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Fourth Quarter 2019 Market Summary

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Fourth Quarter 2019 Market Summary

If you waited to review your portfolio's performance until year-end, you might be surprised by the exceptionally good returns over the past year. All asset classes ended 2019 with above-average returns, which is a stark contrast to 2018, where most asset classes had negative performance.

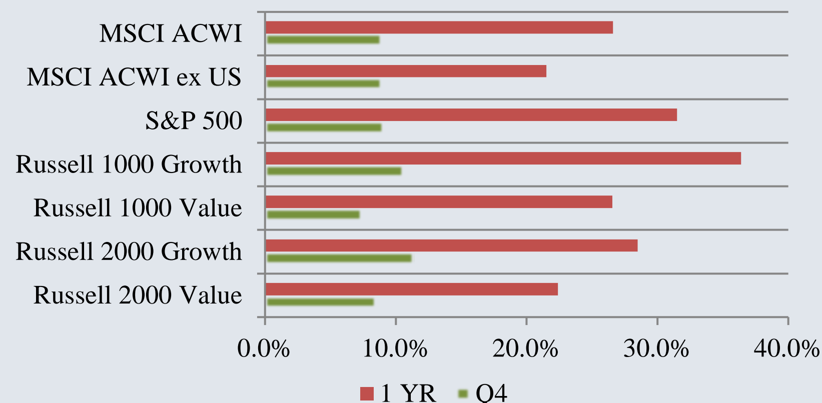
Coming off of a challenging end to 2018, the Fed injected life into the markets by reversing course on existing policy, thus lifting the spirits of investors. The Fed lowered the Fed Funds rate three times during the year and not only stopped rolling off its balance sheet, but increased it by providing liquidity to the repo market. These conditions, and the Fed's supportive rhetoric, led to strong equity and credit-oriented fixed income returns.

However, despite the lowering of interest rates, the U.S. has not seen a decisive pickup in certain segments of the economy. The manufacturing sector is enduring its third down cycle since 2009. This uncertain environment, due in part to shifting trade tariffs, has caused U.S. companies to delay investment and capital spending in favor of stock buybacks. Nevertheless, the pundits are pointing to the strong consumer to buoy the economy as they are encouraged by wage growth, robust holiday sales and crowded restaurants. The strong performance of asset prices over the past year displays investors' optimistic belief that manufacturing will rebound while the consumer will continue spending.

Equities got a boost in the fourth quarter with news of a "phase one" deal agreed upon in structure between the U.S. and China, despite its limited scope. U.S. large company stocks, represented by the S&P 500 Index, are near all-time highs and were up 31.5% for the year. Corporate earnings were positive, but the vast majority of returns were due to valuation expansion. U.S. small company stocks, represented by the Russell 2000 Index and international stocks, represented by the MSCI ACWI ex US Index, were up 25.5% and 21.5%, respectively during the year.

The Bloomberg Barclays U.S. Aggregate Bond Index, which represents a broad basket of bonds, registered an impressive return of 8.7% for the year, as the 10-year Treasury bond yield fell from 2.69% to 1.90%. While a benefit in 2019, interest rate movement is a double-edged sword. A move back to 2018 levels for interest rates would likely lead to negative bond returns. Credit spreads declined during the year, benefitting sectors such as corporate bonds, high-yield and emerging market debt, which had the highest returns for the year. The Fed is signaling it will keep rates unchanged for the duration of the coming year as long as economic data remains stable.

In 2019, we saw Fed intervention, tepid economic growth, and inflation of asset prices – a fitting end to a decade shaped and molded by all three. The past decade was one of the best for U.S. equity returns, especially on a risk-adjusted basis, as volatility was more moderate than past periods. This was a blatant contrast to the prior decade, 2000-2009, which was one of the worst decades for U.S. equities and featured two recessions and extreme market volatility. In 2009, while markets were starting to recover from the "Great Recession", many still predicted that asset returns would be permanently lower and unemployment permanently higher, with PIMCO famously going so far as to dub this scenario the "new normal". What actually transpired was quite the opposite. Central banks took unprecedented action in the last ten years to support economies and markets. This resulted in the first decade in the history of the United States that did not have a recession. Despite the fact that monetary policy is in unknown territory, the Fed feels they have things under control. However, the Central banks' patching of short-term trouble has potentially brought forward future returns.



Fourth Quarter 2019 Market Summary (continued)

What do the next ten years hold? Probably not a duplication of the 2010s. Taking a retrospective view of the last two decades, the ups and downs of the table below outline the cyclicality of markets. The 2000s were deemed a “lost decade” because of the flat returns for U.S. equities. However, looking closely, you’ll see international equities, commodities, REITs, and fixed income all provided solid returns, thus outpacing U.S. equities. These types of leadership changes in asset classes are a key reason to maintain diversity in a portfolio.

		2000-2009 Returns	2010-2019 Returns
S&P 500 TR	U.S. Large Cap	-0.95%	13.56%
Russell 2000 TR	U.S. Small Cap	3.51%	11.83%
MSCI EAFE GR	International	1.58%	6.00%
MSCI EM GR	Emerging Markets	10.11%	4.04%
BBgBarc U.S. Agg Bond TR	Fixed Income	6.33%	3.75%
Bloomberg Commodity TR	Commodities	7.13%	-4.73%
FTSE NAREIT All Equity REITs TR	Real Estate	10.63%	12.59%

In the short-term, the consensus is that the U.S. economy is healthy enough and, with the Fed’s support, a recession in 2020 is unlikely. And why should there be a recession? After all, we have low rates, low inflation, and low unemployment – at least as it stands today. But there are plenty of areas of concern that could be harbingers of future trouble – geopolitics, elevated debt burdens, and valuation excesses.

Long-term, there will likely be surprises that are not foreseeable. Thinking back over the past ten years, how many would have predicted items such as:

- The U.K. leaving the European Union
- The global spread of smartphones and the passing of the torch from the BlackBerry to the iPhone
- Growth of technology firms enabling social media, on-demand and sharing economies
- A former TV host becoming the president of the United States
- China attaining unquestionable global superpower status
- Negative interest rates
- United States credit-rating downgrade
- The commodity boom of the 2000s going bust

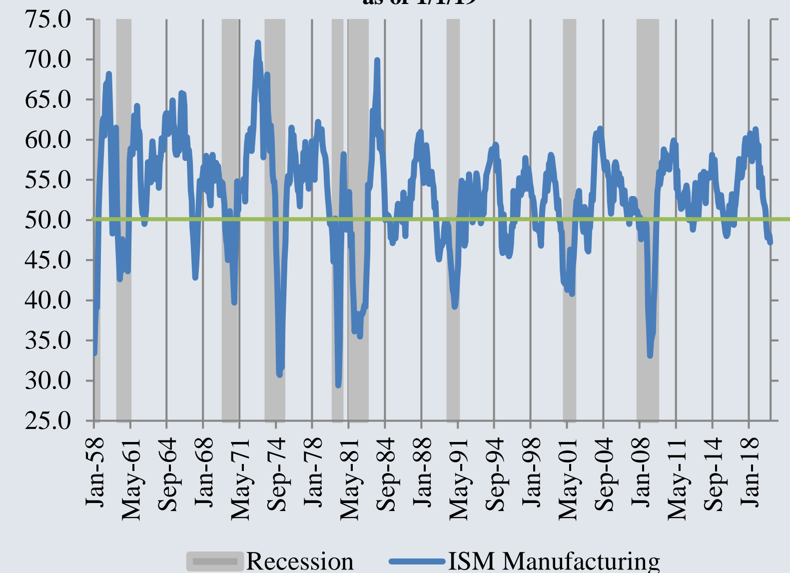
Behavioral biases, such as those influenced by information processing, emotional responses and belief perseverance, play a key role in markets. As such, it is always good to remind ourselves – what we think we know about the future will likely not be the reality. An ever-present, ever-changing kaleidoscope of possibilities are used to forecast the future, and many of the patterns won’t come into focus until a later date, or perhaps not at all. New or unexpected events may arise at any point to disrupt predictions that previously felt like a “sure thing.” Thus, it is important not to impose potentially biased beliefs on the portfolio based on short-term factors. It is an enduring challenge to focus on the long-term view and one’s personal plan objectives. However, the prudent investor will do their best to remain committed to this challenge and stay the course through the day-to-day squalls.

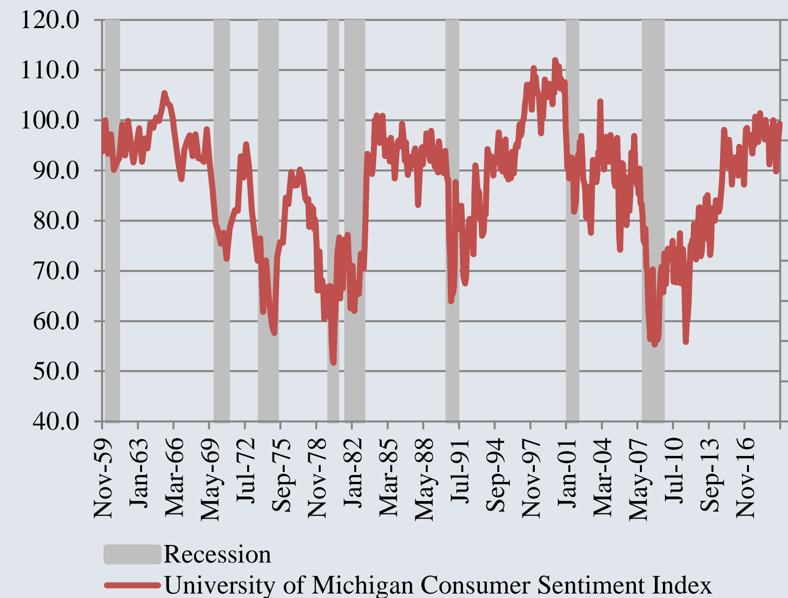
MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of fourth quarter 2019 real GDP, an annual rate increase of 2.1% from the preceding quarter. The economy benefitted from personal consumption and residential fixed investment. In addition, government spending contributed to growth but was offset by weaker business spending. GDP growth has moderated over the past year.
- The ISM Manufacturing Index continued its trend lower during the quarter, finishing at 47.2 in December down from 47.8 in September. Manufacturing has weakened as U.S. trade negotiations continue to cause uncertainty. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish.
- The ISM Non-Manufacturing Index rebounded during the quarter, finishing at 55.0 in December. The services sector has been holding up better than manufacturing.
- In December, the Conference Board Leading Economic Index decreased 0.3% month-over-month to 111.2. The index, which is a composite of leading employment, housing, manufacturing, and market indicators, has remained relatively flat since September 2018. Historically, the index has declined prior to recessions.
- The price of WTI Crude Oil was $61.14 at the end of December, which is 13.0% higher than $54.09 at the end of September. The price of Brent Crude Oil ended the quarter at $67.77, which is 11.1% higher than at the end of September.
- Inflation has remained stable over the past few years. In December, headline CPI increased 2.3% year-over-year. Core CPI, which does not include food and energy, had a 2.3% increase.

CONFIDENCE METRICS

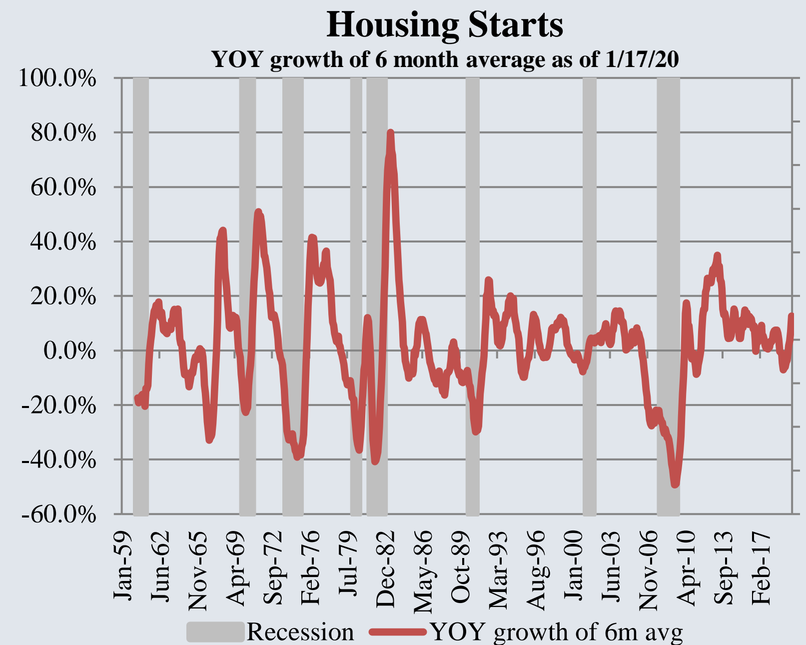
- The University of Michigan Consumer Sentiment Index final reading for December was 99.3. For the quarter, sentiment was a bit higher than the third quarter and it remains at very strong levels.
- The Conference Board's Consumer Confidence Index December reading was 128.2, up from 126.3 in September. The index level indicates that consumers continue to be optimistic about business and labor market conditions.





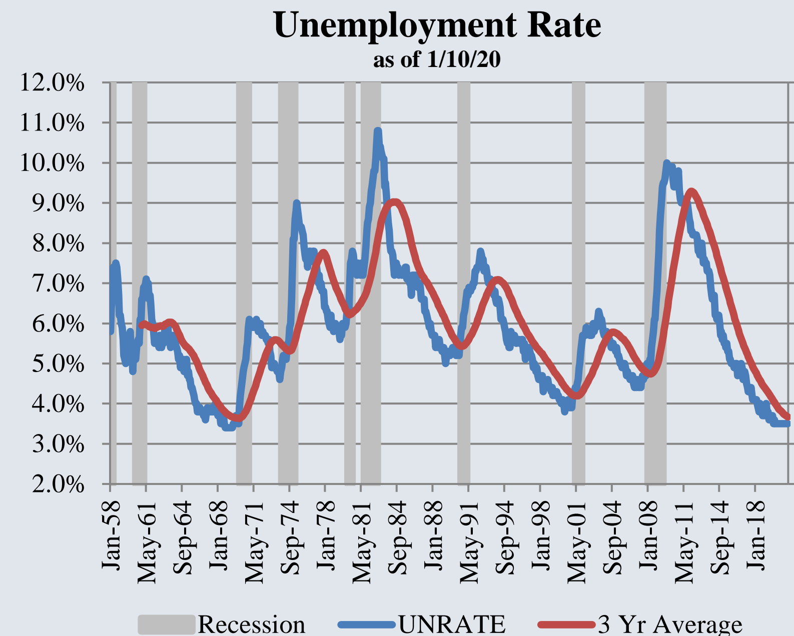
HOUSING

- The housing sector has generally been positive over the past year and is potentially in the beginning stages of renewed growth.
- Preliminary existing home sales increased in the quarter with a monthly average annualized rate of 5.44 million units from 5.43 million units in the third quarter. Unsold home supply remains at low levels.
- The preliminary existing home sale prices for December were 7.8% higher than the levels of one year ago. Prices have been trending up since the beginning of 2012 and reached an all-time high in June.
- New home sales were positive during the quarter and showed strong growth year-over-year. Housing demand picked up in the second half of the year as mortgage rates fell in 2019.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose over 2.5% year-over-year in November. Of the locations in the Index, home prices in San Francisco, Seattle, Phoenix, Las Vegas, and Denver have risen the most since 2011, while New York, Chicago and Washington DC have seen the least price growth.
- Housing starts were slightly up during the quarter and finished with a very strong December number that was above expectations. December starts were the most since 2006.



EMPLOYMENT

- The labor market has generally been healthy. The job growth rate has slowed, as employers are having difficulty finding workers with the required skills. Wage growth is the strongest it has been in a decade, which could lead to consumer spending. Despite a challenging manufacturing and global trade environment, labor data has not noticeably deteriorated. Employment will be a key area to watch over the next few quarters.
- During the quarter, nonfarm payrolls averaged 184,000 jobs added per month.
- The unemployment rate remained flat during the quarter at 3.5%.
- Initial Jobless Claims had been decreasing since 2009 and dipped to lows last seen in 1969; however, claims have flattened over the past two years. The low level of initial claims reflects a tight labor market.

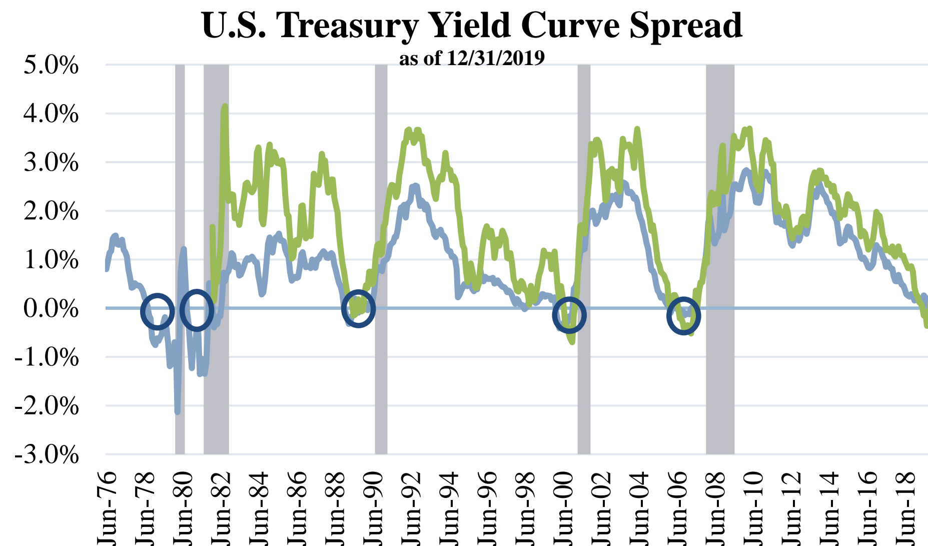


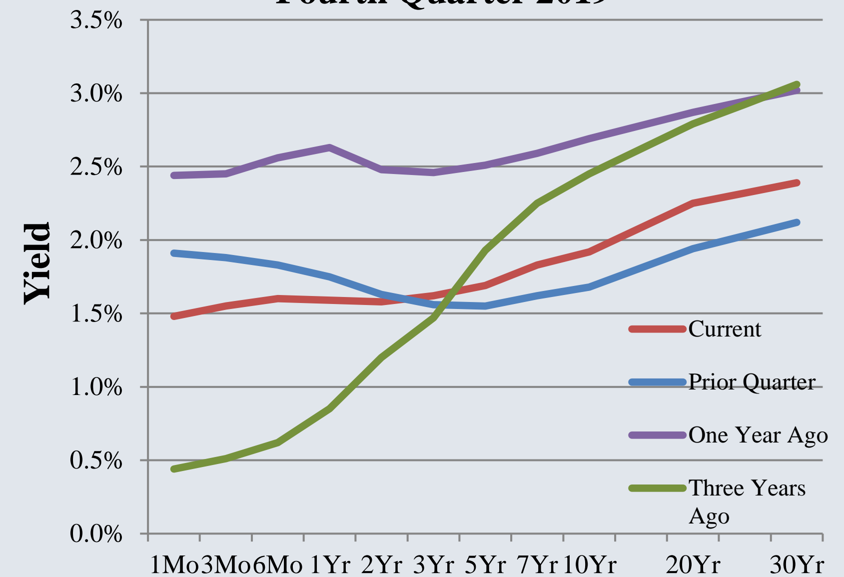
FED POLICY

- The Federal Open Market Committee (FOMC) decided to lower the federal funds rate to a target range of 1.50% - 1.75% in their October meeting. During the year, the Fed cut rates three times and shifted considerably off their policy stance from last December.
- The Fed cited growing global risks, a slowing U.S. economy and subdued inflation as reasons for their increased willingness to support the markets.
- The Fed is expected to remain accommodative throughout 2020. Since September, the Fed has been providing liquidity to the repurchase market, as a response to the temporary spike in overnight funding rates in September.

FIXED INCOME

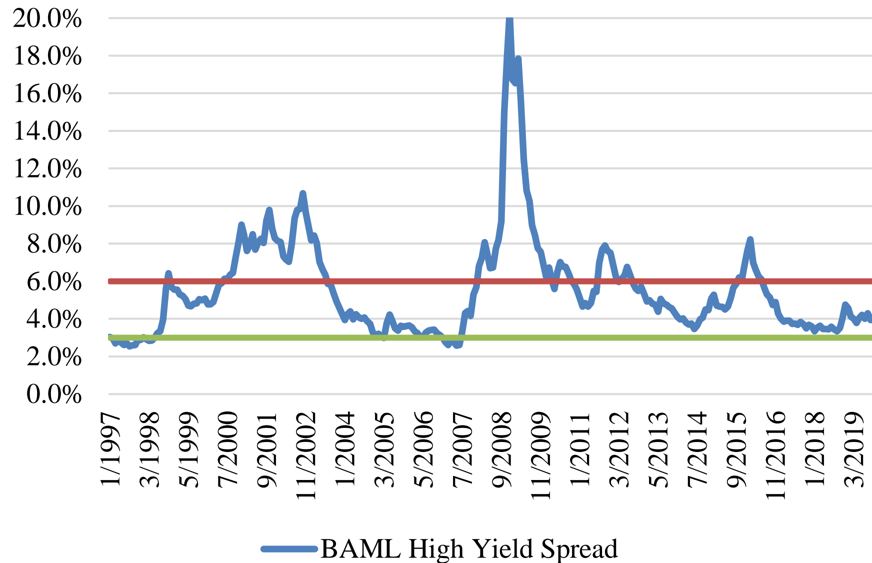
- During the fourth quarter, U.S. Treasury yields declined on the front-end of the curve as the Fed lowered the federal funds rate but yields increased over the intermediate to long-term maturities. These changes caused the yield curve to steepen.
- Short-term interest rates are controlled or heavily influenced by central banks, whereas long term interest rates are controlled by market forces and economic growth.
- U.S. interest rates will likely remain range bound for the foreseeable future as low economic growth, weak demographics and central banks will likely keep yields down. Despite limited expected returns, bonds still act as the ballast of a portfolio during times of volatility.

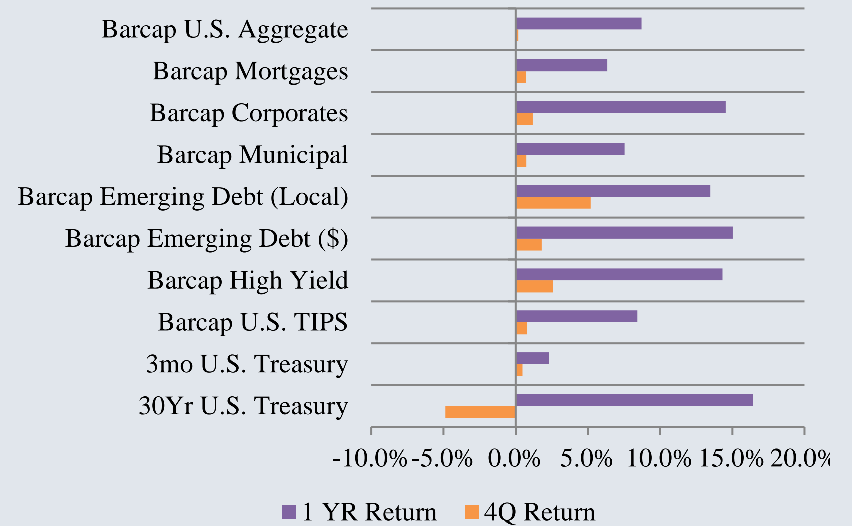


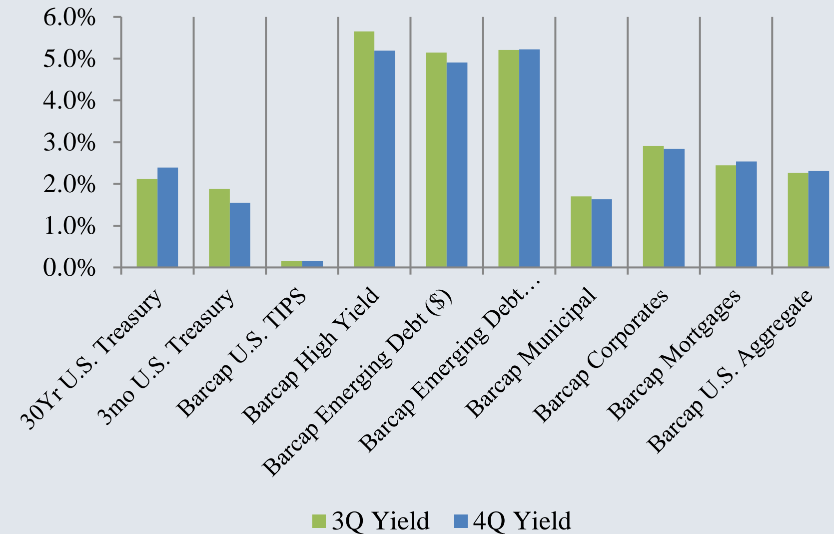


FIXED INCOME (continued)

- During the quarter, the Bloomberg Barclays U.S. Aggregate returned 0.2%. Fixed income returns were impressive over the past year. The Bloomberg Barclays U.S. Aggregate was up 8.7%, as interest rates fell for much of the year.
- Credit spreads compressed during the quarter and remain low as investors continue to seek yield. This environment benefitted credit-oriented sectors such as corporates, high yield and emerging market debt.
- Municipals continue to see above average demand due to the SALT (state and local tax) cap while supply remains low. This led to strong after-tax returns for municipals during the year.
- Despite investors' willingness to accept greater credit risk, fundamentals in the investment-grade corporate and high-yield sectors remain mixed. There is a high amount of leverage in the system and weakening underwriting; however, defaults remain low and corporate earnings remain strong.



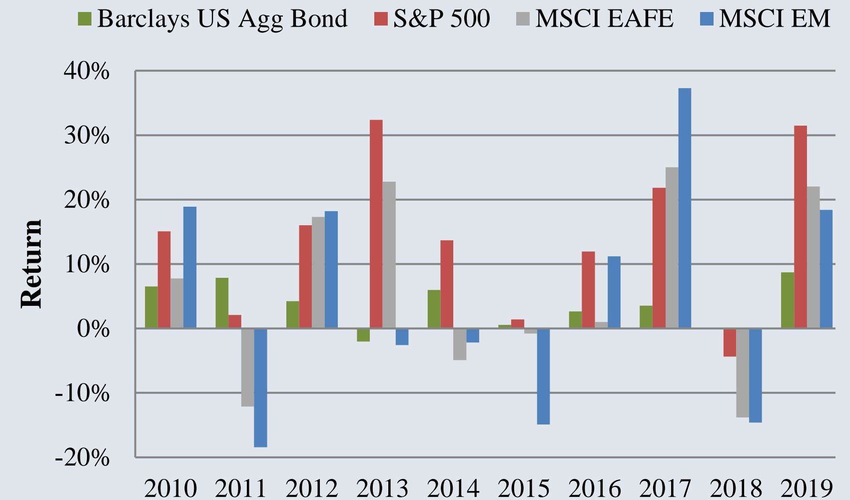




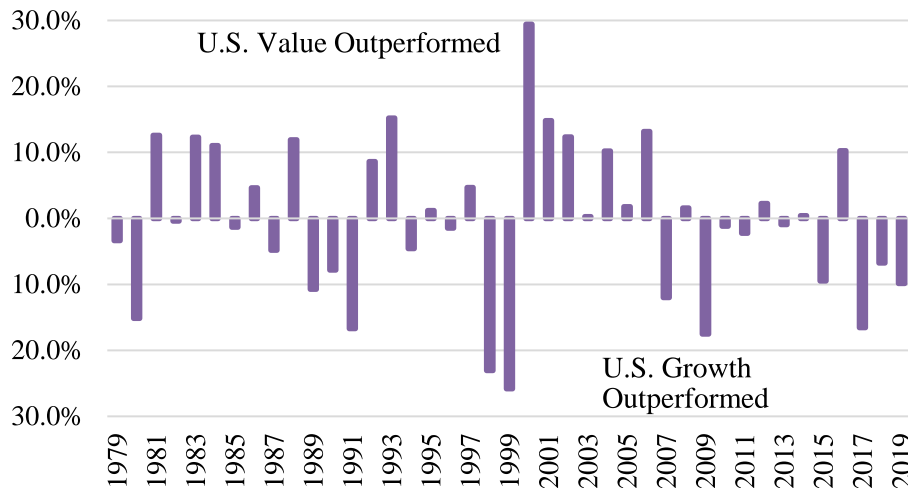
EQUITIES

- The strong performance of equities in 2019 was quite a contrast from 2018, when most equities had negative returns. In the past year, sentiment and monetary policy buoyed equity markets.
- Manufacturing data remains in contraction territory; however, equity markets, displayed their optimism for a re-acceleration of global trade and growth with the strong returns in 2019.
- Dividend yields among global equity markets are currently higher than intermediate government bonds.
- China and the U.S. reached a "phase one" deal in December. The U.S. reduced current and pending tariffs on Chinese goods while China agreed to purchase more U.S. goods, particularly agriculture products. Markets took this development as a strong positive in restoring global growth. A more comprehensive trade deal between the countries is a distant aspiration.

Equity & Fixed Income Market Annual Returns
(as of 12/31/2019)

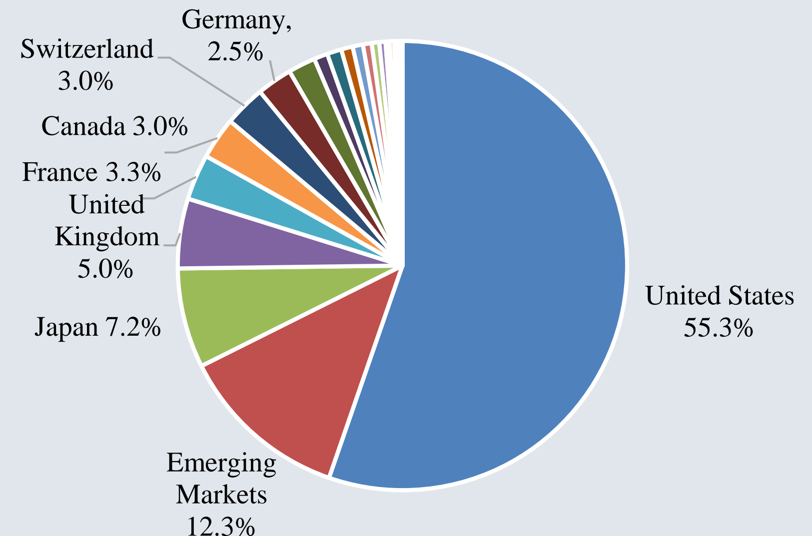


U.S. Value vs. Growth Relative Equity Performance **(as of 12/31/19)**



Russell 1000 Growth TR vs. Russell 1000 Value TR

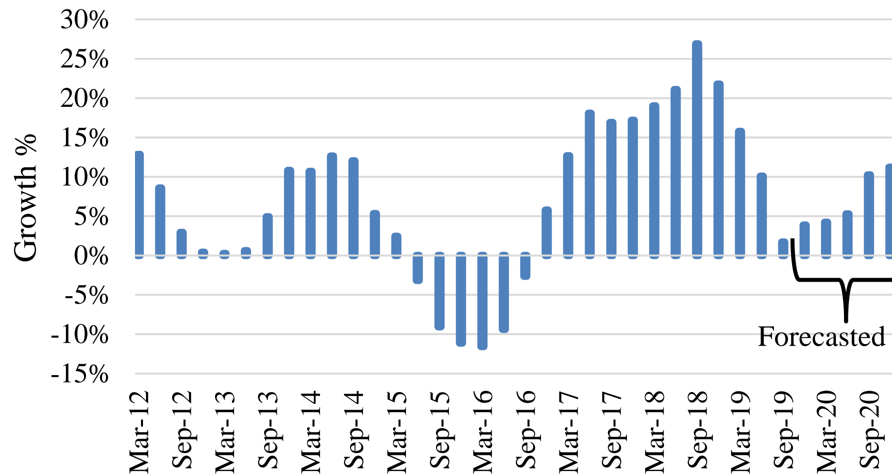
Country Weighting in MSCI ACWI
(as of 1/27/2020)

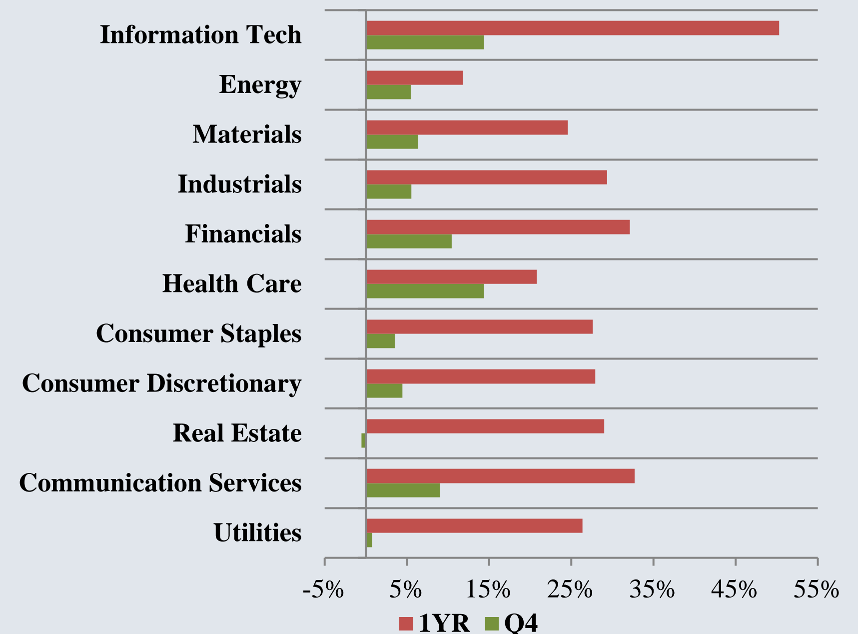


DOMESTIC EQUITIES

- The Russell 1000 Index, comprised of large and mid-capitalization stocks, posted a total return of 9.0% during the fourth quarter. On a year-over-year basis, the Russell 1000 Index has increased 31.4%.
- Small capitalization stocks, as represented by the Russell 2000 Index, increased 9.9% during the fourth quarter. On a year-over-year basis, the index has increased 25.5%.
- During 2019, the majority of U.S. equity returns was due to valuation expansion. U.S. equity forward P/E multiples and trailing P/E multiples are above historical averages. Due to elevated valuations, earnings are expected to drive equity returns in 2020.
- Corporate operating earnings for 2019 were weak. Estimates for 2020 have come down, but are still expected to be high single-digit growth. Operating profit margins remain near historical highs and have yet to be challenged by higher wages or higher inputs due to trade tariffs.

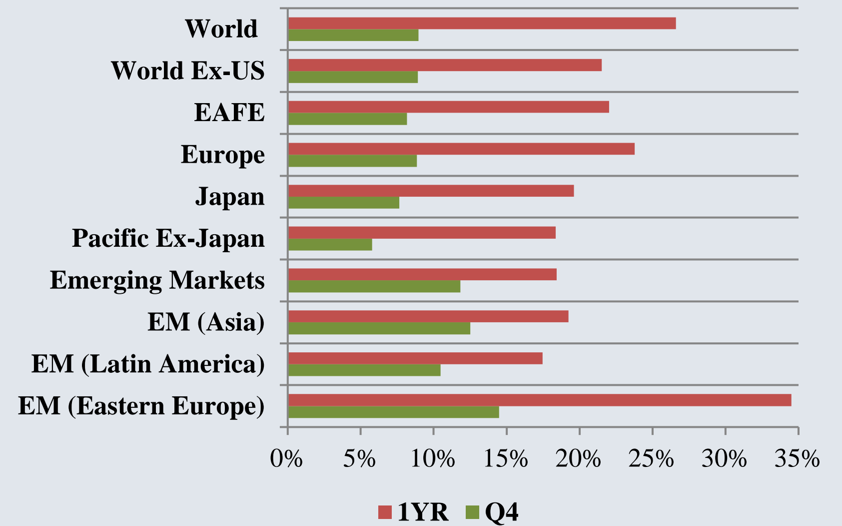
Fourth Quarter 2019 Returns			
	Value	Core	Growth
Mega Cap		10.5%	
Large Cap	7.4%	9.0%	10.6%
Mid Cap	6.4%	7.1%	8.2%
Small Cap	8.5%	9.9%	11.4%
Micro Cap	10.5%	13.5%	17.7%

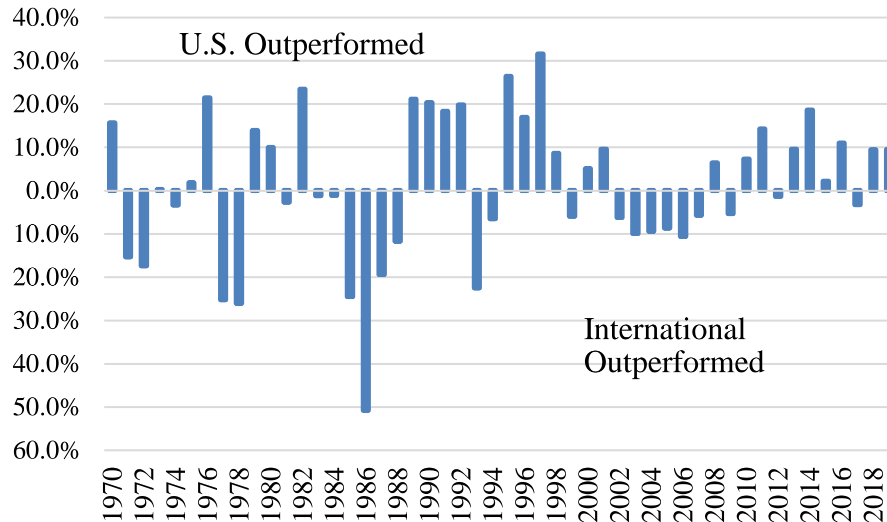




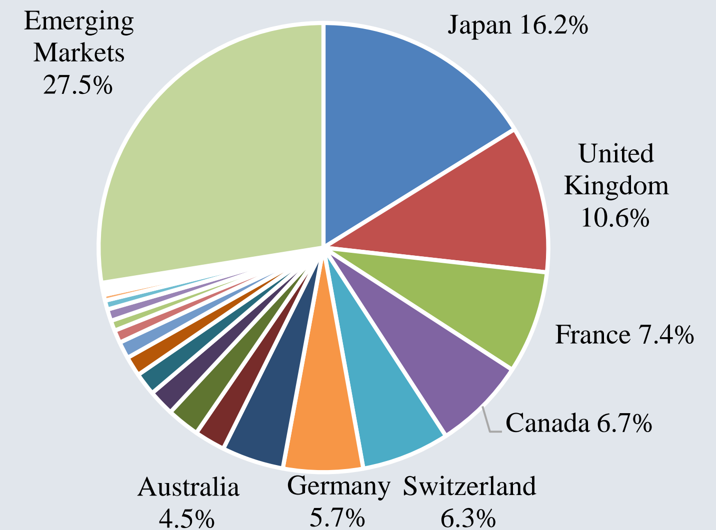
INTERNATIONAL EQUITIES

- Developed international stocks, as represented by the MSCI EAFE, were up 8.2% during the quarter. On a year-over-year basis, the EAFE returned 22.0%, performing worse than U.S. domestic equities.
- Emerging market stocks outperformed developed markets during the fourth quarter as the MSCI Emerging Markets Index increased 11.8%. However, on a year-over-year basis, emerging market stocks trailed developed markets with a return of 18.4%
- Weak global growth and trade continue to challenge exporting countries like Germany, Japan and Korea. Low interest rates have hurt financials, which make up a large percentage of developed international indices.
- Central banks globally have continued to provide monetary stimulus which has supported asset prices.





S&P 500 TR vs. MSCI EAFE NR



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