2020 U.S. Economic & Financial Market Outlook

Providence Business News
2020 Economic Trends Summit

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Tom Tzitzouris
Head of Fixed Income Research

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Investment Strategy
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The Big Picture on Growth in 2020
(The Negative)

First quarter real GDP likely weakest since Q4 2015; Boeing drag hits capex, consumer slows from trade war, housing remains absent (for now), "phase 1" trade deal slow to reverse business demand destruction from trade war, and coronavirus delays demand pickup until Q2.

The Big Picture on Growth in 2020 (The Positive)

Coronavirus drag likely to fade in Q2, with "catchup demand" to come, phase 1 trade deal raises business confidence in Q2, raises business spending by Q3, housing gains steam, albeit from a depressed level, and consumer returns to trend growth by Q3.

The Big Picture on Markets in 2020
(The Negative)

Equity markets are likely to see at least one more leg lower this year, as data on drag from coronavirus rolls in and business confidence remains weak in Q1. For the year, "Main Street is likely to outperform Wall Street, or at least make it close"

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The Big Picture on Markets in 2020 (The Positive)

Fed likely another 15 to 24 months away from tightening again, with 10 year yields capped below 2.5% for 2020, and below 2% for first quarter. Credit spreads may only rise modestly in 2020, though HY defaults should pick up and peak around 3.5% by mid to late 2020.

The Wildcard
"Powell to Confront 'New Risk' to U.S. Economy from China Virus….."

The impact from this virus is likely to completely negate the benefits of a "phase 1 trade deal" for the duration of Q1. But forecasting beyond Q1 is difficult, not impossible, but certainly difficult.

Formative Events in My Financial Career

1) September 15th, 2008

2) September 11th, 2001

3) January 1st, 1991 **???**

January 1st, 1991

45 Credit Unions and Banks Shut by Rhode Island

1/2/91 (*New York Times*)
PROVIDENCE, R.I. — The new Governor of Rhode Island yesterday ordered the immediate closing of 45 state-chartered banks and credit unions until they have arranged Federal insurance for their deposits.

Gov. Bruce G. Sundlun took the step after a private insurance fund ran low on money to guarantee the institutions' deposits and asked to be taken over.

"I am declaring a bank emergency in Rhode Island," Mr. Sundlun said in a statement issued a few hours after taking office.

The 45 institutions, about three dozen of them credit unions, were closed by the Governor have a total of $1.7 billion in deposits, in 300,000 accounts. Depositors will not have access to their money until the banks and credit unions reopen.

Rhode Island Plan to Bail Out Banks a Bitter Pill for All

2/7/91 (*Los Angeles Times*)
PROVIDENCE, R.I. — After 36 mortifying days, about 250,000 scared-out-of-their-wits Rhode Island savers may finally have a way to get at their frozen bank accounts. But they may not get all their money--soon or ever.

Late Tuesday night, a month of haggling behind them, Gov. Bruce Sundlun and leading legislators announced a bailout plan for 15 banks and credit unions whose accounts were insured by a failed private guarantor.

The compromise has mixed news for all parties. It calls for full repayment of accounts up to $100,000--but much of the money will be released in six-month stages over three years and without earning interest.

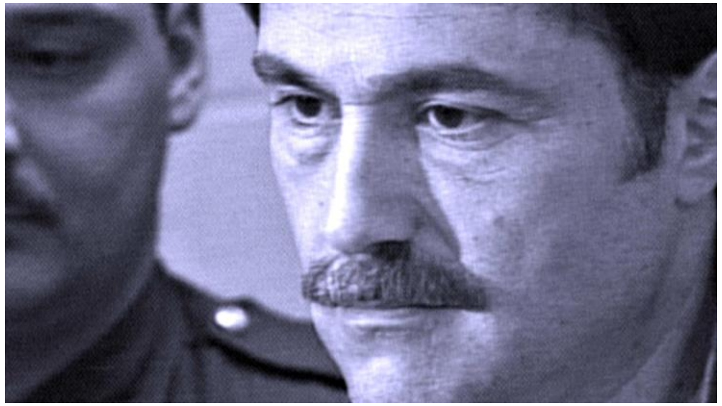
Banking Crisis Still Grips Rhode Island

1/2/92 (*New York Times*)
PROVIDENCE, R.I. — On New Year's Day 1991, Bruce Sundlun was inaugurated as the new Governor of Rhode Island. Less than an hour after the ceremony, he announced that 45 banks and credit unions would be closed indefinitely because of the collapse of the Rhode Island Share and Deposit Indemnity Corporation, the private fund that insured them.

More than $1 billion, belonging to more than 150,000 depositors, was frozen. A year later, many of those people still have not been paid, and state regulators are still ironing out how to do so.

On January 1st , 1991, the Rhode Island Financial System Collapsed

"On Jan. 1, 1991, on his first day in office, Sundlun ordered the closing of 45 credit unions, freezing $1.7 billion in assets"



17 Years Later, the U.S. Financial System Collapsed

"Lehman Files for Bankruptcy, Merrill Sold, AIG Seeks Cash"
- WSJ 9/16/08

"Global Nightmare: If Fannie And Freddie Had Failed"
- NPR 9/9/08

"Rescue to Stabilize Lending, U.S. Takes Over Mortgage Titans"
- WSJ 9/8/08

"JP Morgan Pays $2 a Share for Bear Stearns"
- NY Times 3/17/08

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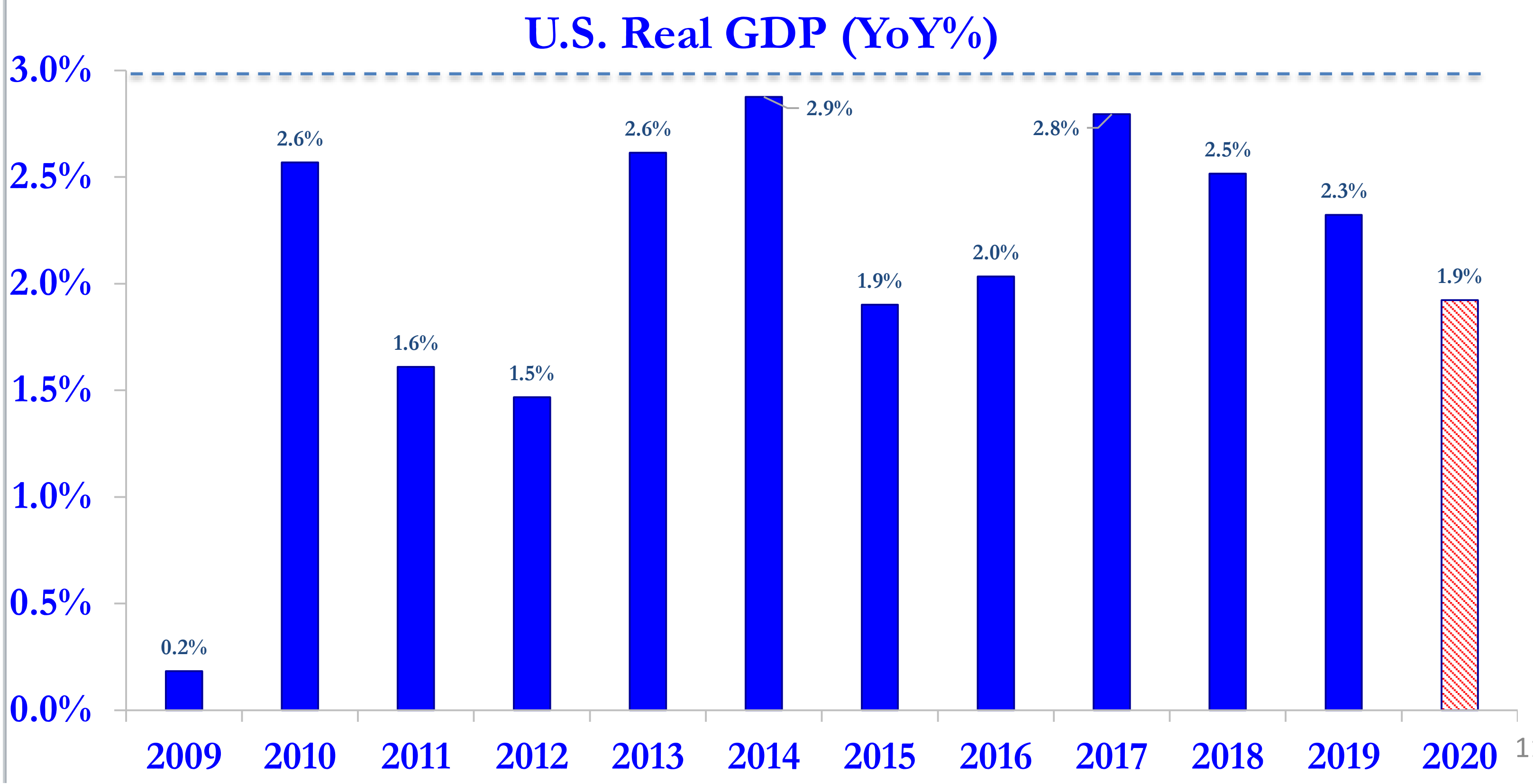
How has U.S. Economy Performed Since 2008?

The short answer is weak….

GDP has averaged 2.10% since 2008, 0.90% less than the long-run average of 3.00%. Why??

We anticipate growth of 1.90% in 2020, with roughly 1.25% in first half of the year, and a 2.5%+ pace in second half of 2020, as "Phase 1" trade deal lifts business confidence, raising GDP slightly above the consumer driven trend of 2% seen since 2008.



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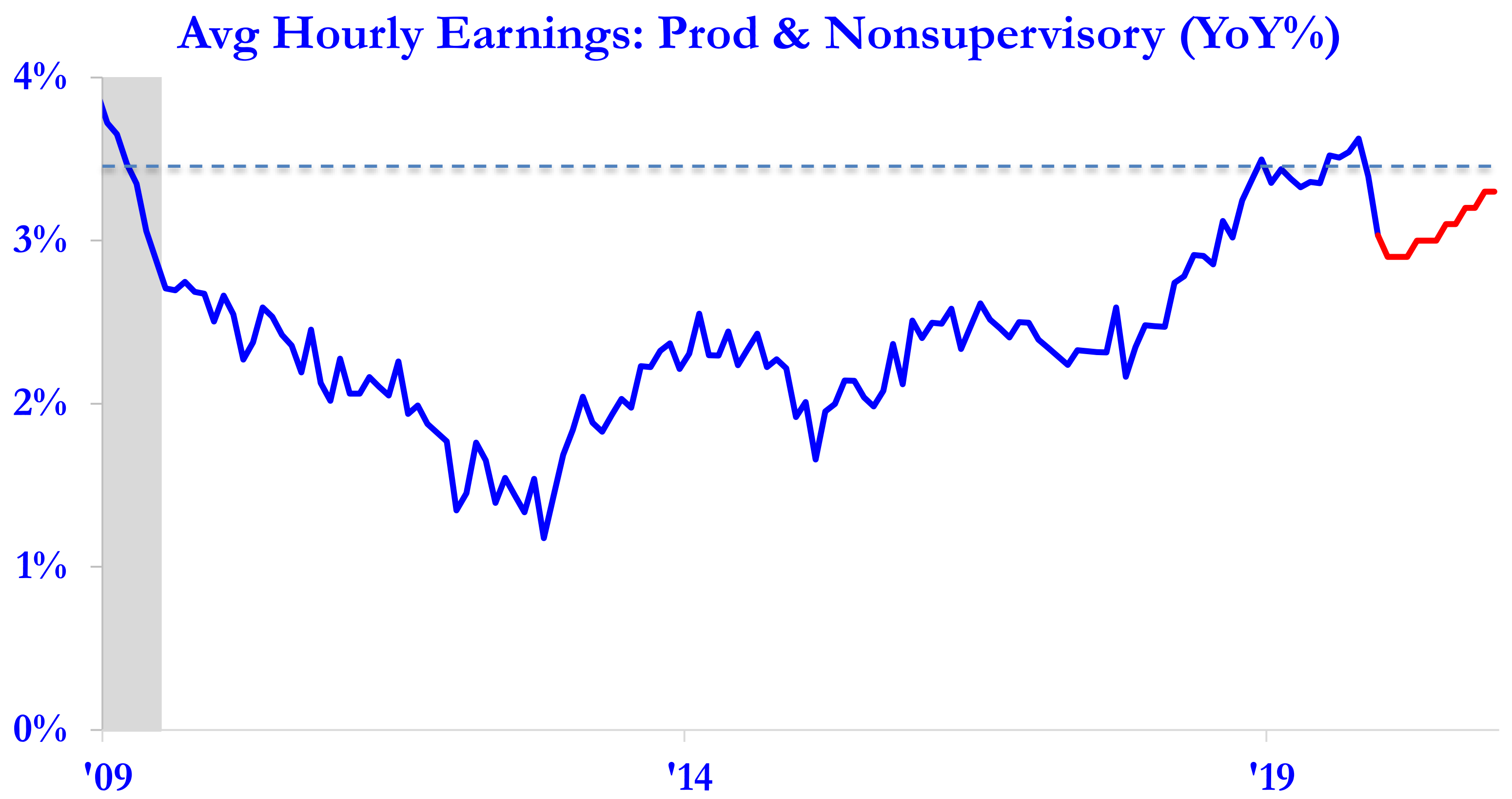
How has U.S. Labor Performed Since 2008?

The short answer is "ok"….

Wage growth has averaged 2.50% since 2008, or roughly 0.90% less than the long-run average of 3.40%.

We anticipate wage growth to slow in Q1 and early Q2 2020, then begin to rise back to about a 3.3% level by year end, as business spending drifts higher and labor markets remain near full employment.



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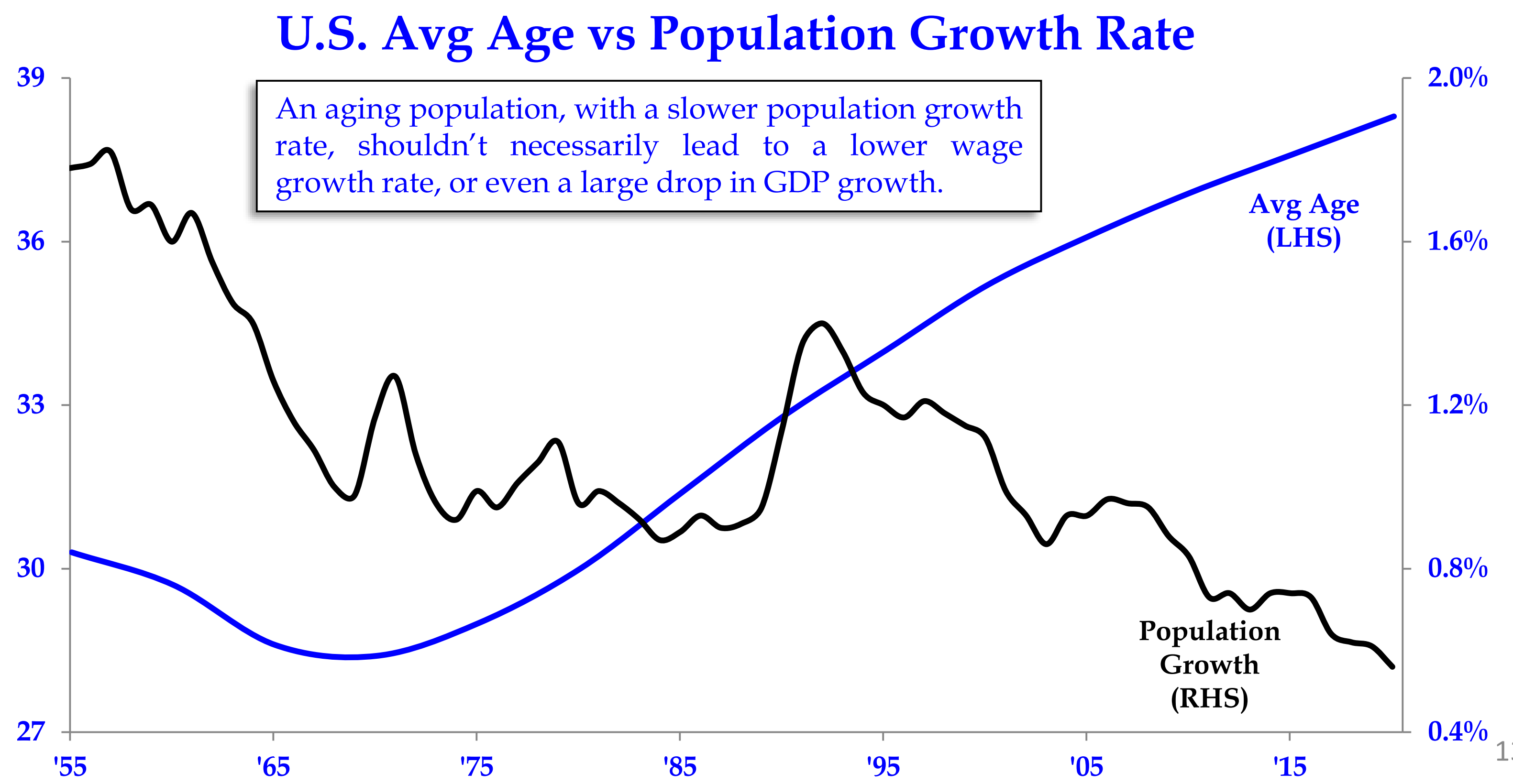
Why have Growth and Wages been Stagnant???

Some say demographics, but we say no….

Slowing population growth can certainly lead to declining GDP growth, it doesn't have to, but it can. But slowing population shouldn't lead to a decline in wage growth, at least not a secular decline. It can lead to a short-term drop in wage growth, as frictional unemployment rises, but if this becomes structural, then it suggests something has changed for the worse. **<u>That something is productivity.</u>**



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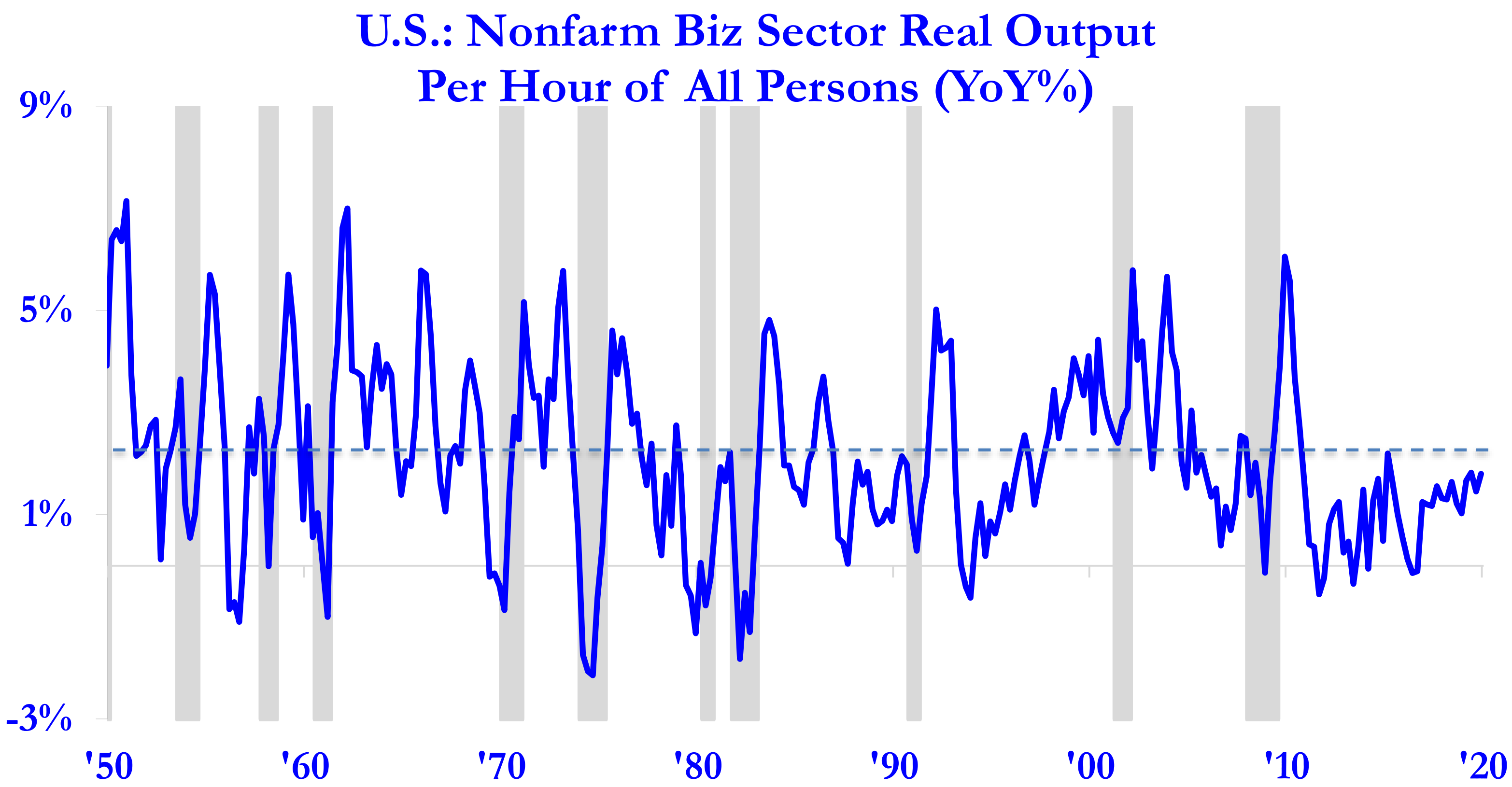
Why have Growth and Wages been Stagnant???

The real answer is productivity….

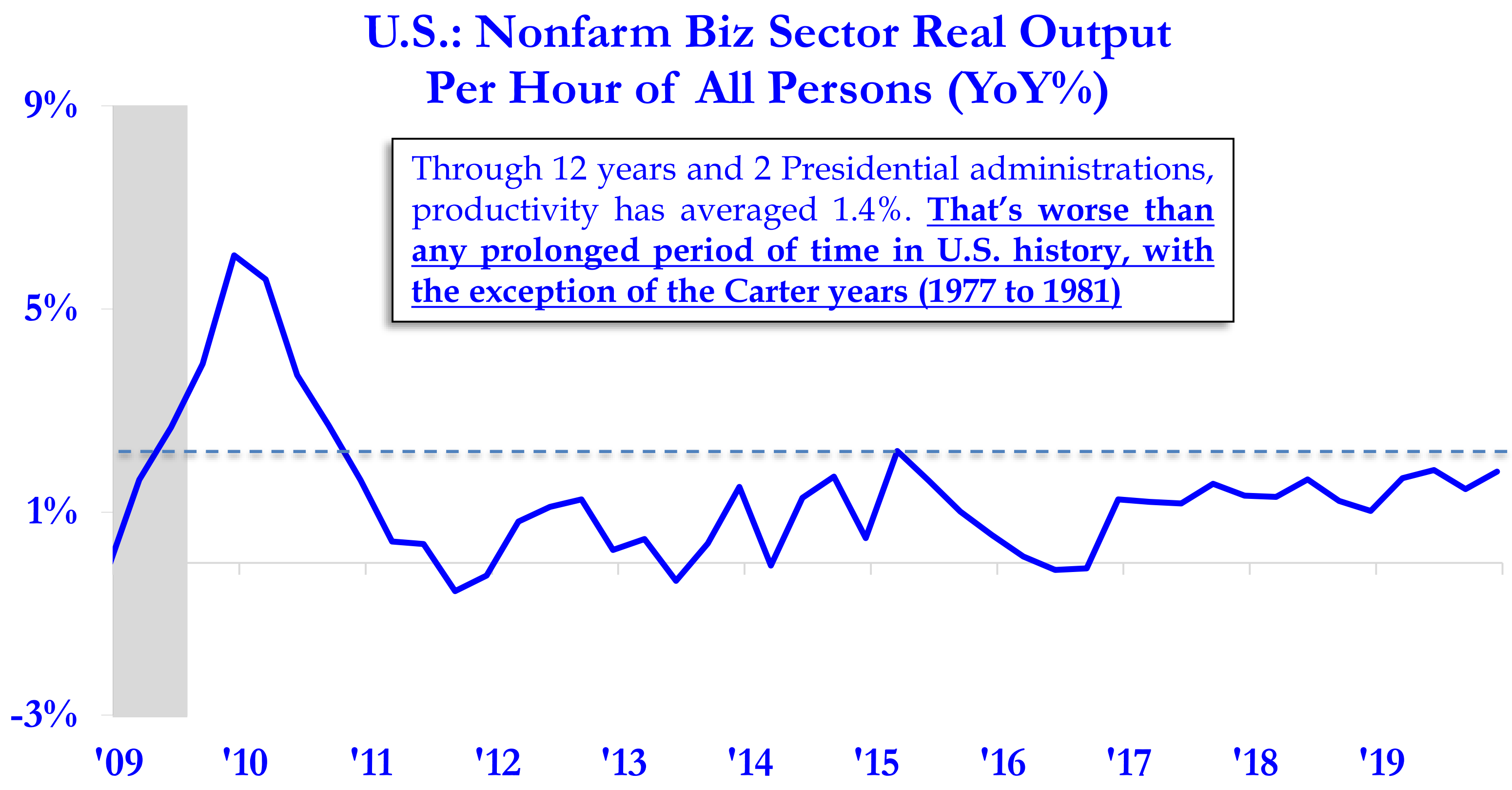
Productivity has averaged 2.2% since 1950, with a strong cyclical component, driven largely by business spending. **<u>When business spending rises, productivity rises, which raises GDP and wage growth.</u>**



How has U.S. Productivity Performed Since 2008

Weak….

Productivity has averaged 0.80% less since 2008 than it averaged over the prior 60 years. GDP has averaged 0.90% less during this period. Wages have also averaged 0.90% less during this period. It's not a coincidence! Wages and growth are lower because productivity is lower.



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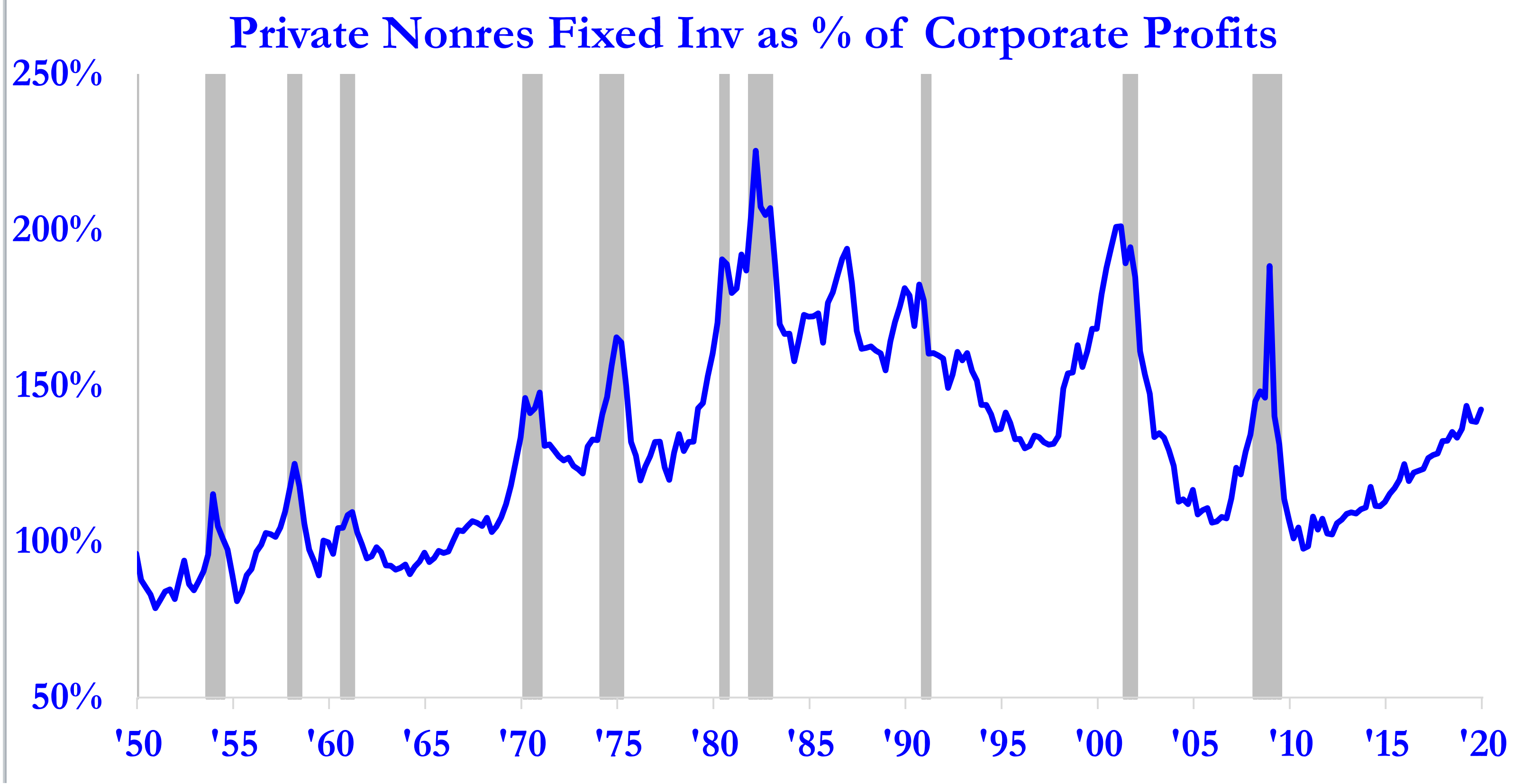
Why has U.S. Productivity been Weak Since 2008?

Lack of business spending….

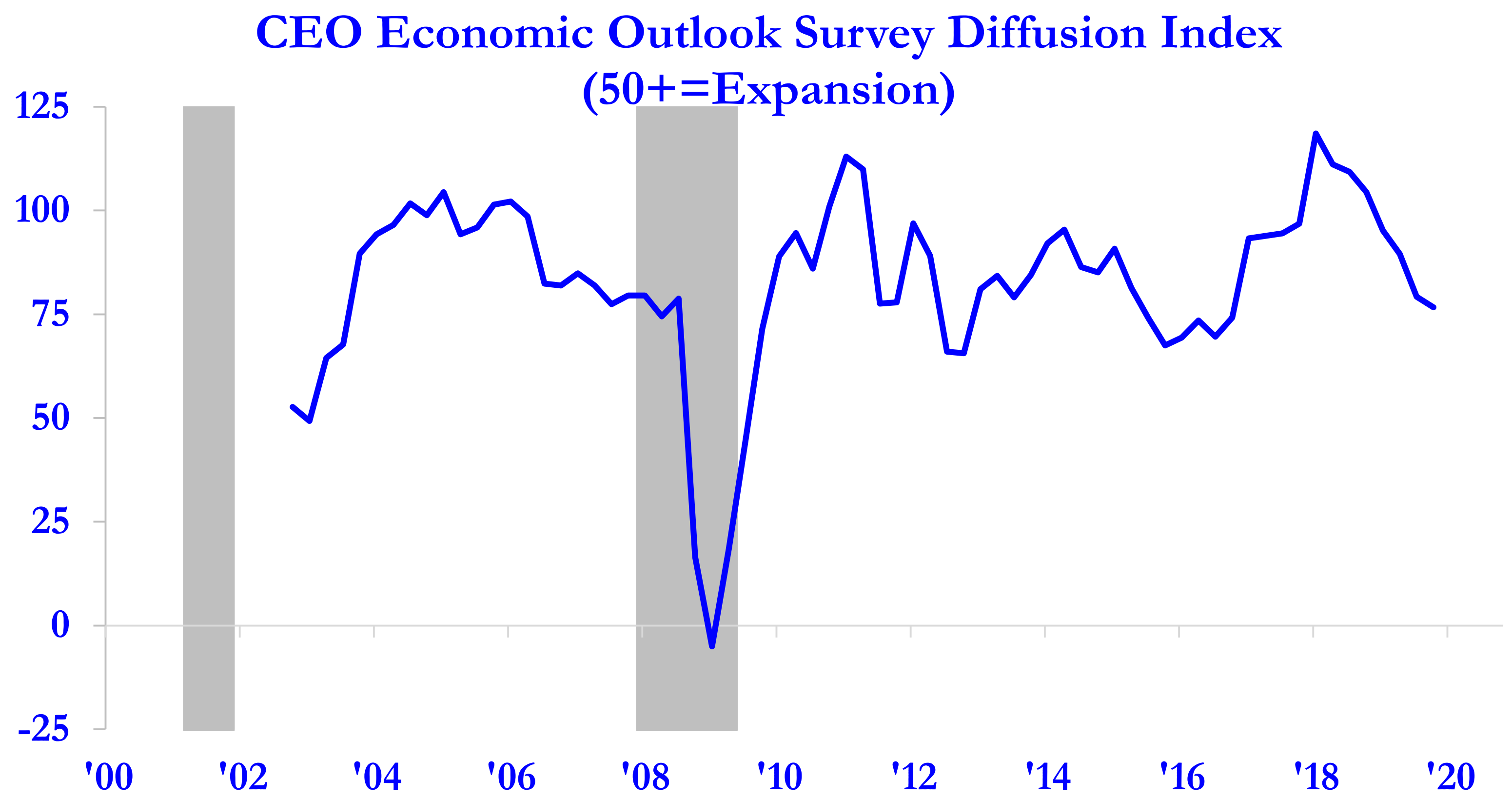
Business spending as a % of corporate profits has been slow to rise since 2008. The positive is that this has reduced the risk of a "boom/bust cycle". The negative is that this has lowered long-run GDP potential and lowered wage growth, all because productivity has been sluggish and output has been missing the "C" part of "C+I+G".



Why has Business Spending been Weak Since 2008?

Business confidence has been weak….

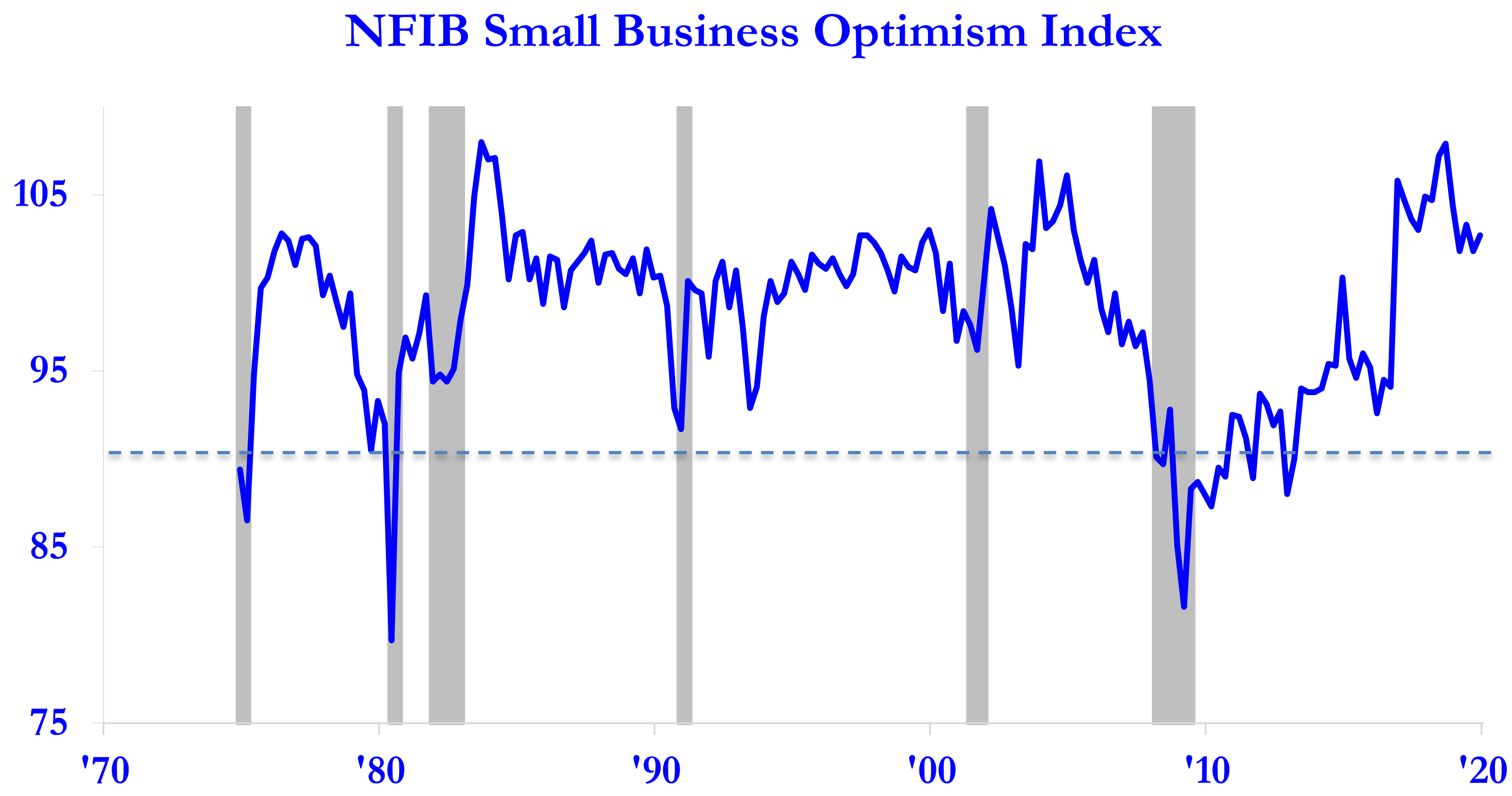
CEO confidence had finally started to rebound after the promise, and enactment of tax reform in early 2018, but this rise in optimism has been completely reversed as a consequence of the 2019 trade war with China, and the prospect of a 2020 trade war with Europe. **<u>An uptick in business confidence is likely by mid-2020, as a phase 1 deal begins to bear fruit, but coronavirus drag is has probably pushed this to late Q2 2020 now.</u>**



Why has Business Spending been Weak Since 2008?

Small business confidence even weaker….

Small business confidence was slow to recover between 2009 and 2014. It then rose, only to see a reversal lower as the Fed tightened in 2015 and energy prices plunged 50%. Confidence rose again in late 2016, and has held near it's all-time peak since. The bad news is that the U.S. lost years of growth due to low investment from small businesses. **The good news is that if confidence holds firm here, small business investment is likely to rise in the next few years.**



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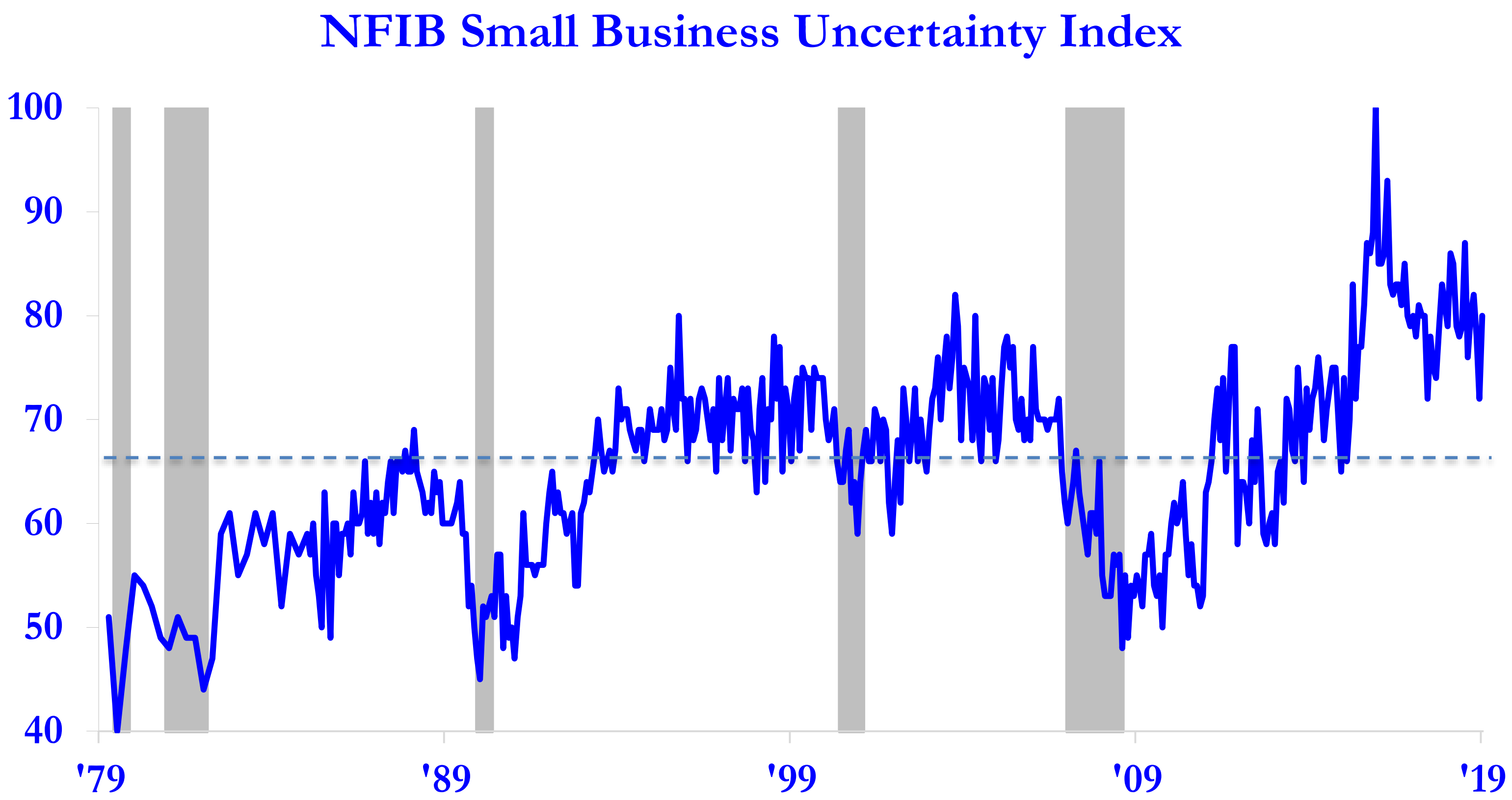
Why has Confidence been Weak Since 2008?

Regulation and policy uncertainty….

Uncertainty, particularly for small businesses, surged from 2009 until late 2016. The drop since has been modest, and choppy, with a return to uncertainty in 2019 that likely cost the U.S. about 0.75% of growth on the year. **<u>We anticipate uncertainty dipping in 2020, as trade frictions at least pause until after U.S. elections. Coronavirus concerns are temporarily causing an uptick in uncertainty to start 2020.</u>**



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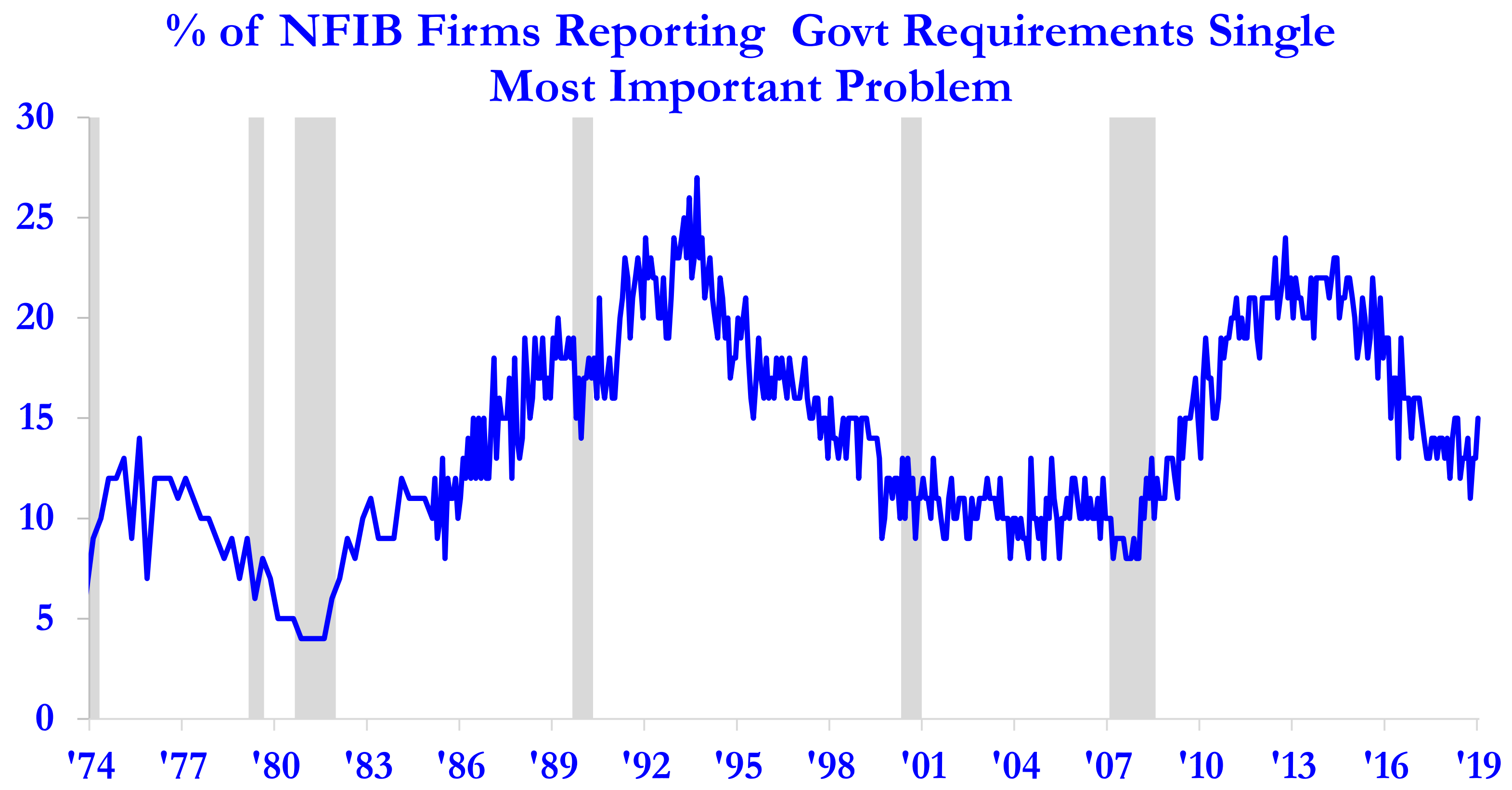
Why has Confidence been Weak Since 2008?

Regulation and policy uncertainty….

Small business confidence was clearly hampered between 2008 and 2014 by the perception, fair or not, that government requirements would be a burden on business operations. This seems to add credence to the notion that the pendulum of regulation had swung too far to one direction, and is now in a secular swing towards a more favorable small business backdrop.



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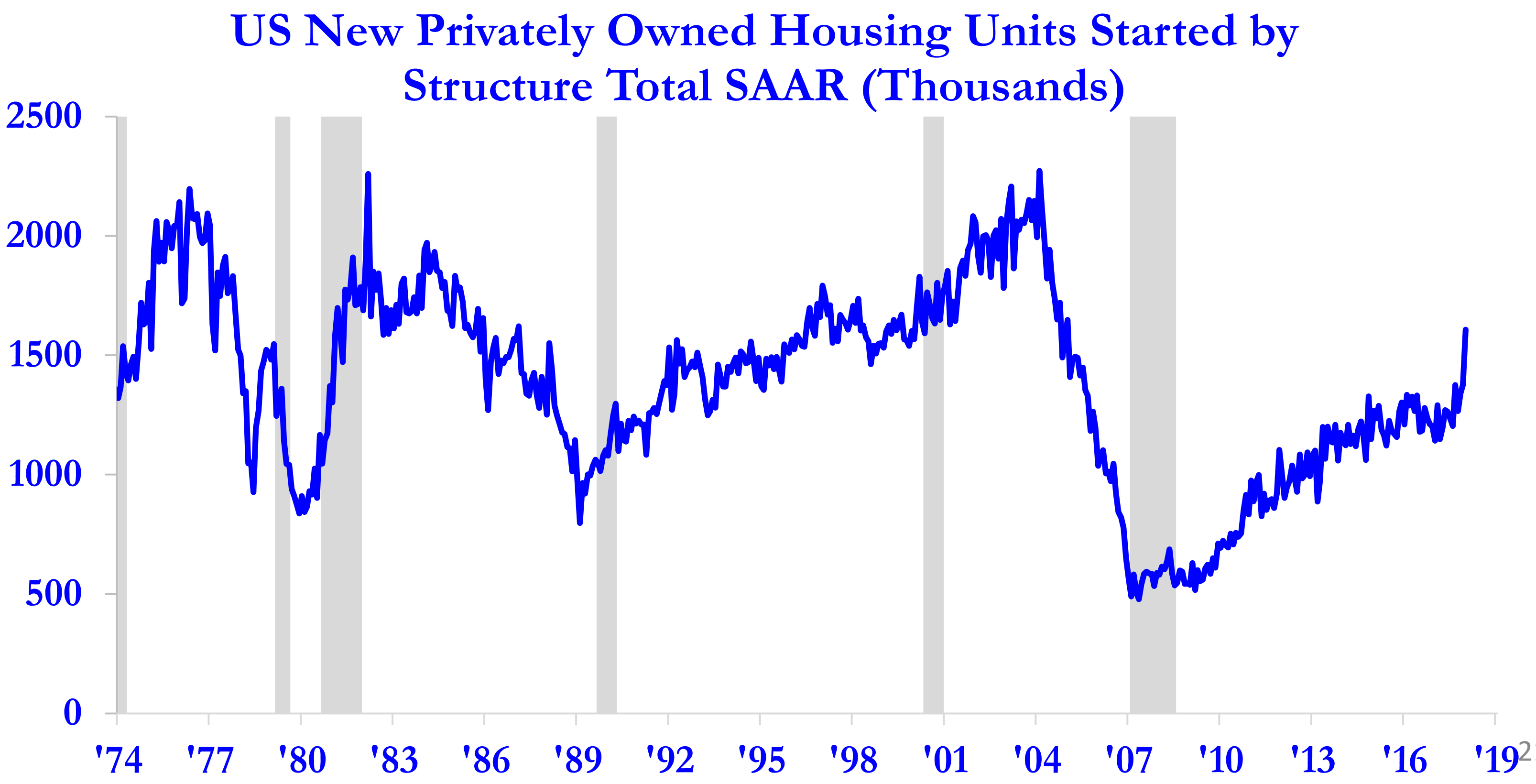
What Else has been Missing Since 2008?

Housing….

Housing (both starts and residential investment in general) has a multiplier effect on growth. It also helps to steepen the U.S. yield curve because of the negative convexity that mortgage-backed securities tend to display, which helps to increase the efficiency of the Fed's monetary policy making. But housing is picking up, with starts and purchases still below maintenance levels, suggesting that we have a way to go from here.



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The Big Picture

We believe that this is beginning to change, despite the warnings on still aging demographics, and we believe that even the issue of aging demographics in the U.S. are likely to take a pause this decade, as birth rates are likely to pick up the longer the U.S. progresses without a recession. All of this suggests that growth potential is slowly shifting back towards 3.00%. 2020 should see a more muted growth pace, at around 1.9% with a 2H acceleration.

With housing and business investment absent, the consumer has been the primary driver of growth, with consumption growing roughly 2.50% a year (population growth + productivity), for GDP growth of about 2.00% a year

Economic Forecast for 2020 and 2021

Drag from 1) Boeing 2) coronavirus and 3) leftover weakness from 2019's trade war will ensure that Q1 is exceptionally weak. As of right now, we see 1.00% real GDP or less. But drag from these forces should ease in Q2, without rebound growth in Q3 and Q4 above trend. Does this continue in 2021? **Unfortunately, too many variables to project a growth rate above trend for next year, but a recession should NOT be the base case for 2021.**

	2020				2021			
	1QF	2QF	3QF	4QF	1QF	2QF	3QF	4QF
Real GDP	1.00%	1.50%	2.50%	2.50%	2.25%	2.25%	2.25%	2.25%
Core CPI	2.00%	2.00%	1.90%	1.90%	2.00%	2.10%	2.20%	2.30%
Fed Funds	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%
Earnings	7.00%				9.00%			

F = End of Period Forecast

Fed Funds Upper Target

S&P 500 Earnings Growth

Yield Forecast for 2020 and 2021

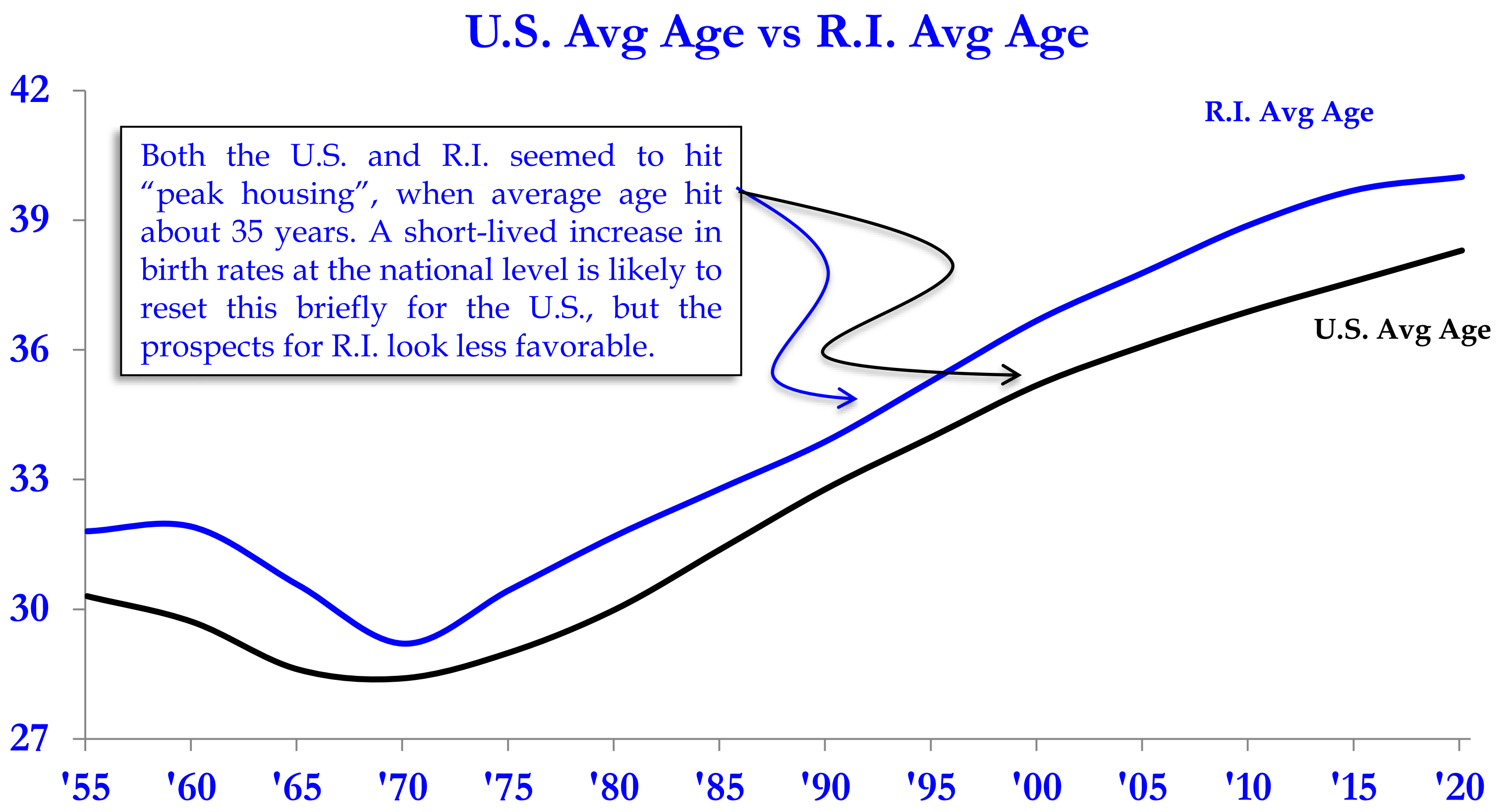
Long bond yields end March below where they started in January, as flight to quality and demand for duration swamps the long end of the curve. But labor markets, driven by consumer growth, are likely to remain healthy throughout 2020, keeping the Fed from cutting this year or next. This should eventually serve to move intermediate maturity yields above 1.50%, after a brief Q1 dip below these levels. **This is goldilocks in a nutshell, so something has to change.**

	2020				2021			
Maturity	**1QF**	**2QF**	**3QF**	**4QF**	**1QF**	**2QF**	**3QF**	**4QF**
1 Year	1.50%	1.45%	1.50%	1.55%	1.55%	1.60%	1.65%	1.75%
2 Year	1.50%	1.45%	1.55%	1.65%	1.70%	1.80%	1.90%	2.00%
5 Year	1.55%	1.45%	1.55%	1.75%	1.80%	1.90%	2.00%	2.10%
10 Year	1.75%	1.60%	1.75%	1.95%	2.10%	2.20%	2.25%	2.30%
30 Year	2.25%	2.10%	2.25%	2.35%	2.50%	2.60%	2.65%	2.70%

F = End of Period Forecast

How Does Rhode Island Stack Up

R.I. began to age faster than the rest of the nation right around the banking crisis (the aging demographics were likely a contributor to peak housing in 1991 in RI like they were for the U.S. as a whole around 2006). But the U.S. began "catching up" to RI around 2015. **This could prove short-lived, and we expect to see a mini "baby boom" in the U.S. in the next few years, bringing avg age lower. Will R.I. participate or will it continue to age?**



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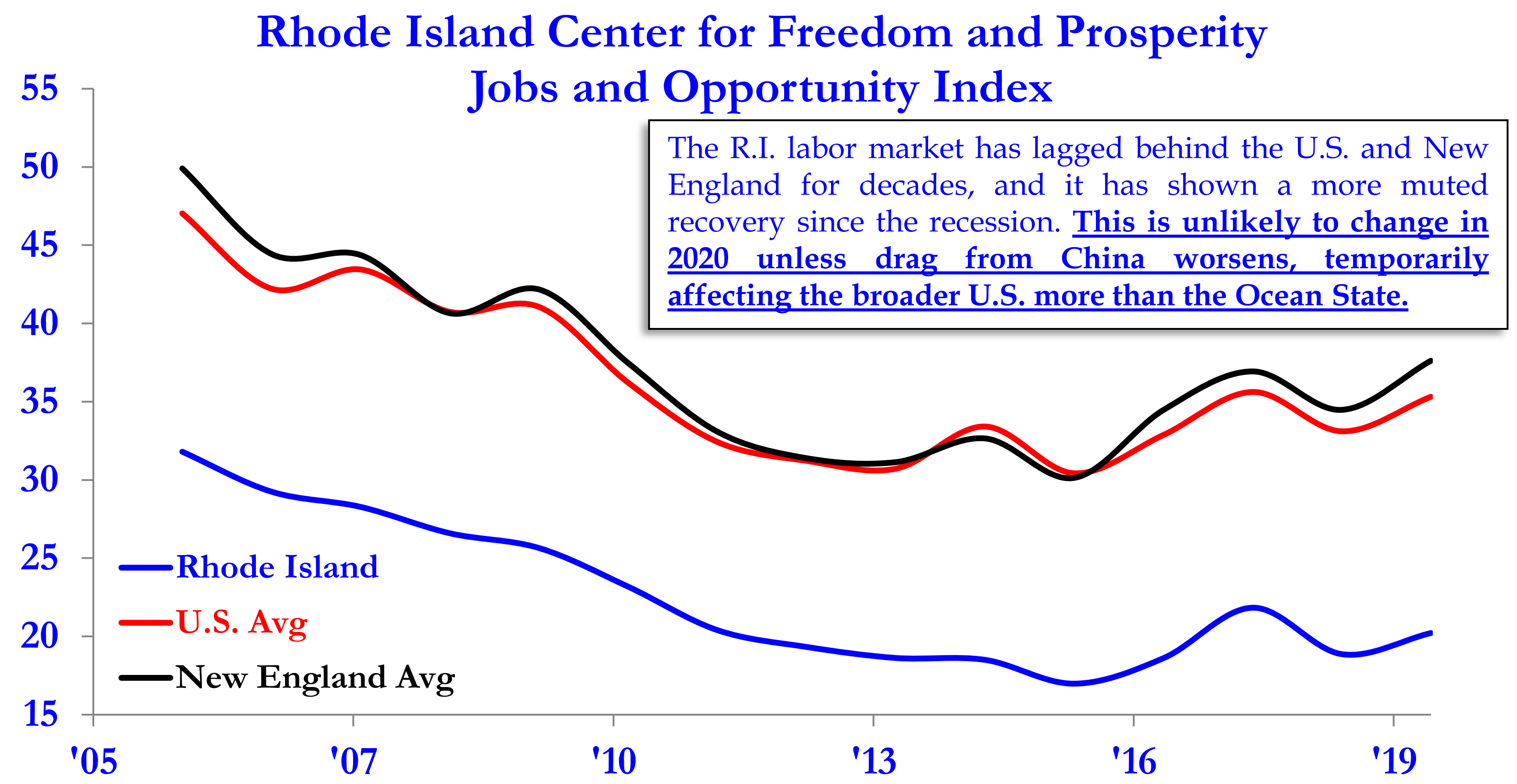
How Does Rhode Island Stack Up

With R.I. continuing to age, the local economy is less likely to see a housing-driven acceleration today vs 30, 20, or even 10 years ago, but it could still outperform the U.S. in 2020 if it proves to be less sensitive to drag from China. This would likely prove to be a temporary outperformance, but one which grows more likely the longer the Chinese economy slows and U.S. business confidence remains weak.



Conclusion: What Does This Mean?

1) Economies grow because they either grow 1) capital 2) labor 3) productivity, or some combination of the 3.
2) Economies grow real per capita income by growing 1) or 3); that is they either save today to have more tomorrow or they find a way to constantly do more with less.
3) We know that capital will always go to where it is treated best, and likewise, labor performs best when it is allowed to act on its own free will, but what drives productivity?
4) It's simple; productivity is driven by respect for human rights and respect for property rights. That is to say that productivity is driven by government respect for the sovereignty of capital and labor.
5) Unfortunately, respect for human rights and respect for property rights are two things that governments love to tinker with.
6) Within the U.S., no state has a perfect record on both; Rhode Island has generally been a leader in the category of respect for human rights, but it's been a laggard in the category of respect for property rights.

APPENDIX – IMPORTANT DISCLOSURES

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