Mitch on the Markets

Portfolio Manager Investing Insights

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4 Market Forecasts for 2020

From an economic and capital market standpoint, 2019 might best be remembered as a year where the trade war dealt some light blows to business investment and overall growth, while dovish monetary policy supported a surge in stock prices. Investors who kept their cool at the turn of last year – when downside volatility ripped through the equity markets – were rewarded for their patience.

So, what's ahead for 2020? Below, I offer four forecasts I think could play out in the new year.

Volatility and Correction Coming

If you look at the S&P 500 over the last 38 years (1980-2018), you'll find that not only are corrections frequent, they have been the norm. The average intra-year correction for the S&P 500 since 1980 is -13.9%! In fact, it has been very rare to get a year where the S&P 500 doesn't fall at least -5% at some point within the twelve-month period. It's only happened twice in the last 38 years (1995 and 2017), when the S&P 500 declined just -3% intra-year.

In 2019, the biggest drawdown we saw was -7%, making it a below-average year for equity market volatility.[1] In 2020, I think we're going to see a correction more in-tune with the longer-term average, and I think it would be wise for investors to mentally prepare for it.

History, and the normal and natural nature of stock market corrections, compel my view. But there is also strong evidence that investors are becoming more optimistic and confident, which in my view tends to make the market more vulnerable to selling pressure. The American Association of Individual Investors (AAII) found in its most recent survey that "optimism rose to its highest level in a year, while pessimism fell to an unusually low level."[2] CNN also publishes a Fear & Greed index showing that 'greed' is on the rise. The more that confidence and optimism build, the higher the probability of a correction, in my view.

Further Isolation from China

Markets cheered the most recent truce reached between the U.S. and China, and it feels for now like the world's two biggest economies have hit the pause button on tit-for-tat tariff levying. But recent history suggests, in my view, that China is likely to fail to follow through on some of its promises, or renege on the agreement altogether.

For example, according to U.S. negotiators, China has committed to agricultural purchases to the tune of at least $40 billion for the next two years, an exorbitant amount by historical standards. In fact, $40 billion of agricultural purchases would amount to almost double the record for what China has purchased from American farmers in previous years.[3] China has growing demand for soybeans and pork, sure, but are they really going to double spending to reach the target? China has done enough overpromising and under-delivering over the years for me to remain skeptical.

Cyclical Surprise

I wrote a Mitch on the Markets column in October 2019 where I pointed out that I'd been "observing a notable rotation away from cyclical sectors and towards defensive sectors." I also noted in the column that there were nearly "2.5 times the amount of put options on the S&P 500 Index as there [were] call options, and the cost of hedging [had] soared to one-year highs across several equity benchmarks."[4]

My conclusion: investors were getting too defensive and that opened the door for cyclicals to outperform looking ahead.

Cyclicals have rebounded since, and in 2020 if we have a global economic recovery, we may see corporate earnings growth that spurs this rotation even further. With optimism on the rise and the Fed likely remaining on the sidelines with no plans to tighten, I think cyclical, "growthy" categories will continue to do well and have the possibility to surprise to the upside. However, an investor always has to be somewhat cautious about buying stocks where the earnings growth is anticipated by the market but not yet reflected in earnings estimate revisions.

Income that Isn't Risk-Free

As mentioned above, the Federal Reserve is likely to remain on the sidelines for much of 2020, in my view, unless there is some unforeseen crisis or negative surprise on growth and employment. On a global level, major central banks appear committed to continued easing, which should keep a ceiling on interest rates and risk-free bond yields. For the millions of retirees out there, and for those planning to retire in 2020, that may mean having to look outside of risk-free Treasuries to generate income in your portfolio.

Fortunately, I believe investors can generate yield in other ways without substantially increasing your portfolio's risk profile. For example, you could explore the municipal bond market, investment grade corporate bonds, and even dividend stocks as alternatives to create cash flow in your investment portfolio while controlling for risk.

Bottom Line for Investors

Looking back at the last two decades, we find that equities have returned just higher than +10% in years when real GDP and inflation (as measured by CPI) were both in the range of 1.5% to 2.5%. In my view, the U.S. economy should generate real GDP right in the 2% range for 2020, and I believe inflation should at least notch 1.5%.[5] In other words, I believe conditions should be good for solid, perhaps high mid-single digit growth in the new year.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] J.P. Morgan, Guide to the Markets, November 30, 2019. https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets/viewer

[2] American Association of Individual Investors, December 19, 2019. https://www.aaii.com/sentimentsurvey

[3] The Wall Street Journal, December 18, 2019. https://www.wsj.com/articles/chinas-farm-purchase-targets-under-trade-deal-face-skeptics-11576665004

[4] October 21, 2019. https://www.zacksim.com/investors-pricing-much-recession-risk/?div=mitch-on-the-markets

[5] Zacks Investment Management, Nov/Dec Stock Market Outlook Report by John Blank

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- Looking back at 2019, the year of failed IPOs. What happened?
- China kicks off 2020 with signs of stimulus
- Americans are taking cash out of their homes, at what cost?

A Year of Failed IPOs

At the outset of 2019, many investors and fast-growing corporations were excited about the year of IPOs ahead. Baseline expectations were that 2019 would eclipse 1999 as the best year for IPOs raising money in the public markets, which would have meant generating more than $108 billion. But 2019 fell woefully short of that mark, with 211 companies raising just $62.33 billion. Some of the shortfall came from issues out of corporations' control – the government shutdown at the turn of the year led to filing delays for many. But a more compelling reason for the shortfall, in our view, was growing investor concern over frothy valuations, high growth companies with no profits, and management teams that were unproven and lacked experience. Companies like Uber, Lyft, Pinterest, and Slack all had high hopes, name recognition, and fast growth rates, but many investors who got in early are still underwater on their investment. According to Dealogic, shares of companies that went public this year are trading about 23% above their IPO prices, which lagged the S&P 500's near 30% rise on the year. Isolating only tech companies makes the field of IPOs look worse, with just an 8% gain compared to the Nasdaq's close to 35% gain.[1]

China Starts 2020 With Signals of Stimulus

Coming off a minor breakthrough with Phase 1 of a trade deal with the United States, the People's Bank of China (PBOC) announced at the turn of the year that they are tilting even further towards easy money. Last week, the PBOC said it would lower reserve requirements at commercial banks by 0.5%, meaning that approximately $115 billion would be released into the financial system. Liquidity in China's financial system tends to get tight around the Lunar New Year, but this is also a signal that China remains committed to goosing economic growth particularly as the trade war enters a make-or-break phase. China has also signaled an understanding that it can no longer rely on foreign investment and exports that have maintained high levels of economic growth for the past decade and beyond, as countries grow more protectionist and as the U.S. becomes a more aggressive trading partner.[2]

Americans are Binging on Home Equity Lines of Credit, Again

With the housing market remaining fairly strong and Americans continually financing lifestyle with debt, house refinancings are on the rise. According to mortgage-data firm Black Knight, nearly 60% of 2018 refinancings came at higher interest rates – the biggest share since before the financial crisis. Homeowners are taking out money at rates and at a pace much higher than the average from 2009 to 2017. While some are using the cash for investments or property renovations – which can increase property values – many are using the money to pay off credit cards, swapping one type of debt for another.[3]

ZACKS INVESTMENT MANAGEMENT, INC.
www.zackspcg.com

[1] The Wall Street Journal, December 29, 2019. https://www.wsj.com/articles/2019-the-year-of-ipo-disappointment-11577615400?mod=djem10point

[2] The Wall Street Journal, January 2, 2020. https://www.wsj.com/articles/global-stocks-launch-higher-after-chinese-easing-move-11577960257?mod=hp_lead_pos1

[3] The Wall Street Journal, December 29, 2019. https://www.wsj.com/articles/americans-are-taking-cash-out-of-their-homesand-it-is-costing-them-11577529000?mod=djem10point