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The Outlook for 2020

Market Commentary

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What a year for the S&P 500, up 30% in 2019! You'd think that the economy is booming, earnings are growing rapidly!

The truth is, the economy is doing well, but not "gangbusters" well. Real GDP, which grew 2.9% in 2018, has decelerated, and will likely be 2.2-2.3% in 2019. The S&P 500's earnings, perhaps surprisingly, have not increased this year. No change! At the end of 2018, the forward earnings estimate for the S&P 500 was about $172, according to Zacks Research. At the end of 2019, it's the same number, $172.

The market's rise this year is entirely due to changes in valuation. That is to say, the price/forward estimated earnings multiple has risen sharply. We started the year with the market multiple at 14.6. It currently stands at 18.8. That's a 30% increase just from valuation! Great for this year, but in the long run, the market increases due to gains in earnings, not valuation.

Has the outlook gotten that much better? Last year, the market was concerned with the Federal Reserve potentially increasing interest rates and a trade war with China. In 2019, the Fed cut rates and eased monetary conditions. Fears of a potential trade war with China seems to have abated, but much depends upon the details of the negotiations. Going forward, we also have to consider the presidential and congressional elections as well as the impact of any change in policy.

The last time the market was at this level of valuation was the first quarter of 2018. Before that, you'd have to go back to 2004. Point is, the market is rarely at this level of valuation. I think it will be difficult to maintain this level throughout 2020.

Last year, I wrote that "With reasonable valuations, good earnings, and a federal reserve that is at or near the end of the interest rate increase cycle, the market is poised for better returns in 2019." I didn't think it would be as strong as it was. This year, the positives are that (1) earnings could grow in our reasonably strong economy, (2) the Fed may be neutral to accommodative and (3) there is the potential for the trade issues with China to be settled. The negatives are that (1) we are at a high valuation, (2) the trade issues with China might not be settled and (3) there will be contentious presidential and congressional elections this year, raising uncertainty.

Bottom line, my outlook is for a slight decrease in the market this year. Valuations are high, any gains will most likely have to come from earnings growth. All it would take is a decline in valuation from 18.8 to 17.5 to offset likely earnings growth, and 17.5 is still a fairly high valuation multiple. Much depends upon the continuing trade negotiations with China and the elections.

2020 should prove be an exciting year!

December 31, 2019

Information obtained through Zacks Investment Research—www. zacks.com