Outlook 2020

The stock market enjoyed its best year since 2013 with the S&P 500, Dow Jones Industrial Average and NASDAQ Composite up 28.88%, 35.23% and 22.34% respectively for 2019. Led by trillion-dollar-plus market-cap giants Apple and Microsoft, which surged 85% and 55% respectively, technology stocks outperformed all other sectors with an amazing 47% increase for the year.

To be sure, the dramatic climb in stock prices was accompanied by a commensurate measure of economic and political drama featuring the longest government shutdown in history, a prolonged inversion of the yield curve, heightened trade war tensions between the U.S. and China, persistent fears of imminent recession punctuated by an outright decline in U.S. manufacturing activity, Brexit anxiety, the impeachment of President Trump, the emergence of far-left candidates for the Democratic Presidential nomination and a world awash with over $15 trillion of negative yielding sovereign debt. The proverbial wall of worry was steep in 2019, fueling stocks higher with each potential obstacle abated as the year progressed.

At year-end prices, the S&P 500 now trades at 18x estimates for 2020 earnings and a more reasonable 16x estimates for 2021. With such stellar gains now in the rearview mirror, valuations resting at multi-year highs and the market's major worries seemingly distant, we suspect that the stock market may be poised for a correction, whether it be in price or time. Let's analyze the economic underpinnings and offer our outlook for 2020.

U.S. Economy

The economy decelerated from 2018's 2.9% pace towards a 2% annualized rate in 2019 as trade war tension with China weighed heavily on U.S. manufacturing activity. Despite this, job growth accelerated towards the end of the year, unemployment dipped to 3.5% matching the lowest level since 1969 and wages have increased 3.1% from a year earlier. Further, catalyzed by President Trump's signature Tax Cuts and Jobs Act (TCJA) and widespread increases in minimum wages, wage growth for the lowest 10% of American workers led all groups with a 7% jump and real disposable income has increased by $6,000 per household. Prior to the passage of the TCJA, the Congressional Budget Office forecasted the creation of only two million jobs over the last three years. In fact, the economy has created seven million new jobs since January 2017. In addition, the Federal Reserve's 2017 median forecast for the unemployment rate at 5% proved to be 43% higher than today's 3.5% multi-decade low. The evidence suggests that the TCJA has provided welcome stimulus. Finally, due to historically low interest rates, recurring debt service payments as a percentage of disposable income also remains at multi-decade lows. As we enter 2020, the U.S. consumer is strong and the super tanker U.S. economy ought to receive at least some benefit from the détente soon to be signed with China. Indeed, the limited deal with China and new trade pact with Mexico and Canada ought to give a slight boost to global GDP. Global GDP growth slowed to 3% in 2019, its lowest annualized rate since the economic crisis. The International Monetary Fund now expects global GDP growth to improve to 3.4% in 2020.

The Federal Reserve

Chairman Powell and the Fed reversed course this year with three rate cuts totaling 75 basis points after hiking rates persistently in 2018. Further, while the Fed did not cut rates again at its December meeting, Chairman Powell reiterated that a meaningful and persistent rise in inflation would be necessary for the Fed to raise interest rates. Especially with the Presidential election looming, the Federal Reserve is highly likely to hold interest rates steady throughout 2020. Highly accommodative Fed policy should help keep interest rates low in the coming year.

Inflation

With unemployment at a 50-year low, it has been surprising to many economists that there has been no meaningful pickup in inflation. While consumer prices rose at a 2.1% annual pace in November, just above the Fed's 2% target, this pace has been unsustainable over the last decade as companies are more reluctant to pass along rising labor costs with higher prices. Moreover, inflation expectations for the next 10 years at just 2.3% as measured by the University of Michigan survey are at the lowest level on record. An unexpected rise in inflation would very likely disturb the long end of the yield curve even as the Fed stands pat. This is a risk that bears watching in the coming year since market participants have grown complacent to the idea that interest rates will remain lower for longer. In such an inflation scare, we would not be surprised to see the yield on the 10-year Treasury rise to at least the 3.2% level reached in the Fall of 2018. That said, we continue to believe that long-term secular trends (demographics, massive government debt, the Amazon effect, globalization and rapid advancements in technology) will continue to keep a lid on interest rates and any material spike higher would be met by strong buying interest and ultimately contained.

Sentiment

With the S&P 50 having its best run in six years, it is not surprising that the current investor sentiment survey by the American Association of Individual Investors (AAII) shows 41.9% of respondents bullish (38% is historical average) and only 21.5% of respondents bearish (30.5% is historical average). What is very surprising, however, is that investors have pulled $135.5 billion from U.S. equity mutual funds and ETFs so far this year, the biggest collective outflow from equity funds on record. Meanwhile, investors have purchased over $277 billion of U.S. bond funds so far this year, the third largest sum on record, and over $482 billion of money market funds, the highest sum flowing into cash equivalents since the Great Recession. Despite the recent AAII survey results, fund flow data indicates that investors are not (yet) chasing the stock market's stellar performance. A burst of investor euphoria evidenced by fund flows piling out of cash and into stocks would be another risk to watch for in the coming year. Euphoria and excess enthusiasm typically mark the end of bull markets, not old age.

Also surprising, Wall Street strategists on average are decidedly less optimistic today than in any other year since 2004. The average forecast calls for the S&P 500 to end 2020 at 3,280, less than 2% higher from the year-end 3,220 close.

Politics

With the stock market shrugging off both the emergence of far-left candidates for the Democratic nomination and the House impeachment of President Trump this year, the implication is that market participants collectively do not expect any material disruption to current economic policies. While this would seem to suggest higher odds for Trump's reelection, election year politics are likely to provide another source of volatility in the coming year.

Conclusion

With the U.S. economy on steady ground, easing trade war tensions with China, an accommodative Federal Reserve, stable inflation and mixed investor/analyst sentiment, it is difficult to make a strong case *against* equities as we head into 2020 and a new decade. That said, the forward PE ratio for the S&P 500 at just over 18x ranks among the highest market multiples since the dot-com bubble. Assuming no disruption to the strong underpinnings mentioned above and no PE multiple expansion, we think it is reasonable that the S&P 500 trades up to 3,550 or 18x forecasted earnings for 2021. We also believe that 2020 will inevitably be a more volatile year than 2019, with heightened potential for a healthy correction.