TURNER INVESTMENTS COMMENTARY

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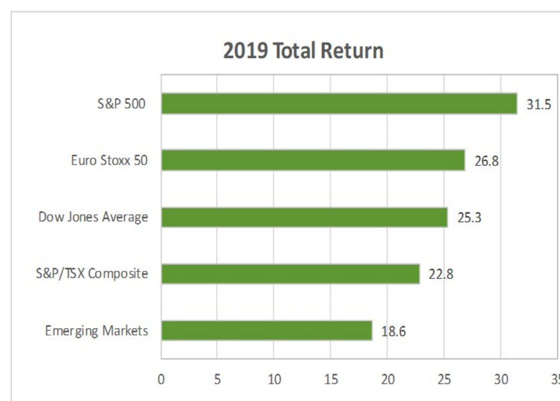
2020 OUTLOOK

EQUITY OUTLOOK

2019—what a year! The S&P 500 and S&P/TSX Composite returned 31.5% and 22.8%, respectively, on a total-return basis, and global equities overall were incredibly strong. We were bullish last year but not that bullish!

In our view, the two key drivers behind 2019's strong performance were the US Federal Reserve cutting interest rates and the recent de-escalation of the US/China trade war as both countries made progress towards a new trade agreement.

2019 market returns (%)



Source: Bloomberg, Turner Investments

The 'phase one' part of this trade deal, which includes China agreeing to buy more US goods (an estimated US$200 billion over the next two years), the US reducing some tariffs on Chinese imports, and progress on limiting China's unfair trade practices, is potentially a major positive for markets in 2020.

While the phase-one deal could provide a small boost to exports and GDP, the larger benefit is the removal of the trade uncertainty that has weighed on businesses and the economy. In particular, we see manufacturing and business investment rebounding this year as a result of the trade deal, which should improve the US and global economies.

While growth in the labour market should slow in North America (unemployment rates are already at historic lows), we still see the labour market remaining strong this year, which should continue to support robust consumer spending.

Overall, we see the US and global economy doing better in 2020 and see low odds of a recession. In trying to assess the odds of a recession we use the indicators in the below table and currently the majority of our key indicators point to a low recession probability in 2020 (only manufacturing is worrisome, but this should rebound on the US/China trade deal).

Moving to the fundamentals, we see corporate earnings growth improving, which should propel stocks higher again this year. After a strong year of earnings growth in 2018, aided by the cut to US corporate tax rates, growth slowed to a crawl in 2019 due to the slowdown in the US and global economies, tough y-o-y comparables and trade uncertainty. With our expectations for stronger economic growth and improvements on the trade front, we see a reacceleration of earnings growth in 2020.

Our Recession Monitor points to low odds of a US recession in 2020

Start of Recession	Manufacturing	Employment	High Yield Spreads	Yield Curve	Housing Starts	Consumer Confidence	Inflation
Jan-80	☒	☒	☒	☒	☒	☒	☒
Jul-81	☒	☒	☒	☒	☒	☒	☒
Jul-90	☒	☒	☒	☒	☒	=	☒
Mar-01	☒	☒	☒	☒	=	☒	☒
Dec-07	☒	☒	☒	☒	☒	☒	☒
Current	☒	☑	☑	☑	=	☑	☑

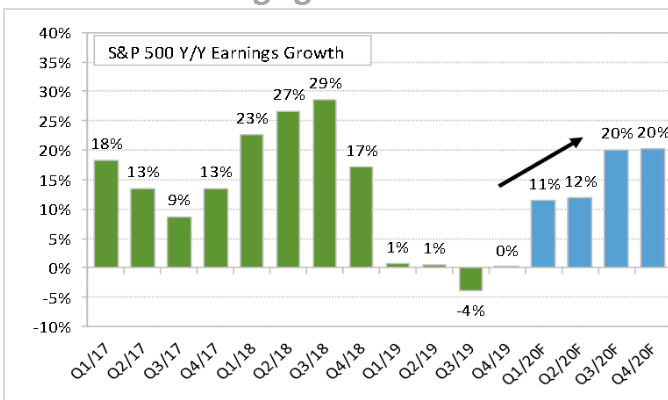
Source: Bloomberg, Turner Investments

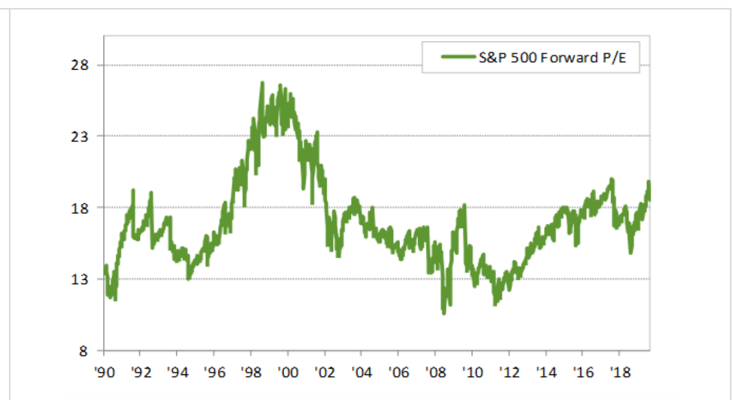
☒Recessionary; ☑ Expansionary; = Neutral

Currently analysts expect S&P 500 and S&P/TSX Composite earnings to surge 17% y-o-y and 15% y-o-y, respectively, in 2020. Stock analysts are notoriously overly optimistic (they buy rose coloured glasses in bulk), so based on our models we see earnings growth coming in at half the consensus estimates (i.e., 7–8% growth y-o-y). This projected earnings growth will be critical to the success of equity markets this year given elevated stock valuations.

With the huge gains in 2019, stock valuations have expanded significantly. The S&P 500 forward P/E, for example, increased from 15x in early 2019 to 20x currently.

2020 US earnings growth should be robust… …but valuations are rich





Source: Bloomberg, Turner Investments

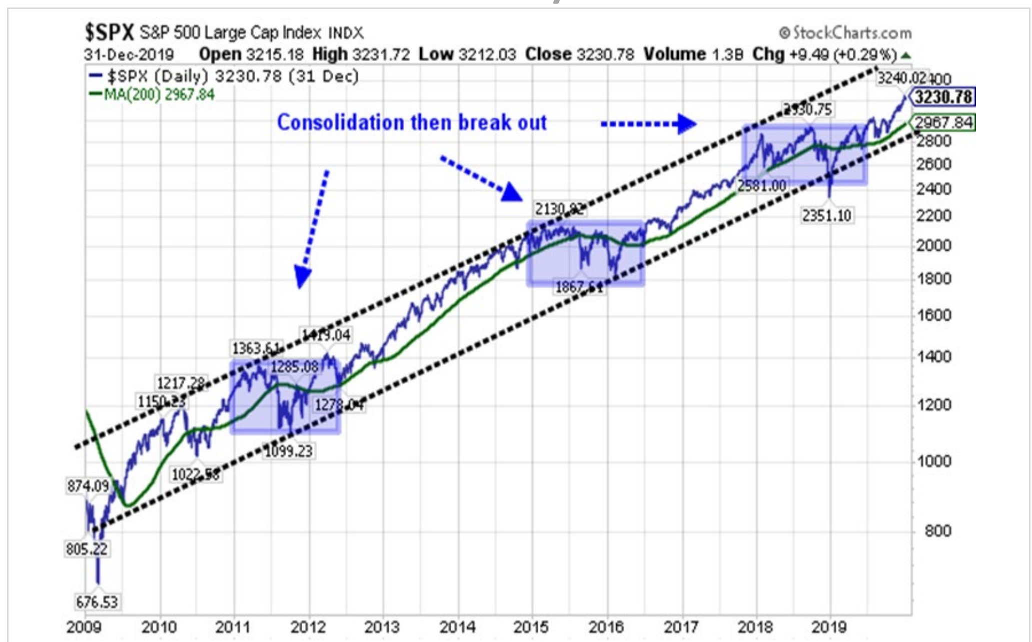
Some worry that the elevated valuations will result in a disappointing year for stock returns. But with inflation low, dovish central banks, and low odds of a recession, we think that this concern is overstated.

This doesn't mean that we won't see bouts of volatility and sell-offs this year. In fact, we see the potential for higher volatility due to the later stages of the business and market cycle. However, overall, we still see positive equity market gains this year, with the magnitude of these gains largely depending on the level of corporate profit growth.

From a regional perspective, we're most bullish on the Canadian, US and emerging markets in 2020.

The final thing we consider in developing our outlook are the technicals. Adjacent is the long-term chart of the S&P 500 and she's a beaut! Frankly, we don't understand how anyone who looks at the charts could be bearish. This is a textbook bullish trend.

S&P 500 technicals remain very bullish



Source: Stockcharts.com, Turner Investments

We have three key bullish observations. First, the S&P 500 remains in a well-defined uptrend (most important). Second, the S&P 500 is above its rising 200-day moving average (green line). Third, note the clear long-term pattern of consolidations (2011, 2015 and 2018) followed by breakouts. The cardinal rule of technical analysis is to "invest with the trend", and that's exactly what we're doing.

Everything else is just noise.

When developing our outlook for the year ahead we also spend a lot of time thinking about where we could be wrong and reading research that is at odds with our personal views. Confirmation bias is a behavioural tendency where people seek out information that aligns and supports their existing views and beliefs. We try to counter this bias by actively seeking out information and views that run contrary to our thinking.

In that vein, we see the following factors that could prove our positive outlook wrong: 1) the US/China trade deal is signed but not adhered to and therefore trade tensions escalate; 2) geopolitical events like the Hong Kong protests or the US/Iran

conflict deteriorate further; 3) 2020 will mark the 11th year of economic expansion and we underestimate how close we are to the end of the cycle; and 4) a surprise US presidential election outcome with a less market-friendly candidate such as Elizabeth Warren or Bernie Sanders prevailing (while unlikely this would probably be the death knell of the bull market).

Overall, we see more positives than negatives for 2020 and therefore see more gains in store for this year. But investors need to be prepared for more volatility and expect more muted gains compared to the awesome 2019.

FIXED INCOME OUTLOOK

Through a variety of bond ETFs, high-quality corporate and government bonds make up the majority of the fixed income weighting in our client portfolios. Their principal purpose is to provide stability. So, with volatility control being the priority, modest returns for these bond positions are generally expected. Therefore, we were pleasantly surprised that many of our bond ETFs had surprisingly strong returns in 2019. In particular, our largest bond ETF holding, the WisdomTree Yield Enhanced Canada Aggregate Bond Index ETF (CAGG) actually gained almost 10% on a total-return basis.

We suspect that these higher-than-expected returns reflected an exaggerated reaction to some of the 2019 economic and equity-market risks—in particular, Donald Trump's trade policy with China, higher equity valuations, Brexit, a struggling German manufacturing sector and a struggling Canadian energy sector. Ultimately, however, many of these risks didn't materialize or at least had limited impact on overall economic and equity-market growth. US GDP growth, for instance, likely came in at 2.3% in 2019—a reasonably robust growth rate and largely in-line with expectations. (Final 2019 GDP growth figures won't be available until later in 2020.)

One Fed tightening cycle is not like the others

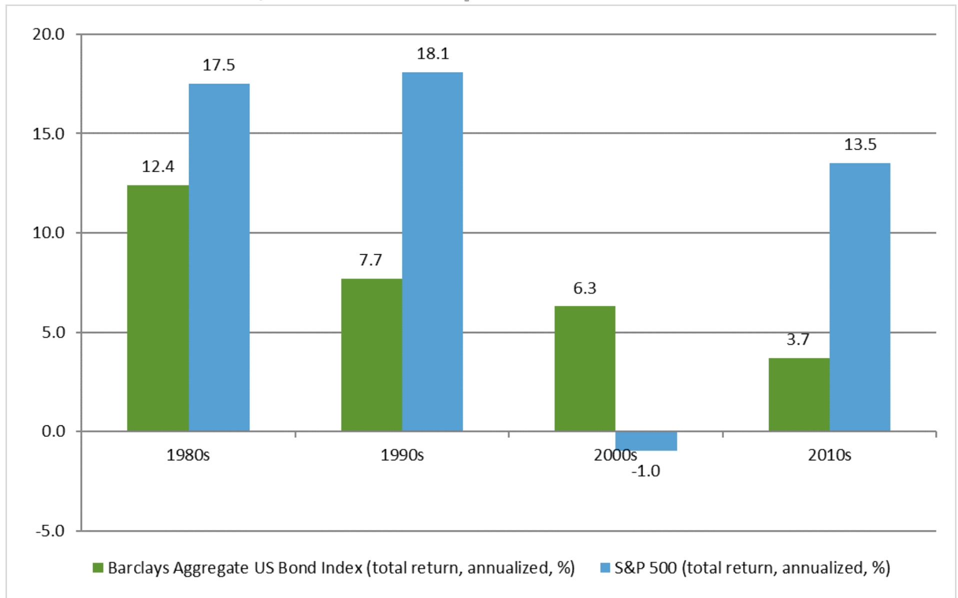
Cycle Start	Cycle End	Number of Days	Number of Hikes	Cumulative S&P 500 Total Return (%)	Overnight rate peak (%)
3/29/1988	6/5/1989	433	11	29.4	9.75
2/1/1994	7/6/1995	520	7	20.3	6.00
6/30/1999	1/3/2001	553	6	-0.6	6.50
6/30/2004	9/18/2007	1,175	17	41.4	5.25
12/15/2015	7/31/2019	1,324	9	57.0	2.50
Average		**801**	**10**	**29.5**	**6.00**

Source: Bloomberg, Turner Investments. A rate-hike cycle is defined as a period of multiple increases in the Federal Funds benchmark overnight rate. Any rate cut ends the cycle. Market returns not annualized. Total return.

After a tightening cycle that resulted in nine rate increases from 2015 to 2018, the US Federal Reserve finally began cutting rates in 2019. Its three rate cuts, of course, drove bond yields lower in both the US and Canada. The US 10-year Treasury yield, for example, fell from a high of nearly 3.25% in 2018 to 1.92% by year-end 2019. The rate cuts effectively ended any hope that the US would return to the high-interest-rate fixed-income environment of decades past. The previous four tightening cycles saw the Fed's benchmark overnight rate peak at more than 5.00% each time. The latest tightening cycle saw the overnight rate peak at only 2.50% (see table above). With the Fed likely to hold rates steady this year (with perhaps equal chances of either one hike or one cut in 2020—call it a coin toss either way) the low interest rate world that we've grown accustomed to is likely here to stay.

Low yields generally translate to low overall bond returns. Therefore, we expect that bond returns will normalize closer to their decade-long average in 2020 (see adjacent chart). The low-yield environment, combined with the bond market's likely overestimation of last year's economic risks, could see bonds 'reset' in 2020 and generate returns closer to their lower historical averages. Therefore, we believe that overall percentage gains from the bond ETF component of our client portfolios will probably be in the low-single-digits this year versus the mid-to-high-single-digits experienced in 2019.

Another decade, another drop in bond returns



Source: Bloomberg, Turner Investments

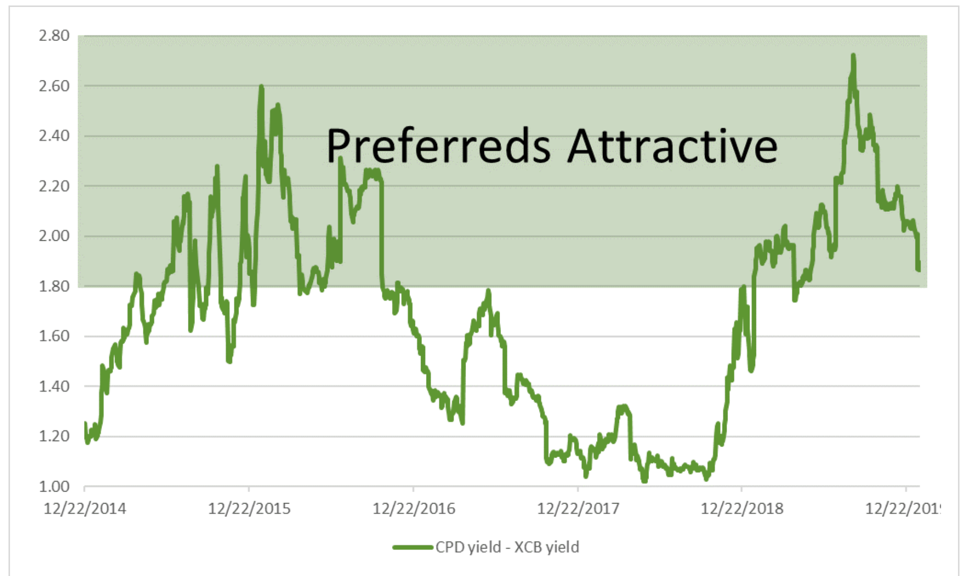
However, as always, the volatility control that bonds inherently provide will be critical as market direction and economic outlook can change rapidly. All of our bond ETF positions have low-to-negative correlations to our equity ETF positions.

Our sizable Canadian preferred share portfolio weighting was a source of mild disappointment in 2019 as our Dynamic iShares Active Preferred Shares ETF (DXP) provided a modest total return of 3.8% but was volatile. Expectations that the Bank of Canada would follow the Fed's lead and begin to cut interest rates, drove Canadian preferred-share prices lower throughout the first half of 2019. The plunging yield of the Government of Canada 5-year Bond, which fell from a high near 2.00% in early 2019 to only 1.14% by September, also contributed to the preferred-share price slide. As the dividends of many Canadian preferred shares are indirectly pegged to the Government of Canada 5-year Bond yield, a lower yield generally means that preferred share prices suffer.

Fortunately, in early September, a compelling DXP yield of close to 5%, combined with expectations that the Bank of Canada would likely hold rates steady instead of cutting, finally enticed investors and contributed to the ETF's strong rally throughout the remainder of 2019.

While the Fed's, and therefore the Bank of Canada's, steady-as-she-goes interest rate policy probably won't aid preferred shares in 2020, we believe that preferred shares continue to offer reasonable value and we are not altering our preferred share portfolio weighting as we enter 2020. In particular, preferred shares are often valued against corporate bonds, which are also bought for their higher-than-average yields. Canadian preferred shares continue to offer a meaningful yield advantage over Canadian corporate bonds (see adjacent chart), which should continue to support investor interest.

Canadian preferred-share yields minus Canadian corporate-bond yields: despite their recent rally, preferred shares still have a substantial yield advantage



Source: Bloomberg, Turner Investments; iShares S&P/TSX Canadian Preferred Share Index ETF (CPD) yield minus iShares Canadian Corporate Bond Index ETF (XCB) yield

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