

INVESTMENT **OUTLOOK**

2020 Outlook:
The Nice House in the Forest

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Overview

For most investors, the last decade was like a nice walk along a wooded and scenic trail that ended with the very pleasant surprise of double-digit equity returns for 2019. Those results, which were unexpectedly robust for holders of U.S. equity, were supported by four strong pillars: continued global economic growth, accommodative monetary policy, substantial share buyback activity and a booming technology sector. Now, as we enter the new decade, most of those features appear to continue to underpin the stability of the investor's house of risk assets.

While one could be critical of the rate of growth during this expansion, there is an interesting feature of the slow pace: it may actually be sustainable and end in a better place than spikes of economic and market pleasure and pain. It appears that, given that the U.S. Federal Reserve (the Fed) has pushed the stimulus button again and a number of indicators of economic activity have returned to more of an upward slope, the U.S. economy is likely to enter its 11th year of expansion, albeit still at a modest pace. With very low rates making U.S. bonds expensive, these policies support relatively expensive U.S. equities and those expensive U.S. bonds are supported by even more expensive European and Japanese bonds. Earnings trends have become more favorable; trade talks look to yield some partial solutions; and valuations, while a bit pricey, don't appear excessively stretched except in a few areas.

This combination of factors suggests U.S. stocks will, perhaps with news-driven volatility, continue their mostly positive run for 2020. In addition to ever-present headline risk, a return to a path of de-globalization, ongoing trade frictions, the politics of a presidential election (and now impeachment), a potential crisis in the Middle East and general uncertainty about policy responses are clear risk factors to any forecast.

In the eurozone, the new president of the European Central Bank, Christine Lagarde, is likely to pursue her predecessor's "anything-it-takes" approach, which when combined with her unique talent for twisting arms, may result in more unified fiscal policy stimulus to increase the pace of growth. Negative rates will likely be ultimately stressful for the banking system. Other strategies are needed to keep growth positive.

Brexit now looks like a reality for the UK, but it appears that a deal is more likely than a hard break and that outcome is mostly baked into current share prices. Although the recent election was a strong mandate, it was not won without an unusual, for the Conservatives, pledge of opening the spigot for the voters. Japan's value-add tax has been at least partially offset by its own fiscal stimulus which may allow it to bump along as well.

Slower growth but lower valuations are also supportive of developed markets that on average, while not robust, we expect to run in the positive range. Risk factors to the developed markets include:

- The lack of an actual Brexit agreement
- A failure for eurozone countries to apply fiscal support
- Trade barriers with the U.S.
- Changes in leadership

Clearly, there is a lot going on in 2020 and 2021.

For the emerging markets, the generally more attractive valuations, modest levels of debt, lowered trade tensions and a U.S. dollar that seems closer to being too expensive than cheap may provide wind at the backs of investors. However, with China and the rest of Asia now such a large part of the index weighting, any crack in their attempt to manage a slower growth curve would change that outlook for the worse. It does now appear that the Chinese government will apply some support via infrastructure spending.

We perennially remind investors that emerging markets can be volatile and good news can quickly be reversed. While the recent “Phase One Trade Agreement” may be positive for the global economy overall, their impact upon individual markets may not be. In addition, the generalized notion that recent progress in the relationship between the U.S. and China will result in the long-term elimination of the associated risks to the emerging markets is at best a stretch. The process of a seismic shift in the relative role of emerging economies in world growth and the political order will cause its share of pain and anguish that will manifest in volatility in affected markets.

A summary of our perspective for the next 12 to 18 months as indicated in the Asset Class Signals section of this *Investment Outlook* shows very little change from our position for much of 2019, noting that while risk factors still exist, overall economic conditions and even valuations continued to be modestly favorable for the most part. We see returns for equities to be in line with long-term expectations with that slight nod to emerging markets. It continues to be difficult to envision any advantage to holding non-U.S. core bonds given negative yields and an expectation of continued slow growth. In alternative fixed income, we have pushed our view on structured credit down to neutral out of concern for the increasing possibility of downgrades in the growing body of single B issues. In the non-traditional asset classes, we have moved the hedge fund opportunity set back to neutral principally due to concerns that alpha production will be challenged for many mandates in a period where fundamentals are not the driving force behind pricing. For most other non-traditional opportunities, we continue to see challenges surrounding the level of dry powder and the trend towards greater allocations as a substitute for more liquid investments. Selectivity is the best protection against too much money chasing too few deals, and we believe there will be areas within most segments where investors can benefit from strong general partners expertise.

At this writing, our general conclusion for risk assets is that Goldilocks is still eating porridge that is neither too hot nor too cold. However, we remind investors to be vigilant. Even after a short nap, one could awake to find a bear in the bedroom and need to run through the woods to escape.



Summary of Outlook Views

The tables on the following pages provide a snapshot of our forward-looking observations on the key macroeconomic factors driving markets and the direction of specific asset classes.

Introduction to Rogerscasey's Signals

Our global macro signals are represented by arrows that reflect select economic indicators' impact on growth except for policy rates where they reflect directional movement. Gray-shaded boxes indicate a change in our view of a particular economic indicator from the previous quarter.

There is a set of five signals for each asset class, represented by shaded circles ranging from an above-normal return outlook (dark green) to a below-normal return outlook (dark red), with the middle circle indicating a neutral outlook (gray). The views represented for each of the asset classes are *relative to* our 10-year capital market assumptions.

If our views on an asset class change from quarter to quarter, that change is represented by an arrow that stretches from the previous quarter's signal to that of the current quarter.

Global Macro Signals and Outlook

Key:



Negative



Neutral, Trending Lower



Neutral



Neutral, Trending Higher



Positive

Developed Markets

Market	GDP Growth	Inflation	Policy Rate	Currency	Equity Valuations
U.S.					
GDP growth held steady at 2.1 percent. U.S. growth is still ahead of the rest of the world. While unemployment is at a historic low and consumer spending is relatively solid, business investment is still declining. More optimism on the state of U.S./China trade relations has boosted stocks recently, and recession potential remains low. The Fed says it will not raise rates in the near term, which will be neither a headwind or tailwind for stocks and the economy.					
Eurozone					
GDP growth was 0.1 percent in Q4, a decline from Q3. The European Central Bank restarted quantitative easing in order to spur growth in the region. The euro rose against the USD, and inflation increased in Q4. Equity valuations are a bit below the long-term median and are cheaper than U.S. stocks.					
U.K.					
Q4 GDP was expected to decline. There seems to be more clarity around Brexit, though its actual outcome is still unsettled. Manufacturing and consumer spending declined. The pound rose in Q4 against the USD. The policy rate was unchanged. Equity valuations look cheap compared to U.S. stocks, though they now stand above the long-term median.					
Japan					
Q4 GDP growth was estimated to decline. The yen stayed flat in Q4, and the Bank of Japan held the policy rate steady. Inflation was unchanged in Q4. Equity valuations are moderate compared with most developed markets.					

Note: Arrows reflect impact on growth except for policy rates where they reflect directional movement.

Key:



Negative



Neutral, Trending Lower



Neutral












Neutral, Trending Higher



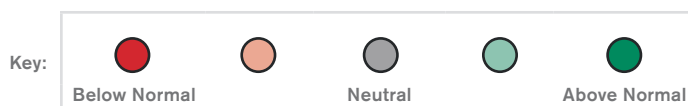
Positive

Emerging Markets


























Market	GDP Growth	Inflation	Policy Rate	Currency	Equity Valuations
China					
GDP growth in Q4 was 6 percent, just as it was in Q3. Trade-related uncertainty and weakening global demand continued to weigh on growth. China's inflation rate rose sharply to 4.5 percent with increasing food demand and costs. The yuan rose against the USD. Equity valuations are close to long-term averages, thus were neither rich nor cheap.					
Rest of EM			N/A		
Economic growth is slowing, and central banks in emerging markets are easing in response. EM currencies were mixed but EM stocks were positive in the quarter. Equity valuations rose in the quarter but are now solidly above long-term median.					

Note: Arrows reflect impact on growth except for policy rates where they reflect directional movement.

Asset Class Signals and Outlook






































Equities

Opportunity Set	Below-Normal Return Outlook		Neutral Return Outlook		Above-Normal Return Outlook	Comments for Quarter
U.S. Large Cap						Odds of a recession remain relatively low, and GDP growth remains slow and steady. Rates are unlikely to move up in the near term. Optimism around global trade and Brexit improves the picture, but uncertainty surrounding geopolitics is a growing risk. Valuations remain above median, but are still not extremely high.
U.S. Small Cap						Still solid economic growth and consumer spending boosts small caps. Valuations are reasonable relative to large caps. Trade uncertainty affects small caps less than it affects large caps. However, if continuing low unemployment pushes up wages, small businesses are hurt more than large ones.
Int'l Dev. Large Cap (Unhedged)						A weaker USD has helped boost unhedged returns in Q4, though they still lag those of U.S. stocks. Developed market stocks were helped by more clarity around Brexit and relatively solid economic news, though worries about growth and populism linger. Valuations for Europe are now above median. While valuations in Japan have risen, they remain below median.
Int'l Dev. Small Cap (Unhedged)						International small caps were also helped by solid economic news and optimism surrounding Brexit. Cheaper valuations relative to the U.S. are a positive, as they are for large caps.
Emerging Markets (Unhedged)						Valuations rose in Q4 and are now farther above the long-term median. Slowing growth in China remains a concern, but could help the rest of EM. The Fed's decision to hold off on raising rates should be somewhat favorable for EMs. As usual, a long-term perspective required, accompanied by short-term volatility.

These views represent our 12–18 month perspective relative to longer-term expectations (10+-year capital market assumptions).

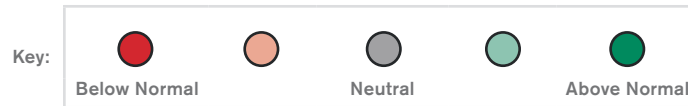


Fixed Income











Opportunity Set	Below-Normal Return Outlook		Neutral Return Outlook		Above-Normal Return Outlook	Comments for Quarter
U.S. Core						Yields fell at the short end of the curve, though they rose at the long end with increased Treasury demand. If rates move at all, they will likely go lower, though the Fed says it is on hold in the near term. Continuing global uncertainty could benefit Treasuries. Current yield/duration profile still not compelling, but is in line with long-term capital market assumptions for U.S. Core.
Non-U.S. Core (Hedged)						Material duration embedded in the Global Aggregate Index means investors aren't being appropriately compensated for the interest-rate risk. Low-to-negative yields in many countries and a USD that is not likely to move a lot lower make prospects here less attractive.
Emerging Market Debt (Hedged)						EMD was positive in Q4. Local currency debt outperformed hard currency as the USD declined. Yields are still more attractive here than in most other fixed income categories. We favor USD-denominated EMD exposure at this time.
High Yield						Spreads contracted further below median in Q4. Nevertheless, still-solid U.S. economic data and low defaults mean prospects here are relatively positive. A rise in oil prices would be positive for HY, as energy companies are a large piece of the HY market.
Bank Loans						Leveraged loan prices gained in Q4. Loans look less appealing as rates will continue to be flat to negative. However, yields on loans remain compelling. Cov-lite issuance remains an issue for loan investors.
Treasury Inflation-Protected Securities (TIPS)						TIPS edged higher amid rising wages and continued low unemployment. Breakevens are still well below the Fed's long-term 2 percent target. Rates are unlikely to move higher in the near term, dampening the prospects for inflation somewhat.
Structured Credit						CLO formation expected to slow to around \$75-100B in U.S. CLO issuance in 2020, however, this should provide sufficient supply for investors allocating to the asset class. The CLO (and broader loan) market saw more dispersion in returns in 2019, with higher quality paper dramatically outperforming lower quality paper. Single B exposure in the CLO market reached north of 40 percent, the highest level in several years, increasing the possibility of downgrades into CCC status impairing certain CLO structures. Prudent manager selection is paramount.

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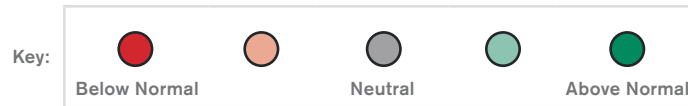
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Fixed Income (*continued*)

Private Credit						Generally speaking, credit performance remains strong as earnings in the middle market grew by more than 10 percent YOY in Q4. The domestically oriented nature of these businesses has shielded them from some of the trade concerns facing more globalized companies. The persistently low interest rate environment has extended the runway for small and mid-sized companies to obtain cheap(er) financing, protecting margins. Defaults have remained relatively benign, however, worsening covenant structures (if they even exist), questionable credit agreements, and increasing dry powder in the space has created a more cautionary tone in this market.
Municipals						Here is new muni text: Issuance is modest in 2019 and fund flows to the sector have been solid this year. Muni valuations are elevated, and munis have lagged the government bond rally. Yield and duration dynamic similar to Aggregate Index and spreads are near long-term lows. Prospect of monetary easing supportive for munis. Tax overhaul makes tax-exempt status more attractive.

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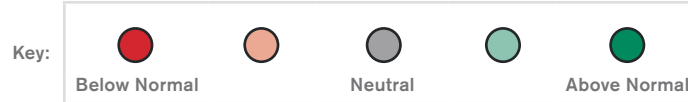


Alternatives
















Opportunity Set	Below-Normal Return Outlook		Neutral Return Outlook		Above-Normal Return Outlook	Comments for Quarter
Hedge Funds						The extended bull market rally, slowing global growth and elevated valuations defined by above-average equity multiples and historically low yields have compelled a continued emphasis on strategies and mandates that seek to generate alpha through more idiosyncratic security selection and/or specialization within more nuanced market segments. Select mandates that fall within the global macro, event-driven, credit and long-short equity strategy categories are primed to capitalize on this dynamic. However, corporate fundamentals and earnings growth prospects have tended to take a back seat to macroeconomic noise of late, resulting in limited alpha production from many hedge fund mandates. Accordingly, expectations to exceed return and risk objectives should be tempered in the nearer term, on average.
Multi-Asset Class Strategies (MACS)						Continued market uncertainty combined with rich valuations is expected to translate to heightened levels of volatility across the capital market spectrum. Accordingly, it is reasonable to anticipate more elevated risk levels associated with these beta-centric mandates given the prevailing market dynamic. Nonetheless, the flexibility afforded MACS investors to maneuver across and within asset classes should prove valuable. Continue to prioritize strategies that offer more levers to pull (e.g., alternative risk premia, global tactical asset allocation and hedge fund replication, among others).
Private Equity						Peak valuations driven by heated market competition, excessive dry powder and the late stages of a market cycle supports a more conservative outlook overall. Strong capital flows and high prices are overhangs especially impacting the large and mega sectors. However, small to lower mid-market cap deals should continue to exhibit relatively greater pricing inefficiencies, less capital flows and competition. Special situation strategies with the ability to participate in both equity and credit investments are poised to provide highly customized financing solutions, but may find deals harder to come by in a low-market distress environment. Robust capital flows to late-stage venture and growth funds will continue to push entry valuations that may pose performance challenges as current vintage year funds enter harvesting periods. Remain more favorable to seed and early-stage venture opportunities.

These views represent our 12–18 month perspective relative to longer-term expectations (10+-year capital market assumptions).

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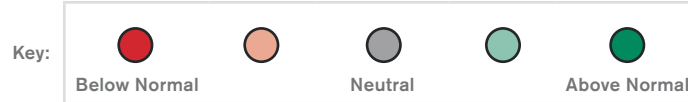


Alternatives (continued)
















Opportunity Set	Below-Normal Return Outlook		Neutral Return Outlook		Above-Normal Return Outlook	Comments for Quarter
Real Estate						Core returns continue to moderate but vacancy and rent growth point reflect solid fundamentals for continued positive performance. Industrial properties likely to continue to be a leading performer due to heavy spending by retailers shifting to more online business models. Pockets of oversupply will persist, specifically luxury multifamily in gateway markets. However, developers anticipated to remain cautious relative to other cycles with rising construction cost dampening a construction surge. With strong employment figures and fundamentals, positive performance is generally anticipated — especially in select value add and opportunistic strategies — but outsized returns will be more challenging to achieve in the current environment.
Infrastructure						Continued successful fundraising by mega-funds are expected to support elevated levels of dry powder over the short-term. Strong competition and robust valuations within traditional sectors will expand interest into other related investment such as social infrastructure, service companies and “smart” infrastructure that uses embedded sensor technologies connecting asset usage with analysis to facilitate enhanced management. As infrastructure fund sizes continue to increase, public-to-private transactions are expected to become a more prevalent investment opportunity set, especially within the energy and communications sectors. Middle-market, core-plus and value-add are anticipated to remain preferred strategies.
Commodities						Overall outlook is mixed. A lack of inflation, soft demand and limited roll yield in forward curves continue to dent broad commodities indices. Industry forecasts suggest a slight decline in global oil prices in the near term given a more moderate risk scenario, to be followed by a rebound due to tightening market fundamentals. Industrial metals are expected to be under pressure, with slowing manufacturing activity in most regions weighing on demand. For precious metals, gold is likely to remain a safe haven and the asset class is anticipated to perform positively as global macro tensions and capital market stress evolves in 2020. On the agricultural front, some commodity price growth is forecasted as U.S. and China reached a temporary trade deal in January, which requires China to purchase more U.S. agricultural products. With phase one of a U.S.-China trade deal reached, less volatility is expected in the broad commodities market over the near term.

These views represent our 12–18 month perspective relative to longer-term expectations (10+-year capital market assumptions).

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Alternatives (continued)

Opportunity Set	Below-Normal Return Outlook		Neutral Return Outlook		Above-Normal Return Outlook	Comments for Quarter
Energy						Market indicators suggest a global oil supply/demand gap over the next two years with the potential to create a commodity price rebound. Public companies will continue to shed lower growth exploration and production prospects and non-core assets, which will provide opportunities for private market upstream investment strategies, specifically in conventional assets relative to shale. Midstream companies continue to be buffered from commodity price fluctuations, and production volumes (and midstream sector cash flows on a per-unit basis) are anticipated to grow. Increased global capacity is anticipated in the downstream refining/distribution sector in the near term. Current market consensus forecasts have 2020 looking like the year where the U.S. becomes one of the largest natural gas exporters in the world. Broader application of renewable power grid distribution is anticipated to remain on track at a measured pace, and cost differentials with traditional energy sources will continue to tighten. Private equity cleantech investments are expected to increase.
Timber						Forecast remains mixed which will continue to moderate returns. A Phase One trade agreement between the U.S. and China is a positive development for the long-term potential of the asset class, although near-term trade dynamics continue to impact hardwood returns. Valuations continue to be threatened by rising severity of natural disasters. Robust spending by U.S. homeowners on home repair and remodeling has buoyed hardwoods while below long-run average housing starts have weakened softwood returns. Low interest rates have kept mortgages enticing and serve as a potential tailwind for housing start recovery and the asset class, bolstered by continued economic strength.
Farmland						The immediate outlook for farmland remains mixed. While U.S. crop yields are expected to rebound in 2020 assuming no major adverse weather conditions — which is no guarantee given uncertain climate change-impacted events — demand remains difficult to calibrate largely due to continued shadow of enduring trade conflicts. Land values are expected to remain steady for the foreseeable future assuming interest rates stay low. The “lower-for-longer” interest rate environment bodes well for farmers allowing for lower interest rates on borrowing, land loans and operating loans. Additionally, a lower-than-normal supply of farmland for sale also helped support land values in most regions.

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