JAKE SIEWERT

This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries and the global economy. I'm Jake Siewert, Global Head of Corporate Communications here at the firm.

Today we'll be talking with David Kostin about what's ahead for US equities in 2020.

But before that, we're going to get a quick markets update from Tony Pasquariello of the Goldman Sachs Securities Division, who's watching five key numbers in markets right now.

TONY PASQUARIELLO

Hey, Jake. Thank you, glad to be with you today. My name’s Tony Pasquariello, I’m the Global Head of Hedge Fund Coverage for the securities division
at Goldman Sachs, and the big number I’m looking at right now is 31 percent. That was the total return of the S&P 500 in 2019, which was the best year since 2013, and a 93rd percentile outcome on a longer-term historical basis.

Now, against the expectations of most people coming out of a very rocky end to 2018, last year wound up being a truly superb year for the stock market, as well as most every other major asset class. Witnessed strong returns in emerging markets, the credit markets, as well as select commodities like oil and gold. So in the end, 2019 played out as one of the highest quality years in the history of financial markets, and U.S. equities are once again one of the very best horses in the race.

By the way, in the last eight years, where S&P was up 20 percent or more, the market was higher in the subsequent year in all eight occurrences, for a
median return of 17 percent.

TONY PASQUARIELLO

So a number that's getting attention right now, but doesn't necessarily tell us what we need to know, is the PE multiple on the S&P 500. So that number started last year at 14.4, and ended last year at 18.8. For historical context, 18.8 is in the 90th percentile of the past 43 years. So that number is rightly getting attention, and I think you have to be respectful of the history book, and what current levels suggest about future returns.

TONY PASQUARIELLO

That said, I don't think it tells us everything we need to know because when you look at the bond market and the very low level of yield that's available today on a global basis, I think it changes the implication. So another number that we follow is the spread between the earnings yield of S&P 500 and 10-year note yields, also known as the
equity risk premium. That current spread is around 500 basis points, compared to a historical spread of 370 basis points, suggesting that stocks remain attractive when compared to bonds.

TONY PASQUARIELLO

Now I’m going to move on to my third number; again, sticking with the relationship between stocks and bonds for a moment, a number that has not moved a lot, but in doing so has actually caught my eye, is the 1.5 percent yield on the 2-year note. My observation here is that a lot of things are going right for risk assets right now. The global economy is expected to pick up speed in 2020, the binary event risk around the U.K. election and the U.S./China trade war has broken in a favorable direction, and again, risk assets have a lot of positive momentum now.

Despite all of that, the front end of the U.S. interest
rate curve isn't moving. That 1.56 2-year note yield I mentioned has barely budged in the past two months, which I think is a function of the Fed telling us that they're committed to keeping the funds rate anchored at a very low level. In real terms, the funds rate is actually negative right now, and I think that's, on net, a bullish underpinning for risk assets in the year ahead.

TONY PASQUARIELLO

Number four, the number that I'm thinking about for the future is 1.445 trillion. That's the wedge between how much money has flowed into fixed income funds and into money market funds versus how much has flowed out of equity funds in 2019.

Below the surface, last year saw 572 billion flow into money markets, that was a record; another 644 billion flow into fixed income funds, that's also a record; against that, 229 billion flowed out of
equities. That was a near record, eclipsed only by the bad old days of 2008. Again, despite the fact that U.S. stocks sit at all-time highs as we speak, and despite the fact that bond yields are significantly lower today than they were in late 2018, last year saw a very clear trend of money moving out of stocks and into the bond market. So we’re spending a lot of time thinking about whether 2020 sees some reversion of that money flow to the benefit of equity funds.

TONY PASQUARIELLO

Finally, a number that I’m thinking about outside the office is 781, or .781. That was the winning percentage of my beloved New England Patriots during the decade that just ended, which was the best of any major professional sports franchise in the U.S. After 781, the next best on the list was the San Antonio Spurs at 698; the Pittsburgh Penguins at 646; and the Golden State Warriors at 645.
JAKE SIEWERT

Thanks, Tony.

Now onto the next segment of the episode with David Kostin, the firm’s chief US equity strategist, who’s here to talk through his team’s 2020 stock market forecasts.

David, welcome to the program.

DAVID KOSTIN

Thank you.

JAKE SIEWERT

So let’s get right to it and put some numbers on stock market projections for 2020. What is your estimate for the S&P500 by year end 2020?

DAVID KOSTIN

Three thousand four hundred.

JAKE SIEWERT

And what would that represent?

DAVID KOSTIN

That would represent about a six percent return from the current level of about 3,200.

JAKE SIEWERT

Okay. And how much will the US economy GDP
grow in 2020?

DAVID KOSTIN

On average the US economy will grow at about 2.3 percent for 2020. And that is pretty much in line with the average annual growth for the last 10 years.

JAKE SIEWERT

All right. So the average S&P profit margin next year?

DAVID KOSTIN

About 10.8 percent which is up just slightly from the current level.

JAKE SIEWERT

Okay. And will US equities enter a bear market in the coming year?

DAVID KOSTIN

Do not expect that you will have a 20 percent decline. I expect the market will rise modestly at the beginning of the year to around 3,250. And then bounce around for a good part of the year
until the election, and expectation is it will rise towards 3,400. And that’s a target at the end of 2020.

JAKE SIEWERT
Okay. Now give some context to those numbers. What’s driving your estimates?

DAVID KOSTIN
So the key driver of estimates is the economy’s growing at around 2.3 percent. And most companies over time grow their revenues in line with nominal GDP. So if real GDP we’re expecting a little over two percent, inflation a little less than two percent, then broadly speaking nominal GDP about four percent. Most companies will grow their revenues at four percent. Margins are going to be, as I indicated, basically flat, maybe slightly higher. That means your sales … nominal GDP equal sales. Your sales equal pretty much your earnings. Your earnings will grow four percent and then there’s about 100 basis points, or
one percentage point increase, from share repurchases. That gives you five percent. So the bottom line is you go around two percent real GDP growth. That’s what drives five percent EPS growth, earnings per share growth, and that’s broadly speaking the trajectory of the market from this level going forward.

JAKE SIEWERT

It’s just math.

DAVID KOSTIN

Just math.

JAKE SIEWERT

So David your team’s 2020 US equity outlook is entitled “United We Fall, Divided We Rise.” Explain that title and what it means to you.

DAVID KOSTIN

Okay. So the goal of forecasting at the end of 2020 is really quite challenging because we have a big event, the US elections, that will take place in early November of 2020. So choosing, or finding,
or identifying a level of the stock market at the end of 2020 will require, does require, making certain assumptions about the election outcome. That’s just math, as you just mentioned earlier. And so the current baseline assumption that we are using is that the divided government that we currently have, which is to say the House of Representatives, the Senate, and the President, The White House, is controlled by different parties, in different forms. That is the baseline assumption we have. And your earnings will grow five percent, your valuation in the market, which is currently around 18.5 times forward PE multiple, will stay around where it is today, and that leads to a 3,400 target.

That is my forecast. And that is a divided government, which currently exists, persists in some form, in 2020 after the election, and that’s the forward. The reason I emphasize this so much
is that really identifying a forecast for the end of 2020 involves making assumptions on earnings for 2021.

The alternative assumption is that you have a unifying government, and one of the key assumptions involves the tax rate for US corporations. The tax rates under the tax cut that took place at the end of 2017 reduced the tax rate, effective tax rate, that companies pay from 27 percent to 19 percent. And if you assume for a moment that that reverses, and that tax cut is repealed, then the earnings growth that we’re currently expecting, looking into 2021, of five percent, would end up being a decline of around seven percent. And that rising uncertainty about the policy in 2021 would also lead to a lower multiple. And so a scenario where you have a roll back of the tax cut, greater uncertainty, would lead to the S&P500 trading
towards 2,600 in my opinion.

JAKE SIEWERT

That would be a very unified Democratic government presumably.

DAVID KOSTIN

That would be the assumption that we are currently making. Because all of the leading candidates for the Democrats currently are proposing to roll back the tax cuts in part to pay for various priorities. So I want to be very clear that I am not making a value judgment on whether those are good or bad policies.

JAKE SIEWERT

Right.

DAVID KOSTIN

But rather the analytical assumption of where earnings will be. And the idea of earnings in 2021, baseline forecast is they’ll rise in line with the economy, kind of the arithmetic and we discussed just a minute ago, and the different scenarios if you
roll back that tax cut, that has significant impacts on earnings. Another way of thinking about this is a certain amount of profits that are currently inuring to an investor would no longer inuring to the equity investor, it would be inuring to the government in ways of reallocating some of that spending.

JAKE SIEWERT
Right. So let’s talk a little bit about monetary policy. At this point most people expect the Fed to stay pretty easy and steady next year, at least in the United States. What does that mean for stocks in the year ahead?

DAVID KOSTIN
So interest rate assumptions are important, variable, in terms of valuation of equities. Equities themselves in the United States are trading at pretty expensive levels relative to history. Somewhere between the 90th and the 95th percentile on every metric going back 40 years. So
they’re high on that level. The one metric that equities are actually quite attractive is value relative to interest rates, which have remained low for quite some time. And so the baseline assumption that we are using in part of US economics team is that the Federal Reserve will be on hold for really the next year and a half. And so some time in the latter part of 2021. So that stable policy rate is also consistent with pretty low long term treasury yields, which are going rise in our forecast slightly to around two and a quarter percent at the end of 2020. And that environment is still positive for equity prices. And that’s partly the assumptions we’re making in our assumption.

JAKE SIEWERT
Because the relative rate of return is high.

JAKE SIEWERT
So you work very closely with Jan Hatzius and his macro-economics team. What’s the outlook for fiscal policy in an election year as a lever to
stimulate growth? Do we expect any action at all on fiscal policy? And could that have an impact on markets?

DAVID KOSTIN

Well, as you indicated, the US economics team is currently expecting the government will run at about a trillion dollar deficit next year. So certainly we’re spending a lot. There’s not as much flexibility in terms of new spending initiatives. And with the divided government that’s currently in Washington it’s probably unlikely to get significant new spending in there, the infrastructure, or other types of investments. So the broad assumption we’re making is that the US consumer, and this is a critical assumption, the US consumer, which is about 70 percent of the US economy, the US consumer’s in a very strong position. There’s both low unemployment rate, lowest unemployment rate in 50 years. Wages are rising at around three and a half percent. Inflation’s less than two. So you
get real wage inflation. Balance sheets of the consumer have been de-levered for 20 years. So the balance sheets of the consumer is strong. Consumer confidence is very high. And so all those assumptions give a view that the consumer is likely to continue to expand and grow and that’s a key driver of the economy and the corporate earnings.

Unfortunately CEO confidence is extremely low, one of the lowest it’s been in 10 years. And that is primarily driven by uncertainty around a trade, uncertainty around political policies, etc. And so the expectation that we have is that the consumer is really the more important driver at this time. And at some point the CEO confidence will improve and certainly as the resolution of some of the uncertainty in politics takes place, that suggests the economic expansion will continue for at least another couple of years.
JAKE SIEWERT

So let’s talk a little bit more about that uncertainty next year. I mean starting with US China trade dynamics. We’ve seen a partial agreement of phase one so far. How does that fit into your base case?

DAVID KOSTIN

So 70 percent of the revenues of US corporations are actually generated domestically. And so that is really a key driver of overall earnings. The trade variable is certainly something that has waxed and waned, reasonably mercurial. Our President in Washington, and a lot of uncertainty in terms of that forecasting process. So we’re assuming that you get some modest rollback of the tariffs. Pretty much what you’ve seen so far. We’re not really expecting any more new tariffs to be levied. And maybe there’s some increased resolution of some variables. But we’re certainly not anticipating a broad resolution in terms of the overall
comprehensive trade. And we can trade at … we actually follow that in the equity market. We can see what the stocks are implying with respect to trade. We can look at the performance of US stocks that sell to China. Companies that, US stocks held domestically, and compare that with Chinese stocks that sell to the United States, and Chinese stocks held domestically. And look at their relationships and indicate that right now the equity market is pricing in something above a 70 percent likelihood of a trade resolution, and that’s basically our forecast that we’re assuming.

JAKE SIEWERT

Okay. So we talked about the election. But let’s go back on one level. How do investors think about the election and its expected impacts on markets? Particularly because, as you said, you’re going to have a period in the beginning of the year where you’re just looking at the primaries and the Democratic nominee. And then the latter half of
the year everyone’s going to be waiting for November.

DAVID KOSTIN

So the idea of the fundamentals are really critical in terms of discussions with clients. Each portfolio manager with whom I speak and interact has different assumptions, both their own political biases as well as their own forecast of what’s likely to take place based on polling data, etc. And so really the fundamentals come down to what is the likely path of profits, and how are we going to value those profits. What’s the probability of the forecast? And so we see as some of the more progressive candidates the probability was increasing sharply earlier in the fall. You saw the managed health care stocks, as an example, decline quite sharply as all the discussion ramped up about Medicare for All and things like that. And that was stocks were viewed at risk under those policies. As the probabilities of progressive
candidates had declined, those stocks have actually rallied quite significantly. And so the idea that you pointed out of the waxing and waning of the political fortunes of different candidates has certain implications for some sectors than others. And so the discussions tend to evolve at the sector level as opposed to the broad market level. I think the broad market level is likely to stay as I indicated. Something in the vicinity of 3250, kind of around those levels, which would be consistent with the forecast we have on profits.

But individual sectors, lots of discussion now around technology, is pretty much bipartisan view. Both Democrats and Republicans, there should be some reg legislation involving privacy, involving some of the technology companies, so that’s a discussion that portfolio managers have. Antitrust questions about different industries. And is I’d say where more of the discussion take place at a more
granular level as opposed to the broad market.

JAKE SIEWERT

Yes. Really hard to predict what that will look like. Are there any other key risks for the US stocks in 2020 that we haven’t discussed beyond trade and the politics?

DAVID KOSTIN

So the most surprising development in the equity market in the last six months to me was the reversal in buy backs. And so corporate share repurchases have been a vital driver of money flow into the market. So if you look at the different components of who owns equities, you have households directly, you have mutual funds, people owning it indirectly. You have international investors and pension funds, for example. Those four categories comprise about 85 percent of the ownership of the US stock market. And so if we look at the flows around who’s buying, who’s selling in these different categories, the
overwhelming demand actually comes from corporate share repurchases. And for a long time that has been a key source of the demand. And that jumped dramatically following the tax cuts that we talked about earlier. Tax rates came down for corporations …

JAKE SIEWERT
Unexpected boom in cash.

DAVID KOSTIN
They took these extra profits and a big chunk of that was used to buy back stock. Of course some of it was also used to invest for growth and do other things. But that jump in buy backs I expect that after 2018 would increase modestly in 2019. In fact, it increased at the first quarter, and then it surprised me, it dropped by 18 percent in the second quarter. And so that reversal of the amount of marginal dollars directed towards buy backs is a surprise. I think that’s a risk or a question about 2020. We are expecting around
five percent decline, our forecast for 2020, to five percent decline year over year in cash spent on corporate repurchasing shares. That’s about a little under $700 billion will be spent. So still a significant amount of money, but it’s down around five percent.

JAKE SIEWERT
Okay. What’s the biggest potential upside event that could positively impact the stock market next year. So a resolution on trade would be a positive development. Because that’s a source of some uncertainty. It’s an uncertainty in the form of higher input costs for corporations. Therefore it has a potential risk for lower margins for some companies, some industries. So a resolution on that front would in fact be a positive, as I indicated earlier. We’re not really expecting much resolution in that area. Pretty much kind of where we are now. But that would be, I think, a positive development for the markets.
JAKE SIEWERT

So look back at 2019 David. Give us the one minute description of what happened in the equity markets this year.

DAVID KOSTIN

I think the most important to understand why we’ve had almost a 30 percent return in US stocks in 2019 is the fact that the stock market fell by 20 percent, almost 20 percent in the fourth quarter of 2018. So we actually had a particularly low starting point from a timing perspective that was important. And 90 percent of the return to the stock market this year, 2019, came from valuation expansion, as opposed to earnings growth. Whether there was not very much earnings growth for 2019. And so we look at the next year, the story is more earnings driven as opposed to valuation driven. So the earnings are the key driver for next year.

JAKE SIEWERT

And to what you attribute that expansion in
valuation this year?

DAVID KOSTIN

Well, the idea of starting point at a particularly low level first. And second is the pivot in the Federal Reserve. And the Federal Reserve at this time last year was anticipated to be hiking interest rates about four times in 2019. And as a result of that pivot, in fact the Federal Reserve ended up cutting interest rates three different times, and that has supported the expansion in the valuation, the relationship between interest rates and stocks. So that’s, I think, the story of 2019 in a nutshell.

JAKE SIEWERT

Okay. So a professional or personal highlight from 2019 and something you’re looking forward to in 2020.

DAVID KOSTIN

So the personal highlight for 2019 is I went to see, on two different occasions, to see oral arguments at the US Supreme Court. I thought it was
extremely interesting. It's a very intimate setting. And to watch the advocates, counsels on both sides, and all the questions, there's a 30-minute argument each side is allotted. And in that 30-minute argument there are 60 questions from the justices. And so watching that back and forth was extremely fascinating to me.

JAKE SIEWERT
Very cool. I've lived in Washington more than 10 years, and I've never been. So you beat me there. Well, David, thank you very much for joining us today.

DAVID KOSTIN
Okay. Thank you very much.

JAKE SIEWERT
That concludes this episode of Exchanges at Goldman Sachs. That's for listening. And if you enjoyed the show we hope you subscribe on Apple Podcast and leave a rating or a comment. And for more from
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