



WILMINGTON
TRUST

PART OF THE M&T BANK FAMILY

2020 Capital Markets Forecast



Market Tug of War

The interplay of
productivity, populism,
and portfolios

Productivity— Everywhere but in the statistics

Order any retail goods from your phone and have them delivered the next day at no additional cost.



Watch unlimited streaming movies on your phone anywhere anytime.



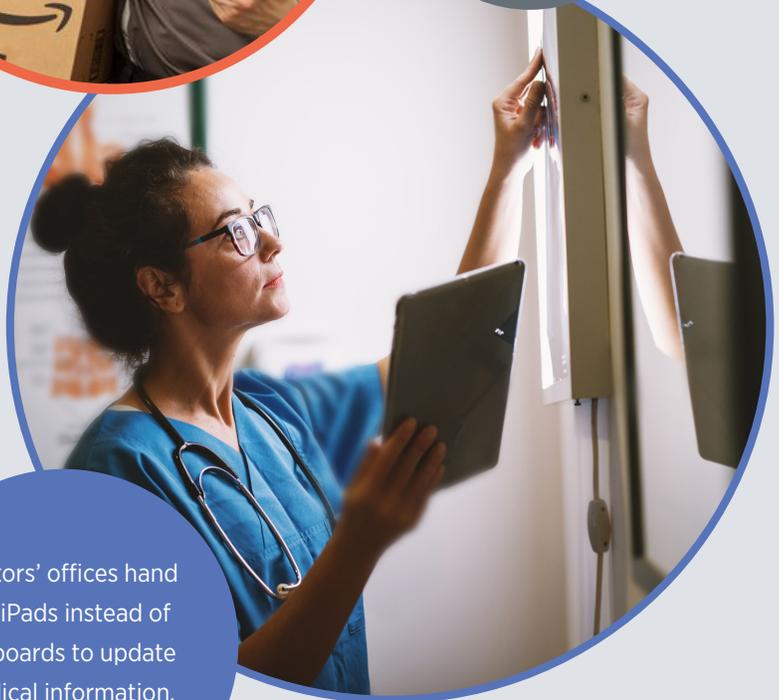
Video chat with kids and grand-kids, and see pictures of them instantaneously.



Tractor-trailers, cars, and airplanes use diagnostics to predict equipment failures.



Doctors' offices hand out iPads instead of clipboards to update medical information.



KEY THEMES

- I Solving the Productivity Puzzle
- II Productivity Driving Populism
- III Testing the Limits of Policy

FROM THE CHIEF INVESTMENT OFFICER



Tony Roth

Wilmington Trust
Investment Advisors, Inc.

Investing is a data-driven process. We comb through economic and market information and use the data as clues that help lead us to a prudent investment strategy. With the scope of the investment universe so large, we rely on private industry and government data to give us the lay of the land. But what if the data are not telling the full story, or worse, are wrong? How do we proceed if we observe one thing to be true, but the data tell us something different?

Nowhere is such a phenomenon clearer than in productivity growth statistics. Government data since 2007 have indicated the slowest productivity growth of any economic expansion in the post-WWII era, well below the long-term average. Yet there is ample evidence of how technological progress is benefiting companies, individuals, and society. In last year's forecast, we offered productivity as an explanation for the low level of inflation observed during this cycle and predicted productivity growth would pick up, and recent data suggest our call is starting to pan out.

The first theme in our 2020 forecast expands on this, digging deeper into pieces of the productivity puzzle to help determine where productivity levels may be today and where its growth is headed. Why, you may ask, are we so focused on productivity, which some consider a "second-tier" data point that is released with an even greater time delay than gross domestic product (GDP) and covered only marginally by the media? We believe productivity is the most important driver of the economy, policy, and societal progress, as it allows the economy to produce more output with less labor. Economic growth is equal to productivity growth plus labor force growth, and higher productivity permits more robust economic growth and higher wages without generating inflation.

At the same time, the wide productivity gains achieved thus far have come at marked social costs. The forces that have propelled productivity have not returned gains evenly across the wealth spectrum. Instead, the jobs market has become "hollowed out" as technology increasingly encroaches on roles in the center of the labor spectrum that have traditionally called for skilled workers. The result is less of the economic pie going to workers and increasing political and economic populism, which we discuss in our second theme.

Our third theme weighs implications on markets of the dueling forces of productivity versus populism, as well as the current manifestations of this conflict between monetary policy and trade policy. This cycle is unique in numerous ways, and the fate of risk assets over the coming year will be a result of how these forces shake out. We share how we are thinking through the push and pull of policy risk over the coming year. We stand at a crossroads, preparing to close out one year and welcome another—with an election whose results are sure to have a sweeping impact on the economy and markets.

And, as always, we resolve to stay ever-vigilant and strive to achieve our perennial goals of asset preservation and growth.



We believe productivity is the most important driver of the economy, policy, and societal progress, as it allows the economy to produce more output with less labor.

THEME I

Solving the Productivity Puzzle

Low measured productivity growth has plagued the current cycle, registering below any other post-WWII expansion. Yet the advancements of the Fourth Industrial Revolution—technologies like artificial intelligence, 5G, and block chain—have ushered businesses and consumers into a world of instant connectivity and high efficiency, trends we explored in last year's Capital Markets Forecast. We are all aware of the incredible power of our smart phones, for example, and this is just the tip of the Fourth Industrial Revolution iceberg. How is it then that, in a world where billions of people are connected instantly on Facebook and other real-time media platforms, anyone can place an international video call for free through Skype, and we can stream TV and movies from anywhere anytime, the overall economy is not more productive? As an aside, we cannot help but be reminded of a phenomenon that became known as the Solow Paradox, named for Nobel Prize-winning economist Robert Solow who observed in 1987, "you see the computer age everywhere but in the productivity statistics."¹ Understanding productivity is incredibly important for informing our views on future rates of inflation, economic growth, and profitability of firms, which are all incorporated into our investment recommendations.

The four puzzle pieces of productivity

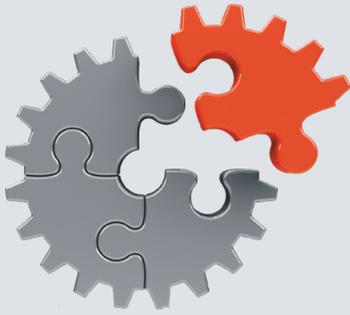
In our view, no single factor explains the disconnect between the advanced technology we see and the current low reported productivity growth. In the remainder of this section, we highlight four pieces of the productivity puzzle that we believe help explain the weakness in the reported statistics, and more importantly, why we believe productivity will move higher in the future: 1) time lag; 2) cyclical and structural factors; 3) firm strategy; and 4) progress. In very disparate ways, the first three help explain why we expect to see technological developments show up in productivity at some point in the future. The fourth, progress, is different in that many technological developments enhance well-being but are not captured in economic growth and, therefore, will never show up in measured productivity.



1. Time lag

There is a sizable lag between the discovery or invention of a new technology and evidence of that technology in the economy-wide statistics. For example, a car company commits to a robotics-based plant, but cars don't roll off the new assembly line for many years, meaning there is a delay between that investment and an increase in the firm's realized productivity. At the macro level, new technologies can elongate this lag due to the time required for a new method to be fully developed, made commercially available, and adopted by enough companies to move the productivity needle across the broader economy. Self-driving cars are an example of a heavily invested technology that has yet to mature, yielding scant measurable output for that investment (estimated by the Brookings Institute to have been roughly \$80 billion industry-wide between 2014 and 2017). In 10 years, we expect autonomous driving technologies to be more commonplace, potentially leading to sharp increases

Productivity 101



Four puzzle pieces of productivity

- Time lag
- Cyclical and structural factors
- Firm strategy
- Progress

Let's start with a brief lesson or refresher for the economics students among you. The measurement of productivity growth is simple in theory but extremely complex in practice. There are many measures of productivity, and the most commonly referenced is labor productivity. Economists measure labor productivity for the macro economy as total output (also known as real gross domestic product, or GDP) divided by total hours worked. Seems easy enough.

The problem is that there are countless practical reasons to explain why getting this number correct is so difficult. After all, it is anything but straightforward to measure and compare units of output for something like legal advice or dependent care. The denominator of the productivity equation (hours worked) is a bit easier to calculate but still makes major assumptions about the 42% of the workforce that are not paid by the hour. The investment industry provides a good example of the challenges on both sides of the productivity equation. On the numerator, "investment advice" is a highly customized and abstract unit of output, the measurement of which is further distorted by innovations such as "robo-advisors" and access to low-cost, passive investment solutions like exchange-traded funds, or ETFs. Measuring the "man-hours" to produce that work (the denominator) is muddled by cross-team collaboration and unmeasured overtime like checking emails at night or dinner meetings.



Fewer companies are representing a larger share of total industry sales. This may be suppressing natural competitive forces and innovation and relates directly to the recent inquiries opened by the U.S. Federal Trade Commission and Department of Justice into the “Big 4” technology companies.



in output, just as the heaviest investment is tapering off, resulting in a boost to productivity like a “J-curve” effect (Figure 1). There are many Fourth Industrial Revolution technologies in a similar position, with tomorrow’s productivity reward likely to be reaped from today’s investment.



2. Cyclical and structural factors

The staggering depth of the previous recession continues to have a significant impact on GDP and productivity figures, even a decade later. On the cyclical side, this is because so many firms tightened their belts, shelving any outlays for new production methods, or even the kind of R&D needed to develop new methods. This essentially means pushing the pause button on any new J-curves. Productivity gains have been delayed as a result (Figure 2).

On the structural side, the rate of churn of old firms dying off and new start-ups being born, known as “business dynamism,” has been on a downward trajectory.² There are several reasons for this. First, historically low interest rates like those in the present cycle have helped keep “zombie” firms in business longer than may otherwise have been the case. Second, onerous regulations for much of the post-crisis period depressed the startup rate of new businesses. Also, in terms of competition, measures of industry concentration³ suggest that U.S. industries are becoming “top heavy,” with fewer companies representing a larger share of total industry sales. This may be suppressing natural competitive forces and innovation and relates directly to the recent inquiries opened by the U.S. Federal Trade Commission and Department of Justice into the “Big 4” technology companies (Google, Amazon, Facebook, and Apple).



3. Firm strategy

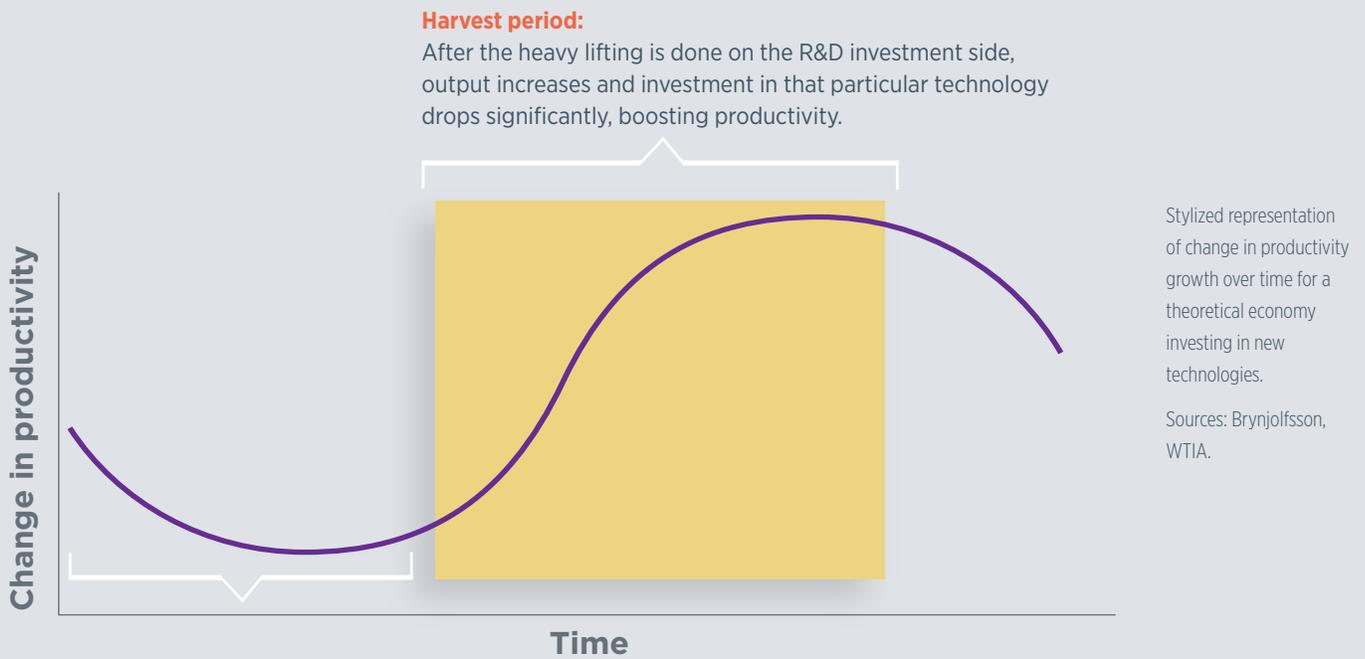
The macro statistics are also weighed down by strategic actions taken by firms, through market creation and cannibalization. Market creation involves a firm-level decision to keep prices low, or give away a product for free, to create a new market or grab share in an existing market. Think of a company like Alphabet, which offers its Google search and YouTube services free for consumers.

The value of these products is technically accounted for in the productivity numerator by advertising dollars but is highly prone to mismeasurement. A McKinsey report⁴ found the 2009 value of internet search to be significantly underrepresented in GDP, on the order of about 30%, likely because there are network and scale benefits to Alphabet grabbing market share that exceed the company’s ad revenue. We have little reason to believe this relationship is more fully captured in today’s output statistics. Additionally, it sharply increases “consumer surplus,” by which we mean the value delivered to the consumer beyond what the consumer is willing to pay (Figure 3).

Let’s look at a case study.⁵ Researchers found the per capita consumer surplus—in other words, what someone is willing to pay for a particular good or service above and beyond what they currently pay—of internet search functionality to be

Figure 1

Time lag leads to a productivity “J-curve”



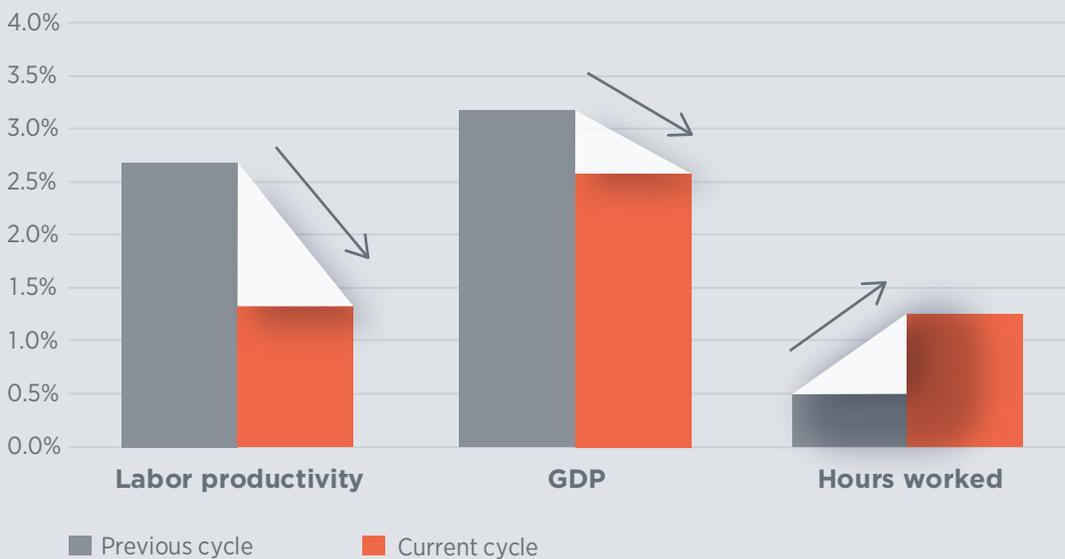
Investment period:

Heavy investment in R&D to establish new markets drags down productivity growth in the early years, when there is still relatively little realized output.

Figure 2

Lowest level of productivity growth in decades

Average annualized growth in productivity, output, and hours worked by cycle (annual % change)



Note: Previous cycle is the expansion from 2002–2007.

Current cycle is from July 1, 2009 to June 30, 2019.

Sources: Bureau of Labor Statistics, Macrobond.

“If you don’t cannibalize yourself, someone else will.”

—Steve Jobs

in the range of \$14,000 to \$22,000 per year. Admittedly, those estimates seem rather high to us, but the point is that there is ample evidence for market creation increasing consumer surplus and understating output in today’s digital economy. Another example of consumer surplus most of us can probably relate to is digital media. Today, for instance, a family of four may spend \$80 or more on a night out at the movies. Compare that to the \$5 to \$12 monthly cost that same family might devote to streaming services through which they may well consume dozens of movies and TV shows each month. The value to the family of all that media consumption typically far exceeds the outlay, but that consumer surplus does not find its way into the GDP or productivity numbers.

Interfirm cannibalization—Firms are also engaged in cannibalization of other firms within an industry. The classic example of this is the e-commerce industry, with Amazon the primary protagonist. As it represents about 38% of online sales, according to eMarketer, why is it not pushing productivity through the roof?

E-commerce is estimated by the U.S. Census Bureau to be roughly twice as productive as traditional retail, but it made up less than 11% of total retail sales in the U.S. in the second quarter of 2019. In addition, Amazon’s growth—about 27% revenue growth averaged over the last five years—is largely a result of stealing market share from traditional mall and big box retailers, which are losing sales but continue to lumber along like productivity dinosaurs; that is, their contribution to the economy for each hour worked is very low. Amazon is effectively cannibalizing the industry, which means total output (the numerator) is not growing very fast, and mall-based zombie retail firms continue to spend on rent and labor, even though foot traffic is down. As Amazon steals share from increasingly unproductive players, rather than growing the pie, it has—for now—put a cap on productivity growth within the retail sector. Once the competition disappears, profits and productivity rise.

Intrafirm cannibalization—E-commerce is also creating an interesting intrafirm cannibalization dynamic in which traditional retailers are frantically spending to build up their online and next-day delivery capabilities while maintaining their physical store presence. This can have the effect of diverting shoppers from Target’s physical store, for example, to the company’s website or app. In other words, Target’s online sales may be growing but only through major investment and at the expense of its physical store sales, putting downward pressure on near-term productivity statistics. Longer term, we expect the entire retail segment to be far more productive.

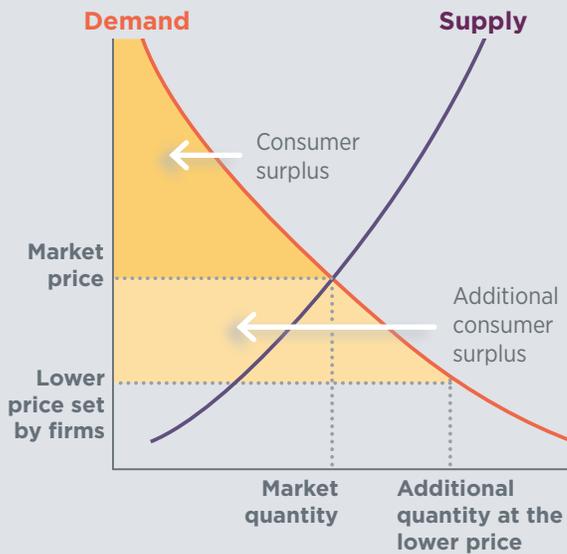
It is worth noting that, in some ways, cannibalization is a necessary evil of progress. Steve Jobs, the late co-founder and long-time CEO of Apple, once discussed the risk of the iPhone stealing sales from the iPod, saying, “If you don’t cannibalize yourself, someone else will.” The long-term growth benefits of innovation should outweigh cannibalization and increase productivity, but it could be messy for some industries in the interim.

Consumer surplus

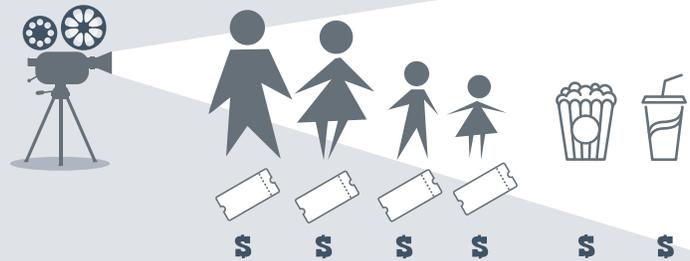
Figure 3

Market creation increases consumer surplus

Setting a low price increases sales or usage and also increases the consumer surplus.



Consumer surplus is the difference between what consumers are willing to pay and what they would actually have to pay for a good or service. In any theoretical, market-equilibrium economy unable to perfectly price discriminate, there exists consumer surplus. In an economy with artificially low prices, or free services like internet search, the consumer surplus area under the demand curve will be larger. This gives consumers more money in their pockets for the same level of utility, which we believe is contributing to a higher personal savings rate than in the last cycle.



Today, a family of four may spend \$80 or more on a night out at the movies.



Compare that to the \$5 to \$12 monthly cost that a family might spend to view dozens of movies and TV shows via streaming services.



Sustainable investing

In our view, sustainable investing strategies are some of the best ways to capture the value created from the social utility form of progress. There are many forms of sustainable and responsible investing, with the two most common being: 1) ESG investing, which invests based on a set of environmental, social, and governance standards across the entire market; and 2) socially responsible investing (SRI), which takes a more exclusionary approach to portfolio construction (e.g., excluding from the portfolio the stocks of corporations that manufacture guns, alcohol, or tobacco). We believe that ESG's more inclusionary approach gives investors a better chance of generating market-like returns, while making a positive contribution to society. Since 2016, sustainable investing assets have grown by 38%, according to the U.S. Forum for Sustainable and Responsible Investment.



4. Progress

Lastly, there are meaningful positive contributions and benefits to society not captured by productivity statistics, since their value is not monetized. As economists and investment professionals, we are trained to focus on the numbers and find the economic or investment implication in everything we observe. However, there are some things that cannot be tied directly to the economic data, yet also cannot possibly be ignored given the societal impact they are having through increased social utility, or progress. Consider the following examples that are understated by or completely left out of traditional productivity measures:

- The benefit of social media and smart phones in continuously connecting people in endless ways for equally endless purposes
- Access to generic medication and proactive health care that reduces hospital admissions (and therefore output as measured in productivity) but increases life span and improves quality of life
- Commoditization of financial products, including “robo-advisors” or low-cost passive vehicles like exchange-traded funds (ETFs), which compress margins for financial institutions but open the financial world beyond the wealthiest individuals
- Impact of companies engaging in costly but more responsible environmental practices, such as reducing their carbon footprints, which may not increase overall output but improves sustainability
- Improvement in child labor practices, which increases short-term wage costs but improves long-term development, health, education, and earnings power for society

In sum

Productivity is not broken. Rather, all the pieces of the productivity puzzle have come together in a way that has resulted in very low measured productivity for the current expansion. We continue to expect measured productivity to move higher through the present expansion and into the next one, which bodes well for higher longer-term rates of economic and wage growth and lower rates of inflation. In our view, higher future productivity is a key tailwind for the global economy that could serve to lengthen the economic cycle, boost corporate profits, and enable a “virtuous cycle” between profit growth and consumer income. We also believe the social benefits of innovation and progress should not be dismissed by investors (even if they are disregarded by most economists), particularly for those looking to combine their financial goals with their personal goals through some form of sustainable investing.



When the benefits of technological advancement accrue to the owners of capital and not to labor, and those advancements also put people out of work, the result is increased support for populist policies.

THEME II

Productivity Driving Populism

Seen on its own, productivity is the single best source of growth for an economy. It drives improved standards of living for people, so the nation that promotes and achieves the strongest advances in technology, capital, and the effective output of its workers will outpace all others in terms of economic growth. Unfortunately, however, productivity exists within a tapestry of economic, social, and political dynamics. Indeed, we see a causal connection between aspects of economic growth and the recent resurgence of populism—broadly defined as a movement that champions the common man, or ordinary person, as opposed to the empowered “elite” establishment. In our view, the rise in populism is at least in part an outgrowth of certain unintended consequences of productivity, such as: 1) gains accruing disproportionately to the owners of capital rather than workers, and 2) secular disruption of the labor force. When the benefits of technological advancement accrue to the owners of capital and not to labor, and those advancements also put people out of work, the result is increased support for populist policies.

Who gets the gains?

When productivity increases, revenue and margins generally improve as a result. In other words, productivity has the effect of “growing the pie.” Who ultimately receives those gains, and how proportional that growth is across each slice of the pie, is a far more complicated issue. Myriad factors are involved, such as the skill required for the new jobs, the need for and availability of labor, the tax structure, and other fiscal policies.

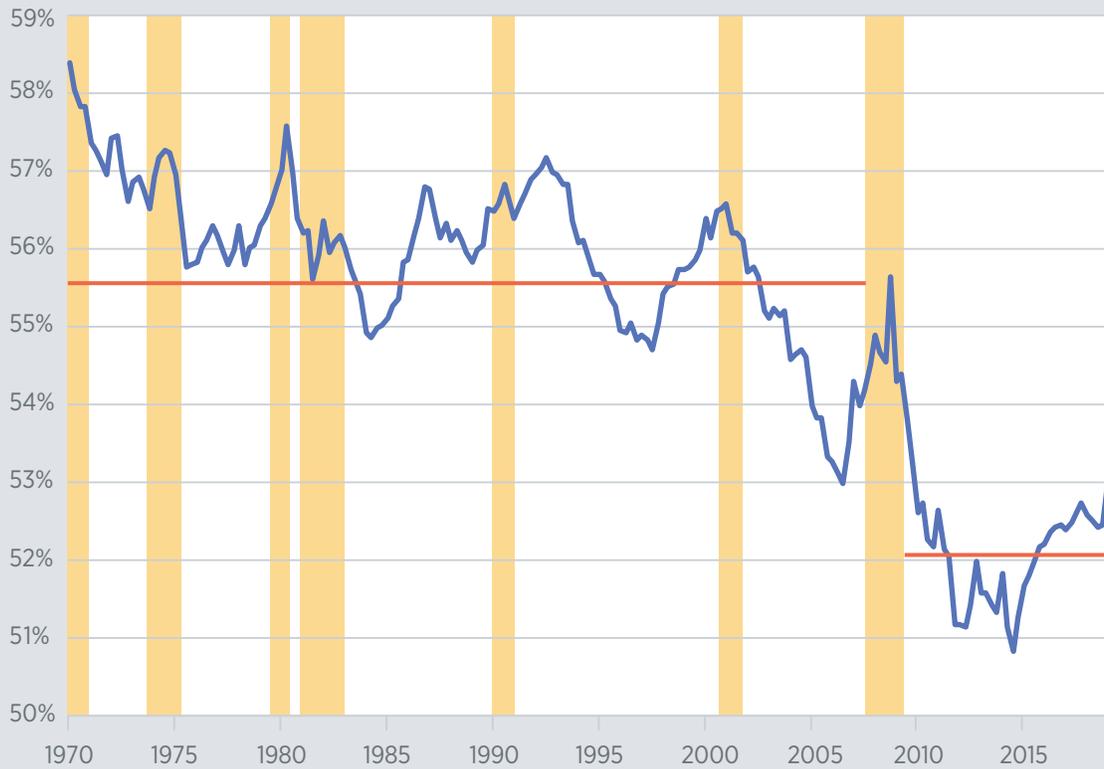
The classic example of technological change, Henry Ford’s assembly line, is instructive. Its introduction reduced the production time of a Model T from 12 hours to 90 minutes. It removed the need for highly skilled artisans who could build an entire automobile and instead created a need for lower-skilled workers who could repeat a simple task for hours on end. One might expect this to reduce the average wage for a Ford employee, but the drastic change created such an avalanche of demand for workers that Ford famously offered \$5 per day, more than doubling the existing standard of roughly \$2.25 at the time. In short, productivity grew the economic pie and took wages along for the ride.⁶ However, according to the World Inequality Database, the workers’ share of the total pie went nowhere for nearly a decade after Ford’s assembly line went into operation.

The distribution of pieces within the economic pie—specifically a shrinking of the average worker’s slice—can be a precursor to populist sentiment. The worker’s slice can be represented by the compensation paid by U.S. firms to employees as a

Figure 4

Labor share of income still low relative to history

Aggregate wages and salaries as a % of GDP



As of June 30, 2019.

Yellow shading represents recession periods.

Red lines represent averages.

Sources: Bureau of Labor Statistics, National Bureau of Economic Research.

Labor's share of GDP fell from

56.5%

at the turn of the century to a nadir of

50.9%

in late 2014. In economic terms,

that much of a drop in such a short time constitutes nothing less than a collapse.

We are confident that, looking forward, even if all outsourcing ceased, the persistent growth of technology and automation would continue to eliminate certain types of jobs, forging discontent within some pockets of the population—a recipe for populist sentiment.

From 2002 to 2018, manufacturing sector employment in the U.S.

declined by nearly

↓ **2.6 million.**

Yet over that same period, real output from the sector

increased by

↑ **32%**

for an average annual rate of 1.7% per year, **a clear sign of higher productivity.**

share of GDP, also known as labor share of income (Figure 4). It exhibits cyclical fluctuations around a structural trend, and in our view, brings some context to the recent rise of populist policies. From 1970 to 2000, there was perhaps a slight downward trend to labor's share, but the real drop started around the turn of the century. Despite recent gains in output per worker for the overall economy, these have not been captured by those workers. Labor's share of GDP fell from 56.5% at the turn of the century to a nadir of 50.9% in late 2014. In economic terms, that much of a drop in such a short time constitutes nothing less than a collapse. Since that low point, labor's share has picked up to some degree, thanks to a tighter labor market and higher wages. It is clear, though, workers are getting less of the pie now than during the post-war era.

The role of globalism

Many researchers and media pundits will pin the post-2000 decline of labor's share of income (and the manufacturing sector's overall woes) to the impacts of NAFTA from the 1990s and China joining the World Trade Organization at the end of 2001. While the U.S.'s trade relationships with Mexico, Canada, and China have had an impact, automation and productivity are also at play, and research is inconclusive as to which is more to blame over the past two decades. Still, we know that from 2002 to 2018, U.S. employment in the manufacturing sector declined by nearly 2.6 million, according to the Bureau of Labor Statistics. Yet over that same period, the Bureau of Economic Analysis reports that real output from the sector increased by 32% for an average annual rate of 1.7% per year, clear evidence of higher productivity. Productivity gains have been even stronger in many service industries. We are confident that, looking forward, even if all outsourcing ceased, the persistent growth of technology and automation would continue to eliminate certain types of jobs, forging discontent within some pockets of the population—a recipe for populist sentiment. (Read more about the types of jobs at risk in "Automation and the workforce: Will robots replace us all?" on page 12.)

Wealth distribution—a historic concentration

In addition to the aggregate income share going to labor being much reduced, the distribution of income among households has been widening, further driving populist sentiment. U.S. Census Bureau data that examine the share of income from 1970 to the present show the top-earning 20% of households gaining an ever-higher share of total income each decade, while the lowest 60% lost share. Academic researchers looking at historic wealth data estimate the wealth accumulation from that income divergence has resulted in the top 0.1% holding the highest share of wealth since 1929, which also happened to be the eve of the Great Depression.⁷ Perhaps it's not surprising that this grave chapter in U.S. history was followed by Roosevelt's New Deal, the largest set of populist policies ever implemented in the nation.

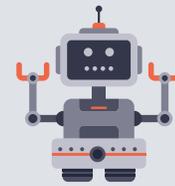
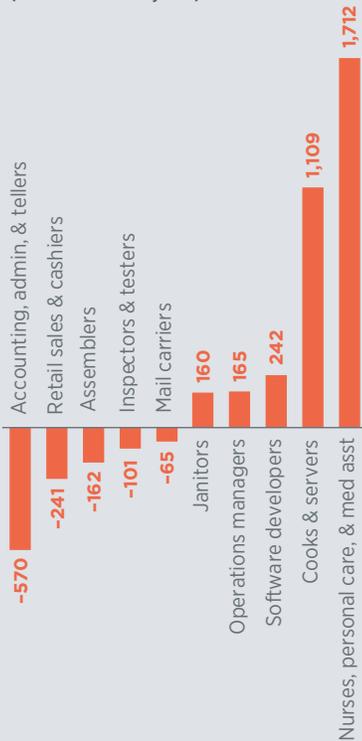


Figure 5

The future of the labor force

Occupations with largest projected gains/declines, 2018–2028 (thousands of jobs).



Sources: Bureau of Labor Statistics, WTIA.

Automation and the workforce: Will robots replace us all?

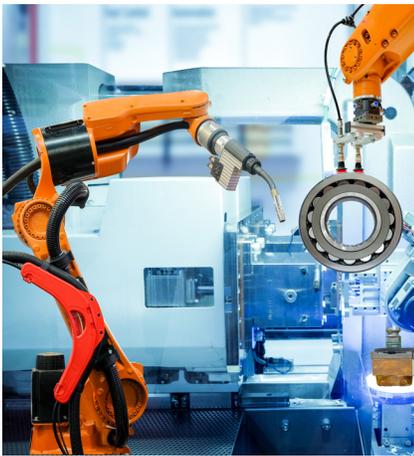
The combination of the words “automation” and “workforce” often conjures images of robots running the world while humans sit idly by on the sidelines. Automation refers to the use of machines to increase the quantity and quality of goods and services produced, while at the same time lowering costs by reducing the number of hours of human labor required to produce those goods and services.

Concerns about machines replacing humans in the workforce have been around for centuries and continue to persist today. However, history suggests the rising use of automation and employment growth overall need not be mutually exclusive. A case in point: Despite the rapid pace of automation in recent decades, nearly 60 million net new jobs have been created in the U.S. since the 1980s computer revolution, according to the Bureau of Labor Statistics. The number of new jobs has more than offset the job losses so far (think of software developers who create applications, or the increased number of transportation jobs created by online retail). This does not change the fact that automation has had and will continue to have a lasting impact on the labor market.

A rising number of jobs will become vulnerable to automation in coming years.⁸ Certain jobs may disappear entirely, particularly those where the bulk of tasks are easily automated because they are “routine” (typically middle-skill, middle-wage jobs).⁹ However, estimates suggest the percentage of jobs that could be fully automated by current technologies is fairly low (0.5% to 5%).¹⁰ The vast majority of jobs will likely see existing job descriptions shift to focus more on “non-routine” tasks, because they are not easily automated and still need to be performed by humans, often in conjunction with technology.

These non-routine jobs typically fall into two categories: high-skill, high-wage jobs involving creativity, abstract thinking, and emotional intelligence; or low-skill, low-wage jobs that require manual work in nonstandard physical settings. As technology evolves, even non-routine job tasks will become more vulnerable. McKinsey estimates approximately 25% of a CEO’s time was spent on tasks that could be automated.¹¹ Progress in fields like artificial intelligence will likely raise such estimates going forward, as machines are better able to learn from data without having to be explicitly programmed (e.g., Amazon, Netflix, or Spotify suggesting “You May Like” recommendations), and able to analyze ever-increasingly complex sets of data.

One of the key impacts of these underlying shifts has been the “polarization” of the labor market. Automation’s elimination of many middle-wage “routine” jobs has forced these workers into jobs at the low or high ends of the skill and wage spectrum. And because more workers tend to migrate to lower-skill job categories rather than to high-skill job categories, income inequality has become one of the key drivers of populism.



Voters across the political spectrum have recoiled at the impacts of automation and outsourcing, morphing the policy proposals of both major parties to resemble “populism of the right” and “populism of the left.”

How does a bill become a law? Hint—first it’s a campaign promise

Populism, an outgrowth of higher productivity, is apparent and has changed the global political landscape significantly, including in the U.S. What would have sounded like fringe views just a few years ago (protectionist tariffs, government-run health insurance, doubling the national minimum wage) have become mainstream.

Voters across the political spectrum have recoiled at the impacts of automation and outsourcing, morphing the policy proposals of both major parties to resemble “populism of the right” and “populism of the left.” The Republican Party, once regarded as the protector of free markets and free trade, has tilted more populist since Donald Trump’s unexpected win in 2016. The Democratic Party, long seen as catering to working class voters, has gone from a single candidate in 2016 supporting a massive increase in the minimum wage and government-run health care, to those being near-prerequisites to candidacy in 2020.

There are several key policies for each party and, believe it or not, some areas of common ground that we believe will be most consequential to investors. In Figure 6, we dimension each policy’s impact and probability of becoming law, with the combination of the two helping to inform our investment view of various industries. For example, we look at a wealth tax such as that being proposed in one form or another by several Democratic candidates. As the name suggests, a wealth tax targets wealth rather than income but can be more difficult to implement than a tax on wages and income, as forms of wealth like artwork or closely held businesses are illiquid and difficult to appraise. Additionally, some candidates are proposing a tax on unrealized gains of financial assets while others are going after the “step-up in basis” enjoyed by heirs of financial assets, all with the goal of reducing wealth inequality.

Assessing the impact of a proposed wealth tax is challenging, particularly as proposals like that of Senator Elizabeth Warren differ from the wealth taxes implemented in other member-countries of the intergovernmental Organization for Economic Co-operation and Development (OECD), which target individuals with a much higher net worth.¹² While this proposal polls well, a full-scale wealth tax is in our view a lower-probability event, though we would not rule out some adjustments to the tax code, including perhaps an increase in the capital gains rate, should a Democrat win in 2020. A capital gains increase could weigh on equity returns broadly, particularly those of small-cap equities, which typically have a higher risk/higher reward payoff structure, and a wealth tax may make equities associated with luxury brands less appealing.

Figure 6

2020 election policy risks

Presidential candidates from both sides of the aisle have embraced populist policies.

We assess the risk and impact of these policies on the economy.

Policy proposal	
<div style="display: flex; align-items: center;"> <div style="writing-mode: vertical-rl; transform: rotate(180deg); font-size: 2em; margin-right: 10px;">Left</div>  </div>	<p>Wealth tax</p> <ul style="list-style-type: none"> High chance A wealth tax would target total wealth (including savings, artwork, and closely held businesses) rather than annual income. Argued to be a more equitable means of distributing wealth, it faces some implementation challenges given the difficulty in accurately valuing many forms of wealth. Low impact We see a fairly high probability of some form of tax increase, though not necessarily a wealth tax. Higher taxes could weigh on equities, broadly, and small-cap and luxury goods companies, more specifically.
	<p>Increase in federal minimum wage</p> <ul style="list-style-type: none"> High chance The federal minimum wage has not increased since 2009, so this will likely garner broad support in a Democratic Congress. Since 1979, the federal minimum wage has increased by 150%, compared to a 274% increase in the Consumer Price Index (CPI). Economic impact is likely to be minimal, as over half of U.S. states already have a minimum wage above the federal level and the Bureau of Labor Statistics estimates that, as of 2017, only 1.3% of all wage and salary workers were paid at or below the federal minimum wage. Low impact Most exposed are retail and leisure and hospitality (restaurants, fast food, hotels) companies, which together employ 65% of all hourly workers earning minimum wage. Discount retail could receive a positive offset from increased spending by lower-income consumers.
<p>Medicare for all</p> <ul style="list-style-type: none"> Low chance A universal, single-payer health system would seek to insure the roughly 28 million uninsured by replacing nearly all private insurance coverage with a public, expanded version of Medicare. There is wide variation in estimates of such a plan's impact on total health expenditures, as well as on the government's bill. High impact Passage looks unlikely but would be a high-impact, negative event for all health care stocks, especially insurers and hospitals. 	

Chance is our view of the likelihood of that policy becoming law should either a Democrat or President Trump win in 2020. Bipartisan policies reflect the risk under either party in the White House.

Impact reflects our view of the impact of this policy on the economy or markets.

Left refers to policies under a Democratic president.

Right refers to policies under a continuation of the Trump administration.

Bipartisan refers to policies at risk under either party.

As of October 3, 2019. Source: WTIA.

Continued



Policy proposal

Antitrust

Medium chance

Investigations into anticompetitive practices by the Big 4 tech companies—Google, Amazon, Facebook, and Apple—garner bipartisan support. A wide range of outcomes is possible for each company, from breaking up one or all of these companies to something more benign such as a fine. The most likely outcome appears to be increased regulation or modest divestitures.

Medium impact

Uncertainty could weigh on the technology and communications services sectors, with specific emphasis on the tech companies mentioned above.

China trade

High chance

Both sides of the aisle are cracking down on China trade practices though with differences on how to extract concessions. The Trump administration has taken issue with the U.S.–China trade balance, while others on both sides of the aisle are focused on intellectual property theft, market access, and subsidies to state-owned enterprises.

High impact

Equity risk sentiment is dependent on trade tensions, while U.S. cyclical and small-cap stocks face an outsized impact. International equities are generally more sensitive to trade developments than U.S. equities.

Drug price reform

Medium chance

When it comes to per capita pharmaceutical spending, the U.S. outspends other major developed countries, in some cases by a factor of 3:1, according to the OECD and The Commonwealth Fund. Prescription drug inflation has tapered off in recent years, but this has become an area of common ground between President Trump and Democrats. Though the end goal may be shared, the methods of getting there vary widely, and we see a medium probability that this issue is addressed regardless of who prevails in the presidential election.

Medium impact

The magnitude of the impact will depend on policy details, but pharmaceutical and biomedical stocks will likely bear the weight of this policy risk through the election.

Right



Tariffs or onshoring

Low chance

While there is bipartisan support for a trade battle with China, there is little support on either side of the aisle for picking fights with other U.S. allies. A second term from President Trump could see unilateral action to address trade deficits with Europe or others.

Low impact

An escalation with other trade partners would be felt by equities broadly and international equities specifically.

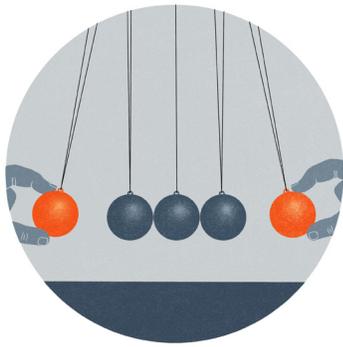
Stricter immigration

Low chance

Developed countries globally are already facing a slowdown in population and labor force growth, one of two key inputs to overall economic growth. Any legislation that meaningfully reduces net immigration into the U.S. could stretch an already-tight labor market and begin to shave tenths off average annual GDP growth, which compounds over time. However, it is possible that immigration reform to increase visas for highly educated or skilled workers could lift the other half of the economic growth equation: productivity.

Low impact

Sweeping immigration reform that dramatically reduces net immigration is still a fairly low probability, with the impacts on equities and fixed income felt more in the long term.



We think it is more appropriate to acknowledge that every time is different, including the current cycle, and we see the greatest threat to the cycle resulting from a unique policy cocktail—one we have not encountered before.

THEME III

Testing the Limits of Policy

As discussed in Theme I, productivity is a long-term tailwind for the economy. Higher productivity can lead to lower inflation, which allows central banks to engage in easier monetary policy and elongates the economic cycle. It also permits a higher long-term structural rate of economic growth. Today, this tailwind is being met head on by policy headwinds of populist sentiment, as described in Theme II, ironically themselves byproducts of innovation. The tailwind causing the headwinds suggest an analogy to a tornado. That may not be a bad way of thinking about what could ensue at some point in the future.

This time—in fact, every time—is different

As productivity is battling against populism for the fate of the economic cycle, the clearest manifestation of that dynamic presents itself in the relationship between monetary policy and trade policy. One reason interest rates are at historic lows in this cycle is the productivity puzzle we describe in Theme I, while trade policy is a response to populist sentiment. Monetary policy and trade policy are taking shape in such a way that makes this cycle very different.

“This time is different.” It’s an oft-used phrase in the investment world, yet one met with intense skepticism, as it is usually meant in the context of investors finding reasons to dismiss what in hindsight were obvious red flags. A perfect example is an inverted yield curve, for which there are many logical reasons why this may not be the prescient recessionary indicator it has been in the past, as we have discussed in *Wilmington Wire* blog posts and elsewhere. We think it is more appropriate to acknowledge that every time is different, including the current cycle, and we see the greatest threat to the cycle resulting from a unique policy cocktail—one we have not encountered before.

A preemptive Fed meets protectionism

Historically, it has been the Fed that has “killed” the economic cycle, albeit out of necessity. An overheated economy would lead to some sort of asset bubble and higher inflation, which would in turn force the Fed to raise rates to protect the price stability pillar of its policy mandate (the other pillar being maximum employment). In the past, the Fed has blown through the stop sign that is an inverted yield curve. But this time is different, in a good way. While we saw key portions of the yield curve invert in 2019 (the 10-year Treasury yield exceeded the 3-month yield in March 2019 and the 2-year yield in August of the same year), for the first time, the Fed began cutting rates before the 10-year/2-year inversion, potentially preempting a more severe slowdown. Even if the economy manages to reaccelerate, it is hard to see the Fed shifting back toward a tightening bias in the near future. This more proactive, cautious Fed, heeding the warning that prior central bankers ignored, is a positive for the U.S. economy’s chances of avoiding a recession in the near term.

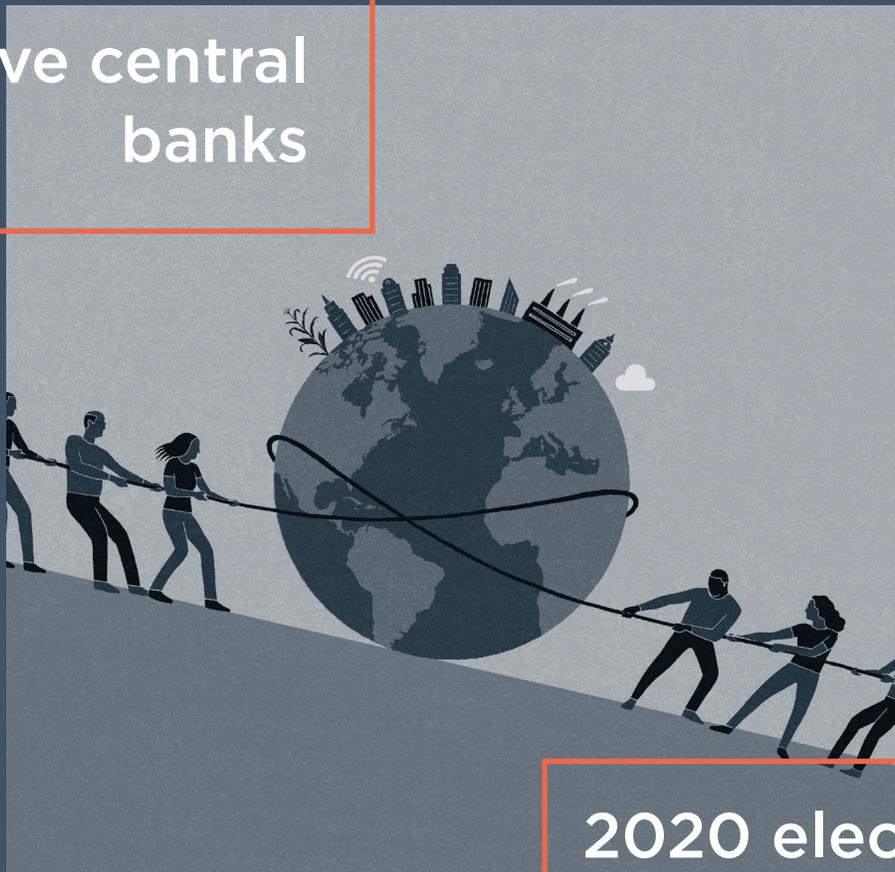
Increasing productivity

Strong consumer

Robust labor market

} positive

Supportive central banks



2020 election risks

Trade uncertainty

negative }

Understanding that the trade negotiations are a two-way street, the reality is President Trump has the ability to either remove tariffs and give the economy a boost into the upcoming election or drive it right off the proverbial cliff.

The Fed's dovish position has echoes across the globe, with global central banks collectively pushing the easiest monetary policy we have seen since 2012 (Figure 7). The tide began to turn in 2019, and we expect that 2020 will be another year of global central bank easing. Along with the Fed, international counterparts including the European Central Bank, Bank of Japan, and People's Bank of China, all seem fairly entrenched in accommodative monetary policy, such as cutting rates or restarting quantitative easing (i.e., purchasing financial assets), and we have little expectation of a broad reversal toward tighter policy over the next 12 months.

Trade takes center stage

Despite the supportive stance of central banks, policymakers are being tested by a new kind of U.S. trade policy that we have not seen to this extent in 90 years: protectionism. We remain politically neutral and will not take a position on the question of whether President Trump's true intention is protectionism or even if his is a noble fight worth the sacrifice of the U.S. economy. Objectively, it is also difficult to measure exactly how much the trade war is weighing on the global economy, though we believe there is sufficient evidence to attribute the 2019 global manufacturing recession in large part to the higher tariffs and the uncertainty regarding future trade relationships. Those arguments aside, we find it significant that the U.S.-China trade fight puts the president in the driver's seat of the economy much more than his predecessors. Understanding that the trade negotiations are a two-way street, the reality is President Trump has the ability to either remove tariffs and give the economy a boost into the upcoming election or drive it right off the proverbial cliff. The risks around the trade war are binary, unpredictable, and extremely high impact.

In this sense, it is a trade policy (as opposed to a monetary policy) misstep that poses the most imminent threat to the current cycle. And despite the Fed's desires to support the current expansion, there are two key reasons why we are concerned that it simply lacks the tools to counter trade-induced headwinds should a resolution continue to evade U.S. and Chinese trade delegations.

1) Interest rates are already so low (the 30-year Treasury yield hit a record low in August 2019), and funding costs are not likely the reason for either the pause in capital expenditures (capex) or deterioration in manufacturing activity. Instead, it seems pretty clear to us that CEOs are pushing the pause button because the goal posts keep moving and the rules of the game keep changing. The Fed can lower rates all it wants; as long as uncertainty remains around the trade terms with key nodes of a company's supply chain, companies will be hesitant to invest.

2) Even though global central banks are definitely in easing mode, they are starting from a much weaker position than in prior recessions (Figure 8). We should not assume that central banks have no ability to react to the next downturn (after all, hardly anyone back in 2007 envisioned quantitative easing or negative interest rates), but the \$16 trillion in negative-yielding debt globally is a nagging reminder that today there are fewer conventional tools at their disposal.

Figure 7

A global shift toward monetary policy easing

Capital Economics Global Central Bank Diffusion Index

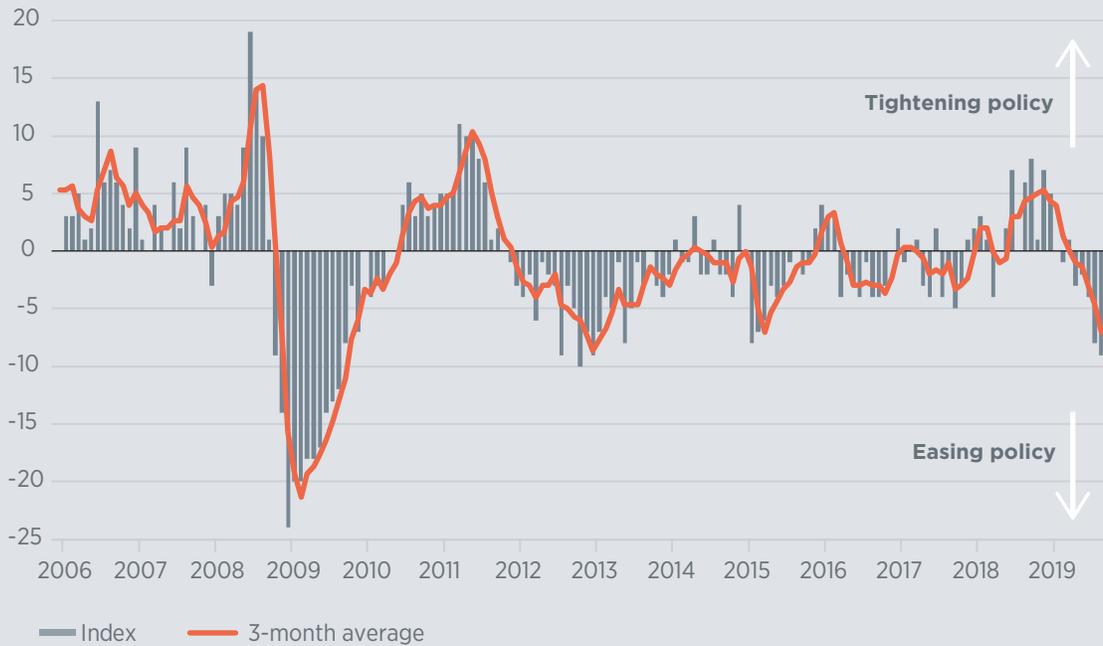
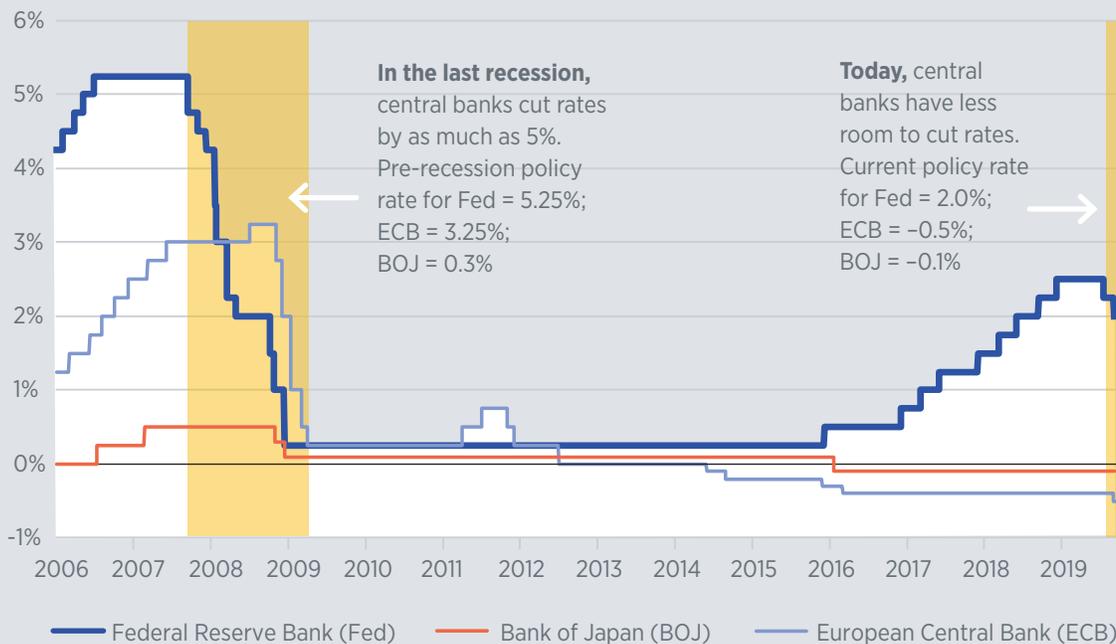


Figure 8

Less room for policy easing this time around

Central bank main policy rates



As of September 19, 2019.

Source: Macrobond.

Glass half full—so what's the good news?

This time is also different in another positive way, which is that we do not see signs of financial bubbles among any of the usual suspects: consumer balance sheets are in good shape, home prices only just surpassed the prior cycle's peak in 2018, and low interest rates pose little threat to corporate debt levels (though this is one area that gives us pause). Valuations for stocks are not overly expensive, though some areas of the bond market appear quite rich. So, while the economic cycle this time around may be more apt to end as the result of a policy miscalculation rather than endogenous causes, we expect that any eventual recession will look very different from the most recent one. We believe that a recession occurring in the next few years is likely to be shallower and led by a pullback in capex, rather than consumer spending. This does not mean the pain will not be felt by financial markets—only that we would expect the economic contraction and market disruption to be relatively mild and short-lived.



How might this year's forecast affect you, your business, and your portfolio? Watch some of our senior leaders discuss the potential impacts at www.wilmingtontrust.com/cm.

Looking ahead

Ultimately, politics and the 2020 U.S. presidential election are of critical importance in the direction of policy, populism, and ultimately, portfolios. Always difficult to handicap but essential to understand, we expect policy to continue to play a particularly important role in the direction of the economic cycle. While the equity market, as measured by the S&P 500, has performed well since President Trump was elected, it has also seen its share of tumult. The market has performed well when influenced by pro-growth policies and suffered from the impacts of restrictive populist policies. Our base case is for enduring economic growth and solid market returns so long as capex and productivity are allowed to flourish. At the same time, populist policies from either side of the aisle could be enough to stop capital investment and consumer spending in their tracks, potentially inducing a recession.

Currently, trade policy is the greatest near-term risk to the economic cycle and one that could outweigh any resurgence in productivity or even a very accommodative Fed. As it relates to trade, it is certainly in the best interest of the administration to avoid a recession or even prolonged slowdown in 2020 and thus, we believe trade principles will ultimately be put aside for self-preservation. However, the U.S. economy is more like a tanker than a speed boat. It cannot be turned on a dime, and the room for error decreases should GDP growth move below the 1.5%–2% range. The economy is also vulnerable to human psychology, and we cannot rule out the possibility that we “talk ourselves into” a recession. As a result, we must stay nimble and avoid the temptation to position ahead of binary policy risks. We advise maintaining a balanced posture in portfolios, including adequate fixed income exposure, hedge funds, and even cash, but not shunning risk assets just yet. An alleviation of trade tensions could still come swiftly and without much warning and would likely usher in another few innings for the current economic cycle.

Endnotes

- ¹ R.M. Solow, "We'd Better Watch Out," *New York Times Book Review*, July 12, 1987, p. 36.
- ² Longitudinal Business Database and Deutsche Bank Global Research, 2019.
- ³ Herfindahl-Hirschman Index, 2019.
- ⁴ "Measuring the value of search," McKinsey & Company, 2011.
- ⁵ "Using massive online choice experiments to measure changes in well-being," *Proceedings of the National Academy of Sciences of the United States of America*, Vol. 116, No. 15, Erik Brynjolfsson,^{A,B} Avinash Collis,^A and Felix Eggers^C (^A Massachusetts Institute of Technology, ^B National Bureau of Economic Research, and ^C Faculty of Economics and Business, University of Groningen, The Netherlands), April 9, 2019.
- ⁶ It's also worth mentioning a less-celebrated point, that the innovation by Ford was disruptive to the industry, reducing the number of auto manufacturers from 253 in 1908 to just 44 in 1929, eliminating jobs at other firms across the country and concentrating newer, lower-skilled positions in a handful of employers. The parallels to Amazon and "Mom and Pop shops" in the retail industry today are striking.
- ⁷ Global Wealth Inequality," *Annual Review of Economics*, Vol. 11, Gabriel Zucman, University of California at Berkeley, February 7, 2019.
- ⁸ The Brookings Institute estimates that by 2030, approximately 25% of U.S. jobs in existence as of 2016 will face high exposure to automation, while 36% will experience medium exposure, and 39% will have low exposure.
- ⁹ Acemoglu and Autor (2011), Foote and Ryan (2014), Jaimovich and Siu (2018).
- ¹⁰ Metropolitan Policy Program at Brookings, "Automation and Artificial Intelligence: How machines are affecting people and places," 2019. McKinsey Global Institute, "AI, automation, and the future of work: Ten things to solve for," 2018.
- ¹¹ <https://hbr.org/2017/02/25-percent-of-ceos-time-is-spent-on-tasks-machines-could-do>.
- ¹² According to the OECD, as of 2018, there were only four countries collecting revenues from wealth taxes—Belgium, Norway, Spain, and Switzerland— with this number having declined from 14 countries back in 1995. The Tax Foundation includes the Netherlands and Italy as also utilizing forms of a net wealth tax.

Photo credit: Ruby slippers on page 7 from "The Wizard of Oz." Loew's, Incorporated, 1939.

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