CLIFFORD SWAN

THE Investment Counselor

FOURTH QUARTER 2019

WISDOM *for* GENERATIONS

MARKET OUTLOOK

By Peter J. Boyle
CFA, CIC

What a difference a year makes. Or does it?

It depends on where you look.

A year ago, we wrote about markets being at all-time highs, a strong domestic economy with extremely low unemployment, growing trade protectionism, the Federal Reserve ("Fed") moving deliberately to raise short-term borrowing rates, and few signs of a looming recession. From a stock perspective, we commented that we felt stock valuations were relatively high, especially within the technology sector.

SO, WHAT HASN'T CHANGED?

The domestic economy is still growing, while at a slower pace, with few signs of inflation and unemployment moving even lower. Internationally, Brexit is still unresolved and trade rhetoric continues while China and the Eurozone face worries about their own slowing domestic economies. In spite of a 15% market correction, which culminated on Christmas Eve, the market has moved 6.5% higher since September of last year, and is near all-time highs.

WHAT HAS CHANGED?

Trade rhetoric has intensified and stalled, causing both China and the U.S. to further escalate tariff levels. The negative impacts of these tariffs are beginning to show up in the economy. So, while the U.S. economy is still growing, manufacturing is slowing and by some measures is in a recession. The ongoing failure to successfully negotiate Brexit has ushered in a new Prime Minister and an upcoming election in the United Kingdom. Argentina now struggles to avoid yet another sovereign debt restructuring. In Washington, we are 12 months closer to the 2020 presidential election, so speculation about prospective policies has already begun.

Most notably, the perceived negative impact of these changes on the domestic economy convinced the Federal Reserve to reverse course. After increasing interest rates four times in 2018 with the aim of "normalizing" rates, thus far in 2019 the Fed has cut rates three times, with divided opinions on future cuts. Since

> "After increasing interest rates four times in 2018 with the aim of 'normalizing' rates, thus far in 2019 the Fed has cut rates three times, with divided opinions on future cuts."

bond prices move in the opposite direction from interest rates, this touched off the largest bond rally in a century—measured by the Bloomberg Barclays Aggregate being up 11.5% in the last twelve months as of the end of October!

In terms of market valuations, by the simple measure of the price-earnings ratio, earnings estimates for the market (using the S&P 500 Index as a proxy) have come down a little; so, on average, the market still appears slightly overvalued.

WHAT ARE WE TALKING ABOUT?

RECESSION FEARS

Many point to the current inverted yield curve[1] as a leading indicator of an upcoming recession. We'll say more on our opinion on the inversion below, but first note

> "…we do not see an imminent recession."

that we do not see an imminent recession. Ten years into an economic recovery, the calendar seems to validate this same concern. However, despite being long in the tooth, we believe the economic expansion will continue. While slowing, recent economic data still shows good job growth, near-record low unemployment, and continuing wage growth, all of which are supportive of continued growth in consumer expenditures. Additionally, recent rate cuts ought to provide a tailwind for business investment as well as reignite mortgage refinancing and housing de-

MARKET OUTLOOK | Continued on page 2

mand. There is no doubt that consumer and small business confidence have been dampened recently by the negative news flow, but these economic indicators are still positive.

IMPACT OF TARIFFS ON THE U.S. ECONOMY

An area of true concern, and one that might tip us into a recession, is the manufacturing sector of the economy. One centerpiece of the Trump administration's policy initiatives has been the attempt to revive domestic manufacturing, with a focus on leveling the playing field with our trading partners. This is not new news, but, despite recent glimmers of optimism, in the absence of fruitful negotiations (particularly with China), the U.S. has increasingly turned to tariffs in an attempt to pressure other countries, who have responded with their own tariffs. Unfortunately, this approach is much like fighting cancer; the body (domestic economy) suffers during treatment in the furtherance of the end goal. While the end goal is still not in sight, tariffs are producing a negative impact on the U.S. economy—particularly manufacturing. In the most recent ISM Manufacturing survey, which measures manufacturing activity, new orders, export orders, and manufacturing employment all plunged. Similar and likely greater economic pain is being felt in China, but who will blink first is up for debate.

POLITICS

Regarding the presidential election, it is far too early for much meaningful discussion—for now, one can only speculate. We will have more to say on potential impacts from policy debates in future writings. At this point, we remind you that, regardless of the outcome, the political system's checks and balances will result in any change likely being incremental. Additionally, the primary election cycle tends to be more polarizing than the general election. Regardless, this won't help dampen market volatility.

INTEREST RATES

The most significant development in the last year has been the level and direction of interest rates. While the Fed may have eventually succumbed to global interest rate imbalances, the persistently negative news flow gave the Fed added impetus to change course and lower rates to help bolster the domestic economy.

It could have been argued, solely looking at the domestic economy, that rates were already sufficiently low. However, in this increasingly global financial market with free capital flows, it would have been difficult to go against the tide of globally lower rates. With negative interest rates in Japan, Sweden, Switzerland, and the Eurozone, coupled with global tensions, it is little surprise that capital is flowing to the U.S. Dollar and Treasuries. We may scoff at earning 1.75% on a 10-year U.S. Treasury, but that far exceeds -0.4% on a 10-year German bond or -0.2% on Japanese 10-year debt. So, instead of the yield curve portending a recession, we believe the shape of the yield curve is being impacted by capital flows, trade, and continued low inflation.

> "...instead of the yield curve portending a recession, we believe the shape of the yield curve is being impacted by capital flows, trade, and continued low inflation."

MARKETS

Given these significant crosscurrents, it is not surprising that the domestic markets have gyrated, while remaining resilient. Backed by the strong dollar and better U.S. economic growth, domestic stocks have outperformed their international counterparts even with their higher valuations. As we mentioned earlier, despite a growing economy and modest risk-aversion, fixed income securities have generally outperformed stocks over the last year.

WHERE TO FROM HERE?

We expect the post-crisis expansion to continue, albeit at a slower pace, buoyed by a re-accommodative Fed. We need, however, to keep a close eye on the manufacturing side of the economy. Current conditions favor stocks,

> "We expect the post-crisis expansion to continue, albeit at a slower pace, buoyed by a re-accommodative Fed."

particularly those with dividends. Additionally, if any of the current negative factors—from Brexit, to U.S./China trade negotiations, to Iran and Twitter chatter—resolve themselves even slightly positively, there is the potential for the markets to climb materially higher. We see little reason for short-term dollar weakness, which ought to be good for investments denominated in the U.S. On interest rates, inflation is not dead, but we think rates will remain lower for longer. As the field for a Democratic candidate thins, we will begin to learn more about how potential policies may impact individual sectors.

Volatility is likely to remain, especially given the duration of the recovery and lingering national and global tensions. As we always remind you, make sure your portfolios are positioned to be able to take the requisite longer-term view with the equity (growth) portion of your portfolio. In other words, keep reserves/liquidity available for those inevitable rainy periods when the sun isn't shining on stocks. ◆

1. An inverted yield curve is a condition in which interest rates on short-term bonds are higher than interest rates on longer-term bonds. This unusual condition traditionally occurs when market participants expect the economy to slow or go into a recession. In a recession, the Federal Reserve would need to cut rates to stimulate the economy, so investors move early in anticipation of pushing down longer-term rates.

BALANCING RISK AND REWARD

By Lloyd K. Wong
CFA

"The two great risks are risking too much but also risking too little. That's for each person to decide." —Jimmy Chin, professional climber

"Just taking risks for risk's sake, that doesn't do it for me. I'm willing to take risks that I think are worth it." —Chris Hadfield, astronaut

Imagine you are on the crest of a snow-covered mountain, gazing at expansive vistas of dramatic snowcapped peaks, surrounded by majestic pine and fir trees. You push off on your skis and glide atop perfect powder, gathering speed as you slalom around trees, feeling the wind in your face, your feet undulating with the varying terrain, until you rest at the bottom. You look up at the face you've just come down, heart beating fast and adrenaline coursing through your veins! Now, imagine an alternative scenario—careening out of control down the mountain, your skis refusing to disengage, hearing a pop and feeling excruciating pain as your knee gives way, unable to bear weight, the result of torn ligaments. This was my experience six years ago when I tore my ACL and MCL at Whistler. Has this changed my desire to ski? Not a bit. For me, the thrill (reward) of skiing outweighs the potential peril (risk).

Life is full of trade-offs between risk and reward. How we choose to balance them is unique to each one of us. Just as I risked personal injury to experience my reward of skiing, we all take risks to pursue rewards we consider worthwhile.

At Clifford Swan, we evaluate risk on a daily basis; investments are undoubtedly far from immune to risk. Just as in life, the reward one receives as an investor is generally relative to the risk one takes.

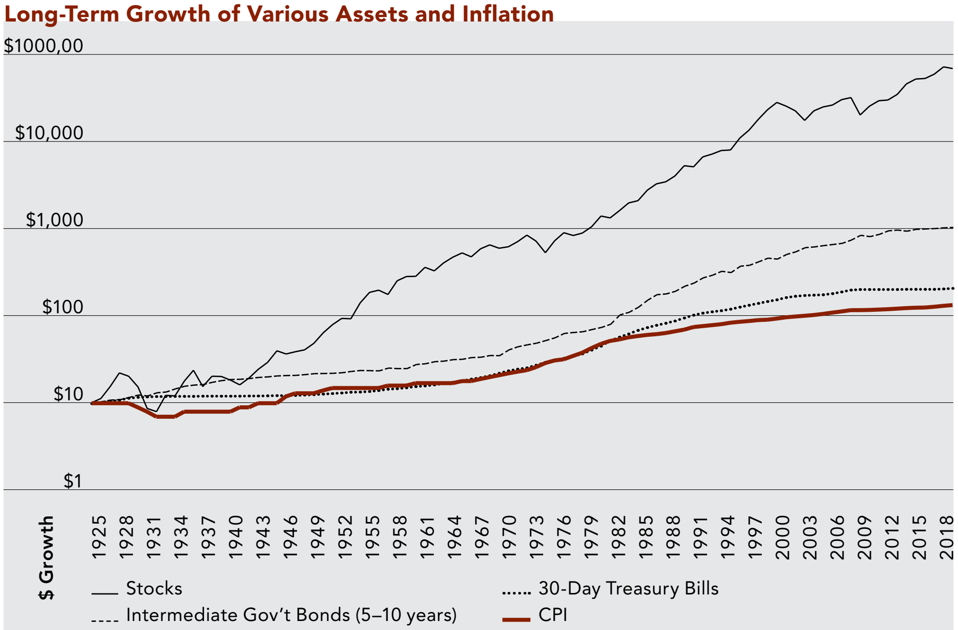
You can see this risk/reward trade-off in the chart below, which shows the long-term growth of stocks, bonds, and Treasury Bills (a proxy for cash) in comparison to inflation (CPI). *Reward* can be interpreted by the slope of a line,

> "Life is full of trade-offs between risk and reward. How we choose to balance them is unique to each one of us."

with a steeper line indicating higher reward. How smooth a line is indicates *risk*—the bumpier a line, the higher the volatility . . . and risk.

Each asset class depicts a particular historical risk/reward profile depending on the steepness and smoothness of its dollar growth journey over time (in this case, 1925–2018). With the understanding that history is not an indicator of future performance, an extremely risk-averse individual can seek to play it safe and invest 100% in a smoother line, such as 30-day Treasury Bills, and likely receive a lower return in the long run for selecting one of the least steep lines. Conversely, if one can tolerate the ups and downs presented by the bumpiest line (stocks), one could invest completely in stocks and gener-

Long-Term Growth of Various Assets and Inflation



Sources: Morningstar, Ibbotson Associates, Bloomberg, Bureau of Labor Statistics

BALANCING RISK AND REWARD |
Continued on page 4

Continued from page 3

ally anticipate receiving a higher return in the long run, as this line is also the steepest line.

HOW MUCH RISK CAN YOU ACCEPT?

The catch is, not everyone has the benefit of a long time horizon. For those who need to start withdrawing from their portfolios, there is always the risk of needing to withdraw funds during one of those times when the steep line is experiencing a bumpy downturn. Therefore, prudence would dictate against investing 100% in the steepest, bumpiest line if one's time horizon is shorter. Each individual will balance risk and reward preferences according to his or her own unique ability to tolerate the risk represented by each of these asset classes; thus, the amount of exposure an investor chooses to take in these asset classes will reflect each investor's unique risk profile. A few of the factors an investor may consider when deciding how much to invest in each of these asset classes include age/time horizon, economic circumstances, and liquidity needs. Determining an investor's unique risk profile is important for setting an appropriate asset allocation (the mix of risky assets and cash, a relatively risk-free asset). Keep in mind that an investor's risk profile may change, as life circumstances, such as illness or job loss, can influence an investor's appetite for risk.

ASSET ALLOCATION

The critical question to ask is, *"Are the rewards you are receiving worth the risks that you are taking?"* For instance, one needs to take sufficient risk to grow portfolio assets enough to beat inflation in order to maintain purchasing power in the future. On the other hand, how did one react to the markets in February 2009, right before the market bottomed? One doesn't want to take so much risk that it results in sleepless nights and anxiety when markets are down. It's not about taking no risk at all, but rather about taking enough *tolerable* risk, and ensuring that you are being adequately compensated for the risk taken. Each asset class has its own risks, as reflected by the roller-coaster-like quality of its line (due to the inherent volatility of each asset class). When setting asset allocation, we want to ensure enough risk is taken to match each investor's unique risk profile—not too little and not too much.

PORTFOLIO CONSTRUCTION

At Clifford Swan, we extend to portfolio construction the concept of ensuring that clients are adequately compensated for the risks taken. Beyond asset classes, the individual securities that we use to build portfolios also have unique risk profiles. We properly assess individual securities' risks in order to control how much we take in portfolios. We are not trying to avoid or eliminate risk altogether, but determine how to mitigate or minimize it.

> "...an investor's risk profile may change, as life circumstances, such as illness or job loss, can influence an investor's appetite for risk."

STOCKS

We approach stock purchases for portfolios in a disciplined manner, considering criteria such as sustainability of competitive advantage, long-term growth prospects, profitability, management stability, balance sheet leverage, earnings volatility, and price attractiveness. Higher quality stocks help to minimize volatility of returns. Buying with sufficient margins of safety helps maximize growth.

BONDS

Some of the criteria we consider when purchasing bonds for a portfolio include credit quality, income stability, price attractiveness, and sensitivity to interest rate movements (a source of volatility in credit markets). As an example, buying higher credit quality bonds helps mitigate the risk of default. All of these considerations assist with minimizing risk, while seeking to maximize compensation for the amount of risk taken.

MUTUAL FUNDS

Among some of the characteristics we seek when purchasing mutual funds are management stability, consistency of investment process, downside protection, positive return history and a long-term focus.

When putting a portfolio together, one needs to be cognizant of both portfolio diversification (having the right mix of asset classes that have low correlations to each other—refer to our June 2017 article on asset allocation) and time diversification (long-term focus and diversification of returns over time).

STAYING THE COURSE

When seeking to initiate a position in a portfolio, one needs to be patient and fight the urge to buy something at too high a price (without a sufficient margin of safety) by caving in to FOMO (fear of missing out). Likewise, one must avoid getting out of a stock at the wrong time, for example because one is impatient with the timing of the stock's price growth. Or, worse yet, getting out of entire asset classes altogether because one feels that "it's a bad time" and risking losing out when those asset classes rebound (market timing). The best approach is to set an asset allocation that reflects your current unique investor risk profile, construct a portfolio that is built for the long term, and have the patience to stick it out.

At Clifford Swan, we seek to balance risk and reward in every facet of the investment management process. We are constantly asking ourselves, "Does the reward received outweigh the risk taken?" ◆

2010–2019: THE DECADE IN REVIEW

By Roger L. Gewecke, Jr.
CFA

Over the last decade, many events have occurred that have affected the economy, the stock market, and the level of interest rates. Let's take a look at this period—at the market circumstances entering the decade, what has actually happened, and what we might have learned from it.

Entering 2010, the market (as measured by the S&P 500 Index) had just gone through a rollercoaster ride, experiencing a 49% decline from 2000 to 2002, followed by a 101% increase over the next five years, and finally a 57% decline from 2007 to 2009. The decade 2000 to 2009 was termed a "lost decade" for stock investors, who lost 1% per year in annual total return over the decade. Although the market had a strong year in 2009, it had only recouped half of the losses it suffered in the 2007–2009 bear market. It was around this time that the word "bubble" made its way into the common financial vernacular, as the technology stocks and housing markets both boomed and burst. 10-year U.S. Treasury Bonds were yielding 3.8% at year-end, which were low relative to recent history at that time. Unemployment peaked at 10%, slightly below the 10.8% reached in 1982.

"The decade 2000 to 2009 was termed a 'lost decade' for stock investors..."

Forecasting the decade ahead, Wall Street did what it does best—use history a little and extrapolate recent events a lot. The 2009 $787 billion stimulus package was designed to improve economic growth a bit, as was quantitative easing, where central banks purchase government bonds and inject money back into the banking system, which then would lower interest rates and encourage lenders to lend more and borrowers to borrow more. Bond strategists predicted that, with a growing economy and relatively low interest rates, bond yields would likely go higher in the years ahead.

So, with the consensus predicting higher but moderate economic growth, higher bond yields, and generally higher but muted stock market growth due to the recent fallout from the global financial crisis, what actually happened?

As always, many economic events have affected the markets in the past decade. Let's look at a few:

"As always, many economic events have affected the markets in the past decade."

CONCERNS ABOUT THE EUROZONE AND ITS DEBT

There was concern in 2010–2011 that Greece may default and economic volatility in other member countries might cause the European Union to unravel. Subsequent aggressive action by the European Central Bank helped keep the European Union alive.

VOLATILITY IN OIL PRICES

Oil prices rallied to a peak of over $110 in 2014, only to drop over the next few years by over 70%. This caused a lot of instability in countries where oil production is a critical part of their economy, as well as in companies who use oil as an important input to their products.

BREXIT

In 2016, the UK voted to exit the European Union and has spent the past three years trying to determine how to do it most effectively. Since London is a major financial and banking center, Brexit has caused a lot of disruption in the European banking system.

THE ELECTION OF PRESIDENT TRUMP

Love him or loathe him (and we know few people who don't have a strong opinion), the election of President Trump has coincided with a strong stock market, which has risen 44% since he was elected. His policies are certainly more growth-oriented than either of his most recent Republican and Democratic predecessors.

TRADE AND TARIFFS

Front and center of today's concerns is an impending and ongoing trade war with China, and the potential for higher tariffs and stifled economic growth for both countries. Most economists believe that "no one wins a trade war," but the President believes that his negotiating

"Front and center of today's concerns is an impending and ongoing trade war with China..."

2010–2019: THE DECADE IN REVIEW | Continued on page 6

Continued from page 5

skills can at least improve the United States' position with its trading partners.

Having reviewed the economic events that have influenced the markets, let's compare conventional wisdom at the start of the decade against what actually occurred:

U.S. ECONOMY

First, let's consider the economy. Over the entire decade, the economy has not had any recessions, but has averaged only 2.2% real GDP growth per annum, which is below its 50-year average of 2.7%. Post-World War II, the economy has averaged 3% growth in GDP, which our economy has not exceeded in any year since 2005. The economy has grown GDP by 2.5% per year thus far in President Trump's term, which is a slight improvement over his recent predecessors, but still below the 50-year average (although unemployment is at a 50-year low).

STOCK MARKET

Next, a look back at the stock market. It did much better than expected, with the S&P 500's total return growing at 12.8% per year through September 30 of this year, well ahead of its compounded annual growth rate of 9.5% since 1925. Many have looked ahead for the next recession or the proverbial "other shoe to drop," but the market climbed a "wall of worry" throughout most of the decade, except for quick 15-20% selloffs in 2011 and 2018.

"Many have looked ahead for the next recession or the proverbial 'other shoe to drop,' but the market climbed a 'wall of worry' throughout most of the decade, except for quick 15-20% selloffs in 2011 and 2018."

"Conventional wisdom seems to be that bond yields will be 'lower for longer,' which is the exact opposite of the forecasts 10 years ago."

BOND YIELDS

Finally, at the end of the third quarter of 2019, 10-year U.S. Treasuries yielded 1.66%, less than half the yields at the start of the decade, allowing bond investors to earn handsome total returns throughout the decade as bond prices went higher while yields worked their way lower. Conventional wisdom seems to be that bond yields will be "lower for longer," which is the exact opposite of the forecasts 10 years ago.

"...discuss with your investment counselor how to diversify appropriately, given your individual situation and your current financial goals."

Now that we have looked back, how do we prepare best for what lies ahead? First, have a healthy skepticism around forecasters, no matter how authoritative they appear on television. Second, don't worry too much about the macroeconomy. Recessions are difficult to predict—you have likely lived through a few already—and with the market at these levels, you have likely done quite well financially. Third, discuss with your investment counselor how to diversify appropriately, given your individual situation and your current financial goals. Finally, remember that there are always concerns about the economy and the stock markets, but they generally have risen and historically it has not been wise to bet against them over the long term. ◆

CLIFFORD SWAN
INVESTMENT COUNSELORS

PROFESSIONALS
Peter J. Boyle, CFA, CIC
James R. Brown
Kevin J. Cavanaugh
Kenneth H. Dike, Esq., CPA, CLPF
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
George E. Hasbun, CFP®
Anil Kapoor, CFA
Gretchen E. Lee
David Y. Lin, CFA
Jennifer I. Maqueda
Daniel J. Mintz
Maxwell R. Pray, CFA
Linda Davis Taylor
Erica S. White, CFA
Lloyd K. Wong, CFA
Randall L. Zaharia, CFA, CAIA®

OFFICES
Pasadena
177 E. Colorado Blvd., Suite 550
Pasadena, CA 91105
626.792.2228 | 626.792.2670 FAX

Evergreen
P.O. Box 2945, Evergreen, CO 80437
720.746.1244 | 720.294.9896 FAX

cliffordswan.com