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# 2019 Finishes With a Bang

## Stocks trounce bonds with double-digit gains

Q4 2019

### Main Points

Stock markets around the world rallied strongly in 2019. Returns likely to be more normal in 2020.

Bonds rallied for the first three quarters due to global and trade uncertainty, but dropped in Q4.

Election uncertainty and high optimism are risks for stocks in the first half of 2020.

A year ago, investors were worried about rising interest rates. Policymakers, like the Fed, reversed course in early 2019.

By the time the year was over, the Fed had cut rates three times and added $240 billion to liquidity.

**Lower rates and some clarity around the China trade agreement drove a move to riskier assets in Q4.**

The S&P 500's 8.5% surge (price only) in Q4 was the best since 2013 and the 19th highest since 1928.

**Stocks trounced bonds.** The S&P 500 gained 9.07% on a total return basis, while the Long-Term U.S. Treasury Bond Total Return Index dropped 4.12% in Q4.

A typical U.S. 60/40 portfolio (S&P 500 Total Return/Barclays U.S. Aggregate Bond Total Return) put in a strong performance for the quarter at 5.44% (**chart below**).

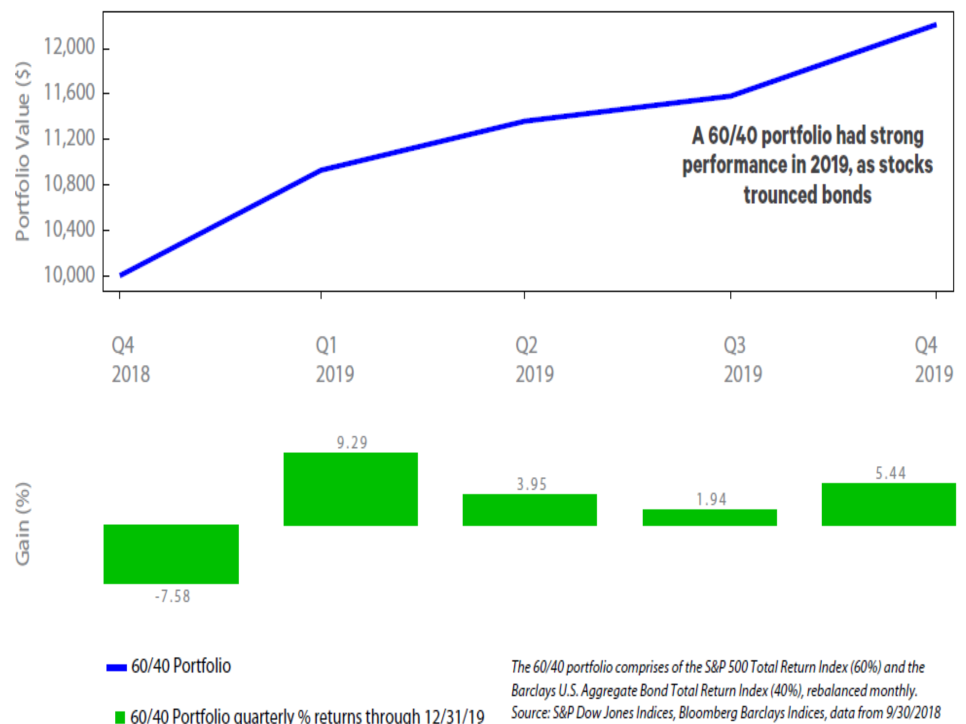
**The Nasdaq Composite Index was the top U.S. equity benchmark.** Led by the tech sector, the Nasdaq surged 35.2% in 2019, including a 12.2% gain in Q4.

**Growth beat Value across all three cap tiers** in Q4 and for all of 2019. The strongest gains were within large-caps. The Russell Top 200 Growth beat the Top 200 Value by 3.33% in Q4.

**Technology and Health Care both surged over 13% in Q4, leading all sectors.**

The U.S. outperformed developed international stocks, while emerging markets kept pace in Q4.

**In contrast to last year, most commodities gained.** Oil prices were up 30%, and gold finished up 18.77% for the year.

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# 2020 Outlook

## Stock gains likely to outpace bonds

There are four cycles that are near critical junctures: economic, earnings, Fed, and election. Whether they align with or counteract each other should determine how 2020 unfolds.

The U.S. economy will likely slow but avoid a recession. Earnings growth should accelerate modestly to about 6%.

If the Fed stops at three cuts, by the second half of 2020, much of the liquidity will have worked its way through the system.

So, a risk for 2020 is that monetary policy shifts from being a tailwind to a headwind in the second half.

An additional risk is the typical path of the market during election years.

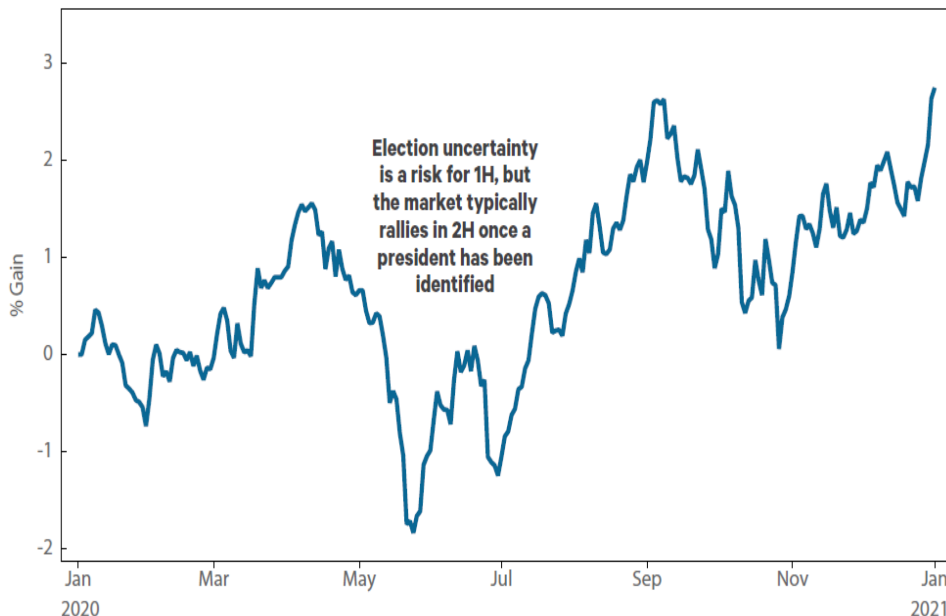
According to Ned Davis Research, the S&P 500 2020 Cycle Composite is weak in the first half (**chart above**), primarily due to the four-year presidential cycle.

While the stock market typically rallies in the second half, it struggles when the incumbent party has lost. The market hates uncertainty, and a new president brings unknowns.

Another risk is that investor sentiment is optimistic. The market is vulnerable to the next piece of bad news— no matter what it is.

Rising rates could continue to pressure bond proxy sectors, like Utilities, in early 2020.

History shows potential market risk in 1H, but gains in 2H




*The Cycle Composite puts equal weight on the one-year seasonal cycle, four-year presidential cycle, and 10-year decennial cycle. Trend is more important than level. Data from 1928 to 2020. Source: Ned Davis Research, Inc., S&P Dow Jones Indices*

Assuming the Democrats don't pull off a "clean sweep," Health Care Services, Biotechnology, Banks, and Integrated Oil could be attractive industries for outperformance.

There should be better performance from global stocks, supported by moderately rising bond yields, and improving global economic growth.

A more risk-on environment should also include rising oil prices, out-performing credit, and steepening yield curves.

The economic recoveries should be most notable in Europe and among emerging markets.

> Election uncertainty and investor optimism are risks for the stock market in the first half.

Emerging market stocks are likely to outperform, which should also be supported by U.S. dollar weakness. Additionally, a weak U.S. dollar would be bullish for the uptrend in gold prices.

Overall though, it shouldn't be a knockout year for stocks.

Stretched valuations and investor complacency are caution flags for stocks.

Additionally, the unknowable impact of the trade war and other geopolitical influences are risks.

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# Stocks

## Gains broad based

The shift toward easy monetary policy was one of the biggest drivers of asset gains.

By the end of 2019, 82% of all central banks' last move was a cut. Fiscally, government spending for the first three quarters of 2019 provided the biggest stimulus since 2009.

As a result, **asset price inflation was rampant in 2019**. All seven regions/major countries gained at least 10%.

**The S&P 500 was a standout, surging 28.9% (price only) in 2019, its best year since 2013 and second-best this century.**

Gains were broad based in the U.S., as all nine Russell style indices gained at least 20%, the most since 2013.

**Growth sectors dominated**. Technology was up 48% in 2019 and contributed one-third of the S&P 500's gains for the year.

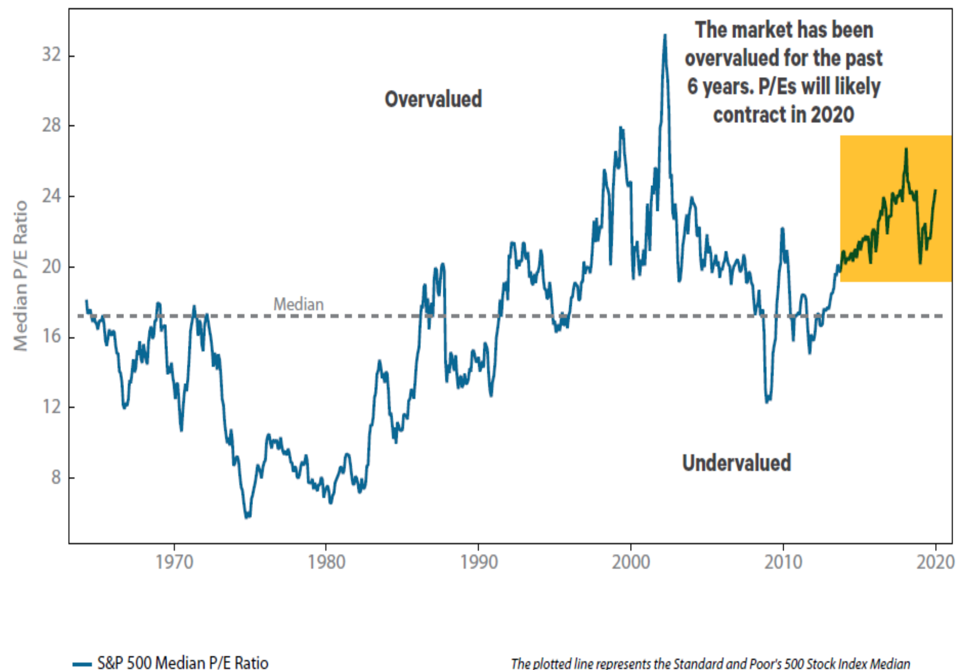
Communication Services was the second-best performing sector for the year, led by Facebook (56.6%) and Alphabet (29.1%).

Energy was by far the worst performer in 2019, rising only 7.6% despite crude oil prices rising over 30%.

### 2020 Outlook for Stocks

Global stocks should continue to have positive gains, supported by improving global economic growth.

Valuations have stayed above average for six years




— S&P 500 Median P/E Ratio

*The plotted line represents the Standard and Poor's 500 Stock Index Median Price/Earnings (P/E) Ratio, representing the median P/E of the 500 stocks in the Standard and Poor's 500 Stock Index universe. Earnings for this calculation are based on 12-month trailing figures. Data from 1964 to 2020.*
*Source: Ned Davis Research, Inc., S&P Capital IQ Compustat*

The economic recoveries should be most notable in Europe and among emerging markets (EM), with EM stocks likely outperforming.

For the U.S., Ned Davis Research places a **target of 3325 on the S&P 500**, which is about 3% above the yearend 2019 closing value.

With positive, but slower economic growth, flat margins, and a projected slowdown in buybacks, earnings growth is likely to be about 6.0%, a modest acceleration from 2019.

Ultra-low interest rates, aided by Fed policy, have made stocks attractive relative to bonds, explaining why stock market valuations have stayed above average for six years (**chart above**).

However, Ned Davis Research has made the case for likely **P/E contraction** in 2020. Historically, when earnings growth has picked up, P/E multiples have contracted. Additionally, the market has tended to look past earnings growth generated by a weak U.S. dollar.

When the year/year change in the dollar has been negative, earnings growth has been strong (13.0%), but the P/E has contracted.

This supports the case for more modest stock gains in 2020.

The economic cycle will continue to **favor large-caps**. Modest deceleration in economic growth has tended to be neutral for Growth versus Value.

Rates, politics, and oversold conditions will be key drivers of sector performance. Look for buying opportunities in Health Care, Financials, and Energy.

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# Fixed Income

## Bonds rallied in 2019 due to global uncertainty, but dropped in Q4

As investors moved into riskier assets, bonds trailed in Q4. While the U.S. Aggregate eked out a 0.2% total return in Q4, the Barclays Long-Term Treasury Bond Total Return Index (comprised of bonds with maturities of 10 years or longer) fell 4.12% (**chart right**).

Despite annoyingly low yields, bonds had their best year since 2002. The U.S. Aggregate Index gained 8.87%.

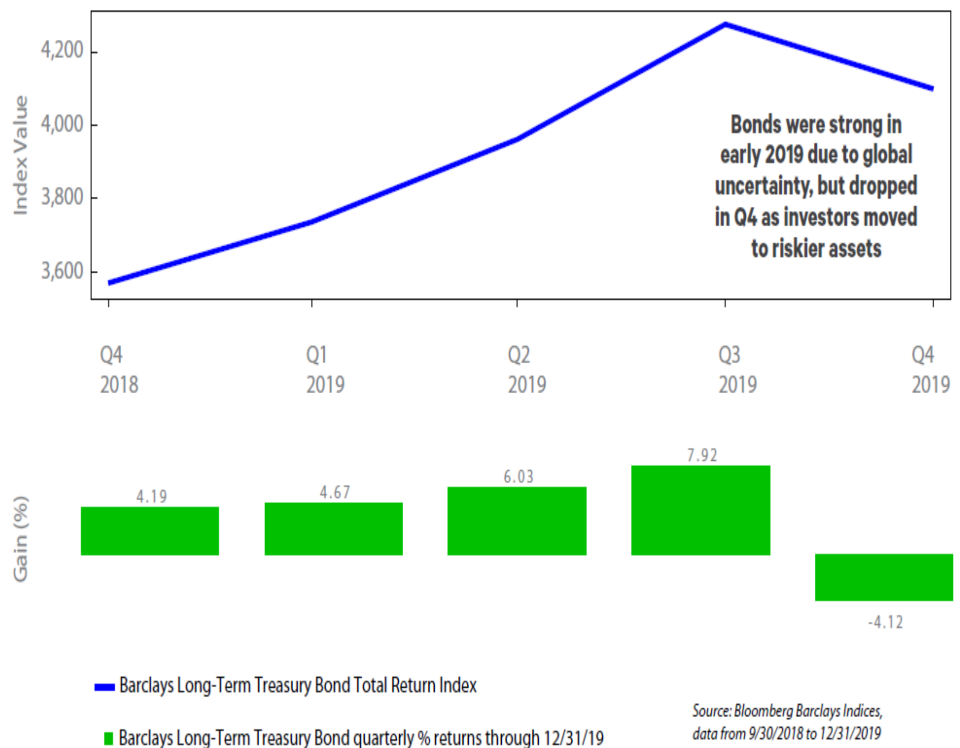
Led by corporates, every sector made money last year. Investment grade corporates took the top spot, returning 14.54%, edging out high yield by 0.22%.

Even the much maligned leveraged loan sector returned a decent 8.64%. The worst performers were the short duration buckets.

With the Fed cutting rates by 0.75% during 2019, it was not surprising that Floating Rate Notes (FRNs) had the lowest return at 4.28%. Asset Backed Securities did 0.25% better.

### 2020 Outlook for Fixed Income

With U.S. and global growth showing signs of bottoming, the major central banks on hold, inflation low, plenty of liquidity, and steady demand for bonds, **yields should be range-bound to modestly higher and credit spreads tight**.




The U.S. economy is likely to continue to slow toward trend growth, or roughly 1.8%.

But with some tentative signs that global growth is bottoming, there could be some upside risk to the outlook. If that materializes, then 10-year yields could gravitate toward 2.00%.

**The bar for the Fed to change policy is high**. It's hard to see inflation running significantly and consistently above the Fed's target. A material change to the economic outlook would be required to warrant additional easing.

Global liquidity should remain plentiful, thereby supporting risk assets. The major central banks are expected to provide $90 to $100 billion a month of support through June 2020.

Residential and commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) remain attractive bond sectors.

Residential mortgages should perform well in a trading range to a slightly higher yield environment. MBS is the best relative value in U.S. universe. Additionally, demand remains strong from both domestic and foreign buyers.

Treasury Inflation-Protected Securities (TIPS) should be favorable vs. nominal Treasurys. With TIPS providing positive yields and guaranteed protection from rising headline inflation, valuations remain attractive.

Munis remain attractive for investors in the top tax bracket, particularly at the long end of the yield curve. Demand continues to be strong amid steady supply.

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