Fourth Quarter 2019 Key Takeaways

Among global equity markets, larger-cap U.S. stocks were once again at the top of the leader board. The S&P 500 Index posted gains in every quarter and surged 9% in the fourth quarter to end the year at an all-time high. Its 31% total return was its second-best year since 1997. (It was up 32% in 2013.) Smaller-cap U.S. stocks rose 25.4% for the year.

Foreign equity markets were also strong. European stocks gained 9.9% in the fourth quarter and 24.9% for the year. After struggling in the third quarter, emerging-market (EM) stocks shot up almost 12% in the fourth quarter and returned 20.8% for the year.

The core bond index was flat in the fourth quarter but gained 8.6% for the year. This was its best annual return since 2002. Below-investment-grade bonds also fared well in 2019. High-yield bonds gained 14.4% and the World Sovereign Bond index rose by 5.90%.

Why did both stocks (risky assets) and bonds (defensive assets) appreciate sharply in 2019? The key driver was the Federal Reserve's sharp U-turn toward accommodative monetary policy. This was followed by other central banks across the globe. Coming into 2019, the Fed was indicating it expected to continue to raise interest rates. This led investors to fear that higher rates could tip the U.S. and global economies into recession, bringing an equity bear market with it. The ongoing U.S.-China trade conflict didn't help matters.

Ultimately, the Fed ended up *cutting* rates three times in the second half of 2019. Late in the year, it also started expanding its balance sheet again via purchases of Treasury Bills in order to boost banking system reserves and inject liquidity into the short-term lending markets. Other major central banks also cut rates and/or provided additional stimulus to the markets during the year. This lessened recession fears.

Meanwhile, inflation (and inflation expectations) remained at or below central bank targets. This lifted concerns that interest rates would be hiked anytime soon, and the bond market rallied.

U.S. equity investors responded to the Fed policy reversal and stimulus much as they have during the past 10 years—by bidding up stock prices and valuations. A détente in the U.S.-China trade war late in the year (the "phase one" deal) was an added boost to market sentiment. Importantly, earnings growth did not drive U.S. stocks higher; the majority of the S&P 500's return came from expanding valuations. Thus, the valuation risk in U.S. stocks, which I've highlighted for some time now, has only grown.

There are reasons to be cautiously optimistic for financial markets in 2020: Monetary policy is easy, recession risks seem to be receding, and some geopolitical risks have abated. That said, I am watching a number of potential short-term risks. Given that I believe recent positive developments have largely been incorporated into stock prices and valuations are stretched for U.S. stocks and bonds, markets are particularly vulnerable to any disappointment or negative surprise. If that should come to pass, I stand ready to keep you informed and to take advantage of any obvious opportunities that may arise as a result of that volatility.

It will be worth restating, even in the context of a letter primarily focused on economics and the investment markets, my overall principle of investment advice. It is goal-focused and planning-driven, as sharply distinguished from an approach that is market-focused and current-events-driven. Long-term investment success comes from *continuously acting on a plan*. Investment failure proceeds from *continually reacting to current events in the economy and the markets*.

Personal Observations from the Year Past

Two thousand nineteen was, in important ways, the mirror image of the previous year. Two thousand eighteen was a dramatically outstanding one for the American economy - and for corporate earnings and dividends - despite which the equity market couldn't get out of its own way, and ended on a terrific downbeat: a 19.8% peak-to-trough decline through Christmas Eve 2018. This past year was the exact opposite: an exceptionally good year for the market - up 31.5%, plus a couple of more percentage points for dividends - even though the economy slowed somewhat, manufacturing went into decline, and the earnings of the S&P 500 almost certainly ended 2019 down slightly year-over-year.

Without laboring the market's course over the entire year, it was in essence a sequence of three important forays into new high ground. First, it made up all of 2018's drawdown, and broke out at the end of April. It then corrected sharply, about which I'll have more to say in a moment. Another series of new highs followed in June-July, and consolidated into the fall. The third and most dramatic breakout took place at the end of October and rallied through year-end, up 28 of 41 trading days from November through year-end.

These three successive waves of new highs seem to me to have attended upon a slowly growing realization that widespread fears of major disaster - trade wars tipping the economy into recession, a significant year-over-year downtick in earnings, and a constitutional crisis regarding impeachment - were overblown. This was particularly true, I think, with respect to the late October breakout and the virtual melt-up that followed. That upswing was ignited by a third-quarter-earnings decline that proved far milder than almost anyone had forecast, and not one but two successive blowout monthly jobs reports.

With all of those rather dry facts out of the way, I'd like to return to the above-mentioned May-June drawdown, which lasted about a month, and took the S&P 500 down about 7%. Technically, this can't even be classified a “correction,” as the Index didn't close anywhere near 10% down. It was, nonetheless, a full-blown panic attack, set off by one of President Trump's most antagonistic tweets regarding China.

It is the way investors reacted to this relatively brief, relatively shallow drawdown which captured my attention. Simply stated, net liquidations of U.S. equity mutual funds and ETFs - absolutely, and especially contrasted with bond fund ***inflows -*** soared to levels not seen since the Great Panic of 2008. I repeat: a one-month, 7% drawdown set off a flight from stocks not unlike the flight witnessed during the existential financial crisis of our time.

Indeed, 2019 saw the greatest equity fund/ETF net liquidations on record going back to 1992, according to the data provider Refinitiv/Lipper. This, mind you, after 10-plus years of 16% compound annual returns for the S&P 500. It is difficult for me to regard these data as anything but a powerfully suggestive contrary indicator.

Set aside momentarily, if you can, the headline issues of the day: the trade situation, an aging economic expansion, impeachment/election uncertainty, and the like. These are not merely imponderable; they're irrelevant to long-term, goal-focused investors like us.

Instead, I would invite you to focus on what seems to be the default setting of the investing public, which I would describe as pessimism verging occasionally into sheer panic. All my reading and all my experience suggest that very meaningful market setbacks have not historically occurred during huge waves of public pessimism and fear. ***Quite the contrary.***

This is not to be taken as any sort of market forecast. As I've always said to you, I'm a planner, not a prognosticator. It is simply an invitation, as we look into the new year, to take some comfort from the rampant fear, even after a decade and more of attractive returns. There will be plenty of time to begin worrying when the stock market once again becomes cocktail party conversation, and everyone around us is excitedly bullish.

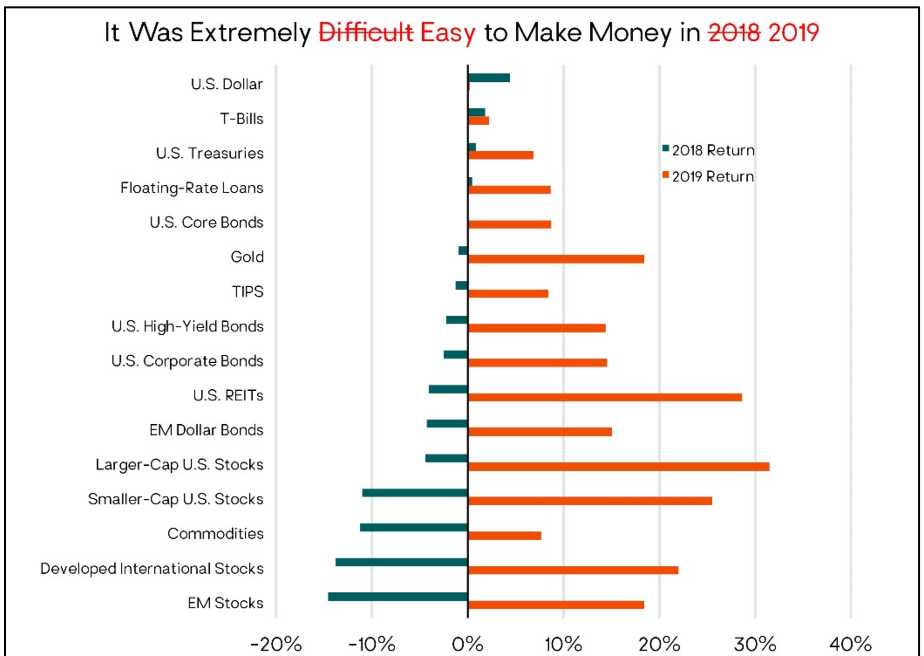
It is overwhelmingly probable, as financial journalism has been shrieking of late, that 2020 will not match the returns of the past year. Few years ever do; that is both manifestly true, and wholly irrelevant. The fact, or more properly the truth, is that goal-focused, planning driven investors had an exceptional year in 2019. We did so not by forecasting this year's returns, nor by jumping into the market just in time to achieve them, but by patiently adhering to our long-term discipline. That, to me, is the great lesson of this past year.

Market and Performance Recap

Our portfolios generated strong returns for 2019, a bullish year for nearly all financial markets. The positive broad-based returns marked a dramatic (and welcome) turnaround from 2018, a year in which nearly all asset classes faltered.

This year’s surprising returns were fueled by a U-turn in monetary policy, as policymakers shifted gears to support a weakening global economy. After tightening financial conditions (raising short-term rates) four times in 2018, the Federal Reserve reversed course and began implementing a more dovish monetary policy (lowering short-term rates three times). Other major central banks also cut rates or provided additional stimulus to the markets via quantitative easing during the year, lessening global recession fears.

U.S. stocks rose in every quarter and surged an additional 9% in the fourth quarter as the United States reached a tentative “phase one” trade agreement with China. The S&P 500 Index’s 31% total return was its second-best year since 1997. (Bested only by 2013’s 32% gain.) Smaller-cap U.S. stocks rose 25.4% for the year.



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Foreign markets were also strong. European stocks gained 9.9% in the fourth quarter and 24.9% for the year. After a weak third quarter, emerging-market (EM) stocks shot up nearly 12% in the fourth quarter and returned 20.8% for the year.

The 10-year Treasury yield dropped from 2.70% at the start of the year to as low as 1.45% in September, ending the year at 1.92%. Investment-grade bonds gained nearly 9%. Credit markets also rallied amid this supportive monetary policy environment: high-yield bonds earned 14.4% and the World Sovereign Bond index rose by 5.90%.

What’s Next for 2020?

After a year like 2019, the obvious question looking ahead is how much higher can equities go? For many years, assets have been flowing into U.S. stocks on the back of a strong U.S. dollar and the United States’ perceived safe-haven status relative to other global economies. In this respect, 2019 was largely an exclamation point on the decade’s investment pattern.

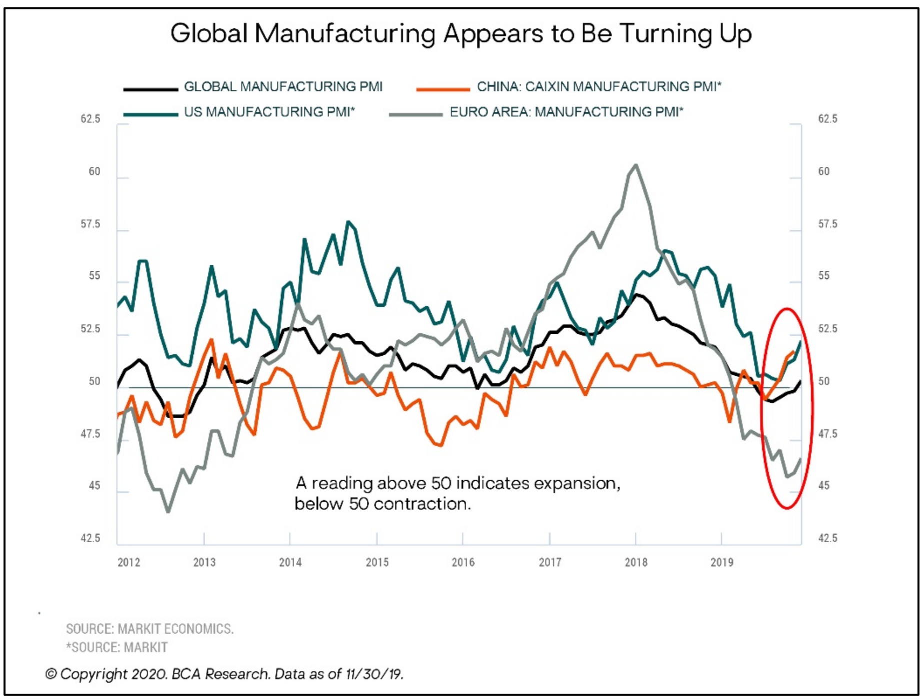
As I look ahead to financial markets in 2020, there are reasons to be cautiously optimistic for financial markets. Accommodative central bank monetary policy and easier financial conditions should continue to support at least a modest rebound in global economic growth. As just one point of reference, the Global Manufacturing Purchasing Managers' Index (PMI) has risen for four consecutive months and inched into expansion territory (above 50) in November. Along with reduced U.S.-China trade risk, this suggests the global economy may be on the rebound. The U.S. consumer also remains in good shape as ongoing labor market strength, wage growth, and low interest rates should continue to support consumer spending and the housing market.

However, with the run up in stock prices in the fourth quarter, it's safe to say that the markets have already priced in this modestly positive economic backdrop. There is a meaningful risk of a sharp sell-off in equities if an unpleasant market surprise or deterioration in the macro environment in 2020 should spook investors who still remember the market sell-offs in 2000 and 2008.

A critical question for a fundamental investor like me is always, "What's in the price?" In this regard, I note that it wasn't corporate profit growth that drove U.S. stocks higher in 2019. Reported earnings for the S&P 500 were actually flat over the first three quarters, and mid-single-digit percentage growth is projected for the fourth quarter. The lion's share (roughly two-thirds) of the S&P 500's 31% return came from a sharp expansion in valuations. I believe such stretched valuations leave U.S. stocks particularly vulnerable to disappointment or negative surprises in the macro environment.

Despite recent positive developments, the U.S.-China trade war could reignite or a different area of geo-economic conflict between the two countries could escalate. This would hurt a still-weak manufacturing sector and impact capital spending and business confidence (CEO confidence is already at recessionary levels).

U.S. election uncertainty, inflation surprises, and Brexit are also among the myriad risks that could impact markets over the coming months. Geopolitical risk is also, as always, a major unknown that I factor into my portfolio downside stress-testing. As of this writing in early January, global tensions are extremely high following the unexpected killing of Iran's military commander by U.S. forces and now Iran's retaliatory missile strike. While it is far too early to know how this will play out on a broad scale, equity markets have largely taken this in stride.



Portfolio Positioning and Outlook

While I watch and weigh the ramifications of short-term risks, it's important to reiterate that I don't invest based on 12-month market forecasts. The uncertainty is too high and the unknowns too many. More important and most relevant for my investment process is my outlook for the next several years, not months. In this respect, my assessment of the risks and opportunities remains consistent with what it's been in recent years.

With U.S. stock prices, relative to their earnings, at levels modestly above historical norms, I continue to see better investment opportunities elsewhere: in foreign developed and emerging market stocks.

Should the positive global growth outlook for 2020 play out, I'd expect foreign stocks to outperform U.S. stocks, given their higher cyclicality and sensitivity to overall GDP growth. Receding Brexit uncertainty should also help prop up European markets, in particular. Furthermore, to the extent the U.S. dollar weakens in this environment—due to it being a *counter*-cyclical currency—that will help foreign stock returns (for dollar-based investors).

My tactical exposure to alternative strategies run by skilled managers is particularly attractive in this environment, given their ability to actively manage portfolio risk exposures (e.g., dialing down risk when the reward is not commensurate) and take advantage of market inefficiencies and opportunities when they appear. The time to use alternative strategies is when the equity markets are nearing highs, not when they're nearing lows. Alternatives are a form of portfolio insurance, and insurance is needed most when the risk of loss is higher than usual, as it with US stocks at this time. Not only do these strategies provide valuable portfolio diversification, but we also expect them to deliver better medium-term returns than a traditional mix of U.S. stocks and core investment-grade bonds. Of course, as long as the U.S. equity markets continue the surge started in 2019, alternative strategies will be a drag on returns. This is the price paid for portfolio protection.

These tactical opportunities are relatively attractive, but none of them are without their own risks. There are few table-pounding, valuation-based fat pitches in the investment markets these days. Ten-plus years of unprecedented central bank stimulus and interest rate repression have inflated the prices of most financial assets, if not the actual global economy.

Given this backdrop—weighing the shorter- and medium-term risks and return opportunities and considering the economic fundamentals versus financial market valuations—I think the wisest course for *risk-conscious* investors continues to be a broadly diversified, moderately defensive posture. For risk-tolerant investors, full exposure to equities is still appropriate, tempered by considerable exposure to the international markets to mitigate the elevated risks I see in US stocks.

Thank you, most sincerely, for being my clients. It is an honor and a pleasure to serve you. I wish everyone a happy, healthy, and peaceful New Year.

Best,

Kelly D. Kane, ChFC, CFP