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Economic and Market Environment
First Quarter 2020

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The Economy

- The U.S. economy likely ended the year on trend line growth, with Gross Domestic Product (GDP) increasing around 2% for the fourth quarter. The fundamentals are solid.
- We believe the U.S. economy can sustain real growth of around 2% over the longer term, and this growth will be accompanied by low inflation and interest rates. Viewed in its totality, this is a constructive outlook.
- The biggest challenge for the economy is sustaining growth at an attractive rate. Aggregate demand and investment are key areas to watch.
- Until significant excesses develop in the areas of inflation, spending, or speculation, the economy should be able to expand without a recession for a few more years, at least.
- Global economic trends may be improving in 2020, a prospect that could bolster U.S. economic growth.
- Monetary policy is now in easing mode. Three federal funds reductions last year signal a willingness on the part of the Federal Reserve (Fed) to do whatever it takes to keep the economic expansion going.

Stocks and Bonds

- 2019 was a banner year for stocks. Unless surprises develop, the positive trend should continue in 2020, although likely at a much lower level.
- Earnings growth is expected to be in the 5-10% range. This may approximate the returns from stocks in 2020.
- Valuations on stocks are higher than normal, but low interest rates tend to support them.
- Bond yields declined in 2019, sometimes substantially, and remain low. Low interest rates typically forecast lower economic growth in the future.
- There are longer-term, structural elements in the domestic and global economies that suggest that interest rates in general will remain lower than normal for the foreseeable future.
- Geopolitical surprises are always a potential threat to economic and market stability. The best hedges against these threats are high-quality, liquid investments.

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Federal Reserve Summary and Forecast

	2019	2020	2021	2022	Longer Run	Comments
Real GDP	2.2	2.0	1.9	1.8	1.9	Steady growth at the long-term sustainable rate
Unemployment Rate	3.6	3.5	3.6	3.7	4.1	Slightly rising unemployment in the long run
PCE Inflation	1.5	1.9	2.0	2.0	2.0	Steady and low inflation
Federal Funds Rate	1.6	1.6	1.9	2.1	2.5	Slightly rising interest rates in a few years

Source: Federal Reserve
Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, December 2019

- The Fed believes current economic conditions are likely to remain in place for the foreseeable future and that monetary policy is in the right place.
- When viewed in its totality, the economic picture it foresees is positive. It would be more positive if GDP growth were higher.
- History would suggest that such consistency in these economic factors is not likely to materialize and that the Fed will be forced to alter their policy within the timeframe of its forecast.
- Our view is that we live in a “2% world,” and this aligns well with the Fed’s views.

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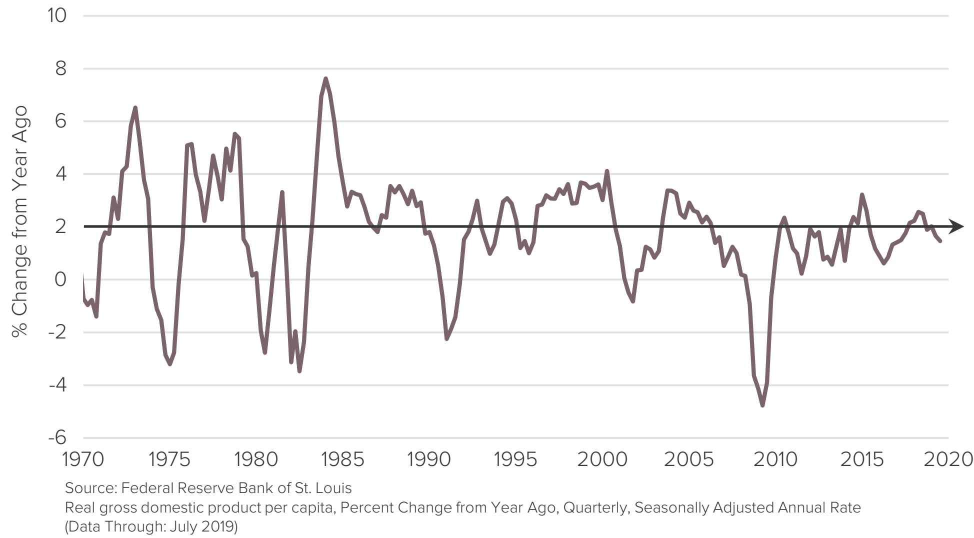
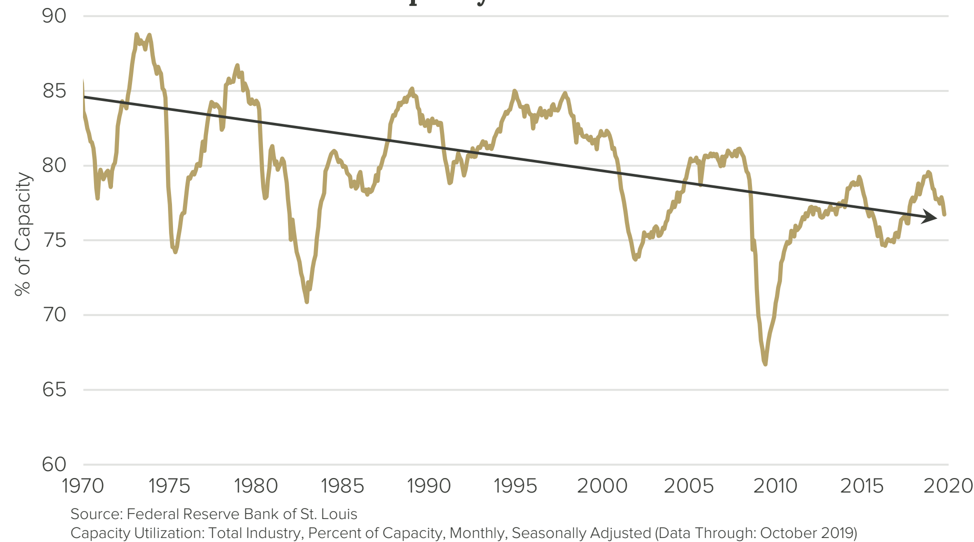


Source: Federal Reserve Bank of St. Louis
Real gross domestic product per capita, Percent Change from Year Ago, Quarterly, Seasonally Adjusted Annual Rate (Data Through: July 2019)

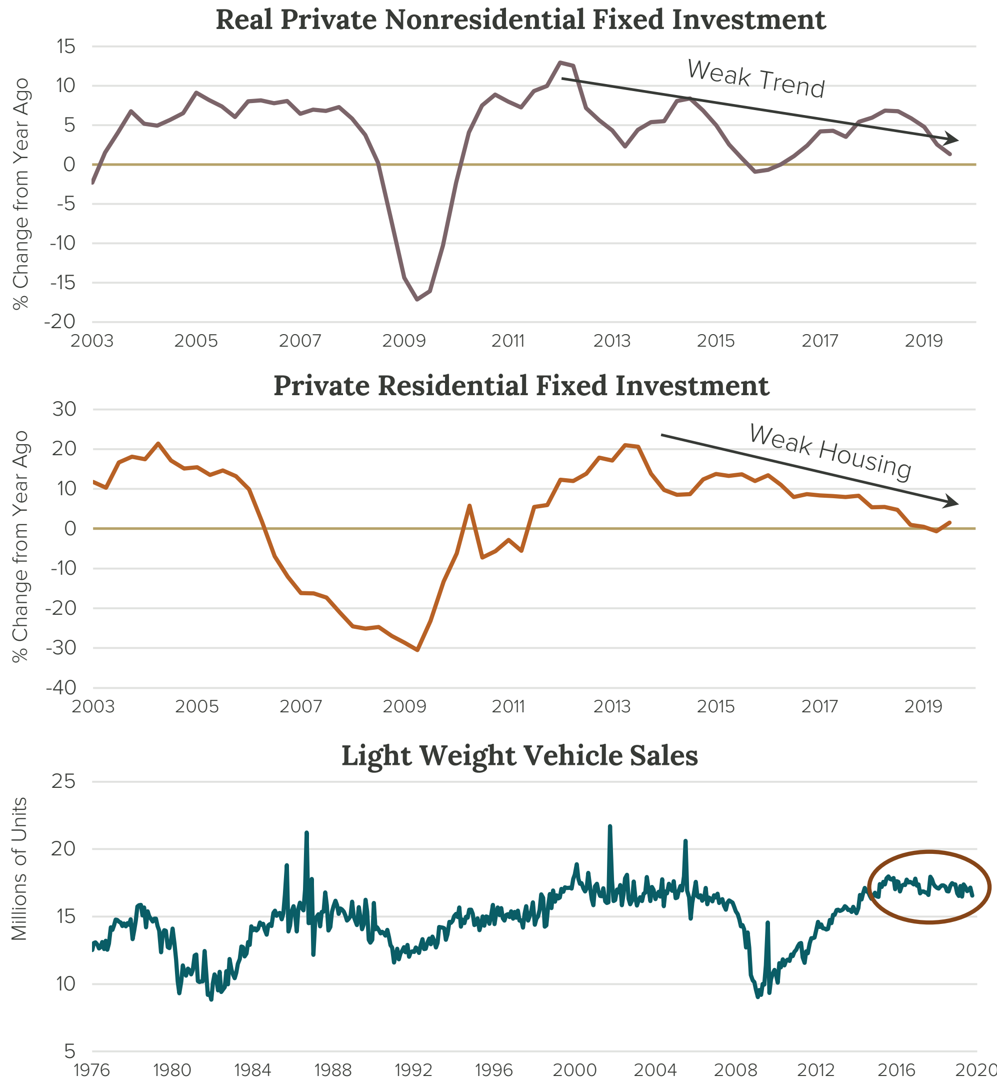
- For the economy to grow, aggregate demand has to continue to grow. Currently the growth is just under 2%, the approximate level at which the economy is likely to sustain its growth.



Source: Federal Reserve Bank of St. Louis
Capacity Utilization: Total Industry, Percent of Capacity, Monthly, Seasonally Adjusted (Data Through: October 2019)

- Capacity utilization continues its long-term downward trend. This may be reflective of the information age and “demassification” of the economy, which requires less capital spending.

The U.S. economy is being supported and driven by **consumption.** It needs help from several areas.



- **Capital Spending**: The Trump tax cut was supposed to fix this. It has not. Trade tensions are another deterrent to capital spending.
- **Housing** has been in a weakening trend for seven years. Low mortgage rates may help.
- **Auto Sales** have been essentially flat for five years. Cars eventually wear out. Time for improvement?

Source: Federal Reserve Bank of St. Louis; Real Private Nonresidential Fixed Investment, Percent Change from Year Ago, Quarterly, Seasonally Adjusted Annual Rate (Data Through: July 2019); Private Residential Fixed Investment, Percent Change from Year Ago, Quarterly, Seasonally Adjusted Annual Rate (Data Through: July 2019); Light Weight Vehicle Sales: Autos and Light Trucks, Millions of Units, Monthly, Seasonally Adjusted Annual Rate (Data Through: October 2019)

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Source: Federal Reserve Bank of St. Louis
Trade Weighted U.S. Dollar Index: Major Currencies, Goods, Index Mar 1973=100, Daily, Not Seasonally Adjusted
(Data Through: November 29, 2019)

- When thinking about economic growth, don't forget about the influence of the U.S. dollar and how it trades in relation to other currencies.
- The dollar is now near a ten-year high. This is a favorable indication of how global investors view the strength of the U.S. economy.
- However, a strong dollar makes foreign purchases of U.S. goods more expensive, thereby depressing exports. This is a limiting factor for U.S. economic growth.
- If foreign economies strengthen in 2020, as some expect, the dollar may weaken and thus give a boost to U.S. economic growth.
- A weaker dollar could also result from rising interest rates abroad.

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10 Year Bond Yields	%
United States	1.929
United Kingdom	0.817
Germany	-0.188
France	0.115
Italy	1.409
Australia	1.3705
Japan	-0.020
Canada	1.699
China	3.133

Source: Bloomberg
(Data Through: 12/31/2019)

- Yields on longer-term bonds usually are predictive of economic growth in the future. Currently they are forecasting slow global economic growth.
- Yields on Chinese bonds are the highest because their economy is growing the fastest. Germany and Japan have negative rates, forecasting low to no growth.
- Negative long-term interest rates are a relatively new phenomenon. They are a reflection of the economic world we live in.
- Negative interest rates are the result of very aggressive monetary policy, as central banks seek to encourage banks to lend instead of holding excess reserves.
- There are signs that global growth can accelerate in 2020. If so, yields can rise marginally, but in our view will remain quite low.

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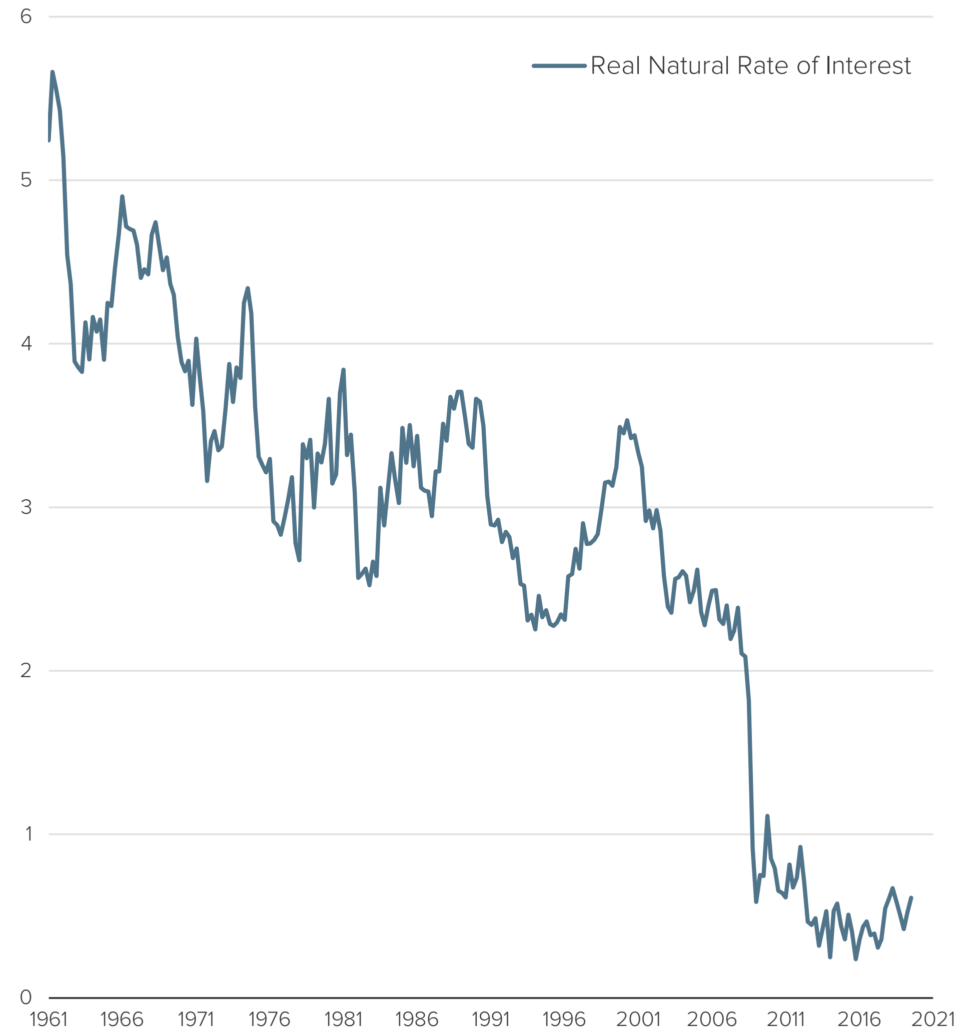
- The real natural rate of interest is the rate at which savings and investment are in balance, that is, when the rate is neither giving the economy a boost nor slowing it down. It can also be called the “neutral” rate.
- Why is this theoretical rate important? Because the Fed factors it into its decisions about whether policy should be stimulative or contractionary.
- Currently, real federal funds, after adjusting for inflation, are lower than the real natural interest rate, signaling an accommodative policy stance.
- The natural rate is low due to secular and structural forces that have conspired to keep economic growth and inflation low.
- Longer-term interest rates will follow the direction of the natural rate. If the natural rate stays low, expect interest rates to stay low also.



Source: Federal Reserve Bank of St. Louis, Federal Reserve Bank of New York
US Natural Rate of Interest (r*) – Holston Laubach Williams current estimates, One-sided estimates (Data Through: July 2019)
Effective Federal Funds Rate, Percent, Quarterly, Not Seasonally Adjusted (Data Through: July 2019)

STOCK MARKET VALUATIONS: TOO HIGH?

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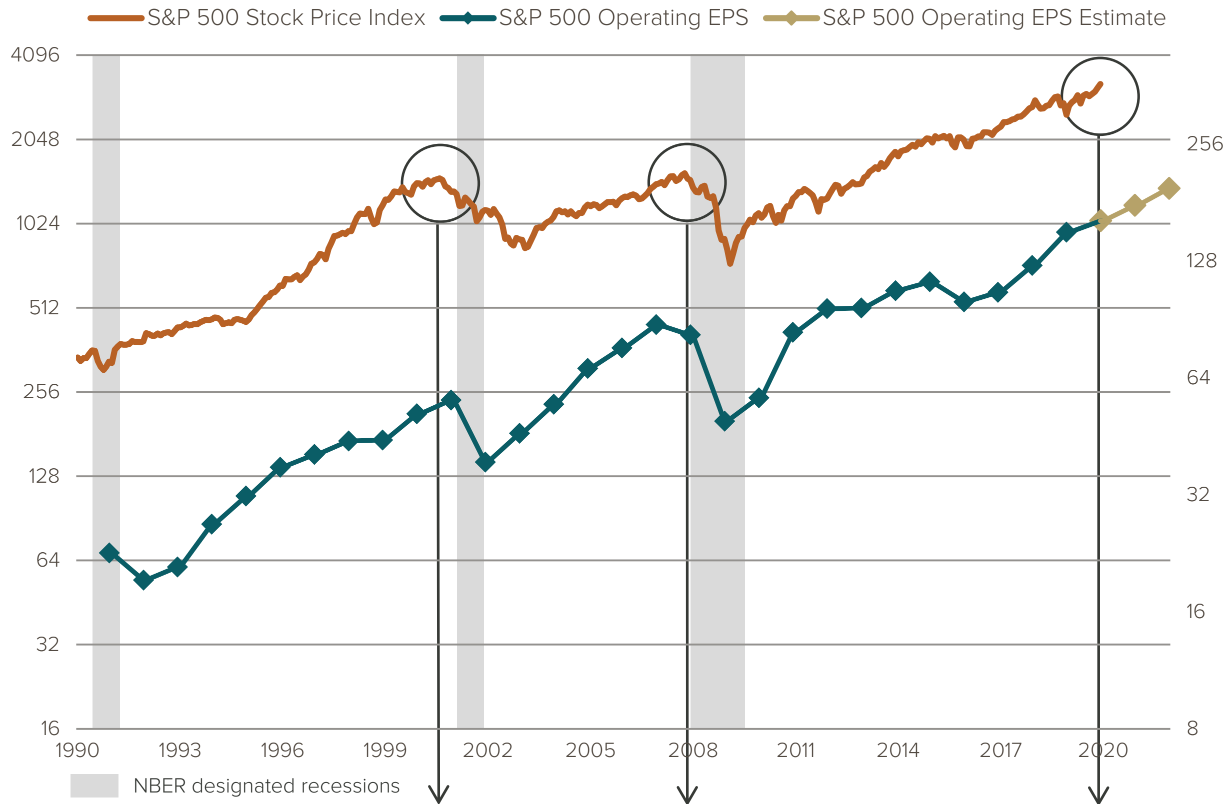

	9/30/2000	10/31/2007	12/31/2019
P/E (NTM)	22.00	14.60	18.17
Yield	1.09	1.73	1.75
Federal Funds Rate	6.52	4.76	1.55
10 Yr. Treasury Yield	5.80	4.48	1.92

Source: Federal Reserve Bank of St. Louis, S&P Global, FactSet
S&P 500 Index, Monthly, End of Period, Not Seasonally Adjusted (Data Through: December 2019)
S&P 500 Operating EPS, Calendar Year (Data Through: December 2018)
S&P 500 Operating EPS FactSet Estimates for 2019, 2020, 2021

- The stock market currently resides at an all-time high. Is it too high?
- The primary driver of stock prices is corporate earnings. These also reside at an all-time high.
- Valuations should be judged relative to history but also relative to the overall economic environment, especially interest rates and inflation.
- We maintain that higher valuations tend to be justified by lower interest rates and inflation.
- Notice that the last two peaks in the stock market occurred just prior to a recession. We do not expect a recession in the near future.

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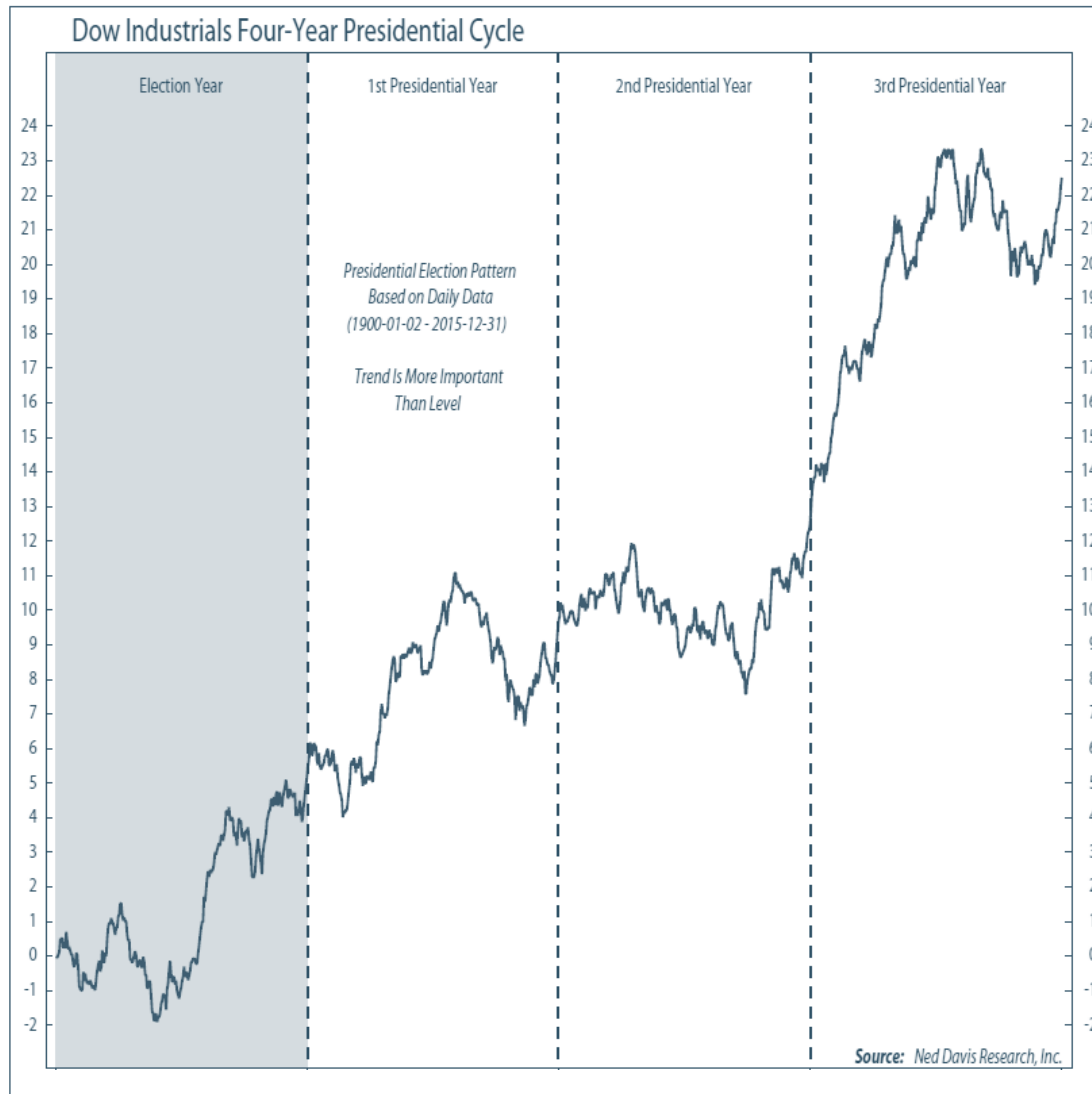
THE PRESIDENTIAL CYCLE: WHAT IT SUGGESTS



- Some investors consider the "Presidential Cycle" as a helpful common stock investment guide.
- The presidential cycle is based on average rates of return in the four years of a president's term.
- Using such averages, the chart suggests positive returns for stocks in 2020, but more modest than in 2019.
- Looking forward, we remain constructive on the outlook for stocks over the long term, regardless of how stock returns conform to the presidential cycle averages.

THE STOCK MARKET: A LOOK AT HIGH RETURN YEARS

Years of 30%+ returns		Return % in the following year	
1927	37.49	1928	43.61
1928	43.61	1929	-8.42
1933	53.99	1934	-1.44
1935	47.67	1936	33.92
1936	33.92	1937	-35.03
1938	31.12	1939	-0.41
1945	36.44	1946	-8.07
1950	31.71	1951	24.02
1954	52.62	1955	31.56
1955	31.56	1956	6.56
1958	43.36	1959	11.96
1975	37.23	1976	23.93
1980	32.50	1981	-4.92
1985	31.73	1986	18.67
1989	31.69	1990	-3.10
1991	30.47	1992	7.62
1995	37.58	1996	22.96
1997	33.36	1998	28.58
2013	32.39	2014	13.69
2019	31.49		
Average	**37.10**	**Average**	**10.83**

S&P 500 Total Return Index
Source: 2017 SBBI Yearbook: Stocks, Bonds, Bills, and Inflation
Roger G. Ibbotson; Duff & Phelps; U.S. Capital Markets Performance by Asset Class 1926-2016

- Stocks can be powerful. They are also volatile.
- Since 1926 there have been 20 different years when the S&P 500 provided returns of at least 30%, including 2019. On average, these extraordinary years occurred every four or five years.
- In those years the average return was 37.10%.
- In the 19 years following a 30% return, 12 of the years show positive returns.
- The average return of the subsequent years was 10.83%.
- There is no predictive value in these numbers, but history indicates that very strong years for stocks can be followed by another year of positive returns.

Breaking Down the Decades:

The return from the U.S. stock market over the last decade mostly came from earnings growth.

	Dividends	Earnings Growth	Change in P/E	Annual Return
1880s	5.1	-2.3	3.2	6.0
1890s	4.3	4.8	-3.4	5.7
1900s	4.8	4.7	0.8	10.3
1910s	5.9	2.0	-3.4	4.5
1920s	6.3	5.6	3.3	15.2
1930s	5.3	-5.7	0.3	--
1940s	5.3	9.9	-6.4	8.9
1950s	6.0	3.9	9.3	19.3
1960s	3.3	5.5	-1.0	7.8
1970s	3.4	9.9	-7.5	5.8
1980s	5.2	4.4	7.7	17.3
1990s	3.4	7.7	6.9	18.0
2000s	1.7	0.6	-3.0	-0.7
2010s	2.3	10.2	0.8	13.3

Source: Bloomberg Opinion (Robert Shiller); December 12, 2019 Don't expect stocks' roaring '10s to repeat in '20s by Nir Kaisser (Data Through: November 2019)

- The decade of the 2010s was a great one. Stocks' compound return was 13.3%, the fifth highest decade of returns since the 1880s.
- Earnings growth of 10.2% accounted for the majority of the gains. Earnings growth in the next decade will probably be lower unless there is another major corporate tax reduction. Not likely.
- Six out of the last 14 decades have given us double-digit returns. Only two of the six have been back to back.
- Changes in price-to-earnings ratios can have a major impact on returns. This was not the case in this decade.
- What is the take-away? Buy high-quality companies that can sustain attractive earnings and dividend growth, and the rest will likely take care of itself over the long run.

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The S&P 500 Index is the Standard & Poor's Composite Index and is widely regarded as a single gauge of large-cap U.S. equities. It is market-cap weighted and includes 500 leading companies, capturing approximately 80% coverage of available market capitalization.

The 10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

The Trade Weighted U.S. Dollar Index is a weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners. Broad currency index includes the Euro Area, Canada, Japan, Mexico, China, United Kingdom, Taiwan, Korea, Singapore, Hong Kong, Malaysia, Brazil, Switzerland, Thailand, Philippines, Australia, Indonesia, India, Israel, Saudi Arabia, Russia, Sweden, Argentina, Venezuela, Chile and Colombia.