January 1, 2020

Risk down, or Melt up?

Dear Clients and Friends,

As we wrap up 2019 and look ahead to a new decade, we see reasons to stay optimistic, but we also remain vigilant for new and old risks that may emerge at unexpected times. On one hand, we see bullish trends, as interest rates and trade policy seem to favor stocks. However, we also worry about elevated investor sentiment, with stocks up 31% in 2019.

We wonder if stocks have gone too far, too fast, pulling forward earnings expectations to be realized in 2020, or could we perhaps be in a "melt-up" scenario that often precedes a recession. On the other hand, if risk factors that have been weighing against sentiment have faded, perhaps equities still have room to run.

We will dig into these themes and compare declining risks with rising investor sentiment. After weighing the good and the bad, we come away with a balanced approach to 2020; we continue to favor U.S. stocks, but with a defensive bias.

More ups than downs

Let's take a quick look back at what drove the historic 2019 rally. For reference, 2019 was the second-best year for the S&P since the dot-com boom of the late 1990s.

Last year started out with a bang, as stocks rallied from a nearly 20% decline that bottomed in late December 2018. Investors entered 2019 worried that the Federal Reserve would continue to raise interest rates, thus putting a damper on the economy and depressing stocks. Early in 2019 the Fed took rate hikes off the table and hinted at cuts, which led to a swift rise in stock prices.

Stocks hit a couple of bumps in the spring and summer as U.S. / China trade tensions worsened and export-related manufacturing began to sputter. At the same time the bond market signaled a looming recession as long-term interest rates fell below short-term rates. However, in the fall and early winter, movement towards a trade truce, steady domestic consumption, and more favorable signals from the bond market boosted stocks, including a 9% return for the S&P500 in the fourth quarter.

What could go wrong?

Coming off a 30%+ year with relatively low volatility, investors might fall into a complacency trap as falling risks create a sensation of blue skies ahead. However, we prefer to take a more dispassionate view of both risks and upside drivers heading into 2020. Let's take a quick look at some downside scenarios before turning back to more optimistic possibilities.

As mentioned above, the late 2019 move in stocks might look or feel like a melt up, which has, in the past, foreshadowed a last gasp for equities before a recession and bear market. Let's dig a little deeper into what might cause a slowdown in the economy and corporate profits to see if this downside scenario might play out.

We worry about excesses triggering the next recession, similar to the dot com and real estate bubbles that led to prior downturns. Stocks are modestly expensive, but valuations suggest to us that we have yet to enter bubble territory. We're more concerned about excess corporate and government borrowing, although low interest rates suggest minimal near-term risk here.

Other recession triggers could include lower factory output or an oil price spike that trickle down to depress consumer spending. Currently, manufacturing surveys seem stable, and oil supply shocks seem unlikely with U.S. shale oil adding flexibility to global production.

A final downside risk could be rising investor worries that the 2020 elections trigger new corporate regulations. While this political risk could materialize, we place low odds on Congress issuing regulations that stifle corporate earnings. Still, we expect increased volatility during this election year as investors parse out the economic ramifications of a shifting political landscape.

What could go right?

Having walked through some downside scenarios, let's look at the other side of the coin. A big upside driver in 2020 could be a steady and massive unwinding of tariffs and related uncertainties for imports and exports. Trade barriers may continue to fall between the U.S. and China, while an updated NAFTA treaty could improve trade throughout North America. Additionally, the European Union could gain greater clarity around the UK's exit.

Lower tariffs and higher global trade could set off a synchronized growth recovery, especially in export-heavy regions, such as Europe and Asia. This trade rebound scenario could be good for U.S. stocks—and even better for equities in higher trading regions.

We see upside potential for the U.S. economy and stocks as we look at other macro factors. U.S. markets could continue to benefit from a "Goldilocks scenario" in which plentiful jobs and low inflation support a stable economy, potentially nudging corporate earnings growth to the higher end of investor expectations (~10% in 2020). The icing on the cake for equities could come from low interest rates, which may continue to make stocks and dividends relatively more attractive than bonds.

Positioning for 2020

We have a bit of optimism and pessimism heading into 2020, as we see some of the upside scenarios listed above offsetting some of the risk factors. While at the moment the Fed has paused, we believe there is room to cut interest rates further, should the trade war heat up. We also expect an evenly paced and steady economy to produce a modest ~5% growth rate for earnings. Earnings growth, coupled with a 2% dividend yield and stable investor sentiment, suggests high single-digit stock returns in 2020.

Our balanced view of the economy, earnings and valuations suggests keeping full equity allocations, but over-weighting defensive stocks within diversified portfolios of securities and individual bonds. As we enter a new decade, we remain committed to our core investment principles and ever mindful of your goals and objectives.

With Warm Wishes for the New Year,

FBB Capital Partners

As we head into the New Year, a few important announcements:

First, please note that the SECURE ACT has become law. There are a number of changes that this legislation has on retirement savings and accounts. The two most prevalent for FBB clients are as follows:

1. If you were born after July 1, 1949 the rules affecting your Required Minimum Distributions from your IRA or other retirement accounts have changed. The required age is now 72 years old (versus the prior age of 70 ½).
2. If the beneficiaries on your IRAs or other retirement accounts include people other than your spouse, then their distribution schedule has dramatically shrunk. Previously, non-spouse beneficiaries could take distributions over the course of their lifetimes. Under the new law, non-spouse beneficiaries are required to take distributions within a 10-year period. This could have significant tax implications to your heirs.

Your portfolio manager will be reviewing the potential implications of the SECURE Act on your financial situation through the course of our normal review schedule. However, as always, if you have any immediate concerns, we encourage you to reach out to your portfolio manager directly.

Second, please keep an eye out on your Inbox for details about the first of two conference calls we will be hosting with our friend Greg Valliere. Greg will help us discern how the primaries and the current political climate may affect markets in 2020. The first call is scheduled for Wednesday February 12th, additional details to follow.

Finally, please note we once again expect a couple of revision cycles for 1099s this year. As such, we advise against filing taxes early.