STRATEGY RESEARCH

Michael Murphy, CFA
Chief Investment Officer

January 2020

1879 Advisors 2020 Outlook

The trade war and an aggressive Fed in 2018 have slowed the economy since the start of 2019. The manufacturing sector has been notably weak while continued job growth has left consumers relatively better off.

For 2020, we expect modest GDP growth ranging from 1% to perhaps 3%. Growth in this range would ensure a dormant Fed leaving the trade war, Brexit and the US Presidential election as the main macroeconomic issues facing investors. A demographic concern that is becoming more apparent is the dramatic decline in US population growth that is shrinking the pool of available workers.

Equities should benefit from moderate earnings growth which combined with dividends and share repurchases, should lead to returns close to long-term averages. Valuations have recovered the declines sustained in the late-2018 equity market sell-off and stocks now appear to be fairly valued given low interest rates, making earnings growth the main driver of expected returns. Our bottom-up equity forecasting models, based on consensus earnings estimates, point towards potential returns in the 9-11% range.

Fixed income markets are more difficult to forecast. Yields are low but could move 100bps in either direction depending on economic performance. Corporate and high yield bonds offer little value and almost no cushion in the event of rising defaults, while municipal bond valuations look more attractive, especially in the 5-15y section of the yield curve.

2020 should be an exciting year for investors but one we believe will look rather average when all is said and done.

1879 Advisors
119 Birch Hill Road
Locust Valley, NY 11560
(800) 433–0323
info@1879advisors.com
Member SIPC

2019 in review

A year ago, US equity markets were falling dramatically as investors perceived that US Federal Reserve policies were beginning to restrict economic growth. The Fed was pursuing a policy of sustained interest rate hikes while simultaneously undoing its quantitative easing strategy. At the same time, uncertainty surrounding US trade policy unnerved investors. By Christmas Eve, the S&P 500 had declined by almost 20%.

The Fed's actions in 2018 had their intended effect and the US economy has weakened consistently since the start of 2019. Year-on-year GDP growth slowed to 2.1% from the 3.1% pace a year ago with the business sector weakening sharply. Consumers have fared better, buoyed by continued employment gains and modest leverage levels. Net exports — the trade deficit — continues to be a modest drag on GDP growth but otherwise is of little economic import.

Despite the challenging macroeconomic environment, the S&P 500 managed to turn in outsized gains, more than rebounding from the sharp market sell-off at the end of last year. The index is up over 31% as of mid-December, well ahead of long-term averages. What's in store for investors for 2020?

We believe macroeconomic risks will ease next year with the Fed largely on the sidelines, some kind of trade détente negotiated with China and a conclusion to Britain's Brexit saga. The US Presidential election will likely be the dominant issue consuming investors with electoral vicissitudes potentially creating volatility in both stock and bond markets. Consensus GDP growth forecasts call for the US economy to grow at a sub-2% rate next year with even the Federal Reserve Board predicting only a 2% increase. Exhibit 3 shows recent Fed activity and that futures markets are pricing in little activity over the next two years.

Our internal model, which is based on analyst consensus revenue forecasts shows, agrees with the consensus in expecting moderate growth, but easing of macro tensions could lead to stronger growth.

Economic outlook

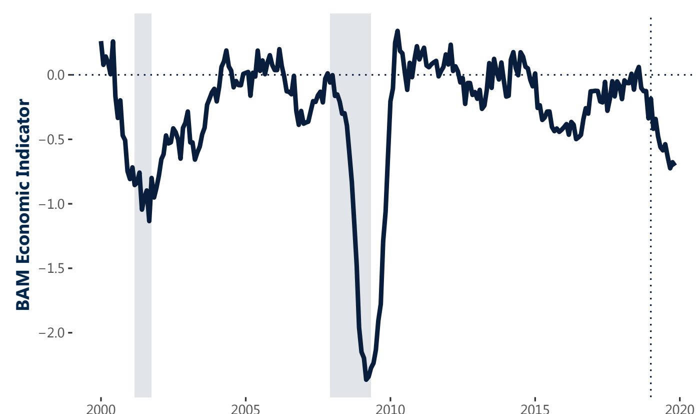
2018 was marked by two main macroeconomic issues: first, as we pointed out in our 2019 Market Outlook, the Fed was aggressively tightening monetary policy by both raising rates and shrinking its balance sheet with no evident inflationary pressures; and, second, investor realization that the 'trade war' was actually going to occur. The trade war, in particular, seemed to cause a sharp reduction in business sentiment and ultimately investment. Exhibit 1 shows our proprietary BAM Economic Indicator began slowing in early 2019 and fell consistently throughout the year. Exhibit 2 shows year-on-year growth in the main GDP components with business slowing sharply and consumer spending holding up.

As we look ahead to 2020, some of these macro headwinds should abate but will be replaced by concerns regarding the 2020 presidential election. The Fed is likely to be on hold throughout next year as it has committed to holding off on rate increases until inflation rises well above its 2% target. A sidelined Fed will remove a significant source of potential market volatility.

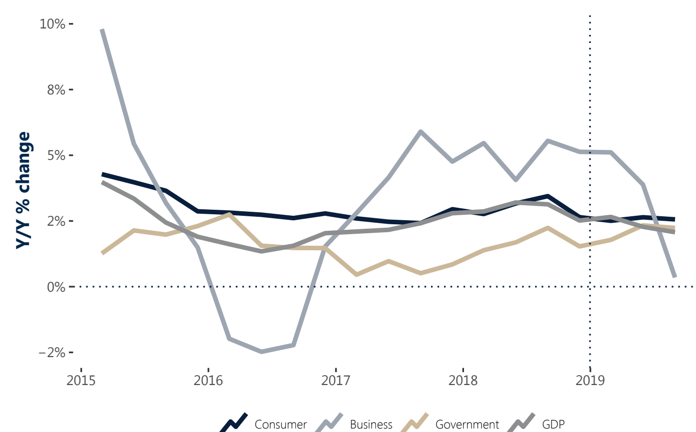
Trade negotiations appear to be making progress with the US and China announcing an agreement on the first phase of a trade deal. We expect thawing of trade relations to bring a recovery in corporate investment in 2020.

The corporate slowdown seems to have barely registered with consumers as continued payroll gains buoy confidence. Retail sales have slowed somewhat from the lofty values seen last year but continue to post growth of around 3%. Consumer debt levels remain in control and the housing market contin-

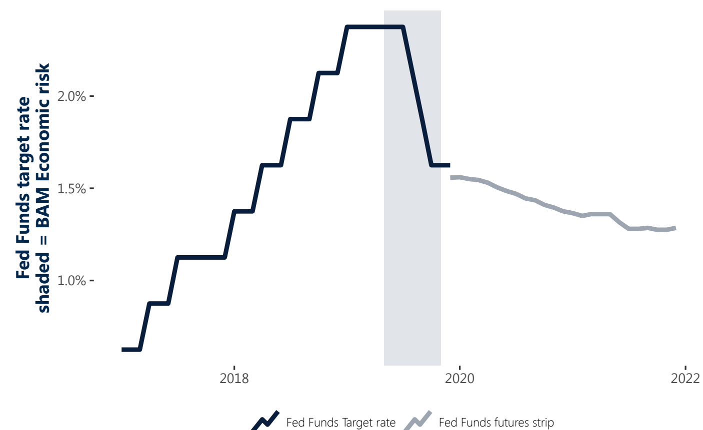
Ex. 1: BAM Economic Indicator



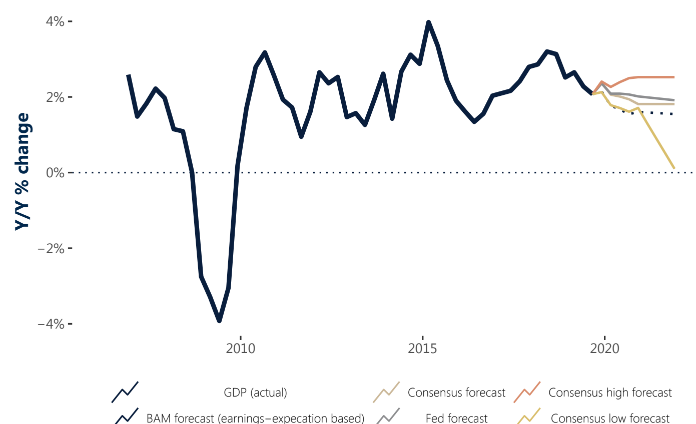
Ex. 2: GDP components y/y growth



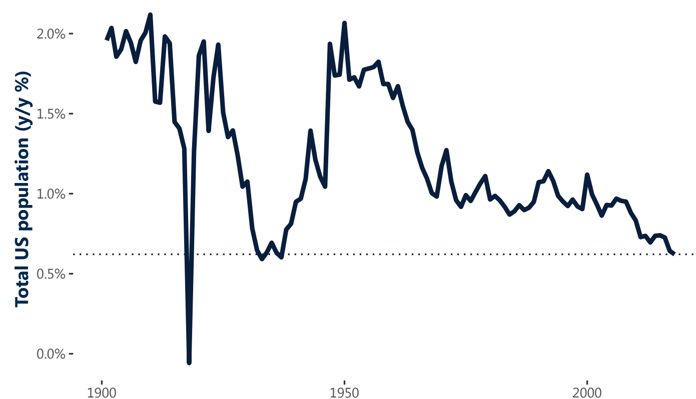
Ex. 3: Fed Funds and futures yields



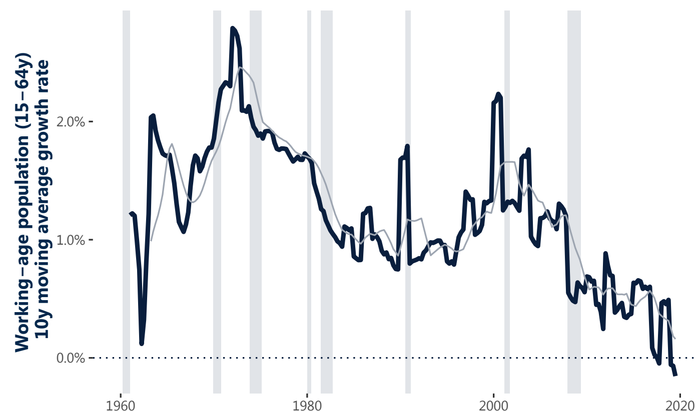
Ex. 4: GDP growth and 2020-2021 forecasts



Ex. 5: US population growth 1900-2019



Ex. 6: US prime working age population (y/y growth)



ues to provide support leading us to conclude that consumer spending will forestall any real chance of recession. Any weakening in spending, however, will significantly increase the chances of recession.

Recession risks remain elevated but we are cautiously optimistic that easing of macro tensions will forestall recession through at least the end of 2020. Consensus economists' GDP forecasts call for growth of 1.8% next year with estimates ranging from 1.5% to as high as 2.5%. The Federal Reserve Board 'dotplot' forecast shows FRB members expect growth of 2% in 2020. Using consensus analyst revenue forecasts for individual S&P 500 companies, we estimate potential GDP growth at the lower end of forecasts but there is the possibility of upside surprise. Exhibit 4 shows recent GDP growth along with the range of analysts forecasts. Economists are generally in agreement that the economy will avoid recession in 2020 with one or two predicting a more dramatic slowdown in 2021.

GDP growth trends have declined since the end of the financial crisis. In the ten years before the crisis, from 1997 through 2007, GDP growth averaged 3.2%. In the ten years since, growth has slowed to 1.8%. Why is economic growth so slow?

We believe one possible reason for slow growth is the sharp decline in US population growth. Looking back on annual population data since 1900 shows that population growth has slowed dramatically since the end of the crisis and the only slowed periods in the last 120 years have been during the Great Depression and the 1918 Spanish influenza pandemic that killed 50 million worldwide (Exhibit 5).

The US had previously enjoyed much higher population growth than its developed market rivals but demographic trends and, we believe, economic insecurity, have caught up. In addition to the overall aging of the population as the baby boomer generation ages, fertility rates have declined to record lows since the financial crisis as women have fewer children. The fertility rate declined to 1.77 children born per woman in the US in 2018, well below the 2.1 rate where births offset deaths. In addition, the accidental death rate has soared in the US, rising nearly 75% since 2000. Accidental deaths include preventable deaths from drugs, alcohol, suicide and firearms and are now collectively the third leading cause of death in the US. The accidental death rate has risen so dramatically that life expectancy in the US has declined for the last four years straight, the only developed market country where this has occurred. Finally, immigration to the US has slowed since the financial crisis and is now at the lowest levels in the past sixty years.

These demographic trends have resulted in a shrinking working-age population. On a year-over-year basis, the population of workers fell by 0.15% (Exhibit 6). Annual growth in workers averaged 1.4% per year prior to the financial crisis and only 0.4% since. A growing population adds both workers and consumers to the economy and, although interactions can be complex, generally results in faster economic growth. Without faster population or productivity growth, the US is set to experience worker shortages, some of which have already been reported in the retail, health care and transportation industries.

The shrinking worker population is one possible explanation for record low unemployment rates. The long, slow and incomplete recovery from the financial crisis has lead to an increased sense of economic insecurity and that has dramatically impacted population growth. Below average economic growth is likely until these trends reverse.

Fixed income outlook

After briefly inverting during the summer, the US treasury yield curve has steepened to about 25 basis points, about where it has hovered for most of the year. Yields remain low. and the 10-year yield could just as easily go up 100bps on economic strength or fall 100bps on economic weakness leading to poor risk / reward (Exhibit 7) from yield, term and duration perspectives.

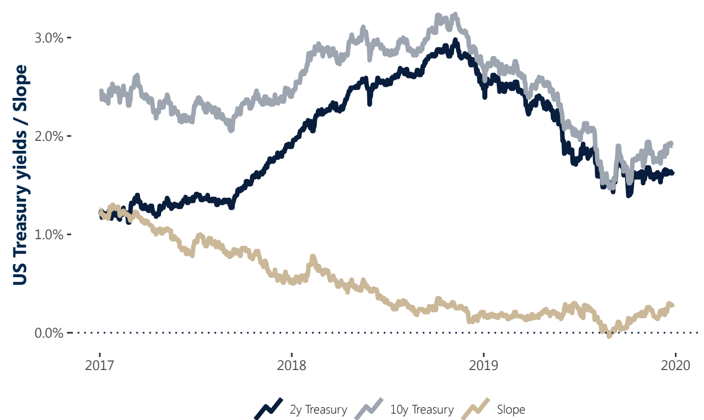
Inverted yield curves have famously predicted the last several recessions. However, we don't believe the brief inversion experienced last August should be interpreted as a recession signal,. First, markets in August experienced below-average levels of liquidity as traders enjoyed summer holidays. Also, prior to previous recessions, yield curve inversions were prolonged, some lasting for several months while the inversion in August lasted for only the three trading days prior to the Labor Day holiday.

Despite being the subject of much concern in 2019, corporate credit spreads remain near historic lows. When considering taxes and potential credit risks, corporate credit spreads remain unattractive. Investment-grade spreads look a bit better than high yield but both are vulnerable to an uptick in default rates. Exhibit 8 shows credit spreads after taxes (maximum Federal tax rate of 37%) and net of long-term average default rates of 4 bps for investment grade and 175 bps for high yield. By these measures investment-grade looks more attractive than high yield credit which we would avoid.

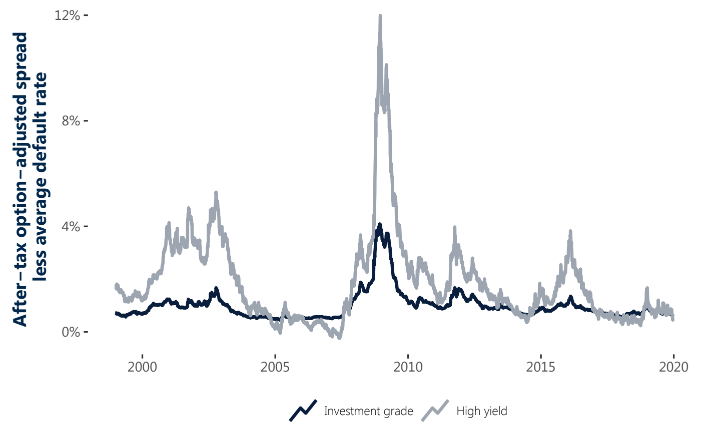
Municipal bonds look more attractive than corporate credit. Muni yields had tightened relative to treasuries in early 2019 as investors sought to shelter income. The 2018 tax reform legislation limited tax deductions for mortgage interest and state and local taxes causing investors to look to municipal bonds to reduce tax bills. Yields have recovered since then, although levels remain low, and municipal bonds show better relative value (Exhibit 9).

Within munis, yields begin to pick up as investors move out on the curve. We see the most attractive opportunities in the 5-15 year range. New York bonds look expensive at the short end but offer relative value after five years. Connecticut bonds also offer potential relative value as the state continues to make progress in addressing its fiscal woes. New Jersey may see another leg down as it has been slower to deal with its underfunded pension and New Jersey Transit systems.

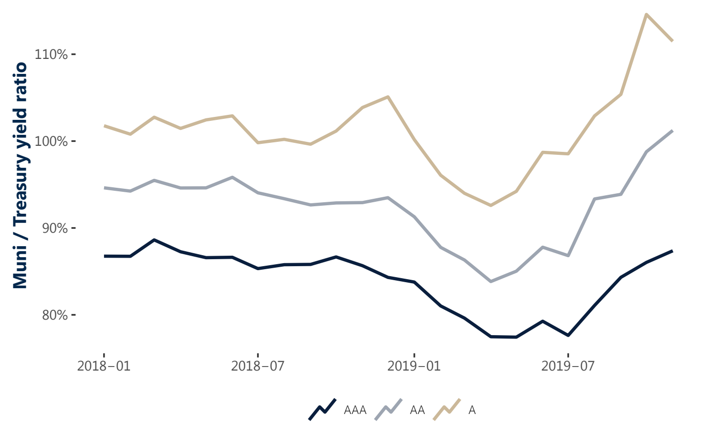
Ex. 7: US treasury yield curve slope



Ex. 8: Credit spreads, net of long-term default rates



Ex. 9: Muni yields as % of treasury yields



Equity outlook

Equity markets in 2019 turned in a stellar year with the S&P 500 rising near 30%. About 10 percentage points of that gain came from earnings growth, dividends and share repurchases, with the bulk, about 20%, coming from multiple expansion.

Heading into 2020, analysts are forecasting earnings growth of 7.5%, about the same as in 2019 (Exhibit 10). Earnings growth at this level is consistent with GDP growth in the 1-3% range. It explicitly assumes companies will increase margins.

Valuation multiples have recovered from the late-2018 correction and have returned to near all-time highs after the strong late-year rally. At these levels, equities look to be modestly overvalued. Even considering expected earnings growth for 2020 and 2021, the enterprise value / EBITDA multiple is still about 12x (Exhibit 11). When considering the low level of interest rates, however, valuation multiples look more reasonable (Exhibit 12). While we are willing to concede that low treasury yields warrant high multiples, we expect some valuation adjustment to occur in 2020 and do not believe equity markets will repeat the outsized gains seen in 2020.

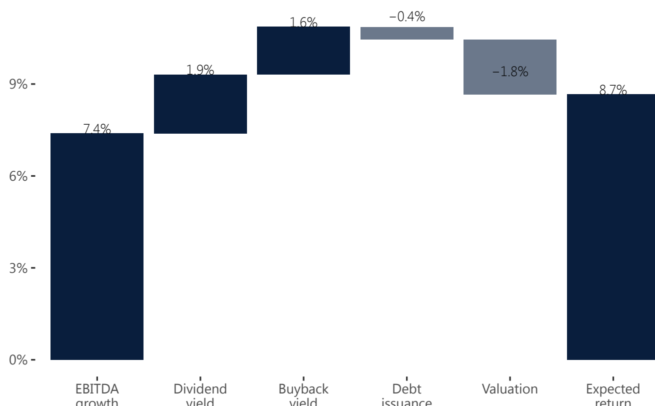
We employ a total shareholder return (TSR) approach to forecasting equity returns and that model performed pretty well in 2019, predicting gains of 24%. For 2020, our TSR model predicts gains of 8.7% comprising 7.4% from earnings growth, 1.9% from dividend yields, 1.5% from stock repurchases offset by 0.4% from debt issuance and 1.8% from expected valuation contraction. Equity returns of 8.7%, while much lower than 2019 returns, would be close to the long-term average return of 7.7%. Exhibit 13 shows how the TSR model builds from earnings growth.

Asset allocation

Translating our 2020 outlook into asset allocation recommendations:

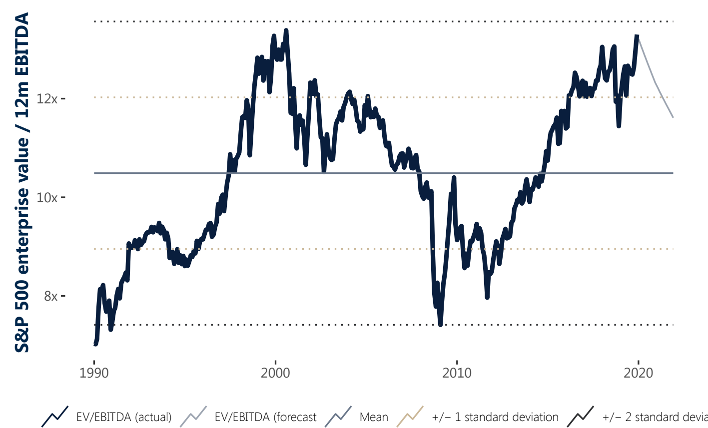
- Cash - overweight by 5-10%
- Fixed income - underweight by 5-10%; avoid high yield credit, neutral on municipals
- Equities - neutral weight - reduce on continued multiple expansion, increase on dips

Ex. 13: 2020 expected return bridge



Ex. 10: S&P 500 EBITDA growth

Ex. 11: S&P EV / EBITDA multiple



Ex. 12: S&P earnings yield

- Alternatives - underweight - avoid hedge funds; some attractive opportunities in private credit, real estate

Conclusion

We expect modest GDP growth that will lead to modest equity returns in 2020 as marco headwinds related to the Fed and trade begin to abate. Recession risks are elevated and highly dependent on consumer behavior but we believe recession will not occur in 2020. Equities look to be fairly-to-overvalued and valuation expansion should not be a large source of returns next year. On the fixed income front, yields are low and could swing in either direction depending on economic performance.

As a result, bonds offer little value at these levels. Within fixed income sectors, investment grade corporate bonds look more attractive than high yield which we would avoid and municipal bonds look more attractive than they have recently. Cash should be a proxy for fixed income positions below five years.

References

Kochanek KD, Murphy SL, Xu JQ, Arias E. Deaths: Final data for 2017. National Vital Statistics Reports; vol 68 no 9. Hyattsville, MD: National Center for Health Statistics. 2019.

OECD, "Main Economic Indicators - complete database", Main Economic Indicators (database)

United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects 2019, custom data acquired via website.

U.S. Bureau of Economic Analysis, Gross Domestic Product

U.S. Bureau of Labor Statistics, Productivity and Costs

World Bank, World Development Indicators

Other sources:

Bloomberg LP

Federal Reserve Bank of Saint Louis

US Census Bureau

Bruderman Asset Management calculations.

Disclosures

This material is for your general information. It does not consider the particular investment objectives, financial situation, or needs of individual clients. This material is based upon information obtained from various sources that Bruderman Asset Management, LLC believes to be reliable, but Bruderman Asset Management, LLC makes no representation or warranty with respect to the accuracy or completeness of such information. The mention of a particular security is not intended to represent a specific recommendation, and the view of these holdings may change at any time based on price movements, new research conclusions or changes in risk preference. Views expressed herein are current only as of the date indicated and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in economic growth, corporate profitability, geopolitical conditions, and inflation. Past performance is no guarantee of future results.

Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses. Your individual allocation may be different than the allocation mentioned here due to your unique individual circumstances but is targeted to be in the allocation ranges for your objective. The asset allocation referenced in this material may fluctuate based on asset values, portfolio decisions, and account needs. The asset allocation suggestions referenced in this material do not take the place of a comprehensive financial analysis.

Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results. S&P 500® Index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities. The S&P 500 is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States.

Securities offered through Bruderman Brothers, LLC, an SEC registered broker-dealer, member FINRA and SIPC. Bruderman Asset Management, LLC is an investment adviser registered with the Securities and Exchange Commission (copy of current Form ADV Part 2A is available upon request or at www.advisorinfo.sec.gov) or by contacting Bruderman Asset Management, LLC at (212) 244-1460 with any questions.