CION INVESTMENTS

The Missing Middle

"Average is over," declares Tyler Cowen, an economist who claims the world is breaking in two.

If you aren't at the very top of your profession, he claims, you'll be at the undifferentiated bottom. Cowen applies this model not only to employment but also to marriage, business, cities, and even entire countries. If you're at the bottom, he says, crossing to the top through an empty middle is all but impossible. 'Average is over' turns contests into winner-take-all because losing comes with permanent consequences.

The trend is not a new one, but the internet, AI, and globalization have put 'average is over' on steroids. The absence of a middle-ground is not always obvious; outliers are hidden by a shroud of averages. Look closely, though, and the 'average is over' divide appears everywhere. And the divide is accelerating.

This is what a polarized world looks like. In politics, it's the absence of moderate voices, or, more specifically, a lack of attention paid to them. In equity markets, it's a majority of market returns being attributable to a few tech aggregators and massive finance firms. The top 10 S&P 500 gainers made up about 20% of the total market return over the decade, but in the last year, the top ten winners accounted for nearly 30% of S&P gains. In employment, the job market is trending towards a small circle of highly paid experts and a mass of commoditized workers supporting them. And so on.

The average looks fine, but without a middle ground, the actual experience is not.

In an 'average is over' world, averages represent a decreasing number of actual people. This divide will define the next decade. In financial markets, niche firms will thrive in areas too specialized or narrow for large, well-resourced giants to enter. The generic middle will hollow out—and not just in the financial markets. There is rich drama concealed on either side of the average, if only we remember to look for it.

2019 MARKET SUMMARY

Before we look at key market drivers for 2020, what happened in 2019?

The US Economy extended its once-in-a-lifetime period of economic expansion.

The US economy had another stellar year. December marked the 126th straight month of economic expansion, the longest streak in US history.

Consumer confidence dropped slightly in Q4 despite robust holiday spending. Holiday retail sales rose 3.4% from a year earlier. The brick-and-mortar retail apocalypse continues, however, because most sales growth has been digital: online purchases are up nearly 20% year-over-year.

In May, unemployment hit a 50 year low and has remained low throughout 2019. A sign of the times is that 'ghosting' jobs is now a thing: an estimated 43% of Gen-Z have accepted and then reneged on a job offer.

US Equity Markets end 2019 at new all-time highs fueled by loose Federal Reserve policy.

Even with tariffs disputes, political uncertainty, and consensus for lower GDP growth, the equity market was unstoppable.

The S&P 500 was up 29% in 2019, its best annual performance since 2013. In the last decade, the S&P 500 has returned 13.5% annually, including dividends, and hit 242 record highs. An investor holding stocks since Queen Victoria's reign would not have experienced a longer bull market.

US Credit Markets were up big for the year. A yield curve inversion signaled a future recession.

After a flat and negative 2018, US credit markets spent 2019 lavishing returns on investors. Investment Grade returned 14.5%, High Yield was up 14.3%, and Leveraged Loans were up 8.6% on the year.

The yield on 30-year US Treasuries has been on a decline for nearly 40 years. In 2019, the yield fell below 2.00% for the first time ever before bouncing up to finish the year at 2.4%.

In August, the yield curve between the two-year note and the ten-year Treasury inverted for the first time since 2007. An inversion is considered a predictor of a future recession. The equity markets shrugged off the inversion, assuming–correctly, as it turned out–that the Fed had their back. Rate cuts by the Fed successfully un-inverted the yield curve.

Central Bank policy was decidedly loose in 2019, leading to equity market gains and fixing the inverted US yield curve.

2019 was the year both the Federal Reserve and the ECB re-committed to a loose monetary policy. When Chairman Powell hinted at normalization in late 2018, the equity markets revolted and the Fed quickly backed off. Central bankers didn't have the stomach for a large equity market decline and couldn't risk triggering a recession. The loose monetary policy that followed brought record economic growth and equity market highs.

In late 2019, the Fed stepped in to support the repo market after an unexpected liquidity issue caused rates to spike. That intervention puts the camel's nose in the tent for more market interventions in 2020.

Global economic growth slowed even as international equity markets delivered high returns and low volatility.

2019 was a great year for global equities, with the EAFE index, an ex-US developed market index, up over 18%. But shift the calendar and the picture turns ugly. From September 2018 to September 2019 global returns were only 3.8%. Two years of equity returns have left global investors about even in real terms.

Eurozone economic growth has slowed materially in 2019. Exporters are caught in the US-China tariff crossfire, which is cited as one reason that Germany nearly ended up in a recession in 2019. Major eurozone economies have been impacted by slowing global growth, with eurozone GDP growth tracking to 1.2% for 2019.

2020 MARKET OUTLOOK

The US will likely continue to experience low unemployment, low inflation, and trade disputes. The US equity market may lose momentum from political uncertainty, but earnings growth will continue. Credit markets, propelled by an influx of capital and low defaults, can continue to perform well although declining lending standards are building up risks. Central banks will almost certainly continue loose monetary policy and be gung ho about market intervention. Slowing global growth may cause international markets to lag and political polarization to become more contentious.

US Economy – The US economy enters 2020 as number one with a bullet, but with concerns about greater political uncertainty.

The United States is, by far, the world's largest economy. It's four times the size of Japan's, which itself is the world's third largest economy by GDP. Even individual states are titans. The GDP of California is the size of the UK's entire economy. The size of the US means that as the US goes, so goes the world.

Expect trade to stay in the headlines for 2020. Once (or maybe, 'if') trade issues with China are resolved, the matrix of trade disputes between and among the US, Canada, Mexico, and Europe will bear close watching.

Business confidence went down every month of 2019 and will likely continue to decline as the irritating hum of politics gets too loud to ignore. With a looming election, this will be a year of elevated uncertainty from a riskier political climate. Political unpredictability will increase even as the world experiences the highest standard of living in all of recorded history. Policy whiplash may delay capital investment, leading to slower growth, as businesses focus more on survival than expansion.

US Equity Markets – Expect moderated returns with continued earnings growth from low rates and plenty of liquidity.

After a decade of great returns, what could push record market highs even higher? There are three primary drivers of equity prices: (1) earnings growth, (2) valuation expansion, (3) dividend yield.

Earnings-per-share growth has been fueled by stock buybacks, which are, in turn, fueled by low rates. The Fed has indicated it will keep rates steady for the near future. Expect more buyback-fueled earnings growth in 2020.

Valuations are stretched and have been for some time. However, they are not excessive based on the Shiller CAPE index's current reading of 31. Although above the long-term median of 15.8, the reading is far from the "dot-com" high of 44. If earnings growth can outpace share price increases then valuation ratios will naturally revert back to historical norms.

Behind every joke is a truth. One joke about risk and leveraged investors has been making the rounds: "It looks ok at 100, it looks good at 90, it looks great at 80, it looks absolutely fantastic at 70, and you're out of business at 60." Expect to hear this one again in 2020. In the event of a large decline, the Fed's existing toolkit may not be potent enough to prop up the equity market.

Credit Markets – The coming end of the credit cycle will be a hot topic in 2020, but we aren't there just yet.

For several years running, credit market oracles have been divining a grim future for lenders. Although we are late in the cycle, low default rates and over $1 trillion of dry power are still fueling an Arcadian credit environment.

Credit investors enter 2020 with serious concerns over declining lending standards. Increased competition from new lenders has spiked leverage levels, erased covenants, and compressed spreads. In other words, lenders are being paid less and taking on more risk.

The market is splitting in two. On one hand are large asset managers who can remain firm on terms and pricing. On the other hand are small, unestablished lenders who are forced to compromise on price and covenants in order to win deals. Manager discipline will pay off when the credit cycle turns; in the meantime, disciplined credit managers will remain selective and avoid transactions without a favorable risk-return tradeoff.

Federal Reserve and Global Central Banks- Expect loose monetary policy to continue in 2020, with an inclination toward intervention.

Could 2020 be the year of negative US rates? There is already over $13 trillion of negative-yielding bonds outstanding, making the US 30-year, now at 2.25%, a relatively high yielder. The ECB has committed to negative rates for the foreseeable future.

2019's repo market intervention makes the Fed seem as jumpy as a nervous cat. The Fed used its balance sheet to flood the repo market with liquidity. Whether you call it QE or not (the Fed doesn't), the intervention worked. But the Fed has shown its hand and now the market knows what to expect. If there is a liquidity crisis, expect the Fed's balance sheet to swoop in.

Expect low rates now, low rates in the foreseeable future, and QE to make a comeback. The Fed has limited ammo to fight a recession, so it will likely take all measures to prevent one from occurring.

European and Global Outlook – A tough road ahead for global equities from slower global growth and greater levels of market correlation. Economic uncertainty catalyzes fraying social harmony.

Euro-zone growth has been muted for years, with lower economic growth expected to continue through 2020 and beyond. Low and negative interest rates will likely persist as the ECB continues to do anything it takes to keep a recession at bay.

A fraying European social fabric will bring more political and economic uncertainty. The zeitgeist has forked. On one hand are populist calls for more self-determination and on the other are establishment exhortations for greater cultural and economic harmonization. The tension between self-determination and economic growth will grow increasingly stark the longer economic growth suffers.

Global markets have become more intertwined over the last 20 years and so have their equity markets. Since 1995, correlations between international equity markets and the S&P have more than doubled. During a global market meltdown, there will be no place to hide.

In 1400, China was the largest economic power in the world with a GDP 30x the size of Britain and accounting for 30% of global GDP. By 1950, China had declined to under 4% of world GDP. In 2020, all eyes will be on China as it gradually retakes the economic throne. Like a young United States, China is aggressive in its expansion, uncompromising in its interests, and immune to criticism—all the traits of a superpower on the rise. Over the next decade, it is all but certain that the most significant global events will be driven by the rise of China.

In finance and in life, outcomes are a lagging measure of principles. Principles come with an immediate cost. Opportunities foregone, short-term gains missed, and hard questions asked. Restraint pays off with compound interest in the long-run. Investors who abandon their discipline to chase returns may succeed… for a short time. Bubbles still occur. When the cycle turns we will see which managers have scoured the data, held firm on their mandate, and are then able to deploy capital at an opportune time. Current discipline creates future opportunity.

In a world without a middle (and with low interest rates to boot), investors must be careful about capital allocation. And if you have to pick a side of the barbell, make sure it's the correct one. Average may be over, but successful investing isn't.