# 2019 ANNUAL REVIEW AND 2020 OUTLOOK

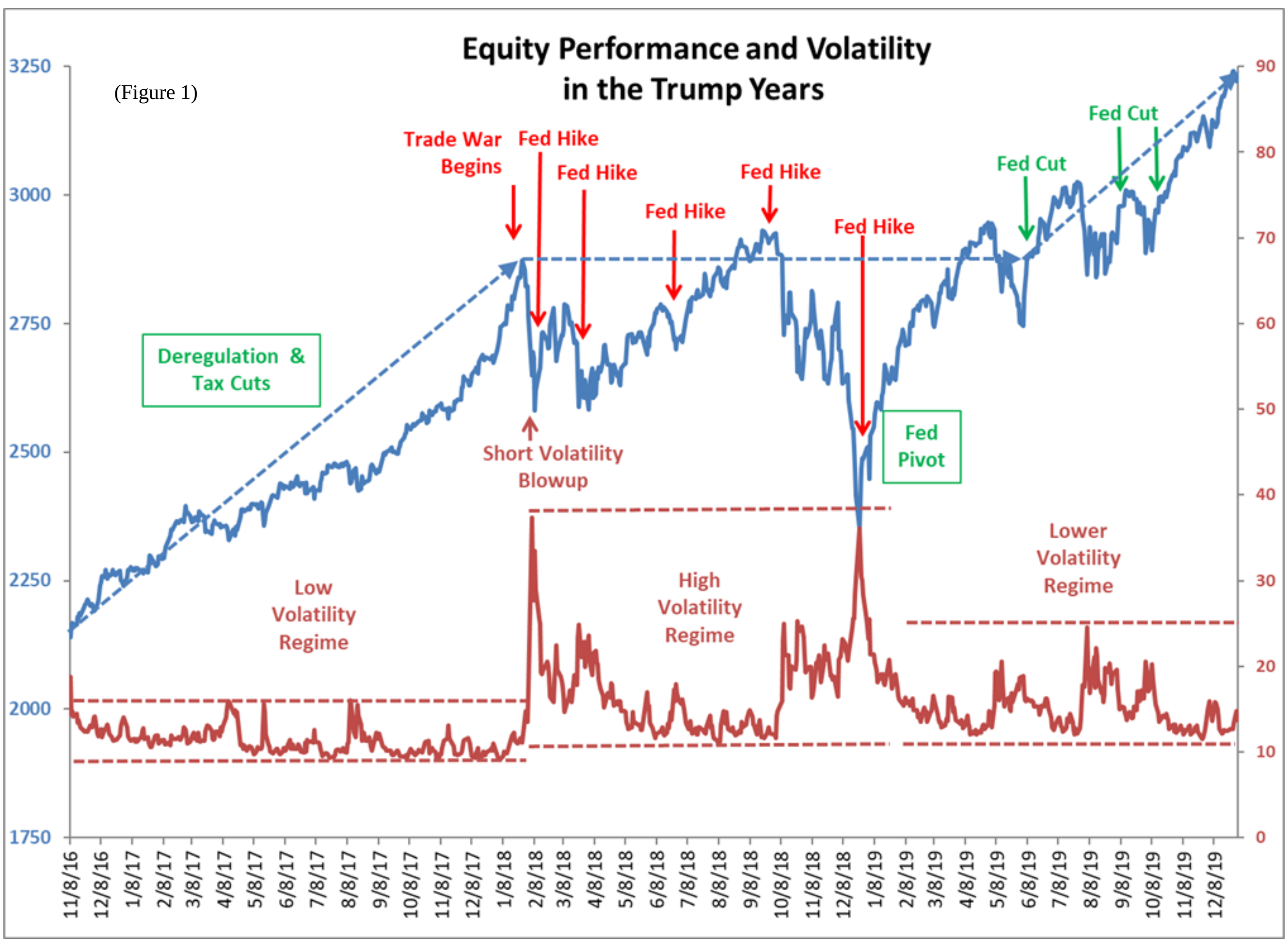
## SUMMARY

Despite a painful market pullback at the end of 2018 and rising fears of a recession, financial markets defied forecasts in 2019, as all asset classes soared on renewed monetary stimulus and trade optimism. For the year, global equities rebounded by 26.6% and commodities gained 17.6%, while U.S. fixed income rose by 8.7% amid declining market volatility. The S&P500 index capped the year by reaching a new high (Figure 1).

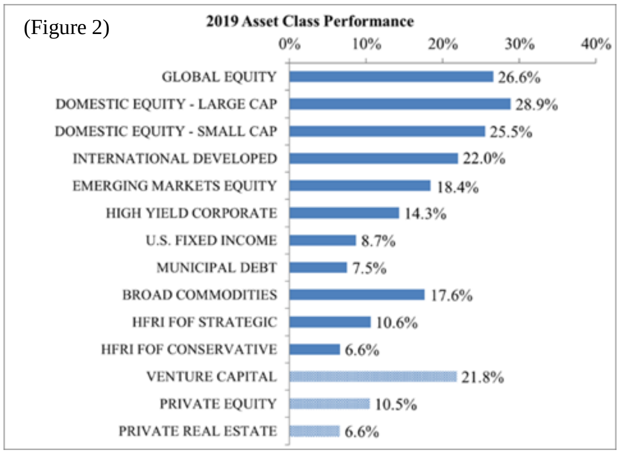
In our 2019 outlook, we correctly anticipated that the bull market would resume and equities would lead bonds, a view mostly predicated on cheaper stock valuations following the market pullback in the fourth quarter of 2018. We were surprised by the scope of investor optimism and the return to a lower volatility regime, which provided few opportunities for alternatives to shine. All in all, 2019 proved to be an excellent year for investors as all major asset classes delivered positive returns.

## REVIEW OF 2019

2019 proved eerily similar to 2017, featuring lower volatility and positive returns across the board. The main impetus for positive performance across stocks and bonds was the change of heart at the U.S. Federal Reserve in January, ending a series of interest rates hikes in the face of sagging economic indicators and rising uncertainty created by acrimonious trade negotiations with China. This was followed in the second half of the year by a series of three "insurance cuts" aimed at stabilizing the global economy. Central banks in Europe and



emerging countries followed suit, creating a wave of monetary stimulus that supported risk assets (Figure 2).

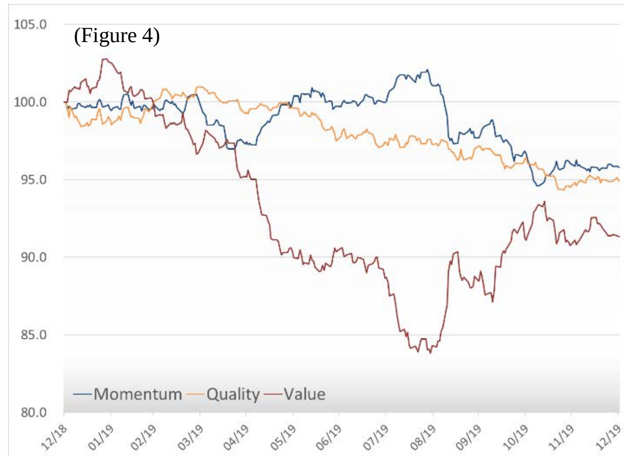



*See page 11 for index key.*

High uncertainty led to declining rates through Labor Day, supporting bonds early in the year. Fixed income returns were then flat through year-end while equities continued to rally (Figure 3).


U.S. equities benefited from a safe haven bid all year long, but by the fourth quarter, monetary stimulus and rising optimism that a trade agreement could be reached boosted lagging markets including emerging market equities and commodities.

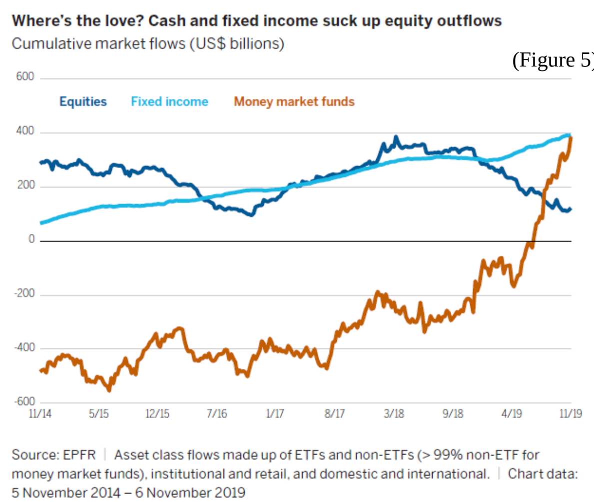
Throughout most of the year, value investing continued to face headwinds. However, this started to change after Labor Day as value factors recovered sharply at the expense of momentum in a market increasingly anticipating a cyclical recovery (Figure 4).




*Source: Deutsche Bank series of market neutral factor indices.*

In hindsight, a forceful central bank response to market turmoil seems almost predictable. After all, we have been conditioned to expect this market "put" since the 1990's.

However, few were willing to bet on it, as evidenced by fund flows that favored cash and bonds through year end (Figure 5).




*Source: Wellington Management*

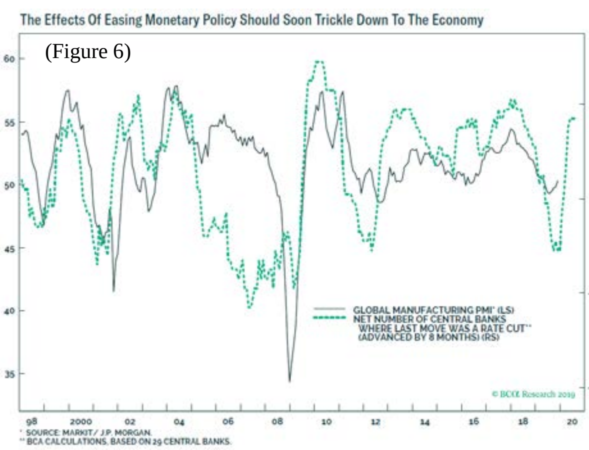
Cautious investors may have missed out on some of the upside, but the markets still rewarded everyone last year.

## ‘CAUSE YOU’RE HOT THEN YOU’RE COLD[1]

While 2019 started in a context of deteriorating economic fundamentals and improved valuations, the opposite is true for 2020 as economic indicators rebound and we now face frothy valuations, another hot and cold situation.

*Hot: Economic Fundamentals*

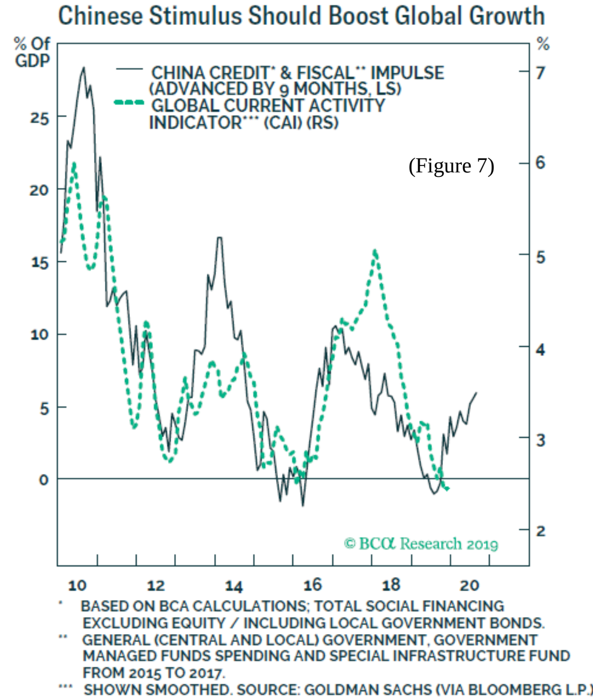
Concerted monetary stimulus is generally a leading indicator of manufacturing activity. Measures of global manufacturing have now troughed and we anticipate a cyclical rebound in economic activity (Figure 6).




*Source: BCA Research*

China was surprised by the beginning of a trade war with the U.S. in 2018 as it had embarked on an effort to rebalance its economy away from export-led growth toward domestic consumption. The uncertainty resulting from new tariffs was enough to tip its economy into a downturn, affecting the outlook of other emerging economies as well as that of major exporting nations in the developed markets, such as Germany or Japan. While investors expected economic stimulation, Chinese authorities were initially slow and measured in their response. However, fiscal and monetary stimulus is now in full swing, which historically is a precursor to a rebound to economic activity (Figure 7).

With the completion of a phase I trade agreement between China and the U.S. there is scope for optimism that trade uncertainty will recede in the near term, at least through the upcoming U.S. presidential election. Longer term, we expect a resumption of trade frictions, but this is beyond the scope of this outlook.

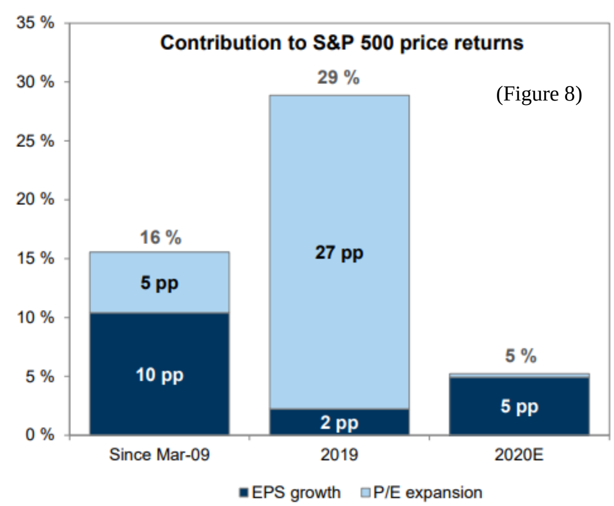



*Source: BCA Research*

*Cold: Market Valuations*

Unlike improving economic fundamentals, a review of market valuations should warrant some caution.

As shown in Figure 8, most of the strong U.S. equity returns in 2019 came from multiple expansion (i.e. the price that investors are willing to pay for cash flows), rather than earnings growth.




*Source: Goldman Sachs*

Most equity valuation metrics point to historically high valuations. The median valuation metrics registers in the 90th most expensive percentile for the aggregate index, and the 99th percentile for the median stock in the index (Figure 9).

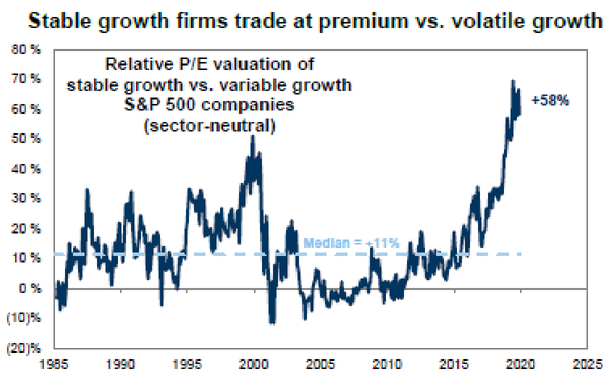
(Figure 9) **S&P 500 valuation vs. history**

| Valuation metric | Aggregate index Current | Aggregate index Historical %ile | Median stock Current | Median stock Historical %ile |
|---|---|---|---|---|
| US market cap / GDP | 203 % | 100 % | NA | NA |
| EV / sales | 2.6 x | 99 | 3.0 x | 99 |
| EV / EBITDA | 12.9 x | 95 | 13.1 x | 100 |
| Price / book | 3.7 x | 90 | 3.5 x | 100 |
| Forward P/E | 18.8 x | 90 | 18.8 x | 98 |
| Cyclically adjusted P/E (CAPE) | 28.3 x | 90 | NA | NA |
| Cash flow yield (CFO) | 7.2 % | 85 | 7.5 % | 81 |
| Free cash flow yield | 4.0 % | 55 | 4.0 % | 63 |
| Yield gap vs. 10-year UST | 341 bp | 30 | NA | NA |
| **Median metric** | | 90 % | | 99 % |

*Source: Goldman Sachs*

This points to limited potential for further multiple expansion, and earnings growth as the main driver of future returns. Unfortunately, investors have already placed a historically high premium on stable growth companies (Figure 10).

(Figure 10)

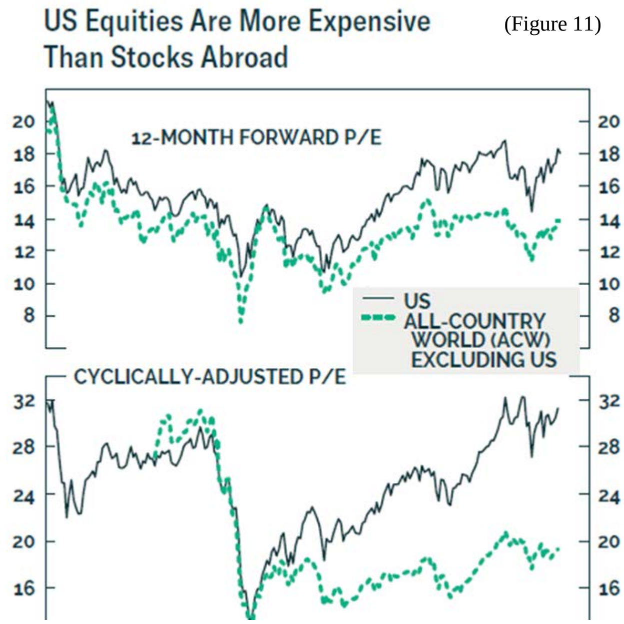



*Source: Goldman Sachs*

High valuations tend to revert to the mean over the long term and prospective returns for market weighted indices don't look compelling. Indeed, passive exposure to U.S. equities appears to be one of the riskiest investments today.

Foreign equities on the other hand, beset with political risk and perennial growth concerns, have lagged their U.S. counterparts for much of the past decade. As a result, valuations appear more attractive than in the U.S. today, as shown in Figure 11.

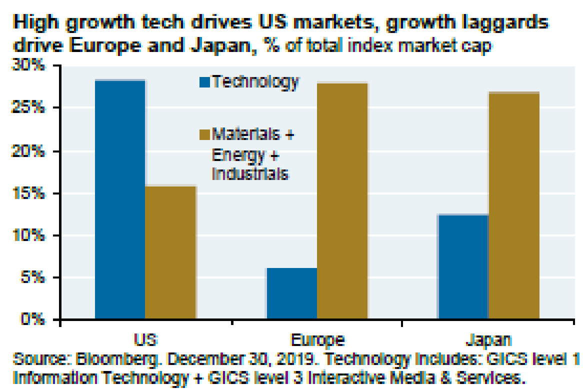
(Figure 11)




*Source: BCA Research*

Of course, what dominates foreign equity indices are variable growth sectors including materials, energy and industrials, which tend to perform better when global growth strengthens (Figure 12).

(Figure 12)




*Source: JP Morgan*

Reconciling a pending cyclical upturn in the global economy and current valuation metrics, our base case scenario is for equities to rise in 2020 but for market leadership to shift in favor of undervalued cyclical sectors and foreign markets.

## (I CAN'T GET NO) SATISFACTION[2]

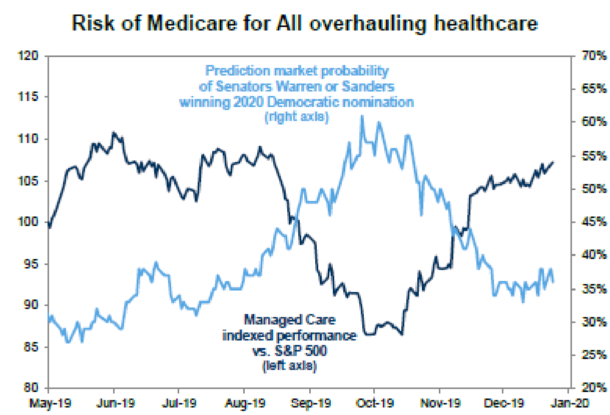
Of course, as allocators we need to plan not only for what we think is the most likely outcome but also for what could go wrong. As always, there is no shortage of potential concerns that could deny us the satisfaction of having made the correct call.

We think that there are three main risks in the short term, all tied to the U.S. election cycle, as well as a fourth long-term worry that we will highlight as well.

*Progressive victory*

The polarization of politics in the U.S. has made progressive candidates Sanders and Warren serious contenders for the Democratic nomination. Some of their proposals would potentially lead to a reversal of fiscal stimulus to fund entitlement programs. Specific sectors may also be disrupted such as healthcare if "Medicare for All" came to pass. As seen in Figure 13, the Managed Care subsector's relative performance was clearly tied to the fluctuating odds of a progressive candidate nomination.

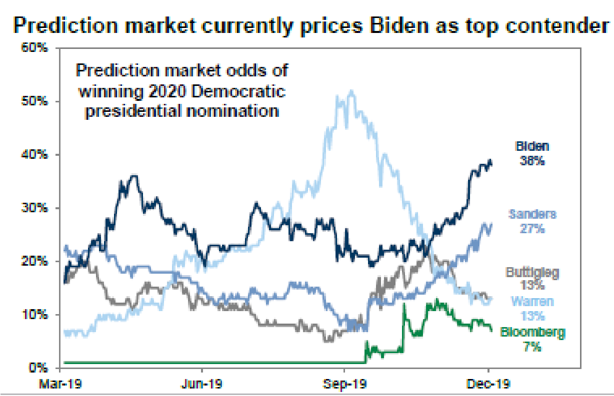
(Figure 13)




*Source: Goldman Sachs*

At the moment, a moderate candidate appears to lead (Figure 14) but we anticipate more market volatility based on the ebbs and flows of the election process.

(Figure 14)




*Source: Goldman Sachs*

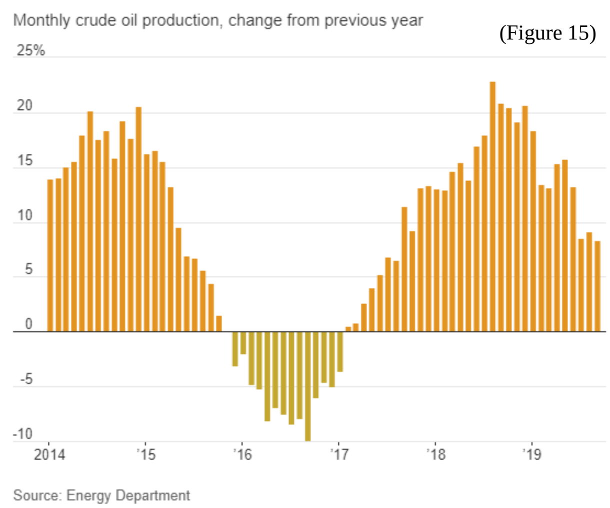
*Geopolitical Shock*

The year opened with the U.S. conducting a drone strike on January 3rd on two high-level targets near the Baghdad International Airport, briefly leading to fears of escalating conflict with Iran. This came on the heels of a drone attack on Saudi oil facilities on September 14th. Clearly, tensions in the Middle East have the potential to surprise markets and we don't think this will abate in an election year.

What was most striking in both events was how short-lived the reaction was in oil markets, with brief spikes on the news soon receding. There seems to be no geopolitical risk premium priced in the markets, and investors apparently will not anticipate any tightness in oil supply until it becomes apparent.

While the world has been awash in oil following the shale "revolution," this may change as shale production basins age and U.S. energy companies cut back on drilling activity to satisfy investor demands for higher returns. Indeed, U.S. crude oil production declined in 2019 (Figure 15) and forecasts anticipate an undersupplied market in 2020, leading to inventory drawdowns.

(Figure 15)




In this context, geopolitical tensions have the potential to lead to oil price spikes which could curtail economic growth.

*Renewed Trade Wars*

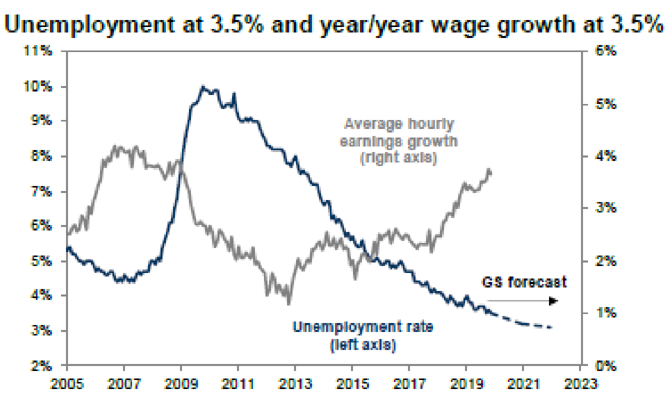
A successful re-election bid by the incumbent Republican president could embolden the administration to resume a tough stance on trade, both with China and Europe. Therefore, the fourth quarter could see a return to uncertainty and higher volatility levels regardless of the outcome of the election.

*Return of Inflation*

A fourth concern to the markets is longer term in nature and less tied to near term political developments, but more dire in its potential consequences.

Inflation has been low for so long that an entire generation of investors may have forgotten about it. Yet an environment of full employment and steady growth supported by monetary and fiscal stimulus is a recipe for long term wage growth. Several arguments have emerged to argue that this time is different: secular stagnation, the Amazon deflationary effect and reduced leverage from trade unions. However, the correlation between labor market slack and wage growth remains intact (Figure 16).

(Figure 16)




*Source: Goldman Sachs*

Barring a surge in productivity, rising wage growth should lead to accelerating unit labor cost inflation. Bull markets don't die of old age, but we think a rise in inflation will eventually tie the Fed's hands, forcing rate increases and an end to easy money conditions, leading to a recession.

## I WILL SURVIVE[3]

"At first I was afraid, I was petrified." As the song hints, it is easy to remain paralyzed in the face of so many potential risks. But this is when careful portfolio construction can help.

As explained above, there is a difference between the probabilities we assign to particular scenarios and the eventual outcome. We envision a higher probability base case scenario featuring a cyclical upturn favorable to equities. Lower probability outcomes mentioned above could result in risk aversion, volatility, recessionary or inflationary conditions which could all have an adverse impact on equity portfolios. Our goal as always is to maintain highly diversified portfolios on behalf of our clients to hedge against these potentially adverse outcomes. Thus, fixed income, real assets and absolute return allocations offer shock absorbers to growth-oriented portfolios centered on equities. Even within equities, a focus on value can help mitigate losses in a downturn.

As Mike Tyson famously quoted: "everyone has a plan 'til they get punched in the mouth." While we would rather avoid such a punch, we keep planning for the unforeseen events that will rock markets by building resilience in diversification.

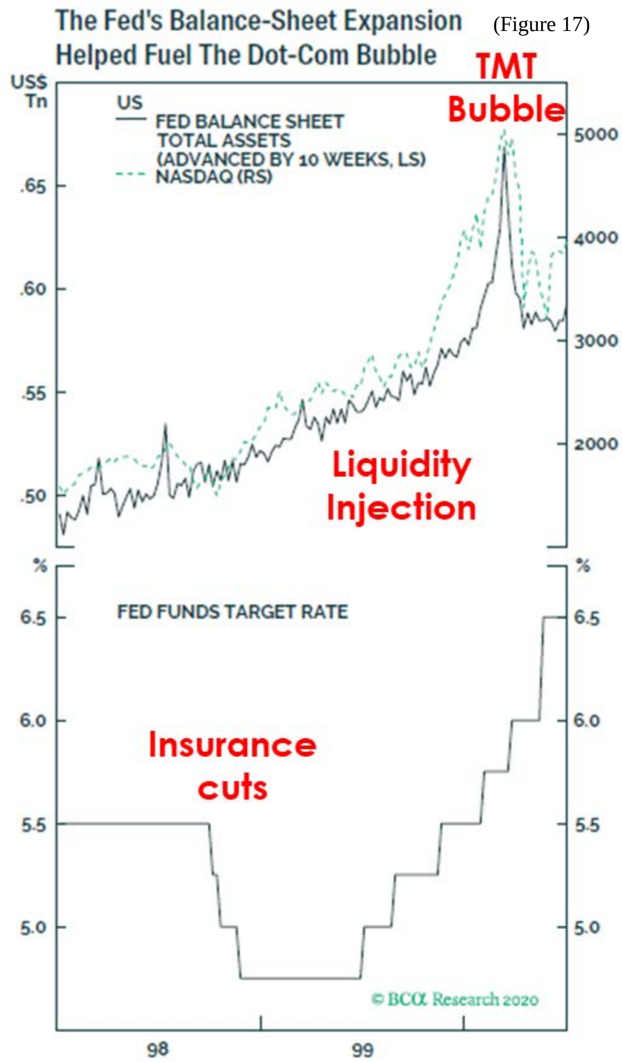
## PARTY LIKE IT'S 1999[4]

We would be remiss to conclude our outlook without mentioning the eerie similarities between 1999 and current market conditions.

Back then as today (see Figure 17):

- U.S. equity markets moved toward peak valuations, led by the Technology sector.
- The Fed implemented a series of "insurance" rate cuts (then in the wake of the Russian default).
- The Fed also injected liquidity in the markets, expanding its balance sheet (then in order to stave off the Y2K scare)

This market setup in 1999 triggered what has been labeled a market "melt-up" where a lot of money found its way into unprofitable and ultimately unsuccessful companies, and a spectacular correction took place once a recession became unavoidable.

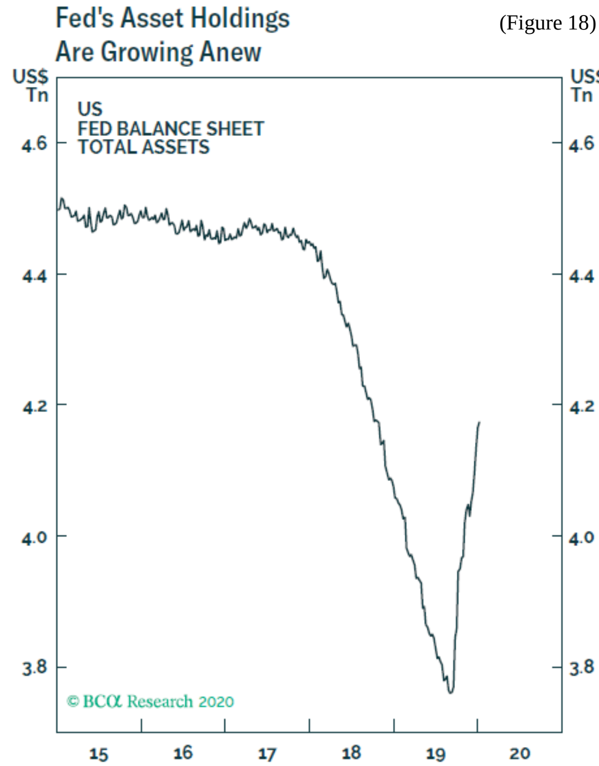


(Figure 17)

*Source: BCA Research*

Of course, things look different this time around. For one thing, the Fed shows no inclination to raise rates and pop the bubble as it did in 2000.

Case in point is the recent injection of liquidity into money markets, which may not have caught as much attention outside of Wall Street. While not technically "quantitative easing" (which involves buying long term bonds, thus reducing their yield and enticing investors into riskier investments), the Fed is now growing its balance sheet again and signaling to markets a continuation of easy money policy (Figure 18).



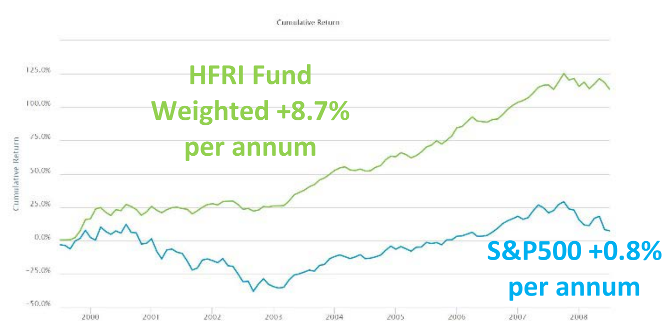
(Figure 18)

*Source: BCA Research*

Still, as philosopher George Santayana observed: "Those who cannot remember the past are condemned to repeat it" and we keep a wary eye on the massive stimulus that has once again propelled investment returns.

If the 2001-02 recession is any guide, investors will be well served to balance exposures with hedge funds, who through a combination of active management and hedging capabilities, were able to protect principal and grow assets during the period.

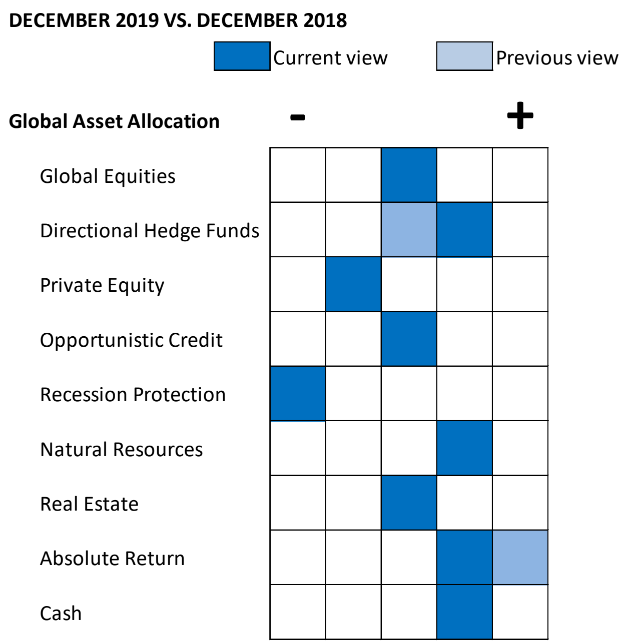
*Cumulative Returns for S&P500 and HFRI Fund Weighted Index, July 1999-July 2008:*




*Source: eVestment*

## KNOCKIN' ON HEAVEN'S DOOR[5]

Achieving investment Nirvana in 2020 will require a subtle balancing act. Our preferences have not changed much from last year, favoring active management, and lower beta, liquid assets. At the margin, bullish near-term views favor market directional hedge funds. For defense, we remain concerned that bonds may not offer as much protection in a downturn given low rates and thus favor cash and absolute return hedge funds.




## INDEX KEY

Global Equity (MSCI All Country World-USD), Domestic Equity Large Cap (S&P500), Domestic Equity Small Cap (Russell 2000), International Developed Equity (MSCI EAFE), Emerging Market Equity (MSCI EM), Energy Equity (MSCI ACWI Energy) Broad Fixed Income (Barclays Aggregate), U.S. Government Debt (Barclays U.S. Treasury), U.S. Inflation-linked (Barclays U.S. Treasury Inflation Notes), U.S. Corporate Debt (Barclays U.S. Corporate), U.S. Securitized Debt (Barclays U.S. Securitized), Emerging Debt U.S. Dollar (JP Morgan Emerging Market Bond Index Global), Emerging Debt local currency (JP Morgan Global Bond Index Emerging Markets), High Yield Debt (Barclays U.S. High Yield), Municipal High Yield (Barclays U.S. Municipal High Yield), Municipal Debt (Barclays U.S. Municipal), Commodities (S&P/Goldman Sachs Commodity Index), Public Real Estate (MSCI U.S. REIT), Global Hedge Funds (HFRI Fund Weighted Composite), Directional Hedge Funds (HFRI Fund of Funds Strategic), Absolute Return Hedge Funds (HFRI Fund of Funds Conservative), Venture Capital (Cambridge Associates Venture Capital Index), Private Equity (Cambridge Associates Private Equity Index), Private Real Estate (Cambridge Associates Private Real Estate).

## RESEARCH/COMMENTARY DISCLAIMER



## ACKNOWLEDGEMENTS

[1] Katy Perry
[2] The Rolling Stones
[3] Gloria Gaynor
[4] Prince
[5] Bob Dylan