ClearBridge Investments

The Long View: A Pivotal Year for Equities

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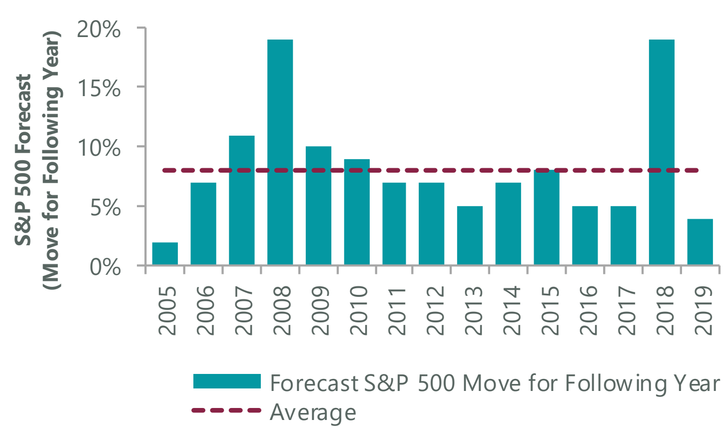
Key Takeaways

- Historical valuation and asset allocation trends suggest a positive upcoming year for equities. In the near term, markets could be choppy given the potential for a growth scare.
- The ClearBridge Recession Risk Dashboard continues to indicate a cautionary yellow signal with no changes this month. We believe the upcoming quarters will be pivotal in determining the fate of this economic cycle.
- Coming out of the first decade in history without a recession, we are likely only halfway through the current secular bull market which should give long-term equity investors confidence.

Investor Skepticism a Potential Catalyst for 2020

There are only three things certain in life: death, taxes and failing to follow through on one's New Year resolutions. Perhaps a fourth truism is witnessed in financial markets each year: equity strategists are perennially bullish and collectively never call a recession. This glass half full view could be in part why equity investors are always last to leave the party as recessions materialize. More importantly, consensus is generally too optimistic when the cycle deteriorates (2000-2002, 2007) and too pessimistic when the market rebounds (2003, 2012). Today, Wall Street strategists are the least bullish on the S&P 500 Index in the last 14 years (Exhibit 1). This collective caution may bode well for next year's market returns.

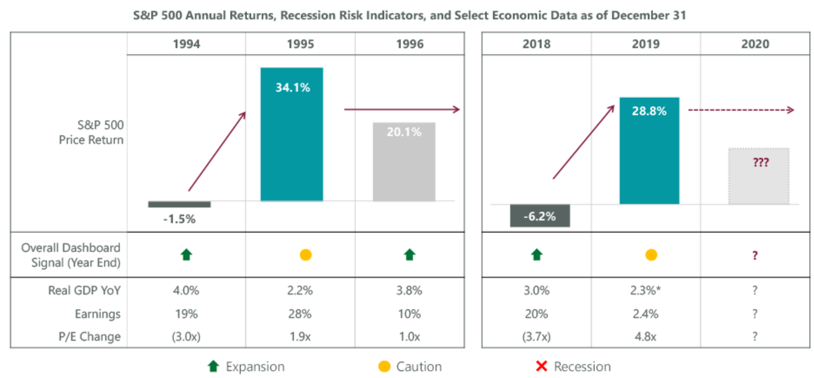
Exhibit 1: Year-Ahead Expectations Lowest in 14 Years



Data as of Dec. 31, 2019. Source: Bloomberg.

Coming into 2019, ClearBridge was more optimistic than consensus. We believed that recession fears were overblown given the solid green output of the ClearBridge Recession Risk Dashboard. We focused on strong parallels with the 2018 economic and market backdrop and historical periods such as 1984 and 1994. Our review of these past environments suggested that absent a recession, markets should bounce back following each reset, which played out once again in 2019. With the benefit of hindsight, we believe the 1994-1995 analogue is more applicable to the current environment. If the economy and market continue to follow the historical pattern, investors should be pleased. 1996 was a robust year for equity investors, with the S&P 500 delivering a price return of 20% (Exhibit 2).

Exhibit 2: Are Stocks Headed for Another Year like 1996?



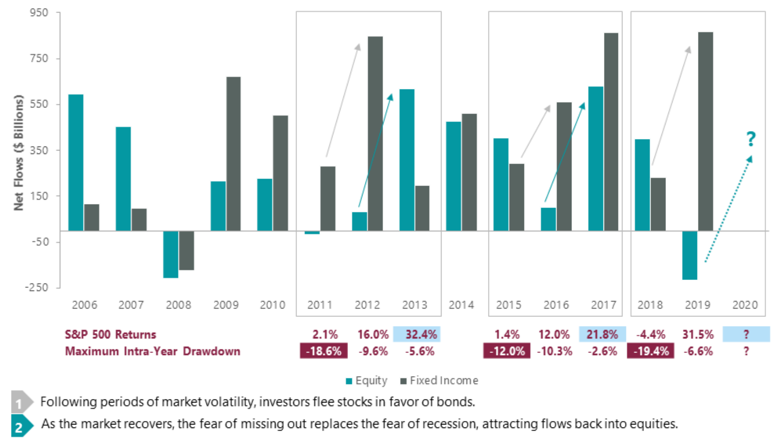
Data as of Dec. 31, 2019. Returns and economic data source: FactSet. Dashboard: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

It may be difficult to see how the market could continue to move higher after 2019's 31.5% total return. However, participation in this year's rally was limited. Many retail investors missed out, as evidenced by the flows into fixed income and equity funds during the year. In 2019, bond and money market funds attracted $868 billion while equity funds saw outflows of $216 billion. This $1.08 trillion net difference in flows is the largest variance in market history between these two asset classes (Exhibit 3).

Plenty of Cash on the Sidelines Available for Deployment

The turmoil from late 2018 spooked investors, leading to a flight to safety that favored bonds over riskier equities. This is a familiar pattern, having also played out following risk-off periods in 2011 and 2015. Specifically, retail investors — still spooked by the two 50% drawdowns of the prior decade — piled into bonds in 2012, 2016, and 2019 despite strong equity returns. Eventually, those concerns turned from fear of a recession to fear of missing out (FOMO), and retail money moved back into equities in 2013 and 2017. This reversal of investor flows helped drive 32% and 22% returns, respectively, for the S&P 500. If this dynamic occurs once again in 2020, returns could once again surprise to the upside. Importantly, there is a plethora of dry powder sitting on the sidelines in money market funds. In fact, money market fund assets are up 22% from last year and currently stand near all-time highs at $3.6 trillion.

Exhibit 3: Fund Flows Signal Investor Caution



Data as of Dec. 31, 2019. Source: JP Morgan.

Another catalyst for elevated returns this year could be continued price-to-earnings (P/E) multiple expansion. As a reminder, there are three sources of returns for equities: earnings growth, multiple expansion, and dividends. Almost all of 2019's return came from multiple expansion with earnings growth roughly flat. Consensus seems to believe that further multiple expansion is unlikely. However, a review of 2018 and 2019 together shows that equity returns over the past two years are entirely explained by improving earnings rather than multiple expansion. More specifically, earnings and the price return for the market are each up 21%. This challenges the conventional wisdom that valuations are running away.

Multiple expansion may continue to occur if historic valuation patterns around peaks are any guide. The median market multiple has traded at a 24.5% premium to the five-year average ahead of the last 10 economic cycle peaks (Exhibit 4). This is consistent with the notion that bull markets end in euphoria and overshoot to the upside. Today, the market trades at a slight premium compared to the previous five years, although we believe valuations have room to move higher. The current low interest rate environment further strengthens this viewpoint.

Exhibit 4: Valuations Not Stretched Relative to Past Peaks

S&P 500 Peak Date Before Recession	Trailing P/E at Peak	5-Year Average	% Premium
May 1946	21.9	12.3	77.4%
Jan. 1953	11.1	8.1	36.4%
Aug. 1956	14.0	11.2	25.5%
Aug. 1959	17.8	14.0	27.4%
Nov. 1968	19.0	17.6	8.3%
Jan. 1973	18.7	17.3	8.4%
Feb. 1980	7.9	9.5	-17.0%
June 1990	17.3	15.1	14.3%
March 2000	30.5	24.0	27.0%
Oct. 2007	19.9	21.3	-6.4%
Median	**18.2**	**14.5**	**24.5%**
Current	**24.3**	**22.7**	**6.8%**

Data as of Dec.31, 2019. Source: JP Morgan.

Can Central Bank Easing Save the Day?

This rosy assessment of future market performance is consistent with the risk-on signals emanating from stocks, rates, credit spreads and commodities. The tail risks from U.S.-China trade wars and Brexit have been reduced and global central banks have collectively flooded the system with liquidity. The Fed's recent balance sheet expansion, for example, reversed eight months of quantitative tightening in nine short weeks. If you include the European Central Bank and the Bank of Japan, the big three central banks are now collectively executing approximately $100 billion per month of quantitative easing. For the first time in almost two years, trade tensions and monetary policy are easing simultaneously and are the key catalysts behind this year's Santa Claus rally.

But it's important to realize that the stock market has a poor track record of identifying recessions early. A deeper examination of recent periods where the Fed has provided three rate cuts shows mixed results: two recessions and two soft landings. Importantly, the market's initial reaction in the first three months were not helpful in identifying which scenario played out as the market moved higher most of the time. The key signal on the economy came six months after the third rate cut, with negative price action signifying recession and positive price action signifying soft landing (Exhibit 5). In today's case, the Fed's third rate cut occurred on October 30th, making the first quarter a critical juncture.

Exhibit 5: S&P 500 Returns Following Third Rate Cut

	Date of Third Fed Cut	+3 Months	+6 Months	+12 Months	+18 Months
Soft Landing	Jan. 31, 1996	2.9%	0.6%	23.6%	50.0%
	Nov. 17, 1998	7.4%	17.6%	23.8%	27.1%
	Average	**5.2%**	**9.1%**	**23.7%**	**38.6%**
Recession	March 20, 2001	7.0%	-13.8%	0.8%	-26.0%
	Dec. 11, 2007	-10.6%	-9.6%	-40.9%	-36.1%
	Average	**-1.8%**	**-11.7%**	**-20.1%**	**-31.1%**

Source: BMO Investment Strategy Group, FRB, FactSet

This focus on the first quarter aligns with the output from the ClearBridge Recession Risk Dashboard. The overall signal for the dashboard turned yellow back in June 2019. On average, an overall yellow signal has turned back to green (soft landing) or red (recession) within six to nine months of the initial change. As such, we believe the first quarter of 2020 will be pivotal in determining the fate of this economic cycle. December did not provide any additional clues as there were no changes to the individual indicators. The dashboard continues to remain firmly in yellow territory, signaling elevated recession risks in the intermediate term (Exhibit 6).

Exhibit 6: ClearBridge Recession Risk Dashboard

		Fourth Quarter 2019	Third Quarter 2019	Second Quarter 2019
Financial	Yield Curve	×	×	×
	Credit Spreads	↑	↑	↑
	Money Supply	●	●	●
Inflation	Wage Growth	×	●	●
	Commodities	●	×	×
Consumer	Housing Permits	↑	↑	↑
	Jobless Claims	↑	↑	↑
	Retail Sales	↑	↑	↑
	Job Sentiment	↑	↑	●
Business Activity	ISM New Orders	×	×	●
	Profit Margins	●	●	↑
	Truck Shipments	↑	↑	↑
	Overall Signal	●	●	●

↑ Expansion ● Caution × Recession

Data as of Dec. 31, 2019. Source: ClearBridge Investments

> Today, the market trades at a slight discount compared to the previous five years, suggesting valuations have room to move higher.

First Quarter Could be Pivotal

One of our core views continues to be that a recession scare will occur in the first half due to the lagged effects of Fed tightening. Taking the Boeing production issue into consideration, it would not surprise us to see a low 1% print (or worse) for first quarter GDP. Whether this metastasizes into a recession remains to be seen. However, many participants believe that the un-inversion of the yield curve means a recession has been averted. History, on the other hand, would suggest that this scenario is not a bullish sign for the economy. In fact, the yield curve was in positive territory ahead of each of the past three recessions with an average steepness of 67 basis points at the onset of the recession. Further, the last three inversions occurred between eight and 16 months before the recession hit, and we are just six months past the initial inversion of the yield curve at present. This means we may not be out of the woods quite yet. In fact, the current market rally is consistent with history, as the S&P 500 rose by double digits for over a year following the 1989 and 2006 yield curve inversions, both of which ended in a recession.

Although the yield curve may not be a helpful guidepost in the near term, a closer examination into business and consumer confidence should provide some important clues. Business confidence appears to have stabilized recently while consumer confidence continues to flirt with cycle highs. While we don't believe that business confidence and capex can bounce materially because of margin pressures, it could be enough to encourage businesses to keep their headcounts steady as we move through a soft patch in the economy. Layoffs are traditionally the last domino to drop as recessions unfold.

If a soft landing (and not a recession) is the ultimate destination, it will likely look much different than the sharp recovery of 2016/2017. First, there's less spare capacity in most major economies today with unemployment rates at or near multidecade lows. This acts as a governor on how fast the economy can ultimately grow. Second, China has shown restraint in doing "shotgun" style stimulus, preferring more of a targeted "rifle" approach. This is in stark contrast to the major stimulus package instituted in 2016 which helped drive global reflation. The deleveraging campaign continues to be a focus of leadership and will continue until growth slows much more dramatically. Forward-looking housing indicators suggest a material slowdown next year, but it would likely take time before leadership changes course. Third, there continues to be little appetite for fiscal expansion in Europe, and a major fiscal package in the U.S. seems unlikely given a divided Congress in an election year, with neither party wanting to compromise and give the other a "win." Finally, the uncertainty created by the presidential election and lingering fears of a trade war will likely keep a lid on business investment.

Exhibit 7: Hard to be Bearish Ahead of U.S. Elections

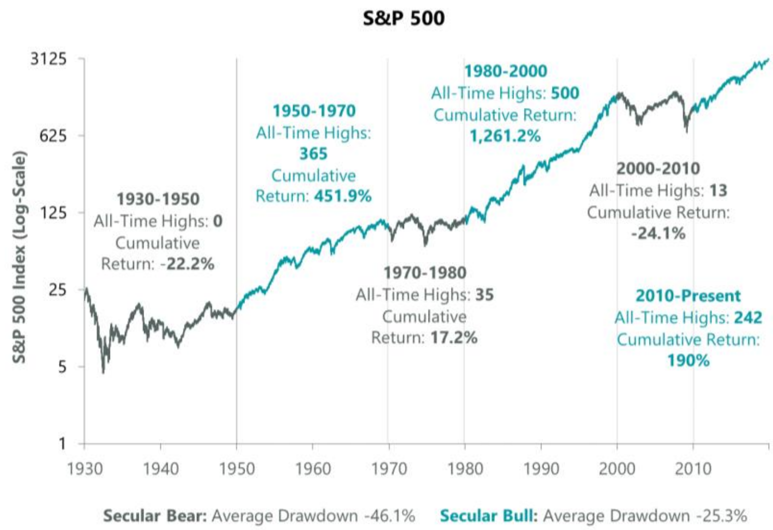
Election	Prior 3 Months	Prior 6 Months	Prior 12 Months
1936	8%	24%	36%
1944	2%	7%	12%
1948	5%	8%	8%
1952	-3%	4%	8%
1956	-3%	-2%	8%
1960	-1%	1%	-4%
1964	3%	6%	15%
1968	6%	5%	12%
1972	7%	7%	21%
1976	0%	1%	16%
1980	7%	22%	26%
1984	5%	7%	5%
1988	2%	7%	10%
1992	-1%	2%	7%
1996	8%	11%	21%
2000	-3%	0%	4%
2004	2%	2%	8%
2008	-19%	-29%	-33%
2012	2%	4%	14%
2016	-2%	4%	2%
Averages	**1%**	**5%**	**10%**
% Times Positive	**55%**	**85%**	**90%**

Although presidential elections may hurt business confidence because of the uncertainty about future policies, market participants should not worry about who will win the election at this point. Markets focus on the economy, typically ignoring political rhetoric until much closer to the election. Since 1936, the market has posted a positive return in the 12 months prior to election day 90% of the time. The average return experience during that year was 9.7% (Exhibit 7). Over the course of the past 80 years, there have been many market-unfriendly candidates, but the market has generally looked past them prior to election day.

Secular Bull Alive and Well

As we close the books on the 2010s, it's important to reflect on how we got here and consider what to expect moving forward. After experiencing the Great Financial Crisis, few would have predicted that this decade would have been the first in U.S. history without a recession. Few would have forecast that the U.S. would be the world's top oil producer. Few would have anticipated the challenging decade for value stocks after 70 years of outperformance. Paradigm shifts will inevitably occur in the next decade, as they always do. While many doubt the U.S. can continue to experience strong equity market performance after its recent run, we disagree. Our view is rooted in longer-term patterns called secular bull and secular bear markets.

Exhibit 8: Secular Bull Markets



Data as of Dec. 31, 2019. Source: Bloomberg.

Since 1930, every secular bear market has been followed by a 20-year secular bull market, suggesting substantial upside for equities (Exhibit 8). This is not to say there will not be speed bumps along the way. Past secular bull markets have seen large drawdowns, with the 1987 crash occurring in the midst of the 1980-2000 secular bull market for example. However, market downturns during secular bull markets have been shallower than in secular bear markets, averaging -25% vs -46%. We believe the U.S. is only halfway through the current secular bull market, meaning despite potential challenges, equity investors should be excited about the coming decade. While there are many potential headwinds, ultra-low interest rates and ultra-accommodative central bank policy can continue to be a wind in the sails of U.S. markets.