Global Outlook for 2020

For investors, 2019 was an interesting year filled with opportunities and challenges. The equity and fixed income markets surprised on the upside. The S&P was up 31.49% and the MSCI All-Country World Index was up 26.60% while the 10-year US Treasury Note price rose, and the corresponding yields declined from 2.74% to 1.89%. by year end. Here is our recap of 2019 and our views on equities and fixed income going into 2020.

Global Equities | Standing at the beginning of 2019, there were indications that the global economy was struggling. U.S. and China were in a trade dispute and the Brexit uncertainty came to a head on January 2019 with the defeat in Parliament of the deal for exiting the European Union. For much of the world, GDP growth expectations for 2019 continued to drop. Japanese and German GDP contracted in the 3rd quarter of 2018. During the 4th quarter of 2018, China's economy grew at 6.4% which was the slowest annual rate since 1990. Manufacturing and investment spending were particularly weak. In addition, the expectation was that earnings growth for 2019 would be less than half the growth in 2018 as the benefits of U.S. tax cuts of 2018 wore off.

Also, going into 2019 the monetary policy in the US and Europe was tightening. The Fed had raised interest rates four times in 2018 with the last increase in December 2018. With interest rates close to 2.5%, cash became an alternative to stocks. In Europe, the ECB confirmed it would end its $3 trillion bond-buying program.

All that seems to be history now. Or is it? Some of the concerns are on-going while some are mitigated. On the positive side, while global growth forecasts continue to be soft with GDP forecasts for 2020 for the developed markets at 1.5% and for the emerging markets at 3.0%, there are tentative signs of bottoming after a rocky year. Business investment rose in Germany in December 2019, tentatively showing signs of recovery. On the earnings front, global corporate earnings growth is forecasted to be 10%, rising from the close to 0% earnings growth in 2019.

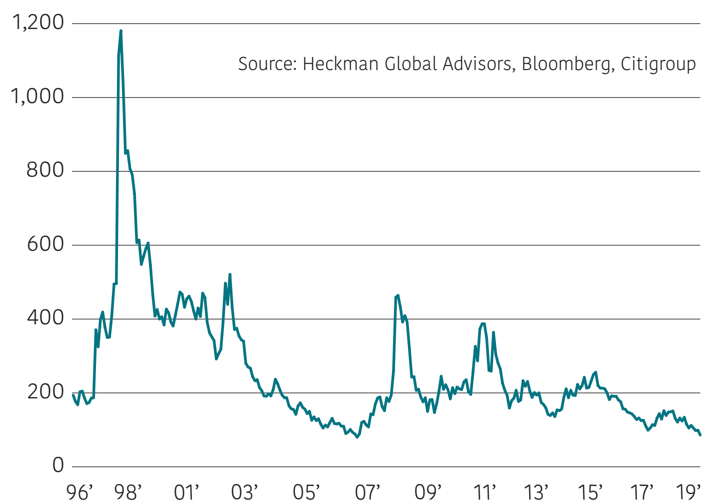
Also, on the positive side, the US Federal Reserve has reversed course and shifted to a dovish stance and will most likely be on hold in 2020. The European Central Bank has cut rates further into negative territory and revived their bond buying program.

In terms of challenges for 2020, there are further downside risks to the global economy. As pointed out above, global growth forecasts continue to be soft. The mini trade deal agreed to between the US and China does not really address longstanding trade issues such as the resolution of intellectual property rights. The election victory of Boris Johnson does not resolve the terms of the trade relationship Britain will have with the EU and the rest of the world. Political uncertainty remains, not so much with the impeachment of Trump but with the 2020 Presidential election.

Our global equity positioning in regions and markets is in the context of a diversified equity portfolio which has positions in each region around the world. We are overweight emerging markets relative to their capitalization. As shown in the chart below, risk seems to be in check for the emerging markets as spreads of emerging market sovereign bonds over US Treasuries are at historic lows. This is reflective of reduced perceived risk in emerging markets as well as narrowing spreads in fixed income markets. Within the emerging markets, Taiwan is overweighted with stable 2020 GDP forecasts and strong momentum. We have increased the overweight in Turkey.

It is inexpensive both in absolute terms and relative to its own history, 2020 GDP forecasts are no longer being downgraded and sovereign risk spreads are narrowing. Brazil continues as an overweight with its stabilized GDP forecasts, undervalued currency, and declining interest rates.

Sovereign Spreads: Emerging Market Averages (Basis Points)



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In addition, many Continental European markets are overweighted. We are overweight some of the smaller markets, including Austria, Ireland, Italy, Portugal, and Spain. Austria, Italy, and Spain are very cheap with forecasted 2020 price-to-earnings of 10x, 11x, and 11x respectively. Ireland looks particularly good on our risk measures, including running a large current account surplus (exporting more than importing) and falling domestic credit growth relative to GDP. Both reflect a lower credit risk environment for Ireland. Portugal also looks good on our risk measures, with sovereign risk spreads falling dramatically over the last 2 years.

In the developed markets of Asia, Japan is marketweighted. It has reasonable valuations with fairly stable GDP forecasts for 2020. However, Hong Kong continues to be underweighted with its 230bps downward revision to 2020 GDP forecasts and a very weak 1-month upward earnings revision ratio (only 38% upward). Australia is also underweighted with its weak export prices relative to import prices.

The U.K. is underweighted despite the election victory of Boris Johnson and a decline in Brexit uncertainty. Though it has cheap valuations—including a dividend yield of 4.4% and a forecasted 2020 P/E of 13x—the U.K.'s GDP forecasts for 2020 have been downgraded, upward revisions to earnings estimates have been weak (34% upward), and it is running a large current account deficit relative to GDP (importing more than exporting).

Fixed Income | The fixed income market had an excellent year in 2019. The bellwether 10-Year Treasury yielded 2.74% at the start of the year. As this is being written at the year end of 2019, the yield on the 10-Year has dropped to 1.89%. The 30-Year Bond had a similar yield movement, going from 2.98% to 2.35% by year-end. The decrease in yields provided substantial price appreciation for fixed income investments. As was mentioned above in the analysis of the equity markets around the world, the investment universe reacted to the ebb and flow of economic and policy news. During the year, the Federal Reserve (the "Fed") cut the Fed Funds interest rate range three times. At the start of the year, their range was 2.25%–2.5%. In July, the range was reduced to 2.00%–2.25%. In September there was an additional quarter of a percent cut, bringing their goal to 1.75%–2.00%.

In October the third cut brought rates to 1.50%–1.75%. With this as a background, what are our opinions about what might happen in 2020?

As mentioned above, we feel that after the dramatic rally in equities that occurred in 2019, the stock market will have more subdued positive returns in 2020. That will be the backdrop for the fixed income market. The Fed will be reluctant to raise short-term rates without clear evidence of economic over-expansion or inflationary pressures.

The longer end of the yield curve will be relatively quiet for the first half of the year, and yields could start to increase due to both economic news and to developments in the 2020 Presidential election in the third and fourth quarters of this year. As a benchmark, it is our opinion that the 10-Year Treasury Note will gradually return to 2.50% by year end.

Credit spreads will continue to be tight between investment grade bonds and lower tier bonds. With the level of nominal rates where they currently are, investors have "stretched" for additional income by buying lower-rated, higher-yielding bonds. This will change when there are increases in defaulting issuers as the economy moves away from boom times to a more traditional outlook.

Within the fixed income universe, the $3.8 Trillion market of municipal bonds will continue to be viewed favorably. Given the changes in the tax code and the dramatically reduced deductibility of state and local taxes, tax-free bonds will continue to attract investors. The ratio of municipal yields to Treasury yields dropped during 2019. Using the industry standard daily rates provided by Municipal Market Data, 10-Year AAA municipal bonds went from 86% of 10-Year Treasuries to 75% by year end. The same was true for long maturity bonds, with municipals going from 99% of the yield of the comparable Treasury, to 89% now.

Within the municipal bond universe, there has been a significant increase in new taxable municipal bonds issuance. They are subject to federal taxation, although in many states they are exempt from state taxation. Estimates for 2020 have an expected new issuance of as much as 20% of the total new bonds. Given the low level of taxable interest rates, and that the Tax Cuts and Jobs Act of 2017 eliminated advance refunding of municipal bonds, in many cases it is a prudent strategy for a municipality to issue taxable bonds that lower debt service costs to the issuer rather than waiting until the actual call date years in the future and hope tax free rates are lower at that time. Given the very low default rate of investment grade municipal bonds compared to taxable Corporate bonds, taxable municipals have found a vibrant investor market. In conclusion, we believe that the longstanding equity bull market can continue its upward trajectory unless there is a shock to the global economy, such as a major trade war or an oil-price shock. However, we do not foresee the same level of eye-popping returns in the equity market as we saw in 2019. With this backdrop of the Fed on hold and low inflation expectations, we expect the returns on most core U.S. Government Bonds and municipal bonds to be modestly positive. In our view, investors should remain diversified into global equities as well as high quality fixed income.

While this is a very brief view of our current thoughts and expectations, we look forward to the new year. It should provide both very unique investment opportunities as well as interesting challenges for investors.

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