

Key Questions

With Tensions Rising, What Should Investors do in 2020?

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“A quick show of hands: Twelve months ago, how many of you believed that the US stock market would be up nearly 30% in 2019?”

This was a question I recently posed to a group of clients and friends. I would guess that no more than 10% of those in the audience raised their hands. And yet, that’s what happened: Despite several headwinds on multiple fronts -- an extremely divisive political climate, concerns over the specter of a recession, a trade dispute between the world’s two largest economies that resulted in a sharp slowdown within the manufacturing sector -- risk assets around the world posted substantial gains in the past year.

We too did not anticipate such an advance. But our forecasting prowess wasn’t all bad: In our publication 9 Key Questions for 2019 written in November 2018, we penned the following paragraphs:

Assuming the S&P 500 Index finishes 2018 at 2850, a forward P/E of 17.4x at year-end 2019, and earnings growth of 6.75%, we arrive at an estimated price target of 3250 as of 12/31/2019, a gain of 14%.

The key determinant is multiple expansion. Without this, upside will be difficult to come by in an environment of decelerating earnings growth. Luckily for market participants, this is what usually happens after a year of multiple compression.

Moreover, further multiple expansion and faster earnings growth would support a gain of 19%, whereas a bear case -- which would entail multiple contraction and no earnings growth -- might suggest a 6-7% decline.

As of December 31, 2019, the S&P 500 Index finished the year at 3231, a mere 0.6% below our unofficial target of 3250. That said, from the time when we made this forecast to the end of 2018, the index collapsed over 15% before regaining momentum in January.

We highlight this not to toot our own horn. Rather, we do so to emphasize our view that setting short-term and overly precise price targets is more noise than signal, and it often leads to unsatisfactory results when an investor becomes overly anchored to them. For this reason, we refrain from doing so in most instances.

We prefer instead to describe a range of outcomes expressed in probabilistic terms, which allows clients to contemplate various scenarios, consult with their advisors, and plan accordingly. For instance, by re-reading the paragraphs above, you can observe a positive skew to our 2019 forecast range (+19% to -6%).

Today, partly because last year’s returns were so strong, our estimated range for US equities in 2020 is negatively skewed from +12% to -20%. Importantly, we do not assign an equal probability to these two disparate scenarios unfolding.

Instead, we believe the economy will continue to “muddle through,” producing a “good enough” backdrop for equities, provided that earnings growth modestly reaccelerates. Thus, our base case for stocks calls for modest gains in 2020, which leads us to currently recommend a balanced allocation to stocks and bonds.

More importantly, we encourage investors to again consult with their advisors and contemplate scenarios of equities rising 12% or falling 20% over the next months. If either event triggers a severe reaction and elicits a need for change in one's spending patterns, a change in an investor's strategic framework may be necessary. We believe that such a change be done extremely judiciously, however, and thus urge investors to maintain a disciplined, long-term perspective. Too often, outsized emphasis is placed on short-term events, such as one-year return forecasts.

It is in this light that we want to address the recent missile strikes in Iraq. It would be a major understatement to say that tensions in the Middle East have been escalating for some time. It may also be an understatement to casually assert that the actions taken by President Trump last week may have sparked a new level of escalation.

To be sure, only time will tell how this situation will play out. Economically, however, so long as a protracted conflict does not transpire, we do not anticipate that a major decline will ensue. Odds of that would increase if oil prices surged 40-50% from current levels to \$90-100 per barrel and remain persistently elevated for some time. This seems unlikely when considering an important fact: 10 years ago, the US was a net importer of oil. Today, the US is a net exporter. Expressed numerically, US domestic oil production has doubled while oil imports have fallen over 60%.

In other words, the US is far less susceptible to oil shocks relative to the past. Moreover, events such as those that transpired last week that produce jolts to equity markets tend to be short-term in nature.

S&P 500 Index Price Performance After Middle East Conflicts Began						
Event	Event Dates	1Wk	1Mo	3Mo	6Mo	1Yr
Operation Southern Watch	01/18/1993	0.73%	-0.81%	2.43%	2.10%	8.71%
Operation Southern Watch	06/28/1993	-2.31%	-1.03%	2.20%	4.14%	-1.00%
Operation Deliberate Force	09/11/1995	1.54%	0.63%	7.59%	11.52%	15.66%
Operation Desert Strike	09/03/1996	1.39%	6.00%	15.55%	20.81%	41.68%
Operation Infinite Reach	08/20/1998	-4.49%	-6.20%	4.84%	16.54%	22.45%
Operation Desert Fox	12/16/1998	5.73%	7.75%	11.82%	15.57%	22.10%
Operation Allied Force	03/24/1999	1.40%	6.96%	5.08%	3.30%	18.29%
Dobley Airstrike - Horn of	03/03/2008	-4.35%	2.72%	4.08%	-3.64%	-47.70%
US Involvement Denied	12/17/2009	2.77%	3.83%	6.36%	1.56%	13.49%
Operation Odyssey Dawn	03/21/2011	0.91%	1.10%	-1.54%	-7.26%	8.25%
Operation Inherent Resolve	09/22/2014	-0.83%	-2.66%	3.83%	4.87%	-2.58%
Response to Attack on US	10/12/2016	0.24%	1.32%	6.14%	8.87%	19.25%
Shayrat Airbase Missile	04/06/2017	-1.21%	1.78%	2.87%	8.25%	10.85%
Response to Douma Chemical Attack	04/16/2018	-0.28%	1.26%	4.50%	3.33%	8.56%
Average Returns Following All Events		0.17%	0.71%	2.11%	4.29%	8.84%
# Returns Up / Down Following Events		8 / 6	10 / 4	13 / 1	12 / 2	11 / 3

We are not suggesting that we are taking recent events lightly, and we will be attentively monitoring this situation going forward. However, as evidenced in the table above, so long as geopolitical crises do not materialize into economic ones, clients should maintain their allocations to risk assets. Furthermore, in the spirit of new year's resolutions, we also believe that investors should resolve to think and act with a longer-term time horizon, and worry about things that are both important and within one's control. We extend our best wishes for peace and prosperity to all.

For more information, [please contact your Key Private Bank Advisor.](#)

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