2019 Fourth Quarter Review of the Markets

Index	4th Qtr Return	YTD Return
S&P 500	9.07%	31.49%
MSCI ACWI Ex USA IMI	9.20%	21.63%
Barclay's Bond Index	0.18%	8.72%
Consumer Price Index	0.84%	2.29%

Investment Commentary

2019 proved to be an exciting year for investors with asset prices rising across the board. After 2018 where full-year performance numbers prompted a shrug, but masked widespread volatility near year-end, 2019 showed strong results against a backdrop that can largely be described as "more of the same". The S&P 500 returned 31.5% for the year.

International stocks had strong performance as well, especially in developed markets. MSCI ACWI ex USA IMI was up 21.6%. Emerging markets, which are a subset of the ACWI index, returned 18.4%.

The Bloomberg Barclays Aggregate Bond index returned 8.7% for the year. This performance was fueled by twin tailwinds of falling interest rates and shrinking credit spreads in corporate bonds (i.e. valuations going up).

Typically, we limit this section to discussing quarterly and annual returns. However, considering we are in the midst of the longest economic expansion on record and closing out a full decade without a recession, perhaps it is worth taking stock of how far we have come from the depths of the 2008 Global Financial Crisis. This market cycle has been spurred on by perhaps the most accommodative and unconventional monetary policy the U.S. has seen since the Great Depression. We've seen central banks injecting liquidity into the financial system with bond purchases on an unprecedented scale ("Quantitative Easing" or "QE") and holding short-term interest rates at, near, or in some cases below zero ("Zero Interest Rate Policy" or "ZIRP") for much of the last 10+ years. Further, while the expansion has been extraordinarily long, the rates of growth and inflation have both been subdued by historical standards. While the expansion has been impressive in terms of duration, in terms of magnitude it can only be described as moderate. The underlying economy has fared reasonably well, but the real winner has been asset prices. Wealth creation during the expansion has largely benefitted those who were already wealthy, since they generally hold the vast majority of financial assets.

From the depths of March 2009, the S&P 500 index has risen from 667 to 3,230 at year end, with an annualized total return of 17.9% per year. Foreign stocks have also performed well on an absolute basis, although they have meaningfully trailed on a relative basis with a compound annual growth rate of around 10.8%. This highlights the power of compounding as the S&P 500 is up nearly 500% while foreign stocks are up just over 200% cumulatively over the same period. Conservative investors have also done well in a low interest rate environment as the bond market is up just over 4% annualized since March 2009 leading to a cumulative return of 54.3%.

We are always mindful that trends do not tend to last forever. When we look at what the 2020s will bring it is likely that many of the things that worked well or defined the 2010s will reverse while others may continue. We will almost certainly have at least one recession in the 2020s. Will this lead to dreaded negative interest rates in the U.S. like we currently observe for much of the rest of the developed world? Will we eventually see stock market leadership from value stocks or foreign stocks that have done well over the long-term but underperformed for the last decade? Will we see the wealth and income gaps that have widened since 2009 begin to contract? Will the rapid pace of disruption we've seen for the last decade eventually slow, or will it accelerate? Will the geopolitical tensions of today lead to the global economy continuing to decouple – have we seen peak globalism? As we embark upon a new decade, these are some of the things we are thinking about.

Economic Outlook

Economic data continued to paint a positive picture in the United States during the fourth quarter. Employment, real personal income, and retail sales all continued their uptrends throughout the quarter. Manufacturing and trade sales peaked for the year during the third quarter of 2019 and the industrial production index is below where it began 2019. However, it appears the woes have been limited to the manufacturing sector and have not spread throughout the economy.

The consumer-oriented economic measures mentioned above are part of the justification for such a strong increase in stock valuations. Expectations that consumers will continue their robust spending should be tempered, as the Consumer Confidence Survey indicates that consumers' outlook for business and labor market conditions is weakening. Even if there is little to suggest this is imminent, the perception on the part of consumers is perhaps enough to create a self-fulfilling prophecy of fear about the future leading to lower spending, which in turn leads to weaker business results and a weaker labor market. If this plays out, it is likely that it will take some time to show up in economic data since firms do not respond immediately to changes in demand.

We mentioned earlier that the economic backdrop in 2019 compared to 2018 could be described as "more of the same." One major difference between the two years was the path of monetary policy. Coming off strong market performance in 2017 driven largely by an improving economy, accommodative monetary policy, and expectations for accommodative fiscal policy (i.e., tax cuts), the U.S. Federal Reserve ("The Fed") spent most of 2017 and 2018 actively shifting monetary policy from accommodative to restrictive. Markets clearly messaged to the Fed by the end of 2018 that the tightening had gone too far. In 2019, the Fed promptly owned up to their misstep and cut the target Fed Funds rate three times before signaling that policy is now appropriate. Furthermore, liquidity issues in the overnight repurchase agreement ("repo") market prompted the Fed to once again provide liquidity to markets and reverse the recent trend of shrinking their balance sheet.

The abrupt shift towards easing of monetary policy provided a major tailwind for asset prices in 2019 (both risky and safe assets). Central banks are unlikely to provide further easing from current levels unless there is a significant downturn in the global economy. While further easing is not likely, accommodative monetary policy from central banks should remain a tailwind to the global economy. One question investors may ponder is what could lead to a reversal in the Fed's decision to ease monetary policy. The Fed's explicit dual mandate is to promote full employment and price stability (generally defined as inflation in the region of 2%). The employment picture is overwhelmingly positive with the unemployment rate at the lowest levels since the 1960s. With both current inflation and forward-looking market-based inflation expectations continuing to run below the Fed's target rate of 2%, it seems unlikely they will feel compelled to reverse the easing of monetary policy that has taken place throughout the course of 2019. While geopolitical risks seem to dominate the news cycle, it's unlikely that these will present sustained material hurdles for markets.

Investment Strategy

The equity landscape looks much different at the beginning of 2020 than it did at the beginning of 2019. Both valuations and earnings growth expectations increased significantly throughout 2019. If we are going to have a strong year in stocks for 2020, it is likely that earnings growth will be responsible for more of the increase than further multiple expansion.

The fixed income landscape, with the exception of nominal yields on U.S. Treasuries, looks similar to the beginning of 2019. We remain concerned that valuations for both investment grade and high yield ("junk") corporate bonds are too high, especially when viewed as a component of the safe portion of client portfolios. When viewed in isolation, stocks do look expensive on a price-to-earnings basis as of year-end. However, when viewed through the lens of value relative to bonds, one can still continue to make the case that stocks are reasonably valued.

At the moment, we do not see reasons for an imminent shift in the allocation to risk assets in client portfolios. As we have written about in previous quarters, deterioration in consumer-driven economic data as discussed above will likely cause us to reallocate portfolios. It appears that the longest ever economic expansion will roll on for now.

As we enter 2020 at generally all-time highs on various stock indices, we encourage clients to reach out to us and discuss their financial plan and risk tolerance. Now would be a perfect time to review your current Investment Policy Statement. We wish you and your family a healthy and prosperous 2020!

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