Economic Expansion and Stock Market Rise to Continue In 2020, But U.S. Election, Geopolitics and Trade Pose Risks to Upbeat Outlook, Experts Say at CFALA Annual Forecast Dinner

LOS ANGELES – Three top market experts offered a cautiously upbeat 2020 outlook at CFA Society Los Angeles's (CFALA) 18th Annual Economic and Investments Forecast Dinner. A macroeconomist forecast a continuation of the record-long U.S. expansion, an equity strategist predicted modest gains for the nearly 11-year-old bull market in stocks, and a political economist told investors that the "rough-and-tumble" U.S. presidential election shouldn't derail their long-term investment plans.

All the leading market strategists, however, advised attendees at Thursday's dinner at the Millennium Biltmore Hotel Los Angeles to brace for bouts of market volatility due to election-year politics in the U.S., geopolitical uncertainty and ongoing trade strife.

The U.S. economy, supported by the Federal Reserve's intent to keep interest rates anchored at current low levels and a 50-year low in unemployment, is seen skirting recession again in 2020.

Sonal Desai, Franklin Templeton Fixed Income's Chief Investment Officer, shared her views in an outlook piece published ahead of the Jan. 30 dinner. In the report, Desai said that U.S. GDP is primed to expand at a healthy 2.5%-plus clip in 2020.

"Overall, I do not expect any dramatic shifts in the macro outlook in 2020; if anything, I believe the consensus remains too pessimistic," Desai said. "I think global growth should remain on an even keel, with U.S. GDP growth at 2.5% to 2.75%, the eurozone around 1% and China around 6%."

Investors, however, should expect some headline-driven turbulence, she said.

"We will again face significant volatility from multiple sources, including political uncertainty, geopolitics and the media's instinct to hype just about every risk that emerges on the horizon," Desai said. "I believe U.S. politics will be the main source of volatility as we head toward the 2020 U.S. presidential election in November. As the election draws nearer, I expect uncertainty on the course of future economic policy will weigh more heavily on markets."

Potential risks to Desai's economic forecast include an inflation scare and continued trade uncertainty despite the recent Phase 1 deal announced by the U.S. and China. Desai expects a continuation of the "tug of war" between the Fed and markets, as the central bank's low rate policy might prove to be too accommodative if the economy grows at a 2.5% to 2.75% clip as she predicts. Desai expects inflation to rise above the Fed's 2% target, bolstered by higher labor costs due to low unemployment. "Even a moderate increase in consumer inflation, if quick enough, might make investors nervous and push long-term rates up more than markets expect," Desai said. "The idea that inflation is no longer a concern, widely embraced by policymakers and analysts, is a dangerous assumption."

Trade tensions are here to stay, she adds.

"Regardless of how next year's elections play out, the global trade environment has changed in a structural fashion, Desai said. "The economic and strategic competition between the U.S. and China will only grow more intense as China keeps investing in advanced technologies; the global shift to greater

nationalism will also prove long-lived. This will not cause trade wars and a global recession, in my view. But from an investment perspective, I expect it will keep impacting specific companies and industries, and it will keep shifting the relative competitiveness and attractiveness of different countries."

With support from the Fed, which has signaled that it will keep its key interest rate in its current range of 1.50% to 1.75%, the U.S. stock market is expected to extend its rally and post gains in 2020, albeit more muted returns than the Standard & Poor's 500 index's nearly 29% gain in 2019.

"Overall, we would not expect more than a mid-single digit stock market move to the upside," said Heather Brilliant, President and CEO at Diamond Hill Capital Management. "Major gains in the stock market from here will be tough."

Brilliant said a repeat of last year's big stock gains, the largest since 2013, is unlikely given the market's "full" valuation and the challenge U.S. companies face in boosting already high profit margins. "We think investors should have modest expectations for improvement in profits and multiple expansion," she said.

The S&P 500, now trading around 18 times its estimated one-year forward earnings, is "not overvalued or trading at an unreasonable valuation given that both interest rates and inflation have stayed low," said Brilliant, adding that "profit margins are as strong as they've been over the past few decades, so we don't see huge upside."

Where the stock market rise last year was driven mainly by P-E expansion, this year's gains will more likely be powered by stronger corporate profits, she said. "In 2020, if the stock market does well it will have to partially come from earnings growth, given where multiples are now," Brilliant said. Headwinds that could impede corporate profit growth include higher payroll costs and the possibility that a power shift in Washington could lead to the Democrats repealing President Trump's corporate tax cuts, Brilliant added.

"If we see wage growth accelerate, it could put downward pressure on profit margins, and it would be challenging for businesses to overcome," Brilliant said. "Clearly, the tax cuts in 2017 have helped profit margins, too, with the effective tax rates for corporations decreasing materially. Depending on what happens in Washington, it's possible that the tax cuts will be repealed, which is a possible headwind."

While Brilliant predicts more stock gains in 2020, she won't rule out a market pullback along the way. "There's always a possibility that we get a meaningful correction, especially with the presidential election and ongoing uncertainty around trade issues and what's going on in the Middle East," she said. "But, given our long-term perspective, we see any pullback as an opportunity, as we don't expect these risks to have a meaningful impact on the fundamentals or valuations of the companies we own over the long run."

A bigger stock market drop, such as a 20% bear market decline, is not part of Brilliant's personal base-case forecast. "It would take some kind of shock," she said. "I don't think the data would support a 20% decline. There are no signs that the economy will take a big downward spiral."

The stock market's steady rise in 2019, when the S&P 500 moved up or down 2% or more on just seven trading days, well below the 72 moves of 2% in 2008 during the financial crisis, is likely to give way to heightened volatility in 2020, Brilliant added. "The market kind of went up and up and up, without seeing a meaningful amount of volatility," she said. "I think in an election year, I would expect to see more volatility in 2020 than in 2019. But that's good because it should provide investing opportunities. When working with planners, one of the most important things we advocate is to stay invested. Historical data show unequivocally that staying invested results in stronger investment outcomes than trying to time the market."

While the U.S. presidential election will likely dominate headlines and markets this year, the "rough-and-tumble campaign shouldn't derail your long-term investment plans," said Matt Miller, Partner, Political Economist and Corporate Affairs Advisor, Capital Strategy Research, Capital Group.

"A look back at every presidential election cycle since 1932 shows patient investors are often rewarded with market gains following the election of a new president," Miller said. "It's also worth noting that the current party majorities in Congress are unlikely to change, no matter whether a Democrat or Republican wins in the fall. Now's not the time to climb the wall of worry; stay patient and be sure to have global diversity in your portfolio."

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