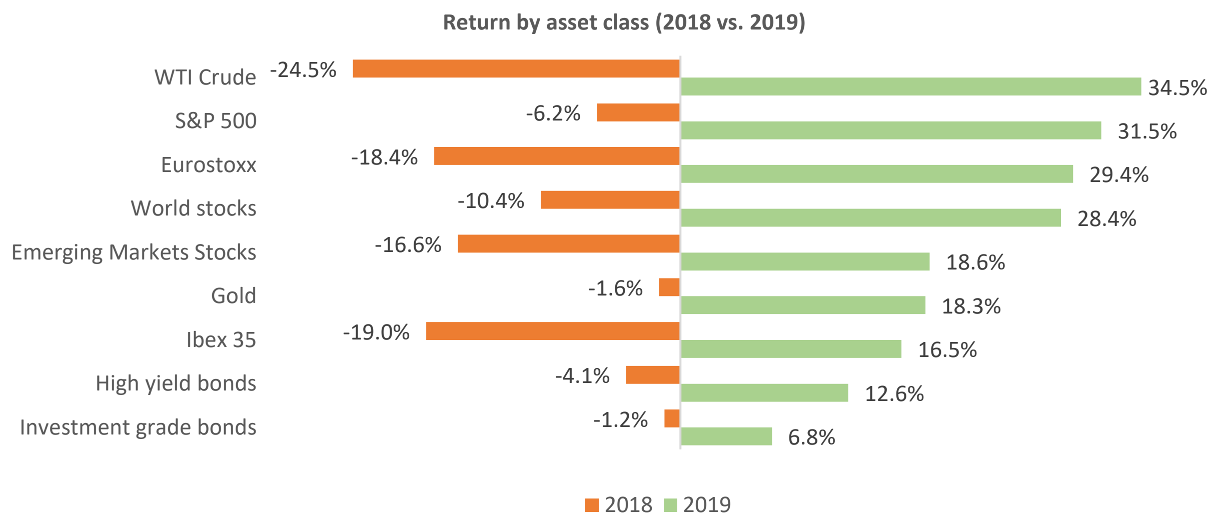
January 17th, 2020

Q4 2019

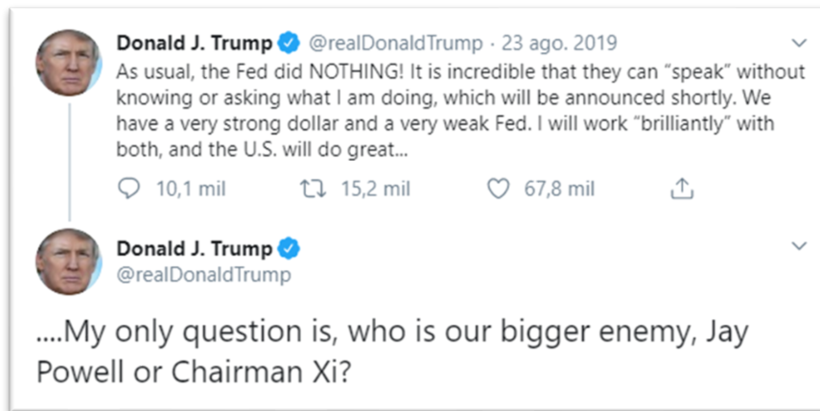
Year's review

2019 has been an extraordinary year for all asset class types, which have mostly obtained one of the best returns of the last decade. The S&P 500, the American benchmark index, has risen 31.5% - the biggest increase since 2013, and before that year, a performance not seen since 1997. The euphoria has unleashed as various political conflicts have dissipated throughout the end of the year. It seems like the US trade war with China enters a truce that could last until the American elections in November of this year, and that the outright majority of Boris Johnson and his Conservative Party will facilitate an orderly Brexit.

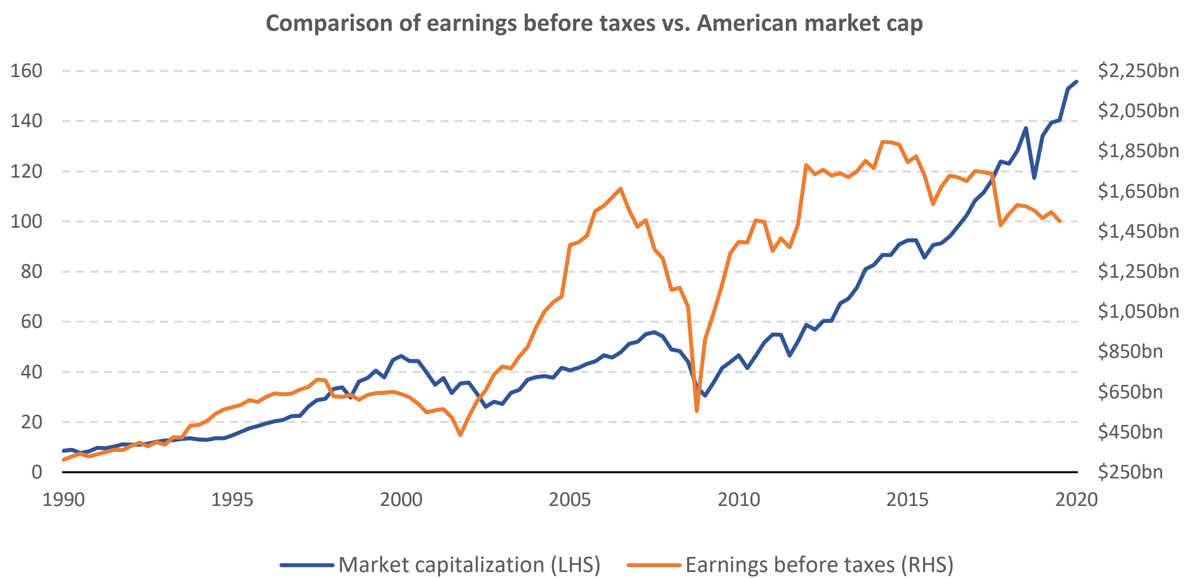


If 2018 was the year in which there was nowhere to hide from the financial market correction (all asset classes fell synchronized), this year, in addition to equities, has also been a very positive year for other assets such as gold (18.3% increase), fixed income (6.8% increase) or oil (34.5% increase). We believe that this paradigm shift in asset correlations is here to stay and hence our proposal to protect ourselves from the next crisis is resorting to volatility - which although it has fallen in 2019, rose sharply in 2018.

Such strong synchronized increase in all kinds of assets hasn't been seen for years. It is impossible to ignore monetary policy and central banks once again as the biggest players of this success. At the end of 2018, the Federal Reserve pointed to two hikes on interest rates for 2019, that have ended up becoming three cuts. We will never know if Jerome Powell, President of the Federal Reserve, couldn't handle Donald Trump's pressure with his constant threats through Twitter, or if the sudden stock market declines at the end of the previous year made him surrender. What we do know for sure is that the US macroeconomic situation has not changed at all, and there is no justification for lowering rates in an environment with unemployment at record lows and the economy growing robustly. We believe that such extraordinary returns would not have been possible in the markets without the essential liquidity assistance of the central banks.



However, despite the fact that the stock market continues to set record highs, so is global debt and more specifically corporate debt. The tax reform promoted by Trump has managed to cover up the stagnation of corporate profits that are pushing the price of companies further away from their fundamental value. At the same time, the share buy-back programs partly financed by new debt issuance also manage to distort multiples to appear more reasonable. In summary, the market shows an image that the economy is more robust than ever, thanks to all the financial engineering carried out by companies: tax reform, debt issuance, share repurchase, and has nothing to do with a real increase of productivity.



It should also be mentioned, that although the Federal Reserve denies having initiated a new quantitative easing program with its daily injections since September in the REPO market, the size of the Fed's balance sheet is growing at its fastest pace since 2008, providing liquidity to the whole system as in times of crisis. It is important to be watching for how long these measures will last and how the market could react when such injections of liquidity end.

2020 outlook

What can we expect then from 2020? The powerful combination of expansive monetary policy and sudden evaporation of global risks seems to be completely discounted, so there aren't many positive news awaiting. In addition, neither the Federal Reserve itself nor the market agents expect any movement on interest rates for this 2020. Economic growth does not seem to be a market driver either, since 2019 confirms the slowdown that economists foresee to continue in 2020 globally. This implies earnings won't increase excessively and therefore for the market to continue rising, investors will have to pay higher and higher multiples. Currently, the EV / EBITDA multiple for the S&P 500 companies (from our point of view, the best multiple for analysis given it doesn't allow for any financial distortion to the fundamental situation of companies) is at 14.4x, at similar levels to those of the dotcom bubble in the year 2000.

For all this, we believe it is naive to expect 2020 to be as extraordinary as 2019, and therefore more caution is required. But neither do we believe that this year of the great crash, mainly because Donald Trump is facing re-election in November. The president's obsession with the performance of financial markets as a thermometer of his presidential success implies that he will do whatever it takes to avoid facing elections with a bear market. He knows his re-election depends on it. And now that we can practically confirm the end of independence of central banks, its greatest tool will continue to be monetary policy, the main player of this cycle.

Warm regards,

Hanway Capital

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