From the desk of the CIO
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2020 Outlook

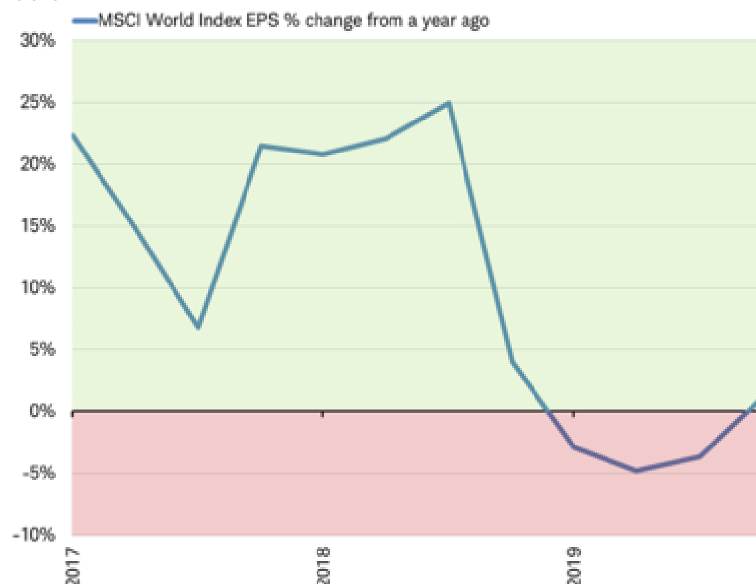
There is nothing magical about a calendar year in financial markets. As a matter of fact, many companies report financial results on what's known as a "fiscal year". A fiscal reporting year is any twelve-month period that ends at the end of any other month than December. You may logically wonder then, why do so many financial firms spend time, effort and money developing calendar year market prognostications? The simple and honest answer is that it is a *marketing opportunity*.

Instead of walking you through a senseless calendar year forecast of overall markets, let's spend the next few minutes of your valuable time discussing the conditions in which we'll be investing right now. To begin with, the obvious elephant in the room, is stock prices, or put another way, business valuations. The one certainty in investing is that over long periods, all assets are priced at their fundamental value. Along the way, in the short-term, assets may be priced optimistically or pessimistically depending on the mood of investors. Since common stock companies are valued based on their prospects for generating future profits and cash flows, it makes sense to consider the chart below that Schwab's Chief Strategist, Liz Ann Sonders included in a recent blog post. The chart shows how the distance between stock prices of the S&P 500 members and their after-tax profits have diverged by an amount not observed in quite some time.

Source: January 17, 2020 Market Commentary, Liz Ann Sonders, Jeffrey Kleintop, Kathy A. Jones

What does this mean to you as an investor? As companies report fourth quarter results and provide guidance into the future of their respective businesses, we need to see current profits, future profits and cash flows that are increasing at a clip necessary to support current prices. Financial markets are forward looking and tend to overshoot the upside and downside at times. If earnings do not materialize to support stock prices where they are today, we'll likely experience a correction. However, if earnings are supportive of today's stock prices, and companies do indeed continue to grow sales and profits beyond where assets are priced today, then continued positive returns are likely. The one obvious difference as we enter 2020 is that we are not investing in a market that just sold off nearly 20%, like we experienced at the beginning of 2019.

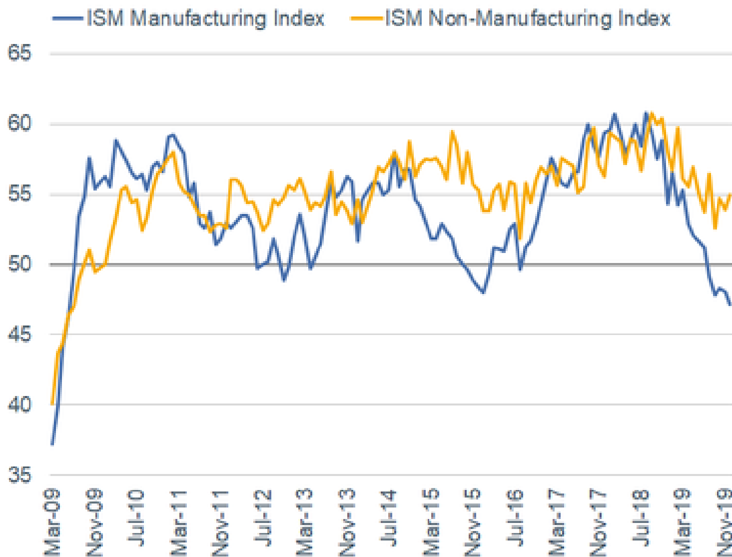
The trade and tariff dispute with China was one of several factors that resulted in a global economic slowdown. While the United States has largely remained among the strongest and steadiest among global economies, the demand for U.S. exports declined in 2019. However, this month the World Bank reported an uptick in global economic output from a previously forecasted 2.4% to 2.5%. As Charles Schwab's Chief Investment Strategist Liz Ann Sonders says, the trend is more important than the level. This uptick in output could be the start of a much needed uptrend. In fact, analyst's estimates of future global corporate earnings have rebounded, as you can see in the chart below.



Source: Schwab Market Commentary, January 17, 2020, Liz Ann Sonders, Jeffrey Kleintop, Kathy A. Jones

Bond investors will likely experience a boring but stable year of interest payments without much movement in bond prices in either direction. Barring any surprises in the levels of inflation or economic activity, we see long-term interest rates rising slightly in 2020 as the economy improves and the Federal Reserve will likely keep short-term rates steady for a while.

Because all economies are gigantic systems of transactions, the more businesses and individuals spend, the greater the economic growth experienced. In the U.S., the services sector is king, but the manufacturing sector is still an important component of the total economy. Manufacturing capital expenditures are made on large machinery, manufacturing plants, corporate headquarters and other investments for future growth. As you can see in the chart below, manufacturing expenditures declined during the trade and tariff disputes of 2018 and 2019, as business leaders were not willing to commit capital in an uncertain business environment. However, business spending by the services sector hung in there and has recently increased. Now that we have seen at least partial resolution to the trade disputes, we believe manufacturing expenditures may increase, which is why we think overall economic growth will rise.



Source: Schwab Market Commentary, January 17, 2020, Liz Ann Sonders, Jeffrey Kleintop, Kathy A. Jones

In summary, it appears world economies as a whole have rebounded off the bottom. Growth is materializing as trade deals are signed and greater certainty is restored for businesses to make decisions.

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