4Q 2019
Market Commentary

The odd tale of financial market performance in 2019 reminds one of the proverb, “Don’t look a gift horse in the mouth.” In case you don’t remember what this means, a horse’s teeth reveal information about its health and age, but one should still be thankful for the gift, even if the bull market looks long in the tooth.

In contrast to the fear-driven market of the 4th quarter of 2018, 2019 produced a stellar year of stock returns not seen since 1997. The broad market represented by the S&P 500 rose 31%. Yet even after such a banner year, investor skepticism remains high. At the end of 2018, we did not share the market’s fear that recession was just around the corner; yet the currents, cross currents and conflicting signs kept many investors in the “defensive” camp for most of 2019.

Even now, many economists place a high probability on 2020 turning into a recession year. Once again, we don’t share this view. With recent success on the “trade war” front, a recession in 2020 appears even less likely. Economic growth did slow in 2019 from the pace of 2017 and 2018—so why did the stock market do so well in the face of this?

As we wrote in each quarter last year, the trade wars, particularly with China, were a significant headwind to U.S. and world economic growth. The uncertainty associated with the resolution of such trade “negotiations” and rising tariffs hurt capital spending plans as corporations delayed spending due to uncertain rules on the playing field. If you can’t figure out where to invest, you simply stop investing. These dynamics are what boosted the risk that rising tariffs and trade barriers could trigger an economic downturn.

The tailwind from the cut in corporate and individual tax rates, the dramatic reduction in regulations, and the reduced tax on repatriated foreign earnings kept the U.S. economy growing near the 2% annual rate. Now with the House passage of the USMCA on December 19th and Phase I of the China trade deal set for signing this coming January 15th, these headwinds should diminish significantly as President Trump has completed his signature trade deals as promised. The fact that neither “deal” is much of a deal should not diminish the benefits from setting the new rules for trade in North America and with China. Reduced uncertainty should have a salutary effect on corporate investment—the missing piece of the U.S. economic growth puzzle.

One can never state with certainty, given the mercurial nature of the President’s negotiating stances and tweets, that the trade battles are ended for now, but the President needs to do nothing more between now and the election to declare victory in his trade policies. In our view, a good part of the stock rally in the 4th quarter of 2019 can be attributed to the market’s growing confidence that the trade wars could be coming to an end.

We don’t believe bilateral trade balances have much impact on economic growth, but maintaining free and open markets with Mexico and Canada will foster both trade and growth, and offer some additional benefits (albeit modest) to investing in the U.S. Furthermore, in the final hour, China, faced with massive loss of pig herds to African Swine Flu, desperately needs U.S. frozen pork and soybeans. The roll back in recently raised tariffs by both the U.S. and China are beneficial, but most of the original 25% tariffs remain in place. The greatest long-term benefit of the Phase I deal would occur if China actually implements and maintains its commitment to end the forced transfer of intellectual property and technology from U.S. companies to Chinese companies. Here the devil will be in the details and China has not historically met its promises. In our view, a significant amount of U.S. investment could be unleashed as a result of the end of the tariff escalations and the rebound in agricultural trade with China.

Separate from the trade uncertainties, Boeing's problems with its 737 Max program were large enough to have macro impact in 2019. Some reports suggest the slowdown in Max production and deliveries took 0.1% or more out of real GDP growth all by itself. As the fixes are finally approved by the FAA in early 2020, production and deliveries will resume, reversing the negative impact. Overall, instead of detracting from economic growth, capital spending and investment should contribute positively to GDP growth in 2020.

If, as seems likely, world growth modestly reaccelerates in 2020, lagging sectors such as metals, industrial and agricultural commodities, energy, and gold could see improving volumes and prices.

After three cuts in the Fed Funds rate in 2019, the Fed once again appears to be on indefinite "hold" in changing monetary policy in 2020. The Fed's flip-flop from tightening at the end of 2018 to easing in 2019 had a huge impact on bond yields and soothed investor nerves, but otherwise did little to benefit economic growth. Intermediate and long-term Treasury bond yields plunged over 100 basis points (1%) in the first eight months of the year, but as the economy didn't seem to be falling into recession, they experienced a reversal of 35-40 basis points from the August lows to the end of the year. From current levels, rising rates are good sign for the economy, not a hindrance.

So is everything set up for another great year in 2020? Perhaps for the economy but probably less so for stock and bond markets. Here are some of the risks we are likely to contend with in 2020:

1. Impeachment has been a non-event for the markets as investors realize that the President will not be convicted by the Senate.

2. The outcome of the presidential election, however, could significantly alter the direction of the economy in 2021. With polar opposite public policy positions, the paths would be dramatically different. Yet it's still too early to determine if the primary elections will produce a Democratic candidate that can beat Donald Trump. Such election uncertainty has been ignored by the markets, but this won't last past March. Expect heightened volatility by then.

3. Easy money has created low interest rates and speculative investment in high-risk corporate bonds. As a result, corporate quality spreads appear to be too narrow as too much debt has been added to the balance sheets of already risky companies as well as the U.S. government.

4. If corporations decide to once again accelerate investment spending, less free cash flow will be available to continue the current spree of stock buybacks. This could have a negative effect on growth in corporate earnings per share.

5. The rising price of gold, even in the midst of the recent rise in interest rates, suggests that the inflation rate may rise at a pace greater than currently expected. It doesn't have to be much of a change to worry markets. This would be good for the industrial economy, but not for the stock and bond markets as a whole.

6. Add to this list the recent heightened conflict between the U.S. and Iran and there are plenty of reasons to exercise caution.

After a decade of price recovery since the extreme trough in 2009, stock prices as a whole are no longer inexpensive. If GDP growth stays in the 2-2.5% range, stock prices could still advance in the single-digit territory. Given the historically wide and still growing disparity in valuations between "growth" and "value" stocks, however, it continues to be SKBA's belief that the relative return opportunity favors non-interest-sensitive value stocks over the growth and bond substitute winners of the last decade.

Happy New Year!

For more information, please contact:
marketing@skba.com or call 800.969.7852