



2020 economic and investment outlook

by The Key Private Bank Investment Center team

Helping investors see clearly amidst abundant uncertainty

In clinical terms, 20/20 vision refers to normal visual acuity, defined as the clarity or sharpness of vision. To most of us, seeing 20/20 means being able to see clearly without the assistance of reading glasses, contact lenses (or in some cases both), or without needing corrective surgery.

Today's investment environment is marked by a myriad of uncertainties, or "known unknowns": the congressional impeachment hearings; the outcome of the upcoming US presidential election; the fate of the US/China trade talks; uncertain tax, anti-trust, and regulatory policies; the three-plus-years-old Brexit saga; North Korea; Hong Kong; Turkey, Iran, and the Middle East, particularly Syria; future interest rate decisions from the US Federal Reserve (Fed) and other global central banks during a period of already near-zero/negative interest rates; ever-increasing corporate and government debt levels; ever-expanding federal deficits; widening wealth inequality; climate change... the list goes on and on.

Amidst this uncertainty, the purpose of our 2020 Outlook is to help investors take a step back, focus on the fundamentals—those that matter most, in our opinion—and attempt to see things with more clarity than would otherwise be apparent. By focusing on various fundamental factors, we hope to tone down the cacophony that frequently accompanies investment commentaries (especially those that take place on cable news networks) and share our views over the next year and beyond.

If one theorized outcome creates an overwhelming sense of anxiety (for instance, a 20% correction in the



An important caveat: We do not pretend to be clairvoyant, and just as 20/20 vision does not equate to absolute perfect vision, our view of the future is not perfectly clear either. Further, given the multitude of uncertainties, in some instances we will discuss a range of scenarios that might ensue. Such scenarios possess greater utility relative to a specific point forecast because they afford investors the opportunity to contemplate various outcomes.

stock market over a short period of time), we posit that adjusting one's portfolio before such an event occurs is highly advantageous, provided that the pre-specified scenario has a reasonable chance of taking place.

We hope you find this report useful, and we wish you and yours a healthy and a prosperous year ahead.

When past is prologue: It's all about the Fed

During the height of the Great Financial Crisis (GFC), the Fed reduced short-term interest rates to zero and kept them there for seven years—far longer than nearly every economist and market observer initially contemplated.

Also during the GFC, the Fed and other central banks around the world instituted a series of mostly untested policies, collectively known as Quantitative Easing (QE). QE refers to a form of monetary policy utilized when conventional policy (e.g., lowering short-term interest rates) is thought to be ineffective since interest rates are already low. When enacting QE, central banks typically purchase longer-term government bonds and other financial assets from financial institutions to inject liquidity into the economy.

QE was implemented on a large scale from 2007-2009 and inarguably mitigated financial pressures that were then present, which ultimately led to a substantial reduction in systemic risk. In short, according to many, the GFC and ensuing recession might have been several degrees of magnitude worse had QE not been applied.

Still, QE has its detractors. Opponents cite the harmful impact QE has on savers (given persistently low interest rates), widening wealth inequality (as financial assets have risen faster than incomes), and increased unpredictability (because QE's long-term effects are not widely known).

Nevertheless, in late 2014, deducing that the patient (the economy) was strong enough to stand on its own without unprecedented amounts of assistance (QE), the caregiver (the Fed) began to slowly remove its support. QE was reduced, and short-term interest rates were gradually increased.



By the fall of 2018, the Fed had raised short-term interest rates eight times from zero to slightly above 2%.

The aim of policymakers was to return interest rates to their “neutral rate” without publicly specifying what “neutral” meant. A simple 60-year average of short-term rates approximated 5%. However, in our 2019 Market Outlook, we stated that we felt that neutral would likely be lower than what was experienced in prior decades.

Soon thereafter, markets agreed with our assessment. In fact, market participants began to criticize the Fed that it had gone too far and raised interest rates too much. Longer-term interest rates—those subject to market forces and not the maneuvers of central banks—began falling as the Fed lifted short-term interest rates once again in December. As a further display of consternation over the Fed's policy, equity markets sharply contracted in the fourth quarter over concerns that the Fed's actions might induce a recession.

While raising such concerns at this time last year, we nonetheless felt that a recession could be avoided if the Fed stopped raising interest rates and if US/Chinese trade tensions did not meaningfully escalate. Neither was a forgone conclusion, but we were modestly optimistic that cooler heads would prevail, and policy makers would not intentionally cause a recession.

A year ago, we felt that a recession could be avoided if the Fed stopped raising interest rates and trade tensions did not meaningfully escalate. Neither was assured, but we were modestly optimistic that cooler heads would prevail.

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We also expected that the yield curve would invert, a phenomenon in which short-term interest rates are higher than long-term interest rates. Yield curve inversions are somewhat rare. Moreover, several studies have noted that inverted yield curves have preceded every recession in the post-WWII era. Importantly, however, not every inversion has led to a recession.

With this view in mind, while we believed a yield curve inversion would occur in 2019, we advised clients to maintain a “cautious, not bearish” mindset, for we also noted that, on average, inverted yield curves typically lead recessions by 12-24 months. In other words, we felt there was time to adopt an outright bearish view and adjust accordingly *if* economic conditions had changed and something worse than a mild slowdown was at hand.



Thankfully, economic conditions did not materially deteriorate, and, as of now, the odds of a recession materializing in the next 12 months have fallen. The longest economic expansion will most likely continue a good while longer, we believe. What lies behind this assertion is the fact that the Fed took action once again.

The Powell Pivot: I can hear you now

In February 2019, in what was dubbed the “Powell Pivot,” Fed Chairman Jerome Powell began intimating that the neutral rate had been attained and higher interest rates were unlikely. Several months later, the Fed went a step further, not merely suggesting that it was done raising interest rates but signaling that interest rates would be lowered. The Fed had heard the market’s disapproval of its prior decisions and was preparing to change course.

Then in the summer, the Fed’s actions followed its words and interest rates were lowered, a mere nine months after it had last raised them. This action would be repeated two more times, ultimately coming closer and closer to market expectations to the point that today, in regard to future interest rate decisions, the Fed’s expectations are roughly in line with the market’s expectations.

Figure 1: Federal Funds Rate (%): 1989-2019

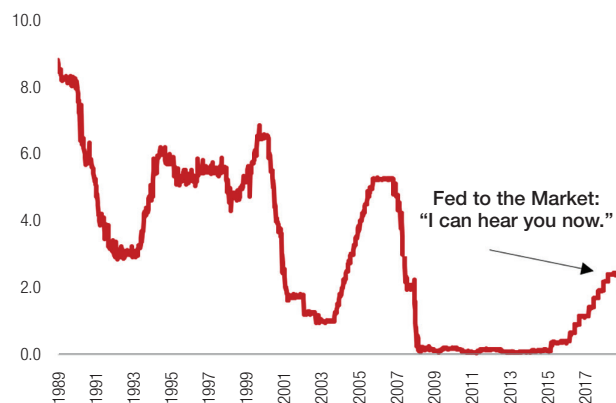
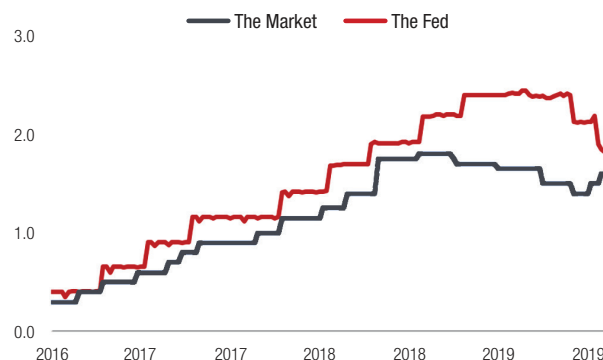


Figure 2: Fed. Funds Rate (%): The Fed vs. The Market



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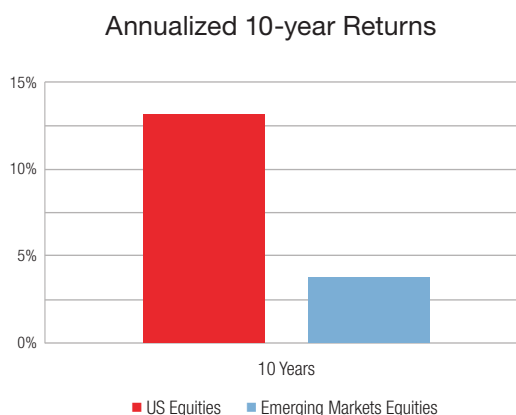


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Against the backdrop of easing financial conditions and the convergence of “Mr. Market’s” expectations with the Fed’s, US equity markets regained more than they lost at the end of 2018 and now trade at record highs. Through the end of November 2019, US equities surged more than 25% on a year-to-date basis, led by large-cap growth stocks. International markets have also rallied strongly in 2019 and stand at multi-year highs. However, by “only” achieving gains of 18.2% in 2019, non-US equities have trailed their domestic brethren, extending a persistently powerful trend that has endured since the GFC.

To wit, over the last 10 years, US equities have produced annualized gains of 13.5%. Emerging market equities, meanwhile, have generated annualized gains of 3.5%. Such lackluster results appear even more meager when one observes that US bonds—not just US stocks—also outpaced emerging market stocks over the same period and with far, far less volatility.

Speaking of fixed income, bondholders have enjoyed healthy gains in 2019 as well. Again, through the



end of November, the Bloomberg Barclays Aggregate Bond Index appreciated 8.8% in 2019, paced by high-quality corporate bonds. Municipal bonds advanced a respectable 7.2%, and commodities, despite experiencing several significant bouts of volatility, gained 12% as of November 30th, as measured by the Goldman Sachs Commodities Index.

While 2018 was a year in which nearly all asset classes other than cash experienced negative returns, 2019 was the mirror image as all asset classes delivered robust gains. And by acknowledging the displeasure of the markets with their policies and reversing course, the Fed’s pivot helped forestall a recession and prompted a return in optimism amongst investors.

Asset Class Annualized Returns Through End of November 2019					
Asset Class	YTD	1 Year	3 Year	5 Year	10 Year
US Large Cap Equity	26.7%	17.1%	14.8%	11.0%	13.5%
US Small Cap Equity	22.0%	8.1%	8.4%	8.2%	12.4%
Non-US Developed Mkt. Equity	18.2%	11.8%	9.6%	4.3%	5.4%
Non-US Emerging Mkt. Equity	10.2%	6.9%	9.2%	3.1%	3.5%
US Core Fixed Income	8.8%	10.8%	4.0%	3.1%	3.6%
US Municipal Bonds	7.2%	8.7%	4.9%	3.6%	4.3%

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Why did they do it?

In truth, one could accuse us of being a bit glib for suggesting that the market's discontent with the Fed's actions in late 2018 precipitated the policy reversal, although we surmise it was partly responsible. After all, falling stock prices result in falling consumer confidence, which typically triggers a decline in consumer spending — a big driver of the US economy and something the Fed would generally seek to avoid. That said, there are three other proximate causes behind the Fed's decision to lower interest rates three times in 2019, all of which will dictate the Fed's further path going forward.

First, in 2019, economic activity appreciably slowed. Leading economic indicators such as the Purchasing Managers' Indexes (PMIs) are implying that manufacturing activity is experiencing a mild contraction in the US and a much larger retrenchment in other parts of the world. More broadly, over the last four quarters, US Gross Domestic Product (GDP), a more extensive measure of economic activity, decelerated to slightly under 2%, down from over 3% registered in the prior four quarters. These are not recessionary conditions, but they are illustrative of a slowing economic environment.

Figure 3: US Purchasing Manager's Index
(>50: eco. activity expanding | <50: eco. activity contracting)

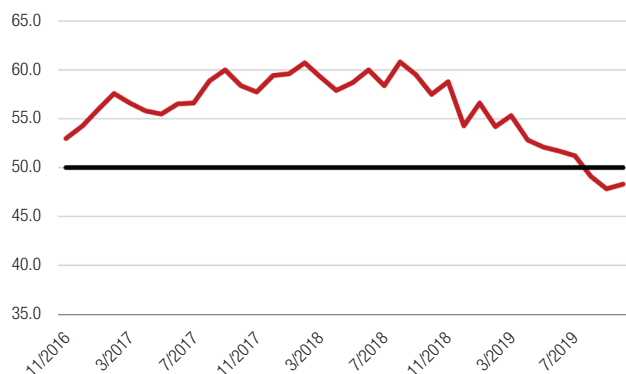
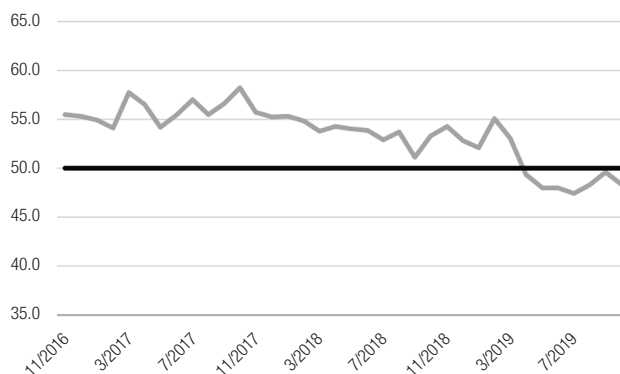


Figure 4: European Union Purchasing Manager's Index
(>50: eco. activity expanding | <50: eco. activity contracting)



The second reason why the Fed reversed course has to do with inflation. As the business cycle ages, inflationary pressures usually build. Typically, in a recession, financial conditions are loosened. Over time, this spurs a virtuous cycle in which businesses make investments and hire workers, which translates into falling unemployment, which translates into rising consumption. Rising consumption prompts further business investment and additional hiring. Unemployment ultimately comes down to a point where the supply of skilled workers falls, emboldening workers to seek higher wages, which compels companies to raise prices to protect their margins. This cycle is how inflation commonly comes about.

Post the GFC, inflation has been curiously tame, averaging just 1.6%, as measured by the Consumer Price Index, versus its longer-term average of 4%. More recently, the CPI in 2018 averaged 2.5% and was above the Fed's inflation target of 2% for 11 of 12 months. In 2019, however, the CPI has averaged 1.7% and met the Fed's inflation target in only one month thus far. This slowdown in inflation provided further justification to the Fed to lower interest rates in the second half of 2019 and will be important to the direction of monetary policy going forward (See Figures 5 and 6 on page 6).

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Figure 5: US GDP Year-Over-Year Percentage Change (SAAR) (Q3 2019)

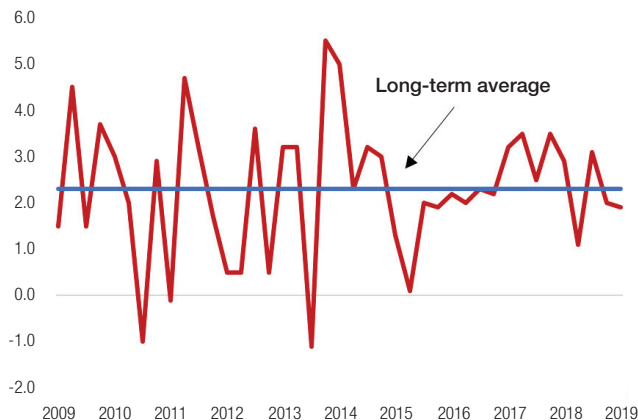


Figure 6: Consumer Price Index Year-Over-Year Percentage Change (September 2019)



Thirdly, despite possessing few tools to directly address it, trade policy uncertainty was another significant factor behind the Fed's decision to change course in 2019.

Falling economic growth, a downshift in inflation, and declining consumer and business confidence all sparked a modest equity market sell-off over the summer, and all are seemingly related to trade policy uncertainty. Soon thereafter, the Fed lowered interest rates in response.

In retrospect, economic activity in 2017-18 might have been pulled forward in anticipation of uncertain trade policies. Businesses, for instance, may have over-ordered ahead of tariffs being instituted, thus lifting demand. In 2019, as uncertainty rose, inventory was worked off and new orders were delayed. Today, inventories are generally back at moderate levels, suggesting a restocking in 2020 is possible so long as

trade tensions do not materially escalate and demand remains intact. In brief, things may simply be getting better by being less bad.

So where does this leave us?

Today, economic growth continues to slow with GDP hovering around 2%—not great, but good, and not a recession either. Wages and other inflationary pressures are modest and not intensifying as they typically would this late into the business cycle.

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While monetary policy is a powerful tool that works to support consumer spending, business investment and public confidence, it cannot provide a settled rulebook for international trade.

– Jerome Powell, Federal Reserve Chairman, August 2019

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The manufacturing sector has borne the brunt of the trade war burden. It's possible that the maximum pain point might be in the past, although the future direction of the US/China Trade War will likely remain extremely fluid. The US consumer has remained the stalwart of the world economy, supported in large part by a robust employment situation. Recent spending trends have slowed somewhat, however, and it is difficult to envision the labor market getting significantly better.

More broadly, political uncertainty is a certainty, one that extends beyond trade. "Big Tech" and "Big Healthcare"

are both too large to ignore and are inviting scrutiny across the political spectrum. Election-year rhetoric further ensures continued volatility, but we caution investors from overreacting to mere words. As we've noted before, campaign promises frequently differ vastly from actual policies, so we advise refraining from making any significant portfolio changes until the votes are counted and full details are known. More worrisome, with policymakers distracted and sharply divided, they may be slow to respond to future crises whenever they come.

This is the state of the economic environment today.

To handicap what might happen next, we present three possible scenarios describing how the investment landscape might look twelve months hence. We will conclude with our probabilities for each scenario, along with two other scenarios for how the economic outlook might unfold over a longer period.

Scenario 1

Muddle through

In this scenario, subpar growth persists, with US GDP annual growth approximating 1.5-2.5%. Similarly, inflation stays relatively rangebound around or slightly below the Fed's inflation target of 2%. Nationwide unemployment (currently at 3.6%) hovers between 3.3-3.9% and wage growth remains modest. The Fed, in response to anemic growth, lowers short-term interest rates once more and then remains on hold, partly to avoid being accused of influencing the presidential election. Long-term interest rates (currently around 1.8%) also remain in a trading range.

After a year in which corporate earnings were flat year over year, company profits in 2020 fail to meet

expectations and are flat/modestly positive (low/mid-single digit actual growth vs. mid-single/low double-digit growth expectations). Already fully valued, US equities deliver flattish/slightly positive performance, while international stocks slightly outperform in US dollar terms as the greenback finishes 2020 slightly lower.

Trade conflict does not materially escalate, and in fact several "mini deals" are achieved. However, structural reforms involving enforcement over intellectual property protections and other "existential" issues remain unresolved. Election-year theatrics provide continuous conversation, but few/no new significant policies or programs are enacted.

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Scenario 2

Cyclical breakout and reflation recovery

Under this scenario, the fog presently apparent within the manufacturing sector clears. PMIs, Industrial Production, and related indicators turn up. Consequently, economic growth reaccelerates, US GDP annual growth pushes toward 3%, and the European Union and parts of the emerging world also experience positive momentum.

Domestically, wage growth climbs above 4%, unemployment falls to 3%, and more workers come off the sidelines and re-enter the workforce. Responding to the jump in wage-price inflation, after pausing in the first half of 2020, the Fed reverses course again: It raises short-term interest rates, the third major policy reversal in three years, which elicits vociferous criticism. Long-term rates follow suit and possibly breach 3%, resulting in unrealized losses for some bondholders and potential pain for certain credit-stretched corporate borrowers.

Corporate profit forecasts are raised, particularly for cyclical companies, with aggregated index earnings delivering high single/low double-digit growth in 2020. Stocks on a global basis advance in anticipation of positive earnings growth but subsequently face resistance amid higher interest rates. The US dollar moves higher and industrial commodities outperform precious metals.

A trade armistice between the US and China is reached, allowing both leaders to proclaim a new era of economic peace. Domestically, however, each faces critics who argue that more could still be done and/or too many compromises were made. Finally, once again, election-year theatrics provide continuous conversation, but few/no new significant policies or programs are enacted.

Scenario 3

Cyclical downturn and deflationary scare

As the name suggests, in this scenario, despite the emergence of some nascent signs of a recovery at the end of 2019, weakening manufacturing trends roll over in 2020 and the US employment picture dims. Unemployment climbs decidedly above 4%, and overall GDP growth slides back to approximately 1.0%. The Fed, while beginning the year saying it is on hold, calls for fiscal measures to offset weakened growth and begrudgingly lowers short-term interest rates. Long-term interest rates react accordingly, falling to new lows (to roughly 1.0%), which provoke recession and deflationary fears.

Corporate profits fall and equity prices slump, possibly paced by US equities given their long-run of outperformance, comparatively loftier valuations, and US dollar weakness. Commodities also fall.

Like Scenario 1, trade tensions do not escalate materially, but negotiators are repeatedly deadlocked and declare a stalemate until the US presidential election has concluded. Gridlock and political divisions in Washington become even more pronounced and nothing gets done, despite aforementioned urgings from the Fed and other central banks to implement fiscal spending initiatives to boost economic growth.

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Asset Class Annualized Returns as of November 15, 2019				
	Current State (Q4:2019)	Muddle Through	Cyclical Breakout	Cyclical Downturn
US GDP*	~2%	~1.5–2.5%	~3%	~1%
US Unemployment	3.6%	3.3–3.9%	Below 3.3%	Above 4.0%
US Wage Growth*	3.0%	2.5–3.0%	~4%	~2%
Short-Term Interest Rates	~1.75%	1.25–1.50%	≥ 2%	≤ 1%
Long-Term Interest Rates	~1.75%	1.7–2.7%	≥ 3%	≤ 1%
US Corporate Profits/Stocks*	Flat/Up (!)	Flat/Up Slightly	↑	↓
US Dollar*	↑	↓	↑	↓
Commodity Prices*	↔	↔	↑	↓
Trade Policy Uncertainty	High but moderating	“Mini Deals”	Armistice	Stalemate
Political Uncertainty	Persistent	Persistent	Persistent	Persistent
Key Private Bank Probability	–	60%	16%	24%

*Year-over-year change. Note: All figures above should not be construed as precise point estimates. Rather, they are intended to be directional in nature versus discrete forecasts.

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As illustrated in the table above, our collective view of the year ahead can be summarized as a “Muddle Through” economic environment -- not an overly optimistic perspective, but not one premised on an imminent recession either. The combined assessment of our Investment Center team’s views does assign the “Cyclical Downturn” situation slightly higher odds of occurring versus the “Cyclical Breakout” scenario, but only marginally so.

That said, our base case is that growth and inflation will remain in a modest range in 2020. Given this, while the Fed will likely be less active next year relative to the past two years, we believe it is more biased to lowering interest rates than to raising them. US equities are poised for modest upside. Yet after a year in which most of the gains can be attributable to multiple expansion versus earnings growth, earnings growth will need to reaccelerate in 2020 for that upside to unfold.

Trade policy arguably remains the biggest wild card for anyone bold enough to make a forecast on this topic. Based on our analysis as of this writing, a far-reaching compromise is unlikely. However, as referenced earlier, the peak in uncertainty may have already passed and several smaller mini deals may be realized in 2020. And in an environment where “better and worse” seemingly

matters more than “good versus bad,” positively trending developments regarding trade may be enough to enable the longest economic expansion and the longest US stock market rally in history to endure.

Longer-term considerations

Recognizing the above scenarios only contemplate what the year ahead might look like, a relatively brief moment in time for long-term investors such as our ourselves to ponder, we offer two more extreme potential outcomes for consideration.

The first of which might be described as a new productivity paradigm, akin to what unfolded in the mid/late 1990s when the Internet was in its infancy. Today, artificial intelligence, machine learning, quantum computing, and other innovative technologies and advances have the potential to unleash an additional boost of economic momentum. This would not only prolong the economic expansion but could propel the economy to a higher plane of growth while keeping a lid on inflation as well.

On the flip side, with interest rates already quite low, another consideration worth acknowledging is a scenario in which a new economic policy paradigm becomes necessary as monetary policy is deemed ineffective. Quantitative Easing, which we discussed earlier, is one such example of a new economic paradigm. But in a more extreme situation, interest rates

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would be cut to zero as fiscal deficits and government spending would be allowed to surge akin to what transpired from the mid-1930s to late-1940s. Also present during this time were increasing social tensions and external conflicts flaring up around the world, making for an interesting parallel to today's environment.

The principal investment risk in this situation, in which the Fed creates money to support the surge in government spending and the US debt effectively becomes monetized, is inflation. This would undermine economic growth and accelerate the need to incorporate new investment tools to enhance one's overall portfolio.

While neither of these longer-term scenarios is fully actionable today from an investment strategy perspective, they do merit deliberation.

No matter what unfolds over the next one year or five years, we will maintain our multi-disciplinary and collaborative approach to assessing economic and investment trends. And we will always adhere to our North Star of putting clients first.

For more information, please contact your Key Private Bank Advisor.

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