

2019 REVIEW 2020 OUTLOOK

JANUARY 2020

As we enter the New Year, we would like to take the opportunity to provide you with a review of 2019 and our outlook for 2020.

EXECUTIVE SUMMARY

- Despite a litany of negative headlines throughout the year, markets experienced strong, broad-based returns in 2019.
- Recession risk remains low in 2020 given the absence of the two major late-stage recessionary factors.
- US monetary policy looks to be on hold at least through the election; the Fed will have a high bar to enact changes.
- With no recession on the immediate horizon and monetary policy on hold, stocks and bonds can post positive returns in 2020, but a repeat of 2019's exceptionally strong returns is unlikely.
- The US election and other global geopolitical events have the potential to impact markets and should be monitored carefully throughout the year.

What a difference a year makes. Investors faced a challenging year in 2018; most major asset classes experienced negative annual returns (bonds as represented by the Bloomberg Barclays US Aggregate Bond Index eked out a positive return of a meager 0.1%) and cash was the best performing asset class. A simple US 60/40 (stock/bond) portfolio experienced one of the worst years in history as financial conditions tightened globally. In contrast, 2019 was a near polar opposite, with all major asset classes posting strong returns on the year and a simple US 60/40 portfolio producing the best risk-adjusted return since the 1960s as both stocks and bonds rallied. To sum up the year for investors in one phrase, 2019 represented a bull market in everything.

As has been the case for the decade as a whole, 2019 was another eventful year for the global economy and geopolitics.

- After tightening monetary policy over the course of 2018, the Federal Reserve acknowledged they tightened too far and issued a mea culpa in the form of three rate cuts over the course of 2019, the first rate reductions since the financial crisis.
- The trade war between the United States and China intensified over the course of the year until December, when both sides announced de-escalation in the form of a "phase one" agreement, which will see the US forgo the imposition of additional tariffs on Chinese goods – at least for the time being.
- A disagreement over an attempt to amend the rules on extradition to the Chinese mainland in Hong Kong sparked a crisis in Hong Kong, which has morphed into an ongoing movement advocating for greater democracy in the territory. The movement represents the strongest challenge to Beijing's authority since the United Kingdom transferred the territory over to Chinese authority in 1997.
- An attack on Saudi Arabian oil infrastructure over the summer briefly took over 6% of the world's oil supply offline. While oil prices spiked in the immediate aftermath, they returned to prior levels within two weeks as additional supply from the United States came on line.
- Brexit dominated the year in the United Kingdom, seeing Theresa May lose her seat as Prime Minister when she failed to construct an agreement with the European Union that passed muster in Parliament. Her replacement, Boris Johnson, prorogued Parliament as the Brexit deadline neared, an act the UK Supreme Court found to be unlawful. In response, Johnson called for a new election, which resulted in the biggest Conservative majority in the UK in 32 years and with it the expectation that Brexit will finally be implemented in 2020.
- Domestically, the House of Representatives voted to impeach a sitting president for only the third time in our nation's history – each previous impeachment ended with an acquittal in the Senate – though the House has yet to send the articles to the Senate for trial.

In short, the year did not lack for negative headlines with the potential to derail markets.

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Despite these events, markets around the world continued to climb over the course of the year. The bellwether for US stock returns, the S&P 500, finished the year up 31.49% on a total return basis, the best annual return for the index since 2013 and the second best year this century. While Large Cap stocks led the way, US equity performance was strong across the board. All nine style boxes (Large/Mid/ Small & Growth/Blend/Value) returned over 20% in 2019. Performance was also strong across all sectors, with Energy the lone sector that did not return at least 18% during the year. Performance was broad-based internationally as well; all seven major geographical regions had equity returns over 10% in 2019. The MSCI EAFE Index of major developed international equity markets returned 22.01% in USD terms. Even the laggard for the year was up nearly 20%, with the MSCI Emerging Market Index returning 18.42% in USD terms. Looking globally, the MSCI ACWI Index, a proxy for the global stock market, returned 26.59% in USD terms in 2019. To put 2019 global stock returns in historical perspective, the MSCI ACWI's 2019 return was the best since 2009, and the second best in the entire history of the index.

Stocks outperformed bonds by the largest margin in six years in 2019, somewhat overshadowing the fact that bonds posted their best annual return in 17 years. The Bloomberg Barclays US Aggregate Bond Index returned 8.72% on the year. Performance in fixed income was broad-based as well, with each sector of the index posting a positive return for the year. Corporate credit led the way with double-digit returns for both investment-grade and high-yield credits. Internationally, developed fixed income performance was slightly weaker, but returns were still in the mid-single digits for all major markets. Emerging market fixed income also had a strong year, with the return of the JPMorgan Global Emerging Market Bond Index finishing at 14.42% in USD terms, the best in 7 years. While cash was the weakest performer, the 2.1% return in 2019 of an all Treasury bill portfolio was still the strongest cash return since 2007.

Coming on the back of a historically poor year for asset returns globally in 2018, the strong, broad-based returns in 2019 were a welcome relief to investors across the world. But what should investors expect for the economy and markets in 2020?

While the current economic expansion in the United States is now the longest on historical record (dating back to 1854), we continue to believe recession risk remains low over the next 12 months.

Historically two late-cycle risks, either singly or in combination, have been the cause of recessions in the US in the modern era – inflationary overheating (and subsequent monetary policy tightening by the Federal Reserve) and/or financial imbalances. Neither of these risks looks threatening as we start 2020.

Inflationary pressures remain below target, and the Federal Reserve recognized they had tightened monetary policy too much in 2018, reversing course and issuing rate cuts for the first time since the Great Financial Crisis in 2009. Monetary policy historically acts with a lag, with the full impact of a rate decision coming a year after the announcement, which suggests that easing financial conditions should bolster the US economy over the course of 2020. The Federal Reserve, keen to remain apolitical and avoid even the suggestion of interference in the 2020 Presidential election, has signaled they will likely hold rates steady throughout the year. Historically, any rate moves during an election year have continued the ongoing trend in monetary policy, not a reversal of course; given the three rate cuts in 2019, this suggests the bar for any decision to tighten monetary policy will be especially high.

Financial imbalances also do not appear to pose a looming threat as we start the year. The US private sector continues to run a robust financial surplus (the previous two recessions were preceded by a private sector financial deficit). This is also true of most major developed economies internationally as well.

While both of these late-cycle risks need to be monitored closely going forward, at present they suggest that the overall recession risk for the US economy in 2020 is relatively low.

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Turning to growth, the main driver of the US economy remains the consumer, and consumers are on their strongest footing in a decade. The economy continues to produce jobs on a monthly basis at nearly double the breakeven rate needed to absorb new entrants to the workforce, and expectations are that the unemployment rate will continue to decline over the course of 2020. Economists predict that the unemployment rate as Americans head to the polls in November will be at the lowest level since 1952. Wage gains have picked up over the last year as well, with the biggest increases occurring for those at the bottom end of the wage scale who also have the highest marginal propensity to consume, a trend expected to continue in 2020.

Residential construction, another key driver of US economic growth, also benefits from structural tailwinds. The current level of building activity remains well below demographic demand, and the homeowner vacancy rate recently hit a 38-year low, suggesting residential construction will be a positive contributor over the next few years.

Finally, the announcement of a “phase one” agreement on the trade front between the United States and China suggests that tariffs have likely peaked, and if the trade war continues to de-escalate, the negative economic effects should begin to abate over the course of the year. The combination of trade détente, easier financial conditions across the globe, and a likely resolution to Brexit should all contribute to a modest improvement in economic growth around the world in 2020 as well. In total, the evidence points to a modest improvement in economic growth globally, and our expectation is for a positive but low economic growth environment, a continuation of the recent trend.

Turning to markets, returns like those experienced in 2019 are highly unlikely for 2020, but a slightly improved global economic growth outlook points to positive returns across assets in 2020.

In equity markets, earnings will be the main driver of performance. On a fundamental basis downside risks should be relatively limited if our expectation for the economic environment proves correct; substantial declines in corporate earnings are exceedingly rare absent a recession. Substantial upside will likely be limited as well however, since expectations for an improved global economic environment are largely already reflected in current prices. The expected economic environment continues to favor domestic quality growth companies and consistent dividend growers. For this outlook to change, we would need to see a substantial pick up in global economic growth and an increase in bond yields. Fixed income returns are also expected to be solidly positive in 2020, as the Federal Reserve has signaled they will almost assuredly be on hold for much of the year and the vast majority of global central banks have shifted to an easier monetary policy stance.

Despite this positive outlook, as with any year we see risks in 2020 as well. The trade war between the United States and China could heat up again over the course of the year, which would have negative ramifications for global economies and markets. The wide spectrum of policy preferences represented both within and between the Democrat and Republican parties present the potential for a substantial increase in volatility as the 2020 election cycle heats up, particularly for sectors like health care and energy. As the recent increase in tensions in the Middle East remind us, geopolitics represents an ever-present risk. But as our recap of major 2019 events shows, markets can continue to climb higher despite the headlines as long as economic and market fundamentals remain healthy.

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As we begin the New Year, recession risk in the US remains low and a slight pickup in global economic growth is expected. Monetary policy shifts during 2019 now see the average central bank biased towards an easing posture, improving financial conditions both in the US and abroad. Against this backdrop, most broad asset classes are expected to generate positive returns. The US election and the potential impact of increasing geopolitical tensions will be the key main events to monitor in the year ahead. While 2020 faces some potential potholes that could generate negative headlines – as does every year – the experience of market investors in 2019 shows that markets can shrug off this noise and generate solid returns. It remains as important as ever to exercise sound investment principals and a high degree of diversification.

We remain committed to focusing on long-term financial goals and priorities and constructing portfolios designed to reach those goals while minimizing risk. The volatility environment experienced over the last two calendar years – one of the worst years for investment returns directly followed by one of the best – demonstrates the value of disciplined professional management.

These ups and downs in the market, exacerbated by the constant stream of headlines disseminating from 24/7 news networks, naturally elicit an emotional response. We humans are prone to behavioral biases, often overreacting to both downturns like markets experienced in the 4th quarter of 2018 and strong returns like those experienced in 2019. In times like these, when headlines flow like a fire hose, determining the facts that matter and filtering out the rest is increasingly vital. Our clients' interests always come first, and our goal for 2020 is to continue to help you to separate the signal from the noise and focus on what truly matters to the economy and markets.

The last 2 years in the markets have not been for the faint of heart – but those who were able to navigate the vicissitudes of the market - to focus on the signal, not the noise – maintain a long-term perspective, and stay the course were rewarded, increasing the probability of achieving their personal or organizational financial goals.

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