2020 Investment Outlook

Running On Empty?

"Looking out at the road rushing under my wheels, I don't know how to tell you all just how crazy this life feels."

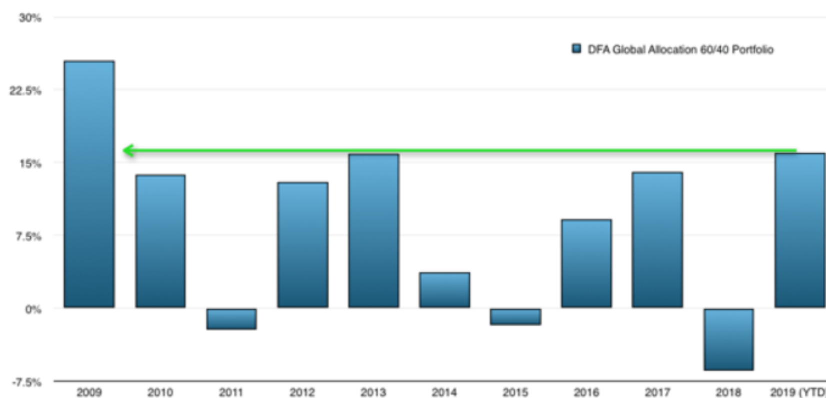
– Jackson Browne – Running On Empty

"Do You Feel Like We Do?"

– Peter Frampton – Frampton Comes Alive

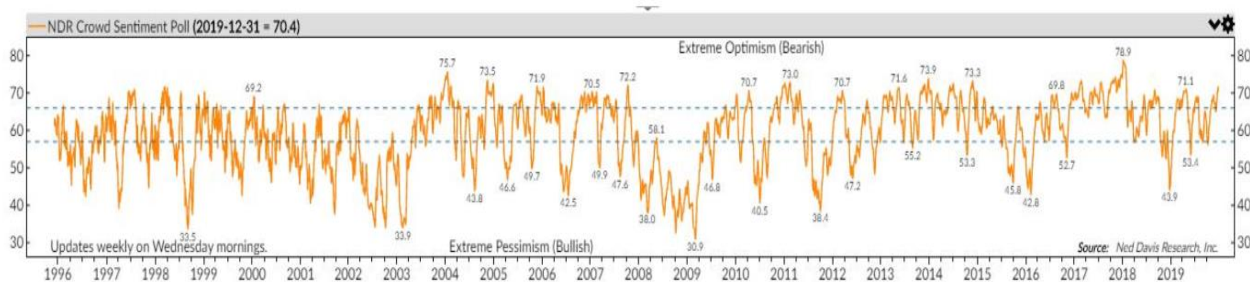
Live albums were all the rage in the 1970's and into the early 1980's. Back then, artists sold their souls to the record companies to get on a music label and get marketing support and distribution for their music, but bands and solo artists earned most of their incomes from live tours. The sound quality of many of those live recordings is pretty amazing consider how far recording technology has advanced since then. Today's digital technology does not capture the same richness and depth of sound as the vintage live rock albums that used 16 and 24 track recording tapes. It's not surprising that old vinyl albums (the iconic 33 1/3 RPM) are making a comeback today given the sound quality produced during those times. Peter Frampton Comes Alive is the greatest selling live album of all time and Jackson Browne had a good one too with Running on Empty. My older brother Dave had a terrific album collection that gave me much enjoyment listening to these live albums on his new stereo sound system.

When Frampton sang Do You Feel Like We Do? through his Heil Talk Box, the concert crowd roared its approval. No doubt global investors did the same if they attended Frampton's Farewell Tour last year as 2019 produced exceptionally robust investment returns across all major asset classes even though the fundamental backdrop was one of heightened global macro uncertainty and decelerating economic growth and corporate earnings. Central banks once again came to the rescue of global investors, pumping economies with liquidity through monetary policy actions, the vast majority of which found its way into financial asset prices. 2019 was the best year for a 60% stock / 40% bond global balanced portfolio since 2013. 2009 was the best return year of the past 11 years but that was the year after the Global Financial Crisis of 2008 when the average balanced portfolio plunged over 22%.

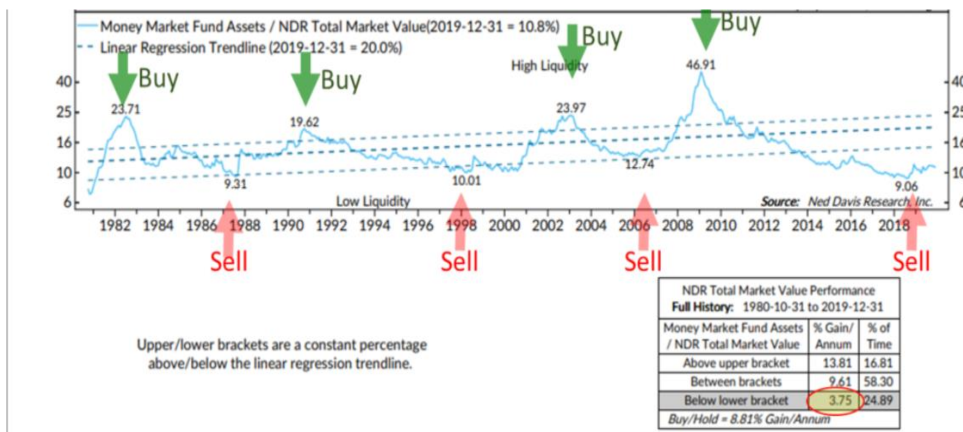


Returns were broadly positive across both stocks and bonds as 75% of global stocks had positive returns and 97% of the bonds in the Bloomberg Barclays US Aggregate Bond Index registered gains.

As you might expect after earning such exceptional returns, investors are very positive about financial markets today and after the huge gains of 2019. The next chart shows a Crowd Sentiment Poll by Ned Davis Research going back to 1996. Note how after the big market declines during the fourth quarter of 2018 (U.S. stocks were down over 14%), investor sentiment experienced a large drop coming into last year. In early January, the Fed made an abrupt change in its monetary policy stance and eventually cut interest rates by 0.75% during 2019. Investor sentiment recovered off of the December 2018 lows and finished 2019 at the high end of the past 25-year range. Sentiment has only reached these high levels 13 previous times going back to 1996. For what it's worth, forward returns have the highest probability of being low or negative when sentiment hits these extreme positive levels.



Another metric that offers a perspective on future U.S. stock returns is money market (cash) levels relative to the market value of the U.S. stock market. This metric is contrarian in nature, similar to the Sentiment Crowd Poll chart above. If investors are holding low levels of cash, it means they are already very bullish and future returns are typically lower. The converse is also true. Note that at the bear market lows in early 2009, investor cash levels were extremely high (46.91). The S&P 500 Index delivered 13.6% annualized returns for the 10 years ending 12/31/19. Today, cash levels are at very low levels, as shown on the right side of the chart. In the table, the red circle shows that when cash levels were at these low levels in the past, which happens around 25% of the time going back to 1980, forward U.S. stock returns were just under 4% annualized. When cash levels are high as they were in early 2009, which occurs around 17% of the time, the forward annualized returns for U.S. stocks were just under 14%. Will this time be different? Maybe, but not likely.

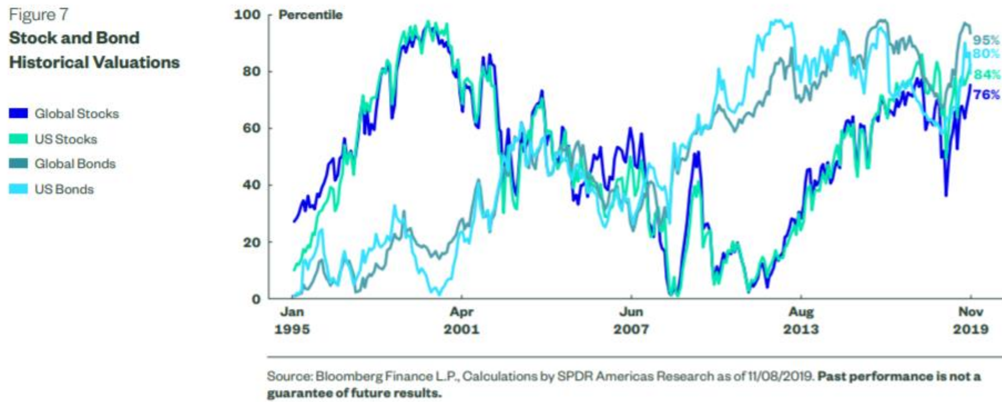


NDR Total Market Value Performance
Full History: 1980-10-31 to 2019-12-31

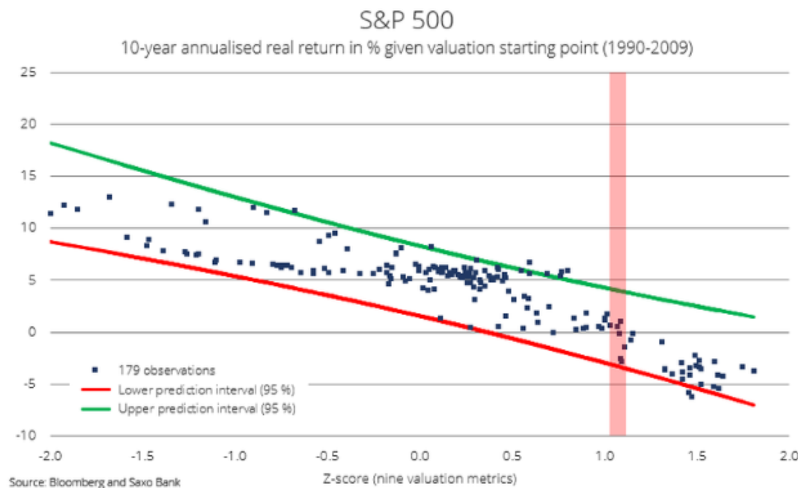
Money Market Fund Assets / NDR Total Market Value	% Gain/ Annum	% of Time
Above upper bracket	13.81	16.81
Between brackets	9.61	58.30
Below lower bracket	3.75	24.89

Buy/Hold = 8.81% Gain/Annum

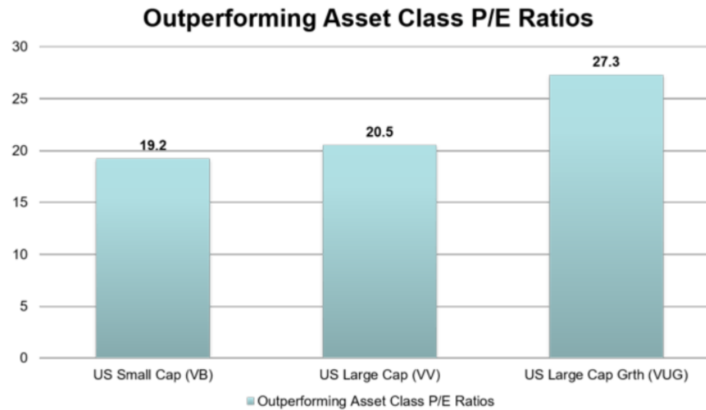
A key question facing investors for 2020 is whether there was such a large pull forward of investment returns during 2019 for both stocks and bonds that global financial markets are now running on empty. The next chart shows how stocks and bonds, both U.S. and non-U.S., are trading near their highest percentile valuation levels going back to 1995. Stocks were only more expensive during the 1999-2000 Tech Bubble peak while bonds are as expensive today as they were in 2011 and 2016, when global economic growth decelerated similar to 2019 and bond yields fell.



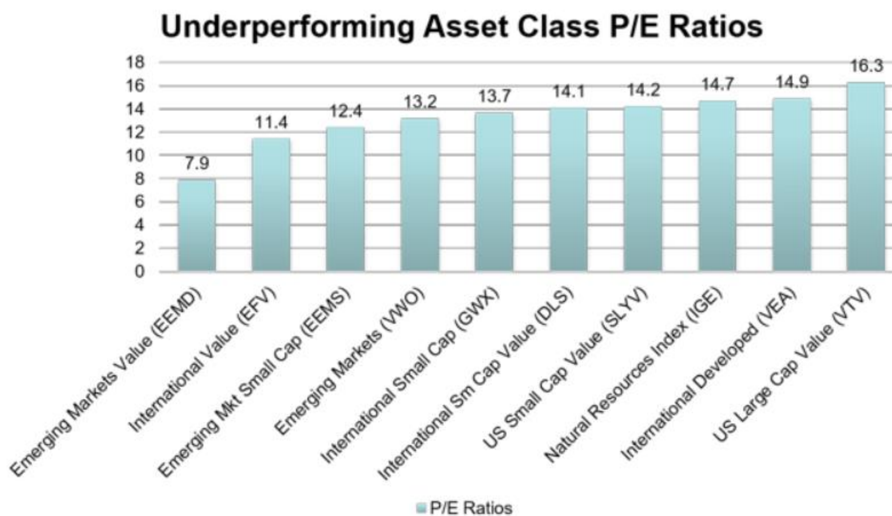
2019's exceptionally strong U.S. stock returns have led to stretched valuations. Combined with high levels of investor sentiment and low cash levels, the odds for a continuation of robust stock returns are quite low. Historically, the higher the starting point for valuations, the lower the future expected returns. This relationship is shown in the next chart, which compares starting valuations and the ensuing 10-year annualized returns for the S&P 500 Index. Analyzing prior periods when starting stock valuations (using a combination of 9 different valuation metrics) were at today's levels, there is a 95% confidence level that the ensuing 10-year annualized returns will fall between -3% to +4% (the vertical pink shaded bar). Considering that we just had a +30% return for U.S. stocks during 2019 and the trailing 10-year annualized returns for the S&P 500 Index as of 12/31/19 was 13.6%, investors should be prepared for low single-digit annualized returns from U.S. stocks over the next decade.



Fortunately, in the decade ahead, investors are not completely locked into low stock returns everywhere. While global stocks are no longer cheap after 2019's big gains, some areas of global stocks offer more attractive relative return opportunities. The next two charts break down the price/earnings (P/E) multiples for numerous categories of stocks based on their 2019 performance. The first chart shows the best performing and most expensive asset classes of 2019, which were all U.S. based. The trailing 25-year average forward P/E multiple for U.S. stocks is 16.3X compared to the 18.3X P/E multiple as of 12/31/19. Large and small cap U.S. growth stocks currently share the title of the most expensive stocks in the world.



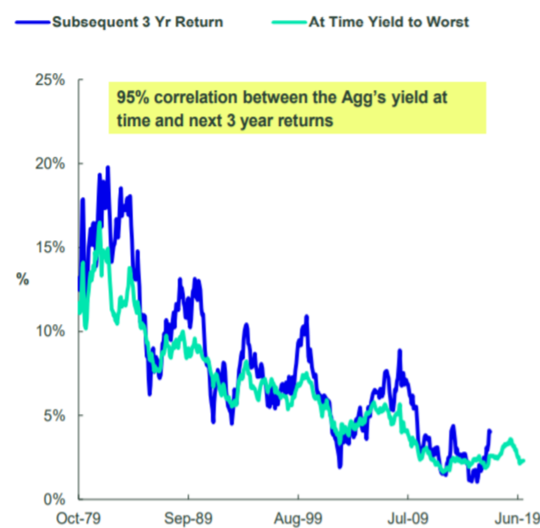
The trailing stock categories from 2019 are captured in the next chart. Even after last year's robust results for stocks, there are categories of global stocks that still offer attractive P/E valuation levels. However, they are not the current market darlings of U.S. large and small cap growth stocks. Recall the prior chart which showed how starting valuation levels have a large influence on forward 10-year returns. Investors would do well to consider some of these more attractively valued stock categories, which may increase the odds for earning higher future stock returns. Behavioral finance research shows that the typical investor tends to buy the most recent best performing (and typically the most expensive) stocks or mutual funds and sell or avoid the most recent laggards. The historical data suggests the odds of long-term financial success are improved by utilizing the exact opposite approach.



The forward return prospects for U.S. bonds are not much better. The next table on the left is a snapshot of the U.S. bond market as of 12/31/19. Except for higher risk bonds such as high yield and convertibles, all categories of U.S. bonds offer yields below 3.0% and all U.S. Treasuries currently have yields below 2.5%. It's even worse overseas, where $12 trillion of bonds have negative yields. The chart on the right shows there is a very high correlation (95%) between starting bond yields and forward 3-year returns. In other words, with the BB Aggregate Bond Index yield at 2.31%, the total return per year from the broad U.S. bond market the next three years will be similar. Therefore, balanced portfolios are unlikely to achieve return enhancement from incorporating investment grade bonds but the risk diversification benefits of bonds still offer value given the low correlation of returns between stocks and bonds.

	Yield		Return			
U.S. Treasuries	12/31/2019	9/30/2019	2019	Avg. Maturity	Correlation to 10-year	Correlation to S&P 500
2-Year	1.58%	1.63%	3.31%	2 years	0.67	-0.34
5-Year	1.69%	1.55%	5.82%	5	0.92	-0.32
TIPS	0.15%	0.15%	8.43%	10	0.62	0.13
10-Year	1.92%	1.68%	8.90%	10	1.00	-0.31
30-Year	2.39%	2.12%	16.43%	30	0.93	-0.32
Sector						
Corporates	2.84%	2.91%	14.54%	11.5	0.52	0.31
U.S. Aggregate	2.31%	2.26%	8.72%	8.1	0.88	-0.01
Convertibles	5.66%	5.87%	22.73%	-	-0.29	0.89
High Yield	5.19%	5.65%	14.32%	5.9	-0.22	0.71
Municipals	1.63%	1.70%	7.70%	10.0	0.54	-0.02
MBS	2.54%	2.45%	6.35%	5.1	0.82	-0.13
ABS	2.87%	2.83%	3.77%	2.3	0.06	0.20
Floating Rate	2.30%	2.56%	4.28%	1.9	-0.20	0.38

Source: JP Morgan Asset Management



Source: Bloomberg Finance, L.P. as of December 31, 2019. Calculations by SPDR Americas

Summary

2019 was an exceptional year for investment returns. However, one year doesn't define investment success any more than one concert defines a successful tour. The past decade has delivered robust and above average financial asset returns, substantially supported by global central banks and their use of low and negative interest rates to stimulate economic growth (which hasn't worked). Peter Frampton must think the last decade of very strong investment returns must have been a dream and can't believe where we've been and probably sing out come on, let's do it again! However, with global bond yields near historical lows and U.S. stock valuations and investor sentiment currently at high levels, it's a challenging setup for future returns. It doesn't necessarily mean 2020 will be a throwaway year but investors should keep their expectations in check. As Jackson Browne sang about life as a musician touring on the road, financial markets may be running on empty and it's time to prepare for more meager prospective investment returns.

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