Insights: December 2019

Market Overview and Performance

As we approach the final trading days of 2019, few people, ourselves included, would have believed anyone who suggested that this year would experience extraordinary gains across almost every asset class. Consider that twelve months ago in December of 2018, the S&P 500 tumbled -15% during the first three weeks of the month wiping out all the gains achieved during the year. And according to many at the time, the world was sitting at the precipice of a global recession. Beyond that perception, if anything, the concerns over trade, tariffs, Brexit, slowing global manufacturing growth and acrimony in Washington only deteriorated as the year progressed. Yet as we sit writing, the S&P 500 is up almost 30% during the past year, global equites are up roughly 20% and even bonds and gold have risen by close to double digits. These returns are well beyond what would be expected on an annual return basis even when all is well with the world. As a result, many investors are closing out the year pleasantly surprised but somewhat perplexed. Market technician Larry Tenatarelli wrote in a recent note, "There are two key ways that I saw people trading this year: Those who are trading with no preconceived top-down narratives are having a great year. Those who are going in with some type of view, `Fed is wrong', `slow economy', etc. have been on the wrong side. The key takeaway is that nobody is smarter than the market. Trying to impose our will or view on the market is a losing proposition." We would certainly agree and feel there are reasons to be optimistic as we look ahead to the events of 2020. Most importantly of course, is the de-escalation of trade tariff retaliation between China and the US.

In the meantime, please enjoy your Holiday Season, and thank you for reading our latest Insights.

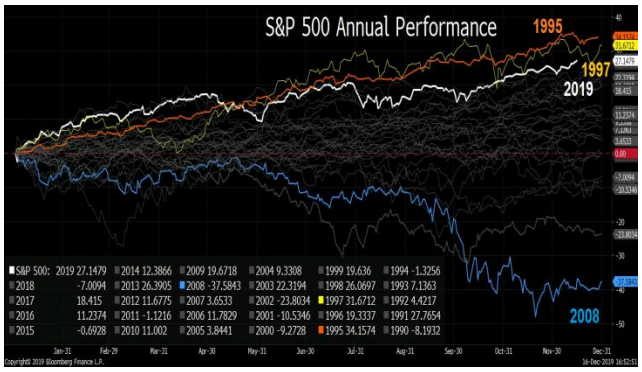
	Month to Date November 30	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	3.63	**27.63**
Russell 2000 Index	4.12	**22.01**
MSCI EAFE Index	1.13	18.17
MSCI Emerging Markets Index	-0.14	10.20
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**-0.05**	**8.79**
Barclay's U.S. Aggregate Credit Index	0.53	**22.24**
Barclay's U.S. Aggregate Corporate High Yield Index	0.33	12.08
Barclay's Municipal Bond Index	0.25	**7.21**
Macro Measures		
Gold	-2.78	**14.94**
Crude Oil	1.83	21.49
CBOE Volatility Index	**-4.54**	**-50.35**
USD Dollar Index	0.90	2.18

Current Theme – The Uncertainties of 2019 Appear to be Resolving – The Removal of Escalating Trade Policies, Brexit Doubts and Rate Increases by the Fed Encourages Investors

The Consensus View in the Market Seems to be that Most of the Unknowns for the Next 12 Months Have Evolved in a Risk Friendly Manner

As we write this month's letter, the S&P 500 is hitting an all-time high of 3200 which brings its annual price return to close to 28%. This is over 30% on a total return basis which includes dividends. As illustrated in the chart below, that represents one of the best performances of the last few decades. Only 1997 and 1995 finished the calendar year with higher returns.

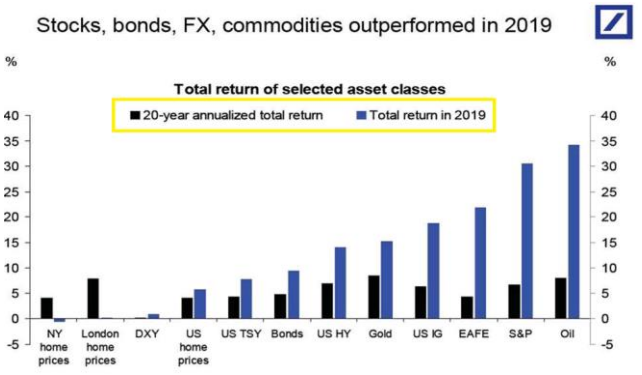
2019 S&P 500 Return of 28% Among Best in 3 Decades



Source: Bloomberg

However, it was not just large cap US equities that performed well this year. In fact, as the chart below from Deutsche Bank highlights, the 2019 returns of almost every asset class was far above what their historical annualized returns have been.

Almost Every Asset Class Outpaced Historical Return Avg.



Source: Bloomberg; Deutsche Bank Global Research

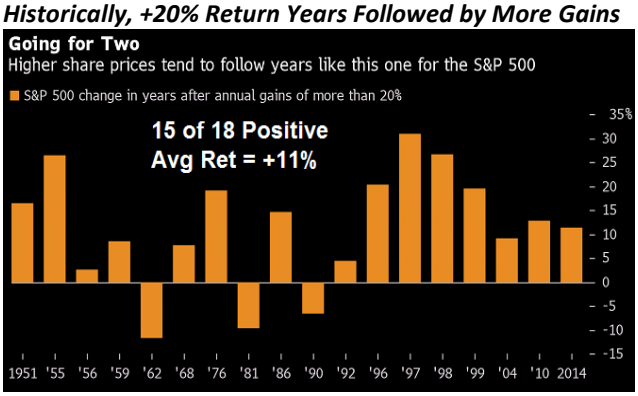
Generally speaking, after experiencing an exceptional return year, we would be leery about the opportunity to achieve further gains. However, it is important to acknowledge that markets have essentially only retraced their way back to where they stood before the US-China trade war begin in early 2018. Looking at the chart below, one can see that global equities (ACWI) have only just this week made it back to the prior peak seen in January 2018. While US markets have fared better rising +10% over the roughly two year period, most other equity regions still remain below past peaks.

Most Global Markets Have Yet to Reach Jan 2018 Highs

Source: Bloomberg

We point this out for two reasons: one, the damage from the trade war is still present, and two, despite the 2019 return number, equity markets are not overly exuberant in a manner that has marked prior market tops in the past. To put it plainly, to a certain degree, 2019 was more of a reaction reversing the extreme pessimism of late 2018. And while almost 30% is unquestionably a big number, it is not necessarily predictive of future declines.

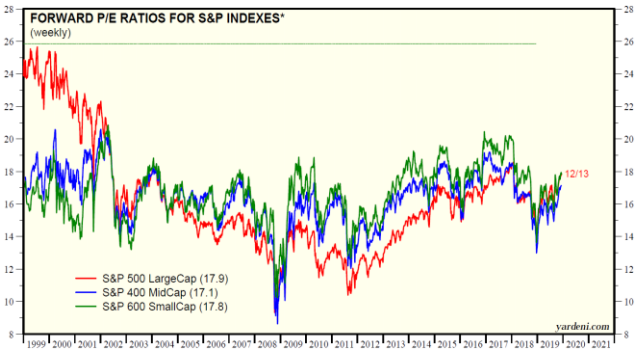
Historically, +20% Return Years Followed by More Gains



Source: Bloomberg; MKM Partners LLC

Consider the previous chart. According to MKM Partners, since 1950 there have been 18 years when the S&P 500 has gained over 20%. On 15 of those occasions, the proceeding year's annual return was positive with average return of 11%. Incidentally, two of three down years, 1981 and 1990, occurred when the economy was entering a recession. The pattern holds for +30% years as well - the market has been higher 10 out 12 times with average return of 15%.

17x 2020 Estimated Earnings is In-Line with Last 20 Years



Source: Dr. Ed Yardeni

Without a doubt, historical patterns are helpful but each year is unique. The justification for further gains from current levels will have to come from valuation and earnings. Despite what some may suggest, PE ratios for 2020 for large, mid and small cap stocks remain within the range of the past 20 years. While clearly not as cheap as they were at the end of 2018, a 17x PE on earnings is not extended.

Cash Flow Valuation Measures Remain Reasonable

Source: Credit Suisse

Similarly, other measures such as Price to Free Cash Flow, a metric we use extensively when analyzing individual companies, does not show that stocks are trading at valuation levels which would cause concern.

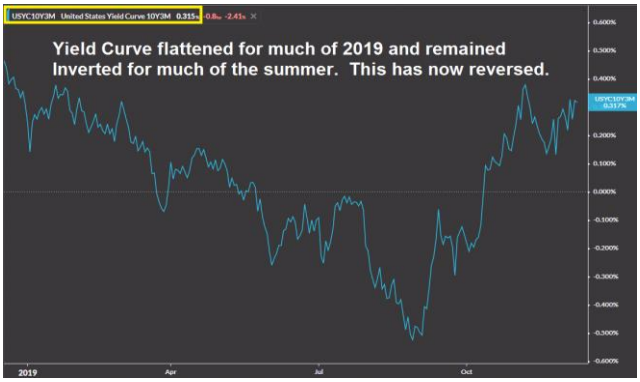
Admittedly, we could show other metrics like the S&P 500 Price to Sales ratio which does look high, but in aggregate, we view the current levels as appropriate as long as the earnings growth component improves as anticipated after the bottom in 4Q 2019.

Earnings Growth is Anticipated to Re-Accelerate in 2020

Source: The Earnings Scout

Even before the announcement of a Phase 1 trade agreement, consensus estimates were for earnings growth to rebound after a precipitous decline which followed the fading impact of corporate tax cuts. After bottoming in the fourth quarter of 2019, earnings are projected to rise to $178.67 in 2020 which would represent growth of 9.7%. This seems very plausible especially when one considers that 4 sectors which represent over 50% of the S&P 500 (technology, consumer services, consumer discretionary and industrials) all had flat or even declining earnings growth in 2019. This provides an easier base to grow from particularly if global trade improves meaningfully.

10 Year-3 Month Yield Curve Has Reversed Inversion

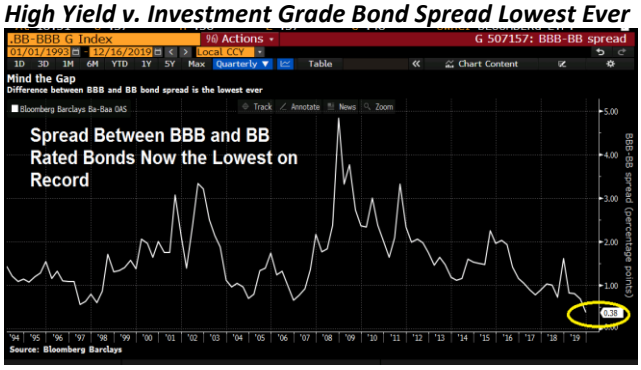


Source: Koyfin Inc.

Importantly, credit markets, which typically provide the first indication of overall market direction, have improved significantly since the end of September.

As the previous chart shows, the yield curve as represented by the difference between the 10 Year Treasury Bond and the 3 Month Treasury Bond has gone from -50 basis points to a +32 basis points. This transition back to a normalized yield curve is generally interpreted to mean that the outlook for economic growth has improved. Additionally, with its third rate cut of the year in October, the Fed essentially confirmed that it would not be moving rates either up or down in 2020. This anchoring statement allows investors to have confidence in the level of short term rates for next twelve months at the very least.

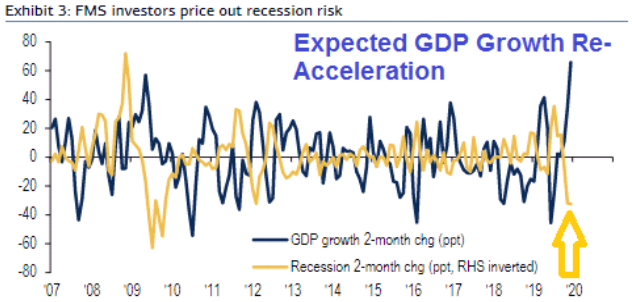
High Yield v. Investment Grade Bond Spread Lowest Ever



Source: Bloomberg; Lisa Abramowicz

If one requires more evidence of confidence from the credit markets, consider that the spread between BBB rated bonds (High Yield) versus BB (Investment grade) hit an all-time record low of just 38 basis points in December. Companies issuing high yield bonds are the least capable of paying back their debt, so as stress levels rise, so too will their required premiums, or yield. With a record low spread over investment grade bonds, the market is suggesting that the current environment is one with low economic risk levels. This optimistic sentiment was also reflected in the recent December BofA Global Fund Manager Survey.

Dramatic Reversal in Growth vs Recession Expectations



Source: BofA Global Fund Manager Survey

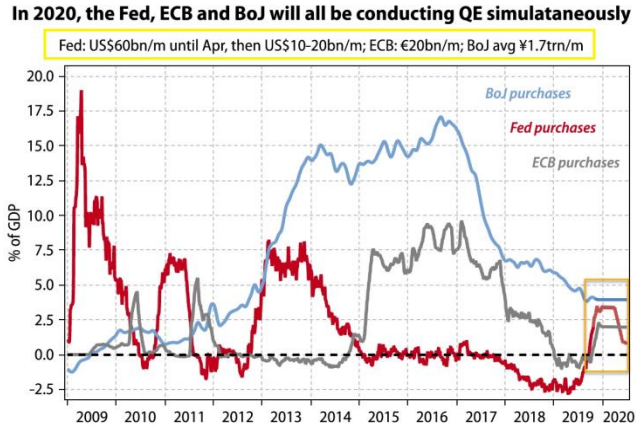
As the previous chart highlights, the firm observed their largest reversal in expectations on record. Expectations for changes in GDP growth (blue line) have spiked higher while the percentage anticipating a recession (yellow line) has fallen dramatically.

Expectations for Profits and Global mfg PMIs Have Risen

Source: BofA Global Fund Manager Survey

Similarly, when looking on a global scale, fund managers have drastically improved their outlook for profit growth (yellow line above). As the graph clearly illustrates, profit growth is highly correlated with global manufacturing PMIs (blue line). The chart suggests that managers believe the recent upturn in global manufacturing data will continue moving higher.

After 3 Yrs of Decline, Central Banks will Inject Liquidity

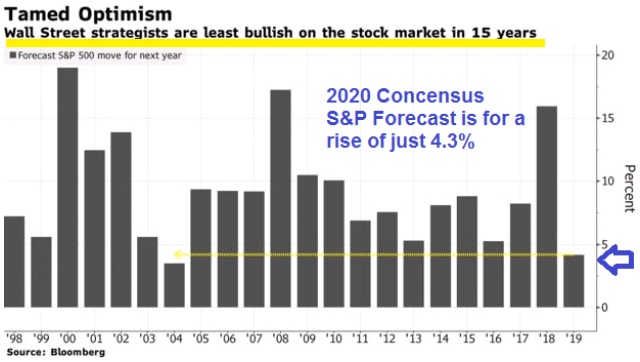


Source: GaveKal / Macrobond

Whether you choose to agree with the label of quantitative easing or not, an important factor behind the investor confidence we are discussing is a significant shift in the behavior of central banks coming in 2020. After peaking at the end of 2016, asset purchases, or the injection of liquidity into the financial system by Central banks in the US, Europe and Japan

all declined for three straight years. However, that trend is set to reverse once again with all three banks set to resume asset purchases in 2020. There are legitimate reasons to argue for either why or why this isn't prudent monetary policy, however, pushing liquidity into the system is beneficial to risk assets and market participants are keenly aware of this impact.

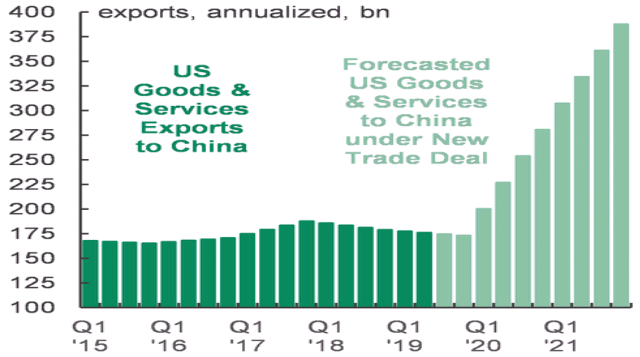
Wall Street 2020 Forecasts Are the Lowest in 15 Years



Source: Bloomberg

With all of these positive sentiment data points, one might question if the view is becoming too optimistic. We would suggest no, since the global economy is still in a "show me" state. Essentially, the improvements we have witnessed across various economic factors and the apparent resolution of several macro issues have to actually come to fruition. Many investors remain skeptical. As evidence, consider the chart above. Wall Street forecasts for the 2020 S&P 500 return sits at just +4%, the lowest estimated gain in 15 years. Of course with the recent announcement of a Phase 1 trade deal between the US and China, those estimates may start to climb. There is a long way to go however, before any tangible benefits from the deal will be felt. Many questions surrounding the

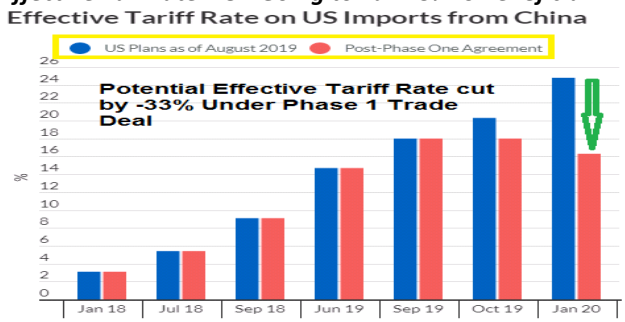
Phase 1 Would Require Huge Increase in China Purchases



Source: Scotiabank Economics; US Congressional Research Service

the actual agreed upon elements of the deal remain, however, the basic tenets are twofold: one, this is largely a transactional agreement where China has verbally signaled an intent to purchase more US goods; and two, the escalating tactics of increasing tariff levels will cease for the time being.

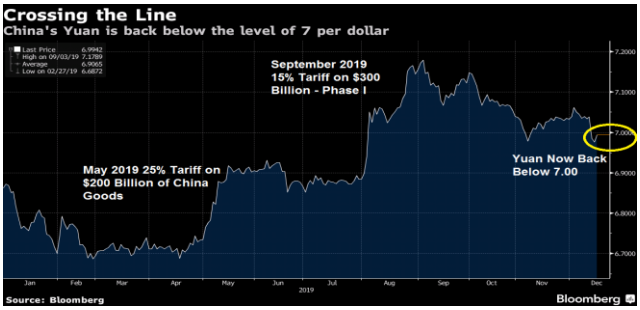
Effective Tax Rate NOT Going to Full 25% is Beneficial



Source: Fitch Ratings; USTR

Both of these pieces are important. With regard to the purchase of goods, the chart at the bottom left highlights the challenges present. The peak in US goods and services from 2017 was $175 billion. The number on the table is for an additional $200 billion of goods purchases over two years. We and many others find it very difficult to believe that this will transpire. More likely is a scenario where purchases increase somewhat but China also essentially just moves some chips around the board by including trade through Hong Kong and ethanol purchases in the accounting which were previously absent. Perhaps more importantly, the effective US tariff rate on China that was set to increase to 25% in December is now held at 16%. As developments evolve, we would suggest using the Yuan/US$ as a proxy of success. It has already strengthened after weakening earlier in the year and we would expect this to continue if all is going well with the deal.

Watch Chinese Yuan Level to Gauge Trade Progress



Source: Bloomberg

Going Forward

As regular readers of our letter will recall, we have held the conviction that the perceived concerns on the macro level were overdone and would not impede price gains as the year progressed. In our August 2019 Insight Letter, we wrote the following: "We are constructive on the near-term outlook for risk assets, but would anticipate some largely sideways price movement over the summer months as trade negotiations evolve. In our view, a resolution of trade disputes combined with a reduction in interest rates has the potential to fuel meaningful gains in equities into year end and 2020." This thesis played out as the Fed cut rates for the third time in October (promising to also hold rates steady for al of 2020) and a Phase 1 Trade deal between the US and China materialized in mid-December. Additionally, after much tumult, a final Brexit resolution appears to be slated for the end of January. This confluence of events removes a great deal of uncertainty that has plagued investors for the last 24 months. And finally, the growing evidence that the slowdown in global growth may be ebbing gives us further confidence as we head into the New Year.

Our sector emphasis for the majority of 2019 has centered around the technology, financial and industrials sectors. This positioning served us well as technology names rose an astounding 47% this year as a group (XLK ETF), financials climbed 31% and the industrial sector returned 28%. While we have reduced position exposure throughout the year to protect gains, we still continue to see opportunity in these areas given the current dynamics. Both the technology and industrials sectors serve to benefit from the potential for improving global trade as well as lower costs of goods sold due to reduced tariffs. The financial sector may also benefit from potentially higher interest rates resulting from a lack of recession fears and the increasing steepness of the yield curve which we have already witnessed.

While small and mid-cap stocks have participated in the gains this year, returning roughly 23%, both segments have lagged their large cap counterparts since end of 2017. Over that time period the S&P 500 has returned over 19% while small and mid-cap stocks have appreciated by only a little over 8%. This leaves small and midcap companies trading at discounts to the S&P 500 despite their higher growth rates. Further, we would be looking to opportunistically add exposure to small and midcap companies heading into a year with potentially improving domestic economic growth.

Equity markets outside of the US are compelling in our view. Non-US markets are much more accommodative in their monetary policy endeavors and will continue to do so in 2020. Importantly, valuations are substantially lower than the US – at multi-decade lows in some cases. This, combined with recent improvements in economic activity in markets like Europe and Japan make non-US markets attractive. We have favored emerging markets equites for quite some time. The asset class has continued to be hindered by both a strong US dollar and trade tensions. However, the valuation and growth levels are compelling. With a reduction in the friction now present in the global supply chain via tariffs, EM assets could potentially represent an important opportunity in 2020.

The relentless flattening yield curve that eventually inverted in mid 2019 has recovered significantly as the threat of a recession appears to be fading away in the eyes of many investors. For our fixed income exposure, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value.

Our measured allocations to gold and non-precious metal commodities have continued to serve us well as a diversifier in our portfolios in 2019. Commodities in particular remain at multi-decade lows in terms of their valuation relative to equities. An improvement in global economic growth could serve as an impetus for the group in 2020.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.