginning of the year to just under 2% by year-end. That was a result we did not expect. Bond rates usually rise when the stock market is strong and investors redeploy funds from bonds to stocks. A major factor pulling U.S. bond rates lower was the renewed sluggishness in overseas economies and continued negative interest rate policies by other central banks. This combination strengthened the U.S. dollar, making our bonds with their relatively higher yields more attractive to investors worldwide. Meanwhile, still-moderate inflation in the U.S. did nothing to cause bond investors to worry about principal erosion from an inflationary environment or restrictive Federal Reserve monetary policy.

The highly watched yield curve inverted slightly for a brief time during the middle of the year as longer-maturity U.S. Treasury bond yields declined faster than the Fed funds rate. Many investors are concerned that this indicates a coming recession, as an inverted yield curve has a good track record of forecasting economic recessions. However, we think it may be premature this time, as the major cause was the bigger drop in long rates due to the influence of overseas demand, as noted above. The curve has in the meantime turned positive again. We will be watching this closely should further inversions occur in the coming year.

We think U.S. bond rates could gradually increase from the current level, as the economies of Europe eventually respond to further monetary stimulus. There may even be some fiscal stimulus applied by European governments, finally beginning to unwind the austerity programs put in place to reduce government debt incurred as a result of the previous economic crisis. China's growth will likely also improve as a result of progress on tariffs and its own increasing fiscal stimulus. The benchmark ten-year U.S. Treasury bond yield could continue the rebound that began in the fall of 2019, when rates moved from around 1.5% to nearly 2.0% by year-end, and might move up to 2.25-2.50%, providing a bit more income to bond investors.

For that reason, we continue to keep maturities relatively short in the bond portions of our clients' portfolios and are underweighted in bonds in balanced accounts relative to long-term target allocations. Even a 0.5% increase in bond rates from late 2019 levels would mean a negative one-year total return for U.S. Treasury securities of longer than three years' maturity and any investment grade corporate bond longer than five years. We are also continuing to gradually reduce corporate bond exposure in favor of U.S. government agency debt and high-quality municipal bonds in anticipation of the eventual end of the current cycle.

The Stock Market

The U.S. stock market in 2019 saw one of its strongest years of the current cycle, with a total return of around 30% for the S&P 500 stock index. As we expected, the market rebounded sharply in the first part of the year from oversold conditions near the end of 2018 amid extreme investor pessimism. However, the momentum continued through to the end of the year, as the Fed drove down interest rates. Ongoing economic growth and optimism on trade fueled additional gains. Technology was far and away the best performing sector on the back of strong earnings growth, which also helped communications stocks. The financial stocks had a strong bounce back despite lower rates. While defensive sectors such as utilities and consumer staples did well in absolute terms, they began to lag as the year wore on and interest rates began to creep up late in the year. Energy was the trailing group of 2019, as investor pessimism kept stock returns muted despite a recovery in oil prices.

Notably, the strong move up in the stock market was not primarily due to earnings growth, although the latter was respectable on the surface. Earnings per share for the companies in the S&P 500 stock index look to have grown nearly 10% for 2019. However, much of that growth was a result of stock buybacks, as underlying corporate operating profits grew by only low single digits. With GDP growth having already slowed from 3.1% in the first quarter of 2019 to the current run-rate of approximately 2%, and wage pressure of 3%, we expect overall operating earnings growth to stay relatively low. If share buybacks, which received a boost from the new tax law in 2018 and 2019, were to moderate, earnings per share growth could be only in the low- to mid-single digits.

A major reason we felt that the stock market would do well in 2019 was its low valuation at the end of 2018. The price-to-earnings (P/E) ratio for the overall market at that time on the coming year's expected earnings had dropped to around 14, a level that we concluded was attractive given the low level of interest rates and continued growth in corporate earnings. Even though earnings growth did slow, interest rates went even lower, supporting higher valuations. The P/E on the market is now pushing 19 times our expectation for earnings for 2020. This ratio is somewhat justified based on current conditions, but we think it also reflects much more optimism than it did a year ago. So, with interest rates gradually rising and earnings growth continuing to slow, we do not see room for much further expansion in the market P/E. Combining single-digit earnings per share growth with a similar P/E a year from now implies a similar single-digit percentage price increase for the S&P index.

Dividends have been growing along with earnings, and so we could see some further increases in 2020, but with currently lower yields versus a year ago due to the strong rise in stock prices, we expect a 2% return from dividends in 2020. Adding that income to expected price increases could provide a mid- to high-single-digit total return for U.S. stocks, still better than that for bonds or cash, but nothing like the results of the past twelve months.

In addition to expecting a lower return for stocks in the coming year—relative to the stellar results of 2019—we could see more variability around that forecast. We would not be at all surprised by a correction early in the year, as investors take advantage of the new tax year to realize profits. Or, given that the market has already shown great sensitivity to even rumors about events in the trade conflict, we could also get a correction if the Phase One trade agreement with China does not, in fact, materialize. Should a correction develop at this point, however, we would view it as an opportunity to increase stock positions.

At the same time, we would also not be shocked by a continuation of the rally. Investor sentiment has improved substantially but is still not at the euphoric levels associated with market tops. It is entirely possible that we could see some sort of "melt-up" if investors were to become confident enough to move more cash off the sidelines or sell bonds to buy more stocks. The fear of missing out is a powerful force and could drive valuations well beyond what we consider reasonable. Because we believe we've already moved pretty far along that path, BTR has been gradually reducing equity weightings in client portfolios as stocks have moved up over the past year. Should the rally continue and the average market P/E ratio move above 20, we would become even more concerned.

Putting that scenario aside, continued economic growth should support the more cyclical sectors of the stock market, such as industrials and materials. And, as these stocks have generally not increased in price as much as some other areas over the last couple of years, valuations are relatively reasonable. These sectors would do even better should China's growth recover somewhat and European economies begin to grow again, as the overseas component of earnings tends to be larger for the more cyclical and manufacturing-oriented industries. Even energy could get a bounce as the stock prices have lagged improved oil pricing, and worldwide demand continues to grow. Financial stocks would benefit from the gradual increase in interest rates.

The strong performance of the technology sector has stretched the valuations of many of these stocks, and earnings will indeed have to grow quickly to support the current high stock prices. We aren't suggesting that these companies can't continue to do well in a growing economy where technological innovation plays a strong part. However, much of this success is currently priced in, and we would be moderately underweighted in this sector until valuations are more in line with earnings prospects. We would also be underexposed to defensive sectors such as utilities, real estate, and consumer staples, as valuations are also high, and the stocks will likely lag in an environment of even modestly rising interest rates. We continue to maintain some exposure, however, as defensive stocks should hold up relatively well in any near-term market correction and we do like the prospects for several of the specific companies whose stocks we own for clients.

Healthcare has been an area of some controversy given the political arguments about how the U.S. healthcare system should be structured going forward, as well as the conflict between the need to keep costs under control and the goals of improving health and increasing lifespans through technological advancement. These factors have often caused the sector to underperform the overall market over the last several years. However, we have been fortunate to find several individual opportunities that have worked out well, and we continue to seek such opportunities going forward and intend to maintain meaningful exposure in this area.

We are asked from time to time if we are considering diversifying our stock exposure to include a more international focus. While BTR did have significant foreign exposure in the 2000s, we have invested almost exclusively in U.S. companies for most of the past decade, correctly concluding that the U.S. economy, along with its stock market, would outperform those of most other parts of the world. Now, we are finally seeing a possible combination of cheaper valuations and some re-emergence of economic growth in parts of Europe and possibly Asia. We think it is still too early to make any meaningful shift to more international diversification, and already have some exposure from many of the large multi-national companies whose stocks we currently hold in client portfolios. We remain on the lookout for international opportunities that might present themselves as the year ahead unfolds.

Conclusion

The investment outlook for 2020 looks decent to BTR, at least in the stock market. U.S. economic growth should continue at a moderate pace and might be aided by increased international growth if further progress can be made on trade conflicts. Consumer spending does not yet show signs of slowing, and business investment activity may once again rebound enough to contribute to GDP growth.

Inflation is still moderate, and the Federal Reserve has indicated that it would accept a little more to keep the current expansion intact. Interest rates in the bond market should resume a gradually increasing uptrend as the later stages of the economic cycle progress, although we are not looking for any inflation-driven spikes, at least in 2020. Federal Reserve policy will likely remain accommodative, with no changes to the Fed funds rate expected this year barring any rapid changes to the economic outlook or external shocks to the world's economies. We are again maintaining shorter-than-average maturities in bond portfolios, and increasingly focusing on the highest quality bonds as the economic and credit cycles age.

The strong stock market of 2019 has reduced the opportunity for outsized gains in the coming year. Valuations are not as cheap as they were a year ago, and corporate earnings growth is likely to be modest. However, we still see positive returns as the most likely outcome for stocks in 2020. While we are a bit cautious about the market in the near term, given its recent strong run, and have pulled back somewhat on our clients' stock exposure, we will look for opportunities to increase stock weightings in any major correction.

We wish all of our friends and clients peace, joy, health, and prosperity in the New Year and for many years to come.