DECEMBER 31, 2019

CRAWFORD
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ECONOMIC & MARKET UPDATE

2019 provided investors with financial market conditions that few could have imagined. The stock market boomed and bond yields declined, favoring owners of both asset classes. The economy recovered from recession fears, and the Federal Reserve (Fed) did its part with aggressive monetary policy. It was a very satisfying year, and we are pleased that the portfolio performed well in this environment. As much as we would like to savor the excellent investment year we just enjoyed, we must move on and turn our attention to the future.

> "The most reliable way to forecast the future is to try to understand the present."
>
> John Naisbitt

John Naisbitt is the author of the 1982 book Megatrends: Ten New Directions Transforming Our Lives, which stayed on the bestseller list for over two years. He is considered a professional forecaster, and since this is the season for forecasting, we open with his quote. He is the first to admit the difficulty of seeing the future but does advise that the best way to get a handle on what might transpire in the future is to realistically grasp the present. We will follow his advice and offer our essential views of the world we live in, economically speaking, and then, unable to resist, make some general forecasts for 2020. We will conclude with some investment advice.

THE WORLD WE LIVE IN All economic activity is driven by timeless economic principles. Among the most critical of these are the relationship between supply and demand and the interplay of savings and investment. The global and domestic economies currently suffer from a shortage of demand relative to supply. In other words, the ability to produce goods and services is greater than the demand for those goods and services. This puts the buyer in the favorable position of being able to resist price increases due to severe competition among the suppliers, the result of which has been a steady decline in inflation over the last 40 years. With the fall of the Berlin Wall and subsequent dissolution of the Soviet Union, millions of workers became available for capitalistic activities, greatly increasing the supply of labor. As these workers became employed, they freely produced goods, further unbalancing the supply/demand equation. We note that it is difficult to identify any shortages in the world today. A related factor, savings and investment, swung in favor of savings. Currently, there is a worldwide "savings glut," that is, a far greater amount of money seeking safe investments like government bonds and too few borrowers taking out loans to invest in capital programs. The preponderance of savers over investors is one of the factors that has led to very low interest rates around the world.

Persistently low inflation and low interest rates are defining elements of the world we live in. Until supply/demand and saving/investment shift back to more normal balances, we expect the world to remain in basically the same situation. We have labeled it as the "2% world," and it means a world in which economic activity is confined to a tight range around a central tendency of 2% Gross Domestic Product (GDP) growth, inflation, and interest rates. This is how we understand the present. Now, let's take a look at the year ahead.

THE ECONOMY IN 2020 Our forecast for the U.S. economy in 2020 is constructive. It calls for more of the same. We expect that when next summer arrives the record long recovery/expansion will enter its twelfth year, and fears of a recession will be dormant. For the full year, inflation will remain tame, and longer-term interest rates will be low but perhaps somewhat higher than current levels. Meanwhile, the Fed will be on hold with federal funds at around 1.65%. GDP will likely come in with another year of roughly 2% growth.

This benign picture for domestic economic activity should be supported by improving developments within the global economy. Manufacturing has been suffering from an extended period of inventory reductions that may be coming to an end. China's economy, which has been in a slowdown, should see better results due to government stimulus measures. Monetary policy is very accommodative globally, as almost all central banks followed the Fed toward lower short-term rates in 2019. Finally, global trade could improve as the Phase One Trade Agreement between the U.S. and China reduces the odds of a destructive trade war.

All forecasts should be made with a good dose of humility. We agree, for history has a way of taking unexpected turns, and any favorable forecast should be offered with an awareness of potential risks to the central scenario. Along these lines, while we expect the extended economic cycle to be sustained further, we recognize that in its later stages the risk of excesses in the credit markets increases, and speculation in the financial markets can signal trouble ahead. Fed policy may also be a risk to the outlook. Recall that the Fed expected to be in a tightening mode in 2019, only to rapidly reverse course mid-year as recession fears mounted, leading to three quick reductions in the federal funds rate. We recognize the difficulty of executing monetary policy successfully, but a period of stability from the Fed would be a welcome sign.

THE STOCK MARKET When thinking about the stock market, a few things should be kept in mind. First, an economic sage once said, "The stock market is not the economy, and the economy is not the stock market." So, while we have outlined a favorable outlook for the economy, it is no guarantee that the stock market will automatically do well. A constructive economic environment is always a precondition for businesses in general to do well over the longer term, but stocks and the economy do not move in lockstep over the short term. Having issued this cautionary warning, we nevertheless believe conditions are in place for positive returns from stocks this year.

A second factor that has favorable implications for the stock market this year is the fact that bear markets, that is, major declines in market averages of 20% or more, almost never occur outside of recessions. Our foregoing discussion of the economy does not include the likelihood of a recession this year, so while this does not necessarily mean positive returns, it also does not suggest a bad year for stocks.

Finally, in the end, stock returns are determined by how much companies earn and how much investors are willing to pay for those earnings. Earnings growth this year is expected to be in the 5% -10% range, and those expected earnings for the broad market trade at a price-to-earnings ratio of about 18. Mid-to-high single digit earnings growth in an environment of 2% economic growth is very respectable. The valuation placed on these expected earnings is not cheap, but remember that low interest rates are a factor that supports higher valuations. In a world of persistently low interest rates any investment that can produce steadily growing profits will be judged more valuable compared to the low return on a fixed investment. We conclude that a total return from stocks of 5% -10% this year would be very acceptable given the outstanding year we have just enjoyed.

THE BOND MARKET Bond investors with longer maturities also experienced a fine year. As both short-term and long-term interest rates declined, bond prices appreciated, adding to the total return. Where do we go from here? Probably not too far. We mentioned above that bond yields might rise moderately this year. Recognizing that we are later in the economic cycle and the aforementioned global factors could push growth slightly higher, we would not be surprised if bond yields ended the year marginally higher. Importantly, we do not expect them to spike, and in the longer run we believe the tendency will be toward lower yields. Certainly, when the inevitable recession arrives, monetary policy will turn very expansionary and bond yields will fall. These thoughts on bonds fit comfortably in the 2% world that we have discussed. As we wrote recently, interest rates are low, and we believe they are here to stay.

We are not dismissing bonds as an investment option. We continue to believe they are the single best diversifier of equity risk, and, especially in balanced portfolios, they serve a vital purpose of preserving capital and stabilizing returns.

OUR ADVICE Stick with quality. We have laid out our expectations for the economy, the stock market and the bond market for the coming year, knowing full well how difficult it is to predict the future. Investors face the same uncertainty when thinking about individual investment choices. All investments are made in the hopes of a future return, yet that future is always uncertain. We believe investors often underestimate the range of potential outcomes when they make investments. Being fully aware of the wide range of potential outcomes leads one to the search for characteristics that can narrow the range, and we believe quality is the best characteristic with which to accomplish this goal.

Our search for quality applies to both stocks and bonds, although it may be more urgent in stocks since the range of outcomes is less wide in bonds. Anything we can place in the portfolio that can limit the range of outcomes and increase the odds of a successful return experience is a quality characteristic. For bonds the chief characteristic is balance sheet strength; for stocks it is the dividend. A strong balance sheet virtually eliminates the possibility of bond default, the worst possible outcome. It also provides companies with operating flexibility in times of economic stress. The dividend points to stability and consistency in the operations of a company and indicates confidence by management in the future prospects of the company. We see no downside to an emphasis on quality, as we believe it does narrow the range of potential outcomes and makes positive returns from investment more likely. Quality will remain as the central aspect of our investment philosophy.