OPPENHEIMER INVESTMENT MANAGEMENT

No Economic Expansion Lasts Forever...

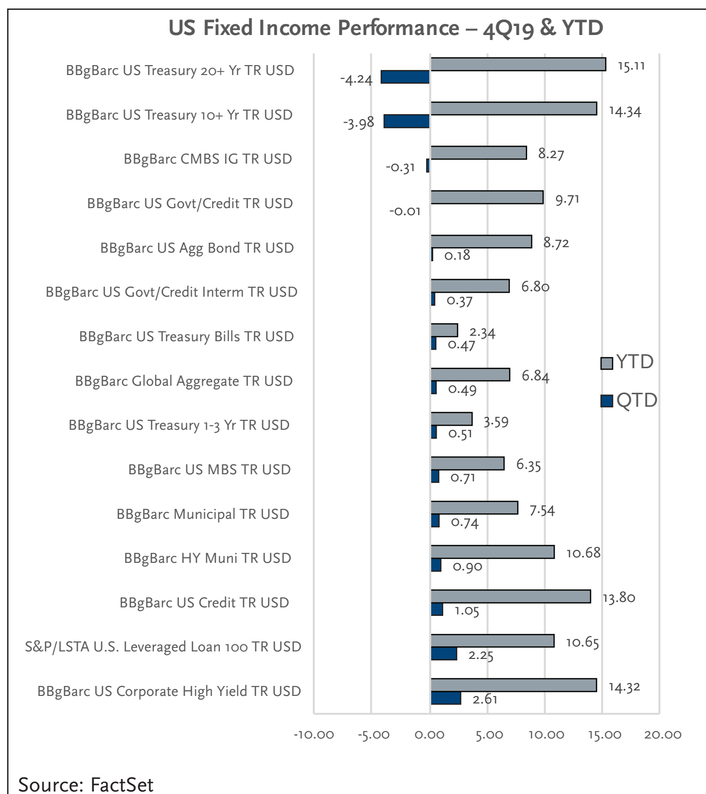
We are not predicting a recession in 2020. However, we would remind our readers to remain vigilant and not invest as if the current expansion will last forever. The economy will be susceptible to recessionary pressures again at some point. The Federal Reserve has done a commendable job at managing and maintaining this expansion, but geopolitical winds can shift quickly harming consumer and business sentiment. Global trade tensions, Brexit, civil unrest in Hong Kong, military conflict with Iran, and the 2020 election are all events we are monitoring closely as we head into 2020.

In this commentary, we will summarize fixed income performance for the fourth quarter of 2019, review phase one of the U.S. China trade agreement, and share our 2020 economic outlook.

Fourth Quarter Fixed Income Recap

2019 began with the 2-year Treasury yielding 2.48% and the 10-year Treasury yielding 2.69%. The Fed pivoted to an accommodating stance with three rate cuts throughout the year thus shifting the yield curve lower. The 2-year and 10-year Treasuries ended the year yielding 1.58% and 1.92%, respectively. Lower interest rates resulted in an impressive price rally across all fixed income segments which posted positive returns for the calendar year with low quality credit being the largest beneficiary of accommodative Fed policy. Fourth quarter performance for specific sectors is summarized below:

- The 10-Year Treasury yield began the quarter at 1.68% and ended at 1.92%. Treasury prices fell as yields rose. Longer-term Treasury prices declined the most. At the same time, the short-end of the curve benefited from rate cuts. As a result, the Bloomberg Barclays U.S. Treasury index ended the quarter with a 0.5% return, benefiting from the short-end of the curve while the long-end posted negative returns.
- Investment grade and high yield credit saw spreads tighten to Treasury bonds during the quarter. The Bloomberg Barclays U.S. Credit index returned 1.1% while the U.S. Corporate High Yield Credit index returned 2.6%. High yield spreads tightened from 475 basis points at the beginning of the quarter to 424 basis points at the end of the quarter. Spread levels remain well below the long term average.
- Leveraged loans/floating rate performed well during the quarter as the S&P/LSTA U.S. Leveraged Loan 100 index returned 2.3%. The financial media has highlighted increasing risks in this market due to higher leverage, looser terms, and lower ratings. The retail and energy sectors are particularly risky, in our view. However, we do not believe the leverage loan market overall presents a systemic risk to the financial system.
- The Bloomberg Barclays Municipal Bond index posted a 0.7% return for the quarter. High yield municipal bonds outperformed investment grade municipals for the quarter with return of 0.9%.
- Local currency global bonds performed well during the quarter helped by currency appreciation as U.S. Dollar index was down 3.0% for the quarter. Just about all major developed and emerging market currencies advanced relative to the U.S. Dollar with the exception of the Turkish Lira, Argentine Peso and Japanese Yen. Developed market sovereign debt denominated in U.S. Dollars was the sole global bond segment to post negative returns for the quarter.



Source: FactSet

Phase One China Trade Deal Terms

Given the timing of this commentary and when the Phase One trade deal was published, the following are our brief and initial comments:

- Many of the intellectual and patent protection measures that China agrees to are already part of other previous agreements that they have signed but did not implement. A new foreign investment law, effective from Jan. 1, bans administrative agencies from forcing technology transfers. It also exposes officials who disclose or leak trade secrets gleaned from regulatory approvals to potential criminal penalties. China agreed to set up a system to resolve conflicts over drug patents, a move that may help U.S. pharmaceutical companies seeking greater protections for their branded medicine in developing nations.
- The agreement outlines both energy and agricultural purchases to be made by China to an extent that the likelihood that China will be able to legitimately keep these commitments over time are suspect. However if purchase reforms are made by Chinese government such as reduced regulation to make buying easier, they are plausible.
- China agree to open up their markets to US banking firms to compete in the credit card business by granting licenses that have been held up for years on behalf of MasterCard, Visa and American Express. These similar promises had been made in the past, but action had not been taken and final approvals granted.
- The US will no longer consider China a currency manipulator and China will continue to keep the yuan rate stable at a reasonable and equilibrium level, not changing the approach they are already utilizing.
- Tariffs remain on roughly $370 billion of Chinese-made items, although the tariff as been cut in half, to 7.5% for some categories of goods.

The most important aspect of the agreement in our view is the likely suspension of further tariff increases in the near term. Net exports were a subtraction from GDP in 2019 due to lower business sentiment. Subsequently, we expect trade to be a neutral-to-positive contributor in 2020 as uncertainty about tariffs lessens. Many questions about this deal remain, but perhaps the most important question on trade is: Was the trade war worth it? We have our doubts. We look forward to learning more about implantation of the concessions from China on intellectual property and technology transfers.

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Our 2020 Economic and Fixed Income Outlook

Our disciplined investment process, now in its 21st year of successful execution, has proven to be dependable through economic cycles. As previously mentioned in this commentary, we do not anticipate a recession in the near term. Economic growth will remain slow, but two quarters of negative GDP remains unlikely. Why are we confident? We explain below.

Corporate Earnings and Capital Expenditures: We are forecasting improvement in corporate earnings from the 1% estimated growth for 2019 to a more robust 5-7% growth for 2020. We expect some modest improvement in business investment during 2020 in step with these improved earnings and the completion of phase one of the China trade deal. An offset to these tailwinds could be the 2020 election and the potential for a less business-friendly administration.

The ISM Manufacturing Index: After spending most of 2018 at a robust level in the high 50s, the ISM Manufacturing Purchasing Manger's Index plummeted through the second and third quarters of 2019, crossing below 50 in August. Levels above 50 signal expansion while levels below 50 signal contraction. While manufacturing is a relatively small portion of the U.S. economy, economists view this index as a key leading indicator of economic strength. Trade tensions, global growth concerns, and the General Motors autoworkers strike were all headwinds in 2019. The ISM leveled off at 48 in the fourth quarter. Meanwhile, PMI's in Europe and China also stabilized while the Markit US PMI Index, which includes more small manufacturers than the ISM Index, rose above 50. The ISM Non-Manufacturing Index also declined for most of 2019, reaching a low of 52.6 in September. Nevertheless, this metric remained in growth territory throughout the year and improved in the quarter with December's reading at a respectable 55.0.

Gross Domestic Product: For 2020, we believe the U.S. economy will continue to grow at or near the same pace as 2019 putting GDP in the 2.0-2.5% range. The Bloomberg consensus for 2020 GDP is 2.3%. There is no compelling reason to expect this year to break out in a meaningful way to the upside or downside. Hence, our "muddle along" description of the economy remains apropos. While the Fed cut rates during 2019, we do not anticipate a significant stimulative effect in 2020. The cuts were mainly defensive in nature, preserving the recovery and allowing the economy to continue to grow around its potential of 2.0-2.5%.

Unemployment: We anticipate the unemployment rate to remain in a range of 3.4-3.8%. More workers will be lured back into the labor force as companies invest in training and relocation, continuing to lessen structural unemployment challenges still lingering from the Great Recession in 2008-2009. We expect the labor force participation rate to continue to increase modestly. Job growth in December of 2019 resulted in average monthly job growth of 176k for the year, 47k less than the 2018 average. We expect moderate but adequate job growth to continue in 2020. With unemployment at record lows and approximately 10,000 Baby-Boomers retiring every day, this cohort will become more and more incentivized to re-enter the job market. Wage growth, currently in the 3% area, will trend higher as is typical in the later part of an economic cycle. One side note: women have now overtaken men as the majority of the US workforce.

Inflation: We expect inflation to trend only modestly higher during 2020. Core PCE (Personal Consumption Expenditures excluding food & energy - the Fed's preferred measuring gauge) finished 2019 at approximately 1.6%. The Fed will make every effort to attain or even exceed their 2% Core PCE target. They may be willing to cut rates further if they feel the economy is slowing, but we do not believe this will be necessary. Similarly, we expect the Fed to tolerate above-target inflation and lower-for-longer rates if the economy reaccelerates. Disinflation is a greater risk and harder to reverse than above-target inflation. For evidence of this claim, look no further than Japan's struggles to reignite growth and inflation in recent years.

Monetary Policy: We believe the Fed has reached the neutral rate after completing three quarter point cuts during the second half of 2019 and reaching a current target Fed funds rate of 1.50-1.75%. If there is a bias, it leans toward additional rate cuts even at the expense of increasing inflation past the 2% target.

Interest Rates: As a result of the three Fed rate cuts during the second half of 2019, the front end of the curve normalized after a brief period of inversion. The following chart depicts the movement. We maintain a bias for interest rates to drift higher in 2020, resulting in a modest steepening of the curve. We do not expect rates to increase substantially, but do expect upward pressure as a result of the previously discussed Federal Reserve posture. We expect the 10-year Treasury yield to end the year between 2.0% and 2.5%.

Investment Grade Corporate Bond Outlook: The rally of 2019 saw investment grade spreads move 50 basis points tighter versus Treasuries in addition to lower interest rates making for a great year of total return. We expect 2020 to be a year with more muted returns. We expect spread tightening to slow in the coming year and are projecting a total return closer to the index coupon in the 3%-4% range. We are positioning portfolios to be dependable components of an overall asset allocation. We remain focused on producing income, not over-reaching for yield, and taking advantage of opportunities presented by the market. We are generally underweighting commodities and cyclicals and overweighting more consumer and defensive sectors in credit. We continue to underweight Treasury, Agency and Mortgage sectors as relative value is lacking compared to the Corporate sector.

High Yield Bond Outlook: We anticipate a very modest increase in high yield defaults during 2020. This increase will likely be the result of continued pressure in the energy and retail sectors. The Energy sector remains under pressure as a result of continued $50-$55 oil when industry balance sheets where designed for $65-$75 per barrel prices. The retail sector has experienced secular pressure of changing consumer preferences for online shopping. The long-term average high yield bond default rate is now at 3.46%. We expect defaults to remain well below that average despite a modest uptick in 2020. High yield spreads tightened 143 basis points versus Treasuries in 2019. We expect spread tightening to slow in the coming year and are projecting a total return closer to the index coupon in the 5.5%-6% range.

Thank You

Another year and another decade are gone. We had ten years of growth, the longest expansion since WW II. Did it feel that good? Well, it did for us because of you, our clients. We want to thank you for your business and introductions to new clients during the past decade. We look forward to serving you in 2020 and helping to successfully navigate the ever changing fixed income landscape. Please remember our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward tradeoffs in our portfolios. While market fluctuations can occur, our long-only style of investing has delivered positive results with reduced volatility over the long term. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

Thank you,

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