Thoughts on the Investment Markets – December 2019

- Interest rates remain the "glue" holding the economy together
- Stocks closed out the quarter, year and decade on a high note
- Bonds delivered their largest calendar year return in nearly two decades

Introduction

Where are financial markets headed in 2020? If you ask the major Wall Street firms, you will get the same answer you always get. Most are predicting mid to high single digit gains with a few outliers on both sides, which is pretty much the same story every year. As we recap 2019 and discuss where we might be headed in 2020, our advice is to ignore these predictions. Instead, focus on your own long-term goals when it comes to making investment decisions. With volatility likely to escalate through the year as the U.S. presidential election nears, cool headed investors will likely be the ones who benefit. Warren Buffet has a famous quote, "Be fearful when others are greedy and greedy when others are fearful." Heeding this advice in 2020 may be especially fruitful.

Economic Review & Outlook

Although it may not be apparent based on the robust gains in the financial markets in 2019, the economy did slow due in part to the waning effects of the Tax Cuts and Jobs Act of 2017. Current estimates predict GDP increased 2.2% in 2019, a decline from the 2.9% increase in 2018. Slowing growth is forecasted to continue with estimates for 2020 declining to 1.8%. These estimates come from the Wall Street Journal survey of more than 60 economists.

Evidence of a decline in economic growth was further supported by the deceleration in corporate profits in 2019. Profits for the S&P 500 companies are expected to have grown by less than 5% this past year, as compared to the 20% growth in 2018. Profit growth was even lower when you remove the effect of share repurchases by corporations.

If corporate fundamentals appear to be weakening, and economic growth slowed, what led to such strong markets in 2019? Two words: interest rates. As 2019 began, investors were on edge, having just experienced the worst December for both the S&P 500 *and* Dow Jones Industrial Average since 1931. Concerns were high as the ongoing trade war was escalating, the Federal Reserve seemed determined to raise interest rates two or three more times in 2019, and corporate profits were set to slow dramatically. In retrospect, despite the "phase one" deal struck in December, the trade war was an ongoing uncertainty throughout the year and corporate profit growth did in fact slow to the low single digits. However, the difference from where we were a year ago is the Federal Reserve. Instead of raising interest rates in 2019, they cut interest rates three times.

The Fed's decision to cut, instead of raise, interest rates was met with widespread investor enthusiasm. Lower interest rates generally raise the value of bonds, which move inversely with interest rates, and stock prices, as lower discount rates increase the value of future earnings. Interest rates can also have a big impact on the economy because of the amount of debt we have as a country. Presently, total Federal public debt stands at just over $22 trillion dollars. This is much different than 20 years ago when total debt hovered just over $5 trillion. Despite the quadrupling of debt in 20 years, interest costs have increased only modestly. Thanks to steadily declining interest rates over the past two decades, the cost of servicing this debt has only increased by 60% despite an increase in debt of over 300%.

In addition to Federal debt, corporate and household debt has also risen over the last two decades. Corporations have increased their debt substantially during this expansion, mostly using the proceeds to increase dividends and buy back stocks. As a result of these higher debt levels, small interest rate increases lead to higher interest payments for consumers, corporations, and the Federal government. Money spent on interest can't go to other purchases and thus slows economic growth. For this reason, we believe low interest rates are the glue holding our economy together.

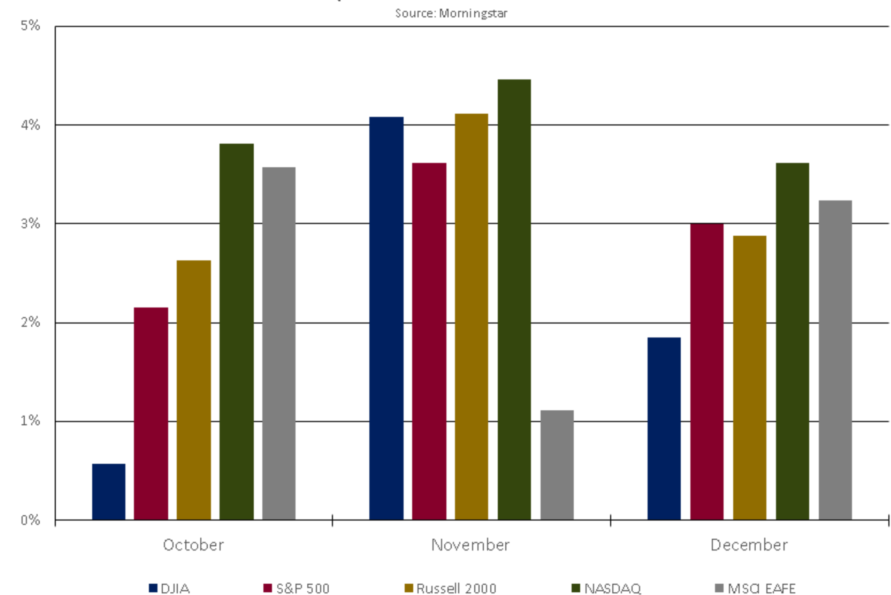
As long as interest rates remain low, this should continue to support the U.S. economy regardless of the outcome of the presidential election. Conversely, if interest rates rise materially, that will curtail the spending ability of consumers, corporations, and the government, which will impact investments beyond just the bond market. So, while other investors are watching the headlines around the election this year, we would advise focusing on what *really* matters: interest rates.

Bond Market Review & Outlook

It appears the long-anticipated demise of the bond market remains in hibernation, as bonds closed out 2019 with their best calendar year return of the decade. Despite the never-ending fearmongering in the press over rising bond yields, the benchmark Barclays Aggregate Index returned 0.2% for Q4 and 8.7% for the year. Lower quality bonds, as measured by the Bank of America U.S. High Yield Index, returned 14.4%. Municipal bonds returned 7.5%, as measured by the Barclays Municipal Index. The most spectacular gains came from the long-term Treasury market with the ICE U.S. Treasury 20+ Year Bond Index returning 15.1%.

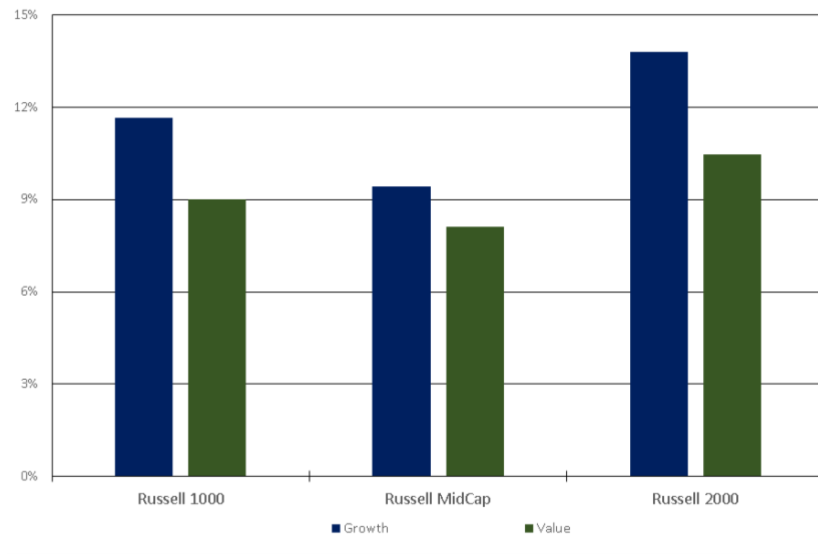
With yields once again at very low levels, some in the financial media are commenting about the risk of rising interest rates to bonds. While we agree that lower yields reduce the long-term upside of bonds, yields can remain low for an extended period, as we have seen in recent years. With economic growth expected to remain muted and inflationary pressures seemingly under control, interest rates could continue to remain low for quite some time. Bonds continue to play an important role in lowering volatility within a well-diversified portfolio.

Stock Market Review & Outlook



Stocks closed out the quarter, year and decade on a high note. The U.S. large cap indices returned 6.7% and 9.1% for the quarter as measured by the Dow Jones Industrial Average and S&P 500 respectively. Small caps followed suit with a 9.9% return by the Russell 2000. Technology shares were not to be left out as the NASDAQ Composite returned 12.5%. Finally, international stocks also participated, albeit not as robustly as U.S. indices, delivering an 8.2% return, as measured by the MSCI EAFE. Lackluster returns by international stocks are nothing new. Over the past decade, the MSCI EAFE outperformed the S&P 500 during only two calendar years. Rewind to the previous decade and the MSCI EAFE outpaced the S&P 500 seven times. What a difference a decade makes!

While we can't be sure if the next decade will flip the script and send international stocks back into the lead, international equities appear much cheaper than U.S. stocks from a valuation standpoint. Global growth forecasts are also higher than U.S. GDP growth forecasts. Thus, lower valuations combined with slightly faster growth suggest long-term investors should find international stocks favorable.



The outperformance by growth stocks continued in the fourth quarter as shown in the Russell Style Index chart. This makes three consecutive years growth has outperformed value. Looking out even further, the Russell 1000 Growth Index has outperformed the value index by an average of more than 10% each year over the past three years. If you compare this to the performance of the two from 2010 to 2015, the outperformance by growth over value was about 2% annually. Thus, not only have growth stocks been outperforming value stocks for more than a decade, but the degree of outperformance has increased dramatically over the past three years. Although trends such as these don't typically end due simply to age, at some point the relative divergence between them suggests a reversion to the mean is coming. Keep this in mind before dismissing value stocks.

Alternative Investments & Hybrids Review & Outlook

In concert with strong returns in stocks and bonds, the broad alternative investment universe gained 1.7% for the fourth quarter and 7.6% for 2019, as measured by Morningstar's Multi-Alternative category. Real estate assets saw particularly healthy gains in 2019, thanks in part to falling interest rates and low vacancy across most sectors. Hybrid managers, which allocate to both stocks and bonds, also posted strong returns as a result of their exposure to these more traditional markets. Morningstar's Broad Commodities category returned 7.9% for the year, led by precious metals and energy. Strategies less correlated to traditional stock and bond markets produced modest gains for 2019 as well. Managed futures, real assets, and merger arbitrage strategies all contributed positive absolute returns.

Conclusion

As we close the books on another quarter, investor optimism is high. Although the U.S. presidential election will surely add some volatility to the financial markets this year, unless you see a sweep by either party, it is unlikely that major policy changes will be enacted in the foreseeable future. With that said, at some point the market will change course and investors will experience a downturn that is measured in months or even years. This very well could still be far into the future and is impossible to predict.

The past year delivered investment returns that exceeded even the most optimistic market predictions. Should financial markets move essentially nowhere in 2020, we believe this would be an acceptable return given the strong gains in 2019. In fact, one could make an argument this would be a healthy outcome since it would allow the economy to essentially catch up to the stock market. In some ways this is what happened in 2011, 2015, and 2018 when the S&P 500 returned between +2% and -5% during those calendar years. All three of these years were preceded and followed by double-digit returns. Keep this in mind as 2020 progresses, especially if the year gets off to a rough start.

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