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Q1 2020 ECONOMIC OUTLOOK

What to watch in Q1 and beyond

Driven by consumption, record-long economic expansion is set to continue.

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Lara is Chief U.S. Economist at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the board of both the Economy League of Greater Philadelphia and Starr Garden Park.

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What to watch in Q1 and beyond

Executive summary

The U.S. economy enters 2020 coasting on the longest expansion on record. The consumer has been the main positive driver of growth, but business sentiment has weakened notably. We expect growth to moderate closer to the long-run trend pace of 1.7%. This gradual slowdown could re-ignite growth concerns, revive policy uncertainty and make it harder for financial markets to gain traction.

Record-long economic expansion set to continue

Thank household consumption for the record economic expansion. Through 11 years of growth, the longest uninterrupted stretch on record, the household has offset isolated weakness in the energy sector (in 2015–2016) and sluggish business investment and trade-related uncertainty (2018–2019). Indeed, over the past five years, consumption has grown faster than the overall economy in all but three quarters.

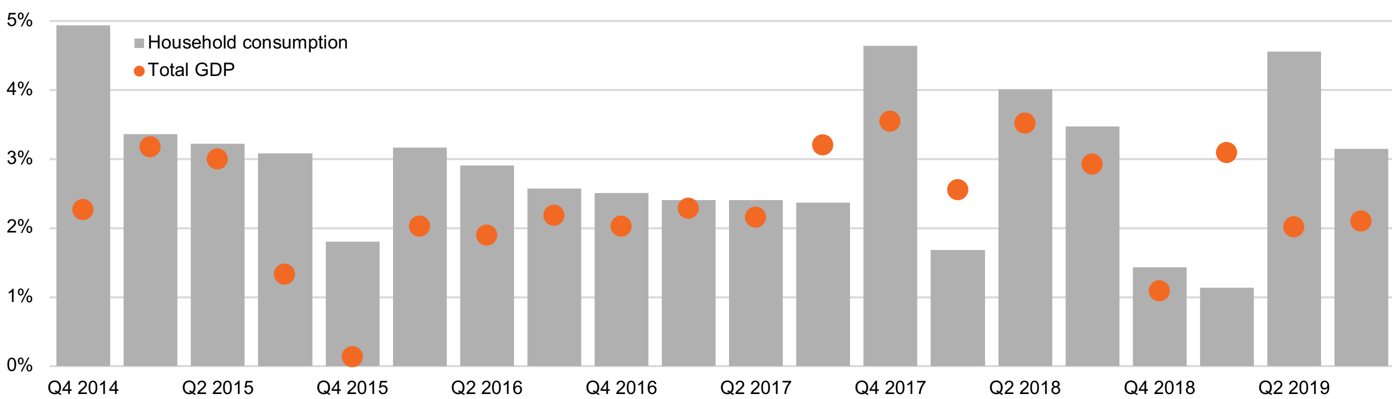
Given the importance of **household spending** for our overall economy, this sector rightly deserves close attention, and the good news is that the outlook is positive. The labor market has bolstered consumer confidence, but the household balance sheet deserves credit, too. Households have increased savings during this expansion and lowered leverage levels. This not only supports current consumption, but provides an important buffer against future headwinds or an uptick in uncertainty.

The labor market roared into 2020 in its best shape in 50 years and is one of the most important supports to consumption and the economy. So far, the benefits of a strong labor market have come without the usual harmful side effects of wage-driven inflation, although real wage gains are starting to materialize. This wage dynamic bears close watching, however, and could test the Fed's willingness to let the labor market run "hot" should labor costs intensify.

Business investment slowed notably in the second half of 2019 as business sentiment soured. There's widespread optimism the phase one trade deal

CONSUMPTION HAS GROWN FASTER THAN TOTAL GDP

%q/q, SAAR



Source: Bureau of Economic Analysis, FS Investments, as of January 6, 2020 between the U.S. and China will help lift the gloom, but we are more cautious. Against a backdrop of slowing growth and important trade issues still lingering with Europe, and a weakening earnings picture, business spending may continue to reflect caution in the coming year.

Too soon to say goodbye to policy uncertainty

In 2019, we wrote about the corrosive impact of policy uncertainty, which materialized forcefully with a global decline in manufacturing activity and sentiment that caused central banks to swing into easing mode. This coming year, we think policy could continue to play an important role in the economy and financial markets.

The **2020 elections** have so far been largely ignored by markets. But by the end of the first quarter, the Democratic primaries will have taken place in 29 states and could narrow the field significantly. As the policy debate crystallizes, the ideological differences between the two candidates could draw more attention. Under this topic, we consider the policy areas where the Executive Branch has outsized impact, which could garner market attention.

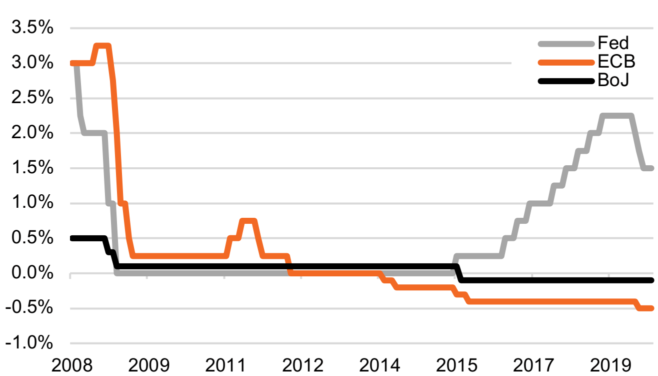
Trade-related uncertainty had an outsized impact on **global growth** in 2019, delivering the weakest year for world GDP since 2009. This was met with widespread central bank easing, driving policy rates lower. With global interest rates at or near historic lows, there is a growing concern that **policy reaction** will pack less potency. Indeed, policies that were initiated during the financial crisis, including asset purchases and negative interest rates, are still in place and were resorted to again when growth was merely experiencing a weak patch.

2019 will be tough to repeat

Few expected the outsized returns of 2019, which started as simply a recovery from the sizable sell-off in Q4 of the prior year. By mid-2019, central bank rate cuts caused interest rates to plunge, delivering outsized price gains for fixed income investors and buoying equity market returns. To top it off, the Fed rebuilt its balance sheet to quell the squall in repo markets. While not an explicit QE policy, it nevertheless injected additional liquidity into markets.

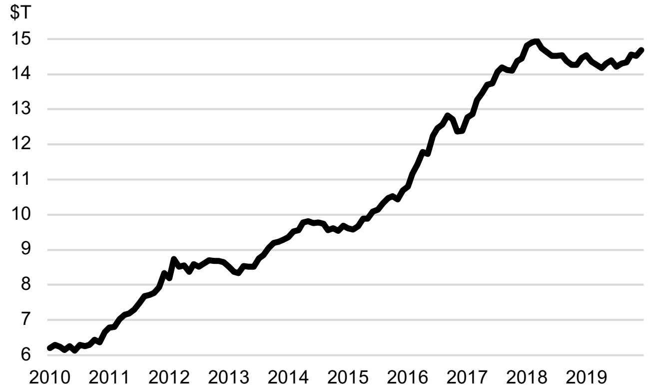
Can this party continue? In **fixed income**, investors may wake up in 2020 with the realization that income gains have now been reduced significantly. In the final four months of 2019, as interest rates were range-bound, the Barclays Agg declined 0.35% – a painful illustration of paltry returns available to traditional fixed income investors when yields stay flat.

POLICY RATES DRIFT DOWN



Source: Macrobond, as of 12/31/2019.

G3 ASSET PURCHASES ARE RISING AGAIN



Source: Cumulative balance sheet of ECB, BoJ and Fed; Macrobond, as of 12/31/2019.

Equity markets enter 2020 with valuations close to 20-year highs. Yet S&P 500 companies are projected to see a second consecutive quarter of negative year-over-year earnings growth in Q4, driven by margin compression and stagnant growth. Looking ahead, equity market returns tend to track with EPS growth, which has decelerated notably. Markets may experience more difficulty finding traction as investors zero in on underlying fundamentals

The consumer: Keep saving, carry on spending

KEY TAKEAWAYS
- Consumption has been the key driver of growth.
- During this expansion, consumer leverage has fallen.
- Higher savings could buffer consumers going forward.

The consumer emerged in 2019 as the dominant driver of growth, and our expectation that the economy will continue its record-setting expansion in 2020 is based on a positive outlook for household spending. Multiple factors support a high level of household confidence, including a strong labor market, modest but steady wage gains and recent asset price appreciation. Two key measures of consumer confidence rest near expansion highs.

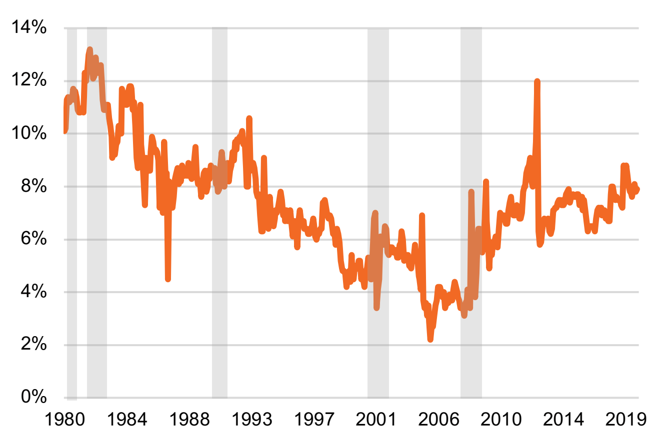
A critical factor for the future path of the economy is the healthy consumer balance sheet. Throughout this expansion, the household savings rate has increased from 6.0% in the first year of the expansion to 8.1% over the past year.[1] This is in notable contrast to the prior three expansions, during which the savings rate fell an average of 2.1%.

A broader look at the household balance sheet shows deleveraging throughout this expansion, unlike the government and corporations, which have taken on debt at record levels. Consumer debt outstanding has risen to almost $14 trillion, but when normalized as a share of GDP was 64.8% in Q3 – the low of this expansion and indeed the lowest since Q1 2003.

Demographics surely have some part in this shift in behavior as the baby-boom cohort is actively saving for retirement. But other evidence suggests a broader shift towards some prudence in spending vs. savings, especially in relation to the arguably over-levered household tendencies of the 2000s. For example, the recent drop in interest rates has caused a fresh wave of mortgage refinancing activity to lower rates, but the overall level of mortgage debt has not increased.

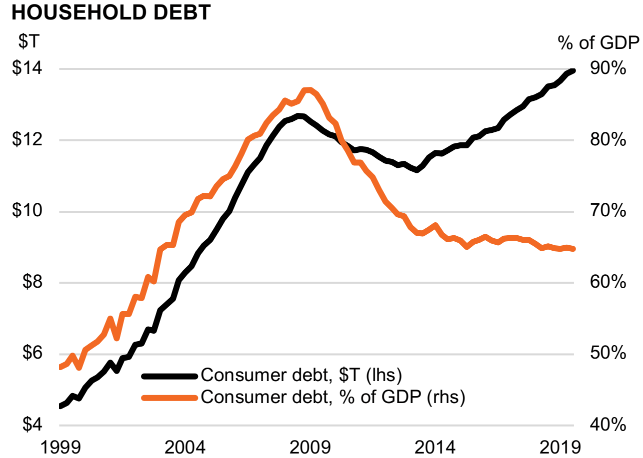
The healthy consumer balance sheet not only supports current consumption, but it provides an important buffer against future headwinds or a significant uptick in uncertainty. It does not make the consumer bulletproof, but certainly improves resiliency, which is increasingly critical at a time when fiscal and monetary policy options would appear to be limited.

RISING SAVINGS RATE BUCKS TREND



Source: Shaded areas represent NBER recession. Bureau of Economic Analysis, NBER, as of January 6, 2020.

HOUSEHOLD DEBT



Source: Federal Reserve, Bureau of Economic Analysis, FS Investments, as of January 6, 2020.

1 Average from December 2018 to November 2019, the latest available data as of January 6, 2020.

Labor market: Little downside to strength

KEY TAKEAWAYS
- Record-strong labor market continued in 2019.
- Wages have risen, but only modestly.
- Labor cost dynamic should be closely watched.

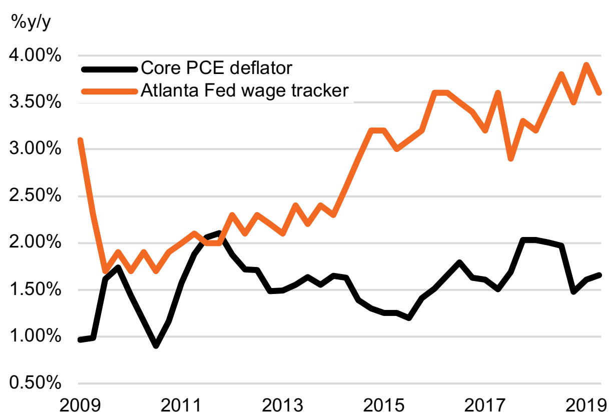
By virtually every measure, the U.S. labor market is starting 2020 in the strongest position in decades. During 2019, the unemployment rate fell from 4.0% to 3.5%, a 50-year low. Other measures also fell, like the “underemployment” (U-6) measure, which fell to an all-time low of 6.7% from 8.1% at the start of the year. This expansion has seen an unprecedented uninterrupted string of monthly job creation averaging well over 2 million jobs per year since 2010, a pace that barely slowed in 2019.

This tight labor market has made the household remarkably resilient to a wide variety of uncertainties. Over the past two years, consumer confidence has remained close to the expansion high despite a trade war, Brexit, a global growth slowdown and even a government shutdown.[2] In the face of broader uncertainties, a healthy labor market is the single-best support for household spending, the largest engine driving our economy forward.

So far, the benefits of a strong labor market have come without the usual harmful side effect of wage-driven inflation, although real wage gains are starting to materialize. Wage growth started to pick up momentum in the past two years. Average hourly earnings averaged 3.2% y/y in 2019, and the Atlanta Fed’s wage tracker accelerated to 3.7% in 2019.

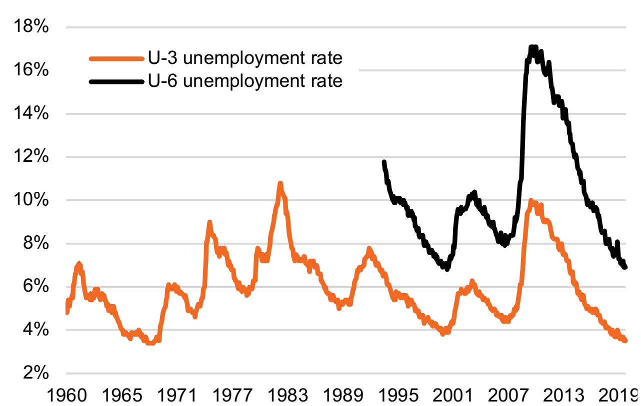
The dark side of higher real wages, of course, is that it has caused unit labor costs to rise from 1.0% y/y in Q1 2019 to 2.2% by Q3, squeezing profitability for companies. This has accelerated modestly enough to be manageable for now. Given low levels of inflation, the Fed has indicated it is willing to let the unemployment rate run “hot” at levels below their long-run estimate of equilibrium, which is currently 4.1%.[3] But this dynamic bears watching in 2020 should the unemployment rate fall further, as most economists expect.

WAGE GAINS ARE OUTPACING INFLATION



Source: Bureau of Economic Analysis, Federal Reserve Bank of Atlanta, FS Investments, as of January 6, 2020.

UNEMPLOYMENT AT MULTIDECADE LOWS



Source: Bureau of Labor Statistics, as of

2 The Conference Board measure of consumer confidence dropped to a 1.5-year low in January 2019 during the government shutdown, but quickly recovered and has remained elevated since.

3 Economic Projections of Federal Reserve Board members, December 11, 2019.

Business investment: Still the weak link

KEY TAKEAWAYS
- Business spending slowed in the latter half of 2019.
- Weak sentiment may not automatically recover.
- We look for investment to remain cautious.

Business investment accounts for only 14% of U.S. GDP,[4] yet it is a major swing factor when considering outlooks for 2020. We expect businesses to remain cautious in 2020 and for business investment to remain a weak spot for growth.

In the second half of 2019, business investment slowed, reflecting the downturn in business sentiment. The decline in business confidence has been somewhat uneven, although both services and manufacturing sector sentiment are below the highs of 2018. While the slide in the services sector outlook has shown early signs of stabilizing, manufacturing sector data has continued to plumb new expansion lows. It is too early to say whether this has hit a bottom or not.

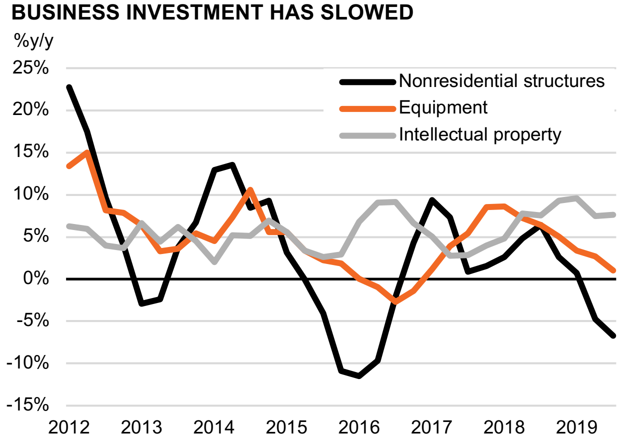
=The slowdown in investment was evident in all three major categories. Nonresidential structures have been partly depressed by the decline in energy investing (shafts and wells are 21%[5] of this category), but equipment investment has been on a steady downtrend for two years and is barely growing at present. One area that remains steadier is spending on intellectual property, which includes software and computers. Stability in this sector is driven by the relatively short lifespan of this type of investment.

One obvious cause of weaker business investment is trade-related tension, which impacted manufacturing activity in major developed economies. There is widespread optimism that the phase one trade deal signed in January will lift some of the gloom. But we think this is premature. The deal is light on details and tariffs remain in place. It doesn't deal with many of the larger issues in U.S.-China relations, and the President could easily re-impose tariffs. We expect policy uncertainty related to China to continue.

We see other reasons why businesses are exercising caution. Primary among them is the expected slower pace of U.S. growth, which over the long term tracks with slower aggregate demand and revenue projections. In addition, as the 2020 elections ramp up, uncertainty around polarizing policy debates could cause businesses to sit on the sidelines until 2021.

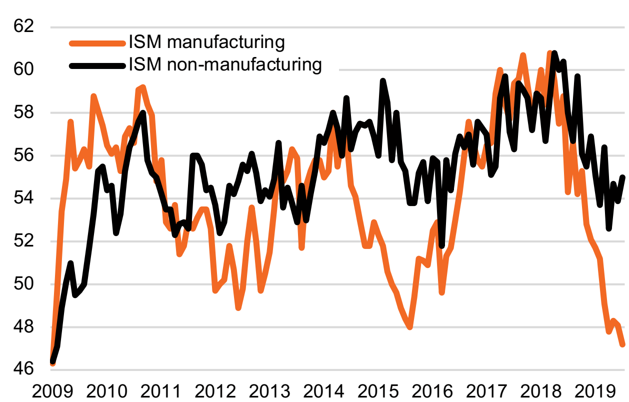
Finally, the tight labor market could have an offsetting impact on business investment. Higher wages have pushed up unit labor costs, squeezing profit margins and potentially causing businesses to delay or scuttle investments. However, the scarcity and higher cost of labor could cause businesses to allocate dollars toward productivity-enhancing investments.

BUSINESS INVESTMENT HAS SLOWED



Source: Bureau of Labor Statistics, as of January 8, 2020.

BUSINESS SENTIMENT BOUNCE OR BUST



Source: Institute of Supply Management, as of January 8, 2020.

4 For full year 2018.

5 In Q3 2019.

U.S. elections: Policy uncertainty creeps in

KEY TAKEAWAYS

- So far, markets have largely ignored 2020 elections.
- Policy debate may crystalize in Q1.
- We see significant policy uncertainty ahead in 2020.

The 2020 election cycle could be particularly impactful on markets given the sharp ideological differences between both parties. We have no call on the election outcome, or even on which Democrat will become the nominee. But by the end of the first quarter, Democratic primaries will have taken place in 29 states and could narrow the field significantly. The policy debate may crystalize, getting the attention of C-suite executives who are making long-run investment and hiring decisions.

To this end, it is worth considering what policy areas the Executive Branch of the government can impact. Many legislative agendas require the approval of Congress, including significant tax reform. But the range of policy proposals in this election could be particularly wide, with meaningful impact on several sectors in particular.

Trade: Presidents have significant autonomy, ranging from adding or removing tariffs, trade pacts and enforcement mechanisms.

Healthcare: The president has authority to strengthen or weaken protection of the Affordable Care Act marketplace, and potentially to lower some prescription prices.

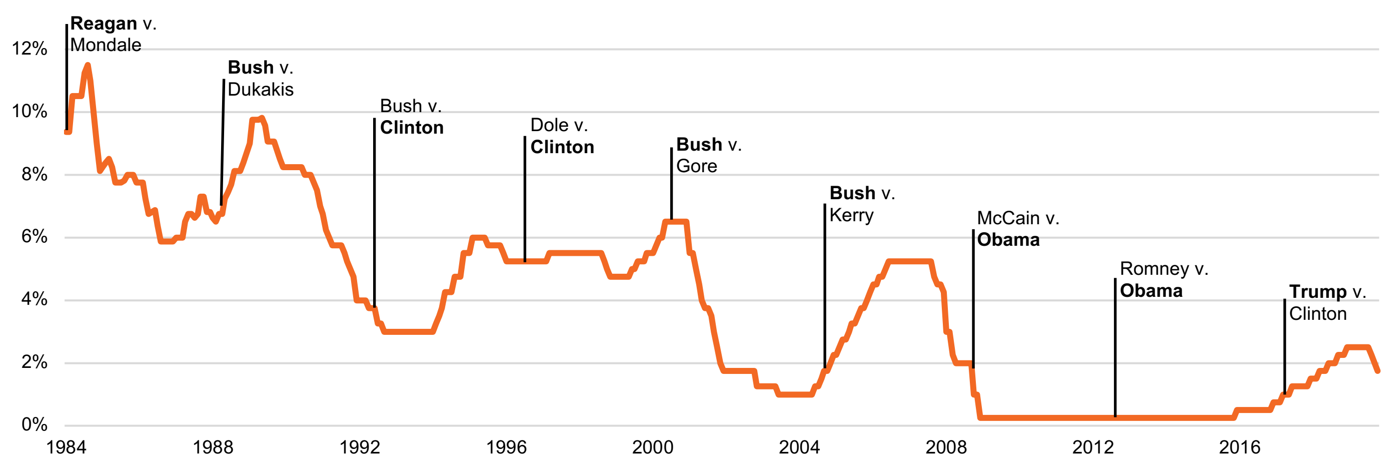
Energy, environment: Presidential authority can allow or ban fracking on federal lands, as well as strengthen or weaken the Environmental Protection Agency.

Technology: Presidential authority could either take a hands-off stance on regulating big tech and roll back net neutrality (current administration) or back varied Democratic proposals of restoring net neutrality or breaking up big tech via antitrust law reforms.

Banking, finance, markets: Presidential authority is significant, although congressional legislation is also key. The current administration has eased some Dodd-Frank regulations, particularly the regulatory burden on smaller banks. Select Democratic proposals include limits on buybacks and corporate leverage, tighter regulation on private equity transactions and breaking up the banks.

A common narrative in the market is that the Fed stays on hold during election years. In fact, the Fed has changed rates in six of the last nine presidential election years. We forecast the Fed on hold in 2020; but should events develop that warrant a rate change, the Fed will not hesitate to act, despite the election.

FED FUNDS RATE AND ELECTIONS



Source: U.S. Federal Reserve, FS Investments.

Trade and global growth: A break in the clouds

KEY TAKEAWAYS

- Trade-related uncertainty has been a drag on growth.
- Outlook for advanced economies is tempered.
- We view phase one of the trade deal as largely cosmetic.

Trade-related uncertainty negatively impacted global growth in 2019, particularly manufacturing output in developed economies. There are early signs that the overhang of uncertainty is lifting, but it may be premature to declare an end to policy uncertainty. Global growth is expected to stage a modest recovery in 2020, but advanced economies are broadly converging toward their potential growth rates, a structurally challenged low-growth environment.

Globally, the manufacturing sector led weakness in 2019, while the services sector was better supported by consumption and acted as a buffer. Still, global growth is estimated to have been only 3.0% in 2019,[6] the lowest since the Great Recession. Looking ahead, the IMF estimates a rebound to 3.4% in 2020, led entirely by an acceleration in growth in developing and emerging economies. Advanced economies are expected to grow at the same pace of 1.7%.

The IMF expects U.S. growth to decelerate to 2.1% in 2020, while we are somewhat more cautious. The Fed currently sees long-run equilibrium U.S. growth at 1.7%, which aligns with our outlook for the coming year.

One key support in the second half of 2019 was central bank easing. The Fed took quick action with three rate cuts, while the ECB cut rates again. However, the Fed has said it expects to keep rates unchanged in 2020, leaving open the question of how much support the economy will get from monetary policy in the coming year. Other major central banks retain a dovish bias, including the ECB and the BoJ. The BoE has signaled it expects to cut rates this quarter.

While there is optimism in this global growth outlook, there is also a growing concern lurking in the background. Policies that were initiated during the financial crisis, including asset purchases and negative interest rates, are still in place and were resorted to again when growth was merely experiencing a weak patch. The balance sheets of the Fed, ECB and BoJ together are again closing in on $15 trillion, the high reached in early 2018. With negative interest rates, low inflation and low growth now pervasive in the global developed world, there is a growing understanding that these monetary policy tools are doing little to solve structural issues that will challenge investors for the coming decade.

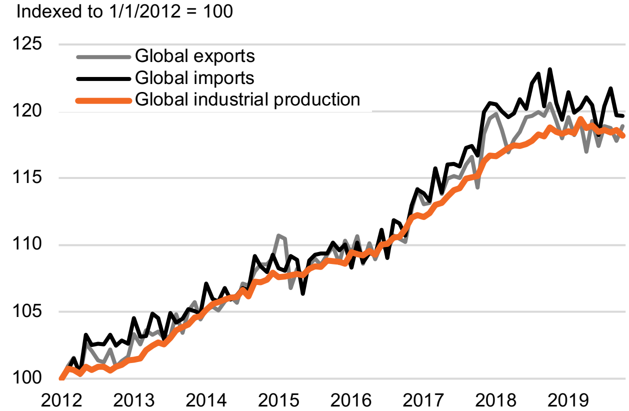
IMF FULL-YEAR GROWTH FORECASTS

	2018	2019	2020
World	**3.6%**	**3.0%**	**3.4%**
Advanced economies	2.3%	1.7%	1.7%
EM, developing economies	4.5%	3.9%	4.6%
U.S.	2.9%	2.4%	2.1%
Euro area	1.9%	1.2%	1.4%
Germany	1.5%	0.5%	1.2%
Japan	0.8%	0.9%	0.5%
U.K.	1.4%	1.2%	1.4%
China	6.6%	6.1%	5.8%

Source: IMF World Economic Outlook, October 2019.

GLOBAL INDUSTRIAL OUTPUT HAS STALLED

Indexed to 1/1/2012 = 100



Source: Netherlands Bureau of Economic Policy Analysis, as of 1/14/2020.

6 IMF World Economic Outlook, October 2019.

Policy reactions: Ammunition is running low

KEY TAKEAWAYS

- Risks of recession have faded.
- Low interest rates will limit Fed ammunition.
- Fiscal spending may be politically unpalatable.

The risk of recession, which flared in mid-2019, seems to have largely faded going into 2020. Nevertheless, there are inherent risks to our outlook that growth will decelerate in the coming year. On paper, growth moderating from over 2.0% in 2019 to 1.7% in 2020 seems like a gentle downtrend, but in the real world the data are rarely so well behaved. Several speedbumps, or even a quarter of zero growth, could be deeply unsettling for markets.

What policy options are left should we get a repeat of mid-2019 yield curve inversion or a deeper slump in business sentiment? One key concern going forward is how willing policymakers will be to expend valuable ammunition, and whether fiscal policy will be available to counteract a disruption in the business cycle expansion.

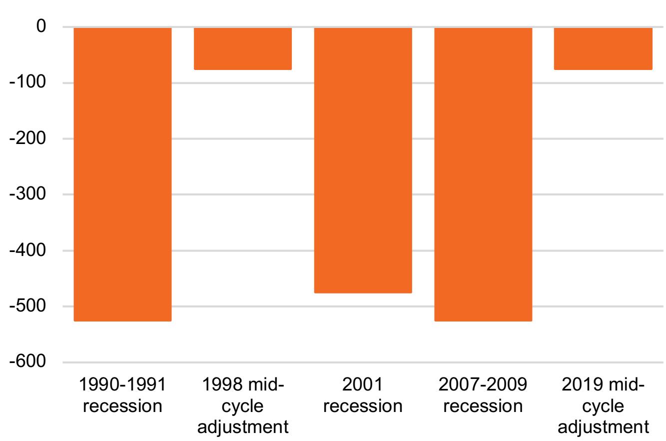
The Fed funds rate target band currently stands at 1.50%–1.75%, leaving only 150 bps of ammunition with which to address further market turbulence or a slump in growth. Fed thought leaders spent much of 2019 socializing research that other policy tools beyond the Fed funds rate were used in the prior crisis with success, and the Fed is ready, willing and able to use those tools again. Namely, quantitative easing and forward guidance. However, as 2019 demonstrated, the policy rate remains the main tool. The Fed is also leaving the door open on negative interest rates should a future downturn become severe.

Fiscal policy takes longer to pass than a Fed rate cut response but has the potential to be significantly more powerful as an economic stabilizer. But this policy response may also face some constraints in a downturn. Total government debt outstanding is now over 100% of GDP, which may limit the appetite of policymakers to increase spending even more. Indeed, the deficit has risen during this expansion, in contrast to prior expansions where growth has been seen as an opportunity to save money and reduce spending.

We don't expect a recession this year, but a bout of surprisingly weak data could cause market volatility. Policymakers would face tough decisions about how much ammunition to expend in the face of further market turbulence, especially should economic fundamentals point toward growth on trend.

FED HAS LITTLE ROOM TO CUT IN A DOWNTURN

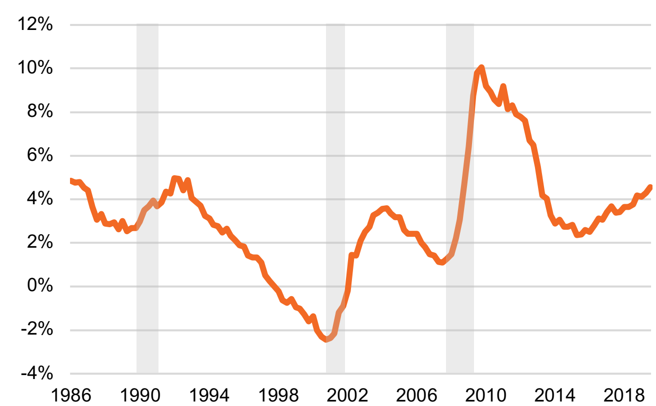
Change in Fed funds,



Source: Federal Reserve, FS Investments, as of 1/14/2020.

DEFICITS HAVE RISEN THIS EXPANSION

Annual federal deficit, %/GDP



Source: U.S. Treasury, Bureau of Economic Analysis, NBER. Shaded areas represent NBER recessions. As of 1/14/2020.

Fixed income: How long can the party go on?

KEY TAKEAWAYS

- 2019 saw strong returns across fixed income.
- High duration means more vulnerability to volatility.
- We favor an active approach to credit in 2020.

Fixed income markets experienced a landmark year in 2019, with nearly all parts of the market posting strong returns. Traditional fixed income was buoyed by declining interest through the first two-thirds of the year. Meanwhile, high yield bonds and loans finished the year strong, returning 14.4% and 8.6%, respectively.

Yields remained range-bound for the final 4 months of 2019 and look anchored at current levels headed into 2020. After returning 9.1% through August, the Barclays Agg declined 0.35% for the rest of the year, illustrating the paltry returns available to traditional fixed income investors when yields stay flat.

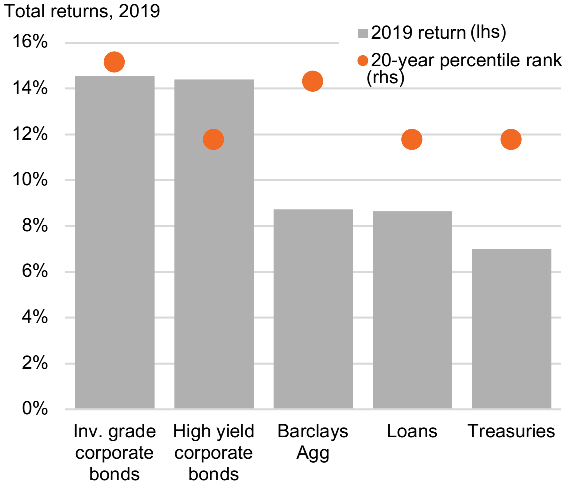
Investment grade corporate bonds exemplify the conundrum in which investors currently find themselves. The asset class returned 14.54% in 2019, the best year since the 2009 recession. While plummeting yields have enhanced returns in the short term, the long-term reality remains stark. Investors must not only deal with meager income, but duration, or the sensitivity of prices to interest rates, which has risen to an all-time high of 8 years. This leaves fixed income investors more exposed to even moderate changes in rates.

Meanwhile, high yields bonds returned 14.4% for the year as spreads tightened from a peak of 548 bps in early January to 372 bps by year-end. Risk assets have been aided by monetary accommodation in 2019, as central banks reacted to slowing global growth. Even bank loans, which fell out of favor as short-term rates fell and saw over $36B in retail outflows on the year, posted solid returns. Wide performance dispersion between different credit ratings suggests investors may want to be more selective in 2020.

After a stellar 2019 for nearly every area of the fixed income market, 2020 will likely offer some reversion to the mean. With yields this low, traditional fixed income has never been more reliant on price gains for returns. Should yields remain range-bound, as we expect, the Barclays Agg could see performance return to levels seen from 2015–2018. Higher income is available in the high yield and bank loan markets, though with spreads fairly tight, we favor an active approach to credit in 2020.

2019 WAS A BANNER YEAR

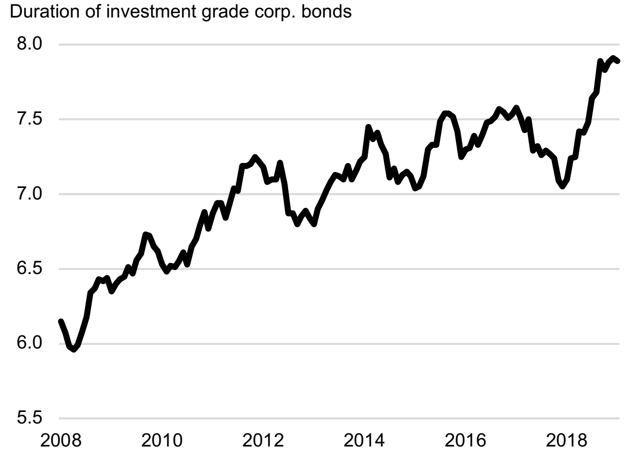
Total returns, 2019



Source: Bloomberg Finance, L.P., ICE BofAML, as of December 31, 2019.

RATE SENSITIVITY ON THE RISE

Duration of investment grade corp. bonds



Source: Bloomberg Finance, L.P., ICE BofAML US Corproate Index, as of December 31, 2019.

Equities: Profitability a key concern

KEY TAKEAWAYS

- 2019 returns were strong despite little earnings growth.
- Earnings picture could present risk for stocks.
- Valuations enter 2020 near two-decade highs.

Equities soared in 2019, with the S&P 500 posting its second-best year since the financial crisis. Coming off a correction in late 2018, markets fought through slowing global growth and were driven upward by central bank easing and a partial resolution to U.S.-China trade tensions. Looking ahead to 2020, we still see a host of risks for equity markets, especially high valuations and questionable fundamentals.

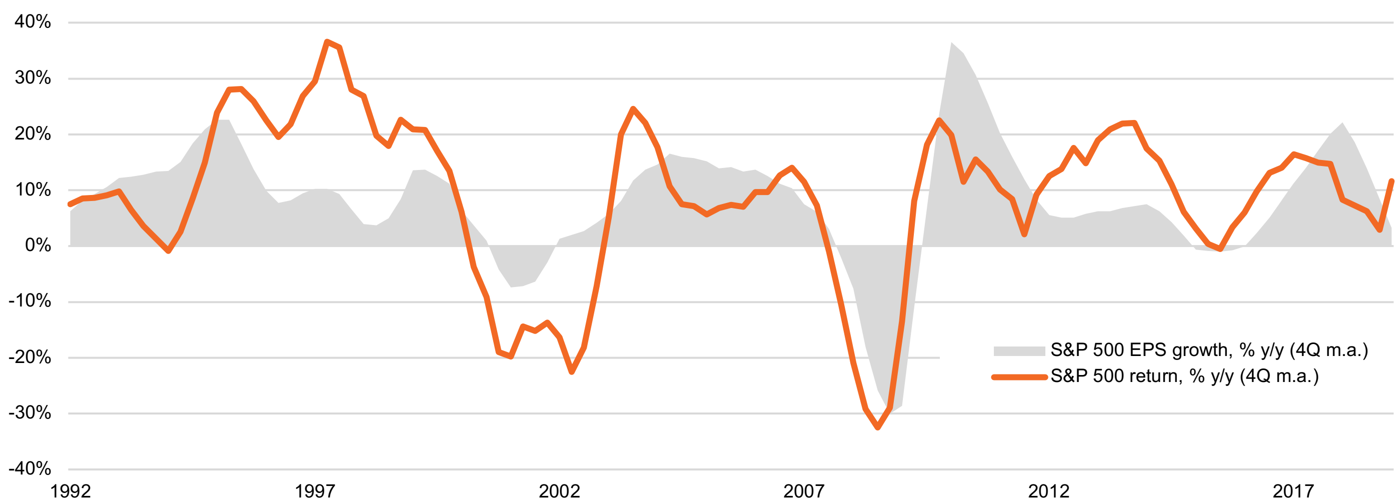
While markets have so far been able to shrug off decelerating economic growth, companies' bottom lines reveal a less rosy picture. S&P 500 companies are projected to see a second consecutive quarter of negative year-over-year earnings growth in Q4, driven by margin compression and stagnant revenue growth. Many analysts expect earnings to recover, especially in the latter half of the year. However, we still see risk that margins remain tight given rising labor costs and firms' limited pricing power, and revenues could be challenged if GDP growth slows more than expected.

Possibly most worrisome is the breadth of the earnings weakness. In Q3 of 2019, 7 of the 11 S&P 500 sectors saw bottom-quartile post-financial crisis earnings growth. Q4 estimates have that number rising to 9 of 11 sectors. Fed easing in 2019 helped equity markets push through this earnings malaise and post strong gains. However, as the graph below shows, the fate of the stock market generally performs in line with fundamentals over the long term.

As earnings have stagnated, valuations continue to climb upward. In 2019, expanding price-to-earnings (P/E) ratios were responsible for more than four-fifths of the 31.5% return of the S&P 500. In fact, the current 12-month forward P/E ratio of 18.3x is near an 18-year high, and well above the long-term average of 14.2x.

2019 was a historic year for the stock market, with stellar returns and muted volatility despite little EPS growth. Risks to the outlook remain elevated, however. U.S.-China tensions, geopolitics and the U.S. presidential election could all present significant uncertainty for markets in 2020.

OVER THE LONG TERM, EQUITY RETURNS FOLLOW EARNINGS GROWTH



Source: Bloomberg Finance, L.P., as of December 31, 2019.