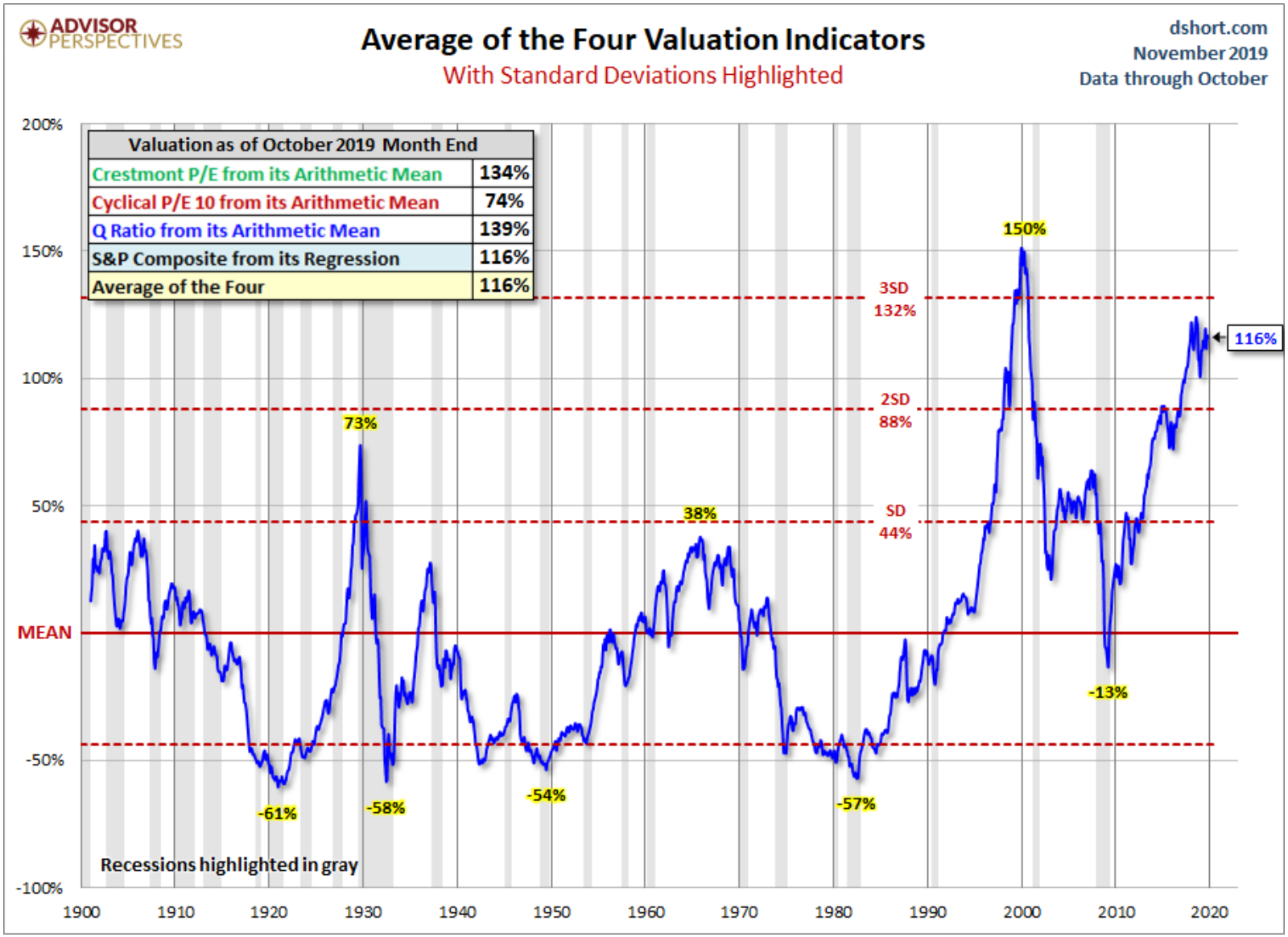
Here is my economic and stock market outlook for 2020. I've borrowed heavily from research, some of which is referenced below. That said, I'll take credit for all the misjudgments that emerge over the course of the year as events unfold.

Before jumping into some of the fundamental issues that are expected to impact the markets in 2020, I'll start with a couple of my ubiquitous charts.

This chart shows the daily progression of the price of SPY, the exchange-traded fund that mimics the total return on the S&P 500. It shows price has risen to the top of a rising price channel which, given the length of time the channel has been in place, suggests potential for a correction of 5ish% (for this and future charts, it should be noted that past performance is no guarantee of future results).

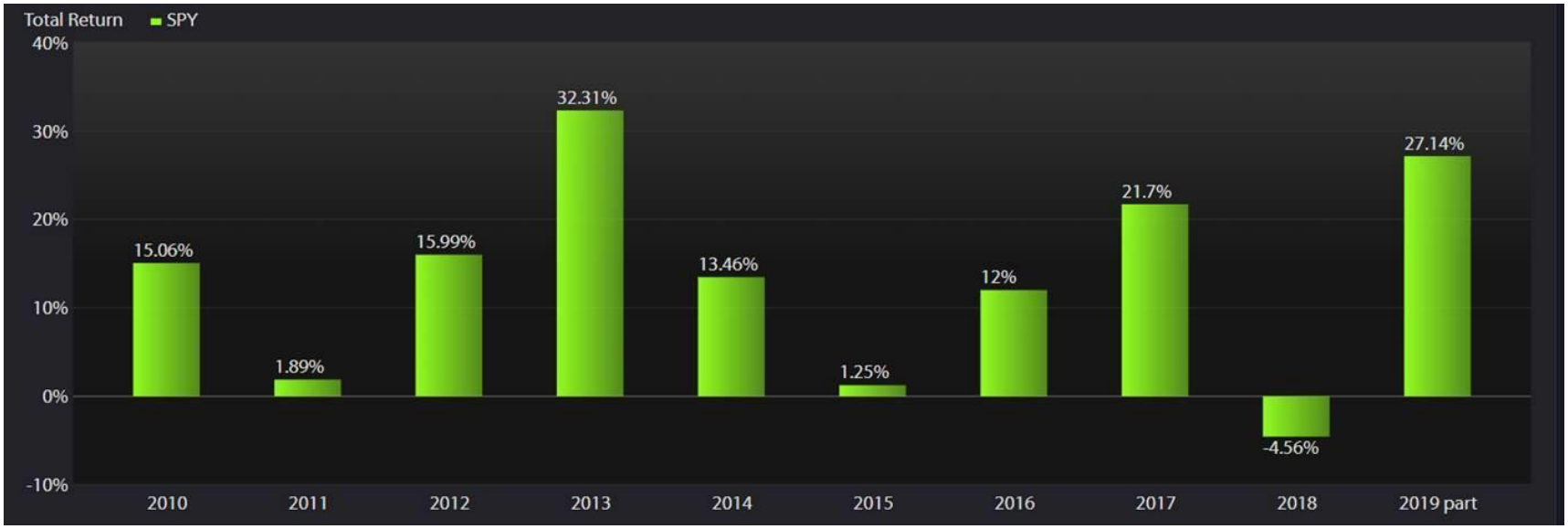
Consistent with this indication of a potential correction, this next chart shows the relative valuation of the S&P 500 compared to a long term average. The average of these four valuation indicators has only been this far away from the long term average once before since 1900. Note that there are two ways this can correct itself when

that time comes: by a sudden price drop or by time passing with much more modest price gains than in the recent past, thereby allowing earnings to catch up to price. I suspect the latter is more likely than the former.



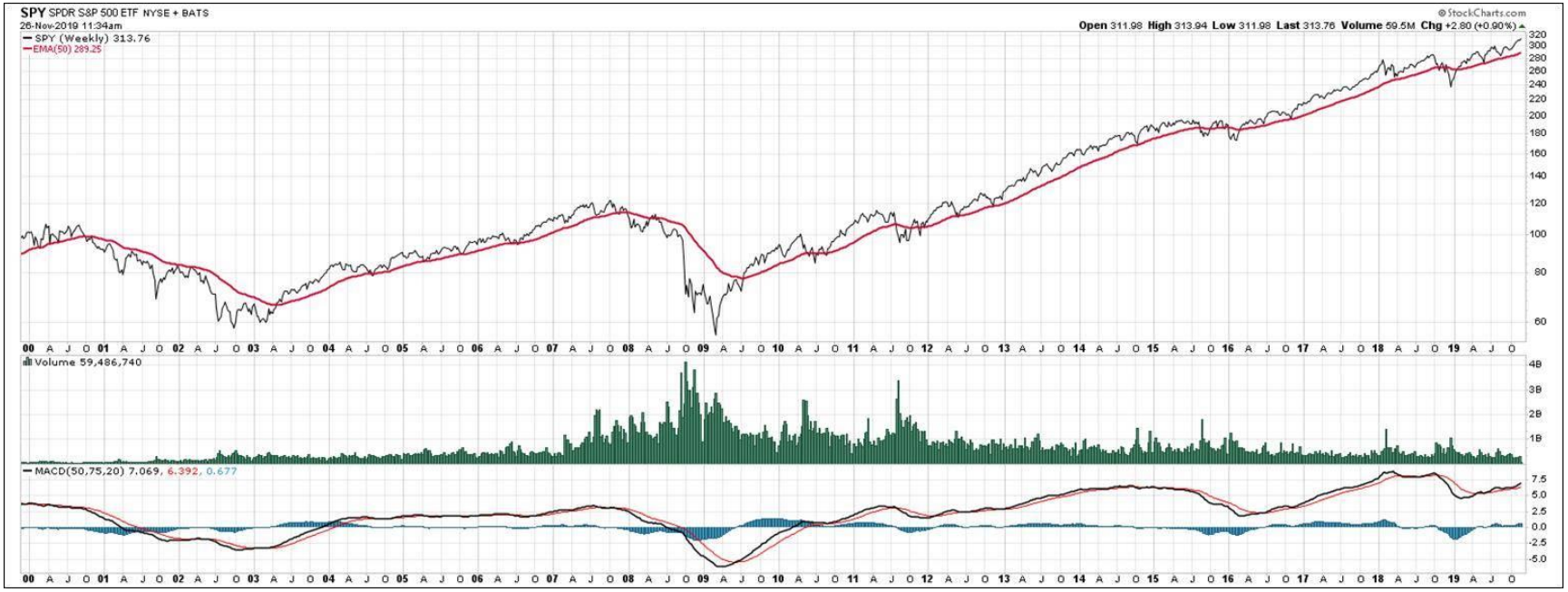
This next chart shows the average annual gains for SPY during the last 10 years, essentially since the Great Recession ended. The average annual return for the period ending November 26th, was a bit over 13%. Assuming no significant correction before the end of the year, the performance during 2019 will be the second highest in the last 10 years and will likely to be considerably less in 2020.

Vanguard has recently published its expected annualized equity returns over the next 10 years to be in the range of 3.5% to 5.5%; Morgan Stanley's estimate is roughly 5%. While focused only on 2020 rather than the next 10 years, Goldman Sachs would appear to be more bullish than Vanguard and Morgan Stanley with an estimated return in 2020 of about 10%.



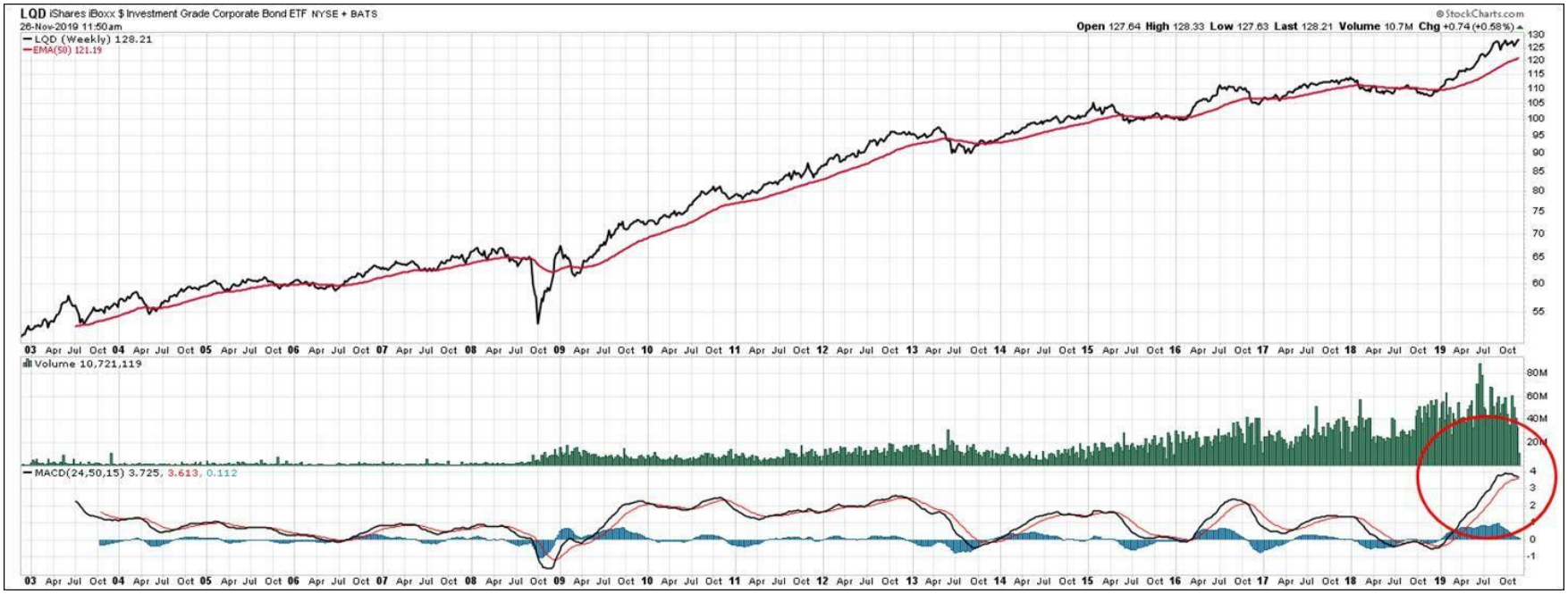
Extending the above chart to 20 years, the average annual return for SPY was about 6%. This chart reinforces the view that high annual returns are highly likely to be followed by years of considerably lower returns.

While the shorter time frame daily price chart for SPY above suggests the potential for a market correction, this longer term weekly chart provides support for the notion that a longer term bull market remains intact, consistent with the view from Goldman Sachs.



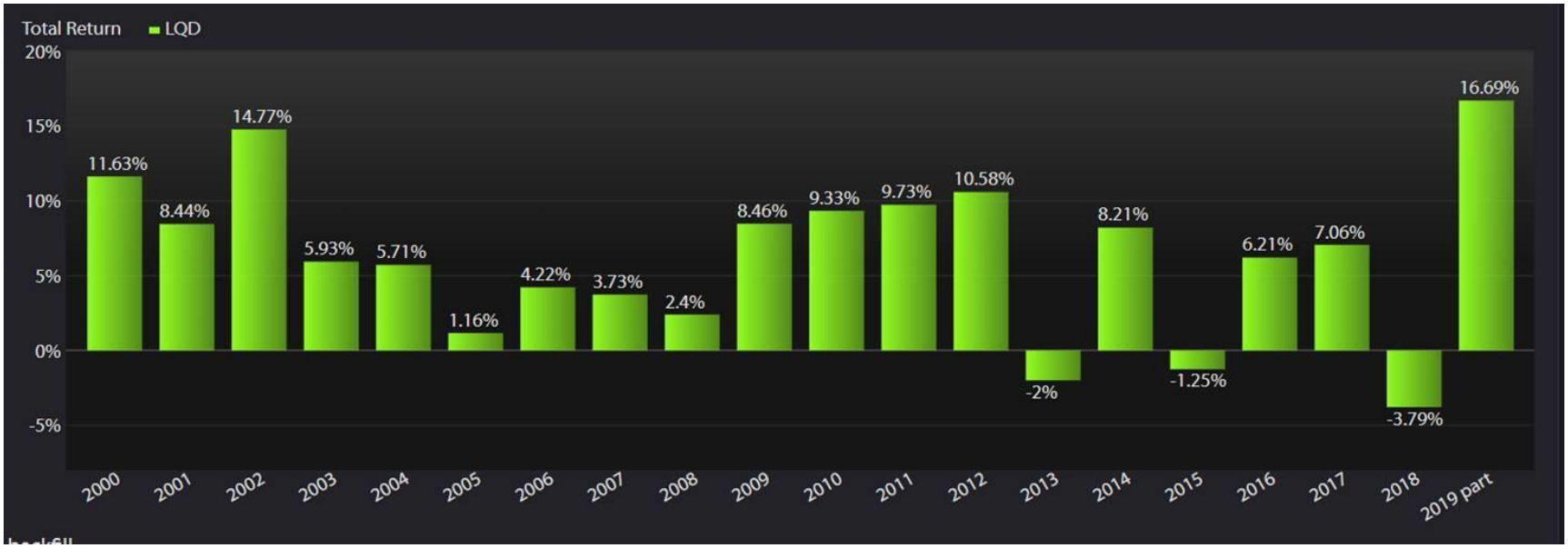
This next chart shows the daily price progression for LQD, the exchange-traded fund that mimics the total return performance of an index comprised of investment grade corporate bonds. While performance has been strong throughout 2019, it has basically stalled since the beginning of September. That said, there is some indication that the stall may be coming to an end with recent improvement in price and momentum (the momentum is shown in the bottom of the chart).

While the shorter term picture for LQD suggests a breakout to the upside, this longer term chart shows recent weakening momentum that has been characterized with corrections in the past. Thus, it's anyone's guess what the near term outlook for bonds will be.



In the next chart, a 20-year examination of investment grade corporate bond returns (LQD) shows that 2019 was an extraordinary year, the highest for the period. The average annualized return for the entire 20 year period was just 6.2%.

Vanguard's estimate for U.S. fixed income returns over the next decade is 2-3% while Morgan Stanley's estimate is closer to 2%.



This next chart shows the daily relative price performance of SPY vs. LQD (equities vs. fixed income). Here, there is a long term channel showing outperformance of equities but with rotation within a channel for the last two years indicating no set direction of relative performance between equities and bonds and, perhaps, giving support for a balanced portfolio strategy for the time being.

This next chart compares the relative performance of a broad index of international equities (VEU) to the S&P 500 represented by SPY. While the domestic equities underperformed international equities in September and October, they appear to be on the upswing again since the beginning of November. While many commentators like international equities for their relative low valuation (that is, they are seen to be due a recovery), I'm still highly skeptical of the need to make a significant commitment to international equities at this time, either developed economies or emerging.

Trying to nail down the net impact of all the economic and political factors that will buffet markets in 2020, much less beyond, is like trying to nail Jell-O to the wall. Here are just a few of those issues I believe will be most impactful, in no special order:

- Earnings: I see corporate earnings as a primary mover of the markets. According to Zacks Research, for the 3rd quarter of 2019, with 477 out 500 companies in the S&P 500 reporting, earnings declined 1.2% from the same period last year (though were still positive) while revenues rose 4.3%, notably faster than inflation. More importantly for the market reaction, 73% beat earnings estimates and nearly 58% beat on revenues. If companies and analysts remain cautious, as I expect they will, I think this "beat" experience will continue, providing ballast for the markets in 2020 as it has this year.

- Trade with China (and others): While I don't expect <u>any</u> agreement with China or, for that matter, any other major trading partner, will have a significant impact on the economy as such, resolving disputes will give at least a short term boost to the market. Of course, lack of resolution would have the opposite effect. With impeachment and the election coming up, it seems reasonable that Trump will avoid an increase in trade tension and sign whatever deal he can get. On the other hand, Trump may see NOT signing a deal with China (that is, "getting tough") as a popular thing with his base. This will rest entirely on Trump's political calculus.

- The Federal Reserve: While it is frequently observed that the Fed takes no action in an election year in order to remain neutral, I suspect that the Fed would take another leg down on the federal funds rate (FFR) <u>if</u> incoming economic data turns weak. Right now, that doesn't seem to be likely, at least in the short term, with retail sales and consumer sentiment reasonably strong, recently increasing manufacturing and non-manufacturing activity, improving small business optimism, increasing strength in housing markets, and a relatively tight labor market.

- Interest rates: Despite what the Fed does on the FFR, market forces drive interest rates. Currently, following a period of declining rates over the last 12 months, treasury rates have remained within a relatively tight channel since August. If long term rates were to turn up for any extended period of time, this could have a depressing effect on equity and bond prices. Right now, despite how low U.S. rates are, they remain higher than most other developed economies, a number of which have <u>negative</u> benchmark government bond rates. Therefore, demand for U.S. treasuries will continue to be strong for the time being, thus keeping a lid on domestic interest rates.

- The U.S. election: While a number of pundits (e.g., Goldman Sachs) speak of a negative impact on markets should the Democrats take control of the White House, even worse should they end up controlling both houses of Congress, I don't see it that way, at least, not after the dust settles. To take an extreme view, should the most "radical" programs of the Democrats be implemented (e.g., Medicare for All, greater infrastructure spending and higher taxation on the wealthy and on businesses), I see this more as a shift in

wealth to those who are more likely to spend it, thus more than offsetting any negative impact on corporate profits from increased taxes. This is especially true, as those who know my feelings on Modern Monetary Theory (MMT) would expect me to say, if the government relaxed its self-imposed constraints on Treasury funding. To take this one step further, in my view, should the Republicans hold the White House, I see greater potential for subdued growth if not a mild recession.

- Corporate actions: As pressure on earnings continues for whatever reason, the motivation for mergers increases. This will provide support for equity prices at the least and possibly fuel further expansion.

One thing I can forecast with a high degree of confidence is that the economic and political noise level will be high and that the markets will respond with periodic shocks, some potentially quite scary. While less certain, I believe the equity and bond markets will continue to provide a positive return on balance, albeit less than we've seen this year, as much of the negativity may already be reflected in prices despite high valuations. Should we see a recession in 2020, I believe it will be shallow as the Fed will fight to keep things from becoming out of control. That said, while we can't completely discount a major correction, if one were to occur, I would expect it to be like last fall and relatively short-lived.

Having a diversified portfolio with low correlated assets will smooth out some of the bumps.

Here's wishing you and yours a wonderful holiday season and a healthy and prosperous New Year.

Ed.

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