What May Tip the Scale?

2020 Schwab Market Outlook

Schwab's team of market experts share their perspectives and provide investment guidance.

SCHWAB CENTER FOR FINANCIAL RESEARCH
Trade wars and a global manufacturing decline weighed on economies in 2019, although central bank rate cuts and resilient consumers provided a positive stock market counterbalance. The question heading into 2020 is: What may tip the scale? Will ongoing trade uncertainty and weakened manufacturing hurt job growth, finally dragging down the services and consumer side of the economy? Or will interest rate cuts and a resolution of the trade war spark a fresh round of global economic growth?

Each section in this 2020 Schwab Market Outlook—U.S. Stocks & Economy, Global Stocks & Economy and Fixed Income—discusses ways to prepare for potentially changing conditions. Having a financial plan and an appropriately diversified portfolio are two key first steps for weathering any market environment. Note that this is just a one-year outlook, and investors should keep their investing time horizon in mind before reacting to any forecasts.

**KEY POINTS**

- The U.S. economy likely will remain split in early 2020, with manufacturing and business investment still struggling amid trade uncertainty, but services activity and consumer spending healthy.

- A resolution of the U.S.-China trade war could reverse business uncertainty and unleash investment. However, a global recession could occur if the manufacturing slowdown spreads to jobs and consumers.

- Ten-year Treasury bond yields should move higher in 2020, assuming recession fears continue to decline. Barring a setback on trade, 10-year yields could rise to the 2.25% to 2.5% area.
The dividing line remains firm

U.S. economic growth slowed in 2019, pulled down by weak business investment and manufacturing activity. Although strength in consumer spending and services persists heading into 2020, we expect stabilization—at best—in growth next year. Myriad uncertainties are clouding the outlook, including earnings and the presidential election. Ongoing trade war ambiguity could further depress corporate confidence and investment.

A key risk in 2020 is that manufacturing weakness and business investment fatigue could hurt services activity and consumer spending, by depressing job growth. Although the U.S. unemployment rate (a lagging indicator) remains low, weekly initial jobless claims (a leading indicator) in manufacturing-oriented states have been rising. As such, U.S. payroll growth may weaken if limited headway is made on a comprehensive trade deal. However, global economic stabilization could be positive for U.S. growth.
TAKE AWAYS

- **High debt levels and a weaker profitability outlook** likely will continue to pressure small-cap stocks. We continue to recommend an overweight to large caps and underweight to small caps within U.S. equities.

- **Factor performance trends** are likely to be more consistent than equity sector performance trends in 2020. (Factors include small- vs. large-cap, value vs. momentum, etc.) Quality—such as strong corporate balance sheets, low debt, consistent earnings—and valuations likely will remain important.

- **Availability and cost of credit** will be a key to whether economic conditions support stock price gains, given that further Federal Reserve rate cuts appear to be on hold. Corporate earnings may have to do more of the heavy lifting.

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**A lift from earnings?**

We expect bouts of market volatility will persist in 2020. Trade news may continue to drive market swings in both directions, absent a comprehensive U.S.-China trade deal. Investor sentiment should also be a factor in market swings, with late-2019's new highs ushering in elevated investor optimism (a contrarian indicator at extremes). Investor sentiment also may continue to swing more widely than usual, with new highs elevating optimism, only to be dented by negative trade news.

Earnings are expected to accelerate in 2020, but that expectation is partly predicated on a positive outcome to the U.S.-China trade war, which remains uncertain. In addition, due to the effects of tariffs and rising labor costs, profit margins could come under pressure in 2020. The macroeconomic environment, including easier monetary policy and lending conditions, supported price-earnings (P/E) expansion in 2019, but those effects are fading. The wide gap between stock market performance and corporate after-tax profits suggests the latter needs to accelerate.

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The gap between S&P 500 index performance and corporate profits is wide

![Graph showing the gap between S&P 500 index performance and corporate after-tax profits](Image)

*With inventory valuation and capital consumption adjustments.
New heroes are needed

International stocks’ double-digit gains for 2019 may be attributed to central bankers’ actions, but trade deals and fiscal policies may be the real heroes in 2020.

As central banks shifted to interest rate cuts in 2019, investors drove up valuations for international stocks, believing that these “Guardians of the Economy” could defeat any threat to global growth. In 2020, growth may depend on comprehensive trade deals and fiscal stimulus to reverse the slowdown in manufacturing and business investment. If tariffs are not lifted before businesses cut jobs, it may undermine the consumer spending supporting the world’s economy.

Manufacturing-focused economies, like Germany, are at the leading edge of the slowdown. This may lead to fiscal stimulus, with an increasing number of leaders already announcing new tax cuts and spending initiatives in their 2020 budgets.
A year of surprises?

International stock valuations are below long-term averages, reflecting 2019’s lackluster global growth and fears of potential weakness ahead. As international stocks tend to be more economically sensitive than U.S. stocks, they may offer more upside potential should growth reaccelerate.

Compared to the past 20 years, global stock markets are now less synchronized with each other, suggesting a globally diversified portfolio may provide effective management of market volatility.

A yield curve inversion can be a negative market signal, as it has often—but not always—preceded global recessions. As importantly, it also has signaled trend reversals in relative performance of global growth and value stocks, international large- and small-cap stocks, as well as U.S. and international stocks. In 2020, new leadership by value, large-cap and international stocks may follow 2019’s inversion.

Historically, long-term asset class trends have tended to reverse after yield curve inversions—that is, when short-term yields are higher than long-term yields—as happened in 2019.
KEY POINTS

- Ten-year Treasury bond yields should move higher in 2020 as recession fears ease. Barring a setback on trade, yields could move back up to the 2.25% to 2.5% area.

- The Federal Reserve is likely on hold for the foreseeable future. The three short-term rate cuts in 2019 successfully “un-inverted” the yield curve.

- Investors should consider adding bonds with longer maturities to their fixed income portfolios if 10-year yields do move above 2.25%.

- The value of the U.S. dollar should remain firm on continued outperformance by the U.S. economy relative to other major countries. However, further gains are likely to be small.

Easing recession fears should boost bond yields

Ten-year Treasury yields should move higher in 2020 as recession fears ease. The lagged impact of the Federal Reserve’s interest rate cuts, signs of stabilization in the global economy and a modest uptick in inflation expectations should provide a boost to intermediate- and long-term bond yields. The risk to our outlook is the ongoing threat of trade tariffs weighing on business investment. Barring further setbacks on trade, 10-year Treasury yields could move up to the 2.25% to 2.5% area, while the chances of a drop back below the 2019 low of 1.52% are diminishing as global recession fears abate.

With the yield curve now “un-inverted” and signs of economic stabilization, the Fed likely will be on hold for the foreseeable future.
TAKE AWAYS

- **Treasury Inflation-Protected Securities (TIPS) appear attractive.** Inflation expectations are low, making the inflation protection that TIPS provide relatively cheap.

- **Underweight high-yield bonds.** The yield advantage they offer relative to Treasuries is low, while corporate profit growth poses a risk in 2020. Investors also should move up in quality in investment-grade corporate bonds, focusing on bonds with “A” ratings or above.

- **Consider higher-rated municipal bonds with maturities in the five- to eight-year range.** Net supply of these bonds is likely to remain low, keeping prices from falling much.

- **Stay local.** International bonds provide diversification, but not much yield. It would take a significant drop in the dollar to make up for the wide yield gaps.

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**Inflation expectations may rise**

The key to higher yields on intermediate- to long-term bonds will be rising inflation expectations. With the economy showing resilience and core inflation edging up, inflation expectations should move higher, potentially adding 50 to 75 basis points¹ to 10-year Treasury yields. Breakeven inflation rates are low, so TIPS are attractive relative to nominal Treasuries for those looking for inflation protection.

Despite signs of economic stabilization, we see risks in the more aggressive segments of the bond markets, like high-yield bonds, bank loans and emerging market bonds. We suggest reducing exposure to high-yield bonds, while moving up in quality in the investment grade market. Municipal bond valuations have improved from early 2019 levels and still appear attractive for investors in higher tax brackets.

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**Inflation expectations are relatively low**

![Chart showing inflation expectations and Fed inflation target rate from 2015 to 2019]

¹A basis point is one hundredth of 1%, or 0.01%; 50 basis points is equal to 0.5%.

Note: The 5-year 5-year forward inflation rate is a measure of the average expected inflation over the five-year period that begins five years from the date data are reported. The rates are comprised of Generic United States Breakeven forward rates: nominal forward 5 years minus US inflation-linked bonds forward 5 years. Source: Bloomberg, using daily data as of 11/14/2019. U.S. 5y 5y Forward Breakeven (USGGSYSY Index)
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Small cap stocks are subject to greater volatility than those in other asset categories.

International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, geopolitical risk, foreign taxes and regulations, and the potential for illiquid markets. Investing in emerging markets may accentuate these risks.

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