TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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Stock Market Development

2019 had its challenges. Global growth was slowing, the U.S.–China trade conflict unfolded, Brexit uncertainty increased, climate concerns took center stage amid extreme weather around the globe, and protests against the political establishment reverberated through Hong Kong, Lebanon, Chile, Ecuador, and many other places. And yet, spurred by global monetary easing led by the U.S. Federal Reserve's three interest rate cuts in 2019, both equities and bonds had a year of stellar returns which concluded an extraordinary decade for the capital markets. Over the course of the 2010s, the S&P 500 gained more than 250%, the investment-grade corporate bond market increased in value by more than 44%, and even gold was up by 30%. The S&P 500 Index gained 31% in 2019. The Bloomberg Barclays US Aggregate Index was up 8.72% in 2019. The 10-year Treasury's yield dropped to 1.90% from 2.68% at the start of 2019.

Fixed Income Market

U.S. bonds have generally outperformed their overseas counterparts, thanks to a relatively stronger economy and bond yields that may be slim, but that are at least positive. Central banks around the world have been even more accommodative than the Fed, with the European Central Bank and the Bank of Japan each targeting negative interest rates. That has made the objectively meager U.S. yields relatively more attractive in comparison, and demand from foreign investors will likely keep a lid on Treasury yields next year. We, therefore, do not expect the 10-year Treasury climbing above 2.20% in 2020. As we are likely to near the end of the current business cycle in the next two years some market volatility can be expected. Therefore, we recommend maintaining a well-diversified portfolio with a relatively short duration and laddered maturities. Focus should be on good credit quality, as the spreads between investment and non-investment grade bonds have shrunken to approx. 50 basis points, as investors were searching for more yield. Bond returns are likely to be limited to interest income only in 2020.

GDP

Recession risks, which had been elevated during the middle part of 2019, have diminished in recent months, helped by additional global monetary easing, a trade truce between the U.S. and China, better prospects for an orderly Brexit, and early signs of a rebound in the global purchasing managers' indices (PMIs). As a consequence, we are confident that a moderate recovery during 2020, after a weaker trend in the first half, is probable. We expect real GDP growth to decelerate to 2%, but remain strong enough to avoid a recession, or trigger the unemployment rate to rise. Although it remains unclear whether the phase-one trade deal with China will prompt a revival in business investment and exports. We expect that this will be quite likely and stimulate growth. Until then, growth prospects will continue to largely depend on consumers.

Federal Reserve Policy

The Fed signaled an on-hold stance in 2020, unless economic data meaningfully change the outlook. However, central banks remain supportive in other ways. The ECB, Bank of Japan, and the Fed are all expanding their balance sheets aggressively, to the tune of about $100 billion per month, which dampens volatility, and boosts a broad range of asset prices. The Fed is expected to keep the federal funds rate steady at 1.5%-1.75% in 2020. They are still concerned with below-target inflation and global risks, but are increasingly confident that the policy adjustment will be sufficient to stabilize growth, unemployment and inflation at their preferred levels.

Corporate Earnings

A return to earnings growth rather than continuous share buybacks is likely to be the main force that drives the S&P 500 stock prices higher in 2020, considering that valuation multiples have already reached the high end of their historical ranges. We expect that stocks will, more or less, remain at their current valuations, and/or rise slightly throughout the year depending on earnings growth. The average earnings estimate calls for a 6% increase from 2019.

Outlook

Among the many factors that could drive U.S. equity market performance in 2020 and beyond are inflation, monetary policy, and valuations. The trend in monetary policies by the central banks is much more in line today and is, therefore, likely to create a better synergy among world economies. Low interest rates support higher stock valuations. This happened in 2019 despite slow economic and earnings growth. The S&P 500 price-to-earnings multiple has expanded to 19.3 from 15.4 at the end of last year. We expect dividend -paying companies to see greater demand from yield-seeking investors. Low borrowing costs will continue to make share buybacks affordable for companies, thus supporting stock prices. Growth sector valuations, like technology, are likely to remain high relative to the broader market, while cyclical sectors are trading near their cheapest levels since the financial crisis. Overall, these signals appear bullish for the stock market and suggest cyclical sectors may lead in 2020. Financials, healthcare, and industrials are all sectors with more attractive valuations, relative to the market. The sectors trade for 13.3, 15.8, and 16.5 times their 2020 earnings estimates, respectively, versus 17.6 for the broader S&P 500. Financials, in particular, is an out of favor sector, with below-average fund ownership, the highest shareholder yield of all in terms of dividends and share buybacks, and attractive growth potential in the Asian markets. Energy remains the cheapest sector. With the U.S. being a net-exporter of energy, the long-term economics of supply and demand point to oil and natural gas prices of $55 per barrel (West Texas Intermediate) and $2.80 per thousand cubic feet (NYMEX)—levels that make many U.S. energy stocks attractive

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at today's prices. Consumer cyclical stocks also look relatively attractive. Bargains, trading at double digit discounts, such as travel and leisure stocks, which are pressured by uncertainty. Technology stocks were leading in 2019 and the median U.S. technology stock is 11% overvalued. However, technology is likely to remain a leader as technology remains key to economic success.

Taking into account the current overall high market valuation, the geopolitical and political uncertainties (election year), the ongoing trade tensions with China, we do not expect a repetition of last year. We rather envision a single digit total return for the S&P 500 TRA in 2020. We continue to prefer a high quality aggregate of diversified investments.

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