2020

★OUTLOOK★

HANLON
Investment Management

EDUCATION SERIES - ASSET MANAGEMENT

Intro

In hindsight, for investors, 2019 was about as easy as it gets. Aside from a few temporary pullbacks, most asset classes surged on January 1st and never looked back. By the end of the year, nearly every asset class posted positive returns, with many delivering double digits. Equity investors were rewarded for continuing to ride out this record-breaking bull market, with US large caps up 31.49% and Mid and Small Caps not far behind at 30.54% and 25.96%, respectively. Developed international stocks returned 22.01% despite the ongoing Brexit saga, and even the trade war drama couldn't keep Emerging Market stocks from posting a solid 18.42% return. Fixed income returns were similarly impressive across the board, with High Yield Bonds up 14.41% in 2019. To put into context how well every asset class performed in 2019, consider the 8.72% return from the Bloomberg Barclays US Aggregate Bond Index ("the Agg"), near the bottom of the table on opposite page (figure 1). While this return looks disappointing relative to other asset classes on the table, it was the best year for the Agg since 2001. For all-around asset class performance, this was the best year for investors since 2009.

Taking a 10-year lookback is a good way to remind ourselves that long-term market outcomes are often shaped not so much by the large, singular headline events, but by the aftershocks. The 2008 financial crisis is no longer in our 10-year rearview mirror, but the resulting effects – economic, regulatory, and behavioral – continue to define markets as we enter the next decade. Some of these effects, like regulations on banks and more restrictive consumer lending standards, are beginning to lessen. Central banks however, after a decade of accommodative monetary policy, are finding it much more difficult to put the genie back in the bottle. Finally, the behavioral impact may be the longest-lasting. A generation of investors came of age during a devastating financial and housing crisis, making them far more risk-averse than prior generations and skeptical of home ownership.

Yet amidst these challenges, there is much reason to be optimistic as we enter the new decade. Yes, the 2000s have thus far been shaped by two of history's biggest stock market crashes. This does not mean that another crash will be the defining event of the 2020s. Rather, the next major catalyst may be a positive event, spurred from one of the breakthroughs in technology that are occurring every day. It wasn't long ago that 2020 sounded like the far-off future. We may not have flying cars, but we do have self-driving ones, powered by technology that seemed like science fiction a decade ago.

This technological renaissance makes it incredibly difficult to forecast 10 years out, but it is a necessary exercise to evaluate what has changed since last year and update our baseline asset allocation expectations. We hope you find our 2020 Outlook helpful and wish you the best of success in your next decade of investing.

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Emerging Market Stocks 78.51%	Gold 28.72%	Gold 9.63%	Emerging Market Stocks 18.22%	US Small Cap 38.82%	US Real Estate 31.78%	US Real Estate 4.23%	US Small Cap 21.31%	Emerging Market Stocks 37.28%	US Agg Bond 0.01%	US Large Cap 31.49%
US High Yield Bonds 44.46%	US Real Estate 28.60%	US Real Estate 9.24%	US Real Estate 17.59%	US Mid Cap 34.76%	US Large Cap 13.69%	US Large Cap 1.38%	US High Yield Bonds 15.33%	Developed International Stocks 25.03%	Global Agg Bond -1.20%	US Mid Cap 30.54%
US Mid Cap 40.48%	US Small Cap 26.85%	US Agg Bond 7.84%	Developed International Stocks 17.32%	US Large Cap 32.39%	US Mid Cap 13.22%	US Agg Bond 0.55%	US Mid Cap 13.80%	US Large Cap 21.83%	US High Yield Bonds -1.51%	US Real Estate 25.76%
Developed International Stocks 31.78%	US Mid Cap 25.48%	US High Yield Bonds 5.95%	US Mid Cap 17.28%	Developed International Stocks 22.78%	US Agg Bond 5.97%	Developed International Stocks -0.81%	US Large Cap 11.96%	US Mid Cap 18.52%	Gold -2.81%	US Small Cap 25.52%
US Real Estate 28.60%	Emerging Market Stocks 18.88%	Global Agg Bond 5.64%	US Small Cap 16.35%	US High Yield Bonds 5.93%	US Small Cap 4.89%	US Mid Cap -2.44%	Commodities 11.77%	US Small Cap 14.65%	US Large Cap -4.38%	Developed International Stocks 22.01%
US Small Cap 27.17%	Commodities 16.83%	US Large Cap 2.11%	US Large Cap 16.00%	US Real Estate 1.86%	US High Yield Bonds 2.13%	Global Agg Bond -3.15%	Emerging Market Stocks 11.19%	Gold 12.79%	US Real Estate -4.84%	Emerging Market Stocks 18.42%
US Large Cap 26.46%	US Large Cap 15.06%	US Mid Cap -1.55%	US High Yield Bonds 14.15%	US Agg Bond -2.02%	Global Agg Bond 0.59%	US Small Cap -4.41%	Gold 7.75%	Global Agg Bond 7.39%	US Mid Cap -9.06%	Gold 18.03%
Gold 22.86%	US High Yield Bonds 12.58%	US Small Cap -4.18%	Gold 6.08%	Global Agg Bond -2.60%	Gold -1.75%	US High Yield Bonds -5.03%	US Real Estate 7.24%	US High Yield Bonds 6.34%	US Small Cap -11.01%	US High Yield Bonds 14.65%
Commodities 18.91%	Developed International Stocks 7.75%	Developed International Stocks -12.14%	Global Agg Bond 4.32%	Emerging Market Stocks -2.60%	Emerging Market Stocks -2.19%	Gold -10.88%	US Agg Bond 2.65%	US Real Estate 4.18%	Commodities -11.25%	US Agg Bond 8.72%
Global Agg Bond 6.93%	US Agg Bond 6.54%	Commodities -13.32%	US Agg Bond 4.21%	Commodities -9.52%	Developed International Stocks -4.90%	Emerging Market Stocks -14.92%	Global Agg Bond 2.09%	US Agg Bond 3.54%	Developed International Stocks -13.79%	Commodities 7.69%
US Agg Bond 5.93%	Global Agg Bond 5.54%	Emerging Market Stocks -18.42%	Commodities -1.06%	Gold -28.65%	Commodities -17.01%	Commodities -24.66%	Developed International Stocks 1.00%	Commodities 1.70%	Emerging Market Stocks -14.57%	Global Agg Bond 6.84%

Exhibit 1: Periodic Table of Investment Returns 2009-2019. Source: Hanlon Research

Economic Backdrop

The most significant development in 2019 was a policy shift from the US Federal Reserve (“the Fed”), pausing for the first half of the year, and then ultimately reversing the prior three hikes to bring the Federal Funds rate to 1.50-1.75%. The dovish pivot put the US central bank more in sync with its international peers, many of which have eased their respective benchmark rates to negative territory. As we close the year, the Fed seems content to hold rates steady for the time being. Inflation data has been consistently soft, at just 1.6% as measured by the Core Personal Consumption Expenditures Index. There was not much justification for the Fed to raise rates in the first place, and the Fed was possibly looking to get its benchmark rate up to a level that would provide capacity for future cuts, i.e. create some dry powder. The Fed is now determined to lift prices/inflation to, or symmetrically above, its 2% target on a persistent basis by keeping rates unchanged through 2020.

The US economy is on stable footing heading into the new year. Unemployment is at a 50-year low, giving consumers confidence to continue to spend. Consumers have been carrying the bull market, as businesses have shown reluctance to engage in significant capital spending, largely due to uncertainty surrounding the trade war. US GDP grew at a 2.1% pace in the third quarter but is widely expected to soften slightly to just under 2% in the coming year.

The expected slowdown in US GDP coincides with an anticipated global growth decline. Euro-area GDP growth continues to sputter along around 1.2% and will likely remain around this level. The Chinese economy is the driving force for growth in Emerging Markets, but this too has fallen to the low end of the government’s target range at 6% in 2019. Even with a Phase I resolution to the tariff dispute, high levels of consumer debt should keep Chinese GDP growth below 6% in the coming year. The years of explosive, 7-9% Chinese growth are behind us.

How economic data is measured in a modern, service-driven economy has increasingly become the subject of debate. Federal Reserve Chairman Jerome Powell raised the topic in October, suggesting that productivity measures, which have been relatively weak, are inadequate and missing a good deal of the actual output produced in modern society. The traditional formula for measuring productivity, GDP divided by total hours worked, is a good enough approximation for hourly employees in a manufacturing-driven society. However, the US economy and most developed economies worldwide are now heavily driven by services, which can be much more difficult to distill into “units of output”. Furthermore, nearly 50% of US workers are salaried employees, and with the advent of technology many workers are always “on the clock”, with the workday extending into late-night and weekend emails. As technology continues to advance, we anticipate changes to the way we measure economic output will be needed.

US Equity

A year ago, we cautioned that while the record-setting bull market was potentially winding down, it was likely too early to rotate out of high-growth names and into value stocks. As prior market cycles have demonstrated, equity bull markets typically have a blow-off top rather than a slow fade-to-black, with the most substantial gains to be had in the high-momentum growth stocks. For most of the year, the S&P 500 Growth Index outpaced the S&P 500 Value Index. However, value stocks have come into favor in the last quarter, bringing 2019 total returns for the Growth and Value Indices near parity, at 31.13% and 31.93%, respectively. Was this year the last gasp of the venerable bull market?

Considering that over the long-run, growth in GDP correlates with growth in corporate earnings, it would be reasonable to expect US equities to cool off a bit from this year's excellent returns as overall economic output declines. However, we don't anticipate a rush out of US equities just yet, given the dominant role US companies play in the global marketplace. US equity valuations are slightly high with the Price-to-Earnings (P/E) ratio of the S&P 500 at around 20.3, based on actual and estimated full-year 2019 operating earnings, compared to a 25-year average trailing P/E of 19.6, but the trade-war resolution would provide potential for improved earnings prospects and propel stocks higher.

While a surprise from the Fed is no longer a major concern, uncertainty over the outcome of the 2020 US Presidential and Congressional November elections will undoubtedly weigh on US equities for much of the year. Buying opportunities will likely arise for Financial sector stocks, particularly bank stocks which were beaten down as interest rates declined. Banking industry stocks look attractively priced with a P/E multiple of just 11.5 (as measured by the SPDR S&P 500 Bank ETF, ticker KBE), significantly below most of their peers in the S&P 500, while also providing higher-than-average dividend yield. The big banks have long served as the Democratic punching bag and calls for tougher regulation will surely occur in the debates; however, privacy and 1st amendment issues have made Big Tech a favorite target of late and the sector may share the attention of the candidates' criticism during the Democratic Primaries.

For most investors, we believe maintaining US equity exposure is necessary, even though markets could be choppy or move sideways until there is more clarity on the election outcome and earnings prospects. In the event of a trade resolution, or with a Trump re-election, markets would likely maintain their positive trend. With longer-term forecasts calling for lower US equity returns over the next decade, event-driven opportunities like this could become increasingly rare.

Developed International Equity

Compared to US Equities, Developed Market (DM) and Emerging Market (EM) equities looked like the walking dead for the last decade, with annualized returns of just 5.43% and 2.91%, respectively, compared to the S&P 500's 13.46% annualized rate. Eurozone economies stumbled out of the Great Recession like zombies that continue to stagger on. One reason for the difference in returns is America's dominance in the technology sector, globally. Aggressive central bank stimulus has thus far failed to improve German manufacturing activity while adversely affecting the large European financial sector.

As we have pointed out in prior years, however, long-term investors who omit DM equities from their asset allocation are ignoring roughly 35% of the global equity market. Many investors have shunned DM equities as the Brexit debacle played out over the past several years, but with a resolution in sight inflows may return and prices appreciate. DM equity valuations are only slightly higher than historical averages, with some areas such a Japanese equity still priced relatively cheap. Japanese equities, measured by the Nikkei 225 Index, are currently priced at a multiple of around 17 times estimated 2020 earnings, below historical norm. The low multiples have triggered a surge in share buybacks, and a

20.72% return in 2019. A trade war resolution and a weakening in the US Dollar could give Japanese equities a further boost.

Emerging Market Equity

Many Emerging Market stocks that rely heavily on exports have suffered the most under President Trump's aggressive trade tactics. In addition to tariffs, EM economies can be highly concentrated in only 1-2 economic sectors and are subject to currency-and-commodity-related volatility, as well as political risks from governmental instability, societal volatility, and wars. For the past decade, EM stocks have failed to deliver returns that justify the additional risks. Inconsistent earnings growth has disappointed investors and led to EM equities becoming less attractive.

Heading into 2020, EM is finally starting to show some relative strength against domestic equities. A de-escalation in the trade war, dubbed "Phase One" of the ongoing talks, provided a preview of what can be expected if a larger agreement finally materializes. With the US Presidency in play in 2020, common sense continues to dictate that it is in President Trump's best interest to get a comprehensive deal completed. If this occurs, the upside moves in EM may be swift and considerable. Despite the uncertainty and volatility inherent in EM investing, we feel the potential returns that will occur outweigh the current risks and advocate for continued EM exposure. EM equities also can provide attractive dividend flows while one waits for anticipated price appreciation.

Longer term, the story remains the same as in prior years. The potential for economic growth is heavily concentrated in the EM economies. Even as China transitions to a consumption-led economy, the GDP growth rates should still be roughly triple that of the US. The demographics also favor EM, where populations are heavily skewed towards younger workers, and absent a comprehensive trade agreement, other EM markets such as Vietnam and Mexico stand to gain from a supply-chain restructuring that is already under way. Technology will increasingly become the equalizer, with EM populations aggressively adopting new technologies to enable commerce and connectivity. The last decade was painful for emerging market equity investors, but we know from prior decades that the asset class can quickly make up lost ground. Therefore, we continue to recommend most investors stay the course and own at least a market weight position in EM, with an overweight position for aggressive investors.

Fixed Income

The outlook for fixed income investors, in both the short and long term, is challenging. Yield continues to be scarce, with US fixed income heavily in demand from both domestic and foreign investors. In 2019, the downward pressure on the long end of the yield-curve, resulting from huge investor demand, led to a temporary yield-curve inversion, a phenomenon considered to be a harbinger of recession. The yield-curve has since reverted to its "normal" state, though this does not guarantee a recession has been avoided. The prior three yield-curve inversions all reverted in advance of their respective subsequent recessions.

The desperate search for yield has also extended into credit markets, with high yield (HY) bonds heavily in demand as we close out 2019, pushing spreads down to 3.5%, the tightest reading since October of 2018. Investors are showing a larger risk appetite as the year ends, bidding up the riskiest bonds.

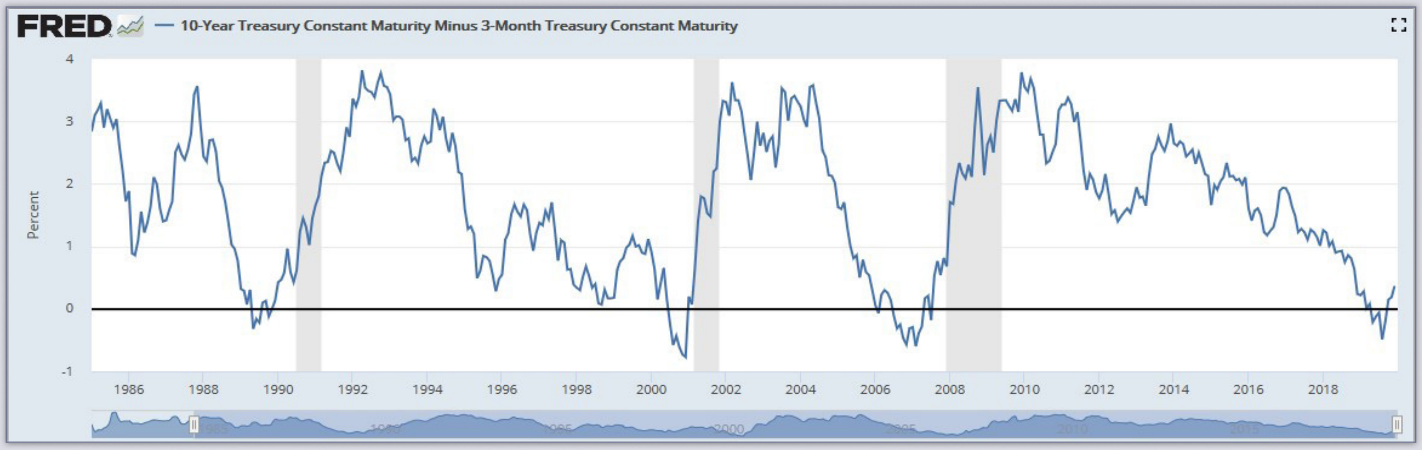

Exhibit 2: Yield Curve Inversions prior to Recessions (shaded areas indicate US recessions). Source: Federal Reserve Bank of St. Louis

For much of the year, the most-speculative Triple C-rated segment of the Bank of America Merrill Lynch US HY index was relatively unchanged while the higher-rated BB and B bonds saw significant spread compression. However, CCCs have experienced solid demand late in 2019.

Increased risk tolerance is also evident in the investment grade (IG) credit market, despite alarms over the proliferation of Triple B-rated bonds in recent years. The BBB segment sits just above HY in credit rating and are therefore susceptible to forced selling if eventually downgraded to below BBB, aka junk status. BBBs now hold a dominant position in broad IG bond markets, at the expense of a diminished proportion of highly-rated, AAA bonds.

Our long-term forecasts for fixed income asset returns reflect these challenges, and we see little chance of global central banks turning hawkish in unison. We believe investors should allocate more heavily to the shorter end of the yield-curve, and pay close attention to the high yield market, which looks expensive and vulnerable to a pullback. We continue to recommend investors diversify exposure by allocating to local currency DM and EM bonds as well, to capitalize on the potential for a weakening US dollar which coincides with the Fed's desire for higher domestic inflation.

Exhibit 3: Growth of BBB-rated debt as percentage of Global Investment Grade Corporate Bond Market. Source: Bloomberg Barclays

Commodities and Alternatives

Broad-Basket Commodities underperformed in 2019, with tariff-induced weaker demand and efficiency-driven increased supply exerting downward pressure on prices. Crude oil prices surged at the start of the year, but for the 2nd half West Texas Intermediate has been trading firmly in the $55-$60 range, with less volatility than in prior years. OPEC actively intervened throughout the year, attempting to support prices with dubiously-adhered-to production cuts. An attack on Saudi Arabian oil fields, attributable to Iran, resulted in the biggest daily price spike since the financial crisis, but the capacity was quickly restored with minimal impact.

In addition to oil, other commodities stand to benefit from a US-China trade deal, with Chinese agricultural purchases being a key component, and the potential for increased natural gas exports also on the table. While in the near term we may see a solid year from commodities, dependent on the trade war outcome, our longer-term expectations are constrained by globally low inflation and a generally lowered global GDP. Moreover, just-in-time delivery, supported by massive improvements in supply chain management and commodity harvesting techniques, will also provide for a smoother ride and less upside in prices for commodities.

Among the other Alternatives, Real Estate Investment Trusts (REITs) were the standout performer in 2019, keeping pace with the S&P 500 for most of the year before fading in November. We anticipate REITs will continue to deliver, given their historical ability to grow dividends. The sector yields roughly 3.2%, more than 50% higher than the S&P 500, making REITs an attractive way to diversify portfolios while generating income. Within the sector, performances can be disparate, with high-growth tech-oriented REITs specializing in data centers or cell phone towers at one end, compared to deep-value brick-and-mortar retail REITs at the other.

Final Thoughts

The start of a new decade is always an exciting event, with the prospect of a "blank slate" for the next 10 years of investing. It seems near certain that this bull will eventually breathe its last breath at some point before 2030, but the stage is set for continued positive returns, albeit potentially less than the long-term averages. The next ten years will likely come with a new set of challenges, with the maturing business cycle bringing lower return forecasts across the board. Despite this more challenging environment, exploitable opportunities are bound to arise for investors who maintain a flexible approach to asset allocation.

Sincerely,

Sean Hanlon, CFP®
CEO and Co-Chief Investment Officer

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