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Market Update

4Q 2019: It's All Good

BALLENTINE PARTNERS | BRUCE D. SIMON, CFA, CPWA®

Recall the situation in December 2018: stocks were suffering through a nearly 20% decline in the quarter, and sentiment was pessimistic. The Fed had raised interest rates four times during the year, hoping to return to more "normal" levels after years of near-zero policy rates. US economic growth was slowing after the burst from the tax reform package passed in late 2017. Growth in Europe and China was also slowing, and a possible acceleration in the trade dispute between the US and China threatened to make things worse. On top of all that, the federal government was shut down over spending disagreements between Democrats and the White House.

If we had known at that time that S&P 500 earnings growth in 2019 would be ***virtually zero***, what would your forecast for stock market returns have been for 2019? Probably not so great.

Well, the results are in, and they exceeded even the most bullish market forecasts. The S&P 500 surged 31.5% in 2019 (including dividends), posting the best performance since 2013. The MSCI ACWI, the broadest measure of global stock market performance, vaulted 26.6%. Overseas, the MSCI EAFE Index of developed market economies jumped 22.0%, while the MSCI Emerging Markets Index was the relative laggard at 18.4%.

But the performance party was not limited to equities. Falling interest rates propelled bonds and other interest-sensitive assets to above-average returns as well. The broadest measure of the investment grade US bond market, Barclays Capital US Aggregate Index, gained 8.7%, and lower-rated high yield bond indices surged nearly 15%. Intermediate term municipal bonds (the most widely-held by high tax bracket investors) returned 5.6%, including income and price appreciation. Real asset categories such as real estate investment trusts (REITs) and infrastructure stocks both gained more than 20%. Spot gold jumped 18.5%. Even the volatile energy pipeline sector, as measured by the Alerian MLP Index, rose 6.6%, helped by a 30%+ rise in oil prices during the year.

In stark contrast to 2018 when the best-performing asset class was cash, it was hard to avoid making money in 2019. So what caused the big reversal? Most obviously, it was a notable change in monetary policy by the Fed. The old market adage "don't fight the Fed" was never more true than in 2019. After the Fed cut rates once in December 2018, it proceeded with three more cuts in 2019. The Fed's efforts to keep rates low, along with the injections made in the fourth quarter to stabilize the short-term repo market, provided the necessary boost to liquidity and investor confidence to drive most markets to all-time highs by year-end.

The other major catalyst for the big rally last year was the overwhelming level of pessimism at the start of the year as indicated by very attractive valuations. As we pointed out in last year's 2018 Market Review letter, the S&P 500 was trading at 14.4 times consensus expected earnings growth for 2019. Even though actual 2019 earnings growth will come in well below expectations for high single-digit growth, the low starting valuation provided ample room for multiple expansion. Stock prices rose in spite of a lack of meaningful earnings growth.

Outlook and Strategy

As we enter a new year, investors are faced with a different set of challenges. Gone are the undemanding valuation levels of the US stock market. Based upon consensus expectations of 9.5% earnings growth in 2020 (a number that in all likelihood is too high), the S&P 500 is trading just over 18 times forward earnings. The higher starting valuation levels reduce the margin for error, and increase the risks of a market setback should economic growth falter.

The US economy is likely to experience another year of steady but unremarkable growth in the 2% range. The huge boost from last year's market rally added nearly $24 trillion in market value to the world's stock and bond markets, providing additional fuel to the surge in US consumer spending that underpins US economic growth. Unemployment remains near historical lows, interest rates are low, and consumers are enjoying real wage growth. In short, the US economy remains on solid footing, with a recession remaining a low probability.

Overseas, economic growth remains more challenging. The German economy, long the economic engine of Europe, remains mired in a manufacturing slump. The UK will face increasing pressure this year to negotiate a trade agreement with continental Europe to avoid a dreaded "hard Brexit." Despite an apparent agreement with the US on a phase-one trade deal with the US, China is struggling with a slowing domestic economy and the lingering impacts of the trade war. Unlike the US, however, valuations in overseas markets appear quite attractive, providing the opportunity for significant gains if reality exceeds expectation.

The Fed is expected to remain on hold for most of 2020, removing the boost that investors enjoyed last year. Inflation is showing nascent signs of a pickup in the US, prompting many fixed income analysts to predict a modest rise in interest rates in 2020. With the bellwether 10 year US Treasury bond currently trading at a yield of approximately 1.90%, a rise to 2.0-2.5% is anticipated. In that scenario, bonds should eke out modest if unspectacular gains.

Perhaps the biggest wildcard to market performance is the 2020 presidential election. The consensus view is that another four years of President Trump will be very market-friendly. Yet the explosion in the federal deficit caused by the tax reform legislation passed in 2017 may become a more important issue in Trump's second term. On the Democratic side, nomination of one of the party's more radical candidates to face Trump in the general election is likely to generate a lot of anxiety among investors. In all, we expect a positive year for financial markets, but are prepared for the surprises that inevitably impact the outlook.

As we go to print in early January, investors are confronting the threat of a significant escalation in tension between the US and Iran. The immediate impact has been a sharp rise in oil prices, as a disruption in the flow of Middle East oil would be a likely target for Iranian retaliation for the killing of

a senior Iranian military official. So far, markets are reacting calmly, but trade-oriented investors may be looking for a reason to sell after last year's huge gains. We will be closely monitoring the situation as events unfold.

Happy New Year to all our clients and friends!

About Bruce D. Simon, CFA, CPWA®

Bruce is a Partner and the Director of Research at the firm. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm.

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