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***2020 U.S. Stock Market Outlook – Highest Equity Risk Since 2008***

Heading into 2020, investors are rightfully feeling pretty good. The S&P 500 has had a strong 2019, with the index up 24% through November 21. Since March 2008 the S&P 500 is now up 366% in its longest ever running bull market!

What could go right in 2020? Lots. What could go wrong in 2020? Lots. When will investors know whether investment skies are clear? Perhaps not until Wednesday November 4, 2020, the day after the 2020 presidential election. What could happen between now and then? Volatility; potentially to an unnerving degree.

Unlike 2017 and 2019, which lined up as easy years to buy stocks, ***2020 is setting up to be a potential rollercoaster, with an unprecedented range of likely foreseeable outcomes***. Equity risk assumed in 2020 is at is greatest, to a significant degree, since 2008. Such risk may not present itself in the market if investors uniformly expect a positive confluence of events; don't bet on it.

This outlook will provide the top ten reasons, in descending order of importance, why U.S. stocks may either move higher or sell off in 2020, with significant dispersion in either direction being highly probable in such an unusual investment year. At the conclusion of each category, prediction bands are included for where the S&P 500 has the potential to close as of December 31, 2020.

**Why U.S. Stocks Can Rise in 2020**

1) **President Trump is re-elected.** President Trump is a capitalist. He references employment figures and stock market levels as barometers of success for his policies. After the 2016 election, in which Republicans won control of the White House, Congress and Senate, it was just a matter of time until business friendly fiscal policies were implemented. Such economic tailwinds culminated when the Tax Cuts and Jobs Act of 2017 was signed into law December 22, 2017. Key features included slashing the US federal corporate tax rate from 35% to 21% and reducing individual income tax rates. Comparably important for business decision-makers has been President Trump's extensive reduction of regulation. A 2020 Trump re-election, with any combination of outcomes in the House/Senate, will ensure at least a stalemate for fiscal policies for another four years, which will be

beneficial to stocks. Current polls are placing a Trump re-election as unlikely, similar to what polls predicted in 2016 for an initial Trump victory. Given the public shaming of Trump through the media and social media, many Trump supporters elect to keep their approval private and even misrepresent their voting intentions to pollsters. The market is aware that polls involving Trump are not to be trusted, unlike polls in a normal election cycle. Trump's economic advisors, led by Larry Kudlow who served in the Reagan administration, are planning a campaign promise of a new round of proposed middle class tax cuts to be implemented after the 2020 election, taking a page from President Reagan's 1984 campaign pledge book. Do not discount the popularity of middle-class tax cuts amongst marginal swing voters in battleground states. A second Trump term will confirm another four years of accommodative fiscal and regulatory policy. Barron's Fall 2019 Big Money Poll has 84% of large institutional investors predicting the U.S. stock market will rise if President Trump is reelected.

2) **U.S.-China trade dispute is resolved**. While this fractious affair arguably punches above its weight, it nonetheless captures headlines and causes investor pause. China is the largest U.S. trading partner. However, the degree of trade is not as relatively large as many believe. According to the U.S. Census Bureau, in 2018 the country's largest trading partners were China at 15.7%, Canada at 14.7%, and Mexico at 14.5%. The continuing trade dispute provides supply chain uncertainty for U.S. companies, and U.S.-imposed tariffs artificially raise the price of goods at home. A partial trade resolution with China will be helpful to stocks. A full trade resolution will be significantly constructive, as businesses internationally will be encouraged by improved visibility on rules of engagement and will have elevated confidence in planning for future growth.

3) **A moderate Democrat is elected President, and tames the progressive wing of the party.** Polls are indicating the Democratic presidential nominee may be a progressive candidate. Polls at this stage often have little correlation with who ultimately secures the nomination. Joe Biden may not be moderate enough for the stock market, if investors believe Democratic majorities in the House and Senate will result. A wild card possibility exists for a late entry candidate into the race. Should the nomination ultimately be secured by Michael Bloomberg or Howard Shultz, the market can rally into the election, and after any presidential outcome. Both Bloomberg and Shultz have flirted with the idea of a nomination run and both declined to formally enter the race. However, that was a year ago when the party was perceived to be shifting further left and business experience was deemed a Democratic electable liability. Signals are suggesting the marginal Democratic voter may not be as progressive as believed a year ago. As progressive policies are emerging to less than universal support within the party, a door may be open for either Bloomberg or Schultz to walk through. Caucuses begin in Iowa on February 3 and the Democratic National Convention concludes on July 16, so

time for an outsider entering is quickly eroding. Market volatility will be exacerbated if investors believe the eventual Democratic nominee will be either Bernie Sanders or Elizabeth Warren. Joe Biden will lessen, but not eliminate, potential volatility. The emergence of a declared moderate candidate, such Pete Buttigieg, will further calm investors' nerves and reduce market volatility. Still, the significant best case for reducing market fluctuations in 2020 will be if a Bloomberg or Schultz candidate strongly places atop Democratic polls and secures the party nomination.

4) **The bond market behaves**. There is more flexibility here than one might suspect. If the widely watched U.S. 10-year bond yield remains near historic lows, equities will possess attractive relative value. The long-term mean reversion rate of the 10-year is approximately 5.5%, which equals a multiple of 17x. Below a 2.0% yield, the multiple exceeds 50x, or approximately 200% higher than the mean reversion multiple! Equity multiples seem attractive by contrast. Perhaps paradoxically, a rising 10-year yield might also be supportive to stocks, if the move occurs for the right reason. Should two of the three aforementioned outcomes result, investors could be emboldened about future prospects and rotate capital from fixed income investments to equities, imposing selling pressure on bonds, leading to higher yields.

5) **Multiple expansion for stocks**. In the context of how bond multiple expansion has occurred over the past decade to an extreme degree, one can understand how the S&P 500 has the potential for its multiple to shoot far above its mean reversion level of approximately 15x. With the S&P 500 at an historic high of 3103 as of November 21, 2019, the index is trading at a trailing 12-month price-to-earnings ratio of 24.2 and an expected forward 12-month price-to-earnings multiple of 18.9x (WSJ Market Data Stocks PE Yield). An 18.9x forward multiple is 23% above the well-regarded mean reversion multiple of 15x. For contrast, in 1999, when economic conditions were in a goldilocks state, the S&P 500 traded above a 30x trailing multiple for much of the year. Given the right environment, do not be surprised to the degree in which multiple expansion may occur for stocks. Institutional investors, supported by demographic contributions, and desperate for returns in a low bond yield environment, desperately want to remain net buyers of stocks. After a big IPO year in 2019, expect new equity issues to fall precipitously in 2020; stock buybacks will fall, but still provide a level of support. Given the right backdrop of accommodative fiscal and monetary policy, growth of demand for stocks can easily surpass growth of supply, which will move stock prices higher. In a world in which over $17 trillion of sovereign government debt can trade at negative nominal bond yields (mostly Europe and Japan), anything can happen with multiple expansion for the most coveted equities on earth if all stars align.

6) **An accommodative Federal Reserve**. The Federal Reserve invoked panic in the stock market Q4 2018 when it raised the Federal Funds Rate 25bp for the fourth time of the year and expressed expectations of indiscriminate further future interest rate increases. The monetary policy shock led to the worst December U.S. stock market performance since the Great Depression. The Fed embarrassingly reversed course in 2019 and cut the Federal Funds Rate three times, each by 25 basis points. After the November 2019 rate cut, Fed Chair Jerome Powell declared: "We would need to see a really significant move up in inflation…before we would consider raising rates to address inflation concerns." The comment was particularly soothing to investors as US inflation remains near historic lows at 1.7%. Historically the Federal Reserve is loathe to raise rates in an election year, for fear of slowing the economy and being labeled politically partisan. Given the Fed's 2018 rate rise blunder, expect it to at least maintain rates throughout 2020, with an outside shot of being additionally dovish. The market may force the Fed to further cut rates if the U.S. dollar appreciates too meaningfully against currencies of major trading partners. Irrespective of subsequent rate cuts, even a neutral Federal Reserve will be supportive of the market, as the current target overnight Fed Funds Rate of 1.50-1.75% is accommodative to equity premiums.

7) **Unemployment, at 50-year lows, continues to fall.** How will growth occur when the economy is operating at full employment? Conventional wisdom may be wrong, and the economy may not be at full employment yet. U.S. October 2019 unemployment of 3.6% is the lowest level since 1969. Economists generally believe full employment results when unemployment touches 4%. How can the economy grow if every person who wants to work is currently working? As low as current unemployment is, the historic low unemployment rate is 2.7%, which occurred during 1952. The widely reported unemployment rate is the government defined U3 rate. The much less closely followed U6 rate, is more expansive and includes discouraged workers, marginally attached workers, and part time workers. The U6 rate as of October 2019 is 6.9%, fractionally higher than its lowest recorded level of 6.8% in October 2000. Does the U6 contain available labor that isn't necessarily deemed to be accessible for growth? We are about to find out in 2020. Economists might be surprised.

8) **Millennials lose a round to Father Time**. The U.S. savings rate (income less spending) of 8.1% in August 2019 is near the highest level in 20 years. For comparison, the savings rate in the first decade of the 2000s generally oscillated from 4-6%. Much of the higher current rate is attributable to Millennials who, as an aggregate, have delayed household formation and home purchases relative to their parents and grandparents. Millennials are having offspring at a later age, living in urban rental accommodation longer, and anecdotally are delaying household purchases until either their first child gets a little bigger, or a second child arrives. Household purchases have

a positive reverberating effect throughout the economy. In 2020, expect another year to pass, and another round of Millennials to capitulate their freestyle ways and tap into their savings to deploy into capital purchases.

9) **Sovereign credit expansion continues.** Worried about debt getting out of control? You are probably at least years too early. U.S. government debt has exploded over the past two decades and will conclude 2019 exceeding 120% of GDP. High right? Well, Japan's economy grows at a much slower structural rate (0.8% in 2018), and its debt-to-GDP exceeds 237%. Still not enough proof that a potentially long credit expansion may lie ahead? Greece, with a debt-to-GDP ratio of 174%, whose 10-year bonds were yielding 24% in 2012, issued new 10-year bonds in October 2019 for 1.5%! Greece's short-term bond yields even turned negative during Q4 2019! Who projected that reality even a year ago!? Excesses from the bond market can rotate into the stock market in 2020 if all significant variables optimally unfold.

10) **Brexit is orderly.** Will the U.K. finally resolve how to gracefully Brexit? Only fools rush in: the referendum was merely 3 ½ years ago in June 2016! A lot of bad news is expected of Brexit; any transition that is only bad, instead of horrendous, may exceed demoralized expectations and be a trigger of confidence for Britain and continental European economies. Such a scenario would most likely serve as a representative discounting mechanism for other geopolitical events, which would then be less bruising to equities.

**How High Can Stocks Go in 2020?**

As 2019 is drawing to a close, with the S&P at 3103, the index trades at a multiple of 17.3x forecasted 2020 earnings of $179. At the conclusion of 2020, stock values will be guided by 2021 earnings expectations, which are currently projected at $198. Given investor capital flows, in a world where trillions of dollars of European/Japanese bonds can trade at negative yields, a modest scenario exists whereby S&P 2021 earnings expectations remain at $198 and the market multiple expands 10% to 19x, to push the S&P 500 to 3,760 by December 31, 2020. Such a move would represent a 21% gain from November 21, 2019 levels of 3103.

A further best-case scenario is even more bullish. Corporate executives may be overly conservative heading into 2020 given the backdrop of the U.S.-China trade dispute and approaching presidential election. A favorable outcome on both fronts might unleash a new wave of confidence that will lead to increased capital spending and growth initiatives that investors will enthusiastically applaud. Should 2020 conclude with a best-case alignment of major variables, it is feasible to see enhanced multiple expansion. Bullish buying could push the market multiple up 15% to 20x forward 2021 earnings. ***The S&P 500 has the potential to reach a December 31, 2020 index level of 3,960 or 28% higher than the November 21, 2019 level of 3103.***

Don't think such a best-case scenario is possible? Who could have predicted in 2017 that buying a 100-year Austrian bond yielding an absurdly low 2% would result in a 100% return on investment over just two years as the yield collapsed to zero? It happened. Do not ignore the prospect of a white swan.

With all of the reasons why stocks can rally in 2020, there is a near-equal factor base for why stocks can devastate a portfolio in this irregular investment year.

**Why U.S. Stocks Can Fall in 2020**

1) **A progressive Democrat is elected President, Democrats maintain the House majority and form a Senate majority.** To an investor in 2020, what are the two scariest words in the English language? Elizabeth Warren. In the pursuit for the Democratic presidential nominee, she is gaining ground in Democrat polling against Joe Biden, a moderate, and has Wall Street fearful of her anti-business rhetoric. She has promised to reverse the Trump corporate tax cuts, which will chop S&P earnings by upwards of 15%, increase personal tax rates, implement a wealth tax, and shift more economic activity from the private sector to the government, including healthcare. Investors are rightfully fearful. If Warren – or her brethren – the older, less likely nominee, Bernie Sanders, continue to poll well, expect investors to become increasingly nervous, and for stock market volatility to increase throughout 2020 heading into the election. Such fears may even result in the stock market at precipitously lower levels on election day than at the conclusion of 2019. While the spotlight will remain on presidential candidates, the outcome of the Senate may also create indigestion for investors; currently, Republicans hold a 2 seat advantage. Republicans will be defending 23 seats and Democrats will be defending 12 seats. Of such seats, Republicans hold 4 high risk seats, and Democrats 1. The Senate is at risk of flipping to an increasingly progressive Democratic party that appears supportive of Elizabeth Warren's far left policies. The House is firmly controlled by the Democrats, with a 236-200 seat majority that should not be contested. Many Democrats want to implement policies to reduce wealth inequality; such an environment will translate to higher equity risk premiums and lower stock prices. Potentially much lower. Barron's Fall 2019 Big Money Poll has 99% of institutional investors projecting stocks will fall if Elizabeth Warren is elected president!

2) **Systemic risk appears: Deutsche Bank?** Investors recall the market risk of 2008/09 that sent global risk assets plummeting. Many do not recall the fear of systemic risk that surfaced just a decade before in 1998, when Long Term Capital Management (LTCM), the fund headed by Nobel Prize winners, collapsed. LTCM had generated outsized profits for several years, before its computer algorithm was busted by a concurrence of outcomes its regression analysis did not project. LTCM had built a model of deploying outrageous

leverage to exploit the recurrence of historical spread convergence. Ending 1997, LTCM's equity was $4.7 billion, but its asset based totaled $128 billion; debt to equity exceeded 25:1. During 1997, Thailand defaulted on its debt; fear soon spread to neighboring markets in Indonesia, Philippines, Malaysia and South Korea. Emerging market problems were not contained and Russia defaulted on its debt in August 1998. By the end of August 1998, LTCM assets had crumbled to $250 million and leverage exceeded 250x. Bankruptcy was inevitable; Wall Street was indifferent until it was discovered that LTCM had over $1 trillion in outstanding counterparty obligations to over 50 of the world's largest financial institutions. Default on such obligations could have paralyzed global capital markets as counterparty risk, unknown through nebulous balance sheets, exploded. The Federal Reserve Bank of New York needed to act fast, and organized a $3.625 billion bailout of LTCM with contributions from the largest global financial institutions, including $300 million apiece from 11 firms. The LTCM fear fiasco brewed up an 18% S&P 500 loss from July through October 1998. Why is LTCM relevant for 2020? Given the plausible extreme outcomes that may stem from the US 2020 election, the possibility exists for significant investment asset volatility. Such sharp moves down could catch at least one overleveraged large financial market participant offside through bad bets, create solvency issues, and potentially lead to significant counterparty risk. The fear of systematic risk would lead to a panic selling in stocks. Who harbors the greatest risk exposure? Deutsche Bank seems the most likely candidate. Stock of Germany's largest lender trades at less than $8, down more than 60% from its 2009 low of $20 and down almost 95% from its 2007 high of $145. European banks have sold access to their balance sheets for too low a premium for decades. Return on equity (ROE) has been enhanced by gearing up a low return on assets (ROA) through leverage. Deutsche Bank has attempted to enhance profitability through entering off-market illiquid swaps, spreads, etc. to a degree that cannot be ascertained by its opaque balance sheet. An event of market distress could reveal DB's balance sheet being as bad as feared. The systematic spotlight is rightly cast on Deutsche Bank. This means the risk probably lies elsewhere.

3) **The bond market does not behave**. If signals of inflation appear, and fixed income investors reassess risk premiums on government debt, a selloff in bonds will translate to higher yields, which may spook stock investors to reset equity risk premiums, which will depress stock prices. While inflation expectations are tame with unemployment at 50-year lows, employer competition for employees may increasingly translate to higher wages. Firms would either attempt to pass through higher costs to consumers, or absorb the costs and see margins compress, which will have negative reverberations on share prices. Once signals of inflation do appear, expect raucous volatility in stocks.

4) **Law of large numbers**. Large cap U.S. technology companies have posted years of stunning revenue growth. How do the largest of companies keep growing revenues at supernormal rates? Eventually they don't, as company growth prospects become victim to their previous successes. When will this occur? At any time. Even in periods of secular growth, hiccups occur and stocks get pummeled. On February 4, 2016, LinkedIn's stock closed at $190 ahead of quarterly earnings. A lower-than-expected growth forecast chopped 43% off the stock's price the next day, taking it down to $109. Growth fears instantly inflicted other tech shares, resulting in significant double-digit losses across the board. How long can the tailwind of U.S. fiscal stimulus (2017 tax cuts), deregulation and monetary stimulus (since 2009) create supernormal growth? The compounding might be long in the tooth for the biggest of tech companies.

5) **Mind the GAAP.** Most fast growing cloud-based tech stocks trade at sky-high values. Many currently lose money, which would be fine given future earnings estimates…except that the industry has conditioned financial analysts to focus on non-GAAP earnings. Non-GAAP earnings are GAAP earnings less employee stock compensation, which is a significant expense for most tech companies. Once non-GAAP earnings are converted to GAAP, expensive tech stocks become outrageously expensive. Many market capitalizations of such stocks are in the tens of billions of dollars. If the market recalibrates pricing models from non-GAAP to GAAP earnings, cloud-based stocks can easily be sawed in half, and hundreds of billions of dollars of market value will evaporate. When might this realization crystallization begin? On any single day over the next few years, for any particular reason, most likely because a cloud-based company slightly lowers its future revenue growth outlook which will send an immediate shockwave throughout high-beta investments.

6) **A progressive Democrat is elected president yet Republicans secure a firm majority of either the House or Senate.** The headline news will be unfavorable to investors, yet the market may resist the urge to panic sell stocks if the result is believed to be a legislative stalemate that prevents business-unfriendly legislation from being implemented. Presidential interventionist headline rhetoric from a progressive president will keep a lid on investor enthusiasm. In this scenario, a modestly lower market will be the best possible outcome.

7) **U.S. dollar appreciates strongly**. Global commerce is dominated by American firms. S&P 500 companies generate 43% of their profits outside of the United States, exposing firms to material foreign exchange rate risk exposure. As the U.S. dollar falls against foreign currencies, foreign profits are reported on U.S. financial statements at higher values. The opposite is true as the greenback strengthens. A falling dollar is a tailwind for U.S. dollar denominated earnings, while a rising dollar is a headwind. 2020 sets up to

potentially propel the USD higher against the currencies of its biggest trading partners. Elevated capital market volatility might push more global investors into the greenback as a safe haven play; conversely, a continually strong growing economy might attract FX dollars seeking higher yield in the U.S. A summary of the currencies for major trading partners:

*Euro – European politicians remain inept to reform fiscal policy to encourage entrepreneurialism and economic growth. The European Central Bank has had to carry all the weight of attempted growth stimulus, which has resulted in an overnight borrowing rate of -0.5% (that's negative). The Euro has no catalyst.

*Chinese yuan – Trump has accused China of artificially maintaining a weak currency. One might suspect China will be more inclined to loosen its currency controls, but as its economic growth slows, the opposite might result.

*Canadian loonie – Canadian politics have gone loony. Investors will further note that politicians have suffocated its oil and gas industry, and the loonie should no longer be viewed as a resource currency.

*British pound – Once the Brits have solved their biggest economic risk, Jeremy Corbyn, they can move on to their lesser problem: solving Brexit.

*Mexican peso – Given such weak outlooks for other currencies, can the peso outperform? Not with its violent crime problem.

The US dollar is poised to appreciate, potentially by a high single digit percentage amount in 2020, which will pose headwinds for U.S. corporate earnings. The Federal Reserve might have to mediate, and further reduce rates to harness a galloping dollar.

8) **U.S. trade war with China is unresolved**. The U.S. and China appear to be close to signing a phase one resolution that will lead to a larger scale agreement. If any hang-ups occur, such as China not enforcing intellectual property rights or refusing to eliminate forced technology transfers of U.S. firms operating in China, negotiations may deteriorate, tariffs may resume, and markets may sell off. This scenario is unlikely, as tariffs have been unilaterally implemented by President Trump. Tariffs create a drag on economic activity, and Trump will do all he can to ensure the economy is as strong as possible heading into the November 2020 election. Do not expect tariffs to increase, or even remain at current levels by summer.

9) **Trade war erupts between U.S. and Europe**. With President Trump having already engaged in trade disputes with Mexico, Canada and China, will focus shift to Europe? Trump has imposed tariffs on some European goods; the

last several years suggest that may only be the beginning. Will Trump engage in another economic dispute prior to election day? Unlikely. Expect this conflict to surface in 2021 if he is re-elected.

10) **China's growth stalls**. Many market observers thought the U.S.-China trade dispute would harm the U.S. more so than China. China has a legacy government that can outlast the cyclical nature of U.S. elections. China appeared to be better insulated to withstand the dispute. That is, until the threat of supply chain relocation from China to elsewhere in Asia was introduced by U.S. companies. Relocation risk, combined with continued Hong Kong civil disobedience, a low-growth trading partner in Europe, and high domestic debt levels created from excess capacity creation, are forming an environment of potentially lower growth rates for China. The prospect of lower China GDP growth may spook the markets again, like on August 24, 2015 when a lower-than-expected Chinese PMI reading sank equities, sending the S&P 500 down more than 5% at its low of the day. Even stalwarts were damaged, as Apple fell as much as 13% and Home Depot fell as much as 20% in a matter of hours.

**How Low Can Stocks Go in 2020?**

In the worst case of a progressive Democratic president governing along with Democratic senate and congressional majorities, investors will expect the new president to execute upon her/his campaign pledge to reverse the 2017 corporate tax cuts and increase the rate from 21% to 35%. Such economically punitive fiscal policy changes will scare investors to underwrite a recession, so reduce 2020 earnings by 3% to arrive at 2021 earnings of $174. Then slash this figure by 15% to reflect higher corporate taxes which equals $148. Given the enhanced uncertain future certainty, expect the market to cower below its mean reversion forward multiple of approximately 15x. Assume an optimistic 7% discount to its long-term level to arrive at 14x. ***The S&P 500 has the potential to reach a December 31, 2020 index level of 2,070 or 33% lower than the November 21, 2019 level of 3103.***

**Three State Capital Investment Structure for 2020**

2020 is setting up as a high probability scenario for some kind of a double run for the U.S. equity market. The primary question is whether President Trump is re-elected, and the market continues its ascent towards a double from his first election, or whether a progressive Democratic president is elected and the S&P 500 doubles back to its November 8, 2016 level of 2,140.

An extreme movement up or down is not guaranteed, though ***the Fund anticipates a low volatility year with just 20% probability. The remaining 80% is split evenly between a strong upwards movement (40% probability) and vicious sell off (40% probability).*** Once again, this market setup is widely different than

entering 2017 or 2019. By Christmas 2020, the S&P 500 may be knocking on 4.000 or flushing down towards 2,000. This year is setting up to expose equity investors to their third largest assumed risk in the past 40 years.

***Three State Capital is structuring its investment methodology for 2020 in preparation for any extreme outcome, with an emphasis on generating market-beating profits should the market rise, and significantly insulating capital/even generating a modest profit should the market materially sell off.***

Your time for reading this outlook is appreciated, and questions are welcomed. Please feel free to reach out at your convenience.

Sincerely,

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