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Innovative Thinking + Smart Strategies

2020: The Year Ahead

Annual Market Outlook

MV Financial Research & Strategy Group

January 24, 2020

MVCM 2020 0008
DOFU: January 2020

The Year Ahead: 2020 Annual Outlook

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Note to our readers: On page 10 you can find an executive summary presenting the key themes we discuss in more detail elsewhere in this report. Of course, we invite you to read the full document for an understanding of the economic, capital market and other forces shaping our thought process.

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I. The World in 2020: Failures of Imagination

A. Worlds Away

"The true nature of the international system under which we were living was not realized until it failed."
-Karl Polanyi "The Great Transformation" (Farrar & Rinehart publishers, New York, 1944)

The last time the calendar saw out the decade of the teens and ushered in that of the 20s – fully one hundred years ago – the world was a very different place. There is no experience in our recent lifetimes to compare to the devastation of the First World War, an event that brought down empires and left widespread misery, resentment and loss of wealth in its wake. The early years of the 1920s were a time when nations tried to pick up the pieces and rebuild their broken societies. But rebuild how? What was the right formula for ensuring that the calamity of 1914-18 would not be repeated?

From our position in 2020 we know very well what happened one hundred years ago, and it did not work out well. The 1920s, while in some ways a progressive and flashy decade with some groundbreaking scientific and economic milestones, as well as social and cultural developments, also contained the seeds of what became a worldwide economic depression in the early 1930s. This period also witnessed the wholesale abandonment of democratic political systems in Italy, Spain and (most fatefully) Germany and Japan. This paved the way to an even more horrific and destructive war. Only after much of the world burned to the ground did a more durable and stable international system arise from the ashes.

The Postwar Order in Peril

That international system – what we commonly refer to as the "postwar world order" or somewhat chauvinistically as the "West" – has survived many twists and turns over the ensuing seventy-five years. It has seen off its main competitor for global dominance with the demise of the Soviet Union in the early 1990s. It has withstood numerous internal political, economic and social disruptions among its constituent nation states. It has opened its doors to accommodate new members of the club, from formerly Communist states in Eastern Europe to emerging markets in Latin America, Africa and Asia. One of those – the People's Republic of China – is now the world's second largest economy.

This system has been sufficiently robust to at times be taken for granted, like background scenery in a play that never changes while the characters act out the story. At its core, the system consists of two fundamental pillars: liberal democracy (free and fair elections, the safeguarding of individual human rights and respect for the rule of constitutional law), and capitalism (free trade, open markets and competitive private enterprise). Not that these two concepts have always been in place everywhere in the system: there have been and continue to be many alternative interpretations of "capitalist" economics, and the case of China's rise in the 21st century clearly demonstrates that liberal democracy is not a necessary condition for economic growth. But those twin pillars of democracy and capitalism have always served as the aspirational ideal for the postwar order – its brand, as it were.

At the dawn of this century's Twenties, though, there are serious concerns about the durability of this postwar order – less unchanging background scenery, and more an active part of the play itself. We are more than a decade away from the worst economic crisis to affect the world since the Great Depression. In some ways it may be easy to think that the impact of the Great Recession has ended. The S&P 500 regained its pre-crash record high back in 2013, after all, and has mostly been on a tear ever since. The current US economic growth cycle is by now the longest on record. Even Europe, threatened nine years ago by the prospective unraveling of the single-currency Eurozone, has managed to muddle its way through the decade without falling into regionwide recession or, as once feared, a deflationary spiral.

But the citizens of the postwar order are not happy. Over the course of the decade, but more notably within the past four or five years, they have made their distaste known in conspicuous fashion. Both the Brexit vote in June 2016 and the outcome of the US presidential election that November caught the conventional wisdom of the world's so-called "elites" completely off guard. In 2019 widespread street protests became a daily fact of life around the world, from Santiago to Paris to Hong Kong. Both democracy and global trade appear to be in retreat, while authoritarian and nationalistic political and economic models find increased favor across the globe. From our vantage point it seems possible to argue that the greatest impact of the 2008 crisis was not in the numbers themselves (which reversed themselves back to health in short order) but rather the moral legitimacy of the system itself and the elite institutions that support it.

We began this report with a quote by the social philosopher Karl Polanyi and a reference to the postwar era of the 1920s, an era Polanyi analyzed deeply in his seminal mid-20th century work "The Great Transformation." We think there is merit in a closer look at certain aspects of this period that might shed light on some of the critical junctures we may be approaching today. The wrong turns of that period, in no small part, were due to failures of imagination on the part of those in a position to make critical decisions. We sense a similar failing of imaginative capabilities today, but nevertheless retain the hope that lessons learned today can be translated into better decisions tomorrow. This is our small contribution to this project of hope in the best way we know how – analysis and insights derived from facts and data.

After the Deluge, More Rain

Put yourself into the shoes of a European policymaker in the early 1920s, and you could easily understand why the impulse was so strong to "go back to the way that it was." The last thirty years of the nineteenth century was a period of nearly uninterrupted peace between the great powers of Europe. The primary mechanism for keeping the peace was not a political arrangement as much as it was an economic one: the gold standard. From the 1870s through the early years of the 20th century trade between nations grew to levels never witnessed in history. To be a member of this global club only one thing was required: the maintenance of convertibility between the national currency and gold, at a fixed rate anchored by the cost per ounce of gold in British pounds sterling (three pounds, seventeen shillings and nine pence per ounce). Any national economic concerns – e.g. labor wages or prices for domestic goods – took a back seat to the paramount issue of maintaining the gold standard.

Most of the leading policymakers of the 1920s had been around to see the fruits of at least part of that long period of prosperity before the Great War. Rather than thinking more deeply about why that system had come apart in the years leading up to the war, they were almost to a man (no women among them, unfortunately) united in their faith that the way forward was to go back, meaning back to the gold standard. In 1925 Winston Churchill, then Chancellor of the Exchequer in Westminster, returned Great Britain to the gold standard at the exact prewar rate of exchange we indicated above, despite being warned (most prominently by John Maynard Keynes) that at that exchange rate British goods would be uncompetitive in global markets.

In the end, Keynes was right and Churchill was wrong. The recreated gold standard did not work, leading to chronic imbalances between balance-of-payments deficit countries (like Britain) and gold-hoarding surplus nations like France (whose monetary mandarins made a series of short-sighted, self-interested policy decisions that amount to an entire discussion itself). By the end of the decade the problems appeared beyond repair as countries once again quit the gold standard (the British themselves, for the last time, in 1931) and the world sank into the icy waters of the Great Depression.

Environments Change…Mindsets Not So Much

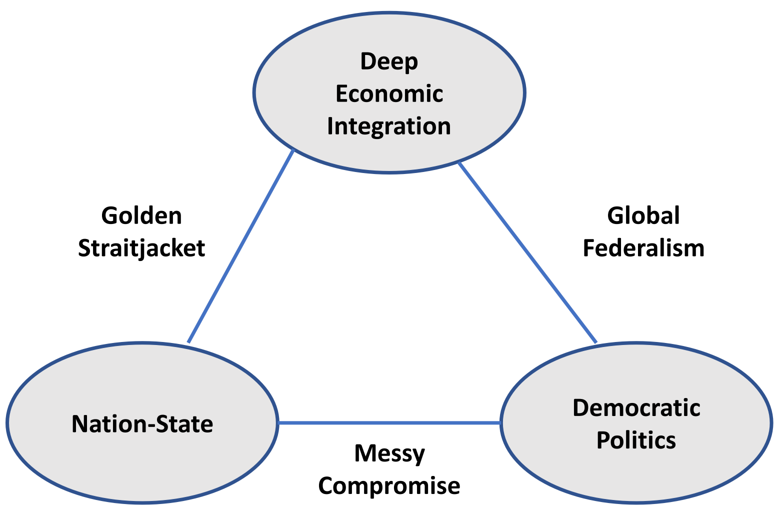
In the end, the primary reason for the failure of the reconstructed gold standard was that the world of the mid-1920s had changed in a number of fundamental and transformative ways from that of the late nineteenth century. The labor movement had grown in response to protests at inhumane conditions in the factories and streets of rapidly industrializing urban centers. The women's suffrage movement was in full swing. Older norms of governance steeped in monarchial and aristocratic traditions were giving way to modern bureaucracies with data-driven policy agendas. In this world of noisily competing claims and interests, the simple subjection of every other economic matter to the single question of gold convertibility was infeasible and unworkable. A rational pair of eyes – like that of economics *Wunderkind* Keynes – could see the unworkability of the old system. But the most powerful figures of the day – even those with the intelligence and stature of Winston Churchill – failed to see these inherent flaws. They looked back on the Concert of Europe – the nineteenth century balance of European great powers that had survived in one form or another since the end of the Napoleonic Wars in 1815 – and tried to reincarnate this mechanism in the form of the League of Nations. The failure of the League, in turn, derived from a failure of imagination.

And this is the point that matters for the purpose of our discussion now, at the outset of 2020. Failure of imagination is the natural byproduct of a mindset rooted in the certainties of what worked in the past, with the attendant inability to grasp the magnitude of change that has occurred organically in the world around us. Where policymakers in 1920 looked fondly back to the peaceful, prosperous decades of the Concert of Europe, today in 2020 there is a yearning for that aspirational idea of the post-1945 world order: the twin pillars of liberal democracy and global capitalism spreading their message of enlightenment and prosperity throughout the world. But as in 1920, so today the world has changed dramatically enough to make that yearning a fantasy. Some of the inherent contradictions of the postwar order have caught up with us. What we need today is not a wishful retreat to the perceived "way things were." What we need is a practical understanding of why things are as they are – and with that practical knowledge, perhaps the beginning of something from which to build a new foundation.

Rodrik's Trilemma

Dani Rodrik is a professor of international political economy at the Harvard Kennedy School of Government, and the author of several bestselling works about economics, markets and society. Back in June of 2007 – well before the Great Recession and its attendant market crash, when Barack Obama was still a junior senator from Illinois and the current occupant of the White House spent his days and nights on reality television sets – Rodrik posted an interesting concept on his blog (which, quaintly, was called "Dani Rodrik's Weblog"). He called this concept "Rodrik's Trilemma." It didn't get much coverage at the time outside the rarefied air of academic conferences and the like, but Rodrik's Trilemma offers a compelling argument that goes to the heart of the conflict between the world we live in today and that aspirational ideal of the postwar order.

Chart 1: Rodrik's Trilemma



Source: Dani Rodrik's Weblog

Here's the basic idea of this trilemma. There are three physical embodiments of the postwar ideal: functioning nation states, democratic politics, and an integrated world economy. Rodrik's argument – and this is what he means by "trilemma" – is that we can't have all three. We can only have two out of three. Now – according to iconic 1970s-era singer Meat Loaf – "two out of three ain't bad." But we don't agree with Meat Loaf – we want three out of three. Is Rodrik right – does the trilemma explain (as per iconic 2010s-era singer Taylor Swift) that "this why we can't have nice things?"

When the international leaders who gathered in Bretton Woods, New Hampshire in 1944 to fashion the architecture of the postwar order made an assessment about what had failed in the 1920s and 1930s, their conclusion (correctly) was “rigid thinking.” In fact they implicitly anticipated Rodrik’s trilemma by understanding that the straitjacket of the gold standard (which after all was the linchpin of the old nineteenth century integrated global economy) made it impossible for nation states to build their own democratic, representative political structures. So they compromised. Bretton Woods created a gold exchange standard in which foreign currencies were convertible into US dollars – which was then established as the world’s reserve currency – with the dollar in turn set to a fixed price per ounce of gold. But there was leeway for countries to work within the IMF and the World Bank (the supranational agencies established at Bretton Woods) to adjust their exchange rates as needed in order to facilitate international trade and rebuild their war-torn domestic economies. Bretton Woods ditched the golden straitjacket in favor of a messy compromise (see Chart 1 above). Bretton Woods was an enlightened, imaginative outcome in contrast to the way that the 1920s-era League of Nations was a failure of imagination. And for many years it worked – the French still refer to the Bretton Woods era as the “Thirty Glorious Years,” even though the system was already showing after just fifteen years the cracks that would eventually bring it down.

Neoliberalism Reborn

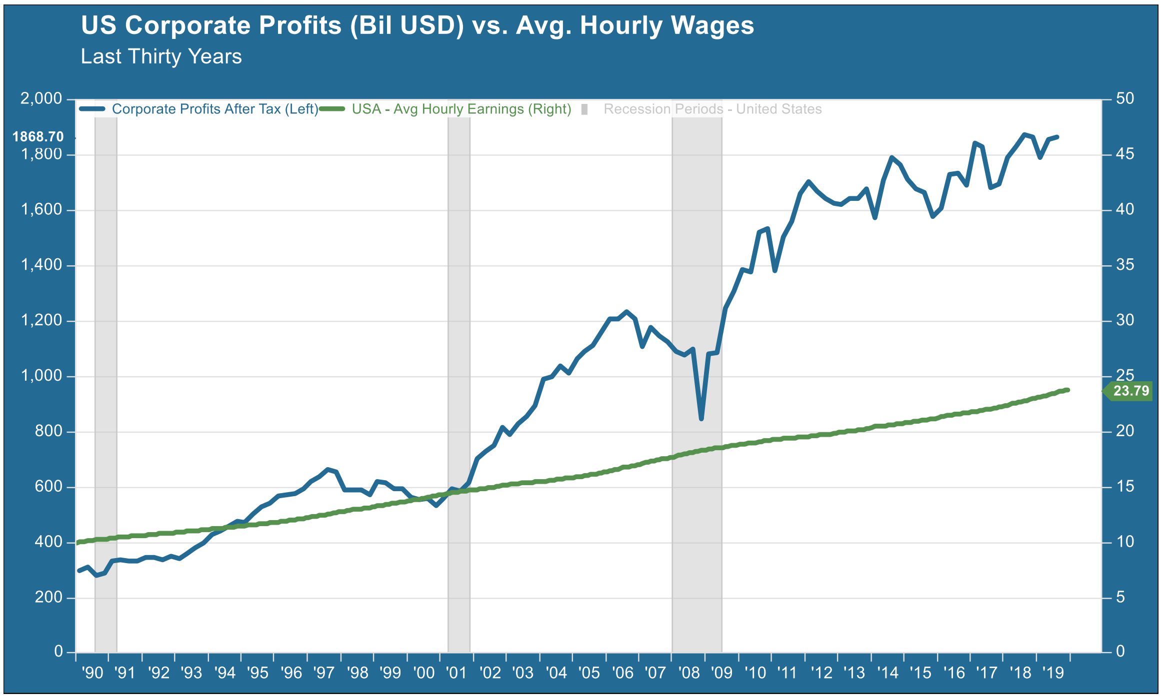
The Bretton Woods architects made a conscious decision to focus on the importance of democratic nation building, with the compromise of carefully managed foreign trade rather than a fully integrated global economy. But the system was not without its critics, right at the beginning of the project. Around the same time, in 1947, another meeting of minds took place in Geneva, Switzerland. This group called itself the Mont Pélerin Society (MPS) and its members had already taken to calling themselves “neoliberals,” led by the eminent economists of the so-called Austrian School Friedrich Hayek and Ludwig von Mises. While there was no one single position statement by MPS as to the ideal way to structure the world of nations and commerce, an idea that held currency with many of them – at least in the abstract – was the idea of a sort of global federalism for nations that wanted to trade with each other (again, see Chart 1 above). This may sound strange to our ears – and indeed it was strange enough back then that most MPS members would admit in their candid moments that it was practically unworkable. But the basic idea would have been a global supranational government that would regulate all matters of global trade and commerce, leaving individual nations (or regions or any other arrangement, they didn’t care so much about what form) to implement their own laws and customs regarding everything else. A nation could set its own laws about, say, free speech or the role of institutionalized religion, but that same state could not run its own Treasury Department or Ministry of Finance that would in any way interfere with the workings of the global economy.

Needless to say, global federalism never became a thing. But the philosophical underpinnings of neoliberalism – most importantly the idea that a market economy can only function when all matters pertaining to a society are subjugated to the primacy of market considerations – took root over the course of the 1970s as the Bretton Woods system sputtered out. Neoliberal thinking was at the heart of the economic deregulation that began under US president Jimmy Carter and kicked into even higher gear under his successor Ronald Reagan. It drove the intellectual arguments for the wide-scale privatization the British government undertook with Margaret Thatcher. Industry after industry deregulated. In parallel, weakening antitrust regulations facilitated the rapid consolidation of industry sectors. The winners – the companies that acquired other companies and grew their market share – set off around a newly accommodating globe to outsource cheap labor, build global demand for their products and services, and eventually construct intricately optimized, multi-part supply chains consisting of both physical and digital assets.

This was neoliberalism, but that term never really entered the popular conversation until it had already gestated for about two decades – specifically, until some of its manifest flaws became too obvious to ignore. The rise of global neoliberalism was in conflict with Rodrik’s Trilemma. Global enterprises had shaken off the fetters of the nation states where they still did business and where they – sometimes – still maintained their headquarters. Without thinking much about it, national economic policies increasingly conformed to the desires of global private enterprise, while occasionally paying lip service (typically in the heat of election season) to the disruptions caused back at home by all the outsourcing and footprint-building and supply-chaining. To refer back to the Karl Polanyi quote at the beginning of this report, we – those who built this system, who wrote about this system and defended this system against its critics – didn't really understand the nature of the system until it started to come apart.

But neoliberalism's losers understood the system. These were the people left behind when decades-old manufacturing centers left their towns in the never-ending quest for growth and profits. Their story during the age of global integration was that of unemployment, stagnant wages and the attendant crises of family disintegration and opioid dependency. Chart 2 below shows the relationship between S&P 500 corporate profits and average hourly wages during neoliberalism's heyday.

Chart 2: Profit and Wage Trends in the US



Source: Bureau of Labor Statistics, MVF Research, FactSet

None of this is to say that ever-deeper global integration is bad – from an economic standpoint there is no competing model for facilitating growth – and growth always has been the lifeblood of capitalism. But the imperative to serve their shareholders and creditors with maximum profits – the sole mandate for private sector companies in our global economy – is only compatible with the interests of a nation state when those interests don't interfere with profits. The left-behind remnant in small, failing Midwestern towns understood Rodrik's trilemma in its basic essence, well before the Great Recession. That calamity would have been a good time for the rest of us to take stock of the system's manifold flaws and think imaginatively about how to repair it. Instead, all our work went right back into rebuilding that same system, with the only goal in sight being how quickly the S&P 500 could recoup its previous record high (answer: five and a half years, in April 2013).

And Now What?

So here we are in 2020, faced with the profound disruptions to the postwar order that have taken place with, seemingly, no real clue as to how to proceed from here. At the level of individual nation-states, we increasingly seem to be forced to contemplate stark binary choices in which either option is deeply flawed. We need look no further than Great Britain in 2019 for a tangible example of this problem.

The original Brexit vote resulted in a small majority for the Leavers, those who preferred to exit the European Union and go it alone. 48 percent of the country opted instead to remain in the Union; nevertheless, a vote is a vote. Given the tightness of the vote and the obvious polarizing nature of the decision to leave the EU, one might have thought that the British government would bend over backwards for an inclusive process that accomplished the goal of Brexit without – as much as possible – completely alienating the sizable portion of the country opposed to leaving. But one would have been wrong in that assumption. The most extreme, hardline factions of the ruling Conservative Party became, in time, the sole voice of the party, with their shopworn gauzy promises of going back to the "way things were" – John Bull and pints of ale in cozy pubs and sheep grazing upon England's pastures green. By 2019 the Tories, one of the world's oldest and most durable political parties with a founding ethos in the spirit of liberal democracy and openness to unrestricted global commerce, had become inward-looking, nationalistic and increasingly ethnocentric. Brexit was not so much a carefully considered alternative economic blueprint as it was a tribal identity badge for its adherents.

That this Conservative Party won a resounding victory in the December 2019 elections says less about the compelling message of its own party platform than it does about an even more gaping failure of imagination on the other side of the debate. The Labor Party – in recent memory the pragmatic, centrist domain of the likes of Tony Blair and Gordon Brown – coalesced around a leader in Jeremy Corbyn who offered up an alternative yearning for the "way things were" – in his case, the way of things in the 1970s when much of Britain's economy was state-owned, uncompetitive, unproductive and unable to deliver the putative benefits of a system that left its citizens contemplating what "socialism" meant for them as they waited in unemployment queues for meager state-provided benefits.

Even the Liberal Democrats, a normally influential and moderate third voice in Britain's multiparty system, could not resist their own tone-deaf variation on promising to go back to the "way things were." As if to remind everyone why they hated smug, better-than-thou neoliberal globalists enough to contemplate Brexit in the first place, the Lib Dems ran on a platform of immediately annulling Article 50 – the legal mechanism for leaving the EU – so that Brexit would never happen. Not a second referendum, not a way to try and split the difference between Leavers and Remainers. Just a prim, nanny-state "we're right and you're wrong, so let us go back to power so we can tell you what to do" stance that goes a long way to explaining why so-called expert opinion is in such disarray today. The Lib Dems, not surprisingly, lost big in December.

We cited the Brexit example here as a single illustration of a problem that is playing out in different guises the world over, all of which seem to somehow find their way back to one argument, like so many misguided carrier pigeons. *We'll go back to how it all was before*. The failure of imagination writ large on the global canvas. Each of these polarized pluralities has its own fantasy of what exactly "the way we were" actually means. Hollowed out, opioid-stricken towns in the US Midwest dream of a prosperous manufacturing society. Upwardly mobile coastal professionals want the neoliberal system to keep giving them the outsize spoils that translate to permanent social advantage and the leg up for their kids to get into Harvard. Reinvigorated socialists want…which wildly successful past example of the socialist experiment, exactly? For all too many – here at home and abroad – "the way we were" also implies a time of less diversity, with physical and cultural walls erected to keep others away from the same opportunities.

So now what? In our polarized world increasingly unable to even agree on what constitutes fact versus fiction, is it even possible to think and act imaginatively in a way similar to how the framers of the Bretton Woods deal created a system for rebuilding a devastated world? In a book called "The Great Leveler" the academic Walter Scheidel argues that problems like inequality and lack of due process fester and become worse until one of the "great levelers" – war, famine, plague, natural disaster – wipes the slate clean and gives society a chance to start anew.

We must hope and keep working for imaginative ways to transition from the old postwar order to our new realities without an unwanted assist from one of Scheidel's levelers. A big part of the challenge is simply to understand the scope of the problems in an analytical, dispassionate way and to waive away our own individual ideological and personal biases in attempting to solve them. For us this is not some adjunct, quixotic quest. It is fundamental to our job as the stewards of money entrusted to us for management. It goes beyond reporting on the latest jobs numbers and retail spending figures, to understanding not just what might be affecting the S&P 500 in any given discrete time period but how vulnerable the system itself is to the disruptions taking place around us.

With that in mind, we now bring the discussion down to the specific forces at play as the new year and the new decade get under way. If this Section I has focused mostly on big-picture, multi-year changes in the world around us, Section II will contain a very different message about how 2020 is shaping up for the economy and investment markets. What is likely to be a very noisy and tense year politically and culturally may, in fact, be a very quiet and calm year economically.

II. 2020 Investment Thesis: The Noise and the Calm

A. Executive Summary

The world may be on the cusp of a new paradigm to replace the seventy-five year postwar order, as we described in the first section of this report, but the year 2020 could conceivably be relatively calm and uneventful from the standpoint of the world economy and investment markets. We explain our reasoning for this below.

The year ahead should see favorable tailwinds for modest appreciation in asset prices, with upside resistance in the form of stretched valuations and downside support in the form of central bank monetary and liquidity support. The key consideration on the upside would be the extent to which investors are comfortable with higher valuation multiples given the lack of alternative investment destinations. The key consideration on the downside will be the ability of central banks to maintain confidence in the effectiveness of their policy stimulus toolkit. A failure of confidence in central banks is, in our opinion, the biggest risk the market faces.

- The recession fears that ran rampant in the summer of 2019 have largely abated. In place of those fears, market observers expect a continuation of modest growth with outperformance by the US over the Eurozone, a modest rebound in some key Asia Pacific economies such as Singapore and South Korea, and China managing to stay somewhere close to its six percent growth targets. **Key risks**: recession in the Eurozone led by Germany, sharp fall-off in US consumer spending negatively impacting GDP growth, China unable to offset expected declines in infrastructure and property-related spending.

- The US – China trade war drove much of the daily movement in equity markets last year. We expect that ongoing issues related to global trade will impact markets less in 2020. The so-called "phase one" deal signed on January 15 accomplishes very little in practice, but lowered expectations should move investor focus elsewhere. **Key risks**: attention may shift from China to Europe. The phase one deal with China was mostly political maneuvering by the US to keep the economy on track during an election year. The same administration seems to enjoy using Europe as a foil to gin up its nativist base, though, and may see short-term political gain to tariffs and other punitive measures.

- Corporate earnings will be front and center in the discussion due to the current stretched level of valuation multiples. Companies on the S&P 500 are trading at price-earnings (P/E) ratios higher than at any time since the tech bubble at the turn of the century. Current earnings growth expectations for the first two quarters of 2020 are in the mid-single digits but are highly likely to trend lower as the release dates approach. **Key risks**: at some point, investors may decide that the glass-half-full approach isn't working when digesting mediocre earnings news, and sell off accordingly.

- Interest rates are likely to remain low in the absence of a notable pickup in global growth and amid the expected continuation of central bank stimulus. All else being equal, low rates should continue to push conservative institutional investors like pension funds and insurance companies out of their ultra-safe habitats and into higher-yielding assets including blue chip equities. **Key risks**: The yield-chasing phenomenon has pushed down risk spreads between Treasuries and other assets like corporate debt, mortgage securities and bank loans. That may backfire if the overall environment looks worse than expected, which in turn could increase spreads and spark a higher number of defaults by weak issuers.

- Central banks will continue to support asset prices and will not hesitate to use whatever tools are at their disposal to head off either an economic recession or a bear market. **Key risks**: Central bankers cannot manufacture organic growth. At some point either organic economic growth will reappear or the central banks will run out of credible stimulus. That second outcome will likely be a very bad day for the market.

B. State of the Global Economy

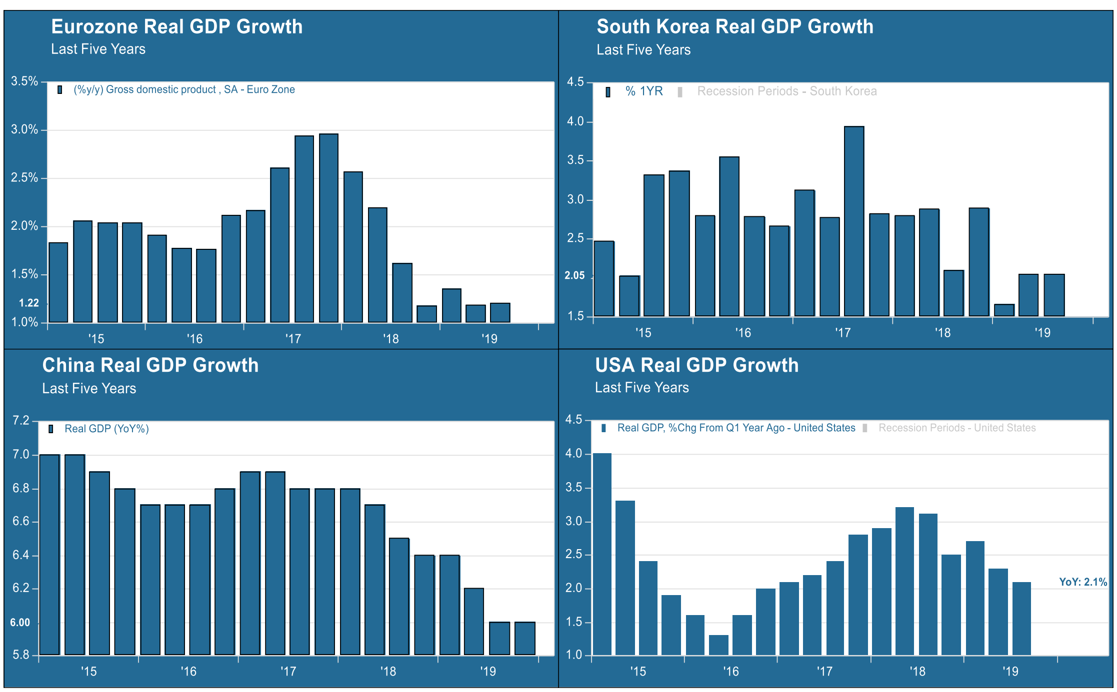
i. Plodding, Predictable and Positive

The current economic recovery in the US is the longest to date, surpassing the previous record of ten years (1991 – 2001) last July. During this period not just the US but most of the world has managed to stay out of recession. The pattern has been striking enough to bake in the same expectations, year in and year out. In summary these expectations go as follows:

- US growth will be slow by historical comparison but will still be better than sclerotic Europe or demographically doomed Japan. Consumer spending, the mainstay of the US economy, needs to remain robust because nether business investment nor net exports nor government spending are likely to offset a downturn in consumption.
- China will do the heavy lifting for the developing world (maybe with an assist from India) but will be far off its torrid pace of earlier this century. The picture does not look promising for other emerging markets or newly developed markets (such as South Korea or Singapore). China has its own domestic problems apart from the trade war with the US.
- The net result will be a global economy expanding in the low-mid single digits (the IMF and the World Bank currently expect global growth to be around 2.5 percent in 2020).

The chart below illustrates the comparative growth trends over the past five years between the US, the Eurozone, China and South Korea. As the chart shows, there has been a pronounced trend lower in each of these cases, with the US now starting to follow the same downward trend.

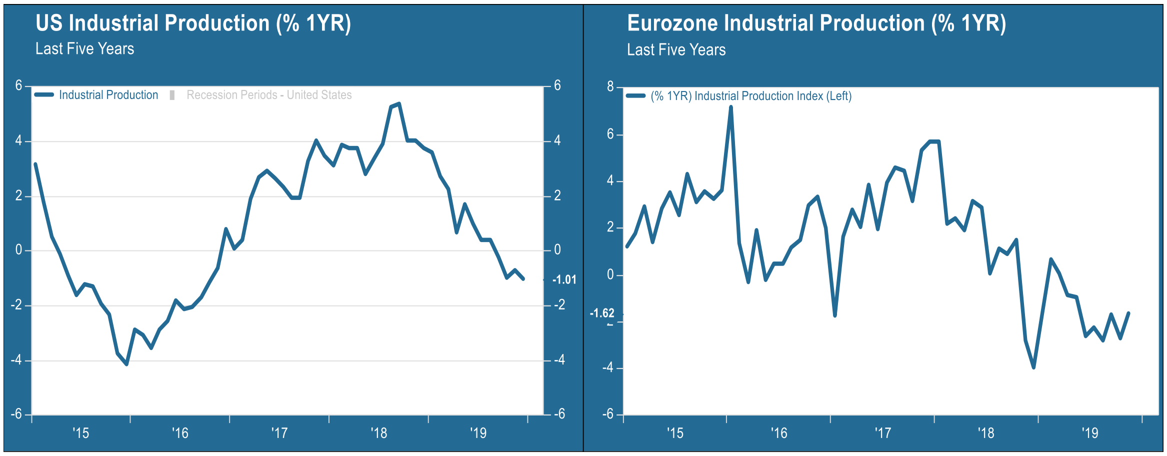
Chart 3: Real GDP Growth in the Eurozone, South Korea, China and the US



Source: FactSet, MVF Research

There is very little at present to suggest that 2020 will be different from the recent past. Fears of a recession in the US have abated since last summer. The Eurozone is potentially closer to turning negative, and much will depend this year on the economic fortunes of Germany, the region's biggest economic engine. In both the US and Europe one of the trends causing some concern is industrial production, which has been on the decline for more than a year. Industrial production is widely regarded as a leading indicator, meaning that it will tend to start turning down well ahead of a recession. The chart below shows the industrial production trend in the US and Eurozone for the past five years.

Chart 4: Industrial Production in the US and Eurozone



Source: MVF Research, FactSet

Offsetting concerns about industrial production trends is the fact that manufacturing makes up only a small part of almost all developed market economies. The services sector accounts for almost 80 percent of US economic output, for example and about three quarters of GDP in the Eurozone.

The one major question for which there appears to be no explicit consensus among economists and other observers is why this slow growth trend has persisted for as long as it has. There are plausible arguments on both the supply and the demand sides of the equation. Business investment has diminished as a contributor to GDP growth, as companies routinely choose to recycle profits back to shareholders through dividends and buybacks. Business productivity, which is the only path to long-term organic growth, remains weak in most countries. On the demand side, demographics suggest the potential for weakness as far as the eye can see: the combination of ageing and rising inequality – again, in almost all geographies – increases the savings rate relative to personal consumption and investment.

ii. The Trade War: Crouching Tiger or Paper Tiger?

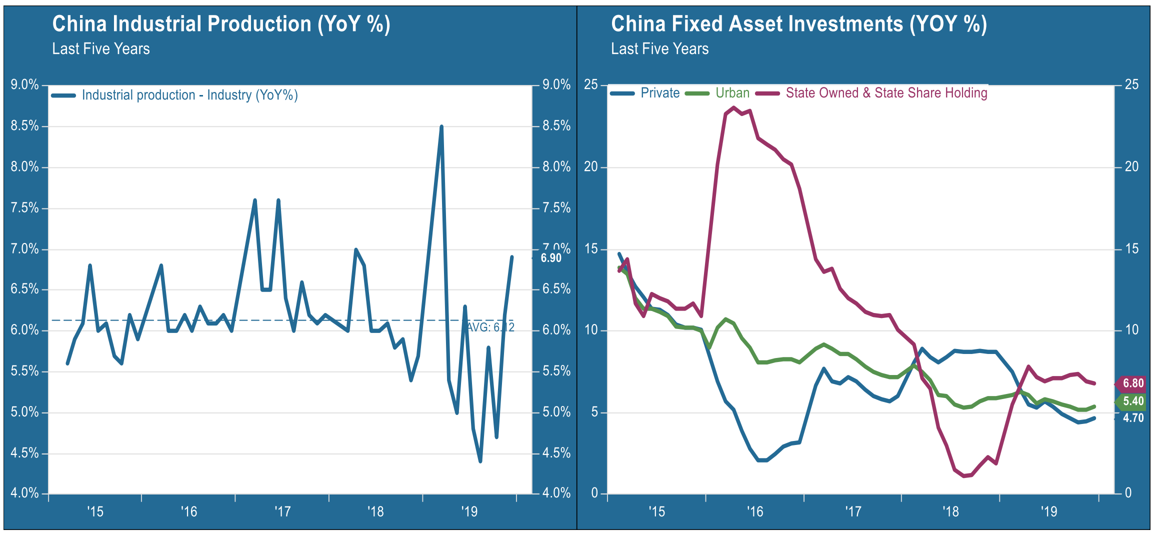
In 2019 the **US-China trade war**, which came into being a year earlier with a series of new tariffs initiated by the US and reciprocated by China, became one of the single biggest economic drivers of asset market sentiment throughout the year. At times it seemed as if intraday market movements responded to nothing other than rumors, speculative tweets and occasional outright lies (China called last night begging for a deal!) about the progress of trade talks. Yet the trade war, coming up now on its second anniversary, so far has had a relatively muted effect on the US economy – and for that matter the Chinese economy as well. Prices of goods subject to tariffs upon entering the US have risen by about 3 percent on average. But the cost inflation seems to mostly have been absorbed by importing companies and not passed onto the US consumer. Consumer price inflation has remained low throughout this period. The volume of trade between the two nations has declined by around $100 billion, yet GDP growth rates for both are only slightly below prevailing trends for the past several years.

In 2020 we expect that the trade war will not be as influential a driver of asset market trends as it was last year. Following the signing of the "phase one" deal on January 15, most of the important issues the phase one deal will not have resolved are likely to be shelved until after the US presidential election in November. The present administration sees the economy as a favorable political message and will be unlikely to take any active steps that could scramble the message.

As for China, the potential vulnerability of the Chinese economy to the succession of new tariffs put in place by the US created concern among investors that 2019 might be a repeat of that six-month period from late summer 2015 to winter 2016, when a series of stumbles in China first popped an asset bubble in domestic Chinese equities and then spread around the world, causing major indexes including the S&P 500 to experience a correction of more than 10 percent.

But the trade war seems to have had a relatively muted impact on China. The chart below shows two key indicators of Chinese economic performance: industrial production and investment in fixed assets. Traditionally these measures have served as useful proxies for overall economic health.

Chart 5: China Industrial Production and Fixed Asset Investment



Source: MVF Research, FactSet

Part of the reason for the fairly benign showing for these two measures in the time since the first imposition of tariffs is that China's dependence on the US economy steadily decreased over the course of the last decade. In 2011 exports to the US accounted for about 6 percent of China's total GDP. In 2019 that share had fallen to below 4 percent. China's main economic priority over this time has been to develop its domestic economy, particularly domestic consumption, and to accomplish this goal it has both diversified its reliance on global trading partners and invested more in services-oriented activities such as technology. In fact the resilience of fixed asset investment (the rightmost chart above) owes more to growth in high tech and consumer services than it does to the old reliable go-to sectors of infrastructure and property.

The fact that there is a pause in the trade war does not, however, mean that all is well. We see two principal concerns that, while either of them may or may not emerge as clear and present threats in 2020, cast a shadow over longer term growth.

The first relates to corporate uncertainty. When companies report their sales and earnings to analysts every quarter, they also provide guidance for future performance based on the prevailing trends and developments in the markets where they compete. One of the problem areas in the US – China relationship conspicuously not addressed by the phase one agreement is the ongoing difficulty US companies have in competing in the Chinese market on equitable terms. As long as this remains as a "to be resolved sometime in the future" item, that uncertainty will persist. This is particularly important in 2020 because corporate earnings are likely to be in close focus year (we discuss this in further detail later in this report).

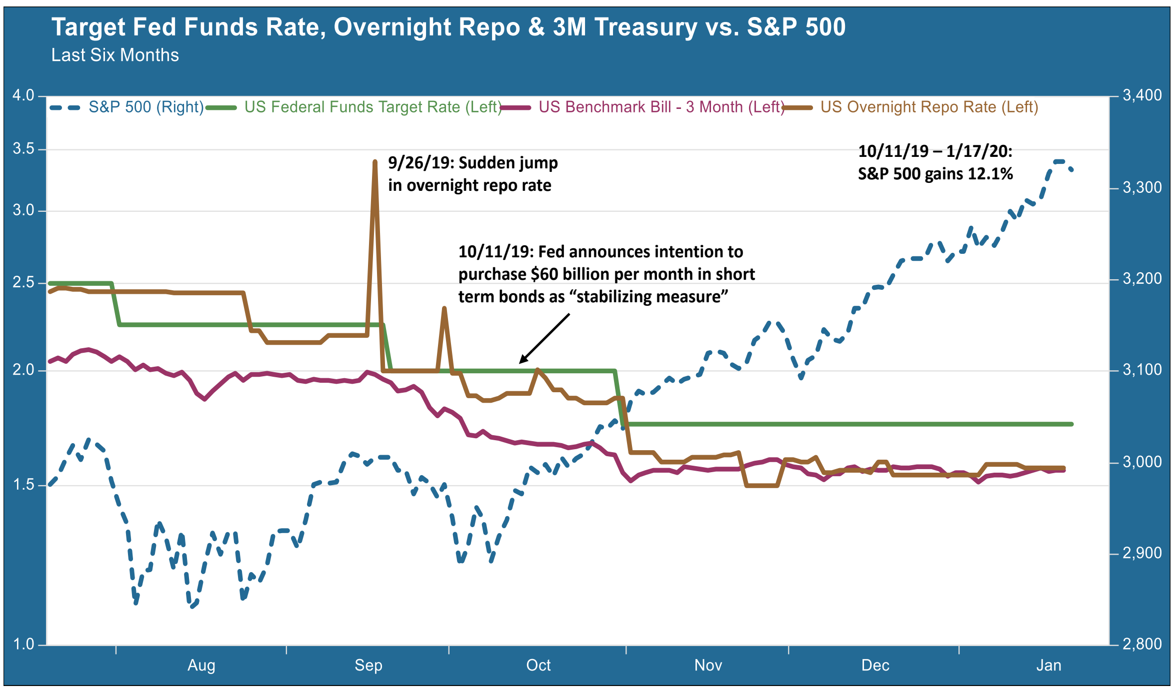
The second concern is that China is by no means the only flashpoint of contentious trade emanating from the US. Hostilities are also prevalent elsewhere in the Asia Pacific Region, in Europe and also in the Americas. Again, we do not expect the US administration to ratchet up material trade hostilities in the lead-up to the election. But pugnacious rhetoric can have its own tangible downside. The current US administration has shown itself partial to using our European allies as a punching bag for firing up its nativist, ethno-populist base on a variety of issues, including trade. A recent example of this was the threatening of new sanctions against the EU in the event that the region's principal nations failed to issue a strongly worded statement and commitments to take action against Iran in the wake of the recent drone strike by the US against the Iranian regime's military leader.

The big picture on global trade is fairly dour. Major economic partners are trading less with each other and looking for ways to offset the decline in growth as the threads of global integration weaken. But it will take a long time for these threads to completely unravel, short of a major catastrophic event. For the time being, global supply chains and demand networks suggest that a diminishing of global grade will not by itself be the harbinger of recession in the immediate term. But it does suggest that the headwinds to stronger global growth will remain fierce.

iii. The Fed and QE Existentialism

A strange thing happened on September 26 last year. The yield on US overnight repurchase agreement securities, typically regarded as one of the most unremarkable corners of the credit market, suddenly spiked up for no apparent reason. In the chart below you can see the unnatural divergence of the overnight rate (in brown) versus two short term yields (target Fed funds rate and 3-month Treasury bill) which the repo rate normally tracks.

Chart 6: Strange Case of the Overnight Repo Rate



Source: MVF Research, FactSet

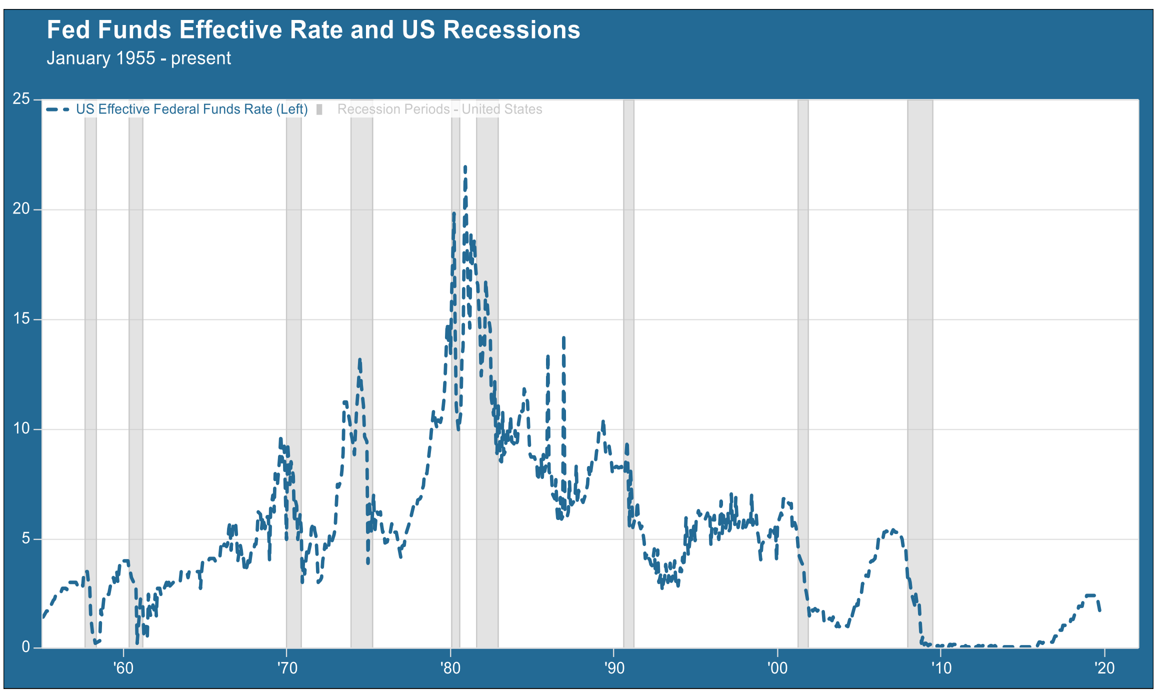
Observers concluded in short order that a supply-demand imbalance was the root cause of the problem, brought about by an increase in cash withdrawals from money market funds by corporations ahead of a tax deadline, with a simultaneous drawing down of reserves by banking institutions ahead of settlement for a recently held Treasury auction. This elicited concern from observers that the low existing level of bank reserves was tied directly to the Fed's winding down of its quantitative easing (QE) program over the prior two years. In response, the Fed quickly marshaled its resources and announced on October 11 that it would immediately start purchasing $60 billion worth of short-term bonds every month in order to stabilize overnight lending markets.

This announcement by the Fed represented the first time the central bank would be growing its balance sheet since it ended its third QE program. Although Fed Chair Jerome Powell and his colleagues took extreme pains to convey the message that this short-term stabilization measure did NOT represent a return to QE, investors chose to see things differently. Now, it would not be fair to say that the $60 billion T-bill purchase operations were the sole reason why the S&P 500 jumped more than 12 percent from October 11 to mid-January of this year. Other factors including another interest rate cut, the announcement of a trade war ceasefire and a corporate earnings season deemed "good enough" were in the mix as well. But the return to an expanding Fed balance sheet added a jolt of adrenaline to the market. This presents a problem to the Fed in terms of messaging. The central bank intends to reduce and then stop its T-bill purchasing operations when it deems the market is stable enough (through changes to bank reserve procedures) to wind down. It will have to convince investors that this was never intended as a QE program…and investors are unlikely to agree.

iv. The Fed and "Never Normal" Interest Rates

2020 starts with **interest rates** reliably close to their historic lows around the world. Over $12 trillion in outstanding global government and corporate debt issues currently trade at negative yields. In the US, the Fed reversed course in early 2019 and lowered its Fed funds target rate three times. During a period of three years in which the central bank tried to bring rates back to "normal" levels the Fed funds rate never even made it halfway to the high point of the previous rate hike cycle in 2004-07. The carnage in global risk asset markets in late 2018 appeared to have unnerved Fed policymakers even in the absence of clear data suggesting that the economy was turning weaker. The chart below underscores the unique nature of monetary policy in the current economic growth cycle versus all others in the postwar period.

Chart 7: US Effective Fed Funds Rate and Recession Periods



Source: US Bureau of Economic Statistics, MVF Research, FactSet

Here is the main takeaway from this chart: despite the current US economic growth cycle being the longest on record, the Fed kept interest rates at or near the zero lower bound for a longer period than in any prior cycle. Both the absolute level of the lower bound and the duration of the easy money policy have no precedents in modern US history. And don't forget that managing the Fed funds rate was only part of the Fed's toolkit during this period – the additional weapon of buying long term securities through its three QE programs was also unprecedented.

The sudden shift in Fed policy in 2019 had an immediate effect on risk asset markets. All else being equal, lower interest rates increase the value of future cash flows because those future streams are repriced at a lower rate for discounting back to the present. The Fed's move explained much of the stock market's positive performance in the weeks following the pivot announcement. But lower rates have another way of boosting a certain class of risk assets; namely, high-quality equities with generous shareholder payout policies. This asset class benefits because highly conservative institutional investors with defined spending policies – think of pension funds needing to keep their plans fully funded or insurance companies with their year-to-year claims payout obligations – need to shift their asset allocation policies accordingly. This dynamic has played out gradually; in the early days of monetary stimulus following the 2007-09 recession the prevailing assumption was that shock measures like zero interest rates and quantitative easing would be temporary. Eleven years later the conventional wisdom has changed and stimulus now appears to be permanent. What this suggests is that valuation multiples, though high by standards of historical comparison, may be more resistant to normal mean-reversion pressures than would once have been the case. As long as interest rates stay low, demand for high-quality large cap equities is likely to remain robust.

The previous point leads us to what we see as the **biggest potential risk ahead**, whether that be in 2020 or (more likely) sometime further down the line. Central bankers themselves are generally not shy in reminding their audiences of the limits of monetary policy. Stimulus by itself cannot create organic economic growth, it cannot improve business productivity and it cannot optimize capital formation to its most efficient and progressive uses. There are quantitative limits to monetary stimulus (even if negative interest rates are a permanent part of the landscape, there is presumably a level below which they will be counterproductive, and chances are we are not too far away from that level now). There are unintended consequences to monetary stimulus: the sudden spike in the overnight repurchase agreement rate last September was an illustration of that.

The risk here is very straightforward. In the absence of the kind of economic growth patterns that were the norm prior to the Great Recession, markets have relied on central bank stimulus for stable, sustainable price appreciation. If the credibility of that stimulus fails – if the tools are demonstrably unable to achieve their targets, then the downside protection of the "central bank put" goes away and substantially increases the likelihood that the bull market will meet its end.

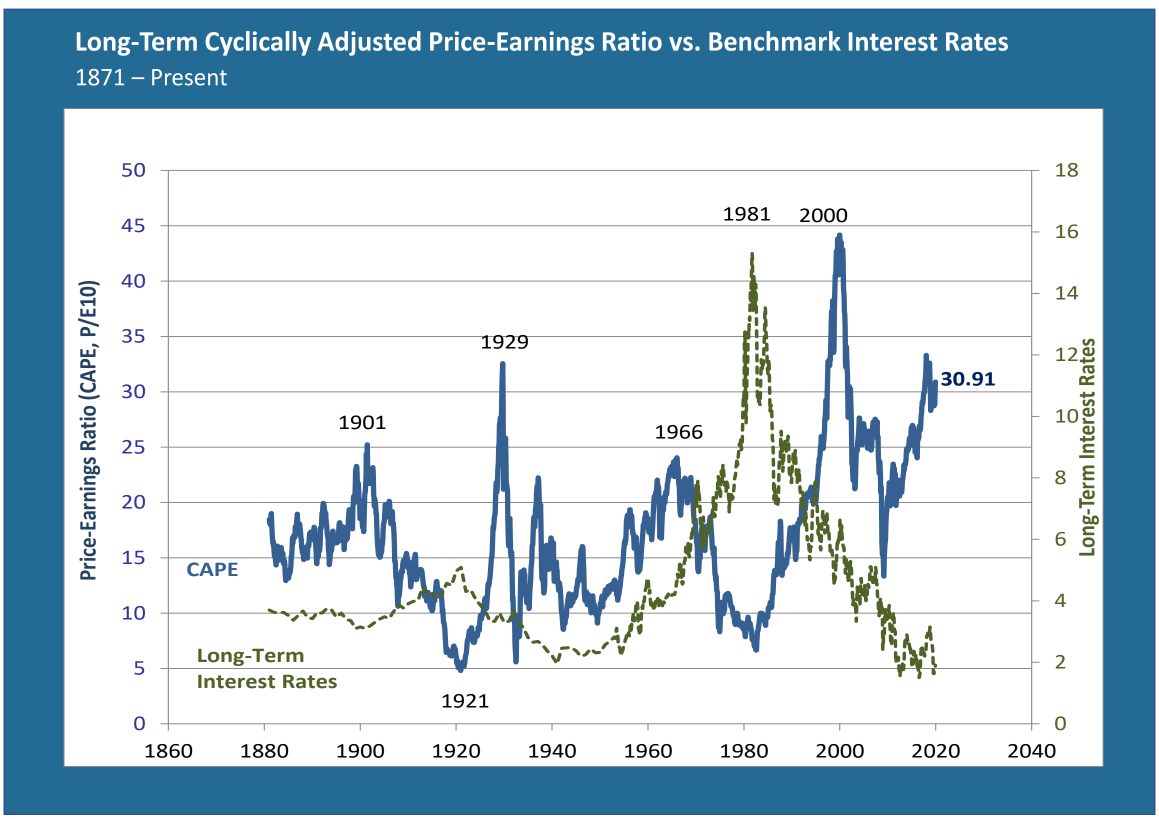
C. State of the Capital Markets

i. The Valuation Conundrum

If you have been a regular reader of MV Financial commentary you may be familiar with one of our oft-used expressions: a "valuation ceiling" on equity prices. We don't expect stock prices to be untethered from the fundamental nature of the business environment in which they operate; rather, prices should over time maintain some reasonably consistent relationship to underlying performance measures like sales, earnings, cash flow or book value. Any time that relationship becomes stretched beyond historic norms is – or should be – a sign that the market is pricey and more likely to turn down in the near future than keep on rising (though the actual timing of such reversions to the mean is notoriously difficult to anticipate).

The problem with relying on historical norms, though, is that no two market cycles are the same, and they are driven by factors unique to each. It's not enough, in other words, simply to say that if the average last twelve months (LTM) price-to-earnings ratio of the S&P 500 is 17.7 times for the past 20 years, then we should in future expect prices to revert to that mean. A P/E ratio or similar valuation measure is really just a measure of supply and demand: specifically, how much investors are willing to pay for a dollar of a company's earnings. That "how much" is subject to a variety of forces at play. There is a case to make that, at present, the environmental reality of low interest rates has the potential to impact the natural valuation levels of equities over a sustained period. To illustrate this, we present the chart below showing the (very) long term trends of a cyclical valuation measure and benchmark interest rates.

Chart 8: S&P 500 CAPE Index and Benchmark Interest Rates



Source: Robert Shiller Online Database (Yale University), MVF Research

There is a lot of information on that chart, so here is how to read it. The green dotted line represents the 10-year US Treasury note as a proxy for the benchmark rate. The blue solid line represents the cyclically adjusted price-earnings (CAPE) ratio, a metric devised by Yale University professor and Nobel Prize in Economics winner Robert Shiller. Unlike a simple P/E ratio, the CAPE ratio shows the average earnings level over a ten-year market cycle to smooth out the distortions of peak and trough periods. Both the benchmark interest rate and the CAPE metric go back to 1871 – essentially, since the beginning of the industrial era.

As of the end of 2019 the CAPE ratio was at 30.9x, just slightly off the level of 32.5x that represented the highest level of the current bull market. Only two prior occasions in market history witnessed a higher peak ratio: 32.6x at the height of the 1929 growth market, and 43.5x just before the tech bubble burst in 2000. In fact, apart from a very brief period at the end of the 1920s and the historical anomaly of the late-1990s dot-com mania, the bull market of 2009 to the present has consistently traded at the highest sustained CAPE levels ever.

Overpriced, right? A believer in the infallibility of mean reversion would be nervous about staying in the market for any longer, sure that the near future can mean nothing but a long, painful downdraft. Unless, that is, something else can explain the anomaly. Something like, say, interest rates.

The second notable feature of the chart is that nominal interest rates are lower today than at any time in the modern era – a phenomenon we have discussed in relation to other contexts elsewhere in this report. What is the relationship between these two metrics?

Again, it comes back to supply and demand – thinking of the P/E ratio as the amount an investor is willing to pay for a dollar of corporate earnings. If something creates higher demand for that dollar of earnings then, all else being equal, the price per share of the stock should rise in relation to the level of earnings per share. The force here acting on demand was the Fed, keeping interest rates low through both its short term management of the Fed funds rate and the three QE programs that targeted longer term rates. There was an explicit intention here on the part of the Fed to push investors out of safe haven assets like Treasury securities and into riskier assets like corporate bonds, preferred stock and common stock. And it worked. Large institutional investors like pension funds and insurance companies had to move out of their normal safe habitats because a stream of Treasury coupons paying close to nothing was not going to enable them to meet their spending plans (e.g. funding corporate pensions or paying out insurance claims). Money that would normally not have come into the stock market flooded into the stock market. Demand went up, and so did the P/E ratio.

What has changed over the past couple years is the gradual realization that, in the absence of an as-yet unseen catalyst for a new wave of organic economic growth (i.e. a wave of commercially viable productivity enhancements), the low interest environment is most likely here to stay. Moreover, the market assumes with a great deal of justification that the Fed would move quickly back into unconventional monetary policy (with extreme measures like negative interest rates or direct purchases of equities by the Fed not out of the question) if prevailing circumstances appeared bleak enough.

None of this is to say that a new plateau of higher average valuations is a definite permanent feature of the market landscape. Nothing is certain, including the ability of the Fed and other central banks to successfully beat back an economic recession or equity bear market with their monetary policy toolkits, however unconventional and successful in the past. But the current circumstances would appear to argue against a conviction that share prices are due for a near-term reversion simply because of their pricy (by historical terms) valuations.

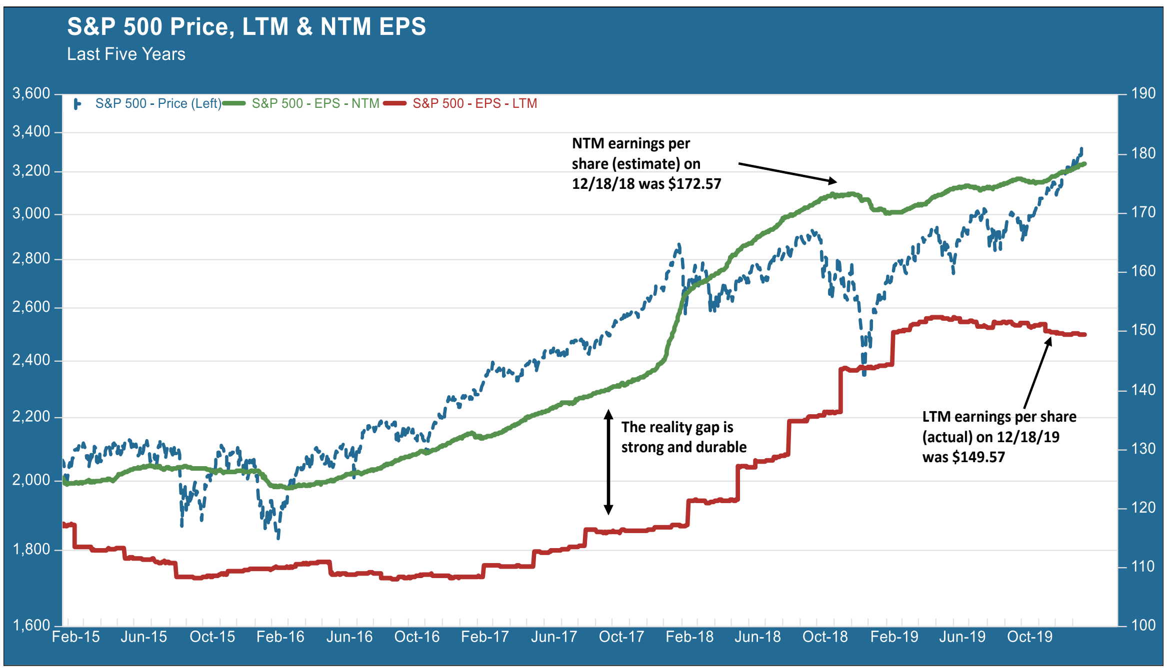
ii. About Those Earnings…

So valuation metrics like the P/E ratio may or may not be substantially overvalued, a bit pricy, or just right, and that is up for debate. What is not up for debate is that earnings themselves – the denominator of the P/E equation – have been flat for the past year. Analyst who follow the companies on the S&P 500 predict that growth will start to kick in again in 2020. For the first half of the year – close enough in time to the present to quantify their predictions for the first and second quarter – the consensus estimate from these analysts is for EPS growth in the mid-single digits. For the full year 2020, that estimate jumps to about 10 percent year-on-year growth, mostly, it seems, on account of some magical things that happen in the second half of the year that manage to kickstart double-digit growth.

Overly rosy predictions for the future are firmly built into the edifice of the quarterly earnings season confab. The basic game is to predict that the EPS numbers that come out, say, twelve months from now will be fantastically wonderful. That sets a mood of optimism (and also makes the P/E ratio numbers based on next-twelve-months (NTM) estimates look more attractive than they would if the estimates were a shade more realistic). Then, as the date approaches when the real numbers will come out, those estimates start coming down dramatically. The goal now is to have the EPS estimates low enough by release date that the actual number will be slightly higher – an "upside earnings surprise" in the parlance of those who play the game. By now everyone has forgotten about those giddy projections of a year ago and can celebrate the "win" of an earnings beat. Everybody's happy.

The disconnect between estimate and reality is clear when you look at the NTM and LTM (last twelve months) earnings trend over time. The chart below shows this trend for the past five years.

Chart 9: S&P 500 Earnings Per Share (LTM and NTM)



Source: FactSet, MVF Research

In the chart above we simply picked one data point – expected earnings per share as estimated in December 2018 for the following December (i.e. the NTM EPS estimate) versus what they actually turned out to be when December 2019 rolled around. But on this five year chart you could do the same for any single date and the reality gap would be firmly in place.

Any investor looking at this chart should be at least a little concerned about stock price prospects for 2020. In the event that a similar pattern to previous years plays out and earnings wind up falling far short of their NTM expectations, then the continuation of the upward price trend in the index (shown in the chart by the dotted blue line) will necessarily involve continued expansion of that P/E multiple beyond its current level. Is there room for the multiple to expand? Yes – as per our discussion in the immediately preceding section, there is an argument to make that continued demand for equities flowing from the Fed's monetary policy will accommodate still-higher P/E valuations. But the headwinds get stronger the higher we fly, and the chances for an Icarus-like scorching by the sun become greater.

In our discussion of the global economy above we observed that global growth for 2020 is expected to be in the neighborhood of 2.5 percent, with the US a bit shy of 2 percent, Europe flat and major developing markets growing in mid-single digit territory. Now, it is entirely possible that some combination of improved margins from process efficiencies and untapped pockets of new demand will help companies maintain a substantial outperformance above overall economic growth. It is perhaps more likely that earnings growth will manage to slightly outpace the 2.5 percent world GDP growth estimate but not by much. How you interpret this dynamic will likely inform your attitude towards the opportunity set for a continuation of the recent trend of stock price gains.

iii. Through the Narrow Gate

Every year, it seems, our annual outlook needs to devote one section to a discussion about why diversification is not working. This year we will sum up the reality in a comparative table, and then proceed to think about what, if anything, can break the stranglehold of a very small number of very large stocks on the market's overall performance. The table below shows the comparative 1 year (ended 12/31/19), 5 year and 10 year (average annual basis for 5 and 10 year) total returns for a set of diversified asset classes.

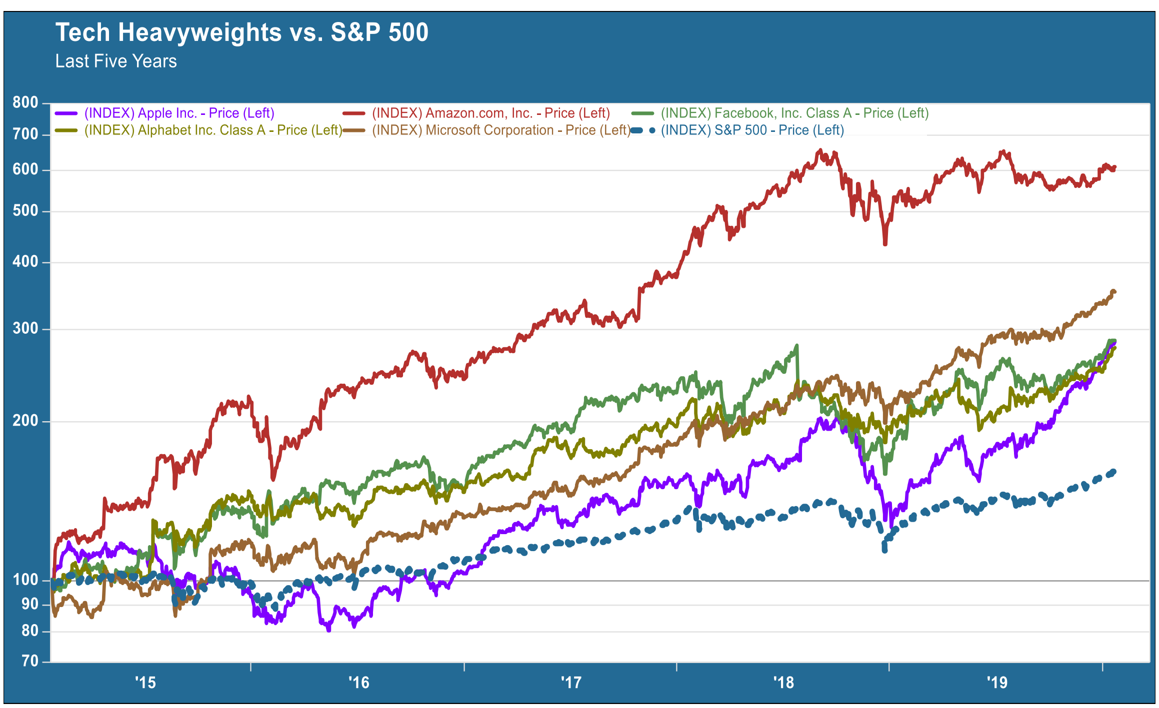
Chart 10: Total Return Comparison for Diverse Asset Classes

Asset Class Index	I Year TR	5 Year Avg. TR	10 Year Avg. TR
Russell 1000 Large Cap Growth	36.4%	14.6%	15.2%
Russell 1000 Large Cap Value	26.5%	8.3%	11.8%
Russell 2000 Small Cap Growth	28.5%	9.3%	13.0%
Russell 2000 Small Cap Value	22.4%	7.0%	10.6%
MSCI EAFE (International Developed)	22.7%	6.2%	6.0%
MSCI EM (International Emerging Market)	18.9%	6.0%	4.0%
Wilshire REIT	25.8%	6.9%	11.9%
Bloomberg Commodity	7.7%	-3.9%	-4.7%

Source: MVF Research, Morningstar Direct

As the chart shows, domestic large cap growth stocks have outperformed each of the other major asset classes shown here over virtually all time periods for a very long time. That may seem narrow enough. But the reality is even narrower. Five companies – Amazon, Alphabet (Google), Apple, Facebook and Microsoft currently make up about 19 percent of the total market capitalization of the S&P 500. The chart below shows the performance of these five companies versus the index over the past five years.

Chart 11: Five Tech Heavyweights Versus S&P 500



Source: MVF Research, FactSet

Think about it: those five companies – all of which have outperformed the benchmark index by anywhere from nearly double to four times – make up almost one fifth of the entire S&P 500. Their combined market capitalization is higher than the entire healthcare sector, which is the second largest index sector after (of course) information technology. Nothing else has come close to the power of these five – and a handful of other companies that likewise dominate their own tech platform domains – over this entire market cycle.

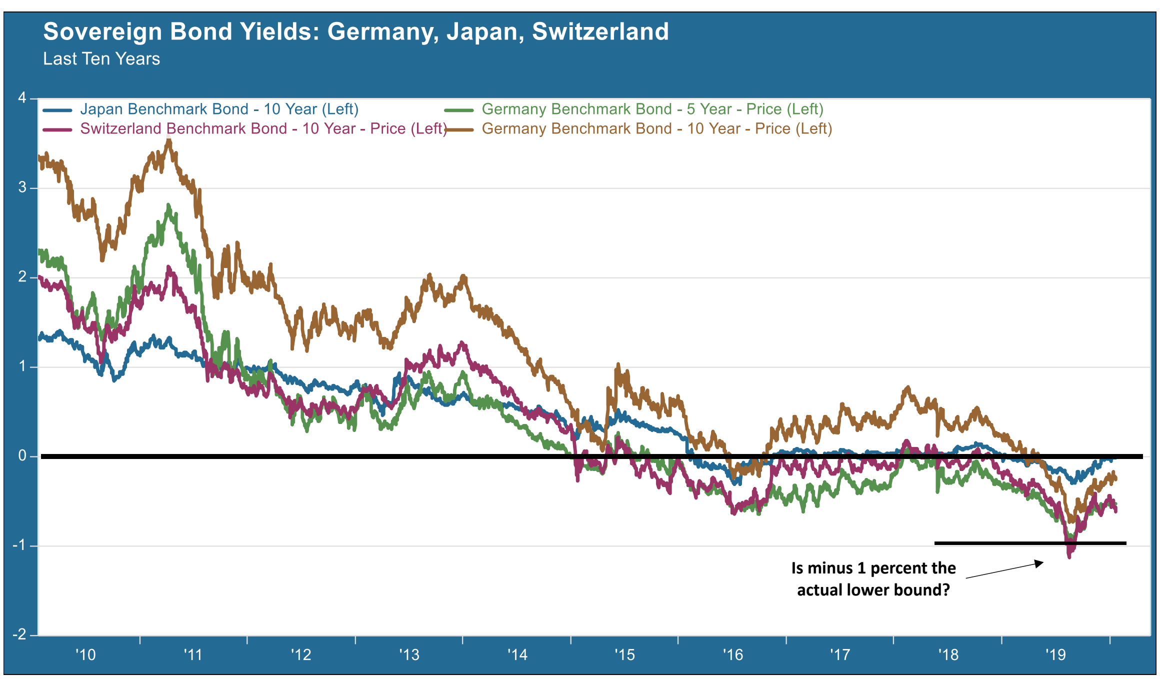
Long-term observers of the stock market will look at this performance and wonder when these five companies will share the fate of generations that have gone before. Every new wave of tech innovation had its own stratospheric leaders: Hewlett Packard in the 1970s, IBM in the 1980s, Microsoft in the 1990s, Google in the 2000s…oh, wait. Microsoft and Google (renamed Alphabet) are still up there in the pantheon. So is Apple, which started as a business in the 1970s. Amazon was birthed in the early years of Internet 1.0. Only Facebook is a relative newcomer, and even so, social media is hardly a new kid on the block anymore. In fact, this Valhalla of tech giants has only become a stronger redoubt of market dominance over the course of this bull market.

True, there is always the possibility for the next new thing that we have not even begun to imagine yet, and it is always possible that whatever that new thing is would make it hard for one of the existing behemoths to reinvent itself again (the way all these companies have managed to do at some critical juncture in the evolution of their business strategies). It is perhaps more likely, though, that one or more may fall victim to regulations (in the EU or somewhere else, at least, but probably not in lobbyist-captive Washington). There are most certainly business risks associated with these very concentrated positions. As much as asset diversification can continue to produce pain relative to a simple broad benchmark of stocks and bonds, there is still no viable competing formula for prudent long term portfolio management.

iv. How Negative Can You Get?

Negative interest rates, once a fanciful construct that seemed to fly in the face of everything we knew about the time value of money, has been a permanent part of the investment landscape since 2015. Over $12 trillion in outstanding global debt circulates with negative yields, and that is down from a peak of $17 trillion last summer, at the height of fears about a potential global recession. The chart below traces the descent of the capital markets into the Wonderland world of negative rates.

Chart 12: Negative Interest Rate Trends



Source: MVF Research, FactSet

It is worth wondering just how low negative rates can go. The very logic is perverse. In the classic formulation of the time value of money, a dollar today is worth more than a dollar tomorrow. That's why when we calculate the present value of a future cash flow stream, we discount that stream to the present using an applicable rate of interest that, in turn, is supposed to represent the opportunity cost of holding that money for a future date rather than spending it immediately. The higher the opportunity cost – in other words, the cost of money – the higher the discount rate and the greater the absolute difference between the present value and the future value.

That formulation of present versus future value underpins the entire discipline of modern portfolio theory as practiced for well over half a century. Negative interest rates turn the formulation on its head. They impose a cost on saving so that a dollar tomorrow is worth more than a dollar today. If you invest $1000 today at a coupon rate of minus 2 percent, that investment will be worth $980 in one year's time, which of course is less than $1000 in one year's time. By this logic it should never be worthwhile to defer consumption in favor of a term investment. And yet, in today's world it is.

So yes, trillions of dollars now trade in the capital market according to that precise and perverse logic. The question is, how negative can rates get before the system cannot take it anymore and spits them back up? Last summer the Swiss 10-year bond fell below minus 1 percent for a brief period. It didn't stay at that level for long, with rates around the world rising again after an inversion in the US yield curve between the 10-year and the 2-year Treasury notes proved to be a short-lived phenomenon.

The question of the absolute lower bound is important for 2020. The European Central Bank is under new management: Mario Draghi, the architect of the "whatever it takes" commitment to supporting the single-currency Eurozone and under whose watch negative interest rates came into being, has stepped down and former IMF chief Christine Lagarde has taken over. Lagarde has kept fairly quiet ahead of a comprehensive strategic review planned by the ECB to assess its ongoing monetary objectives.

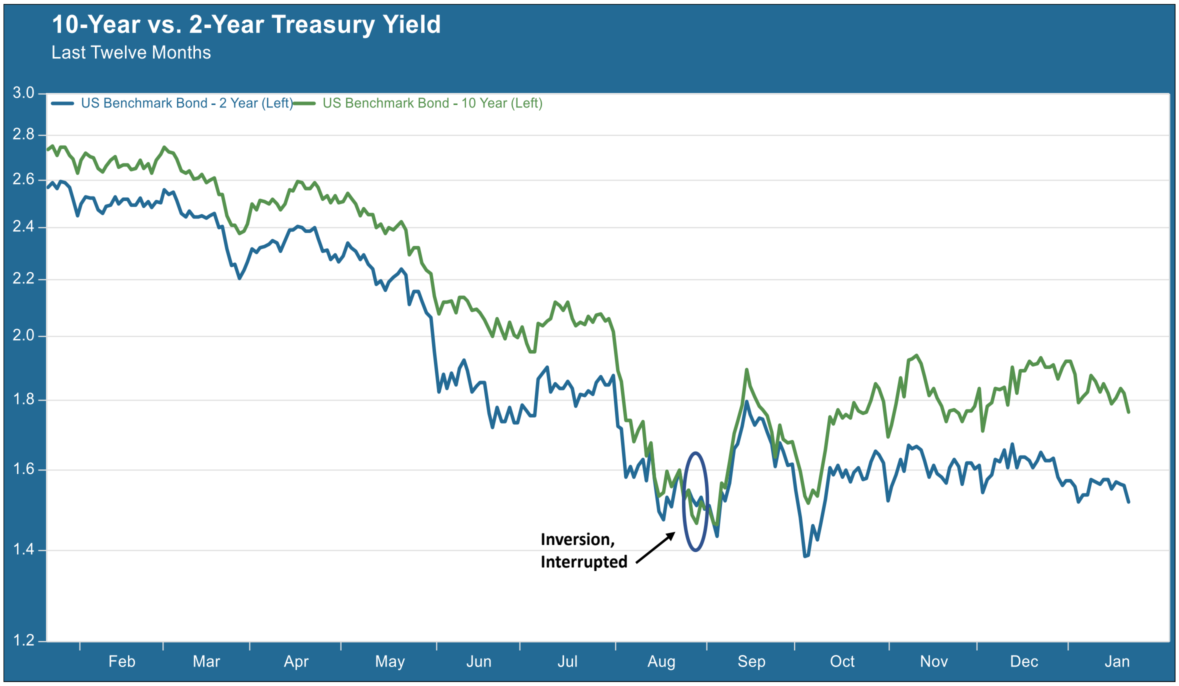
For now, the default assumption (supported by the new wave of easing measures announced by Draghi last September) is for the bank to pursue more of the same: easy money in an attempt to reach the elusive target of 2 percent inflation. At some point – and we think that point will come sooner rather than later – the quest to reach that inflation target will run headlong into the lower-bound constraint on negative rates (whether that be 1 percent or something else). And when that happens, we have a credibility problem with the central bank and its ability to deliver – the very risk that we identified in the previous section of this report as the most serious of the "known unknowns" for the immediate future.

v. The Inversion That Almost Wasn't

Around the same time that the Swiss 10-year bond was testing the limits of negative interest rates, back in the US all the late summer fears about a looming recession crystallized into one point of focus: the spread between the 2-year and 10-year Treasury notes. We had been hearing about inverted yield curves for the better part of the year, because the shortest end of the curve (1, 3 and 6 months) had stayed anchored to the Fed funds rate while longer term rates fell below that level. But the 2-10 spread is a different animal in that it has reliably served as a predictor of recession going back at least to the early 1980s. When the 2-10 inversion took place in late August, it seemed to confirm everyone's worst fears that the recession was now at hand.

But then a strange thing happened: the inversion went away. The chart below shows the 2-10 trend over the past year.

Chart 13: A Very Brief Inversion



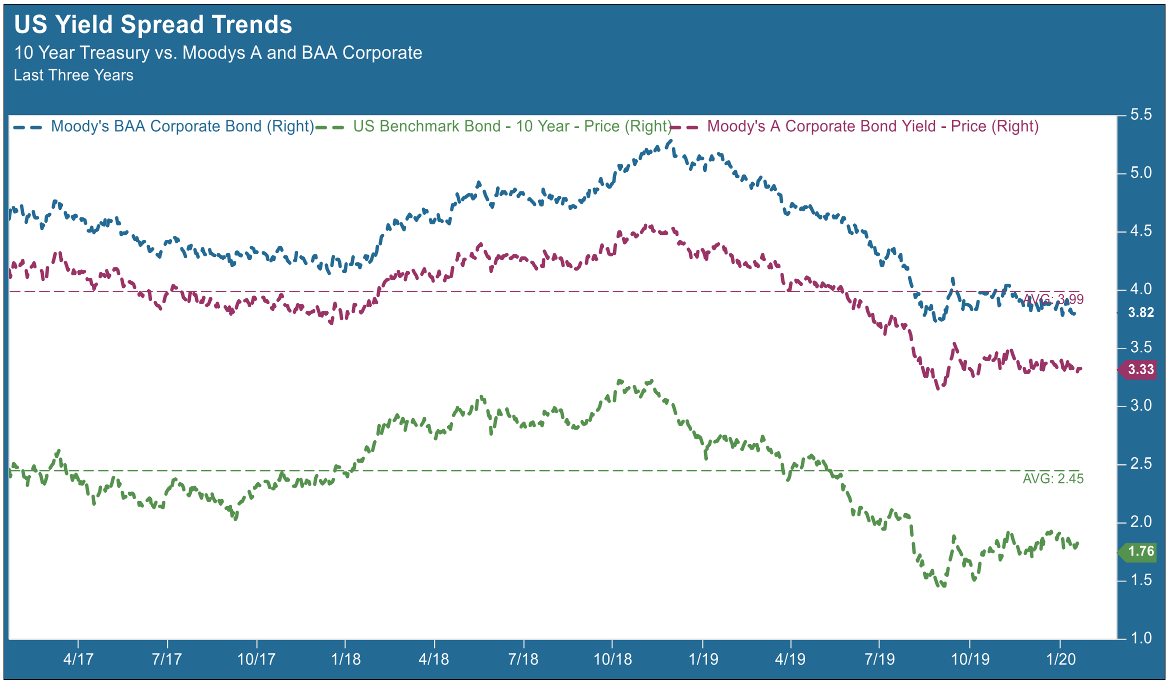
Source: MVF Research, FactSet

Not only did the yield curve un-invert almost immediately, but in the time since it has actually steepened to a more normal-looking upward slope. Partly this is because the Fed funds rate came down last fall and dragged the short end of the curve with it, and partly it is because the overall market narrative, perhaps persuaded by more ongoing reports of strong jobs numbers, resilient consumer confidence and retail sales, and consumer prices right around the target 2 percent level, turned more positive as the year headed to a close. We should add that, just because the curve has normalized in recent weeks does not by itself negate the signal sent by last August's inversion. The timing between inversions and recessions based on past events is by no means exact – and the small number of events themselves suggests an absence of statistical validity in any case. But for purposes of what will happen in 2020, the likelihood of a recession has fallen to the low-probability event the macro data always seemed to be saying was the case, regardless of the shape of the yield curve.

vi. Awash in Corporate Debt

Over $2.5 trillion worth of corporate debt came into the market in 2019, spurred on by the reversion to easy money policies by the Fed and the ECB. A not insignificant portion of the global total came from companies in emerging markets, eager to maintain their competitive positioning in their business markets. The brisk trend of new issues is continuing into the early weeks of 2020. In the US, new investment grade debt issues topped $69 billion during the second week of January, close to the all-time record set last September. Yet despite the flood of new issues, risk spreads remain very tight between benchmark bonds and riskier corporates. As the chart below shows, both higher-quality and lower-quality investment grade bonds have tracked fairly closely to benchmark Treasuries through last fall and into the new year.

Chart 14: Yield Spread Risk Trends



Source: MVF Research, FactSet

Not just investment grade, but high yield debt also has maintained very tight spreads even while new supply has flooded the market. The new supply has been adequately met by robust demand from those same investors we described earlier in this report – pension funds, insurance companies and the like – pushed out of more conservative asset classes to frantically chase yield. This is all fine while the music is still playing and the overall risk environment remains muted.

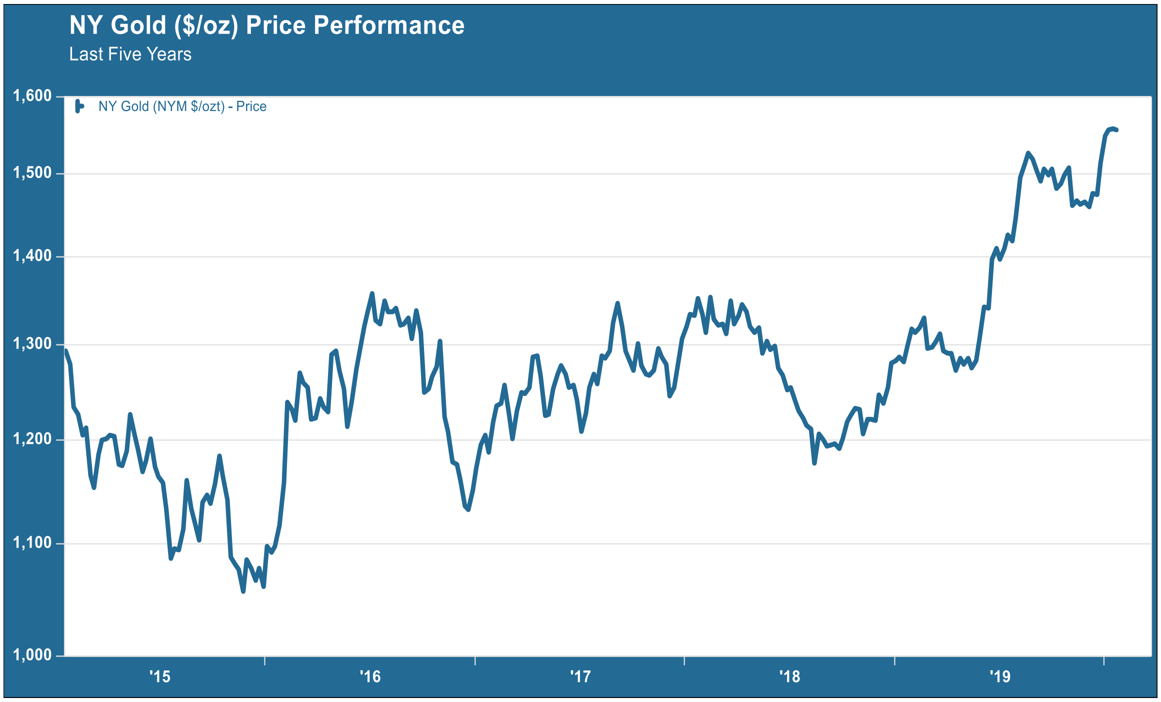
But there are lurking dangers here as well. That flood of new corporate debt has not, by and large, translated into new business investment on the part of the issuing companies. Business investment has been chronically weak as a GDP contributor for the past several quarters. More likely, a good deal of the debt is going into shareholder-friendly dividend and buyback programs. Meanwhile, debt/equity ratios are growing to record levels for S&P 500 companies. That implies a higher interest burden, which in turn implies lower earnings per share (deductions for interest payments affect pretax profits, though not, as a convention, operating income). Lower earnings per share, going back to our earlier discussion about valuation levels, implies even more expensive P/E ratios, which in turn could have at least a cooling effect, if not more, on investor enthusiasm for equities.

vii. Parting Shot: Thoughts About Gold

About what? Fear not, we have not suddenly turned into paranoid preppers, imploring all the good folks out there in late-night cable TV-land to stock up on bullion coins embossed with fierce bald eagle designs. But we normally finish this capital markets section of our annual outlook with a look at something out there in the alternative universe outside of equities and fixed income. This year, that thing is gold.

Gold was on something of a tear through much of last year. Nor did the good times end for this traditional safe haven asset when the risk-off mood of late summer gave way to the go-go party times of the fall and holiday season. In fact gold continues to set new highs right alongside the S&P 500 in the first weeks of 2020. The chart below shows the price performance for gold over the past five years.

Chart 15: All That Glitters



Source: MVF Research, FactSet

Our past beef with gold – with which you will be familiar if you are a longstanding reader of our commentary – was that it was an illusion of safety more than an actual store of safe value. As a commodity, gold trades at whatever price gold trades at – and as an investor in gold you get nothing other than what it is worth on any given day. The safe haven aspect of gold always seemed to be rooted more in some vague idea that as a rare metal it will always be worth something (that plus the 200-odd years between Isaac Newton and the early 20th century when the gold standard was the linchpin of the global trading system).

But in today's world of negative interest rates and little better than zero return on most ultra-safe investments, it is possible to see gold in a different light. Just because the crazy guy in cammo pants on TV is telling you that it is rare and precious doesn't mean that it is not those things. Here's what else: unlike, say, a German Bund, it doesn't come attached with a negative rate of interest. Unlike any credit instrument circulating out there, it is not subject to any specific political risk associated with any specific nation state.

In a way, this ties in nicely with the overall theme of this year's report. We live in a strange time where potentially momentous changes to a long-dominant world order are rumbling at the same time that risk asset markets have arguably never been as investor-friendly. If you are of the mind that one of these things has to give and would prefer to keep things out of the low-risk portion of your portfolio that involve you paying interest income to sovereign states for the "privilege" of lending them money, then perhaps there is a place for a bit of the old precious metal. Not for everyone – and it's not an asset we are as yet ready to include in our model portfolios. But thinking in this way would not necessarily make you paranoid, either.

D. Concluding Thoughts: Where Should You Be Positioned In 2020?

So here we are, early in a year that history books written decades from now may describe as one of the most significant of the early twenty-first century, a year that has the potential to send a convincing message to the citizens of the world that the liberal democracy and global capitalism foundations to which the postwar order aspired for three quarters of a century is in permanent retreat, replaced in fits and starts by different variations, mostly misguided, of Barbra Streisand visions ("the way we were"). And yet, future economic and financial historians may remark with surprise just how calm, stable and almost predictable the world's economic infrastructure remained throughout the year. Paradoxically that combination – sociocultural *Sturm und Drang* and yawningly plodding markets – fits the bill for our most likely scenario (be advised, though, that when we say "most likely" that means other scenarios are also possible, just not as likely, and that conditions have the potential to change very rapidly).

For us, this view translates into an asset allocation strategy that is quite similar to the one we had in place during the better part of 2019. We will continue to balance the primary objectives of growth and capital preservation with a mix of mostly high quality domestic large cap equities and moderate duration fixed income securities, balanced out by other diverse asset classes that help us with the ancillary objectives of yield and targeted low correlation management. The variables we discussed in different sections of this report, as well as others that may emerge, will serve as feedback for out thought process and inform any strategic shifts we might undertake.

One variable that in most likelihood will not precipitate dramatic changes to our strategy will be the US presidential election. We expect that by early summer, if not sooner, we will know the identity of the Democratic nominee who will run against the current president (who will not have been removed from office following his impeachment). As the summer progresses we will probably have at least a sense from the polls how both the presidential race and those for the two houses of Congress are shaping up. Regardless of what all that intelligence suggests, we will find it very hard to make a case that one or another reasonable-likelihood scenario will have such a profound impact on asset markets that it will catalyze a clear and predictable trend.

Even if a post-election trend were to develop, there would be an excellent likelihood that it would run counter to the conventional wisdom ahead of time. We need look no further than 2016 for an example of this. In the weeks before the election that year, the conventional wisdom was that (a) Clinton would win, and (b) if Trump managed to win it would be disastrous for the market. That logic held firm through the early hours of election night: stock futures indexes plummeted when the results started to show that Trump was the likely winner. Then, the victorious candidate tossed out a throwaway line about investing in infrastructure during his victory speech. Almost immediately markets turned around and rallied. Financial stocks and the US dollar led the way and Treasury yields soared as the idea of a "infrastructure-and-reflation trade" seized the fertile imagination of traders. Of course the infrastructure never happened and the Republican Party's bag of tricks was nothing more or less than its old favorite of tax cuts.

If you tune into CNBC for financial and political insights (not recommended), and particularly if you tune in and Democratic nominee Sanders or Warren have a commanding lead in the polls (not likely, but one never knows) then you may observe red-faced pundits advising you to load up with cash and prepare for the apocalypse. That would be a waste of trading costs and a strategic mistake. However the election turns out, the prospect for an immediate, tangible impact on corporations' future cash flows is unlikely – and the longer term impact will not be clear until well after either the new team or the old team has gotten underway with the new term in 2021. There are many constructive ways to be involved with the political process this year – tinkering with your portfolio is not one of them.

These are interesting times, though, and as we prepare for whatever this new decade may throw our way, we will try to resist the ever-present temptation to let failures of imagination take our attention away from the issues that will demand our fullest attention and clearest thinking.

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