WINTER 2020

Investment Commentary

A New Year.
A New Decade.

A Look Back and A Look Ahead

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WEALTH MANAGEMENT

A Recap of 2019

As we bid farewell to another holiday season, another year and this time, another decade, we are reminded that the Bull market that began in early 2009 seems to be impervious to father time.

To recap 2019, it is important to look at December 2018. The health of the market seemed somewhat unsure at the time; trade wars, a government shutdown, fear of additional Fed tightening and concerns about a slowing global economy all weighed on the markets. In a few short weeks nestled in the fourth quarter of 2018 market averages would compress nearly 20%. As a matter of fact, for the year ended 2018, not one major asset class would gain 5%. {For market historians, the last time that happened was 1972. At that time the Dow Jones Industrial Average was flirting with the 1000 level. Today, we are approaching 30,000 on the Dow, which speaks volumes to the benefits of both long-term investing and compounding of returns.}

After markets had begun their dramatic comeback in early 2019, reversing fourth quarter 2018 losses, investors suddenly became unnerved when in March the first yield curve inversion since 2007 was observed. {An inverted yield curve happens when shorter term yields are higher than longer term ones. Being rewarded a higher return for shorter maturities is a unique phenomenon—and is typically associated with an unhealthy economy}. The good news was the 2019 yield inversion was short-lived and from our perspective received too much attention from the financial press for the blip it was. The fundamental drivers causing an inverted yield curve had little to do with the bond market signaling an upcoming recession. A steadying economy, modest inflationary pressures, and continued job growth, all helped ease any residual investor concerns through the summer and fall of 2019.

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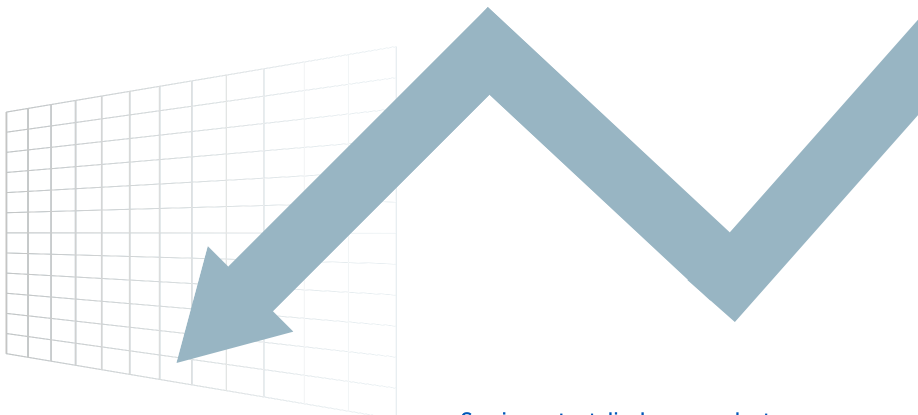
In contrast to the yield curve “flash”, the trade war between China and the US loomed for all of 2019 and carried the potential to reduce global production, investment and trade. Tariffs were imposed from both sides and the tit-for-tat continued until a limited “Phase One” deal was recently announced. The market proved resilient to the yin and yang of talks and tweets. As 2020 unfolds we hope to get greater clarity as to what impact, if any, the next phase deal may have. In a related note there were also several trade agreements being made between the United States and some of its other trading partners, all of which was viewed by market participants as constructive.

ONE SPECTACULAR FLAME OUT

On the home front there was one spectacular flame out in 2019. In September, the WeWork IPO was pulled before going public. This failed attempt hopefully tempered some speculative investor fervor for high concept, high valuation, money-losing companies. This coming to market debacle created an eerie déjà vu feeling that Q4 2019 may play out in a similar fashion where stock prices suffered a lighting quick bear market in the fourth quarter of 2018 .

While the shared office space company once sported a private market valuation of almost $50 billion, the IPO was withdrawn after enormous operating losses were disclosed in their regulatory filings. The company was ultimately forced to cancel the IPO as potential investors fled (soon thereafter, WeWork had to be bailed out by Softbank to remain solvent). This highly-publicized IPO failure hopefully awakened investors to the perils of investing in money losing companies. To further accentuate the point the 1/15/20 WSJ article referenced that today over 40% of listed companies have lost money over the past 12 months—outside of recessionary periods this hasn't happened since the 1990's—and that market cycle didn't end particular well.



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"Risky" Assets Benefited from a Dramatic Federal Reserve Board Reversal in 2019

Two admissions by Federal Reserve Chairman Jerome Powell set the foundation for what is now referred to as the "Powell Pivot" or "Pirouette." Powell acknowledged that the economy was not at risk of overheating in the short term and that unemployment could go even lower without any negative side effects. This was a major change from previous statements.

In Jerome Powell's words: "We really have learned that the economy can sustain much lower unemployment than we originally thought without troubling levels of inflation."

At the end of 2018, Fed leaders were signaling two rate hikes in 2019 to tap the brakes on the economy, which thankfully did not come to pass. Instead, the Fed reduced rates three times in 2019 by a total of 0.75% and signaled it was likely to keep them at the current level until at least 2021.

The Fed's rationale for the cuts was to keep the U.S. economy strong in the face of global developments and to provide some insurance against ongoing risks. It certainly helped. After a volatile summer and as the Fed pivoted to an easier stance, stock markets rebounded to new highs and credit markets show increased confidence that this easier policy would help avert a serious economic slowdown.

We expect in 2020, barring some unwelcome exogenous event, the Fed will do everything in its power to stay out of the spotlight—as has been an unwritten norm in election years. A dormant Fed means it will be up to market forces, alone, to set interest rates. If global economies continue their modest upturn, the unemployment rate just holds steady, wage increases continue (albeit modest to date), and business confidence improves (read tariff/geopolitical concerns lessen) we wouldn't be surprised by a steeper and rising yield curve by late 2020, early 2021.

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Low rates tend to provide cover for highly levered investments/structures. Cheap money, on the margin, tends to lend itself to undisciplined uses of capital. Should the yield curve shift higher it wouldn't be surprising to see some pockets of financial stress in the economy. And on that thought, it may soon be time to focus on finetuning your own balance sheet (corporate or personal). In anticipation capital may become more expensive or difficult to obtain, or cash more rewarding to lenders, now may be the time to contemplate building a comfortable reserve.

An Interesting Start to 2020

Typically, we restrict our quarterly commentary to events ending on the last day of the quarter. This year, we break tradition given the significance of early January events.

The U.S. drone attack which killed Iran's military chief has led to a recent spike in stock market volatility. Though, according to many "market professionals," it poses little risk to the longer-term health of the stock market. According to one highly respected trust company: "We anticipate that these market impacts, as well as those associated with any likely retaliatory action, will be modest and short lived…". We would like to share with you our somewhat different perspective on the financial impact of recent events.

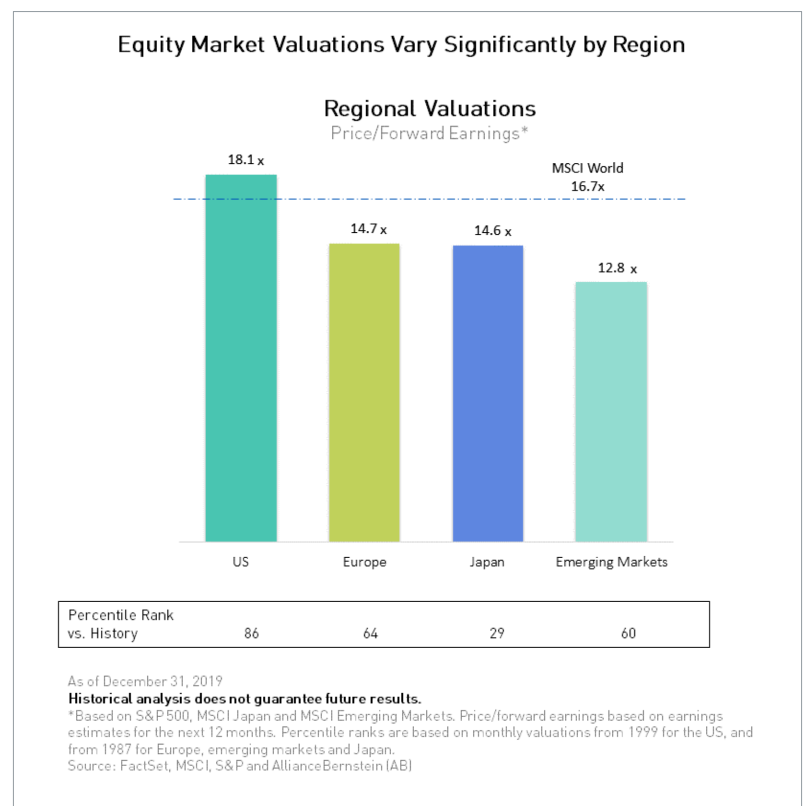
The bullish fervor leading into the new year was not without merit. For "risk" assets such as stocks, good news has been plentiful: Impeachment at this point has been a market nonevent; Phase 1 of a China deal is "totally done;" most Democratic nominee polls have more moderate, former Vice President, Joe Biden leading over candidates considered less market friendly; the Federal Reserve is unlikely to raise rates in an election year; and regulatory and tax reform have helped reprice the stock market indices. Major market news- up until the military strike- has been predominantly friendly and the market momentum and psychology clearly positive. It's also possible, the latest conflict with Iran will get both countries talking again—all too early to assess.

It's important to note, at any time, a series of unexpected data points, surprise developments or an exogenous event can trigger a change in market psychology for specific reasons (Iran tensions) or no reason at all.

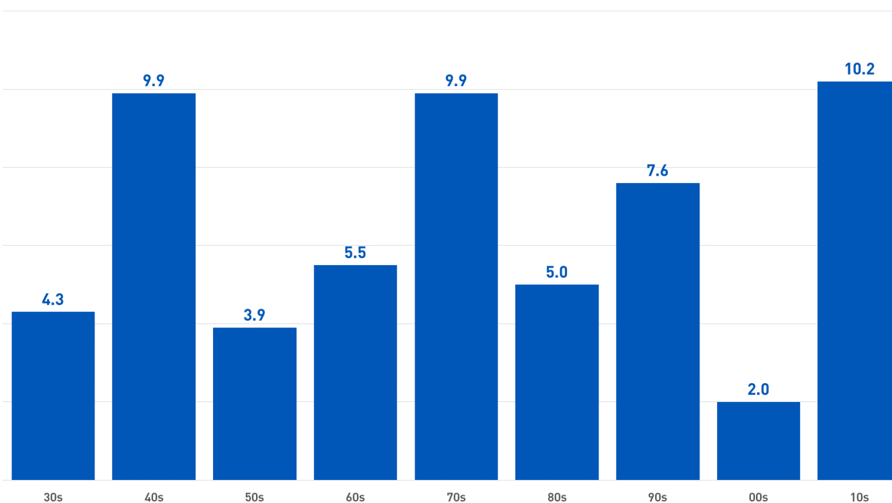
These types of events can be more troubling when market valuations are pricing in an abundance of good news. As current market valuations are trending above historical averages, we need to be mindful volatility and excessive market swings can follow any news that is deemed to negatively impact investor sentiment.

MARKET TIMING MAY BE AN IMPOSSIBLE ACT, BUT PRUDENT MONEY MANAGEMENT IS NOT.

By most measures, the large cap segment of the U.S. market trades at an above average 19x anticipated earnings, while European markets trade at closer to a historical average of 14x, and emerging markets even less, which may generate timely rebalancing opportunities. Obviously, reversion to the mean for price earnings multiples is never a guarantee or by itself should it be a standalone strategy. Let's remember, however, as the decade ending 2010 dramatically proved, the investable market universe should extend beyond our home borders. In that decade, emerging market and international stocks greatly outpaced U.S. markets rewarding those that invested outside any home bias.



A NEW YEAR AND A NEW DECADE



We are believers in long term investing but remain somewhat skeptical that price earnings, multiple expansion, and above average earnings growth will have the same impact on U.S. stock prices in this new decade. According to Credit-Suisse, the annualized S&P 500 earnings per share (EPS) growth rate for the decade ending December 31st, 2019 was 10.2%, roughly 2x historical average. Historically, once EPS growth rates peak from such levels, they decline dramatically the following decade. It's fair to anticipate this will be a different decade with it's own set of surprises. And perhaps there will be different sectors and individual securities that will lead us to greater highs in the market.

WISHING EVERYONE GOOD HEALTH AND FORTUNE IN 2020 AND BEYOND.

The length of our letter exceeds our normal threshold but hopefully you will find it timely and relevant. We expect 2020 will shape up as a year where patience and opportunistic investing will play a rewarding role. Finally, as we like to say, "we are all aging alongside this bull market." Should you have any concerns about the current environment, should there be a change in personal circumstance, or if you have any questions please do not hesitate to contact us:

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