2020 FORECAST – MOSTLY CLEAR AND SUNNY

As our team debates the 2020 U.S. market outlook, the discussion centers around four cycles that are near important junctures: economic, earnings, Federal Reserve policy, and political. Whether they align with or counteract each other will determine how 2020 unfolds. One thing is for sure, it should be an eventful year.

Next year, we are confident investors will see:

- The U.S. economy growing at a real rate of approximately 2%, driven by improving capital expenditures and manufacturing activity, and a strong consumer.
- Global growth accelerating to about 3.3% (fueled mainly by recoveries in Europe and emerging markets).
- Inflation pressures remaining subdued, with a projected 2.2% CPI inflation rate.
- The Federal Reserve remaining dovish, with 10-year Treasury yields fluctuating +/- 25 basis points.
- S&P 500 Index earnings rebounding by about 10%, leading to an approximately 11% total return.
- Bond total returns matching bond interest rates.

The wildcards in our outlook remain election uncertainty and geopolitical risks, especially the outcome over U.S. and China trade negotiations.

THE ECONOMY

In 2019 the U.S. economy faced two key headwinds, tighter monetary policy and a substantial increase in US/China tariffs, which resulted in a global business and profit cycle slowdown. Heading into 2020 these impediments are expected to at least partially reverse.

Easier monetary and fiscal policies are already in motion globally with the majority of the benefits expected to flow through the economy in the coming quarters. On the trade front, we believe that at a minimum, a partial US/China deal with some tariff roll-back will be reached ahead of 2020 election though the exact timing remains unclear.

Global manufacturing is expected to provide the spark for the worldwide rebound and IHS Markit's Global Purchasing Managers' Index has now increased for four consecutive months with positive momentum in orders and inventories. Also encouraging is last month's rebound in U.S. job gains, as the slide in employment growth since midyear posed a serious challenge to the economic expansion.

The improvement in manufacturing and employment are signs of not only a bottoming but a rebound that is setting the stage for growth in 2020.

U.S. EQUITIES

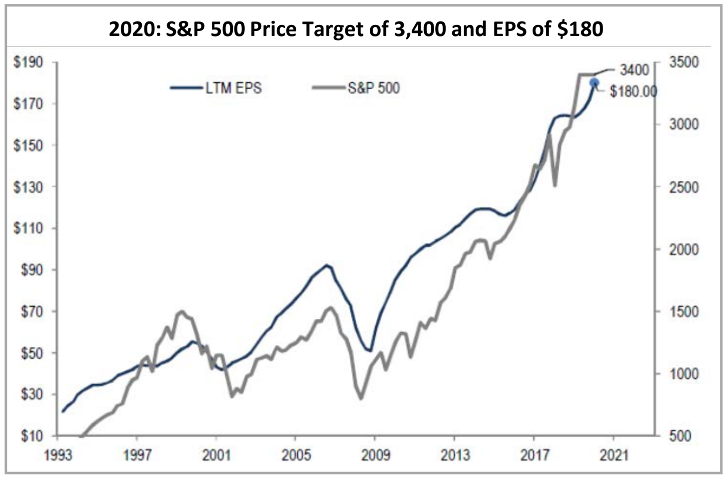
Down years are rare in the U.S. equity market, outside of periods associated with growth scares (4Q 2018), recessions, or financial market bubbles. With these scenarios unlikely in the year ahead, we expect another positive year in the U.S. stock market.

S&P 500 Returns Distribution since 1979

Return range (%):	Years	Number of years per range:
-40 to -30	2008	1
-30 to -20	2002	1
-20 to -10	2001, 2000	2
-10 to 0	1981, 1990, 1994, 2011, 2015, 2018	6
0 to 10	1984, 1987, 2005, 2007, 1992, 1993, 2004, 2016	8
10 to 20	2014, 1979, 1988, 2010, 2012, 2006, 1986, 1982, 1983, 2017, 1999	11
20 to 30	1996, 2019*, 2009, 1980, 1991, 1985, 2003, 1998, 1989, 2013	10
30 to 40	1997, 1995	2

Since 1979, the S&P 500 has experienced 31 years of positive returns, and just 10 years of negative returns. In only 4 instances has the S&P 500 experienced annual calendar losses of greater than -10% in magnitude, all associated with the Tech bubble or Great Financial Crisis. Most down years (which have involved growth scares or recessions) are in the 0 to -10% range.

We estimate that the cumulative damage from tariffs alone has reduced 2019 U.S. EPS growth by roughly 6 percentage points, to the current expected 2%. For 2020, we expect the S&P 500 earnings to rebound by roughly 10%. The global low interest rate environment should maintain multiples (now 18.5x forward earnings) and leads to our S&P 500 price target of approximately 3,400 or an 11% total return.



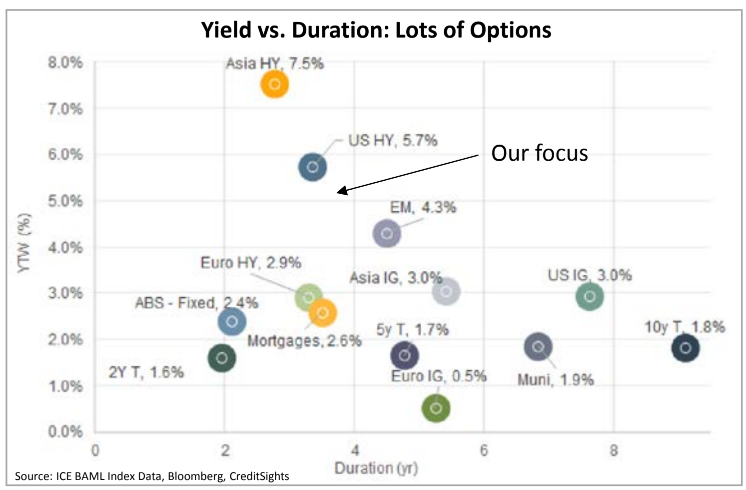
Earnings growth will remain quite sensitive to the U.S./China trade war outcome and its timing. Sector volatility will be primarily driven by interest rates. Rates have risen from their August lows, positively effecting cyclical sectors and negatively impacting bond proxies such as Utilities and REITs.

U.S. FIXED INCOME

Count 2019 as a gift to U.S. bond investors that isn't going to be repeated for some time. This year's returns were helped by December 2018's sell-off that created a great starting point for bond prices. From there the Fed gave investors the interest rate cuts they wanted, and the 10-year Treasury yield is now 100 basis points lower at 1.8%.

Without similar drivers in place, 2019's total returns will be tough to beat in 2020. We expect the coming year's fixed income returns to be muted. The Fed might cut interest rates one more time in 2020. Yet with inflation (and expectations) subdued and economic growth about average, we have a difficult time seeing the 10-year Treasury yield rising above 2%.

With that as our base case, the bond market outlook should favor credit (corporate bonds) in 2020.



Source: ICE BAML Index Data, Bloomberg, CreditSights

Our bond strategy remains focused on **credit risk over maturity risk**. The BBB/BB credits continue to provide an attractive risk return profile, especially in the 3 to 5-year section of the yield curve. Among all investment grade (IG) and high yield (HY) bonds, BBs were the best performer in 2019. With 10-year Treasury yields below 2% there is little value in lengthening maturities.

We hope you have a healthy and joyous Holiday Season and New Year.

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