Legacy Trust

Investment Perspectives

U.S. Economy Gains Steam Heading into 2020

January 2020

Laina M. Mills, CFA, CFP®
Chief Investment Officer

Key Takeaways

- Economic stability and trade tension improvement drove strong equity returns to finish out 2019
- The U.S. economy remains fundamentally solid and we expect a modest pickup in growth in 2020
- Equity market valuations appear fair today and prices could continue to go up if earnings rebound this year as expected
- With yields likely to remain lower for longer and consumer spending still strong, this remains a favorable environment for stock investments

Equity markets closed 2019 with significant gains after a period characterized by volatility and rangebound trading from May through October. Accommodative policy from the Fed helped improve sentiment and stocks reached new high levels to finish the year. The U.S. economy still appears to have room to grow in 2020 as global trade tensions have lessened, financial conditions are accommodative, and American households are financially healthy.

After the market correction that occurred in Q4 2018, equities came out strong in the early weeks of 2019 and recovered all of the previous year's losses early in the new year. Stocks continued their upward march through early May despite flat year-over-year earnings results, but ultimately found cause for a pullback when President Trump announced a fresh round of tariffs on Chinese imports on May 5.

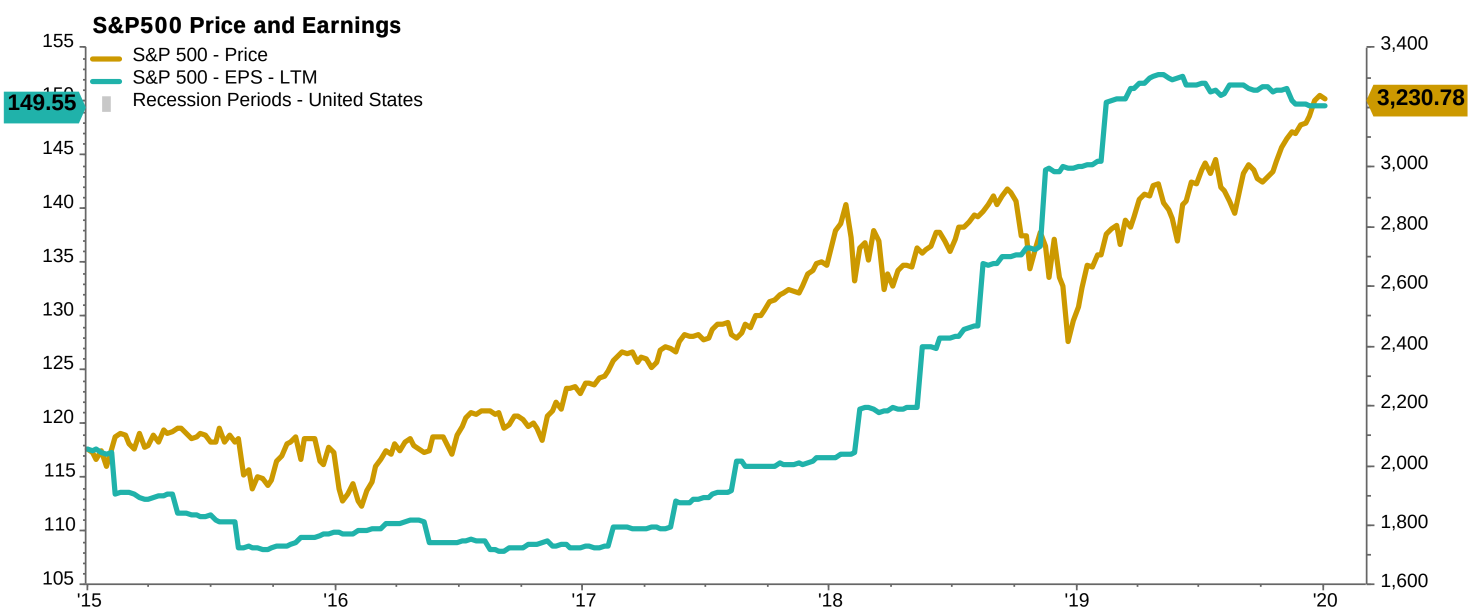
This re-escalation of global trade tensions led to a choppy, sideways market that continued for several months. Global economic growth had already been expected to slow in 2019 and the uncertainty surrounding U.S. trade policy led to a pullback in business investment, which became a drag on GDP growth in Q2 and Q3. Manufacturing activity declined and eventually fell into contraction, which further contributed to stock market volatility. Interest rates dropped significantly in Q2 and Q3 as fears of economic slowdown led some investors to believe that a U.S. recession was approaching, and the Treasury yield curve inverted with short-term bonds yielding more than long-term bonds.

Our view through this period of stock market volatility and interest rate declines was that, while geopolitical considerations including trade negotiations remained a key risk, the U.S. economy was fundamentally healthy enough to avoid a recession and would continue to grow thanks to robust consumer activity. Fortunately this view ultimately played out as expected as the year went on. American households' savings rates remain above the historical average, personal debt service is low, the jobs market is robust and home prices have been improving. All of these factors have contributed to a favorable environment for U.S. consumers. Despite the manufacturing slowdown, the services sector is strong and continues to expand, and this activity accounts for more than 80% of the domestic economy today.

The Federal Reserve responded to the global growth slowdown and the fact that inflation still remains below their target level despite the healthy economic expansion by carrying out what they termed a "mid-cycle adjustment", being careful to avoid signaling a new pattern of prolonged interest rate cuts. The Fed cut interest rates three times from July to October, ultimately concluding at that point that rates were at an appropriate level given current economic conditions. Markets reacted favorably to the re-calibration of monetary policy and the yield curve normalized, albeit at lower rate levels than it began the year. Economic data showed improvement in Q4 as the labor market continued to march along and consumer spending proved strong enough to more than overcome the business spending slowdown.

Ultimately, the uncertainty that characterized much of Q2 and Q3 began to lessen in Q4 and markets reached new highs to close the year. U.S. large cap stocks outperformed with technology companies leading the pack by a large margin. International stocks recovered and finished the year with roughly 20% returns – strong results despite not matching pace with U.S. equities. Cash, which was the best performing asset class in 2018, fell well below all other asset classes in 2019 thanks to the stock market shooting upward and the interest rate backup that drove significant bond market price gains.

It is important to remember that, despite the substantial 2019 calendar year stock market returns, when viewed in context with



Source: FactSet Research Systems
Data as of 12/31/2019

2018 the equity market doesn't appear to have become overstretched. The S&P 500 stands at a valuation that is just slightly above long-term averages, which appears reasonable given the low-inflation, low-rate environment. Further, the bond market, which enjoyed high single-digit returns last year due to the interest rate drop, appears significantly overvalued today. With inflation running between 1.5-2.0%, cash and bonds are going to be unable to protect investors' purchasing power and investors will be dependent upon equities for long-term total return (both yield and price appreciation).

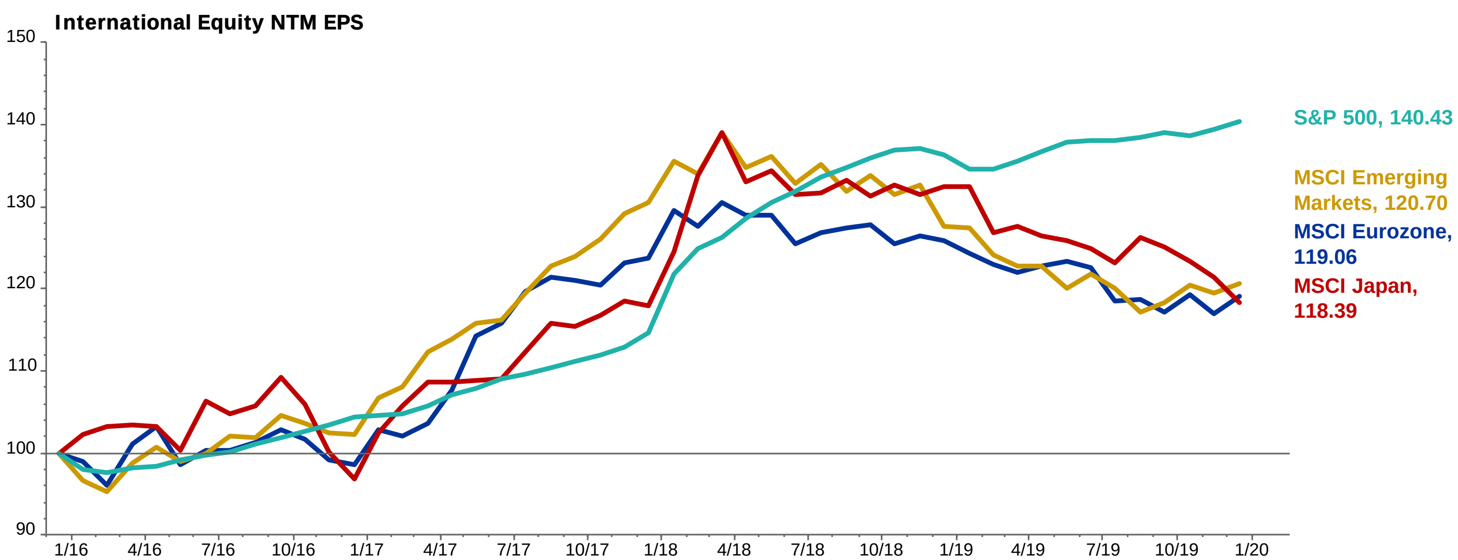
As the economic outlook continues to appear favorable, especially from the U.S., we think equities remain the most attractive asset class today and believe that the economic expansion that began in 2009 still has room to run. The lower-than-typical GDP growth rates that have been a hallmark of this expansion have allowed it to continue longer than average, and we do not see signs of financial imbalances in the system that usually precede recessions, such as a debt or housing bubble. Geopolitical factors are always a risk, particularly in a Presidential election year, but fundamentally the U.S. economy remains strong and should be capable of continuing to handle a modest slowdown in global growth as long as local conditions remain healthy. U.S. corporate earnings, which were flat to slightly negative in 2019, are expected to rebound in 2020 and post modest single-digit growth numbers this year. Stock prices should then have room to grow in line with earnings, which wouldn't extend P/E ratios.

Outside the U.S. we believe the picture is less favorable. While we continue to advocate for globally diversified portfolios, we remain solidly overweight to U.S. equities at the expense of non-U.S. developed markets such as Europe and Japan. The Eurozone in particular has been hit by the global manufacturing slowdown and economic growth is lackluster at best in the region. Developed market equities are trading at much cheaper levels than U.S. stocks but we believe there is economic justification for this discount. The U.S. equity market is much more technology driven than the European market and we think a U.S. overweight is warranted when we look at where we are finding investment opportunities.

Emerging market equities, in contrast to their developed market counterparts, continue to appear attractive from both a long-term secular outlook and a near-term valuation perspective. EMs were battered last year due to heightened global trade tensions but still have solid fundamentals and are poised to generate higher corporate earnings growth in 2020.

With regard to bond investments, it appears that we're back to a "lower for longer" interest rate environment for the foreseeable future. The Fed has indicated that their current rate posture is appropriate given the economic outlook, and foreign demand for U.S. bonds remains as robust as ever (which serves to drive prices up and yields down). Diversified, high quality U.S. fixed income portfolios are expected to earn modest positive returns in 2020 but are unlikely to match last year's returns now that yields have fallen across the curve.

Overall we continue to advise our clients to stick with their long-term strategic allocation plans despite the 10+ year bull market. The underlying economic fundamentals are still strong enough to sustain an expansion and the expected rebound in corporate earnings for 2020 will give the stock market room to post further gains without stretching valuations.



Source: FactSet Research Systems
Data as of 12/31/2019