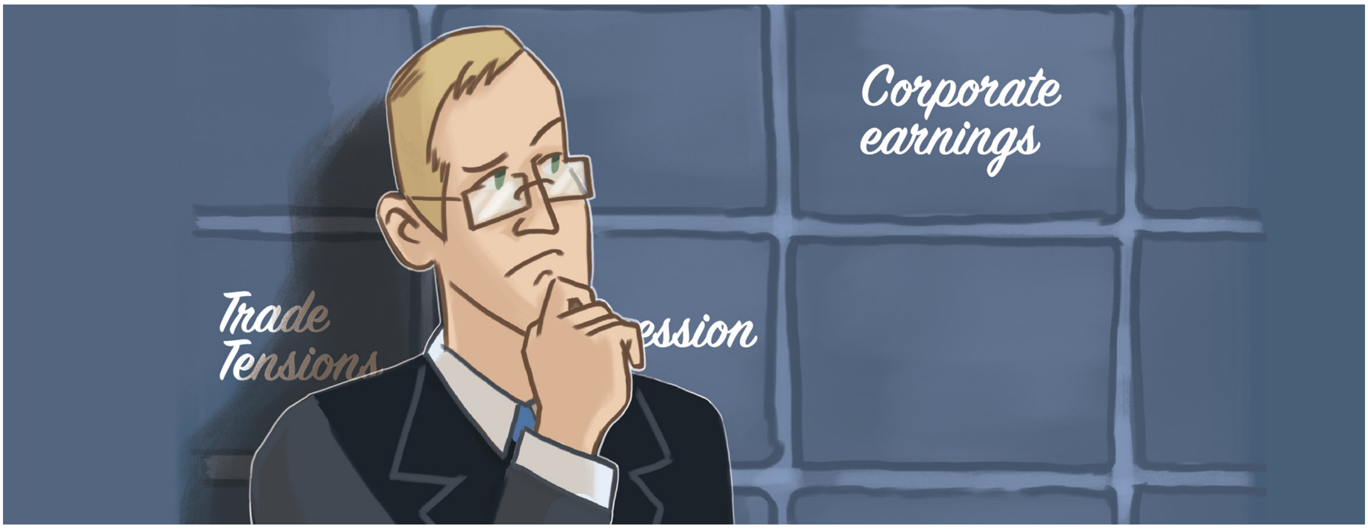


Wednesday, February 5, 2020

Wishes and Worries for 2020

One of modern investment theory's key underpinnings is the idea that markets are efficient and that security prices reflect all available information. If this is true—and markets are efficient—then prices should change when new information emerges. When companies announce good or bad news, prices should quickly adjust to reflect the new state.

One of modern investment theory's key underpinnings is the idea that markets are efficient and that security prices reflect all available information. If this is true—and markets are efficient—then prices should change when new information emerges. When companies announce good or bad news, prices should quickly adjust to reflect the new state.

However, prices reflect not only the current state of things; they must also embed assumptions about the future. And the greater the degree of uncertainty surrounding the future, the more compensation—in the form of return—investors should demand.

Simply put, markets rely on investors' collective assessment of the likelihood and magnitude of potential negative events—or worries—and the continuation of positive events—or wishes. When worries don't materialize and wishes do, sentiment improves and prices rise.

An often-heard phrase in the financial media is, "The markets are climbing a wall of worry." This means that reluctant investors become more and more willing to buy risky assets at higher prices as they tick their worry-list items off, one by one. The reverse is also true. When wishes already baked into prices fail to materialize, both sentiment and prices are likely to fall.

Worries and wishes represent opposite sides of the same coin: Yesterday's resolved worries becoming today's embedded wishes. When investing, it's important to remember both—and say out loud the things you are assuming to be true—to avoid falling off the cliff of wishes that lies at the top of the worry wall.

© 2022 CAPTRUST Financial Advisors

In December 2018, investors stared up at such a wall. After experiencing the worst year for stocks since the financial crisis—with the S&P 500 Index down nearly 20 percent from its high point—investors faced a troubling list of worries. This included concerns over escalating U.S.-China trade tensions, worries that the Federal Reserve was not positioned for slowing global growth, and anxiety that a divisive political environment could lead to government shutdowns and gridlock. On top of that, investors and policymakers alike worried that the global economy was heading toward recession.

Over the course of 2019, as these worries resolved or diminished in investors' minds, markets rallied. Equity markets climbed the wall to the tune of 31.5 percent returns for the S&P 500. Meanwhile, credit spreads—a measure of bond investors' risk perceptions—shrank to within striking distance of all-time lows.

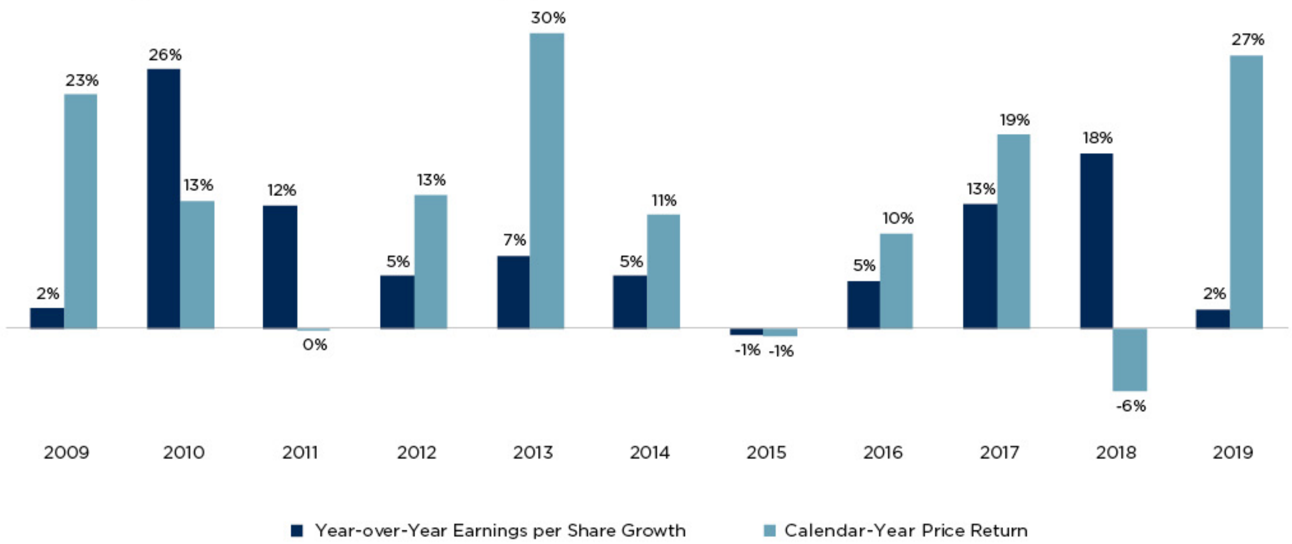
Further, the Federal Reserve resolved a major market worry when it reversed course, making three interest rate cuts. Against concerns over escalating trade tensions, markets celebrated progress toward the United States-Mexico-Canada Agreement (USMCA) as a replacement for the North American Free Trade Agreement (NAFTA) and, late in the year, the announcement of a phase one trade deal between the U.S. and China. Lastly, despite much rancor, the current political divide has not translated into stock market volatility or another government shutdown.

In this issue of *VESTED*, we update the list of worries and wishes on the minds of investors in early 2020.

Worry #1: Meager corporate earnings growth

Although you wouldn't think it given soaring stock prices, U.S. corporate earnings growth was paltry in 2019. As shown below, S&P 500 earnings per share in 2019 had grown only 2 percent year over year, compared to an 18 percent advance in 2018. The earnings pop last year was fueled by the significant reduction in the corporate tax rate from the Tax Cuts and Jobs Act of 2017. This tax cut led to a surge in business spending and investment as well as an increase in stock buybacks that serve to elevate earnings on a per-share basis.

Figure One: Year-over-Year Earnings per Share Growth vs. S&P 500 Calendar Year Price Return



Source: CAPTRUST Research

It is not uncommon to see S&P 500 earnings growth and price returns move out of sync, and there have been many instances over the past decade when price returns eclipsed earnings growth, or vice versa. But with prices at all-time highs and price-to-earnings ratios indicating that stocks are fully valued, much of the support for future price appreciation must come from growth in corporate profits. Earnings expectations for 2020 reflect improvement from 2019's low levels toward mid-to-high-single-digit levels. However, it is important to remember that annual earnings estimates have a tendency to start high and trail down as the future becomes clearer.

Worry #2: The state of global economic growth

Global economic growth is a critical precondition for rising corporate earnings. One of investors' largest concerns in 2019 was the decline of gross domestic product growth across the globe, particularly in parts of the world more sensitive to trade conditions, including China, Germany, and emerging market economies. Recently, we have seen signals that global growth conditions may be finding a bottom, including a steepening of the yield curve and improving economic conditions in Europe.

Typically, investors demand higher yields when they tie their money up in bonds for longer periods. This gauge of the market's confidence in future economic growth conditions can be measured by the yield curve, the difference in yield between short-term and long-term yields. When the Treasury yield curve flattened and briefly inverted in late summer, many interpreted this event as a prediction of recession. The Fed seemed to take notice and introduced its first rate cut since the financial crisis.

More recently, the yield curve has begun to steepen, a healthy sign. The yield differential between 10-year and 2-year Treasurys recently topped 0.3 percent, the highest point in more than a year for this measure.

Germany's economy is sensitive to trade conditions with China and the U.S., and Brexit uncertainty, so it represents an important bellwether for global growth conditions. Recently, the country has seen an uptick in auto sales as conditions have firmed across Europe, and its industrial production appears to have stabilized. A closely watched index of economic conditions published by the ifo Institute for Economic Research in Munich increased in December, and measures of economic sentiment have also moved sharply higher, to the highest levels since February 2018.[1,2] Continued stabilization across Europe and reacceleration of growth in China would support the case of an improving global growth backdrop.

Worry #3: Political uncertainty

Political stability provides a foundation for global economic growth. But here in the U.S., 2020 looks to be a doozy of an election year. As Figure Two shows, stocks have tended to perform reasonably well during presidential reelection years, with average returns of 6.3 percent since 1948 and less volatility than open presidential election years. This reflects investors' expectations that incumbents tend to win reelection. They view the outcome as more certain, and the markets like certainty. This time may be different given the current level of uncertainty and political fluidity emanating from Washington.

© 2022 CAPTRUST Financial Advisors

Figure Two: S&P 500 Index Average Performance in Presidential Reelection Years vs. Open Election Years (1936-2016)

Source: Strategas

A majority of institutional investors believe that President Trump will be reelected. An RBC Capital Markets survey of nearly 120 institutional investors released in December reported that 76 percent of respondents thought he would win.[3] If that were to occur, it would likely bring a continuation of current policies and priorities—likely a positive for markets—along with the potential for more trade conflict and tweet-induced volatility.

However, one worry is the size of the gap between market expectations and approval ratings. The reelection chances cited above would be more understandable if President Trump's approval ratings were similarly high—not sub-50 percent in the midst of impeachment proceedings. This disconnect poses a significant risk if the political environment changes in a way that markets don't expect.

If the winds were to shift toward a higher likelihood of a Democratic wave, then markets would have to digest the policy uncertainty represented by a change in administration. This is particularly true right now when the name at the top of the ticket is unclear and the Democratic candidates represent a wide range of policy views. Depending upon who the nominee is, certain sectors, including healthcare, energy, financial, and large technology companies, could face potential headwinds.

Wish #1: Trade truce

The phase one trade deal announced in December between the U.S. and China represents progress toward resolving a major obstacle for the global economy—and a positive sign for trade-sensitive economies and companies, business confidence, and profits. The announced truce suspended the tariffs on $160 billion of Chinese imports that had been scheduled to begin on December 15 and rolled back some tariffs imposed earlier in the year, in exchange for Chinese purchases of U.S. agriculture products and other concessions that have not yet been detailed. Both sides of the dispute have strong incentives to de-escalate, even if the chances for a more comprehensive trade deal with structural reforms before the elections are small.

Once again, this agreement was announced via Twitter, in lieu of a joint announcement or other

© 2022 CAPTRUST Financial Advisors

traditional means. The details of the agreement are not yet public and are likely still in flux.

One reason that trade uncertainty is so troublesome is that it's unpredictable. When Congress passes a budget, we know we're in the clear for a year, until the next budget cycle. But when a trade truce is announced, even if tensions ease in the short run, there is no guarantee that it will be formalized or that future milestones will be reached.

And with the 2020 election in sight, there is some concern that a de-escalation with China could merely shift the trade war to other parts of the world. Automobile tariffs on Europe, for example, could be popular among auto workers and Rust Belt voters while damaging Europe's fragile recovery.

Wish #2: Accommodative policy environment

Following its series of three interest rate cuts in 2019, the Fed has signaled a pause as it watches incoming economic data. After the last of these cuts, the minutes of the October Fed meeting explained that policymakers viewed the cuts as sufficient to support growth conditions, a healthy job market, and inflation moving toward its 2 percent target.

At the same time, Chairman Powell's comments also served to quell the potential worry of negative interest rates (despite pressure from the White House to move in that direction), stating that it did not see negative interest rates as an attractive policy tool.

Despite its pause, the Fed has other ways to supply economic fuel—namely through open-market operations to buy securities and increase the size of its balance sheet. Since mid-October, the Fed has pursued such purchases to the tune of $60 billion per month. When it last employed quantitative easing in the aftermath of the global financial crisis, the Fed was clear that such measures were intended to stimulate lending and investment. This time, it has struck a different tone. In an October speech, Chairman Powell stated that these security purchases were intended as structural measures to "maintain an appropriate level of reserves."[4]

Call it what you will, the market reaction has been the same: a green light to lend and invest. If an injection of liquidity increases risk taking and dampens volatility, it has a stimulative effect on markets. However, one potential concern is whether the structural issues cited by the Fed could point to other unforeseen issues.

From Miserable to Merry

The change in tone and sentiment over the past year has been striking. Last December, faced with a range of serious economic worries, stock prices were falling and recession fears were rising. Investors were miserable, and not many strategists were calling for a blockbuster year in 2019.

This year has been a stark contrast and provides a reminder of the perils of market timing. Few years have boasted 30 percent returns from the S&P 500 Index, along with high-single-digit returns for bonds. When years like this come along, long-term investors can't afford to miss them. And the only way to reap the rewards is to have and follow a well-constructed and well-understood financial plan. Such a plan provides confidence and ability to stay the course during periods of market uncertainty. The more confident you are in your plan, the less confident you have to be in the markets.

[1] "ifo Business Climate Index Rises at Year-End (December 2019)," ifo Institute

[2] "Renewed Rise in Expectations," ZEW

© 2022 CAPTRUST Financial Advisors

[3] Maranz, Felice, “More Investors Expect Trump to Win in 2020: RBC Survey,” Bloomberg.com

[4] Powell, Jerome, “Data-Dependent Monetary Policy in an Evolving Economy,” federalreserve.gov

Author(s)

Sam Kirby, CFA®

https://www.captrust.com/people/sam-kirby/

Legal Notice

This document is intended to be informational only. CAPTRUST does not render legal, accounting, or tax advice. Please consult the appropriate legal, accounting, or tax advisor if you require such advice. The opinions expressed in this report are subject to change without notice. This material has been prepared or is distributed solely for informational purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. The information and statistics in this report are from sources believed to be reliable but are not guaranteed by CAPTRUST Financial Advisors to be accurate or complete. All publication rights reserved. None of the material in this publication may be reproduced in any form without the express written permission of CAPTRUST: 919.870.6822.

© 2022 CAPTRUST Financial Advisors