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2020 Market Outlook Update Transcript

Chris Schildz: Welcome to another edition of Conversations with Commerce Trust Company. This is Chris Schildz, and with me is Scott Colbert, our chief economist. Scott, thanks for joining us today.

Scott Colbert: Hi, Chris.

Chris Schildz: Now, the tensions with Iran have seemingly eased back here in the early part of January…it's back from the brink. What can the U.S. economy expect in 2020?

Scott Colbert: I'm sure that's a pretty good lead in with what we've got going on overseas. Clearly those tensions popped out in the middle of nowhere and on a perpetual basis, we always have geopolitical risk as a flare up, as kind of an ongoing concern. It pretty much has been almost all of our adult lives. The U.S. economy grew at 2.4% last year probably when it's all said and done. The mean consensus forecast for growth seems to range from about 1.6% to 2% for this year. Let's call it 1.8 as the mid-point. We think it's going to actually, the U.S. economy is going to actually do much, much better. We have a litany of reasons probably why, but maybe, in order of importance...

Scott Colbert: Certainly this trade phase one deal (with China) that we are seeing today is probably the key issue. It was certainly what weighed (down on) us back a little bit last year, obviously when we still grew. And so putting those trade tensions aside we think adds considerable upside. Most people don't pay attention day-to-day to interest rates, but interest rates declined last year, of course, and the Federal Reserve cut rates three times. Interest rates work with a lag and that 75-basis point lower short-term interest rate and the 10-year interest rate fell almost an identical amount. It fell from 2.68% to 1.92%, (and) those lower interest rates should help growth this year.

Scott Colbert: The global economy is improving too. We are still a relatively U.S.-centric economy. More than 80% of our GDP is derived internally with less than 20% affected by overseas, but the globe is turning over as well. You can see that in a few statistics. (For instance,) Emerging Market stocks are outperforming ours (domestic), which of course had a great year, but finally Emerging Markets were taking off a bit. The U.S. dollar has peaked, which helps the international markets. China is even stimulating (its economy)…they're lowering interest rates again and cutting their reserve requirements, and the global leading economic indicators are moving up. So, there's a lot of reasons to think positively. When you really start to look at it from a banking perspective, credit spreads have come down last year and you might recall that stock prices fell, what was it, 18% to 20% in the fourth quarter of 2018. And, of course, they're up 30% this year.

Scott Colbert: But along with that big stock market surge came a reduction in the average cost of a company to borrow. So not only did interest rates come down, but the credit spreads, the extra spread that a company pays to borrow money declined, investment grade credits declined by about 60 basis points. So, they're much tighter. High Yield had an even bigger year, and so did the Emerging Market debt. One thing that people don't talk about very much anymore is the wealth effect. Meaning that as your portfolio grows, you tend to spend a little bit more money. It's hard to believe, but domestic wealth was up about $11 trillion last year with interest rates coming down and the stock market surging, home prices improving, business valuations increasing, corporate earnings increasing just a little bit. The multiplier, this is a little "wonky," but the multiplier effect is about three-tenths to five-tenths of a percent of that new wealth typically gets spent. The year before in 2018 we actually had no wealth created.

Scott Colbert: You'll recall stock prices were down across the board and about the highest-returning asset class was lowly bonds and they gave you about a zero return in 2018, but this year, of course, it's been nothing but upside with a typical balanced portfolio probably returning at least 15%, and in some cases, if you have overweighted stocks, closer to 20%.

So that wealth effect is large. That could add as much as two-tenths to three-tenths of a percent in GDP. And people aren't talking much about that, but there was a negative wealth effect last year, a positive wealth effect this year. And then very simply, if you just track something like corporate tax receipts, they are literally up 5.1% year to date. Now what does that mean? Well, if we're paying 5.1% more taxes, it probably means we're making 5.1% more money. That would be the first cut at nominal growth. You take 5.1%, you subtract out inflation of 2%, and that pushes you towards an estimate closer to 3% rather than 2% growth. So, we're very optimistic about the year.

Chris Schildz: Scott, there's certainly been a lot to focus on in the news, but let's concentrate on China for just a minute in the trade deal. Can you give us some more detail about that?

Scott Colbert: Well, it's an 85- or 86-page agreement. They haven't released the agreement yet, but the gist of it is simply this: that the Chinese have agreed to buy approximately $200 billion more dollars of goods and services from us than they had been. Now, that $200 billion is a "wonky" number because what it really means is they're going to buy about $80 billion more this year and then about $120 billion more off of a baseline from two years ago. Before the whole trade war started. So, cumulatively they're anticipating that they will buy as much as $200 billion.

Scott Colbert: Now the total trade deficit with China was only $400 billion. We would import about $550 billion and export to them about $150 billion, so our trade deficit was $400 billion. This is supposed to narrow that by at least a quarter if you take the hundred per year on average a hundred and a hundred (and so forth). So those goods and services will primarily be agricultural. So, it should be good for the farmers. The worries, of course, are the enforcement mechanisms and what we can do about it if they don't follow through. And it will be fairly difficult actually for the Chinese to suddenly reverse direction and start buying because it takes time to find the suppliers. It takes time to find the sellers. So, this could take a little bit of time, but nonetheless, it at least a lowering of those tensions. And it's pretty clear that the president probably doesn't want to raise them again going into the election year. So, it's a fairly positive spin on the outlook after a fairly negative year with the increasing tariffs.

Chris Schildz: It's certainly been a spark of some kind. We have a Dow flirting with a 29,000 mark. Can the current U.S. expansion continue into an 11th year? And if so, how long and when might it end?

Scott Colbert: Well, we're 10 and a half now, right? January. So, to make it 11 years you have to make it to June. And you just heard how optimistic we are about the forward progress. And in fact the probabilities of a recession compared to this time last year have declined significantly because of the increasing stock market, the declining credit spreads and lower energy prices. Energy prices today, WTI (West Texas Intermediate) crude is about $58 a barrel. We don't talk about energy too much anymore because of course we can make so much of it here and we're less of a net energy importer than we've ever been.

Scott Colbert: That energy prices just haven't been much on our radar screen. But if you think about every major recession we've ever had, they've almost always been accompanied by higher energy prices and rising inflation. And the lack of an increase in energy prices even despite the Iran flare up, very well controlled, very well behaved, even despite the fact that they barely budged when Iran took out the Saudi Aramco facilities with all those missiles earlier in the year, we barely had a budget energy prices. So, I think the lower energy prices really point to a lower probability of a recession. So, we see the economy as continuing to expand for several years more, probably on average a lot longer than the mean consensus. And we've been fairly consistent about that and I can't see why it wouldn't continue with the probabilities of recession even lower today than they were this time last year.

Chris Schildz: You've been an upbeat for a fairly long time up to this point, we've averted a major military conflict with Iran, inflation remains tame, but there are some risks and I bet you could tell us a little bit to see what it looks like.

Scott Colbert: Well, I think the biggest risk to our economy, oddly enough is just a fall in the stock market. Now, the stock market is a leading economic indicator, so what would cause the stock market to fall other than the fact that it's just basically moved record levels and it's probably by almost every measure other than relative to interest rates on the rich side. Probably number one would be the reimplementation of additional tariffs. In other words, if this trade deal, even though we're supposed to be signing it today (January 15), just for whatever reason the administration feels like the Chinese are not adhering to it and we have the ability to reinstate tariffs, I think those tariffs would be a sudden hit to the markets and the sudden hit to the stock market and would cause the outlook to cloud.

Scott Colbert: Secondly, of course we've got the election. Now, everybody wants to point to the election and of course Republicans want to blame Democrats and Democrats want to blame Republicans as the election moves on. But nonetheless, certainly, I'll call them the less pro-business friendly policies out of the Democrat side, particularly say the Elizabeth Warren or a Bernie Sanders side of the Democratic party. To the extent that those take hold, I think those could hold the stock market back or certainly place a dent in the outlook for the business economy. And then I think the third thing would be problems in China that we don't foresee.

Scott Colbert: China is a very leveraged economy. They have built some of their growth on the back of increasing debt much like this economy has, but it's a little more precarious when it's an Emerging Market economy like China, even though they have 1.3 billion people, their debt to GDP ratios are approaching that of the United States where of course their average income per capita is about a 12th still of ours. So, a slowdown in China would also be a material problem. At the margin most of the world's growth has been built upon China. So, anything that would push that backwards also pushes back the forecast.

Chris Schildz: Scott, let's shift back to fixed income for just a second. I think you've said in the past that bonds are an insurance policy for almost any portfolio. It was such a fantastic year for bonds in 2019, can there be a repeat performance in fixed income?

Scott Colbert: The investment grade bond market last year, the average core bond fund was probably up at least 8%, maybe even closer to 9%, so investment grade bonds gave you 9%. How did they do that? They gave you 3% in coupon, plus they gave you a 6% capital appreciation because those interest rates came down. High Yield did even better with something like 10% to 12% to 14% returns in Emerging Markets. Bonds did about the same. So, the fixed income markets were in fact a balanced portfolio. The combination of stocks and bonds last year was about the best it's been in almost 25 years. So, both stocks and bonds were huge contributors. The answer is mathematically, probably no, almost an impossibility that fixed income could provide the same result.

Scott Colbert: What you need fixed income for though largely is an insurance policy against a stock market disaster. Because I will say if the stock prices start to fall, chances are interest rates are coming down. If interest rates go down, then high quality investment grade bonds do pretty well. So, the only way that I see that the interest rate, an investment grade bond portfolio again gives you another 8% or 9%, unfortunately this year will be if the stock market does very poorly. Now, we don't expect that by the way too. When stocks do as well as they have historically there tends to be a follow on. In fact, there's only been six years where the stock market's been up 29% or more. And in each of those following six years, the average return was 19%, the lowest return was 8%. If you take it down to something more like 20% it's more like a 90%, a nine out of 10 possibility that will have positive returns this year falling on a 20-plus percent return year. So, we're still optimistic on the stock side.

Scott Colbert: In addition, other than interest rates coming down, we had those credit spreads contract. And when a corporate bond spreads contract, that also adds to the return. And I don't foresee that, for example, High Yield credit spreads went from five plus percent. In other words, the average High Yield bond was yielding more than 5%, more than a Treasury, to about three and a third percent today. The all-time low is about two and a third, so you don't have much more room to go. An emerging market debt has a similar story and even the average corporate bond today, which yields 91 basis points, the average investment grade corporate bond yields 91 basis points or nine-tenths of a percent more than a treasury bond. The all-time low since 2000 has only been 81 basis points. So we're at the low end of these credit spread ranges or the incremental “oomph” that you can get in an improving economy. So, unfortunately the answer is simply, no, fixed income investments can't possibly give you the same nominal results this year that they did last.

Chris Schildz: Scott, any final thoughts for our audience before we sign off?

Scott Colbert: I guess, I think this is another up year, it's going to be followed with positive financial asset performance. We're still optimistic on the outlook, still optimistic on the economy and we think it can continue longer than most. That still doesn't mean when the economy does start to slow or we have the eventual recession because the business cycle clearly hasn't been repealed, you don't have to get more defensive. And while it's easy to feel good in these up years, I think what we're asking people to do is consider to rebalance their portfolios. Take some of those stock market winnings, put it back into something that you really, really don't feel like you want, which is what? A low-yielding fixed income investment. But again, that's your insurance policy.

Scott Colbert: I will just mention for a warning and a cautionary tale, the last two times we had a recession, the S&P 500 fell 55% in the last recession. It was the deepest and longest recession we ever had. But prior to that we had the internet bubble where the S&P also fell 50%. Will we have a similar 50% loss this next recession? On average stocks are down about 38%, 37% in a (typical) recession. So typically they're not that deep, but my guess is it's likely to be just as deep because we are pushing on valuations now and we are stretched for time. And so this last 30% gain that we got in the S&P 500 unfortunately just creates higher valuations and more money or more potential to be lost in the next downturn. And so while we still think it's a ways away, consider rebalancing, constraint taking off some of the risks here as we move late in the cycle because eventually we're going to want to be more defensive than we are right now.

Chris Schildz: Scott, we'll hope the economy keeps humming along like it has and maybe get into that 11th year. That was Scott Colbert, chief economist for Commerce Trust Company. Thanks Scott.

Scott Colbert: Thank you, Chris.

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