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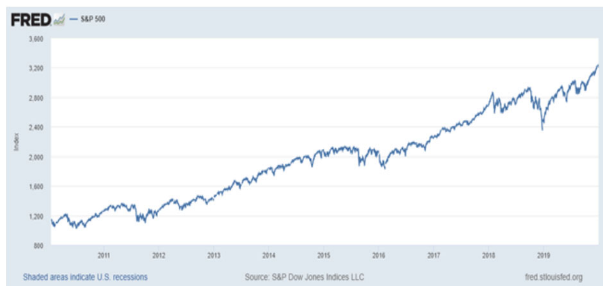
Quarterly Update & Economic Commentary—December 31, 2019

Quarter in Review

The strong fourth quarter capped off a great year for investors. Equities provided the leadership, but returns in fixed income were also very good. The S&P 500 returned 9.07% for the quarter and 31.49% for the year! Small cap and mid cap stocks also had a good year but trailed the S&P 500. The S&P Mid Cap 400 returned 7.06% for the quarter and 26.20% year-to-date, while the S&P Small Cap 600 returned 8.21% for the fourth quarter and 22.78% for 2019. The S&P 500 Value Index outperformed the S&P 500 Growth Index during the quarter and for the year. The last time value outperformed growth was 2016, and it is only the second time in the last seven years that value outperformed growth.



Shifting to the international markets, emerging market equities had a standout December and a great quarter. The MSCI Emerging Markets Index returned 7.46% in December and 11.84% during the quarter. However the calendar year return was only 18.42%. Developed international equity indices underperformed the emerging markets for the month and quarter but outperformed them for the year. The MSCI EAFE returned 3.25% in December, 8.17% during the fourth quarter and 22.01% for 2019. The strong December returns in emerging markets were driven by the softening U.S. dollar.

Fixed income returns ended the year with a whimper, but the calendar year returns were strong. The Barclays Aggregate Bond Index posted an 8.72% calendar year return which was the best calendar year return of the decade. For the quarter, the Barclays Aggregate Index returned a meager 0.18%. The main driver of bond returns was from falling interest rates. For instance, the ten-year treasury started the year yielding 2.65% but ended the year yielding 1.92% and traded as low as 1.43%. High yield bonds benefited from both the drop in rates but also investors' willingness to take on risk. The Barclays US

Corporate High Yield Index returned 2.61% for the fourth quarter and 14.32% year-to-date.

Oil prices steadily climbed higher during the month of December, which resulted in a strong quarter. Crude Oil returned 10.68% during December and 12.93% during the quarter. For the year, Crude prices are up 34.46%. Other strong commodities during the quarter were Coffee, up 28.23%, Cotton, up 13.51% and Wheat, up 12.71%. Gold posted a solid return during the fourth quarter, returning 3.41%, and had a strong calendar year return of 18.87%. Silver also had a good annual return of 15.32% after posting a 5.43% quarterly return. Natural Gas and Nickel were some of the worst performing commodities during the quarter. Nickel lost 18.18% for the fourth quarter but still managed to return 31.40% for the year. Natural Gas lost 6.05% during the quarter and 25.54% for the year.

As outlined above, 2019 was a great year for both equity and fixed income investors. At the start of 2019, the situation was grim; the market had just fallen close to 20% from peak to trough during the fourth quarter of 2018, and many pundits were calling for the end of the bull market and a potential recession forthcoming. While economic growth did slow during 2019, inflation stayed low, the unemployment rate remained at historic lows and the Fed reversed course on their monetary policy decisions.

The Fed raised rates in December of 2018 but then cut rates three times during 2019. Interest rates had already begun to fall on fears of global economic weakness, leading to an inversion of the yield curve. However, the Fed's decision to cut rates brought short-term rates lower and brought the yield curve back to a healthy level. The Fed's actions helped stabilize the economy and markets. The President continued to criticize the Fed for their decision to hike in 2018 and not cut rates quick enough. The Fed began reducing its balance sheet in October 2017 but ended this practice in August of 2019 and the balance sheet began increasing in September of 2019. Assets of the Fed's balance sheet reached $4.5 trillion in 2015 and then declined to under $3.8 trillion in 2019, but ended the year above $4 trillion.

We saw a de-escalation with the trade war between the U.S. and China. The parties agreed to the terms of a "Phase 1" trade deal. This has not been signed yet but is scheduled to be on January 15. The Phase 1 agreement is light on substance, but the main benefit of the agreement is that both sides have agreed to not increase any tariffs in December, as previously scheduled, and the U.S. lowered some of its tariffs that were put on earlier this year. This has been a good development, but Trump has shown that terms and rhetoric can change quickly with this ongoing negotiation between the U.S. and China.

The economic slowdown that was feared in late 2018 and early 2019 has appeared to play out in late 2019. GDP growth for the third quarter was 2.0%, down from the 3.2% in the spring of 2018. The GDPNow forecast for the fourth quarter is tracking at 2.3%. The slowdown is being led by weakness in business investment spending, exports and inventory accumulation.

On the positive side, low unemployment continues and wages are beginning to increase, providing strength to the American consumer. Wages for production and non-supervisory workers climbed 3.7% year-over-year in November. The strong consumer showed up during the holiday shopping season. Overall holiday retail sales, excluding autos, rose 3.4%. It is estimated that e-commerce sales made up 14.6% of total retail sales and rose over 18% from 2018.

Inflation readings are closely watched by the Fed. If inflation runs too high, the Fed may be forced to raise rates which could invoke an unwanted recession. Fortunately, inflation remains in check. November readings for consumer price index (CPI) showed an increase of 2.0% year-over-year, while CPI excluding food and energy was up by 2.3% year-over-year. The Fed's preferred measure, headline PCE and core PCE both are under the 2% target.

The House of Representatives voted to impeach President Trump during the fourth quarter. The impeachment is expected to have little impact on the markets. For the President to be removed from office based on an impeachment, the Senate would need to vote for conviction. Given the current make-up of the Senate this is very unlikely. We expect very little market impact from the impeachment conversation.

The rest of the world continues to show slowing economic expansion. Europe has dealt with political turmoil in in France and Italy, slow manufacturing in Germany and uncertainty around Brexit and the U.S.-China trade wars. The trade war has affected other countries outside of U.S., China and Europe as well, including Japan, Korea and Taiwan. Because of the size of China's economy, China's slowdown impacts both developed and emerging economies alike.

The U.K. has made progress on their plan for an exit from the European Union. The Withdrawal Agreement is expected to be signed January 31 which will make way for further negotiations with the EU and Britain on life after the exit. While the end is still a year away, the path to independence is set and the transition is expected to be smoother than previously thought.

A Look at the Numbers

Name	FOURTH QUARTER RETURN (%)	2019 RETURN (%)
DJ Industrial Average TR USD	6.67	25.34
S&P 500 TR USD	9.07	31.49
S&P MidCap 400 TR	7.06	26.20
S&P SmallCap 600 TR USD	8.21	22.78
NASDAQ Composite TR USD	12.47	36.69
MSCI EAFE NR USD	8.17	22.01
BBgBarc US Agg Bond TR USD	0.18	8.72
Wilshire US REIT TR USD	-1.14	25.76
IA SBBI US 30 Day TBill TR USD	0.41	2.14

A Look Ahead

Market expectations for the next year are high. This is not a surprise given the strong momentum from the fourth quarter and from the past year. It was a year ago, when markets suffered through the fourth quarter of 2018 and expectations were low for 2019. Wall Street analysts and the media tend to have a short-term bias when providing market commentary and forecasting. While 2020 may be another good year for the markets, we do not believe it will be as good as 2019 or as good as the current sentiment suggests.

As we head into a new year, the biggest risks to the rally are the higher valuations of stocks and the potential risk of inflation rising, causing the Fed to raise rates before the economy warrants another rate rising cycle. However, another risk emerged in early January. The U.S. launched an attack on Iraqi soil, killing Qassim Soleimani, an Iranian major general, on January 3, 2020. The attack could have major short- and long-term implications on the Middle East. The Iranian people and government want revenge and Iraq is threatening to expel all U.S. soldiers from their country. Oil prices have spiked and tensions are running high globally. We expect this to be a developing story throughout the next several months.

The consensus is that the U.S. will avoid recession in 2020. Cyclical segments of the economy, like autos and housing, do not look overextended. Additionally there does not appear to be many financial excesses. Assuming inflation does not run wild, the Fed is expected to keep rates at current levels, and this will continue to promote borrowing and discourage saving because of the low relative level of interest rates. Profit margins for business are expected to remain under pressure and profit growth for 2020 is projected to be in the low single digits.

There have been three positive developments on trade uncertainties that should gain more clarity in the year ahead. At the end of 2019 we saw credible progress on the agreement to ratify the replacement to NAFTA, the United States Mexico Canada Agreement (USMCA). We are not expecting to see any major overhaul of trading between Canada, United States and Mexico, but having the uncertainty removed around trade is a positive. As mentioned beforehand, a Phase 1 trade agreement between the U.S. and China is scheduled to be signed on January 15. The agreement should keep any future tariff increases at bay, reducing the risk of further escalation. Phase 1 is only a small step to a more comprehensive deal, but it is positive if both sides agree to not escalate the disagreement any further. A more comprehensive deal will not likely happen until after the election. Lastly, the election late last year in the U.K. has paved the way for a smooth Brexit in late 2020.

In case it has been forgotten, 2020 marks a Presidential election year in the United States. Allowing the election cycle to influence investing decisions is generally a bad idea, not only because the outcome is uncertain but also because the anticipated impact of the elected candidate tends to be exaggerated by both supporters and detractors for different reasons. That said, most market watchers seem to agree that a Trump reelection will be good for the stock market while, conversely, a Democratic victory would probably lead to volatility. How much volatility likely depends on whether a moderate or progressive Democrat wins the nomination. Regardless of who wins the White House, there is a low probability that the Democrats will take the Senate or the Republicans will take the House; the end result is likely to be divided government until at least 2022.

Looking ahead to return expectations for 2020, we can't help but expect more muted returns than in 2019. With low inflation and some level of economic growth, we believe the equity markets could move higher this year, but returns are expected to be more in-line with earnings growth, which is expected to be in the single-digits. International markets are more attractive from a valuation perspective and would benefit if the dollar depreciates against foreign currencies. Developed economies, mainly Europe are still in the early stages of an economic recovery and growth prospects are challenged, and long-term growth prospects of the emerging markets are more attractive. For the dollar to weaken against foreign currencies, we would need to see slower economic growth in the U.S. and a rising trade deficit. With the Fed expected to be on the sideline for the majority of the year, except for the possibility of one more rate cut, and credit spreads already tight, fixed income returns should be closer to the yield they pay.

If anything has changed with your financial picture that may affect your investment strategy, please let us know so we can make any necessary changes.

— ACG Advisory Services

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