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INVESTMENT REVIEW AND OUTLOOK

A Very Good Year (How could that be?)

By almost any measure, stock markets had an outstanding year in 2019. The S&P 500 had a total return, including dividends, of 31.5% while the Dow Jones Industrial Average had a total return of 25%. Global stocks also performed well. The MSCI All-Country World Index had a total return of 27.3%. To place last year's stock market performance in perspective, in the last 20 years the S&P 500 has returned greater than 30% in only one other year (2013).

Reflecting upon the contrast between the headlines and the investment returns of 2019, it is understandable that investors might ask the question, "How could that be?" The year just passed had no shortage of concerning developments including slowing global economic growth, a deepening trade war and heightened geopolitical tensions. Concern about the economy reached a crescendo in the late summer when the U.S. yield curve briefly inverted (short-term interest rates exceeded long rates). Yield curve inversions are often (but not always) a precursor to economic recessions.

How did the stock market manage a strong performance against such a challenging backdrop? The answer is multi-fold. The market began 2019 at a valuation level that, in retrospect, was attractive. The S&P 500 started 2019 at a price to earnings ratio of approximately 15x estimated earnings which was a slight discount to its 10-year average; the dividend yield on the S&P 500 was also relatively attractive at 2.2%. The action of the Federal Reserve during early 2019 (the Fed's "180-degree turn") was another key factor in the stock market performance. Following several years of tighter monetary policy, the Fed reversed course and lowered its benchmark interest rate in mid-2019. The final piece of the stock market puzzle was an ebbing of the "perfect storm" of escalating tariffs, slowing global economic growth and political uncertainty. During the last three months of the year, the U.S. and China finally reached an understanding on a "Phase One" trade agreement and the U.S., Canada and Mexico have reached an agreement on a successor to NAFTA; elections in the U.K. re-affirmed that Britain will leave the E.U. in the coming year. During the second half of 2019, economic indicators in Asia and Europe began to stabilize, and in the U.S. the economy continued to benefit from full employment and robust consumer spending. Despite a steady stream of sometimes unsettling news, 2019 was, indeed, a good year.

More of the Same

At the start of a New Year, it is traditional for Wall Street to prognosticate about the year ahead. This practice can often serve to stretch the thinking of the author and, hopefully, be informative to the reader. However, when it comes to managing investment portfolios, we are often best served by evaluating *current* facts. Experience has shown that our chances of success improve when we use our skills to evaluate the information that we know as fact as opposed to speculating about what *might* happen in the future.

With the foregoing in mind, we are guided by the current economic and geopolitical "facts" that shape the investment landscape. Global economic growth remains modest, but persistent. Interest rate and inflation levels continue to be low by the standards of modern history. Subsiding trade tensions and accommodative central bank policies are additional important underpinnings for global growth. As has been the case for several years now, geopolitical tensions are elevated: populist discontent spans from Europe, to Asia (India), South America and North America where the 2020 U.S. elections hold the potential for either continuity or a significant shift in policies. The recent military strikes between the U.S. and Iran remind us that security tensions around the world continue to be elevated. In summary, the economic backdrop remains constructive and the geopolitical environment remains unsettled.

One important change over the last 12 months has been the relative attractiveness of investment opportunities. Broad stock market valuations, as measured by the forward 12-month price to earnings ratio, are about 20% above their 10-year average levels. Similarly, bond yields, as measured by the 10-year U.S. Treasury bond, have declined from approximately 3% at the start of 2019 to a current yield of 1.84%. Thus, while economic conditions are broadly similar to a year ago, the investment environment has changed measurably. This change calls for greater selectivity in choosing investments and places an increased emphasis on the role of valuation.

It is Hard to See Around the Corner

The end of one decade and the start of a new one provides an opportunity for reflection. Who would have imagined many of the developments of the last ten years? A record length economic expansion, the U.S. becoming virtually energy self-sufficient, the ubiquity of the smart phone in everyday life and Brexit are just some of the developments that few would have predicted. The combination of technological change along with social and political forces make it very hard to "see around the corner." With this caveat, we offer a few thoughts about several trends.

- Innovation has been an important element of economic progress throughout history and this has been especially true in recent decades which have transformed the fields of medicine, computing and communications. Given the current rate of progress, we should expect technological innovation to continue and, perhaps, accelerate. Likewise, innovation-driven businesses, across industries, will be an important investment theme in the years to come.

- Two sectors of the economy in particular, energy and transportation, appear ripe for further disruption from technological change. In the energy sector, technology has had a dramatic impact on the supply of oil and gas via the fracking revolution. At the same time, advancements in wind and solar technology have led to declining costs for these alternative energy sources. The increased abundance of both conventional fossil fuels and alternative, non-carbon fuels may serve to accelerate the transition to cleaner energy sources while also placing economic pressure on traditional producers of oil and gas. In transportation, the combination of inexpensive computing power, advanced sensors and increased battery capacity hold the potential for future changes to both passenger and freight vehicles.

- The recent trend towards populism is a phenomenon that spans the globe. While each individual country has unique economic and social circumstances, it is important to recognize that the growth of populism is a symptom of discontent among the population and not a solution. With that in mind, it is reasonable to expect further changes to the political status quo in nations around the world. If the Brexit vote in 2016 signaled the start of this phenomenon, we can expect some time will pass before the populist wave subsides.

- One of the prominent features of the current global economic cycle is that it has occurred in the context of generally loose monetary policies from global central banks. While there has been some monetary tightening from time to time (such as occurred in the U.S. from 2016-2018), the general trend has been towards monetary easing. In parts of Europe as well as in Japan, central banks have resorted to extraordinary measures such as negative interest rates and outright asset purchases. The low interest rate environment (which is a direct by-product of these policies) has been a boon to businesses, consumers and investors alike. While it is certainly possible that these policies will continue indefinitely, it should be recognized that these policies are both extraordinary and unprecedented in modern times. If and when these policies are curtailed in a meaningful way, it will likely require adjustments across the investment and economic landscape.

In conclusion, 2019 was an exceptional year for investors and for the U.S. economy. Our equity holdings in client portfolios continue to be broadly exposed to the twin themes of innovation and global economic growth. Given the heightened valuations for both stocks and bonds, our asset allocation remains prudent with appropriate exposure to equities while incorporating an “anchor to windward” in the form of short-term U.S. Treasury securities and the gold iShares.

As always, we welcome your comments and questions.