Eight trends point to what we think is a modestly bullish outlook for stocks.

BY ANNE KATES SMITH
Every bull market has its quirks, but this one, in its old age, has developed a split personality. After a near-death experience at the end of 2018, the bull recovered in 2019 and the stock market hit new highs, returning an incredible 23% by the end of October, as measured by Standard & Poor’s 500-stock index. And yet, this is no charging bull. It’s more like a Ferdinand, the old children’s book character who refuses to fight. What’s so strange is that the march to record highs has been
led by investments favored by the timid—big, U.S. blue chips, low-volatility stocks and defensive sectors more in demand during bear markets than in powerful upturns. Money flowing out of stock funds has belied the index gains. “We have a 20% run in the stock market led by all the bearish assets,” says Jim Paulsen, chief investment strategist at the Leuthold Group.

“All this reflects the weirdness of this recovery,” he says. “It’s truly a bull market led by bears.”

We think the bull can manage a more modest run in 2020, with a good chance that market leadership will come from sectors more traditionally, well, bullish. The familiar litany of risks hasn’t disappeared. But rather than obsessing about lurking bears and an imminent recession (at least for a while), it will make sense to mix a little offense with the defense in your portfolio. For some ideas on what to do with your money now, read about the trends we think will shape the market in 2020. Prices and other data are as of October 31.

1. STOCKS KEEP CLIMBING

The stock market has defied the odds by continuing to rise well into its 11th year, despite softening earnings growth, recession fears and a huge cloud of tariff-induced uncertainty. Some of those odds will shift a bit more in the bull’s favor in 2020 as central bank stimulus works through the economy, earnings growth picks up, and investors regain an appetite for risk while at least a partial trade deal with China seems doable.

To be clear, we’re not saying to go all-in on stocks at this late stage in the economic recovery and the bull market. Paulsen thinks an appropriate portfolio weighting now might be about halfway between whatever your maximum exposure is and your average stock exposure. And this is no time for complacency, says Terri Spath, chief investment officer at Sierra Funds. “You have to be tactical and have a plan for how you’re going to manage volatility,” she says.

It seems reasonable to expect the S&P 500 to reach a level somewhere between 3200 and 3300 in 2020. The conservative, low end of the range implies a price gain of just over 5% and, adding dividends, a total return of just over 7%. That translates to a Dow Jones industrial average of around the 28,500 mark. Whether our call is wide of the mark, and whether the peak in 2020 comes at midyear or year-end, depends largely on how much the U.S. presidential election roils the market. We’ll also note that in 2020, a U.S. blue-chip barometer like the S&P 500 might not be your only gauge of success, as small-company stocks and foreign holdings may shine as well.

2. RECESSION FEARS RECEDE

U.S. manufacturing contracted in October for the third straight month, as global trade tensions continued to weigh on the sector. But the report was an improvement from the previous month, and similar indexes are showing more of an inflection. “You’re seeing early green shoots that the manufacturing recession is bottoming,” says Lindsey Bell, chief investment strategist at Ally Invest. (For more from Bell, see the interview at right.)

For the U.S. economy overall, Kiplinger expects growth of 1.8% in 2020, compared with an expected 2.3% in 2019 and 2.9% in 2018. Business spending in the U.S. has been subdued by uncertainty about a trade deal, the fallout from Brexit and angst over the presidential election. But with unemployment at decades-long lows, consumers, who account for the bulk of the U.S. economy, remain a strong underpinning. So does the Federal Reserve, which has cut short-term rates three times since June.

Kiplinger expects the unemployment rate to inch up to 3.8% in 2020 from 3.6% in 2019, and the Fed to cut rates at least once early in 2020. “The economy is in a tug-of-war between geopolitical risk and the underlying resilience of the American household, plus the Fed,” says Mike Pyle, global chief investment strategist at investment giant BlackRock. He is betting on the side that has U.S. consumers and central bankers on it.

3. EARNINGS PICK UP

To say 2019 was a disappointing year for corporate earnings is an understatement. Wall Street analysts expect tepid profit growth of 1.3% for 2019, according to earnings tracker Refinitiv. But context is key: It’s no surprise that 2019 earnings were flat compared with profits in 2018 that were supercharged by corporate tax cuts.

For 2020, analysts expect robust earnings growth of just over 10%. Those rosy projections are no doubt high—consider that a year ago, analysts predicted earnings growth of 10% for 2019, too. A more realistic expectation for earnings growth in 2020 is roughly half the consensus estimate, or 5% to 6%, says Alec Young, managing director of FTSE Russell Global Markets Research. Still, “that’s sufficient to keep the market moving higher,” he says.

Reversing 2019 trends, the strongest profit growth is expected from the energy, industrials and materials sectors—the three biggest laggards in 2019. Based on earnings estimates for the next four quarters, the S&P 500 is trading at 17.5 times earnings—higher than the five-year average P/E of 16.6 and the 10-year average of 14.9, but far from outlandish levels.

4. THE ELECTION TRUMPS EVERYTHING

Before worrying about the 2020 presidential election, investors must first parse the potential fallout from a presidential impeachment—or not. The view on Wall Street is that even if President Trump is impeached, his removal from office is unlikely, and the exercise will turn out to be neutral for stocks. “The whole impeachment process is more political theater than anything else,” says Phil Orlando, chief
stock strategist at Federated Investors.

And although the election promises to be a nail-biting affair, consider that, dating back to 1833, stocks have returned an average of 6% in presidential election years, according to the Stock Trader’s Almanac. In terms of election outcomes, the worst for stocks historically has been a Republican president with a split Congress, according to RBC Capital Markets (with 2019 being a glaring contradiction). Going back to 1933, whenever that leadership configuration has been in place, the S&P 500 has returned just 4% annualized (see the chart, below). The best returns, 14% annualized, come under a Democratic president and a split Congress.

No sector is more in the policy crosshairs than health care, with insurers and drug makers buffeted by proposals to curb prescription prices and expand Medicare. These are variations on familiar themes, and health care stocks often lag ahead of U.S. elections, reports Goldman Sachs, falling behind the S&P 500 by a median of seven percentage points in the 12 months preceding the 11 presidential elections since 1976. As a result, Goldman recommends that investors tilt away from health care stocks. Investors should tread carefully with other sectors most at risk of potential policy changes, including energy (climate risk disclosures, carbon emissions regulations, fracking bans) and financials (more regulation, caps on credit card interest, student debt forgiveness).

5. OFFENSE BEATS DEFENSE

It may seem counterintuitive at this late stage, but the market in 2020 could reward a little more risk-taking, especially when it comes to betting on cyclical stocks (those that are more sensitive to swings in the economy). “It has been rewarding to be defensively aligned over the past 18 months,” says Mark Luschini, chief investment strategist at Janney Capital Management. “We’re beginning to detect a subtle, but we think persistent, shift to cyclical sectors. We think that’s where we want to be positioned in 2020.”

Consider consumer discretionary stocks (those of companies that make nonessential consumer goods). Investors can take a broad-based approach with CONSUMER DISCRETIONARY SELECT SECTOR SPDR (SYMBOL XLY, $121), an exchange-traded fund whose top holdings are Amazon.com (AMZN) and The Home Depot (HD). Sam Stovall, chief strategist at research firm CFRA, says the firm’s favorite discretionary stocks include automotive retailers CARMAX (KMX, $93) and O’REILLY AUTOMOTIVE (ORLY, $436). Bank of America Merrill Lynch recently recommended Mid-Atlantic homebuilder NVR (NVR, $3,637) in the wake of a pullback in the shares in mid October.

BofA also likes shares of industrial bellwether CATERPILLAR (CAT, $138), and it has raised its 12-month price target on the stock from $154 to $165 a share. Within financials, UBS Investment Bank recommends insurance giant AMERICAN INTERNATIONAL GROUP (AIG, $53) based on its outlook for improved underwriting results and increasing profit margins.

Tech is another promising sector for 2020, but with a twist, says Paulsen. “The large caps are over-owned and over-loved,” he says. “Smaller names have done just as well, they have faster growth rates, and they’re not in the crosshairs of regulators,” he adds.

Stocks in the S&P SmallCap 600 Information Technology index trade at close to the same P/E as stocks in the S&P 500 infotech index, Paulsen notes, when the former typically commands an 18% premium. Worth exploring: INVESCO S&P SMALLCAP INFORMATION TECHNOLOGY ETF (PSCT, $91). Top holdings include Cabot Microelectronics (CCMP), Viavi Solutions (VIAV) and Brooks Automation (BRKS).

Don’t abandon defensive holdings, such as consumer staples, utilities or low-volatility stocks. But you’ll want to scout for the less-pricey names. For example, Credit Suisse has come up with a list of low-volatility stocks with what the firm considers more-reasonable valuations, including advertising firm OMNICOM (OMC, $77) and tech company CITRIX SYSTEMS (CTXS, $109).

6. VALUE TAKES OFF

For years, value stocks (those that are bargains based on corporate measures such as earnings or sales) have not kept pace with growth stocks (those boosting earnings and sales faster than their peers). The S&P 500 Value
index has trounced its growth counterpart by more than five percentage points over the past three years. Since September, however, the value index has trounced growth, returning 6.5%, compared with 2%. We’ve seen such head fakes before. But analysts at Bank of America Merrill Lynch see “a convergence of signs for a sustained value run.” Among them: Value stocks, which tend to overlap with industries that are sensitive to economic swings, typically outperform when economic data start to perk up and when corporate profit growth accelerates.

Moreover, according to BofA, value stocks have been shunned by fund managers, leaving them both inexpensive and with lots of room to run. The S&P 500 Growth index recently traded at 22 times estimated earnings for the year ahead, compared with 15 for its value counterpart. Consider adding some value to your portfolio with two funds from the Kiplinger 25, the list of our favorite no-load funds: DODGE & COX STOCK (DODGX) and T. ROWE PRICE VALUE (TRVLX).

7. RATES BOTTOM OUT
Yields on 10-year Treasuries sank as low as 1.47% this past summer as recession fears reached a crescendo. Since then, the Fed has pushed short-term rates lower, and 10-year Treasury yields inched back up to 1.7% by the end of October—once again higher than shorter-term yields, thereby negating the dreaded recession harbinger of the so-called inverted yield curve. Still, Kiplinger doesn’t expect 10-year Treasury yields to climb above 2% as long as the trade war lasts, which poses challenges for income investors. “You need the ballast of Treasuries in your portfolio when there’s volatility,” says Young, at FTSE Russell. “But with rates at crazy-low levels, it’s important to get income from other sources as well.”

High-yield bonds (avoid the oil patch), emerging-markets bonds and dividend-paying stocks such as real estate investment trusts and utilities are good places to hunt for yield. Funds to consider include VANGUARD HIGH YIELD CORPORATE (VWEHX), yielding 4.5%, and TCW EMERGING MARKETS BOND (TGEIX), yielding 5.1%. SCHWAB US DIVIDEND EQUITY (SCHD, $56), a member of the Kiplinger ETF 20 list of our favorite ETFs, invests in high-quality dividend payers and yields just over 3%. Spath, at Sierra Funds, is bullish on preferred stocks. ISHARES PREFERRED AND INCOME SECURITIES ETF (PFF, $37) yields 5.5% (For more ideas, see “Income Investing,” on page 36).

8. OVERSEAS MARKETS REVIVE
A combination of low valuations and fewer headwinds could make international markets worth exploring in 2020. A comparison of MSCI market indexes in relation to expected earnings shows the U.S. recently trading at a P/E approaching 18, compared with almost 14 for the Eurozone and just 12 for emerging markets.

Meanwhile, the European Central Bank launched another round of monetary stimulus in October, and the Fed easing rates in the U.S. should help lift currencies and financial markets in emerging countries. Global trade tensions could de-escalate as the U.S. election approaches, and Britain’s divorce from the EU has taken on a more civil tone.

“The good news on the policy front is recent and may take a few months to boost the global economy,” says market strategist Ed Yardeni, of Yardeni Research. But in terms of portfolio strategies, he says, “the bottom line is that Stay Home has outperformed Go Global during most of the current bull market, but Stay Home could lag over the next six to 12 months.”

A worthy choice for investors considering adding some international exposure is DODGE & COX INTERNATIONAL STOCK (DODFX), with an expense ratio of 0.63%. The fund, which reopened to investors this past spring, has a value tilt and at last report had nearly 20% of assets invested in emerging markets. Top holdings include two French firms, drug maker Sanofi and banker BNP Paribas.

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2019 Update

HOW WE DID

Last year’s January outlook called for Standard & Poor’s 500-stock index to finish between 2950 and 3000. We tempered our expectations in July, adjusting the target down to 2850, but it turns out we just about got it right the first time. Between last January’s issue and this one, the S&P 500 returned 11.4%, including dividends, and sits at 3038 as of October 31. We called for heightened volatility, and investors got it in spades in a market that contained two short but sharp pullbacks and several new highs. We said the top risks for 2019 would be trade tensions and higher interest rates—the Federal Reserve put the kibosh on the latter, but the former continues to plague the market.

Our individual stock calls were a mixed bag. The eight stocks we recommended for 2019 returned 9.6%, on average. Biotech firm Celgene led the way, returning 46.0%. Alternative asset manager Brookfield Asset Management chipped in a 29.4% return, with medical lab equipment maker Thermo-Fisher rounding out the big winners, having returned 24.4%. Chip maker Intel and JPMorgan Chase rose 19.8% and 15.8%, respectively. Discount retailer Ollie’s Bargain Outlet was the biggest dud, surrendering 30.0% thanks to huge sell-offs in December and August. Dow-Dupont and IT consulting firm Cognizant Technology also posted losses.

Among our five stocks to sell, only two lagged the broad stock market, and only one of those, Under Armour, fell in price. We were particularly foolish to diss Shake Shack, which returned an eye-watering 61.5%.