FINANCIAL MARKETS COMMENTARY

4TH QUARTER, 2019

TELEMUS®

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FOURTH QUARTER HIGHLIGHTS

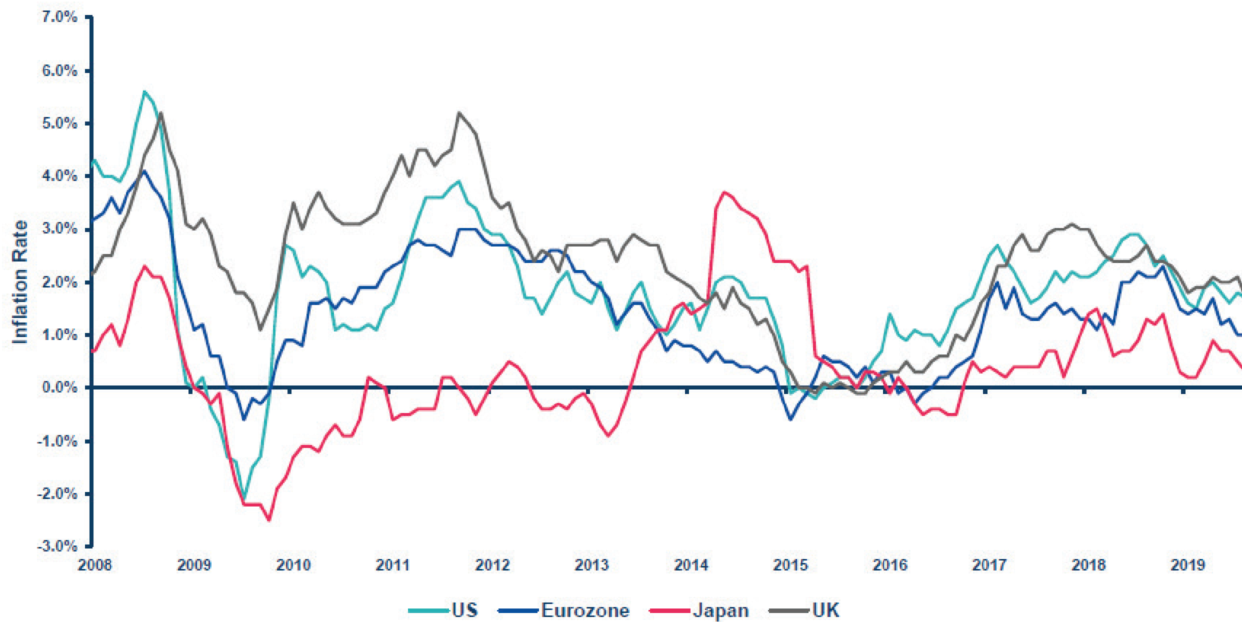
- Economic conditions stabilized in the 4th quarter. As cooperation entered the global lexicon, resolutions were reached around a phase one U.S./China trade deal and with USMCA replacing NAFTA. Moreover, there appears to be a path toward achieving a conclusion to Brexit. These developments serve as a sign of optimism for the global economy heading into 2020.
- Equities had a robust 4th quarter of 2019. Dovish central bank policies in 2019 helped to fuel this better than average result, likely pricing in some future growth. Valuations appear full, but are not overly expensive. Going forward we would expect equity returns to approximate earnings growth as further multiple expansion is less likely.
- Bond returns were muted as gains that stemmed from lower interest rates earlier in the year seem to have played out. Going forward, results are more likely to mirror interest income going forward as we view interest rates to be at the lower end of their range.
- Oil prices rebounded in the 4th quarter as further supply cuts should serve as a support to the commodity price.
- After appreciating throughout much of the year, the dollar weakened during the quarter. This helped to bolster returns of emerging market debt and equity.

ECONOMY

U.S. and global economic conditions stabilized in the 4th quarter. During the summer an inverted yield curve and contracting manufacturing activity served as indicators that a recession may be on the horizon. Since then the yield curve has steepened and manufacturing activity has stabilized, although it remains in contraction. In the U.S., consumer spending and sentiment remain high on the backs of a 50-year low in unemployment and wage growth of roughly 3%.

Global GDP is likely to finish the year around 2.5%. Inflation has remained stubborn at 1.6% globally and at 1.8% in the U.S.

Inflation Rate of G-4 Economies



Source: Bloomberg and Amundi Pioneer. Data through September 30, 2019.
Year-over-year monthly percent change, all items.

ECONOMY

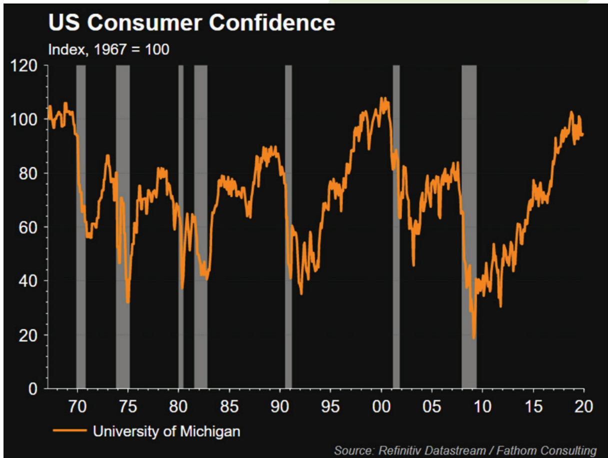
Globally, the 4th quarter seemed to be a transition point back toward stable monetary policies after major central banks paused on any further accommodation. Earlier in the year the Fed, ECB and Bank of Japan all lowered interest rates along with 15 emerging market central banks. These policies were driven by a slowdown in manufacturing activity along with the U.S./China trade dispute.

The Federal Reserve appears to have completed its campaign of easing with a 3rd and final rate cut of 2019 occurring in October. The Fed's posture has now shifted to one where they do not expect to see further rate cuts or increases until there is a notable shift in economic conditions. In particular, our interpretation is that the Fed is increasingly focused on inflation and seeing it sustained above the 2% long-term target.

Manufacturing activity remains in a state of contraction, although the rate of change both in the U.S. and abroad stabilized during the 4th quarter. As many of the key geopolitical risks of 2019 (trade negotiations, Brexit) all seemed to have found some level of resolution in December, there appears to be improving sentiment around the prospect for a renewed pickup in growth during 2020.

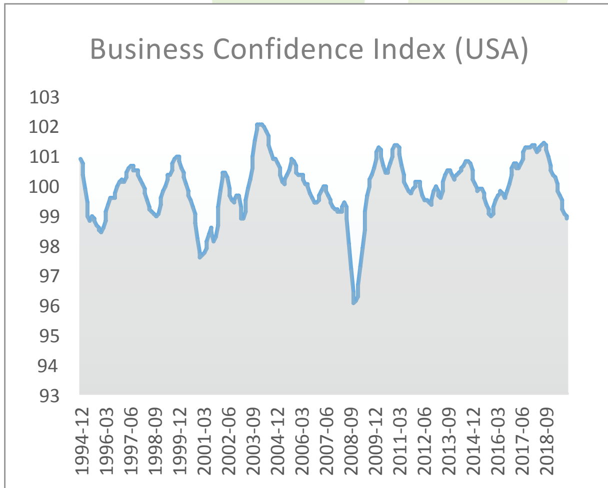
Consumer sentiment readings have remained at high levels throughout 2019. The last time sentiment has been at these levels was the late 1990's. Considering the consumer represents nearly 70% of economic output, this is a positive for the economy. Alternatively, business confidence has been declining of late. The hope is that resolution on trade negotiations and Brexit will improve confidence levels. Given only a phase one trade deal with China was completed, and electoral politics are likely to heat up during 2020, we are not expecting any significant upticks to business confidence.

U.S. Consumer Confidence



Source: Refinitiv

Business Confidence Index



Source: OECD

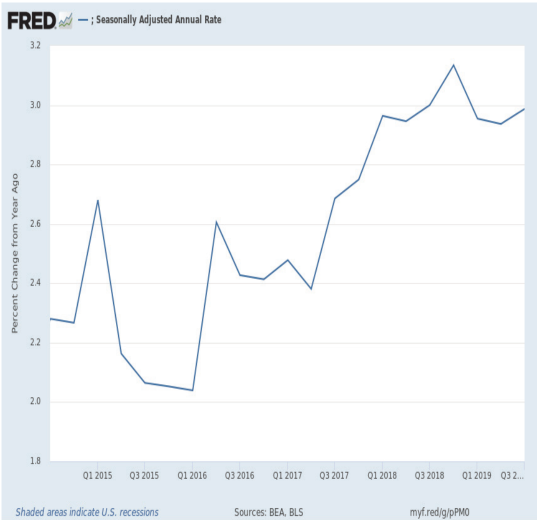
ECONOMY

We do see elevated recession risks. As we look at the drivers of the economy, consumer spending remains healthy. Through November, consumer spending grew 4% y/y, which compares to wage gains of around 3%. While household savings rates remain healthy at 7.9%, the trend in 2019 has been that consumers are outspending their wage gains. While this may continue for awhile longer, it can't continue into perpetuity. Therefore, business spending or government spending will need to pick up in order for the economy to keep up its pace.

Personal Savings Rate

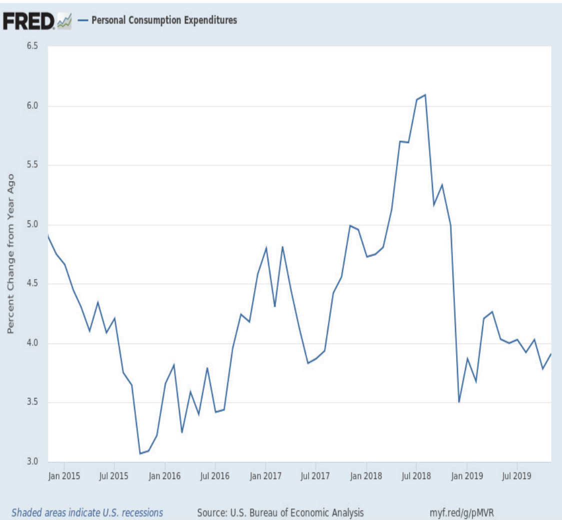
Source: Refinitiv

Wage Growth



Source: FRED database, Federal Reserve

Growth in Personal Consumption



Source: FRED database, Federal Reserve

ECONOMY

With a phase one trade deal done and awaiting approval and phase two negotiations beginning, the prospect for an improvement in business sentiment exists. We would not be surprised to see some improvement in capital spending and inventory re-stocking in 2020, although any improvements are likely to be modest, particularly in light of the fact that key issues remain in China/U.S. trade negotiations and we are entering an election year, which is likely to lead to greater uncertainty.

An added wildcard is the follow on effects from dovish Federal Reserve actions in 2019. While the market clearly benefited from the actions, the economy does not appear to have felt the full benefit from the three rate cuts during 2019. Moreover, as we have stated in the past, the incremental benefit from any additional action from central banks is likely to diminish with each successive action.

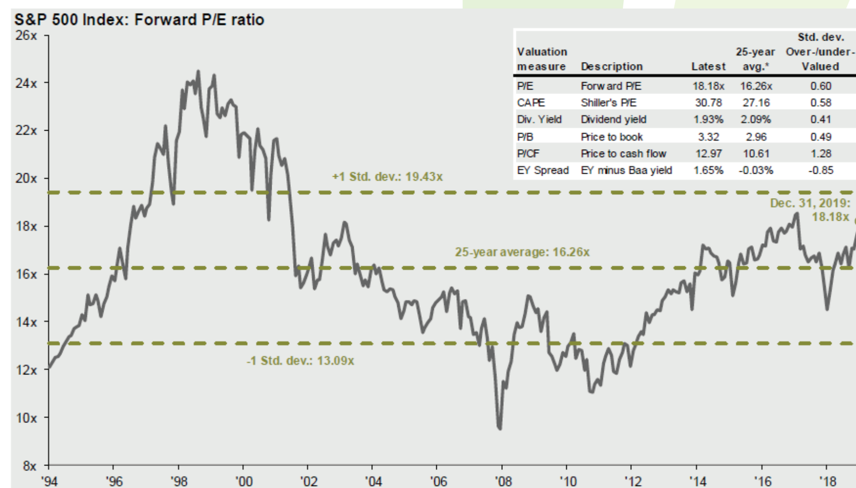
EQUITIES

U.S. Equities climbed steadily during the 4th quarter with the S&P 500 up +9.1%. Many of the major U.S. equity indices hit record highs during the quarter. Although small cap stocks rallied significantly in Q4, they remain below their mid-2018 peak.

US Indices	Q4	2019
S&P 500	9.07%	31.49%
Dow Jones Industrials	6.67%	25.24%
NASDAQ Composite	12.46%	36.69%
S&P Midcap 400	7.05%	26.55%
Russell 2000	9.94%	25.52%
Russell Microcap	13.45%	22.44%

S&P Sectors	Q4	2019
Technology	14.40%	50.29%
Healthcare	14.37%	20.82%
Financials	10.44%	32.09%
Communications	8.99%	32.69%
Basic Materials	6.37%	24.58%
Industrials	5.50%	29.32%
Energy	5.49%	11.81%
Consumer Disc.	4.47%	27.94%
Staples	3.51%	27.61%
Utilities	0.80%	26.40%
REITS	-0.54%	29.00%

Lower interest rates, slightly better than expected 3rd quarter earnings results, stable economic indicators and eventual progress on a U.S./China phase one trade deal collectively led to a drift up in returns. The S&P 500 now trades at a multiple of 18.8x estimated earnings. This compares to a long-term average of 16.3x. Multiples remain within a normalized range, and given the low level of interest rates, a premium valuation is not unreasonable. We would argue, however, that it would be harder to justify any further multiple expansion from here.



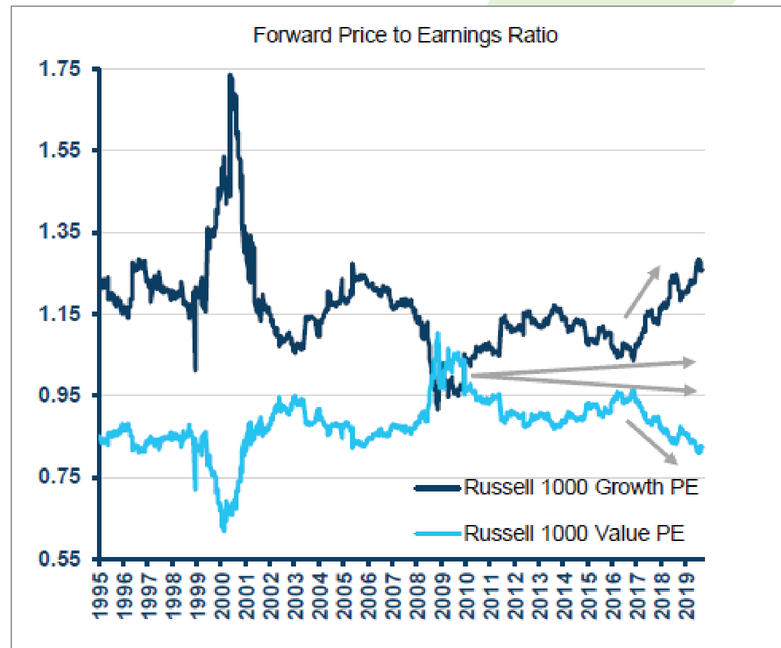
Source: J.P. Morgan Asset Management, FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters.

EQUITIES

Growth stocks continued to outperform value. In September, value stocks experienced a brief respite and outpaced growth. That shift was short lived and growth returned to favor in the 4th quarter. The difference in price/earnings multiples of growth and value stocks is now reaching a level not experienced since the Tech bubble of the late 1990's, although not to the same magnitude. We see this divergence as an indicator of a long-term opportunity in value stocks.

Stock returns outside of the U.S. were equally robust. Developed markets, as measured by the MSCI EAFE, returned +8.2% in Q4, slightly behind their U.S. peers. Emerging markets stocks had a robust 4th quarter, appreciating +11.8% after a strong month of December. Emerging market stocks benefited from strong performance out of Asia and Latin America. A depreciation in the dollar also served to benefit returns.

Ratio of Russell 1000 Growth P/E Multiple to Russell 1000 Value



Source: Amundi Pioneer and Bloomberg

FIXED INCOME

Fixed income markets were benign in the 4th quarter. Interest rates trended higher, more so among long dated maturities. With long-term rates rising more than short-term rates, this resulted in a steepening of the Treasury yield curve. The difference in yield between 2-year and 10-year Treasuries finished the year at the steepest spread since October of 2018.

The modest shift toward higher long-term yields was not significant enough to erode returns. The Bloomberg Barclays U.S. Aggregate index returned a modest +0.5% in the 4th quarter. Returns were driven by current income, as higher yields had the impact of pressuring bond prices.

Credit spreads continued to tighten and are at the lower end of their historic range. Within our clients' portfolios we have noticed an uptick in the amount of bonds that have been called, as the decline in interest rates has led to a wave of refinancing activity.

Mortgage Backed Securities, which have trailed much of the fixed income market in 2019, showed improved results in the 4th quarter, up +0.7%, outpacing the broader bond market.

Municipal bonds posted positive returns across maturities. Results were on par with corporate bonds during the quarter. There remains a considerable amount of inflows into municipal bonds. Supply/demand conditions remain stretched, although the amount of supply improved in the 4th quarter, but not enough to match demand.

A theme from prior quarters has been the amount of negative yielding debt globally. In the 3rd quarter, the amount of negative yielding debt peaked at nearly $18 trillion. That number fell during the 4th quarter and presently sits around $11.5 trillion.

Overnight repurchase agreements (repos) experienced an episode of dislocation in mid-September as yields unexpectedly spiked higher. The Federal Reserve subsequently took measures to step in and stabilize the repo market. The conditions that led to the events in September (corporate tax payments due, treasury bill auctions) were also in play during December, although there did not result in any noteworthy dislocations.

COMMODITIES

OIL

Oil prices rallied in the 4th quarter after OPEC and Russia collectively agreed to cut 500,000 barrels a day of production. This led to a steady climb in oil prices, with WTI Crude Oil finishing the year near its high for 2019.

GOLD

Precious metals continued their strong performance, as the Philadelphia Stock Exchange Gold/Silver index appreciated +21.0%. For the year, the Gold/Silver index was up a remarkable +51.3%.

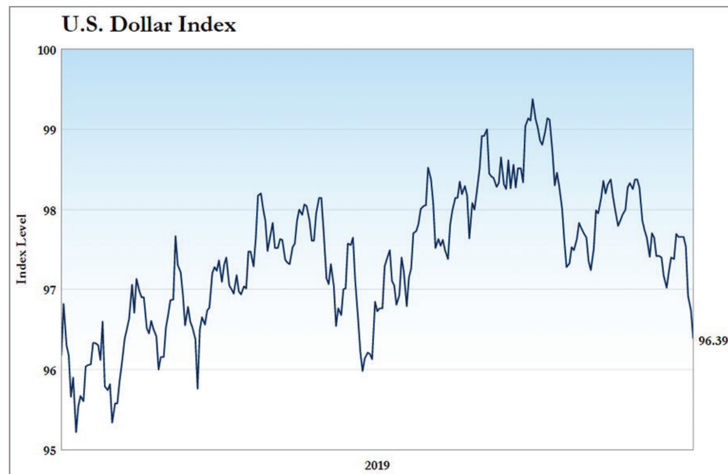
OTHER

A December announcement that the U.S. and China had come to an agreement on a phase one trade deal helped to bolster prices of agricultural commodities.

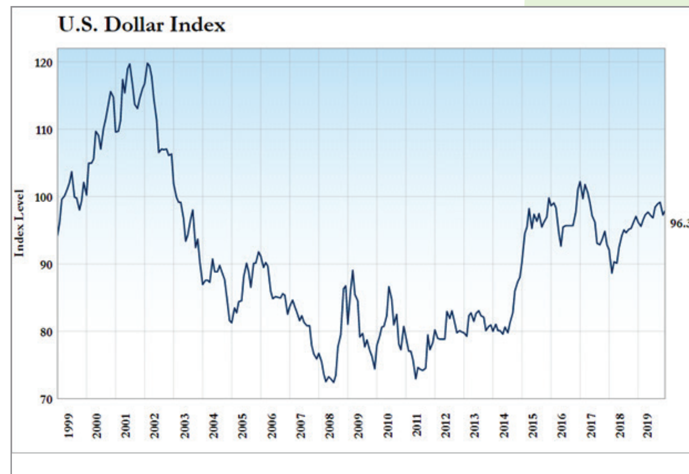
CURRENCIES

Through the first three quarters of 2018, the U.S. dollar strengthened versus other global currencies. Following the landslide Conservative victory in the U.K. and the announcement that the U.S. and China had reached a phase one trade agreement, the dollar began to depreciate in December. For the quarter, the dollar weakened by -3.0%. Despite this adjustment, the dollar remains strong relative to its more recent history. With the Fed on pause and some resolutions around trade and Brexit, we would not be surprised to see the dollar continue to depreciate from here.

Emerging market currencies experienced bouts of volatility, as they are prone to do, during the quarter. Political unrest in Chile has resulted in the Chilean Peso depreciating roughly 9% on the year. This follows substantial depreciations in the Argentinian Peso and Turkish Lira earlier in the year.



Source: Refinitiv, Datastream



Source: Refinitiv, Datastream

LOOKING AHEAD

As the fourth quarter progressed, we began to become more constructive on the economy. The softening conditions we began to see in the 3rd quarter have stabilized and with substantial progress made on geopolitical concerns, we see an avenue for additional economic growth in 2020. With all that said, returns in 2019 clearly borrowed from the future after a 31.5% gain in equities and an 8.7% return in bonds. After all, it was a year where economic growth was softer than expected, corporate earnings growth was flat, and central banks flipped to a dovish posture.

As we look ahead, we are focused on assessing which investment opportunities are adequately compensating our clients for taking risk. Broadly speaking, we are forecasting equity returns in 2020 to be inline with earnings growth (currently estimated to be around 7% in the U.S.) and fixed income returns to come entirely from interest payments. That's not to say there are not pockets of opportunities and longer-term we find value stocks and emerging market equities to be attractive investment opportunities.

While the risk of an economic slowdown has risen, should it occur, we would not expect it to be a deep recession. There are, however, pockets of heightened risk stemming from the level of corporate debt and pervasive exposure of debt across investor portfolios. The Fed itself has called out the level of corporate debt as a risk to the economy. In past cycles, risks associated with corporate debt were constrained to the bond market, more notably the high yield bond market and banks. As banks have scaled back their lending, bank loans have been securitized and are now widely held in individual and institutional portfolios. In addition, the private debt space has increased to a point where some investors are now considering it as an asset class. The broader exposure to debt it not a bad thing, but its important to note that any pickup in borrower defaults is likely to have broader impact than it may have had in prior cycles.

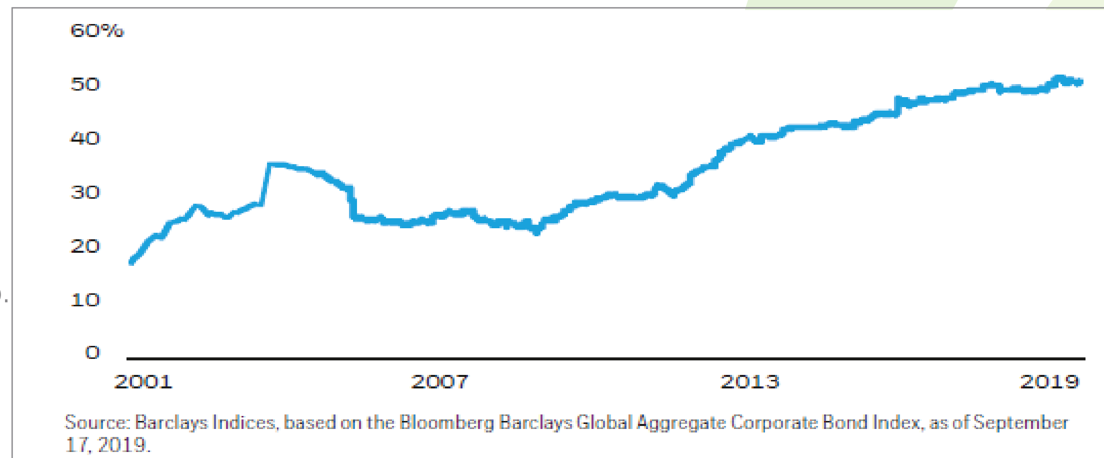
Fixed Income markets are perplexing as strong demand for these instruments and a lack of risk aversion have led to artificially stable conditions. Credit spreads remain at the low end of historic ranges. We've started to see warning signs of higher credit losses on the horizon, as evidenced from higher defaults among CCC rated bonds and widening spreads in riskier parts of the leveraged loan space. In addition, the amount of negative yielding debt globally has pushed some international investors to the U.S., and in particular the U.S. Treasury market. As the amount of negative yielding debt diminishes, or investors begin to worry about the U.S. dollar depreciating, the potential for these investors to sell their U.S. bonds may increase. We view this transitory demand as a near-term risk to fixed income returns, but not one that we'd expect to result in outsized declines. Lastly, we don't think its prudent to bank on interest rates falling further from here, nor credit spreads tightening. Therefore, returns in fixed income are likely to come from interest income, and not price appreciation, in 2020.

LOOKING AHEAD

From a portfolio perspective, the low level of absolute yield in bonds (the Bloomberg Barclay's Aggregate is currently yielding 2.3%) offers less cushion against an equity market pullback than bonds may have provided in past cycles. Bonds continue to add diversification and defensive exposure to portfolios, however, we believe its prudent for investors to have multiple avenues of defense and diversification in their portfolios.

In 2019 high yield issuance was quite strong, although a significant component of new issuance was refinancing of existing bonds that either matured or were callable. As companies have taken on more debt through the economic cycle, the distribution of credit ratings has shifted down. BBB rated bonds now make up 50% of the investment grade corporate bond market (see the chart below). This compares to roughly 20% before the Great Financial Crisis. Lower quality balance sheets combined with below average credit spreads makes investing in corporate bonds more challenging going forward.

BBB rated share of Global Investment Grade market



Source: Blackrock, Winter 2019 Investment Directions.

Outside of traditional asset classes, we have a more neutral stance on alternative investments. Real Estate fundamentals remain healthy, however capitalization rates (cap rates), which are key metrics used in valuing properties, remain near record low levels. In an environment where fundamentals remain strong, we could foresee real estate returns being inline with income generation. Private equity remains expensive with valuations nearly 2 multiple points ahead of historic averages, and significant uninvested capital on the sidelines waiting to be invested. We do not believe that this asset class offers a compelling risk/reward opportunity at the present time. Lastly, hedge funds exhibited improved results in 2019, versus 2018, although returns paled in comparison to long only equity and fixed income strategies. In a more muted return environment, hedge fund results may begin to appear more attractive on a relative basis.

CONCLUSION

As always we thank our clients for their partnership and welcome any comments or questions. For those of you who are not our clients feel free to contact us as well.

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