Skiing the Moguls

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Source: Snowskool.com

Another year is quickly coming to an end. As 2019 winds down and I start to look ahead, opportunities and risks that lie in the economy and markets remind me of a bump run in skiing. For those of you who are avid skiers like me, you will probably understand the analogy. For those of you who haven't skied, let me explain.

Mogul skiing (or a bump run) are a series of bumps on a piste (ski slope) that are formed when skiers push snow into mounds as they do sharp turns. This tends to happen naturally as skiers use the slope (and at the end of the day it is not groomed) or it can also be constructed artificially. Once formed, a naturally occurring mogul tends to grow as skiers follow paths around it, further deepening the surrounding grooves known as troughs. Moguls can grow quite large and they challenge the skill of a skier as they require advanced technique.

As we move into 2020, we are now 11 years into this economic expansion and bull market. So like a bump run, the troughs of this economy and market are very deep as this run has been going for quite some time. Similarly, advanced mogul skiers understand that going down can be physically and mentally demanding because there are a lot more risks. But once a skier has mastered the moguls, it can be incredibly exciting.

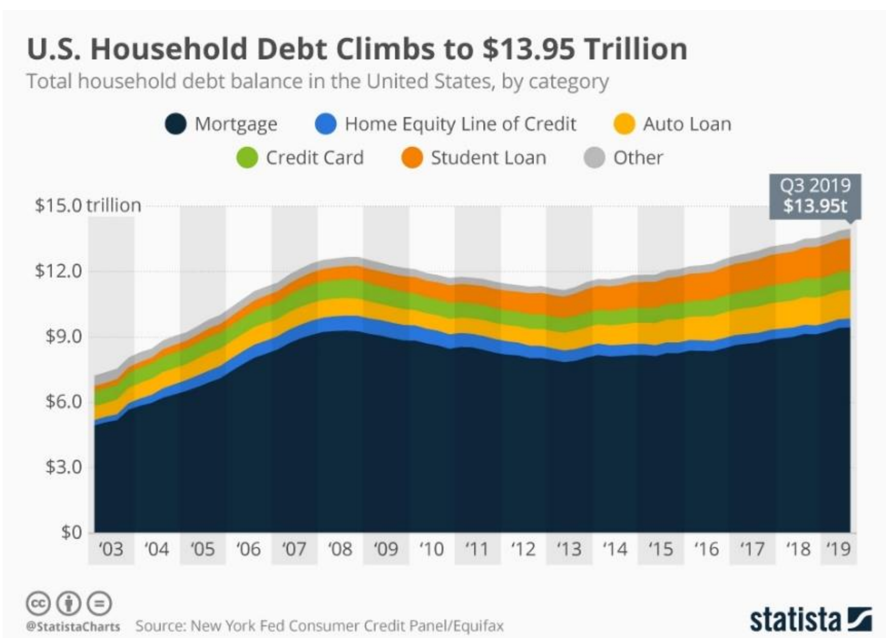
So as I look at the year ahead, I figured I would attack my thoughts just like I would at the top of a bump run. Let's just hope (like skiing) I can get through this in one piece!

Taking the Moguls on – Understand the Risk

I remember taking my oldest daughter down her first double black bump run in Deer Valley (when she was 6-years old). She had absolutely no fear and it was a blast watching her follow me down because I would lose sight of her in between bumps. She was too young to be afraid and too low on the snow to get hurt. She ripped down the mountain making Daddy proud.

So, in my opinion, risks in a bump run and the global markets are relative. What are the risks in 2020? From a macroeconomic perspective, I believe they are a series of risks that need to be watched.

The first is how long can the U.S. consumer continue to drive not only the domestic economy but to a large degree, global growth? As reported by CNN last month, U.S. households are now sitting on a record $14 trillion in mortgages, credit cards, student loans, auto loans and other forms of debt. This is now almost $1.5 trillion above the peak set in 2008 (not adjusted for inflation) and is 25% above the post-recession low of $12.7 trillion.



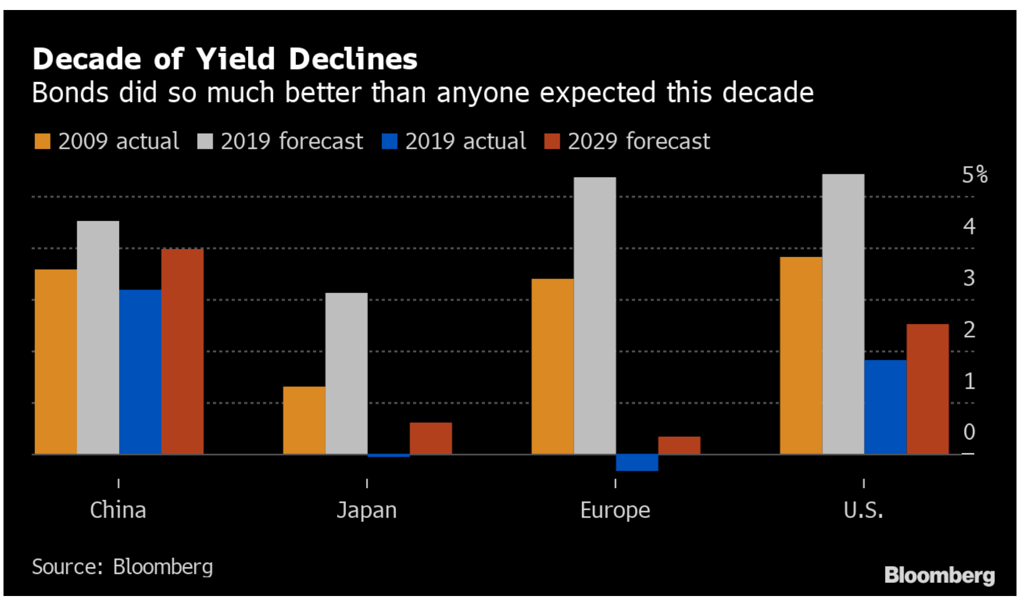
Source: Statista/New York Fed

The good news for the U.S. consumer is that the job market is very robust. In early December the monthly employment report had a better-than-expected jump of 266k in non-farm payrolls removing any lingering fears of a near-term recession. The broad U6 employment report (this includes both unemployed and under-employed) fell to 6.9% and is now at a multi-decade low. The gains were distributed across most industries and should positively impact the outlook for household income. If wage gains continue to rise, the consumer may keep this economy going.

A second risk is an uncertainty around global trade and the impact of trade wars on global supply chains. Concerns persist that trade will continue to hamper the U.S. economy well into 2020 hurting top-line GDP growth. The President put together a preliminary deal with China but stated he is willing to wait until after the election for a larger, long-term deal. Until a long-term deal can be hammered out (with real meat on the bone), these negotiations will act as both a domestic and global GDP headwind.

The last macroeconomic risk I continue to watch (for those who have read my past papers) is central bank policies. Central bankers, led by the Federal Reserve, who have lowered interest rates (in some cases below zero) and added trillions of dollars to the money supply are left with only a few options to fight the next downturn.

With the Federal Reserve, European Central Bank (ECB) and Bank of Japan (BOJ) set to hold their final policy meetings this month, I worry the next ten years could be their most testing yet. Monetary policy effectiveness will be clearly limited going forward. As seen in the chart below, the forecast for yields is not expected to be much higher in 2029 than they are today. Thus, leaving central bankers limited room to operate.



Source: Bloomberg

When skiing the bumps, the more snow on the slope, the easier it is to control your speed and risk when finding your line. But if you hit a patch of ice or, even worse, a rock it makes navigating the bumps very difficult.

Interest rates act much the same as snow. The higher interest rates (without slowing the economy), the more room as to wiggle. So, given the fact that the 10-year U.S. Treasury Bond is yielding around 1.90 in late December, let's just say they are skiing the bumps with rocks all around.

As an example, the Federal Reserve has injected itself into the repo market with billions of dollars daily to keep that market trading efficiently. This market is where cash and pools of securities meet for overnight lending that is critical to banks, investment banks, insurance companies, and asset managers. It has been said that a healthy repo market is the world's largest pawnshop.

Back in April, I highlighted this market along with the Interest on Excess Reserves (IOER) and Fed Funds were dislocating and that something was amiss. This dislocation came to light in September when a mismatch in overnight repo rates went all the way up to an overnight rate of 10% causing the Fed to inject just under $50 billion of liquidity.

Fast forward to today and those markets have improved slightly, due to the fact the Fed has now pledged at least another $425 billion into these markets through early 2020. The Bank of International Settlements, which acts as a consortium for global central banks, issued a report highlighting the risk to these markets (source: CNBC).

So with little wiggle room on rates and parts of the financial markets dislocating, it is anyone's guess if the Fed can ski down these bumps without having a "yard sale."

When you jump in, find your rhythm and stick with it

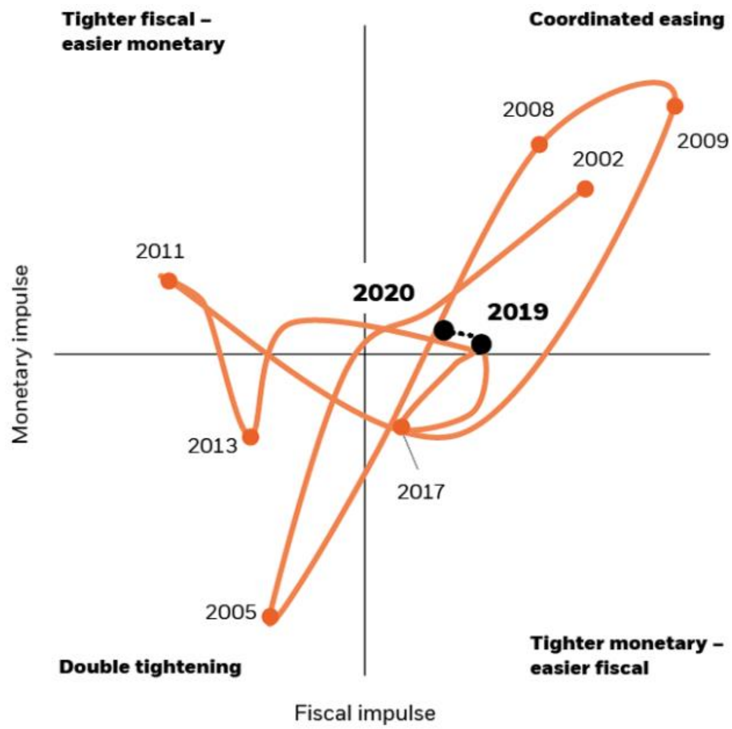
There are always risks in skiing and the markets, but the two things that I have learned from great mogul skiers are; once you jump in, get into a rhythm and commit. I think this applies to investments as well.

To watch a person ski the bumps well is to see a thing of beauty. I hold no such grace, and I use my legs and try to muscle my way down. Great skiers appear to effortlessly dance over bumps, however, I am sure quick, unnoticeable corrections are made throughout the course of the run.

First, you can't go as fast in a bump run as you do in one that is groomed. After 11-years in this bull market challenges may lie ahead for the economy, company earnings and markets. Return expectations may need to be adjusted.

This time last year I anticipated (and wrote) high single-digit equity returns given the Fed's guidance on their rate stance and looking at expected earnings growth. The Fed made a quick pivot in early 2019 and cut Fed Funds three times this year thus helping equities appreciate +20% despite low-single-digit earnings per share (EPS) growth.

My estimates this year will not factor in the Fed. I am looking strictly at EPS estimates to help me determine what investors to expect next year (note: I have written on several occasions that the bias for the Fed continues to be lower, and another rate cut in the next 12 months would not surprise me. See the central banking stimulus chart below).



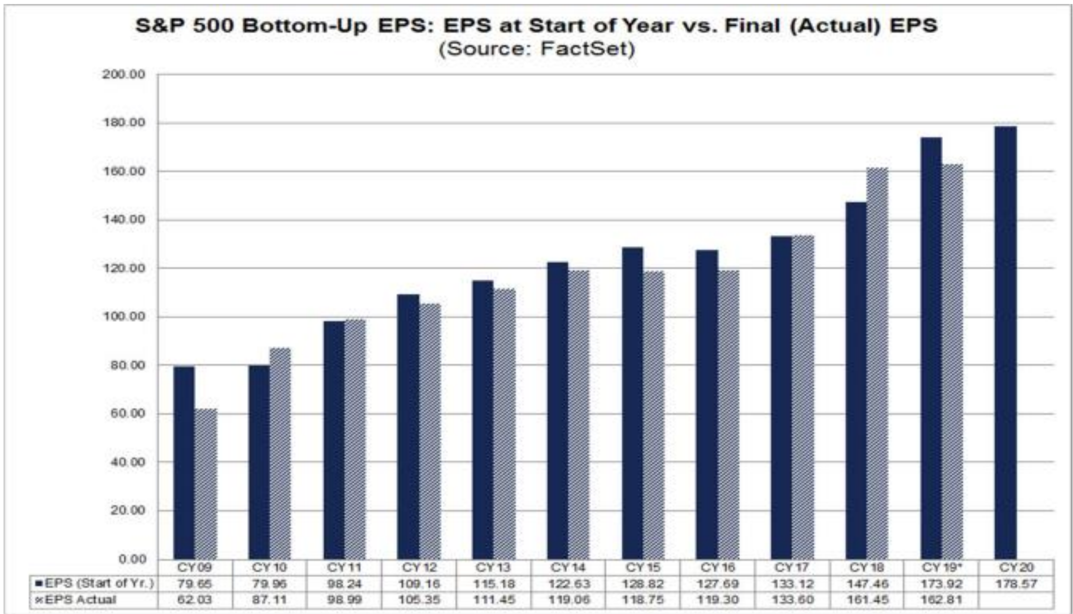
Source: Blackrock

My current 2020 EPS estimate for the S&P 500 is again lower than the consensus estimates. The current 2020 consensus is $178.57 (source: Factset). My estimates are $166.00 - $170.00. For 2019 consensus was $173.92 and my estimate was $165 - $170 per share (see: "Stuck between a rock and hard place" December 18, 2018). According to Factset (chart next page), it appears that the EPS will come in at approximately $162.81.

If earnings come in towards the high end of my estimate, that would mean that year-over-year (YOY) growth in earnings would be approximately 4.29%.

Unless the Fed is planning more rate cuts (which would theoretically mean the economy is not doing as well as hoped), then it's hard to reconcile the S&P appreciating more than mid-high single digits (so long as market fundamentals and true price discovery are in play) with 4.29% ESP growth. As anyone in my position will tell you, there is no guarantee that fundamentals mean anything to the markets, nor will markets act rationally in either direction.

So, equity investors in the market should rebalance positions but stick with it. However, investment expectations should be governed. If the market gives you more, it's the icing on the cake.



Source: Factset

On top or in-between or a little of both?

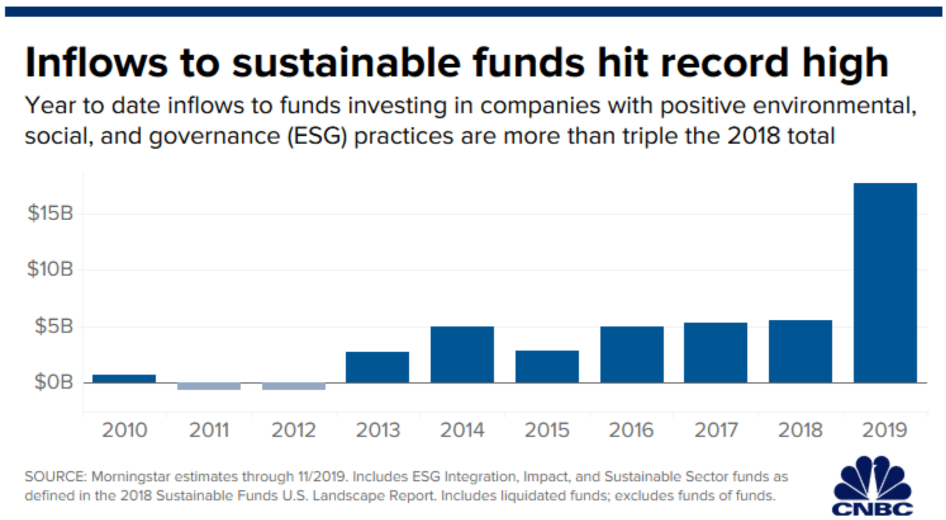
Bump skiing is a lot like investing where risk will determine the enjoyment of the run. So when watching a mogul skier, notice that some like to turn on top of the bump and some like to turn in between (rounding the bump and controlling speed). When I jump into a bump run, the amount of snow generally determines my line. The more snow, the softer a potential accident, the straighter line I take. When the bump run is icy, I tend to round out my turns in between bumps, thus slowing my speed (I am 52 and this body can only take so much).

Again, after an 11-year bull run, as I stand at the top of this market, I think it's time to round out our turns and control our risk.

Personally, I think U.S. investors should look to control risk is several ways. The first is reallocating (or adding) to their positions in foreign markets. International stock valuations are well below long-term averages, reflecting this year's lackluster global growth and uncertainty. Much of that uncertainty has cleared potentially helping European equities mean-revert closer to their U.S. counterparts and creating an opportunity.

As I look forward to 2020, if both the U.S. and Europe offer similar upsides, my tactical preference would be a portfolio with balanced risk and a slightly higher allocation to developed international investment.

The second thing I think investors should do is “follow the money” in ESG investing. For those who have never heard of “Environmental, Social and Governance” (ESG) investing, well you may want to become familiar. This space grew more than $30 trillion according to CNBC in 2018 and investment inflows high records this year (see chart below) as consumers and investors demand more environmentally friendly companies and policies. Once considered a niche approach that costs investors return, these strategies are now proving they can beat the market.



Source: Morningstar/Global Sustainable Investment Alliance/CNBC

There are many ways that investors can incorporate ESG investments or strategies into their portfolio. Risk/return profiles with your advisor should be done before making an investment choice. However, what is clear is that demand is surging for these types of investments. Even if the investor doesn’t necessarily subscribe to being “clean and green” – the money is clearly moving to those companies and it could make sense to allocation some money to this space.

Lastly, when looking at controlling risk and diversifying a portfolio, alternative investments have been increasing in popularity over the last 15 years. A recent study by BCG Consulting Group showed that assets under management (AUM) in alternatives have been rising faster than for any other investment category, except for passive investments.

Just last week the SEC announced it intends to change the qualifications to become an accredited investor to allow more people to be able to invest in alternatives (note: alternative investments generally require a minimum in net worth or income in order to qualify). But, a key question for investors to consider when selecting a strategy is whether or not it will provide them with the genuine diversification benefits and returns they seek.

Hypothetical post-Financial Crisis portfolio results
10-year data as of 9/30/19

	Return	Risk	Sharpe
Original portfolio ▸ 60% Equity ▸ 40% Fixed Income	9.58%	7.40%	1.20
Sourcing to Reduce Volatility ▸ Allocate 15% of Equity ▸ Allocate 0% of Fixed Income	8.52%	5.9%	1.32
Sourcing to Increase Returns ▸ Allocate 3% of Equity ▸ Allocate 12% of Fixed Income	9.64%	7.39%	1.21

Emphasis on decreasing risk

Emphasis on keeping risk the same

Source: Blackrock

Blackrock recently ran hypothetical returns using historical data and they found that depending on how the investor uses alternatives in the portfolio, it can help to either reduce the risk in the portfolio or add a little alpha (return) versus a traditional 60/40 allocation. Now, there are a lot of factors that can help or hurt a portfolio (manager selection, percentage of allocation, etc.). But the point I am trying to make is that, if an investor qualifies, alternatives should be part of the discussion when rebalancing the portfolio in 2020.

Keep a level head

It is likely that no matter how proficient a skier when they jump into a bump run, they are going to get thrown around. Not every turn will be perfect and it's important not to panic and keep a level head.

Out of all the parallels that I have highlighted between skiers and investors, this one is the most important. With the outsized rally in the U.S. stock market this year, most economists and market strategists like myself believe that if history is any guide, performance will be muted in 2020.

Investors who are hoping the rally of 2019 will continue charging ahead may be disappointed. The S&P 500 has returned an average of 6.6% in the year following a rally of 20% or more since 1928 (slightly below the 7.6% return in all years) according to research from Bespoke Investment Group.

Secondly, markets are generally choppy when uncertainty looms. Next year will be a presidential and congressional election year and I don't remember a time when the political parties were so far apart in terms of policies and tone. Investors would be wise to expect higher volatility as 10-15% pull-backs during the course of the year are certainly possible.

In that sort of environment, keeping a level head will be important. Not every day, week, the month will be perfect. In fact, some may be quite rough. But just like a bump skier, it's important to trust your allocation, be disciplined and know that investing in 2020 (like going down a bump run) going to be quite a rush.

With this being the last paper of the year, I want to say thank you to all our clients who have trusted us with their portfolios this year. We are truly honored to serve you.

I wish all of you a very Happy Holiday and a very Prosperous New Year! Happy 2020!