## Market Commentary

*We forecast S&P 500 will generate a modest single-digit absolute return in 2019. The risk-adjusted return will be less than half the long-term average. Cash will represent a competitive asset class to stocks for the first time in many years* - David Kostin, Chief Equity Strategist at Goldman Sachs, Nov 19, 2018

The 31.5% return of the S&P 500 in 2019 was the best showing for the index since 2013 and only the second time this century the index returned more than 30% in a calendar year. While nearly all segments of the global markets delivered good results, US technology companies continued to dominate with the S&P 500 Information Technology Sector returning 50.3%. We saw generally good performance from our managers, although several relinquished part of their outperformance during the fourth quarter as lower quality stocks began to drive index returns. Value stocks, while delivering performance that would have been more than acceptable under normal circumstances, lagged growth for the second consecutive year. Growth stocks dominated outside the US as well, with value strategies lagging in both developed and emerging markets. Three cuts by the Federal Reserve helped drive a nearly 100 basis point decline in Ten-Year Treasury Bond Yields, delivering a boost to bond portfolios (although this gain comes at the expense of lower future returns).

The quote at the top of the page by Goldman Sachs Equity Strategies David Kostin fairly represented the outlook of many at the beginning of 2019. Recessionary fears, driven by a tightening Federal Reserve, trade wars and a nearly 15% decline during the fourth quarter of 2018 in the US stock market, dampened expectations. In our commentary a year ago, I wrote that the market viewed a recession in 2019 as a real possibility and made the astute observation over the course of the year the market would either go up or down:

> *Market declines, such as experienced last year, do not necessarily indicate the beginning of a longer bear market or recession. Last quarter's -13.5% return may be the first leg down of a bear market, or it may be a blip from which the market rapidly recovers.*

**The market's outsized return in 2019 came from a valuation discount at beginning the year** reflecting a significant (but unquantifiable) probability of a recession and bear market which then vanished when a recession failed to materialize. Compared to a modest outlook at the beginning of 2019, Wall Street analysts expect over 15% earnings growth in 2020. Exceeding low expectations last year led to outsized returns. High expectations for this year create the risk of disappointment.

In contrast to the outlook a year ago, **investors appear exuberant about 2020**. Reviewing two dozen 2020 market outlooks written by various investment banks, not a single one predicts a recession. The consensus views the two main sources of recessionary risk in 2019 – Fed tightening and the trade dispute with China – as resolved. While the consensus expects slightly lower US GDP growth, this is offset by higher growth in foreign markets, driven by an end to last year's global manufacturing slowdown. As indicated by Fed Funds Futures, the market does not expect any rate hikes this year, instead projecting nearly a 60% probability of a lower Fed Funds rate by year-end. All the Wall Street forecasts project stocks to continue to outperform cash and bonds. Half of the pieces thought value would outperform and a majority thought emerging markets would shine in 2020. Less than half favored Europe and a minority thought inflation would exceed expectations.

**Risks to this outlook include a Chinese economic slowdown** that began well before the trade dispute and may be resistant to the debt-fueled fiscal stimulus that reignited growth after a similar slowdown in 2016. Continued spending by US consumers constitutes another key assumption to this optimistic outlook. Additionally, it is important to remember the bias of economists and market strategists against forecasting recessions or bear markets. As we outlined last year, economists hardly ever predict recessions. Market strategists at Wall Street have a vested interest in bull markets.

As **the 20 year anniversary of the peak of the 90s Technology Bubble approaches** (the actual date of the peak was March 10, 2000), it is worth reviewing the promise of that period and what subsequent events revealed. Twenty years on, the Internet delivered everything its proponents in 1999 promised and then some. Online retail sales currently comprise about 11% of total retail sales. Online advertising spending in 2019 for the first time surpassed traditional media. Despite this success, the technology-heavy NASDAQ 100 Index delivered an annualized return of 5.1% over the past twenty years, underperforming the 6.1% return of the S&P 500. The S&P 500 Technology Sector Index similarly underperformed. Of the major sectors in the index, the stolid Consumer Staples Sector was actually the top performer since 1999, with an 8.6% annualized return.

**Microsoft, the largest stock in the S&P 500 on December 31, 1999, was the only one of the top ten stocks in the index to outperform the index over the subsequent 20 year period** and the only stock that remained in the top ten. Nine of the ten largest stocks in the S&P 500 at the end of 1999 failed to beat the index over the following twenty years. Three of those stocks – General Electric, Nokia and Citigroup – declined by over 50% in the following 20 years. While it may be difficult to imagine any of today's ten largest S&P 500 stocks losing over half its value by 2040, history suggests this will happen. With increased technological disruption, perhaps the casualty rate will exceed 1999's rate of 30%.

**It appears unlikely that last decade's winners will repeat over the next ten years**. Looking back through the 1970s, no major asset class has been the top performer in two consecutive decades (although gold has the dubious distinction of being the worst asset class of both the 1980s and 1990s). While the Price / Earnings ratio of the S&P 500 expanded a modest 22% over the decade, beginning at roughly 18 and ending at 22, the profit margin increased by 50%, from 6.5% to 9.75%. The record profit margins of 2010s were primarily driven by the dominance of large platform technology companies like Apple, Google, Microsoft and Facebook, all of which boast profit margins above 20%. The outperformance of US stocks versus the rest of the world over the past ten years can largely be attributed to the lack of similar businesses outside the country. Only China, with companies such as Alibaba and Tencent, has business comparable in scale and profitability to the US tech giants. Risks to their profitability are now emerging from increased regulatory and public scrutiny. New competitors may emerge and disrupt current business models. A perhaps underappreciated risk is 'digital nationalism', which refers to the emerging trend of countries around the world constructing barriers to the free flow of data over the Internet, an important trend to watch this decade. While China's example is well known and currently being copied by other authoritarian governments, other countries are placing softer restrictions to protect privacy and/or local businesses. Facebook and Google obtain over half their revenues outside the US. Foreign sales account for about a third of Amazon.com's retail sales (excluding Amazon Web Services, which generates over half of the company's operating income). Our active managers closely follow these issues and we expect their analytical and decision making skills to be a source of alpha in coming years.

**We view the consensus outlook of another year of economic expansion and bull market as probably correct.** 2020 will likely be a year of slower US growth but faster growth in most other countries. However, these optimistic expectations result in few opportunities for upside surprises but many chances for disappointment and volatility. We remain comfortable with our current strategy of maintaining tighter than normal allocation targets and the overall focus of our active managers on owning high quality businesses and avoiding financial risk. We continue to closely watch client liquidity positions and address in our quarterly reporting.

**- Stephen C. Browne, CFA**
Chief Investment Officer
Chief Compliance Officer

**Please mark your calendars**

**February 17, 2020**
Office Closed
In Observance of President's Day

**April 10, 2020**
Office Closed
In Observance of Good Friday

**April 14, 2020 at 11:30AM Central**
Smart Investing Webinar
First Quarter Market Review

**July 14, 2020 at 11:30AM Central**
Smart Investing Webinar
Second Quarter Market Review

**October 13, 2020 at 11:30AM Central**
Smart Investing Webinar
Third Quarter Market Review