

The Long View: A Cross-Asset Class Survey of Global Markets and Macro in 2020

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Risk assets begin 2020 at lofty price levels following 2019's enormous rebound, which was driven by a U-turn in global monetary policy toward renewed easing. Are stocks fully valued, or rather a relative value vs. global bonds at a time when sovereign yields are near sea level, if not underwater? Is inflation, which has been elusive for years, poised to reappear, or will deflationary pressures once again emanate from China, fueling another outbreak in trade tensions? Thornburg Chief Investment Strategist and Portfolio Manager Brian McMahon surveys the unfolding investment landscape, its risks and opportunities, in the year ahead.

- Major central banks have reopened the monetary spigots, lifting global equities indices to or near record highs. Yet bond yields globally continue to ebb. Will markets anticipate an end to central bank liquidity infusions if better economic growth and inflation start to materialize?
- As the U.S.-China trade war grinds on, watch the Middle Kingdom's industrial production and producer price index, which recently returned to negative territory. Does that portend a return of deflationary, supply-side pressures and more trade friction?
- Has the inverse correlation of stock and bond prices broken down? Can the incipient rotation from growth to value stocks hold? How can Environmental, Social and Governance (ESG) investing bolster qualitative analysis? Are passive investing inflows near a tipping point in the U.S.?
- Is the market complacent about the potential risks that the 2020 U.S. general election poses? Can the municipal bond market, which has had an exceptional run since the 2017 tax reform, continue to rally?

Q: *The U.S. Federal Reserve recently announced an expansion of its repurchase agreement operations, resulting in renewed balance sheet growth of \$60 billion per month. The European Central Bank (ECB) recently pushed its deposit rate deeper into negative territory and restarted bond purchases of €20 billion a month. Together with the Bank of Japan (BOJ) and others, major central bank balance sheet growth is on track to blow past \$1 trillion in 2020, fueling the risk-on rally that we've seen of late with equities at record highs and a continued narrowing of credit spreads at a time when roughly 20% of global bonds carry negative yields. How do you expect the latest monetary infusions to impact markets in 2020?*

Brian McMahon: The incremental central bank bond demand is a big deal. The U.S. November employment number was a massive beat, so I thought the bond market would sell off, but it barely got nicked. That shows the power of this incremental buying. Both stock and bond markets appear comfortable front running central banks; this isn't the first time they've seen this movie. A key question in 2020, though, is if financial markets start to anticipate an end to the buying if we see better economic growth.

Also, while a fifth of global bonds with negative yields is a lot, more interesting to me is that 80% of broad global bond indices have market yields of less than 3%. There really aren't many places to find much juice in the bond market.

Q: *Is there a risk of a credit bubble?*

BM: I think the risk is central banks over achieve their goal of creating more inflation. Most people now buying bonds are betting the central banks won't spur more inflation, and inflation expectations are damped down. A lot of people are going against the old adage, "Don't bet against the Fed." They're also betting against the ECB and the BOJ. They don't believe monetary policy can do it. And so far, outside the U.S., many central banks haven't been able to create inflation with simple monetary policies. In the U.S., though, the Consumer Price Index ex-food and energy has been running above 2% for a while; 2.3% was the latest observation. And wage growth has averaged 3.5% over the last three years.

Q: *Could fiscal stimulus, in conjunction with monetary policy, potentially fuel inflation? The U.S. passed major tax reform in late 2017. China has also delivered more stimulus via tax cuts, and even in Germany the calls from both business associations and trade unions for fiscal stimulus are growing.*

BM: There is a perceptible change in the direction of discourse. People are no longer haranguing Greece, Italy and Spain to pursue austerity. Some are pushing the northern Europeans, especially the Germans, to spend more. I think it's too early to call, though. We're not yet seeing big increases in European industrial production or sentiment from producers of tradable goods.

Q: *China is expected to replenish currently low inventories in 2020. Shouldn't that benefit Germany and other exporters in Europe?*

BM: Maybe. Anecdotally, the Chinese have gone into a bit of a crouch because of U.S. trade tensions. It appears Beijing, provincial and municipal governments have all allowed some inefficient, money-losing producers to continue operating just to keep people employed. The government prints money, forces banks to finance the production and factories push it out the door. Just look at the growth of China's M2 money supply and domestic bank credit growth. Its industrial output climbed to 6.2% in November, up from a summer low of 4.4%. They've also allowed some dirty coal-fired power generators to come back on line after restricting cleaner coal imports from the U.S. to offset some of the loss of exports. So, while China's official 2019 GDP growth is lower, it's still tracking at 6% in a big economy. Consensus forecasts put its 2020 growth at 5.7%, which might be too ambitious. On the other hand, if China keeps ramping spending, it may grow even faster than that.

Q: *China's Producer Price Index (PPI) turned negative in July and has continued to fall. Won't that undercut inflation-targeting efforts globally?*

BM: China's PPI turned positive in late 2016. But before that it was consistently negative for about four-and-a-half years; it was exporting deflation through the middle part of the decade. Now it's negative again, but only 1% to 2%. Still, because they're supporting uneconomic domestic production, the World Trade Organization might penalize China again by allowing other countries to put on tariffs.

Interestingly, though, despite Washington's tariffs, the U.S. continues to run net trade deficits of around \$50 billion per month, which is higher than a de-

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cade-long average of a little more than \$30 billion. And that's without importing anywhere near as much oil as we imported ten years ago. So we're importing lots of other stuff, and much of it from China, which has succeeded in displacing a lot of domestic production as well as imports from other places. That's why the Trump administration is trying to draw a line under it. Left to its own devices, that displacement would probably keep going up as China climbs the value-added curve.

Q: Beyond China, other headline risks going into 2020 include the impeachment of President Trump, the U.S. general election and Brexit. What's your take on these?

BM: A negotiated Brexit looks likely now that the Conservatives scored a sweeping victory in the U.K.'s general elections. What happens in the wake of that negotiated Brexit? Many Brits believe it will spark a recession, which will last a couple quarters if not a few years. And then they'll hopefully turn into the Celtic tiger with less regulation, even lower taxes, and become an attractive place to be in business. But clearly City of London (financial services) workers will get hallowed out because they can't be based in London and do business *carte blanche* in Europe. That's already happening.

Q: What about the U.S. political outlook?

BM: Impeachment could get complicated for swing-state Republicans. Around three dozen Senate seats are up for reelection, and around two dozen are held by the GOP. So the GOP has more to lose than gain, and the Democrats just need to win three or four new seats to take the Senate. I imagine it really depends on the quality of the candidates that the parties put up. But it's too early to make predictions. So far, the market isn't really paying attention.

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I do believe the political risks are probably greater than investors are taking into account. We haven't heard enough from Democrats on their plans for economic growth and job creation, including better jobs, and how they plan to make the U.S. more competitive on the global stage.

Q: If few risks are baked in, does that mean investors are complacent?

BM: Well, if we go back to the highest taxes in the industrial world for producers of tradable goods, we'll have fewer tradable goods produced here. Walmart and Home Depot will buy them from the cheapest sources they can, and those won't be located here. I haven't heard any quality discussion about that, including from the Republicans. But I think the GOP gets it a little bit more natively, maybe in part because their support base includes many business owners and managers.

Q: It appears that the traditional inverse correlation between stock and bond markets has broken down. Which one is right?

BM: In an uncertain world, the perception that there's certainty in fixed income has something to do with it. People who are older and have accumulated wealth want more certainty and capital preservation. Historically, it's pretty consistent which demographic cohorts have a majority of the wealth and which are

borrowing up to the gills to start their households.

Q: If wealthier cohorts like the certainty of fixed income, why aren't stocks reflecting the uncertainties of an uncertain world?

BM: Fewer companies are going public and lots of companies are buying back their shares. There's a bit of scarcity of equities. In fact, the number of public companies in the U.S. has fallen by half since the mid-1990s to around 4,400 today. There's growing concentration in almost every industry. The number of equities has also fallen globally, though not nearly to the same extent.

Q: Doesn't that bode well for equities?

BM: It bodes well for the survivors. But it doesn't make me want to buy a U.S. small-cap fund. You want to buy small caps that are going to turn into large caps, but not that many break through. Nearly 30% of Russell 2000 Index constituents are losing money. And aggregated leverage in the index is high: net debt to EBITDA is running at 4.5x. That's an awful combination. Due diligence is critical to negotiate the small-cap minefield.

Q: There's renewed talk about a rotation from growth to value stocks. The relative outperformance of growth over value in recent times has surpassed the dot-com peak. After that bubble burst,

value outperformed in the mid-2000s. But since the Global Financial Crisis, growth has vastly outperformed value. Yet in early 2016 and in late 2018, we heard about rotations from growth to value amid reversals in accommodative monetary policy: in late 2015 it was the end of the Fed's balance sheet expansion, and in late 2018 both "quantitative tightening" and Fed rate hikes. Yet in both instances the rotations proved head-fakes, as growth re-took the lead before long. Now, as noted above, we have the repo operations expanding the Fed's balance sheet with rates at still accommodative levels, and renewed ECB asset purchases. Do you think the current chatter about a growth-value rotation is premature?

BM: You never know. Since Labor Day, there has been a change in the weather. Some more cyclical or value stocks have started to get up off the mat relative to the favored few growth stocks. Growth's outperformance over value is still extreme, though it seems to have peaked.

Q: So are we in the early innings of a corollary to late 2015 and 2018?

BM: Maybe. But value stocks need to see enough economic growth to support more inflation. The other thing is that many growth stocks have rather low earnings and cash flow growth. The dot-com era ended when investors started demanding earnings. Like Wile E. Coyote going off the cliff: he doesn't fall immediately, but then he falls. You see some of that now with Uber and WeWork, which was a poster child for

breakneck growth that wasn't really legitimate; it was very low quality. I'll give you another example: U.S. energy exploration and production companies consuming capital by the tens of billions per quarter, just chewing it up without any cash flow to show for it. Investors feeding capital to these expected growth businesses have started demanding cash flow visibility. I think that's part of what set in. WeWork and Uber may be two matches lighting a more significant fire.

On the flip side, some value and defensive stocks have customers and cash flow but low- or mid-single digit growth. Maybe they're buying back shares or paying dividends and haven't been highly sought after. Yet there has still been major multiple expansion. By late December, the S&P 500 Index was up 29% year-to-date. Most of it, about 90%, was multiple expansion, while actual earnings growth was just a couple points and a big part of that was actually share buybacks.

Interestingly, we've still had less multiple expansion in the stock market than we've had in the bond market. Corporate bond yields of 3.9%—the 10-year U.S. Treasury yield of 1.8% plus a 2.1% "Baa" spread—make for an implied bond market price/earnings multiple of 26x, which doesn't look very attractive to me against an S&P 500 P/E of around 19x. And it has no chance of growing: you're locked in for 10 years at 3.9%. While there are always any number of individual relative values in fixed income, generally at this point I'd rather take a chance with equity, which can equal or better that return.

Now there is equity risk: the dividend may vanish, or go down, or up, and the price of the equity may move around. But you get price risk with your bonds, too. In any event, just compare the current dividend yields of the Investment Income Builder Fund's top-10 holdings versus their marketable bond yields, as we do in a graphic in our [fourth-quarter portfolio commentary](#). That picture is worth 1,000 words to me because it's not some conceptual index. These are recognizable, liquid securities that trade every day, and the dividend yields on almost all of them exceed their current debt yields.

Q: The muni market has also had a great run since the 2017 tax reform. Are the prospects for muni bonds now rather subdued given absolute yield levels? Beyond the risk of tax reform if Democrats win control of the White House and Senate and retain the House, how great are the risks of underfunded pensions and growing retirement health care expenses? The number of states with declining funding ratios has more than doubled in recent times.

BM: I think it's a big risk. You could get more up-to-date commentary from our muni team here at Thornburg. We saw in Detroit that, even with a general obligation, full faith and credit bond, when they got into bankruptcy court, the judge sided with the pensioners rather than the bondholders. Although the pensioners did not have full faith and credit, in a political world, they gave up little or nothing and the bond holders gave up more than half of what was due. It's just another thing investors have to take into account. And it goes to the rich-versus-poor, concentration of wealth debate that's playing out in this and other countries. It's a timely topic. We used to think a general obligation bond was a general obligation.

Now you have to reevaluate that. A lot of money has come in to the muni market,

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and into bonds generally. While the muni market hasn't really been directly impacted by central bank intervention, it's indirectly impacted: if people can't get better yields in the taxable bond market, it pushes down muni yields. Technical dynamics are also supportive: gross supply of tax-exempt issuance projected for 2020 is \$330 billion. A \$170 billion of that is expected refunding of existing muni deals that are callable. Add in taxable muni issuance of around \$80 billion, and there should be net new supply of around \$80 billion. And that's roughly what muni bond fund inflows have been in 2019.

So there's limited supply and strong demand. The rubber band is getting stretched tighter and tighter. As with corporate paper, while there are always relative values for those who look hard, it's crucial to avoid overpaying and to maintain defensiveness when muni and taxable bonds generally are pricey.

Q: ESG investing has obviously become prevalent across the industry. But focusing on governance, as a bottom-up stock picker, you talk to corporate executives all the time. Beyond their record of execution, how do you qualify management? How much of a feel do you get for corporate culture in each of the portfolio holdings? And how heavily does that weigh in your assessment of them?

... investors who target a sensible margin of safety should be well positioned when volatility inevitably hits or investor flows shift. That's when valuations really matter ...

BM: It weighs. You don't want to get conned. From a pure investment standpoint, the most important element is alignment of interest, with management also feeling a fiduciary obligation to shareholders. Hopefully that runs down and through the organization. Governance has many elements, but the element that will really bite you is executives using the company as a personal piggy bank.

Q: Is it easy to discern?

BM: No, but over time you can get a feel. You try to sniff it out on the way in and most of the time it's somewhat apparent. But not always. Some people are clever at making their business look better than it really is. The same is somewhat true with other ESG factors. Take pollution, which is basically akin to deferred unrecognized liabilities; that can come back to bite you. These aren't always easy to sniff out. As far as male/female ratios and composition of boards, it's evolving in a good direction.

Q: Passive investing has been gaining market share of U.S. mutual funds.

Will there be a tipping point, when flows revert to actively managed funds?

BM: Passive investing now accounts for about 45% of U.S. mutual funds. I think it will probably keep growing up to a point.

Q: After which it will be easier for active to outperform because there are so many uneconomic buyers?

BM: I don't think it will ever be easy for active to outperform. But the stocks that have already been pushed up by the incremental passive investor need the next incremental passive dollar. In other words, the passive forces driving many stocks could reverse when passive flows peak. I don't look for that to happen right now. Ultimately, though, if the market is a weighing machine, and I believe it is, active investors who target a sensible margin of safety should be well positioned when volatility inevitably hits or investor flows shift. That's when valuations really matter, both for downside protection and delivering on the upside, whether stocks are classified as growth or value. ■



A Conversation with Brian McMahon, Chief Investment Strategist

Brian McMahon is chief investment strategist for Thornburg Investment Management. He also co-manages Thornburg's global equity portfolios and serves as vice chairman of Thornburg.

Brian joined Thornburg in 1984 as chief investment officer; a role he held until 2019. Brian served as president of the firm from 1997 to 2015 and CEO from 2008 to 2015 and was promoted to vice chairman in 2016. He managed Thornburg's laddered bond portfolios from their inception from 1984 until 2000 and remains actively involved in securities analysis for various Thornburg portfolios.

Brian holds an MBA from Tuck School of Business at Dartmouth College and a BA in economics and Russian studies from the University of Virginia. After receiving his MBA, Brian joined Norwest Bank in 1979, and held various corporate finance positions.

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Correlation – Measurement of the degree to which two variables move together. A correlation coefficient of 1 (the highest) would indicate the returns of the mutual funds and/or indices move in the same direction to equal degrees. A correlation of 0 indicates that there is no relationship between returns. And a correlation of -1 (the lowest) would indicate the performance moved in opposite directions by equal amounts.

Credit Spread/Quality Spread – The difference between the yields of securities with different credit qualities.

Dividend yield is one component of performance and should not be the only consideration for investment.

EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization. An approximate measure of a company's operating cash flow based on data from the company's income statement.

General Obligation Bond (GO) – A municipal bond backed by the credit and "taxing power" of the issuing jurisdiction rather than the revenue from a given project.

M2 – The amount of money in circulation in notes and coin plus non-interest-bearing bank deposits, building-society deposits, and National Savings accounts.

Multiple – A valuation multiple reflects an investment's market value relative to some key metric. Price to earnings ratio (P/E) is a commonly used multiple. It's calculated by dividing a stock's price by the company's earnings per share.

P/E – Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share. Forecasted P/E is not intended to be a forecast of the fund's future performance.

Consumer Price Index (CPI) – Index that measures prices of a fixed basket of goods bought by a typical consumer, including food, transportation, shelter, utilities, clothing, medical care, entertainment and other items. The CPI, published by the Bureau of Labor Statistics in the Department of Labor, is based at 100 in 1982 and is released monthly. It is widely used as a cost-of-living benchmark to adjust Social Security payments and other payment schedules, union contracts and tax brackets. Also known as the cost-of-living index.

Producer Price Index (PPI) – Measures the average change over time in selling price received by domestic producers for their goods and services. The prices included in the PPI are from the first commercial transaction for many products and some services.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index including approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. Source: Frank Russell Company.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

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