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2020 Market Outlook

Recession Risks or Market Myths?

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Highlights:

We believe:

- The U.S. economy will continue to grow, and our projection for the S&P 500 in 2020 is 3500.
- The Federal Reserve will be on hold for the year, with a very high bar to hike rates, and not as high of a bar to cut rates one more time.
- A weakening U.S. dollar will support international market outperformance, led by emerging markets.
- The presidential election year may lead to choppy markets early in 2020, but markets will strengthen during the second half of the year.
- In fixed income, credit spreads suggest bonds are priced to perfection, and we believe continued economic expansion will be supportive of credit.
- Our expectation for the 10-year U.S. Treasury in 2020 is range-bound between 1.5% - 2.5%.

2019 in Review

Every year when we put together our Market Outlook, it's always humbling to go back and review the previous year. 2019 was a great year for the markets, and we're happy to say that even though we were one of the most bullish firms on the Street, the market still exceeded our expectations.

Domestic Equity		Since 2/24/2018	2nd Half 2019	2019
	S&P 500	40.24%	10.92%	31.48%
	Russell 1000	40.22%	10.58%	31.42%
	Russell 2000	33.67%	7.28%	25.49%
	Russell 3000	39.77%	10.36%	31.01%
	Russell 1000 Value	34.03%	8.85%	26.52%
	Russell 1000 Growth	46.61%	12.27%	36.39%
International Equity				
	MSCI Emerging Market	20.28%	7.09%	18.42%
	MSCI All Country World (ex US)	23.13%	6.96%	21.51%
Fixed Income				
	BBgBarc U.S. Aggregate Bond	9.02%	2.45%	8.72%
	BBgBarc U.S. Treasury	7.16%	1.59%	6.86%
	BBgBarc U.S. Corporate	14.63%	4.27%	14.54%
	BBgBarc U.S. Corporate High Yield	15.00%	3.98%	14.32%
	BBgBarc Municipal	7.69%	2.32%	7.54%

Source: Bloomberg

Navigate Your Future. Enjoy the Journey.

We were very bullish on stocks coming into 2019 based largely on pessimistic sentiment, reasonable valuations, and continued economic growth. We had a 2900 target for the S&P 500, which would have been a 16% gain. We even upgraded our target at mid-year to 3000, and the market still surpassed it. On the economic front, we expected the U.S. economy to grow by 2.3% real GDP, and if the fourth quarter GDP comes in at 2%, the annualized GDP for 2019 will be right on our target of 2.3%.

2019 began with investors reeling from the 20% decline in the fourth quarter of 2018, but it sure did end on a high note. The markets posted strong gains across the board, which were helped by the Federal Reserve's about-face, the now longest U.S. economic expansion on record, and the recent cooling in the U.S. trade war with China. We would call the market environment in 2019 the "Everything Rally," with asset classes across the board participating in the risk-on rally.

The rally actually began on December 24, 2018 when the market fell into its Christmas Eve low. The initial rebound was extremely strong and carried over into the New Year. For the year, the S&P 500 gained 31.48% in total return, leading all broad-based markets, making 2019 the 12th best year for the S&P 500 in the post-WWII era.

However, it wasn't just a large-cap rally. All market caps rallied along with international markets, although they still significantly lagged the largest U.S. stocks. Emerging markets also lagged significantly as the effects of the trade war weighed more heavily there than in developed markets. This has been a regular theme over the past decade, with the U.S. outperforming international markets in eight out of the past ten years.

Even fixed income posted strong gains as interest rates fell to near record lows before drifting higher. Corporate credit led the way with investment grade and high yield bonds gaining over 14%.

2020 Outlook: Executive Summary

We enter 2020 with the equity markets primed to build on their secular bull market gains. A lot of the uncertainties that investors have been concerned about have faded into the background as the yield curve steepened, the trade war with China seems to be de-escalating with a Phase One trade deal, political divisiveness in the U.S. has not impeded the market's trajectory higher, and recession fears have turned into growing optimism in the U.S. economy.

With the market posting its 12th best performance in 2019 in the post-WWII era, some people are speculating that the market needs to mean revert and can't possible continue higher. We prefer not to speculate, so we researched how the market performs in the year after large gains.

There have been 12 other years since 1948 when the S&P 500 has gained 30% or more on a total return basis. The next year following, the S&P returned an average of 15.12% with only two modest losses. In years that the S&P 500 was up over 25%, the next year returned an average of 13.73%. From our research, we don't believe that the historical evidence supports a market mean reversion after large gains.

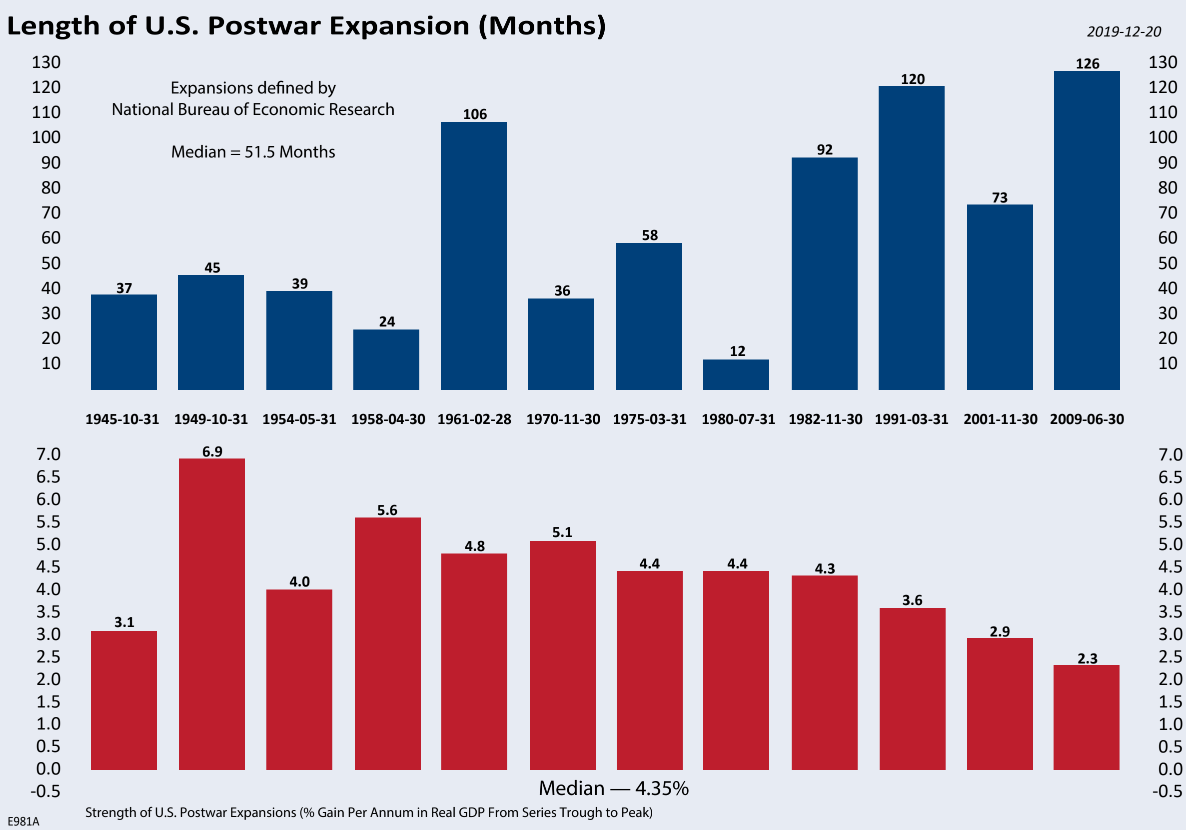
Our expectation for 2020 is for continued gains and our target for the S&P 500 is 3500, which would be about an 8.5% price gain. We also believe that it will be a more volatile year than what we experienced in 2019 based on normal presidential election year trends. Those trends suggest early year weakness before finishing the year in rally mode. The risk of early year weakness is also heightened by bullish sentiment extremes across several investor sentiment gauges.

The U.S. economy should continue its record-long expansion into 2021 with the support of massive liquidity from the Federal Reserve in addition to labor market strength and job growth that has helped drive consumer spending. We believe the U.S. economy will grow 2.25%, with upside potential for faster growth as global headwinds are fading.

We also believe the global economy should accelerate from its slowdown and expand 3.5% as global manufacturing bottoms and 82% of global central banks are easing monetary policy. The Federal Reserve should remain on the sidelines and has set a very high bar for monetary policy adjustments.

There are several risks to the outlook that we believe are more outliers than base-case scenarios. In our opinion, the main risks include excessive short-term investor sentiment, lofty equity market valuations, an unexpected rise in inflation and wage pressures, margin compression, additional trade war drama, political risks in the U.S., and heightened tensions in the Middle East.

Figure 1. | **The Longest Expansion on Record**



Source: Ned Davis Research

Can Economic Growth Continue?

We've mentioned many times in the past that the current economic expansion has been very resilient. The median economic expansion dating back into 1945 has lasted 51.5 months. As shown in **Figure 1**, at 126 months, this current expansion is the longest on record and is almost 2.5x the average length of past expansions. Some reasons the expansion has lasted so long are that it has had few overinvestment bubbles in addition to a record amount of monetary stimulus.

MIT Professor Rudi Dornbusch famously said, "None of the post-war expansions died of old age. They were all murdered by the Fed." In our opinion, the Fed's bias for low rates and easy monetary policy adds shelf life to the expansion.

The fading growth drag from the trade war and the increasingly positive growth impulse from easier financial conditions should keep the economy on sturdy footing in 2020. We also expect business investment—one of the weak spots of the U.S. economy last year—to recover in 2020 as companies respond to strong demand growth in an environment of diminished recession fears.

While any significant progress on a Phase Two trade deal is unlikely given fundamentally unreconcilable differences, increased tariffs should not be a headwind ahead of the 2020 election. President Trump has every incentive to keep China relations strong until he retains the oval office. With the absence of new fiscal stimulus and fading benefits from the tax overhaul, we believe the U.S. economy will grow at a 2.25% pace in 2020, with potentially more upside potential from the easy monetary conditions.

With job creation still running at roughly double its break-even pace and growth likely to remain above trend next year, we believe the unemployment rate will decline to 3.25% in 2020, which would be the lowest rate since the Korean War. Alongside this, we believe there will be a further increase in wage growth and a pick-up in core PCE inflation, but to a rate still below the Fed's 2% target.

In our view, global economic growth should accelerate from the 3.0% pace in 2019 to 3.5% in 2020. Interest rates lead economic activity by one to two years. So, the declines in global short rates in 2019 and bottoming in global manufacturing should boost economic activity in 2020. In addition, China has now cut its reserve requirement five times and is expected to reduce it further in order to put a floor under its economic growth in 2020.

Gauges of Economic Health

While there are a lot of indicators we look at to gauge the health of the economy, there are several that we put a lot of stock in when assessing the economic outlook over the intermediate-term. Those are the Conference Board's Index of Leading Economic Indicators, first time unemployment claims, the health of the housing market, and the shape of the yield curve.

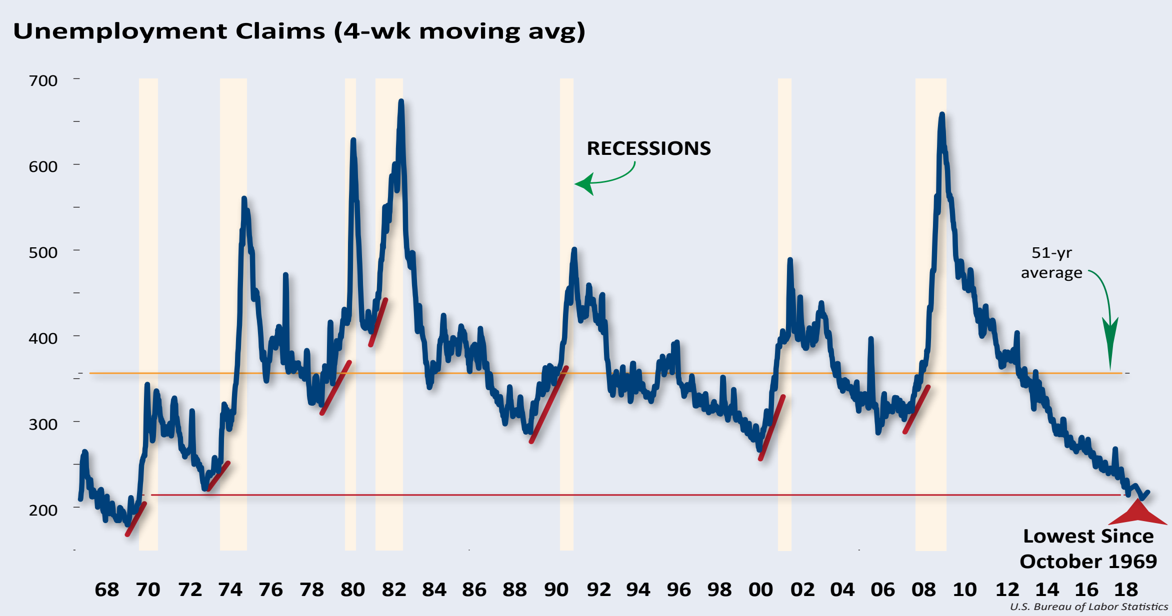
We highlighted these in our last few Market Outlooks and stated that they pointed to continued economic growth. While we are now later in this economic expansion, the indicators still suggest continued economic expansion. Let's look at each one.

The Conference Board's Index of Leading Economic Indicators has hit new high after new high since rebounding from the Credit Crisis. Recently however, Leading Indicators have flattened after declining for three straight months.

We put a lot of emphasis on leading indicators because over the past 60 years, early weakness in the Leading Indicators Index (LEI) has preceded every recession in the U.S. The typical lead time between the peak in LEI and the start of recessions has ranged between four and 21 months. Since 1960, the average lead time has exceeded 11 months.

Finally, prior to the last three recession to hit the U.S. economy, leading indicators were declining for an average of 16 months. While Leading Indicators have dipped a bit, they are still elevated and are not showing the weakness that normally precedes economic recessions, but we are monitoring it closely.

Figure 2. | **Jobless Claims Hit 50-Year Lows**



Source: InvesTech Research

Another indicator that is signaling continued expansion is the number of new claims for unemployment benefits. Typically, unemployment claims start rising about 6-12 months prior to the start of a recession (red lines on graph). As shown in **Figure 2,** the four-week moving average of jobless claims recently hit its lowest level since October 1969, a 50-year low, which is consistent with continued growth in the economy.

Almost 70% of our economy is driven by consumer spending, so an employed and financially healthy consumer is a key driver of economic growth. The unemployment rate and jobless claims are hovering near 50-year lows and we believe the job market remains healthy as we move into 2020.

Mortgage rates have declined by about 100 basis points over the past year, and history shows that declines in mortgage rates lead an acceleration in GDP by about a year. In addition, housing starts and the business cycle are closely linked. A housing start is a metric that shows the number of new residential construction projects began in a month. In essence, housing starts are a sign of pent-up spending that hasn't happened yet.

Ahead of every recession since the 1960s, the 12-month average of housing starts started to roll over ahead of recessions. Earlier this year, as the 12-month average was showing signs of weakness, it raised concerns of a broader slowdown. However, we believe the recent rebound in housing starts and building permits to new cycle highs put those fears to rest.

Shown in **Figure 3** is a table of peaks in housing starts and the lead times to recessions. We find that on average, housing starts peak roughly two years before recessions. Given the fact that housing starts just hit a new cycle high, it suggests that the economy has a good bit of runway to keep expanding.

Figure 3. | **Housing Starts as a Long Leading Indicator**

Peak	Trough	Recession	Peak to Recession
Mar-99	Dec-00	1-Mar	24
May-86	May-91	Jul-90	50
Aug-78	Jul-80	Jan-80	17
Jan-73	Apr-75	Nov-73	10
Jan-69	Jan-70	Dec-69	11
		Average	**22**

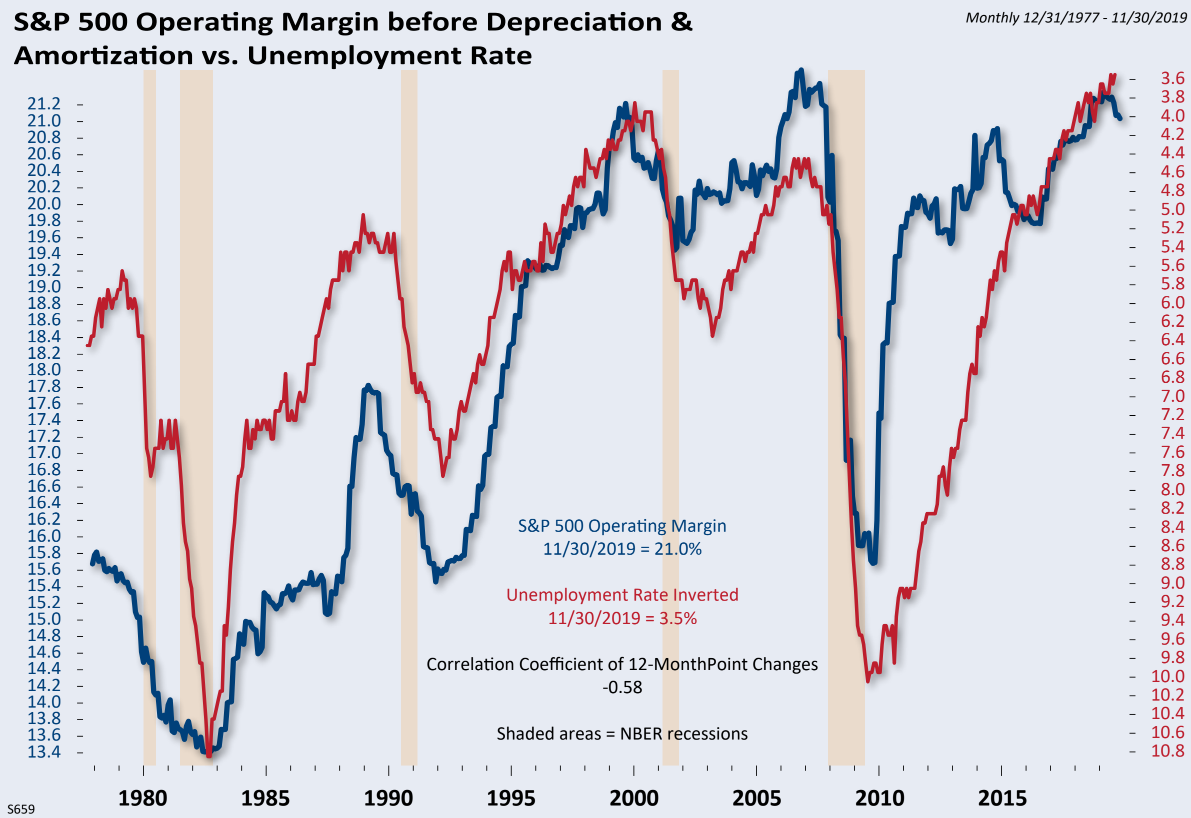
Source: Renaissance Macro Research

In our last Mid-Year Market Outlook, we showed that the unemployment rate often rises by an average of 0.4% before a recession begins. Right now, the unemployment rate is 3.5%, resting at its lowest level since 1969. The rise in the unemployment rate that would signal recession doesn't normally happen overnight—it has taken on average over 200 days, so there is a fairly long lead time of seeing weaker labor markets before a recession starts.

This time, we wanted to expand on that and show causation with corporate margins. Margin deterioration can be a precursor to layoffs and a recession. In the late stage of an expansion, companies often cut labor expense in order to preserve earnings growth. While layoffs may temporarily save growth, it can start a negative feedback loop that leads to recession.

The unemployment rate rises an average of seven months before recession starts and operating margins tend to be a good six-month lead indicator for the unemployment rate. The chart in **Figure 4** shows operating margins have a strong negative correlation with the unemployment rate.

Figure 4. | Operating Margins Are Negatively Correlated to Unemployment Rates



Source: Ned Davis Research

We are watching margins closely because major peaks in operating margins are normally soon followed by major bottoms in unemployment rates prior to a recession. The good news right now is that we are not seeing broad-based margin deterioration.

The yield curve inverted in 2019, which is historically a sign of upcoming economic headwinds. As a reminder, the prior seven recessions dating back to 1962, have all been preceded by an inverted yield curve, but we have had two instances of an inverted yield curve without a subsequent recession. An inversion is often induced by a Fed that tightens rates too much.

Did the Fed Reverse Course in Time?

An important question we ponder as we move into 2020 is whether the Fed's quick and rather dramatic reversal of policy was enough to curtail the potential damage done by higher front-end rates. Were the three rate cuts in 2019 enough to rekindle growth and avert a near-term recession?

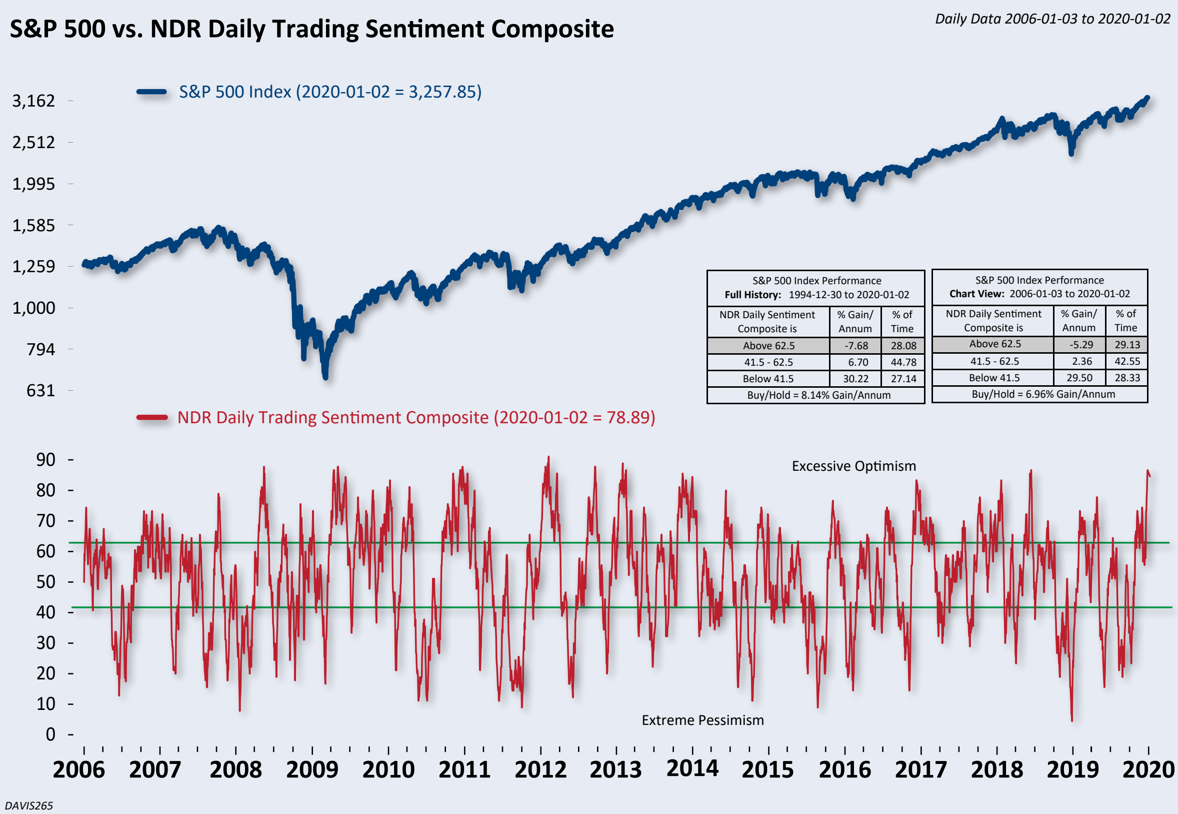
While history does not favor the Fed's ability to engineer this type of soft landing and recovery, it is yet to be seen whether they pulled it off this time. Initially, the economy has continued to grow, and some better momentum surfaced in the latter part of the year, so that is an encouraging sign. All in all, we believe the fundamental backdrop for the economy continues to look solid and we expect growth to continue. In addition, the Federal Reserve does not have a recession in its forecast through 2022.

Investor Sentiment Extremes

Let's turn to the markets, beginning with investor sentiment. Warren Buffet said, "Be fearful when others are greedy and greedy when others are fearful." We enter 2020 with investor sentiment in the exact opposite place than it was in early 2019.

The short-term sentiment chart from Ned David Research in **Figure 5** shows that as the stock market has continued to hit new highs, investor sentiment has risen to an optimistic extreme. Extremes in investor sentiment are normally contrarian indicators, with optimistic sentiment leading to corrections or pullbacks, and pessimistic extremes leading to rebounds.

Figure 5. | **Investor Sentiment at an Optimistic Extreme**



S&P 500 Index Performance **Full History:** 1994-12-30 to 2020-01-02		
NDR Daily Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.5	-7.68	28.08
41.5 - 62.5	6.70	44.78
Below 41.5	30.22	27.14
Buy/Hold = 8.14% Gain/Annum		

S&P 500 Index Performance **Chart View:** 2006-01-03 to 2020-01-02		
NDR Daily Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.5	-5.29	29.13
41.5 - 62.5	2.36	42.55
Below 41.5	29.50	28.33
Buy/Hold = 6.96% Gain/Annum		

Source: Ned Davis Research

That is not the only sentiment measure showing excessive short-term optimism. Put call ratios, low VIX readings, and the American Association of Individual Investors (AAII) survey also show a level of optimistic sentiment that normally precede at least short-term pullbacks. The AAII survey shows that we entered 2020 with elevated readings in bullish sentiment, while bearish sentiment is right at the low end of its multi-year range.

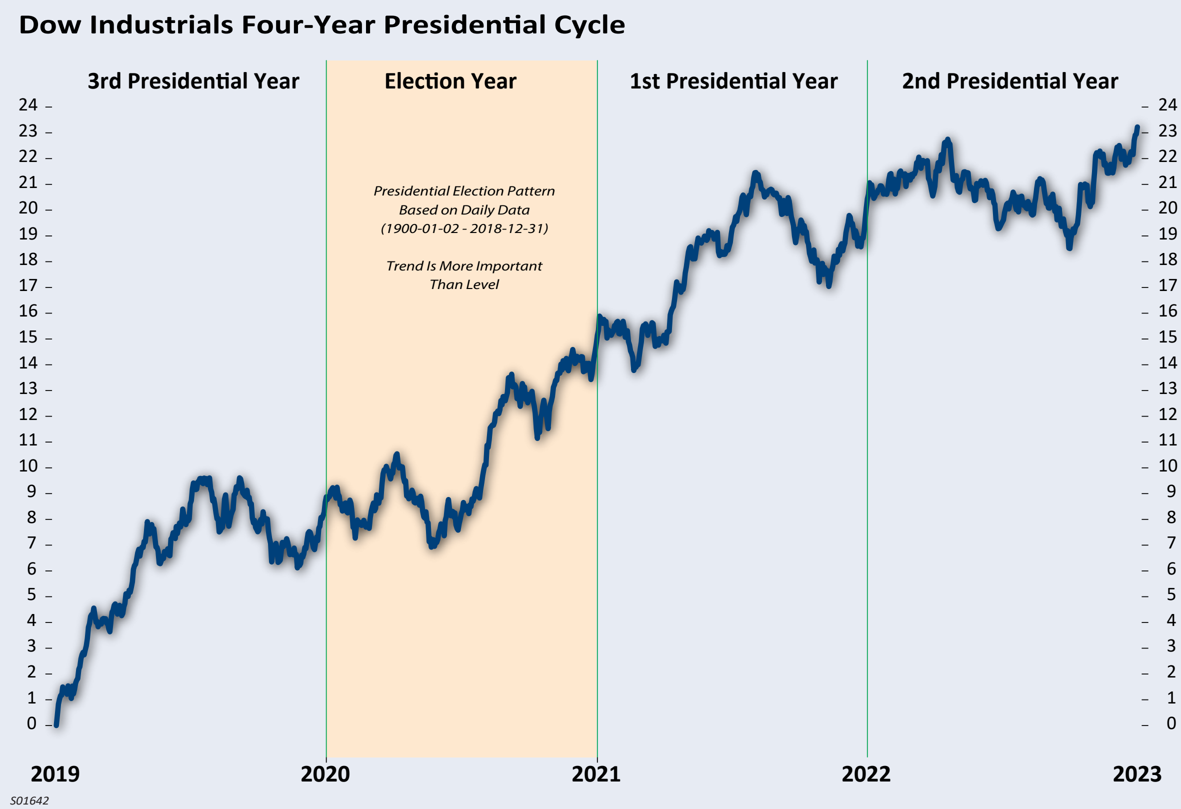
Longer-term sentiment remains favorable for the market. Fund flows out of equity funds and ETFs have been persistent while bonds have captured steady inflows. Fund flows show what investors are actually doing, instead of just how investors are feeling in sentiment surveys. Investors vote with their money, and by-and-large, they have been selling stocks and buying bonds.

From a contrarian perspective, this does not indicate long-term equity market excesses. Any correction we could see given optimistic sentiment polls, expensive valuation, geopolitical risks, etc., should be short-term and replant seeds of fear for the market to again "climb the wall of worry."

Heading into Election Day

The pre-election year is the strongest of the four-year cycle, with an average gain of 16.1% in the S&P 500 since 1948. This factor was a key consideration for our very bullish outlook for 2019. A key factor for the market in 2020 will be the presidential election in November. While the outcome is uncertain, we have gone back and studied prior election years to glean hints as to how the market may respond.

Figure 6. | **Presidential Election Will Be a Key Driver in 2020**



Source: Ned Davis Research

In the post-WWII era, the S&P 500 has averaged a 6.7% price gain in the presidential election year, posting gains 82% of the time. However, that doesn't paint the whole picture. Uncertainty heading into presidential election years has often been a headwind for stocks. The market normally corrects and consolidates in choppy trading during the primary season.

Although the election year rally usually begins in May, the timing of the rally has varied widely, depending on when the market gets comfortable and discounts the eventual likely winner. When the incumbent party candidate has lost, however, equities have tended to decline into Election Day. After this uncertainty has passed, the market has historically rallied strongly into year end.

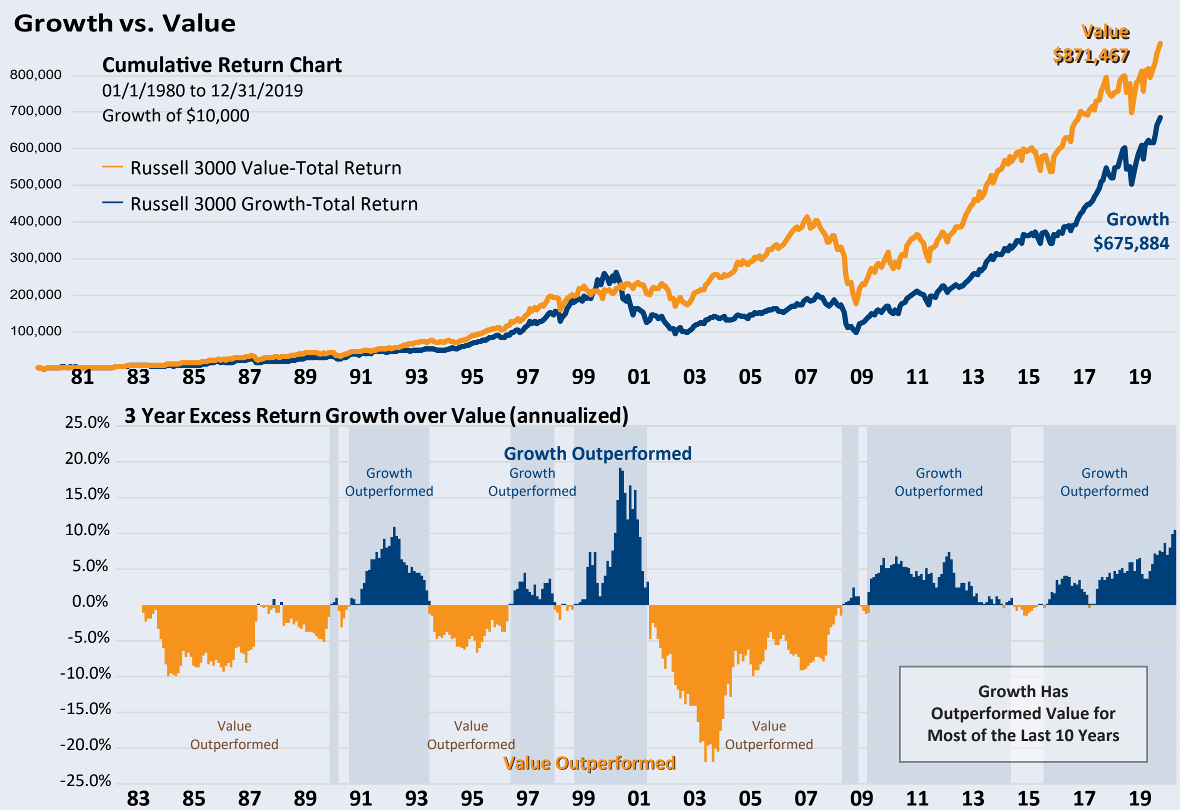
Finally, the market tends do better when the incumbent Republican wins. For example, in the post-WWII era, there have been five cases of an incumbent Republican winning reelection, those years the S&P 500 has gained 8.2% compared to the four cases when the incumbent Republican has lost in which the S&P 500 has declined 4.5%.

When Will Value Reemerge?

Since 2010, value has underperformed growth to an extent rarely seen in the last 70 years, a time when being a value-oriented investor paid significant dividends for investors and active managers. In recent years however, investors piled into growth, momentum and bond proxy stocks, either in pursuit of scarce earnings growth, or in desperate need of dividends.

In the past decade, growth stocks outperformed value stocks more persistently than in any decade since at least the 1930s. The Russell 3000 Growth Index outperformed the Russell 3000 Value Index by 104% in total return. The main reason for growth's strength is slow economic growth. In an environment of subpar economic growth, investors are willing to pay a premium for companies that can deliver consistent earnings without a strong economy, which happen to be growth companies.

Figure 7. | Growth vs. Value: The Last 40 Years



Source: Bloomberg

As shown in **Figure 7**, this had led to a valuation disparity between growth and value stocks that we have not seen since the late 1990s during the tech bubble. We believe that at some point during this market cycle, this trend will reverse, and value factors will be rewarded.

While too early to declare a decisive reversal to this long-running trend, at times over the last few months of 2019, we saw value outperform growth, and small and mid-cap stocks outperformed large-cap stocks. International equities have even shown better relative performance. We believe we might be entering a time late in this bull market run when fundamentals and valuations matter and that active management could add value for investors.

International Markets Poised to Outperform

Could 2020 be the year where international stocks outperform? We believe it's long overdue as U.S. stocks have outperformed in eight out of the past ten years. It's early, but that trend may be shifting. International markets have been keeping pace with U.S. gains since mid-August, and emerging markets have outperformed.

Valuations certainly favor international markets. For example, the P/E for the S&P 500 is over 20. International markets are much cheaper, with the MSCI All Country World ex-US at a P/E of 16.3 and the MSCI Emerging Markets trading at a 15 P/E. It's not just valuations that matter, though. Monetary policy operates with a lag, and currently 82% of global central banks are in easing mode.

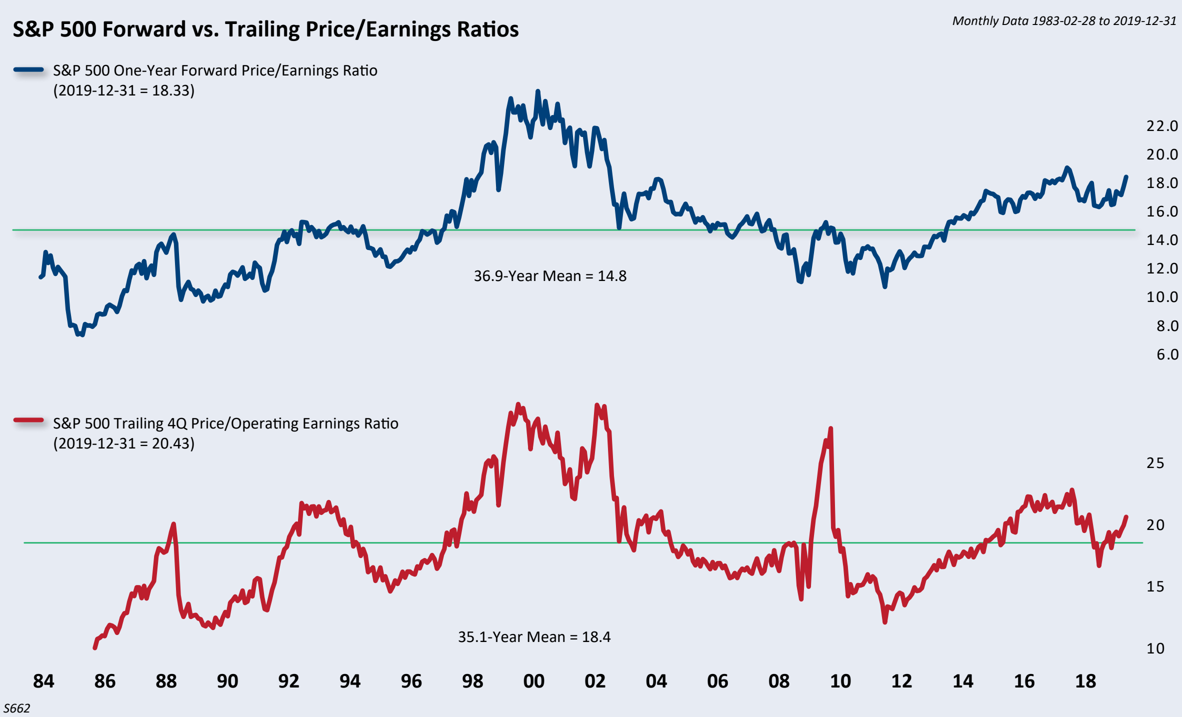
This would suggest that the global economy should accelerate, and recent global manufacturing data paint a picture of improving conditions. Equity market returns are typically the strongest forward-looking when manufacturing survey data is low and turning up, as it is now. As a result, we believe international markets, and in particular, emerging markets, will post stronger relative strength. Additional tailwinds for international equities include expected weakness in the U.S. dollar and monetary stimulus in China. China just cut its reserve requirement again in an effort to put a floor under its economy that is growing at its slowest pace in three decades.

The Valuations Landscape

The S&P 500's P/E ratio (trailing 12-month) began the year sitting right on its long-term average after a steep price decline for the index in the fourth quarter of 2018. In 2019, we saw huge multiple expansion with the P/E ratio rising from 15.6 up to 20.43 as price rose much faster than earnings.

Extreme multiple expansion does not generally lead to down years though, when investors bid stocks up in anticipation of future earnings growth, it typically plays out. Going back 50 years, there have been ten instances of +20% P/E multiple expansion in which the market traded higher eight out of ten times the following year with an average return of 7.4%.

Figure 8. | **P/E Ratios Trading Above Their Long-Term Mean**



Source: Ned Davis Research

You can see from the chart in **Figure 8** of forward and trailing P/E ratios of the S&P 500 that the market is overvalued using traditional valuation metrics. The P/E ratios are trading well above their long-term means. Overvalued markets can get more overvalued, so it's useful to provide some historical perspective on just how rare the current readings are. For example, the market's price/cash flow is in the top 7% of highest valuations, price/net worth is in the top 3%, price/sales is in the top 2%, and the trailing P/E ratio is in the top 7%.

We have said before that valuations can and have remained stretched for extended periods of time, so they are not timing tools, but more a measure to assess potential risks. The valuation landscape is a risk that we are monitoring.

Earnings Growth Will be an Important Driver in 2020

With elevated valuation multiples, earnings growth will be an important driver for the market in 2020. Given the sentiment landscape, valuations, presidential election trends, and other risks earlier mentioned, we could see a 5-10% correction in the first half of the year before the market responds to presidential election strength.

Earnings have been on quite a ride over the last two years. Earnings growth was dramatic in 2018 driven in large part by the tax cuts. Those earnings gains created a very tough comparison year in 2019 and earnings were muted. Now the tables have turned once again, and comps become easier in 2020 for corporate America.

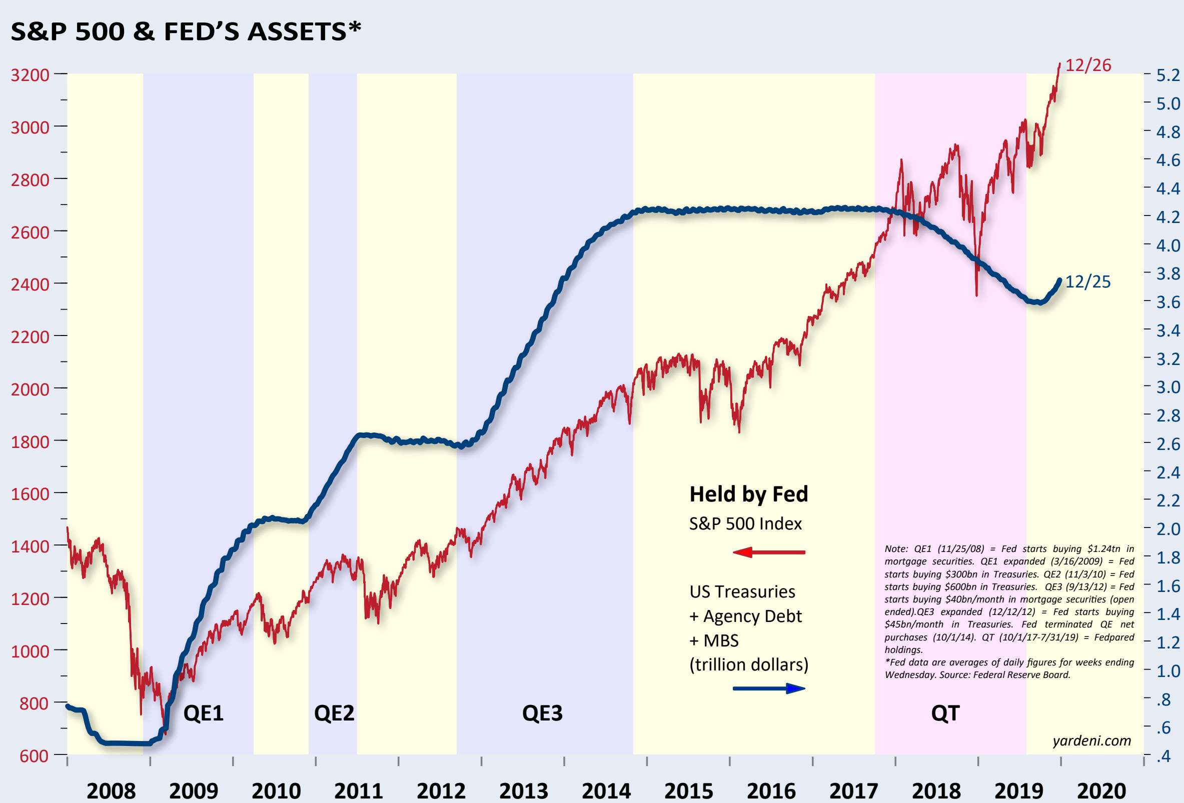
We do not expect further valuation expansion in 2020, so earnings growth will be an important driver of potential stock market gains this year. We expect earnings growth of 5%-7% in 2020. Historically, the market has done very well with single digit expected earnings growth.

Turning to the Fed...

The Fed's easy monetary policy can be seen by the growth of its balance sheet since QE1 was launched in the midst of the Credit Crisis. **Figure 9** shows that virtually all of the market's gains since 2009 have come when the Fed has been expanding its balance sheet. Volatility in 2018 and subsequent equity market losses both occurred after the Fed had already begun shrinking its balance sheet and only accelerated when Fed Chairman Powell discussed more rate hikes and further balance sheet reductions.

The market seems to have responded favorably to Powell's pivot. Now the balance sheet is again expanding as the Fed has stepped up to support the repo market through purchases of T-bills to provide liquidity to the overnight funding markets. While the Fed has said they will end their repo program after six months, we think their program will be expanded as we see zero chance of the federal deficit shrinking.

Figure 9. | **Fed's Balance Sheet Growing Again**



Source: Yardeni Research

The overriding factor for fixed income returns in 2019 was falling interest rates, and most bond sectors showed solid gains for the year. The 10-year Treasury yield fell to its low point of 1.46% in September, just above its record low yield. However, as risk assets rallied late in the year, yields rose with the 10-year yield ending the year at 1.92%. High yield bonds performed better under those conditions than more interest-rate sensitive bonds, validating our long-standing position favoring credit over pure interest rate exposure in the current market environment.

There is plenty of liquidity in the system and the major central banks will provide $90 to $100 billion a month of support through June and around $50 billion of monthly support in the second half of the year. With global growth showing signs of bottoming, low inflation, plenty of liquidity and steady demand for bonds, yields should be range-bound to modestly higher and the curve a little steeper. Our expectation for yields in 2020 is range-bound between 1.5% - 2.5%. Stocks really struggled in 2018 when the 10-year Treasury hit 3%. Given the additional debt that has been added, that rate ceiling may be a little lower now before impacting stocks.

As far as the Fed is concerned, they are likely to be on hold and keep short rates anchored. The Fed's messaging signals a very high bar to hike rates and not as high of a bar to cut rates one more time. In addition, it is a presidential election year, and under normal circumstances, the closer we get to the election, the less likely it is that the Fed alters monetary policy.

Evaluating Inflation Targets

Core PCE, the Fed's preferred inflation measure, sits at just 1.6%, below the Fed's target of 2.0% year-over-year change. This measure has consistently fallen below the Fed's target since the Credit Crisis. In fact, the Fed has not been able to maintain its inflation target for over 20 years.

The Fed is due to complete a year-long review of its monetary policy tools and, according to interviews with current and former policy makers, the central bank is considering a promise that when it misses its inflation target, it will then temporarily raise that target to make up for lost inflation. Since the Fed has missed its target for about 20 years, why does the Fed think it has any control over inflation?

While we expect inflation to remain muted, one of the risks we see in our outlook is an upside surprise in inflation. Inflation risks include short supply of labor, minimum wage increases, increased poaching lifting wages, and now higher oil prices. We are seeing what may be the beginning of wage pressures, with average hourly earnings up 3.1% year-over-year.

Another concern regarding inflation is the renewed geopolitical risks in the Middle East that have pushed oil prices to eight-month highs. It is usually the Fed's response to push up oil prices with rate hikes that ultimately causes a problem for the markets. In this case, with inflation expectations anchored, we don't believe the Fed will respond to the higher oil prices. In addition, Fed Chairman Powell said in his December 11th press conference that "in order to move rates up, he would want to see inflation that's persistent and significant." That does not seem likely in our opinion.

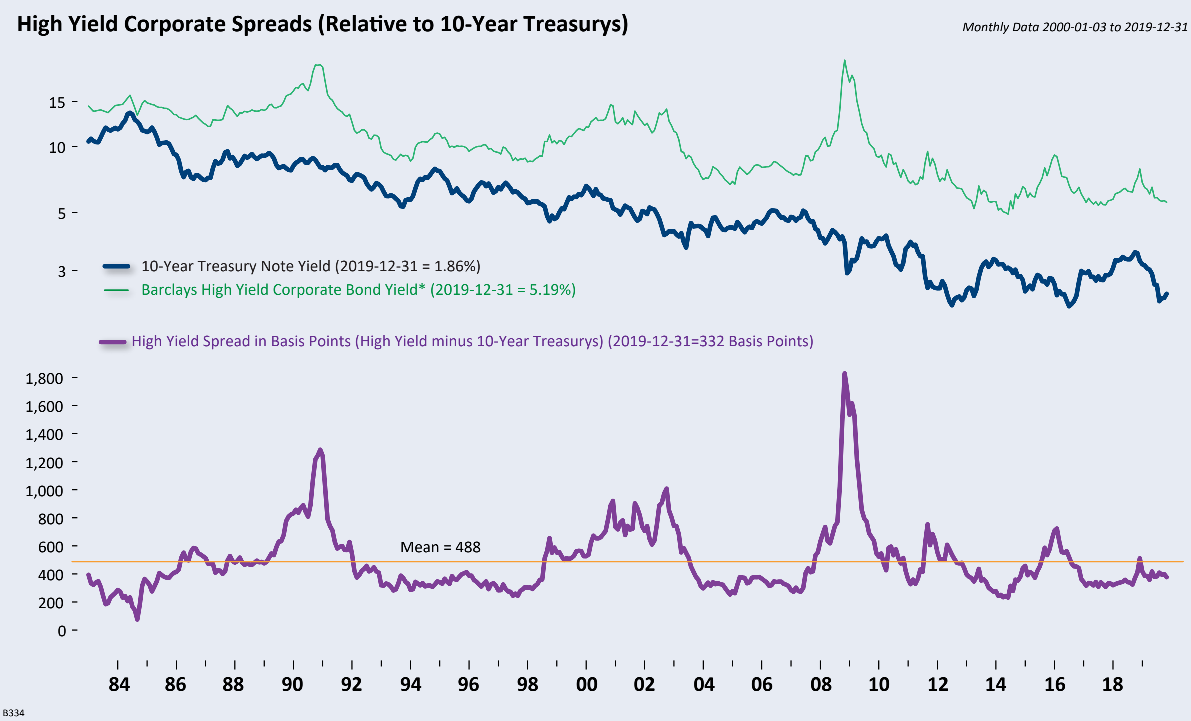
Conditions Supportive of Credit in 2020

As shown in **Figure 10**, high yield credit spreads contracted significantly from a high of 812 basis points in December 2018 to close 2019 at 327 basis points. The credit markets enter the New Year with a risk-on tone and our Fixed Income Total Return portfolio is fully allocated to high yield.

Corporate credit remains richly priced with spreads historically tight across both investment grade and high yield bonds. The yield on the Bloomberg Barclays Intermediate-Term US Corporate Bond Index and the US Corporate High Yield Index ended the year at 2.42% and 5.19%, respectively. For high yield, that was nearly a record low yield. Yields have only been lower for a brief period in the summer of 2014.

Low yields and tight spreads indicate upside potential is limited and bonds are priced for perfection. However, there have been many instances in the past when spreads have remained tight for long periods of time. In our opinion, the positive U.S. economic outlook and improving global economy, in addition to continued central bank liquidity and investor search for yield, should support credit in 2020.

Figure 10. | **Credit Spreads Historically Tight**



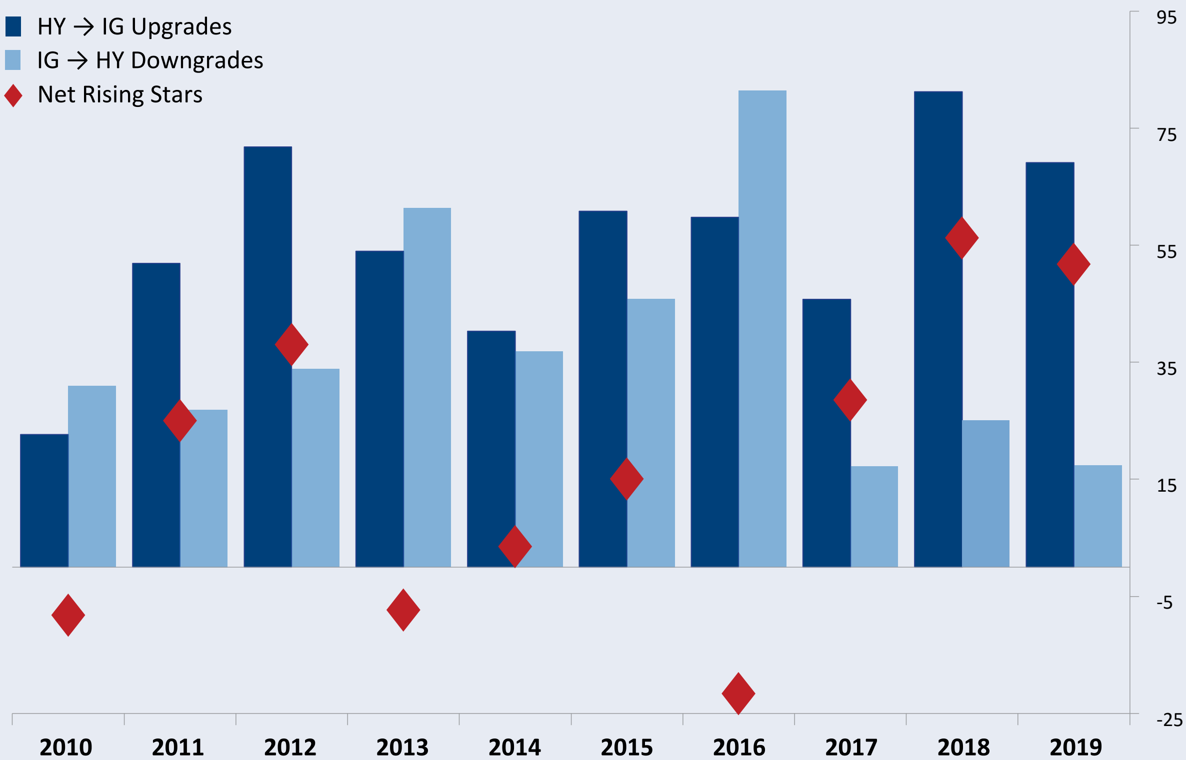
Source: Ned Davis Research

Debt Remains on the Rise

While the amount of rising debt is a risk, it has not posed a problem yet. For example, as shown in **Figure 11**, more than $69 billion of corporate debt was upgraded from high yield into investment grade last year – the second-highest amount of the post-crisis period. Last year's upgrade activity significantly outpaced the $17 billion of debt downgrades into high yield.

Given that we believe there is low recession risk on the horizon, we expect a rather benign environment for downgrades, at least in aggregate. But relative to 2019, we do think the risk is a little higher as the slow growth environment keeps the risk of unexpected transitions into high yield, at least at the idiosyncratic level.

Figure 11. | **Upgrades vs. Downgrades**

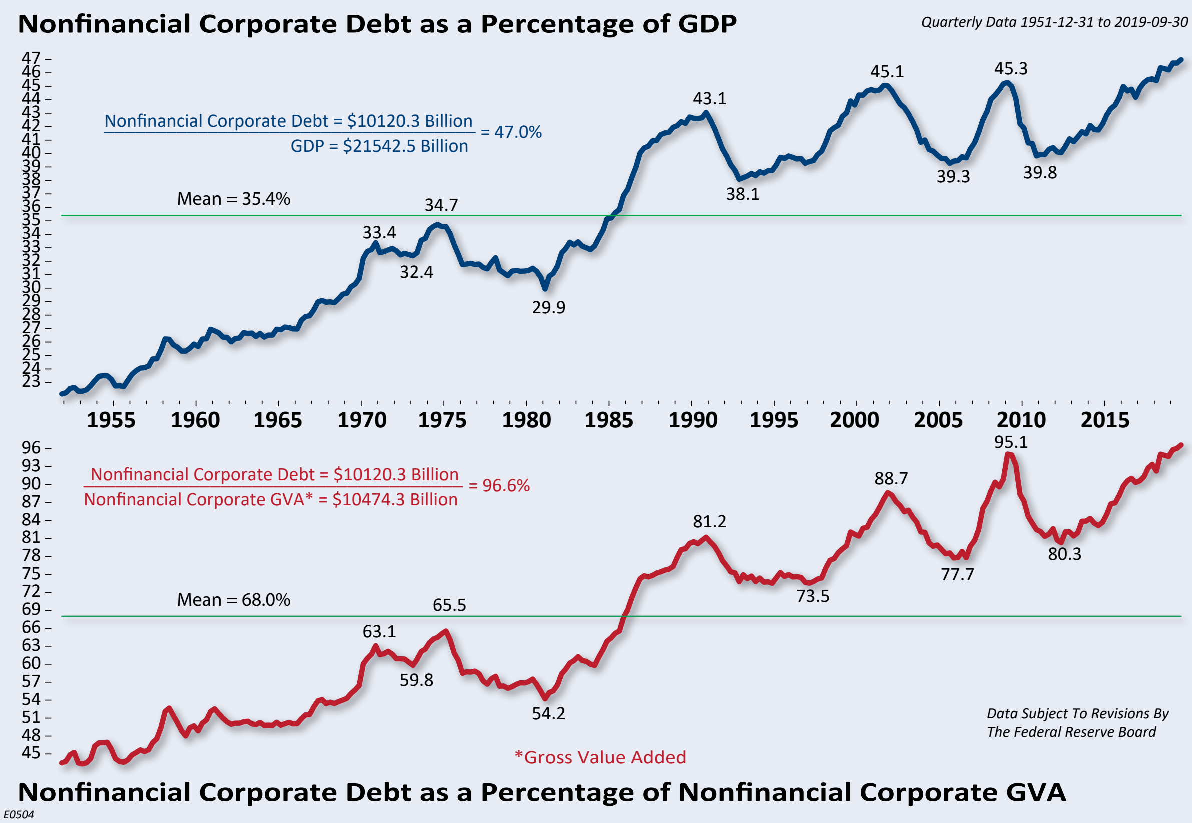


Source: Bloomberg, Goldman Sachs Global Investment Research

We believe the growth of corporate debt is a major concern. As shown in **Figure 12**, relative to GDP, corporate debt is now at record levels. Companies continue levering up with much of the capital raised from new bond issuance used to buy back stock, shifting capital structures away from equity in favor of debt.

This is not a problem when rates are low, but when rates rise, it could make servicing or rolling over the debt a real issue. This combined with the fact that over 50% of investment grade corporate bonds are trading at the bottom rung of investment grade ratings, highlights risks that someday may come home to roost. Our view is this will present an opportunity should it occur, and we believe we are well positioned to capitalize on this opportunity with our active and tactical approaches to managing fixed income.

Figure 12. | **Corporate Debt at Record Levels**



Source: Ned Davis Research

Even though the total amount of debt is at record highs, low interest rates have made servicing the debt reasonably easy, as most companies don't have problems making their interest payments.

Net debt relative to cash flow and interest coverage ratios are both near their mean levels over the past 50 years. Normally, interest coverage ratios are in much worse position than today when recession hits. The economy is cyclical and eventually leverage and interest coverage will be an issue, but we are not there yet. As long as interest rates stay low, this is manageable. It will be a major risk when rates eventually move higher.

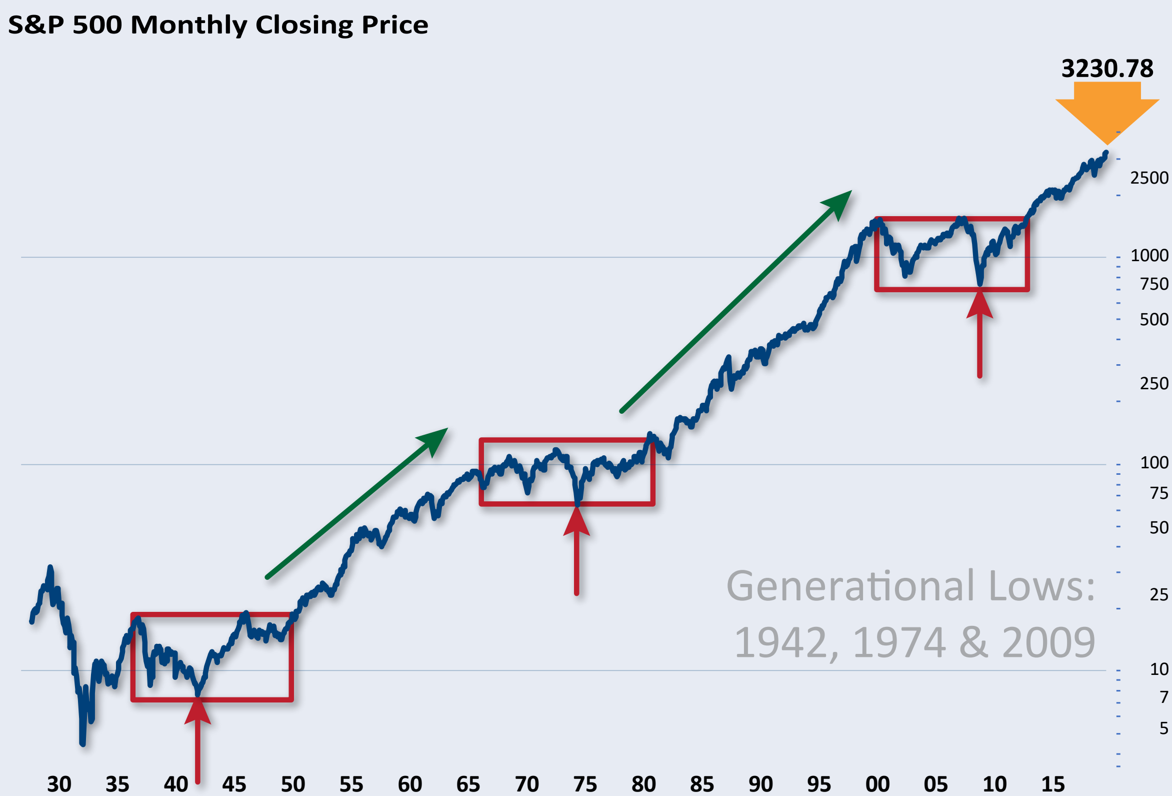
The debt concerns are not just corporate debt, but also too much government debt. A problem we face, and have for many years, is an exploding federal budget deficit. The government should run surpluses in good economic times and deficits in bad times, but that just doesn't happen. There is no political will on either side of the aisle to have fiscal restraint.

The budget deficit is getting worse, and we are well on our way to trillion-dollar deficits. What's scary is the size of the deficit this long into an economic expansion. While we don't expect a recession in 2020, we believe there still is a business cycle, and sure enough, this expansion will end one day, and a recession will ensue. When the next recession strikes, we are likely to see several trillion-dollar annual deficits.

Adjusting Capital Market Expectations in the New Decade

We have concluded the past several Market Outlooks with this chart of the very long-term perspective of the equity markets.

Figure 13. | **Generational Lows: A Long-Term Perspective**



Source: Bloomberg

The chart of the S&P 500 in **Figure 13** dates back into the 1920s. The three boxes in red highlight the last three secular bear markets. Note that once the market eclipsed its prior secular peak, it continued higher for many years. The prior two secular bull runs lasted 22 and 18 years. We are still in the secular bull market that began after the Credit Crisis. We are now into the 11th year, and if history is any guide, the probability of additional secular gains are high.

The returns during this secular bull market have been spectacular. For example, since the Credit Crisis low on 3/9/2009 and for the decade, the annualized total returns were:

	Since 3/9/2009	SInce 12/31/2009
S&P 500	17.97%	13.54%
MSCI All Country World (ex-US)	10.70%	4.96%
BBgBarc U.S. Aggregate Bond	4.12%	3.74%
BBgBarc U.S. Corporate High Yield	11.75%	7.57%

Source: Bloomberg

We would caution investors not to expect those types of returns over the next decade. Capital market expectations need to be ratcheted lower. Our expectation over the next decade is for mid-single digit annualized equity returns.

Conclusion

Given the sentiment landscape, valuations, presidential election trends, and other risks mentioned earlier, we see potential for a 5-10% correction in the first half of the year before the market responds to presidential election strength. We believe the economy should grow 2.25% in 2020 and expect stocks to have positive gains, consistent with a growing economy and historical presidential election year trends.

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As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the firm's portfolio team. Sean joined the firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Investment Team and the Executive Team. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean holds the Chartered Financial Analyst® designation and is a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean has been featured in a number of articles in nationally distributed business journals and newspapers.

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The Bloomberg Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The Bloomberg Barclays US Intermediate Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers that have between 1 and up to, but not including, 10 years to maturity.

The Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

The Bloomberg Barclays U.S. Corporate High-Yield Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Bloomberg Barclays U.S. Aggregate Bond Index: The index is unmanaged and measures the performance of the investment grade, U.S. dollar denominated, fixed-rate taxable bond market, including Treasuries and government-related and corporate securities that have a remaining maturity of at least one year.

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The MSCI Emerging Markets is an index used to measure equity market performance in global emerging markets.

The MSCI All Country World is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world.

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.

Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Index refers to a composite of large and mid-cap companies located in the United States that also exhibit a value probability.

The Russell 2000 Index measures the performance of the 2000 smallest U.S. companies based on total market capitalization in the Russell 3000, which represents approximately 11% of Russell 3000 total market capitalization..

The Russell 3000 Index measures the performance of the 3 000 largest U S companies based on total market capitalization, which represents approximately 98 of the investable U.S. equity market.

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. The stocks in this index are also members of either the Russell 1000 Growth or the Russell 2000 Growth indexes.

Russell 3000 Value Index is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform. Included in the Russell 3000 Value Index are stocks from the Russell 3000 Index with lower price-to-book ratios and lower expected growth rates.

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The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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