GLOBAL CENTRAL ENGINEER SOFT LANDING

In 2019, the global economy appeared to be facing several fundamental headwinds such as an ongoing global economic slowdown, escalating trade tensions (primarily between the U.S. and China, but also with other countries), a global manufacturing recession, growing geopolitical tensions (which saw a brief spike in oil prices), and a potentially hard Brexit. In an attempt to prevent economic conditions from worsening, and ensure the continuation of this long economic expansion, the U.S. Federal Reserve, European Central Bank, and other central bankers around the world cut interest rates and eased monetary conditions.

Simultaneously, U.S. and China came to terms on Phase I of a trade deal, signaling an end to additional tariffs and a roll-back of some previous tariffs. Additionally, Boris Johnson won a significant majority in the latest United Kingdom general election ensuring that any Brexit agreement he negotiates would likely be approved by parliament. As a result of these events financial conditions improved, along with investor risk appetites. Stocks, bonds, and oil prices soared, delivering some of the best annual returns ever.

STOCKS: FADING RECESSION FEARS DRIVE STOCKS HIGHER

The U.S. and China trade dispute led to significant tariff increases, a recession in global manufacturing, disruption in supply chains, and uncertainty around capital expenditures. Markets feared this might tip the global economy into a recession. To counter these concerns, central bankers around the world eased monetary conditions as an insurance policy to prevent a recession. Helping matters further, the U.S. and China announced they had come to terms on Phase I of a long-term trade deal between the two countries. As part of the deal, there would be no further tariff increases and a roll-back of others levied in the past. Global stock markets responded delivering extraordinary returns. The longest U.S. equity bull market in history is now also the best performing one since World War II. The current market boom, which started in March 2009, has produced a stellar 493 percent gain for the stocks of large U.S. companies represented by the Standard & Poor's 500 index through the end of 2019. This record run eclipses the prior best 454 percent total return for the index during the bull market run from 1949 to 1956.

International and emerging market stocks also had strong returns, but lower than U.S. equities. However, they did outperform in the fourth quarter, as the dollar weakened following three Fed rate cuts. This was also the pattern between stocks of large and small capitalization stocks, and growth and value stocks. Within U.S. equities, technology stocks were
the best performers, up over 50 percent for the year. Technology stocks such as Apple, Lam Research, and Advanced Micro Devices offered some of the highest returns in 2019. A low interest rate, low inflation, and low growth environment is supportive of companies with high growth. Investors also see technology companies as less cyclical and more secular growers with potential for penetrating other sectors like payments, healthcare, and automobiles. Central bank easing resulted in interest rates falling across the yield curve, and bond proxy sectors — utilities, consumer staples, and real estate — delivered solid returns in 2019. Energy was the worst performing sector due to excess supply, slowing global growth, and demand destruction from increasing use of alternatives. Healthcare underperformed the broader market hurt by political headlines around Medicare-For-All proposals and pressure from the Trump Administration to reduce drug prices.

**BONDS: FALLING RATES ARE IDEAL ENVIRONMENT FOR BONDS**

With growing fears of a recession in the United States, the Federal Reserve cut its benchmark rate three times in 2019 to a range between 1.5 – 1.75 percent. The Fed called it a mid-cycle adjustment to insure continuation of this long expansion. The European Central Bank also cut its key interest rate 10 basis points, from -0.4% to -0.5% basis points, diving deeper into negative territory. The ECB also committed to a new round of asset purchases starting November 1, 2019, at a pace of 20 billion euros a month, as long as necessary, to hit its inflation target. As the trade war between the United States and China caused a global slowdown and manufacturing recession, dozens of central banks around the world, including those in China and India, eased policy to support their local economies.

As rates fell, the Bloomberg Barclays U.S. Aggregate Bond index delivered solid equity like 8.7 percent returns in 2019. Corporate bonds and emerging market debt, which are more correlated to equities, did even better. Credit spreads narrowed as the soft landing engineered by the Federal Reserve and other central banks reduced the probability of an imminent recession. The Phase I trade agreement between the U.S. and China, low levels of defaults, and investor demand for yield also helped investor risk appetite. Mortgages underperformed the broader benchmark as the Fed is allowing mortgages to run-off its balance sheet and buying Treasurys only. Municipal bonds did extremely well with a 7.5 percent return (which amounts to an 11.5 percent after-tax return), as strong demand drove yields to fall more than Treasury yields.

The U.S. Treasury yield curve, which inverted earlier in 2019, normalized following the Fed rate cuts and the announcement of the U.S. – China Phase I trade agreement. The Fed also announced that they expect not to raise interest rates until inflation exceeded their target of 2.0 percent; they also suggested they are prepared to cut rates in the event the economy slows down. This was a positive message to the markets that the Fed would do what it can to help this long expansion to continue.

**OUTLOOK 2020: CYCLE NOT ENDING YET**

U.S. economic growth is expected to slow in 2020, but the probability of a recession is now much lower. Easing by the Federal Reserve and other global central banks, amid-cycle adjustment, along with a reduction in trade tensions between the United...
States and China, have helped defer the recession further out into the future. The strength of the job market and consumer spending are also reasons to be optimistic about the U.S. economy. The global manufacturing sector was in recession last year but should rebound in 2020 with support from global central bank easing. Since international economies are more dependent on manufacturing than the U.S., we expect them to rebound even as the U.S. slows. While the Federal Reserve is expected to stay on hold, we expect further easing from emerging market central banks along with expansionary fiscal policies. Emerging markets such as India, Brazil, and Russia should be key drivers of global growth in 2020.

Given all the monetary easing and tight labor markets, it is possible for inflation to surprise on the upside. However, secular factors such as low productivity, low wage growth, technological disruption, and anchored inflation expectations should cap the upside. In this macro environment, we anticipate Treasury yields to pick up a bit and the yield curve to normalize further. As such, we anticipate the bond market to deliver modest, low single digit returns in 2020. We maintain a neutral position to duration as a hedge against the potential for the economy to weaken in the coming year. We are overweight credit including high-yield and emerging market debt, as we do not anticipate a recession this year. Securitized sectors continue to provide attractive risk-adjusted opportunities for high-quality, liquid returns. We are positive on the housing sector, and non-agency residential mortgage-backed securities remain compelling amid a shrinking market. We are not as positive on government-backed mortgages as the Fed is no longer purchasing them, but rather allowing them to roll-off the bank’s balance sheet.

Equities should continue to benefit from low inflation, easing of trade tensions and the accommodative shift taken by the Federal Reserve and other global central banks. However, valuations are stretched and we anticipate mid- to high-single-digit returns for U.S. stocks. International, and particularly emerging market equities, are poised to do better as they should benefit more than the United States from the recovery in the manufacturing sector. Monetary easing and fiscal stimulus in many emerging markets should also offer additional tailwinds. With this in mind, we have been increasing risk in our client portfolios. Since we are in the later stages of this economic cycle, we prefer large capitalization stocks over small. Due to the seemingly inexorable rise of technology across all facets of society, we anticipate the growth-focused technology sector to also continue its upward trend over the foreseeable future and are significantly overweight in the technology and communication sectors. Given weak supply-demand dynamics, we remain significantly underweight in the energy sector. With valuations of the overall market stretched, we are also focused on identifying individual companies with idiosyncratic catalysts or inflections.

We anticipate oil prices to be supported by OPEC production cuts, outages, and geopolitical risks. However, increases in U.S. shale and non-OPEC production, along with demand destruction from alternatives, should put a cap on prices. We have no position in commodities, but maintain positions in material and energy stocks and pipelines.

**KEY RISKS:**
- Political – Democrats sweep in November
- Rising inflation and interest rates
- Geopolitics - rising tensions with Iran