SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

December 2019

Global Stocks Notch Additional Gains in November

Overview

In November most major stock indices rose. The monthly return for the S&P 500 was 3.63%, while non-U.S. stocks in the MSCI ACWI ex-USA gained a respectable 0.88%. Although bond market indices had mixed results in November, year to date the main global market indices, for both stocks and bonds, are solidly positive.

In this issue of *Insights*, we assess the current state of the global economy and provide a short preview of our 2020 economic and investment outlook. As we look ahead to 2020, we believe that investors will likely focus on central bank policies, the 2020 U.S. election, and how prominent geopolitical risks could affect the stability of economic and business conditions. The wide range of potential outcomes for each of these areas make it difficult to assign future scenarios with a high degree of confidence. Global economic growth has slowed, and there are several sources of potential disruption that must be taken seriously (among them diverging agendas for trade, competition for global dominance, populism and the wealth-gap, and demographic shifts). However, central bank policies across the globe remain accommodative, and the stabilization or re-acceleration of growth is possible if any of the potentially disruptive risks are neutralized or lessened. Barring some exogenous shock, our base case for 2020 involves positive economic growth in the U.S., continued low inflation, mostly stable employment, and benign monetary policy with little-to-no interest rate policy changes.

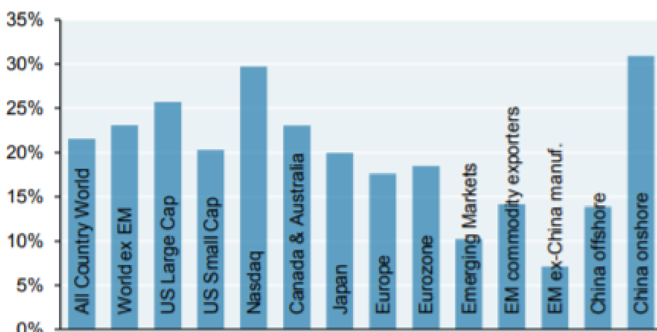
Performance

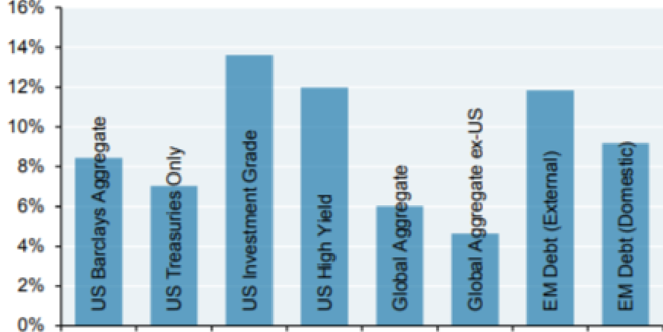
Most major equity asset classes advanced in November; bonds were more mixed (see table below).

	Nov.	2019 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.25	7.21	3.57	4.34	US Muni Bonds
BarCap US Agg Bond TR USD	-0.05	8.79	3.08	3.59	US Taxable Bonds
BoAML US High Yield Master II TR USD	0.27	12.07	5.38	7.61	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-0.48	12.77	5.32	6.73	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-1.82	8.97	0.71	2.25	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	0.88	9.38	1.16	1.03	Hybrid/Hedged Equity
DJ Industrial Average TR USD	4.11	23.05	12.20	13.30	US Equity -- Large
S&P 500 TR	3.63	27.63	10.98	13.44	US Equity -- Large
NASDAQ Composite TR USD	4.64	31.91	13.86	16.30	US Equity -- Large
Russell 1000 TR USD	3.78	27.74	10.80	13.49	US Equity -- Large
Russell Mid Cap TR USD	3.57	27.61	8.88	13.56	US Equity -- Mid-sized
Russell 2000 TR USD	4.12	22.01	8.22	12.38	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	0.88	16.47	3.85	4.74	Int'l Equity -- Comprehensive
MSCI EM NR USD	-0.14	10.20	3.12	3.33	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-2.56	2.52	-6.36	-5.01	Commodities
HFRX Global Hedge Fund USD	1.03	7.31	0.79	1.04	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 11/30/2019

The S&P 500 gained 3.63% on the month, the Russell 1000 Index of large companies gained 3.78%, and the Russell 2000 Index of small companies rose 4.12%. Large-cap and small-cap Russell indices have advanced 27.74% and 22.01%, respectively, for the year through November. The MSCI ACWI Ex-USA Index, a measure of all stocks outside the U.S., inched slightly higher in November by 0.88%, and has posted a gain of 16.47% YTD through November. Although the MSCI Emerging Market Index edged down 0.14% last month, the EM Index is up 10.20% YTD through November. The chart below on the left illustrates these gains for equities, while the chart on the right shows YTD returns for bonds.





The Bloomberg Barclays U.S. Aggregate Bond Index was nearly unchanged in November, dropping by a mere 0.05%. The index is up 8.79% YTD through November. The corresponding Municipal Bond Index rose 0.25%, and it has gained 7.21% YTD. Emerging market bonds were negative for the month, but the magnitude of gains for the two chief indices differed. U.S. dollar-denominated emerging market bonds in the JPMorgan EMBI Global Diversified Index declined 0.48% in November but have gained 12.77% for the year through last month. The local currency EM bond index, the JPMorgan GBI EM Global Diversified Index, dropped more. It was down 1.82% last month, largely on U.S. dollar strength versus the applicable emerging markets currencies. A 50/50 blend of the two EM bond indices has gained 10.87% YTD through November.

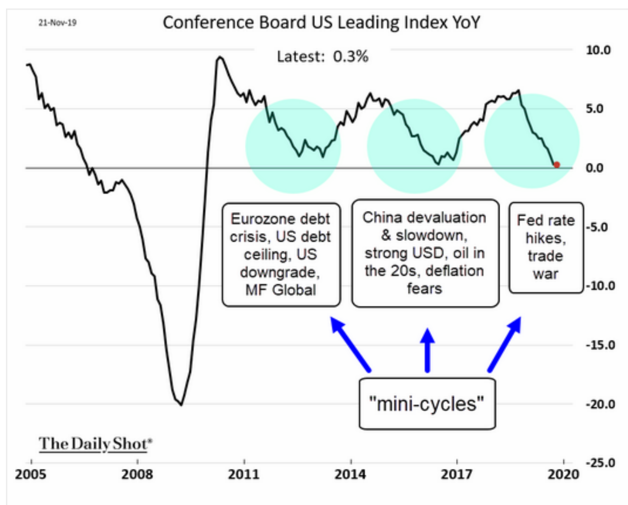
Outlook

We continue to believe that the U.S. economy remains sound and will likely stay on positive footing, perhaps even reaccelerating. However, there are pressures to watch as we enter 2020 that could disrupt general stability.

Q3 GDP growth was revised up from 1.9% to 2.1%, slightly higher than the 2.0% in Q2 and better than expected. Consumer confidence has risen recently (see nearby chart). As we have stated in *Insights* in the past, consumer spending accounts for approximately two-thirds of the overall U.S. economy. Personal income in October (the latest data) was flat, but personal spending increased 0.3% in the month.

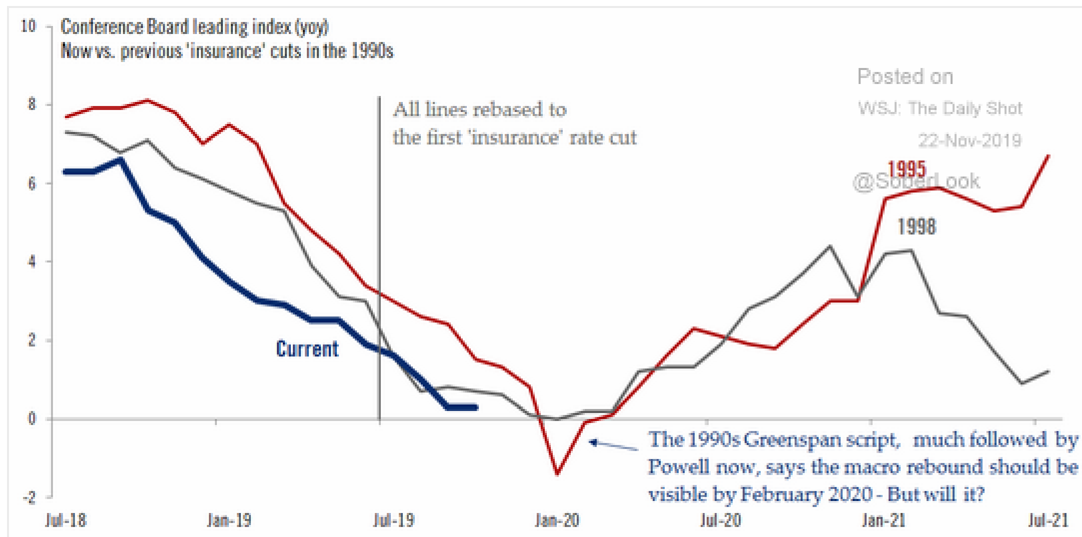
Inflation has continued to be subdued overall. The headline Consumer Price Index (CPI) rose 1.8%, year-over-year, and core CPI, without volatile food and energy components was 2.3%, year-over-year through October. However, the Fed's preferred measure of inflation, the Personal Consumption Expenditures Price Index (PCE) rose just 1.31% year-over-year through October, and the core PCE reading was also lower than CPI, up 1.59% and below the forecasted 1.70% level. As both PCE measures are below the Fed's 2.0% target level, there are few worries at present about overheating inflation. If there had been any worries, the Federal Reserve would not have held rates steady for the first part of the year or lowered them in the second half.

The Fed has in fact engineered what Chairman Powell hopes will function as a series of "insurance cuts," also known as a "mid-cycle adjustment," which are designed to extend the larger economic expansion by igniting a new "mini-cycle." The term mini-cycle refers to ebbs and flows of economic data within an overall economic expansion, particularly in more cyclical industries such as manufacturing, housing, automobiles, etc.



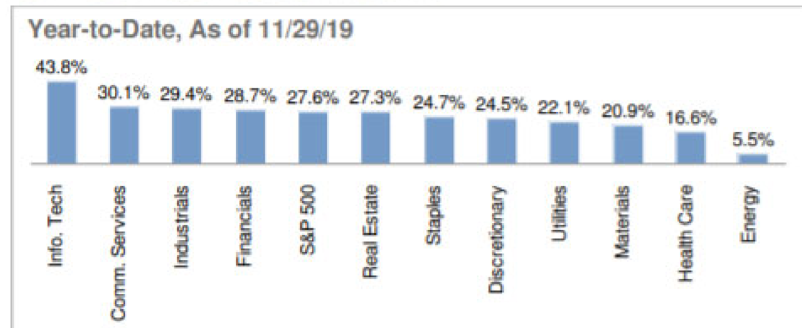
The nearby graphic illustrates this through three mini-cycles based on the Conference Board's index of leading economic indicators, which have all occurred since the last recession in 2009. The U.S. economy has experienced challenges from factors at home and abroad but has navigated them well, with the result that leading indicators picked up rather than point toward contraction. Chairman Powell has stated that a central aim of the Fed's most recent interest rate policy cuts is to foster another pick-up in leading indicators and further extend the U.S. economic expansion.

The graph below uses the same Conference Board leading indicators to compare the Fed's policy moves under Powell to the effects of prior Federal Reserve policy measures under Alan Greenspan in the 1990s. As leading indicators were declining, both Greenspan and Powell preemptively cut policy rates in order to jumpstart the U.S. economy. It takes some time for positive consequences to emerge after monetary policy measures are implemented. If the comparison to Greenspan's "insurance cuts" (i.e., mid-cycle adjustments) in the 1990s is a relevant guide, it may provide evidence for a pick-up in the macro economy in early 2020.



Whether the current Fed's mid-cycle adjustment will have a positive effect is a key question. It remains unclear exactly which way the economic data may turn. Will it turn toward continued deceleration of growth and contractionary readings in various industry reports, or to better-than-expected readings? The uptick in consumer sentiment and consumer spending is encouraging. Wage growth has recently leveled off, but it remains above inflation and could contribute to holiday spending. However, consumer spending and sentiment are both lagging indicators, and so wage growth and employment data may be more important as previews of future economic strength.

U.S. stock market indices in particular this year have risen sharply. All of the sectors in the S&P 500 Index, with the exception of energy, have posted positive returns in the double-digits. Information technology at one extreme (+43.8%) more than balances out energy's more mild 5.5% gain.



Source: Goldman Sachs, Standard & Poors

Although stock prices have in general rocketed higher (the index as a whole is up 27.6%), corporate earnings growth, while better than feared, has been less than impressive. Friction from trade tariffs and fading fiscal stimulus have been the main detractors. Fiscal policy alone should not be counted on to provide a boost in 2020 (especially in an election year). Trade policy friction might ease if there is a Phase One deal between the U.S. and China, but even if there is a comprehensive deal struck in 2020 there may be ongoing effects that drag on corporate earnings as supply chains, for instance, realign and adjust to the new trade policy dynamics. Even with a best-case scenario for the trade policy, investors would still need to confront U.S. equity market valuations.

As you can see from the tables nearby, across large-, mid-, and small-cap U.S. stocks, current valuations are all above their 20-year average price-to-earnings ratio, with the exception of small value stocks. But even small value stocks as a category are nearly fully valued according to this metric (i.e., current P/E is 96% of the 20-year average). That is to say that by this standard the U.S. stock market is fairly or slightly richly valued. Growth stocks are more significantly above their 20-year average than blend or value styles.

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	14.8 / 13.6	17.7 / 15.5	22.6 / 19.2
Mid	15.0 / 14.1	17.9 / 16.1	25.1 / 20.9
Small	15.5 / 16.2	23.2 / 20.4	43.6 / 29.7

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	109.2%	114.1%	117.9%
Mid	106.2%	110.8%	120.4%
Small	96.0%	113.8%	147.0%

Source: JPM Asset Management; as of 11/26/2019

At the same time, given that the currently low interest rate environment is widely anticipated to continue in the near term, stock P/E valuations may be more reasonable than at first glance for two main reasons. One is that bonds may become less attractive to investors, who are likely to shift their assets into equities or other investments with higher return potential than bonds. For example, as of the end of November, the 10-year U.S. Treasury Note yielded only 1.78%. A second reason is that lower interest expenses for companies means lower costs and, therefore, higher profit growth. Higher earnings and profit growth will in turn make for a more attractive valuation relative to the stock price.

What does all of this mean for our economic and investment outlook in 2020?

We will provide a fuller and more updated outlook for 2020 in January. What follows is a brief preview of our outlook on key areas.

- **Overall environment:** There is a high degree of uncertainty amid a wide range of potential outcomes. Factors such as diverging agendas for trade, competition for global dominance, populism, demographic shifts, and technology advances have the potential to unsettle the global economy and investment markets; however, progress or resolution to one or more of these areas may also catalyze economic and investment advances.

- **U.S. GDP growth**: We believe that GDP growth in the U.S. in 2020 will be positive for the calendar year, likely in the 1.5% to 2.25% range. Yet the effects of trade tensions, U.S. presidential election rhetoric, the fading/elimination of fiscal policy stimulus uncertainty, and central bank policy will influence the directional path and magnitude of economic growth. Possible poles range from a shallow recession to accelerating growth near or above 3%.

- **Trade policy**: Our current base case view is that the U.S. and China agree to a Phase One trade deal that provides near-term stability and protections against the imposition of additional tariffs (i.e., no re-escalation). We are doubtful that a more comprehensive deal can be finalized before next fall's U.S. presidential election, but both China and the Trump administration have incentives to reach a partial agreement sooner rather than later.

- **Inflation**: Overall inflation is likely to remain well-contained and run near the Fed's long-term target of 2%. Both headline and core measures of inflation (whether PCE or CPI) may at times run slightly above

2%, but the Fed has indicated that it will tolerate somewhat higher readings for a time as a way to balance out longer stretches of sub-2% inflation.

- **Monetary policy**: Given the likelihood for steady, trend-like growth in the 2% range and low inflation, along with geopolitical risks to the global economy, we think that global central banks in especially developed markets will remain generally accommodative. At present we do not anticipate that the U.S. Fed will raise rates at all in 2020, and we think that it is most likely for the Fed to hold rates steady or cut only once in 2020. However, if economic conditions deteriorate, we think that the Fed may cut two or three times.

- **Employment/labor market**: There may be some incremental gains in employment, but on the whole we think that the unemployment rate is likely to remain within a narrow range of between 3.2% to 3.8%. Currently it is 3.5% as of the November release.

- **Base Case Summary**: Putting this together, our base case forecast anticipates a benign Federal Reserve, steady if unspectacular U.S. GDP growth, well-contained inflation, stable unemployment conditions, yet high uncertainty of outcomes and periods of increased volatility amid geopolitical risks, questions about presidential campaign platform rhetoric and reality, incompletely resolved trade tensions, lower corporate earnings, and low global growth.

- **Investment implications**: If this outlook is correct, then …

    - U.S. bond yields will likely trade within a range but not suffer a sustained spike higher. The 10-year Treasury yield might fluctuate on average between 1.75% and 2.25% at the high end, although we see a chance that it could go lower if conditions turn out much weaker than we anticipate.
    - U.S. stocks would, we think, likely also appreciate modestly, although their multi-year above-historical-average return levels must be taken into account. It is difficult, even with low interest rates, for us to think that the S&P will continue to sustain its 10-year annualized return of nearly 13.5%.
    - Foreign bonds in developed countries may be pressured, not because of hawkish monetary policy moves in places like Japan or Europe, but because so many negative-yielding bonds are not likely to go much more negative and currently have low yields overall. Higher yields and some better economic trends in emerging market (EM) countries make EM bonds more attractive in comparison.
    - Foreign stocks face similar conditions. Stabilization may return to some developed areas like Europe, where Germany has just narrowly escaped falling into a technical recession, but clear catalysts for sustained growth are not evident. Conditions for EM stocks by comparison may point to a better return opportunity.

Conclusion

The U.S. economy has remained solid, although GDP growth globally has been decelerating, a trend that may well continue for the next couple of quarters. As we look ahead to 2020, we think that the future investment landscape is likely to be shaped by the tug of war between accommodative global central bank policies acting to

bolster sentiment and markets, on the one hand, and decelerating economic growth and uncertain or shaky fundamentals amid various geopolitical risks, on the other hand.

There are reasons to believe that the Fed's proactive interest rate policy reductions up to this point and its resumption of balance sheet expansion through various asset purchases may produce economic fruit. The movement toward a Phase One trade deal between the U.S. and China has helped to reduce market tensions about a further escalation in the trade dispute between the two economic giants. Whether such a deal is completed should become clear within the next week or so, since additional tariffs on Chinese goods are scheduled to go into effect on December 15, and a Phase One deal would ostensibly avoid that outcome.

Next year may see periods of increased volatility, which could create some investment opportunities. We have over the last year made asset class positioning closer to neutral in areas like equities, and we have readied ourselves to take advantage of opportunities that may arise going into such an environment.

As 2019 concludes, we continue to be grateful for the trust that our clients place in us daily to shepherd their portfolios and seek to enhance their overall financial lives.

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