Investment Strategy Update

Markets Close Strong

Equity markets shrugged off geopolitical and economic uncertainty in 2019 to post double digit returns across the board. US indices fared the best, with growth stocks again the top performers and the Nasdaq finishing up 35.2% for the year. Despite the fact that they are more negatively impacted by the trade war, emerging markets were also positive with the MSCI Emerging Markets Index climbing 18.4%.

These annual return numbers are impressive however stocks began the year deep in a correction that had many indices down almost 20% in the last quarter of 2018. It now appears the fears which sparked this correction, trade and a global economic slowdown, were overblown. When you look at performance including the correction (September 2018-December 2019), the returns are still remarkable but less indicative of over exuberance: S&P 500 +13.7%, Nasdaq +11.5%, MSCI EAFE +6.72%, and MSCI Emerging Markets +9.5%.

Equity markets are no longer cheap after this rally as earnings have not risen as dramatically as prices. Price to earnings ratios are modestly higher than their long-term averages for US and developed foreign markets, with emerging markets the last remaining pocket of discounted valuation, likely due to ongoing trade uncertainty. Generally, global economic conditions have stabilized, aided by supportive monetary policy and a slight cooling of the trade war. Markets acknowledged this with a strong finish to the year.

Bonds posted their best year since 2002, achieving most of their returns prior to the fourth quarter when rates leveled off. Three rate cuts throughout the year by the Federal Reserve, coupled with demand for US bonds in a global low rate environment, pushed US bond yields lower and prices higher. The 10-year US Treasury yield began 2019 at 2.69% and touched a low of 1.47% in September, but rebounded to close the year at 1.92%. With the threat of recession seemingly less ominous, the Federal Reserve is expected to keep rates stable for 2020.

Index	*2019 (through 12/31)*
S&P 500	+31.5
DJIA	+25.3
EAFE (Int'l)	+22.0
BC Ttl Bond	+8.7

Dow Jones Relative Risk Benchmarks	
Conservative	+8.1
Moderate	+18.6
Aggressive	+27.1

How High Is the Stock Market Really?

The financial news media loves to make a big deal when the market indices reach "new all-time highs"- which many did in 2019. We find that rather than celebrating, this makes many of our clients incredibly nervous, although it shouldn't necessarily. The price level of the index should rise as long as the earnings of the companies that comprise the index are rising as well. Minus setbacks during economic recessions, the market indices have historically continued to climb higher, as have the earnings and dividends of the underlying companies. To better evaluate whether the market is "too high" or overpriced, it is helpful to look at the price/earnings ratio and dividends. Although the index price level may be at a new all-time high, markets have been more "expensive" at times.

Investor Index Comparison

Measure	"Dot Com" Peak 3/24/2000	"Great Recession" Peak 10/9/2007	Year End 2019 12/31/2019
S&P 500 Price Index	1,527	1,565	3,231
P/E Ratio (fwd)	27.2x	15.7x	18.2X
Dividend Yield	1.4%	1.9%	1.9%
10-Year Treasury Yield	6.2%	4.7%	1.9%

Source: JP Morgan Guide to Markets - December 31, 2019

2020 OUTLOOK

FIXED INCOME — After a year of rate cuts, the Federal Reserve and other central banks seem to be pausing. Absent an unforeseen event, we expect interest rates to remain unchanged in the US for the year ahead. Globally rates and inflation remain low, and monetary policy is accommodative. The spike in negative yielding foreign debt has tapered off, but yields in most other countries remain lower that in the US, creating increased demand for US bonds. We expect this combination of factors to keep bond yields low for the foreseeable future, and remain committed to employing active managers in the bond category to determine the best positioning and adjust as needed. While yields are not particularly attractive at this time, fixed income maintains an important role in managing portfolio risk.

Our View — Use active managers to navigate unique interest rate environment

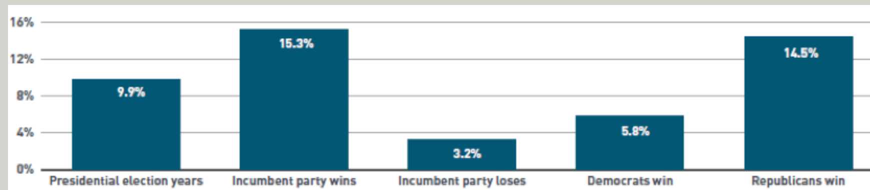
US EQUITIES — Expectations are for the US economy to remain resilient, fueled by low interest rates, full employment, and rising wages. Equities should continue to benefit from these solid economic fundamentals. Returns in 2020 will likely be driven by earnings growth which is estimated to be in the mid to upper single digits. Trade developments and the elections could influence equities as well, potentially enhancing short-term volatility. While we remain cautiously optimistic about US stocks, after a great year like 2019 we recommend trimming exposure where needed to rebalance portfolios back to their previous target allocations. Within the US equity space, we currently favor an even weighting between value and growth, and a slight overweight to small and mid-cap stocks.

Our View — Maintain allocation, rebalance where needed

INTERNATIONAL EQUITIES — Global central banks have been using stimulus to prop up economies in the face of a slowdown, and it has been effective so far. Like US equities, foreign stocks are now also slightly more expensive than their historical average, with the exception of emerging markets. Because valuations are appealing and emerging economies continue to grow at twice the rate of developed countries, we are recommending an increase to emerging markets exposure. Also, emerging economies are heavily export dependent and stand to reap the highest benefit from progress in trade negotiations. We are less confident that the issues facing the European Union will be easily resolved and may result in further stagnation. As a result, a slight shift from developed to emerging markets feels timely.

Our View — Reduce developed markets and increase emerging markets exposure

DID YOU KNOW?



THE MARKET DURING ELECTION YEARS: 1928-2016

Source: MFS Investment Management- Primaries, Caucuses and Elections – Oh My!

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