Easy Money Has Already Been Made

Top Investment Themes for 2020

VERDENCE CAPITAL ADVISORS

At the start of 2019, there are few investors who would have predicted such a stellar year no matter what their investment risk tolerance may have been. After the near bear market in 4Q18, investors entered 2019 trying to navigate through a cloud of uncertainty. The U.S. and China were digging their heels in a brutal trade war, bearish sentiment on equities was near the highest level in six years, economic forecasts were being slashed for U.S. and global growth, political uncertainty was rising, consumer confidence was sliding, and the Fed had just raised interest rates for the ninth time in three years.

Fast forward through the final year of the decade, the doom and gloom quickly turned into euphoria and there was no asset class left behind. Stocks, bonds, commodities and hedge funds all sharply rebounded in 2019 with many major equity indices making new record highs. However, it was not exuberance over economic or earnings growth that drove asset classes higher. In fact, U.S. earnings growth was likely relatively flat for the year. Instead it was a globally coordinated reversal from tight monetary policy to a more accommodative stance as all the major G20 countries either kept rates unchanged near historic lows or cut their benchmark rate.

After such a strong year for all the major asset classes and with global equities (i.e. MSCI AC World Index) hovering near record highs it is likely that the easy money for investors has been made in 2019. The global economy is expected to grow but all the economic data suggest another modest year of growth. In addition, while there is little to no evidence that the U.S. economy will slip into a recession over the next 12 months, we expect volatility to accelerate as we move through a Presidential election year, face growing geopolitical tensions and navigate through the longest economic expansion in U.S. history. Below we highlight our five key themes for 2020.

Theme 1: Recession Unlikely in 2020

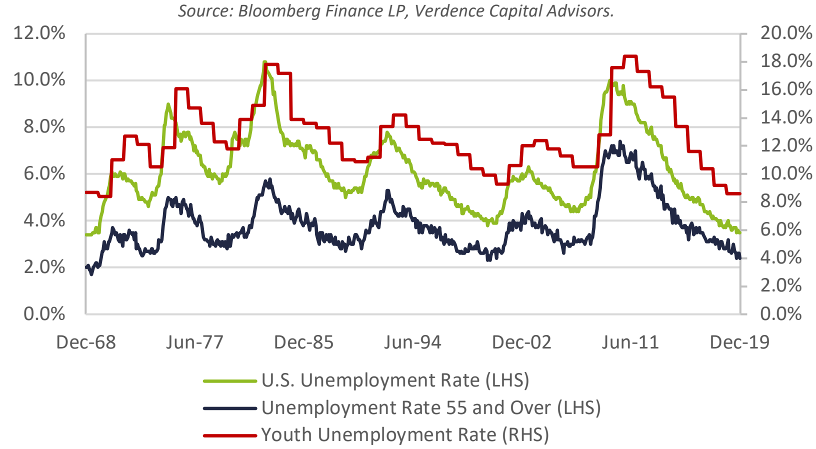
The current U.S. economic expansion is officially the longest in U.S. history surpassing 126 months at the start of 2020. That is impressive by any measure and has spanned the entire 2010s decade. In fact, it is older than many companies that have become entwined in our daily life such as Instagram, Snapchat, Pinterest, Lyft and even older than the first Netflix produced show (i.e. House of Cards). As we navigate through the start of another decade, there is one thing we know for sure. We will have a recession at some point in this decade. However, we do not forecast that we will have to experience that in the next 12 months. Below we list five supportive factors for economic growth in 2020.

1. **Consumer still has wind at its back:** The consumer has been a driving force behind economic growth in recent years. While favorable tax reform may have helped to buoy consumer spending in 2018, there are other supportive factors for the future of the consumer, including:

- **Employment:** Not only does the unemployment rate remain at the lowest level in 50 years but the breadth of the labor market is getting stronger. Even the youth unemployment rate is at the lowest level in 50 years. **(Chart 1).**
- **Healthy balance sheet:** A low interest rate environment, deleveraging and rising incomes have resulted in the household debt service ratio dropping to a record low. In addition, the personal savings rate is well above the historical average suggesting that the consumer is in a good position to withstand unforeseen headwinds (e.g. rising gasoline prices).

Chart 1: Breadth of Labor Market Strong

Footnotes: Data is as of December 2019 with the exception of the youth unemployment rate which is as of 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



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2. **Fed on hold**: While the Federal Reserve will likely keep rates on hold through 2020, interest rates are highly accommodative. In fact, the U.S. economy has never entered a recession when interest rates were this accommodative**. (Chart 2).** In addition, the Fed has started to expand their balance sheet once again. While some of this is technical to support the short-term lending markets, an expansion of the balance sheet is supportive for the economy.

3. **Housing getting a boost:** The 30-year mortgage rate has fallen more than 1% from its 2018 high. As a result, we have seen signs of life emerge in housing. Housing starts are near the highest level since prior to the housing collapse and inventories are tight which supports housing investment. Housing construction may not be a major portion of GDP, but a strong housing market can have far reaching tentacles regarding the net wealth effect, consumer spending (on household furnishings), jobs and construction.

4. **Tax reform still a benefit:** While the bulk of the benefits from the Tax Cuts and Jobs Act may have occurred in 2018 and 2019, we are still seeing companies repatriating cash back to the U.S. from overseas. **(Chart 3).** Since 1Q18, companies have brought back over $1 trillion in revenue from overseas. While part of this is being used for dividends and buybacks, any repatriated money should have long term positive effects for corporate America and the broad economy.

5. **Global economy turning a corner?** Last year it is estimated that world GDP grew at the slowest annual pace since the Great Recession. The back and forth trade war resulted in the near technical recession (two consecutive quarters of negative growth) in Germany and caused China's economy to see the weakest year over year growth rate on record. However, there are signs that the worst may be behind us. Global manufacturing troughed in July 2019 and has since moved back into expansion territory. **(Chart 4).** In addition, surveys in Europe show that economic growth in Germany is accelerating.

Chart 2: Fed is Extraordinarily Accommodative

Footnotes: Data is most recent as of December 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

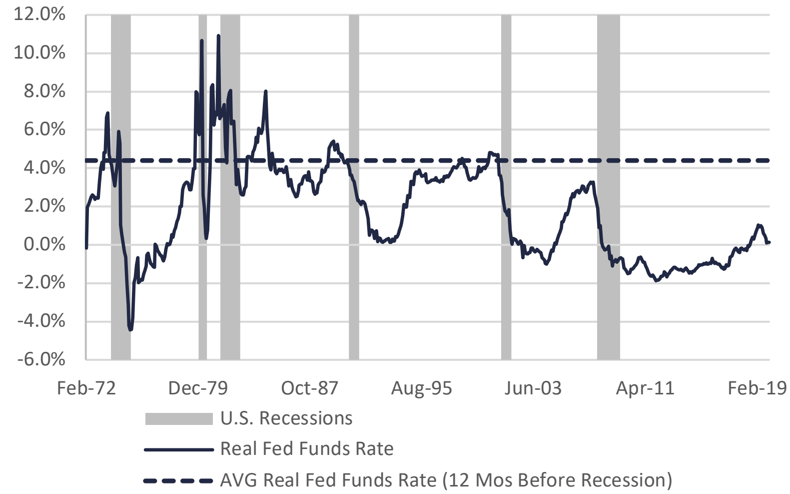


Chart 3: Companies Still Bringing Money Back Home

Footnotes: Data as of 3Q19.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

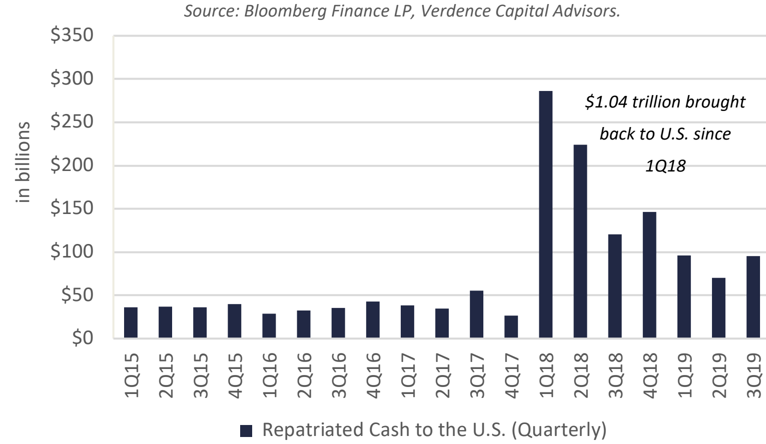
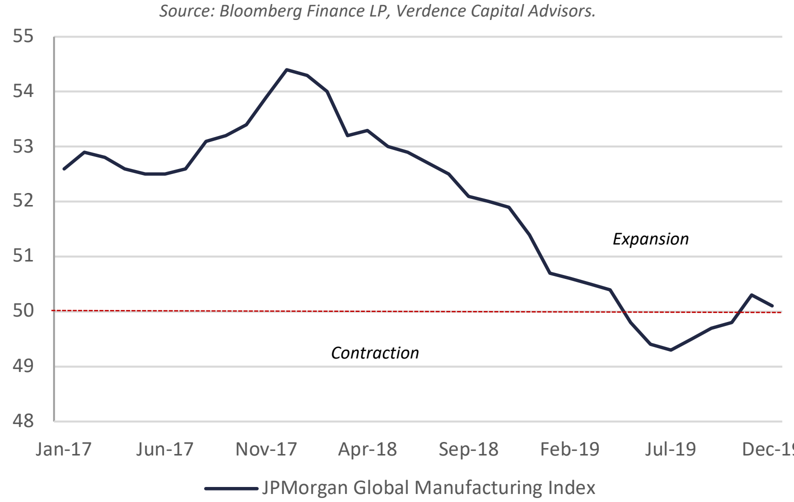


Chart 4: Global Manufacturing Improving

Footnotes: Data as of December 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



Theme 2: Presidential Elections: A Supportive Factor for Growth

Historically, the fourth year of a Presidential term (2020 is Trump's fourth year) is the strongest for economic growth. **(Chart 5).** This is not surprising as an incumbent President is doing everything in their power to either get re-elected or get his party re-elected to the White House. In fact, since 1929, there have only been three occurrences when a recession began in the fourth year of a Presidential term.

Given the highly unique and politically divisive climate we are experiencing in the U.S., it is not surprising to see this Presidential election year test sentiment and fuel volatility. While we can use history as a guide to gauge what may happen from an economic or asset class perspective, we have seen history rewritten with recent elections (e.g. Brexit, Trump's surprising 2016 victory). In fact, this will be the first time in history that a U.S. President was impeached by the House of Representatives, acquitted by the Senate and then seek re-election.

It would be dangerous at this point to make any portfolio changes given what may or may not be the outcome of the Presidential election. It is way too early. However, regardless of your political affiliation, history does tell us one thing. If the economy is good, the labor market is good and wages are at least rising at some level, it is very difficult to unseat an incumbent President no matter what his approval ratings may be. At this point, when you look at the level of inflation and the rate of unemployment, (called the Misery Index) President Trump has the best environment for the consumer since Dwight Eisenhower **(Table 1)** and Americans have seen their net worth increase by $8 trillion since he was elected. A number that is about as large as the economies of Japan and Germany combined.

Chart 5: Fourth Year of Presidential Term Typically Strongest

Footnotes: All election cycles from 1930-2018

Source: Bloomberg Finance LP, Verdence Capital Advisors.

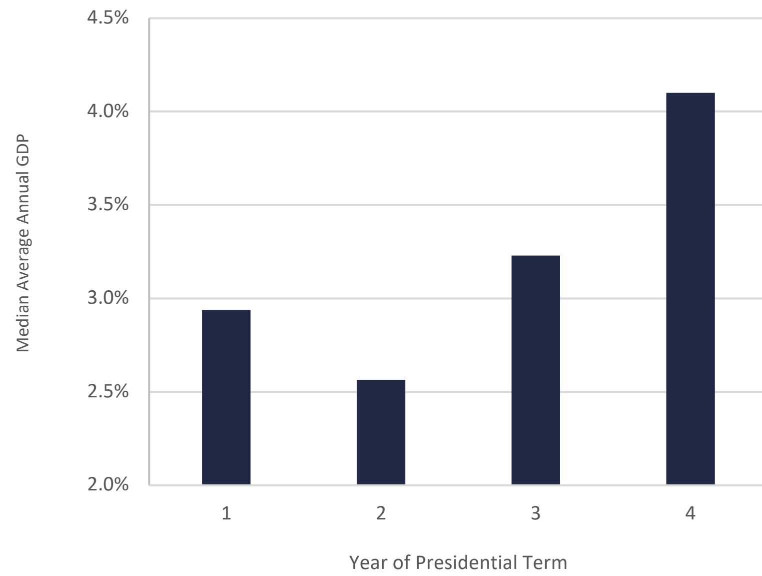


Table 1: Misery Index Shows Consumer in Great Shape

*Footnotes: Misery Index adds the unemployment rate to the year over year change in CPI. *Trump's last year of President term is as of December 2019.*

Source: Bloomberg Finance LP, Verdence Capital Advisors.

	Median Average During Term	Start (Year of election)	End (Last year of President term)	Change During Term
Truman	8.75%	11.50%	5.30%	-6.20%
Eisenhower	5.75%	5.30%	7.00%	1.70%
Kennedy/Johnson	6.80%	7.00%	7.90%	0.90%
Nixon/Ford	10.50%	7.90%	13.50%	5.60%
Carter	13.65%	13.50%	20.80%	7.30%
Reagan	12.30%	20.80%	9.60%	-11.20%
Bush Sr.	10.55%	9.60%	10.50%	0.90%
Clinton	8.35%	10.50%	7.40%	-3.10%
Bush Jr.	7.65%	7.40%	9.60%	2.20%
Obama	9.30%	9.60%	6.20%	-3.40%
Trump*	6.25%	6.20%	5.40%	-0.80%

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Theme 3: Fixed Income: A Tough Act to Follow; Be Defensive

Fixed income had a spectacular year in 2019 as muted inflation pressure, slowing global growth and the Fed cutting interest rates supported bonds. In fact, the 30-year Treasury bond yield hit a record low during the year and long-term Treasuries offered investors equity like returns (Bloomberg Barclays Long Term Treasury Index +14.8% in 2019).

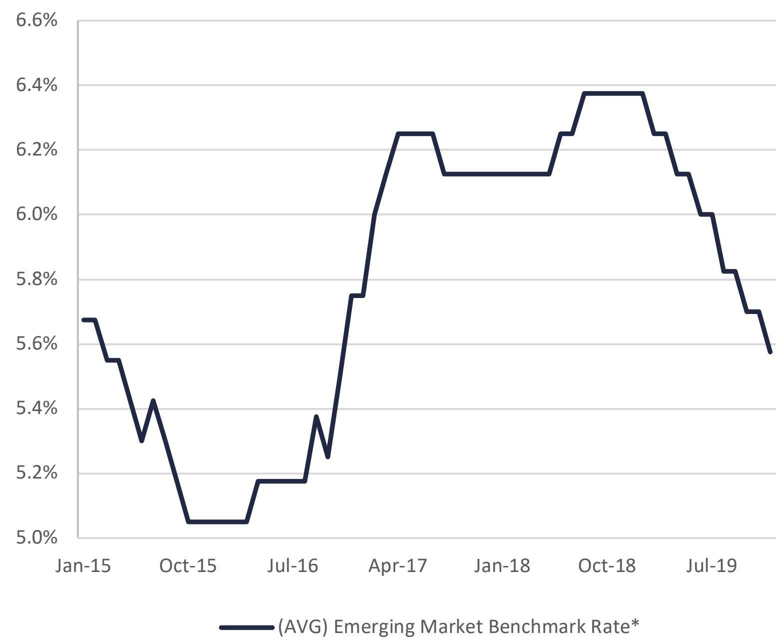
However, this is unlikely to continue in 2020. Not only are interest rates lower than where fundamentals would suggest they should be (looking at growth and inflation) but the rate cuts that helped to drive interest rates lower in 2019 are likely behind us. This does not mean that investors should avoid bonds all together. They have proven to serve their purpose and what we have seen is that in periods of high uncertainty bond yields tend to decline (prices rise). However, with the bulk of returns likely behind us we would recommend the following portfolio positioning for fixed income:

- **Defensive in duration:** With inflation low, growth positive, but modestly slower than 2019, and the Fed likely to remain on hold through 2020 long term interest rates may remain lower than they fundamentally should be in the near term. However, there is little to no value over the coupon in long term bonds and much more downside risk when interest rates start to normalize. Therefore, we would focus on short to very intermediate maturing bonds.
- **Credit expensive; be defensive:** Corporate bonds have benefitted from the downward trend in rates in 2019 and investors searching for anything that offers yield over government bonds. As a result, the extra yield investors earn to take on the credit risk with higher yielding corporate bonds is not attractive. We do not expect a major credit event or surge in default rates in 2020 given the low level of interest rates and projection for positive economic growth. However, the risk/reward in credit has vanished. In addition, because demand for yield has been so strong, corporations have been able to issue bonds with lesser credit quality and pay investors relatively low rates for them. This is a dangerous environment for credit buyers, and we would be defensive with credit quality. Our focus is on high grade corporate bonds and credit alternatives that have lower risk characteristics but carry extra yield for investors.
- **Emerging market bonds offer value:** Emerging market bonds posted a solid rally in 2019 as strength in the dollar moderated and U.S. rates remained low. We expect EM bonds to produce attractive returns in 2020 as global economic growth troughs and moves higher, the Fed remains on hold and the bulk of the dollar strength is likely behind us. In addition, emerging market economies have seen inflation declining which has offered the flexibility for central banks to cut interest rates. **(Chart 6).** This is expected to carry into 2020 which is supportive of local government bonds.

Chart 6: Emerging Market Central Banks Cutting Rates

*Footnotes: *Average of China, India, Indonesia, Korea, Mexico, Brazil, Russia, South Africa. Data as of December 2019.*

Source: Bloomberg Finance LP, Verdence Capital Advisors.



Theme 4: Global Equities: From Recovery to Rotation

After the near bear market in 4Q18, global equities spent most of 2019 climbing to fresh new record highs. The MSCI AC World Index made eight new record highs and the S&P 500 made more than 30 record highs. Nearly every major Index gained back what was lost in 4Q18 and even more. With the massive rally in 2019, investors find themselves in an eerily familiar predicament that they have faced several times in this bull market. With valuations looking fully valued to quite expensive in some areas of the global equity market, should investors chase the crowd or go against the herd mentality to look for value that may have been left behind? We would always recommend the latter. With equities historically attractive versus the low level of bonds **(Chart 7)**, we remain constructive on the global equity market, but we expect to see some rotation into those areas that have been forgotten in recent years. We would recommend the following positioning in global equities in 2020.

- **Favor international over U.S. equities:** The U.S. equity market has been the darling of the global equity markets in recent years and even over the past decade. International economies have struggled to stimulate growth, dealt with reform challenges, fiscal uncertainties, political tensions and most recently the effects of the U.S./China trade war. In contrast, the U.S. has benefitted from a stronger economic environment, better earnings potential, favorable tax reform and a healthy corporate America. As a result, the U.S. has outperformed international equities by over 10% per year since the end of the Great Recession. **(Chart 8).** While some level of outperformance is justified when looking at fundamentals, we see a rotation into international equities to gain traction in 2020 for several reasons *(continued on next page):*

Chart 7: Equities Still Attractive Compared to Bonds

Footnotes: Data is as of January 10, 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

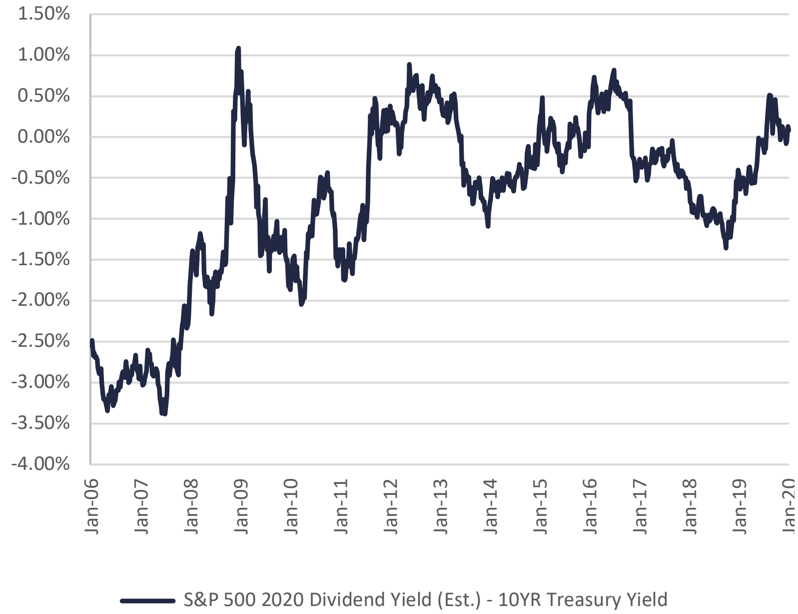
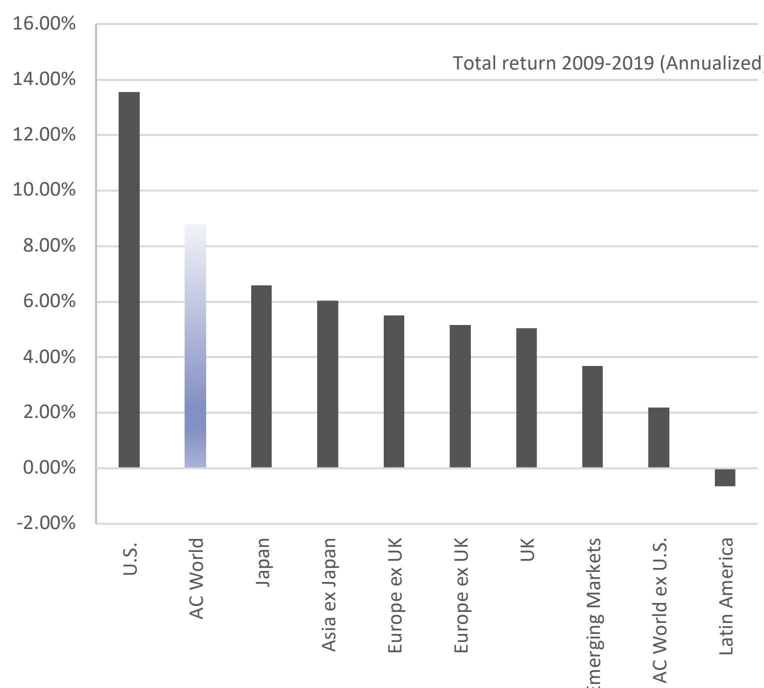


Chart 8: U.S. Has Been Best Performing Region Over Past Decade

Footnotes: Data uses S&P 500 for U.S. equiteis and MSCI Indices for the remaninig indices. Time period reflects 2009-2019 and is annualized.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



1. **Economic activity likely troughing:** When looking at leading economic indicators in some of the major international economies there is evidence that economic growth is bottoming and moving higher. A good time to invest is when growth is beginning to turn around and valuations are attractive. **(Chart 9).**
2. **More appetite for stimulus overseas:** While the developed international markets are already faced with negative interest rates, there is the chance of fiscal policy to stimulate growth in 2020. The emerging markets are likely to lead the global economies in stimulus in 2020. In addition, since the emerging markets do not have negative interest rates there is more flexibility with monetary stimulus.
3. **Valuations:** U.S. large cap equities look expensive when looking at a variety of valuation metrics and are historically expensive relative to international equities. With global growth prospects improving and U.S. equities likely pricing in the bulk of the expected good news, investors are likely to look outside the U.S. for value.
4. **Earnings growth favors international equities:** After a disappointing year for earnings growth in 2019 as the trade war intensified and global growth slowed, international equities are expected to post robust earnings growth in 2020. Compared to the U.S., the emerging markets and Europe have a better earnings growth outlook **(Chart 10).**

Chart 9: Economic Growth on Its Way Higher?

Footnotes: Data is as of December 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

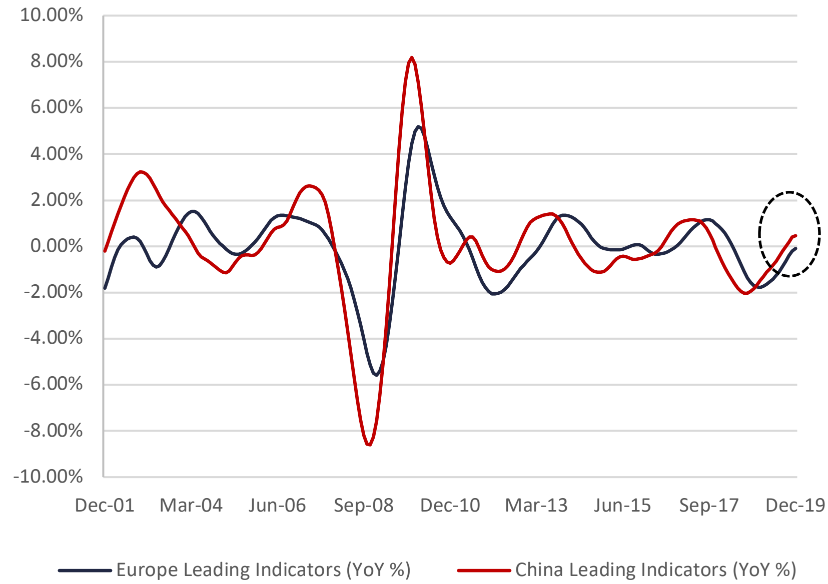
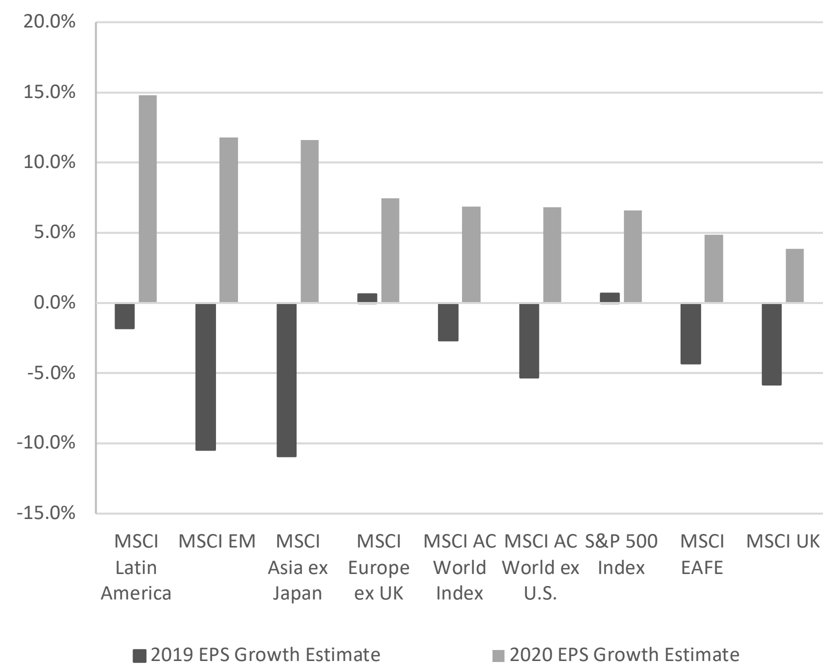


Chart 10: Better Earnings Growth Potential Overseas

Footnotes: Data is most recent as of January 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Within the U.S. selectivity important:** While the broad U.S. market looks expensive compared to international equities, there are pockets of the U.S. market that still offer value. Despite large cap growth stocks taking the brunt of the downturn in 4Q18, they have outperformed large cap value stocks by over 300 bps per year over the past decade. Low interest rates, a colossal amount of liquidity and favorable tax reform have helped growth to have a record run compared to the rest of the market. However, in these late stages of the bull and economic cycle it is dangerous to chase overvalued investments. For example, if you go back to 1999 when growth valuations were stretched as they are now, it was value stocks and REITs that performed after the growth heavy tech bubble burst. In addition, value at the small and midcap level have P/E multiples that are trading at a discount to their historical premium but still have a solid earnings growth estimate for 2020. In contrast, large cap and growth stocks are trading at hefty premiums to their past 15-year average and have a lesser expectation for earnings growth in 2020. **(Chart 11).**

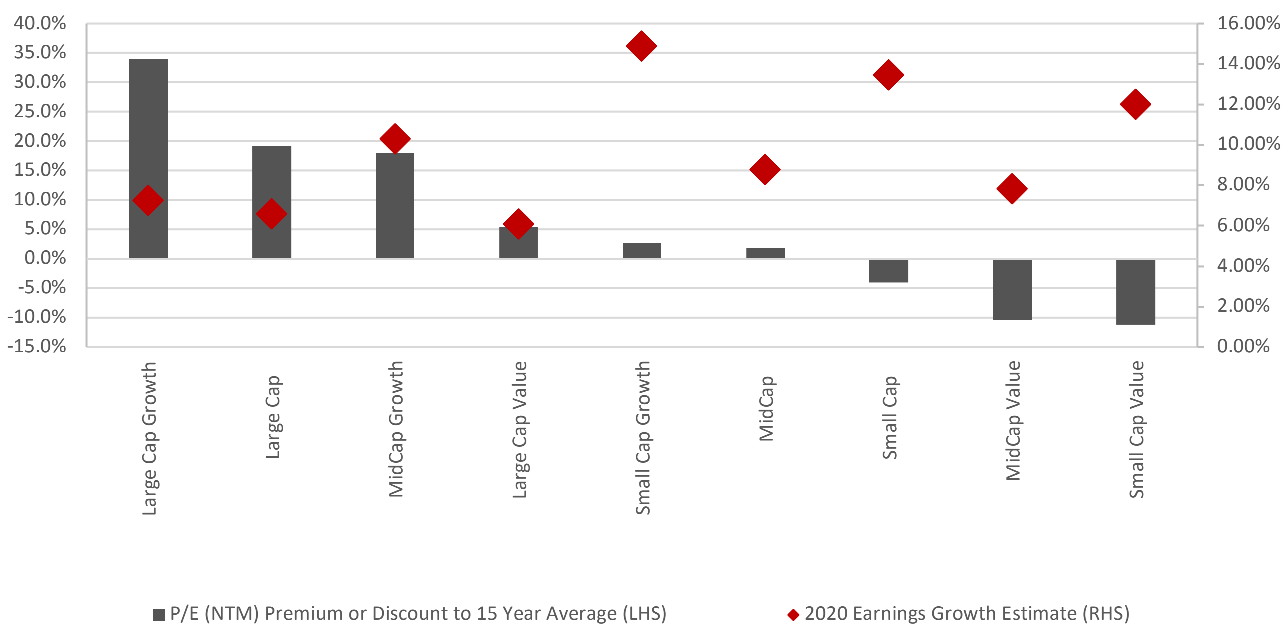
Theme 5: Alternatives: Volatility, Valuations Underpin Alternatives

We acknowledge the fact that some tail risks that weighed on economic growth in 2019 may be fading (e.g. Brexit, U.S./China trade war) but that does not mean that all the tail risks threatening investor sentiment have disappeared. We are still dealing with a massive amount of negative yielding debt that will need to be unwound. Valuations in the public market are uncomfortably high and premiums in the fixed income market are nonsensical. Combine this with rising geopolitical tensions with the Middle East and a highly divisive U.S. Presidential election and it is unlikely we will be fortunate to have another year of below average volatility. As a result, we recommend a healthy allocation to alternative investments. Hedge funds in the credit alternative space are an attractive way to find opportunity in an overvalued fixed income world. Real assets, especially real estate should benefit from low interest rates and can even prosper in a slow, albeit positive growth environment. However, we would focus on private real estate as opposed to public real estate investment trusts that may be correlated to heightened volatility in public equities. In addition, other income producing private equity investments (e.g. private credit) offer diversification and potential for attractive income.

Chart 11: Focus on Solid Earnings and Favorable Valuations

Footnotes: Data as of December 2020.

Source: Bloomberg Finance LP, Verdence Capital Advisors.



The Bottom Line:

There is little to no evidence that the economic expansion in the U.S. will not continue through 2020 at a minimum. In addition, there are signs that the worst in the global economy is coming to an end and a period of economic improvement is ahead. However, it is important to remember that when valuations are this expensive in many areas of the market there may not be a specific event or catalyst that causes a pullback in overvalued investments. In fact, a simple valuation correction stands to be one of the biggest near-term risks for the U.S. equity market specifically. As we navigate through unchartered territory with the U.S. expansion at a record length, the world eventually trying to unwind over $11 trillion in negative yielding debt, political and civil unrest intensifying across the world and a U.S. fiscal deficit that is on an unsustainable path, the decade starting in 2020 will likely present a very different picture for investors than what has been experienced in the past decade. It is more important than ever for investors to be prepared for many different outcomes, drown out the headlines, look past volatility and focus on their long-term investment objectives. In addition, in an environment where most asset classes look fairly valued to expensive it is not a bad thing to have cash on the sidelines to be ready to deploy as opportunities arise.

If you have any questions or feedback, please feel free to reach out to your financial advisor.

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