Q4 2019
INVESTMENT PERSPECTIVES

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- **OUT WITH A BANG:** The 2010s finished on a high note as markets around the world posted heady gains to close the decade. Emerging markets equities led the advance in Q4, but US large cap stocks capped another year of outperformance versus the rest of the world driven by big gainers in the technology sector.
- **TRADE WAR DÉTENTE:** Global trade tensions that had been building over the better part of two years eased in Q4 as the US and China announced a "phase one" trade deal. The pact prevented new US tariffs from being implemented and partially rolled back existing US tariffs on Chinese goods, in addition to creating the framework for a more comprehensive deal. Investors celebrated the de-escalation as evidenced by the MSCI China Index's 14.7% gain during the quarter.
- **FED CUTS AGAIN; NOW ON HOLD:** The Fed cut its benchmark interest rate for the third time in 2019 in an effort to stem growth fears and re-anchor flagging inflation expectations around its 2% target. After the cut, Chair Powell described monetary policy as "appropriate", suggesting no further action from the Fed unless conditions materially change.

MARKET RECAP

Stocks around the globe ended the year with a furious rally as trade tensions between the US and China cooled. Each of the major equity indices that we track on the performance chart to the right posted quarterly gains in excess of 8%, reflecting the decidedly "risk on" mood among investors. After trailing for the first three quarters of the year, emerging markets led the way in Q4, with the MSCI Emerging Markets Index posting an 11.8% advance. Despite the EM surge, US stocks retained their leadership position on an annual basis; the S&P 500 was the pole sitter once again with a gain of 31.5% in 2019.

Fixed income indices also advanced in Q4 with credit markets driving the bulk of the performance. For the year, both investment grade and high yield bonds posted smart gains, buoyed by declining yields and tightening credit spreads. The yield on the 10-year US Treasury closed the year at 1.9%, down roughly 0.8% from the beginning of 2019 and 1.3% lower than its Q4 2018 high water mark. High yield credit spreads—or the additional yield that investors command for buying lower quality bonds—tightened by roughly 200 basis points over the course of 2019 (from roughly 5.3% to 3.3%), reflecting investors' healthy appetite for junk bonds.

FIXED INCOME

Index	USD Total Return (%) Q4 2019	YTD
Barclays 1-10 Yr Muni	0.9%	5.6%
Barclays US Agg. Bond	0.2%	8.7%
BAML HY Master II	2.6%	14.4%

EQUITIES

Index	USD Total Return (%) Q4 2019	YTD
Russell 3000	9.1%	31.0%
S&P 500	9.1%	31.5%
Russell 2000	9.9%	25.5%
MSCI All Country World	9.0%	26.6%
MSCI EAFE	8.2%	22.0%
MSCI Emerging Mkts	11.8%	18.4%

Source: Bloomberg (Data as of 12/31/2019)

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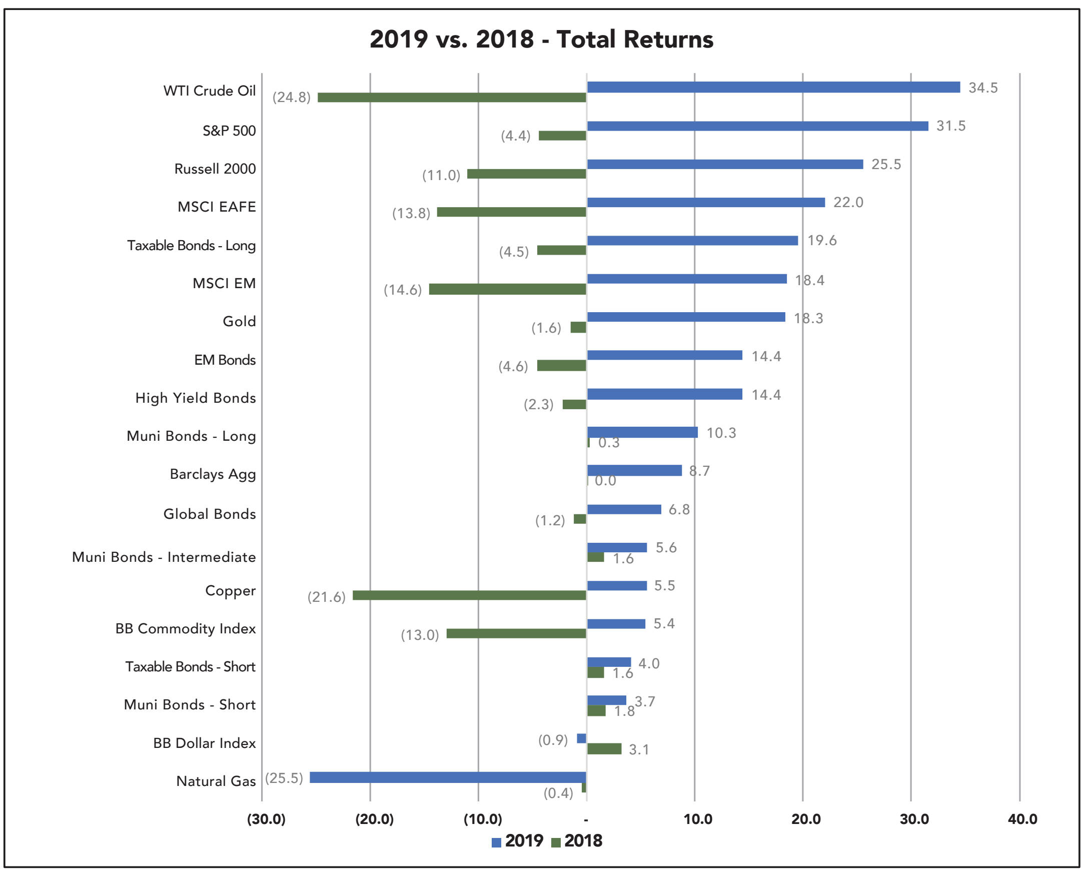
WHAT A DIFFERENCE A YEAR MAKES

December 2019 was a stark contrast to the same period a year ago. Readers will recall that equity markets around the world experienced significant declines in Q4 2018 as the Fed reiterated its hawkish posture and US/China trade war rhetoric reached a fever pitch. The S&P 500 narrowly avoided a 20% decline that would have officially marked the end of the bull market, but still posted its worst December since 1931. Talk of an impending recession began to dominate financial media as data from economically-sensitive sectors was deteriorating.

In an effort to stem the growing concerns, the Fed led a global pivot toward more accommodative monetary policy beginning in early 2019, and markets responded favorably. The S&P 500 rebounded to post its best quarter since the immediate aftermath of the global financial crisis in Q1 2019. Jump forward to Q4, and investors were presented with a macro landscape that was nearly the exact opposite of a year prior. Among the most salient differences:

1) Instead of the Fed hiking interest rates, the Fed cut interest rates for the third time in 2019 during Q4. Worries about an inverted yield curve—i.e., when short-term rates exceed long-term rates, suggesting that monetary policy is too restrictive—faded into the background. Moreover, as opposed to contracting its balance sheet, the Fed began actively expanding its balance sheet in response to liquidity concerns in short-term funding markets.
2) Rather than protectionist trade rhetoric and threats of additional tariffs dominating the headlines, Q4 2019 brought a clear de-escalation of trade tensions between the US and China that resulted in the framework for a "phase one" trade deal (signed after quarter-end).
3) Instead of more Brexit uncertainty—particularly concerning the possibility of a "hard Brexit", or the UK leaving the EU without a deal—the UK election in December produced a clear majority for Boris Johnson's Conservative party that all but ensured a Brexit deal would be reached.

Risk assets flourished against the more supportive macro backdrop. To help visualize the contrast, the chart below juxtaposes the 2018 returns (green bars) and 2019 returns (blue bars) across major asset classes. Most of the worst performers in 2018 rebounded to end 2019 among the best performers—as evidenced by the top third of the chart. In fact, after a 4.4% decline in 2018, the S&P 500 posted its best annual return since 2013 and its fourth best annual return since 1990. Among the markets that we track on the chart, only natural gas posted a loss greater than 1% for the year—indicative of the strong returns across asset classes and around the globe.



Source: Bloomberg (Data as of 12/31/2019)

NO EARNINGS GROWTH, NO PROBLEM

One confounding element of the stock rally in 2019 was the lack of corporate earnings

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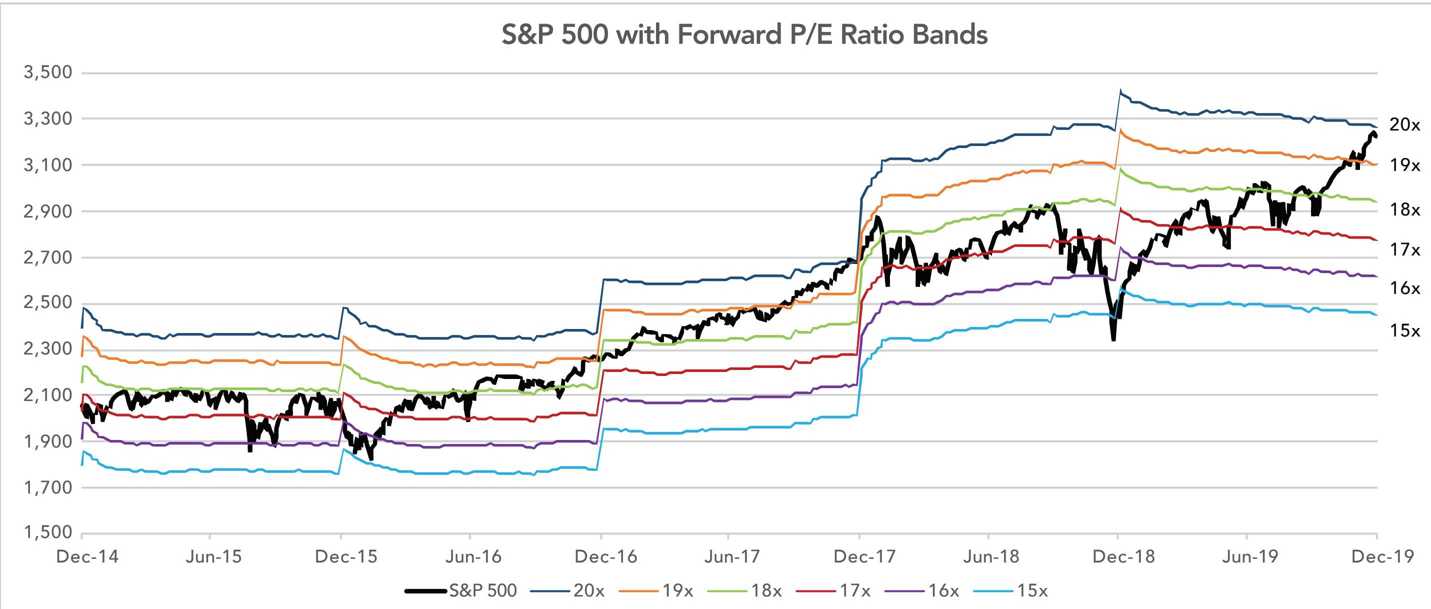
growth accompanying the surge in stock prices. Focusing on the S&P 500, earnings expectations for the next 12 months actually declined modestly over the course of the year—consistent with the narrative of a slowing global economy and flagging manufacturing data. With nonexistent earnings growth, the market advance was primarily driven by a rerating of valuation multiples. Consider the commonly referenced price-to-earnings, or P/E, ratio for the S&P 500; this measure started the year at just under 15x the consensus estimate for the next 12-months' earnings but ended the year at nearly a 20x multiple, per Bloomberg data.

The chart below provides a visual history of the S&P 500 relative to its P/E ratio going back to the beginning of 2015. The black line is the S&P 500 Index level, and the colored bands reflect different P/E multiples, ranging from 15x at the bottom (light blue line) to 20x at the top (navy blue line). If, for instance, the S&P 500 level sits on the red line, that would mean the Index was trading at 17x its next 12-months' earnings. Simplistically, the bottom bands represent cheaper valuations and the upper bands represent more expensive valuations. While it is clear that earnings multiples ebb and flow over time, the multiple expansion in 2019 was noteworthy for its magnitude—particularly on the heels of the sell-off in December 2018.



Source: Bloomberg (Data as of 12/31/2019)

It is difficult to draw definitive conclusions from a rerating like this. For starters, the market is a forward-looking discounting mechanism, meaning that prices should be viewed as leading rather than coincident indicators of economic conditions. Through that lens, perhaps the Q4 2018 sell-off was recognition that the global economy was headed into a soft patch, and the subsequent recovery in 2019 was a reflection of a better economic environment in 2020. There is also an argument that the concurrent decline in interest rates made stocks look more attractive on a relative basis, justifying the higher multiple paid by investors. As a corollary, the Fed's willingness to lower interest rates suggests that it remains predisposed to backstopping the economy and markets at the first signs of stress, thereby reinforcing the concept of the "Fed put"—the implicit expectation that the Fed will act to support asset prices during a material decline.

The less sanguine view would be that the Fed's accommodative actions in 2019 simply re-inflated asset values with little benefit to the underlying trajectory of corporate earnings or the broad economy. In that case, all of the concerns about slowing global growth and weakness in cyclically-sensitive sectors would remain valid—albeit on pause due to a central bank-induced "sugar rush". If the pessimistic thesis comes to pass, history would suggest that current valuation levels reflect a degree of irrational exuberance. For context, the S&P 500 has traded at an average forward P/E ratio of 16.9x since 1990, with its peak of roughly 27x coming during the run-up to the dotcom bubble in 1998. If you apply the long-term average multiple to the year-end earnings estimate, the S&P 500 would trade at roughly

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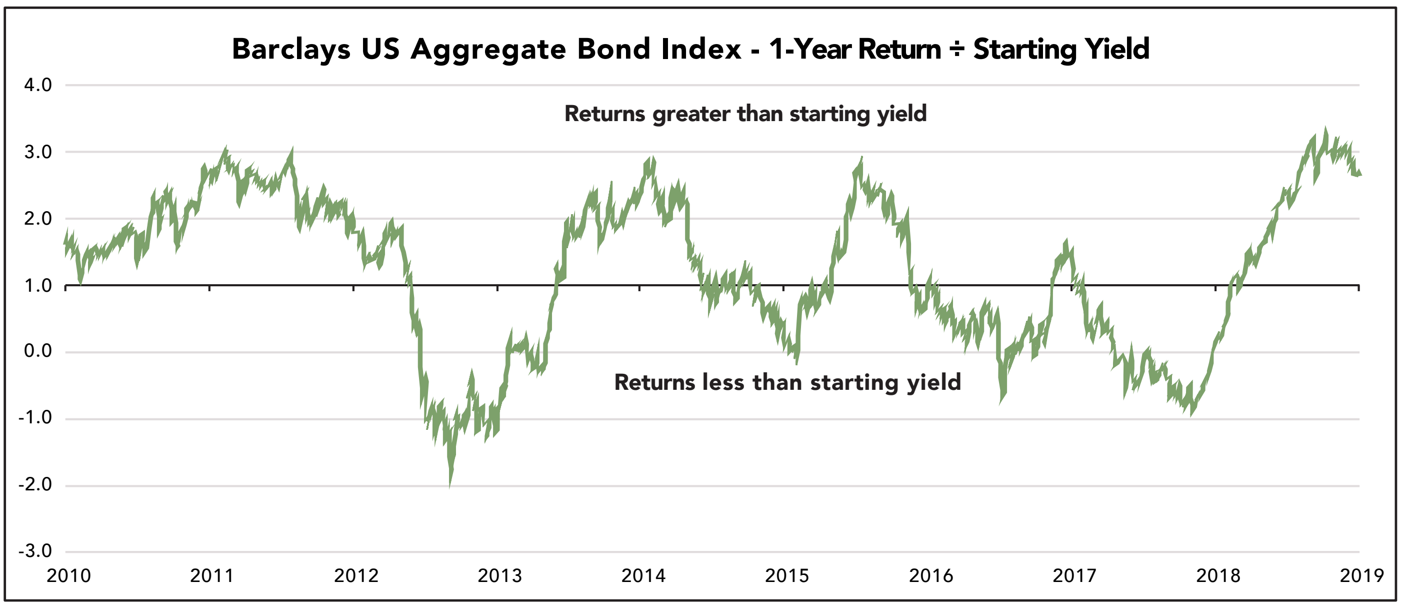
2,763, or 14.5% below the actual index level of 3,231. Valuations are notoriously poor market timing indicators, but in this case, they can at least provide a useful barometer for where markets could be headed if investor optimism wanes and the global growth rebound fails to meet expectations.

BIG TIME BOND RETURNS

A 0.75% move in interest rates may not grab an investor's attention like 30%+ stock market returns, but the declining rate backdrop should arguably be the biggest story of 2019 given its many derivative effects. The prior sections allude to the influence of lower rates on equity prices via improved economic growth expectations and higher valuation multiples, and we could devote pages to the impact on credit markets, housing demand, currencies, etc. But, the direct effect of the move in rates on bond performance was noteworthy in its own right during 2019. Specifically, the decline in rates provided the most significant tailwind for bond returns since the Fed's "Operation Twist" program in 2011-2012, where the Fed was buying long-term bonds and selling short-term bonds.

Consider that the Barclays US Aggregate Bond Index generated an 8.7% total return in 2019, which was roughly 2.6 times its starting yield of 3.3% (total return = income + price appreciation). The chart below tracks this ratio over the last 10 years; a reading of 1.0 would indicate that the 1-year index return was exactly the same as its starting yield, while levels above or below 1.0 indicate that returns were higher or lower than the starting yield, respectively.



Source: Bloomberg (Data as of 12/31/2019)

This ratio reached extreme levels in 2019, hitting 3.4x at its peak, driven by the precipitous decline in yields. The magnitude of the move was extraordinary in the context of the last 10 years. If we assume that the Fed remains steadfastly opposed to negative interest rates, then 2019 may have been the perfect storm for fixed income total returns; there is only so much price appreciation that can be generated by moving from the year-end index yield of 2.2% toward 0%. And, that says nothing of the potential for a rising rate environment and the headwind it creates for bond returns. Interest rates may not be the sexiest investment topic, but the current set-up may make them the most important variable for portfolios in the 2020s. ●

The Decade in Review

In the aftermath of one of the worst recessions in modern times, investors could have been forgiven for feeling less than optimistic about the prospects for the 2010s at the beginning of the decade. The country was scarred from recent events: the housing bubble popped, the financial system teetered on the brink of implosion, the unemployment rate

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jumped to 10%, and financial markets experienced a massive sell-off. As the saying goes, it is often darkest before the dawn, and the new decade ushered in a decidedly fruitful period for financial assets (we will save the Wall St. versus Main St. discussions for another day). We recap some of the defining features of the 2010s below.

FIXED INCOME/INTEREST RATES

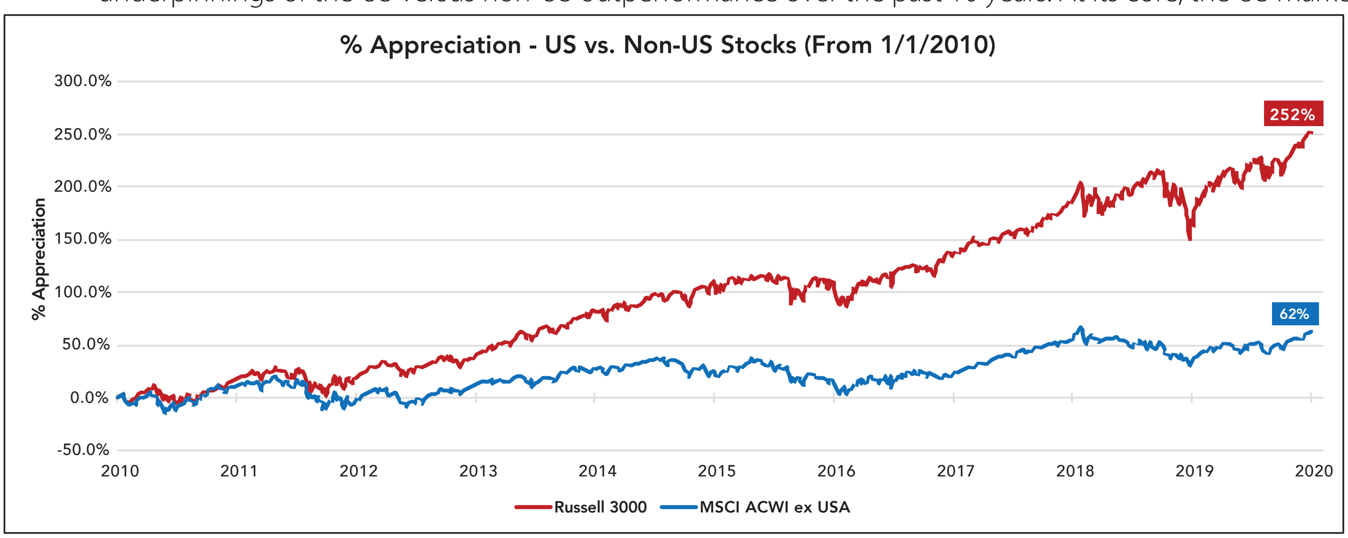
- *Central bank intervention.* Perhaps the most defining feature of the 2010s will be the scope and magnitude of central bank policy around the globe in response to the economic damage wrought by the 2008 global financial crisis. Policies that had previously been relegated to textbook hypotheticals became mainstream tools to fight economic stagnation, including the use of negative interest rates and large-scale asset purchases. The Fed, European Central Bank (ECB), and Bank of Japan (BOJ) now hold over $14 trillion of assets on their combined balance sheets—nearly triple the amount that they held at the beginning of the decade. Roughly 20% of the Barclays Global Aggregate Bond Index had a negative yield at the end of 2019. The long-term implications of these unconventional strategies remain uncertain, but what is clear is that the ultra-low yield environment around the world has pushed investors into riskier, higher-yielding assets.

- *The bond bull market rages on.* Pundits often want to focus on the unprecedented length of the current bull market for US equities, but the bull market in bonds will soon enter its fourth decade. The secular trend of lower interest rates has been a boon to fixed income portfolios, and the 2010s only accelerated the trend via the aforementioned central bank interventionism. Despite fears of runaway inflation and higher interest rates due to quantitative easing, the 10-year US Treasury yield was halved from 3.8% at the start of the decade to 1.9% at the end—a substantial tailwind for fixed income investors during the 2010s, but a potential source of investor anxiety heading into the 2020s as return targets become harder to attain.

EQUITIES

- *US outperformance versus the rest of the world.* For globally-diversified investors, the gap between the performance of the US market, as measured by the Russell 3000 Index, and the non-US market, as measured by the MSCI All Country World ex USA Index, was likely a persistent cause of frustration in the 2010s. For the decade, the Russell 3000 compounded at a 13.4% annualized rate relative to the MSCI ACWI ex USA at 5.0%. The chart below illustrates the performance divergence on a cumulative basis; the Russell 3000 gained 252% versus 62% for its non-US counterpart.

  Regular readers may note that we touched on this topic last quarter, but it is worth revisiting the underpinnings of the US versus non-US outperformance over the past 10 years. At its core, the US market



Source: Bloomberg (Data as of 12/31/2019)

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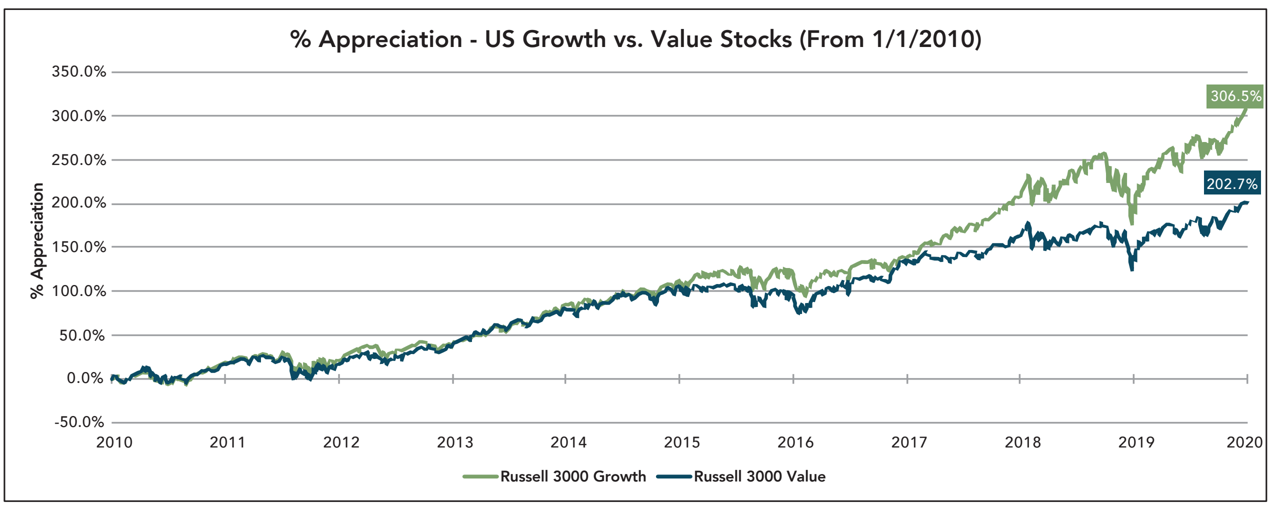
has experienced higher growth rates and higher profitability, driven in large part by the US technology sector—the largest weighting within the US index. Conversely, financials are the largest weighting within the non-US index and have faced substantial profitability headwinds from dynamics such as negative interest rates. More generally, the 2010s appear to have ushered in an era of "de-globalization"; IMF trade data suggests that annual global trade growth only averaged 3.2% in this decade versus 6.0% in the prior 20 years. The US and its domestically-oriented economy has been more insulated relative to countries that are more dependent on export growth.

- *The shift to passive investing.* One of the decade's biggest trends was a shift away from actively-managed strategies into passive investment vehicles, and in particular, strategies attempting to replicate the performance of an index. An underwhelming performance track record for stock picking strategies and continued fee compression for passive funds are oft-cited reasons for why investors have made the change—either in part or in totality. According to data from Morningstar, assets in US index-based equity funds surpassed active equity funds for the first time in August 2019.

  Perhaps the biggest impact of the move toward passive investing comes from the market capitalization weighting scheme used by many indices—i.e., weighting portfolio positions according to the size of the companies. This dynamic creates a momentum effect whereby larger companies receive a bigger share of every incremental dollar invested into the index strategy. In essence, it results in a "buy high, sell low" approach. It remains to be seen how these strategies will respond if investor flows reverse and the momentum trend falters.

- *Dominance of the FAANGs.* By now, you have likely seen a reference to the "FAANG" stocks—Facebook, Apple, Amazon, Netflix, and Google (Alphabet). These tech/consumer titans experienced extraordinary stock price gains during the 2010s that helped fuel dramatic outperformance for growth indices relative to value indices. The chart below shows this dichotomy within the US market; the Russell 3000 Growth returns ultimately bested the Russell 3000 Value by over 100% during the decade.



Source: Bloomberg (Data as of 12/31/2019)

To put some numbers to the magnitude of the FAANG's growth, the chart on the following page plots the total market capitalization of these five stocks relative to the total market capitalization of all US small cap stocks (as measured by the Russell 2000 Index, reflecting roughly two-thirds of all publicly-traded US stocks) since 2015. In the middle of the decade, the FAANGs were valued at nearly $700 billion less than the Russell 2000; since then, the Russell 2000 market capitalization has grown by a modest 17% while the FAANG's value has nearly tripled—now approaching $4 trillion of market value.

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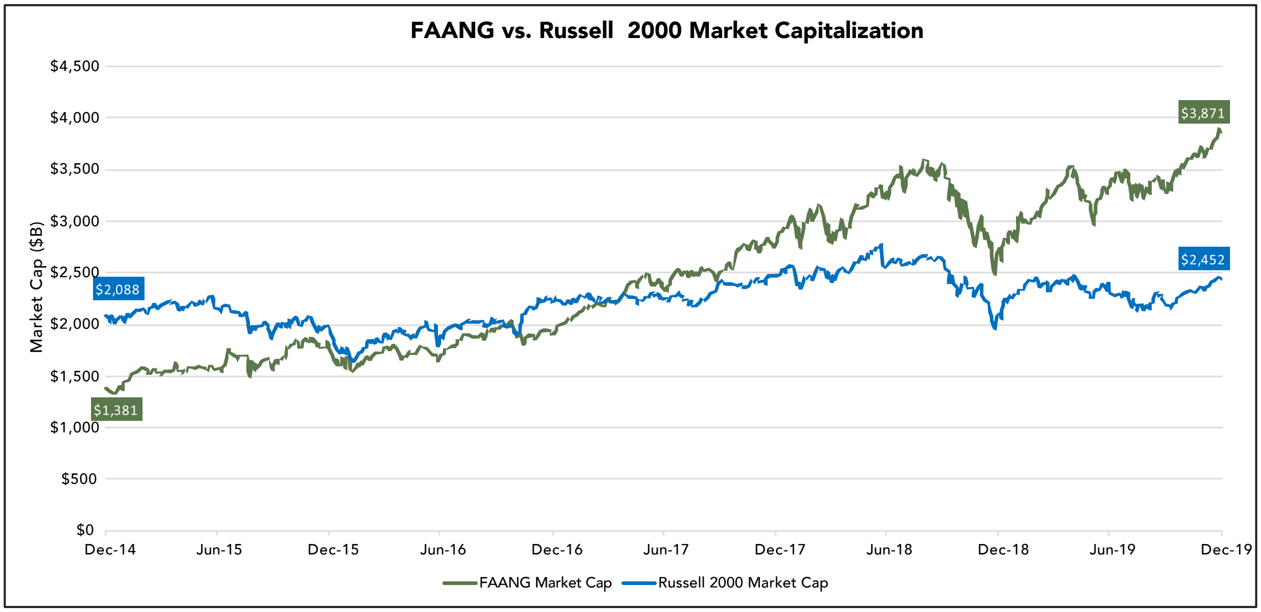

Source: Bloomberg (Data as of 12/31/2019)

ALTERNATIVE INVESTMENTS

- *The rise of the "unicorn".* Over the past 10 years, private companies—typically backed by venture capital and/or private equity groups—have increasingly opted to forego the traditional IPO route in favor of staying private for longer. There are a variety of explanations for this phenomenon, including the increased availability of capital in private markets and the rising regulatory/compliance costs of being a public company. This trend led to a sharp increase in the number of private companies valued at greater than $1 billion (a so-called "unicorn"), a figure that had only been achieved by a handful of companies pre-crisis. Specifically, private market data provider Pitchbook identified 187 US companies with a $1 billion-plus valuation as of Q3 2019 versus roughly 20 in 2010. Globally, that number is closer to 350, per Pitchbook.

  The implications of this trend are still being parsed and may not be fully understood for years. One hypothesis is that small cap indices of listed stocks—like the Russell 2000—are "missing out" on the performance of the strongest companies that would have historically gone public earlier in their life cycles. Perhaps this could offer an explanation for the underperformance of small cap indices relative to large cap indices over the past decade (the S&P 500 gained 256% versus the Russell 2000's advance of 206%). A related trend that has shown no signs of abating is the declining number of publicly-listed companies in the US. Fewer public stocks garnering the same amount of investor assets could conceivably translate into persistently higher valuations, all things being equal.

CHART OF THE QUARTER

US markets—as measured by the S&P 500 Index—punctuated a decade of strong performance with a 31.5% advance in 2019. While the headline figure is impressive, a more granular assessment of the S&P 500's returns is telling.

The Q4 Chart of the Quarter on the following page shows a breakdown of the S&P 500 sector returns for 2019. The blue bar on the chart below represents the index return of 31.5%, and the green bars depict the performance of each of the eleven S&P 500 sectors. Notably, only two sectors outperformed the index last year—information technology and communication services—and tech was the clear winner in 2019 with its 49.6% advance (communication services barely managed to beat the index). The nine other sectors each fell short of the index returns to varying degrees. Remarkably, over the last 30 years, this is the first time that only two sectors beat the index returns. 2019 was truly a unique year in that regard.

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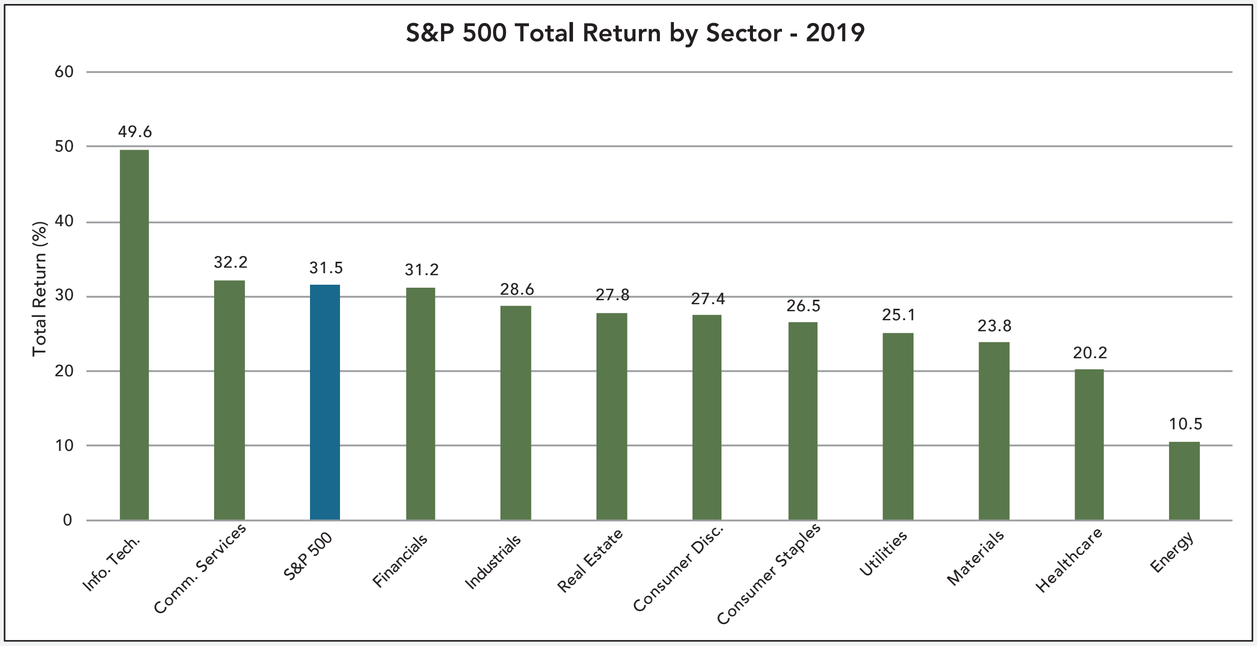

Source: Bloomberg (Data as of 12/31/2019)

The clear takeaway is that outperformance was hard to come by in 2019 outside of the tech sector. Even within the tech sector returns were heavily concentrated in two names: Apple and Microsoft. Those two stocks—out of 70 total names in the sub-index—accounted for nearly half of the sector's advance. It was a similar story in communication services as 3 stocks out of 26—Facebook, Alphabet (Google), and Netflix—were responsible for almost 60% of the sector's total performance. To the extent a portfolio had a value tilt that favored sectors like financials, materials, and energy, and/or a small cap bias, it would have been very difficult to outperform. ●

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