PERFORMA

2020 ECONOMIC OUTLOOK

MARKET PERSPECTIVE

INSIGHTS & REVIEW FROM PERFORMA'S INVESTMENT TEAM

2020 OUTLOOK

In our 2019 outlook, we expected the economic expansion to become the longest on record and identified 2020 as a possible tipping point for the U.S. economy. We advocated for a healthy dose of caution due to increased downside risks, but also stressed that it was not time to panic. Throughout 2019, Performa took a defensive approach when positioning client portfolios. We maintained a slight underweight to equites while moving up in credit quality and carrying less interest rate risk than the index within fixed income strategies. While our defensive approach produced generous absolute returns, it also caused us to underperform on a relative basis. The index-relative underperformance is disappointing and especially hard to stomach when a strategy of blindly buying risk would have generated larger returns for our clients.

As we look to 2020 and beyond, we must be humble enough to acknowledge that the current financial landscape is extraordinary and nobody knows how long it will sustain itself. There is currently $11 trillion worth of negative yielding bonds globally - and that's without adjusting for inflation. Corporate spreads are approaching historic tights and the amount of outstanding BBB debt is unprecedented. Compounding these realities is a lack of voice (at least presently) from Washington D.C. willing to admit that the current fiscal situation is as unsustainable as climate change. The ratio of U.S. debt to GDP is north of 105%, up from 64% in early 2008. Amid all of this, the Federal Reserve cut interest rates three times last year and is quietly growing its balance sheet again (this time through Treasury Bill purchases). Sprinkle in a dash of impeachment, add a pinch of Brexit and sit back to watch as the relentless appetite for risk sends equity markets to fresh all-time highs.

In the face of an aging business cycle, looming presidential election and limited upside catalysts to U.S. economic growth, now is not the time to be greedy and chase returns. The calculus for 2020 is akin to that of 2019; it weighs how much upside one is willing to forego, while still participating, in order to protect on the downside.

Media and market pundits will focus on outsized year-to-date returns, but it is important to remember that from September 20th, 2018 (prior to the Q4 2018 market meltdown) through year-end 2019, the S&P 500 returned 13.08% while the iShares 7-10 Year Treasury ETF returned 12.43% during the same time period[1]. So, yes, 2019 gains were impressive but observing a slightly longer time horizon paints a less rosy picture, especially on a risk-adjusted basis.

The late 2019 euphoria that swept through financial markets, stemming from accommodative Fed policy and a Phase 1 trade deal with China, has our inner contrarian stirring. We suspect that the recent exuberance is overdone and will fade as we progress through the New Year. With plenty of questions unanswered, 2020 should be approached with humility and restraint.

At present, maintaining current exposures with an eye toward the downside is a sensible course of action. In doing so, our clients will continue to participate in any remaining upside in risk markets, albeit to a lesser degree, while providing downside protection should market confidence stumble or economic performance disappoint.

THE YEAR OF THE U-TURN

In mid-December of 2018, U.S. monetary policy maintained a clear tightening bias. The Federal Reserve forecasted two interest rate hikes in 2019, while allowing the size of their balance sheet to slowly decrease in the background. This was by no means new policy, as the mantra of gradual tightening had been in place for years, thanks to a solid U.S. economy supported by a healthy labor market and deficit-financed expansionary fiscal policy.

Entering 2019, Performa forecasted the Federal Reserve to deliver two interest rate hikes. We expected that the expansion could endure the additional tightening and benefits of moving away from the zero-lower bound (accumulating ammunition for the next economic downturn and attempting to restore some sort of normalcy to interest rates and broader capital markets) would factor into the Fed's decision tree. As it turns out, we, much like the Fed, missed the mark by 150 basis points or the equivalent of five quarter-point moves. Instead of hiking twice in 2019, concerns over slowing global growth, destructive trade rhetoric and tepid inflation coaxed the Federal Reserve into delivering three interest rate cuts. A generous amount of easing in the second half of the year, to be sure.

[1]Source: Bloomberg

The dramatic U-turn in monetary policy has little historical precedent and worked to buoy sentiment while sparking activity in the interest rate-sensitive housing sector. The question for 2020 becomes this: will the Fed's preemptive easing be successful in extending an already old expansion and ultimately avoiding a recession?

2020 AS A POTENTIAL TIPPING POINT

For quite some time we have targeted 2020-2022 as the likely end to the current economic expansion. Then poorly timed deficit-financed expansionary fiscal policy that juiced the U.S. economy in 2018 caused us to focus on the earlier part of that range. At this time last year, we expected the current expansion to overtake the 1990's as the longest expansion on record but identified 2020 as a possible tipping point for the U.S. economy.

Today, we would feel much more confident in this call had the Fed followed through and delivered two interest rate hikes in 2019. But as the facts change, so too must our outlook. The unexpected and abrupt monetary policy U-turn has buffeted the near-term prospects for recession but has not removed them from the table. 2020 is still likely to be a pivotal year for the current expansion and financial markets in general as many questions remain unanswered. Not the least of which is who will win the 2020 election?

For now, economic weakness has been contained to business spending and the manufacturing sector. While the Phase 1 trade deal has removed some headline risk, we expect corporations will approach 2020 with prudence as they consider longer-term strategic plans. This caution is more than warranted given considerable political and economic uncertainty and will act as a governor on the broader economy.

To date, consumption has underpinned U.S. economic growth and will be a requirement if the expansion is to sustain itself. Job creation continues to surprise to the upside while initial claims track historic lows and wages show modest year-over-year gains. Consumer sentiment is below cycle highs but still hovers at lofty levels. It is worth noting that consumer surveys have plenty of exposure to equity markets and thus are susceptible to quick and somewhat dramatic swings. With that said, the savings rate has been undeniably strong, which should, at a minimum, temporarily support consumption in the event of a negative shock.

A NOTE ON UNKNOWNS

Call us paranoid, but the recent developments in short-term funding markets have us concerned. Back in September 2019, without notice, overnight rates rocketed higher indicating a lack of liquidity in short-term markets. The spike was quickly discounted as a "perfect storm" borne from sizable corporate tax payments which created a temporary shortage of dollars. Since then, the Federal Reserve has implemented a slew of measures designed to increase liquidity and calm markets. The massive amount of liquidity that the Fed is now injecting into short-term markets could be there to alleviate legitimate technical disruptions (as the Fed describes them), or to potentially mask a deeper, more worrisome issue in funding markets.

At the time, the Federal Reserve was attempting to unwind years of excessively easy monetary policy when their plans were derailed. The message from the market to the Fed was a clear and definitive "we still need your liquidity." Hardly a resounding vote of confidence from market participants. While the Fed has been prepping for the new world of conducting monetary policy in an ample reserves regime, we believe that they failed to anticipate finding the new floor in reserves so quickly. Doing so probably came as a rude awaking for the Fed and its long-term plan for its balance sheet. The last 10 years of experimental monetary policy are going to have a lasting impact as we move into the 2020's. Exactly where the fallout from these practices will land remains one of the biggest unknowns in financial markets today.

SUMMARY

In totality, we expect the U.S. economy to muddle through 2020 and maintain the view that risks to growth remain skewed toward the downside. The recent shift in Fed policy has taken out some of the downside risk, but we see little in the way of catalysts that would produce meaningful upside surprises in the New Year. From a more skeptical perspective, where we find ourselves most frequently, one does not have to work too hard to find potential downside impulses that would send confidence meaningfully lower. Buckle up - it's going to be an interesting year.

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ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for more than 25 years. Our capabilities include asset allocation, active fixed income and equity management through diversified mutual funds and separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our clients. We are 100% employee-owned and have $4.79 billion in captive assets under management and advisement as of November 30, 2019. Our investment philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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