2020 Outlook: The Year's Top Investment Questions

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In 2019, the Canadian stock market posted its best year of the decade, and bonds logged their best return in five years.[1] This is a tough act to follow, so what does 2020 have in store for investors? Here are our views on the year's key investment questions.

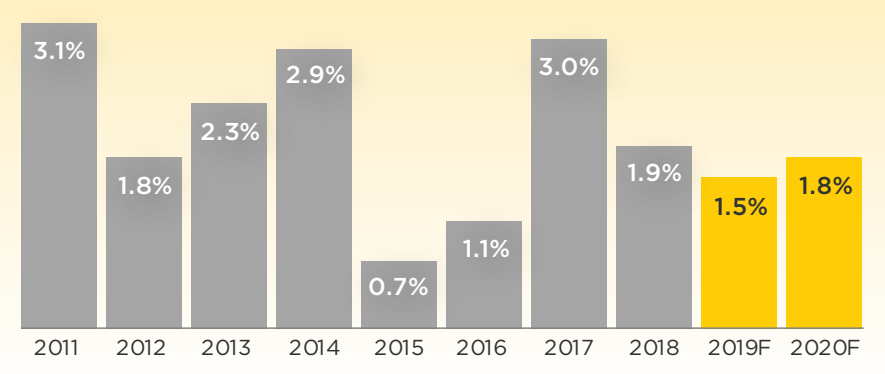
1 Will we see a recession in 2020?

We think the Canadian economy avoids a recession this year. The current economic expansion is set to continue due to slowing solid consumer spending, supported by a healthy labour market, a recovering housing market and still-low interest rates. We expect headwinds from trade tensions and sluggish business investment to keep 2020 growth at about the same pace as last year, between 1.5% and 1.8%.

- **Consumer spending will be the key driver of growth in 2020 –** With the unemployment rate hovering near a four-decade low, we expect the labour market to remain a bright spot in the Canadian economy, even as the pace of job growth likely moderates in 2020. Wages should continue to grow faster than consumer prices, increasing real household incomes. Additionally, with inflation likely to stay near the Bank of Canada's (BoC) 2% target rate and modest economic growth expected, we think it's unlikely the central bank raises rates next year. The BoC is likely to hold benchmark rates at current low levels, helping to keep borrowing costs affordable and fostering solid consumer spending.

  Consumer optimism about the economy is also favourable for residential investment, which rebounded in 2019 after six consecutive quarters of decline. Low mortgage rates and strong population growth (fueled by immigration) should help the housing sector stay on the positive side of the ledger in 2020.

Canadian GDP Growth (%)



Source: Statistics Canada

Edward Jones
MAKING SENSE OF INVESTING

- **Sluggish business investment will keep growth modest** Business investment has become a weak spot in the Canadian economy due to fluctuating trade tensions, slowing global growth and slumping commodity prices. Additionally, subdued foreign demand has held back trade in exports, which accounts for a quarter of the Canadian economy. An expected rebound in global growth and progress in trade talks between the U.S. and China, as well as a ratification of the negotiated trade deal between the U.S. and Mexico, could alleviate trade uncertainty and be catalysts for Canadian business investment this year.

2 Is this the year the bull market ends?

We think the bull market still has some gas left in the tank. While this is the S&P 500's second-longest run on record, there's no expiration dates on bull markets. Instead, they tend to end when recessions emerge or bubbles pop, neither of which we think are imminent. We do believe we remain in the later stages of the cycle, however, with the bull market likely to exhibit the following this year:

- **Still more upside –** The conditions historically associated with a bear market – recession, tight monetary policy, excessive valuations and asset bubbles – are not in place, though we're watching closely. Economic conditions, powered by the consumer, should continue to offer support to the market.

  Unemployment in Canada enters 2020 below 6%, which has happened 12 times since 1960. In those instances, the TSX posted an average return of 6.9% in the following year. The U.S. unemployment rate stands at 3.6%. Since 1950, 16 years have ended with U.S. unemployment below 4.5%. In the year that followed, consumer spending grew by an average of 3.1%, and the average S&P 500 return was 9.9%, reflecting the link between the consumer, economic growth and the direction of the market.

- **Smaller gains ahead –** 2019's 20%-plus stock market returns won't likely be replicated this year, in our view. But bad years don't have to follow great ones: Since 1950, in years when the S&P 500 rose by more than 20%, the average return the next year was 14.8%.

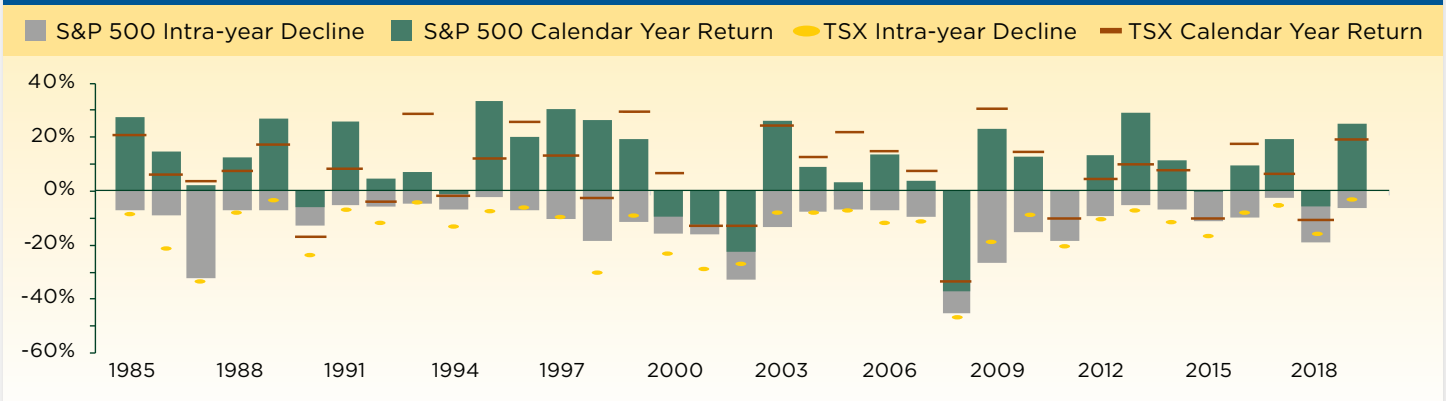
  TSX returns have trailed S&P 500 gains over the past several years, which may continue to be the case in 2020 barring a material rally in energy and materials stocks or outperformance of financials, which face headwinds from a softening housing market and already-high consumer debt. These three sectors comprise 59.7% of the TSX index.[2]

  Stocks are entering 2020 with valuations slightly above long-term averages, which is reasonable given the economic and interest rate backdrop. But to us, there is limited potential for material expansion in the price-to-earnings ratio. The pace of market gains will be set by the pace of earnings growth, which we think will rise at a mid-single-digit rate.

- **Larger, more frequent swings –** The market heads into 2020 with daily volatility running below average for the past several months. The largest pullback in 2019 clocked in at just 6.8%, but we doubt this tranquility will continue in the coming year.

  Political drama, election uncertainties, trade setbacks, misaligned Fed expectations and occasionally underwhelming economic reports will likely overshadow supportive fundamental conditions. The bull market will peak well in advance of the onset of a recession, so the 2021 economic outlook will begin to be priced into the market as we progress through 2020. We don't think a bear market is likely this year, but the risks mentioned above raise the potential for a correction or periodic pullbacks.

S&P 500 Intra-year Stock Market Declines Compared to Annualized Returns



Source: Bloomberg, 11/30/2019.

1 Source: Morningstar S&P TSX Composite Index, Price Return.
2 Source: S&P/TSX indices.

3 What impact will politics have on the markets?

- **A source of volatility –** U.S. politics will occupy the bulk of the headlines as we progress toward the November election. Elevated uncertainty, the seismic gap between candidates' proposed policies and the highly polarized political environment will produce a fair bit of volatility as markets attempt to handicap an outcome. U.S. impeachment proceedings potentially cloud the political picture early in the year, but the spotlight is likely to shine brightly on the primary and general elections as the campaign season hits its stride.

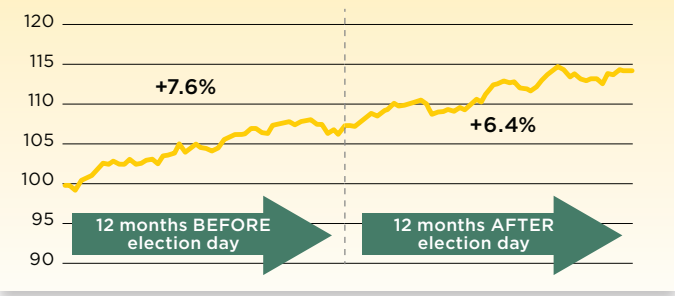
  Election years have historically been positive for the market, with an average annual return above 11% and the S&P 500 rising in 78% of years with a presidential election since 1947.[3] In 2016, the market experienced a 10% correction early in the year, a 5% drop midyear and a 3% decline in the two weeks leading into election day, yet finished the year with a 12% return overall.

- **Not a longer-term market driver –** This election may have a unique feel given the political climate and disparate fundamental views of the candidates. But elections often put opposing views on sharp display. Our expectation is that, regardless of the party that wins the White House, gridlock will prevail in Washington, preventing either administration from implementing a campaign agenda efficiently.

Don't base your long-term investment decisions on short-term election-driven volatility. Past experiences show it's the broader economic backdrop that is typically a more powerful driver of market performance over time. In the examples of prior impeachments, stocks fell in 1974 (Nixon) due to a recession and oil shock, while in 1998 (Clinton), the market rose amid low unemployment, a growing economy and Fed stimulus.

We don't expect the market to ignore the political headlines. But with low unemployment, tame inflation and supportive central bank policy, we think fundamental conditions are poised to outweigh the political turmoil over time.

Average S&P 500 Performance 12 Months Before & After Presidential Elections Since 1947

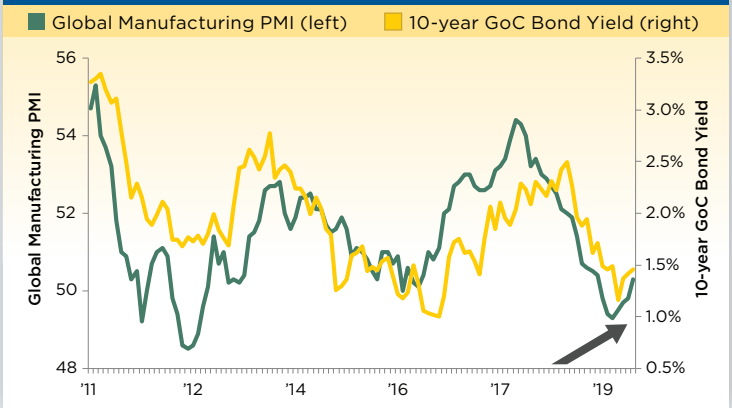


Source: FactSet, 1947-2016.

4 Will interest rates go lower – or even negative – this year?

We think it's unlikely we'll see negative interest rates in Canada and the U.S. anytime soon, based on our economic outlook, the limited evidence of success negative rates have had elsewhere, and alternative stimulus measures, such as asset purchases, the central banks have available. We expect the Canadian and U.S. economies to continue to grow modestly this year, with the 10-year bond yields rising slightly.

Global Trends Influence Domestic Markets



Source: Bloomberg as of 11/30/2019.

- **Bond yields to rise as recession fears recede –** Last year's sizeable decline in long-term interest rates reflected fears of recession, a slowdown in global growth and expectations of a Federal Reserve policy shift. With global growth showing signs of stabilization and trade tensions seemingly easing, rates are not likely to fall materially below 1.5% in Canada and 2% in the U.S., in our view.

- **Fed and BoC on hold for different reasons –** Given the improving global backdrop and mediocre (but positive) U.S. economic growth, the Federal Reserve is likely to keep rates on hold after having lowered them three times last year. At the same time, U.S. policymakers will be in no hurry to raise rates anytime soon in the absence of inflationary pressures and a slowing U.S. economy. The BoC is also likely to stay on the sidelines, as inflation is running on target.

  While the Canadian economy is also decelerating, the BoC will be less inclined to proceed in "insurance" rate cuts, as the potential benefit could be offset by a further stoking of the already frothy housing market. We think a 1.5%-2% range in Canada and a 2%-3% range in the U.S. are reasonable expectations for where interest rates might land in 2020, with the low end a more likely outcome.

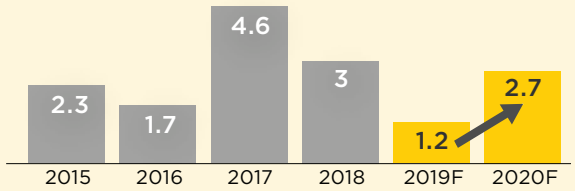
3 Source: Morningstar S&P 500 Price return, Edward Jones calculations.

5 Will the trade war with China end?

Despite promising rhetoric at the close of this year, the U.S. enters 2020 with no long-term trade agreement with China in place, and we think a comprehensive trade deal before the presidential elections is unlikely. Even an interim agreement could strengthen the global outlook and be a catalyst for earnings growth this year, however.

- **Trade tensions take a toll in 2019 –** Trade accounts for a quarter of the U.S. economy and over half of the global economy. In addition, S&P 500 companies earn about 40% of their revenue from countries outside the U.S. As the chart shows, growth in world trade is projected to fall by more than half to 1.2% in 2019 after accelerating by 3% in 2018.[4] Elevated trade tensions have also led to lower worldwide economic growth in 2019 than two years before.

Volume of World Merchandise Trade
Annual % Change



Source: World Trade Organization.

There are signs that trade uncertainty and slowing global growth are affecting U.S. companies. For the third quarter of 2019, S&P 500 companies earning more than half of their revenue outside the U.S. reporting estimated an earnings decline of 7.4%, compared with a 0.4% growth rate for firms earning more domestically.[5]

- **Trade headlines are likely to prompt market volatility –** In addition to the U.S.-China trade talks, a new trade agreement between Canada, the U.S. and Mexico is still subject to change. As other tariffs and levies are proposed, this adds to the market uncertainty. Despite bumpiness ahead, we expect a rebound in global growth and trade in 2020 as ongoing negotiations lead to updated trade agreements and an eventual easing of trade frictions.

6 Will overseas markets keep underperforming?

Overseas stocks performed well in 2019 but still trailed Canadian and U.S. stocks amid trade and other geopolitical uncertainties, a slump in European manufacturing and a slowdown in China. While sluggish growth and trade tensions remain, there are signs global manufacturing may be stabilizing.

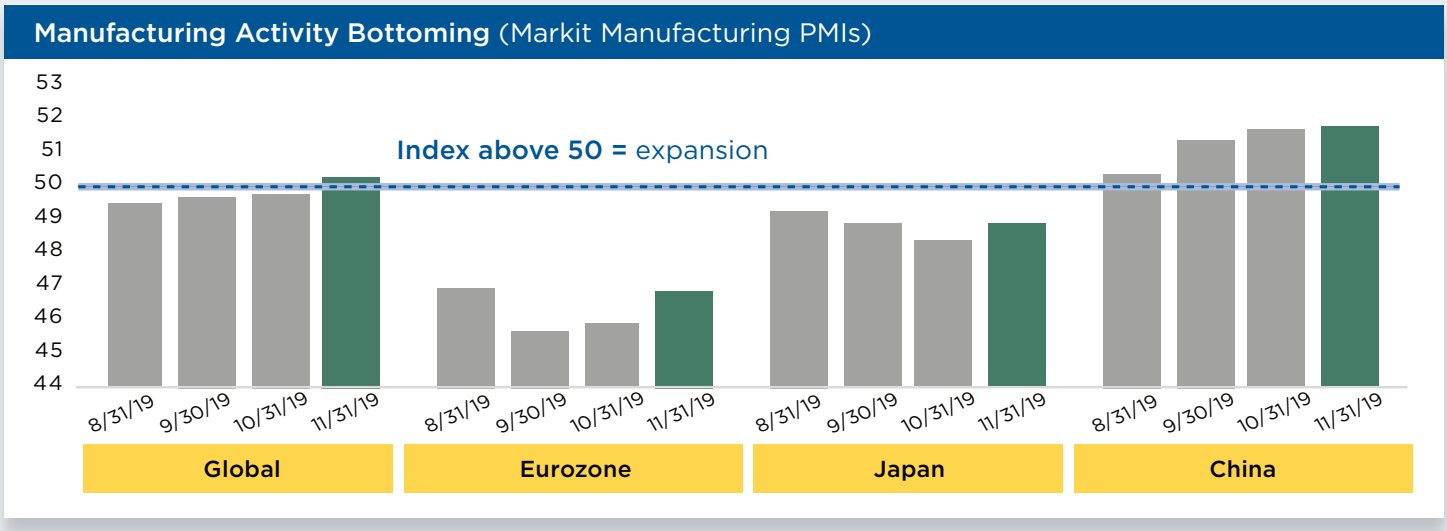
- **Manufacturing activity is recovering –** As global growth fizzled, manufacturing activity contracted, with Europe being hit the hardest. Forward-looking business surveys have shown signs of bottoming in economic activity in both emerging and developed markets, and are consistent with a still-soft but improving demand environment. This suggests the manufacturing downcycle may have run its course. At the same time, activity in the services part of most major economies remains relatively robust, and central bank policies are likely to stay accommodative until growth or inflation picks up.

- **Current valuations reflect pessimism –** Even with last year's rally, overseas stocks are priced at a significant discount to U.S. stocks. While valuations alone don't necessarily translate to better short-term results, they have historically been a good predictor of long-term returns. We believe higher dividend yields and better valuations support the possibility of above-average long-term returns for overseas equities and position them to outperform U.S. large-cap stocks over time. Overseas stocks also can help improve your portfolio's diversification and reduce the sector and security concentration associated with the Canadian equity market.

- **Currency likely not a major obstacle –** The Canadian dollar (CAD) has been largely rangebound against major currencies and the U.S. dollar over the last four years. While the CAD modestly reduced returns for international investments in 2019, we don't expect a major breakout in either direction in 2020, as oil and interest rates – two factors that drive currency in the near term – could be relatively neutral influences.

  Oil prices are likely to be modestly lower given continued strong supply growth combined with a weakening outlook for global demand. Interest rate differentials moved in favour of the CAD last year as major central banks cut rates, while the BoC held them steady. For 2020, we expect both the Federal Reserve and BoC to stand pat unless growth or inflation expectations change materially, so the interest rate differential between the U.S. and Canada will provide less support to the CAD.

4 Source: World Trade Organization.
5 Source: FactSet, November 2019.



Source: Bloomberg Markit Manufacturing PMI as of 11/30/2019.

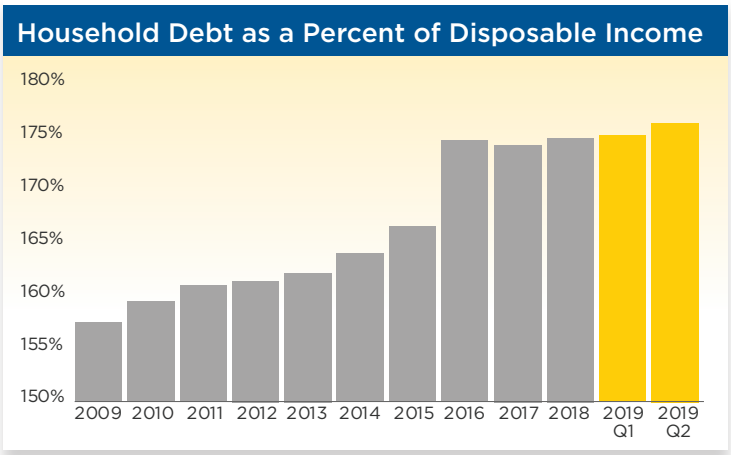
7 What are the biggest threats?

We see three key threats to the bull market this year:

- **Future central bank action is limited by already low interest rates.** The BoC was unique among its developed-market peers in staying pat on benchmark interest rates at 1.75%. In contrast, the Federal Reserve lowered rates three times in 2019 to ward off too-low inflation and as insurance against elevated risks from trade tensions and weakening global growth. With rates already at historically low levels, central banks have little room to cut interest rates further. Despite this limitation, we don't think the BoC or the Federal Reserve will lower rates to negative levels. Instead, they're likely to use other tools, such as asset purchases, if further monetary stimulus is warranted in 2020.

- **Corporate borrowing is at historically high levels.** Ultra-low interest rates have led corporate borrowing to grow faster than GDP through most of the current expansion. 2019 saw an increase in riskier forms of debt, including high-yield bonds and leveraged loans. In addition, half of investment-grade debt is around the lowest level of credit quality. An economic downturn could trigger a selloff in the corporate bond market if bonds are downgraded to speculative levels. However still-low delinquency rates, positive earnings growth and a resilient financial sector make a sizeable disruption in corporate bond markets unlikely in 2020, in our view.

- **Household debt hits a new high.** As shown in the chart, Canadian households owed $1.76 in debt for every $1 they held in disposable income. That compares with just $1.58 of debt to $1 disposable income in the aftermath of the 2008 financial crisis. Consumer spending, already weighed down by high debt levels, may become less resilient to ongoing trade uncertainty and geopolitical concerns this year. However, we think rising wages and rock-bottom interest rates in 2020 will help slow and eventually reverse the growth in household debt over time and pave the way for continued consumer support of the economy.



Source: Statistics Canada

4 Source: Congressional Budget Office, August 2019.

8 How should you prepare for 2020?

This year will likely be defined by steady but modest economic growth, persistently low interest rates and rising uncertainties. But markets are unpredictable, especially in the short term. Now is a good time to review your financial goals with your advisor and ensure your portfolio aligns with your comfort with risk and required long-term return.

Consider the following for:

- **Higher volatility –** We recommend a neutral allocation to equities and suggest rebalancing if necessary to stay at your long-term allocation between equity and fixed income. Bonds can still protect against short-term market selloffs, as was evident during the late 2018 correction and mid-2019 pullback. More defensive sectors (staples, health care, communications and utilities) can help reduce volatility, while appropriate weighting to cyclical sectors (financials, technology, consumer discretionary, industrials, etc.) can provide exposure to ongoing growth.

- **Stabilizing global growth –** Expectations for international markets remain low. We think additional signs of an early rebound in the global economy will provide further support to the recent rally in international stocks. We recommend an overweight allocation to international equities and maintain our underweight allocation to Canadian equity. In addition to U.S. equities, we think overseas developed-market large-caps are attractive, and we recommend a modest exposure to emerging markets.

- **A low-rate environment –** In addition to a core allocation in investment-grade bonds, exposure to high-yield bonds can offer additional portfolio income amid ongoing low rates. We maintain our underweight recommendation to global bonds. Ensure appropriate diversification across maturities. Dividend yields on equities remain attractive relative to current low rates, but remember that stocks are not bond substitutes when it comes to the role of fixed income in providing portfolio stability.

