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The Glass Stays Both Half Full and Half Empty

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The glass stays both half full and half empty

- 2019 was marked by uncertainty as well as relief which, combined, helped boost all asset classes
- We expect no recession in 2020, but also see no strong economic rebound
- Against this view, we see a continuation of the rally in risk assets as unlikely

2019 was a great year for financial markets. Equity and bond markets both rallied with the S&P 500 rising 28.9%, high-yield spreads falling 173 bps, and the yield of 10-year Treasury notes down 77 bps.[1]

The uncertainty emanating from the US-China trade conflict and Brexit, plus the growing fear of recession, benefitted safe assets like US Treasuries and gold.

In our view, risk assets performed well for several reasons:

- The Fed performed a U-turn and eased policy instead of tightening it, with other central banks easing, as well;
- Recession did not materialize;
- The US-China trade conflict did not spiral out of control and an interim deal was reached at the end of last year;
- The outcome of the UK election defused the risk of a hard Brexit and cleared the way for a deal with the EU.

Relief does not last forever

Thus, following the sell-off at the end of 2018, the favorable performance of risk assets in 2019 appeared to be largely relief-driven (events turned out better than feared).

However, relief is not a permanent condition and is unlikely to last until the end of 2020.

- First, new risks may emerge, such as the outbreak of the coronavirus, or during the run-up to the November US elections, or in places of political instability around the world. We find it challenging to assess the probabilities of potential political risks, but think it would be naïve to hope that they play out as favorably as in 2019.
- Second, the economy needs positive news, in our judgment, to keep financial markets going higher as the relief factor fades. While we are not expecting a recession, we also don't think the economy is in shape to spring a truly positive surprise in 2020. In our view, the glass stays both half full and half empty.

Some good news

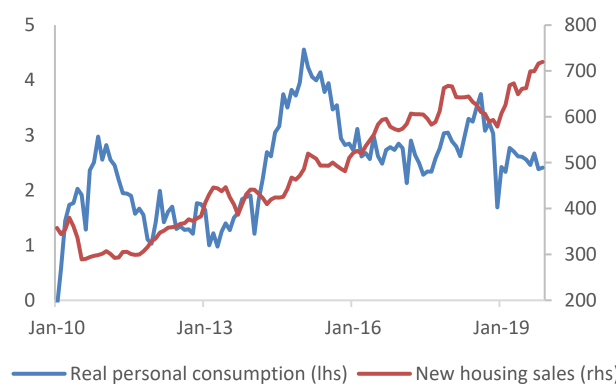
Our expectation that a recession is not very likely in 2020 rests primarily on our positive view on US consumption and housing.

The household sector has continued to enjoy steady employment and income growth; it has done a good job reducing its debt burden, and appears to feel good about itself.[2]

The positive position of households is supported by favorable financial conditions. The banking sector is in especially good shape with less debt and more capital.[3] The result is steady consumption growth and a positive response in housing to lower interest rates (see chart 1).

Chart 1: US consumption and housing

% over-year-ago (lhs) and 1000 units per month a.r. (rhs)



Source: St. Louis Federal Reserve[4]

But damage done is unlikely to reverse

The interim trade deal between the US and China is positive, but damage has already been done.

Global trade volume has declined 5% since 2018, even though no recession has occurred (see chart 2 on the following page).

In our view, since the trade deal is an interim solution, companies will probably hesitate to invest more in export and trading capacities.

Chart 2: Global trade volume

Index 2010 = 100

Source: CFB World Trade Monitor[5]

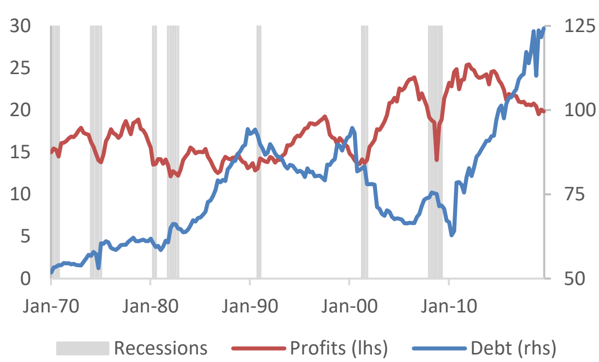
Indeed, the risk is that global trade could suffer more after a temporary truce, given the broader hegemonic struggle between the US and China and the generally more protectionist attitudes between the major economic blocs.

Corporate sector has passed its peak

The uncertain trade outlook is a particular concern for the corporate sector, which has already passed its peak. Profit margins, although still high by past standards, are declining, while the debt burden has reached historic highs (see chart 3).

Chart 3: US corporate profits and debt

% of gross value added (lhs) and % of net worth (rhs)



Source: St. Louis Federal Reserve[6]

To be sure, we don't think the corporate sector is in acute distress and will push the economy into recession. However, we see the combination of deteriorating profit and debt fundamentals and an uncertain trade outlook as likely to weaken corporate investment.

Less policy stimulus likely

Key support for the economy and market sentiment in 2018 and 2019 came from policy. In 2018, the tax cuts helped boost corporate sentiment and generated a cash infusion from overseas remittances.[7] The 2018 tax cuts were followed by the Fed's policy U-turn in 2019.

We do not expect to see similar policy stimulus in 2020. The 2020 federal budget, which passed last August, removes the risk of a government shutdown, but does not include new tax cuts or spending programs.[8] And, we believe, new initiatives are unlikely to pass Congress as the election comes closer.

The Fed is growing its balance sheet again to avoid any liquidity squeezes, but it otherwise appears comfortable with its current policy stance. The Fed has stressed that it needs to see a significant deviation of the actual data from its projections to change policy.[9]

No continuation of the rally expected

Given our views on the economy and policy, it is hard for us to expect another bull-year like 2019 for risk assets. We also think risk assets are richly valued following the rally last year.

- Unless profits unexpectedly bounce, a rally in equities would require higher valuations. This is not impossible, but not very likely in the absence of other positive news like more Fed easing.

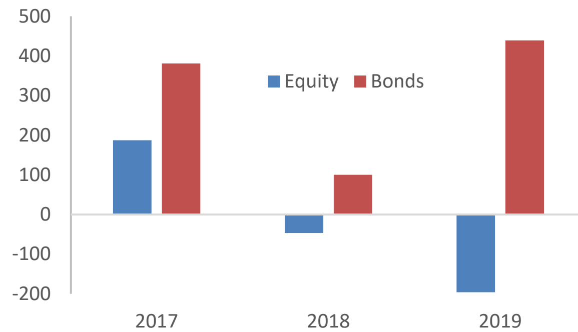
- On the credit side, we see no reasons for acute distress, but we also expect no significant improvement in earnings and debt fundamentals to push spreads tighter.

On the other hand, while we believe the economy is unlikely to deliver a strong upside surprise, we also do not anticipate a major sell-off in Treasuries.

Equity bulls like to point to mutual fund flows and argue that a reversal of the bond inflows and equity outflows[10] in 2019 could push equity markets higher in 2020 (see chart 4). This is possible and could give an equity rally additional momentum, but it is less likely, in our view, without some positive catalyst from economic or policy news.

Chart 4: US mutual fund flows

US$ billion annual net inflows



Source: Investment Company Institute[11]

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

[1] S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SP500, January 5, 2020.

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[4] U.S. Bureau of Economic Analysis, Real Personal Consumption Expenditures [PCEC96], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PCEC96, January 3, 2020.

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[5] CPB Netherlands Bureau for Economic Policy Analysis; World Trade Monitor; https://www.cpb.nl/en/worldtrademonitor

[6] U.S. Bureau of Economic Analysis, Corporate Profits with Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj) [CPROFIT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPROFIT, January 3, 2020.

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[8] https://www.congress.gov/bill/116th-congress/house-bill/3877

[9] https://www.federalreserve.gov/newsevents/pressreleases/monetary20191211a.htm

[10] The fact that mutual fund flows into equity were negative in 2019 raises the question who else bought stocks to cause the rally? The answer is corporates themselves through large-scale buybacks and M&A. Uncertain is whether corporates will continue the buybacks in 2020 at the current pace. https://www.federalreserve.gov/releases/efa/equity-issuance-retirement-quarterly.htm

[11] Investment Company Institute; Summary: Combined Estimated Long-Term Flows and ETF Net Issuance Data (xls); January 3, 2020.

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