Confluence INVESTMENT MANAGEMENT

Current Perspectives

By Bill O'Grady and Mark Keller

2020 Outlook: Storm Watch

Summary – The Base Case:

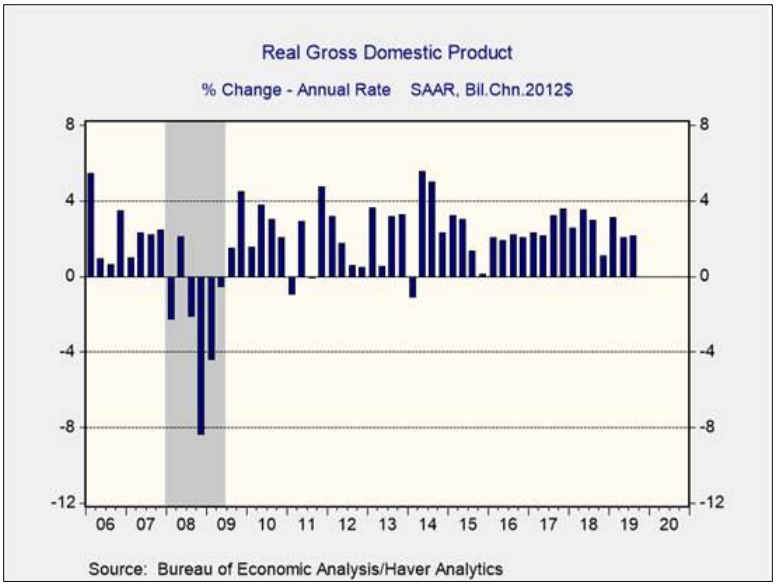
1. Economy grows at 1.5%; consumption has become the primary driver of growth.
2. Expansion continues to set new records for duration; no recession is our base case in 2020, although there are increasing risks of a downturn.
3. Core inflation max is 2.5% next year.
4. Dollar weakens, although the direction is mostly dependent on administration trade policy. We expect preparations for the 2020 elections will lead to a less aggressive trade policy.
5. S&P 500 earnings for 2020 will be $174.91 on a Thomson/Reuters basis (6.00% of GDP).
6. Assuming a P/E of 19.3x, using the S&P earnings projection, our expectation for the S&P 500 is 3375.76.
7. We expect some improvement in the lower capitalization areas of the equity markets, tempered by slower economic growth.
8. Growth has greatly outperformed value in recent years, a trend that has been mostly driven by multiple expansion. While we are expecting only a modest multiple expansion next year, continued outperformance by growth stocks is probable. This long period of outperformance, however, is likely nearing its end. Given the difficulty of timing such a transition, we recommend a balanced position in value/growth.
9. International will benefit if our assumption that the dollar weakens is correct.
10. We expect mostly steady monetary policy next year.
11. We expect the 10-year yield to peak at 2.25% next year, with a range of 1.70% to 2.25%.
12. Investment-grade bond spreads should stabilize; we believe high-yield bonds are overvalued and no more than a benchmark weighting is justified.
13. Despite a weaker dollar, commodities will likely struggle due to slow global growth.

Risks to the Forecast:

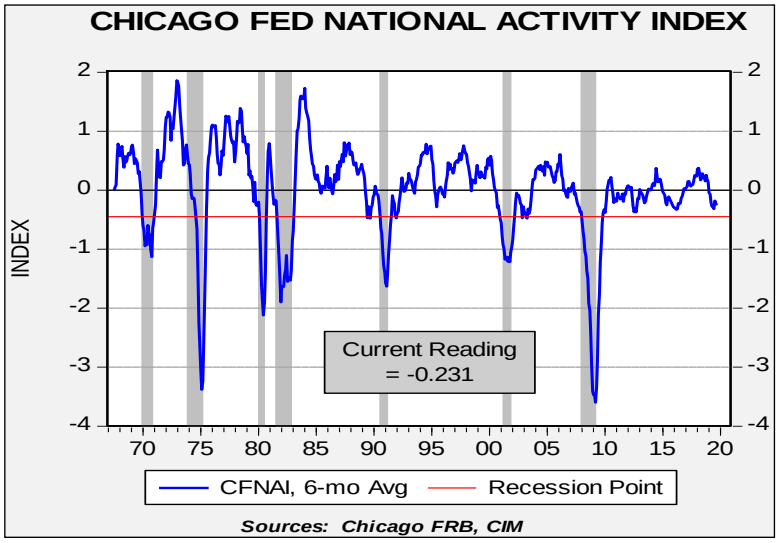
1. ***Primary risk – Recession:*** The Federal Reserve has lowered rates recently and this action may bring us a soft landing. However, recession risks are elevated. We provide market risk parameters below should a recession occur.
2. ***Secondary risk – Election:*** Election years add an element of uncertainty to investment. This year's election is fraught with potential risk.
3. ***Secondary risk – Melt-up:*** Ample liquidity, accommodative monetary policy and fairly valued equity markets could trigger a sharp rise in equity prices, especially if the markets become comfortable with the idea that the Fed has engineered a soft landing. Under this scenario, we provide possible upside parameters below.

The Economy

Our base case for the economy is that the expansion continues but GDP growth will slow to a range of 1.0% to 1.5% in 2020. Growth at this pace is often referred to as "stall speed," which increases the odds of recession. We discuss the impact of recession below; the odds of a downturn are elevated but, for now, there is still a better chance that we avoid a recession in 2020 than not. However, the "spread" has narrowed. We think the odds of recession are 30%, which isn't certainty, but it is elevated.



This next chart shows one of our favorite indicators, the Chicago FRB's National Activity Index. It is a broad-based index that measures the performance of the economy against trend. As the below table shows, this expansion has been rather sluggish.

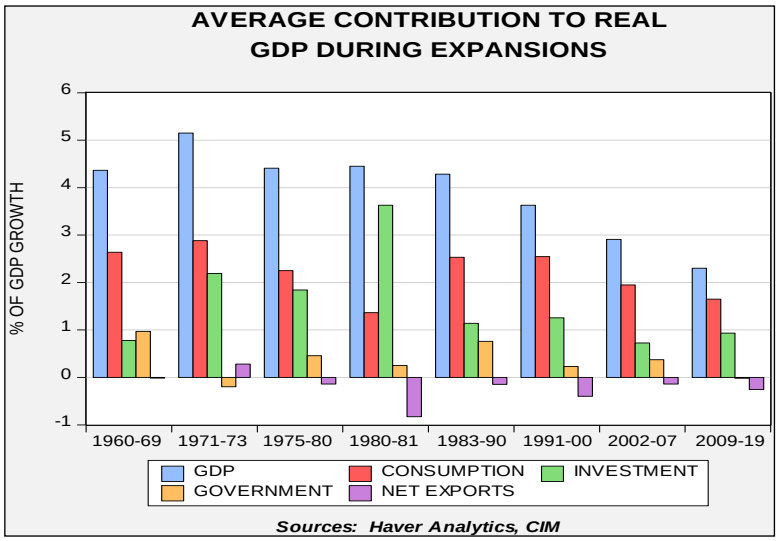


Expansion	Average
1970-73	0.794352
1975-80	0.479167
1980-81	-0.145
1981-90	0.344946
1991-2001	0.159819
2001-07	0.000502
2009-	-0.09993

Although the reading for the current expansion is not the lowest, the 1980-81 expansion was very short and thus not representative of a normal post-recession period. The current expansion is, on average, below trend for the economy. Consistent with the GDP chart below, we have seen a steady decline in the strength of expansions. Slower growth has arguably led to longer expansions; because growth remains near or below trend, bottlenecks rarely develop and inflation remains tame. Without rising inflation, the Federal Reserve has been able to avoid overtightening, reducing the odds of a downturn, which supports longer expansions.

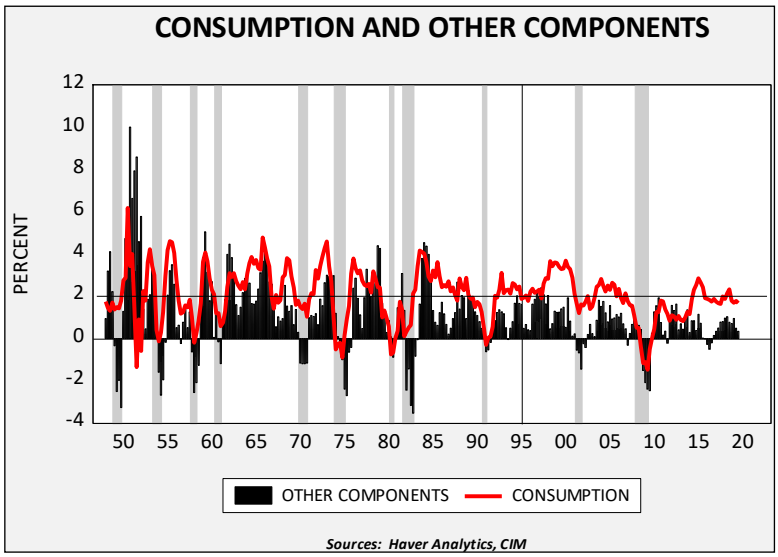
The GDP data confirms this situation. The four components of GDP are consumption, investment, net exports and government purchases.

This chart shows the average GDP and component contribution over the business cycle for the past seven expansions. The current expansion, the longest in our history and the weakest in this series, with GDP averaging 2.3% growth, also has the unusual characteristic of negative contributions from both government spending and net exports. Consumption has also averaged below 2%, the second weakest in this series. Only the 1980-81 expansion had weaker consumption and that expansion was so short it probably isn't representative.



As a general statement, the U.S. economy is heavily dependent on consumption. Although recessions have occurred when consumption has remained positive, these are rare. At the same time, any reading of consumption under 2% increases the odds of a downturn.

This chart looks at the four-quarter average contribution to real GDP from consumption and the other three components. The data shows that recessions rarely occur when the contribution from consumption is running at 2% or above. The only instance was the 1953 recession which was tied to the demobilization from the Korean War. The other three components—investment, net exports and government spending—rarely trigger a recession if consumption is above 2%. The other observation we can make is that the depth of the recession is mostly a function of the decline in consumption. Deep recessions (1973-75, the early 1980s, 2007-09) were characterized by significant declines in consumption. The 1990-91 recession, which is usually considered to be a mild one, was somewhat unusual in that it had a period of negative consumption. In that downturn, the other components fell by a modest amount.

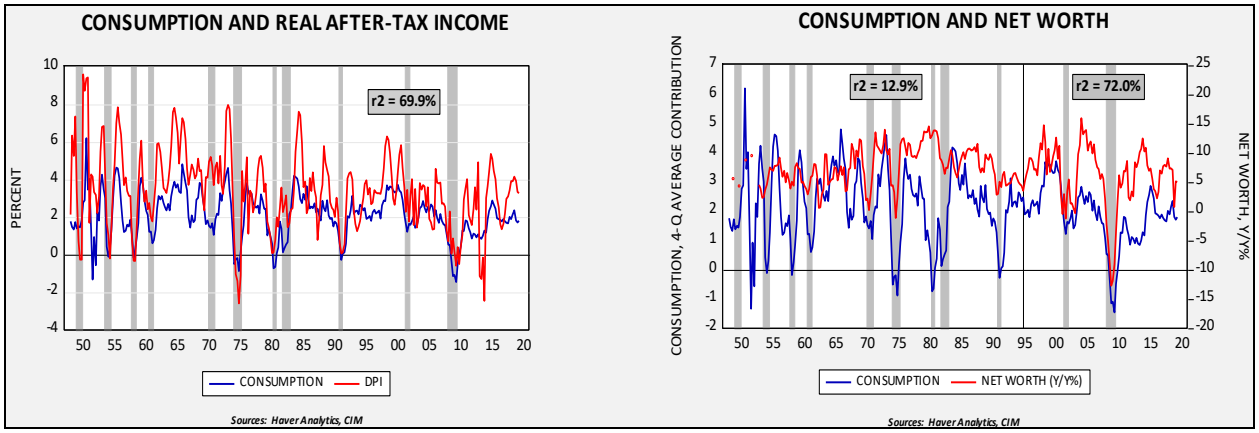


We have placed a vertical line at 1995. The table below shows the contribution of consumption and the rest of GDP during the entire period, along with the averages for expansions and recessions.

	1947-94			1995-Present		
	Consumption	Non-Consumption		Consumption	Non-Consumption	
ALL	2.17	1.43		1.84	0.66	
NON-RECESSION	2.50	1.93		2.00	0.81	
RECESSION	0.62	(1.02)		0.15	(0.77)	

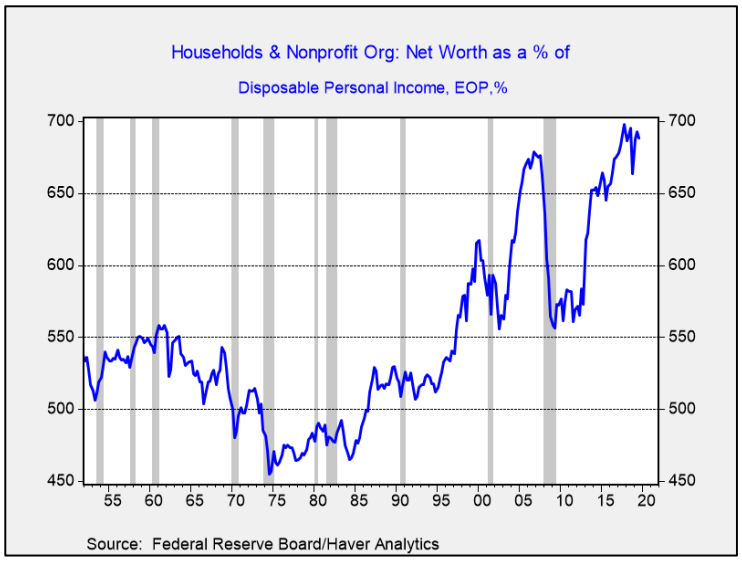
Since 1995, growth has clearly slowed; also, since 1995, the average decline in consumption during recessions is rather large. The table highlights the impact of consumption on growth, showing that the economy has become increasingly dependent on consumption for growth.

So, if consumption dominates GDP, what drives consumption? There are two obvious candidates, income and wealth. The chart below shows our consumption measure along with real after-tax income. As one would expect, the two variables are closely correlated. The yearly change in household net worth had a low correlation until 1995, when the correlation rose sharply. In other words, consumption has become increasingly sensitive to household balance sheets.



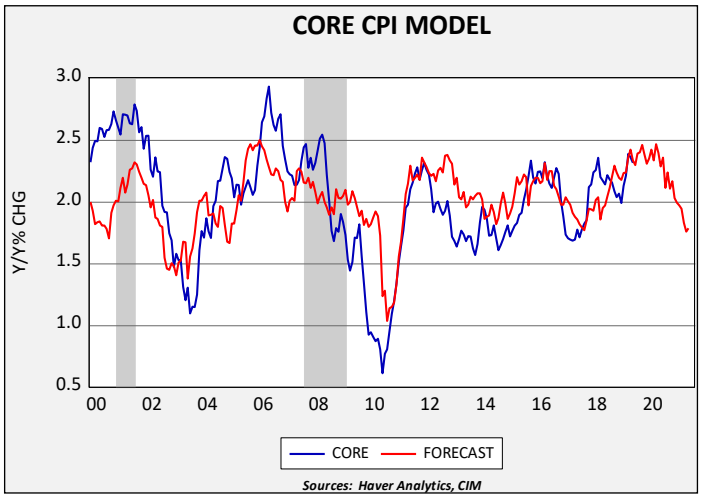
Another way of looking at the rising impact of asset prices is to compare net worth to after-tax income.

From the end of WWII into 1995, the ratio of household net worth to after-tax income ranged between 4.5x to 5.5x. Since 1995, the ratio has increased notably with two recent peaks, one before the tech bubble in early 2000 and another with the housing bubble in 2005-07. Asset values have been rising faster than liabilities since 2012, mostly due to actions by the Federal Reserve to lift growth after the 2008 Financial Crisis. To some extent, given the rising sensitivity of consumption to the financial markets, avoiding a recession may hinge on dodging a major decline in household assets, primarily stocks and real estate.



Given our expectations for weak growth, inflation should remain benign as well. A simple model that forecasts core CPI using the manufacturing ISM index suggests that it will average around 2.3% next year.

This level won't be enough to raise inflation fears at the Federal Reserve, but it is probably elevated enough to prevent aggressive rate cuts absent clear evidence of a recession.



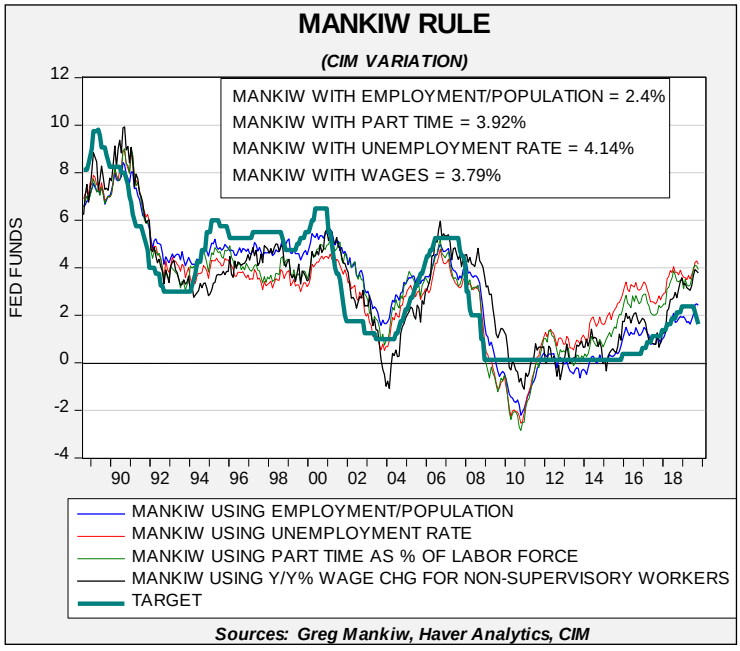
Interest Rates

Our take on long-term Treasury rates is that most of the movement can be explained by the policy rates and inflation expectations. Policy rates are fairly easy to project; inflation expectations are another matter altogether. Milton Friedman postulated that inflation expectations are established over a lifetime of experience. As a proxy, we use the 15-year average of the yearly change in CPI for inflation expectations. As we note below in the long-duration Treasury model discussion, we also add an international dimension with the yen's exchange rate and German Bund yields, along with U.S. deficit data. But, the most important elements are the policy rate and inflation expectations.

There are two ways to project the policy rate—what the economic models indicate and what the financial markets think. The former is important because many members of the FOMC use such models in developing their recommendations for the policy rate.

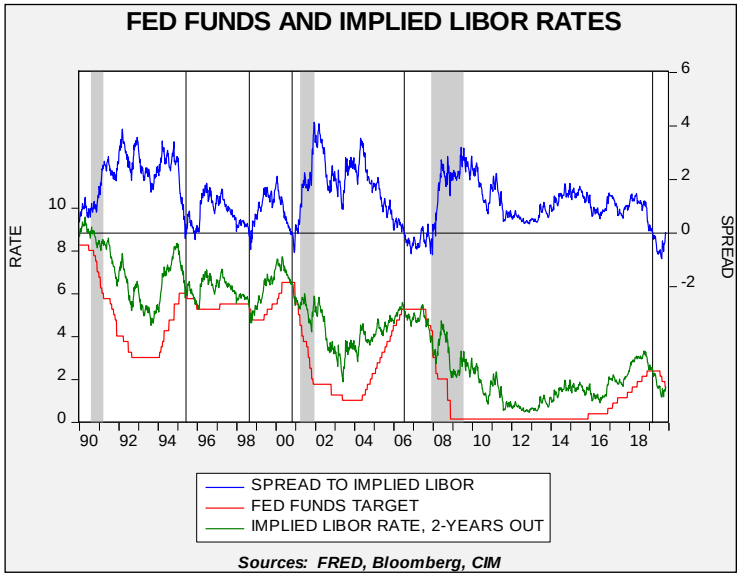
The primary model the FOMC uses to set policy rates is a form of the Taylor Rule. The Taylor Rule is designed to calculate the neutral policy rate given core inflation and the measure of slack in the economy. John Taylor measured slack using the difference between actual GDP and potential GDP. The Taylor Rule assumes that the Fed should have an inflation target in its policy and should try to generate enough economic activity to maintain an economy near full utilization. The rule will generate an estimate of the neutral policy rate; in theory, if the current fed funds target is below the calculated rate, the central bank should raise rates. Greg Mankiw, a former chairman of the Council of Economic Advisers in the Bush White House and current Harvard professor, developed a similar measure that substitutes the unemployment rate for the difficult-to-observe potential GDP measure.

We have taken the original Mankiw Rule and created three other variations. Specifically, our models use core CPI and either the unemployment rate, the employment/population ratio, involuntary part-time employment or yearly wage growth for non-supervisory workers. All four compare inflation and some measure of slack.

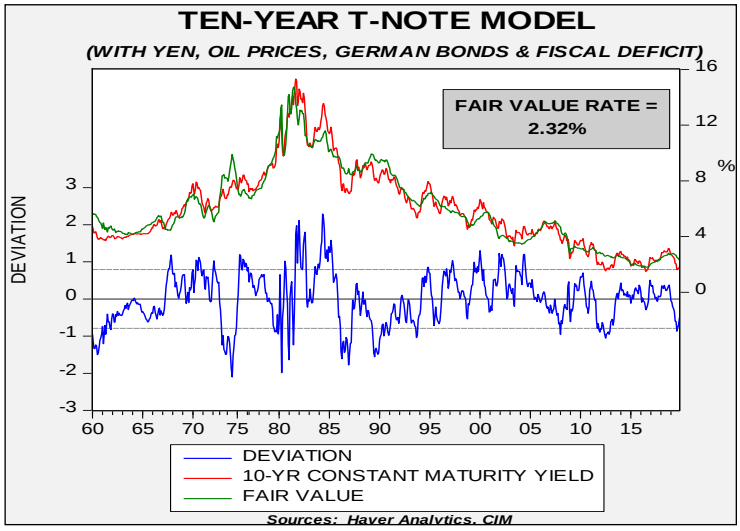


All of the model variations suggest the current level of the fed funds target is too low. For most of 2019, the variation based on the employment/population ratio did signal that policy was too tight. However, recent cuts and a rising ratio have even pushed that variation to signal policy is easy.

On the other hand, the financial markets are suggesting the current policy rate is about right.



This chart shows the fed funds target compared to the implied three-month LIBOR rate from the two-year deferred Eurodollar futures contract. The latter rate indicates expectations for the short-term LIBOR rate, two-years into the future. The spread between the two series is the upper line of the chart. The gray areas show recessions, whereas the vertical black lines show inversions of the spread. In general, when the spread is negative, it suggests the financial markets think policy is too tight. Under the Greenspan Fed, the spread inverted three times and each time the U.S. central bank moved to cut rates. The U.S. avoided recession in two of those three easing cycles. The current rate-cutting cycle appears to be modeled after the 1995 cycle, although the Powell Fed initially was less aggressive than the Greenspan Fed. However, the Powell Fed has moved to eliminate the inversion, which improves the odds that a recession may be avoided.

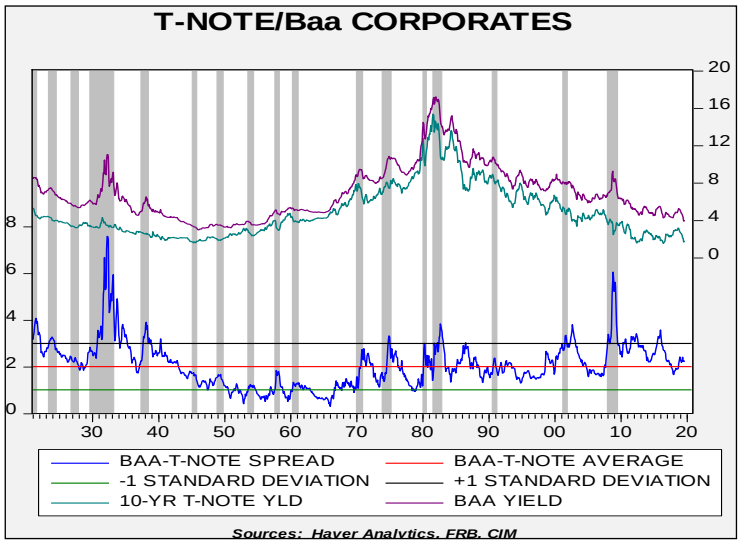


This chart shows our 10-year T-note yield model. It uses fed funds, the 15-year average of CPI, the JPY exchange rate, oil prices, the yield on German 10-year Bunds and the fiscal deficit as a percentage of GDP. The current fair value yield is 2.32%, well above the current yield. Holding all the variables constant except for fed funds, the current 10-year T-note yield is consistent with a zero-interest rate. If we hold fed funds steady and adjust for inflation expectations, the current T-note yield is consistent with 1% inflation. Finally, holding all the variables constant but adjusting the German Bund yield, the current yield is consistent with a -3.80% German Bund.

All of these outcomes are consistent with recession somewhere. It is possible that investors are concerned about a deep recession abroad. But, the longer a recession is avoided the more likely it is that we will see a backup in long-duration Treasuries. However, it should also be noted that even if a recession occurs, significant declines in long-duration yields below the 2019 lows are unlikely.

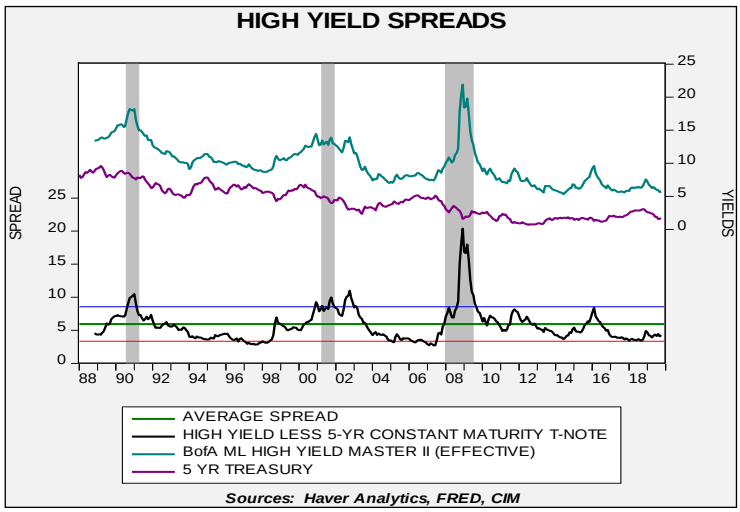
With regard to credit, investment-grade spreads are modestly above their long-term average.

Although there is a case to be made that the Treasury market has already discounted a downturn, there isn't any evidence of similar concerns in the investment-grade market. As the chart shows, during recessions, financial stress tends to widen credit spreads. The fact that overall yields have declined without a serious deterioration of credit does indicate that there is the potential for deterioration in credit if a recession develops.



High yield is showing a degree of overvaluation.

High yield spreads are below average, suggesting there is a risk of major widening if a recession develops.

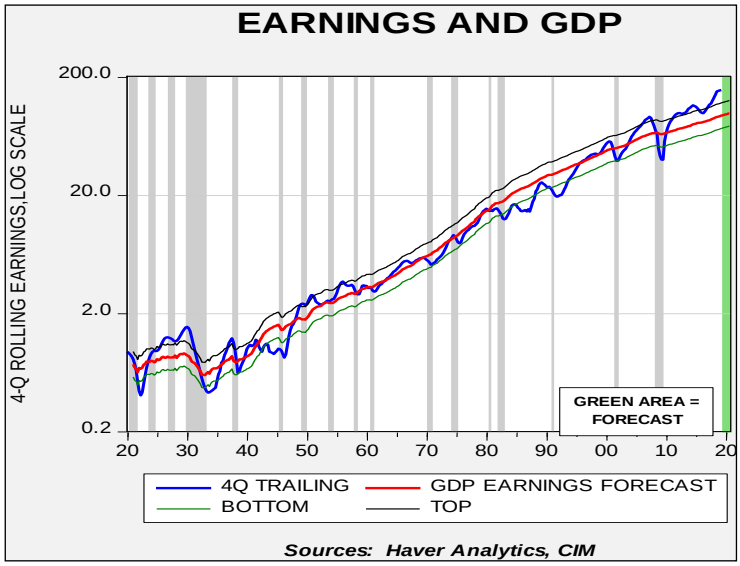


Equity Markets

To simplify matters, we focus our forecasting efforts on the S&P 500 and use that as a guide for other equity areas, e.g., capitalization and international. To forecast the S&P, we begin by forecasting earnings. After that, we forecast the multiple.

During this expansion, earnings have outpaced GDP.

On this chart, we regress S&P 500 per-share earnings against nominal GDP. The red line on the chart shows how much of earnings has likely come from overall economic activity. When the blue line is above the red line, there has been margin expansion, while a reading under the red line suggests the opposite. Margins are historically rich;

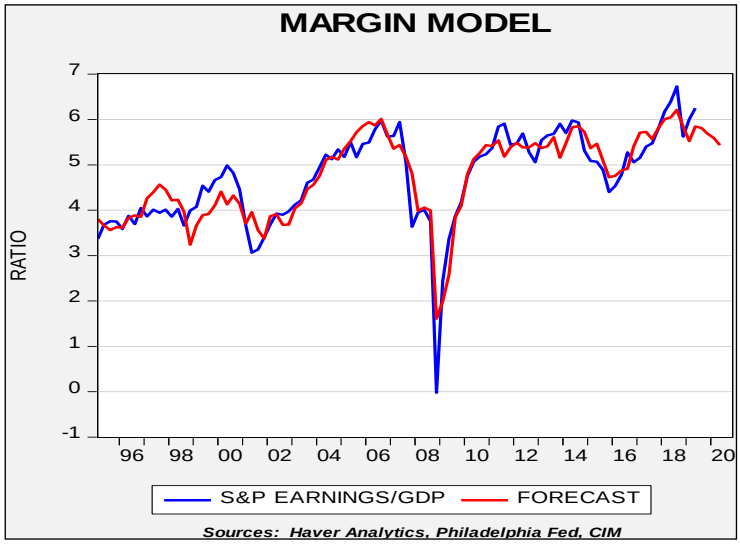


in most cases, when margins are this extended, they tend to fall to one standard error below the red line during recessions. By Q4 2020, the GDP level of earnings would be $98.69 for the S&P 500 (rolling four-quarter level of per-share earnings).

To actually forecast the level of earnings, we use the percentage of total (not per share) S&P earnings compared to GDP.

This chart looks at total S&P 500 earnings as a percentage of GDP. From 1980 into the mid-1990s, the percent ranged between 2.0% and 3.5%. It has risen since then but with much more volatility. We model this relationship since 1995.

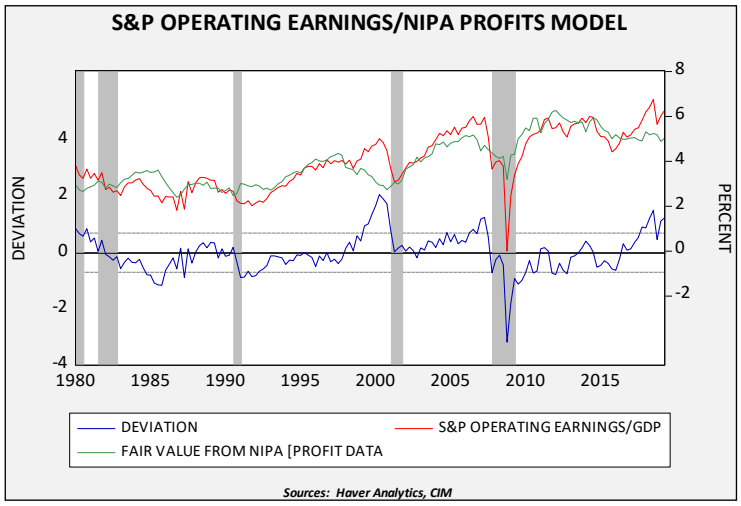
The forecast is based on a model that includes a number of variables, including oil prices, the dollar, net exports, unit labor costs, the relationship of input to export costs and profits from the National Income and Product Accounts (NIPA), the process that generates GDP.



Given our forecast for GDP next year, that would generate a year-end S&P 500 earnings per share of $158.04.[1] However, there is an important factor that may boost earnings above this model's projection.

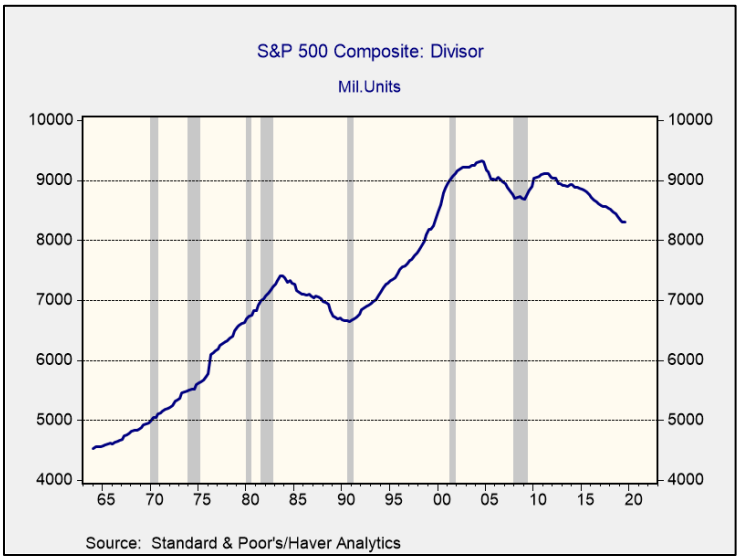
[1] We do our forecasting on operating earnings data from Standard and Poor's. The industry increasingly uses operating earnings data from Thomson/Reuters, the owner of the I/B/E/S service that monitors earnings forecasts. In our research, the Thomson/Reuters data runs about 7% higher than the data from Standard and Poor's. The value quoted above reflects an adjustment to be consistent with Thomson/Reuters.

This chart forecasts S&P 500 operating earnings relative to GDP with the National Income and Product Accounts (NIPA) profit data (after-tax profits with depreciation and inventory valuation adjustment) also scaled to GDP. In the last two business cycles, the deviation line rose well above fair value late in the cycle. In these two episodes, the first move above upper standard error line occurred three to four quarters before the peak spread in S&P earnings compared to the NIPA model. The recession tended to start six to seven quarters after the first breach of the upper line and S&P earnings didn't return to fair value for one to two years. Although we are late in this indicator's cycle, if a recession is avoided, S&P 500 earnings will likely exceed what the NIPA profits data would suggest is normal. If so, S&P 500 earnings will remain elevated.



The deviation in the last two recessions would suggest that the quality of S&P earnings likely deteriorated and were "cleaned up" during the recession. **If a recession is avoided, we would expect 2020 operating earnings, relative to GDP, to be closer to 6%, or a per-share earnings number of $174.91.**[2]

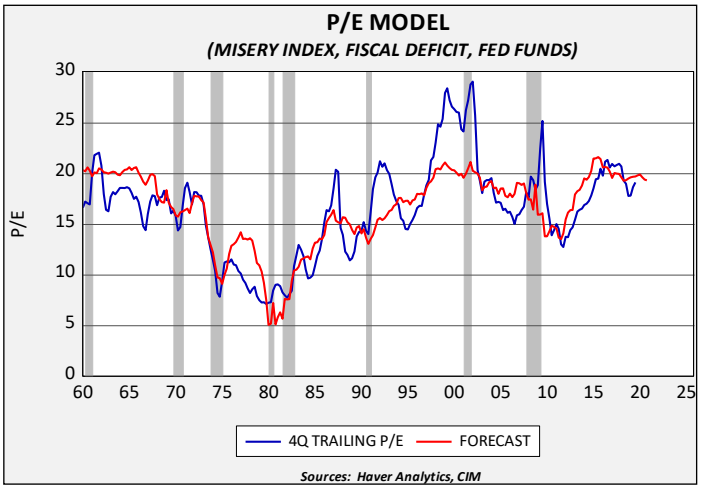
One area that is difficult to forecast in order to calculate earnings per share is the divisor, which is adjusted for mergers, share buybacks, share issuance and changes in the index. The per-share calculation is generated by the divisor.



From 1990 into 2004 the divisor rose as firms tended to issue stock in this period. But, since peaking in 2004, the divisor has steadily declined (with a modest rise after the 2007-09 recession) as buyback activity increased. The lower divisor, all else held equal, tends to increase the per-share calculation. **If the divisor continues its decline, our per-share forecast is overly pessimistic.**

With an estimate of earnings per share, the next step is to divine the multiple.

[2] Using Thomson/Reuters S&P 500 earnings calculations.

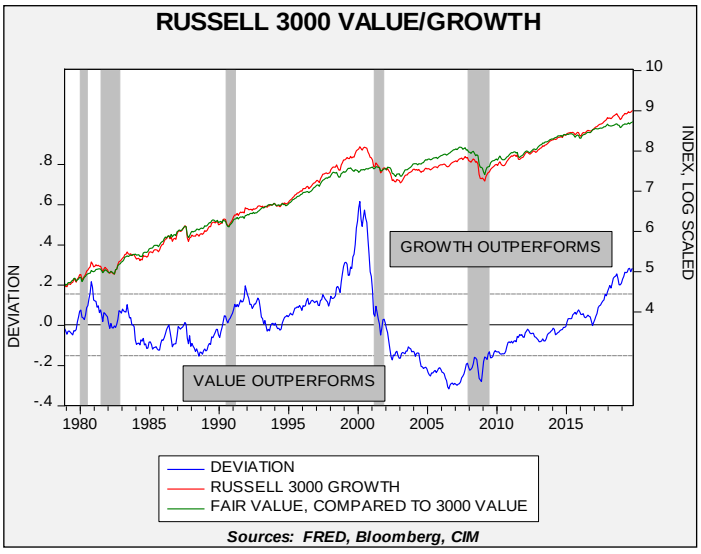


This model uses the misery index (unemployment plus yearly CPI), fed funds and the fiscal deficit as a percentage of GDP. It is projecting a P/E of 19.3x by the end of 2020. **Assuming our S&P operating earnings forecast of $174.91 and the above multiple, our forecast for the S&P 500 for next year is 3375.76.**

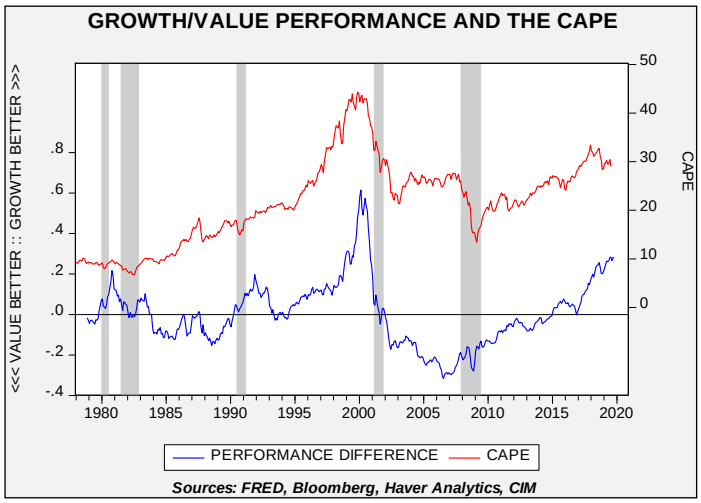
Value/Growth

Since 2017, growth has tended to outperform value.

This chart shows a relative performance model of growth and value. Value peaked in 2006 and has been steadily losing to growth ever since, although it should be noted the rise came with value holding a steep advantage. Based on this model, the relative valuation of growth stocks didn't become extreme until early 2018.



In general, the factor that drives the growth/value relationship is the P/E. We use the Shiller CAPE, which deflates and averages earnings over a decade for the "E" in the ratio.[3] Although there is growing speculation that value is going to gain on growth, a significant reversal will likely require a recession. At a minimum, a serious level of multiple contraction would be needed to reverse to favor value. At the same time, we are expecting a mostly stable P/E which will likely lead to a steady ratio in 2020.

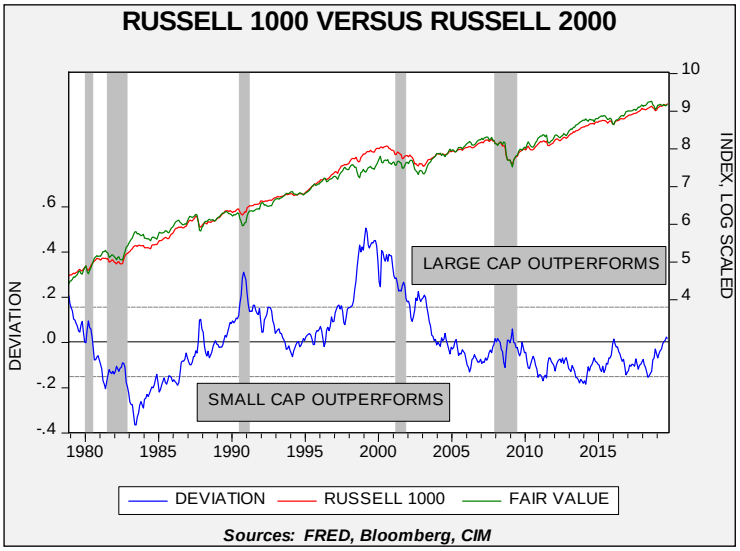


[3] The idea behind that calculation is to smooth out earnings to give investors a better idea of the current market valuation using the trend in earnings. However, the calculation is being distorted because the sharp decline in

Capitalization

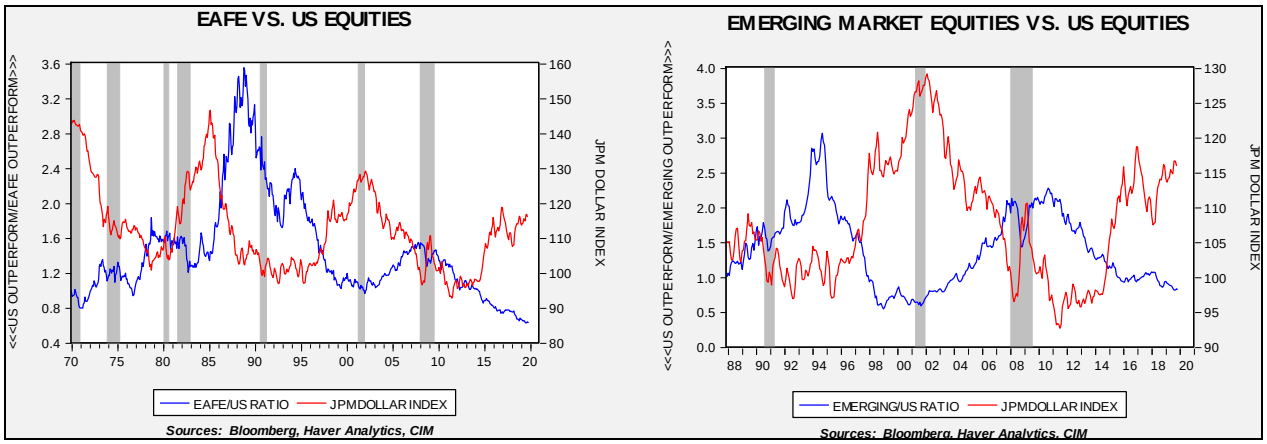
Large capitalization stocks have been outperforming small caps since the middle of last year.

This chart shows a simple regression of the Russell 1000 compared to the Russell 2000. Since the middle of the last decade, small caps have shown some modest outperformance relative to history, although the divergence isn't all that significant. However, we have seen large caps do better since mid-2019 and, based on this model, are now about at a normal level. In general, a rising P/E tends to support large caps, whereas there is an inverse correlation with fed funds. So, easier monetary policy tends to favor small capitalization stocks. Accordingly, for next year, we are looking for only modest multiple expansion and a higher probability of easing than not, which would tend to modestly favor small caps.



International

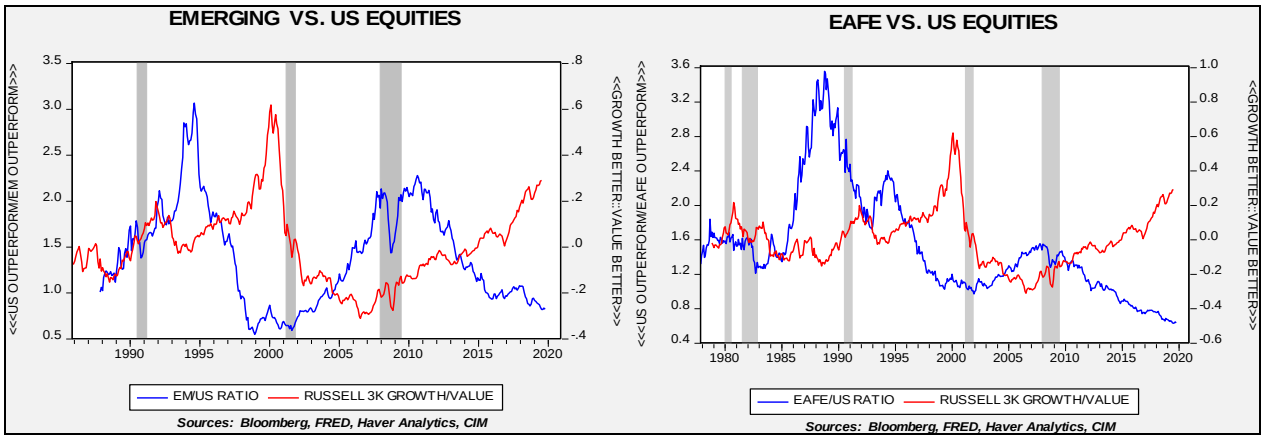
International stocks have lagged domestic equities for most of this expansion. Although valuations are attractive, there are two catalysts that would likely lead to foreign outperformance. First, the dollar needs to weaken.



On both charts, a rising blue line means foreign markets are outperforming. Note that U.S. equities tend to outperform during periods of dollar strength. We discuss the dollar in detail below, but valuation and policy all point to future weakness.

The second factor is growth versus value. U.S. stock indices tend to be weighted toward growth, while foreign indices are weighted toward value. Thus, the current outperformance of growth has also affected the relative performance of international compared to the U.S.

earnings tied to the 2008 Financial Crisis is now rolling off, leading to a decline in the ratio that probably doesn't accurately reflect improving valuations.



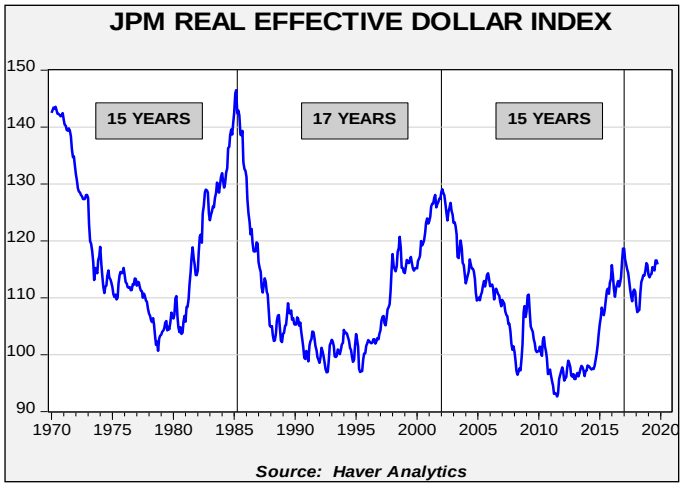
As with the above chart, a rising blue line indicates foreign outperformance and a rising red line shows growth outperformance. In general, when growth outperforms value, domestic outperforms international. We discussed the growth/value issue above; as with the dollar, a catalyst to bring value back into favor, such as a recession or multiple contraction, is probably necessary. Interestingly enough, the last peak in the dollar coincided with the reversal in the growth/value relationship. Until a catalyst triggers a reversal in the dollar and the growth/value relationship, U.S. stocks will likely continue to outperform. However, investors should be prepared to build international positions in the coming year.

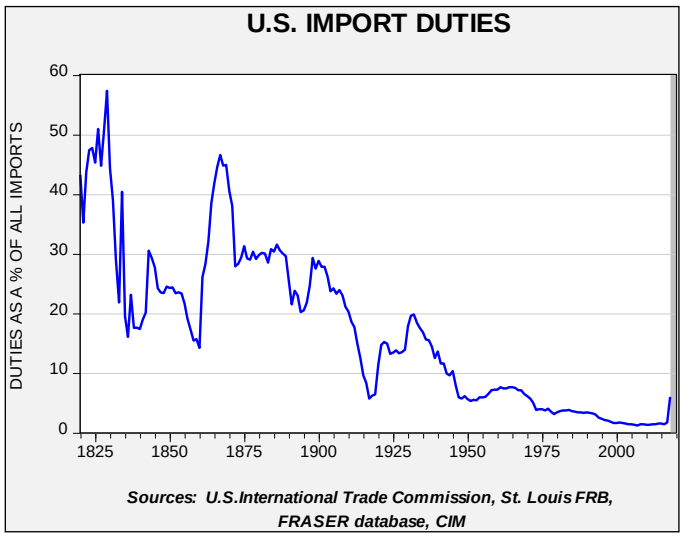
The Dollar and Gold

Since the dollar began to float in 1971, the currency's cycle from peak-to-peak has generally been between 15 to 17 years.

The dollar seemed to be following its history, peaking in early 2017 and falling steadily into early 2018. However, the administration's decision to pursue tariffs reversed the downtrend; although we haven't made new highs, the rally in the dollar has been impressive.

So, why did tariffs matter?



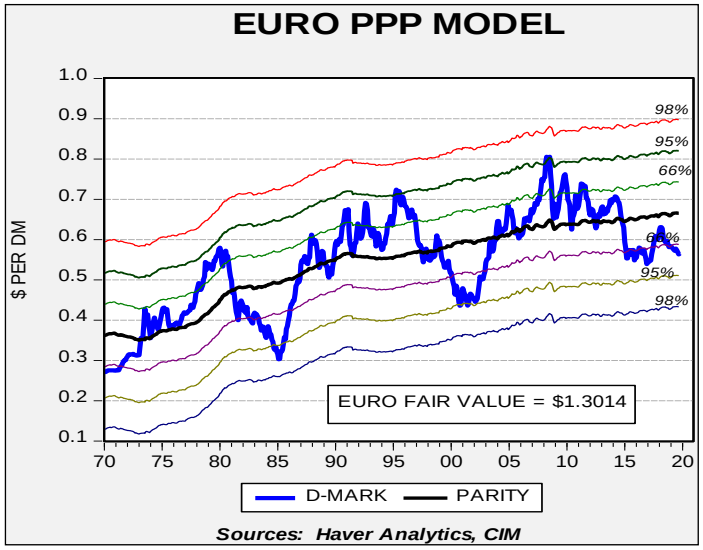


The chart to the left shows U.S. import duties as a percentage of all imports. The last time the U.S. aggressively implemented tariffs was in the 1920s, culminating in the Smoot-Hawley Tariff Act in March 1930. The implementation of this tariff became a narrative to explain the cause of the Great Depression. Although that narrative was overly narrow, tariffs clearly fell out of favor after the Depression. The U.S. model of hegemony was based on steadily freer trade, using the dollar as the reserve currency. There was another important element to the decline in tariffs: they are less effective with floating exchange rates. Under fixed exchange rates, tariffs cannot be easily offset by the

exporting nation. But, under floating rates, if a nation increases tariffs then the exporter merely allows its currency to weaken, offsetting some or all of the tariff. When we estimate the impact of the current level of tariffs, the bounce in the dollar is justifiable.

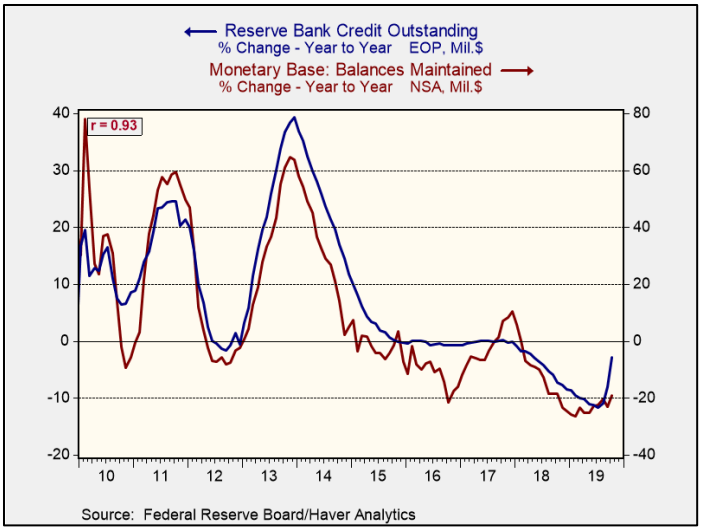
On a valuation basis, we believe the dollar is overvalued. The oldest valuation model is purchasing power parity, which values currencies on the basis of relative inflation. A nation with higher inflation will tend to have a weaker exchange rate. Against nearly all the major currencies, the dollar is overvalued. The chart below shows the dollar/euro relationship using German/ U.S. CPI.

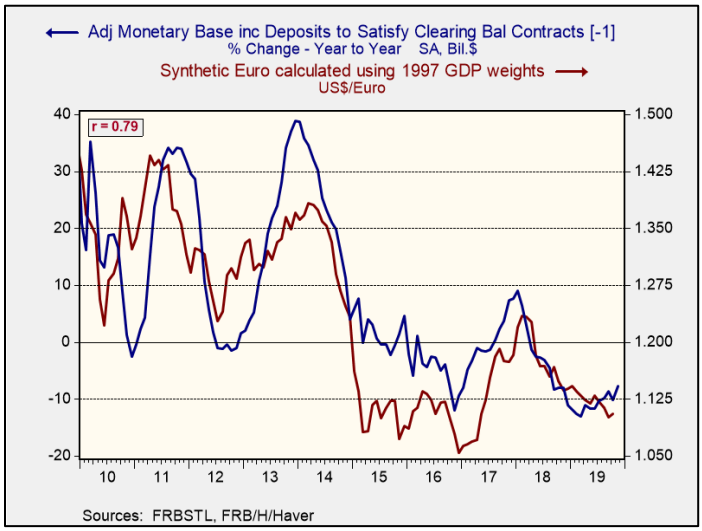
The current fair value for the euro, based on this model, is $1.3014.



A second factor that could weaken the dollar next year is the recent decision by the Federal Reserve to inject liquidity into the banking system. Last September, short-term repo rates spiked due to a lack of liquidity in the financial system. The Fed has responded by aggressively boosting available liquidity; this increase in liquidity will eventually increase the monetary base.

Since 2010, an increasing growth rate in the monetary base has led to a stronger euro.



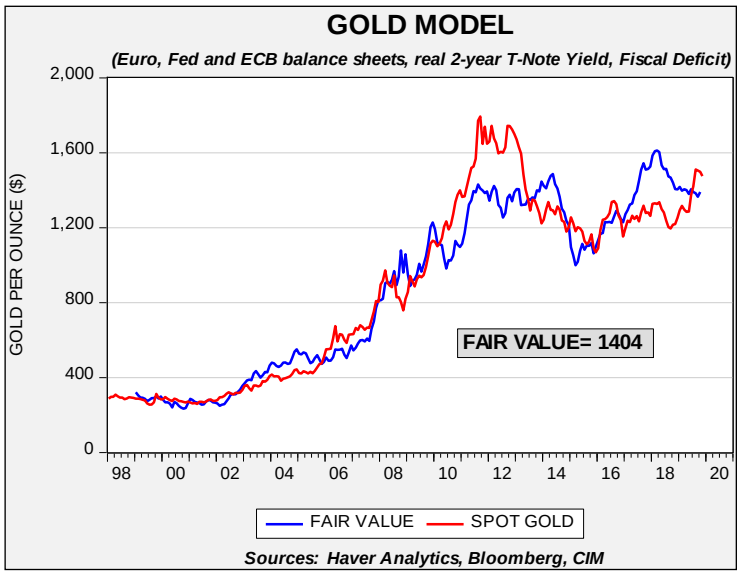


As monetary base growth increases, we should see the euro strengthen in the coming months.

Although gold is usually considered a commodity, in reality, it is more like a non-liability backed currency. In terms of the three functions of money, it has little use as a medium of exchange or as a numeraire, but it does act as a store of value. Our valuation analysis suggests gold has gotten a bit ahead of itself recently, but its longer-term outlook is favorable.

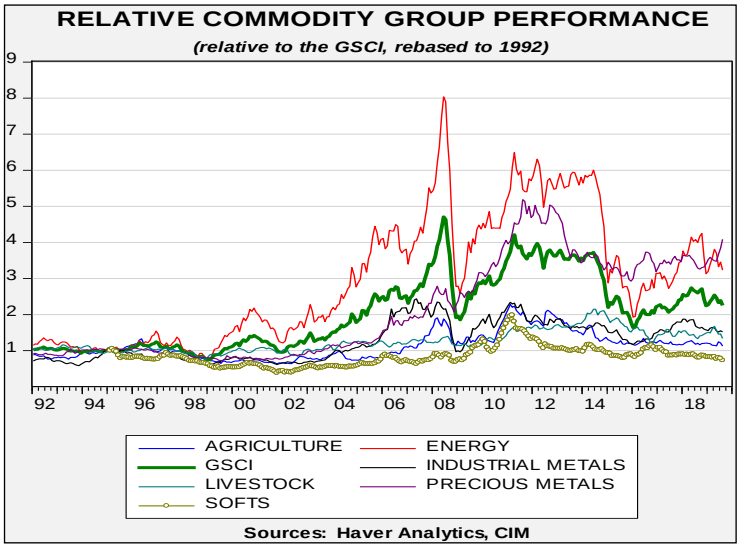
Our short-run model suggests gold is overvalued.

However, all the variables in the model point to higher future prices. The ECB and the Federal Reserve are increasing their balance sheets; easier monetary policy should reduce real two-year Treasury yields and the fiscal deficit is set to widen. If gold prices hold near current levels, the valuation issue will likely address itself. If we are correct on the euro, this process should occur faster.



Commodities

If gold is considered a commodity, then gold and energy are the best performers over the past year.



The rest of the commodity complex remains weak. Historically, global growth and the dollar drive commodity prices; expectations of a sluggish global economy are bearish for commodities, especially industrial metals. Trade tensions have played havoc on U.S. agriculture. A weaker dollar might help the complex, but the primary beneficiaries would be oil and gold, which are already the best performers. Although the long-term breakdown of the global world order is likely to benefit commodities eventually, this factor probably doesn't help in 2020.

Our oil outlook is for prices to remain range-bound in 2020, with WTI priced between $55 to $65 per barrel. OPEC will likely try to maintain supply discipline and we expect U.S. output growth to stall in 2020 due to tighter financial constraints on the energy industry. Offsetting supply constraints will be weak demand due to sluggish global economic growth. If the dollar weakens, we would look for prices to rise to the upper end of our expected range.

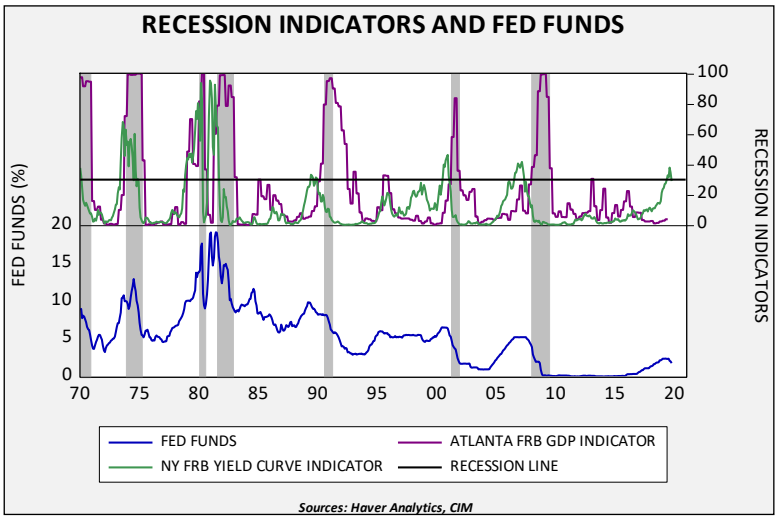
What to expect when you are expecting…a recession.

Predicting a recession is very difficult. Policymakers almost never get it right and private economists struggle to get the timing right as well. Since 1921, the economy has been in recession 230 out of 1,186 months, or just above 19% of the time. Since 1946, thanks to activist fiscal and monetary policy, the months in recession have declined to 13.8%. Since 1983, as inflation fell, the months in recession declined to 7.7%. So, as the years have passed, the odds of being in recession have markedly declined. Given these numbers, positively predicting a recession in any given year is nearly a sure-fire way to be wrong.

That being said, there are some real concerns about the economy. Currently, the financial indicators of the business cycle are signaling elevated risk of recession; so far, these have not been confirmed by economic indicators. In 2019, various permutations of the yield curve have inverted. The yield curve has been a rather reliable indicator of the business cycle and the inversion should be noted. At the same time, economic indicators are still mostly signaling that the economy isn't in grave danger. Unfortunately, the economic indicators only give us about three to six months of warning. So, about the time the economic indicators are signaling trouble, given the lag in reporting, financial markets would likely already be in trouble.

A good method for comparing the signals from financial and economic indicators is to use two data series from the Federal Reserve Banks of Atlanta and New York.

The Atlanta bank has created a GDP-based indicator, while the New York Fed has one based on the yield curve. The New York indicator is designed to signal economic activity a year into the future. We like to combine the two indicators because the Atlanta indicator tends to give false positives. However, in the past, when the New York indicator has moved above 30 followed by an Atlanta indicator rising above 40, a recession has been unavoidable.



Fed funds show us that easing doesn't necessarily protect the economy from a downturn. Even though the FOMC has usually cut rates as the New York FRB indicator penetrated 30, it was not enough to fend off a downturn. Thus, even with the recent rate cuts, the risk of recession remains elevated.

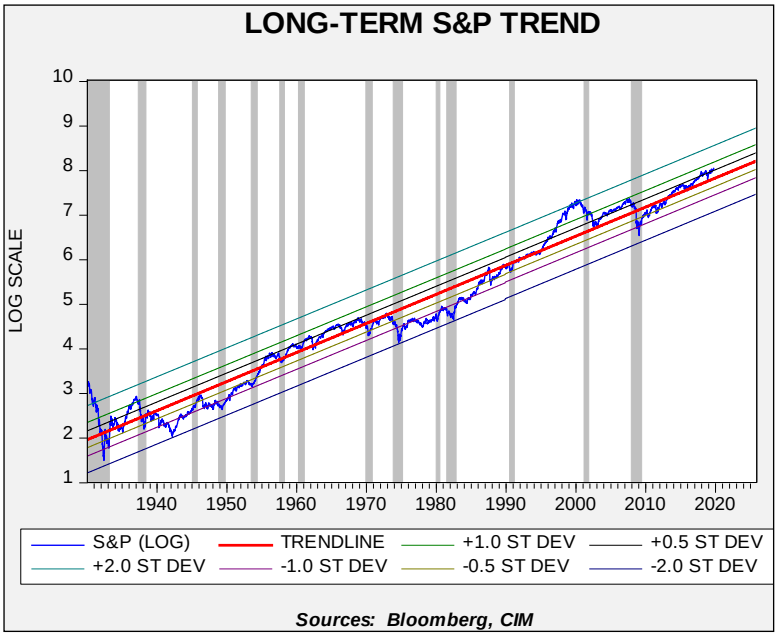
The good news is that the Atlanta indicator is at a level where a recession isn't imminent. The bad news is that the New York indicator has signaled a downturn is coming. Since the 1969-70 recession, the average lead time from the New York recession indicator has been 10 months, with a range of five to 15 months. Thus, by next spring, we could see evidence of a downturn. However, if we use the Atlanta indicator as a signal-confirming device, we should have a better idea of when a recession is actually underway.

In addition, we also publish a business cycle report here at Confluence, which is updated monthly.

If a recession occurs, we would expect the Federal Reserve to lower the policy rate to the zero lower bound. So far, we have no indication that the Fed would implement a negative nominal rate as seen in Europe, although if the downturn was especially severe such an outcome cannot be completely ruled out. With zero fed funds, the fair value yield for 10-year T-notes would fall to 1.72%. On the other hand, credit spreads tend to widen out dramatically. Thus, in a recession, there is a clear benefit to Treasuries compared to credit.

Recalling the ***Earnings and GDP*** chart above, if the recession is mild, earnings would decline to around $98.69 by year's end. The multiple would likely expand to 20x, leading to an S&P 500 of 1973.80. A deeper recession would lower earnings to the one standard error level, or $76.98 by year's end. Even with a 20x P/E, a decline in earnings to this level would generate an S&P 500 of 1539.60, a far more serious downturn.

Another way to gauge the impact of a recession on equities is through trend analysis.



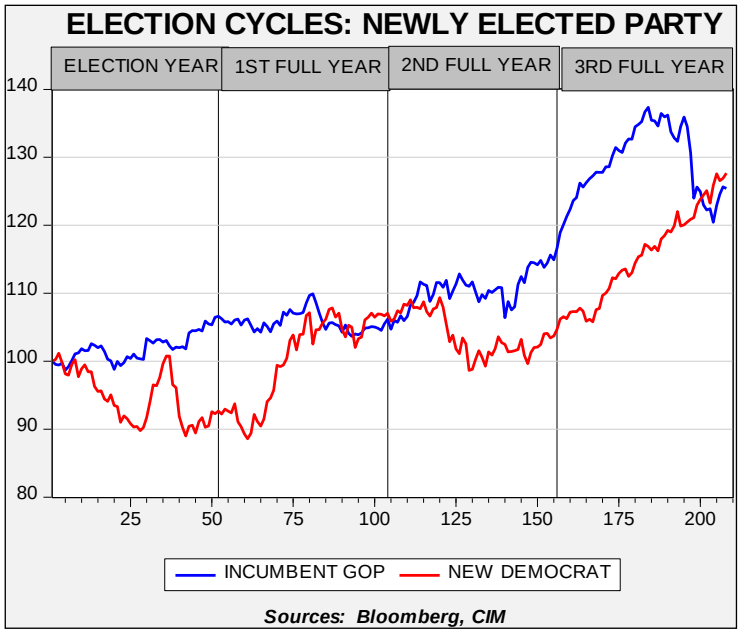
This chart bases the Friday close for the S&P 500 dating back to 1928. We have rebased the index to a log scale and regressed a time trend through the data. The last two bear markets have seen a decline of two deviations, but most normal downturns only show a decline of a single deviation. From current levels on +0.5 deviations, a decline by a single deviation would put the S&P 500 at 2186.45 by year's end. Two deviations would be at 1508.41. We have no reason to expect a deep recession if one occurs, so we would lean toward the 2186.45 level.

Taking the two methods into account, in a "garden-variety" recession the downside would likely be between 1900 to 2200 for the S&P 500. Obviously, the level of decline will depend on where the market peaks. Nevertheless, these levels should give a guideline for likely levels for equities if a recession does develop. We would expect value to outperform as the recession wears on; in a similar fashion, smaller capitalization stocks tend to outperform as recessions end, especially given current extreme levels.

In terms of other markets, a recession may be the catalyst for dollar weakness. Additionally, we would expect gold to outperform in a recession.

The 2020 Election

We will have more to say about the 2020 election in our recently published 2020 Geopolitical Outlook and in upcoming reports next year. The election could provide unusual levels of distraction next year. Not only is the president running for re-election after an impeachment situation, but we anticipate high levels of foreign interference.



To examine this issue, we took the Friday close of the S&P 500 dating back to 1928 and indexed each four-year presidential cycle.

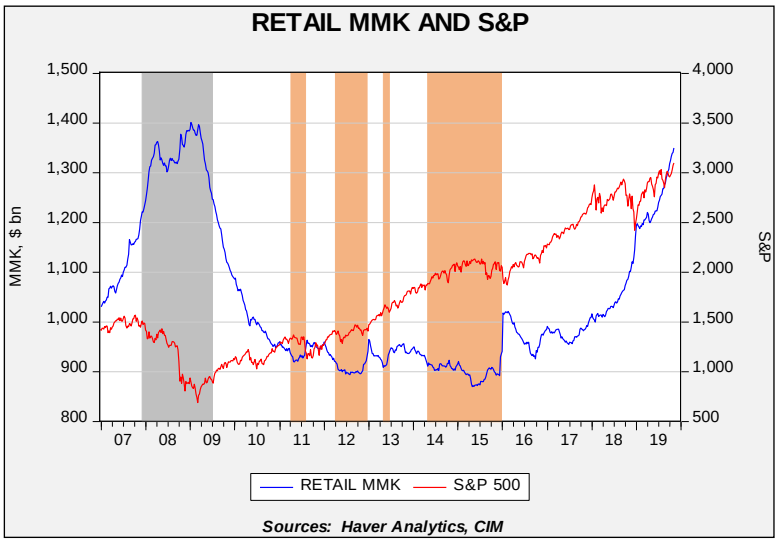
The data is indexed to 100 for the first Friday close of the year of the election and shows the performance over the following four years. The actual election occurs around the 46th week. This year's election is between an incumbent Republican and a new Democrat. Because the incumbent is something of a known quantity, equity market performance is

generally modest until the midterms. If a Democrat wins, the market's initial reaction is negative, with stocks falling, on average, until Q1 of the first year, when the market "catches up" to the performance of an incumbent GOP president. History tends to favor incumbents; since WWII, only two incumbents have lost a second-term election. Thus, the most likely outcome is President Trump's re-election and a modest lift in equities next year (roughly around 6.5%). But, if Trump falters, we could see a rise in market volatility.

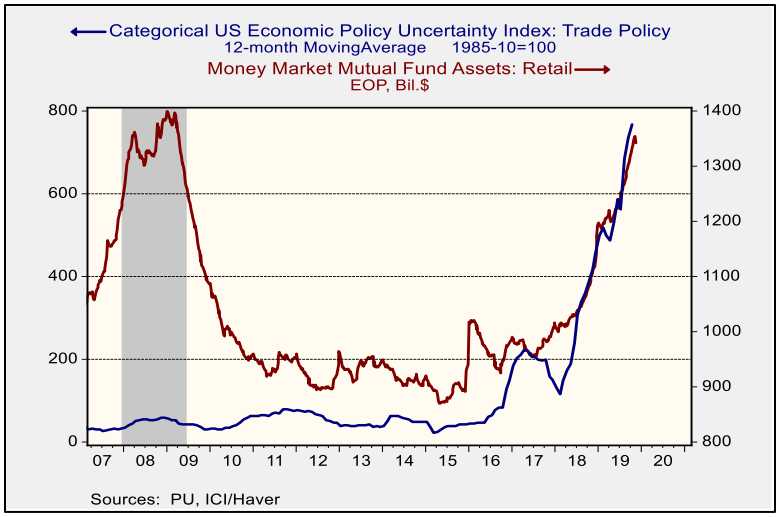
The Melt-Up

In the turmoil of 2007, investors began to move to cash. As they reduced their cash holdings, equities recovered.

This chart shows the weekly average S&P 500 Index and the level of retail money market (MMK) funds. The gray bar represents the 2007-09 recession. The orange bars are periods when MMK funds fell below $920 billion. This level seemed to coincide with market pauses, likely because of a lack of available liquidity. We have seen equity markets continue to rally even though MMK levels have soared. Although the S&P 500 has made a series of new highs, much of the market action has been sideways since Q1 2018. The rise in MMK levels is due, we believe, to concerns over the trade issues.

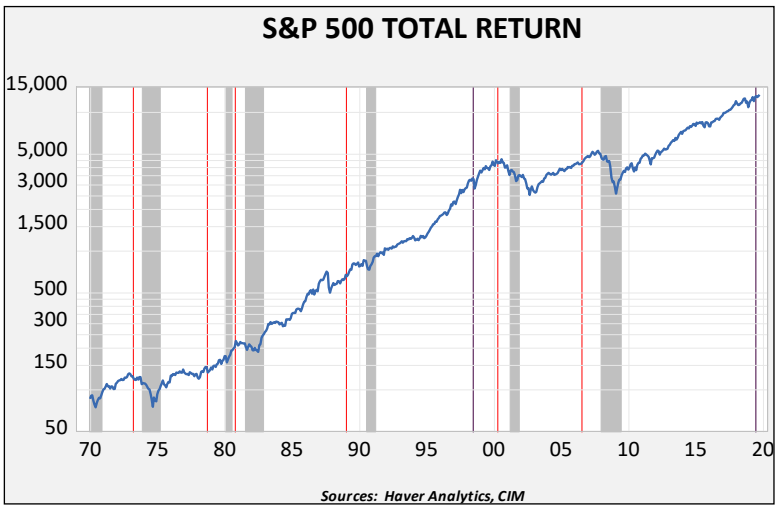


This chart shows the 12-month moving average of the Trade Policy Uncertainty Index with the aforementioned MMK data. As trade uncertainty has increased, retail investors have raised their cash levels. This data suggests that if trade issues are resolved, or at least a truce emerges, then there is ample cash for a significant market rally. Using our trend model above, a rise of a 0.5 deviation from current levels would put the index at 3815.62. At this point, the odds of a notable resolution to trade concerns are unlikely but not zero. Therefore, there is the potential for a major up-leg in stocks.



Another way of thinking about this situation is that the Fed will have engineered a soft landing if a recession is avoided.

This chart shows the total return of the S&P 500 on a log scale; the red vertical lines are yield curve inversions, measured by the 10-year T-note yield less fed funds. The first lesson from this exercise is that equities tend to rally even after inversions. The second is that after a soft landing, such as the one in 1998, the market rally is substantial. **Thus, until the economic data begins to signal a downturn, it is premature for investors to vary their asset allocation strategies in a defensive direction and away from those allocation levels previously determined to be appropriate.**



Conclusion

Economic growth is sluggish, and the risks of recession are elevated. However, at this point, investors should remain invested in stocks, although this would be a good time to evaluate risk tolerance and rebalance to "normal" levels of equity exposure. We comment on financial markets frequently, and we will warn our readers if we see signs of an imminent recession.

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Confluence Investment Management

December 19, 2019

This report was prepared by Bill O'Grady and Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.