Economic Overview

Fixated on the Consumer

SHORT-SIGHTED OR PERFECT VISION IN 2020?

The massive dynamics of global growth and trade were again center stage for the quarter, but there were some important differences. The markets saw a much improved tone to trade as the news hit of at least a potential completion to Phase One of the deal with China soon. Additionally, the positive momentum on the USMCA deal with China and momentum was well received. The Federal Reserve's (Fed's) rate cuts in the third and fourth quarters had pronounced effects upon the economy and the financial markets. The Fed also indicated they would probably be inclined to stay on the sidelines for a period, unless prompted by higher inflation. These actions drove positive business momentum, increased corporate issuance, and generally very positive returns in both the fixed income and equity markets for the fourth quarter.

The economy is somewhat bifurcated. Businesses are doing well, but not experiencing as much momentum as just after the tax stimulus program. The distance from the tax cuts is, in effect, cooling off corporate earnings since many companies used the proceeds for share buybacks and other restructuring. Some business forecasting surveys have shown declines, including the Institute of Supply Management (ISM) manufacturing survey. This survey has shown a decline below the level of 50, which indicates non-expansionary territory. However, the ISM services survey has remained well above 50, demonstrating expansion in the services sector. The U.S. economy has shifted more to a service-based economy over the past decades.

The consumer – responsible for approximately 70 percent of the economy – remains a strong bright spot. U.S. consumers continue to show resilience in spending and are propelling the economy. Confidence remains strong partially due to the low unemployment rate of 3.5 percent and moderate wage increases. Miles Capital believes that the moderation in growth seen in 2019 is not indicative of an upcoming recession, but we continue to monitor consumer and economic activity closely.

The Fixed Income Rally

NOT SO FAST AND NOT SO FIXED

The fixed income markets have generally rallied for over 30 years due to the continued decreases in interest rates. While we had expected the rising interest rate period to last longer to eventually support interest income, unfortunately the lower interest rate trend returned in 2019 as the Federal Reserve (Fed) pivoted in their posture towards interest rates. The Fed lowered interest rates three times in 2019, once during the fourth quarter, then announced they would pause.

Shorter maturity treasury rates (shorter than 3 years) moved lower for the quarter due to the Fed rate decreases. The outlook for global growth improved slightly, and the Fed's stated willingness to let inflation run above their long-term target for a period of time, helped push longer interest rates higher, with the 10-year U.S. Treasury rising 24 basis points to 1.92 percent. The increases in longer rates eliminated pockets of yield curve inversion. Shorter maturity rates are now no longer higher than longer maturity rates, which normalizes the slope of the curve and somewhat lessens concern of a potential economic recession. For the year, interest rates dropped strongly across the entire maturity spectrum.

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The percentage of global negative yielding debt decreased from approximately 30 percent in the 3rd quarter to 19 percent in the 4th as global growth concerns were slightly lessened and global monetary policy remained accommodative. Declining interest rates helped to further bolster fixed income returns for most sectors for the fourth quarter. Absolute returns for the year for fixed income were akin to some positive equity years. Many sectors of the investment grade markets performed very well in 2019, including corporate bonds, government-backed mortgage bonds, municipal bonds, and treasury securities. The Bloomberg Barclays Aggregate Bond Index (Agg), a broad measure of the investment grade taxable U.S. Bond market, rose by 8.7 percent for the year. The average return for the Agg index over the past decade has been 3.74 percent.

Gazing ahead, a repeat of this fixed income performance will be difficult to achieve in in 2020, solely due to the magnitude. But we at Miles Capital believe our clients could still see quite reasonable performance simply based on the Fed hold on rate action pending higher inflation.

BULLS CHARGE Into the new Decade

U.S. equities finished off the fourth quarter on a very strong note. The S&P 500 ended the quarter up 9.07 percent, with gains in 11 of the final 12 full weeks to cap the best year since 2013. Information technology stocks contributed 3.19 percent to the total return for the index, with Apple, Inc. alone contributing 1.23 percent in the quarter. Small Cap stocks did even better than large caps during the quarter, up 9.94 percent. International equities also rallied, but lagged domestic as the MSCI EAFE returned 8.17 percent.

The primary focus of the markets remained on U.S. trade policy with China. After trade talks in Washington in October, a “Phase One” agreement was announced that would provide China some tariff relief in exchange for increased purchase of U.S. agricultural products. In mid-December the U.S. confirmed it would not hit China with a new round of tariffs. Also in December the USMCA (US-Mexico-Canada Agreement) was signed to replace NAFTA, removing further uncertainty in the international markets.

Earnings growth for the third (most recently reported) quarter was -2.21 percent growth year-over-year. That is the third consecutive quarter of earnings declines. This was better than feared as the estimated earnings decline was -3.7 percent at the end of September. For the next quarter, earnings are expected to decline by 1.65 percent. Given that all of 2019 has returned results above forecasts, the fourth quarter earnings could be flat. However, earnings growth is expected to turn around in 2020. Projections are for 5-15 percent growth in each quarter of 2020.

Slow but steady growth in the U.S., supportive monetary policy around the world, and easing tensions between the U.S. and China all indicate that 2020 could continue the rally of 2019. However, surprises from a number of directions include hiccups in the China/U.S. trade negotiations, geopolitical tensions, changes to global economic momentum, and the U.S. presidential election could cause 2020 to fall short of expectations.