STRATEGIC OUTLOOK

Strategic Frontier Management

First Quarter 2020

Equities Are From Mars, Bonds From Venus

- At the dawn of a new decade and rising US potential growth, it is surprising denizens from two different worlds of *Mars or Venus* differ dramatically in their economic interpretation. Consider differences in stock vs bond market returns. The S&P 500 return of 31.5% in 2019 to 3231 far surpassed our noteworthy expected ~20% return with a 2950 year-end target. Meanwhile, Treasury 10-yr. yields plunged from 3.2% in October 2018 to below 1.5% in July, resulting in an inverted yield curve that awoke hibernating perma-bears to screech about recession expectations—does it matter bond yields declined more than short-term rates, rather than short-term rates rising faster than long-term? We have cautioned unusual forces do indeed matter from perspectives of *Mars or Venus*.
- We have stuck with equities for a decade as high margins boosted earnings growth to keep valuations in check although the S&P 500 clocked a 507% return since troughing at 666 on 03/06/09. Still high US profit margins over 13% remain a paradox relative to lower US productivity, but measuring real growth is more difficult with low-to-zero priced services and apps. Venusian malcontents continue to suggest peak earnings, peak growth, and peak margins, thereby missing the 13.2% annualized return of the last decade—yet, valuations are still not stretched, although elevated and could limit future returns.
- Investors are still cautious as strong equity returns drove valuations higher and earnings growth slowed below 2%. However, we would observe that steep declines in Energy (-38%) and Materials (-11%) dragged equity earnings lower from large-cap to small-cap. Moreover, strong earnings growth of 23% in 2018 bolstered US valuation heading into strong 2019 equity returns. US equity valuations are less compelling now, but 2020 earnings growth should accelerate to over 8%, enabling our 3450 S&P 500 target this year and 3650 next year.
- Equity volatility-of-volatility provided contrarians with rewarding opportunities to buy-the-dips in 2018-2019, and suspect more of the same in 2020. Any correction of 7-10% should be an opportunity for tactically-inclined equity investors. However, a bond market correction is not. Divergent monetary, trade, and fiscal (tax & spending) policies reinforced the current *Asynchronous Global Expansion,* which reinforces cyclical economic divergences. Trade and investment forces should further bolster US potential growth, and yield greater international diversification across global equity, fixed income and currency markets with potential growth, inflation, earnings (margin, growth), and competitiveness divergences.
- We expected US interest rates and bond yields to rise in 2019 with firming 2.3% inflation and 2.4% growth (no US recession)—instead, 10yr. Treasury yields fell from 2.7% to 1.9% and the Federal Reserve cut rates ¾%. Investors got spooked by an inverted yield curve and negative global bond yields, as Europe and Japan flirted with recession. Global central banks still are unnecessarily manipulating bond markets and keeping interest rates low for an extended period. This prolonged explicit moral hazard increased financial imbalances, yet economic variables don't indicate any likelihood of a US recession. Instead, we believe global bond valuations remain extended and the best portfolio hedge is still cash or short-term bond funds. Some banks offered 2¼% yield on CDs and bank deposits last Spring, but cutting rates again lowered the hurdle rate for Bitcoin, gold, and alternative funds again, despite being volatile and costly for net return lagging inflation.
- Receding geopolitical and economic uncertainty has helped restore investor, business, and household confidence—improved sentiment and employment boosted household formation driving up home ownership for a renaissance in housing demand, thus starts. We expect greater investment and strong employment with increased cash flow from income growth and earnings repatriation. The US model of reform for trade, fiscal, and regulatory policy reform should begin to spread globally to other nations hoping to maintain competitiveness. With new US trade deals, impeachment trial winding down, resilient US growth, US rate cuts, and BREXIT clarity after the UK election, our focus pivots to the US election and potential balance of power policy consequences. Carryover risks of war on terrorism (inc., Iran), slowing global growth, and fiscal deficits remain.

Stirred, But Not Shaken for a New Decade

Men Are from Mars, Women Are from Venus is a bestselling book published by John Gray in 1992. The book discusses relationship problems between men and women, which he suggests are due to fundamental psychological differences between the sexes, as eponymized in men and women are from distinct planets. The book asserts differences between men and women can be understood in terms of distinct ways they respond to stress and stressful situations.

Current perspectives from Mars vs. Venus highlight the differences of two seemingly different worlds in capital markets. Flip-flopping investor beliefs have coincided with increased equity volatility-of-volatility observed. Global markets responded in unexpected ways to changes in economic relationships over the last decade, although not surprising given continued market manipulation by central banks. Financial imbalances should normalize, including extended bond valuations, as central banks withdraw now unjustified crisis intervention. Negative global bond yields, peaking over $17 Trillion, have moderated somewhat recently, but real interest rates remain negative in other countries also not in recession. Monetary policy has failed to compensate for poor fiscal policy decisions and deteriorating demographics that limited global growth and investment.

Martians and Venusians saw yield curve inversion quite differently, including their respective expectations about the economy and recession risks. We argued that inversion was a transitory consequence of external forces, rather than endogenous economic deterioration, thus was more likely a red herring. We've also observed anomalous returns to investment styles (i.e., risk factors: value vs. growth, large vs. small, momentum, minimum volatility, etc.), sectors, countries, and currencies. Risk factor investing is a remarkable innovation for retail investing, but is it a coincidence with central bank policy or enabling function of ETFs that caused anomalous equity style returns? Upside-down performance of risk factors, such as value and small-cap premiums, reached unprecedented extremes after persisting longer than ever observed. Bond returns also have been more positively correlated with equities than ever before as the US economic cycle extended into record duration.

Global profit margin divergence has been a critical reason for US outperformance versus China, Japan, and Europe. Japan's slow economic growth with lower profit margin risks a value trap for this reason. S&P 500 margin over 13% today has been increasing since 2003, which translated modest revenue growth plus buybacks into greater operating leverage, particularly for large-cap companies and the technology sector.

Venusian malcontents suggested peak earnings, peak growth, and peak margins would derail US equities, so sat on the sidelines and missed out on the S&P 500's remarkable return since the 2009 trough. Regarding valuations, they have pointed to flawed alternative indicators to justify their bearish equity outlook, such as Market Cap/GDP or Shiller's CAPE, which we cautioned against. US equity volatility has retreated below 10%, but what have kept valuations in check was strong S&P 500 earnings growth over the last decade, including over 23% in 2018. Earnings growth slumped in 2019, but mostly due to earnings declines in basic materials and energy—although the capitalization of these sectors is only 20% combined, their declines were so significant as to limit S&P 500 earnings.

The Federal Reserve has been concerned about slowing global growth, trade negotiations, negative global bond yields, and Treasury yield curve inversion, yet US tax revenues remained strong following tax reform, suggesting companies are still reaping benefits of improved business conditions. Global central bankers still seem to believe they are the last best hope to save us from depression (or ourselves)—keeping interest rates low also limits interest on government debt. We've questioned the conflict of interest in *qualitative easing* or easing simply for insurance sake.

While investors are preoccupied about the extended duration of the economic expansion and equity bull market, not every equity correction coincides with recession, and not every recession results in an equity correction—the recession of 1990-91 followed by the Savings and Loan Crisis (1991-92) yielded no extended correction in the S&P 500 (1991: +30.5%, 1992: +7.6%).

In a world turned upside-down with contrasting beliefs from *Mars and Venus*, many long-term relationships seem out of kilter. Lower return correlation, greater volatility-of-volatility in equity and currency markets, and asynchronous global economic conditions provide greater global tactical asset allocation opportunities as risk-on/risk-off behavior fades.

Our Global Tactical Asset Allocation (GTAA) models have routinely identified overvalued markets, including Aug. 2000–Sept. 2002 and the October 1987 Crash. We cringe at suggestion that the equity market is overvalued based on misguided ratios of CAPE (cyclically adjusted Price/Earnings) or Market Capitalization/GDP, which were clearly unable to discern previous periods of equity market overvaluation, as we've shown before. At a minimum, removing government contributions from GDP can provide a truer variable for comparison to debt, market capitalization, and earnings.

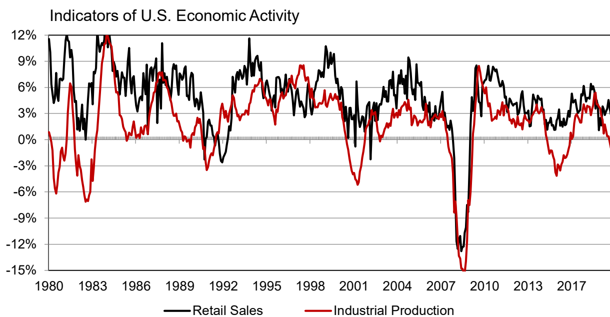
We believe it will be a dismal year for global bonds, particularly in Japan and the US, with rising inflation. Without recession, US credit spreads shouldn't widen much, so short-term corporate, asset-backed, and mortgage bonds can benefit from sustained yield

enhancement. Although tax revenues increased nicely as expected after tax reform, US fiscal reform should pivot to spending reform, although not likely before 2021. The US dollar could be more volatile, oscillating between favorable interest rate differentials versus modest weakness suggested by our tactical currency forecasts.

Economic Outlook

The longer the US economic expansion extends, the more anxious investors become about the timing of the next recession. However, the likelihood of recession doesn't increase with the passage of time, any more than successive flips of a coin increase the likelihood of heads. Goldilocks has returned with the US economy not too hot, nor too cold---but just right. Despite various external risks, we believe secular US potential growth has risen from below 2% before 2017 to at least 2.7% with tax, trade, and regulatory reform. We expect even stronger economic and earnings growth in 2020 benefiting from increased investment, export growth, and construction (inc., housing starts).

After President Trump's election, constructive trade, regulatory, and primarily tax (fiscal) reforms (*That Sneaky Second Derivative*--Q1/2017, *Capitalizing on Enduring Beliefs*—Q2/2017) has bolstered US potential growth, as well as investment, employment, and global competitiveness. US real GDP has been locked into a narrow range. US retail sales has strengthened since 2017, including 6% growth in 2019, while real GDP is just below 2.7% potential growth. Yet, industrial production and business sales rolled over, likely due to various uncertainties in 2019, particularly trade disputes. Construction also weakened, but a reversal took hold in the third quarter, finishing 2019 up a respectable 5%.



Source: Refinitiv DataStream & Strategic Frontier Management

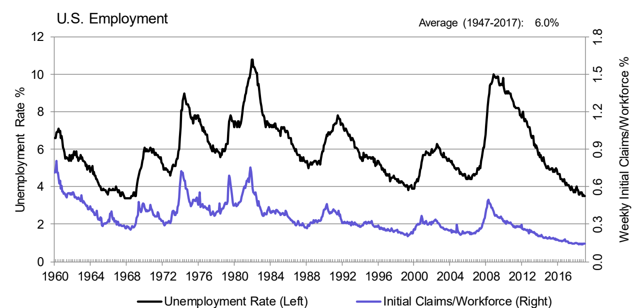
Stable growth in retail sales, housing, employment, and construction can be reinforced by investment and free trade deals that drive net exports to boost potential growth further. The mythical fiscal cliff of sunsetting tax reform never materialized, but noted reforms have a long tail and don't sunset—reform stimulus is substantive year-after-year, unlike effects of spending stimulus that begin to decay the day after being announced, particularly after the money runs out—consider the 2009 wasted $900 billion shovel-ready spending stimulus. Politicians always seem to find a way to spend more money—new entitlement programs ensure it is recurring, but election year politics keep infrastructure in play. At even odds, the only way to envision limiting its fiscal impact is to privatize nonstrategic federal holdings, including vast land and real estate, as we've discussed.

Business cycles stall because central banks hike interest rates faster and/or further than necessary—yet, real rates (T-Bill – CPI inflation) are still well below normal of 1% long after recessions receded, even more so after cutting rates in 2019. Poor fiscal and regulatory policy decisions limited US potential growth after the Financial Crisis, but rose again after tax, trade, and regulatory policy reforms—success offers a model for others, as in the 1980s following President Reagan's lead.

Economic Forecasts	**2015**	**2016**	**2017**	**2018**	**2019**	**2020e**	**2021e**
GDP Growth (Y/Y Real)	2.0	1.9	2.6	3.0	**2.4**	**2.7**	**2.5**
S&P500 Earnings Grw	-1.1	0.5	11.8	22.5	**1.0**	**8.3**	**8.5**
CPI Inflation (Y/Y)	0.7	2.1	2.1	1.9	**2.3**	**2.5**	**2.7**
Unemployment	5.0	4.7	4.1	3.9	**3.5**	**3.5**	**3.8**
Fiscal Deficit (vs.GDP%)	-2.5	-3.1	-3.5	-4.5	**-4.7**	**-5.0**	**-4.5**
Fed Funds Target[1]	0.50	0.75	1.50	2.50	**1.75**	**2.00**	**2.50**
10y Treasury Notes	2.27	2.45	2.41	2.69	**1.92**	**2.55**	**3.25**
S&P 500 Target	2044	2239	2674	2507	**3231**	**3450**	**3650**

Source: Strategic Frontier Management

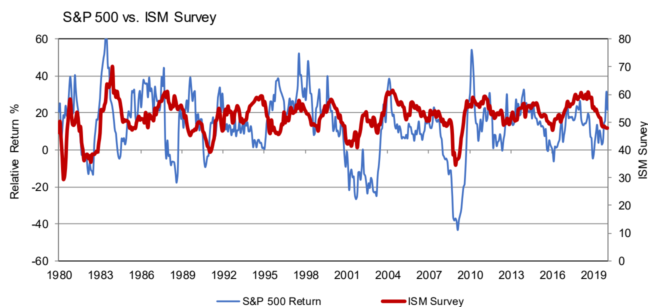
Fiscal and monetary coordination after the Financial Crisis reinforced a *global synchronous recovery* through 2012. Higher asset class correlations inspired the rise of alternative investing and *risk-on/risk-off* paradigm. A more typical a*synchronous global expansion* since 2013 stemmed from moderating coordination, resulting in greater dispersion between countries, sectors, and risk factors. This also provided tradeable global tactical opportunities and international portfolio diversification. US policy divergences resulted in stronger growth than the rest, as inflation gathers momentum. Weak global growth and wider interest rate differences, despite robust US growth, didn't support further stimulus of lower rates. Central bank intervention keeps zombies afloat and increases financial imbalances, including greater debt issuance and leveraged bond holdings of asset owners.



Source: Refinitiv DataStream & Strategic Frontier Management

We have observed that the ISM Survey is one of the best leading indicators for the economy and the stock market—so, slowing industrial production and decline in

the ISM are a concern, albeit still correlated with real growth over 2%. Even if investors remain skeptical, the ISM non-manufacturing survey (54.9) is key with ever greater services activity. We expect a rebound in business to drive real GDP from 2.4% to 2.7% in 2020 as risks have faded. The resilient US economy is unlikely to experience recession in the foreseeable future, even as Europe and Japan flirt with recession.

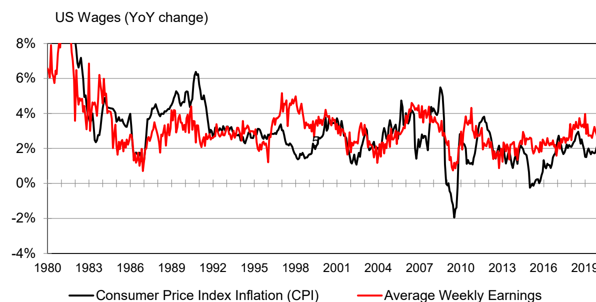


Source: Refinitiv DataStream & Strategic Frontier Management

Many developed countries languished across Europe and Asia for the better part of a decade, in part as demographic headwinds and geoeconomic uncertainties limited growth—misguided fiscal and regulatory policy undermined competitiveness and potential growth, even as the US dollar strengthened. These uncertainties limited investment, employment, and trade globally.

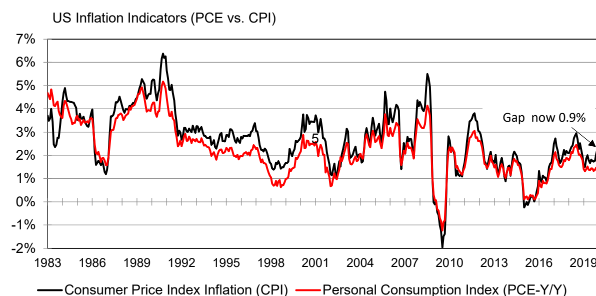
Labor markets tightened as unemployment plunged below 4% at the same time minimum wage increases took hold, boosting wage inflation. Initial claims normalized to the workforce also continues to decline, and is another indicator that labor markets are tightening and should bolster inflation in 2020. It is difficult to justify cutting interest rates for "insurance" with US real growth of 2.4% and CPI inflation of 2.3%, despite weakening global growth, global rate differentials or negative bond yields, inverted yield curves, or trade tensions. We believe rate cuts likely need to be reversed with firming inflation. Fears that raising interest rates might plunge the US economy into recession are misguided. Instead, the yield curve should steepen, but expect increased volatility if interest rates and bond yields do rise.

Politicians remind us that workers were left behind, but the fallacy in calculating *real household income* misconstrues effects of transfer payments, employee benefits, taxes, capital gains, inflation, and other factors. However, wage growth has exceeded inflation since 2014, although usually roughly similar to inflation. Minimum wage increases to $15 clearly boosted hourly earnings higher across the board. Wage growth increases in significance to inflation as services comprise a greater share of economic activity. Weekly or hourly earnings are simple, straightforward, and the most comparable measure of wages.



Source: Refinitiv DataStream & Strategic Frontier Management

Inflation is a critical variable for monetary policy decisions, but why pivot from CPI to PCE? *Myths That Conceal Reality* (Q3/2019) discussed drivers of inflation at the intersection of supply and demand. We described the misguided introduction of the Fed's PCE inflation measure, even as economists suggest CPI might now be too low given *hedonic adjustments* to reflect product innovation, better attributes (i.e., faster, stronger, more powerful, etc.), added features, or higher quality. A new car may be more fuel efficient with greater power, but did the buyer's cost really decline? Cost of televisions declined, but adjustments further reflect widescreen formats with higher resolution and better sound, which use less electricity. Price deflation of technology-enabled goods and services is significant in inflation indices. The PCE index was adopted in 2000, but Dr. Greenspan didn't contemplate that when he suggested CPI might be overstated. We believe that household inflation seems to be much higher than 1.4% PCE inflation in 2019—CPI inflation of 2.3% still feels low.

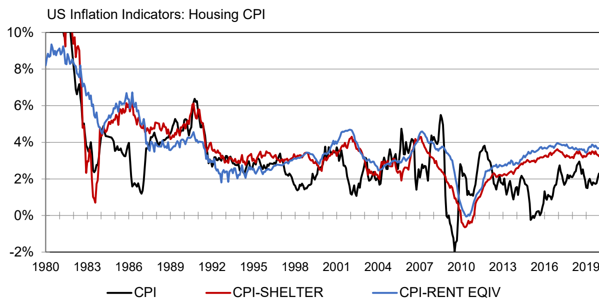


Source: Refinitiv DataStream & Strategic Frontier Management

The Dept of Labor (BLS) calculates many economic statistics, including CPI. The PCE Price Index was designed and maintained by the Dallas Federal Reserve. The FOMC has tremendous interpretive discretion, yet flexibility to adjust PCE weightings is apparently a reason they prefer it. Ad hoc changes to expenditure weights undermine historical comparability and consistency globally. CPI enjoys widespread practical use dating back to 1913 and global comparability to understand business cycle relationships. CPI is still used for adjusting contract prices, as well as indexing employee cost of living increases to Social Security and other

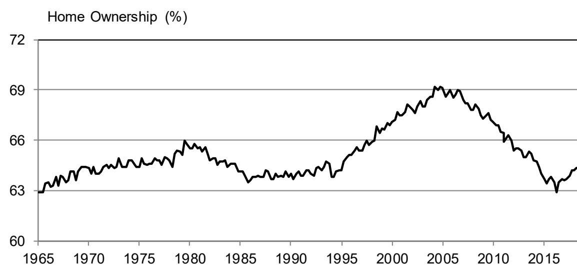
benefits. PCE hasn't proven any better than CPI, while its published history is limited. If measures are so highly correlated, why is PCE better for policy decisions, if only to justify a ½% lower Fed Funds rate? If using PCE lowers government's interest burden, is this a conflict of interest? Calculating the PCE index to inform monetary policy decisions undermines the Fed's credibility.

Housing costs, notably a significant expense, is a key driver of CPI inflation with a 32% weight—not so much for PCE. Housing inflation has bolstered CPI inflation since 2012, and we expect this to continue for at least a year or two. Housing costs increased 3.7% vs. a 2.3% rise in CPI. Of course, location, size, condition, and age are determinants of home values, so there isn't much adjustment to do. Increasing housing demand should drive housing costs higher than CPI inflation.



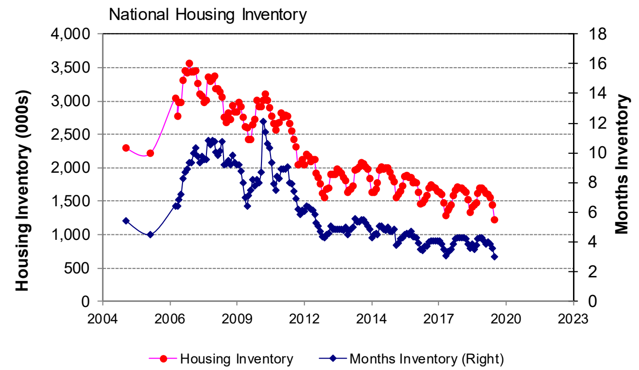
Source: Refinitiv DataStream & Strategic Frontier Management

A theme for 2020, based on rising household formation and home ownership, will be a renaissance in housing starts benefiting from pent-up demand, lower mortgage rates, and moderating uncertainty. A younger generation chose to rent versus buy for a time, but rising rent and increasing in home prices can trigger reconsideration. Housing demand should drive even higher home.



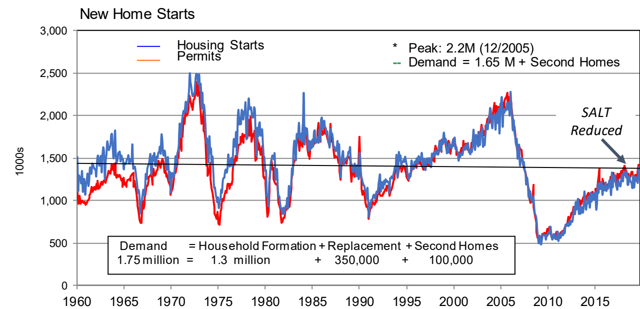
Source: Refinitiv DataStream & Strategic Frontier Management

Improving household confidence and interest in buying a home (NAHB new home buyers) coincides with mortgage rates bottoming out. Residential construction should increase in 2019, as inventory declined to an extraordinary low level, which will continue to bolster rising prices. Housing demand support rising starts and construction permits, while the housing deficit should promote increasing home prices with further to go.



Source: National Association of Realtors, Strategic Frontier

Receding consumer and business uncertainty should increase construction and business investment. Proposed government initiatives of rent control, tax credits, and affordable housing programs never moderated housing costs. However, regulatory reform can lower labor, resource, and material construction costs, while streamlining permit approval can increase housing supply. Reducing the state and local tax (SALT) deduction for income plus property taxes has had an impact on prices on higher priced homes in higher income tax states (i.e.: CA, NY, CT, MD).



Source: Refinitiv DataStream & Strategic Frontier Management

Real estate is unlikely to contribute to the next recession. Instead, we think the next financial crisis is likely to be focused on debt refinancing with a significant increase in issuance and expanding leveraged bond portfolios, including among pension funds. Bloated central bank holdings of bonds eventually must be reduced, so financing refunding will become more challenging, particularly as interest rates rise and government debt increases. Our greater concern must be avoiding a fiscal funding crisis that drives interest burdens much higher.

Household debt vs. income is at the lowest level in four decades ago, and well below the 2009 Financial Crisis peak. The savings rate is at the higher end of a modest 6-8% range since 2010, even if low interest rates discourage bank deposits. Yet, even a modest savings rate into retirement accounts, with employer matching contributions, compounds quickly if market returns are

strong. America's household net worth surged to $114 trillion, up +7.4% over Q1-Q3/2019. An equity correction in Q4/2018 reminded us that 70% of total household assets are financial assets, including cash deposits of $13 trillion and retirement savings. Retirement security, and thus confidence, is increasingly dependent on equity markets. In 1992, James Carville working for President Clinton famously said it's "the economy, Stupid", but today we suggest instead—as political relevance goes—it's "all about the stock market". It may be politically risky to judge policy success by one fickle variable (stock market), rather than a mix of growth in employment, GDP, or earnings, but workers' retirement security now depends on success of their self-directed investment outcomes without pensions to lean on.

Household Balance Sheet ($Bs)	*2015*	*2016*	*2017*	*2018*	*2019-Q3*	Annualized vs. 2007	*1-Year*
Total Assets	105,673	111,821	121,011	122,249	130,218	3.9%	3.3%
Households: Real Estate	26,044	27,954	30,069	31,711	32,862	3.0%	4.9%
Financial Assets (inc. retirement)	74,073	78,138	85,037	84,383	90,975	4.4%	2.7%
Deposits (Bank Acct + Money Fund)	11,232	11,836	12,277	12,947	13,359	4.2%	6.6%
Change in Assets%	1.6%	5.5%	8.8%	4.0%	9.9%		
Liabilities	13,947	14,379	14,930	15,402	15,748	1.0%	3.1%
Home Mortgages	9,579	9,764	10,051	10,321	10,517	-0.1%	2.5%
Consumer Credit	3,411	3,644	3,828	4,010	4,130	4.0%	4.8%
Household Net Worth	91,133	96,844	105,465	106,218	113,832	4.5%	3.4%
Growth Rate (y/y)	3.3%	6.0%	8.4%	0.7%	3.3%		
Disposable personal income (NIPA)	13,917	14,355	15,115	16,005	16,534	3.8%	4.4%
Growth Rate (y/y)	3.2%	3.1%	5.3%	5.9%	4.4%		
						Change since 12/31/2008	
Owners' equity in real estate	13,638	15,183	16,755	18,062	18,672	Net Worth Chg	Fincl Assets
Owners' equity / real estate value %	58.7	60.9	62.5	63.6	64.0	$ 55,817	90%
Motgage/Equity	37%	35%	33%	33%	32%		
Financial Assets/Total Assets	70%	70%	70%	69%	70%		

Source: Federal Reserve, Flow of Funds (Table B.101)

Compounding retirement savings balances, including IRAs and defined contribution (i.e., 401K, 403b, 457, and profit sharing) accounts have made America's net worth more dependent on capital markets. Participation in pension plans peaked about 1982, just after 401K plans were introduced and employers began to switch over. The BLS documents the decline in pension participation from 35% in the early 1990s to just 8% of private-sector workers by 2018. Generally, government and labor union employers still provide access to DB pensions, but increasingly employees must contribute, as well.

Elective retirement savings requires prudent investment management. As challenging as that is, the idea of then taxing wealth is the most insidious idea ever considering the balance sheet above. More than a dozen European countries used to have wealth taxes, but nearly all repealed them, including most recently the debacle in France. Beyond chronic shortfalls in anticipated tax revenue, wealth taxes are very difficult to administer and enforce. Moreover, after-tax income used to purchase these assets was already or will be (deferred) taxed at a 25-40% federal rate, plus state and local tax. More likely is a financial transaction tax on trading stocks, bonds and derivatives—while it sounds like politicians are sticking it to Wall Street, it just passes through to retirement plans and asset owners, including pensions and foundations.

Taxpayers struggle to value of many illiquid, intangible, and difficult to value assets—required annual valuation would only make accountants wealthy and hollow out retirement savings or reduce the savings rate. Consider the challenge valuing homes, furniture, pensions, profit sharing, deferred compensation, option grants, businesses, land, boats, vehicles, intellectual property, or even private equity holdings. Will America support a confiscatory wealth or transaction tax to fund vast new government program liabilities in the general election?

Notwithstanding the notable constitutional challenge of a wealth tax, new taxes often start out narrowly targeting the rich, but every tax scheme eventually broadens and increases. The income tax began modestly in 1913 with the 14th Amendment, but tax revenue remained below 5% of GDP, until it jumped over 17% of GDP[1] during WW II, and never retreated. *Payroll taxes* one contributes over a lifetime of work were added in the 1930s to fund Social Security and Medicare benefits consuming enormous and growing share of nondiscretionary spending, but both programs are effectively insolvent and unsustainable without reform for deficient benefits.

We are very concerned about a new age of baseless political pursuit of *outcome equality*[2] and softening shareholder capitalism, at the expense of *equal opportunity*. Targeting *outcome inequality* is inconsistent with our founding principles and can have an adverse impact on retirement savings. Politicians promise that wealth taxes would counter a rigged political system and raise money for new entitlements, subsidies, and government investment with a terrible track record of mismanagement. Divisive policies of culture warfare seek to sway populist voter favor, but has unintended consequences on potential growth and prosperity.

The global economy has evolved since the Financial Crisis with increasing imbalances and unintended consequences from very low and manipulated interest rates for extended period. Many countries suffer declining potential growth due to poor policy decisions and deteriorating demographics. Europe and Japan will continue to flirt with recessionary conditions, and equity returns will be limited by lower profit margins.

Will Interest Rates Rise Again in 2020?

We expected US interest rates to rise in 2019, as did the Federal Reserve and many other strategists. Instead, interest rates were cut ¾% and bond yields fell by a similar amount. The FOMC now expects interest rates to peak at a lower r* or equilibrium policy rate of 2½%, rather than r* > 4% just a few years ago—we think 3¼% is more likely correct.

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[1] Income taxes have hovered just below 20% of GDP, consistent with Hauser's Law for decades.

[2] Targeting redistribution of wealth and income inequality.

Chairman Powell characterized the first interest rate cuts since 2008 as a "mid-cycle adjustment to policy" to provide insurance against a US economic downturn. Better alignment with non-US policy rates and slowing growth didn't justify interest rate cuts, but increased likelihood the Fed needs to tighten policy in 2020—more than ¼% hike is unlikely given the US election, as is cutting interest rates with falling recession odds. We anticipate restarting run-off of holdings before Fall.

Federal Reserve Forecasts

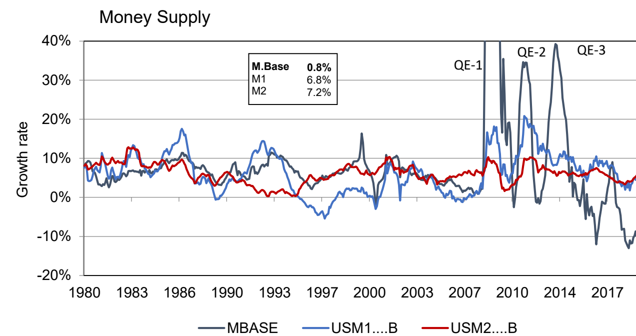
Central Tendency (midpoint)								LongRun Forecast	
U.S. Fed %	2016	2017	2018	2019e	2020e	2021e	2022e	Fed	SFM
GDP	1.90	2.45	3.05	2.15	2.10	1.90	1.90	1.90	2.70
U.Rate	4.70	4.10	3.70	3.55	3.60	3.75	3.75	4.10	4.50
PCE	1.50	1.65	1.85	1.45	1.85	2.05	2.10	2.00	2.50
Core PCE	1.70	1.50	1.85	1.65	1.95	2.05	2.10	2.00	2.50
Implied CPI	1.70	2.15	2.35	2.15	2.45	2.55	2.60	2.50	3.00
Federal Funds	0.35	1.38	2.38	1.85	1.95	2.00	2.25	2.60	3.25

Interest Rates	2016	2017	2018	2019e	2020e	2021e	2022e	Longer Run
FOMC Avg.	0.5-0.75%	1.38%	2.38%	1.63%	1.68%	1.96%	2.23%	2.54%
SFM[1]	0.75%	1.50%	2.50%	1.75%	2.00%	2.50%	3.00%	3.25%
Rate Change	0.25%	0.75%	1.00%	-0.75%	0.25%	0.50%	0.50%	

1. Top-end of indicated Fed Funds range

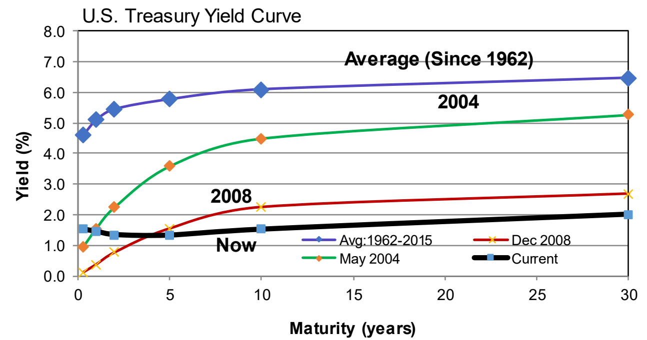
Source: Federal Reserve and Strategic Frontier Management

After the third cut in rates, Chairman Powell noted further cuts were unlikely unless the economy weakens. Under current conditions of low unemployment, near potential growth, and high profit margins, there is no reason for maintaining such low interest rates or a bloated balance sheet. US interest rate cuts for “insurance” were not warranted for mostly external global risks, which combined with recent security purchases, can increase volatility of money again. Unwinding Quantitative Easing (QE) will require years of low or negative money growth, which can be disinflationary. Future QE will provide little value if yield curve is flat or until policy is normalized.



Source: Federal Reserve and Strategic Frontier Management

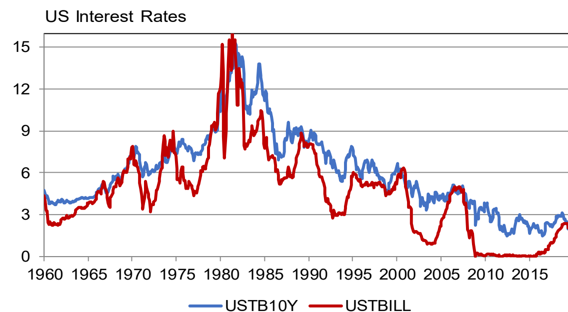
The Federal Reserve has embraced *data dependency* in pursuit of its dual objective of maximum employment and stable prices to moderate long-term interest rates. However, it is a fools' errand seeking to increase inflation, with or without an explicit inflation target. Central banks should abandon *symmetric inflation targeting*. Long-term borrowing rates actually rose and the yield curve steepened after cutting rates, yet there is little consumption to *pull forward* anymore after a decade of low rates. Needed normalization toward 3.25% rather than 1.5-1.75%, can trigger future volatility.



Source: Refinitiv DataStream & Strategic Frontier Management

Last summer the Treasury yield curve inverted for the first time since June 2007, raising concern of increased risk of a US recession. Flattening or inverted yield curves can be symptomatic of weak growth or declining inflation expectations, most often from hiking rates too far or too fast. Inverted yield curves tend to coincide with rapidly slowing growth, but US real growth and CPI inflation both remained stable above 2%, so unusual external forces must be in play. We've highlighted various external forces that drove Treasury lower yields and caused this inversion, suggesting it would only be transitory, even as the flat yield curve above is so unusual without a crisis.

We argued against putting too much faith in the US yield curve inversion given economic conditions. Yield curve inversions don't cause a recession, but falling bond yields can forestall a slowdown by reducing financing costs to promote borrowing for investment and hiring to boost growth. Inverted yield curves naturally reduce demand for longer maturity bonds with negative rate premium for increased risk, thus is terrible for leveraged bond portfolios utilized in LDI and risk parity strategies. Short-term financing cost can rise faster than bond yield, which bankrupted Orange County in 1994. Negative yielding global debt drove Treasury yields lower as investors chased Treasury yields, as well as gold, commodities, and cryptocurrencies with no yield, but expect flows to reverse as US yields eventually rise.



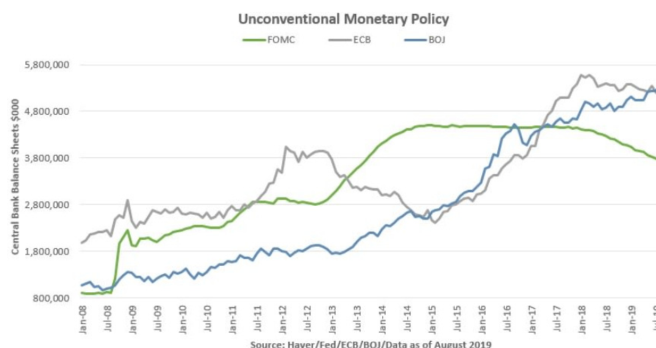
Source: Refinitiv DataStream & Strategic Frontier Management

The slow progression of yield curve flattening since 2010 is unusual, indicating the yield curve isn't reacting to normal precursors of recession. Instead, several external factors were likely key to driving lower bond yields and yield curve flattening, including negative bond yields in Europe and Japan coinciding with a strong US dollar that encourages foreign investment in Treasuries. A stronger US dollar and low currency volatility reduces value-at-risk (VaR) for foreign investors buying unhedged Treasuries, particularly for the Bank of China managing a quasi-pegged currency. Eurobond and JGB yields will tend to rise and fall with Treasury yields until the US dollar weakens or currency volatility increases sufficiently to break this relationship.

If Treasury Bill yields should exceed CPI inflation by 1% and 10-year Treasury yields should exceed T-Bill yields by 1.5% based on historic averages, then if CPI inflation is 2.5%, Treasury yields can easily double to 4.5-5.0%. With high convexity, bond losses compound more quickly for each 1% rise in yield. This highlights a risk of extended duration and bond leverage increasingly adopted by pension funds adding risk parity strategies and LDI objectives. The flat yield curve must eventually rise and steepen, if only to 2004 levels. Treasury yields rising 2½% suggest -12% loss, as starting from lower yield than 1994 offers less income to cover principal loss.

Global central banks continue to manipulate bond markets through forward guidance, bond purchases (quantitative easing), and keeping interest rates low for an extended period. At some point, there is little future demand left to pull forward, and fixed mortgage rates just can't fall any lower. The debt binge on low financing costs can also result in crowding out if rates start to rise and debt service costs increase—US Treasury should take advantage of low rates to extend average maturity. Risk in bond indices has risen as duration extends, convexity is already high, and average credit rating falls.

Easy money policy reinforced explicit moral hazard for households, businesses, and investors that increased financial imbalances. Global bond valuations remain extended due to market manipulation, and negative real yields seem rather peculiar given economic conditions. Imagine ever thinking bond yields could be negative, let alone $17 trillion in global debt at its peak, mostly in Europe and Japan. Eventual normalization of central bank intervention manipulating interest rates will not be easily resolved, but could trigger a global financing crisis. We believe the Federal Reserve balance sheet of $3.8T today shouldn't exceed $1.7T, and needs to be reduced by $1T. Overreliance on both conventional and unconventional monetary policy stimulus left little room to address any future global crisis.



Monetary stimulus is warranted in recession, but moderate inflation is not sufficient to justify lowering interest rates—nor does widening interest rate differences with other countries. Although many other countries think negative rates are fine, the US, Canada, Australia, New Zealand, and the UK (with non-negative rates) should continue normalizing monetary policy. We might add Hong Kong to this group, which has tended to shadow monetary policy of the Federal Reserve.

Normalizing yields can cause a collapse in global bond prices, which could be cataclysmic for central bank holdings, retirement savings, and pension funds. Moral hazard is acutely problematic for Japanese investors, where the BoJ also purchased equity ETFs on a massive scale (ref: 80% of ETF equity shares or 5% of market cap), seeking wealth effects to bolster consumption. Japan's bond holdings have increased to about 50% of government debt as Debt/GDP exceeds 250%. We see no obvious pathway to normalize BoJ holdings or interest rates, increasing risk that Japan cancels its bond holdings when struggling to refinance its debt.

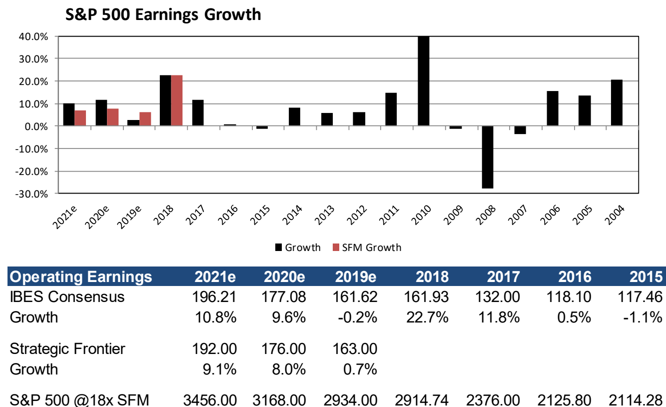
Japan and the Eurozone still struggle to achieve even 1% real growth with easy monetary policy, rather than fiscal policy reform—consequences of social democratic principles should be a forewarning to a new generation of those seeking to promote greater state dependency of statism[3], but there is no free lunch of endless handouts without consequences for this or the next generation—*Modern Monetary Theory* isn't viable (nor modern or magic), despite what Sanders/Warren suggest.

Rising bond yields (interest expense) can undermine fiscal deficits quickly, yet Treasury hasn't taken advantage of low bond yields to extend maturity. The current average US Treasury maturity is under 6 years with over $22 Trillion in federal debt, not including state and municipal debt. We still add about $1 trillion per year to federal debt with a fiscal deficit. The Federal Reserve holds about 15% of our total debt, but 30% of bonds with maturity exceeding 10 years. With already excessive spending, risk of crowding out is increasing.

[3] Political system in which the state exerts substantial centralized control over social welfare and economic policy.

Earnings

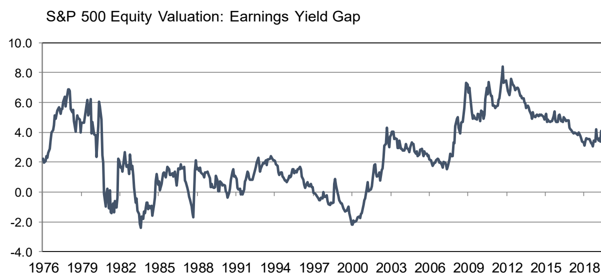
Economic growth translates revenue into earnings growth through profit margins. Lower tax rates can drive up profit margins, as productivity increases with investment and R&D spending. Consider S&P 500 valuation of combined earnings growth of 25.7% return over 2018-2019—so, while the S&P 500 returned 31.5% last year, its valuation reverted to a pre-2018 level with 8.3% earnings growth expected in 2020. Earnings growth upside is possible with stronger revenue growth and ~12% profit margins for the S&P500.



Operating Earnings	2021e	2020e	2019e	2018	2017	2016	2015
IBES Consensus	196.21	177.08	161.62	161.93	132.00	118.10	117.46
Growth	10.8%	9.6%	-0.2%	22.7%	11.8%	0.5%	-1.1%
Strategic Frontier	192.00	176.00	163.00				
Growth	9.1%	8.0%	0.7%				
S&P 500 @18x SFM	3456.00	3168.00	2934.00	2914.74	2376.00	2125.80	2114.28

Source: I/B/E/S and Strategic Frontier Management

Analysts expect S&P500 earnings declined marginally in 2019, if not an earnings recession. It is again popular to reference "peak earnings", but earnings have no upper bound. We expected cyclical Industrials, Financials, and Consumer Discretionary sectors would lead, but we also saw a material decline in Energy (-28.2%) and Materials (-9.8%) earnings that dragged down S&P500 earnings. Declining energy and basic material sector earnings were volatile for several years. Yet, our primary valuation statistic, the S&P 500 remains within a constructive valuation range, even after strong equity returns last year, but strong S&P 500 earnings growth for 2020.



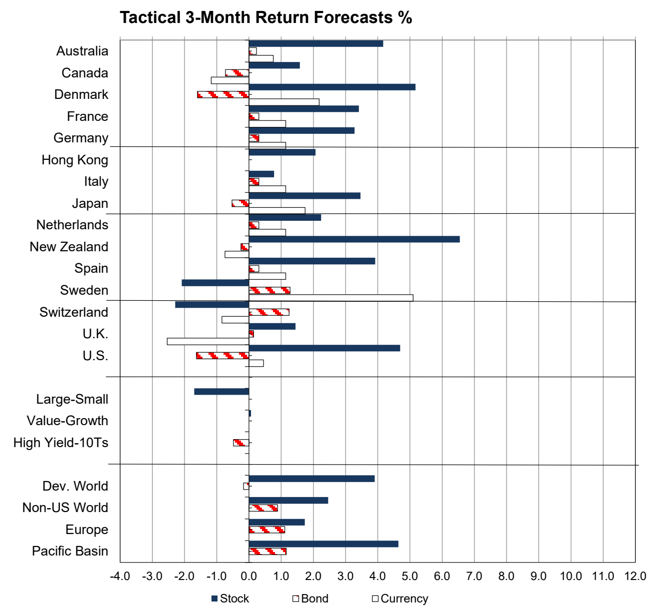
Source: Strategic Frontier Management

S&P 500 profit margin of 12% remains high, particularly compared the Eurozone (7.7%), Japan (6.1%), and Emerging Markets (6.8%), which are about 60% as much. So, understanding differences in profit margins can differentiate earnings growth, and why even stronger economic growth of China hasn't translated into outperformance. Japan is a potential value trap for this reason. Lagging equity performance of Emerging Markets and US small-cap are other examples.

The Class of 2019 IPOs included many unicorns ($1 billion cap), some which have struggled with profitability. Companies like Uber, Lyft, Peloton and others are trading over 30% below their IPO price—many newly public profit-starved companies remain expensive, so listing tended to increase the stock market's P/E ratio. We expect new listings will be scrutinized more by investors, which may bolster the value risk premium.

Global Tactical Asset Allocation Forecasts

Our Global Tactical Asset Allocation discipline forecasts country, risk factor, and currency returns across global equity and bond markets with an 18-24 month horizon, although we publish forecasts as a three-month return.



Source: Strategic Frontier Management

Global equity forecasts remain compelling nearly across the board, and US equity returns still are expected to significantly exceed Treasury bond returns, even after strong 2019 returns through Q3/2019. The US enjoys better economic growth due to tax and regulatory reforms that have boosted potential growth, but earnings growth lagged this year after a very strong 2018, keeping valuations in check. Many strategists favor Japanese equities again this year, but risk of a value trap remains high, in our opinion. Investors should still avoid safe havens and rate sensitive exposures, particularly global bonds, volatile gold, and even bitcoin as bond yields rise.

In the table below, historical returns over various time horizons offer some interesting observations: (1) US equity returns exceeded bond returns over all key

horizons (2) Divergence of *Value* and *Small-cap Equity* risk premiums, (3) *Emerging Market* risk-adjusted returns lagged expectations for a decade, (4) US equities outperformed non-US equities, (5) *US dollar* hasn't appreciated enough to undermine competitiveness—currencies exhibit no risk premium, (6) *Commodity* returns disappointed, including gold with higher volatility than equities, (7) Oil continues to be volatile.

Total Return %	3-Mon	1-Yr	3-Yr	5-Yr	10-Yr	20.Yr	30.Yr
S&P 500 Index	9.1	31.5	15.3	11.7	13.6	6.1	10.0
NASDAQ Composite	13.5	36.5	19.6	14.6	15.9	5.4	11.5
Russell 2000	9.9	25.5	8.6	8.2	11.8	7.6	9.5
Russell Value-Growth	-3.2	-9.8	-10.8	-6.3	-3.4	1.9	-0.2
Non-US (World xUS)	7.9	23.2	9.9	6.0	5.8	3.9	5.1
Emerging Markets	11.9	18.9	12.0	6.0	4.0	7.0	8.4
Small-cap Global	9.3	26.0	10.7	7.9	10.4		
US 10-Year Treasury	-1.9	9.5	3.8	2.6	4.5	5.3	5.8
US Aggregate Bonds	0.2	8.7	4.0	3.1	3.8	5.0	5.9
BAML High Yield Bonds	2.6	14.4	6.3	6.1	7.5	7.0	8.4
Short-term Bonds	0.5	5.0	2.5	1.8	1.6	3.2	4.3
JPM Non-US Bonds	-0.2	5.2	4.4	2.0	1.5	4.1	5.5
US Dollar (TWI)	-0.9	-0.2	-1.2	1.8	2.3	-0.2	0.0
CRB Commodity Index	7.0	7.6	0.0	-1.2	-1.4	3.7	2.0
WTI Oil (US$)	13.0	35.3	4.4	2.7	-26.0	4.4	3.5
Gold (US$)	3.2	18.7	9.5	5.1	3.3	8.6	4.5

Note: Periods greater than a year are annualized thru Dec 31, 2019
Source: Strategic Frontier Management and Refinitiv

Many presumed risk factor anomalies—such as value and small-cap risk premiums--failed to materialize over the last decade, leading many to question *smart beta*. Single risk factor indices are cyclical, so characterizing them as *smart beta* is misleading—this doesn't preclude trying to forecast relative return, as we have done for two decades with size and value. We also believe risk factor investing expands tactical opportunities accessible through low-cost index funds, yet multi-factor strategies resemble factor-tilts of active quantitative strategies.

Risk Factor Returns	3 mo	12mon	3-year	5-year	10-year	20-year	30-year
S&P 500	9.1%	31.5%	15.3%	11.7%	13.6%	6.1%	10.0%
S&P 600 (Small)	8.2%	22.8%	8.4%	9.6%	13.4%	9.8%	10.9%
S&P 500 Growth	8.3%	31.1%	18.7%	13.5%	14.8%	5.6%	10.4%
S&P 500 Value	9.9%	31.9%	11.5%	9.5%	12.2%	6.3%	9.3%
S&P 500 Quality	-3.5%	14.4%	8.4%	8.1%	11.9%	5.9%	10.7%
S&P500 LowVolatilty	7.0%	35.5%	16.8%	12.9%	14.4%	10.8%	11.0%
MSCI High Dividend Yield	-5.8%	4.0%	4.8%	6.3%	11.4%	7.4%	
NASDAQ	12.5%	36.5%	19.6%	14.6%	15.9%	5.4%	11.5%
MSCI Global Equity	8.7%	28.4%	13.2%	9.4%	10.1%	5.0%	7.3%
FTSE Global Small-cap	9.3%	26.0%	10.1%	7.9%	9.9%		

Source: Refinitiv DataStream & Strategic Frontier Management

Chasing revenue growth in a low rate world caused value and small-cap to lag for a decade. Reshuffling tech names into communication services and consumer discretionary will isolate the NASDAQ as potentially the best way to follow the dearly beloved. However, we believe that the time for US small-cap and value to shine is likely overdue, even as our tactical models may be just warming up to such tilts. With accelerating earnings growth, investors need not chase growth and willing to embrace cyclical opportunities, including Financials.

The S&P 500 is trading below 20x operating earnings and 18.4x 2020 earnings, but the S&P 400 Midcap and S&P 600 Small-cap indies are now cheaper with a forward P/E of 17.1x and 17.9x, respectively—this is extraordinary given small-cap equity indexes tend to be more expensive (P/E, P/B, dividend yield) than large-cap. A challenge in 2019 was earnings growth dispersion between sectors. Recasting telecommunications as communications services added constituents like Google, Facebook, and Netflix, to stogy Telecoms. Technology companies such as Amazon and eBay joined Walmart and Macys in consumer discretionary. This reshuffling not only changed the sector behavior of technology, it affected communication services, as well as consumer discretionary with less focus on stores.

	Today	1 Jan	1 Oct	1 Jul	1 Apr
Consumer Discretionary	0.0%	-0.1%	4.2%	6.1%	6.8%
Consumer Staples	1.9%	1.9%	1.3%	1.2%	1.8%
Energy	-29.4%	-28.1%	-21.0%	-11.0%	-11.0%
Financials	8.2%	8.3%	9.1%	9.1%	8.8%
Health Care	9.2%	9.1%	7.4%	6.1%	5.5%
Industrials	-2.2%	-2.1%	0.3%	5.4%	8.0%
Materials	-10.0%	-9.8%	-7.3%	-18.7%	-2.2%
Real Estate	4.6%	4.6%	4.8%	4.2%	3.8%
Information Technology	-1.0%	-1.0%	-2.4%	-2.7%	-1.9%
Communication Services	1.5%	1.6%	2.2%	2.3%	3.5%
Utilities	4.7%	4.7%	4.2%	4.3%	4.5%
S&P 500	*1.0%*	*1.1%*	*1.8%*	*2.4%*	*3.3%*

Source: Refinitiv (Earnings This Week, January 10, 2020)

In managing global tactical asset allocation strategies since 1990, we've learned that tracking business cycles and interest rates in at least 15 countries reveals persistent capital market dependencies on econometric fundamentals that can help forecast returns. Revenues and profit margins are function of economic growth and inflation, which yield insight into earnings, currencies and interest rates. Yet, even accurate economic forecasts won't necessarily ensure good earnings forecasts given importance of operating costs, taxes, interest rates, competitive advantages, and investment from quarter to quarter. Market valuations can diverge significantly from presumed equilibrium, which is to say forecasting stock, bond, and currency market returns is hard.

The stock market doesn't always track the economy, and the economy doesn't always respond to policy changes as expected, even with a long lag. Much like the *Heisenberg Principle*, one can't be certain of both where (or what) and when at the same time. Yet, there is still value in trying to forecast asset returns and risk—the discipline of doing so is both instructive and insightful. Direction can be valuable, even if magnitude and timing are allusive. Forecasts attempting to convey path dependency (rise, then fall) are always precarious.

We expect global equities will outperform bonds by a wide margin led by US stocks. Rising inflation and stronger growth are inconsistent with flattening global yield curves---might this be caused by technical issue(s) rather than fundamental? In which case, global bonds are materially overvalued as more central banks begin tightening policy and inflation gathers momentum. Fiscal deficits persist, so interest burdens are rising with higher interest rates. Need to wind down QE programs will add

refunding to excess debt supply and issuance. Credit ratings don't seem to matter much. We find this troubling, but explain why credit spreads are tight and indebted nations are not concerned about fiscal deficits. Equity valuations often correct when interest rates rise swiftly, but the S&P500 is not extended.

A significant global bond correction after years of market rate manipulation is a more likely to trigger a financial crisis, rather than housing, equity valuations, or policy mistakes. Interest rates must eventually normalize and negative real rates are unsustainable. Japan, and other Eurozone countries with burdensome fiscal debt, particularly Italy, are of most concern. Japan's equity ETF purchases is treacherous for taxpayers and an explicit moral hazard given lack of evidence it supported growth. Spiraling fiscal deficits, plus unsustainable debt, manipulated interest rates, low growth, stagnant margins, and weak currency begs for credit downgrades. Financing costs should soar if investors lost confidence in government ability to repay their debt.

Investors tend to hold hedges for extended periods, including gold, low volatility, options/futures, or alternatives. Investors often fail to capitalize tactically by unwinding hedges, even when they are in-the-money, thus tend to be a drag on performance, providing no economic benefit. Gold holdings increase portfolio volatility like other commodities, regardless of hoped for risk reducing diversification, but return less than cash or even inflation historically. Low rates reduce commodity (and cryptocurrency) hurdle rates of risk-free cash yield, and downside risk to gold (and Bitcoin) increase with any pivot toward monetary tightening. Portfolio diversification is desirable to reduce risk, but not at the expense of being a performance drag. International diversification was limited since the financial crisis, but expect more asynchronous country returns and currency volatility. Investors must be compensated for undiversifiable risk, as Modern Portfolio Theory suggests--management fees, illiquidity and trading costs should not be rewarded, nor diversify portfolio return.

Gold, silver, gems, and other commodities have provided poor risk-adjusted and nominal returns, thus were a poor inflation hedge since 1900 with returns less than US Treasury bills and equal or higher volatility than equities. We've often noted that *input costs can't exceed output costs, therefore commodity returns can't exceed inflation*. This is both theoretical and empirical. Although inflation declined to 1.8% over the last decade, the CRB lagged inflation by 1.1% with 15.8% risk (σ).

Bitcoin and other cryptocurrencies are more volatile than any single commodity, yet provide no logical reason for appreciation in value, other than scarcity. Unlike a currency, it can't be deposited in a bank for yield, and unlike commodities, aren't tethered to inflation. In 2019, we observed that the correlation with gold seemed to increase. Some have argued cryptocurrencies are safe haven assets, but that is it logical given their historic volatility, illiquidity, and trading costs?

Leading business channels continue to headline the Dow Jones 30 Index—this is unfortunate as the broad S&P 500 index is a better US equity performance benchmark with more representative sector weightings. The narrowly focused DJIA of 30 mega-cap stocks doesn't have such breadth, and constituent turnover has changed its behavior with less industrial or cyclical exposure. On Black Monday (Oct. 1987), the DJIA dropped 508 points or about 22%. In contrast, a recent 800-point drop was the 4th worst point decline in history, as breathlessly reported, yet the 3% decline didn't rank in the in the top 500 daily loses on a percentage basis. Historic DJIA point comparisons are provocative, but provide little relevant market context for investors.

Changes in average historical return statistics of mean, correlation, and volatility is being observed from asset classes to sectors and risk factors. Forecasting volatility and correlation has become more difficult after an inflection point in interest rates. This is similarly true for private market asset classes. It has been a decade since the Financial Credit Crisis of 2008. An artifact is that 10-year risk calculations and stock-bond risk premiums are evolving rapidly after memory of it roll off, but lesser known is that 20-year horizons are rolling-off the Tech bubble, as well. While stock-bond risk-adjusted returns look upside-down for that period, every other significant look-back period for the last 30 years suggests stocks beat bonds in the long-run. Given valuations for bonds are far worse than equities, the equity risk premium is unlikely to diminish in the foreseeable future.

We hasten to add, overall capital market returns of a 60-40 balanced portfolio may not be as exciting as the last decades, but chasing expensive and costly alternative funds may be even less compelling. Inability to mark-to-market illiquid or unlisted securities even on a monthly basis doesn't increase portfolio diversification or reduce risk. Private market assets are implicitly riskier than can implied by their small company, illiquid/unlisted, or leverage factor exposures. In this regime, the safest diversifying asset class is indeed cash—although, it would be nice if deposit yields had normalized.

Emerging Market Dynamics

Our view on emerging markets evolved a year ago and equities markets have lagged, as expected, and reiterate our concerns. Since the mid-1990s, we embraced the theme of strong secular growth in emerging countries. Urbanization and industrialization, combined with insatiable consumption, emerging culture of credit, and rapid income growth of an expanding workforce drove higher potential growth. Labor cost advantages provided manufacturing margin to compete on price globally, but

this advantage is declining rapidly with adaptive automation and advanced sensors coupled with machine learning to reverse decades of offshoring—robots are indifferent to geography, thus shipping costs are becoming more significant, so longer distances to markets are a disadvantage.

Emerging Market companies depended on leveraging their labor cost advantage for two decades, but they are suffering with increasing global automation and machine learning that is reducing labor intensity. Job growth is strongest in services, as well as higher skilled and knowledge workers with college degrees. Rapidly rising labor costs in emerging countries has undermined already narrow profit margins. Below we focus on the BRICs, but the story is similar elsewhere—including those reliant on exporting basic resources. Consumer product deflation benefiting developed economies for 20 years is receding, which should boost inflation globally.

China's headwinds of diminishing labor cost advantage and demographic headwinds (one child policy) are already at its doorstep. Labor cost advantages in manufacturing have declined with creative destruction of innovation reversing decades of offshoring. Although the US dollar appreciated somewhat, maintaining China's quasi-peg to the US dollar has been costly. We expect potential growth should slow from over 6% toward 4% by 2025, not 6-7% it hopes to preserve. The coronavirus infection demonstrates fragility of China's universal health care system, as previously with SARs. Mismanaging the outbreak allowed the epidemic to spread faster, requiring a more strident global quarantine that will hit GDP and earnings. U.S. businesses have canceled service, travel and operations in China to prevent spread of the virus, and US Dept of State extended its travel advisory to China from *nonessential* to *any purpose*. So, last year was not a good time for an extended trade dispute with its largest trading partner. The economic disruption of another health scare this year can't help the declining trend in China's growth.

Latin America's record of financial crises, currency devaluation, high inflation, and accruing unsustainable debt lie at the foot of mismanagement under terrible socialist policies. Asserting socialism is no longer revolutionary and noisy, rather it seeks greater state dependency democratically at the hand of populist social reform to sway naïve voters at the expense of reduced economic efficiency, national prosperity, and individual liberties. Failing policies of the *Pink Tide* and how political power was wielded eventually regenerated the discontent that lifted them into power. New political leadership in **Brazil** may help escape from a protracted death spiral into their own socialist abyss begun under President Lula, who was eventually convicted of money laundering and *passive corruption*[4]. Socialist policies are also to blame for terrible conditions that Venezuelans endured as the government collapsed under widespread corruption, yielding insidious inequality by appropriating riches of abundant national resources. Unfortunately, the story is similar for others that promised greater prosperity, equality, and security, but socialism delivered poverty, misery, and oppressive tyranny.

India maintains a higher birth rate and generally embraces free market capitalism. Thus, India may defer the erosion of their competitive advantages for awhile with greater exposure to services, but instead of robotics, machine-learning applications are their greater threat to cheaper offshore labor.

Russia could be the wildcard of the BRICs, but remains dependent on selling energy and needs government reform to reverse course after suffering for generations.

Geoeconomic Issues: Trade and BREXIT

US trade disputes were a headwind to global growth, while trying to secure new trade agreements with the European Union, China, and Japan, while renegotiating NAFTA (Canada and Mexico). Successes of the *New Order in Global Trade*, described in our Fall 2018 op-ed in *The Hill,* are significant to rising US potential growth benefiting from net exports and increased investment. The key pivot in US trade policy is a focus on bilateral trade agreements, rather than complex multi-lateral agreements of deficient compromises. Bipartisan passage of USMCA in the Senate (89-10), as successor to NAFTA, plus bilateral trade deals with China and Japan, have lifted wearisome trade uncertainty. Attention now turns toward completing collaborative UK-US trade deal, ahead of the long-stalled US-EU agreement, which precluded a US-UK trade agreement. We expect a US-UK deal to be finalized this year as negotiation has begun and seems to be a mutual priority—this Administration exceled at closing deals.

Recent bilateral trade agreements around the Pacific are more significant to the US than the withdrawn support for a compromised multi-lateral Trans-Pacific Partnership (TPP) agreement, which overlaps with existing US trade agreements. We expect the trade agreement with China, in particular, will help improve investor and business sentiment, including addressing intellectual property protection. Liberalizing financial services and currency controls in China can provide wide ranging advantages for both countries, and is a template for other countries seeking China agreements. This agreement improves free market protections, which should be unnecessary if the WTO functioned effectively. The focus of debate

[4] *Corruption is a feature, not at bug of socialism* appears to be a recurring theme, although neither nepotism nor self-dealing are consistent with any particular social organizing ideology.

during 2019 seemed to be whether China should wait until after the US election to cut a better deal, but now debate ponders who got the best of the deal. Our focus turns instead to what next in trade policy is conceivable.

The EU should be more conciliatory on the losing end of more than three-year fight to keep Great Britain in the EU. Failure to prosper can accelerate the devolution of the European Union. While eight other countries in the EU don't use the Euro, Italy is most likely to be next to leave the EU, and possible the Eurozone, as well. Italy has both benefited (lower yield interest burden, limited inflation) and suffered (competitive exchange rate, fiscal limitations) as a result of joining monetary union. Further break-up of the EU is increasingly a geoeconomic risk.

The UK now has the freedom to negotiate bilateral trade deals, rather than be subject to compromised multilateral negotiations of EU agreements. The UK was party to 40 EU trade agreements with more than 70 countries, but not the United States or Japan[5]. Yet, the EU's negotiated deals cover just 11% of UK trade, including Japan—this is less meaningful than many likely assumed. Awaiting BREXIT, at least 10 countries signed so-called *continuity agreements* with the UK to maintain existing relative status quo, including: Switzerland, Norway, Iceland, Israel, South Africa, and Chile. South Korea also has announced a pending UK free-trade deal. As trade arrangements reset and currencies adjust, the UK has a unique opportunity to seek new bilateral agreements, just as the US is pursing. Such UK trade agreements should be easier to secure than compromised multilateral EU negotiations, which dragged-on for years.

Boris Johnson led the Conservative Party from a coalition government to their biggest majority since Margaret Thatcher's 1987 election victory at the expense of Socialist Jeremy Corbin's Labour Party—advocating *our socialist agenda* spelled doom for electability under his *Manifesto of Hope*, even if a BREXIT stalemate triggered the election. Membership in the EU brought the issue of European collectivism and European Court to the forefront. Memory of the Financial Crisis triggering global anti-capitalism is fading. Thus, in its worst election performance since the 1930s, Labour now holds just 203 seats, and suggests anti-socialism is rising in the UK—campaigning to force companies to give up 10% ownership to workers, create universal basic income, and raise taxes on the wealthy to pay for all this and other new entitlements didn't gain traction with UK voters.

We discussed the way forward for foreign policy and trade in our follow-up to *British Independence Day* (July 2016) in *Full English BREXIT* (Sept 2019). Boris Johnson has secured an EU Withdrawal Agreement as membership in the EU no longer serves the UK's best interest and restores sovereign rule of law divorced from the European Court of Justice (ECJ). The Conservatives' majority cleared the pathway to leaving the EU on January 31st, however unpacking 40 years of integration will take time to settle key issues. During the transition period through December 31st, negotiations will proceed on free trade, defense, and immigration. Travel freedom and trade between the EU and UK continue unimpeded. Barrier-free trade is desired on both sides of the English Channel, but surely there will be compromise required on labor, taxes, regulation, public assistance, workers' rights, and many other issues. During the transition, the UK must abide by EU rules and laws, and the ECJ will continue exercising its jurisdiction. The frontier between Northern Ireland and the Irish Republic is open, allowing free flow of travel and trade during the transition.

Finally, a geopolitical theme just taking shape is potential progress on an American-led peace deal between Israel and Palestine. Economic impact may be difficult to quantify, but this may be the best hope for a permanent solution of the Israeli state question in 45 years.

Everything Becomes Political Now

Of course, the most critical geopolitical issue affecting US investors is the election in less than a year. Everything tends to be looked at through the lens of a pollical asset or liability, and winning or losing. Policy changes usually take some time to have an effect, but we've noted that the window narrowed significantly under this Administration, which proved its possible to focus on many issues in parallel, and the notion of scarce *political capital* is suspect. This suggests a new thesis: *Clear meaningful policy changes with known economic consequences can be discounted more quickly* than was historically observed. Sentiment now anticipates realistic expectations for policy changes, accelerating feedback. Businesses no longer wait-and-see, instead anticipate.

The balance of power is up for grabs—only the Senate is assumed to be uncontested based on current polling. President Trump's re-election likely hinges on the health of US economy headed into the Fall, but so does control of the House—choices managing the House majority's agenda must be compared to the Administration's achievements, reflected in economic and capital market performance. Voters will be reminded of the now known corrupt origin of Mueller's *Special Council Investigation* (5/2017-3/2019), while awaiting the Durham report. The President was acquitted on the House's *Articles of Impeachment* by a wide margin (even a majority) in the Senate. The separation of powers and organization of our republic was designed not to be a parliamentary government, in other words avoid using impeachment to subjugate the President to will of Congress. Democrats

[5] Japan-EU agreement only recently achieved in Feb. 2019, thereby ineligible for a UK continuity deal. How convenient.

argued impeachment was a patriotic duty to stop him from further harming our democracy, but lacking an alleged crime, a *Minority Report* impeachment for future crimes, likely or not to be committed, isn't consistent with our rule of law. Policy disagreements between agencies and the White House can't be a basis for impeachment.

The business cycle has extended far beyond what most thought possible, and some credit must be attributed to tax, regulatory, and trade policy reforms, which boosted US competitiveness and productivity, while maintaining high profit margins. The chance of US recession has declined during 2019, in our opinion. Trade uncertainty moderated for various reasons given the *US New Order in Global Trade*, while other risks moderated too.

Candidates for the Democrat Party face both *math* and *history* problems that won't go away—namely, how to pay for their populist progressive agenda of policies, which historically undermined economic prosperity every time—the platform will be difficult to walk-back by November. The current platform can't bode well for a general election if economic conditions remain robust with record low unemployment. Eventually, a complex coalition of too many diverse special interests inevitably fractures under compromised or conflicting beliefs.

Voters that believe they benefit from liberty and freedom choose competitive free-markets (invisible hand vs. heavy hand of government) and see through populism of giving away *free stuff* to sway voters. Outside urban strongholds and young voters, Americans tend to reject progressive socialist values—political platforms expecting otherwise are categorical losers under the bright light of general elections. The balance of power may hinge on this issue and its respective policy prescriptions—in other words, the Democratic Party platform that took shape with two dozen candidates vying for attention became an electoral disadvantage, not unlike the experience of the recent UK election.

Stronger growth in 2020 provide needed economic momentum to tackle fiscal spending reform, which can't be tackled until 2021—but the balance of power will be pivotal as to whether fiscal policy reform can be pursued versus extending US indebtedness with new entitlement programs from universal healthcare to universal basic income, universal child care, free college, tuition debt forgiveness, reparations, open borders, affordable housing, and infrastructure spending. Universal health care insurance alone exceeds $30 trillion (double it, because that is what happens with such programs), plus another $30 trillion for everything else. Collectively, proposed programs could cost taxpayers over $60 trillion per decade, or two times tax revenue collected today, despite an annual fiscal deficit of nearly $1 trillion. There is no tax increase that can cover this when state and local government budgets are already struggling and raising taxes would slow potential growth. The highest earners in high tax states already face 50% tax rates—a wealth tax of 2% can exceed annual income.

Politicians argue that *inequality* is the central economic problem today, if not an existential crisis that must be corrected (or redistributed) to avoid social unrest, curb political interference, reduce poverty, and enhance social justice or mobility. Many loaded words used today are provocative short-cuts used to elicit emotion of fair or moral justification for political ends, including: inequality, justice, existential threat, and democracy. Fairness is best achieved with a level playing field of free market competition, without over-regulation, monopolies, or collusion. Anyone find it circuitously self-fulfilling to incite revolution to avoid social unrest? Does redistribution encourage charity for the poor? Fighting poverty is not the same as correcting *inequality*—solutions to these problems are quite different, assuming measuring inequality and associated adverse consequences reliably was even possible.

Different sources of income or wealth inequality have unique economic effects and consequences. Rising income dispersion that was the result of invention, creativity, opportunity, or a little luck in growing capitalist democracies is inconsequential. Following inherited money, including the evolution and generational transfer in the Forbes 400, persistence of American dynastic family wealth is a myth[6] and diffuses quickly in future generations. Business founders pursue entrepreneurial activity at great risk. Removing incentives of greater fortune have adverse consequences—who would take those risks or finance opportunities, if not to maximize one's self-interest? Pledges of charity suggest the current Forbes Top-10 will pass on just a fraction to the next generation, but concern lingers about "buying" political influence, even self-financing campaigns.

Compounding simple wage inflation increases income dispersion with economic growth—stronger growth yields greater dispersion[7], and is a desirable natural consequence. In contrast, income inequality arising from ill-gotten gains of expropriation, political corruption, or uncompetitive behavior coincided with poor economic performance, frail prosperity, or even secular stagnation pervasive among socialist regimes, which inevitably turn to totalitarianism. Thus, we can and should differentiate inconsequential "good" versus consequential "bad"

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[6] Arnott, R., Bernstein, W., Wu, L., "The Rich Get Poorer: The Myth of Dynastic Wealth", Cato Journal (Fall 2015).

[7] Consider two employees earning $50,000 and $100,000/yr. With 3% wage increases over 30 years, an income gap of $50,000 increases to $121,324. If growth increased to 4%, the gap increases 23% to $162,170, but if the higher wage earner realized 5% vs. 3% increases, the income gap stretches to $310,831.

sources of income or wealth inequality. If math drives inequality even partially, what evil justifies redistribution?

America was founded on individual rights of *life, liberty,* and *pursuit of happiness* under equal protection of *rule of law*—if there is a crisis in America, it is these enumerated rights that are most at risk in the name of social justice. There is nothing resembling a fundamental or constitutional right of fairness or equality, except the 14th Amendment's *right to equal protection of the laws*. We support *equal opportunity* as a moral right implicit in civil (1964) and voting (1965) rights acts, but the natural challenge for *equal opportunity* is the slippery slope to quota solutions. If there is a crisis, it is limiting of free market competition and liberty—populist solutions of socialist policies reduce national potential growth.

Access to education is an equalizer that increases opportunity and social mobility, but making it free won't improve outcomes—individuals must make the effort. University tuition need not be free given increasingly vast choices of tech-enabled MOOCs, which provide free (or at nominal cost) and equitable university access to nearly any discipline, anywhere, and anytime. What is the difference between pursuing *Equal Opportunity* versus *Outcome Equality*? We conclude it is virtuous to pursue *equal opportunity,* but not *outcome equality*. Conflating these ideas, limits *equal opportunity*. More entitlements increase dependency, yet reduce freedom and liberty, notwithstanding growth in nondiscretionary spending that is already a tremendous taxpayer burden.

Capitalism was the most successful economic model of the last century, in contrast to the dismal failure of progressive Socialism that has forsaken every adopter of Hayek's *Road to Serfdom*. They were forewarned, yet many examples have followed failed predecessors in the name of social justice. Populist efforts to correct outcome inequality is a terrible solution in search of a problem. Redistribution has proven time and again to undermine economic prosperity, productivity, and potential growth in envious pursuit of correcting outcome inequality.

May Your Sails Find Favorable Winds

While it is true that the US expansion is now the longest in history, likelihood of recession is not a function of time. Expansions don't just die of old age, instead they are typically murdered by central banks seeking to squelch inflation by raising interest rates. Declining earnings during recessions typically trigger equity bear markets, but not every recession result in a correction. Recessions don't emerge out of the blue sky or according to schedules. Obsession with changes in economic growth or "second derivatives" is premature.

We expect the US economy to remain resilient longer than consensus and don't expect a recession in the foreseeable future with potential growth trending toward 2.7% and unemployment below 4%. Investor sentiment was undermined by Q4 weakness. Real estate supply is in deficit, thus fears of a housing correction seem unfounded, although prices have been rising for a decade. This is more likely to draw in fence sitters, reflected in home ownership rates, increasing demand.

Investors seem concerned that an economic storm must be gathering, and appear fixated on equity risks, rather than overvalued bonds. Investors seeking opportunities to get an edge on the market routinely chase growth when the economy lags or earnings growth is low. Divergences in valuation are usually reliable sources of active outperformance, yet technology has continued to shine for some time, even as valuations were stretched—so, *value shrugged*, as did small-cap stocks.

US earnings growth should accelerate with waning geopolitical uncertainty that bolsters economic growth and inflation. We expect US economic growth will benefit from receding risks, while tax, regulatory and trade reform bolster net trade, employment, and investment. Internationally, we expect more of the same, resulting in US outperformance relative to Europe, Japan, and China, but the UK could begin to diverge from the rest of Europe as clouds of uncertainty break up.

Global bond yields should rise, particularly as the US yield curve steepens, central bank holds begin to run-off again (refunding supply), and bond liquidity tightens. Importantly, we expect a negative real return for 10-year Treasuries over the next five years that could undermine balanced portfolio returns. Increasing debt imbalances and liquidity concerns could exacerbate correction of overvalued global bonds, as normalization continues. Credit spreads also may tend to normalize as Investors reduce portfolio duration and risk, although default rates shouldn't change much, but increasing imbalances and liquidity concerns could exacerbate a correction.We expect global equities will outperform global bonds by a wide margin with a marginally stronger US dollar and a possible ¼% hike just after the election.

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