Financial Markets Perspective

January 2020

Getting Back on Track

One Year Later:

One year ago, we made the following forecasts about the global economy and financial markets. Here is what we expected (with follow-up commentary):

✓ *"A continuation of economic growth in a range of 2.50-3.00%"*

- Uncertainty surrounding the impact of the tariff wars and the GM strike lowered economic growth below our expectations with GDP coming in at a 2.1% rate.

✓ *"Oil prices stabilizing between $45-$60 per barrel"*

- For most of the year, oil prices remained in the $50 range jumping above $60 near the end of the year as OPEC continued to ratchet down production. The price of oil closed on December 31st at $57.02 per barrel.

✓ *"Low inflation between 1-2% or lower depending on how long oil prices stay low."*

- Stability in oil prices for most of 2019 led to stability in inflation. The consumer price index finished the year at 2.3% while headline PCE, the Federal Reserve's preferred inflation measure, and core PCE as of November were 1.6% and 1.5% respectively.

✓ *"Stable long-term interest rates with the 10-year government bond yielding 3%."*

- A reversal in Fed policy characterized by three cuts in the fed funds rate surprised all interest rate forecasters and, as a result, the yield on the 10-year government bond declined to 1.92%.

✓ *"An acceptable resolution of the tariff wars between the U.S. and China."*

- As the year ended, the U.S. and China agreed to a "Phase One" resolution of the tariff war that will lower uncertainty and increase trade between the countries. A "Phase Two" discussion is underway that should further reduce trade barriers and intellectual property rights violations.

✓ *"Moderate growth in overall corporate profitability (ex the energy sector)."*

- U.S. corporate earnings proved to be a lot more resilient than many Wall Street analysts were expecting. Out of the companies in the S&P 500 that reported through last quarter, 76% had a positive EPS surprise while 61% had a positive revenue surprise. To put these numbers into perspective: over the past 5 years, 72% of S&P 500 companies have beaten EPS estimates while 59% have beaten revenue estimates.

✓ *"A rally in stock prices back to the record levels achieved in September of 2018."*

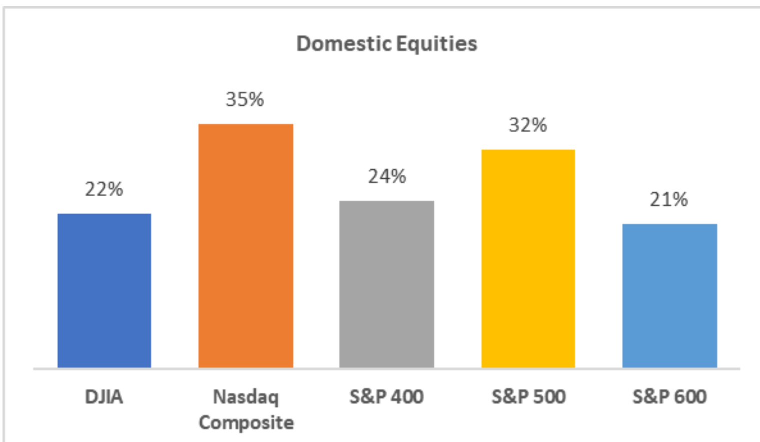
- All stock indices posted record levels in 2019 with the NASDAQ Composite gaining 35.2%, the S&P 500 rising 31.5% and the Dow Jones Industrial Average climbing 22.3%.

✓ *"Continued volatility until global uncertainties unwind (Brexit, Trump, etc.)."*

- The tariff war, Fed policy, Trump tweets and the Brexit drama resulted in financial market volatility last year. Social and political unrest around the globe was another theme as were the proliferation of natural disasters. Fortunately, both global bond and stock markets shrugged off the bad news and experienced healthy gains.

U.S. and Foreign Financial Markets

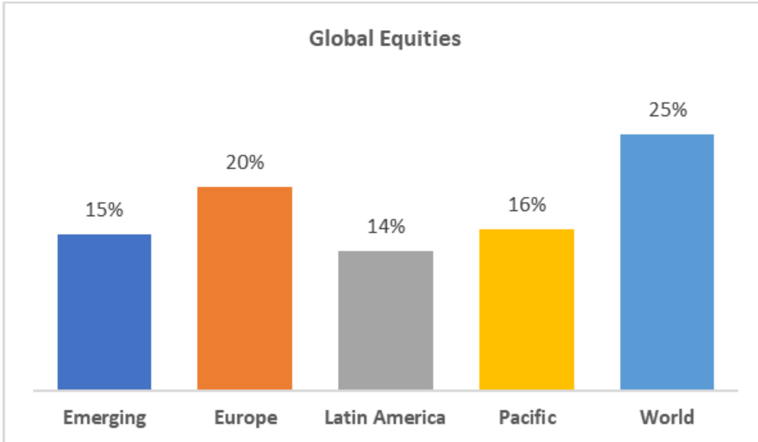
Domestic stocks saw very strong returns last year, bouncing back from a difficult 2018. As you can see in the chart below, the Nasdaq Composite led all major U.S. equity indices in 2019 by a healthy margin. The next best performers were the S&P 500 and the S&P 400 Midcap index. The S&P 500 had its best performance since 2013 and it was the 13th year in the last 25 years that the $28 trillion index has returned at least 15% for the calendar year. The Dow Jones Industrials finished in the rear. While the overall breadth and participation was broad, the small cap Russell 2000 and Russell Microcap indices remain roughly 4% and 9% below their 2018 highs.



Domestic bonds fared well with the taxable bond market finishing up 8.7% as measured by the Bloomberg Barclays U.S. Aggregate Bond index. The index was created in 1986 using publicly traded investment grate government bonds, corporate bonds and mortgage-related bonds with at least 1 year until maturity to calculate returns. This index is used as the primary benchmark by investors in U.S bonds. High yield corporate bonds posted solid total returns of 14%, on average, in 2019.

Foreign stocks also saw very strong returns last year due in part to a lackluster dollar and an easing Fed which helped improve dollar liquidity for the rest of the globe. The era of negative rates in Europe appears to be reaching exhaustion and there is hope that new ECB President Christine Lagarde will steer the region towards more fiscal policy solutions to benefit the European banking system.

Last year was the third best year for European equities in two decades after strong runs in both 1999 and 2009. Maybe it was the 9s? In Europe, the biggest rise was recorded by the UK FTSE 100 index following the Conservative party's historic victory in the December 12th election. Now Boris Johnson has ample room to arrange the UK's exit from the European Union.



As you can see in the chart above, Europe was the best performing region with the French CAC-40 index closing several times above 6,000 that has not happened for 12 years. November of last year also marked the thirtieth anniversary of the fall of the Berlin Wall that led to the collapse of the Soviet occupied, neo-Stalinist DDR and the eventual reunification of Germany forty-five years after the end of the Third Reich. December wasn't a great month for German stocks but the stock market index (DAX) still closed last year near an all-time high. There is not a better proxy in Europe than the DAX index --the umbilical cord of an economic superpower that is one third of the eurozone economy and the world's second largest exporter. In the European region, Russian stocks were the best performers and posted gains of more than 40% last year.

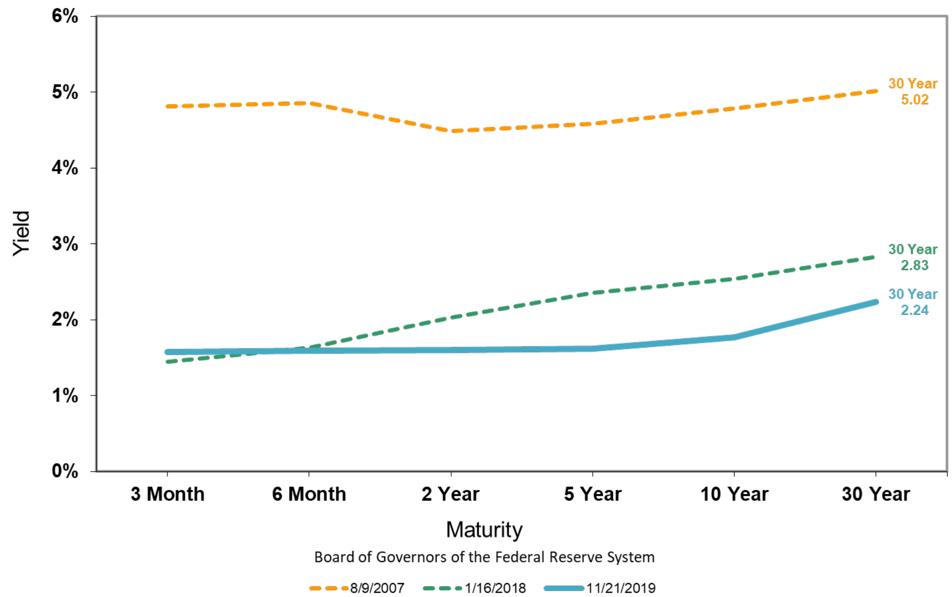
Our neighbors in Latin America also had healthy returns last year even though economic growth was slow. In its October 2019 World Economic Outlook report, the International Monetary Fund cited disruptions in mining supplies in Brazil and slowing private consumption in Mexico as main factors affecting the region's two biggest economies. Future growth, the report says, depends on monetary policy from Brasília and uncertainty subsiding in Mexico. Brazilian stocks finished out the year up 30%, Mexican equities rose a lackluster 8% and Chile actually declined by 18% after the military was put in charge of security in Santiago after youth protests against fare hikes on public transport implemented late last year turned to vandalism and arson.

Stock markets in the Asia Pacific region also enjoyed double-digit gains last year primarily on the back of China's Shanghai composite that rose more than 22% and the Shenzhen composite that gained approximately 36%. Hong Kong equities underperformed relative to their Asian counterparts due to ongoing government protests and only returned 9% last year. Meanwhile, Japanese equities gained more than 19% and were the largest contributor to the region's returns.

The Federal Reserve and Interest Rates:

The major surprise for financial markets in 2019 was an abrupt change in Federal Reserve monetary policy. After embarking on a plan to raise interest rates in 2018, the Fed abruptly reversed policy and cut the fed funds rate (the rate at which banks lend reserves to each other) by 25 basis points on three occasions. One reason the Fed cut rates is the fact that inflation remains at or below the target level set by the Fed. Moreover, unemployment remains at 50-year lows suggesting that the Fed's major economic objectives are being met. As such, the Fed is unlikely to make any further changes in interest rates until there is a change in either of these two variables.

Historical U.S. Treasury Yield Curves



The Yield Curve exhibit above depicts the yields of all maturities (on the x-axis) of government bonds at a point in time. Note that the curve was substantially higher in 2007 and that, over the past year, yields beyond six months fell below the yield levels of one year ago.

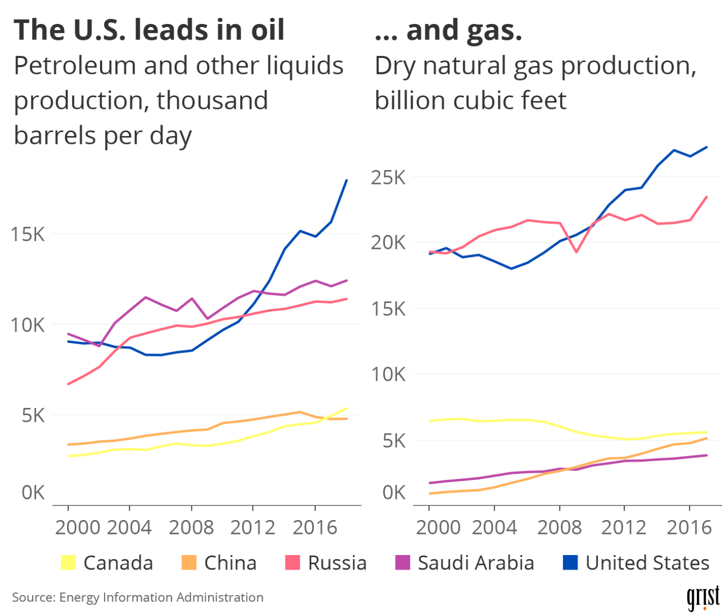
The business community was spooked by Trump's trade wars, but so far American households are not. Low interest rates will continue to benefit the U.S. consumer that has been able to pay down debt and save more. Debt levels relative to income are at their lowest in 40 years, the savings rate is high, and real consumer spending is growing at a rate of almost 3%. The private sector is still adding jobs and the almost 80% of the domestic economy that isn't tied to manufacturing and global trade is growing at a decent clip.

Outside of the U.S., central banks have been experimenting with lower interest rates to stimulate slowing economies. The rationale for this strategy is that lower interest rates would stimulate borrowing by businesses and consumers and increase growth. However, there are two sides to the interest rate equation: the borrower and the lender. When interest rates fall, savers' income falls, and their spending ability also declines. If there are more savers who cut spending than businesses that increase spending through borrowing, then a slowing economy is the outcome. As the global economy continued to slow in 2019, some governments announced plans to provide fiscal stimulus by both increased spending programs and tax rate cuts. Britain, France and China announced such plans in December. The strong returns in global equity markets in 2019 (the strongest since 2009) suggest that investors expect an economic turnaround in 2020 and 2021. In the early 80s, Ronald Reagan cut tax rates and the world followed suit and over 170 countries reduced their tax rates. This "follow the leader" reaction may be getting a do over in response to the Trump tax cuts and the subsequent improvement in the U.S. economy relative to foreign economies.

The Energy Renaissance Continues

Last year was a turning point for U.S. global energy output. America became the world largest oil AND natural gas producer supplanting most of the oil U.S. imports from the Mideast. Crude oil imports from the Middle East have been steadily declining for years. In 2018, oil from the Persian Gulf made up only 16 percent of U.S. petroleum imports. These days, almost half of the oil the U.S. buys internationally comes from the Canadian tar sands. We produced more oil and gas than any other country in 2018 (the most recent data available). We have become a net exporter of both oil and liquified natural gas!

As we have said before, the shift in dollars away from OPEC and into the U.S. could result in a long-term shortage of dollars in the world economy which had benefited from dollars that were used in exchange for OPEC oil and contributed to global transactions. Those dollars are accepted everywhere, and they could be used repeatedly in global business transactions. If those dollars didn't come back to the U.S., they provided a medium of exchange for business transactions. One offset could be an increase in U.S. imports of other products and services and a resultant increase in world trade.



In any case, this wealth retention through domestic oil and gas production will contribute to growing prosperity in the U.S. This abundance is already being reflected in increasing employment, higher real wages and rising standards of living. Hopefully we don't have to fear the forecasts of $150 per barrel oil and the transfer of wealth that such a price surge would force on the general population. The further proliferation of electric vehicles in coming years and rising productivity should put a permanent lid on oil prices. On the other hand, we would prefer to see continued stability in oil prices to maintain the viability of the energy sector and markets in general.

Conclusions:

As we look at our crystal ball, we see the following for 2020:

- ✓ Domestic economic growth in a range of 2 – 3%
- ✓ Oil prices in a range between \$55 – \$65 per barrel
- ✓ Domestic inflation in a range between 1.75 – 2.25%
- ✓ 10-year Treasury bond likely to remain below 2%
- ✓ Accelerating growth in foreign economies
- ✓ Improving corporate earnings and revenue growth domestically and abroad
- ✓ A continued rally in global equity markets
- ✓ Ongoing Congressional gridlock until the November elections
- ✓ Deteriorating political discourse to increase market volatility
- ✓ The stock market advance should continue in 2020 with gains of 10-12%

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