Investment Commentary: Year-End 2019

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2019 was the year of solutions for a stock market coming out of a quick and painful correction in late 2018. The markets were on edge centered around three main issues: Federal Reserve's missteps, a continued trade war with China and declining estimates on corporate earnings. In 2019, we solved most of these issues leading to an extended rebound and year-end rally, quite the opposite finish contrary to 2018. This took investor mindsets from imminent recession to a potential recalibrated global growth story.

From a monetary policy standpoint, the Federal Reserve did a 180° in January 2019 by backing away from its hawkish stance on rates from just a month removed from their treacherous interest rate hike in December 2018. The Fed later preceded to lower rates as 2019 unfolded. In a recent speech Federal Reserve Chairman Powell spoke aggressively about trying to get more inflation in the system by keeping rates lower for longer. This is something we have heard in the past and has had the potential to cause bubbles like the housing crisis over a decade ago. The problem, even in a low interest rate environment, is that technology and globalization continue to put downward pressure on inflation. This should keep the Federal Reserve from moving rates up or down for much of 2020, especially in an election year. The trade war with China also came to a close in late 2019 as the administration put together a phase one deal checking many boxes for concerned investors. The trade agreement should be signed in the weeks ahead and the terms will most likely become more transparent to businesses and investors.

The last hurdle the market had to jump over was corporate profitability; something that we believe is one of the most important things investors should focus on. Estimates for the S&P 500 peaked in fall of 2018 and are down roughly 8% since then. This coming 4th quarter earnings season will be watched closely for management team's guidance on how they think 2020 will shape up. Many analysts are looking to find stability in earnings estimates. While stocks were up 30% (as measured by the S&P 500), earnings are looking to be up only 1% over 2018. This past year can be classified as a big expansion of valuation similar to what we saw in 2013. In 2013, Obama was coming off winning his 2nd term which sent the stock market substantially higher by 33% on only 6% earnings growth. The S&P 500 is now trading at 18x 2020 earnings, a much higher multiple than last year at this time when the forward PE was 15x 2019 earnings. That said, it is a little deceiving in that we had a large selloff in December 2018 and a large bounce back in the 1st quarter of 2019. By the end of the 1st quarter of 2019 the S&P 500 was trading at 17x forward earnings. If investors fled the stock market purely on valuation, they would have missed out on almost a 17% return in the last nine months.

The big question from here is where's the next move in stocks and bonds. Rates are still historically very low, sub 2% on the ten-year treasury bond. We believe that global inflation expectations bottomed somewhere in the 4th quarter of 2019. If investors continue to gain confidence in that scenario then this extended rally in stocks is not over yet. Over the last 20 years the 10-year bond has averaged close to 4% (see chart on page 4) and the S&P 500 PE has been roughly 16x forward earnings (see chart on page 4). To compare these two investments, we take the reciprocal of the PE (1 divided by 16) which gives you 6.25% yield on stocks. If you compare that to the ten-year bond yield, stocks have been trading at a 2.25% risk premium on average to bonds, which are safer.

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To translate in current measures, if the 10 year stays at 2% and you use the 2.25% historical average risk premium, then the PE multiple should be 23.5x. This is significantly higher than where we are today. Many investors would argue there are many issues in our economy, the world, etc. that could affect the market. Looking backwards over the last twenty years, we have had a tech bubble, housing bubble, financial crisis and commodity bubble. We believe if the global growth picture truly bottomed in late 2019 and we continue to see evidence of continued expansion than bonds will sell off and yields will rally. As yields rally it will temper the multiple expansion story for stocks. But if 10-year yields back up all the way to the 2018 highs of 3% the 2.25% average risk premium would equate to a 19x forward PE multiple. If we apply the 19x PE to 2021 earnings estimates for the S&P 500 that would put the S&P value around 3700, or roughly 14% higher. The current risk premium of stocks stands at over 3.5% today which is more than 50% over the 20-year average. This prices in a decent amount of risk. A lot will depend on how earnings estimates come in and how management teams guide their 2020 forecasts.

As 10-year yields bottomed just under 1.5% last fall interest rate sensitive areas like Financials have done extremely well. Other signs like Semiconductors, which are a good early proxy for global cyclicals, have performed quite well off the bottom last summer. Financials and Semiconductors have had good earnings and guidance last quarter confirming these price moves. Hopefully, we see this phenomenon expand to other economically sensitive areas of the markets.

One trend that we believe will continue to develop as 2020 unfolds will be the shift to overseas or international assets. Many U.S. investors have benefited largely by a great ten year move in U.S. stocks. International companies have had a much different experience with more flattish or subdued returns. Roughly 60% of the revenue in the S&P 500 comes from the U.S. while 40% comes from international markets. Compare this to the small cap indices that have 80% of revenue coming from U.S. and 20% from international markets. The trend for much of the last ten years has been to invest in U.S. companies that have great revenue and profitability coming from the U.S. Through middle of 2018, broad small cap equities have out-performed broad large cap equities by 24% from 2010. Recession fears, liquidity, access to the debt markets and larger negative estimate revisions are all reasons investors have lightened up on that spread over the last 18 months. We believe with the trade deal mostly behind us and inflation fears bottoming we are looking for more global exposure. International indices, whether developed or emerging, have underperformed the large cap (S&P 500) index by roughly 60% over the last ten years. We are not thinking we want to abandon the U.S. markets as the economy still looks attractive but looking for businesses, sectors, industries that have more global revenue exposure. Some businesses that fit this continue to be the large cap technology companies like Microsoft, Apple and Google which all have less than 50% of their revenue from the U.S. Other areas would be the payment processors like PayPal, Visa and Mastercard which also have great exposure to global growth and less than 50% exposure to U.S. revenue. Even consumer brands like Nike has 35% of its revenue from the U.S. Also, the video game publishers have less than 50% revenue from U.S. markets and will benefit largely in the next couple years when the new XBOX and PlayStation launch in the Fall of 2020. This is the first console refresh cycle in seven years.

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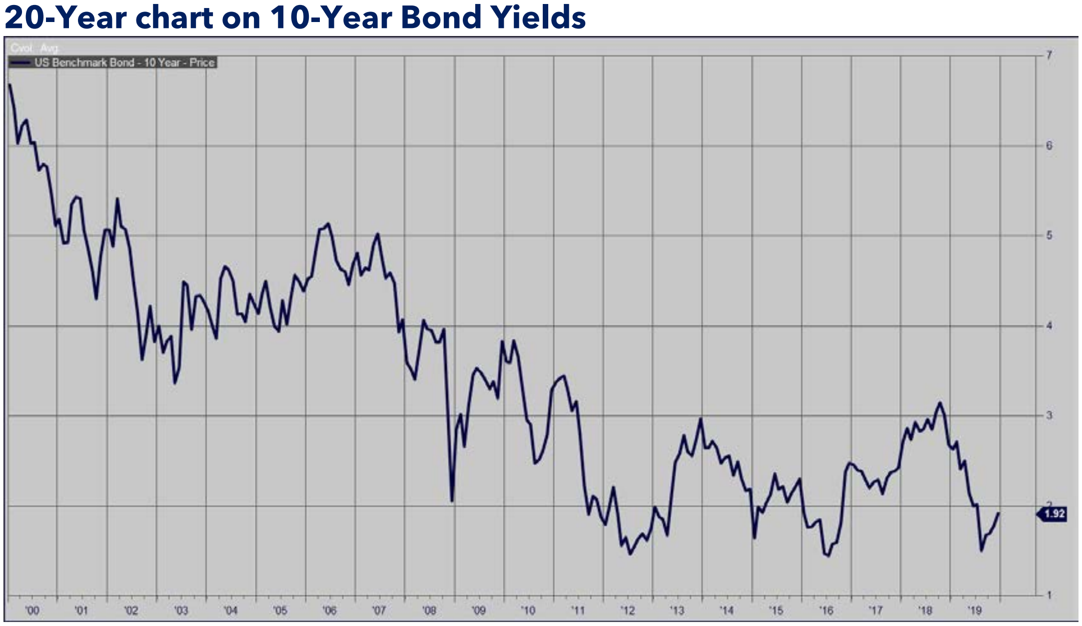
Markets never go up or down in a straight line but stocks still look attractive, especially to bonds. Events we are most focused on to start the year will be: 4th quarter earnings season (mostly for 2020 guidance), Super Tuesday results, ongoing trade negotiations, Iran tensions and international economic data points. While Iran may make big headlines, we do not foresee it as a large market risk, especially since the U.S. is energy independent and we are pretty sure the trade deal with China will lead to us exporting energy to them. This takes away large spikes in oil which could derail the global economy. That said, we do think that energy may be bottoming, which has been one of the worst sectors in the S&P 500 over the last ten years. This might turn into a multiyear turnaround story with some fits and starts.

20-Year chart on S&P Forward Price to Earnings Ratio

20-Year chart on 10-Year Bond Yields



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