



Welcome to the Roaring Twenties? Or the End of a Great Ride? January 2020

My Dear Client:

Welcome, 2020! What a difference a year makes when you recall how we entered 2019. The end of 2018 was frightful, as the three major indices used to track the U.S. stock market all came within basis points (100ths of a percent) of a “bear” market that would have ended the “bull” market that started on March 10, 2009.

A bear market is *arbitrarily* defined as a market that falls 20% or more from its previous high. For an index to recover from a 20% drop, it must gain 25%; keep this in mind as we review 2019 returns.

There is an old saying on Wall Street: *The market climbs a wall of worry*. Indeed, 2019 was an example of how the market can increase anxiety, fear, speculation, and pessimism and still end the year up +31.5%.



Of course, in 2019, the jet fuel that powered the market higher was the other popular old axiom, *Don't fight the Fed or Don't fight the tape!* Both were exemplified in 2019 when the Federal Reserve joined other Central Banks in lowering interest rates the market surged.

Driven by healthy consumer spending, the U.S. economy grew slightly more than 2% in 3Q19. The year-end employment situation continued to contribute a steady average addition of 205,000 jobs/month over the quarter.

Unemployment dipped to the historic low of 3.5% with limited wage pressure. Still, businesses were reluctant to invest, and manufacturing contracted in December to its lowest level since 2009. Even with progress on trade negotiations, parts of the economy have already felt the effects of the prolonged uncertainty.

Equity markets rocketed in 4Q19 thanks to an improved economic picture, alleviated trade tensions with China, and, most importantly, a dovish Fed. The S&P 500 rose 9% during the quarter and 31.5% for the year. It was the best annual performance for the index since 2013.

Growth stocks were dominant over value stocks for most of 2019, but interesting shifts occurred in the quarter. Investors' following the Fed's cues and more favorable valuations, increased their appetite for risk, favoring emerging markets (+12%) over U.S. stocks for the first time all year. Additionally, growth outperformed value by less in the mid-cap and small-cap areas than in large caps.

An unasked question: *If the economy is in such great shape, why did the Fed need to stop raising rates, cut them, and add billions of dollars to the banking system again?*

Domestic Equity Market



Growth continued to triumph over value in Q4, but, for a change of pace, we saw smaller companies outperform larger ones. Micro-caps and small-cap growth rallied 13.5% and 11.4% respectively, while mid-cap and large-cap value were up only 7%. Large-cap growth continued its reign as the top-performing equity style for 2019 with its 36.4% rise with mid-cap growth (+35.5%) following a close second. The laggards were micro-cap and small-cap value, which rose 22% for the year.

U.S. Equity sectors ran the gamut from high flyer to slightly negative. Info-Tech and Health Care were the best performing sectors in Q4, returning 14.4%, followed by a strong rise in Financials (10.5%), Communication Services (9.0%), Materials (6.4%), Industrials (5.5%), Energy (5.5%), Consumer Discretionary (4.5%), and Consumer Staples (3.5%). Sectors that often are a substitute for bonds Real Estate (-0.5%) and Utilities (+0.8%) lagged as yields rose, and risk-taking increased.

For the full year 2019, the technology sector was the biggest winner with a 50% return, driven by surging behemoths Microsoft (+58%) and Apple (+89%). The only sector that did not deliver 20% or higher returns in 2019 was Energy, which returned only 11.8% despite a 34% spike in the price of WTI Crude Oil. This disconnect between the price of oil's rise along with tensions in the Persian Gulf states, while Energy stocks advanced at a more muted clip, speaks to the growing U.S. presence as the world's third-largest oil exporter. Declining trade anxiety with China, Europe avoiding a deep Brexit recession, and Central bank assistance helped all sectors in the U.S.

International Markets

The improved global economic data and advancement in U.S.-China trade negotiations sparked a year-end rally in international equities and a weakening of the dollar.

Emerging markets (as measured by the MSCI Emerging Markets Index) rose 11.8%, outperforming the U.S. S&P 500 (+9%), and developed international (+8.2%) as measured by the MSCI EAFE Index (net of taxes). Within EM, tech-heavy Taiwan rallied nearly 18%, and Russia rallied 17% in Q4 – and more than 50% for the year as its central bank eased interest rates. India was an international laggard, rising just 5% as the country encountered economic and political turmoil.



In developed markets, Germany was up 10% on improved economic data. The U.K. rallied 10% as Boris Johnson won a resounding victory to continue as British Prime Minister. His victory propels him and the Conservative Party toward (finally?) ratifying a Brexit vote and agreement from the European Union at the end of January. Further Mr. Johnson has repeatedly stated that by December 31, 2020 the transition period from the EU will be completed and he will not seek any extensions. While the EU Parliament has cast doubts on this being achievable. Warning the UK cannot expect to enjoy the 'highest quality access' to European markets if – as Mr Johnson is insisting – UK refuses to align with EU rules after Brexit.

On the year, international growth outpaced international value by more than 11%, the most significant calendar year deficit for value ever recorded. While this divergence could be even larger or continue further, this is likely a good time to begin to ponder what “buy low and sell high” might look like in real-time.

Bond Markets



The broad U.S. bond market, as measured by the Bloomberg Barclays Agg Index, delivered 0.2% as rates bounced off their Labor Day lows, and credit continued to outperform. Following the Fed's actions to calm markets with three rate cuts earlier in the year, injections of additional liquidity measures served as an effective backstop for financial markets. During the quarter, investors saw the impact of easy monetary policy as global growth expectations and economic data bottomed and reversed course, increasing optimism and market sentiment.

The improving economic and inflation picture lifted rates and steepened the U.S. Treasury curve. Demand for Treasuries waned during the quarter, pushing the 10-Yr Treasury yield to 1.92%. Concerns regarding an inverted yield curve were put to rest during the quarter as increased growth and inflation expectations lifted long-dated interest rates.

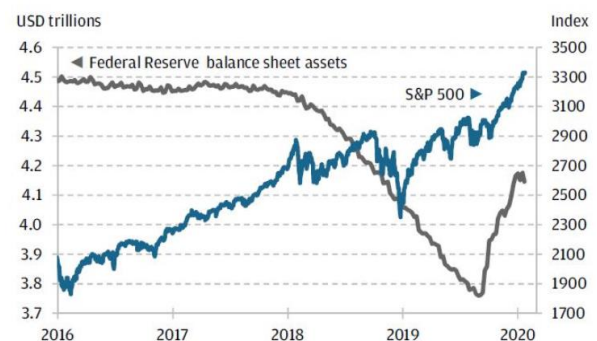
Reduced recessionary fears and increased optimism around prospects for a "Phase 1" trade deal with China drove demand for riskier bonds. High-yield corporates, emerging market debt, and leveraged loans outperformed in Q4. Non-investment grade issuers rated CCC and lower reversed its YTD course in Q4, gaining back relative performance as speculative investors embraced tighter spreads and stronger fundamentals versus expectations. Laggards for the quarter included U.S. Treasuries (-0.8%), U.S. government-related debt (-0.8%), and Asian fixed income (-0.4%).

Risks are building in various areas of the fixed-income credit markets, particularly in corporate credit. While low-interest rates and abundance of liquidity (available credit) have kept defaults low, the disturbing trend according to data compiled by J.P. Morgan is that despite the rally in risk assets in the prior year, the number of defaults rose some 50% in 2019. Today, 50% of the investment-grade market is rated BBB, compared with 35% in 2007. There is some indication that this could be a by product of post -2008 changes made at the various credit rating agencies.

A Look Ahead

The consensus is, no recession in 2020, no trade war with China, job growth rolls on, and corporate profits continue to rise as consumer spending stays healthy. In other words, everything is excellent. The economy is firing on all cylinders with the Fed and tax cuts at its back.

Last quarter, I provided this reflection from Jim Bianco, the head of Bianco Research, on the Fed's expanding balance sheet: "The repo market has been drugged into submission by the Fed. That's fine for a while. But what I am getting concerned about is that they're not figuring out a way to get it off the drug and get it back to normal, and that will be a problem longer-term for them."



I now cite our colleague Scott Miner Global CIO of Guggenheim Investments: "Ultimately, this leads to what he called a Ponzi Market, where the only reason investors keep adding to risk is the fear that prices will be higher tomorrow (or in the case of bonds, yields will be lower tomorrow)."

Daniel Kahneman observed this behavior in his work when he identified that investors' fear of missing an opportunity induces them to buy when they should be selling.

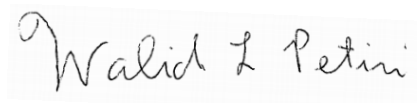
Plain and simple, 2019 was a spectacular year in the markets, particularly the larger-cap portion of the U.S. While I would not advocate significant revisions to your asset allocation yet, moving to the low end of your target ranges after such a large run-up seems timely. I am cautioning against aggressively chasing the market higher with your new cash. As Baron Rothschild said, “I made my fortune by selling too early.”

The chart above courtesy of our colleagues at JP Morgan Asset Management with data from the Federal Reserve and Standard & Poor’s as of January 22, 2020- seems to underscore that the US stock market and the expansion or contraction of the Fed balance sheet are in sync. Maintain a focus on a risk-balanced, multi-asset class approach, and evaluate opportunities when larger short-term declines occur. Consistent with the recommendations of the past few quarters, I would add be patient and disciplined right now as inclusive of the Fed’s actions- the periods of high multi-year gains are very likely behind us. Consider the following:

- Maintain overall U.S. equity allocation to portfolio targets and below max range
- Use gains in U.S. Large Cap equities especially growth stocks for liquidity needs, private investments, and an increased margin of safety (cash)
- Direct fixed income portfolio allocations to high-quality bonds and some proven credit strategies
- Actively seek niche and opportunistic illiquid private investments
- Adjust public equity allocations in emerging market and international equities to higher end of target range by rebalancing gains from U.S. equities
- Favor small-caps over large-caps, for new cash allocations
- Begin allocating to less-expensive U.S. value stocks versus U.S. growth stocks

While we begin the year anew, remaining watchful over your assets to continue achieving your financial objectives continues as the focus of our firm. We should discuss any changes you may have or plan to consider to assure the current strategy for you remains suitable. As always, it is a pleasure to serve you, and I look forward to continuing to work with you toward your goals.

Appreciatively,

A handwritten signature in black ink that reads "Walid L. Petiri". The signature is written in a cursive, flowing style.

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor’s, Federal Reserve Board, JP Morgan Asset Management, Guggenheim Investments.