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Forecasting in an Uncertain World

"Reports that say that something hasn't happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; . . . we know there are some things we do not know. But there are also unknown unknowns -- the ones we don't know we don't know. . . it is the latter category that tend to be the difficult ones."

Donald J. Rumsfeld, Former US Secretary of Defense

Some gaffes age unexpectedly well. Donald Rumsfeld's remarks, widely criticized in 2002 as empty doublespeak, have experienced something of a resurgence. Rumsfeld's paraphrasing of a NASA framework for thinking about risk has benefited from time and gained wider acceptance. As we close the door on the 2010s and enter the 2020s, thinking about the risks we know, don't know, and don't know we don't know can help frame market expectations.

The first step is accounting for "known knowns." Stock prices are near record highs, and while the S&P's forward P/E multiple of 18x isn't excessively stretched, it's hardly cheap. Likewise, bond yields are low with a year-end 10Yr US Treasury of 1.92% priced much richer than historical averages. Both factors suggest more limited upside for financial assets at the start of 2020 than the beginning of 2010 when the 10Yr UST yielded 3.84% and the S&P's forward P/E was 14.3x. Coming off a 2019 where pretty much every asset class "worked," investors ought to expect much more modest 2020 performance.

Any good forecast must also account for factors that could cause results to differ from one's expectations, and there is no shortage of "known unknowns". Unemployment is at levels not seen since the 1960s, which has traditionally led to overheating economies marked by wage and inflation increases. However, this hasn't happened; wage growth is still at levels economists consider sustainable and inflation remains below the Fed's target. We see room for the economy to expand without prompting upward rate pressure, but also acknowledge the risk that this relationship is merely delayed, not broken.

Meanwhile, the Fed indicates their short-term rate policy is on hold and believes that a hike in 2020 is more likely than a cut. Market participants disagree and have priced in the possibility of a cut before year-end. Recently, disagreement between the Fed and the market has been resolved in the market's favor. However, the Fed's willingness to act with a presidential election pending and their political independence already under attack creates the possibility of a policy misstep.

Another unknown is manufacturing, where PMI indices fell into contraction in the second half of the year. Normally this a harbinger of recession, although the American economy has heavily shifted from manufacturing to services over the past few decades. The services economy has remained healthy, a key variable in determining whether growth will continue. Meanwhile, although the US-China trade war has cooled, barriers to trade remain higher than at any other point in post-war history. It's too early to say how the reversal of the long-term trend towards international cooperation will impact growth.

A third, more positive unknown is the Fed's quiet resumption of balance sheet expansion in 2019. The impact of prior rounds of QE appear to have contributed to today's richness in stock and bond valuations. The Fed's recent injection of liquidity into the capital markets has stabilized the repo markets and supported overall risk appetite. To what extent and for how long this continues is an important unknown.

Last are "unknown unknowns" – factors so far off the radar that they are not understood to be risks at all. These may be unforeseen shocks or the impact of long-term economic transformation. It's worth considering that while the modern steam engine was developed by 1778, the Industrial Revolution it powered didn't begin until 1850, or that the electric motor was invented in 1821 yet it would take nearly 75 years to drive the Second Industrial Revolution. Seemingly mature technologies like the computer or the internet have long permeated our economy, yet history suggests the greatest impact may still be to come. Newer technologies like blockchain and artificial intelligence may have revolutionary impacts in ways that today are difficult to imagine let alone forecast.

Putting it all together, a reasonable "base case" for the coming years would be positive but more muted stock and bond returns, with GDP growth slowing but not stalling. This is a sensible point to start an investment plan. However, there are no shortage of "known unknowns", as well as "unknown unknowns" capable of fundamentally altering the status quo. Acknowledging the risk of deviation from a forecast is another way of saying that portfolio diversification is critical, and that an investment plan should account for not just what you know, but also what you don't. "Sticking to your knitting" while carefully monitoring changing market conditions helps lessen the risk of portfolio shocks, foreseeable or otherwise, in the hope that with time your portfolio will age as gracefully as the cryptic remarks that open this letter.

MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Retail municipal flows were the dominant story in 2019 as mutual funds took in a record $93.6B ($25B in Q4). All 52 weeks recorded positive net inflows. An accommodative Fed and moderating recession fears likely influenced demand for long term funds (+$59B net).
- Issuance picked up late in Q3 and throughout Q4 largely driven by increased taxable municipals and taxable advanced refundings. Total new issuance finished 2019 on a strong note at $421.7B, up 22% from 2018, and well ahead of expectations in the $360-370B range.
- Nonetheless, net issuance was still negative (-$50B), although net supply should increase in 2020. JP Morgan is calling for $20B of net negative issuance in 2020, although other strategists forecast positive figures. Regardless, tax-exempt paper remains tight, maintaining a pillar of support for investors.
- Despite a steepening in the AAA muni curve during Q4 (2-10s moved from 20 bps to 40 bps), the front end remains quite flat picking up only 1 bp over the first 4 years. This has maintained the potential appeal of Variable Rate Demand Notes (VRDNs). SIFMA, the proxy for VRDN yields, finished December at 1.32%, equivalent to 8-year AAA muni yields.
- Municipals out-performed Treasuries during Q4 with 10-year AAA muni yields as a percent of 10Yr UST dropping from 84% to 75%. The 10-year ratio should remain lower than historical averages during 2020, perhaps in a 75% - 82% range.
- With over $11T of global debt trading with negative yields (down from >$16T), we continue to believe low global yields are keeping a lid on UST yields. 10Yr UST spreads vs. sovereign debt from Japan, Germany and France remain close to wide levels.
- We see a trading range for the 10Yr UST at 1.60 – 2.10% and believe there is more risk to breaking through on the down side. We anticipate the curve will maintain its relative steepness in 2020. While there may be rationale to support another Fed cut, the presidential election could be a limiting factor. With this in mind, and technicals supporting a strong bid side, our Intermediate municipal strategy duration remains in a 4.65 to 4.75-year range.

Investment Grade Corporates & Treasuries

- As expected, the Fed cut rates at the end of October, although the market ended 2019 forecasting only a 50/50 probability of a 2020 cut. Potential for a Q3 or Q4 rate reduction may be limited (see above), although renewed balance sheet expansion has had a significant easing effect and could again be an alternative tool later in the year.
- IG spreads rallied late in Q3 and during Q4, with an early September high of 122 OAS falling to a 93 OAS low by year-end. This fueled a continuation of strong IG corporate performance throughout 2019. While further spread compression isn't likely, we do not anticipate significant widening.
- Low rates and benign conditions contributed to $186B of new IG issuance in Q4, raising the YTD total to $1.1T. Demand for credit remains strong which should help contain spreads.

Equities

- 2019's bull market (S&P 500 +31.5%) was largely due to multiple expansion (forward P/E grew from 14.5x to 18.2x). The odds of multiples expanding again to that extent in 2020 are low, so we will need renewed earnings growth to fuel more gains. Wall Street analysts project roughly 9% gains in 2020.
- Stocks are relatively expensive vs. long-term averages based solely on metrics such as P/E (the 25-year S&P 500 average is 16.3x), although low interest rates and inflation have historically justified modest premiums.
- We remain cautiously optimistic on stocks due in large part to the US consumer. The consumer has remained resilient and sustainability is supported by the lowest household debt level as a % of disposable income in 40 years. The jobs market and consumer sentiment are two critical variables to watch.
- With the Fed likely to remain accommodative in some manner in 2020, stocks should enjoy a tailwind. Any signs of a meaningful pickup in inflation could pose a risk to this outlook.

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