

## Economic & Market Commentary

What a difference a year makes! Unlike last year, there was no lump of coal in investors' stockings in 2019. Instead most got a pot of gold. It was a difficult year to lose money, as virtually all asset classes ended the year with a profit - a total reversal from 2018 when the Grinch left investors with a big lump of coal. In fact, 2019 was the only year going back to 1984, where the S&P 500, the 10-year Treasury Note, crude oil, and gold all rose by 10% or more, as the Federal Reserve Board's pivot at the end of January triggered the rally.<sup>1</sup> Equities were the biggest winners as the Dow Jones Industrials and the S&P 5000 posted total returns of 25.3% and 31.5%, respectively for the full year. It was the best year for U.S. stocks since 2013, after they registered their lone down year of the decade in 2018.<sup>2</sup> Globally 76% of the 73 countries monitored by The Wall Street Journal also produced positive returns, although the U.S. bettered most foreign markets.<sup>3</sup> Bonds surprised investors by producing another year of good returns. The yield on the 10-year Treasury started the year at 2.68% before ending at 1.91%, generating a solid total return. Bond returns were 3% - 16%, depending on the bond sector and maturity.<sup>4</sup>

Contrary to long-term historical returns, over the last decade large-cap stocks did better than small and mid-cap issues, and growth stocks did better than value stocks.<sup>5</sup> In our last quarterly Commentary, we discussed that the character of the market was beginning to shift, as value stocks began to show renewed signs of life and outperformance. This trend was noticeable in the final months of the year, which was a benefit for our clients' portfolios. A broadening was evident by the fact that 90% of the S&P 500 stocks were up for the year.<sup>6</sup> Continuation of this trend would validate the importance of the economic fundamentals, which drive our investment process. In spite of a broadening of positive returns, only three of the eleven sectors monitored by the Standard and Poor's outpaced the index's return for the year. Technology, Communication Services and Financials all did better than the S&P 500, with Industrials closely behind.<sup>7</sup> These sectors contain very large capitalization issues, which heavily weight the index. A more extreme example of this phenomenon are the FAANGs (Facebook, Apple, Amazon, Netflix, Google and Microsoft), which have been a dominant influence of past performance and were again last year. Four of the five FAANG issues significantly outperformed the index, accounting for close to 30% of the S&P 500's performance, in both the quarter and the year.<sup>8</sup> Energy, once again, was the poorest performing sector, in spite of the fact that the price of oil increased close to 50% during the year.<sup>9</sup>

As we enter a new decade, most asset classes are expensive based upon historical metrics. Bonds have been so for the past several years. Interest rates are well below where most economists would put them under "normal" circumstances. The rule of thumb is the 10-year Treasury should reflect a combination of real economic growth plus inflation, or close to nominal growth. That would indicate the 10-year yield should be in the 3% - 4% range, well above its current 1.8% yield.<sup>10</sup> However, today's consensus wisdom is for rates to remain low for some time and therefore bond prices to remain expensive. Likewise, equities are in expensive territory. After a +30% year, the S&P 500 is trading at a valuation close to 19x estimated 2020 earnings.<sup>11</sup>

At this level, the majority of investors believe stocks are expensive against most valuation measures. Barron's recently published a table showing the S&P 500 is expensive to very expensive against all commonly used valuation metrics, except bonds (interest rates), and we know they are not cheap!<sup>12</sup> The S&P 500 ended the year up more than 31%, this was about 10% above the prior high made in October 2018.<sup>13</sup> While this may not sound extreme, it is important to note that many investors thought the prior market high was richly valued, and the stock market's significant increase in 2019 was mostly generated by P/E expansion (psychological factors), as 2019's earnings are expected to be about flat with 2018. The same was true across the globe, as The Wall Street Journal concluded that 90% of global stock market gains were from P/E expansion.<sup>14</sup> So, the psychological determinants of valuation have been dominant.

Last year, markets were able to absorb geopolitical developments in stride as underlying economic fundamentals remained healthy. Investors withstood a myriad of potential risks, including; fear of recession, Brexit, China trade problems, impeachment proceedings, and the Democratic contestation for the upcoming election. All of these factors were ignored, and markets reached new highs. In addition, recent tensions with Iran went from an incendiary issue to a non-issue over a very short time period.

Today economic fundamentals are reasonably healthy. We ended 2019 with U.S. Real GDP growth of close to 2%, inflation a non-issue, interest rates low, job and wage growth on the upswing, and global growth looking like it was bottoming and ready for an upturn.<sup>15</sup> For the coming year, we remain in the 2% growth camp that we have been in for the past several years. The pace could be choppy as estimates of the Boeing 737 Max problems could shave as much as 0.5% point off early quarter GDP reports.<sup>16</sup> The U.S. consumer is in decent shape, with unemployment low, wages beginning to grow, balance sheets in a strong position, and confidence okay. Corporations, who had their hands in their pockets last year, due to trade and other geopolitical uncertainties, should loosen and lead to improved capital spending. Corporate earnings are expected to grow this year, getting out of last year's rut. The consensus has S&P 500 earnings growing 10%, which is probably high. Over the last decade, earnings ended lower than original forecasts in all but one year, as analysts tend to be overly optimistic. In addition, in a 2% world, with wages increasing and corporate share repurchasing receding, 10% seems too high to us. We are currently in the year-end earnings reporting season, so it will be interesting to see what companies report, and what managements say about prospects. This could well determine the direction of stock prices over the near term.

Thus, we are presented a picture where valuation is extended, psychology is complacent, risks are not given much heed and stocks keep making new highs. The economic fundamentals are in good health, but hardly robust, earnings growth expectations may be too high, and risks have increased.<sup>17</sup> Brexit and China are still unresolved, impeachment is in the air, North Korea and Iran are potential hot spots, and then we have a U.S. presidential election where both sides represent gross departures from the norm, and some would say are dangers to our liberal democratic system. This picture could lead one to conclude that the next 12 months will be a lumpy period at best.

There is a final factor that is an important ingredient in this equation - that is liquidity. We believe there is a lot of liquidity around globally in search of return. We have written about this before, and last time said, “the availability of liquidity searching for return has “trumped” the many risks.” This factor is still key and in fact has perhaps become more so. Virtually all global central banks have their foot on the gas pedal and, while negative yielding global debt has declined from a peak of about \$17 trillion to about \$11 trillion, it still is indicative of loose policy.<sup>18</sup> Our own Federal Reserve reversed course early last year from a tightening bias to a loosening one and cut the Federal Funds rate three times in 2019. Statements since then have indicated a continued bias to keep rates low. In addition, the Fed has:

- Pumped about \$20 billion into the market through repurchase agreements to prevent disruptions in daily money markets.
- Expanded its balance sheet by \$400 billion in four months, bringing it back to \$4.1 trillion from \$3.7 trillion in September (so much for quantitatively tightening).

Other factors that add to the excess liquidity are:

- Individual and institutional investors have taken money out of equities over the course of the year. While they put some back into equities during the fourth quarter, there still is a load of cash on the sidelines. Money market funds are at a level close to where they were in 2009.
- Dividend payments made by the entire U.S. stock market are estimated to reach \$663 billion in 2019 a new record. Further gains are expected this year.
- Cash on the sidelines in venture capital funds (\$276 billion), private equity funds (\$772 billion) and real estate funds (\$333 billion) is estimated to be at record levels as well.
- Finally, Strategas Securities estimates that money supply has been growing at a recent rate of 10.2%, which is significantly faster than what is needed to support the nominal growth in the economy.<sup>19</sup>

All these factors lead us to conclude that there still is excess liquidity in the system, and when there is excess it generally flows to the best returning market. All things being equal (and they never are), this should allow equities to work higher over the near term. We do not expect returns matching last year, but rather expect single digit returns. We also expect volatility to be high as some of the aforementioned risks play out. Clearly the caution light is on, but until we see signs of either deteriorating economic fundamentals and/or diminishing liquidity, we think staying the course is the best thing.

## Fixed Income

Fixed income securities had an exceptionally positive year. The Bloomberg Barclays U.S. Aggregate Bond Index is considered a good representation of a broad sector of investment grade corporate bonds, Treasuries, and government agencies. This index had a total return of 8.72% for 2019.<sup>20</sup> For comparison, in 2018, the index was up .01%. For the fourth quarter the Index returned a modest .18%.<sup>21</sup>

Lower interest rates and tightening credit spreads were the main drivers in the bond market rally. The market value of fixed income securities rise as interest rates decline. The 10-year U.S. Treasury ended the year with a yield of 1.91%. One year ago (12/31/2018), the 10-year closed at 2.68%.<sup>22</sup> The yield curve, as measured from the 2-year Treasury to the 10-year Treasury, steepened 15 bps from the end of 2018.<sup>23</sup> The rising tide of this rally affected all types of fixed income securities, such as Treasuries, government agencies, U.S. corporates and asset backed securities. The longer the maturity the greater was the return, which reflects greater price sensitivity to changes in interest rates.

Tightening credit spreads also contributed to much of the strong fixed income performance in 2019. Corporate credit problems were quite rare in 2019. Corporate bond spreads to Treasuries contracted in 2019,<sup>24</sup> contributing strong overall price performance in the asset class. Nearly every fixed income sector had strong returns for the year.<sup>25</sup> We believe investors were willing to take on more risk, and therefore spreads tightened across all asset classes for the year as investors reached for yield.

One of the primary reasons for lower interest rates was the Federal Reserve's monetary policy. The Federal Reserve uses a variety of tools to implement its monetary policy. One of these tools is setting the Federal Funds target rate. The Federal Funds rate is the rate that banks charge other banks for lending them money. This overnight rate is the starting point of the yield curve. The Federal Open Market Committee (FOMC), meets eight times a year to set the Federal Funds rate. The decision to raise, lower or maintain this rate is based on key economic data the Fed uses to measure the overall health of the economy. The current Federal Funds rate target range is set at 1.50% to 1.75%. The FOMC lowered this rate by 25 basis points (a quarter of a percentage point) three times in 2019.<sup>26</sup> This rate influences all fixed income securities and lowering it three times increased the market values of fixed income securities; the entire yield curve fell as measured from the Federal Funds overnight yield to 30-year maturities.<sup>27</sup>

The three Federal Fund rate cuts were part of the "midcycle adjustment" made by the Federal Reserve as it pivoted four times during 2019. The Federal Reserve entered the year with a raising bias, then pivoted to a pause in rates. The Federal Reserve then pivoted to lowering rates and closed the year pivoting to neutral. Federal Reserve Chairman Jerome Powell indicated that the Fed was not considering raising interest rates in the final quarter of 2019, and not inclined for the foreseeable future.<sup>28</sup>

We believe heightened fears of a recession inverted the yield curve in the second and third quarters of 2019. In our opinion this fear was primarily due to the escalation of the U.S. – China trade war, Brexit, impeachment proceedings, and weaker global growth. An inversion is when yields on shorter maturity Treasuries are higher than yields on longer maturity Treasuries. The inversion between two and ten-year Treasuries has been used historically to predict future economic recessions. Judging by the inverted yield curve in the second and third quarter, the heightened fear of recession peaked in August and dissipated. The yield curve normalized in the fourth quarter and steepened to 34 bps at the close of December.

As we enter 2020, we anticipate rates to be subdued, and returns to be modest in most fixed income asset classes. We believe the Federal Reserve is likely to remain neutral to accommodative in its monetary policy, which should keep rates low. We continue to favor higher-rated corporate bonds, agencies and intermediate-duration Treasuries. For our taxable clients, we anticipate state and municipal revenues will continue to grow, providing investors with stronger credit attributes and attractive after-tax returns in the municipal bond market.

<sup>1</sup>Wall Street Journal (WSJ)

<sup>2</sup>Bloomberg

<sup>3</sup>WSJ 1/2/20

<sup>4</sup>Bloomberg

<sup>5</sup>WSJ

<sup>6</sup>Bloomberg

<sup>7</sup>Bloomberg

<sup>8</sup>Bloomberg

<sup>9</sup>Bloomberg

<sup>10</sup>Bloomberg

<sup>11</sup>Bloomberg

<sup>12</sup>Barron's 1/13/20

<sup>13</sup>Bloomberg

<sup>14</sup>WSJ

<sup>15</sup>BEA.Gov

<sup>16</sup>GDP

<sup>17</sup>Bloomberg

<sup>18</sup>[www.federalreserve.gov](http://www.federalreserve.gov)

<sup>19</sup>Barron's

<sup>20</sup>Bloomberg

<sup>21</sup>Bloomberg

<sup>22</sup>Bloomberg

<sup>23</sup>Bloomberg

<sup>24</sup>Bloomberg

<sup>25</sup>Raymond James

<sup>26</sup>Federal Reserve Bank

<sup>27</sup>Bloomberg

<sup>28</sup>Federal Reserve Bank