Ep36: Economic Forecast for 2020 and a Look Back at 2019

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PATTI BRENNAN: Hi, everybody. Welcome to the Patti Brennan Show. Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best life. Joining me today is Brad Everett. Brad is our Chief Investment Officer here at Key Financial.

Brad, thank you so much for making the trip.

BRAD EVERETT: Hey. Good morning, Patti. I work about 15 feet away, so today I had to leave about 30 seconds before I had to be there.

PATTI: That is one heck of a commute, Brad.

BRAD: We have a nice studio here inside of Key Financial. I had to walk around a delivery of printer paper but it's a pretty convenient trip.

PATTI: It's plug and play. Folks, for those of you who are listening today, we have wonderful privilege of having this studio that has been built in here, right here at Key Financial.

It allows us to really come in here whenever timely issues are coming about. We can just come in here, have a conversation, and share with all of you. Thanks so much for tuning in.

Brad, today, we're going to talk about the backdrop going into last year, what happened, and then what do we expect going forward. You're just coming back from a bunch of conferences. I'm really interested to hear what you've learned from other experts throughout the nation.

Let's first talk about what was going on this time last year. 2019 wasn't supposed to happen, was it?

BRAD: Yeah, it's hard to understand 2019 without talking a little bit about 2018. If you remember, the first three quarters of 2018 were wonderful. Everything was up, up, up, up and up.

PATTI: Rosy.

BRAD: Then you go into the fourth quarter where you have what had been two years of rising interest rates completely reversed, daily talk about trade war and tariffs and things like that. The corporate tax cut, which this giant, single one time boost in bottom line profits.

PATTI: That's a really good point. That's like a shot of adrenaline, increased profits. What do the companies do with the money? That's the question that I always ask is, growth has to be sustainable.

Here they have a wonderful shot of higher profitability. That would warrant higher stock prices, right?

BRAD: Sure.

PATTI: What do you do the next year?

BRAD: I guess all of these businesses that had this one time boost of cash at the end of the year get to make a decision for what the highest and best use of that cash is.

Do we give everybody a raise? Do we hire more people? Do we build a factory? Do we put R&D into a new product, or do we give it back to shareholders?

I think that tended to be a pretty popular choice, was to buyback stocks, and you can do a one time cash dividend. Almost the same thing would be to buy your own shares and drive the price up that way.

PATTI: You drove up the price, fine and dandy, but then you go into the next year, which is 2019. Of course, the stock market is going to take a look and say, "OK, Apple and IBM and all you wonderful companies, what have you done for me lately? I need more, and more, and more."

It would be reasonable to say, "I'm not sure what I can do to give you more earnings."

BRAD: Yeah, buyback doesn't generate any kind of future growth prospect.

PATTI: Yet, earnings did come in higher last year. It is really interesting how resilient our economy has become. Now, manufacturing hasn't done so hot.

BRAD: Right.

PATTI: That was on the decline and that would warrant what happened in 2018. Through the year, then we had this thing with the yield curve.

BRAD: Sure.

PATTI: This terrible, awful thing that everybody is worried about, the inverted yield curve. All the drama, and yet, the stock market continued to power ahead.

BRAD: Yeah, absolutely.

PATTI: One more thing, the United States President gets impeached. Again, everywhere we looked, it was bad news, no matter what you looked at. What does the market look at, and why does it power forward when all that bad stuff is going on?

BRAD: Sure. That's a great question. [laughs] I wish I knew the answer.

PATTI: Actually, it's so interesting. This is why, Brad, you're so good. We don't know the answer, do we?

BRAD: Right, or certainly, what's going to happen, and what it means for the next three months or six months or a time period so short.

PATTI: Exactly. The most important thing that we believe, and I think what you're saying is, nobody understands why markets do something over short periods of time. Fundamentally, longer periods of time, and we're talking years, folks, markets do make sense.

BRAD: Yeah, and I think you could probably go back and show that the market almost always reacts to short term news.

PATTI: That's a good point. Going back to 2018, that massive drop of almost 20 percent was pricing in a recession.

BRAD: Yeah, it just hasn't happened yet. Now, we're almost pricing perfect news for the future. Evaluations are so high. It feels like nothing could go wrong.

PATTI: We talked about headlines, and we talk about the media, and all the negativity, etc. I think it's fascinating that one statistic that you got from the conference about the "New York Times" and the fact that they had 80 articles about a pending recession in August alone.

BRAD: When the yield curve flipped, they apparently had 80 articles about a recession that just hasn't even happened yet.

PATTI: That was in 2019. The market was already doing well. What else do you think led to the market doing really, really well? We're going to talk about whether or not that's unusual, anyway.

BRAD: Again, there's a tremendous overreaction in the short term. When you look at the returns in the market, you just have to spread them out. If you look at 2018, great start to the year, terrible end. Most moderate portfolio is probably down a little bit.

If you include a great 2019, if you smooth that out, you're probably seven percent a year, eight percent a year. You can do that over decades too. If you look at the 2000s, you have this last flat decade on the S&P. If you look at 2010s, they're averaging 13.8, 13.9 percent. Amazing what the average of that is. It's just less than seven percent.

PATTI: How about it?

BRAD: Year to year, it's really tough to pinpoint exactly how the market's going to react to everything. 2019 wasn't out of the ordinary. I saw a stat that, in the last 93 years, 34 of them, the S&P earned 20 percent or more.

PATTI: That's pretty traumatic. A third of the time it earned.

BRAD: It's really not uncommon.

PATTI: Let's look at the other side then, Brad. How many times did it lose 20 percent or more?

BRAD: It'll be six.

PATTI: Out of 94 years, that's amazing. A third of the time, it's up over 20 percent. It's only lost more than 20 percent, six times.

BRAD: 74, 75 percent of the time, the market is up, the S&P in particular, in this 93 year sample. If you think of, call it 70 years that the market was up during that time, 34 of them were up 20 percent. Over the years that the markets up half the time it's up 20 percent or more.

2019 is not extreme. It's not out of the ordinary. It's not very uncommon at all.

PATTI: Yet, to your point, it's priced for perfection right now. We have to be cognizant of that. Just because it happened doesn't mean it's always going to happen certainly going forward as well. We always get back to the fundamentals in terms of "Price for perfection. What does that actually mean?"

BRAD: Just an extreme optimism. What is on the horizon that could actually go wrong? You might be underestimating some of those risks.

The starting point is a really important input, it's hard to look at the next 10 years and say, "Starting where we're starting, could we possibly duplicate the past 10 years?" You would think that's a pretty low probability.

PATTI: Well, we will get into the predictions. Far more relevant would be looking around the world and looking at what our Federal Reserve is doing versus the ECB, etc. Seems like the Fed is on pause?

BRAD: Yeah, it does seem so.

PATTI: Last year's quick turnaround, the Fed pivot. How unusual is that?

BRAD: Very unusual. I don't recall any times where that's happened like that.

PATTI: We're laughing, you guys, because we were talking about this before when we went on air and we said, "Brad, it's crazy that the Federal Reserve decreased interest rates, and we didn't even have a recession." It's very, very unusual for them to do that that quickly, without a crisis going on.

BRAD: They would tend to weed it out and see, rather than just immediately switch strategies that way.

PATTI: You wonder whether or not President Trump mocking the Federal Reserve and pushing them had anything to do with it.

BRAD: Nobody wants to be mocked on Twitter. I don't.

PATTI: I wouldn't want to get in his way. No way.

Let's talk about the Federal Reserve. You were talking about one of the conferences and somebody was saying that, "Quantitative easing was more like a steroids." It wasn't really like medicine.

BRAD: Right. I think the idea being, back to what we were talking about before, did they put a boost into the economy that just can't be compounded or sustained? I don't know. What do you think?

PATTI: I disagree with that, completely. I disagree because what the Federal Reserve did when they lowered interest rates and introduced this new tactics called quantitative easing, did it feel like it was a Wizard of Oz moment? Maybe, maybe not.

What I think it really did was shore up confidence. They were there to save the day. So the American consumer said, "OK. I'm going to breathe a sigh of relief and I'm going to go out there and spend money again," which is really what they needed to do.

BRAD: We're really relying on consumer spending now, which, obviously, starts from consumer confidence. That is certainly an important input.

PATTI: Let's talk about this concept of Japanification. Everybody is worried that because Japan has been in this 30 plus year of decline...I started in the '80s, Brad. I was over in Japan.

At that time, everybody was worried that Japan was going to take over the world. At one point, they bought Pebble Beach Golf Club. They were buying things in New York City as well.

This concept of Japanification is a scary one, because back then, if you look at the Nikkei index, it was at 1989, it peaked at 39,000 yen. It is still 39 percent below where it was over 30 years ago. I have to double check my math, but that would really give us a very low Dow Jones if that ever happened here in the United States.

BRAD: Even if it happened, it's scary enough if it happened instantly and started growing back. This is 30 years later, it's still down there.

PATTI: Exactly. It is pretty scary. Just to give you an idea, folks. In 1989, our Dow Jones closed at 2,590. We are close to 28,000 now.

BRAD: 10, 11 times more.

PATTI: It's crazy. Yet, they are 40 percent below where they were then. That just gives you a feel for the dramatic difference in two very developed nations.

That is also what everybody is worried about because Japan was hit with deflationary spiral that they couldn't get themselves out of. They have negative interest rates.

Europe now has negative interest rates. People worry, "Europe is next. Then maybe the United States is coming close behind."

Let's talk a little bit about that whole concept of Japanification and really brainstorm. Do you think it could happen here? Is that something that we should be worried about?

BRAD: The thing that comes to my mind that one of the major things they're suffering from is demographics. They're just a workforce that's not growing, declining probably. Inflation that has been stuck very low for very long time.

PATTI: Let's talk about that. Everybody things of inflation being bad. By itself, it is bad, but this whole concept of inflation, what happens to a consumer in a deflationary spiral?

BRAD: Sure. If you were a consumer that wanted to buy a new sweater and you knew it was on sale for the next week, you would rush to buy the sweater. But if you knew that the price of the sweater was going to be the same or cheaper six months from now, you might just wait. There's no urgency to spend money.

PATTI: Which is different than what we have here. Everything is always on sale. Hurry up. You see it in the department stores. You better get it now. Otherwise the sale is going to be over, so people do tend to consume it.

BRAD: Yeah, absolutely.

PATTI: I think that the demographics are fascinating also. I think it's important to consider just where the government stands in terms of its ability to help, because clearly decreasing interest rates isn't enough, is it? There is a question as to whether or not it even worked. What's the next step?

BRAD: There's two major components in the GDP growth. Productivity growth and population, or workforce growth. I think productivity seems to come in first. You invent a car and people can drive farther and quicker to work. You have a computer and it comes with another burst.

Productivity doesn't skip along at two percent. Not every worker is just exactly two percent more productive every year than they were the year before.

PATTI: That's a really good point, Brad.

BRAD: There's something that comes along and shocks it up, and then it kind of stays the same forever. The thing that seems to be the most pliable would be demographics. In our case, it's a little different.

We have some political battle that we need to figure out, some kind of legal immigration. As long as United States citizens are having kids at a very slow rate, we need to replace employees somehow. We've got to figure out a way to do that in a productive way.

PATTI: What's the replacement rate that is required in order to keep an economy growing?

BRAD: Oh, jeez. I think 1.7 per household or 1.8 per household or something like that. It's not 2, but...

PATTI: We're right at that point, right?

BRAD: Pretty close or just below.

PATTI: Whereas Japan and Europe is a little bit below that. They've got some issues when it comes to demographics because younger people buy more stuff. They need more things, etc., versus people who are retired and older. They need more services, yes, but they don't need the goods. Who's going to manufacture? It has a real domino effect, doesn't it?

BRAD: Yeah. I don't think it's permanent in our case either. This might be a place where we differ from Japan. We've got a block of millennials that's probably larger than the baby boomers. They'll have kids. They'll have lots of kids. That's a workforce in itself, but their kids aren't going to start working for another 20 years.

PATTI: So there's going to be a lull?

BRAD: Yeah. It's not something that you can never pull yourself out of. It just could take a little bit.

PATTI: That's interesting. In the meantime, in order to avoid that from happening, an economy can lower interest rates or they can have some fiscal stimulus. Get the government start spending some money. That certainly helped during the depression.

The problem is that Japan is not in a position to do that. They are the second highest developed country relative to death to GDP.

BRAD: What did you tell me? It was 235 percent or something?

PATTI: Yeah. It's a crazy number. 234 percent, whereas Germany is at 59 percent. Germany is in a much better place to spend some money to get some things going and get growing again.

BRAD: You would think they even have a better borrowing capacity than we do and a lot of the European countries.

PATTI: They certainly do, because we're at 106 percent. We're not Japan, but we're certainly not Germany. They are in a position to be able to get their economy out of it if they just have that political will to go ahead and allow the debt to grow a little bit just to get things moving.

BRAD: Has that been part of the conversation? Is that being addressed?

PATTI: Yes and no. I think they are still in this mentality of back to the depression and the breadlines and stuff, they don't want inflation. I think they're beginning to realize that deflation is actually worse. We know how to get out of an inflation, it's the deflation that is really very challenging.

It's really hard at this point to increase interest rates. It's just not happening. They've got to do something else. They've got 19 countries over in Europe that all have to agree on this.

BRAD: Right.

PATTI: It can't all be Germany, even though Germany is the largest. There are some things because of that alliance, in terms of exporting to other nations, exporting back to the United States. There are solutions. Again, it comes down to the will.

BRAD: Right.

PATTI: We've talked about that. Now let's talk about India. India's an interesting country, isn't it?

BRAD: Sure. It could be volatile, it could take a long time, but they're a bright spot.

Emerging markets are interesting. They don't have to reinvent the wheel. Developed nations have implemented the things that it takes to become a developed nation.

The technology exists. The ideas have been proven to work or not work. With an emerging market, it's just a case of implementation. You just have to get the money, and the tools, and the labor force trained. You just have to get them there.

PATTI: The one statistic that you shared with me, in India there are a billion people getting skilled.

BRAD: Yeah.

PATTI: That's pretty dramatic. Again, skilled workers is a huge driver for GDP, isn't it?

BRAD: Yeah, absolutely. Think of the brains that are there. I'm always fascinated by this stat, the top 25 percentile of intelligence in India, just the smartest quarter of people, is larger than the entire United States.

Think of the potential that's there to create wealth and productivity.

PATTI: Right. To take that one step further, we think in terms of capital and getting them the tools, right? A billion dollars of capital in the United States is one thing. A billion dollars of capital in India is quite another.

BRAD: Yeah, because you're starting from a lower denominator. Absolutely.

PATTI: The leverage that could produce in terms of the growth in India, and what that could do. There are different pockets in the world that really do present some interesting opportunities.

BRAD: Absolutely.

PATTI: I guess it depends on their willingness to bite the bullet, spend the money, and really jack things up a little bit.

BRAD: Yeah, there are different intricacies of each one. The legal systems aren't the same, the political atmosphere is not the same. There's a lot of stuff to work through.

PATTI: So, we'll be volatile until they do, right?

BRAD: Sure, yeah. Absolutely.

PATTI: Brad, let's take the last five, ten minutes and talk about what's happening in 2020 and the presidential election.

BRAD: Sure, I guess there's a lot of ways to think about it. Obviously, it's a polarizing time, you would think. It's interesting, Phil Camparelli used a Joe Torre line. He said, "Every season, a team wins 50 games and they lose 50 games, it's the middle 62 that decides how the season ends."

That's an incredible political metaphor. In any election, 35 percent of people are always going to vote Democrat, it doesn't matter who the candidate is. 35 percent of people will vote for a Republican, it doesn't matter who the candidate is.

There's a group of people in the middle that is not so one sided, either way. They're willing to rethink it every year, they have specific issues that they care about at the time, and they pick the person that they think is most capable of solving those problems at any given time.

The question is what are they going to do, right?

PATTI: If things are stable, that middle group, they're fully employed, they're making money, their 401k is going up. The question is, and we always go back to that quote, "It's the economy, stupid." Right? It's the economy, the economy, the economy.

Trump is not stupid, right? He didn't get there without something going on upstairs. He knows that trade wars are bad.

BRAD: Yep. War with Iran is bad. All the things that could propel you into recession, I think you would probably try to avoid for the next few months.

PATTI: As we record this, here it is the middle of January 2020, we don't even have enough time to go into a recession.

BRAD: Yeah, by definition I guess you have to wait two full quarters of data, so you would never have enough time to get the information that you get officially say that you're in a recession.

PATTI: I think we can all agree this hasn't been the standard presidential style. The leadership style is very, very different.

Even though the economy is humming along quite nicely, tax rates are low, things are doing very well, there seems to be a group in our population, that are saying, "We just have to get rid of this guy."

It seems to be more for personality, his personality traits, and Twitter, and all that kind of stuff. The question is, are there enough of those people in the middle to sway the election one way or the other?

BRAD: Right. Yeah, it's hard. I guess the way I tend to think about it, and this may or may not be true, but it feels like that group in the middle would prefer stability, like the same thing. What's the last one term President? Was...

PATTI: George Bush?

BRAD: ...Bush. Yeah, right. There is a tremendous boost for an incumbent against a challenger. It's very rare that that person loses.

PATTI: At the end of the day, Brad, does the President really matter?

BRAD: I tend to think that the President is our PR man. He is the PR man for the country.

PATTI: Oh, boy.

BRAD: You think a business cycle is far longer than any President's term.

We hit a bottom in 2008 and 2009, and this economic growth isn't because of Obama. It's not because of Donald Trump. It spanned both of theirs. It spanned a Democrat and a Republican.

The economy does what it does. The business cycle does what it does, and it's going to go on despite whoever's in the White House.

PATTI: Let's wrap this up and think in terms of action items. Given this, given 2020, what's already...We look back, 2019 was a great year.

2020, we've got some headwinds, we've got some international conflict, the presidential election. Things seem to be humming along, but we shouldn't get complacent, right?

BRAD: Yeah. I think this should just serve as a reminder that the stock market is a volatile place to be invested. It's intended for long term money.

If you need money in six months, we shouldn't be trying to figure out what stocks are going to do, anyway.

PATTI: Exactly. Bonds, don't give up on bonds, but don't expect bonds to do what they did in 2019.

BRAD: Yeah. You're not going to get a result net worth of 15 for very many years in a row.

PATTI: Yeah, that's not supposed to happen. That's not a typical return.

Again, we just go into these things assuming coupons, two, three percent, we're happy with that. It's a nice buffer.

Not great for income if you're really looking at it as an income oriented strategy in retirement, but it's important to have that, as well.

BRAD: Yeah, you're exactly right.

PATTI: Well, Brad, thank you so much. This has been fun.

I know you've got a long commute home, back to your seat. Hit the pavement.

Thank you so much for joining me. Thanks to all of you for joining us as well.

If you have any questions, please feel free, go to our website at keyfinancialinc.com. If you want a transcript of today's show, it's all there.

Until next time, I'm Patti Brennan. I hope you guys have a great day.