In 2020, the Critical Number to Know Is 1.8

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Rick Rieder and Russ Brownback argue that contrary to the many year-end outlooks foreseeing either a recession or a rebound in 2020, the most likely path for the economy and markets is more moderate, which can be encapsulated in their theme of "1.8."

In the season of proliferating 2020 outlooks, and in an age of one-word answers to complex questions, often ending in hedged language like "–ish," we think next year will be remembered as being "1.8-ish." What do we mean by this? It's our colloquialism for a macro/fundamental backdrop that hugs equilibrium and is underpinned by a newly pragmatic central bank policy posture that will likely be entrenched for the foreseeable future. Specifically, U.S. real GDP growth and core inflation are both poised to stabilize near their longer-run averages of roughly 1.8%, which should dictate that U.S. 10-Year Treasury rates can hover around 1.8%, in a tight trading range, while Federal Reserve policy rates also stay locked near 1.8%.

A Benign Macro and Market Outlook, Near 1.8

Additionally, from a secular standpoint, roughly 1.8 million people will hit retirement age (65) every six months in the U.S., which is nearly double the pace from just 20 years ago. That demographic development should bring historic amounts of financial asset wealth into the retirement phase of portfolio allocation every year, with a real need for income generation. And, finally, keeping with this theme: the 1.8% annual revenue growth differential between the technology sector and the S&P 500 (ex-tech) will drive investor demand for precisely the kinds of companies delivering on $1.8 trillion-ish of share buybacks, dividends, and research and development spending (see graph).

Source: CapitalIQ, data as of June 30, 2019.

The "1.8" theme has some market relevance as well. Investment-grade credit may not tighten meaningfully, but *we do not expect* BBB spreads to widen towards 1.8%, the pain point of last December, even as growth moderates. Nor do we expect BB spreads to tighten back to 1.8%, the tights of this year, as the companies making up this part of the index face secular challenges amidst a moderate growth backdrop that will warrant additional risk premium.

In equities, while we think EPS growth expectations are too lofty, especially those estimates above $180 per share for the S&P 500, we do expect modest 5% to 6% earnings growth next year, and we also think the P/E ratio can push a couple turns higher than the consensus expects, to near 18X. Regions of the world that have underperformed the U.S. over the last few years are also well positioned to rebound. For example, emerging markets (EM) assets will be flattered by more accommodative global monetary policy, while the Eurostoxx could handily outperform its paltry 1.8% average annual return of the last 18 years, as the ECB joins the global easing initiative.

The Evolving Characteristics of Credit and Equity

Notwithstanding our relatively benign 2020 macro view, we are incredibly excited about the alpha-generating potential that will be borne out of proliferating dispersion across asset classes, sectors and geographies. As a case in point, equities and credit are starting to look like completely different entities with differentiated drivers of returns. The credit quality of the top companies in the S&P 500 has migrated toward AA/AAA territory, just as the supply of the equity asset class is shrinking, with cash-rich companies ramping up share buyback programs.

Meanwhile, the investment-grade credit index has migrated down in credit quality, as tech companies are no longer issuing bonds on the heels of overseas cash repatriation. This increasingly places the burden of new credit bond issuance on capital-expenditure-heavy "old-economy" industrial entities where margins and free cash flow are far less dependable, or on companies that have limited organic growth potential, forcing them to turn to acquisitions. Companies that have strong balance sheets are more willing and able to make the required investments to drive the cash flows of tomorrow. Many of these investments fall under the category of research and development, and cannot be capitalized (think digital), thereby optically depressing cash flow and raising leverage today (a luxury that companies with weaker balance sheets cannot afford).

In another interesting development, many developed market (DM) sovereign assets have also become riskier this year, on the back of an epic duration rally. And while a meaningful rise in yields is unlikely, the very low absolute starting point of yields, combined with flat yield curves, means that the left-tail risk of large losses associated with a duration sell-off are now elevated.

Concurrently, as a more muted (albeit steady) global growth backdrop became entrenched over the course of 2019, we witnessed a large asset allocation shift taking place in markets: outflows from “riskier” equities in favor of inflows to “safer” fixed income. Ironically, these traditional safe-haven-seeking behaviors likely unintentionally led investors to substitute one kind of risk for another, perhaps muting some of the intended risk mitigation. Ultimately, we envision a significant reversal of these flows in 2020, adding to existing outsized demand for higher-quality assets, at the expense of waning demand for lower-quality assets.

Sources: Bloomberg, JP Morgan and BlackRock; data as of December 4, 2019. Note: Projections from JPM

Supply/Demand and the Scarcity of Available Yield

Speaking of demand, the powerful secular forces that have created a demonstrable deficit of yielding assets over recent years will be more powerful than ever in 2020 (see second graph). Because of the massive growth of pension and insurance assets, and the aging demographic globally, roughly three times as much value needs to be invested annually today by the community aged 65+ relative to the turn of the century, a staggering average annual increase of $1.3 trillion per year over the next ten years. That outsized demand will clash with a sobering decline in the net new supply of yielding assets. In U.S. fixed income markets, new issuance (net of Fed asset purchases) is estimated to fall by $725 billion in 2020, a nearly 30% decline from 2019’s levels. Worse, incremental fixed income issuance is now coming at yields that have reset roughly 100 basis points lower versus last year, further diminishing the pool of investment income available to savers.

One of the last bastions of liquid, “yieldy” assets available to investors today is via U.S. corporate equities. This equity contribution increases the pool of available income significantly, and with much better growth potential. Indeed, 20 years ago, corporate free cash flow as a percent of the total pool of fixed income cash flow was around 7%, but today it has surged to more than 40%. However, yield-seeking investors will have to compete with corporate treasurers who will again be aggressive equity buyers in 2020. In fact, the influence of equity share buybacks is underestimated relative to the historic demand for income. Buybacks topped $800 billion in 2019 and the free cash flow yield on those buybacks is 3.7%. These buybacks nearly offset net new U.S. Treasury issuance during 2019, but more significantly, the cash flow that the buybacks removed (that was heretofore available to investors) exceeded the amount of new Treasury coupon income by more than 25%. To us, there is a systemic underappreciation for the immense concentration of income availability for investors that exists among the highest-quality companies, and we fully believe that these cash-generating entities can command higher valuations going forward.

Perhaps the most dominant influence on the deficit of high-quality yielding assets in 2020 will be the powerful rebooting of the global liquidity cycle that occurred in recent months. With major global central banks growing their balance sheets anew, combined with a resurgence of recycled global foreign exchange reserves, we estimate that global liquidity growth will approach $1 trillion in 2020, reversing an onerous 18-month contraction. Demand for high quality yield, declining credit issuance, aggressive stock buybacks and robust liquidity injections are a potent cocktail indeed.

Investment Implications

Putting it all together reveals a 2020 investment conundrum. Substantial duration has entered the market over the last year. Meanwhile, credit spreads and yields have been significantly diminished just as global growth has moderated, leaving the risk/reward trade-off quite unfavorable, especially down the credit spectrum. Finally, as investors clamor for low-risk (high-quality) yield, these scarce assets will only grow scarcer. Thus, it’s become very difficult to build a “great” risk-parity portfolio. As a result, for 2020 we’re building fixed income portfolios that will yield roughly 4% to 5%, but we’ll refrain from reaching excessively for 6% to 7% yields, which were possible just after the December 2018 market rout. We plan on employing a combination of short duration, risk-free assets (that also act as a portfolio hedge), short-dated high-quality DM credit, high-quality securitized assets, and a mix of EM local, sovereign and hard currency credit assets.

We’re also favorably disposed to equities. Over the past 20 years, equities have returned around 11% when real GDP and CPI were between 1.5% and 2.5%, as we expect they will be in 2020, which compared to less than a 4% equity market return in all other economic environments. While macro uncertainties will exist, the base case for owning equities is sound, and using the current earnings yield on global equities of near 7.5% as the expected return target allows us to build a 60/40 portfolio that should conservatively return approximately 7%, with a fairly favorable range of potential outcomes. All told, “1.8-ish” may seem like a boring narrative to begin the new year, but this dull veneer belies a multi-faceted dispersion beneath the surface, from which we think significant alpha can be harvested.

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