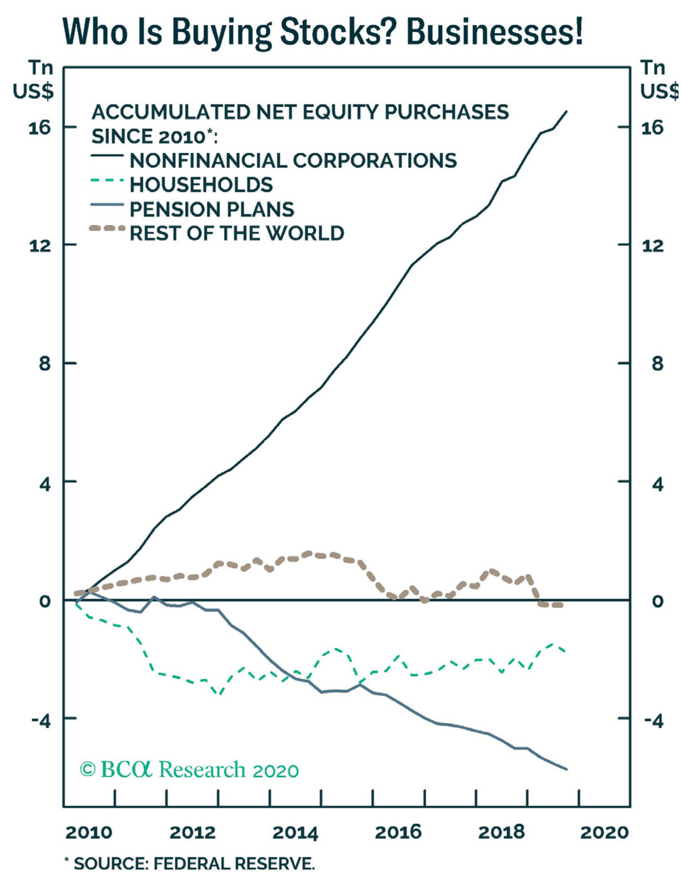
Notes From the North: Market Outlook

December, 2019

What might your expectations have been for the U.S. stock market if, at the beginning of 2019, you knew that real GDP growth would decelerate from 2018 and S&P 500 earnings would decline in each of the first three quarters of the year? Probably not a gain of the magnitude we saw in the first quarter of last year, let alone over the course of the entire year!

In the end, 2019 proved to be the opposite of 2018. In 2018, GDP growth accelerated, unemployment fell, wages rose, business and consumer confidence grew, earnings improved by 20%, and stocks ended the year lower. (The media refrain this time last year was "the worst December for stocks since 1931!") In 2019, real GDP growth rates did decelerate and earnings for the S&P 500 did, in fact, decline in each of the first three quarters of the year. And yet, stocks (*and* bonds) had a banner year. One might reasonably wonder…. "Why?"

Yes, the Federal Reserve changed its stance and went from raising short term interest rates to lowering them, but that does not indicate strength in the economy. Yes, at long last we appear to have reached a watered-down "Phase One" trade agreement with China, but real progress on the issues that President Trump raised may take years. Perhaps it was simply a rebound from 2018's nasty fourth quarter drop of -13.5%. (Forty percent of 2019's calendar returns came in the first quarter, on the heels of that drop. If you combine calendar 2019 with the fourth quarter of 2018, the market was up a strong but less exciting 10.8%.)



Part of the answer may lie in equity fund flows (see chart, right). It turns out that those who normally invest in stocks (households, pension plans and foreigners) have not been eager buyers of U.S. stocks, but corporations have been clamoring for shares throughout this bull market.

This graph charts *cumulative* net equity purchases, so if a line is moving down, the group is liquidating equity holdings on balance. If it moves up, the group is adding to their holdings.

Pensions have been consistently liquidating equity holdings since 2013, while foreign buyers and households have shown a distinct lack of enthusiasm to build equity positions. Households stopped liquidating on balance by 2012, but have been accumulating stock holdings only slowly since then and have still not reached the levels of 10 years ago. On the other hand, corporations have been buying shares with abandon. In 2019 they bought another $2 trillion or so to add to the $14 trillion already accumulated since the start of the decade.

Without a need to significantly increase plant or equipment in order to meet demand, many corporations have instead opted to use cash flow for share buybacks. With interest rates so low, many have even issued debt (borrowed money) in order to buy back their stock. While stock buybacks often draw skepticism, they are a valid use of cash flow. A lower number of shares outstanding will increase earnings per share even if revenues or earnings are flat. The buying also tends to support the stock price, benefiting shareholders and employees who have stock options.

Obviously, corporate buybacks alone don't explain 2019's market action. In the end, we have been reminded once again why market timing is not a statistically successful strategy.

It would be foolish to ignore the facts on the ground, however, and it's good practice to consider others' forecasts even if only for gaining a sense for what is already discounted in the markets. To that end, the well-respected panelists of the *Barron's Roundtable* have just provided us with an excellent summary of the outlook for 2020.

The consensus is that stocks will provide moderate gains in the range of 5%-7% if inflation and interest rates remain under control and assuming an extreme left-wing candidate does not prevail in the upcoming Presidential election. Scott Black of Delphi Management thinks earnings for the S&P 500 Index stocks will rise 5%, to $166. He feels the consensus estimate of $175.52 is too high in an economy growing at a 2% rate. There is less enthusiasm among the group for smaller stocks. The Russell 2000 is already at 21 times earnings and that calculation excludes the negative results from the 600 companies that are unprofitable. Larger firms are expected to continue to fare better than smaller ones, perhaps because they can take better advantage of foreign markets and advanced technology such as artificial intelligence.

Some of the concerns that were expressed include:

1. Consumer confidence is strong, but CEO confidence is at its lowest since 2009,
2. Should growth falter, the Federal Reserve may be out of bullets,
3. If inflation rises significantly more than expected, the bull market would end, and
4. Any serious problems in the credit markets would have a disproportionate effect on stocks because of the amount of corporate leverage and under-funded pension funds.

One of our favorite forecasters, Peter Berezin of BCA, was not a panelist, but his views are worth noting. He has been correctly bullish for some time, partly because he was expecting global growth to accelerate in 2020. He is now somewhat concerned that the U.S. Institute for Supply Management index is still falling while the purchasing managers index in Europe, the UK and Japan gave up some of their November gains. Market sentiment is very bullish, making equities vulnerable to any disappointing news. On the positive side, he thinks the Fed will maintain an accommodative monetary policy and China has just improved liquidity by reducing reserve requirements. While stocks are due for a "breather", he still thinks European and emerging market stocks could end the year with gains of 10%.

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