LINSCOMB WILLIAMS

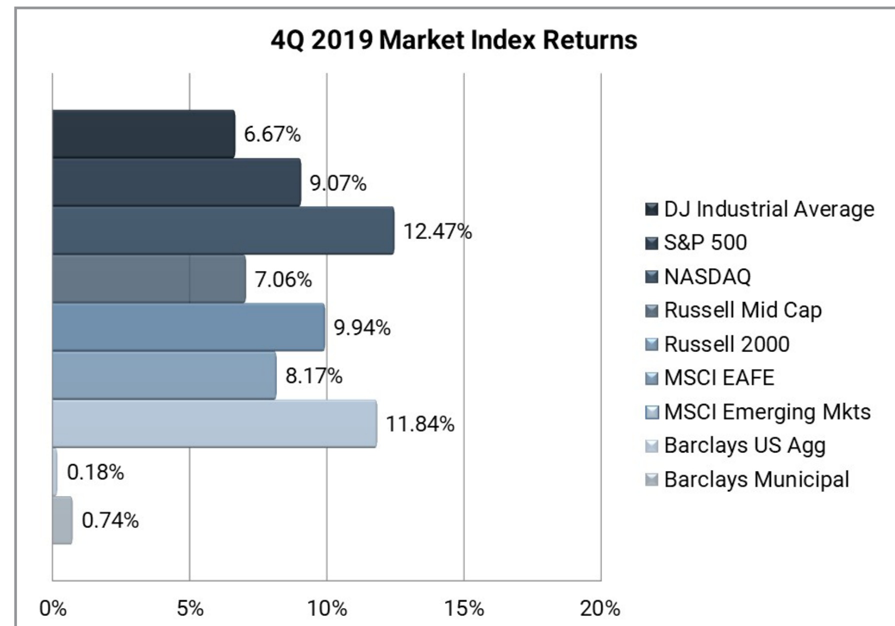
WEALTH MANAGEMENT SINCE 1971

# QUARTERLY MARKET COMMENTARY: *Fourth Quarter 2019*

## *the* ECONOMY

What a difference a year makes. At this time last year, we were still in the middle of a steep market correction. In fact, markets had just experienced what was, by some measures, the worst December for stocks since the Great Depression in 1931. Yet, amidst all the volatility in late 2018, investors received a holiday gift – a market bottom - though few realized it at the time. Down nearly 20 percent from its highs, the S&P 500 arrested its decline the day after Christmas. The ensuing Santa Claus went right on through year's end and even had the temerity to continue all the way to the close of 2019. For investors that stayed the course, the S&P 500 returned a whopping 39.52 percent in just over 12 months. To borrow a quote from Vanguard founder, Jack Bogle, success in investing can depend "on your ability to realize, at the height of ebullience and the depth of despair alike, that this too, shall pass."

But, there must have been some reason stocks flirted with a bear market in 2018, right? Well, not necessarily – stocks have always been volatile assets - but we can point to two main factors as likely catalysts. Those being continued interest rate increases from the Federal Reserve and escalating trade tensions with China. Both of which had investors worried about a potential recession as a result. And though the U.S. and global economy did slow, somewhat, the feared recession never materialized. Indeed, the U.S. is still faring relatively well more than 10 years into this expansion. GDP is expected to come in just over 2 percent for the year, which is a step down from 2018, to be sure, but still right in line with longer-term trends. The primary driver of growth



has been consumer spending, supported by a healthy labor market. Retail sales have increased throughout the year, and the early indication is that it was another strong holiday shopping season. Record low unemployment, currently at 3.5 percent, certainly helps those numbers. We might have expected net job creation to moderate a bit given historically low unemployment, but the 2019 average of 180,000 new jobs per month is very respectable. An underreported and, in our opinion, underappreciated fact regarding recent employment trends has been the steady increase of the "prime age" (those between 25 – 54 years old) labor force participation rate. It bottomed at 80.6 percent toward the end of 2015, but has since drifted steadily upward to its current level of 82.8 percent. A roughly two percentage point increase may not seem like much, but it represents hundreds of thousands of new potential workers. Wage growth has picked up lately as well, now running north of 3 percent annually, handily outpacing inflation which has hovered around the 2 percent mark. The consumer has been the workhorse throughout 2019, but we've also mentioned a burgeoning pick-up in housing activity over the past 6 months. As we close out the year, many important data points including new home sales, as well as new construction and permits, are in clear uptrends. Price appreciation is more subdued, but still positive.

While the consumer is doing quite well, business investment has been meager at best. Lower average commodity prices, ongoing uncertainty surrounding global trade policy, and perhaps the lagged impact of 2018's interest rate hikes, have all served to dampen capital expenditure plans, especially in the manufacturing sector. The ISM Manufacturing survey, a gauge of business confidence, recently fell to a 10-year low of 47.2, consistent with overall GDP growth of just over 1 percent. Total manufacturing and industrial output are both lower today than they were a year ago. The companion services survey though, looks much better at 55.0 (readings above 50 suggest expansion, below 50 contraction).

The story in Europe is similar, with a relatively supportive consumer environment but depressed manufacturing and trade conditions. The unemployment rate for the 28-member European Union (EU) is holding steady at 6.3 percent, its lowest level on record. Many of the bloc's countries though are much more dependent on exports for economic growth compared to the U.S. Thus, the decline in manufacturing has taken a larger toll. Germany, in fact, just barely avoided a technical recession. Other countries on Europe's periphery, Spain in particular, have picked up some of the slack, helping keep overall EU growth solidly in positive territory. In the U.K., we may finally be reaching an end of nearly three years of Brexit drama, or at least the first phase of it. In recent elections, Prime Minister Boris Johnson and his conservative party secured their largest parliamentary majority since 1987, vastly increasing the odds that their latest exit deal is agreed upon. The plan is for the U.K. to officially exit the EU on January 31, 2020.

New consumption taxes in Japan will likely hurt growth in the 4th quarter, but the legislation has been in place for some time and was well prepared for by consumers and businesses. From a policy perspective, Japan's governance is quite stable compared to the rest of the developed world, and it recently passed a fiscal stimulus measure worth over 2 percentage points over the next few years. Many of the country's technology firms have been fervently preparing for wider adoption of 5G and other products and services related to advanced electronic connectivity.

A broad swath of emerging market assets – stocks, bonds, and currencies – all rallied in the 4th quarter, as investors correctly anticipated some type of trade truce between the U.S. and China. And while the ongoing dispute has certainly had a negative effect on China's economy, to the tune of over $90 billion in reduced cross-border trade flows, surrounding countries have benefited. South Korea, Taiwan, and Vietnam have all experienced greater export volumes as supply chains have adjusted in response to new trade policies. One other interesting point that we noted last quarter is that unlike the U.S. and Europe, manufacturing confidence amongst the aggregate emerging market complex is actually higher than it was at the beginning of the year.

## CENTRAL BANKS

For all of 2017 and 2018, major central banks around the world were almost uniformly raising interest rates. The Federal Reserve's (Fed) key federal funds rate rose from just above 0.50 percent to almost 2.50 percent over that period. Not terribly high on an absolute basis, but a meaningful change relatively. This past year, however, the Fed rather abruptly reversed course, cutting rates multiple times in the 3rd and 4th quarter, leaving the current federal funds rate target now between 1.50 percent - 1.75 percent. Fed Chair Jerome Powell has signaled that there will be a high bar for any more near-term action on interest rates, in either direction. Further cuts likely require more pronounced economic weakness, while any increases would depend on sustainably higher inflation.

The European Central Bank (ECB) restarted its quantitative easing program under new president, Christine Lagarde. Twenty billion Euro a month is the set target for bond purchases. Sweden's central bank did buck the trend toward lower rates, if only by moving their key policy rate to 0 percent, out of its previously negative territory. This doesn't necessarily represent policy tightening though, in our opinion, but rather a growing realization among some central bankers that pushing rates below zero may have certain costs that outweigh the alleged simulative benefits.

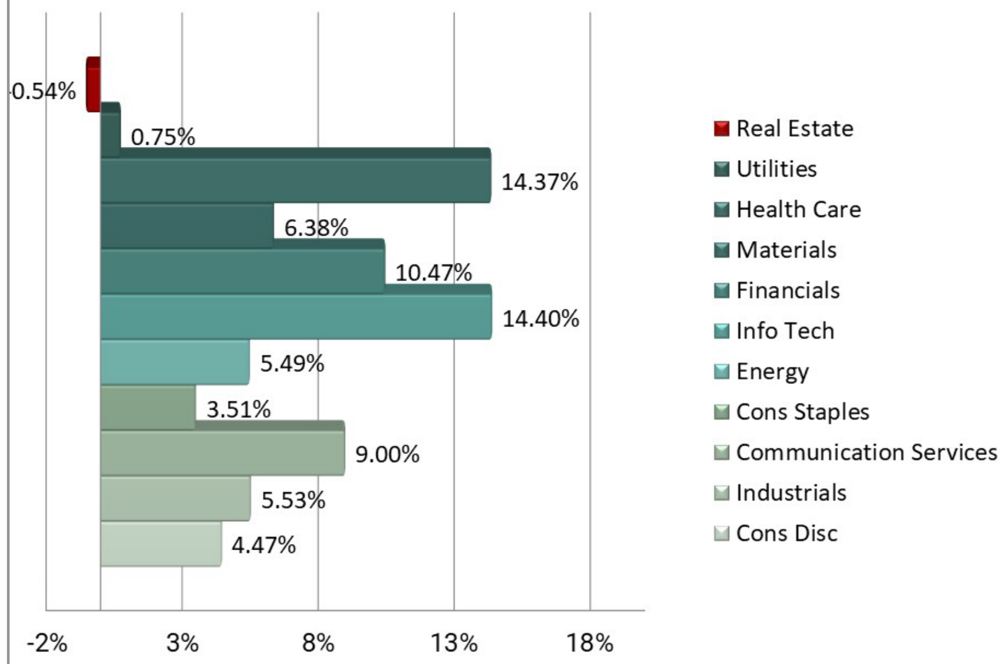
In general, though, the bias around the world is toward easier monetary policy. Lower rates in the developed world allows central banks in emerging markets to do the same. We'd characterize monetary policy in 2019 as being in a synchronous easing cycle.

## FIXED INCOME

Interest rates generally moved lower over 2019, but began to turn up around the globe in the 4th quarter. The 10-year U.S. Treasury yield opened the quarter trading at 1.68 percent and finished at 1.92 percent. A comparable German government bond yield increased from minus 0.58 percent to minus 0.19 percent. So, purchasers of that security can now lock in slightly smaller losses over the next decade.

Despite rising rates, which tend to lower prices, bonds did deliver positive returns over the quarter thanks to coupon payments. The Bloomberg Barclays U.S. Aggregate Index, which tracks a basket of investment grade government and corporate bonds, was up 0.18 percent. Lower-rated, higher yielding bonds performed very well, generating a 2.62 percent return over the same period. Given that strong performance of high yield bonds, spreads – the difference between the yield investors can earn on junk-rated versus investment grade bonds – is now historically thin, reducing the relative reward for taking on additional risk.

Also, an update on a risk we commented on last quarter, the inversion – albeit brief – of the Treasury yield curve at various times in the 2nd and 3rd quarters. Historically, when certain shorter-term rates are higher than longer-term ones, it has been a harbinger of an oncoming recession. Typically, though, this dynamic needed to persist for over three months before the signal became meaningful. Fortunately, the inversion has since reversed itself and the yield curve has returned to a more normal, upward sloping shape.




## EQUITY

Momentum is a powerful force in markets. Investors had already experienced fantastic returns for the first nine months of 2019, yet strength beget strength as stocks surged further in the 4th quarter. The S&P 500 gained 9.07 percent, bringing its total return for the year to 31.49 percent, the best since 2013. Leading the way were technology and healthcare shares, up 14.40 percent and 14.37 percent, respectively. Lagging sectors were the more defensive ones, such as real estate and utilities, which were little changed in either direction. Small cap companies also kept pace, with the Russell 2000 rising 9.94 percent in the 4th quarter.

Overseas returns were strong as well. A clearer path towards the U.K.'s eventual exit from the EU boosted European shares broadly, helping internationally developed markets to an 8.17 percent return during the year's final three months. Reduction in trade uncertainty from the newly announced "Phase One" trade deal between the U.S. and China lifted sentiment around emerging markets more broadly, helping shares in those countries outperform other regions, with a 11.84 percent gain.

We'd be remiss not to mention though that, at least in the U.S., earnings will likely show little to no growth this year. A slight decline is not out of the question either. Some of this is due to tough comparisons to 2018, when the effects of the corporate tax cut provided an outsized boost. The general slowdown in global manufacturing, which has shown signs of stabilizing, is also a factor. Nonetheless, valuation multiples, while not extreme, are trading at the more expensive end of their range over this bull market.

## OUTLOOK

Investors' worst fears at the end of 2018 turned out to be the fuel for a major rally in 2019. Instead of continuing to tighten monetary policy, the Fed did a 180 turn and embarked upon

a moderate easing cycle. Tariffs on China and other major trading partners didn't increase much further, and are actually in the process of being lowered in some instances in accordance with the "Phase One" trade pact. Also, the revised NAFTA agreement will potentially be passed into law soon. The merits of both deals, at least relative to the old arrangements, can be debated. But, the bottom line is that the agreements are a step in the right direction compared to the previous baseline of uncertainty. Of course, stock investors have been well-rewarded for their participation, but where do markets go from here?

The direction of markets in the short-term is impossible to predict, but in general, large drawdowns and bear markets are avoided in the absence of an economic recession, which we do not believe is imminent. The labor market remains healthy in our view. Typically, prior to downturns, layoffs increase significantly and job growth slows substantially, neither of which are happening at present. The current savings rate is well above its 25-year average, and household debt service obligations are fairly low, both of which should provide a cushion for consumer spending going forward. Also, consumer confidence is holding steady at strong levels, consistent with an ongoing expansion. Given that consumer spending has been a stanch contributor to economic growth, we're keeping a close eye on the direction of confidence surveys. Leading indicators on the business side have been flat lately, reflecting the manufacturing slowdown. But there are some early signs of stabilization. Business confidence measures have, on the whole, stopped getting worse. Plus, higher commodity prices, from oil to copper, should incentivize further capital expenditures. We wouldn't be surprised to see more fiscal stimulus out of foreign governments either, especially in Europe and Asia.

One of the main risks we see heading into 2020 is valuation levels. Given the market's performance in 2019, it appears to us that at least some of the expected rebound in economic growth and corporate earnings is already accounted for in stock prices. Secondly, a number of geopolitical risks could elevate volatility going forward. Our research partner, Strategas, points to five: (1) Iran escalation, (2) ongoing trade negotiations with China (even with "Phase One" in place), (3) impeachment of President Trump, (4) other trade policy (i.e., NAFTA, European auto tariffs), and finally, (5) the upcoming Presidential election. We don't know how each of the above will eventually play out, but suffice it to say, there is a wide range of potentially noisy scenarios and outcomes. With higher valuations and a fluid policy environment, we will be keeping a close eye on incoming economic data and corporate fundamentals. But, on balance, we still maintain a constructive outlook on the global economy and financial markets. Facing an uncertain future, we believe the best advice is to stick to the plan. A diverse mix of assets tailored to everyone's unique needs and risk tolerance should serve investors well going forward. As always, we are ready to adapt and modify portfolio allocations, as needed, in response to shifting market conditions.

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