



Fourth Quarter 2019 Commentary

It is fair to say that most investors were surprised by the financial markets in 2019. At the end of 2018, few, if any, strategists would have predicted the 10-year Treasury yield would drop below 2% or that stocks would soar 20% to 30% or more, let alone that both would happen simultaneously. Across global equity markets, larger-cap U.S. stocks were once again at the top of the leader board. The S&P 500 index posted gains in every quarter and surged 9% in the fourth quarter to end the year at an all-time high. Its 31% total return was its second-best year since 1997. (It was up 32% in 2013.) Smaller-cap U.S. stocks rose 27.3% for the year. Foreign equity markets were also strong. International Developed stocks gained 8.3% in the fourth quarter and 22.6% for the year. After struggling in the third quarter, emerging-market (EM) stocks shot up almost 12% in the fourth quarter and returned 20.6% for the year. The 10-year Treasury yield dropped from 2.70% at the start of the year to as low as 1.45% in September, ending the year at 1.92%. The core bond index gained 8.7% for the year – its best annual return since 2002.

Why did both stocks (risky assets) and bonds (defensive assets) appreciate sharply in 2019? The key driver was the Federal Reserve’s sharp U-turn to accommodative monetary policy. This was followed by other central banks across the globe. Coming into 2019, the Fed was indicating it expected to *raise* the federal funds policy rate three more times (75 basis points), on the heels of four rate hikes in 2018. This led investors to fear that excessively tight monetary policy could tip the U.S. and global economies into recession, bringing an equity bear market with it. The ongoing U.S.-China trade conflict didn’t help matters.

Ultimately, the Fed ended up *cutting* rates three times in the second half of 2019. Other major central banks also

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	9.5%	31.5%	12.1%
US Mid Cap Stocks	6.9%	31.1%	9.3%
US Small Cap Stocks	8.1%	27.3%	8.9%
International Developed Stocks	8.3%	22.6%	6.2%
Emerging Market Stocks	11.8%	20.6%	6.0%
US Bonds	0.2%	8.7%	3.0%
Global Bonds	0.7%	5.1%	1.6%
US REITs	-1.1%	24.3%	5.7%

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
 US Mid Cap Stocks: CRSP US Mid Cap TR USD
 US Small Cap Stocks: CRSP US Small Cap TR USD
 Emerging Market Stocks: FTSE Emerging TR USD
 International Developed Stocks: FTSE Developed Ex US TR USD
 US Bonds: Barclays US Aggregate Bond TR USD
 Global Bonds: Barclays Global Aggregate Ex USD TR USD
 US REITs: MSCI US REIT NR USD

cut rates and/or provided additional stimulus to the markets via quantitative easing during the year. This lessened recession fears. Meanwhile, inflation (and inflation expectations) remained at or below central bank targets, mitigating any concern that monetary policy would be tightened again any time soon. The U.S. equity market responded to the Fed policy reversal and stimulus much as it has during the past 10 years—by bidding up stock prices and valuations.

Note that it wasn’t corporate profit growth that drove U.S. stocks higher in 2019. Reported earnings for the



S&P 500 were flat over the first three quarters, and a mid-single-digit percentage increase is projected for the fourth quarter. The lion's share (roughly two-thirds) of the S&P's 31% return came from a sharp expansion in valuations: The S&P 500's P/E ratio shot up from roughly 19x to 23x at year-end (based on the trailing four quarters of earnings).

As we look ahead to the financial markets in 2020, there are reasons for shorter-term optimism—*cautious* optimism—for stocks. There are also notable risks that could lead to a volatile and challenging year. We list several of the pros and cons below. Suffice it to say, economic and geopolitical uncertainty remain elevated and the range of market outcomes wide.

Some Reasons for Market Optimism in 2020

Accommodative central bank monetary policy and easier financial conditions should support at least a modest rebound in global economic growth. If inflation and inflation expectations remain at or below central bank targets, monetary policy is unlikely to tighten in 2020. A quiet year on the monetary policy front would be welcomed by most investors.

The Global Manufacturing Purchasing Managers' Index (PMI), an economic leading indicator, has risen for four consecutive months and moved (barely) into expansion mode in November. Along with reduced U.S.-China trade risk, this suggests the global economy may be on the rebound.

Some key macro risks appear to have abated. A de-escalation in the U.S.-China trade war (the "phase one" deal) should be positive for the global economy, business confidence, and overall market sentiment. In the United Kingdom, Prime Minister Boris Johnson's big election victory sets the stage for an orderly negotiated exit from the European Union (EU).

The U.S. consumer remains in good shape. Ongoing labor market strength, wage growth, and low interest rates should continue to support consumer spending and the housing market.

Fiscal policy may provide some (modest) additional economic stimulus in Europe, China, and Japan, and possibly the United States.

Some Key Market Risks in 2020

Overall, the economic and global macro backdrop appears to be turning to a modestly positive — or at least benign—trajectory for 2020. However, this is the consensus view as well. Financial markets have *already responded very positively* to these developments and the improving

outlook. The risk of an unpleasant market surprise or deterioration in the macro environment in 2020 shouldn't be ignored.

Valuation risk. For investors a critical question should always be, "What's in the price?" In other words, what economic assumptions and expectations are already embedded in current asset prices and valuations? U.S. stock valuations in particular appear lofty and are signaling caution; they are near 1929 and 2007 levels, but perhaps still below the all time highs of 2001.

The ongoing U.S.-China trade war. Despite the recent positive developments, the U.S.-China trade war could reignite or a different area of geo-economic conflict between the two countries could escalate

Falling CEO confidence. CEO confidence is already at recessionary levels.

U.S. election uncertainty. Expect volatility as the markets discount each new political development in real-time right up to the election.

Inflation surprises. If inflation surprises to the upside.

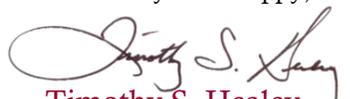
Brexit. An orderly Brexit is not a done deal. There is still risk of a hard exit, "cliff-edge" scenario at the end of 2020 if the United Kingdom and the EU don't negotiate a new trade agreement by then.

Unexpected geopolitical risk. There is always risk of an unexpected shock in the geopolitical realm (e.g., the Middle East, North Korea, China-Hong Kong, or some other area off most investors' radars).

The economic consensus seems to be for decent global growth in 2020 and accommodative central bank policy. This would be a supportive environment for stocks and other financial assets. However, to some extent this outlook is already reflected in current market prices—at least for U.S. stocks—especially after the sharp year-end rally.

As always, we appreciate your confidence and trust. We wish everyone a happy, healthy, and peaceful New Year.




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