QUARTERLY MARKET UPDATE

JANUARY 2020

MARKET RALLY

Name	2019 Return (%)
S&P 500 TR USD	31.5
Russell 2000 TR USD	25.5
MSCI EAFE	22.0
Barclays Emerging Markets	18.4
Barclays US Corporate High Yield	14.3
Barclays US Credit	13.8

Data Source: Morningstar Direct

2019 was an extraordinary year for markets. After an abysmal 4th quarter (specifically December) in 2018, January marked a reversal for equities with the Standard and Poor's (S&P) 500 bouncing back from a technical short-term oversold condition. As investor sentiment improved following a January 4th announcement from the Federal Reserve's (Fed) Chair Jerome Powell that the Fed would maintain patience with its policy approach, the rebound in equity markets strengthened.

Monetary policy, which was no doubt a headwind in the latter part 2018, served as support throughout 2019. No sector was left behind as ten out eleven sectors were up at least 20%. The information technology sector, though, outshone them all with a 50% gain thanks in large part to massive gains by some of its principal components, such as Apple and Microsoft.

Every sector other than energy is trading at a premium to its 10-year average (the real state sector is too new to judge) and six sectors -- consumer discretionary, information technology, consumer staples, utilities, communication services, and materials -- are trading anywhere between 15% and 37% above their 10-year average.

Large-cap stocks outperformed small-cap and mid-cap stocks, and growth stocks outperformed value stocks, though by a minimal amount. All styles posted at least 25% gains.

Robust Valuations

Outsized price gains in most circumstances promote higher valuations. Entering 2019, the S&P 500 was trading at 14.4-times forward twelve-month earnings, a slight discount to the 10-year average of 14.9, according to FactSet. Exiting 2019, the S&P 500 is trading at 18.0-times forward twelve-month earnings, which is a 21% premium to the 10-year average.

This multiple expansion has been a function of falling interest rates resulting from Fed policy, amplified by weak growth and even lower (and sometimes negative) interest rates abroad. Demand for United States Treasury issues remains strong given the unattractive yields of other Sovereign bonds.

Performance chasing, or a fear of missing out, has also played a part as investors have ignored the absence of earnings growth, antagonistic trade dynamics between the US and China, weakening manufacturing activity, and floundering growth in the European Union (EU) and China in favor of exploiting the positive momentum ignited and supported by low rates.

S&P 500 Sectors	2019 Return (%)
Information Technology	50.3
Communication Services	32.7
Financials	32.1
S&P 500	31.5
Industrials	29.4
Real Estate	29.0
Consumer Discretionary	27.9
Consumer Staples	27.6
Utilities	26.3
Materials	24.6
Health Care	20.8
Energy	11.8

Data Source: Morningstar Direct

If the assumption that interest rates will remain low continues to be operable, the concerns regarding a historically full valuation negatively impacting prospective returns could be discounted if earnings growth estimates materialize. While a repeat of last year's returns is highly unlikely, the dynamics informing price action of equites, and ultimately their direction may be similar.

Like last year, investor behavior and attitudes going forward will hinge primarily on economic, political and trade circumstances. Trade developments will impact the economic outlook, and the economic outlook will influence political views and choices. These relationships will be more pronounced as the year progresses but are already sufficiently strong and impactful to the market's psyche.

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Earnings Growth

Regarding earnings growth estimates, analysts are projecting earnings growth of 9.6% for 2020 and revenue growth of 5.4%, according to FactSet. This time last year, analysts were projecting 8.3% earnings growth for 2019 and revenue growth of 5.5%. As chart one indicates, the earnings and revenue growth recorded is expected to be well short of those initial estimates. It is evident that the stock market separated itself in 2019 from downward earnings revisions, choosing instead to focus on the support provided by declining interest rates, where price growth continues to outpace earnings growth by a significant margin. It is unlikely that this magnitude of disconnect between estimates and results will be accommodated by the market two years in a row.

Looking at projected economic growth through the lens of interest rates, the target range for the Fed funds rate stood at 2.25% to 2.50% as 2018 ended. It now sits as 1.50% to 1.75%. The 10-yr note yield stood at 2.68% a year ago. It would fall as low as 1.47% during the 4th Quarter of last year and has since rebounded to 1.92%.

This recent increase is consistent with a projected pickup in global economic activity, which should of course translate to increased earnings growth. There is a fine line in the perception of higher rates, however, as higher rates perceived as inflationary will be accompanied by an apprehension of a tighter monetary policy, stunting risk-on sentiment.

The bottom line is that the market is feeling much better about the economic outlook heading into 2020 than it did heading into 2019 when recession fears were more prominent. However, the materialization of earnings growth in the ballpark of current estimates will be a necessary condition for investors to exhibit comfort with a market trading at a premium.

Consumer Support

Additionally, the Fed's median economic projections for 2020 are consistent with a backdrop still favorable for capital markets. They project 2.0% growth for real Gross Domestic Product (GDP), Personal Consumption Expenditure (PCE) inflation to be 1.9% (which is below the long-run target of 2.0%), and the unemployment rate to remain low in the current 3.7% range.

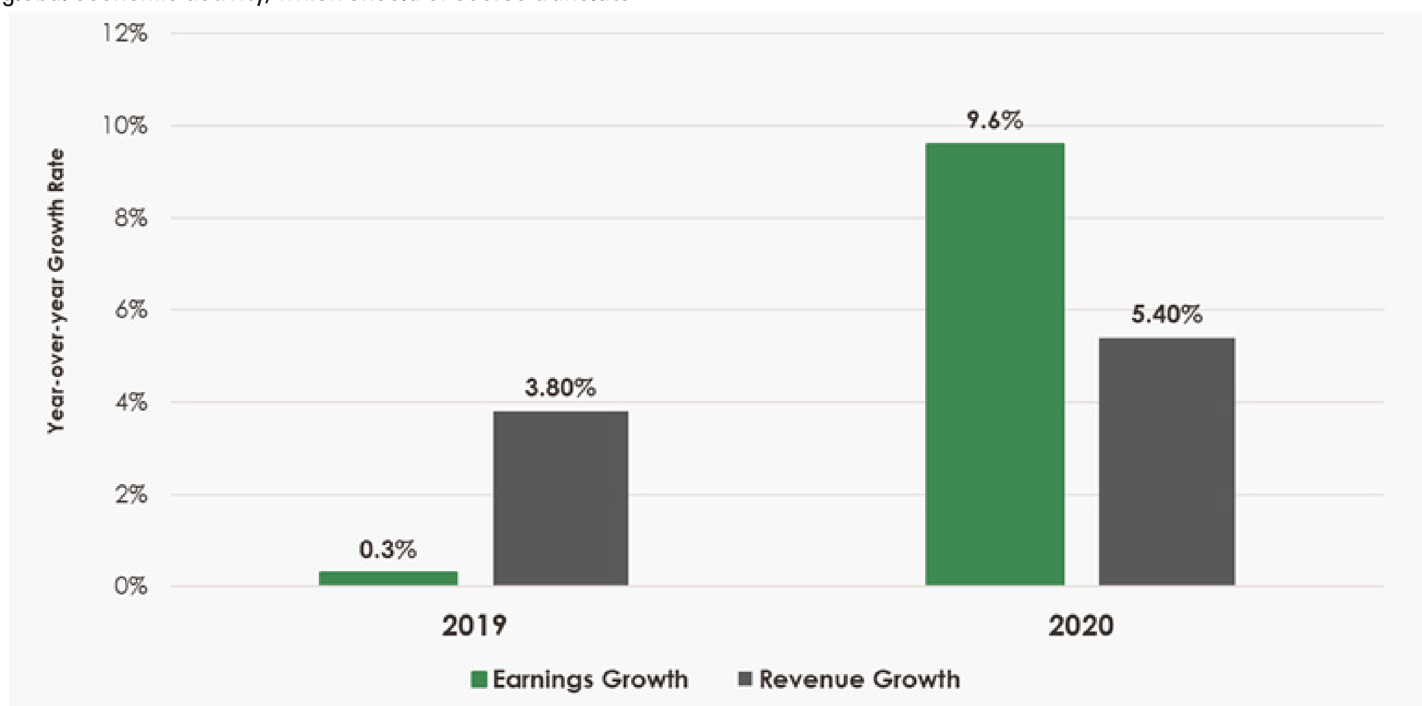

Chart 1 – Projected Earnings and Revenue Growth
Source: FactSet

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That forecast basically anticipates an economy running at a moderate pace, consistent with the last number of years; this is the market's preferred environment as it obviates the need to fear a tightening policy stance from the Fed. However, investors acknowledge the limits of the tools at the Fed's disposal and have been fearful that developments could lead to a deviation from current climate, perhaps even leading to recessionary conditions.

The US consumer, however, has given the economy strength, largely a result of rising incomes and increased feelings of job security (supported by historically low unemployment) which in turn has translated into solid spending.

This durability presented by the US consumer has advanced an optimism vis-à-vis the protracted economic expansion. Further evidence to support that perspective includes:

- The Federal Reserve's policy shift and subsequent reduction in interest rates has helped lower credit costs.
- The 3.5% unemployment rate is at a 50-year low.
- Average hourly earnings are up 3.1% year-over-year.
- Consumer confidence levels remain near a 16-year high.
- Aggregate household debt service payments are declining.
- The consumer drives the US economy, and if the US consumer weakens, it would be a negative not only for the US, but globally. Economic growth, interest rate levels and market prices are clearly all interconnected. As their probable levels and interplay are unknown, uncertainty will be the operative word for the foreseeable future, regardless of the currently more optimistic perspective of investors.
- Often during periods of uncertainty (especially after a protracted gain in assets) there exists a tendency to contemplate short term timing/trading strategies to protect gains. Experience informs us that maintaining a balanced portfolio of quality stocks and bonds to mitigate volatility resulting from unexpected developments are frequently the most consistent with wealth accumulation and the realization of long-term financial goals.

Chart 2 –Personal Income and Spending

Data Source: Bureau of Economic Analysis

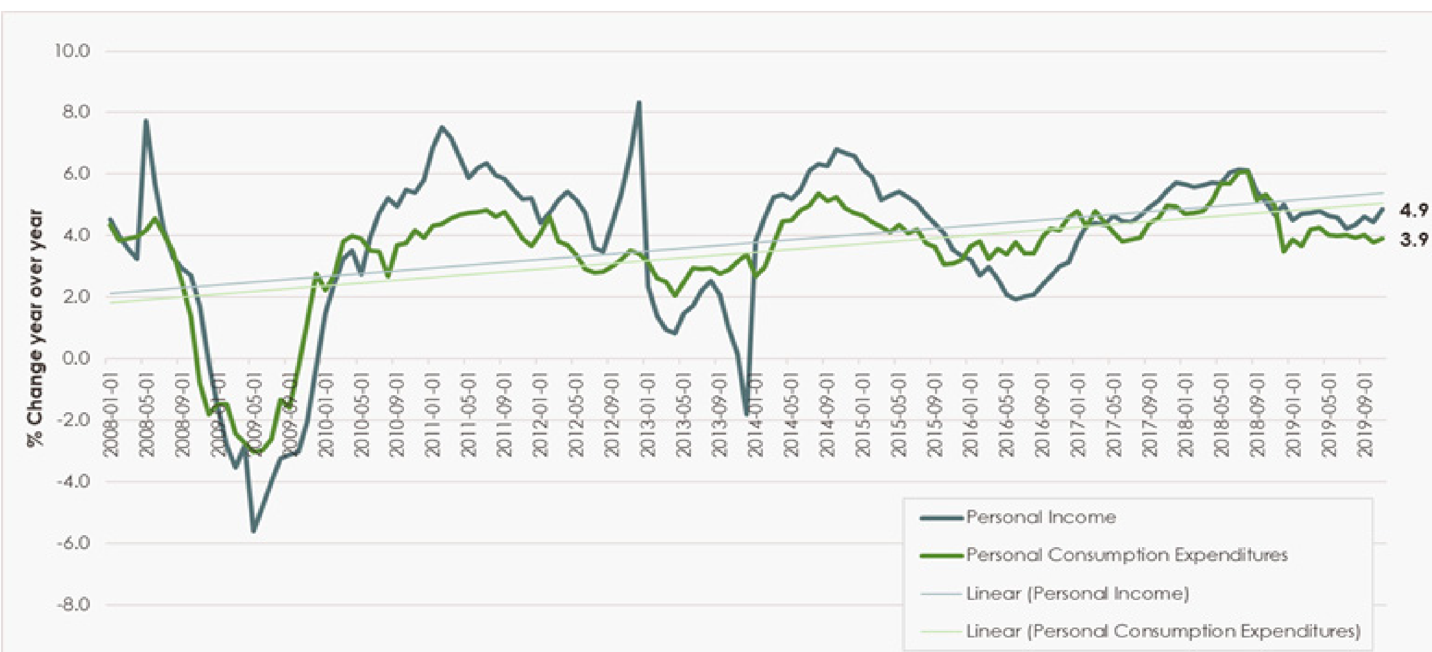

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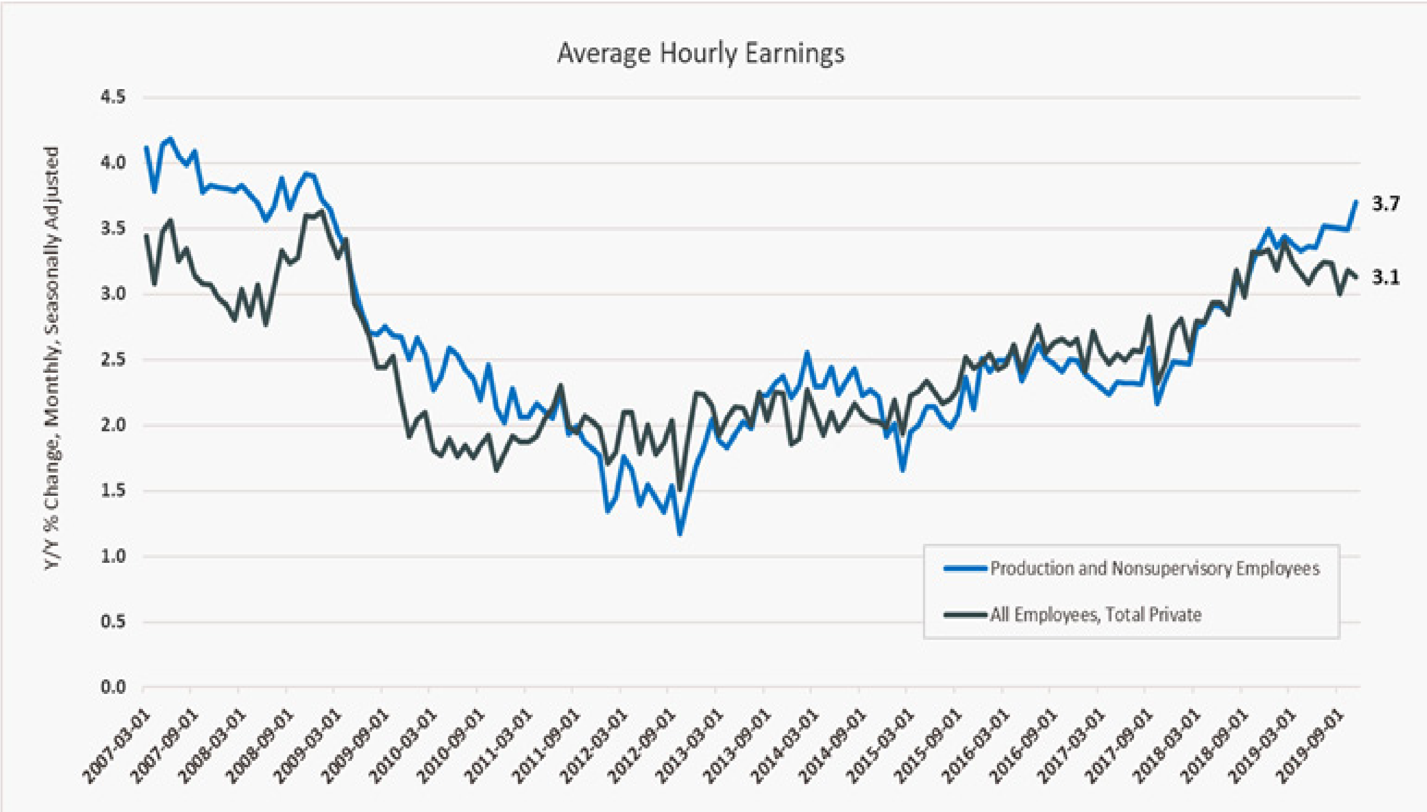
Chart 3 – Wages

Data Source: Bureau of Labor Statistics



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