HAMRICK INVESTMENT COUNSEL LLC

**POLITICAL, ECONOMIC AND CAPITAL MARKETS
REVIEW & OUTLOOK FOR 2020**

- In 2020 we expect political instability in the United States and globally will increase, fostering short-term volatility in the investment markets;
- Economic growth in the U.S. and abroad will continue into 2020 – although at a lackluster rate;
- Continued low interest rates and modest economic growth will support positive returns on stocks; however, a negative geopolitical, economic, or environmental event would exacerbate instability and undermine market returns.

Political Considerations

In the political arena, on both the domestic U.S. and global levels, U.S. President Donald Trump has continued to dominate the headlines. To be sure, vital issues around the world abound. We witness the ongoing drama of "Brexit" – Great Britain's prospective departure from the European Union. Mass protests in Hong Kong, Europe, South America and elsewhere proliferate. Military conflict in the Middle East persists. Most recently, the news from that region has been dominated by reports of the targeted killing by the U.S. of Iranian General Soleimani and subsequent Iranian retaliation. Struggles over tariffs and trade – especially between the U.S. and China – drag on, alongside a variety of other concerns. Yet Trump, with his disruptive and combative style, still garners much of the focus.

Within the United States, leaders in the Democratic Party have chosen to focus on impeachment of the President. Setting aside the necessity or success of this effort, it promises to keep Trump front and center on the political stage in 2020, particularly in light of the prospective presidential election in November. All the commentary we see anticipates that the election will be a bitter one. In our view, this attests to a partisan divide in the U.S., of which Trump is more a symptom than the cause, and which transcends his Administration. Trump's provocative style may make his candidacy vulnerable, but as yet we do not see the Democrats rallying around a credible candidate in opposition to him. Despite the political polarity he generates, the economy and markets have been faring reasonably well. In the absence of fundamental change, it appears to us that Trump is headed for reelection.

On the global stage, we believe that Trump's style has been alienating many prominent allies. In light of the ongoing dominance of the United States in global politics and economics, other nations have acceded to his will. Thus the United States has been successful with many of the policies that it has been promulgating. We are concerned, though, about a backlog of distrust or resentment that has been accumulating. Over the longer term, this will diminish the global political leadership of the United States and detract from its economic clout. Similar to the domestic partisan divide in the U.S., Trump may represent more a reflection of this trend than be the cause of it. For the time being, we expect that the United States will retain its global prominence.

The other global political issues we mention speak to a world that is in flux. It now appears that the United Kingdom will decouple from the Eurozone in 2020. We expect that the disruption will be felt most keenly in Great Britain. We think that social instability, such as that currently underway in Hong Kong, is due in part to advances in technology and social media, which facilitate popular uprisings and will probably spread in 2020. Unrest in the Middle East and Latin America looks unlikely to simmer down.

In 2019 the investment markets took most of the political tensions and conflicts in stride. The greatest sensitivity in the markets was connected to the disputes over tariffs and trade between the United States and China. Towards the end of the year, negotiators made some progress on those issues. The U.S. Congress also passed legislation renewing trade relationships between the U.S., Mexico and Canada bringing the investment markets to new all-time highs.

In 2020 we expect political instability in the United States and globally to increase. The course of the investment markets is always uncertain. Nevertheless, following such robust returns in 2019 in the U.S. and foreign markets in both stocks and bonds, we think periodic retreats and short-term volatility over the course of 2020 are likely.

Economic Review and Outlook

Global economic growth slowed in 2019, with the World Bank estimating the full year world GDP growth will come in at 2.6%, down from 3.0% in 2018. Trade tensions and uncertainty created a drop in trade and a slowdown in business spending for the year. Europe ended the second half of the year with low growth of approximately 1%, as well as a trend of increasing unemployment. Meanwhile, U.S. economic growth also slowed in the second half to less than 2%. Asia, while also moderating, was the region responsible for much of the world's overall increase in economic activity. The economies of China and India continue to experience mid-to-high single digit growth.

In this environment the global economy is being driven by four major structural forces: (1) the decline in global trade; (2) ageing populations in developed countries; (3) ultra-low interest rates; and (4) deficit spending.

(1) Continued trade tensions between the world's two largest economies (the U.S. and China) resulted in a decline of global trade in 2019. While serious, we believe this had only a modest negative impact on global economic growth. However, the resulting uncertainty of how these trade disputes will be resolved (including resolution of Brexit) created a slowdown of business spending which likely had a larger negative effect. Trade tensions have escalated and declined over the course of the current U.S. administration and we anticipate no meaningful improvement to U.S. trade policy in 2020. Even in the event of a change of administration, we do not foresee any quick resolution to many of the current areas of dispute in the years ahead, and anticipate that will be a net drag on economic growth for some time.

(2) Ageing demographics in the developed world and China are reshaping societies and economies profoundly. Many countries in Europe as well as Japan have declining populations, while China's working age population fell in 2019. Declining populations in Europe will continue to be a large strain on its economy. Increased nationalism is impeding immigration, resulting in flat or negative population growth and straining the social contract of government entitlement programs. The Dutch are facing a crisis in their social security system, as low interest rates endanger their ability to pay pensioners, while France has witnessed mass demonstrations rejecting even modest changes to its pension system. By comparison the U.S. still has slightly positive population growth, though 2019 had the lowest growth rate in over a century, coming in at +0.5%. In the U.S., the combination of near record low unemployment and policies that have drastically reduced immigration has created a labor shortage that will restrict the economy in 2020.

(3) Much of the world is stuck in a rut of ultra-low (or even negative) interest rates, which has resulted in unintended economic consequences. For decades central bank policy was focused on the effects of *changes* in rates, and little consideration was given to the long-term effects of their absolute value. Academics have paid increasing attention to the

connection between economic growth and ultra-low interest rates. In short, very low interest rates allow business models with poor economic prospects to succeed by means of cheap financing. These same businesses then create poor future economic returns, structurally reducing economic vitality. Aside from technology firms (which have little capital and borrowing needs), there are now signs that this economic constraint has taken place in Japan, Europe and the U.S.

(4) The last driver of the global economy we highlight is that much of the current growth is coming from governmental deficit spending (nations spending more than their revenues). Fueled by the recent tax cuts, U.S. deficit spending reached nearly $1 trillion in 2019. Globally, when accounting for local government debt across the G20 nations, growth would have contracted without deficit spending. As alarming as this may seem, this has occurred many times in modern history. We believe that in the near term, there will not be negative consequences from the increased governmental debt burden, and government spending will be a source of economic stability in 2020. Beyond 10 to 15 years, however, the situation may become untenable for some developed countries.

The global economy is not constituted only by negative developments. India continues to see robust growth. China's "Silk Road" project of connecting Asia via roads and rails is beginning to see real economic benefits. Across Asia and Africa, many emerging market countries are experiencing increased stability and growth. Millions of people in 2nd and 3rd world countries are rising out of poverty and moving into the middle class.

Closer to home, consumer spending comprises over 70% of economic activity in the U.S. Wage growth accelerated in 2019. Particularly positive for the economy were the most recent 4.7% real wage gains for the bottom quartile of income earners, who spend their wages rather than save. Wage gains should continue to drive the U.S. economy forward in 2020, offsetting continued weakness in trade and business investment.

Looking ahead, we predict that 2020 will be another year of modest GDP growth in the U.S., of 2% or lower. We do not, however, forecast a recession in the year ahead.

2019 Investment Markets Review

2019 was a robust year in the investment markets. Stocks in both U.S. markets and around the world had extraordinary gains. At year end, the Standard & Poor's 500 Index posted total return of 31.5%. The MSCI EAFE Index of international stock markets reported a solid 22.6**%** gain.

Returns on fixed income investments – while not as high as those on equities – were still strong. The Bloomberg Barclays U.S. Aggregate Total Bond Index was up 8.7%. Returns on bonds in international markets were even higher. The Thomson U.S. Average Balanced Fund index,

which represents a mix of stock and bond investments and includes some global diversification, was up 18.6**%** at year end.

These high returns are somewhat deceptive, since they followed sharp market declines in the fourth quarter of 2018. Most of the return in the U.S. equity markets in the first three quarters of 2019 was simply a rebound from that sharp sell-off. At the end of the third quarter, however, the stocks began climbing and maintained that trend through year end. Bonds, in contrast, sold off then quickly recovered in the fourth quarter of 2018, and then posted more or less steady gains through the first three quarters of 2019. Returns on bonds in the fourth quarter of 2019 were muted. If we look back over the 15-month period, returns on both stocks and bonds were still high, but less dramatically so than for the calendar year.

In our view, the action in the investment markets was primarily attributable to two factors. In the fourth quarter of 2018, the markets appeared to sell off in response to fears of the trade dispute between the U.S. and China. Then, in light of prospective economic weakness that trade conflict could generate, the U.S. Federal Reserve Bank reversed its policy of increasing short term interest rates and lowered them three times over the course of 2019. This helped alleviate fears of economic recession and boosted market values of both stocks and bonds. While economic growth remained modestly positive over the course of the year, stock prices mounted considerably higher. With interest rates held well below 2% on the 10-year U.S. Treasury, investors were left with little alternative other than to buy stocks.

Investment Markets Outlook & Strategy

In 2020 we anticipate interest rates will be little changed. In the continued ultra-low interest rate environment, we believe that stock valuations (and subsequently stock prices) will have a large bias toward moving higher. Despite the somewhat sluggish economic environment outlined in our economic forecast, we believe that the modest economic growth, combined with low interest rates, will be enough to fuel positive stock and bond returns in the year ahead. Following such high returns in 2019, we expect that returns will be muted.

However, our outlook is hedged. In 2020 we may see a surprise geopolitical or economic event that will have larger economic and investment market implications than the relative tranquility of 2019. The challenge with an economy running at nearly full steam and already supported by low interest rates is that few tools remain to prevent or mitigate the next downturn. Further, low interest rates act as a magnifier, both up and down, to investment market performance.

Strategically, we look to address this bifurcated outlook in several ways:

(1) With regard to stock investments, in the developed nations we favor companies that have healthy balance sheets and avoid those with the loftiest valuations.

(2) We see the greatest growth opportunity for stocks of companies in emerging markets.

(3) In the fixed income markets, we see the stable economic environment as an opportunity to invest in higher yielding corporate bonds. We also advocate holding a portion of a portfolio's bond allocation in foreign bonds for the diversification benefits.

(4) With respect to the possibility of increased volatility due to low interest rates, opportunities to rebalance accounts more frequently than normal may arise.

The year ahead will surely be a tumultuous political one for the U.S. and the world, and probably a volatile one in the investment markets. However, it follows several years of high returns for investors. In that context, we believe that 2020 may be a good time for investors to take advantage of some of the wealth that has accumulated – to make use of it and to be generous, to ourselves, to our families and friends, to our communities and others. In a world of perpetually uncertain returns on investments, we believe that the value of such generosity is assured.

Roy A. Hamrick, CFA
Portfolio Manager & Strategist

Todd M. Wathey, CFA, MBA, CFP®
Portfolio Manager & Director of Operations

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