January 6, 2020

# 2020 Outlook

Helping investors reach their long-term wealth goals

RICHARDSON GMP

# Challenging

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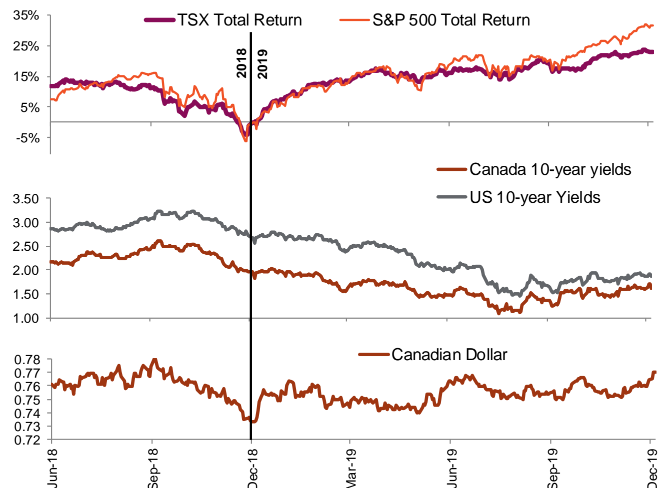
## I. Market recap 2019

When you think back to the beginning of 2019, the S&P 500 and the TSX were licking their wounds after dropping 15% in the last quarter of 2018. The backdrop was grim. Economic growth around the world continued to decelerate, raising concerns of a possible recession. Moroever, markets were "fighting the Fed"; the U.S. central bank still seemed poised to extend its tightening binge, with its ninth rate hike to 2.5% coming in mid-December 2018. Clearly, this wasn't the environment that would have investors expecting to see the S&P 500 subsequently rise 31.5% and the TSX appreciate by 22.9%.

The strong performance in 2019 didn't stop with North American equity markets. Most international equity markets performed in similar fashion. Plus, bond yields fell as did credit spreads, creating a supportive environment for bonds. Even the Canadian dollar did well, starting 2019 at 73.3 and finishing at 77.0 cents.

It wasn't a straight line higher for investments though. Slowing economic growth continued to spread from one country to the next. Germany, with its heavier reliance on global trade, had been flirting with a technical recession. Global manufacturing activity had been contracting. This encouraged central bankers around the world, including the Fed, to cut interest rates and become more accomodative.

Chart 1: a very good year



One of the biggest contributors to volatility in 2019 was the on-again/off-again trade war, notably between the U.S. and China. This added a great deal of uncertainty and contributed to eroding confidence. It was certainly a double-edged sword, at times being highly negative for markets and sentiment, followed by periods of optimism. Thankfully, the year ended on the optimistic side of things.

# II. 2020 outlook & beyond

Before we get into our expectations for the year ahead, lets raise a glass to cheer 2019 because unless things go really well in 2020, there may be a bit of a hangover coming.

## 2020 is priced aggressively

As we start 2020, markets are at all-time highs with elevated valuations, central banks are already highly accommodative, trade tensions have faded, and credit spreads are the tightest we have seen this cycle. This is a much more challenging starting point; while perhaps not priced to perfection, certainly the market is priced aggressively. Just compare the markets today with those of a year ago (Chart 2).

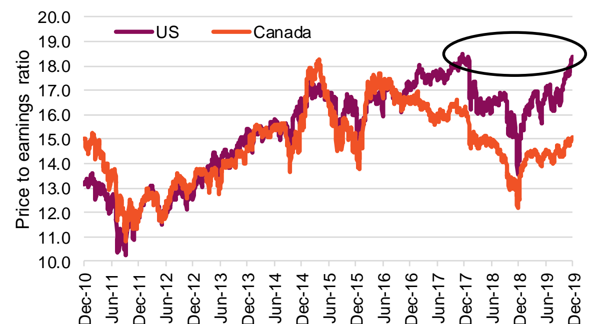
**Chart 2: A more challenging setup for 2020**

| | Jan 2019 | Jan 2020 |
|---|---|---|
| S&P 500 PE Ratio | 14.0 | 18.4 |
| TSX PE Ratio | 12.5 | 15.1 |
| 10-yr US Yields | 2.7 | 1.9 |
| 10-yr Cdn Yields | 2.0 | 1.6 |
| Inv Grade Spreads | 90bps | 44bps |
| Global GDP Forecast | 3.5 | 3.1 |

### Valuations

Today the S&P 500 is trading at 18.4x earnings, which happens to be the peak valuation of this cycle to date, tying the level right before the first correction of 2018 (Chart 3). This is also around the peak experienced in 2014, before another subsequent correction. There is some good news though: while the market advance of 2019 was largely driven by valuation multiple expansion as earnings growth was very muted, 2020 does look better from an earnings growth perspective. Earnings in 2019 appear to have grown by about 3-5% depending on how Q4 comes in. That is pretty low compared with recent years, but also worth noting the market maintained record earnings – an impressive feat. Some good news for the coming year, earnings growth appears set to accelerate, more so in the second half. Current consensus forecasts are for about 15% earnings growth in 2020, and earnings growth often drives market performance.

**Chart 3: Valuations are at cycle highs for U.S. equities**



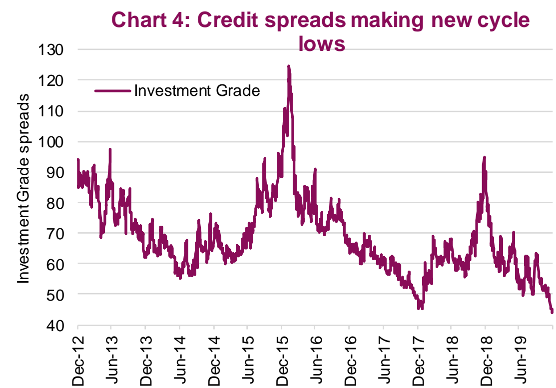

Few would disagree the U.S. market is expensive. We believe at these valuations and with the index near record highs, there is an elevated risk of a correction. Investors typically get emotional when markets are down, but they should be feeling concerned when markets are developing a slight froth. However, valuations outside the U.S. market are more reasonable. The TSX (Chart 3) is not as cheap as it was at the start of 2019, yet remains a little below the average valuation during this bull cycle. International markets, including developed Europe and Asia, are more reasonably valued as well, compared to their own histories and the U.S. market. This was a key input into our move earlier this year to pivot our recommended overweight U.S. equities into more international equity exposure.

### Spreads & bond yields

Bond yields are materially lower today than a year ago, economic growth is more muted yet credit spreads are at cycle lows. Lower bond yields are in part due to central bank easing and continued soft global economic data. In fact at the beginning of 2019, the global economy was forecast to expand by 3.5% for the year. As we enter 2020, the forecast for the coming year is down to 3.1%.

The pivot of the Fed and many other central banks in 2019 was a big deal and helped inflate asset prices, including real estate and equity prices. Now firmly in easing mode, that is probably largely priced in. So what could lift markets from here? Better economic data would be nice, but not too much because if the economy does improve, the market will begin to price in a Fed that may start raising rates again.

Credit spreads, wow! Investment grade spreads over Treasuries have fallen down to less than 50 basis points. That means after a decade of corporations expanding their debt levels, with the investment grade universe is now comprised of almost half BBB (the lowest rating for investment grade debt), the market is rewarding investors for taking on this risk by less than half a percent a year. Talk about picking up nickles ahead of a potential steamroller. For comparisons sake, back in 2011 only 27% of investment grade corporate bonds were rated BBB and the investment grade universe was yielding about 1% above Treasuries. The leveraged loan market is also exhibiting signs of froth. Nearly 80% of leveraged loans are covenant lite, versus only 30% during the finanical crisis. If (or when) the economic data softens more, these risks will likely be punished by rising credit spreads or default rates.




Most times it's rather difficult to piece together all of the moving pieces to come to a definitive statement in these types of outlook pieces. We'll try to be as definitive as possible when we state that spreads will be wider at some point in 2020 as "credit" is very expensive. Forget about eking out every extra basis point, take a step back to focus on what this part of the portfolio is truly about: defence.

**Portfolio action** – 2020 may not be priced to perfection but it's close and that has us believing 2020 will be a challenging year. A lot has to go right to eke out even average gains from this starting point. This could take the form of improving economic growth, more improvement on the trade front, resumption of earnings growth and/or continued central bank accomodation. If some of these fall short or there is a surprise (and there are always surprises), this market is at risk.

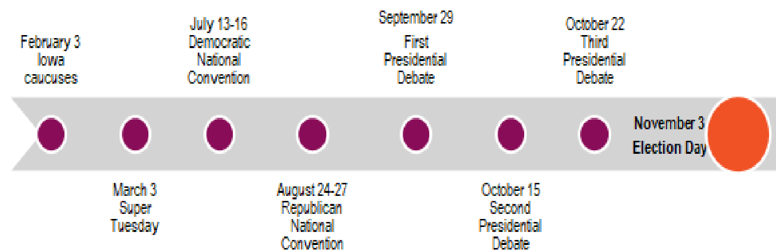
We would not abandon the U.S. equity market, but reducing some exposure or tilting to more defensive value/dividend strategies may prove timely for 2020 given the recent market run and valuation levels. On the credit side, investors are not being rewarded adequately; reducing credit exposure may prove timely.

## Politics in 2020

While we have never, and will never, claim to be political experts, 2020 is setting up to be an politically interesting one from the market's perspective. The cadence of the trade war between the U.S. and China, and to a lesser extent with Canada, Japan and the EU, was a driving force for risk appetite in the markets in 2019. When tensions were escallated or rising, markets suffered. When solutions appeared on the horizon, markets rallied. At the moment, markets appear to be riding a wave of optimism: the phase 1 trade deal between the U.S. and China is a sign of cooling tensions. Understandably, investors have become a bit wary due to false dawns over the past couple years. Our base-case assumption is that this area of market concern continues to fade in 2020 as both countries appear keen. China's economic growth has slowed and less trade tensions would help the situation. Meanwhile, for Trump to win re-election in 2020, the administration could really use a 'win' on this front, especially given how hard key battleground states have been economically hit by the trade war. Americans tend to vote on party lines but if their wages/income have been impacted, loyalty is at risk.

2019 has taught investors, and us, that trying to predict the next move on trade is really anyone's guess. While we do not believe trade will carry as big a market impact in 2020, this could flare up again. Plus, the market is very optimistic at the moment which is a bit risky.

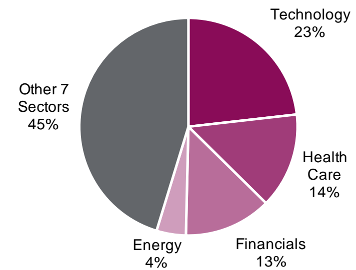
**Key dates for the U.S. election**




Perhaps the bigger risk in 2020 is the election process itself, namely in terms of the Democratic primary race. The chart to the right outlines all of the key election dates over the course of the coming year. Former VP Joe Biden is probably better understood by the markets, Senators Elizabeth Warren and Bernie Sanders are more wildcards. Both, but more so Warren, have spoken out on the following: the dominance of some technology companies and the desire to break up or reduce 'monopoly' situations; the desire to better regulate energy from an environmental perspective; the introduction or re-introduction of additional regulations on financial companies; and revamping America's approach on health care. We don't believe any of these aspirational campaign initiatives would be quick or easy to implement. However, even if they start talking about these kinds of changes, you better believe the market will react and not in a positive way. Technology, energy,

financials and health care comprise 55% of the S&P 500 by market capitalization which could see valuation adjustments as the Democratic Party's nomination process progresses into debates (Chart 6).

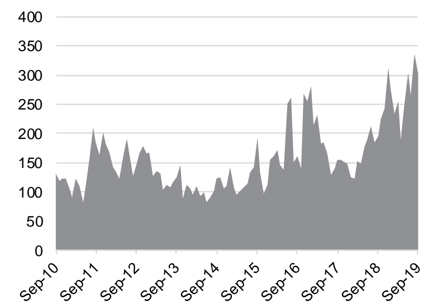
**Chart 6: 55% of S&P 500 is in politically at risk sectors**




One positive is that for any candidate to win, they likely need to move somewhat back to the center. This has been the theme of late, helping health care and other sectors rally. But this is a risk for 2020. Another positive is if there is more talk about increasing U.S. energy regulations, the rather unloved Canadian energy patch may be a beneficiary in the short run.

There are a number of additional political flash points in 2020. Increased violence between the U.S. and Iran is the most pressing at the moment after the death of Qasem Soleimani. Retaliation attacks and how this escalates or de-escalates will matter for markets. In relation to China, there is the unrest in Hong Kong, ongoing human rights issues and the continuing saga with Huawei Technologies. Plus, continued populism globally, Brexit, impeachment and a number of key elections in Europe, 2020 will likely see a market impacted by politics and geopolitical events more than other years, continuing the rise in geopolitical uncertainty (Chart 7).

**Chart 7: The age of uncertainty Global Economic Policy Uncertainty Index on the rise**

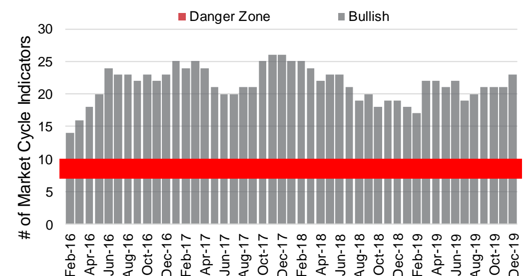



**Portfolio action –** We would not change our outlook as there are too many moving parts. However, as we begin 2020, political tensions within the market are low thanks to the optimism of a Phase 1 trade deal and the fact that nomination rhetoric is not in full swing. If these or others begin to materially weigh on markets, there may be opportunities to deploy capital in the affected areas. Keep some powder dry.

## Market Cycle – old and healthy

| Market Momentum | | | | |
|---|---|---|---|---|
| Canada | | | | ✓ |
| US | | | | ✓ |
| Consumer Model | | ✓ | | |
| HY Spreads | | | | ✓ |
| **US Economy** | | | | |
| Leading Ind (3m) | | ✓ | | |
| Leading Ind (6m) | | ✓ | | |
| PMI | ✓ | | | |
| PMI New Orders | | ✓ | | |
| Cons Sentiment | | | ✓ | |
| Cars | | ✓ | | |
| Homes | | | ✓ | |
| Credit | | | | ✓ |
| Chemical Activity | | | ✓ | |
| Rail | ✓ | | | |
| Energy Demand | | | ✓ | |
| Trucking | | | | ✓ |
| Phili Coinc | | | | ✓ |
| US Unemployment | | | ✓ | |
| **Rates** | | | | |
| Fed Funds | | | | ✓ |
| Yield Curve | | ✓ | | |
| Yield Curve Change | | | | ✓ |
| **Fundamentals** | | | | |
| Valuation Canada | | | ✓ | |
| Valuation US | | ✓ | | |
| Earnings Growth | | | | ✓ |
| Sales Growth | | | | ✓ |
| Margins | | | | ✓ |
| **Global Economy** | | | | |
| CRB | | | | ✓ |
| Oil | | | | ✓ |
| Copper | | | ✓ | |
| Baltic Freight | ✓ | | | |
| KOSPI | | | | ✓ |
| Emerging Mkts | | | | ✓ |
| Global PMI | | | ✓ | |
| **Total** | 3 | 7 | 8 | 15 |

**Chart 8: Market Cycle holding in nicely**




While we clearly have some tempered optimism for 2020 from current levels in the equity and bond markets, it is not all bad news. There are a number of encouraging signs that the slowing pace of global economic growth is at least stabilizing or dare we say improving; we will cover this shortly. Equally encouraging is our Market Cycle Framework. This multi-disciplinary model that incorporates over 30 indicators/signals from North Amercian and global economic data, sentiment, momentum, valuations, rates and fundamentals continues to remain healthy. With 23 bullish signals, this is the most since mid 2018 (Chart 8).

Market momentum remains supportive, which is not too surprising. The U.S. economic indicators have shown some signs of improvement in consumer sentiment and transportation demand. The global economic signals are largely positive and the market fundamentals remain good. On the rate side, while the flat yield curve is negative, it has been getting steeper which is good news. The yield curve, which inverted for a number of months in 2019, remains a concern for the health of the market cycle. Historically, an inverted yield curve has been a precursor of a recession and even though it has steepened, this doesn't mean there isn't a recession on the horizon.

Taken as a whole, our Market Cycle remains positive for a continuation of the current bull market. That doesn't rule out a correction but does imply if we see one, it could prove to be yet another buying opportunity in this aging bull market.

*Market Cycle – if you are interested in reading more on our Market Cycle approach and why the red line in Chart F is the danger zone, please read the December Investor Strategy Report HERE*

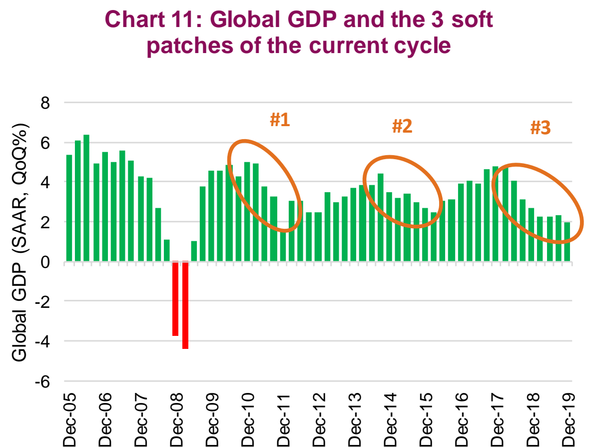
## The economy

The nagging question on everyone's mind is whether the current slowdown in global economic growth is simply the third soft patch in this economic expansion that started in 2009 or if it's the start of a global recession. This slowdown started in mid 2018 as slowing growth in emerging economies spread to more developed economies in Europe and Asia. In 2019 this crossed the ocean to impact both Canada and the U.S.

If you recall from Chart 2, at the beginning of 2019 the global economy was forecast to expand by 3.5% for the year. It now looks like this will come in closer to 3.0%, so clearly coming up a bit short of earlier expectations. Forecasts for most nations were revised lower as the year progressed, so there is lots of blame to go around. Notable declines were in Germany, Italy, India, Brazil, Australia, Chile and Hong Kong.

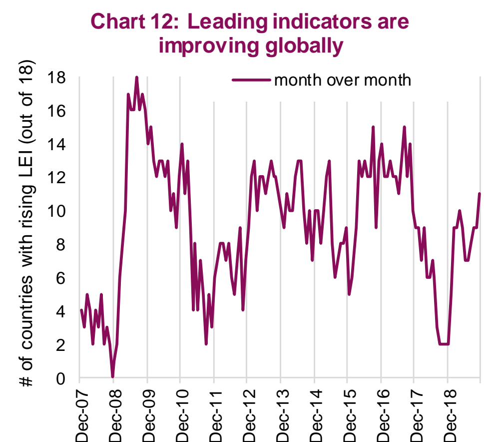
A positive sign is forecasts for 2020 have remained much more stable over the past year and currently the consensus sees a minor uptick in growth relative to 2019. Global GDP growth is expected to be 3.1% in 2020 (Chart 10).

This economic slowdown has primarily impacted a few areas of the global economy and not others, so far. It is safe to say we are in a global manufacturing recession based on activity levels and purchasing manager surveys (PMI). This has also impacted corporate spending as slowing global aggregate demand and uncertainty around the trade war led many companies to dial back on their spending.




The good news is so far this has not spread. Services, which make up a larger portion of most developed economies, continue to show resilience. And the consumer, in both the U.S. and Europe, remain steadfast. It is worth noting we have gone through this before in both 2011 and in 2015, when weak trade and manufacturing led to a soft patch in global economic growth. In both cases, the consumer remained resilient and growth recovered. 2019 could prove to be the third iteration of this pattern (Chart 11). The key is whether the weakness in corporate spending spreads to hiring practices, which would impact consumer spending. If the consumer holds, growth should recover and we are starting to see some encouraging signs.

Leading economic indicators are a basket of economic and market data points that have historically signalled changes in the direction of economic growth. Of the 18 nations that calculate a leading economic indicator index (LEI), more and more are starting to see this index rise (Chart 12). At the end of 2018, only one country had a rising LEI and this has been improving throughout 2019 with 11 seeing improvement in November.

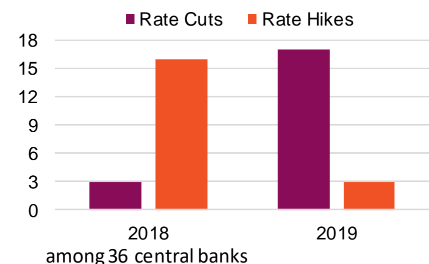



From an overall economic perspective, we are optimistic that the slowdown of the past year and a half may be passing. The consumer has remained resilient thanks to low unemployment, rising wages and healthy personal balance sheets (not the case in Canada). Now with some green shoots starting to show themselves in manufacturing, we are starting to feel comfortable that economic growth is finding a better footing. Of course the data could change, but for now it's more good news than bad. But don't expect global synchronized growth like we had in 2017 – we believe that is no longer on the cards this cycle.

### Monetary policy

One of the biggest pivots in 2019 was that of the global central banks. In 2018 the trend was to raise rates as evident in 16 of the 36 key central banks. In 2019 we saw an about-face with 17 cutting rates and only a couple raising (Chart 13). Many believe the tightening in 2018 went too far and for too long especially after the global economic data continued to soften. Hindsight is easy though. This move to lower rates and becoming more accomodative helped raise asset prices, including real estate, equity and bond markets. That certainly goes a long way in explaining why we had such strong markets in a world with slowing global economic activity.

**Chart 13: Central banks reversal in 2019**




Monetary policy has certainly become the tool *du jour* for trying to manage the economies of the world. Given the softening growth and trade uncertainty, the global central banks once again came riding to the rescue, lifting the markets back up. The economic lift from these rate cuts is a little more complex. Historically, there is a delayed response between the rate cuts and the impact on the economy which could explain why the data has not really started to improve. One sobering thought is that we have used monetary policy as a tool a little too much over the years and now it just doesn't have the impact it did in the 80s, 90s and 00s. With all the rate cuts and quantitative easing over the past decade, global growth has really not gotten going. Unfortunately for many of the world's central banks, interest rates are about as low as they can possibly get in Europe and Japan. Perhaps its cyclical and the time is coming to reconsider fiscal stimulus once again – best to dust off your Keynesian text books.

While the efficacy of monetary policy may have faded, given how many cut rates over 2019, this should still help improve global growth in 2020. This view has certainly helped markets and is a positive for 2020.

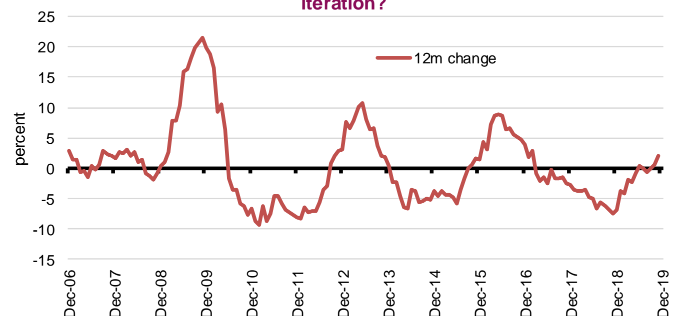
Given the rise in commodity prices, there is a potential for an inflation jolt. Early 2019 had very low inflation numbers, so expect year-over-year inflation numbers to look relatively larger than we've been accustomed to. Household inflation expectations are still low, and we will have to see if this will hold given the expected food inflation that is anticipated to hit consumer pocketbooks next year. We do not anticipate any knee jerk reactions from central banks, given that they have said that inflation would not impact their views unless the moves were significant and enduring.

While the Fed Fund futures are still discounting a slight decline in rates this year, given an improving global growth outlook, we don't believe further cuts are likely. Most FOMC members still see policy on hold for the next year. The Fed has a lot on its plate in 2020 – most importantly in the near term is finding a more permanent solution to fixing the short-term funding (repo) market. Endlessly buying Treasuries and expanding its balance sheet is not a long-term solution. This is still an accommodative policy, even though it is not considered Quantitative Easing. Central bankers clearly stand ready to do "whatever it takes".

### China

While the usefulness of monetary policy for managing some developed economies may be diminishing, that is not the case in most emerging economies including China. China's credit impulse, an amalgamation of various sources of credit capital, has provided a helping hand to the global economy in each of the past slowdowns. This was the pattern in 2009 following the financial crisis, in 2012 after the European debt crisis, in 2016 after oil plummeted, and now again credit is on the rise. The pace is slightly more muted this time as China likely has a debt bubble, so a more cautious approach is warranted. Nonetheless, as this bubble gets bigger, the global economy benefits (as long as it doesn't burst).

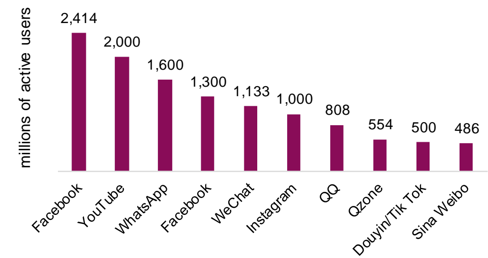
**Chart 14: China credit impulse has helped global growth recover in 2009, 2012 and 2016....will 2020 be the next iteration?**




We don't see China coming to the global economy's rescue again, at least not to the same degree as past soft patches. The government has been more cautious as high debt levels have likely reduced its ability to go on a full-fledged credit binge and there is likely a desire to keep more powder dry in case the trade conflict worsens. The good news is that credit is rising again in China, removing a previous drag on its economy. Add to this a reduction in reserve requirements to start 2020, China is certainly helping. The direction of credit and the pace of China's economic growth slowdown will be key determinants for global growth in 2020. At this point things are looking better including some encouraging manufacturing data to close out 2019.

# III. Thinking in decades

Chart 15: Most Popular Social Networks

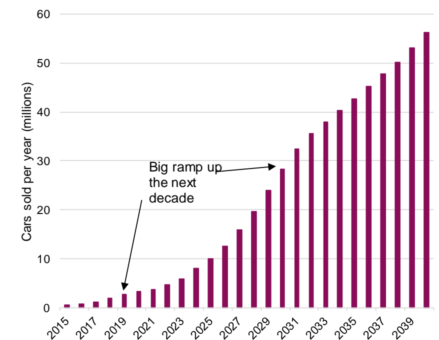



As this new decade begins, it's time for some deep reflection. The last decade was clearly one characterized by massive change, including the transformation of how we shop, interact, use our personal assets, and consume entertainment. Traditional retailing was upended by the mass adoption of online shopping. Further, social media was adopted globally, with 10 different platforms each with over 500 million users. The sharing economy is now activating under-utilized assets in a way that would have been hard to imagine 10 years ago. CDs and DVDs quickly became obsolete as streaming became the preferred delivery method; now, we pay a monthly fee to access as much music/movies/sports as we like, when we like. And perhaps the biggest change has been the rising adoption of smartphones, which grew from 20% to 89% in the U.S. over the past decade. All of these innovations were made possible by broad advancements in cloud computing and the increased speed of broadband communications. **Today's world is yesterday's unthought of future.**

We all suffer from short-term thinking, focusing on events or performance on a monthly, quarterly or yearly basis. However, sometimes taking a BIG step back can help you think in longer time horizons, and what better time to do that than at the turn of a decade. Of course, this fun exercise is pontificating as to what could transpire in the next decade. We know a few things for certain: there will be more change to come and the change will certainly surprise us all. We foresee the potential rise of various interesting and potentially widely disruptive advancements that possess the necessary attributes to change the world and become broadly adopted. So, here are a few up and coming things that we think have a bright future.

### Electric Vehicles (EV)

Chart 16: The coming electric vehicle revolution



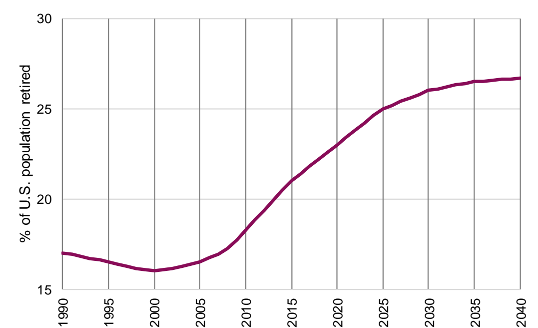

Human transportation is likely in the midst of yet another infrastructure build-out phase. EVs are already here, but the personal transportation industry is very large and doesn't change quickly. With continuous improvements in range, charging speeds, and available models, the annual number of electric and plug-in hybrid vehicles sold is expected to rise from 2.2 million in 2019 to 28 million mid-way through the decade. As this trend progresses, it will gradually shift the infrastructure needs from distributed gasoline to plug-in stations. We could even see the ascent of vertical take-off and vertical landing vehicles if the Jetsons are to be trusted as a guide.

### Artificial Intelligence (AI)

Enabled by mass amounts of data, the move to the cloud, increased connectivity speeds and processing capabilities, AI is poised to have a dramatic impact on society and our everyday lives. These technological advances will power autonomous vehicles, better decision making with big data and much increased automation. All are positive and will increase productivity. The downside is AI may cause material disruptions in the job market and accelerate labour replacement technological advances. AI adoption will likely be further advanced by the implementation of fifth generation broadband wireless communication (5G). 5G technology will allow vehicles, phones, appliances, infrastructure, utilities and more to communicate with each other, in what is deemed the internet of things. Advances in connectivity will likely continue given initiatives among Apple, Google, Amazon, and others working on Bluetooth or satellite-based systems that will allow for connectivity no matter where you are – on the land, water, or air.

### Demographics

Chart 17: Growth rate of % of U.S. population retired expected to slow after 2025




Source: United Nations

One reliable mega trend is changes in demographics. Trends in the dependency ratio (those not in the labour force versus those in the labour force) can have a dramatic impact on economic growth and interest rates. For many developed economies this has limited economic growth over the past decade as more baby boomers retire and millennials have yet to reach their prime spending years. This is set to tilt back to a better growth period in the next decade as the drag of boomers retiring (decumulation phase) could be more than offset by rising millennial spending (chart 17).

Elsewhere, Africa and other regions with very low average ages could become the economic growth engines for the world. Of course, policy mistakes can derail the impact of these demographic trends, so only time will tell. We believe that over the next decade, these demographic shifts will redistribute the sources of global economic growth. The prolific growth China experienced at the start of the millennium and into the beginnings of the last decade was driven by demographics and urbanization, accompanied by growth-friendly policy. While there is no 'next China' visible from a single nation, this pattern could be replicated at a smaller scale across many nations with younger populations. Those regions could provide some of the best growth opportunities.

### Health care

Personalized medicine through genomic sequencing and AI-assisted application and detection is already starting to grow rapidly. The ability to customize a medical approach and leverage predictive analytics could potentially extend the lives of many. Google released a blog post last week that their AI mammogram screening tool was more effective than doctors in a sample of 22,000 images. This technology will likely be made available first to those in the most developed nations, which won't move the needle materially. However, once costs fall to a level where it becomes economical to developing nations, we could observe rapid population growth, that would impact demographics, food, and water demand, and capacity logistics.

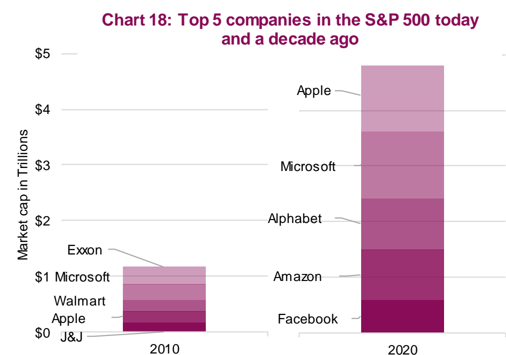
### Climate change

The planet's population has expanded materially in the past 70 years, helping drive a higher pace of economic growth further fuelled by ever-increasing debt levels. One could argue we have been living beyond our means on two fronts: both financially and environmentally. Climate change has been a resulting by-product. Fighting climate change and increasing sustainability is increasingly becoming one of society's primary objectives, as exhibited by Time magazine's choice for Person of the Year for 2019. We believe this trend will continue and accelerate in the coming decade. While not a straightforward or linear process, the world will likely continue to tilt the energy complex to more sustainable sources and increased sustainability overall.

**Portfolio action -** The adoption of the internet, cloud computing, mobile connectivity, streaming and the shared economy over the past decade has changed the market leaders and left some in the dust. Hence, it makes sense that businesses from the previous paradigm would be put under a degree of structural distress. If the leaders can be scored by the market capitalization of a company, just look at how the top 5 changed over the past decade for the S&P 500 (Chart 18). The change in size is also pretty incredible. One reliable lesson that history has taught us over and over is that the leaders of yesterday are usually not the leaders of tomorrow.

The next decade will be full of surprises; this is the only thing we can know for sure. Nonetheless, if you are a long-term investor, having some exposure to these potential societal game changers may prove as beneficial as buying some Netflix a decade ago (for the record, Netflix was the top-performing current member of the S&P 500 over the past decade).

**Chart 18: Top 5 companies in the S&P 500 today and a decade ago**



# IV. How to invest in 2020

| Overall Asset Allocation | - | | | | + |
|---|---|---|---|---|---|
| Equities | | | ■ | | |
| Fixed Income | | ■ | | | |
| Cash | | | | ■ | |
| **Global Equities** | **-** | | | | **+** |
| Canada | | ■ | | | |
| U.S. | | | ■ | | |
| Euro Area | | | | ■ | |
| Japan | | | ■ | | |
| Emerging Markets | ■ | | | | |
| **Fixed Income** | **-** | | | | **+** |
| Canada | | ■ | | | |
| U.S. | | | ■ | | |
| Government | | | ■ | | |
| Investment Grade | | ■ | | | |
| High Yield | ■ | | | | |
| EM Debt | ■ | | | | |
| Prefs | | ■ | | | |
| Duration | ■ | | | | |
| Credit | | ■ | | | |
| **Currencies** | **-** | | | | **+** |
| CAD Short Term (3m) | | ■ | | | |
| CAD Longer Term (1yr) | | ■ | | | |

2020 will be a challenging year for investors and there is a higher-than-normal likelihood it may be a down year for equity markets. The simple fact is the great performance of Q4 2019 appears to have reflected much of the good news on the docket for 2020: a trade truce, some signs of improving economic data and very accomodative central banks. This is reflected in the elevated equity and bond market valuations, which naturally supresses return expectations.

**Overweight cash** – Holding a higher amount of cash does seem prudent given the starting point for the year and the elevated risk of a pull back. Of course, the cause of market weakness is anyone's guess. We could see a reversal in the calming trade tensions, further slippage in economic data, war risk in the Middle East, or even the rhetoric around the upcoming election trigger some weakness. Having some dry powder to do some optimistic buying could work out well.

**Market weight equity –** Despite our cautious shorter-term opinion, don't go calling us market bears. The Market Cycle signals remain supportive for a continuation of this bull market (with some potential bumps). 23 bullish signals out of 33 is certainly encouraging. Global growth has slowed, but the key global consumers, namely the U.S. and European, remain resilient. If holiday spending is any indication, the consumer is likely better than alright. As a result, we do not believe now is the time to be dialling back on equity allocations. Nonetheless, a more defensive posture in favour of lower valuations and dividends/value seems appropriate. Let's not forget this market cycle is now 11 years old, and by historical standards that's considered a longer-than-average run.

**Global equities –** From a geographic perspective, we remain most positively inclined towards Europe, a change we made around mid-2019. This is in part a valuation call given the heightened discount European equities are trading to U.S. equities, 14.4x vs 18.4x. Also, as we are starting to see some improvements on the global growth front, Europe is more sensitive to global trade which could provide another lift in economic activity. Add to this the rise of populism in Europe, a longer-term risk that could translate into short term policital policies that contain increased fiscal spending, adding more to growth.

We remain slight underweight for Canadian equities. Valuations are reasonable in Canada and improvements in global growth would be positive for the TSX as well. However, the economic data in Canada has been coming up short over the past few months and the consumer remains constrained by debt levels. This will likely continue to weigh on financials. Energy shares have rallied strongly in Q4. But given Q1 and Q2 are seasonally weak periods for global energy demand and there is a lot of oil supply scheduled to come on line in 2020, we remain more cautious.

**Bonds –** The term premium remains historically low, implying investors will not be rewarded amply for taking on longer duration risk. And credit spreads are very low, meaning you are not rewarded much for taking on credit risk. This has us underweight bonds and focused on shorter duration with lower than normal credit exposure. If we see economic growth improve, bond yields will rise somewhat, creating another potential headwind.

**Currency –** The Canadian dollar rose materially against the U.S. dollar to finish off the year. This is an opportunity to reduce Canadian dollar exposure in exchange for U.S. Our near term and longer-term stance on the CAD is mildly bearish.

## Potential pivots in 2020

Our greatest conviction call for 2020 is that our strategy will change as the year progresses. Investing is a combination of positioning yourself appropriately given the environment and adjusting to changes or opportunities. Below we have highlighted a few potential pivots we could see developing in 2020.

**Correction** – As we have indicated, we believe there is a heightened risk of a period of market weakness that could come sooner than later. This could be triggered by a resumption of trade tensions, improved economic data calling into question the level of accommodation from central banks, rhetoric around the Democratic primary race and nomination process, or some unforeseen

surprise. If this occurs while our Market Cycle signals remain encouraging, we would view it as an opportunity to increase equity exposure.

**Higher yields** – Better economic data could lead bond yields higher. We are not expecting them to rise materially, but given how low inflation expectations are anchored, we could see a drop in bond prices (higher yields). This would be viewed as an opportunity to add some duration (extend term) or even add to bonds.

**Market cycle** – If we see deterioration in the economic data translating into more bearish signals in our Market Cycle framework, it will be time to start reducing equity. This bull cycle will turn 12 years old in March and while we believe this cycle has another leg to it, reducing equity in year 12 does sound like a prudent idea.

Every year has surprises and 2020 won't be any different. Our team will endeavor to manage our asset allocation services to the best of our ability, making timely and opportunistic changes as the market and data dictate. As one of our guiding principals remains transparency, we will share those changing views in our monthly **Investor Strategy** report. 2020 could be a challenging year and we look forward to helping investors navigate.

Charts are sourced to Bloomberg L.P. & Richardson GMP unless otherwise noted

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