In 2019, the stock market posted its second-best year of the decade, and bonds logged their best return in 17 years. This is a tough act to follow, so what does 2020 have in store for investors? Here are our views on the year’s key investment questions.

1. Will we see a recession in 2020?
While economic growth will likely slow modestly from 2019, we believe the U.S. economy will avoid a recession in 2020. The current economic expansion (the longest in U.S. history) is set to grow this year due to solid consumer spending, supported by a healthy labor market, high savings rates and low interest rates. Despite this positive consumer outlook, we expect headwinds from slowing global growth, trade tensions and sluggish business investment to keep 2020 growth below the 10-year expansion average.

- Labor markets are healthy, but job growth is leveling off – Monthly job growth decelerated from 223,000 on average in 2018 to 167,000 in 2019. In 2020, we expect job growth to remain a bright spot in the U.S. economy, continuing to decline but staying above the 100,000 level necessary to absorb new entrants. The unemployment rate is likely to remain under 4%. We expect wages to grow faster than consumer prices, which means real incomes should also continue to increase this year.

- Consumer spending will drive growth – We think consumer spending remains solid due to healthy labor markets, steadily rising real incomes and growing optimism around trade. For the first time in six consecutive quarters, the housing sector was a positive driver of growth. Low mortgage rates, a record level of housing wealth (as measured by home equity), stronger sales and a pickup in new construction are signs that housing can remain on the positive side of the ledger in 2020. At 8.3%, the personal savings rate is a full percentage point above the 10-year expansion average, and long-term interest rates are expected to remain below 3% in 2020.

### U.S. GDP Makeup

<table>
<thead>
<tr>
<th>Year</th>
<th>Real GDP % change</th>
<th>Consumption</th>
<th>Investment</th>
<th>Government Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>'16</td>
<td>-2.0%</td>
<td>'16</td>
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<tr>
<td>'17</td>
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<td>'20E</td>
<td>6.0%</td>
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<td>'20E</td>
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1. Source: Bloomberg.
• Sluggish business investment will keep growth modest – Fluctuating trade tensions, slowing global growth and the fading effects of the 2018 tax cut have impacted business investment. As shown in the chart on the previous page, growth in business investment has declined over the past three years.

Despite sluggish investment, companies remain profitable, and the decline in manufacturing activity has yet to spill over into the much larger service sector, which accounts for 70% of the economy. Accommodative global central banks and a stabilizing and improving global economy could serve as catalysts to business investment and help keep the economy growing.

2 Is this the year the bull market ends?

We think the bull market still has some gas left in the tank. While this is the second-longest run on record, there’s no expiration date on bull markets. Instead, they tend to end when recessions emerge or bubbles pop, neither of which we think are imminent. We do believe we remain in the later stages of the cycle, however, with the bull market likely to exhibit the following this year:

• Still more upside – The conditions historically associated with a bear market – recession, tight Federal Reserve policy, excessive valuations and asset bubbles – are not in place, though we’re watching closely. Economic conditions, powered by a healthy consumer, should continue to offer support to the market. We’re heading into year-end with an unemployment rate of 3.6%. Since 1950, 16 years have ended with a rate below 4.5%. In the year that followed, consumer spending grew by an average of 3.1%, and the average stock market return was 9.9%, reflecting a link between the consumer, economic growth and the direction of the market.

• Smaller gains ahead – 2019’s 20%-plus stock market returns won’t likely be replicated this year, in our view. But bad years don’t have to follow great ones: Since 1950, in years when the stock market rose by more than 20%, the average return the next year was 14.8%. Stocks are entering 2020 with valuations slightly above long-term averages, which is reasonable given the economic and interest rate backdrop. But to us, there is limited potential for material expansion in the price-to-earnings ratio. The pace of market gains will be set by the pace of earnings growth, which we think will rise at a mid-single-digit rate.

• Larger, more frequent swings – The market heads into 2020 with daily volatility running below average for the past several months. The largest pullback in 2019 clocked in at just 6.8%, but we doubt this tranquility will continue in the coming year. Political drama, election uncertainties, trade setbacks, misaligned Fed expectations and occasionally underwhelming economic reports will likely overshadow supportive fundamental conditions. The bull market will peak well in advance of the onset of a recession, so the 2021 economic outlook will begin to be priced into the market as we progress through 2020. We don’t think a bear market is likely this year, but the risks mentioned above raise the potential for a correction or periodic pullbacks.
What impact will politics have on the markets?

- **A source of volatility** – Politics will occupy the bulk of the headlines as we progress toward the November election. Elevated uncertainty, the seismic gap between candidates’ proposed policies and the highly polarized political environment will produce a fair bit of volatility as markets attempt to handicap an outcome. Impeachment proceedings potentially cloud the political picture early in the year, but the spotlight is likely to shine brightly on the primary and general elections as the campaign season hits its stride.

  Election years have historically been positive for the market, with an average annual return above 11% and the market rising in 78% of years with a presidential election since 1947. In 2016, the market experienced a 10% correction early in the year, a 5% drop midyear and a 3% decline in the two weeks leading into election day, yet finished the year with a 12% return overall.

- **Not a longer-term market driver** – This election may have a unique feel given the political climate and disparate fundamental views of the candidates. But presidential elections often put opposing views on sharp display. Our expectation is that, regardless of the party that wins the White House, gridlock will prevail in Washington, preventing either administration from implementing a campaign agenda efficiently.

  Don’t base your long-term investment decisions on short-term election-driven volatility. Past experiences show it’s the broader economic backdrop that is typically a more powerful driver of market performance over time. Stocks fell in 1974 (Nixon impeachment) due to a recession and oil shock, while in 1998 (Clinton impeachment), the market rose amid low unemployment, a growing economy and Fed stimulus.

  We don’t expect the market to ignore the political headlines. But with unemployment near a 50-year low, tame inflation and supportive Fed policy, we think fundamental conditions are poised to outweigh the political turmoil over time.

| Average S&P 500 Performance 12 Months Before & After Presidential Elections Since 1947 |
|----------------------------------|----------------------------------|
| **12 months BEFORE election day** | **12 months AFTER election day** |
| ![Graph](chart.png)               | ![Graph](chart.png)              |

Source: FactSet, 1947-2016.

Will interest rates go lower – or even negative – this year?

We think it’s unlikely we’ll see negative interest rates in the U.S. anytime soon, based on our economic outlook, the limited evidence of success negative rates have had elsewhere, and alternative stimulus measures, such as asset purchases, the Fed has available. We expect the U.S. economy to continue to grow modestly this year, with the 10-year Treasury yield rising slightly.

- **Bond yields to rise as recession fears recede** – Last year’s sizable decline in long-term interest rates reflected fears of recession, a slowdown in global growth and expectations of a Fed policy shift. With global growth showing signs of stabilization, trade tensions seemingly easing and market expectations now more aligned with current monetary policy, rates are not likely to fall materially below 2%, in our view.

  Given the improving global backdrop and still-positive U.S. economic growth, the Fed is likely to keep rates on hold after having lowered them three times last year. At the same time, policymakers will be in no hurry to raise rates anytime soon in the absence of inflationary pressures and a slowing U.S. economy. Therefore, we don’t see a sizable rebound in rates, with 10-year Treasury yields staying below their peak in 2018. We see interest rates in the 2% to 2.5% range in 2020, with the low end a more likely outcome.

<table>
<thead>
<tr>
<th>Global Trends Influence Domestic Markets</th>
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5 Will the trade war with China end?

Despite promising rhetoric at the close of the year, the U.S. enters 2020 with no long-term trade agreement with China in place, and we think a comprehensive deal before the November election is unlikely. Even an interim agreement could strengthen the global outlook and be a catalyst for earnings growth this year, however.

- **Trade tensions take a toll in 2019** – Trade accounts for a quarter of the U.S. economy and over half of the global economy. In addition, S&P 500 companies earn about 40% of their revenue from countries outside the U.S. As the chart shows, growth in world trade is projected to fall by more than half to 1.2% in 2019 after accelerating by 3% in 2018. Elevated trade tensions have also led to lower worldwide economic growth in 2019 than two years before.

![Merchandise Trade Volume & Real GDP 2015-2020](chart)

Closer to home, there are signs that trade uncertainty and slowing global growth are affecting U.S. companies. For the third quarter of 2019, S&P 500 companies earning more than half of their revenue outside the U.S. estimated an earnings decline of 7.4%, compared with a 0.4% growth rate for firms earning more domestically.  

- **Trade headlines are likely to prompt market volatility** – In addition to the U.S.-China trade talks, a new trade agreement with Canada and Mexico is still subject to change. As other tariffs and levies are proposed, this adds to the market uncertainty. Despite bumpiness ahead, we expect a rebound in global growth and trade in 2020 as ongoing negotiations lead to updated trade agreements and an eventual easing of trade frictions.

6 Will global markets keep underperforming?

International stocks performed well in 2019 but still trailed U.S. stocks amid trade and other geopolitical uncertainties, a slump in European manufacturing and a slowdown in China. While sluggish growth and trade tensions remain, there are signs global manufacturing may be stabilizing.

- **Manufacturing activity is recovering** – As global growth fizzled, manufacturing activity contracted, with Europe being hit the hardest. Forward-looking business surveys have shown signs of bottoming in economic activity in both emerging and developed markets, and are consistent with a still-soft but improving demand environment. This suggests the manufacturing downcycle may have run its course. At the same time, activity in the services part of most major economies remains relatively robust, and central bank policies are likely to stay accommodative until growth or inflation picks up.

- **Current valuations reflect pessimism** – Even with last year’s rally, global stocks are priced at a significant discount to U.S. stocks. While valuations alone don’t necessarily translate to better short-term results, they have historically been a good predictor of long-term returns. We believe higher dividend yields and better valuations support the possibility of above-average long-term returns for international equities and position them to outperform U.S. large-cap stocks over time.

- **Currency less of a headwind** – In six of the past seven years, the rising dollar reduced returns for international developed stocks by an average of about 3% per year when compared to returns in local currencies. We expect the dollar to flatten or fall as global growth stabilizes and potentially rebounds, increasing the chances of improved returns for U.S. investors.

![Rising Dollar Reduced Returns to U.S. Investors (MSCI EAFE total return %)](chart)

2 Source: World Trade Organization.
3 Source: FactSet, November 2019.
What are the biggest threats?

We see three key threats to the bull market this year:

• **Future central bank action is limited by already low interest rates.** The Fed lowered rates three times in 2019 to ward off too-low inflation and as insurance against elevated risks from trade tensions and weakening global growth. With rates already at historically low levels, the Fed has little room to cut interest rates further. Despite this limitation, we don’t think the Fed will lower rates to negative levels. Instead, they’re likely to use other tools, such as asset purchases, if further monetary stimulus is warranted in 2020.

• **Corporate borrowing is at historically high levels.** While household debt has been shrinking for several years, ultra-low interest rates have led corporate borrowing to grow faster than GDP through most of the current expansion. 2019 saw an increase in riskier forms of debt, including high-yield bonds and leveraged loans. In addition, half of investment-grade debt is around the lowest level of credit quality. An economic downturn could trigger a selloff in the corporate bond market if bonds are downgraded to speculative levels. However, still-low delinquency rates, positive earnings growth and a resilient financial sector make a sizable disruption in corporate bond markets unlikely in 2020, in our view.

• **High budget deficits could hamstring fiscal stimulus if needed.** Despite record-low unemployment and positive economic growth, the U.S. deficit reached $984 billion in 2019 and is projected to average $1.2 trillion between 2020 and 2029.4 Over the next 10 years, deficits will top 4% of GDP, higher than the 50-year average, as mandatory federal spending – especially on Medicare, Medicaid and Social Security – is projected to increase faster than revenue. While rising government debt is unlikely to threaten the bull market in the coming year, at its current trajectory, we do believe it poses a risk longer-term. However, what matters more than the debt and deficit are economic and corporate fundamentals, such as growing economy and solid corporate earnings.

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4 Source: Congressional Budget Office, August 2019.
How should you prepare for 2020?

This year will likely be defined by steady but modest economic growth, persistently low interest rates and rising uncertainties. But markets are unpredictable, especially in the short term. Now is a good time to review your financial goals with your financial advisor and ensure your portfolio aligns with your comfort with risk and required long-term return.

Consider the following for:

- **Higher volatility** – We recommend a neutral allocation to equities and suggest rebalancing if necessary to stay at your long-term allocation between equity and fixed income. Bonds can still protect against short-term market selloffs, as was evident during the late 2018 correction and mid-2019 pullback. More defensive sectors (such as staples, health care, communications and utilities) can help reduce volatility, while appropriate weighting to cyclical sectors (financials, technology, consumer discretionary, industrials, etc.) can provide exposure to ongoing growth.

- **Stabilizing global growth** – Expectations for international markets remain low. We think additional signs of an early rebound in the global economy will provide further support to the recent rally in international stocks. We recommend an overweight allocation to international equities, with a larger allocation to developed-market large-caps and modest exposure to emerging markets.

- **A low-rate environment** – In addition to a core allocation in investment-grade bonds, exposure to high-yield bonds can offer additional portfolio income amid ongoing low rates. We maintain our underweight recommendation to international bonds. Ensure appropriate diversification across maturities. Dividend yields on equities remain attractive relative to current low rates, but remember that stocks are not bond substitutes when it comes to the role of fixed income in providing portfolio stability.