KC Mathews, Chief Investment Officer, Eric Kelley, Director of Investment Research, January 2020

We introduced our economic theme for 2020, "The Dominoes are Wobbling", in August 2019. In the second half of 2019, numerous economic variables, or dominoes, started to wobble, hinting that a potential economic slowdown may be on the horizon.

We expect 2020 to be another year of modest economic growth riddled with uncertainty, which will leave the dominoes wobbling, but not tumbling, into a recession.

The Economy

Last year, we worried about tariffs and the potential devastating impact they could have on the economy. We experienced a temporary inversion of the yield curve, suggesting a recession was imminent. Then, we were faced with a presidential impeachment. The dominoes were clearly wobbling.

However, the cause and effect assumptions we were worrying about may have been misguided. Did all these wobbling dominoes negatively impact economic conditions? The U.S. economy grew at 2.3% in 2019, matching the 10-year average and very close to potential GDP. So, 2.3% growth appears to be reasonable, driven by demographics and productivity, not a trade spat.

Yet as we watched the dominoes wobble and worried about their effects, almost every asset class posted positive returns in the calendar year with the S&P 500 gaining 31.5%. As we start 2020, many economic dominoes continue to wobble.

Big Dominoes that May not Matter

There are some significant issues that threaten economic growth and market performance long-term, but we don't think they will spoil the economy or markets in 2020.

Debt/Entitlements

Today, the U.S. national debt stands at $22 trillion, up $2 trillion since President Donald Trump was elected. Even though this is a serious long-term issue, it's important to remember that this has been a serious concern throughout the recent 10-year economic expansion. So, what will change this year? Probably not much.

Trade

Tariffs and protectionism can be a significant domino: The U.S. witnessed that in the 1930s when tariffs were increased to over 50% on a broad basket of goods. The economic impact was a prolonged depression. Numerous tariffs ranging from 15% to 25% were put in place in 2019. Fortunately, the current trade spat appears to be de-escalating as some of the September tariffs were reduced and the December tariffs were postponed. In addition, President Trump announced that the phase 1 deal, which makes these tariff reductions and postponements official, will be signed on January 15.

However, with all the tough trade talk since 2018, U.S. GDP grew 2.9% in 2018 and 2.3% in 2019. The S&P 500 over the past two years is up 12% annualized.

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Politics

How can a president be impeached and the stock market, a leading indicator, increase by 31.5%? This reinforces the case that politics does not change the underlying fundamentals of the economy. Does anyone remember the government shutdown in January 2019 and the impact on the economy? It was the longest U.S. government shutdown in history and the S&P 500 increased 10.4% while it happened. Since 1976, there have been 22 funding gaps, 10 of which have led to federal employees being furloughed. The evidence suggests that in the long term, politics doesn't matter to the economy and financial markets.

Military Conflict

This is a very serious domino for obvious reasons, with challenging moral, ethical and political ramifications. But from a strictly economic perspective, the risk is not as great. North Korea and the Middle East all present some risk of military conflict; this is not new. Clearly, increasing geopolitical risk is a headwind for consumer sentiment, but it is unclear what impact an unpredictable escalation will have on actual economic growth and stock market earnings.

The U.S. has a long history of military conflicts, both large and small, from the Cuban Missile Crisis to the Gulf War. Economic activity during these periods is largely determined by the underlying fundamentals that were in place before the conflicts. Military action can have temporary negative impacts on consumer sentiment and therefore the economy, but for the intermediate term and beyond, basic economic fundamentals (trend GDP growth, inflation, interest rates) tend to guide the economy back to its natural trajectory.

The Economic Dominoes That Matter in 2020

Labor Market

The labor market matters for several reasons. First, labor market growth is a driver of potential GDP. Currently, labor market growth is 0.5% and the Congressional Budget Office forecasts growth over the next 10 years will be 0.4%.

Second, unemployment ended the year at 3.5%. The U.S. has 7.3 million job openings and the number one concern of small business owners is finding qualified workers. It will be difficult to grow GDP without new workers.

Finally, wage inflation can be a driver of headline inflation. Inflation surprises can lead the Federal Reserve to increase rates quickly, which in turn may be negative for financial markets and the economy. Currently, average hourly earnings are up 3.1% - not a wobbling domino yet.

Interest Rates and the Fed

Inflation can be a significant threat to economic growth and financial markets. In this 10-year expansion, inflation hasn't even been a blip on the radar screen. The Fed's target inflation rate is 2%, using core PCE Index. In 2019, core PCE went down, ranging from 1.5% to 1.8%.

Inflation readings above the Fed's target can cause the Fed to hike short-term rates. As monetary policy tightens, it can hinder corporate profits and economic growth. However, the Fed has recently suggested that it will pause on rate adjustments, watch inflation and economic growth indicators, and wait for evidence that supports changing interest rates.

Given the data, we expect interest rates to remain stable throughout 2020. We don't expect the Fed to take any action until there is a meaningful change in economic conditions.

Equity Markets

The stock market climbs a wall of worry, and there is plenty to worry about. Even though we expect modest economic growth in 2020, it will support revenue and earnings growth for corporate America. Much of the return on the S&P 500 in 2019 came from price/earnings (PE) multiple expansion or a change in valuation.

Valuations are getting a bit stretched. At the beginning of 2019, the forward S&P 500 PE was 15 times earnings. Today, it is approximately 18 times forward earnings. Almost two thirds of the 31.5% return is attributable to multiple expansion.

We don't expect continued multiple expansion in 2020. However, 2% economic growth will allow companies to grow revenues by 4% and earnings by 5%. If the multiple remains stable, stock prices should increase 4-6% in 2020 with a S&P 500 target of 3,400 by year end. We do expect to see heightened volatility in the first half of the year due to investors taking gains and 2020 being a Presidential election year.

The Wobble Continues

There were several economic dominoes that wobbled in 2019 and they will continue to wobble in 2020. Historically, these economic variables can wobble for some time, and even when they fall, the economy has 9-14 months before it officially enters a recession.

The data gives us confidence that the U.S. will not see a recession in 2020. Even though we are in the longest economic expansion in history, we are not experiencing the strongest economy in history. From March 1991 to March 2001, the economy grew 43%. In this expansion, the economy has grown 26%.

We think the economy in 2020 can grow in the range of 1.8-2.2% due to modest labor force growth and productivity gains. The current expansion, which we call the Great Moderation, could beat the record not by a few months, but by a few years.

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