ECONOMIC OUTLOOK

bounty management
unique investment insight

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Getting By With A Little Help From Our Friends At The Fed

During the last quarter of 2019, favorable policy developments, including further monetary easing by the Federal Reserve and the de-escalation of the U.S.-China trade confrontation, provided an additional uplift to the stock market. The rally was particularly significant given the economic outlook at the beginning of 2019 – the market had just fallen fourteen percent in a month and there was talk of recession. The economy was bolstered by higher consumer confidence, employment, wages, and corporate profits during the year. Even with all these positives, U.S. GDP growth remained stuck in the 2% range as a sharp contraction in business spending, slowing global growth, and trade wars continued to press the economy. What helped turn the tide in the later part of the year was more clarity on trade with the passing of the new NAFTA (USMCA) agreement, U.K. lawmakers approved an agreement that outlines how they will leave the EU and avoid an abrupt breakup, and easier global monetary policy as the Federal Reserve cut rates and the European Central Bank (ECB) continued with negative deposit rates and asset purchases.

These events also signaled support for riskier assets such as equities. While various valuation metrics appear to be at historically high levels, equites and other asset classes are supported by prolonged monetary easing. GDP continues to struggle even with all the spending, accommodating monetary policy, tax cuts, and consumer confidence. A majority of the price increase in the market was not due to increased earnings - 90% of market gains were due to the willingness of investors to pay more for the same earnings, sometimes referred to as multiple expansion. The percentage of listed companies losing money over the past year is close to 40% - the highest outside of recessions since the internet bubble years of the 1990s – but this did not stop their stock value from going up. The Fed, which did so much to disrupt the market in 2018 by raising rates, abandoned their attempt to normalize rates and cut interest rates in 2019. After reducing the fed funds' rate in October for a third time in 2019, the Fed left interest rates unchanged at its December meeting and, equally important, signaled it intended to stay on the sidelines in 2020.

As we head into 2020, there are several positive factors supporting the markets: low interest rates, consistent low GDP growth, consumer spending, and growing earnings. Some headwinds include high stock valuations by most metrics, contracting manufacturing, geo-political tensions, climate change, possible war in the Middle East, the impeachment of the president, and a $1 trillion annual deficit. Election years tend to be the weakest of the presidential cycle with 4.1% growth on average. The global economic outlook is less certain, particularly in China, Europe and the U.K. with 2019 global GDP estimate by the World Bank at 2.4%, the lowest growth rate since the financial crisis. Germany's economy, Europe's largest, slumped to a six-year low in 2019 and faces challenges in the auto industry, slowing growth in China, and global trade conflicts.

U.S. Economy

The Fed Funds rate moved down to 1.50-1.75% in a turnaround from 2018 for the Fed as inflation never appeared even with the U.S. close to full employment. The Tax Cuts and Jobs Act of 2017 (TCJA) has had a positive effect on consumer spending as well as corporate profits and helped the U.S. guard against oversees' weakness. Tariff increases have essentially wiped out any post-tax income gains made by the Act among lower income earning Americans. U.S. CEOs still rate recession as a significant risk for 2020, though the economic data has improved over the past months. While fixed capital spending hasn't increased at the overall pace of the economy, businesses appear to be adapting to uncertain economic conditions. We expect GDP to moderate in 2020 to a range of 1.5% to 2% after growth of 2.5% in 2018 and an estimated 2.1-2.3% in 2019.

Consumer and Manufacturing

Although retail sales were soft in the fourth quarter (0.4% m/m in October and 0.2% in November), consumer confidence has picked up after a significant drop last quarter. The University of Michigan Consumer Sentiment improved modestly in the 4Q to 97.2 from 93.8 in Q3, with the full year average at 96, the highest level since 2000. Job growth continued its streak in the fourth quarter with a 3-month average increase of 184,000 in nonfarm payrolls compared to the 12-month average of 176,000. Wage growth decelerated towards the end of 2019, with average hourly earnings slowing to 3% y/y in the fourth quarter. The Atlanta Fed's Wage Growth Tracker, however, rested slightly above 3.5%, with a 3.7% reading in November.

In contrast with growth in the broader economy, U.S. factory production sank 1.3% in 2019. It marked the worst year for manufacturing since 2015, as the trade war and soft global growth hurt the industrial economy. Tariffs generally lead to a reduction in manufacturing employment and rising producer prices. Rising input costs and retaliatory tariffs are both negative and more than offset a small positive effect from import protection. Analysts expect manufacturing will pick up in 2020 along with the global economy, but consumer health is paramount to a continued expansion and, barring any shocks, should continue to power the recovery.

Real Estate

According to the National Association of Homebuilders (NAHB), low interest rates and a healthy labor market combined with a need for additional inventory are setting the stage for further home building gains. The NAHB Index rebounded in 2019 as the Federal Reserve lowered interest rates and mortgage rates fell. The Index has improved and was at 76 in December, significantly higher than the levels during the Great Recession. Housing permits and starts have picked up significantly after falling in 2018. Builders continue to grapple with a shortage of lots and labor, while buyers are frustrated by a lack of inventory, particularly among starter homes.

Oil and Commodities

Gold had its best annual performance since 2010, up almost 19%, underscoring a host of economic challenges that are supporting the haven metal even as stocks rallied. The precious metal often performs well when investors are skittish and are trying to protect against a market downturn as well as increasing geo-political and financial risk. Brent crude oil rose to $68 in the 4th quarter boosted by positive US data and optimism for a US-China trade deal. For the year, oil was up +34%, boosted by continuing output cuts by OPEC and its allies including Russia.

World Economy

Europe and U.K.

Despite continuing softness in growth and lingering weakness in the industrial sector in Europe, the service sector and consumer spending remained resilient in major economies. The Eurozone Manufacturing PMI unexpectedly deteriorated to 46.3 in the December from 46.9 in November, while the Services PMI rose to a four-month high of 52.8. The outlook for real GDP growth in 2020 was downgraded slightly by the European Central Bank to 1.1% from 1.2%, compared with an estimated 1.2% growth rate in 2019. The outlook for inflation was also adjusted down to 1.4% from 1.5%. Slow growth and below-target inflation remain the underlying trend for Europe. With the Tory government sweeping into parliament in the December election of Boris Johnson, the U.K. is all but assured to leave the European Union by the end of 2020. Most major news outlets put the odds at 99%+ given the conservative majority, and since Boris Johnson ran primarily on his Brexit promises, there aren't that many conservatives still in the party who would push back.

Japan

Third-quarter real GDP surged to 0.4% q/q or 1.8% annually, driven primarily by household consumption and business investment ahead of the sales tax hike in October. Nevertheless, consumption is set to decline in the fourth quarter and business investment may also slow accordingly. As a result, GDP growth in the fourth quarter, as well as in early 2020, will depend heavily on public investment. The government announced a surprisingly large fiscal spending package - more stimulus - totaling 26 trillion yen ($239 billion) to support the economy. Weak demand and lower private consumption, as well as trade uncertainties and an economic slowdown in the region, may continue to disrupt activity in Japan. The fiscal stimulus will undoubtedly steady growth, but may not be sufficient to drive growth or inflation higher.

China and Emerging Markets

Growth slowed moderately toward 6% at the end of 2019, compared with 6.4% in the 1Q. Activity showed some momentum in November, with industrial profits at 5.4% y/y, the first positive reading since March. The U.S. and China have reached a Phase One trade deal, preventing further escalation of the trade war and easing worries of a steepening slowdown in 2020. But trade policy uncertainties may persist throughout 2020 with the two sides starting to work towards a Phase Two trade deal. Rebounding activity after Phase One of the U.S.-China trade deal should calm worries of a steep slowdown in 2020, but the slower growth trend is unavoidable. The government has pledged to deliver more effective fiscal support as the central bank gets ready to take a more accommodative policy stance, bolstering confidence in slower, but stable annual growth slightly below 6% in the next few years.

After years of sizzling growth in India that helped lift millions of rural citizens into the middle class, the economy is slowing sharply, posing major economic and political problems. In 2018, India was the world's fastest growing large economy at 8%, but in 2019 growth tumbled to 4.5%. The government's corporate tax cut has not shown a significant effect and its struggle to collect taxes limits future fiscal stimulus. In Mexico, despite recent progress on U.S.-China and U.S.-Mexico-Canada trade deals, Mexican GDP growth is likely to stagnate in the fourth quarter following a 0.9% y/y decline in Q2 and another 0.3% y/y contraction in Q3. Weakness in the industrial sector seems to have spread into the service sector, as retail sales contracted 2.3% in October. The OECD reduced their 2019 world growth forecast from 3.4% to 2.9% citing subdued growth and contracting global trade.

Investment Perspective

During the last part of 2019, favorable policy provided additional support to markets to finish the year. On the positive side, market sentiment has been boosted by tentative signs that manufacturing activity and global trade are bottoming out, a broad shift toward accommodative monetary policy, favorable news on US-China trade negotiations, and diminished fears of a no-deal Brexit. Even though the risks are somewhat reduced, the global economy remains sluggish and downside risks remain prominent, including rising geopolitical tensions, notably between the U.S. and Iran, intensifying social unrest globally, further worsening of relations between the U.S. and its trading partners, and deepening economic frictions between other countries.

There are also risks in the financial markets, not the least of which is the presidential election in November. Stocks typically lag in the actual election year relative to the other three years in the election cycle. The trade deal with China could prove ephemeral. Brexit is still dragging on nearly four years after the popular vote to exit the EU. Wages are increasing – the Atlanta Fed median pay gauge is climbing at a 3.7% annualized rate in November - leading to higher costs and lower profit margins. The risk of higher longer-term interest rates is also worth watching as an increase directly affects the stock market as we learned in 2018 when the market fell nearly 20%. The biggest risk may simply be that the stock market is not cheap. When markets rise as quickly as we have seen recently, we tend to see corrections. A range of factors, such as a global macroeconomic event or simply a dial-down in earning's expectations, could trigger selling.

Earnings did not grow much in 2019 and the current reporting season will likely continue that trend. Industry analysts estimate fourth-quarter earnings per share slipped -1.8%. Over the past five years, earnings have beaten estimates by 4.9%. Assuming status quo on global trade, we look for a high single-digit EPS recovery in 2020. The absolute level of S&P 500 earnings remains high and businesses face multiple challenges to generate strong growth rates. For example, earnings experienced a tax-cut fueled gain in 2018, rising 25% and consequently setting up a tough hurdle to jump. Earnings have also been reined in by cautious management teams worried about the trade war. On the positive side, earnings are still receiving a boost from lower interest rates as corporations use proceeds to either lower interest expense or to buy back more shares.

On balance, the positive factors that lifted stocks in 2019 are in place in 2020. These include strong consumer spending, low interest rates, full employment, rising wages, and signs that the shrinking industrial economy has at least stabilized. Bonds continue to be the most overvalued asset class with rates hovering near the bottom. With inflation in the 2% range, both cash and bonds are 0% in real terms. We still favor equities for the long-term, but anticipate some near-term volatility and a possible correction in the markets. The sectors we expect to lead the way include healthcare, energy, communications, and technology. As investors, we try to identify stocks selling at a reasonable price in growing businesses and markets with strong management teams, financial disciple, and a competitive advantage. As global growth decelerates and the possibility of volatility increases, we are fortunate to have accommodating global central banks and our friends at the Federal Reserve to help stabilize financial markets. As always, we remain patient and vigilant.

December 31, 2019
DJIA: 28,538.44
S&P 500: 3,230.78

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.