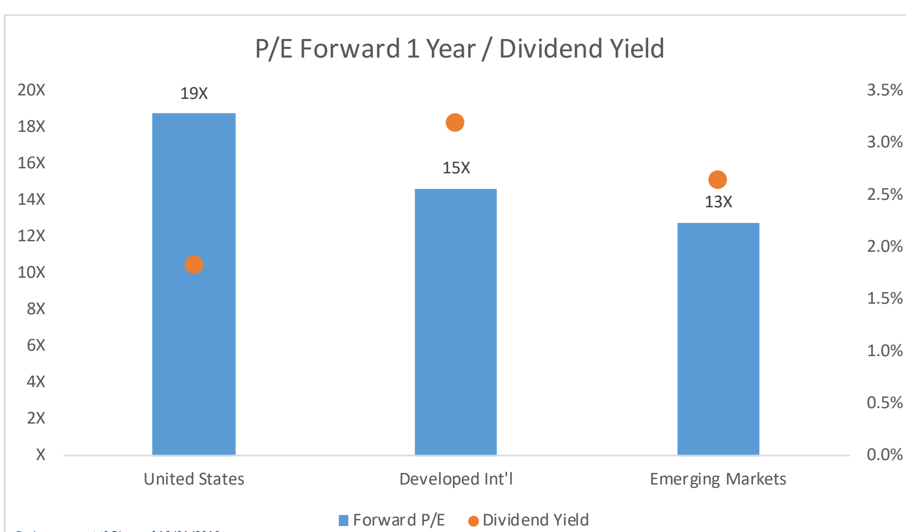
2020 Outlook: Not Quite Goldilocks, But Close

Rebounding from the sharp and abrupt decline during the final months of 2018, equity markets across the world had one of the strongest runs of the decade in 2019. The fear of missing out likely forced many market pessimists to change their tunes and join the revelry. The much-anticipated U.S.-China trade truce, Fed rate cuts, a healthy U.S. economy, Europe's return to quantitative easing, and fading Brexit risks buttressed the market exuberance. After such solid gains, what might equity markets have in store for 2020?

It is unlikely that market returns are to be as high in 2020 as seen during the last year. At the same time, there are not many evident economic or geopolitical risks that could trip up the markets either. Given the favorable backdrop for equity investments, which we detail below, the Thomas White Investment Committee currently expects U.S. large cap equities to return between 5% and 10% in 2020. We also expect the MSCI ACWI ex U.S. Index to return between 10% and 15% for this year, helped by emerging market outperformance.

EARNINGS GROWTH SHOULD SUPPORT EQUITY VALUATIONS

It may sound counterintuitive, but equity valuations do not appear wildly excessive even after the 2019 gains. As we enter the New Year, U.S. large cap equities in the MSCI USA Index are trading at about 19 times one-year forward consensus earnings. Developed markets outside the U.S., represented by the MSCI EAFE Index, are valued at less than 15 times estimated earnings for 2020, a 22% discount to the U.S. market. Emerging markets are cheaper at around 13 times for the MSCI EM Index, representing a discount to the U.S. market of 32%. These valuations are at par or below their respective highs of the last decade, let alone the lofty peaks from before the 2008 financial crisis. In a low yield environment, investors are likely to remain attracted by the nearly 2% dividend yield from U.S. large cap equities. International stocks offer even higher dividend yields of 3% or more.



Data source: MSCI, as of 12/31/2019

KEY TAKEAWAYS

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Indeed, earnings growth becomes much more important for sustaining valuations as the markets scale higher levels. After falling short of initial forecasts over the last couple of years, earnings growth for 2020 should look healthier across most regions. Barring an unexpected global economic crisis or recession, consensus 2020 earnings growth expectations of under 10% for the developed markets and about 13% for the emerging markets do not appear unduly high hurdles.

U.S. - CHINA TRADE WAR DE-ESCALATES

Nothing created more market volatility in 2019 than the twists and turns in the long-winding U.S.-China trade negotiations. The two sides start 2020 with an initial trade agreement in place. The so called 'first phase' deal is more comprehensive than expected, with specific commitments by China on market access and import of U.S. goods, and should avoid new tariffs and acrimony for now. This deal should give the two countries enough space to align their negotiating positions more with long-term economic goals, rather than short-term political gains.

China, Korea, Taiwan, the European Union and Japan are likely to benefit disproportionately from the cessation of U.S.-China trade hostilities. The anticipated pickup in trade volumes should strengthen the manufacturing sectors in these countries, and underpins our optimism about international and emerging markets.

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However, given the broad range of commitments on issues such as intellectual property protections, market access, and currency rates, there is still room for a re-ignition of trade war fireworks if there are delays in satisfying those assurances. More so if the possibility of a leadership change in the U.S. becomes more apparent ahead of presidential elections in November. In that case, China may decide to delay further negotiations on the next phase of the trade deal and the U.S. could become more unyielding and threaten more tariffs. Even then, the turbulence is unlikely to last for an extended period of time after the elections.

THE FED LEADS CENTRAL BANKS TO KEEP RATES LOW

The U.S. Federal Reserve's welcome switch from monetary tightening to rate cuts early in 2019 went a long way towards calming investors alarmed by the collateral damage to global growth from the trade war. In addition to reducing U.S. recession risks, the Fed's three rate cuts during the year also created enough space for other central banks to pursue their own monetary easing measures without unduly worrying about currency weakness against the U.S. Dollar.

The Fed has now set fairly high thresholds, in terms of growth outlook and inflation, for it to move interest rates one way or the other over the next year. The Fed is also likely to be more guarded in its communications ahead of the U.S. presidential elections, not be seen as swayed by political winds. This could mean a relatively uneventful year for central banks across the world, with most of them continuing monetary easing.

CALIBRATED FISCAL STIMULUS BECOMES MORE POPULAR

Public revulsion against the bailout of too-big-to-fail entities after the 2008 financial crisis led to the fiscal austerity measures that followed, and continues even today in Europe. However, the wind of public opinion has changed course in recent years. Angered by low growth rates, meager economic opportunities and growing income inequalities, demand for increased public spending on welfare and social infrastructure has grown. These resentments have led to labor strikes and violent protests, most notably in France. Recent protest movements in Hong Kong and India, though largely political, also seem to partly reflect long-suppressed frustrations from the lack of economic opportunities.

We expect governments, especially in Europe, to become more sensitive to the growing public ire and to consider targeted fiscal stimulus measures. These could include lowering tax rates, raising welfare benefits, as well as increased spending on social and physical infrastructure. While the scale of these fiscal measures is unlikely to be anywhere near the massive spending programs in the aftermath of the 2008 crisis, they should in any case cheer up consumers and help sustain domestic demand growth.

BREXIT: FROM NIGHTMARE TO A LONG YAWN

From its widely acknowledged status as a potential economic nightmare, Brexit has slipped down the list of global growth risks and is now on the verge of disappearing. However, the prospect of completely finalizing a trade agreement between the European Union and the U.K. by the end of 2020 seems unrealistic. This could revive fears of a hard Brexit during the second half of the year, however the two sides are likely to agree on an extension or some form of an interim trade arrangement.

U.S. ELECTIONS: MORE NOISE, BUT LIMITED RISKS

The biggest event on the 2020 calendar, in our opinion, is the U.S. presidential elections. Given the favorable economic data, the probability of a change in administration would have been fairly low when considering earlier presidential election cycles. However, the widening political divisions and social disquiets could potentially make the result more uncertain than expected.

Equity markets could react unfavorably to the possibility of any political change that leads to abrupt shifts in economic policy priorities. However, given the indifferent reaction from the majority of voters to much of the sweeping economic proposals from a few challengers, it is unlikely that such policy agendas would dominate the general election debates. As such, the probability of a presidential candidate being elected with an economic agenda far outside the mainstream, or having the necessary political support to implement significant changes, appears fairly low at this point.

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At Thomas White, we believe our portfolios are well positioned to take advantage of the bright global equity markets outlook. Our sector and regional positioning, especially our emerging markets overweight, are calibrated to benefit from the combination of stronger earnings growth, healthier industrial demand, calmer geopolitical risks, and relatively reasonable equity valuations that we expect in 2020.

We wish you a prosperous year ahead.

P/E Forward 1 Year: The current fiscal year consensus P/E ratio estimate as reported by Institutional Brokers' Estimate System. It is calculated by taking the current stock price and dividing it by the expected earnings per share for the next 12 months.

Dividend Yield: Dividend yield is the ratio of a company's annual dividend compared to its share price.

The MSCI ACWI ex U.S. Index is a stock market index that is designed to measure equity market performance of both developed and emerging markets, excluding the U.S. The MSCI EM Index is designed to measure equity market performance of emerging markets. The MSCI US Index is designed to measure the performance of the large and mid cap segments of the U.S. equity market. The MSCI EAFE Index is designed to measure the equity market performance of developed markets outside of the U.S. & Canada. All indices are unmanaged and returns assume the reinvestment of dividends. It is not possible to invest directly in an index.