ADVISOR PERSPECTIVES

Impeachment, a Coming Election, and a Near-Record Market Rally: What Could it Mean for 2020?

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by Simeon Hyman

of ProShares

As Mark Twain once said, history never repeats itself, but it does often rhyme. The House vote to impeach President Trump coming in mid-December of 2019 certainly feels like a couplet with the Clinton impeachment, which occurred in mid-December 21 years ago. Indeed, there are similarities, but also key distinctions.

	Clinton Impeachment	Trump Impeachment
GDP Growth	4.5%	2.1%
Core CPI	2.4%	2.3%
Unemployment Rate	4.5%	3.5%
Fed Funds Rate	4.8%	1.5%
10-Year Treasury Yield	4.7%	1.9%
Capacity Utilization	82.8	77.3
S&P 500 P/E	28.1	21.6

Two key drivers of solid markets and economies existed then as now—low inflation and low unemployment. But that's where the similarities end. At the beginning of 1999, markets and the economy still had over a year of good times to go, but the seeds of the equity market correction in 2000 and the recession in 2001 were being sewn, in the form of excess. The S&P was trading at a price-to-earnings ratio (P/E) of 28, an extremely high multiple, and gross domestic product (GDP) growth registered an extremely hot 4.5%. The S&P 500 today is trading at a P/E of less than 22, but in a much lower interest rate environment. And the long but muted recovery from the Great Recession has yet to overheat the economy.

The price-to-earnings ratio (P/E) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

Capacity Utilization: A Canary in the Coal Mine

Capacity utilization is the relationship between what we produce and what we could produce if our full manufacturing and production capacity were used—and it's a valuable marker for recession. The tipping point for recession has historically been when capacity utilization rises above 80, as was the case in the last four. With capacity utilization now at roughly 77 (readings above 85 or below 75 are rare extremes), recession risk would appear to be low. Could this time be different? Sure. Capacity utilization is a measure of manufacturing capacity, and in prior periods where manufacturing loomed larger, a 77 reading could have been seen during a recession. Today, the strong consumer sector is supporting modest GDP growth, and with little signs of inflation even from a tight labor market, it's tough to find any signs of overheating that would trigger the next stage of the business cycle.

Capacity utilization refers to the manufacturing and production capabilities being used by a nation or enterprise. It is the relationship between the output produced with the given resources and the potential output that could be produced if capacity was fully used.

Chart of the Month

Capacity utilization and the past four recessions.

U.S. capacity utilization as percent of total manufacturing capacity from December 31, 1974 to November 30, 2019.

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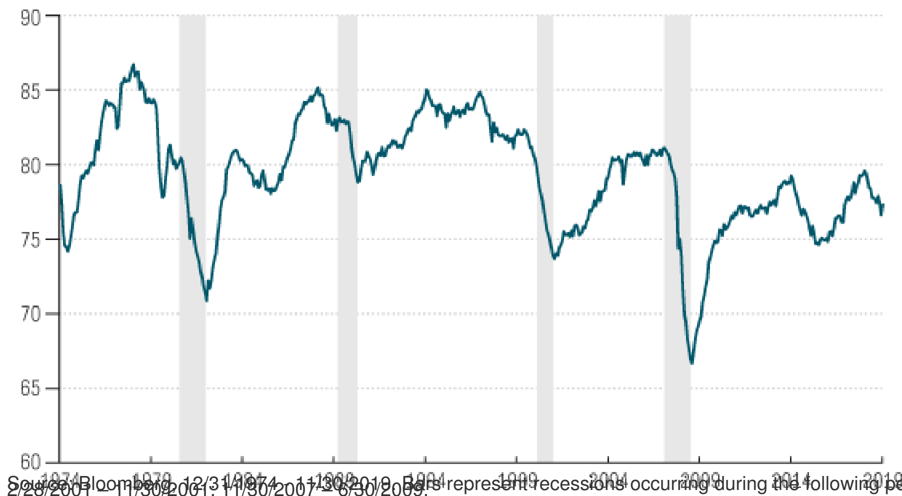

Source: Bloomberg, 12/31/1974 – 11/30/2019. Bars represent recessions occurring during the following periods: 6/30/1981 – 11/30/1982; 6/30/1990 – 3/31/1991; 2/28/2001 – 11/30/2001; 11/30/2007 – 6/30/2009.

Will 2018 Tax Cuts Bump Up 2020 Earnings Growth?

If there's no recession in the cards for 2020, does that mean equities are in the clear? Twenty-one to 22 times earnings is still quite a full valuation, and there has been virtually no earnings growth of late. There may be a bit of an unexpected—but much needed—source of earnings growth in 2020: The Trump corporate tax cuts. This requires a bit of following the bouncing ball. The tax cuts delivered temporary windfalls to companies in 2018. In 2019, companies struggled to anniversary these windfalls as competition drove down prices and effectively passed the tax cuts to consumers. In 2020, companies no longer have the high hurdle of 2018 temporary windfalls. Add to that perhaps a steady drip of good trade news and maybe a little fiscal stimulus (as the presidential election nears...). And then there is the strong consumer. December readings continued to show sky-high consumer confidence, and home price increases hit a five-month high. Don't count out the bull market yet.

Equities Around the World Poised to Gain Strength

Valuations get decidedly more attractive looking beyond U.S. large cap stocks. International equities, seemingly perpetual laggards, are certainly cheaper. Both developed and emerging market equities are trading at more than a 20% P/E discount, and both are trading at more than a 50% price-to-book (P/B) discount, which many argue well represents long-term earnings power. That potential steady drip of good trade news means perhaps even more here, as would any kind of certainty around Brexit. Quietly, the 10- year German Bund yield has climbed back close to zero, a generally bullish sign for European equities, and particularly European financial stocks.

Emerging markets would also benefit from a continuation of the firming trend in commodity prices. And, interesting to note, the balance sheets of emerging market stocks are, in aggregate, stronger than those in developed markets.

Within the United States, mid- and small-cap stocks are also trading at substantial P/B discounts to U.S. large caps. One challenge: leverage. U.S. mid caps have roughly double the leverage of U.S. large caps, and small caps roughly triple. Focusing on quality mid- and small-caps with less leverage may be a prudent way to approach the opportunity. And a quality approach—across the board—could also come in handy if geopolitical tensions rise.

The price-to-book ratio compares a firm's market-to-book value by dividing price per share by book value per share.

Rates Could Start a Move Toward Normal

And while we were all watching stocks go up, up and up, interest rates have risen steadily since August. The yield on the 10-year Treasury is up over 40 basis points (bps). Rates may have further to rise. Back to our tale of the tape, at the end of 1998, at the outset of the Clinton impeachment proceedings, the core Consumer Price Index (CPI) was 2.4%, and the 10-year Treasury yield was 4.65%—a historically "normal" relationship. Today, with roughly the same level of inflation, the 10-year Treasury yield is under 2%. Even in the context of the still-relevant global quantitative easing (QE), rates rising halfway to "normal"—something with a three-handle—seems like a reasonable bet.

The core Consumer Price Index is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services, excluding goods with high price volatility, such as food and energy.

Quantitative easing is a means by which a central bank seeks to increase money supply and encourage lending and investment by purchasing government or other securities from the market.

A Happy Holiday for Retail

Finally, no 2020 outlook would be complete without a quick review of the 2019 holiday season. Early results show that

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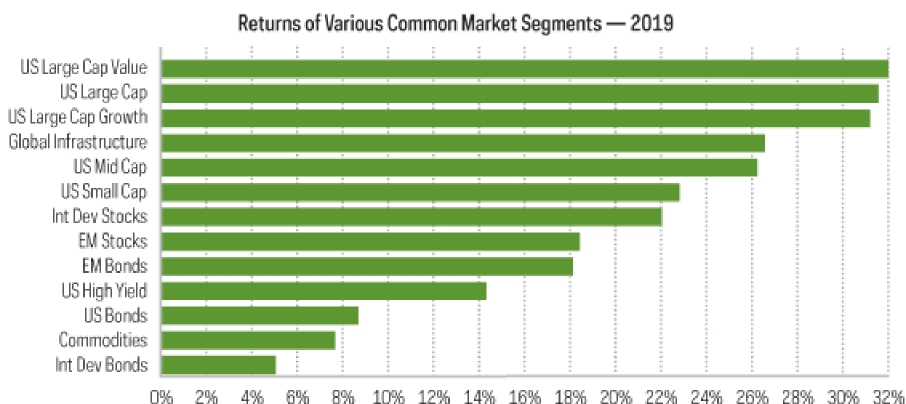
holiday retail sales (ex-autos) increased 3.4%—not too shabby. The considerably higher growth rate of online retail continued, as holiday e-commerce grew 19%.

Performance Recap
All bars green in 2019!



Source: Bloomberg

By Kieran Kirwan, CAIA
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Equity Perspectives

The Bull Market Lives On

Despite entering the year with poor momentum after lousy performance in Q4 of 2018, fears of economic slowdown (perhaps even a recession!), the ups and downs of an ongoing trade war, and ultimately the House passing impeachment articles, the second-longest bull market on record lives on! The S&P 500 set new record highs during 2019 and delivered returns of over 31%. Such high returns often give investors pause as they look ahead, but keep in mind that those returns followed a substantial correction in the last quarter of 2018, and perhaps more importantly, 2020 should see a continuation of a key driver of 2019's performance.

In the Goldilocks Zone

After raising rates in 2018, the Fed cut rates three times in 2019 and signaled that they will be on hold until inflation becomes "significant and persistent." With inflation currently struggling to eclipse 2%, it's easy to see why many anticipate a more dovish Fed for the foreseeable future. And while mild manufacturing weakness had raised some concerns, the combination of a very strong consumer sector and a middling manufacturing sector may be just what will keep the economy in the Goldilocks zone in 2020.

Multiple Expansion Drove the Market

2019's exceptional returns came via multiple expansion and not from earnings growth. In fact, earnings growth for the S&P 500 was flat to down for the first three quarters of the year, and clearly trending lower. Mid and small caps are showing even more deceleration on earnings growth rates.

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Source: FactSet

The multiple expansion in 2019 has pushed valuations into a range that many would consider fully valued. The forward 12-month P/E ratio for the S&P 500 now stands at 18.0x, which is higher than both the five-year (16.6x), and 10-year (14.9x) averages. Even a little bit of earnings growth would surely help ease concerns the market is ahead of itself.

According to FactSet, the estimated (year-over-year) earnings growth rate for 2020 is 9.6%. This rate may strike some as high, given that rate is above the 10-year average earnings growth rate of 9.1% and the fact that recent trends show deceleration. But as we mentioned in the intro, abnormally high growth rates from 2018—which included the one-time impact of tax cuts—are rolling off, making year-on-year comparisons for 2020 relatively easier.

Dividend Growth Stocks Well Positioned

Among the types of stocks that are well positioned for 2020 are dividend growth stocks. Since dividends don't "lie," companies that have consistently increased their dividends have consistently grown their earnings in the last few years.

Other elements of quality that come along with consistent dividend growth are likely to be important in 2020 as well. For example, the S&P 500® Dividend Aristocrats® index in aggregate has slimmer margins than the S&P 500 but higher returns on capital. This ability to "do more with less" is also a valuable trait when growth is hard to come by.

Dividend growth also offers a solution to the higher leverage of mid- and small-cap stocks, with the S&P 400® Dividend Aristocrats® and the Russell 2000 Dividend Growth indexes having substantially lower leverage than the S&P MidCap 400 and Russell 2000® respectively. For those looking to take advantage of attractive valuations in international stocks, both the MSCI Dividend Growers Index and the MSCI Emerging Markets Dividend Growers Index generate meaningfully higher return on assets than the MSCI EAFE and MSCI Developed and Emerging Market Index.

For those worried about potentially rising geopolitical tensions, the historical strong down capture of these dividend growth indices (they've gone down materially less than their broad market counterparts when the broad market declines) is another key attribute.

Infrastructure May Offer Yield at a Reasonable Price

Finally, for those looking for yield at a reasonable price, consider infrastructure stocks. Infrastructure stocks, particularly those that own and operate infrastructure assets—such as those in the DJ Brookfield Global Infrastructure Index—offer analogous traits to dividend growth stocks. Companies that own and operate infrastructure assets generally have stable revenue and earnings streams. And today you can buy those stable revenue and earnings streams at a discount to the broad market, with a nice dividend yield on top. The DJ Brookfield Global Infrastructure Index currently has roughly double the yield of the S&P 500 at a lower price-to-book ratio.

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Fixed Income Perspectives

No Time for Complacency

While some fixed income investors rejoiced following a banner 2019, caution against bond market complacency may be warranted as we continue into 2020. The Bloomberg Barclays US Aggregate Bond Index generated its highest return of the decade, up 8.72%. In a dramatic policy shift, the Fed made the decision to cut rates and successfully uninverted the yield curve during the fourth quarter, helping to temper fears of a recession.

After an initial drop in longer-term rates following the Fed's July 2019 rate cut, the yield on the 10-year Treasury has risen more than 40 bps since August despite—or perhaps due to—two additional rate cuts. While headlines often focus on the Fed and the federal funds rate, which is the overnight lending rate for banks, longer-term yields can have a larger impact on a bond portfolio. Thus, fixed income returns stalled during the fourth quarter as the yield curve steepened. When we dive a little deeper and look at corporate bonds versus Treasurys, we see that Treasurys were negative for the fourth quarter.

	Bloomberg Barclays US Treasury Index	Bloomberg Barclays US Corporate Investment Grade Index	Bloomberg Barclays US AGG Index
Q4 2019 Performance	-0.79%	1.18%	0.18%
2019 Performance	6.86%	14.54%	8.72%

Source: Bloomberg as of 12/31/2019

Tightening Credit Spreads Benefit Corporate Bonds

Corporate bonds were positive for the quarter as they benefited from tightening credit spreads. Spreads indicate the yield premium a corporation pays on its debt versus a Treasury bond of the same maturity. They are often impacted by confidence in the issuer's ability to pay back its debt and thus the outlook for the economy— and the Goldilocks economy clearly boosted this confidence. Aligned with our view of equity markets, the trends of rising Treasury yields and tightening credit spreads may continue in 2020.

Normalization and Its Potential Impact on Portfolios

With longer-term yields seeming to have hit a floor in August, the trend identified in the fourth quarter may continue into 2020. It would in fact be a "normalization" to see the 10-year Treasury yield rise closer toward historical averages, with the relationship between inflation and rates identified surrounding the Clinton impeachment serving as the base case. This would indicate an increase in the 10-year yield of more than 1%, rising from its current yield of 1.9% to somewhere north of 3.0%.

If we are in fact heading toward normalization, duration-heavy portfolios would suffer. On the other side of the spectrum, if recession fears do increase or geopolitical tensions rise, investors may look to safe-haven assets. This would push up the price of Treasurys, weighing down their yield.

Corporate Bonds or Treasurys in 2020?

With respect to corporate bonds, credit spreads have historically had an inverse relationship with the 10-Year. In fact, the two have had a correlation of -0.42 over the past five years. This, in addition to an easing of recession fears, could bolster investor confidence, causing spreads to further tighten. Given our view that a recession is unlikely in 2020, corporate bonds may be better positioned than Treasurys as we head into the new year.

Interest Rate Hedged Bonds Could Generate Alpha

In a scenario where longer-term yields continue to rise and credit spreads continue to tighten, interest rate hedged corporate bonds could serve as alpha generators in a diversified fixed income portfolio. For a proof point, during the fourth quarter, the FTSE Corporate Investment-Grade (Treasury Rate-Hedged) Index was up 4.67%, outperforming the Bloomberg Barclays US Aggregate Bond, Bloomberg Barclays US Treasury Index and Bloomberg Barclays US Corporate Investment Grade Index.

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