Investment Commentary: 12/2019

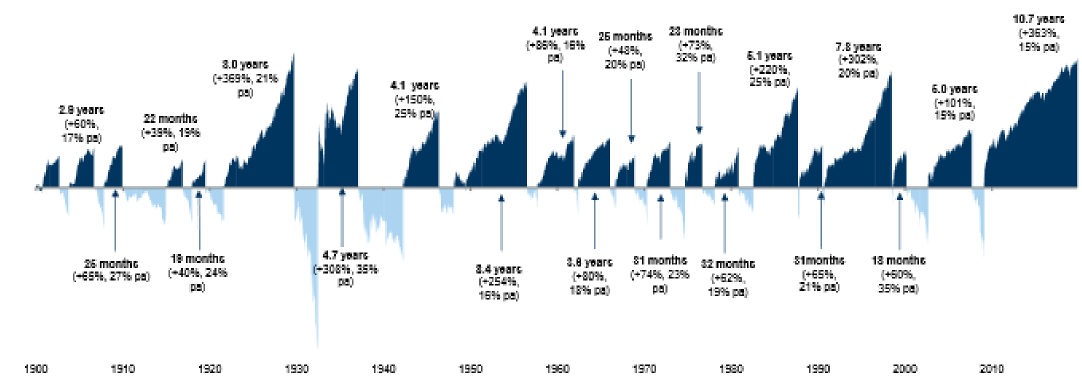
US stocks continued to rally in November, building on already strong returns for the year. So far stocks have enjoyed one of the best years since the Great Financial Crisis (GFC), with the majority of the return coming from increasing valuations (see below). Bonds were mostly flat in November but are also having a strong year, up almost 9% year-to-date. In fact, 2019 has generated the highest returns for a balanced portfolio (60% stocks and 40% bonds) since the late 1990's. Foreign stocks were up 1% for the month and in the high-teens for the year. High-yield bonds are up over 12% for the year while interest rate sensitive real estate invest trusts (REITS) are up over 27%.

"2019 has generated the highest returns for a balanced portfolio…since the late 1990's."

Financial markets this year have been driven by global central bank easing, low interest rates, slow and steady economic growth and recent optimism for a trade deal. Going forward, we believe returns will be harder to come by and will hinge on global growth rebounding and policy uncertainty receding. **In this month's commentary we touch on these topics and others that are likely to drive returns in 2020 and beyond.**

Putting the Rally in Pictures

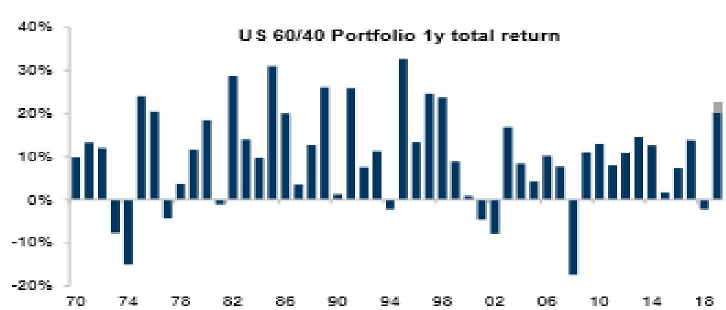
With the strong rally in the S&P 500 this year **we are now in the longest bull market without a 20% drawdown since 1900.** As we write the breadth of performance in the S&P 500 looks healthy and the streak is likely to extend. However, we expect risks to build in 2020 that will eventually pressure the streak.



Source: GFD, Datastream, Goldman Sachs Global Investment Research

It's not just stocks. **So far this year, a balanced portfolio of 60% stocks and 40% had had its best performance since 1998.** As of November 30th the year-to-date performance for the S&P 500 was 27.6% and the Barclays Aggregate Bond index was up 8.8%!

Exhibit 1: So far this year, the US 60/40 portfolio has had its best year since 1998



Grey shading represents 2019 YTD return annualized

Source: Datastream, GFD, Goldman Sachs Global Investment Research

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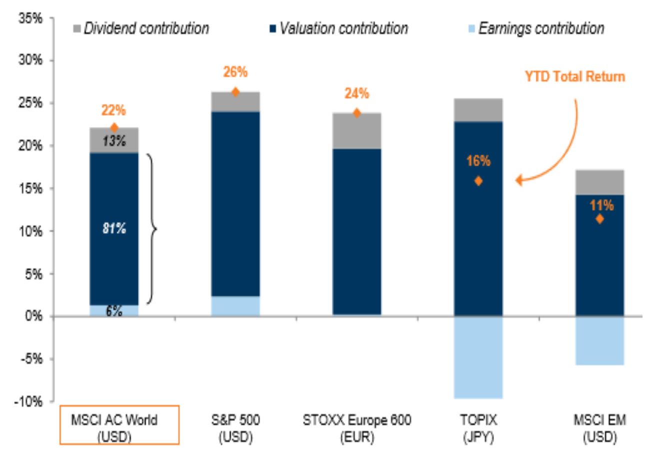
With earnings in the US relatively flat, the vast majority of the returns this year are a result of an increase in the valuation of the stock market. In other words, investors have been willing to pay a higher price for the same level of earnings (P/E ratio) in 2019 than they were in 2018. This has been the case globally as well, with approximately 81% of global returns attributed to higher valuations. Low inflation and interest rates, combined with modest but steady economic growth has been the main contributor to higher valuations.

Exhibit 3: 2019 rally has been driven by valuation gains amid weak earnings growth
Percentage contribution of returns (between dividends, earnings and valuation). Total return is on LHS



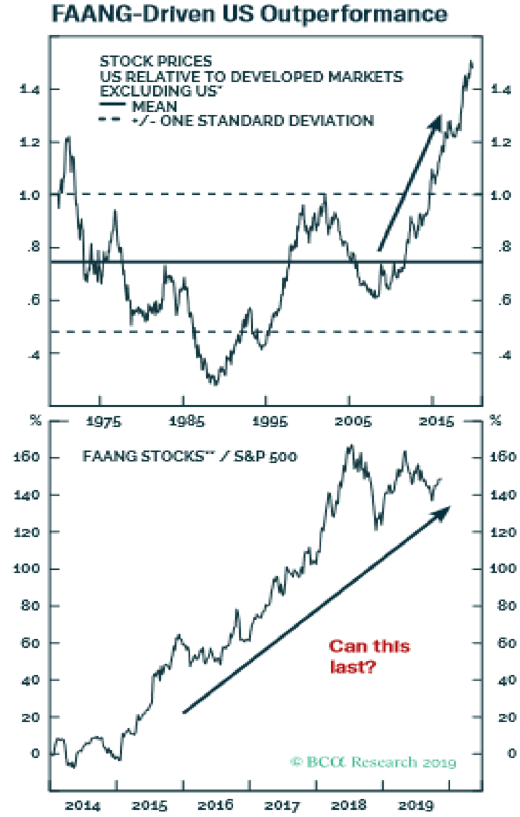
Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research

The performance dominance of growth stocks relative to value stocks continued in 2019, and has been a consistent theme since the GFC. The chart below illustrates that growth has outperformed value since 2007, a historically long period of time. As of November 30th growth stocks were up 32.4% year-to-date while value stocks were up 23.2%. Of note, value stocks have outperformed the past three months and trade at a significant valuation discount to growth stocks.

Exhibit 6: The record outperformance of 'Growth' vs. 'Value'
MSCI World Value vs. Growth

Source: Datastream, Goldman Sachs Global Investment Research

FAANG-Driven US Outperformance



* IN USD. SOURCE: MSCI Inc. DATA (SEE COPYRIGHT DECLARATION).
** EQUAL-WEIGHTED AVERAGE OF FACEBOOK, APPLE, AMAZON, NETFLIX AND GOOGLE (IN USD).

A key driver of the outperformance of both growth and US stocks can be attributed to a handful of stocks in the US. The chart to the right shows the impact the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) have had on the relative performance of US stocks. The chart from BCA Research also raises the question if this relative performance can continue.

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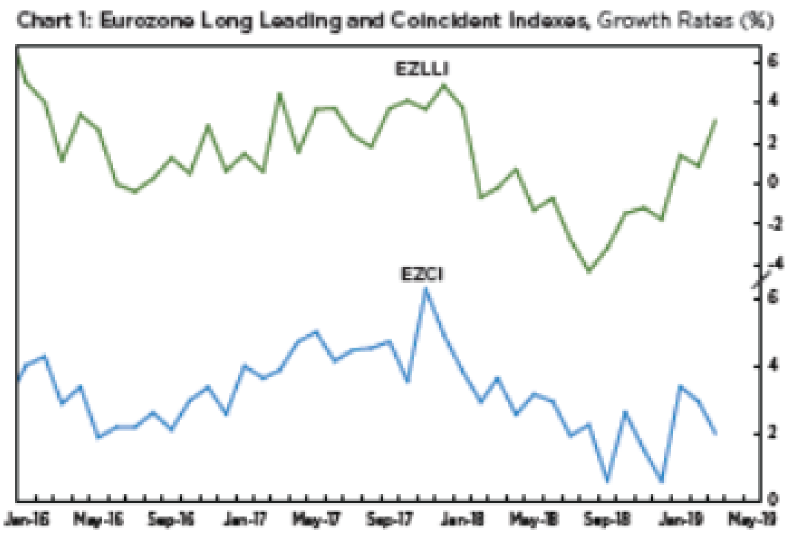
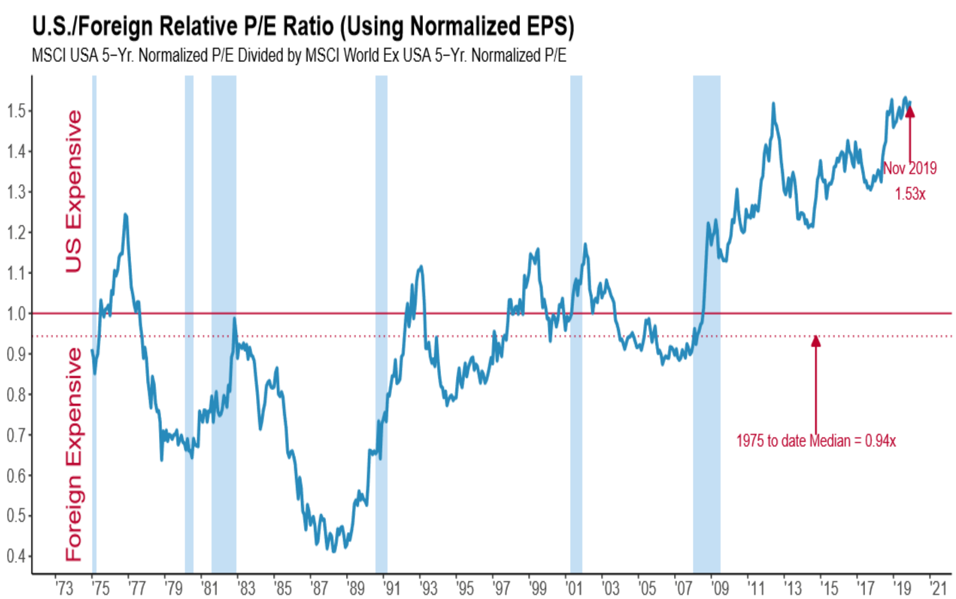
A Potential Surprise

One of our core investment beliefs is that financial markets are *mostly* efficient. In other words, the financial markets do a pretty good job of discounting available information and assigning an appropriate value to assets. In order for investors to receive above market returns they usually need to bet against the consensus opinion that is already priced in to assets. It doesn't happen often, but when investors are willing to bet against the consensus and get it right, it can be a 'surprise' to markets and rewarding to investors. One area we think is positioned to surprise the market is foreign economic growth, particularly in the Eurozone. Despite continued weakness in Eurozone manufacturing the long-term leading indicators have turned up indicating an economic upturn is in the works, see the chart below from the Economic Cycle Research Institute (ECRI).



Given low expect expected economic growth of 1.4% in 2020, low to negative interest rates, low stock market valuations, we believe an upturn in economic growth could provide a real surprise to investors and financial markets. Economic growth above current low expectations would lead to improved investor sentiment and higher demand for foreign stocks. With many foreign stocks yielding over 4% and many foreign bonds yielding near zero (or negative), we think foreign dividend paying stocks are likely to be the biggest beneficiary of an upturn in economic growth. And the valuation cushion of foreign stocks relative to US stocks gives us the confidence to overweight foreign dividend stocks in portfolios. The chart to the left shows the relative P/E ratio (normalized) between the US and foreign markets. When the line trends higher the US is expensive on a relative basis and vice versa.



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Quick Summary of Our Thoughts Heading into 2020

Here's a review of our outlook and how we plan to position to portfolios in the year ahead.

Bonds- with interest rates at historically low levels, our expectations for total returns are low (1-3%) and we own bonds mostly as a defensive position to offset the risk in the growth part of our portfolios. We expect interest rates to gradually increase from current levels and would be underweight duration compared to the benchmarks. We believe valuations are stretched in corporate credits and would be underweight both investment grade and junk bonds. We like inflation-protected bonds in tax deferred accounts as a hedge against higher inflation and municipal bonds for investors in high tax brackets.

US stocks- stocks remain relatively expensive in the US and we would be underweight in global portfolios. However, assuming economic growth recovers in 2020 and a recession is avoided we expect the nearly 11 year bull market will continue. We suggest rebalancing portfolios and reducing exposure to sectors that have outperformed for an extended period of time (growth, technology, real estate, etc.) and rotating into better values (value, dividend payers, small-cap stocks, etc.).

International stocks- as discussed above, we are optimistic on foreign stocks and would be overweight in global portfolios. We believe the relative outperformance of US stocks has reached an extreme and expect foreign stocks to outperform over the next three to five years. Given extremely low (or negative) interest rates in many markets we are optimistic on sustainable and growing dividend paying stocks in the foreign markets. We believe emerging market stocks will also outperform. However, they are likely to provide a bumpy ride and are suitable for investors that can withstand the volatility.

Alternative assets- we use this term to describe assets that don't easily fall into the traditional asset classes of cash, bonds and stocks. We are very selective in this category and only use funds that are liquid (easily sold), have reasonable fees and are transparent. We like this category and believe it will easily outperform cash and bonds over a full market cycle. In addition, given their relatively low correlation to traditional assets, and real return focus it has the ability to greatly improve absolute and relative performance of portfolios.

Risks- the list of potential risks is long (as it usually is!). Here are a few to keep an eye on: the progress of trade negotiations with China (and others); Chinese economic and credit growth; a US recession- we are concerned with the current level of deficit spending and debt, and think it will be a serious issue when the next recession arrives; higher inflation that would cause central banks to tighten policy- watch inflation measures, commodities and the dollar; US election and political risks. The list could be longer, but we'll stop there. In general, we expect the level of risk to rise throughout the year and investors will want to adjust their portfolios accordingly.

If you have any questions on this commentary or would like to discuss investment strategy give us a call.

Happy Holidays and best wishes in the New Year!

- AWM Investments (December 2019)