Stephens
Investment Management Group®

The following contains a brief discussion of the equity markets from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.

2020 MARKET OUTLOOK

The Greek philosopher Heraclitus said, “The only constant is change.”

While change is constant, the *rate* of change is not! As history has progressed from Heraclitus’ time, we think it is safe to say that change has occurred in an exponential fashion, and we are living in the elbow of the curve.

In Heraclitus’ time, change came a bit more slowly than today. Heraclitus’ children almost certainly experienced a lifestyle and environment that was very similar to that of their parents. While we are certain there was change on a micro level, on a larger scale, change could only be measured across generations. As time went on, change came more quickly. Innovation and technology would bring about step-function improvements in quality of life and in the economies around the world. Even in the 19th and undoubtedly in the 20th century, there was significant change over just one generation. The life of the son was appreciably different than the life of the father.

Change is accelerating. That same accelerating change has been affecting the economy and the market as well. Today’s economy isn’t really comparable to the prior decades’. And the complexities of today’s market are probably beyond the scope of any one individual to fully understand. It’s not just that we are experiencing change, but that the *system itself has changed.*

Because of this complexity and because so much of this complexity is new, visibility is low. We could make a compelling and coherent case why the economy is poised to reaccelerate and the market could respond in kind. We could also make a compelling case of the opposite.

Our core belief is that *because of behavioral biases, Wall Street chronically underestimates the magnitude and the duration of change*. Our investment process is centered around identifying change, minimizing our own biases, and exploiting the underestimation of other investors. This is a target rich environment on two fronts. First, there is more underlying change in the economy and with the universe of companies in which we invest. There is also change in the way other investors act – as dollars continue to flow into passive, quantitative, or factor-based strategies, there are fewer investors (or at least fewer dollars) doing what we do.

We whole-heartedly believe that our alpha potential is increasing as a result of these changes. However, we also whole-heartedly believe that it will not be smooth sailing along the way. The factor winds are strong. We fully expect that these factor winds will continue to shift violently on a speculative basis, or at least on the basis of historical relationships that may no longer be valid. These high-level shifts may cause some unnatural and temporary under- or over-performance, revealing what we believe is a much less efficient market.

In terms of our explicit outlook on 2020, it is fairly straightforward. Directionally, the economy is still healthy, and there are reasons to be both optimistic and cautious. The China Phase 1 trade deal will ease those concerns and with the Fed taking an accommodative stance (again) and deliberately trying to overshoot inflation, it’s hard to argue for anything other than the market grinding higher. From a long-term perspective, we worry that the market’s Pavlovian love affair with QE and accommodative policy might reach some limit.

As we write this, the coronavirus outbreak is causing real concern. On top of that, given the focus on the election and the market's implicit belief that Trump will win, if one of the really progressive candidate on the left starts showing real traction, the market could suffer as that possibility gets priced in. Politics aside, the market won't like the policies of Sanders or Warren – investors believe that higher taxes, increased regulation, and a revamp of Healthcare will stifle economic activity and create uncertainty. Even if Trump wins again, our guess is it won't be a straight line from here to November; there will be some doubt and volatility along the way.

The fourth quarter of 2019 gave us another quarter of big passive inflows and a rising-tide effect. If that trend even slows down a bit, it should create a better environment for stock picking. As much as we talk about the macro, our workflow and process is built around examining the micro. We are still focused on finding the very best growth companies in the universe. When the market doesn't differentiate much between those companies and the rest of the index, we actually like the potential it builds for future periods.

We have our behavioral finance hats on, and we are working hard to be unemotional, unbiased, and not fall into the trap of overconfidence or anchoring. As Daniel Kahneman said, uncertainty and doubt are the realm of "System 2" (critical, objective thought).

We are as excited as ever about what we do. Volatility and periods of uncertainty will test investors' patience, but our skillset of identifying change, exploiting others' underestimation of it, and executing with extreme discipline should be the right tools to thrive in this regime.

Ryan Edward Crane

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