2020 Outlook: Upside May Be Harder to Come By Amid a Slow-Moving, Aging Cycle

Watching for hopeful signs to start the year, but investors should prepare for potential market rotations.

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Key Takeaways

- The future trajectory of asset prices will likely depend on the evolution of three major factors —the business cycle, liquidity and market technicals, and asset valuations.
- The global business cycle remains in a mature expansion, with signs of improvement in some areas and a generally modest pace of growth—conditions that often precipitate heightened uncertainty and mixed asset market performance.
- The slow progression through the U.S. business cycle could continue, amid low rates and a solid consumer, but business conditions are mixed and earnings growth is under pressure.
- With global monetary policy turning more accommodative, incremental liquidity could continue to push asset prices higher despite lukewarm fundamentals, but it's possible that easy-money policy may be nearing the limitations of its effectiveness.
- Elevated valuations in a mature business cycle suggest that investors should expect below-average asset returns over the intermediate to long term, but there may be relative opportunities within certain asset categories.

With the U.S. and global business cycles continuing to mature, it will likely be challenging to replicate the strong broad-based asset price gains and low volatility of 2019. However, it's been a slow-moving cycle, and it's possible that the unspectacular but relatively steady economic backdrop can last for a while longer. The following is our outlook for 2020.

Late cycle: Higher uncertainty, less predictable asset return patterns

The global economy remains relatively sluggish, but there are signs that conditions are no longer deteriorating.

- Unlike during prior periods of global softening over the past decade, China's policymakers are emphasizing just enough fiscal and monetary support to maintain stability but not to reaccelerate growth.
- As a result, China's industrial sector stabilized in early 2019 but has not catalyzed a sharp rebound in Chinese growth nor global trade and manufacturing activity.
- However, measures of business confidence and manufacturing in some countries are no longer declining, indicating near-recessionary conditions in major European economies such as Germany and Italy might be poised for an improvement.

The U.S. is firmly in the late-cycle phase as evidenced by tight labor markets, challenged corporate profit margins, and a yield curve that flattened and inverted (Exhibit 1).

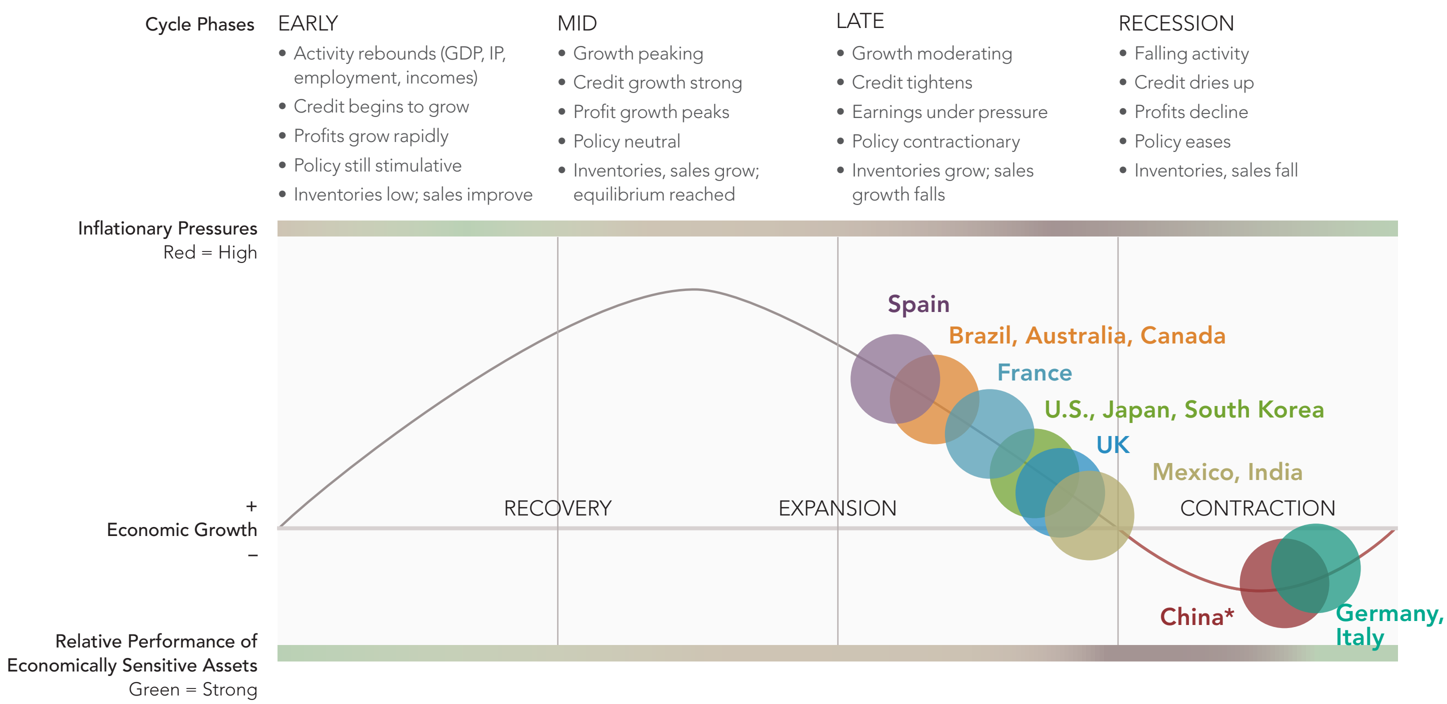
- During 2019, the Federal Reserve's dovish shift toward rate cuts and balance sheet expansion helped soothe financial conditions.
- This has been a prolonged, slow-moving cycle, and our models have yet to register a significant increase in the near-term risk of U.S. recession.
- However, we are cautious about the prospects for a material upswing in the pace of U.S. economic growth.

In general, stocks tend to outpace bonds during the late-cycle phase of expansion (Exhibit 2).

- Historically, about one-third of the time, equities declined during late cycle (and underperformed bonds), implying a much riskier profile than during the earlier phases of the business cycle.
- Since we first identified the full U.S. move to the late cycle in the fourth quarter of 2018, stocks have outpaced bonds, although bond returns have also been strong.
- As is often the case, equity performance has been volatile this late cycle due to the steep drop in late 2018 before the sharp 2019 rally.

EXHIBIT 1: The U.S. and global business cycles are mature, but there are signs in some countries that conditions are no longer deteriorating.

Business Cycle Framework



The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. * A growth recession is a significant decline in activity relative to a country's long-term economic potential. We use the "growth cycle" definition for most developing economies, such as China, because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: Fidelity Investments (Asset Allocation Research Team), as of Nov. 30, 2019.

Three areas to monitor: Glass half-full or half-empty?

Whether the next big move will be an improvement or deterioration in asset markets will likely depend on the evolution of three major factors—the business cycle, liquidity and market technicals, and asset valuations.

Business cycle: Slow and steady could continue, but earnings growth under pressure

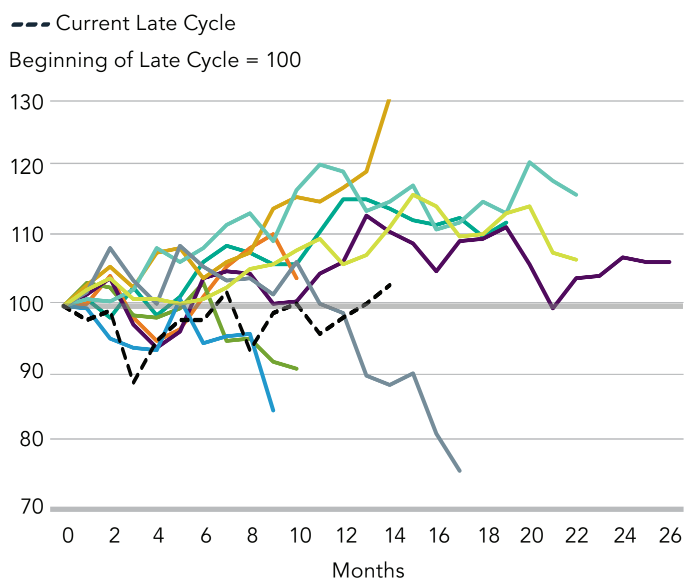
The U.S. cycle has been slow and long, and it may continue to extend.

- The consumer remains in solid shape amid tight employment conditions.
- Lower interest rates have kept consumer debt service manageable and boosted housing activity (Exhibit 3).

However, corporate confidence remains in the doldrums, and business conditions are consistent leading indicators of overall economic activity.

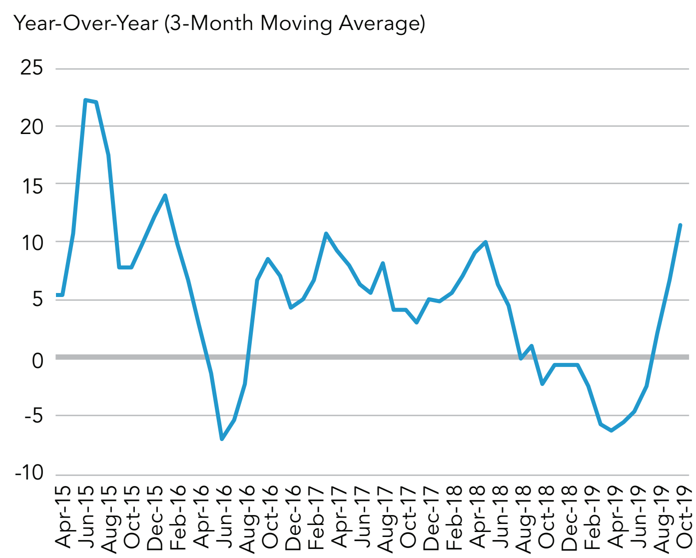
- Capital spending slumped in 2019 amid weak growth and trade-policy disruption, although recent sentiment indicators suggest business confidence may no longer be deteriorating (Exhibit 4).
- The de-escalation of the U.S.-China tariff confrontation could provide some boost to business sentiment, although the apparently narrow scope of the deal is unlikely to completely clear the air and spur investment activity on its own.
- U.S. elections in 2020 will likely act as an additional layer of uncertainty casting a shadow over capex decisions.

EXHIBIT 2: The performance of stocks vs. bonds is generally mixed during the late stage of the business cycle.
U.S. Equity less Investment-Grade Bond Cumulative Performance in the Late-Cycle Phase (1950–2019)



Past performance is no guarantee of future results. U.S. equities represented by the S&P 500® Index. Bonds represented by the Bloomberg Barclays U.S. Aggregate Bond Index. Source: Standard and Poor's, Bloomberg Finance L.P., Fidelity Investments (AART), as of Dec. 6, 2019.

EXHIBIT 3: Lower interest rates have helped stimulate the housing market.
New Housing Permits



Source: U.S. Census Bureau, Haver Analytics, Fidelity Investments (AART), as of Oct. 31, 2019.

The bull-versus-bear battle may ultimately be determined by the trajectory of corporate earnings growth.

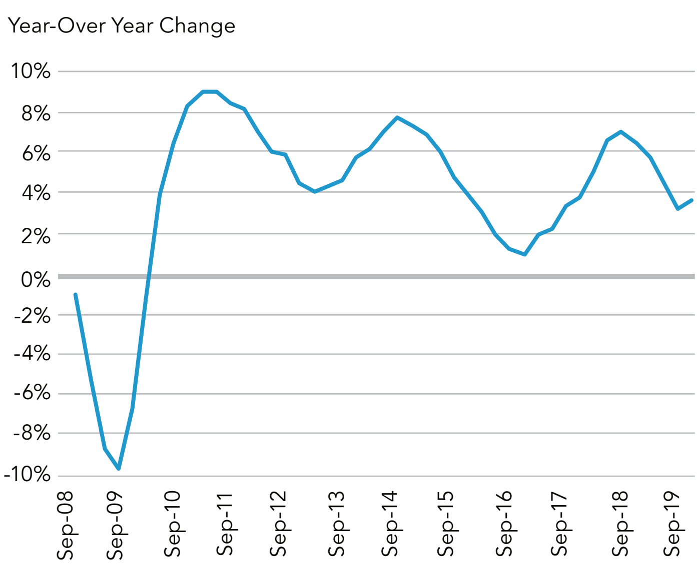
- As shown in Exhibit 5, market consensus expectations for 2020 earnings growth are around 9%, which would be a big rebound from the steadily reduced expectations for 2019 (now around 1.5%).
- With corporations facing extremely tight labor markets, it's difficult for earnings growth to meaningfully accelerate without a material improvement in the global economic backdrop.
- As a result, we expect profit growth to potentially act as a fundamental headwind for stocks in 2020.

Liquidity and market technicals: Sentiment not stretched, but monetary easing less helpful

With global monetary policy turning more accommodative and many of the growth challenges well known, the bull case for market technicals is that incremental liquidity continues to push asset prices higher despite lukewarm fundamentals.

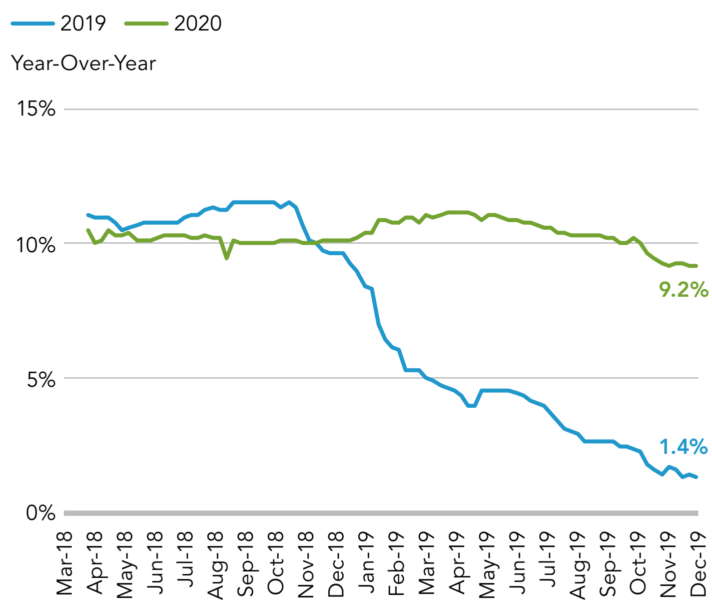
- Bullish investors argue this has always been an unloved bull market, with cash-rich investors positioned conservatively due to the memory of 2008 market losses.
- The supply of publicly traded stocks and sovereign bonds has shrunk due to share buybacks and central bank purchases.

EXHIBIT 4: Capital investment spending has been subdued, but business sentiment may have bottomed.
CFO Survey: Outlook for Capital Spending (Next 12 Months)



Source: Duke Fuqua School of Business/*CFO Magazine*, Haver Analytics, Fidelity Investments (AART,) as of Dec. 11, 2019.

EXHIBIT 5: Investors expect earnings growth to meaningfully reaccelerate in 2020.
S&P 500 Earnings Growth Estimates



Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of Dec. 6, 2019.

The bearish argument is that easier monetary policy is hitting the limitations of its effectiveness, and cracks in financial conditions are already beginning to show.

- Thus far, typical widespread late-cycle tightening of credit and financial conditions has yet to occur in the U.S., in part due to the Fed's move to an easing posture.
- Some financial stress is evident in lower credit-quality tiers, including the rise in credit spreads among triple-C-rated high yield bonds and leveraged loans.
- U.S. banks tightened lending standards for commercial and industrial loans during Q4.
- The stock prices of technology companies that IPO'd this year have dropped an average of 40%, a development that might slow the previously ample flow of private equity money to new firms (Exhibit 6).

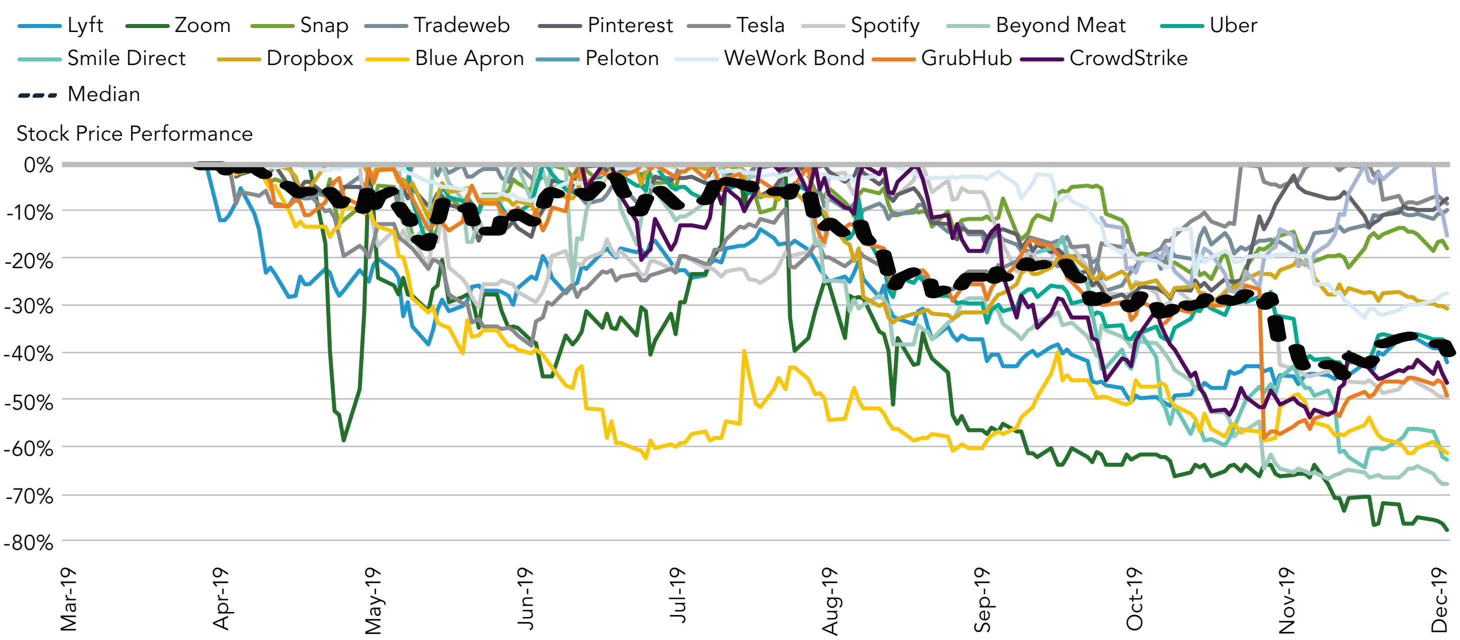
Valuations: Weaker absolute return outlook, but ample relative opportunities

After a decade-long appreciation of asset prices, elevated valuations suggest that investors should expect lower asset returns over the intermediate-term compared to long-term historical averages.

- High equity price-to-earnings ratios and low bond yields suggest returns of both stocks and bonds may be inhibited.

From an asset allocation standpoint, there may be relative opportunities within certain asset categories.

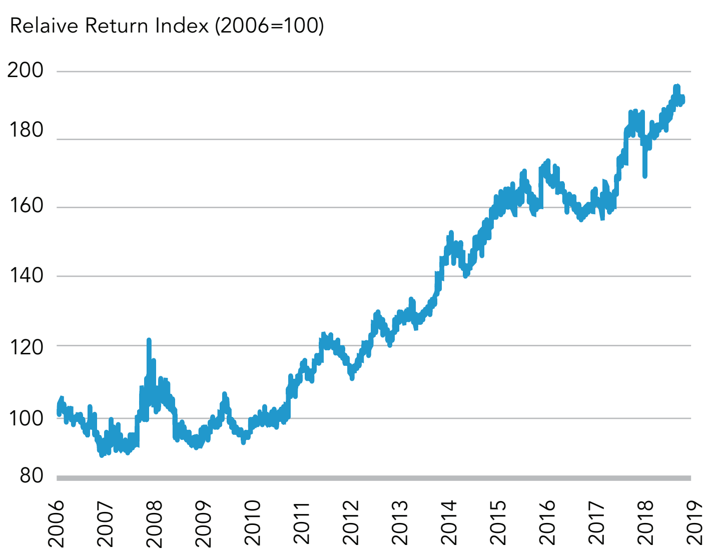
EXHIBIT 6: The median drawdown for large tech IPOs during 2019 has been approximately 40%.
Price Declines of Recent Large Technology Initial Public Offerings



For illustrative purposes only. Past performance is no guarantee of future results. Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of Dec. 6, 2019.

- Decade-long trends of equity relative performance—including U.S. stocks beating international equities and growth stocks outperforming value—may be getting long in the tooth (Exhibit 7).
- Relative valuations are attractive for international equities (compared to the U.S.), and continued dollar strength implies some foreign currencies may be undervalued.
- The relative valuations of inflation-resistant assets also appear attractive; for example, low inflation expectations are priced into Treasury inflation-protected-security (TIPS) prices.

EXHIBIT 7: U.S. equities have outpaced their foreign counterparts for roughly a decade.
Equities Relative Performance: U.S. vs. Rest of World



Past performance is no guarantee of future results. U.S. equities represented by the MSCI USA Total Return Index. Rest of world represented by the MSCI ACWI ex USA Total Return Index. Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of Sep. 30, 2019.

Asset allocation implications

The world will begin 2020 in a mature expansion, beset by policy crosscurrents and an accommodative monetary backdrop. From an asset allocation perspective, this suggests the following observations.

Patience is important

- It's been a long, slow-moving business cycle and it's possible that pace will continue.
- The late-cycle playbook suggests maximum diversification in the face of greater uncertainty, which is a good default position.

Caution is appropriate

- In the latter phases of the business cycle, the distribution of potential outcomes is generally less favorable than earlier in the cycle.
- There is a litany of policy and political risks that may cap the upside for an improvement in business confidence.

Readiness to adjust asset allocation

- Watching closely for a turn in the cycle will be important, with a sharp rotation among asset classes and sectors possible.
- Unloved asset categories whose relative performance has trailed for years (for example, international versus U.S. equities) may be poised to claim leadership.

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The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

AART Research Analyst Jordan Alexiev, CFA, also contributed to this article. Fidelity Thought Leadership Vice President Christie Myers provided editorial direction.

Index definitions

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based, market value-weighted benchmark that measures the performance of the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. Sectors in the index include Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

MSCI ACWI (All Country World Index) ex USA Index is a market capitalization-weighted index designed to measure the investable equity market performance for global investors of large and mid-cap stocks in developed and emerging markets, excluding the U.S.

The MSCI USA Total Return Index is designed to measure the performance of the large and mid-cap segments of the U.S. market. With 640 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

Standard & Poor's 500 (S&P 500®) is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

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