Investment Tally & Perspective

MAJOR ASSET CLASS RETURNS				
	4th Qtr. 2019	1-Year	3-Year	5-Year
Equities				
S&P 500	9.1%	31.5%	15.3%	11.7%
MSCI EAFE	8.2%	22.0%	9.6%	5.7%
MSCI Emerging Markets	11.8%	18.4%	11.6%	5.6%
Fixed Income				
Barclays Capital US Aggregate	0.2%	8.7%	4.0%	3.0%
Barclays Capital US Corp. Inv. Grade	1.2%	14.5%	5.9%	4.6%
Barclays Capital Emerging Market	2.1%	13.1%	6.1%	5.8%
Other Assets				
MSCI US Reit Index	-0.8%	25.8%	8.1%	7.0%
S&P GSCI	8.3%	17.6%	2.4%	-4.3%
ICE WTI Crude Oil	12.9%	34.5%	4.4%	0.4%
Comex Gold	3.4%	16.6%	9.8%	5.2%

Source: Capital IQ — All returns greater than one year are annualized

Market Activity-

Global equities and risky assets surged in the fourth quarter as U.S. stocks generated strong returns of 9.1% and developed international and emerging markets posted total returns of 8.2%, and 11.8%, respectively. In the U.S., stocks exhibiting high quality and good value traded well, while momentum and minimum volatility were positive, but below average. Bonds posted an average quarter.

While our writings often focus on the future, given the exceptional year just realized we thought it may be instructive to review the three main components that drive equity returns – earnings per share growth, dividend yields, and valuation metrics, as follows.

Earnings per share for the S&P 500 have historically (past 31 years) grown at an annual rate of 6.3%. In 2019, forward earnings for the S&P 500 grew 1.6%. Dividends, which are paid from and follow corporate profits, generated a yield of 2.25% in 2019.

Valuations are a more complicated component of returns as they incorporate numerous factors, with primary components being interest rate trends and expectations, growth rates, and investor sentiment. In the past 25 years valuations for the S&P 500 have averaged 16.3x forward earnings. At the start of 2019 the market traded at 15.0x forward earnings and ended the year at 19.0x forward earnings, an expansion of 26.7%.

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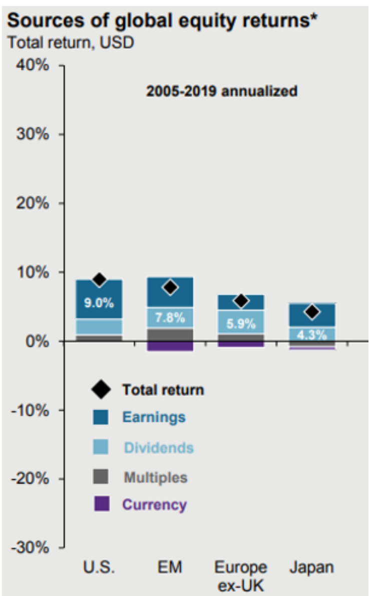
	S&P 500 Price	Next Twelve Month S&P 500 EPS	P/E
12/31/2018	2506.85	167.08	15.0
12/31/2019	3230.78	169.77	19.0
% Change	29%	2%	27%
Dividend Yield	2%		
Total Return	31%		

Source: Capital IQ

The graphic to the left illustrates that most of the total return of the S&P 500 during 2019 is attributable to valuation expansion rather than earnings growth and dividends. This multiple expansion has been driven by two developments – heightened optimism for future growth and accommodative central bank policies.

As we look out to 2020 and beyond, these components of return help frame and estimate the range of outcomes. With earnings growth likely in the mid-single digits and a dividend yield of 1.8%, investors may well anticipate stock returns in the mid-single digit range; higher returns will require earnings growth that exceeds expectations and/or a further lift in valuation, which is the volatile wild card that often greatly influences single year returns.



Source: J.P. Morgan

As seen in the chart to the left, though valuations create year-to-year noise, long term returns are closely related to profit growth and dividend yield.

Economic Developments & Monetary Policy –

The fourth quarter of 2019 saw a mild positive inflection in global economic activity when compared to the third quarter. For 2019, global real GDP is estimated to have increased 2.7%, which is below the 15-year average growth rate of 2.9%. Three significant events helped strengthen the outlook for future growth during the quarter (1) U.S. and China came to an agreement on the first phase of ongoing trade negotiations (2) Boris Johnson's landslide election win in the U.K. which gives him a strong mandate to see Brexit through and (3) Fed communications that removed doubt over the direction of their policies. While these issues remain open and not completely resolved, investors reacted approvingly to signs that they are moving ahead in a positive direction.

From a monetary policy perspective, major central banks continue to ease, or they are firmly on hold at this point. One notable shift in the U.S. Federal Reserve is their focus on getting inflation up to and through their target of 2%. Given the stubbornness of inflation in recent years, many market participants are expecting the central bank to keep rates constant even as growth continues with the labor market remaining tight. As of today, futures anticipate a 2/3rds probability of no change in the fed funds rate by the Fed's June meeting, and a 74.4% chance the fed funds rate is between 1.25% to 1.75% by December 2020 (current range is 1.50% to 1.75%).

Valuation and Sentiment –

Stock valuation metrics appear "rich" or are on the expensive end of historical ranges; this applies in all respects other than when being compared to bond metrics. Not surprisingly, debate continues whether it is appropriate to evaluate stock prices off interest rates that are historically low and impacted by extraordinary central bank policy. We expect interest rates will likely head higher, helped positively by U.S. growth that continues to be solid and support from the Federal Reserve's focus on boosting inflation. Positive factors on rates will be tempered by continued demographic and technological changes. Despite the recent strong performance in markets, investor sentiment continues to remain in a neutral position.

Investment Outlook and Strategy

The Economy, Technology and the Fed

If the economy continues to avoid a recession in 2020, which appears likely, then the recovery and expansion will enter its 12th year of growth. While this record is quite exemplary from a historical perspective, more remarkable is that this period of growth has transpired with inflation remaining tame and, at times, dormant. Will this, and can this period of economic growth continue with inflation remaining low? Yes, though this sunny picture must be viewed with an asterisk as follows.

Economies are quite dynamic, and technological changes in virtually all areas of the economy are taking place at more of an exponential rate than a linear, straight-line manner. Technological developments bring increasing productivity which, oftentimes, are not fully captured in reported figures, whether from government or private sources. Further, as technological changes cause disruption and improve productivity, the impact may result in suppressing inflationary pressures.

Our base case, barring an external shock, is for continued growth in global economies throughout 2020 with the rate of U.S. growth being less than capacity due to a shortage of qualified labor. As we have noted for more than a decade, the role and expanding responsibilities of the Fed are the primary drivers to the direction and speed of the economy and the financial markets. Importantly, Fed Chairman Jerome Powell made it quite clear in recent communications that the Fed will not only tolerate higher rates of inflation, they desire and will be supportive of rates of inflation that exceed their targets.

In sum, communications from the Fed and other central banks clearly express their intention to maintain stimulative policies designed to avoid a recession, and to increase global economic activity. The resulting pools of liquidity will support asset prices unless, and until, the Fed changes its course of actions. For several years we have stated our view that the labor shortage will inevitably result in wage increases that produce inflationary pressures. If, or when, the Fed gets its wish of higher inflation, they will be forced to take actions that tighten the liquidity spigots, and most likely lead to a recession and bear market.

Given that this directional change appears to be a more likely development in 2021-2022, we maintain a neutral investment strategy with a defensive bias. This means that the asset allocation for each client account/relationship between Fixed Income and Equity investments will be at or near the neutral or normal target, with gradual changes in specific investments being made in a more conservative manner.

MAKING RETIREMENT MORE SECURE
AN OVERVIEW OF THE SECURE ACT

On December 20, 2019, as part of a larger government spending package, Congress signed into law the Setting Every Community Up for Retirement Enhancement (SECURE) Act. A 2018 study by the U.S. Bureau of Labor Statistics states only 55% of adults participate in a workplace retirement plan, and those that do are woefully behind. The SECURE Act is a step in the right direction to assist Americans in saving for their retirement and includes changes in the areas of Required Minimum Distributions (RMDS), retirement savings opportunities, and expanding retirement plan access, to name a few. Below are a few of the highlights:

Americans can now delay taking their RMDs until age 72, an important change as people are working and living longer. This allows the assets to potentially grow without being depleted by distributions and taxes. This change occurs immediately for all American's who turn 70 ½ in calendar year 2020 and beyond. The IRS may provide further guidance for those who turned 70 ½ in 2019 and have already begun taking their RMDs. In addition, IRA contributions can be made past 70 ½ if you have earned income.

While many larger employers offer defined contribution type plans to their employees, small and mid-size businesses are behind in offering similar services due to high complexity and costs. The SECURE Act facilitates the adoption of open Multiple Employer Plans (MEPs) that allow unrelated employers to participate in a MEP together, though the rules need to be clarified and the provisions don't go into effect until 2021. Employers can also add a lifetime income option in the form of an annuity to their retirement plan and be protected from lawsuits if the insurer they choose doesn't pay future claims. These annuities would be portable, thus having the ability to transfer to another 401(k) or IRA. Additionally, retirement plan statements would include a "lifetime income disclosure statement" to show how much money you could potentially receive each month if your total 401(k) balance was used to purchase an annuity.

From an estate and tax planning perspective, the SECURE Act no longer allows inherited IRA's to be "stretched" along the beneficiary's life expectancy and will now have to be depleted within 10 years, with no required minimum to be taken in any year. Certain beneficiaries are exempt from this requirement, such as spouses and minor children.

The above does not cover all the changes included in the SECURE Act, and it's important to note that certain features will take years to finalize and implement. While some changes are common-sense and long overdue, they may require additional planning with your tax and financial advisors, as well as your estate attorney. Please view us as a resource for questions, and to review the impact the SECURE Act may have on your retirement goals.