TREASURY | PARTNERS

2019 Review and 2020 Outlook

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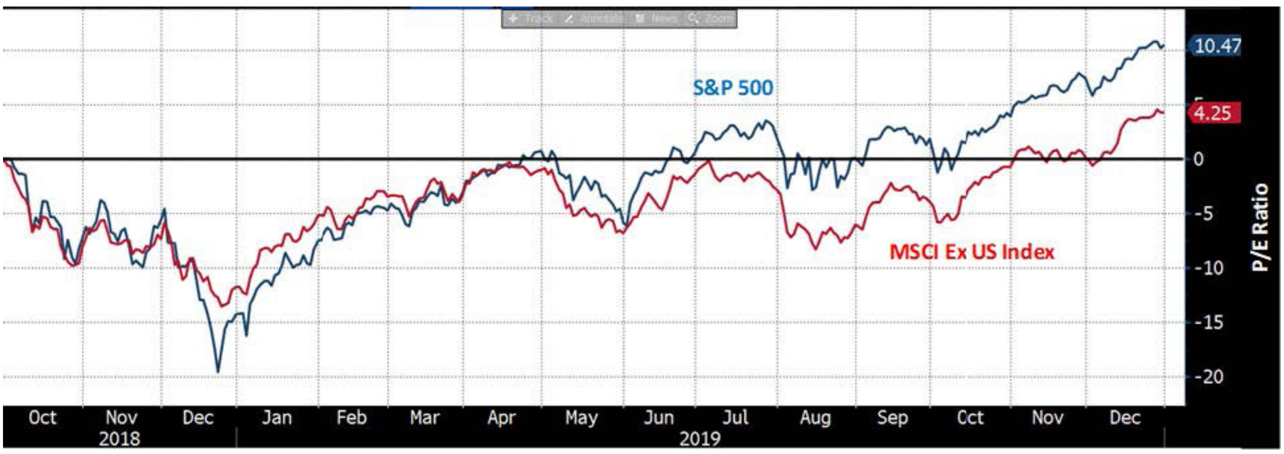
2019 Review

For US investors, 2019 was a good year. The US economy remained solid while the Federal Reserve took a more accommodative stance. Interest rates fell while equity prices rose to all-time highs - the S&P 500 closed the year at 3,230 (a 29% year-on-year increase).

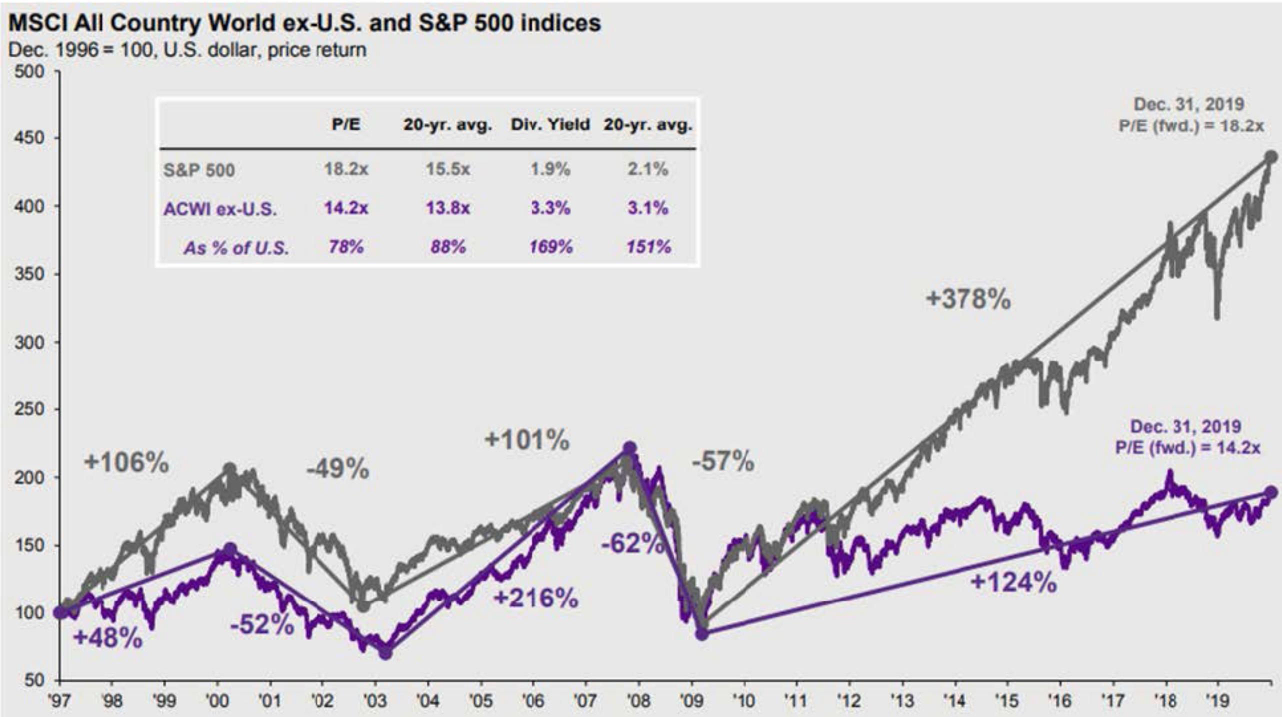
However, there's another story here. Despite the substantial gains since 12/31/18, the depth of the Q4 '18 plunge was such that US equities are only up +10% when measured from 9/30/18. It was a similar story for international equities, as the MSCI ex-US index returned +18% over calendar year 2019, but only +4% since 9/30/2018.

S&P 500 and MSCI ex US Equity Index
Total Returns Since 9/30/18



Source: Bloomberg

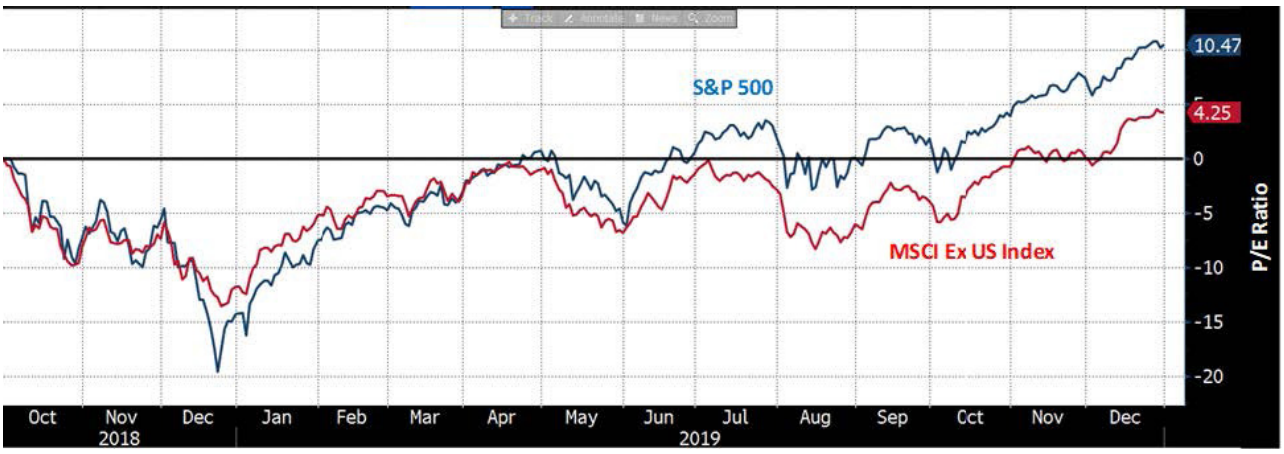
As the chart below shows, US equity markets have outperformed non-US markets for several years running. We've been significantly underweight non-US for this entire time span.



Source: JP Morgan Q1 2020 Guide to the Markets

Despite merely a low single-digit YoY increase in earnings, significant P/E multiple growth (to 21.6x on trailing earnings) was responsible for fueling 2019's excellent gains.

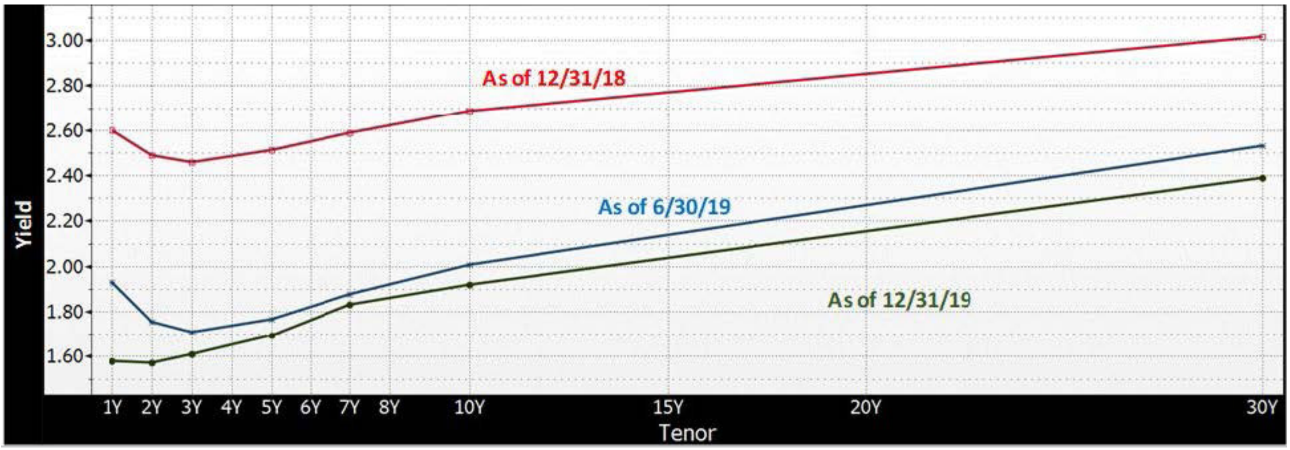
S&P 500 Trailing 12-Month Price/Earnings Ratio



Source: Bloomberg

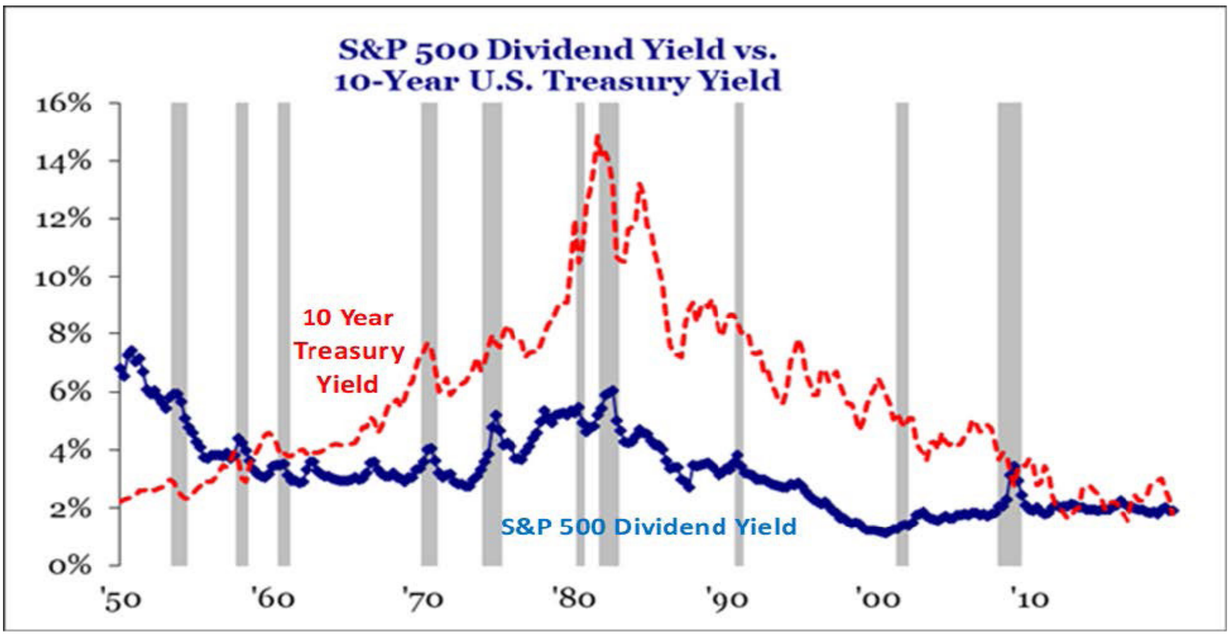
On the Fixed Income side, we began the year with the entire US Treasury yield curve above 2.40% but ended with most of it below 2.00%.

US Treasury Yield Curve Over Time



Source: Bloomberg

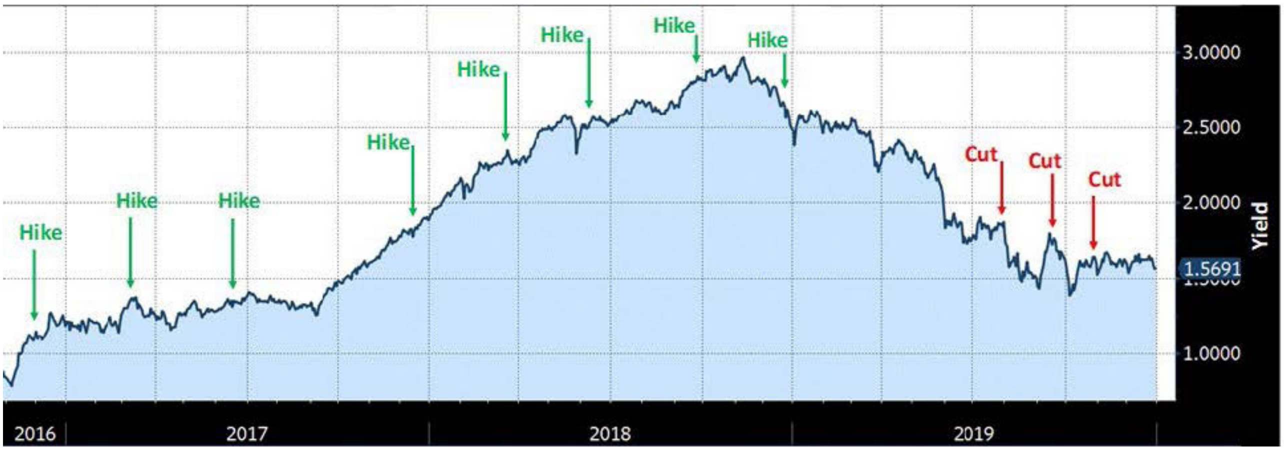
We've seen this pattern of falling rates and rising equity prices several times in the past decade. Historically, though, it's uncommon. Optimism about the economy should lead to rising equity prices and rising yields, as investors sell bonds and buy stocks, but instead the S&P 500 dividend yield now exceeds the 10-year Treasury's yield. This was a rare situation by historical standards that's now transformed into a persistent post-crisis phenomenon, highlighting just how low bond yields remain despite the long-running expansion and tight labor market.



Source: Strategas

Contributing to this environment is a Federal Reserve pivot back to an accommodative stance. The Fed's 3 quarter-point cuts in 2019 mean that the Fed has only raised the Fed Funds rate by 0.25% since the beginning of 2018.

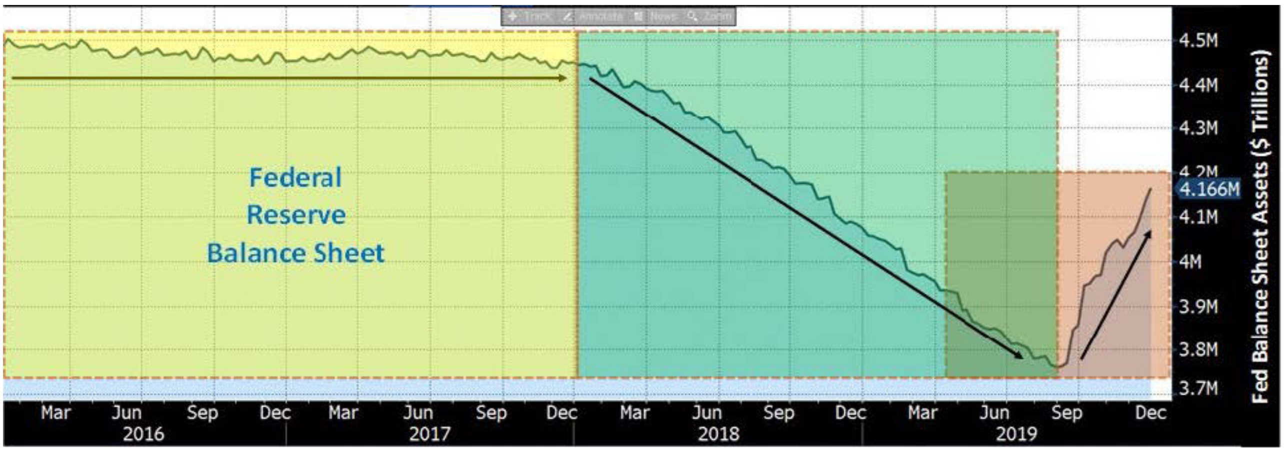
2 Year Treasury Yield vs. Fed Actions



Source: Bloomberg

Perhaps even more consequential is the restarted expansion of the Fed's balance sheet. For scale, 4 months of net purchases at an effective $100 billion/month rate have reversed over half of the previous 1.5 years' worth of gradual runoff.

Federal Reserve Balance Sheet Over Time ($ Trillions)
Yellow = Maintaining Size, Green = Runoff, Red = Emergency Repo Program



Source: Bloomberg

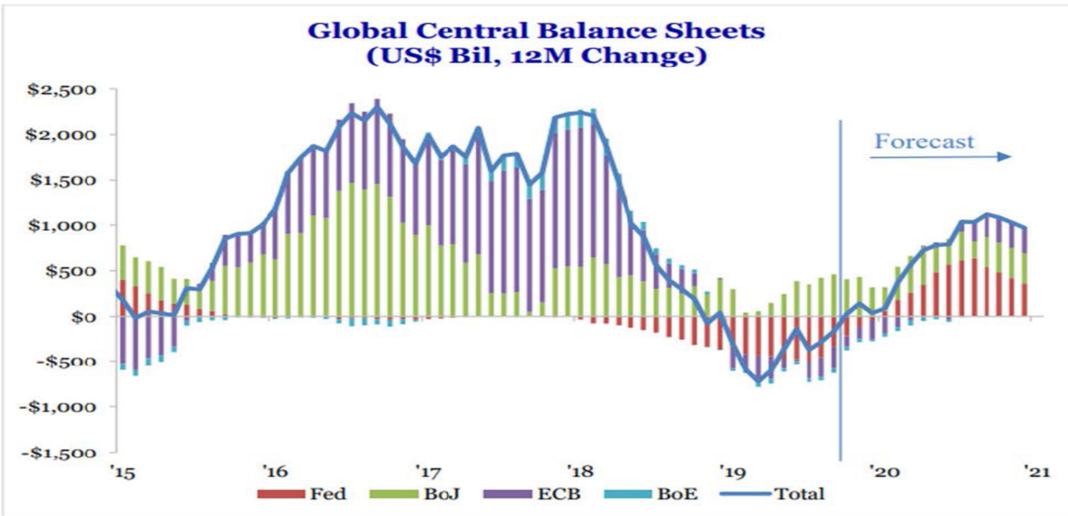
Without getting into the weeds (including the argument whether this qualifies as "Quantitative Easing 4" or not), what's indisputable is that it represents a significant easing in market liquidity and a return to a more accommodative policy stance as we head into 2020.

2020 Outlook: A Tale of Two Halves?

Here are the main themes we're monitoring as the calendar flips to 2020.

Global Synchronized Easing

For the first time in a decade, the Fed, the European Central Bank, and the Bank of Japan are simultaneously increasing the size of their balance sheets. (i.e. engaging in forms of QE).



Source: Strategas

Added liquidity at this scale has historically fueled rising equity prices, and we expect it to do the same in the first half of 2020.

S&P 500 vs. Fed Quantitative Easing Cycles

Source: Bloomberg

The global negative debt overhang we highlighted this past summer is out there (see our report Portfolio Tactics: Positioning Portfolios During a Bond Bubble at treasurypartners.com). Although off its peak, the scale of the problem remains large - as of 12/31, there was nearly $12 trillion in aggregate negative-yielding debt and over 450 million euros' worth of sub-zero corps. Large parts of many major developed nations' yield curves remain below 0%. The fresh rounds of aggressive balance-sheet expansion will continue placing downward pressure on rates which are already starting from this impossibly-low base-line.

Global Sovereign Rates As of 12/31/19

	3 Month	1 Year	2 Year	5 Year	10 Year	30 Year
Australia	0.97%	0.93%	0.92%	0.99%	1.37%	1.99%
Belgium	-0.66%	-0.61%	-0.62%	-0.33%	0.09%	0.93%
Canada	1.65%	1.74%	1.69%	1.68%	1.70%	1.76%
France	-0.65%	-0.61%	-0.60%	-0.31%	0.12%	0.92%
Germany	-0.77%	-0.66%	-0.61%	-0.48%	-0.19%	0.35%
Italy	-0.36%	-0.19%	-0.06%	0.68%	1.41%	2.46%
Japan	-0.11%	-0.13%	-0.13%	-0.13%	-0.02%	0.41%
Netherlands	-0.67%	-	-0.62%	-0.43%	-0.06%	0.34%
Norway	1.36%	-	1.30%	1.39%	1.55%	-
Spain	-0.63%	-0.47%	-0.40%	-0.08%	0.46%	1.32%
Sweden	-0.31%	-	-0.32%	-0.25%	0.15%	-
Switzerland	-0.69%	-0.85%	-0.79%	-0.66%	-0.50%	-0.17%
UK	0.69%	0.59%	0.53%	0.60%	0.82%	1.33%
US	1.55%	1.58%	1.57%	1.69%	1.92%	2.39%

Source: Bloomberg

The net result of this is to drive yield-starved foreign investors into a US bond market that offers positive yields as opposed to guaranteed capital losses. This price-insensitive foreign demand is distorting markets, driving yields lower while equities rise. Other than a return to global growth, the one thing that might cause global central banks to throttle back on their continued easing is a return of inflation.

On that front, we are monitoring a leading indicator called "M2", which represents the growth of the US money supply. Historically, rapid growth in M2 has been a precursor of inflation. Over the last 6 months M2 growth has noticeably accelerated. Moreover, we're seeing survey data report deepening labor shortages across industries, and annualized wage growth is running over 3%. The combination of these factors increases our alert that there's potentially enough smoldering tinder to ignite an inflationary fire.

Source: Strategas

Now, we don't want to overstate our concerns about a return of inflation. After all:

- unemployment has been exceptionally low for years;
- 3% wage growth is a long way from driving inflation, and;
- this isn't the first time we've seen a similar M2 spike this cycle.

Even if 2020 does bring a small dose of inflation, would it alter the near-term outlook for rates? The Fed is moving towards changing its inflation policy to a "time-averaged" target – that is, tolerating >2% inflation for a while in a bid to "catch up" for years of under-target inflation readings. That likely means the bar for future Fed rate hikes is quite high, whereas the bar to cut rates at the first signs of a slowdown is considerably lower.

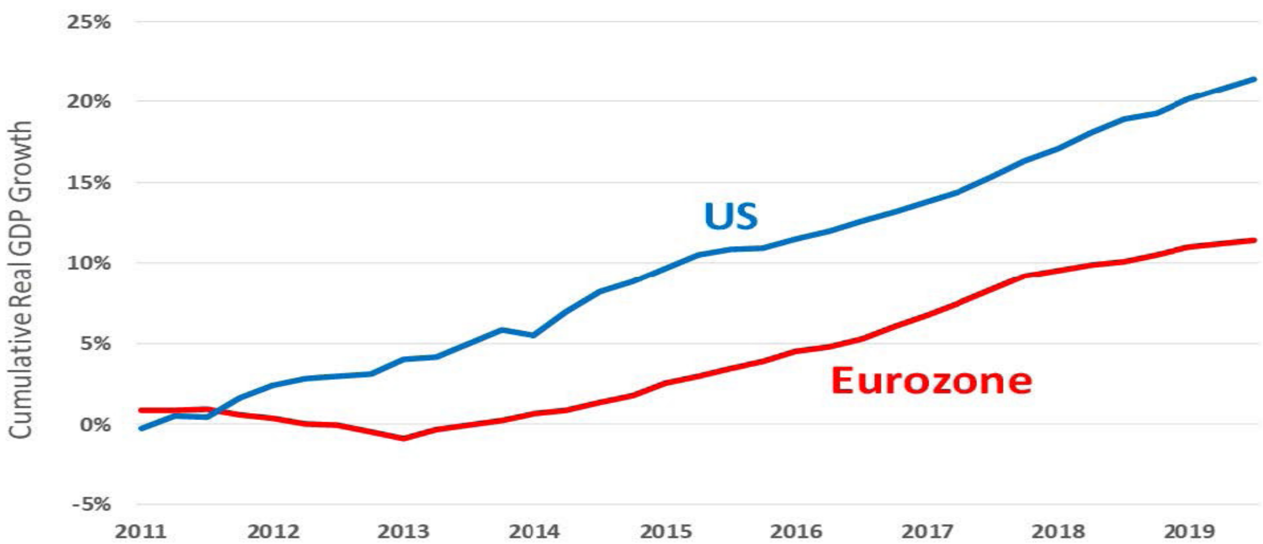
Our base case is modest inflation and the global wave of monetary accommodation supporting rising equity prices (via multiple expansion), especially in the first several months of the year. Yields will remain tightly clamped down. But if inflation takes a leg higher, look for the bond market to front-run a hesitant Fed, causing bond prices to drop and rates to rise. The scale and pace of the market's jumpy reaction could be larger and quicker than anticipated.

...But What About Global Growth?

We expect the US to grow at 2%+ in 2020, assuming Boeing gets its beleaguered 737-MAX flying in Q2. Although it seems hard to believe, this qualifies as top-tier performance when compared to global peers. Many Eurozone economies are stuck in sub-1% growth environments (and occasionally flirting with tech-nical recessions) while also struggling with nonexistent inflation and weakening manufacturing output.

Is more ECB easing really going to change this? We're skeptical. Despite "going negative" in 2014, extreme monetary experimentation has been relatively underwhelming in stimulating economic growth – consider the fact that US real GDP has expanded twice as fast as Eurozone real GDP over the past decade. Why would ECB doubling-down now be expected to lead to different results?

US and Eurozone Cumulative Real GDP Growth



Source: Bloomberg

The worldwide wave of easy money is a powerful tailwind for stock prices, but not necessarily that impactful for real economic growth. Our expectation for steady, 2% trendline US growth is subject to developments in the below 2 idiosyncratic risks.

Trade Wars at a Turning Point?

Trade wars have impacted global economic growth. The most consequential at the moment is the US-China conflict, still simmering despite the purported "Phase 1 Deal" (which, as we anticipated, doesn't tackle the substantive points). We appear primed for ongoing skirmishes through at least the conclusion of the US general election, which adds volatility to the market.

We believe these trade wars are part of a longer-term restructuring of global trade. In addition, they may portend the beginning of a "new Cold War" between the US and China. Both of these have important but ultimately uncertain implications for investors.

The Long Shadow of the 2020 US Presidential Election

Several plausible Presidential candidates are promoting agendas that upend key pillars of our current market-based economy. However, with the first primaries a month away, it's far too early to gauge market impacts. We'll address this in detail later in the year.

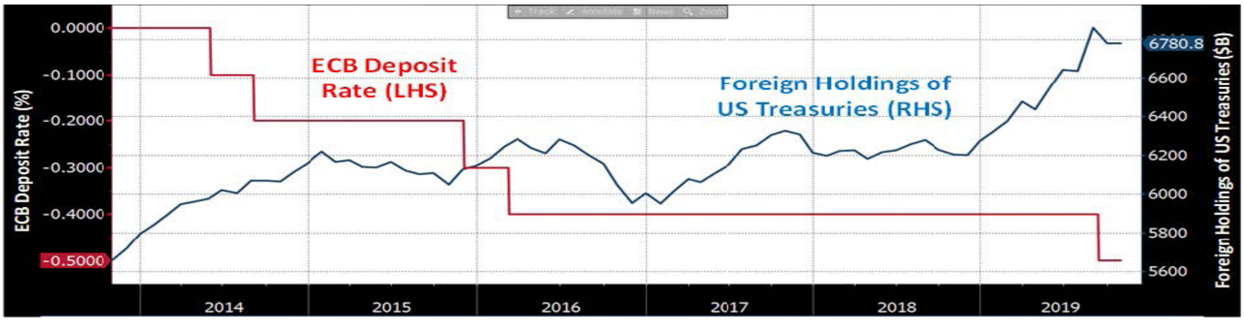
Putting It All Together

Although US equity multiples are elevated, they are not unduly far above historical averages, especially given the low levels of interest rates. To continue this rally, though, we can't rely on more multiple expansion and instead must see renewed earnings growth. We're projecting approximately 7% YoY S&P 500 earnings growth, and the market is currently trading at roughly 18x our forward forecast, which is clearly an elevated level.

Our base case is that this translates to mid-to-high single-digit equity gains (5-8% total returns), mostly front-loaded into the first half of the year. An accommodative Fed, low interest rates, the ongoing strength of the American consumer, and corporate appetite for share buybacks should continue to support P/Es at their current levels.

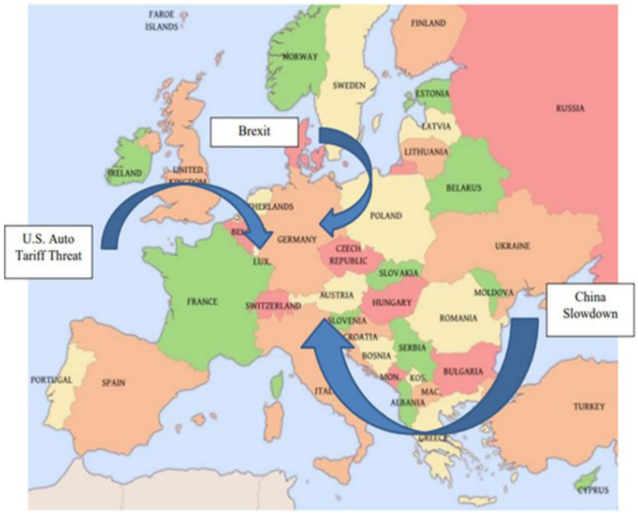
Absent the inflationary shock scenario outlined earlier, US rates should remain low. We see the 10-year Treasury yield struggling to breach 2-2.25%, as much of the global investor base is still trapped in a bond bubble and forced to choke down negative rates. Since the US remains the most attractive bond market, it will likely to continue to attract overseas demand that, in turn, will exert downward pressure on both Treasury yields and credit spreads.

Foreign Holdings of US Treasuries ($ Billions) vs. ECB Deposit Rate



Source: Bloomberg

We're also looking to Germany as an important indicator for both global growth and upcoming interest rate moves. The German economy is uniquely exposed to 3 major risks: trade war threats, the downshift in Chinese growth, and uncertainty over Brexit. How it responds to new developments in each could have influence on global interest rates. The German economy is currently flirting with a technical recession, but there are encouraging signs of stabilization and a plausible argument for a near-term cyclical bounce. With the recent decisive election result in the UK, Brexit-related headwinds may fade as well.



For now, we're maintaining current asset allocations. In equities, we remain overweight US, but for the first time in a decade we're slightly increasing our exposure to non-US equities. Our rationale is multi-faceted:

• The gap between International and US equity market valuations is the highest it's been in over a decade.

• The Eurozone economic downturn shows early signs of having hit bottom, with the large German economy poised to lead the rebound.

• Several major geopolitical stumbling blocks have lessened or shown positive progress (US-China trade deal, passage of the US-Canada-Mexico agreement, and lessened Brexit uncertainty).

• Last, but certainly not least, global central banks are simultaneously providing stimulus through rate cuts and QE, with relatively-low Eurozone equity market multiple seemingly positioned to benefit.

In fixed income, we've recently redeployed a portion of portfolios into intermediate-term corporates. We can't dismiss the possibility that conditions may diverge in two dramatic paths and this measure is designed to maintain flexibility to respond to either outcome. Above all, we continue to monitor the mar-kets for attractive opportunities while closely monitoring our current exposures.

As always, we greatly appreciate the opportunity to oversee your wealth. We wish you and your families a happy, healthy, and prosperous 2020.

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