MV CAPITAL MANAGEMENT

Weekly Market Flash

Our 2020 Investment Thesis

January 10, 2020

Summary

2020 is upon us and it is time for our annual outlook for the year ahead. This week's commentary will serve as a summary of the longer report all our clients will be receiving a couple weeks from now. There is an interesting dynamic at play as the year gets underway: it could, on one hand, be one of the most far-reaching in modern history for shaping how we will live for many years to come. On the other hand, it may be a particularly uneventful year for investment markets, for reasons we will briefly touch on here and analyze in more detail in our forthcoming Annual Outlook.

The market has a history of ignoring both domestic politics and global geopolitical flashpoints. Despite the likelihood of a very noisy year in both of these arenas we expect that, barring as yet unforeseen circumstances, this pattern will likely hold true this year. Rather than wondering what, where and when the next Middle East crisis will manifest itself, or whether the US election season will be the most vicious and controversial yet (hint: with a high degree of likelihood, it will) we believe investors will have their attention riveted on three principal factors: global economic trends, valuations, and central banks. Sound familiar? It should, because these have been just about the only ingredients in the sauce that has sustained the second-largest bull market on record. It will take a sudden and extreme deviation on the part of one or more of these to derail the bull. We do not see such a deviation as a high-probability outcome for the year ahead but should caution that when and if it does occur, the impact could be deep and sustained.

Global Economy

In 2019 there were two primary aspects of the economy under the microscope: the effects of the US-China trade war on global trade patterns, and the related fear that a hotter trade war would lead to a more imminent global recession. Those fears peaked in late summer and then more or less dissipated entirely in the fourth quarter as bellicose rhetoric gave way to the vaguely comforting fog of a "phase one" deal that kicked all the real problems far down the road.

Even assuming (as we do) that the trade war will stay cool and contained for the year (at least until the November elections), the global economy is likely to slow further with little in the way of organic growth catalysts anywhere in the developed or principal emerging economies. Both the IMF and the World Bank have successively downgraded their growth outlooks for 2020 (currently estimated to be around 2.5 percent), with the US a bit below 2 percent, Europe closer to 1 percent and China failing to stay above 6 percent. That being said, slow growth expectations have been baked into investor assumptions for a long time. Should events play out as the current outlook suggests, it would probably not do much to change investor attitudes towards risk assets.

Valuations and Earnings

By just about any conventional valuation metric, the US stock market is very expensive. Not early-2000 stratosphere expensive, but still very, very expensive. The S&P 500's 29 percent price appreciation in 2019 was accompanied by virtually flat growth in earnings per share for the index's constituent companies. So effectively all the gains resulted from an expansion of the price-earnings multiple rather than from a

tailwind of improved corporate performance. At 31 times cyclically adjusted earnings (using the Yale economist Robert Shiller's CAPE methodology) the S&P 500 is currently just below the recent cycle's peak of 33 times in early 2018. That, in turn, is a higher P/E mark than anytime in US stock market history other than the 2000 and 1929 bull market peaks.

There are two ways to look at this valuation puzzle. One is to say that what goes up eventually comes down, so unless corporate earnings suddenly burst out into sizable double digit gains (which few consider likely given the subdued patterns of global demand) there is not much room for further upside. In fact, many typically bullish Street analysts appear to be hedging their predictions for market price targets this year to moderate single digits because the fundamentals supporting a raging-bull case seem so dubious.

The other side to the coin, though, is that valuation metrics including the Shiller CAPE have proved in the past to be rather poor timing guides. In other words, just because something is expensive now doesn't mean it won't be even more expensive tomorrow. That viewpoint plays into the TINA argument – There Is No Alternative – that the easy money of recent central bank policies has literally forced institutional investors to keep on buying equities even when they appear expensive. And that leads us to the third of our key market drivers: the Fed and its fellow monetary mandarins in Brussels, London, Beijing and Tokyo.

The Central Bank Put

One can argue about whether a decade of easy money has been the right medicine for the economy of real goods and services, given that growth rates remain low by historical standards and price inflation has chronically lagged the central bankers' two percent targets. What is not debatable is that asset prices have benefitted. By keeping interest rates low – or in many cases negative – monetary policy has pushed risk-averse investors into making larger allocations in equities, particularly the large and mega-cap stocks with generous shareholder payout policies that have led this bull market. The idea of a central bank "put" – i.e. that any market downturn will result in a flood of new money to push rates down and risk asset prices up – is as close to a law of nature as exists in the financial world.

Central bankers themselves are never shy about reminding investors that, while their monetary policy tools may be effective for softening the contours of market cycles, they are not magicians. Easy money cannot by itself improve business productivity, which is the only source from which genuine long-term economic growth can proceed. For now the central bank put is in place – should the economy soften by more than expected, or should the stock market take a tumble similar to what happened in late 2018 – it would be foolish to expect an outcome other than direct and vigorous central bank intervention.

The problems will start happening when and if the easy money formula fails to deliver the goods. Central banks are just about the only surviving public institutions to have kept their integrity pretty much entirely intact in recent years. But here we are in the longest economic growth cycle on record, without ever having completely weaned ourselves off the monetary stimulus. Last year's rate cuts were given the somewhat misleading euphemism of "mid-cycle adjustments," suggesting something other than keeping a patient medicated who has not been able to function independently for a very long time.

If the Fed can get through 2020 without the need for further rate cuts then we could see the duration of the current cycle extending out further. The default outlook as of today suggests that to be a reasonable assumption. But events can change quickly, and our outlook for the year ahead will not stay static.

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