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A LOOK AT THE YEAR AHEAD: Ten Investment Forecasts and Four Strategic Wealth Management Themes to Capitalize on Them

December 2019

As we acknowledge each December in presenting our outlook for the coming year, no one can know the unknowable or predict the unpredictable. But, as wealth managers, it is our job to analyze the world around us and invest in the context of the short- and intermediate-term economic landscapes. We have never believed in a "one size fits all" portfolio and have always provided custom tailored advice to our valued clients based on their personal goals and risk tolerances. With this in mind, we would like to share with you our perspective and predictions about some significant events that we believe are likely to unfold in the year ahead.

Beacon's Ten Investment Forecasts for 2020

1. U.S. stocks and bonds will deliver single digit returns in 2020.
2. The Federal Reserve will not raise interest rates in 2020.
3. The abnormally low stock market volatility of 2019 will sow the seeds for higher volatility in 2020.
4. S&P 500 earnings will increase at mid-single digit rates or better.
5. No "Phase 2" trade deal will be reached between the U.S. and China in 2020.
6. No "official" recession will occur in the U.S. in 2020.
7. Infrastructure investments will be a winner in 2020 regardless of which party wins the nomination and election(s).
8. Fixed income investments will produce coupon-like total returns in 2020.
9. Real estate prices, as represented by the S&P Case Shiller Index, will increase at the national level, but below its long-term appreciation rate of 3%.
10. Inflation will remain subdued with the CPI below 2% in 2020.

Beacon's Four Strategic Wealth Management Themes for 2020

Beacon's Four Strategic Wealth Management Themes for 2020 echo our forecasts for the coming year and reflect our best thinking to protect capital and improve returns:

1. Volatility will likely increase so remaining diversified is as important as ever to control risk.
2. Seek income from diverse sources, given the low level of investment grade interest rates.
3. The global economy will remain sluggish but avoid recession.
4. Firms strong in intellectual capital will drive returns in the decade ahead.

A Glance Back on the Year That Was

U.S. stocks rebounded strongly from the sharp drop they experienced in 2018Q4, with the S&P 500 up roughly 30% in 2019 as of this writing. The supersized gains in 2019 were likely due to a multitude of reasons, including the Federal Reserve abruptly pivoting from a hawkish stance to a dovish one, improvement in U.S.-China trade relations, and the end of the longest federal government shutdown on record. Bonds also delivered very solid results in 2019, with most intermediate to long-term bond indexes, such as the Barclays Aggregate ("The Agg"), up high single to low double digits.

Before we look ahead to 2020, it seems only fair to look back on our 10 forecasts for 2019. What did we get correct and where did we go wrong? In our view, seven of our ten predictions were correct, one partially correct, and two wrong.

Let's start with our mistakes. We thought bonds would provide muted returns since the Fed was projected to *increase* rates during 2019. Of course, with hindsight, we now know that the Fed cut rates 3 times over the calendar year. Similarly, we expected muni-bonds, which are generally high quality in nature, to outperform taxable bonds. Muni bonds did well but failed to keep pace with most diversified taxable bond indexes, such as The Agg.

Let's move on to our prescient calls from 2019. Stocks delivered positive returns, the Fed raised rates less than two times, real estate prices continued to increase at the national level, oil prices increased, the federal budget deficit exceeded $900 billion, and the current economic expansion became the longest on record. Lastly, we forecast that the U.S. dollar would temper its rate of appreciation versus a basket of international currencies, creating a positive backdrop for international stocks returns. Both elements of the forecast were true, although most international indexes failed to keep pace with the S&P 500 in 2019. If you want to take a sharp pencil to grading our 2019 forecasts you may move this last forecast to the partially correct column. Speaking of which, we expected high quality investments to outperform low quality ones in 2019. This was largely true in the equity space (think FANG stocks or Morningstar's MOAT Index) but high yield bond funds generally delivered low double digit returns, outpacing their more staid, investment grade, counterparts. **Table 1** provides a summary scorecard for our 2019 forecasts.

Table 1: Review of Beacon's 2019 Financial Forecasts

Forecast	Assessment	Rationale for Assessment
Stocks to deliver positive returns	Correct	The S&P 500 is up roughly 30% YTD as of this writing
Fed to raise rates 2x or less	Correct	Consensus was for 3 increases, but the Fed cut 3x
Bonds to provide muted returns	Incorrect	Bonds delivered solid returns w/ Barclays Agg up 8.5%
Real estate prices to increase	Correct	Case-Shiller Home Price Index increased about 2%
The economic expansion continues	Correct	The current expansion is now the longest on record
Federal budget deficit to exceed $900b	Correct	The federal budget deficit is approximately $1 trillion
U.S. Dollar to temper strength, a + for int'l	Correct	DXY up slightly, international equities were strong
Muni market to outperform other bonds	Incorrect	Muni market did well, but underperformed The Agg
High quality to outperform low quality	Partially Correct	High quality stocks, but low quality bonds, did well
Crude oil prices to increase	Correct	Crude oil prices increased from $45 to $60 / barrel

A Closer Look at Beacon's Ten Investment Forecasts for 2020

There is an element of risk in offering predictions, since the future is uncertain. We can state with confidence that some forecasts we offer for 2020 are likely to be correct, some incorrect and some partially correct. We can also predict with great confidence that what will ultimately prove to be some of the major events of 2020 are neither on our list, nor likely on anyone else's. For example, although many analysts thought stocks would rebound in 2019, few saw the roughly 30% surge in the S&P 500, with minimal volatility to boot. It is often the events that few investment strategists are talking about that result in the most extreme market movements.

As noted in our Executive Summary section, Beacon portfolios are custom tailored to each client's unique risk tolerance. Hence, our investment ideas may be appropriate for some clients, while not consistent with the goals and objectives of others. With these important caveats in mind, we humbly offer you some color around our top ten investment forecasts for 2020.

1. **U.S. stocks and bonds will deliver single digit returns in 2020.**

   Stocks aren't inexpensive, with the S&P 500 priced at roughly 18x forward earnings. The twenty-five-year average for this figure is 16.3x, but we believe a low interest rate backdrop can support an elevated valuation ratio. Furthermore, we expect earnings to grow in 2020 as trade policy becomes clearer and consumer spending remains solid. We think stocks can do single digits in this environment. A forthcoming recession would change our thinking to the downside, but we don't see it in the cards for 2020 *(See Forecast 6).* Another surge in equities due to a "bubble-like" mentality that overcomes investors is not out of the question given the dearth of cheaply valued assets and large amounts of cash on the sidelines, but we wouldn't bank on it. Bonds are starting from very low yields, with the benchmark 10 Year Treasury Note at roughly 1.9%, so we foresee a year of clipping coupons resulting in low single digit returns for most fixed income investments. The 8.5% return achieved by The Agg in 2019 would be a stretch, to say the least, for bond investors in the upcoming year since we, and The Fed, don't see an environment of negative interest rates anytime soon.

2. **The Federal Reserve will not raise interest rates in 2020.**

   We believe the Fed will largely be on hold in 2020 due to sluggish GDP growth, tepid inflation, continued trade uncertainty, and a desire to not have undue influence over the November elections, despite their independent status. Fed governors routinely give (vetted) speeches communicating policy views and their general line of thinking on the economy. The minutes of recent past Fed meetings generally show little appetite for further rate cuts or increases. If there is a change to Fed policy in 2020 it's likely to be to the downside, by cutting rates to support the current record expansion.

3. **The abnormally low stock market volatility of 2019 will sow the seeds for higher volatility in 2020.**

   In some respects, investors have been spoiled not only by the tremendous returns in 2019, but also by the minimal volatility. The biggest peak to trough drop in 2019 for the S&P 500 was only 7%, roughly half the average drop over a calendar year according to long-term studies. The lack of volatility is important since it helps investors stay the course and avoid being "shaken out" of long-term positions and thus deprived of subsequent gains when the rebound eventually occurs. Often the lack of volatility causes investors to become complacent, or even aggressive, sowing the seeds for future volatility. There is not a shortage of risks in the market, starting with perhaps the most contentious U.S. Presidential election in decades, as well as continued trade tensions with China *(see Forecast 5).* North Korea has resumed launching rockets, scuttling plans for a "peace dividend" on the Korean peninsula.

4. **S&P 500 earnings will increase at mid-single digit rates or better.**

   If there is a ray of sunshine for stocks in 2020 despite their elevated valuations, it is that earnings are expected to increase at high single digit rates. Large cap titans, such as Alphabet (Google), ExxonMobil, and Boeing are expected to increase their earnings in 2020 at healthy clips after some 2019 missteps and/or earnings writedowns. Furthermore, a wave of companies, including Apple, are expected to benefit from the secular rollout of 5G wireless technology which may power everything from superfast movie downloads to driverless cars.

5. **No "Phase 2" trade deal will be reached between the U.S. and China in 2020.**

A Phase 1 trade agreement was finalized in mid-December, largely focused on the purchase of agricultural products and some modest improvements in the protection of intellectual property (IP). A Phase 2 agreement will require structural changes in the Chinese economy. For example, the World Trade Organization (WTO) places restrictions on government subsidies to industries, while China sees them as essential to develop leadership in key industries, such as robotics and artificial intelligence. We don't see a Phase 2 deal happening in 2020 and perhaps several years beyond. Lack of progress or an escalating war of words could result in additional market volatility.

6. **No "official" recession will occur in the U.S. in 2020.**

One of our forecasts from 2019 was that the current U.S. current expansion would be the longest on record. We are going to double down on that prediction for 2020. We believe that the U.S. consumer, buoyed by the lowest unemployment rate in 50 years, decent wage growth, and record stock and real estate prices, will spend at reasonable levels keeping the economy afloat. We are less optimistic on the spending plans of the other two pillars of the economy, Corporate America and financially strapped federal and state governments, which constitute roughly 30% of U.S. GDP. However, we think the benefits that will accrue from the Phase 1 U.S.-China trade deal and the "new NAFTA," formally known as the United States-Mexico-Canada Agreement (USMCA), should also be enough help stave off the risk of recession.

7. **Infrastructure investments will be a winner in 2020 regardless of which party wins the election(s).**

The problem of America's dated and crumbling infrastructure is a well-known one that is unlikely to go away anytime soon. It's a problem that almost any politician, regardless of party affiliation, can get behind. If the economy is stronger than expected, money may be available to spend on infrastructure. Conversely, if the economy is weak and requires further deficit spending infrastructure investments seem to be a prime focus for targeted funds. A win-win scenario. The Federal Reserve tracks infrastructure spending and numerous exchange-traded funds (ETFs) have cropped up that invest in a basket of infrastructure related firms.

8. **Fixed income will produce coupon-like total returns in 2020.**

After a blockbuster year in 2019, fixed income will provide more muted returns in 2020. With yields range-bound, a Fed seemingly on hold and the absence of meaningful inflation, the yield curve will be relatively stagnant. Therefore, regardless of credit quality or duration, total returns will be in the low to mid-single digits for fixed income.

9. **Real estate prices, as represented by the S&P Case Shiller Index, will increase at the national level, but below its long-term appreciation rate of 3%.**

At the epicenter of The Great Recession and its concomitant fallout was the real estate market and its slew of related mortgage backed securities. Real estate indexes, such as those produced by S&P Case-Shiller, have quietly surpassed all-time highs. The fuel for the rebound has been a benevolent cocktail of low interest rates, a strong job market, an expanding economy, and a record setting stock market. Those ingredients are still in place, albeit on shakier footing looking ahead. We expect real estate prices to move up at the national level, but less than its long-term growth rate of 3%. Of course, there will be substantial variation about the average with high tax states among the most prone to decline, due to the $10,000 federal income tax cap on state and local tax (SALT) deductions. In some cases, a rising stock market can have a greater impact on real estate prices in certain areas, such as "Silicon Valley," where executives in start-ups are often showered with stock options.

10. **Inflation will remain subdued with the CPI below 2% in 2020.**

    The spate of negative bond yields around the developed world are not there by accident. They are there for a reason. Namely they are part of an effort by central banks to kick-start moribund growth. What's the problem? Let's start with production overcapacity on a global scale. Combine that with financially strained, yet savvy shoppers searching for the lowest prices. A decline in union membership has reduced the impact of collective bargaining agreements. Consumer titans, Amazon, Walmart, and Costco delight their customers with low prices, much to the chagrin of firms selling high priced, branded products. And throw in ubiquitous software which is, to use a term from venture capitalist Mark Andreessen, eating the world by completing tasks more quickly and cheaply. A mere 3 months ago investors fretted about an inverted yield curve, often a harbinger of recessions. With this backdrop it's hard for us to see a surge in aggregate inflation, despite ever increasing healthcare and educational costs. When 2020 ends we expect to see the Consumer Price Index (CPI) up 2% or less.

Beacon's Four Strategic Wealth Management Themes for 2020

Investment forecasts in and of themselves are interesting, but of little direct value. They must be actionable if they are to be valuable for our clients. Therefore, coupled with our Ten Investment Forecasts we offer Four Strategic Wealth Management Themes for 2020, which are often tied to the specific investments in your portfolio.

1. **Volatility will likely increase so remaining diversified is as important as ever to control risk.**

   We previously documented the abnormally high U.S. equity returns and abnormally low drawdowns over the 2019 calendar year. Diversification remains the best antidote for risk despite the strong outperformance of U.S. equities relative to most asset classes over the past decade. One of the worst mistakes that investors make is to chase past winners and sell them near their bottoms when they inevitably cool off. Individuals may resent paying insurance premiums during periods when they don't file a claim, but they often feel relief when a claim is paid on their behalf. Similarly, when an inevitable downturn arrives in equities the abnormally low yields on fixed income securities may not look so bad if not downright mouthwatering.

2. **Seek income from diverse sources, given the low level of investment grade interest rates.**

   The temptation that most investors have to obtain extra yield is usually satisfied by taking on extra risk. That type of behavior often ends badly. Think subprime related securities in 2007. Rather, we believe yield should be obtained from a variety of sources, the less correlated the better. These investments may include dividend paying stocks, real estate, infrastructure investments, and traditional bonds of the investment grade and municipal variety. Across this investment menu we favor erring on the side of higher quality given the late stage of the current economic cycle.

3. **The global economy will remain sluggish but avoid recession.**

   The Phase 1 trade deal between the U.S. and China, while not comprehensive, will eliminate some of the uncertainty that businesses have faced. Many firms have also re-engineered their supply chains, making them more robust to future trade tensions. Central banks, in virtually every country around the world, remain accomodative, either cutting interest rates or keeping them at neutral levels. Consumer spending remains robust in the U.S. and has re-accelerated in China. In our view, this mix of events will keep the global economy moving ahead, avoiding recession, albeit at sluggish rates. We aim to capitalize on this theme with global or international equities in our proprietary portfolios and with international funds in our open architecture portfolios.

4. **Firms strong in intellectual capital will drive returns in the decade ahead.**

   One of Warren Buffett's reportedly favorite indicators, market capitalization relative to GDP, shows equities at nosebleed levels, surpassed only by those achieved near the peak of the Internet Bubble. This simple valuation metric ignores the radical reshaping that has occurred within the American economy over the past two decades. For example, roughly 40% of earnings by S&P 500 companies are now generated from foreign sources, and due to outsourcing this income is not reflected in exports so is not included in GDP. Furthermore, the rise in companies strong in intellectual property means they now eclipse industrial ones. These firms, primarily in the Technology and Healthcare sectors, are responsible for a stunning range of inventions including the internet, smartphone, 5G, driverless car, immunotherapy, robotics, social media, and much, much more. These businesses are more scalable and offer higher profit margins than their industrial peers. We believe firms strong in intellectual property will continue to dominate the decade ahead and continually seek to identify both current leaders and emerging ones in our proprietary equity portfolios.

We at Beacon look forward to the opportunity to discuss our Ten Investment Forecasts with you, as well as the ways in which our Four Strategic Wealth Management Themes can be custom tailored to your personal situation. As always, we close by thanking you for your loyalty and support. We consider our relationship with our clients a true partnership, and our sole mission as a firm is to add value to our clients in any way we can. It is with the fulfillment of this mission in mind that each of us at Beacon is focused on individual and collective improvements each day.