# Bank of America Merrill Lynch 2020 Market Outlook: Profits Rise, Economy Slows, Globalization Peaks, and Business-as-Usual Investing Comes to an End

New York City

Key drivers of this year's late-cycle bull market gains are expected to shift as the global markets enter the new year, according to BofA Merrill Lynch Global Research, which was recently named Institutional Investor's top research firm in the world. In its year-ahead outlook, the research team forecasts a bottoming of economic growth in the spring as trade war tensions ease, and relatively low recession risk.

Key highlights include:

- Stocks are expected to outperform bonds handily in 2020 as the global economy bottoms out in the first quarter, while monetary policy remains accommodative. The conventional idea of allocating 60 percent to equities and 40 percent to bonds is unlikely to survive into the 2020s.

- An interim, skinny U.S.-China trade deal should temporarily relieve trade concerns ahead of the U.S. presidential election and pave the way for a midyear, mini-boost in global growth led by U.S. rates and a weaker dollar.
- A rebound in U.S. corporate earnings should spur a long-awaited uptick in capital spending and lift the S&P 500 to another year-end high of 3300, or 6 percent above current levels. In a reversal of trend, U.S. stock returns are expected to lag gains forecast for Europe and emerging market stocks next year.
- The potential for 6 percent total returns on high-grade bonds next year makes U.S. corporate credit particularly attractive in a world facing $12 trillion of negative-yielding debt. Inflows from foreign investors are expected to remain strong, supported by favorable spreads, but today's bond market "bubble" could become the

markets' biggest vulnerability.

"The new year and decade begin near the tail end of the longest bull market on record, and despite recent strong gains, investor anxiety remains at a high level," said Candace Browning, head of BofA Merrill Lynch Global Research. "Many of the driving factors – central bank policy, globalization, oil – have peaked, and new economic paradigms are emerging in response to a different set of challenges facing the world's social, environment, political and economic systems. Rather than focusing on the downside, we think the opportunity for investors will be found in what happens next."

At the annual Bank of America Merrill Lynch Year Ahead Outlook presentation today in New York City, the firm's top strategists and economists discussed the overarching themes that are transforming economies and investing paradigms in the year ahead and throughout the 2020s. Notable among these is the transition to stronger local and regional economic ties, following three decades of economic growth fueled by the benefits of globalization – an unchecked, cross-border free flow of goods, people and capital that rewarded cheap labor and low consumer prices. The shift from globalization to localization and other global macro trends underpins much of Bank of America Merrill Lynch's outlook on the markets and economy next year.

Key macro calls made for the markets and economy in the year ahead are:

- **Slowing global growth:** Global GDP is forecast to slow from 3.8 percent in 2018 to just over 3 percent in 2019 and 2020. Europe should stabilize at around 1 percent, while a below-consensus call on China assumes growth slowing from 6.1 percent to 5.6 percent. Inflation is likely to inch lower from 3.1 percent this year to 2.7 percent by 2021 while policy rates remain flat and fiscal policy stays frozen.

- **U.S. economic slowdown despite strong fundamentals:** U.S. GDP is expected to slow to trend, with growth averaging 1.7 percent over the next two years. On the positive side, inflation should be muted, with core PCE inflation at around 2 percent by the end of 2020. The Federal Reserve is not expected to take further rate action for the foreseeable future, unless a material shift in outlook triggers such a move. Given the Fed's focus on avoiding a recession, the risk of further cutting outweighs hikes.

- **Modest gains in U.S. stocks, with greater upside outside U.S.:** S&P earnings per share are forecast to grow 8 percent to $177 at year-end, and returns will likely be driven solely by corporate earnings vs. price-to-earnings multiple expansions. Emerging markets and Europe could offer more upside in 2020: crowded positioning in the U.S. vs. the rest of the world, and estimate revisions abroad outpacing those in the U.S. support a rotation into global equities. Three significant tactical rotations call for allocation shifts from growth to value, from large cap to small cap, and from the U.S. to the rest of the world.

- **Rates on pause as support from monetary policy wanes:** U.S. rates are expected to lead the way in 2020, with downside risks somewhat diminished and higher repricing likely. Ten-year rates are expected to move from 2 percent at the end of 2019 to 1.8 percent in 2020. The yield curve remains vulnerable to a paring back of Fed easing expectations in the near term, while the swap curve is expected to flatten. Fed actions freed other central banks to ease, and with the exception of China, many are also expected to put rate actions on hold next year.

- **Credit cycle rolls on:** Despite weaker global growth, U.S. investment grade corporate earnings growth of 9 percent is expected, up from 1 percent in 2019, with spreads tightening by 10 basis points and total returns of 4 to 6 percent. Gross issuance will likely be down 4 percent to $1.137 trillion, with net issuance declining 21 percent to $399 billion. In 2020, the 11-year high-yield credit cycle is expected to keep on rolling, though earnings will be the biggest risk. Default rates should stabilize at 4 percent next year, as spreads gravitate to 450 basis points. Key tactical rotations call for smaller over larger issuers, longer over shorter spread duration, and more cyclical sectors.

- **Emerging markets recovery contingent on trade:** The outcome of the U.S.-China trade war is crucial to the outlook for emerging markets in 2020. Total emerging market returns of 7.1 percent in local debt are forecast, but only 2.6 percent for external debt. Latin America is mounting a cyclical recovery, likely led by Brazil and Andrean economies, while Argentina's new government faces extreme economic challenges. Idiosyncratic factors will dominate in emerging EMEA, with Egyptian and Russian local markets and Kenyan and Nigerian external debt favored.

- **Weakening dollar:** The U.S. dollar is expected to weaken in 2020 with diminishing policy uncertainty. The euro and sterling also should benefit from a resolution of Brexit uncertainty, with EUR/USD and GBP/USD rising to 1.15 and 1.39 respectively. Stronger global growth and a weaker dollar will help support emerging markets. USD/JPY is expected to decline to 103, while AUD/JPY and ASEAN FX should appreciate sharply on global reflation.

- **Modest growth in commodities hedge inflation risks:** A positive roll yield should support modest commodity returns in 2020, with dispersion expected within energy, metals and agricultural. Brent crude could hit $70 per barrel by midyear, while diesel may near $100/bbl. Summer U.S. natural gas prices could fall below $2/million British thermal units, as forward balances continue to weaken after the winter. Cyclical raw materials should benefit from a potential inventory restocking cycle, easier Fed policy, and an interim China trade deal, providing an attractive inflation hedge. While copper and nickel are likely to rally in 2020, the outlook for gold and precious metals is more cautious.

- **Sector weights and rotations:** Amid emerging signs of an inflection in the manufacturing economy and interim trade deal, the recommended sector weighting for industrials has moved to overweight from marketweight. Given the likelihood that the trade war re-escalates after the 2020 U.S. presidential election and morphs from a trade war to a tech war, Information Technology moves from overweight to marketweight.
  - Overweight: Financials, Consumer Discretionary, Industrials, Utilities
  - Marketweight: Technology, Communication Services, Health Care, Energy
  - Underweight: Real Estate, Consumer Staples, Materials

Given macro trends impacting the markets, business-as-usual investing is likely to come to an end. Localization, rather than globalization, has major implications for global growth, and a rise in moral capitalism is changing corporate behavior, shifting the focus from shareholders to stakeholders. Investors should consider several longer-term trends for 2020 and beyond: (1) from global to local, (2) from trade war to tech war, (3) from bonds to stocks, and (4) from short-term gains to long-term growth, where environmental, social and governance (ESG) considerations can help isolate the long-term growth stories.

To learn more about these major themes, please listen to a podcast hosted by Candace Browning, "What the 2020s could bring for the markets – and our financial lives."

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Reporters May Contact:
Melissa Anchan, Bank of America, 1.646.532.9241
melissa.anchan@bofa.com

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