2020 Forecast
The Storm before the Calm – The Sequel

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Executive Summary

- The New Year is approaching, riding on the heels of raging global stock and bond market rallies.
- Last year strong fundamentals ultimately led to the best broad-based market in a decade.
- 2020 is likely to begin with faltering fundamentals, including the first negative earnings growth in 12 quarters along with four consecutive months of manufacturing contraction.
- There are divergent outlooks among the "Big 3" (Europe, China and the United States); U.S. is stable, but Europe and China face serious challenges.
- U.S. Manufacturing is contracting, while the U.S. Consumer remains the *game changer*, a likely tailwind in 2020. Expect calm followed by storms, and remember the sequel is never as good as the original.

Introduction

While warnings of recession, bear markets and trade wars going into and throughout 2019 were rampant, calendar year equity returns are shaping up to be among the best since 2009. What did the market miss, and what insight might it give us for our 2020 forecast? Well, contrary to popular belief, when the market is coming to an inflection point, it is *fundamentals* that show the way, *not* price action, which in fact often shows the wrong way.

Recall Q4 2018, when we were making last year's forecast: The S&P 500 was in a correction and plummeted over 9% in December alone and 13% for the quarter, hitting a technical bear market for the period. Times were tough. But, the fundamentals were rock solid in the face of a dour market-contrarian signal. In fact, the S&P 500 had four quarters of corporate earnings growth averaging an explosive 23.6% and the ISM manufacturing index hit a 14 year high of 60.8. These are two of the most powerful determinants of future market prices and were absolutely bullish while collapsing prices were — well — bearish. The fundamentals got it right.

It is now December 2019 and we have a chance to apply what we observed one year ago. This time the markets are not only surging, they are at all-time highs. The fear has gone away and now optimism is finally back in the market. The long awaited rally delivered in a big way. But, let's stop and carefully review the message that the fundamentals have for us as we enter 2020.

What's this? Fundamentals are failing? Uh oh. After three years of positive fundamentals we have an inflection point, from good to bad. But that would be quite a contrarian signal in the face of a year-end rally. Yes, it sure is. Corporate earnings growth, weak all year, faltered in the third quarter with a -0.4% reading and the important ISM manufacturing index just came out with its fourth consecutive contractionary monthly reading. There is a message here: Prices measure current sentiment; fundamentals measure future value. Our 2020 forecast is to batten down the hatches for the impending storm.

Figure 1. Global Perspectives Outlook for Markets, Rates and Sectors in 2020

Rate/Sector Metric	2020 Forecast
S&P 500	3250
S&P 500 Earnings per Share	$172
Crude Oil (NYM)	$65/bbl
Gold	$1350/oz.
Ten-Year U.S. Treasury Yield	1.95%
Trade Weighted $ (DXY)	94
GBP/USD	1.39
U.S. GDP Growth	2.2
Global GDP Growth	3.0

Source: Voya Investment Management. Forecasts are subject to change.

Ten Themes for 2020 Global Perspectives Forecast

Our 10 themes – which will come as no surprise to Global Perspectives readers – are predicated on demonstrating that "fundamentals drive markets," which is also our investment philosophy. In our 2020 forecast, we use letters to signify a meaningful fundamental, starting with the A, B, C's, of course, and continue through the 10th theme signified by J for Jobs.

A - Advancing Corporate Earnings

The S&P 500 is nearly as a much of a global economic indicator as it is a U.S. domestic economic indicator. The U.S. economy was ranked in 2018 as the most competitive economy in the world due to the most pro-growth macro-economic backdrop in the world. It has low tax rates, a massive decrease in the regulatory bureaucracy, full employment, low interest rates, and more. So what's not to like? Nothing! There is nothing not to like about the U.S. economy. It is everywhere else that worries us, especially the other two members of the "Big 3", China and Europe. As we have noted in the past, the Big 3 (Europe, China, and the United States) represent two-thirds of the global economy, so the concerns are real.

Given decades of economic stagnation in Europe, we have always held low expectations for the region. This time we feel it is worse, and detail our concerns below. And while China's slowdown is also adversely impacting Europe, as one of their biggest trading partners, China faces challenges of its own. The U.S.-China trade war is hurting China on multiple fronts, including tariffs, slowing demand, and supply routes shifting away from China. We think it may be worse than China is letting on, and feel that there may be negative surprises in 2020.

The bottom line is that weakness in two of the Big 3 was bad enough to cause Q3 2019 earnings growth to be negative compared to a year ago with a -0.4% reading. Corporate earnings reflect a serious problem in not only the outlook for the global economy, but in the markets as well.

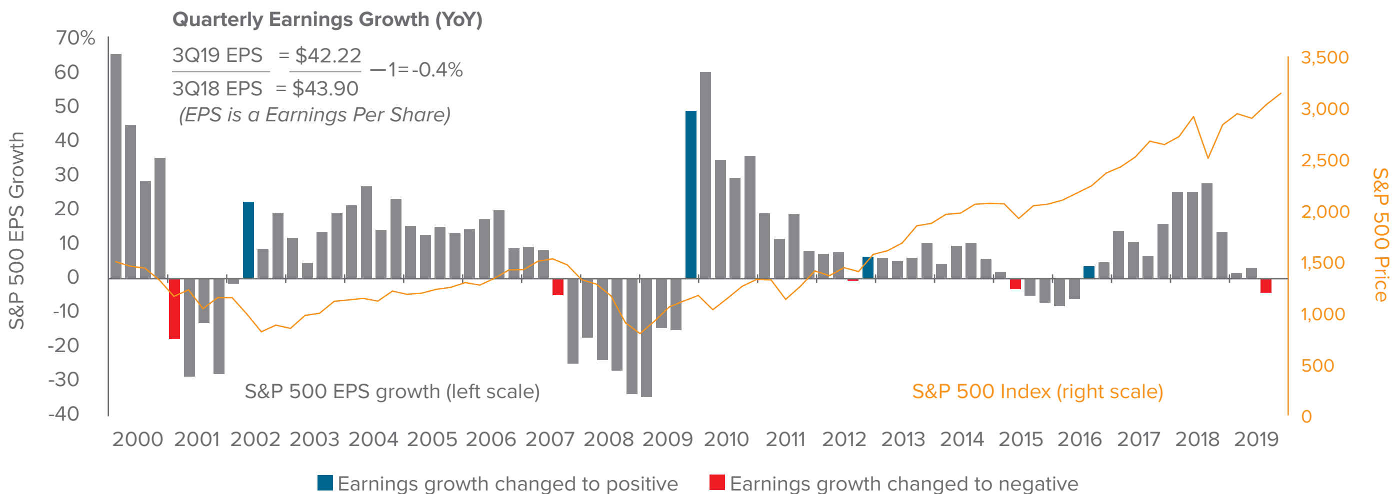
The drivers of the Q3 2019 negative earnings report were as follows:

- Earnings were dragged down primarily by energy, but surprisingly not helped by the only modestly negative topline and bottomline growth for technology.
- Technology likely picked up the global weakness, since over half of its revenue is overseas.
- Revenue growth was solid at +3.8%, driven by Healthcare and Consumer Discretionary.

Our 2020 forecast is:

- S&P 500 price forecast is $3250.
- S&P 500 earnings per share is $172.

Figure 2. Corporate Earnings Growth is a Barometer of Global Economic Health



Source: Refinitiv – Thomson Reuters and FactSet, Voya Investment Management. Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. The S&P 500 index is a gauge of the U.S. stock market that includes 500 leading companies in major industries of the U.S. economy. **Past performance is no guarantee of future results. Indices are unmanaged and not available for direct investment.**

B - Broadening: Manufacturing

- Long a broadening stalwart of the U.S. economy, manufacturing is contracting. The latest U.S. ISM manufacturing PMI weakened to 48.1, the fourth consecutive reading below 50 indicating contraction.
- The last four months has been a broad based contraction in all of the key components.
- GDP report Fixed Investment went negative in Q2 2019 and continued in Q3 2019.

Figure 3. Global Manufacturing Reports Indicate Contraction

ISM Survey: Key Components

	August 2019	September 2019	October 2019	November 2019
Overall Biz	49.1	47.8	48.3	48.1
New Orders	47.2	47.3	49.1	47.2
Shipments	49.5	47.3	46.2	49.1
Employees	47.4	46.3	47.7	46.6
Prices Paid	46.0	49.7	45.5	46.7
Inventories	49.9	46.9	48.9	45.5
Backlogs	46.3	45.1	44.1	43.0

Source: Institute of Supply Management.

C - Consumers, the Game Changers

The consumer has been the bright spot of the U.S. economy with personal consumption in the GDP report growing at an astounding 4.6% growth rate in Q2 2019.

- Full employment and rising wages have sustained the U.S. consumer, representing 70% of the economy.
- Consumer deleveraging continues, having fallen to ~60% of GDP, from over 80% during the financial crisis.
- Retail sales have remain stable, at over $500 billion per month.
- Mortgage interest rates plummetted that set off a rebound in housing and refinancing.
- Rising stock markets create a wealth effect, enticing consumers to spend more.
- Consumer confidence remains historically high despite the uncertainties.

D - Diversify Globally with a Plan

Building robust portfolios requires a plan for market corrections, a plan for bull markets, and a plan for the perennial bear market

- While building robust portfolios requires individual plans for market corrections, bull markets and the perennial bear market, the significant failure of "plans" was most evident in the 2008 credit crisis, the worst bear market in a generation.
- Unintentional risk taking is obviously bad, but extreme caution probably has cost investors more wealth in the past decade. Although 2019 was one of the best markets of the ages, many excessively cautious investors missed out.
- Contrary to popular belief "stay the course" investing is a not pragmatic approach for real people. Behavioral finance's "Prospect Theory" describes how investors "hate losses twice as much as they like gains," thus they need twice the downside protection. Sometimes a defensive posture is more prudent than "stay the course" and having a transparent plan can help remove emotion from investing.

D – Diversification that is effective and avoids the "Folly of Gaming Diversification."

Figure 4. An equal-weighted global diversified portfolio has beaten the S&P 500 over a long period of time for much less risk

Index	Wgt	YTD	2018	2017	2016	2015	3 yrs	5 yrs	10 yrs	20 yrs
Equity										
S&P 500	10%	27.6	-4.4	21.8	0.3	7.0	14.9	11.0	13.4	6.3
S&P Midcap	10%	22.8	-11.1	16.2	-1.1	2.6	9.0	8.6	13.1	9.9
S&P Smallcap	10%	19.2	-8.5	13.2	0.2	3.7	8.5	9.5	14.0	10.3
Global REITs	10%	22.3	-4.7	11.4	-6.7	4.4	10.2	6.5	9.6	9.6
EAFE	10%	18.8	-13.4	25.6	0.8	4.7	10.2	4.8	5.8	4.2
Emerging Mkts	10%	10.6	-14.2	37.8	0.8	0.7	9.4	3.5	3.7	7.7
Average		20.2	-9.4	21.0	-0.9	3.9	10.4	7.3	9.9	8.0
Fixed Income										
Corporate	10%	14.2	-2.5	6.4	-3.2	-0.6	6.0	4.5	5.4	6.0
U.S. Treasury 20+	10%	18.5	-2.0	9.0	-9.1	-1.4	8.0	5.5	7.0	7.5
Global Aggregate	10%	6.2	-1.2	7.4	-1.2	-0.9	3.9	2.0	2.0	4.4
High Yield	10%	12.1	-2.1	7.5	0.0	-2.1	6.3	5.4	7.7	7.2
Average		12.8	-1.9	7.6	-3.4	-1.2	6.1	4.4	5.5	6.3
Overall Average		17.2	-6.4	15.6	-1.9	1.8	8.6	6.1	8.2	7.3

Source: FactSet, FTSE NAREIT, Voya Investment Management. The Overall Average model allocation includes 10 asset classes, equally weighted: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI BRIC Index, Bloomberg Barclays U.S. Corporate Bonds, Bloomberg Barclays U.S. Treasury Bonds, Bloomberg Barclays Global Aggregate Bonds, Bloomberg Barclays U.S. High Yield Bonds. Returns are annualized for periods longer than one year. **Past performance is no guarantee of future results. An investment cannot be made in an index.**

E - Europe: Recession Watch

Europe has many problems that are being papered over by a "whatever it takes" European Central Bank. Let's list a few but there is more, far more:

Germany: Considering it is Europe's main economic engine, our greatest concern comes from Germany's crucial manufacturing sector, which faces:

- Intense demand pressures from U.S.-China trade war.
- Risk of U.S. tariffs on auto-imports from the European Union.
- Risk that manufacturing weakness spills over to the services sector.

Italy: With the fifth largest debt in the world, but limited growth opportunities, Italy faces significant risks. Here is what we are watching for in Italy:

- Its high level of debt also means that there is no room for fiscal measures.
- Its failure to implement the type of reforms that the bailout program enforced in Spain and Portugal.
- It is structurally a very weak economy, feeling the fallout from global trade tensions.

The ECB: The European central bank's bond buying program has helped to only paper over the cracks. But even if there is no recession and no *real* concerns from Brexit, there are serious threats:

- The unintended consequences of the ECB's easy monetary policy are becoming increasingly obvious; assets are not covering existing debt.
- Loss of confidence in the ECB's ability to "kick the can" down the road; investors search for safer and better returns exposes risk to its paper/property/companies.
- The last financial crisis in the Eurozone was driven by a property crash, and if there is a repeat in Germany who will be the anchor then?

F - The Fed is Not the Solution

The Federal Reserve's power to roil markets was on full display late in 2018 when Chairman Powell's "tightening on auto-pilot" language sent markets into a tailspin. Investors' reactions to subsequent Fed decisions have been relatively muted. Still, uncertainty about future policy decisions remain. Nowhere is this more evident than in the repo-market, where banks and other firms borrow cash for short periods in exchange for safe government securities. It is a crucial mechanism to financial markets. Here is what we know at the time of this report regarding the turmoil in the overnight repurchase (repo) market*:

- The Fed has so far committed about $350 billion to alleviate the cash shortage.
- The Fed is in "emergency mode" trying to contain the consistent cash shortage in the repo market, and is buying $60 billion a month in Treasury bills to contain it.
- The Fed is injecting cash into money markets for the first time since the financial crisis – no different than quantitative easing – which may be why markets are surging into year end.

There is more concern though. While the Fed's October rate cut was largely anticipated, it seemed to betray robust employment reports. This raises concerns about "what does the Fed know that we don't." At a minimum, cracks in the central bank's decade of accommodative monetary policy may have set the stage for these unintended consequences.

*WSJ December 9 "More Turmoil in Repo Market Expected" Daniel Kruger and Julia-Ambra Verlaine. Pp B1, B9.

G - Global Growth Divergence: Good United States, Bad World

The good news is that U.S. GDP is expected to grow at a reasonable 2.2% due to U.S. competitiveness and continued strong employment. The bad news is that Europe's growth is largely ephemeral and is supported by unsustainable policies. The amount of "negative yield" Investment Grade corporate and government bonds in Europe and Japan is almost $12 trillion, and coincides with the expectation that inflation and interest rates will stay low (negative, in fact) through 2020.

It is not just Europe that is struggling. South America faces significant challenges (**strong)

- Venezuela's economy, politics and people are facing collapse.
- The Chilean economy, once a standout, has been shut down due to social unrest.
- Brazil has a bounty of natural resources but struggles with a challenging political environment.
- Argentina's leftists were swept back in power in 2019, to the demise of its market.

The simple fact is that the United States is a standout and in our view it is no coincidence that it is the only country to implement pro-business economic reform with aggressive tax cuts and deregulation. In fact, the 2017 tax cuts reduced the U.S. tax burden to one of the lowest among major world economics, falling to 24.3% of GDP, or about half of France's burden and 10% below the OECD 2018 average of 34.3%.

H - Housing's Second Wind

We've seen a second wind for sales and mortgage-related housing data in 2019 with the Fed's policy pivot, but the construction-related data have proven slower to respond. These measures drive the residential component of GDP. A big climb in permits since Q2, and a solid path for starts through October bodes well for Q4 construction. The housing sector faces upside surprises as long as mortgage rates stay low and Fed policy stays accommodative.

I - Inflation in Short Supply

Tariff hikes run the risk of putting upward pressure on traded-goods prices, but at this time that doesn't appear particularly evident. Last year's big corporate tax rate cuts were deflationary, and the net impulse from tax and tariff policy on prices overall is probably still downward, despite the more recent focus on upside tariff effects.

J - Jobs, Jobs, Jobs

Jobs are the big story of 2019 as we go into 2020. The November jobs surge of 266,000 was a blockbuster, and that doesn't include the 41,000 in upward revisions for the prior two months. We also saw gains for both hours-worked and hourly-earnings, with a big upward revision for the October earnings that left the November year-over-year wage gain at a firm 3.1%. The unemployment rate is at 3.5%, a 50-year low.

**WSJ "Tax Cuts Push U.S. Burden to Near World's Lowest", page A2, Friday December 6, 2019.

Risks to 2020 Outlook

- **Lack of Global Growth**
- **Cyberattacks on Countries, Business, Individuals and Infrastructure**
- **Financial Instability in Europe**
- **Russian Hegemony**

Conclusion

The Global Perspectives “Big 3” is our bellwether for global growth and is in a marked deceleration pattern, even though financial conditions are loose with little prospect of tightening. The markets are a different story as we enter 2020, riding on the heels of surging global stock and bond market rallies, even in the face of faltering fundamentals. The concern is that this is a liquidity-driven rally and a “Fear of Missing Out (FOMO)” trade, which is driving markets beyond their fundamental underpinning. The consumer is the bright spot and tends to be the game changer, especially at full employment. Do not be lulled into complacency: we expect and are prepared for regular storms in 2020 – a sequel to last year’s forecast. Thus, it is prudent to have a plan that takes into account blue sky, storms and hurricanes – and to tack accordingly.

General Investment Risks:

All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield inherent in investing. All security transactions involve substantial risk of loss.

Diversification does not guarantee a profit or ensure against loss. **Past performance is no guarantee of future results.**

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