To Our Clients and Friends:

We are pleased to bring you our report for the fourth quarter of 2019.

The healthy start to 2019, which followed a dismal 4th quarter in 2018, continued for the balance of the year. The S&P 500 Index rose 9.07% in the fourth quarter and a staggering 31.49% for the year; the MSCI World ex-USA Index rose 7.91% for the quarter and 23.16% for the year; and the Bloomberg Barclays U.S. Aggregate Bond Index rose 0.18% for the quarter and 8.72% for the year. In fact, with the exception of the MSCI World ex-USA Index, which had a small (0.85%) loss in the third quarter, each of these indices was up in every quarter in 2019.

2019 was somewhat unusual in that it was one of those relatively rare years where both the equity and bond markets had healthy returns, surprising many money managers, economists and the investing public. The gains are a result of many things that happened and a few that did not happen.

What did happen? Contrary to the position it took just 15 months ago, the Fed decided to cut, not raise, short-term interest rates, which it did three times in an anticipatory effort to keep a good economy on track and head off a recession. The ongoing trade war, slowing global growth and weaker U.S. economic data all contributed to the Fed’s decision.

The much-hyped (at the time anyway) yield curve “uninverted.” On August 14 the yield on the 10-year U.S. Treasury bond dipped below, albeit barely, the yield on the 2-year U.S. Treasury bond, technically “inverting.” This was the first time an inversion had happened in over a decade and many used it as a reason to exit the market. Fast forward to December 18 when the spread between the 2-year Treasury yield and the 10-year note climbed to its highest level since November 2018, essentially saying the economy is fine. This should keep the Fed on hold for the foreseeable future.

Volatility remained as a fact of investing life but those that rode it out were rewarded for their patience.

Employment numbers continued to improve. The November jobs report that came out Friday December 6 showed that more jobs were created 2019 rate hikes. Source: J.P. Morgan Asset Management. Even so, to go from forecasting three hikes to implementing three cuts in a little over a year shows not only how difficult the Fed finds predicting the state of the U.S. economy, but also how ready the Fed is to use the tools in its tool belt.

Yield curve inversion has a strong record of predicting recessions. For more on this see page 1 of our 3rd Quarter 2019 letter.

“Exit” is really an understatement: On August 14 the DJIA tanked 800 points, its worst percentage drop of the year.

Source: CNBC.

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1 Readers may recall that we opened our January 10, 2019 letter with the following quote from that day’s Wall Street Journal: “U.S. stocks are on their swiftest rebound in more than a decade, fueled by reinvigorated confidence in the domestic economy and signals the Federal Reserve will take a cautious path on future interest rate increases.”

2 Source: Dimensional Fund Advisors.

3 In September 2018, the Fed was forecasting three rate hikes in 2019 and one last hike in 2020, which would have brought the Fed Funds rate to 3.5%, well above its target long-term “equilibrium” rate of 3.00%. In December 2018 they not only reduced the target rate to 2.8%, they also “officially” removed one of their projected rate hikes. Source: J.P. Morgan Asset Management. Even so, to go from forecasting three hikes to implementing three cuts in a little over a year shows not only how difficult the Fed finds predicting the state of the U.S. economy, but also how ready the Fed is to use the tools in its tool belt.

4 Yield curve inversion has a strong record of predicting recessions. For more on this see page 1 of our 3rd Quarter 2019 letter.

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6 Source: CNBC.
than had been expected by economists, and the unemployment rate fell again, also unexpectedly. The markets cheered this news, surging to near-record highs on that day.

Related, and important due to how long it has not been the case, wages for rank-and-file workers rose at the quickest rate in more than a decade, and far more than the top wage earners⁷.

Manufacturing contracted significantly. The Institute for Supply Management reported on Friday January 3 that its manufacturing index fell to 47.2 in December, the lowest level since June 2009 when it hit 46.3⁸.

Earnings moderated⁹ and valuations rose¹⁰, a combination that is worrying many equity investors. As we have noted many times before, despite what is keeping the equity markets at or above record levels (easy Fed policy, a trade truce, complacency?), eventually earnings are going to have to “catch up” to the current valuations and provide a more real (vs. anticipated) and sustainable reason for equities to continue to rise¹¹.

What did not happen? A recession for one thing. In fact, consistent with the yield curve discussion above, CNBC reported on December 18 that the chances of a recession in the next year fell to its lowest level since June¹². A conclusive resolution to the trade war failed to materialize but the joint U.S.-Chinese announcement in December that they had reached a so-called “phase one” trade deal has given investors reason to be far more optimistic than they have been since the first tariffs were imposed some two years ago¹³. Whether “phase one” actually results in a comprehensive trade war truce will be crucial.

But enough about 2019 – what does 2020 look like? Opinions vary from one extreme to the other. The more thoughtful, credible and reasoned sources we tend to listen to are saying the following:

1. There is little evidence of a U.S. recession in 2020 and, in fact, barring a major shock, the U.S. economy should see decent growth. The Fed standing ready to make further cuts to short term rates should help this.

2. It is easy to assume that the markets will revert to a lower level just because they have come so far in such a short time. This is not necessarily a given however. While the past is by no means a guarantee of the future, equity markets tend to increase in years after they have had significant gains.

3. A good 2020 is going to be dependent on continued strength (both in terms of consumption and level of optimism) of the U.S. consumer.

4. While it is always possible that geopolitical tensions (especially of the magnitude that the killing in Iraq of a leading Iranian general and Iran’s retaliatory strike on Iraqi airbases that house U.S. troops represent), can always spook the market. Thankfully, however, these tend to be short-lived¹⁴.

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⁷ Pay for the bottom 25% of wage earners rose 4.5% in November from a year earlier, while wages for the top 25% of earners rose 2.9%. Source: Federal Reserve Bank of Atlanta.
⁸ Any number below 50 represents contraction.
⁹ S&P 500 earnings were essentially flat in 2019, according to Morgan Stanley.
¹⁰ As of this writing, the S&P 500 Index is trading at ~24 times trailing twelve month earnings; the mean number is ~16. Source: muptl.com. Forward earnings multiples, however, are now only modestly above historical levels. Source: JP Morgan’s Chief Strategist David Kelly.
¹¹ As John Lynch, chief investment strategist for LPL Financial, put it, “In 2019 expanding valuations drove gains for stocks, but in 2020 we expect earnings to do the heavy lifting.”
¹² This from responses to the December CNBC Fed Survey.
¹³ On March 1, 2018, President Trump announced his intention to impose a 25% tariff on steel and a 10% tariff on aluminum imports. As we all know now, that was just the beginning.
¹⁴ Mark Haefele, global CIO for global wealth management at UBS, sums this point up well: “Geopolitical events by their nature are unpredictable, but previous periods of increased tensions suggest that the impact on wider markets tend to be short-lived ... More
and, absent an all-out war or sustained spike in oil prices, should not bother the disciplined, long-term investor too much.\textsuperscript{15} Tensions, unrest and threats are likely to keep oil prices volatile (if not elevated) for some period of time, however.

5. Complacency (specifically, being lulled into thinking that the markets can continue to climb in an almost linear fashion) is a big risk. Intra-quarter drops in the CBOE Volatility Index (VIX) could be an indication of this\textsuperscript{16}. As we said, ultimately earnings need to catch up with valuations in order for the markets to sustain (and improve upon) current levels. Artificial stimuli from the Fed and its counterparts worldwide (most influential of which are the European Central Bank and the Bank of Japan, both of whom have recently injected liquidity into their respective systems in an effort to get their economies going) can help only so much and for only so long.

As always, having a suitable financial and investment plan is the best way to harness the markets and minimize the impact of those things (and there are many, not the least of which is uncertainty) that tend to roil the markets.

We remind (and urge) our clients to make sure they contact us promptly if and when there are any changes to their financial situation, investment objectives or risk tolerance. If such changes suggest a change to your financial plan or investment allocation, we can help you make and implement those changes.

We recently sent our clients a summary of the Setting Every Community Up for Retirement Enhancement (SECURE) Act, was just signed into law. The Act expands opportunities for individuals to increase their retirement savings in a number of ways, including removing the age limit restricting IRA contributions and raising the age at which required minimum distributions must commence, just to name two. For those reading this online, a copy of the SECURE Act can be found here. We would also be happy to send you a paper copy, upon request. If you have any questions about how the SECURE Act may affect you, please contact us.

\textsuperscript{15} Given the magnitude of the market’s run, arguably without the fundamentals to support such a rise, some have even said that the market was “just looking for a reason to drop.” It got one.

\textsuperscript{16} According to Mike Wilson, CIO and head U.S. equity strategist at Morgan Stanley, during the fourth quarter, 30-day realized volatility for the S&P 500 plummeted from over 21 percent to just five and a half percent. According to Mr. Wilson, this is one of the lowest realized volatility readings in the past 20 years, the first percentile to be exact.