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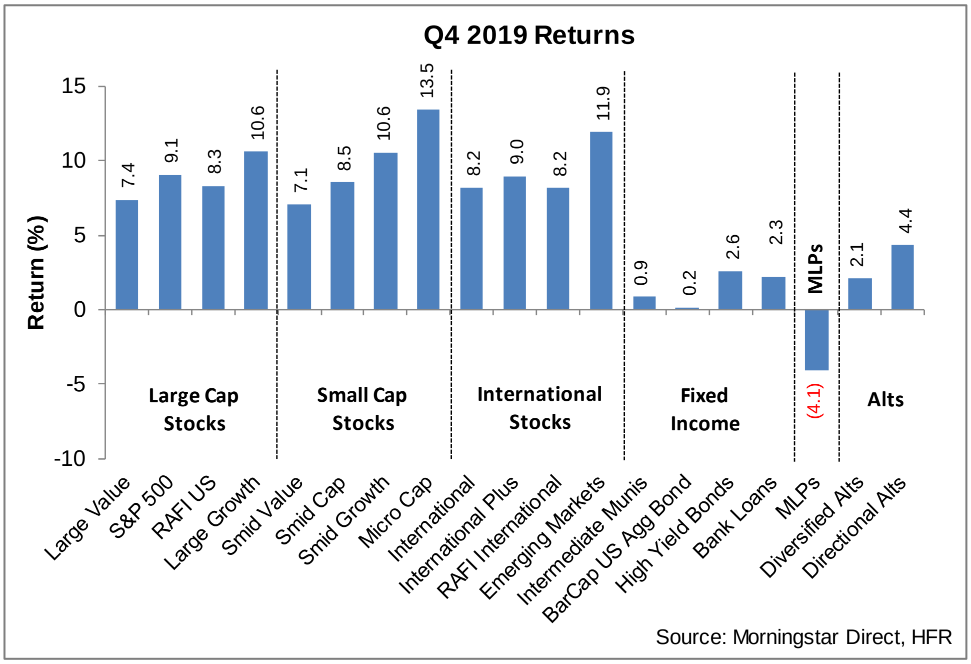
Fourth Quarter 2019 Investment Review & Outlook



EXECUTIVE SUMMARY

Q4 2019 Recap:

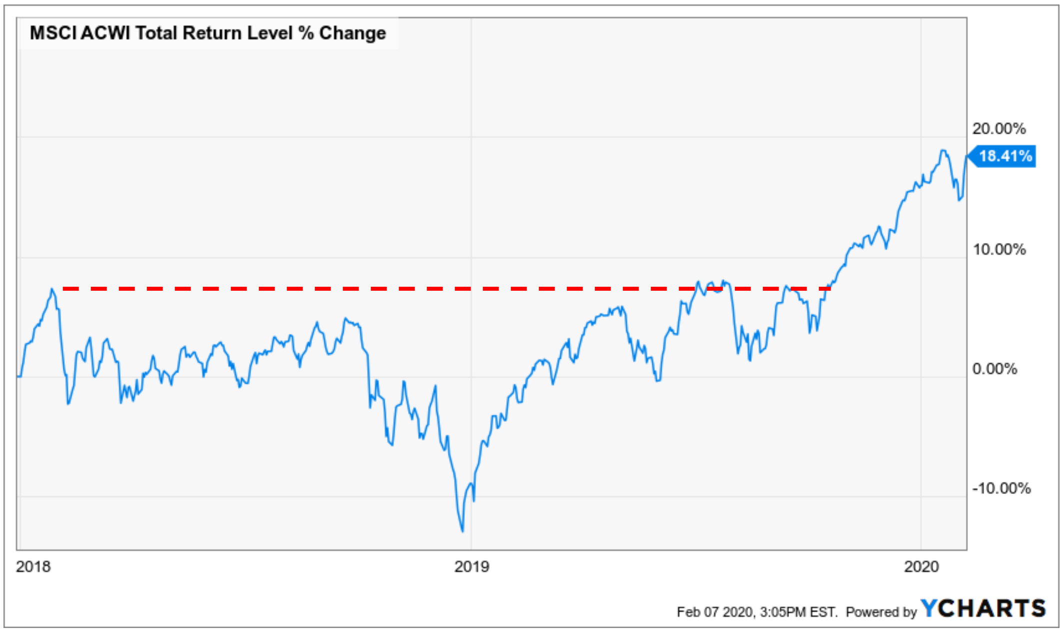
- Global stocks took off in the fourth quarter following a sluggish middle portion of the year. This drove markets to all-time highs and one of the best calendar year gains we have seen in 20 years
- The rally in Treasury yields cooled a bit in the fourth quarter, but this year's overall move lower was enough to push the Barclays US Aggregate Bond index to its best return since 2002
- Technology led all sectors with an incredible 50% (!!!) gain for the year, fueled by large constituents like Apple (+89%) and Microsoft (+58%)

NEXT Outlook:

- Many of the headline risk factors – namely the Fed and the US-China trade dispute – appear off the table for the moment. This has allowed the market to regain its momentum until the next risk factor comes into focus (US election this fall?)
- After a year of no earnings growth and large gains in the market, stocks are no longer cheap as they currently trade at 18x price-to-earnings. The market needs earnings growth to come through to drive the market higher from here

To Our Clients and Friends,

What a year! 2019 proved to be an exceptional period for both stock and bond markets. The S&P 500 exceeded 30% for just the 2nd time in the past 20 years, while the Barclays US Aggregate Bond index return of 8.7% was its best since 2002. Markets marched higher despite a relatively negative stream of data and headlines. Most notably: the global economy slowed, corporate profit growth was non-existent, and the specter of a trade war between the US and China hurt confidence and investment throughout the year.

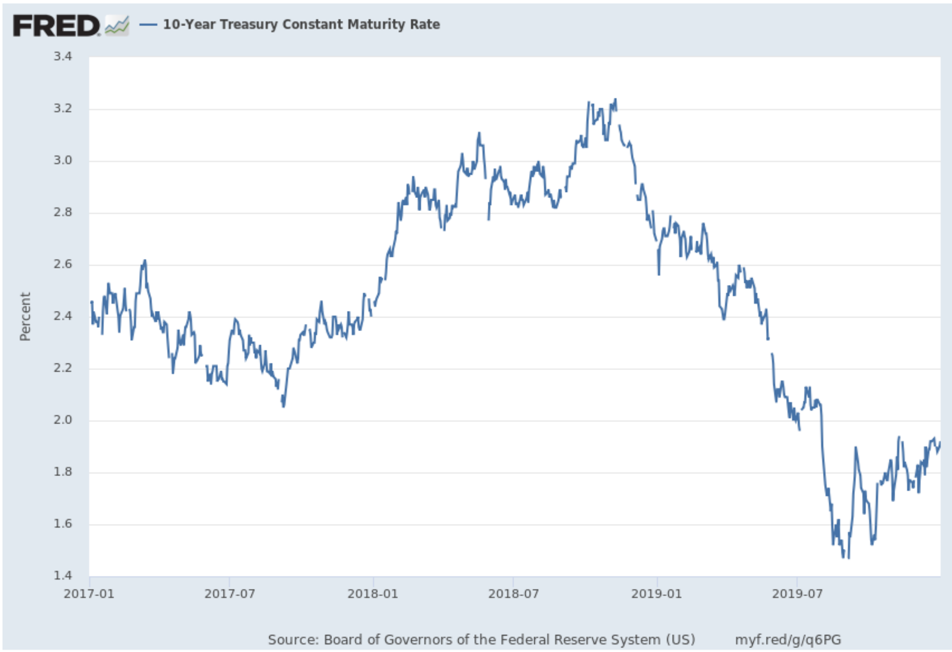


Of course, stock markets are forward-looking and many of those issues were priced into performance in the previous year. The global stock market fell nearly 20% at one point during the fourth quarter of 2018, only to recoup most of those losses in early 2019. By the end of April, the S&P 500 was up 18.3% on the year and had regained the all-time highs last set in 2018.

The Federal Reserve played a big role in this performance. After hiking short term interest rates seven times in 2017 and 2018, investors were concerned that the restrictive policy would choke off economic growth. In early 2019, however, Fed Chairman Jerome Powell made it clear to markets that the central bank would take on a more accommodative stance (and, indeed, they delivered on this promise by cutting rates three times and ending efforts to shrink their balance sheet). This dramatically improved investor sentiment and fueled a large part of the market rally in the early part of the year.

2019's outstanding performance did not occur in a straight line, however, as the US-China Trade War took a few unexpected turns during the year. In May, a widely expected deal between the two countries fell apart and tensions intensified sharply. Over the proceeding months, President Trump and China jousted back and forth with escalating tariff increases on each other's exports. Between April and the September, the stock market failed to gain any ground, chopping sideways and struggling to break higher.

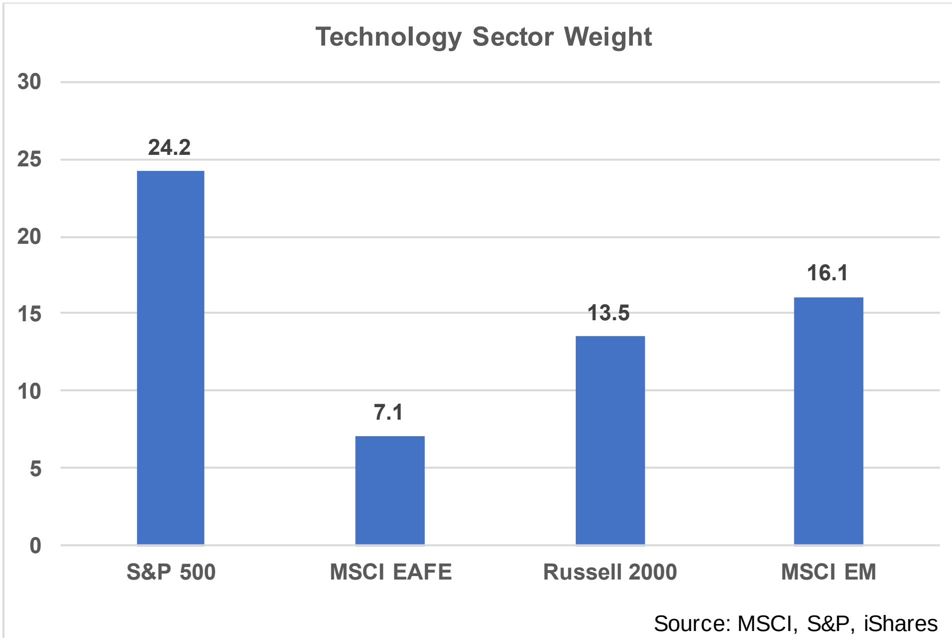
In October, those tensions appeared to thaw as the US announced a "Phase 1" deal with China and delayed tariff increases set to take place that month. With both the Fed and China Trade issues seemingly resolved, financial markets finally appeared to fully embrace a "risk on" mentality. Stock markets rallied, unabated, through the rest of the year – nearly reaching double digit performance in the fourth quarter alone. Meanwhile, the bond market – which up until the fourth quarter had sent conflicting signals with the stock market – finally softened, as interest rates backed up approximately 0.50% in the final months of the year.



Market Review

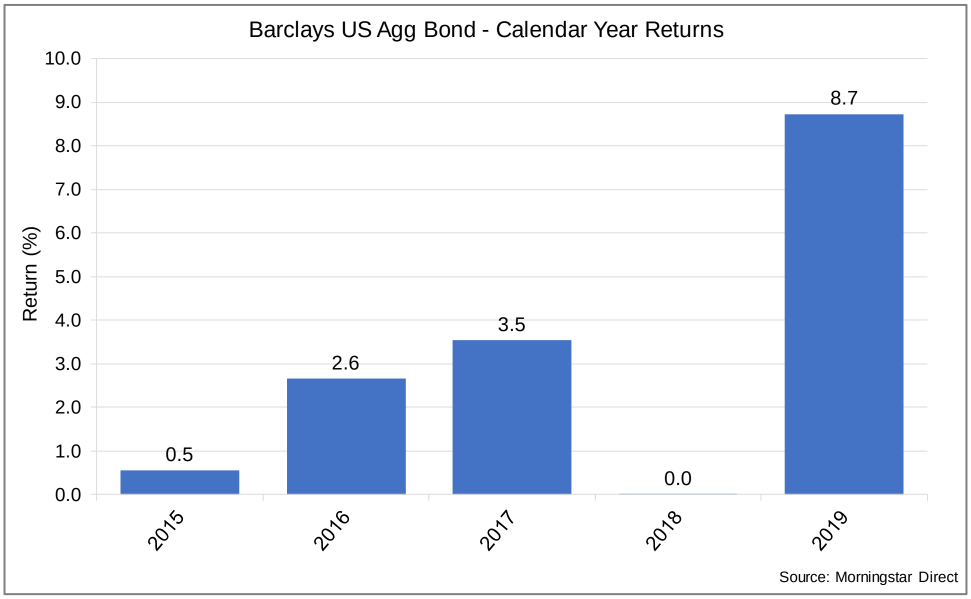
US large cap stocks led performance for the quarter and the year relative to other markets. In the fourth quarter, the S&P 500 rose 9.1% to bring full 2019 returns to 31.5%. While the market broadly did well, technology stocks were the clear outlier, rising an astounding 50.3% for the year! That is not a typo. Large constituents like Apple (+89%) and Microsoft (+58%) experienced phenomenal gains to boost the sector and the headline index higher.

When examining other markets, the performance of the technology sector was a key factor. One would normally expect riskier segments like small caps and emerging markets to outperform in a year of such large stock market gains. However, small cap stocks and foreign markets maintain a much lower allocation to the technology sector and thus were unable to keep up with the S&P. A similar impact was seen between growth and value stocks, with the former outperforming by more than 10% for the year.



In a vacuum, foreign markets had a strong year – developed international and emerging markets rose 23% and 19%, respectively. With just 7% in technology stocks and the shadow of Brexit hanging over it, however, the European markets struggled to keep up with the US. Likewise, in Asia the US-China Trade War caused a constant seesawing in the Chinese equity market. For the year, Chinese equities – which now make up 32% of the index – rose 24%. Unlike prior years, currency was not a big factor in international market performance as the dollar was relatively stable relative to the rest of the world.

While it captured fewer headlines than the stock market, bond markets also posted a stellar year as we noted in our intro. High quality bonds, represented by the Barclays US Aggregate Bond index, gained 8.7% on the year. This was highly unusual given the performance of the equity markets: typically when stocks rise sharply, investors are shedding safe assets to buy riskier ones. That activity weighs on bond performance and causes longer dated interest rates to rise. Instead, we saw Treasury yields decline sharply between November 2018 and October 2019. The yield on the 10-year Treasury, for example, fell 1.75% during that time period – or more than half of its prevailing yield at the start of the time period. In the bond world, that is a very significant move and it caused bonds prices to increase sharply.



We caution investors to not extrapolate this level of performance going forward. As you can see in the chart above, low single digit performance is more typical of a quality bond portfolio. Historically, a bond's yield to maturity is a very strong indicator of its forward-looking return. At just over 2% taxable today, the outlook for traditional bonds is underwhelming. The performance of 2019 is simply not repeatable, absent intermediate-term interest rates moving to zero.

Other segments of the fixed income markets also performed well. High yield credit and bank loans – both below investment grade corporate debt – posted double digit gains for the year. The former rose more than 14% due to its interest rate sensitivity. In the municipal markets, non-investment grade municipal bonds rose 10.7%. That market has seen spreads tighten sharply as municipal debt has seen increased demand in a post-SALT tax environment. We observe that bond prices appear rich across the board these days – in both investment grade and non-investment grade areas. We continue to be selective and opportunistic within the asset class for client portfolios, but there is no question fixed income will be a challenging space to make money in the years ahead.

Finally, the non-traditional sectors posted positive performance, although it was hard to compete with the sharp moves observed in the traditional equity and bond markets. Diversified hedge fund strategies, which maintain a much lower sensitivity to equities and interest rates, finished the year up 8%. Directional hedge funds rose just under 14%. Energy infrastructure stocks, represented by the Alerian MLP index, rose 6.6% for the year (and were one of only a few asset classes to lose money in the fourth quarter). We continue to see negative sentiment surrounding the energy complex, as the S&P 500 energy sector was the worst performing area of the market, underperforming the broader index by nearly 20%.

Outlook

Despite being just one month into the year, 2020 has already been quite eventful. We have witnessed a shocking US military strike on a powerful Iranian general, the impeachment of the US President, and a new virus spreading across the globe causing fears of a pandemic. It's a testament to the strength of this market that it has largely taken these events in stride. January finished the month flat, but stocks have since rebounded and are up several points on the year already. It feels as though there is powerful momentum in this market at the moment and it is not clear what it will take to disrupt it.

Some may be questioning whether it's time to take some chips off the table after such a sensational year. No one has a crystal ball when predicting the market, but we do make a few observations:

- Last year's return was substantial, but we must also remember a large portion of those returns were simply digging us out of the 2018 hole. Until we broke back through all-time highs in early October, the global stock market had produced virtually no return in the prior 20 months.
- The track record for stocks in the year following 20%+ gains has been a positive one, historically. In the 26 prior such instances for the S&P 500, the average return was 13% and markets declined in just five of those years.[1]
- Economic and corporate data appear to be troughing after a flat to sluggish 2018. The overhang of the US-China Trade War has, at least for the moment, eased, while the Federal Reserve remains squarely in an accommodative mode. Corporate earnings also will no longer be subject to comparison against 2018 figures (earnings are reported on a year-over-year basis), which were inflated due to the corporate tax cut.

When reviewing the summary of 2019 market performance, it is clear that headline macro factors had an outsized influence. While the Presidential election this fall may have its own say about performance this year, one thing is clear to us: corporate earnings need to get back on track for this rally to continue. Market sentiment alone is not enough to push the markets to another significant gain. Since the market rose 30% last year with zero earnings growth, the price of stocks has become modestly expensive at 18x price-to-earnings. The denominator in that ratio, earnings, must increase lest stocks trade north of 20x. Those levels were last seen during the tech bubble of the late 1990s, which ultimately proved to be a precarious time for stock markets.

Regarding the Presidential election, it is still too early to say exactly who will emerge from the democratic party and what the potential implications are for the stock markets. At this stage we will re-emphasize what we have said in the past: the biggest (short-term) threat to the markets will be if the corporate tax cut is overturned. That would most likely take a Democratic sweep across the House, Senate, and Presidency. Thus, Senate elections may prove to be more important than who is sitting in the White House one year from now (from that narrow perspective).

Finally, given its recent dominance of headlines, we make the following observations about the Coronavirus. The history of previous epidemics like SARS, Swine Flu, etc. has been a small momentary blip for stock markets followed by a swift recovery. While the humanitarian aspect of these episodes is tragic, the economic damage tends to be fleeting. There is always the possibility of such issues deepening in a way that we have not previously seen, but at this juncture we do not recommend any change in investment strategy.

As always, if you feel your personal financial situation has changed or you would like to revisit your asset allocation, please do not hesitate to call or visit our offices.

Kindest regards,

[1] Source: SunTrust

Your Investment Team
2/5/2020

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