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Traub Capital 2020 Q1 Outlook

Background
There is not a lot of insight to be gained by looking at 2019 all by itself. Equity returns for the year were exceptional. The S&P 500 return was 31% with dividends included. Much of that return, however, stemmed from volatility, rather than from any long-term effect. The volatility impact was the rebound from the fairly sharp downturn experienced in the last quarter of 2018. In December of 2018, doom and gloom were pervasive, but our analysis concluded that the downturn would most likely be a short term one. We were very glad to see that the downturn was indeed short-term, as we had concluded and that staying invested or adding to stock exposure turned out to have been the best strategy.

Better insight into the future can be garnered from at least making an attempt to filter out the volatility represented by looking at either 2018 or 2019 in isolation and trying instead to identify a trend. Looking at two years gives at least an approximation of the trend since the short-term drop and subsequent rapid recovery are filtered out. Taken together, the return for the two years, 2018 and 2019, is 12% per year with dividends reinvested and that 12% is just a touch over the very long-term annual return for US equities of 10.5% since the formulation of the modern S&P 500 index in 1957. (Note that you can get longer-term statistics by looking at the Dow Jones Average, which goes back to the beginning of the 1900's. However, not much insight is so gained as the long-term annual investment return is just about the same at 10%.)

So, comparing the average annual return of 12% over the past two years, to the long-term return of 10.5% per year does not show much difference. As hard as it might be to accept, perhaps we should just conclude that the past couple of years were pretty average. Then for a "forecast" we could tack another 10% return for 2020, since that is about the long-term average, and call it a day. Simply adding 10% might wind up not that far from where the S&P 500 will be at the end of 2020 but that projection would be pretty simplistic and most likely rather unsound, as it would ignore any impact from the US economy, or from any other factors for that matter. Just calling for another 10% would be indeed way high if the US economy were headed into a tailspin, and it would probably be too low if the US economic picture was proven to be overwhelmingly bright, especially if coupled with euphoric optimism among investors. That said, however, looking at 65 years of history is not a bad place to start. The trouble is that stock market returns rarely produce around the long-term average. In fact, only 6.5% of all years actually produce an equity return between 8% to 12%. So rather than just forecast an "average" return, it would be important to look at the other factors to see how they all might add up.

Depressing the Equity Markets

Since WWII, there have been 11 economic recessions and eight bear markets (defined as a decline of 20% or more in the S&P 500 Index). With the exceptions of the 1962 and the 1987 bear markets, each of the other six bear markets has been accompanied by a recession. Three recessions did lead to substantial declines in the stock market, but not quite reaching the 20% threshold and the market plowed ahead during the other two recessions.

The conclusion is warranted that a recession generally, but not always, leads to a significant stock market decline; and there are other, but less frequent reasons that also can lead to a major stock market decline.

Rule Out Recession

Looking ahead, let's assess the recession risk and that risk is small indeed. The US economic picture continues to be extremely good. Job creation remains very strong and inflation is creeping up, but it remains low and should not get much over 2% in 2020. Unemployment continues to run at record low levels. Productivity gains continue to cancel out most, if not all wage gains, keeping a lid on price increases and helping to maintain corporate profit levels. Housing starts continue to hold steady at 1.3 million.

With steady, low inflation, it is unlikely that the Fed will raise their short term Federal Funds rate, which is generally a key factor in the market direction, where increases in the rate generally portend lower levels of the market. We project the Fed to hold the Federal Funds rate throughout 2020. The 10-year Treasury rate should continue its gradual ascent, which starts the year at 1.9% and we project it to finish at 2.1%. We have discussed the "Yield Curve" in recent outlooks and dismissed the headline clamoring about the "Inverted Yield Curve" and its resulting equity market decline. With very small increases in long-term interest rates and a steady Federal Funds rate of 1.5%, the Yield Curve will retain its normal upward slope.

The "Trade War", which garnered so many headlines, is easing and even if it were not, the impact would not be huge. These positive factors will boost the US economy to healthy growth of about 2.5% in real terms.

Overseas: in Europe, we will continue to see very low growth in the 1.5% range which is not much different than we have seen in the last decade. In Japan, growth will be down a tick from 0.7% to 0.4%. In China, the economic picture will be sufficiently stable as they continue to work on their banking problems and pick away at structural reforms to bring more control to their provincial governments. Growth rates in China will decline from the 7% range of the recent past down to a bit under 6%. However, growth of almost 6% on the world's second largest economy is still a very big number and the waning "Trade War" should provide a bit more economic stability and should open markets a bit more for Western companies, which will also be favorable for corporate profits.

All-in-all, it is a bright economic picture, particularly for the US. The risk of recession is very low for 2020. We should not see a negative impact on the equity markets from a projected economic downturn.

Declining Uncertainty

Markets hate uncertainty and as 2020 unfolds, we should see less of it. Political uncertainty will decline. The democratic presidential field will narrow down and it will be clear who will become President by November, if not sooner. With a split Congress and the focus on the Presidential elections, no substantive legislation will be passed that would result in a major reallocation of wealth this year. The headline grabbing "Trade War" rhetoric will die down as it becomes "old news". As far as the markets are concerned, less uncertainty is a good thing.

We should note that while we are expecting uncertainty to decline, the potential for Elizabeth Warren or Bernie Sanders to win the presidency is greater than zero. Should either of these candidates win, we can expect to see a detrimental impact in stock market prices. Once installed in office, passing their legislative agenda will be quite another matter and when it becomes clear that that agenda will not be implemented intact, the markets would recover, but likely not until 2021.

Corporate Earnings

Corporate earnings were disappointing in 2019 to say the least. The year began with an expected increase in S&P 500 earnings in the 8 to 10% range. That earnings growth evaporated as the year ensued, and finished with just a 2% gain. A chunk of the decline was due to a bit of a decline in the price of oil, which hurt energy stocks, but lower energy prices should have helped the balance of the corporate sectors and we did not see that happen. Interestingly, in spite of not getting the earnings forecast correct, the markets seemed to ignore the lack of expected growth. The perverse nexus between corporate earnings and market prices is even clearer when looking down to the sector level. Most notably, there was no increase in earnings for the Information Technology group, yet the market prices for that sector increased almost 50%. The only sector where earnings decline was reflected in the respective decline in market prices was in the Materials Sector, where earnings declined 16% and the market price for the sector declined 18%.

For 2020, earnings for the S&P 500 companies are expected to increase 9.7%[1]. We believe that this level of earnings increase is already discounted in the current price levels for the overall market. For 2021, we project another 7% increase in earnings. With the 9.7% increase in earnings expected in 2020, the price to earnings (P/E) multiple is now 17.7 times forward projected earnings which is a value that is higher than the recent historical average, but way less than the mid 20's that occurred during the asset bubble of 2000. In fact, today's forward earnings multiple of 17.7 times is just a tad under the average forward P/E ratio from 1982, which is 17.9x. The conclusion from the earnings is that market valuations are presently a bit higher than "normal" but not alarmingly so.

[1] Factset

And when one considers the abnormally low interest rates compared to history, we believe the current premium in the P/E multiple is justified. Lower rates lead to higher multiples and vice versa.

Investor Sentiment and Flow of Funds

Throughout 2019, funds have been consistently flowing out of the equity sectors of the market and into the bond sectors. At the same time, investor sentiment as measured by the American Association of Individual Investors has been dour. In the past two months, however, investor sentiment has increased substantially. This optimism has not yet been reflected in the flow of funds. However, it is quite possible that investor sentiment will continue to improve and with it, it is quite possible that money will start flowing back into the equity sector and out of bonds. The impact of these two factors could be quite substantial, but very hard to predict. We do expect, however, that the net impact in 2020 will be positive for equity prices. The unfortunate consequence of over trend positive sentiment is over trend equity prices and over trend market prices will be a setup for a subsequent year decline. We will need to watch this trend and if we see euphoria start creeping in, then 2020 will prove better than expected, but it will diminish the chances for a good year in 2021 and a reason for us to become progressively defensive during the coming year.

Everybody Else

We think that investors are generally agreed that the market is hard to predict, yet there are many (including us) that continue to make predictions. For 2020, the average of the predictions including dividends is up 5.5%[2]. At any given time, the generally expected view of the market is already priced in so the market rarely does what is generally expected. Given the generally favorable economic environment that we expect, we can comfortably eliminate substantial negative returns and we don't expect low positive returns since that is already priced in.

Marginally Higher Interest Rates

We do expect longer term interest rates to be a bit higher next year. Higher interest rates equate to higher discount rates and lower price to earnings ratios. The projected increase in intermediate to long-term interest rates is the one variable that dampens our enthusiasm for 2020.

Our Prediction

Economic evidence points to a favorable environment for the equity markets in 2020. The positive factors include good earnings, low inflation, generally good economic conditions, falling uncertainty. The increase in interest rates puts a slight damper on the outlook, so our best guess for the equity markets by this time next year is an increase of 8 to 10%. We do believe that it is possible that an increase in investor sentiment will nudge more funds to flow into equities and boost prices higher, so there is a distinct possibility that returns for next year could be higher, or even substantially higher than a positive 10%. We also note that our old friend "volatility" will be with us again in 2020. The volatility factor could make a plus or minus 10% impact when measured at a specific

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[2] Market Watch

point in time including year-end. However, as we have seen volatility tends to be transient.

As always, we appreciate the faith that you have put into Traub Capital in 2019 and we will continue our quest to maintain that trust in the coming years. Please do not hesitate to contact us should you desire more information on any aspect of our economic outlook and we look forward to working with you in the upcoming years.   Also, as a reminder, we are happy to work with you on any financial planning issues that you may face. We have a done a fair number of retirement planning analyses this past year and would be happy to prepare a retirement report for any of our clients.