Introduction

THE ROAD AHEAD 2020

In mid-2019, the current economic expansion officially became the longest in U.S. history. At over 11 years’ duration, it has now exceeded the longest such run on record going back to 1854. That record-breaking span has been a key support under a lengthy equity bull market. Can it last? We believe it can.

Looking at today’s situation we see many similarities to this time last year:

- The economy continued to grow — though more slowly — supported by a strong consumer and jobs market.
- While the U.S.-China trade dispute and its accompanying tariffs were still a headwind to sentiment, consumers and investors demonstrated resilience, adapting to the uncertainty.
- Equities remained on an upward trajectory leading to new highs in the stock market in 2019, while fixed income markets acted as a source of income while providing surprising strong returns.

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We see some important differences as well:

- Recession fears heated up in the summer months as the near-term boost provided by tax cuts faded, the manufacturing sector slipped into contraction, and the yield curve briefly inverted.

- In response, the Fed reversed course, stepping back from its tightening bias. The central bank’s decision to trim its short-term policy rate provided not only a tangible easing in financial conditions, but signaled that policymakers were willing to deviate from their prescribed policy to ease financial conditions. That provided a much needed and well-timed boost to consumer and investor confidence.

- Political uncertainty in Washington escalated, echoing a more uncertain political and policy environment globally.

Despite a range of uncertainties, returns across the equity and fixed income markets were remarkably strong heading into the final weeks of the year. So, where does that leave investors heading into 2020? In the pages that follow, we’ll discuss the outlook for the economy, Fed policy, fixed-income conditions, and the global equity market environment. Welcome to The Road Ahead 2020.

The economy:

**GROWTH HAS SLOWED. CAN THE CONSUMER SOFTEN THE LANDING?**

The economy appears to be well-positioned to continue to grow into 2020, but the overall pace of growth is expected to slow on a year-over-year basis, as the stimulus introduced by tax cuts two years ago becomes fully digested and trade disputes and impeachment talk continue to create uncertainty for businesses.

In absence of a major breakthrough in U.S.-China trade negotiations, we expect trade issues to remain a major source of potential downside risk in 2020. The recent announcement of a tentative partial deal with China would be welcome in the agricultural sector and could bring a nice boost to economic sentiment, but much work remains to reach a comprehensive agreement. The reported deal takes off the table the threatened round of 25% tariffs that were set to take effect December 15, while also slashing by 50% other tariffs already in place. Still, the near-
term outlook for trade policy is anything but certain and will likely remain a meaningful source of uncertainty for the global economy for some time to come.

Business investment and exports generally trended negative in 2019, and those headwinds are expected to continue until greater clarity is reached on trade policy. The impact was unambiguous in the manufacturing sector, which took the brunt of the impact and slipped into contraction in recent months, underscored by unusually weak Institute for Supply Management (ISM) manufacturing index data. Against that backdrop, an unexpected increase in export orders toward the end of 2019 accompanied by a small increase in new orders and production helped slow the rate of decline and provided some optimism that the manufacturing sector may be finding a floor.

The service sector also slowed more than had been anticipated in late summer. The ISM Service index dipped to a three-year low in September, but also showed signs of life more recently, regathering some steam in October and November.

Despite the challenging environment for manufacturing in particular, it’s important to remember that the service sector, which is over six times the size of the manufacturing sector, is still expanding — just at a slower pace. If the recent improvement in indicators holds, it would bode well for growth to stabilize as well.

Job creation was a bit choppier in recent months but rebounded sharply in November. Nonfarm payrolls are on track to grow by about 2.1 million for 2019, and we expect it to remain solid in 2020. Still, with unemployment at 3.5%, job creation is likely to slow as employers continue to be challenged to find skilled workers. Even so, employment conditions still provide a solid foundation for the economy, but particularly the consumer sector. Additionally, small business confidence is also relatively strong, which is important given the critical role that they play in job creation.

The bright spot heading into 2020 is the consumer sector — the engine that drives about 70% of the U.S. economy. Consumers are relatively upbeat from a long-term perspective both in their view of the economy and their personal financial situation. The sector is buoyed by a solid job
market, gradually improving wage growth, growing household net worth, and manageable debt payment costs relative to income. The importance of a strong job market for households can’t be overstated, as job creation is highly correlated with consumer spending. Retail sales are underscoring this optimism, with solid results in recent months supported by strong auto sales in particular. The recent resurgence in home sales, lifted by lower mortgage rates, also illustrates the resilience of consumers. This is all good news for the economy overall as confident consumers are typically willing to spend. A note of caution, however, looking ahead to 2020, as the potential for new tariffs to be imposed on a wide range of consumer goods would raise prices and dampen spending. For now, at least, that risk appears to be fading, but could certainly bubble up again should the Trump Administration decide to retighten the screws on China as trade negotiations continue.

The remaining wild card for 2020 is the global economy. The United Kingdom narrowly avoided recession last quarter, and growth is still slow across much of Europe and Asia. China in particular merits watching closely, given its prolonged slowdown and its global significance. While a global slowdown alone is unlikely to push the U.S. into a recession, it would have a dampening effect on sentiment and growth. Still, the consensus view is for the U.S. to grow by 1.5 – 2.0% in the coming year.

Clearly, there are risks to the downside, but the typical catalysts for recession aren’t readily apparent. Energy prices remain low, the Fed isn’t aggressively tightening to stem inflation, and there isn’t a clear bubble in some area of the economy that needs to be purged. The greatest risk is probably that of a self-inflicted policy mistake, with continued escalation in trade frictions being the most likely candidate.

The bottom line:

Although the economy remains positioned for growth, its pace is slowing, and downside risks exist. The key question going into 2020 is
whether the recent stabilization in indicators represents a turning point and whether the strong jobs market and resiliency of the U.S. consumer can navigate the slowdown to a soft landing. We believe they can, and the evidence of that is growing.

Fed policy:

**WILL THE FED HOLD STEADY OR CONTINUE TO EASE?**

Heading into 2019, the Fed communicated its plan to hike rates through the year, suggesting four increases for a total of 100 basis points. At the time there was concern tight labor markets would lead to inflationary wage growth, inflation would rise above the Fed’s 2% target, and that higher rates were called for to prevent overheating. A few months later, the Fed reversed this guidance. What happened?

Most notably, the imposition of tariffs and general uncertainty around U.S.-China trade negotiations contributed to a marked slowdown in the U.S. economy that alleviated the inflation concerns. This slowdown was accompanied by moderating growth outside of the United States as well. Ultimately, other factors intervened and the Fed no longer needed to do so.

Faced with this new reality, the Fed changed course, cutting the federal funds rate three times for a total of 0.75% since August. While it hasn’t returned to quantitative easing per se, it has provided additional liquidity in response to short-term funding issues in the overnight repo market by expanding its balance sheet.

When considering the Fed’s dual mandate — price stability and maximum employment — the story today is mixed. While the unemployment rate has dropped meaningfully in recent years to a level well-below the Fed’s estimate of full employment, inflation has consistently undershot the fed’s desired 2% threshold. Ultimately, the absence of meaningful price pressures has provided the Fed leeway to pivot to a much more dovish approach.
Heading into 2020, it’s our view that the Fed will try to maintain maximum flexibility and will most likely hold rates steady, although additional cuts are a possibility if the economy unexpectedly slows further. Any increase in rates appears highly unlikely in the near term, particularly in view of the Fed’s previously stated willingness to let inflation slightly overshoot its target rate of 2% to balance out the sustained period under the target. Lower rates have contributed to easier financial conditions, and the positive spillover effects are now becoming evident — particularly in interest rate sensitive areas of the economy (such as housing). The Fed’s stance provides some reassurance that the risk is low that overtightening will lead the economy into recession — a view reinforced by the fact that most major central banks across the globe are also in easing mode, creating a relatively accommodative environment.

The bottom line:

Heading into 2020, growth and inflation appear to be stabilizing and the Fed is taking a wait-and-see approach. If indicators slip unexpectedly, the Fed appears to be ready to provide additional easing to extend the expansion. Conversely, the near-term probability of a rate hike is exceptionally low.

Fixed income:

DIVERSIFICATION IN UNCERTAIN TIMES

2019 brought unexpectedly strong returns to the bond market due to slower economic growth, falling inflation expectations, and trade uncertainty weighing on the global outlook. The result was a sizable, unexpected decline in long-term rates that flattened (and for a brief period inverted) the yield curve. The Fed’s pivot to cut short-term interest rates to stimulate the economy was another significant development, although the rally in long-term bonds had largely run its course before the Fed first eased in August.

Outside of the U.S., negative yields made U.S. Treasuries comparatively attractive, resulting in strong demand from foreign investors.

Looking ahead, with the Fed signaling fewer rate cuts and signs of stabilization in growth, we believe that further near-term downside for long-term rates is also limited. Indications that economic indicators are
bottoming have mitigated recession concerns. Still, inflation expectations remain rangebound and growth expectations are still tempered, suggesting that the likely upside in long-term rates is somewhat constrained. However, this outlook could quickly change for a variety of reasons, including the outcome of trade negotiations, the direction of the global economy, or a rebound in inflation pressures—all of which could influence investor sentiment and impact long-term interest rates, spreads, and the shape of the curve.

Heading into 2020, low interest rates are acting as a tailwind for corporations by keeping financing costs comparatively low. For investors, however, credit spreads are near historically tight levels, putting pressure on overall yields. While opportunities still exist in corporate credit, given the relative strength of consumers, we believe mortgage-backed and asset-backed securities can provide an attractive yield advantage to Treasuries. Given the environment of low rates and tight spreads, we believe that active managers can play a critical role in managing risk, by avoiding certain credits or sectors and by taking advantage of opportunities when they arise.

Municipal bonds had a positive year in 2019, supported by strong demand from individual investors. Supply was also down year over year, providing a strong technical tailwind for yields. In addition, the municipal market is still a relatively high-quality area for investment, with credit events likely to be isolated to those issuers already in the headlines. We see demand extending into 2020 as investors continue to seek high-quality sources of income, particularly on an after-tax basis. Muni bonds fit the bill for many, remaining an attractive shelter in taxable portfolios.

Returns in both taxable and tax-exempt bonds in 2019 have been unexpectedly strong, and it’s highly unlikely that returns in the coming year will replicate that performance. So, with an expectation that total returns will weaken in 2020, why own bonds? In short, we believe a bond portfolio with a heavy emphasis on quality remains the best diversifier to equity risk. Bonds can protect principal while also possibly increasing in value in a flight to quality.
during a downturn in the equity market. And while we believe the economy is well-positioned for continued growth into 2020, existing uncertainty on numerous fronts serve as a reminder that high-quality bonds have historically held up well in volatile periods.

The bottom line:
The outlook for bonds going into 2020 is relatively muted, and returns are unlikely to be as strong as 2019. However, an uncertain economic outlook positions high-quality bonds as an important part of a balanced portfolio as a source of income, overall portfolio risk reducer, and ballast to equities.

Global equities:
VALUATIONS ARE FULL; PREPARE FOR VOLATILITY
Given a range of uncertainties on a variety of fronts, one might have expected global equity markets to struggle in 2019. However, that couldn’t be further from the truth, with gains across the globe solidly in double-digit territory, led by returns of over 25% in the U.S. through the end of November. Looking towards 2020, we see a relatively supportive environment for equities, if recent indications translate to the economy emerging from its soft patch and transitioning into stable growth in the coming year.

We believe earnings could be positioned for improvement in 2020, thanks in part to U.S. and global central bank easing, better conditions in the manufacturing sector, the resilience of consumer spending, and even a moderate pickup in growth. We anticipate further support to equities and risk assets as Fed rate cuts flow through to the broad economy in the coming quarters.

Some valuation measures have crept up in the past year, and there’s no question that stocks aren’t cheap today. We also don’t believe they are grossly overvalued, particularly given the relatively low global interest rate environment. Assuming that economic growth does in fact stabilize and the Fed remains supportive, we believe valuations should continue to be sustained into 2020. Some caution is called for, however, as markets face the potential for heightened volatility due to a lack of clarity around trade policy, potentially rising labor costs, geopolitical uncertainty, and economic weakness in parts of Europe and Asia.
While acknowledging the many risks that exist, we also believe they’re being priced in by investors to a good extent. And it’s also important to remember that an overly negative sentiment can make it harder to see potentially positive catalysts for the economy and equities. For example, a meaningful breakthrough in the trade dispute would be a positive from a business sentiment perspective and could nudge corporate America off the sidelines to free up investment. Further, election year returns have been generally (although not universally) positive over many decades.

Perhaps the most important support for the economy heading into 2020 is the resilient U.S. consumer, whose spending has fueled solid growth and has been the primary engine for the economy in recent years. There is also a meaningful correlation between consumer confidence and equity valuations, suggesting that valuations should be supported so long as consumers remain generally upbeat in their expectations for the economy.

On the international front, we believe the slowdown outside of the U.S. could counterintuitively be a positive for international equities, as both global monetary policy and relative valuations could be supportive of foreign stocks. Multiple valuation measures of international equities relative to U.S. markets are near multidecade lows. Moreover, foreign equity markets also provide a higher dividend yield than their U.S. counterparts. All things considered, we believe international equities will compare favorably to the U.S. equity market over a multiyear time frame and should provide an attractive opportunity for long-term investors.

The bottom line:

Looking ahead, we recognize that a range of risks are present, and periods of volatility are likely, particularly during this phase of the cycle. Yet, underlying fundamentals still support equities. And, while a repeat of the strong performance in 2019 is unlikely, we believe equities are still well-positioned to outperform cash and high-quality bonds over a multiyear period.
Summary:

STAY INVESTED AND FOCUS ON LONG-TERM GOALS

The U.S. economy is currently in its 11th year of expansion, which is without precedent. While most data points to a continuation of the current expansion into 2020, a range of uncertainties (several of which we touched on) create downside risk to the economic outlook.

Across the capital markets, there is very little that appears cheap today. Valuations are full, and investors should be prepared for the potential for elevated volatility in an environment of lower expected returns as the market digests political developments in Washington, clarity on the future path of Fed policy, progress on trade negotiations, corporate earnings, and the continuing drumbeat of economic data.

If the consumer sector remains resilient and manufacturing finds a bottom (which may already be underway), the economy appears poised to experience a soft landing and be well-positioned for takeoff when economic growth begins to accelerate again.

What does that mean for the investor?

With uncertainty on multiple fronts, it may be tempting to try to time the market. But history tells us this is virtually impossible to do successfully. Why? Market timers have to be right twice — knowing when to get out and when to get back in. By going to the sidelines, investors can miss potential rebounds and the compounded growth on that money going forward. Making that even more difficult is the need to overcome the hurdle of taxes and transaction costs. It shouldn’t be surprising that studies have shown that the average investor underperforms the market by a meaningful margin. Most don’t have a long-term strategy.

Instead, we believe it’s critical to stay focused on your long-term financial goals. Ultimately, to be successful over the next decade and beyond, it’s important to establish your tolerance for risk, understand your goals and objectives, consider your true investment time horizon, and create an appropriate asset allocation plan to govern your investment decisions. Within that framework, success largely hinges on ignoring the noise and looking through short-term uncertain, staying
committed to that strategy, and having the discipline to rebalance to take advantage of opportunities as they arise.

The events of 2019 reinforce the wisdom of such a strategy. The global economy and capital markets had to push through a range of risks and negative developments. It’s not as if all the news was universally positive. The wall of worry had to be climbed, and that’s exactly what happened. Sitting on the sidelines would have been a costly decision for investors.

It’s a great reminder that unexpected events happen with frequency that affect market and economic conditions either positively or negatively. There’s no map to predict the path. A good investment strategy is like a navigation system that recalibrates effectively when the route changes. There may be unexpected detours, stops and starts along the way, but the destination doesn’t change. Our job is to provide you with insights, advice, and recommendations on your journey, helping you to navigate the unexpected turns that may, and will periodically, occur on the Road Ahead.

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