



JANUARY 2020

## MARKET REVIEW

The year 2019 proved to be very positive for the markets. Unemployment is at a 50 year low. Home prices are at an all-time high. The current bull market is approaching 4,000 days, and stocks are at an all-time high. U.S. equities charged sharply higher across the board to put an exclamation point on a very strong 2019. Fed rate cuts, an expansion of the balance sheet, and optimism around a "Phase One" trade deal with China each boosted the markets. But, why doesn't it feel quite so great?

Part of this is certainly the trade tensions, the political acrimony, and the growing geopolitical uncertainty. Surely the ebb and flow on these fronts is in part responsible for the rather violent rotations in the market of late – rotations largely disguised from the casual observer by the outsized headline index gains. As this bull charges into 2020, we seem poised to continue the current expansion. Financial conditions are more fueled than one year ago, following not only 3 cuts of the Fed Funds rate, but also a significant expansion of the Treasury's balance sheet (estimated to be the equivalent of an additional 50bps of easing). Not only have domestic financial conditions eased, but, larger emerging market economies and the bulk of Developed countries are also easing. Easing so far into an expansion is unprecedented – but so are such tame inflation numbers. Stocks are expensive, and so increased volatility should not be discounted – but conditions are so unique that this bull may just persist.

The bond market saw a significant reshaping of the yield curve over the past three months. The short end of the curve reacted to Fed easing, while rates rose from 3 to 30 years as trade uncertainty faded with the optimism of the U.S. and China's Phase 1 trade deal. The Phase 1 deal, which is due to be signed in mid-January, means the planned new tariffs will not be imposed, while U.S. tariffs imposed in September on \$120 billion Chinese goods will be reduced by one half. The 25% tariffs on \$250 billion of Chinese goods will remain. China has also agreed to increase purchases of U.S. goods, with a highlight on agricultural produce.

The Fed cut interest rates once in the quarter before indicating that "the current stance of monetary policy is appropriate". The GDP expanded by an annualized rate of 2.1% in the third quarter, better than was expected and stronger than was reported in the second quarter. Further, the unemployment data reports came with better than expected wage inflation. Other economic data, such as the purchasing managers' indices, which survey the manufacturing and services sectors, continue to indicate a modest expansion.

The U.S. 10-year treasury yield rose a quarter of a point from 1.66% to 1.92%, while the two-year treasury yield dropped from 1.62% to 1.57%, steepening the yield curve as the market took a more optimistic view on the economy.

Corporate bonds performed exceedingly well to cap a strong year. High yield outperformed, but U.S. investment grade was also strong relative to government bonds and across various sectors.

To sum, the path of 2019 economic growth was largely characterized by a tug-of-war between geopolitical drags offset by global monetary policy easing. Tariff and trade uncertainty weighed heavily on business sentiment, producing a sharp deceleration in global capital spending and manufacturing output.

The recent U.S. hiring data mentioned, however, has been an encouraging sign that the U.S. economy could be withstanding the global slowdown and continued trade-related uncertainty. The U.S. economy has performed very close to expectations in 2019. GDP growth was forecast to slow from 2.9% in 2018 to somewhere between 2.0%-2.6%. With three-quarters of actual data reported, 2019 has been on track to hit a growth rate of 2.3%.

Even as growth has shifted to a lower gear, the economy appears to be advancing at a fairly solid pace. This resiliency is perhaps best reflected in the labor market, which has continued to defy expectations and generate sturdy payroll growth, record low unemployment, and steadily improving wages.

Consumers have remained the linchpin of U.S. growth. The solid job, wage and income gains have accounted for the persistence in elevated consumer confidence. Household spending has received a notable boost from



one factor that was not anticipated at the beginning of 2019 – lower interest rates. The Federal Reserve cut interest rates three times in 2019 on worries that weakness in trade, business investment, and manufacturing could derail U.S. growth by triggering cutbacks in spending and hiring.

## MARKET OUTLOOK

It was a challenging year for the global economy in 2019, and 2020 is not shaping up to be much easier. Several factors have combined to restrain the performance of the global economy. The most pronounced area of weakness has been the industrial sector, with industrial output in contraction territory for many key economies during recent months, including Canada, the Eurozone, Japan, and the United Kingdom.

One of the key factors contributing to the industrial downturn has been the extended and persistent escalation of trade tensions between China and the United States. The longer the industrial sector remains under pressure, the greater the risk of a spillover of weakness into the consumer and services sectors.

Although the industrial sector has been a cause of concern, the consumer and services sector has, so far, generally been a source of confidence. Job growth has been relatively solid and, with unemployment rates low by recent standards, wage growth has picked up across many countries and regions. Moreover, the modest rate of CPI inflation across many economies has added to the real purchasing power of consumer incomes.

With monetary policy settings in most major economies already aggressively easy and fiscal policy unlikely to loosen much, the outlook has remained for steady and subdued economic growth. Economic growth in most foreign economies will remain modest over the next two years. Global GDP growth looks to be close to 3.0% in 2019, which would be the slowest pace of growth since the global recession of 2008 and 2009. Global GDP is also expected to be about 3.0% in 2020.

The U.S. economy has continued to plug along, but has pulled back from the robust pace of 2018. Consumer spending on goods and services

plus housing growth has formed the key pillars of a U.S. outlook that foresees the economy expanding 2.0% in 2020, a slight cooldown from 2.3% in 2019. Underlying this view is the strength of the labor market, absorbing more and more workers, while wage growth should hold at fairly robust levels. And, with low-interest rates, the ingredients are present for household spending to rise at a sustainable rate in 2020.

In contrast, business investment will be less supportive of the outlook. Manufacturing output has been in a slump globally in 2019, and recently in the U.S. Despite a Phase 1 trade deal with China, trade policy uncertainty will not likely diminish enough to see a big resurgence in private investment. Outstanding trade disagreements remain with China, the EU, and other nations. What's more, political uncertainty associated with the November 2020 election is likely to hamper plans by businesses to expand capacity until further clarity on the likely direction of future policies.

In the United States, no economic recession is expected, but the signs of an aging economic cycle are increasing. The most likely scenario is that the economic expansion that has been underway in the United States will continue for the foreseeable future, although at a subdued pace. Likewise, economic growth in most foreign economies will remain modest in 2020. However, the unsettled political and geopolitical environment at present imparts more uncertainty than usual into this economic outlook. A year ago, markets were nervous amid concerns about U.S.-China trade policy, a less accommodative Federal Reserve, continued Brexit delays, and numerous other geopolitical issues. Throughout the year, a recession seemed possible as global manufacturing contracted and the U.S. yield curve inverted. Today, central bank easing, the apparent de-escalation of trade disputes, and generally encouraging economic data have pushed global stock markets higher, with U.S. equities reaching new all-time highs by the end of 2019. Significant uncertainties remain, however, including the potential re-escalation of trade conflicts, a shift in central bank policies, the agenda of the next occupant of the White House, and other geopolitical risks including unrest in Hong Kong and actions by Iran. All things considered, the outlook for 2020 is cautious and return expectations should be lowered.

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