Reams Asset Management

Investment Outlook 2020

Executive Summary

"You gotta take what you can, when you can, while you can … and you gotta do it NOW. Because if you think Mick Jagger will still be out there trying to be a rock star at age 50, you are sadly, sadly mistaken."

- Dennis Hope, *Almost Famous*

In the middle of Cameron Crowe's 2000 biopic *Almost Famous*, the "big time" rock manager Dennis Hope utters these words to up-and-coming fictional 1970s rock band Stillwater. The scene represents a critical turning point in the band's trajectory: a sorely needed upgrade of resources and professionalism, but at the cost of a not-so-subtle loss of innocence, idealism, and authenticity in pursuit of the almighty dollar.

Of course, the dialogue is cleverly played as an inside joke to the audience: While the band members nod along and agree with Mr. Hope's sense of urgency, all characters involved would be in utter disbelief to learn that in 2019, a 76 years young Mick Jagger completed yet another run of sold-out stadium concerts with The Rolling Stones.

In fact, a quick scan of upcoming events at your local concert venue likely confirms that a lucrative and seemingly endless stream of touring acts is not merely confined to rock royalty such as the Stones, but also includes a bevy of artists old enough to collect Social Security. Most, if not all, of these acts are decades removed from their creative and commercial zeniths, and many are fielding ersatz lineups with key band members conspicuously absent from the stage. Yet demand to be transported back to the music of one's youth remains insatiable. In that sense, Mr. Hope from *Almost Famous* couldn't have been more wrong about this particular party being over quickly.

The same unexpected staying power could also describe current financial markets. Much like the relentless drive of Sir Jagger and his brethren, capital markets continue to defy all reasonable expectations as we conclude the 12th consecutive year of growth in the United States. By any measure, this market cycle has been lengthy, yet equity markets continue to plow ever higher. Global interest rates, meanwhile, have collapsed to record low levels. At one brief point in summer 2019, over $17 trillion dollars of global debt actually had negative interest rates. Investors in some international domains were so concerned over future prospects that many willingly parted with capital to invest in securities ensuring negative returns – absent further declines in yields, of course. This concept is certainly going to take some getting used to.

Meanwhile, the volatility that emerged from hibernation in the fourth quarter of 2018 fell away almost as quickly as it appeared. In January, the Federal Reserve quickly backtracked on its rate hike campaign, and the newly dovish language was all that was needed to highlight their primary concern: bolstering asset valuations. Equity markets responded predictably and zoomed to an impressive +31.5% gain in 2019, while 10-year Treasury yields dropped 77 basis points to a paltry 1.92% over the same timeframe.

Just as the idea of a rock band touring into their senior years would have been dismissed out of hand in 1974, the market behavior, activity, and results that we have seen in recent years would have been unthinkable just two or three decades ago. This naturally begs the question: Is there a paradigm shift underway in global markets to a permanently higher valuation plateau, lower-for-longer global interest rates, miniscule inflation, and inevitable demographic headwinds? What becomes of volatility if that is the case?

These questions highlight our annual Investment Outlook. As always, our economic assessment pays particular attention to tail risks – i.e. where market consensus might err and what factors are, perhaps, not priced into current valuations. Over market cycles, these tail risk events have generally caused meaningful investment performance dispersion, giving rise to both significant challenges and outsized opportunities.

At Reams, we responded to the volatility of the fourth quarter of 2018 and moved a meaningful portion of our portfolios from very safe and liquid instruments to more active risk positions by the beginning of 2019. Our defensiveness heading into the fourth-quarter selloff served us well, and the subsequent repositioning allowed us to participate in the early 2019 rally. While valuation metrics once again appear rich, the fundamental outlook remains somewhat cloudy. As such, we resumed our defensive stance as the year unfolded and largely maintain this course as we head into the new year.

The overall outlook for 2020 is perhaps as difficult to forecast as any year in recent memory. After the incredible run of risk assets through and including 2019, most professionals are understandably a bit cautious near term. Yet, most weeks there is further confirmation that sellers are in short supply and investors continue to chase the lure of ever higher returns. Be wary of signs of insatiable greed in capital markets; to continue our metaphor, the rock show may not be over anytime soon, but those expecting an encore performance along the lines of recent history may be left wanting. Remember that none other than Mick Jagger himself famously cautioned, “You Can’t Always Get What You Want.”

What follows is our attempt to lay out key economic data and issues we are tracking, gauge where consensus estimates are and what tail risks exist to that consensus, and determine what opportunities may present themselves going forward.

Reams’ Key Areas of Focus for 2020

Highly uncertain future market direction, with trade question headlining

- GDP growth remains positive and economic fundamentals robust, but there are few obvious catalysts for potential acceleration to the upside.
- Market gyrations in 2019 largely followed developments in U.S.-China trade negotiations and tariff levies. Market consensus has now priced in the completion of a “Phase 1” deal in early 2020, as well as further optimism for a more comprehensive “Phase 2” agreement.
- Absent a larger resolution on the trade front, trends of manufacturing weakness globally and lower business capital expenditures portend continued caution among global businesses broadly and cyclical sectors in particular.
- Interest rate movement may surprise in either direction; zero-bound interest rates in the U.S. are not the base case but remain plausible given global correlation of interest rate declines.

Federal Reserve future policy and efficacy in question

- While the Federal Reserve enacted three cuts in 2019, current estimates suggest only one additional quarter point rate cut in 2020, and even that one is far from certain.
- The justification for the rate-cutting campaign has been tenuous given the economy’s core strength, and views among the Federal Reserve voting members are not unanimous.
- The efficacy of future policy to further support asset valuations – not to mention actual growth and inflation – appears questionable, as the market has “front-run” the recent Federal Reserve moves and anticipated, if not influenced, the three rate cuts to date. With rates now approaching record lows, further cuts may not have the same stimulative impact as those that preceded.
- The turn of Fed policy direction in 2019, along with the ensuing rally in risk assets, only underscores how dependent our highly leveraged economies have become on accommodative central bank policy globally.

Inflation remains 'X' factor, and its re-emergence could prove disruptive to current markets

- Inflation remains low globally, hovering close to the targeted 2.0% level in the U.S. but far lower in other key areas (Japan, Eurozone).
- Nothing in terms of monetary or fiscal policy has been successful in stimulating inflation over the past decade, which is one reason why the U.S. yield curve remains stubbornly flat.
- Late-cycle inflation could be understated by official data, and a sudden, unanticipated rise could force the Federal Reserve's hand to increase rates as an initial response.
- Alternatively, we may have entered an entirely new paradigm wherein inflation remains subdued as a result of permanently changed supply/demand dynamics.

Volatility is once again inexpensive, but with periodic spikes; the implied opportunity cost of defensiveness is low

- With risk assets generally on the expensive end, volatility (as measured by the VIX Index) is low and potentially undervalued.
- Even if the status quo persists in 2020 – middling but positive GDP growth, low inflation, flattish yield curve – bouts of sporadic volatility could likely appear.
- Recent volatility spikes have been of shorter duration and lesser magnitude than historical averages. This could be the result of the experimental monetary backdrop of the past decade, or perhaps indicative of technical factors and risk parameter shifts that are more systemic in nature.
- The Reams playbook of utilizing volatility opportunistically can still thrive even if the backdrop continues to support the new paradigm we've witnessed over the past decade; we do not require an outright recession or some massive disruption to execute our time-tested approach, but merely temporary price dislocations.

What is the Consensus Viewpoint?

	2019 Actual	2020 Consensus	2020 Downside	2020 Upside
GDP Growth	**2.10%**	**1.80%**	**0.70%**	**2.40%**
Unemployment Rate	3.53%	3.70%	4.50%	3.00%
CPI Inflation Rate	1.80%	2.00%	1.30%	2.80%
Federal Funds Target Rate	1.75%	1.47%	0.50%	2.25%
10-Year U.S. Treasury Note	1.84%	1.95%	1.00%	3.00%
IG Corp OAS Spread	+104	----	+160	+80
ML High Yield YTW	5.72%	----	7.50%	4.75%
VIX Index	15.68	----	30.00	10.00

**Consensus Economic Forecasts based on Bloomberg Survey Results as of December 10, 2019. 10 YR U.S. Treasury forecast based on 1 Year Forward Curve as of December 31, 2019 .*

For 2020, economists surveyed by Bloomberg collectively forecast GDP growth of +1.8%, which falls on the lower end of yearly output since the financial crisis of 2008/09. The projected 2020 number represents a sequential decline from 2019, the second consecutive year of lowered estimates, but still conveys a continuation of the elongated economic growth cycle. Weighing on late 2019/2020 data is the reluctance of many businesses to commit to significant capital expenditures while they await greater clarity on trade discussions between the U.S. and China, as well as on further geopolitical risks such as the details of the United Kingdom's impending departure from the Eurozone (Brexit), social unrest in Hong Kong and Peru, and most recently an escalation of hostilities between the U.S. and Iran.

Though U.S. GDP is far from robust, many core underlying statistics remain in good shape. Unemployment is expected to remain well below 4.0% and touched a 50-year low mark this past year. While consistent inflation has proven elusive, the current metrics are running close to the Federal Reserve target of 2%. This 2% figure is somewhat random in and of itself, and the official data measuring inflation is suspect as well. That said, U.S. inflation easily surpasses international developed markets such as the Eurozone and Japan, which are perpetually combating fears of moribund inflation or even outright deflation.

Rates dropped sharply in 2019 and the 2-10 year segment of the yield curve briefly inverted in summer 2019. While some curve steepening helped normalize rates in the fourth quarter of 2019, they remain paltry overall and the long end remains historically low. Expectations suggest one more 25 basis point cut during 2020, although this view is far from unanimous and the timing is in question. Federal Reserve Chairman Powell has suggested that the committee does not want to imply that further rate cuts will materialize, but the market (and indeed the White House itself) is certainly encouraging such activity. The 10-Year U.S. Treasury note is expected to finish 2020 at 1.95%, slightly above current levels. Recall that a similar level of modest increase was anticipated for 2019. These projections got the direction itself entirely wrong, but the revised expectations following the Fed's policy pivot in early 2019 vastly underestimated the degree of rate tightening that would, in fact, occur over the course of the year.

The VIX Index, a key measure of equity volatility, receded from a brief spike in late 2018 and returned to levels more befitting early 2018 when capital markets were similarly sanguine on risk. This quick decline in the VIX ran counter to our view that volatility has been underestimated during the later stages of this market cycle. Levels are expected to remain low in 2020, but even if the eventual year-over-year delta is modest, we anticipate periodic bouts of volatility driven by shifts in expectations against an uncertain macroeconomic backdrop.

Elsewhere in the world, GDP growth rates are also expected to decline modestly in 2020. Despite full throttle accommodation by the ECB, Eurozone GDP growth is expected to be just 1.0% for the year, pulled lower by weakening manufacturing sector data from Germany, the region's largest economy. China, meanwhile, has continued to publish GDP growth figures above the psychologically important 6.0% level, but even these official numbers continue to march lower despite massive government intervention to boost GDP, much of it in the form of increasing sovereign debt. Current estimates are for 2020 GDP growth of 5.9% and the Chinese government has even floated the possibility of sub-6.0% GDP growth going forward – perhaps as much of an admission as you'll see anywhere that there are at least some limits to central government-induced economic output manipulation.

Consistent with Reams' traditional approach to scenario analysis, we prefer to focus on the factors that might cause results to deviate from the consensus, either to the upside or downside.

What is the case for lower-than-consensus interest rates?

Much of the downside case for interest rates was realized in 2019; therefore, the downside case in 2020 would likely involve a continuation of the same causal factors. The key factor on the downside would likely be a sharper reduction – or at least the fear of a sharper reduction – in GDP growth than is currently forecast, prompting the Federal Reserve to cut rates more aggressively. Such an outcome could come from a number of scenarios, including decreased liquidity, reduced lending appetite, and exogenous shocks to the system from adverse geopolitical developments.

Among the more telling economic data supporting this case is manufacturing data both in the U.S. and particularly abroad. Much of this data has been showing sequential weakness, and manufacturing Purchasing Managers' Index (PMI) readings for several key economies are below 50, indicating a contraction in manufacturing activity. Germany, troublingly, has seen very weak manufacturing data and has been flirting with negative GDP growth. Much of these data sets are in the form of surveys and, of course, measure sentiment that could easily change overnight. However, a number of entities are withholding large orders, delaying purchases, restricting supplies, etc. This pullback and heightened risk aversion is in response to the bevy of global uncertainties: uncertainty on trade policy and tariff impacts, uncertainty on political regimes and upcoming U.S. elections, uncertainty on geopolitical hotspots such as Iran, Hong Kong, Italy, and several South American nations. Collectively this has caused an understandable degree of caution among purchasing managers and manufacturing executives.

Managing inventory means gauging demand accurately, which is a tricky proposition in the most benign of backdrops and now even more so with a host of unknowns.

Political risk could be another potential wild card driver of rates to the downside, especially in the U.S. with upcoming 2020 elections. In the event that one of the more liberal candidates emerges victorious from the Democratic primaries, or even the Presidential election itself, fears of anti-business policies could see equities drop and rates decline as investors flee to U.S. Treasurys as a means of safety against a "risk-off" backdrop. While handicapping the political landscape is beyond the scope of this Outlook, we would note that U.S. policy shifts are typically more incremental than wholesale, irrespective of which party is in nominal control of the branches of government. Whatever the outcome of the November elections, some form of divided government is all but certain as neither party is likely to control all of the House, Senate, and Oval Office. This setup has generally been favorable for capital markets and, again, tempers extremist rhetoric and pushes toward more centrist and consensus policies, to the extent any substantive legislation even makes it into law. Therefore we view politically induced volatility as more fleeting in nature, but such episodes may offer technical trading opportunities in 2020.

One big potential downside risk has been a mainstay of our last several Outlooks: China experiencing an unforeseen economic slowdown of far larger magnitude than is currently being discussed. This has admittedly not come to fruition, nor is there any expectation or timeline that suggests 2020 is sure to be the year this occurs. That said, risks appear to be mounting that China's economic growth is running along a dangerous precipice on top of a mountain of debt. GDP/total debt is now above 300%, a level some economists believe to be meaningful. More recently, reports have surfaced of troubled middle market and shadow banking lenders. What isn't in doubt is that the centrally planned government has crammed significant debt into the system, debt that has to reside somewhere, and there simply aren't enough large and economically solvent institutions in which to place it all at this point. Perhaps this debt-fueled growth remains on track for several more years, but this run of unprecedented expansion feels long in the tooth and increasingly precarious.

Beyond the global manufacturing slowdown and China growth shortfalls, there are a host of known and unknown causes for concern. Capital markets are continuing to shrug these off for the time being, and that may indeed be warranted. To be sure, the U.S. economy remains fundamentally solid at this juncture. However, based on current information and consensus expectations, we would put greater probability on a downside case unfolding in 2020 rather than an upside surprise.

What is the case for higher-than-consensus interest rates?

The upside scenario most likely to result in higher than forecast interest rates would stem from a comprehensive agreement between the U.S. and China on trade. The two countries have been sparring for much of the past 18 months, and both sides have levied meaningful tariffs on imported goods that most economists believe to be mutually non-productive. While rhetoric has gone back-and-forth on a nearly daily basis, a “phase 1” agreement in principle was announced as of December 2019. If the theoretical “phase 2” follows in short succession, and is widely viewed as resolving most of the disputed terms of trade, then a more normalized and business-friendly environment could bolster output, consumption, and investment both in the U.S. and abroad.

We would ascribe this likelihood a minority probability, particularly given that China is notoriously savvy and may be incentivized to withhold making impactful concessions until after the U.S. presidential election. Conversely, the current U.S. administration may want to close a deal sooner rather than later with the election cycle looming, and of course China is aware of this pressure point. Either way, while the White House and various governmental agencies may be entirely justified by what they perceive to be an inherent disparity in current agreements, and may reflexively take issue with the current trade deficit, everyone acknowledges the importance of China as a rising superpower. Closing markets to an estimated population of 1.4 billion is simply not an option for any multi-national business in 2020. Without doubt, this remains a very delicate line for both sides to walk. Look no further than the present social unrest in Hong Kong as a political minefield for businesses and governments alike.

In any event, an agreement that appeases capital markets and spurs global trade could boost GDP growth, push rates higher, and cause inflation to re-emerge. Business investment that has been curtailed or postponed could be unleashed suddenly and meaningfully. On a lesser scale than a comprehensive trade deal, clarity/resolution on the timing and particulars of the United Kingdom’s departure from the Eurozone could also ignite pent-up business reinvestment in that region.

After these current headlines, however, it is hard to find too many “upside scenarios” that would prompt meaningfully higher interest rates in the short run. Part of this is due to the reality of the global backdrop: U.S. rates are historically low, but sovereign rates are lower still in nearly every developed market. Although currency hedging costs make the arbitrage trade unattractive, U.S. rates are certainly responsive to the gravitational pull of low rates globally. We witnessed this most dramatically in August 2019, when the 10-YEAR U.S. Treasury yield dropped 52 basis points in just one month as fears of zero-bound or negative interest rates in the U.S. took hold on the heels of European Central Bank and Bank of Japan accommodative talk that pushed their respective rates even deeper into negative territory.

The trajectory of Japan, in particular, warrants caution for the United States. Demographic trends in Japan (namely an older and healthier population, and declining birth rates) are ahead of the U.S. but share some similarities, and warning signs abound. Japan’s GDP growth has been middling at best for 30 years, and rates seem permanently anchored around zero in an effort to boost consumption.

This is not to say that rates can’t ever go up again or the U.S. is destined to fall into a period of economic morass as Japan has experienced. But at least in the near term, rates are attenuated to the downside and the global economy seems predisposed to, if not near-dependent on, historically low global rates. In the decade following the financial crisis, the uniform playbook has been to add more debt to the system at such attractive rates – in both the government and corporate segments of the economy. The weakest of these creditors, and indeed the sheer volume of debt outstanding, is subsisting, in part or in whole, based on cheap and readily-available financing. Fourth quarter 2018, albeit brief in duration, showed the fragility of the system to the prospect of even modestly higher rates.

One additional catalyst for upward rate movement could be the reintroduction of substantial inflation. Inflation has been a vexing topic this cycle, as traditional Phillips Curve disciples would have expected higher inflation based on heavy monetary policy influence and all-time low unemployment rates. This has not been the case to any substantive degree, however, with many theories as to why inflation has been stubbornly low but few definitive answers. Among them: rising cross-border correlation in (low) wages; peak labor productivity gains; wage gains at both the lowest and highest ends producing lower money multiplier effect; and millennials delaying significant life milestones versus prior generations (marriage, childbirth, home purchases), thus consuming less/later than anticipated. Whatever the causes, low inflation has provided the benefit of stable costs for businesses and consumers, as well as cover for the Federal Reserve to make rate movements based on the almost mythical 2% target.

It is not obvious what would ignite inflation at this point, given the failure of both monetary and fiscal policy to do so. One possible scenario is a concerted effort to devalue the U.S. dollar relative to major trading partners. If the U.S. Treasury believed that other nations or economic blocs were manipulating their currency to benefit trade balances, the U.S. could retaliate by printing additional currency and running even greater budgetary deficits. A weaker U.S. dollar would help boost exports and mitigate large trade deficits, and thus help GDP measures in the short run.

Along the same lines as currency devaluation, a movement to embrace all or some of the Modern Monetary Theory (MMT) ideas pushed by some factions would similarly be inflationary by design. MMT posits that GDP growth can be accelerated or at least perpetuated by running large fiscal deficits, and if inflation emerges as a byproduct, this can be dealt with via tax increases. While most economists frown upon this line of thinking, MMT has gained traction in certain circles, particularly politicians looking to fund large governmental projects. Ultimately, running debt/GDP at dangerously high levels could slow economic growth, as has been the case in Japan, and in a recessionary context the absolute debt load could be problematic at best and cataclysmic at worst. Moreover, the theory predicates that several large-scale governmental interventions be timed perfectly, which is exceedingly difficult to execute. More axe than scalpel, if you will. However, aspects of MMT could find converts in certain scenarios, and in the case of implementation, soaring inflation would at least initially cause rates to rise in response.

Corporate Sector Outlook

After a meaningful sell-off in fourth quarter 2018, corporate bonds bounced back sharply in 2019, led by strong first quarter returns in particular following a dovish shift by the Federal Reserve. Against this "risk-on" backdrop, both investment grade and high yield spreads fell and excess returns (vs. duration-adjusted Treasurys) soared to 676 basis points for investment grade and 934 basis points for high yield in 2019.

Results were buoyed by another year of solid, if unspectacular, economic growth in the U.S. and corporate earnings that generally exceeded analyst estimates. Moreover, strong technical factors still support credit markets broadly. This includes a large amount of cash still on the sidelines from institutional investors, a relative paucity of yield available globally, modest or slightly decreased issuance year-over-year, and liquid, accessible credit trading.

Investment grade credit spreads (measured by OAS) fell by 60 basis points in 2019, to just 93 bps above comparable U.S. Treasury securities. Supply at the investment grade level was down slightly year-over-year due to a smaller number of blockbuster merger and acquisition-related financings, further buoying technical support for the corporate market. While we acknowledge the robust demand for corporate credit and see no readily apparent near-term catalyst for prices to move lower, we also believe that market cycles still exist and that this particular bullish cycle is extraordinarily old.

In response to the remarkable 2019 rally, we have once again adopted a defensive stance towards corporate credit. Valuations appear increasingly rich across the quality and maturity curve, and volatility rests at subdued levels. Specifically, we have reduced idiosyncratic risk as spreads have compressed uniformly and offer little separation between lower and higher beta sectors. Over the course of the year, we tactically traded a basket of high yield and investment grade CDS to quickly gain beta exposure in a range-bound context, which was additive to 2019 returns. However, we enter 2020 with little long-dated corporate exposure and a higher-quality stance relative to the broad corporate sector. Within corporate cash bonds we continue to favor financials versus industrials and have a majority of our positioning concentrated on short-dated (1-3 year) securities.

Securitized Sector Outlook

Securitized products continued their multi-year trend of trading with a lower spread beta versus corporates, outperforming in risk-off markets while underperforming in risk-on markets. While securitized products generally outperformed Treasurys during 2019, outperformance was modest and nowhere near levels seen in the corporate market. In addition, with global growth concerns, the Fed pivot to cutting rates, and U.S.-China trade concerns all putting downward pressure on rates, agency MBS in particular had a relatively challenging 2019. The sharp mid-summer decline in rates caused the refinance index to spike to levels not seen for several years, bringing MBS prepayment concerns to the forefront and widening spreads in appreciation of this risk. MBS recovered as rates rose in the fourth quarter, modestly outperforming Treasurys by 54 bps.

We enter 2020 with a broader macroeconomic backdrop of late-cycle concerns leading to continued caution regarding most asset classes. However, we believe that a neutral position is warranted for agency MBS following a mid-summer decline in rates that led to improved valuations. Away from agency MBS, our current participation in the securitized market remains limited and focused in short-dated (1-3 year) positions in asset-backed, commercial mortgage-backed, and agency multi-family mortgage-backed securities. These biases are rooted in the strong structural support, collateral strength, and stability of cash flows that are characteristic of these securities and complement our view that the current environment has few obviously undervalued opportunities.

For more information regarding Reams Asset Management, please contact us at 812.372.6606.