Market Commentary

December 31, 2019

Despite a number of headwinds, 2019 ranks among the best years for investors in recent memory. Among the major asset classes, the worst performer in 2019, US Treasury Bills, returned 2.5%. Only six times in the past 25 years has the worst performing asset class had a positive return, and 2.5% is the highest return for the worst asset class over that period. The 2019 S&P 500 return was 31.5%. Other than 2013's 32.4%, you have to go back to 1997 to find a better return for the S&P. Boring old bonds also had a great year, with the Barclays Aggregate up 8.7% in 2019, its highest annual return since 2002.

The S&P 500 was up 9.1% in Q4, putting an exclamation point on a very strong 2019. The S&P hit an all-time high on January 9, 2020, breaking the old record set only 2 weeks earlier. The Technology sector had a monster Q4 and 2019, returning 14.4% and 50.3%, respectively. Small Cap Growth stocks had a great Q4, up 11.4%. However, Large Cap Growth led the way for all of 2019, returning 36.4%. On the international side, Emerging Market stocks had a blow-out Q4, returning 11.9%. For all of 2019, however, Developed Markets outperformed, returning 22.7% vs. Emerging at 18.9% (all in US Dollar terms). While bonds did extremely well in 2019, interest rates drifted higher late in the year, leading to a lackluster 0.2% return for the Barclays Aggregate Index in Q4.

Markets were comforted by news that the US and China had come to an agreement on a "Phase One" trade deal, which is expected to be signed January 15th. The deal will reduce some U.S. tariffs on Chinese goods while boosting Chinese purchases of American farm, energy and manufactured goods and also address some US complaints about intellectual property rights. However, this agreement will not put this issue to bed. Expect trade tensions to flare occasionally for the foreseeable future, which will no doubt roil markets.

For the first time ever, the US economy started and ended an entire decade without entering a recession, and the current expansion is now the longest in US history (41 consecutive quarters of growth). However, while fears of recession seem to have receded and the unemployment rate remains at a multi-decade low, the overall economic data picture is less than robust, both in the US and worldwide. For example, Citigroup calculates a data change index for 40 countries. This index compares the current growth rate of various economic data to the one-year average. Only 25% of developed world economies are currently growing faster than their one-year averages.

So what are the primary risks for investors as we begin 2020? Much ink was spilled in 2019 predicting a recession, largely due to the yield curve inversion that occurred last year. The curve is no longer inverted, but has the damage already been done? Is a recession inevitable? Some argue that we won't know until late in 2020 because of the typical lags between inversions and recessions. As mentioned earlier, economic growth in the US has been good, not great. Likewise, corporate earnings have been OK, but stock valuations are stretched. Despite the best efforts of central banks around the world and years of easy monetary policy, there has been little inflation around the world. Central bankers continue to be concerned about deflation.

At a conference one year ago, former Fed Chair Janet Yellen said, "I don't think expansions just die of old age." Her predecessor, Ben Bernanke agreed saying, "I like to say they get murdered." The point is, recessions aren't inevitable (Australia hasn't had recession in 25 years), and one cannot simply count days/months/years on a calendar to conclude that a recession is coming. When recessions occur, it is typically due to either (1) some unforeseen "shock" that damages consumer confidence (e.g. a spike in oil prices) or (2) a major imbalance develops in some sector of the economy which forces a painful adjustment period (e.g. a stock market bubble). Often, it is central bank policy errors that lead to recession-causing imbalances.

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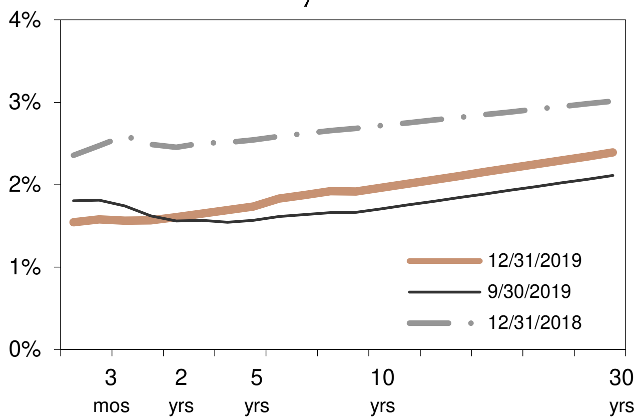
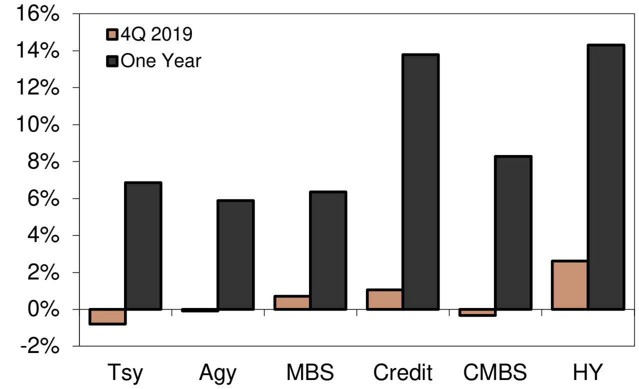
US Treasury Yield Curves



Sector Index Returns



Speaking of central bank policy errors, we feel that one of the biggest risks for investors in 2020 is the Fed's ability to handle some growing imbalances in the US financial system. A wonky issue that has gained little attention outside the financial press is the disruption that occurred in the repo market in September of last year when financing rates spiked, leading to a mini-panic. A repurchase agreement, or "repo," is a short-term agreement to sell securities in order to buy them back at a slightly higher price. It is a form of short-term borrowing for dealers in government securities, and it is a critically important feature to keep the financial markets running smoothly. In response to the spike in rates, the Fed was forced to pump additional liquidity into the system to prevent markets from freezing up. It is unclear exactly what caused the spike in rates, but the result has been a massive increase in the size of the Fed's balance sheet. Since late September, the Fed balance sheet has been growing at a pace of about $100 billion per month, a rate of growth that exceeds that of the period following the Great Recession.

Market volatility has picked up in recent months in both stocks and bonds. The MOV and the VIX are two market indices that measure volatility, or "fear," in bonds and stocks, respectively. These indices are currently sitting at elevated levels and appear to be moving higher. Most market watchers agree that artificial intelligence and machine trading are amplifying market movements. Gone are the days when price changes were determined by human beings reading company financial statements and press releases. Today, machines "scrape" millions of data elements such as prices and even phrases from the web and other private data sets. Markets can jump in milliseconds after the release of an economic report or a company press release. The challenge for investors is to maintain discipline, focus on fundamentals, and avoid chasing irrational market price moves.

With world central banks once again unanimous in their desire for stimulative policy, look for the monetary spigots to be turned wide open and for financial assets to benefit. "Don't fight the Fed" is sage advice in this climate, and, despite their lofty valuations, stocks are likely to be well bid. In our fixed income portfolios, we continue to tactically adjust portfolio durations to take advantage of anticipated interest rate changes. Currently, our client portfolios have average maturities comparable to their respective benchmarks. We continue to believe that the US economy is on solid footing, but interest rates should remain low in the near term due to loose Fed policy. However, long-term rates are likely to eventually drift higher as inflation pressures build. Given the massive rally in risky assets, we do not believe investors are receiving adequate compensation for holding lower-rated corporate bonds.