Investment Newsletter

4th Quarter 2019

The U.S. and international stock markets posted exceptional total returns for the 4th quarter and 2019. Investors were particularly encouraged by progress in the U.S.-China trade negotiations, further monetary easing by the Federal Reserve, and the alleviation of the political stalemate in the U.K.

Index	4th Quarter	2019
S&P 500	+9.07%	+31.49%
MSCI All-Country World ex-U.S.	+8.99%	+22.13%
MSCI Emerging Markets	+11.93%	+18.88%

Looking forward, the economic outlook for 2020 is encouraging. Corporate earnings growth is forecasted to accelerate on the heels of a Phase 1 U.S.-China trade deal and lower interest rates. In addition, the consumer remains in good shape, unemployment remains low, wage gains have been improving, inflation remains low, and central banks remain accommodative. As a result, recession fears have been alleviated and the yield curve is no longer inverted.

Despite these positives, there remain several concerns:

- U.S.-China trade conflict is not fully resolved. China has yet to confirm its purchase commitment for an increase of $200B of U.S. goods and services over the next two years in the Phase 1 deal. Moreover, it has stated it doesn't want to change economic policies that are working, and that it doesn't need to uphold international standards that it had no role in establishing.

- Heightened geopolitical tensions in Iran and Hong Kong.

- U.S. Presidential Election in November 2020.

- The S&P 500's valuation is extended. On a price-to-earnings basis, the S&P 500 is trading at a +22% premium to its 10-year average, but at a -25% discount to its all-time high in 1999.

- The U.S. economy and stock market are at all-time records. The U.S. economic expansion and the 'bull market' in U.S. stocks are both the longest on record.

- Growing government and corporate debt. The ratio of U.S. debt to GDP is now 106.6% vs. 59.7% in 2000, and nonfinancial corporate debt is close to a record high relative to U.S. GDP.

- Increased federal and state regulatory scrutiny of large technology companies such as Amazon (AMZN), Facebook (FB) and Alphabet (GOOG) over monopolistic practices.

- The U.S. manufacturing sector has been contracting. The Institute for Supply Management (ISM) Purchasing Managers' Index (PMI), an indicator of manufacturing strength, has posted a reading below 50 (<50 = contraction) for five consecutive months. The December reading of 47.2 was the weakest since June 2009.

The fixed income markets also posted strong performance in the 4th quarter and 2019.

Index	4th Quarter	2019
Bloomberg Barclays U.S. Intermediate Government/Credit	+0.37%	+6.80%
Bloomberg Barclays Municipal Bond 1-5 Year Blend	+0.87%	+4.03%

Bond yields declined, with the 10-Year U.S. Treasury yield hitting a low of 1.45% in early September. Recession fears, sparked by the China trade war, dominated investor sentiment. Weakening economic data led the Federal Reserve to reverse course and lower interest rates three times in 2019. Additionally, extremely low (and even negative) interest rates around the world made the U.S. bond market look comparatively attractive to foreign investors, further strengthening demand.

Municipal bonds performed especially well in a year of very strong demand. Despite very low interest rates, municipal bond fund net inflows reached historically high levels.

Going forward, our strategy remains the same: We are focused on short- and intermediate-maturity, high-quality, liquid corporate bonds, taxable and tax-exempt municipal bonds, and U.S. Treasuries. At these low interest rate levels and rich valuations, the risk of negative returns is much higher if interest rates rise. Our overall objective is to minimize risk in client portfolios.

In summary, given the S&P 500's exceptional performance last year and significant increase in valuation, now is an opportune time to prudently reduce outsized individual equity positions and rebalance portfolios back to long-term asset allocation targets. While we remain constructive on the economy, we are mindful of ongoing market uncertainties and risks. Accordingly, we will continue to pursue selective investment opportunities in a disciplined manner based on our stringent investment criteria.