Auld Lang Syne

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by Team

of Stellar Capital Management

Last New Year's Eve, most would not have forecasted the extent of the gains experienced by the U.S. stock markets this year. On the heels of the worst December since 1931, the Federal Reserve's (the Fed) 180-degree turn, from restrictive to accommodative policy, fueled the S&P 500's roughly 30 percent surge and pushed the U.S. economic expansion into record territory. In July the economy barreled past its previous 120-month record set in 2001, and claimed the title of the longest uninterrupted expansion since recordkeeping began in the mid 1800's.

An old adage used by experienced investors is that markets climb a wall of worry on the way to new records. In 2019 the worries included efforts by many developed countries to "better" manage (i.e., restrict) immigration, continued stagnation in European economic activity, and continued trade related uncertainty, which partially sidelined capital investment. These worries led to elevated economic forecasts being lowered, while economic activity continued to trudge along an upward path. In the end, it was the only the forecasts that fell, meaning that we did not talk ourselves into a recession. The dismal science of economics remains stronger than the dismal reality show of politics, and sadly, voters that weren't confused to begin with, certainly are now, as every issue has three sides, and sorting out fact from fiction has become a full-time job.

In the U.S., our 45th President is facing an impeachment trial in the Senate while in the midst of his re-election campaign. Since this is not a frequent occurrence in the U.S., there is no strong evidence to suggest that these proceedings or the outcomes will move the markets or the economy one way or another. More critical than the outcome of the impeachment process are the policy goals of the Executive and Legislative branches of government in 2021. The market and economy seem to like current economic policies, so any significant changes could alter the trajectory. Any speculation on significant policy changes at this point just adds more noise to an already noisy room. Political polarization is growing in our country, and it makes you wonder (jokingly so) if at some point, a mixed political marriage will lead to one's excommunication from their political party. This ongoing divisiveness between the major political parties is neither healthy nor does not make a positive contribution to our economy or society. We hope for more constructive collaboration in the future but must wait till November to see what the polls bring us.

According to the most recent Bloomberg survey, 2019 U.S. economic growth is forecast to come in around 2.3 percent, which is not terrific, but not bad with considering the crosscurrents faced. Forecasts for 2020 and 2021 are currently hovering around 1.8 percent. Economists are a reactive bunch and are generally not willing to incorporate events that "could" alter a forecast until those events actually occurs. At present, the stock markets seem to have priced in some, if not all of the crosscurrents dissipating, while the economists have not. Over the past year, we have commented that the stock and bond markets were forecasting different economic outcomes, as demand for the growth of stocks and the safety of bonds rose in tandem. The outsized demand for bonds contributed to an inverted yield curve (i.e., long-term rates are below short-term rates), which stoked recession fears. As the Fed began cutting rates in January, longer-term interest rates declined in lockstep, however, by the end of March, the Fed had successfully un-inverted the yield curve as the Fed cut rates at a faster pace than long-term rates fell. As a result, headlines concerning pending economic doom associated with an inverted yield curve have all but evaporated. However, it seems that if the expectations built into recent stock market gains are not soon realized, we should expect a setback.

Looking ahead, these are a few important issues to keep an eye on:

1. Interest rates. The magnitude of the decline in interest rates has made the future path of interest rates a critical issue. Low interest rates are good for borrowers and non-banking companies as interest expense is low but are bad for fixed income investors as interest income is low. Proper management of debt and fixed income investments is always important, but from these low levels, an increase in interest rates can have significant negative outcomes for borrowers and lenders alike. Most market participants and most professionals were not managing money the last time interest rates rose significantly, making it a bit easier to underestimate the impact of rising rates.

2. Currency. We have been blessed with a strong currency, but, should economic growth and political stability improve outside the U.S. at a faster pace than it does inside, the tide will likely turn. Should the strength of the U.S. dollar subside or weaken, one of the underpinnings of a low inflation environment in the U.S. will disappear, causing ripple effects across

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the economy. It is always difficult to predict exchange rates, and the timing of such changes, and this time will be no different.

3. Trade. The market expects that trade negotiations will eventually come to a successful conclusion. While we are also in this camp, it is the alternative thesis that will change the present upbeat tone of the market and economy. When trade issues are settled, it is likely that international companies and markets will fare better on a relative basis than the U.S., as those economies are much more leveraged to trade than the U.S.

4. Inflation. There have been discussions about building inflationary pressures from persistent wage increases, rising housing prices, and other associated components. Inflation is forecast to hover around 2 percent for most of the next two years, riding on the back of technology advances, the strength of the U.S. dollar with respect to the currency of our trading partners, and the relative weakness of foreign economies. These pillars have offset some of the cost pressures and mitigated the impact of increased tariffs, keeping a lid on reported inflation. Any combination of a weakening currency or cementing of trade deals should spark more global economic activity, taking the lid off inflation in the U.S. Should this occur, we should see a ripple effect in the bond market, as interest rates, in the simplest sense represents the cost of money.

In economic and market terms, 2019 was a good year. Going forward, the extended length this expansion should not be a primary worry, as expansions do not die of old age. Previous expansions have been executed by restrictive policy and/or die as the result of collateral damage from exogenous events. With the Fed on the sidelines this year, we'll be keeping an eye on events that could change the status quo.

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