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Can We Save Some Of This For 2020?

Financial assets produced excellent results in 2019. It wasn't a sure thing, however. One expects markets to become a little ragged at the leading edge of the longest economic expansion in modern times. This was the case as we entered summer; the yield curve inverted as growth slowed, fears of recession grew, and stock prices stumbled (a bit).

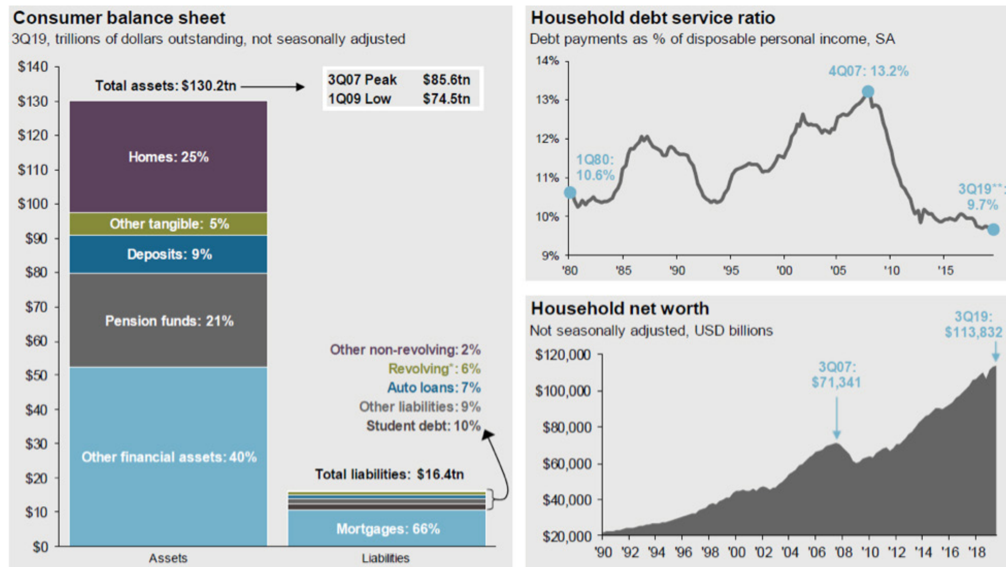
The Federal Reserve put on its white hat and rode to the rescue, cutting its benchmark rate three times in as many meetings. Calm returned, sentiment improved, and both stock and bond prices rose. Economic activity picked up, and balanced portfolios produced their best returns since 2009.

The natural inclination is to expect a reversal of at least some of these gains in 2020. Will that happen? At some point in the year, undoubtedly. But, beginning to end, we expect reasonable results. There are three primary building blocks in our outlook. First, the prospects for economic growth in the U.S are strong. Second, inflation is yet to be a concern for central banks; interest rates will remain range-bound and low. Finally, and perhaps most surprising, is market history. Let's consider these, one by one.

Economic Momentum Will Carry Well Into 2020

Tariff battles hurt manufacturing and agriculture in 2019. Without minimizing the seriousness of these challenges, the major driver of economic activity remains consumer spending. And while headlines focus on the negative, this foundation of our economy is strong. Consumer spending accounts for just over two-thirds of GDP, and consumer balance sheets are in the best condition of the post-World War II era.

Note the data on the accompanying charts from J.P. Morgan Asset Management. Consumer assets and net worth are nearly twice the levels as at the peak of U.S. economic activity prior to the credit crisis. Most important, the consumer sector (as a whole) is not going deep in debt to support its expenditures. Debt service as a percentage of disposable income is the lowest in the last four decades. Add to this record employment, rising wages, and strong confidence reports, and the stage is set for decent growth in 2020.



Source: J.P. Morgan Guide to the Markets, December 2019

Source: BCA Research Outlook 2020

Inflation Will Remain Below Target and the Federal Reserve Will Remain On Hold

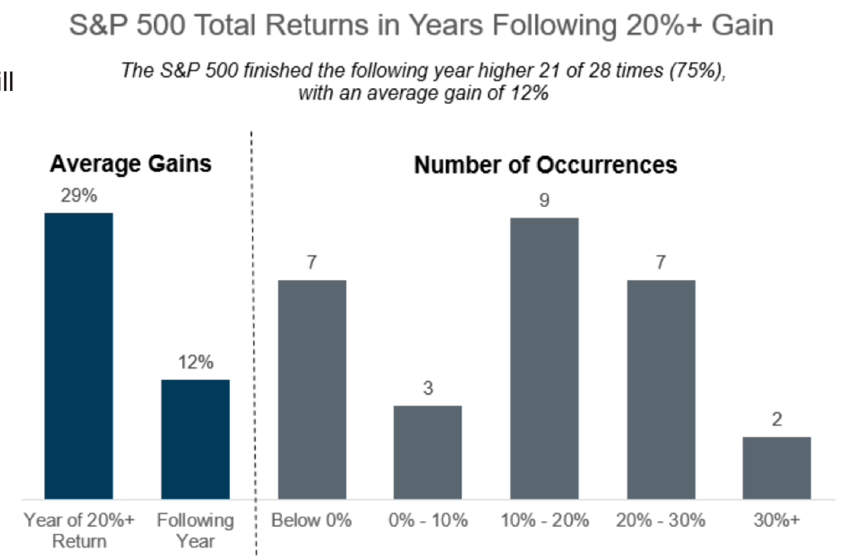
One of the phenomena of recent years was the Federal Reserve's insistence that low inflation is transitory and more restrictive policies were appropriate. Markets disagreed; this difference of opinion was responsible for at least some of the pressure on stock prices in mid year. The Fed's 'mid-cycle adjustment', announced in the fall, was belated recognition of the power of a strong dollar to offset tariff-related changes in import prices. This action brought U.S. policy closer to that of most central banks, and closer to market expectations.

Markets still price inflation-protected securities (whose principal value rises with inflation) at levels well below the Fed's target. A second chart, courtesy of BCA Research, suggests that consistent 2.0%+ inflation readings are not in the near future. We expect monetary policy, here and abroad, to remain steady for most of 2020. This should provide support for fixed income prices, if not yields.

Will Markets Repeat - Or Maybe Rhyme?

It's natural to expect a retrenchment after a strong year. It would be nice to 'stash away' some of the 2019 results to help smooth the inevitable rough spots ahead -- thus the theme of this Outlook. But will the markets be that challenging?

Based on the building blocks of market behavior -- the economy, interest rates, and inflation -- equities should produce reasonable returns in 2020. And, history supports this view. From the end of the Great Depression, the S&P 500 rose 20%+ twenty-eight times. Twenty-one of those occasions were followed by additional gains the next year, with an average gain of 12%.

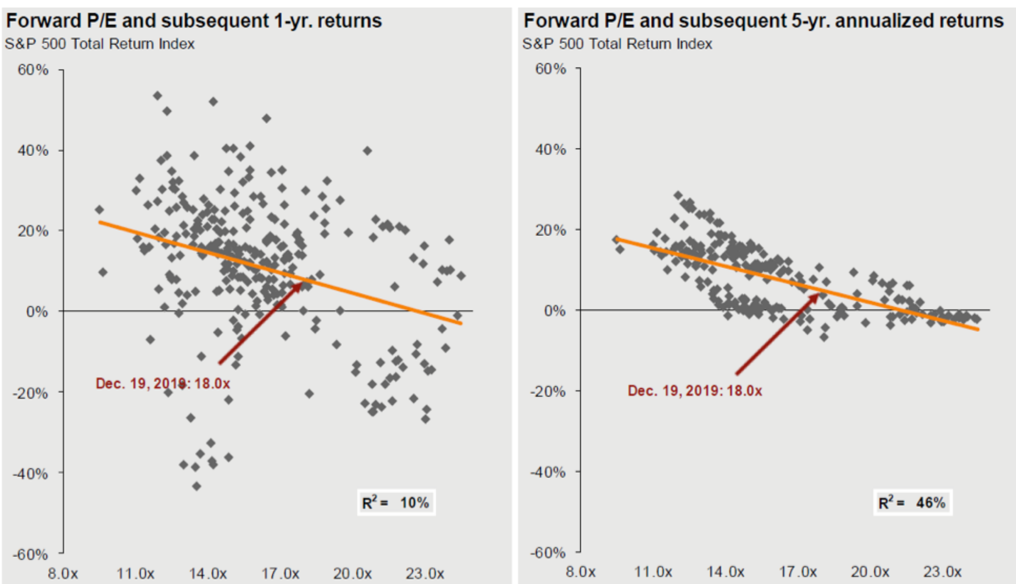


Source: Bloomberg LP, Security National Bank Wealth Management

But Valuations Are a Headwind

Nearly all measurements show financial assets in the U.S. at the upper end of historic valuations. History also tells us that future returns are highly correlated to valuation at the beginning of a measurement period. As shown in the left chart below, anything can happen in a short period. For longer terms, the predictive power of valuation is strong. As of mid-December, the expected annual return for the S&P 500 is in the mid-single digits over the next five years.

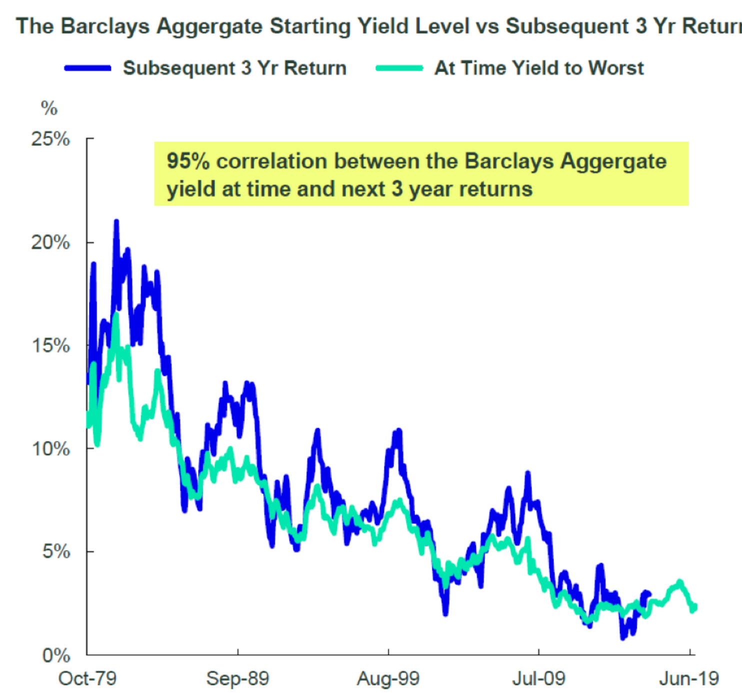
The outlook for fixed income returns is more straightforward. There is a near-perfect relationship between starting yields and subsequent years' returns. The accompanying graphic, from State Street Global Advisors, suggests broad bond market total returns just above break-even in the early years of the new decade.



Source: J.P. Morgan Guide to the Markets December 2019

Our Position and Plans

Economic progress will continue in 2020, here and abroad. Financial markets should follow, although valuation considerations suggest gains will be well below those recorded in 2019. Portfolios under our management will remain fully invested, with enhanced attention to risk control. Equity exposure will have a small value tilt and likely higher exposure to foreign markets. Bond exposure will focus on high quality and below-benchmark duration. Non-traditional assets, designed to counter periodic bouts of volatility, may be built into our models. We expect to report favorable absolute and relative returns as the new decade begins.



Source: State Street Global Advisors, December 2019